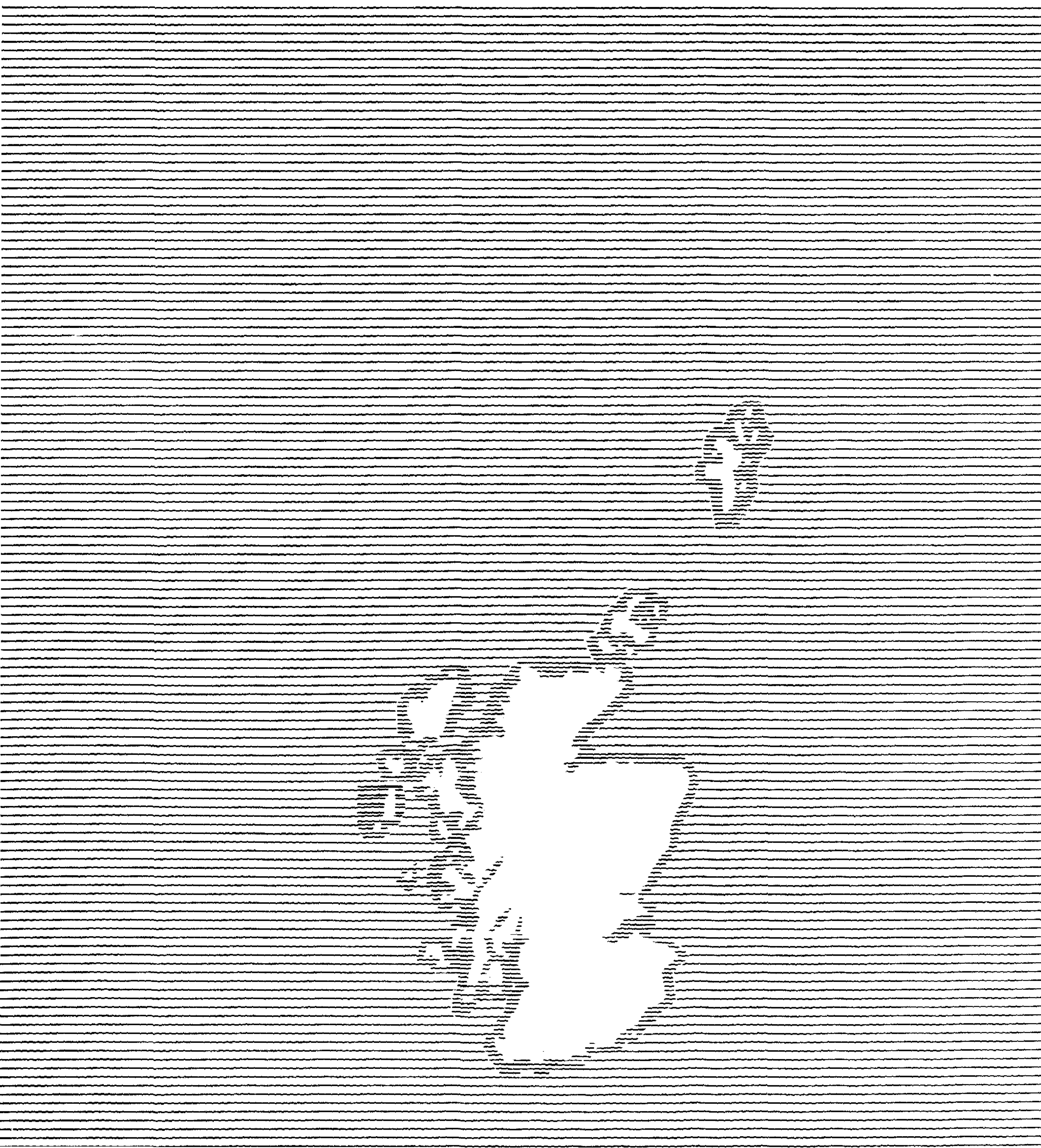
The Fraser of Allander Institute

Quarterly Economic Commentary

October 1981



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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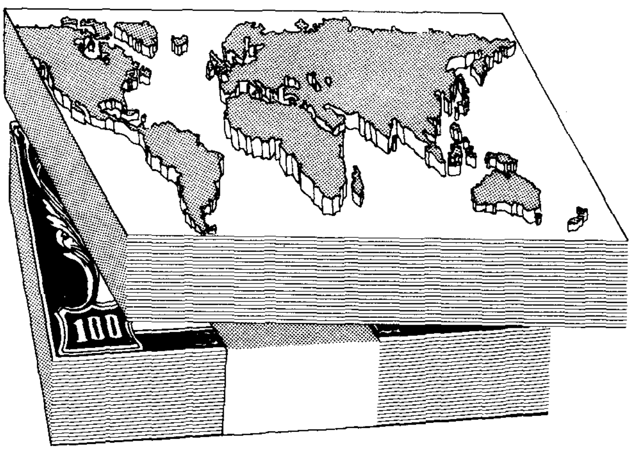
Signed articles express the views of the authors and not necessarily those of the Fraser of Allander Institute.

