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19 November 1990

Barry Potter Esq
Private Secretary to the
 Prime Minister
10 Downing Street
LONDON
SW1

Dear Barry

EPC REPORT ON THE UK ECONOMY

You mentioned to me last week the existence of a report from the European Commission about the UK economy which discussed the case for entering the ERM in 1985, the independence of the Bank, and subsequent monetary developments.

I think the document in question is probably the report on the UK economy prepared by Commission officials for discussion at the Economic Policy Committee in December. We have seen a first draft of this which is to be discussed with officials here this week. Following discussion in EPC, the report as amended will eventually be published in the Spring of next year.

... I attach the current draft and I have sidelined the relevant sections on pages 8-11. As you will understand, the paper should be treated as confidential.

Yours
John

JOHN GIEVE
Principal Private Secretary

II/421/90-EN

THE UNITED KINGDOM

ECONOMIC POLICY AND PROSPECTS IN THE ERM

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The United Kingdom : Economic Policy and Prospects in the ERM

I. INTRODUCTION

Sterling entered the exchange rate mechanism (ERM) of the EMS in October 1990, ending many months of uncertainty as to the timing and conditions of entry. The move, to a central rate of DM 2,95 to the pound with transitional 6% margins, was accompanied by a one percentage point reduction in short-term interest rates to 14%, exactly a year after these were raised to 15%.

The easing of monetary conditions was taken against increasing indications that the economy had already embarked upon a period of substantially slower growth, following a more hesitant slowdown over the previous year and a half from the extreme overheating of 1986-88. ERM entry was also justified by the government on the ground that inflation was soon expected to peak, and then to start on a downward trend. Actual inflationary performance worsened substantially during the course of 1990, with the differential against ERM members widening in advance of entry, not fulfilling the government's intentions implied in the "Madrid conditions" (Graph 1).

The progressive slowdown in demand and activity during 1989 and 1990 led to a rise in unemployment beginning in April 1990. A rise in the nominal exchange rate from the beginning of 1990 gathered strength during the course of the year on speculation about ERM entry; together with rising UK wage costs and falling productivity the real exchange rate rose substantially (Graph 2). The current account has nevertheless recently improved as an easing of domestic demand and of pressures on capacity have resulted in an increase in net exports.

Short-term prospects indicate a difficult period of adaptation to performance consistent with successful ERM membership. It seems likely that wage formation will decelerate only slowly. This implies, if sterling's central rate is to be maintained, the likelihood of the real exchange rate continuing to appreciate. Pressure will thus come to bear particularly on the foreign trading sectors of the economy with probable employment losses at the whole economy level continuing for some time.

II. RECENT DEVELOPMENTS AND SHORT-TERM PROSPECTS

Recent developments

The 1986-88 overheating provoked a progressive tightening of short-term interest rates from mid- to late 1988, with a further one percentage increase in October 1989. As acknowledged by the authorities(1), mistakes were made in not recognising the extreme strength of demand in the 1986-88 period and in thus applying the policy brakes too late and initially too lightly. This helps explain the slowness of the subsequent adjustment.

The momentum of demand growth continued into 1989 but at a reduced pace. Final domestic demand growth in 1989 was halved compared with 1988 (3,5% compared with 7,2%, Table 1). Meanwhile the symptoms of overheating grew worse rather than better. The current account deficit peaked in 1989 at 3,7% of GDP, although underlying volume trends already indicated a very strong recovery in net exports from early 1989 (Graph 3). Underlying inflation worsened considerably from 1988 for reasons including the labour market continuing to tighten, exchange rate depreciation and generally rising prices of traded goods.

The nominal effective exchange rate peaked in January 1989 (Graph 4), supported by the level of UK interest rates. Thereafter financial market confidence weakened progressively and the exchange rate fell 12% through the remainder of the year to a trough in December. The fall in the exchange rate had a considerable effect on easing monetary conditions overall(2); in addition there was some limited and unintended easing of fiscal policy (see below).

The restrictive effects of the monetary policy tightening of the previous year were thus somewhat eroded. A "growth pause" in the middle of 1989, particularly observable for consumers' expenditure, was thereafter reversed with further buoyant demand. Non-oil output grew more slowly during 1989 (2 1/4%, fourth quarter on a year earlier, compared with 5 3/4% in 1988 on 1987), but still relatively strongly (Table 2). Total GDP grew somewhat more slowly because of the major reduction in oil output following the mid-1988 Piper Alpha accident. Extraction of oil and gas in 1989 was almost a fifth below the 1988 level and a quarter less than 1987.

Although the slowing of growth through 1989 was in response to policy tightening the effects were blunted by the fall in the exchange rate and by inadequately sustained pressure on the personal sector. A tighter fiscal policy might have permitted a more targeted approach to the personal sector: the virtually exclusive reliance on interest rates as a stabiliser had obvious costs in the UK context (via

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(1) See Treasury Bulletin, Summer 1990 and Bank of England Quarterly Bulletin, May 1990.

(2) The accepted rule of thumb, confirmed in most econometric models, is that a 4% fall in the exchange rate roughly corresponds to a 1% point reduction in short-term interest rates.

exaggerating the rise in "headline" inflation - the RPI - and thus fuelling wage claims and boosting public transfers and tax allowances via the indexation mechanisms). In the event, private consumption growth in 1989 continued to be supported, if less strongly, by the same combination of real income growth, consumer credit and additional borrowing backed by housing equity as in the immediately preceding years.

In the first half of 1990 the economy continued to register moderate growth. However, the factors sustaining growth weakened. The exchange rate appreciated, particularly from April when speculation began in earnest on ERM entry. The below-potential growth of the onshore economy from 1989 eventually led to a turnaround in the labour market. Unemployment began rising from April, with indications that employment may subsequently have stabilised or even have declined. The annual adjustment of many mortgage payments, after the further rise in interest rates in October 1989, took effect from the spring. The depression in the housing market also damaged consumer confidence: average house prices fell from late 1989. Inflation worsened progressively, considerably aggravated at the "headline" level by the introduction of the local authority Community Charge (poll tax) from April[3], by higher mortgage rates and by the effect on the index of the previous house price boom. While consumers' expenditure continued to grow, the corporate sector now seems to have begun a more serious readjustment, with cutbacks in investment.

In the first half of 1990 the improvement in the external current account was not fully sustained, apparently reflecting a resurgence of domestic demand (Graph 5). However, in the third quarter the slowing domestic and international economy and declining competitiveness was evident in declines in both imports and exports.

Short-term prospects

Evidence has built up over the last few months that the economy has now entered a recession. Manufacturing output has declined steadily since a peak in April; more significantly, the decline is concentrated in investment goods, where the level in August was already 5% below that in April. More forward-looking survey data point to a significant reduction in business confidence. A substantial slowdown in growth of the monetary aggregates - a principal justification for October's one percentage point reduction in interest rates - also points to declining activity.

