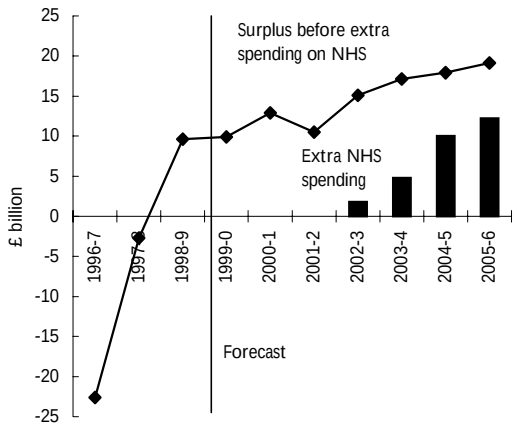
The UK economy

Martin Weale and Garry Young

The healthy state of economy will allow increased public expenditure

- The economy will grow by 3.2 per cent in 2000 and 2.3 per cent in 2001.
- Manufacturing will enjoy its best year since 1994, with output expanding by 2.4 per cent in 2000.
- Inflation will stay just below the government's 2.5 per cent target in 2000 and 2001.
- The current account deficit will widen to £17 billion in 2000.
- The Prime Minister's new objective to raise health spending as a proportion of GDP to the EU average by 2005 can be met without breaking the golden rule.

The prospective surplus in the current budget



The economy is poised to grow strongly in 2000, powered by a brisk increase in domestic demand and a recovery in exports. The swift return to buoyant economic conditions will push wage earnings growth to 5 per cent. However, a rise in productivity growth, the strong pound and rising competitive pressures in retail markets will keep inflation at bay over the next two years. The inflation target can be met with a rise in base rates to 6.5 per cent.

Domestic demand will rise by almost 4 per cent in 2000, somewhat faster than in 1999. Household spending will grow at 3.5 per cent, sustained by a healthy increase in real household disposable income and the 50 per cent rise in household wealth since 1996. The drag from net trade will be considerably less than in 1999, as exports stage a recovery. Exports will increase by 6.5 per cent in 2000, double their annual rate of growth in 1998 and 1999. Exporting firms will benefit from the upturn in trade as the world economy picks up speed.

Average earnings set to rise but costs will be supressed by increased productivity growth

With economic growth above trend, the labour market will tighten still further and average earnings growth will pick up to 5 per cent. However, a rise in productivity growth should contain annual unit labour cost growth to around 3.5 per cent over the next two years. With continuing import price deflation in 2000 and keener price competition in the retailing sector, this should be compatible with the inflation target, but only with falling profit margins.

The medium-term outlook for the public finances is sufficiently favourable to make affordable the Prime Minister's new objective for health spending. On existing plans, we project a current account surplus of £19 billion by 2005/6. If health spending were to rise by then to the EU average of 8 per cent of GDP, this would involve extra expenditure of £12 billion, so that the new

goal can be attained without breaching the golden rule.

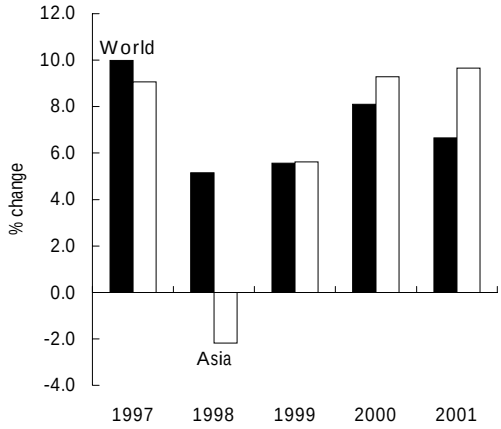
But the fiscal boost will push up annual inflation by almost 1 per cent from 2001. GDP will be higher but the exporting sector of the economy will suffer. And, taking into account the demographic structure of the population, income tax revenues need to be 13 per cent higher than would otherwise be the case in order to pay for the increase in health spending. Given our budgetary projections this does not necessarily mean that taxes need to rise, but it would leave standard rate tax almost 3p and higher rate tax 5p higher than they would be without the increased health spending.

The world economy

Paul Ashworth, Dawn Holland, Florence Hubert, Nigel Pain and Dirk Willem te Velde

- The global economy will rebound in 2000 as world trade expands by 8 per cent.
- Inflationary pressures will remain muted with inflation in the OECD staying under 2 per cent.
- The euro zone will grow at its fastest since German unification, prompting the European Central Bank to raise interest rates to 4 per cent.
- The US economy will grow by almost 4 per cent, leading the US Fed to raise interest rates to 6.25 per cent.
- Japan's government debt will rise in 2001 to over 120 per cent of GDP, the highest ratio in the OECD.

