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International take-over boom continues

Foreign purchases of UK companies increase the money supply

Downward revisions to growth forecasts

The combination of the over-valued pound and the rise in base rates from 6% to 7 1/4% have led to downward revisions in forecasts for output growth in 1998. Back in the spring the Treasury's compilation of forecasters reported an average growth forecast for 1998 of 2.7%. In November the figure was 2.4% and - given all the hubbub about "the Asian effect" - it will certainly fall again in the next month or two.

but forecasters making such revisions ignore the money supply

A common practice of British economists is to regard interest rates, the exchange rate and the budget deficit as the key influences on demand and output "in the short run" (i.e., over the next two years). There is little or no discussion of the relationship between money supply growth and macroeconomic outcomes in this short-run period, even though hardly anyone doubts that in the long run the demand to hold real money balances depends predominantly on real variables. The disjunction between economists' conventional short-run "model" of national income determination and their views about the long-run relationship between money and national income is peculiar. Surely the long-run relationship can hold only if money affects demand and output in a sequence of short runs. On the whole, the evidence is that sharp changes in real money supply growth are important to asset prices and economic activity with lags of much less than two years. *Further, periods of real money growth above 5% a year or of negative real money growth are unsustainable. Either the inflation rate or the rate of nominal money supply growth has to change, so that real money growth is brought closer into line with the 2% - 2 1/2% trend increase in real output.*

Money supply growth remains high, partly because of foreign buying of UK companies

A macroeconomic prognosis based on money supply developments gives a very different message for 1998 from the conventional approach. The annual rate of real money growth has been above 5% since early 1995. A two-and-half-year period like this cannot be dismissed as a blip. Further, there is little evidence of a slowdown in money growth. In recent quarters foreign companies have been borrowing sterling on an unprecedented scale in order to finance purchases of UK companies. The result is to boost the money holdings of the UK shareholders when they sell out, adding to the excess money balances in the economy (particularly in the financial sector) and so providing renewed support to asset prices. The last few weeks have seen this sort of international corporate finance activity *increasing, not decreasing*. (Examples are Lafarge's £1.8b. acquisition of Redland and Federal-Mogul's £1.39b. purchase of T & N.) The increase in UK demand and output may slow down in early 1998, but it is unlikely that the deceleration will be to a beneath-trend rate.

Summary of paper on

"The decline and fall of the modern European state"

Purpose of the paper

It is well-known that adverse trends in demographics and employment will increase the tax burden and slow economic growth across the industrial world in the next 30 or 40 years. The paper tries to answer the question "could the effect be not just to act as a drag on economic growth, but even to cause declines in national output?".

Main points

- * **Never-ending economic growth has been taken for granted in the post-war period. It is an assumption of political debate in the modern European state.**
- * **The rise in output per head of population ("living standards") can be interpreted as the sum of increases in *productivity* (output per person employed), *participation* (the ratio of people in work to the population of working age) and *demographics* (the ratio of the working-age population to the total population).**
- * ***Productivity.* Since the early 1970s productivity growth has slowed down. Realistic projections are for 1%- or 1-1/2%-a-year increases in output per head.**
- * ***Participation.* Trends in participation vary between industrial countries, but seem to be healthiest in countries with relatively low taxation and social security contributions (such as the USA and Japan). In Europe the proportion of working-age men actually in work has fallen in the last 30 years, particularly in France and Italy.**
- * ***Demographics.* Demographic projections from the World Bank suggest that the ratio of the working-age population to the total population could be falling by over 1/2% a year in the main industrial countries after 2010.**
- * **Combining all three influences on growth, prolonged periods of static or even falling living standards are to be expected in Europe in the early decades of the next century.**

This paper - which formed the substance of a lecture to the think-tank, Politeia, on 3rd December - was written by Professor Tim Congdon.

The decline and fall of the modern European state

Could national output fall, on a trend basis, in significant industrial nations?

A second "Antonine Age" in the post-war period Never-ending economic growth is an assumption of our times. Because living standards have been rising more or less continuously since the Second World War, it seems unimaginable that they could drop over an extended period. Indeed, the whole post-war period could be termed a "second Antonine Age", comparable with the first Antonine Age described by Gibbon in the famous three opening chapters of *The Decline and Fall of the Roman Empire*. Demographic trends will constrain economic growth over the next 30 or 40 years throughout the industrial world. Are there any circumstances in which growth could come to a complete halt or even be reversed?

