The UK economy

Martin Weale and Garry Young

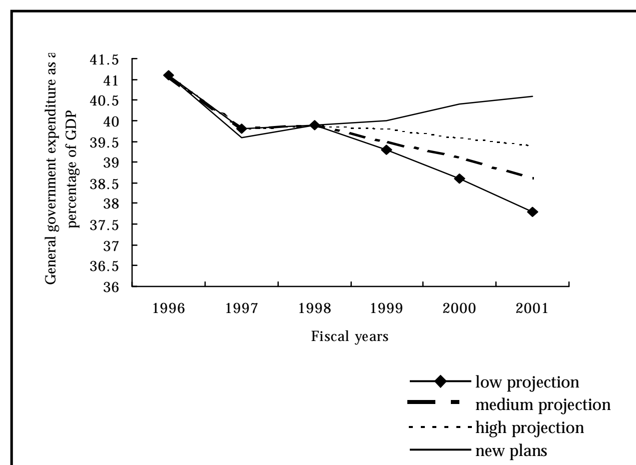
- New public expenditure plans will keep interest rates and the exchange rate higher than previously expected.
- Public sector net borrowing will run at over 1 per cent of GDP in the next three fiscal years.
- The risk of joining EMU at an uncompetitive exchange rate has risen.
- The economy will stall in the second half of 1998.
- The slowdown will curb inflation which should fall to 2.1 per cent by the end of this year and meet the target of 2.5 per cent in 1999.

The main development in the past three months has been the new government spending plans which are much more generous than anticipated. They amount to an increase in real expenditure of 3 per cent a year from 1999–2001. We now project public sector net borrowing of over 1 per cent of GDP in the next three years, compared with the Treasury forecast of balance. This deficit is consistent with the golden rule of borrowing to invest, but leaves the public finances vulnerable to an economic downturn, the more so since government borrowing has become increasingly cyclical.

The sharp rise in government spending will keep interest rates higher than would otherwise have been the case and delays their eventual reduction. It will also reduce the fall in sterling. We now project entry into EMU at DM2.70 rather than DM2.60. This entry rate will leave British unit labour costs in relation to the euro-zone 13 per cent higher than in the past. The danger is that the UK will have to undergo a protracted period of below trend growth to restore competitiveness within the euro-zone after joining EMU.

The economy is currently poised to stall with minimal growth in the second half of the year and almost a one in two chance that output will be lower at the end of the year than in the second quarter. The rise in government spending in the next tax year will help sustain GDP growth of 1.5 per cent in 1999. There is, however, a 20 per cent risk of recession next year. Despite the current high rate of earnings growth distorted by bonuses, we still expect the government to meet its inflation target in 1999.

Public spending plans sharply increased



The new spending plans compared with March Budget projections

Fiscal Report

Martin Weale and Garry Young

The government has adopted two fiscal targets. First of all, the golden rule is intended to ensure that borrowing takes place only to finance net investment. Secondly net public sector debt should be kept to a stable and prudent proportion of GDP.

We argue that, for a proper understanding of the effect of the public sector on the economy, the existing current and capital accounts need to be complemented by a proper macroeconomic budget. This shows the impact of the public sector on level of consumption and saving in the economy as a whole. It differs from the split between current and capital accounts because

- Receipts shown as current income in the government's accounts may in fact be paid out of saving rather than at the expense of consumption.
- Payments regarded by the government as current expenditure may add to saving rather than to consumption

This means that the golden rule can be met even if the government substantially reduces the overall level of saving in the economy.

In order to ensure that our macroeconomic budget is consistent with the government's sources and uses of funds we have to show separately net transfers paid abroad (which are a deduction from national saving) and receipts of property income by the government. We can then calculate the total impact of the public sector on national saving as its impact on domestic saving less net transfers paid abroad. Table 1 and 2 show data in this form for the period 1984-1996 and our estimates for 1997-2001. We find that the public sector reduces national saving by about 7% of GDP, and that the amount it adds to consumption is likely to rise from 6.4% of GDP in 1998 to 7.2% next year. This compares with a peak addition to consumption of 14.1% in 1984 and a peak deduction from saving of 11.2% in 1993.

