MEMORANDUM

TO: The Bank of England, Prime Minister Blair
FROM: David Levy & Brian Gormley
CC: Kathryn Dominguez
RE: Economic Policy Recommendation

Over the last five years, the United Kingdom has enjoyed tremendous economic success. With success, new options for potential expansion of the economy also emerge. Our economic analysis attempts to briefly understand how previous actions have affected the economy, but more importantly discuss the new options and constraints the United Kingdom should consider.

Policy options fall under both domestic and internationally headings. First, we consider how the United Kingdom should move towards increasing GDP by eliminating the output gap. In addition, we discuss the benefits and drawbacks for the United Kingdom in joining the European Monetary System. We begin with a brief description of the past five years of the United Kingdom’s economic performance and then discuss the proposed questions.

**Domestic Recommendation**

For the past five years, the United Kingdom has enjoyed unprecedented growth. We sight three structural shifts for the boom. First, world supply shocks dropped oil prices to record lows from 1996-98. Next, the UK deregulated many industries forcing increased competition and expanded output and most importantly did not cause prices to rise. Finally, Great Britain also reformed its welfare system, which reduced government expenditure and therefore interest rates and lifted many people into the employment ranks, dropping unemployment to new lows.

Meanwhile, although a typical IS-LM analysis would predict that an economic expansion would normally raise inflationary pressures, no such trend has occurred. The Bank of England (BE) has issued a wide array of policies to keep inflation targeted at 2.5% per year. In fact, reports are showing that expected inflation is 2.3% a year. With this, unemployment has dropped to 4.7%. Summing lowering expectations of inflation and previous negative supply shocks, it is possible that a shift in the Phillip’s Curve has occurred that would account for such anomalous data (see Figure 2).

Policy makers should consider this shift when thinking about inflationary policy. The Phillip’s Curve shows a trade off between unemployment and inflation. Bank authorities always must consider the benefits and costs of a low inflation economy with higher unemployment.

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1. Taken from Allen Blinder’s talk on the new economy given Thursday, April 7th 2000.
2. IMF’s Public Information Notice on the United Kingdom.
3. Ibid.
4. Taken from Stephen Pickford’s Statement on the United Kingdom, March 1st, 2000. Pickford is executive director of the UK for the IMF.
5. First quarter data of 2000 from the IMF.
However, due to a shift of the curve inward, this trade-off becomes less severe as low inflation is now associated with a lower level of unemployment.

The question remains whether the three sources of growth sighted above are one-time shocks or phenomena that will persist over time. Although oil prices have recovered since the price lows of the mid-nineties, the effects of tighter welfare policies and deregulation are unclear. Despite this ambiguity, there are several factors that may justify government intervention:

1) The current account is falling into a deficit. Many analysts note that this is a sign that the domestic economy could be producing more to satisfy the demands of its population.
2) Domestic investment is outpacing domestic savings.
3) Most intriguing to us, the output gap has been positive for the last four years.

As a result, two proposals for government action are currently being considered. First, the BE, which recently has pursued a slightly looser monetary policy to revive a slumping economy, has forewarned of a tighter future, possibly to prevent overheating in the economy or to increase savings\(^6\). In addition, the government is running budgetary surpluses, so we evaluate the effects of a tax cut.

Looking at the data, unemployment has been declining and inflation has remained persistently low. We therefore have trouble blaming the output gap on the labor supply. People are working now more than ever. Thus, we believe the output gap is due to a lack of investment to acquire enough capital to match the increased labor supply.

Regarding monetary policy, it is not clear if a complimentary monetary shift is in order if the BE has already declared that it wants to keep inflation at a low rate. Because of the supply shocks of the mid-nineties and the reductions in inflation by the Bank of England, people are truly less concerned about rising prices. As a result, inflation expectations seem to be fairly low, which may make contracting the money supply unnecessary.

Further, a reduction in high-powered money might not allow banks to lend the correct amount out for businesses to accrue enough human or physical capital to perpetuate growth or maintain a steady-state equilibrium (see Figure 3). The British Parliament is currently subscribing to the “Golden Rule\(^7\).” The goal of this policy is to bring the capital stock to a level that will maximize consumption and further grow the economy. If a decline in investment leads to a drop in the steady-state level below the Golden Rule, future generations would not consume as much as they could. Therefore, for all the reasons cited above, monetary contractions should be approached with discretion.

