5 Growth, Stability and Employment

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

The Government's central economic objective is to achieve high and stable levels of growth and employment. The growth, stability and employment test assesses the potential impact of EMU membership on the UK economy and whether it would improve the prospect of achieving this central objective. These conclusions are conditional on the UK economy demonstrating sustainable and durable convergence. The 1997 assessment concluded that joining before such convergence was secured would risk harming both growth and employment.

Key points:

- **EMU membership could enhance productivity in the medium term by increasing trade and investment and by stimulating competition. It could also help to promote economic reform in the EU and encourage specialisation in the longer term. Therefore, EMU could potentially have an effect on all five of the key drivers of productivity. Based on broad-based evidence on the impact of trade, it seems reasonable to assume that each 1 percentage point increase in the ratio of trade to GDP increases real GDP per head by at least $^1/_3$ per cent in the long run and perhaps by as much as $^2/_3$ per cent. In a best case scenario, with stability assured through the achievement of sustainable and durable convergence, a long-term increase in trade with the euro area at the top of the estimated 5 to 50 per cent range and increased investment spurring competition, UK output could be around 9 per cent higher over 30 years within a successful EMU than outside. This could add around $^1/_4$ percentage point a year to GDP growth.**
- **This is conditional on the achievement of sustainable and durable convergence between the UK and the euro area. In the circumstances where it is not assured, the trade benefits from EMU would be likely to be at the lower end of the range. This means that the potential gains to trade and competition from EMU membership could be negligible even over the long term. However, initial estimates suggest that although there is a lack of flexibility and convergence in some euro area countries, EMU has increased trade within the euro area by between 3 and 20 per cent since 1999. In practice, additional volatility and uncertainty resulting from EMU membership in the absence of sustainable and durable convergence could have a negative impact on the actual level of UK output in the long term.**
- **The potential effects of EMU would be greater on productivity than on employment, but both could be affected by any increase in volatility. Without sustainable and durable convergence between the UK and the euro area, EMU membership could increase the cyclical volatility of employment in the UK. It is harder for the labour market to adjust to large increases in unemployment than small ones, so the risk of less stability in output and employment would entail an increased risk of higher structural unemployment in the UK. These risks would be reduced if sustainable and durable convergence were assured, in which case the UK would be able to reap the potential employment benefits of EMU membership.**
- **Whatever the degree of sustainable and durable convergence, any risks to the UK of EMU entry could be compounded by the European Central Bank's (ECB's) inflation objective and by a rigid and overly mechanistic interpretation of the Stability and Growth Pact (SGP). The Government will continue to work with other European countries in the development of the macroeconomic policy framework to minimise these risks to the UK and to existing EMU members.**
- **EMU would have a differential impact on business sectors in the short term. Open and exchange rate sensitive industries, including many manufacturing industries, would feel the impact of EMU most directly, although all firms would be affected by improved access to capital which could facilitate expansion and restructuring. Increased competition would be particularly beneficial in many service sectors which have, to date, been less exposed to the effects of the Single Market than the goods sector. By removing a currency barrier to trade and potentially improving access to funding, EMU could be especially helpful to small and medium-sized enterprises (though less so to micro-enterprises). At the opposite end of the size spectrum, EMU could also facilitate the development of multinational enterprises.**

- **Regions with more firms in sectors affected by exchange rate volatility could see larger initial effects of EMU entry and regions with more cyclically-sensitive industries would be more vulnerable to increased instability arising from a lack of sustainable and durable convergence. But short-run differences would be expected to even out in the long term.**
- **EMU could have long-term benefits for households, including potentially lower prices and higher wages. But this assessment finds that the achievement of sustainable and durable convergence between the UK and the euro area has not been demonstrated. Essentially this means that, at the present time, the UK economy would be more volatile in EMU. The impact of this on households would vary depending on their specific circumstances. Homeowners could be particularly affected by interest rates set at a level unsuitable for UK conditions. Workers in industries that are particularly vulnerable to economic conditions could face longer periods of unemployment. Pensioners would face greater uncertainty over the real value of their pensions.**
- **The Government places great importance on developing the economic reform programme to encourage flexibility and dynamism across the EU. This entails providing maximum scope for countries and regions to develop their own approaches to economic policy, provided that these do not obstruct the functioning of the Single Market. Free and fair competition encourages trade, stimulates productivity and enables the countries of the EU to progress more rapidly together than they could apart.**

The overall conclusion of the growth, stability and employment test is:

- **EMU membership could significantly raise UK output and lead to a lasting increase in jobs in the long term. As noted above, the assessment shows that intra-euro area trade has increased strongly in recent years as a result of EMU, perhaps by as much as 3 to 20 per cent; that the UK could enjoy a significant boost to trade with the euro area of up to 50 per cent over 30 years; and that UK national income could rise over a 30-year period by between 5 and 9 per cent. A 9 per cent increase in national income would translate into a boost to potential output of around $^1/_4$ percentage point a year, sustained over a 30-year period. Despite the progress made since 1997, the lack of sustainable and durable convergence means that, for the UK, macroeconomic stability would be harder to maintain inside EMU than outside, were the UK to make a decision to join at the present time. The potential uncertainty created by the price stability objective of the ECB and the potential constraints on the use of fiscal policy for stabilisation under the current interpretation of the SGP increase the chances that output and employment would be less stable inside EMU. The Government supports the direction in which the EU macroeconomic framework is evolving. Enhancing the flexibility and dynamism of the European economy, building on the achievements of the economic reform programme agreed at Lisbon, will also be important if the full benefits of EMU are to be realised. Entering EMU on the basis of sustainable and durable convergence is essential so that the UK can benefit from the substantial increases in cross-border trade, investment, competition and productivity that EMU could provide. Lower prices would lead to a lower cost of living, a key potential benefit of EMU entry for households, but one that would only accrue if entry were on the basis of sustainable and durable convergence. Poorer households tend to spend a greater proportion of their income on goods and services, so lower prices could benefit such households relatively more than wealthier ones. Overall, we can be confident that the growth, stability and employment test would be met once sustainable and durable convergence has been achieved.**

Policy requirements:

- **In terms of macroeconomic policy, the Government's announcement of its intention in the next Pre-Budget Report to give the Bank of England a symmetric inflation target as measured by the Harmonised Index of Consumer Prices will improve the quality of the UK inflation target and will also help ensure inflation expectations in the UK remain in line with those of the euro area.**
- **The conclusions to the assessment of the flexibility test set out the Government's wide-ranging agenda for enhancing flexibility in the UK and EU to deliver high and stable levels of UK employment.**
- **The Government will continue to pursue its wide-ranging strategy to tackle the barriers to productivity growth and close the productivity gap. This involves continued microeconomic reforms in the UK to target the five key drivers of productivity, combined with support at the European level for policies to strengthen competition and the Single Market.**

Stability in Europe – policy frameworks:

- **In its May 2003 review of monetary policy strategy, the ECB restated that: "*Price stability is defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. Price stability is to be maintained over the medium term*". The ECB review went on to state that: "*At the same time, the Governing Council agreed that in the pursuit of price stability it will aim to maintain inflation rates close to 2% over the medium term*". At the present time, the potential for uncertainty that the ECB's inflation objective creates could produce deflationary risks in certain countries, although the fact that, to date, euro area inflation has averaged 2 per cent suggests that in practice this risk has not materialised.**
- **At the EU level, the Government supports the direction in which the EU fiscal framework is evolving. In the ongoing debate on the interpretation of the SGP, the Government's approach will be to emphasise the significance of the economic cycle, sustainability and low debt, and the important role the Maastricht Treaty gives to public investment and the implications of this prudent approach for the interpretation of what are '*exceptional and temporary*' circumstances in relation to the 3 per cent reference value, for countries with low levels of debt.**
- **Many of the issues being considered in the European Convention could have far-reaching consequences for the future performance of EU economies, whether they are part of the euro area or not. The Government will continue to work with other European countries to ensure outcomes that will bolster stability and enhance the ability of European economies to raise productivity and employment levels. It will oppose proposals that would lead to unnecessary rigidities.**
- **Although ECOFIN remains the decision-making body for the EU in economic and financial policy, in EMU the UK would be a member of and attend all – and not some – meetings of the Eurogroup, thereby participating fully in euro area decision making.**

THE IMPORTANCE OF GROWTH, STABILITY AND EMPLOYMENT

5.1 The critical overall question for the UK is whether joining EMU would improve the prospect of achieving the Government's central economic objective of high and stable levels of growth and employment:

> *In summary, will joining EMU promote higher growth, stability and a lasting increase in jobs?*

Government strategy

5.2 The Government's strategy for increasing UK output and productivity has three strands:

- maintaining **macroeconomic stability** to help businesses and individuals plan for the future, underpinned by comprehensive reforms to the UK's macroeconomic policy framework since 1997;
- implementing **microeconomic reforms** to remove barriers that prevent markets from functioning efficiently; and
- increasing **employment opportunity** for all, through measures to help people move from welfare into work and to make work pay.

5.3 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 mean there is more wealth to share around. High levels of employment mean that more of the population is able to share in this wealth, gaining from and contributing to the prosperity of the country. High levels of stability mean that the economy is no longer subject to damaging fluctuations that create uncertainty and hinder long-term planning.

Conclusions of the 1997 assessment…

5.4 The Treasury's 1997 assessment of the five economic tests concluded that:

> *"…there could be substantial benefits for both growth and employment if the UK economy was to join a successful EMU. But to be in a position to benefit would require:*

- *that the UK economy was sufficiently and durably converged with the other members' economies to make participation permanently viable;*
- *that the UK economy was sufficiently flexible to respond to shocks and other changes that will occur over time."*

...remain relevant...

5.5 These conclusions remain relevant. Participation in a successful single currency would further stimulate integration between the UK and other European economies through elimination of currency risk prompting an increase in trade and competition. This could increase productivity, both in the UK and in the wider European economy, which would raise output and living standards.

5.6 But the concerns raised in 1997 over the conditions required to ensure that the full benefits from EMU membership are realised also remain relevant. As set out in the Introduction, demonstrating the achievement of sustainable and durable convergence is the precondition without which the UK cannot reap the potential benefits of EMU membership.

...as do the lessons

5.7 The re-evaluation of the conclusions of the 1997 assessment described in the Introduction provides valuable lessons for the assessment of the growth, stability and employment test. In particular:

- EMU now means a real choice between policy frameworks;
- the importance of the potential benefits of EMU;
- EMU's performance matters (as does that of other monetary unions);
- EMU would have distributional consequences; and
- one-off economic events can have long-lasting economic consequences.

A wide-ranging analysis...

5.8 The assessment of the fifth test is a challenging task. Some benefits would only become apparent in the longer term and the single currency itself remains in its relative infancy. As in the rest of the assessment, some effects can be modelled and quantified within a range, such as the likely effects of EMU on international trade, while others require a more qualitative analysis. The analysis of this test focuses on the likely effects of EMU on the key variables of growth, stability and employment, but it also recognises areas where uncertainty remains. The test focuses on the potential benefits of EMU. Chapter 6 brings together the assessment of each of the five tests to reach an overall conclusion on the economic case for EMU membership.

...considering future developments

5.9 To enable a forward-looking approach, particularly in light of the potentially large long-term implications of EMU membership for the UK economy, this chapter also considers likely future developments related to EMU. This includes a review of the EU's economic reform programme and of possible future developments in economic governance in the EU.

5.10 As the Introduction to the assessment has set out, the decision on whether or not to join EMU needs to take full account of the costs and benefits, both of joining and of not joining under the following assumptions:

- if the UK were to decide to join EMU, the decision would be irrevocable;
- whether or not the UK decides to join EMU, the national interest will continue to be served by the UK's full participation in the EU and its support for policies to build a more dynamic and open Europe. Following EU enlargement in 2004, the EU will be the world's largest single market and it will remain the most important external market for UK producers; and

- it is in both the UK's national interest and the interest of the wider EU for the UK to join EMU under conditions that minimise the transitional and longer-term costs of joining.

Structure of the test

5.11 The assessment of the growth, stability and employment test is divided into five sections which consider the following key issues and questions:

- **Macroeconomic stability** answers the question: **How would the EMU macroeconomic framework affect UK economic stability?**

  This involves analysis of how the EU's macroeconomic policy framework is evolving, drawing on the EMU study *Policy frameworks in the UK and EMU*.

- **Productivity and output** answers the question: **What is the potential impact of EMU on UK trade, competition, productivity and growth?**

  This section employs the in-depth analysis of the potential gains to trade and competition contained in the EMU studies *EMU and trade* and *Prices and EMU*.

- **EMU and employment** answers the question: **How might EMU affect both the underlying level and cyclical path of employment?**

  This includes consideration of how short-term volatility of employment could affect its long-term equilibrium level. It draws on the analysis in the assessment of the flexibility test and the EMU study *EMU and labour market flexibility*.

- **Distributional effects of EMU** answers the question: **What would be the distributional impact of EMU on UK business sectors, nations and regions, and households?**

  This section considers how the costs and benefits of EMU might be distributed, drawing on the EMU study *EMU and business sectors*.

- **Growth and employment in Europe** answers the question: **What do prospective developments in Europe imply for growth, stability and employment?**

  This section considers how the European economic reform programme and the European Convention will shape the future performance of the European economies.

- The **Conclusions** bring together the analysis to assess whether the growth, stability and employment test has been met.

MACROECONOMIC STABILITY

The importance of macro-economic stability…

5.12 This section addresses how EMU membership would affect the macroeconomic policy framework and macroeconomic stability in the UK. Stability helps individuals and businesses to plan for the long term, improving the quality and quantity of investment in the economy and helping to raise productivity and the sustainable rates of growth and employment. Macroeconomic stability is also a prerequisite of successful economic reform, since a framework of stability permits the rapid achievement of the full benefits of structural reform policies. For these reasons, the impact of EMU on macroeconomic stability is crucial to the overall assessment of whether it would be in the UK's national economic interest to join the single currency.

...and of the frameworks to deliver it

5.13 The focus of this section is the policy frameworks to deliver stability, drawing on the EMU study *Policy frameworks in the UK and EMU*. The wider issue of whether the UK would be stable within EMU depends on whether sustainable and durable convergence has been achieved, as assessed in the convergence and flexibility tests.

5.14 The role of policy frameworks in delivering stability was a key issue for some of the current members of EMU who saw EMU membership as the only route to achieving a robust framework capable of providing stability. Following the introduction of the UK Government's new macroeconomic framework since 1997, the UK economy has experienced a high level of stability, demonstrating the benefits to credibility which robust macroeconomic frameworks provide.

5.15 For this assessment, what matters is the robustness of macroeconomic policy frameworks and their capacity to maintain stability in response to the shocks that the UK would experience in or out of EMU. The EMU study *Policy frameworks in the UK and EMU* contains a detailed analysis of the robustness of the macroeconomic frameworks of the UK and the euro area in terms of three key objectives: credibility, flexibility and legitimacy. As discussed in the assessment of flexibility, these objectives can be achieved through the principle of 'constrained discretion'. Long-term stability requires a credible overall framework which constrains macroeconomic policy to achieve clear long-term and sustainable goals, but which allows discretion to respond flexibly to shocks. Such a framework should command legitimacy; that is, public and parliamentary support at all points in the economic cycle.

