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REVIEW OF THE QUARTER'S ECONOMIC TRENDS

The World Economy

The World economy continues its troubled recovery from the depths of the 1974-75 recession with evidence of a renewed convergence in experience amongst the major economies. The initial recovery in Germany, Japan and the United States has lost much of its momentum, whilst performance in other developed countries has improved somewhat. The likely result is a slower overall rate of expansion in 1977 than occurred last year.

The outlook remains uncertain and uninviting. The goal of reducing inflation has once again been accorded pride of place in many of the larger European economies, to the exclusion of policies to increase domestic demand and curb unemployment. Investment and export-led growth are seen as the only permissible avenues of expansion; but so long as private and public sector demand remains weak, owing to strict fiscal and monetary policies, the scope for renewed growth appears limited. The United States will not be willing to stimulate the rest of the world indefinitely at the expense of its balance of payments. The oil-exporting countries, after an initial surge in activity are now trimming back their expansion plans into line with the slower growth in oil revenues. Nor is stimulus likely to come from the non-oil developing countries who remain constrained by current and accumulated balance of payments deficits. The communist countries face a similar constraint because of their high levels of foreign borrowing over the past few years. The developed world has drifted , albeit unconsciously, into the situation which the Rambouillet summit of 1975 sought to avert. The major economies remain deflated, and none, with the possible exception of the United States, is prepared to be the first to reflate domestic demand. In such a situation a convincing case can be made, not for selective reflation of a few major economies, but for gentle reflation of the Western world as a whole. Such a reflation would have to be carried out within the agreed framework of a broadened snake, a North-South accord on commodity prices, and, where necessary, incomes policies. The failure of the Rambouillet summit suggests that the prospects of an effective international agreement are remote.

Nevertheless, there are several indications which suggest that the time is ripe for such a decision. The experience of the last eighteen months has shown that reflation of the United States and German economies is of itself insufficient to restore the world to its trend rate of growth in the foreseeable future. The lagged effects of the recession now appear to be spreading to the Scandinavian countries, which had previously avoided the worst effects. Perhaps most importantly, the initial stock and durable replenishing phase of the recovery is now practically fully spent, and there is little prospect of a sustained recovery in investment demand sufficient to replace it.

It is debatable whether a mild general reflation would adversely affect national rates of inflation. A high level of excess capacity in both men and machines permits rapid productivity growth in the short run. Raw material stocks in producing countries remain high in the face of current depressed demand, and the foreign exchanges are going through a period of relative calm. Of much greater importance is the likely effect on the volume of unemployment, which will certainly rise during 1977 in the absence of some such measures. Failure to agree on co-ordinated action may consign many of the European economies to an extended period of stagnation, whose only desirable consequence may be the attainment of a lower rate of inflation, but at the cost of unacceptable levels of unemployment and a deteriorating capital stock.

Figures for the first quarter of 1977 for world growth of output, employment, prices and trade are not available at the time of writing. However, recent forecasts from various quarters reinforce the feeling of concern. The latest survey of the Economic Commission for Europe (ECE) suggests that gross domestic product for Western Europe will grow at not more than 3% in 1977. It also forecasts that unemployment may top the previous highest post-war level in Western Europe. At the same time the ECE Report estimates the average increase in consumer prices in 1977 will be about 9% compared with 10.5% in 1976. The National Institute Economic Review forecasts that consumer prices in the OECD countries will rise at a rate of 8.3%, compared with 8.6% in 1976. For OECD member countries, the National Institute forecasts an increase of 4-4½% in total output of goods and services compared with 5-5½% in 1976. Total industrial production is expected to increase by about 5½% in 1977, compared with 8½-9% in 1976. At the same time the volume of world trade is expected to grow at between 6 and 7% in 1977 for all goods compared with 12% in 1976 ,(for manufactures the respective figures are 7% and 11%).

The UK Economy

In December 1976, the UK government secured a $3.9billion loan from the IMF. As we predicted in our last issue, this loan has restored foreign confidence in sterling, albeit temporarily. As a result, the pound, having slipped from $2.40 in early 1975 to $1.58 in October 1976, rose to $1.71 during December and has remained steady at this level. The authorities have tried to stabilise the rate, fearing that any further rise might impair export price competitiveness. To effect this stabilisation, substantial amounts of foreign currency have been bought and the foreign exchange reserves at the end of March stood at $9618m. - almost twice the April 1976 level of $4848m.

