

C1 The Government's economic objective is to build a strong economy and a fair society, where there is opportunity and security for all. Ensuring opportunity for all in the global economy requires taking long-term decisions to promote flexibility and fairness.

C2 *Long-term global economic challenges and opportunities for the UK*, published alongside the Pre-Budget Report, sets out how the far-reaching changes in technology, production and trading patterns are reshaping the global economy. Faster information flows and falling communication costs are breaking down geographical barriers to economic activity. International trade and investment is growing and production is becoming increasingly flexible, specialised and dispersed across continents. Many emerging markets are growing strongly and their workforces are developing higher skills levels and becoming more productive. These trends suggest that the next ten years and beyond will see fundamental change in the global economy. Flexibility in labour, product and capital markets is critical to ensuring that individuals and firms can adapt to changes and thrive in a globally competitive environment.

C3 The Government is committed to advancing flexibility and fairness together. In the more competitive and integrated global economy, the future pace of change will be ever quicker and more intense. This has great potential benefits in terms of growth and prosperity but also entails difficult adjustments for individuals and firms as labour and capital are redeployed from traditional sectors to expanding ones. It is critical to ensure fairness through policies that expand opportunity and choice, and provide security for the vulnerable, while maintaining incentives to work and save. The introduction of the National Minimum Wage and reforms to the tax and benefits systems help to cushion the impact of economic shocks on household incomes, while high quality and responsive services such as Jobcentre Plus, provide incentives and practical support to enable people to re-enter the labour market. Combining flexibility with fairness ensures that everyone in society has the support they need to achieve their full potential in a modern, dynamic economy.

C4 In his statement to the House of Commons on 9 June 2003 on UK membership of the single currency, the Chancellor gave a commitment to publish six monthly reports on trends and progress in labour, product and capital markets. This annex is the third of these reports. It complements a range of other information the Government produces on economic developments and structural policy reforms in both the UK and internationally, particularly across Europe. The report records progress on the Government's reforms of labour, product and capital markets, which promote flexibility and fairness.

C5 This annex is divided into two sections:

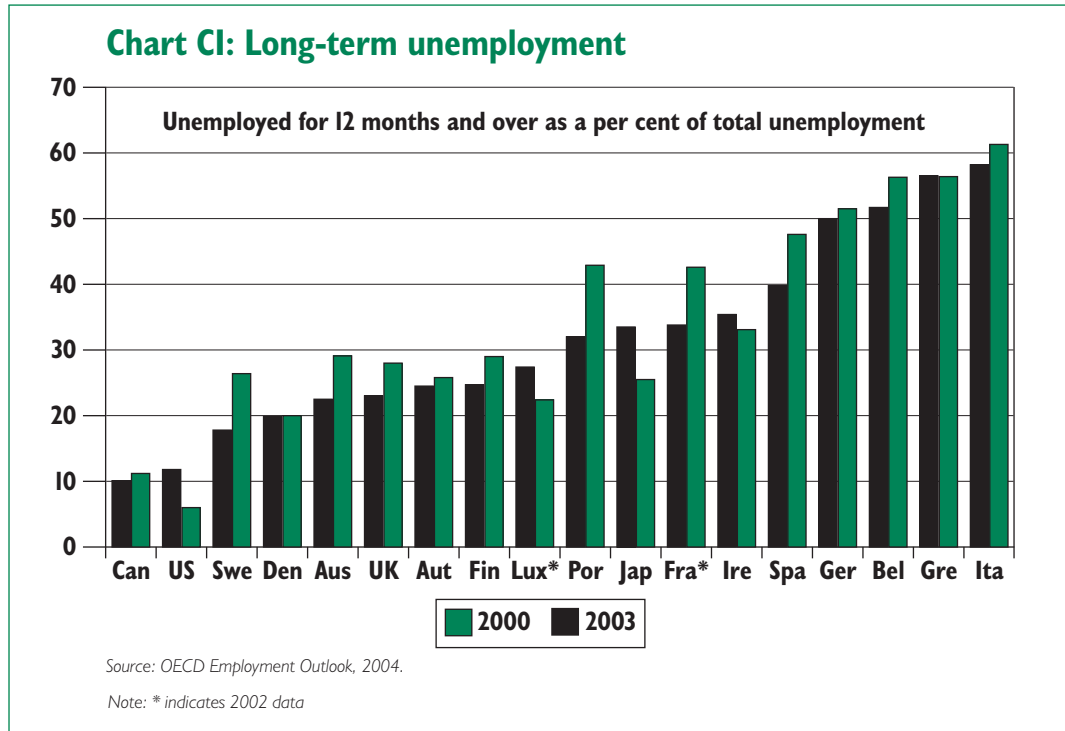
- the first section explains the importance of a flexible economy in a global context and how the Government's policies combine flexibility with fairness; and
- the second section sets out the action the Government has taken to boost flexibility in labour, product and capital markets since Budget 2004 and in this Pre-Budget Report.

WHY FLEXIBILITY MATTERS

Why flexibility is needed **C6** Flexibility is the ability of firms and individuals to respond to economic change efficiently and quickly. Economic change can come in many different forms. In recent years, advances in information and communications technology, the increased integration of emerging markets with the global economy and high oil prices have been prominent developments affecting industry. In an increasingly integrated global economy, the pace of these changes is faster than in the past. If markets and individuals do not have the flexibility and adaptability to respond to change, then exposure to foreign competition in new markets and new technologies may result in falling relative earnings or long-term unemployment, particularly among lower skilled workers.

Characteristics of flexibility **C7** Economic flexibility describes an economy's capacity to adjust to such changes. There are many different ways in which workers and firms can adjust to change. For firms, adjustment may involve altering prices or changing a product line. For a worker, adjustment may be learning a new skill, moving into a different job in the same firm or even changing employer. Adjustment is achieved by a combination of changes occurring in the labour, product and capital markets supplemented, if necessary, by complementary changes in the stance of monetary and fiscal policy. Flexibility is about minimising the costs of adjustment.