Living standards depend on productivity, participation and demographics

In answering this question, the key identity is

$$O/P = O/E \times E/W \times W/P$$

where O is output, P population, E employment and W the population of working age. So O/P is output per head of population ("living standards"), O/E output per person employed ("productivity"), E/W employment as a ratio of the population of working age (labour force participation or "participation", for short) and W/P is the population of working age as a ratio of population ("demographics"). The change of living standards can be interpreted as the sum of changes in productivity, participation and demographics.

In the past productivity growth has been the dominant influence on rising living standards in the industrial West. (See p. 4.) But, looking ahead, it seems unrealistic to expect productivity growth to be more than 1 1/2% a year over the long term. Indeed, in view of recent decelerations in productivity growth in several countries, a case could be argued for adopting a lower figure of only 1% a year. (See p. 6.)

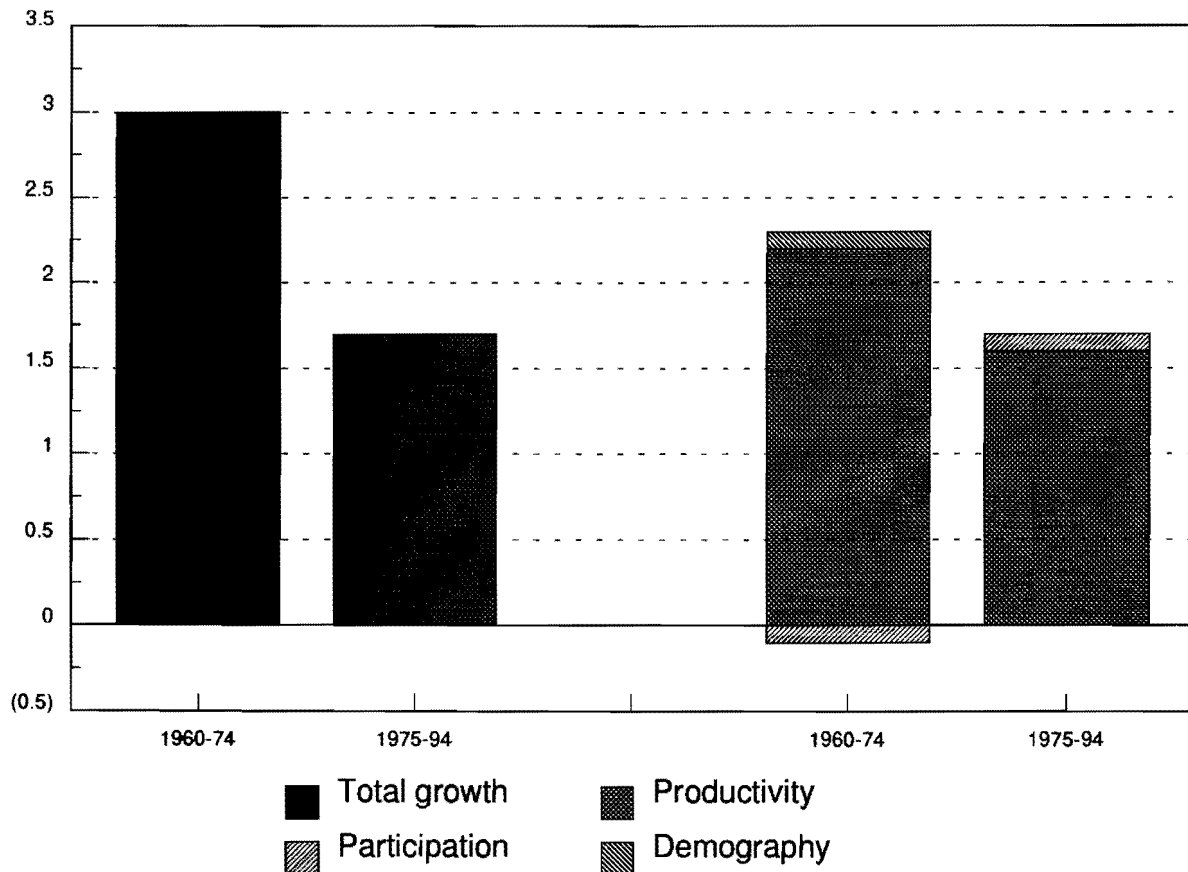
But, if high taxes continue to cause falling participation, living standards might start falling

Trends in participation have varied sharply between different countries. In the USA and Japan labour force participation has increased and unemployment has remained low, so that the population of working age is more actively employed than 10 or 20 years ago. But in Europe participation has declined, notably in France and Italy, perhaps because of high taxes and social security contributions. (See p. 7.) The decline in participation has been most marked for men. (See p. 8.) If the decline in participation continues at rates similar to the last 15 years, if demographic patterns follow estimates prepared by the World Bank (see pp. 10 and 11) and if productivity growth is 1% a year, the next 40 years would see falling living standards in Italy and negligible growth in France, the UK and Germany. (See p. 12.) While these assumptions could be criticized as pessimistic, they are realistic. The nation states of modern Europe might have to consider the disturbing possibility that excessive taxation - intended to finance the welfare state - is the main cause of falling labour force participation.

