

The Fraser of Allander
Institute

**Quarterly
Economic
Commentary**

July 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

REVIEW OF THE QUARTER'S ECONOMIC TRENDS

The World Economy	1
The United Kingdom Economy	3

THE SCOTTISH ECONOMY

Indicators of Economic Activity	6
Industrial Performance	9
Employment and Unemployment	16
Regional Review	20

OUTLOOK AND APPRAISAL 25

STUDENTS BRIEF

The Development of the Scottish Clearing Banks	28
---	----

SPECIAL ARTICLE

Regional Development Grants : The Scottish Experience 1975-1979 By N A Fraser & I Orton	34
---	----

PUBLICATIONS OF THE INSTITUTE

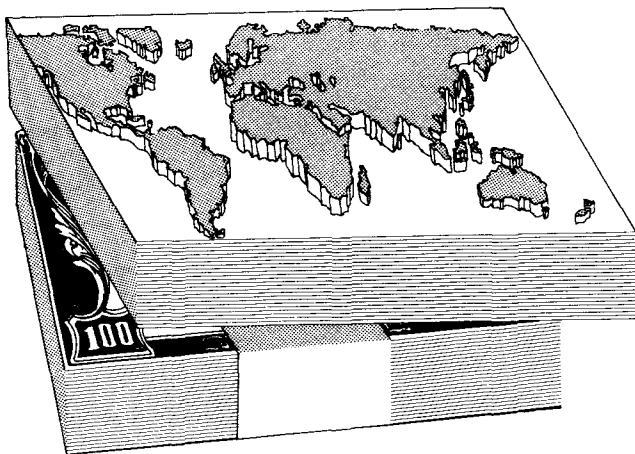
The Commentary is edited by D N F Bell, with contributions
by

N Fraser	A Jowett	L Moar
D Hamilton	F Kirwan	N O'Donnell
F Harrigan	I McNicoll	I Orton

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

The World economy is now clearly moving into recession. Industrial output in the United States, having risen by 9.7% between 1st quarter 1978 and 1st quarter 1979, fell back in the first three months of 1980, with production in March 1.5% below the level of the same month in 1979. Since fluctuations in the US economy have tended to precede those of other developed countries in recent years, this downturn is strongly indicative of the onset of recessionary pressures in the developed world as a whole. The London Business School forecast that world output is only likely to rise by 0.5% during 1980, while consumer prices will increase by about 15%. The OECD also take a pessimistic view. Their July forecast suggests that growth in the OECD countries during 1980 will average 1.25% while the rate of inflation will be about 12%.



monetary policies adopted in 1976/77. While the UK, Japan, Germany, France and Italy adopted fairly tight monetary policies over this period and consequently experienced a decline in output growth followed by a steady reduction in inflation, the US in contrast pursued a more accommodating monetary strategy with the result that GDP grew rapidly by historical standards, averaging just under 5% per annum for the period 1975/1979. The other developed countries entered the expansionary phase of the cycle somewhat later than the US. The rate of inflation in the US accelerated dramatically in consequence of the excessive monetary growth, reaching 14.7% in April 1980. Because of this increase in inflation the US adopted restrictive policies before the rest of the developed countries and is now leading them into recession.

The major reason for the difference in timing of cyclical fluctuations between the USA and the rest of the developed countries lies in the differing

A further rise in the price of oil stemming from the OPEC meeting in early June will deepen the recessionary pressures as countries strive to adjust their trade deficits. The price of a barrel of oil now ranges from \$32 charged by the Saudis to \$38 for some of the higher quality crudes produced in countries such as Algeria. Because of a fall in demand however, the world economy has been able to absorb the reductions in supply from Iran. Indeed, growing surpluses have begun to put downward pressure on the price. The leaders of the seven major Western powers, at their summit meeting in Venice, have agreed to press ahead with programs to reduce their dependence on oil. How this is to be achieved without constraining economic growth

was unclarified. Further, the plans to double the output of coal by 1990 and encourage other forms of substitution away from oil in order to meet their target of a reduction in oil's share of energy demand from 53% to 40% are unrealistic.

