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Part A

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Part A

ERDF + OECD PAPERS

11.7.89

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the department for Enterprise

The Rt. Hon. Tony Newton OBE, MP
Chancellor of the Duchy of Lancaster and
Minister of Trade and Industry

PMP

Rt Hon Sir Geoffrey Howe QC MP
Foreign Secretary
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Our ref
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Date 20 January 1989

CH/EXCHEQUER
REC. 23 JAN 1989
ACTION CST
COPIES TO

✓ 23/1

Dear Foreign Secretary,

EUROPEAN REGIONAL DEVELOPMENT FUND: INDICATIVE ALLOCATION

Last June's Council Regulation on the reformed structural funds gave the European Commission authority to decide an indicative national allocation of the ERDF for the period 1989-93. The Commission is now due to take its decision on 25 January, and to announce it shortly thereafter.

I am very concerned by the likelihood that, despite a doubling in the size of the Fund, the decision will imply a fall in UK receipts from their present annual level of about £400m to possibly only £300m. As Northern Ireland's share of the total will rise, receipts to Great Britain would be proportionately lower still.

Such news would be greeted with dismay throughout the recipient regions in England, Scotland and Wales. We could expect strong protests in Parliament and in the regions, particularly from those local authorities which are the chief beneficiaries. Programmes of ERDF grant, including some announced only just before Christmas, such as Yorkshire and Strathclyde, would have to be cut back sharply. There would also be public expenditure implications despite the increase in rebate under the Fontainebleau arrangements, as well as a loss to our balance of payments.

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When we first learned of this possibility you kindly spoke to the Secretary-General of the Commission in November, and then to M. Delors in December. My Permanent Secretary and Sir David Hannay have also made our expectations plain on several occasions. In accordance with the hope the Prime Minister expressed in the House after the European Council last February, that the level of UK receipts would continue to increase, we pressed for an allocation from the Fund equivalent to average annual receipts of over £500m.

Our representations succeeded in delaying the Commission's decision into the New Year, when Bruce Millan became the responsible Commissioner. Sir David saw Bruce Millan last week and Ian Lang wrote to him on Malcolm Rifkind's behalf on 18 January.

I had a long telephone conversation with Bruce Millan myself yesterday. I pressed him to put forward recommendations that, at the very least, would result in there being no reduction in the absolute level of receipts to Great Britain even though, because of the doubling in size of the Fund, there would still be a reduction in our percentage share. Unfortunately there is no sign yet of his agreeing even to this. He gave me the impression that he is sympathetic in principle but feels boxed in by the decisions that have already been taken by his predecessor. He has, however, hinted of a possible further delay in the Commission's decision.

I hope that you and colleagues will agree that we should do all we can to persuade the Commission to take a more sympathetic view of the UK position. Time, however, is now very short before the current 25 January decision date. I am due to see Bruce Millan, and I hope also Leon Brittan, in Brussels on Monday 23 January. I believe you will not yourself be at the Foreign Affairs Council on the same day, but I wonder if, before 25 January, you might have another word with Delors, asking him at least to postpone the decision, to allow time to consider the strong representations that I gather a number of Member States in addition to the UK are making. These include France, which it is apparently proposed should receive little or no increase for its mainland regions.

I shall keep you and colleagues in touch with developments. If we do succeed in having a decision delayed I may wish to enlist colleagues' support in further lobbying of the Commission.

I am sending copies of this letter to the Prime Minister, Nigel Lawson, Peter Walker, Tom King, Nicholas Ridley, Malcolm Rifkind and to Sir Robin Butler.

Yours sincerely,

Peter Smith

JA3ACE

PP TONY NEWTON

(Approved by the Chancellor and signed in his absence)

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FM UKREP BRUSSELS
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TELNO 174
OF 232044Z JANUARY 89
INFO ROUTINE EUROPEAN COMMUNITY POSTS

FRAME STRUCTURAL
ERDF INDICATIVE ALLOCATION AND OBJECTIVE 2 REGIONS
MR NEWTON'S MEETING WITH COMMISSIONERS MILLAN AND BRITTAN :
23 JANUARY 1989

SUMMARY

1. NO FINAL DECISION TO BE TAKEN ON INDICATIVE ALLOCATION OF ERDF UNTIL OBJECTIVE 2 LIST FINALISED. GUARANTEE RECEIVED FROM COMMISSION THAT ALL COMMITMENTS MADE TO THE UK BY THE END OF 1988 WOULD BE HONOURED. UK TO CONTINUE TO MAKE REPRESENTATION TO COMMISSION ON INDICATIVE ALLOCATION AND OBJECTIVE 2 LIST.

DETAIL

MEETING WITH MR MILLAN

2. MR NEWTON SAID THAT PRELIMINARY FIGURES SHOWED THAT GREAT BRITAIN MIGHT ONLY RECEIVE ABOUT 400 MECU A YEAR FROM THE ERDF IN THE FUTURE AS COMPARED WITH 550 MECU IN PREVIOUS YEARS. IT WAS COMPLETELY UNACCEPTABLE THAT THERE SHOULD BE ANY SUCH REDUCTION GIVEN THE DOUBLING OF THE STRUCTURAL FUNDS. THERE WAS A HIGH LEVEL OF EXPECTATION FROM UK LOCAL AUTHORITIES WHO WOULD FIND IT INCOMPREHENSIBLE IF THE UK RECEIVED LESS MONEY THAN PREVIOUSLY. AS A MINIMUM THERE SHOULD BE NO CUT IN THE ABSOLUTE LEVEL OF GB RECEIPTS. IT WOULD BE UNREALISTIC FOR THE UK TO EXPECT THEIR SHARE TO INCREASE, BUT THE 13 PERCENT THE UK CONSIDERED JUSTIFIED REPRESENTED ONLY A MODEST INCREASE IN THE ABSOLUTE LEVEL OF FUNDS. IT WAS IMPORTANT THAT THE UK SHOULD NOT BE WORSE OFF THAN FRANCE OR GERMANY. MAINLAND FRANCE WOULD APPARENTLY HAVE RECEIVED AN INCREASE OF 4 PERCENT A FIGURE THEY CONSIDERED UNACCEPTABLE. HE HOPED THE COMMISSION WOULD NOT BE PRESSED TO TAKE A DECISION ON WEDNESDAY. IT DID NOT MAKE SENSE TO TAKE A DECISION ON INDICATIVE ALLOCATIONS BEFORE THERE WAS A FINAL LIST OF ELIGIBLE AREAS.

3. MR MILLAN SAID IT WAS NOT POSSIBLE TO GIVE EVERYONE THE ERDF ALLOCATIONS THEY WANTED. HE COULD ONLY APPLY THE REGULATIONS, TO WHICH MEMBER STATES, INCLUDING THE UK, HAD AGREED. THE INDICATIVE ALLOCATIONS SHOULD HAVE BEEN DECIDED AT THE END OF 1988 AND WERE NOT SUPPOSED TO BE MECHANICALLY RELATED TO THE OBJECTIVE 2 LIST. THERE

WAS AN ILLOGICALITY IN THIS BUT THAT WAS THE WAY THE REGULATIONS HAD BEEN DRAWN UP. ON TIMING, THE COMMISSION WOULD NOT TAKE A DECISION ON 25 JANUARY ON THE INDICATIVE ALLOCATION TO OBJECTIVE 2 REGIONS. HOWEVER, AN EARLY DECISION WAS IMPORTANT FOR MEMBER STATES AS PLANS HAD TO BE SUBMITTED BY THE END OF MARCH. MR NEWTON SAID IT WAS MORE IMPORTANT TO GET THE RIGHT RESULT THAN TO STICK TO A RIGID DEADLINE. MR MILLAN SAID IT MIGHT PROVE TO BE IN THE UK'S INTEREST TO HAVE THE NEW SYSTEM OPERATING SOON. THE UK WAS LIKELY TO PRODUCE BETTER PLANS AND PROGRAMMES THAN SOME OTHER MEMBER STATES AND SO COULD EXPECT TO PICK UP MORE OF THE FUND. MR NEWTON EMPHASISED THAT EVEN IF THIS WERE SO IT WOULD NOT HELP DEFUSE THE POLITICAL ROW THAT WOULD ARISE IF THE ALLOCATION INDICATED A 20-30 PERCENT DROP IN RECEIPTS.

4. MR MILLAN HIGHLIGHTED SOME OF THE PROBLEMS HE FACED IN DRAWING UP THE OBJECTIVE 2 LIST. BY USING THE BASIC CRITERIA IN ARTICLE 9 OF THE FRAMEWORK REGULATION AND 1986-88 STATISTICS, SOME 16.8 PERCENT OF THE COMMUNITY POPULATION WAS ELIGIBLE FOR CONSIDERATION. THE REGULATION SAID THIS SHOULD BE LIMITED TO 15 PERCENT. ON A STRICT INTERPRETATION THE REGULATION SPECIFIED 15 PERCENT OF THE POPULATION LIVING OUTSIDE OBJECTIVE 1 REGIONS BUT THE COMMISSION PROPOSED TO INTERPRET THIS AS 15 PERCENT OF THE TOTAL COMMUNITY POPULATION. THERE HAD BEEN REPRESENTATIONS FROM LONDON, ROTTERDAM AND MADRID ALL SEEKING INCLUSION IN THE LIST. THE DIFFICULTY WAS THAT LONDON FOR EXAMPLE HAD A VERY HIGH POPULATION. THERE WAS GOING TO BE A REAL PROBLEM CONCENTRATING THE INITIAL LIST AND OBVIOUSLY SOME REGIONS WHOSE EXPECTATIONS WERE HIGH WOULD BE DISAPPOINTED. DISCUSSIONS WOULD BE HELD WITH MEMBER STATES TO REDUCE THE LIST TO 15 PERCENT. THE COMMISSION COULD DECIDE TO REMOVE WHOLE REGIONS OR TO SELECT THE MOST SERIOUSLY AFFECTED AREAS WITHIN THE REGIONS: THE LATTER BEING THE MOST LIKELY CHOICE.

5. MR MILLAN SAID THAT THE INDICATIVE ALLOCATION WAS NOT A QUOTA BUT AN INDICATIVE FIGURE THAT MEMBER STATES COULD USE AS A GUIDE IN THE PREPARATION OF PLANS. ONE OF THE PROBLEMS HE FACED WAS THE LACK OF COMMUNITY STATISTICS FOR EVERY MEMBER STATE. CONSIDERATION HAD BEEN GIVEN TO PRODUCING A PROVISIONAL INDICATIVE ALLOCATION WHICH WOULD HAVE BEEN SUBJECT TO AMENDMENT, BUT THIS WAS POLITICALLY DIFFICULT AND RAISED EXPECTATIONS. HE DID NOT NOW WANT TO PRODUCE AN INDICATIVE ALLOCATION UNTIL THE OBJECTIVE 2 LIST WAS FINALISED. THIS MEANT THAT THE OBJECTIVE 2 LIST WOULD NEED TO BE FINALISED MORE QUICKLY THAN EXPECTED. THE UK HAD ALWAYS DONE WELL FROM THE ERDF AND THERE WOULD CLEARLY BE PROBLEMS IF EXPECTATIONS WERE NOT REALISED. THE COMMISSION WOULD HONOUR THE ERDF COMMITMENTS ALREADY AGREED FOR THE UK. THE DIFFICULTY WOULD BE IN THE FUNDING OF FUTURE PROGRAMMES.

6. MR NEWTON SAID THAT HE CONSIDERED ONE OF THE RELEVANT FACTORS TO BE TAKEN INTO CONSIDERATION IN THE INDICATIVE ALLOCATION WAS GDP PER HEAD. THERE WAS NOTHING IN THE REGULATIONS TO EXCLUDE THIS. AREAS COULD HAVE VERY SIMILAR UNEMPLOYMENT LEVELS BUT WIDELY DIVERGENT GDP PER HEAD AND THUS A VARYING NEED FOR ASSISTANCE. MR MILLAN DID NOT CONSIDER GDP TO BE RELEVANT. IT WAS MENTIONED IN THE REGULATIONS IN RELATION ONLY TO OBJECTIVE 1 REGIONS. IT WOULD BE APPROPRIATE TO LOOK AGAIN AT THE METHODOLOGY FOR INDICATIVE ALLOCATIONS WHEN THE FINAL LIST WAS DRAWN UP. UNEMPLOYMENT WAS OBVIOUSLY THE MAIN CRITERION BUT MODULATION OF THIS CRITERION WOULD HAVE TO BE EXAMINED. APPROPRIATE GDP FIGURES MAY NOT BE AVAILABLE FOR ALL MEMBER STATES. MR NEWTON SAID THE UK WOULD MAKE FURTHER REPRESENTATIONS IN WRITING ON THE CALCULATIONS AND METHODOLOGY.

7. MR MILLAN DID NOT WANT TO DAMAGE UK REGIONAL POLICY. THERE WAS NOTHING IN THE REGULATIONS TO SAY THAT MEMBER STATES' RECEIPT FROM THE FUND WOULD NOT REDUCE. IT WAS THE STRUCTURAL FUNDS AS A WHOLE THAT WERE BEING DOUBLED NOT NECESSARILY THE ERDF. MR NEWTON SAID THAT HE WAS NOT ARGUING OVER MINOR PERCENTAGE REDUCTIONS BUT THE OUTCOME LOOKED LIKE A DRASTIC REDUCTION OF THE UK SHARE. THERE WAS A NEED FOR A BROADLY ACCEPTABLE OUTCOME AND SOME SCOPE FOR DISCRETION.

8. PLOWMAN (UKREP) REPORTED THAT IN THE MARGINS OF THE FAC, MRS CHALKER HAD SPOKEN TO PRESIDENT DELORS SETTING OUT THE UK POSITION. PRESIDENT DELORS HAD TAKEN NOTE AND ACCEPTED THAT THE UK SHOULD RECEIVE NO LESS THAN IT RECEIVES NOW. MR MILLAN REPLIED THAT PRESIDENT DELORS WAS IN NO POSITION TO MAKE SUCH CONCESSIONS. IT WAS A MATTER FOR THE COMMISSION TO DECIDE. (FULL TEXT IN MIPT).

9. IN CONCLUSION, MR NEWTON SAID THAT HE WELCOMED THE FACT THAT NO FINAL DECISION WOULD BE TAKEN ON 25 JANUARY. FURTHER REPRESENTATIONS WOULD BE MADE TO THE COMMISSION ON THE CALCULATIONS. THE UK WAS ANXIOUS TO PLAY ITS PART IN THE PARTNERSHIP AND WOULD CONTINUE TALKING TO THE COMMISSION. THE FACT REMAINED THAT A REDUCTION IN GREAT BRITAIN'S RECEIPTS FROM THE ERDF WOULD BE UNACCEPTABLE.

MEETING WITH SIR LEON BRITTAN

10. IN A BRIEF MEETING, MR NEWTON BROUGHT SIR LEON BRITTAN UP TO DATE ON DEVELOPMENTS. HE REITERATED HIS CONCERN ABOUT THE PROPOSED ERDF ALLOCATION TO THE UK. IT REPRESENTED AN ABSOLUTE REDUCTION IN UK SHARE FROM THE ERDF AND WOULD CREATE CONSIDERABLE POLITICAL DIFFICULTIES, PARTICULARLY IN THE LIGHT OF EXPECTATIONS RAISED BY

THE DOUBLING OF THE STRUCTURAL FUNDS. IT WAS NOT UNREASONABLE FOR THE UK TO EXPECT EQUITABLE TREATMENT IN THE ERDF SHARE-OUT, PARTICULARLY SINCE FRANCE, WHICH STOOD TO RECEIVE A MODEST INCREASE IN ERDF RESOURCES, HAD DESCRIBED ITS ALLOCATION AS UNACCEPTABLE.

11. MR NEWTON WAS ABLE TO REPORT TO SIR LEON BRITTAN, COMMISSIONER MILLAN'S EXPRESSED VIEW THAT A DECISION ON THE ALLOCATION OF ERDF RESOURCES TO OBJECTIVE 2 REGIONS WOULD BE DELAYED UNTIL THE LIST OF OBJECTIVE 2 REGIONS WAS DETERMINED. MR NEWTON ALSO REPORTED PRESIDENT DELORS' UNDERTAKING EARLIER IN THE DAY TO MRS CHALKER. (SEE PARAGRAPH 8 ABOVE.)

12. SIR LEON BRITTAN SAID HE HAD BEEN FOCUSSING MAINLY ON THE CHOICE OF ELIGIBLE REGIONS RATHER THAN THE ERDF SHARE-OUT. THE METHODOLOGY FOR ESTABLISHING THE OBJECTIVE 2 REGIONS WAS NOT LOGICAL. AREAS QUALIFYING FOR NATIONAL REGIONAL AIDS SHOULD BE TAKEN INTO ACCOUNT AS WELL AS REGIONAL DISPARITIES. MR NEWTON SAID THAT SELECTION OF REGIONS BASED SOLELY ON ASSISTED AREA STATUS WOULD BE LIMITING AND WOULD RULE OUT SOME UK REGIONS WHICH WERE SERIOUSLY AFFECTED BY INDUSTRIAL DECLINE AND WHICH MET THE COMMISSION'S OWN CRITERIA. EQUALLY LIMITING WAS THE COMMISSION'S INTENTION TO REFER TO UNEMPLOYMENT STATISTICS FOR THE YEARS 1986-1988. EXPECTATIONS OF ELIGIBILITY HAD BEEN CREATED IN CERTAIN UK REGIONS BECAUSE OF THE COMMISSION'S PREVIOUSLY STATED INTENTION TO USE STATISTICS BASED ON THE YEARS 1985-1987.

13. IN CONCLUSION, MR NEWTON SAID HE WAS GLAD A DECISION ON ERDF ALLOCATIONS TO OBJECTIVE 2 REGIONS WOULD NOW BE DELAYED. THE UK WOULD USE THE OPPORTUNITY TO DISCUSS WITH THE COMMISSION THE FACTORS TO BE TAKEN INTO ACCOUNT IN ASSESSING THE ALLOCATION, INCLUDING THE USE OF GDP.

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OF 231936Z JANUARY 89
INFO ROUTINE EUROPEAN COMMUNITY POSTS

FRAME STRUCTURAL

ERDF : INDICATIVE ALLOCATIONS

SUMMARY

1. IN THE MARGINS OF THE FOREIGN AFFAIRS COUNCIL PRESIDENT DELORS GAVE MRS CHALKER AN ASSURANCE THAT THE UK WOULD NOT RECEIVE LESS MONEY FROM THE ERDF THAN IT RECEIVES NOW. THE SECRETARY GENERAL OF THE COMMISSION WILL BE FOLLOWING THIS UP.

DETAIL

2. IN THE MARGINS OF THE FOREIGN AFFAIRS COUNCIL TODAY MRS CHALKER SPOKE TO PRESIDENT DELORS ABOUT THE UK'S SHARE OF THE EUROPEAN REGIONAL DEVELOPMENT FUND (ERDF). MRS CHALKER RECALLED THAT YOU HAD EXPRESSED CONCERN TO DELORS WHEN YOU SPOKE TO HIM IN DECEMBER.

3. WE NOW UNDERSTOOD THAT THE UK'S ESTIMATED RECEIPTS COULD BE AS LOW AS 8 PERCENT (1.3 PERCENT OF THE FUND UNDER OBJECTIVE 1, 5.7 PERCENT UNDER OBJECTIVE 2 AND OUR ESTIMATE OF 1 PERCENT FOR OBJECTIVE 5(B) ETC). THIS IMPLIED AN ACTUAL REDUCTION IN UK RECEIPTS, AND EVEN MORE SO OF GREAT BRITAIN'S. WHILE WE ACCEPTED A REDUCTION IN THE UK'S SHARE BECAUSE OF INCREASED EMPHASIS ON THE POORER MEMBER STATES, IT WOULD NOT BE POLITICALLY UNDERSTOOD IF, IN THE CONTEXT OF DOUBLING THE FUNDS, THE ABSOLUTE AMOUNT WERE TO FALL.

4. DELORS REPLIED BY ILLUSTRATING IN ROUGH GRAPH FORM HOW THE GROWTH NOW DECIDED SHOULD BE ALLOCATED. THE LION'S SHARE WOULD GO TO OBJECTIVE 1 REGIONS WHICH WOULD RECEIVE A STEADILY RISING AMOUNT AND THE UK SHOULD RECEIVE NO LESS THAN IT RECEIVES NOW. MRS CHALKER THANKED HIM FOR THIS ASSURANCE.

5. THIS DISCUSSION WAS REPORTED TO THE MEETING BETWEEN MR MILLAN AND THE CHANCELLOR OF THE DUCHY OF LANCASTER, MR NEWTON. MR MILLAN, WHO HAD JUST EXPLAINED HOW THE COMMISSION INTENDED TO PROCEED AND HIS LACK OF ROOM FOR MANOEUVRE, IMMEDIATELY SAID THAT DELORS WAS

SOMETIMES TOO GENEROUS. THE DECISION WAS NOT FOR THE PRESIDENT ALONE BUT FOR THE COMMISSION. A FULL RECORD OF THE MEETING IS IN MIFT.

6. I SPOKE SUBSEQUENTLY TO THE SECRETARY GENERAL OF THE COMMISSION. WILLIAMSON ADVISED AGAINST CEMENTING THE AGREEMENT BY WRITING TO DELORS AT THIS STAGE. DELORS MIGHT FEEL THAT HE HAD BEEN TRAPPED AND THE RESULT COULD BE A STEP BACKWARDS. HE, WILLIAMSON, WOULD APPROACH THE DELORS CABINET TO ASK THEM HOW THEY WERE GOING TO PUT DELORS' UNDERTAKING INTO EFFECT. HE WOULD ALSO SPEAK TO MR MILLAN'S CABINET IN THE LIGHT OF THEIR RESPONSE.

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From The Secretary of State for Wales

THE RT HON PETER WALKER MBE MP

CH/EXCHEQUER
REC. 24 JAN 1989
ACTION CST
COPIES TO

J 24/1

Our ref: CT/12034/89

24 January 1989

Dear Secretary of State

EUROPEAN REGIONAL DEVELOPMENT FUND: INDICATIVE ALLOCATIONS

I have just seen Tony Newton's letter to you of 20 January concerning the likely content of the Commission's imminent decisions on allocations under the European Regional Development Fund (ERDF).

Frankly this is appalling and I trust that you will indeed be able to persuade M Delors both to delay the announcement and reconsider its consequences.

I appreciate that the change in the Structural Funds as a result of the fundamental review of their operation may well present the Commission with difficult funding decisions in the immediate and short term but it is simply not acceptable for the Commission to behave as if it is starting with a clean slate in resource terms when obviously it is not.

EC Programmes are clearly in existence, either approved or lodged well in advance of the implementation of the structural fund review (and supposedly protected on those grounds by transitional arrangements) and the existence (and cost) of these needs to be taken into account when the Commission reaches its decisions. That is part of the responsibility the Commission bears for ensuring a smooth transition from the old to the new regime.

Rt Hon Sir Geoffrey Howe QC MP
Secretary of State for Foreign and
Commonwealth Affairs
Foreign and Commonwealth Office
Downing Street
LONDON SW1A 2AL

/It is also, ...

It is also, I would have thought, the only acceptable way to proceed if the Commission is paying anything other than lip service to the idea of "Partnership" of which it has made great play. Those local and public authorities concerned have, for example, expended considerable time and effort in drawing up strategies for their areas covering the period up to 1991/92 - and in some cases, such as the Dyfed, Gwynedd and Powys programme - have already started to implement them. They are not, therefore, in a position to make the sort of arbitrary reductions which the Commission's figures imply. Nor can they accommodate the considerable hiatus in the flow of grant which the need to re-write and renegotiate programmes and plans would require.

Like Tony Newton, I am therefore firmly of the view that we must do all we can, as soon as we can, to change the Commission's mind. I am scheduled to visit the States from 30 January - 3 February but had anyway been deliberating what action might need to be taken in the context of certain of the Welsh programmes. I would, therefore, be more than ready to lend my support if the consensus is that concerted lobbying would be useful.

Copies to this go to the Prime Minister, Nigel Lawson, Tom King, Nicholas Ridley, Malcolm Rifkind, Tony Newton and to Sir Robin Butler.

Yours sincerely

Keith Davies

Approved by the Secretary of State
and signed in his absence

ec2.ss/mcm/chanerdf

PS/CHANCELLOR

FROM: M C MERCER
DATE: 24 JANUARY 1989

cc: PS/Chief Secretary
PS/Paymaster General
Sir P Middleton
Mr Wicks
Mr Anson
Mr Lankester
Mr Monck
Mrs Lomax
Mr Burgner
Mr R I G Allen
Mr Revolta
Mr Evans
Mr Towers
Mr Call

NOTED

Ch,
see also Mr Walker's letter, attached; and Mr Newton's of 25/1 (+ Sir GH of 25/1)

24/1

EUROPEAN REGIONAL DEVELOPMENT FUND: INDICATIVE ALLOCATION

The Chancellor has received a copy of the Chancellor of the Duchy's letter of 20 January to the Foreign Secretary in which Mr Newton says that the Commission's forthcoming decision on indicative national allocations of the ERDF could imply a fall in the UK's annual receipts from their present level of around £400 million to only £300 million or so.

2. There is no need for the Chancellor to reply. But you may wish to draw to his attention the attached telegram from UKREP which reports M. Delors as having told Mrs Chalker (apparently without first clearing his lines with Mr Millan) that the UK should not receive less from the ERDF than it does now.

Yes, see also MIFT which reports Millan in more detail.

M C MERCER

M C MERCER

dti

the department for Enterprise

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The Rt. Hon. Tony Newton OBE, MP
Chancellor of the Duchy of Lancaster and
Minister of Trade and Industry

Rt Hon Sir Geoffrey Howe QC MP
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Direct line 215 5147
Our ref
Your ref
Date 25 January 1989

Dear Geoffrey,

EUROPEAN REGIONAL DEVELOPMENT FUND (ERDF)

I wrote to you on 20 January about my concern over the Commission's indicative allocation of the European Regional Development Fund, and suggested another intervention with Delors. The prospects now already look much better.

It is very helpful that Lynda Chalker was able to obtain from Delors an assurance that UK receipts from the Fund will not fall, as recorded in telegram number 173 of 23 January 1989.

Meanwhile I saw Bruce Millan on 23 January, as reported in telegram number 174 of that day and I have since written to him along the lines of the assurance given by Delors. I found Bruce more realistic than when we had spoken on the telephone, but still more impressed by the arithmetical complexities of his task than by the dictates of political commonsense. He told me that the Commission would, as I had asked, now be postponing the allocation of the Objective 2 part of the Fund until the list of Objective 2 areas is finalised. This effectively means for between two and five weeks. I will keep up pressure on him during this time, and in particular seek to

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improve on Delors' assurance by having it apply to Great Britain's receipts rather than the UK's (as Northern Ireland's will be going up by 30% or so).

I am sending copies of this letter to the Prime Minister, Nigel Lawson, Peter Walker, Tom King, Nicholas Ridley, and Malcolm Rifkind, and to Sir Robin Butler.

Yours ever,
Tony

TONY NEWTON

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REC. 25 JAN 1989
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CHANCELLOR OF THE DUCHY OF LANCASTER

European Regional Development Fund: Indicative Allocation

1. Thank you for your letter of 20 January.

2. At my request, Lynda Chalker spoke to Delors in the margins of the Foreign Affairs Council this week. He assured her that UK receipts from the ERDF will not be allowed to fall. This is in addition to the helpful indication you received from Bruce Millan that the decision on ERDF indicative allocations will be put off until the list of objective 2 regions has been finalised.

3. We have more than achieved our immediate goal with Delors, and David Hannay has asked David Williamson to follow up with Delors' cabinet, to see how his undertaking will be put into effect.

4. We must also keep up the pressure on Bruce Millan with a view to ensuring that the GB (as distinct from UK) take does not fall. Now that the allocations decision has been delayed, it should be harder for him to argue that the die was cast before he joined the Commission.

5. I am copying this minute to the other recipients of your letter.

GH

(GEOFFREY HOWE)

Foreign and Commonwealth Office
25 January 1989

chex.rm/jmt/79 UNCLASSIFIED

FROM: J M G TAYLOR
DATE: 27 January 1989

MR MERCER

cc PS/Chief Secretary
PS/Paymaster General
Sir P Middleton
Mr Wicks
Mr Anson
Mr Lankester
Mr Monck
Mrs Lomax
Mr Burgner
Mr R I G Allen
Mr Revolta
Mr Evans
Mr Towers
Mr Call

EUROPEAN REGIONAL DEVELOPMENT FUND: INDICATIVE ALLOCATION

The Chancellor was grateful for your note of 24 January, the contents of which he has noted.

J M G TAYLOR

35/3 IF2/dr.2.7.2

Ch, Content with line in para 12?

Amazing that he has ... But the ... circs, OK.

FROM: P EDMONDS
DATE: 9 February 1989

If you have any problems with the line in paragraph 12, on Paye's reappointment, could you please let us know tomorrow (Friday) so we can alert the FCO.
HME 9/2

1. ~~MR~~ EVANS
2. CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Riley
Mr Melliss
Mr Tyrie

OECD SECRETARY GENERAL

You are seeing Mr Paye, OECD Secretary-General, at 11.30 on Monday 13 February. Mr Paye will be accompanied by his Scottish Chef de Cabinet, Tom Alexander, and by Mr Gray, our Ambassador to the OECD. Mr Wicks will also be attending the meeting. Mr Paye will already have called on the Foreign Secretary, and he will be meeting the Minister for Trade after lunch. I attach an outline of the visit, which is in preparation for the OECD Ministerial.

G7 Meeting 3 February

2. Mr Paye would be interested to hear about the outcome of your discussions in Washington. He may also want to discuss UK economic policy.

OECD Ministerial

3. This year's OECD Ministerial meeting will be on 31 May and 1 June. You might want to say to Paye that clear Ministerial guidance in past communiques has helped progress on trade issues, especially agriculture, and structural adjustment. As well as the current economic situation, Ministers may wish to discuss trade and agriculture, depending on the outcome of the GATT Trade Negotiating Committee meeting in April, and how best to take forward the OECD's work on structural reform.

Structural Reform

4. You might like to express strong support for further OECD work in agriculture, tax reform, financial markets, trade policies, industrial subsidies and international investment. All these subjects have a clear international dimension, and the OECD already has considerable expertise in them. The Americans are pressing, and the OECD Secretariat may agree that labour markets should be included in this priority list. Labour markets are of course crucial for economic performance and structural adjustment but do not have the same international dimension and may be a less profitable subject for OECD work. The Americans are also keen for the Secretariat to develop further their indicators of structural reform. Those the Secretariat produced in November 1988 were in fact general indicators of macroeconomic performance, and are therefore potentially misleading as structural indicators. Most countries had problems with them when they were discussed in EPC. You might say that we believe it is important to measure progress in structural reform, but that indicators need to be specific to individual markets and sectors. The PSE in agriculture - developed by the OECD - is a good example.

Role of Fiscal Policy

5. Mr Paye apparently sees a major role for fiscal policy in generating investment and channelling it into infrastructure, and he may wish to discuss this with you.

OECD/NIEs Informal Seminar (24- 25 January)

6. You may wish to note the encouraging outcome of the initial meeting (Mr Bayne of the FCO led the UK team) and express the view that increasing co-operation is in the interests of both the OECD countries and the NIEs.

(Newly Industrialised Economies: 4 Asian tigers and Thailand were represented).

Debt

7. The Secretary-General may raise the question of possible OECD involvement in debt issues. You might want to express understanding of the OECD's wish to pursue further links with the non-OECD world, including the developing countries. But OECD should not become directly involved with the debt issues covered by the IFIs.

OECD issues

8. There are also domestic OECD issues you may wish to discuss with the Secretary-General.

OECD Budget

9. Paye may complain that the UK has been taking an unduly restrictive line in the OECD budget this year. You should be aware that:

i. The initial OECD budget envisaged an increase of no less than 9 per cent in cash terms;

ii. even after pressure, led by the UK, for a more moderate increase, the proposal is now for about 6 per cent, compared with a 2½ per cent rate of French inflation;

iii. the OECD attempted to argue that the original 9 per cent cash increase was equivalent to 0.4 per cent in real terms!

You might want to remind the Secretary-General of the UK's move some years ago from volume planning to cash planning, and commend this to the OECD. We are already working for change in the OECD's budgetary procedures. You might want to add that it is particularly important that salaries should be brought under budgetary discipline. Pay Division's note of 8 February to the PMG refers. Mr Paye will be meeting the Secretary-Generals of other co-ordinated organisations on Tuesday to discuss budgetary and pay issues. (He's not going to this now).

further behind

Henderson Pamphlet

10. If Mr Paye mentions David Henderson's recent paper '1992: The External Dimension', you may want to strongly endorse Henderson's warning of the need to reduce protectionism in Europe and the United States and endorse the right of OECD officials to take part in public debate.

DAFFE Post

11. You might want to express disappointment that the well-qualified UK candidate was not appointed, and stress the importance of appointments being made on merit not on grounds of nationality or positions already held within the organisation.

Paye's Re-Appointment as Secretary - General

12. Paye is seeking re-appointment as Secretary General and, because he has on balance done a good job and because there is no alternative in sight, the Foreign Secretary is proposing to tell him of our support in the following terms: "good job at OECD, glad to hear seeking reappointment in the autumn, understood no other candidates, delighted to support candidature." We have discussed this with Sir Peter Middleton who agrees there is little choice and that we would lose by holding back.

P. Edmonds

P EDMONDS

35/3 IF2/dr.2.7.2

VISIT OF THE OECD SECRETARY-GENERAL TO LONDON 12-14 FEBRUARY 1989

Sunday 12 February

2030 Arrive London Heathrow by AF820

Monday 13 February

1030 Foreign Secretary
1130 Chancellor of the Exchequer
1300 Lunch (hosted by Mr Bayne)
1530 Minister for Trade (MAFF representative to attend)

Tuesday 14 February

Visit to Met. Office, Bracknell for meeting of Secretary-Generals of OECD, NATO and other organisations with co-ordinated pay.

1730 Depart London Heathrow by AF817 for Paris chex.ps/jmt/17

SENIOR APPOINTMENTS
IN CONFIDENCE

Folder for meeting

FROM: J M G TAYLOR
DATE: 10 February 1989

MR H P EVANS

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Riley
Mr Edmonds
Mr Melliss
Mr Tyrie

OECD SECRETARY GENERAL

You asked whether the Chancellor was content that we should let Paye know that we supported his reappointment as Secretary General.

2. The Chancellor has commented that it is amazing that we have no candidate ourselves. But in the circumstances, he is prepared to go along with this.

J M G TAYLOR

chex.rm/jmt1/24 CONFIDENTIAL cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Riley
Mr Edmonds Mr HP Evans
Mr Melliss
Mr Tyrie

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

13 February 1989

Richard Gozney Esq
Private Secretary to the
Secretary of State for Foreign and
Commonwealth Affairs
Foreign and Commonwealth Office
Downing Street
LONDON
SW1

Dear Richard

MEETING WITH OECD SECRETARY GENERAL

M. Jean-Claude Paye, the OECD Secretary General, called on the Chancellor this morning. He was accompanied by Mr Tom Alexander and HM Permanent Representative to the OECD. Mr Wicks was also present.

OECD May meeting

Paye said that the Secretariat were now preparing for the May meeting. The most important policy objective must be the defeat of inflation. Three weapons were required: monetary policy; budgetary "consolidation"; and strengthening "structural policies". These would be of differing importance to different countries - "consolidation" would be most important in the United States, for example, while strengthening "structural policies" (ie supply-side adjustment) would be most important in Germany. The problem of external imbalances remained worrying. Did the Chancellor see the German surplus as a potential threat in Europe?

The Chancellor said that he would put the exposition differently. It was clearly right to take immediate steps to beat down inflation. Monetary policy was, however, the only way of achieving this objective. Fiscal policy played a different role - it maintained market confidence, and it allowed monetary policy to operate more easily. For example, Canada and Italy were reluctant to maintain high interest rates because of the huge cost of repayment. Similarly, structural adjustment was essential for improving economic performance, but was not really directed to the defeat of inflation. Structural adjustment would be important in freeing up the German economy. Paye agreed that structural adjustment was not of major importance in defeating inflation. He also agreed with the need to liberalise much of the German economy.

Paye asked whether the OECD May meeting should discuss debt, in preparation for the Paris Summit. The Chancellor said that debt would be a major item in the April meetings in Washington. He doubted whether there would be anything further to be said by May. It would be more important to focus on trade, and would fit better with the GATT timetable. Paye agreed with this. He commented that Dunkel (GATT) had said he was optimistic about liberalisation in agriculture, but pessimistic about liberalisation in relation to intellectual property. The Chancellor said that agricultural liberalisation was the single most important objective. The OECD would want to try to maintain the momentum. He noted the valuable contribution which the OECDs work on PSEs had made to the last Summit in Toronto.

On external imbalances, the Chancellor said it was genuinely difficult to know whether what we were seeing at the moment was a temporary halt in the reduction of imbalances, or a genuine reversal. There was not yet sufficient evidence to form a definite view.

OECD's role in relation to regional interests

Paye said that the non-EC OECD members had suggested that the OECD should seek to ensure that the single European market did not lead to discrimination against them. The Chancellor urged Paye to be active on this front, but to be even handed - the OECD should also ensure that eg the Canada/US trade agreement did not work against other OECD members.

Henderson pamphlet

The Chancellor said he had agreed with the arguments in Mr David Henderson's recent paper "1992: The External Dimension", on the need to reduce protectionism in Europe and the United States. Paye said that the Spanish and the EC Commission had grumbled informally to him about this pamphlet. He had said he thought it helpful to the debate. He had had one or two points of difficulty with the paper, but had been in general agreement with its arguments.

Yours sincerely

J M G TAYLOR
Private Secretary

cst.ps/13jm14.2/lets

2 — cc:
Chancellor
EST
Sir Peter Middleton
Mr Wicks
Mr Lankester
Mr Mountfield
Mr Bottrill
Mr Halligan
Mr P Davis
Mr Moore
Mr Bent
Mr G T W Jones
Mr Call

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW

The Hon Alan Clark MP
Minister for Trade
Department of Trade and Industry
1 - 19 Victoria Street
London
SW1H OET

14th February 1989

Dear Alan,

US PROPOSALS FOR AN OECD BAN ON AID AND EXPORT CREDIT SUBSIDIES FOR STEEL PLANT PROJECTS

Thank you for your letter of 3 February. I accept your compromise proposal. A special OECD working group to consider the substance of the US ideas on steel is all the US have sought at this stage in the Consensus, and is an obvious stage in having them examined seriously. I accept that it will be for the US authorities to make their case for the proposals in the working group. I understand that the EC Export Credits Group (which settles the EC position in the Consensus) will return to this subject at its next meeting to be held on 15-16 February and I hope that our delegation will put this proposal to that meeting.

I am copying this letter to Chris Patten and Lynda Chalker.

Yours Ever,
John

JOHN MAJOR

aef2.jb/bottrill/minute/chan

pp

FROM: A R H BOTTRILL
DATE: 23 MAY 1989
EXT: 4720

MR J M G TAYLOR

cc Sir P Middleton
Sir T Burns
Mr Wicks
Mr Anson
Mr Lankester
Mr H P Evans
Mr Mountfield
Mr R I G Allen

CHANCELLOR'S INTERNATIONAL ISSUES MEETING: EXPORT CREDITS

I understand that we are to discuss the Chancellor's speech for the OECD Ministers' meeting this afternoon. One of the topics that will be raised by the Canadians and Americans will be the need for further reforms to the OECD Consensus on export credits and on mixed credits. See the attached extract from today's FT.

2. There are useful public expenditure savings at stake and we are keen to give this reform some political impetus at the OECD meeting and, if necessary, at the Summit. The Chancellor and others, therefore, may find it helpful to have an early sight of the draft brief that Mr Halligan has prepared.

attached

ABottrill.

A R H BOTTRILL

aef2.cj/halligan/letter/weiss.2

OECD MINISTERIAL COUNCIL

31 MAY - 1 JUNE 1989

BRIEF No. 4A : EXPORT CREDITS

Objective

To support US and Canadian attempts to insert a reference in the communique calling for the OECD Consensus Group to reach agreement on further reductions in export credit subsidies by the 1990 OECD Ministerial.

Background

2. USA and Canada have proposed that the communique should call for further reductions in export credit subsidies to be negotiated in the OECD Consensus. The US have tabled specific language, which seeks these reductions by the time of the 1990 OECD Ministerial. (Annex A). The Canadians have also been trying to get a reference to stronger international discipline in the Economic Summit communique and will propose this at the Sherpa meeting, immediately following the OECD Ministerial.

3. The US and Canadians have made these proposals because of their frustration at slow progress in the OECD Export Credit "Consensus" Group. Last March the Canadian Chairman of the Consensus (Mr Coleman) put forward various proposals for further subsidy reductions but they have made no headway. This is partly because of general inertia in the Consensus following the negotiation of some earlier reforms in 1987 (which did not all take effect until mid-1988), and partly because the EC has been unable to formulate an agreed response. (Community competence prevails in the Consensus group). The US and Canadians are trying to get things moving again in the Consensus group by getting a political steer from the OECD Ministerial and the Summit.

4. At the last Sherpa meeting the UK supported the US/Canada proposals, Germany sympathised with the objective but did not

think it a big enough issue for the Summit, while France, Japan and EC Commission were cool or hostile. Germany may well support a communique reference at the OECD Ministerial but we expect that (based on their Sherpa performance) France, Japan and the Commission will argue that we should wait until we can evaluate the effect of the 1988 changes to the Consensus before undertaking further changes. At a minimum they will want to delete the US proposal for action prior to the 1990 OECD Ministerial.

5. It is longstanding UK policy to seek the diminution on a multilateral basis of export credit subsidies. This policy was reaffirmed last December when Ministers endorsed ECGD's International Negotiating Objectives. We should therefore give the US and Canadian proposals our strong support. The US draft paragraph (Annex A) is perfectly acceptable but we have drafted an alternative Annex B in case something shorter is required. It could serve for either the OECD or Summit communique or both. The key point is to retain the remit to the Consensus group to reach agreement by the 1990 OECD Ministerial.

6. We should not be specific in either communique about the detailed measures that we want to see adopted in the Consensus. Details are for the OECD Consensus group. If substance is discussed though, we can give indications of our immediate priorities.

7. Reforms boils down to two issues:

a. commercial interest rates on standard export credits;

b. restrictions on aid related export credits ("mixed credits")

8. The present Consensus rules divide the world into three categories: Category 1 (over \$4,000 per head), Category 2 (\$835-\$4000 her head), Category 3 (under \$835 per head). The last Consensus reforms (negotiated in 1987 but not implemented until June 1988) provided for <u>commercial interest rates</u> only in Category 1 markets and increases in the "matrix" interest rates charged in

Category 2 and 3 markets. However, these matrix rates are below sterling and dollar commercial interest rates and subsidies. (If credit is given in low interest rate currencies it must be at matrix rates). These subsidies currently cost the taxpayer £250 million per year. Our priority is to replace matrix rates by commercial rates in Category 2 markets as soon as possible.

9. The 1988 reforms also included measures to tighten up discipline on <u>mixed credits</u>. The minimum subsidy percentage was increased to 35 per cent for Category 2 and 50 per cent for Category 3 markets with the objective of making them more expensive for donors and this discouraging them. (Mixed credits are not allowed for Category 1 markets). Early experience since these changes were implemented has been discouraging with no reduction in their number. The UK seeks the establishment of an OECD working group to evaluate the results of the recent changes and to consider further reforms. We should not get drawn into detail on the type of further reforms that we want at these meetings. Further reforms could allow us to reduce the present £90 million per year that the UK "mixed credit" scheme (ATP and soft loans) costs the taxpayer.

10. If a discussion gets started on Consensus issues some countries may say that the US and Canada are currently holding up the country category reclassification exercise and ask them to accept proposals tabled by the OECD Secretariat. These proposals would, by reference to the most recent GNP per head figures, promote some countries (thereby making them ineligible or less eligible for future subsidies) and demote other countries (making them eligible for more subsidies). The US is seeking a system of upward reclassification only and the Canadians a system that it would make it harder to downgrade than to upgrade a country. There is an overall majority in the EC for the OECD Secretariat proposals for "automatic" reclassification but agreement has not yet been reached. The UK has no position yet as Ministers are still discussing the issue. So, any attempt to settle or influence the reclassification issue at the OECD Ministerial or Sherpas should be resisted.

PARIS ECONOMIC SUMMIT
FOURTH MEETING OF PERSONAL REPRESENTATIVES (EVIAN)
2-4 JUNE 1989

Points to Make

UK supports Canadian proposal for strengthened international discipline on the use of subsidised export credits to be on the Summit agenda.

2. Since the last reforms of the Consensus were negotiated in 1987 (although not implemented until June 1988), work in the Consensus has been on a "care and maintenance" basis. Response to Mr Coleman's attempts to press ahead with further reforms has been disappointing.

3. A reference in the Summit communique to the need for strengthening of international discipline on using subsidised export credits and a call for action by a certain date (say the 1990 OECD Ministerial) would help get things moving.

4. Detailed discussion of Consensus issues is not appropriate for the Summit. Details must be worked out in the OECD Consensus group.

5. UK's priority is to eliminate matrix rates for Category 2 (middle income) countries and to replace them by commercial rates. We recognise that other countries have other priorities, such as limiting mixed credits. We would also be interested in discussing this. But these details should be left to the Consensus group. Summit should simply give the OECD Consensus group a steer, through a paragraph in the communique (Draft attached).

Industrial Subsidies

22. Ministers note the progress on the work on industrial subsidies following the mandates given in 1986 and 1987. Priority will now be given to completing the information and reaching early agreement on the methodology for the second phase of the work which will be directed at transparency. IMPROVED TRANSPARENCY OF GOVERNMENT SUPPORT TO INDUSTRY IS AN IMPORTANT AND NECESSARY STEP FORWARD IN THE ACTUAL assessment of the economic impact of industrial subsidies.

EXPORT CREDIT SUBSIDIES

22 BIS. MINISTERS NOTED WITH SATISFACTION THE SUBSTANTIAL PROGRESS THAT HAS BEEN MADE IN REDUCING TRADE AND AID DISTORTING EXPORT CREDIT SUBSIDIES. DESPITE THIS PROGRESS, MEMBER COUNTRIES AGREE THERE IS CONSIDERABLE SCOPE FOR ADDITIONAL REDUCTIONS IN SUCH SUBSIDIES. ACCORDINGLY, THE APPROPRIATE OECD BODIES WILL INTENSIFY THEIR DELIBERATIONS ON TIED AID AND STANDARD EXPORT CREDIT PRACTICES WITH A VIEW TOWARD ACHIEVING FURTHER REDUCTIONS IN TRADE AND AID DISTORTING EXPORT FINANCE SUBSIDIES PRIOR TO THE 1990 MINISTERIAL.

ANNEX 3

DRAFT PARAGRAPH FOR SUMMIT COMMUNIQUE

OECD CONSENSUS

We reaffirm our support for the Arrangement on Guidelines for Officially Supported Export Credits (the "Consensus"). We note with satisfaction the reforms introduced last year and call on the Participants to the Arrangement to make further progress on reducing export credit subsidies by the time of the 1990 OECD Ministerial meeting.

Contesting the point at which trade becomes aid

Peter Montagnon on the debate behind negotiations on how to limit the sweetening of export credits

THE PROBLEM of concessional lending was not one that could be solved. It simply had to be managed to keep it within reasonable limits.

This was the reaction of one weary export credit official last week as he contemplated the prospect of yet another round of negotiations in the Organisation for Economic Co-operation and Development to curb the rampant practice of mixing export credits with aid.

Just two years after the last round, Canada and the US are pressing for a new one designed to reduce what many perceive as the distortion to both trade and aid flows which results from sweetening export credits in this way. They are trying to get industrial country trade and finance ministers to launch a new set of negotiations at their meeting in the OECD later this month so that a package of new rules can be ready 12 months from now.

Whether they will succeed in the short run is a moot point. Their plan is meeting resistance from other countries that feel it is too early to embark on another review, but even some of these admit that the time is not too far off when the simple pressure of cost will force a fresh international look at the whole business of subsidised export credits.

The background to the Canadian and US initiative owes something to both domestic budget pressures and to broader international concerns.

The US Export-Import Bank is once again under attack from free marketeers in Washington whose overriding concern is to prune the federal budget by reducing subsidies of all kinds. Suddenly Canada, too, has been forced to focus on the issue. It has found itself in the curious position of shelving its C$8bn submarine programme for budgetary reasons while increasing sharply its concessional loan allocations because of prior commitments.

An international agreement to curb mixed credits would bring both governments relief from exporters who complain of their stinginess in matching the competition.

There is, however, some broader justification for seeking a review at this stage. Figures submitted to the OECD by members of its Consensus on Export Credits rules show that offers of mixed credits jumped 30 per cent in the year to last June and have continued to run at a high level ever since.

> **The fear is that the review of subsidy rules in 1987 failed to achieve the effect of curbing the practice of mixed credits**

The fear is that the laborious review of subsidy rules completed in 1987 has failed to achieve the desired effect of curbing the practice of mixed credits.

It was intended to work by setting higher minimum levels of aid grant, making mixed credits more expensive and forcing governments to cut back. Instead what some fear has been happening is that aid that would have otherwise been used for straightforward development purposes has been diverted into mixed credits.

This is worrying not least because mixed credits go mostly to middle-income developing countries that have thus been taking money that should normally be used to alleviate the plight of the poorest.

The US and Canada may have some trouble convincing their negotiating partners of this argument, however, because of the lack of reliable figures. The OECD has no means of telling how many of the offers of mixed credit which are notified to itare actually taken up by developing countries.

Some European countries feel that more time is needed to assess the real trend. But there seems to be little doubt that eventually the 1987 package will have to be re-opened and new rules set.

When this happens, the result is likely to be complicated, because discussion will turn on not only finding a new way of curbing mixed credits, which is more effective than simply raising the mininum grant content of individual credits. It will also have to encompass a long agenda of related issues which are piling up on the Consensus agenda.

For example, the UK, with its new concessional credits for both China and Indonesia, has been particularly aggressive on the mixed credit front. But new OECD talks would provide an opportunity to push for a long-cherished objective of removing the maturity limits on official export credits to rich countries, such as the Soviet Union, which are no longer eligible for interest rate subsidy.

For the long list of finance ministries worried about the general cost of export credit schemes, the review would provide an opportunity to reduce still further the interest subsidies which are routinely permitted on conventional credits to middle-income and poorer developing countries. This would entail a review of the matrix of permitted rates with particular focus on cutting subsidies directed towards middle-income countries where the bulk of export credit and mixed credit business is done.

There is also concern in low-interest countries, such as Japan, that the minimum rates are pitched so high as to make it hard for them to offer any interest rate subsidies while high-interest countries are able to gain an advantage by doing so with loans in their own currency.

Although Japanese interest rates are low, it is widely accepted that Japan has been hit by the appreciation of its currency which has made its export credits costly for developing countries to service. On the other hand the country has also been criticised for not reporting as mixed credits export credits which are sweetened with untied aid. Competitors complain that even though the aid is notionally untied the resulting business still somehow ends up in the hands of Japanese companies.

Last, although it is not directly related to the question of the Consensus rules, there is the question of transparency of export credit agency accounts. This has been given a new lease of life by the decision of Britain's Export Credits Guarantee Department sharply to increase its provisions on developing country debt.

The UK would now like other agencies to be similarly candid about their financial position. After all, one of the surest ways of winning public support for cuts in overall spending on export credits ought to be ruthlessly to expose its cost.

jsh/ch-oecd24 **CONFIDENTIAL**

FROM: J S HIBBERD (EA1)
DATE: 25 MAY 1989
EXT : 4590

CHANCELLOR OF THE EXCHEQUER

cc : Sir Peter Middleton
Sir Terence Burns
Mr Wicks
Mr Evans
Mr Riley
Mr Sedgwick
Mr Gieve (IDT)
Mr Melliss (IF)
Mr O'Donnell
Mr Pickford (EB)
Mr Owen (EA1)

Thanks. This note concentrates on the OECD 1989 f'cast. But a really big effort must be made to persuade them to revise their 1990 H1 forecast. At present they are greatly understating the effect on 1990 of the tightening the monetary policy has occurred so far on imports & the CA deflation are concerned.

OECD FORECASTS OF THE UK

We have just received revised OECD forecasts for the UK covering 1989 and 1990. This follows a meeting on 2-3 May of the OECD's Working Group on Short-Term Prospects which I attended with Caroline Turk. The forecasts were on the table when Sir Peter Middleton and Sir Terence Burns attended the Economic Policy Committee meeting. Since then OECD have reworked their numbers taking account of recent information and - to a limited extent - of our comments. We have not received any revised text, but it is quite likely that - as with the OECD forecast numbers - there will be some aspects of it not to our taste, notwithstanding the efforts to get changes.

2. The revised OECD forecasts will be background to the ministerial meeting that you will attend next week. The Economic Outlook with these forecast numbers and the revised text will be published on 18 June. The table overleaf compares the OECD forecast with the FSBR. Compared with the FSBR, the OECD envisages:

- lower output growth;

- a higher initial level of inflation and little decline in 1990;

- a gently rising current account deficit rather than the small decline for 1990H1 in the FSBR.

Domestic demand

3. The OECD forecasts for **domestic demand** are broadly in line with the FSBR. The only significant point we challenged at the meeting was their much more buoyant forecast of stockbuilding in 1989 compared to a

MPARISON OF OECD APRIL FORECAST WITH FSBR

GDP AND ITS COMPONENTS (Constant Prices)
(Percent change on previous period at annual rate)

		1989	1990	1989H1	1989H2	1990H1
GDP	FSBR	2.3	np	1.7	2.3	2.6
	OECD	2.4	2.0	2.8	2.3	1.9
CONSUMER EXPENDITURE	FSBR	3.3	np	2.9	1.4	2.2
	OECD	3.3	2.5	2.1	2.7	2.5
FIXED INVESTMENT	FSBR	4.5		4.2	4.6	0.1
	OECD	5.6	3.2	7.3	3.0	3.3
STOCKBUILDING	FSBR	-0.6	np	-1.3	-0.7	-0.3
	OECD	-0.1	-0.2	-0.3	-0.5	-0.2
TOTAL DOMESTIC DEMAND	FSBR	2.5	np	1.5	1.3	1.4
	OECD	2.9	2.1	2.4	1.8	2.2
EXPORTS (G+S)	FSBR	4.6	np	6.6	7.4	6.3
	OECD	3.6	5.0	5.7	4.9	4.9
IMPORTS (G+S)	FSBR	4.6	np	0.0	3.5	2.2
	OECD	6.5	4.7	4.0	3.1	5.1

PRICES AND EARNINGS
(Percent change on previous period at annual rate)

		1989	1990	1989H1	1989H2	1990H1
GDP DEFLATOR	FSBR	6.0	np	5.1	5.2	4.6
	OECD	6.8	5.9	6.7	6.3	6.2
CONSUMER EXPENDITURE DEFLATOR	FSBR	5.5*		5.2*	5.7*	4.3*
	OECD	5.7	5.2	5.7	5.4	5.2
AVERAGE EARNINGS	FSBR	9.4*		10.5*	7.1*	9.8*
	OECD	9.4	8.8	9.5	9.4	8.8

CURRENT ACCOUNT BALANCE £ Billion

	1988	1989	1990
FSBR	-14.7	-14.5	-12.1
OECD	-14.7	-16.5	-17.6

np = not published

* The FSBR does not contain forecasts of the consumer expenditure deflator or average earnings. Nor do we provide such forecasts publicly if asked to do so.

forecast run down of stocks of £¼ billion in the FSBR. We maintained that, as the emerging slow-down in domestic demand was perceived by industry, stocks, which may have been inappropriately built-up in late 1988, would be run off through 1989.