5.16 In comparing the frameworks, it must be remembered that there are several intrinsic differences between them. In particular, the euro area framework has been designed to apply to a number of countries which have pooled responsibility for certain functions in EMU, while the UK framework applies solely to the UK.

Monetary policy framework

Monetary policy and stability

5.17 The lessons from economic theory and history are that a credible monetary policy framework – one which the public, business and markets trust to meet its objectives – is vital for macroeconomic stability.[1] Households and firms need to be confident that the monetary authorities will preserve price stability, in response to both inflationary and deflationary shocks. There is a strong consensus that such credibility is best achieved by delegating the operation of monetary policy to an independent central bank, which is less vulnerable than the government to the suspicion that it would sacrifice its long-term monetary stability goals by making a short-term dash for growth at the expense of future inflation.

UK and euro area frameworks

5.18 These principles are well reflected in the monetary policy frameworks of both the UK and the euro area, which share some important similarities. In particular:

- interest rate decisions are taken by an **independent central bank** with a statutory mandate to ensure price stability and, without prejudice to that, to support growth and employment;
- the frameworks incorporate a substantial degree of **transparency** in the form of publishing analysis and providing data; and
- both frameworks command a high degree of **credibility** in terms of conditioning private sector expectations that inflation objectives will be met.

[1] An in-depth assessment of the problems caused by the lack of credibility of previous UK monetary regimes is included in *Reforming Britain's Economic and Financial Policy*, HM Treasury, 2002.

Box 5.1: The European Central Bank (ECB)

The EMU study *Policy frameworks in the UK and EMU* sets out in detail the monetary policy frameworks operating in the UK and the euro area and therefore highlights the changes that EMU entry would mean for monetary policy in the UK.

The ECB is responsible for monetary policy in the euro area. Interest rates are set by the Governing Council of the ECB, which comprises a six-member Executive Board (appointed by euro area Heads of State or Government) and the Governors of the National Central Banks participating in EMU (there are currently 12).

If the UK were to join EMU, interest rates for the UK would no longer be set by the Monetary Policy Committee (MPC) of the Bank of England, but by the ECB for the euro area as a whole. Under current arrangements, the Governor of the Bank of England would have a seat on the ECB Governing Council but, depending on the number of EMU members, may not have a vote all of the time. The 2003 Spring European Council agreed changes that establish a system of rotation of voting rights among the euro area's national central banks once EMU membership rises above 15 countries.

Like the Bank of England, the ECB is independent from direct political control; it alone has the ability to change interest rates to meet the objectives of monetary policy. And as in the UK, the primary objective of monetary policy in the euro area is to achieve price stability. Unlike the MPC, however, where the objective of price stability is defined by the Government in setting the inflation target, the ECB is left to define price stability for the euro area. The ECB has defined price stability as *"a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%"*. This definition of price stability is to be *"maintained over the medium term"*.

The ECB uses a 'two pillar' approach to achieving the price stability objective, assigning a special role to monetary aggregates under its 'first pillar' and considering a range of relevant indicators under the 'second pillar'. The MPC gives no special role to monetary aggregates; rather, these are considered together with all other relevant indicators. In May 2003, the ECB announced the outcome of its review of its monetary policy strategy. This reaffirmed its price stability objective and went on to state that: *"At the same time, the Governing Council agreed that in the pursuit of price stability it will aim to maintain inflation rates close to 2% over the medium term"*.

RPIX and HICP

5.19 Since 1997, the Government has set the Bank of England an inflation target of $2^1/_2$ per cent as measured by RPIX (the Retail Prices Index excluding mortgage interest payments). As described in Box 5.1, the ECB has defined price stability as "*a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%.*" It might appear that the ECB is pursuing a more restrictive target than the UK. However, differences in the basket of goods and services included in each measure and the way that individual prices are weighted together in the aggregate mean that, over the long term, $2^1/_2$ per cent for RPIX inflation corresponds to around 2 per cent for HICP inflation.

Target symmetry

5.20 The UK inflation target is explicitly symmetric; deviations below the target are treated as seriously as deviations above. The symmetric target means that monetary policy is neither unnecessarily loose nor unnecessarily tight and, in effect, allows policymakers to aim for the highest level of growth and employment consistent with keeping inflation at the Government's target. By contrast, the ECB does not have an explicitly symmetric inflation target. The objective is to keep HICP inflation below 2 per cent but does not define a lower bound; though the May 2003 review states that: "*…the Governing Council agreed that in the pursuit of price stability it will aim to maintain inflation rates close to 2% over the medium term*".

5.21 Asymmetry in the price stability objective has a number of implications. Although the ECB's price stability objective relates to positive inflation, it carries a risk of deflation, especially in individual countries, although the fact that, to date, euro area inflation has averaged 2 per cent indicates that in practice this risk has not materialised. More generally, the lack of an explicit target rate increases the uncertainties for other economic agents. The euro area's fiscal authorities might be overly expansionary because they fear that the ECB would not react vigorously enough to a shortfall in demand and inflation. Private sector firms and individuals lack an explicit anchor for their inflation expectations, meaning that their planning could be more affected by the short-term inflation volatility that is an integral feature of the adjustment process in EMU.

5.22 There are some other important differences between the current UK and euro area monetary policy frameworks:

- the ECB does not publish the minutes of meetings or a record of the voting patterns of its Governing Council;
- there are fewer formal mechanisms to hold the ECB to account; and
- the composition of the decision-making bodies is different, especially in terms of size and regional make-up.

Effects of enlargement

5.23 Ten new Member States are expected to join the EU in 2004. Unlike the UK, they do not have an opt-out from EMU and once the ECOFIN Council decides that they meet the '*necessary conditions*' they will join the single currency. When they do so, the ECB will be aiming for price stability over a larger number of countries, with a more diverse range of economic characteristics. Other things equal, this will reduce the weight of existing members in the overall euro area aggregates which the ECB focuses on.

5.24 In his contribution to the EMU study *Submissions on EMU from leading academics*, Professor Paul De Grauwe notes that enlargement means that: "*countries will face more often than today the possibility that ECB interest rate decisions do not reflect their national interests*".

5.25 That said, the economic weight of the existing euro area is much greater than the weight of the accession countries, so the overall stance of ECB policy would still primarily be determined by economic conditions in the existing euro area.

Inflation in EMU

5.26 Over a long time period, the average level of inflation in the UK should be similar whether the UK joins EMU or not. This is confirmed by measures of inflation expectations, which show that both central banks are expected to succeed in maintaining low and stable inflation.

5.27 However, as discussed in the assessment of the flexibility test, UK inflation would be likely to be more volatile in the short term if the UK joined EMU. This is because changes in UK inflation would be serving to aid adjustment to country-specific shocks in the absence of an independent monetary policy. In itself, such short-term volatility would not be very costly. It could become more costly if it affected longer-term inflation expectations, leading people to have overly high or low expectations of future inflation.

Fiscal policy framework

Fiscal policy and stability

5.28 As with monetary policy, a sound fiscal policy framework enhances macroeconomic stability by increasing private sector confidence that governments will refrain from implementing policies that could disrupt the economy, either in the short or longer term. Both the UK and the EU have established fiscal policy frameworks for this purpose, as detailed in the EMU study *Policy frameworks in the UK and EMU*. However, while the UK framework is designed to ensure sound public finances just for the UK, the EU framework is designed to ensure consistency between the overall objectives of several decentralised fiscal authorities, each with their own national frameworks. Whether inside or outside EMU, individual tax and spending policies remain a matter for EU Member States and the EU fiscal framework applies to all EU members, not just those of the euro area.

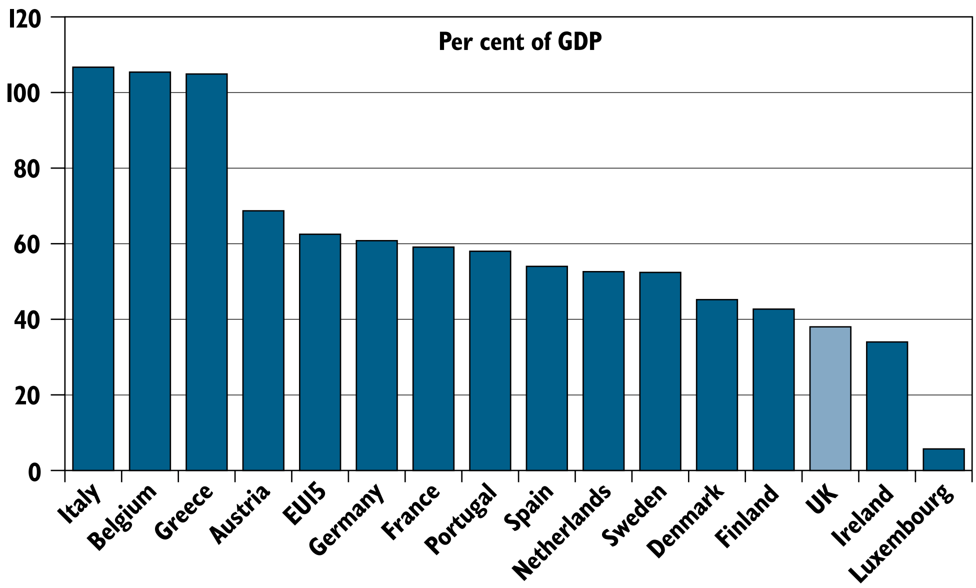
Sustainable public debt

5.29 Robust frameworks for fiscal policy are particularly important to constrain the ability of governments to accumulate high levels of debt. High levels of public debt can:

- crowd out the funds available for private sector investment; and
- raise the credit risk of public borrowing. High debt levels increase the risk that future taxpayers may not be willing to service the debt incurred by their predecessors. This can generate an adverse cycle in which creditors demand higher interest rates to compensate for the risk of default, but higher debt service costs increase the likelihood that the debtor may actually default.

5.30 Chart 5.1 demonstrates the very wide range of government debt levels in the EU at present. The UK has one of the lowest gross debt levels in the EU, at 38 per cent of GDP at the end of March 2003, compared with an EU level of 62 per cent at the end of 2002.

Chart 5.1: General government gross debt, end 2002



Note: UK figure for end of March 2003.
Source: Budget 2003 for UK; Eurostat for other countries.

Fiscal policy framework

5.31 As discussed in the assessment of flexibility, the Government's fiscal policy framework is based on the five key principles set out in the *Code for Fiscal Stability* – transparency, stability, responsibility, fairness and efficiency. The Code requires the Government to state both its objectives and the rules through which fiscal policy will be operated. The Government's fiscal policy objectives are:

- over the medium term, to ensure sound public finances and that spending and taxation impact fairly within and between generations; and
- over the short term, to support monetary policy and, in particular, to allow the automatic stabilisers to help smooth the path of the economy.

5.32 These objectives are implemented through two fiscal rules, against which the performance of fiscal policy can be judged. The fiscal rules are:

- **the golden rule:** over the economic cycle, the Government will borrow only to invest and not to fund current spending; and
- **the sustainable investment rule:** public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. Other things being equal, net debt will be maintained below 40 per cent of GDP over the economic cycle.

EU fiscal framework

5.33 The EU fiscal framework described in Box 5.2, including the Stability and Growth Pact (SGP), is designed to safeguard sound government finances and prevent countries pursuing policies that could generate imprudently high levels of public debt. The high levels of public debt in some EU countries shown in Chart 5.1 reflect the absence of such safeguards in the past. Overall EU public sector debt peaked in 1996 and has declined since to 62 per cent of GDP at the end of 2002.

Box 5.2: The EU fiscal framework

While individual tax and spending policies remain a matter for EU Member States, there is an EU framework to promote and maintain sound public finances and to aid coordination between the fiscal authorities. This framework, which applies to all EU members, including the UK, has three levels:

- **the Excessive Deficit Procedure (EDP), agreed as part of the EC Treaty at Maastricht in February 1992. This outlines the rules that general government net borrowing should not exceed 3 per cent of GDP except in '*exceptional and temporary*' circumstances, and that general government gross debt should not exceed 60 per cent of GDP unless the level of debt is sufficiently diminishing and approaching the reference value at a satisfactory pace;**
- **the Stability and Growth Pact (SGP), adopted as a Council Resolution and two Council Regulations by the European Council in Amsterdam in June 1997. This builds on the EDP and introduces the requirement that over the medium term, Member States' budgetary positions should be '*close to balance or in surplus*'; and**
- **implementation through the Code of Conduct on the content and format of Stability and Convergence Programmes, agreed as an Economic and Financial Committee Opinion endorsed by ECOFIN in October 1998, and revised in June 2001. The Code emphasises the importance of measuring deficits in cyclically-adjusted as well as nominal terms.**

Population ageing

5.34 A framework that focuses on maintaining prudent levels of debt will also help to ensure that EU Member States address the long-term challenge to public finances posed by population ageing discussed in Box 5.3.

Box 5.3: The consequences of population ageing in the EU

The average age of the populations of all EU Member States is expected to increase significantly in the decades ahead.

Population ageing has implications for public spending on pensions and on goods and services used heavily by the elderly, such as health care. If policies do not change, estimates prepared for ECOFIN project public pensions expenditure alone to rise by 3.2 per cent of GDP in the EU between 2000 and 2040. There are, however, considerable disparities across EU countries, depending on factors such as employment rates and the arrangements for public pension schemes. Other things equal, some countries could expect to see very substantial rises in public pensions spending, placing a burden either on public debt levels or on taxpayers in those countries. Reflecting prudent policies, low debt levels and high employment rates, the UK is well placed to cope effectively with the costs of population ageing.

EU countries have recognised the problems that population ageing might cause for public finances and have endorsed a 'three-pronged strategy', involving an appropriate combination of increases in employment, debt reduction and pensions system reform in each country. The Government strongly supports this approach.

Pension liabilities and EMU

5.35 Some commentators, including Professor Patrick Minford in his contribution to the EMU study *Submissions on EMU from leading academics*, have claimed that UK membership of EMU would mean that the UK would take on pension liabilities in other countries. This is not the case – the EC Treaty explicitly rules out the adoption of the liabilities of one country by the EU as a whole, the ECB or any Member State. EU expenditure is, in any case, subject to a legally-binding ceiling. Like many other governments, the UK Government would argue strongly against the central adoption of pension liabilities were it to be proposed.

5.36 In fact, in terms of fiscal policy the two main effects of EMU entry would be that the UK would:

- be obliged under the SGP to **avoid excessive deficits** rather than just endeavour to do so. The UK could be subject to sanctions were it judged to have an excessive deficit; and
- **participate in Eurogroup discussions**, which aim to coordinate policy between the euro area fiscal authorities and between the fiscal and monetary authorities.

Supporting economic stabilisation

5.37 Fiscal policy can support economic stabilisation, either through the operation of the 'automatic stabilisers' or the use of 'discretionary policy'. The assessment of the flexibility test and the Treasury discussion paper *Fiscal stabilisation and EMU* make clear that, if the UK were to join EMU, there could be an increased case for stabilisation through fiscal policy and discuss a range of options. In practice, fiscal policy has, since the start of EMU, not played a substantial stabilising role in the euro area.

