

### **If problems emerge is there sufficient flexibility to deal with them?**

The assessment of the flexibility test is key to the overall assessment of the five tests. Flexibility is the ability to respond to economic change efficiently and quickly while safeguarding fairness. Sufficient flexibility ensures that shocks do not have long-lasting effects and that high levels of output and employment are maintained. Flexibility ensures convergence is  *durable*. The 1997 assessment judged that the UK and EU as a whole needed to develop more flexibility, particularly in labour markets. This is why the UK Government has been at the forefront of promoting flexibility in both the UK and EU. Flexibility is now recognised as being even more important than it was in 1997.

If there were a high degree of convergence, then the degree of UK flexibility required, though still high, would be less. But the assessment of the convergence test is that there is not this degree of settled and sustainable convergence.

#### **Key points:**

- Inside EMU, loss of national monetary policy and the nominal sterling-euro exchange rate means that other adjustment mechanisms would have to work harder. Wage and price adjustment are the most effective adjustment mechanisms available, but there is also a potentially enhanced role for fiscal policy. National monetary unions, including the UK, have been successful without high internal mobility.
- UK labour market flexibility has improved markedly since 1997. Significant falls in overall unemployment and long-term unemployment have accompanied strong employment growth giving the UK one of the lowest levels of unemployment in the OECD, lower even than the US. The 1997 assessment observed that the UK already had a relatively high degree of employment flexibility. This has been maintained, as demonstrated by a high incidence of part-time employment and flexible working practices. Moreover, evidence since 1997 points to an underlying improvement in wage flexibility. However, important challenges remain in the UK to reduce inactivity and repeated spells of worklessness and to enhance skill levels and improve mobility. Adjustment mechanisms have not been fully tested in recent years as the UK has had a relatively stable macroeconomic environment. If the UK decided to join EMU, wage movements would need to play a greater role in adjustment.
- EMU membership puts a premium on the need for institutional structures to cope with shocks. Therefore, while the positive reforms to the institutional and policy framework in the UK suggest that recent improvements can be sustained, more progress on labour market reform would enhance flexibility in the UK and advance the Government's long-term goal of employment opportunities for all. In the context of EMU, it would also increase the durability of convergence between the UK and the euro area.
- A decision to join EMU would increase the need for rapid price movements and would also make it necessary for firms to be able to respond effectively to shocks and adapt to the competitive opportunities that the single currency will bring. The UK has a reasonable degree of price flexibility with relative prices both rising and falling within the overall inflation aggregate. Moreover, the UK generally exhibits a competitive business environment and the Government is committed to further sharpening competition forces and improving opportunities for entrepreneurship in all areas of the community. Since the 1997 assessment there has been much effort to promote competition at the EU level. Despite progress, the degree of competition and market flexibility falls short of what might be achievable as measured by the US.
- Capital markets play an important role in stabilising the impact of shocks between regions in the US, facilitated by highly integrated financial markets. Although cross-border risk sharing is not significant in Europe at present, greater financial market integration would enhance the scope for risk sharing across the EU, and bolster its role as an adjustment mechanism.

- The experiences of EMU members to date illustrate the role that adjustment mechanisms can play, in particular regarding the implications of inflation differences within EMU. There are some signs that EMU membership has facilitated euro area wage flexibility. As a large monetary union with a high degree of diversity between states, the US also shows the importance of a high degree of market flexibility and capital market integration.
- Fiscal policy has the potential to support market adjustment mechanisms inside EMU. But enhanced stabilisation mechanisms would need to meet a range of criteria to ensure their worth and be implemented when the understanding of the mechanisms by which fiscal policy affects the real economy has increased.

**The overall conclusion of the flexibility test is:**

- UK labour market flexibility has improved markedly since 1997. Significant falls in unemployment have accompanied strong employment growth giving the UK one of the lowest levels of unemployment in the OECD, lower even than in the US. While considerable progress has been made to reform labour, product and capital markets in the UK and the euro area, more can be done to ensure the UK economy is resilient to deal with the risks identified in the convergence test and the challenges of EMU membership. Inflation volatility is very likely to increase inside EMU. Greater flexibility in the UK and throughout the euro area would minimise output and employment instability, helping to ensure convergence was durable and that the potential benefits of EMU could be fully realised. This underlines the importance of maintaining progress on a range of economic reform policies to enhance flexibility and resilience to shocks, particularly in labour markets. The less progress on flexibility that is achieved in the EU, the greater the premium on a high level of flexibility in the UK economy. Overall, at the present time, we cannot be confident that UK flexibility, while improved, is sufficient. Reflecting this, at the present time, the achievement of sustainable and durable convergence has not been demonstrated. But increased flexibility through the measures we set out will help to provide greater reassurance that the economy can meet the additional demands that EMU membership would pose and contribute to achieving sustainable and durable convergence.

**Policy requirements:**

- Flexibility, the ability to respond to economic change efficiently and quickly in a way that maintains high employment, low inflation and unemployment, and continued growth in real incomes, ensures convergence is durable. Sufficient flexibility ensures shocks do not have long-lasting effects and that high levels of output and employment are maintained.
- In the labour market, the Government is continually working to enhance flexibility and is going further through a package of measures designed to increase wage flexibility in the public sector, improve skills, particularly at the basic and intermediate level, give greater local discretion in the delivery of employment policies and increase labour supply by helping more people to move from welfare to work and increasing cyclical economic migration.
- In the product market, the Government has announced the full independence of the UK competition authorities and is going further to enhance competition in specific markets, reform the planning system to make it work more efficiently and introduce a package of deregulatory reforms to ease the burden of regulation on small business.
- In the capital market, the Government will increase flexibility through reforms to improve access to finance for small enterprises with high growth potential and consultation on further reform to the corporation tax system.
- The degree of fiscal stabilisation may need to increase inside EMU where the absence of a UK-specific monetary policy may cause the degree of macroeconomic volatility to increase. The Treasury discussion paper *Fiscal stabilisation and EMU* explores a number of policy options to make discretionary fiscal policy more effective for stabilisation purposes and strengthen the automatic stabilisers. The paper

considers the reforms to the institutional framework that EMU membership would require to ensure an enhanced fiscal stabilisation policy operates symmetrically, credibly and transparently and which policy levers are likely to prove most effective.

- Credible policy options include a new symmetrical fiscal rule to trigger the Government to consider taking action, publishing a Stabilisation Report to enhance transparency, increasing the role of independent audit and specific fiscal instruments that could be used for stabilisation purposes. The Treasury will conduct further analysis into these issues to ensure that the policy proposals deliver effective counter-cyclical stabilisation of the economy were the UK to join EMU.

#### Stability in Europe - policy frameworks:

- All European countries have embarked on an ambitious programme to reform labour, product and capital markets and the Government supports policies to strengthen competition in the EU and the Single Market. However, it is important to make more progress at the European level, in particular on employment flexibility, trade and the Single Market in financial services. The less progress on flexibility that is achieved in the EU, the greater the premium on a high level of flexibility in the UK economy.

## THE IMPORTANCE OF FLEXIBILITY

**The flexibility test** 2.1 Flexibility is the ability to respond to economic change efficiently and quickly while safeguarding fairness. Changes include the impact of innovation and changing technology, shifts in consumer preferences and external shocks to the UK economy, such as the recent global slowdown. A high degree of flexibility means that the UK will be resilient in the face of such shocks and will minimise costs in terms of lost output and jobs. The central question in this test is, were the UK to enter EMU:

*If problems emerge is there sufficient flexibility to deal with them?*

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

2.3 Flexibility matters whether or not the UK joins EMU. It ensures that the UK is able to make the most of trade and investment opportunities and new technologies. It also means that, within the UK, regions have the ability to adjust to meet changing and differing needs at the local level. Flexibility is also important in ensuring the Government meets its objective of achieving high and stable levels of growth and employment.

2.4 But flexibility would be particularly important if the UK joined the single currency. As noted by the Chancellor in a recent speech:<sup>1</sup>

*“Indeed in a single currency area where the old flexibilities to adjust exchange rates and interest rates are no longer available at a national level, labour, product and capital market flexibilities are even more essential. Adjusting to shocks without putting at risk high and stable levels of growth and employment demands even greater market flexibility.”*

<sup>1</sup> ‘The Road to Full Employment: Economic Reforms for a More Flexible and Dynamic Britain and Europe’, speech by the Chancellor of the Exchequer to the Centre for European Reform, 10 March 2003.

**2.5** The experience of EMU to date shows that, in order to make a success of the single currency, countries need even more resilience to unexpected events since the ability to vary national interest rates and the nominal exchange rate between euro area countries no longer exists. As the test highlights, it is crucial to the membership decision that the UK economy has *sufficient* flexibility to deal with problems that might emerge in EMU. Sufficient flexibility means a high level of flexibility, both for existing members of EMU but also for countries which wish to join.

**2.6** A successful single currency within a successful single market is of benefit to Europe. A recent Treasury paper<sup>2</sup> makes clear that EMU membership puts a premium on ongoing reform of EU labour, product and capital markets, delivered through the Lisbon agenda. The Government will continue to argue that employability, flexibility and stronger competition policies must be a top priority, so that EMU can be a sustained success. This will be particularly important as EMU expands to take in the new Member States joining the EU in 2004.

**The 1997  
assessment**

**2.7** The 1997 assessment judged that the UK did not yet have sufficient flexibility to cope with the challenges of monetary union and to compensate for the lack of convergence. In particular, the 1997 assessment noted that the UK and EU labour markets needed greater flexibility. Entry in these circumstances – without sufficient flexibility – would have been extremely costly, as demonstrated in the ‘what if’ exercise described in the Introduction. A key lesson from this is that flexibility would also be important for the transition to EMU. The impact of entry would be less likely to feed through to the real economy if there were sufficient flexibility.

**The 2003  
assessment**

**2.8** The assessment of the convergence test has concluded that a high degree of settled and sustainable convergence has still not been achieved. The key question for the flexibility test, therefore, is whether there is a sufficient degree of flexibility to compensate for this and minimise the risks of entering EMU on this basis. Flexibility is now recognised as being even more important than it was at the time of the 1997 assessment, reflecting the challenges of the global economy and the increased demands that EMU membership would make on the UK economy.

**Convergence and  
flexibility...**

**2.9** Even if cycles and structures had been assessed in the convergence test to be compatible, there would still be times when the UK would be more likely to experience different shocks – or different transmission of common shocks – to the euro area.

**2.10** As flexibility relates to the resilience of the economy and its ability to adjust rapidly while minimising disruption, it determines the *durability* of convergence. Consequently, the convergence and flexibility tests together determine whether there is **sustainable and durable convergence** between the UK and the euro area. As emphasised in the Introduction, sustainable and durable convergence is a precondition for realising the potential benefits of EMU membership for the UK.

**...and the  
growth, stability  
and employment  
test**

**2.11** High levels of flexibility will mean that workers and firms are able to take advantage of the opportunities that EMU membership would offer. Flexibility complements and supports productivity, particularly in supporting the key drivers of productivity through skills, competition, enterprise and innovation, and is a key element in the assessment of the fifth test on growth, stability and employment. The assessment of the fifth test also considers the broader issue of the impact of the UK decision on EMU on employment levels.

<sup>2</sup>Meeting the Challenge: Economic Reform in Europe, HM Treasury, February 2003.

### Structure of the test 2.12

The assessment of the flexibility test considers the following key issues and questions:

- **Flexibility and adjustment mechanisms in EMU** answers the questions: **How would adjustment differ inside EMU? Which types of flexibility matter? How much flexibility is needed in principle? How might joining EMU affect overall stability?**

The section considers how joining EMU might change adjustment to shocks and what types of flexibility would be most important inside EMU. The implications of different degrees of flexibility and how EMU might impact on macroeconomic stability are also considered. It draws on the EMU study *Modelling shocks and adjustment mechanisms in EMU* and the analysis in the EMU study *The exchange rate and macroeconomic adjustment*.

- **Market flexibility** answers the question: **How flexible are UK and euro area labour, product and capital markets?**

Flexibility in all three markets is assessed with a focus on the types of adjustment most important inside EMU: wages for labour markets; prices for product markets; and risk sharing for capital markets. The framework adopted ensures a structured assessment, not just of flexibility in individual markets and regions, but also of how markets can interact and evolve and what this implies for the priorities for making a success of EMU. The assessment draws on the EMU studies *EMU and labour market flexibility*, *Prices and EMU* and *EMU and the cost of capital*.

- **How flexibility and adjustment works in practice** answers the question: **How much adjustment and flexibility is experienced in practice in monetary unions?**

This section considers how existing monetary unions such as the US and UK adjust in practice, and also examines the experience of euro area countries since 1999. Evidence on how the US adjusts in practice draws on the EMU study *The United States as a monetary union*.

- **The potential for fiscal flexibility** answers the question: **What role does fiscal policy play in adjusting to shocks and might this be enhanced inside EMU?**

Fiscal policy is an important tool available to policymakers within a monetary union. The fiscal policy section is informed by the Treasury discussion paper *Fiscal stabilisation and EMU*.

- The **Conclusions** assess the evidence on different forms of flexibility to answer the question: **Is the degree of flexibility sufficient for the flexibility test to be met?**

These conclusions go on to address the question of whether the assessment of the convergence and flexibility tests together show that the achievement of sustainable and durable convergence has been demonstrated.

## FLEXIBILITY AND ADJUSTMENT MECHANISMS IN EMU

**2.13** This section develops important insights which frame the subsequent assessment of the flexibility test. It draws on the EMU study *Modelling shocks and adjustment mechanisms in EMU* and the analysis in the EMU study *The exchange rate and macroeconomic adjustment*. The section considers four questions:

- how would adjustment differ inside EMU?
- which types of flexibility matter?
- how much flexibility is needed in principle?
- how might joining EMU affect overall stability?

### How would adjustment differ inside EMU?

**2.14** The economy continually needs to adjust to changing circumstances, affecting the competitiveness and profitability of the goods and services that it produces. The UK has experienced a number of such disturbances or shocks in recent years. Some are specific to parts of the UK, such as the foot and mouth crisis in early 2001. Others affect the UK as a whole, for example the strong rise in consumer spending in the late 1980s caused by financial market liberalisation. And others are global in nature, such as the ICT boom in the late 1990s and the heightened uncertainty following the recent global slowdown.

**Flexibility ensures prompt adjustment to shocks**

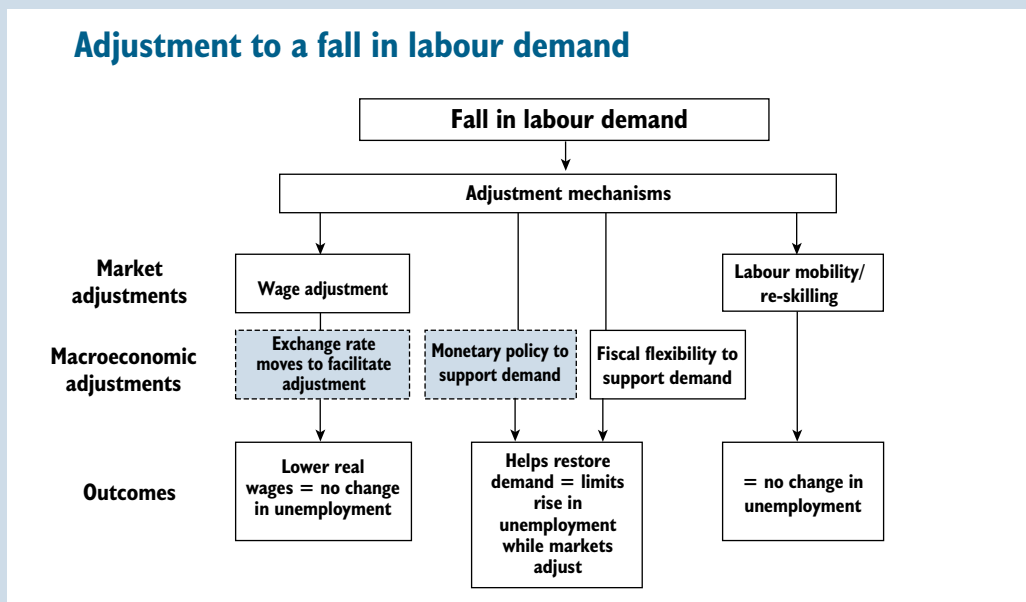
**2.15** In or out of EMU, economic flexibility determines how costly adjustment to such shocks is likely to be in terms of unnecessary disruption to the real economy. In a flexible economy, rapid market adjustment, supplemented if necessary by effective policy action, ensures that any adverse impact is minimised. In an inflexible economy, little or no adjustment will cause disruption to the real economy. For example, if the UK economy were to experience a fall in demand for its exports, the resulting fall in the demand for labour would lead to higher unemployment. If workers find it difficult to re-enter the workforce, unemployment might stay higher for some time. There could therefore be a more sustained impact on the economy which, in the worst case, could have permanent effects.

**2.16** Determining which aspects of flexibility matter most for a monetary union requires an understanding of how an economy adjusts to shocks in general inside and outside EMU. Box 2.1 illustrates, in a simplified form, how the UK economy might respond to the case, already highlighted, of a fall in external demand for UK export products. Possible adjustment channels include market adjustment, such as wage movements or labour mobility, and policy adjustment including monetary and fiscal policy and movements in the exchange rate.

**2.17** In comparing how the economy adjusts inside EMU compared to outside, the key difference is that interest rates can no longer be set for national circumstances and the nominal sterling-euro exchange rate can no longer move to facilitate adjustment. Removal of these adjustment mechanisms means that the remaining ones have to work harder. If there is little or no flexibility, and therefore little or no adjustment, unemployment will rise.

**Box 2.1: Adjustment mechanisms inside and outside EMU**

The diagram below steps through the possible responses to a shock that causes a fall in the demand for UK export products and leads to a fall in the demand for labour in the UK. The shaded boxes indicate adjustment mechanisms that would not be present inside EMU.



There are a number of potential adjustment routes:

- real wages (money wages adjusted for inflation) could fall to help restore labour demand;
- outside EMU, the nominal exchange rate with the euro area could fall, making UK exports more competitive and facilitating real wage adjustment;
- displaced labour could move to a different region or another country, or workers might re-skill to enable them to move to other industries; and
- fiscal policy and, outside EMU, independent monetary policy, could be eased to support domestic demand.

Inside EMU, the key difference is that interest rates can no longer be set for national circumstances and the nominal sterling-euro exchange rate can no longer move to facilitate adjustment. Inside or outside EMU, an inflexible economy will experience a rise in unemployment.

**Adjustments to a common shock do not differ...**

**2.18** Loss of these adjustment mechanisms inside EMU would not be a matter of concern if a shock affected the UK and the euro area equally and if the UK and the euro area had broadly similar responses to interest rate changes. In this case, the ECB's interest rate response would be the same as that of the Bank of England if the UK were outside EMU, and the sterling-euro exchange rate would not need to adjust in response to the shock. So changes in inflation and output in the UK would be broadly similar whether inside or outside EMU.

**...but they do to a UK specific shock**

**2.19** But in the face of a shock specific to the UK, the situation is different. Box 2.2 explains this in more detail, focusing on the case of a temporary positive shock to UK demand, based on analysis in the EMU study *Modelling shocks and adjustment mechanisms in EMU*.

**2.20** The different way that the economy responds to this (or any country-specific) shock inside and outside EMU importantly depends on the role of the interest rate and the exchange rate in helping the economy to adjust.

**Outside EMU...** **2.21** Outside EMU with an independent monetary policy and nominal sterling-euro exchange rate:

- interest rates could be raised to moderate demand in the UK economy; and
- the nominal sterling-euro exchange rate could appreciate, increasing the price of UK exports and lowering the competitiveness of the UK economy vis-à-vis euro area countries, measured by the real exchange rate.

**2.22** Together, these two key channels would help to ensure that inflation remained close to target and output returned to trend.

**...and inside EMU** **2.23** Inside EMU, the adjustment path to a country-specific demand shock (for example, of the sort that might originate in the UK housing market) is very different. The example in Box 2.2 reinforces many of the lessons from the decision not to join EMU in 1999, highlighted in the Introduction:

- interest rates no longer play a primary adjustment role. In fact, because inflation rises due to strong demand, real interest rates actually fall significantly, exacerbating inflationary pressures and destabilising the economy;
- the nominal sterling-euro exchange rate is fixed but the real exchange rate still adjusts through price and wage movements, although this now happens much more slowly. This becomes the primary market adjustment mechanism inside EMU;
- moreover, inside EMU the euro area price level, rather than the UK price level, now effectively acts as a nominal anchor for the UK price level, with only a small degree of slippage allowed. Any period of high inflation in the UK relative to the euro area must be followed by a period of lower inflation in the UK relative to the euro area. Unless prices are completely flexible, this requires a period of UK output falling below potential; and
- since the adjustment mechanisms inside EMU are less effective, and in the absence of anything less than complete price flexibility, the responses of inflation and output to shocks are more protracted and volatile with adverse consequences for growth and employment.

**2.24** However, it is important not to exaggerate the role that an independent monetary policy can play in helping the economy to adjust. Permanent shocks to demand or supply reflecting a change in economic fundamentals require structural changes or permanent shifts in relative prices whether the UK is inside or outside EMU. An increase in interest rates or an appreciation of the nominal exchange rate can only support the adjustment process. Neither can shocks that require adjustment between regions or industries within the UK be helped by an independent monetary policy.

