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CABINET

DEFENCE AND OVERSEA POLICY COMMITTEE

QUALIFYING CONDITIONS FOR A CORRECTIVE MECHANISM :

THE ROBUSTNESS OF A GDP PER HEAD CRITERION

Memorandum by the Chancellor of the Exchequer

At the meeting of OD Committee on 8th October I expressed reservations about the two-part qualifying criterion proposed in OD(79)25, on the grounds that the GDP per head condition was insufficiently robust. The Committee asked me to supply it with further information on the developments in exchange rates and relative growth rates that would be needed for the United Kingdom to reach the Community average GDP her head in an enlarged Community.

2. The attached note by my officials goes into this question in some depth. Its conclusions are on the whole reassuring. The improvement in the United Kingdom's real growth rate that would be required to bring us to the Community average GDP per head before the end of the century without a sustained rise in the real exchange rate is almost inconceivable, however successful our economic policies may prove. A steep rise in the real exchange

rate, sufficient to carry us over the same threshold, appears a slightly greater risk. But for such an exchange rate appreciation to disqualify us under the averaging arrangements proposed in OD(79)25, it would either have to be sustained and accompanied by a significant improvement in our growth performance, or to continue at a rate sufficient to offset the growth rate differential against us. It seems unlikely that we could achieve the historically high rates of growth that would be needed in either case at a time when real exchange rate rises were eroding significantly the competitiveness of UK industry.

3. If GDP per head were measured at purchasing power parities the UK would now be very close to the Community average in a Community of 12. But unless our relative growth rate improves markedly we shall already be 11 per cent below the average by 1983, the earliest feasible date for full enlargement. And because calculations on this basis are insulated from the vagaries of market exchange rates UK GDP per head could only rise above the average by this route if there were a real improvement in our relative economic performance.

4. I conclude that the possibility of changes of the required size and duration occurring over the next five years is small, too small to justify our expending a significant amount of negotiating capital in safeguarding ourselves against the risk entailed. I suggest therefore that for the present we should confine our efforts to securing one vital objective in this area - the raising of the GDP per head threshold from the figure of 85 per cent of the Community average embodied in the Financial Mechanism to 100 per cent - and to a second, highly desirable one - the retention of a three year averaging provision. We should also resist any suggestion that GDP per head should for the purposes of a mechanism be calculated using purchasing power parities.

5. Any mechanism that is established will no doubt include a clause providing for a review after a specified period. I suggest that we should insist that a review should also take place if at

any point a country that has previously qualified for relief ceases to do so. A provision on these lines, which could hardly be triggered before 1985, would give the United Kingdom an opportunity to fight its case for continued relief on its merits in the circumstances then prevailing. We should also insist on the automatic three-year phasing-out arrangement proposed in OD(79)25. Taken together these two provisions should, I believe, provide us with as much protection against loss of relief as we can hope to negotiate.

6. I invite my colleagues to endorse the conclusions set out in paragraphs 4 and 5 above.

(G.H.)

H.M. Treasury
19th October 1979

QUALIFYING CONDITIONS FOR A CORRECTIVE MECHANISM :
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OD(79)25 proposes that one component of the "trigger" for any corrective mechanism should be a test of relative prosperity. Specifically, it suggests that to qualify for relief a Member State should have a GDP per head which is below the Community average when calculated over the three-year period immediately preceding the year for which a refund is sought.

2. There is an element of risk involved in relying on a GDP per head criterion. It would clearly be unacceptable if the UK were to find itself paying a net contribution to the EEC quite disproportionate to its economic strength when its GDP per head was only marginally above the Community average. At the same time, however, OD recognised that considerable negotiating capital might have to be expended to secure an indefinite and cast-iron guarantee against this risk.

3. The Chancellor was therefore invited to circulate a note illustrating the circumstances under which UK GDP per head might reach the Community average, particularly over the next five years.

