THE FRASER OF ALLANDER INSTITUTE

QUARTERLY ECONOMIC COMMENTARY

July 1976

The Fraser of Allander Institute for Research on the Scottish Economy was established in the University of Strathclyde on 1 January 1975, as the result of a generous donation from the Hugh Fraser Foundation. Its principal function is to carry out research on the Scottish economy and its research programme includes the analysis of short-term movements in economic activity. The results of this work are published each January, April, July and October in the Institute's Quarterly Economic Commentary. The Institute also publishes a series of Research Monographs to provide an outlet for original quantitative research on the Scottish economy, and a series of occasional essays on economic policy entitled Speculative Papers. In co-operation with the Scottish Council Research Institute and IBM United Kingdom Scientific Centre the Institute is compiling a set of input output tables for Scotland. The Institute also wishes to thank the Scotsman Publications Limited for its financial support in the appointment of a Research Fellow to work on the construction of forecasting models.

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REVIEW OF THE QUARTER'S ECONOMIC TRENDS

The World Economy

The initial recovery phase of the leading economies in the second half of 1975 occurred at a fairly leisurely pace compared to past experience of the upturn. However, the first quarter of 1976 has seen industrial production expanding rapidly in most countries, with an expected rise of 10% over the same period last year. This increases momentum in the world economy has led to revision of official forecasts of many important indicators. The volume of world trade is now expected to rise by 10% this year. Total output, which fell by 1½% last year, should increase by 5% this year. Inflation in most countries is now in single figures on an annual rate basis. Profit levels have improved considerably: so far there is little evidence of a recovery in investment in plant and machinery.

In a previous issue, (October 1975), we argued that the path of the world economy out of recession was very much dependent on the performance of the US economy. Recovery in America is now a year old. The primary force in moving the USA out of recession had been an increase in consumer expenditure which reflected government policy, and falling inflation and unemployment rates. The upturn in the stockbuilding cycle is now providing a further boost to the economy. Real output growth should be around 6½% this year, while unemployment is expected to fall below 7% and corporate profits should increase by 30%. This improvement in profit levels should provide some stimulus to investment which has been rather weak, (see the last two issues of the Commentary). Costs are also at a favourable level in comparison to most competitors, and wage cost increases, given the expected output increase, should not be inflationary.

This generally healthy picture has been marred by a few economic forecasters expressing fears of overheating in the US economy, founded on the quickening pace of economic activity experienced in the first half of the year. On the other hand a recent assessment of the initial phase of the upswing by a leading New York Bank has suggested that the current growth path is somewhat similar to the 1960 upturn which lasted for eight years. A comparison of economic indicators in different upturns has led them to believe that the present recovery is well-balanced. Of course, the picture can quickly change.

The upswing is now in a crucial phase where the forthcoming Presidential election could lead to an untoward expansion, though at present the Federal authorities seem committed to reducing the budget deficit and keeping a tight reign on the money supply. Other leading countries are also conscious of the need for monetary restraint. One would hope that this form of political self-control would be initiated in the UK; otherwise there will continue to be pressure on the sterling exchange rate, (see the April Commentary).

The German recovery, as in the USA, is largely fuelled by domestic demand, although exports and export orders have been rising since the beginning of the year. The volume of retail sales in the 1st quarter of 1976 was 5% up on the same quarter in 1975 partly because the savings ratio has fallen from a 17% high in early 1975 to 14% in the second quarter of 1976. Real GDP should grow around 6% and unemployment is continuing to fall. While the German economy is experiencing a massive trade surplus and the resulting D-mark appreciation will worsen the terms of trade, this is unlikely to detract from Germany's continued prosperity.

Unlike the US or German experience Japan's recovery has been export-led; exports in March were up 18% on a year earlier. Real GDP is likely to increase by 5½% this year. Profits have risen by 50% over the last year and inflation has fallen rapidly to under 10%. Japan would appear to be bouncing back.

In general, many industrialised countries are displaying favourable signs of recovery similar to the US, German and Japanese experience outlined above. However, other countries, like France and the UK who postponed taking action against inflation, find themselves at a different stage of the cycle. Hence, they are still faced with recessionary pessimism and uncertainty. The stage would now seem to be reached where the next twelve months will be of decisive importance for the world economy if it is to achieve a period of sustained economic growth.

