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- COUNTRY STUDIES -



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Executive Summary

The pound sterling entered the exchange rate mechanism (ERM) of the EMS in October 1990. Entry took place at a central parity of 1 UKL=2,95DM with transitional 6% margins. This move by the UK authorities followed over two years after the beginning of the sharp tightening of monetary policy in May 1988, when the extent of the extreme overheating of the economy of 1987 and 1988 had started to become clear.

Following an uneven deceleration during 1989 and the first half of 1990, demand and activity weakened very substantially in the second half of 1990. The economy entered into recession, with falling manufacturing output and an accelerating rise in unemployment. Although the onset of the growth slowdown seems to have been domestic and policy-induced, external factors also turned unfavourable: substantially slower growth in North America, a deceleration in continental Europe and, from August 1990, the Gulf crisis.

Inflation, the reduction of which is the main policy priority, worsened during the slowdown in 1989 and 1990. The underlying rate doubled from around 4% at the beginning of 1988 to around 8% in late 1990 (7 1/2% excluding the effects of oil). Inflationary momentum, originally demand-led, fed into nominal wage pressures, which have so far largely persisted despite the move into recession, and would if sustained lead to a deterioration in international competitiveness. A difficult period of adaptation to successful ERM membership may thus be in prospect.

Analysis of economic performance over the longer term suggests that inflation is one of a number of key areas of concern. Among others, there is a tendency for the pattern of growth to be biased towards private consumption at the expense of investment. Important factors may be the tax treatment of owner-occupied housing and other features of the housing market. Low private sector saving, only partly compensated by high public sector saving, thus proved insufficient to finance the levels of investment achieved during the later part of the 1980s - levels which, even in 1988, at the height of the last cycle, were not exceptional by international standards.

Contributing to the difficulties of controlling inflation is a labour market which still exhibits insufficient flexibility, despite the major reforms undertaken since 1979. A final main area of concern is the current external deficit. In 1989 this reached almost 4% of GDP. Although the major increase in the deficit clearly resulted from overheating, it is of concern that underlying trends may be adverse, particularly for manufactures.

The policy structure in place since 1980 has relied on a nominal monetary and fiscal policy framework - the Medium Term Financial Strategy (MTFS) - for the control of inflation, while an ambitious programme of supply - side reform has been pursued to improve the economy's growth potential.

In the 1980s the authorities found it difficult to achieve a successful approach to monetary policy. From the mid-1980s, evident difficulties in assessing the response to financial deregulation and statistical underestimation of the strength of the economy led to what, in retrospect, was an inappropriately loose monetary stance before corrective action was undertaken beginning in 1988.

The change of monetary regime as a consequence of ERM participation now imposes obvious constraints on policy. In particular, although the current weakness of the economy and the impending decline in inflation can be expected to put downward pressure on nominal interest rates, reductions will be constrained by the need to maintain the exchange rate. ERM membership does nevertheless provide the opportunity to rebuild the policy credibility-in the domestic economy and in financial markets-eroded during the 1980s. Gains in credibility should be reflected in swifter disinflation and greater convergence between UK interest rates and those of the UK's ERM partners.

The credibility problem, particularly the failure to maintain control of inflation in the second half of the 1980s, has also affected the fiscal side of the MTFS. Nominal targets for revenue and borrowing have been subject to substantial annual revisions; in contrast, firmer control of nominal public expenditure has led to real growth in spending lower than planned. The financial balance of the general government sector thus moved into very large surplus in the financial year 1988-89. Since then the surplus has declined, and a modest financial deficit is projected by the Commission services for the current financial year, ending in March 1991. This reflects significant growth in expenditure, in volume as well as nominal terms. Higher deficits are projected for the two forthcoming financial years, the consequence of expected cyclical weakness in the economy rather than an easing of policy.

Although ERM entry has coincided with adverse short-term trends in the real economy, its contribution to reducing the output and employment costs of disinflation will be maximised if the authorities' commitment is fully apparent. A successful move to narrow (2 1/4%) margins should help; an essential buttress is that the overall policy stance remains oriented towards disinflation, through and beyond the current recession.

Enhanced credibility of policy might itself in this way promote more rapid adjustment of wage and price setting. Improvements in economic structure, pursued as part of an ongoing process of supply-side reform, could also include encouraging more moderate pay-bargain-

ing, taking account of the UK's position within the ERM and the evolving single market. A new approach, successfully pursued, could bring forward the attainment of robust growth achieved in conditions of low inflation.

PART I

United Kingdom: Economic Policy and Prospects in the ERM

Introduction

Sterling entered the exchange rate mechanism (ERM) of the EMS in October 1990, ending many months of uncertainty as to the timing and conditions of entry. The move, at a central rate of DM 2,95 to the pound with

transitional 6% margins, was accompanied by a one percentage point reduction in short-term interest rates to 14%, exactly a year after these were raised to 15%.

The cut in interest rates was made against increasing indications that the economy had already embarked upon a period of substantially slower growth, and was possibly already in recession; this followed a more hesitant slowdown over the previous year and a half from the extreme overheating of 1986-88. ERM entry was also justified by the government on the ground that inflation was soon expected to peak, and then to start on a downward trend. However, actual inflationary performance worsened substantially during the course of 1990, with the differential against ERM members widening in advance of entry (Graph 1)

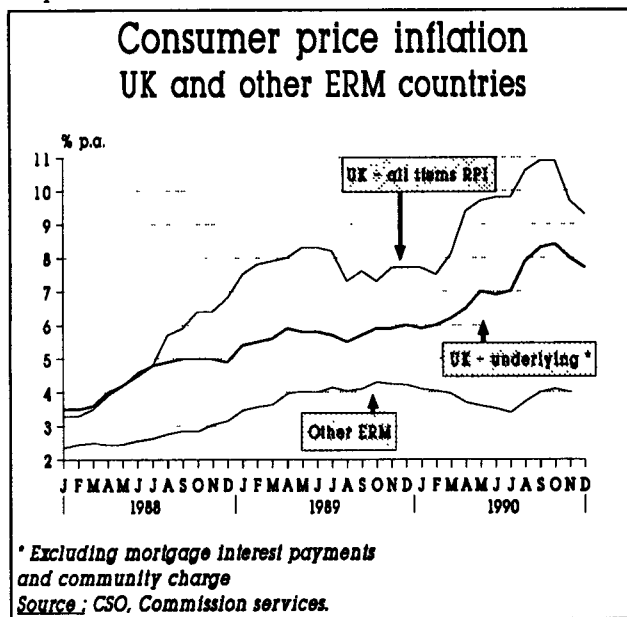
The progressive slowdown in demand and activity during 1989 and 1990 led to a rise in unemployment beginning in April 1990. The nominal exchange rate, after falling over much of 1989, recovered from early 1990. This recovery gathered strength during the course of the year on speculation about ERM entry. Because of accompanying rising UK wage costs and falling productivity the real exchange rate rose substantially (Graph 2). The current account has nevertheless recently improved as an easing of domestic demand and of pressures on capacity have so far resulted in an increase in net exports.

Short-term prospects indicate a difficult period of adaptation to the sustained low inflation performance consistent with successful ERM membership. It seems likely that wages will decelerate only slowly, in which case maintenance of sterling's central rate will imply the real exchange rate continuing to appreciate. Pressure will thus come to bear particularly on the foreign trading sectors of the economy with employment losses at the whole economy level likely to continue for some time.

Recent developments

The 1986-88 overheating reflected an unanticipatedly strong response by the private sector to the financial deregulation of the 1980s. Credit expansion increased greatly, while the monetary stance remained largely accommodating. Recognition of the degree of overheating provoked a progressive tightening of short-term interest rates from mid- to late 1988, with a further one percentage point increase in October 1989. As acknowledged by the authorities¹, mistakes were made in not recognising the extreme strength of demand in the 1986-88 period

Graph 1



Graph 2

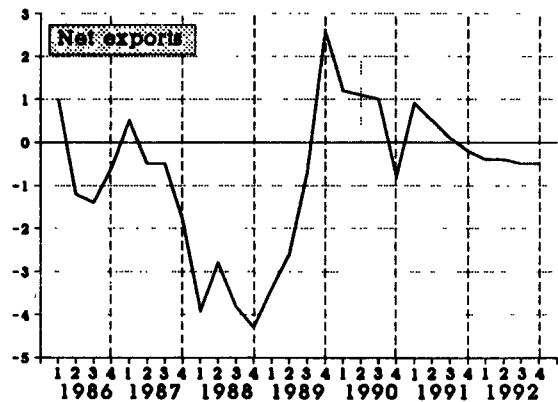
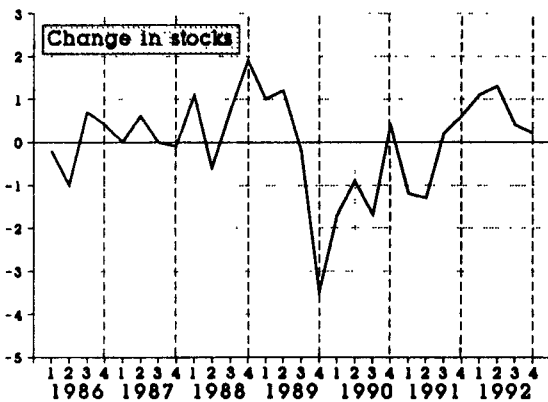
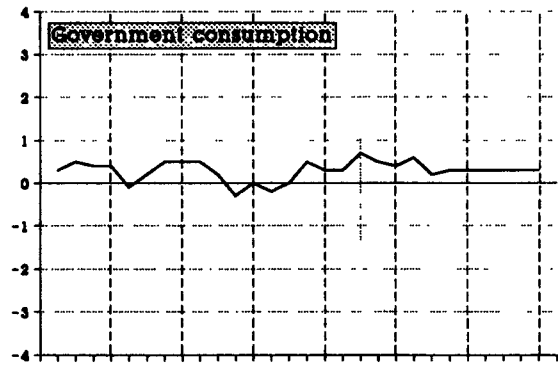
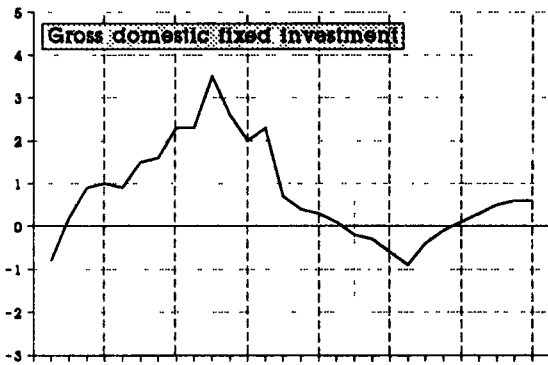
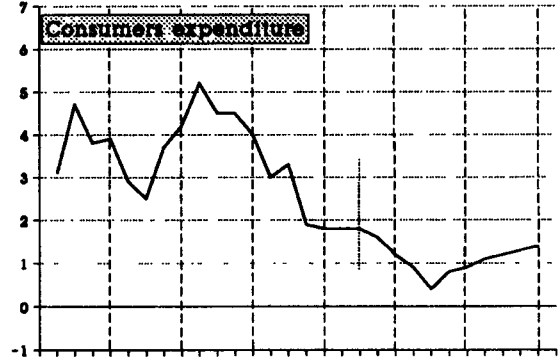


1) See Treasury Bulletin, Summer 1990 and Bank of England Quarterly Bulletin, May 1990.

Graph 3

Contributions to changes in GDP

Per cent change over 12 months



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

and in thus applying the policy brakes too late and initially too lightly. This helps explain the slowness of the subsequent adjustment.

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

The nominal effective exchange rate peaked in January 1989 (Graph 4), supported by the level of UK interest rates. Thereafter financial market confidence weakened

Graph 4

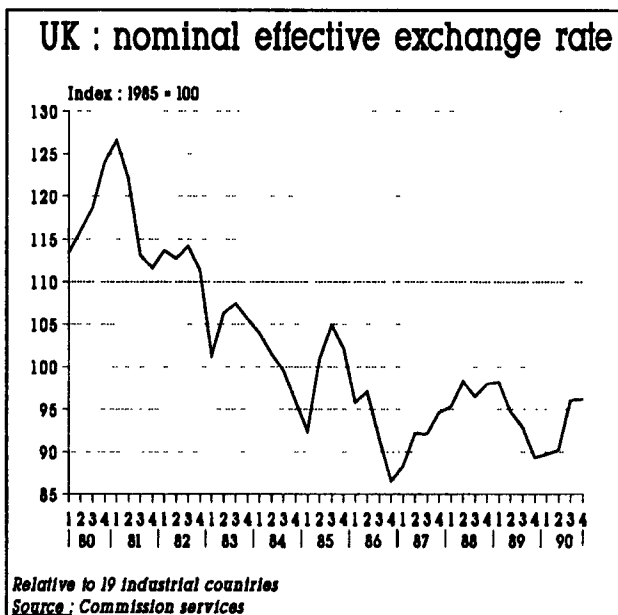


Table 1: GDP and its expenditure components at constant market prices (% change on previous period)

	1988	1989	1990*	1991*	1992*
Private consumption	7,2	3,9	2,4	1,1	1,9
Government consumption	0,5	0,8	2,5	1,9	1,6
Gross fixed investment	14,8	4,8	-1,2	-1,6	2,5
- Residential (20%)	5,7	-3,0	-7,1	0,7	1,4
- Business	20,4	7,1	-1,0	-3,1	3,2
- Other	-2,5	3,2	8,2	5,5	0,0
Final domestic demand	7,2	3,5	1,8	0,8	1,9
Stockbuilding (% of GDP)	1,0	0,6	-0,3	-0,7	0,0
Total domestic demand	8,0	3,1	0,9	0,4	2,7
Exports of gds. & serv.	0,2	4,3	5,1	1,7	3,2
Imports of gds. & serv.	12,8	7,0	2,5	0,5	4,1
GDP (average measure)	4,6	2,2	1,5	0,7	2,4
Deflators ¹ :					
- Private consumption	4,9	6,1	7,0	6,3	4,8
- GDP (expend. meas.)	6,7	7,0	7,7	6,8	4,8

Forecasts of the Commission services, November 1990
1) Adjusted for impact of Community Charge

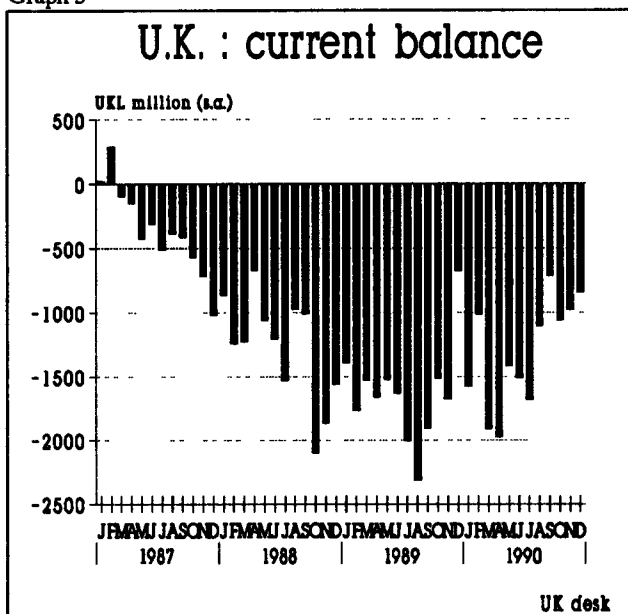
progressively and the exchange rate fell 12% through the remainder of the year to a trough in December. The fall in the exchange rate had a considerable effect on easing monetary conditions overall ²; in addition there was some limited and unintended easing of fiscal policy (see below).

The marked decline in household saving during the 1980s was strongly associated, as the decade progressed, with the interaction of adjustment to financial liberalisation and increasing net wealth from housing (reflecting high owner occupation and generous tax treatment) and financial assets. Lower household saving was the main factor behind declining national saving during the 1980s. When investment recovered sharply from 1986 to 1988, to levels in relation to GDP more comparable with those overseas, the inadequacy of national saving was reflected in the current account deficit and later inflationary pressures ³.

In 1990 the economy continued to register moderate growth in the first half. However, the factors sustaining growth weakened. The exchange rate appreciated, particularly from April when speculation began in earnest on early ERM entry. The below-potential growth of the onshore economy from 1989 eventually led to a turnaround in the labour market. Unemployment began rising from April, with the rise accelerating sharply in the final quarter. The effect on the personal sector of the further rise in interest rates in October 1989 was delayed to some extent by many institutions holding back a

- 2) A rule of thumb, supported by most econometric models, is that a 4% fall in the exchange rate roughly corresponds to a 1% point reduction in short-term interest rates.
- 3) A discussion of these issues can be found in "The United Kingdom", Country Studies, Economic Paper No. 79, CEC Directorate-General for Economic and Financial Affairs, July 1990.

Graph 5



further rise in mortgage rates until March 1990, and because many mortgage schemes are subject to annual review⁴. Consumers' expenditure continued to grow; nevertheless the depression in the housing market damaged consumer confidence: average house prices fell from late 1989. The corporate sector began a more serious readjustment, with cutbacks in capital expenditure and employment.

In the second half of the year there was an abrupt deterioration in the economy. Early evidence that the economy entered a recession in the third quarter of 1990 was later confirmed by GDP data showing all the major expenditure components having declined. Non-oil output declined 1/2% in the third quarter (total GDP dropped 1%). Manufacturing output has declined steadily since a peak in April; more significantly, the decline is concentrated in investment goods, where the level in November was already 9% below that in April. The available data for the fourth quarter indicate a further weakening. Survey data point to the very significant reduction in business and consumer confidence. A substantial slowdown in growth of the monetary aggregates—a principal justification for October's one percentage point reduction in interest rates—also underlines the decline in demand.

To some extent the UK downturn may reflect a more general slowing of the industrial economies: signs have also emerged of a weakening in the continental European economies, with the notable exception of Germany, while the USA and Canada have also entered into recession. Weaker overseas demand would help explain why

the downturn in the UK appeared relatively swiftly. Early uncertainty in the Gulf, eventually leading to war, has played a role. Nevertheless, the main reasons appear to be of domestic origin, especially the tighter monetary stance imposed since 1988 and a real exchange rate that has erratically but eventually tightened.

Inflation, lagging the weakening of demand, worsened progressively during 1990, with sharply higher petrol prices because of the Gulf crisis from the third quarter. Inflation was considerably aggravated at the "headline" level by the introduction of the local authority Community Charge from April⁵, by higher mortgage interest rates and by the effect on the composition of the index of the previous house price boom.

In the first half of 1990 the improvement in the external current account registered in 1989 was not fully sustained, apparently reflecting recovery of domestic demand (Graph 5). However, in the second half the slowing domestic and international economy was evident in decline in imports and the stabilisation of exports, and the trade deficit fell.

Short-term prospects

The forecasts of the Commission services, prepared in October and early November 1990, suggest a largely cyclical recovery in UK output prospects from late 1991, with underlying growth remaining below potential in 1992 (see Tables 1-3). Total GDP in 1992 is boosted by a sharp recovery in oil output. Output is expected to grow by 3/4% in 1991 and by 2 1/2% in 1992 (2% for the non-oil economy in 1992), with the manufacturing sector under particular strain and with unemployment rising

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

% GDP 1985	1988	1989	1990*	1991*	1992*
Energy & water (11)	-4,4	-9,5	-1,2	-3,2	4,9
- Oil & gas extract (6)	-8,6	-18,6	4,9	-4,9	8,8
Manufacturing (24)	7,3	4,3	0,2	-0,7	3,0
Construction (6)	9,0	4,1	1,8	-0,8	1,6
Services and other (58)	5,1	3,4	2,0	1,7	1,9
Non-oil GDP ¹	5,7	3,5	1,1	0,8	2,1
GDP, output meas. (100)	4,9	2,4	1,3	0,6	2,4
GDP, average measure	4,6	2,2	1,5	0,7	2,4

* Forecasts of the Commission services, November 1990

1) GDP output measure excluding oil and gas extraction

- 4) About 60% of UK mortgages are floating rate and payments thus normally respond quickly to changes in short-term interest rates. Of the remainder, about half of building society schemes are adjusted annually in the spring.
- 5) In England and Wales. The tax had already been effect in Scotland from 1989 while Northern Ireland was unaffected.

deflator, adjusted to remove the impact of the Community Charge) is forecast to slow to 5 1/2% p.a. by the end of 1991 and to 4 1/2% p.a. by the end of 1992; the annual rise in wages and salaries per head falls to 7 3/4% by the end of the first year and to 6 1/4% by end-1992. The household saving ratio, 7 3/4% by mid-1990, continues to rise progressively to over 9%, consequent on low real private consumption growth. The current account deficit stabilises at 2% of GDP in 1991 and 1992 after 3% in 1990.

The government's own forecast published in November, to the end of 1991, is very similar (the chief difference from the Commission forecast is in projecting higher private consumption growth in 1991 and lower public consumption). However, a more substantial downturn, consequent on less buoyant external conditions, in addition to the continued appreciation of the real exchange rate, or further falls in investment expenditures, cannot

be ruled out. The crisis in the Gulf is a major uncertainty which has very probably further disturbed confidence. The indicators available since these forecasts were prepared have suggested the possibility of a more severe recession than projected by the Commission or UK authorities.

Key areas of concern

As a consequence of the severe overheating in 1986-88 serious imbalances in the economy emerged: the current account deteriorated significantly, and inflation later rose sharply. These imbalances continue to characterize current macroeconomic performance. Though the current account deficit has contracted somewhat, underlying inflation continued to worsen until the fourth quarter of 1990. Sterling's participation in the ERM has made more urgent the achievement of low inflation and better internal and external balance.

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

	1988	1989	1990*	1991*	1992*
FINANCIAL FACTORS					
Interest rates¹					
- 3-m Interbank	10,3	13,9	14,8	13,5	11,5
- 20-y govt bond	9,4	9,6	11,4	11,3	10,7
Monetary aggregates					
- M0	6,9	5,9	:	:	:
- M4	17,6	18,2	:	:	:
GGFB ² , calendr yr	1,0	0,9	-0,2	-0,7	-0,6
GGFB, financel yr	1,4	0,0	-0,1	-0,7	-0,4
Exchange rates					
- DM/UKL	3,12	3,08	2,88	2,93	2,93
- USD/UKL	1,78	1,64	1,76	1,89	1,95
LABOUR MARKET					
Comp of employees per head	8,1	8,8	10,4	8,7	6,7
Employment	3,3	2,8	2,0	-0,4	0,0
Unemployment ³	8,5	7,0	6,4	7,3	8,0
EXTERNAL CUR BALL ⁴	-3,2	-3,7	-2,8	-2,0	-2,1
WLD TRADE ASSUMPS.					
Volume	9,5	7,9	6,9	4,6	4,9
Oil price ⁵	15,0	18,0	24,0	29,0	25,0

* Forecasts of the Commission services, November 1990

1) Period average, %

2) General government financial balance, % of GDP

3) % of civilian labour force, SOEC standardised definition

4) % of GDP

5) USD/bbl, EC average cif price.

A growth pattern biased towards private consumption

The rapid expansion of domestic demand in the period 1986-1988 took place against a changing financial and economic background. As noted above, financial reforms had eased constraints on borrowing and made housing wealth more liquid. At the same time, disposable income rose strongly in response to high employment and real wage growth and as a result of the 1987 and 1988 tax cuts. The depreciation of sterling in late 1986 and the decline in interest rates following the stock market crash a year later eased monetary conditions and contributed to the inflation potential.

This pattern of developments strongly reinforced existing structural features of the economy unduly in favour of private consumption. The decline in household saving since the early 1980s, referred to in the review of recent developments, accelerated. This was associated particularly with wealth effects from the appreciation of residential property and financial assets which fuelled credit growth within the newly liberalised financial system. The strength of the housing market was reflected also in demand for housing-related consumer durables. In the period 1979-89 private consumption grew on average by 3,3% p.a. compared with only 2,3% p.a. for total GDP; in the four-year period 1986-89 these figures were 5,7% p.a. and 3,8% respectively. The strong recovery of investment back to more normal levels in relation to GDP, when it finally came in 1987 and 1988, could not then be accommodated, given low saving, without throwing the economy radically out of balance. While supply-side reforms had undoubtedly raised potential output, this was, it appears, inadequate compared to demand growth.

	1986	1987	1988	1989	1990	1990			
						Q1	Q2	Q3	Q4
Prices									
Retail price index									
-All items	3,4	4,2	4,9	7,8	9,5	7,8	9,7	10,4	10,0
-Underlying ¹	3,3	3,5	4,4	5,7	7,2	6,0	6,8	7,7	8,0
Producer prices in manufacturing									
-Materials and fuel inputs	-7,6	3,1	3,3	5,7	-0,1	2,9	-1,0	-0,8	-1,9
-Output (domestic sales)	4,3	3,8	4,5	5,1	5,6	5,4	6,3	5,9	5,9
Import prices ²	-4,4	2,6	-1,0	6,5	n.a.	7,3	3,2	-1,6	n.a.
of which :									
-Goods	-6,0	2,8	-1,1	6,5	n.a.	6,7	2,6	-2,5	n.a.
-Non-oil goods	-0,6	1,8	-0,5	5,6	n.a.	6,4	4,3	-1,9	n.a.
New house prices ³	17,0	17,5	26,0	16,0	n.a.	9,3	5,8	n.a.	n.a.
National accounts deflators⁴									
-Private consumption	4,4	4,3	4,9	5,8	n.a.	6,2	6,9	7,3	n.a.
-GDP at market prices	3,5	5,1	6,7	6,8	n.a.	5,9	7,2	9,1	n.a.
Earnings and costs									
Underlying earnings									
-Whole economy	7,5	7,8	8,8	9,1	n.a.	9,5	9,8	10,2	n.a.
-Manufacturing	7,9	8,2	8,7	8,7	n.a.	9,2	9,4	9,5	n.a.
Unit labour costs⁵									
-Whole economy	5,5	4,2	6,8	9,2	n.a.	10,1	10,2	12,1	n.a.
-Manufacturing	4,2	1,7	2,6	5,0	n.a.	8,2	7,3	10,0	n.a.

