HM Treasury

UK MEMBERSHIP OF THE SINGLE CURRENCY

AN ASSESSMENT OF THE FIVE ECONOMIC TESTS

October 1997

Preface

The decision on a single currency must be determined by a hard-headed assessment of Britain's economic interests. In my speech to the Royal Institute for International Affairs in July, I set five economic tests on which any decision about UK membership of EMU should be based. I called for a national debate on the single currency which was launched by the publication of two booklets: one on the pros and cons of EMU, by David Currie, and the other on practical information for business about EMU. These have been distributed widely and have reached a large audience. The debate has advanced since July with discussion and publication of a number of influential studies and papers. I established the Business Advisory Group. It has met to discuss the practical questions that arise, whether Britain is in or out of EMU.

I also commissioned an in-depth assessment of the economic consequences of EMU. This paper, which is now being published, sets out the Treasury's assessment of the five economic tests I set:

- Are business cycles and economic structures compatible so that we and others could live comfortably with euro interest rates on a permanent basis?

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

- Would joining EMU create better conditions for firms making long-term decisions to invest in Britain?

- What impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets?

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

Rt Hon Gordon Brown MP
Chancellor of the Exchequer

October 1997

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Executive summary

The Government's central economic objective is to achieve high and stable levels of growth and employment. Britain's economic interests in the single currency need to be judged against this central objective.

To make this assessment, the Chancellor of the Exchequer has set out five economic tests which have to be met before Britain enters:

- Are business cycles and economic structures compatible so that we and others could live comfortably with euro interest rates on a permanent basis?
- If problems emerge is there sufficient flexibility to deal with them?
- Would joining EMU create better conditions for firms making long-term decisions to invest in Britain?
- What impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets?
- In summary, will joining EMU promote higher growth, stability and a lasting increase in jobs?

Sustainable and durable convergence is the touchstone and without it we cannot reap the benefits of a successful EMU. It means that the British economy:

- has converged with Europe;
- can demonstrably be shown to have converged;
- that this convergence is capable of being sustained; and
- that there is sufficient flexibility to adapt to change and unexpected economic events.

This report summarises the Treasury's assessment of how Britain fares against the five economic tests at present.

Cyclical convergence

At present, the UK's business cycle is not convergent with the rest of our European partners. Base rates are 7 per cent in the UK, which is the right level for British conditions to achieve our inflation target. But in Germany and France key official interest rates are just above 3 per cent. In Britain the recession and subsequent recovery began earlier than on the Continent.

The UK's divergence is not a new factor. In the past, our economic cycle has been both more volatile than, and out of line with, those of France and Germany.

Some of the difference reflects different UK macroeconomic policy settings. Others reflect shocks such as oil price rises and German unification, which affected some countries differently from others.

But there are also structural differences in the UK economy – for example in our trade patterns, oil, company finance and housing market. Their significance for the UK cycle is difficult to judge but they can affect the way in which we respond to external shocks and to changes in interest rates.

Over the next few years the UK's convergence should increase as the Continental economies continue to recover from recession and the UK economy steadies. But it is not safe to assume that convergence will be sustainable, and demonstrably so, for some years. A period of stability, through continuing to aim for low inflation and sound public finances, would be necessary to ensure that convergence was sustainable and durable, and to provide a basis for successful membership of the single currency. The structural differences may remain for some time, though further integration in the Single Market should promote further convergence. The continuation of low inflation should also help to make our housing market less speculative, reducing the influence of past volatility.

Flexibility

To be successful, monetary union needs both lasting convergence and an economy with the ability to adjust to change. This is because EMU involves an inevitable loss of domestic control over monetary policy, and we cannot rule out some future shocks occurring even with durable macroeconomic compatibility. Also, as the single currency reduces barriers to trade in the Single Market, firms and their employees will need to be able to adapt to the changes and opportunities this will bring.

Flexibility is important both for product and labour markets. Firms need to be flexible in their pricing and margins, responding to demand for their products. They need to be innovative and flexible in their business strategy. In the labour market, wage bargaining needs to be realistic and take account of developments in productivity. And employees need to be well-skilled so that they can adapt to change in the job market. Flexibility may be particularly important for the UK if there is any risk that our business cycle has not fully converged with those of the other EMU members.

In Britain, there are weaknesses particularly in key areas – in the level of skills, the high numbers of workless households, and high levels of long-term unemployment. The Government's agenda for investing in human capital and helping people from welfare into work is designed to address them. In product markets the Government already aims to increase competition and tackle restrictive practices.

Europe also needs to tackle its problem of high unemployment, to make EMU work as a whole. Of course, the measures that are taken are the responsibility of individual governments.

The assessment concludes that, in labour markets particularly, the UK has not yet achieved sufficient flexibility to meet the challenges of EMU membership.

Investment

In principle, the single currency should help to boost investment across the economies of its members. A successful single currency would:

- create a zone of macroeconomic stability and low inflation to provide a stable framework in which firms can plan and invest; and
- be a complement to the Single Market, boosting competition and providing new opportunities for companies to invest.

The favourable effects for investment in the UK can only be achieved if the UK is sufficiently converged and prepared. Entering the single currency before we have achieved durable and sustainable convergence would discourage investment.

Macroeconomic stability

The single currency is unprecedented and the European Central Bank (ECB) will face technical and other challenges in setting interest rates over a wide area. Uncertainties will inevitably remain until it has built up a track record. But evidence from financial markets suggests that it is expected to achieve its objective of low inflation. Those countries which are expected to join EMU have seen long-term interest rates fall steadily towards German rates.

In Britain, macroeconomic instability in the past has been one of the factors behind a relatively poor investment performance. The Government has taken steps to establish a stable framework for the future, with a sound fiscal policy framework and operational independence for the Bank of England in setting interest rates. However, the markets still charge a premium on long-term borrowing, suggesting that inflation expectations and/or uncertainty are still slightly higher than they are expected to be in the EMU zone. So Britain could make further gains in terms of stability from joining the single currency, if the wider economics were right.

The single currency and the Single Market

More than half of Britain's trade is with the rest of the European Union. The Single Market has brought significant benefits for our exports, inward investment and job creation.

The single currency could deepen competition in some parts of the Single Market. It will reduce transaction costs and exchange rate uncertainty on trade within the euro-zone. It will also make prices more transparent and easier to compare across the Single Market. It should also intensify competition. In this way it could open up new trading opportunities and encourage firms to invest in new markets.

It is difficult to predict how far-reaching this change will be. And it will affect us whether or not we join EMU. However, British firms would be better placed to make the most of the opportunities if we were members of the single currency.

Thorough preparation by British business is essential either way. But they are particularly necessary if we join the single currency. Preparations have begun, but more is needed to put British business in a strong position to make the most of EMU membership.

Financial services

EMU will affect our financial services industry more profoundly and more immediately than other sectors of the economy.

The financial services industry contributes around 8 per cent of our national income and provided total net overseas earnings of almost £23 billion in 1996. It is an area where the UK has a record of success and comparative advantage. Across Europe, financial services are likely to be most immediately and directly affected by the replacement of national currencies with the euro.

The financial sector, and in particular the City, has made significant steps to prepare for EMU, helped by the work of the Bank of England. The City's strengths should help it to thrive in EMU whether the UK joins or not. But the benefits and new opportunities from the single currency will probably be easier to tap from within the euro-zone.

There are still some remaining preparatory issues to be resolved in the final negotiations on the introduction of the single currency. Some of these could affect the balance of advantage and disadvantage for the financial sector. Also further preparatory work would be needed in some areas for the financial sector to be able to benefit from British membership of EMU.

Employment and growth

The fundamental test is how Britain's membership of a successful single currency would affect prospects for British employment.

The assessment concludes that membership of EMU has the potential to enhance both growth and employment prospects

But these benefits would accrue only if there were sufficient convergence and the UK economy were sufficiently flexible to make Britain's joining EMU a success. Otherwise, the resulting turbulence could considerably damage them.

But Britain's economic cycle is currently not converged with Continental Europe. This would present a risk to the stability of the economy if we were to join EMU in the near future. A period of stability and low inflation is needed to achieve convergence and in particular to be sure that it is durable. The new UK macroeconomic framework that the Government has put in place will help achieve this aim.

There are also further steps needed to be sure that our economy is flexible enough to withstand the pressures of EMU. The Government's structural policies will help improve the position.

In summary, we need to demonstrate sustainable and durable convergence before we can be sure that British membership of EMU would be good for growth and jobs. Joining before such convergence is secured would risk harming both.

Section 1: Cyclical convergence

"Are business cycles and economic structures compatible so that we and others could live comfortably with euro interest rates on a permanent basis?"

Importance of the test

1.1 The Maastricht Treaty rightly emphasises the importance of achieving a high degree of sustainable convergence, if a country is to participate in EMU.

1.2 In joining EMU, interest rates in the UK would no longer be set in response to domestic economic conditions. Rather, the ECB would set interest rates to achieve price stability in the EMU area as a whole. If economic conditions in the UK were similar to those in the EMU area then the ECB's monetary policy would be appropriate for the UK. But if conditions in the rest of the EMU area were very different from those in the UK euro interest rates could often be too high or too low for the UK, making economic conditions less stable. So it is important that the UK cycle is broadly in line when we join EMU and that this convergence is sustainable.

1.3 Variations in the exchange rate can play a beneficial role in dampening the cycle in divergent economies. The monetary authority of an economy that is growing rapidly will tend to run a relatively tight monetary policy, causing the exchange rate to appreciate, thus reducing demand. Conversely, if demand is slack, interest rates will be relatively low and the currency is likely to depreciate, thereby increasing demand. If the UK were in EMU this adjustment mechanism would no longer apply to the UK. This would be a potentially serious loss if the UK economy had not converged with other Member States.