5.38 Setting fiscal rules over the economic cycle provides room for the automatic stabilisers to operate and also allows for changes in the fiscal stance to restrain or stimulate demand, provided that any change is symmetric. However, the SGP does not take explicit account of the economic cycle; its limits are defined in nominal rather than cyclically-adjusted terms. This introduces an asymmetry that could reduce the degree of fiscal stabilisation and encourage pro-cyclicality. This view is shared by many, including Professor Charles Wyplosz who, in his contribution to the EMU study *Submissions on EMU from leading academics*, states: *"The asymmetry of the SGP implies that fiscal policy may have to become pro-cyclical in downturns while there is no incentive to make it counter-cyclical in upswings"*.

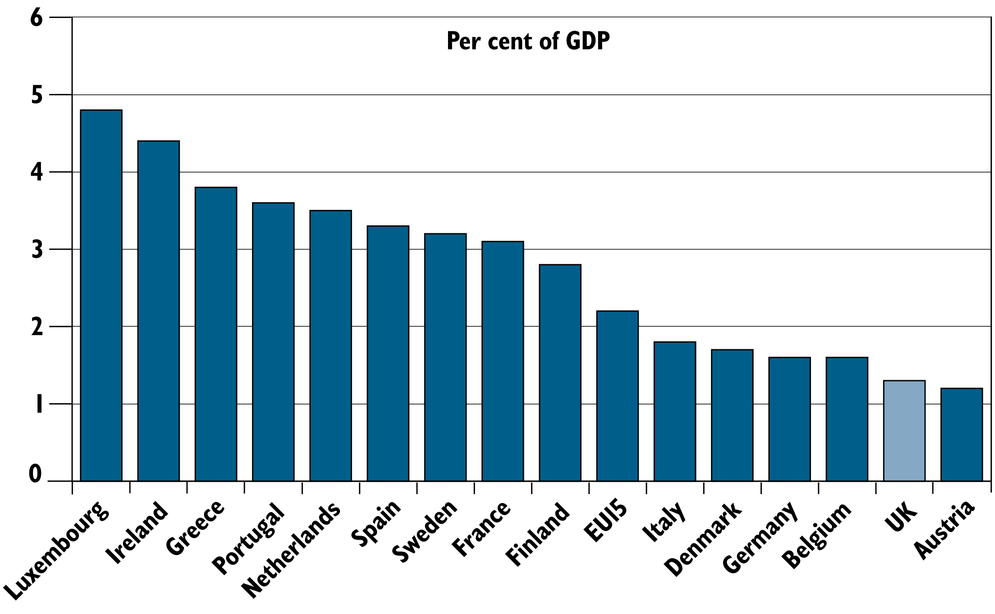
Borrowing for investment

5.39 The UK fiscal framework allows the Government to borrow in order to finance public investment. In the context of sound public finances and economic stability, public investment not only raises welfare through the provision of high quality public services but can also help to raise the overall productive potential of the economy. Where investment today benefits future generations it is appropriate for it to be financed by borrowing, meaning that future generations bear some of the cost. Sustained increases in public sector investment, together with reforms to ensure that taxpayers receive value for money, are central to the Government's long-term goal of delivering world class public services.

Investment in public services: the UK approach…

5.40 To achieve its long-term goal of delivering world class public services, the Government is borrowing modestly to fund increased investment. Chart 5.2 shows that public investment in the UK still lags behind that in most EU countries, despite recent increases, and there is still much to be done to turn round the legacy of under-investment. UK public sector net investment is projected to more than double over the coming years. This is consistent with the fiscal rules because, while the Government is projected to borrow modestly, the current budget is projected to remain in surplus over the economic cycle and net debt remains well below 40 per cent of GDP.

Chart 5.2: Gross public investment, 2002



Source: Estimates from European Commission spring 2003 forecasts.

...and the EU approach

5.41 The EU fiscal framework recognises, to some extent, the importance of public investment. For example, Article 104 of the EC Treaty states that assessment of whether a country's deficit is excessive needs to take into account '*whether the government deficit exceeds government investment expenditure*'. But this recognition was not made explicit in the SGP and the medium-term objective that the budgetary position should be '*close to balance or in surplus*' could be interpreted to mean that investment should be financed by current taxpayers, not by future ones, potentially harming inter-generational fairness. This could be a particular issue for the new Member States after enlargement of the EU.

Recent developments...

5.42 The EU fiscal framework is relatively young and EU Member States have been actively considering how to strengthen it. The March 2003 European Council fully endorsed a report from ECOFIN on improved budgetary coordination and invited ECOFIN to implement its conclusions, which suggest:

- a greater focus on the **budgetary position adjusted for the economic cycle** and agreement that the automatic stabilisers should operate symmetrically over the cycle;
- greater attention on **debt reduction** and, more generally, the longer-term sustainability of public finances, including through the determined pursuit of a comprehensive strategy to meet the challenges of ageing populations;
- recognition of the importance of the **quality of public finances**, with a view to raising the growth potential of the EU economies; and
- emphasis on the need to take into account **country-specific circumstances** when assessing the '*close to balance or in surplus*' requirement of the SGP, including the long-term sustainability of public finances and allowance for the automatic stabilisers to operate fully without breaching the 3 per cent reference value.

...and evolution

5.43 The Government supports the direction in which the EU fiscal framework is evolving. In his contribution to the EMU study *Submissions on EMU from leading academics,* Professor Ray Barrell notes: *"We should also accept that frameworks should change as the world changes, and as reputations are built."* The Government recognises that this is the case for both the UK and euro area frameworks.

5.44 Although ECOFIN remains the decision-making body for the EU in economic and financial policy, in EMU the UK would be a member of and attend all – and not some – meetings of the Eurogroup, thereby participating fully in euro area decision making.

Economic policy coordination

5.45 Economic policy coordination enhances stability by ensuring that the policies enacted by separate authorities do not pull in opposite directions. Both the UK and the euro area macroeconomic policy frameworks contain mechanisms for enabling coordination between policymaking institutions. Policy coordination can take a number of different forms, including information exchange, agreement on objectives and more active coordination on particular policies. For example, a Treasury representative attends MPC meetings, but cannot vote. A wide range of academic studies have shown that effective coordination can produce substantial gains, supporting macroeconomic stability nationally and internationally.

UK system – information exchange and consistent objectives

5.46 Policy coordination within the current UK framework is fairly straightforward. There is a single monetary authority and one national fiscal authority which have complementary objectives, both set by the UK Government. Policy coordination is assisted by high levels of information sharing between the two authorities. This ensures that they have a clear understanding of each other's strategies.

Euro area system inherently more complex

5.47 In the euro area, policy coordination is inherently more complicated because there is a single monetary authority but multiple fiscal authorities. This means that there is a need not only for coordination between the monetary and fiscal authorities but also between the individual fiscal authorities. To an extent, coordination problems are reduced by the fact that each authority's policies have a different reach: the ECB policy stance affects demand across the whole euro area while each fiscal authority acting individually will mainly affect demand in its own area. Even so there will be some spillovers from fiscal policy between countries, with smaller and more open economies in particular affected by fiscal policy changes in their main trading partners. And the ECB's monetary policy stance needs to take account of the fiscal stance in the euro area as a whole.

5.48 The euro area has a range of institutional arrangements to ensure that the ECB and individual member governments are well informed of each others' objectives and strategies for achieving those objectives:[2]

- the **SGP**, which provides for substantial information exchange between fiscal authorities and with the ECB;
- the **Broad Economic Policy Guidelines (BEPGs)**, agreed annually by the European Council, which set out non-binding recommendations to Member States in a range of economic policy areas;
- **Eurogroup**, an informal meeting of euro area Finance Ministers and the ECB President, promoting information exchange between euro area countries; and
- **ECB attendance at ECOFIN** meetings and meetings of its main supporting committee, the Economic and Financial Committee, and non-voting attendance at ECB Governing Council meetings by a representative of ECOFIN.

5.49 These arrangements minimise the risk that policies will be poorly coordinated and hence contribute to private sector confidence that macroeconomic policies will support stability in the euro area. There is, however, some suggestion that they may not currently be used to their full potential.

Fiscal federalism: neither necessary nor desirable

5.50 It is sometimes argued that a federal fiscal policy is required to complement the single monetary policy. But this is neither necessary nor desirable, as set out in detail in the EMU study *The United States as a monetary union*. It is not necessary because individual Member States are able to use their national fiscal policies for stabilisation purposes, if needed. They are also able to cooperate with other Member States when a concerted fiscal response is required. It is not desirable because citizens in different Member States have different preferences over the appropriate mix and level of tax and spending policies. Fiscal policy remains the responsibility of Member States, whether in or out of EMU. In his contribution to the EMU study *Submissions on EMU from leading academics*, Professor Antonio Fatás argues that: *"the implementation costs* [of a European fiscal federation] *are too large to compensate for the small potential benefits".*

[2] The first two mechanisms apply to the entire EU but they can, of course, facilitate coordination within the euro area too.

Financial stability

5.51 Another important aspect of maintaining economic stability is the arrangements for ensuring financial stability. The UK has established clear responsibilities for the three public authorities with roles in this field – HM Treasury, the Bank of England and the Financial Services Authority – with a clear structure for coordination between them. There is no EU or EMU level responsibility for financial supervision, which remains the preserve of individual countries. But information sharing and coordinated surveillance of financial stability issues are important and the Government supports the recent establishment of a Financial Services Committee to advise ECOFIN. The UK Government, like many others, believes that official support operations remain a national responsibility for euro area members.

Conclusion: how would the EMU macroeconomic framework affect UK economic stability?

5.52 Whatever the degree of sustainable and durable convergence, any risks to the UK of EMU entry could be compounded by the ECB's inflation objective and by a rigid and overly mechanistic interpretation of the SGP. The Government will continue to work with other European countries in the development of the macroeconomic policy framework to minimise these risks to the UK and to existing EMU members.

Policy requirements

5.53 In terms of macroeconomic policy, the Government's announcement of its intention in the next Pre-Budget Report to give the Bank of England a symmetric inflation target as measured by the Harmonised Index of Consumer Prices will improve the quality of the UK inflation target and will also help ensure inflation expectations in the UK remain in line with those of the euro area.

Stability in Europe – policy frameworks

5.54 In its May 2003 review of monetary policy strategy, the ECB restated that: "*Price stability is defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. Price stability is to be maintained over the medium term*". The ECB review went on to state that: "*At the same time, the Governing Council agreed that in the pursuit of price stability it will aim to maintain inflation rates close to 2% over the medium term*". At the present time, the potential for uncertainty that the ECB's inflation objective creates could produce deflationary risks in certain countries, although the fact that, to date, euro area inflation has averaged 2 per cent suggests that in practice this risk has not materialised.

5.55 At the EU level, the Government supports the direction in which the EU fiscal framework is evolving. In the ongoing debate on the interpretation of the SGP, the Government's approach will be to emphasise the significance of the economic cycle, sustainability and low debt, and the important role the Maastricht Treaty gives to public investment and the implications of this prudent approach for the interpretation of what are '*exceptional and temporary*' circumstances in relation to the 3 per cent reference value, for countries with low levels of debt.

5.56 Although ECOFIN remains the decision-making body for the EU in economic and financial policy, in EMU the UK would be a member of and attend all – and not some – meetings of the Eurogroup, thereby participating fully in euro area decision making.

PRODUCTIVITY AND OUTPUT

5.57 EMU's effect on productivity is one of the major considerations in the assessment of the growth, stability and employment test. Higher productivity enables higher living standards and better public services.

5.58 Continued macroeconomic stability is vital for the achievement of the Government's productivity agenda. Historically, the UK economy has suffered from macroeconomic instability which has led to a substantial productivity gap between the UK and many other advanced industrial economies. A more stable macroeconomic environment enables firms and individuals to plan with confidence. Consequently investment, innovation and enterprise will tend to be higher, leading to higher productivity levels and more rapid output growth.

Five key drivers of productivity

5.59 In pursuing its long-term goal of achieving a faster rate of productivity growth in the UK than its main competitors and closing the productivity gap, the Government's policy is focused on the five key drivers of productivity:

- enhancing **competition** to improve flexibility in product and capital markets and promote greater business efficiency and consumer choice;
- promoting **enterprise** by removing the market barriers that deter entrepreneurship and prevent new firms from developing and growing;
- supporting **science and innovation** to harness the potential of new technologies and to provide more efficient ways of working;
- improving **skills** among young people and the adult workforce to generate a flexible and dynamic labour market; and
- encouraging **investment** and better investment decision-making through stronger local and national capital markets.

EMU's potential effects…

5.60 EMU membership could affect all these drivers of productivity, either directly or indirectly. Joining EMU would remove a barrier to trade between the UK and the current euro area countries and would enhance competition across the euro area. EMU could potentially stimulate investment by aiding the integration of capital markets. It could also help to spread innovation and technological change across the single currency area. Box 5.4 examines the productivity gap between the US and the euro area and considers the lessons of the US as a monetary union for productivity in the euro area. It is the link between higher productivity and higher potential output that provides the basis for the estimated range of improved UK growth levels arising from EMU membership presented later in the chapter.

Box 5.4: The United States as a monetary union

The EMU study *The United States as a monetary union* considers the lessons that can be learned from the long history of the US as a single currency area. The US experience is interesting because its economy is broadly similar to the euro area in terms of overall size of market and its balance between domestic and foreign demand, and because it spans a large geographical area with diverse regional characteristics. Productivity levels in the US are around 19 per cent higher[a] than in the EU, in part because the US has a more integrated market.

Insights from examining the experience of the US are discussed in detail throughout the assessment. They include:

- **the evidence that a monetary union can survive and prosper with quite varied business cycles and in the presence of asymmetric shocks;**
- **the benefits of having a high degree of flexibility, particularly in labour markets, to help adjustment to asymmetric shocks;**
- **the stimulus to trade, investment and competition that a large single market with very few barriers to trade can bring (although other factors have also played a part); and**
- **the US dollar's role in the development of integrated and deep US financial markets has facilitated investment and also encouraged risk sharing.**

There are also some important differences between the US and European monetary unions which mean that the US does not provide a blueprint for EMU. Most notably, the political context for the two monetary unions is very different. The US states chose federal structures for fiscal policy to underpin political union, while in the EU fiscal policy is the responsibility of individual Member States. In addition, the institutions of the US monetary union have evolved over a long period of time while the euro area's institutions have been developing over a relatively short period of time.

[a] Eurostat Structural Indicators estimate of productivity defined on a GDP per worker basis. The gap on a GDP per hour worked basis is smaller, as discussed in *Meeting the Challenge: Economic Reform in Europe*, HM Treasury, February 2003.

…over different timeframes

5.61 The EMU study *EMU and business sectors* identifies the various ways in which EMU might raise productivity over different time frames:

- immediate effects associated with joining the single currency;
- short to medium-term impacts through trade and investment; and
- long-term effects through competition and against the background of the more general restructuring of the industrial landscape.