C8 In a flexible economy, people will move in and out of employment, both within and between industries, as the demand for labour, products and capital change. One indicator of flexibility within a country is the rate of long-term unemployment. A country with large numbers of long-term unemployed is not adjusting labour or production fast enough. The UK, partly as a result of the effectiveness of the New Deal regime, has lower rates of long-term unemployment compared to many European countries. Chart C1 shows how the UK long-term unemployment rate has fallen from 28 per cent in 2000 to 23 per cent in 2003, although this still remains above the levels achieved in the US and Canada.

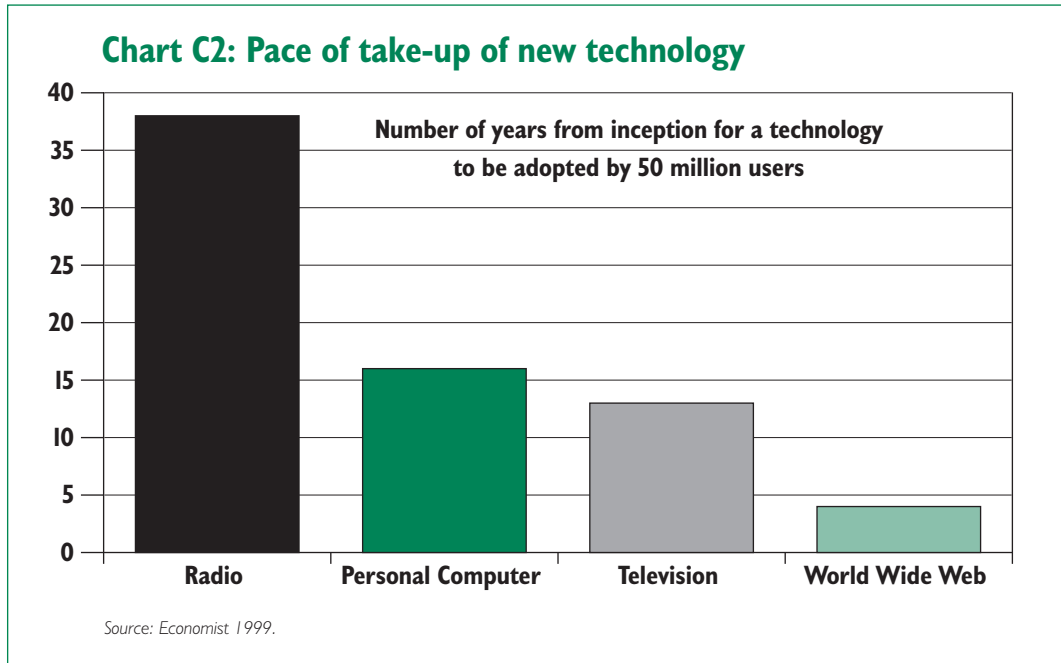


FLEXIBILITY AND THE GLOBAL ECONOMY

Globalisation and flexibility

C9 As set out in *Long-term global economic challenges and opportunities for the UK*, published alongside this Pre-Budget Report, changes in the global economy can deliver significant potential benefits. However, global change also creates new challenges. To succeed in an increasingly integrated global economy, countries need to be flexible, open and outward looking. If firms and individuals do not have the flexibility and adaptability to respond to change then exposure to overseas competition and new technologies can entail large transitional costs. The UK economy, as an open and global economy, is constantly undergoing a process of structural change, with the amount of labour and capital required by some industries declining, freeing up resources for use in the production of new goods and services.

C10 A key feature of the changing global economy is the rapid rate of technology change. As the pace of global economic change has accelerated, competition and innovation have shortened the typical life cycle of products, leading to faster renewal. As Chart C2 demonstrates, the pace of take-up of new technology has increased over recent years. As a result, firms’ abilities to adapt and to take advantage of new technologies and markets are increasingly crucial to their success. The same is also true in the labour market where employees must update their skills more frequently than before and the concept of a job-for-life no longer holds.



Flexibility, skills and innovation in the global economy

CII Structural change is a constant feature of a well-functioning, flexible economy. As some sectors decline, so other sectors – requiring different skills – will expand. More integrated global markets and cross-border trade and investment are likely to lead to an increased pace of structural change. Increasing rewards to innovation mean that the UK will increasingly depend on its ability to create new knowledge and translate it into innovative goods and services. In addition, the number of skilled workers are rising rapidly in emerging markets such as China and India. This will create great opportunities for the global economy but, if the UK is to make full use of these opportunities, it needs to ensure it has a highly skilled, flexible workforce.

CI2 The pace of technological change and global integration are expected to increase demand for a more highly skilled workforce with the ability to adapt to changing technologies and shifting product demand. For advanced economies, looking to move into high-value added areas, there will be a premium on high-skilled workers. Moreover, skills that were once regarded as high-level are now increasingly viewed as basic skills. So countries will need to invest in the skills of their whole workforces, and ensure that they equip individuals to re-skill continually in order to compete and adjust in the global economy.

Capital market flexibility in the global economy

CI3 Advances in information and communications technology have facilitated the development of new financial products and enabled a greater integration of international capital markets. These developments have increased the opportunities for risk sharing and portfolio diversification. They have extended the range of financing options available to entrepreneurs, firms and households, thereby increasing both the flexibility and the resilience of the financial system. Increased financial market flexibility can also help economic adjustment by making it easier for areas with high unemployment to attract the investment needed to develop new businesses and create new jobs.

Flexibility and fairness – the UK approach

C14 The Government is committed to promoting fairness alongside flexibility and enterprise so that everyone can take advantage of opportunities to achieve their full potential in an outward-looking, flexible economy. The reforms of the welfare state introduced by the Government reflect its aims of eradicating child poverty, supporting parents to balance their work and family life, promoting saving and ensuring security for all in old age. The Government is also committed to a modern and fair tax and benefit system. The introduction of the National Minimum Wage and reforms to the tax and benefits systems help to cushion the impact of economic shocks on household incomes, while high quality and responsive services, such as Jobcentre Plus, provide incentives and practical support to enable people to re-enter the labour market. Combining flexibility with fairness ensures that everyone in society has the support they need to achieve their full potential in a modern, dynamic economy.

