2. General Review

The International economy

At present it is difficult to form a generally agreed view on what has happened during the last six months to the world economy. It is impossible to establish an agreed view of what will happen in the next six months. The debate and the uncertainty centre round the current recession in world trade. There is no argument that the current recession is the most severe to be experienced since the last war. The problem lies in forecasting how and when recovery will take place.

The rather murky picture of events in the first half of 1975 hardly gives ground for optimism and certainly contradicts those forecasters who expected a quick recovery. It is apparent that not only is the amplitude of the downturn greater than any which has been experienced post-war, but also the length of time needed to effect a recovery is unprecedented over the same period.

In the aftermath of the oil price rises in late 1973, industrial production in the OECD countries has fallen and unemployment has risen sharply. The fall in industrial production took effect from about the middle of 1974, and was mostly a reaction to the deflationary monetary and fiscal policies which were adopted to alleviate the strain on the balance of payments position, and to minimise the domestic inflation likely to be causes by the general rise in the prices of primary commodities, including oil. In the first two quarters of 1975 the downward trend in industrial production appears to have continued. One exception is Japan which experienced a slight rise in the second quarter. Certain industries have been particularly badly hit. For instance total OECD production of textiles was 8% lower at the beginning of 1975 than it was during 1970. Chemical production in the OECD declined by over 12% between the first quarter of 1974 and the first quarter of 1975. Basic metal production fell by 16% over the same period, while the output of metal products fell by 10%. The contraction of world markets for these and other commodities has, as we shall see in later sections, had damaging effects on the Scottish economy.

By July of this year most of the OECD countries, with the exception of the UK, had begun to reduce their rates of domestic inflation. Further, thanks mainly to large increases in imports by the oil-consuming countries, the collective balance of payments current account for the larger OECD countries is estimated to have moved into substantial surplus in the second quarter of this year.

Given these two factors of improving balance of payments, and falling rates of inflation, the stage seemed set for the implementation of domestic reflationary policies to return these economies to a path of steady expansion, from which they had been so abruptly diverted by the OPEC cartel. However, many governments have been cautious about adopting expansionary policies despite pressure by the IMF on those countries least troubled by balance of payments difficulties to take the lead in reflation.

The Japanese government has already administered three mild doses of reflation to its economy. The last package, announced in September, is an injection of around $6.7 billion which is intended to push the growth rate up to around 6%.

However, it is around the US economy that most interest is centred at present. A necessary condition for the expansion of world trade, and therefore the recovery of those economies, including the UK, who rely heavily on external trade, is a recovery in the United States. The confusion mentioned at the beginning of this section stems largely from uncertainty as to what interpretation should be put on recently published statistics of US economic activity.

In July this year there were at least four factors signalling an upturn in the US economy during the second half of 1975:

- the rise in the rate of inflation had apparently been reversed. From a 14% rate in the three months ended October 1974 the rate of increase in consumer prices fell to 5% in the three months ending May 1975

- the composite index of leading indicators had been rising since March
- the money supply had been expanding considerably more rapidly from January
- there were certain indications of an actual recovery such as a large increase in housing starts in May and a steady rise in retail sales from April.

However, the opinion that the US was moving steadily toward recovery was given a severe setback recently when figures were released indicating that the rate of inflation had risen sharply in the period June to August, moving into double figures once more. Further, and perhaps as a reaction to this rise, retail sales dropped by 0.8% in August. A definite rise in inflation would be likely to make the American authorities much more cautious about adopting expansionary policies. This would inevitably delay world recovery. The crucial question which has not yet received a definitive answer is whether the rise is a temporary aberration due to special factors, such as American grain sales to Russia pushing up world food prices, or whether the rise is due to the expansionary measures which President Ford has already initiated. Whatever the correct answer it is to be expected that the American authorities will be unwilling to adopt further expansionary measures until there is a clear reduction in the rate of inflation. This will inevitably delay world recovery for longer than had previously been expected. Thus, contrary to the view expressed in the last Commentary it seems unlikely that output in the OECD countries will increase before the end of the year. This inevitably means further increases in unemployment through the first half of 1976, given the lag in employment demand to changes in output.

The United Kingdom

In the last issue of the Commentary (July 1975 page 12), we pointed out that, while the UK had so far postponed the necessary internal adjustment of the economy, it could not expect to escape it. This prediction has now been confirmed by the fall in GDP in the second quarter of 1975.

Both The Bank of England and The National Institute of Economic and Social Research foresee GDP reaching its nadir during the third or fourth quarter of this year, followed by a very slow recovery, in effect, stagnation through 1976. The National Institute estimates the year-on-year change in GDP to be a decrease of ¾% from 1974 to 1975, and then an increase of 1.2% from 1975 to 1976. While output is slowly increasing next year, unemployment is seen to continue rising. The National Institute estimate for unemployment this winter (seasonally adjusted, excluding school leavers and adult students) is 1¼ million, rising perhaps to 1½ million by the end of 1976.

Against the broad indicators relating to the second quarter of 1975, three particular statistics stand out. First, it is clear that the fall in output has occurred most sharply in the manufacturing sectors of the economy. There, the index of output fell more sharply from first to second quarters than it did even between the last quarter of 1973 and the first quarter of 1974, when the three-day week was in operation. Secondly, there was a notable check to the growth rate of employment income in the second quarter, and thirdly all components of final demand fell in the second quarter in real terms <u>except</u> public expenditure.

The check to the growth of income from employment foreshadowed the fall in real personal disposable income which has already set in, and which is expected to continue throughout the next six quarters, (i.e. until the end of 1976). For many commentators the critical question in the management of economic policy over the next six quarters is whether the political pressure to reflate, brought about by rising unemployment and falling living standards, can be resisted. To this is closely related political pressure for import controls.

Official strategy can be described as monetary wage restraint coupled with a policy of abating domestic inflationary pressures and waiting for the hoped-for upturn in world trade. This period of waiting, which might well extend to one and a half years, might usefully be occupied by attention to the underlying structural problems of the British economy. The proper solution to the problem of large foreign motor