Growth patterns in the past

Productivity growth dominant growth influence in OECD as a whole

Chart shows % p.a. increase in output per head of population in two left-hand bars and the relative size of the three growth influences in the two right-hand bars.

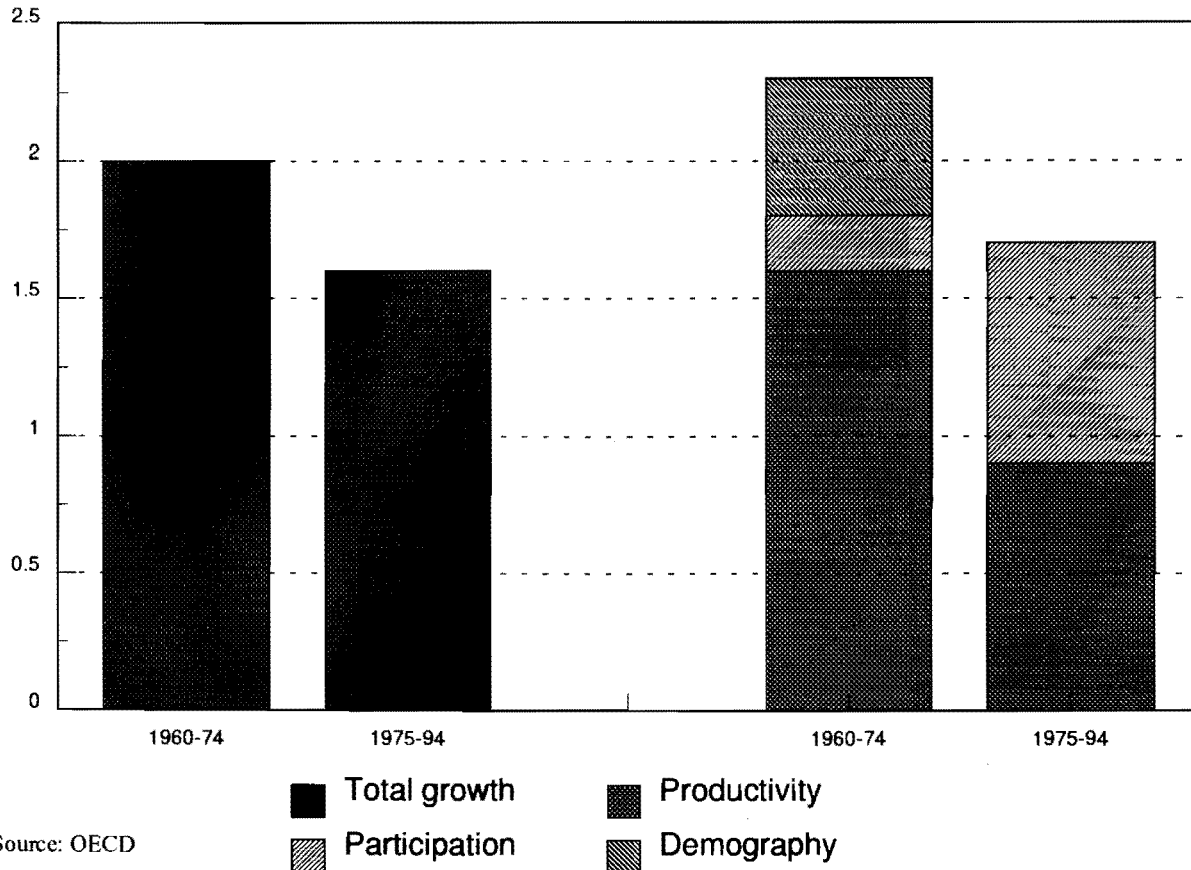


Note that three influences in RH bars do not add up exactly to growth in LH bars because of rounding and other inconsistencies. For explanation of terms, see p.5.

Economic growth was particularly rapid in the 1950s and 1960s, as Europe and Japan copied superior technology that already existed in the USA. For the OECD as a whole output per head of population went up by over 3% a year. As the USA and the UK grew at lower rates than the average, the rest of the industrial world enjoyed growth rates of 4% or more. A marked slowdown began in the early 1970s, with output growth dropping to under 2% a year. In both the early and later periods improvements in productivity were the dominant influence on the gains in living standards. However, it is interesting that in the second period of slower growth demographics remained favourable, in sharp contrast to the outlook in coming decades.