C15 Flexibility in labour, product and capital markets is critical to economic success in a globally competitive environment. However, in the short term, flexibility may be associated with considerable changes as labour and capital are redeployed from traditional activities into expanding industries. At any point in time, these costs will fall disproportionately on particular individuals and particular industries. For the individuals concerned this may entail considerable short-term costs, in terms of income, and in the challenges they face to acquire new skills and find new employment. It is therefore important that flexibility is accompanied by measures that enable individuals to cope with and benefit from change. Such measures ensure that flexibility is accompanied by fairness. For example, policies that support individuals through periods of unemployment, and equip them to re-enter the labour force, promote fairness by ensuring that these dislocation costs are minimised. They also contribute to flexibility by enabling individuals to make the transition between different forms of employment more rapidly.

C16 The regulatory environment is an important determinant of both flexibility and fairness. Effective and well-focused regulation can play a vital role in correcting market failures, ensuring health and safety and good working practices and in driving up standards. However, unnecessary or poorly designed regulation can be an obstacle to flexibility, restricting employment growth and competitiveness, particularly for smaller firms. The Government is committed to ensuring that the negative impacts of the regulatory framework are minimised. This includes clear impact assessments for new legislation; removing unnecessary, ineffective or counterproductive regulation; and ensuring that where legislation is appropriate it is simple, clear and effective.

FLEXIBILITY IN LABOUR, PRODUCT AND CAPITAL MARKETS

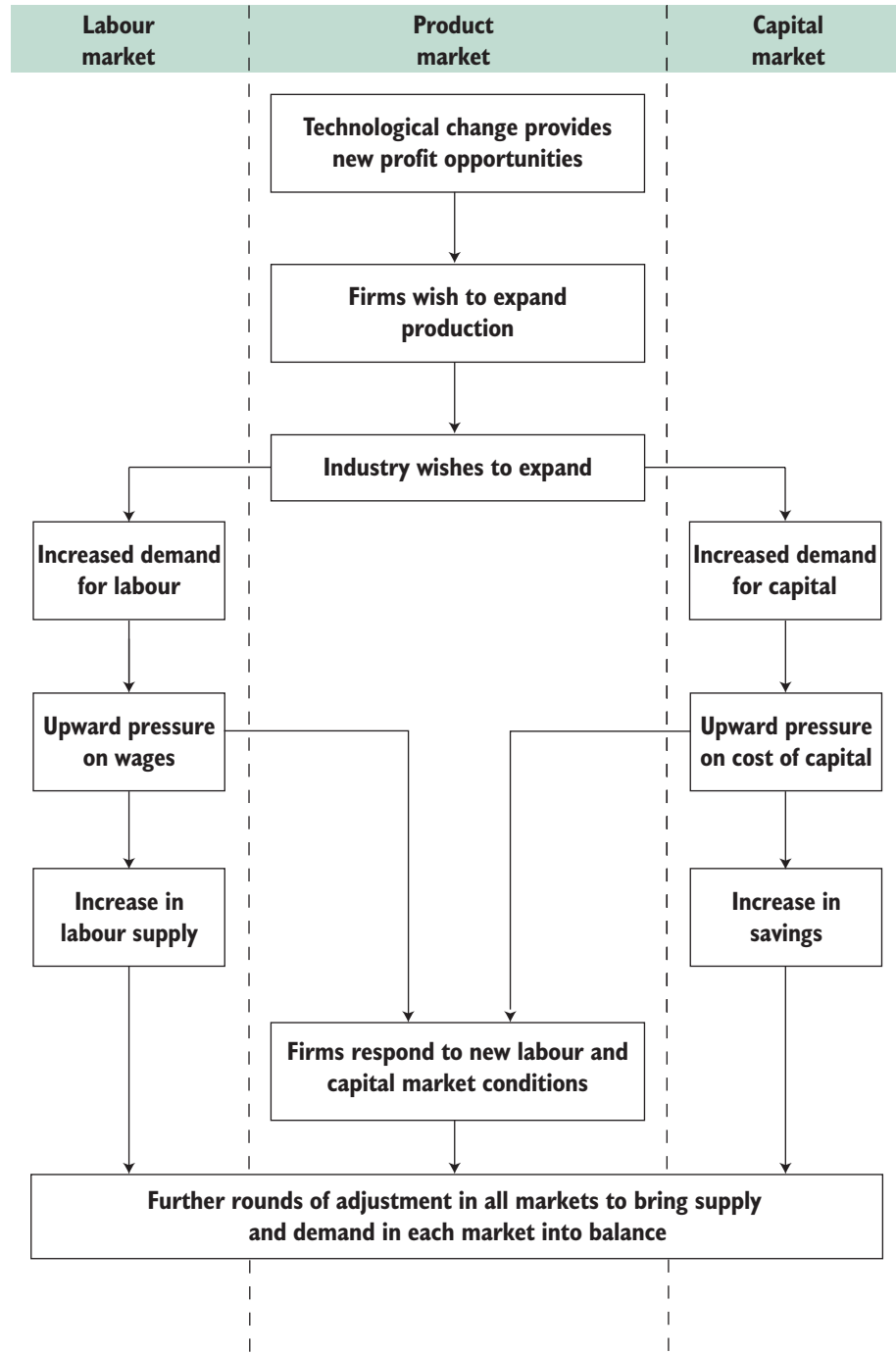
C17 The overall flexibility of the economy depends on the interaction of flexibility in the labour, capital and product markets, as illustrated in Box C1. This interdependence implies that the overall flexibility of the economy depends on each market working as effectively as possible. The diagram illustrates how changes originating in the product market are transmitted to the labour and capital market and back to the product market. Further rounds of adjustment and feedback will occur until the balance of supply and demand is restored in each market. Changes originating in labour and capital markets, for example, as a result of tax and benefit changes, which affect labour supply or a change in risk aversion affecting the cost of capital, will similarly be transmitted to other markets, with the economy's overall adjustment reflecting the interactions between all three markets.

Labour market flexibility **CI8** The performance of the labour market is central to the well being of the economy and society. A flexible and efficient labour market has the ability to adjust to changing economic conditions in a way that maintains high employment, low inflation and unemployment, and continued growth in real incomes. Backed up by policies which equip people rapidly to adjust to change and provide support for those who are not in employment, it implies an economy that is fairer, more competitive and more productive.