**2.25** It is also important to emphasise that medium-term inflation in the UK would still be guaranteed by the price stability objective of the ECB. But the inflation paths are likely to be very different inside and outside EMU. Outside EMU, price levels between the UK and the euro area can diverge in principle for sustained periods. Inside EMU, UK prices would be anchored by the price level in the euro area, with little scope for slippage.<sup>3</sup>

<sup>3</sup> For a very small EMU member which comprises a negligible share of EMU output, this response to a country-specific shock is strongly analogous to price level targeting.

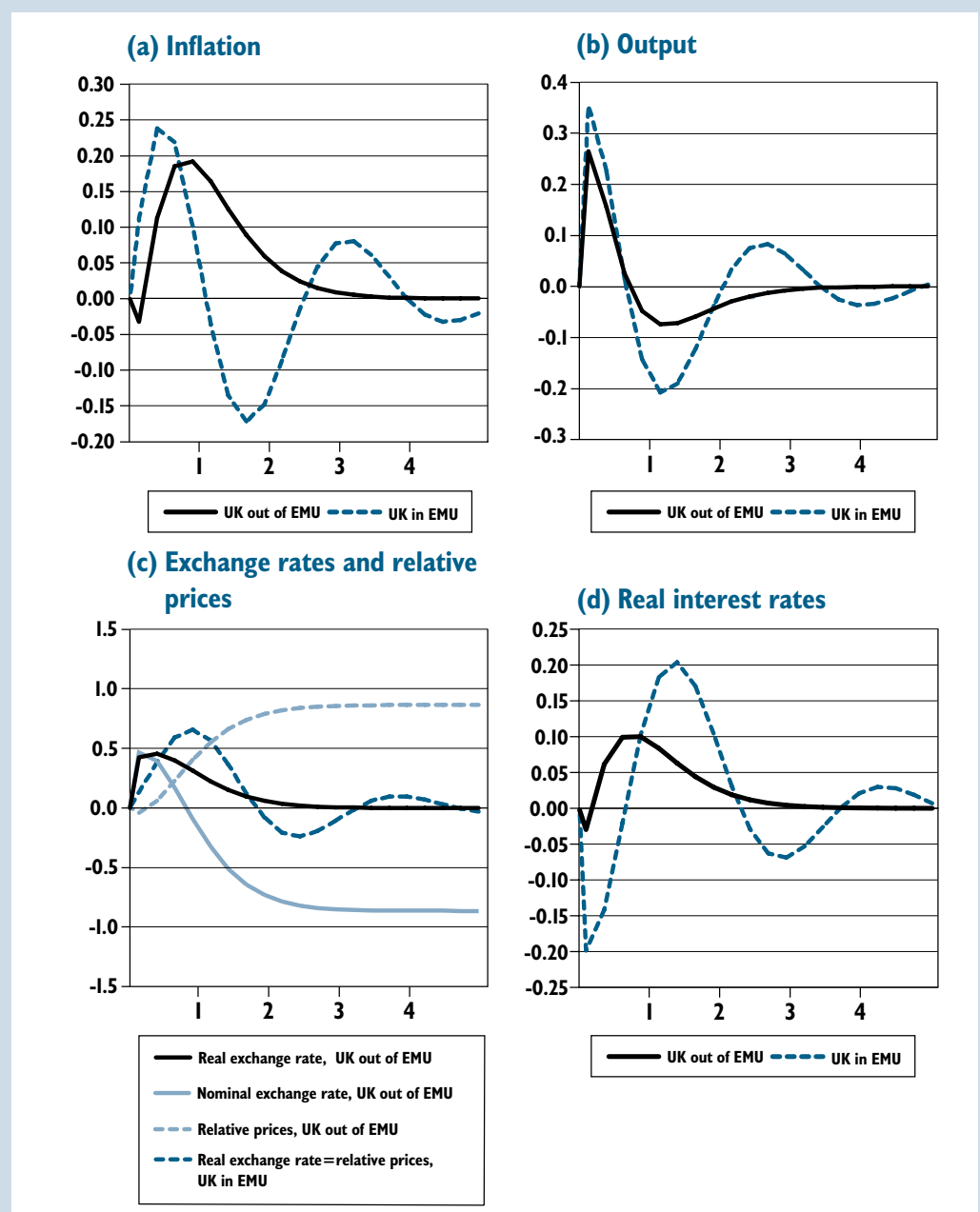
### Box 2.2: Adjustment to a temporary positive demand shock

Charts (a)-(d) illustrate the responses of the UK economy in the years following a temporary positive demand shock.<sup>a</sup> The immediate effect is that UK output rises above potential – both inside and outside EMU (see Chart (b) below).

Outside EMU, when output rises above trend, the UK inflation rate increases in response and the Bank of England reacts by increasing interest rates. Two key adjustment mechanisms act to help return inflation to target:

- a rise in the real interest rate; and
- a rise in the nominal and real sterling-euro exchange rate.

As a result of this adjustment, the UK price level is permanently higher, offset by a permanently lower nominal exchange rate. This is termed price level slippage (see Chart (c)).



**Inside EMU, the adjustment is very different. The ECB also responds to the demand shock in the UK, but now only to the extent that it affects euro area-wide inflation (the UK weight would be roughly one fifth). But neither of the key adjustment mechanisms already highlighted work in the same way inside EMU:**

- **real interest rates will initially fall rather than rise, potentially exacerbating the adjustment process (see the dashed line in Chart (d)); and**
- **the real exchange rate appreciates but more slowly than when the nominal exchange rate was available, relying entirely on relative prices to take on the burden of adjustment.**

**Without the initial restraint from real interest rates or the nominal exchange rate appreciation, UK inflation initially rises more strongly. This generates a bigger but later real exchange rate appreciation. However, inside EMU, the euro area price level now effectively acts as an anchor for the UK price level.<sup>b</sup> So the period of high inflation in the UK must be followed by a period of low inflation relative to the euro area. In the model this is achieved by a period where UK output is below potential. Overall, this process makes the adjustment path of inflation more cyclical and protracted.**

**The later discussion in this chapter clarifies how the degree of price flexibility in the UK, both in absolute terms and relative to the euro area, has implications for the degree of inflation and output volatility.**

<sup>a</sup> These simulation responses are run on the stylised model of the UK and euro area economies described in the EMU study *Modelling shocks and adjustment mechanisms in EMU*. The variables are plotted in terms of percentage difference from base except for inflation and interest rates which are defined in terms of percentage points relative to base.

<sup>b</sup> Although the anchor would slip to the extent that UK prices affect prices in the extended euro area including the UK, where the UK would account for around one fifth of GDP.

## Which types of flexibility matter?

**2.26** These findings highlight the importance of wage and price flexibility in EMU, especially for shocks that require an adjustment in the relative price level between the UK and other countries. Wage and price flexibility are also important in facilitating adjustment within the UK.

**2.27** The degree of wage and price adjustment needed to respond to a shock depends on how easy it is for workers to move between different types of employment and between different locations. For example, a worker with transferable skills will be able to move easily from one job to another. Price and wage adjustment could also be less if businesses were able to create jobs easily when there is excess labour supply. Equipping the workforce with appropriate skills and facilitating entrepreneurship allows for a flexible redeployment of labour and capital in response to changing market conditions, contributing to the overall flexibility of the economy.

**2.28** The ability of an economy to respond to shocks depends not only on how readily wages, price and quantities can adjust, but also on the effectiveness of demand stabilisation mechanisms. Stabilisation may occur through private sector responses: for example, firms and households may either draw on their savings or borrow in order to maintain their spending when incomes fall. The role of capital markets in facilitating adjustment is discussed in detail in a later section. Macroeconomic policy can also assist stabilisation, through changes in monetary and fiscal policy. Inside EMU, monetary policy would no longer operate at the national level, so fiscal policy would have a potentially greater role to play in macroeconomic stabilisation. The potential role of fiscal policy is discussed in detail in the penultimate section of this chapter.

## How much flexibility is needed in principle?

**2.29** To help answer the central question posed by the flexibility test – is the degree of flexibility sufficient – it is important to address the issue of how much is needed in principle. The straightforward answer is that a high degree of flexibility for all economies implies faster adjustment in response to shocks and better outcomes in terms of output and employment. Inside EMU, a higher degree of flexibility will also allow all economies to successfully reap the benefits of currency union.

### Different degrees of flexibility

**2.30** In practice, some countries may be more flexible than others, so they may respond more quickly to shocks. This increases the likelihood that euro area-wide interest rates will not be appropriate for UK conditions even when faced with shocks that are common to the UK and the euro area. On the basis of the analytical work in the EMU study *Modelling shocks and adjustment mechanisms in EMU*, Box 2.3 discusses the implications of different degrees of flexibility, in absolute and relative terms, if the UK were to join EMU.

**2.31** The key conclusions from this analysis are that:

- if price flexibility were low in both the UK and the euro area, output and inflation would tend to suffer from long drawn out responses in the face of shocks – with sustained periods of output and employment below potential;
- if prices in the UK were more flexible than prices in the euro area, output stability in the UK would be much improved. But this advantage would be offset by greater inflation volatility. This occurs because the ECB would need to take account of sluggish euro area price adjustment when setting euro area monetary policy. So interest rates would not be appropriate for the UK and UK inflation would be needlessly volatile, even when faced with similar shocks to the euro area. This price volatility might have adverse consequences for the real economy in the UK and therefore makes it even more important that the UK achieves high levels of flexibility; but
- if prices were highly flexible in both the UK and the euro area, this would represent the best outcome. Now, output volatility would be lower and inflation would be well controlled at target levels. Inflation differentials between the UK and the rest of the euro area would only emerge when relative price changes were warranted, and they would take place promptly.

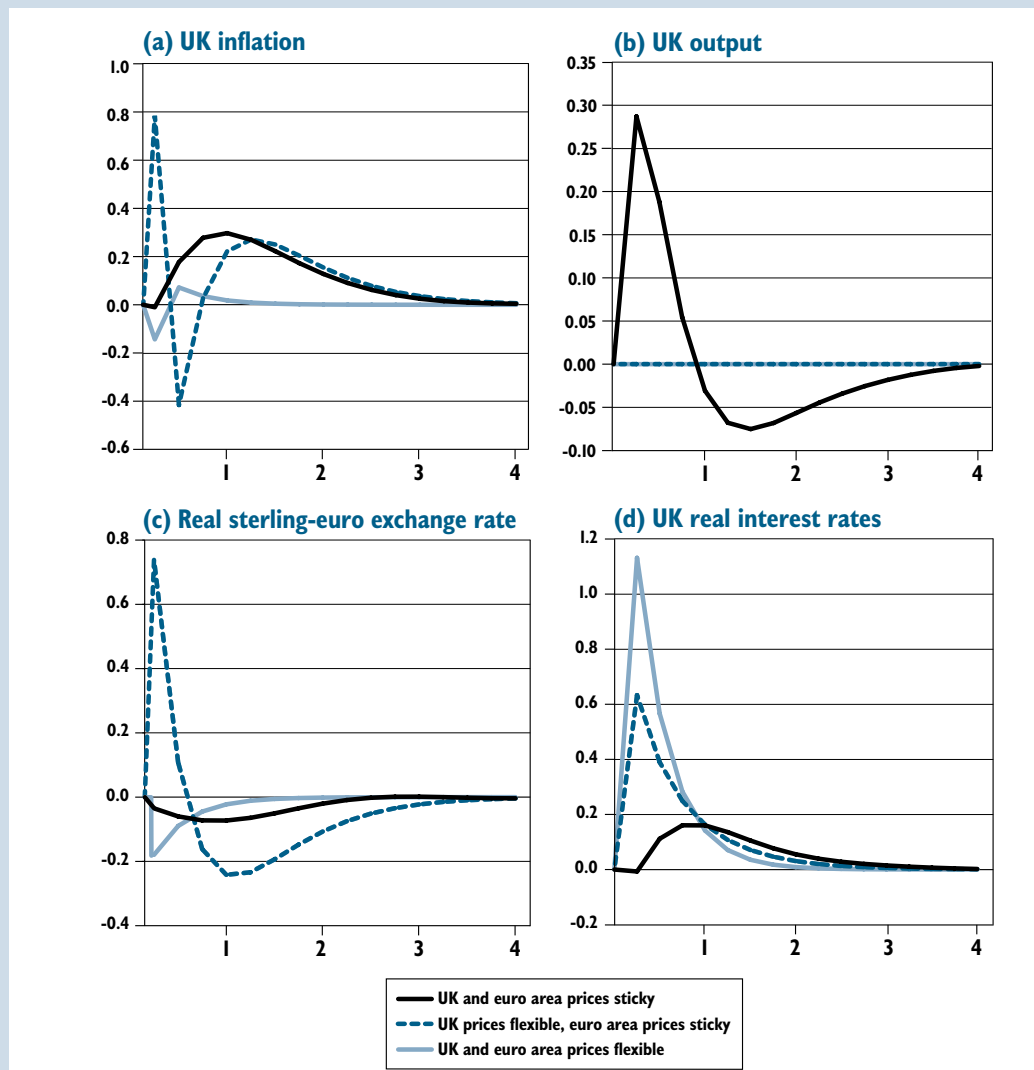
**2.32** In his contribution to the EMU study *Submissions on EMU from leading academics*, Professor Andrew Hughes Hallett notes similarly: “*Put simply, rigidities in one place spill over to constrain the performance of others. Hence asymmetries in the capacity of labour markets to adjust, asymmetric shocks, or asymmetric transmissions, all cause spill over which damage others (unless price flexibility is perfect).*”

**2.33** The assessment of the degree of flexibility needed in principle must be closely linked to the assessment in the convergence test of compatibility, because even if the UK is highly flexible, or better still both the UK and the euro area are highly flexible, without settled and sustainable convergence the costs of membership may still be prohibitively high compared to a policy of staying outside EMU.

### Box 2.3: The implications of different degrees of flexibility

The charts below show the impact of a temporary common positive demand shock in the UK when the UK is assumed to be in EMU, drawing on the simulation responses of the model introduced earlier.<sup>a</sup> Different assumptions about the degree of relative price flexibility are illustrated:

- when both the UK and the euro area have relatively inflexible or ‘sticky’ prices, UK inflation rises only slowly in response to the shock and output rises above potential (see dark solid lines in Charts (a) and (b)). Because the shock affects the euro area symmetrically, the effect on the real sterling-euro exchange rate is small;
- when the UK is assumed to have perfectly flexible prices but euro area prices are still sticky, UK output now stays at potential (see Chart (b)) but prices now respond more quickly than in the euro area. So UK inflation rises significantly (see dashed line in Chart (a)) and the real exchange rate appreciates vis-à-vis the euro area (see the dashed line in Chart (c)). This occurs despite the common nature of the shock; but
- in the case where both UK and euro area prices are highly flexible, the required movement in the real exchange rate between the UK and the euro area is very small (see light line in Chart (c)) since the impact of the shock is symmetric and the effect on UK output and inflation is minimal (see Charts (a) and (b)). This is the first best outcome of the three shown.



<sup>a</sup> The variables are plotted in terms of percentage difference from base except for inflation and interest rates which are defined in terms of percentage points relative to base.

## How might joining EMU affect overall stability?

**Macroeconomic stability is important** **2.34** Macroeconomic stability matters whether or not the UK joins EMU. Large and unpredictable fluctuations in output, employment and inflation impose significant economic and social costs and, if sustained, can hold back the economy's long-term growth potential. The current UK macroeconomic framework is designed to promote long-term stability by ensuring low inflation and sound public finances. This has helped the UK to maintain steady and stable growth in times of uncertainty, such as the recent global slowdown.

**2.35** As discussed above, a decision to join EMU would mark a substantial change in the UK's macroeconomic framework and the mechanisms through which the economy adjusts to shocks. Professor Ray Barrell notes in his contribution to the EMU study *Submissions on EMU from leading academics* that: "Choosing the best framework for a country requires that we can decide which volatilities matter most and which framework reduces those volatilities at least cost". Any decision on EMU must take into account the expected impact of EMU on stability.

**The impact of EMU on stability** **2.36** It is not clear in principle how joining EMU would affect overall stability, although the analysis of adjustment mechanisms has framed consideration of the issues. The analysis in Box 2.2 establishes that macroeconomic adjustment tends to be more protracted inside EMU in the face of a particular type of shock; it illustrates the case of a temporary demand shock specific to the UK economy. But it is important to understand how macroeconomic stability would be affected in the face of the full range of shocks that might be expected inside EMU.

**2.37** Joining EMU would immediately provide one source of stability: the nominal sterling-euro exchange rate would be fixed. To the extent that this has been volatile in the past, joining EMU would eliminate this volatility. However, since the exchange rate can also act as an adjustment mechanism, cushioning the impact of shocks, joining EMU might act to increase volatility elsewhere.

**Two studies assessing volatility inside EMU** **2.38** Two academic studies have attempted to weigh up these different influences. They tend to give contradictory messages – one finds that volatility increases inside EMU while the other finds that it falls. Box 2.4 summarises the findings.

**2.39** The EMU study *Modelling shocks and adjustment mechanisms in EMU* uses the same illustrative model featured in Boxes 2.2 and 2.3 to reconcile these different findings. It does so by producing new estimates of the potential effects of EMU membership on UK volatility. And it examines the sensitivity of the conclusions to different assumptions about the structural characteristics of the UK and euro area economies and the types of shocks likely to be experienced inside EMU.

**Box 2.4: How volatile would inflation and output be inside EMU?**

The table below presents the predicted macroeconomic volatility inside EMU from two academic studies. A ratio greater than 1.0 implies volatility is higher inside EMU than outside, while a ratio less than 1.0 implies lower volatility inside EMU.

	Ratio of volatility UK inside EMU compared to outside EMU	
	Inflation	Output
Barrell, Hurst and Kirsanova (2003)	0.96	1.06
Minford (2001)	3.12	1.12

Source: Barrell, Hurst and Kirsanova, 2003, 'Choosing the Regime in an Uncertain World: The UK and Monetary Union', National Institute Discussion Paper No. 209; Minford, 2001, 'Tests 1 and 2: Flexibility and the costs in economic variability', in *The Economic Case Against the Euro*.

- **Barrell, Hurst and Kirsanova (2003)** conclude that inflation volatility would be lower inside EMU, but output volatility would be higher.<sup>a</sup> Using estimates of exchange rate shocks based on the experience of the 1990s partly explains this result. This may be because the sterling-euro exchange rate was more volatile than the euro-US dollar exchange rate over this period.
- **Minford (2001)** finds that both output and inflation volatility would be higher inside EMU. A high degree of price flexibility in his model helps to explain the greater inflation volatility. Also, using a longer time period, Minford estimates that euro-US dollar shocks have been more volatile. These assumptions also partly explain why this study predicts an overall increase in volatility.

Assumptions about the role of the sterling-euro exchange rate are a key driver of these results. If the sterling-euro exchange rate is found to be excessively volatile – that is a source of shocks to the economy in itself – then joining EMU eliminates this.

However, as discussed in the convergence test and in the EMU study *The exchange rate and macroeconomic adjustment*, the sterling-euro exchange rate has not primarily been a source of shocks in recent years, suggesting that EMU would not immediately lower volatility from this source.

Volatility analysis of a wider range of scenarios in the EMU study *Modelling shocks and adjustment mechanisms in EMU* clarifies how different assumptions about market flexibility and other adjustment mechanisms, such as fiscal policy, affect the results. The main results are presented in the table below.

	Ratio of volatility UK inside EMU compared to outside EMU	
	Inflation	Output
Main model	1.36	1.20
More UK price flexibility	1.41	1.09
Augmented fiscal policy in UK	1.11	0.92
Highly volatile nominal sterling-euro exchange rate	0.84	0.99

Source: EMU study *Modelling shocks and adjustment mechanisms in EMU plus new results*.

**In the main model case, both inflation and output volatility is expected to rise inside EMU. But different assumptions can change this:**

- as suggested by the earlier analysis in Box 2.3, a higher degree of price flexibility in the UK implies that output volatility increases by less inside EMU than in the main model case but the degree of variability in inflation is greater;
- augmenting fiscal flexibility to allow for a greater fiscal stabilisation role reduces the increase in inflation volatility inside EMU considerably. And output volatility would be lower inside EMU than outside; and
- assuming that the sterling-euro exchange rate outside EMU has been highly volatile leads to the result of lower inflation and output volatility inside EMU than outside.

<sup>a</sup>This study updates Barrell and Dury (2000), which concluded that entering EMU would lead to a greater reduction in inflation volatility and a larger increase in output volatility than the latest results show. See Barrell and Dury, 2000, *Choosing the Regime: Macroeconomic Effects of UK Entry into EMU*, Journal of Common Market Studies 38(4), pp. 624-644.