In the USA rising participation crucial since the 1970s

Chart shows % p.a. increase in output per head of population in two left-hand bars and the relative size of the three growth influences in the two right-hand bars.



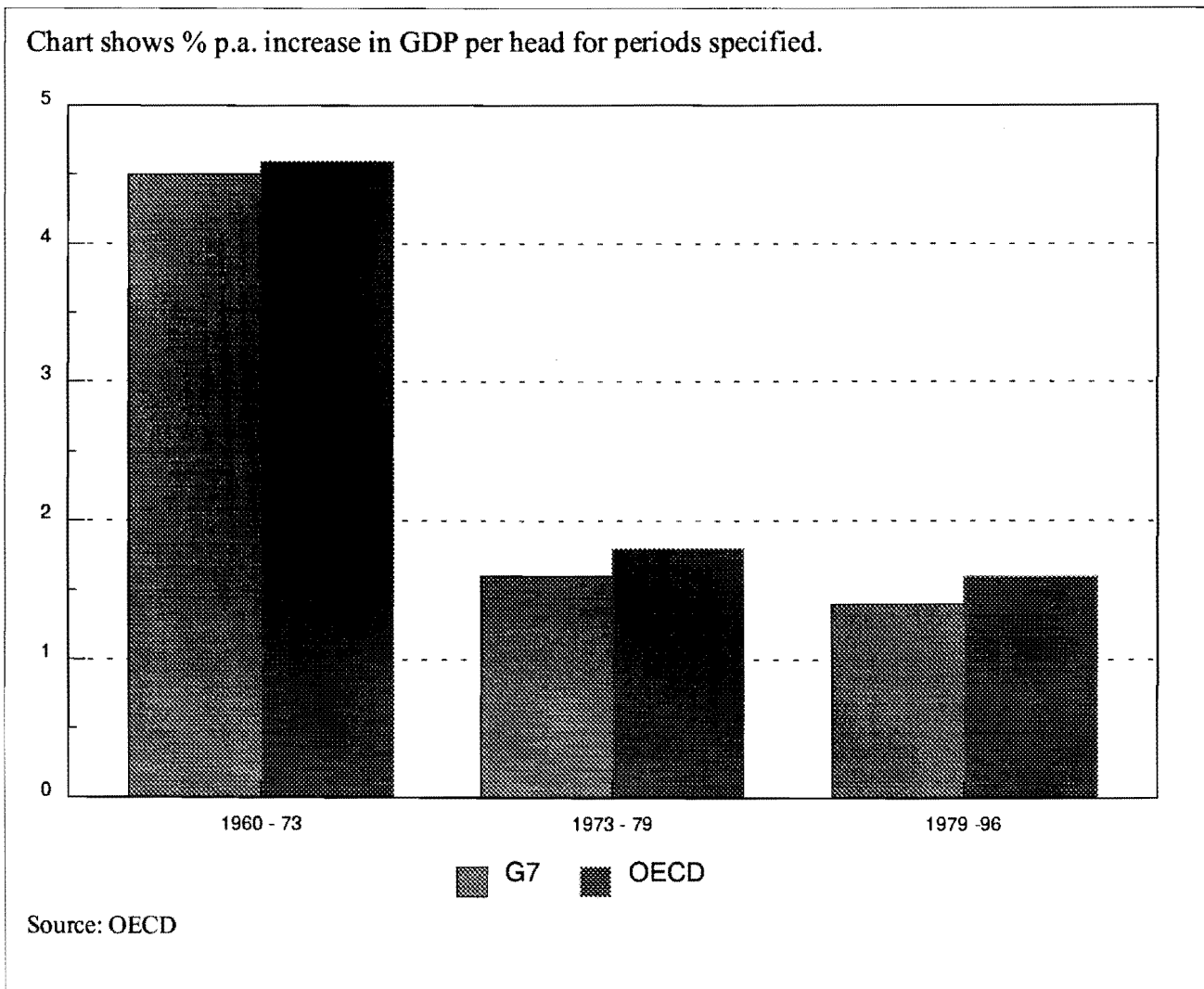
Source: OECD

Productivity is GDP per person employed; participation is ratio of population of working age (15-64) in work; demography is ratio of working age population to total population

In the USA the slowdown in growth between the earlier and later periods was less pronounced than in other industrial nations. (Growth was not particularly high in the earlier period and so it had less far to fall.) Even so, productivity growth from 1975 to 1994 ran at under 1% a year, far less than in other industrial nations. The continued expansion of output depended heavily on extra participation, particularly a remarkable increase in the number of women in employment. (See p. 7.) Some economists have questioned the accuracy of official productivity estimates, as these seem "too low" given the technology advances over recent years. A key point is that, on average, women are paid less than men (and so are presumably less productive). So a rise in the ratio of female to male employment would lower productivity growth.

