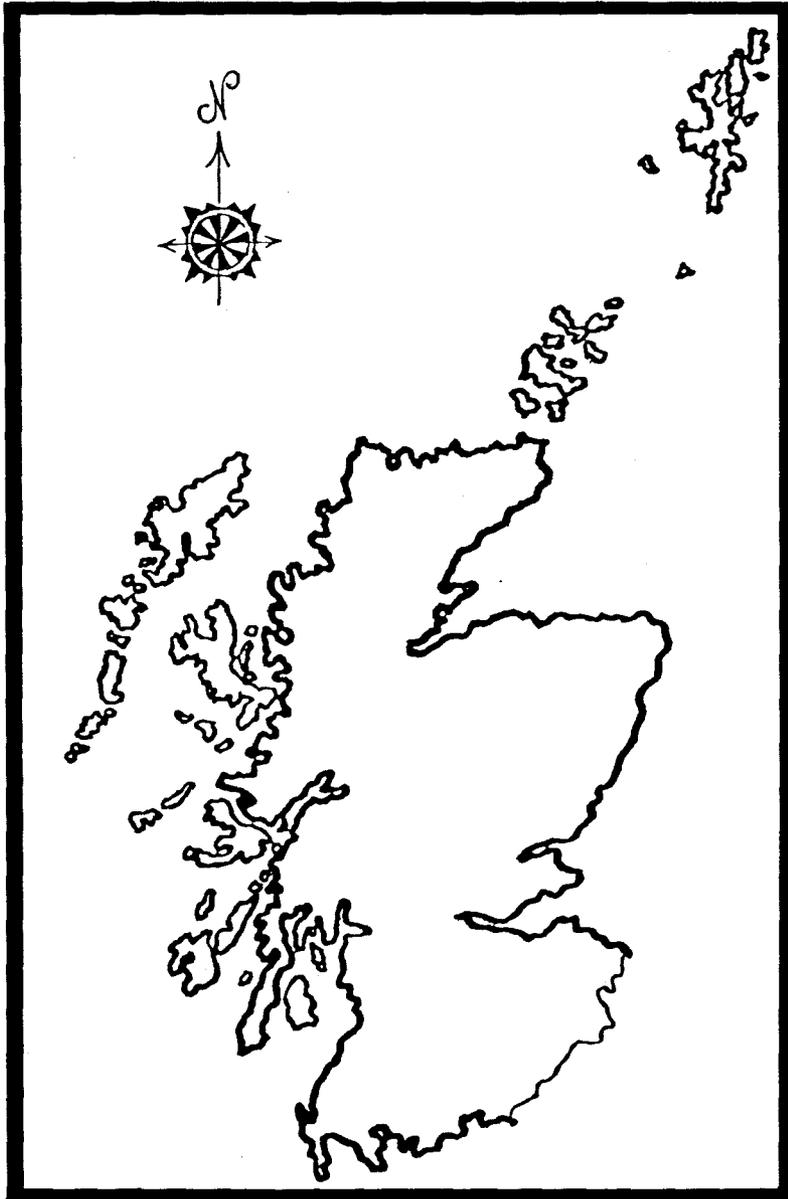


# THE FRASER OF ALLANDER INSTITUTE

QUARTERLY ECONOMIC COMMENTARY



October 1978

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.

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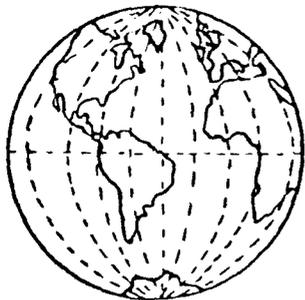
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The views expressed in the Special Article are those of the author and not necessarily those of the Fraser of Allander Institute.



## THE WORLD ECONOMY

monetary instability. In turn this has led to uncertainty on money and financial markets which has contributed to the weakness of the revival in investment demand, a revival firmly established only in the United States.