However, there is still considerable uncertainty as to the severity of the slowdown. Judgments about this severity will be a crucial factor in UK economic policy-making over coming months. Of particular concern in this connection is the UK's past record of failure to assess developments correctly, in part due to statistical deficiences.

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(3) In England and Wales. The tax had already been effect in Scotland from 1989 while Northern Ireland was unaffected.

To some extent the UK downturn may reflect a more general slowing of the industrial economies : signs have also emerged of a weakening in some of the continental European economies, notably France, while the USA and Canada are also experiencing similar trends. Weaker overseas demand would help explain why the downturn in the UK has appeared relatively swiftly. Nevertheless, the main reasons appear to be of domestic origin, especially the tighter monetary stance imposed since 1988 and a real exchange rate that has erratically but eventually tightened.

A substantial downturn, consequent on less buoyant external conditions, in addition to the continued appreciation of the real exchange rate, or further falls in investment expenditures, cannot be ruled out. The crisis in the Gulf is a major uncertainty which could further disturb confidence in addition to the impact on oil prices.

The autumn forecasts of the Commission services assume a path for oil prices, in relation to the Gulf crisis, of some relaxation after the current tension (Table 3). For the UK they assume only gradual adjustment by the private sector to the need for greater wage restraint. This assumption is based on wage settlement trends already established for the current pay round and the absence of any clear indication that these will be revised down in response to ERM membership.

The forecast suggests little significant recovery in UK output prospects until well into 1992. Output grows by under 1% in 1991 and by 1 1/2% in 1992, with the manufacturing sector under particular strain and with unemployment growing throughout the period. Inflation (private consumption deflator, adjusted to remove the impact of Community Charge) falls to 5 1/2% p.a. by the end of 1991 and to 4 1/2% p.a. by the end of 1992; the annual rise in wages and salaries per head falls to 7 1/2% by the end of the first year and to 6 1/4% by end-1992. The household saving ratio, which had already recovered from a 1988 trough of under 5% to 7 3/4% by mid-1990, continues to rise progressively to over 9%, consequent on low real private consumption growth. The current account deficit stabilises at 2% of GDP in 1991 and 1992 after 3% in 1990.

III. KEY AREAS OF CONCERN

The rapid expansion of domestic demand in the period 1986-1988 took place against a changing financial and economic background. Financial reforms had eased constraints on borrowing and made housing wealth more liquid, while disposable income rose as a result of the 1987 and 1988 tax cuts. The depreciation of sterling in late 1986 and the decline in interest rates following the stock market episode a year later eased monetary conditions and contributed to the inflation potential. In the course of the expansion, the personal savings rate plummeted and monetary growth was rapid. At the same time, supply-side reforms had undoubtedly raised potential output, but, it appears, inadequately compared to demand growth.

As a consequence of this severe overheating serious imbalances emerged : the current account deteriorated significantly, while inflation rose sharply. These imbalances continue to characterize current macroeconomic performance. With sterling's participation in the ERM it is more urgent to achieve low inflation, and to achieve a better external balance.

III.a Inflation

Prices in the UK have risen at a stubbornly high rate compared to other EC countries, particularly in the late 1980s.

The retail price index (RPI) rose by 2,4% (year/year) in July and August 1986; this is the lowest inflation rate recorded by this index during the 1980s. From early 1987 on, however, RPI inflation displayed a gently rising trend, and after the summer of 1988 inflation rose at a faster pace. This trend peaked at the rate of 10,9% in September 1990. The RPI measure of inflation, which includes mortgage interest payments and the Community charge, is subject to policy shocks and it may overestimate the extent of deterioration in UK's inflation performance. However, the deterioration is also confirmed by the index which excludes mortgage interest payments and the Community charge. This underlying rate of inflation has followed a trend similar to that of the RPI, rising from below 3% in the summer of 1986 to 8,3% in September 1990. Consequently, the inflation differential between the UK and its main EC partners has widened substantially.

The acceleration of inflation is reflected in labour market developments and, at the same time, wage inflation has been a contributor to the deterioration in price performance. Table 6 reports some key data over the period since 1985. Earnings growth decelerated substantially over the 1980s, falling below 8% in the spring of 1986 at a time when unemployment had stabilized at over 10% of the labour force. Real wage growth has remained positive throughout this period. In the first half of 1990 the underlying growth rate in earnings in the total economy averaged 9,7%, and 9,3% in manufacturing; during this period productivity has slowed down, while unit labour costs have risen at a fast pace. Despite the rapid productivity growth in manufacturing, economy-wide productivity performance has been uneven; as a result, pressures to imitate wage gains of high-productivity sectors in the rest of the economy have led to a decline in the economy's international cost competitiveness.

III.b Labour market adjustment

While cyclical developments will undoubtedly help to bring about a reduction in the current high rate of inflation what is required in the United Kingdiom is not only that inflation be reduced but that a low level of inflation is sustained. For this to occur there will have to be a change in wage behaviour. The UK authorities have undertaken significant reforms in the labour market in the 1980's. Among the most important have been :

- programmes to improve the suitability of the long-term unemployed for work, and their ability to find work,

- reform of the unemployment benefit system to encourage job search and to improve job-matching,

- reform of industrial relations legislation to improve access to work for job-seekers and to enable more flexible and cost-effective working patterns,

- legislation to enhance the rate of growth of small firms and thereby to improve the level of competition in product markets.

The outcome has been an improvement in the trend rate of growth of productivity, during the past decade. Furthermore, the acceleration of wage inflation during the expansion of 1986-88 was considerably less pronounced than in previous periods with excess demand, indicating an enhanced flexibility of the labour market following the supply-side reforms. Nevertheless, in comparison with other industrial countries, UK wage behaviour has displayed greater rigidity, and this has occured despite the record levels of unemployemnt experienced during the first half of the decade. Thus, the latest Commission forecasts foresee only a relatively slow fall in inflation to 4 1/2% by the end of 1992 mainly due to slow wage adjustment. While the factors explaining wage behaviour in the UK are not fully understood there are a number of reasons why wages may be relatively sticky :

- rapid growth of activity in recent years, which has led to significant shortages of skills in some key sectors and regions and which illustrates a deficiency in the stock of skilled manpower,

- **insufficient decentralisation of collective bargaining** into local labour markets, and particularly with reference to the public sector,

- **insufficient mobility of labour**, partly attributable to failures in the structure of collective bargaining but also caused by imbalance in regional economic activity and the implications of this imbalance for the housing market,

- the survival of **inflationary expectations** amongst pay bargainers, and the entrenched view that compensation for past inflation is a property right.

III.c <u>The balance of payments</u>

The balance on current account has deteriorated sharply in the post-1986 period. Movements in the current account balance are highly correlated with movements in domestic demand relative to domestic output; thus, the large external deficit of recent years reflects principally the strength of domestic demand, and is a coincident characteristic of the rapid expansion which has taken place.