Productivity

Clear decline in productivity growth since the early 1970s

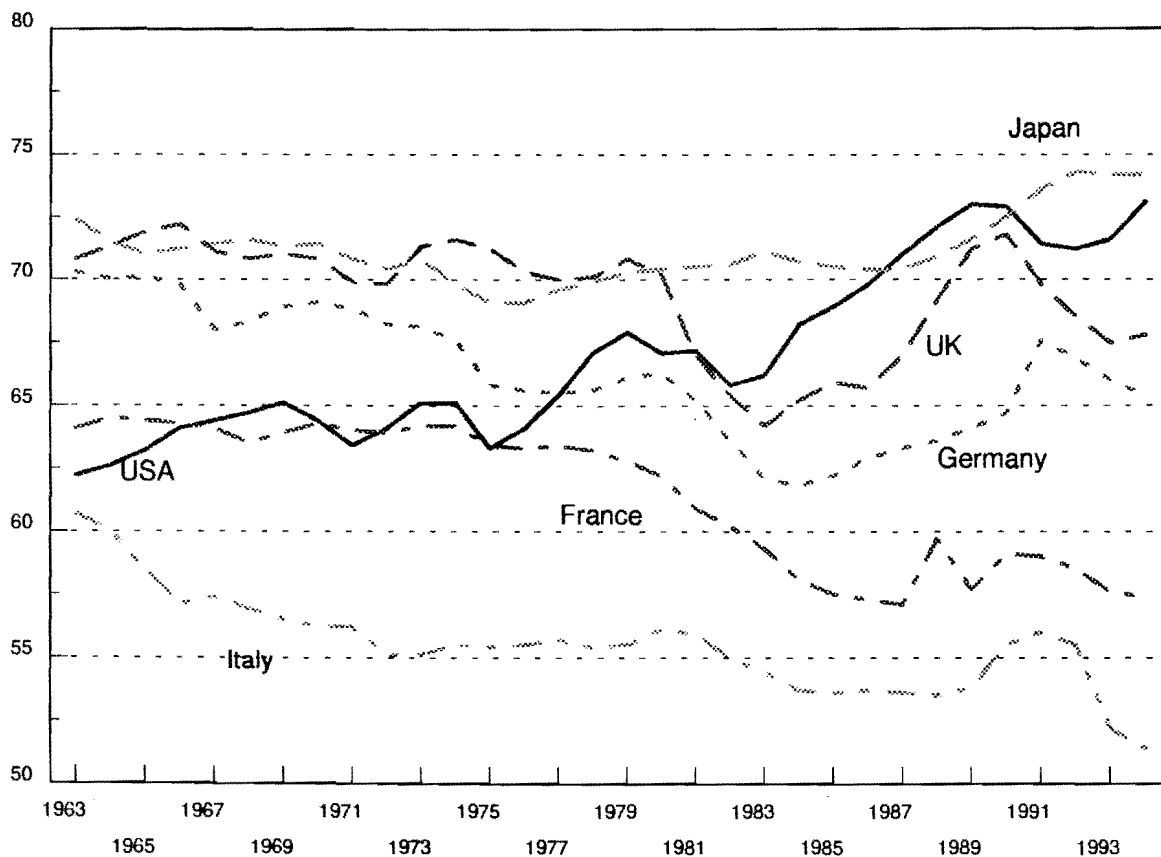


This chart shows the clearly-defined drop in productivity growth that occurred in the early 1970s. (4%-a-year productivity growth could not go on for ever. It would cause output per person to rise by 50 times in 100 years and 2,500 times in 200 years, and this is plainly absurd.) The deceleration is sometimes attributed to the rapid inflation of the 1970s, with higher oil prices taking much of the blame. But this is not altogether convincing. Between 1979 and today inflation has run at moderate rates and energy prices have returned to much the same levels (in real terms) as in the 1960s. Yet productivity growth has remained at 1 1/2% a year or less. Indeed, the trend appears to be for productivity growth in the industrial world to decline, implying that a projection of only 1%-a-year productivity growth is plausible. (This is picked up on p. 12.)

