Quarterly Economic Commentary

January 1980

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.

The Institute wishes to thank the Scotsman Publications Limited and Shell UK for their financial assistance in the production of the Quarterly Economic Commentary.

The Fraser of Allander Institute, University of Strathclyde,
100 Montrose Street, GLASGOW G4 OLZ
Telephone 041-552-4400 Extension 3303

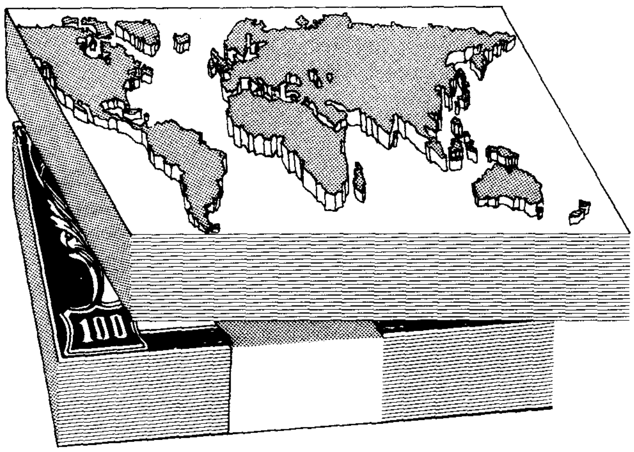
CONTENTS

The Commentary is edited by D N F Bell, with contributions by:

G Emmett	*F X Kirwan*	*I Orton*
N Fraser	*I H McNicoll*	*D R F Simpson*
A Jowett	*L Moar*	*A A Wingfield*

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



Most commentaries which are being written at this time take a markedly pessimistic view of the economic prospects for the non-communist world over the next twelve months, and beyond. This view, reflected in the unprecedented rise in the price of gold, arises from uncertainty about the willingness or the ability of the United States to maintain the political framework within which the non-communist world economy has operated since the second World War and the fear of continuing rises in the price of oil.

In the long run, however, the events in Iran and Afghanistan are likely to strengthen rather than weaken the US presence in the world. The external value of the dollar will depend upon the comparative domestic inflation and productivity rates of the United States and its principal trading partners. The rising price of oil is a burden which the United States shares with most countries; the higher that prices rise the more will countervailing forces tending to increase the supply of oil and to diminish the demand for oil gather strength. Consequently, too much weight should not be placed on short-run factors, although it must be said that all economic forecasts made at the present time should be treated with more than usual caution, because of the political uncertainties.

Although their overall growth rate will be less in 1980 than it was in 1979, the industrialised countries as a whole should not experience a fall in output in 1980. Performance will, of course, differ from one country to another.

In the United States, the recession has been longer delayed and less marked than anticipated. Indeed, there are even those who claim that while growth has ceased, there has not yet been an actual fall in output. The resumption of growth of output expected initially to occur in the first quarter of 1980, may now be postponed to the third quarter. Consumer prices are expected to increase at an annual rate of around 11%, and if inflation is politically even more unpopular than unemployment, as seems to be the case, then the Administration can be expected to make every effort to demonstrate to the electorate that the rate of increase is falling before the Presidential election in November. The present US recession is the consequence of a deliberate act of monetary policy; but its timing and extent are beyond Washington's control.

A slowdown in the rate of growth of output to less than 2% is expected for the EEC countries, though once again there are divergencies of experience. In West Germany, the growth rate has been marked down in the last three months from 3% to 2½%. But it is the expected rate of inflation which causes the greatest concern in Germany.

That rate is now expected to rise from around 4.5% in 1979 to about 5.5% in 1980, a rate which might be envied by most of its trading partners. In France, consumer prices are expected to continue rising at the 1979 rate of around 11.5% while the rate of growth of output is expected to be of the order of 2.5%.

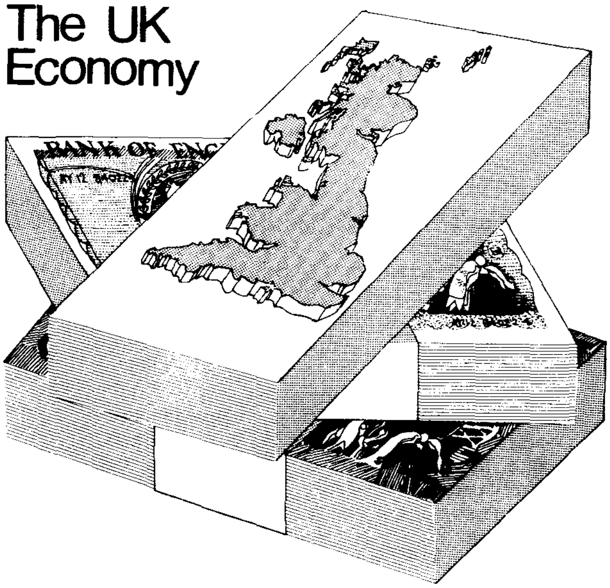
The European picture of deceleration of growth of output and an acceleration of price inflation in 1980 is mirrored in the expected performance of the economy of Japan. The GDP growth is expected to fall from a 1979 rate of 5½% to around 4%. Consumer prices, thought to have increased by around 2% in 1979 are now expected to rise by around 7% in 1980. Japan's persistent balance of payments surplus, for so long a destabilising factor in the world of international settlements, seems certain to have disappeared in 1979, and is not expected to reappear in 1980.