Table 1. The macroeconomic budget

£bn, calendar years

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Contribution to consumption	45.8	44.0	43.8	43.2	39.6	40.1	41.5	53.8	65.2	75.1	73.6	68.8	74.1
Contribution to saving	–23.6	–23.9	–26.8	–28.7	–26.3	–26.7	–32.7	–40.2	–56.4	–65.5	–64.9	–61.3	–62.8
Net transfers abroad	2.1	3.4	2.2	3.3	3.2	4.3	4.6	1.1	4.8	4.9	5.1	7.1	5.0
Equals Factor incomes	24.4	23.6	19.2	17.8	16.5	17.7	13.4	14.7	13.6	14.5	13.8	14.6	16.3
Contribution to consumption as % of GDP	14.1	12.3	11.4	10.2	8.4	7.8	7.5	9.3	10.9	11.9	11.0	9.8	10.0
Contribution to saving as % of GDP	–7.2	–6.7	–7.0	–6.8	–5.6	–5.2	–5.9	–7.0	–9.4	–10.4	–9.7	–8.7	–8.5
Memo													
Contribution to national saving as a % of GDP	–7.9	–7.7	–7.5	–7.6	–6.3	–6.0	–6.8	–7.2	–10.2	–11.2	–10.5	–9.7	–9.2

Table 2. The macroeconomic budget

£bn, calendar years

	1997	1998	1999	2000	2001
Contribution to consumption	65.1	53.1	61.7	67.6	68.5
Contribution to saving	–55.8	–50.4	–55.2	–61.4	–62.7
Net transfers abroad	4.3	5.2	4.0	4.1	4.1
Equals					
Factor incomes etc	13.6	7.9	10.6	10.3	9.9
Contribution to consumption as % of GDP	8.3	6.4	7.2	7.5	7.2
Contribution to saving as % of GDP	–7.1	–6.1	–6.4	–6.8	–6.6
Memo					
Contribution to national saving as % of GDP	–7.7	–6.8	–6.9	–7.2	–7.0

The implications of the Boskin report

Nicholas Oulton
(NIESR)

The Boskin Report has synthesised research into the accuracy of the CPI bus has gone further than most earlier studies by attempting an overall evaluation

The Boskin Commission has claimed that the US Consumer Price Index (CPI) is currently overestimating the true rate of inflation by 1.1 percentage points per annum. This is their central estimate: they give what they call the " plausible range" as 0.8 to 1.6 percentage points per annum.

Because this report was commissioned by the Committee on Finance of the US Senate and also because their findings seem to offer a politically painless way of cutting the US budget deficit, their Report is likely to be highly influential.

There have been many academic criticisms of the CPI in the past and there is a considerable consensus on its theoretical failings as a measure of the cost of living. A number of biases have been identified, some of which have been quantified.

The CPI is based on the concept of a fixed basket of goods and services and one which moreover is out of date. Therefore by comparison with a true cost of living index, it tends to overestimate inflation. This is called substitution bias. But the Boskin Commission finds that this only accounts for a bit under half of the total upward bias. The bulk of the bias, 0.6 percentage points per annum out of 1.1, arises (they claim) from the failure of the Bureau of Labor Statistics to account properly for quality change and the introduction of new goods.

Because both entitlements and tax bands are indexed to the CPI, acceptance of the Boskin Commission's findings would have a dramatic effect on the US budget deficit

While the Commission's conclusions on substitution bias are relatively uncontroversial, the same cannot be said for new goods and quality adjustment. This is a relatively under-researched area but the Commission's findings cannot be dismissed as just speculation. In the present state of knowledge, they are quite reasonable and consistent with other evidence about the US economy.

If a 1 percentage point reduction in CPI growth began in 1997, then by 2006 the federal budget deficit would be reduced by one third, or $134.9 billion. This latter figure is made up of an increase in revenue of $44.5 billion, a reduction of outlays of $64.4 billion and a reduction in debt service payments of $26.1 billion. But it is unlikely that the procedures for estimating the CPI will be revised in the near future to eliminate the full extent of the bias identified by Boskin. A medium term reduction of CPI growth by about 0.7% seems more plausible.

Acceptance of Boskin will also require economic history to be rewritten. Based on the Boskin central estimates and other evidence, US GDP growth in the period 1970 to 1996 has been underestimated by about 0.9% per annum.

Official back data are unlikely to be revised by anything like the full extent of the bias identified by Boskin. But US price indices in the future will probably gradually incorporate some at least of the improvements sought by Boskin. As a result US GDP growth will appear to rise, eventually by as much as 0.5% p.a., even though no genuine improvement in economic performance has actually occurred.

Boskin's conclusions about US price indices will have consequences for other industrialised countries

Recent evidence for the U.K. suggests that use of a formula recommended by Boskin for averaging price quotes together would reduce measured inflation by a substantial amount. This formula, the geometric mean, is used in Eurostat's Harmonised Index of Consumer Prices but not in the RPI. In a recent period, the harmonised index was lower by 0.4% per annum as a result of using the geometric mean formula.