Underlying the deterioration in the external balance is essentially an insufficiency of domestic savings to finance domestic spending and, consequently, this excess demand for savings has been financed through the current account deficit. The government has taken the view that, since the large excess demand for savings and the deterioration in the external balance is principally a reflection of private sector decisions, it should not be a subject for policy concern. However, current account developments throughout the 1980s pose some important questions regarding both macroeconomic and resource allocation policies.

- The inadequacy of domestic savings suggests that the current account deficit may become a constraint on economic expansion. Furthermore, it implies that greater policy attention to enhance the saving potential of the economy is warranted.

- Sustained current account deficits will potentially have adverse implications for sterling. The recent experience suggests that UK interest rates have incorporated an unobserviable, but probably significant, risk premium associated with external deficit related expectations. Such depreciation expectations could inhibit a convergence of interest rates and contribute to inflation expectations.

- The sharp deterioration in the UK's basic balance in recent years has meant that capital inflows of a short-term nature have been the principal instruments in financing these deficits. Such inflows are volatile and easily reversible, and have probably made sterling more vulnerable, and may also have contributed to the need to keep interest rates high.

- The principal source of the deterioration in the current account balance has been the balance on merchandise trade and, in particular, trade in manufactures. The secular widening of the deficit in these products indicates that the UK's relative ability to compete internationally in human capital- and technology-intensive goods may have declined. The emerging pattern of specialization may be suggestive of more fundamental inadequacies in the country's human capital and skills development.

- The surpluses on interest, profits and dividends (IPD) transactions, which provided an offsetting element to the rising deficits or merchandise trade in the 1980s, have been reduced sharply in 1990. Should this decline become permanent, a structural weakness in the country's international transactions may emerge.

- Recent inflation trends have led to an appreciation of sterling's real exchange rate. Between 1987 and June 1990 the real exchange rate (based on normalized unit labour costs in manufacturing) has appreciated by 9%, principally reflecting growth in labour costs. These developments have led to an important deterioration in the country's competitiveness in manufactures, and suggest the vulnerability of external trade performance to cost pressures.

With sterling's membership of the ERM the option to offset losses in competitiveness, resulting from high wage and price inflation, through nominal exchange depreciation will be severely limited. The principal means to regain and maintain international competitiveness is through low inflation, and it is now all the more important to achieve low inflation soon. While the financing of current account deficits will be less of a problem within the ERM, further expansion of the UK economy could be inhibited if it were to be associated with sustained large scale external imbalances.

IV. THE MONETARY AND FISCAL POLICY FRAMEWORK

Since 1980 the government has set monetary and fiscal policy within the framework of its Medium Term Financial Strategy (MTFS). While the precise formulation of policy and the medium-term projections for real and nominal output, monetary growth and the public finances have been revised each year, the central objective of the MTFS has remained consistent. This is to provide "a nominal framework within which the government pursues its objective of bringing down the rate of inflation"[4].

The MTFS has remained similar in design from 1984 up to its latest March 1990 version. Monetary policy has been framed using a narrow (M0) target range but with considerable attention given to the exchange rate and the broader monetary and credit aggregates. The public finance projections have focused on the implications for public sector borrowing and recently on debt repayment.

The MTFS approach is examined in the following two sections, respectively on monetary and exchange rate policy and on fiscal policy, focusing on the requirements for successful participation in the exchange rate mechanism.

IV.1. MONETARY AND EXCHANGE-RATE POLICY

a. The problem of indicators and credibility

Monetary policy was considered the principal element of the new stability-oriented adjustment strategy introduced in 1980 in the MTFS. However, during the 1980s it became increasingly difficult to interpret the movements of monetary aggregates because of shifts related to supply-side innovation and credit deregulation. The difficulties led to several changes in the choice of target aggregates and to a more judgemental approach to monetary control using not only the money stock figures but other financial and economic indicators: interest rates, yield curve movements, asset prices and, notably, the exchange rate.

(4) Financial Statement and Budget Report, March 1989.

By 1986, the difficulties in interpreting broad money were considered so great that broad money targeting was abandoned(5). Given the abandonment of broad money targeting, a plausible alternative nominal anchor might have been the exchange rate. Indeed, it has emerged that ERM entry was mooted as early as late 1985. However, oil prices fell very sharply at the time, implying a need for a real depreciation of sterling. Achieving that depreciation without a nominal exchange rate movement would have involved a transitory period of falling prices, and might have proved costly in terms of output and employment. Thus, the nominal exchange rate was allowed to depreciate sharply during the course of 1986, while broad money growth accelerated. During this period, the authorities laid emphasis on the largely offsetting impacts on prices of a falling oil market and a falling exchange rate.

By late 1986, downward market pressure on the exchange rate came to an end : the competitive position had improved, and unemployment had finally started falling. The time seemed ripe to place more weight on the nominal exchange rate as an indicator. Unfortunately, while the money demand implications of financial market changes were recognized, the aggregate demand implications of those same changes were less obvious at the time. Improved consumer and investor confidence combined with vastly increased borrowing opportunities to produce a remarkably strong boom in domestic demand. In such circumstances, had they been fully recognized, the appropriate response wold have been to shift the target exchange rate significantly upwards. However, from early 1987 until the Spring of 1988, sterling "shadowed" the DM within a range widely thought to be from DM 2,90 to DM 3,00.

By the time intense market pressure induced the authorities to "uncap" sterling in the early Spring of 1988, there was a great deal of inflationary momentum in the economy. Although interest rates began to rise in May 1988, it was not until November of that year that the seriousness of the problem was fully recognized. The tardiness of the policy response inevitably made it more severe, with base rates being forced to a peak of 15% by late 1989, double the level of Spring 1988.

The question of whether or not fast growth of broad money in 1986-87 and the acceleration of M0 in 1988 was an **independent** source of inflation in 1989-90 cannot, even now, be answered with any great confidence. But it is clear that doubts about the indicator function of the aggregates led, during 1987 and early 1988, to excessive reliance on an indicator that was at the time even more misleading, the exchange rate. At times, the authorities appeared to take the view that the fast growth of the monetary aggregates did not matter

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(5) The authorities continued to pay attention to broad aggregates, and also published target ranges for narrow money, M0, but in practice movements in these variables ceased to be invariable triggers for monetary policy actions, i.e. changes in short-term interest rates.

as long as the exchange rate was firm against an apparently stable anchor, the DM. As has been noted by the Governor of the Bank of England, it is unlikely that the conduct of monetary policy over that period would have been any different had it been in the hands of an independent central bank, except that the Bank of England might have given less weight than did the Chancellor of the Exchequer to the exchange rate as an indicator.