4. In the event the Secretariat have largely ignored our arguments, revising their forecast down only slightly. This is despite a clear statement in the April CBI Economic Situation Report (of which the OECD were aware) which pointed to destocking during 1989 (copy attached). This is more in line with the FSBR than the OECD's view.

5. The Secretariat also have a slightly more buoyant view of total investment, mainly because of stronger growth in private housing investment.

Current account balance

6. The OECD originally projected a current account deficit of £16½ billion in 1989 (FSBR = £14½ billion), with a further deterioration of £17½ billion in 1990 (FSBR = £12 billion). This was subject to considerable discussion at the forecasters' meeting. We argued that the prospect for export growth was considerably more buoyant than OECD foresaw, given both the behaviour of exports in the first quarter and the likely impact of the easing of capacity constraints on exports. The OECD agreed to look again at their current account forecasts; and amended them slightly. The revisions in 1989 reduce the forecast current account deficit by around £½ billion.

7. Although the OECD's imports forecast for 1989 is higher than in the FSBR (6½ per cent growth compared with 4½ in the FSBR), we think that the outturn for imports of goods in the first quarter makes the OECD forecast look fairly reasonable. (In the first quarter, imports of goods were 9½ per cent higher than in 1988). However, their export forecast still looks too pessimistic. If exports of goods less oil were to grow at the same rate as in the first quarter for the rest of 1989, the annual growth rate would be 9 per cent. If as well exports of services were to grow at only 2½ per cent (as in the FSBR), total exports would grow by 7½ per cent. The OECD's forecast of 3.6 per cent must therefore assume either a marked slowdown in the growth of exports of goods through the year, or very slow growth of exports of services. We think that the growth of exports of goods is more likely to rise through the year as capacity constraints ease.

OECD and FSBR Current Account projections - £billion

		1989	1990
Visible balance	OECD	-23.5	-24.6
	FSBR	-21.4	-21.7
Services balance	OECD	3.9	4.6
	FSBR	4.3	5.2
IPD & net transfers	OECD	3.3	3.2
	FSBR	2.5	3.9
Current balance	OECD	-16.3	-16.8
	FSBR	-14.5	-12.1

Inflation and Earnings

8. The OECD do not forecast RPI inflation. Instead they project the **consumer's expenditure deflator.** Their forecast for 1989 is very close to the unpublished FSBR forecast. Our views are very similar on **average earnings** growth in 1989, though again we do not publish our forecast. The OECD foresee a faster rise in the **GDP deflator** in 1989 (6.8 per cent against 6 per cent in the FSBR) mainly because of an increase in the terms of trade. They have it abating hardly at all in 1990H1, while we projected it to come down to about 4½ per cent (again not published).

Conclusions

9. There is still some daylight between our projections and the OECD's. However, it will not be easy to argue that the OECD forecasts for 1989 are obviously extreme, as the comparisons below illustrate:

Comparative Forecasts

	1989			1990		
	GDP growth (percent)	Current account (£billion)	Consumer price inflation (percent)	GDP growth (percent)	Current account (£billion)	Consumer price inflation (percent)
FSBR	2.3	- 14½	5½(Q4-RPI)	2.1	-12.1	3½(Q4-RPI)
OECD	2.4	-16.3	5.2(H2-CED)	2.0	-16.8	5.2(H2-CED)
NIESR	2.3	-17.1	6.6(Q4-RPI)	1.6	-15.3	6.6(Q4-RPI)
IMF	3.3	-18.0	6.5(Q4-CED)	2.1	-14.6	5.0(Q4-CED)

[redacted]. Nonetheless the relatively small difficulties between the OECD and the FSBR - given the margins of error around such forecasts - are sufficient to produce an uncomfortable picture with no improvement in inflation and the current account while output growth drops below potential. The fact that some other groups have produced a similar picture will certainly enhance the credibility of the OECD figures.

J S HIBBERD

There is accumulating evidence that the economy is slowing, yet commentators are impatiently seeking signs of some impact on the balance of payments and inflation. Just as rapid demand growth in 1988 was accompanied by a deterioration in the balance of payments and a rise in inflation, slower demand growth will help to secure an improvement. But it will be some months before the headline figures begin to show this.

Consumer spending

High interest rates are already having a very significant impact on consumer demand. Though the retail sales figures for February were revised upwards and now stand 3.1% above January's level, the underlying trend of high street spending is still flat. This was confirmed by the estimates for March, which showed sales in the first quarter to be 0.3% down on the previous three months. Compared to the same three months a year ago, the annual rate of growth is now 3.8%, compared to 6.5% for 1988 as a whole. This slowdown is reflected in the preliminary figures for consumer spending as a whole, which is estimated to have risen by only 0.6% between the last quarter of 1988 and the first quarter of this year.

This slower rate of growth in spending is confirmed by the Distributive Trades Survey results for March. Though the balance of retailers reporting sales higher than a year ago picked up to 35% in March, following February's record low result, this compares to an average balance of 50% during 1988. Other sectors within the distributive trades provide evidence of slower growth in consumer spending, with motor traders reporting, on balance, that sales in March were actually lower than a year ago.

Stockbuilding

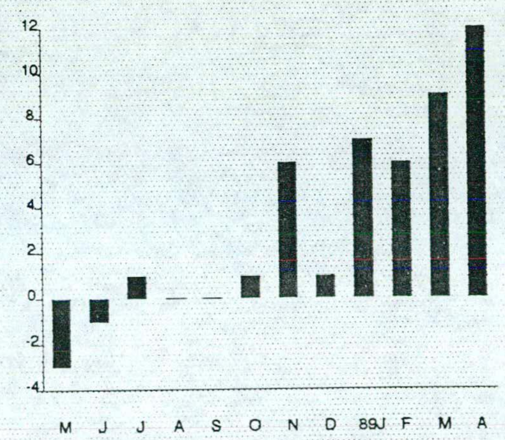
The slowdown in spending, combined with the impact of higher interest rates, is contributing to a build up of stocks throughout the economy. The Distributive Trades Survey shows stocks building up much more than expected over the first three months of this year. As a result, stocks, in relation to expected sales, are now reported to be at the highest level recorded in the six-year history of the survey. This build up in stocks is also reflected in the manufacturing sector, with the April Industrial Trends Survey showing that stocks of finished goods are now considered to be above normal by a balance of +12% of respondents - the highest levels seen since 1986 (see Chart). As a result, manufacturers now expect to run down stocks - of raw materials, bought in supplies, work in progress and finished goods - over the next four months

Orders and output

This is clearly worrying for domestic producers because it means less orders in the future. The Industrial Trends Survey has already shown order books weakening in the early part of this year, and as a result output is also expected to grow less rapidly. The April Survey shows that over the last four months, the volume of total orders grew at a much slower rate than during 1987 and 1988 and a similar rate of growth is expected over the next four months. Output has also slowed and the balance of respondents expecting an increase over the next four months - at 12% - is the lowest recorded since July 1986.

MANUFACTURERS' STOCKS OF FINISHED GOODS

% balance reporting more than adequate)



mp.pc/Riley/190

RESTRICTED

FROM: C J RILEY (MP)
DATE: 26 May 1989
Extn: 4439

CHANCELLOR

cc
Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Anson
Sir T Burns
Mr Wicks
Mr Lankester
Mr Monck
Mr Phillips
Mr Scholar
Mr Culpin
Mr H P Evans
Mr C W Kelly
Mrs Lomax
Mr Luce
Mr Peretz
Mr Sedgwick
Mr Spackman
Mr S Davies
Mr Gieve
Mr Grice
Mr Hibberd
Mr O'Donnell
Mr Matthews
Mr Meyrick
Mr Mowl
Mr Pickford
Mr Barrie
Mr Savage
Mrs Chaplin

Thanks. I agree with X. For that reason, press comment will tend to focus exclusively on the OECD's short-term 'cost' & risk on this. J Important that [illegible] stresses the balance.

OECD EDRC SURVEY OF THE UK

We have just received a preliminary draft of the annual review of the UK economy - attached. A revised version will be discussed at the EDRC meeting on 19 June; normally the revisions are very slight. Following the meeting we shall attempt to negotiate drafting changes with the OECD Secretariat, prior to publication of the final version a few weeks later.

2. We are in the process of studying the paper and preparing our drafting suggestions. We shall send these to you, together with the general line which we propose to take at the meeting, during the week beginning 12 June. In the meantime you may care to glance at the report, especially the concluding chapter (beginning on page 53).

3. At first sight the draft seems reasonably satisfactory. It points with approval to improvements on the supply side and in public sector efficiency (the special topic of the review), giving credit for Government policies while stressing that a good deal remains to be done. It also gives credit for the policy measures taken to deal with recent excessive growth of domestic demand and re-emergence of inflationary pressures, though there is a hint that more may need to be done. A slower move back to budget balance than envisaged in the MTFS is suggested together with, a tendency in general to err on the side of overkill. It is also suggested that further tax measures to favour saving should be contemplated.

4. As I say, these are only preliminary reactions, and we shall be looking at the draft very closely. It is proposed that we should be represented at the EDRC meeting by myself, Jim Hibberd (since Peter Sedgwick expects to be on paternity leave), and one other - to be decided after closer examination of the draft - to field questions on public sector efficiency.

CJR

C J RILEY

FROM: D I SPARKES
DATE: 26 May 1989

MR HIBBERD (EA1)

cc Sir P Middleton
Sir T Burns
Mr Wicks
Mr Evans
Mr Riley
Mr Sedgwick
Mr Gieve
Mr Melliss
Mr O'Donnell
Mr Pickford
Mr Owen

mrp

OECD FORECASTS OF THE UK

The Chancellor was grateful for your minute of 25 May concerning the revised OECD forecasts. He commented that your note concentrates primarily on the OECD 1989 forecast. But a really big effort must be made to persuade OECD to revise their 1990 H1 forecast. At present they are greatly underestimating the likely effect in 1990 of the monetary tightening that has already occurred, so far as imports and the GDP deflator are concerned.

D.M.

DUNCAN SPARKES

idt.lp.hjb.99

Ch
We can play all this pretty much by ear
AA

Nigel. I wd not be worried by 'competition for press attention': first, I don't know all that much [illegible]; [illegible] UK press will come to my press briefing whatever [illegible] before departure [illegible]

RESTRICTED

FROM: H J BUSH (IDT)
DATE: 26 May 1989
x 5252

PS/CHANCELLOR

cc Mr Wicks
Mr H P Evans
Mr Gieve

PRESS ARRANGEMENTS FOR OECD VISIT, 1 JUNE

I have been talking to UKREP about arrangements for a press conference during the Chancellor's visit to OECD. I gather that the original preference was for after lunch, just prior to departure for the airport. However, the timing of the Chancellor's bilateral with Secretary Brady is still unclear, and it appears that a number of other press conferences are being arranged for this time.

2. Obviously, the timing of the Brady bilateral will be the determining factor but, subject to this, there would be some advantage in a pre-lunch session. There looks to be less competition for press attention, and it might be helpful to have the UK interpretation of the meeting out early. ???

3. We have received a number of bids for short radio and TV interviews. We are likely to receive more. So far, though, we have:-

(i) BBC News - Graham Ingham would like a very short interview (no more than a couple of questions) in the expectation that this will secure time on the main bulletin on what will be, with President Bush's visit, a heavy news day;

(ii) a bid from Channel 4 news (for a 5 minute interview);

(iii) a bid for a 5 - 10 minute interview from Radio France Internationale, the overseas service of French radio with an audience mainly in Latin America and Francophone Africa. The subject would be the British position on Europe.

RESTRICTED

4. We need not take final decisions on all these now. But my inclination would be to rule out the French radio interview given how tight time will be; its subject matter; and the rather rarefied audience. An interview with Ingham, who is more alive to Treasury concerns than others in the BBC's Economics Unit, could be worth doing.

Anthony Bush

H J BUSH

jsh/ch-oecd26 **CONFIDENTIAL**

FROM: J S HIBBERD (EA1)
DATE: 26 MAY 1989
EXT : 4590

CHANCELLOR OF THE EXCHEQUER

cc : Sir Peter Middleton
Sir Terence Burns
Mr Wicks
Mr Evans
Mr Riley
Mr Sedgwick
Mr Gieve (IDT)
Mr Melliss (IF)
Mr O'Donnell (EA2)
Mr Pickford (EB)
Mr Owen (EA1)

OECD FORECASTS OF THE UK

The revised OECD forecasts described in my minute of 25 May are their <u>final</u> forecasts. The OECD are unable to change their forecasts now, given the long period between finalising their forecasts and getting the Economic Outlook printed. Publication is due on June 18; printers' proofs may be available to us as early as June 12. The points you made about import growth and inflation in 1990 were both strenuously put across by Caroline Turk and me at the Working Group on Short-term Prospects on 2-3 May and at EPC last week, which Sir Peter Middleton and Sir Terence Burns attended. OECD would not be shifted far from their original position.

JH

J S HIBBERD

Noted.
2. But the OECD f'casts, Mr [illegible] will have a lot to take.
There will need to stress, <u>also</u>, the high degree of uncertainty attached to all forecasts, & those from [illegible] in particular.

CONFIDENTIAL

ORGANISATION FOR ECONOMIC
CO-OPERATION AND DEVELOPMENT

CONFIDENTIAL

Paris, drafted: 29th May 1989

dist: 30th May 1989

EDR(89)19

Or.Engl.

ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE

1988-1989 ANNUAL REVIEW

UNITED KINGDOM

DRAFT ECONOMIC SURVEY BY THE SECRETARIAT

(Note by the Secretariat of the Committee)

The attached draft Economic Survey of the United Kingdom is submitted to the Economic and Development Review Committee for CONSIDERATION.

The Annual Review of the United Kingdom by the Economic and Development Review Committee has been arranged for Monday, 19th June 1989. The examining countries are the Netherlands and the United States.

The tables, diagrams, annexes and statistical annex will be circulated separately.

It should be noted that the United Kingdom authorities did not have the opportunity to comment on this draft before it was circulated.

Contents

Tables

Diagrams

Introduction

1. The strong expansion of the United Kingdom economy in 1987 continued virtually unabated during 1988. As highlighted in Part I of this Survey, this reflected both booming investment and buoyant household demand, underpinned by a brisk expansion of borrowing, in particular mortgage credit. Both employment growth and the trend of wages steepened. With the economy increasingly coming up against capacity limits, inflation started to edge up and the current-account deficit widened sharply.

2. In view of increasing signs of overheating, the authorities have progressively tightened monetary conditions since mid-1988 (Part II). The rise in short-term interest rates by more than 6 percentage points has damped monetary expansion, and in particular mortgage lending, and has contributed to maintaining a strong exchange rate. The medium-term orientation of fiscal policy puts the burden of short-term adjustment on monetary policy. But fiscal policy has contributed to restraining demand by sticking to nominal spending targets in spite of higher-than-expected inflation. The implied tightening of the fiscal stance is continued in the 1989 Budget, combining expenditure restraint with only modest tax reductions. On the basis of these policies, the recent marked slowdown in household spending, especially in the housing market, can be expected to continue and to reduce the growth of real domestic demand below that of potential output. This might arrest the rise in inflation and the external deficit. There is considerable uncertainty, however, about the underlying strength of demand and inflationary pressures, and about the effects of policy tightening. Slow progress in reducing inflationary tensions and imbalances in the economy could undermine confidence in sterling and lead to a "hard landing" of the economy (Part III).

3. Although, despite the spurt in recent years, GDP growth since the previous cyclical peak in 1979 has hardly exceeded 2 per cent per annum, conditions would seem to be favourable for the economy to return to a higher growth path over the medium term (Part IV). Productivity gains have increased significantly, in particular in manufacturing, profitability has recovered, and investment has surged, boosting the growth rate of productive potential. Improved supply-side performance owes much to structural policy reforms pursued over the last decade. The special Chapter of the Survey (Part V) reviews Government policies aimed at making the public sector itself more efficient. The United Kingdom has taken a leading role in this area, introducing modern management and efficiency monitoring techniques, transferring significant parts of activity to the private sector, and increasing competitive and financial pressure on public-sector management.

I. An overheating economy

Excessive growth of domestic demand

4. The economy has been subject to markedly stronger demand pressures than foreseen when the United Kingdom was examined a year ago. With a high rate of capacity utilisation, output has grown somewhat more than expected and imports have surged (Table 1). To a large extent the extraordinary buoyancy of both consumer and business demand can be attributed to improved economic confidence, although the relaxation of monetary policy in the aftermath of the stock-market crisis has also played a role. The announcement in the March 1988 Budget of changes to mortgage tax relief seems to have led to an advancement of household borrowing and spending. But the fiscal stance has, if anything, been tighter than foreseen, with the tax burden broadly stable and public expenditure falling in real terms.

(Table 1. Demand and output)

5. Although the picture emerging is clearly that of an overheating economy, the inadequacy of available national accounts data makes it difficult to trace the course of the economy over the past two years or so with any precision. The various measures of GDP show widely differing paths within years (Diagram 1), and even for 1988 as a whole growth in the expenditure-based measure falls short of that in the income and output measures by almost 2 percentage points. At the same time large "balancing items" have emerged in sectoral financial accounts, equivalent to the difference between the income and expenditure measures of GDP. In particular, the personal sector appears to have acquired more financial assets than the national income and expenditure estimates imply, but balancing items have also become unusually large for the corporate and overseas sectors. Preliminary work in the Central Statistical Office, aimed at providing balanced national and financial accounts for the 1985-87 period, suggests that there has been substantial under-recording of gross fixed capital formation and personal saving, while the growth in company profits and deterioration in the external balance has been probably somewhat over-estimated. Given the sizeable residual errors, revisions to statistics have also been unusually large. Over the last six months or so, domestic demand in 1987 has been revised upwards by about 1 per cent, with changes to investment data particularly important. Figures for 1988 shown in Table 1 are likely to understate the strength of demand to at least the same extent. As revisions to the output measure -- considered the most reliable -- are normally limited, this can be expected to result in a higher rate of growth in the "average" measure of GDP in 1988 than recorded at the moment.

(Diagram 1. Measures of GDP)

6. Even allowing for special factors (such as accidents depressing North Sea oil production), output growth seems to have fallen back somewhat during the course of 1988, reflecting capacity constraints rather than lack of demand. Since late 1988 there are indications of a slowdown in household spending, in particular in the housing market, in response to higher interest rates. Increased stockbuilding appears to have been partly involuntary. According to business surveys, order books and output expectations have become less buoyant, and some easing of capacity pressures seems to have occurred. But investment activity and intentions have as yet shown little sign of weakening.

7. In terms of contributions to GDP growth, consumer demand has remained the mainstay of economic expansion. Its more rapid rise in 1988 (Table 1) mainly reflected soaring demand for durables, especially cars, and for services, notably international travel. A greater proportion of the rise in consumer spending than before can be traced to the evolution of real personal disposable income which, boosted by high employment growth, increased by almost 5 per cent. But the contribution from a decline in the savings rate remained substantial: before recovering a little, the personal saving ratio reached a low of 3 per cent in the third quarter of 1988; this compares with a peak of more than 15 per cent at the beginning of the 1980s. With strong residential investment, the personal sector has moved into a financial deficit of some 7 per cent of disposable income.

8. The steep fall in the personal sector saving ratio (Diagram 2) may be regarded as the most important factor behind excessive growth of domestic demand and the associated deterioration in the external balance. Although, for both economic and statistical reasons, more importance should be placed on developments in aggregate savings of the private sector in total, the decline in the measured personal saving ratio has been of such magnitude as to warrant some examination and explanation. The large discrepancies in the statistics give rise to doubts, though, about the true extent of the fall. Contrary to the saving ratio derived from income/expenditure accounts, an alternative measure derived from financial flow data has remained fairly stable over the last few years. Yet, while recognising that personal income is probably underestimated, the Central Statistical Office considers statistics on financial transactions in general less reliable; the above mentioned "balancing exercise" suggests that in 1987 the saving ratio may have been underestimated by 2 percentage points. Another problem of measurement arises from the fact that the personal sector in the national accounts includes pension and life assurance funds and unincorporated businesses. The higher value of pension funds has led to "contribution holidays", i.e. lower employer contributions, which count as personal income. This has significantly lowered the measured personal saving ratio over the last few years in favour of higher company saving (1).

(Diagram 2. Personal consumption and saving)

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1. There is also a view that income arising from unincorporated businesses may be misallocated between the personal and corporate sectors.

9. The phenomenon of steeply falling household saving ratios has not been unique to the United Kingdom. During the the 1980s a large decline, though from a higher level, has also been registered in France, Italy and Canada, and over a longer period there has been a similar fall in the United States; in some Nordic countries current net household saving has even become negative. The main reasons for this appear to have been disinflation (meaning less erosion of the real value of financial assets), rising consumer confidence, demographic factors, sharp increases in equity and housing prices, and financial liberalisation, which has increased the personal sector's capacity to borrow. Inflation adjustment considerably mitigates fluctuations in the United Kingdom saving ratio in the late 1970s and early 1980s but does not contribute much to explaining saving behaviour over the past five years or so. Lower inflation may, however, have contributed to a strengthening of consumer confidence, which has been bolstered by several years of rapid expansion of employment and real incomes. Recent research has pointed to the influence on aggregate saving of the age distribution of the population. This could have significant consequences for future savings behaviour, as the long-term decline in the proportion of middle-aged high savers will be reversed in the 1990s.

10. The decline in the personal saving ratio during the 1980s has been a result of increased borrowing rather than a decrease in gross savings. The brisk expansion of consumer credit and, in particular, mortgage borrowing, part of which seems to have been to finance consumption, is a consequence of financial liberalisation but also reflects the strong rise in share prices and escalation of house prices. The increased market value of personal wealth has reduced the need for new savings and served as a collateral for borrowing. Although personal sector debt has grown much faster than disposable income, it has risen only moderately in relation to personal wealth, in particular if account is taken of housing wealth (Diagram 2). With the personal sector's net worth continuing to grow strongly, its financial position has, on average, remained healthy. Nonetheless, an increasing number of households may be over-extended or severely constrained. Interest payments now amount to some 13 per cent of disposable income and exceed interest receipts for the personal sector.

11. Notwithstanding some leakage into current consumer spending, the bulk of mortgage borrowing has served to finance house purchases. Investment in housing has gathered growing momentum since the mid-1980s (Table 1). The limited supply response to buoyant demand, due in part to restrictions on land use, has meant that house prices have soared (Diagram 3). The housing market was particularly buoyant in the first half of 1988, when mortgage interest rates reached a low and the announced limitation of mortgage tax relief as from August acted as an additional stimulus. Since then, with a progressive rise in interest rates, there are signs that the housing market is easing: mortgage lending commitments have fallen markedly, and housing starts have decelerated (Diagram 3).

(Diagram 3. Housing indicators)

12. Over the past two years private non-residential investment has been the most rapidly growing demand component, expanding by about one-third (Table 1). Capital spending in the service sector has remained strong. Manufacturing

investment has recovered markedly, although, according to latest estimates, its level in 1988 just exceeded that in 1979. Investment has continued to be concentrated in plant and machinery rather than non-residential structures. Strong upward revisions to historical data have brought estimates for fixed capital formation more in line with what could be expected against a background of high profitability and capacity utilisation but, as explained above, some under-recording may still persist. As a proportion of GDP, recorded gross business investment has reached a historical high. In net terms, the picture appears weaker: after falling to a low of 1 1/2 per cent by 1983, the investment ratio net of depreciation has just recovered to above 4 per cent, about the level of the 1970s. The decline in the business sector's capital/output ratio since the early 1980s appears to have continued. The improvement in capital productivity, which compares favourably with developments in other Member countries, would seem to be not just a cyclical phenomenon but to reflect a better quality of investment. Together with improved efficiency in the use of resources, this may have contributed to the steep rise in the business sector's rate of return on capital back to pre-1973 levels.

13. The strength of domestic demand, along with worsening international competitiveness, has led to growing net imports (for details see below). Part of the sizeable deterioration in the real foreign balance (Table 1) may reflect a diversion of output from foreign to domestic markets as a result of scarcity of capacity. It is notoriously difficult to assess the degree of resource pressures. One measure is the estimated gap between actual and potential output, the latter defined as the maximum level of output consistent with stable inflation. Such a measure, derived from the country supply block in OECD's INTERLINK model, suggests that in 1988, as in the late 1970s, the United Kingdom economy was operating above potential. Although, with steepening growth in total factor productivity and capital formation, potential output growth is estimated to have edged upward towards 3 per cent, the strong economic expansion over the last few years has meant that the large gap between aggregate supply and demand which had opened in the 1980/81 recession had been probably closed by 1987. Survey evidence for the manufacturing sector (Diagram 4) points in the same direction. By the end of 1988, the proportion of firms citing plant capacity as a factor limiting output had reached the previous peak of the late 1970s. The percentage of firms operating at full capacity was even higher than during the 1973/74 boom. There are indications, however, that supply is more responsive at given high levels of capacity utilisation than in the past. With output growth moderating, capacity utilisation rates in manufacturing have fallen off in recent months.

(Diagram 4. Capacity constraints)

Tightening labour market conditions

14. The strength of economic activity has been reflected in the labour market. With rising employment rates, shortages of skilled labour have increased markedly, though not to the extent recorded at cyclical peaks up to the early 1970s (Diagram 4). The findings of the 1988 Labour Force Survey indicate that the marked decline in unemployment since mid-1986 has been associated with much stronger expansion of both labour demand and supply than thought before. Total employment growth in 1987 and 1988 is now put at around

3 per cent per annum (Table 2). As a result, labour productivity performance now looks less favourable: growth in output per head appears to have dropped to below 1 per cent in the twelve months to late 1988, implying a virtual stagnation of hourly productivity, given a continued rise in overtime work. As productivity gains in manufacturing have remained high (Table 2), this largely reflects poor measured performance in the service sector. Output in the service sector may be underestimated, but correction for this would probably raise productivity levels more than short-term productivity advances.

(Table 2. Labour market)

15. With the recovery gaining momentum, there has been a marked shift in the sources of employment growth. Up to 1987, the rise in employment was largely confined to the service sector, self-employment, and dependent part-time work. Revised data show that, after declining by about one-third since the late 1970s, employment in manufacturing started growing again in mid-1987. While self-employment and dependent part-time work has continued to grow faster than the average, their contribution to employment growth in the year to spring 1988 dropped to below and slightly above one-fifth, respectively, as compared to around two-fifths each over the preceding three years (the rest in that period being accounted for by government employment schemes, Table 3). An outstanding feature in the recent period has been the recovery of male full-time employment, reversing the fall in the three years before. At the same time, growth in part-time employment among men picked up, and the percentage of those who worked part-time because they could not find a full-time job dropped from more than 20 per cent to around 15 per cent. This was still significantly higher than in the case of women, in particular married women, who work predominantly part-time and account for the bulk of part-time working people. The number of people participating in work-related government employment and training programmes, which had increased by over 200 000 or two-thirds over the 1984-1988 period to more than 2 per cent of total employment, has tended to rise less rapidly.

(Table 3. Decomposition of employment growth)

16. Labour supply has responded flexibly to the buoyancy of demand. With the number of discouraged workers dropping markedly, the increase in economically-active people accelerated to over 1 1/4 per cent in the year to spring 1988, according to provisional Labour Force Survey data, although the expansion in the working-age population slowed to an annual rate of less than 1/2 per cent. The resulting rise in the overall participation rate since 1986 reflects a continued increase in female participation and a reversal of the fall in the activity rate for men. Statistics available for the remainder of 1988 imply a stagnation of the labour force, which appears implausible, given the strength of the economy. Hence, employment growth could be underestimated, as in the year before; or alternatively, the claimant count could overstate the decline in unemployment since spring 1988.

17. The latest Labour Force Survey broadly confirms the marked fall in unemployment shown by registration data for the year to spring 1988. This contrasts with the years before when alternative measures of unemployment had often displayed widely diverging trends (Diagram 5). By the second quarter of 1988, according to the Survey-based standardised ILO/OECD measure, the rate of

unemployment was about 8 1/2 per cent, close to the claimant count and sharply down from the 1986 peak of 11 1/2 per cent. The assessment of more recent developments is complicated by changes in benefit regulations for young people, most of whom are no longer eligible for income support, as they have the guaranteed opportunity of a place on the Youth Training Scheme. To avoid discontinuities in the statistics, official figures (the adjusted claimant count) now relate only to claimants aged eighteen or over. This series, which is used to extrapolate standardised data since the 1988 Labour Force Survey, shows a further fall in the unemployment rate by about 2 percentage points over the last twelve months. The rise in the number of unfilled vacancies, on the other hand, already petered out in the course of 1988, and shortages of skilled labour appear to have eased significantly since the turn of the year (Table 2, Diagram 4).

(Diagram 5. Measures of unemployment)

Resurgence of inflation

18. With capital utilisation rising and labour slack diminishing, pressures on resources have led to a marked pick-up in inflation. When the United Kingdom economy was examined a year ago, there was some concern about cost and price developments, but evidence on resource pressures was considered inconclusive and, apart from the housing market, there were few signs of a resurgence of inflation. Indeed, contrary to developments in many other Member countries, the inflation process in the United Kingdom appeared to be characterised by considerable inertia: after having fallen sharply in the early 1980s, inflation had displayed no clear trend, fluctuating around an underlying rate of close to 5 per cent. A sudden spurt in inflation in the mid-1980s followed upon a large fall in the exchange rate and marked rise in import prices (Table 4). By contrast, the pick-up in inflation in the first half of 1988 occurred against a background of a rising pound and subdued import prices. It was only later in the year that imported inflation added to the pressures emanating from high resource utilisation.

(Table 4. Costs and prices)

19. The doubling of the twelve-month increase in retail prices over the past year to 8 per cent by April 1989 overstates the acceleration in inflation. Unlike in most other Member countries, mortgage interest payments are included in the retail price index, as a measure of the cost of housing for owner occupiers. Compared to alternative measures, such as imputed rents, this tends to make the price index more volatile, because the average level of mortgage interest payments is very sensitive to changes in interest rates. Although elimination of this component from the index removes the effect of changes in the cost of housing for owner occupiers, the adjusted index would seem to give a better indication of the underlying trend of inflation. On this measure, the inflation rate has risen by about 2 1/2 percentage points over the past year or so, to about the level of the previous peak in 1985 (Diagram 6). Another indicator for the underlying inflation rate, the rise in the non-food producer price index, has so far remained below the 1985 peak, accelerating only more recently after a moderate upward drift during 1988.

(Diagram 6. Price developments)

20. Due to the revisions to employment and productivity data unit labour cost estimates now show a much more pronounced acceleration (Table 4) than was previously apparent. Yet, the recovery of profit margins -- welcome in its own right -- has continued to contribute to the inflation process, though to a diminishing degree. In manufacturing, about one-sixth of the increase in producer prices in 1988 can be attributed to higher margins. For the economy as a whole, a comparison of the rates of growth in the GDP deflator and in unit labour costs would seem, at first glance, to indicate some squeeze on margins. But, apart from the provisional nature of and substantial margin of error attached to the deflator, it has to be taken into account that a large fall in North Sea profits depressed this indicator by about 1 percentage point in 1988. Non-oil trading profits of industrial and commercial companies are estimated to have grown by about a fifth, as in the year before.

21. High profits and labour market tightening have combined to put upward pressure on wages. The underlying rate of growth of average earnings, which had remained within a narrow range of 7 1/2 per cent to 8 per cent in the five years to 1987, moved upward to 9 per cent in mid-1988 and has fluctuated around this rate since. Viewed against the sharp fall of unemployment, wage trends might have been expected to steepen even more. Survey evidence suggests that labour-market pressure has re-emerged as a consideration in pay bargains: while in the mid-1980s the level of unemployment had reportedly little influence on settlements, the need to recruit or retain labour is now considered as important as company profitability and the cost of living. Econometric evidence for manufacturing points to a relatively limited impact of skill shortages on overall wage growth, although the former explain most of the <u>increase</u> in wage inflation since 1987 (2). To a large extent, the rise in earnings growth has been the result of higher settlements, which have edged up to about 7 per cent in manufacturing and somewhat more in the service sector. Rising overtime work has also contributed, although to a diminishing degree in recent months, as well as several large catch-up rises in the public sector (notably in the health sector). While wage increases in the financial sector have slowed down sharply, they have remained high in construction and even turned up in some manufacturing industries, such as motor vehicle production. This has been in part the consequence of inflation protection clauses in some longer-term agreements. These not only trigger off wage adjustments in response to the steep rise in the retail price index associated with increasing mortgage interest rates, but also induce subsequently other groups without revision clauses in their contracts to try and catch up.

Sizeable external imbalance

22. The deterioration in the current external account quickened in 1988, reflecting domestic-demand growth as well as a weaker competitive position. Mostly as a result of a strengthening pound sterling, the competitive edge stemming from the real depreciation of the currency in the eighteen months to early 1987 had been lost by the end of 1988 (Table 5). Adverse effects on trade volumes of the rise in sterling have been mitigated, though, by significant improvements in the terms of trade. Of the total rise in the

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2. A. Sentance and N. Williams, "Skill Shortages: A major problem for British Industry?", <u>CBI Economic Situation Report</u>, London, March 1989.

current-account deficit in 1988 of about 2 1/2 per cent of GDP, about two-thirds are attributable to non-oil trade, the decline in the surpluses on both oil trade and invisibles accounting for the rest. The non-oil trade deficit has tended to widen markedly during the course of the recovery (Diagram 7). Trade in manufactured goods, traditionally in surplus, has moved into increasing deficit since 1983. Since the mid-1980s, in volume terms, imports of manufactures have grown by one-half, while exports have expanded by only one-quarter (Table 5). The current balance turned into deficit when the deterioration in the non-oil trade balance was no longer offset by rising surpluses on oil trade and invisibles. Lower prices and falling production, partly due to accidents, had virtually wiped out the oil surplus by early 1989. Net receipts of interest, profits and dividends have kept rising, owing to a still sizeable stock of net overseas assets (amounting to about one-fifth of GDP) and lower dividend payments to overseas oil companies; but this has been outweighed by a fall in the balance on services, partly due to a rising deficit on travel.

(Table 5. External trade and the current account)

(Diagram 7. Current account developments)

23. Though there may be some under-recording of net current-account earnings, it is unlikely to be important in relation to the size of the deficit (more than 3 per cent of GDP in 1988). The large errors and omissions item in the balance of payments appears to reflect mainly under-recording of capital inflows. Recorded transactions show a net outflow of £0.6 billion in 1988, resulting from an increase in net short-term inflows and a return of the balance of long-term transactions to a substantial outflow.

24. The marked worsening in the external balance in 1988 reflects both rising import penetration and disappointing export performance. With buoyant domestic demand and capacity shortages in some industries, the volume growth in merchandise imports almost doubled to 13 1/2 per cent. The rise in imports was particularly pronounced in finished manufactures, with imports of passenger cars, intermediate and capital goods growing fastest. More recently, with demand for consumer goods weakening, imports have increased less rapidly, but their twelve-month growth has of late remained above the rate for 1988 as a whole. The recent surge in import penetration followed a weaker trend in the mid-1980s which seems to have reflected a temporary pause in the recovery, with relatively weak investment activity, preceded by some improvement in price competitiveness on the domestic market. The increase in import penetration has been less pronounced in value terms, as import prices have declined relative to domestic prices. The long-run rise in the share of total aggregate demand that is met by imports would not in itself be worrying as long as it reflects increasing specialisation in international trade and greater openness of world markets. The upward trend in import penetration has not, for example, been much steeper than in Germany, where the level of import penetration is even higher than in the United Kingdom. It gives cause for concern only if there is no parallel upturn in foreign earnings through investment income or exports.

25. Following some improvement since the mid-1980s, export performance deteriorated markedly in 1988. Merchandise exports declined in real terms, as oil output fell sharply (Table 5). The growth rate of manufactured exports

fell significantly short of the expansion of world markets, even if erratic items are excluded. Exports of capital goods rose strongly, benefiting from the world-wide investment boom, while exports of intermediate goods and consumer goods decreased somewhat. Gaps in the United Kingdom's product range may in part explain this poor trade performance. The reversal of the earlier real depreciation is likely to have contributed: according to business surveys, non-competitive export prices are by far the most important factor limiting the ability to win orders; on the other hand, on average, exporters appear to have been able to raise profit margins further. With capacity utilisation particularly high in some consumer-goods industries, capacity shortages have certainly played a role too. Indeed, exports of consumer goods have picked up more recently, when domestic demand began to weaken. Total merchandise exports, after falling back in late 1988, have also shown signs of recovery in recent months (Table 5).

26. Notwithstanding the recent deterioration, manufacturing trade performance over the 1980s compares favourably with past experience and has not been significantly worse than that of many major competitors. In both volume and value terms, there has been little change in world market share over the past five years or so. A constant market share analysis covering developments up to 1987 may help explain the apparent ending of a long-term deterioration. It breaks down the growth differential between world imports and United Kingdom exports of manufactures into three components: a regional-composition effect, a product-mix effect, and a residual. Data limitations impose the use of value data, which may be distorted by exchange-rate fluctuations. Hence, the residual term can give only a rough indication of changes in price and quality competitiveness and other supply-side effects. Table 6 shows that the product-mix effect has been positive over the past two decades, suggesting that British producers have succeeded in taking advantage of the most dynamic markets by adjusting the structure of their products (see below). With a shift away from developing countries and towards the European Community and the United States, the regional composition of exports has had a damping effect on export growth over the last decade. The residual term, which used to be highly negative in the past, has moved towards positive values over the last few years. This is likely to reflect in part the fall in the real exchange rate, reversing the strong increase in the second half of the 1970s. But supply-side improvement may also have contributed, enhancing non-price competitiveness and altering the sensitivity of exports to changes in price competitiveness and demand.

(Table 6. Constant market share analysis)

27. Closer analysis of export trends reveals that, despite the overall positive contribution of the product mix, the majority of product groups still recorded losses in world market share in the 1980s, and many of them in strongly-expanding markets. The most important example is motor vehicles, which account for a high proportion of total exports. Performance was generally more favourable in the area of products with a high technology content. These findings are corroborated by an analysis of both the level of "revealed comparative advantage" (the relation of the export/import ratio of a commodity group to the aggregate export/import ratio), an indication of specialisation in certain production, and its change between 1982 and 1987 (Diagram 8), a period characterised by a movement into trade deficit and by a real depreciation. The range of products, which are divided into five

categories, is shown in Table 7. In the 1980s, research-intensive products in general gained comparative advantage. In total, two-fifths of the included products recorded a rise in comparative advantage or decline in comparative disadvantage. Comparative advantage shrank in relatively important groups such as specialised industrial machinery and equipment and fabricated metal products. Comparative disadvantage increased in several labour-intensive industries, as well as for transport equipment, and many consumer goods such as electrical, photographic and optical products. In sum, increasing specialisation and rising comparative advantage in the area of high-technology products together with the robustness of some "strong points" (such as industrial chemicals) has its counterpart in other areas which not only include the traditional labour-intensive sectors but more significantly differentiated goods.

(Diagram 8. Revealed comparative advantage)

(Table 7. Product composition of foreign trade)

II. The policy response

Marked tightening of monetary policy

28. Within the framework of the Government's medium-term-oriented strategy, the task of containing inflation falls on monetary policy. Over the last few years, determining the required degree of monetary restraint, the choice of policy levers and of intermediate targets have been complicated by a number of factors. With financial liberalisation and innovation reducing the usefulness of broad monetary aggregates as guides for policy-making, policy decisions have necessarily become more judgmental. The evidence of a range of indicators has been used to assess monetary conditions, with particular weight being given to narrow money in relation to its target range and to the exchange rate. In spite of strong expansion of broad money and credit, interest rates were brought down significantly in the aftermath of the stock-market crisis in late 1987, the fall in equity prices being regarded as equivalent to a tightening of monetary conditions. In these circumstances, a relaxation of monetary policy was deemed necessary to prevent a collapse of confidence. The easier stance of policy was maintained into 1988. Interest rates were cut further as upward pressure on sterling persisted despite shrinking international interest differentials and sizeable official intervention in foreign exchange markets (Diagram 9). Although some indicators, notably narrow money, and house and asset prices, pointed to emerging inflation pressures, the strengthening exchange rate was thought to indicate appropriately tight monetary conditions.

(Diagram 9. Interest rates and exchange rates)

29. In the middle of 1988, there was mounting evidence that monetary policy was too loose and had been so for some time. Beginning in June, the authorities took advantage of adverse sentiment towards sterling to raise interest rates gradually. But it was only in August, and again in November, when it had become increasingly clear that domestic demand was continuing to grow excessively, that interest rates were increased further even though the exchange rate was moving upwards. There are now first signs that the marked tightening of monetary policy has begun to bite: prices and turnover in the housing market have turned downwards, mortgage borrowing has declined, and growth of narrow money has slowed down towards its target range (see below). The authorities have made it clear that interest rates will stay as high as necessary for as long as necessary to reduce inflationary pressures and have reconfirmed their commitment to not accommodating increases in domestic costs by exchange rate depreciation. More recently, downward pressure on sterling due to falling interest differentials against major countries and changing market sentiment has been met by massive official intervention in foreign exchange markets and a further rise in interest rates (in late May 1989).

30. The expansion of narrow money (M0, mainly notes and coins in circulation) overshot the 2 to 6 per cent target range set for the financial year ending in March 1988 but remained below the top of the band on a seasonally adjusted basis. Throughout the following twelve-month period M0 growth stayed above the (lowered) target zone of 1 to 5 per cent. Seasonally-adjusted data suggest that most of the rise of more than 6 per cent over the year to March 1989 occurred before September and that M0 growth continued to move towards the (unchanged) target band at the beginning of the current financial year. Year-on-year growth rates of unadjusted data, though distorted by the unwinding of the effects of a postal dispute last autumn, confirm the impression of a slowdown in narrow money growth in line with consumer spending. The marked flattening in the upward trend of the income velocity of M0 in 1988 does not, however, support the proposition that the relationship of narrow money to nominal income is more stable than that of broader monetary aggregates.

31. Broad aggregates have reacted less to the tightening of policy in mid-1988. After some deceleration late in the year, their rates of growth have moved back to previous peak rates. Growth of M3 had accelerated to more than 20 per cent in 1987, as building societies shifted to holding a greater proportion of their liquid assets in the form of bank deposits, and has fluctuated at around this rate since. Twelve-month growth of M4, which includes deposits held with banks and building societies, has been drifting upwards over the past few years to reach 18 1/2 per cent in September 1988 and again in March 1989. Among the counterparts to broad money, sterling lending by banks and building societies to the private sector has of late moderated only marginally from 1988 peak rates of almost 25 per cent (Table 8). This reflects continued high lending to businesses, as takeover and merger activity and capital spending have remained buoyant. Companies are likely to be influenced by longer-term borrowing costs, which have risen little (see below). However, higher interest rates already appear to have affected borrowing by the personal sector, which has become more highly geared, paying now more in interest on its floating-rate liabilities than it receives on its floating-rate assets. Consumer credit expansion has slowed down markedly. Mortgage borrowing, which accounts for the bulk of personal credit, fell back sharply following the ending of multiple tax relief on mortgages in August 1988; notwithstanding some recovery most recently, underlying demand would seem to have weakened significantly in response to higher mortgage costs.

(Table 8. Formation of money supply)

32. Since 1986, the Government's funding policy has been aiming at a broadly neutral impact on liquidity. Originally based on M3, the "full fund" rule has been defined in terms of M4 since the 1988 Budget: the authorities now seek to fund the aggregate of the net total of maturing debt, the public sector borrowing requirement, and any underlying increase in foreign exchange reserves by sales of government debt outside the banking and building society sectors. Should this total become negative, so-called "unfunding", i.e. purchases of debt, will be required. Virtually full funding was achieved in 1987/88 (in terms of M3, Table 8), notwithstanding the authorities' decision that massive exchange market intervention in this period did not need to be sterilised within the financial year. In 1988/89, public-sector operations had a contractionary effect on liquidity as the liquidity drain from the rapidly-rising budget surplus more than offset liquidity injections

from the diminished accumulation of foreign exchange reserves and considerable repurchases of public debt.

33. Funding developments, and in particular the fact that much of the redeemed government debt has been of longer maturity, may have contributed to the emergence of a sharply downward sloping yield curve. Indeed, despite the steep rise in short-term rates (from a low of 7 1/2 per cent in May 1988 to 13 per cent in November and 14 per cent in May 1989), longer-term interest rates have remained within the 9 to 10 per cent range. The influence of government debt management on this relative stability, which has been a feature of recent years (Diagram 9), is difficult to quantify. Empirical work (3) has generally revealed little impact of the quantities of bonds issued on yields, and the effect of changes in outstanding amounts of bonds of a particular maturity is hard to gauge, all the more so as the decline in sales in government securities has been accompanied by a rise in non-public sector fixed-rate sterling bonds. Allowing for this, government funding may have had only limited bearing on the position and shape of the yield curve. Econometric evidence (4) points to a diminishing impact of changes in short-term on long-term rates. This implies that monetary authorities, while retaining significant control over short-term rates, have less influence on long-term rates. Another, not necessarily alternative, interpretation of the sharply downward sloping yield curve is that the authorities have instilled confidence that the rate of inflation will remain in a relatively narrow band over the medium term. Indeed, the differential between conventional and index-linked government bond yields indicates that inflation expectations have remained relatively stable within a 5 to 6 per cent range. OECD research (5) suggests that the inflation-risk premium demanded by savers investing in bonds may be influenced by the development in the public debt or public expenditure burden, which have shown a substantial decline in the case of the United Kingdom (see below).

Substantial budget surplus

34. In the context of the Government's strategy, fiscal policy is considered an inappropriate instrument for short-run demand management, though account is taken of the economic situation in setting the budgetary stance each year. As noted in last year's Survey, at the time of the introduction of the March 1988 Budget, there was a case for fiscal tightening as the economy was rapidly approaching full capacity limits. On the other hand, the budget was already in surplus, and the Government was committed to further tax reform. In the event, the Budget provided for tax cuts of about 1 per cent of GDP (compared to an indexed base). With continued expenditure restraint, this was projected to leave the surplus broadly unchanged from the year before.

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3. See e.g. C. Goodhart and D. Gowland, "The Relationship Between Long-Dated Gilt Yields and Other Variables", Bulletin of Economic Research, Vol. 30 (1978), No. 2.

4. D. K. Miles, "Recent Developments in the Pattern of U.K. Interest Rates", Bank of England Discussion Papers, No. 36, February 1989.

5. Economies in Transition. Structural Adjustment in OECD Countries, OECD, Paris 1989.

35. According to provisional estimates, the Public Sector Debt Repayment (PSDR -- the budget surplus) in the financial year 1988/89 (ending in March) amounted to £14.3 billion (about 3 per cent of GDP), as compared with projections of £3 billion and £10 billion in the 1988 Budget and Autumn Statement, respectively; excluding privatisation proceeds, which were almost £2 billion higher than initially planned, the public sector's net financial asset/liability position is estimated to have improved by as much as £7.3 billion compared to an initially-budgeted deterioration of almost £2 billion. Much of the higher net repayment of debt comes from extra tax receipts (Table 9), due to higher-than-forecast growth of nominal GDP (11 per cent instead of 7 1/2 per cent, with higher inflation accounting for three-quarters of the difference). Indeed, despite substantial cuts in personal income tax rates, the non-oil tax/GDP ratio fell only marginally, compared with expectations of a broadly stable tax burden. Higher growth also led to expenditure saving, through reduced spending on social security and employment programmes, and through improved finances of public corporations. This largely offset extra spending for pay settlements and capital grants. Tight expenditure control meant that little use had to be made of the budgeted reserve. As budget appropriations were in general not adjusted for higher inflation, general government expenditure (excluding privatisation proceeds, which in the Budget are treated as negative expenditure) dropped by about 2 per cent in real terms, instead of rising as projected; relative to nominal GDP, its level fell by 2 percentage points to 39 1/2 per cent, as compared with a Budget forecast of a fall of half a point.

(Table 9. Budgetary developments)

36. Although, in keeping with their medium-term strategy, the authorities ruled out a midyear adjustment to the Budget in the face of excessive domestic demand, public expenditure trends and plans, as revealed by the Autumn Statement of November 1988, implied a tightening of the fiscal stance. In spite of a significantly higher price level, general government expenditure (excluding privatisation receipts) for the present financial year 1989/90 was kept broadly unchanged relative to previous plans; within the unchanged total the Government was able to accommodate claims for increased spending on health and education by using expenditure savings on account of lower unemployment and by reducing the unallocated reserve. Expenditure targets for the early 1990s, however, were revised upwards compared with previous plans. With inflation projected to come down, this is expected to allow a significant rise in real terms. As a ratio of GDP, general government expenditure would continue to decrease, because of a falling interest burden brought about by reductions in net public debt. Debt interest declined as a proportion of GDP from 5 per cent in 1981/82 to 3 3/4 per cent in 1988/89 and is projected to fall further to 2 3/4 per cent by 1991/92.

37. The March 1989 Budget was introduced against the backdrop of rising inflation and a high external deficit on the one hand, and tentative signs of a slowdown in domestic demand on the other. In view of the considerable uncertainties about the extent of the prospective slowdown, the authorities, while reaffirming the principle of a balanced budget, decided to budget a surplus similar to that recorded in the preceding financial year (Table 9). Excluding privatisation proceeds (put at £5 billion), the PSDR is expected to rise by some £2 billion, to around £9 billion (just under 2 per cent of GDP). Spending plans are those set out in the Autumn Statement and in more detail in

the January 1989 public expenditure White Paper. In spite of markedly falling debt interest payments, the growth in general government expenditure (excluding privatisation proceeds) is projected to accelerate to 7 per cent. At the same time, the rise in government receipts is expected to slow in line with that of nominal income, with tax measures merely offsetting real fiscal drag.

38. Adjusting for the net cost of indexing tax rates and allowances, Budget measures are estimated to reduce taxation and national insurance contributions by about £2 billion in 1989/90. Apart from the indexation of income tax thresholds and allowances, the measures include: non-indexation of most excise duties to damp retail-price inflation; improvements to personal equity plans and employee share schemes to encourage saving; reduction of the corporation tax burden for small companies; further reduction in tax privileges for company cars; increases in VAT to comply with the European Court's judgement; more favourable tax treatment of unleaded petrol; reform of the taxation of life insurance and changes to the unit trust tax regime; abolition of the earnings limit for pensioners; and reform and reduction of employee national insurance contributions. The last two measures should encourage new entrants to the labour market (see below); becoming effective only in October, they will nearly double the budget cost of the tax package in the following financial year.

39. The priority accorded to reducing the fiscal deficit and the emergence of macro-imbalances have so far precluded a substantial reduction in the overall tax burden. After changing little in the first half of the 1980s, the general government financial balance on a national accounts basis, which is unaffected by financial transactions such as privatisation proceeds, improved by almost 5 per cent of GDP in the four years to 1988, with about two-thirds of the change reflecting a higher level of economic activity. The move from a deficit of 4 per cent of GDP in 1984 to a surplus of 3/4 per cent of GDP in 1988 resulted from a decline in the GDP shares of expenditure and revenue by 7 and 2 percentage points, respectively (Diagram 10). The fall in the overall revenue ratio is largely attributable, though, to lower oil prices and output. The ratio of non-oil tax revenue (including social security contributions) to non-oil GDP decreased only marginally over this period and remains about 2 1/2 percentage points above the level of the late 1970s. However, as argued in last year's Survey, the tax system has been made somewhat more efficient over the last few years. Progress in reducing the fiscal deficit in the first half of the 1980s was hampered by a high share of interest outlays in public spending. Indeed, the primary budget balance, which excludes net interest payments, had already moved into surplus in the early 1980s. Net government debt had declined as a proportion of GDP during the 1970s because of high inflation rates but remained at a high level (Diagram 10). With the fiscal balance moving into surplus, the fall in the debt/GDP ratio has become more pronounced. Although its present level of about one-third is the lowest since the First World War, it is still above that of many other Member countries, including Japan, Germany and France, and about the same as in the United States.

(Diagram 10. General government finances)

Continued supply-side reforms

40. Supply-side reforms continue to play a central part in the Government's overall economic policy to promote non-inflationary economic growth. Last year's Survey gave an overview of the numerous measures which had been taken to promote the functioning and flexibility of markets. Part V of the present Survey examines in some detail how the Government has attempted to increase the efficiency of the public sector, including privatisation and proposed changes to the delivery of health care. Recent measures comprise changes in taxation to reduce efficiency losses of financing public expenditure, labour market policies, and proposed deregulation in product and financial markets.

41. The 1989 Budget continued the tax reform programme by restructuring the National Insurance system, widening the tax base, and harmonising the tax treatment of different forms of savings. The social security reform, which is confined to employee contributions, aims at easing distortions on work-leisure decisions at the lower end of the income scale. A single rate of 9 per cent with an initial allowance, plus a lump-sum tax payment once an earnings limit is reached, replaces a system where employee contributions were determined by applying three different earnings-related rates to total earnings after a threshold had been passed. This still results in a sudden increase in tax liability once a relatively low earnings limit is reached, where the marginal tax rate exceeds 100 per cent, but further spikes on the contribution rate function have been eliminated. The tax base has been broadened somewhat for both direct and indirect taxes. Tax privileges on income in kind (such as company cars) have been further reduced. Unchanged upper limits on mortgage relief in nominal terms and the introduction of a (price-indexed) limit on tax-privileged pensions reduce the scope for using these tax breaks. This should limit tax-motivated investment in such forms of savings. Further measures have been taken to stimulate share ownership in general and in particular for employees taking a share in their own company.

42. Building on previous reforms, recent labour-market measures have been aimed at increasing flexibility, enhancing training and education, and limiting trade-union power:

-- Labour-market flexibility. The 1988 Employment Act repeals most legislation that still discriminates in employment and training matters between men and women. It also removes numerous restrictions on the hours of work of 16 to 18 year-olds, and eases rules governing dismissal of staff.

-- Training. In September 1988, the Government introduced the new Employment Training programme for the long-term unemployed, which subsumes the Community Programme and other adult training schemes. Employers have been reluctant to participate in the scheme so far and there are 175 000 people taking part in the programme instead of the 600 000 originally envisaged. A White Paper on the future course of training (Employment for the 1990s) envisages major organisational changes in the provision of skill acquisition. Centralised government-led training is to be replaced by local employer-led groups which will form a national network of training and enterprise councils to plan and deliver training. Existing training programmes will continue but under the responsibility of the new councils, which will be mainly financed from the current training budget.

-- Education. The Education Reform Act 1988 provides for fundamental changes in the way young people will be prepared for working life. It introduces a common core curriculum with stronger emphasis on work-related subjects than before, and standardised assessments on students' progress at various stages. The implementation of the Act could run into difficulties owing to lack of qualified teachers in the new subjects. Special recruitment efforts have so far had little success.

-- Limitations on trade-union power. The 1988 Employment Act continues the process of increasing the accountability of union officials to their members. It also removes legal immunities from strikes in support of a closed-shop system (which covered an estimated 3.6 million employees in 1984) and repeals remaining legal protection for the post-entry closed shop. A policy discussion document envisages a further weakening of the closed-shop system and greater limits on lawful secondary industrial action.

43. The Government has proposed major deregulation measures in some parts of the product market, in addition to measures discussed in Part V of the Survey:

-- Legal services. Key features of the reform of legal services, proposed in January 1989, include ending restrictive practices in advocacy, especially the termination of a "closed shop" in presenting cases in front of judges; increasing the competition in conveyancing by opening up the market to all institutions with qualified personnel; and reforming price setting of legal services by lifting restrictions on contingency fees. To pre-empt Government legislation, the group most affected has already announced some relaxation of restrictive practices.

-- Broadcasting. Proposals to liberalise the commercial broadcasting market include the establishment of new channels; selling of broadcasting licences by competitive tender rather than awarding them on the sole judgement of a regulatory body; and the removal of takeover protection of independent television companies, although the government will remain in control of takeovers.

