General Review

The World Economy

There are now unmistakable signs of a sustained recovery in world trade and production. Both the imports and the exports of the leading industrialised countries in February were substantially above their level of twelve months previously. It may reasonably be expected that world trade as a whole will expand by about 7% in real terms this year Different countries are emerging from the recession at different rates: amongst the first to emerge clearly from the recession has been the United States.

After the uncertainties and false starts which marked its recovery in 1975, the United States economy so far in 1976 has been showing encouraging signs of a steady revival. The stimulus appears to be coming largely from an increase in consumer expenditure, and this is reflected in new housing starts, new car sales, in rising industrial production, personal incomes, and in the index of leading indicators.

A comparison of such indicators with their performance in the past suggests that the pace of recovery from the present recession in the United States is slower than on previous occasions since the end of World War 2: it is certainly slow enough to have left a considerable gap in the level of capacity utilisation in manufacturing. Although it has stopped rising, the level of unemployment remains high by historical standards. It is clear that the American authorities prefer a policy of cautious expansion to the risk of higher inflation through a faster expansion of monetary demand. This policy of cautious expansion may seem to be justified by the further moderation of the rate of consumer price inflation in January, while wholesale prices fell in both January and February.

If the United States continues to hold to its policy of moderate monetary growth, and if this policy is followed by other leading industrialised countries such as West Germany, we must expect to see a further depreciation of the sterling exchange rate with respect to the dollar and the Deutsche Mark. Of course, in an election year there is always the possibility that the US government might be tempted to move monetary and fiscal policy in a more expansionary direction with a view to significantly reducing the high level of unemployment. If this possibility were pursued, then of course the chances are that the response to the stimulation of aggregate demand would come in the form of an increase in the rate of inflation as well as, or even in place of, an increase in the volume of output.

The pattern of recovery in West Germany is broadly similar to that in the United States. Real GNP increased by 3 per centage points in the last quarter of 1975, while unemployment has levelled off and there are signs of a continuing decline in the rate of inflation. As in the United States, recovery has been backed by an increase in private consumption, but in Germany there are signs that both exports and export orders are increasing. At the beginning of the year the government was forecasting a growth in real GNP of 4.5% during 1976, but the report on the economy prepared by the joint working party of the five main economic research institutes forecasts growth of 5.5% this year. The upward revision of the forecast reflects the continuing flow of encouraging economic statistics which have appeared in the German economy in the first quarter of this year. The rate of inflation is expected to fall to 4.5% from 6.0% in 1975, while the level of unemployment in West Germany has now fallen below the UK rate.

The timing and speed of the upturn is less clear in Japan than in the United States or West Germany. Consumer spending appears still to be inhibited by lingering uncertainties concerning inflation and employment, and the level of personal savings remains at over 25%. While some industries are doing well again, others are still working a long way below capacity. With rising government expenditure and exports, it is only a matter of time before consumer spending adds to the impetus of recovery. The official forecast is for a rate of growth of real GNP of 5.6% in 1976.

With substantial recoveries expected this year in the other European countries, except the UK and Italy, and with the oil producing countries continuing to maintain a high level of imports, the general impression is of a slow but steady expansion of major world markets throughout the rest of 1976.

The United Kingdom

The fall in total output which began in the fourth quarter of 1974 appears to have ended. Each of the three measures of GDP increased in the fourth quarter of 1975, the output measure by a little over ½%. During 1975 real living standards fell by around 4%, despite an increased share of wages and salaries in total money income during the year.

The rate of increase in prices has continued to slow down, but it is still twice as fast as in the UK's principal trading partners. It now seems unlikely that the government's target of a 10% increase over the previous twelve months will have been reached by the last quarter of this year.

Unemployment has continued to rise, although more slowly of late, until the seasonally adjusted monthly figure for March showed a fall. This particular statistic points to two distinct views about the timing of the upswing from the present recession.

The orthodox view, of which the principal exponents are the National Institute and the Bank of England, is that only a modest recovery in output can be expected in 1976. On this view, unemployment may be expected to continue rising, if more slowly, until perhaps the end of the year or even the first quarter of 1977. But there may be a substantial decline in the rate of inflation by the end of the year.