Participation

1. Marked divergence between Europe and other industrial societies

Chart shows % ratio of employed population of working age to total population of working age, for men and women combined



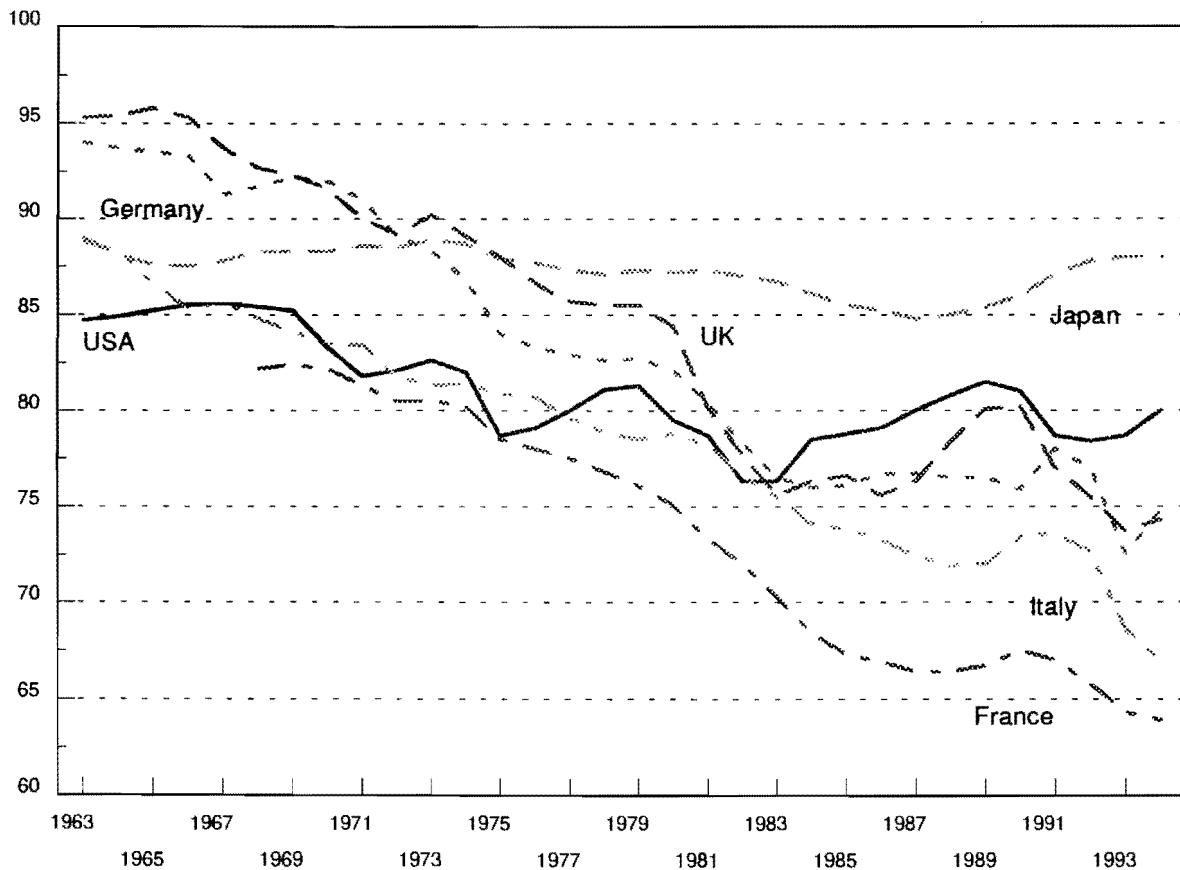
Source: OECD

Societies' effectiveness in using all their potential workers (i.e., the population of working age) varies considerably. It depends on i. the proportion of the population of working age in the labour force ("the participation ratio") and ii. the proportion of the labour force actually in employment ("the employment ratio"). The activity ratio - shown in the chart - is the product of the two ratios. These six industrial nations divide into three groups. The first is the USA and Japan where the activity ratio is over 70%, and has been stable or rising; the second includes Germany and the UK where the activity ratio is between 65% and 70%, and again has been stable or rising; the third consists of France and Italy, where the activity ratio is under 60% and has been falling. France and Italy also have the highest ratios of public spending to GDP of this group of nations.

Participation

2. Falling male participation in general, with collapse in France and Italy

Chart shows % ratio of employed population of working age to total population of working age, for men alone.



Source: OECD

This chart gives the most frightening part of the analysis. Across the industrial world the activity ratio of men is lower now than it was in the 1960s, except in Japan. But there are dramatic differences between countries. In the USA the male activity ratio has changed little in the last 20 years, apart from the effects of the business cycle. In both Germany and the UK the male activity ratio is in a long-run downward trend, but there are cyclical interruptions and, arguably, the trend has flattened out since the early 1980s. In France and Italy the downward trend is most pronounced, with no sign of easing in the last decade. Indeed, in the French case the slide in male labour force participation may even have accelerated in the 1990s. Labour market regulation, as well as high taxes, may be relevant here.