1.4 If the UK were to enter monetary union without durable convergence, then the loss of domestic monetary policy and lack of exchange rate freedom could make the UK cycle more volatile. This lack of stability would damage investment and the underlying rate of growth and employment would suffer.

1.5 It is not safe to assume that the act of joining monetary union would automatically trigger convergence. That depends, for example, on whether the lack of convergence arises from different monetary policies or other factors. We therefore need to understand, as best we can, the reasons for current and past cyclical differences and why there has not been convergence in the past.

Current position

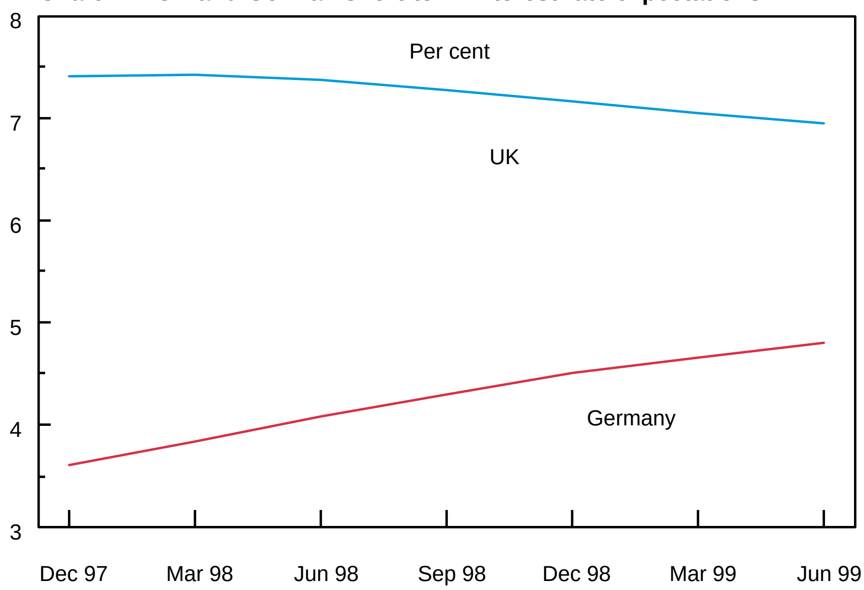
1.6 Currently the UK economy is clearly not in line with many other European countries. Having suffered a deep recession in the early 1990s there has been reasonably strong growth subsequently. Unemployment has fallen, and we estimate that the output gap (the difference between actual and trend output) has closed. However, growth in other countries in

Europe has generally been much weaker, unemployment is high and there is considerable excess capacity.

1.7 These different cyclical positions are reflected in the interest rate differentials. UK official rates are currently 7 per cent compared with key official rates in Germany and France which stand at 3.3 per cent in both countries. The recent levels of sterling have reflected these differentials, among other things. With considerable excess capacity in the Continental economies, lower official rates there are consistent with price stability.

1.8 This cyclical divergence is expected to narrow before 1999 but is unlikely to disappear. Although it is extremely difficult to forecast the cyclical position even a year ahead, it is likely that more spare capacity will remain in Germany and France than in the UK. This is reflected in the market expectations of short-term interest rates illustrated in Chart 1.1. It shows how markets expect short-term UK and German interest rates to evolve through to June 1999. German rates from 1999 can reasonably be used as a proxy for euro rates. These expectations should be treated with some caution but nevertheless imply that the market believes the UK economy will continue to have higher short-term interest rates than Germany in two years time. Some would say that if the UK were to join EMU in the first wave interest rates would be lower than those required for price stability in the UK. They go on to say that fiscal policy might have to be tightened excessively to offset the ensuing demand pressures. Clearly such short-term adjustment to fiscal policy would not be in the interest of long-term stability.

Chart 1.1: UK and German short-term interest rate expectations[1]



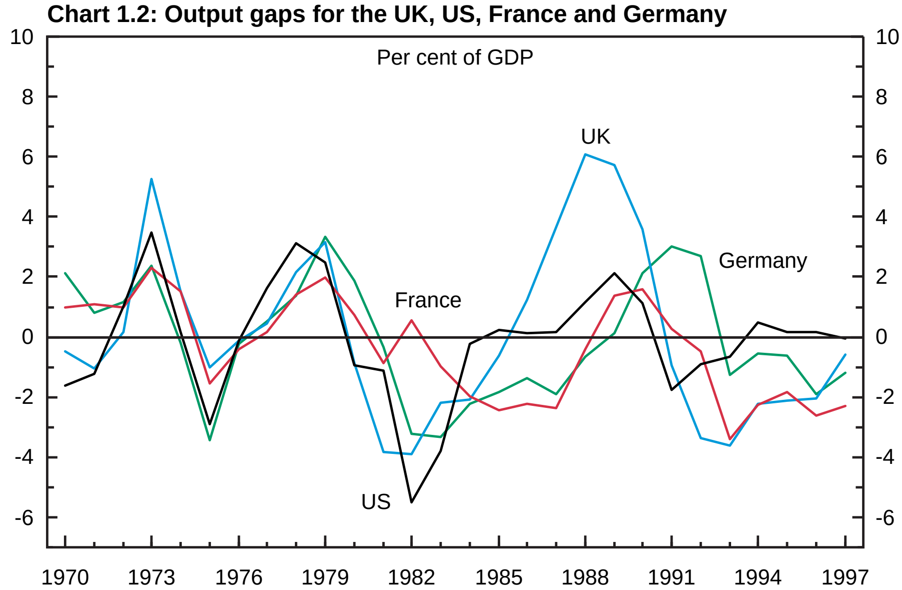
[1] *Derived from futures contracts averaged over the past two months.*

1.9 While the difference in the output gaps between the UK and the likely initial EMU participants will probably narrow by 1999, joining EMU could remain risky in the period soon after that. Output gaps may initially be converging, but this could be temporary. For example, the UK economy might be slowing while growth on the continent could be rising, so that any similarity in output gaps would not be sustained. It is not sufficient for economic conditions to coincide for a short time. It must be clear and demonstrable that our economies can remain sustainably converged. We can ask what lessons history provides.

Past cycles

1.10 The current cyclical divergence is by no means unusual. Chart 1.2 plots OECD estimates of the output gaps in the UK, US, France and Germany. While the cycles moved relatively closely between 1973 and the early 1980s, this pattern broke down subsequently. The UK became increasingly out of step with Germany during the 1980s, while the US and UK cycles have been relatively synchronised.

Chart 1.2: Output gaps for the UK, US, France and Germany



1.11 Table 1.1 sets out the average GDP growth rates along with the standard deviations for several time periods. The two most recent full UK economic cycles were 1975-81 and 1981-92, while 1982-93 was the most recent full international economic cycle. Low standard deviations for both Germany and France indicate that growth has been less volatile in these countries than in the UK.

Table 1.1 Average annual GDP percentage growth rates and standard deviations

	UK		US		Germany		France	
	Ave.	s.d.	Ave.	s.d.	Ave.	s.d.	Ave.	s.d.
1970–96	2·1	2·27	2·7	2·23	2·5	1·90	2·6	1·68
1979–96	2·0	2·18	2·4	1·96	2·2	1.79	2·0	1·31
Economic cycles:								
1975–81 (UK)	1·0	2·12	2·9	2·32	2·2	2·11	2·4	1·46
1981–92 (UK)	2·0	2·30	2·6	2·23	2·5	1·79	2·1	1·19
1982–93 (Intl.)	2·3	2·08	2·6	2·24	2·4	1·95	1·9	1·51

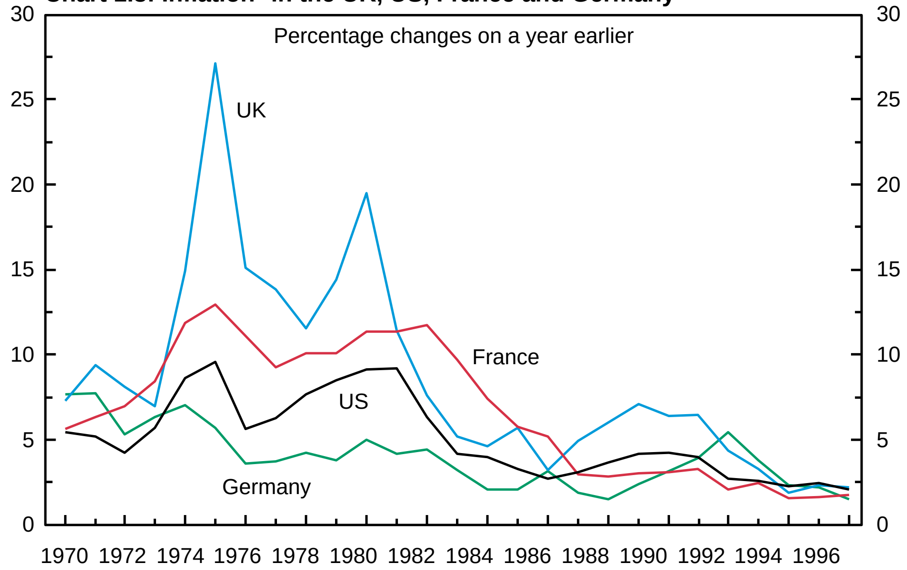
1.12 The correlation coefficients reported in Table 1.2 show that the timing of the UK economic cycle has been closer to that in the US. For all periods, the US and UK record high correlation coefficients, consistent with relatively synchronised economic cycles, while in both the latest UK and international cycles there was little or no correlation between UK and German growth. Overall, the correlation of the cycles between the US and the UK tends to be higher than between the UK and Germany or the US and Germany. Similarly, higher correlation coefficients are normally recorded for France and Germany than France and the UK, although the difference is less marked.

