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Assessment and recommendations

Growth has slowed less than elsewhere...

Growth has slowed since the summer of 2000, falling from significantly above to just below potential, but held up better than in the other major OECD economies. A series of domestic shocks, including the most severe foot-and-mouth disease crisis ever to hit the country, bad weather conditions and rail disruptions, do not appear to have had much adverse effect on overall economic activity, and the slowdown has mostly stemmed from global factors, notably the unwinding high-tech bubble and faltering overseas demand. This has been reflected in a decline in total fixed capital formation in the first half of 2001, notwithstanding a pick-up in government investment and resilient residential investment. The weakening of activity since late 2000 will be reinforced by the economic consequences of the 11 September terrorist attacks in the United States.

... but domestic and external imbalances continued to build up

While macroeconomic performance has been good overall, concerns about growing domestic and external imbalances have heightened. To date most of the private services sector has continued to grow relatively strongly, and construction activity has strengthened, contrasting sharply with weakening activity in the internationally-exposed industries, especially in parts of manufacturing. While the high-tech industries have been disproportionately hit by the slowdown in global demand this year, the persistent strength of sterling against the euro has continued to put pressure on the more traditional manufacturing industries. It has severely squeezed output, profit margins and employment in manufacturing, which went into a recession in the first half of 2001. Volume growth of imports has consistently outpaced that of exports, and the trade deficit has widened further this year. One counterpart of this emerging

imbalance has been the sharp fall in the household saving ratio since 1997, as macroeconomic stability, including sustained low inflation, and strong gains in wealth have reduced the appetite for saving. This has been associated with buoyant private consumption underpinned by strong household confidence, which was further bolstered in the first half of 2001 by falling interest rates, rapidly rising house prices and vigorous after-tax income growth.

***Unemployment
has declined
further...***

Despite the job losses in manufacturing, total employment has continued to expand. Lately, this has been helped by the first rise in public sector employment in two decades, reflecting stepped-up recruitment in education and, to a lesser extent, by hospital trusts. While the employment rate has continued to rise, the unemployment rate, based on the labour force survey measure, has come down further from already fairly low levels by historical standards, and has stabilised at close to 5 per cent since spring 2001. It has dipped below most estimates of the rate that is compatible with stable inflation, indicating that the labour market has indeed become pretty tight.

***... while inflation
has remained
subdued***

Wage growth has been relatively subdued so far, however, and consumer price inflation has been remarkably low. Indeed, on the harmonised measure (HICP), the United Kingdom has had the lowest inflation rate of all European Union countries since February 2000, averaging close to one per cent, against 2.5 per cent in the euro area. On the domestic measure of retail prices excluding mortgage interest payments (RPIX) as targeted by the central bank, inflation has averaged 2.1 per cent over that period, below the 2½ per cent monetary policy target. Various measures of core inflation have run below 2 per cent. To a considerable extent, this has reflected the lagged impact of the exchange rate appreciation. More recently, inflation has picked up to around target, partly due to the impact of poor weather and of the foot-and-mouth epidemic on food prices and partly because the exchange-rate effect is waning.

***The outlook holds
serious risks...***

The projection is for growth to drop below potential in 2002, as confidence has deteriorated after the terrorist attacks in the United States, with a recovery reaching potential growth by 2003. However, fiscal measures on both the

tax and on the spending side provide a significant demand stimulus, so that the slowdown should be less severe than in most other European OECD countries. Accordingly, inflation is projected to remain close to the target. This seemingly benign baseline will depend in large part on the outlook overseas, but in any case the underlying imbalances are projected to worsen and cannot continue to do so indefinitely. Therefore, the probability that they would unwind abruptly is on the rise. One key adjustment channel would be a re-alignment of exchange rates, plausible in the light of most assessments of the fundamentals but which so far has failed to materialise, and which UK policymakers cannot readily make happen. Depending on the circumstances, speed and extent of such an exchange rate shift, the effect on growth and inflation might be significant.