**In most cases, macroeconomic volatility increases inside EMU**

**2.40** The main findings on macroeconomic volatility from the EMU study *Modelling shocks and adjustment mechanisms in EMU*, also summarised in Box 2.4, are that:

- macroeconomic volatility is expected to be higher inside EMU on a wide range of assumptions;
- if price flexibility is assumed to be higher in the UK than in the euro area, this magnifies the deterioration in inflation volatility inside EMU but makes the deterioration in output variability much smaller (this is consistent with the earlier analysis of the effects of flexibility in Box 2.3);
- an augmented role for fiscal policy can help to mitigate the increased volatility inside EMU; and
- macroeconomic volatility is only likely to fall inside EMU if volatility in the sterling-euro exchange rate has been a significant source of shocks in the past. The EMU study *The exchange rate and macroeconomic adjustment* presents evidence that this has not been the case, as discussed in the assessment of the convergence test.

## Safeguarding stability inside EMU

**Inflation volatility**

**2.41** The above discussion strongly implies that greater inflation volatility would be a feature of EMU membership. Inflation volatility has potentially important implications. For example, it may make it harder to separate relative price signals – important for resource allocation – from more general inflationary pressures. In turn, this makes it difficult to plan ahead and undertake sensible resource decisions to invest and save for the future. This could threaten the realisation of the potential benefits of EMU.

**2.42** Inflation also has distributional effects. It can interact adversely with the tax and benefit system as many payments are linked directly to measured inflation. High inflation lowers the real value of interest payments made to savers but makes borrowing more attractive. This sometimes leads people to invest in certain types of assets, like property, which tend to retain value better in times of high inflation. Other things being equal, this inflation effect could unhelpfully serve to boost demand further and could intensify the risks identified in the convergence test.

**2.43** In order to limit to the short term the adverse effects of higher inflation volatility, medium-term expectations would need to be firmly anchored to the euro area aggregate. The evidence in the convergence test shows that inflation expectations in the euro area are anchored by the ECB's medium-term price stability objective and are around 2 per cent on the HICP measure.

**2.44** As well as requiring a clear medium-term euro area-wide anchor, the Government would have several national policy options to minimise risks to overall stability inside EMU. Ensuring a high degree of market flexibility would lower overall volatility and imply that interest rates were more appropriate for more EMU members more of the time. Fiscal policy could also play a greater role in stabilising the economy and support market adjustment. Together, greater market and fiscal flexibility would help to ensure macroeconomic stability inside EMU.

### Conclusion: flexibility and adjustment mechanisms in EMU

**2.45** These findings highlight important issues that frame the assessment of the flexibility test. Inside EMU, loss of national monetary policy and the nominal sterling-euro exchange rate means that other adjustment mechanisms would have to work harder. Wage and price adjustment are the most effective adjustment mechanisms available, but there is also a potentially enhanced role for fiscal policy. National monetary unions, including the UK, have been successful without high internal mobility. The discussion motivates the next three sections on supply-side flexibility in labour, product and capital markets. The assessment then considers monetary unions in practice, including the experiences of the UK, the US and EMU to date. Finally, the issue of how fiscal policy may need to play a greater role in adjustment in EMU is discussed.

## MARKET FLEXIBILITY: ADJUSTMENT THROUGH WAGES AND LABOUR MARKETS

### The importance of a flexible labour market for EMU

**2.46** This section examines the flexibility of UK and EU labour markets. An efficient and flexible labour market that creates jobs, increases competitiveness and raises productivity is essential to the UK, irrespective of whether it is a member of EMU or not. The analysis of the previous section shows that any decision to join the single currency places a premium on adjustment mechanisms such as prices. In the labour market this equates to wage flexibility. EMU membership also has the potential to create higher levels of employment through greater trade opportunities and market integration. Sufficient wage flexibility, as well as other forms of labour market flexibility, would be necessary to realise the gains.

**2.47** An appraisal of the UK labour market was central to the 1997 assessment of the flexibility test, which concluded:

*“...in labour markets particularly, the UK has not yet achieved sufficient flexibility to meet the challenges of EMU membership.”*

### A framework for assessing labour market flexibility

**2.48** This section assesses detailed evidence of labour market flexibility, particularly wage flexibility. It is based on the comprehensive analysis in the EMU study *EMU and labour market flexibility* and complements the quantitative analysis of adjustment mechanisms discussed earlier. There is a particular focus on labour market performance since 1997.

**2.49** The analysis uses a **new framework** developed for the assessment to analyse the flexibility of labour, product and capital markets, covering:

- **characteristics** – the mechanisms through which the labour market adjusts in response to a shock. Wage flexibility is particularly important. However, EMU puts a premium on flexibility in all aspects of the labour market, including the ability of workers to increase their level of training, to adapt their skills and to be more mobile, and the ability of firms to offer diverse working practices;
- **outcomes** – the key indicators of how well labour markets are functioning, both in aggregate and across different socio-economic groups and regions. This includes an appraisal of job creation, unemployment, wage pressures and job matching; and
- the **institutional environment** – the policy and social environment in which the labour market operates. The key institutional factors influencing labour market adjustment are analysed and drawn together into a comparative indicator of labour market flexibility in the UK and other countries.

## Characteristics of flexible labour markets

**The importance of flexible wages in EMU** **2.50** Adjustment of wages inside a monetary union is vital because changes in external competitiveness will be driven by inflation differentials alone. A sufficient level of wage flexibility – the ability of wages to eliminate imbalances between the supply of and demand for labour – is therefore necessary to ensure economic stability within EMU. Wage adjustment can occur at the sectoral level – **relative wage flexibility** – or the aggregate level – **real wage flexibility**, which in turn is influenced by **nominal wage flexibility**.

**Relative wage flexibility** **2.51** The 1997 assessment observed that relative wages in the UK were able to reflect new and changing demands in the economy. This remains the case today. The EMU study *EMU and labour market flexibility* notes that between 1999 and 2001, regional wages in the UK grew faster in regions of low unemployment, such as the South East. This contributed to the continued narrowing of unemployment rates between regions of the UK. Similarly, the wages of skilled workers have been rising relatively faster than those of workers with lower skills.

**Real wage flexibility...** **2.52** Historically, real wage flexibility has appeared relatively low in the UK and may have contributed to the high levels of unemployment experienced in the 1980s and early 1990s. Real wages have tended to be rigid in the face of high levels of unemployment but have grown strongly when unemployment has fallen. The 1997 assessment noted that the UK had reached a critical point in the economic cycle where typically wage inflation would have accelerated as unemployment fell further, and that it was too soon to tell whether labour market performance had improved or would revert to past patterns.

**...appears to have improved in the UK** **2.53** Evidence detailed in the EMU study *EMU and labour market flexibility* points to an improvement in real wage flexibility in the UK. Importantly, these results are consistent with a wide range of academic work comparing real wage flexibility across countries. New analysis undertaken for the assessment finds that UK real wages have become more responsive to the level of unemployment (see Box 2.5). The analysis on its own is insufficient to conclude with certainty that real wage flexibility has increased because identifying significant changes with confidence is difficult. However, the fact that unemployment has declined sharply in the UK in recent years without igniting inflationary pressures in the labour market suggests this improvement is genuine.

**2.54** At the same time, the OECD has recently noted that EMU membership may have increased wage moderation in the euro area, while the IMF has noted how the recent resilience of the EU jobs market reflects greater wage moderation.<sup>4</sup>

**Nominal wage flexibility**

**2.55** Real wages adjust either through a change in the nominal money wage or through changes in the price level. In a low inflation environment, nominal wage rigidities (barriers that prevent nominal wages from changing) may become a more important source of real wage rigidity. This could be a particular problem in EMU, since wage adjustment would be an important adjustment mechanism.

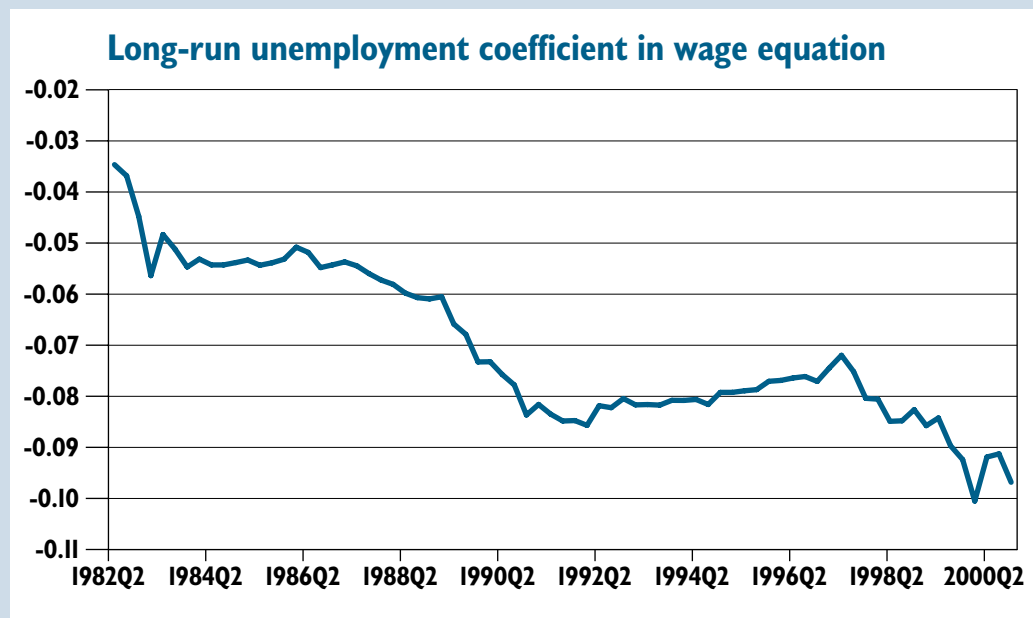
**2.56** Nominal wages are generally adjusted annually in UK wage negotiations, potentially allowing for a relatively high degree of nominal flexibility, although at the expense of some short-term adjustment. Moreover, bonus payments have allowed the private sector to be more flexible in the recent downturn, as reflected in the low growth in average private sector earnings over 2001 and 2002.

**Box 2.5: Has UK real wage flexibility improved?**

Treasury analysis undertaken for the assessment and reported in the EMU study *EMU and labour market flexibility* assesses whether real wage flexibility – the sensitivity of real wages to unemployment – has increased in the UK in recent years.<sup>a</sup>

The estimate of real wage flexibility, derived from the wage equation used in the Treasury's macroeconomic model, is shown in the chart below. If real wage flexibility has increased, the value of the long-run coefficient on unemployment in the wage equation should have fallen over time, with any given level of unemployment having a greater (offsetting) impact on real wages.

The results show a fall in the long-run coefficient on unemployment in recent years, suggesting an increase in real wage flexibility.



<sup>a</sup> See the EMU study *EMU and labour market flexibility* for a detailed explanation.

**2.57** In all countries, downward nominal wage rigidity is an issue. Employees are resistant to a cut in nominal wages and many employers reluctant to impose one. The extent to which this became a problem would depend on whether nominal wage cuts were necessary to adjust to a shock.

<sup>4</sup> *Economic Survey of the Euro Area*, OECD, 2002; *Staff Report on Monetary and Exchange Rate Policies of the Euro Area and the Trade Policies of the EU*, IMF, 2002.

**2.58** The EMU study *EMU and labour market flexibility* notes that many individuals in the UK do not experience a change in their nominal wage from one year to the next. This suggests that downward nominal rigidities may interfere with labour market adjustment in the UK. However, the degree to which this is a constraint has not been fully tested to date. In recent years, inflation has been close to its target of 2½ per cent a year and average earnings have increased by around 4½ per cent a year, providing considerable scope for movements in real and relative wages even in the face of any resistance to nominal wage cuts.

**Conclusion: wage flexibility**

**2.59** Overall, relative and real wage flexibility seem to be reasonably high in the UK and appear to have improved in some areas since 1997. However, this has not been fully tested in recent years. Wage flexibility would be more severely tested by a decision to join EMU, where price movements would need to play a greater role in adjustment to shocks. There are some signs that EMU membership has facilitated euro area wage flexibility. Because of its key role in adjustment, the level of real wage flexibility in the UK and the euro area poses a risk to successful UK membership of EMU. Budget 2003 announced the Government's intention to increase wage flexibility in the public sector labour market through a stronger local and regional dimension to the setting of public sector pay.

**Geographic labour mobility...**

**2.60** EMU places a premium on flexibility in all aspects of the labour market. One such adjustment mechanism is the ability of individuals to move residence in order to find employment – **geographic labour mobility**. A number of commentators have suggested that high levels of geographic mobility in the US have been important in allowing it to function effectively as a single currency area, as discussed in the EMU study *The United States as a monetary union*.

**...is low in the EU...**

**2.61** Geographic mobility in the EU is much lower than in the US. This is also true of geographic mobility within countries, including the UK. Many of the barriers to geographic mobility, particularly across borders, relate to family commitments, career progression and benefits and property. As such, it is unlikely that mobility in the UK or the EU will increase quickly. In his contribution to the EMU study *Submissions on EMU from leading academics*, Professor Barry Eichengreen notes: “*The creation of a single market and the transparency created by the single currency . . . will facilitate greater labor mobility over time. There is some anecdotal evidence of this already . . . but one's main impression is that movement in this direction is slow*”.

**...but should not constrain any decision to join EMU**

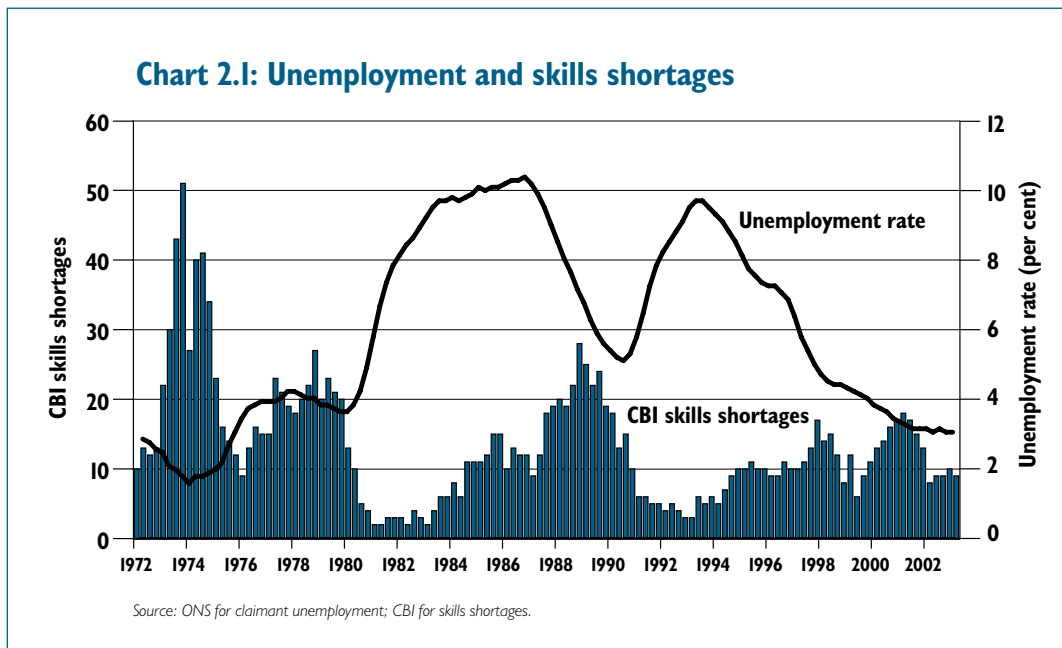
**2.62** Geographic mobility, both across borders and within countries, is undoubtedly desirable and would support a successful EMU for existing members and for the UK and other countries should they decide to join. However, as set out in the EMU study *EMU and labour market flexibility*, low geographic labour mobility is unlikely to be a primary risk inside EMU, for a number of reasons. National monetary unions, including the UK, have been successful without high internal mobility. Dr Daniel Gros notes in his contribution to the EMU study *Submissions on EMU from leading academics* that the difference between international and inter-regional mobility in Europe is low, such that: “*EMU should thus not be much more difficult to manage than the existing monetary unions in Europe that member states represented up to 1999*”. Moreover, a decision to migrate often entails significant costs, so geographic mobility is a more suitable adjustment mechanism to permanent shocks. It is not a key substitute for the role of monetary policy, which responds only to temporary or cyclical shocks.

**Conclusion: geographic mobility**

**2.63** Geographic labour mobility is low both within and between EU Member States. However, because geographic mobility would be an imperfect substitute for a national monetary policy, this is not likely to be a significant risk to the viability of EMU either for existing members or for the UK. However, policy measures to increase geographic mobility would improve the performance of the UK labour market and help UK performance in EMU, as well as the performance of existing members. It is therefore a priority for the Government.

**Functional flexibility...** **2.64** **Functional flexibility** is the ability of the workforce to perform different tasks and acquire and apply different skills. It is complementary to, but can also act as a substitute for, geographic labour mobility. Inside or outside EMU, but particularly within a single currency area, functional flexibility is important to ensure that individuals have the skills to adapt to increased competition and to compete for a wide range of jobs in a changing economic environment.

**...skills shortages have not increased as unemployment fell...** **2.65** The 1997 assessment of the flexibility test concluded that the level of skills in the UK might constrain the ability of the economy to respond to the structural changes brought about by EMU. The steady decline in unemployment and the absence of a strong pick up in skilled labour shortages since then (see Chart 2.1) may mean that functional flexibility has been less of a constraint for firms than was feared, although EMU membership would still bring additional challenges.



**...but imbalances remain** **2.66** However, evidence suggests that, relative to the US, France and Germany, the UK still suffers from significant skills imbalances. While the number of people in the UK with high skill levels compares well internationally, the level of intermediate skills is low and a large proportion of the UK population possesses low skills. While progress has been made since 1997, the stock of low-skilled workers is only being reduced slowly. A continual improvement in skill levels, particularly among those with the lowest skills, is necessary in order for the UK economy to respond to technological change.<sup>5</sup>

**Conclusion: functional flexibility** **2.67** A highly educated workforce with a culture of lifelong learning is more likely to be able to adapt to economic change. While skills shortages may not have been as large a constraint as previously feared, imbalances still remain in the UK's skills base. Improving the level of skills, particularly among those with the lowest skills, is therefore a focus of the Government's agenda for enhancing flexibility in the UK.

**Employment flexibility** **2.68** It is important that employers are willing and able to adopt flexible patterns of working. **Employment flexibility** boosts the available supply of labour by ensuring that employees can combine employment with other activities and responsibilities.

<sup>5</sup> The Government's strategy for tackling skill shortages is set out in *Developing workforce skills: piloting a new approach*, HM Treasury and Department for Education and Skills, April 2002.

**2.69** The 1997 assessment emphasised that the UK is relatively successful at matching the demands of the market to the needs of workers. Part-time workers make up around 25 per cent of the UK workforce, generally as a result of workers' choice. This is high in comparison to much of Europe, although the incidence of part-time employment has also increased in other EU countries during the 1990s. Compared to the EU as a whole there is also a relatively high number of employees with flexible working patterns in the UK, such as shift, night and weekend working, although these are also becoming more widespread in the rest of the EU.

**2.70** The European Commission has recently noted that the liberalisation of temporary contracts across the EU may have been an important reason behind the recent strong growth in employment. However, as the EMU study *EMU and labour market flexibility* notes, caution is needed in drawing conclusions about the relationship between temporary contracts and labour market flexibility.

**Conclusion: employment flexibility** **2.71** The 1997 assessment observed that the UK already had a relatively high degree of employment flexibility. This has been maintained, as demonstrated by a high incidence of part-time employment and flexible working practices.

## Outcomes in flexible labour markets

**2.72** The EMU decision must be consistent with the UK Government's objective since 1997 to extend employment opportunity to all in a changing labour market: the modern definition of full employment. High levels of employment help deliver fairness and social inclusion in any economy, irrespective of whether it is a member of a currency union or not. High levels of long-term unemployment or economic inactivity can also prevent the labour market from working effectively, for example if they lead to supply bottlenecks and skills shortages. This may be more of a constraint in EMU where the need for labour market adjustment is greater. This section focuses on employment and unemployment outcomes in relation to adjustment. The assessment of the growth, stability and employment test considers the broader issue of the potential impact of EMU on employment levels.

**Employment in the UK...** **2.73** The Government's policies to tackle structural weaknesses in the UK labour market have helped to raise employment to its highest ever level. Between the third quarter of 1997 and the first quarter of 2003, the number of people in work in the UK increased by nearly 1.4 million and the employment rate rose from 72.9 per cent to 74.6 per cent. That said, more progress can be made. Employment rates remain low in the most deprived areas of the country and for people from ethnic minorities; and while overall employment has risen, overall inactivity has fallen by less.<sup>6</sup>

**...and in Europe as a whole** **2.74** The 1997 assessment noted that Europe as a whole needed to be able to create jobs and tackle its problem of high unemployment in order to make EMU work. There has been an improvement in the employment performance of the EU labour market since 1997, a period which has also seen a pick up in economic growth (see Box 2.6).

**2.75** However, more still needs to be done. The challenge of invigorating European labour markets is considerable and reform will require imagination and ambition on the part of employees, employers and policymakers. The paper *Towards Full Employment in the European Union*<sup>7</sup> identifies priority areas for action along with policy recommendations for how these might be addressed.

