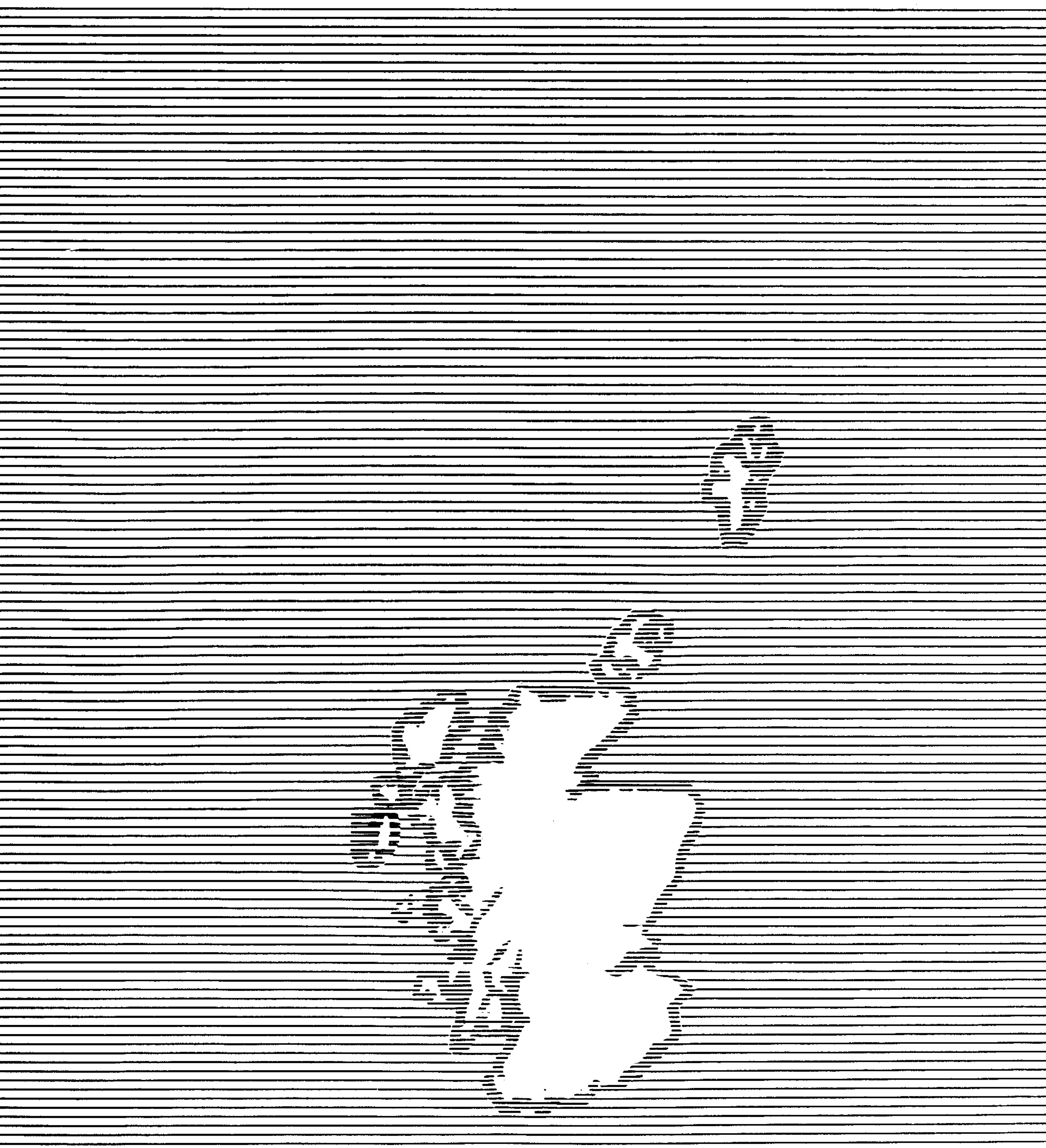
University of Strathclyde

The Fraser of Allander Institute

Quarterly Economic Commentary

May 1982



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 February, May, August and November 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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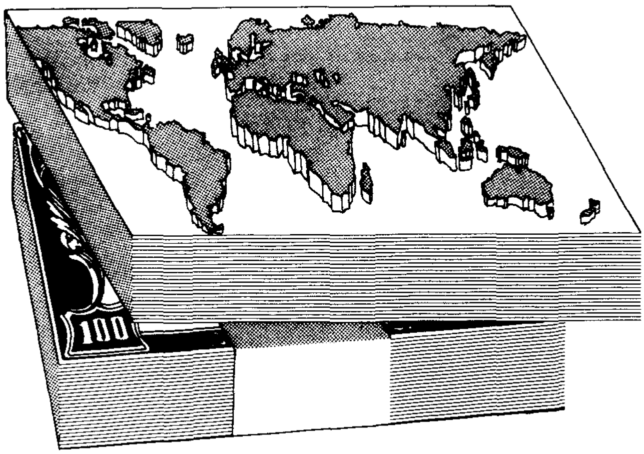
The World Economy