From early 1989 until May 1990, sterling was falling under the impact of the markets' worries about political factors, and their perceived effect on the disinflationary commitment of the authorities as well as perceptions that adjustment of the large current account deficit might call for sterling depreciation, despite a further rise in interest rates in May (increase of the bank rate to 14% from 13%) and October 1989 (increase of base rate to 15%). There are also grounds for thinking that the pound was lower than justified by "fundamentals" (i.e., the changing balance of supply and demand in the economy), and that a further increase in interest rates would have been economically unjustifiable. Nonetheless, this change in market perceptions of the UK economy contributed to looser monetary conditions and made it more difficult for monetary policy to affect wages and profit margins, since a declining pound enlarged the room for manoeuvre of British export companies during 1989, as well as contributing directly to inflation through higher import prices.

b. The background to ERM entry

From May 1990 onwards, the markets began to anticipate early membership of the ERM. The prospect of a "floor" to the currency, combined with high yields on sterling financial assets, pushed sterling up. This tightened monetary conditions. By October 1990, the authorities were of the opinion that the slowdown in the economy in prospect was sufficiently sharp to bring the prospect of falling inflation, and might even produce an unnecessarily pronounced economic contraction. They thus took sterling into the ERM in early October, at the same time cutting base rates for the first time in two and a half years.

The decision to enter the ERM at a 2,95 DM/$ can be characterized as involving a judgement that the exchange rate was "right", despite the persistence of a large current account deficit, in the light of the need to exert downward pressure on inflation. The shortfall in domestic demand relative to potential output which will be involved in restoring **external balance** will, in the absence of nominal depreciation, have to induce a deceleration of domestic costs. And, for **internal balance** to be restored, the rate of increase of domestic costs will at some point have to undershoot the rate of cost increases in partner countries, a necessity that was avoided by the decision **not** to join the ERM in 1985.

Several factors, however, distinguish the present situation from that of 1985. First, the need to reduce UK inflation is now more urgent than it was perceived to be in late 1985. Second, in 1985 the factor appearing to require a real depreciation (falling oil prices) was

itself an independent agent of inflation. Third, inflation is now likely to accelerate in Europe, and most notably in Germany, so that a UK inflation undershooting would not have to involve actual price deflation. Fourth, and perhaps most important, the monetary policy mistakes of 1987 and 1988 weakened the anti-inflationary credibility of the authorities and created some doubts in the minds of economic agents about the credibility of the authorities' commitment to pursue disinflation. The need for an anchor, one that may reduce the output and employment costs of disflation by directly influencing wage and price determination was thus increased.

c. Monetary policy challenges in the new context

The United Kingdom has embarked upon ERM membership at a time of particular uncertainty relating not only to the external environment (the oil shock, the prospects for the US economy and the dollar) but also to the functioning of the ERM at a time when the nature of the anchor role in the system is unclear.

Influences external to the Community are likely to have a restraining effect on UK output. In addition, the asymmetric shock represented by German unification may lead to higher interest rates in Germany which, if followed by other ERM countries, including the United Kingdom, would intensify recessionary trends in the United Kingdom. If it could be expected that the weakness of activity in the economy would quickly lead to a slowdown in core inflation, the wide margins enjoyed by the United Kingdom could provide sufficient monetary policy flexibility to reduce interest rates and avoid a major recession. Indeed, on the most optimistic scenario, rapidly declining inflation expectations could permit reductions in interest rates even without a fall in sterling within its fluctuation band.

However, there is little evidence as yet that wage settlements are decelerating. If wage inflation remains stubbornly high, it cannot be excluded that interest rates might actually have to be raised to defend the sterling parity. It remains to be seen whether ERM entry will itself have a direct expectational effect, increasing the credibility of commitment to disinflation even at the cost of recession, and thus reducing the activity cost of disinflation.

IV. 2 FISCAL POLICY

The government's approach to budgetary policy, in comparison with changes in the monetary and exchange rate policies also set out in the Medium-Term Financial Strategy (MTFS), has shown greater stability. Policy has been presented in relation to the government's longer term aims of reducing the shares of taxation and public expenditure in GDP and of establishing a sustainable path for public sector borrowing, consistent with monetary stability. Medium-term projections have thus been published of general government receipts, expenditure and public sector borrowing together with projections for the path of nominal GDP, real growth and inflation. Table 6

illustrates the key aggregates from the March 1990 MTFS by financial years[6].

Despite this public articulation of the key elements of the public finances, the MTFS has never decisively gained credibility as an instrument for influencing expectations, particularly with regard to inflation. Annex V explores in more detail why this should be so. One obvious point is that recent paths of inflation projected in successive versions of the MTFS, as in the official short-term forecasts, have been persistently exceeded, throwing doubt on the public finance projections which are in nominal terms (rather than, for example, "cost" terms, i.e. relative to movements in the GDP deflator). Another, perhaps more fundamental, point is that the government itself is not bound to the levels projected for expenditure and taxation beyond the forthcoming financial year. In practice such future levels are only indicative of medium-term intentions. Both expenditure (in the autumn) and taxation (in the spring) are instead determined afresh in the annual cycle of policy-making. This indeterminacy of the MTFS is compounded by the practice that has been adopted of building extremely large margins of flexibility into the published projections. On the expenditure side, the "reserve" (unallocated future expenditure) is very sustantial; the scope for future tax cuts or higher expenditure is usually present for later years of the public borrowing/debt repayment projections as the so-called "fiscal adjustment". The result is that, in practice, the MTFS conveys little certainty about nominal or real levels of future taxation, expenditure and borrowing.

It is nevertheless possible that the MTFS approach could be built on to re-establish and enhance the overall credibility of policy within the framework of ERM particiaption. The latter should contribute greater nominal stability to the MTFS. Fiscal policy within the MTFS could for its part gain greater coherence by establishing a more genuine multi-year approach to public expenditure and taxation planning. Issues that could usefully be considered in this area are whether more economically significant objectives could be articulated : for example, trends in public investment or government financial balances as well as public debt repayment or borrowing. Another issue, particularly relevant currently, is whether cyclical influences and underlying policy should be explicitly discussed.

As regards recent trends, the public finances underwent a rapid move into very large surplus (net debt repayment) in 1988-89, greater in speed or extent than planned by the government. Debt repayment declined in 1989-90 and official forecasts from November 1990 are for a further weakening in the current financial year.

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(6) The financial year runs from April to March.

Focusing on the general government financial balance(7) indicates an almost unchanged surplus of 1% of GDP between calendar 1988 and 1989. However, Commission forecasts suggest that this will be followed by a small deficit in 1990 and deficits in 1991 and 1992 of about 1/2-3/4% of GDP. The reduction in the surplus in 1990 reflects some cyclical weakening (but limited, given the lags in the reaction of the labour market to output and of corporate tax collection lags), and significantly higher expenditure, in volume as well as nominal terms. The higher deficits in the two later years are principally because of cyclical effects.

From the information available it would seem that there has already been some weakening of expenditure control in the current year. In 1991 and 1992 it may become more difficult for fiscal management to maintain an appropriately tight stance for reducing inflation. There will be pressures on both the expenditure and taxation fronts, with the overall picture obscured by cyclical influences tending to raise the financial deficit.