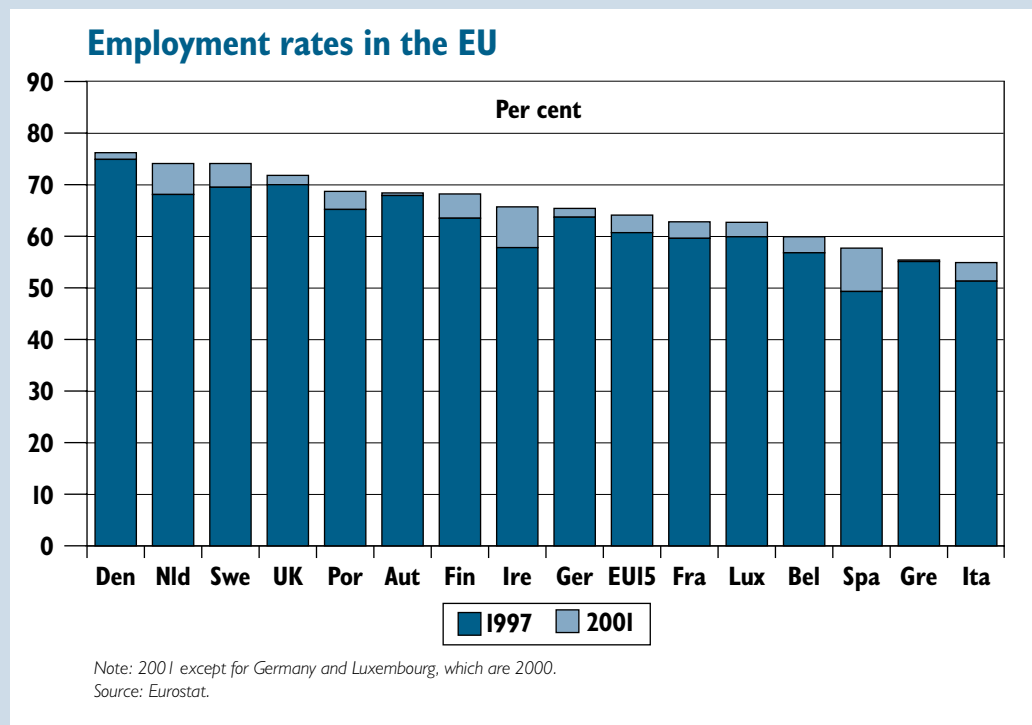
<sup>6</sup> The Government's strategy for extending employment opportunity for all is set out in *The changing welfare state: employment opportunity for all*, HM Treasury and Department for Work and Pensions, November 2001.

<sup>7</sup> *Towards Full Employment in the European Union*, HM Treasury, Department of Trade and Industry, and Department for Work and Pensions, July 2002.

**Box 2.6: Employment opportunity across the EU**

Employment is at the heart of economic and social reform in Europe. At the Lisbon European Council in March 2000, EU leaders set out their aspirations for a Europe that would be “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”. Ambitious ten-year targets were set for total and female employment rates, with a separate target for older workers set one year later in Stockholm.

Much has been achieved since 1997, as set out in more detail in the EMU study *EMU and labour market flexibility* and the recent progress report on economic reform in Europe.<sup>a</sup> In particular, between 1997 and 2001, over 10 million jobs were created in Europe.



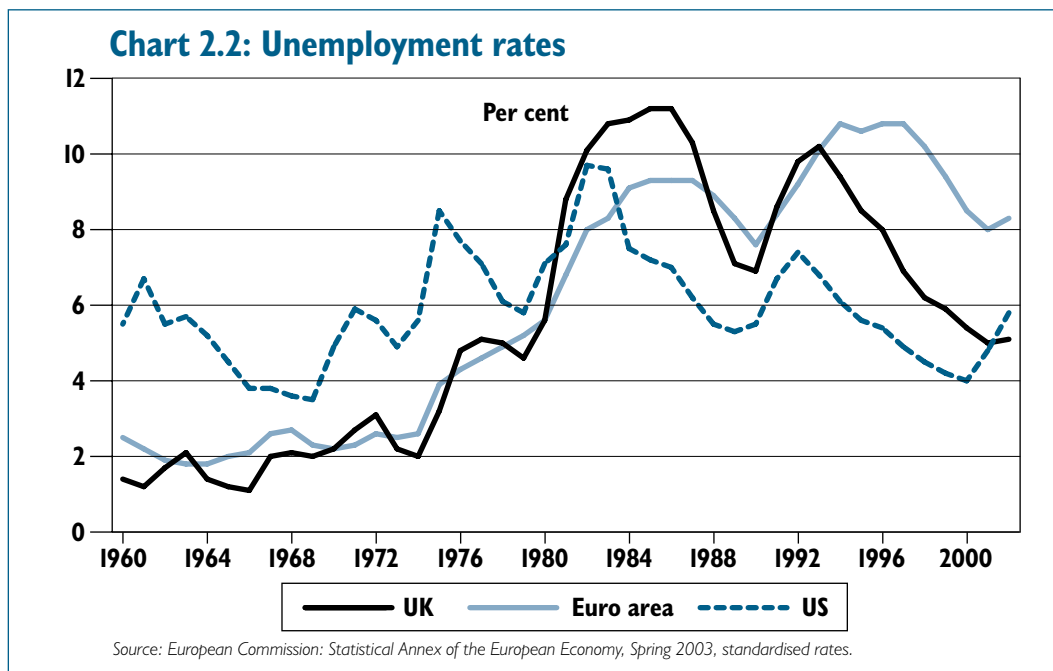
Progress has been particularly strong in some of the smaller EU Member States, such as the Netherlands and Ireland (see the above chart). Spain has also seen strong employment growth, although the employment rate remains low by EU standards. While larger euro area economies such as Germany, France and Italy have seen their employment rates rise since 1997, the EU average employment rate remains some way below the Lisbon target of 70 per cent.

<sup>a</sup> *Meeting the Challenge: Economic Reform in Europe*, HM Treasury, February 2003.

### Shocks can have long-term consequences

**2.76** It is arguable whether the recent improvements go beyond a purely cyclical effect or whether they would unwind if a large shock were to hit the European economy. Historically, Europe's experience has been one of negative shocks raising unemployment temporarily from its equilibrium rate, but slow labour market adjustment then resulting in much of the increase in unemployment becoming entrenched.

**2.77** Chart 2.2 indicates that following negative unemployment shocks in the 1970s and 1980s, the unemployment rate remained higher in the euro area and, until recently, the UK than in the US, which has experienced more stable unemployment rates. In other words, shocks have had long-lasting effects on the labour market. As discussed in the Introduction, such effects can become permanent. Most recent data show that the UK currently has one of the lowest rates of unemployment in the OECD, lower even than the US.



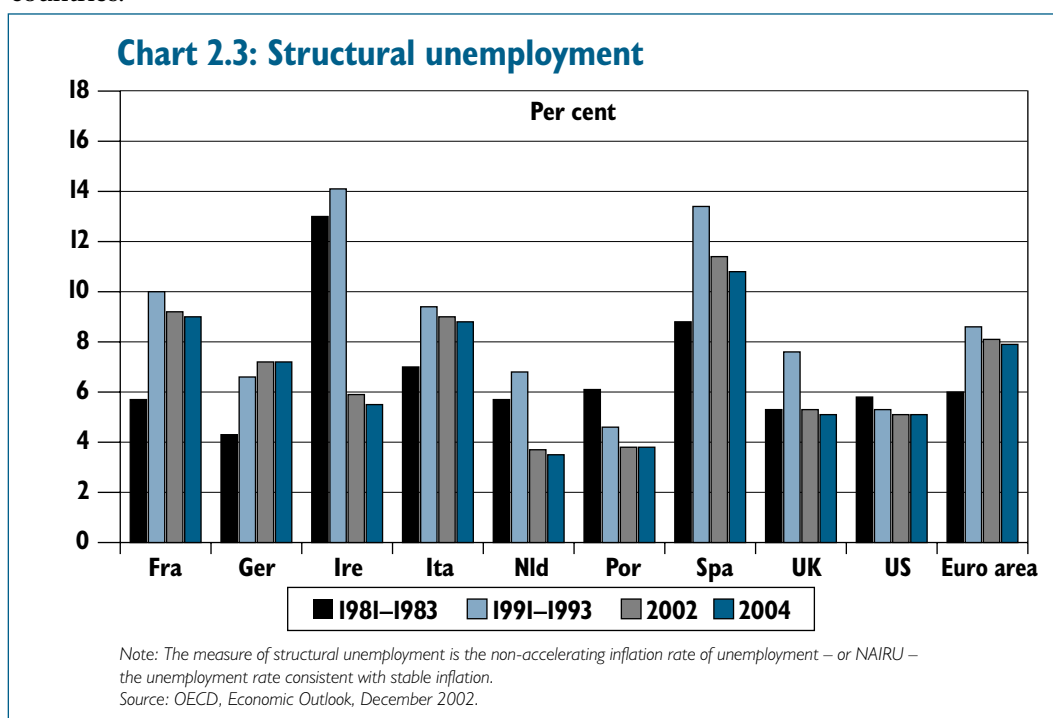
**Structural unemployment has fallen in the UK...**

**2.78** Analysis of the structural component of unemployment indicates the extent to which a fall in unemployment reflects greater structural labour market flexibility rather than a purely cyclical effect. Chart 2.3 presents OECD estimates of one measure of structural unemployment. This shows that:

- structural unemployment in the UK has fallen from nearly 8 per cent in the early 1990s to around 5½ per cent at present;
- progress in the other large EU Member States has been slower. Structural unemployment has been relatively stable since 1990 and remains high; and
- there have been significant falls in structural unemployment in some of the smaller EU Member States such as Ireland and the Netherlands.

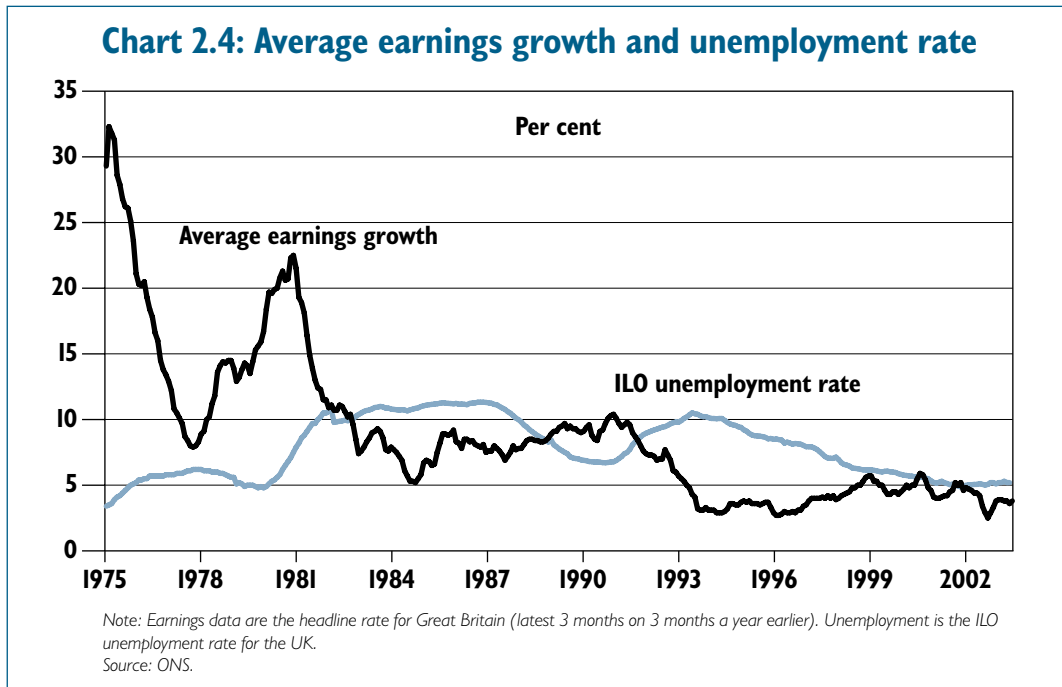
**...but the EU picture is mixed**

**2.79** This mixed picture suggests that shocks can still have long-lasting effects in EU countries.



**Benign wage pressures suggest the fall in structural unemployment is genuine...**

**2.80** Earnings growth is a simple and timely labour market outcome measure. The recent profile of average earnings growth suggests supply side improvement in the UK and is supportive of there having been a gentle fall in structural unemployment.<sup>8</sup> Since 1997 unemployment has fallen to rates last seen in the 1970s, yet average earnings growth has remained consistent with the current inflation target and estimates of trend productivity growth (see Chart 2.4). In the past, when unemployment has fallen to such a low level, wage inflation has accelerated significantly.



**...as does an improvement in mismatch**

**2.81** The UK labour market is also now better able to adapt to imbalances across market segments:

- the relationship between unemployment and vacancy rates appears to have improved in the late 1990s, indicating better job matching.<sup>9</sup> Across Europe the evidence is mixed, with the relationship worsening in Germany and France in the mid to late 1990s, suggesting that job mismatch has increased; and
- the dispersion of regional unemployment rates in the UK has fallen since the beginning of the 1990s. Each region has seen sharp falls in unemployment, although localised pockets of unemployment remain. However, regional unemployment dispersion is more pronounced in other parts of Europe.

**Long-term unemployment has fallen...**

**2.82** The 1997 assessment emphasised the importance of ensuring that specific groups did not become permanently detached from the labour market. This is necessary to ensure that the economy does not run into labour supply bottlenecks and skills shortages. Since 1997, previously marginalised groups have been reintegrated into the labour market. In particular, the level of long-term unemployment, which averaged 710,000 in 1997, had fallen to 324,000 by February 2003.

**...but challenges remain**

**2.83** However, challenges remain to ensure employment opportunities for all in the UK. The employment rates of lone parents, the over 50s, ethnic minorities and people with disabilities remain below the national average, while certain deprived areas continue to endure unacceptably high levels of worklessness.

<sup>8</sup> The EMU study *EMU and labour market flexibility* notes that the change in the monetary policy regime, and its impact on reducing inflation expectations, may also have helped improve the trade-off between unemployment and inflation.

<sup>9</sup> The 'Beveridge Curve' depicts the relationship between unemployment and vacancies, and is discussed in the EMU study *EMU and labour market flexibility*.

## The institutional environment

- Shocks can have long-lasting effects** **2.84** The discussion has highlighted how negative shocks to European labour markets have historically led to long-lasting increases in unemployment. Evidence summarised in the EMU study *EMU and labour market flexibility* indicates that this is a result of the institutional environment interacting with the shocks that hit the economy. This slows the speed at which unemployment returns to its sustainable level, and in some cases can lead to permanent increases in equilibrium unemployment. In EMU, the loss of national monetary policy and the nominal sterling-euro exchange rate as adjustment mechanisms increases the need for an institutional environment that is conducive to flexibility.
- 2.85** The interaction of the tax and benefit system influences labour market flexibility through its impact on labour supply, unemployment and wages. While maintaining fairness and social inclusion, it is important that the interaction of the tax and benefit system does not erode the incentive to seek work.
- Work is now more financially rewarding...** **2.86** Since the 1997 assessment, the Government has introduced a number of reforms to the tax and benefit system in order to make work pay, particularly for those on low incomes. Reforms to income tax, national insurance and the introduction of a system of targeted tax credits have:
- increased the minimum income that people can expect when moving into work. The introduction of the Child and Working Tax Credits has increased the gains to work for households with children. The extension of in-work support to workers aged 25 and over without children or a disability will significantly increase work incentives for this group too; and
  - increased incentives to move up the earnings ladder, with the number of households facing marginal deduction rates of over 70 per cent falling by over half a million since 1997.
- 2.87** OECD figures show that the UK has gross replacement rates for different groups (the ratio of out-of-work to in-work income) comparable to the US and lower than many European countries.
- ...and the unemployed are better equipped to take up jobs** **2.88** Increasing the effective labour supply by improving work skills and disciplines can reduce the need for employers to raise wages and therefore increase the medium to long-run responsiveness of wages to unemployment. Although spending on active labour market policies in the UK is low by international standards, it appears to be well targeted. The evaluations of the various New Deal programmes in the UK have shown positive results in terms of reducing long-term and youth unemployment as well as unemployment among those aged over 50.
- Labour market regulation remains conducive to flexibility** **2.89** Well-designed employment protection legislation (the rules governing hiring and firing) offers clear benefits to employees. Badly designed protection legislation can impose excessive costs on employers and deter them from offering jobs where the returns from creating the job are too low in relation to the associated cost. Where this is the case, protection legislation acts as a barrier to labour market flexibility. Studies suggest that employment protection legislation in the UK is less heavy-handed than in many other OECD countries, and more conducive to market flexibility, although other European economies have also generally improved over the 1990s.
- Has the National Minimum Wage reduced flexibility?** **2.90** The National Minimum Wage underpins the Government's tax and benefit reforms. By setting a wage floor, it is one piece of regulation since 1997 that might hold back the ability of the labour market to adjust to shocks. This would be the case if it reduced employment or set an inappropriate going rate for wage increases across the economy. However, the evidence so far suggests that the National Minimum Wage is set below the level at which the employment constraint starts to bite and that there has been a negligible impact on the pay of those not directly affected by its introduction.

**Is the collective bargaining system conducive to flexibility?**

**2.91** Since the 1980s the UK has moved to a more decentralised and uncoordinated wage bargaining system. This structure means that relative wages can adjust more readily to industry, sector and regional conditions. However, maintaining balanced pay claims will be essential to ensuring this positive performance can be sustained going forward.

**2.92** Collective bargaining structures differ greatly across the EU. Both trade unions and employers' associations are organised in very different ways. However, collective bargaining outcomes in the 1990s, in terms of real wage growth, have shown both long-term moderation and convergence compared with previous decades.

**An indicator of labour market flexibility**

**2.93** The EMU study *EMU and labour market flexibility* presents an estimated summary indicator of labour market flexibility. The indicator confirms that the institutional environment affecting the performance of the UK labour market compares favourably with that in many other countries and is consistent with the improved labour market performance observed in recent years being sustained – see Box 2.7.

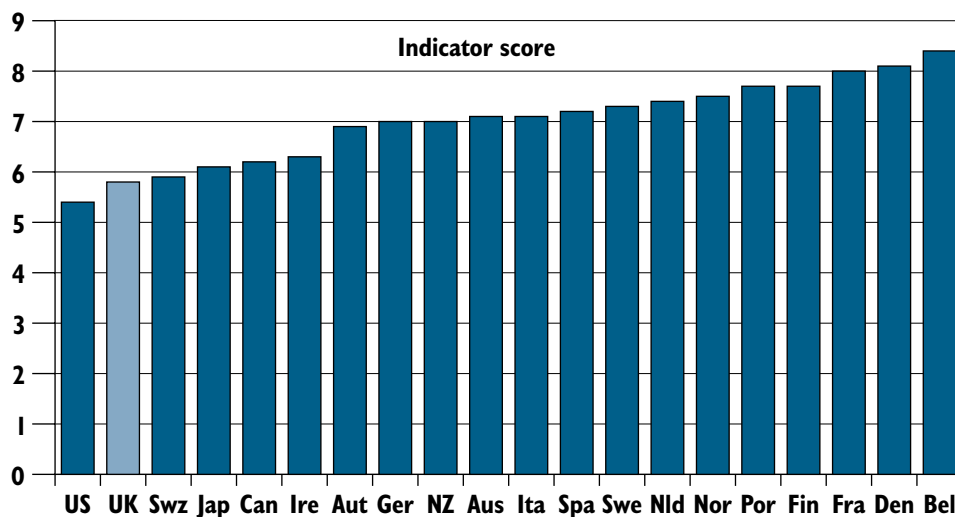
**Box 2.7: An indicator of labour market flexibility**

The EMU study *EMU and labour market flexibility* presents a summary comparative indicator of labour market flexibility, based on the main institutional characteristics of the EU labour market.

Countries that are more flexible than the average score a value less than 7 in the chart below, and countries that are less flexible than the average score more than 7.<sup>a</sup>

Consistent with other composite indicators of labour market performance, this suggests that flexibility is relatively high in countries outside the euro area. The indicator confirms that the institutional environment for the UK labour market compares favourably with many other countries and is consistent with the improved UK labour market performance observed in recent years being sustained.

**An indicator of labour market flexibility**



Note: A lower value implies a more flexible institutional environment.  
Source: HM Treasury.

<sup>a</sup>For a full explanation of the indicator's derivation, see Annex B of the EMU study *EMU and labour market flexibility*.

**2.94** The changes to the institutional and policy framework in the UK – in particular, the reforms to the tax and benefit system in order to make work pay, the introduction of active labour market policies and the enhanced UK regulatory environment – are conducive to labour market flexibility and imply that the recent improvements in the UK labour market can be sustained.

### **Conclusion: how flexible are UK labour markets?**

**2.95** UK labour market flexibility has improved markedly since 1997. Significant falls in overall unemployment and long-term unemployment have accompanied strong employment growth, giving the UK one of the lowest levels of unemployment in the OECD, lower even than the US. The 1997 assessment observed that the UK already had a relatively high degree of employment flexibility. This has been maintained, as demonstrated by a high incidence of part-time employment and flexible working practices. Moreover, evidence since 1997 points to an underlying improvement in wage flexibility. However, important challenges remain in the UK to reduce inactivity and repeated spells of worklessness and to enhance skill levels and improve mobility. Adjustment mechanisms have not been fully tested in recent years as the UK has had a relatively stable macroeconomic environment. If the UK decided to join EMU, wage movements would need to play a greater role in adjustment.