Recent trends in GDP per head

4. The last year in which UK GDP per head exceeded the average of what later became the EEC(9) was 1967, when it was above Irish, Italian and Dutch levels, but below those of other Member States. Since then average EEC GDP per head has grown by 11.5 per cent a year at current prices and exchange rates. The UK, by contrast, managed only 7.9 per cent a year with the result that UK GDP per head had fallen to only 72 per cent of the Community average by 1978. The 3.6 per cent a year growth rate differential reflected two factors:

i. a real growth rate differential, against the UK, of 1.1 per cent a year; and

ii. a <u>fall</u> in the UK's real exchange rate* vis-a-vis EEC of 2.5 per cent a year (ie the UK's exchange rate against the EEC fell by 2½ per cent a year more than was needed to compensate for her worse inflation performance).

The historical record is summarised in the Annex.

5. In 1978 the actual levels of GDP per head at average prices and exchange rates for the year are shown below. (The EEC(10) includes Greece which will be a full member of the Community in 1981.)

TABLE 1 : <u>GDP per head</u>

e.u.a.	EEC10	EEC12	UK	UK as % of EEC10	UK as % of EEC12
1978	5862	5309	4328	73.8	81.5

<u>Possible future developments</u>

6. There are two ways in which UK GDP per head could reach or exceed the Community average:

i. through an appreciation of the real exchange rate; and

ii. by achieving a real growth rate above the Community average;

or, of course, by some combination of the two. Table 2 illustrates the scale of the changes that would be required for the UK to reach the Community average in each of these ways.

TABLE 2

		EEC10	EEC12
1. <u>Real exchange rate appreciation</u>			
(Assuming equal real growth rates)			
Appreciation must be:	from 1978	38%	23%
	from 4 October 1979	29%	13%
2. <u>Differential growth rates</u>			
(Assuming constant relative real exchange rate)			
To achieve the EEC average in:	UK growth must <u>exceed</u> the Community average by at least:		
1984		+6.3%pa	+4.3%pa
1989		+3.1%pa	+2.1%pa
1999		+1.5%pa	+1.0%pa

*Movements in the real exchange rate show how far changes in market (or nominal) exchange rates compensate for differences in inflation rates between countries. An example may illustrate the point. Between 1977 and 1978, sterling depreciated 5 per cent against the DM. But since inflation was 6½ per cent higher in the UK than in Germany, the <u>real</u> exchange rate <u>rose</u> by 1½ per cent.

Real exchange rate

7. An appreciation in the real exchange rate would be the quickest way by which UKincome might rise to the Community average. This would need to be sustained over several years if the GDP criterion were based on three year averaging. It would take a 36 per cent rise in the real exchange rate, compared with 1978, to bring this about. The required rise in the nominal exchange rate would be less, to the extent that inflation was higher in the UK. At present, UK inflation is about 3 per cent above the EEC average; the required nominal appreciation over 1978 is therefore about 33 per cent. Since the real exchange rate had already risen by about 9 per cent by the beginning of October, it would take a further rise in the nominal rate of around 24 per cent.

8. To reach the EEC average in a Community of 12 would require an appreciation from now on of only 13 per cent - sustained over several years. But this does not allow for any ground that may be lost between now and the date of enlargement as a result of our relatively low growth rate. Since the three acceding countries have historically experienced growth rates well above the average for the EEC 9 (as the Annex shows) it would be optimistic to assume that the gap will not have widened further by 1983.

9. Movements of this order in the real exchange rate cannot be totally discounted especially if real oil prices continue to rise. Indeed, with North Sea oil it is plausible to assume that, at least over the next five years, the trend in the real exchange rate will be up rather than down (as over the last decade). Large movements in the real exchange rate have been a feature of recent experience. Since the fourth quarter of 1976, the nominal sterling exchange rate has risen $8\frac{1}{2}$ per cent against the EUA, implying a real exchange appreciation of the order of 18 per cent. But this rise has left sterling relatively highly valued, by historical standards, and a further substantial rise in the real exchange rate may be unlikely in the immediate future. In the medium term, there could be further increases in the real exchange rate, if for example there were another sharp jump in the oil price. As

North Sea oil production passes its peak, however, the balance of risk may shift somewhat. Sterling may look less like a "petro-currency" and become more vulnerable to worries about the UK's industrial base in the post-oil period.

