

THE FRASER OF ALLANDER INSTITUTE

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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 has compiled 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

For most of the industrialised world the first half of 1977 has been a period of relatively slow growth, and relatively little progress towards the twin policy goals of price stability and full employment. In many ways the situation is radically different from that of similar periods of slow growth in earlier decades, when the constraints on the expansionary leanings of finance ministers stemmed mainly from the balance of payments. While many countries now shoulder deficits which would have been thought unbearable in the sixties, the primacy of the trade balance as a policy constraint has been usurped by inflation. Governments now refrain from expanding demand because of the supposedly adverse effects on inflation, rather than the former fear of a balance of payments deficit.

But this is not the only difference, for the chosen instruments have also changed. The years since 1973 have seen the widespread espousal of monetary targets and measures, and a contemporaneous reduction in the importance of fiscal policy. The policy focus has shifted from a concern with the expansionary effects of a budget deficit to the effects on the monetary aggregates of financing the deficit. This shift in emphasis from fiscal to monetary measures is reflected in a slower speed of adjustment, and consequently in a slower world recovery than many commentators had expected.

The one country where recovery appears to be almost complete is the United States. In spite of the severe weather at the turn of the year, GNP appears to have risen by over 6% in the first quarter. A strong recovery is evident in consumer demand, with instalment credit extremely buoyant and personal savings at their lowest level since 1963. The consequences can be seen in a falling unemployment rate which stood at 7% of the labour force in April, a level below that which prevailed throughout the past two years, and a widening deficit in the balance of trade. So far there has not been a significant recovery in fixed investment, though anticipatory data appear to suggest that this is imminent. GNP is expected to grow by 5% in 1977, and by perhaps the same amount, or marginally less, in 1978.

Activity is not nearly as buoyant in Japan, where industrial output appears to have almost stagnated since November 1976.

The UK Economy

At the time of writing the chances of establishing any form of Stage 3 settlement appear remote. Increasing militancy amongst grass roots trade unionists, resulting principally from recent substantial declines in real wages, is undermining the government's ability to secure any agreement with the union leadership, even one which establishes the rule of a twelve month gap between pay settlements.

It is clear that the government feels that a further extension of pay policy is a key element in its short-term economic strategy. Wage increases well above the rate of productivity growth are likely to put pressure on the money supply and also, if large settlements are made in the public sector, on the public sector borrowing requirement. If the government adhere to the limits on domestic credit expansion and the public sector borrowing requirement agreed with the IMF then the cost of maintaining the current level of inflation will be yet higher unemployment. On the other hand, the current strength of the pound, resulting from favourable balance of payments figures, has increased foreign exchange reserves to \$11.6 billion in June and may tempt the government to consider a short-term expansion of the economy through less stringent monetary and fiscal policies. The resulting increase in real incomes, perhaps politically expedient, would probably be short lived as further inflation would undermine the exchange rate's current stability.

However, the increasing value of North Sea oil might be sufficient to offset these destabilising effects and might so enable the rise in real incomes to be maintained. The government are thus faced with the stark choice of attempting to hold back real incomes until the UK rate of inflation can be brought into line with those of our competitors or of using the North Sea as a surrogate IMF to maintain real incomes. Undoubtedly, the latter is the more politically expedient course of action. Nevertheless, the use of oil revenues to simply maintain consumption will do nothing to tackle the underlying problems of the UK economy. Unless the government quickly announce a clear strategy for the areas in which oil revenues are to be used, particularly productive investment, the case for higher consumption is likely to win by default.

The inability of the UK economy to match the growth rates of its foreign competitors is amply demonstrated in Table 1 where industrial production in March 1977 in various industrial economies is tabulated.

Whilst the budgetary stance is mildly expansionary, the planned public works program has gained little momentum. Private fixed investment has also been sluggish, and all components of final demand with the exception of exports remain depressed. Households' real disposable income fell in 1976, further deflating consumer demand. Given the job security enjoyed by many Japanese employees, the depressed state of the economy has not been strongly reflected in the level of registered unemployment, which stood at 2% of the labour force in March. Nevertheless, it is a figure which is rising, and on which little impact will be made by forecast GNP growth of 5½% this year. Inflation, which was running at an annual rate of 8.8% in March is expected to moderate somewhat, and coupled with a rise in the real disposable income of households, a somewhat faster rate of GNP growth is expected in 1978.

