

National Institute Economic Review

No. 185

July 2003

Executive Summary

The *Review* is the quarterly publication of the National Institute of Economic and Social Research. Each issue contains a survey of the economic situation and prospects in the UK and in the World. In addition there are articles which cover related issues in greater depth.

The latest issue is published on:

Friday 25th July with a release time to the press of
00.01 hours on that day.

The July 2003 edition contains the following research articles:

- **Benchmarks and targets under the SGP. Evaluating safe deficit targets using NiGEM**
by Ray Barrell and Ian Hurst
- **Annualised hours contracts: the way forward in labour market flexibility?**
by David N.F. Bell and Robert A. Hart
- **The domestic performance of UK multinational firms**
by Sourafel Girma
- **Foreign ownership, microelectronic technology and skills: evidence for British establishments**
by Dirk Willem te Velde

The UK economy

by Ray Barrell, Simon Kirby, Rebecca Riley and Martin Weale

- We expect GDP to grow by 1.9 per cent in 2003 and by 2¾ per cent in 2004 and 2005.
- Consumer spending will increase by 2.2 per cent this year and by 1.5 per cent in 2004.
- If world trade growth does not accelerate next year, output will be 0.5 per cent lower by the end of 2005.
- We do not expect any substantive change in monetary policy from the adoption of a new inflation target at the end of the year.
- Public sector net borrowing will rise to 3 per cent of GDP in 2004–5 and remain above that level in the following two years.

The UK economy will grow by only 1.9 per cent in 2003

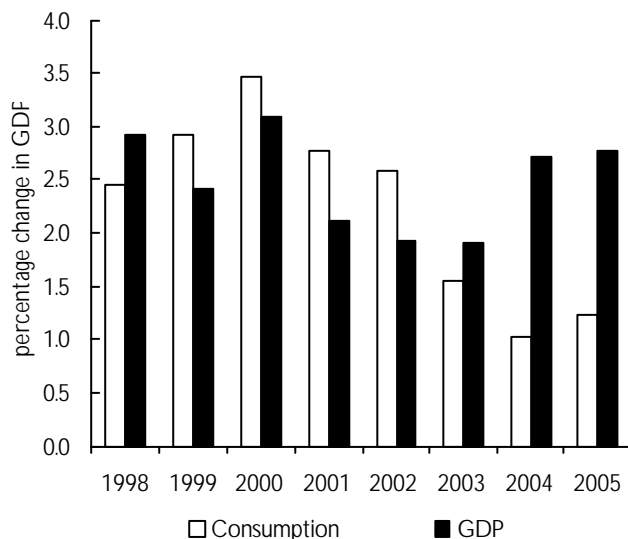
After growing by only 0.1 per cent in the first quarter, the economy picked up speed in the second quarter, growing by 0.4 per cent according to National Institute estimates. Our forecast envisages a further acceleration to above-trend rates of quarterly growth in the second half of the year. This tempo of expansion should be sustained in 2004, resulting in growth of 2.7 per cent. However, the slow start to this year means that the economy will grow by only 1.9 per cent in 2003, the same as in 2002.

The consumer boom has ended. Over the past seven years, consumer spending grew by more than 4 per cent a year. But in the three years to 2005, it will grow by less than 2 per cent a year. The consumer boom is over because real income is rising much less rapidly, taxes on income have risen and saving from disposable

income is set to increase.

Real disposable income will grow by only 1.5 per cent this year and by 1.7 per cent in 2004. The savings ratio will rise from 4.3 per cent in 2003 to 5.6 per cent in 2005.

Share of growth accounted for by consumption



Inherent weakness in domestic demand in the Euro Area is holding back export performance. If we saw a 4 per cent reduction in imports into the Euro Area, caused by weak demand rather than by a realignment of the

exchange rate, output would be 0.5 per cent lower after two years. Interest rates would be cut by 50 basis points.

In constructing the forecast, we have assumed that the change in the inflation target from the Retail Price Index excluding interest payments to the Harmonised Index of Consumer Prices will not affect the short-term stance of monetary policy. The National Institute has investigated the path of interest rates if the Bank of England had been operating with the HICP measure of inflation since 1997. It finds that the switch might have loosened monetary policy in 2000 but not at other times, assuming that the Bank focuses on underlying inflation.