44. Some progress has been made in dismantling trade barriers over recent years but, despite the Government's commitment to free international trade in goods and services, significant import impediments remain in operation. For example, the United Kingdom has about 600 bilateral arrangements under the Multi-Fiber Agreement. Moreover, there are a number of bilateral industry-to-industry arrangements limiting imports of motor vehicles, household electronic goods, steel products and numerically-controlled machines (for details see Annex I) .

45. The Government has continued the deregulation of financial markets as well as the development of the rules governing the provision of financial

services. As from last August, building societies are allowed to provide a wider range of services, thus enhancing competition in retail financial services. The 1989 Budget removed the Bank of England's control on the timing of new issues in the equity and bond market. The regulatory regime for sterling commercial paper and short-term corporate bonds is also to be significantly liberalised. The 1986 Financial Services Act, which sets up the ground rules for regulating the provision of financial services, came into full operation in April 1988. It has become apparent that the regulatory framework was too complex with excessive cost of compliance. In response the Government has proposed an amendment to the Act, which should simplify the rules and lower the burden of compliance. The Securities and Investment Board, the regulator of the financial industry, has continued to develop further rules to protect investors, including detailed disclosure rules.

III. What kind of slowdown?

External environment and main assumptions

46. Growth in the OECD area has been much more buoyant than expected a year ago. The tightening of monetary policies in major countries in response to increasing inflation should, however, slow the expansion of demand. The latest OECD projections, published in June, put annual output growth in Member countries at just under 3 per cent over the next eighteen months and export market growth for United Kingdom manufactures at just below 7 1/2 per cent on average, with some deceleration during the projection period. Delayed effects from the earlier rise of sterling and some deterioration in international competitiveness in the period ahead, on the technical assumption of unchanged exchange rates, are expected to entail some loss in export market shares. The oil price assumption is $16 per barrel as from the first half of 1989, with no change in real terms thereafter. The downward trend in oil exports is assumed to be temporarily interrupted as output recovers from the effect of accidents.

47. Macroeconomic policies are assumed to remain tight. The authorities have made it clear that interest rates will stay as high as necessary for as long as necessary to reduce inflation pressures. And they have reaffirmed that the Government is not prepared to accommodate increases in domestic costs by exchange-rate depreciation. Accordingly, only a slight fall in interest rates is assumed to occur by the end of 1990. This should bring the growth of narrow money (M0) back into the 1 to 5 per cent target range during the course of this year. In line with Budget plans, discussed above, the general government financial balance is projected to remain in substantial surplus, stabilising somewhat below 2 per cent of GDP in 1990. This implies a further tightening of fiscal policy this year and a broadly unchanged fiscal stance thereafter.

Short-term prospects

48. The progressive tightening of policies since the middle of last year should be increasingly felt during the course of 1989. As foreshadowed by business surveys and other leading indicators, the rate of growth of domestic demand is likely to drop markedly (Table 10), to below that of potential output. With inflation pressure subsiding only slowly (see below), the increasing household debt-servicing burden, smaller tax adjustments, and the petering-out of employment growth are expected to moderate the rise in personal real disposable income. At the same time, the downward trend in the personal saving ratio over the 1980s may well be reversed as households, on

average, are more heavily geared than in the past and hence more sensitive to high and rising interest rates. Spending on durables and housing investment are therefore projected to drop. Companies are more likely to be influenced by longer-term borrowing costs, which have risen little. Hence, business capital spending should hold up better in the near term. Indeed, investment intentions have remained robust. Yet, the weakening of household spending along with some squeeze on profit margins is expected to damp business investment in 1990. The recovery has been characterised by a run-down in stock/output ratios reflecting technical improvements in inventory management as well as high real interest rates. Hence, the recent build-up of inventories seems to have been partly involuntary and may be unwound in the period ahead, contributing to the projected slowdown in domestic demand.

(Table 10. Short-term prospects)

49. Export growth will be enhanced to the extent that there is less diversion of output to meet strong domestic demand. However, any such capacity effect will probably be limited by worse competitiveness. Import growth is expected to slow down markedly in response to the cooling of domestic demand and easing of capacity constraints. Still, the resulting improvement in the real foreign balance is projected to be temporary only. With weaker domestic demand and a continued, though much slower, contraction of real net exports, growth of GDP is likely to decline to around 2 per cent in the course of 1990. This compares with an estimated growth of productive potential of some 3 per cent, and would thus imply a significant easing of pressures on resources.

50. In response to slower output growth, the increase in employment is projected to slacken, possibly giving way to some labour shedding in the course of 1990 as companies react to a squeeze in their profit margins. The rise in labour-force participation rates shown by revised statistics is expected to come to a halt. This should limit the effect of slower activity growth on unemployment, although the fall in the unemployment rate since 1986 may go into reverse before the end of 1989. Easier labour-market conditions and reduced overtime payments should lead to a slight downward drift in wage increases in the course of 1990. This year, however, cost pressures could intensify due to the combined effect of higher wage increases and temporarily lower productivity growth. Yet, as demand pressures weaken, this may be offset by shrinking profit margins. With import price increases slowing, inflation should subside, though remaining high by international comparison. Although competitive pressures are expected to limit the rise in export prices, further terms-of-trade gains are projected, partly reflecting higher North Sea oil prices. Any such gains are, however, unlikely to outweigh the continued, though slowing, deterioration of the foreign balance in volume terms. As a result, the current-account deficit may increase slightly, but could fall in relation to GDP after having exceeded 3 1/2 per cent in recent months.

Soft or hard landing?

51. The presented outlook is for a "soft landing", with inflationary pressures subsiding gradually and the external deficit falling gently as a

proportion of GDP without the economy entering a recession. Improvements to the supply side of the economy have increased the chances for such a scenario to materialise. Nevertheless, there remains a risk of a less smooth path of adjustment. In the past, the restoration of macroeconomic stability was typically achieved by a "hard landing" triggered by restrictive policies. This could again occur, in particular if slow progress in reducing tensions and imbalances in the economy undermines market confidence in sterling, and calls for a further sharp tightening of policy. As discussed in Part I, large discrepancies in national accounts statistics and erratic indicators in recent months make an assessment of the economic situation difficult. But the risk that policies have been tightened too much appears minor. The greater risk would seem to be that the buoyancy of demand conditions and extent of inflation embedded in the system -- or of the policy tightening needed to bring it under control -- have been underestimated.

52. The projected moderation in consumer spending is critical to the further course of the economy. Uncertainties surrounding the saving behaviour of households are considerable, however. Research suggests that because of changes in the financial position of the personal sector and increased competition in the provision of financial services consumer expenditure is now more responsive to variations in interest rates than it was in the past. However, given the recent nature of these changes, there are inevitable uncertainties attached to consumers' reactions to movements in interest rates. The same is true for the interaction between housing wealth and consumer spending. Hence, the personal saving ratio may not recover as projected. In this case both price pressures and the external deficit would be exacerbated. This could unsettle foreign exchange markets. It is also unclear how far the erratically high rate of retail price inflation, attributable to the impact of sharply higher mortgage interest rates on the index, will spark off a price-wage spiral. In any case, continued labour-market tightening would be incompatible with the projected fall in wage and price inflation.

IV. The post-1979 cycle in perspective

53. With a period of policy-induced economic slowdown in prospect and, indeed, called for in view of the tensions and imbalances in the economy, the post-1979 cycle can now be put into a longer perspective. As the performance of the United Kingdom economy since the present Government first took office in 1979 was reviewed in some detail in last year's Survey, the following section is confined to an updating and reassessment of previous findings. After recapitulating briefly the Government's strategy, it confronts objectives with achievements, highlights the main features of the post-1979 cycle as compared to past experience and that of other Member countries, and concludes with a discussion of the macroeconomic adjustment problem facing the authorities.

The strategy

54. The prime objective of the Government's economic policy has been to bring down inflation while improving output and employment conditions over the medium term. Macroeconomic policies have been formulated within a nominal framework, the Medium Term Financial Strategy (MTFS), the tenth version of which was set out in the 1989 Budget. The MTFS has been complemented by policies designed to improve the working of markets and supply performance. While the ultimate goal of policy has not changed, intermediate objectives have been adjusted in response to changing circumstances. Originally, the emphasis was on tight monetary growth targets, then defined with respect to broad money, and supporting reductions in public sector borrowing. Later on, more attention has been given to nominal GDP growth and to the exchange rate. Over time, there has been a shift to a more judgmental approach to policy-making, with the discretionary use of interest rates guided by an eclectic array of indicators. Reduced emphasis on monetary targets reflected the fact that, following the abolition of exchange controls and other measures of financial liberalisation, the signals provided by broad money had become increasingly unreliable. The income velocity of narrow money (M0, the only remaining targeted monetary aggregate) has shown greater stability over the past decade. However, as noted in Part II, this has not excluded short-term fluctuations. Indeed, as financial innovations appear to have led to significant shifts of demand for narrow money, the relative stability of M0 velocity may be the result of offsetting influences, reducing its usefulness as a guide to policy. Using the exchange rate as an anchor for policy seems equally problematic, as witnessed by last year's experience.

55. In contrast to monetary targets, which have proved difficult to meet, the intermediate objective of fiscal deficit reduction has been achieved earlier and more strongly than initially envisaged. This has prompted the authorities to move from a medium-term objective of deficit reduction to a long-term objective of balanced budget. In some measure the move of public finances into surplus reflects the fact that greater weight is now accorded to

the state of the economy in the operation of fiscal policy. While the budget stance was tightened during the recession of the early 1980s, automatic stabiliser effects have been only partly offset in later years; and, in the latest MTFS, it has been explicitly stated that cyclical conditions warrant a deviation of the budget balance from the previously announced medium-term path.

56. Following notable successes in the early 1980s in bringing down inflation, the associated downward trend in the growth of nominal GDP, the key intermediate objective, has not been sustained (Diagram 11). In fact, in recent years, nominal GDP has increasingly overshot the projected path, growing by around 11 per cent in both 1987/88 and 1988/89 instead of decelerating towards 6 per cent as postulated in the 1986 MTFS. While initially this was due to both higher-than-expected output and price increases, it has subsequently reflected mainly rising inflation. As a result, the inflation/output split has worsened markedly. This has been the consequence of excessive demand growth during the last phase of the economic upturn, following upon a pronounced improvement during the early 1980s. Measured from peak to peak, the division of nominal GDP growth between output growth and inflation was much more favourable over the 1979/88 period than during the 1973/79 cycle and similar to earlier experience, suggesting that there have been policy-induced improvements in supply performance.

(Diagram 11. The nominal income split)

Main features of the 1979-88 cycle

57. Other economic indicators generally confirm this picture: the deterioration in performance in the 1970s has been reversed; and, compared with other Member countries, there has been a relative improvement. Other salient features are:

- **Economic growth** during the 1981-88 recovery, at over 3 per cent per annum, was not outstanding compared to previous upswings, but the upturn was unusually long (Table 11). Given the preceding fall in output, growth over the whole 1979/88 cycle, at just over 2 per cent per year, was significantly higher than during the preceding cycle, but fell short of the previous long-term trend rate, in spite of positive contributions from the oil sector. While exceeding rates recorded in France and Germany, GDP growth remained below the G7 average, but much less so than in the past (Table 12).

- Despite exceptionally sharp job losses in the downswing of the early 1980s, **employment** gains over the the 1979/88 cycle slightly surpassed the long-term average, as self-employment and part-time work increased strongly. But this did not prevent a strong rise in **unemployment**, which doubled both for the average of and during the cycle. After exceeding the OECD average by a large margin up to 1987, the rate of unemployment has since dropped sharply and is now running at just above the OECD area rate and below that of France, Italy, and Canada among the other major OECD countries.

- Nominal wage increases have come down considerably since the 1970s, when they moved up parallel to unemployment. The same is true for **price inflation**, which was much lower during the 1981/88 recovery than during the two preceding upswing periods. However, the disinflation process of the early 1980s could not be sustained. While remaining above the levels of the early 1960s, inflation has, however, tended to exceed the OECD average by much less than previously.

-- Contrary to the preceding cycle, the **external balance** was in surplus in the 1979/88 period as a whole, allowing the accumulation of sizeable net overseas assets. However, the swing into deficit during the last two years was large by historical standards. As discussed in Part I, this reflected not only the dwindling oil surplus but also persistent deterioration in non-oil trade performance: while losses in export market shares have slowed, there has been virtually no reduction in the growth of import penetration (Table 11).

-- **Labour productivity** advances during the latest upturn were not exceptional but, taken over the whole 1979/88 cycle, they were much higher than during the preceding one and broadly in line with the long-term trend. Productivity gains continued to fall short of the G7 average, though significantly less so than previously as productivity performance abroad remained broadly unchanged (Table 12). Measurement problems could mean that non-manufacturing and economy-wide productivity gains are understated, but this may also be the case for other countries. Growth in labour productivity in manufacturing over the last decade has been impressive, outstripping by a wide margin both the previous United Kingdom trend rate and the G7 average. This favourable performance reflected substantial labour-shedding, notably in the early 1980s. In fact output growth was rather modest, despite the recent upsurge. In some service industries, significant increases in part-time work reduced output per person employed relative to output per hour worked; the opposite was the case, however, in manufacturing, as overtime work increased. The scope for catching up with high-productivity countries has probably contributed to the United Kingdom's good performance. Yet, as noted in last year's Survey, the negative labour productivity differential against other major Member countries is significantly reduced when measured per hour.

-- With a parallel improvement in the trend of capital productivity, the growth in **total factor productivity** is estimated to have more than doubled as compared to the 1973/79 cycle -- the most pronounced gain among major Member countries -- and may have reached an annual rate of around 1 1/2 per cent in recent years. Following a sharp fall in the early 1980s, **business investment** has recovered strongly over the last few years, to a historically high level in relation to GDP. With rising growth in total factor productivity and capital formation, **potential output** growth is estimated to have recovered to around 3 per cent more recently. As noted in Part I, improved efficiency has contributed to the steep rise in business profits and restoration of rates of return on capital to pre-1973 levels.

(Table 11. Economic performance indicators)

(Table 12. Comparative performance indicators)

The need for adjustment

58. Notwithstanding improved supply performance, excessive demand pressure on resources has developed over the past few years, as evidenced by the acceleration of inflation and the large current-account deficit. Internal and external imbalances ensuing from the extraordinary buoyancy of domestic demand in 1987-88 boosted profits and put upward pressures on wages. As the economy slows down, these pressures should abate, but neither official nor OECD projections see the inflation rate coming down substantially in the near future. Indeed, following the sharp fall in the early 1980s, inflation remained obstinately high at an underlying rate of some 5 per cent. This resulted from remarkably stable earnings growth, with the underlying rate stuck at just under 8 per cent, and underlying productivity growth of somewhat over 2 per cent. A continued decline in inflation in line with the Government's MTFS would seem to require significant margins of idle capacity and labour market slack.

59. The recent deterioration in the external position is also to a considerable extent a reflection of demand pressures, with strong growth in import-intensive components of domestic demand, such as business investment and consumer spending on durables, leading to an upsurge in imports. As public-sector finances have moved into surplus, the weakening external balance has, as its counterpart, a pronounced swing in the private sector's financial balance into sizeable deficit (Diagram 12). This reflected both a recovery of private investment and a decline in total private sector savings, stemming from the steep fall in the personal saving ratio. The strengthening of public-sector finances is the result of a trend decline in investment and, most recently, a pick-up in public savings. As discussed in Part I, the decline in personal savings has a variety of causes, including rising personal wealth combined with easier access to credit because of financial liberalisation. Although the personal debt/income ratio should tend to stabilise, the influence of some of these factors may persist for some time. And the rise in business-sector savings, which has partly offset the fall in personal savings, is unlikely to continue. Hence, high public savings may be required to maintain the level of national savings and avoid a still larger current-account deficit.

(Diagram 12. Savings/investment balances)

60. As the emergence of the external deficit has not been associated with a weakening of public finance, or public sector deficits for that matter, the authorities have been concerned only to the extent that it reflected inflationary demand pressures. According to this view, external deficits emanate from private-sector investment and saving decisions, and capital will be imported from overseas whenever investment opportunities are greater than domestic savings. In these circumstances, the role of fiscal policy is considered to be limited, the task of alleviating demand pressures falling on monetary policy. However, there are two considerations which might call for a more active involvement of fiscal and budgetary policy in either redressing private sector savings/investment balances or in compensating for insufficient domestic saving. First, there are important elements in the fiscal system which have a bearing on private saving-investment decisions and their weight

has grown with financial liberalisation. Secondly, if the hoped-for self-correcting mechanisms were stretching over too long a period, a creditworthiness constraint could emerge and disruptive exchange market reactions occur. Although the present strong net external asset position should help contain such a risk, discretionary action on the fiscal and budgetary side to raise the national saving ratio would also contribute to sustaining foreign investors' confidence in sterling assets and profitable investment opportunities.

V. Public sector efficiency

61. During the past ten years or so public sector activities have been subjected to critical scrutiny by the Government with a view to raising input/output efficiency and to assess whether a number of traditional public services should continue to be provided and produced by the state or be transferred to the private sector. This reassessment has taken place against the backdrop of budgetary strains and emerging strong pressure on public resources. It has also been part of the Government's drive to improve the overall efficiency of the economy in order to promote non-inflationary economic growth (see Part IV). Apart from distortions introduced into the market economy as a result of financing public provision, there has been heightened concern about possible inefficiencies in public production stemming from the absence of "disciplining" market mechanisms, notably the absence of bankruptcy and takeover threats to management and of competitive pressure. As a result there was a perception that the public sector was claiming more resources than needed and that input factors were being employed sub-optimally. Moreover, the absence of direct charges for most government services or distorted pricing policies made it difficult to adjust adequately supply to social demand.

62. This chapter covers a range of issues related to efficiency in provision of general government services and in public corporations. It does not deal with efficiency aspects of revenue-raising and the political process in revealing public choice. Measures taken during the 1980s to improve input/output relations in the public sector at large and discussed under separate headings which range from management reforms and improved incentive structures to strengthened external monitoring and tighter controls of expenditure and inputs, and from increased competition in provision of government services to large-scale privatisation programmes.

General Government

Productivity measurements: Inputs and outputs

63. The importance of running an efficient government sector is clearly conveyed by the fact that it employs about a fifth of all labour and capital resources in the economy (Table 13). Government claims on labour resources grew rapidly in the post-war period up to the mid-1970s, slowing down thereafter relative to the growth of the labour force. The government share in the economy's total capital stock has also shown a downward trend over the last decade. The distribution of labour resources between main government levels has been relatively stable since the 1960s with local government employment some 20 per cent higher than central government employment (Table 14). The stability of the principal subsectors' shares in the aggregate

masks important changes that have taken place within those subsectors. In central government, the large reductions in the shares of the Civil Service and HM Forces have almost been outweighed by increases in the National Health Service (NHS). Labour resources in local government have been shifted towards the education system. The bulk of general government's capital stock resides with local authorities, reflecting their role in providing accommodation to households, but there has been a trend in the direction of increased shares for central government.

(Table 13. General government claims on resources)

(Table 14. Distribution of resources in general government)

64. The principal problem in assessing productivity trends in government is the lack of data on government output. Present national accounting conventions measure output movements in general government very largely by changes in the numbers employed, which implies no measured productivity growth. This paucity of data on quantitative output partly reflects difficult conceptual problems in defining government output related to its multi-dimensional nature: education involves the acquisition and development of various cognitive and non-cognitive skills; health care includes the alleviation of different sufferings, which vary in the distress and incapacity they create, and the prevention of ill-health; and the police service maintains public order and deters crimes which vary in their severity. Even if data was available on each of the separate components they could not be aggregated by assigning relative values to them as weights because these values are not known in the absence of a well-functioning price system. Moreover, disentangling the effects of government activity from other influences on health conditions, crime, and skills is very difficult. However, imperfect and incomplete proxy indicators of final outputs have been developed. Examination results for school leavers suggest that the education system has been successful in improving the cognitive skills of students, but there are a number of problems of using test results for drawing such inferences (6). A surge in reported crime rates over the last decade suggests that the law and order system has not been successful in its prime objective but it may also reflect that crimes are more willingly reported than before. In the health system, a number of proxy indicators have been suggested but the more sophisticated ones, such as morbidity rates and "quality-adjusted life-year" (QUALY) scores (7), are not available on nationwide basis. Mortality rates indicate that the health system is making progress in improving the health condition of the population.

(Diagram 13. Final output indicators in general government)

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6. On the difficulties of using test results to measure general skills, see e.g. Royal Statistical Society, "Assessment of examination performance in different types of schools", Journal of the Royal Statistical Society, Series A 147(1984), pp.569-581.

7. On QUALY scores, see e.g. M.F. Drummond, "Output measurement for resource allocation in health care", Oxford Review of Economic Policy, 5 (1984), pp.59-74.

65. The difficulty of defining and measuring final outputs in government has focused attention on intermediate or activity indicators. In principle such intermediate output indicators can be constructed for the bulk of government activity. Productivity developments, based on such intermediate indicators, show a varied picture across government (Table 15). In the Civil Service, intermediate productivity indicators for the 1980s suggest an average growth rate for tax collection departments which compares favourably to similar activities in the private sector (8), but claimant-staff ratios in the social security system have grown only moderately. Throughput in the National Health Service has risen sharply over the last decade by any measure (Diagram 14), with the increase in in-patients cases exceeding employment growth by an average of 2.3 per cent a year. Moreover, the sharp fall in the average length of stay in hospitals suggests that capital productivity has increased markedly. In local government intermediate productivity trends appear to be particularly unfavourable. These are dominated by developments in the education sector where demographic factors have reduced school rolls sharply and much faster than resources were retired (Diagram 15).

(Table 15. Intermediate productivity indicators in government)

(Diagram 14. The National Health Service: throughput and resources in hospitals)

(Diagram 15. Primary and secondary state education: pupil-teacher ratios)

Management reforms

a) Management problems and the reform programme in the 1980s

66. Up to the end of the 1970s, efficient resource management in the government sector was rendered difficult by prevailing, sometimes conflicting, management objectives, rigidities in the budget system, and lack of information about resource use. In contrast to the private sector, public sector management objectives have traditionally not been to employ resources in the most cost-effective way in the pursuit of a well-specified objective. An important objective for managers in the public sector has been to stay within detailed cash allocations, but they may also have influenced their allocations in order to maximise their budgets or the number of staff. A common element behind these objectives was that they focused the attention of management on cash outlays for inputs, while the output side was neglected. The outcome for individual activities was rarely quantified and played no role in the annual budget cycle. Rigidity in the budget system, while facilitating expenditure control, limited the ability of top management to transfer funds between blocks and years. Blocks authorised by Parliament were divided up by

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8. See Chapter 6 in M.S. Levitt and M.A.S. Joyce, The Growth and Efficiency of Public Spending, Cambridge University Press 1987.

central units in individual Departments and the Treasury, and passed down the management line in ever finer detail. At the end of the line individual production managers had little opportunity to vary the input mix in order to operate at lower cost. Nor did the control system offer much flexibility in transferring spending between financial years, inviting irrational end-year spending. Lack of management information about economic costs compounded the difficulties stemming from management objectives and budget rigidities. Cash authorisation budgets did not give line managers much information about the resource use and costs involved in carrying out their activities. In stark contrast to private business practice, government budgets did not record the use of resources on an "accrual" basis but only cash transactions. Unfunded expenditures, such as cost of capital services and accrued pension rights, were rarely known to managers.

67. The 1980s have seen major steps by central government to improve management in the Civil Service, the National Health Service, and in certain parts of local authorities' activities. Management reforms in the Civil Service were introduced by the Financial Management Initiative (FMI) in 1982, and the Government has recently launched a new drive for management reorganisation through the establishment of executive agencies (9). The National Health Service (NHS) went through a major re-organisation in the first half of the 1970s, and further reforms took place in 1982. The White Paper on NHS reforms, published in February 1989, envisages further major changes in management practices (10). Local authorities are autonomous in designing their internal management structure, which can vary considerably from one authority to another. Central government can however influence the management systems through legislation, and the Education Reform Act 1988 involves significant management changes in the education system run by local government. Although management reforms in the various parts of general government have differed somewhat, they include a number of common elements. These are greater orientation towards outputs rather than inputs, improved cost information to all levels of management, and devolution of operational decision making to production managers.

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9. See Treasury and Civil Service Committee, Third Report, Session 1981-82, Efficiency and Effectiveness in the Civil Service, (HC 236), HMSO 1982; Efficiency Unit, Improving Management in Government: The Next Steps, HMSO 1988; Civil Service Management Reform: The Next Steps, The Government reply to the Eighth Report from the Treasury and Civil Service Committee, Session 1987-88, HMSO 1988. See also National Audit Office, The Financial Management Initiative, HMSO 1986.

10. See Department of Health, Working for Patients, HMSO 1989.

b) Reorientation of management objectives - performance indicators

68. A necessary first step in the management reform programmes has been to give more attention to outputs in the government sector. This re-orientation has been reflected in the progress of constructing intermediate output indicators, such as throughputs. To avoid the danger inherent in focusing on an indicator which covers only one aspect of the service provided, output indicators are sometimes accompanied by quality measures, such as error rates and the average length of time taken to deliver a service (11). The emphasis on output has been mirrored in the number of performance indicators which Departments report in the annual Government Expenditure White Paper. At the beginning of the 1980s there was no such information, while the 1988 White Paper contained about 1000 indicators requiring output measures while there were fewer than a hundred quality indicators. Progress in constructing such indicators has been greatest for activities involving case work, such as processing documents and providing well-specified services to individuals, but there has been only limited progress in a number of areas, such as for policy-related work.

69. The most common use of output indicators to improve efficiency is to set performance targets for management, and to compare efficiency over time and between comparable units. Performance targets, such as productivity and unit costs, appear to be mostly confined to the Civil Service. Departments are autonomous in setting themselves targets, and the Government Expenditure White Paper contained about 350 such targets in 1988, but the Prime Minister's Efficiency Unit has been given the responsibility to assist Departments in their target setting. There are major difficulties in setting realistic targets for management if its activities are unique, and there will always be an ad hoc element in the process. Ambitious performance targets may give an incentive to managers to improve outcomes, especially if they are backed by an adequate reward system, but over-ambitious targets can lead to unwanted consequences, such as deterioration in the quality of service. The inability of users to switch to an alternative supplier could mask such a deterioration. Performance comparisons across similar units are systematically carried out for local authorities and regional health services and for a number of activities in central government. Such comparisons typically reveal large variations in efficiency and unit costs, pointing to significant scope for efficiency improvements. However, such differences may reflect different client mixes rather than productivity differences (12). For example, variations in pupil-teacher ratios across school authorities are often the

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11. On the progress in constructing performance indicators in government, see S. Lewis (ed.), Output and Performance Measurement in Central Government: Progress in Departments, Treasury Working Paper No. 38, HM Treasury 1986; P. Durham (ed.), Output and Performance Measurement in Central Government: Some Practical Achievements, Treasury Working Paper No. 45, HM Treasury 1987.

12. See e.g. Levitt and Joyce, op.cit.

result of different socio-economic backgrounds of students rather than productivity differences. Nonetheless, performance comparison is a useful monitoring device, and improved analytical comparison techniques (13) and improved information systems should enhance its status in the future.

c) Improved information - management budget systems

70. The drive towards making managers at all levels more cost-conscious has centred around the introduction of management accounting systems throughout central government organisations. In contrast to the conventional cash allocation budgets, these systems seek to record the cost of resource use and relate costs to outputs and the aim of production. These management budget systems are discussed in Annex II. Despite continuous refinement in the 1980s, these systems still have limitations with respect to coverage of resource use and the extent to which costs are apportioned down the management line. Information about labour costs is readily available and managers in the Civil Service know about the accommodation costs they are incurring due to the practice of charging Departments market-based rents. The cost of using other assets is rarely known as they are used free of charge. Indeed, there is only scant information about the asset position of the government due to the lack of proper balance-sheet accounting. Departments have been asked to prepare comprehensive asset registers, and the proposed NHS reforms involve charging hospitals for their use of capital and land, thus requiring detailed asset records. While significant progress has been made in apportioning costs down the line, in large areas of government there is still much to be done in relating costs to individual activities. For example, hospital departments may have good information about aggregate costs incurred but have difficulties in apportioning them to different types of treatments. The Resource Management Initiative (RMI) has taken first steps in linking information about the diagnosis of patients and the cost of treatment. As a part of the proposed NHS reforms, the Government intends to involve a significantly greater number of hospitals in the RMI and a precondition for self-governing status of hospitals is adequate costing of treatment.

71. Management accounting systems have not yet been integrated with the annual resource-bidding process. Physical output indicators played no role in the annual budget cycle in the initial stages of the management reform programmes, but starting from 1987 Departments have been asked to support their initial bids ("baseline expenditures") with output and performance

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13. The analytical comparison methods include deviations from a conditional mean derived from standard regression models and deviations from an estimated maximum obtained by data envelopment analysis. For a survey of how these techniques have been used in the United Kingdom, see M. Barrow and A. Wagstaff, "Efficiency Measurement in the Public Sector: An Appraisal", Fiscal Studies 10 (1989), pp.72-97.

measures. Any proposals for additional resources must be supported by information on what indicators and targets for outputs will be used to evaluate their use. Most Departments have made only limited progress in translating their spending plans into physical output and resource use, although there are notable exceptions (see Annex). However, there are inherent difficulties in reconciling management accounting systems and appropriation accounts. This is most visible for capital expenditure where management accounts record the use of capital services for specified periods while the appropriation accounts register no user costs. As management systems become more comprehensive in terms of costs covered, it will be increasingly difficult to reconcile the two control systems. While it is possible to look at them side by side, it involves the risk of managers receiving different signals about resource use. In particular, there may be a danger that unfunded resource costs will play a smaller role in management decisions than funded ones (14). Appropriation accounts were abandoned a long time ago in the private sector, as they were considered to be inadequate management tools. It may be necessary for the government to switch to accrual-based accounts to reap the full benefits of improved management information systems.

d) Devolution of operational decision-making

72. The rational for decentralised operational decision making is that line managers have better information than the centre to adjust the input mix to improve services to clients and to lower costs than the centre. The ultimate aims of the management reforms in the Civil Service and the National Health Service have been to devolve operational decision making down the line to production managers while at the same time making managers more accountable for their decisions. The construction of performance indicators and management budget systems has been a necessary prerequisite for combining flexibility at lower levels of management and tighter internal monitoring by senior managers. Some progress has already been made in giving line managers more flexibility in managing resources. For example, the Civil Service now contains about 1500 budget holders with some freedom to switch expenditures from one component to another (15). The extent of the devolution differs markedly between different Departments. Most of them allow managers to switch between grades of personnel, and some allow switching between labour costs and other running costs, while switching between running costs and capital expenditure is rarely permitted.

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14. See Chapter 13 in R.N. Anthony and R.E. Herzlinger, Management Control in Nonprofit Organizations, Revised Edition, R.D. Irwin 1980.

15. For a survey on devolution in the Civil Service, see Budgeting. Second Report on the Implementation of the Recommendations of the Multi-Departmental Review, Vol. II, HM Treasury 1988.

73. However, it would appear that discretionary power of production managers to manage resources is still rather limited. There are three reasons for this. **First**, effective devolution is severely circumscribed by the common industrial-relations policy across large segments of Central Government. Thus, pay and employment conditions are determined in bargaining between civil service unions and central departments, with limited influence from line managers on the process. Also, recruitment of staff to the middle and higher levels of the Civil Service has been centralised, thus limiting the extent to which line managers could directly employ qualified staff. **Secondly**, production managers have been reluctant to assume the responsibility of budget holders. This has been most pronounced in the National Health Service, where devolution has so far stopped short of turning the majority of doctors into budget holders, as they fear it would compromise their clinical autonomy. **Thirdly**, there has been some hesitancy in relaxing rigidities in the budget system for fear of losing control over total expenditure. For example, devolving responsibility for pay negotiations to line managers could weaken the governments' ability to withstand pressure from centralised public sector unions. On the other hand, it might also assist the government in its aim to link public sector pay to local labour market conditions (see below). Limited progress has been made in allowing greater flexibility of transferring funds between blocks authorised by Parliament or between financial years. And Departments have been reluctant to devolve budgets down the line.

74. A number of measures have recently been taken to increase devolution of operational decisions across general government. In the Civil Service, the "Next Step" initiative will give an impetus to devolution by transferring executive work of the Service to Executive Agencies. The agencies are intended to have significant autonomy in day-to-day operations while still remaining part of central government and subject to Parliamentary spending control. The chief executive of each agency will make a "contract" with his Minister, specifying in detail the tasks of the agency and how its performance should be measured. The agency is then expected to be run along commercial lines, with the chief executive having significant power in staff management. Three such agencies have already been established (covering 6 000 employees) (16) and 30 more are under consideration (covering about 175 000 employees, or a little less than a third of the Civil Service). The NHS reform proposals call for a greater degree of independence for individual hospitals from their regional health authorities. The proposals open the possibility of hospitals acquiring a self-governing status by opting out of regional health authority control. This would give hospitals the freedom to specialise in treatments of their own choice. They would also have greater liberty in recruiting staff and in determining pay and work conditions. The Education Reform Act 1988 has also prompted major devolution in local government by turning all state schools into management units, with flexibility in staffing arrangements and a high degree of independence in

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16. The agencies which have already been established are the Vehicle Inspectorate, Companies House (which registers new companies and information about companies in general) and HM Stationary Office (HMSO).

running their own affairs. The Act also opens the possibility for individual schools to opt completely out of local authority control, and be funded by central government. This would give schools some independence in designing their curriculum.

Incentive structures and efficiency

75. Incentive structures in the government sector have traditionally not encouraged efficiency. Promotions have been linked to the ability to give policy advice and ministerial support, rather than efficient allocation of resources. Pay for the bulk of government employees is determined in nation-wide bargaining between a few unions and a few units from the government side, while pay for professionals has been determined by review bodies. This procedure has resulted in uniform pay structures across government, and in an automatic progression within pay scales according to seniority. Pay in the government sector has rarely been linked to performance, mainly because of lack of performance-related indicators.

76. In recent years, the Government has sought to increase pay flexibility in the public sector, principally by linking pay more to local labour-market conditions and to special retention and recruitment problems. Some moves have also been made in linking pay to performance. Over the last year the Government has concluded settlements with unions in the Civil Service about performance-related pay arrangements, which had existed for top management since 1985, while employees in Executive Agencies will have special incentive schemes tailored to each agency. The new service-wide pay arrangements combine features of the old system, such as annual automatic progression up the scale for each grade subject to a maximum, and performance links (17). The new feature allows for accelerated progression up the standard scale if performance merits such a move, and for the possibility of discretionary annual awards for good performance beyond the maximum of the standard scale for a specified proportion of staff.

77. While the new arrangements mark an important break with past practices, it is uncertain whether they will have an appreciable impact on incentives. Service-wide pay arrangements related to performance cannot specify what constitutes a good performance, given the diversity of activities pursued in the Civil Service, and the lack of an explicit criterion may weaken the incentive signal. This problem can be avoided in agencies, where contracts are tailor-made to fit particular circumstances. A performance-related pay settlement has recently been concluded for one of the agencies already established, and if that sets a precedent for future agencies it will mark a significant change in central government pay arrangements. Outside the Civil Service, performance-related pay arrangements have been established for top managers in the National Health Service, and the proposed NHS reform package extends these arrangements to senior and middle managers lower down the scale.

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17. See New Pay Arrangements for Grades 5, 6 and 7, HM Treasury 1988; New Pay Arrangements for Executive, Office Support & Related Grades, HM Treasury 1989.

78. The need to change succession procedures in light of changed management objectives in the Civil Service was emphasised at the start of the Financial Management Initiative. To provide existing and prospective managers with incentives to operate new management systems and to master new management techniques, it was considered necessary to link promotion to ability to manage resources. Changes in management objectives were reflected in succession policy, which is relatively well-developed for the most senior grades in the Civil Service. By insisting on management training, and some experience in resource management, as a precondition for entering the senior ranks of the Civil Service, the authorities have given financial incentives to civil servants to develop managerial skills. However, a recent Government report indicates that career prospects are still seen by managers in the Civil Service to depend on skills and experience in policy and ministerial support rather than on efficient resource management.

Greater exposure to competitive forces

a) Competitive tendering and contracting out

79. Testing the cost-efficiency of government activity has increased over the last decade by making in-house production units compete with producers in the private sector in a competitive tender for specified tasks ("market contestability") (18). However, it is still confined to relatively few areas and probably covered only 7.5 per cent of total government expenditure on goods and services (Table 16) in 1986/87. The main impetus to greater use of competitive tendering in the 1980s has been provided by legislation and directives from the top. The Local Government Act 1980 introduced mandatory market testing of government activity and the 1988 Act extends this practice into 8 new areas starting from 1989. Obligatory competitive tendering in the National Health Service started in 1984 for three support services, while mandatory market testing in the Civil Service for service-wide activities commenced in 1986. Prior to mandatory requirements all major units of government had used competitive tendering to some extent. Mandatory market testing requires public-sector units to invite tenders from a number of sources, and some local authorities have accepted bids from foreign companies. The implementation of tendering has in general involved significant changes in management practices along the lines of the management reform programmes discussed above. Outputs of activities have now to be specified in detail so that contracts can be monitored and enforced; management accounting systems had to be established for the contracted activities and the basis for evaluating the costs of public provision had to be changed, e.g. by taking account of capital costs, to prevent in-house bids from having a competitive advantage. Production managers have been given more flexibility to manage resources and determine working conditions so as to remove disadvantages compared to private bidders. While management reforms were under way when tendering was decided, market testing has undoubtedly speeded up the process.

(Table 16. The scope of mandatory market testing)

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18. See A. Pera, "Deregulation and privatisation in an economy-wide context", OECD Economic Studies, N° 12 (forthcoming).

80. Increased contestability has generally resulted in major savings, but the extent to which it has resulted in contracting out differs markedly between administrative units of government (Table 17). In the Civil Service the great majority of contracts has been awarded to private sector units and estimated savings have been significant. In the National Health Service contracting out has been relatively modest while annual recurrent savings are estimated to be up to a fifth (19). In local government, the degree of contracting out construction and road maintenance has been relatively stable before and after market testing became mandatory. No estimates are available of the amount of savings resulting from mandatory testing of these activities, but there is evidence that it has improved value for money. Major savings have been registered by local authorities which have voluntarily subjected some services, such as refuse collection, to competitive tendering in the 1980s (20). Estimated savings from extending the range of services which have to be put to tender according to the 1988 Local Government Act are in the range of 20 per cent. Given the large gains from market testing in the National Health Service and local government, it would seem particularly promising to increase the coverage of mandatorily tested activities. Large differences in cost effectiveness of providing similar services in different authorities indicate that the potential for savings is big.

(Table 17. Contracting-out and estimated savings)

b) Procurement practices

81. The Government has sought to increase competition among its private sector suppliers of goods and services. For the central government, about 38 per cent of total spending is on goods and services from the private sector of which about half concerns military expenditures (21). Notwithstanding improvements in cost effectiveness made at the beginning of the 1980s, reviews of purchasing in 1984 concluded that major savings could be achieved by a number of changes in purchasing and supply procedures.

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19. On estimated savings from market testing activities in the NHS, see National Audit Office, Competitive Tendering for Support Services in the National Health Service, HMSO 1987; S. Domberger, S. Meadowcroft and D. Thompson, "The Impact of Competitive Tendering on the Costs of Hospital Domestic Services", Fiscal Studies 8 (1987), pp.39-54.

20. See S. Domberger, S.A. Meadowcroft and D.J. Thompson, "Competitive Tendering and Efficiency: The Case of Refuse Collection", Fiscal Studies 7 (1986), pp.69-87; J. Cubbin, S. Domberger and S. Meadowcroft, "Competitive Tendering and Refuse Collection: Identifying the Sources of Efficiency Gains", Fiscal Studies 8 (1987), pp.49-58.

21. See Government Purchasing. A Review of Government Contract and Procurement Procedures. Report to the Prime Minister, HMSO 1985.

Following a review on non-military procurement, targets of 5 per cent savings were set for Departments and a Central Unit on Purchasing was established to assist Departments in implementing the recommendations of the review body. Although these targets have not been met so far, the programme appears to have met with significant success. Savings of 4 per cent have been achieved by a combination of factors: improved purchasing techniques (e.g. post-tender negotiations, leasing or renting instead of buying, and searching for cheaper near-substitutes), improved procurement planning, reduced stockholdings, longer lists of potential contractors, improved information systems, etc. (22). Similar successful methods have been used in the Ministry of Defence. There has been a marked increase in the use of competitive tendering in placing contracts, the market has been opened up to foreign suppliers, and there has been a steady regress in the value of contracts granted on the basis of cost plus a percentage margin (23).

c) Privatisation

82. Privatisation in general government has been mainly limited to selling of council (local authority) housing. Local authorities have traditionally been major suppliers of accommodation to households, and at the beginning of the 1980s about one in seven households resided in council houses. The incoming government in 1979 set up schemes to encourage council tenants to purchase their accommodation at a discount. The motivation for this policy was to spread property ownership, but as discussed in last year's Survey there is also evidence that the council-house system hampered the regional mobility of labour. Spending restraint in local authorities had also resulted in a backlog of much-needed maintenance, which could be carried out more efficiently if tenants took the responsibility for running their accommodation. Since 1979 more than a million units have been sold, or approximately one in every six local authority dwellings in 1979. Other asset sales in general government include e.g. sale of surplus land in the NHS. The Government is seeking to encourage the private sector to take a greater role in providing road services, which appear to be deficient (see below). The private sector has initiated some projects, including the Channel Tunnel, in exchange for a long-term lease.

d) Competition in health care and education - internal markets

83. Private provision of education and health care has existed alongside public provision without exerting much pressure on the public sector to improve efficiency and response to consumers. Given that public provision is free at point of delivery, it has proved impossible for the private sector to

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22. See Government Purchasing. Progress Report to the Prime Minister from the Central Unit on Purchasing, HMSO 1988.

23. See HM Treasury, The Government's Expenditure Plans 1989-90 to 1991-92, Chapter 1 - Ministry of Defence, HMSO 1989.

compete on the basis of price but it has nevertheless been able to achieve a foothold in the market because it provides higher-quality services. The private health sector has also enjoyed some tax privileges. However, quality advantage and tax privileges have not sufficed to create strong private "merit goods" sectors. In 1984, the last year for which comparable data are available, the private health sector was smaller than in most Member countries (Table 18), despite rapid growth since the beginning of the 1970s. The private education sector has registered only a modest rise in its market share over the last decade (Diagram 16).

(Table 18. The size of the private health sector)

(Diagram 16. Pupils in private schools)

84. The lack of competitive pressure from the private sector due to small size has been compounded by its specialisation and customer targeting. The private health sector has a strong presence in institutional care for the elderly and the disabled, where the public sector has been relatively weak, but it has avoided the more expensive acute care. Where the public and private health sectors overlap, such as in elective surgery, the initial target group for the private sector was overseas patients. When the inflow of overseas patients declined in the 1980s, the private sector, often by subcontracting to the National Health Service, was able to make some inroads in the domestic market, helped by lengthening waiting lists in the public health sector. The overhaul of the education and health sectors in the 1980s have not been aimed directly at increasing the role of private provision but indirectly it may prove to be a stimulus to the private sector.

85. The 1988 Education Reform Act restates the principle that compulsory education should be provided by the government free at point of delivery but introduces an internal market among education establishments to strengthen the role of consumers. In the old system, local education authorities allocated students among the schools in their catchment area in order to even out the workload among the schools and parents had little influence over the school chosen for their children. In positive response to the existence of excess capacity in schools, the new system gives parents the right to send their children to any school within a given region, and state schools will be obliged to accept students as long as they have spare places. Moreover, schools will have incentives to attract students as their revenue will increase with the number of students and so will the remuneration of their managers. Competition among schools will principally be based on the quality of their teaching of core curriculum subjects, and in their choice of subjects taught outside the core curriculum. The absence of price or cost competition implies that there are limited market incentives for schools to operate efficiently. However, in the present state of over-capacity in the education system the provisions of the Education Reform Act may lead to rationalisation of resources. Schools which lose in the quality competition will see declining rolls and eventually close, releasing capital and labour to other sectors.

86. The proposed National Health Service reforms are based on the same principle as the education reform but introduce cost competition in some parts

of health delivery to strengthen the internal market mechanism. One of the motivations for the NHS review was to increase the responsiveness to consumers. This is to be brought about through increased competition among general practitioners (GPs), i.e. the primary care physicians, for patients. Competitive pressure will be stimulated by increasing the proportion of GPs' income which depends directly on the length of their patient lists and by making it easier for patients to switch from one GP to another. Patients will tend to go to GPs who offer better service in terms of effectiveness and timeliness of treatment. Large GP practices (currently covering 9 per cent of all GPs and serving a quarter of the population) will have additional financial incentives to have large patient lists as they are eligible to become budget holders with the size of their budget depending on the number of patients. If the total cost of treating patients is smaller than the budgeted allocation, the difference can be ploughed back into the practices and thus increase the wealth of GPs. Hospitals will be able to charge for their services at point of delivery, and the most efficient ones will be in a position to charge the lowest price for treatment, in order to attract patients.

87. The NHS reform is a bold attempt to introduce market forces in health delivery. It is difficult to assess how the reforms will work in practice, as the details have yet to be worked out and no pilot studies have been done. The success of the reforms will depend on how well they deal with the traditional problems of competition in health delivery (24). **Firstly**, since patients are relatively badly equipped to assess the quality of treatment they receive from their doctor, the best doctors may not attract the largest number of customers. It is crucial that peer reviews should be made public in order to prevent doctors from attracting customers by exploiting asymmetry of information. **Second**, because of the nature of hospital services and patients' reluctance to seek services far from home, hospitals are local monopolies. It is essential that adequate safeguards be set to prevent hospitals from exploiting their monopoly power, e.g. by making them subject to standard competition laws. Apart from these inherent problem, it will be necessary to prevent budget-holding GPs from benefiting from changing their client mix rather than by cutting the cost of treatment. This would require that actual budgets given to GPs should depend on the type of patients as well as on the number on GPs' lists. However, there might be substantial administrative costs in operating such a complex system.

External monitoring

88. External monitoring of the efficiency and effectiveness of government expenditure has been greatly enhanced in the 1980s. The National Audit Office (NAO), which was established in 1983, has an explicit remit to conduct efficiency audits in central government in addition to traditional certification audits. The efficiency audits involve comprehensive studies of

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24. On these problems, see, Structural Adjustment and Economic Performance, OECD Paris 1987.

specific areas, such as the use of operating theatres in the NHS, management of prison services, procurement in defence, and the financial control of military units. The studies seek to identify and analyse evidence of unsatisfactory value-for-money, and to make recommendations about necessary improvements. Similar studies are carried out on local authorities' expenditure by the Audit Commission, also established in 1983. An important aspect of its value-for-money work is to compare the costs of providing similar services across different local authorities, and to disseminate information about best work practices. Neither the NAO nor the Audit Commission have any powers to enforce their recommendations, but their reports have large public exposure and put managers under pressure to take corrective actions. No estimates are available of value-for-money savings from the efficiency audits of the NAO, but the Audit Commission estimates that in the 1983-1986 period it identified value improvements of £492 million of yearly recurrent expenditure. Reflecting usual time lags in implementing recommendations, the improvements realised in the same period were less impressive (£80 million).

89. The Government has made a special effort to monitor efficiency in the Civil Service, reflected in the establishment of the Efficiency Unit in 1979. Although part of the Civil Service, it works outside the Departmental structure and the head of the Unit is responsible directly to the Prime Minister. The Unit pioneered the method of efficiency scrutinies in Departments, which were later extended to the NHS. These scrutinies focused on particular activities, which were chosen by very senior management in Departments but with the advice of the Efficiency Unit. The scrutinies involved top management selecting a production manager with detailed knowledge of the area under consideration to make a thorough evaluation of efficiency and to recommend improvements. The investigation and implementation of an action plan are supposed to take no longer than 24 months. Since 1979 the Unit has undertaken over 300 scrutinies and these have resulted in savings of a recurring total of some £300 million a year (0.25 per cent of central government expenditure). The Efficiency Unit also organises efficiency seminars for each Department at 18 month intervals. These seminars, which are chaired by the Prime Minister, review efficiency developments and they have increased the accountability of ministers and top civil servants with respect to use of resources.

Expenditure and direct input controls

90. Tight expenditure and input controls in the 1980s have forced managers to economise on resources in face of unchanged or increased workloads. The incoming Government in 1979 established employment reduction targets for the Civil Service. The initial aim was to reduce manpower in Departments by 15 per cent in the period up to 1984. After this target was met, a new target called for further reductions of 5 per cent by 1988. In 1988 targets for reduction in manpower were replaced by targets for running costs, which had been introduced two years earlier. The new targets embodied efficiency increases of 1.5 per cent per year, and allowed managers to have greater flexibility in organising production. Stringent spending limits have been used elsewhere in government to enforce greater cost efficiency. To this end

as well as with a view to gaining better control over public expenditure, spending limits in a number of areas have been set since 1976 in cash rather than volume. However, legislation stipulates that large programme areas, such as social security benefits, are demand led, though entitlement rights have become subject to rigorous scrutiny, and this has implied that spending restraints have fallen disproportionately on the adjustable parts, principally running costs and capital spending (Diagram 17). Attempts to impose expenditure controls on local authorities have been compromised by their tax raising power and central government has assumed ever-increasing power over local government finances to limit expenditure increases. Changes in local authority taxes, such as the introduction of poll taxes, is one part of this strategy (25).

(Diagram 17. The structure of general government expenditure)

91. While direct input controls appear to have been successful in increasing the efficiency and effectiveness of government services, the inflexibility of the spending system has resulted in some unwanted supply-side effects. Apart from input reductions, running costs have been limited by restraining wage increases for government employees. These have fallen significantly behind private sector wage developments (Diagram 18), and this has resulted in serious recruitment and retention problems. Despite special arrangements to increase salaries of groups where the shortage is most acute, such as nurses, there are still problems. Where the government is competing with the private sector for similar kinds of labour, it will have to pay a common wage in the long run or find itself with lower quality manpower. Remuneration of employees should reflect the benefit to society of using their services or mis-allocation of resources will result. Another unwanted side effect is that the cut in capital expenditure in the 1980s may have resulted in a shortage of infra-structure capital, as the underlying demand for such services has increased rapidly (26). For example, road traffic has increased tremendously over the last decade while there has been only moderate increases in the length of the road network and the quality of the existing network has deteriorated (Diagram 19). This has increased road congestion, with obvious costs for society.

(Diagram 18. Public sector pay settlements in the 1980s)

(Diagram 19. Supply and demand in road services)

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25. See e.g. D.A. Livesey, "Central Control of Local Authority Expenditure", Oxford Review of Economic Policy 3 (1987), pp.44-59.

26. The Confederation of British Industries has estimated that the cost of road congestion to industry alone is about £3 billion per year. See Building on business success, CBI, London 1989.

Public enterprises

92. The rationale for the public-corporation sector was that profit-oriented enterprises in the private sector, even when controlled by regulations and subsidies, would not produce socially desirable outcomes. National security interests necessitated production of some domestic inputs, such as coal; employment goals would be impaired by too rapid structural changes, e.g. in the steel and shipbuilding industries; and the danger of exploitation of monopoly power in utilities, as well as their vital role in modern society, was thought to call for public ownership. However, towards the close of the 1970s it became apparent that state ownership had often not yielded the benefits which were supposed to go with public status. The performance record of public enterprises proved to be disappointing in the 1970s (27). Growth in technological efficiency fell behind that of the private sector, and a number of public-sector enterprises experienced a fall in their total factor productivity. High-tech corporations were an exception to this general pattern, but their level of production efficiency was lower than in comparable firms abroad. Allocative efficiency was also impaired by pricing policy. There appears to have been a tendency to price products below marginal costs, either because of an obligation to provide uniform services at common prices across the whole country or with a view to maximising output. Discriminatory pricing was present in some of the corporations. Allocative efficiency appears also to have been defective, with over-investment in some industries (e.g. electricity) while lack of investment characterised others (e.g. the water and sewage industries). Product development and responsiveness to consumers' needs was generally considered to be deficient. A number of factors seem to have contributed to this performance.

93. The lack of clear management accountability was a major weakness in the control of public enterprises. In principle, the Government was to leave day-to-day operational decisions to management for which the latter would be fully accountable. In practice, central government frequently interfered with operational decisions in the pursuit of its macroeconomic goals, such as inflation and aggregate demand, thus blurring the line of accountability. Another weakness in the control of the public-enterprise sector was the lack of operational management performance indicators and lack of adequate monitoring. The objective of management in the 1970s was to supply goods at economically efficient prices with investment being subject to a test discount rate criterion, which was low compared to the rate of return in the private sector, but the extent to which managers pursued these objectives could not be monitored on a regular basis. Pricing was generally on a cost-plus basis and

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27. See e.g. J. Vickers and G. Yarrow, Privatisation; An Economic Analysis, MIT Press 1988; R. Molyneux and D. Thompson, "Nationalised Industry Performance: Still Third-Rate?", Fiscal Studies 8 (1987), pp. 48-82.

investment decisions were distorted by the fact that their costs were readily capitalised into prices. Public enterprises were monitored by their parent Departments and the monitors stood at a clear disadvantage with respect to information about technology and costs when assessing management performance. Moreover, some corporations did not themselves have the information to allow an assessment of the efficiency of their pricing policy. The disappointing record and control problems resulted in new attempts to enhance efficiency in the public-enterprise sector.

The "re-orientation" approach

94. The "re-orientation" approach involved a mixture of greater pressure on management and strengthening of monitoring, but the problems of accountability were not tackled. The new approach was heralded by the 1978 White Paper on public corporations. It emphasised financial targets as the prime objective of management instead of marginal cost-pricing. At the same time the financial target was changed from a test discount rate for individual investment projects to a required rate of return for a whole investment programme. The enhanced status of financial objectives for management purposes was supplemented by alternative performance targets, such as unit cost targets. The latter was intended to stimulate internal efficiency but it proved hard to make them of central importance to managers. Financial pressure on public-sector corporations was sharply increased by the introduction of **External Financing Limits** (EFLs), i.e. the maximum levels for the difference between revenues and the sum of current and capital expenditure. The impact of EFLs on efficiency enhancement differs from cash limits on Department spending because public corporations are able to reduce their EFL by raising their product prices. Given that many have significant market power, this would seem to be an easy way to avoid taking difficult efficiency-enhancing measures. In practice this does not seem to have been the case, either because the degree of market power is not strong enough or because managers are pursuing output-maximising policies. There is evidence that tight EFLs have increased management resolve to stand firm in insisting on efficiency improvements against strong opposition from the workforce (28). While EFLs may induce productivity increases they offer only a limited mechanism for improving allocative efficiency.

95. Reducing statutory barriers to entry in activities where public corporations have been the sole supplier can induce both internal and allocative efficiency. Prior to privatisation the telecommunications, gas and express coach services were subject to some deregulation. In the first two cases, the deregulation put little pressure on the incumbents. Liberalisation of express coach services in 1980 was followed by intense pressure on management to lower prices and improve services, and while these pressures

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28. See e.g. Molyneux and Thompson, op.cit.

subsided as the incumbent gained control over the market again, they may nevertheless have had lasting effects on efficiency. Moreover, the deregulation appears to have put the state railways under pressure to improve efficiency and consumer responsiveness. An alternative way to stimulate efficiency in the 1980s has been better monitoring. The Competition Act 1980 made it possible for ministers to refer public corporations to the Monopolies and Mergers Commission for efficiency scrutinies. The MMC has examined a number of corporations and generally found problems with their pricing policy. In light of the findings, the minister responsible can instruct the corporation to change behaviour.