The United Kingdom Economy

The rapid expansion of world trade, together with the further depreciation of the £, does provide the long-awaited opportunity for an expansion of United Kingdom exports. Whether this opportunity will be realised depends upon a range of factors such as the Government's ability to restrain domestic demand and the ability of individual firms to compete in overseas markets on terms other than price. Despite the recent encouraging performance of exports, the level of new export orders in the engineering industry remains well down on last year.

GDP in the first quarter of 1976 showed an increase of roughly 1% over the previous quarter's level, thus confirming that the UK has passed the bottom of the recession in terms of output. The principal stimulus to recovering demand is expected to come from stockbuilding as well as from exports, so that by the end of this year the annual rate of increase of GDP is expected to be more than 3%. Much of the advance in industrial production comes from Chemicals, Steel, and Building Materials. Generally, consumer goods and investment goods have not increased their output as fast as intermediate goods.

None of this increase in output is expected to be reflected in any substantial rise in private consumption. Indeed, the National Institute expects that real living standards, (real personal disposable income), which first began to fall in 1975 will continue to fall throughout 1976 and 1977, although more slowly.

In our last issue we pointed to two alternative views about the pace of recovery of the UK economy in 1976. Since then, the National Institute have revised their own forecasts to bring them more into line with those of the Cambridge Economic Policy Group. That is, they see unemployment falling earlier and prices rising faster than they had expected at the beginning of this year. As we predicted in our January issue, the rate of price inflation will be about 15% in the last quarter of 1976. This may be a cause for disappointment, but need not be a cause for concern so long as the present moderate growth rate of the money supply is adhered to. On the other hand, the rapid acceleration of manufacturing production in May, coupled with the sharp rise of raw material costs in June, have revived fears of a revival of inflation later in the year.

The 15% inflation rate, coupled with the unexpected success of the US and West Germany in reducing their rates of inflation goes a long way to explaining the spectacular fall in the sterling-dollar exchange rate which took place over a three month period from the beginning of March to the end of May. A curious feature of this event was the fact that the Bank of England lost more than $3,000 million of its foreign exchange reserves in an unsuccessful attempt to maintain the rate of exchange at its former level. Under the existing system of international exchange rates, a country may either tolerate a fall in the external value of its currency or it may use its reserves of foreign currency to maintain the rate at an artificial level for a certain period of time by selling foreign currency in the market. To experience both a loss of reserves and a fall in the exchange rate at the same time is unusual.

The immediate consequence of this dissipation of its foreign exchange reserves was that the Government was forced to seek a $5,300 million credit arrangement from its major trading partners. The United States Treasury subsequently made it clear that they and other creditors expected in return a significant change in the direction of UK economic policy. This view was later supported by the Bank for International Settlements. Both organisations made it plain that cuts in public expenditure would be interpreted as a sign of intent.

The cutting of public expenditure to appease foreign holders of sterling has become a time-honoured ritual. It does temporarily alleviate the symptoms but does nothing to attack the underlying problems of the British economy. These problems include a reluctance to accept technical progress, or occupational mobility, or higher profit rates, or even an appropriate structure of incentives. Despite the long-standing preoccupation of policymakers and commentators with short monetary and fiscal measures there are some signs that official thinking on economic policy in the United Kingdom is moving in new directions. We refer to the attempts on the part of the Government through the National Economic Development Office to evolve a new "industrial strategy". This means, in essence, taking a micro-economic, selective, long-run view of the economy rather than a macro-economic, general, and short-run view. On 7 July NEDO released the results of working parties who had prepared reports on each of thirty-nine industries. A common feature of most of the reports is the clear indication that most of the short-term problems reflect long-term weaknesses: low productivity, poor delivery performance, and a lack of flexibility in the use of resources. The logic of this line of thinking, if pursued, is bound to face the Government with politically difficult decisions. Whether they will take these decisions remains to be seen.

However, it is encouraging to find a recent statement from the Department of Employment which suggests that the Government are giving consideration to a major change in the institutional framework for training. The arrangement under consideration is one whereby the initial cost of training is borne collectively rather than directly by individual companies.

While unemployment may shortly be expected to level off, it seems unlikely that the total will fall below 1 million before the end of 1977. In the meantime, the TUC leadership has courageously accepted a fall in the living standards of its members. The Trades Union leaders were persuaded to do so by the evidence that, otherwise, unemployment would rise to even higher levels in the future. The general acceptance of this view surely marks the end of the post war period of Keynesian economic policy. Since 1945 it has been officially believed that cuts in real wages will not reduce unemployment. Yet circumstances seem to have convinced Government and Unions alike of the painful truth that they may.