COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 9 of Council Regulation (EC) No. 1466/97 of 7 July 1997

on the updated convergence programme for the United Kingdom 2000-01 to 2006-07

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) no. 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], stipulates that countries not adopting the single currency have to submit convergence programmes to the Council and the Commission. In accordance with Article 9 of this Regulation, the Council has to examine each convergence programme within two months after its submission. This examination has to be based on the assessments prepared by the Commission and the Economic and Financial Committee. The Commission has to adopt a recommendation on each programme. On the basis of this recommendation and after having consulted the Economic and Financial Committee, the Council will have to deliver an opinion, following its examination of the programme.

The United Kingdom's convergence programme covering the period 1997-98 to 2003-04 was submitted on 22 December 1998 and assessed by the Council on 8 February 1999[2].

According to the Regulation, the updated convergence programmes, to be presented annually, may also be examined by the Council in accordance with these same procedures. The first annual update, covering the period 1998-99 to 2004-05, was submitted on 21 December 1999 and examined by the Council on 28 February 2000[3]. The second annual update, covering the period 1999-00 to 2005-06, was submitted on 21 December 2000 and examined by the Council on 12 February 2001[4].

The United Kingdom submitted the third and most recent updated convergence programme, covering the period 2000-01 to 2006-07, on 20 December 2001. The Commission services have carried out a technical evaluation of this updated programme, which warrants the following assessment:

The third update of the convergence programme called "Maintaining Economic Stability" is a clear, comprehensive, statement of UK economic policy and prospects. It conforms to the Code of Conduct agreed for stability and convergence programmes

The UK has enjoyed a decade of steady growth with inflation falling to low levels. The public finances have revealed surpluses in recent years and the gross debt to GDP ratio is one of the lowest in the EU. Unemployment is close to its lowest level since the 1970s; again one of the lowest rates in the EU. The economy has developed close to that expected for 2001 as a whole, despite the weaker global environment. The government surplus, shown at 2% of GDP in 2000-01, was nearly a full percentage point above expectations. Inflation remained subdued in 2001.

This favourable situation has, since 1997, been associated with monetary and fiscal policies put in place by the government to secure macro-economic stability. The framework for these policies defines clear policy objectives and an allocation of responsibility that gives appropriate accountability including the role of co-ordination between monetary and fiscal policy.

[1] OJ L209, 2.8.1997
[2] OJ C68, 11.3.1999
[3] OJ C98, 6.4.2000
[4] OJ C77, 9.3.2001

The economic projections reported in the programme to 2004, (the last year for detailed economic projections), suggest a continuation of this benign performance with GDP growth centred on 2¼% in 2002 – a little below trend growth of 2½%. Growth is expected to revive to 3% (centre of the range) in 2003 and return to trend in 2004. Inflation is projected to be a little below target in 2002 and on target thereafter.

This outlook is not dissimilar to that of the Commission though GDP growth is projected to be higher in 2002 in the programme. Both the Commission and the programme see a return to higher and more balanced growth in 2003, with a less negative contribution from net exports than in recent years. The expectation that inflation will remain close to the 2½% target looks likely. There are risks to this benign view as recognised in the programme. The programme considers that the macro-economic policy framework leaves the UK better placed than on previous occasions to cope with instability in the global economy.

The programme presents projections and analyses of the public finances to 2006-07. These are also presented in cyclically adjusted terms, though given the closeness of output to potential over the programme period there is little difference from the unadjusted figures. These reveal that the government's golden rule, (that the current balance does not fall into deficit over the cycle), is achieved, as is the sustainable investment rule based on a sustainable level of the net debt to GDP ratio. Gross debt relative to GDP falls from 40% in 2000-01 to just over 36% by the end of the programme period. However, the general government balance is seen to move into slight deficit in 2001-02 for the first time since 1997-98; a deficit that rises to 1.1% of GDP in 2002-03 which would broadly persist until the end of the programme. A deficit of around 1% of GDP now emerges, one year earlier than in the previous update, largely as the result of temporary economic factors (eg. a lower level of GDP than previously projected, and lower financial company profits).

The update notes that the projections are an interim update and do not necessarily represent the outcome the government is seeking (since projections are based on announced policy and the budgets for 2002 and subsequently have yet to be set). The Commission recognises that the programme's budgetary projections are made, for public finance purposes, on a cautious GDP trend growth assumption of 2¼%. In practice the public finances may turn out stronger than expected by the authorities. Indeed, in the short term, this is the Commission's view. The government finances appear to be sustainable given the low, and falling, debt to GDP ratio. The deficit, in the medium term, largely emerges as a result of addressing the very low level of public sector investment which is close to the lowest in the EU. However, in terms of the programme's projections, it cannot be said that a fiscal position of close to balance or surplus is achieved in the medium term as required by the Stability and Growth Pact. The persistence of a deficit of around 1% of GDP for much of the programme period suggests that the Broad Economic Policy Guidelines would not be complied with in the medium term.