96. Judged against the productivity record in the 1980s, the new approach towards the nationalised industries appears to have been a major success. Labour productivity has shown impressive gains, exceeding those of manufacturing despite the strong revival of the latter compared to the 1970s (Diagram 20). Productivity in most corporations has increased more rapidly than in earlier periods, and some corporations have registered striking increases in output per head. For example, British Steel increased its labour productivity by an annual average of 12 per cent in the 1979-1988 period and output per head in British Coal rose by more than 50 per cent in the three years after a serious industrial strike in 1984. These gains have come about by a mixture of retirement of inefficient production units and greater flexibility in the workplace. In this process the workforce of still-existing public corporations was reduced by a quarter in the ten-year period to 1988. As the full potential of such measures has not yet been realised, rapid productivity growth could persist for a number of years. Public corporations have not been as successful in aligning prices with costs as they have been in improving productivity. Pricing practices appear to deviate significantly from the marginal cost principle, and the structure of prices suggests widespread practices of cross-subsidisation.

(Diagram 20. Labour productivity performance)

<u>The privatisation approach</u>

97. In contrast to the "re-orientation" approach, the privatisation approach aimed at increasing efficiency by transferring government shares in commercial companies or public corporations to the private sector. Following a relatively slow start, the privatisation process gathered momentum after 1983, with large public utilities being transferred to the private sector (Diagram 21). A comprehensive list of asset sales to date is provided in Annex II. Not all asset sales have involved significant change in management objectives, i.e. from a public interest motive to a profit objective. About 45 per cent of all privatisation proceeds to date have been raised by selling government shares in corporations run along commercial lines. Even here, the transfer of assets to more demanding investors may have had an appreciable impact on management. Sales of public corporations have, however, involved re-orientation of management objectives. As a result of privatisation employment in the public corporation sector has been reduced by half a million, or approximately a quarter of the workforce at the start of the privatisation programme (Table 19). The Government has announced major future

sales of public corporations. The water industry is to be sold later this year, and the sale of the electricity industry is set for 1990-91. After completion of announced future privatisations, remaining nationalised industries will be the coal industry, the railways, the Post Office, and a number of corporations engaged in transportation.

(Diagram 21. Privatisation proceeds)

(Table 19. Privatisation of public corporations)

98. Some privatised corporations operate in highly competitive markets but the largest ones have natural monopoly, and networking and co-ordination externalities in some segments of their activities. The privatisation of public-sector companies operating in markets with a high degree of competition appears to have had beneficial effects. Most have grown rapidly but profitability developments after privatisation have remained mixed, reflecting market conditions (Table 20). Productivity and allocative efficiency appear to have benefited from the rigours of competition, and corporations have been forced to improve their product range. For corporations with natural monopoly in parts of their activities it can be expected that the pursuit of profits will induce technical efficiency, though in the absence of regulation allocative efficiency will be impaired. A common feature of past privatisation of these corporations is that they have been sold intact, i.e. the natural monopoly part has not been separated from the ones where competition is possible and regional natural monopolies have not been separated from each other. For example, the privatised British Telecom is engaged in network operating, where there is only limited scope for competition, as well as activities where it faces potential competition (e.g. provision of telecommunications services of all kinds and the supply of customer premises equipment). The future privatisation of the electricity industry will involve restructuring, but there will still be a significant degree of vertical integration between competitive and non-competitive activities in most of the corporations. Moreover, the industry will be required to generate one-fifth of its supply from non-commercial non-fossil fuels (i.e. nuclear power) as a public-interest obligation.

(Table 20. Privatised companies: Trends in turnover, profits and employment)

99. Up to now three corporations (British Telecom, British Gas and BAA, formerly the British Airport Authority) have been privatised requiring detailed regulation about price setting to prevent abuse of market power, and two major forthcoming privatisations (the electricity and water industries) will be accompanied by regulations limiting their scope for action. In designing the regulatory framework to limit the abuse of market power, the authorities have had to decide which operations need to be regulated and what form such regulation should take. The first issue has arisen for integrated corporations, where the degree of competition varies between different segments of their activities. Although attempts have been made in the past to bring all products facing limited competition under the umbrella of price regulation, subsequent developments suggest that the initial coverage was too narrow. For example, the revision of British Telecom's licence has added to

the number of products covered by price controls. Moreover, the Monopolies and Merger Commission has recently found evidence that British Gas has abused its monopoly power in the wholesale market, which had been left outside price controls due to pressure from management. Developments after the privatisation of utilities suggested that price regulation needed to be supplemented by quality control, and recently the corporations have accepted that they will be subject to financial penalties for bad customer services. For example, British Telecom now has to compensate customers to a minimum extent of £5 per day if it takes more than two days late in providing a line or if it is more than two days to repair a fault. The privatised water industry will be subject to similar financial penalties for bad customer service.

100. The form of regulation for all regulated privatised corporations, present and prospective, was chosen so as to be based on a price cap rather than profits, with the price cap applying to the average of regulated prices, leaving corporations considerable freedom to vary the structure of prices. The price cap formula has differed somewhat between industries. A common base has been to limit price increases to "RPI minus X", where RPI is the growth in the retail price index and X is the regulation parameter, reviewed every 5 years. Variants on this formula take account of specific input prices. The gas industry is allowed to pass all North Sea fuel input prices to consumers; BAA can pass allowable security costs to prices; the forthcoming private electricity companies will be able to allow average increases in generation transmission and distribution costs, and a "nuclear levy", to be reflected in prices; and each of the future privatised water companies will be able to charge prices so as to obtain an 8 per cent rate of return, in order to induce them to carry out much needed investment. In principle, X should be based on potential reductions in costs and given large elements of sunk costs in the investment of the regulated corporations it would seem necessary to take account of desirable investment in setting the regulation parameter. Such optimal pricing arrangements would require that the regulator has more information than is typically available. Apart from the water industry where it is obvious, X appears to be set to allow reasonable average rates of return, in effect reducing the price cap regulation to a long-run profit regulation. Some elements of inefficiencies associated with rates of return regulation, e.g. lack of incentives to improve productivity and a bias towards expanding the capital stock beyond what is economically efficient, may thus be embedded in the current system. However, guaranteeing investors with adequate rates of return may be necessary to ensure timely renewal and modernisation of capital when large sunk costs are involved (29).

101. A major aim of privatisation has been to increase competition so that market pressures could gradually reduce the need for regulation. The regulatory agencies for telecommunications (OFTEL) and gas (OFGAS) were given an explicit remit to guard against anti-competitive behaviour. There were two areas of particular concern in this respect. Firstly, the incumbents could have an unfair advantage in the potentially competitive part of their operations by exploiting their market power in other areas. The price

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29. On these issues see e.g. Vickers and Yarrow, op. cit.

regulation formulas discussed above did not exclude the possibility of predatory pricing. For example, the corporations could stay within average price limits by a combination of high prices for products which are facing little competition and low prices for products which were subject to potential competition. Such cross-subsidisation is prohibited in the corporations' licences, and where tariffs have been significantly restructured they have brought prices more in line with costs rather than having involved exploiting market power. A second source of concern was that the vertical integration of some of the privatised companies could give them an unfair advantage in potentially competitive markets. For example, both British Telecom and British Gas operate national and local distribution networks and have an interest in limiting the access of other local networks to their national one where they are the sole suppliers. Their licence instructs them to interconnect other systems but experience shows that they do so only as a last resort. The same companies combine also network operations and apparatus supply, and there is concern that this may give them an advantage in the latter. Competition in the gas market may also be limited by the incumbent through its dominant position as a buyer of gas from the North Sea. While regulatory agencies have had some success in injecting competition into areas dominated by privatised companies, especially telecommunications, the structure of these industries makes it more difficult than for single product firms.

102. A possible major advantage associated with privatisation is that management will be monitored by the capital markets, and the threat of takeover will induce managers to be more efficient. Moreover, management will have to base its investment decisions on market-based interest rates rather than relatively low required rates of return. Evidence suggest that management of the big privatised corporations are quite sensitive to stock-market valuations. However, the effectiveness of the stock market in disciplining bad management may be exaggerated. A number of privatised corporations have indeed been protected from the danger of takeovers during the first few years by size restrictions on individual shareholdings or government holdings of its "golden" shares. Management in the regional electricity and water companies will thus enjoy immunity from takeovers for at least five years after privatisation while management of the electricity generating companies, the national grid, and the Scottish electricity companies will enjoy indefinite immunity. The government also holds golden shares in British Telecom, British Gas, and Britoil. The Government's objective in exercising its golden-share option is to ease the entry of the corporations into the private sector and to prevent hostile takeovers of corporations of strategic interest. But even in the absence of government protection, it is unlikely that big privatised companies would come under a credible takeover threat. Their sheer size makes them unlikely takeover candidates. In 1987 British Gas and British Telecom were the second and third largest private companies in the United Kingdom, and their market capitalisation was a multiple of the largest takeover ever in the country (Table 21).

(Table 21. The market capitalisation of major privatised companies)

103. The privatisations of public utilities have already yielded some benefits, but a more determined and coherent policy towards asset transfers to the private sector and strengthening competition would have been desirable. Privatisation has revealed restrictive business practices which already existed before but the transfer to the private sector has opened the possibility to injured parties to seek redress through recourse to standard competition laws. Privatisation has also resulted in organisational changes in some companies which has improved management and procurement practices. However, it would appear that a shake-up of the structure of privatised industries would have strengthened forces of competition and facilitated regulation. A separation of goods facing competition and goods produced under little market pressure into independent production units would have limited the extent to which cross-subsidisation and vertical integration could be used for anti-competitive purposes. Moreover, breaking the non-competitive units into regional companies would have allowed the regulator more scope for yardstick regulation. For example, the regulatory parameter in the "RPI minus X" formula could have been made to depend on average costs of the industry as a whole, inducing individual firms to do better than the average. Smaller production units would also have made the disciplining of capital markets more effective. The extent to which a break-up is desirable, either because extra efficiency gains could be reaped or competitive forces strengthened, differs from one corporation to another, but the full range of benefits which could potentially be drawn from privatisation does not seem to have be realised yet.

VI. Conclusions

104. After more than seven years of strong and sustained expansion, the United Kingdom economy is showing signs of growing strains. With domestic demand in real terms increasing more than twice as fast as potential output in 1988, capacity constraints have emerged and inflation has picked up. The rate of unemployment has fallen markedly since 1986 and the trend of wages has steepened. The external current-account deficit has widened sharply under the combined impact of strong domestic demand pressure and deteriorating international competitiveness.

105. With mounting evidence that domestic demand was continuing to grow excessively, monetary policy was tightened substantially during the second half of 1988. Initially the authorities took advantage of a weakening exchange rate to raise interest rates gradually, but subsequent increases were effected even though the currency was coming under renewed upward pressure. Maintaining a strong currency has become a cornerstone of the Government's counter-inflation policy. During the first months of 1989 interest rates remained broadly stable, with temporary downward pressure on sterling being met by official intervention in foreign exchange markets, but in late May the authorities raised interest rates further to support the exchange rate.

restrictions

106. The 1988/89 Budget turned out to be tighter than originally envisaged as tax cuts were more than offset by fiscal drag and a marked fall in public expenditure in relation to GDP. Consumer confidence seems to have been boosted by the tax reductions, and the Budget announcement of ~~changes~~ in mortgage tax relief appears to have led to anticipatory household spending. The March 1989 Budget reaffirmed the Government's commitment to exchange-rate stability and to maintaining interest rates high for as long as necessary to reduce inflationary pressure. The Budget implies a further tightening of the fiscal stance, combining a continued fall in public expenditure relative to GDP with modest tax reductions broadly compensating for fiscal drag. While the balanced-budget rule was reconfirmed as a guiding policy principle, the budget outlook for the current financial year is nevertheless for a rising financial surplus (net of privatisation proceeds).

107. There are first signs that the marked tightening of policy since mid-1988 has begun to bite: mortgage borrowing and consumer credit demand have slowed, house prices and real-estate transactions have fallen, and private consumption growth appears to have slowed down markedly in the first quarter of 1989. Survey evidence points to some easing of pressure on resources and weakening consumer and business confidence. OECD projections, based on current and announced policies, are for a marked drop in the rate of growth of domestic demand, with slackening household spending leading to a slowing of business investment with some lag. With net import volumes continuing to rise, though at a diminishing pace, real GDP growth is projected to decline significantly, stabilising at just under 2 per cent during 1990,

about 1 percentage point below the estimated rate of growth of potential output. The implied easing of pressure on resources should induce a fall in inflation and in the external current-account deficit relative to GDP. However, given the tensions that have built up over the past year, progress in both areas is likely to be slow and uneven.

108. Risks and uncertainties attaching to the outlook are considerable. Large discrepancies between demand and output measures in the national accounts and erratic patterns of some indicators make it difficult to assess the extent of inflation pressure now embedded in the system; it could be underestimated and the deceleration in demand could be less pronounced than projected. It is also unclear whether and to what extent the erratically high rate of retail-price inflation, attributable to the impact of higher mortgage interest rates on the index, will give a twist to the price-wage spiral. A further layer of uncertainty attaches to the extent and timing of the effects of monetary policy in today's much more liberal financial environment. If the decline of inflation proves to be more hesitant than expected, policy might have to be tightened further, with adverse consequences for a time for economic activity.

109. It should be borne in mind in this connection that the recent spurt of inflation started from an underlying rate of close to 5 per cent. With inflation in this sort of range it is more difficult to absorb shocks satisfactorily. The task of policy would therefore now appear to be not only to remove the excess demand of the last year or so but to resume the earlier process of disinflation which has been marking time for several years. Seen in this light, there seems little risk that the tightening of policy to date represents "overkill"; and there will be good reason to err on the side of restraint in the future setting of policy.

110. According to the Government's Medium-Term Financial Strategy, the task of reducing excess demand and inflation falls on monetary policy. Fiscal policy, considered an unsuitable instrument for short-run demand management and stabilisation, is assigned the supportive confidence-building role of establishing and preserving sound public finance and the provision of appropriate economic incentives. However, given the size of present inflationary tensions and imbalances in the economy on the one hand, and the crucial importance of maintaining confidence of financial markets in sterling assets, and of economic agents generally in the Government's anti-inflation policy on the other, there is clearly a danger of over-burdening and over-stretching monetary policy. Given, furthermore, long lags before the impact of monetary tightening is fully felt, fiscal policy may have to play a more active role in the process of rebalancing the economy and the reduction of inflation pressure. The Government's willingness to accept cyclically-induced variations in the budget balance must be welcome in this context, but these would not take enough steam out of the economy if domestic demand exceeded the projected path. A more ambitious fiscal objective for a time would serve to bolster both financial-market confidence and the credibility of the government's stabilisation policy. This would imply that the planned gradual move from the present budget surplus towards a balanced budget might need to be more stretched out over time than has so far been envisaged.

111. The external current-account deficit reflects low national savings combined with strengthening investment. As a proportion of GDP, national savings have declined through the 1980s to the lowest level since the early 1960s. Despite the recent surge in private investment, the GDP share of total investment still falls considerably short of the average level of the 1970s, reflecting shrinking public investment over the last decade. The decline of personal saving, which more than accounts for that of national saving, may take time to reverse, given the imponderable effects of factors like financial liberalisation and rising household wealth. Thus, domestic saving, even if it recovers more than foreseen at present, may well remain too low in the foreseeable future to match the investment required to sustain satisfactory economic performance. The United Kingdom's comfortable net foreign asset position and improved returns on productive investment will help maintain favourable conditions for financing large current-account deficits. However, should the United Kingdom become less attractive as a place for foreign investors, the case for more ambitious fiscal objectives would be strengthened. It is sometimes argued that private saving adjusts to offset changes in fiscal balances in anticipation of induced changes in future tax burdens. OECD research suggests that such effects are at most partial. In any case, there is a role for fiscal policy to make taxation more supportive to saving. Further steps in this direction were announced in the 1989 Budget. But some distortions remain which, in interaction with financial liberalisation, still tend to encourage household borrowing.

112. Over the last decade, supply-side policies have been pursued with greater determination and vigour than in most other Member countries. Deregulation of product and factor markets has increased competitive pressure on management and the workforce to become more efficient and responsive to consumer needs. Other supply-side measures have aimed at improving conditions for economic growth through manpower training and education and by reducing distortions resulting from taxes and government transfers. Training schemes to improve the skills of long-term unemployed have been strengthened, and the education system has been made more responsive to the needs of the economy; statutory regulations governing the functioning of the labour market have been relaxed, and restrictive work practices lessened; and competition in financial markets has been further increased through deregulation. All these measures, together with others under active consideration, should help promote non-inflationary growth in the future.

113. Notwithstanding the drive for increased efficiency, important weaknesses on the supply side remain. The tax and social security systems continue to interfere unduly with decision making in the private sector through their combined effects on marginal income taxation and differential treatment of income components. In the absence of taxes on imputed rent and capital gains, mortgage interest relief still represents a significant tax distortion. Limited progress has been made in dismantling remaining trade barriers, and a number of industry-to-industry agreements continue to restrict foreign access to domestic markets. Successful implementation of recent education reforms will remove deficiencies in work-related education of people of school age, but as long as only a small proportion of people receive formal education beyond school-leaving age, the basis for the workforce to take full advantage of modern work organisation and production techniques will remain inadequate.

114. Over the last decade, the Government has introduced new techniques to make the public sector more efficient, and a number of them have been applied in other Member countries. Efforts have focused on management reforms and external monitoring. Greater attention to output and performance has replaced preoccupation with inputs and cost control, and major devolution of decision making in operational matters is envisaged in the near future. However, much needs to be done to improve management information systems as a base for assessing resource allocation. Performance targets have been an integral part of the management reform programme, and although often somewhat arbitrary, they may have given a spur to managers to operate more efficiently. Small moves have been made to relate remuneration to such targets. The possibility for private sector producers to compete with government provision of services (market contestability) is still limited, but where such a threat of potential competition exists major savings have been recorded. This suggests that there should be increased recourse to market testing, and that public-sector management reforms should be developed with that in mind. Introducing competition in the delivery of health care and education is a novel approach to use market incentives within the public sector. Provided that public-sector production units are prevented from engaging in monopolistic practices and that consumers take advantage of the internal market, the new approach is likely to stimulate efficiency.

115. Privatisation has involved the transfer of responsibility for provision of goods and services from the public to the private sector. Given the nature of production in many privatised companies, the devolution of responsibility has been only partial. Public utilities that have been privatised are subject to extensive regulation as to pricing and the nature of services, and in the case of some pending privatisations the private sector will be obliged to take on non-commercial tasks and be subject to detailed scrutiny of investment decisions. Moreover, management in many privatised companies enjoys greater government protection from takeovers than in most other private companies. Limited use has so far been made of enhancing competition and facilitating regulations by structural measures. Breaking up of large integrated corporations in the process of privatisation, and separating local monopolies from each other, would seem to have been the most effective way of stimulating efficiency. However, many privatisations and other public-sector reform measures are too recent to allow comprehensive assessment, but where their impact has already been felt it has been generally favourable.

116. In sum, United Kingdom economic performance in the 1980s has been marked by an unusually sustained expansion and by distinct signs of improvement on the supply side. But demand growth in 1987 and 1988 was too rapid. Policy now needs to bring inflation on to a firmly downward path while maintaining the momentum of structural reform.

chex.ps/aa2/49 **RESTRICTED**

FROM: A C S ALLAN
DATE: 31 May 1989

R

MR H J BUSH (IDT)

cc Mr Wicks
Mr H P Evans
Mr Gieve

PRESS ARRANGEMENTS FOR OECD VISIT: 1 JUNE

The Chancellor was grateful for your minute of 26 May. He is not concerned about "competition for press attention". We can make arrangements as things develop tomorrow, but he thinks that doing the press conference last thing before departure will almost certainly be best. Among other things, he will want to wait until after the outcome of the Bundesbank Council meeting has been announced.

ACSA

A C S ALLAN

RESTRICTED

FROM: A C S ALLAN
DATE: 31 May 1989

~~BF 6/6~~ ~~9/6~~ 29/6

MRS CHAPLIN

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr H P Evans
Mr Peretz
Mr Sedgwick
Mr Gieve
Mr Pickford
Mr Tyrie
Mr Call

Please ask IF when OECD forecast will be published

Alex 9/6

LETTER FROM JOHN SMITH

... I attach a letter to the Chancellor from John Smith. The Chancellor feels this will require a bland reply in due course - but certainly not to be sent until the OECD forecast has been published. I should be grateful if you could prepare a draft.

ACSA

A C S ALLAN

From: The Rt. Hon. John Smith, Q.C., M.P.

HOUSE OF COMMONS
LONDON SW1A 0AA

31st May 1989

Rt Hon Nigel Lawson, M.P.,

Chancellor of the Exchequer,

H.M Treasury,

Great George Street,

LONDON

Dear Nigel,

I am disturbed that the OECD has predicted another record deficit for the U.K's balance of payments in 1989 of £17 billion, and a further worsening to a record £17.5 billion in 1990.

It is surely alarming that the OECD's forecasts, prepared for their ' Economic Outlook', are significantly worse than the forecasts you gave to Parliament in the Budget Statement on 14th March. Can you explain the discrepancy between the Treasury and the OECD forecasts, and confirm that that you will now revise your forecast for the balance of payments in 1989 and 1990?

Given the prospects of a further deterioration in the balance of payments in the years ahead, what level of interest rates do you believe will be required to finance a deficit of these dramatic proportions? And what will be the implications for Britain of a seemingly indefinite period of high interest rates?

What further misery is in store for Britain's homeowners and what further burdens will fall upon British industry as a result of your policies and the relentless slide into unprecedented deficit?

Yours sincerely
John Smith

From: The Rt. Hon. John Smith, Q.C., M.P.

HOUSE OF COMMONS
LONDON SW1A 0AA

This will require a [illegible] upon an out course – but [illegible] not sent until the OECD [illegible] published.

31st May 1989

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Chancellor of the Exchequer,
H.M.Treasury,
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Yours sincerely,
John Smith

FROM: **A C S ALLAN**
DATE: **31 May 1989**

Pg

MR J S HIBBERD (EA1)

cc Sir P Middleton
Sir T Burns
Mr Wicks
Mr H P Evans
Mr Riley
Mr Sedgwick
Mr Gieve
Mr Melliss
Mr O'Donnell
Mr Pickford
Mr Owen

OECD FORECASTS OF THE UK

The Chancellor was grateful for your minute of 26 May. Mr Gieve will need a line to take on the OECD forecasts, which will need to stress, inter-alia, the high degree of uncertainty attached to all forecasts, and those of the current account in particular.

ACSA

A C S ALLAN

FROM: A C S ALLAN
DATE: 31 May 1989

MR C J RILEY (MP)

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Lankester
Mr H P Evans
Mr Sedgwick
Mr Gieve
Mr Hibberd
Mr O'Donnell
Mr Pickford
Mrs Chaplin

OECD EDRC SURVEY OF THE UK

The Chancellor was grateful for your minute of 26 May. He agrees with your comment that at first sight the draft seems reasonably satisfactory. For that reason, press comment will tend to focus exclusively on the OECD's short-term forecast and not on this. It is important that Mr Gieve redresses the balance.

ACSA

A C S ALLAN

Mr Alex Allan,

These are the

Chancellor's

N. C. J

OECD MINISTERIAL COUNCIL, 31 MAY - 1 JUNE

BRIEF NO 10: EAST/WEST ECONOMIC RELATIONS

OBJECTIVES

1. To exchange views on economic developments in Soviet Union and Eastern Europe.

2. To consider appropriate Western response.

3. (If raised) To moderate any ideas for an active OECD involvement in East-West economic relations; and to establish clear distinctions between OECD provision of technical economic information to the Soviet Union and Eastern Europe (acceptable), OECD provision of economic advice (resist) and full and associate membership of these countries in the OECD (resist).

BRIEF 10 EAST/WEST ECONOMIC RELATIONS

D12AAB/1

POINTS TO MAKE

Economic Reforms

- Period of great change and diversity in Eastern European countries. Pace and effectiveness of reforms vary widely.

- In the Soviet Union, fundamental contradictions of Perestroika increasingly apparent; trying to mix genuine market forces with central planning.

- Soviet economy in deep trouble: budget deficit (11% of GNP), poor 1988 harvest; reduced hard currency earnings; repressed inflation; large rouble overhang; wages rising twice as fast as production.

- No coherent alternative to perestroika. But public discontent likely to be major problem if results not apparent in next 2-3 years.

- In Hungary, structural reforms have brought economy closest to a market-based system in Eastern Europe. Hungarians facing up to vital need to reform property rights. But much still needs to be done, especially to cut back subsidies to industry and allow insolvent companies to go bankrupt.

- Despite unique political advance of the Round Table (and some important moves to stimulate the private sector) Poland has so far failed to make major retreat from a command economy towards market mechanisms for prices, subsidies, etc. Inflation (possibly ca 100% this year) increasingly intractable problem and real wages continue to rise. An IMF agreement will be difficult to negotiate.

D12AAB/2

- Elsewhere in Eastern Europe, Bulgaria (confusedly) and Czechoslovakia (slowly and still against stiff resistance) are moving along the reform path. GDR (secure under the economic protection of West Germany) and Romania (sui generis) oppose reform resolutely.

Western response

- Poland and Hungary say they will need new resources if political reform is to prosper; the former, in particular, wants generous debt rescheduling and new credits; both want easier trade access and a large flow of Western investment;

- West should respond positively but cautiously; should look at reforms actually in place rather than promised; and should dispense assistance in phase with the pace of economic reforms.

- On debt and credit issues, West's response should continue to be based on IMF/Paris Club. IMF agreements holds the key to progress in West's economic relatins with Poland: West should be flexible and constructive but should not connive at a weak programme, eg could consider shadow programme or back loaded programme, which ensured conditionality without a large initial IMF financial commitment.

- European Community's trade relations with Eastern Europe differentiate on basis of relative effectiveness of market-related economic reforms. On COCOM. UK supports need for more effective controls over fewer items. But lack of hard currency is key constraint on imports.

- Exaggerated view in Eastern Europe of Western Governments capacity to direct private investments. Existing governmental arrangements (Investment Promotion and

Protection Agreements - IPPAs; limited insurance by export credit guarantee agencies; publicity and missions) can be used to fullest extent, but investment decisions ultimately matters for the commercial judgement of companies.

- Some Soviet interest in GATT, IMF. Would need to see considerable changes towards more open market-oriented economy before such membership would be a real possibility. (Long-standing Eastern European members of GATT - Poland, Hungary - have not been able to participate fully). Should also be wary of potential political implications.

OECD Role (If raised)

- In principle, believe OECD could play a role in providing advice to Soviet Union and Eastern Europe on technical issues, eg methodologies, forecasting etc. But policy advice coming from OECD would be very difficult for eg the Russians to swallow. And for Eastern countries already IMF members need to avoid trespassing on areas of policy advice more appropriately and effectively done by IMF. Ground-rules would have to be carefully drawn and resource implications set out and considered.

- But vital that OECD remain an essentially Western, market-economy organisation. Important to make clear to Russians and East Europeans they should not aspire to full or associate membership: OECD not an organisation open to every country and we must not weaken its effectiveness.

- (If raised) Asian NIES in a different category; much closer to OECD's liberal, market-based principles.

BACKGROUND

1. East/West Economic Relations is not on the agenda of the Ministerial meeting, but will be discussed at lunch on either the first day (by the Foreign Secretary) or, more likely, the second (by the Chancellor). Ministers will mainly wish to exchange views on economic developments in Eastern Europe and the appropriate Western response, but it is likely that the OECD's role in East-West relations will be raised. At the restricted dinner for the Executive Committee in Special Session (ECSS) on 16 May, the US representative suggested as a personal idea that the OECD might discreetly provide technical and even policy advice to the Russians and other East Europeans.

2. We do not believe this would be an appropriate role for the OECD. It could play a larger role in supplying information on technical economic issues. But policy advice is unlikely to be welcomed by the Russians and would be inappropriate for Eastern Europe countries which are members of the IMF. Moreover, we should retain the OECD as a "Western organization" for the foreseeable future. The West needs somewhere to concert the approach to UN and UNCTAD conferences, Western economic summits, etc. This need will be even greater if the USSR joins the IMF and the GATT, whose membership rules, unlike the OECD's, are in principle universal. In view of these considerations, ground-rules for any closer links with the Soviet Union and Eastern Europe need to be extremely carefully laid out.

3. In accordance with past practice, Yugoslavia, which is an OECD member with Special Status, has been invited to the lunch and is expected to attend. Yugoslavia's delegation is likely to be led by a Minister.

Economic Reforms

4. The advent of Gorbachev and his programme of reform in the Soviet Union have altered the basic equation in Eastern Europe. Whereas the Soviet Union was earlier seen as a brake on reform, now it is the major exponent of reform. While Gorbachev has not expressly renounced the Brezhnev doctrine, he has laid more emphasis on separate roads to socialism. East European leaders now have more scope for pursuing their own individual policies. Whether there are limits to this freedom, and if so what they are, is probably as unclear to the East Europeans as it is to us. As a result of this more relaxed Soviet attitude, the East European countries have pursued increasingly divergent policies. These range from Hungary, which is pursuing economic reforms considerably more adventurous than anything so far contemplated in the Soviet Union, to Romania, where President Ceausescu's policies are becoming ever more Stalinist.

5. It is clear that this process of change in Eastern Europe has been determined almost entirely by internal pressures in individual countries combined with the shifting attitude of the Soviet Union. The influence of the West has been mainly through its own example of economic success and political flexibility.

Trade and Debt

6. The main characteristic of East-West trade is its relatively low level. In the past 15 years, the OECD countries' trade with Eastern Europe has remained virtually unchanged, accounting for between 3 - 3.5% of their total trade. Only some 4% of the EEC's total trade (exports and imports) were accounted for by Eastern Europe in 1987. Although there is considerable variation between countries within this average, the constraints on Eastern Europe of

debt service, the shortage of foreign exchange coupled with the non-convertibility of their own currencies, and the countries' general lack of international competitiveness suggest that a substantial increase in East-West trade is unlikely in the short to medium term.

7. Between 1984 and 1987, the region's external debt rose continuously partly because of the fall in the US dollar, but also largely because of a deterioration in the countries' hard currency balance of payments, resulting from a worsening in the terms of trade combined with the need for faster domestic growth. There was a slight fall in 1988 only as a result of an increase in the dollar's value; by the end of that year gross external debt totalled just over \$129 bn (net debt \$97 bn); excluding the Soviet Union, Eastern Europe's gross debt stood at \$91 billion, and net debt at \$74 billion. The extent of the problem varies significantly between countries. Czechoslovakia and the GDR still have fairly light debt burdens. But in both Hungary and especially Poland the debt burden is very considerable. Romania alone has succeeded in reducing its external debt, but at great domestic cost. The debt burden in individual countries, actual or potential, continues to act as an important constraint on new Western credits and on import growth.

Western Organisations

8. During the past year, there have been a number of important developments in the EC's relations with Eastern Europe. First, in June, the EEC and the Council for Mutual Economic Assistance (CMEA) signed a joint declaration establishing formal relations between the two bodies. There then followed the establishment of official relations between the EC and the individual European CMEA states, except Romania. Parallel to this process, the EC and

Hungary signed a trade, commercial and economic cooperation agreement in September, and one with Czechoslovakia on industrial products in December. Negotiations with Poland and Bulgaria are underway, and a mandate is currently under discussion for negotiations with the USSR.

9. COCOM partners recognise need to restrict control lists to minimum necessary; work continues to reform COCOM procedures and streamline visits.

10. Hungary, Poland and Romania are long-standing members of the GATT and also the IMF/IBRD. Bulgaria has applied for full membership of GATT (an observer since 1967) and the USSR is expected to apply.

The West's Response

11. The political advances in the Polish Round Table accords have led to further calls for Western economic aid. Both Polish Government and Solidarity have pleaded for action to relieve the burden of debt and restart supplying Western credits for a limited and highly selective number of projects. The UK Government have consistently taken the line, broadly endorsed by all major Western Governments, that Poland must first concentrate on reaching an agreement with the IMF so as to provide a framework for reform and adjustment and as a precondition for a longer-term Paris Club rescheduling. (UK, however, prepared to support interim Paris Club agreement for 1989 maturities). We believe an IMF Arrangement must commit the Poles to the maximum tolerable level of adjustment. We would not connive at any relaxation of conditionality, but would be prepared to consider a "shadow programme" where IMF resources were not committed.

12. Only the US Government has so far announced a package of trade and investment measures for Poland, but these are not far-reaching. The UK is currently reviewing options for assistance in other areas of trade, investment and the transfer of skills and expertise. Other Governments, especially West Germany, are also reviewing policies but have so far played their cards close to their chests.

ORGANISATION FOR ECONOMIC
CO-OPERATION AND DEVELOPMENT

CONFIDENTIAL

Paris, drafted:

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ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE

1988-1989 ANNUAL REVIEW

UNITED KINGDOM

DRAFT ECONOMIC SURVEY BY THE SECRETARIAT

(Note by the Secretariat of the Committee)

The attached draft Economic Survey of the United Kingdom is submitted to the Economic and Development Review Committee for CONSIDERATION.

The Annual Review of the United Kingdom by the Economic and Development Review Committee has been arranged for Monday, 19th June 1989. The examining countries are the Netherlands and the United States.

The tables, diagrams, annexes and statistical annex will be circulated separately.

It should be noted that the United Kingdom authorities did not have the opportunity to comment on this draft before it was circulated.

Contents

Tables

Diagrams

Introduction

1. The strong expansion of the United Kingdom economy in 1987 continued virtually unabated during 1988. As highlighted in Part I of this Survey, this reflected both booming investment and buoyant household demand, underpinned by a brisk expansion of borrowing, in particular mortgage credit. Both employment growth and the trend of wages steepened. With the economy increasingly coming up against capacity limits, inflation started to edge up and the current-account deficit widened sharply.

2. In view of increasing signs of overheating, the authorities have progressively tightened monetary conditions since mid-1988 (Part II). The rise in short-term interest rates by more than 5 percentage points has damped monetary expansion, and in particular mortgage lending, and has contributed to maintaining a strong exchange rate. The medium-term orientation of fiscal policy puts the burden of short-term adjustment on monetary policy. But fiscal policy has contributed to restraining demand by sticking to nominal spending targets in spite of higher-than-expected inflation. The implied tightening of the fiscal stance is continued in the 1989 Budget, combining expenditure restraint with only modest tax reductions. On the basis of these policies, the recent marked slowdown in household spending, especially in the housing market, can be expected to continue and to reduce the growth of real domestic demand below that of potential output. This might arrest the rise in inflation and the external deficit. There is considerable uncertainty, however, about the underlying strength of demand and inflationary pressures, and about the effects of policy tightening. Slow progress in reducing inflationary tensions and imbalances in the economy could undermine confidence in sterling and lead to a "hard landing" of the economy (Part III).

3. Although, despite the spurt in recent years, GDP growth since the previous cyclical peak in 1979 has hardly exceeded 2 per cent per annum, conditions would seem to be favourable for the economy to return to a higher growth path over the medium term (Part IV). Productivity gains have increased significantly, in particular in manufacturing, profitability has recovered, and investment has surged, boosting the growth rate of productive potential. Improved supply-side performance owes much to structural policy reforms pursued over the last decade. The special Chapter of the Survey (Part V) reviews Government policies aimed at making the public sector itself more efficient. The United Kingdom has taken a leading role in this area, introducing modern management and efficiency monitoring techniques, transferring significant parts of activity to the private sector, and increasing competitive and financial pressure on public-sector management.

I. An overheating economy

Excessive growth of domestic demand

4. The economy has grown a little more than foreseen when the United Kingdom was examined a year ago. Demand pressures, however, have been markedly stronger and, with a high rate of capacity utilisation, imports have surged (Table 1). To a large extent the extraordinary buoyancy of both consumer and business demand can be attributed to improved economic confidence, although the relaxation of monetary policy in the aftermath of the stock-market crisis has also played a role. The announcement in the March 1988 Budget of changes to mortgage tax relief seems to have led to an advancement of household borrowing and spending. But the fiscal stance has, if anything, been tighter than foreseen, with the tax burden broadly stable and public expenditure falling in real terms.

(Table 1. Demand and output)

5. Although the picture emerging is clearly that of an overheating economy, the inadequacy of available national accounts data makes it difficult to trace the course of the economy over the past two years or so with any precision. The various measures of GDP show widely differing paths within years (Diagram 1), and even for 1988 as a whole growth in the expenditure-based measure falls short of that in the income and output measures by almost 2 percentage points. At the same time large "balancing items" have emerged in sectoral financial accounts, equivalent to the difference between the income and expenditure measures of GDP. In particular, the personal sector appears to have acquired more financial assets than the national income and expenditure estimates imply, but balancing items have also become unusually large for the corporate and overseas sectors. Preliminary work in the Central Statistical Office, aimed at providing balanced national and financial accounts for the 1985-87 period, suggests that there has been substantial under-recording of gross fixed capital formation and personal saving, while the growth in company profits and deterioration in the external balance has been probably somewhat over-estimated. Given the sizeable residual errors, revisions to statistics have also been unusually large. Over the last six months or so, domestic demand in 1987 has been revised upwards by about 1 per cent, with changes to investment data particularly important. Figures for 1988 shown in Table 1 are likely to understate the strength of demand to at least the same extent. As revisions to the output measure -- considered the most reliable -- are normally limited, this can be expected to result in a higher rate of growth in the "average" measure of GDP in 1988 than recorded at the moment.

(Diagram 1. Measures of GDP)

6. Even allowing for special factors (such as accidents depressing North Sea oil production), output growth seems to have fallen back somewhat during the course of 1988, reflecting capacity constraints rather than lack of demand. Since late 1988 there are indications of a slowdown in household spending, in particular in the housing market, in response to higher interest rates. Increased stockbuilding appears to have been partly involuntary. According to business surveys, order books and output expectations have become less buoyant, and some easing of capacity pressures seems to have occurred. But investment activity and intentions have as yet shown little sign of weakening.

7. In terms of contributions to GDP growth, consumer demand has remained the mainstay of economic expansion. Its more rapid rise in 1988 (Table 1) mainly reflected soaring demand for durables, especially cars, and for services, notably international travel. A greater proportion of the rise in consumer spending than before can be traced to the evolution of real personal disposable income which, boosted by high employment growth, increased by almost 5 per cent. But the contribution from a decline in the savings rate remained substantial: before recovering a little, the personal saving ratio reached a low of 3 per cent in the third quarter of 1988; this compares with a peak of more than 15 per cent at the beginning of the 1980s. With strong residential investment, the personal sector has moved into a financial deficit of some 7 per cent of disposable income.

8. The steep fall in the personal sector saving ratio (Diagram 2) may be regarded as the most important factor behind excessive growth of domestic demand and the associated deterioration in the external balance. Although, for both economic and statistical reasons, more importance should be placed on developments in aggregate savings of the private sector in total, the decline in the measured personal saving ratio has been of such magnitude as to warrant some examination and explanation. The large discrepancies in the statistics give rise to doubts, though, about the true extent of the fall. Contrary to the saving ratio derived from income/expenditure accounts, an alternative measure derived from financial flow data has remained fairly stable over the last few years. Yet, while recognising that personal income is probably underestimated, the Central Statistical Office considers statistics on financial transactions in general less reliable; the above mentioned "balancing exercise" suggests that in 1987 the saving ratio may have been underestimated by 2 percentage points. Another problem of measurement arises from the fact that the personal sector in the national accounts includes pension and life assurance funds and unincorporated businesses. The higher value of pension funds has led to "contribution holidays", i.e. lower employer contributions, which count as personal income. This has significantly lowered the measured personal saving ratio over the last few years in favour of higher company saving (1).

(Diagram 2. Personal consumption and saving)

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1. There is also a view that income arising from unincorporated businesses may be misallocated between the personal and corporate sectors.

9. The phenomenon of steeply falling household saving ratios has not been unique to the United Kingdom. During the the 1980s a large decline, though from a higher level, has also been registered in France, Italy and Canada, and over a longer period there has been a similar fall in the United States; in some Nordic countries current net household saving has even become negative. The main reasons for this appear to have been disinflation (meaning less erosion of the real value of financial assets), rising consumer confidence, demographic factors, sharp increases in equity and housing prices, and financial liberalisation, which has increased the personal sector's capacity to borrow. Inflation adjustment considerably mitigates fluctuations in the United Kingdom saving ratio in the late 1970s and early 1980s but does not contribute much to explaining saving behaviour over the past five years or so. Lower inflation may, however, have contributed to a strengthening of consumer confidence, which has been bolstered by several years of rapid expansion of employment and real incomes. Recent research has pointed to the influence on aggregate saving of the age distribution of the population. This could have significant consequences for future savings behaviour, as the long-term decline in the proportion of middle-aged high savers will be reversed in the 1990s.

10. The decline in the personal saving ratio during the 1980s has been a result of increased borrowing rather than a decrease in gross savings. The brisk expansion of consumer credit and, in particular, mortgage borrowing, part of which seems to have been to finance consumption, is a consequence of financial liberalisation but also reflects the strong rise in share prices and escalation of house prices. The increased market value of personal wealth has reduced the need for new savings and served as a collateral for borrowing. Although personal sector debt has grown much faster than disposable income, it has risen only moderately in relation to personal wealth, in particular if account is taken of housing wealth (Diagram 2). With the personal sector's net worth continuing to grow strongly, its financial position has, on average, remained healthy. Nonetheless, an increasing number of households may be over-extended or severely constrained. Interest payments now amount to some 13 per cent of disposable income and exceed interest receipts for the personal sector.

11. Notwithstanding some leakage into current consumer spending, the bulk of mortgage borrowing has served to finance house purchases. Investment in housing has gathered growing momentum since the mid-1980s (Table 1). The limited supply response to buoyant demand, due in part to restrictions on land use, has meant that house prices have soared (Diagram 3). The housing market was particularly buoyant in the first half of 1988, when mortgage interest rates reached a low and the announced limitation of mortgage tax relief as from August acted as an additional stimulus. Since then, with a progressive rise in interest rates, there are signs that the housing market is easing: mortgage lending commitments have fallen markedly, and housing starts have been rising less rapidly (Diagram 3).

(Diagram 3. Housing indicators)

12. Over the past two years private non-residential investment has been the most rapidly growing demand component, expanding by about one-third (Table 1). Capital spending in the service sector has remained strong. Manufacturing

investment has recovered markedly, although, according to latest estimates, its level in 1988 still fell short of that in 1979. Investment has continued to be concentrated in plant and machinery rather than non-residential structures. Strong upward revisions to historical data have brought estimates for fixed capital formation more in line with what could be expected against a background of high profitability and capacity utilisation but, as explained above, some under-recording may still persist. As a proportion of GDP, recorded gross business investment has reached a historical high. In net terms, the picture appears weaker: after falling to a low of 1 1/2 per cent by 1983, the investment ratio net of depreciation has just recovered to above 4 per cent, about the level of the 1970s. The decline in the business sector's capital/output ratio since the early 1980s appears to have continued. The improvement in capital productivity, which compares favourably with developments in other Member countries, would seem to be not just a cyclical phenomenon but to reflect a better quality of investment. Together with improved efficiency in the use of resources, this may have contributed to the steep rise in the business sector's rate of return on capital back to pre-1973 levels.

13. The strength of domestic demand, along with worsening international competitiveness, has led to growing net imports (for details see below). Part of the sizeable deterioration in the real foreign balance (Table 1) may reflect a diversion of output from foreign to domestic markets as a result of scarcity of capacity. It is notoriously difficult to assess the degree of resource pressures. One measure is the estimated gap between actual and potential output, the latter defined as the maximum level of output consistent with stable inflation. Such a measure, derived from the country supply block in OECD's INTERLINK model, suggests that in 1988, as in the late 1970s, the United Kingdom economy was operating above potential. Although, with steepening growth in total factor productivity and capital formation, potential output growth is estimated to have edged upward towards 3 per cent, the strong economic expansion over the last few years has meant that the large gap between aggregate supply and demand which had opened in the 1980/81 recession had been probably closed by 1987. Survey evidence for the manufacturing sector (Diagram 4) points in the same direction. By the end of 1988, the proportion of firms citing plant capacity as a factor limiting output had reached the previous peak of the late 1970s. The percentage of firms operating at full capacity was even higher than during the 1973/74 boom. There are indications, however, that supply is more responsive at given high levels of capacity utilisation than in the past. With output growth moderating, capacity utilisation rates in manufacturing have fallen off in recent months.

(Diagram 4. Capacity constraints)

Tightening labour market conditions

14. The strength of economic activity has been reflected in the labour market. With rising employment rates, shortages of skilled labour have increased markedly, though not to the extent recorded at cyclical peaks up to the early 1970s (Diagram 4). The findings of the 1988 Labour Force Survey indicate that the marked decline in unemployment since mid-1986 has been associated with much stronger expansion of both labour demand and supply than thought before. Total employment growth in 1987 and 1988 is now put at around

3 per cent per annum (Table 2). As a result, labour productivity performance now looks less favourable: growth in output per head appears to have dropped to below 1 per cent in the twelve months to late 1988, implying a virtual stagnation of hourly productivity, given a continued rise in overtime work. As productivity gains in manufacturing have remained high (Table 2), this largely reflects poor measured performance in the service sector. Output in the service sector may be underestimated, but correction for this would probably raise productivity levels more than short-term productivity advances.

(Table 2. Labour market)

15. With the recovery gaining momentum, there has been a marked shift in the sources of employment growth. Up to 1987, the rise in employment was largely confined to the service sector, self-employment, and dependent part-time work. Revised data show that, after declining by about one-third since the late 1970s, employment in manufacturing started growing again in mid-1987. While self-employment and dependent part-time work has continued to grow faster than the average, their contribution to employment growth in the year to spring 1988 dropped to below and slightly above one-fifth, respectively, as compared to around two-fifths each over the preceding three years (the rest in that period being accounted for by government employment schemes, Table 3). An outstanding feature in the recent period has been the recovery of male full-time employment, reversing the fall in the three years before. At the same time, growth in part-time employment among men picked up, and the percentage of those who worked part-time because they could not find a full-time job dropped from more than 20 per cent to around 15 per cent. This was still significantly higher than in the case of women, in particular married women, who work predominantly part-time and account for the bulk of part-time working people. The number of people participating in work-related government employment and training programmes, which had increased by over 200 000 or two-thirds over the 1984-1988 period to more than 2 per cent of total employment, has tended to rise less rapidly.

(Table 3. Decomposition of employment growth)

16. Labour supply has responded flexibly to the buoyancy of demand. With the number of discouraged workers dropping markedly, the increase in economically active people accelerated to over 1 1/4 per cent in the year to spring 1988, according to provisional Labour Force Survey data, although the expansion in the working age population slowed to an annual rate of less than 1/2 per cent. The resulting rise in the overall participation rate since 1986 reflects a continued increase in female participation and a reversal of the fall in the activity rate for men. Statistics available for the remainder of 1988 imply a stagnation of the labour force, which appears implausible, given the strength of the economy. Hence, employment growth could be underestimated, as in the year before; or alternatively, the claimant count could overstate the decline in unemployment since spring 1988.

17. The latest Labour Force Survey broadly confirms the marked fall in unemployment shown by registration data for the year to spring 1988. This contrasts with the years before when alternative measures of unemployment had often displayed widely diverging trends (Diagram 5). By the second quarter of 1988, according to the Survey-based standardised ILO/OECD measure, the rate of

unemployment was about 8 1/2 per cent, close to the claimant count and sharply down from the 1986 peak of 11 1/2 per cent. The assessment of more recent developments is complicated by changes in benefit regulations for young people, most of whom are no longer eligible for income support, as they have the guaranteed opportunity of a place on the Youth Training Scheme. To avoid discontinuities in the statistics, official figures (the adjusted claimant count) now relate only to claimants aged eighteen or over. This series, which is used to extrapolate standardised data since the 1988 Labour Force Survey, shows a further fall in the unemployment rate by about 1 1/2 percentage points over the last twelve months, with some slowdown only most recently. The rise in the number of unfilled vacancies, on the other hand, already petered out in the course of 1988, and shortages of skilled labour appear to have eased significantly since the turn of the year (Table 2, Diagram 4).

(Diagram 5. Measures of unemployment)

Resurgence of inflation

18. With capital utilisation rising and labour slack diminishing, pressures on resources have led to a marked pick-up in inflation. When the United Kingdom economy was examined a year ago, there was some concern about cost and price developments, but evidence on resource pressures was considered inconclusive and, apart from the housing market, there were few signs of a resurgence of inflation. Indeed, contrary to developments in many other Member countries, the inflation process in the United Kingdom appeared to be characterised by considerable inertia: after having fallen sharply in the early 1980s, inflation had displayed no clear trend, fluctuating around an underlying rate of close to 5 per cent. A sudden spurt in inflation in the mid-1980s followed upon a large fall in the exchange rate and marked rise in import prices (Table 4). By contrast, the pick-up in inflation in the first half of 1988 occurred against a background of a rising pound and subdued import prices. It was only later in the year that imported inflation added to the pressures emanating from high resource utilisation.

(Table 4. Costs and prices)

19. The doubling of the twelve-month increase in retail prices over the past year to 8 per cent by April 1989 overstates the acceleration in inflation. Unlike in most other Member countries, mortgage interest payments are included in the retail price index, as a measure of the cost of housing for owner occupiers. Compared to alternative measures, such as imputed rents, this tends to make the price index more volatile, because the average level of mortgage interest payments is very sensitive to changes in interest rates. Although elimination of this component from the index removes the effect of changes in the cost of housing for owner occupiers, the adjusted index would seem to give a better indication of the underlying trend of inflation. On this measure, the inflation rate has risen by about 2 1/2 percentage points over the past year or so, to about the level of the previous peak in 1985 (Diagram 6). Another indicator for the underlying inflation rate, the rise in the non-food producer price index, has so far remained below the 1985 peak, accelerating only more recently after a moderate upward drift during 1988.

(Diagram 6. Price developments)

20. Due to the revisions to employment and productivity data unit labour cost estimates now show a much more pronounced acceleration (Table 4) than was previously apparent. Yet, the recovery of profit margins -- welcome in its own right -- has continued to contribute to the inflation process, though to a diminishing degree. In manufacturing, about one-sixth of the increase in producer prices in 1988 can be attributed to higher margins. For the economy as a whole, a comparison of the rates of growth in the GDP deflator and in unit labour costs would seem, at first glance, to indicate some squeeze on margins. But, apart from the provisional nature of and substantial margin of error attached to the deflator, it has to be taken into account that a large fall in North Sea profits depressed this indicator by about 1 percentage point in 1988. Non-oil trading profits of industrial and commercial companies are estimated to have grown by about a fifth, as in the year before.

21. High profits and labour market tightening have combined to put upward pressure on wages. The underlying rate of growth of average earnings, which had remained within a narrow range of 7 1/2 per cent to 8 per cent in the five years to 1987, moved upward to 9 per cent in mid-1988 and has fluctuated around this rate since. Viewed against the sharp fall of unemployment, wage trends might have been expected to steepen even more. Survey evidence suggests that labour-market pressure has re-emerged as a consideration in pay bargains: while in the mid-1980s the level of unemployment had reportedly little influence on settlements, the need to recruit or retain labour is now considered as important as company profitability and the cost of living. Econometric evidence for manufacturing points to a relatively limited impact of skill shortages on overall wage growth, although the former explain most of the increase in wage inflation since 1987 (2). To a large extent, the rise in earnings growth has been the result of higher settlements, which have edged up to about 7 per cent in manufacturing and somewhat more in the service sector. Rising overtime work has also contributed, although to a diminishing degree in recent months, as well as several large catch-up rises in the public sector (notably in the health sector). While wage increases in the financial sector have slowed down sharply, they have remained high in construction and even turned up in some manufacturing industries, such as motor vehicle production. This has been in part the consequence of inflation protection clauses in some longer-term agreements. These not only trigger off wage adjustments in response to the steep rise in the retail price index associated with increasing mortgage interest rates, but also induce subsequently other groups without revision clauses in their contracts to try and catch up.

Sizeable external imbalance

22. The deterioration in the current external account quickened in 1988, reflecting domestic-demand growth as well as a weaker competitive position. Mostly as a result of a strengthening pound sterling, the competitive edge stemming from the real depreciation of the currency in the eighteen months to early 1987 had been lost by the end of 1988 (Table 5). Adverse effects on trade volumes of the rise in sterling have been mitigated, though, by significant improvements in the terms of trade. Of the total rise in the

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2. A. Sentance and N. Williams, "Skill Shortages: A major problem for British Industry?", CBI Economic Situation Report, London, March 1989.

current-account deficit in 1988 of about 2 1/2 per cent of GDP, about two-thirds are attributable to non-oil trade, the decline in the surpluses on both oil trade and invisibles accounting for the rest. The non-oil trade deficit has tended to widen markedly during the course of the recovery (Diagram 7). Trade in manufactured goods, traditionally in surplus, has moved into increasing deficit since 1983. Since the mid-1980s, in volume terms, imports of manufactures have grown by one-half, while exports have expanded by only one-quarter (Table 5). The current balance turned into deficit when the deterioration in the non-oil trade balance was no longer offset by rising surpluses on oil trade and invisibles. Lower prices and falling production, partly due to accidents, had virtually wiped out the oil surplus by early 1989. Net receipts of interest, profits and dividends have kept rising, owing to a still sizeable stock of net overseas assets (amounting to about one-fifth of GDP) and lower dividend payments to overseas oil companies; but this has been outweighed by a fall in the balance on services, partly due to a rising deficit on travel.

(Table 5. External trade and the current account)

(Diagram 7. Current account developments)

23. Though there may be some under-recording of net current-account earnings, it is unlikely to be important in relation to the size of the deficit (more than 3 per cent of GDP in 1988). The large errors and omissions item in the balance of payments appears to reflect mainly under-recording of capital inflows. Recorded transactions show a net outflow of £0.6 billion in 1988, resulting from an increase in net short-term inflows and a return of the balance of long-term transactions to a substantial outflow.

24. The marked worsening in the external balance in 1988 reflects both rising import penetration and disappointing export performance. With buoyant domestic demand and capacity shortages in some industries, the volume growth in merchandise imports almost doubled to 13 1/2 per cent. The rise in imports was particularly pronounced in finished manufactures, with imports of passenger cars, intermediate and capital goods growing fastest. More recently, with demand for consumer goods weakening, imports have increased less rapidly, but their twelve-month growth has of late remained above the rate for 1988 as a whole. The recent surge in import penetration followed a weaker trend in the mid-1980s which seems to have reflected a temporary pause in the recovery, with relatively weak investment activity, preceded by some improvement in price competitiveness on the domestic market. The increase in import penetration has been less pronounced in value terms, as import prices have declined relative to domestic prices. The long-run rise in the share of total aggregate demand that is met by imports would not in itself be worrying as long as it reflects increasing specialisation in international trade and greater openness of world markets. The upward trend in import penetration has not, for example, been much steeper than in Germany, where the level of import penetration is even higher than in the United Kingdom. It gives cause for concern only if there is no parallel upturn in foreign earnings through investment income or exports.

25. Following some improvement since the mid-1980s, export performance deteriorated markedly in 1988. Merchandise exports declined in real terms, as oil output fell sharply (Table 5). The growth rate of manufactured exports

fell significantly short of the expansion of world markets, even if erratic items are excluded. Exports of capital goods rose strongly, benefiting from the world-wide investment boom, while exports of intermediate goods and consumer goods decreased somewhat. Gaps in the United Kingdom's product range may in part explain this poor trade performance. The reversal of the earlier real depreciation is likely to have contributed: according to business surveys, non-competitive export prices are by far the most important factor limiting the ability to win orders; on the other hand, on average, exporters appear to have been able to raise profit margins further. With capacity utilisation particularly high in some consumer-goods industries, capacity shortages have certainly played a role too. Indeed, exports of consumer goods have picked up more recently, when domestic demand began to weaken. Total merchandise exports, after falling back in late 1988, have also shown signs of recovery in recent months (Table 5).

