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Institute

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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 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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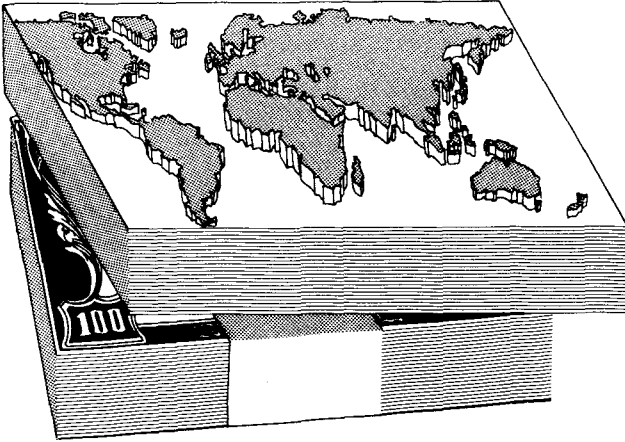
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The World Economy



The economies of the advanced industrialised countries, identified as those member countries of the OECD, largely constitute the external environment within which the Scottish economy operates. One of the features of the post-war period has been the growing integration of these economies. This can not only be seen in the statistics of trade between them, but also in the increasing flows of portfolio and direct investment. It is also the case that domestic macroeconomic policies have become increasingly harmonised, so that the response of individual governments of the OECD countries to the second round of crude oil price rises was almost entirely a uniform one. This degree of integration amongst the advanced industrialised economies does not seem to have been significantly loosened, as might have been expected, by the institution of a regime of floating exchange rates in 1971.

Amongst the OECD countries, the seven largest, (USA, Japan, West Germany, France, Britain, Italy and Canada), account for about 83% of total economic activity, while the United States itself accounts for no less than 35%. It may not be surprising therefore that what happens in the United States is of major consequence to the other advanced countries. While the intensity of the present recession varies from one country to another, the timing of the cycle is broadly uniform, and it would not be an exaggeration to say that most countries are closely watching events in the United States to see when the upswing there will materialise. The present circumstances therefore justify a rather more detailed look at the present situation of the United States economy than is normally the case in this section of the Commentary.

In mid-July of each year the **United States** government is required by law to publish its official economic forecasts for the next eighteen months. The current official view is that real GNP will grow at an annual rate of between 4% and 5% from now until the end of 1983. While other forecasts are much less optimistic, generally falling in the range from 2% to 4%, all agree that growth is on the way. Yet it is well to remember that one year ago a poll of 18 US economic forecasting organisations showed an average expectation of a rise in the US real GNP of over 4% in the following nine months. The actual outcome is now estimated to have been a fall of more than 5%. Judging the recovery of the US economy at the present time is just as hazardous as it was twelve months ago, if not more so.

On the positive side is the fact that after six months of sharp decline, GNP did begin to grow again in the second quarter of this year; however, this was due primarily to a reduction in the rate of destocking by industry. Again, the combined index of leading indicators has increased in each of the three months April, May and June of this year after falling successively for the previous eleven months. Finally, a stimulus to aggregate demand has been provided by the Federal income tax cuts and pensions increases which took effect on 1 July.

On the negative side, interest rates remain high - in real terms around 8% - even though inflation has fallen sharply to below 7%. It is not simply the high level of interest rates which is discouraging borrowers coming to financial markets, it is also the hope that they may come down further which is causing them to defer their investment decisions. On the other hand would-be lenders are unwilling to commit themselves to lower interest rates since they feel that inflationary pressures and thus interest rates may rise again. Their views are founded on two considerations, one short-term, the other long-term. The short-term consideration is that political pressures generated by the prolonged duration of the recession will cause the Federal Reserve to loosen further its shaky control of the money supply. The other consideration is the failure of the Reagan administration to control the size of its foreseeable budget deficits. It is reliably estimated that the 1983 budget deficit will be between \$141 billion and \$151 billion and that for the next two years deficits will remain in the range of \$145 to \$160 billion.