... which represents a challenge for setting the right policy stance

While monetary policy has already been eased considerably, the monetary authorities should stand ready to move swiftly if the underlying imbalances in the economy were to unwind abruptly or the economy to slow even more than expected. The more restrictive policy stance in 2000 reflected above-potential growth. It has eased in 2001, but reaction lags imply that its impact will be felt mostly next year. If the international environment were to weaken further while the exchange rate remained broadly unchanged, a further relaxation of monetary policy would be called for. Indeed, reversing a cut in interest rates which, with hindsight, was seen to be unnecessary would probably be less costly than excessive caution in the UK context, since central bank credibility is well-enough established to weather such a reversal. If, in contrast, the exchange rate were to fall sharply, monetary policy would need to relax by less or may even have to tighten to offset the external stimulus on demand and inflation.

Inflation targeting has functioned well thus far, but some aspects of the framework may yet evolve

While monetary policy has been successful over the past several years, questions have been aired about the framework underpinning monetary policy. A number of them have been addressed very transparently by the Bank of England, including in the context of an external and published audit. One issue, which pertains to the remit set by the Government, is the possible reformulation of the target in terms of the HICP – the harmonised index used for international

comparisons across the European Union – as opposed to the well-known national measure RPIX. Switching from the RPIX to the HICP might be desirable at some point in the future, not least because the HICP formula is less susceptible to an upward bias in measured inflation. However, the HICP as it currently stands excludes owner-occupied housing costs, and it may be wise to wait until agreement is reached at European level on how to include these. Another issue, which may become more prominent in case of the adoption of the HICP, is a lowering of the numerical target. In spring 2001, the Treasury reconfirmed the key elements of the framework, including the target itself and, more fundamentally, the position of the Government on joining the euro area. Abstracting from what adopting the euro would call for, the authorities seem to sense that it may be too early, too risky and not obviously profitable to amend a still relatively recent framework. With respect to the adoption of the euro, the position spelled out back in October 1997 remains unchanged: this option will be put to Parliament and to voters at large if and when the Treasury assesses that the economic case can be made, unambiguously, that joining the euro area would benefit the UK economy. The assessment is due by mid-2003.

The Government is increasing spending on its key priorities

Budgets in the late 1990s embodied significant fiscal consolidation. *Ex post*, the stance was even tighter than planned, with revenue higher and spending lower than budgeted. As a result, fiscal stock and flow ratios now look very comfortable, leaving room for the automatic stabilisers to operate unfettered in the event of a slowdown. They also offer room to address some long-standing problems, most prominently the poor quality of public infrastructure and some key public services, which not only reflects that available resources are not properly mobilised but also results from a long period of under-funding. Public spending is therefore being stepped up in some areas – notably public transport, health and education. Going forward, the imperatives stemming from the current budgetary framework and a legacy of under-investment imply that the structural fiscal position will move from a small surplus at present towards a deficit of around one per cent of GDP over the medium term. This is in line with the projections set out in Budget 2000 and confirmed in Budget 2001, and implies a significant easing over time.

The budgetary framework has addressed earlier weaknesses...

The fiscal framework has evolved considerably in recent years and is the subject of a special chapter in this *Survey*. The current spending plans are consistent with the medium-term budgetary framework introduced in 1997. The latter had addressed a number of weaknesses of the former regime, notably a bias against capital expenditure and, more generally, poor conditions for longer-term planning adversely affecting central government spending departments, local authorities and public enterprises. Departmental spending was indeed characterised by pronounced swings and capital spending was squeezed to very low levels. The Government considers that these weaknesses are the major cause for the poor performance of crucial public services. Improvements in this regard are seen as key to enhancing economic growth and welfare. At present, the core of the budgetary framework consists of biennial Spending Reviews, comprising a set of three-year plans for discretionary expenditure, specified per department, called Departmental Expenditure Limits. Remaining expenditure (mostly social security) is managed separately on an annual basis. Once agreed, the Treasury is committed to funding the projected levels of discretionary expenditure. However, in exchange spending departments are being held accountable for achieving their policy targets, which are specified in Public Service Agreements.