EMU's immediate effects

Four key entry effects

5.62 The immediate effect of EMU entry would be felt through four channels:

- lower transaction costs when trading with the euro area;
- a reduction in exchange rate uncertainty;
- greater price transparency for euro area imports and exports; and
- transition costs associated with the changeover to the single currency.

Currency transaction costs

5.63 Outside EMU, firms and travellers incur costs in changing pounds into euros and euros into pounds. The resources currently devoted to these activities could be used more productively if there was a single currency. The benefits of eliminating transaction costs are greater for smaller countries and those with unsophisticated financial systems. In the UK's case, they are probably small – no more than 0.1 to 0.2 per cent of the level of GDP[3] – with most of the gains falling to smaller companies. Separate, but related to this, is the issue of seigniorage which is discussed in Box 5.5.

Box 5.5: Seigniorage

Seigniorage, or monetary income, is generated through the issuance of national currency, whereby banknotes and coins cost less to produce than their face value or selling price. The change from sterling to euros, resulting from a decision to join EMU, would have an impact on the UK's seigniorage revenue.

The UK's seigniorage on coins would not be affected by EMU membership. For notes, the UK would lose the revenues gained from the issuance of sterling notes but would receive a share of the income from the total issuance of euro notes in the euro area. This share would depend on the UK's share of euro area GDP and population. Countries that are low users of cash relative to their GDP and population, such as the UK, could potentially gain from these arrangements. However, uncertainty surrounding future note issue volumes, interest rates, relative GDP and populations means that it is difficult to predict the net impact of UK EMU membership on banknote seigniorage. The likelihood is that the impact, be it positive or negative, would be relatively small.

Exchange rate uncertainty and hedging

5.64 Exchange rate uncertainty is likely to be more costly. Exchange rate movements cause fluctuations in firms' expected cost and revenue streams and the value of their assets and liabilities. These fluctuations are costly to risk averse firms. In the medium term, they may lead to a reduction in investment, as discussed in the assessment of the investment test, and in international trade, covered in the next section of this chapter, harming productivity. There are mechanisms to insure against exchange rate risk, for example by using forward contracts or currency options to help hedge against risk. However, these are usually effective only over a relatively short time period; it is difficult to insure against longer-term exchange rate misalignments. Because of the economies of scale involved, smaller businesses are likely to find exchange rate uncertainty more costly than larger ones.

[3] European Commission, *One Market, One Money*, European Economy, No. 44, October 1990.

Price transparency

5.65 EMU entry would also increase the transparency of prices across a large single market. With prices quoted in the same currency in the UK as in other euro area economies, consumers and firms would be better able to make informed choices between retailers or suppliers of comparable goods and services. This would increase competition and thus efficiency.

Transition costs

5.66 Against this, EMU entry would impose some one-off transition costs on businesses, individuals and the public sector. Microeconomic changeover costs would include the costs of upgrading software and introducing dual pricing systems in shops and they are discussed briefly in Box 5.6. These are qualitatively different and distinct from the macroeconomic transition costs assessed in the convergence test, drawing on the analysis in the EMU study *Modelling the transition to EMU*.

Box 5.6: Changeover costs

There are no reliable estimates of the one-off costs of a UK changeover to the euro. It is impossible to estimate the costs accurately even for existing euro area members and trying to produce an estimate for the UK would place an unnecessary burden on businesses. In particular, in many cases it is difficult to separate out the effects of the changeover from other changes that would have been undertaken anyway, such as upgrading of accounting and IT systems. While some organisations have attempted to estimate the likely costs, the wide range of estimates produced highlights the difficulties involved.

Notwithstanding this, it is generally accepted that careful advance preparation would help to minimise the costs involved. It is for this reason that the Government continues to supply a wide range of information to businesses and individuals, including in the *third outline National Changeover Plan* published alongside this assessment.

Conclusions on immediate effects

5.67 While these effects of EMU entry will affect UK firms and individuals immediately, they will be largely 'one-off'. Over time, the size of the effects will be small in comparison to the potentially long-lasting effects of EMU entry on trade, investment, competition and productivity.

EMU and UK trade

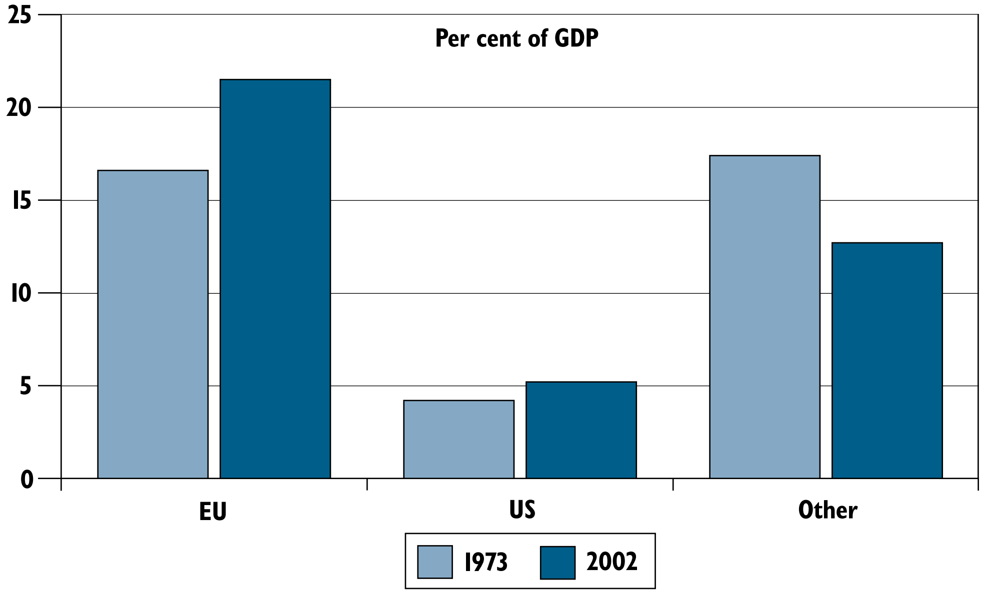
Importance of trade

5.68 These immediate effects could increase cross-border trade in the short to medium term. Trade raises the productivity and living standards of trading partners, allowing firms and countries to exploit economies of scale and to specialise in areas of comparative advantage. The EMU study *EMU and trade* provides a comprehensive overview of the theoretical and empirical economic literature on the subject of how EMU might affect the UK's level and pattern of international trade. It includes a full evaluation of recent work on the impact of EMU to date.

UK trade in the EU

5.69 The potential benefits from adoption of the euro depend positively on the degree of trade integration between the UK and the euro area economies. A high level of integration implies more scope for gains through the elimination of currency fluctuations and transaction costs. The UK has experienced a striking increase in trade with other EU countries since joining the then European Economic Community (EEC) in 1973, both in absolute terms and relative to its trade with other countries. Chart 5.3 shows that UK trade in goods with the EU as a percentage of GDP has risen by around 5 percentage points over the period. The EU is the UK's main trading partner. Successive expansions in the size of the EU and therefore in the number of people who benefit from the reduction in barriers to trade between EU citizens (now 377 million and to become 451 million following enlargement in 2004) has been a major stimulant to economic growth and prosperity in Europe.

Chart 5.3: UK trade in goods – 1973 and 2002



Note: Data on services trade are not available for 1973. For illustration, UK services trade was 6.6 per cent of GDP with the EU, 2.9 per cent of GDP with the US and 4.8 per cent of GDP with the rest of the world in 2001 (latest available Eurostat estimates).
Source: OECD.

5.70 After the EU, the UK's next most important trading partner is the US, closely followed by Asia. Both regions represent just under one fifth of total UK trade. Compared to other EU countries, a relatively higher proportion of UK service and income transactions is conducted with non-EU countries, especially the US.

5.71 UK trade integration with the EU is similar to that of other large Member States. UK trade in goods and services (exports and imports) with the EU is equivalent to just under 30 per cent of UK GDP. This is below the EU average, but close to that of other large EU economies such as France, Germany and Italy.

5.72 The UK tends to trade more with the US than do other large Member States. In addition, the importance of the US dollar in conducting trade is greater than implied by the share of the US in UK trade alone. If joining EMU implied greater volatility of sterling against the US dollar, this would partially offset the benefits of stability with the euro.

The European market in context

5.73 The European Single Market Programme launched in 1985 aimed to eliminate the remaining barriers to cross-border trade within the EU, including non-tariff barriers such as limitations on the free movement of capital. However, there remains room for still greater international trade in the EU. While US producers benefit from a large and well-integrated domestic market, European firms find it difficult to exploit economies of scale as effectively as their US counterparts, contributing to the productivity gap between the EU and the US. One of the driving forces behind the creation of the European single currency was the view that separate currencies were an important impediment to further trade integration.

How large are the effects?

5.74 Academic research since the 1997 assessment has suggested that the effects of EMU on trade could be much more significant than was implied by earlier estimates, which related primarily to the elimination of largely short-term exchange rate volatility. An influential study found very substantial potential effects of currency unions on trade. This result prompted further research and many contributions to the EMU study *Submissions on EMU from leading academics* have emphasised the issue.

5.75 The EMU study *EMU and trade* uses three main approaches to assess the potential impact of EMU membership on UK trade:

- examining how a reduction in exchange rate volatility affects trade;
- using evidence on trade generally within currency unions; and
- using evidence on trade specifically within EMU to date.

Evidence from exchange rate volatility

5.76 As discussed earlier, exchange rate movements are costly to firms, by creating uncertainty over expected costs and revenues for firms that trade in different currency areas. That said, many studies fail to identify a meaningful negative relationship between exchange rate volatility and trade, and some even find a weak positive link. Those studies that do establish a clear negative link find that the increase in trade arising from a monetary union is unlikely to exceed 10 per cent. However, this methodology is limited in that observed exchange rate volatility is an imperfect measure of currency risk; participation in a fixed exchange rate regime, for example, does not necessarily eradicate the risk of sporadic (and major) realignments, as the evolution of the Exchange Rate Mechanism (ERM) demonstrated.

Evidence from currency unions

5.77 More recent research has advanced the earlier findings on exchange rate volatility by focusing on the particular experience of members of a currency union. In an influential study, Professor Andrew Rose found that countries in currency unions trade three times more with each other than countries with separate currencies. He revisits this work and the substantial literature it has triggered in his own contribution to the EMU study *Submissions on EMU from leading academics*, and concludes: *"…my quantitative survey of the literature shows substantial evidence that currency union has a positive effect on trade. When the estimates are examined collectively, this effect is large in terms of both economic and statistical significance, implying that currency union is associated with an approximate doubling of trade."*

5.78 This type of result has been replicated many times, but the economic mechanisms underpinning it are not well understood. More importantly, the results mainly reflect the fact that many currency unions are between smaller, poorer countries. Professor Rose and others doubt that they are fully applicable to assessing the trade impact on existing EMU members, or on the UK if it were to join. In his contribution to the EMU study *Submissions on EMU from leading academics,* Professor Peter Kenen notes: "*most of the currency unions included in Rose's sample involve small developing countries, and Rose himself was careful to warn against drawing any strong inference about the trade-raising effects of EMU.*"

Evidence from EMU

5.79 Subsequent studies have attempted to produce results that are applicable in the EMU context and the emerging research consensus signals substantial gains to trade through membership of a currency union, although much lower than initially estimated by Rose (see Box 5.7).

Box 5.7: The impact of EMU on trade to date

With EMU now in place it is possible to examine how the level of trade has evolved so far. Trade intensity within the euro area has increased since the currency's launch. Extra-euro area trade for EMU members has risen more sharply over the same period, though this may reflect buoyant US growth, ongoing integration of the EU with Central and Eastern Europe and other fast growing economies, oil price rises and, possibly, the depreciation of the euro.

Detailed studies on this subject, including research produced for the Treasury based on existing work and on the limited data available, support the thesis that the euro is already having an appreciable impact. They indicate that although there is a lack of flexibility and convergence in some euro area countries, EMU has increased trade within the euro area by between 3 and 20 per cent since 1999.[a] On the basis of recent studies, Professor Jeffrey Frankel comments in his contribution to the EMU study *Submissions on EMU from leading academics* that: *"It seems clear that the trade effects of monetary union are not limited to small countries"*.

[a] A range of between 3 and 25 per cent is cited in the EMU study *EMU and trade*. But in subsequent work by the same authors, Micco, Stein and Ordoñez (2003), the upper bound of 25 per cent has been revised down to 20 per cent, closer to the range of 3 to 13 per cent in the work produced for the Treasury which provides the lower bound to the range used in this assessment of 3 to 20 per cent. The work for the Treasury finds that the estimated boost to trade is much lower when the underlying trend is estimated over the 1990s than is found by studies where it is estimated over the 1980s and 1990s.

EMU is not trade diverting

5.80 Research indicates that the increase in trade within a currency union is not at the expense of trade with non-members. Indeed, some studies find that not only is a currency union not trade diverting but it is actually trade creating with non-currency union members. This means that the UK would gain some of the benefits from the greater integration among euro area members, even outside EMU. In his contribution to the EMU study *Submissions on EMU from leading academics*, Professor Jacques Mélitz states that evidence shows that: *"monetary union increases trade between members and non-members (though less so than between the members) … In other words, even without adopting the euro, the UK will get many of the advantages of EMU…"*. However, there could be a risk that because euro area firms would benefit from greater productivity by exploiting economies of scale, the profit margins of some UK firms could fall.

Conclusions on EMU and trade

5.81 On the basis of a detailed review of the evidence, the EMU study *EMU and trade* concludes that a reasonable range for the potential increase in UK trade with the euro area in the long term resulting from UK membership of EMU is between 5 and 50 per cent, without any trade diversion from UK trade with the rest of the world. The lower end of this range equates with the lower estimates of the increase in intra-euro area trade that has already occurred between member countries. The upper estimate pays much greater attention to the wider benefits of currency union, and appears closer to the more likely outcome in the long term.

5.82 But realisation of the higher end of the range if the UK joined EMU would be contingent on the achievement of sustainable and durable convergence. Without the maintenance of continued stability, the trade benefits of joining EMU would be negligible.

EMU and UK competition

The importance of competition

5.83 The effect of EMU on trade is the key driver of increased competition. Competition is important to assessing how EMU membership could affect UK productivity in the longer term, since competition increases the incentive for firms to innovate and helps to shift the allocation of resources from less to more productive enterprises. Indeed, some argue that the strengthening of competition as a result of EMU will prove to be its greatest longer-term impact.[4] Greater competition would lead to lower prices, increased choice and/or improved quality, which would transmit the potential productivity gains of EMU to final consumers. The EMU study *Prices and EMU* examines how EMU membership could affect UK prices and competitive pressures. It includes detailed analysis of the latest trends in prices and the possible influences on them. The flexibility test's analysis of the role of prices as an adjustment mechanism is also relevant.

EMU's potential effects

5.84 EMU lowers transaction costs between countries in the currency area because it removes exchange rate risk and the direct costs of currency exchange. It should also reduce consumer search costs by making it easier to compare prices across countries. These could increase the size of the effective market for UK firms and consumers, stimulating competition. This may be reflected in an actual increase in trade between countries, as already discussed, or in greater pressures on local firms to innovate and to price more competitively as they respond to the threat of that trade.