All in all, the update shows that the UK has sustainable public finances, is addressing the very low level of government investment, has a low level of debt and is relatively well placed to face the problem of ageing on the public finances as noted below. However, more assurance would be given to that view if the projections were to reveal 'the close to balance or surplus in the medium term" of the Stability and Growth Pact. Accordingly, it is recommended that the authorities address the government finances and their projections to reveal that the terms of the Stability and Growth Pact would be expected to be met. To that end it would be preferable if the budgetary projections to 2006-07 were reported, also, on the basis of the 2½% trend GDP growth assumption that anchors "the neutral case view of economic prospects".

On Commission estimates, the cyclically adjusted government balance shows a loosening of policy, equivalent to 1.1% of GDP between 2001-02 and 2003-04; policy is broadly neutral subsequently. A small negative output gap is foreseen in 2002 with inflation remaining low so the stance does not seem inappropriate. Announced fiscal policy has not stopped the MPC, recently, from easing monetary policy significantly.

The convergence criteria on inflation, long-term interest rates and the public finances are comfortably met. The provision of long term forecasts of public finances showing them to be sustainable on current policies is welcome as is the description of policies put in place to offset the impact of 'ageing' on the public finances.

The programme describes measures of economic reform intended to achieve the goals of full employment in every region and raise productivity performance. The programme stresses the commitment to the objectives of the Lisbon Council.

On EMU, the programme refers to the policy set out in 1997. While there may be problems in the internationally tradable sector, the UK economy seems to be living with an exchange rate that is much higher than that seen in the mid 1990s. Though there is some evidence to suggest that exchange rate volatility has declined in recent years, a significant fall in sterling remains a possibility.

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On the updated convergence programme for the United Kingdom 2000-01 to 2006-07

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council regulation (EC) No. 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[5], and in particular Article 9 (3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On 12 February 2002 the Council examined the updated Convergence programme of the United Kingdom which covers the period 2000/2001 to 2006/2007. The programme envisages a government deficit of 0.2 % of GDP in 2001/2002, a deficit of 1.1% in 2002/2003 rising to 1.3% of GDP in 2003/04 before falling to 1% of GDP in the two final years of the programme; 2005/06 and 2006/07. The Council considers it appropriate that the programme stresses the securing of macroeconomic stability supported by sound monetary and fiscal policies and continued structural reform.

The programme is built upon a macro-economic framework showing GDP growth of 2¼% in 2001 and the same in 2002, rising to 3% in 2003 before returning to growth, at trend, of 2½% in 2004. The Council considers the macro-economic forecasts and the trend growth assumption of 2½% to be realistic. It notes, the projections in the programme for the public finances are, for reasons of caution, based on a lower assumption for trend growth namely 2¼%.

With respect to inflation and interest rates, the United Kingdom continues to fulfil the convergence criteria with some margin. The Council notes that the monetary framework of inflation targeting, with operational responsibility for interest rate changes given to the Bank of England, has been an important condition for securing low inflation expectations. The Council notes that under the current policy framework, the programme projects the UK inflation target to be achieved over the programme period. The United Kingdom has fulfilled the convergence criterion on the long-term interest rate for some time. This helps confirm the credibility given to the UK's stability oriented framework for macroeconomic policy.

[5] OJ L209, 2.8.1997

Council notes that while there are signs of reduced exchange rate volatility, it cannot yet be concluded that this policy framework has delivered a sustained stable exchange rate. Therefore the Council recommends that the United Kingdom continue with the stability-oriented policies with a view to securing exchange rate stability which, in turn, should help reinforce a stable economic environment.

The general government finances are, in the current year, 2001/2002, expected to be close to balance, in actual and also in cyclically adjusted terms, thus fulfilling the requirements of the Stability and Growth Pact. However, the Council notes that a projected deficit of a little more than 1 % of GDP emerges in 2002/03 and persists, around that level, in the remaining years of the plan to 2006/07. A deficit of around 1% of GDP now emerges one year earlier than in the previous update, largely as the result of temporary economic factors (including a lower level of GDP than previously projected, and lower financial company profits). The Council acknowledges that, in the medium term, this 1% of GDP deficit persists in the projections, both unadjusted and cyclically adjusted, as a result of the use of a very cautious trend growth assumption of 2,25 % per annum and as a consequence of increased government investment as a share of GDP. Further, it notes that the public finance projections are an interim update and do not necessarily represent the outcome the government is seeking (since projections are based on announced policy and the budgets for 2002 and subsequently have yet to be set). Nevertheless a sustained deficit of 1% of GDP, or thereabouts, if realised, would not be in line with the requirements of "close to balance or surplus in the medium term" contained in the Stability and Growth Pact. Accordingly, the Council recommends that the projections of public finances be addressed to reveal that the terms of the Stability and Growth Pact would be expected to be met. To that end, the Council would prefer that the budgetary projections to 2006-07 be reported, also, on the basis of the 2½% trend GDP growth assumption that anchors "the neutral case view of economic prospects". The Council welcomes that the UK is addressing the very low level of government investment.

The Council notes that the programme provides an assessment of the long-term outlook of the public finances and a description of policies that could be addressed to minimise the impact of ageing. The Council considers that the UK, with a low and falling debt to GDP ratio, is in a good position to meet the consequences of ageing populations and welcomes that the public finances are sustainable on current policies..

The Council welcomes the structural reforms included in the programme. It notes, with approval, that the progress on economic reforms should help to raise productivity performance and secure further improvements in the labour market.