1) Excluding mortgage interest payments and community charge (poll tax)
2) Goods and services, balance of payments definition
3) Average price of new dwellings : mortgages approved
4) Adjusted for impact of community charge
5) Wages and salaries per unit of output
Source : CSO

	1986	1987	1988	1989	1990	1990			
						Q1	Q2	Q3	Q4
(% change on year earlier, s.a.)									
Employment	0,1	2,0	3,3	2,8	n.a.	2,1	2,1	1,8	n.a.
of which :									
Employees									
-Whole economy	-0,1	1,3	3,0	2,2	n.a.	1,7	2,1	1,7	n.a.
-Manufacturing	-2,6	-1,1	1,5	0,2	n.a.	-0,9	-0,7	-1,1	n.a.
Self-employed	2,4	7,5	5,2	7,7	n.a.	5,3	4,3	4,3	n.a.
Labour productivity¹									
-Whole economy	3,0	2,9	1,3	-0,3	n.a.	-0,3	0,3	-1,2	n.a.
-Manufacturing	3,3	6,3	5,5	3,6	n.a.	0,8	1,9	-0,1	n.a.
Levels, s.a.									
Unemployment									
Thousands	3107,2	2822,3	2294,5	1695,7	1661,8	1612,1	1612,1	1652,6	1770,5
Rate (%)									
-National definition	11,2	10,3	8,3	6,4	5,8	5,7	5,7	5,8	6,2
-SOEC definition	11,4	10,4	8,5	7,0	6,4	6,3	6,2	6,4	6,8
Unfilled vacancies									
(thousands)	188,8	235,4	248,6	225,6	173,5	197,9	194,1	166,5	134,6

1) Output per person employed
Source : CSO

Inflation

Economic overheating resulted in progressively worse inflation from early 1988.

In 1990 the year-on-year increase reached 10.9% in September and October. The retail price index (RPI) measure of inflation, which includes mortgage interest payments and the community charge, is subject to policy shocks and overestimates the extent of deterioration in the UK's inflation performance during this period. However, the deterioration is also confirmed by other measures (Table 4). The annual increase in the RPI excluding mortgage interest payments and the community charge, for example, rose from below 3% in the summer of 1986 to a peak of 8.4% in October 1990. Additionally excluding the effects of oil indicates an annual inflation rate of about 7 1/2% in late-1990. Consequently, the inflation differential between the UK and its main EC partners has widened substantially.

The acceleration of inflation is reflected in wages. Earnings growth decelerated substantially in the first half of the 1980s, falling below 8% p.a. in the spring of 1986 at a time when unemployment exceeded 10% of the labour force. Earnings growth then crept back up, with occasional remissions during 1988 and 1989. By mid-1990 the underlying growth rate in earnings reached 10% p.a., only decelerating slightly in the fourth quarter. Productivity growth has slowed appreciably as output growth has declined but with delayed repercussions on the labour market (Table 5). Even in manufacturing, the decline in output has brought to a halt the growth of output per head. The annual growth of manufacturing unit labour costs rose to about 10% in 1990; for the whole economy the rise in the year to the third quarter was 12%. If inflation is to be reduced wage increases will thus have to decelerate substantially, probably to a medium-term norm of well under 5% p.a. This would involve at least a halving of the present rate of nominal increase.

Labour market adjustment

The UK authorities undertook significant labour market reforms in the 1980s. Among the most important were:

- programmes to improve the suitability of the long-term unemployed for work, and their ability to find work,
- reform of the unemployment benefit system to encourage job search and to improve job-matching,
- reform of industrial relations legislation to improve access to work for job-seekers and to enable more flexible and cost-effective working patterns,

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

The outcome has been an improvement in the trend rate of growth of productivity during the past decade. Furthermore, the acceleration of wage inflation during the expansion of 1986-88 was considerably less pronounced than in previous periods with excess demand, indicating an enhanced flexibility of the labour market following the supply-side reforms. Nevertheless, in comparison with other industrial countries, UK real wage behaviour has displayed greater rigidity, and this has occurred despite the record levels of unemployment experienced during the first half of the decade⁶.

The factors explaining wage behaviour in the UK are not fully understood. However, a number of factors have contributed to the appearance of inflationary wage trends in recent years:

- rapid growth of activity in recent years has magnified important shortages of skills in some key sectors and regions and revealed a deficiency in the stock of skilled manpower,
- insufficient mobility of labour, partly attributable to failures in the structure of collective bargaining but also caused by imbalance in regional economic activity and the implications of this imbalance for the housing market,
- the survival of inflationary expectations amongst pay bargainers, and the entrenched view that compensation for past inflation is a property right.

The present structure of collective bargaining (a patchwork of centralised and decentralised agreements) may itself contribute to the development of inflationary pressures in the labour market. The structure enables the transmission of nominal wage settlements from high activity to lower activity (or lower value-added) regions. It also facilitates the imitation of relatively high wage settlements across bargaining groups, and this process might become even more significant in the single market if imitation occurs across national borders. The importance of imitation might be reduced or moderated if an effective dialogue between pay bargainers and the government were able to identify a sustainable path for real wages in the context of ERM participation.

The balance of payments

Movements in the current account balance are highly correlated with movements in domestic demand relative to domestic output. The large external deficit of recent

6) Labour market and wage adjustment in the UK is further explored in Part II, Chapter 1 and in "The United Kingdom", op. cit. pp. 19-22.

years reflects principally the rapid expansion of domestic demand which has taken place. Chapter 2 in Part II explores the balance of payments in greater depth.

Underlying the deterioration in the external balance since 1986 is essentially an insufficiency of domestic savings to finance domestic investment spending. Consequently, this excess demand for savings has been financed through external inflows, reflected in the current account deficit. The government has taken the view that, since the large excess demand for savings and the deterioration in the current external balance principally reflect private sector decisions, an external deficit should not be a subject for policy concern except as a symptom of excess demand in the economy. However, current account developments throughout the 1980s pose important questions regarding both macroeconomic and resource allocation policies.

- Recent inflation trends have led to an appreciation of sterling's real exchange rate. Between 1987 and June 1990 competitiveness as measured by the real exchange rate (based on normalized unit labour costs in manufacturing) has appreciated by 9%, mainly reflecting growth in labour costs.
- The principal source of the deterioration in the current account balance has been the balance on merchandise trade and, in particular, trade in manufactures. The secular widening of the deficit in these products raises the issue of whether the UK's relative ability to compete internationally over a broad range of technology-intensive goods may have declined over the longer term. While it is encouraging that the UK share of world trade in manufactures has been broadly stable since 1984, this period was one of very strong productivity growth and improving cost competitiveness. It will be more difficult to extend these competitiveness gains into the medium-term.
- The surpluses on interest, profits and dividends (IPD) transactions, which provided an offsetting element to the rising deficits on merchandise trade in the 1980s, have been reduced sharply in 1990. If this decline becomes permanent, the balance of international transactions would be structurally weaker.
- Sustained current account deficits have potentially adverse implications for the exchange rate. Interest rates may incorporate an unobservable, but possibly significant, risk premium associated with the existence of an external deficit, leading to expectations of depreciation. Such depreciation expectations could inhibit a convergence of interest rates and contribute to inflation expectations.
- The sharp deterioration in recent years in the UK's basic balance (i.e. the current account plus long-term capital flows) has meant that capital inflows of a short-term nature have been the principal instrument for

financing these deficits. Such inflows are particularly volatile and easily reversible. They may have contributed to the need to keep interest rates high. The increased volatility and reversability of even "long-term" capital flows, given international financial deregulation, strengthens the point in relation to the continued existence of a significant current account deficit.

Sterling's membership of the ERM severely limits the option to offset losses in competitiveness, resulting from high wage and price inflation, through nominal exchange rate depreciation. Indeed, as stressed earlier, it seems inevitable that for some time the real exchange rate will appreciate, eroding competitiveness further. The principal means to arrest and reverse this trend is through low inflation and substantial productivity growth. While the financing of current account deficits may be eased within the ERM, further expansion of the UK economy could be inhibited if it were to be associated with sustained large-scale external imbalances.

The monetary and fiscal policy framework

Since 1980 the government has set monetary and fiscal policy within the framework of its Medium Term Financial Strategy (MTFS). While the precise formulation of policy and the medium-term projections for real and nominal output, monetary growth and the public finances have been revised each year, the central objective of the MTFS has remained consistent. This is to provide "a nominal framework within which the government pursues its objective of bringing down the rate of inflation"⁷.

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

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

7) Financial Statement and Budget Report, March 1989.

Monetary and exchange-rate policy

The problem of indicators and credibility

Monetary policy was considered the principal element of the new stability-oriented adjustment strategy introduced in 1980 in the MTF. Initially M3 was targetted. However, during the 1980s it became increasingly difficult to interpret the movements of the broad monetary aggregates because of shifts related to financial supply-side innovation and credit deregulation. The difficulties led to several changes in the choice of target aggregates and to monetary control using not only the money stock figures but other financial and economic indicators: interest rates, yield curve movements, asset prices and, notably, the exchange rate.

By 1986, the difficulties in interpreting broad money were considered so great that broad money targeting was abandoned⁸. Given the abandonment of broad money targeting, a plausible alternative nominal anchor might have been the exchange rate. ERM entry was mooted in late 1985. However, oil prices fell very sharply at the time, implying a need for a real depreciation of sterling. Achieving that depreciation without a nominal exchange rate movement would have involved a transitory period of falling prices, and might have proved costly in terms of output and employment. Instead, the nominal exchange rate was allowed to depreciate sharply during the course of 1986; broad money growth accelerated. During this period, the authorities laid emphasis on the largely offsetting impacts on prices of a falling oil market and a falling exchange rate.

By late 1986, downward market pressure on the exchange rate came to an end: the competitive position had improved, and unemployment had finally started falling. The time seemed appropriate to place more weight on the nominal exchange rate as an indicator. Unfortunately, while the money demand implications of the financial deregulation carried out during the period were recognized, the aggregate demand implications were less obvious. Improved consumer and investor confidence combined with vastly increased borrowing opportunities to produce the overheating of the economy discussed earlier. The appropriate response would have been to tighten monetary policy significantly. However, from early 1987 until the spring of 1988, sterling "shadowed" the DM within a range widely thought to be from DM 2,90 to DM 3,00, with upward pressure on the exchange rate set by cuts in interest rates (in addition to the international lowering of interest rates after the stock exchange collapse of October 1987).

It is clear that doubts about the indicator function of the aggregates led, during 1987 and early 1988, to excessive reliance on an indicator that was at the time even more

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

From early 1989 sterling fell under the impact of the markets' worries about political factors, and their perceived effect on the disinflationary commitment of the authorities. In addition, there were perceptions that adjustment of the large current account deficit might call for sterling depreciation, despite a further rise in interest rates in May (to 14% from 13%) and October 1989 (to 15%). This change in market perceptions of the UK economy contributed to looser monetary conditions and made it more difficult for monetary policy to affect wages and profit margins, since a declining pound enlarged the room for manoeuvre of companies competing both abroad and domestically with imports, as well as contributing directly to inflation through higher import prices.

The background to ERM entry

The monetary policy mistakes of 1987 and 1988 weakened the anti-inflationary credibility of the authorities. The need for an anchor capable of reducing the output and employment costs of disinflation by directly influencing wage and price determination was thus increased.

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

The decision to enter the ERM at a 2,95 DM/UKL central rate can be characterized as involving a judgement that the exchange rate was "right", despite the persistence of a large current account deficit, in the light of the need to exert downward pressure on inflation. The shortfall in domestic demand relative to potential output which will be involved in restoring external balance will, in the

8) The authorities nevertheless continued to pay attention to broad aggregates, and also published target ranges for narrow money, M0. However, fast growth of the monetary aggregates did not lead to a restrictive monetary policy.

absence of nominal depreciation, induce a deceleration of domestic costs. This will not necessarily involve explicit policy action: financial pressures on the private sector will largely determine the timing and extent of such deceleration. And, for internal balance to be restored, the rate of increase of domestic costs will at some point have to undershoot temporarily, the rate of cost increases in partner countries.

Several factors, however, distinguish the present situation from that of 1985. First, the need to reduce UK inflation is now more urgent than it was perceived to be in late 1985. Second, in 1985 the factor appearing to require a real depreciation (falling oil prices) was itself an independent agent of disinflation. Third, inflation is not now decelerating in Europe, most notably in Germany, so that UK inflation undershooting would not have to involve actual price deflation.

Monetary policy challenges in the new context

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

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

However, evidence as yet is that wage settlements are only beginning to decelerate. If wage inflation remains stubbornly high, it cannot be excluded that interest rates may have to be raised to defend sterling's parity. It remains to be seen whether ERM entry will itself have a direct expectational effect, increasing the credibility of the authorities' commitment to disinflation and thus reducing the employment and activity costs involved.

Fiscal policy

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

Despite this public articulation of the key elements of the public finances, the MTFS has never decisively gained credibility as an instrument for influencing expectations, particularly with regard to inflation. Chapter 5 of Part II explores in more detail why this should be so. The most obvious point is that recent paths of inflation projected in successive versions of the MTFS, as in the official short-term forecasts, have been persistently exceeded. It is nevertheless possible that the MTFS approach could be built on to re-establish and enhance the overall credibility of policy within the framework of ERM participation. Crucially, the latter should contribute greater nominal stability.

As regards recent trends, the public finances underwent a rapid move into very large surplus (net debt repayment) in 1988-89⁹, greater in speed or extent than planned by the government. Debt repayment declined in 1989-90 and official forecasts from November 1990 are for a further weakening in the current financial year.

Focusing on the general government financial balance¹⁰ indicates a similar surplus of about 1% of GDP in both calendar 1988 and 1989 (Table 6). However, Commission forecasts suggest that this will be followed by a small deficit in 1990. The reduction in the surplus in 1990 reflects some cyclical weakening (but so far limited, given the lags in the reaction of the labour market to output and of corporate tax collection lags), and significantly higher expenditure, in volume as well as nominal terms.

Outline expenditure decisions for the 1991-92 and two following financial years were announced in the November 1990 Autumn Statement. For 1991-1992 the government's "planning total" for public expenditure was set over 10% higher than the outturn expected for 1990-91. Total general government expenditure, exclud-

9) The financial year runs from April to March.

10) Although the MTFS focuses on the public sector debt repayment or borrowing requirement (PSDR/PSBR), a better guide to the stance of fiscal policy is given by the general government financial balance (surplus or deficit, GGFB). The latter excludes privatisation receipts, lending and miscellaneous financial transactions which do not materially influence the net worth of the general government sector: see Chapter 5 in Part II which analyses budgetary policy in more detail. Note, however, that during the 1980s there was a significant consolidation of the finances of public corporations.

	Calendar years						Financial years					
	1987	1988	1989	1990*	1991*	1992*	1987-88	1988-89	1989-90	1990-91*	1991-92*	1992-93*
Financial balance (GGFB)	-1,3	1,1	0,9	-0,3	-0,7	-0,6	-0,6	1,4	0,0	-0,1	-0,7	-0,5
PSDR/PSBR	0,3	2,5	1,8	1,6	0,7	0,5	0,8	3,0	2,2	0,5	0,1	0,3
Memo												
Privatisation receipts	1,5	1,3	0,9	0,9	1,0	1,0	1,2	1,5	1,5	0,9	0,9	0,9
PSDR/PSBR excluding privatisation receipts	-1,2	1,2	0,9	0,7	-0,3	-0,5	-0,4	1,5	0,7	-0,4	-0,8	-0,6
Annual changes (+=higher surplus)												
Financial balance (GGFB)	1,0	2,4	-0,2	-1,2	-0,4	0,1	1,7	2,0	-1,4	-0,2	-0,6	0,2
PSDR/PSBR excluding privatisation receipts	0,3	2,4	-0,3	-0,2	-1,0	-0,2	1,6	1,9	-0,8	-0,9	-0,5	0,2
Cyclically adjusted GGFB												
a) Using trend output	0,3	1,8	-0,3	-0,9	0,3	0,3	:	:	:	:	:	:
b) Using moving benchmark	0,7	1,5	-1,2	-1,6	0,0	0,5	:	:	:	:	:	:

* Forecasts of the Commission Services;
Source: CSO, Commission Services

ing privatisation proceeds, is projected to increase by just over 2% in real terms over 1990-91. Compared with earlier intentions expenditure plans were increased by about UKL 8 billion (1 1/4% of GDP). This represents notably: higher than expected inflation (particularly because most transfers are indexed to the rise in the Retail Prices Index in the year to September, which to September 1990 was 10,9%), higher numbers of claimants on demand-led programmes, higher expenditure on health and higher current grants to local authorities to reduce the increases in the community charge in April 1991 that would otherwise be required.

In 1991 and 1992 it may be difficult for fiscal management to maintain an appropriately tight stance for reducing inflation. There will be pressures on both the expenditure and taxation fronts, with the overall picture obscured by cyclical influences tending to raise the financial deficit. Forecasts of the Commission services indicate financial deficits of 1/2-3/4% in both years. The higher deficits in 1991 and 1992 are nevertheless principally because of more pronounced cyclical weakness in the economy. Adjusting for these might indicate a marginally tighter stance on present policies (assuming in particular no large-scale tax reductions).

The government has made it clear that it will not normally resist cyclical influences on the budget and that the "automatic stabilisers" will be allowed to operate. Thus, while the medium-term objective of a balanced budget remains, expenditure is unlikely to fall in the short-term as a proportion of GDP. Movements in taxation, especially corporate tax receipts, may have an even larger short-term influence on changes in the actual government financial balance than expenditure changes. The current move into recession is likely to imply a sharp reduction in corporate tax receipts from the 1991-92 financial year, while personal income tax receipts will be restrained by an absence of further employment growth (and perhaps reductions).

Overall, the need to bear down on inflation implies that the fiscal stance cannot afford to be significantly relaxed beyond normal cyclical influences on revenue and expenditure. A possible target to aim for is a financial deficit roughly balanced (or in very moderate deficit¹¹) over the medium term. This is somewhat more ambitious than the MTFs's current concept of a "balanced budget" in the sense of zero borrowing, given that the latter includes privatisation receipts of UKL 5 billion p.a. The actual deficit in the short term would, of course, be larger because of cyclical effects.

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

Within these overall constraints there remain opportunities for both continuing with fiscal reform (for both taxation and public expenditure management) and for varying the overall composition and level of expenditure and taxation. Consideration of supply side needs, explored further below, suggests that there are probably grounds for higher public investment to strengthen the infrastructure.

For taxation there are also obvious weaknesses, particularly with regard to housing where, compared to other major countries, current treatment is especially generous to owner occupation in general and mortgage financing in particular. The main reliefs are complete exemption from capital gains tax, the absence (since the abolition of domestic rates) of any tax linked to capital or imputed rental values and the income tax relief (limited to a non-indexed ceiling) on mortgage interest payments. This issue is explored further in Chapter 4 of Part II (Housing). The 1986-88 overheating was aggravated by the role played by housing finance in a context of a very high ratio of owner occupation to overall housing tenure and financial liberalisation. This combination seems to have been a major reason why private saving declined excessively relative to investment. It seems desirable to aim for much lower subsidisation of housing through the tax system, even if full neutrality is not achieved.

The supply-side and the Single Market

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

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

- deregulation of product and labour markets (the attack on 'red tape') has encouraged small businesses and created the opportunities for new working patterns and practices.

The outcome is measured by an improvement in the trend rate of growth of productivity. Trends in productivity are an important predictor of international trade performance and research undertaken by, and on behalf of, the Commission suggests that, despite general trade performance being open to question, significant comparative advantage has been achieved or maintained in several industries. Telecommunications, computers, pharmaceuticals and financial services should all gain significant advantages from the Single Market¹².

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

- evidence showing that pay differentials for skill are inadequate in some sectors to provide incentives for improvement in abilities, particularly amongst youths and for example in engineering,
- evidence that many school-leavers are uninterested in education and training, which is an obvious constraint upon subsequent progress and prospects,
- evidence that quality of training has been low, and an inadequate base for subsequent learning.

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

Important connections can be identified between the efficiency of the labour and housing markets. The large differentials in property prices across the United Kingdom reflect the concentration of higher-paid activity in the South-East quadrant, which is an important constraint upon regional mobility of labour. The private rented property sector has been slow to develop in response to recent deregulation, which represents a further constraint.

12) See European Economy/Social Europe, Special edition 1990, pp.325-340.

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

Conclusions

The UK has joined the ERM at a time when there is considerable nominal divergence from the path followed by its main European partners. While current developments suggest that underlying UK inflation will decline over the coming months, the extent and sustainability of the decline in inflation are by no means certain. Nevertheless, the decision to enter the ERM at this time must be seen as expressing the government's commitment to strengthen its anti-inflation stance, and to reduce, and keep low, the rate of nominal expansion of the UK economy¹³. Membership increases the urgency of reducing inflation rapidly. It is not itself a sufficient policy for achieving disinflation.

It is essential that the policy commitment to observe the exchange rate target is beyond question. If this precondition is not met, the ERM will fail to serve the objectives of policy stability and predictability, and will make little contribution to disinflation. It might be argued that the choice of a 6 percent band for sterling is too wide and that the narrow band should have been chosen. While the wide band may be justified on transitional grounds, a successful transition to the narrow band should increase the disinflationary credibility of the authorities.

There are risks that inflation may prove more stubborn than currently foreseen, particularly if wage growth remains high. The output cost of disinflation would then rise. In order to promote adjustment to, and secure durable, price stability, disinflation must continue to be the priority of economic policy. In the United Kingdom wage behaviour has not been compatible with sustained low inflation. The government is, nevertheless, averse to incomes policies or social dialogue addressed to wage moderation. In these circumstances the credibility of overall policy becomes vital as the means through which the exchange rate commitment in the ERM bears on the corporate and labour sectors of the economy.

The question of the appropriate stance of policy is of central importance. In the course of the economic slowdown, the decline in real output and in inflation will exert downward pressure on nominal interest rates. Under these circumstances, it would appear appropriate to expect some easing of market rates. However, it is not clear how much room for manoeuvre will be available to

the authorities: disinflation requires that real interest rates (measured by the expected underlying rather than the RPI rate of inflation) must remain significant to ensure the transition to low inflation. Premature reductions in interest rates would erode the credibility of the policy commitment to price stability.

The need for restraint applies also to fiscal policy. There has been some easing of policy in the past two years. The sharp reduction in the public sector debt repayment (PSDR), and its dependence on asset sales, make it vulnerable to a variety of pressures. More significantly, the general government financial balance already appears to have moved into deficit in the current financial year, and a deepening of the deficit is expected from 1991-92. While expected changes from 1991-92 represent cyclical effects, the increases in public expenditure announced in this year's Autumn Statement point to the considerable pressures bearing on the overall stance of policy. The need to bear down on inflation suggests that the budgetary stance needs to remain tight. It would be inappropriate to abandon fiscal restraint -beyond accepting the operation of the conventional stabilisers- in order to strengthen the recovery.

The recovery in household saving noted in recent quarters is a welcome signal of macroeconomic adjustment, and will offset the recession-induced decline in public sector saving. However, the experience in the second half of the 1980s suggests that financial liberalisation has had a significant influence on spending and saving behaviour. In particular, it is now possible to consume and save according to longer term trends in income, in contrast to earlier years when financial constraints were prominent. This has reinforced a medium-term growth pattern biased towards private consumption. High growth in the 1980s was over-reliant on consumption growth, at the expense of falling saving and inadequate scope for domestic financing of a sufficient level of investment. While the task of promoting saving in this environment is more difficult to accomplish, there still remains the need to raise the savings potential of the economy to match an adequate level of investment. Further progress is required.

Reform of the tax treatment of owner-occupied housing could have a role to play. Distortions in the housing market appear to have contributed to the recent overheating. They also add to labour market rigidities and thus exacerbate wage inflation. Furthermore, the potential to realize a greater proportion of the liquidity of housing wealth in a liberalized financial environment implies that the expansionary potential of policy will be greatly amplified with adverse consequences for inflation and the balance of payments. Should this potential remain

13) The potential for ERM membership to act as a disinflation mechanism in the case of the UK is discussed in "The United Kingdom", *op. cit.*, especially pp. 48-52 and pp. 62-63.

unchecked within the ERM, it could prove an important destabilizing factor making adjustment to the exchange rate constraint very difficult.

The UK has made significant progress in improving the supply side of the economy. However, further progress could be useful. Labour market flexibility could be improved further to reduce the costs of disinflation. Greater labour mobility would contribute to easing wage pressures at times of high employment: reform of housing

market policy would be a crucial step. From a longer-term perspective, the supply of skilled labour needs to be enhanced, requiring more effective manpower and training programmes, or an improvement in the incentives to workers to undertake such training. The need to raise the supply potential of the economy, already important in the context of the European Single Market, becomes even more decisive in the run-up to economic and monetary union.

PART II

SPECIAL TOPICS

Chapter 1

Wage Determination and the NAIRU in the United Kingdom

Strong associations exist between the rate of growth of output per head and the change in the real wage in the long-run. Over shorter periods, changes or failures in the functioning of labour and product markets may disturb the association and lead to inflationary pressures appearing in the labour market. Changes or failures in the functioning of the labour market lead to an upward shift in the real wage when such a shift is unwarranted by the trend in output per head. Changes or failures in the labour market may also enable successful resistance to downward shifts in the real wage when a downward shift is warranted by the appearance of a "shock" or disturbance. The effect of the "shock" or disturbance is to depress the rate of growth of output. One example of such a "shock" is a step increase in the real value of commodity prices. The common effect of an upward shift in the real wage, or real wage resistance, is to put upward pressure on unit labour costs.

When confronted with upward pressures on unit labour costs, firms will raise prices in order to sustain profits. The ability to raise prices will be constrained by the elasticity of demand with respect to prices for products and services. It will also be constrained by expectations about the rate of growth of total nominal incomes (and the rate of growth of domestic demand) in the foreseeable future and expectations about developments in monetary and fiscal policy during that period. Firms will eventually need to adjust costs of production as an alternative to higher prices and this will lead to lower employment and higher unemployment. The urgency of the need to reduce costs of production will depend upon the state of competition in the product market, which itself determines the elasticity of demand with respect to prices. Firms operating in monopolistic or oligopolistic markets will have better opportunities to raise prices, but the effects will be felt in higher unemployment amongst those working in more competitive product markets.