... and is built upon transparent and simple fiscal rules, although these need to be interpreted with care

To prevent capital expenditure embodied in the expenditure limits from being squeezed, the framework includes a “golden rule” which states that, on average over the economic cycle, current expenditure should be funded through current revenues whereas investment may be debt-financed. Therefore, in the event of a permanent fall in government revenues, current, not capital expenditure would be affected *a priori*, while cyclical fluctuations in revenues should not affect discretionary spending at all. The golden rule is complemented by a “sustainable investment rule” stipulating that public sector net debt should remain at a prudent level. Together, they are instrumental in pursuing several key objectives of budgetary policy, including a better allocation of resources, macroeconomic stability and fiscal sustainability. The rules improve the prospects for intergenerational fairness, but do not ensure it. For example, the national accounts definition of current and capital

spending on which the golden rule is based neglects the fact that the effects of benefits resulting from current expenditure in areas like education extends well beyond the current fiscal year. The rules support the notion that those generations who benefit from public spending should meet, as far as possible, the costs of the services they consume. However, the rules' contribution in this regard cannot be fully assessed satisfactorily without knowing the ultimate incidence of the costs and benefits of both public expenditure and taxation, although long-term projections and generational accounting, both of which the Government undertakes, can be helpful in this respect. There is also an associated risk of misallocation of resources to the extent that the fiscal rules favour fixed over human capital formation, which heightens the need for careful cost-benefit analysis prior to expenditure decisions. While the Council of the European Union has noted that in the medium-term the government's finances would not be in line with the prescription of "close to balance or in surplus" contained in the Stability and Growth Pact, the fiscal projections are sufficiently prudent.

Target-based expenditure planning is laudable, but its effectiveness should be enhanced

While the principle of target-based expenditure planning is laudable, past experience has revealed some scope for greater effectiveness in its implementation. The formulation of targets has improved considerably since their introduction, as they have become better geared to relevant policy outcomes as opposed to inputs and processes. However, it is important that spending departments do not focus excessively on quantifiable targets to the detriment of harder to specify but perhaps equally important policy objectives. Ministers are responsible for delivering their targets published in Public Service Agreements. Where departments fail to meet targets, they will be held to account on the basis of a process of regular reviews. The achievement of the targets is currently audited within the central administration, but with much information being made available publicly, there is a strong public commitment to deliver on the targets by the Government. Appointing an external auditor such as the National Audit Office might, however, strengthen the framework further. Meanwhile, the Government could take further steps to encourage good performance against targets by more systematically granting

financial bonuses or other forms of rewards to departments or teams that perform well.

Experience with public private partnerships is mixed, and a broader range of options might be explored

The Government intends to expand the involvement of the private sector in the funding and operation of the public capital stock where this is expected to yield gains in operational efficiency, through public-private partnerships. Around one-third of net public infrastructure investment is currently carried out under this regime. However, experience to date with such partnerships has been mixed. Through public-private partnerships, the Government purchases the services of public infrastructure, rather than the infrastructure itself, from a private provider, which may result in cost savings. In some cases the Government also participates in the capital of the provider through a joint venture. The advantages of this set-up are that partnerships can be tailor-made, while private sector skills are introduced in the public sector and benefits from higher efficiency may be shared with taxpayers. The flip-side of such arrangements is that the taxpayer may also bear the financial risk of failure. Moreover, some potential efficiency gains may be foregone, because the incumbent provider likely faces less market scrutiny as compared with a situation where the purchaser-provider link would be looser. Therefore, the Government should carefully weigh the pros and cons of entering into partnerships as a shareholder, and, more generally, reduce its dependence on the incumbent franchise or concession holders. Overall, the current plans to provide services privately in sectors such as health and education are limited. Such services are provided on a much larger scale privately in many OECD countries and greater ambition in this respect would raise competition and performance in these sectors.

Funding of local government could be better geared to promote effective public expenditure

Like many OECD countries, the United Kingdom is grappling with difficulties in striking an appropriate balance between mobilising local authorities (county, district and town councils) for the delivery of national priorities and ensuring accountability *vis-à-vis* their own electorate. A particular challenge in the UK context is the need to reform the grant distribution system, which is complex and controversial, not least because of growing *ad hoc* “ring-fenced” grants

to promote national policy goals. The new budgetary framework has aimed to bring greater predictability and stability to local authority funding, with the Spending Reviews setting firm funding for three years. However, funding could be organised in a way that better reflects the demarcation lines between public expenditure programmes that are their own responsibility and those that are within the domain of central government. In particular, while national priorities should be grant-funded, local governments could be given more freedom to levy fees and charges that reflect the marginal cost of provision of local public services.