3. Activity ratio falling in Europe, particularly in France and Italy

Table shows the % annual change in ratio of employed population of working age to total population of working age ("the activity ratio"), for men and women combined.

It reflects two influences -

- i. the ratio of the population of working age in the labour force, and
- ii. the ratio of the labour force in employment

	Activity ratio 1979	Activity ratio 1994	% annual change 1979 - 94
USA	67.9	73.1	0.5
Japan	70.3	74.2	0.4
Germany	66.1	65.4	(0.1)
UK	70.8	67.8	(0.3)
France	62.8	57.4	(0.6)
Italy	56.1	51.4	(0.6)

Source: OECD

The table quantifies more precisely the message of the chart on p. 7. In the last 15 years the activity ratio has climbed in both the USA and Japan, although for rather different reasons. In the American case male participation in the labour force has been roughly stable, but female participation has gone up by about 1% a year. With women on average producing 0.8 as much as men, the rise in female participation has accounted - in arithmetical terms - for about 3/4% a year of the USA's growth since 1979. (See p. 5.) The fall in the activity ratio in France and Italy has been running at 0.6% a year over the 15-year period. This has been concentrated among men in late middle age. Whereas in Japan almost 80% of men in their early sixties are working, in France the ratio is slightly above 20%.

Demographics

1. Some countries have relatively favourable situation, with little change until 2010

Chart shows % ratio of population of working age to total population.

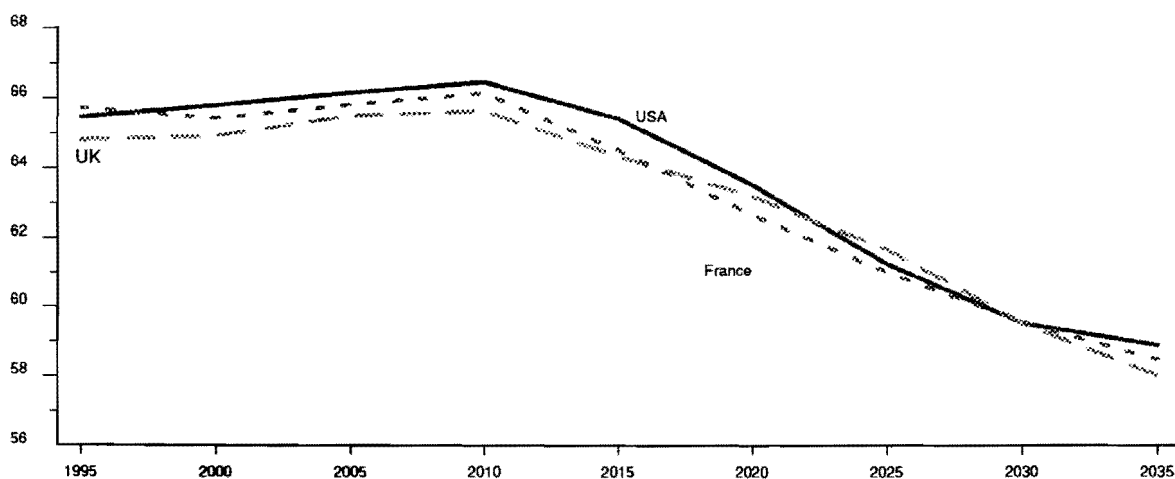


Table shows % p.a. change in population of working age to total population.

	USA	UK	France
1995-2000	0.1	0.0	(0.1)
2000-2005	0.1	0.2	0.1
2005-2010	0.1	0.0	0.1
2010-2015	(0.3)	(0.4)	(0.5)
2015-2020	(0.6)	(0.4)	(0.6)
2020-2025	(0.7)	(0.5)	(0.5)
2025-2030	(0.6)	(0.7)	(0.5)
2030-2035	(0.2)	(0.5)	(0.4)

Source: World Bank

The "greying" of the populations in the industrial world has been much publicised. In Japan, the fall in the ratio of working-age population to the total population is most marked between now and 2015. Elsewhere in the USA, the UK and France, the immediate post-war decades saw high birth rates. After the "baby boomers" retire 60 or more years later (i.e., from 2010 onwards), the ratio of working-age population to total population drops typically by about 1/2% a year. Unless immigration suddenly increases (which would cause social problems), slower economic growth is likely. In fact, immigration is an important influence on population growth only in the USA.