Events in the first three quarters of this year suggest that a return to the relative economic stability and prosperity of the 1960's is by no means assured. The world economy continues to be characterised by slow growth in industrial production and in the volume of trade. National inflation rates, while considerably lower than at the trough of the recession in 1975, still display sufficient international variation to be an important factor in the recent recurrent bouts of

It now appears that growth in the world economy this year is unlikely to exceed that of 1977. In effect the improvement in the growth performance of the major European economies has been offset by a slowdown in the American economy. In retrospect, the buoyant conditions of the second quarter in both the United States and some of the larger European economies may have been due primarily to the aftermath of severe weather and to a recovery from the effects of industrial disputes than to any self-sustaining revival in activity. The OECD in its most recent Economic Outlook remained pessimistic about growth and inflation prospects in the light of decreasing fiscal stimuli and a return to more inflationary wage settlements.

In the United States, the annual rate of price inflation rose to 10% in the second quarter, at a time when most other economies were reporting a continued deceleration. For the year as a whole, the rate is likely to be close to 8%, with a similar figure expected for 1979. The unemployment rate fell to 5.7% in June, but may well rise in the new year as production is restricted in response to unplanned accumulation of inventories caused by a weakening of consumer demand. A rise in the personal savings ratio appears certain given the high level of consumer credit and the steady upward movement in interest rates. For the year as a whole GDP is likely to grow by just under 4%, with next year's figure somewhat lower, perhaps of the order of 2½%.

In Japan, manufacturing employment has fallen steadily throughout the year reflecting the static level of industrial production. Unemployment, in consequence, has risen to the historically high level of 2% of the labour force. However, reasonably buoyant export markets and a reflationary budgetary stance should ensure GDP growth of over 5% this year and a likely similar performance in 1979.

In Germany some acceleration of growth is expected in the coming year but the underlying trend remains weak and growth is unlikely to exceed 3% in 1978. Industrial production has been almost stagnant since the middle of last year with food, drink and tobacco the only buoyant sector. Manufacturing employment has been falling since January, but so, paradoxically has the overall level of unemployment. The same is not true in France, where unemployment is rising and the number of vacancies falling. Industrial production has been sluggish throughout the year, with activity also depressed in the capital goods and construction sectors. Price inflation remains a problem, exacerbated by the relaxation of controls and the freeing of public utility prices, with the consumer price index currently rising by some 1% a month.

In Italy, price inflation also remains high, the twelve month increase to June 1978 being of the order of 12%. Over the same period the volume of industrial production actually contracted while a severe reduction in activity took place in the construction industry. Nevertheless, the level of unemployment has fallen somewhat since mid-1977. GDP growth of just over 2% is expected this year, with a slight acceleration into 1979.

Several major question marks hang over the world economy, notably in the fields of trade and international monetary relations. The latter is currently dominated by the persistent weakness of the dollar, and by the proposed European Monetary Union\*. It is however, all too frequently ignored by those who call for deflation of the US economy as a means of strengthening the dollar, that such a policy would remove the major source of growth and demand from the already depressed world economy. In the field of international trade, moves to counter aggressive Japanese exporting by a return to protectionism would in the long run have similar consequences for the world economy.

\* It is hoped to examine this subject in greater detail in a future issue of the Commentary.



Official statistics which have been released since our last Commentary confirm that the UK economy has been enjoying a significant growth of output and real wages in the last twelve months. Between the last quarter of 1977 and the second quarter of this year, the output measure of GDP rose at an annual rate of about 6%, while in the first seven months of this year manufacturing output has been rising at an annual rate of about 5%.

## THE UK ECONOMY

In the twelve months up to July, average wage earnings rose about 15% while prices were rising by only 8%. The resulting increase in the real disposable income of householders has been further boosted by reductions in income tax. The consequent growth in consumer spending is reflected in the volume of retail sales, of which the seasonally adjusted index rose from 106.3 in the first quarter of this year to 111.5 in August.

The growth of consumption has been assisted by external factors. Weak world commodity prices and the sterling exchange rate which was rising throughout 1977, have meant a 3% improvement in the terms of trade so far this year, following a 4% improvement last year. The output of North Sea oil will have contributed some £3,000 million to the current account of the balance of payments in 1978.