CI9 The key characteristics of a flexible labour market are that:

- wages adjust to maintain the balance between labour supply and labour demand;
- the labour force is equipped with transferable skills that employers require, enabling the rapid redeployment of labour within or between firms when labour demand changes;
- firms do not find it prohibitively costly to create employment or to vary it when needed;
- workers are able to commute easily or move residence in order to find employment;
- working patterns meet the needs of both employers and employees, increasing labour supply; and
- there is an institutional environment that encourages labour force participation, equips people to adapt to change and provides support for those without employment, enabling them to remain active participants in the labour market.

Box C1: The interaction between labour, product and capital markets



Product market flexibility C20 Product market flexibility relates to the ease with which firms are able to respond to changing market conditions. For individual firms or industries, increased flexibility enables them to respond rapidly, allowing firms to exploit new opportunities and to deal with potential challenges effectively. Flexibility provides firms with the scope to succeed in a competitive market environment.

C21 The main characteristics of a flexible product market are that:

- there is a competitive environment which rewards efficiency, discourages waste and provides firms with strong incentives to adapt the range and quality of their goods and services to provide their customers with good quality products at competitive prices;
- there is a strong capacity for innovation, enabling firms to develop and implement new processes and products ahead of their competitors;
- there are low barriers to entry which allow new firms to challenge incumbents creating incentives for innovation and efficiency; and
- a regulatory environment in which the constraints on business yield clear benefits to the wider economy, and are not disproportionately costly in terms of their effect on firms' incentives to hire, train, innovate and invest.

Capital market flexibility

C22 Capital markets contribute to the flexibility of the economy by ensuring that capital is employed effectively. Efficient capital markets ensure that business, entrepreneurs and innovators have ready access to the funds they require in order to develop their ideas. Capital markets also play an important role in balancing the risks and returns of different uses of capital, screening out projects that have an unacceptably high level of risk.

C23 Flexible capital markets can also play a role in underpinning flexibility in labour and product markets. They should allow individuals to borrow when necessary in order to enhance their education and skills with beneficial effects on productivity and the employability of the individuals concerned.

C24 In product markets, flexible access to finance should allow firms to reallocate resources efficiently and to invest, as appropriate, in new processes and products.

C25 A flexible capital market can also promote fairness by enabling all individuals to take advantage of educational and business opportunities. However, government intervention may on occasions be required to ensure that information asymmetries do not lead to some individuals being unfairly denied access to capital markets.

C26 The main characteristics of a flexible capital market are that:

- firms have a range of financing options available to them, which allows them to access the capital they require at a competitive price, and on competitive terms. This applies particularly to firms seeking capital for high risk projects, where efficient capital markets are best placed to price the risk appropriately;
- firms and households have the ability to hold a diverse portfolio of assets spread across regions and sectors, so that they can use income from these assets to insure against a fall in income that is specific to their own region and sector; and
- there is sufficient borrowing and lending capacity in credit markets to allow households and business to smooth fluctuations in income.

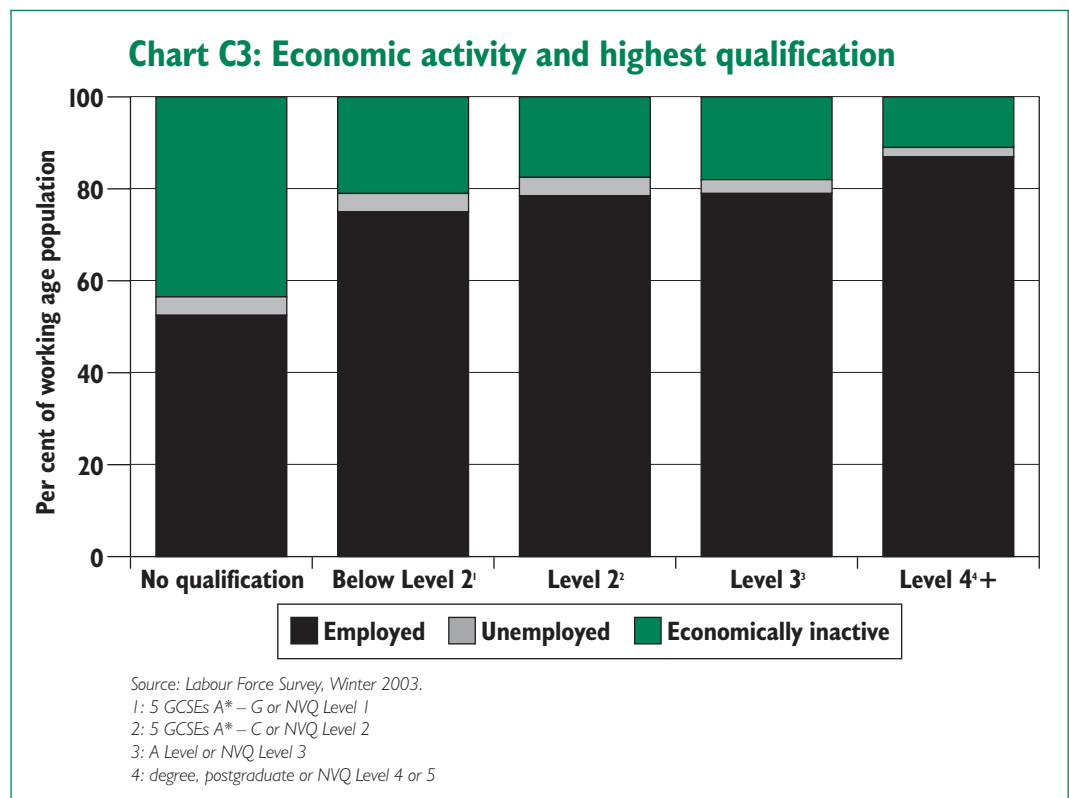
MEASURES TO PROMOTE FLEXIBILITY

C27 This section of the report summarises the action the Government has taken since Budget 2004 and in this Pre-Budget Report to promote flexibility and fairness in the UK economy.

Measures to promote flexibility and fairness in labour markets

C28 The Government’s long-term goal is employment opportunity for all – the modern definition of full employment. In an increasingly open and integrated global economy, the countries that will prosper are those with flexible and outward looking economies, which can react effectively to changing economic circumstances. This Pre-Budget Report sets out action to build on the successful recent performance of the UK labour market, and tackle the long-term challenges of increasing flexibility, reducing inactivity and helping those groups in society that face particular barriers to work.