26. Notwithstanding the recent deterioration, manufacturing trade performance over the 1980s compares favourably with past experience and has not been significantly worse than that of many major competitors. In both volume and value terms, there has been little change in world market share over the past five years or so. A constant market share analysis covering developments up to 1987 may help explain the apparent ending of a long-term deterioration. It breaks down the growth differential between world imports and United Kingdom exports of manufactures into three components: a regional-composition effect, a product-mix effect, and a residual. Data limitations impose the use of value data, which may be distorted by exchange-rate fluctuations. Hence, the residual term can give only a rough indication of changes in price and quality competitiveness and other supply-side effects. Table 6 shows that the product-mix effect has been positive over the past two decades, suggesting that British producers have succeeded in taking advantage of the most dynamic markets by adjusting the structure of their products (see below). With a shift away from developing countries and towards the European Community and the United States, the regional composition of exports has had a damping effect on export growth over the last decade. The residual term, which used to be highly negative in the past, has moved towards positive values over the last few years. This is likely to reflect in part the fall in the real exchange rate, reversing the strong increase in the second half of the 1970s. But supply-side improvement may also have contributed, enhancing non-price competitiveness and altering the sensitivity of exports to changes in price competitiveness and demand.

(Table 6. Constant market share analysis)

27. Closer analysis of export trends reveals that, despite the overall positive contribution of the product mix, the majority of product groups still recorded losses in world market share in the 1989s, and many of them in strongly-expanding markets. The most important example is motor vehicles, which account for a high proportion of total exports. Performance was generally more favourable in the area of products with a high technology content. These findings are corroborated by an analysis of both the level of "revealed comparative advantage" (the relation of the export/import ratio of a commodity group to the aggregate export/import ratio), an indication of specialisation in certain production, and its change between 1982 and 1987 (Diagram 8), a period characterised by a movement into trade deficit and by a real depreciation. The range of products, which are divided into five

categories, is shown in Table 7. In the 1980s, research-intensive products in general gained comparative advantage. In total, two-fifths of the included products recorded a rise in comparative advantage or decline in comparative disadvantage. Comparative advantage shrank in relatively important groups such as specialised industrial machinery and equipment and fabricated metal products. Comparative disadvantage increased in several labour-intensive industries, as well as for transport equipment, and many consumer goods such as electrical, photographic and optical products. In sum, increasing specialisation and rising comparative advantage in the area of high-technology products together with the robustness of some "strong points" (such as industrial chemicals) has its counterpart in other areas which not only include the traditional labour-intensive sectors but more significantly differentiated goods.

(Diagram 8. Revealed comparative advantage)

(Table 7. Product composition of foreign trade)

II. The policy response

Marked tightening of monetary policy

28. Within the framework of the Government's medium-term-oriented strategy, the task of containing inflation falls on monetary policy. Over the last few years, determining the required degree of monetary restraint, the choice of policy levers and of intermediate targets have been complicated by a number of factors. With financial liberalisation and innovation reducing the usefulness of broad monetary aggregates as guides for policy-making, policy decisions have necessarily become more judgmental. The evidence of a range of indicators has been used to assess monetary conditions, with particular weight being given to narrow money in relation to its target range and to the exchange rate. In spite of strong expansion of broad money and credit, interest rates were brought down significantly in the aftermath of the stock-market crisis in late 1987, the fall in equity prices being regarded as equivalent to a tightening of monetary conditions. In these circumstances, a relaxation of monetary policy was deemed necessary to prevent a collapse of confidence. The easier stance of policy was maintained into 1988. Interest rates were cut further as upward pressure on sterling persisted despite shrinking international interest differentials and sizeable official intervention in foreign exchange markets (Diagram 9). Although some indicators, notably narrow money, and house and asset prices, pointed to emerging inflation pressures, the strengthening exchange rate was thought to indicate appropriately tight monetary conditions.

(Diagram 9. Interest rates and exchange rates)

29. In the middle of 1988, there was mounting evidence that monetary policy was too loose and had been so for some time. Beginning in June, the authorities took advantage of adverse sentiment towards sterling to raise interest rates gradually. But it was only in August, and again in November, when it had become increasingly clear that domestic demand was continuing to grow excessively, that interest rates were increased further even though the exchange rate was moving upwards. There are now first signs that the marked tightening of monetary policy has begun to bite: prices and turnover in the housing market have turned downwards, mortgage borrowing has declined, and growth of narrow money has slowed down towards its target range (see below). The authorities have made it clear that interest rates will stay as high as necessary for as long as necessary to reduce inflationary pressures and have reconfirmed their commitment to not accommodating increases in domestic costs by exchange rate depreciation. More recently, downward pressure on sterling due to falling interest differentials against major countries and changing market sentiment has been met by massive official intervention in foreign exchange markets.

30. The expansion of narrow money (M0, mainly notes and coins in circulation) overshot the 2 to 6 per cent target range set for the financial year ending in March 1988 but remained below the top of the band on a seasonally adjusted basis. Throughout the following twelve-month period M0 growth stayed above the (lowered) target zone of 1 to 5 per cent. Seasonally-adjusted data suggest that most of the rise of more than 6 per cent over the year to March 1989 occurred before September and that M0 growth continued to move towards the (unchanged) target band at the beginning of the current financial year. Year-on-year growth rates of unadjusted data, though distorted by the unwinding of the effects of a postal dispute last autumn, confirm the impression of a marked slowdown in narrow money growth in line with consumer spending. The marked flattening in the upward trend of the income velocity of M0 in 1988 does not, however, support the proposition that the relationship of narrow money to nominal income is more stable than that of broader monetary aggregates.

31. Broad aggregates have reacted less to the tightening of policy in mid-1988. After some deceleration late in the year, their rates of growth have moved back to previous peak rates. Growth of M3 had accelerated to more than 20 per cent in 1987, as building societies shifted to holding a greater proportion of their liquid assets in the form of bank deposits, and has fluctuated at around this rate since. Twelve-month growth of M4, which includes deposits held with banks and building societies, has been drifting upwards over the past few years to reach 18 1/2 per cent in September 1988 and again in March 1989. Among the counterparts to broad money, sterling lending by banks and building societies to the private sector has of late moderated only marginally from 1988 peak rates of almost 25 per cent (Table 8). This reflects continued high lending to businesses, as takeover and merger activity and capital spending have remained buoyant. Companies are likely to be influenced by longer-term borrowing costs, which have risen little (see below). However, higher interest rates already appear to have affected borrowing by the personal sector, which has become more highly geared, paying now more in interest on its floating-rate liabilities than it receives on its floating-rate assets. Consumer credit expansion has slowed down markedly. Mortgage borrowing, which accounts for the bulk of personal credit, fell back sharply following the ending of multiple tax relief on mortgages in August 1988; notwithstanding some recovery most recently, underlying demand would seem to have weakened significantly in response to higher mortgage costs.

(Table 8. Formation of money supply)

32. Since 1986, the Government's funding policy has been aiming at a broadly neutral impact on liquidity. Originally based on M3, the "full fund" rule has been defined in terms of M4 since the 1988 Budget: the authorities now seek to fund the aggregate of the net total of maturing debt, the public sector borrowing requirement, and any underlying increase in foreign exchange reserves by sales of government debt outside the banking and building society sectors. Should this total become negative, so-called "unfunding", i.e. purchases of debt, will be required. Virtually full funding was achieved in 1987/88 (in terms of M3, Table 8), notwithstanding the authorities' decision that massive exchange market intervention in this period did not need to be sterilised within the financial year. In 1988/89, public-sector operations had a contractionary effect on liquidity as the liquidity drain from the rapidly-rising budget surplus more than offset liquidity injections

from the diminished accumulation of foreign exchange reserves and considerable repurchases of public debt.

33. Funding developments, and in particular the fact that much of the redeemed government debt has been of longer maturity, may have contributed to the emergence of a sharply downward sloping yield curve. Indeed, despite the steep rise in short-term rates (from a low of 7 1/2 per cent in May 1988 to 13 per cent as from November), longer-term interest rates have remained within the 9 to 10 per cent range. The influence of government debt management on this relative stability, which has been a feature of recent years (Diagram 9), is difficult to quantify. Empirical work (3) has generally revealed little impact of the quantities of bonds issued on yields, and the effect of changes in outstanding amounts of bonds of a particular maturity is hard to gauge, all the more so as the decline in sales in government securities has been accompanied by a rise in non-public sector fixed-rate sterling bonds. Allowing for this, government funding may have had only limited bearing on the position and shape of the yield curve. Econometric evidence (4) points to a diminishing impact of changes in short-term on long-term rates. This implies that monetary authorities, while retaining significant control over short-term rates, have less influence on long-term rates. Another, not necessarily alternative, interpretation of the sharply downward sloping yield curve is that the authorities have instilled confidence that the rate of inflation will remain in a relatively narrow band over the medium term. Indeed, the differential between conventional and index-linked government bond yields indicates that inflation expectations have remained relatively stable within a 5 to 6 per cent range. OECD research (5) suggests that the inflation-risk premium demanded by savers investing in bonds may be influenced by the development in the public debt or public expenditure burden, which have shown a substantial decline in the case of the United Kingdom (see below).

Substantial budget surplus

34. In the context of the Government's strategy, fiscal policy is considered an inappropriate instrument for short-run demand management, though account is taken of the economic situation in setting the budgetary stance each year. As noted in last year's Survey, at the time of the introduction of the March 1988 Budget, there was a case for fiscal tightening as the economy was rapidly approaching full capacity limits. On the other hand, the budget was already in surplus, and the Government was committed to further tax reform. In the event, the Budget provided for tax cuts of about 1 per cent of GDP (compared to an indexed base). With continued expenditure restraint, this was projected to leave the surplus broadly unchanged from the year before.

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3. See e.g. C. Goodhart and D. Gowland, "The Relationship Between Long-Dated Gilt Yields and Other Variables", Bulletin of Economic Research, Vol. 30 (1978), No. 2.

4. D. K. Miles, "Recent Developments in the Pattern of U.K. Interest Rates", Bank of England Discussion Papers, No. 36, February 1989.

5. Economies in Transition. Structural Adjustment in OECD Countries, OECD, Paris 1989.

35. According to provisional estimates, the Public Sector Debt Repayment (PSDR -- the budget surplus) in the financial year 1988/89 (ending in March) amounted to £14.3 billion (about 3 per cent of GDP), as compared with projections of £3 billion and £10 billion in the 1988 Budget and Autumn Statement, respectively; excluding privatisation proceeds, which were almost £2 billion higher than initially planned, the public sector's net financial asset/liability position is estimated to have improved by as much as £7.3 billion compared to an initially-budgeted deterioration of almost £2 billion. Much of the higher net repayment of debt comes from extra tax receipts (Table 9), due to higher-than-forecast growth of nominal GDP (11 per cent instead of 7 1/2 per cent, with higher inflation accounting for three-quarters of the difference). Indeed, despite substantial cuts in personal income tax rates, the non-oil tax/GDP ratio fell only marginally, compared with expectations of a broadly stable tax burden. Higher growth also led to expenditure saving, through reduced spending on social security and employment programmes, and through improved finances of public corporations. This largely offset extra spending for pay settlements and capital grants. Tight expenditure control meant that little use had to be made of the budgeted reserve. As budget appropriations were in general not adjusted for higher inflation, general government expenditure (excluding privatisation proceeds, which in the Budget are treated as negative expenditure) dropped by about 2 per cent in real terms, instead of rising as projected; relative to nominal GDP, its level fell by 2 percentage points to 39 1/2 per cent, as compared with a Budget forecast of a fall of half a point.

(Table 9. Budgetary developments)

36. Although, in keeping with their medium-term strategy, the authorities ruled out a midyear adjustment to the Budget in the face of excessive domestic demand, public expenditure trends and plans, as revealed by the Autumn Statement of November 1988, implied a tightening of the fiscal stance. In spite of a significantly higher price level, general government expenditure (excluding privatisation receipts) for the present financial year 1989/90 was kept broadly unchanged relative to previous plans; within the unchanged total the Government was able to accommodate claims for increased spending on health and education by using expenditure savings on account of lower unemployment and by reducing the unallocated reserve. Expenditure targets for the early 1990s, however, were revised upwards compared with previous plans. With inflation projected to come down, this is expected to allow a significant rise in real terms. As a ratio of GDP, general government expenditure would continue to decrease, because of a falling interest burden brought about by reductions in net public debt. Debt interest declined as a proportion of GDP from 5 per cent in 1981/82 to 3 3/4 per cent in 1988/89 and is projected to fall further to 2 3/4 per cent by 1991/92.

37. The March 1989 Budget was introduced against the backdrop of rising inflation and a high external deficit on the one hand, and tentative signs of a slowdown in domestic demand on the other. In view of the considerable uncertainties about the extent of the prospective slowdown, the authorities, while reaffirming the principle of a balanced budget, decided to budget a surplus similar to that recorded in the preceding financial year (Table 9). Excluding privatisation proceeds (put at £5 billion), the PSDR is expected to rise by some £2 billion, to around £9 billion (just under 2 per cent of GDP). Spending plans are those set out in the Autumn Statement and in more detail in

the January 1989 public expenditure White Paper. In spite of markedly falling debt interest payments, the growth in general government expenditure (excluding privatisation proceeds) is projected to accelerate to 7 per cent. At the same time, the rise in government receipts is expected to slow in line with that of nominal income, with tax measures merely offsetting real fiscal drag.

38. Adjusting for the net cost of indexing tax rates and and allowances, Budget measures are estimated to reduce taxation and national insurance contributions by about £2 billion in 1989/90. Apart from the indexation of income tax thresholds and allowances, the measures include: non-indexation of most excise duties to damp retail-price inflation; improvements to personal equity plans and employee share schemes to encourage saving; reduction of the corporation tax burden for small companies; further reduction in tax privileges for company cars; increases in VAT to comply with the European Court's judgement; more favourable tax treatment of unleaded petrol; reform of the taxation of life insurance and changes to the unit trust tax regime; abolition of the earnings limit for pensioners; and reform and reduction of employee national insurance contributions. The last two measures should encourage new entrants to the labour market (see below); becoming effective only in October, they will nearly double the budget cost of the tax package in the following financial year.

39. The priority accorded to reducing the fiscal deficit and the emergence of macro-imbalances have so far precluded a substantial reduction in the overall tax burden. After changing little in the first half of the 1980s, the general government financial balance on a national accounts basis, which is unaffected by financial transactions such as privatisation proceeds, improved by almost 5 per cent of GDP in the four years to 1988, with about two-thirds of the change reflecting a higher level of economic activity. The move from a deficit of 4 per cent of GDP in 1984 to a surplus of 3/4 per cent of GDP in 1988 resulted from a decline in the GDP shares of expenditure and revenue by 7 and 2 percentage points, respectively (Diagram 10). The fall in the overall revenue ratio is largely attributable, though, to lower oil prices and output. The ratio of non-oil tax revenue (including social security contributions) to non-oil GDP decreased only marginally over this period and remains about 2 1/2 percentage points above the level of the late 1970s. However, as argued in last year's Survey, the tax system has been made somewhat more efficient over the last few years. Progress in reducing the fiscal deficit in the first half of the 1980s was hampered by a high share of interest outlays in public spending. Indeed, the primary budget balance, which excludes net interest payments, had already moved into surplus in the early 1980s. Net government debt had declined as a proportion of GDP during the 1970s because of high inflation rates but remained at a high level (Diagram 10). With the fiscal balance moving into surplus, the fall in the debt/GDP ratio has become more pronounced. Although its present level of about one-third is the lowest since the First World War, it is still above that of many other Member countries, including Japan, Germany and France, and about the same as in the United States.

(Diagram 10. General government finances)

Continued supply-side reforms

40. Supply-side reforms continue to play a central part in the Government's overall economic policy to promote non-inflationary economic growth. Last year's Survey gave an overview of the numerous measures which had been taken to promote the functioning and flexibility of markets. Part V of the present Survey examines in some detail how the Government has attempted to increase the efficiency of the public sector, including privatisation and proposed changes to the delivery of health care. Recent measures include changes in taxation to reduce efficiency losses of financing public expenditure, labour market policies, and proposed deregulation in product and financial markets.

41. The 1989 Budget continued the tax reform programme by restructuring the National Insurance system, widening the tax base, and harmonising the tax treatment of different forms of savings. The social security reform, which is confined to employee contributions, aims at easing distortions on work-leisure decisions at the lower end of the income scale. A single rate of 9 per cent with an initial allowance, plus a lump-sum tax payment once an earnings limit is reached, replaces a system where employee contributions were determined by applying three different earnings-related rates to total earnings after a threshold had been passed. This still results in a sudden increase in tax liability once a relatively low earnings limit is reached, where the marginal tax rate exceeds 100 per cent, but further spikes on the contribution rate function have been eliminated. The tax base has been broadened somewhat for both direct and indirect taxes. Tax privileges on income in kind (such as company cars) have been further reduced. Unchanged upper limits on mortgage relief in nominal terms and the introduction of a (price-indexed) limit on tax-privileged pensions reduce the scope for using these tax breaks. This should limit tax-motivated investment in such forms of savings. Further measures have been taken to stimulate share ownership in general and in particular for employees taking a share in their own company.

42. Building on previous reforms, recent labour-market measures have been aimed at increasing flexibility, enhancing training and education, and limiting trade-union power:

-- Labour-market flexibility. The 1988 Employment Act repeals most legislation that still discriminates in employment and training matters between men and women. It also removes numerous restrictions on the hours of work of 16 to 18 year-olds, and eases rules governing dismissal of staff.

-- Training. In September 1988, the Government introduced the new Employment Training programme for the long-term unemployed, which subsumes the Community Programme and other adult training schemes. Employers have been reluctant to participate in the scheme so far and there are 175 000 people taking part in the programme instead of the 600 000 originally envisaged. A White Paper on the future course of training (Employment for the 1990s) envisages major organisational changes in the provision of skill acquisition. Centralised government-led training is to be replaced by local employer-led groups which will form a national network of training and enterprise councils to plan and deliver training. Existing training programmes will continue but under the responsibility of the new councils, which will be mainly financed from the current training budget.

-- Education. The Education Reform Act 1988 provides for fundamental changes in the way young people will be prepared for working life. It introduces a common core curriculum with stronger emphasis on work-related subjects than before, and standardised assessments on students' progress at various stages. The implementation of the Act could run into difficulties owing to lack of qualified teachers in the new subjects. Special recruitment efforts have so far had little success.

-- Limitation on trade-union power. The 1988 Employment Act continues the process of increasing the accountability of union officials to their members. It also removes legal immunities from strikes in support of a closed-shop system (which covered an estimated 3.6 million employees in 1984) and repeals remaining legal protection for the post-entry closed shop. A policy discussion document envisages a further weakening of the closed-shop system and greater limits on lawful secondary industrial action.

43. The Government has proposed major deregulation measures in some parts of the product market, in addition to measures discussed in Part V of the Survey:

-- Legal services. Key features of the reform of legal services, proposed in January 1989, include ending restrictive practices in advocacy, especially the termination of a "closed shop" in presenting cases in front of judges; increasing the competition in conveyancing by opening up the market to all institutions with qualified personnel; and reforming price setting of legal services by lifting restrictions on contingency fees. To pre-empt Government legislation, the group most affected has already announced some relaxation of restrictive practices.

-- Broadcasting. Proposals to liberalise the commercial broadcasting market include the establishment of new channels; selling of broadcasting licences by competitive tender rather than awarding them on the sole judgement of a regulatory body; and the removal of takeover protection of independent television companies, although the government will remain in control of takeovers.

44. Some progress has been made in dismantling trade barriers over recent years but, despite the Government's commitment to free international trade in goods and services, significant import impediments remain in operation. For example, the United Kingdom has about 600 bilateral arrangements under the Multi-Fiber Agreement. Moreover, there are a number of bilateral industry-to-industry arrangements limiting imports of motor vehicles, household electronic goods, steel products and numerically-controlled machines (for details see Annex I) .

45. The Government has continued the deregulation of financial markets as well as the development of the rules governing the provision of financial

services. As from last August, building societies are allowed to provide a wider range of services, thus enhancing competition in retail financial services. The 1989 Budget removed the Bank of England's control on the timing of new issues in the equity and bond market. The regulatory regime for sterling commercial paper and short-term corporate bonds is also to be significantly liberalised. The 1986 Financial Services Act, which sets up the ground rules for regulating the provision of financial services, came into full operation in April 1988. It has become apparent that the regulatory framework was too complex with excessive cost of compliance. In response the Government has proposed an amendment to the Act, which should simplify the rules and lower the burden of compliance. The Securities and Investment Board, the regulator of the financial industry, has continued to develop further rules to protect investors, including detailed disclosure rules.

III. What kind of slowdown?

External environment and main assumptions

46. Growth in the OECD area has been much more buoyant than expected a year ago. The tightening of monetary policies in major countries in response to increasing inflation should, however, slow the expansion of demand. The latest OECD projections, published in June, put annual output growth in Member countries at just under 3 per cent over the next eighteen months and export market growth for United Kingdom manufactures at just below 7 1/2 per cent on average, with some deceleration during the projection period. Delayed effects from the earlier rise of sterling and some deterioration in cost and price competitiveness in the period ahead, on the technical assumption of unchanged exchange rates, are expected to entail some loss in export market shares, which should diminish, however, over time. The oil price assumption is $16 per barrel as from the first half of 1989, with no change in real terms thereafter. The downward trend in oil exports is assumed to be temporarily interrupted as output recovers from the effect of accidents.

47. Macroeconomic policies are assumed to remain tight. The authorities have made it clear that interest rates will stay as high as necessary for as long as necessary to reduce inflation pressures. And they have reaffirmed that the Government is not prepared to accommodate increases in domestic costs by exchange-rate depreciation. Accordingly, only a slight fall in interest rates is assumed to occur by the end of 1990. This should bring the growth of narrow money (M0) back into the 1 to 5 per cent target range during the course of this year. In line with Budget plans, discussed above, the general government financial balance is projected to remain in substantial surplus, stabilising somewhat below 2 per cent of GDP in 1990. This implies a further tightening of fiscal policy this year and a broadly unchanged fiscal stance thereafter.

Short-term prospects

48. The progressive tightening of policies since the middle of last year should be increasingly felt during the course of 1989. As foreshadowed by business surveys and other leading indicators, the rate of growth of domestic demand is likely to drop markedly (Table 10), to below that of potential output. With inflation pressure subsiding only slowly (see below), the increasing household debt-servicing burden, smaller tax adjustments, and the petering-out of employment growth are expected to moderate the rise in personal real disposable income. At the same time, the downward trend in the personal saving ratio over the 1980s may well be reversed as households, on

average, are more heavily geared than in the past and hence more sensitive to high and rising interest rates. Spending on durables and housing investment are therefore projected to drop. Companies are more likely to be influenced by longer-term borrowing costs, which have risen little. Hence, business capital spending should hold up better in the near term. Indeed, investment intentions have remained robust. Yet, the weakening of household spending along with some squeeze on profit margins is expected to damp business investment in 1990. The recovery has been characterised by a run-down in stock/output ratios reflecting technical improvements in inventory management as well as high real interest rates. Hence, the recent build-up of inventories seems to have been partly involuntary and may be unwound in the period ahead, contributing to the projected slowdown in domestic demand.

(Table 10. Short-term prospects)

49. Export growth will be enhanced to the extent that there is less diversion of output to meet strong domestic demand. However, any such capacity effect will probably be limited by worsening competitiveness. Import growth is expected to slow down markedly in response to the cooling of domestic demand and easing of capacity constraints. Still, the resulting improvement in the real foreign balance is projected to be temporary only. With weaker domestic demand and a continued, though much slower, contraction of real net exports, growth of GDP is likely to decline to around 2 per cent in the course of 1990. This compares with an estimated growth of productive potential of some 3 per cent, and would thus imply a significant easing of pressures on resources.

50. In response to slower output growth, the increase in employment is projected to slacken, possibly giving way to some labour shedding in the course of 1990 as companies react to a squeeze in their profit margins. The rise in labour-force participation rates shown by revised statistics is expected to come to a halt. This should limit the effect of slower activity growth on unemployment, although the fall in the unemployment rate since 1986 may go into reverse before the end of 1989. Easier labour-market conditions and reduced overtime payments should lead to a slight downward drift in wage increases in the course of 1990. This year, however, cost pressures could intensify due to the combined effect of higher wage increases and temporarily lower productivity growth. Yet, as demand pressures weaken, this may be offset by shrinking profit margins. With import price increases slowing, inflation should subside, though remaining high by international comparison. Although competitive pressures are expected to limit the rise in export prices, further terms-of-trade gains are projected, partly reflecting higher North Sea oil prices. Any such gains are, however, unlikely to outweigh the continued, though slowing, deterioration of the foreign balance in volume terms. As a result, the current-account deficit may increase slightly, but could fall in relation to GDP after having exceeded 3 1/2 per cent in recent months.

Soft or hard landing?

51. The presented outlook is for a "soft landing", with inflationary pressures subsiding gradually and the external deficit falling gently as a

proportion of GDP without the economy entering a recession. Improvements to the supply side of the economy have increased the chances for such a scenario to materialise. Nevertheless, there remains a risk of a less smooth path of adjustment. In the past, the restoration of macroeconomic stability was typically achieved by a "hard landing" triggered by restrictive policies. This could again occur, in particular if slow progress in reducing tensions and imbalances in the economy undermines market confidence in sterling, and calls for a further sharp tightening of policy. As discussed in Part I, large discrepancies in national accounts statistics and erratic indicators in recent months make an assessment of the economic situation difficult. But the risk that policies have been tightened too much appears minor. The greater risk would seem to be that the buoyancy of demand conditions and extent of inflation embedded in the system -- or of the policy tightening needed to bring it under control -- have been underestimated.

52. The projected moderation in consumer spending is critical to the further course of the economy. Uncertainties surrounding the saving behaviour of households are considerable, however. Research suggests that because of changes in the financial position of the personal sector and increased competition in the provision of financial services consumer expenditure is now more responsive to variations in interest rates than it was in the past. However, given the recent nature of these changes, there are inevitable uncertainties attached to consumers' reactions to movements in interest rates. The same is true for the interaction between housing wealth and consumer spending. Hence, the personal saving ratio may not recover as projected. In this case both price pressures and the external deficit would be exacerbated. This could unsettle foreign exchange markets. It is also unclear how far the erratically high rate of retail price inflation, attributable to the impact of sharply higher mortgage interest rates on the index, will spark off a price-wage spiral. In any case, continued labour-market tightening would be incompatible with the projected fall in wage and price inflation.

IV. The post-1979 cycle in perspective

53. With a period of policy-induced economic slowdown in prospect and, indeed, called for in view of the tensions and imbalances in the economy, the post-1979 cycle can now be put into a longer perspective. As the performance of the United Kingdom economy since the present Government first took office in 1979 was reviewed in some detail in last year's Survey, the following section is confined to an updating and reassessment of previous findings. After recapitulating briefly the Government's strategy, it confronts objectives with achievements, highlights the main features of the post-1979 cycle as compared to past experience and that of other Member countries, and concludes with a discussion of the macroeconomic adjustment problem facing the authorities.

The strategy

54. The prime objective of the Government's economic policy has been to bring down inflation while improving output and employment conditions over the medium term. Macroeconomic policies have been formulated within a nominal framework, the Medium Term Financial Strategy (MTFS), the tenth version of which was set out in the 1989 Budget. The MTFS has been complemented by policies designed to improve the working of markets and supply performance. While the ultimate goal of policy has not changed, intermediate objectives have been adjusted in response to changing circumstances. Originally, the emphasis was on tight monetary growth targets, then defined with respect to broad money, and supporting reductions in public sector borrowing. Later on, more attention has been given to nominal GDP growth and to the exchange rate. Over time, there has been a shift to a more judgmental approach to policy-making, with the discretionary use of interest rates guided by an eclectic array of indicators. Reduced emphasis on monetary targets reflected the fact that, following the abolition of exchange controls and other measures of financial liberalisation, the signals provided by broad money had become increasingly unreliable. The income velocity of narrow money (M0, the only remaining targeted monetary aggregate) has shown greater stability over the past decade. However, as noted in Part II, this has not excluded short-term fluctuations. Indeed, as financial innovations appear to have led to significant shifts of demand for narrow money, the relative stability of M0 velocity may be the result of offsetting influences, reducing its usefulness as a guide to policy. Using the exchange rate as an anchor for policy seems equally problematic, as witnessed by last year's experience.

55. In contrast to monetary targets, which have proved difficult to meet, the intermediate objective of fiscal deficit reduction has been achieved earlier and more strongly than initially envisaged. This has prompted the authorities to move from a medium-term objective of deficit reduction to a long-term objective of balanced budget. In some measure the move of public finances into surplus reflects the fact that greater weight is now accorded to

the state of the economy in the operation of fiscal policy. While the budget stance was tightened during the recession of the early 1980s, automatic stabiliser effects have been only partly offset in later years; and, in the latest MTFS, it has been explicitly stated that cyclical conditions warrant a deviation of the budget balance from the previously announced medium-term path.

56. Following notable successes in the early 1980s in bringing down inflation, the associated downward trend in the growth of nominal GDP, the key intermediate objective, has not been sustained (Diagram 11). In fact, in recent years, nominal GDP has increasingly overshot the projected path, growing by around 11 per cent in both 1987/88 and 1988/89 instead of decelerating towards 6 per cent as postulated in the 1986 MTFS. While initially this was due to both higher-than-expected output and price increases, it has subsequently reflected mainly rising inflation. As a result, the inflation/output split has worsened markedly. This has been the consequence of excessive demand growth during the last phase of the economic upturn, following upon a pronounced improvement during the early 1980s. Measured from peak to peak, the division of nominal GDP growth between output growth and inflation was much more favourable over the 1979/88 period than during the 1973/79 cycle and similar to earlier experience, suggesting that there have been policy-induced improvements in supply performance.

(Diagram 11. The nominal income split)

Main features of the 1979-88 cycle

57. Other economic indicators generally confirm this picture: the deterioration in performance in the 1970s has been reversed; and, compared with other Member countries, there has been a relative improvement. Other salient features are:

-- **Economic growth** during the 1981-88 recovery, at over 3 per cent per annum, was not outstanding compared to previous upswings, but the upturn was unusually long (Table 11). Given the preceding fall in output, growth over the whole 1979/88 cycle, at just over 2 per cent per year, was significantly higher than during the preceding cycle, but fell short of the previous long-term trend rate, in spite of positive contributions from the oil sector. While exceeding rates recorded in France and Germany, GDP growth remained below the G7 average, but much less so than in the past (Table 12).

-- Despite exceptionally sharp job losses in the downswing of the early 1980s, **employment** gains over the the 1979/88 cycle slightly surpassed the long-term average, as self-employment and part-time work increased strongly. But this did not prevent a strong rise in **unemployment**, which doubled both for the average of and during the cycle. After exceeding the OECD average by a large margin up to 1987, the rate of unemployment has since dropped sharply and is now running at just above the OECD area rate and below that of France, Italy, and Canada among the other major OECD countries.

-- Nominal wage increases have come down considerably since the 1970s, when they moved up parallel to unemployment. The same is true for **price inflation**, which was much lower during the 1981/88 recovery than during the two preceding upswing periods. However, the disinflation process of the early 1980s could not be sustained. While remaining above the levels of the early 1960s, inflation has, however, tended to exceed the OECD average by much less than previously.

-- Contrary to the preceding cycle, the **external balance** was in surplus in the 1979/88 period as a whole, allowing the accumulation of sizeable net overseas assets. However, the swing into deficit during the last two years was large by historical standards. As discussed in Part I, this reflected not only the dwindling oil surplus but also persistent deterioration in non-oil trade performance: while losses in export market shares have slowed, there has been virtually no reduction in the growth of import penetration (Table 11).

-- **Labour productivity** advances during the latest upturn were not exceptional but, taken over the whole 1979/88 cycle, they were much higher than during the preceding one and broadly in line with the long-term trend. Productivity gains continued to fall short of the G7 average, though significantly less so than previously as productivity performance abroad remained broadly unchanged (Table 12). Measurement problems could mean that non-manufacturing and economy-wide productivity gains are understated, but this may also be the case for other countries. Growth in labour productivity in manufacturing over the last decade has been impressive, outstripping by a wide margin both the previous United Kingdom trend rate and the G7 average. This favourable performance reflected substantial labour-shedding, notably in the early 1980s. In fact output growth was rather modest, despite the recent upsurge. In some service industries, significant increases in part-time work reduced output per person employed relative to output per hour worked; the opposite was the case, however, in manufacturing, as overtime work increased. The scope for catching up with high-productivity countries has probably contributed to the United Kingdom's good performance. Yet, as noted in last year's Survey, the negative labour productivity differential against other major Member countries is significantly reduced when measured per hour.

-- With a parallel improvement in the trend of capital productivity, the growth in **total factor productivity** is estimated to have more than doubled as compared to the 1973/79 cycle -- the most pronounced gain among major Member countries -- and may have reached an annual rate of around 1 1/2 per cent in recent years. Following a sharp fall in the early 1980s, **business investment** has recovered strongly over the last few years, to a historically high level in relation to GDP. With rising growth in total factor productivity and capital formation, **potential output** growth is estimated to have recovered to around 3 per cent more recently. As noted in Part I, improved efficiency has contributed to the steep rise in business profits and restoration of rates of return on capital to pre-1973 levels.

(Table 11. Economic performance indicators)

(Table 12. Comparative performance indicators)

The need for adjustment

58. Notwithstanding improved supply performance, excessive demand pressure on resources has developed over the past few years, as evidenced by the acceleration of inflation and the large current-account deficit. Internal and external imbalances ensuing from the extraordinary buoyancy of domestic demand in 1987-88 boosted profits and put upward pressures on wages. As the economy slows down, these pressures should abate, but neither official nor OECD projections see the inflation rate coming down substantially in the near future. Indeed, following the sharp fall in the early 1980s, inflation remained obstinately high at an underlying rate of some 5 per cent. This resulted from remarkably stable earnings growth, with the underlying rate stuck at just under 8 per cent, and underlying productivity growth of somewhat over 2 per cent. A continued decline in inflation in line with the Government's MTFS would seem to require significant margins of idle capacity and labour market slack.

59. The recent deterioration in the external position is also to a considerable extent a reflection of demand pressures, with strong growth in import-intensive components of domestic demand, such as business investment and consumer spending on durables, leading to an upsurge in imports. As public-sector finances have moved into surplus, the weakening external balance has, as its counterpart, a pronounced swing in the private sector's financial balance into sizeable deficit (Diagram 12). This reflected both a recovery of private investment and a decline in total private sector savings, stemming from the steep fall in the personal saving ratio. The strengthening of public-sector finances is the result of a trend decline in investment and, most recently, a pick-up in public savings. As discussed in Part I, the decline in personal savings has a variety of causes, including rising personal wealth combined with easier access to credit because of financial liberalisation. Although the personal debt/income ratio should tend to stabilise, the influence of some of these factors may persist for some time. And the rise in business-sector savings, which has partly offset the fall in personal savings, is unlikely to continue. Hence, high public savings may be required to maintain the level of national savings and avoid a still larger current-account deficit.

(Diagram 12. Savings/investment balances)

60. As the emergence of the external deficit has not been associated with a weakening of public finance, or public sector deficits for that matter, the authorities have been concerned only to the extent that it reflected inflationary demand pressures. According to this view, external deficits emanate from private-sector investment and saving decisions, and capital will be imported from overseas whenever investment opportunities are greater than domestic savings. In these circumstances, the role of fiscal policy is considered to be limited, the task of alleviating demand pressures falling on monetary policy. However, there are two considerations which might call for a more active involvement of fiscal and budgetary policy in either redressing private sector saving-investment balances or in compensating for insufficient domestic saving. First, there are important elements in the fiscal system which have a bearing on private saving-investment decisions and their weight

has grown with financial liberalisation. Secondly, if the hoped-for self-correcting mechanisms were stretching over too long a period, a creditworthiness constraint could emerge and disruptive exchange market reactions occur. Although the present strong net external asset position should help contain such a risk, discretionary action on the fiscal and budgetary side to raise the national saving ratio would also contribute to sustaining foreign investors' confidence in sterling assets and profitable investment opportunities.

V. Public sector efficiency

61. During the past ten years or so public sector activities have been subjected to critical scrutiny by the Government with a view to raising input/output efficiency and to assess whether a number of traditional public services should continue to be provided and produced by the state or be transferred to the private sector. This reassessment has taken place against the backdrop of budgetary strains and emerging strong pressure on public resources. It has also been part of the Government's drive to improve the overall efficiency of the economy in order to promote non-inflationary economic growth (see Part IV). Apart from distortions introduced into the market economy as a result of financing public provision, there has been heightened concern about possible inefficiencies in public production stemming from the absence of "disciplining" market mechanisms, notably the absence of bankruptcy and takeover threats to management and of competitive pressure. As a result there was a perception that the public sector was claiming more resources than needed and that input factors were being employed sub-optimally. Moreover, the absence of direct charges for most government services or distorted pricing policies made it difficult to adjust adequately supply to social demand.

62. This chapter covers a range of issues related to efficiency in provision of general government services and in public corporations. It does not deal with efficiency aspects of revenue-raising and the political process in revealing public choice. Measures taken during the 1980s to improve input/output relations in the public sector at large and discussed under separate headings range from management reforms and improved incentive structures to strengthened external monitoring and tighter controls of expenditure and inputs, and from increased competition in provision of government services to large-scale privatisation programmes.

I. General Government

Productivity measurements: Inputs and outputs

63. The importance of running an efficient government sector is clearly conveyed by the fact that it employs about a fifth of all labour and capital resources in the economy (Table 1). Government claims on labour resources grew rapidly in the post-war period up to the mid-1970s, slowing down thereafter relative to the growth of the labour force. The government share in the economy's total capital stock has also shown a downward trend over the last decade. The distribution of labour resources between main government levels has been relatively stable since the 1960s with local government employment some 20 per cent higher than central government employment (Table 2). The stability of the principal subsectors' shares in the aggregate

masks important changes that have taken place within those subsectors. In central government, the large reductions in the shares of the Civil Service and HM Forces have almost been outweighed by increases in the National Health Service (NHS). Labour resources in local government have been shifted towards the education system. The bulk of general government's capital stock resides with local authorities, reflecting their role in providing accommodation to households, but there has been a trend in the direction of increased shares for central government.

(Table 1. General government claims on resources)

(Table 2. Distribution of resources in general government)

64. The principal problem in assessing productivity trends in government is the lack of data on government output. Present national accounting conventions measure output movements in general government very largely by changes in the numbers employed, which implies no measured productivity growth. This paucity of data on quantitative output partly reflects difficult conceptual problems in defining government output related to its multi-dimensional nature: education involves the acquisition and development of various cognitive and non-cognitive skills; health care includes the alleviation of different sufferings, which vary in the distress and incapacity they create, and the prevention of ill-health; and the police service maintains public order and deters crimes which vary in their severity. Even if data was available on each of the separate components they could not be aggregated by assigning relative values to them as weights because these values are not known in the absence of a well-functioning price system. Moreover, disentangling the effects of government activity from other influences on health conditions, crime, and skills is very difficult. However, imperfect and incomplete proxy indicators of final outputs have been developed. Examination results for school leavers suggest that the education system has been successful in improving the cognitive skills of students, but there are a number of problems of using test results for drawing such inferences (6). A surge in reported crime rates over the last decade suggest that the law and order system has not been successful in its prime objective but it may also reflect that crimes are more willingly reported than before. In the health system, a number of proxy indicators have been suggested but the more sophisticated ones, such as morbidity rates and "quality-adjusted life-year" (QUALY) scores (7), are not available on nationwide basis. Mortality rates indicate that the health system is making progress in improving the health condition of the population.

(Diagram 1. Final output indicators in general government)

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6. On the difficulties of using test results to measure general skills, see e.g. Royal Statistical Society,"Assessment of examination performance in different types of schools", Journal of the Royal Statistical Society,Series A 147(1984), pp.569-581.

7. On QUALY scores, see e.g. M.F. Drummond, "Output measurement for resource allocation in health care", Oxford Review of Economic Policy, 5 (1984), pp.59-74.

65. The difficulty of defining and measuring final outputs in government has focused attention on intermediate or activity indicators. In principle such intermediate output indicators can be constructed for the bulk of government activity. Productivity developments, based on such intermediate indicators, show a varied picture across government (Table 3). In the Civil Service, intermediate productivity indicators for the 1980s suggest an average growth rate for tax collection departments which compares favourably to similar activities in the private sector (8), but claimant-staff ratios in the social security system have grown only moderately. Throughput in the National Health Service has risen sharply over the last decade by any measure (Diagram 2), with the increase in in-patients cases exceeding employment growth by an average of 2.3 per cent a year. Moreover, the sharp fall in the average length of stay in hospitals suggests that capital productivity has increased markedly. In local government intermediate productivity trends appear to be particularly unfavourable. These are dominated by developments in the education sector where demographic factors have reduced school rolls sharply and much faster than resources were retired (Diagram 3).

(Table 3. Intermediate productivity indicators in government)

(Diagram 2. The National Health Service: Throughput and resources in hospitals)

(Diagram 3. Primary and secondary state education: pupil-teacher ratios)

Management reforms

(a) Management problems and the reform programme in the 1980s

66. Up to the end of the 1970s, efficient resource management in the government sector was rendered difficult by prevailing, sometimes conflicting, management objectives, rigidities in the budget system, and lack of information about resource use. In contrast to the private sector, public sector management objectives have traditionally not been to employ resources in the most cost-effective way in the pursuit of a well-specified objective. An important objective for managers in the public sector has been to stay within detailed cash allocations, but they may also have influenced their allocations in order to maximise their budgets or the number of staff. A common element behind these objectives was that they focused the attention of management on cash outlays for inputs, while the output side was neglected. The outcome for individual activities was rarely quantified and played no role in the annual budget cycle. Rigidity in the budget system, while facilitating expenditure control, limited the ability of top management to transfer funds between blocks and years. Blocks authorised by Parliament were divided up by

8. See Chapter 6 in M.S. Levitt and M.A.S. Joyce, The Growth and Efficiency of Public Spending, Cambridge University Press 1987.

central units in individual Departments and the Treasury, and passed down the management line in ever finer detail. At the end of the line individual production managers had little opportunity to vary the input mix in order to operate at lower cost. Nor did the control system offer much flexibility in transferring spending between financial years, inviting irrational end-year spending. Lack of management information about economic costs compounded the difficulties stemming from management objectives and budget rigidities. Cash authorisation budgets did not give line managers much information about the resource use and costs involved in carrying out their activities. In stark contrast to private business practice, government budgets did not record the use of resources (on an "accrual" basis) but only cash transactions. Unfunded expenditures, such as cost of capital services and accrued pension rights, were rarely known to managers.

67. The 1980s have seen major steps by central government to improve management in the Civil Service, the National Health Service, and in certain parts of local authorities' activities. Management reforms in the Civil Service were introduced by the Financial Management Initiative (FMI) in 1982, and the Government has recently launched a new drive for management reorganisation through the establishment of executive agencies (9). The National Health Service (NHS) went through a major re-organisation in the first half of the 1970s, and further reforms took place in 1982. The White Paper on NHS reforms, published in February 1989, envisages further major changes in management practices (10). Local authorities are autonomous in designing their internal management structure, which can vary considerably from one authority to another. Central government can however influence the management systems through legislation, and the Education Reform Act 1988 involves significant management changes in the education system run by local government. Although management reforms in the various parts of general government have differed somewhat, they include a number of common elements. These are greater orientation towards outputs rather than inputs, improved cost information to all levels of management, and devolution of operational decision making to production managers.

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9. See Treasury and Civil Service Committee, Third Report, Session 1981-82, Efficiency and Effectiveness in the Civil Service, (HC 236), HMSO 1982; Efficiency Unit, Improving Management in Government: The Next Steps, HMSO 1988; Civil Service Management Reform: The Next Steps, The Government reply to the Eighth Report from the Treasury and Civil Service Committee, Session 1987-88, HMSO 1988. See also National Audit Office, The Financial Management Initiative, HMSO 1986.

10. See Department of Health, Working for Patients, HMSO 1989.

(b) Reorientation of management objectives - performance indicators

68. A necessary first step in the management reform programmes has been to give more attention to outputs in the government sector. This re-orientation has been reflected in the progress of constructing intermediate output indicators, such as throughputs. To avoid the danger inherent in focusing on an indicator which covers only one aspect of the service provided, output indicators are sometimes accompanied by quality measures, such as error rates and the average length of time taken to deliver a service (11). The emphasis on output has been mirrored in the number of performance indicators which Departments report in the annual Government Expenditure White Paper. At the beginning of the 1980s there was no such information, while the 1988 White Paper contained about 1000 indicators requiring output measures while there were fewer than a hundred quality indicators. Progress in constructing such indicators has been greatest for activities involving case work, such as processing documents and providing well-specified services to individuals, but there has been only limited progress in a number of areas, such as for policy-related work.

69. The most common use of output indicators to improve efficiency is to set performance targets for management, and to compare efficiency over time and between comparable units. Performance targets, such as productivity and unit costs, appear to be mostly confined to the Civil Service. Departments are autonomous in setting themselves targets, and the Government Expenditure White Paper contained about 350 such targets in 1988, but the Prime Minister's Efficiency Unit has been given the responsibility to assist Departments in their target setting. There are major difficulties in setting realistic targets for management if its activities are unique, and there will always be an *ad hoc* element in the process. Ambitious performance targets may give an incentive to managers to improve outcomes, especially if they are backed by an adequate reward system, but over-ambitious targets can lead to unwanted consequences, such as deterioration in the quality of service. The inability of users to switch to an alternative supplier could mask such a deterioration. Performance comparisons across similar units are systematically carried out for local authorities and regional health services and for a number of activities in central government. Such comparisons typically reveal large variations in efficiency and unit costs, pointing to significant scope for efficiency improvements. However, such differences may reflect different client mixes rather than productivity differences (12). For example, variations in pupil-teacher ratios across school authorities are

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11. On the progress in constructing performance indicators in government, see S. Lewis (ed.), *Output and Performance Measurement in Central Government: Progress in Departments*, Treasury Working Paper No. 38, HM Treasury 1986; P. Durham (ed.), *Output and Performance Measurement in Central Government: Some Practical Achievements*, Treasury Working Paper No. 45, HM Treasury 1987.

12. See e.g. Levitt and Joyce, op.cit.

often the result of different socio-economic backgrounds of students rather than productivity differences. Nonetheless, performance comparison is a useful monitoring device, and improved analytical comparison techniques (13) and improved information systems should enhance its status in the future.

(c) Improved information - management budget systems

70. The drive towards making managers at all levels more cost-conscious has centred around the introduction of management accounting systems throughout central government organisations. In contrast to the conventional cash allocation budgets, these systems seek to record the cost of resource use and relate costs to outputs and the aim of production. These management budget systems are discussed in Annex II. Despite continuous refinement in the 1980s, these systems still have limitations with respect to coverage of resource use and the extent to which costs are apportioned down the management line. Information about labour costs is readily available and managers in the Civil Service know about the accommodation costs they are incurring due to the practice of charging Departments market-based rents. The cost of using other assets is rarely known as they are used free of charge. Indeed, there is only scant information about the asset position of the government due to the lack of proper balance-sheet accounting. Departments have been asked to prepare comprehensive asset registers, and the proposed NHS reforms involve charging hospitals for their use of capital and land, thus requiring detailed asset records. While significant progress has been made in apportioning costs down the line, in large areas of government there is still much to be done in relating costs to individual activities. For example, hospital departments may have good information about aggregate costs incurred but have difficulties in apportioning them to different types of treatments. The Resource Management Initiative (RMI) has taken first steps in linking information about the diagnosis of patients and the cost of treatment. As a part of the proposed NHS reforms, the Government intends to involve a significantly greater number of hospitals in the RMI and a precondition for self-governing status of hospitals is adequate costing of treatment.

71. Management accounting systems have not yet been integrated with the annual resource-bidding process. Physical output indicators played no role in the annual budget cycle in the initial stages of the management reform programmes, but starting from 1987 Departments have been asked to support their initial bids ("baseline expenditures") with output and performance

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13. The analytical comparison methods include deviations from a conditional mean derived from standard regression models and deviations from an estimated maximum obtained by data envelopment analysis. For a survey of how these techniques have been used in the United Kingdom, see M. Barrow and A. Wagstaff, "Efficiency Measurement in the Public Sector: An Appraisal", Fiscal Studies 10 (1989), pp.72-97.

measures. Any proposals for additional resources must be supported by information on what indicators and targets for outputs will be used to evaluate their use. Most Departments have made only limited progress in translating their spending plans into physical output and resource use, although there are notable exceptions (see Appendix). However, there are inherent difficulties in reconciling management accounting systems and appropriation accounts. This is most visible for capital expenditure where management accounts record the use of capital services for specified periods while the appropriation accounts register no user costs. As management systems become more comprehensive in terms of costs covered, it will be increasingly difficult to reconcile the two control systems. While it is possible to look at them side by side, it involves the risk of managers receiving different signals about resource use. In particular, there may be a danger that unfunded resource costs will play a smaller role in management decisions than funded ones (14). Appropriation accounts were abandoned a long time ago in the private sector, as they were considered to be inadequate management tools. It may be necessary for the government to switch to accrual-based accounts to reap the full benefits of improved management information systems.

(d) Devolution of operational decision-making

72. The rational for decentralised operational decision making is that line managers have better information than the centre to adjust the input mix to improve services to clients and to lower costs than the centre. The ultimate aims of the management reforms in the Civil Service and the National Health Service have been to devolve operational decision making down the line to production managers while at the same time making managers more accountable for their decisions. The construction of performance indicators and management budget systems has been a necessary prerequisite for combining flexibility at lower levels of management and tighter internal monitoring by senior managers. Some progress has already been made in giving line managers more flexibility in managing resources. For example, the Civil Service now contains about 1500 budget holders with some freedom to switch expenditures from one component to another (15). The extent of the devolution differs markedly between different Departments. Most of them allow managers to switch between grades of personnel, and some allow switching between labour costs and other running costs, while switching between running costs and capital expenditure is rarely permitted.

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14. See Chapter 13 in R.N. Anthony and R.E. Herzlinger, Management Control in Nonprofit Organizations, Revised Edition, R.D. Irwin 1980.

15. For a survey on devolution in the Civil Service, see Budgeting. Second Report on the Implementation of the Recommendations of the Multi-Departmental Review, Vol. II, HM Treasury 1988.

73. However, it would appear that discretionary power of production managers to manage resources is still rather limited. There are three reasons for this. **First**, effective devolution is severely circumscribed by the common industrial-relations policy across large segments of Central Government. Thus, pay and employment conditions are determined in bargaining between civil service unions and central departments, with limited influence from line managers on the process. Also, recruitment of staff to the middle and higher levels of the Civil Service has been centralised, thus limiting the extent to which line managers could directly employ qualified staff. **Secondly**, production managers have been reluctant to assume the responsibility of budget holders. This has been most pronounced in the National Health Service, where devolution has so far stopped short of turning the majority of doctors into budget holders, as they fear it would compromise their clinical autonomy. **Thirdly**, there has been some hesitancy in relaxing rigidities in the budget system for fear of losing control over total expenditure. For example, devolving responsibility for pay negotiations to line-managers could weaken the Governments' ability to withstand pressure from centralised public sector unions. On the other hand, it might also assist the government in its aim to link public sector pay to local labour market conditions (see below). Limited progress has been made in allowing greater flexibility of transferring funds between blocks authorised by Parliament or between financial years. And Departments have been reluctant to devolve budgets down the line.

74. A number of measures have recently been taken to increase devolution of operational decisions across general government. In the Civil Service, the "Next Step" initiative will give an impetus to devolution by transferring executive work of the Service to Executive Agencies. The agencies are intended to have significant autonomy in day-to-day operations while still remaining part of central government and subject to Parliamentary spending control. The chief executive of each agency will make a "contract" with his Minister, specifying in detail the tasks of the agency and how its performance should be measured. The agency is then expected to be run along commercial lines, with the chief executive having significant power in staff management. Three such agencies have already been established (covering 6000 employees) (16) and 30 more are under consideration (covering about 175 thousand employees, or a little less than a third of the Civil Service). The NHS reform proposals call for a greater degree of independence for individual hospitals from their regional health authorities. The proposals open the possibility of hospitals acquiring a self-governing status by opting out of regional health authority control. This would give hospitals the freedom to specialise in treatments of their own choice. They would also have greater liberty in recruiting staff and in determining pay and work conditions. The Education Reform Act 1988 has also prompted major devolution in local government by turning all state schools into management units, with flexibility in staffing arrangements and a high degree of independence in

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16. The agencies which have already been established are the Vehicle Inspectorate, Companies House (which registers new companies and information about companies in general) and HM Stationary Office (HMSO).

running their own affairs. The Act also opens the possibility for individual schools to opt completely out of local authority control, and be funded by central government. This would give schools some independence in designing their curriculum.

Incentive structures and efficiency

75. Incentive structures in the government sector have traditionally not encouraged efficiency. Promotions have been linked to the ability to give policy advice and ministerial support, rather than efficient allocation of resources. Pay for the bulk of government employees is determined in nation-wide bargaining between a few unions and a few units from the government side, while pay for professionals has been determined by review bodies. This procedure has resulted in uniform pay structures across government, and in an automatic progression within pay scales according to seniority. Pay in the government sector has rarely been linked to performance, mainly because of lack of performance-related indicators.

76. In recent years, the Government has sought to increase pay flexibility in the public sector, principally by linking pay more to local labour-market conditions and to special retention and recruitment problems. Some moves have also been made in linking pay to performance. Over the last year the Government has concluded settlements with unions in the Civil Service about performance-related pay arrangements, which had existed for top management since 1985, while employees in Executive Agencies will have special incentive schemes tailored to each agency. The new service-wide pay arrangements combine features of the old system, such as annual automatic progression up the scale for each grade subject to a maximum, and performance links (17). The new feature allows for accelerated progression up the standard scale if performance merits such a move, and for the possibility of discretionary annual awards for good performance beyond the maximum of the standard scale for a specified proportion of staff.

77. While the new arrangements mark an important break with past practices, it is uncertain whether they will have an appreciable impact on incentives. Service-wide pay arrangements related to performance cannot specify what constitutes a good performance, given the diversity of activities pursued in the Civil Service, and the lack of an explicit criterion may weaken the incentive signal. This problem can be avoided in agencies, where contracts are tailor-made to fit particular circumstances. A performance-related pay settlement has recently been concluded for one of the agencies already established, and if that sets a precedent for future agencies it will mark a significant change in central government pay arrangements. Outside the Civil Service, performance-related pay arrangements have been established for top managers in the National Health Service, and the proposed NHS reform package extends these arrangements to senior and middle managers lower down the scale.

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17. See New Pay Arrangements for Grades 5,6 and 7, HM Treasury 1988; New Pay Arrangements for Executive, Office Support & Related Grades, HM Treasury 1989.

78. The need to change succession procedures in light of changed management objectives in the Civil Service was emphasised at the start of the Financial Management Initiative. To provide existing and prospective managers with incentives to operate new management systems and to master new management techniques, it was considered necessary to link promotion to ability to manage resources. Changes in management objectives were reflected in succession policy, which is relatively well-developed for the most senior grades in the Civil Service. By insisting on management training, and some experience in resource management, as a precondition for entering the senior ranks of the Civil Service, the authorities have given financial incentives to civil servants to develop managerial skills. However, a recent Government report indicates that career prospects are still seen by managers in the Civil Service to depend on skills and experience in policy and ministerial support rather than on efficient resource management.

