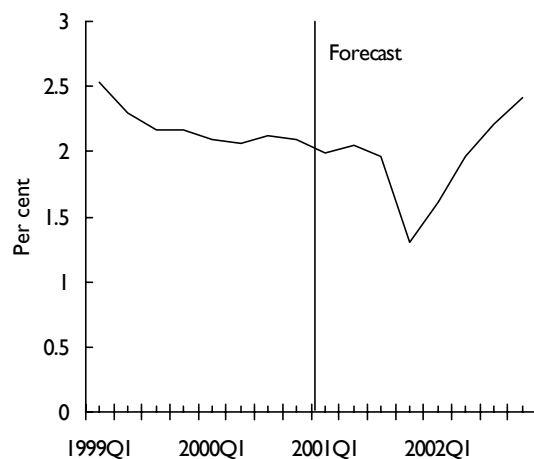

The UK economy

Andrew P. Blake and Martin Weale

- The inflation rate will fall below 1.5 per cent by the end of this year, triggering a letter from the Governor of the Bank of England to account for this deviation from the inflation target of 2.5 per cent.
- This will occur even though the economy will again grow strongly in 2001, with GDP increasing by 2.9 per cent because of the stimulus from the public spending boom and a weaker pound.
- The main risk to growth in 2001 is a further decline in American equity markets. The knock-on effects from a 20 per cent fall in US equity prices would cut GDP growth to 2.1 per cent.
- Even with growth picking up to reach 3.3 per cent in 2002, inflation will only rise to the target at the end of the year.
- **The British economy is on course to achieve lasting cyclical convergence with the Euro Area.**



When the Chancellor established the inflation target regime, it was generally expected that any failure to meet the 2.5 per cent target by more than a percentage point would be through an overshoot rather than an undershoot. But the National Institute's central forecast is that inflation will fall below 1.5 per cent by the end of this year. That will mean that the Governor of the Bank of England will have to write an explanatory letter to the Chancellor setting out how he intends to raise inflation.

In the event, he may have little to say, since the medium-term outlook is for gradually rising inflation after the low point in the final quarter of this year. This upward pressure on inflation will be generated by continuing strong growth. We expect GDP to increase by around 3 per cent per annum over the next three years. However, inflation will only start to move above target in 2003.

The principal expansionary influence on the economy is the public spending boom. Government consumption is projected to grow by 4 per cent a year in 2001 and 2002, with even more rapid growth in public sector investment. A second key stimulus is the decline in the pound against the euro, which will help the hard-pressed manufacturing sector.

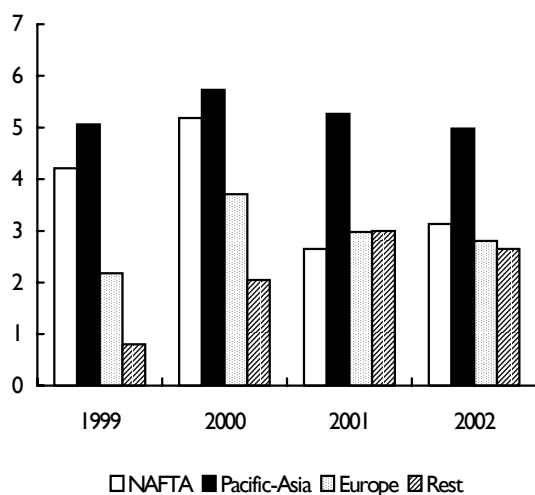
The principal risk to growth in 2001 is a further fall in American stock markets. A 20 per cent decline in equity prices in the US would lead to lower equity prices in the UK and slower growth in Europe as the euro strengthens against the dollar. In all, this would cut growth in the UK to 2.1 per cent even with prompt cuts of 75 basis points in the repo rate by the Bank of England.

On the face of it, the economy has met the most important of the Chancellor's five tests on whether Britain can join the euro – whether Britain has achieved cyclical convergence with Europe. The cyclical position of the UK is now strikingly similar to that of the major Euro Area economies. Differences in output gaps – actual GDP in relation to potential GDP warranted by underlying growth – are insignificant in comparison with those as recently as the late 1990s. Interest rates are also set to converge at 5 per cent within five years. This is consistent with membership of the monetary union but gives rise to some inflationary pressures.