The United Kingdom faces a productivity challenge

In addition to the need to raise the effectiveness of the public sector, the United Kingdom also faces the challenge to increase the low level and modest growth of productivity in the private sector – issues that are intertwined. By international standards, investment in both human and physical capital has been weak and sluggish productivity growth is an important reason for the longer-term decline endured by manufacturing. The Government has long recognised the problem, and numerous initiatives, big and small, have been launched to address it. Changes have frequently been made to policies that have yet to fully run their course, complicating business and household decisions and making it hard to administer and evaluate the measures. Assessing their effectiveness is also hampered by their incremental nature. While the thrust of the Government's reform agenda is commendable, it should be pursued in a way that fosters greater stability in the policy environment.

Investment in human capital has been stepped up but remains insufficient

While the United Kingdom enjoys a low unemployment and high employment rate by European standards, exclusion of low-skilled workers from the labour market and attendant poverty remain high, distressingly so in some localities. To some extent, this is because the education and training systems have failed to provide the right skills. Efforts to remedy this have been intensified in recent years, including via the hiring of more teachers. Pay scales remain overly rigid, however, and further differentiation in teachers' remuneration packages might help relieve the remaining bottlenecks. Literacy and numeracy targets have been set and on those measures progress is being made. At the executive

level, a deficit in homemade managerial talent, both in the private and in the public sector, has necessitated hiring managers from overseas. Similarly, teachers and nurses are being recruited abroad to fill supply shortages. Joblessness can also reflect insufficient incentives to take up a job. However, the working families tax credit and the national minimum wage, both in place since 1999, strengthen these incentives. Combined with other tax and benefit changes, they have had a significant redistributive impact in favour of families with children and pensioners, partly offsetting the trend widening in income disparity. The various welfare-to-work “New Deal” programmes also reinforce work incentives for those who are on the fringes of the labour market. This approach appears to deliver worthwhile results for some labour market groups, despite the inevitable deadweight losses and the difficulties many programme participants face in finding a stable job. In a tightening labour market, the hardest to help account for an increasing proportion of the New Deal client group. This highlights the importance of the personalised advice provided to enhance their employability and justifies the increase in the degree of benefit-conditionality in the New Deal which was prompted by initial problems in its implementation. More can be done, however, notably by reforming the council tax credit and the housing and disability benefits, so as to lower further the high marginal effective tax rates still faced by some of the jobless.

Measures are being taken to unleash competitive forces...

The regulatory environment, broadly defined, inhibits competition less than in most other OECD countries. Even so, earlier *Surveys* have noted that there is scope for lowering market entry barriers. Recent measures include the creation of a research and development (R&D) tax credit for small and medium-sized enterprises, which is to be extended to large firms, although in what form remains to be determined. Efforts at streamlining regulation have also been deployed, although at the same time a considerable volume of new regulations has continued to be introduced. New proposals have been launched in 2001 to go further on several fronts. An Enterprise Bill is in the works, which *inter alia* would make cartel behaviour a criminal offence, revamp merger control and reform bankruptcy rules. The proposed toughening of the antitrust framework and proposals to

depoliticise merger control are welcome, and should be swiftly enacted. As regards the regulation of utilities, the remit of the regulators should be better focussed on competition issues, with the environmental and social agenda delegated to the competent ministries.

... and entrepreneurial spirits

Entrepreneurs generally face a better business environment in the United Kingdom than in most other OECD countries. Nevertheless, earlier *Surveys* have highlighted various institutional factors that discourage risk-taking. In particular, the stigma of bankruptcy remains an impediment to business creation. The proposed measures – including the abolition of government agencies' privilege to be paid before other creditors and easier involvement of external administrators – attempt to facilitate a fresh start for those who failed honestly while sanctioning those who abuse creditors. This distinction might be difficult to make in practice, however. Another strand of work is the review of company law. So far, the latter has evolved piecemeal, incorporating European directives and responding to corporate scandals as they arose. As an overall set of rules, it has become arcane and out-of-date. A large, albeit not exhaustive set of recommendations has now been tabled to modernise company law, a notable omission being measures to tighten the link between managerial performance and compensation. Many would represent genuine improvements but should now be combined into a new body of law that can be enforced in practice. Moreover, rendering the traditionally uncertain and slow urban planning system more business-friendly is urgently needed.