**2.96** EMU membership puts a premium on the need for institutional structures to cope with shocks. Therefore, while the positive reforms to the institutional and policy framework in the UK suggest that recent improvements can be sustained, more progress on labour market reform would enhance flexibility in the UK and advance the Government's long-term goal of employment opportunities for all. In the context of EMU, it would also increase the durability of convergence between the UK and the euro area.

**2.97** It is now recognised across Europe that to realise the full benefits of EMU membership requires more progress on a range of economic reform policies to enhance flexibility and resilience to shocks, particularly in labour markets. Europe as a whole, and especially the larger EU economies, needs to match the impressive flexibility record of some of the smaller EU Member States. The less progress on flexibility that is achieved in the EU, the greater the premium on a high level of flexibility in the UK economy.

**Policy requirements** **2.98** In the labour market, the Government is continually working to enhance flexibility and is going further through a package of measures designed to increase wage flexibility in the public sector, improve skills, particularly at the basic and intermediate level, give greater local discretion in the delivery of employment policies and increase labour supply by helping more people to move from welfare to work and increasing cyclical economic migration.

## MARKET FLEXIBILITY: ADJUSTMENT THROUGH PRICES AND PRODUCT MARKETS

### The importance of a flexible product market for EMU

**2.99** This section considers the flexibility of UK and EU product markets. A flexible product market, that promotes competition and encourages innovation and research, is important irrespective of whether or not the UK joins EMU. However, a decision to join EMU would increase the need for rapid price and factor movements and would also make it necessary for firms to be able to respond effectively to shocks and adapt to the competitive challenges that the single currency would bring. Product markets also play an important role in supporting productivity, particularly through competition, enterprise and innovation. This is discussed in more depth in the assessment of the growth, stability and employment test.

### Links to labour and capital markets

**2.100** Product market flexibility complements labour and capital market flexibility. In the labour market, firms need employees to be able to adapt readily to economic change. Firms also require capital markets to be flexible to ensure access to a wider range of financing options.

**2.101** The 1997 assessment observed that:

*“The liberalisation of product markets has progressed further in the UK than in many other EU countries...But some problems remain and new measures are planned to make further improvements, particularly to competition policy.”*

**2.102** This section looks at product market flexibility in more detail with a particular focus on price flexibility – a key adjustment mechanism in EMU in the absence of the nominal sterling-euro exchange rate and independent national monetary policy. It draws on the evidence presented in the Government’s White Paper on EU economic reform *Realising Europe’s Potential: Economic Reform in Europe* and the subsequent progress report (HM Treasury, 2002 and 2003). The role that inflation can play as an adjustment mechanism is discussed in the EMU studies *Modelling shocks and adjustment mechanisms in EMU* and *Prices and EMU*.

### A framework for assessing product market flexibility

**2.103** The analysis adopts the same framework as for labour markets:

- **characteristics** – the mechanisms through which the product market adjusts to a shock. The focus is on the important role of price flexibility;
- **outcomes** – key indicators of the operation of product markets such as price differentials and mark-ups; and
- the **institutional environment** in the product market and how it influences the adjustment process.

## Characteristics of flexible product markets

### The importance of flexible prices in EMU

**2.104** Flexible product markets play a key role in promoting **price flexibility** – a particularly important adjustment mechanism for an economy inside a monetary union. Inside EMU, relative price adjustments are the only means for changes in competitiveness between countries to occur. For example, a country with an overheating economy will have more inflationary pressure, while a country with weaker demand will have less; higher inflation in the rapidly growing economy will lower its relative competitiveness and reduce overheating pressures.

### Inflation adjustment in the euro area

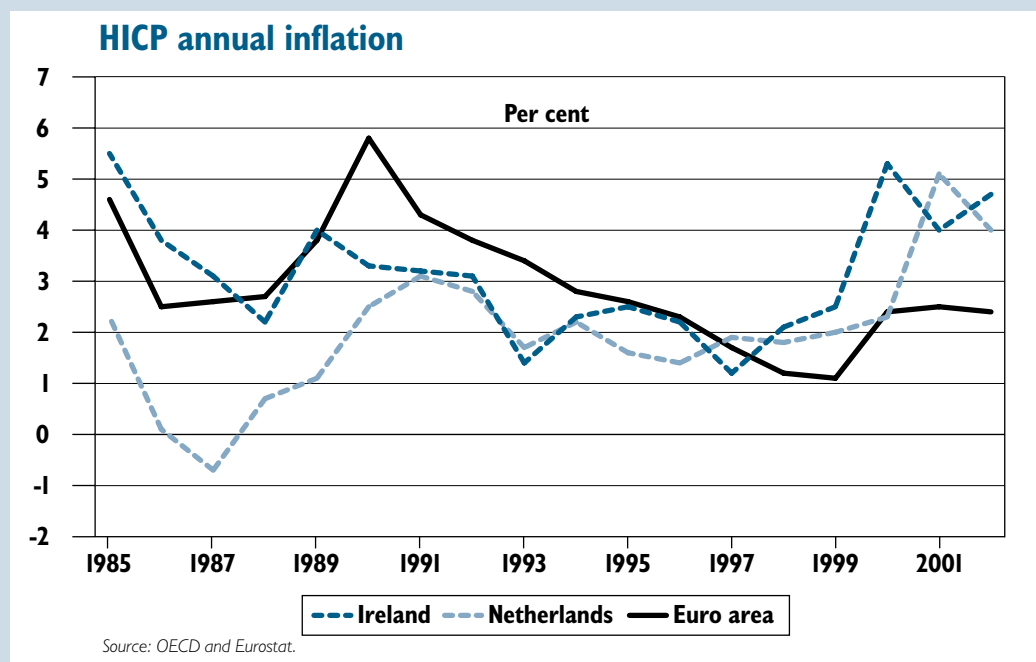
**2.105** The experiences of Ireland and the Netherlands in EMU provide interesting case studies. Both economies grew strongly over the mid to late 1990s and inflation rates rose well above the euro area average. The resulting real exchange rate appreciation helped their economies to absorb and adjust to the overheating pressures (see Box 2.8).

#### Box 2.8: Inflation as an adjustment mechanism – Ireland and the Netherlands

Ireland and the Netherlands have both experienced inflation rates above the euro area average as well as strong property price inflation inside EMU. Not surprisingly, both economies also experienced strong growth in output above potential and tight labour markets.

In both cases, inflationary pressures played a role in helping the economies adjust to shocks within EMU. The European Commission<sup>a</sup> has noted that: “In the event of country-specific circumstances, though, the nominal interest rate and exchange rate can no longer provide for cyclical and structural adjustment. Therefore, price pressures will arise, changing the real exchange rate and, as a consequence, relative competitiveness . . . such a deterioration of relative competitiveness within EMU is not per se undesirable, as relative prices and wages are an essential economic adjustment mechanism in the monetary union.”

Blanchard<sup>b</sup> argues that a higher rate of inflation in Ireland inside EMU was part of the optimal adjustment package as it was difficult to make the case for tightening fiscal policy. Similarly, the OECD<sup>c</sup> notes that wage-price inflation in the Netherlands was part of the normal adjustment process within a single currency area and appropriate to realigning the competitive position of the Netherlands with other euro area economies.



<sup>a</sup> The EU Economy: 2001 Review, European Economy No. 73, European Commission, 2001.

<sup>b</sup> Blanchard, ‘Country adjustments within the euro area: lessons after two years’ in Alesina et al. ‘Defining a Macroeconomic Framework for the Euro Area’, Monitoring the European Central Bank 3, London, CEPR, 2001.

<sup>c</sup> OECD Economic Survey of the Netherlands, OECD, 2002.

### Price flexibility in the UK...

**2.106** Adjustment differs in the UK where, outside EMU, interest rates together with exchange rate movements ensure that inflation remains at target. Nonetheless, relative price movements between regions and industries ensure adjustment and competitive resource allocation within the UK.

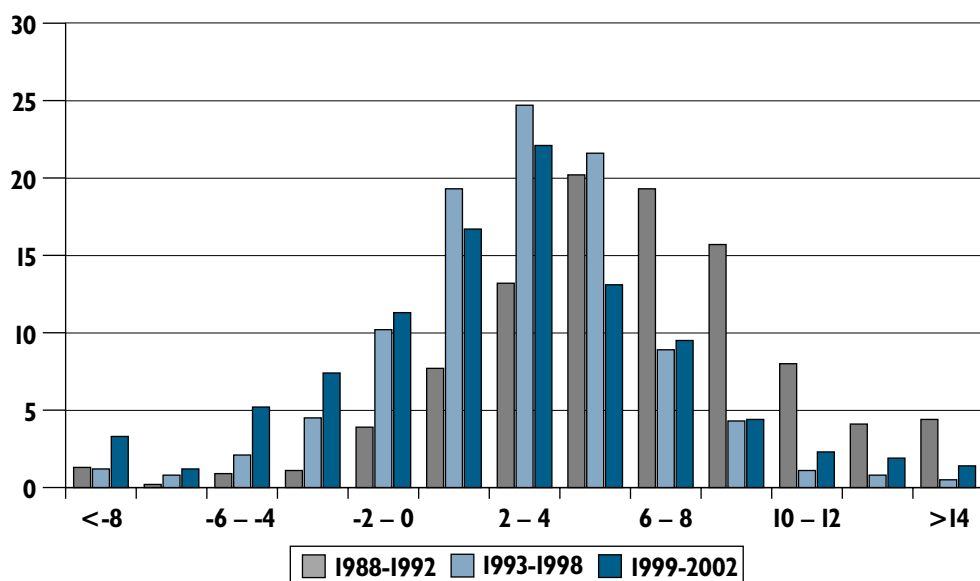
**...is not instantaneous...** **2.107** Like wage adjustment, price adjustment will not be instantaneous. Prices are sticky or slow to adjust due to the costs involved in changing prices, or firms might be reluctant to lower their prices leading to downward nominal price rigidity.

**...but there remain a wide range of price movements** **2.108** A low and stable inflation environment might lead firms to lengthen the time between price changes. However, analysis of RPIX inflation shows that there have been relative price movements in the UK during the 1990s when the inflation rate was much lower and more stable than in the past (see Box 2.9). In recent years, a high proportion of price movements have been negative, suggesting that UK firms are willing to cut prices as demand conditions change. Evidence from the euro area shows that price falls are also present within the euro area inflation aggregate.

### Box 2.9: Price flexibility in the UK

The chart below shows the distribution of weighted price movements in the annual UK Retail Prices Index excluding mortgage interest payments (RPIX) averaged over different time periods. Each bar shows the proportion of goods and services that have inflation rates within a given range: for example, on average between 1999 and 2002 the prices of a small proportion of goods and services rose by more than 14 per cent annually, while the prices of around a fifth of goods and services rose by between 2 and 4 per cent.

**Distribution of weighted annual RPIX inflation rate over time**



Source: Calculated from ONS data.

The chart clearly illustrates that the whole distribution has shifted to the left since 1992, reflecting the relatively lower inflation environment and greater macroeconomic stability in the UK. A significant number of price movements within the distribution are negative, in other words price falls are not uncommon. Indeed, in 2002 around a quarter of the distribution was negative. The Bank of England<sup>a</sup> notes that the increasing prevalence of price cuts suggests that the efficient allocation of resources in a low-inflation environment has not been hampered by a lack of downward flexibility in prices.

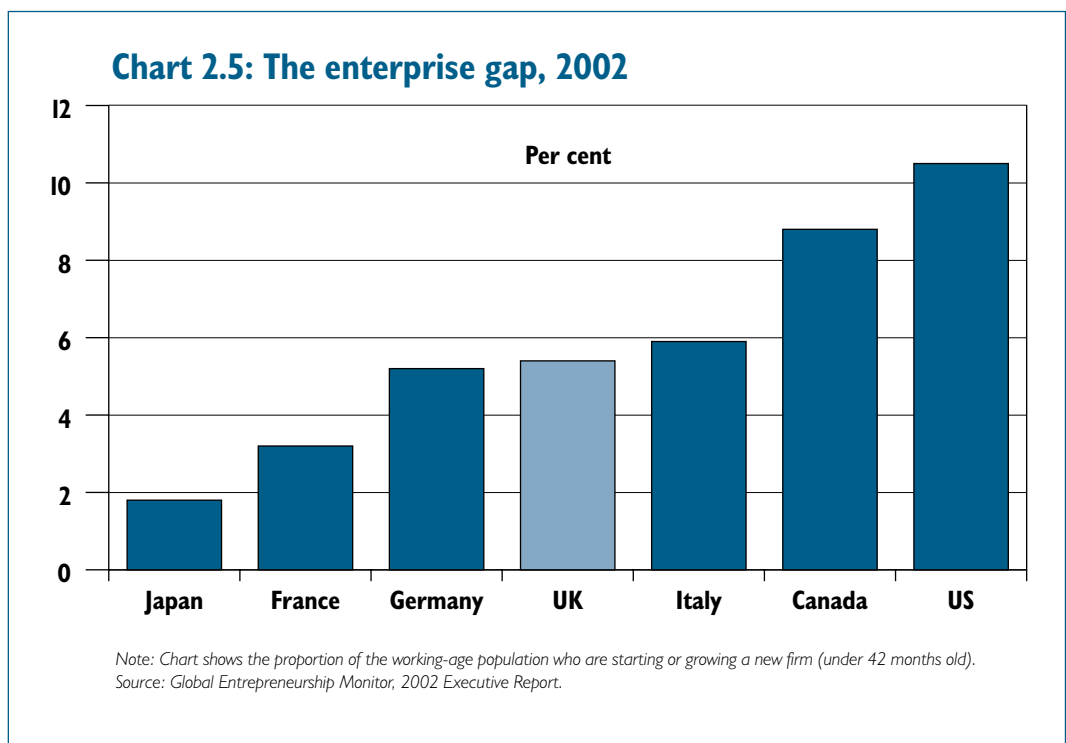
<sup>a</sup> Inflation Report, Bank of England, August 2000.

**2.109** Price flexibility can also be considered by examining how firms alter their margins or mark-ups in response to shocks. The mark-up is the profit margin that a firm charges over the cost of producing a product or service. Studies have found that the correlation between mark-ups and output is positive in the UK – that is, firms raise their mark-up when output is high and lower it when output is low. This is one source of stabilisation for output and employment in response to shocks.

**2.110** Survey evidence suggests that firms typically review prices at set intervals rather than responding to particular events, which may lead to price stickiness. But surveys also show that prices are determined primarily with regard to market conditions and that greater competition increases the frequency of price reviews.

### Competitive markets

**2.111** Competitive and open markets enhance price flexibility. These features are difficult to quantify but recent reforms and progress towards greater Single Market integration suggests that the EU is doing better than it was. Yet, on many indicators, the UK and the EU still underperform the US. As illustrated in Chart 2.5, it is estimated that around 5½ per cent of working-age adults are engaged either in starting a new business or in running a young firm in the UK, although start-up rates tend to vary widely across different communities. This figure is close to the European average, but is barely over half the US level.



## Outcomes in flexible product markets

### Product market outcomes

**2.112** The evolution of prices is important in EMU because price transparency is one of the potential benefits of a successful single currency, as discussed in the assessment of the growth, stability and employment test. Such transparency can improve the signals for firms when deciding whether to move resources away from inefficient areas to more productive and innovative uses, or when to enter and exit particular markets. This increases the dynamism and flexibility of the product market. The product market also influences labour market outcomes – for example, competitive product markets create an incentive to use labour efficiently, increasing the flexibility of the labour market.

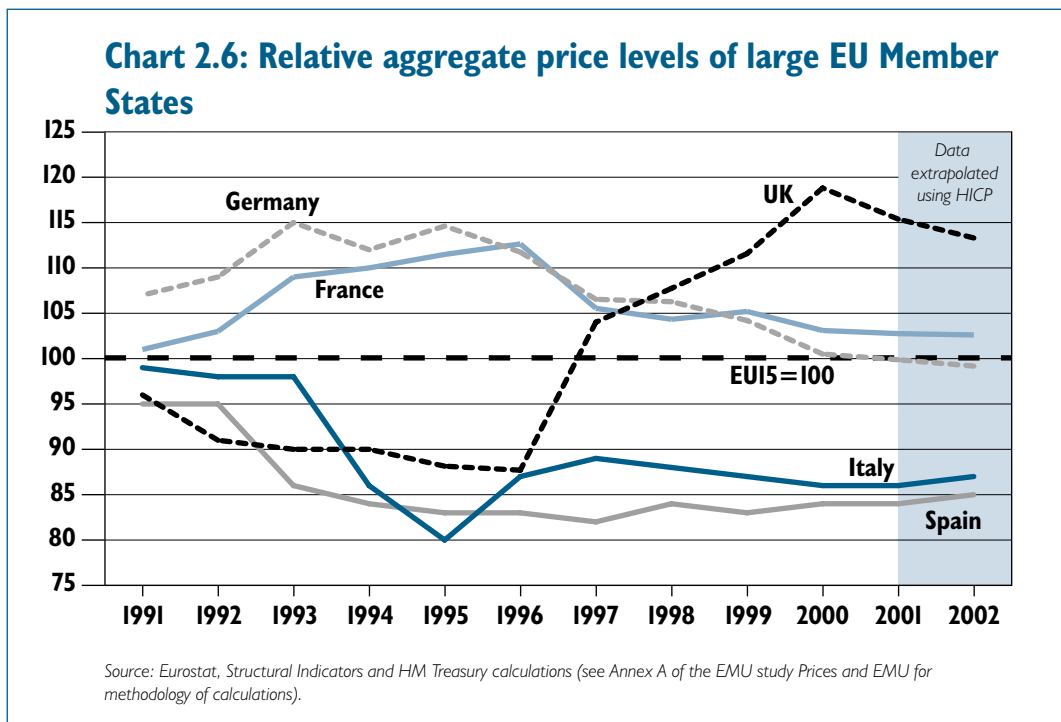
**Price competitiveness could go further in the EU**

**2.II3** Markets with greater flexibility should exhibit low price differentials between regions or countries as competitive forces help to erode price differentials. The EMU study *Prices and EMU* discusses price differentials in the EU and finds that:

- price dispersion in the US is lower than in the EU, suggesting there is considerable scope for further price convergence both in the EU and between the UK and other European economies;
- prices across the EU are generally higher than in the US, implying there are still barriers to fully realising the benefits of the Single Market within the EU; and
- prices vary widely between EU countries. No country is uniformly expensive or uniformly cheap, although the UK tends to be relatively more expensive for a number of products.

**Relative price levels**

**2.II4** The relative price level (RPL) is the ratio of domestic to foreign prices adjusted for the exchange rate between domestic and foreign currency. Chart 2.6 shows the relative aggregate price levels for the large EU countries. In the mid 1990s, the price level in the UK moved from being below the EU average to above it. The EMU study *Prices and EMU* argues that much of this increase can be explained by the rise in the nominal sterling-euro exchange rate over the same period. Because prices are not fully flexible, the nominal exchange rate can determine relative prices for several years.



**Mark-ups in the UK similar to the US**

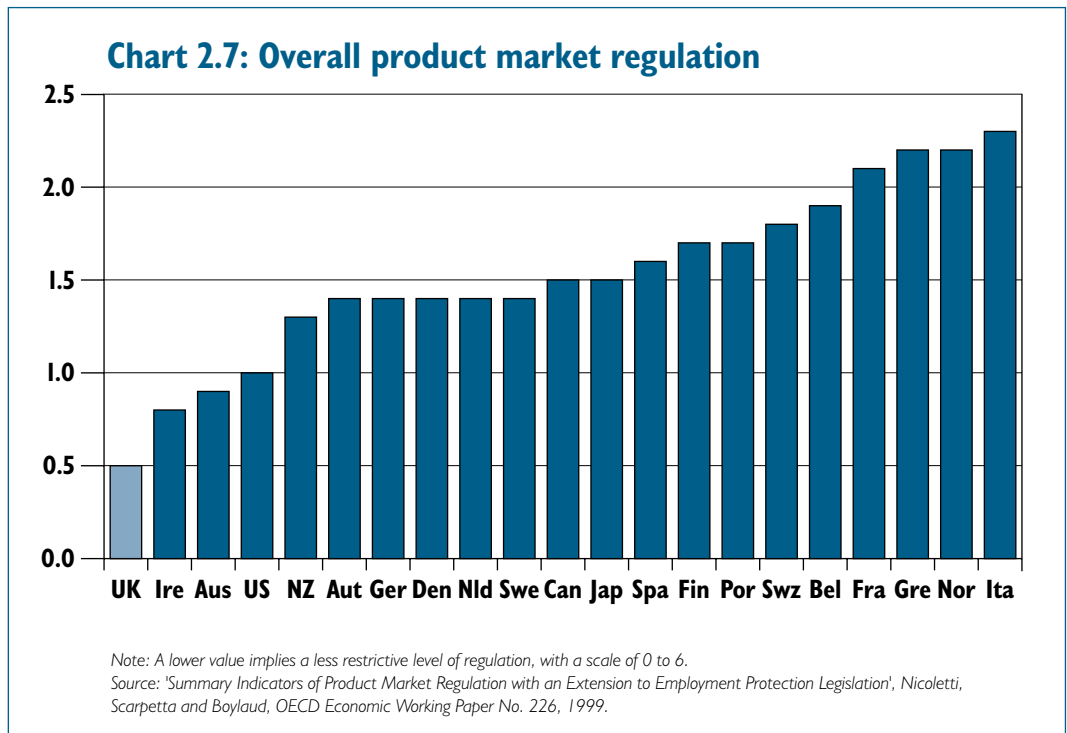
**2.II5** A closely related indicator is the size of margins or mark-ups. Greater competition is associated with lower mark-ups, as high margins are a signal for firms to enter the market. Studies typically find evidence that markets are not perfectly competitive and that mark-ups in the UK are similar to the US but are higher in large European countries and Japan. For example, in one study average US mark-ups were 10 to 15 per cent, while in other countries they were 15 to 30 per cent.