The dynamics of the association between productivity, wages, prices and unemployment are brought together in the concept of the NAIRU (the Non-Accelerating Inflation Rate of Unemployment). The concept suggests that there is one level of unemployment which is compatible with stable inflation, which is the level of unemployment at which workers are prepared to accept the wage offers which are consistent with firms' pricing ambitions and with the level of growth of GDP in the economy. The

efficiency (and speed) with which wages respond to changes in unemployment is determined by the combination of structural factors and failures in the labour and product markets. The rate of change of wages will eventually respond to the change in unemployment but the process of adjustment may take some time. Empirical evidence suggests that the process of adjustment in the United Kingdom has been slow in the past.

Empirical estimates of the level of the NAIRU are subject to considerable uncertainty, are often unstable when tested and depend heavily upon the specification of wage determination in any particular model. However, the concept of the NAIRU has been an important influence upon labour market policy in the United Kingdom and therefore upon policy measures taken to improve the flexibility of real wages. In fact, legislative and policy initiatives in the United Kingdom have brought about considerable reform in labour and product markets during the past decade. The level of the NAIRU should now be much lower than during the period of the early- to mid-1980's. However, the NAIRU is also higher than the levels of unemployment recorded in 1990. The following investigates further the ways in which wages are determined in the United Kingdom and looks particularly at the structural factors and failures which are the foundations of the principle of the NAIRU. It reviews some of the details of structural reform and looks at the important structural problems which remain in place. It concludes with an assessment of the short-term prospects for wages and prices.

1. Models of wage determination

Recent empirical work has attempted to explain the path of real wages in the United Kingdom by reference to models of collective bargaining¹⁴. The models are based upon a 'cost-plus' system of pricing, where costs are dominated by wages and import prices. The rate of increase in nominal wages is the outcome of a compromise between firms and workers. Workers (perhaps represented by unions) are concerned to add a mark-up to prices when determining wages and firms are concerned to add a mark-up to wage costs when setting prices. Firms and unions must bear in mind the rate of growth of domestic demand and the condition of the labour market. Firms and unions will naturally refer to the level of profits when striking a bargain.

14) See, for example, Layard and Nickell (1985). The detailed reference is at the end of the text.

The bargaining models thereby describe a relationship between pricing behaviour and unemployment. The rate of change of unemployment influences the willingness of firms to concede wage increases and the strength of trade unions to enforce them. The more recent empirical developments propose that there is one level of unemployment which is consistent with stable prices, and this is the non-accelerating inflation rate of unemployment (NAIRU). The level of the NAIRU is observed to vary dramatically across countries. The remarkable feature of the 1970's and 1980's is the very large increase in the NAIRU in the United Kingdom, and indeed in the European Community. The increase in the NAIRU in the United Kingdom was particularly concentrated into the period from 1981 to 1983 but the higher level of unemployment persisted until 1986.

Analytical and empirical work has sought to explain the level of the NAIRU by reference to the supply-side of the labour market. The explanation and measurement of the level of the NAIRU is particularly difficult. However, there are certain factors which may improve the capacity of those in work to bring about a step increase in their real wages through some structural failure or change on the supply-side of the labour market. The principal factors are:

- Mismatch, which implies that an important part of the available labour supply is unattractive to employ, given the state of technology and the potential productivity of that labour,
- Job search, where the unemployed (or potential employed) search less hard for work, perhaps because unemployment benefits have become more generous (the reservation wage has risen) or because of discouragement amongst the unemployed at the difficulties of gaining access to work,
- Legislative failure, where employment legislation (perhaps relating to hiring and firing procedures) is changed and alters the balance of power in the labour market, leading to changes in firms' willingness to recruit and changes in their production methods, and
- Union militancy, where workers decide that circumstances have changed and an opportunity has appeared for introducing a trend change in the distribution of national income towards wages. The strength of union militancy may be altered by changes in labour legislation.

The combination and strength of these factors also determines the ability of workers to resist a reduction in the net real wage when 'shocks' appear. Primary examples of 'shocks' include:

- Taxes, where rising taxes (perhaps community charge or even mortgage costs) lead to a demand for compensating increases in nominal wages,
- Relative import prices, where the underlying trend in the price of imports is raised relative to the price of final domestic output, leading to a rise in the price of final domestic output relative to value-added, and

- A productivity slowdown, where the trend rate of growth of productivity turns down (for whatever reason) and the consequences for wage growth are resisted. Nominal wages sustain their previous path.

In the medium-term, the effect of these structural factors or failures is to shift the relationship between real wages growth and productivity in favour of real wages for those in work. The following examines the circumstances which enable this shift to be achieved in practice.

2. "Insider - outsider" and hysteresis

The manner and circumstances in which workers (unions) are able to impose upward movements in the real wage, or resist downward pressures upon the real wage, has been the subject of sophisticated analysis. The most convincing explanations are based upon developments of the "insider-outsider" models of the labour market.

In these models, unions select the wage by virtue of their "insider" power and firms choose the number of workers they will employ. "Insiders" will encourage the recruitment of "outsiders" only for as long as additional recruitment adds to the marginal revenue product of those in work. "Outsiders" will be willing to enter work provided the expected marginal revenue product exceeds the reservation wage, measured by the level of out-of-work income. "Insiders" will exercise and maintain their power by constructing rules and codes which can be used to restrict access and raise labour turnover costs for firms. Power may very well be exercised through trade unions, but this is not a necessary condition. The possession of power may be supported by the complexity of production techniques inside the enterprise (and the associated complexity of skills) or power may be won by the formation of informal coalitions among those with higher or professional skills.

The incentive to exclude "outsiders" is enhanced if "outsiders" have lower order skills and abilities compared to "insiders". "Insiders" will then prefer to maintain barriers to employment and capture for themselves the additional rent from future increases in profits. The situation will be sustainable provided firms are willing to negotiate only with "insiders". However, firms may be quite willing to deal only with "insiders" because recruitment of "outsiders" has certain risks of failure (choosing the wrong workers) and they may prefer to maintain good relations with the highly-skilled (and more productive) "insiders". The outcome is consistent with behaviour which finds firms preferring to invest in labour-saving capital equipment rather than recruit new workers, and being encouraged to do so by "insiders" because the benefits for their "insider" revenue product (and subsequent real wages) are superior. The potential for "insider" behaviour will be further enhanced where firms are operating in oligopolistic or monopolistic markets, because firms will then have fewer incentives to resist the construction of barriers to "insider" entry and will be able to pass on cost pressures in higher product prices. In fact, "insiders" will have still further incen-

tives to erect barriers (and capture economic rent) where product markets are subject to restricted competition because their bargaining strategy is also subject to fewer constraints.

Separate analysis has claimed to find evidence of hysteresis in the labour market. Hysteresis might be seen to occur when the labour market establishes equilibrium at a given level of unemployment and then (*ceteris paribus*) maintains that equilibrium level of unemployment into the future. However, the equilibrium level of unemployment which is established is in no sense unique and there are various (perhaps numerous) levels of unemployment which might be consistent with a similar path of real wages. History then matters and the best explanation of current levels of unemployment is past levels of unemployment. The implication is that rates of change, rather than any particular level, of unemployment influences real wages. The hysteresis proposition is at least partly consistent with the "insider-outsider" model of the labour market. In the specific case of the United Kingdom, hysteresis could be said to be gestating during the 1970s when the rate of technological adjustment to changes in the structure of demand and prices on world markets was delayed by various changes in industrial and labour market policy. The "shock" of the change in inflation regime at the beginning of the 1980s led to a widespread release of labour (and abandonment of capital) and a very fast rise in unemployment. The rise in unemployment was so fast that the labour market was unable to cope with the required adjustment. Unemployment was then locked in at the higher level by malfunctions in labour and product markets.

The explanation for the failure of real wages to respond to the high levels of unemployment is nevertheless incomplete. The important, remaining questions are why "outsiders" fail to approach firms directly and why they do not set up new businesses in order to compete with the "insiders". The answer to the first question might be that firms delegate a component of screening costs of new workers to "insiders", and "insiders" have incentives to exclude many of the new applicants. The answer to the second question may be that "outsiders" lack the required skills and knowledge for forming coalitions with other "outsiders" and may be unable or unwilling to accept the risks inherent in forming new enterprises. The rules, structure and generosity of the unemployment benefit system may offer strong disincentives. The creation of new enterprises, or the adoption of innovative working patterns which might enable re-entry to work, may be discouraged by rules and regulations ("red tape") and by codes of conduct constructed by "insiders". One further problem is that access to capital markets for "outsiders" may be restricted because of collateral requirements and the associated risks attached to borrow-

ing. One final, and important, implication of hysteresis is that the effects of unemployment on job-seekers are cumulative and skills and motivation deteriorate with duration of unemployment spell.

3. The significance of the structure of collective bargaining

Other research has adopted elements of both the "insider-outsider" and hysteresis proposals and asserted (with dubious empirical support) that institutional features in the bargaining system¹⁵ may lead to failures in the adjustment of real wages to particular levels of unemployment and that these failures may be durable. The United Kingdom is judged to have a system of collective bargaining which combines both elements of national and decentralised bargaining. The analysis supposes that bargainers work within a 'Prisoner's Dilemma' and that nominal wages are determined by reference to labour market conditions in the regions, or local labour markets, of the United Kingdom which are experiencing the most buoyant conditions. Nominal wage increases are then transmitted throughout labour markets in low activity regions. The rigidity of wage determination is emphasised by failures of labour mobility made worse by inflexibilities in the housing market. The inflexible housing market is encouraged by tax-incentives for owner-occupation and a poorly-developed rental sector. The proposition is extended by the notion that high levels of owner-occupation have encouraged an inflationary psychology in the United Kingdom, because housing is used as a major store of personal wealth.

The inefficiencies imposed by the structure of collective bargaining will be magnified by failures in expectations regarding the future path of domestic demand and inflation. Inflation surprises will be resisted in wage determination in the high activity regions or labour markets and these will again be transmitted across all labour markets. Failure by the monetary authorities to implement the stated path of the Medium-Term Financial Strategy will encourage forward-looking settlements which attempt to anticipate the path of inflation in the determination of real wages, thereby cultivating an inflationary attitude in economic life. The persistence of inflationary expectations (or the presumption that growth in nominal incomes will inevitably be faster than predicted in the MTFS) combined with inefficiencies in the hybrid system of collective bargaining will also substantially delay the speed of adjustment of real wages to changes in the rate of growth of economic activity.

15) See, for example, Calmfors and Driffill (1988). The uncertainties attached to the empirical work relate principally to the judgements required to obtain a satisfactory description of the prevalent system of collective bargaining in any particular country.

4. The recent behaviour of real wages and unemployment

Real post-tax wages and salaries were falling between 1980 and 1982, as unemployment increased from 1,074 million to 2,700 million. Real post-tax wages and salaries then increased at an accelerating rate through to 1988, in which year the increase was about 7 1/2%. Measured unemployment continued to increase through to 1986, where it peaked at 3,133 million. Unemployment then fell dramatically from 1986 to 1990, reaching a low point of 1,604 million in March 1990. Unemployment has now begun to rise. The annual rate of increase in real post-tax wages and salaries has been declining from the peak of 7 1/2% in 1988 and is now averaging about 2%. One interesting feature of the data is that the rate of increase in real post-tax wages and salaries has been declining during a period when unemployment has been falling steeply, in contrast to a period between 1982 and 1986 when real post-tax pay was rising rapidly when unemployment was also rising.

Further analysis of the trend in the data, from 1987 to 1989, shows that the response from employment to the acceleration in economic activity was much more impressive when compared with earlier periods of expansion. Increases in employment will naturally lag expansions in output which explains why large improvements in productivity appeared in 1987 and 1988 but then began to disappear as employment rose more rapidly and as trends in nominal wages moved gradually upwards. Nevertheless, the rate of increase in nominal wages appears remarkably modest in comparison to the rate at which unemployment fell during the period from 1986 to 1989.

The final important feature in the data is that the rate of increase in real wages compared to productivity trend has changed substantially during the most recent decade. The improvement in productivity performance relative to real wages growth explains the underlying improvement in the proportion of national income appearing as profits. The present slowdown in the rate of growth of output is putting considerable upward pressure on unit labour costs and downward pressure on profit margins. However, the decline in net profit margins is a comparatively recent event and only began in earnest in the Autumn of 1989 and in the first half of 1990.

5. Has the supply-side of the labour market changed?

Models of wage determination continue to be based upon an inverse relationship between the rate of change of unemployment and the rate of change of nominal wages. However, the problem in modelling wage determination is to estimate the level of unemployment at which increases in nominal wages will begin to moderate. The earlier review describes how recent research into the supply-side of the labour market has sought to explain the NAIRU (the Non-Accelerating Inflation Rate of Unemployment) by reference to "insider-outsider" phe-

nomena and hysteresis. The broad implication of this research is that the level of unemployment at which nominal wage increases will begin to moderate is determined by a series of structural factors or failures. Structural factors or failures enable the most productive of those in work to organise the conduct of business in a way which provides substantial economic rents for themselves.

The thrust of government policy for the labour market has been consistent with (and heavily influenced by) this view of the world. Wide-ranging reforms and initiatives have been introduced, many of which are intended to strengthen the competitive position of "outsiders". The initiatives have aimed to:

- build "bridges" between the long-term unemployed and employers, - raise the marginal revenue product of "outsiders" through direct training programmes,
- encourage the creation of new businesses to improve product market competition,
- encourage job search by reducing the generosity of unemployment benefits, both by revising allowances and by strengthening eligibility criteria,
- improve incentives to work through changes in the structure of personal taxation, and
- stimulate the adoption of new and flexible working patterns.

The following describes the reforms and initiatives in more detail.

Mismatch

The long-term unemployed have benefited substantially from the fall in total unemployment since 1986 and it seems probable that the Government's Restart Programme has been an important influence. The Restart Programme has attempted to establish direct links between firms and the longer-term unemployed, by systematic interviewing of job-seekers and the provision of self-help facilities through job clubs. Employment Training has attempted to provide additional skill training to assist re-entry to work. One of the important objectives of the Programme has been to reform the attitudes of both firms and job-seekers about the potential of the long-term unemployed to re-enter work. The improvement in the structure of labour supply achieved by the Programme is suggested by the unemployment-vacancy ratio, which shows that levels of unemployment consistent with given levels of notified vacancies have fallen sharply since 1986. The change is represented by a leftward movement of the u/v ratio since that year. It is also noticeable that overall measures of skill shortage have been much lower than in previous periods of comparable acceleration in economic activity.

Job search

The Restart Programme has been supported by changes in the rules relating to unemployment benefit entitlement and income support. The job-search criteria for the receipt of unemployment benefits have been strengthened and now resemble arrangements in Scandinavia and Switzerland. The rules relating to young people benefits have also been tightened with a view to encouraging job search or participation in further education and training programmes. The reorganisation of the administration of unemployment benefits (the merging of the provision of services in job matching and benefit payments) should also be contributing to an improvement in the speed of job search and in the efficiency of the matching process. Job search should also have been improved by revisions to the personal tax and national insurance contribution systems, combined with changes to the structure of in- and out-of-work State benefits through Income Support. The benefits of improved job search appear not only in lower unemployment but also as an improvement in competition for jobs as (for example) the long-term unemployed gain access to work and improve their longer-term credentials in the eyes of recruitment agents.

Systems of pay bargaining and reward

Evidence has appeared of improving flexibility in pay bargaining systems and a movement away from the indeterminacy which is supposedly determinantal to efficiency in nominal wage determination. The evidence appears in a fall in the numbers covered by industry-level agreements, measured by the New Earnings Survey and the Workplace Industrial Relations Survey. The trend away from industry-level agreements (and towards plant-level arrangements) would be encouraged by the break-up of the engineering industry agreement, although the future of the engineering agreement remains unclear. Increasing flexibility in regional pay determination is suggested by recent data which show that the ordering of regions by pay levels is undergoing change after prolonged rigidity. The rise of East Anglia, and the relative fall of the North-West and Northern regions, are necessary preludes to inter-regional adjustments. Evidence also suggests that overall levels of pay now include greater elements for bonuses and profit-related pay, and the extent of wage drift as an element in total average earnings does appear to have fallen relatively quickly during the recent period of deceleration in economic activity.

Improved productivity trend

The suggestion of increasing flexibility in pay systems is also associated with an increasing diversity of employment structures and working practices. Employment legislation (and some direct Employment Measures) have sought to provide the opportunity for the creation of a wide range of patterns of working hours and the major features have been a rise in part-time working, self-employment and sub-contracting and changes in the patterns of shift-working. Industrial relations legislation, during the past decade, should also have provided the necessary framework for the adoption of better working practices and improved technology. Examples are the abolition of the National Dock Labour Scheme and the adoption of new technology in the newspaper industry. The new environment of industrial relations should have contributed to a trend improvement in productivity with enhanced wage moderation. Benefits from improvements in the industrial relations framework will continue to appear over several years, as new expectations are formed and confirmed.

Union militancy and legislation

The decline in union militancy during recent years (but particularly since 1986) is one of the outstanding features of the institutional framework of the labour market. The 1988 Employment Act has continued the process by increasing the accountability of trade union officials to their members and removing legal immunity from strikes which are called to support the closed shop. It also repeals most legislation which discriminates between males and females in employment matters. It has removed working-time restrictions for young people, and eases some of the rules concerning the release of workers.

Small firms

Competition in product markets (and the potential for "outsiders" to re-enter the labour market) have been encouraged by several initiatives. The structure of corporation and value-added taxes has been amended. The Business Expansion and Loan Guarantee Schemes have enabled an improvement in the financing of small businesses and the Business Development Initiative provides support for consultancy and information systems for small firms. Regional policy has also been reformed, away from the previous systems of automatic grants and subsidies and towards a system based on advice and incentives. The opportunities for small businesses to enter product markets have been promoted by the freeing-up of competition for public sector projects and

the insistence on the introduction of competitive bidding and sub-contracting in the provision of local authority services.

6. Important rigidities remain in the labour market

The review of evidence so far suggests a significant improvement in actual and potential supply-side performance for recent and future years. Nevertheless, OECD estimates¹⁶ for the period up to the mid-1980's show that the responsiveness of real wages to changes in economic activity (proxied by the rate of change of unemployment) is sluggish at best compared to the major industrial countries although not greatly inferior to many of the EC Member States. The following reviews evidence for continuing rigidities and inefficiencies in the labour market in the United Kingdom.

Education and training

The new Training and Enterprise Councils are an attempt to raise employer commitment to training and education and to improve their relevance to the structure of needs in local labour markets. The 1988 Education Reform Act provides for fundamental changes in the way young people will be prepared for working life, introducing a common core curriculum with stronger emphasis on work-related subjects and standardised assessments of student progress. However, there are considerable doubts about the manner in which post-compulsory education and training will be acquired by 16 to 19 year-olds and whether the facilities to deliver such education and training are available, either inside or outside of State-funded colleges. Evidence suggests that the average quality of training inside the Youth Training Scheme (delivered principally inside the firm) has been low and it is unclear whether revisions through the new Youth Training programme will be an improvement. The resolution of these issues has considerable implications for the quality and flexibility of labour supply, and for the strength of competition in labour markets, both in the immediate future but particularly in the long-run. The experiment in voucher-funding for a percentage of young people may be beneficial, but such funding will need to be supported by considerable improvements in information available to young people and in the status and priority which young people attach to the acquisition of education and training.

Collective bargaining and skill differentials

Whilst statistical evidence is poor, the strong impression is that pay differentials for skill within important sectors of industry are inadequate to provide sufficient incentives for participation in training and further education. The problem of pay differentials also applies to young people, where young people's pay appears to be too high to provide employers with incentives to train within the firm. Pay differentials for skill also provide few incentives for young people to acquire new and higher abilities upon their own initiative. The narrowness of differentials is particularly evident when comparisons are made against countries operating the dual system of youth training, such as Germany and Switzerland. The compression of skill differentials in some industries in the United Kingdom is almost certainly associated with insufficient occupational mobility, which is the outcome of excessive specialisation in formative education and training, and the consequence of inflexibility in working practices and patterns at some major workplaces. The problem of young person pay differentials has contributed to the decline of formal skill apprenticeships in the United Kingdom, and the present Youth Training arrangements are unlikely to reverse that trend.

Geographical mobility

There is evidence for a trend away from industry-level bargaining but very little evidence for bargaining founded upon conditions in local labour markets. However, the essential requirement for effective devolution in pay bargaining (and pay flexibility in local labour markets) is an improvement in occupational and geographical labour mobility. Immobility of labour is partly the outcome of significant differences in regional property prices, which magnify the significance of high levels of owner-occupation. Regional differences in house prices are attributable to regional imbalance in the location of higher value-added (and higher paid) activity and the effects that this imbalance has upon regional land values. The continuing absence of a rented sector is a further impediment to the freer movement of labour, but aversion to renting is also associated with the tax advantages available for owner-occupation. The problems associated with labour immobility have appeared in severe skill shortages in some sectors, regions and occupations as the rate of growth of economic activity has accelerated and approached a peak.

Competition in product markets

Empirical evidence for the United Kingdom indicates a strong association between levels of competition in product markets and the responsiveness of real wages to

16) Refer, for example, to the empirical work by Coe (see 'References')

changes in economic activity. Monopolistic elements in particular markets naturally indicate the speed with which firms will moderate the rate of increase in their prices when circumstances are changing. The speed with which imports entered the United Kingdom during the years of peak growth in nominal incomes (1988 to 1989) suggest a high degree of competition from foreign goods across many sectors. However, there are several markets where competition is restricted by domestic conditions or where voluntary agreements with overseas producers provide the foundation for 'insider' power to be exercised within firms. Some major examples appear in transport services, telecommunications and the motor industry. Such problems are equally apparent across all EC Member States.

7. Assessment of the prospects for wage determination

The most recent explanations of wage determination in the United Kingdom continue to identify a relationship between the rate of change of wages and the rate of change of unemployment. The identification thereby includes a relationship between the rate of change of unemployment and the rate of change of prices, because wage costs exercise a dominant influence upon prices. Structural factors and failures in labour and product markets have important effects upon wage determination, because they moderate or nullify the benefits of competition and present the opportunities for upward pressures upon real wages which are inconsistent with trends in output per head. Structural factors or failures also lead to inflexibilities in the real wage (real wage resistance) when confronted with "shocks" which reduce the rate of growth of output. The level of unemployment which is required to exert effective constraint upon the path of wages and prices (the NAIRU) is therefore determined in the structure of labour and product markets.

Extensive research has been undertaken, during the past decade, into the extent of real wage flexibility in the United Kingdom. Work at OECD and the Centre for Labour Economics (see 'References') suggests that real wages have been relatively inflexible in the face of a rise in unemployment and that significant losses of output and employment will be required before inflationary pressures in the labour market are moderated. The findings can be compared with estimates which suggest that the NAIRU in the United Kingdom, during the first half of the 1980's, may have been in the range of 10%-11%¹⁷. The evidence on the present state of flexibility in the UK labour market is that important change has begun to appear since about 1986, and that the NAIRU has by now been significantly reduced. The responsiveness of real wages to unemployment should have been improved by the various legislative changes and programmes which

have led to re-entry of an important part of the long-term unemployed to work. The ease of access should also be improved by the various reforms in industrial relations which have enabled and encouraged changes in working patterns and practices, and enabled the adoption of new technology. The overall effect should be an improvement in the quality of labour supply and the extent of competition for jobs and contracts for work. The improvement in the balance of power in labour and product markets, between firms and workers' representatives and between "insiders" and "outsiders", should also enable more rapid adjustments in the rate of increase in unit labour costs. The more effective adjustment should be supported by greater flexibility in the composition of pay rewards. Greater competition in product markets, and particularly the entry of new firms, should be supported by initiatives which have encouraged the creation of new businesses and the introduction of new competition in the provision of public sector services.

The record of reform is much less impressive in the restructuring of collective bargaining. Public sector pay bargaining systems have changed very little during the past decade, although the intention to continue the decentralisation of Central Government into agencies and into the regions should present much greater opportunities for bargaining reform. OECD evidence shows that the responsiveness of wage settlements to inflation is much higher in the United Kingdom than in many industrial countries and that responsiveness is asymmetrical. Wage settlements therefore react very slowly to a falling rate of inflation but respond much more vigorously to a rising rate of inflation. The failure to undertake a more determined reform of collective bargaining is likely to have left this inflationary psychology intact. Nevertheless, trends in the data for real post-tax wages present grounds for optimism. The rate of increase in wages during the period since 1986 has been modest compared against the rate of expansion of economic activity and the size of the fall in unemployment. The data also reveal an improvement (during the past decade) in the trend of productivity growth against real wages, leading to a substantial revival in profits. The rate of increase in real post-tax wages has been falling substantially since 1988, as inflation (measured by the retail price index) has accelerated whilst nominal wages have increased only gradually.

The outlook for wage determination in the short-run is as follows. Inflationary expectations have strengthened as the retail prices index has accelerated and it will take time for these expectations to moderate, and influence bargaining behaviour. It will also take time for revised expectations to feed through into wage contract commitments, unless contracts are subject to early revision. The reforms so far undertaken in labour and product markets should lead to a much better response from real wages

17) The figures represent a judgement by the Commission Services based upon trends in the data of inflation and unemployment and the empirical work of Layard and Nickell, IMF and OECD (see 'References' at the end of the Annex).

to the rate of change of unemployment, compared to responsiveness in the first half of the last decade. However, the inflationary attitudes of bargainers (amongst firms and workers) remain entrenched and this will constrain the speed of adjustment which can be expected in the real wage. Earnings growth is unlikely to fall below about 6 1/2% (rounded) before the end of 1992. Underlying productivity growth is probably of the order of 2 1/2-3% and (if so) the underlying level of inflation is likely to settle at about 4 1/2% (rounded) by the end of the same year. The figures assume that firms anticipate the present slowdown in economic activity to be relatively short-lived and base their decision-making on medium-term expectations for output growth. It is assumed that firms will wish to maintain broadly their present (trend) level of profits when negotiating pay settlements.