The world economy

Paul Ashworth, Ray Barrell, Karen Dury, Dawn Holland, Florence Hubert, Ian Hurst, and Nigel Pain

- The world economy is slowing down but our central forecast suggests that fears of a major setback in 2001 are misplaced: global output will grow by 3.5 per cent and world trade by a respectable 8.4 per cent.
- Worries about an American recession are also overstated: our baseline forecast is that the US will grow by 2.4 per cent in 2001, supported by lower interest rates and tax cuts.
- The slowdown in the EU will be less significant than in the US: the Euro Area will grow by 2.9 per cent in 2001, helped by fiscal and monetary easing.
- The Japanese economy will falter in 2001, with GDP increasing by only 1.4 per cent.
- **The main risk to the world economy is a further fall in stock markets: a 20 per cent decline in American equities would bring growth in 2001 down to 1.5 per cent in the US and 2.3 per cent in the Euro Area.**



The world economy is slowing down after the fastest year of growth since 1984, but fears of a major setback appear misplaced, unless there is a further sharp decline in equity markets. Growth of 3.5 per cent in world GDP will be considerably higher than the average annual rate in the first half of the 1990s. So, too, will be the 8.4 per cent growth in world trade.

The deceleration in global growth is being led by the sharp decline in American growth, particularly in the first half of the year. However, our main forecast suggests that fears of recession are overstated. There is

plenty of scope for further easing in monetary policy and a relaxation of fiscal policy. This should prevent the American The world economy is slowing down after the fastest year of growth since 1984, but fears of a major setback appear misplaced, unless there is a further sharp decline in equity markets. Growth of 3.5 per cent in world GDP will be considerably higher than the average annual rate in the first half of the 1990s. So, too, will be the 8.4 per cent growth in world trade.

The deceleration in global growth is being led by the sharp decline in American growth, particularly in the first half of the year. However, our main forecast suggests that fears of recession are overstated. There is plenty of scope for further easing in monetary policy and a relaxation of fiscal policy. This should prevent the American economy from sliding into recession. We expect the US to grow by 2.4 per cent in 2001, half the exceptional rate achieved in 2000, picking up to about 3 per cent per annum in 2002 and 2003. This should be sufficient to bring inflation under control, although the current account deficit will remain sizeable at nearly 4

per cent of GDP.

Tax cuts and a quarter point reduction in the repo rate will help to maintain robust growth in the Euro Area in 2001. GDP will increase by 2.9 per cent, only a modest slowdown from the 3.5 per cent achieved in 2000. That growth will be sustained by a healthy expansion in domestic demand, which is expected to grow by 2.7 per cent. Helped by tax cuts, consumer spending will increase by 2.8 per cent.

The Japanese recovery will slow in 2001. GDP is expected to grow by only 1.4 per cent, lower than the 1.9 per cent achieved in 2000. The economy will be hit by a sharp decline in the contribution of net exports to growth as world trade slows down. Domestic demand will not pick up the baton because business confidence has stalled, consumer spending remains subdued and the room for further fiscal stimulus has essentially been exhausted.

The main risk to this fairly benign scenario is a sharp collapse in investor confidence in the US. If American equity markets were to decline by a fifth, as investors become more risk averse, this would cut output growth in 2001 (compared with the baseline forecast) by 0.9 per cent in the US and 0.6 per cent in the Euro Area – even with sharp declines in interest rates.

Qualifications and international mobility: a case study of the European chemicals industry

Heather Rolfe

(National Institute of Economic and Social Research)

Despite measures aimed at promoting free movement, employers in the chemicals industry rarely recruit from other member states, except for specialist positions.

European citizens have had the right to free movement across member states for many years, since 1968 for those in the six founding countries. However, levels of movement have been far lower than expected, particularly since the 1970s. This is puzzling given the higher standards of living enjoyed in some European countries and the opportunities to experience a different way of life which freedom of movement offers.

