

**Quarterly
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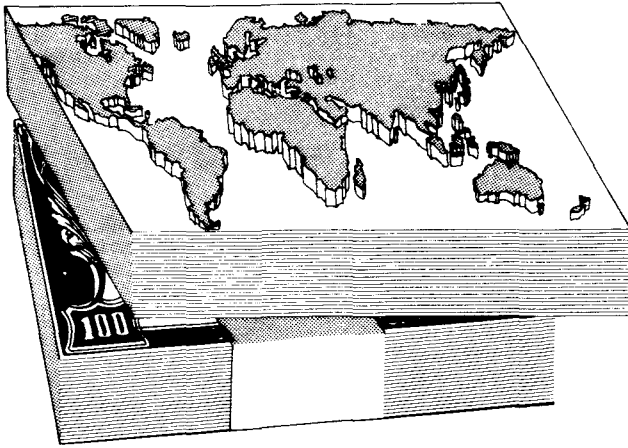
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The World Economy



While demand management policies in the major industrialised countries are in a state of concerted divergence, and there are mildly favourable economic prospects for 1979 in all of these countries, there is a widespread feeling that this stability is unusually precarious and would easily be upset by political events.

During the past three years, the United States economy has made substantial progress in terms of output and employment, while its balance of payments has deteriorated, and the rate of increase of consumer prices almost reached double figures in the middle of 1978. Over the same period, West Germany and Japan have enjoyed balance of payments surpluses and low rates of inflation, while their output and employment levels have grown relatively slowly. Now in 1979, it is claimed, this process

will be reversed. According to official expectations, Japan and Germany will expand their levels of domestic demand, thereby reducing their external surpluses, while the United States will experience a brief and mild recession in the course of the year. So far as Japan is concerned, this official hope of an expansion of aggregate demand seems unlikely to be fulfilled. The appreciation of the yen in 1978 has led to a fall in Japanese exports in volume terms, (though not in dollar terms), while independent economic forecasts suggest there is likely to be little growth in the elements of domestic demand in 1979. In the United States, a recession now does seem likely, and it is hoped that this will dampen inflationary pressures and further diminish that country's balance of payments deficit. This deficit has already been reduced by the movement in exchange rate over the last six months, which has produced an effective revaluation of 15% for the yen, and a devaluation of around 9% for the dollar.

The consensus among forecasters in the United States appears to be that GNP in real terms will grow by just over 1% for 1979 as a whole, although a slight fall in output is expected in the second and third quarters of the year. This expectation has been strengthened by the President's decision, announced on November 1st, to give priority in economic policy to reducing the rate of inflation. The majority of economists believe that this policy will be given effect mainly by restrictive monetary and fiscal measures: the voluntary price and wage guidelines are thought unlikely to prove effective. When the recession comes, it is likely to be triggered by a fall in the sales of consumer durables, notably houses and automobiles. Since the recession is expected to be the briefest and mildest ever recorded, economists are already looking beyond it to the resumption of demand expansion in the twelve months leading up to the Presidential election of November 1980. Since this view seems to be widely held, it may be questioned whether the recession will have the desired effect in reducing inflationary expectations. At the time of writing, consumer prices are expected to rise by over 7% in 1979, while the unemployment rate should remain broadly unchanged at around 6½%.

In West Germany, the IFO Survey taken in November showed that business confidence in the economy was at a higher level than at any time in the previous four years. The real growth of GNP in 1979 is expected to be about 4 per cent, with consumer prices rising at about 3 per cent, and the level of unemployment slightly higher at 4½ per cent of the labour force. Behind this optimistic climate of opinion lies an expansion of production and of new orders, particularly in the capital goods industries, while recently issued official statistics suggest that between 1975 and 1978 income from profit rose faster than did wages and salaries.

In Japan, a medium term forecast by the Japan Economic Research Centre predicts growth in real GNP at 4½% in 1979, with consumer prices rising between 3 and 4%. Unemployment is expected to remain at the 2½% level. The growth of domestic demand implied by this forecast is substantially less than that which had been hoped for by Western and official commentators. The forecast predicts only a slight reduction in 1979 of the current account surplus of around \$15 billion realised in 1978.

Some stimulus to European trade may be offered by the eleven smaller OECD members, whose aggregate economic importance outweighs that of West Germany. Their average growth rate of 3% is expected to come largely from the expansion of domestic demand. France and Italy, who are not members of this group, are expected by OECD forecasters to have real GNP growth rates of 3½% each in 1979.

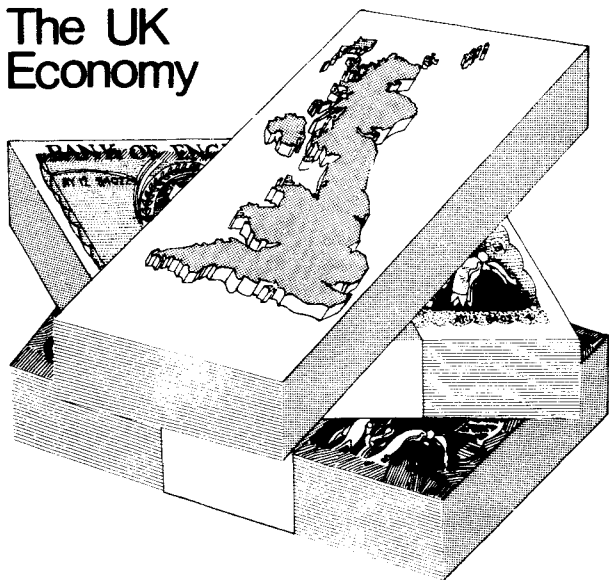
Behind this mildly optimistic view of economic events in the world in 1979 lurk potential problems, mainly political in origin. Should one of these flare up, they would alter the picture considerably.

