The World Economy

Ray Barrell, Julian Morgan, Nigel Pain and Florence Hubert

Improving prospects for the World Economy

Steady growth continues after the pause of a year ago.

- The world economy is recovering well from the growth pause just over a year ago.
- Helped by the depreciation of the Yen, Japan is showing strong economic growth.
- The economies of continental Europe have been assisted by the fall in the Deutsche Mark.
- The North American economies are likely to grow strongly this year but to slow in 1998 after a tightening of monetary policy in the United States.

Growth rates in the major economies have converged, with the US, Japan, France Germany and the UK all expected to grow at between 2 and 3% in 1997. Italy is expected to grow at only about 1% this year. Next year it should joint the other economies growing at between 2 and 3%.

Changes in exchange rates have helped bring about this convergence. The dollar appears to be slightly over-valued and the DM and the Yen slightly undervalued, but, with the exception of sterling, exchange rates are much closer to sustainable levels than they have been for several years.

This steady growth has led, in Europe, to a recovery in both business and household confidence, which should help sustain the rising trend in output.

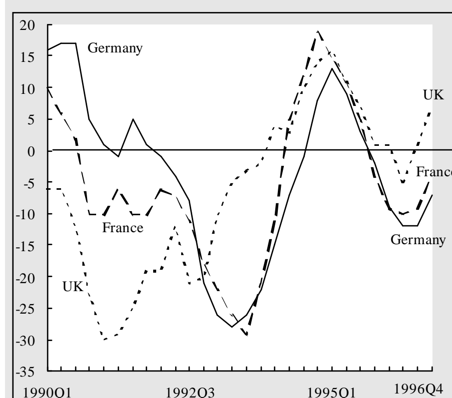
Inflation rates this year, ranging from about 1½% in Japan to 2¾% in Italy show similar convergence.

- All potential members of the European Monetary Union are likely to meet the inflation target.

US interest rates to rise

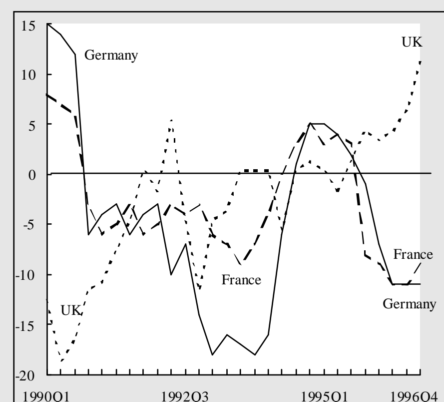
- We do expect to see a further increase in interest rates in the United States this year with a further increase next year as a means of keeping such pressures in check.
- Next year there are also likely to be interest rate increases in France, Germany and Japan.

Industrial confidence in Europe



Source: European Commission business and consumer surveys. Long-run average from 1986–96 equals zero.

Consumer confidence in Europe



Source: European Commission business and consumer surveys.
Long-run average 1986–96 equals zero.

The dominant feature of the European economic scene is likely to be a tightening of fiscal policy.

- On present plans France, Germany, Italy and Spain are all likely to have budget deficits above the 3% of GDP required by the Maastricht Treaty while the UK's deficit is likely to be just inside the target.
- In 1998 the deficits in France, Germany and Spain are expected to fall inside the target.
- Italy's deficit is not expected to fall within the target in the next three years

There will probably be further budgetary cuts and tax increases in France, Germany and Spain to bring them inside the target.

Unemployment is expected to remain a problem in continental Europe. Modest falls are to be expected from current rates.

- We expect unemployment to fall from 11% to 9½% in Germany, from 12¼% to 10½% in France between now and the early part of the next century. A similar modest fall is expected in Spain with no real change to the unemployment rate in Italy.