Greater exposure to competitive forces

(a) Competitive tendering and contracting out

79. Testing the cost-efficiency of government activity has increased over the last decade by making in-house production units compete with producers in the private sector in a competitive tender for specified tasks ("market contestability") (18). However, it is still confined to relatively few areas and probably covered only 7.5 per cent of total government expenditure on goods and services (Table 4) in 1986/87. The main impetus to greater use of competitive tendering in the 1980s has been provided by legislation and directives from the top. The Local Government Act 1980 introduced mandatory market testing of government activity and the 1988 Act extends this practice into 8 new areas starting from 1989. Obligatory competitive tendering in the National Health Service started in 1984 for three support services, while mandatory market testing in the Civil Service for service-wide activities commenced in 1986. Prior to mandatory requirements all major units of government had used competitive tendering to some extent. Mandatory market testing requires public-sector units to invite tenders from a number of sources, and some local authorities have accepted bids from foreign companies. The implementation of tendering has in general involved significant changes in management practices along the lines of the management reform programmes discussed above. Outputs of activities have now to be specified in detail so that contracts can be monitored and enforced; management accounting systems had to be established for the contracted activities and the basis for evaluating the costs of public provision had to be changed, e.g. by taking account of capital costs, to prevent in-house bids from having a competitive advantage. Production managers have been given more flexibility to manage resources and determine working conditions so as to remove disadvantages compared to private bidders. While management reforms were under way when tendering was decided, market testing has undoubtedly speeded up the process.

(Table 4. Mandatory market testing)

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18. See A. Perea, "Deregulation and privatisation in an economy-wide context", OECD Economic Studies, N° 12 (forthcoming).

80. Increased contestability has generally resulted in major savings, but the extent to which it has resulted in contracting out differs markedly between administrative units of government (Table 5). In the Civil Service the great majority of contracts has been awarded to private sector units and estimated savings have been significant. In the National Health Service contracting out has been relatively modest while annual recurrent savings are estimated to be up to a fifth (19). In local government, the degree of contracting out construction and road maintenance has been relatively stable before and after market testing became mandatory. No estimates are available of the amount of savings resulting from mandatory testing of these activities, but there is evidence that it has improved value for money. Major savings have been registered by local authorities which have voluntarily subjected some services, such as refuse collection, to competitive tendering in the 1980s (20). Estimated savings from extending the range of services which have to be put to tender according to the 1988 Local Government Act are in the range of 20 per cent. Given the large gains from market testing in the National Health Service and local government, it would seem particularly promising to increase the coverage of mandatorily tested activities. Large differences in cost effectiveness of providing similar services in different authorities indicate that the potential for savings is big.

(Table 5. Contracting-out and estimated savings)

(b) Procurement practices

81. The Government has sought to increase competition among its private sector suppliers of goods and services. For the central government, about 38 per cent of total spending is on goods and services from the private sector of which about half concerns military expenditures (21). Notwithstanding improvements in cost effectiveness made at the beginning of the 1980s, reviews of purchasing in 1984 concluded that major savings could be achieved by a number of changes in purchasing and supply procedures.

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19. On estimated savings from market testing activities in the NHS, see National Audit Office, Competitive Tendering for Support Services in the National Health Service, HMSO 1987; S. Domberger, S. Meadowcroft and D. Thompson, "The Impact of Competitive Tendering on the Costs of Hospital Domestic Services", Fiscal Studies 8,(1987), pp.39-54.

20. See S. Domberger, S.A. Meadowcroft and D.J. Thompson, "Competitive Tendering and Efficiency: The Case of Refuse Collection", Fiscal Studies 7,(1986), pp.69-87; J. Cubbin, S. Domberger and S. Meadowcroft, "Competitive Tendering and Refuse Collection: Identifying the Sources of Efficiency Gains", Fiscal Studies 8, (1987), pp.49-58.

21. See Government Purchasing. A Review of Government Contract and Procurement Procedures. Report to the Prime Minister, HMSO 1985.

Following a review on non-military procurement, targets of 5 per cent savings were set for Departments and a Central Unit on Purchasing was established to assist Departments in implementing the recommendations of the review body. Although these targets have not been met so far, the programme appears to have met with significant success. Savings of 4 per cent have been achieved by a combination of factors: improved purchasing techniques (e.g. post-tender negotiations, leasing or renting instead of buying, and searching for cheaper near-substitutes), improved procurement planning, reduced stockholdings, longer lists of potential contractors, improved information systems, etc. (22). Similar successful methods have been used in the Ministry of Defence. There has been a marked increase in the use of competitive tendering in placing contracts, the market has been opened up to foreign suppliers, and there has been a steady regress in the value of contracts granted on the basis of cost plus a percentage margin (23).

(c) Privatisation

82. Privatisation in general government has been mainly limited to selling of council (local authority) housing. Local authorities have traditionally been major suppliers of accommodation to households, and at the beginning of the 1980s about one in seven households resided in council houses. The incoming government in 1979 set up schemes to encourage council tenants to purchase their accommodation at a discount. The motivation for this policy was to spread property ownership, but as discussed in last year's Survey there is also evidence that the council-house system hampered the regional mobility of labour. Spending restraint in local authorities had also resulted in a backlog of much-needed maintenance, which could be carried out more efficiently if tenants took the responsibility for running their accommodation. Since 1979 more than a million units have been sold, or approximately one in every six local authority dwellings in 1979. Other asset sales in general government include e.g. sale of surplus land in the NHS. The Government is seeking to encourage the private sector to take a greater role in providing road services, which appear to be deficient (see below). The private sector has initiated some projects, including the Channel Tunnel, in exchange for a long-term lease.

d) Competition in health care and education - internal markets

83. Private provision of education and health care has existed alongside public provision without exerting much pressure on the public sector to improve efficiency and response to consumers. Given that public provision is free at point of delivery, it has proved impossible for the private sector to

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22. See Government Purchasing. Progress Report to the Prime Minister from the Central Unit on Purchasing, HMSO 1988.

23. See HM Treasury, The Government's Expenditure Plans 1989-90 to 1991-92, Chapter 1 - Ministry of Defence, HMSO 1989.

compete on the basis of price but it has nevertheless been able to achieve a foothold in the market because it provides higher-quality services. The private health sector has also enjoyed some tax privileges. However, quality advantage and tax privileges have not sufficed to create strong private "merit goods" sectors. In 1984, the last year for which comparable data are available, the private health sector was smaller than in most Member countries (Table 6), despite rapid growth since the beginning of the 1970s. The private education sector has registered only a modest rise in its market share over the last decade (Diagram 4).

(Table 6. The size of the private health sector)

(Diagram 4. Pupils in private schools)

84. The lack of competitive pressure from the private sector due to small size has been compounded by its specialisation and customer targeting. The private health sector has a strong presence in institutional care for the elderly and the disabled, where the public sector has been relatively weak, but it has avoided the more expensive acute care. Where the public and private health sectors overlap, such as in elective surgery, the initial target group for the private sector was overseas patients. When the inflow of overseas patients declined in the 1980s, the private sector, often by subcontracting to the National Health Service, was able to make some inroads in the domestic market, helped by lengthening waiting lists in the public health sector. The overhaul of the education and health sectors in the 1980s have not been aimed directly at increasing the role of private provision but indirectly it may prove to be a stimulus to the private sector.

85. The 1988 Education Reform Act restates the principle that compulsory education should be provided by the government free at point of delivery but introduces an internal market among education establishments to strengthen the role of consumers. In the old system, local education authorities allocated students among the schools in their catchment area in order to even out the workload among the schools and parents had little influence over the school chosen for their children. In positive response to the existence of excess capacity in schools, the new system gives parents the right to send their children to any school within a given region, and state schools will be obliged to accept students as long as they have spare places. Moreover, schools will have incentives to attract students as their revenue will increase with the number of students and so will the remuneration of their managers. Competition among schools will principally be based on the quality of their teaching of core curriculum subjects, and in their choice of subjects taught outside the core curriculum. The absence of price or cost competition implies that there are limited market incentives for schools to operate efficiently. However, in the present state of over-capacity in the education system the provisions of the Education Reform Act may lead to rationalisation of resources. Schools which lose in the quality competition will see declining rolls and eventually close, releasing capital and labour to other sectors.

86. The proposed National Health Service reforms are based on the same principle as the education reform but introduce cost competition in some parts

of health delivery to strengthen the internal market mechanism. One of the motivations for the NHS review was to increase the responsiveness to consumers. This is to be brought about through increased competition among general practitioners (GPs), i.e. the primary care physicians, for patients. Competitive pressure will be stimulated by increasing the proportion of GPs' income which depends directly on the length of their patient lists and by making it easier for patients to switch from one GP to another. Patients will tend to go to GPs who offer better service in terms of effectiveness and timeliness of treatment. Large GP practices (currently covering 9 per cent of all GPs and serving a quarter of the population) will have additional financial incentives to have large patient lists as they are eligible to become budget holders with the size of their budget depending on the number of patients. If the total cost of treating patients is smaller than the budgeted allocation, the difference can be ploughed back into the practices and thus increase the wealth of GPs. Hospitals will be able to charge for their services at point of delivery, and the most efficient ones will be in a position to charge the lowest price for treatment, in order to attract patients.

87. The NHS reform is a bold attempt to introduce market forces in health delivery. It is difficult to assess how the reforms will work in practice, as the details have yet to be worked out and no pilot studies have been done. The success of the reforms will depend on how well they deal with the traditional problems of competition in health delivery (24). **Firstly**, since patients are relatively badly equipped to assess the quality of treatment they receive from their doctor, the best doctors may not attract the largest number of customers. It is crucial that peer reviews should be made public in order to prevent doctors from attracting customers by exploiting asymmetry of information. **Second**, because of the nature of hospital services and patients' reluctance to seek services far from home, hospitals are local monopolies. It is essential that adequate safeguards be set to prevent hospitals from exploiting their monopoly power, e.g. by making them subject to standard competition laws. Apart from these inherent problem, it will be necessary to prevent budget-holding GPs from benefiting from changing their client mix rather than by cutting the cost of treatment. This would require that actual budgets given to GPs should depend on the type of patients as well as on the number on GPs' lists. However, there might be substantial administrative costs in operating such a complex system.

External monitoring

88. External monitoring of the efficiency and effectiveness of government expenditure has been greatly enhanced in the 1980s. The National Audit Office (NAO), which was established in 1983, has an explicit remit to conduct efficiency audits in central government in addition to traditional certification audits. The efficiency audits involve comprehensive studies of

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24. On these problems, see OECD, Structural Adjustment and Economic Performance, OECD 1987.

specific areas, such as the use of operating theatres in the NHS, management of prison services, procurement in defence, and the financial control of military units. The studies seek to identify and analyse evidence of unsatisfactory value-for-money, and to make recommendations about necessary improvements. Similar studies are carried out on local authorities' expenditure by the Audit Commission, also established in 1983. An important aspect of its value-for-money work is to compare the costs of providing similar services across different local authorities, and to disseminate information about best work practices. Neither the NAO nor the Audit Commission have any powers to enforce their recommendations, but their reports have large public exposure and put managers under pressure to take corrective actions. No estimates are available of value-for-money savings from the efficiency audits of the NAO, but the Audit Commission estimates that in the 1983-1986 period it identified value improvements of £492 million of yearly recurrent expenditure. Reflecting usual time lags in implementing recommendations, the improvements realised in the same period were less impressive (£80 million).

89. The Government has made a special effort to monitor efficiency in the Civil Service, reflected in the establishment of the **Efficiency Unit** in 1979. Although part of the Civil Service, it works outside the Departmental structure and the head of the Unit is responsible directly to the Prime Minister. The Unit pioneered the method of efficiency scrutinies in Departments, which were later extended to the NHS. These scrutinies focused on particular activities, which were chosen by very senior management in Departments but with the advice of the Efficiency Unit. The scrutinies involved top management selecting a production manager with detailed knowledge of the area under consideration to make a thorough evaluation of efficiency and to recommend improvements. The investigation and implementation of an action plan are supposed to take no longer than 24 months. Since 1979 the Unit has undertaken over 300 scrutinies and these have resulted in savings of a recurring total of some £300 million a year (0.25 per cent of central government expenditure). The Efficiency Unit also organises efficiency seminars for each Department at 18 month intervals. These seminars, which are chaired by the Prime Minister, review efficiency developments and they have increased the accountability of ministers and top civil servants with respect to use of resources.

Expenditure and direct input controls

90. Tight expenditure and input controls in the 1980s have forced managers to economise on resources in face of unchanged or increased workloads. The incoming government in 1979 established employment reduction targets for the Civil Service. The initial aim was to reduce manpower in Departments by 15 per cent in the period up to 1984. After this target was met, a new target called for further reductions of 5 per cent by 1988. In 1988 targets for reduction in manpower were replaced by targets for running costs, which had been introduced two years earlier. The new targets embodied efficiency increases of 1.5 per cent per year, and allowed managers to have greater flexibility in organising production. Stringent spending limits have been used elsewhere in government to enforce greater cost efficiency. To this end

as well as with a view to gaining better control over public expenditure, spending limits in a number of areas have been set since 1976 in cash rather than volume. However, legislation stipulates that large programme areas, such as social security benefits, are demand led, though entitlement rights have become subject to rigorous scrutiny, and this has implied that spending restraints have fallen disproportionately on the adjustable parts, principally running costs and capital spending (Diagram 5). Attempts to impose expenditure controls on local authorities have been compromised by their tax raising power and central government has assumed ever-increasing power over local government finances to limit expenditure increases. Changes in local authority taxes, such as the introduction of poll taxes, is one part of this strategy (25).

(Diagram 5. The structure of general government expenditure)

91. While direct input controls appear to have been successful in increasing the efficiency and effectiveness of government services, the inflexibility of the spending system has resulted in some unwanted supply side effects. Apart from input reductions, running costs have been limited by restraining wage increases for government employees. These have fallen significantly behind private sector wage developments (Diagram 6), and this has resulted in serious recruitment and retention problems. Despite special arrangements to increase salaries of groups where the shortage is most acute, such as nurses, there are still problems. Where the government is competing with the private sector for similar kinds of labour, it will have to pay a common wage in the long run or find itself with lower quality manpower. Remuneration of employees should reflect the benefit to society of using their services or mis-allocation of resources will result. Another unwanted side effect is that the cut in capital expenditure in the 1980s may have resulted in a shortage of infra-structure capital, as the underlying demand for such services has increased rapidly (26). For example, road traffic has increased tremendously over the last decade while there has been only moderate increases in the length of the road network and the quality of the existing network has deteriorated (Diagram 7). This has increased road congestion, with obvious costs for society.

(Diagram 6. Public sector pay settlements in the 1980s)

(Diagram 7. Supply and demand in road services)

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25. See e.g. D.A. Livesey, "Central Control of Local Authority Expenditure", Oxford Review of Economic Policy 3 (1987), pp.44-59.

26. The Confederation of British Industries has estimated that the cost of road congestion to industry alone is about £3 billion per year. See CBI, Building on business success, CBI 1989.

II. Public enterprises

92. The rationale for the public corporation sector was that profit-oriented enterprises in the private sector, even when controlled by regulations and subsidies, would not produce socially desirable outcomes. National security interests necessitated production of some domestic inputs, such as coal; employment goals would be impaired by too rapid structural changes, e.g. in the steel and shipbuilding industries; and the danger of exploitation of monopoly power in utilities, as well as their vital role in modern society, was thought to call for public ownership. However, towards the close of the 1970s it became apparent that state ownership had often not yielded the benefits which were supposed to go with public status. The performance record of public enterprises proved to be disappointing in the 1970s (27). Growth in technological efficiency fell behind that of the private sector, and a number of public-sector enterprises experienced a fall in their total factor productivity. High-tech corporations were an exception to this general pattern, but their level of production efficiency was lower than in comparable firms abroad. Allocative efficiency was also impaired by pricing policy. There appears to have been a tendency to price products below marginal costs, either because of an obligation to provide uniform services at common prices across the whole country or with a view to maximising output. Discriminatory pricing was present in some of the corporations. Allocative efficiency appears also to have been defective, with over-investment in some industries (e.g. electricity) while lack of investment characterised others (e.g. the water and sewage industries). Product development and responsiveness to consumers' needs was generally considered to be deficient. A number of factors seem to have contributed to this performance.

93. The lack of clear management accountability was a major weakness in the control of public enterprises. In principle, the Government was to leave day-to-day operational decisions to management for which the latter would be fully accountable. In practice, central government frequently interfered with operational decisions in the pursuit of its macroeconomic goals, such as inflation and aggregate demand, thus blurring the line of accountability. Another weakness in the control of the public-enterprise sector was the lack of operational management performance indicators and lack of adequate monitoring. The objective of management in the 1970s was to supply goods at economically efficient prices with investment being subject to a test discount rate criterion, which was low compared to the rate of return in the private sector, but the extent to which managers pursued these objectives could not be monitored on a regular basis. Pricing was generally on a cost-plus basis and

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27. See e.g. J. Vickers and G. Yarrow, Privatisation; An Economic Analysis, MIT Press 1988; R. Molyneux and D. Thompson, "Nationalised Industry Performance: Still Third-Rate?", Fiscal Studies 8 (1987), pp. 48-82.

investment decisions were distorted by the fact that their costs were readily capitalised into prices. Public enterprises were monitored by their parent Departments and the monitors stood at a clear disadvantage with respect to information about technology and costs when assessing management performance. Moreover, some corporations did not themselves have the information to allow an assessment of the efficiency of their pricing policy. The disappointing record and control problems resulted in new attempts to enhance efficiency in the public enterprise sector.

The "re-orientation" approach

94. The "re-orientation" approach involved a mixture of greater pressure on management and strengthening of monitoring, but the problems of accountability were not tackled. The new approach was heralded by the 1978 White Paper on public corporations. It emphasised financial targets as the prime objective of management instead of marginal cost-pricing. At the same time the financial target was changed from a test discount rate for individual investment projects to a required rate of return for a whole investment programme. The enhanced status of financial objectives for management purposes was supplemented by alternative performance targets, such as unit cost targets. The latter was intended to stimulate internal efficiency but it proved hard to make them of central importance to managers. Financial pressure on public-sector corporations was sharply increased by the introduction of **External Financing Limits** (EFLs), i.e. the maximum levels for the difference between revenues and the sum of current and capital expenditure. The impact of EFLs on efficiency enhancement differs from cash limits on Department spending because public corporations are able to reduce their EFL by raising their product prices. Given that many have significant market power, this would seem to be an easy way to avoid taking difficult efficiency-enhancing measures. In practice this does not seem to have been the case, either because the degree of market power is not strong enough or because managers are pursuing output-maximising policies. There is evidence that tight EFLs have increased management resolve to stand firm in insisting on efficiency improvements against strong opposition from the workforce (28). While EFLs may induce productivity increases they offer only a limited mechanism for improving allocative efficiency.

95. Reducing statutory barriers to entry in activities where public corporations have been the sole supplier can induce both internal and allocative efficiency. Prior to privatisation the telecommunications, gas and express coach services were subject to some deregulation. In the first two cases, the deregulation put little pressure on the incumbents. Liberalisation of express coach services in 1980 was followed by intense pressure on management to lower prices and improve services, and while these pressures

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28. See e.g. Molyneux and Thompson, op.cit.

subsided as the incumbent gained control over the market again, they may nevertheless have had lasting effects on efficiency. Moreover, the deregulation appears to have put the state railways under pressure to improve efficiency and consumer responsiveness. An alternative way to stimulate efficiency in the 1980s has been better monitoring. The Competition Act 1980 made it possible for ministers to refer public corporations to the Monopolies and Mergers Commission for efficiency scrutinies. The MMC has examined a number of corporations and generally found problems with their pricing policy. In light of the findings, the minister responsible can instruct the corporation to change behaviour.

96. Judged against the productivity record in the 1980s, the new approach towards the nationalised industries appears to have been a major success. Labour productivity has shown impressive gains, exceeding those of manufacturing despite the strong revival of the latter compared to the 1970s (Figure 8). Productivity in most corporations has increased more rapidly than in earlier periods, and some corporations have registered striking increases in output per head. For example, British Steel increased its labour productivity by an annual average of 12 per cent in the 1979-1988 period and output per head in British Coal rose by more than 50 per cent in the three years after a serious industrial strike in 1984. These gains have come about by a mixture of retirement of inefficient production units and greater flexibility in the workplace. In this process the workforce of still-existing public corporations was reduced by a quarter in the ten-year period to 1988. As the full potential of such measures has not yet been realised, rapid productivity growth could persist for a number of years. Public corporations have not been as successful in aligning prices with costs as they have been in improving productivity. Pricing practices appear to deviate significantly from the marginal cost principle, and the structure of prices suggests widespread practices of cross-subsidisation.

(Diagram 8. Labour productivity performance 1960-1988)

The privatisation approach

97. In contrast to the "re-orientation" approach, the privatisation approach aimed at increasing efficiency by transferring government shares in commercial companies or public corporations to the private sector. Following a relatively slow start, the privatisation process gathered momentum after 1983, with large public utilities being transferred to the private sector (Diagram 9). A comprehensive list of asset sales to date is provided in Annex III. Not all asset sales have involved significant change in management objectives, i.e. from a public interest motive to a profit objective. About 45 per cent of all privatisation proceeds to date have been raised by selling government shares in corporations run along commercial lines. Even here, the transfer of assets to more demanding investors may have had an appreciable impact on management. Sales of public corporations have, however, involved re-orientation of management objectives. As a result of privatisation employment in the public corporation sector has been reduced by half a million, or approximately a quarter of the workforce at the start of the privatisation programme (Table 7). The Government has announced major future

sales of public corporations. The water industry is to be sold later this year, and the sale of the electricity industry is set for 1990-91. After completion of announced future privatisations, remaining nationalised industries will be the coal industry, the railways, the Post Office, and a number of corporations engaged in transportation.

(Diagram 9. Privatisation proceeds)

(Table 7. Privatisation of public corporations)

98. Some privatised corporations operate in highly competitive markets but the largest ones have natural monopoly, and networking and co-ordination externalities in some segments of their activities. The privatisation of public-sector companies operating in markets with a high degree of competition appears to have had beneficial effects. Most have growth rapidly but profitability developments after privatisation have remained mixed, reflecting market conditions (Table 8). Productivity and allocative efficiency appear to have benefited from the rigouts of competition, and corporations have been forced to improve their product range. For corporations with natural monopoly in parts of their activities it can be expected that the pursuit of profits will induce technical efficiency, though in the absence of regulation allocative efficiency will be impaired. A common feature of past privatisation of these corporations is that they have been sold intact, i.e. the natural monopoly part has not been separated from the ones where competition is possible and regional natural monopolies have not been separated from each other. For example, the privatised British Telecom is engaged in network operating, where there is only limited scope for competition, as well as activities where it faces potential competition (e.g. provision of telecommunications services of all kinds and the supply of customer premises equipment). The future privatisation of the electricity industry will involve restructuring, but there will still be a significant degree of vertical integration between competitive and non-competitive activities in most of the corporations. Moreover, the industry will be required to generate one-fifth of its supply from non-commercial non-fossil fuels (i.e. nuclear power) as a public interest obligation.

(Table 8. Privatised companies: Trends in turnover, profits and employment)

99. Up to no three corporations (British Telecom, British Gas and BAA, formerly the British Airport Authority) have been privatised requiring detailed regulation about price setting to prevent abuse of market power, and two major forthcoming privatisations (the electricity and water industries) will be accompanied by regulations limiting their scope for action. In designing the regulatory framework to limit the abuse of market power, the authorities have had to decide which operations need to be regulated and what form such regulation should take. The first issue has arisen for integrated corporations, where the degree of competition varies between different segments of their activities. Although attempts have been made in the past to bring all products facing limited competition under the umbrella of price regulation, subsequent developments suggest that the initial coverage was too narrow. For example, the revision of British Telecom's licence has added to

the number of products covered by price controls. Moreover, the Monopolies and Merger Commission has recently found evidence that British Gas has abused its monopoly power in the wholesale market, which had been left outside price controls due to pressure from management. Developments after the privatisation of utilities suggested that price regulation needed to be supplemented by quality control, and recently the corporations have accepted that they will be subject to financial penalties for bad customer services. For example, British Telecom now has to compensate customers to a minimum extent of £5 per day if it takes more than two days late in providing a line or if it is more than two days to repair a fault. The privatised water industry will be subject to similar financial penalties for bad customer service.

100. The form of regulation for all regulated privatised corporations, present and prospective, was chosen so as to be based on a price cap rather than profits, with the price cap applying to the average of regulated prices, leaving corporations considerable freedom to vary the structure of prices. The price cap formula has differed somewhat between industries. A common base has been to limit price increases to "RPI minus X", where RPI is the growth in the retail price index and X is the regulation parameter, reviewed every 5 years. Variants on this formula take account of specific input prices. The gas industry is allowed to pass all North Sea fuel input prices to consumers; BAA can pass allowable security costs to prices; the forthcoming private electricity companies will be able to allow average increases in generation transmission and distribution costs, and a "nuclear levy", to be reflected in prices; and each of the future privatised water companies will be able to charge prices so as to obtain an 8 per cent rate of return, in order to induce them to carry out much needed investment. In principle X should be based on potential reductions in costs and given large elements of sunk costs in the investment of the regulated corporations it would seem necessary to take account of desirable investment in setting the regulation parameter. Such optimal pricing arrangements would require that the regulator has more information than is typically available. Apart from the water industry where it is obvious, X appears to be set to allow reasonable average rates of return, in effect reducing the price cap regulation to a long-run profit regulation. Some elements of inefficiencies associated with rates of return regulation, e.g. lack of incentives to improve productivity and a bias towards expanding the capital stock beyond what is economically efficient, may thus be embedded in the current system. However, guaranteeing investors with adequate rates of return may be necessary to ensure timely renewal and modernisation of capital when large sunk costs are involved (29).

101. A major aim of privatisation has been to increase competition so that market pressures could gradually reduce the need for regulation. The regulatory agencies for telecommunications (OFTEL) and gas (OFGAS) were given an explicit remit to guard against anti-competitive behaviour. There were two areas of particular concern in this respect. Firstly, the incumbents could have an unfair advantage in the potentially competitive part of their operations by exploiting their market power in other areas. The price

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29. On these issues see e.g. Vickers and Yarrow, op. cit.

regulation formulas discussed above did not exclude the possibility of predatory pricing. For example, the corporations could stay within average price limits by a combination of high prices for products which are facing little competition and low prices for products which were subject to potential competition. Such cross-subsidisation is prohibited in the corporations' licences, and where tariffs have been significantly restructured they have brought prices more in line with costs rather than having involved exploiting market power. A second source of concern was that the vertical integration of some of the privatised companies could give them an unfair advantage in potentially competitive markets. For example, both British Telecom and British Gas operate national and local distribution networks and have an interest in limiting the access of other local networks to their national one where they are the sole suppliers. Their licence instructs them to interconnect other systems but experience shows that they do so only as a last resort. The same companies combine also network operations and apparatus supply, and there is concern that this may give them an advantage in the latter. Competition in the gas market may also be limited by the incumbent through its dominant position as a buyer of gas from the North Sea. While regulatory agencies have had some success in injecting competition into areas dominated by privatised companies, especially telecommunications, the structure of these industries makes it more difficult than for single product firms.

102. A possible major advantage associated with privatisation is that management will be monitored by the capital markets, and the threat of take-over will induce managers to be more efficient. Moreover, management will have to base its investment decisions on market-based interest rates rather than relatively low required rates of return. Evidence suggest that management of the big privatised corporations are quite sensitive to stock-market valuations. However, the effectiveness of the stock market in disciplining bad management may be exaggerated. A number of privatised corporations have indeed been protected from the danger of take-overs during the first few years by size restrictions on individual shareholdings or government holdings of its "golden" shares. Management in the regional electricity and water companies will thus enjoy immunity from take-overs for at least five years after privatisation while management of the electricity generating companies, the national grid, and the Scottish electricity companies will enjoy indefinite immunity. The government also holds golden shares in British Telecom, British Gas, and Britoil. The Government's objective in exercising its "golden" share option is to ease the entry of the corporations into the private sector and to prevent hostile take-overs of corporations of strategic interest. But even in the absence of government protection, it is unlikely that big privatised companies would come under a credible take-over threat. Their sheer size makes them unlikely take-over candidates. In 1987 British Gas and British Telecom were the second and third largest private companies in the United Kingdom, and their market capitalisation was a multiple of the largest take-over ever in the country (Table 9).

(Table 9. The market capitalisation of major privatised companies)

103. The privatisation of public utilities have already yielded some benefits, but a more determined and coherent policy towards asset transfers to the private sector and strengthening competition would have been desirable. Privatisation has revealed restrictive business practices which already existed before but the transfer to the private sector has opened the possibility to injured parties to seek redress through recourse to standard competition laws. Privatisation has also resulted in organisational changes in some companies which has improved management and procurement practices. However, it would appear that a shake-up of the structure of privatised industries would have strengthened forces of competition and facilitated regulation. A separation of goods facing competition and goods produced under little market pressure into independent production units would have limited the extent to which cross-subsidisation and vertical integration could be used for anti-competitive purposes. Moreover, breaking the non-competitive units into regional companies would have allowed the regulator more scope for yardstick regulation. For example, the regulatory parameter in the "RPI minus X" formula could have been made to depend on average costs of the industry as a whole, inducing individual firms to do better than the average. Smaller production units would also have made the disciplining of capital markets more effective. The extent to which a break-up is desirable, either because extra efficiency gains could be reaped or competitive forces strengthened, differs from one corporation to another, but the full-range of benefits which could potentially be drawn from privatisation does not seem to have be realised yet.

VI. Conclusions

104. After more than seven years of strong and sustained expansion, the United Kingdom economy is showing signs of growing strains. With domestic demand in real terms increasing more than twice as fast as potential output in 1988, capacity constraints have emerged and inflation has picked up. The rate of unemployment has fallen markedly since 1986 and the trend of wages has steepened. The external current-account deficit has widened sharply under the combined impact of strong domestic demand pressure and deteriorating international competitiveness.

105. With mounting evidence that domestic demand was continuing to grow excessively, monetary policy was tightened substantially during the second half of 1988. Initially the authorities took advantage of a weakening exchange rate to raise interest rates gradually, but subsequent increases were effected even though the currency was coming under renewed upward pressure. Maintaining a strong currency has become a cornerstone of the Government's counter-inflation policy. Since November 1988 interest rates have remained broadly stable with temporary downward pressure on sterling being met by official intervention in foreign exchange markets.

106. The 1988/89 Budget turned out to be tighter than originally envisaged as tax cuts were more than offset by fiscal drag and a marked fall in public expenditure in relation to GDP. Consumer confidence seems to have been boosted by the tax reductions, and the Budget announcement of changes in mortgage tax relief appears to have led to anticipatory household spending. The March 1989 Budget reaffirmed the Government's commitment to exchange-rate stability and to maintaining interest rates high for as long as necessary to reduce inflationary pressure. The Budget implies a further tightening of the fiscal stance, combining a continued fall in public expenditure relative to GDP with modest tax reductions broadly compensating for fiscal drag. While the balanced-budget rule was reconfirmed as a guiding policy principle, the budget outlook for the current financial year is nevertheless for a rising financial surplus (net of privatisation proceeds).

107. There are first signs that the marked tightening of policy since mid-1988 has begun to bite: mortgage borrowing and consumer credit demand have slowed, house prices and real-estate transactions have fallen, and private consumption growth appears to have slowed down markedly in the first quarter of 1989. Survey evidence points to some easing of pressure on resources and weakening consumer and business confidence. OECD projections, based on current and announced policies, are for a marked drop in the rate of growth of domestic demand, with slackening household spending leading to a slowing of business investment with some lag. With net import volumes continuing to rise, though at a diminishing pace, real GDP growth is projected to decline significantly, stabilising at just under 2 per cent during 1990, about 1 percentage point below the estimated rate of growth of potential

output. The implied easing of pressure on resources should induce a fall in inflation and in the external current-account deficit relative to GDP. However, given the tensions that have built up over the past year, progress in both areas is likely to be slow and uneven.

108. Risks and uncertainties attaching to the outlook are considerable, however. Large discrepancies between demand and output measures in the national accounts and erratic patterns of some indicators make it difficult to assess the extent of inflation pressure now embedded in the system; it could be underestimated and the deceleration in demand could be less pronounced than projected. It is also unclear whether and to what extent the erratically high rate of retail-price inflation, attributable to the impact of higher mortgage interest rates on the index, will give a twist to the price-wage spiral. A further layer of uncertainty attaches to the extent and timing of the effects of monetary policy in today's much more liberal financial environment. If the decline of inflation proves to be more hesitant than expected, policy might have to be tightened further, with adverse consequences for a time for economic activity.

109. It should be borne in mind in this connection that the recent spurt of inflation started from an underlying rate of close to 5 per cent. With inflation in this sort of range it is more difficult to absorb shocks satisfactorily. The task of policy would therefore now appear to be not only to remove the excess demand of the last year or so but to resume the earlier process of disinflation which has been marking time for several years. Seen in this light, there seems little risk that the tightening of policy to date represents "overkill"; and there will be good reason to err on the side of restraint in the future setting of policy.

110. According to the Government's Medium-Term Financial Strategy, the task of reducing excess demand and inflation falls on monetary policy. Fiscal policy, considered an unsuitable instrument for short-run demand management and stabilisation, is assigned the supportive confidence-building role of establishing and preserving sound public finance and the provision of appropriate economic incentives. However, given the size of present inflationary tensions and imbalances in the economy on the one hand, and the crucial importance of maintaining confidence of financial markets in sterling assets, and of economic agents generally in the government's anti-inflation policy on the other, there is clearly a danger of over-burdening and over-stretching monetary policy. Given, furthermore, long lags before the impact of monetary tightening is fully felt, fiscal policy may have to play a more active role in the process of rebalancing the economy and the reduction of inflation pressure. The Government's willingness to accept cyclically-induced variations in the budget balance must be welcome in this context, but these would not take enough steam out of the economy if domestic demand exceeded the projected path. A more ambitious fiscal objective for a time would serve to bolster both financial-market confidence and the credibility of the government's stabilisation policy. This would imply that the planned gradual move from the present budget surplus towards a balanced budget might need to be more stretched out over time than has so far been envisaged.

111. The external current deficit reflects low national savings combined with strengthening investment. As a proportion of GDP, national savings have

declined through the 1980s to the lowest level since the early 1960s. Despite the recent surge in private investment, the GDP share of total investment still falls considerably short of the average level of the 1970s, reflecting shrinking public investment over the last decade. The decline of personal saving, which more than accounts for that of national saving, may take time to reverse, given the imponderable effects of factors like financial liberalisation and rising household wealth. Thus, domestic saving, even if it recovers more than foreseen at present, may well remain too low in the foreseeable future to match the investment required to sustain satisfactory economic performance. The United Kingdom's comfortable net foreign asset position and improved returns on productive investment will help maintain favourable conditions for financing large current-account deficits. However, should the United Kingdom become less attractive as a place for foreign investors, the case for more ambitious fiscal objectives would be strengthened. It is sometimes argued that private saving adjusts to offset changes in fiscal balances in anticipation of induced changes in future tax burdens. OECD research suggests that such effects are at most partial. In any case, there is a role for fiscal policy to make taxation more supportive to saving. Further steps in this direction were announced in the 1989 Budget. But some distortions remain which, in interaction with financial liberalisation, still tend to encourage household borrowing.

112. Over the last decade, supply-side policies have been pursued with greater determination and vigour than in most other Member countries. Deregulation of product and factor markets has increased competitive pressure on management and the workforce to become more efficient and responsive to consumer needs. Other supply-side measures have aimed at improving conditions for economic growth through manpower training and education and by reducing distortions resulting from taxes and government transfers. Training schemes to improve the skills of long-term unemployed have been strengthened, and the education system has been made more responsive to the needs of the economy; statutory regulations governing the functioning of the labour market have been relaxed, and restrictive work practices lessened; and competition in financial markets has been further increased through deregulation. All these measures, together with others under active consideration, should help promote non-inflationary growth in the future.

113. Notwithstanding the drive for increased efficiency, important weaknesses on the supply side remain. The tax and social security systems continue to interfere unduly with decision making in the private sector through their combined effects on marginal income taxation and differential treatment of income components. In the absence of taxes on imputed rent and capital gains, mortgage interest relief still represents a significant tax distortion. Limited progress has been made in dismantling remaining trade barriers, and a number of industry-to-industry agreements continue to restrict foreign access to domestic markets. Successful implementation of recent education reforms will remove deficiencies in work-related education of people of school age, but as long as only a small proportion of people receive formal education beyond school-leaving age, the basis for the workforce to take full advantage of modern work organisation and production techniques will remain inadequate.

114. Over the last decade, the Government has introduced new techniques to make the public sector more efficient, and a number of them have been applied

in other Member countries. Efforts have focused on management reforms and external monitoring. Greater attention to output and performance has replaced preoccupation with inputs and cost control, and major devolution of decision making in operational matters is envisaged in the near future. However, much needs to be done to improve management information systems as a base for assessing resource allocation. Performance targets have been an integral part of the management reform programme, and although often somewhat arbitrary, they may have given a spur to managers to operate more efficiently. Small moves have been made to relate remuneration to such targets. The possibility for private sector producers to compete with government provision of services (market contestability) is still limited, but where such a threat of potential competition exists major savings have been recorded. This suggests that there should be increased recourse to market testing, and that public-sector management reforms should be developed with that in mind. Introducing competition in the delivery of health care and education is a novel approach to use market incentives within the public sector. Provided that public-sector production units are prevented from engaging in monopolistic practices and that consumers take advantage of the internal market, the new approach is likely to stimulate efficiency.

115. Privatisation has involved the transfer of responsibility for provision of goods and services from the public to the private sector. Given the nature of production in many privatised companies, the devolution of responsibility has been only partial. Public utilities that have been privatised are subject to extensive regulation as to pricing and the nature of services, and in the case of some pending privatisations the private sector will be obliged to take on non-commercial tasks and be subject to detailed scrutiny of investment decisions. Moreover, management in many privatised companies enjoys greater government protection from takeovers than in most other private companies. Limited use has so far been made of enhancing competition and facilitating regulations by structural measures. Breaking up of large integrated corporations in the process of privatisation, and separating local monopolies from each other, would seem to have been the most effective way of stimulating efficiency. However, many privatisations and other public-sector reform measures are too recent to allow comprehensive assessment, but where their impact has already been felt it has been generally favourable.

116. In sum, United Kingdom economic performance in the 1980s has been marked by an unusually sustained expansion and by distinct signs of improvement on the supply side. But demand growth in 1987 and 1988 was too rapid. Policy now needs to bring inflation on to a firmly downward path while maintaining the momentum of structural reform.

FROM: J S HIBBERD (EA1)
DATE: 5 JUNE 1989
EXT : 4590

CHANCELLOR OF THE EXCHEQUER

cc : Sir Peter Middleton
Sir Terence Burns
Mr Sedgwick
Mr Gieve (IDT)

OECD ECONOMIC OUTLOOK

I attach the UK Chapter due to be published in the OECD's Economic Outlook on 18 June.

JH

J S HIBBERD

Ch
Doesn't look too bad
AA

No; this is the press will fasten on X, ...

aw 31/5.

1) pl. cc Mr P. Edwards, HM Tsy
- herewith UK passage for next 'Economic Outlook' - planned publication date 18 June

2) Back to me please
[initials] 31/5

Mr Sedgwick
cc Mr SJ Davies
Mr Kibberd
Mr O'Donnell
Mr Bush (CPDT)

UNITED KINGDOM

Key features

There are signs of a marked deceleration in household spending since the turn of the year, in particular on housing. By contrast, business investment appears to have remained buoyant. Output growth seems to have fallen back somewhat since late 1988, though this may reflect capacity constraints rather than lack of demand. With the economy operating close to full capacity and labour market conditions continuing to tighten, inflation has kept rising into 1989. As import growth has remained strong, the current-account deficit has reached a high level by both international and past United Kingdom standards, running at an annual rate of nearly 4 per cent of GDP in recent months.

Concerns about the continued momentum of domestic demand -- growing again at about twice the rate of potential output in the second half of 1988 -- and its potential inflationary consequences led the authorities to initiate a further rise in interest rates in late November 1988. This contributed to a marked, though temporary, further firming of sterling and a moderation in the growth of money and credit, in particular mortgage lending.

590/5

The most recent rise in interest rates at the end of May reflected the authorities' resolve to stem a fall in the effective exchange rate. The medium-term orientation of fiscal policy puts the burden of short-term stabilisation on monetary policy. Fiscal policy has contributed, however, to restraining aggregate demand by sticking to nominal spending targets in spite of higher-than-expected inflation. The implied tightening of the fiscal stance is continued in the 1989 Budget, which combines a further fall in public expenditure relative to GDP with only modest tax reductions for the financial year starting in April.

These policies could slow down the growth in real domestic demand to below that of productive potential over the next eighteen months or so, inducing a fall in inflation. However, given the tensions that have built up over the past year, inflation is likely to remain unacceptably high throughout this year and next. The external deficit may come down a little in relation to GDP but, assuming constant nominal exchange rates, is expected to widen further in absolute terms, as trade performance will be adversely affected by the deterioration in international competitiveness.

Risks and uncertainties attaching to the outlook are considerable. Large statistical discrepancies between demand and output measures of GDP and erratic patterns of some indicators in recent months make it difficult to assess the extent of inflation pressure currently embedded in the system; it could be underestimated and the deceleration in demand could be less pronounced than projected. It is also unclear how far the erratically-high rate of retail price inflation, attributable to the impact of sharply higher mortgage interest rates on the index, will feed into a price-wage spiral.

Recent trends

In the second half of 1988 the expenditure measure of GDP showed virtually no increase, while the output measure, considered most reliable, still rose by an annual rate of 3 1/4 per cent. Although in part reflecting special factors, such as adverse effects of accidents in North Sea production, a slowdown in underlying activity growth appears nevertheless to be under way. Output growth in service industries came almost to a halt towards the end of 1988, while manufacturing output, growing by 7 per cent in 1988 as a whole, expanded at an annual rate of 4 per cent in the fourth quarter of 1988. In the first quarter of 1989, output growth in manufacturing decelerated further to an annual rate of 3 per cent, and the output measure of GDP was virtually flat, according to provisional estimates.

Growth of private consumption, which was buoyant during most of 1988, slowed to an annual rate of 2 per cent in the first quarter of 1989, pointing to a continuation in the recovery of the personal saving ratio from a low of 3 per cent in the third quarter of 1988. Housing investment fell in the second half of 1988, although from such a high level that it is too early to say whether this marks the beginning of a sustained downswing. Large upward revisions to historical data now show business investment growing at double-digit rates since the first half of 1987. Intention surveys suggest a continuation of this trend into 1989. The build-up in stocks in late 1988 seems to have been partly involuntary, thus confirming the impression of some weakening in final demand.

Total exports declined in the course of 1988. The fall was more than fully accounted for by lower exports of oil as a result of accidents in the North Sea. While this factor continues to affect exports in 1989, growth of non-oil exports, particularly of consumer goods, was buoyant in the early part of the year. Import volumes have continued to grow strongly, reflecting buoyant demand for capital goods and semi-manufactures, but, excluding oil and erratic items, their rate of growth fell below that of exports in the first quarter of 1989. A further rise in the terms of trade also contributed to some improvement in the trade balance in early 1989, after a steady deterioration through 1988. The current-account deficit is estimated to have run at £4 1/2 billion in the first quarter of 1989, compared with £14 1/2 billion (more than 3 per cent of GDP) in 1988 as a whole.

The findings of the 1988 Labour Force Survey have led to a strong upward revision of employment data, with total employment growth in the two and a half years to December 1988 now put at 2 3/4 per cent per annum. New figures show a reversal in the long-term decline in manufacturing employment in mid-1987 and a rise continuing into 1989. As a result, productivity performance now looks less favourable, slowing to 1/2 per cent for the economy as a whole in the twelve months to the fourth quarter of 1988 in spite of continued strong gains in manufacturing, partly due to North Seal oil production interruptions. On the other hand, labour force developments now correspond better to what could have been expected in the light of demographic trends and high activity growth. The Survey broadly confirms the fall in unemployment shown by registration data for the year to spring 1988. People under eighteen years are now guaranteed a full-time training place and are therefore no longer entitled to claim unemployment-related benefits. The number of unemployment benefit claimants aged eighteen or more continued to decline markedly over the last year (to 6 1/2 per cent of the workforce in April 1989). Shortages of skilled labour, however, appear to have eased somewhat, and the rise in vacancies has levelled off.

The tightening of labour-market conditions since 1986 has led to upward pressure on wages. Pay settlements in manufacturing have risen to just under 7 per cent in the fourth quarter of 1988, about 1 per cent more than a year earlier, with service sector settlements even slightly higher. Boosted by continued high overtime, the underlying increase in effective earnings has fluctuated around 9 per cent since mid-1988. Due to revisions to employment and productivity data, unit labour cost estimates now show a much more pronounced acceleration over the past year or so, with the annual increase in manufacturing reaching 3 per cent in early 1989. Still, the rise in profit margins has continued to add to the inflation process, though to a diminishing degree, as import price increases were damped by the strong pound until early-1989. The increase over twelve months in non-food producer prices and in retail prices excluding mortgage interest -- which may serve as indicators for the underlying inflation rate -- has moved into the 5 to 6 per cent range. The GDP deflator, a measure of domestically-generated inflation, rose even more through 1988.

Policies

The Public Sector Debt Repayment (PSDR -- the budget surplus) in the financial year 1988/89 (ended in March) amounted to £14.3 billion (about 3 per cent of GDP), compared with a Budget forecast of £3 billion. Excluding privatisation proceeds, which were £2 billion higher than initially planned, the outcome, at £7.3 billion, exceeded initial expectations by more than £9 billion. With higher-than-forecast growth of nominal GDP, tax receipts were higher, spending on social security and employment programmes lower, and finances of public corporations better than expected. Tight expenditure control has meant that general government expenditure (excluding privatisation proceeds) fell by about 2 per cent in real terms, instead of rising as projected. The consolidation of government finances is evidenced by the fall the stock of net public sector debt to an estimated 32 per cent of GDP in March 1989, down from over 50 per cent ten years earlier.

The 1989 Budget continues the tightening of fiscal policy, with public expenditure falling in relation to GDP and the tax burden expected to remain broadly unchanged. The PSDR is projected to be about the same as realised in the previous financial year; excluding privatisation proceeds, the budget surplus is expected to rise by some £2 billion. Adjusting for the net cost of indexing tax rates and allowances, budget measures are estimated to reduce taxation by almost £2 billion. As from 1990/91, the Government intends to reduce the budget surplus gradually.

The March Budget reconfirmed the target range for the growth of narrow money (M0) of 1 to 5 per cent for the current financial year. Having been above the range throughout 1988/89, on a seasonally-adjusted basis, the aggregate entered the new financial year again above target. There are signs, however, that M0 has slowed down in response to the sharp rise in short-term interest rates. In the six months to April 1989, the annualised growth rate of M0 was only 1 per cent, and it may now have moved within its target band. Broader aggregates have reacted less to policy tightening, with the growth of M4 remaining high at 18 per cent. Lending by banks and building societies to the private sector has decelerated, though its pace has remained rapid. Lending to the personal sector, both on mortgage and other uses, has moderated after the strong expansion up to mid-1988, while lending to businesses has remained high. A notable feature of financial-market developments has been the stability of long-term interest rates in the face of sharp fluctuations of short-term rates. These increased by 5 1/2 percentage points in the six months to November 1988, and by a further point in May 1989 (to reach 14 per cent). As reconfirmed by the Budget, the Government's funding policy aims at a broadly neutral impact on liquidity. With the budget in surplus, this requires so-called "unfunding", i.e. repurchase of debt. The fact that much of this buying-in of government securities was of longer maturity, so as to secure greater future interest savings, has contributed to the emergence of a sharply downward sloping yield curve.

Prospects

The progressive tightening of policies since the middle of last year should be increasingly felt during the course of 1989. The authorities have made it clear that interest rates will stay as high as necessary for as long as necessary to reduce inflationary pressures. The general government financial balance is projected to remain in substantial surplus, stabilising at somewhat below 2 per cent of GDP in the course of 1990. As foreshadowed by business surveys and other leading indicators, the rate of growth of domestic demand is projected to drop markedly and remain below that of productive potential. High inflation, smaller tax adjustments and the petering-out of employment growth are expected to slow the expansion of households' real disposable income. The downward trend in the personal saving ratio over the 1980s is likely to be reversed; but uncertainties surrounding the saving behaviour of households are considerable, given the discrepancies in the statistics and the difficulties in gauging the effects of factors like financial liberalisation or house-price developments. It would seem reasonable, however, to expect that the effect on expenditure of interest-rate increases will be significant, because households are now, on average, more heavily geared than in the past. Companies are more likely to be influenced by longer-term borrowing costs, which have risen little. Hence, in contrast to private consumption and housing investment, business capital spending should hold up in the near term. But the weakening of household demand along with some squeeze on profit margins is expected to damp business investment in 1990.

Lagged effects from the rise of sterling during 1988 and some deterioration in international competitiveness in the period ahead, on the assumption of constant nominal exchange rates, are expected to entail some loss in export market shares over the projection period. Export market growth for manufactures is projected to decelerate somewhat, to an annual rate of below 7 per cent by late 1990. The downward trend in oil exports is assumed to be temporarily interrupted as output recovers from the effect of accidents. With weaker domestic demand and a continued, though much slower, rise in net imports, growth of GDP is projected to decline significantly, dropping to slightly below 2 per cent in 1990.

In response to slower output growth, the increase in employment is projected to decelerate and the employed workforce may even drop a little towards the end of the projection period as companies react to a squeeze in their profit margins. The rise in labour-force participation rates, shown by revised statistics, is likely to come to halt. This should limit the effect of slower activity growth on unemployment. Even so, the rate of unemployment may start to rise before the end of 1989, reversing the trend seen since 1986. Easier labour market conditions and reduced overtime payments should lead to a slight downward drift in the increase in effective earnings in the course of 1990. This year, however, cost pressures could intensify due to the combined effect of higher wage increases and temporarily lower productivity growth. As demand pressures weaken, this is likely to be offset, though, by reduced profit margins. With import price increases slowing, inflation should subside, though remaining high by international comparison. Although competitive pressures are expected to limit the rise in export prices, further terms-of-trade gains are projected. Any such gains are, however, unlikely to outweigh the deterioration of the foreign balance in volume terms. The current-account deficit may, therefore, increase slightly, but could fall in relation to GDP.

FROM: A C S ALLAN
DATE: 7 JUNE 1989

MR HIBBERD

cc Sir P Middleton
Sir T Burns
Mr Sedgwick
Mr Gieve

OECD ECONOMIC OUTLOOK

The Chancellor was grateful for your minute of 5 June and the copy of the UK chapter. He thought it was not too bad, though the press will fasten on the comments that 'inflation is likely to remain unacceptably high throughout this year and next' and 'the external deficit .... is expected to widen further in absolute terms'. IDT will need a line to take on these points.

ACSA

A C S ALLAN

mp.pc/Riley/201

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Thanks. Apart from the points you will see (I have made) 2 others (all on the [illegible] chapter):

para 104: Don't like reference to "detachment" of interest [illegible] competitiveness. No evidence of this, & implies need to ~~[illegible]~~ devalue (also appears elsewhere in the report) [illegible] 22 [illegible]

105: Interest rate [illegible] in June: scarcely gradual (from [illegible] ½% a week for 4 successive weeks). 2nd sentence [illegible] deleted.

106: 3rd sentence: "changes" should be "instabilities" [illegible]

110: Sentence [illegible] [illegible] fiscal than monetary tightening. In fact, reverse is the case. This sentence should go.

FROM: C J RILEY (MP)
DATE: 14 June 1989
Extn: 4439

CHANCELLOR

cc Sir P Middleton
Sir T Burns
Mr Anson
Mr Phillips
Mr H P Evans
Mr Peretz
Mr Sedgwick
Mr S Davies
Mr Gieve
Mr Hibberd
Mr Pickford
Mr Rayner
Mr Barrie

OECD EDRC SURVEY OF THE UK : 1988-89

I am attending the EDRC meeting in Paris on Monday, accompanied by Jim Hibberd (EA1) and Paul Rayner (FM). We have now studied the draft survey (latest version attached for you only) and will send the attached list of suggested changes to the OECD Secretariat, without the stars indicating order of importance. Although we shall certainly not get them all through, I am hopeful that we shall be able to ensure that the points which concern us most are dealt with more satisfactorily.

2. In my opening remarks I intend to welcome this year's survey as a reasonably fair account of the economy and of economic policy in the UK over the last year or so. The OECD's forecast differs from our budget forecast in a number of respects, but we shall not be able to change it any further. It is in any case not significantly at variance with our own views given the margins of error involved.

3. There are, however, a number of important points which we shall need to get across in the meeting:

- The draft does not give sufficient credit for the slowdown in demand and activity which has already occurred, starting in 1988 (see, for example, paragraphs 1 and 6);

- If proper allowance is made for the North Sea, productivity growth is not now virtually stagnant as asserted in paragraph 14;

- The Government has emphasised its commitment to getting back on top of inflation and will keep policy as tight as is necessary to do so. The main uncertainty is about the level of interest rates necessary to achieve this;

- It is not correct to presume that the risk of policy now being insufficiently tight is greater than the risk of it being too tight, as the draft implies (see paragraphs 51, 108 and 109);

- The experience of 1988 does not cast doubt on the trend in velocity of MO, nor on its greater stability than the velocity of broader aggregates (paragraph 30);

- The impression given in various places that there may be a saving problem, which underlies the external deficit, requiring either a tighter fiscal policy or tax measures to boost saving, is not correct (paragraphs 8, 52, 111);

- The draft does not give sufficient credit for the underlying tightening of fiscal policy, over and above that caused by automatic stabilisers, which has occurred in the last two years or so. There is no reason to believe that monetary policy may be over-burdened (paragraph 110);

- UK policy has not become markedly more judgemental nor more discretionary. It has never been mechanistic and has always required the exercise of sound judgement (paragraph 54);

- The speed at which unemployment falls will inevitably slow, but there is no necessary reason why it should need to rise over the medium term in order to bring inflation down (see paragraph 52).

4. I shall also welcome this year's special chapter in the survey on public sector efficiency. This is a helpful record of developments in an area in which the UK has a very good record. The list of suggested changes contains a number of detailed points which we shall seek to get across in the drafting session, including the following:

- The treatment of management accounting is rather poor, and needs completely rewriting;

- Perhaps because of the pace of change, the material on the NHS needs considerable updating and betrays a number of inaccuracies and misunderstandings;

- The material relating to pay does not fully reflect recent developments, and the drafters do not appear to appreciate the significance of the switch to affordability/recruitment and retention considerations.

5. If you have any comments, or wish to add any further points, please let me know by the end of the week.

CJR.

C J RILEY

OECD EDRC SURVEY OF THE UK, 1988-89 : UK COMMENTS ON EDR(89)19 DRAFT OF 29 MAY

INTRODUCTION

Paragraph 1: The first sentence is misleading: the evidence suggests that neither output nor demand "continued virtually unabated during 1988". Replace "during" with "for much of" and delete "continued virtually unabated" (**)

Paragraph 2: "Burden" in the third sentence gives an unwelcome bias, redraft as: "The medium-term orientation of fiscal policy implies that the task of keeping money GDP growth on track over the short term is assigned primarily to monetary policy". (*) In the next sentence, before "by sticking" add "through the operation of automatic stabilisers and". (**) Sixth line from the end, replace "might arrest" with "should reverse". (**)

The last two sentences should make clear that the main uncertainty is over the extent and duration of the policy tightening needed to bring inflation down. Redraft as: "There is still some uncertainty, however, about the speed with which demand and inflationary pressures will be reduced. Slow progress would mean policy being tighter for longer, making a "hard landing" of the economy a possibility." (**)

I. AN OVERHEATING ECONOMY

Paragraph 4: Add "which took place both in the UK and elsewhere" after "relaxation of monetary policy" in the third sentence. (*).