Raising schooling attainments by grouping pupils within each class

S.J. Prais
(NIESR)

Are Continental whole-class teaching methods the way forward in British schools?

One of the current fundamental teaching issues—affecting how best to raise pupils' attainments—is the extent to which there should be a move away from the British individualised 'child centred' approach towards whole-class teaching on the Continental model. The new Government task forces on numeracy and literacy have recently recommended that, in the central and greater parts of each lesson, the children in a class are still to be divided into a number of sub-groups according to their ability; the recommendation thus retains the child-centred approach which imposes great burdens on teachers in classes of normal size.

The July issue of the *National Institute Economic Review* contains an article by S J Prais re-analysing earlier studies of the effects of such 'within-class ability-grouping' on pupils' attainments in mathematics. It argues that such grouping techniques have been shown in many experimental classroom studies to lead to highly variable results, with some very marked declines in pupils' attainments. The slightly positive average calculated from such studies by a recent Canadian analysis thus cannot be relied upon for policy purposes. The paper says:

> 'there must be grave worries that the current encouragement by official educational circles in England of within-class grouping of pupils according to their ability will serve to widen the disparity of pupils' attainments and, more generally, to exacerbate English schools' teaching problems in relation to slow-developing children, with a consequential slowing of the rate of progress of the class as a whole.'

Instead, the author recommends a more thorough-going approach to whole-class teaching, including (a) flexibility in age of entry to school, depending on a child's rate of development and readiness for school; (b) additional teaching-time for pupils with difficulties; (c) greater clarity in the essential elements of each year's syllabus, in contrast to the over-elastic scope of the current National Curriculum.

Financial crisis in East Asia: Bank runs, asset bubbles and antidotes

Marcus Miller and Pongsak Luangaram
(University of Warwick and University of Bristol. Written for the Clare Group)

This article examines key questions posed by the crisis in East Asia: what went wrong, and why? how to fix it? and, how to prevent a recurrence? To answer them, the authors, Miller and Luangaram (writing for the Clare Group in the *National Institute Economic Review*) provide a brief overview of recent developments in the miracle economies of East Asia, focusing mainly on Korea, Indonesia and Thailand. They focus too on some of the shadows that came to darken the glittering success story—on declining competitiveness and growing financial vulnerability; and on regulatory failures in banking.

Problems caused by reversal of capital flows, insolvency or weak regulation?

Based on the distinction between illiquidity, due to a shortage of cash, and insolvency arising from a failure of economic prospects, three main views of the current crisis are discussed. First that it was simply due to reversal of capital flows, to a failure of collective action on the part of creditors which could and should have been solved by supplying extra liquidity—or by forcing creditors to rollover their loans. Second the view that the miracle had grown into a bubble that finally had to burst: so the problem was essentially one of insolvency. Finally the view that the authors prefer, that the panic was not wholly groundless (and rescue efforts were bound to be difficult) mainly because weak regulation combined with implicit deposit guarantees had left local bankers free to gamble with the money that global capital markets had poured into their parlours. Panic set in when foreign depositors realised that there were not enough dollar reserves left for the guarantee to be credible. This account (championed most notably by Paul Krugman of MIT) involves both illiquidity and insolvency and helps to explain why the IMF was unwilling simply to throw money at the problem.

Better surveillance needed to prevent a repetition

To prevent any recurrence, the authors conclude by proposing the following:

- To create an early-warning surveillance mechanism of financial regulations and supervisory systems, jointly staffed by the IMF and the World Bank.
- To request the surveillance unit (or other appropriate body) to devise capital inflow controls and regulatory procedures so as to reduce financial vulnerability of the emerging market economies.
- To convene a new Working Party of the G10 to commend steps for resolving liquidity crises by debt roll-overs and workouts, and to urge any changes in the Articles of the IMF that may be necessary.
- For this Working Party (or an appropriate alternative) to conduct a post mortem enquiry into the East Asian crisis to establish a magnitude of the losses resulting from implicit deposit insurance and to recommend measures appropriate for financial resolution.
- To delay writing the requirement of capital account liberalisation into the Articles of the IMF until it is safe to do so; in other words till sufficient progress has been made on the foregoing action points.