The World Economy

Monetary controversies enliven discussions about the state of the world economy at the present time. First, there is the question of nominal interest rates, which are at historically high levels in most of the industrialised countries. Some politicians in European countries have implied that the United States is to blame for this situation, and that other advanced countries have been forced to raise their own rates of interest in order to discourage outflows of capital. While it is certainly true that high US interest rates can be attributed to a combination of monetary and fiscal policies in that country, it is not at all obvious that other countries are compelled to follow suit. On the contrary, it is clear that recent increases in interest rates have been prompted by domestic considerations as well as by a desire to defend a particular exchange rate.



It is the official view of the US Treasury, expressed at the recent annual meetings of the International Monetary Fund and the World Bank that current world inflationary conditions "mirror an excess of world liquidity". For this reason, the US is opposed to a further allocation of Special Drawing Rights. On the other hand some of the poorer countries of the world are looking for further 'liquidity' to pay their oil and debt service bills. An evident solution is to change the existing rules for distributing SDRs based on IMF quotas so that the neediest nations would get the largest shares, while keeping down the total size of the allocation. To do this, however, would require an explicitly political concession, not only on the part of the industrialised countries, but also on the part of the oil-producing developing countries.

In the **United States** the overall outlook for the economy in the next six months is one of a continuing standstill. The composite index of leading indicators has declined five times and risen three times in the first eight months of 1981. Undoubtedly, an important factor in this situation is the continuing tight money policy pursued by the Federal Reserve Board. The Treasury is showing signs of nervousness that this policy might be too restrictive, thus prejudicing the growth of more than 5% in real GDP which is officially hoped for in 1982. Even amongst the President's own supporters in the Senate there is very considerable scepticism that the 1982 budget deficit can be kept to its planned limits. Indeed, the President has just signed a Bill raising the Federal Government's borrowing authority to more than $1,000m, for the first time in history. This year government borrowing absorbed about half of all net new saving in the United States. The current rate of inflation is between 8% and 9%, while earnings are growing at between 9% and 10%. In September, the rate of unemployment rose to 7.5%.

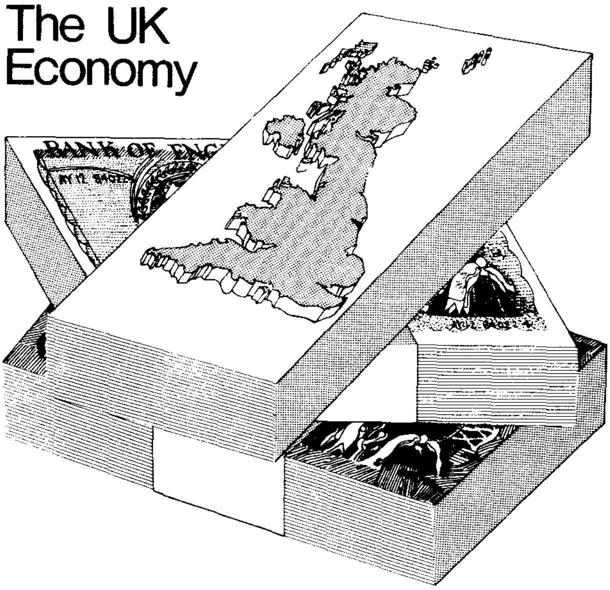
The world's most energy deficient industrialised country, **Japan,** has managed to restore surplus to its balance of payments and stability to its domestic price index within eighteen months of the doubling of world oil prices. One of the major sources of demand during this period has been the rate of growth of exports. In the first quarter of 1981 exports have continued to rise sharply so that the current account balance of payments moved into surplus. The government's economic planning agency is now looking to domestic demand to be the major source of growth for real output which it envisages will increase by more than 5% in the twelve month period from April 1981. Should there not be a spontaneous revival in consumer demand and in domestic investment, there is only limited scope for further increases in exports, this limit being provided by the heightened sensitivity of the other advanced countries to the further erosion of their domestic markets.

In **West Germany**, the latest available statistics show little indication that the recession is coming to an end. However, the government has signalled its confidence that the worst may be over by revaluing the mark within the EMS, and by lowering the official short term interest rate from 12% to 11%.

In the first six months of this year GNP fell by 1.5% and industrial production in August was below the level of production in August 1980. Real consumer spending in 1981 is likely to fall for the first time since the War, and new domestic industrial orders have been flat for twelve months. The annual rate of inflation is some 6%, and it is hoped that a rising mark will have beneficial effects on import prices. More worrying are the official projections which show that unemployment might rise from its present rate of 5.5% to 7.5% in 1982, the proportion being even higher amongst the younger generation.

Following the 8.5% devaluation of the franc against the mark, the new government in **France** has adopted a number of measures in pursuit of its objective of lowering the rate of inflation from its present 14% to 10%in 1982. These measures include price freezes on a range of politically sensitive goods, as well as a freeze on planned increases in public investment. However, since the price freezes are only temporary, and since total government expenditure next year is planned to rise by some 27%, there must be some doubts as to whether these measures by themselves will be successful in reducing the rate of inflation. On the positive side, the trade unions have so far responded sympathetically to the government's request for negotiations about voluntary wage restraint, and the short term rate of interest has been reduced.