The current UK budget will run a deficit of £12 billion in 2004–5

The outlook for the public finances remains gloomy. The current budget will run a deficit of £12 billion in 2004–5. There is a 67 per cent chance that the current budget will be in deficit in 2005–6. Net borrowing will increase to £34 billion in 2004–5 and to £40 billion in 2005–6. The deficit under the Maastricht definition will exceed the treaty limit of 3 per cent of GDP in both 2005–6 and 2006–7. Public sector expenditure on goods and services and on investment will account for around 1 percentage point of GDP growth this year and next.

The world economy

by Ray Barrell, Bettina Becker, Amanda Choy, Sylvia Gottschalk, Dawn Holland and Olga Pomerantz

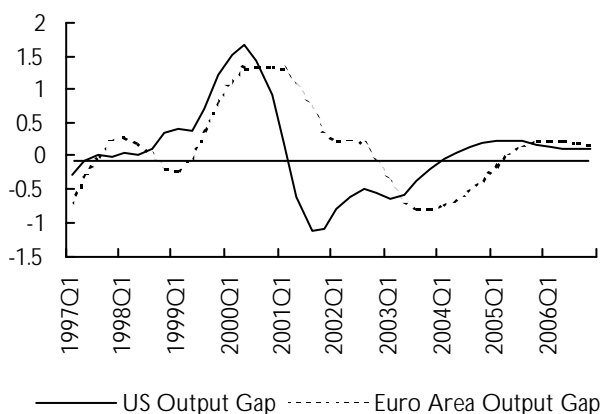
- **The recovery in the global economy has stalled: world GDP will grow by only 2.9 per cent this year, a little lower than in 2002, and by 3.2 per cent in 2004.**
- **American GDP will increase by 2.4 per cent in 2003 – no higher than last year – and by 3 per cent in 2004.**
- **The Euro Area will experience even slower growth this year than in 2002: GDP will rise by 0.6 per cent in 2003 compared with 0.8 per cent last year.**
- **The Japanese economy remains weak, with growth in GDP of 0.7 per cent this year, rising to 1 per cent in 2004.**

An upswing in world trade has been postponed to 2004

The world economic recovery is proving to be a more modest affair than expected, in part because of the short-term impact of the continuing realignment of the euro and the dollar. We have lowered our forecast for GDP growth in 2003 from 3.2 per cent in April to 2.9 per cent. The upswing in world trade has been postponed to 2004, when it is forecast to rise by 7 per cent. It will grow by only 3.2 per cent this year, less than in 2002. With the Euro Area performing so poorly, a continuing global recovery is now heavily dependent upon the United States.

The US will grow more rapidly than any other G7 economy in 2003 and 2004, but the pace of expansion will be moderate compared with the late 1990s. The overall environment for business investment has improved, but the positive influences have been partly offset by the rise in long-term real interest rates caused by the escalating budget deficit. These factors are likely to reduce consumption growth in the medium term, and this has led us to lower our forecasts for average growth rates from 2004 onwards.

Output gaps in the world economy (% of potential GDP)



Because of weaker business investment we have halved our previous growth forecast for the Euro Area in 2003, lowering our output projections by at least 0.4 percentage points for Italy, France, the Netherlands, Germany and Austria. Inflation is expected to decline to about 1 per cent next year. There is a 15 per cent probability of deflation

in 2004. Weak growth is testing the commitment of some European governments to keep budget deficits below the stability pact's ceiling of 3 per cent of GDP. France and Germany are expected to breach that limit in 2004 for the third consecutive year.

The prospects for Germany are especially bleak

The prospects for Germany, which accounts for almost a third of the Euro Area's GDP, are especially bleak. The economy will be at a standstill for the second successive year in 2003 and GDP will increase by only 1.3 per cent in 2004. The risk of deflation is high, with a probability of over 40 per cent next year; the odds would exceed 50 per cent if the euro were to appreciate by a further 5 per cent.

Japanese Domestic demand is forecast to grow by only 0.2 per cent this year

The Japanese economy remains vulnerable to a setback in the global economic recovery. Domestic demand is forecast to grow by only 0.2 per cent this year and by 0.4 per cent in 2004. So GDP growth will continue to rely upon net trade. However, exports are growing more slowly in 2003 because of weakening demand in Asian markets.