Other commodity prices are much more sensitive to fluctuations in the demand from industrialised countries. After a rapid increase of 17.2% in 1979 the increase in 1980 is likely to be much more modest. Coupled with the oil price rise, the downward pressure on commodity prices will cause a substantial worsening of the balance of payments deficits of the non-oil developing countries. Their total deficit will amount to around \$60 billion in 1980. The funding of this debt poses a great problem to the world financial system. Commercial banks have become wary of over-extending themselves and national aid programmes are nowhere near the scale required. This puts the onus on the official institutions, notably the IMF, to extend their lending. It seems unlikely that this will be possible unless the IMF is prepared to attach less stringent conditions to its loans.

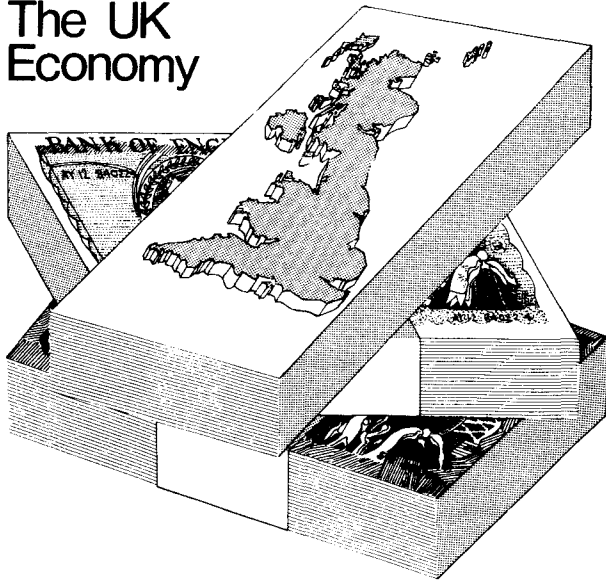
In the **US**, the outlook is for continued recession throughout 1980. Industrial production fell by 1.2% between January and March and further falls are to be expected. The car industry has been particularly hard hit and pressure for import controls is increasing. Unemployment has risen dramatically, from 6.4 million in January to 8.2 million in May. With price inflation at 14.7% and earnings having only risen by 7.4% over the year to 1st quarter 1980 continued depression in consumer markets is likely; dissaving would need to be on a substantial scale to make up the shortfall in real earnings.

The **Japanese** economy is also beginning to slow down. After a massive 3.9% rise in industrial production during the month of February alone, the level of production fell back in March and April. The stimulus to production is a consequence of the weakness of the yen which in turn results from a balance of payments deficit on current account caused largely by the oil price increase. The rate of inflation has begun to accelerate, reaching 8.4% in April.

The **West German** economy also ran a considerable (\$4.7billion) current account deficit in 1979, again heavily influenced by the increase in the price of oil. After a 5% growth in industrial production in 1979, output has been static in the first four months of 1980. Unemployment has risen sharply, from 780,000 in February to 862,000 in June. This may pose some particular problems during this recession because the normal German response to slackness in the labour market, namely the repatriation of guest workers, is no longer an option.

In **France**, INSEE predict a 4% to 5% drop in industrial production over the next six months, signalling the onset of recession. Due to increased competitive pressure, price inflation should fall from its present 15% to 12% by the end of the year. The pressure of demand will be partly maintained by the strength of investment although unemployment is still likely to rise from its present level of 1.47 million.

The UK Economy



The UK economy has entered a recession whose depth and intensity are likely to exceed the corresponding characteristics of the 1974-75 downturn. This is most starkly exemplified by the 8% fall in manufacturing output in the twelve months to May 1980 and the rise in unemployment of 295,000 between December 1979 and June 1980. The distinguishing feature of the current downturn is that the deflationary shock resulting from the OPEC price rises is being reinforced by contractionary fiscal and monetary policies, most notably in Britain but also amongst other major trading nations (see the World Economy). The fact that such policies, which are the polar opposites of Keynesian orthodoxy, and whose short run effects only exacerbate existing deflationary tendencies, are being implemented, should not trigger an immediate denouncement but should engender a certain scepticism.