It is unlikely, however, that the rate of increase of real wages observed in the last twelve months can be maintained for long. While there is no longer an early external constraint, thanks to North Sea oil, on the traditional consumer-led boom, there is still the internal constraint of productive capacity acting upon the growth of real income. Gross domestic fixed capital formation, in real terms has remained virtually constant from 1973 to the second quarter of 1978. However, the recent Department of Industry survey of manufacturing investment intentions anticipates an increase of about 9% in the second half of the year, with a further rise of about 6% expected in 1979, a response, no doubt to the increase in consumption.

Despite these favourable short-run indicators, it remains true that the long-run position is unsatisfactory. The rate of growth of productivity in recent years falls far short of other comparable economies. We must

point out yet again that no lasting improvement in the growth rates of output and employment can be expected so long as official policy gives priority to short run considerations. Specifically, policy must be directed to creating an institutional and attitudinal environment favourable to the occupational mobility of labour and the encouragement of profit and innovation, whether in publicly or privately owned enterprises.

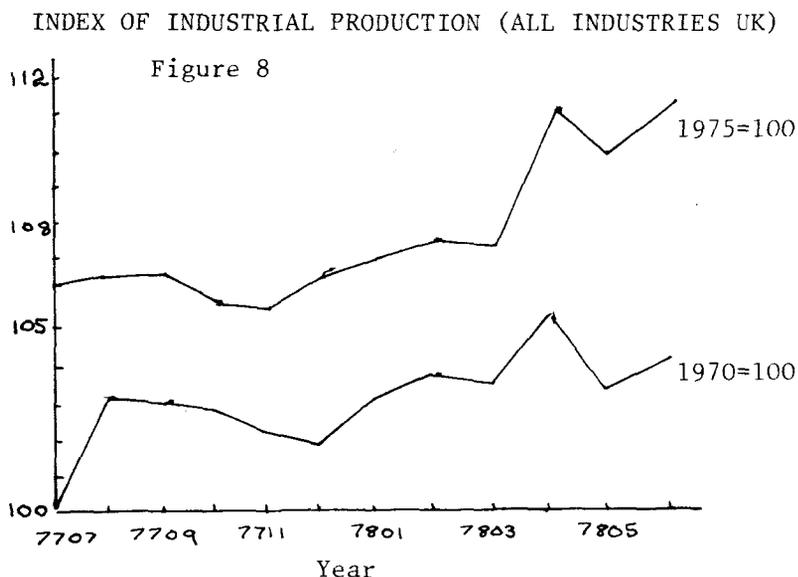
The London Business School estimates that over the next twelve months prices can be expected to increase by around 10%. This forecast is based on the assumption that the domestic prices of UK manufacturing output is determined primarily by world market prices. It is further assumed that sterling will maintain its present external value until well into 1979, and that world manufacturing prices will rise by around 8% in sterling terms. The same forecasters believe that average earnings in the United Kingdom will rise by about 12%, allowing a modest rise of 2% in average pre-tax real wages over the next twelve months. This would be accompanied by an increase in output of about 3%.

Behind these forecasts lies the assumption that the government will stick to its moderately restrictive monetary policy, whatever else happens. It seems that this is most likely to be effected through direct controls on bank lendings so that the resultant growth of the money supply may be around 10%. This objective will effectively determine the long-run limit of average wage increases, just as the prices which UK producers competing with overseas producers can afford to charge will effectively limit price increases in the private sector. In the short-run higher wage settlements are possible, but their principal consequence will be an increase in unemployment.

Incomes policy is then seen as a device to contain the level of unemployment. The outcome of the discussions between the government and the TUC on the target level of wage settlements in Stage Four is unknown at the time of writing. But present indications are that the forecast quoted above of an outturn of 12% for annual average earnings may not be far off the mark. However, if the frustration after three years of income restraint has been under-estimated, and if the government should capitulate to just one major strike, then it would face the choice between an immediate acceleration of inflation or a later acceleration of unemployment, or even, in the extreme case, both. But the government appears determined not to succumb especially with the electoral reward for success in the offing.

