Statement by Stephen Pickford, Executive Director
for the United Kingdom
March 1, 2000

1. Let me begin by expressing my authorities' appreciation for the efforts of Michael Deppler and his team. They have produced a useful report on the Article IV consultation, and an interesting set of background papers which address a number of topical issues.

Recent economic developments and prospects

2. A year ago some observers were anticipating a recession in the UK. Both the staff and my authorities were confident that the necessary slowdown would be shorter and shallower than had typically been the case in the past. This confidence has proved well founded. While the economy did slow significantly towards the end of 1998, growth accelerated through 1999 with output in the fourth quarter almost 3 per cent higher than a year earlier.

3. The balance of growth has also improved. Manufacturing output has picked up on the back of a very strong rise in productivity, together with increases in both overseas and domestic demand.

4. Looking forward, there continues to be little difference between the staff and my authorities on the prospects for the UK economy. The latest official forecast, prepared last November, was for growth this year of 2 ½- 3 per cent. The staff forecast of 3 per cent is at the top end of that range. Updated official forecasts will be presented in the Budget on 21 March.

5. In recent months the outlook for the world economy has improved, and strong growth has been recorded in household wealth, income and borrowing. In response to these developments, the Bank of England's Monetary Policy Committee has concluded that the pace of growth in domestic demand needs to be restrained to achieve the government's inflation target in the medium term. The MPC has therefore acted pre-emptively in raising interest rates to 6% - a total of 100 basis points since September last year.

6. Monetary policy has the main task of managing short term macroeconomic movements, while fiscal policy is geared to ensuring sound public finances over the medium term. Nonetheless, to promote stability the government believes that fiscal policy should, where prudent and sensible, support monetary policy through the cycle, while continuing to meet the fiscal rules.

Macroeconomic policy framework

7. The government's macroeconomic policy framework seeks to entrench economic stability by establishing:

- clear long-term policy objectives for inflation and fiscal policy;

- transparent procedural rules for monetary and fiscal policy making; and
- openness and accountability in policy making. Last year's Report on Observance of Standards and Codes (ROSC) showed that the UK exceeds many requirements of the fiscal transparency code and is highly transparent as measured against the code on monetary and financial policies. The UK is also fully compliant with the Special Data Dissemination Standards (SDDS).

Fiscal policy

8. The UK now has in place a much improved and transparent fiscal framework and two tough fiscal rules - the golden rule and the sustainable investment rule. The fiscal decisions taken in the last two and a half years have restored sound public finances.

9. However, the need to continue to meet the fiscal rules means there is no room for complacency: forecast errors on the public finances are large, and a cyclical improvement must not be confused with a structural improvement. That is why the government will maintain a cautious approach.

10. The fiscal rules are further supported by a spending framework which seeks to ensure that all spending, both capital and current, gives value for money. An important element of the new framework is that a distinction is made between current and capital spending at the departmental level, consistent with the distinction in the fiscal rules. This is designed to help remove the bias against investment inherent under the previous regime.

11. The government is also committed to raising the level of public investment in the UK within prudent limits set by the sustainable investment rule. While the fiscal rules are set to ensure sound public finances, the government has other mechanisms in place to identify worthwhile public investment. As part of the new framework, all government departments are required to produce investment strategies setting out how they manage and appraise their existing capital stock and investment programs, and how these programs contribute in a cost effective way to departments' aims and outputs. These investment strategies will be a key input to the forthcoming spending review which will determine the government's spending priorities for the next three year period.

12. The staff have also provided some suggestions in the area of budget reporting, going beyond the suggestions in last year's ROSC. This is an issue which my authorities take seriously. A number of steps have been taken since the last Article IV consultations to improve reporting, including improvements to the public finance statistical releases; and last November they published a guide to analysing UK fiscal policy, which will help to enhance public understanding of the objectives and operation of fiscal policy. Resource accounting will be introduced later this year which will bring public accounting practices more closely into line with those of the private sector. Under the Code for Fiscal Stability, the government is committed to improving Parliament's and the public's ability to scrutinise fiscal and debt management policy, and will continue to review progress in this area and to consider ways of achieving even greater transparency. The government will consider carefully the staff's additional suggestions.

Monetary policy

13. The monetary policy framework is also highly transparent. Publication of the quarterly Inflation Report and the minutes of the monthly MPC meetings ensures that the public is well informed about monetary policy. Members of the MPC are held individually accountable for their performance.

14. To date, the framework has worked well:

- Inflation has remained stable and close to target, and monetary policy has helped the economy adjust smoothly to shocks.