Measuring the impact

5.85 Evidence on the likely scale and pace of the impact of EMU on prices can be drawn from:

- the experiences of those countries which have already entered EMU;
- patterns of price dispersion and the inferences that can be drawn about their underlying causes; and
- comparison with the US.

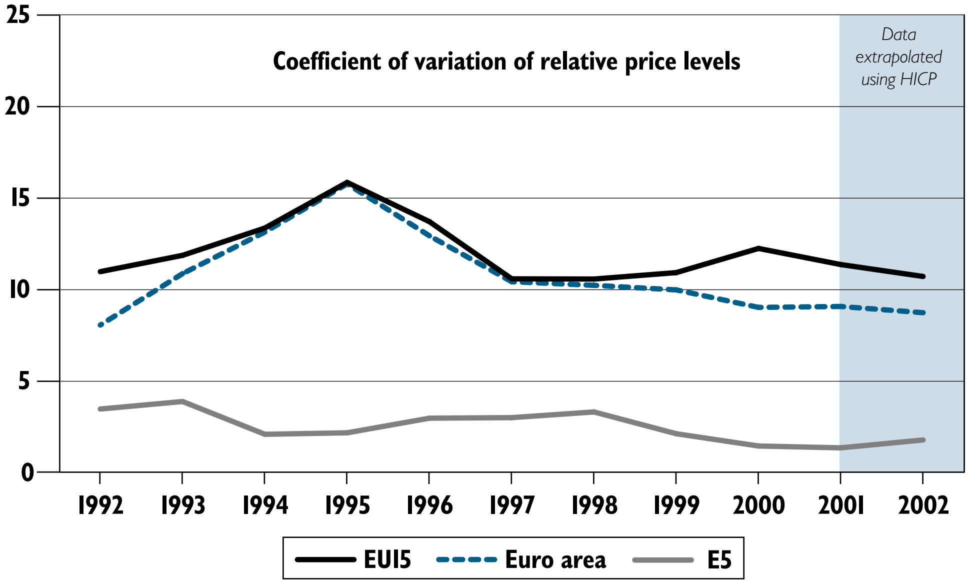
Experience of EMU to date

5.86 It is still rather early to draw definitive conclusions about prices from the experience of EMU so far. The full effects are likely to come through only slowly. Nonetheless, basic statistical analysis suggests that prices in the EU, and particularly in the euro area, have been converging since the mid 1990s – see Chart 5.4. A number of factors, including exchange rates and the Single Market Programme, may have contributed to this convergence, but the single currency may also have played a part. Given that the UK's relative price level is generally above the EU average, any price convergence as a result of EMU would tend to lower UK prices.

5.87 Countries at the geographical centre of the euro area (the 'E5' – France, Germany, Belgium, Luxembourg and the Netherlands) have shown more price convergence than the euro area as a whole. This is consistent with a gradual increase in market integration, beginning at the centre. Evidence at a more disaggregated level provides a similar picture, although some sectors have displayed more price convergence than others.

[4] Sir Alan Budd, former Chief Economic Adviser to the Treasury, noted in his Bristol Convocation speech of 4 February 2002 'Making sense of the Euro debate' that: "*The microeconomic argument in favour of the euro is that it will increase efficiency by reducing transaction costs and increasing competition*".

Chart 5.4: Price convergence in the EU



Note: For methodology of calculations, see Annex A of the EMU study Prices and EMU.
Source: Eurostat and HM Treasury calculations. Data are weighted by country and item.

Patterns of price dispersion

5.88 The level of market integration and competition is affected by a wide range of factors. For example, a market that is highly regulated in one country might be more difficult for other firms to enter even in the presence of a single currency – allowing the incumbents to charge higher prices. Transport costs are another obvious barrier, especially for bulkier goods. As a result, price dispersion between countries varies significantly by both product and market. Countries that are relatively expensive for one product can be relatively cheap for another. A separate currency may only be one among many factors that explain price differentials.

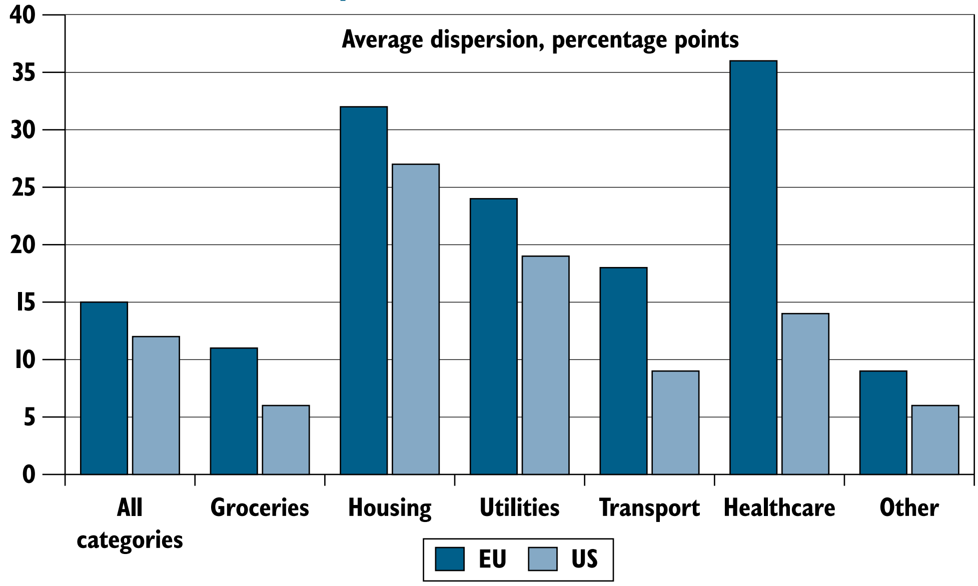
Comparison with the US

5.89 The interplay between currency-related and other barriers to market integration can be illustrated by comparison with the US. Chart 5.5 shows that price dispersion is lower in the US than in the EU. Price levels, at least for internationally traded global brands, also appear to be significantly lower in the US. This may indicate higher levels of competition and suggests that there is scope for the EU to improve. The US not only has a single currency, however, but also a well-established integration of its markets that has developed over a long period of time, as discussed in the EMU study *The United States as a monetary union*. Consequently, higher price convergence in the US is a result of a combination of currency union and a range of other factors.

Conclusions on EMU and competition

5.90 A single currency has the potential to reduce the divergence between UK and EU prices and intensify competition in the UK, particularly by increasing the likelihood of cross-border entry into markets. The benefits in terms of increased productivity and output, though, would be likely to emerge only over a long time period. Moreover, it would only be possible to gain these benefits in full by working in parallel to tackle other barriers to competition in Europe, some of which are discussed in the analysis of European economic reform below.

Chart 5.5: Price dispersion in the EU and US



Source: European Commission working paper: Price levels and price dispersion in the EU, Economic Trends Supplement A, No. 7, 2001.

Conclusion: what is the potential impact of EMU on UK trade, competition, productivity and growth?

Substantial possible gains…

5.91 EMU membership could enhance productivity in the medium term by increasing trade and investment and by stimulating competition. Later sections make clear that it could also help to promote economic reform in the EU and encourage specialisation in the longer term. Therefore, EMU could potentially have an effect on all five of the key drivers of productivity. Based on broad-based evidence on the impact of trade, it seems reasonable to assume that each 1 percentage point increase in the ratio of trade to GDP increases real GDP per head by at least $^1/_3$ per cent in the long run and perhaps as much as $^2/_3$ per cent. In a best case scenario, with stability assured through the achievement of sustainable and durable convergence, a long-term increase in trade with the euro area at the top of the 5 to 50 per cent range and increased investment spurring competition, UK output could be around 9 per cent higher over 30 years within a successful EMU than outside. This could add around $^1/_4$ percentage point a year to GDP growth.

…but not without sustainable and durable convergence

5.92 This is conditional on the achievement of sustainable and durable convergence between the UK and the euro area. In circumstances where it is not assured, the trade benefits from EMU would be likely to be at the lower end of the range. This means that the potential gains to trade and competition from EMU membership could be negligible even over the long term. However, initial estimates suggest that although there is a lack of flexibility and convergence in some euro area countries, EMU has increased trade within the euro area by between 3 and 20 per cent since 1999. In practice, additional volatility and uncertainty resulting from EMU membership in the absence of sustainable and durable convergence could have a negative impact on the actual level of UK output in the long term.

Policy requirements

5.93 The Government will continue to pursue its wide-ranging strategy to tackle the barriers to productivity growth and close the productivity gap. This involves continued microeconomic reforms in the UK to target the five key drivers of productivity, combined with support at the European level for policies to strengthen competition and the Single Market.

EMU AND EMPLOYMENT

5.94 The Government's long-term goal is employment opportunity for all. Worklessness, particularly on a long-term basis, is a constraint on the UK's growth potential and a major cause of poverty and deprivation for many individuals and their families. The Government's aim is to ensure a higher proportion of people in work than ever before by 2010. The decision on EMU entry must not put at risk this long-term goal.

Structural and cyclical employment

5.95 For analytical purposes, it is helpful to distinguish between the structural rate of employment and its cyclical component, analogous to the analysis of unemployment in the assessment of the flexibility test. The structural rate is the level of employment that is consistent with non-inflationary growth. In general, employment in excess of this structural rate will be associated with rising inflation, while employment below the structural rate will be associated with falling inflation. The cyclical component reflects the movement of employment around its structural rate over the course of the business cycle. At any particular point in time, the actual level of employment in a country will be determined by its structural rate and the cyclical position.

5.96 The longer-term potential benefits of EMU on output would be more likely to be felt through productivity than through employment. But EMU membership could have some impact on both the cyclical and structural components of employment.

Hysteresis: when cyclical unemployment becomes structural

A bridge between cyclical and structural unemployment

5.97 In practice, the analytical distinction between cyclical and structural unemployment is not clear cut. In flexible labour markets, the structural unemployment rate will be largely unaffected by cyclical developments. But in less flexible labour markets, those who become unemployed may find it difficult to re-enter employment. When this occurs, an initial cyclical change in the unemployment rate becomes locked in as a structural shift. This tendency for short-term effects to have permanent consequences, known as hysteresis, is a recurring theme of this assessment. Here, it provides a bridge between the cyclical and structural analysis of unemployment.

5.98 Drawing on the EMU study *EMU and labour market flexibility,* the assessment of labour market flexibility concludes that:

- the more flexible is the labour market, the lower is its structural rate of unemployment;
- the UK labour market has become more flexible since the 1997 assessment and would be in a better position to respond to any problems that might emerge within EMU; but
- UK flexibility has not been fully tested in recent years, which have been characterised by a relatively stable macroeconomic environment.

5.99 This underlines the importance of sustainable and durable convergence between the UK and the euro area. A lack of sustainable convergence increases the risk of large cyclical increases in unemployment which might then become structural in nature, as occurred in the 1980s.

Evidence of hysteresis effects

5.100 There is strong evidence that European economies, including the UK, have been prone to hysteresis effects, contributing to high and persistent unemployment during the 1980s (see Charts 2.2 and 2.3 in Chapter 2). By contrast, the structural unemployment rate in the US has remained relatively constant over the past decades, despite undergoing substantial recessions in the early 1980s and early 1990s.

EMU's effect on structural employment

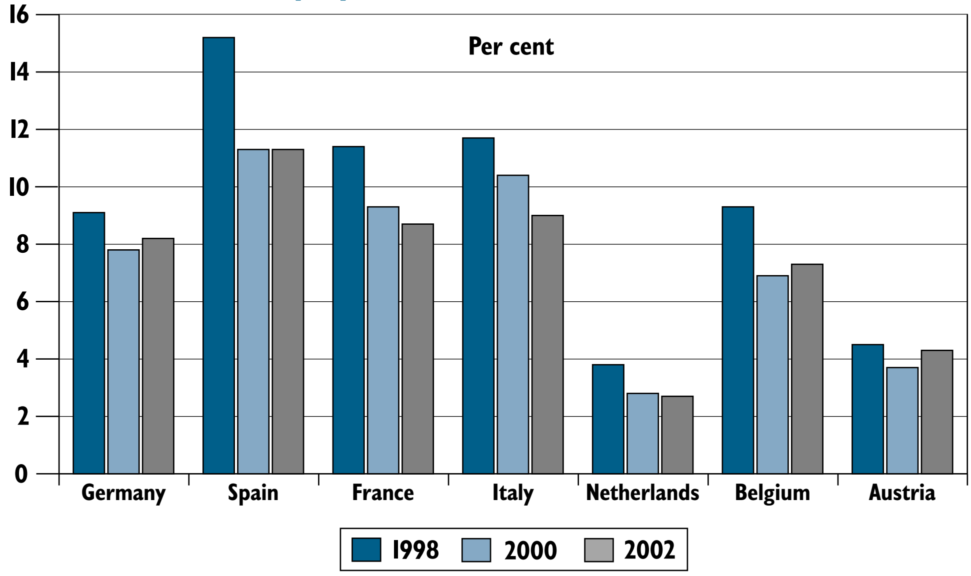
EMU does not imply convergence of structural employment rates

5.101 Some have claimed that UK membership of EMU would inevitably mean that the UK's employment rate would converge on the euro area average. If this were the case then it would imply a substantial reduction in UK jobs. But both economic theory and evidence show that this claim, which is linked to the argument that trend output must also converge (as discussed in the assessment of the convergence test), is mistaken.

5.102 Employment rates within a monetary union can diverge because the equilibrium rate of employment is largely independent from the monetary stance. Other factors are more important determinants of the structural rate of employment, such as the structure of wage bargaining, the degree of regulation and the structure of the tax and benefit system. The assessment of the flexibility test and the EMU study *EMU and labour market flexibility* set out how these factors can influence labour market adjustment and the structural employment rate.

5.103 Empirical research confirms that sharing a common currency does not imply sharing the same unemployment rate. Indeed unemployment rates can vary by more between regions of the same currency area than they do across currency areas. Within the UK there were substantial and persistent differences in regional unemployment rates during the 1980s and early 1990s. In the same way, there have been persistent regional differences in the US, despite its long history as a monetary union. And in the euro area to date, the larger economies have continued to experience quite different unemployment rates (see Chart 5.6).

Chart 5.6: Unemployment rates in the euro area



Source: Eurostat Structural Indicator for standardised unemployment.

EMU's impact…

5.104 EMU membership could have an impact on the UK's structural rate of employment through two channels:

- encouraging greater competition and greater integration of product and capital markets; and
- providing a catalyst for reform of labour, capital and product markets, either by governments or by the private sector.

…through competition and integration…

5.105 Intensified product market competition in EMU could increase the efficiency of resource use, as firms' mark-ups over costs would fall. This in turn would enhance labour productivity and real wage levels. This could increase the supply of labour and raise the structural level of employment. However, there is no systematic correlation between the size of a currency area and the employment rate, so the size of this effect is likely to be small.

