

At a glance...

The UK Economy

Outlook for 1998

- Sharp slowdown to 1.5 per cent growth in the first half; a one in four chance of a recession
- Inflation to fall to 2.4 per cent by end-year despite average earnings growth of almost 5 per cent
- Unemployment rate to fall below 5 per cent
- Pound to fall to 2.80DM by end-year
- Interest rates to peak at 7.5 per cent this spring coming down to 7.25 per cent this autumn
- House prices to rise by 9 per cent.
- Fiscal position improving but no case for policy loosening

Outlook till end 2000

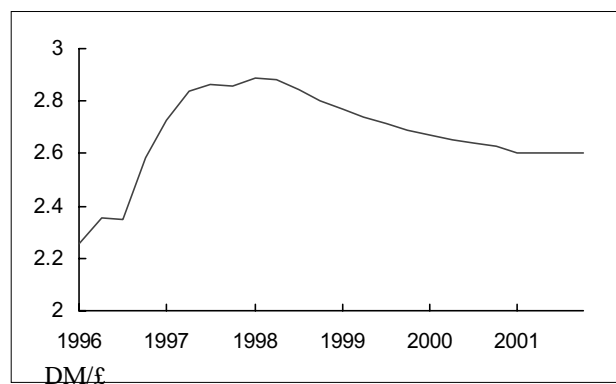
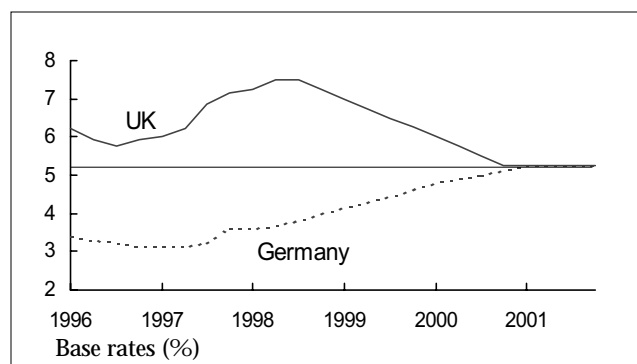
- Interest rates to fall to 5.25 per cent
- Pound to fall to 2.60DM

The economy will decelerate abruptly in the first half of the year. Exports will be hit by the delayed impact of the strong pound and to a lesser extent by the Asian crisis. Another contractionary force is the tight rein on public spending. Although the consumer will continue to sustain the economy, the delayed impact of last year's interest rate increases will ensure there is no repeat of the 1997 spending boom. Manufacturing will bear the brunt of the slowdown with growth of less than 1 per cent. The central forecast is for a soft landing with GDP growing by 1.9 per cent in 1998, but there is a one in four chance output will fall below the level reached at the end of last year.

Underlying retail price inflation will drop below the government's target of 2.5 per cent by the end of the year despite a buoyant labour market and a fall in the pound. There is sufficient fat in profit margins to absorb a rise in average earnings of almost 5 per cent and a weakening pound will not work its way through to retail prices given the lack of feedthrough from its appreciation over the last eighteen months.

Looking forward to the end of 2000, base rates will fall to 5.25 per cent and the pound will reach 2.60DM, a rate compatible with entry into EMU. These declines are sharper and sooner than expected in the financial markets. They follow from our assumption, incorporated in the forecast for the first time, that the UK will join the single currency in 2003 and will need to satisfy the requirement for exchange rate stability for two years before entry.

EMU and the outlook for interest rates and sterling



The World Economy

Outlook for 1998

- Asian fall-out on Western economies limited, provided no further setbacks
- World trade to grow by 5.75 per cent and OECD output by 2.6 per cent
- Japan the main loser with growth almost halved to 1.4 per cent because of Asia effect; a one in five chance of recession
- US and EU to grow by 2.6 per cent
- Recovery of smaller Asian economies quicker than anticipated: S.Korea to grow by 2 per cent
- Fed to hold fire but short rates to rise by half a per cent in core EU
- Dollar to peak in first quarter but subsequent decline modest
- OECD inflation to decline, but no threat of deflation