Paragraph 6: This understates the extent to which demand growth has slowed. There is no evidence to support the claim that slower output growth during the course of 1988 reflected "capacity constraints rather than lack of demand", redraft so that "and slower demand growth" replaces "rather than lack of demand". (**) Next sentence, redraft as: "Since late 1988 there has been a slowdown in household spending, in particular in the housing market, in response to higher interest rates". Add a new sentence: "Retail sales growth has slowed accordingly." immediately afterwards. (**)

Paragraph 7: The first sentence is very misleading, redraft as: "The rate of increase in investment in 1988 was far faster than the rate of growth of consumption although, given the higher weight of consumer spending in GDP, consumer demand made the larger contribution to GDP growth". (*)

Paragraph 8: This overstates the importance of the falling personal sector savings ratio. Redraft the first two sentences as: "Only a part of the steep fall in the personal sector saving ratio has been reflected in saving by the private sector as a whole. Lower personal sector savings have been largely offset by higher company sector savings. Although changes in total private sector or total national saving and their relationship to investment are of more relevance to domestic demand and the external balance, the decline in the measured personal sector savings ratio nevertheless warrants some examination and explanation." (***)

Paragraph 11: Final sentence, replace "there are signs that the housing market is easing" with "the housing market has eased considerably". (*)

Paragraph 12: In the third sentence delete "although ... its level in 1988 still fell short of that in 1979" and replace with "and its level is now higher than at the previous peak in 1979". (**) After the sentence ending on the eleventh line of page 8, add: "However, comparisons of net investment rates need to be treated with some caution in view of uncertainty about the size of the capital stock and the associated estimate of depreciation used for the 1980s." (**)

Paragraph 13: On the tenth line insert "short run" before "potential". In the longer term new capacity and, hopefully, a lower sustainable rate of unemployment will raise potential output.

Paragraph 14: Top line of page 9, whole economy productivity growth in 1988 was affected by interruptions to oil output. Redraft the fifth sentence as: "As a result, labour productivity growth in 1987 and 1988 now looks slightly less favourable: growth in output per person employed in the non-oil economy appears to have dropped to just under 1½ per cent in the year to late 1988." (***) This most certainly does not imply "a virtual stagnation of hourly productivity" and this assertion together with the reference to "the continued rise in overtime work" should be deleted. (***) There is no economy-wide information on changes in hours worked during 1988 but, for what it's worth, the ½ per cent rise in hours in manufacturing would not by itself depress whole economy output per hour by more than 0.1 to 0.15 per cent.

On the final sentence, measurement problems affect both the recorded level and rate of change of service sector productivity. Better measurement would raise the level and, as the share of services in total output and employment grows, the measured rate of growth of whole economy productivity. Amend the final sentence to read: "Output in the service sector may be underestimated, and correction for this would probably raise both productivity levels and short-term productivity advances." (**)

Paragraph 16: There is no reason to believe the second half of the final sentence of this paragraph and it should be deleted (**)

Paragraph 17: Second line, replace "registration" by "claimant". (**)

Paragraph 18: In the first sentence delete "marked"; it is not true of underlying inflation. (*)

Paragraph 19: On the first line replace "retail prices" with "the retail price index". (*) Second line, insert "greatly" before "overstates" and replace "acceleration" by "rise". (*)

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Paragraph 21: Penultimate line, insert "may" before "induce": this is simply speculation about what may possibly happen. (*).

Paragraph 22: Capacity constraints should be mentioned in the first sentence. Insert "and capacity shortages" after "domestic demand growth". (**) Redraft the second sentence as: "The improvements in competitiveness stemming from the real depreciation of the currency in the eighteen months to early 1987 had been reversed by the end of 1988." (*) In the penultimate sentence, "temporarily reduced" should replace "virtually" wiped out". (**) It would be better to delete the estimate of the size of the stock of net overseas assets from the last sentence "amounting to about one-fifth of GDP" since there is no satisfactory official measure. (*)

Paragraph 23: The assertion in the first sentence that underrecording of net current account earnings is unlikely to be important in relation to the size of the deficit cannot be justified. It is quite likely that underrecording of invisibles in particular is significant, although probably not as important the underrecording of capital inflows. Redraft the first two sentences as: "Though there may be some underrecording of net current account credits, the large errors and omissions item in the balance of payments is likely to reflect mainly underrecording of capital inflows." (**)

Paragraph 24: The figure in the second sentence should be 13 per cent and not 13½ per cent. Delete the last part of the fourth sentence - "but their twelve month growth rate...." - since imports of consumer goods fell between 1988Q4 and 1989Q1. (**)

II. THE POLICY RESPONSE

Paragraph 28: Delete the assertion that "policy decisions have necessarily become more judgemental". (**) UK policy-making has always involved a considerable amount of judgement.

Paragraph 29: Replace "and had been so for some time" in the first sentence with "in common with other countries". (**) Add a new third sentence: "In doing so they both tightened and changed the balance of monetary policy." (*)

Paragraph 30: Redraft the first sentence as: "The expansion of narrow money (MO, mainly notes and coin in circulation) remained just below the top of the 2 to 6 per cent range set for the financial year ending in March 1988, on the seasonally adjusted basis." (**) Delete the last sentence. There is no convincing evidence of a marked flattening in the velocity of MO in 1988. Given the state of the National Accounts for 1988, it would be dangerous to conclude otherwise even if the numbers appeared to suggest a flattening. (***)

Paragraph 31: Little attention should now be paid to the behaviour of M3. Unlike M4, M3 does not include the liabilities of both banks and building societies and, in recent years, this has significantly reduced its usefulness. Delete the third sentence therefore. (**) Add "though the annualised six month growth rate has fallen significantly since September 1988" to the following sentence on M4 growth. (**) We cannot support the penultimate sentence which asserts that consumer credit has slowed markedly and it should be deleted. (*) On the last sentence replace "notwithstanding some recovery most recently" with "and", since the recent increase in building society loans mostly represents an increase in market share rather than lending overall. (**)

Paragraph 32: Replace "Since 1986" by "Since 1985". (*)

Paragraph 33: After the full stop in the thirteeth line add a new sentence: "Indeed in 1988 the total sterling bond market continued to grow at an appreciable rate." (*) Reference might be made to the Economic Progress Report for May 1989 which carried a feature on the sterling bond market.

Paragraph 34: The 1988 Budget provided for tax cuts of "just under" rather than "about" 1 per cent of GDP. (*) Replace the final sentence with: "This was projected to leave the overall tax burden and, with continued expenditure restraint, the budget surplus broadly unchanged from the year before." (*)

Paragraph 35: On the fourteenth line, delete "compared with expectations of a broadly stable tax burden". (*)

Paragraph 37: In the second sentence, add "and its implications for receipts and expenditures" after "slowdown". (**) Penultimate sentence, "rise" not "accelerate". (*)

Paragraph 38: First line, replace "tax rates and allowances" with "the tax system". (*) Describe the Budget either as changes from an indexed base or as changes from a non-indexed base. The second sentence appears to score both the indexation of allowances and the non-indexation of specific duties. Delete "apart from the indexation of income tax thresholds and allowances" in the third and fourth lines (*) On line six, it is better to say "wider share ownership" than "savings". (*)

Paragraph 39: OECD's latest debt-income ratio projections for 1990 show the UK below the US.

Paragraph 41: "Harmonising" on line 2 should be replaced by "making a number of changes to" (*) Replace the second, third and fourth sentences with: "The reform of employees' National Insurance Contributions will improve work incentives by eliminating the steps in contributions at £75 and £115 per week, which involved marginal tax rates of over 100 per cent. The contributory principle for national insurance benefits is maintained by keeping a minimum contribution of 2 per cent of earnings at the lower earnings limit of £43 per week (1988-1989) but this initial step is more than halved from 5 per cent pre-reform. On earnings between the lower earnings limit and £325 per week (the upper earnings limit in 1988-1989), employees will pay a single rate of 9 per cent." (**) It might help to use a diagram (for example chart 4.1 from this year's FSBR) to help illustrate the change.

Paragraph 42: Delete the second sentence in the section on training. Replace with: "Build up of participation has been slower than expected and there are 175,000 people currently taking part in the scheme compared with an original target build up to around 265,000 at any one time and 560,000 in a year." (**)

III. WHAT KIND OF SLOWDOWN?

Paragraph 49: The fourth sentence mentions a temporary improvement in the real foreign balance. But table 10 shows a projected deterioration in both 1989 and 1990. The sentence could be dropped or replaced with: "However, these favourable trends are not sufficient to prevent some projected deterioration in the real foreign balance." (*)

Paragraph 51: The third full sentence on page 25 should be deleted. The statement about hard landings is not true of the past in general: at most it applies to the last two recessions. But it does not really even apply to 1974-1975 since it was not restrictive policy that triggered the hard landing in 1974-1975 - UK policies were fairly accommodative - but world developments and the domestic inflationary consequences of the 1972-1973 boom. (**) In the final two sentences no evidence is offered for the assertion that the greater risk is that inflationary pressures have been underestimated. They should both be deleted. (***)

Paragraph 52: Delete "Hence the personal saving ratio may not recover as projected.... could unsettle foreign exchange markets." There is as good a chance that the saving ratio may recover faster than projected; and continuing strength of demand is more likely to be reflected in higher interest rates than a weaker exchange rate. (***)

The last sentence is much too strong and difficult to justify; it should be deleted. Inflationary pressures could well be reduced if the labour market continues to tighten but at a much slower rate than in the last two years. (***)

IV. THE POST-1979 CYCLE IN PERSPECTIVE

Paragraph 54: Delete the sentence starting on the twelfth line: "Over time". Policy-making is not and never was mechanistic. (***) Delete the penultimate sentence. While MO has been affected by financial innovation, its velocity has increased in a stable and predictable way over a long time. Short term velocity fluctuations are not, in themselves, a major drawback; they do not prevent the appropriate monetary conditions being maintained over the medium term. (***)

Paragraph 56: Delete "increasingly" from the second sentence and replace "postulated" with "projected" (**). Replace "it has subsequently" with "in 1988-89 it" in the third sentence (**). Next sentence replace "the output/inflation split has worsened markedly" with "the improvement in the output/inflation split has been partially reversed." (**)

Paragraph 57: The third sentence of third indent could be taken to imply that disinflation has come to an end. Replace with: "Temporarily the disinflation process of the early 1980s has come to a standstill" (**) Table 12 confirms that UK whole economy productivity growth was above the G7 average for 1979-1988 contrary to what is said in the fifth indent. The second sentence of the fifth indent should be redrafted: "for the first time in three decades, productivity gains are ahead of the G7 average". (***)

Paragraph 58: In the third line replace "acceleration" by "rise" again. (*) Replace last sentence with: "A continued decline in inflation, in line with the Government's MTFS, will require slower rates of growth than have recently been experienced. The Government estimates the medium term trend in output growth consistent with declining inflation to be some 2¾ per cent (3 per cent in the non-oil economy)." (***)

Paragraph 59: On the tenth line replace "a trend decline in (public) investment" with "broadly stable investment", replace "and, most recently," with "coupled with". (***) Information on public sector investment is published in the Public Expenditure White Paper (see, for example, table 21.4.9. of 1989 PEWP).

Paragraph 60: This gives a rather over simplified account of the Government's approach to the external deficit, and its link with fiscal and monetary policy. Replace by: "As the emergence of the external deficit has not been associated with the weakening of public finances, or public sector deficits for that matter, and the private sector behaviour underlying it reflects a number of essentially temporary factors, the authorities have been concerned primarily with the associated inflationary demand pressures. Temporary external deficits emanating from unbiased private sector investment and saving decisions, and accompanied by sound fiscal and monetary policies, can readily be financed by capital flows from overseas. This is especially evident when the imbalance reflects substantial domestic investment opportunities. In these circumstances, the role of fiscal policy is considered to be limited, the task of alleviating demand pressures falling on the automatic fiscal stabilisers and monetary policy.

However, there are two issues which must be addressed in this context when considering the appropriate role of fiscal and budgetary policy. First, there are important elements in the fiscal system which have a bearing on private saving and investment decisions, and their weight has grown with financial liberalisation. If there is a presumption that the balance of saving and investment is significantly distorted as a result, then fiscal reform is called for. Secondly, if the hoped-for self-correcting mechanisms were stretching over too long a period, a creditworthiness constraint could emerge and disruptive exchange market reactions occur. But with the present strong UK net external asset position, continuing strong public finances and tight monetary policy, the risk of this should be low. Nevertheless, this does indicate a need to err on the side of caution in fiscal and budgetary policy, sustaining the national saving ratio and foreign investors' confidence in sterling assets and profitable investment opportunities." (***)

V. PUBLIC SECTOR EFFICIENCY

Paragraph 61, second and third lines: Would be better to say: "with a view to improving both allocative and technical (input/output) efficiency" - ie to produce more useful outputs, as well as producing even useless outputs more efficiently.

Paragraph 64, first sentence: This misleadingly implies that final output measurement should be a main focus for development. Better to say: "A serious constraint on measuring productivity trends in government is the difficulty of measuring the final output of public services."

Paragraph 64, last sentence: Mortality rates are a function more of nutrition and plumbing than of health care. Better to say: "mortality rates throw some light on whether the health system, together with improvements in living conditions and nutrition, are improving the health of the population."

Paragraph 65, last sentence but two: Delete "capital". Shorter hospital stays imply greater productivity of medical staff and other current resources, as well as capital.

Paragraph 66, penultimate sentence: Delete "In stark contrast to private business practice". The point here is that cash budgets are important in the private sector too, and that for many activities they can be a perfectly sensible and sufficient form of budgeting.

Paragraph 67, third sentence: Amend to read "... first half of the 1970s. Further structural reforms took place in 1982, and changes to the way the system is managed have been introduced since 1985."

Paragraph 68, penultimate sentence: Amend to read "... contained about 1000 output measures and over 800 performance measures, including about 70 quality of service indicators."

Para 69, last sentence but two: Amend to read "... reflect factors other than productivity differences, such as client mixes."

Paragraphs 70 and 71: Delete and insert the following: "The drive towards making managers at all levels more cost-conscious has centred around the introduction of budgetary and management accounting systems throughout Central Government organisations. This major change has necessitated the development of systems which disaggregate cost information down to individual line managers; the linking of line management budgets to the overall aims and objectives of the organisation, and the granting of flexibility to switch expenditure from one cost element to another; all without losing the vital discipline of cash expenditure controls which remains an essential element of Government financial management.

These management budgets are discussed in Annex II. While in general much progress has been made in making cost data more readily available to all levels of line management, more remains to be done in measuring the cost of capital assets. However, work is now underway in this field with a growing number of departments now maintaining comprehensive asset registers. In the NHS the proposed reforms involve charging hospitals for their use of capital and land, thus requiring detailed asset records to be developed. While significant progress has been made in building up the input side of budgetary and management accounting systems, much remains to be done in evaluating the cost of outputs and activities. Progress is however also being made in this field. For example in the NHS, the Resource Management Initiative (RMI) has taken the first steps in linking information about the diagnosis of patients and the cost of treatment. As part of the proposed NHS reforms, the Government intends to involve a significantly greater number of hospitals in the RMI and a precondition for self-governing status of hospitals is adequate costing of treatment.

Progress is also being made in the much more difficult task of integrating these systems with the annual resource-bidding process. For example, departments are asked to support their initial bids ("baseline expenditures") with output and performance measures. Any proposals for additional resources must be supported by information on what indicators and targets for outputs will be used to evaluate the use of these resources. This is one of the most difficult aspects of developing budgetary and management accounting systems within non-commercial Government departments and this is therefore an area where more remains to be done by departments to translate their spending plans into quantifiable outputs and activities. Substantial progress is however being made, (see Appendix).

All of these developments require the integration of the management accounting systems with the existing cash accounting procedures. It requires care to make sure that managers do not receive unduly conflicting signals about resources used - eg by providing an incentive to look more closely at cash costs rather than other non cash resource costs. The private sector also recognises the need to look at both total resource costs and cash flow at different times and for different purposes and a similar requirement also exists in the Government sector."

Paragraph 72, last sentence: Amend to read "... other running costs. Switching from capital expenditure into running costs requires explicit Treasury and Parliamentary authority, in order to avoid undermining the effectiveness of gross running costs control".

Paragraph 73, fifth sentence: Insert "some" before "production managers."

Paragraph 73, sixth sentence: Delete the sentence. It is true that most consultants are not budget holders. General management has however improved financial management and control in the NHS, with greater acceptance of the principles of budgeting at all levels.

Paragraph 73, last two sentences: Delete and substitute: "Progress has been made in allowing greater flexibility of transferring funds between financial years, within the limitations imposed by the need to maintain proper control of public expenditure and economy in the use of public resources".

Paragraph 74, fourth sentence: Amend to read "The Chief Executive of each agency will operate within a "framework document" and corporate and business plans, which will specify in detail...."

Paragraph 74, fifth sentence: At end, add "and often greater financial flexibility."

Paragraph 74, sixth sentence: Amend to read "Seven such agencies have already been established (covering 7000 employees) (16) and 32 more are under consideration (covering about 187 thousand employees, or about a third of the Civil Service)."

Paragraph 74, footnote 16: Amend to read "... in general), HM Stationery Office (HMSO), National Weights and Measures Laboratory, Warren Spring Laboratory, the Resettlement Units (which provide temporary accommodation and training for the homeless) and the Civil Service College."

Paragraph 74: Delete sentences 7-10 which are almost entirely wrong. Substitute: "The NHS reform proposals include greater delegation of responsibility to local level. In addition, hospitals will have the option of self-governing status, completely independent of health authority control. Such hospitals would have greater freedom to manage their own affairs, for example in financial matters and in setting the pay and conditions of service of staff, than hospitals which continue to be managed by health authorities."

Paragraph 75, line six: It would be more correct to say that "pay for <u>some</u> professionals has been determined by review bodies". There are many civil servants (eg lawyers) who would regard themselves as professionals but whose pay is conducted by negotiation in the usual way.

Paragraph 76, line four: The first long-term pay agreement with a civil service union incorporating performance pay was with the IPCS in May 1987. This was followed by the IRSF in January 1988, with the unions representing Grades 5 to 7 in July 1988 and with the NUCPS and CPSA this spring. This sentence should therefore read "over the last <u>two years</u> the Government has concluded <u>agreements</u> with the unions of the Civil Service about performance-related pay arrangements <u>which now cover about 90 per cent of staff</u>". In the same sentence it would be more correct to say "executive agencies <u>may</u> have special incentive schemes tailored to each agency".

Paragraph 77: Delete first 3 sentences and substitute: "Performance pay is only part of what is being done to improve performance management. It goes with much greater emphasis on the setting and monitoring of objectives for individuals, the degree of achievement of which is an important part of annual appraisals. People are now encouraged to be much more conscious of what they need to do in order to turn in what will be regarded as a good performance, and this will of course vary significantly from activity to activity. Objective setting for individuals is easier in most agencies because of the nature of the executive work with which they are concerned."

Paragraph 77, fourth sentence: Amend to "A more explicitly performance-related pay structure is currently being discussed for one of the agencies ...."

Paragraph 77, fifth sentence: Amend to read "... Service, and are being extended to ..."

Paragraph 79, first sentence: When describing the British system, our own terminology should be used. The end of the sentence should therefore refer to "market-testing".

Paragraph 79, Table 16: The expenditure on Civil Service laundry in this table should read £7.5m, not £75m.

Paragraph 79: Insert after third sentence: "In 1980 the Prime Minister announced that the Government's policy was to transfer work out of departments whenever this was "commensurate with sound management and good value for money for the taxpayer".

Paragraph 79, fifth sentence: Amend to read: "Obligatory competitive tendering in the NHS started in 1983 for three support services, and the 1989 White Paper proposed extending this into other areas, including certain clinical areas. Mandatory market testing was introduced in the civil service for five specified services in 1985, and extended in 1986 across all activities".

Paragraph 79, ninth sentence: Delete "management accounting ... activities and."

Paragraph 79, tenth sentence: Amend to read "... working practices..."

Paragraph 80, first sentence and Table 17: Should begin "Increased market testing has ...". Table 5 simply compares government departments and the NHS, and so references to differences "between administrative units of government" is misleading. It should be amended to "between the Civil Service and the National Health Service." The figures in Table 5 come chiefly from the CBI report, but this shows that the NHS percentage for contracting out should read 15 per cent. The figure of 97% for the Civil Service comes from the same CBI report.

Paragraph 80, penultimate sentence: Amend to read "... promising to designate new areas for mandatory testing as the 1988 Act has done".

Paragraph 81, first and second lines: As far as the purchasing initiative is concerned, the Government's aim has been to increase the efficiency of departments' procurement, not simply to increase competition in the private sector. Amend the sentence to read: "The Government has sought to increase the efficiency of its procurement processes".

Paragraph 81, third and fourth lines: The drafting of the second sentence is unnecessarily confusing. It is obvious that all government spending on goods and services ultimately comes from the private sector. We also cannot discover where the figure of 38 per cent comes from. The 1984 report gives a figure of £14,900m for expenditure on goods and services in 1982 and the PEWP shows total central Government spending in 1982-83 of £81,788 giving a figure of 18%. We therefore suggest the following redraft "... in 1982 about 18 per cent of total spending was on bought in goods and services of which about half ..."

Paragraph 81, footnote 21: The Government Purchasing report was published in December 1984 not 1985.

Paragraph 83, line four: insert "largely" before "free at point of delivery". Delete the references in the third and fourth sentence to tax privileges. Some private hospitals have charitable status, but their tax treatment reflects their position as charities, not the fact that they are hospitals. The penultimate sentence of this paragraph (and the table) is misleading. The table refers to the amount of health care that is financed privately, not how much is supplied privately. Thus, patient charges are scored as private expenditure, and these are a lot lower in the UK than in, say, France or Germany. This has nothing to do with the size of the "private health sector", which is a quite different issue. Both this sentence and the table should be omitted.

Paragraph 84, second sentence: This is misleading since private sector institutional care has depended very heavily on public funds via income support. A better redraft would be: "Although the private health sector has a strong presence in institutional care for the elderly and the disabled, much of this growth has been induced by the availability of social security as a means of finance. This has provided little incentive for the public sector to become heavily involved".

It is not clear in what sense the the term "acute" is being used but it cannot be in the sense that we use it in this country. Virtually all treatment covered by private medical insurance is acute medicine or surgery.

Paragraph 86: Delete last three sentences and substitute: "Large GP practices with more than 11,000 patients (currently 9% of practices, serving about a quarter of the population) may opt to hold budgets with which to purchase certain types of hospital treatment and other patient care. The budgets will be set according to the size of the patient list and other factors. Doctors will be able to redeploy savings on the budgets to improving the patient care in other ways. Hospitals will be funded for the work that they do, and will compete with each other to provide services to districts acting on behalf of their resident populations".

Paragraph 87: Delete the fifth sentence. Peer review can only work if it is confidential. Amend the seventh sentence to read: "The White Paper proposes that there should be safeguards ...". Delete the final two sentences of the paragraph and substitute "The White Paper accordingly proposes that budgets given to GPs should reflect the age structure of the patients on their list, as well as other factors such as morbidity".

Paragraph 90, sentences 3-6: Amend to read: "The initial aim was to reduce manpower in Departments by almost 14 per cent in the period up to 1984. Before this target was met, a new target called for further reductions of over 6 per cent by 1988. Since 1988 pressures on Civil Service manpower have been replaced by cash controls on running costs, which had been introduced two years earlier. These call for efficiency increases of 1.5 per cent per year, but allow managers greater flexibility within the cash total".

Paragraph 91: This paragraph should be deleted. If it remains, it needs completely rewriting:

(i) We do not accept the contention in the first sentence that the spending system is inflexible.

(ii) The second sentence implies a fairly mechanical link between keeping running costs down and pay policy. In fact, of course, both are driven by a concern for affordability.

(iii) We do not know what base date has been taken for diagram 6. It is, of course, possible to get quite different pictures by judicious choice of starting dates. It is interesting that the one group they sing out (nurses) have actually had some substantial real increases over the last few years, in relative as well as absolute terms.

(iv) The report should not give the impression that there are general recruitment and retention problems as a result of bearing down on public sector pay. There are, of course, difficulties in a number of areas, some of them important ones. But they are not generalised. They tend to be geographical (mainly London) or related to specific skills and disciplines, some of which (like IT staff or lawyers) are in short supply nationally.

(v) This leads on to the fourth sentence, which rather gives the impression ("despite special arrangements") that what we are engaged in is some kind of ad hoc sticking plaster approach. In fact, of course, the whole thrust of pay policy in the public sector, more advanced in some areas than others, is flexibility, precisely because it allows us to target areas of recruitment and retention cost-effectively because we can respond to them in a targeted way.

(iv) The third from last sentence is wrong in implying that there has been a cut in capital expenditure in the 1980s; on the government's definition, capital spending has been broadly constant from 1978-79 to 1988-89 (Table 21.4.9 of the 1989 Public Expenditure White Paper).

(vii) The last two sentences are also tendentious. It may be that we have not spent enough on transport infrastructure. But we doubt that that could be explained as a result of the "inflexibility of the spending system". Surely it has been the consequence of deliberate decisions?

Paragraph 93: This seems to refer to the 1967 White Paper regime which used 8 and 10% TDRs:- fifth sentence "which was comparable to the rate of return in the private sector" rather than "low compared to".

Paragraph 94: In the fourth sentence: "other" for "alternative". seventh sentence: "public corporations **may be able**".

Paragraph 97 and Table 19: We have some difficulties in reconciling the figures given with our own figures, set out in the table at the Annex. Paragraph 97 and Table 19 should be revised in the light of the Annex.

Paragraph 98: The penultimate sentence would more accurately read: "The future privatisation of the electricity industry will involve restructuring, but there will remain an element of integration between competitive and non-competitive activities in some of the corporations".

Final sentence: The word "about" should be inserted between "generate" and "one fifth".

Paragraph 100: End of fifth sentence: This sentence is about cost pass-through so "and each of the future privatised water companies will be able to raise prices to cover costs (including a reasonable return on capital) mainly for statutory obligations not allowed for in the initial price setting".

In the eighth sentence: "Even beyond the water industry where it is a specific legislative requirement, X appears to be set to allow the expectation of a reasonable average rate of return if efficiency targets are achieved, in effect narrowing the difference between price cap regulation and long-run profit regulation".

In the last sentence: "However, allowing investors in companies of average efficiency the expectation of adequate rates of return may be necessary ..."

Paragraph 102: In the second sentence: "... investment decisions on market-based costs of capital rather than estimated and uniform public sector capital costs".

In the fifth sentence: "..... A number of privatised companies, including British Telecom, British Gas and Britoil, have indeed been protected from the danger of take-overs during the first few years by temporary size restrictions on individual shareholdings, included in the company's articles of association and supported by government holdings of a "golden" share ..." The seventh sentence should then be deleted. The eighth should read "The government's objective in creating "golden" shares is ...."

__Paragraph 103__: Add at end "However the electricity industry will be restructured and the 10 Water Authorities will be sold as separate companies".

VI. CONCLUSIONS

__Paragraph 104__: Delete "growing" in the first sentence. (***) It is inconsistent with the "easing of pressure" noted towards the end of paragraph 107.

__Paragraph 106__: Second sentence, insert "1988" before "Budget"; replace "appears to have led" by "appeared to lead." (**)

__Paragraph 107__: In the final sentence replace "is likely to be" with "may be". (**) Paragraph 108 makes the uncertainty clear.

__Paragraph 108__: This paragraph gives an unbalanced view of the risks and uncertainties, focussing unduly on the down-side without mention of the possibility that the outturn may prove more favourable than the OECD forecast. Remedy this by deleting "it could be underestimated and the deceleration in demand could be less pronounced than projected" in the second sentence, and add the following sentence at the end of the paragraph: "On the other hand, given lags in the effects of policy changes, the degree of tightness may be underestimated, and progress in bringing down inflation may be more rapid than envisaged." (***)

Paragraph 109: Given the uncertainties referred to in the previous paragraph, delete "there seems little risk that the tightening of policy to date represents overkill" in the final sentence." (***)

Paragraph 110: This paragraph does not give the Government sufficient credit for a tightening of fiscal policy over the last two years over and above that implied by the automatic stabilisers. Therefore insert before the final two sentences: "Its decision to permit a further underlying tightening of fiscal policy in the last two years, not associated with the economic cycle, is thus also to be welcomed." (***)

Paragraph 111: The first few sentences of this paragraph contain a number of assertions about the saving-investment balance which are incorrect. Total national savings have not "declined through the 1980s", neither have they reached "the lowest level since the early 1960s". The share of total investment in GDP is not "considerably short of the average level of the 1970s". The sentence beginning at the end of the twelfth line on page 55 is also misleading. If the UK became less attractive to investors, the Government's monetary policy would mean that interest rates would tend to rise and the private sector financial deficit to fall. There would be no necessary reason for the public sector deficit to fall. The final part of the paragraph switches from the role of the budget balance to the role of changes in the structure of taxation. No evidence is presented to support the suggestion the tax treatment of different forms of saving significantly affects the aggregate level of savings as against its composition. There are a number of reasons for doubting that the effect on the aggregate level of savings is significant in the UK.

The paragraph should thus be completely rewritten: "The external current deficit reflects strong investment in excess of national savings and has been associated with the move of the private sector as a whole into financial deficit for the first time since the early 1950s. Over the medium term it is likely that the private sector's financial position will move back towards surplus and that the external deficit will fall. In the shorter term, higher interest rates will also encourage savings. The effects of taxation on private sector saving should be considered as well. The 1989 Budget included a number of measures to promote wider share ownership and to limit tax-privileged pensions. The limit for mortgage interest relief has not changed, despite the large rises in house prices over the previous year, thus supporting the effects of higher interest rates in slowing down household borrowing." (***)

Paragraph 112: After the third sentence add: "Key measures have been taken to improve incentives by cutting marginal tax rates for individuals and companies and by tightening access to unemployment-related benefits." (**)

Paragraph 113: The second sentence overstates the problem. It should be redrafted to read: "Income-related benefits continue to mean high marginal combined tax and benefit withdrawal rates for the small number of people in the so-called "poverty trap" while some benefits (such as private use of a company car) continue to be relatively lightly taxed." (**)

Paragraph 115: Amend the end of the third sentence to read: "subject to scrutiny of investment plans."

ANNEX

		PUBLIC CORPORATIONS	EMPLOYMENT IN UK	
1981	2	British Aerospace	73,000)	75,000
		Cable and Wireless	2,000)	
1982	2	National Freight Corporation	26,000)	28,500
		Britoil	2,500)	
1983	1	Associated British Ports	10,000	
1984	2	Enterprise Oil	48)	240,048
		British Telecom	240,000)	
1986	1	British Gas	89,000	
1987	2	British Airways	36,000)	53,000
		Royal Ordnance	17,000)	
1988	3	BAA	7,200)	
		PER	340)	61,090
		British Steel	53,550)	
ongoing sales		National Bus Company	50,000	
		British Shipbuilders' subsidiaries*	30,700	
		British Rail subsidiaries¬	14,040	
		TOTAL	651,378	

* British Shipbuilders' subsidiaries comprise the workshop yards and ship repair and general engineering companies.

¬ British Rail subsidiaries include British Transport Hotels (sold 1983-1984), Sealink UK Ltd (1984), British Transport Advertising and Doncaster Wagon Works.

	COMMERCIAL COMPANIES	
1981	Amersham International	1,531
1984	Jaguar	9,200
1987	Rolls-Royce	38,995
1988	Rover	41,000
	TOTAL	90,726

ANNEX II: MANAGEMENT ACCOUNTS. Delete and insert the following

1. An account is a structured record of actual monetary transactions kept as part of an accounting system. It involves the presentation and interpretation of the results of those transactions in order to assess performance over a period and the financial position at a given date. In addition it also involves the projection in monetary terms of future activities arising from alternative planned courses of action. The published financial accounts are the principle instrument available to outside bodies to monitor managerial effectiveness. The internal management accounts are the means used by all levels of management to help formulate policies, to plan and control the activities and to aid decisions on alternative courses of action. It follows that management accounting information plays a vital part in both long term (formulation of objectives) and also short term (budgeting) planning. Both functions require iterative movement up and down the management line of data involving objectives, budgets, out-turns and revised budgets and objectives. Thus the efficiency of the internal communications network will have major implications for the efficiency of the organisation as a whole.

2. Financial management developments within Government departments within the UK have required the development of management accounting systems. These complement the continuing financial accounting requirements which continue to form the basis of parliamentary planning and control. The management accounting systems differ from the traditional financial accounts in two important respects:-

(1) Firstly they aim to record outputs of Government activity as well as inputs. Financial accounts will usually concentrate on inputs because the recording of outputs can often require the adoption of accrual accounting which relates the expenditure incurred in a period to the output achieved in that same period. It is important that both the financial accounts and the management accounts are produced from the same basic

data and are consistently reconciled. It is also necessary to reconcile the cash resource bidding and allocation process with the detailed operational planning. An example of how this can be successfully achieved in practice can be seen in the Customs and Excise Department. In its management plan the Department divides its allocation of running costs to main functions (Customs, Excise, VAT, and corporate services), and in the business plans for each of the main functions the running costs are further divided up between various activities. An example of a business plan for one of the operational areas in the Customs and Excise Department is given in the table. The running-cost figures are translated into physical input units (staff years) which are linked to physical output units by applying performance targets. Moreover, planned output targets are also supplemented by quality targets. The linkages between the operational and financial systems should allow more rational planning.

(2) Secondly the management accounts differ from the traditional financial accounts in that they aim to record all costs associated with the use of resources in a given time period and not only resource costs which involve cash flows. The main differences between the two are the accruing superannuation liability of staff, the consumption, as opposed to the purchase, of raw material and the amortisation of the capital cost of fixed assets such as plant, machinery and equipment as well as that accommodation which is not part of the common-user estate. Because the management accounts include capital amortisation they do not, unlike the financial accounts, show the outlays for capital formation as costs in the period. The extent to which these non-cash resource costs are currently included in departmental management accounts and budgets varies according to the stage of development within individual departments. In general the development of such costs will take place earlier where there are significant

operational or efficiency benefits to be obtained and this will vary from department to department. For capital-intensive segments of the public sector, such as nationalised industries, it is vital to have information about the economic costs of using fixed assets and much effort has been devoted to designing an appropriate accounting framework for the purpose(2). While the case for doing the same for Departments will vary from department to department, it would appear, where appropriate, to allow a better basis for making decisions about the appropriate capital/labour ratio in a period when information technology is being increasingly used.

3. Management accounting developments in Government departments needs, like its commercial counterparts, to recognise the requirements both of top management and lower levels of management. The needs of the former have been met by the development of corporate top management systems. These systems are designed for Ministers and senior civil servants to facilitate policy decision-making, particularly decisions regard the balance among programmes and the relation of programmes to objectives. The top-management systems describe the programmes being carried out in departments and their resource intensity, assessment of past performance and planned and targeted performance in the future. Each department has its own top management system which in principle contains consolidated information from accounting and other information systems lower down the management line. Budgets and management accounts contain information about input-output relationships and the costs incurred by those responsible for delivering the service in question. The information in budgets and management accounts will differ somewhat between different levels of management. In principle, they should contain data about costs which are directly under the control of the management in question. Thus, accommodation costs and costs related to central services may not appear in lower-level budgets

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(2) See eg HM Treasury, Accounting for Economic Costs and Changing Prices, I-II, HMSO 1986

and management accounts but only be carried in central budgets. Apportioning these common costs down the management line can, however give important, information about the total costs involved with individual activities. Although such information may be of limited use to lower level managers it can facilitate top management in deciding on the balance among programmes.

ANNEX III - CALENDAR OF MAIN ECONOMIC EVENTS

1988

2nd February: (and on other occasions): The calendar records the timing of clearing banks' base rate changes. It would be better to give the date of the Bank of England signal which led to the changes. In this case, change to: "**1st February** Bank of England signals ½ per cent rise in base rates to 9 per cent."

18th March... change to "**17th March** Bank of England signals 1 per cent cut in base rates to 8½ per cent."

11th April... change to "**8th April** Bank of England signals ½ per cent cut in base rates to 8 per cent."

18th May... change to "**17 May** Bank of England signals ½ per cent cut in base rates to 7½ per cent."

3rd June... change to "**2nd June** Bank of England signals ½ per cent rise in base rates to 8 per cent."

7th June... change to "**6th June** Bank of England signals ½ per cent rise in base rates to 8½ per cent."

23rd June... change to "**22nd June** Bank of England signals ½ per cent rise in base rates to 9 per cent."

29th June... change to "**28th June** Bank of England signals ½ per cent rise in base rates to 9½ per cent."

5th July... change to "**4th July** Bank of England signals ½ per cent rise in base rates to 10 per cent."

19th July... change to "**18 July** Bank of England signals ½ per cent rise in base rates to 10½ per cent."

UNCLASSIFIED

Insert: "**3rd August** Government announces plans to create a market in short term Treasury bills denominated in ECUs."

9th August... change to "**8th August** Bank of England signals ½ per cent rise in base rates to 11 per cent."

26th August... change to "**25th August** Bank of England signals 1 per cent rise in base rates to 12 per cent."

26th November... change to "**25th November** Bank of England signals 1 per cent rise in base rates to 13 per cent."

1989

Budget measures x) insert "low octane" before "leaded petrol".

25th May... change to "**24th May** Bank of England signals 1 per cent rise in base rates to 14 per cent."

chex.pj/jc/14.6.2

RESTRICTED

Papers please

FROM: **MRS JUDITH CHAPLIN**
14th June 1989
x4359

PRINCIPAL PRIVATE SECRETARY

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr H P Evans
Mr Peretz
Mr Sedgwick
Mr Gieve
Mr Pickford
Mr Tyrie
Mr Call

LETTER FROM JOHN SMITH

The Chancellor asked me to draft a reply to John Smith's letter about the OECD forecasts to appear in their "Economic Outlook". He did not wish to send the reply before the "Economic Outlook" was published, which I see from Mr Hibbert's minute is expected on 18 June.

2. He wished for a bland reply. The most bland reply would merely thank John Smith for his letter and go on to say:

Thank you for your letter of 30 June.

Industry Act

"The next forecast of the current account deficit for 1989 and 1990 will as usual be made at the time of the Autumn Statement. [~~It is not normal practice to issue revised forecasts between the Budget Statement and the Autumn Statement.~~"] There are no problems in financing a deficit of the present size provided we maintain sound policies, as we will.

3. However, I attach an alternative letter in case he wishes to reply more fully.

JC

JUDITH CHAPLIN

RESTRICTED

LETTER TO:

Right Hon. John Smith, QC, MP

I am writing in reply to your letter asking me to revise the forecasts of the current account deficit for 1989 and 1990 given in my Budget Statement, in the light of forecasts from the OECD.

Forecasts are merely forecasts, and those of current account deficits are particularly subject to a wide margin of error. The current account deficit is the difference between two large numbers based on underlying statistics which we recognise are neither wholly accurate nor reliable. Indeed, in 1989, the balancing item exceeded the current account deficit.

You recognised this difficulty yourself when you said early in 1989 speaking of the trade gap:

> "Obviously these are matters which are extremely difficult to forecast. I do not think that getting them right or wrong is the prerogative of any particular government."

I therefore see no reason to alter our forecast because another forecast varies from that of the Treasury. My next forecast will be made in the Autumn Statement in the usual way.

eb.ph/sjp1/19

FROM: S J PICKFORD (EB)
DATE: 15 JUNE 1989
X 4549

PRINCIPAL PRIVATE SECRETARY 12/2 cc Mrs Chaplin

LETTER FROM JOHN SMITH

In case no one else points these out:

- the OECD's economic outlook is now expected not to be published until 29 June;

- the last sentence of the second paragraph in the draft letter should, after today's figures, read something like "Indeed, in 1988, the balancing item was almost the same size as the current account deficit".

Stephen Pickford

S J PICKFORD

UNCLASSIFIED

FROM: P N SEDGWICK (EA)
DATE: 16 JUNE 1989
EXT : 4459

PPS

cc: Sir Peter Middleton
Sir T Burns
Mrs Chaplin

BF 28/6

LETTER FROM JOHN SMITH

Mrs Chaplin's minute and draft letter.

2. Publication of the OECD Economic Outlook will not now be until June 29.

3. The statement in the longer of the two draft letters about the balancing item (in 1988, not 1989) being larger than the current account deficit is no longer true since the publication of the latest balance of payments figures yesterday. The balancing item, is however, still very large at about 3 per cent of GDP.

Ch
Do you think it's worth replying now?
AA

No - wait for him to write again -

P.N.S
P N SEDGWICK

FROM: D I SPARKES
DATE: 19 June 1989

C J RILEY (MP)

cc Sir P Middleton
Sir T Burns
Mr Anson
Mr Phillips
Mr H P Evans
Mr Peretz
Mr Sedgwick
Mr S Davies
Mr Gieve
Mr Hibberd
Mr Pickford
Mr Rayner
Mr Barrie

MWP

OECD EDRC SURVEY OF THE UK: 1988-89

The Chancellor was grateful for your minute of 14 June attaching the draft OECD EDRC survey of the UK. In addition to the points that you make, the Chancellor had one or two other changes, all in the conclusions of the survey:

- Paragraph 104: the Chancellor does not like the reference to deteriorating international competitiveness in the final sentence. There is no evidence of this and the implied need to devalue (also apparent elsewhere in the survey) is distinctly unhelpful.

- Paragraph 105: as regards the second sentence, interest rates were increased by a full 2 per cent in June. This can scarcely be described as "gradual", even if it was ½ per cent a week for four successive weeks. This sentence should be deleted.

  Paragraph 106: in the second sentence, the word "changes" should read "restrictions", and the anticipatory spending referred to was house purchases rather than general household spending.

- Paragraph 110: the fourth sentence implies that fiscal policy is quicker acting than monetary policy. In fact, the reverse is the case. This sentence should be deleted.

D.C.S.

DUNCAN SPARKES

mp.pc/Riley/209

UNCLASSIFIED

FROM: C J RILEY (MP)
DATE: 21 June 1989
Extn: 4439

CHANCELLOR

cc Sir P Middleton
Sir T Burns
Mr Anson
Mr Wicks
Mr Phillips
Mr H P Evans
Mr Peretz
Mr Sedgwick
Mr S Davies
Mr Gieve
Mr Grice
Mr Hibberd
Mr Pickford
Mr Rayner
Mr Barrie

Ch/ Any last minute comments on Survey's introduction & conclusions? I have spotted only one correction they failed to make.

DLS.

OECD EDRC SURVEY OF THE UK

Jim Hibberd, Paul Rayner and I attended the EDRC meeting on the UK economy in Paris on Monday, 19 June, and the drafting session with the OECD Secretariat on the next day. I am reasonably hopeful that the outcome will be a Survey which does not cause us undue problems.

2. There was general agreement in the Committee both that the main short term problem facing the economy is upward pressure on inflation, and that there is considerable difficulty in assessing whether policy is sufficiently - or excessively - tight in current circumstances. Some members of the Committee, including Lange (US), argued that policies were probably about right, but if anything the balance of opinion was that some further tightening might need to be considered. In this the Committee were influenced by the deterioration in the short term inflation prospect since the Budget, and the reduction in the exchange rate over the last month or so. But there was also a predisposition to accept the argument that monetary policy should not be overburdened, the implication being that fiscal policy may need to be tighter in the next few years than envisaged in the MTFS. There were, of course, a number of jibes about the Government's position on the EMS, but no serious probing of our position.

3. Many delegates commented favourably on our record on supply side policies, and the progress made in increasing public sector efficiency. Some argued that, given the present level of unemployment, the recent upward drift in wage settlements was a sign that the labour market was still functioning poorly despite the reforms of the 1980s. The general consensus was that the deteriorating trend in wage settlements was a source of concern, which should be highlighted in the Survey.

Not quite — see para 10b

4. At the drafting session with the Secretariat we persuaded them to make most of the changes we had put forward. All the changes which you suggested (Duncan Sparkes' minute of 19 June) were accepted. The resulting redrafts of the introductory and concluding sections are attached (changes sidelined).

5. The next stage is for the revised draft to be reconsidered by the EDRC, probably in the first week of July. The aim is to finalise the introduction and conclusions by the end of this week, so any last minute suggestions would need to be communicated to Paris during the course of tomorrow. There may be some scope for making amendments to the other chapters next week.

Y

6. Approval of the final text by the EDRC is normally a formality, though we cannot rule out the possibility of objections to our redrafts of crucial passages. We shall try to ensure advance warning of any possible problems. Publication is expected in the first half of August; I should be grateful if you would indicate whether you are content with this timing.

CJR

C J RILEY

REDRAFT

INTRODUCTION

The strong expansion of the United Kingdom economy in 1987 continued for most of 1988. As highlighted in Part I of this Survey, this reflected both booming investment and buoyant household demand, underpinned by a brisk expansion of borrowing, in particular mortgage credit. Both employment growth and the trend of wages steepened. With the economy increasingly coming up against capacity limits, inflation started to edge up and the current-account deficit widened sharply.

2. In view of increasing signs of overheating, the authorities have progressively tightened monetary conditions since mid-1988 (Part II). The rise in short-term interest rates by more than 6 percentage points has damped monetary expansion, and in particular mortgage lending, and has contributed to maintaining a strong exchange rate. The medium-term orientation of fiscal policy implies that the task of keeping money GDP growth on track over the short term is assigned primarily to monetary policy. But fiscal policy has contributed to restraining demand through the operation of automatic stabilisers and by sticking to nominal spending targets in spite of higher-than-expected inflation. The implied tightening of the fiscal stance is continued in the 1989 Budget, combining expenditure restraint with only modest tax reductions. On the basis of these policies, the recent marked slowdown in household spending, especially in the housing market, can be expected to continue and to reduce the growth of real domestic demand below that of potential output. This should reverse the rise in inflation and the external deficit in relation to GNP. There is considerable uncertainty, however, about the underlying strength of demand and inflationary pressures, and about the effects of policy tightening. Slow progress would mean policy being tighter for longer, making a "hard landing" of the economy a possibility (Part III).

3. Although, despite the spurt in recent years, GDP growth since the previous cyclical peak in 1979 has hardly exceeded 2 per cent per annum, conditions would seem to be favourable for the economy to return to a higher growth path over the medium term (Part IV). Productivity gains have increased significantly, in particular in manufacturing, profitability has recovered, and investment has surged, boosting the growth rate of productive potential. Improved supply-side performance owes much to structural policy reforms pursued over the last decade. The special Chapter of the Survey (Part V) reviews Government policies aimed at making the public sector itself more efficient. The United Kingdom has taken a leading role in this area, introducing modern management and efficiency monitoring techniques, transferring significant parts of activity to the private sector, and increasing competitive and financial pressure on public-sector management.

VI. CONCLUSIONS

104. After more than seven years of strong and sustained expansion, the United Kingdom economy is showing signs of strain. With domestic demand in real terms increasing more than twice as fast as potential output in 1988, capacity constraints have emerged and inflation has picked up. The rate of unemployment has fallen markedly since 1986 and the trend of wages has steepened. The external current-account deficit has widened sharply primarily reflecting strong domestic demand pressure.

105. With mounting evidence that domestic demand was continuing to grow excessively, monetary policy was tightened substantially during the second half of 1988. Maintaining a strong currency has become a cornerstone of the Government's counter-inflation policy. During the first months of 1989 interest rates remained broadly stable, with temporary downward pressure on sterling being met by official intervention in foreign exchange markets, but in late May the authorities raised interest rates further to support the exchange rate.

106. The 1988/89 Budget turned out to be tighter than originally envisaged as tax cuts were more than offset by fiscal drag and a marked fall in public expenditure in relation to GDP. Consumer confidence seems to have been boosted by the tax reductions, and the 1988 Budget announcement of restrictions in mortgage tax relief appears to have led to anticipatory household spending. The March 1989 Budget reaffirmed the Government's commitment to exchange-rate stability and to maintaining interest rates high for as long as necessary to reduce inflationary pressure. The Budget implies a further tightening of the fiscal stance, combining a continued fall in public expenditure relative to GDP with modest tax reductions broadly compensating for fiscal drag. While the balanced-budget rule was reconfirmed as a guiding policy principle, the budget outlook for the current financial year is nevertheless for a rising financial surplus (net of privatisation proceeds).

No - ~~sp~~ House purchases -

107. There are first signs that the marked tightening of policy since mid-1988 has begun to bite: mortgage borrowing and consumer demand have slowed, house prices and real-estate transactions have fallen, and private consumption growth appears to have slowed down significantly in the first quarter of 1989. Survey evidence points to some easing of pressure on resources and weakening consumer and business confidence. OECD projections, based on current and announced policies, are for a substantial drop in the rate of growth of domestic demand, with slackening household spending leading to a slowing of business investment with some lag. With net import volumes continuing to rise, though at a diminishing pace, real GDP growth is projected to decline significantly, stabilising at just under 2 per cent during 1990, about 1 percentage point below the estimated rate of growth of potential output. The implied easing of pressure on resources should induce a fall in inflation and in the external current-account deficit relative to GDP. However, given the tensions that have built up over the past year, progress in both areas may be slow and uneven.

108. Risks and uncertainties attaching to the outlook are considerable. Large discrepancies between demand and output measures in the national accounts and erratic patterns of some indicators make it difficult to assess the extent of inflation pressure now embedded in the system. It is also unclear whether and to what extent the erratically high rate of retail price inflation, attributable to the impact of higher mortgage interest rates on the index, will give a twist to the price-wage spiral. A further layer of uncertainty attaches to the extent and timing of the effects of monetary policy in today's much more liberal financial environment. If the decline of inflation proves to be more hesitant than expected, policy might have to be tightened further, with adverse consequences for a time for economic activity. On the other hand, given lags in the effects of policy changes, the degree of tightness and its impact on inflation may be underestimated.

109. It should be borne in mind in this connection that the recent spurt of inflation started from an underlying rate of close to 5 per cent. With inflation in this sort of range it is more difficult to absorb shocks satisfactorily. The task of policy would therefore now appear to be not only to remove the excess demand of the last year or so but to resume the earlier process of disinflation which has been marking time for several years. Seen in this light there will be good reason to err on the side of restraint in the future setting of policy.

110. According to the Government's Medium-Term Financial Strategy, the task of reducing excess demand and inflation falls on monetary policy. Fiscal policy, considered an unsuitable instrument for short-run demand management and stabilisation, is assigned the supportive confidence-building role of establishing and preserving sound public finance and the provision of appropriate economic incentives. However, given the size of present inflationary tensions and imbalances in the economy on the one hand, and the crucial importance of maintaining confidence of financial markets in sterling assets, and of economic agents generally in the Government's anti-inflation policy on the other, there is clearly a danger of over-burdening and over-stretching monetary policy. The Government's willingness to accept cyclically-induced variations in the budget balance must be welcome in this context, but these would not take enough steam out of the economy if domestic demand exceeded the projected path. Its decision to permit a further underlying tightening of fiscal policy in the last two years, not associated with the economic cycle, is thus also to be welcomed. A more ambitious fiscal objective for a time would serve to bolster both financial-market confidence and the credibility of the government's stabilisation policy. This would imply that the planned gradual move from the present budget surplus towards a balanced budget might need to be more stretched out over time than has so far been envisaged.

111. The emergence of an external current deficit reflects a marked strengthening of investment, taking it to levels in excess of national savings. This has been associated with the private sector as a whole moving into financial deficit for the first time

since the early 1950s; the private sector saving ratio has fallen, while private sector investment has risen to record levels in relation to GNP. The fall in private saving has been associated with a number of temporary factors which will go into reverse. In the shorter term higher interest rates will also encourage savings, as will measures in the 1988 Budget. These included a number of provisions to promote wider share ownership and to limit tax-privileged pensions. The limit for mortgage interest relief has not changed, despite the large rises in house prices over the previous year, thus supporting the effects of higher interest rates in slowing down household borrowing.

111a. Over the medium term it is likely that the private sector's financial position will move back towards surplus and that the external deficit will shrink. However, the timing and precise extent of this rebalancing process are uncertain given the imponderable effects of factors like financial liberalisation and rising household wealth. Meanwhile, the United Kingdom's comfortable net foreign asset position and improved returns on productive investment should help maintain favourable conditions for financing temporary current-account deficits.

112. Over the last decade, supply-side policies have been pursued with greater determination and vigour than in most other Member countries. Deregulation of product and factor markets has increased competitive pressure on management and the workforce to become more efficient and responsive to consumer needs. Key measures have been taken to improve incentives and to reduce distortions by cutting marginal tax rates for individuals and companies and by tightening access to unemployment-related benefits. Other supply-side measures have aimed at improving conditions for economic growth through manpower training and education and by reducing distortions resulting from taxes and government transfers. Training schemes to improve the skills of long-term unemployed have been strengthened, and the education system has been made more responsive to the needs of the economy; statutory regulations governing the functioning of the labour market have been relaxed, and restrictive work practices lessened; and competition in financial markets has been further increased through deregulation. All these measures, together with others under active consideration, should help promote non-inflationary growth in the future.

113. Notwithstanding the drive for increased efficiency, important weaknesses on the supply side remain. Income-related benefits continue to mean high marginal combined tax and benefit withdrawal rates for the small number of people in the so-called "poverty trap" while some benefits (such as private use of a company car) continue to be relatively lightly taxed. In the absence of taxes on imputed rent and capital gains, mortgage interest relief still represents a significant tax distortion. Limited progress has been made in dismantling remaining trade barriers, and a number of industry-to-industry agreements continue to restrict foreign access to domestic markets. Successful implementation of recent education reforms will remove deficiencies in work-related education of people of school age, but as long as only a small proportion of people receive formal education beyond school-leaving age, the basis for the workforce to take full advantage of modern work organisation and production techniques will remain inadequate.

114. Over the last decade, the Government has introduced new techniques to make the public sector more efficient, and a number of them have been applied in other Member countries. Efforts have focused on management reforms and external monitoring. Greater attention to output and performance has replaced preoccupation with inputs and cost control, and major devolution of decision making in operational matters is envisaged in the near future. However, further work needs to be done to improve management information systems as a base for assessing resource allocation. Performance targets have been an integral part of the management reform programme, and although often somewhat arbitrary, they may have given a spur to managers to operate more efficiently. Some moves have been made to relate remuneration to such targets. The possibility for private sector producers to compete with government provision of services (market contestability) is still limited, but there it has been undertaken major savings have been recorded. This suggests that there should be increased recourse

to market testing, and that public-sector management reforms should be developed with that in mind. The use of market incentives and competition is a novel approach to the provision of public sector services such as health and education. Provided that public-sector production units are prevented from engaging in monopolistic practices and that consumers take advantage of the internal market, the new approach is likely to stimulate efficiency.

115. Privatisation has involved the transfer of responsibility for provision of goods and services from the public to the private sector. Given the nature of production in many privatised companies, the devolution of responsibility has been only partial. Public utilities that have been privatised are subject to extensive regulation as to pricing and the nature of services, and in the case of some pending privatisations the private sector will be obliged to take on non-commercial tasks and be subject to scrutiny of investment plans. Moreover, management in many privatised companies enjoys greater government protection from takeovers than in most other private companies. Limited use has so far been made of enhancing competition and facilitating regulations by structural measures. Breaking up of large integrated corporations in the process of privatisation, and separating local monopolies from each other, would seem to have been the most effective way of stimulating efficiency. However, many privatisations and other public-sector reform measures are too recent to allow comprehensive assessment, but there their impact has already been felt it has been generally favourable.

116. In sum, United Kingdom economy performance in the 1980s has been marked by an unusually sustained expansion and by distinct signs of improvement on the supply side. But demand growth in 1987 and 1988 was too rapid. Policy now needs to bring inflation on to a firmly downward path while maintaining the momentum of structural reform.

ORIGINAL DRAFT

Introduction

1. The strong expansion of the United Kingdom economy in 1987 continued virtually unabated during 1988. As highlighted in Part I of this Survey, this reflected both booming investment and buoyant household demand, underpinned by a brisk expansion of borrowing, in particular mortgage credit. Both employment growth and the trend of wages steepened. With the economy increasingly coming up against capacity limits, inflation started to edge up and the current-account deficit widened sharply.

