

ECONOMIC PAPERS

COMMISSION OF THE EUROPEAN COMMUNITIES • DIRECTORATE-GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

No. 79

July 1990

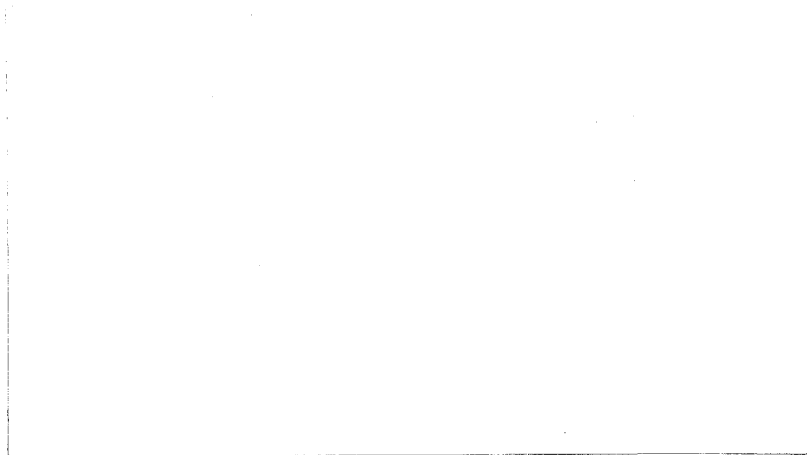
COUNTRY STUDIES

The United Kingdom



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The United Kingdom

Directorate-General for Economic and Financial Affairs*

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Tassos Belessiotis and Ralph Wilkinson.

The United Kingdom Economy (1979 - 1990)

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CHAPTER 1

UK ECONOMIC PERFORMANCE SINCE 1979

1.1 Introduction : a government committed to radical change

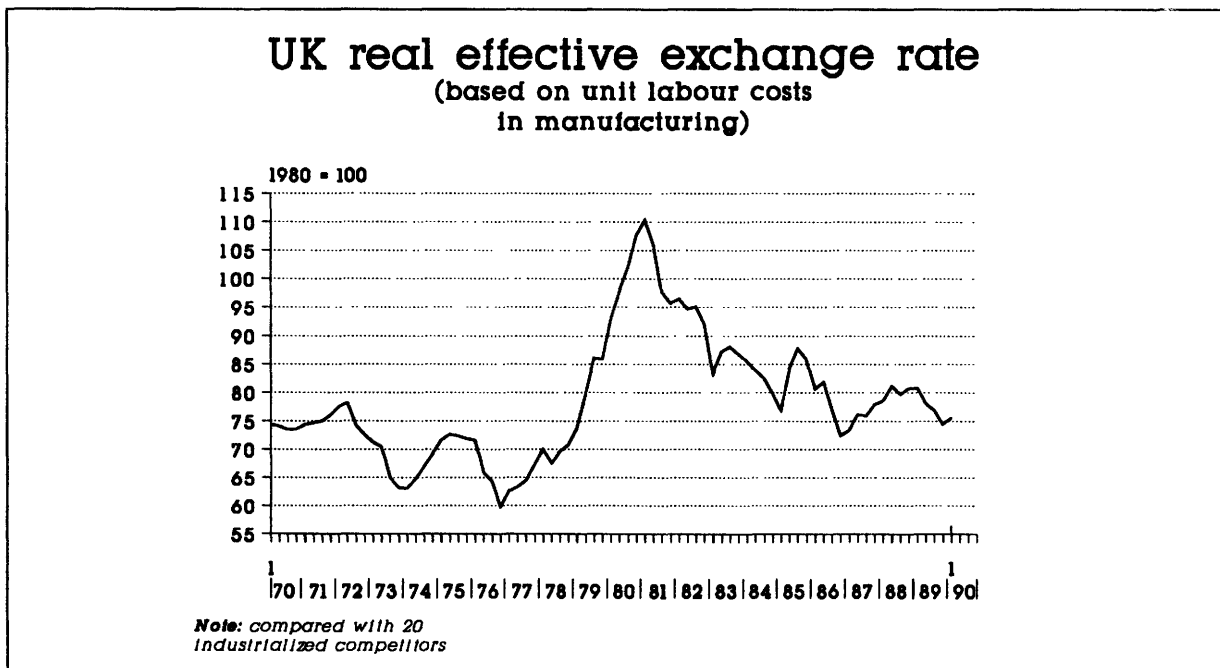
The present United Kingdom government first took office in May 1979. The economic situation it then faced was extremely difficult. The United Kingdom had experienced a long period of relative economic decline particularly apparent in the post-war period and accelerating in the 1970s.

More urgent problems were largely of domestic origin, and reflected the failure in the 1970s to establish a social and economic consensus capable of delivering reasonable rates of growth with low inflation. Instead, social tensions in labour relations were acute, and wage settlements in the private and public sectors were very high and accelerating. A cyclical peak in economic activity had recently been passed and a downturn was in prospect. International financial confidence, following the 1976 crisis which culminated in borrowing from the IMF and after the 1978 breakdown in the government-unions entente, was extremely fragile. Added to this the second oil shock of 1979 increased inflationary pressures and deflated demand. On the other hand, the UK had begun exporting crude oil in 1976, moved into surplus in its oil trade in 1980, and could look forward in the 1980s to a position of being a considerable net oil exporter.

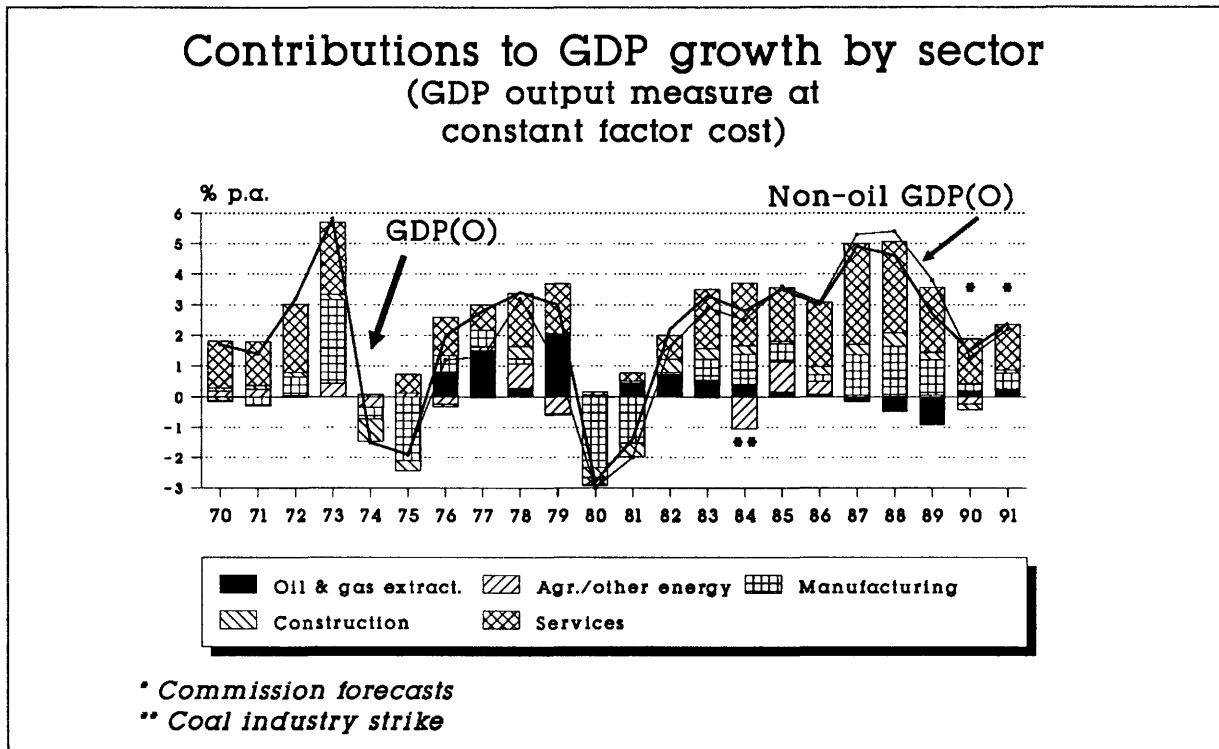
This background of relative economic decline and short-term crisis fostered the election of the new govern-

ment pledged to the introduction of policies radically different in nature and scope from its predecessors. Such policies challenged the established economic and social consensus and the "conventional wisdom". The main elements were, at the macroeconomic level, a commitment to a monetarist counter-inflation policy and a rejection of intervention in exchange markets and of short-term counter-cyclical fiscal policy. At the structural level many of the tenets associated with monetarist supporters were also embraced : a belief in maximising the role and efficiency of markets and of minimising the role of the state (particularly as regards the shares in GDP of public expenditure, taxation and activity accounted for by public corporations and as regards employment in the public sector).

There were no obvious links between these policy stances and Community membership. Indeed, the commitment to a completely independent monetary policy entailed the rejection of full participation in the EMS, which had been inaugurated in March 1979 : the new government confirmed the decision of its predecessor to remain outside the EMS's centrepiece exchange rate mechanism (ERM). Major elements in the reorientation of policy undertaken by the UK (and US) nevertheless foreshadowed more general changes of stance in countries within and outside the Community. These came to include the commitment to public expenditure control, tax reform and reduction, and emphasis on improving the supply side of their economies by enhancing the role of market mechanisms. Within the Community many ideas



Graph 1.1 : Real effective exchange rate.



Graph 1.2 : Contributions to GDP growth by sector.

for improving the supply side and combining this with trade integration came to be encapsulated in the single market programme published in 1985.

1.2 Overview : successes and missed opportunities

Judged from a mid-1990 standpoint, the UK's economic record since 1979 presents an uneven picture, with undoubted successes marred by equally evident failures. In retrospect some elements of the sub-optimal performance, particularly regarding inflation, seem to have been avoidable.

Economic circumstances at the beginning of the government's term of office in 1979 were unfavourable. The onset of the cyclical downturn from 1979 coincided with higher oil and other commodity prices and cost push pressures arose from inflationary wage claims. Inflationary pressures were exacerbated by the new government's major switch from direct to indirect taxation. It was against this background that the government attempted to limit monetary growth via raising interest rates. The exchange rate appreciated strongly in real terms (Graph 1.1) and a deep, partly policy-induced recession resulted. Fiscal policy was not used to offset the fall in demand and, indeed, the March 1981 budget was strongly deflationary.

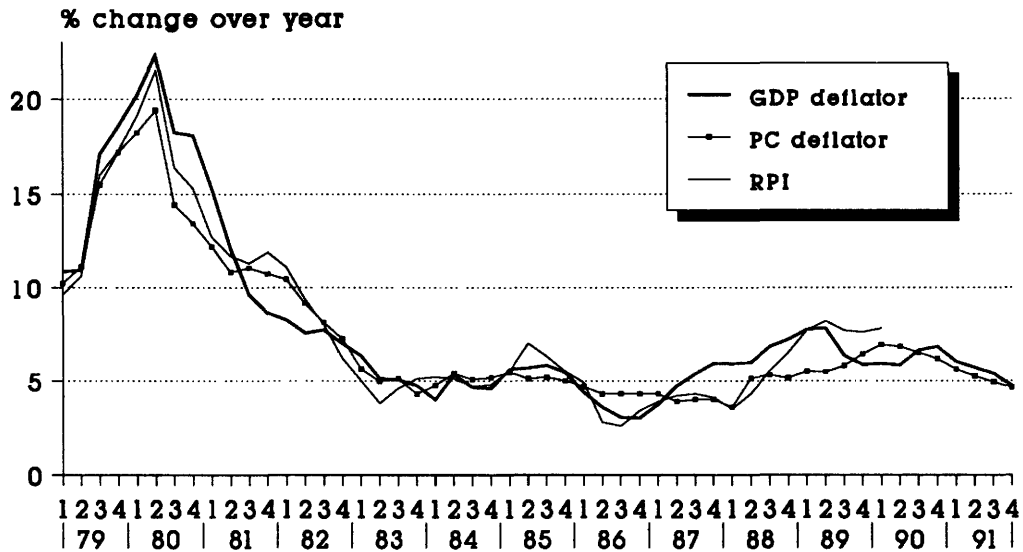
The manufacturing sector bore the brunt of recession, experiencing a very large reduction of capacity and employment (of the 4.2% fall in total output between 1979 and 1981, 3.4% points were attributable to a 14.2% decline in manufacturing and the rest to construction - Graph 1.2). Inflation fell rapidly, from an annual peak of over 16% in 1980 to 5% by 1983 (private consumption deflator - Graph 1.3). However, unemployment rose equally quickly, from under 5% of the civilian labour force at the turn of the decade to 10-11%, where it remained until 1987 (Graph 1.4).

The recovery in output from 1981, which began to be reflected in the total employment figure from 1983, marked the beginning of a long, strong upswing which continued until 1988. The upswing was associated with significant structural changes in the economy. A reduced **manufacturing** sector experienced a recovery in output with very rapid productivity growth as working practices became more flexible; the decline in employment was largely arrested and on occasion even reversed. Profitability recovered to levels much closer to those in other major industrialised countries. Rises in manufacturing output did not, however, keep pace with demand and the UK experienced an inexorably rising deficit in its trade in manufactures : from a surplus of 2.7% of GDP¹ (10% of manufacturing value-added) in 1980 to a deficit of 3.8% of GDP (16% of manufacturing value-added) in 1988

1) Throughout this study, unless explicitly mentioned otherwise, the average measure of GDP at market prices is used. There remain considerable uncertainties about the precise scale and structure of growth because of large and frequent revisions to the UK national accounts statistics in recent years and important discrepancies within the accounts. Recent published national accounts incorporate substantial explicit adjustments (particularly, increases in expenditure on fixed investment and stockbuilding) to reconcile more closely the different measures of GDP.

Inflation indicators

Private consumpt. & GDP deflators & RPI



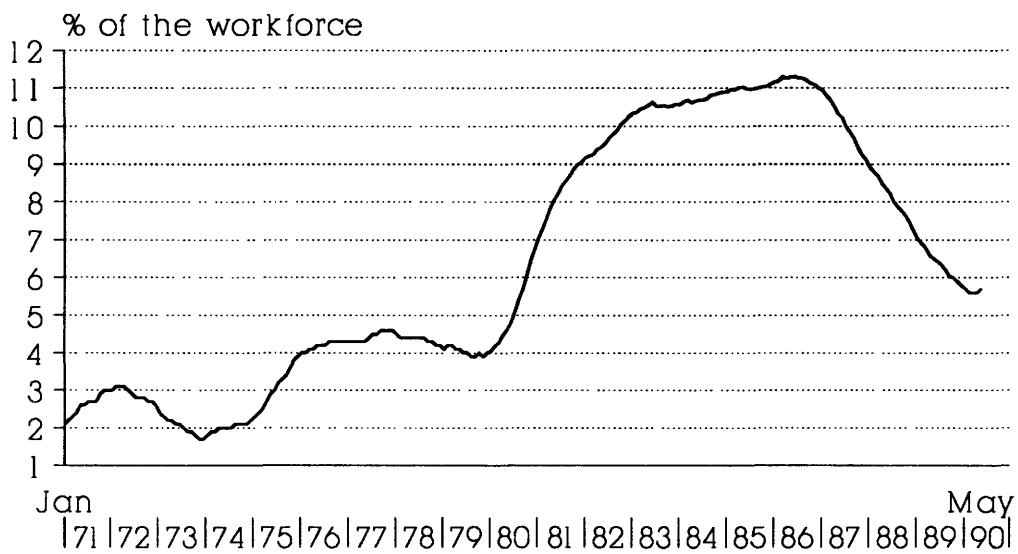
1990/91: Commission forecasts (GDP & PC)
 Private consumption and GDP deflators
 adjusted for Community charge

Graph 1.3 : Inflation indicators.

U.K. unemployment rate

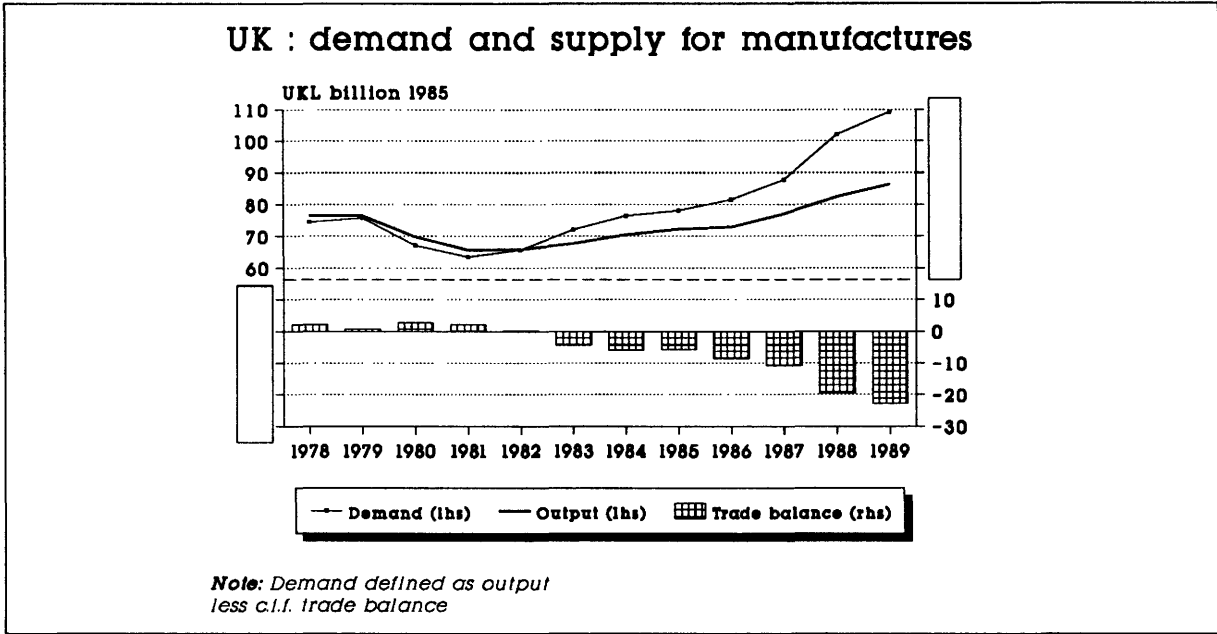
1971 - 1990

(seasonally adjusted)

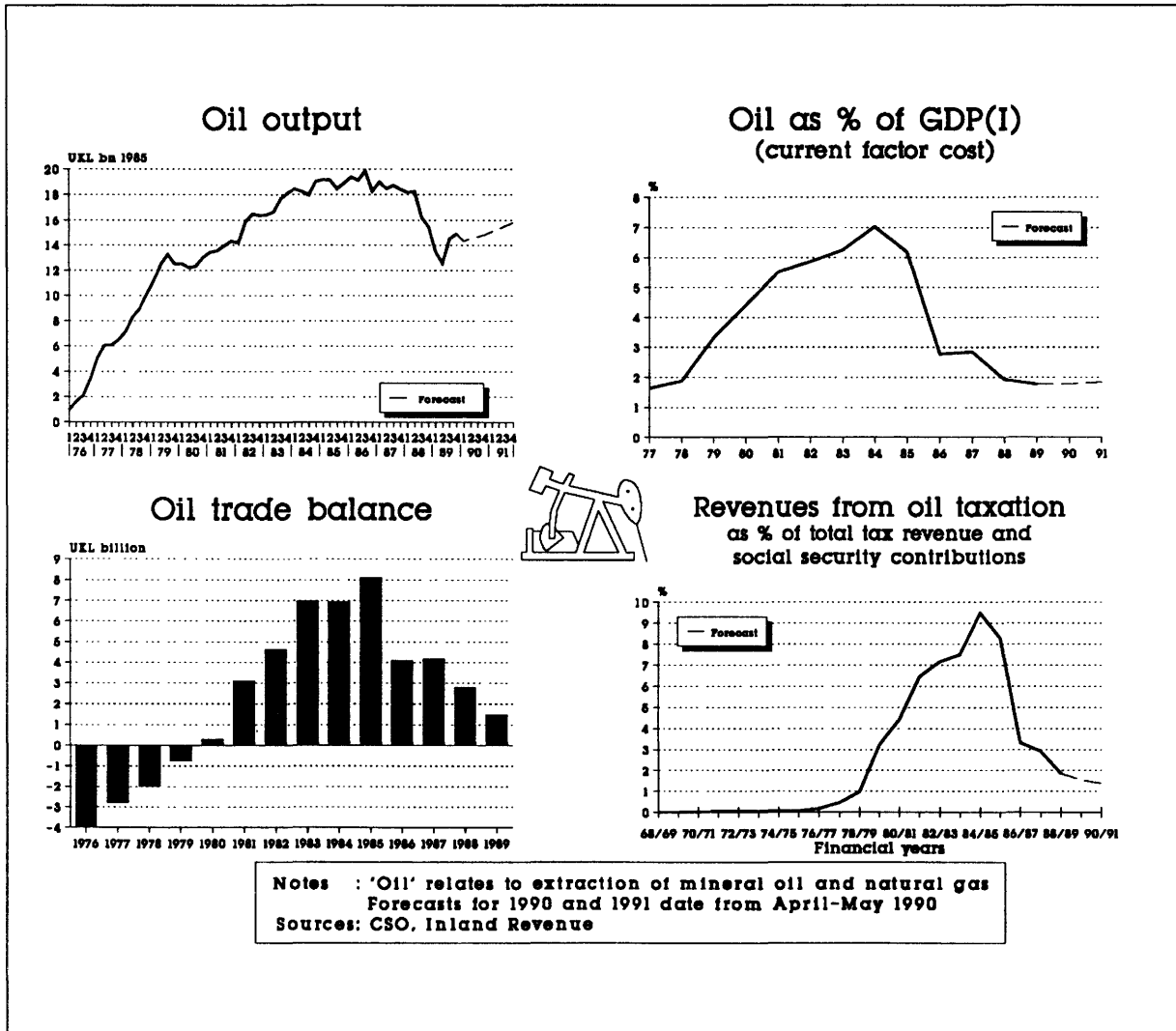


Source: CSO

Graph 1.4 : Unemployment rate.



Graph 1.5 : Demand and supply for manufactures.

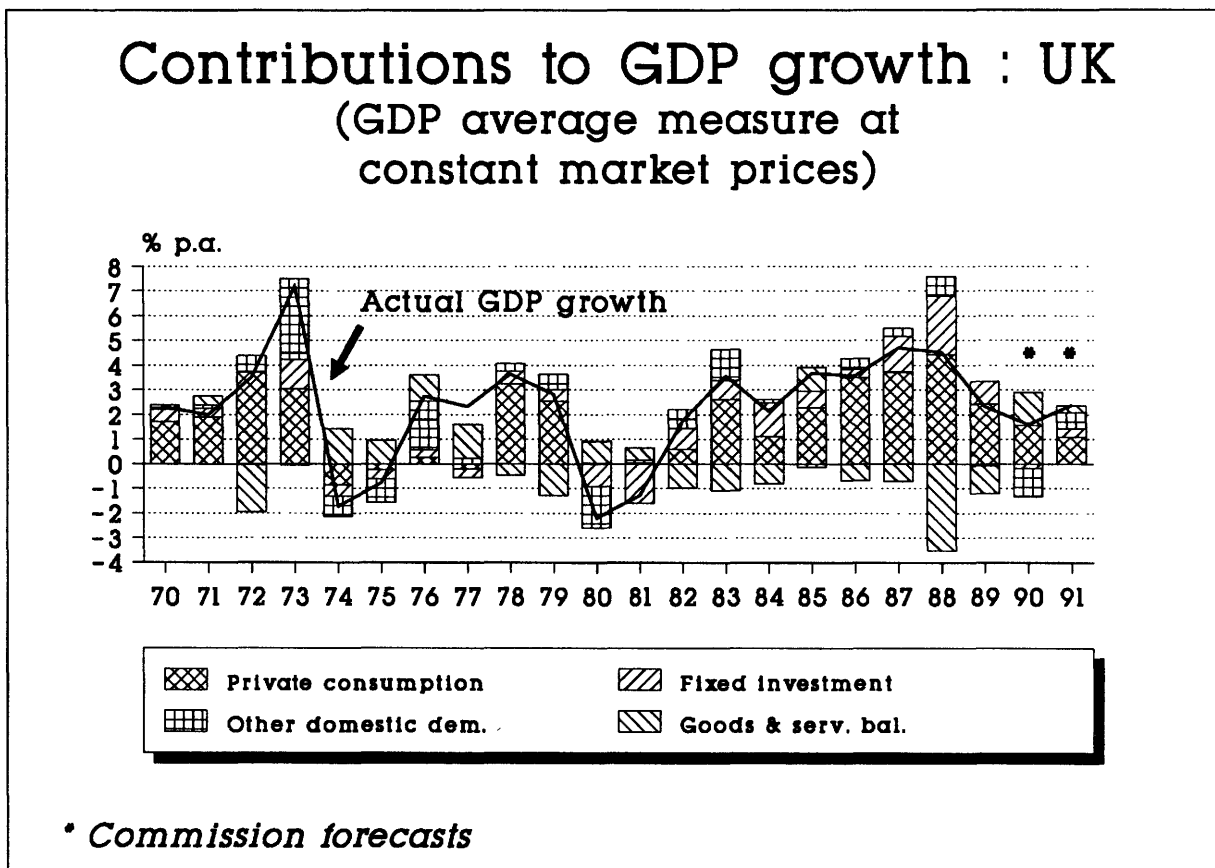


Graph 1.6 : Oil.

(Graph 1.5). In a trend which promised longer-term relief, the latter part of this period saw considerable inflows of Japanese and other direct investment in manufacturing. This was notably the case in the motor industry, where established companies had been relatively unsuccessful in matching overseas quality and productivity levels.

To a certain degree, some pressure on the manufacturing sector from early in the 1980s could have been expected from the build-up in the oil surplus and a tendency, neglecting changes emanating from international capital flows, for the real exchange rate to appreciate in consequence. The increase in *oil and gas* output

expansionary (Graph 1.7). The chief motor was private consumption, fuelled by high real wage growth, successive tax changes and liberalisation in the provision of credit. Consumer confidence increased sharply once it had become clear that the recession had been surmounted and it seemed that continuing real income growth was assured. This in turn stimulated the demand for credit, especially for mortgage finance. Real wealth increased rapidly with very strong rises in residential property values and the level of the stock market (private shareholding being favoured by the government's privatisation programme and tax incentives for equity holding). Real consumption growth averaged 4 1/2% p.a. in the period 1983 to 1988. Fixed investment by business, a much



Graph 1.7 : Contributions to GDP growth.

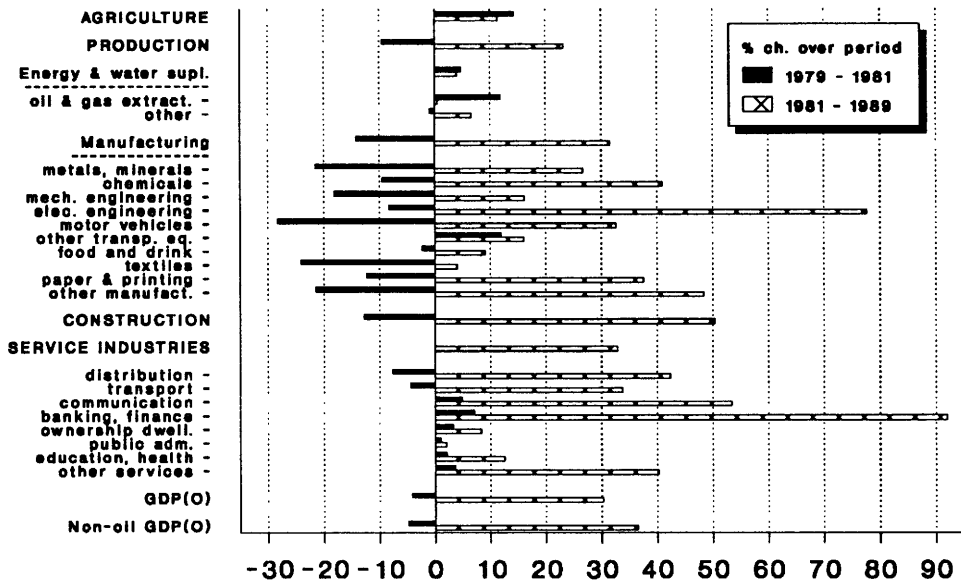
was itself a major structural change. In terms of its proportionate significance to the economy, the "offshore" economy was most important during the first half of the 1980s, masking the underlying deterioration in the current account and peaking in terms of its share of current price GDP in 1984 and in terms of physical output in 1986. From the collapse in oil prices in 1986 and with the beginning of a secular decline in production, this significance waned swiftly, and in 1989, in the wake of accidents affecting production, oil and gas extraction accounted for less than 2% of current price output against 7% five years earlier (Graph 1.6).

As regards the onshore economy, the long upswing was dominated by the growth of private domestic demand, particularly from 1983 when fiscal changes were

smaller volume of expenditure than consumption, expanded by an annual average growth of 7 1/2% in this period, with negligible or negative growth in 1983 and 1986. Public final expenditure, by contrast, remained under tight control and contributed little to the expansion: government consumption and fixed investment as a proportion of GDP falling from almost 24% in the early 1980s to 21% by 1988.

The consequences of this expansion of demand were distributed fairly evenly in output growth throughout the economy (Graph 1.8). Exceptions were agriculture and energy (below average growth) and construction (above average growth); among services the growth of the financial services sector was particularly marked. The substantial net employment growth was entirely in services, with

GDP - Output growth by sector



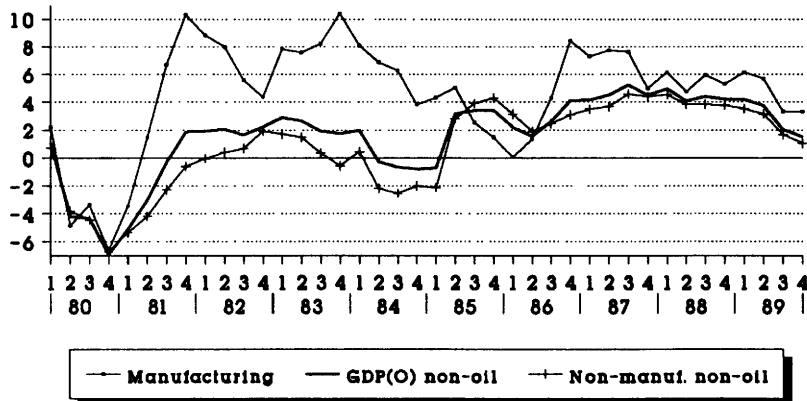
Source: CSO

Graph 1.8 : GDP - Output by sector.

much of the growth accounted for by a growth in female participation and characterised by a growth in part-time and contract employment. Productivity growth in services was low to negative and for the whole economy low (Graph 1.9).

The upswing peaked in mid-1988. The expansion in demand in that year, some 7%, was clearly far in excess of the growth in capacity, which was already over-stretched. The inflationary pressures were most evident in the ballooning of the trade deficit (Graph 1.10). Underlying inflation began to rise sharply as margins further in-

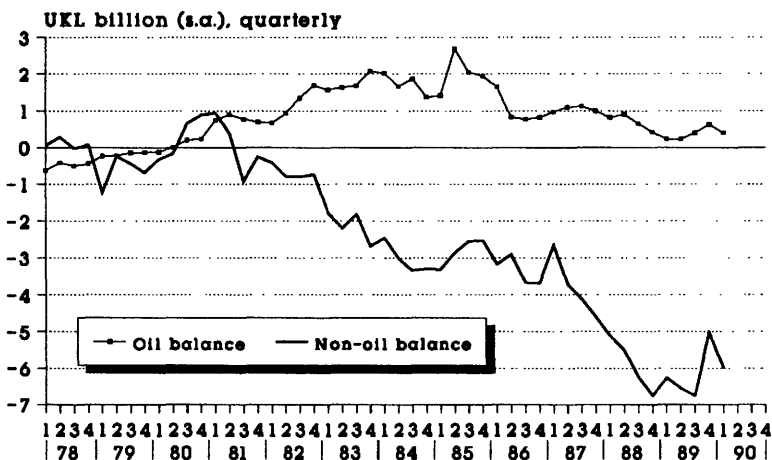
Productivity growth Manufacturing, GDP(O) non-oil, non-manufacturing non-oil



Source: CSO

Graph 1.9 : Productivity growth.