An alternative view put forward by the Cambridge Economic Policy Group in their review of 29 March suggests that "output will rise fast as destocking ends and world trade recovers". Unemployment will level off and even fall for a while, but price inflation will not fall below 13% by the end of 1976. Support for the Cambridge view is to be found in the unfilled vacancies figures, which many hold to be a more reliable guide to the labour market than unemployment, and which have been rising for three months in succession. Cambridge pessimism about inflation may also be supported by the rate of increase in the money supply.

The indicators which are available at the time of writing, (14 April), do not offer a clear view as to the timing and strength of any recovery in the UK economy. Certainly, the index of longer leading indicators published in Economic Trends shows a continuing rise, and this positive indicator is supported by the results reported in the monthly survey of business opinion conducted by the Financial Times. On the other hand, manufacturing output in February fell below the January level, while the latest figures on retail sales and new car registrations show no sign of a revival in consumer expenditure.

Since the second half of 1975 rising public consumption and a slower rate of destocking have provided the main stimulus to aggregate demand. The government has declared its intention of restraining the growth in public consumption. If this intention could be realised, and private consumption similarly held down, then resources may be available for increased exports and most importantly for increased investment. With the devaluation of the pound,and the steady expansion of overseas markets as the year moves on, the demand for UK exports seems assured. It is much less certain that a similar demand for capital goods will be forthcoming in the near future. The available evidence on recent investment behaviour and declared investment intentions suggests that the fall in manufacturing investment which marked the year 1975 may continue through 1976. The gap in aggregate demand could certainly be filled by expanded private consumption, but this would only be at the cost of future employment and living standards.

One of the remarkable features of the inflation of the past two years has been the way in which it has eroded profits. After deducting stock appreciation, the share of company trading profits in UK domestic income in 1975 was just over 6%, about ½% below the share in 1974, and well below the ten year average of 12%. In the United States, the corporate profit margins in 1975 were the lowest for thirty years. In the last issue of the Commentary we referred to the dual role of profits as both an incentive to and a means of investment. We think that this theme is sufficiently important to justify returning to it briefly in this issue.

It should first of all be made clear that the role of profits as a means to investment does not refer to its role as a source of liquidity. Liquidity can be increased at any time by an act of government, but only profits can create the potential supply of real resources (capital goods) which is required for investment. Of course, capital goods can be imported but this imposes a future burden on the economy.

In the course of the next two months, there will be an intensive debate about economic policy in the United Kingdom. During this period of negotiation between the government and the TUC, discussion will centre on the government's proposal for income tax reliefs conditional upon acceptance of a 3% limit to money wage increases. But the debate will inevitably be widened, and various other devices will be advanced, singly and in packages, for the management of the economy. Such devices will include other wages policies, monetary and fiscal arrangements, import controls and devaluation.

The fact that we wish to emphasise is that all these devices, including that advanced by the Chancellor of the Exchequer, are purely short-run: none of them, either singly or in combination, can make future employment and output levels higher in the longer-run than they otherwise would have been. The necessary condition for achieving the latter objective is to raise substantially the rate of investment. As we said before, future employment at non-decreasing real wages can only be expanded by increasing the present level of profits. If at the same time the circumstances of the economy require a larger share of output going to exports, and a significant increase in the numbers of people to be offered employment, then it seems unlikely that all of these objectives can be realised simultaneously without lowering the present level of real wages. Such a painful course of action might be avoided by continuing to borrow abroad and/or reducing public consumption. But each of these courses has also a real cost.

In the long run the only solution to the problems of the British economy lies in raising productivity more rapidly, which implies in turn a willingness to accept technical progress, occupational mobility, higher profit rates, and an appropriate structure of incentives. We would suggest that it may be as important for the government to direct its economic policy to these objectives as towards short-run demand management. In particular, we repeat our belief that government policy should be so directed that re-training rather than unemployment should be the accepted normal consequence of the loss of a job.

It may be objected that acceptance of technical progress, higher profit rates, and an appropriate structure of incentives are politically unacceptable to a substantial part of the population, presumably because they do not like the private ownership of property, thus of profits. If these attitudes persist, then it is certainly possible to change the forms of ownership of productive organisations from private to social. And of course many forms of social ownership are available, ranging from producers co-operatives to state-owned monopolies. Any such changes are a matter for the political process. What economists should point out is that such a possible change in institutions, transforming "capitalist profit" into "socialist surplus", does not permit any escape from the necessity of observing the foregoing rules for increasing output and employment. These rules are as true for the UK economy to-day as they are for any other real world economy, whether capitalist or socialist, whether past, present or future.