Benchmarks and targets under the SGP. Evaluating safe deficit targets using NiGEM

by Ray Barrell and Ian Hurst
NIESR

Some redesign of the SGP appears inevitable

The Euro Area Stability and Growth Pact (SGP) has come under strain, with Germany, France and Portugal all breaching the conditions of the Pact. All have continuing deficits in excess of 3 per cent of GDP, and there appears to be little political will to deal with these breaches. The expansionary fiscal policies of the two largest countries in the Euro Area have called into doubt the sustainability of the Pact, and some redesign appears inevitable.

It is difficult to conceive of European Monetary Union without a Pact of some form, and the potential causes of variations in budget deficits have to be taken into account when designing any new pact. In this note we use our model, NiGEM, to discuss the variability of budget deficits and the potential safe limits if breaches are to be avoided.

We discuss minimum benchmarks for fiscal policy and budget targets that are relevant to any fiscal pact the Euro Area might adopt. We conclude that a commitment to keep deficits within bounds is consistent with setting a medium term target for the deficit of 1 per cent of GDP.

1. If all Euro Area country face shocks of the same magnitude as the more fortunate countries in the last decade then setting targets of 1 per cent of GDP would mean breaches of a 3 per cent floor would be rare.
2. Some countries face large shocks. Allowing automatic stabilisers to work does not mean large deficits. Large shocks are often associated with changes in the supply side of the economy, when fiscal deficits are counterproductive.
 - a. Deficit targets of 1 per cent of GDP are acceptable if there is a willingness to deal with large supply shocks.
 - b. Using the automatic stabilisers for demand shocks stabilises output.
 - c. Offsetting the automatic stabilisers when there is a supply shock stabilises output
3. The optimal set of fiscal targets for the UK are largely unaffected by the choice of the exchange rate regime.

The large deficits we see in France and Germany are largely the result of a political decision to loosen the fiscal stance

The large deficits we see in France and Germany are largely the result of a political decision to loosen the fiscal stance. This is inconsistent with the intentions of the SGP, but is unlikely to have been particularly productive in raising output.

Annualised hours contracts: the way forward in labour market flexibility?

by David N.F. Bell and Robert A. Hart
Department of Economics, University of Stirling

Annualised hours contracts offer a number of advantages for both companies and their staff

What if working time were organised by annual hours rather than weekly hours? New research by Professors David Bell and Robert Hart explores the impact of 'annualised hours contracts' (AHCs), a way of arranging hours of work that currently covers 3-4% of British employees. Their study suggests that AHCs offer a number of advantages for both companies and their staff: hourly wages tend to be higher; overtime is lower; job security is stronger; plant capacity is used more efficiently; and firms enjoy greater flexibility in scheduling work and responding to demand for their products.

UK industry has been dominated by the organising of working time around the working week. But there are other ways to arrange working time: it could be organised around an annual cycle rather than a weekly one, as with AHCs. Such an arrangement offers firms more flexibility in the way they use their workforce. And employees generally benefit by being paid higher wage rates for agreeing to join an AHC.

Management and workers agree on a number of annual hours

In a typical AHC, management and workers agree on a number of annual or 'rostered' hours. Leaving aside holidays, rostered hours may vary over the year, so that, for example, the firm is better able to meet seasonal fluctuations in demand. AHCs also include rostered shift systems.

Workers may also agree to an annual number of reserve hours to provide additional flexibility

As well as rostered hours, workers may agree to an annual number of reserve hours. These hours are used to provide additional flexibility. For example, they can be used to meet unforeseen events such as short-run upward surges in demand or abnormal absenteeism. They can also be used to cover planned events that support production and service activities such as training courses, planning meetings and company briefings.