- The MPC has established a track record of operating in a pro-active, forward looking manner.

- The framework has also established considerable credibility. Survey and financial market data suggest that people expect price stability to be maintained in the long term. Long term inflation expectations have fallen to around 2.3 per cent. Short term official interest rates peaked at 7.5 per cent in June 1998, half their early 1990s levels. And, as the staff have noted, the inflation premium in long term UK interest rates has declined to levels comparable to those of the euro area.

15. Staff agree that this framework has worked well. There is, however, one specific issue on which the views of my authorities and of the staff diverge. Staff have criticized the constant interest rate assumption underlying the inflation forecast. But it is important to be clear about how the forecast is used in the setting of interest rates. Staff's analysis of the consequences of behaving according to a mechanical policy rule based on constant interest rates is correct. But the MPC follows no such mechanical policy rule.

16. The Inflation Report presents forecasts conditioned on two possible assumptions about paths for future interest rates - a constant interest rate and the market rate. They are "what if" statements which provide an important input into the MPC's discussions and judgement about the appropriate level of rates. But neither the constant interest rate conditioning assumption, nor the market rate assumption, corresponds to any optimal profile of interest rates, nor is it a policy rule. More generally, no policy reaction function could fully encapsulate all the possible sets of circumstances that the MPC could face in setting policy. Nevertheless, my authorities appreciate the continuing dialogue with staff about the technicalities of monetary policy.

Longer term structural issues and policies

Welfare to work

17. The principles of the Welfare to Work program are now well established, although some key measures such as the Working Families Tax Credit and various elements of the New Deal have only been in effect for a few months.

18. A thorough assessment of the specific policies would be premature at this stage. However, where preliminary assessment has been possible, it has been very positive. It shows that the National Minimum Wage - the adult rate will be raised to £3.70 in October and youth rate to £3.20 in June - has had no adverse effects on employment or inflation. And an assessment by the National Institute for Economic and Social Research of the early stages of the New Deal for Young People estimated that by the end of its first four years the program will have moved around one quarter of a million young people into work.

Competitiveness and productivity

19. The productivity gap between the UK and its major competitors is substantial and longstanding. My authorities are therefore committed to improving productivity performance.

20. The government's strategy for meeting this challenge is focussed on five key areas:

- raising investment;
- encouraging enterprise and innovation;
- improving skills;
- promoting competition and better regulation; and
- raising public sector productivity.

21. The new macroeconomic framework will encourage stability and investment. Also the government has: cut corporation tax; provided £19 billion of additional funds for education and skills; and £1.4 billion for science; introduced a new Competition Act; established new Public Service Agreement targets; and is seeking a doubling of public investment.

Pensions

22. The UK, like many other countries, must face the challenges presented by an ageing population. Demographic changes in the UK will be less marked than in some other countries. Nevertheless, the current system of pension provision is unlikely to meet the needs of a more flexible labour market.

23. The government's reform proposals therefore aim to gradually shift pension provision away from the government towards the private sector by encouraging a significant increase in the level of voluntary savings, through Stakeholder pensions which are more flexible and more portable than existing pensions. The reforms will build on the existing partnership between the state, employers, and private pension providers, and ensure better pensions for those on low incomes.

Financial sector

24. In January the Financial Services Authority published the main lines of the regulatory approach it proposes to follow when it becomes the single regulator for the UK's financial services industry later this year. This approach recognises the realistic aims and limits of regulation, and the responsibilities of consumers and financial sector management. It will involve a new FSA-wide operating framework for identifying and assessing risks, including the key themes for priority action. The new operating framework will come fully into effect in 2001/02.

EMU

25. I am grateful to the staff for their analysis of the pros and cons of possible UK entry into EMU. It represents a well balanced assessment and is underpinned by a comprehensive survey of the recent academic literature on optimal currency areas and business cycle synchronicity.

26. Given the UK's opt-out status, the determining factor underpinning any government decision on EMU entry will be whether the economic benefits for the UK of joining are clear and unambiguous, based on five economic tests. The government has said that it is not realistic to expect a decision to join during this parliament, since a period of stability and settled convergence will be necessary before membership can be considered. Nevertheless, preparations are being made so that, should the economic tests be met, a decision to join a successful single currency could be made early in the next parliament. The staff's main conclusion – that "an overriding economic case for or against entry cannot be made at this moment" – is therefore consistent with the view of my authorities.

Concluding remarks

27. As always, these have been useful consultations. The fact that we will be publishing the staff report made no difference to their conduct. Staff have challenged our thinking in some areas, and we welcome this since it helps us to improve the ways in which we both formulate and present policy.