In the major European economies the picture is somewhat mixed. Overall demand remains depressed in France, the only buoyant section being consumer demand, and even there the rate of growth is somewhat less than in 1976. In spite of strict price control, inflation shows signs of returning to double figures. Seasonally adjusted unemployment continues to rise, while the balance of trade shows signs of returning to equilibrium. Attempts by the government to hold the rate of increase in wages below that of prices appear to be succeeding, with consequent effects on household income. GNP as a result is expected to grow by 3½% this year. Consumer demand also remains somewhat depressed in Germany, but may recover in the latter part of this year as real personal disposable income increases under the impact of generous wage settlements and low inflation. Industrial production declined during the first quarter, and while unemployment is falling, it is likely to remain above 1976 levels throughout the year. It looks exceedingly unlikely that the target of GNP growth in excess of 5% will now be achieved. The expected upturn in private fixed investment has not materialised and consequently growth this year may be as low as 4%, with a similar performance anticipated for 1978. The rate of increase of consumer prices remains low, at 3.8% on a twelve month basis in April, and the balance of trade remains favourable.

In Italy, consumption and investment remain surprisingly buoyant. Industrial production has followed a somewhat erratic course of late, the strongest performance coming from the investment goods sector. The economy still faces three major problems. Inflation though decelerating, was running at an annual rate of 19.9% in April. Given the growth of earnings, which increased by 35% over the year to March, single digit inflation appears unlikely in the immediate future. The consequences can be seen in a deteriorating unemployment situation and a weak balance of trade. GNP growth is likely to be of the order of 3-4% this year, and somewhat similar in 1978.

The UK Economy

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It is clear that the government feels that a further extension of pay policy is a key element in its short-term economic strategy. Wage increases well above the rate of productivity growth are likely to put pressure on the money supply and also, if large settlements are made in the public sector, on the public sector borrowing requirement. If the government adhere to the limits on domestic credit expansion and the public sector borrowing requirement agreed with the IMF then the cost of maintaining the current level of inflation will be yet higher unemployment. On the other hand, the current strength of the pound, resulting from favourable balance of payments figures, has increased foreign exchange reserves to \$11.6 billion in June and may tempt the government to consider a short-term expansion of the economy through less stringent monetary and fiscal policies. The resulting increase in real incomes, perhaps politically expedient, would probably be short lived as further inflation would undermine the exchange rate's current stability.

However, the increasing value of North Sea oil might be sufficient to offset these destabilising effects and might so enable the rise in real incomes to be maintained. The government are thus faced with the stark choice of attempting to hold back real incomes until the UK rate of inflation can be brought into line with those of our competitors or of using the North Sea as a surrogate IMF to maintain real incomes. Undoubtedly, the latter is the more politically expedient course of action. Nevertheless, the use of oil revenues to simply maintain consumption will do nothing to tackle the underlying problems of the UK economy. Unless the government quickly announce a clear strategy for the areas in which oil revenues are to be used, particularly productive investment, the case for higher consumption is likely to win by default.

The inability of the UK economy to match the growth rates of its foreign competitors is amply demonstrated in Table 1 where industrial production in March 1977 in various industrial economies is tabulated.

Table 1 Industrial Production March 1977 (1970 = 100)

France	129.0
Germany	113.6
Italy	130.4
Canada	129.4
United States	125.2
Japan	131.2
United Kingdom	107.1

The depressingly familiar pattern of low growth in the UK economy relative to our international competitors was perhaps tolerable when the level of unemployment was low. However, when, as at present, unemployment levels are at a post-war peak, the inability of the UK economy to sustain steady growth is exacerbating the already acute problems caused by unemployment.

The National Institute currently expect the UK GDP growth rate to be 1.5% in 1977 and 2.3% in 1978. These are well below the 3%-4% range which, it is claimed elsewhere in the Commentary, would enable the unemployment rate in Scotland to be brought down to 5% by 1981. It is not surprising then that the National Institute forecasts a level of unemployment of 1.4 million in the fourth quarter of 1977, rising to 1.6 million in the same period of 1978.

As hinted above, the balance of payments figures have recently improved substantially, the net deficit in the first quarter of 1977 being £293 million. In comparison, the average quarterly deficit in 1976 was £356 million and in 1975 £409 million. Figures for the second quarter so far indicate continued improvement and the National Institute expect that a substantial surplus of £736 million will be realised in the second half of 1977. North Sea oil will play a major part in this improvement. Its effect is likely to transform what would have been a £1.8 billion deficit this year into a £400 million surplus.