The Fraser of Allander Institute

Quarterly Economic Commentary

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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.

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CONTENTS

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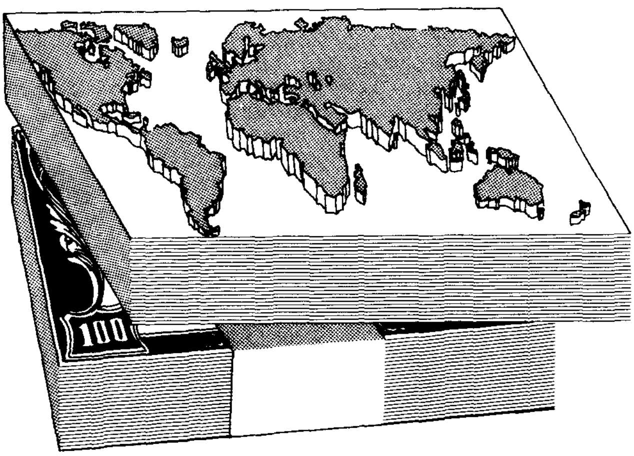
The views expressed in the Special Article are those of the authors and not necessarily those of the Fraser of Allander Institute.

The World Economy



Twice since 1974 substantial increases in the world market price of crude oil have demonstrated the vulnerability of production, employment and trade in the industrialised countries. Most of the oil importing advanced countries are still reacting to the 1979/1980 round of oil price increases. Any further increases in oil prices this year would strike a fatal blow to the fragile recovery which is anticipated for 1981. Fortunately, the prospects for a respite from major price increases this year are fairly good. The 9% price increase which has just been put into effect means that the average price now runs at 35$ per barrel. It is thought unlikely that there will be more than a further 5% increase in the average price during the course of 1981, unless substantial stockbuilding should take place. Despite the Iraq/Iran war there has still been sufficient oil available to meet the dampened demand. It is expected that total non-Communist world oil consumption in 1981 will be 1% less than the 1980 level, which in turn was 6% down on 1979. It is sometimes forgotten that OPEC production accounts for less than half of this total annual supply. Prospects for avoiding substantial price increases in the near future will depend on the industrialised countries' capacity to find adequate substitutes and therefore to continue to hold down their demand while output rises.

The recovery of the **United States** economy appears to have got under way in the last quarter of 1980, as was anticipated in the October issue of our Commentary. Preliminary official estimates are that GNP grew at an annual rate of around 4% following minimal growth in the third quarter and a short sharp fall in the second quarter of that year. While interest rates have once again climbed to record levels, normally indicating a forthcoming downturn in economic activity, the index of leading indicators showed its sixth consecutive monthly increase in November. The consensus of forecasters appears to be that for the first half of 1981 a slow growth of output is the best which can be hoped for. It is unlikely that President Reagan's new economic policies will have any significant effect, either for good or for ill, much before 1982. Whatever he does, the rest of 1981 should be marked by a continuing decline in the rate of inflation, apparently running at about 11%, and a continuing slow growth of output. The abatement in the rate of inflation which is anticipated for the coming year is unlikely, however, to be be substantial. The deflationary effects of the tighter monetary policy which has been proclaimed by the Fed for 1981 may well be offset by high energy and food prices. Amongst President Reagan's promised policy measures are a 10% cut in income tax and a decrease in government non-defence spending. Whatever the long-term benefits of these policies, the short-term effects are likely to be harmful.

Nothing which has happened in the last three months has caused us to change the view expressed in our last issue that before the end of this year the **Japanese** economy will have completed its adjustment to the 1979/1980 oil price increases. Real GNP grew by 1.5% in the third quarter of 1980, following a 0.8% rise in the second quarter. It therefore looks as if the government's target of real GNP growth of 4.8% in the twelve months to 31 March 1981, can be realised. Japan is not likely to repeat the remarkable productivity growth of 1979, when unit labour costs actually fell, in either 1980 or 1981. However, the fall in raw materials prices expected during the coming year should offset higher labour costs, so that the rate of consumer price inflation should fall from now on, averaging about 5.5% for the year 198[illegible] Despite the recent oil price increases an expected decline in the volume of domestic demand for oil should mean that the total oil import bill may increase by no more than around $5billion which will not be enough to prevent the current account external balance returning to surplus in 1981, albeit a small one, after two deficit years in 1979 and 1980.

In **West Germany** consumer prices are rising between 4% and 5%, with the rate of increase expected to continue to decline from the 6% peak in second quarter 1980. Unemployment remains at around 4%. Nevertheless, concern is acute about the size of the current account deficit which in 1981, as in 1980, is expected to be substantial. Adjustment is eventually to be achieved through continued tightening of monetary policy. This will mean a fall in investment spending in 1981, although total output should grow slightly. There are indications that West Germany's poor external trade performance is not simply due to cyclical factors but in part at least reflects underlying difficulties such as increasing labour market distortions and growing competition in traditional markets for German manufactured goods.