Asia leads the world trade recovery



The world economy will experience a strong recovery in 2000. Global GDP will increase by 3.7 per cent and world trade by 8.1 per cent, the highest growth rates since 1997. Concerns about inflation will lead central banks to raise interest rates in North America and Europe. However, the increase in annual inflation to just under 2 per cent in the OECD in 2000 and 2001 will be modest in comparison with earlier economic cycles. There is still considerable spare capacity in Japan and many emerging market economies, and competitive pressures in the developed world continue to exert downward pressure on inflation.

A strong rebound in Asia is stimulating the world recovery. In the second half of 1999, the Asian bounceback contributed as much to world economic growth as the continued strength of the American economy. Trade with Asian countries, which fell by 2 per cent in 1998, will rise by 9 per cent p.a. over the next two years.

Euro zone interest rates are likely to increase

The Asian recovery will help push growth in the euro area to 3 per cent in 2000, the highest since 1990. After reducing GDP growth by half a percentage point in 1999, net exports will add as much in 2000. With consumer confidence at its highest since the late 1970s, robust household spending will sustain growth in domestic demand of around 2.5 per cent. Inflation is increasingly likely to breach the ECB's target ceiling of 2 per cent. In response, it is expected to raise interest rates by a percentage point.

The US economy will continue to grow strongly, with GDP expanding by 3.7 per cent in 2000. This will push consumer price inflation above 3 per cent

for much of the year. However, continuing productivity growth and a monetary tightening of 75 basis points will help contain future inflationary pressures. The inflationary impulse from rising oil prices is also less marked now because of the declining energy intensity of production.

The Japanese economy is being helped by the Asian recovery but economic growth of 1 per cent in 2000 will be a modest affair. The government is approaching the limits of fiscal stimulation to the economy. The government budget deficit will run at 8.5 per cent of GDP in 2000 and 8 per cent in 2001. The ratio of gross government debt to GDP will rise above that of Belgium and Italy by the end of 2001.

How well can we measure graduate overeducation and its effects?

H. Battu*, C.R. Belfield** and P.J Sloane*
(*University of Aberdeen and **University of Stirling)

Has overeducation resulted in an increasingly large proportion of graduates being employed in non-graduate grade jobs?

The number of students entering higher education in Britain has risen substantially in the last decade and the Government is committed to increasing the age-participation ratio still further. Yet the question arises as to whether there are sufficient graduate-level jobs to absorb this increased output of graduates or whether future graduates will have to accept jobs which formerly require only a lower level of education. This is what is implied by overeducation. Earlier work by the authors found that eleven years after graduation only 70% of graduates had ever had a job which required a degree.

It is, however, not straightforward to define and measure overeducation. This paper uses data from two cohorts of graduates from 1985 and 1990 and surveyed in 1996, to compare three different measures of overeducation. The first measure is based on respondents' answers to a question on whether a degree was a requirement in the job specification for their current main employment. The second measure attributes overeducation to individuals based on the average education level for their occupation, where more than 50% of the workers have a highest qualification at equivalent to A-level or below. (i.e. the modal worker is a non-graduate). The third measure is based on individual responses to a question on how satisfied the respondent was with the match between their work and their qualifications. It is found that these three measures are only weakly correlated.

Employers do not up grade jobs to make them more suitable for the overeducated

Despite this, whichever measures are used the effects of overeducation on earnings and job satisfaction are similar. Overeducated graduates earn less and have lower job satisfaction compared to graduates matched in jobs appropriate to their level of education. These effects are more pronounced for females than males, though the results are ambiguous with respect to which sex is more prone to overeducation. Finally, the authors are unable to detect any evidence suggesting that employers are tending to upgrade the tasks allocated to those employees who are overeducated relative to their colleagues.

These results suggest that further research is required on the differential work experience of graduates, especially given the newly imposed requirement for students to meet a higher proportion of the costs of their education. Further consideration also needs to be given to the appropriate proportions of individuals with varying levels of qualifications in the labour market.

Should the UK join EMU?

Michael Artis
(European University Institute, Florence)

The European Monetary Union is a little over a year old. When the decisions were made about which countries would be eligible for consideration for membership of the EMU, the UK exercised its option not to participate. With three other EU member countries also not participating (Sweden, Denmark and Greece) the European Monetary Union went ahead on the basis of an initial membership of eleven countries. Exchange rates between the currencies of the member countries of the Union are completely fixed and monetary policy decisions for them are taken by the European Central Bank, based in Frankfurt. The participating countries have also accepted some restrictions on their fiscal policy independence.

The UK faces the question whether—and when—to join the EMU. Political, public and business opinion appears very evenly divided on the issue, which obviously has political as well as economic dimensions. The article, which appears in the Review as a paper from the Clare group attempts to appraise the economic arguments.

Joining EMU is less advantageous for the UK than most of its current members

Economic analysis has long approached the questions raised by the putative formation of monetary unions within the framework of analysis offered by Optimum Currency Area theory. That framework recognizes that a large volume of intra-trade is a positive indicator for the formation of a monetary union or currency area. The UK's trade involvement with its potential monetary union partners is not out of line with that of its principal comparators, the larger economies (France, Germany and Italy) in the Union. As a negative indicator for participation in a monetary union the framework indicates the incidence of asymmetric shocks. If a country experiences shocks that are seriously out of line with those impacting its potential partners, then the common monetary policy that monetary union implies, will be unsuitable. On this ground the EMU can be seen as a less interesting option for the UK than it is for most of the current members. The article cites statistical evidence in favour of this conclusion.

