EUROPEAN COMMISSION
DIRECTORATE GENERAL FOR
ECONOMIC AND FINANCIAL AFFAIRES

"The UK economy, post-recession – same as it ever was?"

A seminar organised by the European Commission

29 June 2010, Brussels

Summary of discussions

Note: *Powerpoint presentations given by speakers and discussants are not summarised in detail, as they are available on the UK seminar page of ECFIN's external web page.*

First Session: Cyclical and structural explanations of the UK's 'Golden Decade'

Following a welcoming and opening remarks by Marco Buti, three presentations were given on the subject of the UK's positive pre-crisis economic performance, focusing in particular on the structural underpinnings of its economic success during a period where strong cyclical factors were also supportive of growth: Ray Barrell (NIESR) offered a growth accounting analysis of UK economic performance, which took into account framework conditions such as regulation, competition and trade openness, as well as skills and the growth in financial services. Chris Pissarides (LSE) gave an overview of the UK's strong employment performance since the mid-1990s, followed by an outline of the UK government's productivity agenda in economic policymaking, presented by Ken Warwick (BIS).

Given the central importance that the measurement of skills played in Ray Barrell's analysis, which identified three skill categories (lower, intermediate, high) and which imputed changes in these groups' relative marginal product by changes in their wage differentials, much of the subsequent discussion revolved around the adequacy of such an earnings-based proxy. Two points of view emerged: Some participants feared that such an approach risked capturing unrelated phenomena such as wage compression, which in turn was affected by labour supply developments, the tax system and trade. Others maintained that improvements in aggregate educational attainment should, in an economic sense, be counted as skills if and only if they were accompanied by rises in the price of the corresponding labour segment, which in competitive markets would entail that its marginal product had risen. The latter further argued that while education almost certainly involved private 'consumption good' benefits to the individual, from an aggregate point of view these should only be considered as labour-quality-enhancing if *someone else* was willing to pay for their acquisition.

A second theme revolved around the UK's institutional and policy frameworks. Regarding product and labour market regulation, participants were in agreement that the 'UK model' was both of a high quality and of significant economic benefit to the UK. Econometric analysis confirmed that changes in the regulation of privatised industries and the 1998 Competition Act had boosted labour productivity growth, and benchmarking exercises among OECD peers confirmed the UK's leading position in terms of the quality of labour and product market policies. The regulatory agenda since the early 1990s had not changed much, however, and the UK's macro-prudential framework and the fiscal rules in operation up to 2008 had – especially with the benefit of hindsight - not performed well.

Finally, a perspective on the future of the UK labour market was offered that suggested that lower-skilled employment would be likely to witness the strongest growth in employment rates in the longer term, as with rising living standards people's consumption of domestic and recreational services would increase significantly, and that these were by and large not to be automated. Against this background, the UK's strong labour market framework was likely to continue to lead the way internationally.

Session 2: financial and monetary policy

This session was based around presentations by Professor E Phillip Davis assessing the effectiveness of financial and monetary policy before and during the crisis and considering next steps and by Spencer Dale of the Bank of England summarising the key economic issues the Bank has faced in setting monetary policy in the unprecedented economic conditions of the crisis and subsequently.

After the presentations, a key point which emerged in discussion was the extent to which the fact of the UK having suffered a severe recession and financial instability - in spite of having an apparently effective inflation targeting framework - undermined the case for inflation targeting overall. The point was made that excessive confidence in the effectiveness of inflation targeting had probably been damaging. In historical context, with the Japanese lost decade and the American depression both having begun in low-inflation climates, this overconfidence looks more obvious. With hindsight, strong money supply growth in spite of low and stable inflation in the UK pre-crisis could have been a warning sign. However, the weaknesses of money supply as a monetary policy indicator were also highlighted, for example the possibility of strong money supply growth in a liquidity trap as cash balances increase. Most agreed that inflation targeting was not enough on its own to maintain financial stability, but many thought it still useful. There was consensus that a broader range of macroprudential tools should be developed, but also that policymakers must accept that the genesis of the next crisis is not wholly predictable and that policy effectiveness has its limits.

On the Bank of England's crisis response, the question arose of the effectiveness of the Bank of England's quantitative easing (QE) programme and whether it would have been more effective if combined with credit easing (i.e. the purchase of corporate as well as government bonds). Some participants thought it very likely that a stronger stimulus could have been delivered through credit easing, but it was pointed out in response that total outstanding volume in the UK corporate bond market was only around £50bn, meaning that credit easing on anything like the scale of the nearly £200bn of government bond purchases would have been difficult or impossible. Other aspects of the uncertainty around the impact of QE were also highlighted, particularly the possibility of international leakages and importing of QE effects from other economies, with one participant arguing that US quantitative easing may have had at least as big an effect on the UK economy as the Bank of England's intervention. There was also some consideration of whether the stock or the flow of QE had the most important impact with the view expressed that stock was by far the most important, but that some temporary effect from flows could not be ruled out.