…stimulating reform…

5.106 One particularly important part of the EU's overall economic reform agenda discussed later in this chapter is reform of labour markets to promote the creation of more and better jobs. EMU could potentially act as a catalyst for reforms, improving robustness and responsiveness to shocks. Box 2.6 (in Chapter 2) discusses the recent achievements in the EU, including the creation of over 10 million jobs between 1997 and 2001.

5.107 But there is still more to be done. In particular, encouraging people to remain active for longer in their working lives remains an EU-wide priority. This demands a wide-ranging approach across a number of policy areas. These include tax and benefit reform, regulation, access to flexible working patterns and active labour market policies such as training and lifelong learning. Other important European priorities include strengthening gender equality and combatting discrimination. In July 2002, the Government published *Towards Full Employment in the European Union* to review the progress made and to identify areas for further reform. Moreover, the EU is not static; labour market reforms that ensure a dynamic, competitive and socially inclusive society are all the more necessary to cope with the challenges of an enlarged and increasingly globalised EU.

…and dynamic effects in the private sector

5.108 EMU could also have dynamic effects on the behaviour of private sector agents. It could increase the degree of wage flexibility and labour mobility, for example, because of the elimination of exchange rate uncertainty for temporary workers in another EU country. This could lead to a lasting reduction in regional mismatch between employee skills and job vacancies and an increase in the sustainable employment rate. However, differences in languages and cultures mean that any effects would probably be fairly small and take some time to materialise.

EMU's effect on the cyclical volatility of employment

5.109 Whether in or out of EMU, the UK economy will change and evolve in response to economic shocks and the responses to them. Sound economic policies can reduce the impact of these shocks but cannot eliminate them entirely, so the actual employment rate will still vary over time. Employment may not change sharply in response to small shocks, for example because employers try to 'ride out' the shock with their existing labour force (often termed labour 'hoarding'). Larger variations from potential output may have a greater impact, with the change in employment from the original shock potentially amplifying the cycle. For example, firms might reduce their workforce in response to an initial negative shock. This will reduce consumers' purchasing power and may lead to a further reduction in firms' desired levels of employment.[5] Without sustainable convergence there is a risk of an adverse feedback, in which a lack of convergence creates a greater risk of cyclical differences between the UK and the euro area, which leads to differential employment responses, which then exacerbates the divergence in demand and output.

[5] In his contribution to the EMU study *Submissions on EMU from leading academics*, Dr Daniel Gros argues similarly that movements of workers in response to a shock could magnify the initial shock.

Conclusion: how might EMU affect both the underlying level and cyclical path of employment?

5.110 The potential effects of EMU would be greater on productivity than on employment, but both could be affected by any increase in volatility. Without sustainable and durable convergence between the UK and the euro area, EMU membership could increase the cyclical volatility of employment in the UK. It is harder for the labour market to adjust to large increases in unemployment than small ones, so the risk of less stability in output and employment would entail an increased risk of higher structural unemployment in the UK. These risks would be reduced if sustainable and durable convergence were assured, in which case the UK would be able to reap the potential employment benefits of EMU membership.

Policy requirements

5.111 The conclusions to the assessment of the flexibility test set out the Government's wide-ranging agenda for enhancing flexibility in the UK and EU to deliver high and stable levels of UK employment.

DISTRIBUTIONAL EFFECTS OF EMU

5.112 Subject to the achievement of sustainable and durable convergence, the effects of EMU membership on trade, competition and employment identified in previous sections would be felt more immediately and more keenly in some industries, regions and households than in others. This section considers how these effects would be transmitted through the UK economy. It draws on the much more detailed analysis undertaken in several EMU studies, including *EMU and business sectors, Prices and EMU* and *Housing, consumption and EMU*. The analysis does not attempt to pick out particular potential winners or losers, but seeks to identify the general factors that could cause differences in the timing and the intensity of the changes which might occur across firms, regions and households.

EMU and UK business sectors

5.113 The EMU study *EMU and business sectors* assesses how EMU membership might help, hinder or reshape the UK's industrial performance, and how this impact might be distributed across different UK industries and over different time periods.

Changes in or out of EMU

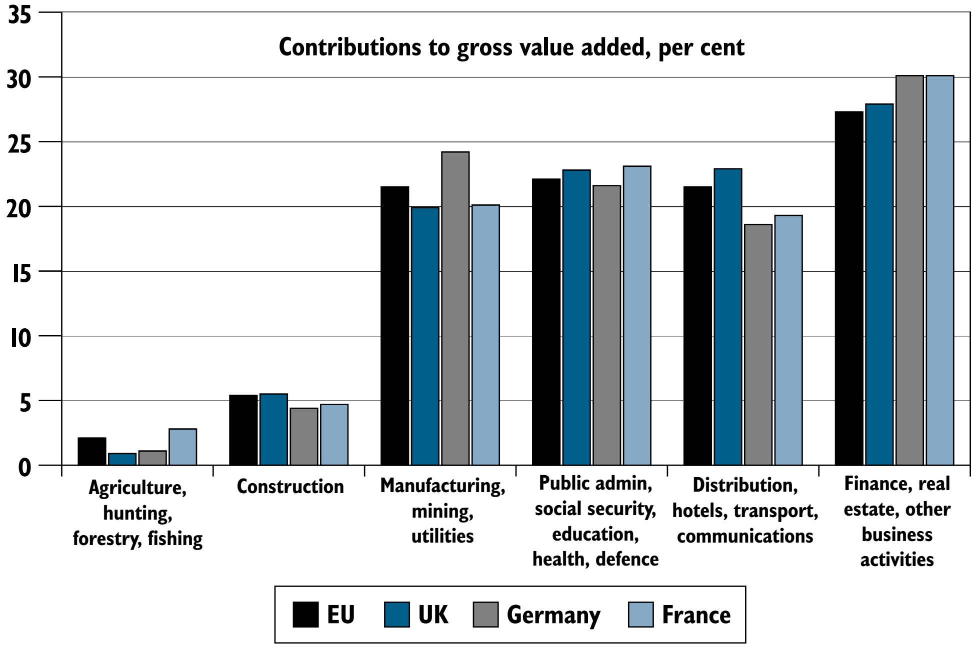
5.114 EMU affects UK business whether or not the UK is a member. Increased competition within the euro area, and greater cross-border trade and investment, imply new challenges and opportunities for UK firms that sell to euro area customers, buy from euro area suppliers or compete with euro area firms. Were the UK to join EMU, the challenges and the adjustment costs would be qualitatively and quantitatively different; so too would the opportunities and benefits, both for UK firms and consumers. In either case, UK industry needs to be sufficiently flexible to adapt to a new environment.

5.115 The challenges and opportunities posed by EMU entry are not qualitatively different from those that businesses continually face in response to changes in technology, consumer preferences and competitive pressures from rival producers. Successful businesses respond to these by adapting their production techniques, marketing, distribution, investment, employment and pricing.

How do EU and UK industrial structures compare?

5.116 At present, the UK's industrial structure is similar in many respects to that of the EU as a whole, though not necessarily to individual Member States. For example, the UK's output and employment structures are similar to those of France, but slightly different from those of Germany, due to Germany's larger manufacturing sector – see Chart 5.7.

Chart 5.7: Business sectors in the EU, 2002



Note: French data for 2001. Data presented in tabular form in Table 1.2 for UK, Germany and France.
Source: Eurostat.

Important differences remain

5.117 However there remain differences, as discussed in the assessment of the convergence and investment tests. More UK workers are employed in large firms than is the case in the EU as a whole, and UK firms are more likely to raise external funding directly from equity markets. Services account for a higher proportion of UK trade, due in part to the invisible earnings of international wholesale financial services located in London. Historically, the UK has also received a larger amount of foreign direct investment than other EU countries, especially from the US.

5.118 These differences would play a role in determining the distributional impact of EMU on UK business at the sectoral level, although the analysis at the aggregate level in the assessment of the convergence test suggests that the overall effect of such differences would pose a low to medium risk to sustainable convergence.

Characteristics determining EMU's sectoral impact

5.119 UK membership of EMU would change the business environment by removing nominal exchange rate uncertainty between the UK and euro area countries. This would make it easier for some UK firms to compete in euro area markets and for some euro area firms to compete in the UK. The intensity and nature of EMU's effect on individual sectors would vary according to a number of different characteristics, detailed in Box 5.8.

Box 5.8: Distributional effects implied by key sectoral characteristics

The EMU study *EMU and business sectors* focuses on six key sectoral characteristics which may influence the way in which EMU membership affects different business sectors.

Sectors which are highly open or exchange rate sensitive (for example, tourism) would be more affected by EMU than those which trade less, though the impact would vary depending on whether exposure or sensitivity is primarily to euro area or non-euro area currencies.

The impact of EMU would be influenced by pricing behaviour. EMU would be most likely to facilitate price convergence in sectors where products are differentiated, where UK prices are outside the range of large euro area members and where markets are not segmented by national preference or regulation.

Different market structures imply different EMU impacts. Sectors with high potential for mergers or acquisitions, or where customers are more able to compare products and prices across countries, would tend to be more affected.

Firm size is an important characteristic. The benefits of EMU (and the increase in competition) would be relatively pronounced in sectors characterised by small firms (for example, the manufacturers of car components). More integrated product and capital markets may, at the same time, facilitate the development of multinational enterprises.

In terms of finance and ownership, enhanced capital market competition and integration would have a clear impact 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 foreign direct investment (for example, machinery and equipment), form strategic alliances (for example, pharmaceuticals) or have separate managerial control and ownership.

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 (for example, consumer durables or construction) or which find cyclicality to be particularly damaging (for example, commodity chemicals).

Nominal exchange rate uncertainty and manufacturing

5.120 Under the right conditions, the removal of nominal exchange rate uncertainty would provide a clear benefit for firms that either already export to the euro area or would contemplate doing so once exchange rate uncertainty had been removed. This would be particularly beneficial for much of the manufacturing sector, which is more open than the services sector. Manufacturing exports were £173 billion in 2000 (35 per cent of total manufacturing output at market prices), compared to services exports of £75 billion (6 per cent of total services output). The removal of exchange rate uncertainty would also benefit euro area manufacturers competing in the UK market. Provided that sustainable and durable convergence was assured, this would provide opportunities for firms with competitive strengths arising from the quality of their products or from their productivity. Firms with weaknesses in these areas would need to rise to this challenge over time.

How might EMU affect industry structure in the longer term?

5.121 In the longer term, the reduction of barriers to trade and investment that EMU membership implies would lead to some restructuring of production across Europe. This could have long-term consequences for the UK's industrial structure. Specialisation might increase, as firms would be more likely to cluster in regions in order to benefit from external economies of scale, such as the ability to draw on a pool of skilled labour and technology.

5.122 The potential impact of a major reduction of barriers to trade and investment is supported by evidence from the experiences of countries joining the EU and the Single Market Programme. While the picture for original EU members is somewhat mixed, specialisation clearly increased for those countries which joined in the 1970s and 1980s (including the UK), as the rigours of the Single Market shaped their economies. For the most recent wave of entrants, specialisation rose in the mid to late 1990s. With enlargement of the EU from 2004, there could be a further boost to specialisation.

Potential gains from specialisation in the UK

5.123 Though specialisation has been increasing, the UK is currently less specialised than euro area countries, and the EU is less specialised than the long-standing US monetary union. Increased specialisation is associated with greater productivity because it enables a more efficient allocation of resources. Lower UK specialisation at present could, therefore, suggest scope for greater potential productivity gains from EMU. Although any increase in specialisation carries a potential for a greater incidence of sector-specific shocks, this is a long-term and gradual process. The assessment of the convergence test indicates that any risk from this is relatively slight.

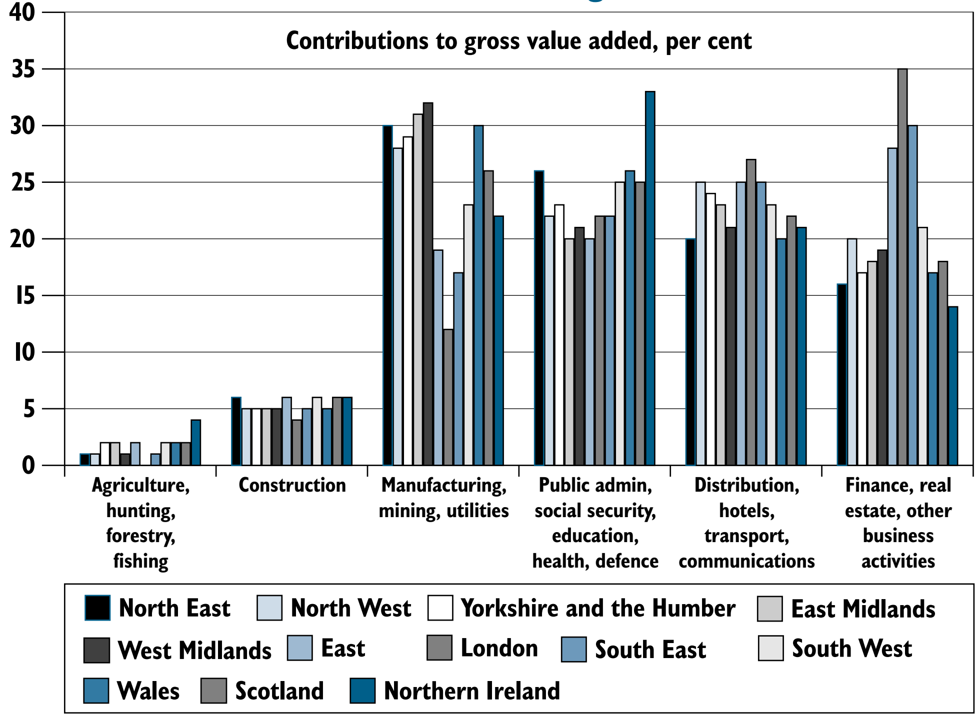
EMU and UK nations and regions

Sectoral structures key

5.124 The effect of EMU on the regions of the UK is closely related to the effect on business sectors. Differences in regional industrial structure would affect the timing and the intensity of the competitive pressures faced by individual regions. Differences in the flexibility of regional economies would determine how well they responded. For regions, as for businesses, EMU provides opportunities as well as challenges, and many of its effects will exist regardless of whether the UK enters EMU or not, because the UK will be affected by the way that European firms adjust to EMU.

5.125 Regions with more firms in sectors affected by exchange rate volatility could see relatively larger initial effects. And regions that contain more cyclically-sensitive industries would be more vulnerable to increased instability arising from a lack of durable convergence. Chart 5.8 shows that for some sectors – manufacturing, mining and utilities, and finance, real estate and other business activities – regional differences can be sizeable and often greater than differences between the UK and the other large EU countries (see Chart 5.7). The assessment of the convergence test, while recognising the potential for differences, concludes that they do not have a large impact overall on the degree of cyclical convergence between UK regions.

Chart 5.8: Business sectors in UK regions, 1998



Source: ONS, latest available data.

5.126 Regional industrial structures are not static and their future evolution will depend critically on how well regions are able to respond to the challenges and the opportunities posed by EMU. The strength of regional adjustment mechanisms is crucial in promoting growth and ensuring that any short-term shocks would not become more long lasting. In particular, flexibility of wages and prices could help adjustment between regions, as could labour and capital mobility. In his contribution to the EMU study *Submissions on EMU from leading academics*, Dr Daniel Gros stresses the importance of considering inter-regional as well as international labour mobility as an adjustment mechanism.