The judgement about prospects is based upon the view that the NAIRU is now significantly lower than the figure of 10-11% established during the first half of the 1980's and is within the range of 7-8% on the international definition of unemployment. Further improvement in the responsiveness of wages to changes in unemployment will require additional and substantial improvements in the supply-side of the economy. The relevant policy areas include education and training (and particularly amongst 16-19 years-olds), more decisive reform of collective bargaining and the improvement of competition in particular product markets. The benefits of further reform would emerge in the widening of regional, occupational and skill differentials and an improvement in geographical mobility. The evidence suggests that there is already some change appearing in regional pay differentials but this process could be accelerated by greater decentralisation of pay bargaining into local labour markets and the continuing reform of the owner-occupied and rented sectors of the housing market. Widening of pay differentials for skill would provide the appropriate environment for greater acquisition of education and training throughout the labour force, which would make a major contribution to the reduction of the NAIRU and enhance the responsiveness of real wages to changes in unemployment.

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Chapter 2

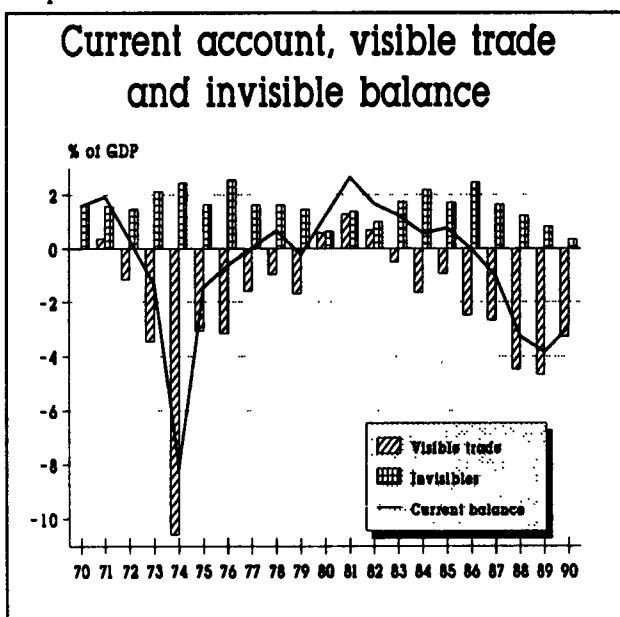
The Balance of Payments and International Transactions of the UK in the 1980s

1. Introduction

The UK's balance on external balance over the past thirty years has fluctuated between deficit and surplus according to movements in domestic demand relative to domestic output. The present annex reviews the evolution of the external transactions of the UK, particularly with reference to the decade of the 1980s when major structural reforms have taken place. These reforms have affected capital account transactions. The easing of constraints on domestic and international financial activities has also influenced the pattern of domestic spending, and, therefore, the country's external balance. Furthermore, the removal of exchange controls in 1979 and the financial innovations of the 1980s has made intermediation of domestic and international capital more efficient, and the financing of balance of payments deficits possible without large and disruptive exchange rate adjustments.

Graph 2.1 shows the evolution of the current account balance as percent of GDP over the past twenty years. The balance has recorded large deficits in periods of reflation, 1974 and in the late 1980s, while in the periods of deflation of the early 1970s and 1980s the external accounts have moved into sizeable surpluses. Also, during periods of demand changes the balance of payments has rapidly moved in the opposite direction.

The overall balance on international transactions masks important differences in the evolution of specific accounts. Thus, growing deficits in some categories of goods and services have coexisted with growing surpluses in others. Underlying these developments are changes in the country's ability to compete internationally, changes in tastes, changes in institutional regula-



tions, and changes in incomes. While the aggregate state of the balance of payments is a principal indicator of macroeconomic disequilibrium, developments in individual items of the balance of payments offer a more microeconomic view of the adjustment process. In an open economy these developments are directly related trends in employment and, ultimately, to the country's standards of living.

2. Merchandise trade and invisibles

2.1 Visible trade

The visible trade balance represents the principal item of the balance of payments. It has traditionally been in deficit with the exception of periods of deflation. The deficit peaked at a record value of close to UKL 24 billion in 1989 in the course of the recent cycle. Merchandise transactions are the the most income-elastic component of a country's international transactions and, as a result, are very responsive to changes in the levels of economic activity at home and abroad; in addition, they display smaller but, nevertheless sizeable, elasticities with respect to price changes, making it possible for exchange rate changes to contribute to balance of payments adjustment.

Table 2.1 presents key data on UK's international transactions during the 1980s. It is evident that the current account deterioration during this period is accounted principally by the worsened deficit on visible trade.

Movements in visible trade contain a cyclical and a secular element. The cyclical component is essentially the dominant factor in changes in the balance, as well as in changes in the current account balance. Cyclical movements in the world economy relative to the UK contribute to raising UK exports above trend. It is difficult to evaluate the elasticity of export supply with respect to movements in world incomes and prices. However, the evidence from the different cyclical positions of the UK relative to the rest of the world in the late

Table 2.1 Visible, Invisible, and Current Account Balance (UKL billion)

	1980	1985	1987	1988	1989	1990*
Visible Trade	1,36	-3,35	-11,22	-21,10	-23,84	-17,95
Service Balance	3,65	6,69	6,63	4,50	4,70	3,12
IPD Balance	-0,18	2,51	3,68	4,79	4,10	2,14
Transfers Balance	-1,98	-3,11	-3,40	-3,55	-4,58	-3,39
Invisibles Balance	1,49	6,09	6,91	5,74	4,22	1,88
Current Account	2,85	2,74	-4,31	-5,36	-19,62	-16,09
Balancing Item	0,92	7,07	-0,24	7,60	15,69	na

Source: CSO: "Economic Trends", various issues;

* Provisional;

s.a. invisibles data are for Q1-Q3 - only the invisibles balance in Q4 is projected at zero.

1980s suggests that these supply elasticities can be sizeable especially when domestic demand is slowing down; in these circumstances export availability increases. There is also evidence that the supply potential of UK manufactures has increased substantially as a result of the supply-side reforms of the 1980s¹⁸.

The quantitative responsiveness of imports to changes in domestic demand and prices has increased over time, reflecting the greater openness of the UK economy and its progressive integration into world trade, and especially its integration with the other European Community countries. Elasticities of UK merchandise imports with respect to domestic expenditure have been estimated over the period 1980-1988, as well as over other samples, and some results are reported in Table 2.2. Seen in historical perspective, the short-run elasticity of imports with respect to the ratio of import to domestic prices in the 1980s has doubled compared to the previous twenty years; similarly, the long-run elasticity is twice as large as in the previous two decades.

The composition of domestic demand is also an influential element in the structure and responsiveness of imports. The result of the table suggest that an one percent change in total domestic expenditure causes imports to increase by 0,9 of one percent in the short-run, and by 1,8 percent in the long-run. Again, these estimates are considerably higher in this decade compared to the previous two. However, these responses are not identical across categories of domestic spending. Import demand with respect to private consumption displays the largest elasticity (0,724 in the long-run), followed by exports of goods (0,502), and by changes in stocks (0,462); the response of imports to investment activity appears to be of lesser importance (0,181). These estimates indicate that export activity is import-intensive and, consequently, an increase in exports will be accompanied by a

	Short-run	Long-run
Relative Price	-0,218	-0,426
Total Expenditure	0,900	1,758
Private Consumption	0,448	0,724
Total Investment	0,112	0,181
Exports of Goods	0,311	0,502
Inventories*	0,286	0,462

Source: Commission services.
* this is a semi-elasticity

substantial increase in imports, and the net effect on the balance of payments will be much less when this interdependence is taken into account.

The data reported in the table provide an explanation for the rapid deterioration of the visible trade and current account balance in the course of the current cycle. Underlying this development is primarily the strength in consumption growth; while investment activity has also been buoyant, it contributes substantially less to import demand and to the deficit. In view of the relatively low price elasticities, it is clear that an improvement in the current account and visible trade deficit is contingent upon the extent to which growth in domestic demand will be contained.

A closer examination of the pattern of merchandise trade reveals an apparent secular decline in the ability of the UK to compete in markets for highly income elastic products. These are products intensive in technology and human capital, and, consequently, closely correlated with high incomes. During the past thirty years the UK has recorded increasing deficits in manufactures and semi-manufactures, as well as in chemicals and machinery and transport equipment. The observed pattern of the country's international trade provides an indication of the changing comparative advantage, without recourse to the unobservable deeper structural parameters (production and tastes) which determine the

Table 2.3: The Revealed Comparative Advantage of the UK

SITC Group	Average 1981/89		
	World	EC-11	Rest of the World
0. Food	-0,43	-0,36	-0,51
1. Beverages and Tobacco	0,17	-0,20	0,55
2. Crude Materials	-0,46	0,01	-0,69
3. Fuel Products	0,19	0,63	-0,18
4. Oils, Fats and Waxes	-0,60	-0,49	-0,74
5. Chemicals	0,09	-0,09	0,32
6. Manufactures	-0,16	-0,19	-0,14
7. Machinery/Transport	-0,05	-0,22	0,08
8. Miscellaneous Manufactures	-0,15	-0,18	-0,13

Source: Calculated from Eurostat (1989): "External Trade", Yearbook 1989, Table 7; and Eurostat (1990): "External Trade", Monthly Statistics, 6/1990, Table 8.

18) See, for example, M.Landesmann and A.Snell (1989): "The Consequences of Mrs. Thatcher for U.K. Manufacturing Exports", Economic Journal, March.

character of trade. An index of the UK's revealed comparative advantage in the 1980s is reported in Table 2.3. The index is the ratio ¹⁹ :

$$h = (X(i,j) - M(i,j))/(X(i,j) + M(i,j))$$

where X = exports, M = imports, i = commodity, j = country. The index is bounded between -1 and 1. Positive values represent a surplus, and negative values a deficit, position. The data suggest that, during the 1980s, the UK had a comparative advantage in Beverages and Tobacco products and in Chemicals vis-a-vis the world. However, in its trade with the EC-11 the UK is competitive only in SITC Groups 2 and 3, Crude Materials and Fuel Products. In its trade with the rest of the world the UK has a comparative advantage in the commodity categories as in its global trade.

The surplus on Fuel products is related to North Sea oil production. Net oil exports have contributed substantially to the current account performance, particularly in the early 1980s, and are the principal factor behind the current account surpluses of that period, when the real exchange rate appreciated sharply against the rest of the world. It is unlikely that the surplus would have emerged in the context of that appreciation, i.e., without oil. This suggests that it was possible to pursue a disinflation policy based on real exchange appreciation because the oil surplus cushioned the current account position; in its absence, the incipient current account deficit would have led to a rapid exchange depreciation and would have rendered an exchange rate-based disinflation, and perhaps the complete disinflationary strategy, very difficult to sustain.

A more interesting comparison is the evolution of the revealed comparative advantage over time. In the 1960s the UK recorded surpluses in SITC categories 1, and 5 to 8, in its world trade. These surpluses were also recorded in its EC-11 trade, except for Miscellaneous Manufactures. In the next decade the comparative advantage in Manufactures was eroded while the deficit in Miscellaneous Manufactures widened. Quite surprisingly, the disadvantage in Food improved. The key characteristic of this period is the decline in the comparative advantage in Manufactures, Machinery and Transport Equipment, and Miscellaneous Manufactures; the surplus in Chemicals was, however, sustained. In the decade of the 1980s the UK reveals a substantial decline in its ability to compete in those product categories which require technologically advanced methods of production, and are also highly human-capital intensive. This decline has occurred despite improvements in the supply side of the economy which has raised the economy's ability to supply exportables in the 1980s.

The EC-11 is becoming the UK's dominant trade partner, accounting for 50,3% of UK exports, and for 52,6% of UK imports, in 1989. Even though the emerging pattern of specialization raises questions about the country's prospective competitiveness, it is likely that the single market will benefit the supply of UK exportables, and especially manufactures, in a wider and more closely integrated Europe.

2.2 Invisibles

The balance on invisibles has historically been in surplus. This surplus has risen over the 1980s to a peak of UKL 9,4 billion in 1986, but has subsequently declined considerably. Of the three constituent balances, net transfers have historically recorded deficits, while the balance on interest, profits, and dividends (IPD) has, except in 1980, been in surplus. The service balance has remained in continuous surplus over the period.

International service activities covered by the accounts include two principal components, travel and financial services; also included separately are sea transport and civil aviation and government transactions.

The travel balance has fluctuated between surpluses and deficits in a manner reflecting the state of the international business cycle. In addition, these transactions are price-elastic to some important extent, and exchange rate changes are contributing factors in the recorded swings. In recent years the travel balance has moved into a sizeable deficit which peaked at close to UKL 2,5 billion in 1989.

The growing surplus on transactions in financial services is largely a reflection of London's prominence as a financial center. The surplus was UKL 9,5 billion in 1987; this was three times as large as the surplus in the late 1970s. The largest single component of the balance relates to financial transactions, which have produced over 50% of the financial services surplus through activities of financial and related institutions. This balance peaked at a surplus of UKL 5,5 billion in 1987.

The rapid buildup of surpluses on the IPD account came to a halt in the late 1980s. This balance records net earnings on international investment and on other financial transactions. These surpluses provided an offsetting element to the rising deficits in merchandise trade over the 1980s, but their size declined after the peak of UKL 4,9 billion in 1988. Changes in the IPD balance reflect primarily the influence of two developments: first, changes in domestic relative to foreign profitability, and, secondly, changes in the rate of return and in the stock of net international indebtedness. A third and more dif-

19) See, for example, the use of this index in B.Balassa and M.Noland (1989): "The Changing Comparative Advantage of Japan and the United States", *Journal of the Japanese and International Economies*, June.

	1980	1985	1986	1987	1988	1989
Insurance	1,10	3,27	4,90	4,64	3,52	2,93
Banking	0,14	1,27	2,19	1,26	0,78	-0,68
Investment Trusts*	0,20	0,94	1,10	0,82	0,89	1,42
Brokerage etc Earnings	0,50	0,82	0,82	0,83	1,04	1,25
Other	0,14	0,26	0,60	1,16	1,13	1,26
Total Net Receipts	2,08	6,56	9,61	8,71	7,36	6,18

Source: CSO (1990): "The City's Invisible Earnings in 1989", 1/10/1990;
 * net income of investment trusts, unit trusts, and pension funds

difficult factor to observe is changes in expectations about currency movements; these affect the timing of conversion of foreign-currency earnings into sterling.

Net earnings on direct investment transactions peaked at UKL 8,0 billion in 1989. In addition, the increase in net capital inflows to finance the large current account deficit of the previous three years, and the high interest rates in the UK, have contributed to the weakening in the balance on IPD. Thus, net earnings on portfolio investment peaked at UKL 3,2 billion in 1985, prior to the emergence of the large current account deficits and of the current high interest rates. During the latter part of the 1980s there has also occurred a decline in the UK's net asset position related to domestic banks' international transactions.

The balance on invisibles records realized flows of non-merchandise earnings which arise from the country's net international investment position. The recorded flows do not take account of increases in the value of the country's net international investment arising from capital gains. This, according to Pratten²⁰, distorts the recorded balance on invisibles and overestimates the deficit on the balance of payments. Consequently, the balance of payments difficulties are strictly liquidity problems, while the potential balance of payments position is more than offset by the flow of capital gains. Nevertheless, the pronounced decline in the surplus on invisibles is an important determinant of the increased current account financing requirements in recent years.

Data on the role of the City in international financial transactions is shown in Table 2.4. The principal sources of earnings from international activities are provision of services and receipts from investments in the form of interest, dividends, and profits. The institutions involved are insurance companies, banks, investment management offices, and brokerage firms. Of these, insurance firms are the dominant actors in terms of size of net receipts. Total net receipts of all the identified institu-

tions peaked at UKL 9,61 billion in 1986. In subsequent years net receipts have declined, reflecting primarily a lower surplus on insurance transactions.

The key contributor to the deficit on the balance of transfers is the government's contributions and subscriptions to international organizations, bilateral aid, and other grants. Private transfers represent a small amount in the total and there are no discernible trends in these transactions. Although the deficit on transfers is sizeable, it receives little economic attention.

2.3 Errors and omissions in the balance of payments

An important development in the balance of payments accounts in the 1980s has been the increase in the size of the residual item, shown as the balancing item in Table 2.1. This item, which fluctuated between the equivalent of net credit and net debit over much of the 1970s, has been the equivalent of a net debit since 1976, with the exception of 1982 when a net credit was recorded. Its size has increased to an unprecedented extent in the period following the 1986 "big bang" financial reforms, as can be seen from Table 2.1. It is, clearly, difficult to attempt to evaluate developments in recorded current account transactions when the residual estimate threatens to dwarf these data.

Difficulties with balance of payments accounts are not unique to the UK. During much of the post-1973 period, with the advent of generalized floating, industrial countries have recorded sizeable residuals in their international transactions, and the world trade discrepancy recorded in the early 1980s raised questions about the quality of, and the method used in collecting, the data. As Table 2.5 shows, throughout the 1980s several industrial countries encountered balance of payments residuals which, unlike the previous decade, have been systematically of the same sign; i.e., either consistently a credit item, representing the equivalent of a capital

20) See C.Pratten: "Capital Gains and the Balance of Payments", Department of Applied Economics, University of Cambridge, manuscript, no date.

Table 2.5: Net Errors and Omissions: Selected Countries (UKL billion)

	1980	1984	1985	1986	1987	1988	1989
Canada	-1,01	-4,93	-4,53	-2,29	-2,28	-1,59	-2,40
France	2,28	0,65	0,29	0,81	0,85	0,94	-2,94
Germany	-1,20	2,03	3,09	2,00	0,33	2,44	2,33
Italy	-0,38	2,35	-3,99	-1,55	-2,46	-0,69	na
United Kingdom	1,12	7,48	6,93	20,10	12,46	16,94	24,55
United States	25,01	23,81	15,27	11,29	1,88	-8,30	22,60

Source: IFS, country line 77e.d; na = not available

outflow (Canada and Italy), or consistently a debit item representing the equivalent of a capital inflow (mostly all the other countries shown in the table). What is striking, however, is the increase in the size of the residual in UK's accounts following the implementation of financial reforms of the early 1980s and, in particular, after the 1986 "big bang" reforms. The United States is another case where the emergence of systematic and large net errors and omissions has coincided with domestic financial reforms. In view of the fact that the UK and the US have financial systems which are more highly developed and have been subject to greater liberalization reforms compared to the other countries, a large component of the balancing item is likely related to financial flows.

Evidence from other countries suggests that the residual item is highly correlated with the net foreign asset position of domestic banks, and is also related to the trade balance. In addition, service transactions are potentially another area where underrecording may exist. These correlations indicate that, while it is possible to treat the balance of payments residual item as the equivalent of a capital inflow or outflow, this is not entirely correct. The asymmetry in the timing of international trade receipts and payments is also an important factor contributing to the difficulties in properly covering and measuring international transactions. However, this asymmetry problem should not be a permanent feature of the accounts, because such positive errors in the current period should be unwound in the next. It is very difficult to see if the UK data are consistent with this because the aggregate errors mask such details.

The meaningfulness and reliability of recorded international transactions is undermined by the large balancing item. In this respect, statistics on external transactions present similar inadequacies as other official statistics in recent years.

3. The capital account

Capital account transactions of the UK have undergone changes in the 1980s, reflecting the removal of exchange controls and the financial and regulatory innovations during the decade. The removal of exchange controls, implemented in 1979, were a pioneering example of the liberalization pursued in subsequent years by other EC countries. The financial reforms of the following years

widened the portfolio choice of UK residents vis-a-vis the rest of the world and reduced the costs of international financial transactions. Consequently, the role of London in international financial intermediation has been enhanced.

An outstanding feature of the capital account is the large size of gross flows recorded in recent years. The data presented in Table A6 reveal the increased importance of particular capital account transactions in the 1980s. Thus, as a result of the removal of exchange controls, direct and portfolio investment activities have flourished. In the pre-1979 regime a variety of restrictions inhibited these categories of financial transactions and the size of these investment flows was relatively small. By contrast, the flows recorded in the 1980s indicate that UK's financial markets have become closely integrated with world financial activity.

The balance on direct investment flows deteriorated sharply in the 1980s. Direct investment activity by UK residents has become the dominant feature of these flows; a record outflow of UKL 20,7 billion was recorded in 1988. Direct investment in the UK by overseas residents has also risen during these years; direct investment inflows peaked in 1989 at UKL 18,3 billion. The balance on direct investment transactions has posted an unprecedented deterioration during the current decade, compared to a virtual balance over the period under the regime of exchange controls. However, in the first half of 1990 a net inflow was recorded in this account.

Transactions in portfolio investment have also undergone significant changes in the past ten years. Since 1979 the flows recorded under this category increased to an unprecedented extent. For example, the mean value of portfolio investment by UK residents abroad over the 1970s is an outflow of UKL 169,1 million; in the 1980s, the mean outflow is in the range of UKL 12 billion. The outflow on foreign securities transactions by UK residents peaked at UKL 36,8 billion in 1989. An exception to this pattern is the inflow recorded in 1987 which was related to the stock market crash late that year.

Inflows of foreign capital on portfolio transactions have increased over the past ten years, in contrast to the experience of the 1970s. These inflows have risen substantially in the second half of the 1980s but, in general, remain lower than the capital outflows from purchases

	1980	1985	1987	1988	1989	1990		
						Q1	Q2	Q3
Direct Investment								
In the UK	4,355	3,865	8,681	9,218	18,408	7,721	2,995	7,023
Abroad	-4,867	-8,465	-19,198	-20,685	-19,393	-4,492	-4,471	-2,181
Portfolio Investment								
In the UK	1,431	8,913	20,801	14,394	10,927	0,582	1,073	2,206
Abroad	-3,310	-19,426	3,323	-9,899	-35,897	-2,232	-0,621	-0,221
Net Bank Currency Transactions								
Sterling	0,266	2,520	3,899	8,974	7,395	3,883	-0,544	0,752
Foreign Currency	0,669	5,106	-0,498	4,962	7,576	-0,467	-2,986	-6,930
UK non-Bank Transactions with Banks Abroad								
Deposits etc.	-2,360	-1,442	-5,441	-2,947	-9,388	-2,806	-1,994	-2,549
Borrowing	-0,137	2,705	3,435	5,437	17,623	4,579	1,384	1,920
Reserves	-0,291	-1,758	-12,012	-2,761	5,439	0,129	-0,076	-0,432
Net								
Capital Flows	-3,940	-7,241	4,565	7,575	3,931	6,791	-4,341	1,393

Source: CSO (1989): "United Kingdom Balance of Payments", 1989 Edition, and CSO (1990): "United Kingdom Balance of Payments: Preliminary Figures for 1990 Q3", December 12, 1990; a negative (positive) sign indicates a capital outflow (inflow) and represents an increase (decrease) in net international assets; the data are not seasonally adjusted.

lio transactions by both UK residents in foreign securities, and by foreign investors purchasing UK securities, have increased in magnitude after the removal of exchange controls. The balance on these transactions, however, has not displayed any specific trends.

Long-term capital inflows and the current account balance provide an indication of the sustainability of trends in a country's external accounts. The main reason is that, unlike short-term capital movements which are volatile and reversible, long-term capital movements are less volatile and more permanent in character. The sum of the balance on long-term capital and on the current account is the basic balance. In the case of the UK the basic balance is shown in Table 2.7. It is clear that there has been a sharp deterioration in the basic balance over much

of the 1980s, particularly over more recent years. In 1989, the net outflow on portfolio capital, combined with the current account and direct investment debits, gave rise to a basic balance deficit of UKL 46.1 billion.

The deterioration of the basic balance position in recent years means that the financing of the current account deficit has been effected through short-term capital inflows. This could suggest that the UK has become more vulnerable to volatile expectations, and that the need to maintain high interest rates to offset the associated risk premia increased over the current cycle. In addition, such weakness in the long-term capital balance could have affected adversely the exchange rate. It is possible that the recorded basic balance in fact underestimates the external weakness involved. The distinction between short- and long-term capital is an accounting rather than an economic one; while, for example, the distinction is made on the basis of the initial maturity of the security in question, it is possible that, as the term to maturity draws closer, the security becomes a short-term claim. In addition, speculative transactions in stocks and equity do not resemble the stable long-term capital flows the basic balance purports to depict.

The rise in net inflows through the banking system mirrors the deterioration in the current account and the basic balance. While banks probably aim at achieving a flat net foreign asset position, or they unwind rapidly depar-

	1980	1985	1987	1988	1989
Current Account	2,85	2,74	-4,31	-15,36	-19,62
Direct Investment	-0,51	-4,60	-10,52	-11,47	-0,98
Portfolio Investment	-1,88	-10,51	24,12	4,49	-24,97
Basic Balance	0,46	-12,37	9,29	-22,34	-45,57

Source: Calculated from the data in Tables 2.1 and 2.6

tures from this, large net capital inflows have been recorded after 1987, both in sterling and in other foreign currencies. These are more volatile than portfolio and direct investment capital. Net inflows on this balance peaked at UKL 15,9 billion in 1989. In the first half of 1990 net inflows have persisted, albeit at some lower rate.

Increased borrowing by the UK's non-bank public from banks abroad, as well as deposits with international banks abroad, has taken place in recent quarters. The outflow on deposits with banks abroad rose sharply in 1989 at UKL 9,4 billion; in the first half of this year, however, the bulk of these transactions has been unwound. High interest rates in the UK, and the close integration of the UK with world financial markets, underlie the increased capital inflows through non-bank borrowing from banks abroad. This doubled between 1988 and 1989 to UKL 6,4 billion. In the first half of 1990 borrowing has continued even though there are signs that it is easing.

Changes in international reserves are related to intervention activities in foreign exchange markets. While at times these changes have been sizeable, they are related to operations in the foreign exchange market.

Net capital flows are the counterpart of current account transactions they finance. The recent deficits have led to an increased surplus in the capital account, which peaked at UKL 7 billion in 1988. The largest component of this inflow in recent years has been of short-term character; these inflows reflect surpluses on activities of the banking sector. This is also correlated with sterling-financing of direct investment and portfolio activities of foreigners in the UK. To the extent that these inflows are of volatile and reversible character sterling's entry into the ERM may impart greater stability. The high interest rates and sterling volatility of the previous three years may be indications that, indeed, short-term capital inflows were sustained by a positive premium. At the same time, despite the potential risks involved, there have been no circumstances in which the supply of international capital to the UK appeared to have diminished.