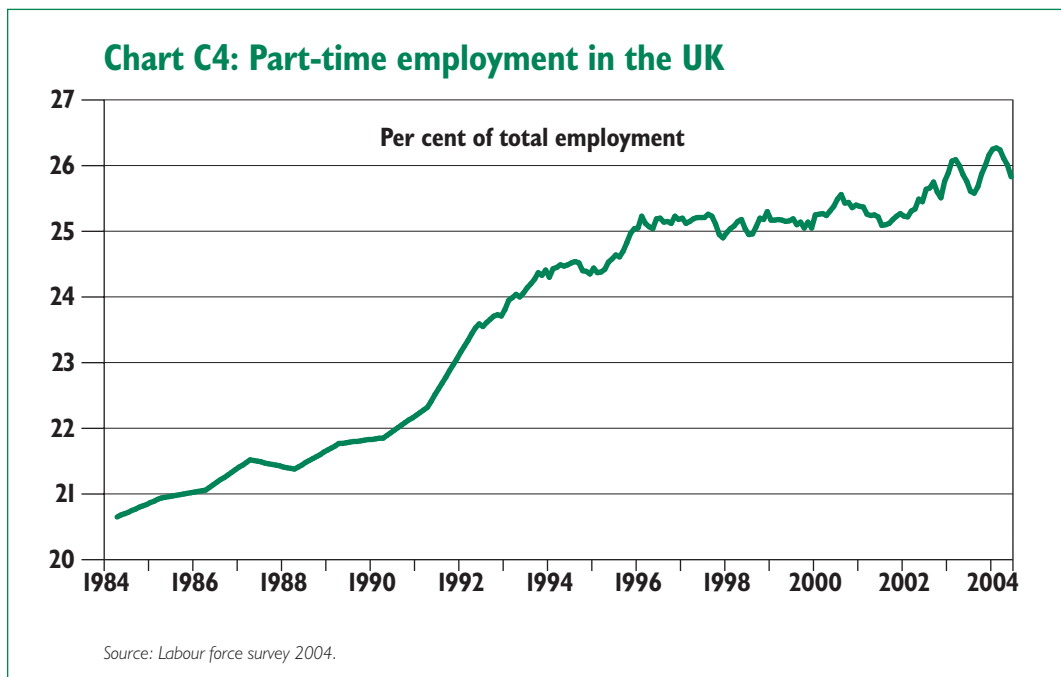
Developing skills C29 *Skills in the global economy*, published alongside the Pre-Budget Report, explains that a highly-skilled workforce with a culture of lifelong learning is likely to be able to adapt faster and more effectively to global change: intensifying international competition; accelerating technological change and changing patterns of consumer demand. The proportion of people in the UK with high level qualifications, such as degrees, compares well internationally. However, the proportion of the workforce with intermediate level skills in the UK is comparatively low and a large proportion of people possess low or no qualifications. The Government is committed to ensuring that all adults can acquire the skills necessary to move into sustainable jobs, progress into more skilled employment and adapt to change in the workforce. Chart C3 shows how an increase in educational attainment increases the likelihood of being in work, illustrating the importance of education for individuals and the economy.



C30 Chapter 6 in this Pre-Budget Report describes the Government's programme for driving improvement at all levels of the education system. Chapter 3 sets out the measures the Government is taking to achieve its ambitions of raising workforce skill levels and enhancing employability. Measures include:

- a **National Employer Training Programme** providing free and flexibly delivered training for low-skilled adults in work;
- an **independent review to be led by Sandy Leitch**, Chairman of the National Employment Panel and formerly a Chief Executive of Zurich Financial Services to examine the UK's future skills needs and priorities;
- implementing the **New Deal for skills**; and
- piloting a **Learning Allowance** that will allow benefit claimants to participate in full-time training as well as pilots of a skills coaching service to provide one-to-one personalised support.

Employment flexibility C31 If labour demand and supply are to be matched efficiently, a range of working patterns are needed, which give employers the flexibility to vary capacity levels and employees the choice to balance their work and other responsibilities, for example, through reduced hours or temporary work. The UK shows a significant degree of employment flexibility, with a wide distribution of hours worked and widespread adoption of flexible working practices. Chart C4 shows how the incidence of part-time employment in the UK increased over the 1980s, early 1990s and in the past few years.



C32 In line with its determination to advance both flexibility and fairness in the labour market, the Government is committed to giving parents more choice and support in balancing their work and family responsibilities. The Government's strategy involves supporting parents' choices; tailoring financial support to families' circumstances; enhancing access to good quality childcare and parenting services; and working in partnership with business to promote the benefits of flexible working and support the take up of best practice approaches. New initiatives introduced since the Budget, and described further in Chapter 5, include:

- a **ten-year strategy for childcare**, setting out how the Government will achieve its long-term vision of affordable, good quality childcare for all parents who need it, and provide parents with real choices in balancing work and family responsibilities;
- an extension of paid **maternity leave** from six months to nine months from April 2007 and improvements to financial support for childcare costs;
- **improvements to the childcare element** of the Working Tax Credits; and
- allocating **£769 million in additional funding for Sure Start** in the 2004 Spending Review to establish Children's Centres in every community, increase the number of childcare places available and set up a pilot to extend free early education.

Improving labour market opportunities

C33 The performance of the UK labour market has been strong over recent years by both historical and international standards. However, the Government is determined to achieve its goal of employment opportunity for all by ensuring that everybody who is able and wants to work is given the appropriate assistance to help them to do so, while maintaining support for those people who are unable to work.

C34 To this end, the Government has introduced a number of measures, described fully in Chapter 4, to provide support to individuals to help them overcome the barriers to work that they face, including:

- a major expansion of the **Pathways to Work pilots** for incapacity benefits claimants;
- a package of changes to further help people on **incapacity benefits**;
- an extension of the **In-Work Credit for lone parents** to six further pilot areas; and
- a revised and strengthened **Jobseeker's Agreement** with a clearer focus on the jobseeker's responsibilities and personal record of job search.