10. It may also be optimistic to assume, as the preceding calculations do, that the UK will achieve a growth rate as high as the EEC average over the next few years. If our growth rate remains relatively low, then the real exchange rate appreciation required to take us above the Community average would be correspondingly larger. On balance, the chances of UK GDP per head attaining the EEC average through this route - and staying there for any length of time - are rather remote.

Real growth rate

11. In the absence of a substantial real exchange rate appreciation, the possibility of the UK's income per head reaching the EEC average is even smaller. It would require an even greater improvement in the UK's relative economic performance. In a Community of 12, the UK growth rate would have to exceed the EEC average by 4.3 points a year for UKincome per head to reach the Community average in five years. If, in line with the trend since 1973, the EEC grew by 3 per cent a year, this would imply sustained UK growth at over 7 per cent a year - an achievement which is quite outside our experience this century. Even if the UK growth rate were to rise to a more realistic 4 per cent a year, while the rest of the Community did no better than in the recent past, UK GDP per head would not reach the Community average until the end of the century - unless there were also a sustained rise in the real exchange rate.

Combination of improved performance and higher exchange rate

12. In practice, UK GDP per head might reach the EEC average as a result of a combination of factors - a higher real exchange rate coupled with greatly increased real growth rate. The two are by no means incompatible; both could result from a major improvement in the trend of productivity or better trading performance, for example. On the other hand, a higher real exchange rate, resulting from an increased speculative demand for sterling associated, for example, with a higher oil price would tend to damage growth.

13. A dramatic improvement in UK performance aside, it is just conceivable that the gap between the UK and the EEC average might be closed if there were a severe disruption to economic activity in the rest of the Community from which the UK were somehow insulated. For example an acute shortage of oil and a sharp rise in oil prices. In these circumstances there could well be a further real appreciation in sterling. However, such an eventuality is intrinsically improbable. Even on the strong assumption that the UK alone could continue to enjoy normal oil supplies, we could not emerge unscathed from a major crisis, since our own output would be seriously affected by the consequent reduction in world trade and also by the loss of competitiveness implied by a rising real exchange rate. Even at maximum production, North Sea oil is unlikely to contribute more than 5 per cent of GNP.

14. Table 3 illustrates some of the possible combinations which might bring the UK up to the EEC average. It shows clearly that the changes in the UK's relative economic performance would have to be either very marked or else sustained over a very long period of time to close the gap. Given past trends, the UK will be doing well if it only achieves the same growth rate as the rest of the Community, at a constant real exchange rate. Compared with the recent past, it will be a significant achievement merely to arrest the UK's relative decline.

Table 3

		EEC10	EEC12
		% per annum	
1.	Assuming sustained 20 per cent appreciation in real exchange rate from 1978: differential growth rate needed to achieve EEC average by:		
	1984	+2.5%	+0.6%
	1989	+1.3%	+0.3%
	1999	+0.6%	+0.1%
2.	Assuming that average Community growth exceeds UK growth by 1½% a year; annual average exchange rate appreciation needed to achieve EEC average in:		
	1984	7.8%	5.7%
	1989	4.6%	3.6%
	1999	3.0%	2.0%

14. These calculations suggest that a below-average GDP per head, buttressed by a three-year averaging provision, is likely to prove robust in all but the most exceptional circumstances. Enlargement to a full Community of 12 will not take place before 1983. Three-year averaging, plus a three-year phasing out period, as suggested in OD(79)25 should safeguard the UK from paying a full net contribution until 1988 at the earliest.

Purchasing power parities

15. The preceding discussion assumes that incomes per head are measured at market exchange rates. This may prove a controversial issue. Other member states may argue that purchasing power parities provide a better basis for comparison if the intention is to assess relative living standards. The UK has strongly resisted this line of argument in the past. We shall no doubt continue to do so, and while our case is not very strong on economic and statistical grounds, we can cite the existing Financial Mechanism which values GDP at market prices. We can also point, less convincingly, to problems of estimation and revision with purchasing power parities.

16. The real difficulty for us in using purchasing power parities is that on this basis the UK is very much closer to average Community income per head. In a Community of 12, the UK's GDP per head at purchasing power parity would have been scarcely below average last year: even in the EEC(9), it was 92 per cent of the average.