World Forecast summary

Percentage change

	GDP[a]						Consumer prices[b]					
	US	Japan	Germany[d]	France	Italy	UK	US	Japan	Germany[d]	France	Italy	UK
1990	1.3	5.2	5.9	2.5	2.2	0.4	5.1	2.6	2.7	2.9	6.3	5.5
1991	-1.0	3.8	13.3	0.8	1.1	-2.0	4.2	2.5	3.7	3.2	6.9	7.5
1992	2.7	1.0	1.8	1.2	0.6	-0.5	3.3	1.9	4.7	2.4	5.6	5.0
1993	2.3	0.3	-1.1	-1.3	-1.2	2.1	2.6	1.2	4.0	2.2	5.0	3.4
1994	3.5	0.7	2.9	2.8	2.2	3.8	2.4	0.8	2.9	2.1	4.6	2.5
1995	2.0	1.3	2.0	2.2	2.9	2.5	2.4	-0.5	1.9	1.6	5.7	2.5
1996	2.4	3.7	1.4	1.3	0.7	2.1	2.1	0.2	1.9	1.7	4.3	2.8
1997	2.8	2.0	2.5	2.6	1.1	3.0	2.4	1.6	1.9	1.7	2.7	2.1
1998	2.0	2.7	2.5	2.7	2.1	2.6	2.6	1.7	1.6	1.8	3.1	2.4
1999	2.1	2.6	2.5	2.4	2.7	2.4	2.8	1.4	2.0	1.9	3.5	2.9
1987-91 av	2.1	4.8	5.6	2.9	2.6	2.1	4.4	1.6	2.2	3.1	6.2	5.6
2000-2004 av	2.0	2.3	2.5	2.4	2.4	2.3	2.5	1.2	2.4	2.3	4.0	3.4

	Total world trade	Manuf trade volume[e]	OECD ind. prod	Major 7 GDP	Major 7 CED[b]	OECD GDP	OECD CED[b]	EU GDP	EU CED[b]	NAFTA GDP	NAFTA CED[b]	World manuf. prices($)[c]
1990	5.8	5.8	2.0	2.4	4.3	2.6	4.6	3.0	4.8	1.4	5.0	11.3
1991	4.7	3.5	-0.6	1.4	4.2	1.3	4.5	3.0	5.5	-0.7	4.2	-1.2
1992	7.3	2.8	-1.4	1.7	3.3	1.8	3.5	0.9	4.7	2.6	3.1	3.1
1993	4.4	3.0	0.6	1.0	2.7	1.0	2.9	-0.5	4.0	2.2	2.6	-6.3
1994	11.3	9.3	4.9	2.8	2.3	2.8	2.4	2.9	3.3	3.6	2.2	4.9
1995	10.0	9.0	3.2	2.0	2.0	1.9	2.3	2.5	3.1	1.4	2.3	11.7
1996	5.1	4.4	1.4	2.3	1.9	2.4	2.0	1.6	2.7	2.5	2.0	-2.1
1997	8.2	8.0	3.7	2.5	2.2	2.6	2.2	2.4	2.4	3.1	2.3	-5.0
1998	7.0	5.5	2.6	2.3	2.3	2.4	2.4	2.6	2.4	2.2	2.6	2.3
1999	7.2	5.6	3.0	2.4	2.4	2.5	2.5	2.5	2.7	2.3	2.7	3.4
1987-91 av	7.1	6.2	3.0	3.0	3.8	3.0	4.0	3.3	4.4	2.1	4.4	6.0
2000-2004 av	7.1	5.3	2.8	2.2	2.5	2.3	2.6	2.4	3.1	2.2	2.5	3.0

(a) GDP growth at market prices.
(b) Consumers' expenditure deflator.
(c) Price of OECD exports of manufactures in US$.
(d) The figures are on a pan-German basis since 1991. The 1991 GDP figures are distorted by the impact of unification.
(e) The forecast figures are based on the exports of OECD countries.

The UK Economy

Marie Sheldon and Garry Young

Moderate economic growth

The high exchange rate has dampened fears of an economic boom.
- We expect output growth of 2.6% this year and 2.5% next year.

It means that different sectors are likely to experience very different rates of economic growth.
- Manufacturing output is forecast to grow by under 2% this year
- Output of business services is expected to rise by 7%

There are similar imbalances in the pattern of demand
- Private consumption is expected to grow by nearly 4% in 1997.
- Public consumption is expected to rise by only 1% in volume terms.
- Import growth will exceed export growth giving a negative contribution to overall demand.