Visible trade balance Trend in oil and non-oil balance



Graph 1.10 : Visible trade balance.

creased, with the acceleration in wage growth following. Monetary policy became increasingly restrictive in consequence, with a progressive tightening of short-term rates through 1989 (policy issues are the subject of Chapter 2).

The consequences of the change to a highly restrictive monetary policy allied with an underlying cyclical slowdown are still in the process of working themselves out. So far the results have been uneven, with demand and output growth having slowed but with inflation having worsened and the external account deficit showing only a partial improvement. Performance in 1989 and early 1990 has demonstrated continuing underlying weaknesses which have yet to be surmounted. Chief among these is the persistence and indeed aggravation of inflationary pressures, and the lack of a convincing policy framework for eliminating them. More long-term in nature is a question mark about the suitability of the productive structure, particularly the adequacy in extent and quality of the tradeables goods and services sector and notably of manufacturing. A third related issue is the need to improve the quality and occupational and geographical flexibility of the workforce.

These weaknesses - at least the first and third - are recognised and acknowledged by the government, which has explicitly oriented its overall policies to remedying them. Much of the necessary change is very long term in nature, such as improving the educational and vocational standards of the working population. It is difficult, nevertheless, to escape the conclusion that important opportunities over the past ten years have been missed. This

applies particularly to the failure to build on early success in achieving a marked reduction in inflation to below the Community average. From 1986, in particular, the government implicitly seems to have been satisfied with a still moderately high rate of inflation (4-5% p.a.), rather than achieving a convincing further reduction. Tacitly, persistent nominal wage growth far above productivity growth and high rates of credit expansion incompatible with price stability of current production and assets, with the inevitable recurrent recourse to devaluation, have been accepted. This approach has not resulted in an excessively high 'steady state' rate of inflation, but in a creeping acceleration which ultimately has had to be reined in with restrictive policies prejudicial to sustained investment and employment expansion.

1.3 Demand and output

The important policy differences between the UK and its Community partners referred to in the introduction have been partly responsible for the cyclical differences between the UK and the other economies. For the United Kingdom, 1987 and 1988, it is now apparent in retrospect, marked the final phase of the long cumulative upswing that followed the sharp recession which reached its trough at the turn of 1980-81. The previous cyclical peak had been in 1978-79², marking the end of the faltering upswing which had followed the first oil shock. The second oil shock in 1979 reinforced the cyclical downturn, after a period of exceptional growth in the second quarter of 1979.

2) Whole year GDP growth peaked at 3.7% in 1978 dropping to 2.2% in 1979, but there was an exceptional increase in output in the second quarter of 1979, which also marks the peak of the CSO's coincident cyclical indicator.

The 1979-88 cycle places the United Kingdom in a class apart from the Community as a whole, particularly the ERM countries. Both the depth of the early recession phase and the strength of the subsequent recovery were more intense in the UK. Most importantly, also, 1988 did not appear to mark a pronounced cyclical peak elsewhere, where growth continued robustly. For the 1979-88 period as a whole UK GDP increased by 2,0% p.a. Within the period, however, UK GDP fell by 3,1% between 1979 and 1981 and subsequently grew by an average of 3,1% p.a. Growth in 1989 was 2,3% (but only 2% through the year to the fourth quarter), while Commission forecasts for 1990 suggest growth of only a little over 1 1/2%, recovering towards 2 1/2% in 1991 (Graphs 1.2 and 1.7).

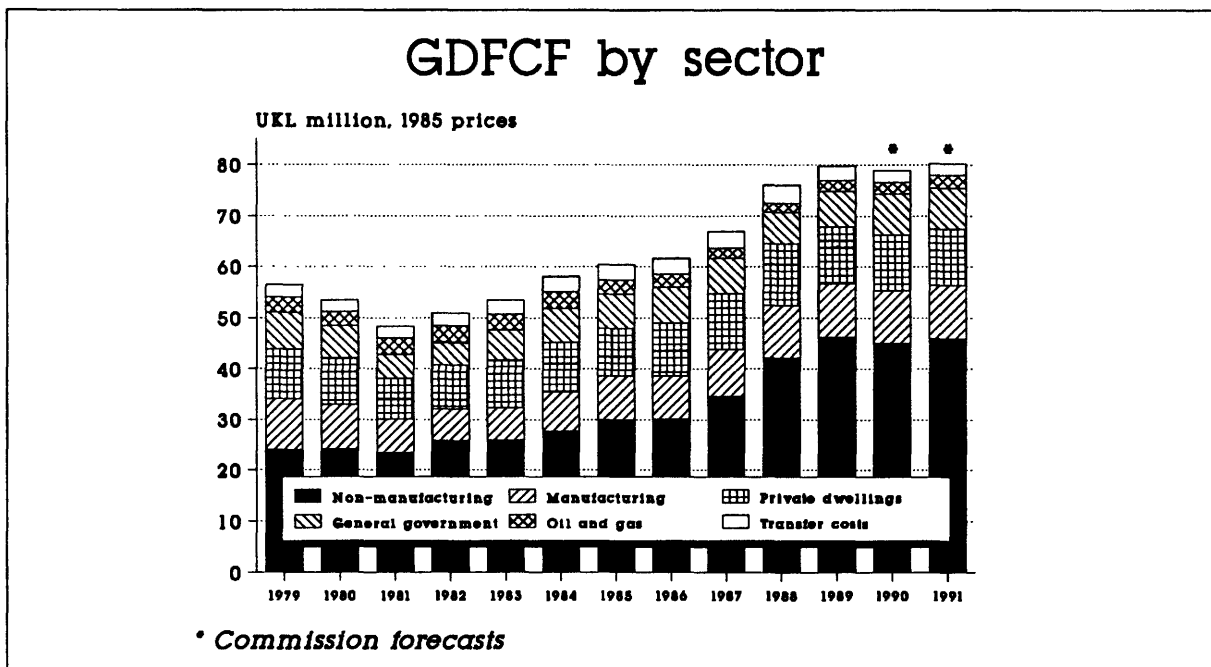
The relatively fast expansion of output in the UK from 1982 up until 1988 reflected rapid growth of domestic private sector demand. Examination of Graph 1.7 would suggest that this period could further be divided: 1982, a year of technical cyclical recovery which had already begun in 1981, 1983 to 1985, at the end of which the reflationary impetus from 1983 was weakening, and 1986 to 1988, years of unsustainably high demand growth culminating in the extraordinary growth of 1988. Growth in the initial 1983 to 1985 period was further distorted by the miners' overtime ban and subsequent strike which lasted from 1984 to early 1985. This is estimated to have cut 1984 output by about 1% (cf. Graph 1.2), with lower stockbuilding and net fuel exports, and to have raised 1985 output growth by a smaller amount.

The external contribution to growth was negative in all years from 1982 to 1989 except 1985 (and is only likely to again turn positive in 1990). The principal demand impetus came from growth of private consumption. Business fixed investment also grew fairly rapidly up to 1985

and then stabilised in 1986. Investment growth again resumed very strongly from 1987 and in 1988 aggravated overall demand pressures, expanding by over 20%. Private residential investment accelerated from 1986. Public expenditure, both consumption and investment, remained tightly constrained by the authorities and made a much smaller direct contribution to the growth process (1983 being a notable exception, with a significant boost from both current and capital spending).

The dominant role of *private consumption* in overall growth owes as much to the weight of consumption in GDP (63% in 1989) as to its rate of growth (4% on average from 1982 to 1989, compared with 5,8% for total fixed investment). The saving ratio fell sharply, chiefly associated with increased borrowing (mostly mortgage loans), influenced by financial deregulation (bank lending controls were abolished in mid-1980 and hire purchase controls in mid-1982). Consumer confidence benefitted from falling inflation and rising real wages and, from 1983, rising employment. Momentum became clearly unsustainable from 1986: two years of 5 1/2% p.a. growth followed by 7% growth in 1988.

Some of the causes of the most recent upturn in private consumption are discussed in Box 1 on saving. They appear to involve a combination of increased consumer confidence, wealth (particularly because of higher residential property prices), borrowing and real wage growth. The origins of the growth surge thus appear to lie partly with a general recognition that the performance of the economy was improving favourably, allied with rapid growth in real incomes. This process was reinforced by the rapid expansion of credit opportunities available to households.



Graph 1.11 : Fixed investment by sector.

Fixed investment, as noted above, provided the initial impetus to the beginning of the upturn from late 1981. Non-manufacturing business investment was the chief component, but private residential investment was also important. In 1983 both the latter and also public investment sustained the recovery when business investment stagnated, hit by falling North Sea commitments (Graph 1.11). Business investment recovered in 1984 and 1985 before again falling back in 1986, a year of weak investment activity overall. The more recent recovery in investment dates from 1987, when non-oil, non-manufacturing business investment grew rapidly (15%). Manufacturing investment in terms of its contribution to total demand is of relatively minor significance (accounting only for some 20% of total business investment in 1985 and under 15% of total fixed investment). Its importance for the overall growth of productive potential and in relation to competitive strength is greater, however. Manufacturing investment collapsed after peaking in 1979. At its trough in 1982 its level was only a little over 60% of its level three years earlier. Recovery thereafter, from a very low base, averaged about 7% p.a. up to 1989, about 3% points faster than the growth of manufacturing output. However, this still left the level of manufacturing investment in 1989 only a little above that ten years earlier.

Investment growth accelerated in 1988 (19% for total business investment against 11% in 1987) and overall investment was boosted by private residential investment (10%). The latter cooled equally abruptly in 1989 from tighter monetary policy but business investment still grew quite sharply (8%). Indicators for 1990 point to a weakening in most sectors, probably leading to a slight overall fall in investment expenditure. North Sea capital expenditure, after falling substantially in recent years, has again begun to expand vigorously. Total offshore investment is now being buoyed by the Channel tunnel project.

The significant sectoral shifts in the pattern of investment growth through the upswing phase of the cycle preclude a simple interpretation of the aggregate figures, although these do indicate a sustained support for demand except in 1986 when the pattern of business investment was distorted by the phased change in the corporation tax regime. The domestically-led nature is clear from the leading role of non-manufacturing business investment. The expansion of manufacturing capacity indicated a strengthening of confidence but came too late to create sufficient capacity at the end of the cycle (indeed, the strength of demand for capital goods itself contributed to the deterioration in the trade position). Growth in investment in equipment outstripped growth in non-residential construction investment, an indication that investment was of a more capital-deepening rather than widening nature, and again a pointer to the overall level of capacity growing too slowly relative to demand.

Total domestic demand expanded more rapidly than output in the upswing (an average of 4 1/4% p.a. in the seven years to 1988 compared with under 3 1/2% p.a. for GDP). The difference was explosive in 1988, when demand expanded by 7 1/2%. There has thus been a steady deterioration in the *real overseas balance* arrested only

temporarily in 1985. The resulting negative contribution to GDP growth averaged 1/2% between 1982 and 1987 and a massive 3 1/2% in 1988, declining to 1% in 1989.

Imports have risen strongly in volume terms since 1982. The exceptional growth of 12 1/2% in 1988 was a sign, with rising inflationary pressure, of overheating in the economy which led to the major tightening of monetary policy. Demand growth from 1989 slowed and is projected to continue to do so in 1990, with Commission forecasts of a moderate 2% rise in 1991. *Exports* have risen more slowly than imports, and actually fell in 1988, with some diversion to home demand probably occurring. The balance of payments is discussed in Section 1.6.

Changes in the structure of *output* are shown in aggregate in Graphs 1.2 and 1.8. While the 1980-81 recession was concentrated virtually exclusively in manufacturing and construction, with other branches of output virtually stable, the recovery since 1981 saw output growth distributed fairly widely. The 14% loss in manufacturing output in the two recession years was more than made up by growth to 1989 (31%, i.e. 13% higher than in 1979).

At a more disaggregated level changes in relative output performance are naturally more striking. Among the primary sector activities, agricultural output expanded rapidly up to 1984, then slipped back, under the influence of policies at Community level. Total energy and water supply output was little changed between 1979, 1981 and 1989. However, these years include the build-up of *off-shore oil and gas extraction* to its peak in 1985, its subsequent decline and then abrupt output falls in 1988 and 1989 following major accidents in production equipment (Graph 1.5). Since the output weights are presently 1985-based, only the year after the value of oil and gas output peaked in relation to GDP, changes in oil output are given much greater significance than would result from choice of a more recent base year: in 1985 oil and gas extraction had a 6.2% GDP weight, against a share of current price factor income of under 2% in 1990. Other points to note are the scaling back of the coal industry with the widespread closure of capacity after 1984, and the expansion of water supply which has accorded with that of total GDP.

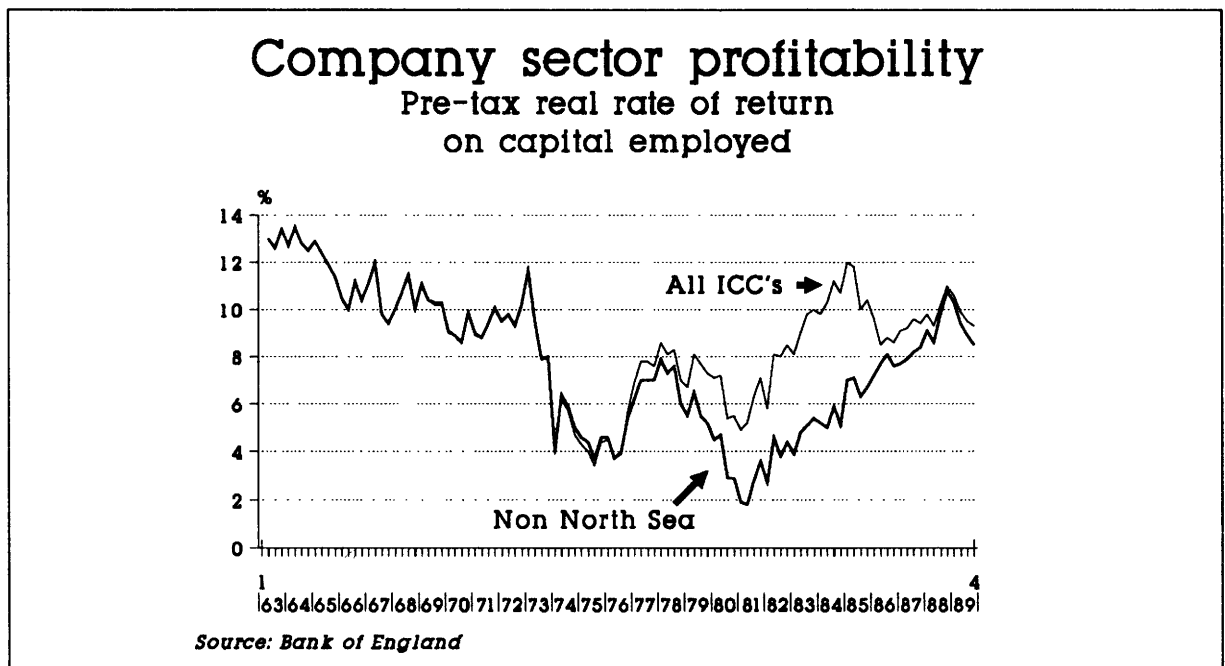
Most individual *manufacturing* sectors have expanded output since 1979. This is particularly so for chemicals, electrical engineering, transport equipment other than motor vehicles, paper and printing and miscellaneous manufacturing. Exceptional losses have been sustained by textiles (including artificial fibres), mechanical engineering, miscellaneous metal goods industries and motor vehicles. The decline of the motor industry (only 5% of total manufacturing) had been arrested by the late 1980s, with output on an increasing trend and considerable inward investment flows (from Japan and France) and by retained profits from established US manufacturers. This followed substantial public subsidies given earlier to the remaining UK manufacturer (now Rover), effectively then publicly owned and later sold to the UK private sector.

Output of the *construction* industry has been strongly pro-cyclical, progressing towards boom conditions in 1988 and 1989. Short-term prospects are for a sharp contraction, with private dwellings construction already in retreat and business investment, particularly for capital-widening (which favours the industry) being scaled back. Public sector and utility projects (water and sewerage, roads and the Channel tunnel) are nevertheless sustaining underlying output.

Analysis of the *service sector* is rendered less exact by the difficulties of measuring output and the low level of disaggregation. It is clear from Graph 1.8 that the major proportion of output growth during the 1980s was accounted for by services, a product largely of their higher weight in total output (58% in 1985), and to a smaller extent to faster output growth in total (33% between 1979 and 1989 against 25% for total GDP). The clearest identified expansion was in financial services, output of which almost doubled over the period. Other major increases were in distribution, communications and services not individually specified. Largely within the public sector, output of education and health services is recorded as growing by over 15%.

financial services was perhaps more double-edged, partly reflecting the growth of the City's international role, but probably also unsustainable expansion in the wake of the 1986 'Big Bang' and earlier financial liberalisation.

Overall, expansion of manufacturing *capacity* systematically lagged demand from 1982 (Graph 1.5), suggesting that output growth was too strongly weighted towards non-tradeable services, despite a simultaneous trend decline in the real exchange rate. This strongly suggests continuing inadequate non-price performance and/or a failure to take advantage of strong domestic demand growth. Further evidence on the domestic aspect is given by a market sector analysis of production industries output growth. During the recovery period (from 1982 to 1989) consumer goods industries grew less than two thirds as quickly as investment goods industries; growth of production of 'other durables' (i.e. other than cars) was particularly weak. Yet during this period growth of durable consumption, narrowly defined, grew by three quarters in volume compared with 65% for fixed investment. Taking account of clothing and footwear consumption (officially classified as non-durables) equalises the growth rate of demand for consumer durables and fixed investment. Within the former demand category, con-



Graph 1.12 : Company sector profitability.

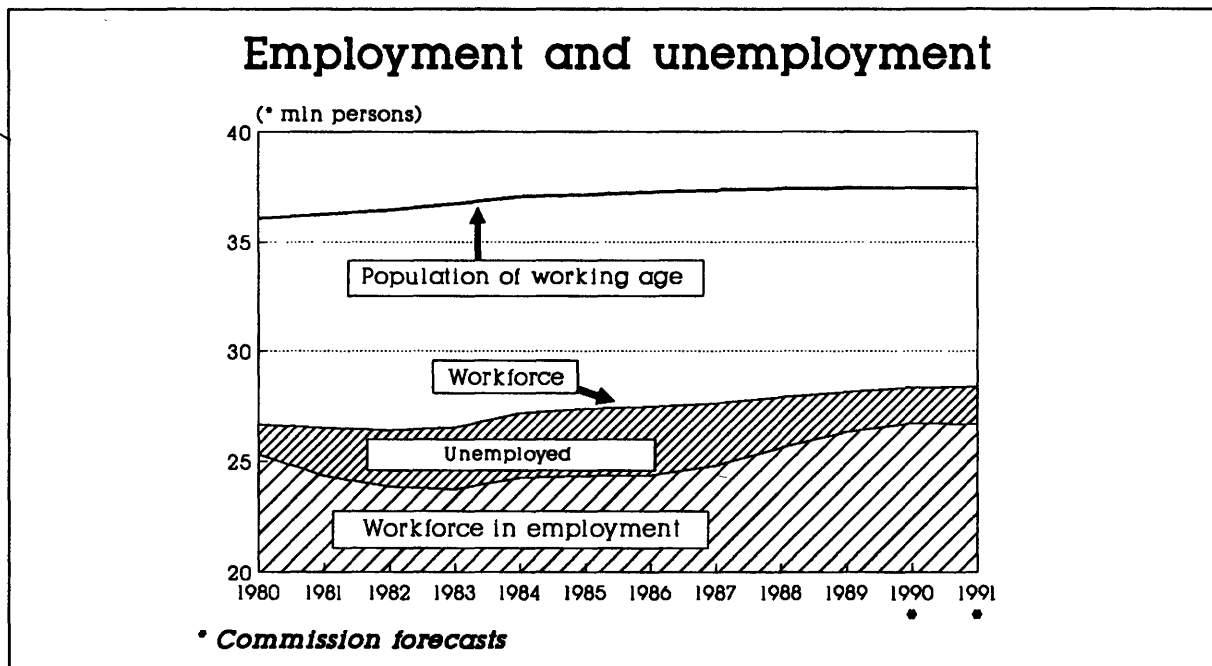
Output performance in the 1980s brought the economy closer to its underlying potential, and was reflected in *profitability* first recovering and then attaining record levels (Graph 1.12). The progressive withdrawal of subsidies and other forms of intervention were important in reducing capacity in inefficient sectors of the economy such as coal-mining, shipbuilding and motor vehicles. Competitive pressures also led to a sharp contraction of textiles and a relative decline of footwear and clothing production. On the other hand, strength in other sectors such as those dependent on higher technology led to substantial output growth (e.g. aerospace). The expansion of

sumption of goods other than cars, furnishing and clothing jumped by over 100% during these seven years, demand which at the margin must have been supplied mainly by imports. This overall picture is supported by evidence from import penetration ratios (further discussed in section 1.6). Ratios of imports to total demand (home demand plus exports) were held stable for motor vehicles as the domestic industry recovered. For most other consumer goods industries, except furniture, import penetration increased. Import penetration for investment goods also increased, but with more differentiated results.

1.4 The labour market and productivity

Demographic factors were of muted influence in boosting the supply of labour during the 1980s. The resident population in the 15-29 years old group rose throughout the period, but to a limited extent, and then chiefly in the first half of the decade : this group totalled 12,5 million in 1979, 13,3 million in 1984 and 13,5 million in 1987. Numbers in the 45-64 group were in decline after 1984. In total the population of working age rose by

of 1980, only stabilizing onto a new (and still gently declining) trend in 1983. Between the fourth quarter of 1979 and the second quarter of 1983 manufacturing employment was reduced by over a fifth (the so-called "shakeout") compared to an output fall of about 13%. The *unemployment* rate had remained around 4% since the mid-1970s up to early 1980, but rose progressively through the first half of the 1980s, only peaking at 11,2% (national definitions) in 1986 as the gain in employment



Graph 1.13 : Employment and unemployment.

1/2-3/4% p.a. in the 1979-84 period and up to 1989 by about half that rate. By 1989 the working age population had largely stabilised (Graph 1.13).

Of more significance for labour supply were changes in *participation ratios*, particularly the expansion of women's labour force participation (and some decline in that of men). In Great Britain the participation ratio for women of working age (16-59) rose by 7% points to 71% between 1981 and 1989, while that for men dropped marginally to 87%. Women's employment was favoured by the pattern of output growth in the 1980s, particularly the growth of services. A continued increase in women's participation is responsible for the bulk of the officially estimated increase in the labour force during the 1990s : women are expected to account for over 90% of the 0,8 million increase between 1989 and 2001.

At the beginning of the decade, the 1980-81 recession was of a sufficient severity to induce a significant fall in employment and a major increase in unemployment. Prior to the recession, *employment* peaked in the fourth quarter of 1979 at 25,5 million. The trough was only reached in mid-1983 at 23,6 million, a loss of approaching 2 million jobs. The fall was concentrated in manufacturing. Although manufacturing had long tended to shed jobs, the pace accelerated markedly from the beginning

fell somewhat short of the expansion in the workforce (Graph 1.4). Rates recorded for men were higher than for women (the former rising from around 5% to over 13% compared with a rise from around 3% to 8 1/2% for the latter), in contrast to the experience in most Community countries.

A pronounced decline in unemployment and an even stronger growth in employment were two of the most positive features of the post 1981 recovery. Unemployment fell steadily from mid-1986 to reach 5,6% by March 1990; total employment expanded by an average of 1 3/4% p.a. between mid-1983 and mid-1987 and by over 3% p.a. in the two years to mid-1989.

From its 1983 trough total employment increased by 3,13 million in the five years to June 1989, including a very substantial proportion of self-employed (1,02 million) (Table 1.1). While employment in industry and construction fell by 0,45 million over this period service sector employment rose by 2,2 million, of which 0,8 million was in financial services. Women in particular benefited from the expansion in employment, their numbers increasing by 1,6 million, including about four fifths of the 0,8 million increase in part-time employment. The number of male employees changed little until 1987, but has recently also been climbing.

	1981	1982	1983	1984	1985	1986	1987	1988	1989
Changes in civilian employment¹ (millions)									
Total	-0,98	-0,43	0,29	0,45	0,30	-0,02	0,43	0,81	0,72
Employees in employment	-1,10	-0,48	-0,34	0,18	0,19	-0,04	0,20	0,69	0,47
— men	-0,76	-0,35	-0,26	-0,05	0,01	-0,16	-0,05	0,27	0,00
— women	-0,34	-0,12	-0,08	0,23	0,17	0,13	0,24	0,42	0,47
— agriculture, forestry and fishing ²	-0,01	0,00	-0,01	-0,01	0,00	-0,01	-0,01	-0,01	-0,01
— production and construction industries	-0,72	-0,38	-0,37	-0,15	-0,07	-0,18	-0,11	0,08	-0,01
of which : manufacturing	-0,70	-0,35	-0,33	-0,12	-0,05	-0,13	-0,07	0,07	0,01
— services	-0,24	0,03	0,05	0,33	0,27	0,19	0,29	0,61	0,47
Self-employed	0,11	0,05	0,05	0,28	0,11	0,02	0,23	0,13	0,26
Part-time employment				0,22	0,14	0,12	0,21	0,08	0,16
— men				0,06	0,04	0,02	0,08	0,03	0,00
— women				0,16	0,11	0,09	0,14	0,06	0,16
Unemployment rate (% of labour force)³	9,1	10,6	11,6	11,6	11,8	12,0	10,7	8,5	6,7

1) June to June. Defined here as the sum of changes in employees in employment and of changes in self-employment (the national definition also includes among the employed participants in work-related government training programmes).

2) Great Britain.

3) Annual average, SOEC standardised definition.

Source : UK official statistics, Eurostat (unemployment rate).

Table 1.1 : Employment and unemployment.

Since 1986 the fall in unemployment, by some 5 1/2% of the workforce up to March 1990, has been substantially more rapid than in the rest of the Community. While part of the fall in the registered number of unemployed undoubtedly reflected the deterrent effect of tougher registration criteria and the mopping up of the otherwise potentially unemployed on government sponsored employment schemes, the scale of the reduction points to the genuine underlying improvement in the labour market.

Labour productivity, driven by improvements in the manufacturing sector, increased at a significantly faster pace than in the 1970s. Manufacturing productivity growth, given strong output growth, averaged 4 1/2% p.a. from 1979 to 1989, faster than the 1960-73 period (3 1/2% p.a.) and sharply higher than the intervening period (3/4% p.a.). This performance is partly due to cyclical factors, and is weakening with slower growth of production. A more interesting question, however, the answer to which will not be clear for some time, is how much of the cyclically adjusted increase represents "one-off" elimination of overmanning and a move to more flexible working practices and how much represents a shift to a sustainable higher growth path.

By contrast measured service sector productivity has not undergone any dramatic change in recent years (Graph 1.9, which excludes distortions arising from changes in oil and gas production), though measurement problems might preclude any such effect being evident. The growth of whole economy productivity, as a result of high employment growth, actually turned negative in the latter part of 1989. Although this was largely the result of the decline in oil and gas output, it pointed to the much less impressive productivity results outside manufacturing and consequent inflationary pressures.

1.5 Inflation

Through the 1970s, following the first oil price shock, counter-inflationary performance in the UK was the worst of any major industrialised country apart from Italy. The average rise per year in the private consumption deflator during the period from 1974 to 1979 was 15,6%, against 12,2% in the Community as a whole, 4,7% in Germany and 10,9% in France. From 1980 to the end of 1982, under the combined weight of the new policy regime introduced by the incoming government, the recession and labour shakeout and exchange rate appreciation, inflation fell abruptly. The annual rise of the pri-

vate consumption deflator dropped from a peak of 16,2% in 1980 to 4,8% in 1983.

The major success of the UK in braking the high level of inflation at the beginning of the decade was not, however, carried forward. Inflation up to 1988 moved within a fairly limited range of 3 1/2-5 1/2% p.a., with the average annual rise in the private consumption deflator for 1983-87 being 4,7%.

Inflation has been resurgent since early 1988. The deteriorating trend is exaggerated if changes in the most publicised price index, the all-items Retail Prices Index (RPI) are taken as the measure of inflation, since changes in mortgage interest rates have generally amplified movements in other elements in the index since late 1987. Nevertheless, the RPI, excluding the effect of mortgage interest costs, and other price indices, such as manufacturers' output prices and the GDP deflator, tell an essentially similar picture : inflation bottomed out at 3 1/2-4% p.a. during 1987, then rose steadily during the course of 1988 and 1989. The momentum has accelerated in 1990 towards what is expected to be a peak. Thereafter policy should succeed in achieving some moderation.

Apart from the depreciation of sterling in 1986 which partly offset the potential gains from lower oil prices and the relative decline of the dollar, the sources of poor inflationary performance are home-grown. The rise in *wage costs* failed to decelerate in response to better price performance in the mid-1980s, earnings per head growing remarkably steadily at around 7 1/2% p.a. before accelerating to over 9% during 1988 and 1989. In the manufacturing sector, with rapid productivity growth, this implied moderate growth of unit labour costs up until 1989 when output growth came to a halt; for the whole economy, with no differentiated pattern of earnings growth between manufacturing and services, unit labour cost growth has been much higher, about 5% in 1987 rising to 9% in 1989. Added to this has been a substantial expansion of *profit margins*, particularly in manufacturing. This was especially the case in 1985-86, when output prices only moderately reflected cheaper imported inputs, but continued through 1987 and 1988. The strength of demand and the high level of capacity utilization enabled producers to widen profit margins and probably made them less inclined to resist wage pressures. For the whole economy this recovery in profitability to a more internationally comparable level encouraged a higher level of investment. On the other hand, given the failure to achieve wage moderation, it contributed to inflation failing to fall to the extent registered in other major countries and then accelerating.

The intractability of wage pressures leading to inflation is further explored in Box 2 to this chapter. Tentative conclusions there from looking at the behaviour of the UK labour market are that nominal wage growth reacts significantly to expected inflation, real wage pressures, labour market imbalances and (negatively) to the proportion of long-term in total unemployment. For the UK mismatches between labour supply and demand (occupationally and geographically) have long been recognised

as significant in stimulating wage growth. In current circumstances this implies a willingness by employers to accede to high nominal wage demands in order to retain staff, even if profits are squeezed if product and service prices are more restrained by the weakness of demand.

This is important in relation to the government's counter-inflationary strategy, which consists essentially in applying pressure on the corporate sector, via weakening demand, to restrain wage growth. Evidence so far has been disappointing : nominal wage rigidity has remained characteristic. Results would appear to suggest that only a major regime change, downwardly influencing inflationary expectations, and greater flexibility in the supply of qualified labour will succeed in drastically and permanently lowering wage inflation.

1.6 The balance of payments

The United Kingdom entered the 1980s with its current balance of payments in a position of strength, due principally to its transition from net oil importer to net exporter at a time of high real oil prices following the second oil price shock. Its position in the mid-1970s had been extremely weak, with the current deficit reaching 4 1/2% of GDP in 1974 after the first oil price shock. However, following the domestic austerity measures of 1976 and the build-up of oil production (the first exports from the continental shelf were in 1976, with self-sufficiency attained in 1980) the current account recorded a surplus of 1 1/2% of GDP in 1980, rising to 2 1/2% the following year (Table 1.2).

1981 marked a peak for the current account surplus. Within two years deficits were again recorded, and though a moderate surplus (0,7% of GDP) was recorded in 1985 (the year when the oil surplus peaked) the current account otherwise recorded annual outturns of progressively deepening deficits. The deterioration in 1988 was spectacular, with a current deficit of 3,2% following a deficit of 1,6% in 1987, and even more so in 1989 (3,8% of GDP). Commission forecasts show the deficit falling back in 1990 but then stabilising at a high level.

The main components of the current account - oil and non-oil visible trade and invisibles - have all contributed to the worsening in performance. The *non-oil trade deficit* has grown from a small surplus in 1981 to 4,8% of GDP in 1989. The surplus on *trade in oil*, which reached a maximum of 2,3% of GDP in 1985, has fallen with declining production and the generally much lower level of oil prices; in 1989, in the wake of accidents further depressing production, it was only 0,3% of GDP (Graph 1.10). The net surplus on *invisibles* has also tended to decline, falling from 1,6% of GDP in 1981 to 1,3% in 1988 and 0,8% in 1989 as net receipts from services and of interest, profits and dividends (IPD) declined.