Table 1.2 Correlation coefficients of US, UK, French and German growth rates

	UK/US	UK/D	US/D	UK/F	D/F	US/F
1970–96	0·66	0·31	0·40	0·46	0·65	0·30
1979–96	0·56	0·01	0·17	0·38	0·49	0·10
Economic cycles:						
1975–81 (UK)	0·86	0·82	0·78	0·82	0·97	0·86
1981–92 (UK)	0·47	–0·14	0·10	0·48	0·19	0·05
1982–93 (Intl.)	0·52	–0·30	0·11	0·35	0·42	0·06

1.13 Chart 1.3 compares the inflation performance of the four countries. With the adoption of relatively accommodating policies to the oil price shock of the 1970s, the UK experienced significantly higher inflation than the other countries. Similarly, the large output gap at the end of the 1980s resulted in relatively high inflation. In recent years inflation rates have converged, as policies have focused on achieving low inflation.

Chart 1.3: Inflation[1] in the UK, US, France and Germany



[1]*GDP deflator*

Would cycles remain divergent under EMU?

1.14 A view of the future must depend on an analysis of the past. It is important to distinguish between one-off shocks, the policy response to shocks and structural differences. By their nature, shocks are unpredictable but we can consider whether the shocks of the past two decades are likely to have been exceptional. The new macroeconomic framework that has been put in place should improve the conduct of policy and EMU members will be subject to a similar approach to policy-making. Structural differences may present more of a problem but it is possible to put in place policies which are both useful in their own right and which help to reduce the differences. Flexibility of labour and product markets would be important, especially for the UK if it is less converged than other countries.

1.15 The recent history of the UK can be summarised as follows. Financial liberalisation triggered a boom in the late 1980s as macroeconomic policy initially failed to contain the increase in demand. Policy was eventually tightened and led to a recession at the beginning of the 1990s. The recent period of above-trend growth reflects the recovery from that recession. The shock of unification led to a period of strong growth in 1990 and 1991 in Germany. Interest rates were raised to control inflation which, through the ERM, caused other countries to tighten monetary policy as well. The UK began to recover before the other EU countries. It is reasonable to say that shocks on a scale of both financial deregulation and German unification are very unusual. The UK's new macroeconomic policy framework is also designed to reduce volatility.

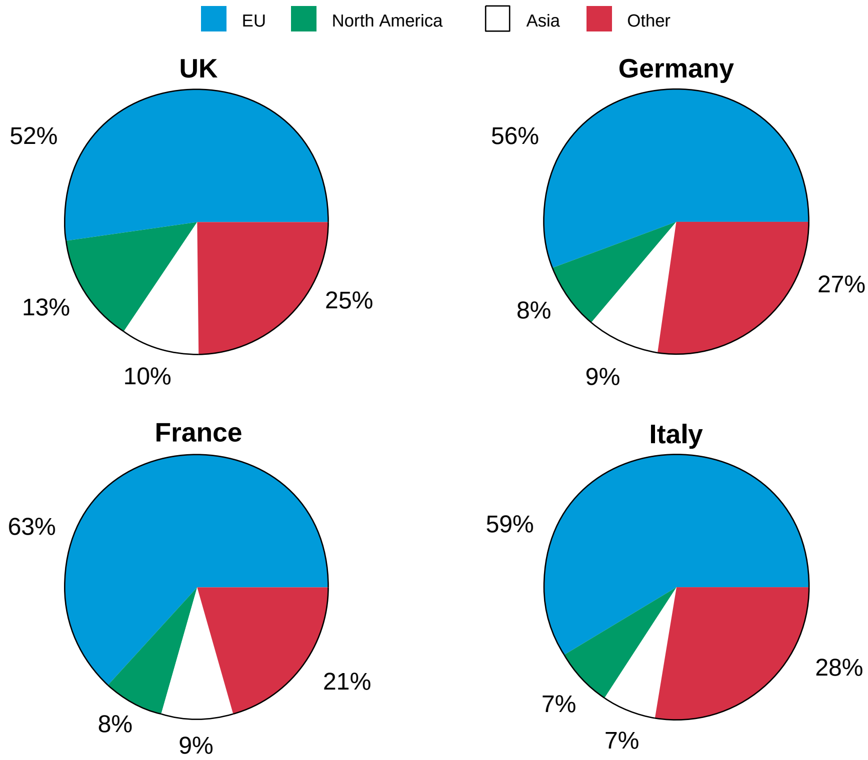
Structural differences

1.16 There are a number of other reasons why the UK may have been subject to different shocks in the past. No two countries are ever identical but the UK has certain features that clearly make it different from other countries in the EU.

Trade

1.17 The proportion of UK trade with other Member States is below the EU average. So the UK is vulnerable to changes in demand in non-European Union countries to a greater extent than other Member States. And a shock in one Member State will probably not have as great an impact in the UK as elsewhere in the EU. The close link between the UK and US cycle may reflect the fact that a greater proportion of our trade is with North America.

Chart 1.4: Trade by geographical destination, 1995



1.18 In time, the pattern of UK trade may change. The proportion of UK trade with other Member States has risen over recent years. And if the UK were to join EMU, the removal of exchange rate volatility would probably increase trade flows between the UK and the other EMU countries, reducing the chances of asymmetric shocks. On the other hand, if increasing trade flows lead to greater specialisation, regions could become more susceptible to industry-specific shocks.

Personal sector

1.19 There are several important and interrelated differences between the personal sector in the UK and in the other Member States. Owner-occupation is higher in the UK for example. In 1995, 66 per cent of UK households owned their own homes compared with an EU average of 56 per cent. High and variable inflation rates have made housing an attractive investment. The housing market has been more volatile in the past than in many other Member States, although some others also exhibit highly variable house prices.

Table 1.3 Volatility of house prices 1970–1994

	EU[1]	Germany	Ireland	Italy	Netherlands	Spain	UK
Short-term	3·1	5·4	5·2	8·5	9·8	2·5	10·1
Medium-term	3·1	5·3	3·0	8·4	11·1	3·5	8·7

Short-term volatility: Standard deviation of annual house price inflation.
Medium-term volatility: Standard deviation of house prices relative to trend.
Source: Ball, M. and Grilli, M. (1997).
[1]EU refers to coverage of above countries as well as Austria, Denmark, Finland, France and Sweden.

1.20 The importance of the housing sector is reflected in the personal sector balance sheet. Mortgage debt in the UK totals 57 per cent of GDP in the UK compared with the EU average of 33 per cent. As a result the stock of household debt is higher here than many other EU countries. This makes the UK more susceptible to changes in interest rates.

1.21 UK households hold a high proportion of their wealth in equities. As such they are more vulnerable to international equity market movements. This difference should not be exaggerated, however. Much of the personal sector's holding of equity is in pension funds, and a shock in the equity markets is less likely to affect household behaviour directly.

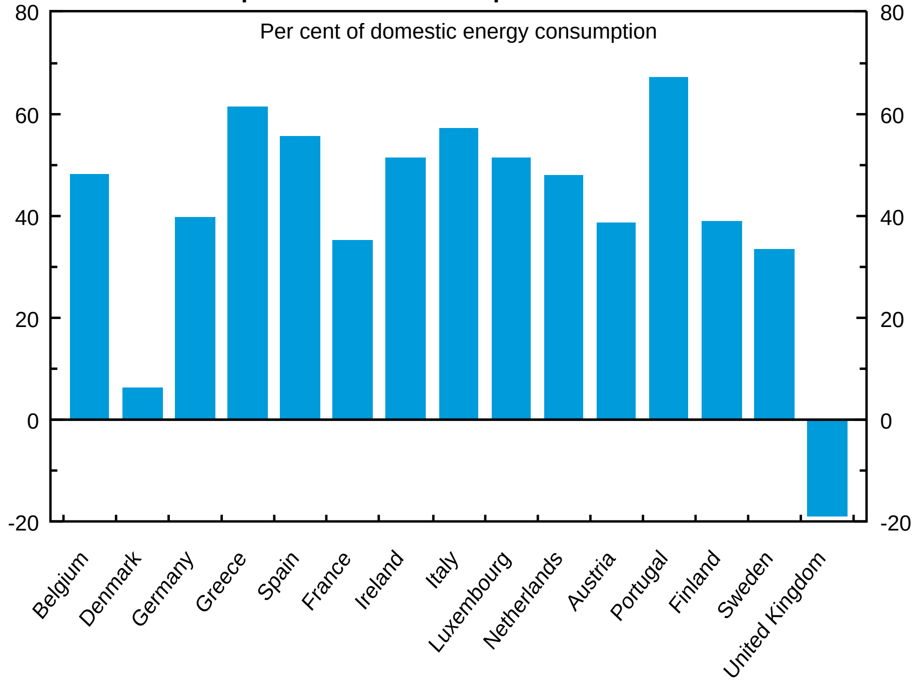
Corporate sector

1.22 In the UK, large companies rely more on equity finance and small firms more on variable-rate loans than their European counterparts. This again may reflect the UK's history of high and variable inflation which has encouraged the use of short-term finance rather than fixed-rate debt.

Oil

1.23 The UK has been a substantial net exporter of oil since 1980. Oil price movements have thus had a distinct impact on the UK relative to its European partners. This may explain why the UK has been subject to different shocks in the past. Production now is at record levels and the UK is likely to remain an oil exporter for some time. The DTI have estimated that there are still substantial oil reserves, possibly in excess of total oil production in the UK to date.

Chart 1.5: Net imports of crude oil and petroleum



Response to shocks

1.24 Structural differences are important not simply because they make the UK susceptible to different types of shocks, but also because they affect how the UK responds to shocks. Even if the UK is affected by the same shocks but then responds differently, the UK economy could diverge from other countries in EMU.

1.25 For example, the response of the UK economy to a change in official interest rates may be different because of the greater use of floating rate debt. If the UK were in EMU and the ECB increased rates, then the UK might react differently from other countries, causing a divergence. Evidence on this is inconclusive. Some work suggests that the UK is more sensitive to interest rates, but this is not the conclusion of all studies.