Regional policy measures

5.127 Regional policy measures can help regions to develop their adjustment capacity and further their economic development. In the UK, the Government's strategy for regional development has three main strands:

- **macroeconomic stability**, providing a stable basis to plan and invest following decades of under-investment;
- **microeconomic reforms to tackle market failures** at the national, regional and local level, focused on the key drivers of productivity discussed earlier; and
- a **regional policy framework of devolution and decentralisation** so that regions have the resources and flexibility to deliver locally-led policies, within a framework of clear accountability.

5.128 Action at an EU level also has a role. Although EU regional policies – including cohesion policy, state aid reform and lending by the European Investment Bank – have delivered benefits in the UK and EU, current arrangements are often too centralised and inflexible. That is why the Government has put forward, in the recent paper *A modern regional policy for the United Kingdom*, a new EU Framework for Devolved Regional Policy (see Box 2.13 in the flexibility test). As detailed in the assessment of the flexibility test, this would keep the strengths and lose the weaknesses of the current EU system, with delivery of regional policy substantially devolved and decentralised to give greater flexibility to Member States and regions.

Euro area experience

5.129 As already discussed, the EMU study *Prices and EMU* presents evidence that the impact of EMU in some areas, such as price convergence, has so far had stronger effects on countries closer to the geographical core of the euro area. This is consistent with theoretical predictions that the benefits would disperse gradually across the single currency area and suggests that UK regions most closely integrated with the euro area at present, such as the South East, would be likely to feel the impact of EMU membership first.

Long-run impact

5.130 Provided that regional adjustment mechanisms are sufficiently robust, it is unlikely that monetary union would be more advantageous to one area than to another in the long run. This is because levels of productivity and employment are determined by factors that are either largely independent of monetary union or would be affected equally across regions, such as wage-setting institutions, the incentives to innovate and the degree of product market competition. Short-run differences would even out in the long term, with regional differences remaining dependent on these more fundamental factors. Consumers in all regions would benefit from the effect of increased competition, leading to lower prices and better quality goods and services in the longer term.

EMU and UK households

5.131 EMU membership would have important implications for UK households. Its effects would vary between different households, depending on factors such as the level of household income, type of employment and whether or not households own their own homes. In the immediate period following entry, households would need to adjust to using the new currency. After the changeover, bank accounts, wages and prices would all change into euros. The UK official short-term interest rate would be set by the ECB on the basis of conditions in the euro area as a whole. This would have implications for the stability of the UK economy. It would also affect the interest rates which homeowners pay on mortgages and other debts. Over the longer term, if EMU were to increase business competition in the UK, this could reduce the prices which consumers pay for goods and services. EMU could also have implications for jobs, working patterns and wages. This section explores the impact of EMU in five areas of particular importance for households:

- the changeover to the euro;
- interest rates and housing;
- prices and the cost of living;
- wages and employment; and
- pensions.

The changeover to the euro

5.132 The most immediate and noticeable impact of EMU membership for households would be that sterling would be replaced by the euro as the currency of the UK. After the changeover, bank accounts, prices, wages and pensions in the UK would all be set in euros. It would take time for both households and businesses to adjust to using this new currency. There would also be immediate practical benefits. For example, there would be no need to change currency before going on holiday to euro area countries as the same euro notes and coins are accepted by shops, hotels and restaurants throughout the euro area. The *third outline National Changeover Plan*, published alongside this assessment, gives several detailed practical examples of how UK households would be affected by a changeover to the euro.

Interest rates and housing

5.133 Another important and immediate implication of EMU entry is that the level of UK interest rates would be set by the ECB rather than by the MPC of the Bank of England and they would be the same across the euro area, as discussed in detail in the assessment of the convergence test. This has particularly important implications for homeowners, as it would affect the interest rate paid on mortgages. The UK has a high level of mortgage debt compared to many other EU countries and a relatively high proportion of variable interest rate mortgages. If the UK were to join at the current time, there would be a fall in UK interest rates, as the interest rate set by the MPC for the UK is currently higher than the rate set by the ECB for the euro area. But this would be likely to be a relatively short-term effect. Over time, the assessment's conclusion is that UK interest rates would not be significantly higher or lower inside EMU than outside, on average, if sustainable and durable convergence were achieved.

5.134 The ECB sets interest rates on the basis of economic conditions across the euro area as a whole rather than on the basis of conditions in one country, as the MPC does for the UK. This could mean that if the UK was to enter EMU, interest rates would at times be set at a level that was not appropriate for the UK. For example, UK homeowners could find that interest rates were rising at a time when the UK economy was in a downturn. Higher mortgage and loan rates would lead to lower income available for spending at the time when homeowners needed it most. The likelihood of this scenario would be greater the higher the risk of country-specific shocks and economic structures, as discussed in the assessment of the convergence test.

Prices and the cost of living

5.135 Over time, EMU entry could promote increased competition in UK business markets through increased trade and investment between the UK and the existing euro area countries. The analysis in this assessment suggests that if the UK were to enter EMU on the right basis, then these effects could be large. In such circumstances, firms in the UK would face greater competition from elsewhere in the euro area. This could lead firms to reduce prices to match those of more efficient competitors. For example, the analysis in the EMU study *The United States as a monetary union* shows that in general the prices of consumer goods and services are lower in the US than in other large economies. One likely reason for this is the greater level of competition in the large and integrated US market.

5.136 Lower prices would lead to a lower cost of living, a key potential benefit of EMU entry for households, but one that would only accrue if entry were on the basis of sustainable and durable convergence. Poorer households tend to spend a greater proportion of their income on goods and services, so lower prices could benefit such households relatively more than wealthier ones.

Wages and employment

5.137 In EMU, the single interest rate and exchange rate are no longer available as tools to help policymakers stabilise the UK economy in the face of economic disturbances and change. The analysis in this assessment shows that at the present time, because the achievement of sustainable and durable convergence between the UK and the economies of the euro area has not been demonstrated, this would result in higher economic volatility. In particular, output and inflation volatility would be higher in EMU. One consequence of this would be that employment and wage levels would be more volatile. Households could find that there would be longer periods when wage earners were without jobs. This could particularly be the case in industries which are sensitive to economic conditions, such as those producing investment goods for which demand falls strongly if the economy enters a downturn.

5.138 If the UK were to enter EMU on the right basis, then increased business competition would lead to important changes in the UK business environment. This could affect the types of jobs available in the economy and the level of wages. Increased competition over a larger market would lead to increased opportunities for strong firms, but weaker firms might struggle to survive. Employees might be required to move jobs and learn new skills to adapt to the changing economic environment. Over the long term, the productivity of UK firms could increase in EMU, which might result in higher wages. But for this important potential benefit to be realised, the UK would have to enter EMU on the basis of sustainable and durable convergence.

Pensions

5.139 Many private pension payments are set at a fixed value – they are not adjusted automatically for inflation. This means that if prices rise quickly then the value of goods and services which can be purchased with a fixed pension would be eroded. The analysis in this assessment shows that UK inflation is likely to be more volatile in EMU. At times, price increases would be higher than expected, reducing the standard of living for pensioners. There would also be times when price increases would be lower than expected, which would benefit pensioners. But overall the environment would be one of greater uncertainty.

Conclusion: what would be the distributional impact of EMU on UK business sectors, nations and regions, and households?

5.140 EMU would have a differential impact on business sectors in the short term. Open and exchange rate sensitive industries, including many manufacturing industries, would feel the impact of EMU most directly, although all firms would be affected by improved access to capital which could facilitate expansion and restructuring. Increased competition would be particularly beneficial in many service sectors which have, to date, been less exposed to the effects of the Single Market than the goods sector. By removing a currency barrier to trade and potentially improving access to funding, EMU could be especially helpful to SMEs (though less so to micro-enterprises). At the opposite end of the size spectrum, EMU could also facilitate the development of multinational enterprises.

5.141 Regions with more firms in sectors affected by exchange rate volatility could see larger initial effects of EMU entry and regions with more cyclically-sensitive industries would be more vulnerable to increased instability arising from a lack of sustainable and durable convergence. But short-run differences would be expected to even out in the long term.

5.142 EMU could have long-term benefits for households, including potentially lower prices and higher wages. But this assessment finds that the achievement of sustainable and durable convergence between the UK and the euro area has not been demonstrated. Essentially this means that, at the present time, the UK economy would be more volatile in EMU. The impact of this on households would vary depending on their specific circumstances. Homeowners could be particularly affected by interest rates set at a level unsuitable for UK conditions. Workers in industries that are particularly vulnerable to economic conditions could face longer periods of unemployment. Pensioners would face greater uncertainty over the real value of their pensions.

GROWTH AND EMPLOYMENT IN EUROPE

A prosperous Europe is good for the UK

5.143 Growth and employment performance in Europe are central to the UK national economic interest. The EU is, and will remain, the UK's main trading partner. As a result, strong growth in Europe will bolster the performance of the UK economy. The Government is committed to the success of EMU, whether or not the UK joins.

5.144 As in the UK, the prospects for growth and employment in other European countries are heavily dependent on maintaining macroeconomic stability and promoting a dynamic and flexible economic environment in which competition, entrepreneurship, investment, skills and innovation enable the EU economies to raise productivity, employment and living standards.

Macroeconomic stability: a prerequisite for success…

5.145 The euro area macroeconomic policy framework assessed above provides for euro area price stability and sound public finances. Macroeconomic stability is a prerequisite for successful economic reform. The Government believes that in both the UK and the EU this can best be achieved through a framework that promotes constrained discretion – constraining policy to achieve long-term goals while providing short-term flexibility to respond optimally to unexpected events. The Government supports recent moves in this direction in the EU.

…together with sound structural policies

5.146 But macroeconomic stability is not enough. The employment and productivity performance of an economy largely reflect policies which encourage its citizens to work, save, invest and innovate. These are the policies that will provide European countries with the flexibility and the dynamism that will ultimately determine whether the euro area can fulfil its potential and match the economic performance of more dynamic counterparts such as the US. This point is stressed by Professor George Tavlas in his contribution to the EMU study *Submissions on EMU from leading academics*. He argues that, so far: "*The governments of the member states of EMU…have not completed the necessary structural reforms in labour, product, and financial markets…to allow monetary union to reach its growth potential.*"

5.147 For much of the past 50 years, the European economies have successfully maintained strong economic growth and high employment. But more recently they have not matched either the employment or productivity performance of the US.

European economic reform programme

5.148 Recognising this, EU leaders agreed an economic reform programme at the Lisbon European Council in 2000, committing themselves to the aim of making the EU: *"the most competitive and dynamic knowledge-based economy in the world, capable of sustaining economic growth with more and better jobs and greater social cohesion."* To achieve this aim, they agreed a common agenda for strengthening the Single Market and improving the efficiency of labour, capital and product markets. Successful implementation of the Lisbon strategy will also provide European economies with the flexibility needed to ensure economic success within EMU.

Box 5.9: Progress in key areas of the Lisbon agenda

In February 2003, the Government published *Meeting the Challenge: Economic Reform in Europe*, a report on progress made in key areas of the Lisbon agenda since it published the White Paper *Realising Europe's Potential* in February 2002. The report notes that there has been clear progress in recent years in some areas. For example:

- **employment**. The EU has created 5 million jobs since the beginning of 2000, taking the 2001 employment rate to 64.1 per cent;
- **EU regulatory environment**. Recent measures, including the Commission's Action Plan of June 2002, represent a major potential improvement in the way that the EU develops legislation;
- **cars block exemption**. New rules will, from October 2003, allow dealers of new cars to market their services freely throughout the EU;
- **research and innovation**. The 6th Community Research Framework Programme was adopted in June 2002. There is still a long way to go, but this should support a substantial increase in research activity;
- **communication**. Adoption of legislation forming the new regulatory framework for electronic communications and a new e-Europe 2005 Action Plan; and
- **energy liberalisation**. Member States have agreed to open fully electricity and gas markets to competition by 2007.

However, the effects of many of these policy moves have yet to come through and many markets still lack the flexibility to enable the full realisation of the potential gains from EMU. Employment and productivity continue to lag behind US levels in aggregate. Recognising the need for further work in its February 2003 report, the Government outlined ten key areas in which economic reform could provide significant and early benefits within the Lisbon agenda of increasing productivity and employment:

- modern social policies that promote skills, employment and labour market flexibility, in particular among older workers;
- promotion of entrepreneurship to create jobs across all ages and groups;
- better implementation and enforcement of better regulation;
- progress on, and implementation and enforcement of, the Financial Services Action Plan (FSAP) to deliver better access to low cost capital and greater choice;
- improved corporate governance;
- boosting the knowledge-based economy via an R&D framework which better promotes innovation, especially in clean technologies;
- stronger and more effective competition policy;
- a modernised state aid regime;
- a single market for services; and
- an effective regional policy which supports economic reform and addresses market failure.

5.149 The Government believes strongly that comprehensive reform of Europe's labour, product and capital markets is vitally important to deliver the dynamic Europe of full employment and social justice to which Europe is committed. In February 2002, the Government published a White Paper to support the Lisbon economic reform programme, *Realising Europe's Potential: Economic Reform in Europe*, followed by a progress report in February 2003, *Meeting the Challenge: Economic Reform in Europe*, summarised in Box 5.9. It also considered the EU's employment record in depth in *Towards Full Employment in the European Union*, July 2002.

5.150 Flexibility is central to ensuring that the European economy is able to attain the objectives that were agreed at Lisbon. Flexibility is important not only to enable regional and national economies to adjust to shocks, but also to allow them to realise their full productive potential. As discussed above, a lack of flexibility makes it harder to maintain full employment, particularly after a severe economic downturn. It contributes to high structural unemployment rates and weak consumer and investor confidence, leading to low growth of demand and output.

5.151 Implementation of the Lisbon agenda would go a long way to addressing these weaknesses. As the Prime Minister wrote in his foreword to the report *Meeting the Challenge: Economic Reform in Europe:*

> *"There remains a daunting amount to be done. But we Europeans need to do it if we are to compete in a globalised economy."*

5.152 If flexibility in the euro area takes time to increase, it is even more important that the UK economy should have a high level of flexibility to make a success of EMU membership.

5.153 Looking ahead, two other important developments will affect the strength and dynamism of the European economies in the years to come:

- **enlargement of the EU.** In 2004, ten new Member States are expected to join the EU, bringing in another 75 million citizens to create the world's largest single market. Productivity and employment in the new Member States are relatively low, implying potential for high growth as they integrate with and adopt the technologies used in the existing Member States; and

- the **rules governing economic policies** in the EU. Proposals currently being discussed at the European Convention will be important in shaping these and it is vital that these proposals promote flexibility and dynamism (see Box 5.10).

Box 5.10: The European Convention

The European Convention, headed by Valéry Giscard d'Estaing, is currently discussing a draft constitutional treaty for the EU. The constitutional treaty it proposes will need the unanimous agreement of all Member States in order to be introduced – like other Member States, the UK would have a veto at the Intergovernmental Conference that would ultimately decide.