Strong internal demand growth appears to be an important determinant of the worsening of the trade balance. Since the beginning of the 1980s, growth in the UK has generally exceeded that of its main partners. Compared with the Community, the difference has been

Table 1.2 : Balance of Payments

(% of GDP)	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990 ¹	1991 ¹
1. Current account	-0,3	1,2	2,6	1,7	1,3	0,6	0,9	0,0	-1,0	-3,2	-3,8	-3,0	-2,8
1.1 Visibles	-1,7	0,6	1,3	0,7	-0,5	-1,6	-0,9	-2,5	-2,6	-4,5	-4,5	-3,3	-2,9
of which : non-oil	-1,3	0,5	0,1	-1,0	-2,8	-3,7	-3,2	-3,5	-3,6	-5,1	-4,8		
1.2 Invisibles	1,4	0,6	1,3	1,0	1,8	2,2	1,8	2,5	1,6	1,3	0,8	0,3	0,1
of which :													
Services ²	1,9	1,6	1,5	1,1	1,3	1,3	1,9	1,6	1,4	0,9	0,8		
Interest, profits and dividends ³	0,6	-0,1	0,5	0,5	1,0	1,4	0,8	1,4	1,0	1,2	0,9		
Transfers	-1,1	-0,9	-0,6	-0,6	-0,5	-0,5	-0,9	-0,6	-0,8	-0,8	-0,9		
2. Non-bank capital flows (net)	-1,7	-2,0	-3,6	-2,8	-2,6	-5,9	-3,7	-4,6	1,3	-1,4	-3,4		
2.1 Direct investment	-1,5	-0,2	-1,2	-0,4	-0,7	-1,9	-1,3	-1,8	-2,5	-2,5	0,1		
2.2 Portfolio investment	0,3	-0,8	-1,7	-2,7	-1,8	-2,6	-3,0	-3,6	4,0	0,4	-5,4		
2.3 Other net trans. of non-govt. sector	-0,4	-0,8	-0,7	0,2	0,2	-1,1	0,8	0,9	-0,3	0,7	1,9		
2.4 Net transactions of general government	-0,2	-0,1	0,0	0,1	-0,4	-0,2	-0,2	-0,1	0,2	0,0	0,1		
3. Net overseas transfers of UK banks	1,8	0,4	-0,3	1,4	0,9	3,2	2,2	2,7	0,6	3,1	3,1		
4. Subtotal (1+2+3)	-0,1	-0,4	-1,3	0,2	-0,5	-2,1	-0,7	-1,9	0,9	-1,5	-4,0		
<i>Financed by :</i>													
5. Change in official reserves⁴	-0,5	-0,1	1,0	0,5	0,2	0,3	-0,5	-0,8	-2,9	-0,6	1,1		
6. Balancing item⁵	0,6	0,5	0,3	-0,7	0,3	1,8	1,2	2,7	2,0	2,0	3,0		

1) Economic forecasts of the Commission Services, April-May 1990.

2) Includes net labour income from abroad.

3) Including unremitted profits.

4) Increases in reserves : (-).

5) Including allocations of SDRs (1979, 1980 and 1981).

Source : CSO.

Table 1.2 : Balance of payments.

particularly marked : over 1 1/2% p.a. on average between 1981 and 1989, with differences of over 4% in 1983 and 1988. This explains in part the strong growth in import volumes (excluding oil, over 8 1/2% p.a. between 1981 and 1989) and possibly a diversion of production capacity from exports to the domestic market.

Nevertheless, cyclical differences alone are insufficient to explain the deterioration of the current balance fully. Exporters' cost competitiveness improved until the end of 1986. Since then, however, the position has worsened sharply, as a pronounced strengthening of the exchange rate has aggravated the tendency for UK unit labour costs to rise faster than in its main partners. Relative unit labour costs in manufacturing measured in a common currency (the measure of the real exchange rate shown in Graph 1.1) thus rose by some 20% between the fourth quarter of 1986 and the end of 1989. Whole economy

unit labour cost comparisons are even worse, because of a smaller difference in productivity performance in non-manufacturing : against other Community countries the relative UK increase was 12% in 1988 and a further 4 1/2% in 1989. Nominal depreciation from early 1989 has however, offered some relief, and 1990 on average should show a fall on 1989.

An analysis over a longer period suggests in addition that more fundamental factors have influenced the UK's commercial performance. Import penetration ratios in virtually all the principal sectors of manufacturing have increased significantly since the beginning of the 1980s, in total rising from 28% in 1981 to 35% in 1987 and 1988 and 36% in March 1989. Some rise in such ratios is in itself to be expected from the trend towards increased international trade specialisation and is thus a common feature in most industrialised countries. For international

comparison, the increase in the ratio over a longer period, between the mid-1970s and mid-1980s, was 12% points in the UK (23% to 35%), 10% for France (20% to 30%) and 7% for Germany (15% to 23%). What is of concern is rather the *speed* of increase in the UK, relative to manufacturing export performance, the *levels* attained, and the fact that it occurred at the same time that significant margins of domestic capacity remained unused in certain industries. These factors are evidence of an inadequate domestic supply response to the changes in domestic demand.

The trend in manufactured exports is more encouraging: the steep decline in world market share before 1982 was substantially arrested up to 1987; though the share slipped again in 1988 much of the slippage was recouped in 1989. On balance, however, apart from cyclical effects, it seems that the underlying tendency for trade performance to worsen continues to reflect structural weaknesses accumulated in earlier years.

Despite substantial identified direct and portfolio net outflows, the current deficit has been financed without undue difficulty, partly through net bank borrowing and partly through unidentified net inflows. The latter is the balance of payments *balancing item*, which the auth-

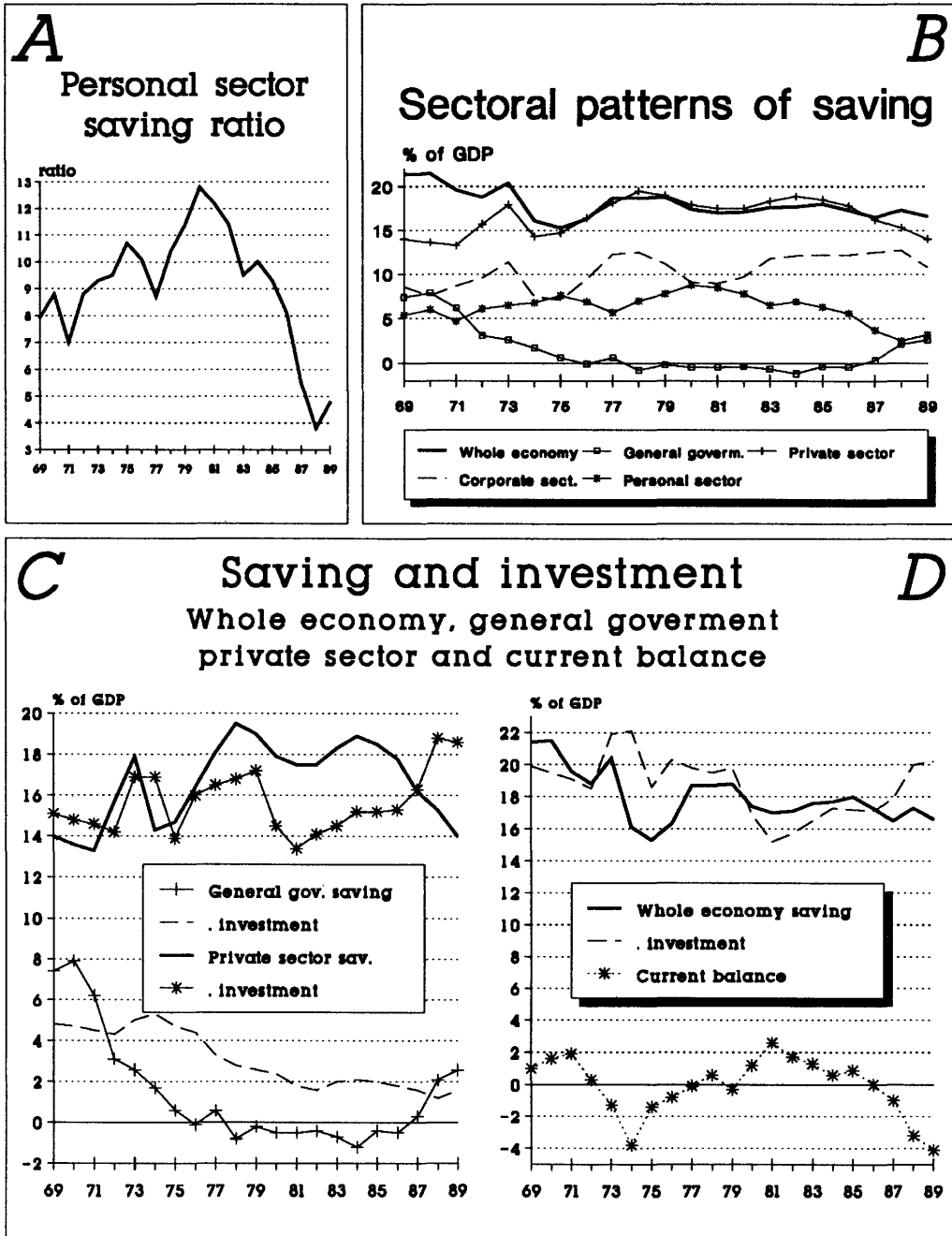
orities think principally reflects additional private capital inflows, and which in recent years has assumed huge dimensions : in 1989, for example, 3,2% of GDP, or four-fifths of the current deficit. This large unidentified element implies that the UK *capital account* is not at all well identified, possible reflecting the scale of financial transactions given London's financial role. It is striking, nevertheless, that the "basic balance" (current account and net direct investment and portfolio flows) has been consistently negative because of net "long-term" capital outflows. The identified short-term financing (essentially bank finance) is cumulatively reducing net overseas earnings (as seen in the reduction in I, P, D receipts in 1989) and further exposing the exchange rate (and thus domestic stabilisation policy) to changes in foreign exchange market confidence. In the short- to medium-term, recent capital market trends (excluding the large repatriation of funds seen in 1987 after the world stock markets crisis) will probably continue, with institutional funds and direct investment giving increasing weight to overseas, especially European, markets. In the absence of a substantial current account strengthening the UK's international payments situation will continue somewhat fragile, while buttressed by a very strong external asset position (UKL 94,0 billion at end-1988).

BOX 1.1

SAVING IN THE UNITED KINGDOM

Substantial shifts have been occurring in personal sector saving behaviour and in the sectoral pattern of saving in the whole economy in recent years. The *personal saving ratio* declined sharply between 1980 and 1988 (Graph 1.14 A). In 1988 the saving ratio¹ reached only

4.1% of personal disposable income, the lowest since the 1950s, before recovering somewhat in 1989. The decline started when real personal incomes were being squeezed during 1981 and 1982, but continued throughout the subsequent period of rapid real income growth. However,



Graph 1.14 : Saving and investment.

1) Measured net of stock appreciation

the estimates of personal saving derived from the income and expenditure accounts (which are subject to wide margins of error and have undergone substantial revisions in recent periods) may overstate the steepness of the decline; other estimates derived from financial transactions and investment data (admittedly also subject to uncertainties and lacking full coverage) confirm the decline in the saving ratio but suggest that it has been more gradual and less marked.

Among the factors which influenced personal saving in the 1980s were :

- the marked slowing in the *inflation rate* between 1980 and 1983 which lessened the need to save in order to maintain the real value of accumulated savings (real balance effect);
- the *expansion of employment* from 1983 onwards and the *decline in unemployment* from 1986 which had a favourable impact on consumer confidence and weakened the precautionary motives for saving;

- a more general improvement in *perceptions of future prospects*, reflected in the rapid increases in the prices of equities and property held by the personal sector (wealth effect);
- *deregulation and innovation in the financial sector*, which have widened the opportunities for and greatly facilitated personal borrowing; the stock of financial liabilities of the personal sector rose from 73% of personal disposable income at end 1983 to over 110% at the end of the third quarter of 1989; the decline in the saving ratio is a reflection not so much of a slower rate of asset accumulation but rather of a faster expansion of indebtedness;
- *demographic (e.g. age structure) and social developments* which have led to a rapid rise in the number of households, despite slowing population growth; the setting up of new households, as well as a very active housing market, is associated with increased spending on consumer durables, etc.;
- actuarial *surpluses in private sector pension funds* in recent years made possible a reduction in em-

Table 1.3 : Saving and investment by sector

(% of GDP)	1980	1985	1986	1987	1988	1989
Gross saving ¹						
– Households	8,8	6,3	5,6	3,7	2,5	3,2
– Enterprises	9,1	12,2	12,2	12,5	12,7	10,8
– General government	-0,5	-0,4	-0,5	0,3	2,1	2,6
Total	17,4	18,1	17,4	16,5	17,3	16,6
Capital transfers (net receipts)						
– Households	0,1	0,1	-0,0	-0,1	-0,3	-0,2
– Enterprises	0,2	0,0	0,0	-0,1	-0,0	-0,3
– General government	-0,4	-0,3	-0,1	0,1	0,2	0,3
Gross investment ¹						
– Households	3,9	4,3	4,8	5,2	5,6	4,9
– Enterprises	10,6	10,9	10,5	11,1	13,2	13,7
– General government	2,4	2,0	1,8	1,6	1,2	1,7
Total	16,9	17,2	17,1	17,9	20,0	20,2
Net lending (+) or net borrowing (-)						
– Households	5,0	2,1	0,8	-1,5	-3,3	-1,9
– Enterprises	-1,1	1,5	1,7	1,4	-0,5	-3,0
– General government	-3,4	-2,7	-2,4	-1,2	1,1	1,3
Total domestic	0,5	0,9	0,1	-1,3	-2,7	-3,6
Counterpart :						
– Balance of current transactions with the rest of world	1,2	0,9	-0,0	-1,0	-3,2	-4,1
– Unexplained residual	-0,7	0,0	-0,1	0,3	0,5	0,5

1) Excluding stock appreciation.

Table 1.3 : Saving and investment by sector.

ployers' contributions to these funds (equivalent to some 2% of personal disposable income between 1983 and 1988), recorded as a reduction in both personal income and saving.

Although personal saving has declined, relative to both personal income and GDP as a whole, there have been some offsetting movements in saving by other domestic sectors (Graph 1.14 B). In particular the *enterprise sector*² benefiting from a recovery in profits, has seen a substantial rise in its saving relative to GDP since 1980, partly compensating the fall in personal saving. At the same time the *general government* sector moved from being a dissaver in the early years of the decade to making positive saving after 1987. For the *whole economy*, therefore, saving as a percentage of GDP has remained reasonably stable (varying within the range 16 1/2 - 18% since 1980).

The upward movement in the *investment ratio* since 1981 and especially its upsurge in 1988 (particularly concentrated in the private business sector) led to a swing of 5,4% of GDP in the whole economy saving/investment balance over the period to 1989 (Graph 1.14 C). The counterpart of this was the deterioration in the current external balance, which moved from a surplus of 2,6% of GDP in 1981 to a deficit of 4,1% in 1989, a recorded swing of 6,7% of GDP (Graph 1.14 D). Deficiencies in the statistics mean that not all the change in the current account can at present be explained by the movements in domestic saving and investment, especially in 1988, when the saving/investment deficit widened by 1,3% of GDP while the current external deficit was 2,1% of GDP larger than in the previous year (Table 1.3).

2) Including public corporations.

BOX 1.2

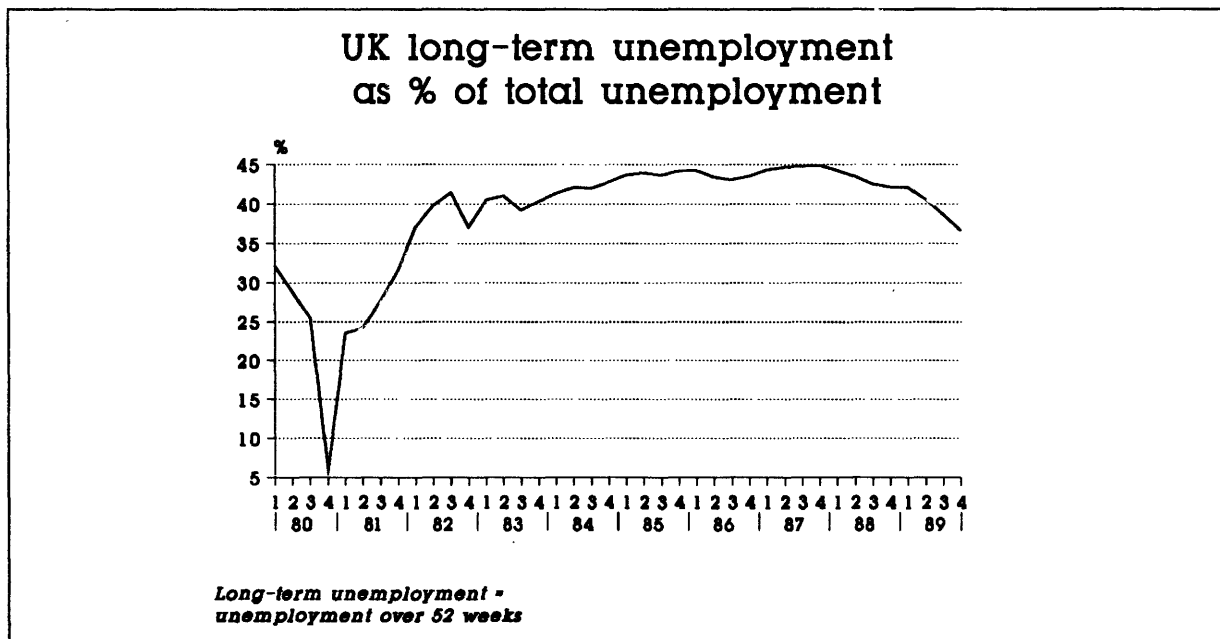
THE LABOUR MARKET AND WAGE INFLATION

Wage inflation has been a prominent aspect of British macroeconomic performance and, despite regulatory reforms introduced in the 1980s, continues to characterize recent trends. We review here some characteristics of the UK labour market which help explain the persistence of wage inflation during the 1980s. First, we look at labour market imbalances, and subsequently we provide some econometric evidence on wage determination.

Brown and Wadhvani (1990) argue that the intended counterinflationary effect of the labour market legislation of the 1980s failed to materialize. Union/non-union wage differentials did not narrow and over much of the period wage increases were stubbornly high despite record levels of unemployment (see Graph 1.15 which shows the rise in average earnings in manufacturing compared with the unemployment rate). The first point to note is the



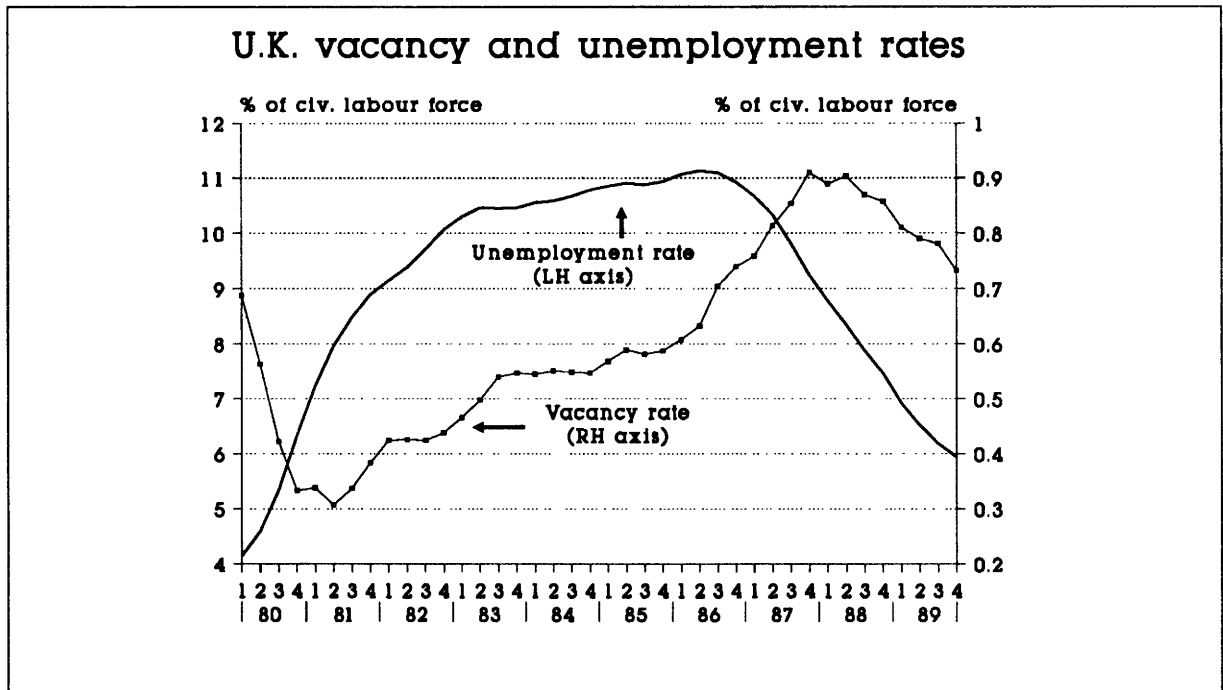
Graph 1.15 : Unemployment and wages.



Graph 1.16 : Long-term unemployment as % of total unemploym.

Phillips curve-type behaviour of wage changes and unemployment. The sharp increase in excess supply of labour in the early 1980s was accompanied by an equally sharp deceleration in wage inflation. However, with the unemployment rate stabilizing at over 10% in the period between the beginning of 1982 and the end of 1986, wage inflation did not decelerate significantly. This behaviour is consistent with the predictions of the hysteresis hypothesis, according to which high *levels* of unemployment have little effect on wage settlements; instead, *changes* in unemployment determine wage changes. In its weak form hysteresis predicts that the level as well as the change in unemployment determine wage inflation. On the basis of this hypothesis, the neoclassical prediction that wage growth would accelerate once unemployment falls below the natural rate has no explanatory power since the actual rate follows the actual rate of unemployment. Wage inflation in this case does not reflect disequilibrium in the labour market. Work at the IMF (1988) finds strong support for the hysteresis hypothesis in the case of the UK.

played little or no role in wage determination. However, the evidence discussed below casts doubt on this proposition. Wage pressures may also reflect labour market imbalances and a deterioration in the role of the labour market in job and worker allocation. There is evidence that the relationship between unemployment and vacancies has shifted outwards substantially in the 1980s suggesting that labour market imbalances have indeed worsened. Graph 1.17 shows the time path of the unemployment and vacancy rates in the 1980s, and Graph 1.18 presents the vacancies-unemployment (V/U) relationship, over the period 1971-1989. The first graph clearly indicates that during much of the 1980s rising vacancies and rising unemployment coexisted. When the labour market allocates workers to jobs efficiently, rising vacancies (unemployment) should parallel falling unemployment (vacancies); in other words, changes in aggregate demand are mirrored in changes in vacancies and, in the opposite direction, in unemployment. Graph 1.17 suggests that this was not a characteristic of the labour market in the 1980s.

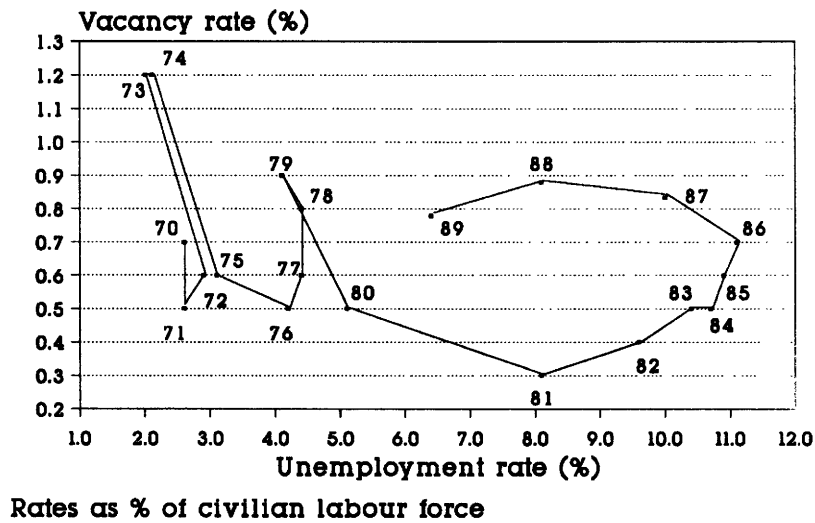


Graph 1.17 : Vacancy and unemployment rates.

One aspect of hysteresis is the role of "insiders"/"outsiders" in wage determination (Blanchard and Summers (1987)). According to this view wages are determined by union members ("insiders") without any influence from the excess supply conditions in the market for non-union workers ("outsiders"). Graph 1.16 shows the ratio of long-term unemployed to all unemployed workers in the 1980s. This ratio rose sharply in the early 1980s and continued to stay high (close to 44%) through the rest of the decade. Casual empiricism would suggest that the coexistence of high unemployment, high long-term unemployment, and high wage inflation is consistent with the hysteresis prediction. In other words, the long-term unemployed, who have contributed substantially to the overall increase in unemployment in the 1980s, have

The shift in the V/U relationship is most prominently shown in Graph 1.18. The efficiency of labour allocation appears to have been particularly high in the first part of the 1970s. However, this relationship has shifted decisively to the right; the shift implies that for a given level of vacancies (unemployment) the labour market produced more unemployment (vacancies) over the 1980s. This is evidence of a decline in the matching process and thus of reduced efficiency in labour allocation. Jackman, Layard and Pissarides (1989) suggest that the labour market imbalances shown by the shifting V/U relationship reflect a decline in the effectiveness of the unemployed in searching for new jobs ("search effectiveness"); and Layard and Bean (1989) argue that micro studies point to the decline in the search efficiency of

The V-U relationship in the UK



Graph 1.18 : The vacancy-unemployment relationship.

"outsiders" in finding jobs (further discussion of the importance of the V/U relationship can be found in Blanchard and Diamond (1989)). The implication for wage determination is that an increase in labour demand (vacancies), for a given level of labour supply (unemployment), puts significantly more pressure on wages when labour market efficiency is reduced than when efficiency improves. This phenomenon appears to be a crucial feature of the labour market record of the 1980s.

The importance of these hypotheses for wage determination in manufacturing in the 1980s were evaluated using a quarterly econometric model estimated over the period 1982 to 1988; data from the recession period of the early 1980s were excluded. The dependent variable is the quarterly rate of change of nominal wages in manufacturing, annualized (NOMWAGE). The explanatory variables are : expected inflation (PYEXP, the fitted value of the quarterly change of the GDP deflator (at an annual rate) on its past value over eight quarters); manufacturing productivity growth (GR); the percentage change in import prices (PMQ) at annual rates; the ratio of long-term to total unemployed (LORATE/LURE); a real wage resistance variable, the deviation of nominal wage change from the change in the GDP deflator lagged two quarters (NOMWAGE(-2) - PYDOT(-2)); and a variable representing the structural component of changes in the V/U relationship (VUST). The latter is approximated by the deviation of the cyclical component of the V/U relationship from the absolute value of the V/U relationship (the cyclical component is, in turn, the fitted value of the V/U variable on the deviation of actual from potential output and on its value lagged one quarter); this deviation is interpreted as the structural component of V/U movements. OLS results, predicated on the complete absence of money illusion (i.e. a coefficient of one on PYEXP), are as follows:

$$\begin{aligned} \text{NOMWAGE} = & \text{PYEXP} + 7,293 \quad +0,128^*(\text{PQM}) \\ & (1,90) \quad (2,20) \\ & +0,143^*(\text{GR}(-3)) \quad -0,483^*(\text{LORATE/LURE}) \\ & (1,76) \quad (2,94) \\ & +0,582^*(\text{NOMWAGE}(-2)) - \text{PYDOT}(-2) \\ & (4,44) \\ & +0,309^*(\text{VUST}) \\ & (3,32) \end{aligned}$$

$$\begin{aligned} R^2 = 0,72, \text{ DW} = 1,75, \text{ SER} = 2,17, n = 1982:Q1 - 1988:Q4 \\ (\text{absolute } t\text{-statistics in parentheses}) \end{aligned}$$

The results suggest that the nominal wage is composed of an expected domestic inflation component, compensation for import price movements, and productivity gains. The results confirm that three shocks impinge on the wage function : the ratio of long-term to total unemployment, which is found to have exerted a substantial restraining effect on wage growth (a 1% increase in the ratio LORATE/LURE slows wage growth by approximately one-half of a percent); real wage resistance, in that past real wage gains are partially reflected in current wage movements; and the structural component of the V/U relationship, which suggests that a 1% increase in structural imbalances would accelerate wage growth by one third of one percent.

The results cast doubt on the hysteresis hypothesis about the role of long-term unemployed in wage determination; more importantly, they confirm that labour market imbalances have been an important factor in wage growth. This factor must have been particularly important during the post-1987 period of high employment when labour shortages became especially pronounced. This evidence, as well as the anomalous behaviour of the structure of excess demand in the labour market in the 1980s, suggest that the UK labour market remains an area where further policy initiatives would be warranted.

CHAPTER 2

ECONOMIC POLICY IN THE 1980s

2.1 Introduction

The character of British economic policy in the 1980s was radically different from that in previous decades. The coming into office of the Conservative government in 1979 not only aimed at breaking the tradition of "stop-go" policies which were prominent during previous administrations, but also provided a different intellectual approach to managing the economy.

This revisionism was partly a reflection of the ascendancy of monetarism and of classical financial principles in academic and in policy centres. These ideas found fertile ground in the UK where rising inflation, deteriorating labour market conditions, a worsening industrial relations climate, and inadequate policy responses had characterized recent economic history.

The overriding objective of economic policy in 1979 was the reduction and containment of inflation, which, after running at an average 4,2% p.a. in the period 1966-1969, had accelerated to 12,9% in the subsequent ten years and reached 21,9% in May 1980 (all-items Retail Prices Index). The government's approach to containing inflation was enshrined in the Medium-Term Financial Strategy (MTFS), a framework within which monetary, fiscal and exchange rate policies were to be formulated. In it, monetarist principles were reflected in the fact that the government adopted nominal targets for monetary growth and expected to reduce the rate of inflation by gradually reducing the rate of monetary growth. The objectives of reducing public borrowing - itself subject to target - and stabilising the ratio of debt to GDP were consistent with the principle that current deficits should be expected to be offset by future surpluses; as a result, government deficits were not regarded as contributing to inflation. In addition to subjecting macroeconomic policy to the constraints of the MTFS, the government pursued a series of other reforms aimed at improving the supply side of the economy. These included reforms aimed at the tax system, financial and labour markets and measures to privatize certain public sector activities.

Perhaps the crucial innovation in British economic policy in the 1980s was not the commitment to combat inflation¹, but the priority placed on the supply side of the economy and the reduced emphasis on demand management. Furthermore, the recognition that policy commitments needed to be credible was an essential ingredient in the design and adoption of the MTFS. Following the

Labour government's Letter of Intent to the IMF in 1976, the MTFS represents the second and most important development in recent British fiscal history, and it is particularly significant in that it adopted fiscal restraint in 1981 at a time when output was below potential.

2.2 The philosophy and performance of the MTFS

The central feature of the publicly announced economic strategy in 1979 was gradualism. The tightening of monetary and fiscal policy embodied in the MTFS involved a gradual reduction in nominal GDP growth brought about by a reduction in the growth of money supply, sterling M3; a reduction in the level of real government spending within four years to five percent less than the level in the 1979-80 financial year; and a reduction in the public sector borrowing requirement (PSBR) from 4 3/4% of GDP in 1979-80 to 1 1/2% of GDP in 1983-84. The proposed course of monetary and fiscal policy implied a sharp decline in the public sector's stimulus to economic activity and a significant tightening of macroeconomic conditions.

The MTFS is a nominal framework, within which inflation and real activity are determined by supply-side developments, in turn influenced by government initiatives. The rationale for the MTFS was that the consistency of short-term policy actions should be judged in the context of a medium-term framework which, in addition, would enhance the credibility of the government's policy commitments and reduce uncertainty about future policies. As a result, it was expected that the benefits from policy credibility would also be manifest in the short-run and would minimize the output costs of the proposed anti-inflation strategy². These considerations are particularly relevant in the light of the stabilisation failures of the 1970s.