Promoting geographical mobility

C35 A labour force that is able to move within and between regions enhances labour market flexibility by enabling workers to move to available employment opportunities. Evidence suggests that in the UK, as elsewhere in Europe, geographic labour mobility is low compared to the US. The Government has introduced several measures that aim to raise the ability and incentives for workers to commute or move location in order to find employment.

C36 In March 2004, Kate Barker published her final report¹, setting out the reasons underlying the lack of supply responsiveness of housing in the UK. The Government accepted the central recommendation of this report that there should be a step change in housing supply, making it easier for households to access employment opportunities wherever they occur. To achieve this goal the Government announced:

- **an additional £1.3 billion for housing in 2007-08** compared to 2004-05; and
- **the Planning Delivery Grant (PDG)** where over £150 million has been allocated to planning authorities to drive up the performance of the planning system.

C37 The current system of Housing Benefit can be complex, both for claimants to understand and Local Authorities to deliver, and is acting as a constraint on labour mobility both in and between regions. The Housing Benefit reform programme is now addressing these difficulties in the following ways:

- a **Housing Benefit Reform Fund worth £180m during 2006-08** to enable the roll out of flat-rate allowances and to improve the administration and structure of the Housing Benefit system; and
- a series of measures to continue to **simplify the Housing Benefit and Council Tax Benefit** system.

Measures to promote flexibility and fairness in product markets

C38 Chapter 3 of this Pre-Budget Report sets out the Government's programme of reform aimed at promoting flexibility and boosting productivity growth in the UK economy by focusing on measures which boost competition, enterprise, innovation, skills and investment.

Competition C39 Competition enhances flexibility by providing incentives for firms to respond quickly to changes in market conditions. Competitive pressures on firms in UK product markets results in firms striving to adopt more efficient working methods and to develop new products and services which meet the changing demands of consumers. Greater competition enhances the incentives for firms to innovate and to invest in order to raise their productivity and keep ahead of their rivals.

C40 Globalisation, through international trade and investment, adds to the competitive intensity of the economy. Open markets, with low barriers to trade and investment, permit access to new opportunities in new countries and markets. This facilitates specialisation in those goods and services that economies produce more efficiently.

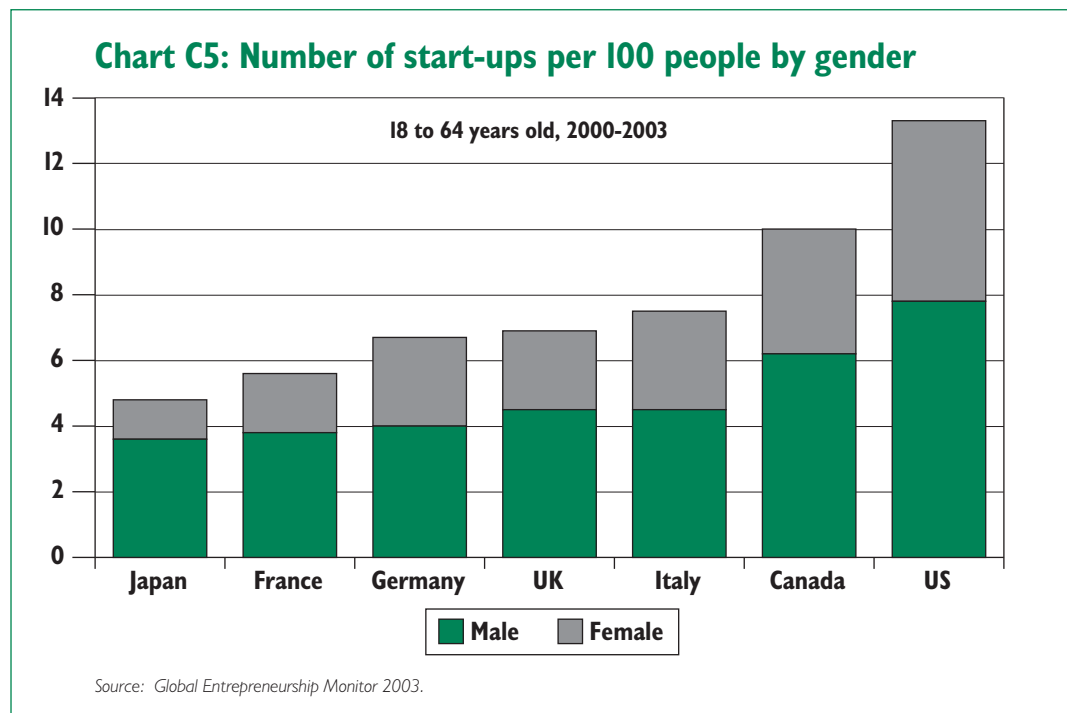
C41 The Government continues to take steps to enhance competition, empower consumers and promote flexibility, discussed in more detail in Chapter 3. These include:

- progress on **promoting competition in a number of specific markets**;
- a range of **measures to protect consumers** including an ongoing review of the UK consumer framework; and
- action to improve **competition in public procurement**.

¹ *Delivering Stability: Securing Our Future Housing Needs*, Kate Barker, March 2004.

Enterprise C42 Enterprise is a key driver of a modern, high-productivity economy in which opportunity is open to all. The Government believes it is essential to make the UK a more entrepreneurial economy, so that it is well placed to meet the long-term opportunities and challenges of an increasingly globalised economy.

C43 A good indicator of the enterprise culture in an economy is the proportion of the population who start a new business. Chart C5 shows the number of people starting a new business in the UK compared to the other G7 countries. The chart shows that the UK, with 6.9 start-ups per 100 people, is less entrepreneurial than some countries. The chart also shows that the proportion of women starting a company in the UK (35 per cent of new start-ups) is smaller than in the US (41 per cent), Canada (38 per cent) or Italy (40 per cent), all of which have higher aggregate totals than the UK.