1.26 Even if the UK transmission mechanism differs from others, it could change. A period of low inflation or low inflation expectations could lead to a shift in borrowing patterns. There might be increasing use of fixed rate mortgages as uncertainty about future inflation rates was reduced (and with it the risk associated with fixed nominal rate long-term borrowing). Similarly UK companies might choose to make greater use of corporate bonds. More stable macroeconomic conditions should also help to reduce volatility and speculation in the housing market.

Is there sustainable convergence?

1.27 Participation in a monetary union does not require that all Member States are perfectly in line. Shocks and responses to them do not have to be identical. In the UK, different regions have more or less spare capacity at any one moment, yet the UK functions effectively as a monetary union.

Similarly, the regions of the US suffer from different shocks but the union remains a coherent whole. The parallel between EMU and other monetary unions should not be exaggerated, however, as labour mobility and budgetary policy in EMU will not be very similar to other unions. There may, in fact, be some advantages to cycles being slightly out of phase, in that if one country is growing rapidly while another is growing sluggishly, they may help to stabilise each other.

1.28 In EMU the UK would still retain flexibility over fiscal policy. With monetary policy targeted at EMU-wide monetary conditions, it would be important that fiscal policy is able to respond to country-specific events in the UK, as elsewhere. Given the Government's commitment to sound public finances – current projections show that the general government financial deficit will fall to ¼ per cent of GDP by 1998-99 – there would be headroom within the Stability and Growth Pact to adjust fiscal policy if circumstances required. Provided that the volatility of output is no larger than it has been in the past, there should normally be room for both the generally beneficial 'automatic stabiliser' properties of the fiscal system to operate and for some additional discretionary changes in fiscal policy, if that was what conditions called for.

Conclusion

1.29 On balance the UK is not convergent enough to commit to joining EMU in the first wave. Our economic cycle is not in line with others. Although there should be some convergence, it is not yet safe to assume that it will be sufficient for some time. In addition it is not clear enough that the shocks that have caused the UK to diverge in the past will cease to be a problem. It is difficult to establish the extent to which policy differences or structural differences have caused the UK cycle to diverge in the past. The UK needs a period of economic stability to demonstrate that convergence is sustainable.

1.30 If we attempted to join EMU too soon, there is a risk that interest rates would be too low for price stability in the UK and that other measures would be needed to slow the economy. Fiscal policy might have to be tightened, excessively, which could jeopardise the economic stability on which success depends.

Section 2: Flexibility

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

Importance of the test

2.1 For successful membership of a monetary union the UK needs labour and product markets that work effectively. Even with a high degree of sustainable convergence, individual economies will continue to be affected by shocks and changes to the internal and external economic environment. With the loss of domestic control over monetary policy and the exchange rate as a means of adjusting to shocks, a greater burden of adjustment will fall to factor and product markets. Furthermore, there will inevitably be some uncertainty over whether the UK economy has truly converged with the rest of the EMU area. This will place an even higher premium on well functioning product and labour markets. If there is insufficient flexibility there may be adverse consequences for employment and living standards.

The product market

2.2 The debate often focuses on labour markets, but while labour market flexibility may be the main issue, it is only part of the picture: product markets matter too. Firms need to respond effectively to shocks, both in terms of pricing and production decisions, and also in deciding on entry and exit from particular markets. They need to be flexible with their business strategies and be ready to adapt to the different competitive challenges that the single currency will bring.

2.3 The liberalisation of product markets has progressed further in the UK than in many other EU countries. Competition has been introduced in new areas such as telecoms and energy. There has been sectoral liberalisation, for example in retailing, housing and financial services, and the regulatory burden has been reduced, especially on small businesses. But some problems remain and new measures are planned to make further improvements, particularly to competition policy.

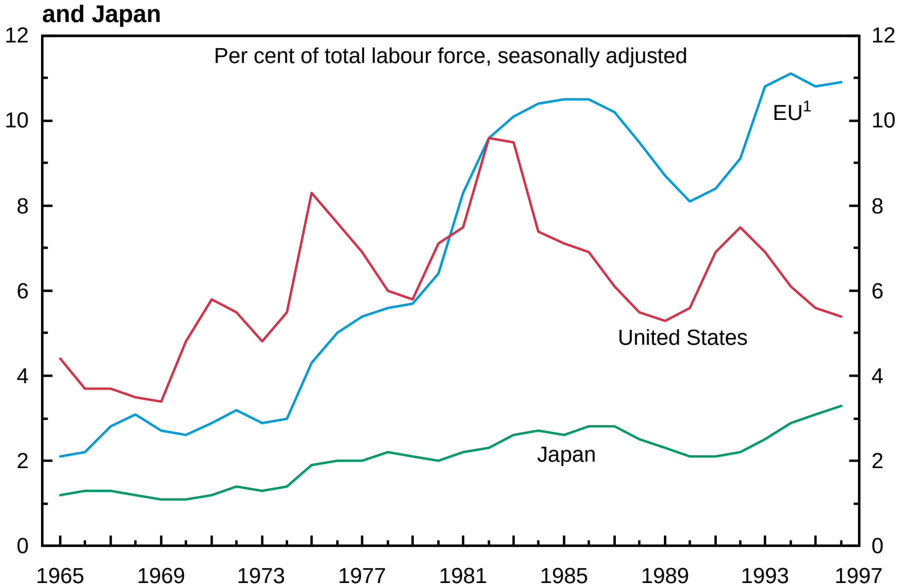
The labour market

2.4 A successful single currency should be positive for employment. But alongside the potential benefits, there are important risks. The loss of domestic control over monetary policy and the exchange rate as a means of adjusting to shocks means that a greater burden of adjustment falls on labour markets. So it is crucial that the labour market works effectively.

2.5 Different economies can achieve this in different ways. In many European countries systems of co-ordinated pay bargaining, strong social partnerships, and a positive approach to training and skills have in the past helped to deliver a better outcome on unemployment than we have achieved in the UK. But, across Europe, these arrangements are under pressure from structural change and competition from the global economy. Another approach is the liberalised and decentralised labour market that has characterised the Anglo-Saxon economies. But here too there are pressures. Many relatively flexible economies, particularly the UK, have failed to provide their citizens with the skills necessary to be employable in the modern labour market and to move up the employment ladder to higher paying jobs. They have also failed to ensure decent minimum standards and social inclusion.

2.6 In Europe today, 18 million people are unemployed, of whom around 9 million have been unemployed for over a year. In 1996 employment as a proportion of the working age population was less than 60 per cent in Europe, compared with around 75 per cent in the US and Japan. The problem of generating jobs is Europe-wide. Much of the explanation lies in low levels of growth and an expanding supply of labour. But the fact that high levels of unemployment have been sustained for some years, and show little sign of coming down decisively in the near future, is bringing clearer evidence of an inherent structural problem with European labour markets. A number of factors may be relevant here. For example, labour market institutions that favour the power of ''insider'' groups and existing workers (at the expense of new entrants to the labour market and ''outsiders'', such as the long-term unemployed) prevent the flexibility and adaptability needed for a successful EMU.

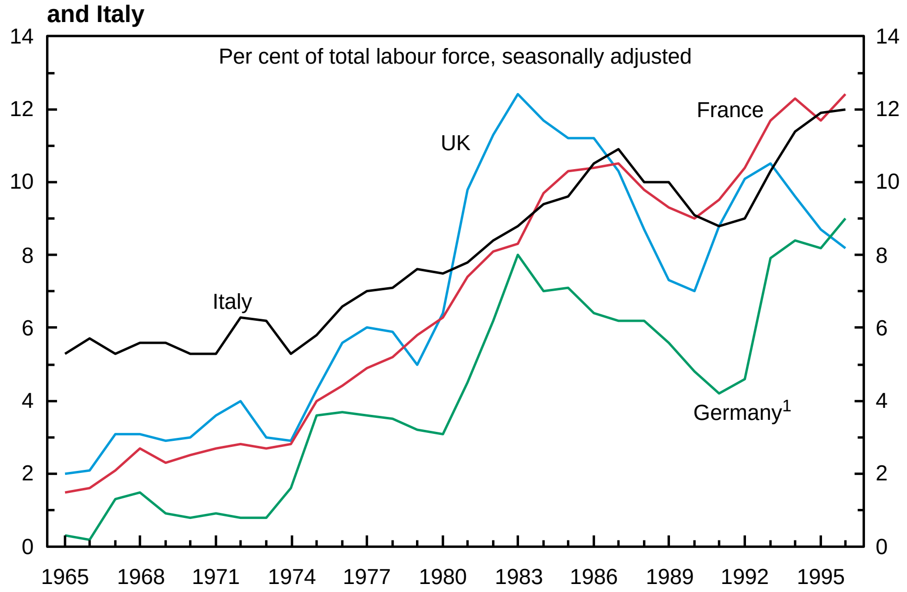
Chart 2.1: Standardised unemployment rates: EU, United States and Japan



[1] *EU excluding Austria, Denmark, Greece and Luxembourg.*

2.7 Governments across Europe are introducing structural reforms to make their labour markets more successful at adapting to economic change. Of course, these reforms are vital for all of Europe, whether or not individual countries are in or out of EMU. But EMU increases the costs of failing to improve the effectiveness of labour markets, and increases the costs to the economy and to society of poorly functioning labour markets.

Chart 2.2: Standardised unemployment rates – UK, France, Germany and Italy



[1]*Data relates to unified Germany from January 1993*

2.8 The UK will be supporting these efforts through our Presidency of the EU and the G8 group of leading industrial nations. We do so by first acknowledging that we need to improve our own performance. While the UK labour market is relatively flexible in some respects when compared with the rest of Europe, there are still weaknesses that need to be addressed. Although the recent experience on unemployment in the UK has been relatively positive, after 5 years of economic recovery there are still around 2 million people unemployed (as measured by the Summer 1997 Labour Force Survey). This is the most obvious sign of labour market failure, but we should also look at the experience of those outside the labour market altogether. Changing family structures, and the poor job prospects of specific groups, have both contributed to a situation in which one in five working age households – a total of 3½ million households – have no one in work.