The Convention is discussing the EU's competences, the powers of its institutions and its legislative procedures. It is not primarily concerned with the policies of the EU, including its economic policies. Nonetheless, some members of the Convention have proposed changes to the EU's system of economic governance including to:

- **the SGP and other aspects of the EU fiscal framework including surveillance;**
- **the institutional balance between the European Commission, the European Parliament and Member States in economic policy coordination, including for the BEPGs;**
- **the role of Eurogroup, the informal grouping of euro area finance ministers;**
- **the scope of the EU budget; and**
- **taxation and social policy.**

The Government is playing a full and active role in the Convention. The Government will support proposals that contribute to the dynamic and socially cohesive economy envisaged at Lisbon. The Government opposes proposals that would produce unwarranted constraints on the flexibility of labour, product and capital markets, and thereby undermine the success of EMU.

The Government's position is consistent with the 'open method of coordination' endorsed at Lisbon, which combines EU level agreement on guidelines and objectives with national determination of the policies most appropriate to realise them. The open method of coordination allows individual countries to address national concerns effectively and enables countries to learn from each other through periodic monitoring, evaluation and peer review of each country's performance.

Taxation and social policy

Competition where possible, coordination where necessary

5.154 Some argue that a successful single currency requires greater harmonisation of tax and social policies across Europe.[6] The UK Government disagrees, believing that this would not promote dynamism and flexibility. Its approach to tax policy within the EU can be summarised as competition where possible, coordination where necessary. This approach rests on three foundations:

- taxation is a matter for Member States, in keeping with the principle of subsidiarity. Tax is at the heart of economic policy, a key aspect of national sovereignty and a matter for national governments and parliaments;
- tax reform should promote wider economic reform and not create additional barriers to trade; and

[6] Including Professor Paul Masson in his contribution to the EMU study *Submissions on EMU from leading academics*.

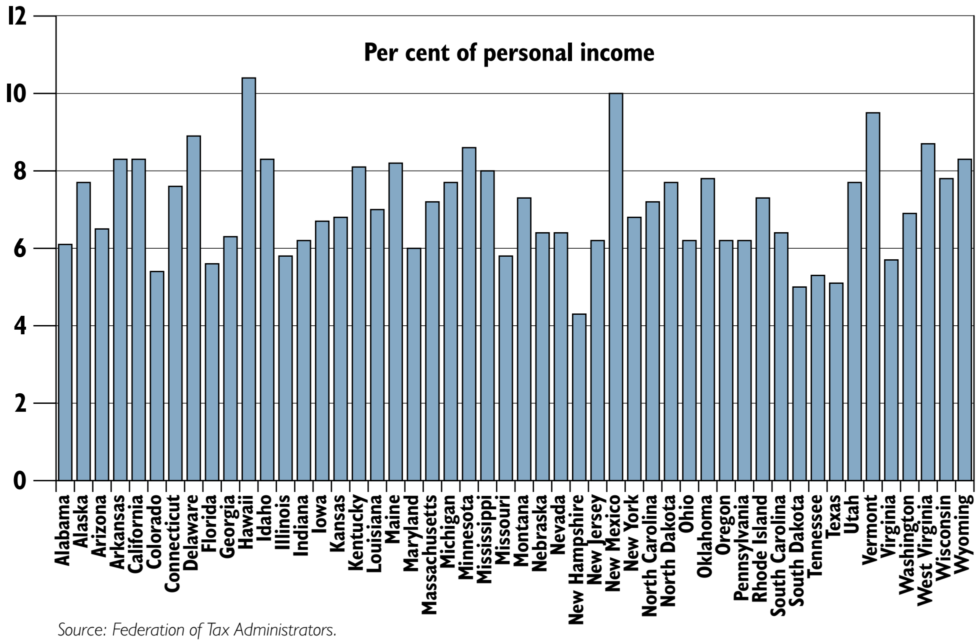
- the economic priority for Europe is reform to promote growth, prosperity, jobs and social inclusion. Any proposals on tax must be, and must be seen to be, consistent with this agenda.

5.155 The Government therefore opposes unnecessary tax harmonisation which would constrain Member States' economic success. It does not accept that tax harmonisation is an inevitable consequence of EMU. EMU does not require, either in principle or in practice, the harmonisation of direct taxation. Indeed, countries inside a monetary union might need fewer rather than more constraints on variations in their individual tax rates and bases in order to aid adjustment to country-specific shocks.

Taxation in US states

5.156 The Government's approach is supported by the experience of the US, described in the EMU study *The United States as a monetary union*. US states have a wide variation of taxation rates (see Chart 5.9), reflecting different preferences and economic conditions. The US has functioned very effectively as a monetary union while maintaining a high dispersion of tax rates and tax takes. There is no reason to believe that a single currency requires tax harmonisation. 'Harmful' tax competition is best tackled by improving the flow of information between tax authorities, not by harmonising tax rates.

Chart 5.9: State tax revenues in the US, 2001



Source: Federation of Tax Administrators.

Treaty position

5.157 The EC Treaty makes EU initiatives on tax a matter for unanimous agreement of all Member States. While some contributors to the European Convention debate have argued that tax legislation should be possible when supported by a qualified majority of Member States, the UK Government, like a number of other Member States, does not share this view, believing that this could harm legitimacy and national autonomy. Any changes to the Treaty provisions would require unanimous agreement of Member States, meaning that the UK is able to veto any unwarranted moves towards greater tax harmonisation.

5.158 The Government is committed to maintaining national control over tax policy and rejects the claim that increased tax harmonisation is a necessary consequence of participation in the single currency. In an increasingly global economy, fair tax competition, coupled with effective action to combat harmful tax competition, is key to promoting the competitiveness of the EU, while allowing governments to respond to national preferences.

Social policy

5.159 The Government adopts a similar approach to social policies. It is committed to ensuring decent minimum standards for employees while providing a safety net of support for those who are unable to work. However, the Government rejects the view that harmonisation of social policies is necessary. The combination of different national circumstances, and different strengths and weaknesses, means that there is no single blueprint or EU 'social model' for delivering shared EU objectives. Member States must identify and address their policy priorities in the light of their own circumstances and preferences. Harmonisation tends, in this context, to be an overly blunt tool and a more tailored response will often be more appropriate. This position is independent of the question of UK membership of the single currency.

Treaty position

5.160 Under Article 137 of the EU Treaty, the EU can adopt minimum standards in various social policy areas. These minimum standards then become binding across the Union, for EMU and non-EMU members. In some fields, decision-making is by qualified majority voting, in others by unanimity. UK membership of EMU would not have any impact on the situation in this respect.

Conclusion: what do prospective developments in Europe imply for growth, stability and employment?

5.161 The Government places great importance on developing the economic reform programme to encourage flexibility and dynamism across the EU. This entails providing maximum scope for countries and regions to develop their own approaches to economic policy, provided that these do not obstruct the functioning of the Single Market. Free and fair competition encourages trade, stimulates productivity and enables the countries of the EU to progress more rapidly together than they could apart.

Stability in Europe – policy frameworks

5.162 Many of the issues being considered in the European Convention could have far-reaching consequences for the future performance of EU economies, whether they are part of the euro area or not. The Government will continue to work with other European countries to ensure outcomes that will bolster stability and enhance the ability of European economies to raise productivity and employment levels. It will oppose proposals that would lead to unnecessary rigidities.

CONCLUSIONS: THE GROWTH, STABILITY AND EMPLOYMENT TEST

5.163 EMU membership could enhance productivity in the medium term by increasing trade and investment and by stimulating competition. It could also help to promote economic reform in the EU and encourage specialisation in the longer term. Therefore, EMU could potentially have an effect on all five of the key drivers of productivity. Based on broad-based evidence on the impact of trade, it seems reasonable to assume that each 1 percentage point increase in the ratio of trade to GDP increases real GDP per head by at least $^1/_3$ per cent in the long run and perhaps by as much as $^2/_3$ per cent. In a best case scenario, with stability assured through the achievement of sustainable and durable convergence, a long-term increase in trade with the euro area at the top of the 5 to 50 per cent range and increased investment spurring competition, UK output could be around 9 per cent higher over 30 years within a successful EMU than outside. This could add around $^1/_4$ percentage point a year to GDP growth.

5.164 This is conditional on the achievement of sustainable and durable convergence between the UK and the euro area. In the circumstances where it is not assured, the trade benefits from EMU would be likely to be at the lower end of the range. This means that the potential gains to trade and competition from EMU membership could be negligible even over the long term. However, initial estimates suggest that although there is a lack of flexibility and convergence in some euro area countries, EMU has increased trade within the euro area by between 3 and 20 per cent since 1999. In practice, additional volatility and uncertainty resulting from EMU membership in the absence of sustainable and durable convergence could have a negative impact on the actual level of UK output in the long term.

5.165 The potential effects of EMU would be greater on productivity than on employment, but both could be affected by any increase in volatility. Without sustainable and durable convergence between the UK and the euro area, EMU membership could increase the cyclical volatility of employment in the UK. It is harder for the labour market to adjust to large increases in unemployment than small ones, so the risk of less stability in output and employment would entail an increased risk of higher structural unemployment in the UK. These risks would be reduced if sustainable and durable convergence were assured, in which case the UK would be able to reap the potential employment benefits of EMU membership.

5.166 Whatever the degree of sustainable and durable convergence, any risks to the UK of EMU entry could be compounded by the ECB's inflation objective and by a rigid and overly mechanistic interpretation of the SGP. The Government will continue to work with other European countries in the development of the macroeconomic policy framework to minimise these risks to the UK and to existing EMU members.

5.167 EMU would have a differential impact on business sectors in the short term. Open and exchange rate sensitive industries, including many manufacturing industries, would feel the impact of EMU most directly, although all firms would be affected by improved access to capital which could facilitate expansion and restructuring. Increased competition would be particularly beneficial in many service sectors which have, to date, been less exposed to the effects of the Single Market than the goods sector. By removing a currency barrier to trade and potentially improving access to funding, EMU could be especially helpful to SMEs (though less so to micro-enterprises). At the opposite end of the size spectrum, EMU could also facilitate the development of multinational enterprises.

5.168 Regions with more firms in sectors affected by exchange rate volatility could see larger initial effects of EMU entry and regions with more cyclically-sensitive industries would be more vulnerable to increased instability arising from a lack of sustainable and durable convergence. But short-run differences would be expected to even out in the long term.

5.169 EMU could have long-term benefits for households, including potentially lower prices and higher wages. But this assessment finds that the achievement of sustainable and durable convergence between the UK and the euro area has not been demonstrated. Essentially this means that, at the present time, the UK economy would be more volatile in EMU. The impact of this on households would vary depending on their specific circumstances. Homeowners could be particularly affected by interest rates set at a level unsuitable for UK conditions. Workers in industries that are particularly vulnerable to economic conditions could face longer periods of unemployment. Pensioners would face greater uncertainty over the real value of their pensions.

5.170 The Government places great importance on developing the economic reform programme to encourage flexibility and dynamism across the EU. This entails providing maximum scope for countries and regions to develop their own approaches to economic policy, provided that these do not obstruct the functioning of the Single Market. Free and fair competition encourages trade, stimulates productivity and enables the countries of the EU to progress more rapidly together than they could apart.

Overall conclusion

5.171 EMU membership could significantly raise UK output and lead to a lasting increase in jobs in the long term. As noted above, the assessment shows that intra-euro area trade has increased strongly in recent years as a result of EMU, perhaps by as much as 3 to 20 per cent; that the UK could enjoy a significant boost to trade with the euro area of up to 50 per cent over 30 years; and that UK national income could rise over a 30-year period by between 5 and 9 per cent. A 9 per cent increase in national income would translate into a boost to potential output of around $^1/_4$ percentage point a year, sustained over a 30-year period. Despite the progress made since 1997, the lack of sustainable and durable convergence means that, for the UK, macroeconomic stability would be harder to maintain inside EMU than outside, were the UK to make a decision to join at the present time. The potential uncertainty created by the price stability objective of the ECB and the potential constraints on the use of fiscal policy for stabilisation under the current interpretation of the SGP increase the chances that output and employment would be less stable inside EMU. The Government supports the direction in which the EU macroeconomic framework is evolving. Enhancing the flexibility and dynamism of the European economy, building on the achievements of the economic reform programme agreed at Lisbon, will also be important if the full benefits of EMU are to be realised. Entering EMU on the basis of sustainable and durable convergence is essential so that the UK can benefit from the substantial increases in cross-border trade, investment, competition and productivity that EMU could provide. Lower prices would lead to a lower cost of living, a key potential benefit of EMU entry for households, but one that would only accrue if entry were on the basis of sustainable and durable convergence. Poorer households tend to spend a greater proportion of their income on goods and services, so lower prices could benefit such households relatively more than wealthier ones. Overall, we can be confident that the growth, stability and employment test would be met once sustainable and durable convergence has been achieved.

Policy requirements

5.172 In terms of macroeconomic policy, the Government's announcement of its intention in the next Pre-Budget Report to give the Bank of England a symmetric inflation target as measured by the Harmonised Index of Consumer Prices will improve the quality of the UK inflation target and will also help ensure inflation expectations in the UK remain in line with those of the euro area.

5.173 The conclusions to the assessment of the flexibility test set out the Government's wide-ranging agenda for enhancing flexibility in the UK and EU to deliver high and stable levels of UK employment.

5.174 The Government will continue to pursue its wide-ranging strategy to tackle the barriers to productivity growth and close the productivity gap. This involves continued microeconomic reform in the UK to target the five key drivers of productivity, combined with support at the European level for policies to strengthen competition and the Single Market.

Stability in Europe – policy frameworks

5.175 In its May 2003 review of monetary policy strategy, the ECB restated that: "*Price stability is defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. Price stability is to be maintained over the medium term*". The ECB review went on to state that: "*At the same time, the Governing Council agreed that in the pursuit of price stability it will aim to maintain inflation rates close to 2% over the medium term*". At the present time, the potential for uncertainty that the ECB's inflation objective creates could produce deflationary risks in certain countries, although the fact that, to date, euro area inflation has averaged 2 per cent suggests that in practice this risk has not materialised.

5.176 At the EU level, the Government supports the direction in which the EU fiscal framework is evolving. In the ongoing debate on the interpretation of the SGP, the Government's approach will be to emphasise the significance of the economic cycle, sustainability and low debt, and the important role the Maastricht Treaty gives to public investment and the implications of this prudent approach for the interpretation of what are *'exceptional and temporary'* circumstances in relation to the 3 per cent reference value, for countries with low levels of debt.

5.177 Many of the issues being considered in the European Convention could have far-reaching consequences for the future performance of EU economies, whether they are part of the euro area or not. The Government will continue to work with other European countries to ensure outcomes that will bolster stability and enhance the ability of European economies to raise productivity and employment levels. It will oppose proposals that would lead to unnecessary rigidities.

5.178 Although ECOFIN remains the decision-making body for the EU in economic and financial policy, in EMU the UK would be a member of and attend all – and not some – meetings of the Eurogroup, thereby participating fully in euro area decision making.