The world economy

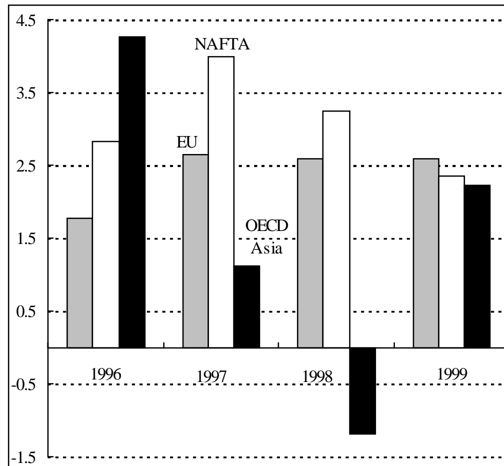
Dawn Holland, Florence Hubert, Julian Morgan, Nigel Pain, Dirk te Velde and Véronique Genre

- The Asia crisis will cut world trade growth by over a third in 1998.
- The Japanese economy will contract by 1 per cent this year, prolonging the slump in the worst affected parts of South-East Asia.
- A strong monetary stimulus and a restoration of confidence in the banking system are required to stimulate demand in Japan.
- The risk of a Chinese devaluation has risen.
- The EU will be the strongest performing region in the OECD in 1999 with growth of just over 2.5 per cent.
- US consumer price inflation will rise sharply in 1999.

The Asia trade effect
(% of GDP)

Change in balance of trade with Asian economies over year to 1998Q1	
US	–0.56
Germany	–0.45
France	–0.34
UK	–0.69
Spain	–0.34
Canada	–1.81
Australia	–2.01

The Asia growth effect
GDP growth (%)



The Asia crisis has shown no sign of abating this year. Our calculations show that the trade turnaround with the Far East has already reduced GDP growth in developed economies by 0.5 per cent. As a result world trade growth will fall sharply to 6 per cent in 1998.

The Japanese economic outlook has deteriorated markedly in the last quarter. As a result we are now expecting GDP to fall by almost 1 per cent in 1998. This in turn is blighting the recovery prospects for the rest of Asia and raising the risk of further disruption through a Chinese devaluation. The Chinese yuan is now less competitive than it was before the devaluation of 1994.

The Japanese government's fiscal package should shore up the economy when it is finally implemented later this year but will not have long-lasting effects. However, a special model simulation suggests that a strong monetary stimulus—an announced permanent 15 per cent rise in the money stock—would have a much more powerful effect on the economy, reducing real interest rates by 2 percentage points and raising output by 3 per cent over the next two years.

The EU is set to be the strongest performing region within the OECD in 1999 as economic growth in the US slackens to 2 per cent. However, the slowdown in the American economy will not prevent a marked deterioration in inflation. We expect the private consumption deflator to rise from just 1 per cent this year to 2.5 per cent in 1999, reflecting cost pressures from the labour market.

Labour costs and employment policy

Robert A. Hart and Robin J. Ruffell
(University of Stirling)

This article evaluates government policies to reduce youth unemployment by reducing employers' labour costs. Given a European climate of tight monetary and fiscal policy, it concentrates on two major policy initiatives that have been designed to be revenue neutral. The first is the Conservative's 1985 reform of employers' National Insurance Contributions (NICs) which reduced contribution rates for lower paid workers and increased them for the highest paid workers. Its attractiveness to government was that the measures could be revenue neutral while producing a net positive increase in employment. The second is Labour's current New Deal job scheme under which an employer who provides a part-time or full-time job to an 18–24 year old who has been employed for at least 6 months will receive a per-capita weekly fixed-sum for 6 months plus a payment towards the cost of training. Also revenue neutral this has been financed from windfall tax receipts from private utilities.

- Both policy interventions alter relative fixed and variable labour costs to the employer. Fixed costs do not vary with working hours while variable costs do.
- The workers-hours labour demand analysis adopted by the authors incorporates the important distinction between fixed and variable labour costs, a factor usually omitted from related studies.

Influence of subsidy reduces with longer employment period

- The NICs intervention represented cost changes that applied to *both* new and existing workers. In contrast, the New Deal subsidies are payable only in respect of new workers.

1985 Budget measures aimed to create jobs particularly amongst the low paid

- The 1985 Budget reduced employers' tax liability in respect of low-paid employees by up to 5.45% while raising tax rates from zero to 10.45% for high-paid workers on earnings above the so-called Upper Earnings Limit.
- Large net changes in contributions resulting from the 1985 measures affected relatively few industries. Three industries experienced percentage NICs decreases of more than 4 per cent and six industries increases of more than 4 per cent. The former group of industries accounted for 11.5 per cent of the total workforce while the latter comprised 27.6 per cent.
- This estimate for employment gain resulting from this analysis is remarkably similar to other estimates carried at the time of the NICs reforms by analysts using somewhat different methods.
- Under the present government's New Deal initiative, employers are given £60 per week for six months and a £750 training grant for taking on an 18-24 year old who has been unemployed for at least six months and are receiving a Jobseeker's Allowance. The scheme is designed to help about 120,000 unemployed young persons.

