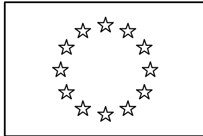

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 30.1.2003
SEC (2003) 128 final

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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 of the United Kingdom, 2001-02 to 2007-08

(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], stipulated that countries not participating in the single currency were to submit convergence programmes to the Council and the Commission by 1 March 1999. In accordance with Article 9 of this Regulation, the Council had to examine each convergence programme based on the assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty, the Economic and Financial Committee. The Commission adopted a recommendation on each programme. On the basis of this recommendation and after having consulted the Economic and Financial Committee, the Council delivered an opinion, following its examination of the programme. 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.

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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].

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 1999-2000 to 2005-06, was submitted on 21 December 2000 and examined by the Council on 12 February 2001[4]. The third annual update, covering the period 2000-01 to 2006-07, was submitted on 20 December 2001 and examined by the Council on 12 February 2002[5].

The United Kingdom submitted the fourth and most recent updated convergence programme, covering the period 2001-02 to 2007-08, on 19 December 2002. The Commission services have carried out a technical evaluation of this updated programme, namely taking into account the Communication from the Commission to the Council of 27 November on strengthening the co-ordination of budgetary policies[6]. This evaluation warrants the following assessment:

The fourth update of the convergence programme, called "Sustainability for the Long Term", is a clear, comprehensive, statement of UK economic and budgetary policy and prospects. It broadly conforms to the Code of Conduct agreed for stability and convergence programmes.

[1] OJ L209, 2.8.1997
[2] OJ C68, 11.3.1999
[3] OJ C98, 6.4.2000
[4] OJ C 77, 9.3.2001
[5] OJ C 51, 26.2.2002
[6] COM (2002) 668 final, 27.11.2002.

The economic policies as reflected in the planned measures in the convergence programme update comply in part with the 2002 Broad Economic Policy Guidelines.

It is appropriate that the programme stresses, as did the previous programme, the importance of securing macro-economic stability supported by sound monetary and fiscal policies and continued structural reform. These policies have delivered low and stable inflation in recent years; close to the lowest in the EU in recent months. 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 UK has enjoyed steady growth in recent years. The public finances have shown surpluses in the years 1998-99 to 2000-01 and the gross debt to GDP ratio is one of the lowest in the EU. Unemployment rates are around the lowest since the 1970s; again, among the lowest in the EU. GDP growth has been lower than expected in 2002 in a framework of a weak global environment but has been sustained by strong household consumption and growth in public expenditure, both current and fixed investment. The government finances moved into a small deficit in 2001-02 and the deficit is expected to rise substantially, to 1.8% in 2002-03. This is largely due to the effects of the global slowdown and especially its effects on financial company profits and associated tax revenues. But it also rises due to planned increases in discretionary expenditure.

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The economic projections reported in the programme to 2005 (the last year for detailed economic projections) suggest a closing of the negative output gap by 2005 as the global environment recovers with GDP growth centred on 2¾% in 2003 – around trend growth. Growth is expected to rise a to 3¼% (centre of the range) in 2004 and 3% in 2005. Inflation is projected to be a little below target of 2½% (RPIX measure) in 2003 and on target thereafter.

This outlook in 2003 and 2004 is more positive than that of the Commission services' Autumn forecasts, though the latter also see a substantial acceleration in GDP in 2003 as the global outlook improves. The programme sees a more rapid closing of the negative output gap and, in particular, a more rapid rise in fixed investment. In the short run, to 2004, the programme's economic projections appear to be on the optimistic side.

The programme presents projections and analyses of the public finances to 2007-08. These are also presented in cyclically adjusted terms. The projections show a surplus on current balance, on average, to the end of the programme period in 2007-08 which would be in line with the government's "golden rule". Gross government debt relative to GDP falls to 37.9% in 2002-03 before rising a little to stabilise around 39% in 2003-04 to the end of the programme period in 2007-08. However, the general government balance is seen to move from a slight deficit of 0.2% of GDP in 2001-02 to one of 1.8% in 2002-03 and 2.2% in 2003-

04 before falling to 1.7% in 2004-05 and 1.6% in the subsequent years to 2007-08. In cyclically adjusted terms, the deficit would rise from 0.2% in 2002-03 to 1.4% in 2003-04 and by the end of the programme to 1.6% of GDP in 2006-07 and 2007-08. Compared to the previous programme update, the projected deficit is now 0.7% of GDP higher in 2002-03 and 0.9% higher in 2003-04 for cyclical reasons especially that of lower receipts associated with depressed financial company profits which are expected to be transitory. However, the cyclically adjusted balance, at 1.6% of GDP in 2006-07 and subsequently, is now some 0.6 of a percentage point of GDP higher than in the previous update. This results from further rises in planned discretionary expenditure, especially investment expenditure, announced since the last programme.