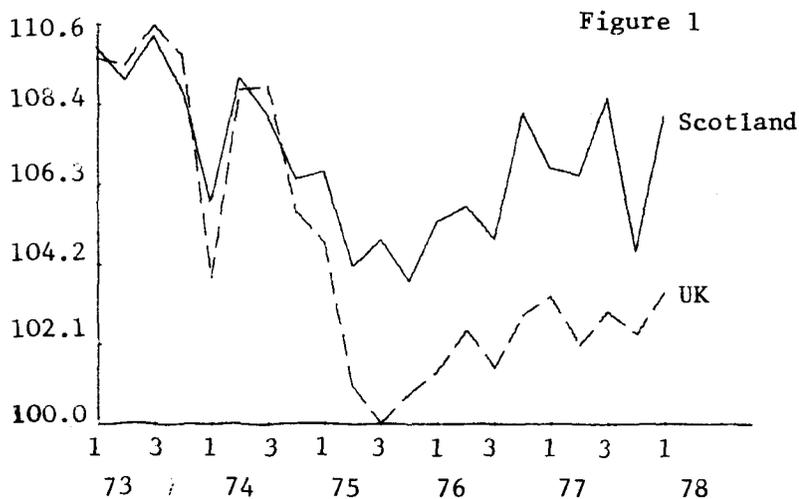
Since the last issue of the Commentary, the Central Statistics Office have issued a new set of annual estimates of their index of industrial production, based upon 1975 instead of 1970 weights. The results are remarkable. While the old series showed that the output of all industries was only about 2% higher in 1977 than it was in 1975, the new series shows that output grew by 6% in the same period. According to the CSO, three-quarters of the difference arises from the result of reweighting the production of oil. While this procedure is entirely legitimate, the difference quoted between the new and old series underlines the importance of having separate indicators for production in the oil and non-oil sectors of the economy.

Less easily explained is the continuing and embarrassing discrepancy between the three measures of the quarterly Gross Domestic Product which are published by the CSO. At the beginning of this section we observed that the output measure of GDP had increased by about 6%, at an annual rate, between the fourth quarter of 1977 and the second quarter of 1978. Over the same period, the income measure of GDP moved by 4.6%, and the expenditure measure by 2.6%



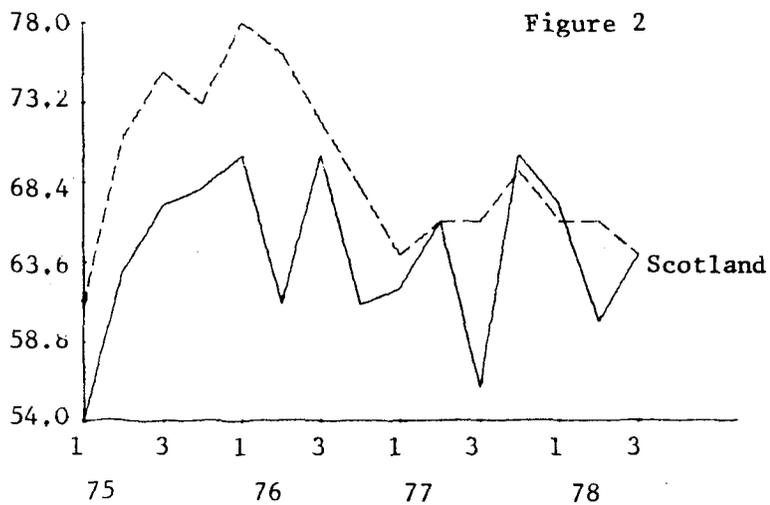
Source: *Trade & Industry*

## INDUSTRIAL PRODUCTION: TOTAL (SEAS ADJ)



Source: S E P D

## EXCESS CAPACITY: CBI SURVEY



Source: CBI Industrial Trends