The intent of the MTFS was to combine monetary and fiscal policy in a coordinated manner to reduce inflation. The necessity for policy coordination was based on the recognition that a decline in monetary growth was an essential prerequisite to reduce inflation while, at the same time, it was contended that pressures on interest rates, emanating from fiscal deficits in the early 1980s, had to be contained by reducing the presence of the public sector in capital markets. In other words, coordination implied that the projected interest rate increases associated

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- 1) Such commitments were common throughout the 1970s; the Labour Government's announcement of monetary targets to combat inflation in 1976 is an indication of the determination involved.
 - 2) In retrospect, the output cost of the 1981-85 disinflation was substantial. A measure of output cost evaluated in the light of the decline in inflation is the "sacrifice ratio". In the UK the ratio of cumulative increase in unemployment over its 1980 level to 1985, relative to the decline in inflation during this period, amounts to 1,8; this is lower than Germany's and France's (6,8 and 2,1, respectively) but higher than other countries' and quite high in absolute value. See Bean and Symons (1989), Table 3.

with monetary restraint would not be amplified by fiscally-induced pressures on financial markets.

In setting PSBR targets, the government takes account of several factors, including the desired balance between fiscal and monetary policy, the phase of the economic cycle, international and domestic financial and interest rate developments, oil revenues, and privatisation proceeds. The latter are treated as negative expenditure and thus reduce the PSBR; consequently, the reported PSBR data have at times overestimated the extent of fiscal adjustment actually occurring. However, the PSBR and, more recently the PSDR (public sector debt repayment i.e. a negative PSBR) targets take account of prospective privatisation proceeds, and attention has been drawn to the PSDR excluding privatisation proceeds in order to represent the fiscal stance more accurately³.

Table 2.1 reports the respective four-year projections and outcomes for the PSBR presented in successive budget statements over the period 1980-1989. As can be

The data also reveal that the PSBR targets may not have constituted a rigid policy course. In the 1980-81 recession the PSBR amounted to 5,3% of GDP, over 2 percentage points higher than projected in March 1980. Bean and Symons (1989) argue that this overrun is less pronounced than could have been expected under previous administrations, indicating the reluctance of the government to engage in short-term stabilisation at the cost of abandoning its commitment to the publicly announced policy course and to medium-term objectives. On the other hand, discrepancies between actual and target values of the PSBR reflect the cyclical sensitivity of the variable and suggest that strict adherence to the pre-announced objectives may be suboptimal when forecasts of the economy can be inaccurate. Adjustment of PSBR objectives due to cyclical developments would, however, erode the credibility gains inherent in the policy in the first place.

The initial disinflation and the inflation acceleration in the post-1986 period raise several questions about the

Table 2.1 : United Kingdom medium-term financial strategy (MTFS)
Projections and outcomes for the public sector borrowing requirement

(financial years; % of GDP)

	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Projections															
MTFS 1980	4 3/4	3 1/4	3	2 1/4	1 1/2										
MTFS 1981		6	4 1/4	3 1/4	2										
MTFS 1982			4 1/4	3 1/2	2 3/4	2									
MTFS 1983				2 3/4	2 3/4	2 1/2	2								
MTFS 1984					3 1/4	2 1/4	2	2	1 3/4	1 3/4					
MTFS 1985						3 1/4	2	2	1 3/4	1 3/4					
MTFS 1986							2	1 3/4	1 3/4	1 1/2	1 1/2				
MTFS 1987								1	1	1	1	1	1		
MTFS 1988									-3/4	-3/4	0	0	0		
MTFS 1989										-3	-2 3/4	-1 3/4	-1	-1/2	
MTFS 1990												1 1/4	1/2	0	0
Outturn	4,8	5,3	3,3	3,1	3,1	3,1	1,6	0,9	-0,9	-3,0	-1,5				

Source : Financial Statement and Budget Report, various issues.

Table 2.1 : Medium-term financial strategy (MTFS).

seen, the goal of reducing the PSBR/GDP ratio was reached and, in fact, a surplus was achieved in 1987-88. This success encouraged the government to set a zero PSBR for the 1989-90 fiscal year. However, the emergence of a surplus equivalent to 3,0% of GDP in 1988-89 prompted the adoption of a gradual approach to the zero PSBR objective; the March 1990 MTFS projected a surplus declining to the equivalent of 1/2% of GDP by 1991-92 and falling to zero subsequently.

contribution of the MTFS and its exact role in influencing the government's key policy objective, the control of inflation. As can be seen in Table 2.2, nominal GDP growth declined from 17,9% in 1979 to 6,9% in 1986 but accelerated to 11,3% in 1988. The inflation rate (as measured by the GDP deflator) fell to a low 3,5% in 1986, partly reflecting the decline in oil prices; however, inflation accelerated to 6,7% in 1989. What has been the role of the MTFS in these developments ?

3) A general discussion of the fiscal and budgetary implications of privatization can be found in Mansoor (1988).

Table 2.2 : UK GDP, volumes and prices

	(% change)												
	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990 ¹	1991 ¹
Nominal GDP ^{2,3}	17,7	16,9	10,0	9,5	9,1	6,9	9,5	7,2	9,9	11,3	9,4	8,0	7,9
Real GDP ²	2,8	-2,2	-1,3	1,7	3,6	2,1	3,7	3,6	4,7	4,5	2,3	1,6	2,4
GDP deflator ³	14,4	19,5	11,4	7,6	5,3	4,6	5,6	3,5	5,0	6,5	6,9	6,3	5,4

1 Forecasts of the Commission services, April-May 1990

2 Average estimate, market prices

3 After removing distortion arising from introduction of local authorities' Community Charge

Table 2.2 : GDP, volumes and prices.

Of the two elements in the MTFs, the role of monetary restraint is uncontroversial : moderation in monetary growth is a necessary condition to reduce the trend rate of inflation. However, the role of fiscal (PSBR) targets is less certain. The evidence that public sector deficits and/or debt affect real interest rates, as argued by the MTFs plan, is ambiguous ⁴. In particular, since interest rates are primarily determined in international financial markets, fiscal targets may be of questionable importance in interest rate determination.

Another possible reason for the fiscal targets relates to the issue of sustainability of fiscal deficits and the possible interaction between fiscal deficits and inflation; this relationship is weakened by the government's commitment to fiscal targets. According to Sargent and Wallace (1981), a low rate of current monetary growth may raise expectations about future inflation through debt monetization in the presence of large prospective fiscal imbalances, unless it is accompanied by fiscal restraint. Sargent (1981) argued that the MTFs was not credible because the plan, based on targetted monetary growth and large fiscal deficits, was not feasible ⁵. Begg (1987) and Bean and Symons (1989), however, pointed out that the role of printing money to finance government spending is trivial in the UK context and the corresponding risk of future monetization was insignificant. The link between deficits and inflation, or the sustainability of projected deficits, were thus unimportant issues in understanding the role of fiscal targets in the MTFs. Begg (1987) went further to note that "the announced PSBR targets bear so little relation to the information one would really wish

about the sustainability of the currently envisaged fiscal programme that they cannot seriously be viewed as enhancing the credibility ... of medium-term fiscal policy. They do, however, have an important implication for the ... contingent aspect of policy." In reviewing the case that fiscal targets strengthened the conduct of monetary restraint, he found that "the fiscal component of the MTFs was (n)either necessary (n)or sufficient for the conduct of tight monetary policy". This view was echoed by Bean and Symons (1989) who commented that a number of industrial countries have successfully implemented disinflationary programmes without fiscal correction, and that, while "fiscal correction may often be an essential part of a disinflationary programme, particularly where capital markets are thin and seignorage is important, it is not obvious that it was necessary in the British case".

The importance of the fiscal targets should be seen in the light of the change in regime in 1979. The PSBR targets were an attempt to establish a credible anti-inflationary policy by promising to switch off the automatic fiscal stabilizers ⁶, to tighten fiscal policy should inflation rise unexpectedly ⁷, to promote productivity growth, and to remove economic disincentives. In the process, short-term demand management was rejected from the policy choices while the government's credibility was enhanced by the fiscal restraint amidst the 1981 recession. Begg (1987) contended that the fiscal targets contributed indirectly to the anti-inflationary stance by promising to tighten the real fiscal stance, and not to ease fiscal policy, should real interest rates rise, in an attempt to reduce the burden of debt. The fact that only marginal adjustments

- 4) The empirical literature concerned with the effect of fiscal variables on interest rates is very large but deals primarily with the US situation.
- 5) Sargent (1981) noted that "a minimal requirement that a plan be credible is that it is feasible in the first place. A restrictive "k-percent" rule for the (monetary) base and a permanent and large government deficit just are not feasible. On this view, in order that the current British plan be viewed as credible it is necessary that the large prospective government deficits over the next several years be counterbalanced by prospective surpluses down the line. It is difficult to point to much either in current legislation or, equally important, in the general British political climate that could objectively support such an outlook. On this view, the large government deficits that have accompanied the government's medium-term financial strategy raise serious questions about whether the plan has the logical coherence that is necessary for the plan to be credible to the public". Sargent's concerns have proved to be unfounded : the public sector, instead of running unsustainable, inflation-inducing, deficits has been repaying public debt since the 1987-88 financial year. Furthermore, Bean and Symons (1989) argue that the concerns were misplaced, since in 1979 the permanent fiscal deficit was zero.
- 6) This is Buiter and Miller's (1983) point.
- 7) Since the fiscal targets were announced in nominal terms, based on inflation and GDP projections, an unexpected increase (decrease) in inflation corresponds to a tighter (easier) real fiscal stance.

to the PSBR targets have been made over the past ten years supports this interpretation.

Since the fiscal component could only indirectly contribute to the anti-inflationary stance, the recent acceleration of inflation may be attributed to past monetary policy errors or to the absence of an inflation target in the medium-term strategy or both. A review of the conduct of monetary policy is presented in the next section. On the other hand, the fiscal targets are too vague about their inflation implications and so may be inadequate to moderate inflation expectations and to secure price stability. A nominal anchor, such as an explicit inflation target or ERM participation⁸, may be required to promote price stability in the medium term.

2.3 Monetary policy

The essential instrument of monetary policy in the UK is the short-term rate of interest: the commercial banks' base lending rates are determined through changes in the rate at which the Bank of England purchases eligible Treasury and commercial bills from discount houses⁹. Direct controls which were occasionally employed in the 1970s have not been used since 1980. Reserve requirements are minimal (0,45%) and are set by prudential considerations, not for reasons of monetary control. Higher reserve ratios are regarded as being detrimental to the competitiveness of the British banking system. The exchange rate has also been used to influence monetary conditions, particularly after the breakdown of monetary targetting.

A policy intended to offset excessive growth in the demand for bank credit by the private sector was in place until 1985. The policy, known as "overfunding", required that government securities be sold to the non-bank public to offset the extra liquidity associated with the increased demand for bank credit. In effect, "overfunding" aimed at stabilizing interest rates¹⁰. However, since short-term interest rates could be controlled by the Bank of England with the intent of influencing growth of the monetary aggregates, the policy of "overfunding" made no independent contribution to liquidity or monetary control. Since 1985 a policy of "full funding" has been pursued so as to produce a neutral impact of government finance on liquidity. The new policy requires that transactions in

government debt in the course of financial year equal the balance of maturing debt, and any change in official reserves; however, this rule has not been applied rigidly¹¹.

Monetary targets have played a central role in the MTFs and have been key instruments in the government's anti-inflation policy. Monetary targets were first announced in 1976 with the Labour Government's Letter of Intent to the IMF. However, during the 1980s, the UK experienced the same difficulties as other industrial countries in interpreting signals from the behaviour of the monetary aggregates about interest rates and aggregate spending. As a result, the monetary aggregate monitored as a policy guide has changed several times and, also, information from other economic and financial indicators has been used to supplement information from the monetary aggregates. While initially broad monetary aggregates were targetted, from 1986 an explicit target has only been set for the monetary base, MO, a narrow aggregate comprising mainly currency in circulation.

Table 2.3 summarizes the experience with monetary targetting since 1980; it also shows other variables which at the same time have been subject to a target range. It is clear that M3 overshot its range or advanced very close to its upper range systematically during the 1980-86 period. M1 was no more successful and a broad liquidity aggregate, PSL2, grew above its target range as well. MO, on the other hand, posted within-target growth in the four years 1984-87 but grew above the range in 1988 and 1989. The authorities have placed more emphasis on MO because the narrow aggregate has displayed more stability. This is also reflected in the fact that the target bound for annual growth in the aggregate has been reduced by 3 percentage points, from 4-8% in 1984 to 1-5% for the post-1988 period.

The difficulties encountered in the conduct of monetary policy implemented with a targetting procedure are reflected in the frequency with which the choice of targetted aggregate has changed. While initially sterling M3 exhibited a stable relationship with spending and interest rates, in 1982 and 1983 it was necessary also to use information from M1 and PSL2; in the period 1984-1986 both sterling M3 and MO were targetted while M1 and PSL2 were dropped; from 1986 on, only MO has been formally

8) Issues related to ERM participation are addressed in the next chapter.

9) See Goodhart's (1989) discussion, particularly pp. 327-328.

10) Goodhart (1989) provides an extensive analysis of "overfunding". The policy was motivated by the apparent trivial response of monetary aggregates to changes in interest rates; in the event, Bank of England measures to offset movements in monetary aggregates were necessary.

11) A discussion of funding policy can be found in the 1990-91 "Financial Statement and Budget Report", HM Treasury, March 1990.

Table 2.3 : Target and actual monetary growth in the MTFS										
(growth rates in %)										
	Monetary Aggregate								Other variables	
	£ M3		M1		PSL2		MO			
	Target	Actual	Target	Actual	Target	Actual	Target	Actual		
MTFS 1980	7-11	19 1/2								PSBR
MTFS 1981	6-10	12 3/4								PSBR
MTFS 1982	8-12	11 1/4	8-12	12 1/4	8-12	11 1/2				PSBR
MTFS 1983	7-11	9 3/4	7-11	14	7-11	12 1/2				PSBR
MTFS 1984	6-10	12					4-8	5 1/2		PSBR
MTFS 1985	5-9	16 1/2					3-7	3 1/2		PSBR; Nominal GDP
MTFS 1986	11-15	14 1/2					2-6	4		PSBR; Nominal GDP
MTFS 1987							2-6	5 3/4		PSBR; Nominal GDP
MTFS 1988							1-5	6 1/4		PSBR; Nominal GDP
MTFS 1989							1-5	6		PSBR; Nominal GDP
MTFS 1990							1-5			PSBR; Nominal GDP

Source : Financial Statement and Budget Report, various issues.

Table 2.3 : Target and actual money growth in the MTFS.

targetted. However, information from the PSBR as well as from movements in nominal GDP relative to target (or "broad objective", as the path for nominal GDP is described) has supplemented the evidence from the monetary aggregates since 1985. Since 1987, the exchange rate has also played an important role in the determination of monetary policy. Clearly, the broader the spectrum of variables monitored, the less easy it becomes to explain policy unambiguously.

The sources of instability characterizing the relationship between monetary aggregates, interest rates, and nominal spending have been institutional and regulatory changes, competition and financial innovation. At the initial stage, sterling M3 was chosen as the intermediate target because a stable money demand function for this aggregate was found to have existed in the 1960s and 1970s¹². However, the aggregate displayed instability as soon as it was targetted. Two developments are important here : the abolition of exchange controls in 1979, and the removal of the supplementary (non-interest bearing) special deposits (SSD or "the Corset") in 1980; these had

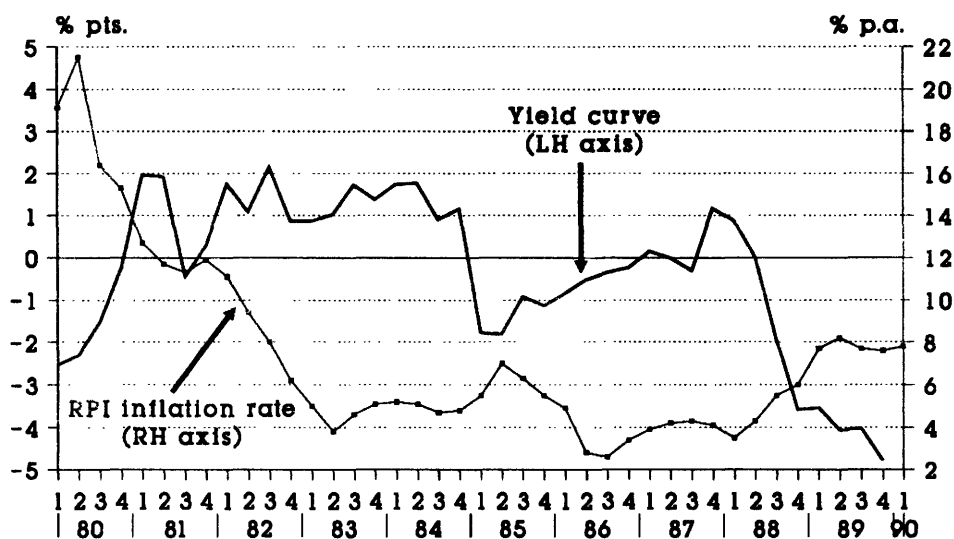
been adopted in 1973 in response to accelerating inflation. The removal of the Corset was regarded as essential to prevent intermediation being driven outside the banking system in the event of a prolonged use of the SSDs. Adaptation to the deregulated environment of the 1980s meant that the cost of holding money, and the portfolio opportunities which emerged, could not be represented by simple money demand relationships commonly used in the design of monetary targetting procedures. Furthermore, overshooting of targets was likely to be a reflection of changing behaviour with respect to holding money balances, particularly in an environment of disinflation, and not an excess supply of money which could have inflationary implications¹³. How difficult it was to interpret monetary policy at a time of structural change in money demand can be seen from the experience with the targetting of sterling M3 in 1981. While above-target growth would have suggested that monetary policy was easy, interest rates were rising, the exchange rate was appreciating and output was declining substantially below potential; the growth of sterling M3 was inconsistent with the tightening of monetary conditions under way.

12) It is questionable how stable the sterling M3 function was in the first place. Goodhart (1989) noted that the stability of the function had broken down in 1972-73 and had remained unstable ever since. The reason why the authorities chose this aggregate as an intermediate target in 1979 was that the surge in prices and nominal spending in 1974-75 were attributed to earlier changes in sterling M3, confirming the presumed link between money and nominal variables.

It is clearly essential to have a stable relationship between nominal spending and the targeted variable. With velocity of circulation constant, the growth of the monetary aggregate can be projected on the basis of real expenditure and inflation. Assigning them specific value yields the target range for the monetary aggregate. In turn, the path of the monetary aggregate serves as a leading indicator of movements in spending and in inflation. If growth is placing the aggregate above its target range it could signal the need for a tightening of policy; assuming that the monetary aggregate is responsive to interest rate movements, monetary contraction would require higher interest rates. The breakdown in money demand relationships in the 1980s has rendered this framework obsolete.

13) A change in money holding behaviour may occur if people are willing to hold more money than previously at given levels of income and prices; in this case the ratio of income to money, or the income velocity of circulation, declines. Greater holdings of money balances, held willingly, do not constitute an inflationary threat.

Yield curve* and inflation



* 20-year Government security/
3-month Treasury bill rate differential

Graph 2.1 : Yield curve and inflation.

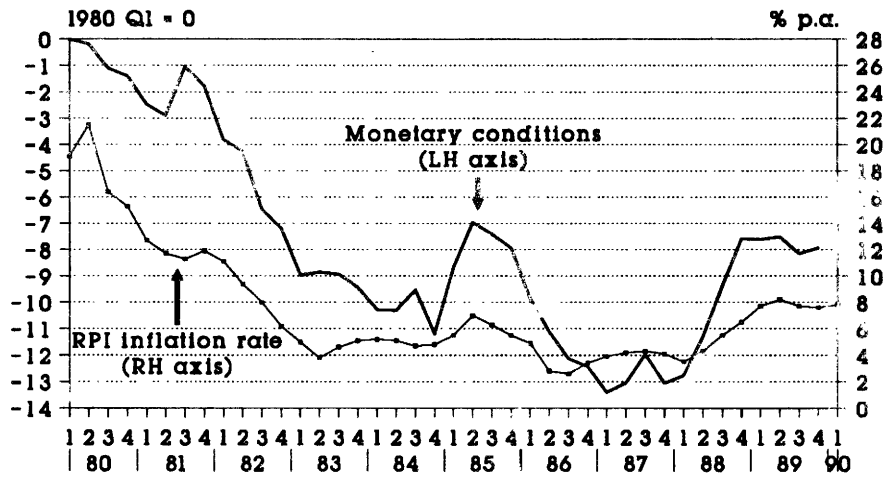
As information from the monetary aggregates continued to represent inadequately prospective inflation and nominal spending developments and the state of monetary tightness, the authorities gave more prominence to the exchange rate. This has been particularly pronounced since 1987 when several factors impinging on the international value of sterling became less important : the smaller role of oil in the UK economy and the initial decline in inflation and in inflation differentials between the UK and other industrial countries. In addition, commitment to international cooperation and to exchange rate stability implied that policy should be framed with a view to the exchange rate as well. From February 1987 to February 1988, the sterling exchange rate was not permitted to exceed 3 DM. It was recognised that maintaining exchange rate stability might not always be consistent with interest rate objectives, although following the October 1987 crash of world stock markets there were additional fears of a threat to stability that incited UK and other countries' authorities to depress interest rates. The consequent decline in rates, nevertheless, contributed to easing monetary conditions to an extent, viewed in retrospect, inappropriate given the strength of demand. The re-emergence of inflation in 1989 may in part be a consequence of the monetary ease pursued during this period.

Real interest rates remained high during most of the 1980s. During the period of disinflation at the beginning of the decade the real 3-month Treasury bill rate was negative. However, the rapid decline in inflation and the slow downward adjustment of short-term rates, reflecting to some extent the determination of the authorities to contain inflation, led to rapid increases in real interest rates. From a trough of -0.83% in the second quarter of

1981, the real 3-month Treasury bill rate rose to 7.25% in the first quarter of 1985; its average value to the first quarter of 1990 was 4.82%.

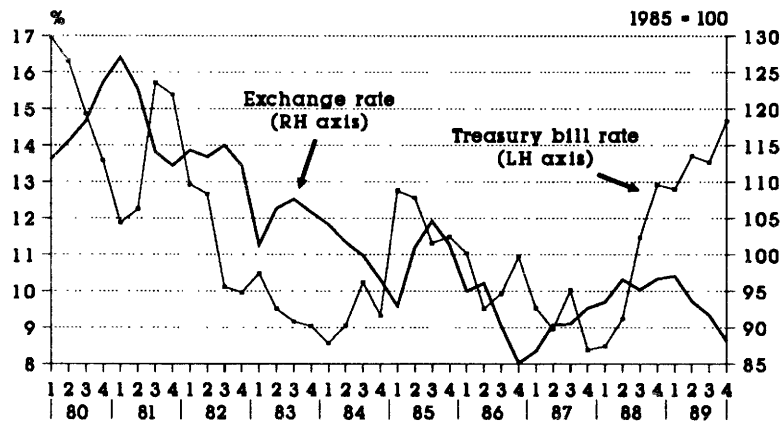
Much of the movement in real short-term interest rates was due to the volatility of nominal rates. Long-term yields displayed much less volatility during the 1980s. Developments in the differential between long- and short-term interest rates can be indicative of movements in inflation expectations; a steepening (flattening) of the yield curve is a reflection of deteriorating (improving) expectations about inflation prospects during the term of the financial instrument. Graph 2.1 shows the differential between the 20-year Government bond and the 3-month Treasury bill rates and the inflation rate measured by the year on year rise in the RPI since 1980. The first point to note is that the yield curve has been inverted during several quarters; in the beginning of the period, in the mid-1980s, and since the spring of 1988 the differential has been negative. These have been periods when actual inflation was high or accelerating and inflation expectations were deteriorating, and monetary policy acted to counter these developments. One explanation for the failure of the bond market to reflect adequately these inflation developments may indicate the credibility the authorities enjoyed; bond yields did not rise commensurately with inflation because market participants had confidence in the government's anti-inflationary commitment. The prompt increases in short-term interest rates during these periods and the tightening of monetary conditions are consistent with this interpretation. However, the graph also suggests that monetary policy followed rather than anticipated inflation developments. The inflation accelerations in the second quarter of 1983, in

Index of monetary conditions and the inflation rate



Graph 2.2 : Index of monetary conditions.

Sterling effective exchange rate and the 3-month Treasury bill rate



Source: CSO, *Economic Trends*

Graph 2.3 : Sterling effective exchange rate.

the third quarter of 1986, and at the beginning of 1988, were accompanied by some steepening in the yield curve, before the differential turned negative. According to some analysts, debt repayment has also contributed to keeping down yields in some segments of the term structure; this, however, implies non-substitutability among foreign and domestic assets and segmented bond markets, which may be less plausible in an area of increasing international financial integration.

Since interest rates and the exchange rate together can be viewed as monetary policy transmission agents, an index of monetary conditions combining both is shown in Graph 2.2 together with the rate of inflation. The components of the index, the 3-month Treasury bill rate and the Bank of England's nominal effective exchange rate index for sterling, are presented in Graph 2.3. The monetary conditions index, which is defined as zero in the first quarter of 1980, represents the contractionary (expan-

sionary) impact on aggregate demand of movements in the interest rate and in the exchange rate¹⁴. To the extent that price changes reflect deviations of output from its potential, an inflationary (deflationary) shock can be offset by appropriate monetary restraint (ease). Consequently, the index of monetary conditions reflects the course of anti-inflationary policy.

As can be seen from Graph 2.3, in at least three episodes during the 1980s interest rates and the exchange rate moved in opposite directions, indicating offsetting impacts on demand. In late 1980, the expansionary effect of interest rate declines was offset by an appreciation of sterling; although the latter had a dramatic impact on the manufacturing sector (see Chapter 1), it also contributed to disinflation. The decline in sterling from mid-1985 was resisted temporarily; the impact of the recovery of the currency from its trough in the fourth quarter of 1986 was partly balanced by the interest rate declines in the aftermath of the October 1987 stock market episode. Since the spring of 1989, the exchange rate has weakened while short-term interest rates have risen substantially.

Movements in the index closely parallel movements in the inflation rate. Graph 2.2 shows the easing of monetary conditions since the beginning of 1980, effected by exchange depreciation and declines in interest rates, and the decline in inflation. However, while inflation displayed a gentle upward trend from the end of 1986 to the beginning of 1988, and then accelerated, monetary conditions continued to indicate a trend easing of policy until the spring of 1988. The exchange appreciation in late 1987 and early 1988 was not contractionary to the extent required to restrain demand; in addition, interest rate declines associated with stabilizing sterling at around 3 DM during this period contributed to the buoyancy of demand and eased monetary conditions. The inflation potential of

these circumstances was eventually shown in the price increases which followed. Subsequently in 1988, monetary conditions tightened significantly, primarily as a result of the interest rate increases implemented from May. Monetary conditions were flat through 1989 as inflation reached a plateau; the inflation acceleration in 1990 has not prompted any further tightening of monetary conditions.

2.4 Fiscal and budgetary policy

The adoption of targets for the PSBR and the intention to adhere to them represent a choice not to influence aggregate demand through fiscal policy. However, because the targets are specified in nominal terms and inflation can rise or fall unexpectedly the stance of fiscal policy must be evaluated in real terms. The recent inflation acceleration, for example, has reduced the value of the debt repayment (PSDR) and has made the contribution of the fiscal stance, in real terms, less contractionary. This is one of several considerations in evaluating the net expansionary contribution of the public finances to the economy¹⁵.

Table 2.4 shows indices of fiscal policy since 1979. The PSBR is the actual borrowing requirement which treats privatization proceeds as a negative capital expenditure; the public sector financial surplus (PSFS) or deficit (PSFD) treats them as a form of finance and, therefore, provides a more accurate picture of the pressures the public sector exerts on capital markets; the cyclically and inflation adjusted public sector financial surplus (PSFSC) is the OECD's estimate of the cyclically adjusted budget deficit after taking account of the impact of inflation on outstanding government net debt, and gives an indication of the discretionary component of fiscal policy. The data reveal that there can be considerable dif-

14) The index is based on the hypothesis that deviations of real output from its base (or target, or potential) value can be offset by interest rate and/or exchange rate deviations from their base values; this is the IS curve written in deviation form:

$$\log(y) - \log(y^*) = -a(R - R^*) - b(\log(\text{EXCH}) - \log(\text{EXCH}^*)) + u - u^*$$

where:

y = real output or demand

R = nominal rate of interest

EXCH = nominal exchange rate index, foreign currency per unit of domestic currency

u = disturbance term

a = interest semi-elasticity of demand

b = exchange rate elasticity of demand.

Starred variables represent base case values. Clearly, a positive disturbance ($u - u^* > 0$) which raises output above y^* can be offset by an increase in interest rates ($R - R^* > 0$) or an exchange rate appreciation ($\text{EXCH} - \text{EXCH}^* > 0$) or some combination of both. The index can be rewritten as: $\text{IMC} = (R - R^*) + (a/b) (\log(\text{EXCH}) - \log(\text{EXCH}^*)) \times 100$.

This is presented in graph 2.2. The base chosen was the first quarter of 1980 when interest rates peaked; the exchange rate peaked in the first quarter of 1981. The index should, therefore, be interpreted in terms of movements from the base. For example, Graph 2.2 shows that, relative to the peak of disinflationary conditions at the beginning of 1980, monetary conditions generally eased up to the end of 1984. While the nominal index is useful in representing short-term policy movements, over longer periods when price stability is less assured a real index of monetary conditions should be used.

Values for the parameters were obtained from the OECD INTERLINK model (Richardson, 1987). According to this, a one percentage point decrease in short-term interest rates, which fixed exchange rates, raises real UK GDP by 0,4 percent; a 10 percent exchange rate depreciation, with fixed interest rates, raises real GDP by 0,9%. The slope term is $0,09/0,4 = 0,225$: the interest rate effect is almost five times as large as the exchange rate effect.

15) See the discussion in Heller, Haas and Mansur (1986) as well as the notes edited by Blejer and Chu (1988); see also Seth (1989) and Yarrow (1989).

Table 2.4 : The public finances since 1979

(balances as % of GDP)			
Calendar year	PSBR	PSFS	PSFSC
1979	6,4	-4,3	-
1980	5,1	-4,5	2,8 (2,9)
1981	4,1	-3,1	3,4 (0,6)
1982	1,8	-2,7	2,9 (-0,5)
1983	3,8	-3,4	0,1 (-2,8)
1984	3,2	-4,0	-0,2 (-0,3)
1985	2,1	-2,7	0,4 (0,7)
1986	0,6	-2,0	-0,1 (-0,5)
1987	-0,3	-1,0	0,0 (0,1)
1988	-2,5	1,3	1,5 (1,6)
1989	-1,8	...	1,6 (0,0)

PSBR : public sector borrowing requirement

PSFS : public sector financial surplus

PSFSC : cyclically and inflation adjusted PSFS, OECD estimates; in parenthesis is the change in this ratio which is also an indicator of fiscal stance

Source : C. Bean and J. Symons (1989) : Table 2;CSO;and OECD (1989).

Table 2.4 : The public finance since 1979.

ferences in the measure of the fiscal position according to the way privatization proceeds are treated¹⁶. More importantly, the real fiscal position adjusted for cyclical factors indicates that, contrary to the expansionary fiscal stance indicated by the positive PSBR data up to 1986, fiscal policy was contractionary throughout the 1980s. In particular, the fiscal stance moved from a cyclically-adjusted deficit of 0,1% of GDP in 1979 to a surplus of 2,8% of GDP in 1980, at a time of a severe economic downturn. The surplus grew to 3,4% of GDP in 1981 but has subsequently declined noticeably. In 1988 and 1989 fiscal policy once more became contractionary. The severe fiscal contractions of the early 1980s constitute major errors from the perspective of counter-cyclical demand management. However, the government had rejected aggregate demand management as a policy objective and, consequently, the budget deficit was only important in the context of the MTFs targets. At the same time, and in view of the inability to develop and implement monetary policy based on stable money to income relationships, fiscal policy may have assumed a more direct role in the process of disinflation during the 1980s.