The **French** economy experienced a sharp fall in production in the second quarter of 1980, but this had begun to level out by the end of the year. Nil growth is forecast for the first quarter of 1981 but thereafter a modest upturn in output is expected. Inflation currently at about 13% is expected to moderate to around 11% in the course of the year, while unemployment seems to have stabilised at around 7% of the labour force.

The UK Economy

The recession has intensified. Belying earlier forecasts the current downturn is proving more severe and probably more prolonged than its precursor of 1974-75. The overall level of output is estimated to have fallen by 2.5 - 3% during the past year. A further, though less marked, fall is predicted for 1981, with at best a hesitant recovery emerging in the latter half of the year.

It is difficult, indeed in some instances impossible, to find parallels of recent trends in the experience of previous years. The fall in manufacturing output has been precipitate, the level in November being the lowest for 13 years, while the profitability of the corporate sector in the first half of 1980 was the lowest ever recorded. The rate of increase in unemployment and the extent of the deterioration in the competitive position of the trading sector are without precedent since the Great Depression and the return to gold respectively. The only encouraging features have been the deceleration of inflation, the fall in interest rates, and the movement into sustained surplus of the current account.

The immediate outlook is dismal, though the character and severity of the recession are likely to change. The most significant contractionary element over the past year has been sustained destocking, which has manifested itself in a contraction of orders to industry and consequent redundancies, while on external account this has been mirrored by a significant fall in the volume of imports, perhaps of the order of 10% for the year as a whole. The components of final, as opposed to intermediate, demand have partially offset the depressing effect of destocking. Buoyed up by increases, albeit small, in real personal disposable income, consumers expenditure remained at its 1979 volume, while the personal savings ratio increased by several points. Exports remained buoyant till the fourth quarter in spite of an estimated 40% deterioration in the competitive position of the UK during the year to November. Government current expenditure, reflecting the growing volume of transfer payments, maintained its inexorable upward course.

This phase is now almost over. The destocking cycle has practically run its course, with some rebuilding of inventories likely in the latter half of the year, but as inventory liquidation declines as a contractionary force, the components of final demand are set to weaken. The coming year is likely to see a contraction of real personal disposable income as the pace of wage inflation slackens, employees national insurance contributions rise, rates on domestic dwellings increase sharply and, as seems likely, the Chancellor fails to compensate income earners for the inflation of the past year when adjusting the personal tax system in the April budget. The net result of all these factors is likely to be a fall in the volume of consumers expenditure in 1981. These deflationary factors may be partially offset by a reduction in the personal savings ratio if the rate of price inflation continues to decelerate (though in the light of monetary growth throughout 1980 one must be less than sanguine about this).

Meanwhile, the volume of exports is likely to contract, reflecting slower growth in British markets, the lagged effect of sterling's appreciation during the last two years and the widening gap between trends in unit wage costs in Britain compared with her trading partners. Similar factors, coupled with the completion of the inventory liquidation phase, are likely to induce a recovery in the volume of imports. While such developments will tend to depress the level of aggregate demand the current account is forecast to remain in surplus during 1981.

On current spending plans the government intends - the recession notwithstanding - to reduce general government expenditure on goods and services by over 2% during 1981. It is furthermore intended that this reduction be concentrated exclusively in fixed investment, government current expenditure remaining at its 1980 level. The former intention is misguided, while the latter, given the almost certain prospect of a further period of recession, is probably impossible.

The evolution of the labour market is unlikely to be encouraging over the next several years. There is little evidence of firms hoarding labour in anticipation of an early upturn. Output per head, which would be expected to fall significantly if such hoarding were taking place , shows little sign of such behaviour. The consequent shedding of labour is not however being fully reflected in the numbers registered as unemployed. In the year to June 1980, total employment fell by almost 400,000 and the population of working age grew by almost 200,000, yet the numbers registered as unemployed increased by less than 300,000. It would appear therefore that the volume of hidden unemployment has increased significantly during the current recession. The implication of this development for future trends in registered unemployment is disturbing, as the hidden unemployed are likely to re-enter the labour market in the event of an upturn, thereby rendering the level of registered unemployment considerably less sensitive to variations in the pressure of aggregate demand.

Notwithstanding the depth of the recession it is the government's intention to continue to attempt the implementation of the overall policies set out in the medium term financial strategy. Indeed as noted in previous Commentaries this financial strategy is probably in the best long run interests of the UK economy. However the government seem incapable of following their own stated intentions, the chosen instrument (or target for who is to say which it is ?), the broad money supply M3, has until recently been beyond control. The Secretary of State for Industry did well to remark that the first eighteen months of the government's term had been "lost", but might have gone on to note that the "loss" in terms of foregone output and employment would have been even greater if PSBR and money supply targets had been met. It is the prospect of such further losses which confront the UK economy in the immediate future.