The second proposal relates to a tax cut. While the government could decrease its marginal tax rates and thereby create incentives for businesses and families to save more, it seems that such a fiscal policy would only shift net domestic saving to the private sector. Any

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\(^6\) Taken from the IMF Public Information Notice on the United Kingdom

\(^7\) Taken from Stephen Pickford’s Statement on the United Kingdom, March 1\(^{st}\), 2000. Pickford is executive director of the UK for the IMF.
incentive the government creates through lower taxes will only reduce the current budget surplus it now enjoys and therefore lead to either a counterproductive outcome (less overall saving) or, if Ricardian Equivalence plays out perfectly, only a neutral result.

In light of this analysis, we recommend that the government start to retire the debt. By buying back its bonds, it will lower the interest rates for businesses willing to borrow, which in turn will stimulate investment. By allowing more domestic investment opportunities through lower interest rates, businesses will be able to accumulate more capital stock and decrease the output gap. As a result, over the long-term, higher output and growth will be achieved. An additional consequence of lower interest rates will be manifested in the current account. As cited above, net imports have been slightly outpacing net exports. However, by reducing the interest rate, foreign investment will decrease, lowering the demand worldwide for British Pounds and facilitating an increase in net exports. As net exports become more positive, GDP will grow at higher rates, thus further increasing national income. This course of action appears more theoretically sound than either a contracted money supply or a government tax cut if the ultimate goal is to produce the dual outcomes of higher GDP and continued low inflation.

LIMITS

The limits to this policy center on the size of both the presumed Phillip’s Curve shift and increase in inflation due to debt repurchasing. Although sound monetary policy has reduced the interest rate and discouraged foreign savings to some extent, using part of the budgetary surplus to buy back public debt may not further diminish the interest rate enough to depreciate the Pound and slow foreign capital into the economy. Also, the recent monetary stability may have reduced the risk premium foreign investors demand to save in the U.K. Consequently, a high priced pound would not allow current account surpluses and positive net exports.

Additionally, buying the government debt may increase inflation to a level uncomfortable with the Bank of England. With an expanded money supply and a subsequently lower interest rate currently persisting, fears of uncontrolled inflation may force the BE to reverse its monetary and interest rate policy at the slightest hint of expansion, thereby reducing investment.

The entire scenario is contingent upon the policies of the Bank of England. In 1997, the BE assumed the entire debt of the British government. Therefore, if the BE observes price pressure becoming too high, it may decide to assume the government payments but not in turn reduce interest rates.

If the BE considers only the Retail Price Index (RPIX), chances are this interest rate reduction will pass. Investment items, especially those designated in the capital stock, are most likely not listed in the retail price index and therefore would not be measured in inflationary adjustments. Ideally, the BE would allow firms to invest and not see an increase in the RPIX.

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8 Taken from the Bank of England report Government Debt Structure and Monetary Conditions.
Foreign Policy Recommendations: Should the United Kingdom Join the European Monetary System?

Perhaps more consequential for the United Kingdom than the potentially malicious macroeconomic effects of rising inflation or a tax cut is the lingering dilemma of whether or not to fix the Pound with the Euro. As of January 1st, 1999, eleven countries on the European Continent switched to the single currency. This development, along with pressure from EU member countries, has forced the United Kingdom to scrutinize the feasibility and desirability of such a move.

According to the United Kingdom’s Treasury Department, Britain should not pursue monetary unification with the Euro until five key macroeconomic indicators are met. The indicators include cyclical convergence, flexibility, investment, financial services, and employment and growth. As of 1997, neither convergence of the British and Continental economies nor labor, price, and production flexibility had occurred sufficiently to warrant the risk associated with fixing the exchange rate. Although the potential benefits of increased investment, sustained growth and stability, and opportunities for both employment and expansion of financial services enticed policy leaders, the real possibility of economic disaster loomed large enough to dissuade entry for the then foreseeable future.

Utilizing course material, this policy dilemma can be analyzed rigorously. As is clear from the IS-LM and Mundell-Fleming models, fixing an exchange rate forces a country to abdicate the use of monetary policy as a tool to stabilize macroeconomic performance. As discussed in the supplementary readings, a fixed currency leaves a country little recourse to asymmetric shocks or sluggish local economic conditions, particularly in the absence of factor mobility and coordinated fiscal transfer payments (both of which apply in the case of Europe and the U.K.). To determine how much the past concerns detailed above still hold, we provide an updated analysis with more recent economic figures.