Inflationary fears overstated

There is no need for an immediate increase in interest rates in order to control inflation
- The exchange rate has risen by almost 15% since last summer and this is exerting downward pressure on the inflation rate
- The Retail Price Index is expected to rise only very slowly in the rest of this year.

By the end of the year the RPI excluding mortgage payments will be 2.0% higher than at the end of 1996.
- Next year we expect the rate of inflation to be 2.1%
- Nevertheless we expect an increase of ½% point in the interest rate after the election. It will probably be reversed in the autumn.

Labour Market Conditions

Compared with the situation in 1990 there is substantially more slack in the labour market
- The proportion of the population of working age not working is 25.9% compared with 22.2% in 1990 and 27.5% at the end of the recession.
- Employment (including self employment) is over 1 million lower than it was in the last boom.
- The number of people of working age has risen by nearly 800,000.
- Data on pay settlements show no sign of an increase in wage rates.
- The published data showing 5% p.a. increase in earnings may have been inflated by bonuses paid out in advance of the election.

In any case wages should normally be expected to increase faster than prices. If the rate of inflation is 2½% p.a., then the economy should be able to afford pay increases of around 4½% p.a.
- In the short term any slightly higher wage rises are likely to be met by a reduction in profit margins from their current high level.

Nevertheless policy is unbalanced, with monetary policy too tight and fiscal policy too loose. Our *Fiscal Report* suggests that fiscal policy needs to be tightened to put the government's finances on a sustainable basis.

Fiscal Report

Marie Sheldon, Martin Weale and Garry Young

For the first time the *National Institute Economic Review* includes a **Fiscal Report.** This is intended to provide a regular independent comment on the prospects of the government reaching its fiscal targets. It will usually appear every six months in the *National Institute Economic Review* in line with the budgetary cycle.

The best guide to the way in which the public finances have changed is given by looking at the net worth of the whole public sector. This is calculated as the sum of publicly owned tangible assets less the public sector's net financial liabilities. It has declined by 40% of GDP since 1991.

Public sector net worth as a guide to the fiscal position

- As a consequence of the decline in public net worth property income is lost and debt income is increased.
- In 1997 taxes are have to be higher by £2.8bn because of this.
- The extra borrowing since 1990 means that the standard rate of income tax is raised by over 1½p in the £.

The public sector balance sheet

Per cent of GDP

End of financial year	Tangible assets	Net financial liabilities	Net worth
1990–91	71.2	21.4	49.8
1991–92	63.9	23.0	40.9
1992–93	59.7	31.0	28.7
1993–94	58.6	37.2	21.4
1994–95	57.1	39.7	17.4
1995–96	57.7	42.4	15.3
Forecasts			
1996–97	*56.2*	*45.2*	*11.0*
1997–98	*56.6*	*45.9*	*10.7*
1998–99	*56.5*	*44.9*	*11.6*
1999–00	*55.3*	*43.1*	*12.2*
2000–01	*54.2*	*41.3*	*12.9*

Source: *National Accounts Blue Book Table 12.12.* Own calculations to show as percentage of money GDP.

Public expenditure

If the new government wants to avoid the embarrassment of large tax increases it will have little option except to stick to the current government's spending plans. These imply very slow growth in the Control Total of non-cyclical government spending and reduce Control Total spending from 34.9% of GDP in 1996/7 to 32.5% in 1999/2000.

- The high level of public spending is a consequence of a surge in spending between 1989 and 1993. The position has been stabilised since then but its effects remain.
- There are doubts that the government will be able to stick to these targets, but government departments are already operating within the limits for 1997/8, and there is no sign yet of the large pay settlements which might lead to a surge in spending.

Public revenue

We expect that the new government will make two substantial tax increases
- We have assumed that the windfall tax will raise £5bn over two years
- Reduction of the tax credit on dividend income to 10% will raise £3½bn

But offsetting this, a cut in the rate of VAT on fuel will cost £¼bn.

Sustainability

With these tax changes and tight control of spending, the PSBR is projected to fall 0.7% of GDP by 1999-2000 and to stay at that level in 2000-2001.