Efforts are underway to enhance the safety and efficiency of financial markets

One of the major recent reforms in the financial sector has been the creation of an integrated regulator, the Financial Services Authority (FSA), in place of the nine supervisory entities previously responsible for prudential and conduct-of-business supervision. With financial institutions increasingly engaging in a range of business activities crossing traditional functional boundaries, this centralised approach has some clear advantages. It provides these institutions with a single regulatory interlocutor, reduces the risk of inconsistent regulation and regulatory arbitrage and facilitates the understanding and monitoring of individual

financial institutions' risks. A potential risk would be that the lender of last resort is not sufficiently well informed about the development of financial institutions, but this issue has been addressed by a memorandum of understanding between HM Treasury, the Bank of England and the FSA, and regular – formal and informal – contact between the three institutions. The new framework has not been tested yet by a genuine recession or by a major financial institution failure, but some smaller scale pension saving problems have highlighted that supervision is intrinsically difficult because there is a trade-off between ensuring competition and consumer protection. Moreover, the Government should implement the measures recently put forward concerning pension funds, in particular stricter requirements as regards trustees' professionalism, as these may help prevent future mishaps.

Summing up

Overall, the United Kingdom's macroeconomic performance has been robust. Growth has slowed only little so far and unemployment has declined further than most observers expected, without igniting inflationary pressures. While sound monetary and fiscal policies have contributed to greater macroeconomic stability, domestic and external imbalances have been building up and some deep-seated structural problems endure, as acknowledged by the authorities themselves. In particular, productivity growth remains disappointing. Furthermore, while the sheltered sector has expanded rapidly, manufacturing continues to be in structural decline, moving into recession this year due to faltering overseas demand, and in particular the global ICT slump. These developments came on top of persistent sterling strength against the euro, which had already made trading conditions tough. Looking ahead and taking into account the heightened downside risks due to the recent terrorist attacks in the United States, further interest rate cuts might be required, unless a sharp fall in the exchange rate were to boost demand and inflation. Fortunately, the impressive fiscal consolidation in recent years is providing ample room for the automatic stabilisers to operate in the event of a sharpening downturn. Due to the previously announced trend increase in public expenditure aimed at addressing longstanding under-investment in public services, the fiscal stance is loosening significantly over time from its current

strong position. In particular, government spending on health, education and infrastructure will rise significantly, though the authorities will need to ensure that the improvements being sought are implemented efficiently. In exchange for more stable funding, spending departments will be held accountable for results. To improve productivity performance and also to lower poverty among marginalized groups, further efforts are needed to raise human capital and work incentives, to reduce obstacles to entrepreneurial activities, and to strengthen competitive pressures. Continuing with a focussed and well-prioritised programme of structural reforms to address remaining weaknesses, while preserving the gains from building a more stable and predictable framework for macroeconomic policy, offers the best prospect for continuing good economic performance in the present uncertain global environment.

Glossary of acronyms

AGM	Annual General Meeting
AME	Annually Managed Expenditure
BRTF	Better Regulation Task Force
BSP	Basic State Pension
BT	British Telecom
CC	Competition Commission
CGT	Capital Gains Tax
CTC	Children's Tax Credit
CVA	Company Voluntary Arrangements
DEL	Departmental Expenditure Limit
DGFT	Director General of Fair Trading
DMCI	Dynamic Monetary Conditions Index
DTI	Department of Trade and Industry
EC	European Commission
ECB	European Central Bank
EMI	Enterprise Management Incentive
ETF	Environmental Task Force
EU	European Union
EUR	Euro
FMD	Foot-and-Mouth Disease
FSA	Financial Services Authority
FSCS	Financial Services Compensation Schemes
FTET	Full-Time Education and Training
FY	Financial Year
G10	Group of ten countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, United Kingdom, United States) plus Switzerland
GAR	Guaranteed Annuity Rate
GDP	Gross Domestic Product
GP	General Practitioner
HB	Housing Benefit
HICP	Harmonised Index of Consumer Prices
HMT	Her Majesty's Treasury
ICT	Information and Communication Technology
IMF	International Monetary Fund
ISA	Individual Savings Accounts
IT	Information Technology
JSA	Job Seeker Allowance
LEA	Local Education Authority