Outline expenditure decisions for the 1991-92 financial year were announced in this November's Autumn Statement. The government's "planning total" for public expenditure was set over 10% higher than the outturn expected for 1990-91. Compared with earlier intentions expenditure was increased by about UKL 8 billion (1 1/4% of GDP). This represented notably: higher than expected inflation (particularly because most transfers are indexed to the rise in the Retail Prices Index in the year to September, which was 10,9%), higher numbers of claimants on demand-led programmes, higher expenditure on education and higher current grants to offset the impact of the Community Charge.

These adjustments illustrate clearly that pressures on expenditure in the short-term are likely to come from inflation (especially pressures to raise public pay), cyclical and political factors (a general election must be held by June 1992 at the latest). The government have made it clear that it will not normally resist cyclical influences on the budget and that the "automatic stabilisers" will be allowed to operate. Thus, while the medium-term objective of a balanced budget remains, expenditure is unlikely to fall in the short-term as a proportion of GDP.

Movements in taxation, especially corporate tax receipts, may have an even larger short-term influence on changes in the actual government financial balance than expenditure changes. The current move into recession is likely to imply a sharp reduction in corporate tax receipts from the 1991-92 financial year, while personal income tax receipts will be restrained by an absence of further employment growth (and perhaps reductions). Commission forecasts of reductions

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(7) Although the MTFS focuses on the public sector debt repayment or borrowing requirement (PSDR/PSBR), a better guide to the stance of fiscal policy is given by the general government financial balance (surplus or deficit, GGFB). The latter excludes privatisation receipts, lending and miscellaneous financial transactions which do not materially influence the net worth of the general government sector. See Annex 5 which analyses budgetary policy in more detail.

in the government's financial balance in 1991 and 1992 rely largely on lower corporate tax receipts, while little further change is foreseen in the cyclically adjusted balance after the reduction - representing an easing of policy, apparently unintended - in 1990. This rests equally, however, on there being no future large-scale discretionary tax reductions.

Overall, the need to bear down on inflation implies that the fiscal stance cannot afford to be significantly relaxed beyond normal cyclical influences on revenue and expenditure. This suggests that a reasonable target to aim for is probably a financial deficit roughly balanced (or in very moderate deficit(8)) over the medium-term. This is somewhat more ambitious than the MTFS's current concept of a "balanced budget" in the sense of zero borrowing, given that the latter includes privatisation receipts of UKL 5 billion p.a. The actual deficit in the short-term would, of course, be larger because of cyclical effects.

Within these overall constraints there remain opportunities for both continuing with fiscal reform (for both taxation and public expenditure management) and for varying the overall composition and level of expenditure and taxation. Consideration of supply side needs, explored further below, suggests that there are probably grounds for higher public investment where current published intentions are not ambitious but where needs such as transport and social welfare infrastructure have received widespread publicity.

For taxation there are also obvious weaknesses, particularly with regard to housing where, compared to other major countries, current treatment is especially generous to owner occupation in general and mortgage financing in particular. This issue is explored further in Annex IV (housing) and in discussion of the supply side. One risk is that of repeating the role in the 1986-88 overheating played by housing finance in a financially liberalised context; it seemed then to be a major reason why private saving declined excessively relative to investment.

To guard against this in future it seems desirable to aim for less extreme subsidisation of housing through the tax system, even if full neutrality is not achieved. One option that would help prevent short-term destabilising episodes would be to the limit the relief from capital gains tax on main residences. On grounds of greater overall fiscal neutrality, consideration could also be given to taxation related to the capital value of land or housing. With the replacement of the local authority property tax the UK is now among the very few countries where such values are not explicitly or implicitly (via rental values) included in the central and/or local government tax base.

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(8) A "moderate deficit" might be targeted at a constant net general government financial liabilities to GDP ratio. Given a current ratio of a little under 20% and sustainable growth of around 2 3/4% p.a., this would imply a medium-term deficit target of around 1/2% of GDP. Cf. the 1988 formulation of the MTFS with a medium-term target for the PSBR excluding privatisation receipts of 1% of GDP.

V. THE SUPPLY-SIDE AND THE SINGLE MARKET

The United Kingdom has pursued supply-side policies in the past decade which are particularly supportive in the transition to a world of greater competition, and freer trade. Notably,

- financial and capital markets have been liberalised for several years, providing a stimulus to competition and activity in domestic financial services,
- subsidies have been reduced, and privatisation has introduced new opportunities for financing and for promoting efficiency,
- foreign direct investment has increased and has been influential in revising work practices,
- reforms in taxation policy have improved incentives to work and created an environment more conducive to investment, as well as a more efficient allocation of investment funds,
- attitudes to the management of resources in the public sector have been reformed by the introduction of market mechanisms and financial evaluation of outputs ('value for money'),
- industrial relations legislation has improved the balance of power in the labour market and raised optimism and expectations about rates of return on new assets,
- deregulation of product and labour markets (the attack on 'red tape') has encouraged small businesses and created the opportunities for new working patterns and practices.

The outcome is measured by an improvement in the trend rate of growth of productivity. Trends in productivity are an important predictor of international trade performance and research undertaken by, and on behalf of, the Commission suggests that significant comparative advantage has been achieved or maintained in several industries. Telecommunications, computers, pharmaceuticals and financial services should all gain significant advantages from the Single Market.

The commitment to stable exchange-rates inside the Single Market will make important demands upon the flexibility of wage determination when confronted with significant shocks. It also requires the permanent suppression of inflationary pressures arising from within domestic markets. The past programme of supply-side reform has made significant progress towards these objectives for the medium-term but a number of important problems remain. Structural problems in the labour market may be identified by,

- evidence showing that pay differentials for skill are inadequate in some sectors to provide incentives for improvement in abilities, particularly amongst youths and for example in engineering,

- evidence that many school-leavers are uninterested in education and training, which is an obvious constraint upon subsequent progress and prospects,

- evidence that quality of training has been low, and an inadequate base for subsequent learning.

The solution of problems in education and training will be particularly important during a period when enterprises are adapting to the needs of the Single Market. Education and training is vital to the raising of productivity performance, where average levels are currently measured to be some way below those of the major industrial Member States. Raising productivity levels will be all the more important if wages were to begin to rise towards the levels paid in the higher productivity States.

Important connections can be identified between the efficiency of the labour and housing markets. The large differentials in property prices across the United Kingdom reflect the concentration of higher-paid activity in the South-East quadrant, which is an important constraint upon regional mobility of labour. The rented property sector has been slow to develop, which represents a further constraint. Tax relief on mortgage repayments continues to create distortion in the allocation of funds between investments, and has in the past led to an excessive store of wealth in housing assets. Borrowing based upon wealth in housing assets played an important part in the recent overheating in consumer spending.

The considerable progress made in privatisation has nevertheless raised important issues about the extent of effective competition for those industries or enterprises which have been transferred to private ownership. The problems concern the consistency and transparency of domestic competition policy in ensuring that barriers to product market entry are removed or reduced and the potential this should create for truly contestable markets.

