The UK economy

Martin Weale and Garry Young

- The government's new plans for departmental spending are affordable, but the fiscal loosening does pose a threat to the outlook for inflation and interest rates.
- Growth will pick up next year as export performance improves because of greater buoyancy in world trade and the fall in the exchange rate.
- In order for inflation to stay on target in 2001, interest rates will have to rise by half a percentage point by the start of next year.
- The upward pressure on interest rates will be limited by a decline in the growth of private sector spending as households increase their saving rate and non-manufacturing business investment
  increases less rapidly.
- Inflationary pressures should also be restrained by a recovery in productivity growth.

The new public expenditure plans for the fiscal years 2001–2 to 2003–4 announced in the spending review are affordable. The risk of a serious setback to the public finances is small because the current position is so strong. With the economy set to expand quite sharply, revenues will remain buoyant. We project public sector net borrowing remaining in surplus until 2002–3 and a deficit of only £1bn in 2003–4.

The sharp rise in government spending will undoubtedly boost the economy in the second half of the year and in 2001. Government consumption will rise by 4.5 per cent next year and the big expansion in public investment will contribute to an increase in gross fixed investment of 5.2 per cent.

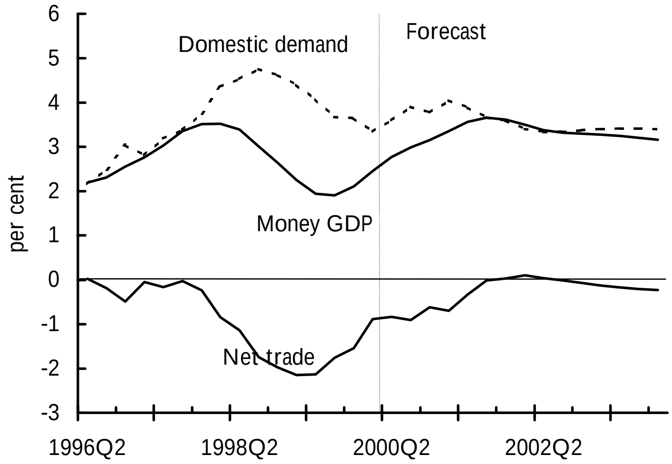
The increase in spending is awkwardly timed since the outlook for growth has improved. The economy will expand more vigorously than previously expected, by 3.2 per cent in 2000 and 3.6 per cent in 2001. Growth is stronger mainly because the drag from net trade is abating as exports

respond to faster world trade and the fall in the exchange rate. Export growth will double to 6.9 per cent in 2000. The growth will pick up further to 7.6 per cent in 2001, the best performance since 1997. As a result, net trade will cease to hold back the economy next year.

Inflationary pressures will start to build up because the economy will be growing faster than its potential trend rate of growth at a time when there is little spare capacity. This will spur two further quarter point rises in interest rates by the first quarter of 2001. We then expect the repo rate to remain at 6.5 per cent for the rest of the year.

The upward cycle in inflation and interest rates will be restrained by two forces. The first is a slackening in the growth of private sector spending. Household consumption has been rising ahead of income as the saving rate has fallen, but the opposite is now likely to occur in 2001 as the saving rate rises. In addition, non-manufacturing business investment, which has been

Net trade ceases to be a drag on the economy



expanding at double-digit rates, will grow much less rapidly.

The second disinflationary force is a rebound in productivity growth. This was disappointingly low in the second half of the 1990s. This was partly because so many more people found jobs but also because of the difficulties of manufacturing, which is typically the source of much of overall productivity growth. Productivity for the economy is now forecast to grow from 1.4 per cent in 1999 to 2.3 per cent in 2000 and 2.9 per cent a year in 2001–2.

The world economy

Paul Ashworth, Ray Barrell, Dawn Holland, Florence Hubert,
Nigel Pain & Dirk Willem te Velde

- Strong Asian growth is boosting the recovery in the world economy, with global GDP now forecast to increase in 2000 by 4.6 per cent, the highest since 1996.
- Inflationary pressures in the US will prompt the US Fed to raise interest rates a further three-quarter points by the end of the year.
- Inflation in the Euro Area will remain above 2 per cent in 2000 and 2001, and this will lead to a further rise in interest rates of half a percentage point by the end of the year.
- The robust Asian recovery is stimulating the Japanese economy which is now expected to grow by almost 2 per cent in 2000.