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The trend growth assumption of 2½% to 2006-07, for public finance purposes, while higher than the 2¼% assumed in the last update, is a little lower than the programme's neutral trend assumption of 2¾%. The latter is in line with Commission services calculations. For example, application of this trend growth, by the Commission services, yields a cyclically adjusted deficit that declines to 1.2% of GDP in 2005-06 compared to the 1½% of the programme. Moreover, the cyclically adjusted deficits would result, in very large part, from the welcome 'reversal' of the historic decline, to low levels - around the lowest in the EU - of net public investment relative to GDP, in line with the 2002 Broad Economic Policy Guidelines. This is projected to rise from 0.9% in 2001-02 to 2.2% in 2007-08.

In its recent Communication on *Strengthening the co-ordination of budgetary policies*[1], the Commission suggested that a small deviation from the 'close to balance or in surplus' requirement of a longer-term nature be envisaged for Member States where debt levels are well below the 60% of GDP reference value, and when public finances are on a sustainable footing. The projections in the UK updated convergence programme show a low and stable level of the general government gross debt-to-GDP ratio from 2003-04. It is also noted that on the basis of current policies and the assumptions in the programme, ageing populations are projected to have a limited impact on public spending on pensions as a share of GDP. Given these considerations, the UK could envisage running a small deviation from the 'close to balance or in surplus' requirement without jeopardising the sustainability of the public finances in the longer term. However, the deficits projected for the later years of the programme are at around 1½% of GDP, both actual and cyclically adjusted. It is also noted that the relatively high projected deficit of 2.2% of GDP in 2003-04 is based on an optimistic 2¾% GDP growth assumption. Such budgetary plans could lead to a deficit that could

potentially approach the 3% of GDP threshold and, consequently, they would not be in line with the medium-term requirement of the Stability and Growth Pact. Consequently, the UK authorities should aim for a 'medium-term' budgetary deficit that is small enough to ensure that the 3% deficit ceiling is not breached in any year.

The attention paid to the sustainability of public finances in the convergence programme is welcome. The variety of indicators used to examine long-run budgetary challenges and issues related to intergenerational equity are very useful. It is considered that on current policies and the assumptions in the programme, the UK is well placed to meet the budgetary costs associated with ageing populations. Much of the financial sustainability of the pension system depends on the performance of private pension providers. If private provision produces significantly less than the anticipated coverage or level of pensions, future governments may face increased claims of means-tested benefits. However, a budgetary position of a limited deficit in the medium term would help avoid any risk of emerging budget imbalances in the context of ageing populations, and give greater assurance to the programme view that "the public finances, based on current policies, are sustainable in the long-term".

The programme describes measures of economic reform intended to deliver high-quality public services. It also describes measures to achieve the goal of a higher proportion of people in work in 2010 than ever before and to achieve a higher sustainable rate of productivity growth. In view of the relatively low level of productivity in the UK, compared to its competitors, these measures are considered desirable.

The convergence criteria on inflation and interest rates are assessed to be fulfilled with some margin. On EMU, the programme refers to the policy set out in 1997 and the 'five tests' assessment that will be made by June 2003. The programme believes that exchange rate stability can only be achieved on the basis of sound economic fundamentals so it is considered as the outcome of, and not the target for, all other economic policies. While there may be problems in the internationally tradable goods sector, the UK economy seems to be living with an exchange rate that is 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 reversal of such a trend remains a possibility. If it occurs, this may result in a less stable macro-economic path and government finances than those projected in the programme. In this context, ERM2 membership, once a judgement on the appropriate parity between the pound and the euro has been made, could add another pillar of stability to the sound and effective

[1] COM (2002)668 final, 27.11.2002

fiscal and monetary framework in place.