2. In other countries continuous deterioration in prospect

Chart shows % p.a. change in population of working age to total population.

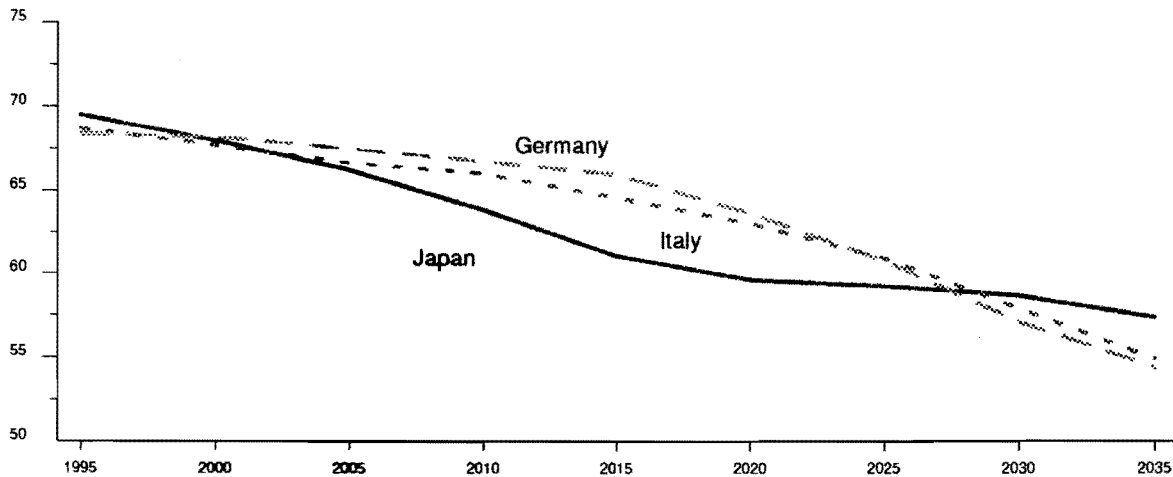


Table shows % p.a. change in population of working age to total population.

	Japan	Germany	Italy
1995-2000	(0.5)	(0.1)	(0.3)
2000-2005	(0.5)	(0.2)	(0.3)
2005-2010	(0.7)	(0.2)	(0.2)
2010-2015	(0.9)	(0.2)	(0.4)
2015-2020	(0.5)	(0.7)	(0.5)
2020-2025	0.0	(0.9)	(0.7)
2025-2030	(0.2)	(1.2)	(1.0)
2030-2035	(0.4)	(0.1)	(1.1)

Source: World Bank

Although the USA, the UK and France have their problems, the threat to economic growth from demographic change is "low risk", certainly over the next 15 years. On the other hand, Japan, Germany and Italy could be categorized as "high risk". The ageing of Japan's population is particularly marked in the 1990s and the first two decades of the next century. (The Japanese government's reluctance to pursue fiscal expansion is partly explained by this demographic background.) By contrast, the "greying" in Germany and Italy is most pronounced between 2015 and 2035, when in several quinquennia the ratio of the working-age population to the total population falls by over 3/4% a year. When productivity growth is running at only 1% a year or so, the danger of falling living standards is obvious.

Living standards

Virtual stagnation in European living standards for 40 years

Table shows project % change in output per head of population, using assumptions explained in text.

	O/E	E/W	W/P	O/P, "Living standards"
USA	1.0	0.3	-0.3	1.0
Japan	1.0	0.2	-0.5	0.7
Germany	1.0	-0.1	-0.6	0.3
UK	1.0	-0.3	-0.3	0.4
France	1.0	-0.6	-0.3	0.1
Italy	1.0	-0.6	-0.6	-0.2

Assumptions

For basis of analysis, see p.3.

1. Output per person employed rises 1% p.a. across G6
- 2 Activity ratio (E/W) follows past trends. (See p. 9.)
3. Demographics (W/P) based on World Bank projections. (See pp. 10-11.)

The table brings together the three influences on "living standards" (in the sense of output per head of population), adopting the 1%-a-year figure for productivity growth and assuming that trends in labour force participation are similar to or the same as those in the last 15 years. As expected, across the industrial world the improvement in living standards is held back by adverse demographic trends. But the USA and Japan still do enjoy improving living standards over the next 40 years, with their relatively low levels of taxation being associated with further increases in labour force participation. In Germany and the UK living standards advance, but by under 1/2% a year. In France living standards barely change, while in Italy they fall. Of course, these dire outcomes for France and Italy would change if they could raise the activity ratio of their working-age populations.