The global recovery is gathering momentum. World trade will grow by 10.5 per cent in 2000, double the rate of increase last year and the fastest increase since 1994. The upswing is spurring the best performance by developed countries since 1988: output in the OECD will grow by 4 per cent this year. A rebound in Asian economic activity is the principal spur to this acceleration in global economic activity. Trade is surging in much of Asia: the dollar value of trade was more than a quarter higher in the first half of 2000 than a year earlier.

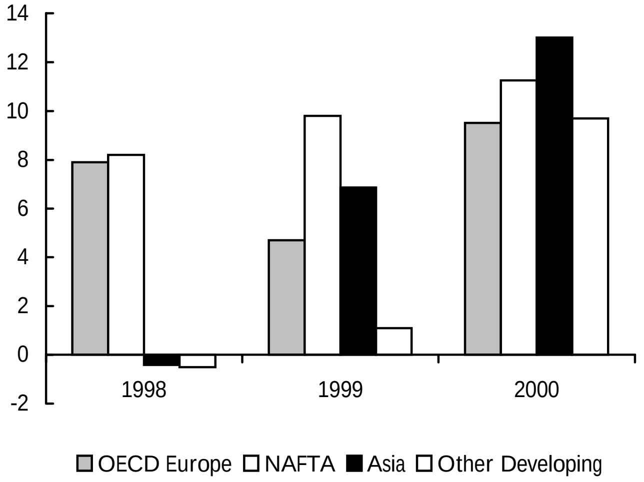
The US economy continues to grow very strongly – GDP will increase by 5 per cent this year – and there is no clear sign of a significant slowdown. Despite improvements in productivity, the current pace of expansion is much faster than the potential rate of growth. Labour earnings growth is set to rise from 4¼ per cent this year to 5¼ per cent in 2001. Inflation is turning out somewhat higher in 2000 than the US Federal Reserve had expected at the start of this year. This will lead to swifter and sharper monetary tightening: we now expect the Federal Funds rate to be raised to 7¼ per cent by the end of the year. It will remain at this level in the first half of 2001.

The Euro Area economy is experiencing robust growth as exporters take advantage of the weak euro and buoyant external demand. All this year's acceleration in growth can be traced to higher net exports. The number of jobless continues to fall and the unemployment rate will decline to 8.6 per cent next year, the lowest since 1992. The European Central Bank will tighten policy further in order to deal with inflation which will stay above its target ceiling of 2 per cent. We expect a rise in interest rates of at least half a percentage point over the next six months.

The Japanese economy is now forecast to perform more strongly in 2000. Annual economic growth will be around 2 per cent this year and next. Large manufacturers are benefiting from the strength of the Asian recovery and export volumes are forecast to grow by 11 per cent this year. Despite a fall in government investment, domestic demand will grow by 1½ per cent, mainly because of a sharp recovery in business investment. A return to nominal wage growth suggests that disinflationary pressures are abating. However, growth prospects in the medium term remain modest as Japan struggles to cope with

Developing economies drive world trade recovery

Growth of merchandise trade volumes by region
per cent



the impact of an ageing society and the government pursues a policy of fiscal retrenchment.

Effects of minimum wages on the gender pay gap

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Roughly speaking, three quarters of British women of working age have paid jobs at the turn of the Millennium, compared with around four-tenths in 1950. The main growth up to 1985 was in part-time employment. Since then there has been a small increase in full-time employment. Along side the increase in women's participation in the labour market has come a gradual move towards equality in wages between men and women. The relative hourly mean wage of women in full-time manual jobs rose from 47 per cent of men's in 1938 to 72 per cent in 1996. A similar but lower trend is visible for non-manual workers. In contrast to the converging wage rates among male and female full-timers, the pay of female part-timers relative to men has remained steady. The gap between women employed full-time and part-time actually grew wider. Along side the increase in gender wage equality, there has been a rise in disparities within the wages of men full-timers, closely followed by increasing inequality within the wages of women full-timers. Part of the increasing equality, therefore, has been due to the wages of the worst paid men falling to meet the wages of the worst paid women along side positive growth in women's education and work experience.