2. In view of increasing signs of overheating, the authorities have progressively tightened monetary conditions since mid-1988 (Part II). The rise in short-term interest rates by more than 6 percentage points has damped monetary expansion, and in particular mortgage lending, and has contributed to maintaining a strong exchange rate. The medium-term orientation of fiscal policy puts the burden of short-term adjustment on monetary policy. But fiscal policy has contributed to restraining demand by sticking to nominal spending targets in spite of higher-than-expected inflation. The implied tightening of the fiscal stance is continued in the 1989 Budget, combining expenditure restraint with only modest tax reductions. On the basis of these policies, the recent marked slowdown in household spending, especially in the housing market, can be expected to continue and to reduce the growth of real domestic demand below that of potential output. This might arrest the rise in inflation and the external deficit. There is considerable uncertainty, however, about the underlying strength of demand and inflationary pressures, and about the effects of policy tightening. Slow progress in reducing inflationary tensions and imbalances in the economy could undermine confidence in sterling and lead to a "hard landing" of the economy (Part III).

3. Although, despite the spurt in recent years, GDP growth since the previous cyclical peak in 1979 has hardly exceeded 2 per cent per annum, conditions would seem to be favourable for the economy to return to a higher growth path over the medium term (Part IV). Productivity gains have increased significantly, in particular in manufacturing, profitability has recovered, and investment has surged, boosting the growth rate of productive potential. Improved supply-side performance owes much to structural policy reforms pursued over the last decade. The special Chapter of the Survey (Part V) reviews Government policies aimed at making the public sector itself more efficient. The United Kingdom has taken a leading role in this area, introducing modern management and efficiency monitoring techniques, transferring significant parts of activity to the private sector, and increasing competitive and financial pressure on public-sector management.

VI. Conclusions

104. After more than seven years of strong and sustained expansion, the United Kingdom economy is showing signs of growing strains. With domestic demand in real terms increasing more than twice as fast as potential output in 1988, capacity constraints have emerged and inflation has picked up. The rate of unemployment has fallen markedly since 1986 and the trend of wages has steepened. The external current-account deficit has widened sharply under the combined impact of strong domestic demand pressure and deteriorating international competitiveness.

105. With mounting evidence that domestic demand was continuing to grow excessively, monetary policy was tightened substantially during the second half of 1988. Initially the authorities took advantage of a weakening exchange rate to raise interest rates gradually, but subsequent increases were effected even though the currency was coming under renewed upward pressure. Maintaining a strong currency has become a cornerstone of the Government's counter-inflation policy. During the first months of 1989 interest rates remained broadly stable, with temporary downward pressure on sterling being met by official intervention in foreign exchange markets, but in late May the authorities raised interest rates further to support the exchange rate.

106. The 1988/89 Budget turned out to be tighter than originally envisaged as tax cuts were more than offset by fiscal drag and a marked fall in public expenditure in relation to GDP. Consumer confidence seems to have been boosted by the tax reductions, and the Budget announcement of changes in mortgage tax relief appears to have led to anticipatory household spending. The March 1989 Budget reaffirmed the Government's commitment to exchange-rate stability and to maintaining interest rates high for as long as necessary to reduce inflationary pressure. The Budget implies a further tightening of the fiscal stance, combining a continued fall in public expenditure relative to GDP with modest tax reductions broadly compensating for fiscal drag. While the balanced-budget rule was reconfirmed as a guiding policy principle, the budget outlook for the current financial year is nevertheless for a rising financial surplus (net of privatisation proceeds).

107. There are first signs that the marked tightening of policy since mid-1988 has begun to bite: mortgage borrowing and consumer credit demand have slowed, house prices and real estate transactions have fallen, and private consumption growth appears to have slowed down markedly in the first quarter of 1989. Survey evidence points to some easing of pressure on resources and weakening consumer and business confidence. OECD projections, based on current and announced policies, are for a marked drop in the rate of growth of domestic demand, with slackening household spending leading to a slowing of business investment with some lag. With net import volumes continuing to rise, though at a diminishing pace, real GDP growth is projected to decline significantly, stabilising at just under 2 per cent during 1990.

about 1 percentage point below the estimated rate of growth of potential output. The implied easing of pressure on resources should induce a fall in inflation and in the external current-account deficit relative to GDP. However, given the tensions that have built up over the past year, progress in both areas is likely to be slow and uneven.

108. Risks and uncertainties attaching to the outlook are considerable. Large discrepancies between demand and output measures in the national accounts and erratic patterns of some indicators make it difficult to assess the extent of inflation pressure now embedded in the system; it could be underestimated and the deceleration in demand could be less pronounced than projected. It is also unclear whether and to what extent the erratically high rate of retail-price inflation, attributable to the impact of higher mortgage interest rates on the index, will give a twist to the price-wage spiral. A further layer of uncertainty attaches to the extent and timing of the effects of monetary policy in today's much more liberal financial environment. If the decline of inflation proves to be more hesitant than expected, policy might have to be tightened further, with adverse consequences for a time for economic activity.

109. It should be borne in mind in this connection that the recent spurt of inflation started from an underlying rate of close to 5 per cent. With inflation in this sort of range it is more difficult to absorb shocks satisfactorily. The task of policy would therefore now appear to be not only to remove the excess demand of the last year or so but to resume the earlier process of disinflation which has been marking time for several years. Seen in this light, there seems little risk that the tightening of policy to date represents "overkill"; and there will be good reason to err on the side of restraint in the future setting of policy.

110. According to the Government's Medium-Term Financial Strategy, the task of reducing excess demand and inflation falls on monetary policy. Fiscal policy, considered an unsuitable instrument for short-run demand management and stabilisation, is assigned the supportive confidence-building role of establishing and preserving sound public finance and the provision of appropriate economic incentives. However, given the size of present inflationary tensions and imbalances in the economy on the one hand, and the crucial importance of maintaining confidence of financial markets in sterling assets, and of economic agents generally in the Government's anti-inflation policy on the other, there is clearly a danger of over-burdening and over-stretching monetary policy. Given, furthermore, long lags before the impact of monetary tightening is fully felt, fiscal policy may have to play a more active role in the process of rebalancing the economy and the reduction of inflation pressure. The Government's willingness to accept cyclically-induced variations in the budget balance must be welcome in this context, but these would not take enough steam out of the economy if domestic demand exceeded the projected path. A more ambitious fiscal objective for a time would serve to bolster both financial-market confidence and the credibility of the government's stabilisation policy. This would imply that the planned gradual move from the present budget surplus towards a balanced budget might need to be more stretched out over time than has so far been envisaged.

111. The external current-account deficit reflects low national savings combined with strengthening investment. As a proportion of GDP, national savings have declined through the 1980s to the lowest level since the early 1960s. Despite the recent surge in private investment, the GDP share of total investment still falls considerably short of the average level of the 1970s, reflecting shrinking public investment over the last decade. The decline of personal saving, which more than accounts for that of national saving, may take time to reverse, given the imponderable effects of factors like financial liberalisation and rising household wealth. Thus, domestic saving, even if it recovers more than foreseen at present, may well remain too low in the foreseeable future to match the investment required to sustain satisfactory economic performance. The United Kingdom's comfortable net foreign asset position and improved returns on productive investment will help maintain favourable conditions for financing large current-account deficits. However, should the United Kingdom become less attractive as a place for foreign investors, the case for more ambitious fiscal objectives would be strengthened. It is sometimes argued that private saving adjusts to offset changes in fiscal balances in anticipation of induced changes in future tax burdens. OECD research suggests that such effects are at most partial. In any case, there is a role for fiscal policy to make taxation more supportive to saving. Further steps in this direction were announced in the 1989 Budget. But some distortions remain which, in interaction with financial liberalisation, still tend to encourage household borrowing.

112. Over the last decade, supply-side policies have been pursued with greater determination and vigour than in most other Member countries. Deregulation of product and factor markets has increased competitive pressure on management and the workforce to become more efficient and responsive to consumer needs. Other supply-side measures have aimed at improving conditions for economic growth through manpower training and education and by reducing distortions resulting from taxes and government transfers. Training schemes to improve the skills of long-term unemployed have been strengthened, and the education system has been made more responsive to the needs of the economy; statutory regulations governing the functioning of the labour market have been relaxed, and restrictive work practices lessened; and competition in financial markets has been further increased through deregulation. All these measures, together with others under active consideration, should help promote non-inflationary growth in the future.

113. Notwithstanding the drive for increased efficiency, important weaknesses on the supply side remain. The tax and social security systems continue to interfere unduly with decision making in the private sector through their combined effects on marginal income taxation and differential treatment of income components. In the absence of taxes on imputed rent and capital gains, mortgage interest relief still represents a significant tax distortion. Limited progress has been made in dismantling remaining trade barriers, and a number of industry-to-industry agreements continue to restrict foreign access to domestic markets. Successful implementation of recent education reforms will remove deficiencies in work-related education of people of school age, but as long as only a small proportion of people receive formal education beyond school-leaving age, the basis for the workforce to take full advantage of modern work organisation and production techniques will remain inadequate.

114. Over the last decade, the Government has introduced new techniques to make the public sector more efficient, and a number of them have been applied in other Member countries. Efforts have focused on management reforms and external monitoring. Greater attention to output and performance has replaced preoccupation with inputs and cost control, and major devolution of decision making in operational matters is envisaged in the near future. However, much needs to be done to improve management information systems as a base for assessing resource allocation. Performance targets have been an integral part of the management reform programme, and although often somewhat arbitrary, they may have given a spur to managers to operate more efficiently. Small moves have been made to relate remuneration to such targets. The possibility for private sector producers to compete with government provision of services (market contestability) is still limited, but where such a threat of potential competition exists major savings have been recorded. This suggests that there should be increased recourse to market testing, and that public-sector management reforms should be developed with that in mind. Introducing competition in the delivery of health care and education is a novel approach to use market incentives within the public sector. Provided that public-sector production units are prevented from engaging in monopolistic practices and that consumers take advantage of the internal market, the new approach is likely to stimulate efficiency.

115. Privatisation has involved the transfer of responsibility for provision of goods and services from the public to the private sector. Given the nature of production in many privatised companies, the devolution of responsibility has been only partial. Public utilities that have been privatised are subject to extensive regulation as to pricing and the nature of services, and in the case of some pending privatisations the private sector will be obliged to take on non-commercial tasks and be subject to detailed scrutiny of investment decisions. Moreover, management in many privatised companies enjoys greater government protection from takeovers than in most other private companies. Limited use has so far been made of enhancing competition and facilitating regulations by structural measures. Breaking up of large integrated corporations in the process of privatisation, and separating local monopolies from each other, would seem to have been the most effective way of stimulating efficiency. However, many privatisations and other public-sector reform measures are too recent to allow comprehensive assessment, but where their impact has already been felt it has been generally favourable.

116. In sum, United Kingdom economic performance in the 1980s has been marked by an unusually sustained expansion and by distinct signs of improvement on the supply side. But demand growth in 1987 and 1988 was too rapid. Policy now needs to bring inflation on to a firmly downward path while maintaining the momentum of structural reform.

FROM: D I SPARKES
DATE: 22 JUNE 1989

MR RILEY (MP)

cc Sir P Middleton
Sir T Burns
Mr Anson
Mr Wicks
Mr Phillips
Mr H P Evans
Mr Peretz
Mr Sedgwick
Mr S Davies
Mr Gieve
Mr Grice
Mr Hibberd
Mr Pickford
Mr Rayner
Mr Barrie

mp

OECD EDRC SURVEY OF THE UK

The Chancellor was most grateful for your minute of 21 June reporting developments at the EDRC meeting on the UK economy in Paris earlier this week. He was pleased that the Committee were disposed to accept most of the changes you put forward; he commented that we must hold onto all these improvements. He noted that words "household spending" still appear at the end of the second sentence of paragraph 106; he still thinks "house purchases" would be better.

2. The Chancellor also noted your comment that the Committee was inclined to accept the argument that monetary policy should not be over-burdened, with the implication that fiscal policy may need to be tighter in the next few years than envisaged in the MTFS. He commented that this looks more like an assertion than an argument and he wondered what lay behind the Committee's thinking. A lower exchange rate?

3. Finally, the Chancellor noted that publication of the Survey is expected in the first half of August. He is content with this timing.

D.I.S.

DUNCAN SPARKES

cst.ps/5jm26.6/lets

UNCLASSIFIED

cc:
Chancellor
EST
Sir P Middleton
Mr Bottrill
Mr Wicks
Mr Mountfield
Mrs Lomax
Mr P Davis
Mr Mercer
Mr Halligan

Treasury Chambers, Parliament Street, SW1P

The Hon Alan Clark MP
Minister for Trade
Department of Trade and Industry
1 - 19 Victoria Street
London
SW1H OET

27th June 1989

Dear Alan,

RECLASSIFICATION OF COUNTRIES FOR CONSENSUS PURPOSES

Thank you for your letter of 24 April. I have also seen Chris Patten's letter of 22 May.

I have delayed replying until now because I wanted to review the position after the mid year meeting of the OECD Consensus group. As you know, this group met from 12-16 June when the reclassification issue was again on the agenda. As I expected the US delegation vetoed any question of downward reclassification. As a result, the Group decided to place the reclassification issue on one side, while the Secretariat did some work to discharge the remit given them at the OECD Ministerial to review the present Consensus.

Although that remit was weaker than I would have liked, there is a prospect that it could lead to a package of proposals, including further discipline on mixed credits, differentiated interest rates for Category 2 markets and moves to reduce subsidies in Category 3 markets. If this happened we would have to return to the reclassification debate, but as the issue is now on the backburner in international fora, I suggest that we leave it until the shape of the Secretariat's package becomes apparent.

In making this suggestion I should say that I see no reason to change my view that, on merits, upward recalssification only is the correct course. In particular I think that you may underestimate both the likely increase in subsidy and the danger of the USSR being reclassified to Category 2 if downward reclassifications are conceded. The subsidy implications depend upon business forecasts in the markets that fall to be downgraded and the estimates put forward by ECGD officials for these markets, especially Nigeria, are very questionable. Also, the prospect of the USSR eventually falling into Category 2 would be quite high if the Secretariat's proposal to set the Category 1/2 threshold at $5,500 per head was accepted. But, as I suggest above, we do not need to resolve these arguments at the moment and I suggest that we return to the subject when we see the shape of a reform package in the Consensus.

I am copying this letter to Lynda Chalker and Chris Patten.

Yours Ever,
John

JOHN MAJOR

CONFIDENTIAL
until 23.01 hrs on Thursday 29 June
then UNCLASSIFIED

File: JB/003

FROM: R DEANE
DATE: 27 JUNE 1989
ext 5207

SRichards 27/6

JMP

1. MR PICKFORD
2. MR GIEVE

cc Chancellor (+1 for No.10)
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Scholar
Mr H P Evans
Mr Peretz
Mr Riley
Mr Sedgwick
Mr Hibberd
Mr O'Donnell
Miss O'Mara
Mr Melliss
Mr Bush
Mr Dyer
Mr Owen
Mr Edmonds
Mrs Chaplin
Mr Tyrie

Ch/ Content with line to take?

DJS

OECD ECONOMIC OUTLOOK: JUNE 1989

OECD's latest Economic Outlook has been sent to the press, embargoed until 23.01 hrs on Thursday 29 June.

2. We have as usual had opportunity to comment on earlier drafts. The secretariat have taken on board some, but not all, of our comments on both the text and the forecast.

3. As far as the UK is concerned, this Economic Outlook should not present too many problems. The UK section will probably attract most press attention, and this is discussed in more detail below. I also attach a note on the world outlook (prepared by Mr Edmonds).

UK ECONOMY

Factual

(a) Policy

(i) On monetary policy the OECD recognise that "the medium term orientation of fiscal policy puts the burden of short-term stabilisation on monetary policy". The OECD state that the recent tightening of monetary policy seems to have been effective. "MO has slowed down in response to the sharp rise in short-term interest rates" and "lending to the personal sector, both on mortgages and other uses, has moderated after the strong expansion up to mid-1988; while lending to businesses has remained high."

(ii) One notable feature of financial market developments has been "the stability of long term interest rates in the face of sharp fluctuation of short-term rates" and the "emergence of a sharply downward sloping yield curve." The OECD note that "companies are more likely to be influenced by long-term borrowing costs" ... and that "business capital spending should hold up in the near term."

(iii) The OECD recognise that "the authorities have made it clear that interest rates will stay as high as necessary for as long as necessary to reduce inflationary pressures."

(iv) On fiscal policy, the OECD say that policy over the last year has contributed "to restraining aggregate demand by sticking to nominal spending targets in spite of higher-than-expected inflation". "The 1989 Budget continues the tightening of fiscal policy, with public expenditure falling in relation to GDP and the tax burden expected to remain broadly unchanged." "The consolidation of government finances is evidenced by the fall in the stock of net public sector debt to an estimated 32 per cent of GDP in March 1989, down from over 50 per cent ten years earlier."

(b) Outlook (see attached tables)

(i) The OECD's summary of the outlook for the UK is that the growth of real domestic demand should fall "below that of production potential ... inducing a fall in inflation." However, given the tensions that have built up over the past year, inflation is expected to remain unacceptably high this year and next ... and the external deficit may come down a little in relation to GDP but ... is expected to widen further in absolute terms."

(ii) The OECD say that the risks and uncertainties attached to this outlook are considerable. "Large statistical discrepancies between demand and output measures of GDP and erratic patterns of some indicators in recent months make it difficult to assess the extent of inflation pressure currently embedded in the system; it could be under-estimated and the deceleration in demand could be less pronounced than projected. It is also unclear how far the erratically-high rate of retail price inflation, attributable to the impact of sharply higher mortgage interest rates on the index, will feed into a price-wage spiral."

(iii) "The progressive tightening of policies since the middle of last year should be increasingly felt during the course of 1989" according to the OECD. Interest rates are expected to remain high "for as long as necessary to reduce inflationary pressures" and the "general government financial balance is projected to remain in substantial surplus." "The growth of domestic demand is projected to drop markedly and remain below that of productive potential." However the OECD are forecasting slightly faster demand growth than the FSBR (1¾ per cent against 1¼ per cent in 1989H2).

(iv) The OECD expects "higher inflation, smaller tax adjustments and the petering out of employment growth ... to slow the expansion of households' real income." The downward trend in the personal saving ratio is expected to be reversed but there are uncertainties in gauging the effects of financial liberalisation and changes in house prices. The OECD however expects the effects of the recent tightening to be "significant", particularly since households are now "more heavily geared than in the past."

(v) "Companies are more likely to be influenced by longer-term borrowing costs, which have risen little". Business investment is expected to hold up in the near term. However, weaker demand growth and some squeeze on profit margins should "damp business investment in 1990". The OECD are forecasting faster total investment growth than the FSBR (5¾ per cent against 4½ per cent in 1989). GDP growth is forecast to slow from 2¾ per cent in 1989H1 to 2 per cent in 1990H1.

(vi) The OECD are expecting cost pressures to "intensify" this year due to the effects of higher wage settlements and temporarily lower productivity growth. Easier labour market conditions and reduced overtime payments "should lead to a slight downward drift in the increase in effective earnings in 1990". A levelling out of participation rates should limit the effect of reduced output growth on unemployment. Cost pressures are likely to be offset by reduced profit margins this year as demand pressures weaken. With import price inflation slowing "inflation should subside". However, "inflation is expected to remain unacceptably high throughout this year and next" and will remain "high by international standards". The consumers' expenditure deflator is expected to rise by 5¾ per cent in 1989H1 falling steadily to 5 per cent in 1990H2. The GDP deflator is expected to be a little higher than the FSBR forecast throughout the period.

(vii) International competitiveness is expected to deteriorate on the assumption of constant nominal exchange rates ($1.68, the rate on 2 May). Combined with the rise in sterling during 1988, this is expected to lead to "some loss in export market share". Exports of goods and services are forecast to increase by 3½ per cent in 1989 compared with the

FSBR forecast of 4½ per cent. Weaker domestic demand is expected to reduce import growth. The OECD's forecast of 6½ per cent import volume growth is higher than the FSBR forecast of 4½ per cent. This "deterioration of the foreign balance in volume terms" will be partially offset by "further terms of trade gains". The OECD forecast that "the current account deficit may, therefore, increase slightly, but could fall in relation to GDP (the OECD forecast a deficit of £16.7 billion this year and next).

Line to take

Welcome OECD's recognition that the tight monetary and fiscal policies necessary to bear down on inflation are in place and are having a significant impact. Forecasts show a fall in the rate of growth of domestic demand to below that of productive potential, continuing strong investment growth, and a steady decline in inflation.

Positive

1. "The progressive tightening of policies since the middle of last year should be increasingly felt during the course of 1989."

- "M0 has slowed down in response to the sharp rise in short term interest rates".

- "Lending to the private sector....has decelerated "

- "inflation should subside"

2. "There are signs of a marked deceleration in household spending since the turn of the year, in particular on housing. By contrast, business investment appears to have remained buoyant."

3. "Business investment [has been] growing at double-digit rates since the first half of 1987."

- business capital spending forecast to remain strong

4. "Growth of non-oil exports, particularly consumer goods, was buoyant in the early part of the year (1989)".

Defensive on specific points

1. Inflationary pressures strong. OECD recognises that "the erratically-high rate of retail price inflation [is] attributable to the impact of sharply higher mortgage interest rates on the index". OECD also say that policy tightening has been having the desired effect on money supply and consumer credit and that inflation is expected to "subside". Inflation is forecast to fall steadily through this year and next.

2. Risk that domestic demand will slow by less than projected? [OECD say that it is difficult to estimate the extent of inflationary pressures embedded in the system - due to problems with the statistics - thus the deceleration in demand could be slower than projected.] Also true that demand could decelerate faster than forecast. OECD acknowledge that policy tightening is working (see defensive 1). Always said that it would take time for policy measures to have their full effect.

3. Current account deficit deteriorating. [OECD forecast that deficit may "increase slightly, but could fall in relation to GDP".] Current account forecasting always hazardous and subject to a wide margin of error. Good supply side performance, boosted by large increases in investment, should improve the prospects for exports. Tight monetary and fiscal policies will reduce growth in domestic demand - and hence demand for imports. OECD's forecast deficit is larger than FSBR forecast in part because they expect higher growth of domestic demand (and hence imports) this year.

ROBERT DEANE

UNITED KINGDOM

Demand, output and prices

Percentage changes from previous period, seasonally adjusted at annual rates, volume (1985 prices)

	1987 current prices billion £	1986	1987	1988	1989	1990	1988 I	1988 II	1989 I	1989 II	1990 I	1990 II
Private consumption	260.0	5.7	5.4	6.5	3¼	2½	5.6	6.2	2	2¾	2½	2¼
Government consumption	85.6	2.0	1.1	0.5	½	¾	−1.4	0.9	¼	¼	¾	¾
Gross fixed investment	73.2	1.7	8.3	11.8	5¾	3¼	14.5	5.1	7¼	3	3¼	3¼
Public[a]	11.5	0.9	−9.4	−8.8	−4¼	2	−5.6	−25.8	6	2½	1¾	2¼
Private residential	12.4	8.3	6.3	11.2	−2¼	1	20.1	−0.4	−1¾	−4¾	3	3
Private non-residential	49.3	0.3	14.4	17.2	9¼	3¾	18.4	13.9	9½	4¾	3½	3½
Final domestic demand	418.7	4.2	5.0	6.2	3¼	2¼	5.8	5.0	2¾	2¼	2¼	2¼
* change in stockbuilding	1.0[b]	0	0.1	0.3	0	−¼	−0.2	0.7	−¼	−½	−¼	0
Total domestic demand	419.7	4.2	5.1	6.5	3	2	5.5	5.6	2½	1¾	2¼	2
Exports of goods and services	107.2	3.7	5.4	−1.0	3½	5	−3.0	−1.9	5¾	5	5	5¼
Imports of goods and services	112.1	6.4	7.4	11.9	6½	4¾	8.0	15.6	4	3	5	5¼
* change in foreign balance	−4.8[b]	−0.7	−0.6	−3.8	−1	−¼	−3.3	−5.2	¼	¼	−¼	−¼
* compromise adjustment	−0.4[b]	−0.2	0.1	1.0	¼	0	1.3	1.1	0	0	0	0
GDP at market prices[c]	414.5	3.2	4.6	3.7	2¼	2	3.6	1.6	2¾	2¼	2	2
GDP implicit price deflator	–	3.5	4.8	6.6	6¾	5¾	5.9	8.8	6¼	6	6	5¾
Memorandum items												
Consumer prices[d]	–	4.3	3.8	5.0	5¾	5¼	5.1	5.9	5¾	5½	5¼	5
Industrial production	–	−2.3	5.6	6.9	5	1¾	5.2	9.5	4½	2	1¾	1¾
Unemployment rate	–	11.7	10.2	8.2	7	7¼	8.7	7.6	7¼	7	7¼	7½

* As a percentage of GDP in the previous period.
a) Including nationalized industries and public corporations.
b) Actual amount of stockbuilding, foreign balance and compromise adjustment.
c) Data for GDP in the past are based on a compromise estimate which is the average of the expenditure, output and income estimates of GDP. The compromise adjustment is the difference between compromise GDP and the expenditure estimate of GDP.
d) National accounts implicit private consumption deflator.

Appropriation account for households

Percentage changes from previous year

	1987 billion £	1986	1987	1988	1989	1990
Compensation of employees	226.5	7.7	8.0	11.1	10	8¼
Income from property and other	70.4	7.6	7.6	13.0	10¾	7
Current transfers received	52.6	8.6	3.4	3.3	6	7¼
Total income	349.5	7.8	7.2	10.3	9½	8
Less: direct taxes	43.6	9.2	6.4	11.7	10¼	8¾
current transfers paid	30.5	8.1	8.8	11.0	9	6
Disposable income	275.4	7.6	7.2	10.0	9½	8
Consumers' expenditure	260.0	10.3	9.4	11.8	9	7¼
Saving ratio (as a percentage of disposable income)	–	7.5	5.6	4.1	4¼	4½

Balance of payments

Value, $ billion

	1987	1988	1989	1990	1988 I	1988 II	1989 I	1989 II	1990 I	1990 II
Seasonally adjusted										
Exports	129.9	142.6	151	164	71.4	71.2	75	77	80	84
Imports	146.5	179.1	191	206	87.0	92.1	95	96	101	105
Trade balance	−16.6	−36.6	−40	−41	−15.6	−21.0	−20	−20	−20	−21
Non-factor services, net	8.7	6.2	7	8	3.3	2.9	3	3	4	4
Investment income, net	8.8	10.7	11	11	5.3	5.4	5	6	6	5
Private transfers, net	−0.3	−0.6	0	0	−0.2	−0.3	0	0	0	0
Services and private transfers, net	17.3	16.3	17	18	8.4	7.9	8	9	9	9
Official transfers, net	−5.4	−5.8	−5	−5	−3.2	−2.6	−3	−3	−3	−3
Current balance	−4.8	−26.1	−28	−28	−10.5	−15.6	−15	−13	−14	−15
Memorandum items (s.a.a.r.)										
Per cent changes in volume[a]										
Exports	5.3	0.7	4½	5	−1.9	0.5	6¼	4¾	5	5¼
Imports	7.5	13.4	7	5	10.2	18.0	4	2¾	5¾	6

Note: Detail may not add, due to rounding.
a) Customs basis.

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OECD OUTLOOK NO 45: JUNE 1989: WORLD ECONOMIC FORECAST AND POLICIES

Line to Take

1. Broadly agree with the OECD's assessment of the current situation and prospects. After exceptionally strong growth in 1988, growth in the world economy expected to slow to a more sustainable rate in 1989 and 1990.

2. Agree that the tightening of monetary policy since June 1988 has been necessary to control rising inflation, and that inflation in the industrialised countries can be expected to level off. But also agree that countries must continue to pursue firm monetary policy to control and reduce inflation.

3. While acknowledging that current account surpluses and deficits have proved to be more long lasting and sustainable than earlier expected, the OECD is concerned that some countries' debtor (and creditor) positions may cause sharp pressure on financial markets. Our position is that today's free capital markets will handle the associated capital flows as long as confidence is maintained by sound domestic policies. Net overseas asset positions of the major economies are not excessive. (US had net overseas liabilities of about 10 per cent of GNP at end 1988. Japan and ~~US~~ Germany had net overseas assets of about 15 per cent of GNP.)

4. Agree that while coordination of monetary policy actions and coordinated intervention can help to smooth erratic movements in exchange rates, there are no substitutes for sound domestic fiscal, monetary and structural policies.

5. Agree that sound government financial positions are vital. Agree that where they have not already been achieved, governments should act to reduce their fiscal deficits and to restrain the growth of public sector debt, and that this can best be done by reducing government expenditure.

6. Agree that continuing <u>structural reform</u> is necessary to promote the better working of goods, capital and labour markets, and of the public sector.

7. Agree that maintaining the <u>open world trade</u> system vital for all countries and that present agricultural policies, with their high costs and inefficiency, must be reformed. Agreement in the Uruguay Round of trade negotiations will be an important step towards these common objectives.

Background

Forecast

Table 1 compares the OECD's current forecast with that of December 1988.

Table 1: Comparison of OECD Forecasts

	Percentage changes					
	December 1988			June 1989		
	1988	1989	1990	1988	1989	1990
Major seven countries:						
Real GNP	4¼	3¼	2¾	4.2	3¼	2¾
Domestic Demand	4½	3¼	2¾	4.6	3½	2¾
Consumers expenditure deflator	3¼	3½	3¾	2.9	4	4¼
Volume of World Trade:						
Total	9	7½	7	8.7	7½	7
Manufacturers	10½	8½	8	10.1	8	7½

2. The OECD forecasts for demand, output and trade in 1989 and 1990 are little changed from the December Economic Outlook. The forecast shows G7 real GNP growth slowing from over 4 per cent in 1988 to 3¼ per cent and 2¾ per cent in 1990. The OECD's estimate of potential GNP growth for the G7 is 2¾-3 per cent, so this forecast should be seen as a prediction of continued vigorous growth.

3. The OECD's judgement on inflation has changed since December, with the forecasts for 1989 and 1990 being raised by half per cent. But the judgement is that, on balance, monetary policies have probably been tightened sufficiently since June 1988 to stop inflation rising significantly above its present level. Our latest forecast shows G7 inflation falling in 1990 as the full effects of the tightening since summer 1988 work through.

4. The US current account deficit and Japanese current account surplus declined further in 1988, as proportions of GNP. The OECD does project a further fall in the US current account surplus in the next two years. We, and the IMF, see the US current account deficit increasing over the medium term, at least in dollar terms. No further reduction is expected in the Japanese or German current account surpluses.

Table 2: Current Account Position

	Percentage of GNP			
	1987	1988	1989	1990
United States	-3.4	-2.8	-2.3	-2.1
Japan	3.6	2.8	2.7	2.7
Germany	4.0	4.0	4.0	4.2

5. The average unemployment rate in the OECD has fallen to 7 per cent : the last time it was this low was in 1981.

Policy Recommendations

1. The Outlook notes that monetary policy has been tightened since June 1988, and recognises that it will take time for this to be fully reflected in slower demand growth and lower inflation. Tightening must be sufficient to control inflation, yet not excessive, as that could cause a recession. Our judgement is that monetary policy may have to be tightened further.

2. The Outlook argues that cooperation is needed to prevent a large, abrupt decline of the dollar and to ensure broad alignment of competitiveness among countries. We can also agree with the view that this cooperation can only support, and not replace, sound domestic policies.

The Outlook expresses the view that in many countries with current account deficits, raising national saving is desirable. Where government budgets are in deficit (eg in the US), "eliminating this drain on saving provides clear scope for action".

4. Countries with current account surpluses, according to the Outlook, can contribute to adjustment by removing structural impediments to investment, but should not relax budgetary discipline. We can agree with this recommendation for Japan, where reform is needed of land taxation, agriculture and distribution, and for Germany, where reform is needed of agriculture, transport, and the use of industrial subsidies.

5. The Outlook calls for continuing structural reform in goods, labour and capital markets, and of public sectors. Such action is needed "to improve domestic economic performance over the coming decade and beyond. Reforms can contribute to high employment, strong productivity growth and efficiency".

6. The Outlook specifies the maintenance of the open world trade system, and reform of agricultural support, as common priorities for all countries. Crucial to this will be reaching agreement in the Uruguay Round of trade negotiations on ways to curtail the trade practices that are restricting free trade and causing misallocation of resources.

FROM: A C S ALLAN
DATE: 29 June 1989

MRS J CHAPLIN

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr H P Evans
Mr Peretz
Mr Sedgwick
Mr Gieve
Mr Pickford
Mr Tyrie

LETTER FROM JOHN SMITH

The Chancellor was grateful for your minute of 14 June. Since the OECD's Economic Outlook was not, in the event, published until today, he felt that there was no need for him to reply to Mr Smith unless he writes again.

ACSA

A C S ALLAN

HOUSE OF COMMONS
LONDON SW1A OAA

FAX NO 01 219 5792

TO: Rt Hon NIGEL LAWSON MP

FROM: Rt Hon JOHN SMITH QC MP

DATE: FRIDAY 30 th JUNE

NO OF PAGES
(Including
this sheet) 2

If there are any problems with this fax please contact:

DAVID WARD on 219 6441 or 769 6789

IDWARD TEL No. 01 769 6789 30,06,89 8:17 P.02

From: The Rt. Hon. John Smith, Q.C., M.P.

HOUSE OF COMMONS
LONDON SW1A 0AA

30th June 1989

Ch
Reply as at X?
papers please
Yes please
AA

Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
H.M. Treasury
Great George Street
LONDON SW1

Dear Nigel,

X I am sorry you have not yet felt able to reply to my letter of 31st May in which I invited you to revise your Budget forecast for the balance of payments deficit.

I am prompted to write again following the publication today of the OECD Economic Outlook No.45 (June 1989). The OECD now predicts a further record balance of payments deficit of \$28 billion (£18 billion) both this year and next.

Given that the Treasury assists in the preparation of such forecasts, is it not now proper for you to inform Parliament that your Budget forecast of a £14½ billion deficit seriously underestimates Britain's worsening balance of payments, and to provide a revised, and more credible, forecast of the external deficit as soon as possible.

I ask you once again, with the prospect of further deterioration in the balance of payments confirmed by the OECD, what level of interest rates will be required to finance a deficit of these dramatic proportions? And what will be the consequences for the British economy of a seemingly indefinite period of high interest rates?

Yours sincerely,

John Smith

chex.jp/aa/63

cc PS/CST
PS/FST
PS/PMG
PS/EST
Sir P.Middleton
Sir T. Burns
Mr H.P. Evans
Mr Peretz
Mr Sedgwick
Mr Gieve
Mr Pickford
Mrs Chaplin
Mr Tyrie

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

3 July 1989

Rt Hon John Smith QC MP
House of Commons
LONDON
SW1AA 0AA

PU

Dear John

Thank you for your letter of 30 June. The next Industry Act forecast of the current account deficit for 1989 and 1990 will as usual be made at the time of the Autumn Statement. There are no problems in financing a deficit of the present size provided we maintain sound policies, as we will.

Yours ever

Nigel

NIGEL LAWSON

chex.ps/aa/12

pw

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

12 July 1989

N Willis Esq
General Secretary
Trade Union Congress
Congress House
Great Russell Street
LONDON WC1B 3LS

Dear Mr Willis

The Chancellor has asked me to thank you for your letter of 7 July about the Paris Economic Summit, and for sending him the statement by the Trade Union Advisory Committee to the OECD.

Yours sincerely

Alex Allan

A C S ALLAN
Principal Private Secretary

Trades Union Congress

Congress House
Great Russell Street
London WC1B 3LS

Telephone. 01-636 4030
Fax: 01-636 0632
Telex: 268 328 TUCG

Your reference:

Our reference: E/BC/AB/V

Date: July 7 1989

Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1

CH/EXCHEQUER
REC. 11 JUL 1989 11/7
ACTION Mr HP Evans
COPIES TO Mr Lacks
Mr Mountfield

An Acknowledgement from me?

Yr psr. AA

Dear Chancellor

Paris Summit Meeting

I am writing to draw your attention to the views of the TUC and of the International Trade Union Movement in advance of your visit to Paris for the World Economic Summit.

I attach a statement which has been drawn up by the Trade Union Advisory Committee to the OECD and which has also been submitted to President Mitterand as the host of the Summit.

The TUC fully supports the points made in the TUAC statement and I hope that you will give the points made careful consideration in your preparation for the Summit and in the deliberations in Paris. The statement was drafted before the brutal suppression of the pro-democracy demonstrators in China. In a letter to President Mitterand, the President and General Secretary of TUAC stated that these events reinforce the message in the statement that economic relations with China as well as with the Soviet Union and some countries of Eastern Europe should be extended in ways and on conditions which promote the free practice of trade union and other basic democratic rights.

You will see that the TUAC statement also deals with a number of issues including employment, equality, production capacity, poverty, debt and development, international trade and investment, and the working and living environment.

All these are important issues and I would particularly emphasise the need to make progress on the debt issue. The International Confederation of Free Trade Unions has warned of the risks to fragile democratic institutions of the reversals to development and of the human suffering caused by the burden of debt repayment. I hope that progress on this issue can be made at this year's summit.

I am writing in similar terms to the Prime Minister.

Yours sincerely

Norman Willis

General Secretary

Encs:

TUAC
OECD
CSC
OCDE

trade union advisory committee to the
organisation for economic cooperation and development
commission syndicale consultative auprès de
l'organisation de coopération et de développement économiques

Réf.

TRADE UNION STATEMENT
TO THE OECD MINISTERIAL COUNCIL
AND THE PARIS SUMMIT
May - July, 1989

(Adopted by the TUAC Plenary Session
Paris, 11 - 12 May, 1989)

Introduction

1. The recent economic growth rate of 4% in the OECD area is to be welcomed and needs to be sustained. But despite this strong growth almost 30 million people in OECD countries remain unemployed and many millions more find only precarious work; persistent poverty exists in the midst of affluence; many industrial regions continue to decline; and, most developing countries face grave deprivation which threatens democratic institutions.

2. Sustainable prosperity and economic efficiency cannot be based on these widening divisions. Groups of people must not be allowed to lag far behind in enjoying the benefits of economic growth that other groups already enjoy. Governments are responsible for the task of spreading the benefits of economic growth and for providing opportunities for people to contribute to that growth. Full employment in good quality jobs and the relaunch of balanced economic development must be the aim of policy makers.

3. Any reappearance of high and rising levels of inflation in OECD countries would be damaging to working people and would worsen the prospect of achieving this aim. It must be avoided. Yet this must not be done by deliberately slowing growth, through restrictive monetary and fiscal policies resulting in higher unemployment. The task is to sustain growth and reduce unemployment and inflation at the same time. Central to this must be policies which raise productive capacity and which provide workers with the necessary skills through training and retraining, so as to ensure that new employment opportunities are created. Achieving this will require a genuinely common approach by governments in consultation with trade unions and employers.

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4. To achieve this, OECD countries have the following tasks to accomplish:

- To sustain and make sustainable the high rate of economic growth achieved during the past year, so as to improve significantly the employment situation.

- To use selective investment policies to channel profits into productive activities and active manpower policies to upgrade and expand training and retraining.

- To enable "declining industrial regions" to recover and contribute to balanced economic and employment growth. Their industrial structures need to be modernised, and much economic and social infrastructure investment is required.

- To ensure that the benefits of growth are distributed equitably to all in society, especially to the substantial numbers of people living - and working - in conditions of chronic poverty or hardship.

- To relaunch economic and social development in both the poorest and the middle income developing countries. Debt reduction and an increase in official development assistance are required, under conditions which create improved economic performance worked out in consultation with the social partners.

- To ~~strengthen the~~ multilateral trade and investment system through explicit social obligations on those benefitting from trade and investment liberalisation. OECD governments should co-ordinate their policies concerning the growing economic links of the Soviet Union, some countries of E. Europe and China with the OECD countries.

- To take urgently the necessary practical measures to improve and safeguard the external environment and the working environment.

Towards Full Employment

5. The OECD's Founding Convention pledges governments to cooperate in order to "achieve the highest sustainable economic growth and employment and a rising standard of living in Member Countries". The fight against unemployment requires sustained economic growth of both a quantitative and a qualitative kind. Over the past two years, job creation in the OECD area has exceeded labour force growth so that finally unemployment has started to go down. This trend must be reinforced, because unemployment remains intolerably high. Trade imbalances between OECD countries should be reduced within the context of higher not lower growth.

6. The rise in interest rates is unnecessary. It damages growth, employment, and investment and it increases the debt burden of developing countries. It demonstrates a heavy-handed readiness to put on the economic brakes and an unwillingness to sustain non-inflationary growth by other means. This contrasts with the variety of tools which are available yet which remain little used to tackle the real problems and deficiencies.

7. Shortage of productive capacity and price pressures are not general but are sector specific and regionally concentrated. These can be overcome through investment policies and improved productivity and through broadening the base of growth and spreading the benefits of growth. The persistence of inflation fears, at high levels of unemployment and when regions are still in crisis, is an indictment of the investment performance of firms and the inadequacy of structural policies introduced by governments.

Expanding Productive Capacity

8. For working people, the quality of jobs is as important as the quantity of jobs created. Unregulated and insecure employment is growing fast, especially though not exclusively for women workers, and this leads into a serious degradation of working conditions in many sectors. Nor does this contribute to high productivity of the economy as a whole.

9. Although productive investment has taken place over the last ~~years, it remains ina~~dequate. Structural policies should identify the shortages of capacity and the necessary policies to improve and extend the productivity of OECD economies. Profits have risen spectacularly since 1980 but too much of this increase has been diverted into speculative activity. The focus of corporate activity has shifted to short-term returns. This damaging trend has been aggravated by a flurry of predatory take-overs and threats of take-over which prevents management from acting responsibly to develop production.

10. Selective investment policies, including but not limited to public investment, are needed to channel profits into productive uses. Specific measures, including taxation, should be introduced to control and discourage speculative activity in order to make it less profitable than real investment. Government legislation and regulations on institutional investors should be revised so that they may better contribute to long-term productive investment. Furthermore, the alarming gaps which have appeared in the public infrastructure, as identified by a number of trade union and business groups, still remain to be filled.

11. Active manpower policies are urgently required to anticipate labour market problems and to reintegrate those groups suffering from what has become a dangerously fragmented and polarised employment situation in many countries. Programmes should contain measures targeted towards the wide variety of unemployed and employed people in order to save and

improve the quality of existing jobs, to enable the creation of good new jobs and to equip the disadvantaged and potentially disadvantaged groups with skills necessary for access to these jobs. Measures must result in improvements to the basic and vocational education systems, a significant increase in the volume and quality of training and retraining, and special schemes for vulnerable workers and those in precarious jobs. In many cases this requires an increase in public resources for training and retraining measures. Reductions in working time, including limits on overtime working are needed. Accelerated technological change has provoked or renewed discussion on life-long learning. An important initiative would be the establishment by OECD governments of the right for all workers to receive regular and paid educational leave, irrespective of their employment status.

12. Growth within OECD countries is regionally imbalanced, and with the growing internationalisation of investment this problem has taken on a new dimension. Besides the long-standing issue of the development of peripheral regions, the last decade has seen an intensification of the decline of those industrial regions where contracting sectors are concentrated and where many of the long-term unemployed live. A process of deterioration was allowed to occur without anticipatory counteracting measures being in place to provide adequate alternatives for restructuring. It is repeatedly claimed that labour mobility would be a remedy; in fact, outward migration dangerously exacerbates the problems of such industrial regions and is no solution. These regions face a major task to modernise ~~their economic~~ structures and provide jobs with a future. This would contribute to the balanced development of the OECD economies overall.

13. Fulfilling this task combines sectoral, regional and social policies. Solving the problem requires initiatives in the regions concerned, but also - and importantly - it requires national and international policies to improve the chances of success of regional initiatives. The OECD is well equipped to evaluate the issues involved and identify those policies most likely to bear fruit. A <u>major programme on restructuring the industrial regions</u> needs to be launched by the OECD, akin to its work already underway on rural restructuring.

14. A number of key requirements for successful regional regeneration have been shown to be:

- the existence of a body or authority capable of developing a strategy, mobilising local activity and coordinating approaches at a regional level; this should involve both public and private sectors;

- undertaking education, training and regular retraining to equip workers with new skills and to develop local management abilities;

- the renewal of infrastructures, investment in which has declined in many countries over the last decade in areas such as transport, telecommunications, environmental services, housing, energy conservation and new sources of energy;

- the improvement in the environment and quality of work and life;

- the reconversion and reclamation of land given over to industrial uses;

- new technologies (e.g. environmental technology) as the basis of company modernisation, for the creation of new companies and to develop new sources of economic activity. This requires an effort to develop human skills and facilities for research and development, improve university-industry links and encourage product innovation, particularly in new areas of socially useful activity.

Poverty in OECD Countries

15. The presence of poverty in OECD countries is one indication that balanced growth is not being achieved. Estimates based on national definitions indicate that in both Europe and North America between 10 and 15 percent of the population are living in poverty, that in some countries this proportion is growing, and that many already poor people are falling deeper into poverty. The growth of long-term unemployment has been a major cause of poverty. ~~But in~~ addition the growth of poor quality jobs and squeezed social expenditures have taken their toll on the standard of living and have pushed whole families into hardship. Providing economic security for the whole of the population would increase economic efficiency as well as being socially just.

16. Inequalities are increasing and persistent hardship is the reality for new groups of people who previously have not faced such a situation. The escalation of housing costs in many urban areas has pushed new groups into poverty and homelessness. Although unemployment remains the major reason for poverty, having a job is no longer any guarantee against poverty. Minimum wage regulations have been eroded. Insecure jobs, low-paid jobs, recurrent spells of unemployment and involuntary part-time work have augmented the numbers experiencing hardship. Furthermore, such employment is frequently outside employment protection and social insurance schemes. Workers are trapped in low productivity work and are dispensible employees whenever restructuring takes place. They must be given the right of access to training or retraining.

17. It is the responsibility of governments, who are not using the range of policies to restore full employment in good quality jobs, to remove the underlying causes of poverty. The situation facing the poorest people today cannot be divorced from the consequence of governments' actions to restrict expenditure on social security systems, to undermine or abolish

minimum wages, to reduce unemployment compensation and other social benefits and to restrict access to facilities. This has to be considered against a trend towards whole groups of workers who are often not covered at all by social security, e.g. part-time workers and workers with precarious employment status.

18. The social protection systems of OECD countries must be able to protect citizens, given the economic and social changes which are taking place. The OECD should develop comparable indicators by which the extent of poverty in different OECD countries can be measured. This would serve as a basis for judging the effectiveness of policies to eliminate poverty.

Debt and Development

19. Solutions to the debt crisis must serve to strengthen democracy and development, not place added strains on fragile institutions and economies. The outflow of resources from debtor countries and continued austerity are undermining efforts to create jobs and increase investment needed to generate the wealth through which loans could be repaid. Rather, chronic deprivation and violence results from the present debt strategy.

20. The way out of the debt crisis is through the development of productive capacity, the creation of jobs and the alleviation of poverty. This will create the basis for a stable ~~pattern of growth and~~ improvements in developing countries' balances of payments. Trade unions must be closely involved in formulating the economic and social policies needed to achieve this growth. Neither the governments nor the creditor banks nor the IMF and World Bank can hope to gain the confidence of working people for the economic changes that are required without consulting the organisations which represent them.

21. Sustaining such development requires the building of institutions and structures which help development, but this must also be supported by increased financial flows from OECD countries. This is not a question of generosity but of common interest and shared responsibility. Given the harm already done, Official Development Assistance has an added role in overcoming the consequences of austerity policies. Most OECD countries fail to meet the UN target for official development assistance of 0.7% of GNP. The target must be met: - aid, credits and other resource flows to developing countries can and should be increased and devoted to tackling poverty and encouraging sustainable development rather than being syphoned off for debt servicing. Programmes and projects which enable environmental protection and improvement need to be supported by the OECD countries, IMF and World Bank. In consultation with the social partners, the conditionality, policy advice and surveillance of the IMF and World Bank have to be re-directed towards their original functions of support for broad-based productivity growth and viable development. Private investment needs to be integrated in developing country economies so as to

meet these objectives. They need to work closely with ILO in this area.

22. So far, last year's Toronto Summit initiative for the Sub-Saharan African countries has had little impact and has been interpreted in a very narrow way. Previous "plans" have been unsuccessful in tackling the problem of the middle-income developing countries' debt. In its current spirit, IMF conditionality has set back development for a generation as well as widening the gaps between rich and poor. Austerity when applied in already poor developing coutries has catastrophic results. This is compounded by the unstable functioning of the international monetary system resulting in higher interest payments and by the burden on deficit countries to restructure and contract, without corresponding obligations on surplus countries.

23. The goal must be the removal of debt. As their rising profits have shown, creditor banks have yet to take their fair share of losses as the price of past imprudence in lending. They must be prepared to accept more far-reaching methods for debt reduction. Such methods are necessary to build a basis for development that in the long term supports a pattern of growth in which financial commitments can be met out of increased export earnings. OECD governments must reduce the interest burden on outstanding debt, maintain high rates of demand in the OECD area for exports of developing countries and facilitate the restructuring and writing down of debt to levels commensurate with developing countries' ability to pay.

International Trade and Investment

24. Far-reaching structural changes are being induced by internationalisation through trade and investment. This is also leading to greater instability and social tension as trade and investment flows are distorted by major imbalances between countries and as a larger amount of trade is non-competitive (eg. countertrade, intrafirm trade). Persistent trade conflicts and rising suspicions over the activities of multinational enterprises and corporate raiders are the inevitable outcomes. The hardest issues in the current GATT Round remain to be resolved and the outcome will be determined by the broader environment.

25. Further economic integration is no reason, and cannot be an excuse, to undermine social standards. The multilateral trade and investment system must be strengthened through the explicit incorporation of social rules to be observed by those benefitting from trade and investment liberalisation. Such obligations are not a source of further uncertainty; on the contrary, they are the necessary basis for effective multilateral rules which would obviate many unilateral measures.

26. Between countries of equivalent economic development and strength, major differences in social and working conditions accord an unfair competitive advantage to those with the lower

standards. Social provisions and working conditions have, therefore, to be harmonised so as to generate the highest standards. This is not an automatic process. National regulations and international agreements are needed to achieve the necessary social basis for sustainable economic integration. The newly industrialised economies have to achieve, as a matter of urgency, a re-orientation of their economies towards improved social provision and working conditions.

27. International restructuring by multinational enterprises, the growth in direct foreign investment and the damaging aspects of hostile takeover activity are affecting more and more people directly and indirectly. An alarming amount of this is fuelled by financial speculation. There are serious risks to the international flow of investment if such activities are not regulated. As a first step, the good practice provisions of the OECD Guidelines for Multinational Enterprises have to be enforced and put on a par with the right of establishment and national treatment provisions. In addition, competition authorities must cooperate to strengthen their regulations covering merger and takeover activities to prevent the raiding of assets and to safeguard the social rights of the employees. Workers need to be better protected in circumstances where, as happens, the same employees find themselves over a short space of time working for different employers from different countries with different corporate objectives. Such an environment not only destroys good industrial relations but also undermines the efficiency of the companies.

28. OECD countries must improve access for exports from developing countries and remove discrepancies which exist among themselves in this respect. It is also necessary to ensure a stable and sufficient level of earnings from commodity exports. However, no government should be allowed to violate internationally agreed worker and trade union rights and minimum labour standards in order to capture export markets and to attract foreign investment. The benefits of greater participation in international trade must contribute to the social and economic progress of developing countries' populations. OECD governments should ensure that international support is built up for the inclusion of a Social Clause embodying them in the GATT.

<u>Economic Relations with the Soviet Union, E. Europe and China</u>

29. The TUAC has noted with close interest the increasing economic links of the Soviet Union, some countries of E. Europe and China with the OECD countries. There is a strong prospect of an intensification of these links in the near future. The TUAC also notes the process of change in this same group of countries which offers prospects for the development of pluralistic democratic systems. TUAC welcomes these positive indications for political development and urges OECD governments to ensure that the provision of aid, credit, loans, trade preferences, guarantees, investments and other forms of

economic relation are extended in ways, and on conditions, which promote the free practice of trade union and other basic democratic rights as well as bringing about economic development and material benefit for working people in the countries concerned. The OECD and Member countries have some information about economic and social developments there but need to equip themselves to be able to analyse the economic situations and to monitor the expanding economic links and their social and political impact. The OECD governments should co-ordinate their policies in this area, making use of the OECD forum.

30. The TUAC therefore calls on OECD governments to develop a co-ordinated approach based on the OECD Guidelines for Multinational Enterprises and relevant ILO instruments and to ensure that these standards are fully respected by OECD-based companies operating in E. Europe, the Soviet Union and China. In particular, OECD governments should influence the growing economic relations so that ILO Conventions 87 and 98 concerning freedom of association, the right to organise and to bargain collectively are fully applied; and that basic standards in ILO instruments on occupational health and safety and on other aspects of conditions of work and life are respected.

The Working and Living Environment

31. National and international measures are urgently needed before it is too late to stop the irreversible destruction of ~~the environment~~. The potential damage of global warming due to atmospheric pollution and deforestation illustrates the dangers of not taking preventive action. Growing concern with the environment is a result of intense public pressure raising awareness of the scale of the threat. But although environmental risks are well known in many cases this is not reflected either through the market mechanism or through agreement on national or international regulations. Indeed, immediate economic pressures often encourage the unsustainable exploitation of natural resources. A global programme for environmental recovery is required.

32. Improvement of occupational health and safety is also essential. Tens of thousands of workers are killed or injured each year, due to the dangers in the working environment. This is preventable. Workers are exposed to hazards and pollution at work many times worse than that which society as a whole is prepared to tolerate. In many cases the risks are known but preventive measures are not taken because competitive advantage can thereby be gained. In yet other cases, safety is mainly a question of proper training, the right to information and good industrial relations, but these are not practiced. Governments have to encourage the active involvement of employee representatives in the improvement of both working and living environments.

33. A mixture of price policies (taxes, incentives, subsidies) and regulations are needed, which are internationally

compatible and enforceable. The aim should be both a change in consumption patterns and increased investment, in newer technologies which embody environmentally cleaner products and processes. Economic, employment and environmental goals are not in contradiction to each other. The key to future economic development is the efficient utilisation of natural resources. A market in environmental technology has started to develop but it remains necessary for such technology to be made widely available and disseminated on a world wide basis so that developing and other non-OECD countries can make use of low cost applications. The composition of economic growth, but not its rate, is affected by ensuring that industry meets better international environmental standards. These will mean that economic growth will be more sustainable and job-creating over the long-term.

34. The polluter-pays principle, or the "risk-creator pays" principle, is sound. But it needs to be reviewed to ensure that anti-pollution practices are introduced at a fast pace - not at the pace of the slowest firm. Anticipatory adjustment policies should be introduced where necessary to cope with any resulting job displacement in a socially acceptable manner. Trade unions in the industries affected should, therefore, be fully involved in such measures.

35. In sum, the practical measures which are required include:

- enforcement of mandatory energy saving targets which encourage energy conservation and investment in new, ~~environmentally sound~~ energy sources; the IEA has shown that 30% energy savings could still be made with existing technologies;

- improved research into the environmental impact of new and existing chemicals, and the tightening and enforcement of chemicals regulations in the workplace and in the external environment;

- greater resources devoted to R&D in renewable energy sources and "clean" technologies;

- adjustment assistance for workers affected by stricter environmental standards;

- a major increase in infrastructure investment, an improvement in the environmental and energy conservation standards of the infrastructure, and investment in environmental services;

- identified responsibility for headquarters' management in multinational enterprises for the environmental performance of their operations as a whole;

- investment in forest protection and reafforestation; and,

- projects to improve the environment in the aid and debt reduction programmes for developing countries, through bilateral channels and multilateral institutions.

36. The OECD has a particularly important role to play. In conjunction with the IEA, it needs to advance a major programme on energy conservation and research into clean sources of energy. The work on chemicals control and biotechnology, and on major accident prevention, needs to be strengthened and extended. And an infrastructure evaluation and development programme needs to be launched. But many of these issues go beyond the OECD countries and environmental standards and programmes have to be established which apply to both developing and other non-OECD countries. The coordination between different international organisations in the environmental field should be improved and the OECD should play a leading role in this.