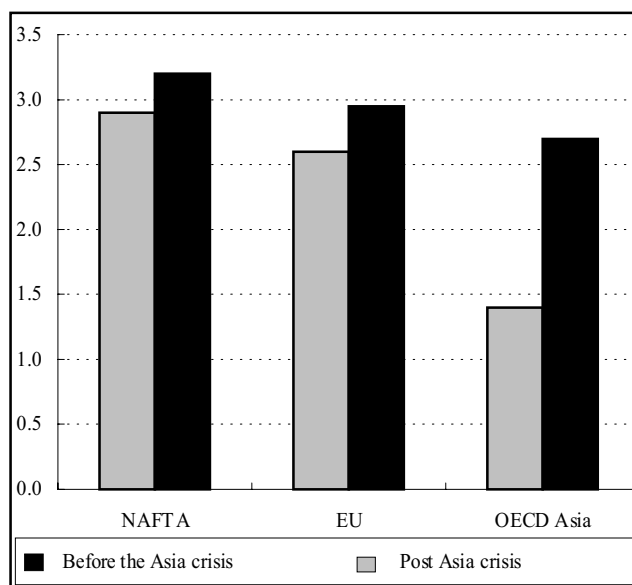
The Asian crisis will have a less severe impact on the world economy than is widely feared as long as there are no further upsets. Its effect will be to reduce world trade growth by 2.25 per cent and OECD growth by half a per cent. This marks a retreat from the strong global upturn of 1997, but will match the respectable performance of 1996.

Asian flu is virulent but this is no economic pandemic in the making. South Korea, Indonesia, Malaysia, the Philippines and Thailand account for under 7 per cent of world trade. Precisely because of the Asian crisis, the US and Europe are being treated with shots of easier monetary policy than would otherwise have occurred. The risk of recession is most serious in Japan but this is likely to lead to countervailing action by the government with a further loosening in fiscal policy from earlier plans.

The US economy will continue to expand strongly though not at the same barnstorming rate of 1997 as buoyant domestic demand is offset by a decline in net trade, which will cut GDP growth by 1 per cent. The fall-out from Asia will not brake a strengthening recovery in core Europe and this will lead to higher interest rates in the run up to monetary union. Italy is expected to form part of the first wave of EMU on political grounds despite the still precarious state of the public finances: the reported spectacular improvement in the budget deficit in 1997 owes much to fiscal windowdressing. In economic terms, it would be better to defer Italian entry to 2002.

Asia fall-out

Growth in GDP growth in 1998 (%)



The Implications of Switching from Unfunded to Funded Pension Systems

David Miles

(Imperial College, Merrill Lynch and the CEPR)

This article analyses the implications of switching from unfunded to funded pension systems. It focuses on the state pension schemes in the major European countries and considers the political feasibility and economic impacts of reducing the scale of unfunded state pensions and increasing reliance upon pensions that are backed by assets accumulated from past contributions.

Measures needed as life expectancy rises and fertility rates drop

- A combination of rising life expectancy and declining fertility rates will, in the absence of dramatic shocks (wars, new fatal diseases) or of a sharp rise in inflows of relatively young immigrants, cause the proportion of the population aged over 65 to rise sharply over the next forty years in nearly all developed countries. With an unfunded scheme if the proportion of the population of working age falls relative to the number over the current typical retirement age at least one of the following must happen: contribution rates will rise; the average level of pensions relative to wages will fall; the age of eligibility for receipt of pensions will rise; or the system will move into deficit (assuming it started in balance).

- Because the rate of return on assets is likely to exceed the growth of aggregate wages in Europe it is plausible that *in the long run* and *on average* people would be better off if pensions were funded. But in the transition from an unfunded to a funded scheme funds need to be accumulated and that requires national saving to be higher. While deficit financing can, under certain circumstances, help spread the burden of the transition across generations the scale of extra debt that might be needed in many European countries is problematic in the context of Monetary Union.

UK in better situation than the rest of Europe as it transfers to a funded pension scheme

- Ultimately, it is likely to prove hard to make significant headway towards greater funding of pensions in Europe without some people being worse off. The task is harder the more generous are existing state pensions, the more rapid is the ageing of the population and the more constrained is the government in using deficit financing. Given all this the UK is in a relatively good position (*vis a vis* rest of Europe) to complete a transition which, arguably, began almost twenty years ago. Things are much tougher on the Continent. It is plausible that in most countries a majority of those of current voting age would themselves be worse off under a phasing out of unfunded state pensions, even though future generations might enjoy big gains. For this reason a transition to funded pensions could be permanently blocked.
- But there are more than transitional issues. Unfunded pension schemes can help people insure against shocks that affect particular generations and because such schemes often involve intra-generational redistribution (because linkage between contributions made and pensions subsequently received is often quite low), as well as inter-generational transfers, they can help compensate for missing insurance markets. A key question for those who advocate a complete move to funded schemes is how the redistributive and insurance roles that are played, to varying extents, by state-run, unfunded pension schemes could be achieved by other means.
- One central message of this paper is that there is no simple way out of the problem that many European governments find themselves in. A switch to funding imposes costs while sticking with generous unfunded pensions will