Economic policy under the present administration is notable for its rejection of the Treasury's own brand of Keynesianism. It has been replaced by a radical new doctrine where many of the traditional "targets" and "instruments" of the Keynesian approach have been rejected and in some cases juxtaposed. The immediate targets appear to be the growth of the money supply and the size of the PSBR. Output and employment, the traditional Keynesian targets, are simply being allowed to adjust to whatever level accommodates these new aims. The official explanation of this abandonment of the conventional approach is that short-run reversal of the roles of targets and instruments is necessary to the attainment of longer term goals. In particular it is argued, a long-term reduction in the rate of inflation and increase in production will only be possible following a period of unpleasant adjustment. Central to this new policy stance is a fundamental change in the role of public spending in the economy. In Keynesian terms such spending performs a pump priming role in supporting demand. Under present policies such public expenditure assumes a much more pro-cyclical role rising and falling in step with aggregate demand. Since the multiplier mechanism remains intact, such policies are likely to exaggerate and magnify fluctuations in aggregate output.

This policy and its Keynesian predecessor both contain desirable elements and both also embody fatal flaws. The flaw in the policies pursued by the last government was to attempt to maintain the volume of aggregate demand by raising current rather than capital expenditure. The present government has fallen into a similar trap. Government current expenditure must be dependent on the current level of output which sustains it, but the same is

not true of capital expenditure. Yet it is the latter which is being cut. During 1980, the Treasury forecasts a fall of 17.5% in the volume of central government fixed investment, while current consumption is expected to remain unchanged in real terms. Such measures may lead to the attainment of the governments short run targets, but seem unlikely to contribute to the attainment of longer term goals. Indeed, by reducing the potential capacity of the economy, the reduction in investment is likely to contribute to the long-run maintenance of high levels of inflation.

The attainment of the announced monetary targets restricts the growth of current price expenditure and output. The annual change in these quantities consists of both a volume and a price component. Over a period of years their product approximates the rate of growth of the broadest measure of the money supply. If the rate of growth of real output (the volume effect) is relatively stable over time then it is possible to predict the rate of price inflation (the price effect) from rates of money supply growth with a degree of confidence. This necessary condition does not hold in the UK at present. The rate of inflation will exceed that of money supply growth if the volume of real output contracts - which is precisely what is taking place currently. The greater the gap between money wage inflation and money supply growth the greater is likely to be the immediate contraction in output and, with a lag, the fall in employment and rise in unemployment. None of this the government denies. The long term success of the chosen strategy is crucially dependent on the link between wage increases and employment levels being grasped and acted upon. To date there is only isolated evidence that this process is taking place and this comes mainly from the private sector. There is not yet any indication of how successful the government will be in curbing wage increases in the public sector in the next wage round.

Meanwhile the consensus amongst forecasters is that the fall in **GDP** is likely to be of the order of 2.5% during 1980 with a somewhat smaller contraction in 1981. On the demand side, **government expenditure** and **gross domestic fixed capital formation** are declining. Under the latter heading the fall in **manufacturing investment** is put at 8% - 12% in volume by the DOI Investment Intentions Survey. This prediction reflects the poor profitability of the non-oil sector, its competitiveness eroded by the appreciation of sterling and accelerating wage inflation, depressed demand expectations, and the cost of finance. Recent Treasury estimates suggest that the decline in the competitive position of British manufacturing industry in the last year has been a staggering 30%.

The process of **destocking** now underway suggests a further depressing effect on the volume of activity. The liquidation of inventories is encouraged by the interest costs of financing them, and by the falling volume of demand, manifested in the early months of this year when the stock to output ratio actually rose in spite of significant destocking.

The level of registered **unemployment** is rising strongly in response to the contraction and all forecasters expect it to rise above 2,000,000 during the present recession, differing only on the length of time likely to elapse before this occurs. At present the main contraction in employment is occurring in the manufacturing sector. As the recession deepens this pattern is likely to be replicated in other sectors. At the same time demographic factors are contributing to a sustained growth in labour supply.

The government's chosen strategy may succeed in its aim of reducing inflation but the structure of the British labour market is such that the associated levels of unemployment and volumes of output foregone are likely to be large. Furthermore there remains the very real possibility that the end result will be a situation of underemployment equilibrium of the type diagnosed by Keynes in the 1930's. Yet even if the government desired to boost the volume of demand by additional capital expenditure, very real problems remain. The first concerns the funding of the additional expenditure within existing monetary targets. The second concerns the economic agents through whom increased expenditure is channelled, the traditional avenues of local authorities and nationalised industries are plainly inappropriate, having failed in the past. The government truly faces not one, but many dilemmas.