Together with the objective of reducing the PSBR to GDP ratio there has been the broader objective of reducing the presence of the state in economic activity. To accomplish this, targets for a declining share of public sector expenditure in GDP have been set and tax reforms intending to reduce the burden of taxation and to remove tax-related distortions affecting private decisions have

been adopted¹⁷. The approach has been to alleviate the tax burden by introducing reform measures to parallel the path of expenditure containment.

Originally the government intended an absolute reduction in expenditure in real terms. In practice, small annual real increases were accepted up to 1984-85, a year during which expenditure was boosted by the miners' strike. In the January 1985 and 1986 public expenditure white papers expenditure held constant in the medium-term was planned. However, from 1987-88 an objective to permit moderate real increases in public expenditure below the rate of increase of GDP was adopted. The buoyancy of the economy actually led to an appreciable reduction in the share of public expenditure in GDP. As can be seen in Table 2.5, this ratio fell from 45% in 1984 to 38% in 1988. There have been significant changes in the shares of individual public expenditure components in GDP. Compared to 1979, transfers to enterprises (subsidies), debt interest and gross fixed capital formation are appreciably lower. The share of current transfers to persons at first rose but subsequently has fallen back. Government consumption has remained broadly stable. The fall in unemployment and the recovery in profits have been the main factors in the decline in the ratio of current transfers to GDP, while the decline in the stock of national debt and the easing in interest rates underlie the fall in interest payments. While defence expenditures have been curbed, spending on health and education has grown at the same rate as GDP. On the other hand, the overall decline in the share of public investment spending

16) See Mansoor (1988) on considerations in evaluating the budgetary importance of privatization.

17) A detailed discussion of tax reform is presented in Box 2.1.

Table 2.5 : General Government expenditure and receipts

	(% of GDP)			
	1979	1984	1988	1990 ¹
Current transfers	14,0	16,2	13,5	13,9
To enterprises	2,4	2,3	1,3	1,1
To households	10,6	13,3	11,6	11,2
To the rest of the world	1,0	0,6	0,7	0,7
Interest payments	4,4	4,9	3,9	3,0
Government consumption	19,7	21,6	19,7	19,4
Gross fixed capital formation	2,6	2,1	1,2	1,7
Total expenditure	41,1	45,4	38,3	37,1
Indirect taxes	15,0	16,2	16,2	15,8
Direct taxes	12,8	14,4	13,1	13,4
Social security contributions	5,8	6,9	6,9	6,1
Other current receipts	4,2	3,9	2,9	2,6
Total receipts	37,8	41,5	39,1	38,9

1) Commission projections April-May 1990

Source : CSO, Commission services.

Table 2.5 : General government expenditure/receipts.

masks some important increases in real spending on roads, railways, and health while capital spending on education and housing has fallen; the former reflects declining enrolments and the latter the increased emphasis on private rather than public housing construction.

A key element in the tax reform plans was the reduction in the burden of taxation. As can be seen from Table 2.5, however, the overall share of tax receipts has risen from 37,8% of GDP in 1979 to 39,5% in 1988, although it is projected to fall to 38,9% this year. The share of all revenue sources has risen, more so that of indirect taxes. (Not shown is the decline in revenues related to oil production.) VAT rates were increased from 8 to 15 percent in 1979. However, the base on which indirect taxation is applied constitutes only 56% of consumer spending; if measures were adopted to widen the base, revenues from this source would be likely to rise significantly.

While the overall level of taxation has not changed significantly since 1979, major tax reforms have changed the structure of individual taxes. Personal and corporate tax rates, and employee social security contributions, have been reduced significantly. The potential decline in revenue associated with these measures has been offset by reforms aimed at broadening the corporate tax base. In addition, rapid economic growth has also contributed to enhancing revenues. While the adopted measures have promoted rationalization of the tax system and have gone

far in removing distortions, further important steps remain to be taken.

The success with which the PSBR objectives have been met prompted the government to announce in the March 1987 MTFS a medium-term projection for public borrowing to remain at 1% of GDP. Revenue buoyancy made this short-lived, and the following year's MTFS replaced it with a medium-term projection of a zero PSBR (after the surplus of 3/4% of GDP recorded in 1988-89). A balanced budget is expected to promote a stable environment within which private decisions are made and, at the same time, to be a simple and clear policy rule. However, it is not certain that this objective is consistent with likely public expenditure requirements in the medium term. In particular, the aging of the population and the rise in public pension liabilities should be taken into consideration in the setting of fiscal targets; furthermore, the path of oil revenues should also be reviewed in this context. The decline in the private saving rate and the saving/investment balance may also be elements of concern. If developments in these areas reflect institutional and/or policy distortions (financial deregulation and tax-related distortions, for example) fiscal policy could be designed with a view to correcting these anomalies. Further, the desirability of sustaining a certain and predictable tax policy over the medium-term, and the likelihood that expenditure requirements will increase, suggest that a surplus rather than a balanced budget target may be more appropriate for the coming years.

The public sector net debt to GDP ratio declined rapidly during the 1960s and 1970s, from 123,2% in 1960 to 48,7% in 1979, chiefly through the impact of inflation. The rate of decline slowed down in the early part of the 1980s reflecting the sharp increase in real interest rates and the slowdown in inflation. However, additional progress was made during the second half of the decade as borrowing was reduced. While the commitment to medium-term fiscal objectives has undoubtedly been the key factor in the process of fiscal consolidation, political factors may also have been important. In particular, the election of majority governments, with terms of office long enough to implement policy changes, has been found to be an explanatory factor of the speed at which fiscal consolidation has taken place in several OECD countries¹⁸. In the case of the UK the repeated election with clear majorities of the present government has made the commitment to medium-term fiscal objectives possible.

2.5 Supply-side policies

The United Kingdom can justly lay claim to have been the leader within the Community in efforts to improve the supply side of the economy. In the assignment of objectives at the beginning of the present government's term of office, improving the supply side was recognized as the key to improving long-term economic performance; it was also clear to most observers that such performance had progressively fallen behind most of the UK's main partners, and the need for improvement was correspondingly greater. Ten years later, the Treasury estimated in the 1989 version of the MTFs that the medium-term potential growth rate of the non-oil economy was 3% per annum, and of the whole economy, taking account of the peak in oil production having been passed in 1985, 2 3/4%. This is significantly higher than that achieved over the cycle from 1973 to 1979 (1,5%) or from 1979 to 1988 (2,1%). While many supply side improvements by their nature will take time to bear their full fruits (e.g. educational reform), this higher potential growth rate is indicative of the progress made.

Supply-side policy, an umbrella term covering a wide range of policies, is reviewed below under the following headings :

- the labour market;
- measures to encourage enterprise;
- markets for goods and services;
- financial markets.

A review of the success of supply-side policies,

measured by productivity gains, is also presented. Finally, tax reform and privatization, key supply-side initiatives, are discussed in two boxes.

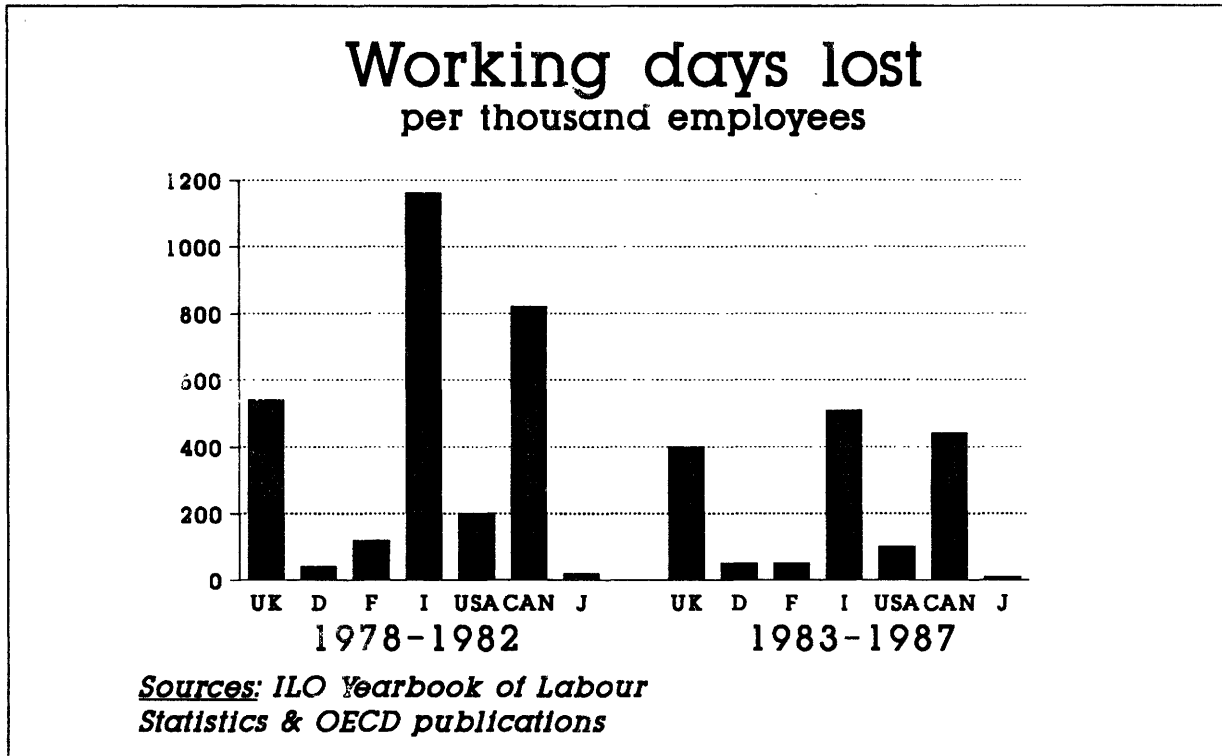
2.5.1 The labour market

Measures to reform the pattern of *industrial relations* and curb trade union power have been the most visible aspects of labour market policies. A series of reforms embodied particularly in the Employment Acts of 1980, 1982 and 1984, removed most of the legal immunities previously enjoyed by trade unions. The chief measures have been to prevent supportive industrial action being taken other than in the enterprises directly concerned, to make unions liable centrally for the actions of branches, to require the direct election of union officials and to require membership ballots on official strike calls. The government has also announced its intention to legislate to end the pre-entry "closed shop", where potential employees are required already to be union members. Using internationally comparable data for the decade 1978-87 (the latest available) days lost through industrial disputes in the UK fell from an average of 540 days per thousand employees in the period 1978 to 1982 to 400 days in the period 1983 to 1987 (data for the UK alone indicate a modest rise from 1987 to 1989). Though this is still somewhat higher than in many major industrial countries (lower than in Italy or Canada, but significantly higher than in Germany, France, the USA and Japan - see Graph 2.4) the UK seems to have shed its former image as a country particularly subject to such unrest. Trade union membership fell continuously from an all-time peak in 1979 of 13,3 million. By 1988 numbers were down to 10,2 million, a fall of 23%.

A more flexible attitude to *work practices* has also been encouraged, leading to fewer problems over restrictive practices and demarcation disputes. These changes are often summed up as representing an increased "ability for managers to manage" and have almost certainly been major factors in improving productivity and encouraging investment by foreign as well as domestic firms. Their impact on wage bargaining is less clear. A tighter labour market and the recent acceleration of inflation have seen a renewed tension in wage bargaining and will be a more severe test of the new structures in place.

Attempts to influence *pay bargaining* have been made via tax incentives to increase employee equity and profit-related schemes. Privatization has also played a role, typically favouring some distribution of shares to employees and in certain instances taking the form of management buyouts. Pension arrangements have been liberalised, with personal ('portable') and corporate pension schemes encouraged. Similarly, reform of personal

18) Roubini and Sachs (1989) find that difficulties in economic management in the post-1973 period, associated with coalition governments, were an important factor in explaining the process of fiscal adjustment. Once it was recognized that the slowdown in economic growth and the rise in unemployment would be more than transitory, OECD governments embarked upon different courses of fiscal consolidation, depending upon their prevailing political characteristics. The UK, together with Germany and Japan, are notable cases of vigorous fiscal adjustment in the 1980s. The election of majority governments during the 1980s made fiscal correction in the UK possible.



Graph 2.4 : Working days lost.

taxation has been directed towards improving incentives and encouraging work effort.

Changes made or proposed in *education* recognise that standards in the UK have fallen behind those of other countries in key areas such as numeracy, and give rise to below-potential performance later in working life. Notable initiatives include the setting of a national core curriculum, reform of the examination system and the promotion of 'city technology colleges', the latter attempting to integrate local enterprises into vocationally-oriented schooling.

Extra effort is being placed on *training*. This is an area where the UK lacks a strong craft- or employer-based tradition. The Youth Training Scheme was introduced in 1983. The employment training programme (ET) began in September 1988 to provide training for the unemployed, especially those out of work for six months or more; take-up of places, provided with the cooperation of employers and voluntary bodies, has so far been somewhat disappointing. A White Paper published in January 1989 proposed a more comprehensive approach centred on local employer-led groups (Training and Enterprise Councils, TECs) coordinating a range of programmes suited to the local labour market and backed up by a national training agency. In all a network of 82 TECs are planned, of which 10 were already operational in April 1990.

2.5.2 Encouraging enterprise

Measures taken to favour greater enterprise include reform of the corporate tax system, the aiding of business start-ups and the growth of small firms, and a significant change in the thrust of regional policy.

The *corporate tax system* was changed radically with proposals made in the 1984 Budget, moving to a broader base with lower rates. The corporation tax rate was reduced progressively from 50% for the 1983 financial year to 35% from 1986; fixed investment accelerated tax allowances were also phased out by 1986. Business start-ups and small businesses have been promoted by softer corporate and value-added tax structures and a number of special schemes. The Business Expansion Scheme favours equity funding of small firms; the Loan Guarantee Scheme eases the supply of loan finance; a third scheme, the Business Development Initiative, subsidises consultancy advice. Apart from government measures, the development of venture capital and relative ease of financing via such means as leveraged buy-outs (the latter also for larger companies) has progressed further in the UK than in the rest of the Community. The net result has been to promote greater firm mobility. Total VAT registrations, for example, rose by 30% between 1980 and 1987; the net stock of business registered rose steadily from some 1,3 million to over 1,5 million.

Regional policy has become significantly more selective. The former automatic regional development investment grants have been abolished. In their place have been introduced selective investment grants and consultancy services. In effect, more reliance is now placed on a mixture of intervention and market incentives.

2.5.3 Markets for goods and services

As part of the broad policy objective to encourage greater competition, specific actions affecting the markets for goods and services have also been taken. These include deregulation and liberalization, and moves in the direction of a more explicit competition criterion as the

basis of reviewing proposed mergers and restrictive practices.

Deregulation and liberalisation have had most scope for impact in the market for services. One channel for change has been the privatization programme (see Box 2.2). While perhaps public finance and labour union concerns were present in the earlier years of the programme, in later years more attention has been given to stimulating the competitive environment in which the enterprises operate. The forthcoming privatization of the electricity industry, for example, provides for a competitive splitting and deregulation of generating capacity whereas there was comparatively little basic change made in the gas industry when it was privatised in 1986-87. A potential conflict of interest is, however, apparent: the more monopoly profits are guarded in the proposed structure of an enterprise being privatised, the greater should be the returns to the government on its sale.

Services such as transport (air and buses), legal services (property conveyancing, with further reform proposed of general legal services) and telecommunications have been subject to extensive deregulation. The public sector, especially local government and the health service, has been encouraged to adopt a more rigorously competitive approach to the provision of services, often contracting out where in-house provision was previously quasi-automatic.

Evidence from international price studies indicates that services, at least to final consumers, remain expensive in the UK relative to the price of final output. This suggests that there is scope for the reform programme to be carried forward and extended, as the government is planning to do in the area of legal services. The internal market programme, which is discussed in more detail in the next chapter, is also of importance in this respect.

The UK's approach towards *mergers* and *restrictive practices* has been characterised by a greater degree of official discretion as regards what is best in the "public interest" than, for example, in the USA or Germany where the impact on competition has been the key criterion. This emphasis is changing to some extent. A review of mergers policy published in March 1988 concluded that the potential effect on competition within the UK should be the main consideration in evaluating the reference of a proposed merger to the Monopolies and Mergers Commission; the fundamental structure of national merger control nevertheless remained intact. However, the impact of Community involvement in merger control is increasing, and will continue to do so following the adoption of the December 1989 regulation discussed in Chapter 3.

2.5.4 Financial markets

Financial markets and the financial system have been subject to wide-ranging reform. *Foreign exchange controls* were abolished in 1979, exposing domestic companies to the need to earn more internationally comparable rates of return; the abolition of *dividend con-*

trols in the same year can be seen in this light as a complementary measure. Identified capital outflows have been considerable, enabling the UK to build up a considerable stock of overseas assets at the time of earning large but temporary oil surpluses.

The ending of exchange controls helped reinforce London's predominance as the chief European financial centre. This was also aided by the "Big Bang" *stock exchange* reforms of October 1986. These reforms, made by the institutions concerned under the threat of government intervention, ended a number of restrictive practices as regards dealing in stocks and shares and membership of the exchange and enhanced the introduction of new technology. Regulation of the *securities* and *life assurance* business was reformed in 1986. The generally competitive environment has attracted considerable secondary dealing of non-UK securities. Sterling capital markets were further deregulated in 1989, including the abolition of the queuing system for new issues.

More domestically oriented financial deregulation has included giving *building societies* much more scope to compete with banks and other credit institutions over a wider range of services, to raise capital in the wholesale markets and to change their status from mutual to public companies. This has intensified competitive pressures in credit markets, which had already been given an earlier impetus by the abolition of *hire purchase controls* in 1982.

2.5.5 Supply-side reforms and productivity performance

Is the remarkable productivity performance of the UK economy during the 1980s merely a consequence of the long economic cycle, or have supply-side reforms contributed to a permanently higher path of productivity gains? This question is critical in understanding prospective inflation developments and the sustainability of rapid real wage gains, such as those observed in 1989. For instance, if the productive potential of the economy has increased in a permanent fashion, then rapid growth in real wages is sustainable; if, however, the productivity gains have been a mere reflection of the strength of the economic recovery and are not permanent then rapid wage growth is inconsistent with stable output growth.

The channels through which supply-side reforms could have influenced economic efficiency and productivity are numerous. Reform of the personal and corporate tax structures should affect both the quantity and the quality of labour supply, and have a beneficial impact on investment activity. Measures directed towards improving the functioning of the labour market and enhancing the flexibility of working arrangements should have contributed to the allocative efficiency of labour. Training and education activities improve the quality of the labour input, while financial market reforms make possible a more efficient allocation of savings and encourage new and innovative forms of intermediation and investment financing. There may also be indirect efficiency gains related to the recognition that the government would not provide shel-

ter to inefficient and troubled firms, and the threat of competition has forced rationalization. Recent research estimates that the underlying rate of productivity growth is between 3,5% and 5,5%¹⁹.

It is very difficult to measure the effect of some of the possible forces acting on efficiency, particularly since a high degree of interdependence is present. However, several studies have attributed the increase in productivity to the change in the climate of industrial relations and to the reforms directed towards improving the flexibility of the labour market. According to Bean and Symons (1989), increased efficiency in the utilization of the labour input lies at the heart of the British productivity performance in the 1980s. They contend that the decline in union power, either because of legislation or because of the 1981 recession, reduced the degree of overmanning, which was a central feature of the pre-1980 period. In particular, multi-unionism and bargaining with individual unions over manning levels rather than employment had led to

an increase in the labour requirements per unit of output and for given production techniques, and had raised labour costs leading to a reduction in the level of output and substitution away from "expensive" labour. However, with the advent of the labour market reforms and the decline of overmanning the productivity performance of the economy dramatically improved.

This does not suggest that the pace of productivity gains will be maintained in the future. The curbing of union power was an once-and-for-all phenomenon and cannot be expected to be the source of continuing productivity gains. Furthermore, it is possible that a transitory, cyclical element, is present in the decline of union strength, and the return to high employment may renew its potency. Sustainable productivity gains are determined by the human capital embodied in the labour input. Government initiatives towards education and vocational and technical training are crucial in this context.

19) See P. Spencer (1987) for an assessment.

BOX 2.1

TAX REFORM IN THE UK

Key tax reform measures introduced since 1979

- *Personal income*

Two tax rates : top marginal tax rate, 40% for taxable income over UKL 20 700 (1990/91 Budget); basic rate of personal income tax, 25% - medium-term objective is 20%; standard personal allowances raised by a third in real terms between 1978/79 and 1990/91.

- *Capital taxation*

Inheritance tax top rate 40%.

- *Social security contributions*

Four rate bands for employees and employers; top employee contribution rate 9%; lower contribution rate for low-paid workers; ceiling for employers' contribution abolished; national insurance surcharge abolished.

- *Means-tested social security benefits*

Rationalization of the income tax system and the Family Credit, Income Support, and housing benefits; assessment of all income-related entitlements on after-tax rather than gross income; unemployment benefits subject to income tax; tightening of work-test principle.

- *Household income*

Effective April 1990, spouses are taxed independently on all income, including capital gains; extra personal allowance for married couples retained.

- *Household savings*

Abolition of investment income surcharge; real capital gains taxed at personal income tax rates with tax exemption of UKL 5 000 per annum; introduction of Personal Equity Plans in which up to UKL 4 800 investment per annum in equities bear no tax liability if held for a year; Business Expansion Scheme (BES) offers tax relief for up to UKL 40 000 per annum in new equity in unquoted UK trading companies; up to UKL 500 000 can be raised by any one firm through BES; Profit Related Pay encouraging profit sharing, with tax relief granted; tax exempt special savings accounts (TESSAs) to be available from January 1991.

- *Pension savings*

Measures to encourage personal pensions; measures to enhance pension transferability between different pension plans organized by employers; greater individual contributions to occupational pension plans within existing tax exemption limits; limit to tax-exempt contributions to pension schemes, established after March 14, 1989, based on an annual salary of UKL 60 000, adjusted annually at the rate of inflation; limit of two thirds (UKL 40 000) of the annual salary; limit of UKL 90 000 tax-free lump

sum withdrawal from pension plans established after March 14, 1989; these limits apply also to new members of existing plans.

- *Housing*

Imputed income from owner-occupied housing, and capital gains on principal residence continue to be untaxed; interest payments of up to UKL 30 000 on loans secured by principal residence can be deducted from personal income taxes; residential property tax (rates) replaced by Community Charge (poll tax) largely independent of individual economic circumstances and unrelated to property.

- *Corporate taxation*

Enlargement of corporation tax base through the replacement of accelerated depreciation provisions by economic depreciation and through changed treatment of stocks (abolition of stock relief); reduction of tax rate from 52% to 35%; tax rate for small business lowered from 42% to the basic personal tax rate.

- *Business privileges*

Limitations on entertainment expenses; tightening of tax rules regarding company cars.

- *Interest payments on debt*

Nominal interest payments deductible from corporate tax base at the new lower rate of 35%.

- *Dividend payments*

Tax relief for shareholders at the new lower basic personal income tax rate of 25% for taxes paid at the corporate level.

- *Local business taxation*

From 1990 nationally uniform tax rate on rental value of business property the proceeds of which are pooled and distributed to local authorities in proportion to their adult populations.

- *Indirect taxation*

Increased VAT rate from 8% to 15%, covering only 56% of consumer spending; 30% is subject to zero tax while another 15% is exempt.

Key objectives

Several tax reform measures adopted in OECD countries in the 1980s were initiated in the United Kingdom. Key objectives of tax reform have been to reduce the share of tax revenues in GDP, improve efficiency, remove tax-related disincentives, and provide tax incentives to offset market distortions and attain social objectives, e.g. encourage share and house ownership and alleviate poverty. To achieve these the government has

proceeded in a piecemeal fashion implementing various reforms in successive financial years.

Reform of the tax system has been a central feature of the economic policy adopted in 1979, reflecting the emphasis placed on the supply side of the economy. The government recognized that the tax system could retard economic growth by affecting the quality and quantity of labour supply, and by distorting the allocation of capital away from its most productive uses towards tax-favoured investments. In addition, it could discourage entry of various individuals (married women, low-income workers, young workers etc.) into the labour market and could perpetuate current and life-time income and wealth inequality. Tax reform was seen as an instrument to enhance the supply potential of the economy rather than to promote income redistribution.

Main features

A significant shift towards enhancing the share of indirect taxation in total revenues occurred in 1979 when the standard VAT rate was raised from 8% to 15%. The increase in revenue permitted reductions in the top marginal personal tax rate from 83% (98% for investment income) in 1979 to 40% in 1988, the second lowest in the OECD and the lowest in the EC. The basic personal tax rate has been reduced by 8 percentage points to 25% and is intended to decline to 20% in the medium term.

Reform of the corporate tax system involved a reduction of tax rates from 52% to 35% and an enlargement of the tax base through the introduction of economically meaningful depreciation allowances. The ceiling on employers' social security contribution was abolished as was the national insurance surcharge. The enhanced corporation tax liability made possible the lowering of the social security contribution for low-paid workers. In addition, the tax rate for small business was reduced from 42% to the basic personal rate of 25%. Nominal interest payments on corporate debt continue to be deductible at the corporate rate of 35% while taxes paid at the corporate level are credited to reduce the tax liability of recipients of dividends. The latter measure, credited at the basic personal tax rate of 25%, is intended to relieve the double taxation of dividend income.

Reform of local taxation has two elements: local business taxation is now levied at a nationally uniform rate and the proceeds are distributed to local authorities according to their proportion of adult population; and a uniform poll tax (the "Community Charge") levied on local residents, irrespective of their economic circumstances (except for the very poor) and unrelated to property, has replaced local property taxes ("rates") on residential housing.

Special tax treatment is accorded to household income and savings, as well as to housing. Up to the 1989-90 tax year, the wife's income was added to the husband's who received a married man's allowance, and a separate personal allowance was granted to the wife. This system was intended to treat income earned on an individual basis

and to limit the disincentives for married women to join the labour force, and, at the same time, treat the family as a unit. However, these objectives could only be satisfied in a compromise manner. With effect from April 1990 spouses are taxed independently on all incomes, including capital gains, while a personal married-couple allowance is retained.

The 1990-91 budget announced the introduction of Tax Exempt Special Savings Accounts (TESSAs) effective January 1, 1991. Up to UKL 9 000 savings will be tax-exempt if held for five years; UKL 3 000 may be deposited in the first year. Provided that no capital is withdrawn for five years, interest earned will be exempt in its entirety.

Owner-occupied housing consumption remains untaxed, capital gains on the principal residence are tax-exempt, and mortgage interest payments of up to UKL 30 000 can be deducted from the personal tax liability. Furthermore, pension fund contributions can be deducted from taxable income while capital income earned by pension funds and lump-sum withdrawals (up to 25% of value) from the fund are not subject to tax.

Impact of the reforms

The tax system affects economic behaviour by introducing a "wedge" between the private value of an economic activity and its tax-inclusive price, and plays an important role in the allocation of resources. Since it is designed to meet several objectives, including resource allocation, the complexity of the tax system is such that reported tax parameters, and/or revenue transferred to the state, underestimate the true cost of tax-induced distortions to society. An important objective of tax reform has been to reduce or eliminate these distortions and, according to some estimates, the welfare gains in the case of the United Kingdom could amount to between 6% and 9% of GNP.

One source of gains is the potential increase in labour supply - even though the after-tax increase in household income could adversely affect female participation and lead to a perverse decrease in labour supply - and the fostering of entrepreneurial incentives; another is the more favourable treatment of savings. Reform of corporate taxation has contributed to efficiency and has improved incentives favouring equity financing. The use of depreciation allowances has reduced differences in effective tax rates on real assets and has limited discriminatory tax treatment of investment in a variety of assets. Reform of local business taxation may be beneficial to the extent that differential regional rates are abolished.

Tasks remaining

Some important deficiencies remain to be addressed. Housing represents the most important component of personal wealth, reflecting partly the favourable tax treatment accorded. Since this has contributed to a (tax-induced) bias in the composition of portfolios and has raised residential investment, reform of measures affecting housing can improve the allocation of capital and

affect the economy's intertemporal performance, by encouraging a more entrepreneurial distribution of savings. More equal treatment of different forms of personal saving would be a step in correcting this distortion. However, incentives to channel savings through the institutions (insurance and pension funds) may partly be offset by ad hoc measures such as personal equity plans and the business expansion scheme.

Since effective personal tax rates can differ significantly from nominal ones, integration of the various sources of income is desirable. In particular, the social security system could be integrated with the personal income tax to minimize distortions and remove the disincentives introduced by the interaction of the two separate systems.

There continues to be a bias favouring debt financing arising from the deductability of interest costs. While the relief of dividend taxation removes some of the disincentives associated with equity financing, the possibility of further cuts in personal tax rates (at which the dividend credit is imputed) implies that the tax advantages of debt financing will increase.

To remove these anomalies further integration of the personal and corporate tax systems would be desirable.

In addition, since inflation can raise the tax burden in the absence of indexation, further steps could be taken to bring the basis for personal and corporate taxation closer to real capital income.

The rate of indirect taxation in the United Kingdom is low in comparison with the rest of the OECD countries. VAT is levied on about 56% of consumer spending, leaving 30% taxed at zero rate and the remaining 15% tax-exempt. Benefits could accrue from a broadening of the tax base.

One objective of public finance is to promote equity and, in this respect, tax reform has not been a contributing factor. The adoption of flat personal tax rates implies that the progressivity of the tax system is severely curtailed. At the same time, the increase in indirect taxes in 1979 had a regressive character. While it could be argued that the increase in consumption taxes would discourage spending, raise savings, and promote economic growth, personal sector savings in the UK have not responded to these tax incentives. Viewed from the perspective of equity considerations alone, the tax reform measures have made the tax system much less progressive and, according to Layard and Nickel (1989), have been a key factor in a significant increase in inequality since 1979.

BOX 2.2

PRIVATIZATION

Over the period since 1979 the British government has privatized more than 41 entities, 19 of which took the form of security sales on the London Stock Exchange while the remainder have been management buyouts and private sales. The stock market proceeds exceed UKL 18 billion while total privatization proceeds - including proceeds for the 1989/90 fiscal year - amount to UKL 27,7 billion. In comparison, equity funds raised over the same period by private companies amount to around UKL 24 billion. Privatization has reduced the state-owned component of industry by 45 percent since 1979. The accompanying table presents key data on the British privatization record.

In the initial stage an important argument was that through privatization the power of public sector unions would be restrained. Additional arguments in favour of privatization have been the beneficial impact of asset sales on the public sector finances, particularly in the context of the MTFs, widening of share ownership, and increased corporate efficiency. However, in the early 1980s the privatization policy was only a relatively minor component of the government's economic agenda. The successful sale of British Telecom in 1984 and its popularity with private investors provided the impetus to embark on a more ambitious privatization programme.

In addition to the sale of public enterprises, there have also been substantial sales of local authority-owned housing to tenants (capital receipts for housing of English local authorities amounted to over UKL 18 billion between 1981/82 and 1989/90), and many local authority and hospital services previously provided by public employees have been opened to private tender.

Privatization proceeds are treated as negative expenditure in the government's spending plans and they effectively reduce the reported PSBR and can distort the data on the level of public expenditure. The privatization proceeds initially were a major help in reducing the PSBR, and they now continue to swell the size of the public sector surplus, (although public finances are at present in surplus even if privatization proceeds are excluded).

In the UK, and in Western Europe more generally, public sector provision of various goods has been justified by actual or perceived failure of private markets to operate efficiently; a prominent type of this is the case of natural monopoly. However, privatization of such entities may not improve efficiency unless their monopoly position is open to challenge to the extent required to produce a competitive outcome. Failing this, regulatory measures have been used extensively. Privatization of regulated firms - telecommunications, gas, airlines, etc. - poses special problems since the incipient gains may offend the objectives protected by regulation. In this respect, the government retained special rights with nine of the privatized firms, and has placed limits on the size of single

shareholdings on several of them, even though these provisions are expected to lapse in the long run (as was allowed in the case of Jaguar, permitting its sale to Ford).

Introducing competition in certain public sector activities in the UK has improved efficiency as regards, for example, refuse collection and some hospital services. However, the existence of natural monopoly requires policies to distance the owner of the natural monopoly from activities where competition is possible since, otherwise, the monopolist would acquire the whole market. Such separation has occurred in the case of British Rail and the road-haulage and ferry businesses. It has not happened in the case of British Telecom and British Gas, where each now-privatized entity holds a dominant position in the industry. However, the Office of Telecommunications and the Office of Gas have been established to regulate prices and promote competition, even though the domain of the latter Office is restricted to promoting competition in the domestic market.