2.9 The effectiveness of the labour market is meeting structural changes, without damaging effects on employment and living standards, can be measured by a number of key elements, including:

- Wage flexibility – Can we avoid a situation where real wages accelerate while unemployment remains at unacceptable levels? Can we reflect structural change through shifts in relative wages, eliminating mismatches between labour demand and supply?

- Employment flexibility – Can people move from declining to expanding industries? Are there barriers to labour mobility that can be overcome? Can we match the demands of the labour market with the personal and family responsibilities of workers?

- Employability and lifelong learning – Are there employment opportunities for all those who want to work? Do we do enough to help the long-term unemployed and other disadvantaged groups find work? Do we provide opportunities for lifelong learning?

Wage flexibility

2.10 Wage flexibility – the ability of wages to eliminate mismatches between the supply of and demand for labour – is an important element of a successful monetary union. In the past the UK economy has had serious problems with real wage rigidity in the face of high levels of unemployment, and accelerating wage inflation as unemployment fell. Some other countries have been more successful at restraining wages and re-integrating the unemployed back into the labour market. It is far from clear that the UK labour market has improved sufficiently on this score to enable it successfully to participate in a single currency.

2.11 There are, however, some optimistic signs. The depreciation of 1992 did not result in a general increase in wage or price inflation even though import costs rose sharply. In part this was no doubt a result of the degree of spare capacity available in the economy at that time, following the severe recession in the preceding years. Nevertheless it was encouraging that firms and wage-setters were responsive to demand conditions, and able to see through nominal cost and price developments to focus on real competitiveness. And more recently earnings growth has remained at relatively modest levels by historical standards despite significant falls in unemployment. However, unemployment has probably been above its sustainable level for most of this economic cycle, which should have put downward pressure on earnings growth.

2.12 The UK economy is now reaching a critical point in the economic cycle where, in the past, wage inflation would have accelerated, with the associated negative implications for jobs. Whilst it is hoped that unemployment can fall further without putting upward pressure on wages, it is still too soon to tell whether the UK is returning to the past pattern. We will need to continue to monitor the behaviour of skills shortages, real wages and unemployment.

2.13 It is also important that *relative* wages are flexible. Rigid pay differentials between different types of jobs mean that the economy adjusts only slowly to shifts in the pattern of demand. The UK labour market has one of the most decentralised systems of wage determination in Europe. This feature of our labour market helps to ensure that wages are sensitive to specific demand conditions, and this ought to place the UK economy in a relatively good position to reap the benefits of increased competition in a single currency area.

2.14 In conclusion, we have a system of wage determination that is relatively successful at ensuring that *relative* wages reflect new and changing demands. But it remains to be seen whether the historical problem of recurrent cycles of wage inflation and unemployment has been addressed. The measures that the Government has announced in its Employment Action Plan will be essential to ensure that the necessary improvements to the UK labour market are made. However, this is not something that can be achieved immediately.

Employment flexibility

2.15 The UK labour market is very fluid – each year about 7 million vacancies are filled, roughly half of which are taken by people previously out of work. Most job separations are voluntary and, when people do enter unemployment, about half find work within three months. This fluidity is partly a result of hiring and firing rules which are, and probably always have been, less restrictive in the UK than in other EU countries. As a result, the UK labour market can respond relatively effectively to structural change, by moving workers from contracting to expanding industries.

2.16 The UK labour market is also relatively successful at matching the demands of the market to the needs of its workers. The UK labour market has always been relatively unregulated compared to other EU countries. We have a wider range of hours of work than anywhere else in the EU. Only 10 per cent work a ''standard'' 40 hour week, compared to 25 per cent in Germany and 45 per cent in France and Italy. A high proportion of part-time work, most of which is voluntary, is helpful in allowing workers with family or personal commitments to find a job.

2.17 While wage and price adjustments are the optimal response to changing economic circumstances, labour or capital mobility can also play a part in responding to major and long-term shifts in demand or comparative advantage. In principle, the Treaty provides for full freedom of movement of both capital and labour. However, in practice while capital is highly mobile both inside and outside the EU, the extent of cross-border labour migration is low and tends to be focused on highly paid professionals. Social, economic and cultural barriers to labour mobility remain high.

2.18 It is far from clear that capital will flow to areas of high unemployment in the absence of wage flexibility – indeed the opposite could be the case. This suggests that there might be some place for further measures designed to enhance cross-border labour mobility. Most notably, there might be a case for further work on pensions mobility and language training. This would help the single currency area to avoid high levels of regional unemployment in response to acute asymmetric shocks where wage adjustments could not carry the full strain.

2.19 Mobility of labour is important in ensuring that people can find jobs when they need them. Mobility between Britain and other EU countries is not particularly high, especially compared with mobility between US states, for a variety of cultural and institutional reasons. But it is also important that, within the UK, the barriers that prevent people moving to new jobs are removed. Research by the Department of the Environment, Transport and the Regions has found important links between housing and labour mobility. Social housing can prevent people moving to find work. The UK has a relatively high level of owner occupation and, in recent years, negative equity and volatility in house prices have also been factors hindering labour mobility. Stability in house prices is an important element underpinning flexibility in the labour market.

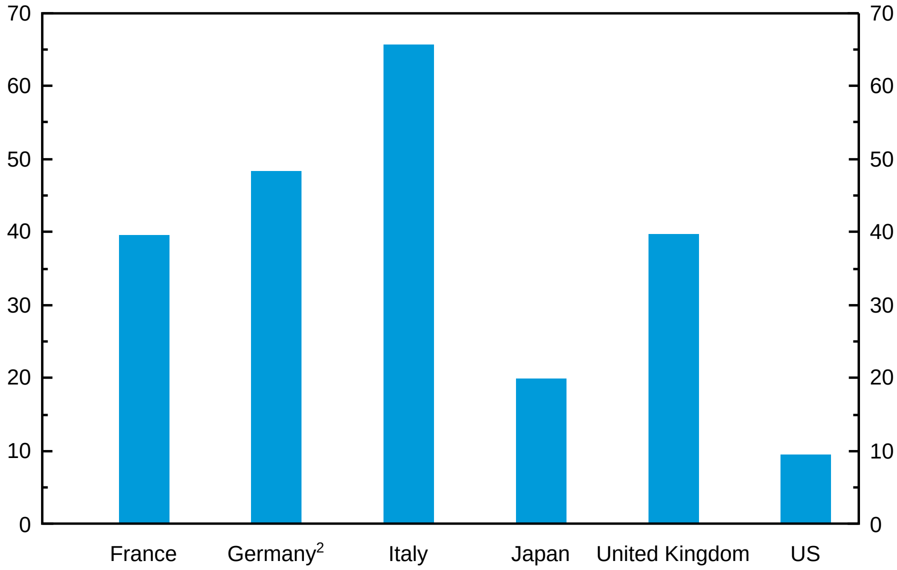
Employability and lifelong learning

2.20 Of course, for individuals this flexibility can lead to insecurity. It is important therefore that individuals are properly equipped for the demands of structural change, so that the economy can respond to the challenges of the global economy without falling into long-term unemployment. Our failure to equip people properly to play a full part in the modern labour market is one of the key failures of the UK, and an area we need to improve.

2.21 This failure is particularly obvious from the experience of specific groups, each of which the Government is targeting through the Welfare to Work initiative:

- the long-term unemployed;
- the young unemployed;
- lone parents; and
- the long-term sick and disabled.

Chart 2.3: Long term unemployment[1] as a percentage of total unemployment, 1996



[1]*Defined as greater than one year's duration*

[2]*Data for 1995*

2.22 After long periods out of work, these groups can become detached from the labour market. The result is not only damaging to the individuals concerned, and to society as a whole, but it can prevent the labour market from working effectively. High levels of long-term benefit dependency reduce the effective supply of labour, and prevent the labour market from creating new jobs without running into supply bottlenecks and skills shortages. And, in addition, the raising of taxation to finance social security benefits currently affects the incentives of those in work.

2.23 We also need to ensure that our tax and benefit system supports an effective and flexible labour market and ensures that work pays. The current tax and benefit system creates traps which often prevent people from being better off in work than out of work (the unemployment trap), and from raising their incomes in work (the poverty trap). It also creates a culture of dependency by sending out the wrong messages about the balance between rights and responsibilities, and the importance of work to community and family life.

2.24 Another important area where the performance of the UK may not meet the demands of a monetary union is in the field of lifelong learning and skills. The UK is relatively strong in higher education, but elsewhere levels of attainment remain low, and many young people leave school without the basic skills they need for the modern labour market. The skills of the long-term unemployed are particularly poor, with about a third having no qualifications and a half only basic qualifications. The concept of lifelong learning is particularly relevant to the debate about EMU. The ability to adapt to structural change and increased competition depends on people having the basic skills needed to compete for a wide and changing range of jobs. And individuals need the opportunity to re-train in new skills to reflect the changing pattern of labour demand.

Conclusion

2.25 A successful single currency requires labour and product markets that work effectively. In the UK, persistent long-term unemployment, lack of skills and in some areas insufficient competition indicates insufficient flexibility to adapt to change and to meet the new challenges of adjustment that a single currency would bring. We need to work further to ensure:

- That the UK economy is able to bring people back into employment without igniting wage pressures. We are at a critical stage in the economic cycle, and given a period of growth and stability we should be able to form a clearer view about the prospects for sustained job creation.
- People have the skills to adapt, and opportunities for lifelong learning. We need to be sure that specific groups are not left behind in poverty and unemployment traps created by the tax and benefit system, without the support of an active welfare to work policy.
- The EU economy as a whole is able to create jobs and respond to structural change, as is needed.

Section 3: Investment

"Would joining EMU create better conditions for firms making long-term decisions to invest in Britain ?"