The chemicals industry might be expected to recruit from far afield because it has high skill requirements and has suffered from skill shortages. However, the research, based on interviews with fourteen employers in a number of member states, found that employers recruit locally wherever possible, nationally when necessary and internationally for selected employees only. While some companies prefer to recruit locally and nationally for broadly 'patriotic' reasons, the main considerations are the cost of international recruitment and the availability of skills nearer to home. The internal training systems established by most companies minimise their dependence on a supply of skilled labour, and allow them to meet most of their skill needs.

Although chemical companies are able to meet their needs for production staff and technicians locally, they generally express a willingness to recruit citizens of other member states. However, they say that they receive very few job applications from residents of other member states.

Employers do, however, look further afield for research and other specialist staff. Companies in the pharmaceutical sector are particularly active in international recruitment of research scientists. As a representative of a French company with a strong research base explained,

'We recruit internationally for research because this widens the search for the best scientific solutions. We have skills shortages in some areas, such as bioinformatics and look to Europe and beyond to recruit these staff because they are in such short supply'.

In the chemicals industry transfer of existing staff is a far more common practice than recruitment from other member states because it is cheaper than external recruitment and allows existing employees to widen their experience of the company's operations. Rarely is this practice extended to non-managerial or non-professional staff. Companies in the chemicals industry strongly value accumulated experience in company practices and a period of absence might involve missing out on new developments. In any case, production workers were believed to be reluctant to move, as one employer remarked,

‘Some of our employees wouldn’t even contemplate moving twenty miles down the road and would find moving from the North to the South (of England) a massive culture shock, so they aren’t likely to apply for a job in Germany’.

Do employers know whether an applicant’s ‘foreign’ qualifications equip them to do the job? This is not easy when there are no common qualifications standards within the chemicals industry for jobs below degree level. The only ‘equivalent’ qualification is PhD, which is an international standard. Employers admitted that they sometimes do not know whether an applicant’s qualifications are equivalent to the national qualification required or preferred for the job. They may therefore under-estimate an applicant’s skills and reject them unfairly. Employers might feel more confident about recruiting some types of applicants, for example technicians, if equivalent qualifications were known and understood. Therefore, if increasing numbers of European citizens are persuaded to take up their right to free movement, employers must ensure that they are not unfairly rejected through ignorance of their qualifications.

Understanding ‘the essential fact about capitalism’: markets, competition and creative destruction

Wendy Carlin, Jonathan Haskel and Paul Seabright
(Written for the Clare Group)

How turbulent and disruptive is the competitive process in modern market economies, and what are the side-effects of the pressures it exerts on firms to improve their productivity? In this article we report evidence from UK manufacturing industry and from a sample of transition countries in Eastern Europe and the former Soviet Union. This shows that :

- Even in the UK productivity growth resembles Darwinian natural selection more than a rational learning process, with entry and exit of industrial plants contributing more to productivity growth than improvements within existing plants.
- In transition economies there has also been a great deal of turbulence and industrial change since the introduction of liberalised markets (contrary to some popular impressions of lethargy on the part of former state-owned firms), but to much less beneficial effect in terms of productivity growth.
- The overall environment within which competition takes place may have an important influence on the effectiveness of the process : a mere willingness to adapt on the part of individual firms is not enough.

In the article we distinguish two ways in which competition works in modern capitalist economies to improve productivity. The first is through *incentives*: encouraging improvements in technology, organisation and effort on the part of existing establishments and firms. The second is through *selection*: replacing less-productive with more productive establishments and firms, whether smoothly via the transfer of market shares from less to more productive firms, or roughly through the exit of some firms and the entry of others. Our evidence from the UK suggests that selection is responsible for a large proportion of aggregate productivity growth in manufacturing, and that much of this is due in turn to selection between plants belonging to multi-plant firms. We also investigate whether the nature of the selection process varies across the business cycle and report evidence suggesting that it is less effective in booms and recessions, contrary to some views about the invigorating effects of adversity on productivity.