As Table 1 demonstrates, significant progress has been made by European economies toward economic convergence. Like the U.K., the Euro countries have enjoyed rising output, falling unemployment, and stable prices with relatively low inflation. Over the period of 1997 and 1998, output as measured by 1995 Euros grew 2.2% and 2.7%, respectively. Over the same period, unemployment fell from 11.6% to 10.9%. Although still a far cry from Britain’s roughly 5% average, this declining trend, accompanied by rising GDP, indicates a general convergence. Additionally, the moderate unemployment rate can be explained easily by a different cultural and political environment that values high wages and low inflation and tolerates higher unemployment rates by providing substantial worker compensation packages for frictional unemployment, child care, and health care. In contrast, inflation, the counterpart to

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12 See Appendix B. Data taken from the December, 1999 publication of OECD’s Main Economic Indicators.
13 Also see Attachment 1.
unemployment, has remained extremely low, with changes in the CPI wavering around 1% over
the last few years. Finally, for the past year and a half, the current account balance has been in
surplus, meaning that they were a net lender abroad.

All of these macro indicators demonstrate economic strength and significant potential for
long-term prosperity. As discussed in class, a graphical representation of the effects of economic
integration shows larger benefits and diminished costs the greater the extent of convergence (see
Figure 1). Although our analysis suggests that the U.K. is moving closer towards economic
integration with the European continent, it remains unclear whether in reality this shift is
sufficiently large to make monetary union a sound policy choice. If the benefits do in fact
outweigh the costs, then perhaps the United Kingdom should reconsider its independent stance.
However, other sources such as continued labor inflexibility due to immobility and language
barriers cast doubt on Britain’s true graphical placement, therefore perpetuating ambiguity.

Despite the partially optimistic outlook above, many political and economic reasons exist
for legitimate concern, and policy gurus should approach any effort to fix the Pound with
cautions. Politically, under the Blair administration, the United Kingdom has installed
parliaments for both Scotland and Northern Ireland. While optimists may point to how the U.K.
can manage three government systems under one bank, others point to the potentially
detrimental, alienating effects of the BE abdicating its discretionary authority.

In addition to political considerations, economic obstacles to fixing currencies also exist.
Among many instances in recent economic history, the crises in 1992 with the Pound and 1994
with the Peso exemplify the dangers of fixing currencies. Capital flight, economic shocks, and
political instability hardly ever can be anticipated and will wreak havoc on the unsuspecting.
Additionally, with oil comprising such a large portion of U.K. exports, Britain may never realize
an extremely integrated economy with that of the continent. Such specialization leaves the door
open for supply shocks and divergent economies, the very plagues only a competent Fed chair
can cure.

In light of these issues then, our recommendation is to restrain naïve optimism at the
recent macro trends, and allow patience and time guide future determinations of the national net
benefits to joining the Euro. If true integration and labor flexibility have obtained, the macro-
economies will continue the recent trend towards convergence. If not, current patterns are
merely temporary and divergence can be expected. Either way, economic fluctuations within the
next few years will make manifest the appropriate policy alternative.

**Conclusion**

The United Kingdom has many factors to consider as it ponders which macroeconomic
policies to pursue. Domestically, with monetary policy acting soundly, we submit that the
government should retire part of the debt to lower interest rates and boost investment. With a
growing GDP and constant government spending, public saving and investment should increase.
Looking internationally, the decision of whether or not to join the European Monetary System is
difficult and filled with both political and economic pressures. Only the test of time can
determine whether sufficient economic convergence and labor flexibility will obtain such that
pursuing a fixed currency will prove prudent.
**References**

Taken from the Bank of England report Government Debt Structure and Monetary Conditions.


Data taken from the December, 1999 publication of OECD’s Main Economic Indicators.

The International Monetary Fund’s Public Information Notice on the United Kingdom, March 6, 2000. This release is where we obtained the U.K. home data as well.

The Bank of England Report Government Debt Structure and Monetary Conditions by Alec Chrystal and Andrew Haldane. This is a summary of a conference on debt and monetary conditions that took place in June 1998.


APPENDIX

Table 1
EURO ZONE DATA

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<td>5307.4</td>
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<td>Unemployment (%)</td>
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<td>Current Account (bill euros)</td>
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Table 2
The United Kingdom

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<td>4.7</td>
<td>4.3</td>
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<td>18</td>
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<td>Gross Domestic Investment</td>
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<td>The Output Gap</td>
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Figure 1. The Benefits and Costs of Integrating Currency.

Illustration: Our analysis has shown a shift towards economic integration. The extent of the shift remains questionable.
Illustration: Recent monetary stability along with prior supply cost reductions have decreased inflation without raising unemployment. In fact, unemployment continues to decline. Many policy makers still believe a relationship between unemployment and inflation exists, forcing the assumption that the curve has shifted in to hold this relationship.

Illustration: Capital stock is accrued through investment. By lowering the interest rate, investment should increase, raising the capital stock.