Has privatization contributed to economic efficiency in the United Kingdom? It is difficult to offer an unambiguous answer since a mixture of privatization of firms, operating already in a competitive environment, and of natural monopolies accompanied by regulatory rules, has occurred and the net impact on efficiency is unclear. At the same time, purchases of fixed assets by privatized firms have almost tripled, while value added by public corporations has declined significantly; approximately 750 000 employees have been transferred to the private sector; profits have increased; the stock market has received privatization issues with enthusiasm, and equity prices of privatized firms have traded initially well in excess of issue quotations; new managerial qualities have emerged and a re-orientation of public sector corporate culture has taken place.

The setting of the issue price appears to have been a major difficulty in the privatization process. The difficulty relates to the fact that assets of uncertain value are offered to the market: significant initial discounts have been necessary. Mayer (1987) estimates that, relative to normal discounts, the cost of privatization in the United Kingdom has amounted to over 10% of gross proceeds and relative to zero discount approaches 20% of gross proceeds.

Despite the increased share ownership brought about by privatization, the dominant shareholders in privatized firms are financial institutions. Concentration of share-ownership has in fact increased further during the years of privatization, and the influence of small investors in managerial matters has hardly changed as a result of privatization.

The water industry was privatized in December 1989, following a financial restructuring involving the writing-

<i>The British privatization experience, 1979 - 1990</i> ¹		
Financial Year	Firm	Total gross proceeds ² (UKL million)
1979/80	British Petroleum	377
1980/81	British Aerospace	
	National Enterprise Board Holdings	210
1981/82	Amersham International	
	Cable and Wireless	493
1982/83	Associated British Ports	
	Britoil	455
1983/84	British Petroleum	
	Britoil	
	Cable and Wireless	1 139
1984/85	Associated British Ports	
	British Telecom	
	Enterprise Oil	
	National Enterprise Board Holdings	2 050
1985/86	British Aerospace	
	British Telecom	
	Britoil	
	Cable and Wireless	2 707
1986/87	British Airways	
	British Gas	
	British Telecom	4 460
1987/88	British Airport Authority	
	British Airways	
	British Gas	
	British Petroleum	
	British Telecom	
	Rolls-Royce	
	Royal Ordnance	5 140
1988/89	British Airport Authority	
	British Gas	
	British Petroleum	
	British Steel	
	British Telecom	7 073
1989/90	British Petroleum	
	British Gas	
	British Steel	
	Water	3 580
		<u>27 684</u>

1) Including sales of government-owned shares in established public companies e.g. British Petroleum plc.

2) Including later instalments of receipts from sales in earlier financial years.

Source : HM Treasury (1990) : "The Government's Expenditure Plans 1990-91 to 1992-93", January.

Table 2.6 : The British privatization experience.

off of almost UKL 5 billion of debt. The ten water authorities were sold as separate entities. The initial payment for the 2,18 billion shares was UKL 1,00 per share; the cost of floatation was estimated at UKL 62 million. The government has announced the establishment of the Office of Water Services whose main function is to regulate price increases. The next major candidate for privatization is the electricity industry. The sale of the electricity industry will be the largest privatization so far. The

generation and supply distribution sides of the industry are to be split up to encourage competition. Further away the sales of British Rail and British Coal are in prospect. The shares still held by the government in already-privatized companies, e.g. 49% of British Telecom, may also be sold. The government's expenditure plans indicate that privatization proceeds are projected to continue at about UKL 5 billion per year (roughly 1% of GDP) until at least 1993-94.

CHAPTER 3

THE UK AND COMMUNITY ECONOMIC POLICIES

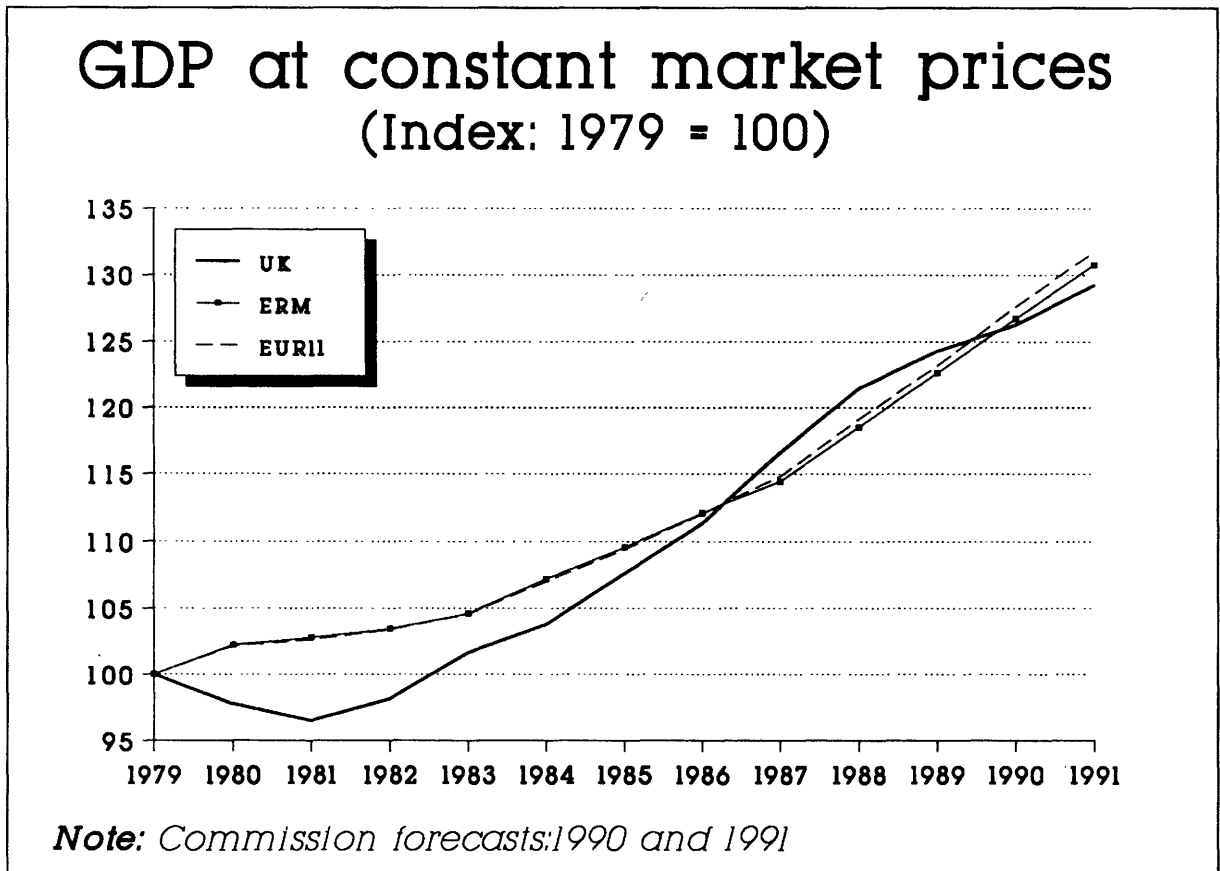
3.1 Macroeconomic policy and performance compared

Chapters 1 and 2 have surveyed UK economic policy and performance from a domestic standpoint. In the Community perspective both are distinctive and undoubtedly strongly interconnected. Macroeconomic policy has been dominated by an overriding difference from the UK's main Community partners : the decision not to participate in the exchange rate mechanism of the EMS and to rely instead on the government's own medium term financial strategy (MTFS). This in turn has contributed to the UK's having a cyclical performance and inflation record also quite different. The decision to remain outside the ERM has also reinforced the differences in performance arising from the UK's particular emphasis on structural reforms such as financial liberalisation and the consequent growth of credit. While the EMS issue is discussed primarily in the following section, its bearing on most aspects of performance should be borne in mind in what follows.

Table 3.1 summarises UK performance relative to the rest of the Community since 1979 (the assumption of office by the present government and also the inauguration

of the EMS), including Commission forecast data to the end of 1991, for five of the chief aspects : growth, price stability, current account balance and employment and unemployment.

Over the ten year period to 1989, and before making any allowances for cyclical differences, the record was broadly similar in important respects. Annual average *GDP growth* in the UK and the ERM countries taken together was virtually identical, at about 2 1/4% p.a. (Graph 3.1). *Inflation* in the UK, as measured by the private consumption deflator, was only slightly higher : 7% p.a. compared with 6 1/2% in the other countries (between which, however, performance was very disparate). Showing greater contrast, *employment* growth in the UK was significantly higher : about 6% for the period compared with 3 1/4% in the ERM bloc. The UK *unemployment* rate was on average higher, 9 3/4% against 8 1/2%, but was lower by 1989 : 6 3/4% against 8 1/2%. The average annual UK *current account balance*, which moved from a large oil and recession-induced surplus in the early years to a very large deficit at the end of the period, was a deficit of a little under 1/2% of GDP; this compares with an annual average for the ERM countries of a marginal surplus.



Graph 3.1 : GDP at constant market prices.

Table 3.1 : Main macroeconomic indicators 1979-91, UK and the Community

	1989/79	1989	1990 *	1991 *	1981/79	1988/81	1991/88 *
(i) GDP at market prices ¹							
UK ²	2,2	2,3	1,6	2,4	-1,8	3,3	2,1
ERM countries ³ :							
- D	1,8	3,4	3,7	3,7	0,8	1,9	3,6
- F	2,1	3,5	3,2	3,2	1,4	2,0	3,3
- I	2,5	3,2	3,1	2,8	2,6	2,4	3,0
- Other ⁴	1,8	3,8	3,2	2,8	0,6	2,1	3,2
Total	2,1	3,4	3,3	3,2	1,4	2,1	3,3
EUR 11 ⁵	2,1	3,6	3,4	3,2	1,3	2,2	3,4
(ii) Inflation : private consumption deflator ¹							
UK	7,0	5,8	6,6	5,1	13,6	5,3	5,8
ERM countries ³ :							
- D	2,9	3,1	2,8	3,0	5,9	2,0	3,0
- F	7,2	3,5	2,9	3,0	13,2	6,1	3,1
- I	11,2	6,0	5,5	5,0	19,3	9,7	5,5
- Other ⁴	4,4	2,6	2,6	2,8	8,4	3,6	2,6
Total	6,5	3,9	3,5	3,5	11,8	5,4	3,6
EUR 11 ⁵	7,4	4,7	4,3	4,2	12,7	6,3	4,3
(iii) Employment ¹							
UK	0,4	2,8	1,5	-0,1	-2,1	0,7	1,4
ERM countries ³ :							
- D	0,2	1,4	1,7	1,7	0,2	0,0	1,6
- F	0,1	1,7	1,5	1,4	-0,3	-0,1	1,5
- I	0,8	0,2	0,7	0,5	1,0	0,7	0,5
- Other ⁴	0,2	0,9	1,0	0,7	-0,6	0,3	0,9
Total	0,3	1,1	1,3	1,1	0,6	0,2	1,2
EUR 11 ⁵	0,3	1,6	1,4	1,2	-0,1	0,3	1,3
(iv) Unemployment ⁶							
UK	9,6	6,7	6,1	6,3	9,8	10,8	6,4
ERM countries ³ :							
- D	6,5	5,5	6,0	6,2	5,8	6,8	5,9
- F	9,4	9,5	8,8	8,1	8,0	9,9	8,8
- I	9,5	11,0	11,0	11,0	8,4	9,9	11,0
- Other ⁴	10,9	9,5	9,1	8,8	10,5	11,1	9,1
Total	8,8	8,6	8,5	8,4	7,8	9,1	8,5
EUR 11 ⁵	10,0	9,5	9,4	9,2	8,6	10,4	9,4
(v) Current account balance ⁷							
UK	-0,4	-4,1	-3,0	-2,8	2,0	-0,6	-3,3
ERM countries ³ :							
- D	2,0	4,5	4,3	5,1	-1,3	2,5	4,6
- F	-0,5	-0,4	-0,3	-0,2	-0,7	-0,4	-0,3
- I	-0,9	-1,3	-1,1	-1,5	-2,2	-0,4	-1,3
- Other ⁴	0,4	2,0	2,0	1,9	-2,2	1,0	2,0
Total	0,3	1,3	1,3	1,4	-1,6	0,7	1,3
EUR 11 ⁵	0,0	0,6	0,5	0,6	-1,8	0,4	0,6

*) Forecasts, April-May 1990

1) % p.a. change

2) Average measure

3) Countries participating in the exchange rate mechanism of the EMS (excluding Spain)

4) B, DK, IRL, L, NL

5) EC excluding UK

6) % of civilian labour force, SOEC standardised basis

7) % of GDP at market prices

Source : Commission Services.

Cyclical differences were, however, important, such that the foregoing aggregate figures convey little indication of the very different path followed by the UK economy during this period. In the UK the 1980-81 recession was particularly deep, with GDP falling 3 1/2% and manufacturing output 10%, and with the unemployment rate rising to over 10% (as explained in greater detail in Chapter 1). In the continental economies the growth pause was more subdued but also longer lived. Growth was hit by the second oil shock, but there was nothing corresponding to the severity of the real exchange rate appreciation experienced by the UK. Domestic demand growth continued to be feeble, and thus the 1982 US recession was significant in aborting an incipient recovery: German GDP actually contracted in that year. Growth resumed in 1983, but initially only very weakly as the reorientation of French macroeconomic policy in that year hit output in France and Belgium.

The most recent UK cycle in terms of output growth thus began from a trough in 1981 and peaked in 1988; the employment growth cycle lagged by about two years (spring 1990 seems to mark the trough of unemployment, following the 1988 cyclical peak in output growth). The ERM countries have experienced a more attenuated cycle, from a trough in 1983 building up towards strong growth in 1988 with a clear peak not yet having clearly been reached (a weakening in the second half of 1989 may have represented a peak, with strong growth expected this year representing fresh impetuses from structural changes in eastern Europe and from anticipation of the single market); employment consequences have also been lagged. Current short-term prospects suggest that depressed conditions in the UK may only lift after a year or so, while growth in the ERM countries will remain reasonably buoyant.

Depending on which periods are selected, UK-ERM comparisons will thus vary considerably, with inclusion of the 1980-81 periods and 1989 onwards, when the cyclical and policy-induced slowdown began to take effect, proving less flattering to the UK. The approach taken here is to refrain from over-emphasising such period comparisons. Nevertheless, some such are hardly avoidable. Table 3.1 gives data with sub-periods largely based on UK experience: 1981/79, 1988/81 and (using Commission forecasts for 1990 and 1991) 1991/88; the mismatching with cycles in other countries should be noted. The middle period is obviously when UK performance appears most relatively favourable. GDP grew by 3 1/4% p.a. against 2% p.a. for the ERM bloc. Employment, still declining in 1982 and 1983, grew on average by 1% p.a. compared with a bare 1/4% p.a. in the ERM countries. Unemployment declined from 1986 from a higher proportion of the civilian labour force than in the ERM bloc to a smaller proportion by 1988. In 1987 and 1988, employment creation in the UK was greater than in the rest of the ERM countries taken together. Only Spain among the larger countries (and outside the ERM until 1989) has recorded a higher rate of employment creation since 1986, while growth in Germany and France has been much more modest.

The chief obvious failing in this otherwise mainly impressive performance was in *price stability*. By 1988 UK inflation as measured by the private consumption deflator was clearly higher than in any of the ERM countries (5% p.a. compared with 2 3/4% on average and 4 3/4% p.a. for Italy, the highest rate). However, this failure was only evident towards the end of the period, and clearly had much to do with the large sterling depreciation of late 1986 and the overheating which then gathered pace. From 1982 to 1986 UK inflation was actually lower, on average, than in the ERM countries (7% p.a. against almost 8 1/4% p.a.). Nominal unit labour cost growth in the UK was even lower, 4 3/4% p.a., with the recovery in profitability achieved partly through higher margins contributing to inflation. That the later acceleration in inflation was not higher owed much to the deterioration in the current account, which reached a measured deficit of almost 2% of GDP in 1987 and over 4% in 1988, after a rough overall balance in the 1982-86 period. This compares with an average annual current account surplus of 3/4% for the ERM countries (2 1/2% for Germany alone).

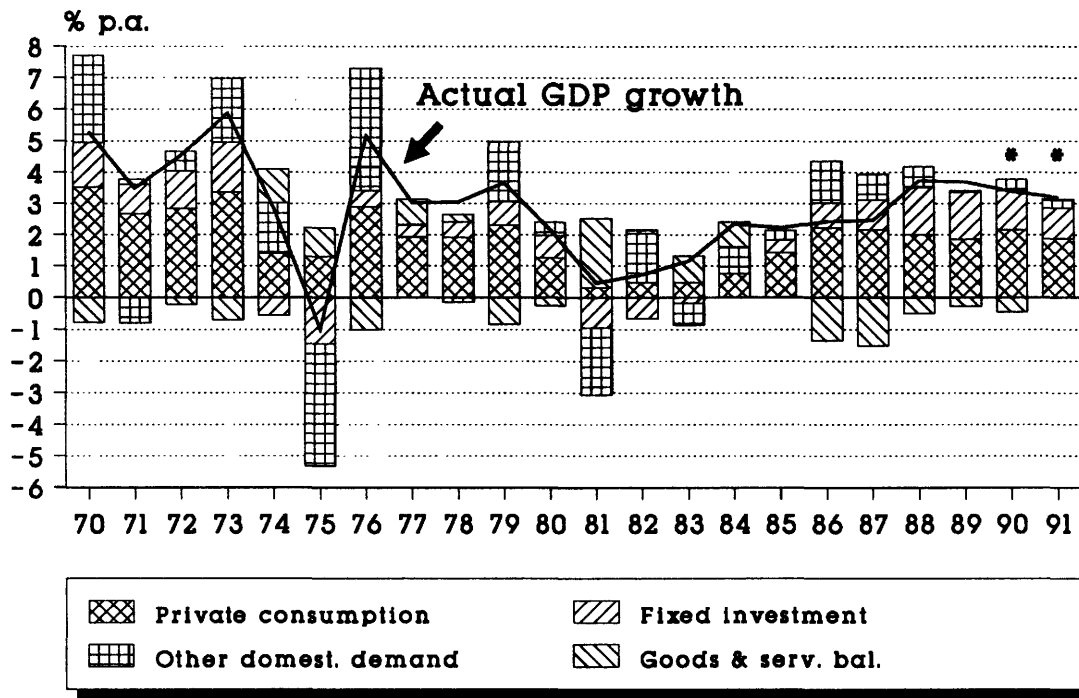
A relatively successful performance for the UK in the middle of the decade was thus not uniform. Drastic disinflation and more rapid growth in the early years were achieved partly at the price of the particularly deep recession in 1980-81. In turn this success was progressively eroded from 1986 onwards by overheating and exchange rate instability; final domestic demand growth rose from 4 1/4% in 1986 to 5 1/4% the following year and over 7% in 1988. This compares with unspectacular but more consistent performance by the ERM countries.

Recent relative performance and short-term prospects represent an attempted unwinding in the UK of the earlier overheating, together with downward cyclical influences that would probably have arisen even with earlier steadier growth. In contrast growth has increased in buoyancy in the ERM countries, from 2-2 1/2% p.a. in the mid-1980s to around 3 1/2% p.a. from 1988. Unemployment has remained very high but has been edging down. Employment growth has accelerated. Inflation has accelerated modestly, as in most industrial countries. The current account surplus, dominated by a growing imbalance for Germany, is running at around 1-1 1/2% p.a. Against most yardsticks economic performance has qualitatively improved (significantly for certain smaller ERM countries) but is not signally different from earlier in the 1980s.

The different pattern of *demand growth* since 1979 can be seen by comparing Graphs 1.6 and 3.2. What distinguishes the UK's experience, beyond its pronounced cyclical character, is the strong relative role of private consumption growth, a product of both rapid real wage rises and a falling household saving ratio, and vigorous investment. While the saving ratio has fallen in other Community countries during the 1980s (especially in France and Belgium), the severity of the decline in the UK has not been matched elsewhere.

That private demand growth, particularly of private consumption, could be, and was, so much stronger in the

Contributions to GDP growth : EUR-11



* Commission forecasts

Graph 3.2 : Contributions to GDP growth : EUR-11.

UK reflects to a unique degree institutional features and experience during the 1980s. The strength of *consumer spending* owed much to the combination of financial liberalisation, the entrenched use of the housing market for the holding of household wealth and the marked change in expectations once employment began to rise. The strength of household credit growth, partly through the mechanism of "equity release" for existing property owners (the taking out of second or higher mortgages with collateral provided by rising property prices, the credit proceeds of which were then partly channelled into other consumer spending), had no parallel elsewhere in the Community. In these other countries, however, the pattern of demand growth has not been uniform. Some similarities to the UK's experience of rapid domestically led growth can be found in the experience of Italy and the new members, Spain and Portugal. Here, too, there have emerged tensions on the current external balances. In the ERM countries taken together, growth, lower overall in 1982-1988, has been more balanced between internal and external demand. The recovery of *fixed investment* expenditure has also been a general phenomenon in the Community and elsewhere, helped by a recovery of profitability, but the growth has been less vigorous than in the UK. *Public consumption* growth in the ERM bloc has been only a little less than GDP growth.

The foregoing comparison of the UK with its Community neighbours at the whole economy level does not

yield unambiguous judgements : the underlying problems at the beginning of the decade were different in the UK in nature and scale. This could be seen most clearly in the initially weak condition of UK *manufacturing*, hit hardest during the 1980-81 recession. A slimmer manufacturing sector survived to achieve substantial output and productivity growth during the 1980s, and even for a time expanded employment (Table 3.2); profitability rose towards international levels. In international comparison UK manufacturing productivity growth in the 1980s, at about 5 1/2% p.a. after 1981, comfortably exceeded that in other major industrialized countries, where growth slowed from the pre-1973 period. The unweighted average for Germany, France and Italy, for example, is under 3% since 1979 compared with about 5% up to 1973 and 2 1/2% in the intervening period. Nevertheless, there has been a strong cyclical element in UK performance which has weakened with slower growth of production.

Commission data also confirm that in the industrial sector alone the UK still records substantially lower *productivity* than in all three other countries, reflected in a lower level of employee compensation. In 1988, for example, UK industrial productivity was about one quarter below the level of France and Germany and a fifth below that of Italy. On the other hand, compensation per employee was also higher outside the UK, ranging from some 10% higher in Italy to approaching 40% higher in Germany. As noted in Chapter 1, service sector produc-

Table 3.2 : Manufacturing in the UK, Germany, France and Italy

	1989/79	1989	1990 *	1991 *	1981/79	1988/81
(i) Output ¹						
UK	1,3	4,8	1,2	2,0	-7,3	3,3
D	1,0	4,8	4,5	4,5	-0,8	1,0
F	0,6	3,8	3,7	3,5	-1,1	0,7
I	2,6	5,3	2,9	2,7	1,7	2,8
(ii) Employment ¹						
UK	-2,8	0,5	-1,0	-1,5	-6,3	-2,3
D	-0,6	1,6	1,7	1,8	-1,0	-0,9
F	-2,0	0,4	0,5	0,5	-2,3	-2,3
I	-1,4	0,6	0,2	0,2	-1,1	-1,8
(iii) Labour Productivity ¹						
UK	4,2	4,3	2,2	3,5	-1,1	5,8
D	1,6	3,1	2,8	2,6	0,2	1,8
F	2,7	3,4	3,2	3,0	1,2	3,1
I	4,1	2,7	2,7	2,5	2,9	4,6

* Forecasts, April-May 1990

1) % p.a. change

Source : Commission services

Table 3.2 : Manufacturing.

tivity growth has not undergone any dramatic change in recent years. Levels of whole economy productivity in the UK thus remain generally lower than in other major countries with the exception of Japan (Graph 3.3).

The strategic policy choices made by the UK in the 1980s to tackle its underlying problems were very distinctive and the consequent cyclical divergences, still to be played out to a point where simple comparisons are not inevitably misleading, are significant. It is clear nevertheless that there has been an important relationship between policy and performance, and also clear in the UK case that there were serious policy errors, both active and passive, from 1986 onwards. UK macroeconomic policy both contributed directly to overheating and a resurgence of inflationary pressure, and indirectly in its lateness to recognise and react to the strength of overheating.

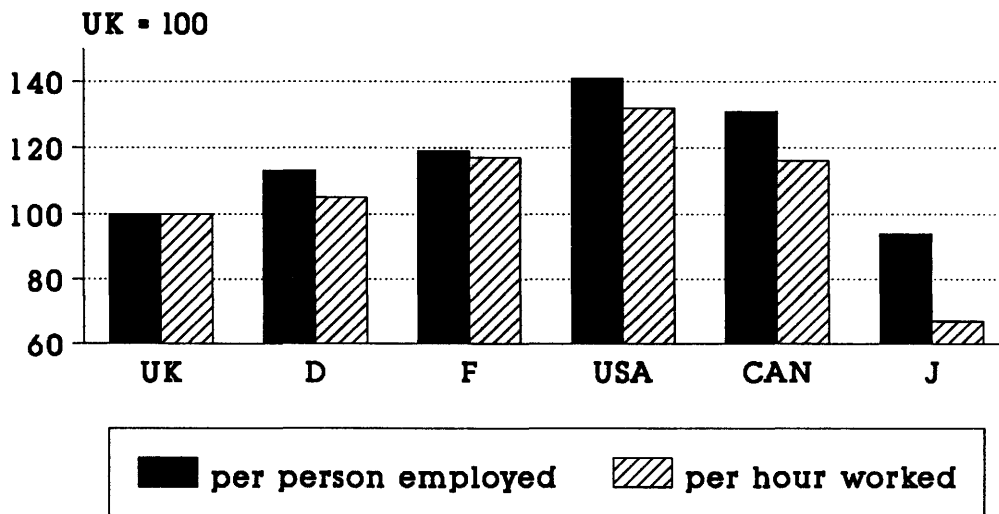
What is less clear in the policy/performance nexus is whether recent UK errors were strategic (the choice of an independent MTFs rather than ERM strategy) or more tactical (operational) in nature. For example, would an MTFs restricted to fiscal policy, an analogous approach to monetary policy directed by an independent central bank, and perhaps a slower pace of financial liberalisation, have been more successful in delivering low inflation? The issue is important in the Community context, and underlies much of the ERM debate discussed in the next section. Again, conclusions cannot be clearly drawn, and risk being only of historical importance given the UK commitment to ERM participation during Stage One of

EMU. Nevertheless, the UK authorities could convincingly point to success in the early to mid-1980s, continued strong output and employment growth subsequently, and evidence of a higher path of potential output growth as broadly justifying their approach. The failure to carry forward early success in establishing price stability needs to be seen in this overall context, as does thus the currently main alternative approach - ERM participation - to reestablishing it.

In the UK the resurgence of inflation has tended to emphasise the importance of exchange rate and monetary policy at the expense of the broader thrust of macroeconomic and *public sector policy*. Here, however, from the beginning of the 1980s the contribution of the present government's approach in helping to lead a reorientation of policy within the Community has been significant: the 'conventional wisdom' has changed in consequences.

There have been a number of strands. One of the main is to stress the greater efficiency and thus desirability of the private (roughly equated with market) sector vis-à-vis public (equated with non-market) sector. Much of this policy reorientation is microeconomic in nature but with important macroeconomic consequences. Thus one message was that the government should in the first instance reduce and then contain the size of the public sector, both as regards the direct absorption and management of resources and public transfers. State enterprises are privatised; public expenditure growth is restrained. This permits a combination of a reduced tax burden and reduced deficits and hence debt burden, transferring greater

Relative productivity levels, 1986 GDP per pers. employed & per hour worked whole economy



Source: OECD

Graph 3.3 : Relative productivity levels, 1986.

resources to the private sector. Within a reduced public sector economic efficiency is emphasised. Public administration is made more efficient by limiting staff numbers and to some extent simulating market mechanisms. Social transfers are the object of severe restraint. The tax system is overhauled and generally made simpler and less discriminatory, a combination of fewer allowances and rates and thus permitting lower schedules.

Much of this approach was also led, outside the Community, by the US, a classic example being the tax reforms enacted in 1986. The joint example of these two countries, and the fervour with which reform was espoused in the UK, were undoubtedly influential in changing the mood within the Community. Impatience with growing *public deficits, debt and tax burdens* hardened. *General government expenditure* as a proportion of GDP reached a peak of 50% for the EC-11 in 1985 and has been edging down since; current receipts have been stabilised at 44-45% of GDP since 1983. General government deficits peaked at 6 1/4% of GDP for the EC-11 in 1983 and by 1989 were under 4%; the reduction in the primary deficit (excluding debt interest) is greater, from 2 1/2% of GDP in 1981 to a surplus of over 1 1/4% in 1989. Countries where policy recognisably changed stance include Germany (1982), France (1983), Belgium (1985) and Ireland (1987), in the latter two cases because of threatening public finance and external debt servicing situations.

The changes recorded above for the rest of the Community in aggregate have been less dramatic than in the UK (probably reflecting, inter alia, differing abilities and wishes to effect radical political change). In many instances progress elsewhere seems undesirably slower, as for example the reduction of industrial subsidies or the retention of tax systems incompatible with greater international economic integration. Progress in improving the structural efficiency of their public sectors (government, agencies and utilities) appears much less impressive in other Community countries, even when the intent is acknowledged. In many of these areas an agenda established in the early 1980s, notably by the UK, is still being pursued.

The UK approach to macroeconomic policy itself was discussed in Chapter 2. Emphasis in public expenditure planning and taxation policy is given to a medium term approach, the progressive attainment of targets relating to the size of the public sector or the level of public deficits and debt/GDP ratios. Short-term fiscal activism is thus explicitly shunned, as being unlikely to be operationally beneficial given the uncertainty and variability of lags in the system. Monetary and exchange rate policy have been oriented explicitly to price stability. Given the obvious difficulties the UK has experienced, it is here that policies have been most subject to revision, from an originally fairly simplistic monetarist approach in the first MTFS (1980) to an almost completely judgemental approach in the recent years.

Strategic policy in this field in the other countries has also bent towards the UK approach, but far more selectively. A medium-term approach to fiscal plans accords with the needs of budgetary constraint in several countries, while others (Germany, for example), have only ever exceptionally attempted short-term stabilisation via changes in fiscal stance. The most obvious difference is, of course, the role of the EMS and the exchange rate mechanism, and it is this to which attention is now given.

3.2 The UK and the EMS

3.2.1 Exchange rate policy and developments

Following the removal of exchange controls in October 1979, and of other barriers to free capital movements, the external value of sterling was left to be determined by market conditions without intervention to influence currency movements. Consistent with monetarist principles, sterling was left to appreciate, reaching its peak at the beginning of 1981. This occurred during a period of declining interest rates. In subsequent years, the realisation that monetary targetting could not be relied upon to signal adequately the course of nominal income led the government to extend the range of monetary and economic indicators used to evaluate economic policy. The exchange rate became a key indicator in the post-1982 period, and gained further prominence in the period following the Plaza Accord (September 1985).

The real exchange rate appreciation in the 1980-82 period contributed significantly to the difficulties in industrial adjustment but was also a key factor in the disinflation achieved. However, the experience suggested that foreign exchange markets could take currencies persistently far from fundamental equilibrium, and the behaviour of the dollar offered further support to this view. In the post-September 1985 period policy aimed at stabilising the external value of sterling, in sharp contrast to the 1979/81 period when the Chancellor opposed intervention. During this latter period the exchange rate became a central element of monetary policy. The currency suffered a particularly sharp decline in 1986 associated with the collapse in oil prices, and interest rates were raised in response.

The objectives of exchange rate policy became particularly uncertain in the period between March 1987 and the spring of 1988. Initially, the stock market collapse of October 1987 provided the rationale for interest rate reductions; subsequently, sterling was trading in a narrow range against the DM, and when it rose above 3.00 DM interest rates were cut or intervention was intensified. This shadowing of the DM restricted the leeway with which these instruments were used. Expectations that the exchange rate would be maintained led to large capital inflows. The incipient appreciation was offset through in-

tervention which led to an increase in money supply growth. The implied policy conflict was resolved in the summer of 1988 when interest rates started rising in stages to tighten monetary conditions and sterling was allowed to appreciate.