The UK Economy



In the second quarter of 1981 the index of industrial production* for the United Kingdom was 8% below its level for the corresponding period in 1980. This notwithstanding, there do appear to be signs that the bottom of the output trough may now have been reached. Chemicals and Metal sectors, whose performance is often regarded as a precurser of what is likely to occur elsewhere in the economy, both experienced increases in production. Remaining evidence, however, suggests that the prognostications of those who believe the worst is over should be treated with caution. Certainly, there is little reason to believe that unemployment will not continue to rise at least until the autumn of 1982. Indeed, without the intervention of government sponsored work schemes, the registered unemployed would be nearer the 3,500,000 mark. While the goods market may therefore show some signs of recovery in coming months, conditions in the labour market are likely to remain extremely depressed.

Since the latest ministerial changes the future course of policy seems more certain. The defeat of inflation continues to be the major object of government efforts and the policy instruments through which this is to be accomplished remain primarily financial in nature. This new found conviction of the Treasury has, in the last month, been manifested by a two point rise in the structure of short term interest rates. This move is most easily understood as one intended to sustain the international value of the pound. With the pound depreciating in international money markets over the past few months the prospect of single figure inflation in the foreseeable future was rapidly fading. In August, the retail price index rose 0.6% to 11.5% with an identical rise taking the tax and price index to 14.9%. Without countervailing measures, future rises seemed inevitable. The rise in manufacturing input prices of 25% (annual rate) over the first half of 1981, largely due to the increased dollar cost of oil, was just beginning to feed through to prices in the shops. Further depreciations in the value of the pound against the mark and other EMS linked currencies in late summer were certain to exacerbate this trend.

That the government has again resorted to interest rates manipulations as its major weapon in the fight against inflation is unlikely to please those critics within the 'monetarist' ranks who have long argued the need for

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*Excluding oil and gas.

more elemental forms of monetary control. To control the price of money does not guarantee that its supply will respond sympathetically and thereby neutralises interest rates as an instrument for controlling the level of domestic activity. More mundane problems, however, preoccupy the CBI, who estimate that the latest rise will add £500m to their costs. With increases in mortgage and other credit charges now in the pipeline it seems the most immediate impact of the interest rate changes will be to raise further the rate of inflation. In the longer run (over the next six months or so) the level of inflation will depend primarily on how other cost factors adjust to the new higher level of interest rates. If recent improvements in productivity per unit wage and salaries can be maintained and the pricing policies of nationalised industries ammended to make them more sensitive to market forces, then inflation may fall to single figures sometime next year. It will at least take this time for the benefits which follow from a more stable exchange rate to feed through to retail prices.

The use of interest rate policy to control prices has, earlier in their term of office, proved effective for the present government. The costs this imposed on the domestic economy have been well documented in this Commentary and elsewhere. Ironically, with the election of a government pledged to tight monetary control in the United States the use of interest rates for this purpose is now more problematic. To achieve any given exchange rate target (implicit or explicit) the rise required in domestic interest rates, with high interest rates elsewhere in the world (4 - 4.5% in **real** terms), is now more substantial than would have been required eighteen months ago. The costs of 'exporting' domestic inflation therefore becomes that much greater. Indeed, if the psychology is such that interest rate rises in one country provokes reaction elsewhere, the use of the exchange rate to control the domestic price level may only succeed in inhibiting the volume of international trade. With international money markets in a continual state of flux, co-operation between the OECD countries is urgently required to resolve this difficulty.

Clearly, there are some areas in which the operation of economic policy could be improved without inflicting any material damage on the government's own brand of monetarist ideology. As alluded to above, reform of nationalised industries pricing policies is one such area. The standard remedy for the allocative inefficiencies which arise from monopolies is to stipulate a price for their product which fairly reflects their costs of production. If this could be achieved by reference to operating practices elsewhere in the world, for example, then the government could both enhance efficiency within the nationalised sector and reduce inflation at the same time. In return, borrowing restrictions on nationalised industries could be lifted. Since financial markets are unlikely to finance unprofitable ventures this should not swell the public sector borrowing requirement. In addition, short term governmental borrowing considerations should not take precedence where projects are evidently in the national economic interest. The decision on the recent oil pipeline proposals is especially worrying in this respect. In the international sphere, announcement of a target range of exchange rates might alleviate uncertainty in financial markets but is in itself unlikely to remove the problem without some form of agreement between the major industrialised countries of the world. The alternatives here would seem to be either to link the value of the pound to the dollar, which seems to be what the present government has in mind, or to join the EMS. However, these measures cannot be regarded as a substitute for an effective counter cyclical fiscal policy. Investment in socially profitable **capital** expenditure programmes need not be inflationary since the increased tax revenues and reduced unemployment benefit payments which follow from the output and employment generated may be used to offset the initial borrowing required to finance the expenditure.