Rises in retirement ages likely to happen

generate big rises in contribution rates and in associated labour market distortions. Gradual increases in (state) retirement ages are planned in several countries (including the UK, Germany, Italy and the USA) and these increases help to reduce annual contribution rates to either funded or unfunded schemes (for a given level of pensions). In the light of the sharp rises in life expectancy over the past fifty years, and the decline in the amount of physically demanding labour, a phased in rise in retirement ages is surely appropriate. In 1945 life expectancy at birth for a male was about 65 years in the UK. In 1995 the figure was about 75; World Bank projections are that life expectancy by 2050 will be about five years greater again. Regardless of the merits of funded and unfunded schemes gradual rises in retirement ages over time are likely.

The Stability Pact: Safeguarding the Credibility of the European Central Bank

Michael Artis and Bernhard Winkler

(European University Institute and CEPR and European University Institute)

Is the Stability Pact more than a straitjacket? Some people have described the European Union's Stability and Growth Pact as an 'instability pact': a strait-jacket that promises its bearers (the member countries of the Euro zone) a lot of discomfort for no seeming gain.

This article aims to describe the provisions of the Stability and Growth Pact in detail, and to present a rationalization for the discipline it imposes. Its authors, Professor Michael Artis and Dr. Bernhard Winkler of the European University Institute, claim that the rationale for the Stability and Growth Pact should be sought in the positive strengthening it gives to the European Central Bank and the relief it promises from conflict between monetary and fiscal policy. The main points made in the article are:

What are the purposes of the Stability and Growth Pact

- The provisions of the Pact centre on a country's response to being found in a position of "excessive deficit". Subject to exceptions and qualifications, an excessive deficit—as in the Maastricht Treaty—is one of over 3 per cent of GDP. The Pact seeks to provide sanctions against countries which do not respond positively to an excessive deficit position.
- The extent to which the Pact will succeed in providing a genuine discipline through sanctions or the threat of them depends *inter alia* on the flexibility permitted though the escape clauses it allows for countries in objectively difficult circumstances, and on the degree to which countries may exploit qualified voting procedures to resist the working of the Pact.
- Although the sanctions envisaged in the Pact are geared to fiscal deficit situations in excess of 3 per cent of GDP, the Pact calls for countries to target a fiscal balance of zero in the medium term.
- If this medium-term target is realized, the accusation that the Pact would act as a straitjacket is not a powerful one. A margin of 3 percentage points decline to a deficit position would in 'ordinary' cycles be sufficient to accommodate the normal operation of the "built-in stabilizers" (the automatic change in effective rates of taxation and expenditure due to the business cycle).
- The most difficult period for the Pact seems likely to arise in the initial transition period, if there is a deterioration in economic conditions and countries enter the Monetary Union already at or close to the 3 per cent deficit limit. At this point the Pact runs the risk either of imposing genuine harm or of being effectively flouted.

Stability needed
to allow
European Central
Bank
independence

- The reason for the Pact's attempt to impose fiscal discipline is the need to supply the European Central Bank (ECB) with genuine and effective independence. Whilst the Statutes of the ECB give it formal independence from national governments and from organs of the European Union, and also provide it with a statutory duty to pursue price stability, the fact is that the ECB starts with no reputation, untested credibility and no supportive political "constituency".
- The ECB's formal independence in these circumstances may expose it to actions by fiscal authorities that would undermine its authority. The Stability and Growth Pact may be viewed as a means of attempting to secure the ECB from such contingencies.
- There are many alternative sources of concern about the 'excessive' size of government that might lead to a desire for the assertion of fiscal discipline. But it is difficult to see how any of these alternative sources of concern should be significantly heightened by monetary union. It is because the formation of the Euro Zone establishes a new monetary authority and because of the possibilities of friction between monetary and fiscal policy that the Stability Pact makes sense. In this context the Stability and Growth Pact may be viewed as a first step in the progressive formation of overall European (or Euro-Zone) economic policy.