The currency came under continuing pressure from the end of 1988. The key factor was the deterioration of inflation expectations and of expectations for depreciation in an environment of robust domestic demand. In November 1989 sterling weakened when the Chancellor of the Exchequer, Mr. Lawson, resigned over the implicit issue of the degree of priority to be given to sterling's joining the ERM. The currency has remained weak in the first half of 1990 and has displayed considerable vulnerability to adverse expectations concerning domestic economic prospects. The debate about whether and when the UK should join the ERM became increasingly intense as the absence of a nominal anchor and of a commitment to sustain an exchange rate target came to be accorded greater importance as factors underlying much of the recent resurgence of inflation.

3.2.2 The UK and the ERM

The UK participates in two features of the European Monetary System (EMS) : the European Monetary Co-operation Fund (exchanging 20% of gold and foreign currency reserves for ECUs), and the ECU of which sterling forms part of the basket of currencies. The UK is not a member of the central Exchange Rate Mechanism (ERM); both the Labour government in office at the time of the EMS's inception (March 1979), and the Conservative government which succeeded it in May 1979 chose to stay outside the ERM.

The urgency in deciding whether to join the ERM or not has become particularly pronounced in the post-1988 period. During this period the monetary aggregates have failed to serve as an adequate intermediate target to contain inflation : the MTFs framework has been of dubious value to stabilise expectations and wage and price pressures have intensified in response to earlier overheating. All these are in sharp contrast to the experience of the ERM economies. In addition, the accelerating process of European integration has focused attention on the pressure for the UK to join the ERM and become a more active actor in the emerging institutional arrangements. The success of the ERM in promoting exchange rate stability and convergence, and the deterioration in UK macro-economic conditions, were key factors in the government's commitment, made in the Madrid European Council of June 1989, for sterling's participation in the ERM when certain conditions had been fulfilled¹.

Arguments against membership have been numerous; some have focused on maintaining freedom to improve

1) According to the government, the following conditions should be satisfied before UK membership becomes effective : a decline in UK inflation; removal of exchange controls by EMS members; sufficient progress towards completion of the internal market; liberalization of financial services; and agreement on competition policy.

competitiveness through exchange rate depreciation, others on the special role of sterling as a major investment currency (and formerly on its petro-currency status). As regards the first argument, it should be noted that real, not nominal, exchange rates determine competitiveness and, in this respect, pegging the nominal exchange rate requires a reduction in inflation to improve competitiveness. This is consistent with the counter-inflationary performance of the ERM. However, nominal exchange rate adjustment could change the real exchange rate in the short-run, even if the effect is not sustained. Clearly, nominal exchange rate adjustments fully offset by price changes do not constitute changes in competitiveness.

Sterling's role as an investment currency can be exaggerated. It is clearly not commensurate with London's importance as a financial centre, where much internationally oriented business is conducted in other currencies. Nor is sterling a major store of international wealth. Rather the risk seems to be that the relative breadth and liquidity of sterling markets could lead to particular volatility. Nevertheless, ERM participation could reasonably be expected to reduce this.

A more critical argument notes the previous extensive reliance on capital controls in certain ERM countries as a means of maintaining a greater measure of monetary independence. However, in the UK controls have been abolished; a tendency towards (uncovered) interest parity must then hold if the sterling exchange rate is fixed within the ERM². In other words, since interest differentials in a world of unrestricted capital mobility reflect expected depreciation, fixing the exchange rate exerts pressure on nominal interest rates between countries to converge. This convergence of UK to continental interest rates may be inappropriate for domestic macroeconomic objectives. In particular, if nominal interest rates in the UK were to converge to levels prevailing in low-inflation countries, this may cause UK monetary growth to accelerate with further inflationary implications. Alternatively, an inflationary shock, with quasi-fixed interest rates, would lower the real rate of interest in the country experiencing an inflation acceleration; this is contrary to the monetary contraction required to offset the shock. In these circumstances the system would be unstable as expectations for realignment and depreciation of sterling would emerge, leading to balance of payments crises associated with reserve losses occurring in an attempt to support the parity. Outside the ERM, an inflationary shock could be countered by interest rate increases as well as currency appreciation. Thus ERM participation, while it could possibly contribute to lowering interest rates and inflation in periods of stability, could also play a destabilizing role in periods of turbulence.

This argument is important in view of current counter-inflationary policy in the UK. Since fiscal policy is determined by the MTFSS targets, the burden of combatting inflation has been carried by monetary policy. For short-term stabilization purposes, an inflation acceleration would reduce the value of the fiscal surplus in real terms and would lead to a perverse movement with regard to the stabilization objectives. As interest rates would be largely determined by ERM obligations, there would be no instruments available to respond to the inflationary shock. This may become an important restriction on the country's ability to contain inflation, but is a consequence of the chosen policy design. As Artis (1989) points out, the particular policy mix is politically determined and there is no reason why more flexibility in fiscal policy should not be used to support monetary policy. It could also be argued that, since ERM participation could yield substantial credibility returns, the commitment to medium-term fiscal targets could to some extent be relaxed without destabilizing the expectational environment. Finally, ERM membership would still leave a margin for exchange rate adjustment since at present the system is far from a fixed exchange rate arrangement. It would, therefore, leave considerable room for UK interest rates to continue diverging from interest rates in other ERM countries with the extent of the divergence depending on the permitted fluctuation margins. The experience of the ERM countries shows that divergences in national interest rates continue to exist, reflecting not only exchange rate uncertainty but also country-specific policy and other characteristics (tax laws, discriminatory measures, controls on investment flows, high indebtedness, etc.), as well as imperfect substitutability between various financial assets. While a tendency towards interest rate convergence has occurred over the post-1979 period, UK interest rates could enjoy some degree of independence which could be used for domestic stabilization.

The sustainability of exchange rates in the ERM depends also on the extent to which UK and other countries' macroeconomic structures and policy objectives differ and, consequently, influence exchange stability. With respect to the latter, UK policy objectives could be regarded as identical with those of the ERM countries, thus removing one source of macroeconomic disturbance. However, when macroeconomic structures differ, fixed exchange rates are suboptimal, even in the presence of common policy objectives, in the event of shocks. Real exchange rate realignments are then an essential mechanism to redistribute the costs of disturbances among member countries when production cannot be relocated³.

Two considerations can be invoked to support the argument that the UK and the EC economic structures differ. First, the UK labour market is characterised by various rigidities which, even in the presence of supply-

2) These points have been associated with Sir Alan Walters' opposition to ERM participation. A related discussion can be found in F. Giavazzi (1987).

3) See F. Giavazzi (1987) : op. cit.

side reforms, continue to play a key role in the wage determination process. In particular, skill imbalances and the housing market limit labour mobility : both would thus accentuate the inflationary or deflationary consequences of an external shock and could contribute to undue strains on the exchange rate.

Secondly, there are arguments based on optimal currency area criteria. For example, Holmes (1989) notes that, unlike Germany, the UK has a greater propensity to import goods, and a surplus on the invisibles account; the structure of the British balance of payments is such that the deficit in visible trade is partially offset by the surplus in invisibles; the opposite holds for Germany. Holmes concludes that the German economy is less open than the UK.

Both considerations would tend to be less important over the medium term. Improving labour market flexibility is a continuing concern in all member states, but relative to other countries it could yield substantial efficiency gains in the UK. Significant improvements are likely to take place in the coming years, partly in response to the completion of the internal market, even though an important degree of inertia may continue to characterize labour markets. These improvements will lessen the impact of deflationary or inflationary shocks, as labour (and capital) move towards the expanding sectors with greater ease and limit the need for exchange rate changes.

The degree of openness of an economy has been an important consideration in the theory of optimum currency areas. According to McKinnon (1963) the need for exchange rate changes in response to external shocks is a diminishing function of the extent to which the country in question participates in international trade. As each country produces tradable goods and services and non-tradables, and since factor mobility between the two sectors may be limited, fixed exchange rates are appropriate for countries which consume a basket of goods where tradables are prominent; for countries which consume primarily non-tradables flexible exchange rates are appropriate. This is due to the fact that fixed exchange rates imply fixed real balances in terms of tradable goods, for given prices of tradable goods; while flexible exchange rates imply variable real balances in terms of tradable goods. Contrary to Holmes' argument, the openness of the UK economy strengthens the case for its participation in the ERM since the value of money in terms of tradables would then be fixed. Finally, the programme for the completion of the internal market and liberalization of capital movements will enhance the openness of all EC economies and will have an important impact on the pattern of their international transactions; this development weakens substantially arguments based on differential trade structures.

Improving the economy's flexibility through structural policy initiatives such as those pursued by the UK, raises the economy's ability to adjust to an exogenous shock. Limiting exchange flexibility could nevertheless raise the costs of adjustment. Were the UK to join the ERM, an

important policy instrument would not be available to restore equilibrium in the event of a shock. This, however, must be viewed in the light of the increased flexibility of the UK economy over the 1980s. A fixed exchange rate for sterling is primarily for this reason more sustainable at the beginning of the 1990s than in previous years :the economy is more flexible. Since exchange rate flexibility and allocative flexibility can substitute for each other to achieve economic stabilization, as shown by the theory on optimum currency areas, it is likely that the potential stabilization costs may be less than conventionally assumed. Limiting exchange flexibility in these circumstances could then enhance the potential of counter-inflation policy because the need for currency realignments would correspondingly decline as the exchange parity became sustainable and therefore credible.

The balance of the arguments for and against UK participation in the ERM indicates that substantial benefits could be reaped if such a step were taken. The key argument against membership, the insufficiency of instruments to control inflation when domestic interest rates converge towards rates in other ERM countries, is important only to the extent that the limited role of fiscal policy in stabilization in the UK is politically determined. On the other hand, the exchange rate regime could become a critical disinflationary vehicle by anchoring expectations and thus changing wage and price behaviour.

Since the Madrid European Council additional progress has been made in furthering European integration, and the conditions set by the UK for ERM membership have substantially been met, with the exception that UK inflation has accelerated. In recent official statements the deterioration in inflation performance has been the key argument for postponing membership, while noting that joining the ERM during stage one of the move towards monetary union, beginning on July 1, 1990, remains the government's objective. The UK has chosen to lower inflation outside the ERM, rather than join the ERM at the current rate of inflation and disinflate within the system's constraints. With downward wage and price inflexibility and with UK inflation differentials worsening, it might appear suboptimal to abandon the option of gradual nominal exchange depreciation to restore competitiveness. However, this can become entrenched behaviour, as the experience of the past two years has shown. At the same time, comparing the experience of the ERM countries and the UK during the 1980s, it is evident that the former have achieved remarkable stability and that the ERM has promoted convergence among the member states, while the UK has displayed greater macroeconomic instability. In the absence of a credible counter-inflationary policy commitment, as currently appears to be the case, ERM membership could speed up the process of disinflation by offering the most convincing policy option for economic stabilisation.

3.2.3 Some evidence on the impact of ERM membership

Medium-term simulations of full ERM membership for the UK economy have been performed by the NIESR (National Institute for Economic and Social Research)

Table 3.3 : NIESR Simulations : The consequences of EMS membership, 1989-1993

	Effective exchange rate (1985=100)		Short-term interest rate (%)		Real short-term interest rate ¹ (%)		Unemployment (millions)		Retail price inflation (% p.a. change)	
	B	ERM	B	ERM	B	ERM	B	ERM	B	ERM
1989	93,7	94,3	13,5	13,3	5,7	5,6	1,8	1,8	7,8	7,7
1990	88,8	96,8	14,0	11,4	7,3	7,4	1,6	1,6	6,7	4,0
1991	85,1	98,3	13,0	7,4	7,5	6,8	1,7	1,7	5,5	0,6
1992	81,3	99,0	13,0	5,3	8,7	6,2	1,8	1,9	4,3	-0,9
1993	77,4	99,4	13,0	5,2	8,5	5,5	1,8	1,9	4,5	-0,3

B = Base case forecast

ERM = ERM participation simulation

1) Calculated with the RPI inflation

Source : B. Anderson, A. Britton, and P. Gregg (1989).

Table 3.3 : NIESR Simulations.

using their UK econometric model (see National Institute Economic Review (1989)). Sterling was assumed to move in line with a weighted average of the DM, the French franc, and the lira relative to non-ERM currencies. It was further assumed that UK short-term interest rates moved gradually over a period of two years towards the average of European rates. ERM participation was assumed to begin in the fourth quarter of 1989. The results of this simulation were contrasted with those of the main NIESR forecast.

Key variables from these projections are shown in Table 3.3. The results suggest that Britain's inflation problems would be alleviated and a period of rapid disinflation and declining interest rates would emerge. Underlying this is a projected exchange appreciation (5,4% between 1989 and 1993 in the ERM case against a 17,4% depreciation projected in the base case)⁴ and an assumed fiscal contraction which leads to a public sector surplus (PSDR) of 6% of GDP, compared to 3% in the base case. The contractionary effect of exchange appreciation and of fiscal restraint is more than offset by the decline in interest rates so that the output and employment effects of ERM participation appear to be small. Real interest rates are significantly lower than in the base projection, and follow a declining path; in 1993 the real short-term rate is three percentage points lower than in the base projection.

What difference would ERM participation have made to British macroeconomic performance over the past ten years? In a retrospective simulation made by the National Institute, which assumed that membership com-

menced in 1979, it was suggested that this would have initially worsened the inflation situation but subsequently have reduced it significantly. This reflects the fact that the exchange rate would have been lower than the actual rate in the early 1980s, and an important disinflationary mechanism would not have been operative. The opposite occurs in the period 1986-1988. While the performance of the real economy in the ERM case is very similar to what actually happened, membership would have further increased inflation when it was high and would have reduced it further when it was low. It can be argued that the UK avoided the implied inflation variability by not joining the ERM in 1979. This simulation indicates that the timing of UK ERM participation should be considered in the light of domestic inflation developments, since exchange rate appreciation remains an important disinflationary instrument. Its importance should be balanced against the effect participation could have on inflation expectations. If the latter effect is substantial, an ERM-induced disinflation could develop irrespective of the current rate of inflation. However, it is not possible to quantify the effects of the change in the exchange rate regime on wage and price behaviour.

Abolition of controls over international capital movements was a major policy initiative by the UK government, and an important step in advancing financial market integration in the EC. However, free capital mobility and participation in the ERM are complementary policies, in that the prevailing system permits capital market liberalization in the context of exchange rate stability, and requires closer policy cooperation to strengthen the system. The Commission itself has argued

4) The exchange appreciation is based on an assumed depreciation of the US dollar during this period.

that sterling's absence from the ERM poses problems for the UK, its closer trading partners, and the EC as a whole⁵. Other commentators have argued that the UK, while tacitly pursuing a policy of exchange rate stability against key EC currencies, does not enjoy the benefits of policy credibility arising from the formalization of the arrangement, even though "the credibility of the exchange rate commitment is far more valuable than the credibility of the MTFS in affecting inflationary expectations"⁶. Among the difficulties caused for other countries, sterling's non-participation in the ERM has made it difficult for Ireland to proceed with the removal of exchange controls. For the Community as a whole, plans to go beyond an area of free trade, towards a system of closer policy coordination, have been rendered more difficult as a result of sterling's absence from the ERM.

UK participation in the ERM will thus benefit not only the country but also the EC as a whole. The government's clear undertaking to join the ERM, made at Madrid in June 1989 and reconfirmed subsequently, represent an important development in this respect.

3.3 The UK and the Single Market

3.3.1 From domestic supply-side reform to the Single Market

The programme envisaged for the completion of the internal EC market involves removal of all visible national barriers to trade in products, standardization of trade in services, abolition of qualitative restrictions on trade and removal of preferential treatment of national firms by national governments. By unifying the twelve national markets into one large, EC-wide market, the objective is to exploit scale economies and associated cost declines, to promote efficiency by fostering competition, and to enhance the growth and job-creation potential of the member countries in an environment of stable prices.

The United Kingdom government has been a strong supporter of the internal market programme. Its own early emphasis on domestic supply-side measures to improve economic performance extended naturally to espousing a wider Community approach aimed at competitive deregulation and the removal of non-tariff barriers to trade which are at the heart of the single market process. UK official support is thus partly philosophical. However, an appreciation of national interest also undoubtedly plays a role, as in an expectation that, for example, certain UK industries such as financial services will benefit from more open markets within the Community. In practical terms the UK has been the leading member country in terms of adopting single market directives in national legislation. As of the end of February 1990, of 158 directives passed at Community level (out of the 279 in the 1985 White Paper), the UK had legis-

lated in respect of all except nine. This compares with a gap of 51 in the case of Italy, for example.

There are, however, obvious areas of concern to the UK (and often other countries') authorities. This applies particularly when Community proposals are thought to impose unacceptable constraints on national sovereignty. Issues relating to fiscal harmonisation, discussed below, are a case in point. Another, related rather than integral to the internal market, is that of the "Social Charter" which is thought to run counter in philosophy to the government's deregulatory approach to employment legislation and the provisions of which are regarded as potentially damaging to employment if put into practice.

3.3.2 UK policies and the Single Market

Certain policy areas stand out for their relevance to the single market programme while not always formally part of it. They include liberalisation of capital flows, taxation and competition policy. The UK's approach has been distinctive in all three areas.

Liberalisation of capital movements

With certain exceptions for Ireland, Greece, Spain and Portugal, all international capital flows should be freed from control from 1 July 1990. In the UK, however, all controls were removed in 1979 and the UK became the leading example within the EC in the liberalization of capital movements. The measures in question were applicable to portfolio and direct investment, holdings of foreign currency deposits by residents, and sterling lending to non-residents by UK banks and by the non-bank sector. Restrictions on sterling-financing of third-party (that is, non-UK) trade is thought to have diminished the international role of the currency.

In the pre-1979 regime, foreign currency required to finance portfolio investment by domestic residents had to be obtained from the sale of existing foreign-currency denominated assets or from foreign currency borrowing, thus contributing to the creation of an investment currency market. In this market investment currency was at a premium which on occasion was in the range of 30-50%. Foreign currency holdings by domestic residents were restricted to those representing working balances, while sterling lending to non-residents was restricted to trade-related requirements. Direct investment flows were generally restricted when the foreign currency required to finance overseas investment was obtained at the official sterling exchange rate, unless it was shown that the transaction had a positive balance-of-payments impact; however, currency obtained through borrowing or in the investment currency market was free of controls. It was also required that at least two-thirds of after-tax profits were repatriated. The impact of regulations on direct investment transactions is estimated to have been minimal.

5) See "Creation of a European Financial Area", Communication from the Commission to the Council, November 1987. Reprinted in *European Economy*, (1988b).

6) S. Fischer (1987).

The controls were aimed at the financing rather than the level of direct investment abroad and their impact on the net flows was small.

The abolition of controls regulating monetary transactions had a significant impact on some key variables. M3, the aggregate which includes foreign currency deposits, advanced rapidly, while interest differentials between domestic and offshore deposits declined significantly in the post-1979 period. In addition, there was a significant decline in the volatility of domestic/off-shore interest differentials in the post-abolition period.

Removal of controls on international capital transactions is a prerequisite for the integration of financial and capital markets; unrestricted capital movements expand the opportunities for international portfolio diversification, and improve the allocation of international savings. These objectives are part of the EC programme for the completion of the internal market. The UK experience suggests that the abolition of controls strengthened the process of deregulation of financial markets and contributed to London's importance as an international financial centre. Furthermore, liberalization stemmed the long-term decline of sterling in international finance: for example, sterling-denominated bond issues rose significantly in the post-1979 period. The character of monetary policy also changed, in that quantitative and legal restrictions ceased to be regarded as possible instruments of monetary management. The UK experience confirms that domestic interest rates converged towards international interest rates in the post-1979 period, implying some loss of monetary autonomy.

Since liberalization of capital movements can be expected to affect the distribution of financial activity in the Community, the government has taken a key interest in the progress of liberalisation (making progress elsewhere a condition of ERM participation, for example). Removal of discriminatory policies should strengthen the comparative advantage aspects of international financial activity. The UK government expects this will contribute to London's position as the dominant financial centre in the EC. Experience and tradition in international financial intermediation are important elements of comparative advantage; London has a long history of serving as an international financial centre, and it is indeed possible that its position will be consolidated within the Community.

Taxation in the Community

In the Community context there are three areas of taxation policy which have attracted particular attention because of their potential significance for the internal market programme. These are indirect taxation (VAT and taxes on alcohol, tobacco and mineral oils), the taxation of savings and corporate taxation. Under the Single European Act Council decisions on taxation need to be unanimous and are thus difficult to reach. This is both because governments resist measures that threaten a loss of revenue, economic activity or price rises in their country and also because of objections to the intrinsic loss of sovereignty in accepting a role of Community decision-

making. The consequence is that only limited progress has been made in reaching agreement on Commission proposals in these areas. For indirect taxation agreement on a regime with few immediate significant implications for the UK is now probable; by contrast common regimes for the taxation of saving or for corporate income (apart from the changes noted below) seem likely to find agreement only with greater difficulty.

Indirect taxation

In the field of indirect taxation the Commission's approach has been based on the principle of abolition of fiscal frontiers within the internal market. This would imply the total freedom to buy anywhere within the Community and transfer goods into the country of final consumption without frontier checks. For this to be achieved without undue distortion of trade the Commission's initial proposals envisaged rates of VAT and other major indirect taxes approximating at certain levels or within certain ranges. Levying of taxation would be based in practice on the 'origin', rather than as at present, 'destination' method, although the latter would be retained as the basic principle for the distribution of total receipts within the Community. Thus a system of compensation - a clearing mechanism - to offset the impact on national treasuries of the difference between production and consumption of goods and services on national territory would be instituted.

The Commission's proposals for tax harmonisation remain under discussion. Original proposals included two VAT bands of 4-9% (reduced rate) and 14-20% (standard rate). Zero-rating was to be abolished. For alcohol, tobacco and mineral oils, unique rates or bands would apply chosen by reference to some compromise between the widely different current levels in different Community countries.

These proposals were strongly opposed by the UK government on the grounds that such a degree of harmonization was unnecessary. Objections raised the issues of tax sovereignty, social impact (continued zero-rating of food and children's clothing for VAT purposes has been given as an election commitment), health concerns (the Commission's proposals would have meant steep reductions in spirits and tobacco duties) and practicality (whether the clearing mechanism was feasible). The UK instead proposed a looser system based on the continuation of a destination principle and zero-rating for exports.

In May 1989 the Commission submitted revised proposals which attempted to accommodate UK and other countries' objections. Without proposing details of revised tax rates, both VAT and other indirect taxes would offer scope for marked inter-country differences. There would be a minimum but no maximum standard rate of VAT, while some zero-rating would continue to be allowed as a 'temporary derogation'. Taxation by destination would apply for mail order purchases, transport equipment (mainly cars) and exempted bodies (the public sector - e.g. hospitals - and insurance companies). There would be direct clearing for large international companies (again virtually amounting to taxation by destina-

tion). For alcohol and tobacco the absence of maximum rates would allow local high tax regimes (such as the UK's) to continue, with retail sales controlled by a device such as excise stamps, but with complete freedom for individual travellers to import. For mineral oils unique or narrow band ranges would be retained. In May 1990 a second set of revised proposals dealt with the collection system. These broadly followed the UK position, in retaining, at least until 1996, the existing destination and zero export rating system, and relying on direct information from trading companies to fill the gap in fiscal control left by abolition of frontier customs documents.

For the UK it appears that such proposals would have no major macroeconomic impact. Small potential revenue increases are likely to arise from realignment of mineral oil duties with perhaps more significant product price changes (cheaper diesel oil, possibly encouraging higher imports of diesel-powered cars, a sector where the UK industry is weak; petrol duty might increase). Higher VAT revenue would arise to the extent that some products lose their zero-rating, although here, too, the impact is unlikely to be severe if the UK obtains continued derogation for a wide range of goods and services. For comparison, ending zero-rating without allowing for changes in consumption patterns suggests a revenue increase of about 1% of GDP for 1989-90. Existing standard rate VAT, alcohol and tobacco duties are unlikely to be directly affected by the proposals, although unlimited imports by individual travellers would put downward pressure on rates.

It should be emphasised that these effects are only extremely indicative, based on the assumption of agreement on a likely package of measures. Present indications are nevertheless that an eventual system would allow for more inter-country differences than originally proposed and for the UK would impose minimal disruption to existing tax practices. Such a Community system would then resemble the present US situation, where constraints on tax rates are competitive in nature (allowing significant differences between states), inter-state commerce is free and enforcement of the destination principle is undertaken on a pragmatic case by case basis.

The taxation of income from savings

Commission proposals to introduce some minimum harmonization of the taxation of income from savings (an interest withholding tax) have not been pressed. The proposals were partly stimulated by fears that liberalization of capital movements throughout the Community would encourage a flight of tax-evading capital from high tax to low tax countries (e.g. from France to Luxembourg). The essence of the proposals was to introduce a minimum rate of withholding tax on interest from deposits and bonds for all Community residents, supplemented by facilitating

the exchange of information between the different Community tax authorities. Non-Community residents would be exempt from the tax.

In the UK the proposals met with opposition from both the authorities and the banking community. Apart from the familiar ground of the sovereignty principle, objections were based principally on the fear of driving out savings from the Community with consequences of higher interest rates and the loss of financial business. Within Europe Switzerland and the sterling offshore centres have been cited as potential alternative havens for tax-shy funds. Germany's experience of substantial capital outflows (especially to Luxembourg) after introduction of a withholding tax in January 1989, forcing its subsequent repeal, was also noted.

In point of practice it seems doubtful whether a Community withholding tax regime, if ever introduced, would have substantial implications for the UK. For domestic residents, the UK already has such a system for bank and building society interest (reformed in the 1990 Budget), supported by tax reporting arrangements of long standing, while London's importance as an international banking centre is based essentially on wholesale interbank business which would not be affected by such a tax. The incidence of a new tax would thus be limited to tax-shy funds from other Community residents: for the UK it seems unlikely that these are important relative to overall business.

Corporate taxation

Corporate taxation is, after indirect taxation, the second fiscal area where the internal market White Paper held out the prospect of a Commission initiative. It is equally an area where unanimous Council agreement has proved elusive. The White Paper focussed on measures to remove obstacles to cooperation between enterprises in different member states; outside the 1992 programme proper are general harmonization issues such as the base and rate of corporate taxes and the relationship with individual shareholder taxation, where there is no particular timetable constraint.

As long ago as 1969 the Commission tabled two draft directives. The first presented proposals to ease cross-border mergers and asset transfers⁷. These proposals attempted to deal with two main issues, first, the taxing of the difference between the market and book values of assets acquired through the merger, treated as a national capital gain; and secondly, the taxation, and potentially double taxation, of post-merger profits. As regards the first problem, the Commission proposed that tax should be deferred until capital gains are actually realised, while for the second the proposal was to restrict national taxa-

7) Draft directive on tax treatment of mergers and transfers of assets between two or more firms residing in more than one member state (COM(69)5, base art. 100 EEC).

tion to profits generated within a particular member state, excluding profits generated by a subsidiary in another state. This fell short of proposing fully consolidated accounting, in which losses from a foreign subsidiary could be offset against parent company profits, although this had been included in earlier drafts of the proposals and has been reintroduced during recent discussion of a European company statute. The second proposed directive aimed to prevent double taxation occurring in the case of a company's equity stake in a business in a different member state⁸. In general, income from corporate risk capital would only be taxed where the income arises, not again after repatriation of profits on which tax has already been paid. A third draft directive dating from 1976 was for a binding arbitration procedure on national tax authorities to prevent double taxation in the cases where one authority adjusts declared transfer prices between internationally associated companies in its favour (boosting profits in the area under its jurisdiction) without offsets elsewhere⁹. The three directives were finally passed in June 1990; Germany will be allowed until 1996 to comply fully with the first of these.

The more general issues of corporate taxation - the rate of tax and withholding taxes on dividends - were the subject of a draft directive in 1975¹⁰. This proposed establishing a compulsory band (45-55%) for corporate tax rates and a common imputation regime (again with a 45-55% band) for a withholding tax. However, the draft directive did not deal with the base of corporate taxation and for this reason the European Parliament refused to deliver its opinion, legislatively deadlocking the proposal. Recently the Commission has reexamined the issue of the taxable base and new harmonised rules may be proposed.

From the United Kingdom point of view there seem strong grounds for facilitating tax treatment of cross border mergers and investment activities, given the outward orientation of UK enterprises and the future importance of acquisitions to take advantage of the single market. The three directives passed in June 1990 seem attractive for these reasons. However, this is less obviously true of the 1975 proposals as originally drafted. In the intervening period the UK has followed the US lead in considerably broadening its corporate tax base, introducing economic depreciation and reducing the corporate tax

rate (from 50% to 35%). These proposals were contained in the 1984 Finance Act. In addition the corporate tax regime for smaller business has been considerably lightened. The UK has thus a particularly light regime of corporate taxation within Europe, even taking account of the trend in other countries towards widening corporate tax bases and reducing rates¹¹. 'Harmonization' might thus pose particular adjustment problems for the UK. In addition, the unanimity requirement for subsequent changes of rate bands could effectively stall substantial tax reform on the scale engineered by the UK since 1984.

Competition policy, deregulation and liberalization

Policies furthering competition include, as well as competition policy strictly defined i.e. monopolies, mergers and restrictive practices legislation, measures in favour of deregulation and liberalization. Such policies thus come firmly within the ambit of the supply side policies discussed in Chapter 2.4. In this section more attention will be given to the Community context.

As regards competition policy, the Delors report on economic and monetary union emphasised the need to deal with conventional restrictive practices and abuse of market power. In addition mergers, takeovers and excessive use of government subsidies were cited¹². This view follows a period during which, on the basis of existing powers, the Commission has taken a more active intervention role in blocking new anti-competitive moves and in attempting to roll back existing restrictive practices. Recent examples affecting the UK include intervention by the Commission to scale down the debt write-off assistance provided by the UK government to British Aerospace on its acquisition of the largely publicly-owned Austin-Rover motor vehicles group (from UKL 800 million initially to UKL 469 million) and more stringent vetting of the conditions of takeovers having a potential Community impact (such as of British Caledonian by British Airways). The regulatory climate has thus tightened, both as regards intra-private sector moves and state aids, with more attention directed from an early stage of any new proposal at the likely Commission response.

The impact of this trend is likely to be marked in the UK, for two main reasons. First, as noted in Chapter 2.4, UK competition policy has traditionally been charac-

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- 8) Draft directive on common tax arrangements applicable to parent companies and subsidiaries of different member states (COM(69)5, COM(85)360, base art. 100 EEC).
 - 9) Draft directive on the adjustment of profits (elimination of double taxation) between associated companies (arbitration procedure) (COM(76)611, base art. 100 EEC).
 - 10) Draft directive on the harmonization of systems of company taxation and of withholding taxes on dividends (COM(75)392).
 - 11) In terms of pre-tax profits the UK had the lowest tax burden for all five manufacturing sectors surveyed in a 1989 inter-country comparison including Germany, France, Italy, Sweden, the USA and Japan. DIW (German Institute for Economic Research), *Die Besteuerung der Unternehmensgewinne : 7 Industrieländer im Vergleich* (The taxation of corporate earnings : 7 industrial countries compared).
 - 12) Committee for the Study of Economic and Monetary Union (1989), para. 25.

terised by considerable executive discretion as to the impact on the "public interest" rather than explicit legal criteria; this contrasts with the more formalised approach of the Commission based upon the EEC Treaty (Article 85 and 86 for companies and 92 and 93 for state aids) and legally enforceable (by national courts, the Commission and ultimately the European Court). Secondly, takeover activity involving large enterprises is far higher in the UK than other member states, and for international takeovers UK companies are by far the most active of any member. In 1988, for example, UK companies spent USD 44 billion on foreign acquisitions (three-quarters in North America, a tenth elsewhere in the Community). French companies, the next most acquisitive, spent USD 11 billion, again chiefly in North America but with almost USD 4 billion in the Community (against USD 4 1/2 billion by UK companies)¹³. Takeovers within the UK are also higher by number and value although here the differences are smaller: in 1988 over 1 200 companies were acquired with a value of over UKL 22 billion; for comparison in France there were some 800 acquisitions with a value of FF 180 billion (= UKL 17 billion)¹⁴.