The large flows on direct investment by UK residents abroad would appear to suggest that the UK has become a less attractive place to invest for UK residents compared to the rest of the world. This could, perhaps, be the case. Direct investment flows are motivated by longer-term expectations about profitability, and it is possible that UK investors perceive investment in the UK as less profitable compared to investment abroad. An additional factor is that direct investment is a portfolio decision, representing a component of investors' portfolio and determined according to expected return and risk. It is very likely that these outflows represent portfolio diversification activities, motivated by changing expectations of risk and profitability. The emergence of a positive balance on direct investment in the first half of 1990 may be an indication that international and domestic investors expect that investment in the UK will outperform

investment abroad; this is possibly related to opportunities brought forward by the completion of the internal market in 1992.

4. The international investment position of the UK

The UK has accumulated an impressive international investment position over the past decade which, despite the recent current account deficits, continues to rank high in international comparisons. International assets constitute the principal source of earnings on invisibles, and international liabilities give rise to invisibles payments. The worsening of net assets related to bank lending and borrowing internationally in the late 1980s is highly correlated with the decline in the surplus on invisibles.

Data on the UK's international assets and liabilities are shown in Table 2.8. Total international assets have risen from UKL 231 billion in 1980 to UKL 779,5 billion in 1989. The principal component of international assets is the stock of bank lending abroad, representing almost 54% of the total in 1989. Second in magnitude is the stock of portfolio investment held by UK residents, followed by equity in direct investment abroad. The rest of the asset items are of lesser importance.

The stock of international liabilities has also risen during this decade. At the end of 1989 total international liabilities stood at UKL 867 billion, up substantially from UKL 212,9 billion in the beginning of the decade. The largest component of liabilities is the stock of international borrowing by UK banks. In terms of the banks' net assets it has been a debit item in the accounts. The stock of liabilities in the direct and portfolio investment accounts are substantially less than the corresponding assets. There has also been some notable increase in non-bank borrowing from banks abroad, but this has also been outpaced by deposits.

The residual item in the balance of payments has been the equivalent of a capital inflow in the 1980s and, as such, represents a cumulative increase in the country's international liabilities over this period. While not entirely appropriate to treat the balancing item as a capital account item, it nevertheless suggests that the official estimates of the UK's international liabilities underestimate the "true" indebtedness when unadjusted for the cumulative net errors and omissions.

The country's net international investment position rose sharply over the decade, from UKL 18,1 billion in 1980 to UKL 112,5 billion in 1989. This increase has been the result of a stock adjustment process in domestic and international investors' portfolios in response to the removal of exchange controls in 1979, and to financial and regulatory innovations of the subsequent years. While there has been some weakening in the stock of net international assets in the late 1980s, large and persistent deficits would be required to reduce the country's accumulated net international investment to any serious extent. In fact, the projected weaker economic activity next

next year, and the reduction in the current account deficit, will likely bring this developments to a halt. It may be argued that, after ten years of financial deregulation and reform, the current state of portfolios of UK and international investors is in equilibrium. In this state, the UK has emerged as a large international creditor.

The official statistics probably underestimate the extent of the UK's net international investment, since equity investment by UK residents abroad is recorded at book rather than at market value. A market valuation of direct investment, according to Pratten²¹ would have these estimates doubled. The principal source of the increase is unrecorded capital gains. Given the country's overseas equity investments, potential capital gains, of the order of UKL 12 billion per annum, could be expected to more than offset current account deficits at the rate recorded in the late 1980s. The prospective stream of capital gains should, of course, be evaluated at the probability that capital losses could also emerge. In addition, they are uncertain and erratic, and are principally related to world inflation and to a genuine increase in the value of real assets. In an environment of disinflation, inflation as a source of capital gains will likely become of lesser importance in coming years. However, further gains in the values of real assets may be foreseeable in coming years.

5. Concluding comments

The review of the evolution of the international transactions of the UK over the 1980s reveals the important changes which have taken place as a result of financial and regulatory innovations. A consequence of these changes has been that UK's financial markets have become more closely integrated into world financial activity, paralleling the integration of goods and services markets which has taken place in the context of world trade, and more specifically, EC trends. These developments have undoubtedly expanded the portfolio and wealth opportunities of UK and international residents, and have given rise to substantial gains from trade. In addition, the increased responsiveness of UK's import demand in the 1980s, compared to previous decades, also suggests that substantial integration of the UK with the international economy has taken place. Greater integration in commodity markets requires financial markets of greater breadth and depth to finance potential disequilibria without undue changes in exchange rates and without disruptive volatility in financial markets. The removal of exchange controls and the subsequent reforms have, it can be argued, provided the required background for greater stability in the country's international trade and payments.

The high elasticity of imports with respect to domestic spending suggests that, other things constant, an improvement in the current account deficit must be essentially effected through expenditure adjustments. Price

Table 2.8: The International Investment Position of the UK (UKL billion, end of period)

	1980	1985	1987	1988	1989
Assets					
Direct Investment	33,2	73,9	89,5	106,3	139,6
Portfolio Investment	19,1	102,1	120,4	149,1	221,3
Bank Lending Abroad	147,3	369,7	425,4	448,1	521,9
Non-Bank Deposits	7,6	22,6	27,8	31,7	46,5
Official Reserves	13,3	13,2	27,0	28,7	26,3
Other(*)	10,5	18,0	15,0	15,0	23,9
Total International Assets	231,0	599,6	705,1	778,9	979,5
Liabilities					
Direct Investment	26,4	43,3	58,5	66,9	86,5
Portfolio Investment	11,8	32,2	62,1	76,8	100,3
Bank Borrowing from Abroad	156,9	416,0	474,2	511,7	605,0
Non-Bank Borrowing from abroad	9,3	19,9	23,6	27,3	39,0
Other(*)	8,5	7,8	10,7	13,8	36,2
Total					
International Liabilities	212,9	519,2	629,1	697,0	867,0
Net International Investment Position	18,1	80,5	76,0	81,8	112,5

Source: CSO (1990): "United Kingdom Balance of Payments", 1990 Edition;

(*) residual, which includes central government and overseas authorities' holdings of exchange reserves

21) See C.Pratten: op. cit.

elasticities appear to be small, and it would require large exchange rate changes to promote adjustment. The need for expenditure adjustments to correct external disequilibria will be more pronounced in the coming years within the ERM, because the exchange rate will play a lesser role; expenditure-reducing or expenditure-expanding, rather than expenditure-switching, policies will be the principal mechanisms of adjustment.

The main determinant of pronounced balance of payments movements is policy shocks; an expansionary shock will be accompanied by a widening external deficit. It is possible that the ERM constraints will limit the frequency of policy-induced balance of payment deficits. However, should they emerge, it will likely be possible to finance them at foreseeable interest differentials without placing undue pressures on the exchange rate system. To start with, the recent experience provides no evidence that the financing of current account deficits has occurred under conditions of strain. Growing world wealth has made financing of current account deficits possible, albeit at some risk premium. These high real

interest differentials between the UK and other countries constitute, in fact, the relative price necessary for international portfolios to adjust.

The decline in the trading advantage of the UK in categories of goods which offer the greatest promise to sustain employment and raise the standards of living in the future may be an area of concern. A nation's comparative advantage is determined, to a large extent, by the productivity associated with investment in technology and education. The UK appears to be experiencing a secular decline in technology- and human-capital intensive goods. While there are no balance-of-payments reasons to intervene in international trade, there may be reasons for improving the country's longer-term productive potential that a reversal of the emerging pattern of specialization is warranted. The strengthening of UK's comparative advantage in financial services is one example of a successful adjustment to a widening European and, indeed, international financial environment.

Chapter 3

The Efficiency of and Constraints on UK Monetary Policy in the Late 1980s

1. Financial deregulation and more powerful UK monetary policy

The Bank of England's macroeconomic model of the UK economy provides econometric evidence that short-term real interest rates have become more powerful in explaining the behaviour of the various components of aggregate demand - notably residential investment and durable consumption- while long-term interest rates have a strong impact on non-residential investment and, especially, on investment in manufacturing, distribution and services.

1.1 Efficiency of monetary tightening on the personal sector

Financial innovation and liberalisation of the UK financial system during the eighties resulted in an increase in competition. This both led to a reduction in costs and margins of intermediation in the banking system and enhanced the availability of credit. At the same time, sustained growth in real incomes took place while consumer confidence increased as inflation was slowing down. As a result, both the financial assets and liabilities of the personal sector experienced a sharp increase from 1981 onwards.

Monetary tightening -via higher base rates and, thus, mortgage rates- has become more powerful than in the past since a higher proportion of householders are now affected by changes in mortgage rates and a higher percentage of their incomes are devoted to mortgage debt servicing. More stringent monetary conditions have affected aggregate demand and inflation through two traditional mechanisms:

- increasing the cost of borrowing, thus, making saving more attractive; and
- by affecting real disposable income.

The factors which have increased the efficiency of interest rate increases, from the mid-eighties onwards, are as follows:

- the personal sector has moved from being a net creditor to a net debtor, when only floating-rates assets and liabilities are considered. This was mainly the result of the financing of housing purchases. A rise of both intervention and the deposits rates will have a negative impact on the net balance of interest-bearing assets and liabilities of the personal sector, since payments will be higher than receipts;
- the stock of personal sector net floating-rate assets as a percentage of disposable income has decreased substantially since 1981;

- younger households have substantial net debt, face higher debt-service ratios and have a greater marginal propensity to consume than the older households which, as a group, hold net assets;
- the amount of debt-service as a proportion of annual disposable income shows, particularly from 1988, a marked increase when compared with the previous ten years. This rise in the income gearing reflects both the increase in the interest rates and the change in the mortgage market following the break-up of the building society cartel and the entry of the banks when financial liberalization took place in the early 1980's.

1.2 Efficiency of monetary tightening in the corporate sector

Financial deregulation and increased competition in the 1980s led to an increase in both the assets and liabilities side of the corporate sector financial balance sheet. The factors which have increased the efficiency of a monetary tightening in the corporate sector are related to the substantial rise of companies' exposure to changes in short-term interest rates:

- net interest-bearing liabilities have increased substantially. Since 1987, the net financial liabilities and the negative net "floating-rate" position of ICC's have grown fast. This increase in borrowing partly reflects the rapid growth in investment and dividend payments during 1987-88 and higher levels of merger and take-over activity.
- the corporate sector financial position has deteriorated substantially. As aggregate debt indicators suggest, the capital and income gearing ratios have increased steadily since the middle of 1988 and ICCs moved into a financial deficit towards the end of 1987.

2. Constraints on the efficiency of monetary policy

2.1 Arising from the personal sector

A number of offsetting factors might have softened the impact that interest rate increases could have had on personal sector spending behaviour.

- annual adjustment schemes for mortgages might have delayed the impact of higher mortgage interest rates;
- supply-side innovation by lenders may have attenuated the effects of higher base rates;
- lenders had a greater incentive to avoid increases in the mortgage interest rate in order to maintain turnover because higher competition compressed lenders' profit margins in the mortgage market and, thus, increased the share of items more directly related to the level of turnover. As a result, the transmission of a tightening in policy from base rates to mortgage rates has been postponed although not reduced;

Table 3.1: Interest Rates (quarterly averages)

	Nominal short term	Nominal short term	Real long term ¹
1985q1	13,03	10,88	5,73
q2	12,59	10,72	5,41
q3	11,70	10,32	5,04
q4	11,62	10,35	4,97
1986q1	12,38	9,88	5,50
q2	10,18	9,09	3,54
q3	9,98	9,81	4,24
q4	10,90	10,57	5,32
1987q1	10,63	9,59	4,76
q2	9,17	8,95	3,60
q3	9,81	9,96	4,38
q4	9,23	9,37	3,98
1988q1	9,02	9,17	3,98
q2	8,41	9,35	3,92
q3	11,35	9,52	4,16
q4	12,49	9,34	3,85
1989q1	13,07	9,30	3,90
q2	13,48	9,65	4,12
q3	13,94	9,53	4,03
q4	15,09	9,95	4,60
1990q1	15,19	11,04	5,34
q2	15,11	11,46	5,72
q3	14,95	11,19	5,43
q4	13,83	10,70	4,94

1) Adjusted-inflation is calculated as a 60 months moving average of CPI deflator looking 3 years backwards and 2 years forward.

For the latest months the Commission's forecasts have been used.

Table 3.2: Demand and output (change per annum)

	Private Consumption	Total Domestic Demand	GDP
1985	3,73	2,94	3,68
1986	5,58	4,22	3,47
1987	5,38	5,09	4,73
1988	6,87	6,68	4,13
1989	3,87	3,49	2,18
1990	2,45	1,78	1,52
1991	1,14	0,78	0,68
1992	1,88	1,95	2,37

- the reaction of wage bargaining, either to cuts in real disposable income or to higher RPI - through higher mortgage rates- in a context of labour market tightness, might also have had a limiting impact on monetary policy efficiency.

2.2 Arising from the corporate sector

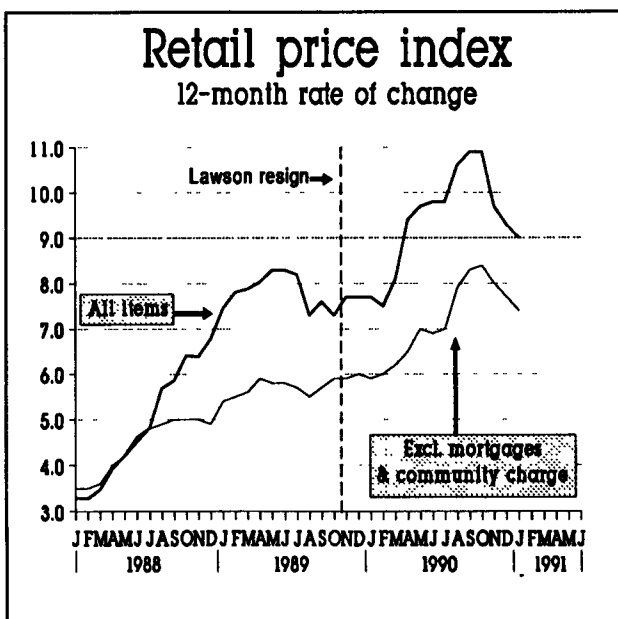
Also in the corporate sector we can find a number of factors suggesting a lower impact of monetary tightening in the activity level:

- increased of profitability of the corporate sector, (the real rate of return in capital was 9.5% in 1988-89 against 2.5% in 1981).
- improved financial position of companies, as a result of the decrease in the inflation rate, when compared with previous periods;
- the increase in nominal long-term rates has been smaller than that in short-term rates, although some catching-up took place recently. This might be relevant for the efficiency of transmission mechanisms to the extent that, except for housebuilding, companies' investment was primarily influenced by real long-term interest rates. But adjusted-inflation long-term interest rates may also have increased since early 1987 (Table 3.1).

3. Why has monetary policy not yet coped with the inflation problem?

From 1985 to 1989, the UK economy experienced a strong consumption-led growth performance. Internal demand outpaced domestic output growth, leading into price and current account deficit increases (Table 3.2).

Graph 3.1



During the years 1982-87, UK inflation appeared to be under reasonable control. From 1988 onwards, however, strains in the economy began to show up in inflation, which accelerated from 4% during most of 1987 to 6% by April 1989 and to 10.6% in August 1990 on an RPI basis. This increase was more muted when excluding housing payments from the RPI (Graph 3.1), although the upwards trend remained clear.

The main elements explaining the acceleration of inflation can be summarized as follows:

Sources of poor inflationary performance are home grown....

The rise in wage costs failed to decelerate in response to an improved price record in the mid-1980s. Initially, this reflected strong productivity gains, at least in manufacturing. But, subsequently, as productivity growth slowed down, unit labour costs accelerated for the whole economy, from about 3.6% in 1987 to over 6.3% in 1988 and 9.4% in 1989 (Graph 3.2). In addition, profit margins expanded substantially during the boom. The strength of domestic demand and the high level of capacity utilisation enabled producers to increase profits and made them more ready to accept wage claims, especially with a weak pound -during much of 1989 and early 1990- which protected the profitability of manufacturing industry from international competition.

Moreover, houses were used as collateral for higher spending on durable goods with unfavourable repercussions on prices and the external deficit. This was possible because house prices experienced a sharp recovery in 1982-88, with a particularly strong rise in 1988.

...and demand strength was underestimated.

Over the past four years official statistics have been showing significant discrepancies and have been submitted to major revisions which made their assessment much less clearcut. The statistics on output and internal demand for 1987-88, in particular, have been consistently revised upwards. There was also an important problem of policy management: that of assessing and reacting to the strength of private sector demand response to improved medium-term business expectations, consumer confidence rebuilt from the 1981-82 recession and increased availability of borrowing opportunities against optimistic perceptions of future earnings.

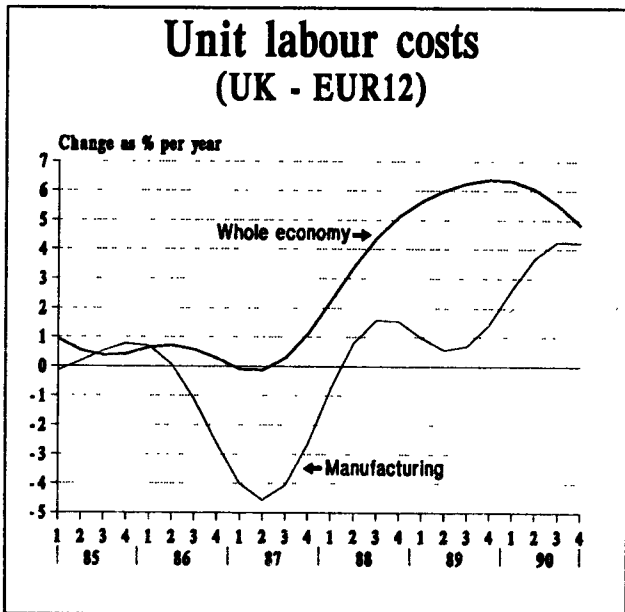
The strength of the demand response was initially underestimated by all forecasters, and the acceleration in inflation damaged the credibility of the Medium Term Financial Strategy (MTFS) in maintaining downward pressure on inflation expectations.

Monetary policy did not react fully...

The unsustainable growth rate of domestic demand had an inflationary potential which emerged only with some delay. Interest rates were actually reduced in October 1987 (in response to the crash) and again, with much less ex ante justification, in the spring of 1988, to restrain a rise in sterling. It is rather clear that the monetary policy mistakes of 1987 and early 1988 were technical, not politically-inspired.

Determined monetary policy measures to counter the overheating were not taken until November 1988, making the subsequent tightening of policy -illustrated both by the upward shift in the yield curve and by its inversion in 1989 and 1990 (Graph 3.3)- more severe because of its tardiness.

Graph 3.2



Graph 3.3

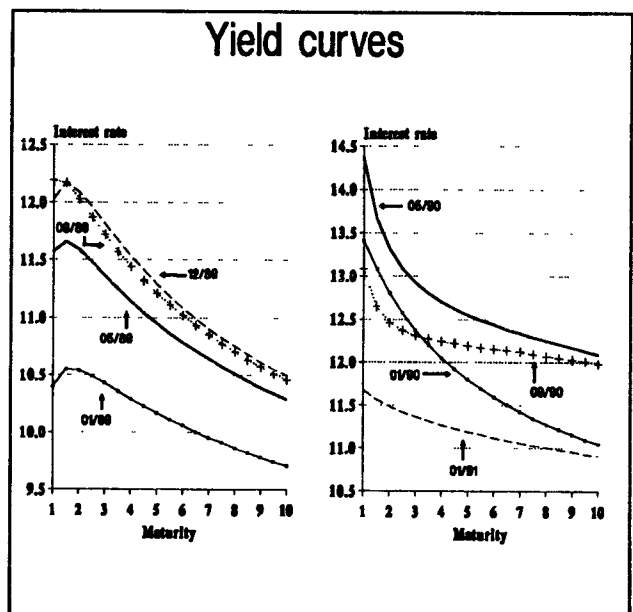


Table 3.3: Monetary Aggregates (as % change per year)

	MO	M4
1986q1	3,7	14,6
q2	3,2	16,3
q3	4,0	15,8
q4	5,2	15,9
1987q1	4,4	14,6
q2	4,5	14,1
q3	5,0	15,4
q4	4,9	16,2
1988q1	5,2	16,8
q2	6,6	16,9
q3	7,7	18,6
q4	7,7	17,6
1989q1	6,7	18,0
q2	5,8	18,6
q3	5,0	17,6
q4	5,4	18,4
1990q1	5,9	17,8
q2	6,7	17,0
q3	5,0	14,4

...since monetary indicators were misread...

Monetary aggregates were less reliable as leading indicators of nominal expenditure since they were affected by structural shifts related to supply-side innovations and credit deregulation throughout the 1980s.

It was more difficult to assess the overshooting of broad money aggregates (sterling-M3 and M4) which were growing at above 15% a year from 1986 onwards (cf. Table 3.3). This could represent an undesired evolution of nominal expenditure -that should, therefore, be corrected- or, in contrast, could indicate changes in the relative yields of financial assets included in the definition of broad money and those excluded, which should be accommodated.

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

...and the fall in Sterling loosened domestic monetary conditions.

From early 1989 until May 1990, sterling was falling under the impact of political worries and their perceived effect on the disinflationary commitment of the authorities, despite a further rise in interest rates in November 1989.

The political unpopularity of interest rate increases (because of their impact on mortgage holders) made it impossible to react more vigorously to this slide in view of the rather late position in the electoral cycle. However, there are also grounds for thinking that the pound was lower than justified by "fundamentals" (i.e., the changing balance of supply and demand in the economy), and that a further increase in interest rates would have been economically unjustifiable.

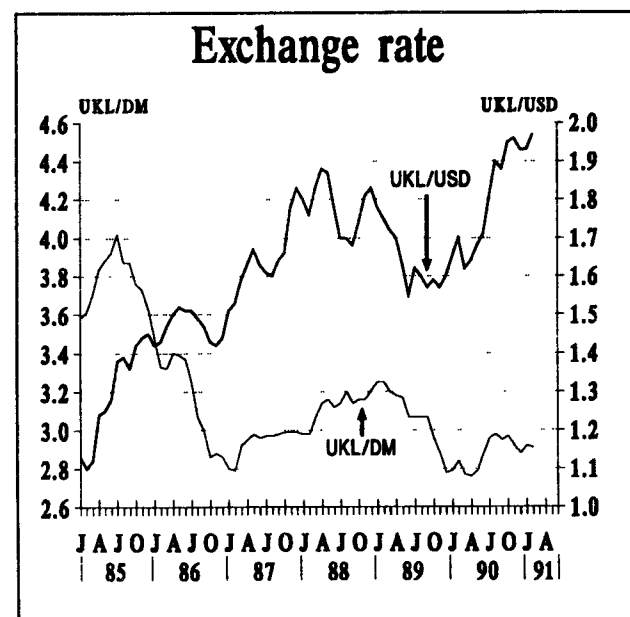
This change in market perceptions of the UK economy contributed to loosening monetary conditions and made it more difficult for monetary policy to affect wages and profit margins since a declining pound enlarged the room for manoeuvre of British export companies during 1989, as well as contributing directly to inflation through higher import prices.

4. Conclusions

Concerns have been expressed that deregulation and supply-side innovation in financial markets during during the 1980's may have weakened the impact of monetary tightening on aggregate demand and inflation and blurred the transmission mechanisms of monetary impulses to the real sector.

However, recent econometric evidence makes it clear that the impact of a hike in UK interest rates on expenditure has become more powerful in recent years. Both the personal and the corporate sectors are now more interest rate sensitive.

Graph 3.4



The enlarged borrowing capacity arising from the financial innovation process has been compensated by the shift in the personal sector from being a net creditor to a net debtor. This reduced the ability of households to maintain expenditure when debt service costs were increasing.

An increase in borrowing took place in the corporate sector, and during the past 18 months its financial position has deteriorated substantially. As a result, companies' exposure to interest rate changes has increased significantly.

UK monetary policy has become apparently less effective in reducing headline inflation partly because of the mechanical effect of higher base rates -and, thus, higher mortgage rates- on the RPI and the consequent heightening of wage pressures. If less distorted measures are used, the acceleration in inflation has been much less.

Nonetheless, underlying inflation has increased very significantly as the authorities underestimated demand strength and were slow to tighten monetary policy in order to face in time the inflationary potential of an overheating economic situation. In fact, the required degree of monetary tightness has needed to be considerable, given the strength of demand pressures (i.e., there has been large outward shift in IS curve, so a big move in the LM curve, involving politically-unpopular high interest rates, has been necessary to counter overheating).

Moreover, the difficulty in assessing the stance of monetary policy has increased during the 1980s. Structural shifts related to financial market change and, in particu-

lar, to the deregulation of credit have affected the indicator role of the monetary aggregates. The authorities have had increasing recourse to flexibility, discretionality and judgement in implementing monetary policy, and focused in a range of indicators, including the exchange rate, asset prices, the yield curve and coincident indicators of activity as well as monetary aggregates. None of these, singly or in combination, has yet provided an accurate guide to:

- the degree of monetary tightness required; and
- the degree of monetary tightness prevailing.

In spite of the constraints imposed by the above-mentioned structural factors, which could delay the contractionary impact of a hike in interest rates, a tightening of UK monetary policy should have, all in all, a greater impact in both reducing expenditure and fighting against inflation than was the case in the past and should have such an impact with fewer distortionary side-effects. The tightening of monetary policy, however, will eventually bring down the underlying rate of inflation only through a period of higher unemployment, as in other countries.

The recent entry of sterling into the ERM with wide bands preserves some margin of manoeuvre for monetary policy. Whether policy will acquire more credibility, resulting in a more direct, expectational influence on wages and prices (i.e., a reduction in the output cost of disinflation), induced by ERM entry is an open question, with the econometric evidence relating to existing ERM members still mixed.