Importance of the test

3.1 The Government's central economic objective is to achieve high and stable levels of growth and employment. The Government wants to increase the quantity and quality of long-term investment in industry, infrastructure and new technologies in order to raise the trend rate of growth.

3.2 In principle, a successful EMU should provide a stimulus to investment both here and in the rest of the EU. For the UK, however, entry into EMU before we were sufficiently converged and prepared would risk damaging investment prospects.

3.3 The main mechanisms by which improved investment conditions can be expected to be achieved by EMU include:

- creating a zone of macroeconomic stability and low inflation to provide a stable environment in which firms can plan and invest;
- acting as a complement to the Single Market, boosting competition and providing new opportunities for companies to invest.

3.4 These are considered in turn.

Stable macroeconomic environment

3.5 At least part of the UK's poor growth performance may be attributed to macroeconomic instability. A stable macroeconomic environment with low inflation is therefore important. Sustained strong output growth is also more likely if markets are allowed to function well. Stability is particularly important for the quality and quantity of long-term investment:

- businesses and individuals need to have confidence in future economic prospects if they are to plan effectively for the long term. If firms are to take up investment opportunities they must also be confident that the economy will not be subject to excessive swings in economic growth;
- confidence that inflation will remain low helps to encourage savings which then go to fund investment. Inflation volatility adds to the risk premia on long-term interest rates, which raises the returns required by lenders. And inflation makes it difficult for firms to assess the strength of current demand for their products from movements in prices. This makes them more cautious about investing in additional capacity.

3.6 It is broadly accepted that higher macroeconomic volatility, such as in the exchange rate, inflation, interest rates and personal consumption or GDP, results in lower levels of investment. Volatility increases the required rate of return on investment decisions. Most investment expenditure is, at least in part, irreversible. That is, there are sunk costs which cannot be recouped should market conditions turn out to be worse than expected. The capital stock can be adjusted upwards but it cannot be adjusted downwards (other than through depreciation). Firms have an option to delay investment until there is more information on demand conditions. Essentially this increases the ‘hurdle’ rate of return on investment.

3.7 Direct survey evidence of firms indicates uncertainty about demand is a significant obstacle to investment. For most of the period 1991 to 1996 the CBI Industrial Trends Survey found that for more than 50 per cent of firms, uncertainty about demand was limiting their investment plans. Academic studies on the impact of volatility on investment generally show that increased volatility and uncertainty result in lower levels of aggregate investment. A recent assessment of UK investment performance and policy concluded that fiscal and monetary policies which avoided the extremes of either aggravating recessions or fuelling inflationary booms, as seen in the recent past, would be likely to encourage investment.

3.8 Some studies have looked more specifically at the implications of exchange rate volatility for domestic and foreign direct investment. The conclusion tends to be that aggregate investment is higher under fixed exchange rate regimes. Furthermore, within flexible exchange rate regimes, increased exchange rate volatility tends to reduce investment, though the evidence is not conclusive. However, it has to be recognised that flexible exchange rates can help ameliorate the impact of certain kinds of shock. Fixed exchange rates do not, by themselves, guarantee a more favourable environment for businesses (including exporters). And there can be benefits from exchange rate adjustment when economic cycles are out of line.

EMU can bring macroeconomic stability

3.9 Whether we are in or out of EMU, the provision of a more stable macroeconomic framework will be an essential condition for higher investment in the UK.

3.10 The Government’s decision to give operational responsibility for setting interest rates to the Bank of England and the new rules for fiscal policy set out in the July Budget were important steps in ensuring greater economic stability and establishing a credible framework for macroeconomic policy. This will make firms and individuals more confident in arriving at decisions for the long term.

3.11 Membership of a successful EMU should in due course enhance these moves to greater economic stability. However, that requires:

- the euro area, helped by the actions of the ECB, develops into a zone of macroeconomic stability; and
- that the UK cycle has demonstrably converged, in a durable and sustainable way, towards those in the rest of EMU.

3.12 The aims of macroeconomic policy in the euro area will be broadly in tune with the UK’s. Low inflation is the ECB’s primary objective, as a means to sustainable growth across the Union. In aiming to meet that objective the ECB will face important challenges, particularly in the early years. EMU itself will involve profound structural changes that may alter the workings of the euro-economy in significant and unpredictable ways. There will be technical challenges too as the operation of monetary policy beds down. It will take a while for the ECB to establish its reputation as its track record builds up. Nonetheless, the markets expect the ECB to perform well in ensuring the euro area is a low inflation one.

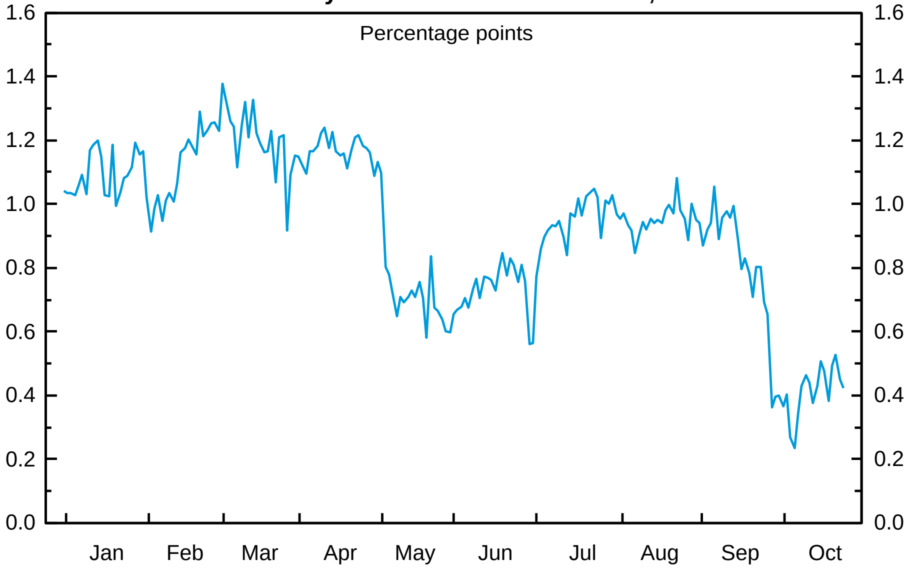
3.13 For many countries a lasting fall in nominal and real interest rates is one of the main economic reasons for joining EMU. During the 1980s and the 1990s, many countries followed German monetary policy as a way of sharing their reputation for sound financial management. If the ECB can match the Bundesbank's record, EMU would consolidate this benefit permanently across the euro area.

Effect of EMU membership on UK interest rates and policy credibility

3.14 In recent years, long-term interest rates among expected participants of the single currency have been converging on German levels. Financial markets currently behave as if an expectation that a country will join EMU enhances confidence in its commitment to low inflation. This is best measured by looking at forward short-term interest rates (ie the short rate that is expected to prevail at some date in the future) rather than long-term interest rates (which are, broadly, the average of short rates expected to prevail from now until some date in the future). The latter are affected by the economy's *current* cyclical position.

3.15 Day-to-day data are volatile, mainly in response to changed expectations about EMU and it is best to look at broad trends, rather than focusing on the exact differentials at specific points in time. The forward 5-year differential, averaged over the past two months, shows that UK rates are around 70 basis points higher than in Germany. (The difference is some 180 basis points when the yields are compared.) This points to a belief by markets that there would be a credibility gain for the UK from joining EMU.

Chart 3.1: UK-German 5-year forward rate differential, 1997



3.16 Lower nominal rates may ease cash constraints for firms, for example by cutting the up-front cost of borrowing. But it is *real* interest rates that determine the overall cost of servicing debt, and therefore they have the most important effects on investment and output. Part of the reduction in nominal interest rates is likely to be accompanied by a reduction in inflation expectations (although this may involve a period of adjustment), so in the longer term, the reduction in real interest rates (ie nominal rates deflated by expected inflation) is likely to be smaller than the reduction in nominal rates.

Investment and the Single Market

3.17 The single currency will act as a complement to Europe's Single Market. Reduction of transaction costs, a reduction in exchange rate uncertainty and greater price transparency will reduce costs and increase competition. The elimination of uncertainty will have a direct impact on investment, and, along with the reduction of transaction costs, an indirect impact through its effect on trade. The increase in trade that should follow from a larger, more integrated and efficient market will also improve opportunities for investment. In or out of EMU, the UK will be affected and will need to prepare for the changes, and opportunities, that the start of EMU in 1999 will bring.

Transaction costs

3.18 The economies of Europe are closely integrated in terms of trade, and the Single Market has further increased the potential for integration. Exports account for about one third of the EU's GDP, more than half of which is made up of trade within the region. A single currency that encompassed all fifteen Member States could therefore halve the amount of transaction costs involved in currency conversion. A smaller EMU group would yield smaller gains, but these would nevertheless be of value.

3.19 As well as allowing firms to make higher profits on existing intra-EU trade, the single currency would remove a barrier – in terms of cost and inconvenience – which may be restricting the level of trade. The lower costs of managing cash, which include benefits from a reduced need for financial management expertise, will be particularly important for smaller and medium-sized firms who are less able to benefit from economies of scale.

Exchange rate uncertainty

3.20 Currency fluctuations can act as a significant barrier to trade and competition. In the end, it is real competitiveness that matters for sales production and investment decisions. But currency movements dominate short-run movements in firms' competitive positions. Unless these can be hedged or absorbed, they present a disincentive to export.

3.21 Larger firms are able to hedge currency risk in a number of ways at a fairly low cost. These include:

- the use of future and swap markets, particularly for hedging short-term currency movements;
- firms which have production facilities in more than one country, or which buy from and sell into a variety of markets, may already be hedged to a large extent; and
- hedging over time – setting losses from adverse movements one year against gains from favourable movements in another year.