One view of the evolution of women's relative wages is that it is the result of compositional change: employment at the top end of the market expanding in occupations with low discrimination, while less skilled jobs are relegated to part-timers. Alternatively the main changes can be seen to have resulted from changes in the way the labour market rewards skills as it becomes more flexible. The first account applies to some, but not all, managerial and professional occupations. The second explains the increased dispersion in both men's and women's pay. The convergence in wage rates between men and women could have been brought about by several institutional changes, not just Equal Pay legislation. Rates of remuneration have converged for men and women in full-time jobs, but there have also been composition changes in human capital. These changes in the composition of the labour force are mirrored (if not perfectly matched) by changes in the composition of jobs, offering a partial, though not complete, explanation of wage change. In so far as improved wages and other equal opportunity policies have encouraged women to acquire more education and labour force experience, the convergence of women's wages towards men's is a self-generating process. Those who fail to acquire skills are excluded from the more advantageous parts of the labour market and are left further behind, with the deteriorating wages in casual, particularly part-time jobs. It is interesting to consider what impact the introduction of the statutory minimum wage in April 1999 is likely to have on earnings inequalities between men and women?

The Low Pay Commission did not estimate the effects of the Statutory Minimum Wage on gender wage inequality although they did estimate that in total around 2 million employees should receive higher earnings from the UK's introduction of a minimum wage of £3.60 per hour for adults from April 1999; of these 1.5 million were female and 0.5 million were male beneficiaries. Estimates of the gender equality effects suggest the female/male wage ratio will improve slightly at the mean from 0.70 to 0.72 for manual workers from the introduction of a £3.60 minimum wage. There is also some improvement predicted for the ratio when female part timers are compared with (all) male manual workers from 0.66 to 0.68. The improvements in gender wage ratios are likely to be slight because both low paid men and women benefit from minimum wages, and partly because the threshold of £3.60 is so low.

Policies that act directly on differences between men and women in the labour market would be expected to have a larger effect on the gender wage. Estimates suggest that a very large change would arise from ascribing men’s hourly rates of pay per broad occupation category to women from 0.70 to 0.93 in the case of manual workers. Changes similar in size to those resulting from the introduction of a Statutory Minimum Wage would result from redistributing manual women employees through occupations in the same proportions as men but without changing their occupational wages. However, non-manual workers are estimated to gain larger improvements from this type of occupational change.

These estimates suggest that policy that could deliver equal pay within occupational groups or could enforce the same occupational distribution for both sexes would be likely to have a greater impact on gender earnings ratios than the minimum wage set at £3.60. This is not surprising given that minimum wages only impact at the bottom of the wage distribution and affect both men and women, whereas giving women men’s wages or occupations operates across all levels of wages and benefits women only.

Such simple illustrations should not be interpreted as the predicted outcomes of realistic policy options because they only consider first round effects and they do not consider the implementation issues surrounding policies which are likely to seriously dampen effects from equal pay or other options. Whilst extending the scope of equal pay or reducing occupational segregation may in principle each lead to much greater improvements in hourly ratios for women as a whole, the problems of implementing such policies are also much greater than those associated with minimum wages. A higher minimum wage has the potential to have a greater effect on gender wage equality.

A tale of two cycles: closure, downsizing and productivity growth in UK manufacturing, 1973–89

Nicholas Oulton

From the peak of 1979 to the peak of 1989, output per person employed in UK manufacturing rose by 48%. In the previous cycle, 1973–9, labour productivity fell by 4%. A common view of the 1980s is that under the gun of the strong pound and the 1980–81 recession manufacturers simply closed their least productive plants. So higher productivity was purchased at the cost of lower output and capacity.

This article uses a new source, the ARD, the longitudinal database of the Census of Production, to re-examine this question. The great advantage of the ARD is that it allows the researcher to measure and analyse the productivity of each individual establishment. The fortunes of individual establishments can be tracked over time.

Contrary to the common view, closures did not play a major role in accounting for productivity growth in 1979–89. Establishments which exited did indeed have lower productivity than survivors so their disappearance raised productivity. But the effect is small. Two thirds of productivity growth was due to growth within surviving establishments.

Most productivity growth occurred in establishments which reduced employment. But despite an overall fall of a quarter in employment, 16% of productivity growth occurred in establishments which expanded employment.

The main difference between 1973–79 and 1979–89 was in the productivity growth rate amongst survivors. In 1973–79, it was negative overall and over half of employment in 1973 was in establishments where productivity subsequently fell.