Chapter 4 Housing

1. Introduction

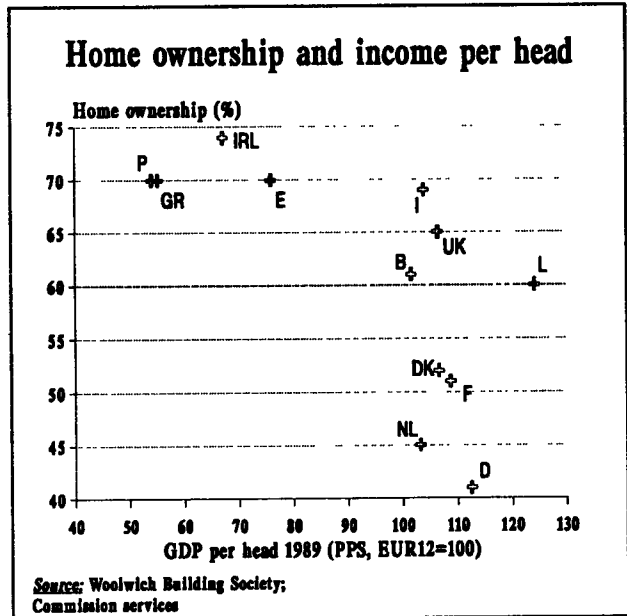
The economic impact of the housing market in the UK has attracted considerable attention. One main reason is that, in any analysis of the 1986-88 overheating, it is clear that housing played a considerable destabilising role. Secondly, there are considerable fears that this potential for destabilisation is still potent and could be extremely damaging to future economic performance within the ERM. Thirdly, there are grounds for believing that the housing market is a serious impediment to the efficient functioning of the labour market. Finally, because of housing's central social role, it has become subject to considerable influence from targeted intervention through the taxation and public expenditure regimes and through environmental planning controls; it is thus natural to wish to examine the scope for revising such policies to produce a more economically desirable outcome.

2. Main features of the UK housing market

In general terms, the UK has shared to a larger degree than the continental European economies (but in common with other English-speaking countries and with Japan) the desire to promote home ownership as against other forms of tenure. This desire has been particularly shared by the present government. In 1987 63% of households in Great Britain were owner-occupiers, up from 54% in 1981 and 49% in 1971; in the 30-59 age group (by head of household), the 1987 proportion approached three-quarters²². Within the overall category of owner-occupation, about three-fifths are owned with a mortgage, overwhelmingly from a bank or building society.

Of the 37% of households renting in 1987, over two-thirds were renting from local authorities while under a third - about a tenth of all households - were renting privately, mostly unfurnished property. Particularly striking over the past twenty years have been the rough halving in privately rented accommodation and the decline in the local authority housing stock. The latter followed subsidised sales to tenants in consequence of the central government's "right to buy" legislation of 1980 and 1988 and reduced public expenditure for the construction and renovation of housing. The lack of an

Graph 4.1



accessible rental market of adequate size and quality encourages owner occupation at a relatively early age: on average, well under thirty for first-time buyers.

Housing overall in the UK appears to be in excess supply: by 1987 the housing stock numbered 22,8 million dwellings, compared with 21,5million households the previous year. Residential investment as a proportion of GDP declined slightly during the 1980s, to about 3 1/2%, significantly lower than in the major industrialised countries as a whole (about 5%). Over half the housing stock was constructed post-war.

Home ownership is by far the largest single item in personal sector net wealth - 52% for the gross value of housing in 1988 (40% for housing equity) - just as mortgages are by far the largest component of financial liabilities - 65% in 1988. A tendency to regard housing wealth in financial asset terms encourages high turnover in the housing market, with mortgages redeemed, on average, after about six to seven years, resulting from "trading up" to more expensive properties with higher gearing of mortgage debt to income.

22) Social trends, 1990 edition. By region the proportions for all households are fairly homogeneous with the striking exception of Scotland, where home ownership is proportionately lower than tenure of public housing (43% compared with 48% in 1987): Regional Trends, 1989. Among the richer countries of the Community, the UK has the highest degree of home ownership with the exception of Italy. There is a weak inverse relationship between national income levels and home ownership - see Graph 4.1. The UK owner-occupation proportion is strikingly higher than in Germany (area excluding new Länder), which in 1987 was 38%; subsidised tenancies in Germany in the same year accounted for 20% of the total occupied stock, a third of the rental market.

3. Public intervention in the housing market

Public intervention in the housing market has been extensive and of long-standing. The main forms include direct provision of housing, through local authorities and housing corporations, rent and security of tenure control, in both the public and private rented sectors, tax reliefs on owner occupation, mortgage financing, and provision for rental, the "right to buy legislation" just noted, and environmental planning controls affecting the potential for new building.

Controls of long-standing over the private rental market have resulted in the major reduction in tenure referred to above through a shrinkage of effective supply. Excess demand is shown by free market rents being substantially above controlled rents (in 1979 this gap was estimated at about 75%²³). The shrinkage of the sector resulted in controls being eased from 1988, particularly by new tenancies being linked to market rents and for more shorthold tenancies. Local authorities were empowered in the same year to subsidise private sector

rental provision, while the Business Expansion Scheme (BES) introduced in 1983, giving tax relief on investment, was extended to companies letting accommodation. Other recent government initiatives yet to make significant headway include the encouragement of "housing action trusts" (HATs) and the "rent into mortgage" option for encouraging more local authority tenants to transfer progressively into private ownership status. A consistent theme of central government action has been to reduce local authority tenure.

It seems unlikely that these initiatives will have a major impact on widening the private rental market when set against the fiscal incentives to mortgage-financed home ownership. These are both of a current and capital nature. On the current side, given the general approximation of the UK's personal taxation system to a comprehensive income tax²⁴, the main incentive is the absence of any tax on imputed income. This contrasts with the BES for rental provision. The replacement of domestic rates by the community charge in Great Britain, completed in 1990, removed the one outstanding tax related to domes-

Table 4.1: Taxation of Housing (1987 tax rules)

	Deductibility of interest		
	Principal residence	Secondary residence (a)	Taxation of imputed rent
United Kingdom	TA(L)	No	No
Belgium	TA(L)	TA(L)	Yes
Denmark	TA	TA	Yes
Germany	TA(b)	No	Yes
Greece	TA(L)	No	Yes
Spain	TA(L)	TA(L)	Yes
France	TC	No	No
Ireland	TA(L)	No	No
Italy	TA(L)	TA(L)	Yes
Luxembourg	TA(L)	TA(L)	Yes
Netherlands	TA	TA	Yes
Portugal	TA(L)	TA(L)	Yes
Austria	TA(L)	No	No
Finland	TA(L)	TA(L)	Yes
Sweden	TA	TA	Yes
Switzerland	TA	No	Yes
Turkey	No	No	No
United States	TA	TA	No
Canada	No	No	No
Japan	TC(L)	No	No
Australia	TC(L)	No	No
New Zealand	No	No	No

a) 1985 tax rules
b) Abolished in 1988

23) P. Minford, P. Ashton and M. Peel, "The effects of housing distortions on unemployment", Oxford Economic Papers, 1988.

24) i.e. where income from wealth is taxed at the same rate as earned income and assets are accumulated from post-tax income. The theoretical alternative is an expenditure tax system where the returns from assets are exempt but dissaving is taxed. The UK system is actually mixed, and some important recent reforms have been of an expenditure tax nature, e.g. PEPs and TESSAs allowing tax-free returns from equities and deposits under certain conditions.

tic property income. The second current incentive is the income tax relief on mortgage interest payments related to a main residence up to a mortgage ceiling of UKL 30,000 (a ceiling which has remained unchanged in nominal terms since 1983). On the capital side, capital gains on a main residence owned for at least one year are exempt from capital gains taxation. The official estimated cost of mortgage interest relief in 1989-90 is UKL 7 billion, the largest single relief after account is taken of the main initial allowances. The estimated cost of capital gains relief is also estimated at UKL 7 billion, but more tentatively²⁵. These sums compare with total revenue raised from income tax in 1989-90 of UKL 48,8 billion and from capital gains tax of UKL 1,9 billion; in 1990-91 one per cent off the standard rate of income tax would have cost about UKL 1 1/2 billion in revenue.

The UK is not, of course, the only country to give favourable tax treatment to mortgage-financed owner occupation. Among industrialised countries surveyed by the OECD on the basis of their 1987 tax rules, the US, France, Japan, Austria, Ireland and Australia allowed mortgage interest deductibility and left imputed income untaxed, although in France the tax credit rather than allowance system limited the gain (Table 4.1)²⁶. In practice, the actual operation of the tax systems under various inflation and real interest rate and financing assumptions result in computed "tax wedges" for housing investment where the UK (only matched by Sweden) is outstandingly generous for typical mortgage financing - see Table 4.2²⁷. Of particular note from the table is not only the large but extremely inflation-progressive tax advantage in the UK, as higher nominal interest rates (in reality mostly representing a form of premature capital repayment) are also offset against tax up to the mortgage

Table 4.2: Tax wedges for housing investment
(Percentage points, using 1985 tax parameters)

	Real interest rate							
	3				5			
	Inflation rate				Inflation rate			
	0	5	10	15	0	5	10	15
	Borrowing case							
UK	-0,71	-1,90	-3,10	-4,29	-1,19	-2,38	-3,57	-4,76
Germany	-0,06	-0,11	-0,11	-0,11	-0,15	-0,18	-0,18	-0,18
France	-0,03	-0,09	-0,15	-0,18	-0,10	-0,19	-0,29	-0,29
Sweden	-0,53	-1,86	-3,19	-4,52	-1,06	-2,39	-3,72	-5,05
USA (b)	-0,79	-2,11	-3,43	-4,74	-1,32	-2,64	-3,95	-5,27
	-0,45	-1,20	-1,95	-2,70	-0,75	-1,50	-2,25	-3,00
Canada(c)	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
Japan	-0,23	-0,23	-0,23	-0,23	-0,35	-0,35	-0,35	-0,35
Australia	-0,13	-0,33	-0,54	-0,75	-0,33	-0,66	-1,00	-1,33

(a) 1985 tax parameters

(b) 1987 tax parameters

(c) No tax relief

Note:

The calculations take into account:

a) the deductibility of interest payments and eventual limits,

b) the availability of tax credits and subsidized loans,

c) the taxation of imputed income from owner-occupied housing.

Source: M. Fukao and M. Hanazaki: "Internationalisation of financial markets and the allocation of capital". OECD Economic Studies, Spring 1987.

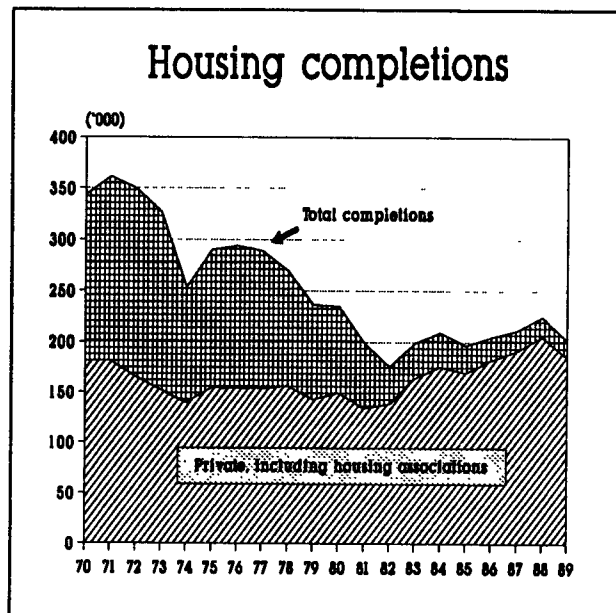
- 25) Source: 1990 public expenditure white paper, Cm 1021. The cost of mortgage interest rate relief will fall as interest rates are reduced.
- 26) A. Dean, M. Durand, J. Fallon and P. Hoeller, Saving trends and behaviour in OECD countries, OECD Working Paper No.67, June 1989. Note that Table A4.1 excludes local property taxes (e.g. France has a system very close to the domestic rates replaced in the UK). The table thus underestimates the UK's fiscal generosity towards housing.
- 27) Note, however, that the OECD calculations based on 1985 tax parameters in Table A4.1 assumed for the UK a typical property costing UKL 37800. Non-indexation of the UKL 30000 mortgage ceiling, a relatively much higher rise in the UK in house prices (a UK average of UKL 75000 in 1989) and a reduction in UK income tax rates will have reduced the UK wedge.

ceiling. Moreover, of the countries just mentioned, the US, Japan and Australia taxed capital gains on housing, as did Austria if the property were disposed of within ten years of acquisition²⁸. Only Ireland had a similarly liberal tax regime, and then not in the context of the degree of financial liberalisation undertaken by the UK during the 1980s. While interest deductibility (in real terms, indexed for inflation) can be theoretically justified under a comprehensive income tax system as being neutral in asset allocation effect, such a system would also of necessity imply taxation of imputed income and real capital gains²⁹.

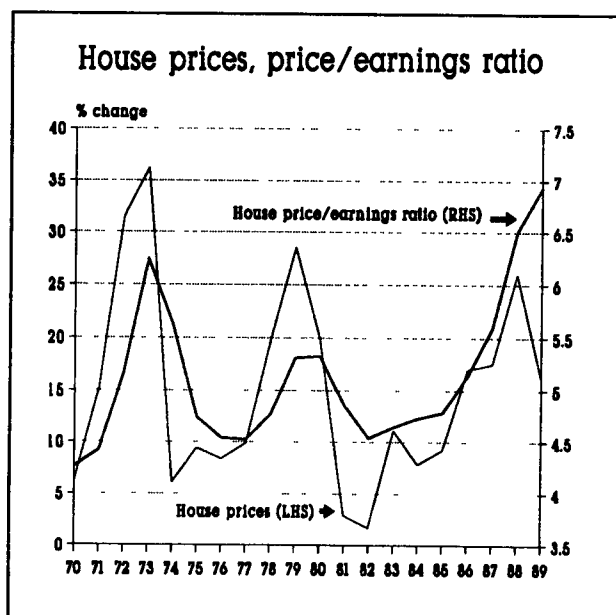
Apart from stimulating demand for housing, the trend of public intervention has also in recent years tended to limit its supply. The restriction of the private rented sector, followed more recently by a measure of deregulation, has been described above. The enforced sale of publicly owned housing by giving tenants the right to buy (first in 1980, then with fewer restrictions in 1988) is directly neutral in effect. Over time, however, it may contribute to a growing mismatch between supply and demand by restricting the supply of entry-level accommodation. More obviously, the large decline in net public expenditure on housing represents only partially the effect of such sales. Total general government expenditure on housing, net of receipts from sales, declined from UKL 6,1 billion in 1979-80 to UKL 2,9 billion in 1988-89, a real decline of three-quarters. As a proportion of general government expenditure, housing declined from 5,5% in 1979-80 to 3,2% in 1988-89 (an estimated 3,7% in 1989-90³⁰). A major decline in public housing completions during the 1980s has been the major factor behind the decline in overall housebuilding since the 1970s: in 1989 only 17,7 thousand public dwellings were completed against 88,5 thousand in 1979, although most of the reduction was made up by higher private completions (Graph 4.2)³¹.

Given the significant net surplus of housing compared with households and the undoubted quality improvement over recent decades, the decline in public and (in trend terms) private housebuilding seems appropriate in terms of overall resource allocation. Nevertheless, the boom in house prices over the 1980s discussed below was regionally very differentiated. Above all, the extreme skewing of house price inflation to London and the south-east suggests supply factors as well as higher regional growth of demand played a role, with relatively stronger planning controls on new development in the region.

Graph 4.2



Graph 4.3



28) Price Waterhouse International Tax Guide 1989, quoted in Greenwell Gilt Weekly, No. 279, 19.3.1990.

29) Alternatively, to retain neutrality within an expenditure tax system mortgage interest deductibility would be abolished but imputed income and capital gains could remain untaxed.

30) Annual Abstract, 1990; public expenditure white paper, January 1990, (op cit).

31) Muellbauer and Murphy nevertheless consider that the decline in public completions during the 1980s had a significant effect in bidding up house prices, given real income growth. See J. Muellbauer, *The Great British Housing Disaster and Economic Policy*, Institute for Public Policy Research, Economic Study No.5, 1990.

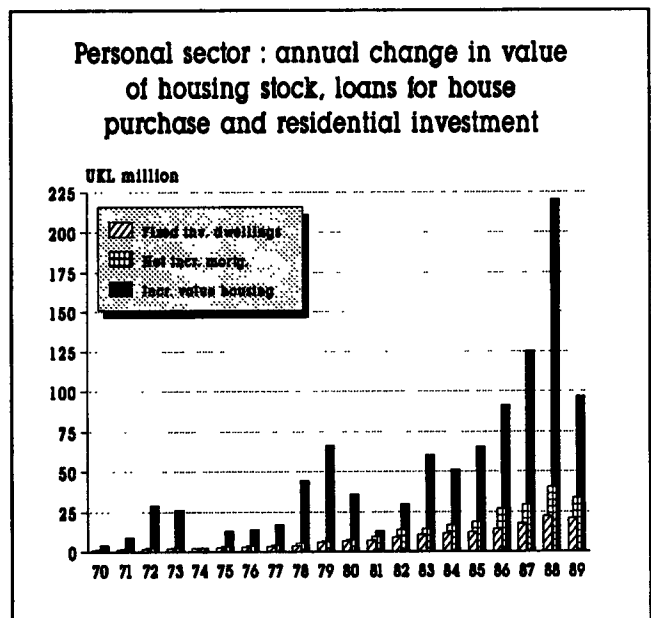
4. The role of housing in the 1986-88 overheating

House prices rising far in advance of general price inflation or, more significantly, real income growth, were both a primary symptom and cause of the overheating during the last cycle. The average price of new dwellings on which mortgages were approved rose by 17% p.a. in 1986 and 1987 and by 26% p.a. in 1988, taking the ratio of house prices to earnings to an historically high level (Graph 4.3). This generated a substantial increase in personal sector net wealth³². Prices rose a further 16% in 1989, from the end of which year prices have been roughly static but with an apparently marked contraction of turnover. These are national averages: the "boom and bust" has been more pronounced in London and south-east England, where there have been significant nominal falls over the past year. The last comparable cycle in house prices was associated with the 1973 boom, although there was a minor cycle peaking with the economy in 1979.

The causes of the recent rise in house prices are not typically fully explained by standard modelling techniques. It is clear that the factors which usually lead to higher house prices would have led to some significant rise in any case: real income growth, rising employment, increasing household formation for demographic and social reasons, falling interest rates, increasingly tight planning controls, declining construction and a shrinking rental market were factors in this direction. Nevertheless, over and above these factors, it seems clear that house prices responded to the financial liberalisation undertaken in the 1980s and that this was a major factor in both directly and indirectly (via its effects on demand and income growth) raising prices³³.

The first major additional factor affecting the housing market was the entry of banks on a substantial scale into the mortgage market following the removal of credit controls in 1980, which themselves had become ineffective following the ending of exchange controls in 1979. Competition from the banks prompted the building so-

Graph 4.4

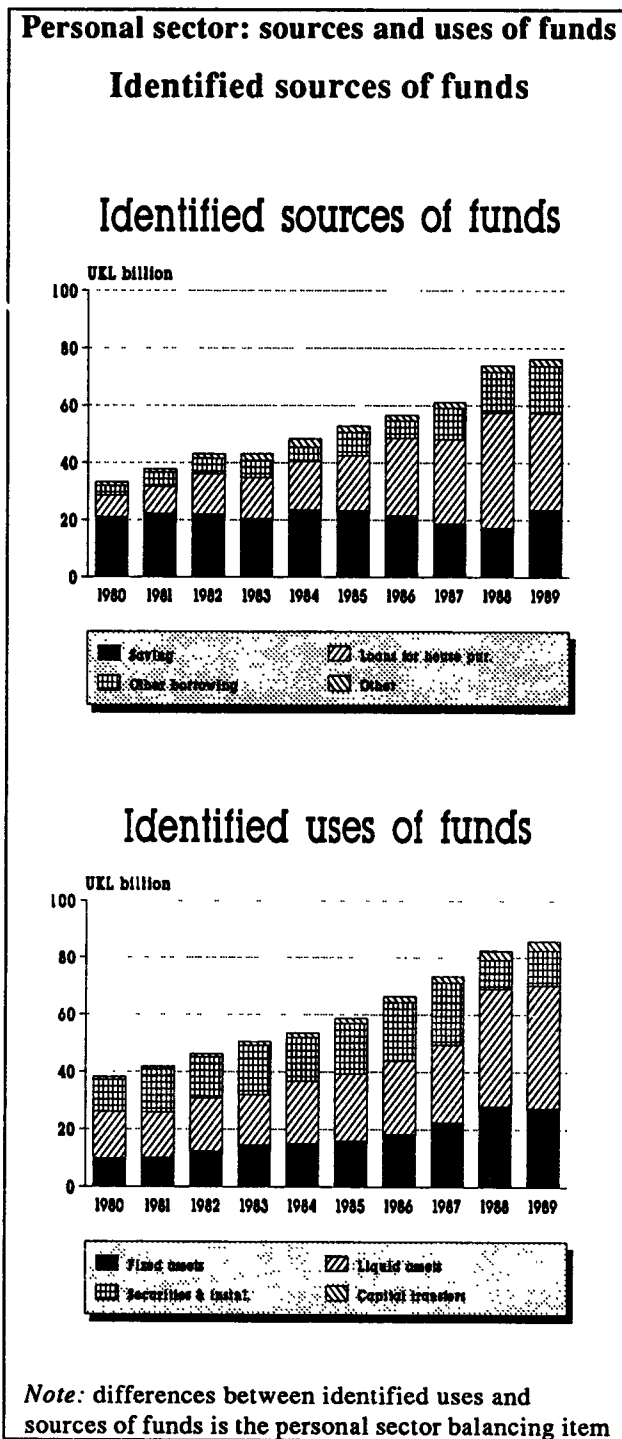


cieties to drop their interest rate cartel and led to extensive deregulation of the societies in 1986. The Building Societies Act of that year liberalised both the asset and liabilities sides of their operation, inter alia allowing wholesale money market borrowing, the granting of second mortgages and unsecured loans (though at least 90% of lending had to consist of first mortgages on principal residences).

Financial liberalisation replaced a system of extensive societies-administered credit controls, characterised by cartelized, below market rate mortgages with mortgage queues of fluctuating length. From 1986 onwards there was a major increase in borrowing by the personal sector, principally accounted for by loans booked for house purchase (Graph 4.4). Total loans for house purchase rose from UKL 19,0 billion in 1985 to UKL 40,8 billion in 1988. This compares with a doubling of total personal sector borrowing from 27,2 billion to UKL 54,8 billion over the same period.

- 32) The increase in the value of the housing stock accounted for just over half of the 48% nominal increase in gross personal sector wealth between 1985 and 1988. The bulk of the remaining increase was due to the stock market boom.
- 33) Muellbauer, op. cit., reports that a conventional model of the ratio to income of the mortgage stock less equity withdrawal "hugely underpredicts for 1981-88 with the prediction error peaking in 1987-88"; similarly for the ratio of mortgage advances to house prices for first-time buyers.

Graph 4.5



More significantly, the increase in the stock of mortgage debt over the three years 1986 to 1988 of UKL 94,5 billion compares with a cumulative flow of personal sector investment in fixed assets of UKL 38,2 billion on new dwellings and UKL 15,5 billion on net purchases of land and existing buildings -UKL 54,7 billion in total over the same period (Graph 4.5). A large part of the difference represented substantial "equity withdrawal", i.e. increased debt on the existing housing stock³⁴. Given the continuing increase in house prices, capital gearing actually fell slightly: the mortgage stock of UKL 127 billion in 1985 compared with UKL 527 billion for the value of personal sector housing (24%); by 1988 mortgage debt of UKL 222 billion compared with a housing stock of 964 billion (23%)³⁵. Equity withdrawn (replaced by borrowing on preferential mortgage terms) added to but far outweighed the still substantial UKL 6 billion increase in non-mortgage borrowing between 1985 and 1988 to finance higher consumer spending.

Overheating thus became a cumulatively reinforcing process, in which the supply of and proceeds from housing finance became a key factor. Equity withdrawn stimulated consumer spending (with a high import content), real income and overall demand growth. This in turn stimulated the rise in house prices, where part of the rise seems to have been a speculative bubble phenomenon, encouraging more equity withdrawal, aided and abetted by new and vigorous competition between the banks and building societies to expand their assets. House price inflation, skewed to London and the south-east, added to general inflationary pressures by inhibiting labour mobility and inciting wage claims made more difficult to resist by the lack of skilled labour³⁶. Higher house prices, and thus mortgages, added directly to the retail prices index (the main reference for wage bargaining) because of the chain-weighting process of revising the index basket. This effect, which in 1990 was still affecting year-on-year comparisons of the index, would thus have "exaggerated" the increase in underlying inflation even without the mortgage rate increases since 1988.

The expansion also had the conventional effect of stimulating a residential construction boom, although this was not a primary source of the overheating of demand (see again Graph 4.1). Residential investment peaked in 1988 at a level about a fifth above that of three

- 34) The difference between the increase in the mortgage stock and the flow of residential investment is only an upper limit indication of the extent of equity withdrawal. In practice, there are other reasons for discrepancy such as new mortgages taken out on bequested property: see A.E. Holmans, Government Economic Service Working Paper No. 92, 1986. A. Kaletsky, writing in the Financial Times on 29.6.90, ("Home truths on housing market") quotes unpublished Bank of England estimates on equity withdrawal rising from UKL 1,3 billion in 1980 to UKL 24,5 billion in 1988.
- 35) For 1989, it is estimated that gearing remained around 23%.
- 36) A particular factor behind the rise in house prices in the UK generally, but especially in London and the south-east, may have been the expansion of employment in financial services. Here salaries are typically at a premium and fringe benefits often include subsidised mortgages.

Private investment in dwellings dropped about 6% in 1989 and perhaps dropped by somewhat more in 1990. The sharply cyclical behaviour of private housebuilding has nevertheless been destabilising, and the contraction of the industry in 1990 was a forerunner of a wider downturn.

5. The disincentive to labour mobility

The effects of the housing market in restricting labour mobility have already been alluded to. There are three principal problems: the lack of an adequately large and flexible free rental market; the difficulty of gaining accommodation in or, once in, transfer between, public ("council") housing; and regional house price differences, especially the large premium in London and the south-east which inhibits inward migration. All three factors reflect the unintended side-effects of public policy intervention in the housing market.

Labour mobility within the UK has traditionally been low, leaving significant dispersion in regional unemployment rates and, to a lesser extent (because compensated by public transfers), in real income levels. Why this should be so probably partly reflects substantial social immobility, given the strength of regional cultural differences within the UK. Nevertheless, research shows a substantial effect from housing tenure differences³⁷. Subsidised public housing tenants are, unsurprisingly, the most immobile and this seems to play a major role in restricting mobility of manual workers.