Based on this assessment, the Commission has adopted the attached recommendation for a Council opinion on the convergence programme update of the United Kingdom and is forwarding it to the Council.

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 of the United Kingdom 2001-02 to 2007-08

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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[1], 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 [18 February] the Council examined the United Kingdom's updated convergence programme, which covers the period 2001-02 to 2007-08. This update provides detailed information, including the analysis of the long-term sustainability of public finances, which is broadly in line with the code of conduct. The economic policies as reflected in the planned measures in the convergence programme update comply in part with the 2002 Broad Economic Policy Guidelines.

The Council considers it appropriate that the programme stresses, as did the previous programme, the importance of securing macro-economic stability supported by sound monetary and fiscal policies and continued structural reform. The Council notes with satisfaction that these policies have delivered low and stable inflation in recent years. The convergence criteria on inflation and long term interest rates are fulfilled with some margin and the programme projects that the inflation target will continue to be achieved over the programme period.

The programme is based upon a macro-economic framework that shows GDP growth rising from 1½% in 2002 to growth centred on 2¾% in 2003, 3¼% in 2004 and 3% in 2005. The Council considers that the macro-economic forecasts are somewhat optimistic in the short term and that there are downside risks to growth. However, the trend growth assumption of 2¾% is consistent with Commission services calculations and higher than the 2½% used in

[1] OJ L209, 2.8.1997

the programme that underpins the cyclically adjusted projections of the government finances. The general government finances are projected, in the programme, to show deficits of 1.8% of GDP in the current year, 2002-03, and 2.2% in 2003-04. In cyclically adjusted terms, these would be equivalent to 1.1% and 1.4% of GDP, respectively. The deficit would be around 1.6% of GDP in the final years of the programme - 2005-06 to 2007-08 – both in nominal and cyclically adjusted terms. Much of the rise in the deficit over the programme period results from the planned reversal of the decline in public investment relative to GDP, in line with the 2002 Broad Economic Policy Guidelines. The Council notes, with approval, that the UK gross debt to GDP ratio is projected to remain relatively low at around 39% in 2003-04 and subsequently.

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The Council notes that the actual projected deficits in 2002-03 and 2003-04 are now substantially higher than those foreseen in the previous programme update by 0.7 and 0.9 percentage points of GDP respectively. The Council acknowledges that this rise in the deficit in 2002-03 and 2003-04 results mainly from cyclical factors.

The projections show a low and stable level of the general government gross debt-to-GDP ratio from 2003-04. The Council notes that on the basis of current policies, ageing populations are projected to have a limited impact on public spending on pensions as a share of GDP. Therefore, the Council considers that the UK could envisage a small deviation from the 'close to balance or in surplus' requirement without jeopardising the sustainability of the public finances in the longer term, because the debt levels are well below the 60% of the GDP reference value, and its public finances are on a sustainable footing. However, the deficits projected for the later years of the programme are at around 1½% of GDP, both actual and cyclically adjusted. Moreover, the Council notes that the relatively high projected deficit of 2.2% of GDP in 2003-04 is based on an optimistic 2¾% GDP growth assumption. Such budgetary plans could lead to a deficit that could potentially approach the 3% of GDP threshold and, consequently, they would not be in line with the medium-term requirement of the Stability and Growth Pact. Consequently, the Council recommends that the UK authorities should aim for a 'medium-term' budgetary deficit that is small enough to ensure that the 3% deficit ceiling is not breached in any year.

The Council welcomes the attention paid to the sustainability of public finances in the convergence programmes and notes with interest the variety of indicators used to examine long-run budgetary challenges and issues related to intergenerational equity. The Council considers that on current policies and the assumptions in the programme, the UK is well placed to meet the budgetary costs associated with ageing populations. The Council notes,

however, that much of the financial sustainability of the pension system depends on the performance of private pension providers. If private provision produces significantly less than the anticipated coverage or level of pensions, future governments may face increased claims of means-tested benefits. Therefore, it considers that a budgetary position of a limited deficit in the medium term would help avoid any risk of emerging budget imbalances in the context of ageing populations and give greater assurance to the programme view that "the public finances, based on current policies, are sustainable in the long-term".

The Council welcomes the measures of economic reform which, among other objectives are intended to achieve a higher sustainable rate of productivity growth. In view of the relatively low level of productivity in the UK, compared to its competitors, the Council welcomes these measures.

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