

# **Analysis of European and UK business cycles and shocks**

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HM TREASURY

# EXECUTIVE SUMMARY

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- 1** This study reviews some of the literature pertaining to convergence tests based on business cycle and shock correlations, updating some of the work that has been done before.
- 2** The first section lays out the basic features of what is meant by convergence, and the role of business cycle measurement and the identification of shocks in this context; after that comes a section which explains the main facts about UK convergence with the euro area, the EU and some of the principal Member States.
- 3** There is a positive correlation to be found between the UK cycle and the cycle in other European countries over an extended period; the same is true for the correlation of identified demand shocks, at least when only supply and demand shocks are identified (when policy shocks are also identified the correlation of the demand shocks falls sharply, as is also true for other participants in the EU).
- 4** The next issue considered is whether there is or has been a 'UK idiosyncrasy': by this term observers have meant to grant that there is, or has been, something a bit different about the UK business cycle and the UK economy's experience of shocks that has marked it out from continental European experience. In one version the UK business cycle is identified as more sympathetic with that in North America than with that in continental Europe. Another argument is that it is possible to identify a 'core and a periphery' in the EU, and that the UK has belonged to the periphery rather than the core.
- 5** It remains true that the UK's cycle is strongly correlated with that in the US, somewhat more so than with those in Europe, and also that the UK's GDP fluctuations seem to have been sharper than those of the major continental European economies. In addition, the evidence from regional fluctuations suggests that no UK region is strongly associated with the European cycle.
- 6** These are features of the 'UK idiosyncrasy'. But there is no technical requirement for the degree of correlation that should be established; the standard set by the cross-correlations inside the US does not appear to be a minimum standard. A number of investigators have used the US as an example of a working and successful monetary union, and have performed similar measurements on the regions or the states of the US as they have on the member countries of the EU.
- 7** Last but not least, the study notes the point that statistical measures conducted over past data may not be a good guide to the future experience of an economy which undertakes such a seemingly profound change of direction as that which is involved in joining a monetary union. There is no doubt that in the event that the UK were to join the euro area, its business cycle behaviour would eventually change; policy would be different and trade would likely increase still further. But the outcomes of these changes cannot be predicted with confidence.
- 8** Finally, the report takes a critical look at what might be called the 'OCA null'. This is the basic maintained hypothesis of Optimal Currency Area (OCA) theory that an independent monetary policy and the exchange rate that goes with it form a 'first best' means of stabilising the economy. But this can well be questioned. In particular, it might be that the foreign exchange market is as much a source of shocks as it is a buffer.