## The institutional environment

**Regulatory indicators show the UK is competitive...**

**2.116** For the potential benefits of EMU to be fully realised it is important that the institutional and policy environment promotes price flexibility, supports businesses and entrepreneurs and ensures that there is effective competition in all markets.

**2.117** Summary indicators, such as those produced by the OECD, show that the UK has the least restrictive regulation in product markets of those studied (see Chart 2.7). Germany's product market also has relatively less restrictive regulation, but France and Italy are more restrictive.

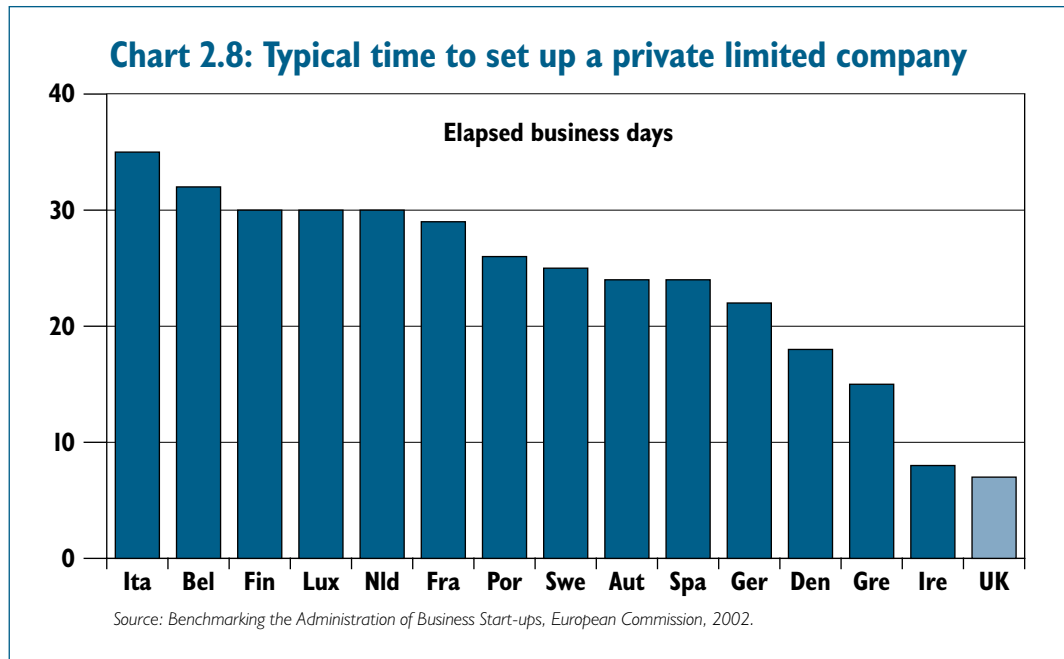


**2.118** Other research organisations support these findings:

- the Economist Intelligence Unit (EIU) global business environment rankings score the UK well, both retrospectively (1998 to 2002), and looking forward (2003 to 2007) where the UK is ranked the fourth most attractive business environment out of 60 countries; and
- the Global Competition Review recently ranked the UK as equal second in its world league table.

**...and business start-up costs are low**

**2.119** Removing obstacles to new firms setting up in business is particularly important for promoting competition and innovation. Evidence on business start-ups shows that the UK performs well in this area. It takes around seven working days to set up a business in the UK – the shortest time in the EU (see Chart 2.8). The UK also has the second lowest costs needed to set up a new business.



**Promoting competition and enterprise...**

**2.120** These indicators are largely static and do not reflect reform initiatives in the UK or the EU in recent years. The UK Government is committed to improving competition and enterprise and has announced a wide range of measures to progress this agenda.

**2.121** Alongside measures to improve investment, innovation and skills, the Government has sought to strengthen competition by radically overhauling the competition regime to ensure that it is among the best in the world, while addressing the barriers to entrepreneurship in many communities.

**2.122** Through the Competition Act 1998 and the Enterprise Act 2002, the Government has made competition policy a key element of its microeconomic strategy. The reforms grant full independence to the UK competition authorities, giving the Office of Fair Trading (OFT) a clear proactive role to keep markets under review and new powers to impose criminal penalties for individuals engaging in hard core cartel activity.

**...throughout the UK**

**2.123** The Government's strategy for building an enterprise society in which people from all backgrounds can consider and act on opportunities for enterprise was set out in *Enterprise Britain: a modern approach to meeting the enterprise challenge*, published in November 2002.

**2.124** The Government is committed to removing obstacles to entrepreneurship, especially in disadvantaged areas. The measures that it has introduced include cutting the corporation tax rate to 30 per cent, the small companies rate to 19 per cent and the starting rate to zero. It has designated 2,000 Enterprise Areas where social attitudes, market failures and the business environment generate particular problems, and is taking additional steps to break down barriers to enterprise in these areas.

**Product market flexibility in the EU...**

**2.125** The Single Market Programme and more recently the economic reform agenda initiated by European leaders at Lisbon in 2000 have acted as significant drivers of market integration and competition in the EU.

**2.126** The Government reported earlier this year on progress on reforms in EU economies in *Meeting the Challenge: Economic Reform in Europe*. There have been substantial developments, including progress on the liberalisation of energy and communications markets, research and innovation initiatives, ongoing work on European competition policy and changes to the state aid regime. However, European economic performance in recent years has remained weaker on many counts than that of the US.

**...to match the dynamism of the US**

**2.127** The importance of a large integrated single market in promoting competition in the US is highlighted in the EMU study *The United States as monetary union*. Indeed, the relatively greater dynamism and flexibility of the US economy has been a feature of much of this section. The Government's 2002 White Paper, *Realising Europe's Potential: Economic Reform in Europe* noted:

*"For the full potential of the Single Market to be realised, Member States need first to remove the remaining legal, administrative, technical and other barriers which hamper Single Market integration, and which prevent Europe from attaining the levels of competition and growth enjoyed by the US."*

### Conclusion: how flexible are UK product markets?

**2.128** A decision to join EMU would increase the need for rapid price movements and would also make it necessary for firms to be able to respond effectively to shocks and adapt to the competitive opportunities that the single currency will bring. The UK has a reasonable degree of price flexibility with relative prices both rising and falling within the overall inflation aggregate. Moreover, the UK generally exhibits a competitive business environment and the Government is committed to further sharpening competition forces and improving opportunities for entrepreneurship in all areas of the community.

**2.129** Since the 1997 assessment there has been much effort to promote competition at the EU level. Despite progress, the degree of competition and market flexibility falls short of what might be achievable as measured by the US.

**Policy requirements**

**2.130** In the product market the Government has announced the full independence of the UK competition authorities and is going further to enhance competition in specific markets, reform the planning system to make it work more efficiently and introduce a package of deregulatory reforms to ease the burden of regulation on small business.

## MARKET FLEXIBILITY: ADJUSTMENT THROUGH RISK SHARING AND CAPITAL MARKETS

**The importance of a flexible capital market for EMU**

**2.131** This section examines the flexibility of UK and EU capital markets. Risk sharing through capital markets can also play a role facilitating adjustment in EMU. A flexible and integrated capital market can provide financial instruments that help those consumers and firms with sufficient wealth to smooth or stabilise their consumption following a shock, compensating for the loss of national monetary policy and the nominal sterling-euro exchange rate. More generally, highly flexible and efficient financial markets ensure that capital is allocated to where it earns the highest returns for a given level of risk, raising growth. Well developed capital markets offer a range of funding options for investment and a supply of capital for new projects or business start-ups. The key driver of efficient capital markets is the institutional environment, particularly regulation.

**2.132** The EMU studies *The United States as a monetary union*, *The location of financial activity and the euro* and *EMU and the cost of capital* provide a comprehensive overview of the substantial body of literature on the impact of EMU on financial markets that has emerged since 1997.

**A framework for assessing capital market flexibility**

**2.133** Drawing on these studies, this section assesses capital<sup>10</sup> market flexibility using the same framework as for labour and product markets:

- **characteristics** – the mechanisms through which the capital market adjusts to a shock. The key focus is on the important role of risk sharing;
- **outcomes** – the indicators of how well capital markets are functioning, in particular the level of financial market integration; and
- the **institutional environment** and the extent to which it will influence the adjustment process. The regulatory framework in which capital markets operate is a central issue.

### Characteristics of flexible capital markets

**2.134** Capital markets can help **risk sharing** between countries and regions, which may be particularly important in EMU. There are two types of capital market risk sharing:

- first, if firms or households hold a diversified portfolio of assets spread across regions and sectors, they can use the income from these assets to insure against a fall in income that is specific to their own region or sector; and
- second, households can borrow or lend on credit markets to smooth fluctuations in income.

**The importance of risk sharing for EMU**

**2.135** The reason why risk sharing across geographical areas is important in the context of EMU is because it provides one mechanism with which to adjust to the type of shocks that an independent monetary policy and the nominal sterling-euro exchange rate would normally address. To be effective, risk sharing requires appropriately regulated financial markets that allow capital to flow across countries, regions and industries to smooth adjustment to shocks, and which offer a diverse range of financing options to investors and borrowers.

**Risk sharing in the US**

**2.136** Risk sharing is one of the key mechanisms available to smooth the impact of regional or sectoral shocks in the US. The EMU study *The United States as a monetary union* finds that market risk sharing between US states is higher than between national economies (see Box 2.10).

**Box 2.10: Risk sharing in the US**

The EMU study *The United States as a monetary union* discusses how capital markets have become increasingly important as a channel for smoothing shocks in the US. It reviews a number of studies that show that risk sharing is an important adjustment mechanism in the US, and perhaps more important than fiscal transfers. Estimates suggest that between 35 per cent and 60 per cent of shocks are smoothed through risk sharing in the US.

Research finds that market risk sharing between US states is higher than that found between countries in the EU, largely because capital and credit markets in EU countries are less well integrated than those in the US. This is consistent with ‘home bias’ (where investors hold portfolios which are heavily weighted to domestic assets) at the national level leading to less international diversification than would be predicted by models of optimal portfolio allocation. If EMU prompts increased capital market integration it could reduce home bias within the euro area and so facilitate greater risk sharing.

<sup>10</sup> Portfolio and physical capital are both considered, although the focus is on portfolio capital. Physical capital is focused on in the assessment of the investment test.

**2.137** EMU could have a number of effects on investment strategies, increasing capital market integration and the potential for greater risk sharing within the euro area. In his contribution to the EMU study *Submissions on EMU from leading academics*, Professor Jean Dermine states: “A single currency in Europe changes fundamentally the competitive structure of the corporate bond and equity markets, since one key source of competitive advantage, namely home currency, disappears”.

**Portfolio diversification** **2.138** Portfolio diversification means that investors hold claims on other regions’ output, for example through equity ownership. In his contribution to the EMU study *Submissions on EMU from leading academics*, Professor Peter Kenen notes: “By fostering the integration of capital markets, a monetary union will enhance the ability and willingness of households to diversify their holdings of financial assets and thereby self-insure against asymmetric shocks”.

**2.139** The removal of currency costs on cross-border financial transactions in EMU removes one potential barrier to portfolio diversification in the euro area. Efforts to remove barriers in the EU capital market through measures contained in the Financial Services Action Plan (FSAP), which are complementary to appropriate regulation by national authorities, are particularly important in determining the degree to which individuals can take advantage of the benefits of portfolio diversification.

**2.140** If the endogenous convergence effects discussed in the assessment of the convergence test promote economic convergence in euro area countries, this could reduce the benefits of country-based portfolio diversification for euro area investors. If national economies move together more closely, and currency risk is removed, then there is less advantage from diversifying across countries. In such circumstances, investors may find that portfolio allocation strategies will be dominated by sectoral, rather than country, considerations.

**Physical capital mobility** **2.141** A high level of physical (or fixed) capital mobility can also help economic adjustment. For example, capital may flow to a region with high unemployment to take advantage of low wages, thus returning unemployment to trend. The extent to which capital is mobile in the euro area will be closely linked to the degree of wage flexibility and also to the remaining barriers in the Single Market. Capital is more mobile where wages adjust and where markets are efficient and offer a range of types of funding and a supply of capital for new projects or business start-ups. If these conditions are in place, capital can be quickly reallocated across regions, industries or countries in response to changing economic conditions.

**2.142** As with geographic labour mobility, physical capital mobility is a relatively more effective adjustment mechanism in the face of long-term structural problems. It is not a suitable adjustment mechanism for short-term shocks – a key consideration when evaluating the case for UK entry.

## Outcomes in flexible capital markets

**Greater Single Market integration** **2.143** The evidence to date is that EMU has affected euro financial market integration, for example:

- a direct consequence of the single currency has been the establishment of an efficient wholesale euro payment system that ensures a smooth flow of funds across the euro markets. The successful introduction of TARGET,<sup>11</sup> the EU's cross-border wholesale payments system, has allowed funds to move smoothly across the EU; and
- as discussed in the EMU studies *The location of financial activity and the euro* and *EMU and the cost of capital*, the euro-denominated corporate bond market grew strongly after the start of EMU and the average size of issue has increased.

**Equity risk sharing: portfolio reallocation** **2.144** Portfolio diversification is one measure of greater market integration and, in the US, has acted to smooth the impact of regional or sectoral shocks. The EMU study *EMU and the cost of capital* provides evidence that portfolio diversification has increased since the start of EMU, and investors have adopted portfolio allocation strategies which are less biased towards domestic assets and are spread more widely across EU countries and sectors.

**2.145** However, for a variety of reasons, including market and regulatory constraints, which affect not only portfolio allocation but also wider efforts to integrate EU markets, portfolio diversification in the euro area has not reached its full potential. Because efforts to remove barriers in the Single Market will take some time, the benefits of risk sharing in the euro area may therefore appear gradually. Consequently, capital markets in the euro area will provide a limited adjustment mechanism in the near future, although if barriers are removed they should become more effective over time.

**Foreign direct investment** **2.146** An outcome of capital mobility is increased cross-border investment flows – for example, foreign direct investment (FDI) can flow more freely across borders in order to take advantage of market opportunities, as discussed in the assessment of the investment test and the EMU study *EMU and business sectors*. The UK has been a leading recipient of inward investment into the EU over recent years. In 2001, the UK was the most successful country in the EU at attracting inward investment and the second most successful in the world.

**2.147** As the assessment of the investment test discusses, the removal of exchange rate volatility in EMU should promote cross-border investment flows within the euro area. This will allow capital mobility to play a greater role in economic adjustment to long-term structural change.

## Institutional environment: market regulation

**2.148** The appropriateness of the institutional and regulatory environment will be a major influence on the ability of consumers and firms to take advantage of the capital market mechanisms that enable them to spread risk and smooth or stabilise consumption. While the euro itself could be a further catalyst for financial market integration, this is only a complement to ensuring that policy-induced barriers do not hamper the integration of EU Member States' markets.

<sup>11</sup> Trans-European Automated Real-time Gross settlement Express Transfer system.

**Financial market infrastructure** **2.149** EU financial market infrastructure is undergoing a period of change. This is being driven by a strong business case for rationalising its fragmented nature rather than by the single currency (although EMU may have added additional impetus). One effect of the fragmented nature of the EU's market infrastructure, as well as a number of regulatory barriers in individual Member States, has been to hold back portfolio diversification. It has increased the cost of cross-border financial transactions by keeping transaction costs on cross-border activity at much higher levels compared to domestic transactions. Trades made across EU borders are more expensive than domestic trades (although no more expensive than trades between the US and Europe).

**2.150** Tackling these policy-induced barriers is therefore key to capital market integration and to the functioning of capital markets as an adjustment mechanism across borders in the EU and within EMU.

**2.151** Expectations of the level of integration which the FSAP and other measures can achieve need to recognise evidence from the US, indicating that full integration may be unlikely to occur. As the assessment of the financial services test demonstrates, even if policy-induced barriers are removed through initiatives such as those contained in the FSAP, a number of 'natural' barriers are likely to segment the EU market, such as the differences in language, law and legal tradition.

### Conclusion: how flexible are capital markets?

**2.152** Capital markets play an important role in stabilising the impact of shocks between regions in the US, facilitated by highly integrated financial markets. Although cross-border risk sharing is not significant in Europe at present, greater financial market integration would enhance the scope for risk sharing across the EU and bolster its role as an adjustment mechanism.

**Policy requirements** **2.153** In the capital market, the Government will increase flexibility through reforms to improve access to finance for small enterprises with high growth potential and consultation on further reform to the corporation tax system.

## HOW FLEXIBILITY AND ADJUSTMENT WORKS IN PRACTICE

**2.154** The various aspects of flexibility considered in preceding sections can be illustrated by considering the experiences of existing monetary unions. This section examines how adjustment has occurred in practice, both within EMU and also within more long-standing monetary unions such as the US and the UK. The analysis in this section draws on the EMU studies *The United States as a monetary union* and *EMU and labour market flexibility*.

### Experiences in the euro area since 1999

**Experiences inside EMU** **2.155** The experience of countries within EMU since 1999 illustrates how different economies have performed in the absence of national monetary policy and individual nominal exchange rates with other euro area countries. These experiences provide important lessons for the UK and confirm the insights of the earlier analysis.

**Diverse growth...** **2.156** Inside EMU, economic performance has varied considerably. Growth was initially stronger in Ireland and the Netherlands, generating overheating pressures in these countries. Growth has been weaker in Germany, which had a negative output gap in 1999 and again in 2002 (see Table 2.1).

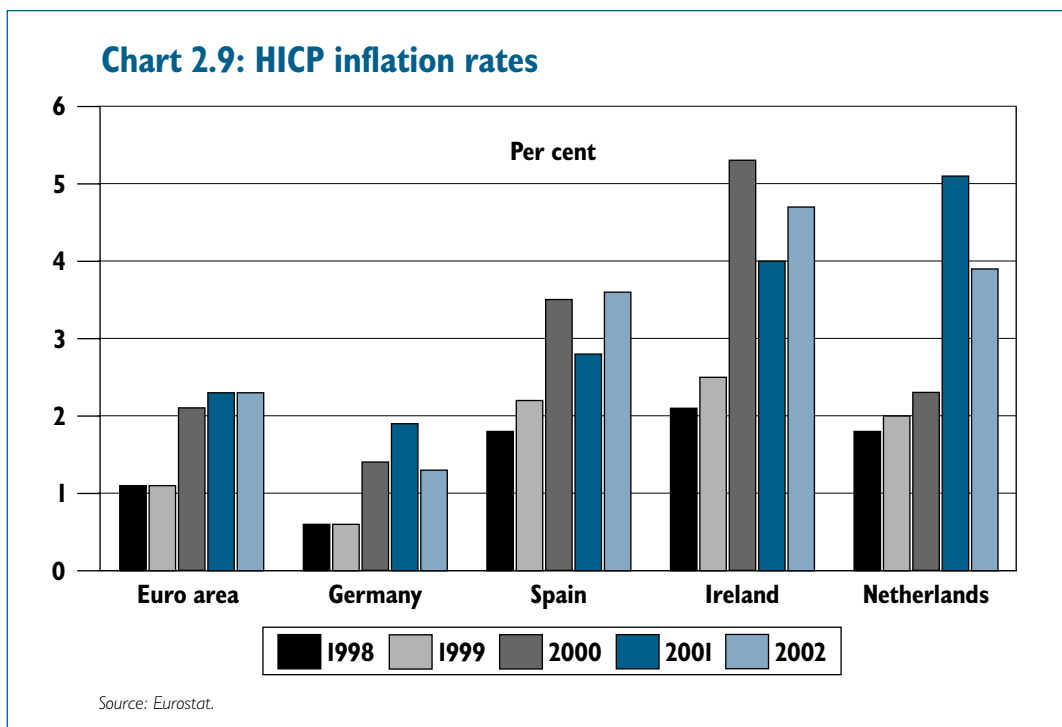
**...and transition experiences** **2.157** Euro area economies had different experiences in the transition to EMU, as discussed in the assessment of the convergence test. In particular, Ireland's transition entailed a sharp reduction in interest rates immediately prior to joining EMU. This added to domestic overheating pressures in Ireland at the start of EMU.