In more detail, the main findings are:

1. Over 1979–89, the dispersion of productivity across establishments actually increased. The so-called long tail of under-performers lengthened. There was huge variation in the growth of productivity. Even amongst surviving establishments, a quarter experienced negative productivity growth and these accounted for 18% of employment in 1979 and 21% in 1989.
2. Over 1979–89, closures are not able to explain the upsurge in productivity which occurred. True, establishments which disappeared had lower productivity than those which survived. But this by itself would have had only a small effect on overall productivity. New entrants played a bigger role, accounting for 28% of the aggregate productivity gain. But the bulk of the gain, 65%, was due to productivity growth within surviving establishments. This last point holds true even for the recession period 1979–82.
3. The bulk of productivity growth can be ascribed to establishments where employment fell. This is true both in aggregate and at the sectoral level.

Nevertheless, establishments in which employment grew accounted for 16% of productivity growth, despite the 25% fall in employment in manufacturing as a whole.

4. Productivity growth was highest in the largest establishments. In fact, the top 36 establishments, each with 7,500 or more workers and employing 17% of the 1979 workforce, accounted for almost a third of aggregate productivity growth. These establishments also had large declines in employment.
5. In the earlier cycle of 1973–79, productivity growth was quite rapid in those establishments where it rose at all. The problem was that amongst survivors, over half of employment was in establishments in which productivity fell.

Christopher Dow on major recessions

Michael Artis, John Flemming, Robin Matthews and Martin Weale
(Written for the Clare Group)

This CLARE group article, written jointly by Michael Artis, John Flemming, Robin Matthews and Martin Weale, reviews Christopher Dow's last book "Major Recessions: Britain and the World 1920–1995" Oxford University Press 1998 (paperback forthcoming 2000). He died at the age of 82 as it was published.

The book seeks to draw lessons from five British 20th century recessions identified by Dow as having been 'major'. They are those of 1920–1, 1929–33, 1973–5, 1979–82 and 1989–92. It also alludes to other countries, and especially the role of the US Great Depression of 1929–33.

For practical purposes, Dow defines major recessions as sizeable absolute falls in output and rises in unemployment from one calendar year to the next.

He argues that both consumption and employment adjust more quickly to such large shocks. If this were true, it could have been used to distinguish major from minor recessions more systematically. Supporting evidence is, however, not found to be compelling.

He relies largely on what he sees as demand shocks to explain recessions; typically these are amplified by confidence effects—which can occasionally initiate a recession. He sees little rôle for supply effects of the OPEC oil shocks, arguing convincingly that effects on effective UK capital stock would be too small.

He argues that major recessions involve permanent downward displacement of the trend of capacity output—hence such recessions are very costly. This conclusion is very sensitive to his methodology—in particular his adjustment of estimated capacity output for employment changes.

His rejection of any notion such as the NAIRU, which may have trended upwards over much of the post-war period, requires downward shifts in the trend line if capacity is not to diverge excessively from actual output. After a recession, growth is seen as reverting to little more than its recession-free trend.

He emphasises the effect of a dramatic fall in working hours on the 1920–1 recession.

He rejects the view that the gold standard had much to do with the US Depression of 1929–33 which contributed heavily to others' recessions.

The 1989–92 recession is seen as the aftermath of a wave of optimism triggered by financial liberalization, which underlines the importance of containing booms if recessions are to be avoided—as was done by controls in the immediate post-World War II period.

Since unforeseen developments are inevitable, and will sometimes be large and adverse, recessions cannot be entirely avoided, but policy can reduce their frequency and severity. Despite his Keynesianism, there is much that is surprising in Dow's recommendations—such as his support for the Private Finance Initiative.

Dow recognizes the complex interaction of interest and exchange rates. He does not see any single indicator such as the inflation rate, to which monetary policy should respond.

Dow, consistently unfashionable, makes little of globalization as reducing the effectiveness of national policy. The recent experience of Japan suggests that national stabilization policy may be indeed still have its uses.

Finally, even if some parts of his model prove shaky in the light of empirical analysis, those who read the book are unlikely to forget his general picture of the irregular occurrence of major recessions—greatly affected by confidence—which lead to permanent downward shifts in the growth path of the economy.

The CLARE Group contributes an article to the National Institute Economic Review *in January and July. The members of the group are: M.J. Artis, T. Besley, A.J.C. Britton, W.J. Carlin, J.S. Flemming, C.A.E. Goodhart, J.A. Kay, R.C.O. Matthews, D.K. Miles, M.H. Miller, P.M. Oppenheimer, M.V. Posner, W.B. Reddaway, J.R. Sargent, M.Fg. Scott, P. Seabright, Z.A. Silberston, S. Wadhwani and M. Weale. Drafts of this article have been discussed among members of the CLARE Group, but responsibility for the views expressed rests with the author alone.*