The article recognises that the argument cannot be left at this point, for two reasons. First, the optimal currency area analysis makes some assumptions, which can be questioned. It assumes, for example, that:

* nominal exchange rate changes translate reliably into corresponding real exchange rate changes;

* it overlooks that a separate currency may be a focus for speculative destabilization as well as a means of stabilization;

* and it neglects the possibility that joining the union may itself prove a means of reducing the asymmetry of shocks and of allowing for efficient risk-spreading.

The article reviews these arguments with some sympathy, whilst warning

that none are decisive in removing the relevance of the traditional theory. Secondly, however, the article notes that the relevant question for the UK now is not whether EMU is a "good thing" but whether joining a going concern is not better than staying out.

Staying out of EMU could be a feasible option

The "staying out" option is termed in the article "the Canada solution" to draw attention to the fact that staying out of a monetary union with a big neighbour with which there are close trade and other ties is a perfectly feasible option. Nevertheless, there are some likely costs of isolation—the possibility that the Single Market would unravel, so far as the UK is concerned, if the euro/dollar exchange rate were to prove volatile, cannot be ignored. Capricious alterations in competitiveness brought about by exchange rate changes are likely to be cited as reason for reinstating some protection. And the possibility of excessive exchange rate volatility in itself is an unwelcome one: studies appear to show that the UK has imported instability through this channel in the past and could do so in the future.

The article concludes that there is a positive, though not overwhelming, case *on economic grounds* for the UK to join the EMU, albeit there would be some transitory cost while the business cycles and experience of economic shocks between the UK and the EMU remain divergent.

The implications of the comprehensive spending review for the long-run growth rate: a view from the literature

Richard Kneller
(NIESR)

In July 1998 the Government set out its expenditure plans for the remainder of the current Parliament in the comprehensive spending review (CSR). Central to these were increases of £20bn each in expenditure on education and on health and around £6bn on infrastructure over a period of three years. The CSR is thus targeting expenditure at Labour's priorities of education and health. Principally it should enable the Government to fulfill its election pledges to reduce waiting lists in hospitals and class sizes in schools.

Will the CSR help to raise the trend rate of growth?

The Government also aims to raise the trend rate of growth of the economy by 0.25 of a percentage point per annum. As stated in the recent Treasury report on the UK's trend rate of growth the expenditure plans of the CSR may help to achieve this objective (although no quantitative assessment is made). Using the current state of economic knowledge this paper attempts to fill this gap and make a quantitative assessment.

There are difficulties in assessing the long-term effects of the CSR

According to National Institute estimates (July 1998) the CSR will contribute approximately 1 percentage point to the growth rate of GDP in both 1999 and in 2000. While such short run impacts on the economy are reasonably easy to model, the potential impact on the long run growth rate of the economy is less so. This can be largely attributed to conflicting evidence on the relationship between government spending and long run growth. However, it is estimated that the CSR can increase trend growth by as much of 0.1 percentage point per annum.

Comparative properties of models of the UK economy

Keith B. Church, Joanne E. Sault, Silvia Scherri and Kenneth F. Wallis
(ESRC Macroeconomic Modelling Bureau, University of Warwick)

The ESRC Macroeconomic Modelling Bureau at the University of Warwick was established in 1983 to help achieve a greater openness and understanding of economic models and their associated forecasts and policy analysis. The House of Commons Treasury and Civil Service Select Committee envisaged that through its comparative exercises the centre would improve the availability of model-based evidence.

A final comparative analysis of the UK's major macro-models

This research centre closed in September 1999 but during its lifetime it undertook regular comparative studies of the models supported by the ESRC, namely the London Business School, National Institute of Economic and Social Research, "Compact" model based at the University of Exeter, "CUSUM" based at Cambridge University and the HM Treasury model. This article is the final piece in a series published by the *National Institute Economic Review* which has analysed the properties of these models.

The authors look at the present properties of these leading macroeconometric models of the UK economy, as revealed in four simulation exercises. The tests are carried out in a common operating environment that reflects the broad objectives of current policy - sound public finances and low inflation - by using feedback rules for income tax and interest rates. However, the authors are also able to look back at the development of these models throughout the Modelling Bureau's lifetime.

Models have developed over time into better analytical tools

Although not all the models compared have existed throughout the existence of the Bureau, improvements in the analysis provided by all these models over sixteen years is apparent. In fact developments in both theoretical structures and econometric methods have helped the establishment of one of the newer models, the COMPACT model, which encompasses recent macroeconomic theory. Econometric models are now better able to analyse the current monetary and fiscal policy environment, their economic theory is better grounded and they have firmer econometric foundations than was the case in the 1980s.