**Table 2.1: Euro area output gaps**

	1999	2000	2001	2002
Germany	-0.2	1.1	0.4	-0.9
Netherlands	2.8	3.3	1.8	-0.2
Ireland	4.4	6.0	3.7	2.3

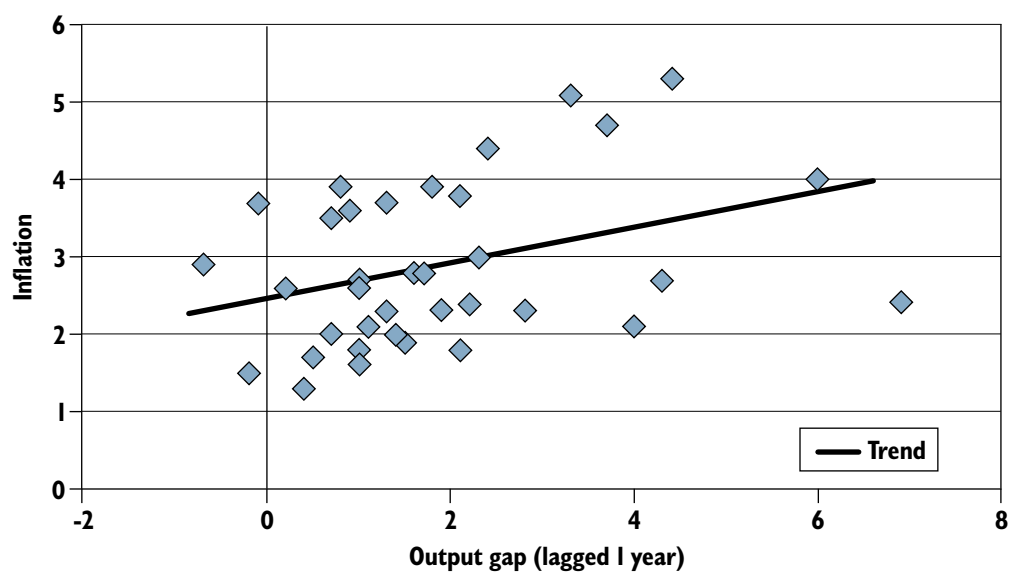
Source: European Commission spring 2003 forecasts.

**Inflation differences...** **2.158** Inside EMU, differences in cyclical positions can no longer be accommodated by national monetary policy and the nominal exchange rate. The convergence test presents 'Taylor rule' estimates of the appropriateness of short-term interest rates given the cyclical position of the individual euro area economies. Evidence suggests that price and wage movements have played a role in adjustment inside EMU. In their contribution to the EMU study *Submissions on EMU from leading academics*, Professor Willem Buiter and Dr Clemens Grafe note: "It is encouraging that differential national rates of price and unit cost inflation can be observed to be at work in the Euro area while the ECB ensures a low average inflation rate for the Euro area as a whole". Inflation has been highest in countries where demand and output was initially strong – namely Ireland, the Netherlands and Spain, while economies such as Germany, with relatively weak growth, have seen low inflation – see Chart 2.9. The role of inflation in adjustment and the degree to which cyclical factors account for the degree of inflation divergence is analysed further in Box 2.11.



**Box 2.1 I: Has inflation helped adjustment?**

Treasury empirical work confirms that cyclical differences have contributed to inflation differentials between euro area countries since the start of EMU. The chart below illustrates that there has been a positive relationship between output gaps and inflation rates in euro area countries. Simple regression analysis finds that a country's inflation rate is linked positively to the economy's cyclical position but negatively to the relative price level, which demonstrates a degree of price level convergence, although this effect is not strong. But the simple regression does not explain inflation completely, indicating that other factors also contribute to inflation differences; for example, inflation rates in both Ireland and the Netherlands were boosted by tax changes during this period.

**HICP inflation and output gap in euro area countries, 2000-2002**

Source: HM Treasury based on European Commission and Eurostat data.

Applying the results to Ireland in 2000, the regression equation suggests that around 1 1/2 percentage points of Ireland's 5.3 per cent inflation rate reflected cyclical factors. Applying these results to Germany in 2002 suggests that the cyclical position added very little to inflationary pressures.

**...house price inflation...**

**2.159** Overheating pressures in some EMU economies have also been evident in strong house price inflation (see Box 2.12). In his contribution to the EMU study *Submissions on EMU from leading academics*, Professor John Muellbauer notes property prices rose strongly in the most recent upswing in Spain, Ireland and the Netherlands.<sup>12</sup> In contrast, property prices in Germany fell in real terms. These developments have to be seen in the context of the longer-term trends already discussed in the assessment of the convergence test.

<sup>12</sup> For analysis of housing markets in the UK and the Netherlands see the EMU study *Housing, consumption and EMU*.

### Box 2.12: House price inflation and adjustment inside the EU

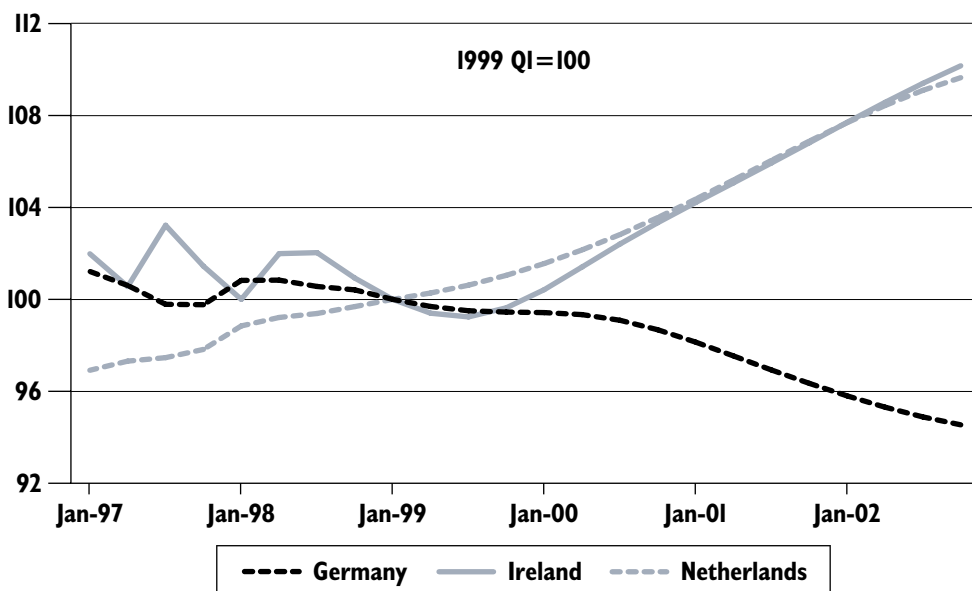
Several euro area economies have experienced strong house price inflation since the start of EMU, particularly Ireland, the Netherlands and Spain. Between 1997 and 2001, house prices in the Netherlands rose by just under 10 per cent a year, slightly higher than the rises experienced in the UK over the same period. Irish house prices grew by 12 per cent a year over the same period.

Strong fluctuations in house prices cause economic difficulties inside or outside EMU because of the potential for speculative bubbles. But, inside EMU, they might be particularly problematic since euro area interest rates would not respond to house price cycles that were only evident in particular countries. Consequently, other instruments would be needed to deal with housing market volatility. In his contribution to the EMU study *Submissions on EMU from leading academics*, Professor John Muellbauer notes that Denmark has a number of instruments that help to stabilise the market in times of pressure and that: “the Danish property tax proves a powerful automatic stabiliser, which can be activated if consumer spending needs to be stimulated or brought under control”.

### ...and real exchange rate movements

**2.160** As the analysis in this chapter has highlighted, inside a currency union, changes in the real exchange rate between members are the consequence of inflation adjustment. Strong inflationary pressures in Ireland and the Netherlands have led to an appreciation in the real exchange rate and a decline in competitiveness vis-à-vis euro area partners, helping to alleviate excess demand – see Chart 2.10. By contrast, the real exchange rate in Germany fell in line with weaker inflationary pressures, improving its competitiveness relative to the euro area average.

**Chart 2.10: Real effective exchange rates against the euro area (using nominal unit labour cost deflator)**



Source: European Commission.

**2.161** For countries outside EMU, nominal exchange rate movements may substitute for inflation differences as a means of achieving relative price level changes. The EMU study *The exchange rate and macroeconomic adjustment* suggests that the strength of the real exchange rate of the UK relative to the euro area in recent years was warranted by the strength of domestic demand in the UK. In addition, the EMU study *Prices and EMU* finds that the rise in the nominal sterling-euro exchange rate was the key factor driving the rise in the UK price level relative to the EU average in the late 1990s.

### Fiscal policy inside EMU

**2.162** Fiscal policy can also support adjustment mechanisms inside EMU and is discussed in detail in the next section of this chapter. The operation of the automatic stabilisers helps to stabilise output in individual economies over the economic cycle. For example, during an upswing, unemployment benefit payments tend to fall and tax receipts tend to rise, dampening the cycle. In a downturn, unemployment benefit payments rise and tax receipts fall, moderating the slowdown.

**2.163** The Treasury discussion paper *Fiscal stabilisation and EMU* provides estimates of the strength of automatic stabilisers in the EU. Some estimates suggest that volatility can be reduced by around a quarter on average in the EU, while others suggest these effects are lower (see Table 2.2).

**Table 2.2: Effectiveness of automatic stabilisers in large EU countries**

	Percentage of fluctuations in output that are smoothed <sup>1,2</sup>				
	European Commission Quest Model				OECD Interlink model
	Consumption shock	Investment shock	Export shock	Productivity shock	
Germany	17	9	10	13	31
France	23	13	14	13	14
Italy	21	11	12	17	23
UK	18	9	8	11	30
EU average (unweighted)	23	12	14	13	24

<sup>1</sup> EC Quest model results show the percentage of GDP fluctuations that are smoothed.

<sup>2</sup> OECD Interlink model results show the percentage of root mean squared (RMS) deviations of the output gap that have been smoothed from 1991 to 2000.

Source: *Public Finances in EMU - 2001*, *European Economy*, No. 3, pages 70 and 188-190; European Commission, 2001.

**2.164** Further support can be provided through discretionary fiscal policy action at a national level. As discussed in the EMU study *Policy frameworks in the UK and EMU*, fiscal policy has generally not been counter-cyclical since the beginning of EMU, meaning that it has generally not helped to counter periods of below or above trend growth. During 2000, when the euro area economy was growing at above trend rates, the fiscal policy stance was expansionary in all three large euro area economies.

## Adjustment in long-standing monetary unions: UK and US

### UK regions also need flexibility...

**2.165** In terms of adjustment within a monetary union, UK regions are analogous to countries in EMU or states in the US. Flexibility at the regional level has enabled different parts of the UK to prosper with interest rates that are set with respect to national rather than local economic conditions.

### ...even more inside EMU

**2.166** Regional flexibility would become even more important if the UK decided to join EMU. The characteristics and institutions that promote economic adjustment between UK regions would also equip the UK to thrive within EMU. Moreover, inside EMU, regions would need more flexibility as monetary policy would be set for the euro area as a whole, making interest rates less responsive to regional needs than is currently the case.

**Regional flexibility improving...** **2.167** Like EMU members and US states, UK regions rely mostly on market mechanisms to adjust to shocks specific to their region. The EMU study *EMU and labour market flexibility* shows that while geographic mobility between UK regions is not high, there is a reasonable degree of relative wage flexibility between regions.

**2.168** Evidence also suggests that the UK has recently been better able to match the supply of and demand for labour in individual regions. While the recovery of the late 1980s was largely confined to the south of England, more recently every region in the UK has seen sharp falls in unemployment.

**...but more can be done** **2.169** Nonetheless, there remain important differences between regional economic outcomes. At the sub-regional level, areas of high unemployment sit alongside areas with high vacancies. In some regions, output per person is nearly 40 per cent lower than in London, the region with the highest output per person in the UK. There have also been significant differences in local housing markets, and in particular in house price inflation, as discussed in the assessment of the convergence test.

**A modern regional policy for the UK and the EU** **2.170** The UK's long-run growth and prosperity depends on every nation and region of the UK performing to its full economic potential. That is why the Government has recently launched a modern regional policy, which aims to facilitate a higher degree of flexibility within and between UK regions.

**2.171** EMU membership would place an even greater premium on regional flexibility for the UK, as it does for existing members. This is why the Government also wants to ensure that, in the future, regional policy in the EU is substantially devolved to the regions, providing the flexibility for Member States to pursue the right regional policies to meet differing needs. The Government's policy proposals are outlined in the paper *A modern regional policy for the United Kingdom* which is discussed further in Box 2.13.

**Adjustment in the US** **2.172** The US's experience as a large and successful monetary union demonstrates the importance of flexibility to ensure that monetary union works well. The US is the world's largest economy and the regions of the US need to be able to adjust without independent monetary policies and nominal exchange rates between them.

**2.173** The EMU study *The United States as a monetary union* discusses how labour markets play a key role in US adjustment, through both wage adjustment and mobility between regions. More generally, the US exhibits strong competitive pressures helping to ensure that prices adjust quickly and efficiently. As discussed in the section on product markets, it will take some time before the EU reaches the dynamism of the US.

**2.174** The US also makes much greater use of financial markets in facilitating risk sharing. Diversified risk sharing across a broad and deep capital market helps to stabilise the economy in the face of shocks. The degree of risk sharing in the US is much greater than between members of the euro area but, as discussed in the earlier section on capital market flexibility, this may change as financial markets become more integrated.

**Fiscal federalism** **2.175** The federal tax and benefit system in the US provides some inter-regional insurance against asymmetric shocks – although this is no more, and probably less, than is already provided, on average, at a Member State level in the EU. Within individual US states there is also provision for 'rainy day' funds, analogous to the idea of using 'buffer funds' at the Member State level inside EMU. Fiscal flexibility in the UK and the euro area is considered further in the next section.

**Box 2.13: A modern regional policy for the United Kingdom**

The Government is pursuing a modern regional policy designed to improve the performance of every region, tackling the specific market and social failures that are holding them back. Real flexibility and resources have been devolved and decentralised to the nations and regions of the UK to deliver locally-led policies, within a clear framework of accountability, including:

- a move from centrally-administered innovation policies to the encouragement of local technology transfer between universities and companies and the development of regional clusters of specialisms;
- a move from a national ‘one size fits all’ approach to skills, to devolving a significant proportion of the learning and skills budget, starting with pilot schemes for post-19 training in selected regions, to promote regional excellence;
- a move from centrally-run housing and transport policies to greater regional coordination;
- continuing to remove the barriers preventing firms from starting up and growing in the UK’s most deprived communities;
- the creation of Regional Development Agencies (RDAs) to act as strategic drivers of growth in the English regions, with increased flexibility and funding rising to £2 billion; and
- starting with the East and West Midlands and the North West, implementation of business support pilots, including RDA co-management of Business Links Operators, to ensure more effective regional business support in closer alignment with Regional Economic Strategies.

It is also vital to modernise the European dimension of regional policy based on the principles underpinning domestic policy, so that it is locally led and substantially devolved. In this context, the consultation paper *A modern regional policy for the United Kingdom*<sup>a</sup> outlines the Government’s commitment to regional flexibility in the UK and the euro area and puts forward a proposed new approach for EU regional policy, an EU Framework for Devolved Regional Policy.

Under this Framework, EU Member States would agree common principles but delivery of regional policy would be substantially devolved and decentralised, and offer greater flexibility to Member States and their nations and regions. EU support, both financial and institutional, would be refocused on those poorest Member States that will benefit most from direct EU involvement.

<sup>a</sup> *A modern regional policy for the United Kingdom*, HM Treasury, Department of Trade and Industry and Office of the Deputy Prime Minister, March 2003.

## Conclusion: how much adjustment and flexibility is experienced in practice in monetary unions?

**2.176** The experiences of EMU members to date illustrate the role that adjustment mechanisms can play, in particular regarding the implications of inflation differences within EMU. There are some signs that EMU membership has facilitated euro area wage flexibility. As a large monetary union with a high degree of diversity between states, the US also shows the importance of a high degree of market flexibility and capital market integration.

## THE POTENTIAL FOR FISCAL FLEXIBILITY

**2.177** The assessment of the flexibility test has so far concentrated on how labour, product and capital markets help the economy to adjust to shocks. As such, it has focused on the actions of individual workers and firms. However, government can also help the economy to adjust to shocks and stabilise output, through the use of monetary and fiscal policy.

**2.178** Inside EMU, national monetary policy would no longer be available. This would not necessarily act as a constraint if the shocks hitting the UK economy prompted a response from the ECB which was similar to that which the MPC of the Bank of England would have made outside EMU. But some shocks may require a policy response that is specifically tailored to the needs of the UK economy.

**2.179** In EMU, fiscal policy is potentially able to play this role. Because it also impacts directly on aggregate demand at the macroeconomic level, it could provide a substitute for the loss of national monetary policy. This section considers the potential for fiscal flexibility to support market adjustment inside EMU, drawing extensively on the Treasury discussion paper *Fiscal stabilisation and EMU*.

### An enhanced role for fiscal policy

**2.180** In the current UK policy framework outside EMU, monetary policy is the main policy instrument available to support market adjustment. Fiscal policy supports monetary policy in this stabilisation role by helping to smooth the path of the economy to shocks. However, it is generally not used in a discretionary manner to stabilise output.

**2.181** Any decision to join EMU would mark a substantial shift in the UK economic environment. With monetary policy no longer tailored for UK needs, the ability of the economy to respond to shocks would be reduced, all other things equal. This implies that the UK's hard won stability could be put at risk by creating greater volatility, with possible adverse effects on growth and employment.

### An enhanced stabilisation role in EMU?

**2.182** A high degree of flexibility minimises these risks and would help to compensate for the loss of some adjustment mechanisms inside EMU. The preceding analysis of labour, product and capital markets suggests a relatively high degree of flexibility in the UK. However, there are times when market flexibility might usefully be complemented and enhanced. As discussed in the assessment of the convergence test, there remain areas where the UK is not fully convergent with the euro area and to the extent that fiscal stabilisation can be enhanced effectively, any lack of convergence would correspondingly be less problematic.<sup>13</sup>

**2.183** This raises two questions of importance to the UK EMU decision:

- what role can fiscal policy play in stabilisation?
- could its role potentially be enhanced inside EMU?

**2.184** These two questions are considered in the Treasury discussion paper *Fiscal stabilisation and EMU*. This section draws heavily on the results of that paper and also the EMU study *Policy frameworks in the UK and EMU* which analyses the robustness of the macroeconomic frameworks in operation in the UK and the euro area. The euro area fiscal framework is based around the Stability and Growth Pact (SGP) and is considered in detail in the assessment of the growth, stability and employment test.

<sup>13</sup> Fiscal policy was not covered extensively in the 1997 assessment. The experience since 1997 of the operation of new fiscal policy frameworks in the UK and the euro area make this an important issue for fuller consideration in this assessment.

## The current UK macroeconomic framework

**The current UK framework...** **2.185** The UK macroeconomic framework is designed to promote long-term economic stability, with low and stable inflation and sound public finances. Within this framework monetary policy plays the primary stabilisation role in the economy. It has the responsibility to achieve price stability which helps support the Government's objectives for advancing long-term economic prosperity.

**2.186** Fiscal policy supports monetary policy in helping to stabilise the economy in the short term primarily via the full operation of automatic stabilisers, as discussed above.

**2.187** The principal role of current UK fiscal policy is to ensure the sustainability of public finances over the medium term. Fiscal policy also addresses welfare and equity considerations and must be set so as to ensure fairness within and between generations. Box 2.14 summarises the UK macroeconomic framework for monetary and fiscal policy.

### Box 2.14: The UK macroeconomic framework

#### Monetary policy framework

The primary objective of monetary policy is price stability. The Bank of England's MPC has full operational independence for setting interest rates to meet the Government's inflation target.

The monetary policy framework aims to maintain price stability because this is the most important contribution monetary policy can make to achieving long-term economic prosperity.

The inflation target is symmetric which ensures that outcomes below the target are treated as seriously as those above. If inflation deviates by more than 1 percentage point above or below target, the Governor of the Bank of England must send an open letter to the Chancellor of the Exchequer.

#### Fiscal policy framework

UK fiscal policy is based on five key principles of fiscal management which are set out in *The Code for Fiscal Stability*<sup>a</sup> – transparency, stability, responsibility, fairness and efficiency. The Code also requires the Government to state its objectives and fiscal rules through which it operates fiscal policy based on these principles. The Government's key fiscal objectives are:

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

The EMU study *Policy frameworks in the UK and EMU* provides a full description of the UK macroeconomic policy framework.

<sup>a</sup> *The Code for Fiscal Stability*, HM Treasury, November 1998.

**...is designed to provide flexibility and accountability** **2.188** The macroeconomic framework within which UK monetary and fiscal policy operates is designed to allow the authorities the flexibility to respond to shocks, but also to ensure there are clear limits on what they can do. This has been referred to as the principle of ‘constrained discretion’ and is discussed further in the assessment of the growth, stability and employment test.<sup>14</sup> The overall framework should thus constrain macroeconomic policy to achieve long-term and sustainable goals and thereby ensure the Government’s objectives are credible, but also allow for flexibility to ensure that policy can help to stabilise the economy. The UK framework places a premium on ensuring that the Government is accountable to Parliament and the public for its actions.