- This is not enough to stabilize the ratio of public sector net worth to GDP
- For the public finances to be on a sustainable footing, further cuts in spending or increases in taxes of about ½% of GDP or £3½bn at today's prices are needed.

Summary of the UK forecast

	Probabilities[a]						Retail price index[f]			
	Inflation target met[b]	Output falling[c]	Real gross national income[d]	Real GDP[d]	Manufacturing output[d]	Unemployment[e]	All items	Excl. mortgages	Current balance[g]	PSBR[h]
1996	–	–	3.4	2.4	0.4	2.0	2.6	3.2	0.0	23.5
1997	*61*	*0*	*3.4*	*2.6*	*1.8*	*1.7*	*2.5*	*2.0*	*0.2*	*21.4*
1998	*54*	*13*	*2.8*	*2.5*	*3.2*	*1.5*	*2.3*	*2.3*	*-2.6*	*10.6*

(a) In percentage terms. (b) Inflation excluding mortgages below 2½ per cent per annum at the end of the year. (c) A fall in the annual average output. (d) Percentage change, year-on-year. (e) UK, fourth quarter, million. (f) Percentage change, fourth quarter on fourth quarter. (g) Year, £ billion. (h) Fiscal year, £ billion.

European investment and German FDI: Implications for Domestic Investment and Central European Economies

Jamuna Prasad Agarwal (University of Kiel)

- German foreign direct investment (FDI) is currently over twice its average in the first half of the 1980s. The EU share in it nearly doubled, and FDI in Central Europe grew much faster. This article by Jamuna Agarwal of Kiel University argues that this growth has been stimulated by European integration, and is likely to continue, especially as Central European countries remain on course for EU membership.

- Agarwal argues further that this growth is not detrimental to domestic investment in Germany. Conversely, together with earnings (including licence fees and royalties) the net trade effect of FDI supports domestic capital formation. Thus, worries about the negative consequences of FDI outflows for the German economy are largely unfounded.

- Recently, inflows of FDI in Germany have lagged far behind outflows heightening concerns about Germany as an attractive location for business.

- Mergers and acquisitions cannot easily take place in Germany because of low stock market capitalisation, cross holding of shares, and the influence of the state, banks and trade unions on management.

- Low FDI inflows to Germany are a consequence of the high international competitiveness of its domestic enterprises based on their proprietary assets related to technology and markets. Foreign investors find it difficult to overcome this entry barrier.

High wage costs and rigid labour markets discourage investment into Germany

- High wage costs and rigid labour market conditions may have further discouraged foreign investors in choosing Germany as a business base.

The Impact of Foreign Direct Investment on Sectoral Adjustment in the Irish Economy

Frances Ruane and Holger Görg (Trinity College, Dublin)

- The high rates of growth achieved by Ireland, the *Celtic Tiger*, in recent years have been much commented upon. This paper examines one element which has contributed strongly to that growth, namely, the significant levels of inward foreign direct investment (FDI). The focus of the paper is on Ireland's approach towards promoting FDI over the past four decades and the significant employment effects it has generated in the Irish economy since the 1970s.

- Recognising its limited resources and small domestic market, Ireland began to promote itself in the 1950s as an FDI-friendly economy, capable of providing a manufacturing base in Europe for non-European investors and as a relatively cheap manufacturing base for investors from other European countries. Promotion took the form of providing a combination of discretionary grants and corporate-tax relief, designed and implemented to attract modern, high-profit industry. Today Ireland actively seeks projects which add to existing *high-tech* industrial clusters, e.g., in electronics and pharmaceuticals, and in internationally-traded services. In addition to fiscal policies, levels of education and infrastructure have been improved to attract companies to Ireland.

Significance of FDI in Ireland has risen rapidly over the last 20 years

- The importance of FDI to the Irish economy has risen significantly over the past twenty years and now almost half of the employment in the Irish manufacturing and internationally-traded services is in foreign-owned companies. This represents a very high level of foreign-ownership by world standards.

- While today the UK is Ireland's most serious competitor for non-EU investment, in the 1950s it was the most important source of FDI in Ireland.