3.22 Smaller firms are less able to hedge than larger firms: the use of future and swap markets is more expensive for smaller transactions; small firms are less likely to be diversified in terms of the currencies in which they transact; and they are less likely to have the financial resources to absorb adverse currency movements. Participation in the single currency, which would remove intra-EMU currency risk, could therefore be an important benefit to small firms' trade and investment.

Price transparency

3.23 Exchange rate uncertainty not only discourages firms from selling in foreign markets, it also discourages consumers from purchasing directly from foreign firms due to a lack of price transparency. Although the price will be known at a given point in time, unless the transaction is paid for immediately, the actual price in terms of domestic currency is unknown – this will apply to all consumer purchases made by instalments and also to many transactions between firms, where payment is often made a month or more after delivery of the goods (which in turn will be some time after the terms of the sale are agreed).

3.24 The single currency will not eliminate a lack of transparency entirely – for example multinationals may continue to vary transfer prices within their operations in order to change calculations of value-added and profit in different parts of their business. But it is reasonable to expect an increase in the transparency of transactions overall, which should have a beneficial impact on competition and trade and, over time, on the quality of investment.

3.25 It is difficult to tell how profound these changes will be. Many of the effects will take time to come through. Companies that make the most of the opportunities the bigger, more competitive market offers, will stand to gain. Firms that fail to adapt, or which are under prepared, will face the biggest risks. It is reasonable to think that British firms will be better placed to make the most of these opportunities if we join the single currency. Either way, it will be important that business is properly prepared for the start of EMU. That is why the Government has taken action through its Business Advisory Group, and elsewhere, to address this issue.

Foreign direct investment

3.26 The UK attracts a significantly larger share of inward investment than other countries in the EU. This reflects a number of important benefits that we offer including low taxes, the English language and a flexible labour market. These advantages to locating in the UK will remain whether or not the UK joins EMU. It is interesting to note that recently inward investment has risen to record levels at a time when many investors are already assuming that the UK will opt out of the first wave. But participating in a successful EMU should add to the UK's existing advantages.

3.27 International investors look keenly at the stability of economies in making their decisions. In the shorter term, while the UK remains insufficiently converged with the rest of Europe, there would be risks for stability in the UK as a participant in EMU, and hence for inward investment, as compared with staying outside. Over the longer term, if the UK, though economically stable, remained outside a successful EMU there is the opposite danger that inward investment decisions at the margin would move against the UK, as companies look increasingly favourably on the euro area.

Conclusion

3.28 Over the next few years, the changes in the macroeconomic framework introduced by this Government should lead to greater economic stability in the UK. A successful EMU would be wholly consistent with this objective and could help to enhance it. This could lead to lower interest rates and would help to promote investment. The single currency will also complement the Single Market: reducing transaction costs and exchange rate uncertainty, and increasing price transparency which should boost competition and trade. In sum, the quantity and quality of UK investment should benefit from membership of a successful single currency. Critically, however, premature entry into EMU, ahead of durable and sustainable convergence, could prove damaging to investment.

3.29 The level of inward investment is unlikely to be significantly affected in the short run if the UK does not enter EMU in the first wave. Over the longer term, if EMU succeeds in promoting stability and strengthening the Single Market, then the overall level of this investment can be expected to increase in participating Member States. However, foreign investors may increasingly look towards the euro area and countries perceived to be staying out for the longer term may lose out.

3.30 British firms will be affected by EMU whether or not we join the single currency. Firms would be better placed to make the most of the opportunities if we participate. But if we do not, it will be important that stability is achieved over the coming years to allow businesses to plan ahead effectively. Preparations ahead of the 1999 start date have already begun, but more needs to be done to put British business in a strong position to make the most of EMU.

Section 4: Financial services

"What impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets?"

Importance of the test

4.1 Financial services account for around 8 per cent of UK GDP, and provided total net overseas earnings of almost £23 billion in 1996. The UK has a significant comparative advantage in wholesale financial services and the City is by a large measure the pre-eminent financial centre in Europe. Retail financial services are also strong in the UK, although naturally less internationally dominant than our wholesale markets. The financial system supports other industries and plays a leading role in helping the wider economy prepare for EMU. Given the importance of the financial sector to the UK, it is vital that the decision on whether to join the single currency does not damage its competitiveness. The dynamic nature of the sector means that there is no room for complacency.

Changes resulting from EMU

4.2 The implications of the single currency for the financial sector will be profound and immediate. EMU will remove an existing barrier between national markets within the euro area. The cost and quality of financial services will be more easily comparable across national boundaries. For those outside EMU, entering this market will be simplified, since one currency balance sheet will support operations across many countries. Large corporate customers will seek savings by centralising banking operations. All this points to an acceleration of trends which have already arisen as a result of new technology, globalisation and the Single Market. These include: more cross-border competition in wholesale banking, securities markets and between financial centres; greater securitisation of borrowing; and more competition in retail banking within individual countries.

4.3 EMU will also involve some one-off disturbances. The changeover to the euro may be particularly costly for some smaller retail banks. Intra-euro area foreign exchange trades will disappear, and some banks will have to adapt their operations if the methods of the ECB differ from previous national practices.

4.4 Within the wholesale financial markets, specific important changes will include:

- the removal of currency barriers to cross-border investment within the euro area. This will allow greater international diversification of portfolios. Equity trading may become focused in fewer, highly liquid exchanges, through fewer, but larger, intermediaries.

- The creation of a large and liquid market in euro-denominated instruments. Deeper bond markets could encourage yet more firms to issue bonds. Credit risk, rather than currency risk, will be important. Instruments which are as yet relatively underdeveloped in Europe could well expand.

- The likelihood of bond market liquidity becoming focused around a single yield curve. There will be competition among sovereign issuers to issue benchmark instruments.

- The loss of intra-euro area foreign exchange dealing. This will hit those exchanges whose business now predominantly involves European currencies. In contrast, extra-euro area currency trading is likely to be concentrated in those exchanges with international currency business today – notably London.

- The possible use by the ECB of reserve requirements on euro deposits within the euro area as a tool of monetary policy. However, this remains to be decided, as do the conditions under which they would be applied, such as the level of remuneration.

- The creation of a single monetary authority, with harmonised monetary policy instruments, implying uniform access to euro liquidity within the single currency area.

4.5 Within retail banking, important changes will include:

- The creation of a large pool of euro savings and a single market for euro loans. A major barrier to cross-border competition between banks within the euro area will be lifted: retail banks will be able to take euro deposits in one participating country and recycle them as retail loans elsewhere within the euro area without currency risk.

- More large corporate customers will look for single financial institutions to handle many of their transactions across the euro area.

The competitiveness of the City

4.6 The City enjoys advantages stemming from a combination of factors, only some of which will be affected by either the creation of the single currency or whether or not the UK participates. These include:

- the presence of very large and liquid markets for trading securities and currencies;

- an accommodating regulatory regime and a relatively benign tax system;

- international demand for wholesale financial services, making the City less reliant than other centres upon the state of the domestic economy;

- a critical mass of core financial market activity and support services such as accountancy, telecommunications, IT and legal services; and

- access to a large English-speaking skilled workforce with relatively flexible labour market regulations.

4.7 These advantages will place London in a good position to compete following the introduction of the single currency, whether or not the UK joins. The City is also preparing well for EMU, recognising its impact on its business. The Bank of England's work in co-ordinating preparations is highly regarded both here and abroad. Important recent developments include: provision for legal continuity of contracts under UK law; CREST and other securities settlement systems which should improve the scope for pan-European settlement links; and good progress in the development of wholesale euro payments systems. London's equity and derivatives exchanges already operate in a multi-currency environment. Although there is no room for complacency, there is room for some optimism about the competitiveness of UK-based institutions in the wholesale financial markets whether or not the UK joins the single currency.

4.8 Turning to the question of whether early UK participation in the single currency would benefit the City, there are arguments that joining would help consolidate its position as the leading European financial centre. If the UK were to join, there might be strong economic incentives for the ECB to conduct a large share of its money market operations in London's relatively liquid markets. The City would also be a natural conduit for outside investors, borrowers and issuers of securities to gain access to the euro area. EMU would reduce currency barriers to the further consolidation of certain wholesale financial EU business in London. In the derivatives and equities markets, in particular, there is considerable ''first mover advantage'' to the centre which can attract a critical mass of liquidity.

4.9 An important assumption, however, is that ECB monetary policy operations do not impose such a burden on UK banks (via costly reserve requirements, for example) that much of the City's current business would be driven elsewhere. There will certainly be pressures from the markets for any reserve requirements to be remunerated at reasonably close-to-market rates, reducing the tax-like effect on banks. If the UK were to participate in EMU at an early stage, it would be in a better position to press the case in the ECB for moderate measures, such as remunerated rather than unremunerated reserve requirements.

4.10 One risk of remaining outside the single currency is that we cannot be sure that UK based banks would have access to the proposed euro payment system TARGET (trans-european automated real-time gross express transfer settlement system) on the same terms as banks located in euro countries. This issue cannot be resolved until the ECB has been established. In any event, other payment routes will be available some of which may in practice be more cost effective than TARGET which has been devised primarily as a central bank tool rather than as a commercial service.

4.11 Another possible disadvantage of not joining the single currency is the risk that participating countries might be able to exploit any loopholes in existing Single Market legislation to block UK access to euro markets. In particular, the Investment Services Directive contains provisions to enable measures to be imposed for the ''general good'' of EMU stability. However, there are strong legal arguments that such exploitation of Single Market law would not be easy, and that the Commission should also act to prevent any such abuse of the Single Market.

The competitiveness of retail banking

4.12 Retail banking in the UK is relatively profitable and is concentrated in a smaller number of institutions than in most EU countries. Retail financial services are also relatively strong and innovative. The UK has undergone more restructuring in banking employment than elsewhere in Europe. Significant and early financial reform in the UK contrasts with the prevalence of state-run banks in France, Italy and Spain and the dense network of savings banks in Germany. Nonetheless, despite recent developments in telephone and direct financial services and banking, the branch bank network in the UK remains traditionally organised, and some continental banks have been turning more rapidly to new technology. In all countries there has been considerable activity in creating mergers and alliances, especially between banks and insurance firms.