Several major British companies - including BP Chemicals, Blue Circle Cement, ICI Chlor Chemicals, Grampian University Hospitals NHS Trust, Manchester Airport, United Distillers, Samsung Electronics, Tesco Stores and Zeneca - have implemented AHCs. But Bell and Hart's research is the first to investigate the use of AHCs in depth across the whole British economy. Their results, based on the UK Labour Force Survey, show that:

- AHCs presently cover about 4% of full-time female and 3.3% of full-time male employees in the UK.
- Employees covered by AHCs are often union members. While it may seem paradoxical that unions are required to help bring about greater working time flexibility, AHCs are complex and require extensive bargaining between employers and employees before they can be implemented. Unions provide a focus for such bargaining.

Hourly wage under an AHC is estimated to be 14% higher

- The hourly wage under an AHC is estimated to be 14% higher than the hourly wage under an equivalent standard contract. This is the average hourly return that employees make from switching to an AHC.
- AHCs are associated with those companies that experience relatively volatile and unpredictable movements in the demand for their products.
- Employees with AHCs experience more variation in their hours over the working year. This seems to suggest that AHCs provide flexibility of hours over and above the standard contract.
- AHCs are strongly associated with a desire to obtain more plant utilisation over the working year, particularly associated with the operation of complex shift systems. For example, AHC organisations are more likely to operate complex Continental-type shift systems and/or more weekend and bank holiday working.

AHCs may be a useful device for bringing stability to a workforce

- Employees involved in AHCs have been in their jobs for a long time, regard their jobs as permanent and are not interested in seeking new employment. This is a strong argument in favour of AHCs: they may be a useful device for bringing stability to the workforce.

The authors conclude that there is room for a greater adoption of AHCs especially among large companies that require complex scheduling arrangements. However, it is unlikely that AHCs will be a dominant form of working time arrangement in the foreseeable future.

The domestic performance of UK multinational firms

by Sourafel Girma

Department of Economics, University of Leicester

Is the performance of a multinational company dependent on the home country it is based in? Or are all multinational companies equally efficient? It is important to investigate this issue for a more targeted policy that encourages the flow of inward investment. For example, if what matters is multinationality alone, irrespective of home country status, then governments should perhaps direct some of the resources they are currently devoting to attract "foreign" multinationals, towards encouraging indigenous firms to become multinationals.

This research tries to find out whether U.K multinational companies have a "home advantage" over "foreign" multinationals that are plying their trade in the U.K, and it reaches to two major conclusions:

The performance of UK multinationals in the UK is not as impressive as their foreign counterparts

(a) The performance of U.K multinationals in their "own turf " is not as impressive as their foreign counterparts, specially US-based multinationals. This finding lends support, albeit indirectly, to the concern voiced by economists and policy makers alike that the productivity of the U.K is lagging behind its major international competitors.

(b) Unlike "foreign" multinationals, U.K-based multinationals are found be ineffective when it comes to transferring their special know-how to their newly acquired subsidiaries. This would appear to vindicate the effort undertaken by policy makers in the U.K to attract incoming foreign direct investment.

Foreign ownership, microelectronic technology and skills: Evidence for British establishments

by Dirk Willem te Velde
Overseas Development Institute

Foreign owned establishments lead the adoption of new micro-electronic technology

Foreign owned establishments lead the adoption of new micro-electronic technology. This conclusion is based on new research using the Workplace Employee Relations Survey panel for 1990-1998. A detailed analysis of the adoption of 11 types of micro-electronic technologies in 1990 and 1998 shows that "foreign owned establishments were quicker to adopt new technologies, but by 1998 the domestically-owned establishments made more use of new technologies than did foreign-owned establishments". All technologies were introduced in the 70s and 80s and include data and word processing, design, machine and process control, automated handling and storage, retail applications, quality control and others. The analysis applies to 560 private establishments representative for all British private firms with more than 25 employees.

Private manufacturing firms competing with firms abroad are quicker to adopt more technologies

The research also finds that private manufacturing firms competing with firms abroad are quicker to adopt more technologies: "for 1998....it is not foreign ownership as such but exposure to foreign competition (at home or abroad) that determines the adoption of technologies."

Foreign ownership is also found to affect the structure of the labour market: "foreign-owned establishments employ fewer skilled manual workers but more professional and technical workers". However, there is some variation by location of the foreign parent firm. US, Canadian, and non-UK EU-owned establishments employ more senior managers and senior technical and professional workers than British owned establishments, whereas other foreign establishments, including Japanese, employ more administrative and clerical workers.