There are a number of reasons why takeover and merger activity should be more pronounced in the UK than in the other member states - the size and depth of equity markets in relation to GDP¹⁵, the legal form of the enterprises and the openness, in both directions, to companies in other English-speaking countries. While mergers and acquisitions, national and international, can be expected to increase in most member countries in consequence of the 1992 programme, this differential will probably persist. In this respect an important step was the Council's adoption of the merger control regulation in December 1989. This instituted a 'one-stop' system of control, meaning that only one authority (the Commission or national authorities) will vet any particular merger. Thresholds for the Commission's involvement have initially been set fairly high (ECU 5 billion, to be lowered after four years). At national level, the pressure for reform with greater legal clarity (for example, whether the impact on competition is assessed in national or Community terms) might thus be expected to increase.

In other areas of competition policy the UK has been more clearly a leader within the Community. Thus the general supply side orientation of economic policies has led to a significant reduction of state aids, a consequence of the shrinking of the public enterprise sector and a re-

luctance to subsidise the private sector. Significantly, the subvention to British Aerospace to acquire the Rover group was associated with the latter's transfer to the private sector, while somewhat similar assistance is being given to the water authorities on their privatization. Public procurement policy, particularly defence procurement and the wish to favour domestic suppliers, might cause more tension. The 1980s, however, saw a definite move toward less protectionism in this respect.

UK and Community policies are also in broad conformity in two areas where the Commission has taken a particularly active role in promoting competition: telecommunications and air transport. In both industries Community prices are in general conspicuously higher and output lower than what would be expected in a unified market¹⁶. In most member states telecommunications are provided by a single state corporation, often also the postal service, with cross-subsidisation between local and trunk and international and between telecommunications and postal services common. In air transport "flag" carriers, partly or exclusively state-owned, typically receive protection on internal routes and operate bilateral cartels on intra-European routes.

In the UK British Telecom was privatised in 1984 and British Airways and the British Airports Authority in 1987 (see Box 2 on privatisation in Chapter 2); regulatory action (licensing new market entrants) aimed to guard against monopoly abuses. In telecommunications user equipment choice was freed and a second company (Mercury) licensed to compete for use of basic wired services. Two competing systems have been licensed for basic cellular services. In air transport British Airways was required on privatization to surrender some routes to a second British carrier (British Caledonian) while the authorities have taken a liberal attitude to licensing additional carriers on international routes. The UK has thus increased in importance as a hub for international services offering cheaper fares and greater route choice than most rival centres. However, the domestic competition regime did not prevent the subsequent takeover of British Caledonian by British Airways, thus severely reducing competitive pressures from a second national carrier.

13) P. Buigues (1989).

14) *British Business*, 10 February 1989 (see also footnote 13).

15) The UK is by far the largest European market in terms of traded companies and capitalisation, the latter representing about half of GDP; by contrast only some 1 080 companies trade on the eight German stock exchanges, representing about a quarter of GDP.

16) More cost competitive telecommunications tariffs would benefit consumers by 4 billion ECU p.a., according to the Cecchini report (1988, op. cit.). However, it should be noted that the Commission's 1987 Green Paper on telecommunications proposed leaving the existing industry largely intact for 'reserved' (i.e. basic) services, particularly voice telephony. Potential savings on 'competitive' services (VANS, etc.) would nevertheless still be substantial (2 billion ECU p.a.), as would be direct equipment costs savings from greater standardisation. The Commission's approach to air transport liberalization has also avoided full-scale deregulation on US lines, preferring phased weakening of existing bilateral agreements for intra-Community routes and greater freedom regarding fares and route access. A 1986 report in *The Economist* estimated variable route costs to be typically 20% higher in Europe than the US while fares were 35-40% higher (quoted in *European Economy* (1988a)).

3.3.3 The costs and benefits of the Single Market for the UK economy

The overall impact of market completion is expected to be significant for the performance of the UK economy. A successful response to the single market, in the UK and elsewhere in the Community, would imply higher domestic production in aggregate while prices would be lower. The economy's ability to compete internationally should improve, easing pressures emanating from the external sector. These benefits should be reflected in employment gains and in public finances. While the short-term impact of market completion may cause significant restructuring and dislocation, benefits should be particularly pronounced in the medium term.

Static effects

The static effects of the completion of the internal market on the UK economy refer to the once-and-for-all impact of removing barriers to market integration on production and consumption. These are the first-round effects and represent a first approximation of the overall impact of market integration.

Market fragmentation is regarded as an important trade barrier by UK businesses. In surveys conducted in the context of the 1992 project UK firms ranked national standards and technical regulations first in a list of trade barriers, followed by various administrative barriers, while frontier delays and costs ranked third (the respective ranking of these barriers by all surveyed EC firms was similar but reversed the order of the first two).

Research undertaken for the Cecchini study¹⁷ revealed that in 1986 national customs practices EC-wide cost between ECU 8,4 and 9,3 billion. The administrative costs to UK firms per consignment in intra-EC trade were ECU 75 for imports and ECU 49 for exports (the respective Community averages were ECU 67 and ECU 86). Transport costs are also raised by customs formalities, with delays in delivery of goods within the UK market being significantly shorter than those for delivery to an equidistant destination on the continent. One consequence of these costs is that the volume of trade between the UK and the rest of the EC is lower than in the absence of market fragmentation. According to survey results, EC importers were estimating a 1,0% increase in import volumes, and exporters a 3,2% increase in export volumes, upon completion of the internal markets. These results underestimate the potential increase in intra-EC trade since firms not currently engaged in trade, particularly small firms, would be likely to find it profitable to expand their activities beyond national borders.

Purchases by public entities are important components of demand in the EC. However, procedures and standards differ widely. Public procurement in a fragmented EC market tends to favour domestic producers over foreign suppliers and, as a consequence, the benefits arising from competition are foregone. In the UK total public purchases in 1984 amounted to ECU 118,9 billion (21,8% of GDP) while total public procurement (that is, that part of public purchasing which is subject to contracts) was estimated between ECU 54,2 and ECU 76,2 billion (10% to 14,1% of GDP). Removing barriers to public procurement is regarded as an important step in the completion of internal market. Estimates by the Commission suggest that the gains to the UK economy would amount to ECU 3,4 billion, or 0,6% of 1984 GDP. These gains consist of cost savings due to lower prices (ECU 1,0 billion), improved efficiency due to wider competition (ECU 0,3 billion), and cost savings due to restructuring of firms where the public sector is a dominant agent (ECU 2,1 billion)¹⁸. British firms ranked differences in VAT rates as the least important barrier to business¹⁹.

Some indications of the effects on manufacturing industry is given by the results of a contribution by the UK Department of Trade and Industry to a joint Community-wide study using a uniform methodology²⁰. This study first selected "sensitive" industries on the basis of the significance of non-tariff trade barriers. These accounted for about one half of total manufacturing output and employment. Industries were analysed at the three digit NACE level (corresponding to broad product groups, e.g. "agricultural machinery"). These industries were then classified according to different indicators of competitiveness based on relative trade performance and relative output levels. Four such indicators were aggregated to produce a "score" indicating overall competitive strength, both on a "static" basis, and on a "dynamic" basis (the latter looking at changes to performance in the period 1982-87). UK industries identified as having the strongest "static" competitiveness included computers, telecommunications equipment, pharmaceuticals, chemicals and measuring equipment. At the other end of the scale were glass, textile machinery, domestic electrical appliances, motor vehicles, cotton goods and footwear. In total sixteen "below average" industries accounted for 20% of manufacturing output and 22% of manufacturing employment in 1987; the fifteen "above average" performers accounted for 21% of output and employment. "Dynamic" scores were fairly similar, although there was a less pronounced tendency to extreme values and measuring equipment and footwear moved into the average category. Another comparison relates UK trade performance to overall EC demand growth in the 1980-85 period. Interestingly, UK relative manufacturing strength is somewhat biased towards high demand growth sectors, with the outstanding

17) See P. Cecchini (1988).

18) See *European Economy*, (1988a), Table 3.4.4.

19) See P. Cecchini (1988) : op. cit., Table 1.1.

20) "Sectoral impact of the internal market on industry", *European Economy* (forthcoming).

exception of motor vehicles, where poor UK performance in the 1980s coincided with high demand growth.

Such analysis is, however, necessarily based on past data and to some extent backward-looking. A more forward-looking approach can be gained by looking at trends in direct investment, though here the latest data relate to 1987 and thus can barely reflect single market factors. Investment from elsewhere in the Community in UK manufacturing was small (UKL 0,2 billion) and has increased negligibly (investment for all sectors was UKL 2,9 billion in 1987). More significant has been manufacturing projects from outside the Community, notably investment by Japan. The inward flow from Japan exceeded UKL 750 million in 1987 and since then major projects have been announced by Toyota and Honda, following the earlier establishment of the Nissan car plant. In total about 45% of Japanese direct investment in 1987 and 1988 in the Community was located in the UK, higher than the UK's cumulative share of Japanese investment (under 40%).

Outside manufacturing, financial services should become cheaper. A potential price reduction of 13% is envisaged, with the centre point of the range of estimates being 7%²¹. The extent of potential gains here reflects the fact that the abolition of exchange controls and the liberal financial regime prevailing in the UK has already yielded many benefits. Nevertheless, a 7% decline in the price of financial services is estimated to amount to 0,8% of GDP in terms of value-added for financial services and also in terms of the gain in consumer surplus. At the same time, adjusting for the size of the financial service market, the UK gain in consumer surplus from the integration of credit and insurance markets is estimated to rank first at ECU 5,1 billion, representing over one-quarter of the estimated total Community gain.

Dynamic effects

These effects refer to the impact of market integration on the exploitation of scale economies due to increased market size, and on competition. These are more elusive and less subject to precise quantification, partly because they are interdependent. However, they constitute potentially the most important consequence of the 1992 project.

Dynamic gains can be classified into three categories : (a) the decline in costs associated with larger volume of output and restructuring of production; (b) the decline in costs and prices arising from wider competition; and (c) a series of non-price effects associated with competitive pressures to improve quality and encourage innovation.

Evidence indicates that the potential gains from exploiting scale economies can be very substantial for UK firms. The UK market size is too small compared to the minimum efficient scale of production for many industries and this has been estimated to raise production costs by up to 25%. In the case of cars, for example, the minimum efficient scale is 200% of UK production and 20% of total EC production; in computers, aircraft, cellulose fibres, and rolled aluminium it exceeds 100% while it is less than 20% relative to EC totals²². Scale economies can also be present in the service sector but these are much more difficult to evaluate. At the same time, the likely effects associated with learning and experience can be very substantial as well.

An indication of the prospective gains from enhancing competition is existing EC price differentiation for the same goods. In 1985, for example, the (tax-inclusive) price dispersion for total final consumers' expenditure (goods and services) measured by the standard deviation was about 22% of the average Community price; the price dispersion for consumer goods alone (excluding energy and services) was almost 20%. These measures overestimate the true dispersion measured between countries and by product to some extent. Differences in indirect taxes contribute significantly to raising these dispersion measures, although substantial price differences remain after tax differentials are removed (the coefficient of variation for consumer goods ex-tax falls to 15,2%). The gains from convergence of the prices of goods and services are estimated to be between 2,1% and 8,3% of EC GDP, depending on the convergence hypothesis assumed.

Additional competitive implications relate to the disciplinary effects international trade brings forward, which are expected to promote cost-minimization in Community firms. Finally, there is evidence that an uncompetitive environment is unfavourable to innovation in the UK²³. Improving competition could yield significant externalities in innovative behaviour, further reinforcing the virtuous circle which appears to characterize competition and innovation.

Table 3.4 summarizes views by UK firms, as well as those for the EC as whole, concerning the impact of market integration. In many cases the proportion of UK firms expecting improvements is greater than the EC average. A reduction of costs is expected by a net 58% of respondents with the majority projecting slight cost reductions. A substantial increase in sales to the EC is reported as well, while a net 61% expect the opportunities to outweigh the risks for their own firm, and a net 45% expect the opportunities to exceed the risks for the whole economy.

21) This reflects the fact that financial product prices in the U.K. are 2-12% higher than the theoretically lowest price, with the centre of the possible range being 7%. The U.K. ranks second to the Netherlands in terms of the smallest difference between actual and theoretically lowest price in financial services. See *European Economy* (1988a), Table 5.1.4.

22) See *European Economy*, (1988a) Part D and Tables 6.1.4 and 6.1.5.

23) See P. Geroski (1988).

Table 3.4 : UK and EUR12 business opinion regarding completion of the internal market

	UK	EUR12
Cost reduction ¹		
- Very significant	8	25
- Slightly significant	50	37
- Net effect ²	-58	-60
Increase in sales volume ³		
- Exports to EC countries	78	64
- Exports to non-EC countries	12	24
- Total sales to all markets	68	54
Opportunities and risks ⁴		
- For own firm	61	49
- For the economy	45	36

1 Survey response in percent.

2 Percentage difference between firms expecting a reduction (-) in costs and firms expecting an increase (+).

3 Percentage difference between firms expecting an increase (+) in sales and firms expecting a decrease (-).

4 Percentage difference between firms expecting greater (+) opportunities and firms expecting greater risks (-).

Source : European Economy (1988a), Tables 8.1.1, 8.1.2, and 8.1.4.

Table 3.4 : UK and EUR12 business opinion.

Of the principal reasons for the expected increase in sales, UK firms ranked the improved ability to enter new markets first, followed by improvements in non-price competitiveness (for example, changes in product range), and by reduction in product prices in existing markets. These results indicate that the market integration effects are expected by UK producers to be significant.

Similarly encouraging results were obtained by a Bank of England survey of the implications of market integration for the UK financial service industry ²⁴. The survey indicated that financial institutions were generally positive about 1992 prospects, expecting an increase in economic activity to levels which would have taken much longer to reach without the market completion programme, and projecting greater opportunities and greater competition for the industry. While a true single market in financial products was viewed as remote, a common market in corporate financial services was expected to develop first; on the other hand, respondents believed that retail financial services would continue to remain fragmented along national lines for some time, despite the removal of restrictions on market entry.

Some macroeconomic implications of market completion

The gains from market integration will be reflected in the behaviour of the major macroeconomic variables. An

assessment of the overall macroeconomic performance of the UK was undertaken by the Commission in the context of the 1992 project. Table 3.5 summarizes the results for key variables.

The impact effects of the 1992 measures are small, as shown in the table, even though most macroeconomic indicators register noticeable improvement. However, employment and the public sector and external balances relative to GDP post some deterioration. On the other hand, gains in labour productivity raise real wages which, in turn, contribute to private consumption and become the key growth factor over the medium-term. Real income gains are also made as a result of the decline in prices associated with removal of market barriers. Once the economy has adapted to the new environment, and in combination with the interdependent dynamic effects of market integration, the medium-term performance of the UK economy is decidedly superior to that in the absence of the 1992 measures. Real GDP and the real wage are projected at four percentage points and at 2,7 percentage points higher, respectively, six years after the completion of the internal market, while employment is projected to be greater by almost 400 000. Important constraints on the macroeconomic environment, arising from the public and the external sectors, appear to be easing as the share of these balances in GDP improves. Overall, the improved domestic and EC-wide macroeconomic environment should raise the well-being of UK citizens both as

24) See Bank of England (1989).

Table 3.5 : The impact of market completion on the UK *

	Year 1	Year 2	Year 6
Percentage differences in levels			
Real GDP	0,81	2,44	4,00
GDP deflator	-2,52	-4,72	-8,06
Private consumption price	-2,55	-4,33	-7,43
Real wage rate	0,94	0,65	2,71
Labour productivity per head	1,79	2,95	2,91
Employment	-0,64	-0,08	1,39
Absolute differences			
Employment ('000)	-157	-16	385
Budget surplus (% of GDP)	-0,06	0,71	1,80
External balance (% of GDP)	-0,33	-0,32	0,61

*) The results show the effect of the completion of the internal market on the variables in question, compared to a non-completion scenario.

Source : M. Catinat, E. Domi, and A. Italianer (1988), Table 6.1.

Table 3.5 : The impact of market completion on the UK.

producers and consumers once the internal market is complete.

Caveats

Economic change results in winners and losers and while the programme for the completion of the internal market is projected to yield important benefits to member countries, transitional costs associated with the restructuring of individual economies are possible. The Cecchini report and model simulations have already indicated that during the transitional period employment may actually decline before it rises again once the adjustment period is over. This section discusses some possible qualifications to the gains discussed in the previous section. The discussion is general and not limited to the UK alone.

Completion of the internal market will redistribute production between countries and also between different regions within a country. The reason for this is that specialization will take place according to factor endowments, and sectoral redistribution of production will be intensified. Declining sectors will experience losses and expanding sectors will reap gains. Broadly speaking, the gains from free trade should be sufficiently large to compensate the losers and leave the country better-off compared to the situation of restricted trade. To effect this redistribution of gains mechanisms at the national and at the Community level will be required. For example, national policies which promote regional and sectoral labour mobility must be implemented. Equally important, Community policies enforcing competition must be in place to prevent firms from exploiting unfairly the advantages of market enlargement.

The complementarity of national policies and policies directed at enlarging the internal market are particularly relevant in the case of the UK. There is evidence that one of the factors explaining the persistence of regional disparities in income and unemployment in the UK is the housing market. Labour is immobile, despite adverse sectoral and regional fortunes, because of the tendency of housing prices to rise faster than nominal wages in areas of strong housing demand. These difficulties could worsen in the context of market integration and for this reason the need to review housing policy is urgent.

The Single European Act introduced important provisions to strengthen the Community's economic and social cohesion, and the Delors report noted that, in the process of economic and monetary union, an optimum allocation of resources and improved distribution of welfare would require regional and structural Community programmes. In February 1988 the European Council voted to enhance the Community's regional and structural policies in several respects : the size of the structural funds will be doubled over the period to 1993; emphasis will shift from project to programme financing; a new form of partnership between the Community and the receiving regions will be established; adjustment through movements of capital rather than labour will be promoted; and policies improving infrastructure, research and technological development will be pursued. In September 1989 an allocation of ECU 793 million from structural funds was made for the UK for regional development. Finally, co-ordination of macroeconomic policies will also help ease transitional difficulties.

There is some evidence, however, that the traditional view of market integration overestimates the adjustment costs involved. In particular, it is more realistic to assume that specialization takes place within an industry rather than at a regional level; therefore, redistribution of production and labour will take place within the industry and/or the firm. Furthermore, scale economies, strategic behaviour, and research and development are more im-

portant than factor endowments in determining the pattern of specialization; as a result, it is not possible to determine a priori which countries and which regions will in fact succeed in an integrated market. Both these considerations cast doubt on the traditional view which regards economic change as inflicting substantial losses. It is likely that adjustment to a complete internal market will be less costly than initially estimated.

CHAPTER 4

THE UK AT THE BEGINNING OF THE 1990s

4.1 The legacy of the 1980s

The 1980s saw fundamental changes in UK economic policy, accompanied by bold initiatives to improve the supply potential of the economy, strengthen incentives to produce, and reduce the role of the state in economic activity. As seen in the previous chapters, however, macroeconomic performance deteriorated in the post-1987 period, and questions have been raised about whether policy in the 1980s has contributed to a fundamental change in the UK economy, or whether the long recovery of the 1980s is simply an extended normal upswing.

It is difficult to answer this question. At the same time, it is likely that the period prior to the Conservative government's assumption of office (May 1979) constitutes an entirely different sample of economic and, perhaps, social values. The government's economic policies attacked the prevailing post-war consensus by strengthening economic activity along market, and away from interventionist, lines. As a result, productivity performance has improved relative to the EC countries. Although unemployment initially increased, employment gains have been substantial. However, the course of inflation is of extreme concern. In addition, fiscal prudence has been accompanied by private dissaving. Income inequality has increased. In the late 1980s macroeconomic stability and the balance of payments have, once more, become areas of concern. Thus fundamental questions about the economy remain.

First, wage inflation has been a persistent feature of the 1980s despite high unemployment, and more recently has intensified. While this is a normal development in circumstances of rising employment, skill imbalances and regional labour immobility associated with the boom in the housing market¹ have also played a contributing role. Such skill shortages may also threaten productivity performance.

Second, employment may have become more vulnerable. While the cycle in output explains the greater variability of employment, labour market reforms may not have gone sufficiently far in securing labour market flexi-

bility in so far as wages are concerned. In particular, the three employment acts of the early 1980s (1980, 1982 and 1984) preserved trade union immunity from civil action on pay and working conditions but not on organisation and manning levels², implying that higher wages in the unionised sector would produce greater short-term employment losses as firms found it easier to adjust pay-rolls. The legislation has thus been important in influencing labour utilization, but has not affected union mark-up on wages and, hence, has not contributed to narrowing union/non-union wage differentials. Some observers have attributed persistent wage inflation to this failure.

A third area of concern is the behaviour of the external accounts and its message regarding short-term economic stabilization. The balance of payments moved into a substantial deficit in the post-1987 period, reflecting to a large extent excess demand in the domestic economy. While it is evident that stabilization would contribute to reversing the deficit, the behaviour of the balance of payments viewed through the 1980s reflects more fundamental imbalances. First, the real appreciation of the early 1980s was, paradoxically, accompanied by a surplus on current account which persisted up to 1987. The persistence of the current account surplus was due to the contribution of North Sea oil; in the absence of the oil factor, the balance of payments would probably have been in substantial deficit. This oil-induced surplus permitted disinflation to be pursued through (the partly induced) exchange rate appreciation. In its absence, Layard and Nickell (1990) note that inflation would have been substantially higher, especially if fiscal and monetary policy had aimed at producing the actual balance of payments and unemployment record of the 1980s. If, as they contend, the disinflation of the 1980s was achieved only because of the oil factor, it is possible that the basic problem of achieving macroeconomic balance and low inflation remains to be tackled. Secondly, current account imbalances reflect imbalances in domestic absorption relative to output, or disequilibrium in investment spending relative to the supply of domestic savings to finance it. A remarkable characteristic of the second half of the decade has been the sharp decline in the personal saving rate, a development also prominent in other economies

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- 1) The evidence on the interdependence of the labour and housing markets is discussed in a symposium published in the *Oxford Bulletin of Economics and Statistics* (1989). See also Pissarides and Wadsworth (1989).
 - 2) This point is made by Matthews and Stoney (1990). See also Brown and Wadhvani (1990) for a related discussion. While the legislation may have contributed to greater employment variability in the 1980s compared to earlier periods, the amplitude of output fluctuations has been also greater in the last decade. The coefficient of variation for civilian employment (the ratio of the standard deviation to the mean of the variable) is :

1960 : 1 - 1969 : 4	= 1,63%
1970 : 1 - 1980 : 4	= 1,48%
1981 : 1 - 1988 : 4	= 2,22%
1982 : 1 - 1988 : 4	= 2,33%.

which have undergone financial deregulation. The surplus on public finances, the wider private expenditure deficit and the consequent payments deficit are suggestive of the need for better macroeconomic balance to be pursued in the 1990s.

The other Community countries are together the UK's largest trading partner. Further market integration within the EMS framework implies closer synchronization of economic activity which will be further reinforced at the policy levels. Flexible exchange rates make monetary policy independence possible in the short-term, but rarely permanently affect the real exchange rate. Persistent divergence in the UK from the behaviour of wages and prices in the ERM countries through exercise of the short-term freedom to inflate would contribute to macroeconomic instability by raising the volatility of inflation, interest rates, the exchange rate and output. The associated uncertainty, in sharp contrast to the ERM countries, would have adverse implications for economic performance.

4.2 Stabilization questions

The UK economy peaked in 1988. Policy has been aimed at restoring non-inflationary conditions and reversing the balance of payments deficit. The policy approach to promote adjustment has been via changes in interest rates. However, the monetary squeeze implemented over the past two years has been slow to produce the intended results. Inflation has been persistent, influencing wage settlements, expected depreciation, the level of interest rates and, ultimately, the credibility of government policy. These developments occurred in an economy where a veritable change in regime took place in 1979 and where important supply-side initiatives have been implemented. Furthermore, despite the anti-inflation rhetoric and a policy design of promoting price stability, the UK is entering the 1990s in some macroeconomic disarray, where the risks of slow growth and stubborn inflation for the foreseeable future have intensified. Why has this happened? Answering this question is critical to understanding the crucial policy options in the near future. Key to these is the credible anchoring of expectations.

The model of disinflation adopted by the UK government in 1979 was that of a sharp disruption of inflationary expectations through monetary and fiscal contraction, in which currency appreciation played an important role. This model quickly establishes policy credibility and causes rapid expectations adjustment. In contrast, the strategy of those countries which have successfully achieved disinflation within the ERM involves a gradual adjustment of expectations and a slow acquisition of credibility since substantial exchange rate appreciation is not available to the member countries. The ERM strategy

for the more inflationary economies is characterized by a protracted deflationary period where currency adjustments are minimized; the UK strategy, on the other hand, entailed a quick adjustment in output and expectations brought about in part by an overshooting exchange rate³.

The longer-term implications of the two strategies are quite different. The experience of the ERM countries shows that while credibility is slow to develop, once in place it is difficult to lose; consequently, inflation and inflation expectations remain subdued. The UK experience shows that credibility, which can be gained at substantial short-term output cost, can be lost because of either systematic policy errors (inadequate policy tightening in the early stages of the post-1986 boom related to underestimation of excess demand) or because there is no nominal target sufficiently reliable to commit policy and promote macroeconomic stability. As a result, inflation and inflation expectations can become firmly embedded in private contracts.

UK wage and price inflation in the beginning of the 1990s has also been affected by expectations that currency depreciation will ultimately offset losses in competitiveness associated with excessive wage and price increases. Incipient real exchange appreciation has been countered through nominal exchange depreciation, while domestic wage and price setting appear to be inelastic with respect to real exchange rate increases⁴. This process is only a special case of inflation inertia in an economy where expectations are forward looking, and the cost of failing to accommodate inflationary behaviour is severe in terms of output lost. In the UK, the current policy is to deflate the economy gradually and minimize output losses. But because there is no constraining discipline on monetary policy (such as provided by fixed exchange rates or by an independent central bank), the policy of gradualism could be reversed towards expansion again; in other words, the announced precommitment can always be reneged upon and the policy may not be credible.

Thus, unlike the disinflationary episode of the early 1980s, the UK strategy to contain inflation in the early 1990s is that of gradualism. However, unlike the ERM strategy, there is no nominal anchor to secure price stability. In view of the failure of monetary targetting to serve as an anchor to expectations, and as the MTFs has been of past limited success as a stabilisation mechanism, there is a strong a priori case that the exchange rate should become the intermediate target. Clearly, in order to avoid the inflation and disinflation cycles which have become characteristic of recent economic performance, some permanent commitment to sustain an exchange rate objective would be required. From the perspective of policy commitment, participation in the ERM now represents the most credible option.

3) de Grauwe (1989) discusses this comparison extensively. See also Giavazzi and Giovannini (1988) on this issue.

4) Some preliminary evidence is reported in Belessiotis (1989) on the behaviour of prices and of the monetary authorities in periods of real appreciation and real depreciation.

4.3 The UK and European Monetary Union

Decisive steps to achieve economic and monetary union in the EC have already been made. In particular the Delors report envisaged a three-stage process by the end of which exchange rates would be irrevocably fixed and decisions on monetary policy and aspects of national fiscal policies would be transferred to Community institutions. UK policy regarding EMU stands in sharp contrast to the majority of member countries. The UK has objected to the centralization of decision-making power away from elected national representatives to institutions in Brussels and, in particular, to the possibility that national fiscal policy may be subject to binding rules of a supranational authority. The government has argued that fiscal coordination is not essential for monetary union and, with monetary policy tied to the monetary union, that fiscal independence is the only instrument available to respond to external shocks and restore output. These arguments imply a less centralised currency union where fiscal independence remains with the national authorities and market forces are relied upon to provide the necessary policy discipline. At the Madrid conference of June 1989, the government, while setting out conditions for participation in the ERM, objected to the notion that implementing stage one of the Delors report necessarily implied that the subsequent stages would follow.

A British proposal, sketching an alternative route to monetary union, was presented by the then Chancellor of the Exchequer, Mr. Lawson, at the European finance ministers meeting in Antibes in September 1989, and was subsequently published by the Treasury⁵. The proposal centred on the notion that prudent monetary policy would lead to currency competition, and together with market-imposed fiscal discipline, would drive out of circulation high-inflation currencies in favour of one or several whose characteristics as money were superior. Drawing on ideas enunciated by Hayek (1976a, 1976b) the proposal envisages that high-inflation countries will see their currencies gradually replaced by more stable currencies, thus imposing a significant discipline on the monetary authorities of the former. Ultimately, currency competition could lead to a currency union because the more an individual currency is used, the more useful it is as money, and the greater the domain over which an individual currency is used the greater the scale economies accruing to the users. These scale economies are social and individual, and extend over space and time. Currency competition might ultimately lead to one currency serving as money in the EC, or, alternatively, several might continue to coexist, because of national characteristics continuing to impinge upon the demand for money. The Chancellor did not speculate about the full implications of currency competition for monetary union. The UK proposal might thus be seen as an evolutionary alternative to stage 2 of the Delors report in which non-inflationary monetary policies dominate.

This proposal is not, however, in the spirit of the Delors notion of monetary union. Unlike the latter, no specific steps or institutions are envisaged to strengthen the process of currency union. In essence, currency competition represents an alternative to the Delors Report proposals, and it is uncertain that it could lead to a monetary union.

Independently of whether the UK proposal is consistent with the Delors report, there are several problems with the process of currency competition. First, the proposal may not be consistent with prospective developments in the EMS, since the increasingly fixed exchange rates aspired to virtually amount to one currency while the condition of currency substitution required for competition to be effective would not be satisfied. Secondly, from the perspective of the liquidity service of money, financial deregulation has led to a large fraction of the national money stock becoming interest-bearing. Different inflation rates fully reflected in nominal interest rates have thus become less intrinsically problematic; rather, what is important is the predictability of the currency's purchasing power. The implication is that the resources required to establish the most predictable currency may significantly outweigh the prospective benefits. Klein (1977) notes that currency substitution and switching to new monies appears to be highly inelastic with respect to the currency's inflation rate. Even in high inflation countries the extent of currency substitution occurring largely reflects the store of value rather than medium of exchange function of money.

Thirdly, an argument also due to Klein (1977) points to the fact that the demand for currency depends on such non-economic characteristics as confidence, which is not simply related to inflation and which may be difficult to establish through currency competition. Finally, in view of the scale economies in the use of money, money appears to be a classic case of natural monopoly. Thus, in the ultimate state, the central bank whose currency has dominated will become the regional bank determining monetary policy for the EC. While this outcome is theoretically possible, evidence from the monetary history of various countries indicates that the likelihood of this happening is very remote. Even if it were to happen the externalities associated with money would require that the regional bank be "nationalized", or some EC authority would be required to determine monetary policy. Thus even the logic of currency competition may require the establishment of an EC-wide institution.

In the Commission's opinion, made public in March 1990, the process of monetary union should involve a new Community institution responsible for monetary policy (the Eurofed), close dialogue between this institution and member states on economic and financial policies, and coordination of budgetary policies to ensure coherence with monetary policy, including voluntary restraints on fiscal action (rather than centrally determined

5) See HM Treasury (1989).

rules as in the Delors report); a single currency (the ECU) was also envisaged. These proposals are more flexible than those of the Delors Committee; at the same time, the macroeconomic benefits from policy coordination among member states will be enhanced, and there is room for market forces to exert discipline on fiscal policy. Even though these proposals view the process of monetary union from a sharply different perspective from the UK, there is opportunity for UK views to continue to receive attention within a more flexible framework of debate. However, to enhance its influence, the UK needs to show commitment to a clearer and feasible vision of monetary union to be achieved in the 1990s.

An intergovernmental conference to discuss amending the Treaty of Rome and lay the foundations for monetary union is to begin at the end of 1990. The British government is preparing to offer new proposals in the intervening months which, while falling short of proposing a single currency, are expected to be a significant advance over the initial evolutionary vision of European monetary union⁶. This initiative possibly signifies greater acceptance by the UK of a type of monetary union closer to that currently envisaged by the other EC countries. More importantly, it signals the desire to exert greater influence through positive contributions to the continuing dialogue. This is a welcome development, which is likely to enrich the intellectual character of the debate about European monetary union.

6) In June 1990 the Chancellor of the Exchequer outlined proposals, amplified by the Bank of England, for stage 2 of EMU during which a "Hard ECU" would be issued as a new common (but parallel) currency by a "European Monetary Fund". These proposals followed preparation of this draft.

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