17. On the other hand, purchasing power parities are relatively unaffected by volatile and unpredictable movements in market exchange rates. Changes in our relative position, on this basis, will depend on our real growth rate compared to the rest of the Community. Clearly if we succeed in bringing our growth rate up to or above the Community average, there is a risk that in 1983 we will still be uncomfortably close to the critical threshold. If, on the other hand, relative real growth rates continue in line with past trends, with the UK growing some 2 per cent a year less than the EEC 12, our GDP per head, evan at purchasing power parities and in a Community of 12, may be only 89 per cent of the EEC average by 1983 Table 4 summarises the possible outcome, on this assumption.

TABLE 4

UNITED KINGDOM GDP PER HEAD AS PERCENTAGE OF EEC AVERAGE ON PURCHASING POWER PARITY ESTIMATES

	EEC 9	EEC 12
1978	92	[99]*
1981	87	[93]*
1983	85	89

SOURCE: SOEC, UN estimates

*Note: Enlargement to 12 will not occur before 1983

18. It is quite possible that the UK could be above the EEC average on one measure of income per head but not another - indeed this was the case in 1968, when we fell below the EEC average on a market exchange rate measure, as a result of the 1967 devaluation, but stayed above it at purchasing power parities. But it is difficult to judge which measure would be the more likely to take us over the EEC average mark in the future. Certainly the UK is much closer to the average on a purchasing power parity basis, and in this sense the risk may look greater. But movements on an exchange rate basis can be sharp and unpredictable. They are also prone to statistical quirks. There is a recent example, resulting from the 1979 Budget, when the switch from direct to indirect taxation added 2 per cent to the UK GDP at market prices. This carried through to the EEC comparison on a market exchange rate basis, but not on a purchasing power parities basis.

19. What can be said with some confidence is that if we do cross the average on a purchasing power parity basis, it will be because we really are relatively more prosperous in relation to Europe. The same is not necessarily true on an exchange rate basis.

Conclusion

20. If GDP per head is valued at market exchange rates, it will probably require a further sharp and sustained rise in the real exchange rate, combined with a marked improvement in our past relative growth performance, before the UK reaches the Community average even in an EEC of 12.

21. The possibility of changes of the required size and duration taking place over the next five years at least, look remote. But given the danger of unforeseen, and possibly large, movements in the exchange rate, the three year averaging provision could be an important safeguard for the UK and we should press hard for it.

22. It is hard to judge whether the risks of rising above the EEC average are greater if GDP per head is measured at purchasing power parities. On this basis, we would now be very close to the average in a Community of 12, though this may not be so by the time of enlargement. But purchasing power parities are not subject to the vagaries of market exchange rates, and if we do rise above the average on this measure it will be because our relative growth rate has improved.

23. However GDP per head is valued it is highly improbable that the UK would fail the GDP per head criterion in a Community of 9 or 10. Enlargement will not become effective until 1983. With a three-year averaging plus a three-year phasing out period the UK should be safeguarded until 1988 at the earliest.

ANNEX : HISTORICAL RECORD - GDP, REAL EXCHANGE RATES : UK, EEC 9 AND EEC 12

Growth rates (annual averages)	Nominal GDP/head Current prices & exchange rates (EUA)			Nominal GDP Current prices & exchange rates (EUA)			Real GDP				Real exchange rates	
	UK	EEC9	EEC12	UK	EEC9	EEC12	UK	EEC9	EEC12	New 3	UK/EEC9	UK/EEC12
1959-62	5.6	7.7		6.4	8.7		3.3	4.8			-0.8	
1963-67	6.1	7.3	7.6	5.7	8.2	8.4	3.3	4.1	4.3	7.0	-0.7	-0.7
1968-72	6.0	10.1	10.3	6.3	10.9	11.0	2.5	4.7	4.9	7.5	-2.4	-2.2
1973-77	8.8	12.7	13.5	8.8	13.1	13.8	1.5	2.6	3.0	3.8	-3.2	-3.5
1978	13.2	11.9		13.1	12.0		3.3	3.0			0.8	

SOURCE : Eurostat National Accounts, European Economy