Prospects for the world economy during the remainder of 1982 are becoming clearer and hitherto widely divergent forecasts from various organisations are being amended towards a general consensus. The most favoured scenario is now one in which slow recovery is expected in the latter part of 1982 following static, or even declining, GNP figures in the first and second quarters. Overall 1982 growth in real GNP in the industrialised countries is likely to be in the order of 1%-1.5%, with the year-end annual equivalent growth rate being 2.5%-4% depending on the degree of optimism one has concerning the speed and strength of the recovery. The main component of recovery will be an upturn in stockbuilding, or more precisely a deceleration in the rate of stock depletion which has been extremely high in the past two years. These expected growth rates are insufficient to significantly reduce unemployment, which is still expected to total 30 million plus for the OECD countries as a whole at the end of 1982. High unemployment, and the improbability of any significant real rise in the price of oil in view of the present glut, suggests that inflation will continue to fall in most countries.

Clearly, the foundation for recovery in 1982 is a fragile one, for the prospects for the main expenditure aggregates are not promising: world trade is not expected to grow significantly and could even decline if the pressures for protectionism (arising mainly from high domestic unemployment) are translated into action. Real consumer expenditure is likely to remain relatively static since the growth rate of nominal disposable income is moving towards that of price inflation in most industrialised countries, and is even falling behind in some. High interest rates and company balance sheets still reeling from the effects of recession continue to depress investment prospects, and the continuing concern of governments with the size of public sector deficits makes any significant increase in autonomous (as opposed to 'automatic' counter-cyclical) public expenditure improbable. These factors, coupled with their generally consistently over-optimistic forecasts for 1982 made a year ago, have made most forecasters much more cautious in predicting the extent of recovery later in 1982, and some are even suggesting that this recovery may not be sustained far into 1983.

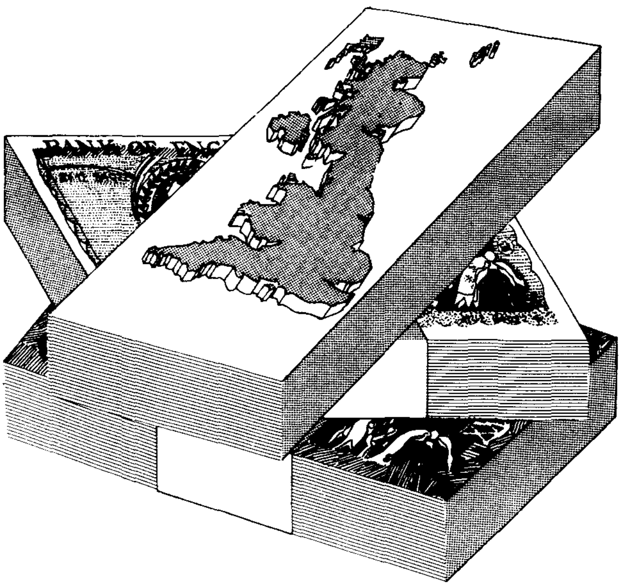
As always, however, the prospects for individual nations vary somewhat. In the **United States**, the prospects for the remainder of 1982 are becoming increasingly gloomy. After increasing between January and February, industrial production fell again in March 1982, being 7.2% less than in the equivalent month of 1981. Overall, industrial production was 14.5% down in the first quarter of 1982 compared with the last quarter of 1981. The unemployment rate is currently 9% and rising. The important composite index of leading indicators fell by 0.5% in March, the eleventh successive monthly fall. Business anxiety is centred on the high level of interest rates, which remain at post-war peaks. High interest payments on funds borrowed during the recession in combination with squeezes in prices in product markets is causing a severe strain on the corporate sector, with business failures reaching a twenty-year peak in late 1981. It is unlikely that any significant reductions in interest rates will take place until the federal budgetary crisis is resolved.

In **West Germany**, interest rates are falling because of improvements in the current account trade balance, which may produce a surplus of 5bn DM this year and because of a continuing decline in the rate of inflation towards 4% p.a. this summer. The domestic economy remains weak, however, and it is forecast that real GDP growth in 1982 may be only +0.5% with unemployment remaining high at 1.8 million. Germany's export performance improved significantly during 1981, with an increase in export value of 13.1% over the previous year. A continuation of these trends could produce a visible trade surplus of 50bn DM in 1982. The various movements of these key economic indicators suggest that the German government is likely to come under pressure from its trading partners to introduce some expansionary fiscal measures in the near future.

The **Japanese** economy recorded a negative growth in GDP in the last quarter of 1981 of -0.9%, equivalent to an annual fall of 3.5%. This is the first quarterly fall in GDP for seven years. The main reasons for the decline in GDP were static domestic demand and a significant slow-down in exports. In spite of some recovery in early 1982, export value was still 3.7% less in February than it had been in the equivalent month of 1981. The immediate prospects for Japanese exports are not favourable: export letters of credit, which have been found to be a good leading indicator were down 3.5% in January 1982 and 7.1% in February 1982 from equivalent 1981. Furthermore, although Japan's overall level of exports has declined, its exports to the EEC and the US have not. In view of the domestic circumstances in these countries, further restrictions on the importation of Japanese goods remain a strong possibility.