The effects of low labour mobility are further explored in Chapter 2.1 on wage determination. In the longer run market mechanisms should offset the extreme imbalances of housing accommodation and price that have developed in the 1980s. Employers have incentives to relocate in areas where accommodation is cheaper and more plentiful and thus where staff are easier to attract and retain, easing pressure on congested regions. Indeed there is already some evidence for this in the course of the current slowdown, with house prices having fallen the most in nominal terms in London³⁸. Given the persistence of the problem in the UK it would, however, be unwise to count on this trend being substantial.

Moves to increase labour mobility from the side of the housing market need to focus on ensuring a better regional balance of housing supply and demand and more flexible tenure arrangements. This probably implies as a

first priority a larger free rental sector and subsidised provision targeted by household income rather than by tenure. Changes in owner occupation could also be eased by simplifying the conveyancing process (e.g. by registering all property) and thus cheapening transfer costs, though these are already low in international comparison.

6. The housing market in the context of the ERM

The deficiencies in the structure of the UK housing market identified above - particularly the fiscal distortions and the constraints on labour mobility from an insufficiently large pool of rented dwellings at market prices - are such that it would have been wise to correct them even if the UK had remained outside the exchange rate mechanism. With membership now achieved, this becomes more urgent, if a damaging repeat of housing's destabilising contribution to the recent overheating is to be avoided.

The personal sector in general has become used to regarding housing as the asset offering the most secure, risk-free rewards. Particularly because of the fiscal incentives of mortgage-financed owner occupation and the large trend appreciation in house prices it has been rational to do so. Obtaining the largest available mortgage and acquiring the most valuable dwelling (especially in periods of high inflation), with frequent "trading up", has thus been encouraged. The current depression in the housing market has reversed some of the recent gains, but it would be surprising if this potential pattern had ended. The replacement of domestic rates - linked, if indirectly, to imputed income on housing - by the community charge has added another incentive to invest in housing³⁹.

Many observers have drawn attention to the potential overhang for equity withdrawal which the housing stock in a financially liberalised context represents⁴⁰. Of the value of housing of around UKL 1 120 billion at end-1989, outstanding mortgages represented only UKL 255 billion. Thus, if nominal sterling interest rates decline significantly within the ERM (as the risk premium is eroded, and inflation is brought under control), there is a substantial risk of a sharp increase in personal sector mortgage borrowing. Part of this would almost certainly represent equity withdrawal (i.e. higher gearing on the

37) G. Hughes and B. McCormick, "Housing markets, unemployment and labour market flexibility in the UK", *European Economic Review* Vol. 31 No.3, April 1987.

38) The contraction of financial services employment in the City of London may also have played a role, Cf. n.15.

39) According to estimates by P. Spencer and G. Hughes, the effect might be to add 18-20% to house price-income ratios. These estimates may be at the top end of the range.

40) See, e.g., Muellbauer, *op. cit.*, and articles and letters in the *Financial Times* through July 1990.

housing stock) through higher first and subsequent mortgages, and possibly unduly stimulate private consumption directly. Even that part which was fully reflected in an increased value of housing would be likely to generate significant, again possibly destabilising, wealth effects on private consumption.

Both longer term and more immediate solutions have been offered. Financial liberalisation might be partially reversed, for example, with more "prudent" limits enforced on the extent to which housing could provide loan collateral⁴¹. Most of the other solutions concern reforming the tax system. In the longer term a reinclusion of property or land values in the tax base (local or central government) seems to be called for. If this were accompanied by the phasing out of mortgage interest rate relief (or its limiting to the first few years, as in Germany) then a substantial, demand-neutral reduction in tax rates could be envisaged.

The more immediate need to control the flow of equity withdrawal might also be approached through the tax side. Spencer and Kaletsky (elaborated by Muellbauer) separately have argued for extending capital gains tax to

main residences. Under one version of this proposal, on a combined sale and purchase transaction, tax would be attracted on the excess of the realised sales value of a house over the equity invested in a new dwelling, less an exemption limit (e.g., UKL 5 000 p.a., indexed). The limit would also apply to mortgage increases on existing property above the exemption limit⁴².

7. Conclusions

The housing market is subject to significant distortions arising from public intervention, principally tenure controls and fiscal incentives to mortgage-financed owner occupation. The private (or market-related) rental market is too small to ensure sufficient labour mobility. Tax reform in the direction of greater neutrality towards housing should be pursued. In the shorter term there may be a case on stabilisation grounds for extending capital gains taxation to primary residences, and for controls on the provision of credit secured against housing.

41) E.g. the suggestion by Shields that first mortgages should not exceed 92% of the purchase price and that subsequent new secured loans would not be allowed to exceed 70% of the value. See J. Shields, "Controlling household credit", *National Institute Economic Review*, August 1988. Shields alternatively suggests a tax on credit.

42) J. Muellbauer, letter to the *Financial Times*, 11.7.1990.

Chapter 5 Fiscal Policy

1. The nominal framework: the medium-term financial strategy

Budgetary policy continues to be made within the framework of the Medium Term Financial Strategy (MTFS) first adopted in the March 1980 Budget and revised annually since. The approach has remained to provide "a nominal framework within which the Government pursues its objective of bringing down the rate of inflation"⁴³. Essential attributes are the setting of medium-term paths (typically, the current and three prospective financial years)⁴⁴ for monetary aggregates, money GDP, the GDP deflator and the public finances. In the UK context, the main initial novelties of this approach were a medium-term monetarist approach to achieving disinflation by attempting to influence the expectational environment and the bringing together of revenue and expenditure planning, also over the medium-term.

While the approach to monetary policy in the MTFS has undergone drastic revision⁴⁵ the fiscal policy framework has shown greater apparent stability. Key aspects are the publication in each MTFS⁴⁶ (itself published as part of the principal Budget document, the Financial Statement and Budget Report (FSBR)) of medium-term paths for minimally disaggregated general government expenditure and receipts and public sector borrowing (or, since 1987-88, debt repayment). Table 5.1 shows the these aggregates from the March 1990 MTFS. Aggregates are shown throughout in nominal, not deflated terms⁴⁷. Public expenditure plans for the MTFS period (less the outlying year) are published in detail at the turn of the year preceding the MTFS. The main new information contained in each MTFS as regards budgetary policy is thus the prescribed stance for taxation and public sector borrowing.

The indicated path for public sector borrowing is not necessarily, however, the residual between general government expenditure and receipts and the allowance for market and overseas borrowing by public corporations.

In practice an unidentified "wedge", the so-called "fiscal adjustment", has always been included to boost the net borrowing profile in financial years beyond that of the new Budget year, allowing scope for future tax reductions, higher expenditure or higher debt repayment. By convention the fiscal adjustment has been regarded as indicating future tax reductions.

There is a second element implicit in the MTFS which adds to uncertainty about future plans. This is the "reserve" in the detailed public expenditure plans which is an unallocated contribution to total future expenditure, allowing for higher than budgeted inflation as well as genuinely additional expenditure. In recent years the reserve has been massive for outlying years of the public expenditure plans: in March 1990, for example, the reserve for 1992-93 was budgeted at around 1 1/2% of GDP for that year.

Fiscal plans for future years are thus subject to considerable uncertainty, despite the apparent precision of the MTFS numbers. In addition, as might be expected, the published inflation profile has always been optimistic. There is, consequently, some loss of credibility in the exercise, the more so as successive annual revisions to the MTFS projections in recent years have been large and have given the impression of being opportunistic⁴⁸. Moreover, in the UK the synthesis of revenue and expenditure planning which is of the essence of the fiscal side of the MTFS does not correspond to the annual cycle of fiscal policy making. In practice, public expenditure plans for the forthcoming financial year are settled in the second half of the preceding calendar year, with indicated plans for future years reopened for negotiation a year afterwards. The "Budget" in March is oriented to tax decisions for the year ahead in the light of the public expenditure decisions already taken (and in March subject to usually only minor revision).

The economic significance of publication of the MTFS fiscal aggregates for years beyond the one immediately ahead is difficult to gauge. The original intention, to show public sector borrowing was consistent with planned monetary growth, lost some of its force with the move away from the early emphasis on sterling M3 growth (to which the PSBR was directly related as an

43) Financial Statement and Budget Report (FSBR), March 1989.

44) The financial year runs from April to March.

45) Notably, increased emphasis on the exchange rate as an indicator of monetary conditions and the shift from broad to narrow money as a targeted aggregate.

46) Published as part of the principal Budget document, the Financial Statement and Budget Report (FSBR). Text of Footnote

47) The 1980 and 1981 versions of the MTFS showed deflated aggregates.

48) As the OECD remarked in its most recent survey of the UK economy, recent practice has been to project forward unchanged in the forthcoming financial year the estimated nominal outturn for public sector debt repayment in the financial year just ending, despite there being substantial changes for this aggregate in successive MTFSs, i.e. the official PSBR forecasts were subject to large errors.

Table 5.1A: The Medium-Term Financial Strategy, March 1990: A. General Government Expenditure (UKL billion)

	1988-89	1989-90	1990-91	1991-92	1992-93	1993-94
Public expenditure planning total	145,5	162	179	192	203	215
Local authorities' self-financed expenditure	10,1	14	13 1/2	14	15	15 1/2
Central government debt interest	17,5	17 1/2	17	15 1/2	15	15
Accounting adjustments	5,0	4	3 1/2	3 1/2	4 1/2	5
General government expenditure ^{1,2}	178,2	198	213	225	238	250
Privatisation proceeds	7,1	4	5	5	5	5
General government expenditure excluding privatisation proceeds	185,3	202	218	230	243	255

1) General government expenditure, privatisation proceeds and the public expenditure planning total are rounded to the nearest UKL 1 billion from 1989-90 onwards; local authorities' self-financed expenditure, debt interest and accounting adjustments are rounded to the nearest UKL 1/2 billion. General government expenditure excluding privatisation proceeds is assumed to grow by 13/4% in real terms in 1993-94.

2) General government expenditure includes debt interest payments to other sectors as follows (UKL billion): 1988-89 - 18,0; 1989-90 - 18 1/2; 1990-91 - 17 1/2; 1991-92 - 16 1/2; 1992-93 - 16; 1993-94 - 15 1/2.

Source : Financial Statement and Budget Report (FSBR), March 1990

Table 5.1B: The Medium-Term Financial Strategy, March 1990: B. General Government Receipts (UKL billion)

	1988-89	1989-90	1990-91	1991-92	1992-93	1993-94
Taxes on incomes, expenditure and capital ¹⁾	144,8	158	170	177	186	196
National insurance and other contributions	33,0	33	36	38	40	43
Interest and dividends	6,5	7	6	6	6	6
Other receipts	5,5	6	6	7	8	8
General government receipts ²⁾	189,8	203	219	229	240	253
of which North Sea revenues	3,2	2	3	3	3	3

1) Includes the local authority community charge (poll tax) from 1989-90 onwards.

2) General government receipts, and its components, are rounded to the nearest UKL 1 billion from 1989-90 onwards.

Source : Financial Statement and Budget Report (FSBR), March 1990

Table 5.1C: The Medium-Term Financial Strategy, March 1990: C. Public Sector Debt Repayment ¹ (UKL billion)

	1988-89	1989-90	1990-91	1991-92	1992-93	1993-94
General government receipts	189,8	203	219	229	240	253
General government expenditure	178,2	198	213	225	238	250
Fiscal adjustment from previous years	:	:	:	:	1	2
Annual fiscal adjustment ²	:	:	:	1	1	1
GGDR	11,5	6	6	3	0	0
Public corporations' market and overseas debt repayment	3,0	1	1	0	0	0
PSDR	14,5	7	7	3	0	0
Money GDP at market prices ³	478,1	519	548	585	622	657
		(519)	(558)	(596)	(633)	(669)
PSDR as % of GDP	3	1 1/4	1 1/4	1/2	0	0

1) Rounded to the nearest UKL 1 billion from 1989-90 onwards.

2) Means lower taxes or higher expenditure than assumed in lines 1 and 2.

3) Figures in brackets adjust for the distortion arising from the replacement of domestic rates by the community charge.

Source : Financial Statement and Budget Report (FSBR), March 1990

expansionary influence). A later use was to demonstrate the trends of taxation and expenditure in relation to GDP and thus in relation to the government's objectives of reducing both these ratios⁴⁹. In current circumstances assessing the impact of future tax policy is hazardous: assumptions must be made about future inflation, allocation of the expenditure reserve and the fiscal adjustment. This difficulty concentrates attention, perhaps unduly, on very recent trends in public finances and future projections delivered by conventional forecasting techniques.

2. Recent developments in public sector borrowing and debt repayment

Recent developments in the public finances are shown in Table 5.3. The most notable feature is the emergence of a huge negative PSBR, i.e. a positive PSDR (debt repayment), in 1988-89 (3% of GDP) after a move to modest debt repayment the previous year, its halving in 1989-90 and a further weakening in the current financial year despite the March 1990 Budget forecast of maintenance of the 1989-90 level.

Graph 5.1 shows movements in the PSBR by sector: the central government's own borrowing requirement (CGBR(O))⁵⁰, the local authorities' borrowing requirement (LABR) and the public corporations' borrowing requirement (PCBR). It is clear that recent changes in

Table 5.2

A. General Government Expenditure (Excluding Privatisation Proceeds)^(1,2) as % of money GDP

1964-65	35 3/4	1974-75	48	1984-85	46
1965-66	37 1/4	1975-76	48 1/2	1985-86	44 1/2
1966-67	38 3/4	1976-77	46	1986-87	43 1/2
1967-68	42 1/4	1977-78	42 3/4	1987-88	41 1/4
1968-69	40 3/4	1978-79	43 3/4	1988-89	38 3/4
1969-70	40 1/4	1979-80	43 1/2	1989-90	39 (39)
1970-71	40 3/4	1980-81	45 3/4	1990-91	39 3/4 (39)
1971-72	41	1981-82	46 1/2	1991-92	39 1/2 (38 3/4)
1972-73	41	1982-83	46 3/4	1992-93	39 1/4 (38 1/2)
1973-74	42 3/4	1983-84	45 3/4	1993-94	39 (38 1/4)

B. Non-North Sea Taxes, National Insurance Contributions and the Community Charge^{1, 2)} as % of non-North Sea money GDP

1964-65	29 1/2	1974-75	35 1/2	1984-85	37 3/4
1965-66	31 1/4	1975-76	36	1985-86	37
1966-67	32	1976-77	36	1986-87	37 1/2
1967-68	33 1/4	1977-78	35	1987-88	37 3/4
1968-69	35 1/4	1978-79	34	1988-89	37
1969-70	37	1979-80	35	1989-90	36 3/4 (36 3/4)
1970-71	36 1/4	1980-81	36	1990-91	37 3/4 (37)
1971-72	36 3/4	1981-82	38 1/2	1991-92	36 3/4 (36)
1972-73	32 1/2	1982-83	38	1992-93	36 (35 1/2)
1973-74	33 1/4	1983-84	37 1/2	1993-94	36 (35 1/4)

(1) 1989-90: Budget estimate; 1990-91: Budget forecast; 1991-92 onwards: MTFs projections (after fiscal adjustment).

(2) Ratios in brackets adjust for the distortion arising from the replacement of

Source: FSBR, March 1990

49) The results show for the government's period of office a sharp decline in the expenditure-GDP ratio but a broad stability in the tax-GDP ratio: see Table 5.2.

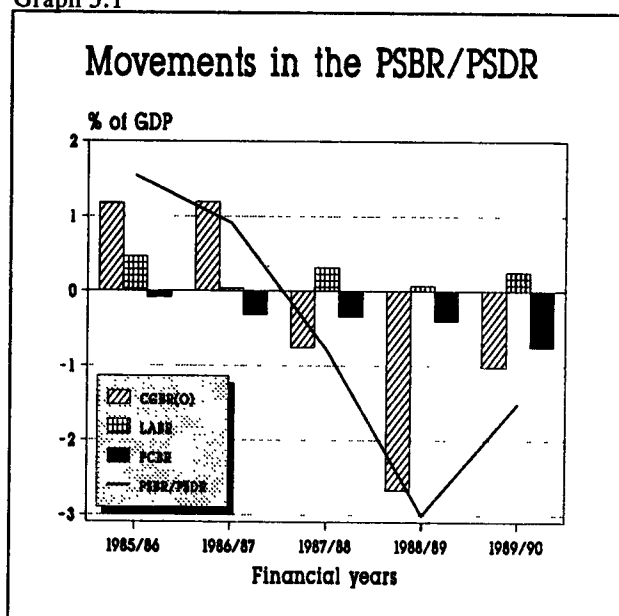
50) "Own" or "O" here implies that lending to local authorities and public corporations is excluded.

Table 5.3: Public Finances, 1985-1990
(% of GDP)

	Calendar years						Financial years					
	1985	1986	1987	1988	1989	1990	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91
	(forecast)						(forecast)					
General government												
Current receipts												
- Taxes and social security charges	37,9	36,9	36,4	36,2	35,7	36,2	37,2	36,7	36,7	35,9	35,5	36,7
- Other	3,4	3,4	3,2	2,9	2,8	2,6	3,9	3,3	3,1	2,9	2,8	2,4
- Total	41,3	40,3	39,6	39,1	38,6	38,8	41,1	40,1	39,8	38,8	38,3	39,1
Current expenditure												
- Final consumption	20,7	20,7	20,3	19,6	19,4	19,8	20,7	20,6	20,2	19,3	19,4	20,2
- Subsidies	2,0	1,6	1,5	1,3	1,1	1,0	1,8	1,6	1,4	1,2	1,1	1,0
- Current grants	14,1	13,9	13,2	12,2	11,9	12,0	13,9	13,9	13,1	11,8	11,9	12,3
- Debt interest	4,9	4,5	4,3	3,8	3,6	3,4	4,9	4,5	4,1	3,8	3,5	3,3
- Total	41,8	40,7	39,3	36,9	36,0	36,2	41,2	40,5	38,8	36,1	35,9	36,7
Current surplus	-0,5	-0,4	0,4	2,3	2,6	2,5	-0,1	-0,5	1,0	2,7	2,5	2,4
Fixed investment	1,8	1,9	1,7	1,3	1,8	2,2	1,9	1,8	1,7	1,4	2,0	2,3
Other capital items (net receipts)	-0,4	-0,1	0,0	0,1	0,0	-0,6	-0,3	-0,0	0,0	0,1	-0,5	-0,2
Financial balance, GGFB	-2,8	-2,4	-1,3	1,0	0,9	-0,3	-2,4	-2,3	-0,6	1,4	0,0	-0,1
Privatisation receipts	0,7	1,0	1,5	1,3	0,9	0,7	0,7	1,1	1,2	1,5	0,8	0,9
Other financial items	-0,3	0,6	-0,0	-0,5	-0,4	-0,1	-0,2	-0,1	-0,1	-0,5	0,4	-0,3
Borrowing requirement/ debt repayment (GGBR) (+=surplus)	-2,4	-0,9	0,1	1,9	1,4	0,3	-1,9	-1,2	0,4	2,4	1,3	0,5
Public corporations market and overseas borrowing	0,3	0,2	0,2	0,6	0,4	0,1	0,3	0,3	0,3	0,6	0,3	0,0
PSBR/PSDR	-2,1	-0,7	0,3	2,5	1,8	0,4	-1,5	-0,9	0,8	3,0	1,5	0,6

Source: CSO, Commission Services

Graph 5.1

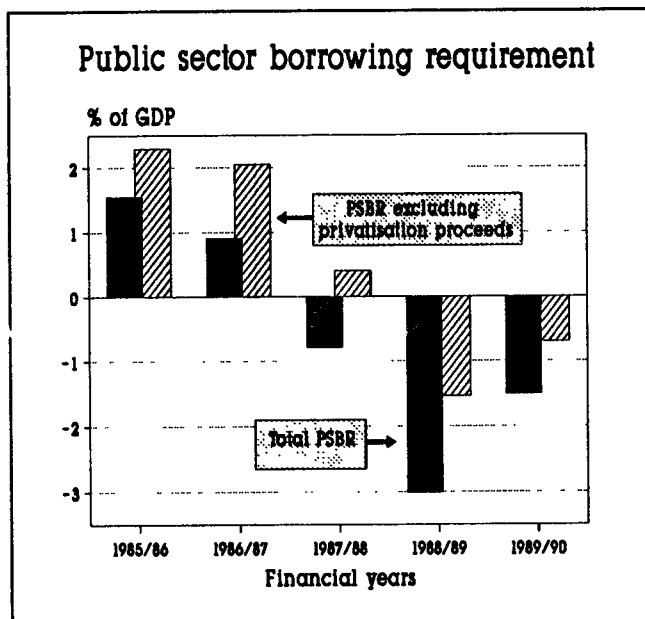


the PSBR/PSDR have been dominated by changes in the CGBR(O), though the peak debt repayment in 1988-89 was supported by favourable coincident changes in the LABR and PCBR.

The sharp decline in the negative CGBR(O) (lower debt repayment) in 1989-90 is rather misleading as an indication of the extent of the easing of the fiscal stance. A very large (UKL 3,5 billion) transfer to the public corporations contributed. A second factor of a financial nature was a decline of about UKL 3 billion in privatisation receipts (a shortfall of about UKL 1 billion against previous expectations). Privatisation proceeds had previously built up progressively in the 1980s to peak at over UKL 7 billion in 1988-89 (in which year sales from gas industry shares alone yielded over UKL 3 billion): Graph 5.2 shows the PSDR gross and net of privatisation proceeds⁵¹. A third particular reason for the decline in the surplus in 1989-89 was a below-trend growth in social security receipts by about UKL 2 billion repre-

51) A UKL 2 billion reduction in 1989-90 privatisation proceeds compared with the previous financial year had been projected in March 1989; the shortfall against expected proceeds was thus under UKL 1 billion.

Graph 5.2



senting contribution rebates offered by the government in the 1989 Budget as a one-off incentive to take out personal (i.e. private-sector) pension schemes.

Of these three factors tending to depress the CGBR(O) on 1989-90 the first was PSDR-neutral while the remaining two acted to reduce the PSDR. A third important factor reducing debt repayment, and the only one which clearly represented a more expansionary impact on the economy, was higher than expected (by about UKL 1 billion) capital expenditure by the local authorities ahead of the introduction by central government of more stringent controls on such expenditure from the 1990-91 financial year. Thus the "underlying" decline in the PSDR between 1988-89 and 1989-90 was about UKL 1 1/2 billion (0,4% of GDP, a gross decline of UKL 6,6 billion offset by a UKL 2,9 billion reduction in privatisation proceeds and by over UKL 2 billion of social security rebates). Of this UKL 1 1/2 billion, about a half represented lower tax revenues from North Sea oil and gas revenues because of the major contraction of production following the 1988 Piper Alpha and subsequent accidents and also because of oil price weakness.

Developments in the first three quarters of the 1990-91 financial year indicate a further weakening in the public finances. Conclusions nevertheless must remain tentative. In particular, the impact of the new local authority finance arrangements, particularly the new poll tax ("Community Charge") and non-domestic property tax ("rating") system introduced in England and Wales from April⁵² and changes in the timing of expenditure have been important and make comparison with earlier years difficult. In the March 1990 Budget a UKL 7 billion PSDR was projected, assuming that below-potential growth would roughly offset the reversal of the special factors that had depressed the 1989-90 outturn. How-

ever, up to December, the public sector had a cumulative borrowing requirement of UKL 2,6 billion, compared with a UKL 3,4 billion debt repayment in the same period a year earlier, with similar cumulative proceeds from privatisation (UKL 3,7 billion against UKL 3,6 billion).

Of the total increase in net borrowing of UKL 6,1 billion, central government accounted for the major share, UKL 4,1 billion, while local authorities contributed UKL 2,8 billion; the PCBR dropped by UKL 0,9 billion. As regards the local authorities, the new Community Charge has been subject to large payment arrears and its introduction in general to higher collection costs of both a current and capital nature. A huge element of local authority borrowing in the second quarter remains unexplained: a balancing item of UKL 1,8 billion in addition to an unprecedented accruals shortfall of UKL 1,1 billion. Payment arrears should be reversed in time.

More information is available for central government. The Treasury estimates that departmental cash outlays in the first nine months, excluding special factors, especially the impact of centralised pooling and redistribution of business property taxes to local authorities, were 12% up on a year earlier. On the receipts side there were cumulative increases of 8% for taxes and charges combined: 10% in direct taxes, 6 1/2% in the main expenditure taxes and 6 1/2% in social security receipts. These increases compare with a planned nominal increase in the planning total excluding privatisation proceeds for the whole of 1990-91 of 10,5% and of 8,1% in taxes and charges. The increase in cash expenditure may thus so far be running somewhat ahead of the planned increase while revenue has increased roughly in line.

A pointer to some weakening of control over expenditure in the current financial year is the national accounts data for the second and third calendar quarters of 1990. The seasonally adjusted volume of general government consumption expenditure increased by 4,0% over a year earlier with a higher increase for central government consumption (4,7%). These increases still fall short of those indicated by the summary cash data for total outlays in these two quarters, although the annual increase in the latter fell back significantly in the fourth quarter.

These developments do not provide a firm foundation for any very confident prediction of short-term public finance trends. In particular, unexplained borrowing so far in 1990-91 points to timing influences which will subsequently be partly reversed. On the other hand, the rapid weakening in the economy from the third quarter can be expected to have an increasing effect on both receipt and outlays, while the Gulf war, and the preceding military build-up, will also put serious pressure on expenditure. The Commission services in their autumn forecast, before the conflict, and assuming only moderate recession, projected a UKL 3,1 billion (0,5% of GDP) PSDR for the

52) In Scotland from April 1989.