LFS	Labour Force Survey
LOLR	Lender Of Last Resort
M&A	Mergers and Acquisitions
MAFF	Ministry of Agriculture, Food and Fisheries
MCI	Monetary Conditions Index
METR	Marginal Effective Tax Rate
MFR	Minimum Funding Requirement
MIG	Minimum Income Guarantee
MPC	Monetary Policy Committee
NAO	National Audit Office
NDDP	New Deal for Disabled People
NDLP	New Deal for Lone Parents
NDLTU	New Deal for Long-Term Unemployed
NDYP	New Deal for Young People
NHS	National Health Service
NIC	National Insurance Contributions
NMW	National Minimum Wage
OFGEM	Office of Gas and Electricity Markets
OFT	Office of Fair Trading
OPRA	Occupational Pensions Regulatory Authority
PBR	Pre-Budget Report
PFI	Private Finance Initiative
PPB	Policyholders Protection Board
PPP	Public-Private Partnership
PSA	Public Service Agreements
PSBR	Public-Sector Borrowing Requirement
R&D	Research and Development
RIU	Regulatory Impact Unit
RPIX	Retail Price Index excluding mortgage interest payments
RPIY	Retail Price Index excluding mortgage interest payments and indirect taxes
SBS	Small Business Service
SERPS	State Earnings-Related Pension Scheme
SME	Small and Medium-sized Enterprises
SR	Spending Review
SRA	Strategic Rail Authority
SSA	Standard Spending Assessment
UMTS	Universal Mobile Telephone Systems (third generation mobile telephone systems)
VAT	Value Added Tax
WBTYP	Work-Based Training for Young People
WFTC	Working Families Tax Credit
WRPA	Welfare Reform and Pensions Act

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BASIC STATISTICS OF THE UNITED KINGDOM (2000)

THE LAND

Area (1 000 km ²):		Major cities (thousand inhabitants, 1997):	
Total	241	Greater London	7 122
Agricultural (1997)	187	Birmingham	1 014
		Leeds	727
		Glasgow	612

THE PEOPLE

Population (thousands, mid-2000)	59 756	Total labour force (thousands)	29 572
Number of inhabitants per km ²	248	Civilian employment (% of total):	
Net increase in population, 1997-2001, estimated annual average (thousands)	154	Agriculture, forestry and fishing	1.5
		Industry and construction	25.1
		Services	73.1

PRODUCTION

Gross domestic product:		Gross fixed capital investment:	
In £ billion	943.4	As a % of GDP	17.5
Per head (US\$)	23 930	Per head (US\$)	4 192

THE GOVERNMENT

Public consumption (% of GDP)	18.5	Composition of House of Commons (number of seats):	
General government (% of GDP):		Labour	410
Current and capital expenditure	37.0	Conservatives	164
Current revenue	39.0	Liberal	52
Net debt	33.1	Ulster Unionists	6
Last general elections: 7 June 2001		Other	27
		Total	<u>659</u>

FOREIGN TRADE

Exports of goods and services (% of GDP)	28.1	Imports of goods and services (% of GDP)	29.8
Main commodity exports (% of total):		Main commodity imports (% of total):	
Chemicals	13.3	Manufactured goods and articles	28.6
Manufactured goods and articles	23.4	Electrical machinery	23.4
Electrical machinery	22.6	Road vehicles	10.8
Mechanical machinery	11.8	Mechanical machinery and other transport equipment	11.7

THE CURRENCY

Monetary unit: Pound sterling		September 2001, average of daily rates:	
		£ per US\$	0.683
		£ per euro	0.623

Note: An international comparison of certain basic statistics is given in an annex table.

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•

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•

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