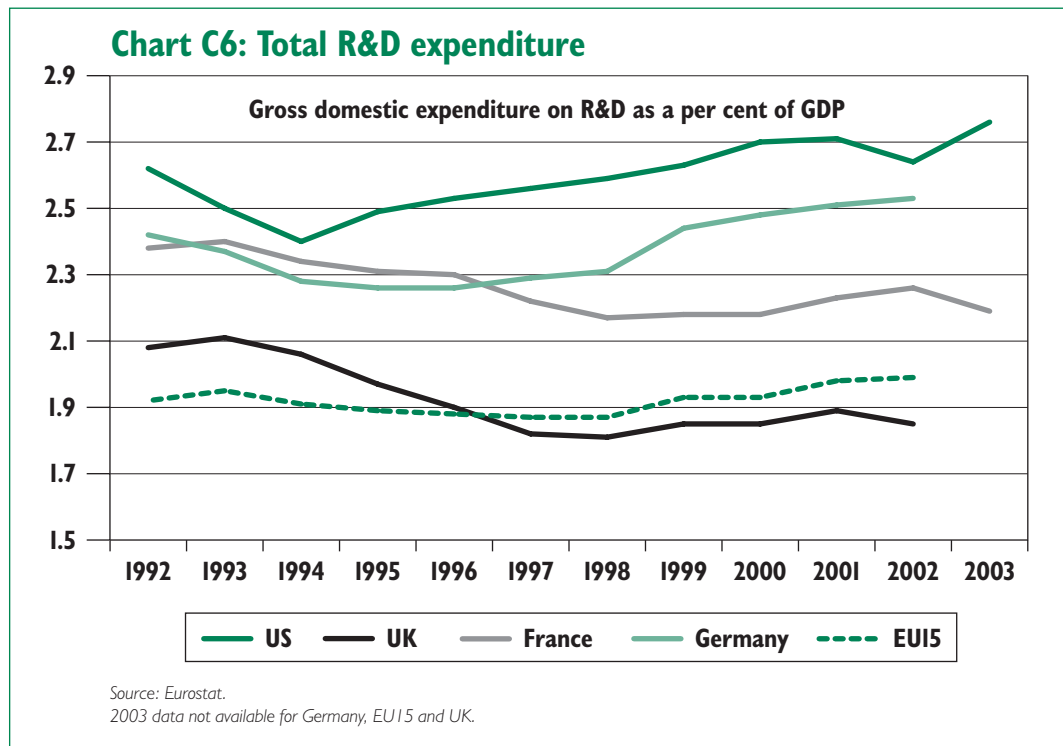


C44 Since Budget 2004, the Government has introduced a number of initiatives to improve enterprise education and culture in the UK, described further in Chapter 3. These include:

- publication of the interim report of the **Hampton Review** recommending improvements to the current system of regulatory inspection and enforcement, to reduce the administrative burden on business;
- reforms to reduce the **regulatory burden on enterprise**, including the extension of Common Commencement Dates to other areas of legislation and progress on the Panel for Regulatory Accountability;
- measures to **improve the tax system** including simplifying tax administration for small businesses and modernising the structure and administration of business tax; and
- a variety of measures to improve enterprise through **education and create a climate in which entrepreneurial activity is valued.**

Science and innovation C45 Science and innovation are key drivers of productivity growth. Recent OECD research suggests that 1 per cent growth in public research and development leads to a 0.17 per cent increase in total factor productivity in the long run². The rate of technological change is particularly rapid in today's integrated global economy. This impacts on production methods and new product development and increases the importance of innovation for businesses. The UK's future prosperity is likely to depend increasingly on the capacity to expand knowledge through science and translate it into innovative products and better services.

C46 The UK has an excellent science base but, in recent years, has been investing less on R&D research as a proportion of GDP in comparison to other major developed economies. While the UK still performs well in international comparisons of academic publications and citations, this position is unlikely to continue without an increase in public and private R&D investment.



C47 The Government is taking steps to promote science and innovation in the UK economy through increase in investment and by encouraging the commercial potential of primary research, discussed in more detail in Chapter 3. Further steps since the Budget include:

- implementation of the ten-year **Science and Innovation Investment Framework**, through strengthening the partnership with business on raising investment in UK R&D and taking forward the recommendations of the **Lambert review** of business-university collaboration; and
- legislation to remove the tax uncertainty for researchers involved in public sector and **university spin-off companies** to encourage the commercial development of public sector research.

² R&D and Productivity Growth: Panel data analysis of 16 OECD countries, Guillec and van Pottelsberghe de la Potterie, 2001.

Investment C48 Investing in new technology and capital is important if firms are to respond to new opportunities in a competitive and entrepreneurial way. Where there are financial or structural barriers to new investment, firms' competitiveness will be constrained. In addition, investment in underlying infrastructure can help to facilitate flexibility in wider labour and product markets. The Government has undertaken the following action since the Budget to promote investment in the UK economy, discussed in more detail in Chapter 3:

- **implementation of the changes recommended by the Graham Review** on the Small Firms Loan Guarantee by the end of 2005; and
- draft guidance for investment managers interested in bidding to establish one of the new pathfinder **Enterprise Capital Funds**.

Measures to promote flexibility and fairness in capital markets

C49 Capital markets contribute to the flexibility of the economy by providing entrepreneurs and firms with the finance they require to fund their activities. A flexible capital market ensures that finance is provided at the lowest price appropriate to the investment risk borne by the provider. Efficient capital markets enable individuals to smooth out fluctuations in their income by offering a wide range of saving vehicles and allowing individuals prudently to borrow against future income.

SME finance C50 The ability to access external sources of finance is essential if small businesses are to take full advantage of the investment opportunities available to them. Access to finance enables entrepreneurs and innovators to develop their ideas, ensuring that resources get directed to where they can be most profitably employed. The Government aims to ensure that the process of capital allocation works well for all businesses and that funds are allocated to all those companies who can profitably use them regardless of their size. New measures introduced include:

- easing of financial regulation by allowing **self-certification of sophisticated or high net worth investors**, making it easier for small firms to raise finance from business angels; and
- consultation on the implementation of the new **EU Prospectus Directive**, which will remove further barriers to small firms raising finance.