At the opening of a new decade, it is fashionable to look more than one year ahead, and to speculate as far as ten years. Following this fashion is difficult to justify, but impossible to resist. Our view is that, short of global war, the most signficant characteristic of the 1980's will be a slowing-down in their average rate of growth of output.

The immediate determinants of economic growth are broadly three: shifts in final demands by consumers, changes in the availability of primary raw materials, and changes in technology. On consumer spending, it seems likely that purchases of material goods will increasingly give way to purchases of services, including health and education, as well as leisure services. This will certainly contribute to a slowing down of the overall growth rate as it is conventionally measured. Secondly, while there is no question of the world "running out" of raw materials as some of the more fanciful visions of the future would have it, it does seem probable that most primary commodities will become increasingly costly over the next decade. There are those who think, like the classical economists, that the present tendency for the price of raw materials to rise relative to the price of manufactures will continue indefinitely. The only forces which are likely to counteract this tendency effectively are those of technical progress. While the forces of technical progress may yet win the race against the increasing costs of production of raw materials in the world as a whole, the portents for the advanced countries are less encouraging.

Despite the continuing strength of the United States economy it is possible to detect signs of a gradual slowing down within it. Throughout the past decade business investment has been on a declining trend. Likewise the proportion of GDP spending devoted to R & D has declined since 1964. And there is impressionistic evidence that the rate at which major innovations have been taking place has declined, and that US producers have been seeking protection from foreign competition more frequently in recent years than was formerly the case. It is suggested that such signs may be indicative of a social environment which is becoming more cautious and less willing to take risks. If this true of the most advanced of the advanced countries, it is likely to become true of the other advanced countries when they reach the income levels of the United States.

The UK Economy



The UK economy is in recession. All GDP measures suggest a fall between the second and third quarters of last year, with output data suggesting the decline was as severe as 2% of GDP. The alternative measures of GDP present somewhat different pictures. Expenditure data imply that GDP in the first three quarters of 1979 was only marginally above that of the first half of 1978; the output measure, by contrast, puts the growth rate a full 1% higher. In both cases growth was due almost wholly to increased North Sea oil and gas production. During 1979 as a whole, GDP may have increased by perhaps 1% with most of this growth occuring in the second quarter.

The current account of the balance of payments was in deficit by £2.4bn in 1979 despite a contribution by North Sea oil production of nearly £4bn. Imports, responding to buoyant consumer demand, rose by 11% in volume during the year. The performance of the export sector was considerably poorer, the volume increase being of the order of 3%. A variety of factors contributed to this disappointing performance on the trade balance. Widespread industrial disruption during the course of the year weakened the supply response of domestic industry, political problems in Iran and Nigeria dampened export demand, while the oil inflated exchange rate led to increased competition on both home and export markets.

Year on year, consumer prices rose by over 12% but on a December to December basis the rate of increase was considerably faster at 17% reflecting the increase in VAT introduced in the June budget. However the price index of manufacturing inputs (which does not include VAT) also rose steeply in the latter half of the year, displaying an increase of 21% over the twelve month period to November. Rising fuel and raw material prices contributed significantly to this figure.

The level of registered unemployment began to increase in October and continued to do so for the remainder of the final quarter, reversing the downward trend of the previous 24 months. By mid-December 1.3 million people, or 5.5% of the labour force were registered as unemployed. On the demand side of the labour market the number of notified vacancies has been falling steadily since the middle of 1979. As yet no significant acceleration of wage inflation is evident, but the most recent figures have been artifically depressed by the engineering dispute, and by the delayed beginnings of the new wage round.

The UK economy thus enters the new decade facing a rather unpromising conjunction of factors, both in the short and medium terms. In some respects, the recession now commencing is similar to that of 1974-76, though it is generally expected to be both less severe and less prolonged. In both cases, an OPEC induced oil price rise was superimposed on an economy where aggregate demand had recently peaked. However, whereas in 1974, the government opted to support domestic demand, the present policy is to restrain public sector demand and attempt to impose a strict monetary policy. Whatever the long term effects of such policies, the short run consequences are unappealing. All published forecasts, including that of the Treasury predict a fall in GDP in 1980 of at least 1%; the level of registered unemployment rising to at lease 1,600,000; the rate of retail price inflation exceeding 20% by mid year and remaining in double figures well into 1981; and finally the current account of the balance of payments remaining in deficit, albeit at a somewhat lower level than in 1979.

The recession comes after a period of exceptionally rapid growth in real personal disposable incomes, which grew by nearly 15% over the period mid 1977 to date. As a result, the behaviour of consumer's expenditure is likely to be somewhat stronger over the coming year than at a comparable stage of the previous recession, and the decline in personal consumption recorded then may not be repeated.

For manufacturing industry however, trading conditions are likely to appear more unfavourable that at the outset of the 1974-76 recession, when nominal interest rates were considerably lower and the exchange rate unsupported by North Sea oil. As in 1974, industry will respond to reduced demand and liquidity problems by reducing inventions and postponing investment, factors which in turn make the recession more pronounced, stock adjustment accounting for the bulk of output contraction.

And after the recession? It has yet to be convincingly demonstrated that the UK economy will not continue to stagnate - as it has done since the close of the previous recession.