### Fiscal policy in stabilisation

**Does fiscal policy work as a stabilisation mechanism?** **2.189** A key question inside a monetary union is whether fiscal policy can help to *stabilise* demand effectively in the absence of independent monetary policy. In many ways, fiscal and monetary policy are similar: they can both influence aggregate demand fairly directly and both are needed less when market flexibility is high. For example, if workers adjust to an adverse shock by accepting lower wages, then unemployment benefits (an automatic stabiliser) will not need to rise. Inside EMU, the impact of fiscal policy would also tend to be more powerful, as UK policy would have relatively little impact on euro area demand and hence there is less chance that a change in fiscal policy would be offset by a change in interest rates.

**Automatic stabilisers** **2.190** In the current UK macroeconomic framework outside EMU, the automatic stabilisers play a supporting stabilisation role. This mechanism would continue to operate inside EMU. Empirical evidence already presented suggests that the automatic stabilisers have had a stabilising impact in the UK and across the EU. However, evidence for the relative strength of automatic stabilisers across the EU is not clear cut. There are reasons to believe that the automatic stabilisers might be slightly weaker in the UK than in some other EU countries, for example because the government sector is relatively small in size.

**Discretionary fiscal policy** **2.191** In addition to the automatic stabilisers, the Government can use fiscal policy in a discretionary way. In principle, discretionary fiscal policy has the advantage that it can be tailored to meet macroeconomic targets and respond to specific shocks. In addition, discretionary fiscal policy does not suffer from the same problem as the automatic stabilisers, which can be destabilising in the face of a supply shock.<sup>15</sup>

**2.192** Analysis in the EMU study *Modelling shocks and adjustment mechanisms in EMU* shows that greater use of fiscal policy has the potential to reduce volatility inside EMU. However, discretionary fiscal policy is not without its problems, which were highlighted during the 1950s and 1960s when the UK used discretionary fiscal policy more actively. In particular:

- the incentive is for governments to loosen fiscal policy in downturns but not to tighten fiscal policy during booms, i.e. it is pro-cyclical, not symmetric; and
- there are lags between fiscal policy decisions and their implementation, and also their effect on demand.

<sup>14</sup>A fuller definition for this term can be found in Chapter 2 of *Reforming Britain’s Economic and Financial Policy*, HM Treasury, 2002 and also *Macroeconomic frameworks in the new global economy*, HM Treasury, November 2002.

<sup>15</sup>For example, a temporary adverse supply shock such as a surge in the oil price would boost inflation and depress output. The operation of the automatic stabilisers would help to boost output, but could raise inflation further.

**The importance of institutional design** **2.193** The problems associated with the use of discretionary fiscal policy in the past can be addressed through careful choices in institutional design. A well-designed institutional framework promotes transparency, accountability and credibility in fiscal policy. These features are at the core of the Government's new macroeconomic framework introduced since 1997. Key criteria for choosing fiscal policy in order for it to be effective are outlined in Box 2.15.

**Box 2.15: Making fiscal policy effective**

There are a number of criteria that can be used to improve institutional design when choosing fiscal policy instruments:

- policies should be designed to be **symmetric** over the business cycle;
- policy should be **forward looking**;
- operating rules should be clear and **transparent**; and
- the stabilisation policy **objective** should be clearly distinguished from other fiscal policy objectives.

Specific instruments should also aim to maximise the effect on activity, minimise lags and, as with all tax and spending interventions, governments will also be mindful of the implications for wider government objectives such as efficiency and equity.

## Could the role of fiscal policy be enhanced?

**Fiscal policy options in EMU** **2.194** The role of fiscal policy inside EMU could be enhanced in two ways:

- strengthening the automatic stabilisers; and
- developing the existing framework to make discretionary fiscal policy for stabilisation purposes more effective.

**Strengthening the automatic stabilisers** **2.195** The case for strengthening the automatic stabilisers inside EMU is considered in the Treasury discussion paper *Fiscal stabilisation and EMU*. The basic features of the automatic stabilisers are attractive: they are automatic so do not involve implementation and decision lags; they are symmetric; and they can be separated from other aspects of fiscal policy.

**2.196** However, the automatic stabilisers can also have an adverse impact on efficiency. Because they impact directly on taxes and benefits, they might affect incentives or the tax burden faced by certain sectors of the economy. It is thus not clear what the 'optimal' degree of automatic stabilisation would be for the UK inside EMU. Further work is required in a number of areas before a properly informed assessment of the case for strengthening the automatic stabilisers can be made.

**Discretionary policy and institutional design** **2.197** Even if strengthened, the automatic stabilisers can generally only dampen the effects of a shock and may therefore, on their own, provide an insufficient degree of stabilisation, particularly for large shocks. This suggests that more active discretionary fiscal policy might be required. To achieve that, a new institutional framework might be needed. In his contribution to the EMU study *Submissions on EMU from leading academics*, Professor Lars Calmfors states that: “the effectiveness of fiscal policy as a stabilisation tool can probably be raised significantly through various institutional reforms establishing a more well-defined and transparent policy framework that borrows from the experiences of monetary policy making”.

**2.198** A new institutional framework could potentially involve:

- modification of the **fiscal objectives** and **fiscal rules** to reflect better the stabilisation objective;
- better mechanisms to improve **accountability** and **transparency**; and
- reduction of **lags** by setting up new institutional structures or modernising the existing ones.

**An additional fiscal stabilisation objective...** **2.199** Making stabilisation a more explicit objective inside EMU would help facilitate use of a more active stabilisation policy. This would make explicit the Government’s **pre-commitment** to such an objective and help to ensure that policy operated in a **symmetric** way. The symmetric operation of discretionary fiscal policy over the economic cycle is at least partly enforced by the two current fiscal rules: the golden rule and the sustainable investment rule – set out in Box 2.16.

**Box 2.16: Fiscal rules in the current UK framework**

The Government’s fiscal objectives are implemented through rules. The current 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 (defined as below 40 per cent of GDP).

**...and fiscal rule** **2.200** There is a case, however, for looking at an additional rule to enforce counter-cyclical fiscal policy. The Government could pre-specify a rule setting out exactly how it would respond to any deviation in output from trend or debt from its medium-term target. However, past experience also shows that it can be undesirable to focus policy too much on a pre-specified formula or an intermediate indicator rather than the target outcome itself. The most appropriate response will vary according to the type of shock that has occurred and the economic context, so some degree of flexibility would be preferable.

**2.201** A credible option would be a rule under which the Government would commit to a discretionary fiscal policy response under particular circumstances, for example if the forecast of the output gap exceeded a certain level, say plus or minus 1 or 1½ per cent of GDP. That is, if the economy was expected to grow considerably above or below trend, the Government would respond symmetrically to large forecast positive or negative output gaps. The Government could also retain the flexibility not to act if it believed there was a strong case against discretionary fiscal policy action. In either case, the Government could be required to write an open letter to Parliament explaining its actions (see Box 2.17).

**Box 2.17: An open letter to Parliament for fiscal policy**

The open letter to Parliament for fiscal policy could be used to explain:

- why the output gap is forecast to exceed the pre-announced trigger value;
- how the action the Government is taking is consistent with achieving greater stabilisation, or its reasons for *not* taking discretionary fiscal policy action;
- the period in which it expects the output gap to reduce to within the pre-announced range; and
- how this approach meets the other fiscal policy objectives and the Government's wider economic objectives.

An open letter system currently operates within the UK monetary policy framework. If inflation deviates by more than 1 percentage point above or below the inflation target, the Governor of the Bank of England must send an open letter to the Chancellor of the Exchequer outlining why the deviation has occurred and how the Bank of England intends to respond.

**Ensuring transparency** 2.202 Implementing new fiscal rules or measures inside EMU would heighten the need to enhance fiscal transparency and accountability. A credible option would be for the Government to publish a regular **Stabilisation Report** on a pre-announced timetable.

**Stabilisation Report in the UK...** 2.203 The Stabilisation Report would provide an assessment of recent macroeconomic developments and indicate how the Government would meet its fiscal stabilisation objective. The report could set out:

- an analysis of recent macroeconomic developments, including the latest forecasts for UK output, inflation and the public finances;
- an assessment as to whether the UK output gap was likely to exceed the pre-announced trigger value over the forecast horizon; and
- if so, a description of the Government's planned response. This could identify the fiscal instruments to be used for stabilisation purposes and indicate the process for their reversal in future, helping to ensure that the discretionary fiscal policy changes were understood to be temporary and that 'ratchet effects' were avoided.

Such regular reporting could inform public debate and enhance monitoring of the Government's fiscal stabilisation policy. Indeed, it could provide a specific role for Parliamentary scrutiny of fiscal policy as, for example, the Chancellor could present the Report to Parliament.

**...and independent audit** 2.204 Given the complexities of operating a more active stabilisation policy, there is a clear case for enhancing independent audit. This could be achieved by increasing the role of independent analysis, particularly on the more technical aspects of policy, or strengthening the monitoring of fiscal policy through existing EU structures.

**Stabilisation fund** 2.205 Other governments have considered setting up a fiscal stabilisation fund. Such funds would effectively build up when the economy was performing well in order to provide funds to be used when the economy was performing less well. This would be kept separate from other parts of the public accounts in order to increase transparency and ensure it was only used for stabilisation purposes. However, such a fund would be unnecessary if other mechanisms existed to help avoid pro-cyclical outcomes and ensure sufficient transparency.

**Fiscal Policy Committee** **2.206** Some commentators have considered the option of an independent Fiscal Policy Committee, which would be delegated the authority to change some fiscal instruments to pursue stabilisation policy objectives, analogous to the current arrangements for monetary policy. However, this would introduce some accountability problems and would not be consistent with parliamentary tradition in the UK, as it would challenge parliamentary sovereignty with respect to fiscal policy.

**Instruments** **2.207** Greater use of discretionary fiscal policy would mean that the Government would have to choose the most effective **instruments** to achieve stabilisation. The instruments chosen would ideally overcome the well-known problems of lags involved with implementing discretionary fiscal policy. Importantly they would also need to have minimal adverse effects on income distribution and be easily reversed when economic conditions changed.

**A greater role for the regulator** **2.208** The Treasury discussion paper *Fiscal stabilisation and EMU* considers a range of fiscal instruments on both the tax and expenditure side. The most promising instruments for fiscal stabilisation policy would appear to be expenditure taxes, which could be relatively effective at stabilising output, with limited undesirable impacts on incentives, the supply side or the overall equity of the tax system. Expenditure tax rates can be changed using the existing tax regulators. The tax regulators can currently change a number of taxes including VAT and excise duties outside the annual Budget cycle although these have not been used in practice in recent years – see Box 2.18. Greater use of the existing tax regulator powers would help to minimise lags in the use of discretionary fiscal stabilisation policy and reforms could increase their suitability for this purpose.

**2.209** Fiscal instruments that could help stabilise the housing market are another possibility. They could help to reduce volatility in this sector in the same way that the automatic stabilisers operate in the economy on aggregate, as well as potentially providing an additional discretionary stabilisation tool.

**Box 2.18: The existing tax regulators**

The existing regulator powers are formalised in several pieces of legislation. Various regulators have the authority to change:

- VAT (by a maximum of 25 per cent of the existing rate);
- the rates of the majority of excise duties on alcoholic drinks, hydrocarbon oils, betting and gaming and Air Passenger Duty by up to 10 per cent of the existing rate; and
- the rates of duty on tobacco products by up to 10 per cent of the existing rate.

The regulators were originally introduced in the 1960s and 1970s to allow the Government to change indirect tax rates between Budgets for demand management purposes but they have not been used since the 1970s.

**A stabilisation role for fiscal federalism?** **2.210** Regions in a currency union can in theory also borrow from each other; for example, countries or regions suffering from an adverse shock can borrow from the rest of the monetary union. This is usually referred to as fiscal federalism. The lack of potential for fiscal federalism among euro area countries in comparison with the US is sometimes cited as a reason why EMU will not be able to function as effectively as a monetary union.

**2.211** Greater fiscal federalism is unnecessary if regions within a monetary union already have a high degree of stabilisation at the regional level. The EMU study *Policy frameworks in the UK and EMU* notes that euro area countries already have considerable scope for stabilisation at the national level, making greater use of a federal function unnecessary. This is discussed further in the assessment of the growth, stability and employment test.

**Fiscal stabilisation in the US**

**2.212** Nevertheless, the US provides a good benchmark against which to consider fiscal stabilisation in practice among a group of diverse states, as discussed in Box 2.19. In the US, adjustment to shocks through fiscal policy could occur in one of two ways. First, federal level policies could redistribute income across regions. Second, state governments could run fiscal surpluses or deficits to adjust to shocks.

**Box 2.19: Fiscal stabilisation in the US**

Following a regional shock, the US federal government can provide stabilisation through the tax and transfer system and through grants and subsidies to regions. The stabilisation provided is lower than in many EU countries, in part because of the smaller share of the economy accounted for by the public sector. The EMU study *The United States as a monetary union* considers studies that attempt to quantify the degree of stabilisation provided by the US federal tax and transfer system – finding that the system possibly offsets around 15 per cent of shocks.

State governments in the US have relatively large budgets and so could attempt to use fiscal policy to stabilise the regional economy, for example by running a deficit in the face of a downturn. However, US states (unlike euro area countries) do not use their budgets as a stabilisation tool; almost without exception, they limit fiscal policy through balanced budget requirements. This behaviour is voluntary and not imposed by the federal government.

During the economic expansion of the 1990s, many states did set aside ‘rainy-day funds’ as a defence against a downturn. By the end of fiscal year 2001 (end September 2001), the National Association of State Budget Officers estimates that states had built up reserve balances totalling 7.7 per cent of annual expenditures. States such as Maine, Missouri, Ohio and Kentucky have used their funds to balance a shortfall in their budgets for the fiscal year 2002.

**Conclusion: what role does fiscal policy play in adjusting to shocks and might this be enhanced inside EMU?**

**2.213** Fiscal policy has the potential to support market adjustment mechanisms inside EMU. But enhanced stabilisation mechanisms would need to meet a range of criteria to ensure their worth and be implemented when the understanding of the mechanisms by which fiscal policy affects the real economy has increased.

**Policy requirements**

**2.214** The degree of fiscal stabilisation may need to increase inside EMU where the absence of a UK-specific monetary policy may cause the degree of macroeconomic volatility to increase. The Treasury discussion paper *Fiscal stabilisation and EMU* explores a number of policy options to make discretionary fiscal policy more effective for stabilisation purposes and strengthen the automatic stabilisers. The paper considers the reforms to the institutional framework that EMU membership would require to ensure an enhanced fiscal stabilisation policy operates symmetrically, credibly and transparently and which policy levers are likely to prove most effective.

**2.215** Credible policy options include a new symmetrical fiscal rule to trigger the Government to consider taking action, publishing a Stabilisation Report to enhance transparency, increasing the role of independent audit and specific fiscal instruments that could be used for stabilisation purposes. The Treasury will conduct further analysis into these issues to ensure that the policy proposals deliver effective counter-cyclical stabilisation of the economy were the UK to join EMU.

## **CONCLUSIONS: THE FLEXIBILITY TEST**

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**2.216** Inside EMU, loss of national monetary policy and the nominal sterling-euro exchange rate means that other adjustment mechanisms would have to work harder. Wage and price adjustment are the most effective adjustment mechanisms available, but there is also a potentially enhanced role for fiscal policy. National monetary unions, including the UK, have been successful without high internal mobility.

**2.217** UK labour market flexibility has improved markedly since 1997. Significant falls in overall unemployment and long-term unemployment have accompanied strong employment growth giving the UK one of the lowest levels of unemployment in the OECD, lower even than the US. The 1997 assessment observed that the UK already had a relatively high degree of employment flexibility. This has been maintained, as demonstrated by a high incidence of part-time employment and flexible working practices. Moreover, evidence since 1997 points to an underlying improvement in wage flexibility. However, important challenges remain in the UK to reduce inactivity and repeated spells of worklessness and to enhance skill levels and improve mobility. Adjustment mechanisms have not been fully tested in recent years as the UK has had a relatively stable macroeconomic environment. If the UK decided to join EMU, wage movements would need to play a greater role in adjustment.

**2.218** EMU membership puts a premium on the need for institutional structures to cope with shocks. Therefore, while the positive reforms to the institutional and policy framework in the UK suggest that recent improvements can be sustained, more progress on labour market reform would enhance flexibility in the UK and advance the Government's long-term goal of employment opportunities for all. In the context of EMU, it would also increase the durability of convergence between the UK and the euro area.

**2.219** A decision to join EMU would increase the need for rapid price movements and would also make it necessary for firms to be able to respond effectively to shocks and adapt to the competitive opportunities that the single currency will bring. The UK has a reasonable degree of price flexibility with relative prices both rising and falling within the overall inflation aggregate. Moreover, the UK generally exhibits a competitive business environment and the Government is committed to further sharpening competition forces and improving opportunities for entrepreneurship in all areas of the community. Since the 1997 assessment there has been much effort to promote competition at the EU level. Despite progress, the degree of competition and market flexibility falls short of what might be achievable as measured by the US.

**2.220** Capital markets play an important role in stabilising the impact of shocks between regions in the US, facilitated by highly integrated financial markets. Although cross-border risk sharing is not significant in Europe at present, greater financial market integration would enhance the scope for risk sharing across the EU, and bolster its role as an adjustment mechanism.

**2.221** The experiences of EMU members to date illustrate the role that adjustment mechanisms can play, in particular regarding the implications of inflation differences within EMU. There are some signs that EMU membership has facilitated euro area wage flexibility. As a large monetary union with a high degree of diversity between states, the US also shows the importance of a high degree of market flexibility and capital market integration.

**2.222** Fiscal policy has the potential to support market adjustment mechanisms inside EMU. But enhanced stabilisation mechanisms would need to meet a range of criteria to ensure their worth and be implemented when the understanding of the mechanisms by which fiscal policy affects the real economy has increased.

**Overall conclusion** **2.223** UK labour market flexibility has improved markedly since 1997. Significant falls in unemployment have accompanied strong employment growth giving the UK one of the lowest levels of unemployment in the OECD, lower even than in the US. While considerable progress has been made to reform labour, product and capital markets in the UK and the euro area, more can be done to ensure the UK economy is resilient to deal with the risks identified in the convergence test and the challenges of EMU membership. Inflation volatility is very likely to increase inside EMU. Greater flexibility in the UK and throughout the euro area would minimise output and employment instability, helping to ensure convergence was durable and that the potential benefits of EMU could be fully realised. This underlines the importance of maintaining progress on a range of economic reform policies to enhance flexibility and resilience to shocks, particularly in labour markets. The less progress on flexibility that is achieved in the EU, the greater the premium on a high level of flexibility in the UK economy. Overall, at the present time, we cannot be confident that UK flexibility, while improved, is sufficient. Reflecting this, at the present time, the achievement of sustainable and durable convergence has not been demonstrated. But increased flexibility through the measures we set out will help to provide greater reassurance that the economy can meet the additional demands that EMU membership would pose and contribute to achieving sustainable and durable convergence.

**Policy requirements** **2.224** Flexibility, the ability to respond to economic change efficiently and quickly in a way that maintains high employment, low inflation and unemployment, and continued growth in real incomes, ensures convergence is durable. Sufficient flexibility ensures shocks do not have long-lasting effects and that high levels of output and employment are maintained.

**2.225** In the labour market, the Government is continually working to enhance flexibility and is going further through a package of measures designed to increase wage flexibility in the public sector, improve skills, particularly at the basic and intermediate level, give greater local discretion in the delivery of employment policies and increase labour supply by helping more people to move from welfare to work and increasing cyclical economic migration.

**2.226** In the product market the Government has announced the full independence of the UK competition authorities and is going further to enhance competition in specific markets, reform the planning system to make it work more efficiently and introduce a package of deregulatory reforms to ease the burden of regulation on small business.

**2.227** In the capital market, the Government will increase flexibility through reforms to improve access to finance for small enterprises with high growth potential and consultation on further reform to the corporation tax system.

**2.228** The degree of fiscal stabilisation may need to increase inside EMU where the absence of a UK-specific monetary policy may cause the degree of macroeconomic volatility to increase. The Treasury discussion paper *Fiscal stabilisation and EMU* explores a number of policy options to make discretionary fiscal policy more effective for stabilisation purposes and strengthen the automatic stabilisers. The paper considers the reforms to the institutional framework that EMU membership would require to ensure an enhanced fiscal stabilisation policy operates symmetrically, credibly and transparently and which policy levers are likely to prove most effective.

**2.229** Credible policy options include a new symmetrical fiscal rule to trigger the Government to consider taking action, publishing a Stabilisation Report to enhance transparency, increasing the role of independent audit and specific fiscal instruments that could be used for stabilisation purposes. The Treasury will conduct further analysis into these issues to ensure that the policy proposals deliver effective counter-cyclical stabilisation of the economy were the UK to join EMU.

**Stability in  
Europe - policy  
frameworks**

**2.230** All European countries have embarked on an ambitious programme to reform labour, product and capital markets and the Government supports policies to strengthen competition in the EU and the Single Market. However, it is important to make more progress at the European level, in particular on employment flexibility, trade and the Single Market in financial services. The less progress on flexibility that is achieved in the EU, the greater the premium on a high level of flexibility in the UK economy.