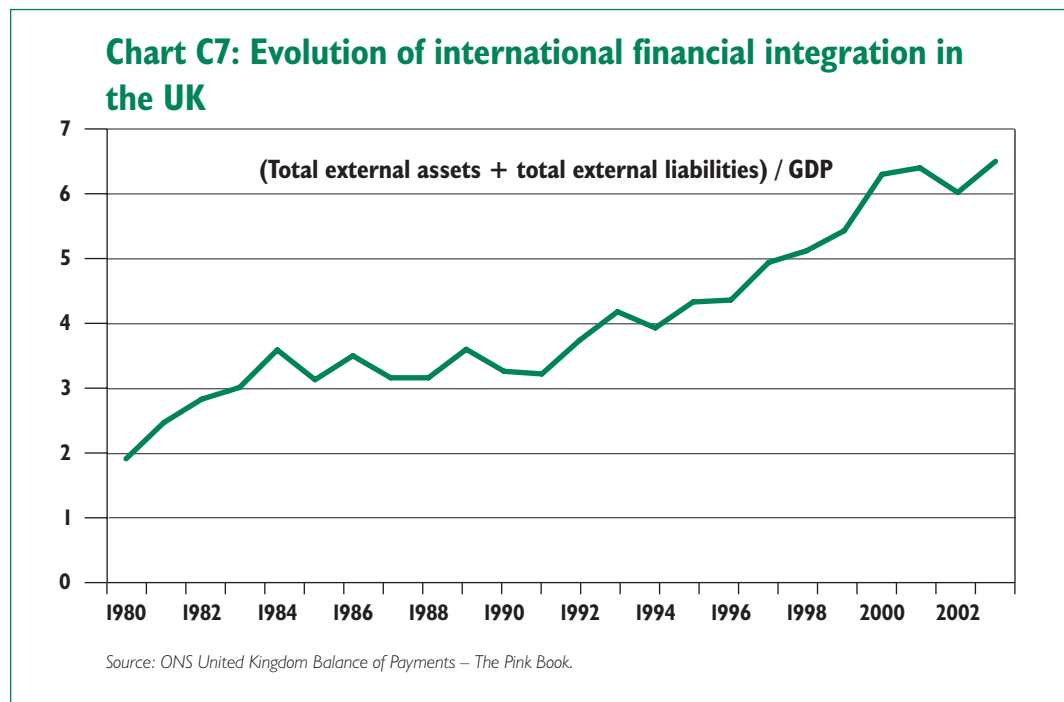
Investment and corporate finance C51 An effective regulatory framework for investment decisions ensures that capital is allocated to the most efficient purposes, thus enhancing productivity, improving returns to investors and reducing the cost of capital. Improved transparency of information flows, better monitoring by principals and more effective accountability by agents are key elements of this framework. Over the past six years, the Government has undertaken a comprehensive review of all aspects of the investment chain, which connects individual savers and investing companies, and this is discussed more fully in Chapter 3. The Government has undertaken a programme of reform, going with the grain of the workings of markets. The complex interactions between the weaknesses at different points in the chain mean that each problem needs to be addressed if the overall goal of promoting more efficient approaches to investment is to be realised. The most recent elements to improve the workings of the investment chain include:

- measures to improve the efficiency of **pension funds**: strengthening the **competence of pension fund trustees**; and improving returns through the deregulation of investment restrictions;
- inviting Paul Myners to conduct an **independent review of the governance of mutual life offices**, which will report before the end of this year;
- enhancing the quality of information to investors through better **audit regulation, more extensive disclosure rules for listed companies and measures to improve shareholder voting**; and
- introducing, in the near future, deregulatory reforms to place **open-ended investment companies** on a more similar regulatory footing to authorised unit trusts.

Capital Markets C52 integration

Capital market flexibility is enhanced by greater integration of domestic and international capital markets. Greater integration provides access to deeper and more liquid capital markets with probable benefits in terms of a lower cost of capital as a result of a more efficient allocation of capital. This will ensure that savers get the best return on their money and are able to hold a diversified portfolio of assets while funds flow to firms offering the best investment opportunities encouraging innovation. Global capital integration also facilitates risk sharing where a decline in returns in one market can be offset by increasing returns in another.

C53 Chart C7 shows a summary volume-based measure of international financial integration used by the IMF.⁴ The measure is the sum of total UK external assets and liabilities as a percentage of GDP and can be used as a proxy for financial openness and capital market integration. The chart suggests capital market integration has increased over 300 per cent in the UK since 1980, with a marked acceleration during the 1990s.



⁴ *International Financial Integration*; IMF working paper 03/86; April 2003.

C54 The Government also continues to work with other EU Member States towards the creation of an integrated EU capital market and to press for greater integration of EU-US capital markets. Recent important steps in this direction have included:

- joint HM Treasury/FSA consultation on UK implementation of the EU's **Market Abuse Directive**. Implementation will introduce largely minor changes to the UK's existing regime promoting the integrity of financial markets and thereby their role in the process of capital allocation; and
- consultation on proposals for UK implementation of the **EU Prospectus Directive**.

C55 Assets and savings provide opportunity and independence throughout life, flexibility to adjust to unforeseen events and financial security in retirement. Based on the principle of progressive universalism, the Government seeks to make asset ownership accessible to all and will provide more help for those who need it most. The Government seeks to provide targeted support and incentives for saving from childhood, through working life and into retirement. Chapter 5 highlights three measures the Government is taking to further promote saving and asset ownership:

- consulting on retaining the current **Individual Savings Accounts** limits;
- a larger **Saving Gateway** pilot; and
- consultation on a further payment at age 7 in the **Child Trust Fund**.

CONCLUSIONS

C56 Globalisation and the rapid pace of technological change highlight the importance of flexible and dynamic economies. Flexible labour product and capital markets which allow businesses and individuals to respond to changes in technology, consumer prices and competitive pressures by quickly adapting their production techniques, investment and employment, provides the key to economic success in a globally competitive environment.

C57 As was highlighted in the Treasury's economic assessment of the case for joining EMU, a high level of flexibility is especially important when a country needs to adjust to country-specific shocks within a monetary union, since a country-specific monetary policy response is not an option.

C58 The Government is committed to the approach of advancing flexibility and fairness together, by enabling individuals and firms to cope with and respond to change. This report sets out the range of specific measures the Government is implementing in pursuit of these objectives, to ensure that the UK economy is well equipped to respond to current, and future, opportunities and challenges. A review of progress on the Government's reform agenda will be published at the time of Budget 2005