Finally, it would seem reasonable to expect that countries which start far behind in the productivity race ought to be able to catch up relatively quickly, simply through copying the leaders. Imitation should be easier than innovation. In fact our evidence from transition economies strikingly refutes this view. It suggests that in the absence of a well functioning competitive infrastructure (a predicament that characterises many poor countries as well as those that were formerly centrally planned), selection may be associated with much more turbulence and a lower rate of productivity growth than in relatively prosperous societies. We report results of a survey of firms in transition economies suggesting that, particularly in the former Soviet states (excluding the Baltics), poor output and productivity performance has not been due to an unwillingness on the part of firms to change and adapt. On the contrary, there has been a great deal of restructuring,

much new entry and large reallocations of output between firms; but such activity has been much more weakly associated with improved performance than we would expect in established market economies. We conclude the paper with some discussion of policy implications.

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. Wadhvani 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.

The inflation forecast

Charles Goodhart
(London School of Economics)

Given the long and variable time lags between interest rate changes and responses in output and inflation, an inflation forecast must lie at the heart of monetary policy. In the UK the Bank's inflation forecast and Report were developed when the interest rate decision still lay with the Chancellor. Its, largely unchanged, continuation has led to certain tensions once that decision was delegated to a Monetary Policy Committee of independently responsible experts. In this paper the question is raised whether such a Committee should be jointly and individually responsible for the inflation forecast, and what might be considered as alternative procedures.

There are bound to be differences in views between the members of MPC, each of whom is individually responsible. Such disagreements in practice became sufficiently acute that the MPC's forecast could only proceed under the umbrella of a single, unified Inflation Report if some account of these differences was publicly expressed, e.g. in Table 6B. This has led to some confusion between the uncertainty inherent within any single forecast and the range of views between the members of MPC.

Would the situation be improved by other modes of forecasting, i.e. shifting the responsibility for the forecast elsewhere? Goodhart considers various alternatives. The only one which he considers preferable to the present system would be for the Governor to take the final individual responsibility for the single forecast, but this to be 'approved' by the MPC, as laid down by the Bank of England Act.

The economic effects of business to business internet activity

Martin Brookes and Zaki Wahhaj
(Goldman Sachs International)

A constant feature of industrial economies is change in the ways businesses operate to produce goods and services. Such changes are the foundation of productivity growth over the long-term. An integral part of this process is technological innovation which, in recent decades, has becoming increasingly linked with information technology.

Despite the growing use of IT, it has long been difficult to discern any clear boost to economic growth. Recent studies have found that at the firm level, this paradox is more apparent than real, as ICT capital investments have made a substantial contribution to output and productivity, particularly when complemented by other forms of investment such as software and training.

Much IT spending in economies is now focused on the internet. Until recently most discussion of the role of the internet in the economy concentrated on the retail sector and the growth of online retailers. But the greatest impact of the internet is likely to be felt elsewhere in the economy. Projections of growth of business transacted over the internet show that values of business-to-business transactions are likely to form the dominant part of e-commerce. Such "B2B" use of the internet is growing rapidly and is expected to continue growing strongly.

There is reason to believe that B2B commerce will have a significant economic impact over and above the normal process of innovation and productivity growth. Two factors account for this suspicion. First, the size of the impact of B2B. Second, the speed of its development.

B2B commerce is enabling companies to achieve dramatic savings in the costs of production. As it becomes more widely adopted the savings should be felt across large sectors of industrialised economies. This represents a positive supply shock, boosting potential GDP. The shock will reduce aggregate inflation pressure in economies, prompting central banks in industrialised countries to ease monetary policy and producing stronger economic growth.

Therefore, the net effect is likely to be higher GDP and not lower inflation. It is possible to make quantitative estimates of the impact of B2B commerce on inflation, growth and interest rates in industrialised countries using the input-output accounts published by national statistical agencies and standard macroeconomic models. The direct benefit of B2B is to produce aggregate cost savings of up to 4%. Using the IMF's macroeconomic model Multimod, the aggregate cost savings translate into an estimated boost to output of 5 per cent in the major industrialised countries. The impact will take many years to feed through, boosting trend growth in industrialised countries for more than a decade.