VI. CONCLUSIONS

The UK has joined the ERM at a time when there is considerable nominal divergence from the path followed by its main European partners. Current developments suggest that UK inflation will decline over the coming months. The speed and the timing of the decline in inflation are by no means certain. The decision to enter the ERM at this time must be seen as expressing the government's commitment to strengthen the anti-inflation stance, and to reduce, and keep low, the rate of nominal expansion of the UK economy. Membership also implies that it is more urgent to bring down inflation rapidly.

The difficulties involved in monetary targeting, and given the limited de facto usefulness of the MTFS in guiding inflation expectations inevitably increases the importance of ERM membership as he principal mechanism available to the UK authorities to pursue and complete the disinflation initiated in mid-1988. ERM entry should involve treating the exchange rate as the overriding target of monetary policy, not simply as an indicator of policy, and it is essential that the policy commitment to observe the exchange rate target is beyond question. If this precondition is not met, the ERM will fail to serve the objectives of policy stability and predictability, and will make little contribution to the disinflation efforts under way. This is particularly the case in the United Kingdom where wage behaviour has not been compatible with sustained low inflation and where the government is averse to incomes policies or social dialogue addressed to wage reduction. In these circumstances credibility becomes all the more important as the means through which the exchange rate commitment in the ERM is transmitted to the corporate and labour sectors of the economy and influences their behaviour.

In addition, the UK government's commitment to maintain a tight policy during the current phase of the disinflation will be essential in maximising the credibility gains from ERM membership. It might be argued that the choice of a 6 percent band for sterling is too wide to secure a restrictive policy, and that the narrow band should have been chosen. While the wide band prevents the government from exploiting all the potential credibility gains it can be noted, on the other hand, that in so far as it has prevented an overly rapid decline in interest rates it has acted to maintain strict monetary conditions. A rapid transition to the narrow band would, however, increase the disinflationary credibility of the authorities.

The question of the appropriate policy stance will be of central importance in coming months. The UK is currently in a recession induced by the restrictive policy stance pursued. The government expects this to be a short-lived slowdown, with RPI inflation declining to 5,5% at the end of 1991. Clearly, there are risks that inflation may prove more stubborn, particularly if wage growth remains high. Should this be the case, the recession will last longer and the output cost of disinflation will rise. In order to promote adjustment to, and secure durable, price stability, disinflation must continue to be the priority of economic policy.

In the course of the economic slowdown, the decline in real output and in inflation will exert downward pressure on interest rates. Under these circumstances, it would appear appropriate to allow market rates to ease. However, it is not clear how much room for easing monetary policy will be available to the authorities : disinflation requires that real interest rates (measured with the underlying rather than the RPI rate of inflation) must rise or at least remain constant during the transition to low inflation. Premature reductions in interest rates would erode the credibility of the policy commitment to price stability.

The need for restraint applies also to fiscal policy. There has nevertheless been some easing of policy in the past two years. The sharp reduction in the public sector debt repayment (PSDR), and its dependence on asset sales, make it vulnerable to a variety of pressures. More significantly, the general government financial balance already appears to have moved into deficit in the current financial year, and a deepening of the deficit is expected from 1991-92. The increases in public expenditure announced in this year's Autumn Statement point to the considerable pressures bearing on the overall stance of policy.

Current indications are that prospective changes in the underlying budgetary position, after some recent easing, largely reflect cyclical influences and substantial accommodation of inflation in public expenditure totals. The need to bear down on inflation suggests that the budgetary stance needs to remain tight, with public expenditure management contributing directly by restraint to the disinflation process. The current recession and expected slow recovery cannot be ignored in interpreting the evolution of the public finances. It would nevertheless be inappropriate to abandon fiscal restraint - beyond accepting the operation of the conventional stabilisers - in order to strengthen the recovery.

Fiscal objectives for the medium-term should continue to be set within the context of the MTFS. This framework could be built upon as a useful vehicle to enhance further predictability and transparency of fiscal policy. A reasonable medium-term objective for the MTFS might be a modest financial deficit for the general government sector, although year-to-year variations would inevitably reflect short-term factors and overall policy needs. Within these constraints, there is also room to continue pursuing tax and expenditure management reform. These will contribute to furthering the supply side reforms of the 1980s and increasing the economy's flexibility.

The recovery in personal savings noted in recent quarters is a welcome signal of macroeconomic adjustment, and will offset the recession-induced decline in public sector savings. However, the experience in the second half of the 1980s suggests that financial liberalisation has had a significant influence on spending and saving behaviour. In particular, it is now possible to consume and save according to longer term trends in income, in contrast to earlier years when financial constraints were prominent. While the task of promoting savings in this environment is more difficult to accomplish, there still remains the need to raise the savings potential of the economy, so that current account deficits will be lesser factors constraining an economic expansion. In this respect, raising the savings potential should become an important objective of tax reform.

Reform of the tax treatment of owner-occupied housing is such a step. Distortions in the housing market appear to have been a source of adjustment difficulties in the course of the recent overheating, contributing to labour market rigidities and wage inflation.

Furthermore, the potential to realize a greater proportion of the liquidity of housing wealth in a liberalized financial environment implies that the expansionary potential of policy will be greatly amplified with adverse consequences for inflation and the balance of payments. Should this potential remain unchecked within the ERM, it could prove an important destabilizing factor making adjustment to the exchange rate constraint very difficult.

The UK has made significant progress in improving the supply side of the economy, and this enhanced flexibility will contribute to the successful adaption to the ERM regime. However, further progress in a number of areas could be useful in achieving and maintaining lower inflation. For example, labour market flexibility could be improved further so that the costs of disinflation are contained. Greater labour mobility would contribute to easing wage pressures at times of high employment, and reform of housing market policy would be a crucial step here. From a longer-term perspective, the supply of skilled labour could also be enhanced which would require either a review of the existing manpower and training programmes, or an improvement in the incentives to workers to undertake such training. The need to raise the supply potential of the economy is important in the context of the European single market. While the UK is expected to benefit from the 1992 initiatives, supply-side reforms would help to ensure that these benefits reach all sectors of the economy, and, ultimately, raise the country's standards of living.

Table 1 : GDP and its expenditure components at constant market prices (% change on previous period. s.a.)

	1988	1989	1990*	1991*	1992*
Private consumption	7.2	3.9	2.4	1.1	1.9
Government consumption	0.5	0.8	2.5	1.9	1.6
Gross fixed investment	14.8	4.8	-0.5	-0.7	1.7
- Residential (20%)	5.7	-3.0	-6.7	2.1	1.7
- Business (69%)	20.4	7.1	-0.3	-2.2	1.9
- Other (11%)	-2.5	3.2	8.6	6.0	0.3
Final domestic demand	7.2	3.5	1.9	1.0	1.8
Stockbuilding (% of GDP)	1.0	0.6	-0.2	-0.5	-0.1
Total domestic demand	8.0	3.1	1.1	0.7	2.2
Exports of gds. & serv.	0.2	4.3	6.4	3.1	3.0
Imports of gds. & serv.	12.8	7.0	3.6	1.6	4.2
GDP (average measure)	4.6	2.2	1.7	1.1	1.7
Deflators[1]:					
- Private consumption	4.9	6.1	7.0	6.3	4.8
- GDP (expend. meas.)	6.7	7.0	7.7	7.1	5.1

* Forecasts of the Commission services. November 1990.