Session 3 – Fiscal policy and sustainability

The session was based around presentations from Dave Ramsden summarising the recent Emergency Budget (EB) and its implications for fiscal policy in the longer term, from Carl Emmerson giving a critical assessment of the EB, from Xavi Ramos on the growth and distributional effects of fiscal policy and from Martin Weale on the sustainability of UK consumption.

In the discussion, the question of negative fiscal multipliers was discussed. The UK's recent experience on this had been encouraging, with the major fiscal consolidations in the early 80s and 90s having been followed by rapid growth, although both were accompanied by large cuts in interest rates and sterling depreciation. There was a suggestion that negative fiscal multipliers showed that the argument to avoid consolidating too fast in order to protect growth was flawed. However, it was pointed out that Keynesian arguments on aggregate demand cannot be ruled out, especially if the private sector is subject to liquidity constraints.

There was also some discussion about the relative importance of private and public sector indebtedness. Some pointed out that while an economy's overall net lending was an important variable, high private sector net saving should nonetheless not be used an excuse for persistent government deficits. However, it was also argued that the two variables affect each other (for example through Ricardian effects) so they are to some extent endogenous. Regarding the question of whether housing wealth might in fact be fully transferred from one generation to the next via bequests, it was explained that relevant data did not support the conclusion that accumulated housing wealth was fully transferred to the following generation via inheritances, but rather consumed in part by the current generation.

On the policy mix in the EB, there was some discussion of the decision to weight the consolidation 80:20 in favour of spending cuts over tax increases. There were good reasons for this, it was argued, since government spending as a share of GDP has risen above the OECD average and many or all of the obvious avenues for tax raising (income tax, national insurance, VAT, capital gains tax) have already been exploited.

Concerning the new government's fiscal mandate, which is to achieve cyclically-adjusted current balance by the end of the five-year forecast period, there was some discussion of whether the government's chosen 50% probability threshold for achieving the mandate against which it was judged by the Office for Budget Responsibility was high enough. Participants argued that this was a judgement call – a higher probability of hitting the target could be achieved by planning a faster consolidation or by setting a less stretching target, but these were more political issues. Given the current uncertainty, positive surprises on the deficit could allow the government to make the targets in future budgets more stretching by bringing forward the date by which the fiscal mandate must be achieved.

Panel Discussion: (Re-)Defining the UK economy's position in the EU and global economy

The panel discussion covered a wide range of topics, of which financial stability, the UK's new fiscal architecture and consolidation plans provided the main grounds for discussion. Concerning the former, participants remarked that UK macroprudential regulation under the 'tripartite agreement' had failed largely because of information flow problems between the FSA and the Bank, and ultimately because no special resolution mechanism for bank failures was in place. Eventually such a mechanism was installed, which now worked well.

Looking ahead, speakers remarked that future regulatory challenges were considerable, and especially so for the UK, which displayed an (arguably) unfortunate coincidence of being a small, open economy with a large banking sector and external balance sheet, but without the privilege of issuing a highly demanded reserve currency and with only limited fiscal space for future bank bailouts. While this made the UK financial system particularly vulnerable, the economy's demonstrated strength in services production and exports thereof pointed to a promising growth strategy, which should concentrate on these comparative advantages rather than try to emulate highly successful goods producers, potentially at high cost with limited chances of global success.

Even with successful and better regulation, however, many speakers felt that the next major crisis would be inevitable, irrespective of supervision changes, but that supervision should be strong, decisive and intrusive as well as geared towards minimising the likelihood and fallout of a future crisis. Disaster myopia may help explain past tendencies amongst policymakers to make insufficient provisions for future crisis. This, precisely, should however be one of the objectives for fiscal policy, and the occurrence of two fiscally devastating crises in the UK within twenty years make underlined the urgency of such a goal. Many policy options existed to pre-fund future crises, including changes in the retirement age, which were merited in terms of increasing longevity and would enhance labour supply, or the move towards user-payments for healthcare and education.

Concerning the newly-created Office for Budget Responsibility (OBR), participants felt that the OBR needed to be accountable in view of the potentially wide-ranging and quasi-redistributive function that it played within the fiscal policy framework. Some felt that its role may be exercised best if, rather than simply rubber-stamping government fiscal plans, it were allowed to comment on the appropriateness of a given fiscal policy target. A counterargument to this was that this would overstep its intended function and would therefore undermine its effectiveness. Methodologically, the government's current fiscal policy target suffered from being defined in cyclically-adjusted terms, making it dependent of measuring the unobservable variable of the current output gap. Measurement of the output gap itself was complicated through both capital and labour being mobile to a significant extent, although speakers disagreed on the permanent effect of the crisis on labour supply via migration.