	Calendar years						Financial years					
	1987	1988	1989	1990*	1991*	1992*	1987-88	1988-89	1989-90	1990-91*	1991-92*	1992-93*
Financial balance (GGDB)	-1,3	1,1	0,9	-0,3	-0,7	-0,6	-0,6	1,4	0,0	-0,1	-0,7	-0,5
PSDR/PSBR	0,3	2,5	1,8	1,6	0,7	0,5	0,8	3,0	2,2	0,5	0,1	0,3
Memo												
privatisation receipts	1,5	1,3	0,9	0,9	1,0	1,0	1,2	1,5	1,5	0,9	0,9	0,9
PSDR/PSBR excluding privatisation receipts	-1,2	1,2	0,9	0,7	-0,3	-0,5	-0,4	1,5	0,7	-0,4	-0,8	-0,6
Annual changes (+ = higher surplus)												
Financial balance (GGFB)	1,0	2,4	-0,2	-1,2	-0,4	0,1	1,7	2,0	-1,4	-0,2	-0,6	0,2
PSDR/PSBR PSDR/PSBR excl. privatisation receipts Cyclically adjusted GGFB	0,3	2,4	-0,3	-0,2	-1,0	-0,2	1,6	1,9	-0,8	-0,9	-0,5	0,2
a) Using trend output	0,3	1,8	-0,3	-0,9	0,3	0,3	:	:	:	:	:	:
b) Using moving benchmark mark	0,7	1,5	-1,2	-1,6	-0,0	0,5	:	:	:	:	:	:

* Forecasts of the Commission Services; GDP percentage adjusted for impact of Community Charge.
Source : CSO, Commission Services

of GDP) PSDR for the current financial year, followed by PSDRs of UKL 0,5 billion and UKL 1,6 billion in the two following financial years.

3. The economic impact of UK budgetary policy

While the MTFs has continued to give prominence to the PSDR this is not necessarily the best guide to the economic impact of fiscal policy. A major reason in the UK's case is the significance of privatisation receipts, which substitute for issuance of gilts as a source of finance and which in financial year 1990-91 are likely to be higher than the PSDR itself. More generally, excluding financial transactions which do not change the net financial liabilities of the public sector, and the finances of the public corporations which make difficult cross-country comparison and for the UK alone have little recent coverage continuity because of privatisation, suggests focusing on changes in the general government financial balance (GGFB).

Table 5.4 shows annual figures for the GGFB on both a calendar year and financial year basis, with projections of the Commission services up to 1992-93. The general path resembles that for the PSBR excluding privatisation proceeds. Thus the move to large financial surplus in

1988 coincides with that to net debt repayment, and there is a move back to financial deficit in 1990-91 after the small surplus in 1989-90.

However, the abrupt decline in the financial surplus between 1988-89 and 1989-90 (UKL 7,9 billion, 1,5% of GDP) is explained by the same factors underlying the contraction of the PSDR between the two years (apart from the reduction in privatisation receipts), pointing to the limitations of this measure also. Particularly, the UKL 3,5 billion capital grant to the coal industry, despite affecting the GGFB, was of the nature of a financial transaction and so too (to a degree depending on consumers' ability to look forward) was the almost UKL 2 billion of social security contribution rebates. Only the remaining decline in the financial surplus, some UKL 2 1/2 billion (1,2% of GDP), mostly accounted for by local authority capital spending, was the main additional expansionary impulse. The expected move into financial deficit in the current year is more clearly an expansionary change.

The methods used in the past for assessing the economic significance of changes in budget deficit - various cyclical adjustments - have met with increasing resistance and distrust on the part of both government and non-government users. This is essentially because too much weight came to be placed on their utility for a number of different tasks: trying to isolate a "discretionary" element in deficit changes, using them to assess the "sus-

nability" of fiscal policy, or interpreting them as a measure of the "impact" of policy. Thus a recent UK Treasury Working Paper concluded that:

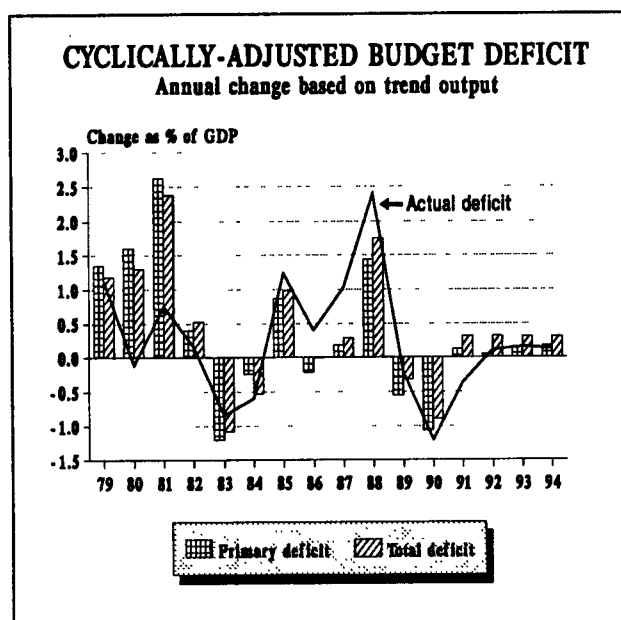
"We do not believe that the cyclically adjusted deficit is a useful measure of discretionary fiscal policy - partly because it is affected by many things outside the government's control (e.g. unexpected changes in interest rates, oil prices or tax receipts), and partly because acquiescence in changes in the automatic stabilisers is as much an act of policy as a change in tax or benefit rates"⁵³.

Cyclically-adjusted deficits were not dismissed, but assessed more modestly:

"(they) may be useful as a benchmark for describing and monitoring fiscal stance over the cycle, and for assessing sustainability; for this to be the case... the adjustment... must be measured around some level of activity that is achievable in the medium-term..."⁵⁴

Recent work by OECD economists, based particularly on work by Blanchard, has emphasised the need for several indicators of fiscal policy, targeted to its different aspects: especially the description of the government's budgetary position netting out as far as possible the quasi-automatic cyclical effects (such that the remaining

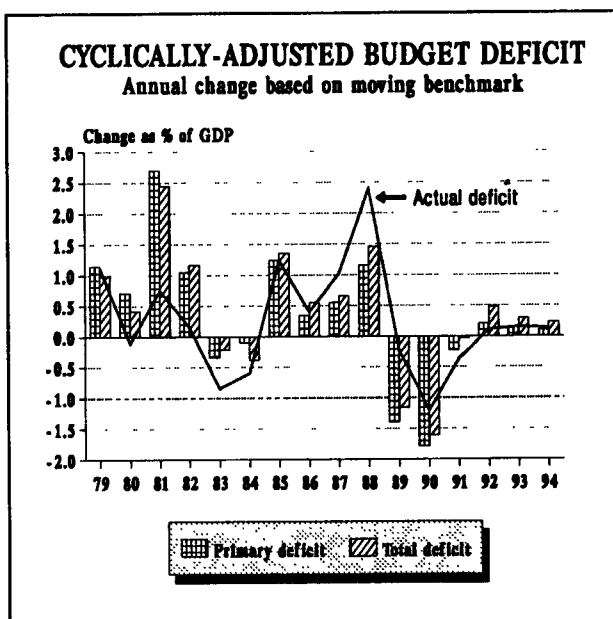
Graph 5.3



change is often termed discretionary); sustainability; the demand impact; and finally allocational consequences⁵⁵. The calculations below are based largely on their approach, although for past years absolute levels of some indicators differ, probably because of using different concepts of net debt and because of data revisions⁵⁶. The allocational issue is not addressed.

The first issue is what movements have taken place in the budgetary position net of cyclical influences. The method of adjustment used in the past has often relied on unrealistic estimates of potential output (peak-to-peak measures, for example). Adjusting for the effects of the cycle has been done below on two different bases, following Chouraqui et al. First, a time trend of average annual GDP growth over the last cycle (2,6% p.a. between 1979 and 1988) has been used as a measure of attainable trend growth in the medium-term, and the consequent output gaps used to make adjustments to individual income and expenditure components⁵⁷. The second approach, based on Blanchard, simply adjusts for the difference in output between successive years, making adjustments to the same general government account items as in the first approach.

Graph 5.4



- 53) H. Brendenkamp, The Cyclically Adjusted Deficit as a Measure of Fiscal Stance, Treasury Working Paper No52, April 1988. The statement is the responsibility of the author.
- 54) Idem.
- 55) J.-C. Chouraqui, R.P. Hagemann and N. Sartor, Indicators of Fiscal Policy: a Reassessment, OECD Department of Economics and Statistics Working Paper No.78, April 1990; O.J. Blanchard, Suggestions for a new set of fiscal indicators, OECD Department of Economics and Statistics Working Paper No. 79, April 1990.
- 56) The general government net debt concept used by the OECD appears to be gross debt less short-term financial assets. The concept used here is net financial liabilities, i.e. gross debt less all financial assets. The difference is equivalent to about 20% of GDP.
- 57) Items adjusted were household direct taxes, business direct taxes, indirect taxes, social security contributions, other receipts and unemployment benefits. Output elasticities were taken from Chouraqui et al: 1; 3,4; 0,7; 0,5; 1; and 1 respectively.

Graphs 5.3 and 5.4 show the annual changes in the financial and primary deficits (i.e. the financial deficit before (net) interest payments) using respectively the two different adjustment methods with, in each case, the change in the actual deficit. Although the two approaches do not yield identical results, particularly when output movements are large, the general impression is very similar. Even more strikingly, the adjusted changes parallel the actual changes in the budget deficit.

If the cyclical adjustments are appropriate, then the substantial move into financial surplus towards the peak of the last cycle can only partially be attributed to the cycle; Analogously, fiscal impulses cannot be put forward as in any conventional sense responsible. On the other hand, however, it is possible that the adjustments inadequately capture the structures of the tax and expenditure systems (fiscal drag in the case of personal income tax for example) and thus exaggerate the restrictive impact of fiscal policy in the move to surplus. In addition this approach in no way captures what may have been an expansionary impulse from the government signalling current and expected future tax cuts in successive Budgets.

The results for 1989 reflect the sharp erosion of the PSDR referred to earlier, but equally illustrate the limitations of the approach: the "catch-all" nature of the residual change in the deficit shown in the charts includes items such as the drop in oil taxation and the one-off social security rebates, the interpretation of which as fiscal easing would be misleading.

Some of the weakening shown in 1990 is also suspect, because of the large first quarter capital grant to a public corporation (in the case of the trend output calculation this would account for most of the deterioration). For

1991 the two methods differ, suggesting small increases or decreases in the deficit. From 1992 the results converge in indicating a very modest tightening.

An alternative, more direct approach to assessing the demand impact of fiscal policy is to use the indicators developed by Blanchard⁵⁸:

- The first two of these assume that taxpayers are forward-looking⁵⁹, taking into account the impact on households' consumption of government real debt interest and current and expected future tax levels (net of government transfer receipts), and adding the direct demand impact of government expenditure on goods and services.
- The first of this pair, the forward-looking index of fiscal impact (IFI) assumes that future years' taxes are discounted by a trend real rate of interest and an additional discount factor representing a "degree of myopia".
- The second, an adjusted forward-looking deficit (AFD), approximates the first measure, by taking an average of tax ratios to GDP over the current and as anticipated over the next four years and avoiding any discounting or use of household spending propensity.
- The second pair of measures are "fully myopic" analogues of the first two, assuming that future tax ratios are equal to current levels:
 - the "myopic impact" (MFI) and
 - the "inflation-adjusted deficit" (IAD)⁶⁰

Because the levels of fiscal impact indicators calculated in this way are sensitive to the precise choice of aggregates it is again more helpful to look at the annual changes. The five year time horizon of the IFI matches

58) Blanchard, op cit; Chouraqui et al, op cit.

59) The calculations which follow assume a five-year time horizon.

60) The four measures are calculated as follows:

1. Index of fiscal impact (5-year time horizon), IFI:

$$IFI_5 = G_5 + b \left[rB_5 - \frac{r+p}{1+r+p} \right] * \left[1 - \left(\frac{1}{1+r+p} \right)^5 \right]^{-1} \\ * \left[\sum_{i=0}^4 \left(\frac{1}{1+r+p} \right)^i T_{5+i} \right]$$

2.: Adjusted forward-looking deficit, AFD

$$AFD = G + rB - T$$

3.: Myopic fiscal impact, MFI

$$MFI = G + b(rB - T)$$

4.: Inflation-adjusted deficit, IAD:

$$IAD = G + rB - T$$

where

G is government expenditure on goods and services,

T is taxes net of transfers (T is the average level of T in the current and following four years)

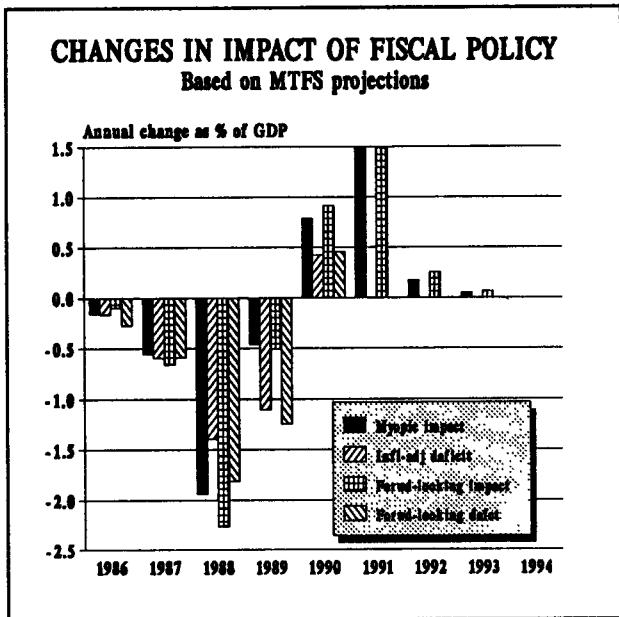
B is net general government financial liabilities

r is the implicit real yield on B (3-year moving average, nominal yield deflated by GDP market prices deflator)

b is households' marginal consumption propensity, taken as 0.77 and

p is the degree of "myopia", set to 3% p.a.

Graph 5.5

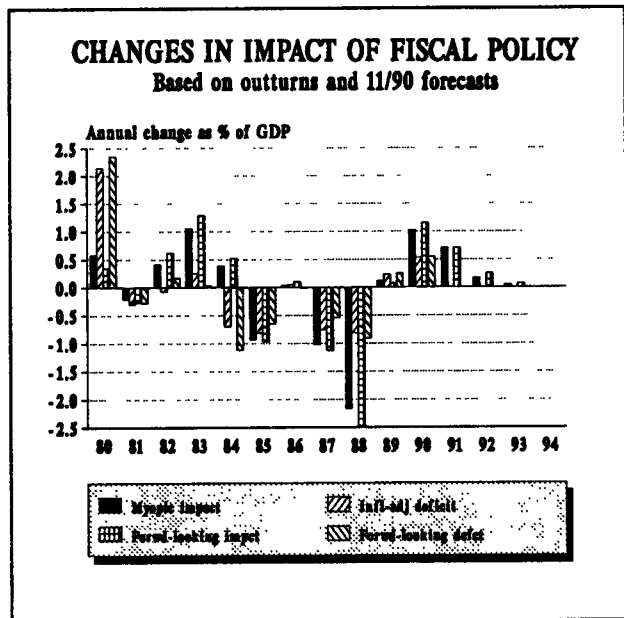


that of the MTF5, and in a first calculation successive editions of the MTF5 have been used as indicators of future tax ratios (assuming the "fiscal adjustments" such as discussed on page 1 accrue in tax reductions). Transfer payments to GDP ratios have been projected forward at a flat initial year level in each case. The annual changes in the four measures are shown in Graph 5.5 for calendar years since 1986; forward-looking measures can be calculated only up to 1990, while the "myopic" measures are shown up to 1994.

With only two exceptions (the change in the inflation-adjusted deficit between 1987 and 1988, and the changes between 1988 and 1989) the year-to-year changes are reasonably congruent. They suggest that, if the March MTF5 projections had always correctly anticipated the future course of the public finances, and such projections were credible, then policy would have had a tightening demand impact up to 1989 and some expansionary impact from 1990. Of particular note is the highly contractionary calculated impact of the forward-looking measure in 1988, the peak of the last cycle (over 2% of GDP): the 1987 MTF5 projected a PSBR of 1% of GDP for the 1987-88 and successive years; the 1988 version turned this into a PSDR of 3/4% of GDP in 1988-89 (the 1987-88 outturn) and a zero balance thereafter.

Such indications are only tentative. In particular they neglect divergences of outturn from projections (often already large in the course of any current financial year) and the consequent revisions of expected future deficits. Graph 5.6 thus recalculates the four measures using only outturn data and Commission services' projections. On this basis policy has been shifted in an expansionary direction with effect from 1989, with shifts of about 3/4% p.a. indicated for 1990 and 1991. Although, in view of the reasons for cautious interpretation of recent trends entered earlier, not too much should be made of these results, they point to a significant change from a 1988 position of extreme tightness.

Graph 5.6



4. The appropriate fiscal stance in the medium-term

In the March 1990 MTF5 the government announced its intention that "tight monetary and fiscal policies (would) be maintained over the period covered by the MTF5 so as to achieve the (planned) deceleration in money GDP". ERM membership, once the government's conditions had been met, was seen as "complementary to the MTF5 policy framework". As noted at the end of the previous section, fiscal projections pointed to a gradual fiscal easing (zero PSDR by 1992-93), with output growth back to its potential growth path by the end of 1991 and inflation low and on a firm downward track.

Current short-term prospects are significantly less favourable for both inflation and output. Sectoral imbalances remain large, with still insufficient private sector saving and a large external deficit. ERM membership, with an imperative need to reduce inflation towards the better performance of other members and with less independent room for manoeuvre on interest rates, will probably focus greater attention on the government's fiscal plans. In current circumstances the government will be concerned not to unduly deepen the loss of potential output which seems unavoidable in the short-term, but at the same time to maintain a credibly tight policy continuing to bear down on inflationary pressures for the medium-term.

This suggests a potentially enhanced role for the MTF5 as regards the role of fiscal policy. While, apart from Germany, the experience of other ERM members points to a continuing role for some independence of monetary policy action, it seems inevitable that the heavy emphasis on monetary policy in previous MTF5s will no longer be appropriate. For fiscal policy the need is to build a credibility in appropriate medium-term intentions that has not, for the reasons given in Section 1, so far been clearly established. This is likely to imply, in current circumstances, transparent intentions for a firm

medium-term fiscal policy path. At the same time the potential need for a certain flexibility of budgetary response has to be recognised, particularly if domestically unwarranted changes in monetary conditions threaten to render inappropriate the overall policy mix.

ERM entry has not therefore superseded the MTFS approach. Instead, the latter can now play an essential complementary role in anchoring public expectations of stability-oriented policies over the medium term. The fiscal stance cannot be decided independently of monetary conditions - interest rates and the exchange rate - and the existing imbalances in the economy - inflation and the external deficit - nor, in practice, of the level of real output in relation to its potential. What is required is that the fiscal stance in combination with monetary conditions should credibly contribute to a fairly rapid rebalancing of the economy and most of all to disinflation. This might make it appropriate to formalise a medium-term objective for the MTFS period, subject to levels of real output and changes in monetary conditions⁶¹.

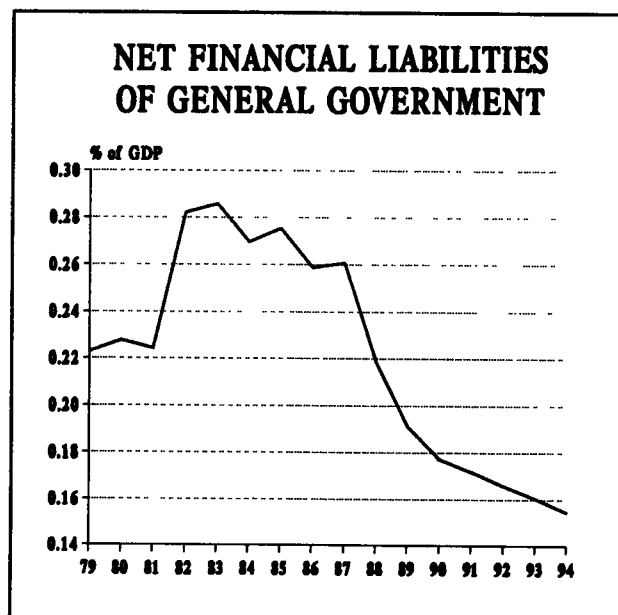
Judging how to respond to output changes - for example, the current recession - is more difficult. It is already part of the MTFS normally to accept the operation of the fiscal stabilisers, "(setting) tax rates on medium to long term considerations"⁶². This seems desirable, and in such circumstances the "underlying" MTFS fiscal path could be considered as applying to a trend rate of output growth and sharp fluctuations from the published projected output path considered as grounds for departing from the fiscal targets.

However, extreme caution is called for. The analysis in Section 3 suggested that cyclically-adjusted deficits did not in practice diverge enormously from actual deficits. Moreover, to the extent that below-potential growth should promote disinflation, is inevitable and is partly a response to existing policy, it is obviously not appropriate to try to offset this completely. The stance of policy, cyclically adjusted, should instead continue perceptibly to bear down on inflation.

5. Longer-term considerations

The stated longer term fiscal objectives of the MTFS are to reduce both public expenditure and taxation in relation to GDP, to improve "value for money" in public spending, to reduce tax rates, and to balance the budget (PSDR/PSBR), implying a continuously falling debt-GDP ratio⁶³. Within this framework, the contribution of expenditure and the tax system to the supply side is to be enhanced; thus tax reform is an ongoing process and a medium-term target of a 20% standard rate for income tax (currently 25%) has been reiterated. A falling debt interest burden and, more recently, prospects for reduced defence requirements, should enable a greater proportion of resources to be channelled to other priority areas of expenditure.

At the macroeconomic level the UK's public finance prospects offer considerable flexibility. There is clearly no "sustainability" problem of potentially explosive public debt growth. All conventional indicators of current and prospective deficits reveal a fairly reassuring picture, with general government's net financial liabilities continuing to decline in relation to GDP: see Graphs 5.7 and 5.8, based on calculations of current and Graph 5.7

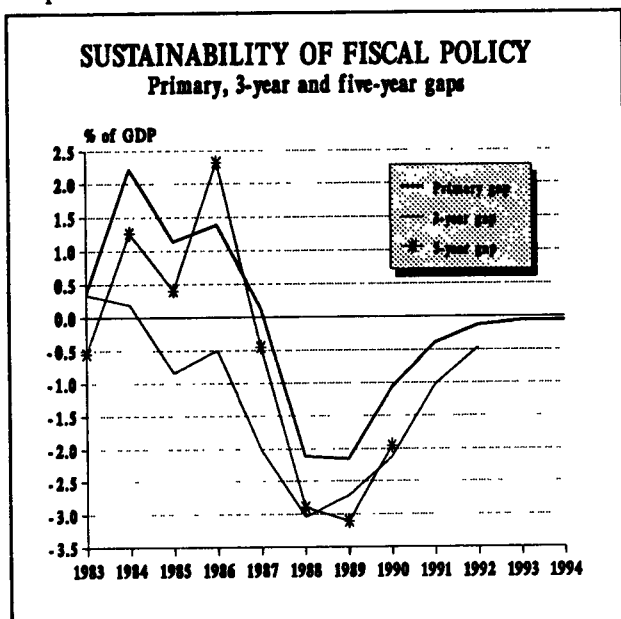


61) A "moderate deficit" might be targeted at a constant net general government financial liabilities to GDP ratio. Given a current ratio of a little under 20% and sustainable growth of around 23/4% p.a., this would imply a medium-term deficit target of around 1/2% of GDP. Cf. the 1988 formulation of the MTFS with a medium-term target for the PSBR excluding privatisation receipts of 1% of GDP.

62) FSB, March 1990.

63) Idem.

Graph 5.8



future financial deficits⁶⁴. In such circumstances it seems justifiable to consider more qualitative aspects of the public finances.

The government's objective of a continuing reduction in the tax burden might be called into question, given apparent capital spending and other requirements: the need to improve infrastructure, education and labour market training to meet the challenges of the internal market have received widespread discussion in the UK. Continuing reform of the tax structure could further improve the supply side of the economy.

At the very least, it seems desirable that the government should have a clear view of its ultimate objective for the balance of public and private sectors in the economy, rather than the apparently limitless reductions in taxation and public expenditure in relation to GDP which are currently the nominal objectives. More generally, there is accumulating evidence that a substantial backlog of infrastructural needs has been allowed to develop, notably in transport and social capital such as prisons. Against this background, it is disappointing that public expenditure plans published in January 1990 continue to indicate modest only levels of public investment. Through the 1980s up to 1989-90 total public sector asset creation showed little change in real terms. For the years to 1992-93, where published capital expenditure plans are available only for central government, expenditure

was due to rise by almost 6% in the current financial year on the previous year, but thereafter to show a progressive decline. Even a pro rata allocation of the expenditure reserve to such expenditure would barely maintain the 1990-91 level.

There are nevertheless favourable circumstances for public expenditure in the UK in the longer term: the absence of pronounced demographic pressures (lower dependency ratios than elsewhere) and little legacy of past over-generous social welfare commitments. Against such a background it seems appropriate to consider in more depth how best to capitalise on these advantages in combining improvements in the economy's supply side with effective social provision.

6. Conclusions

Fiscal policy has been eased. The sharp decline in the budget surplus between 1988-89 and 1989-90 nevertheless considerably overstates the degree of easing between these two years. Between the 1989-90 and the current 1990-91 financial years policy has eased further but to a degree which remains unclear from current statistics. Expenditure has been under pressure from the introduction of the new local authority poll tax, from sharply higher inflation and from intense pressure to increase the volume of expenditure. Prospects for a move into financial deficit in the short-term are largely cyclical in origin. While not necessarily inappropriate, such prospects could be set in relation to an objective such as a modest sustainable deficit over the medium term. Changes in monetary conditions—perhaps not wholly voluntary—will also need to be taken into account in setting the fiscal policy stance: it is important that the overall stance of policy remains oriented to disinflation. ERM participation should enable more credible presentation and use of the MTF approach.

In the longer term the general public finance environment is favourable. Advantage could be taken to enhance the public sector's contribution to improving the supply side of the economy, particularly by making up backlogs in public infrastructure and improving the education and training systems. This calls into question the extent of the potential for further reductions in the ratios of tax and public expenditure to GDP but not of continuing tax reform.

64) The sustainability indicators are based on Blanchard and Chourraqui et al, op. cit. The sustainability condition is that the debt-GDP ratio cannot grow faster than the difference between the interest rate and the GDP growth rate, if the former exceeds the latter (if the latter exceeds the former there cannot be a sustainability problem). The "gaps" identified in Graph 5.8 show the differences between the average tax-GDP ratio and those needed to guarantee sustainability, based on the current year, the forthcoming three years and the forthcoming five years respectively. Negative values indicate sustainability.

Economic Papers

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