[1] Adjusted for impact of Community Charge.

Table 2 : Output by sector
(% change on previous period. s.a.)

(% GDP weights, 1985)	1988	1989	1990*	1991*	1992*
Energy & water (11)	-4.4	-9.5	2.9	3.9	4.1
- Oil & gas extract (6)	-8.6	-18.6	8.9	5.5	6.9
Manufacturing (24)	7.3	4.3	1.3	-0.3	1.2
Construction (6)	9.0	4.1	2.5	0.5	1.8
Services and other (58)	5.1	3.4	1.3	1.1	1.6
Non-oil GDP[1]	5.7	3.5	1.2	0.8	1.5
GDP, output meas. (100)	4.9	2.4	1.5	1.0	1.7
GDP, average measure	4.6	2.2	1.7	1.1	1.7

* Forecasts of the Commission services. November 1990.

[1] GDP output measure excluding oil and gas extraction.

Table 3 : Recent developments and short-term prospects : other key elements
(% change on previous period unless specified otherwise)

	1988	1989	1990*	1991*	1992*
FINANCIAL FACTORS					
Interest rates[1]					
- 3-m interbank	10.3	13.9	14.8	13.5	11.5
- 20-y govt bond	9.4	9.6	11.4	11.3	10.7
Monetary aggegates					
- M0	6.9	5.9	-	-	-
- M4	17.6	18.2	-	-	-
GGFB[2], calendr yr	1.0	0.9	0.1	-0.4	-0.5
GGFB, financl yr	1.4	0.0	0.0	0.0	-0.4
Exchange rates					
- DM/UKL	3.12	3.08	2.88	2.93	2.93
- USD/UKL	1.78	1.64	1.76	1.89	1.95
LABOUR MARKET					
Comp of employees per head	8.1	8.8	10.7	8.5	6.8
Employment	3.3	2.8	1.7	-0.3	0.0
Unemployment[3]	8.5	7.0	6.4	7.3	7.8
EXTERNAL CUR BAL[4]	-3.2	-3.7	-2.9	-2.0	-2.1
WLD TRADE ASSUMPS.					
Volume	9.5	7.9	6.9	4.6	4.9
Oil price[5]	15	18	24	29	25

* Forecasts of the Commission services. November 1990.

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[1] Period average, %.

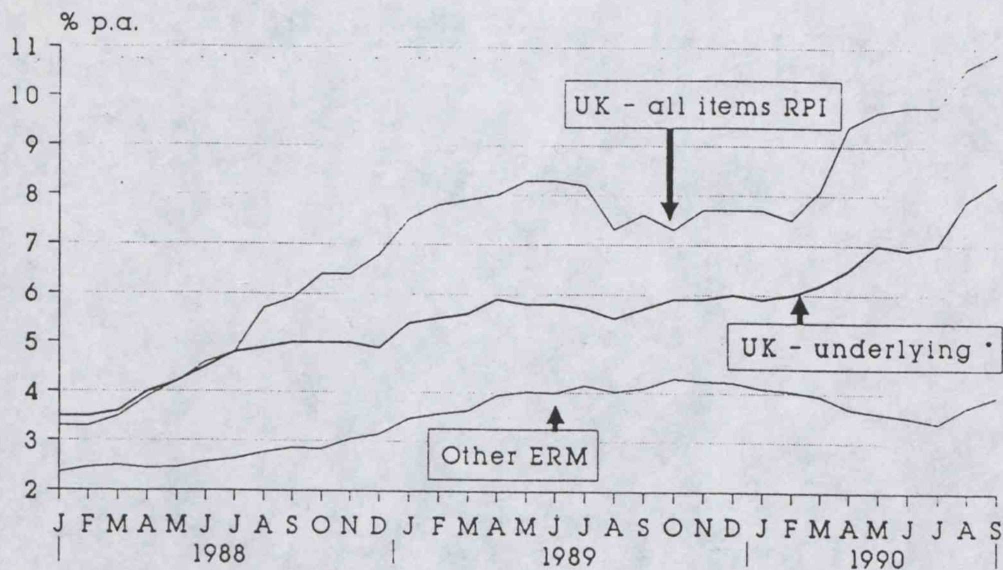
[2] General government financial balance, % of GDP.

[3] % of civilian labour force, SOEC standardised definition.

[4] % of GDP

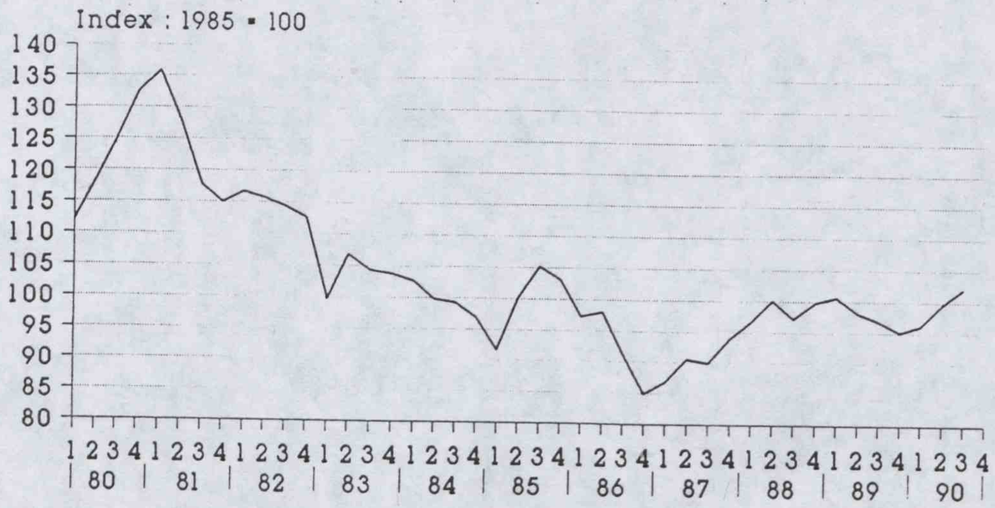
[5] USD/bbl, EC average cif price.

Graph 1



Source : CSO, Commission services.