The first of these problems concerns oil. It has been estimated by OECD that every 10% rise in the price of crude oil adds one half of a percentage point to the rate of inflation in the Western countries. It is in this context that the price rise of 14% announced in December by OPEC should be judged. Perhaps more serious may be an unsettling effect on business confidence. The unfavourable impact of the oil price rise on the balance of payments of most industrialised countries could add one further element to the protectionist pressures which are likely to be a second major threat to world economic stability in 1979. Perhaps the strongest antidote to these pressures is the multilateral trade negotiations at Geneva under the auspices of GATT. While the Carter Administration is favourable to maintaining liberalised trading arrangements, the agreements must be approved by Congress at a time when the US may be entering a recession, and when Japan has shown little sign of achieving the promised reduction of its trade surplus. In the rich countries, protectionist pressures are abetted by governments unwilling to deal directly with disproportionate money wage rises, and in the poor non-oil countries by the continued worsening of their current account balances.

On the positive side, it may be argued that the move to establish a European Monetary System can be regarded as a sign of greater international political coherence, while rates of price inflation seem to be in decline throughout the industrialised world.

The Year Just Ended

The UK Economy



Over the year just ended, GDP appears to have grown at a rate of 3-3½% (measured at 1975 prices). Growth was especially rapid in the second and fourth quarters. In the former case this was largely due to a high level of stock building and to a temporary decline in imports, while in the latter case consumers demand and exports were particularly buoyant. As the year closed the rate of price inflation appeared to be stable at an annual rate of 8%, though the closing months saw substantial rises in market interest rates and in MLR.

The monthly trade figures fluctuated erratically throughout the year, and coupled with a sizeable decline in the customary surplus on invisibles, led to an out turn of approximately zero for the current account of the balance of payments over the year as a whole. This out turn contrasts

sharply with the sizeable surpluses forecast earlier in the year. Labour market conditions improved somewhat over the twelve months just ended with registered unemployment some 100,000 lower in November compared to the corresponding month in 1977.

The most pronounced feature of 1978, however, was the rapid rise in real personal disposable income, and the revival in consumer's expenditure which this induced. Apart from a mild hiccup in September-October the volume of retail sales rose steadily throughout the year, with the demand for durable consumer goods especially buoyant. Income tax rebates and wage increases considerably in excess of the rate of price inflation, were sufficient to sustain not only an increase of the order of 5-6% in the volume of consumption, but also to permit a slight increase in the personal savings ratio. The import content on this consumer led boom was substantial. For the year as a whole imports rose by 6-7% in volume terms with imports of finished manufactures especially buoyant. Exports, by contrast, grew in volume by 3-4%. The traditional constraint on consumer led recovery - a balance of payments deficit on current account - was practically inoperative due to the availability of North Sea Oil, which is estimated to have contributed some £2½bn to the current account last year.

The sterling effective exchange rate remained relatively stable during the latter half of the year. By the end of 1978 it stood marginally above its level of two years previously. The preoccupation of the foreign exchange markets with the plight of the dollar helped to distract attention from the somewhat volatile behaviour of sterling M_3 in the early part of the year, and from the non-appearance of the much heralded current account surplus.

The Year To Come

Detailed forecasts for 1979 have already been published by the Treasury, the National Institute, and the London Business School. Comparison of individual components of the forecasts is rendered difficult by the recent rebasing of national income figures to constant 1975 prices. The Treasury and National Institute forecasts are presented using this new base while the London Business

School forecasts are set out in terms of 1970 prices. However each body does present a GDP forecast at constant 1975 prices and these being comparable, are set out below:

Table 1 1979 Forecasts

	GDP Growth (at 1975 prices)	Retail Prices
H M Treasury	2.4	9.0
London Business School	3.3	9.9
National Institute	3.8	9.5

Sources: *Economic Progress Report Supplement, November 1978*
 London Business School Economic Outlook 1978-82, Vol. 3 No.1
 National Institute Economic Review No. 86 November 1978

The somewhat lower Treasury GDP forecast reflects their assumption that the Government's Stage Four income guideline of 5% will be observed. The implied growth in personal consumption is consequently somewhat lower than that implied by the other two bodies. By contrast these assume more realistic earnings growth of the order of 12% for 1979 as a whole. Given their common forecast of single figure inflation this implies continued growth of real incomes, albeit at a considerably slower rate than in 1978. As a result the rate of growth of consumer's expenditure is expected to slacken over the coming months.

The GDP growth rates set out in the table above hold out little prospect of further reductions in the level of registered unemployment over the year ahead. Indeed, given the current level of wage settlements and the government's avowed monetary targets, some increase in unemployment can readily be countenanced in the medium term. The London Business School suggests that the government's fiscal and monetary policies may become inconsistent in the coming financial year unless substantial increases in taxation are implemented in the forthcoming budget. Given the advanced phase of the electoral cycle, the timing of such measures must be highly problematical.

Over the somewhat longer term, further reductions in the rate of inflation seem unlikely. The conjunction of weak commodity prices, a stable exchange rate, and a once off rise in real disposable incomes provide an ideal opportunity to unwind the wage-price spiral. This opportunity has been lost by, on the one hand, suggesting a pay norm far below actual or expected rates of price inflation and on the other, demanding wage increases far in excess of actual price changes.

The abandonment of fixed exchange rates may have removed the discipline of the balance of payments, but it has replaced it with the discipline of the exchange rate. Inflationary wage settlements may be accommodated by exchange rate depreciation, but they are also at the same time eroded by it.