NICs measures resulted in an employment gain of about 154,000 jobs

- A critical aspect of any employment evaluation of the New Deal concerns the expected length of jobs created under the scheme. Clearly, the maximum subsidy effects on employment will be realised if the expected length of newly created jobs is six months. The New Deal does not constrain employers to offer jobs for longer than six months. The authors considered a range of expected lengths of new jobs up to twenty four months in length.
- Employment estimates with respect to the New Deal can be summarised as follows. (a) If all potential employers expect jobs to last for six months only,

Will the New Deal initiative be as effective in creating long-term jobs as National Insurance restructuring?

and under the full possible per-capita subsidy of £2310, the employment creation estimates are well in excess of the number of eligible unemployed under the New Deal. (b) If all potential employers are considering creating jobs of 12 months or more, employment creation effects are too small to measure: spreading the subsidy over a longer period very rapidly reduces the subsidy's estimated employment impact.

- On face value, the New Deal is a potent means of creating short-run jobs but a less convincing instrument for longer term job creation. The intuitive reasoning is quite easily understood. In terms of jobs with an expected six-month duration period, the subsidies to new workers have relatively big measurable impacts on labour costs *averaged over all employees.* As the job duration is increased—i.e. outside the period eligible for subsidy—the marginal employment subsidies quickly have negligible effects on average costs and, therefore, on associated employment changes.
- The main uncertainty of the New Deal initiative is the length of job created as a result of the marginal subsidies. Within the typical firm's labour cost structure, the form of the subsidies provided are unlikely to play a major role in influencing decisions to create jobs of expected long duration. By contrast, National Insurance re-structuring can be geared to produce a cost climate that helps to price younger unemployed workers into long-term jobs.

Large-scale EMU: the May Council decisions and implications for monetary policy

John Arrowsmith
(NIESR)

Will the Council's decisions create a successful environment for the euro?

This note looks at the way the Council last May reached its decision that eleven countries will take part in EMU on 1 January 1999 to see whether, on the economic evidence available to the Council, the right decision was made or whether it might have prejudiced the future monetary policy of the euro area. The author, [NIESR Senior Research Fellow] John Arrowsmith, examines the detailed reports on the economic performance of the individual EU Member States that the European Commission and the European Monetary Institute had sent to the Council and contrasts the Commission's optimistic conclusions with the more critical assessments of the EMI. He also focuses on the independence of the European Central Bank in the light of its decision-making structure and the row in the Council over the appointment of the ECB's President.

The economic assessments of the Commission and the EMI were conducted in terms of the convergence criteria specified in the Maastricht Treaty. Their findings that all Member States except Greece satisfy the requirement of low inflation and interest rate convergence are uncontentious. Much more questionable is the Commission's judgement that the governments of the same fourteen countries have achieved a sound financial position. Relying on much the same evidence as the Commission, the EMI questions the sustainability of government finances in seven of the eleven countries now chosen for EMU. The author's own analysis of the data places a question mark over all the EMU participants except Luxembourg. The Commission also delivers a positive verdict on the eleven in respect of exchange rate stability. This criterion was designed to provide a market test that economic convergence was sustainable but the author argues that for countries such as Finland, Italy and Ireland outside the traditional core of the ERM, 'convergence trading' in the expectation that the Council decision would be favourable rendered the test invalid.

Participating countries must build on the favourable economic climate if single monetary policy to succeed

The independence of the ECB is unlikely to have been compromised by the row over the presidency of the ECB and the political compromise reached. Indeed it may well have stiffened Wim Duisenberg's resolve to carry the Executive Board with him in giving an independent lead in the policy-making General Council. Of greater concern is that the row has diverted attention from the more fundamental question of the basis on which the eleven EMU countries were selected. On the evidence provided by the Commission and the EMI an economic case could have been made for delaying the start of EMU. As it is, many of the participants will enter EMU with weak government finances and, for some, at exchange rates that may not be an accurate reflection of economic fundamentals. The author concludes that, unless the EMU countries take advantage of the present favourable economic climate to consolidate their positions further, the new policy framework could be severely tested later in the cycle with a fiscal stance that in aggregate is too lax, placing an undue burden on the single monetary policy.