Graph 2

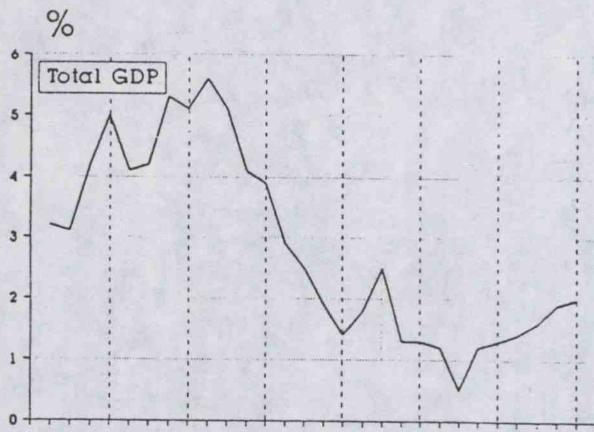


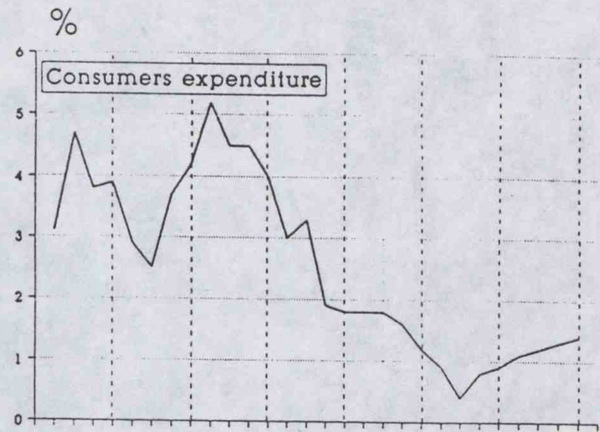
Source: International Monetary Fund;
1990 Q2 and Q3 estimated by Commission services

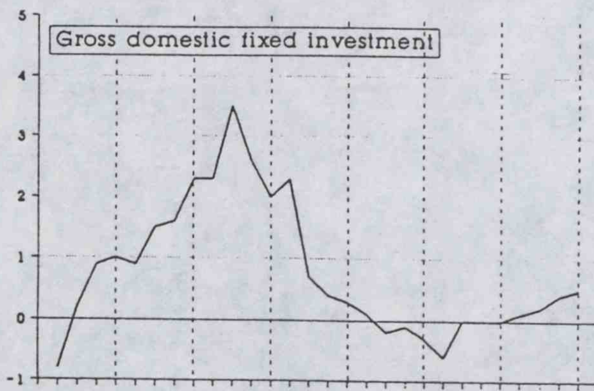
Graph 3

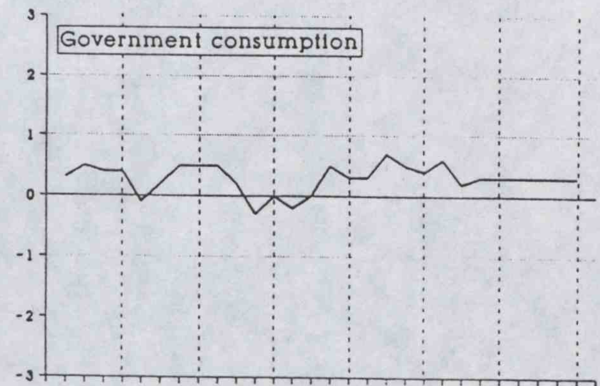
Contributions to changes in GDP

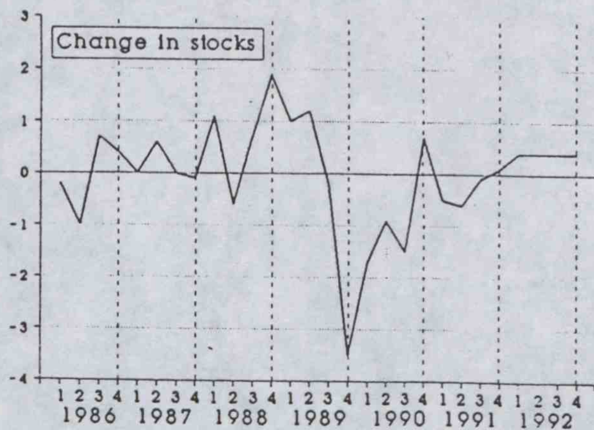
Per cent change over 12 months

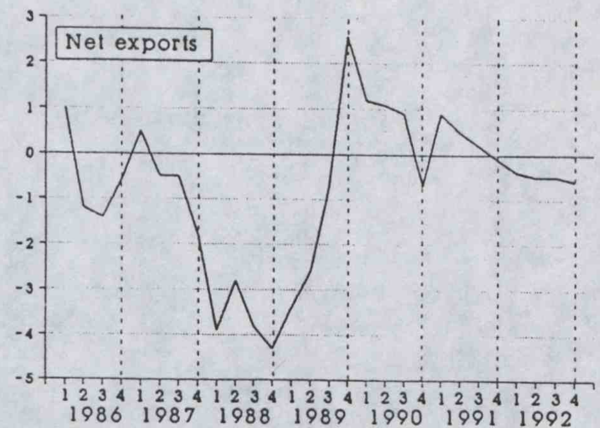






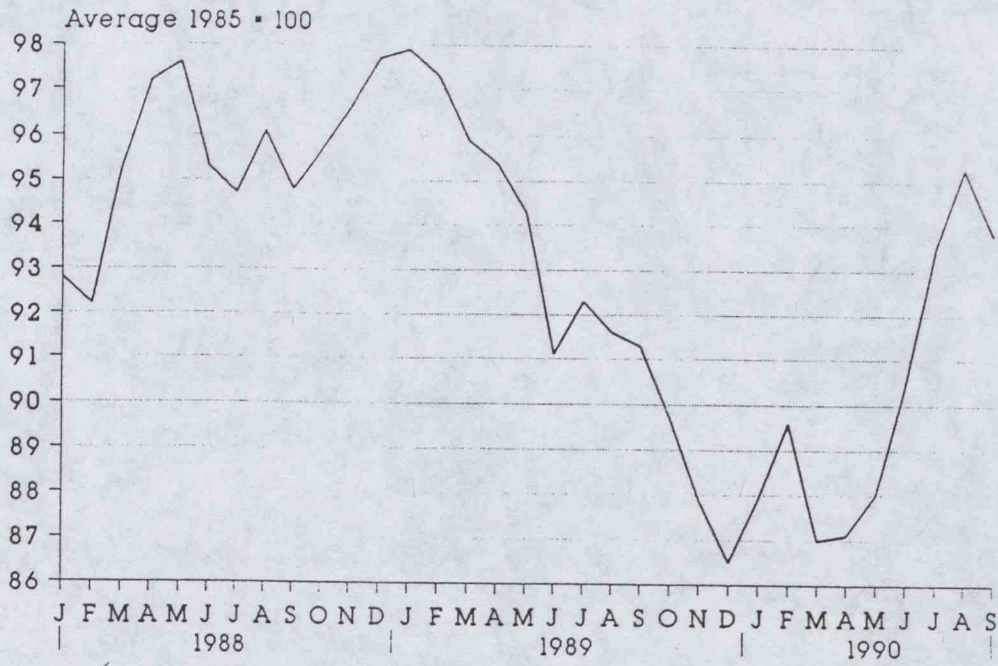






Note: from 1990:Q3 Commission forecasts, Nov.'90

Graph 4



Graph 5