  Though still significant, employment in UK firms has declined dramatically over the last twenty years, primarily reflecting the fact that many UK-owned firms closed or contracted following the removal of tariff protection in the 1970s, and that Ireland is not an especially attractive location for UK industry.

- The major source of FDI in Ireland for the past 20 years has been US companies, which now account for a quarter of *total* employment (over half of employment in foreign companies) in Ireland. The flow of US investment increased with Ireland's entry into the European Community in 1973 and has grown with further integration of the EU markets, with Ireland becoming the European base for several major US companies (e.g., Intel, Gateway 2000).

FDI has created a modern manufacturing sector

- The strategy pursued has been successful in that Ireland now has a modern manufacturing sector and has sustained employment in manufacturing at a time when employment in manufacturing in the EU fell dramatically. Led by US-owned firms, there has been a process of industrial restructuring towards *high-tech* manufacturing sectors and internationally-traded services.

- Challenges to Ireland's continuing success in winning FDI will come increasingly from other EU countries and from the countries in Eastern Europe which are also seeking to attract FDI.

Foreign Direct Investment in Europe

Ray Barrell and Nigel Pain

Rapid growth of FDI in Europe in the past decade

Foreign direct investment (FDI) has grown rapidly over the past decade, especially within Europe. Over two-fifths of all direct investments are now held within Europe, compared to only 30 per cent a decade ago. This has led to increasing interest in the costs and benefits that are generated by FDI. Such issues are particularly important for the UK economy, whose aggregate stocks of outward and inward FDI reached 30 per cent and 21 per cent of GDP respectively at the end of 1995.

Analysis of the level of FDI in Europe shows that:

- the UK has historically been the most important location for FDI in Europe, hosting around 23 per cent of all existing investments in Europe as of 1995. This share has fallen from 30 per cent a decade earlier;
- growth in inward investment since 1979 is often claimed to reflect the low burden of business regulations and flexible labour market in the UK. Comparisons with more heavily regulated Germany, which has received little inward FDI, would seem to confirm this;
- the evidence from other countries suggests that labour flexibility is not the sole factor in investment decisions. France has received more inward investment since 1990 than the UK. During this period UK firms have been the single most important investors in France. Other countries such as Belgium, Netherlands, and Ireland have for many years received more inward investment in per capita terms than the UK;
- the rapid growth of inward investment in Spain since 1986 and Sweden since 1991 suggests that countries become more attractive investment locations once they make a commitment to become an active participant in an integrated Europe

Labour costs, labour regulation, skills and productivity influence investment decisions

Labour costs and regulations continue to matter in investment decisions, as do the skills and productivity of the workforce. The UK has fared well in attracting relatively labour intensive investments, but relatively poorly in attracting more capital intensive or R&D intensive investments. Countries such as France, Germany, Ireland and Austria, with well-educated and more numerate workforces and a higher level of technical skills, often attract such investments.

Employment figures provide one means of evaluating the types of FDI located within the UK. An analysis of the operations of US foreign affiliates within Europe in 1994 shows that:

- some 763,000 people are employed in US affiliates in the UK. These affiliates produce six per cent of UK output;
- whilst nearly half of the assets within Europe owned by US companies are in the UK, the sales and gross product (value added) of affiliates in the UK amount to only a quarter of the European total. The gross product of manufacturing affiliates in Germany is higher than those in the UK;
- labour productivity measured in terms of value added per employee is over 12 per cent lower in US affiliates in the UK than the average of all US affiliates in Europe, and 28 per cent lower in UK manufacturing affiliates, at prevailing market exchange rates.

- output per employee in UK-owned manufacturing firms is around three-quarters of that in US-owned affiliates.

The UK also appears to do less well in attracting high-tech investments in Europe. The research intensity of US affiliates in the UK, measured as R&D expenditures relative to sales, is below the European average, with the most research intensive affiliates being located within Germany, France, Belgium and Ireland.

EU membership affects the level of inward investment

Membership of the European Union and the perceived commitment to European integration also affect the level of inward investment, particularly from firms outside Europe.