The Internationalisation of German Companies' R&D

John Cantwell and Rebecca Harding

(University of Reading and University of Brighton)

This article examines trends in the internationalisation of German large company R&D since 1969. The authors, John Cantwell (University of Reading) and Rebecca Harding (University of Brighton) place these trends in the context of concern within Germany about the internationalisation process generally, and in particular the perceived decline in the strength of Germany as suggested by the increase in outward relative to inward DFI. Using data on patents granted in the USA to the world's largest firms between 1969 and 1995 they argue that it is mistaken to be pessimistic about German technological performance on two grounds:

- (1) The research and innovation infrastructure of the economy remains strong. This has historically supported the effective management of technology and remains a potent source of German competitive advantage.
- (2) The increasing tendency of German companies to locate their R&D abroad should be seen as part of a general increase in the internationalisation of R&D in large firms and, hence, is a positive measure of competitiveness rather than the reverse.

German
technological
activity becoming
increasingly
international

Germany has been catching-up with a world-wide trend to internationalise technological activity and has done this on the basis of its core technological strengths developed historically at a national and corporate level:

- *German technology is internationalising.* This is evident from the increase in the share of research that German large firms conduct abroad, in absolute terms and when compared to other large firms from the rest of the world.
- *Internationalisation is strongest in key sectors of technological specialisation.* This would appear evident from the increase in the share of foreign-located research by German companies in the chemical and pharmaceutical

industries (in large part outside the chemical fields, but in other related areas) and by German firms in the electrical equipment and motor vehicle industries (in large part in electronic and motor vehicle technologies). German companies have internationalised their research most in the industries which are the most science-based, in which they hold the strongest competitive position relative to other European firms.

More research is being carried out in Germany by foreign companies

- *Germany has increased in attractiveness as a location for R&D over the period 1969-1995.* The most noticeable increases in US patenting activity from foreign companies conducting research in Germany are in the chemicals, pharmaceuticals and metal industries, reflecting their desire to access traditional strengths in Germany. Although the share of research of non-German firms outside their home base that was located in Germany has declined slightly in the early nineties on average, the trend is upward over the period 1969-95 as a whole.

- *German-owned companies retain their dominance of German-located R&D in the core technologies of five key industries: electronics, chemicals, pharmaceuticals, metals and motor vehicles.* The domestic dominance of German-owned firms in electronics increased in 1969-82, and then fell back again (to a share of about 70%), which suggests that German firms have maintained their technological specialisation in this science-based area, but at the same time it is an area in which Germany has recently become a more attractive location for the research of foreign-owned firms. In chemicals the German-owned share is over 90% on average, but *historically* Germany has had a strength in chemicals and in order to take advantage of this, foreign-owned companies have now increased their share of local R&D to 13% in chemical processes and 15% in bleaching and dyeing. In pharmaceuticals foreign companies were keen to take advantage of Germany's historical strength and between 1969-82 increased their share of German-based research in this area. However, since 1983 the importance of large scale research in this industry has increased yet further and German domestically-owned R&D has similarly again re-established its share of all German-located research. Likewise in motor vehicles the foreign-owned share of German-located research rose up to 1990, but fell back considerably in 1991-95.

Superior specialist technology benefits certain sectors of the economy

- *German companies have developed technological specialisms clearly focused on the core technologies of the chemicals, pharmaceuticals, metals, electronics and motor vehicles industries.* Companies from these industries demonstrate Revealed Technological Advantage domestically and abroad from research in the relevant science-based technologies, and tend not to diversify much outside these fields.
- *Case studies of three companies - Hoechst, Siemens and Bosch - illustrate how internationalisation has supported corporate technological competitiveness.* Hoechst increased its foreign origin patenting over the period 1969-1995 by nearly 20%. This is a larger rise than other companies in the same industry and operating across similar technological areas. Siemens saw an increase in its foreign origin patenting with a particularly large jump in overseas research between 1978-82 and 1983-86, when the rise was 9%. The rise in foreign-origin patenting for Bosch was 23% up to 1990, but followed by consolidation in 1991-95. All three companies demonstrated focus in their areas of technological development abroad which were, critically, supportive of their traditional strengths within Germany. The foreign research of these companies was directed towards developing new areas of related strength rather than duplicating domestic research. Good examples of this were Hoechst's involvement with biotechnology, and Siemens in semiconductors through their now substantial overseas research capabilities.