Finally, the performance of other major economies can be indicated briefly. In **France** industrial production fell at a rate of 3.0% p.a. during the first quarter of 1982, with unemployment rising to 8.7% in March. Consumer price inflation fell slowly, reaching an annual equivalent rate of 12% during the first quarter. In **Canada** and **Italy**, industrial production fell sharply during the first quarter, reaching annual rates of -16.5% and -10.5% respectively. However, while the Canadian rate of inflation continued to decline, that in Italy appeared to be starting to rise again. Unusually among Western economies, industrial production in **Holland** and **Sweden** rose in the first quarter of 1982, by 7.5% p.a. and 4.5% p.a. respectively.

The U.K. Economy



While estimates of Gross Domestic Product in the first quarter of 1982 are not yet available, the performance of the index of industrial production suggests that GDP is liable to fall. In the three months to February, industrial production is 1% lower than in the previous three months. The index of manufacturing output has fallen by 2% in the corresponding period. However, the major forecasting organisations still expect a rate of growth of GDP of about 1.5% in 1982 over 1981. Should this forecast be realised - and it is more than usually uncertain - then it would mean that the fall in the first quarter of this year would be a temporary aberration. If so the turning-point of the recession would have been reached in the second half of 1981, after a continuous two year decline. The fall in GDP of 6% between 1979 and 1981 is unprecedented since the War.

The rate of increase of wholesale prices, as measured by the index of input prices reached its peak at about the same time: the year-on-year change was recorded at 18.2% last October, falling to 8% in March this year. The year-on-year increase in the retail price index was just over 10% in March, the lowest such increase since May 1979.

While the precise timing and speed of the upswing remain a matter of speculation, there are two important issues about this recession which remain to be resolved. The first concerns producers. It is the extent to which the productivity gains realised in the recession may be maintained in the long run. To even discuss such a question is to suggest the remedial nature of the recession, an implication which was unthinkable in the last thirty-five years. Yet it is a measure of how quickly Keynesian economics has gone out of fashion, that few economists have troubled to enquire of this year's Budget whether it was expansionary or deflationary from the point of view of aggregate demand.

In the twenty years up to 1973, labour productivity in the United Kingdom increased at an average annual rate of 3.2%. However, between 1973 and 1982 the increase was only 0.9% annually. But in the last eighteen months, there have been substantial increases in productivity in most sectors of industry. In the year up to the fourth quarter of 1981, output per head in manufacturing increased by over 10%. This gain is larger than in previous post-War recessions, but then the fall in output has been larger also.

The critical questions for the future of the UK economy are to what extent these productivity gains have been realised by companies developing new products, introducing new technology, developing new markets, or improving working practices and management attitudes, and to what extent these new developments - essentially a willingness to adapt to change - will persist once the recession has ended. While there are plenty of examples of individual firms having responded positively to the pressures of the recession, it is still too early to say how representative these firms are. It is, too early to say whether the recession has contributed to an improvement in the long-term growth trend of productivity.

The second issue concerns the behaviour of wage-earners to the events of the past two and a half years.Households, or at least the great majority of them, have been adversely affected by the recession in two ways. First, there has been a dramatic increase in unemployment, and secondly, there has been a decline in real incomes. Since the autumn of 1979 unemployment has risen by more than one and a half million, and very many more people are engaged in various make-work schemes devised by the Government. Hitherto, this level of unemployment has aroused surprisingly little political resistance, as the results of the recent local government elections in England and Wales show. Even the widely publicised forecasts that, while unemployment may level off this year, it is unlikely to decline for a further three years or more, have been met with remarkable apathy.

While the wage-earners may be prepared to revise their post-War expectations concerning full employment it seems most unlikely, however, that they would be willing to revise downwards their expectations concerning rising levels of real income. The experience of previous post-War recessions and periods of wage-restraint, suggests that people are quite willing to accept temporary standstills in their standard of living, but there is no reason to believe that they are willing to accept stagnation or a prolonged standstill. Yet it is difficult to see how the UK economy can offer anything else in the near future. Between 1977 and 1980, real personal disposable income rose by 17%, and has fallen by 2% during 1981. Given the fall in real incomes implied by the recession, it would appear that further downwards adjustments have yet to come. It appears most unlikely that these would be accepted. In that event, if nominal wage increases were to be disproportionate to productivity increases, then the UK economy would re-enter its familiar cycle of declining competitiveness followed by increases in unemployment.

There are questions for the longer term. For the rest of this year the prospects are fairly clear: inflation levelling-off at 8% or 9%, unemployment levelling-off at between 3 and 3.5 million, with any recovery in output depending primarily on private investment in stockbuilding and fixed assets.