- Investment in Europe enables these firms to bypass barriers to trade and gain access to the wider market. The cost competitiveness of the UK has helped it attract Japanese investments, but only because Japanese firms wanted to produce in Europe.
- Large multinational companies do not appear to view the Social Chapter as an obstacle that cannot be overcome. The level of FDI by UK companies in continental Europe exceeds the level of investment by foreign companies in the UK.
- The need to avoid currency volatility matters to companies. Thus monetary union may affect the location of production by giving some firms an incentive to locate in continental Europe, close to their main markets.

Surprisingly little is known about the consequences of FDI in Europe, in spite of the attention given to it by policymakers in recent years. The available evidence for Europe suggests that:

- foreign companies have raised labour productivity, and hence economic growth, and improved export performance in the UK, Irish and Belgian manufacturing sectors. Inward investment has also raised exports from a number of other EU economies, notably Spain and Portugal;
- there is little evidence that foreign investments in non-manufacturing sectors have generated beneficial supply-side improvements, apart from in the petroleum industry. It is not clear how foreign investments in water companies and railway operators confer significant benefits on host economies;
- outward foreign direct investment has costs and benefits for investing economies. Empirical evidence from the UK, France, Germany, Spain and Sweden suggests that outward investment worsens export performance. However the investments raise national income by increasing the income from existing firm-specific assets. Between 1990-95 earnings from UK FDI were equivalent to 2¾ per cent of GDP per annum.

Regional Economic Integration and Foreign Direct Investment: The Case of German Investment in Europe

Nigel Pain and Melanie Lansbury

Single market boosts German FDI in UK and Europe as a whole

New research from the National Institute shows that the single market programme in Europe has boosted the level of inward investment by German companies in the UK and other European countries. Some 1.2 million people are now employed in the European subsidiaries of German companies as a result of the rising level of foreign direct investment (FDI) over the past decade. Around 180,000 of these workers are employed in the UK, representing 1¼ per cent of private sector employment. Our research indicates that close to one-fifth of the total stock of German foreign direct investment in the EU and one-third of the total stock of German FDI in the UK can be ascribed to the decision to create an internal market.

A step-up in direct investment was not foreseen in the mid-1980s when the single market programme was launched, with the European Commission anticipating that the main gains from removing internal non-tariff barriers would come via trade. Companies were expected to restructure production to supply the single market from ne location with greater economies of scale.

However direct investment by German companies in the EU rose by £18.7 billion between 1986 and 1990, and by £30.9 billion from 1990 to 1994. As a result 49 per cent of the total stock of direct investments made by German companies overseas was held in EU countries in 1994, up from a third in 1982.

Our analysis of the impact of the single market on the pattern of outward investment by German companies shows that:

- the UK, the Netherlands, Italy and Portugal have gained significant extra investments;
- the largest effects have occurred in the financial services, electrical and transport industries;
- the UK and Belgium are the main gainers from the additional investment in financial services;
- the level of outward investment in chemicals and mechanical engineering has been reduced, with German firms concentrating production in Germany and exploiting economies of scale;
- manufacturing investments have been diverted away from the United States into Europe.

These results, plus those from an earlier analysis of UK firms, suggest that the single market programme has raised the stock of FDI in the European Union economies by an amount equivalent to 0.5 per cent of EU GDP (at constant prices.)

Labour market flexibility and skills important in attracting investment in manufacturing

Our research also highlights the importance of labour market flexibility and skills in attracting inward investment in manufacturing sectors:

- the UK is found to have benefited from greater labour market flexibility, measured in terms of declining relative labour costs and strike actions. These factors account for 15 per cent of the growth of German FDI in the UK since 1986;
- however similar benefits have been experienced by France, Italy and Austria, all of whom have different labour market institutions;
- the UK has fared relatively poorly in attracting investments from firms in research-intensive sectors in Germany. This matters because such firms have a greater propensity to invest outside Germany.

These results suggest that the UK has become one of the preferred locations within the EU for labour-intensive investments. Other investments which require either a higher level of skilled labour, or involve a greater degree of process and product innovations are more likely to be located elsewhere in Europe.