The strength of sterling has assisted the Bank of England in cutting Minimum Lending Rate from its high of 15% last October and November, to 9¼% in April. The fall in interest rates will ease some of the pressure on personal and corporate liquidity. The building societies, however, have been slow to respond to the reductions, claiming that the success of the recent National Savings issue has cut their inflow of funds. Whether the lower rates will result in increased corporate investment, remains to be seen. The restrictions imposed by the Bank of England last November mean that any stimulus to demand arising from the lower interest rates would have only a marginal effect on bank advances. Recently published figures showed that fixed capital expenditure by manufacturing, distributive and service industries in 1976, at £3750m, was lower in real terms than at any time since 1968. And despite the lower interest rates, because of the current excess capacity in the economy, there is at present little expectation of a strong expansion in investment.

Any beneficial effects of the interest rate decline on the personal sector have been more than offset by recent increases in other prices which have not been compensated for by wage increases. While retail prices rose by 16.2% between February 1976 and February 1977, basic hourly wage rates for manual workers rose by only 8.5% in the same period. Households, in attempting to maintain consumption patterns, have cut back on saving as real incomes fell. Recent evidence of the squeeze on personal saving is the reduction in the ratio of personal saving to personal disposable income from 15.5% in the third quarter of 1976 to 11.6% in the fourth quarter. This is the lowest level which the ratio has reached since 1973. No abatement in the rate of price inflation can be expected over the next quarter, since a large part of the 28.4% increase in costs of basic materials and fuels to producers (between February 1976 and February 1977) has yet to be passed on.

The Chancellor went some way to diminishing the fall in real incomes by increasing income tax allowances in his March budget, at an expected cost of £1.3bn in a full fiscal year. Although this measure will be partially offset by the £800m to be raised from increases in duties on oil and tobacco, a further £960m may be distributed to income-earners through a 2p cut in the bottom rate of income tax, if a "satisfactory" pay policy can be agreed with the unions to replace Stage Two.

The government clearly believes that a "Stage Three" settlement is crucial to its short-term strategy. Indeed, it is likely that a wages free-for-all, especially before North Sea oil makes a significant impact on the balance of payments, would, once more, weaken sterling and so place the government in the unenviable position of having to introduce further deflationary measures shortly before an election. On the other hand, many unions will clearly oppose any Stage Three settlement. Even those unions not wholly opposed to the Social Contract may have difficulty in persuading their members, especially the skilled, whose wage differentials have been eroded by Stages One and Two, to join a Stage Three agreement. All parties have agreed that any settlement should be more flexible than the previous arrangements, particularly with respect to productivity agreements. However, no concensus view on the exact nature of this arrangement has emerged. One proposal floated by the government is the introduction of a 'kitty' system whereby a pecentage limit is fixed for each industry; then each bargaining unit within the industry makes out a case for its share of the 'kitty'. This system would be difficult to monitor and might well be a recipe for inter- or intra-union disputes. The outcome which seems most likely to emerge in present circumstances is one which will implicitly allow an annual rate of increase of the money wage of the order of 15 to 20%, a rate of price inflation in a similar range, a distribution of the wages increment more in favour of the better paid, and a level of unemployment in the region of 1.7 million by the end of 1978.

Whatever arrangement is struck, it is unlikely that wages and salaries will return to their real 1975 levels until 1979. The Treasury forecast only 1½% growth in real GDP for the period July 1976 - June 1978 which is expected to come principally from rises in investment, stockbuilding and exports - leaving no room for an expansion of consumption. The National Institute expects an even lower growth rate during 1977, with a rise to 1½% during 1978. This rate of expansion will be insufficient to absorb the expected increase in the supply of labour and consequently unemployment is expected to reach 1½ million by the end of this year.

The balance of payments, after a record visible trade deficit in January of £345m is expected to improve during the remainder of

1977. In his budget projections the Chancellor expected the current account to be in deficit around £500m in the first half of 1977, to be in balance in the second half of the year and to move into £500m surplus between January and June 1978. The National Institute take a more optimistic view, expecting that there will be a surplus of over £500m in the second half of 1977.

Clearly North Sea oil will play an important role in improving the balance of payments. However, it is equally clear that the prospect of oil revenues has already influenced past government policy, particularly with regard to the accumulation of foreign debt. The fact that some of the oil revenues will have to be used to repay the $20bn foreign debt which falls due between now and 1985, means that some of the benefits of oil have already been taken. Without the external borrowing undertaken by governments since 1973 the fall in living standards would have been greater than it already has been.