4.13 Infrastructure preparations for EMU in the UK are on target, although the main banks are not generally planning to offer widespread accounts in euro to individuals in 1999. This springs in part from commercial decisions about how and when during the transition period individuals in countries which join the single currency will choose to use the euro, and in part from uncertainty about the likelihood of the UK joining. In practice, banks in some other countries such as the Netherlands have arrived at similar commercial decisions, although some larger banks in Germany and Belgium, for example, say that they plan to offer euro services to personal customers much earlier. UK banks would be very hard-pressed now to be able to offer widespread individual services in euro in 1999 if the UK were to join and competitive pressures required them to do so.

4.14 Corporate customers of retail banks will want euro accounts whether or not the UK joins, and UK banks are planning to offer the necessary corporate services. However, it is likely that continental banks will see the introduction of the euro as an opportunity to increase their corporate market share, especially if UK-based institutions are insufficiently well prepared.

4.15 From a strategic perspective, there are probably sufficient UK retail banks and financial service providers above a threshold minimum size to be competitive in a cross-border environment. But competitors on the Continent are increasingly engaging in mergers and acquisitions and UK-based banks need to be aware of the evolution of this market structure in the context of EMU.

Conclusion

4.16 In summary, EMU offers benefits to the UK financial sector, whether the UK is in or out. But the benefits and the opportunities from the single currency will probably be easier to tap from within the euro zone. If the UK were to join EMU in its early years, then the impact on the City should be positive, assuming the opportunities provided by EMU are not outweighed by the costs of meeting ECB reserve requirements. The retail financial sector, however, might struggle to make the necessary preparations in time. It could face stiffer competition thereafter, but would do so from a relatively strong financial position. By reducing costs and enhancing competition, EMU should boost European financial services in general: all Member States should benefit, including the UK. UK-based financial services might also benefit if onerous ECB reserve requirements were to drive euro business towards London. Over time, some companies and investors might gravitate to financial service providers in the euro area, although the best assessment at this stage is that the City is at least as well prepared as other centres and that legal or other barriers to trading in euro in the City should not arise.

Section 5: Employment and growth

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

Importance of the test

5.1 The single currency is a significant further step in developing the Single Market and offers the opportunity of further increases in trade. The creation of a zone of monetary stability and the removal of exchange rate uncertainty will help increase investment, jobs and growth in Europe. This will benefit Britain whether we are in or out. The critical question for Britain now is whether participating in the single currency will improve the prospect over the coming years of meeting the Government's central economic objective of high and stable levels of growth and employment.

5.2 The preceding discussion of each of the economic tests addresses this issue. The fundamental test is whether joining EMU would, overall, be good for growth and jobs.

The potential benefits from EMU

5.3 Potentially UK membership of a successful single currency could be positive for employment. For example, the structural or sustainable rate of unemployment, ie the rate consistent with stable inflation, would be reduced if EMU succeeds in:

- Encouraging greater competition in product markets and greater factor mobility. By giving a boost to the Single Market, and improving price transparency, EMU could help to create the conditions in which structural unemployment falls. EMU might also increase mobility of factors of production – labour and capital – and so reduce the mismatch between supply and demand that creates higher unemployment.

- Reducing the damaging effects of volatility. A volatile cycle not only leads to high and variable cyclical unemployment, it also increases the structural element, by creating long-term unemployment and increasing the numbers who give up the search for work. If EMU succeeds in promoting greater stability it may also help in reducing structural unemployment.

- Increasing the momentum towards reforming factor and product markets. By increasing the costs of failing to reform, and the benefits from making markets work better, EMU could help to focus attention on these problems. The importance of meeting the conditions for monetary union is already prompting EU governments to address the areas where the labour market is failing.

5.4 Growth and investment should also be encouraged by EMU. For example, the level of intra-European trade can be expected to increase as a result of increased transparency and reduced transaction costs.

5.5 Investment would also be strengthened in EMU if the euro area develops successfully into a zone of stability. The UK Government has already taken action, outside EMU, designed to ensure economic stability in the British economy. By giving operational independence to the Bank of England in setting interest rates and through firm and disciplined fiscal rules, the Government has increased the chances of achieving lasting stability in the UK. With the benefit of a period of economic stability, and avoiding the policy mistakes of the past, the UK will be all the more ready to reap the benefits of the single currency.

5.6 The increase in price transparency that the single currency will bring could also help strengthen investment. As the Single Market develops, foreign direct investment might be increasingly attracted to the UK, if it were in EMU. But to obtain the full benefits businesses will need to be better prepared for the single currency than they currently are. That is why the Government is taking steps to make British business better prepared through the work of the Business Advisory Group.

5.7 EMU offers considerable benefits to the UK financial sector, whether we are in or out. But the benefits and the opportunities from the single currency will probably be easier to tap from within the euro zone. The City in particular is well prepared and would be well placed to cope with early entry. Increased competition and reduced costs should boost European financial services in general. While that will also boost UK business, especially if as an ‘‘out’’ the UK benefits as an ‘‘offshore’’ centre, there is a risk that, over time, some companies and investors may gravitate to financial services firms in the euro zone. The balance of advantage on this test remains in favour of membership of the single currency.

Can these benefits be realised?

5.8 It is clear from the above that there could be substantial benefits for both growth and employment if the UK economy was to join a successful EMU. But to be in a position to benefit would require:

- that the UK economy was sufficiently and durably converged with the other members' economies to make participation permanently viable;

- that the UK economy was sufficiently flexible to respond to shocks and other changes that will occur over time.

5.9 Joining without these conditions being satisfied would benefit neither growth nor employment. There could be substantial economic turmoil, under such circumstances, with serious harm to jobs resulting. Assessment of the evidence on these two scores is therefore vital. The discussion in the earlier sections of this paper suggests the following to be the main points.

5.10 Durable convergence is vital to the long-term success of participating in the single currency. At present the UK economy is not synchronised with the rest of Europe. With official interest rates at 7 per cent in the UK and just over 3 per cent in Germany and France, there is a sizeable difference which reflects the different states of the cycles. Forward-looking measures also suggest that a significant difference is expected to remain in 1999 and thereafter. It is of course the case that not every country's economic cycle needs to be in line all of the time. Indeed, that could cause difficulties of its own. But successful convergence requires being, and being confident about staying, within tolerable limits. If we were to join the single currency in the first wave there is a risk that euro interest rates would be too low for British economic conditions. That would risk an inflationary boom which would jeopardise the economic stability on which success depends.

5.11 In the past, the UK's economic cycle has been more in line with the US than the Continent. It has been noticeably more volatile than both. Some of the differences reflect large shocks, such as dramatic oil price changes, which affected countries in different ways; and German reunification in particular. Part of the difference also reflects macroeconomic policy settings. In this respect, monetary union could help to improve the position; as should the policies this Government has adopted to achieve economic stability.

5.12 But structural differences, such as in our property market, oil and trade patterns and company finance arrangements, have also been at work. Achieving low inflation and generating the confidence that it will remain low will help in this regard – for example, by reducing the volatility of our housing market. Similarly a period of sound public finances and appropriate changes to the tax system should assist with the financing of investment. But, as discussed in the earlier parts of the paper, other measures to reduce structural problems will also be necessary to improve convergence prospects. The effects of such policies take some time to emerge.

5.13 A successful monetary union requires flexibility to cope with change and to respond quickly to shocks, particularly when cross-border labour mobility is likely to remain low for some time, as is expected in EMU. Flexibility is needed in both product and labour markets. It clearly makes sense for any country adopting the common currency to undertake market reforms to increase flexibility as quickly as possible. But weaknesses remain in the UK which make it unclear that we are yet ready to be able to cope adequately with potential shocks that might arise in EMU, especially in the early years. The Government's welfare-to-work programme and the agendas for improving skills and competition are designed to remove the underlying weaknesses that remain. A successful strategy here should help improve the prospects of being ready to meet the flexibility test in the years to come.

The balance

5.14 Joining EMU undoubtedly has the potential to enhance both growth and employment prospects provided the UK economy is in a state to be able to meet the challenges that membership will bring. That depends upon practical issues such as whether convergence with the other member economies is sufficiently great and deep-seated and whether there is sufficient flexibility.

5.15 It seems clear that:

- neither flexibility nor convergence are sufficient at present to make joining EMU in the near future desirable;
- the combination of the new UK macroeconomic policy framework, wider developments within Europe and the structural policies that the Government has put in place will increase flexibility and convergence; but
- generally, such policies take time to have their effect. Unless there is some profound change in circumstances in Britain and in the rest of Europe, it is likely to be some years before we can demonstrate that we have achieved sustainable convergence.

Government preparations

Government actions include:

- establishing a standing committee on preparations for EMU;
- extending Lord Simon's Treasury responsibilities to include European Business Preparations in the government;
- monitoring our inflation target and inflation measure in the light of the practices of the ECB;
- ensuring that our fiscal rules, and our deficit reduction plan, continue to be consistent with the terms of the Stability Pact, thus underlining our commitment to avoiding an excessive deficit under Article 104c of the Treaty, and supporting greater economic coordination in Ecofin;
- promoting greater flexibility in the UK economy and in Europe through our "Getting Europe to Work" initiative;
- introducing new competition legislation, which draws on the best of European and wider international policy and practice;
- commencing work on the detailed transition arrangements for the possible introduction of the euro in Britain, including notes and coins;
- stepping-up the work on what business should do now to prepare for the introduction of the euro in 1999;
- working with the Business Advisory Group on what government must do to prepare the economy for EMU whether we are in or out;
- continuing to negotiate to secure the best interests of our financial sector and for opening up the Single Market in financial services.

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