A further negative feature of the US scene is that businessmen, faced with the fact that their capital costs are rising faster than the prices they receive for their final products, are suffering a severe squeeze on their sales and profits, and take a more pessimistic view of the future than do other observers. Other negative indicators include the fact that industrial production declined in June for the tenth month out of the past eleven, while housing starts fell by 15% following a one month increase, and new orders for non-defence capital goods fell by 5.5%. There was also a sharp drop in retail sales in June.

Taken together, all of these indicators suggest that no short-term forecast of the US economy can be offered with any degree of confidence. The most likely outcome remains a slow recovery throughout the remainder of 1982, but its fragility will make it unusually vulnerable to any surprise developments, whether these be of a political, technical, or financial character.

The outlook in **West Germany** is equally uncertain. On the one hand, official forecasts by the government and by OECD expect a recovery in the second half of the year, leading to a rate of growth of output of around 3% in 1983. Supporters of this optimistic view can cite an anticipated favourable effect on consumer spending of the continuing fall in the rate of inflation, (now around 5%), and the fact that this year's wage settlements (around 4%) offer Germany continuing labour cost advantages in export markets. There have also been recent signs of recovery in the housing construction sector. This, however, is sensitive to interest rates, which have recently stopped falling.

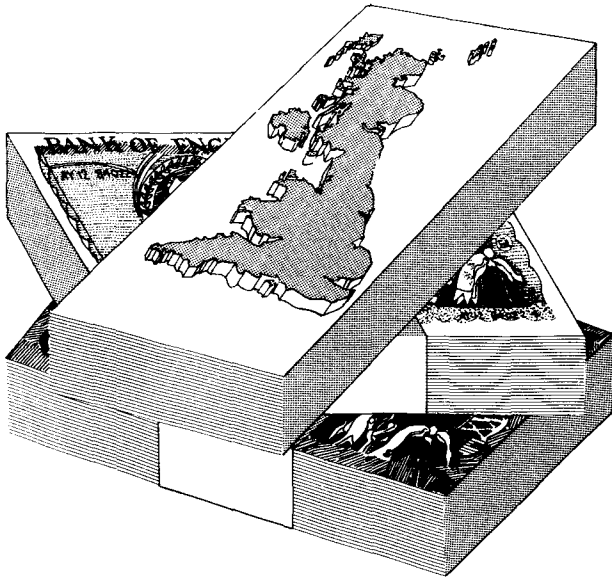
The negative indicators include a dip in export orders, a continuing decline in domestic orders and in the IFO indicator of business confidence. There was a sharp rise in industrial production in the month of June. The pessimistic consensus is that real output growth next year may be in the range of 1.5% to 2%, while there will be no growth at all in 1982. However, both optimists and pessimists are agreed on their forecasts of unemployment. The rate is expected to rise from its present 7.2%, (compared to 5.3% twelve months ago), to 8% next year.

If, as seems likely, the growth rate of GNP proves to be less than the optimists believe, this will imply a higher net borrowing requirement than planned by the government, an outcome which could easily be the final breaking factor in the increasingly fragile SDP-FDP political coalition.

Sustained by domestic demand, **Japan** is expected to achieve a growth rate of output of around 2% in 1982, less than half the rate achieved in the decade between 1970 and 1980. The prospects for the Japanese economy are clouded by the simmering trade disputes with the United States and the EEC. These could lead to the unilateral imposition by other countries of trade barriers to Japanese exports, which could have catastrophic consequences. The Japanese balance of payments surplus on current account is once again rising rapidly. Ironically, the failure of the yen to adjust upwards is largely attributable to the capital outflows provoked by the current level of US interest rates.

Since the devaluation of the franc, growth forecasts for **France** have been continuously revised downwards. While the government had originally hoped for a 3% growth rate this year, (following a 0.3% rate of growth in 1981), the latest semi-official forecast is that the rate may fall "below 2%". Further, a recent survey of business opinion, finds that business men foresee "no improvement in production in the coming months".

The U.K. Economy

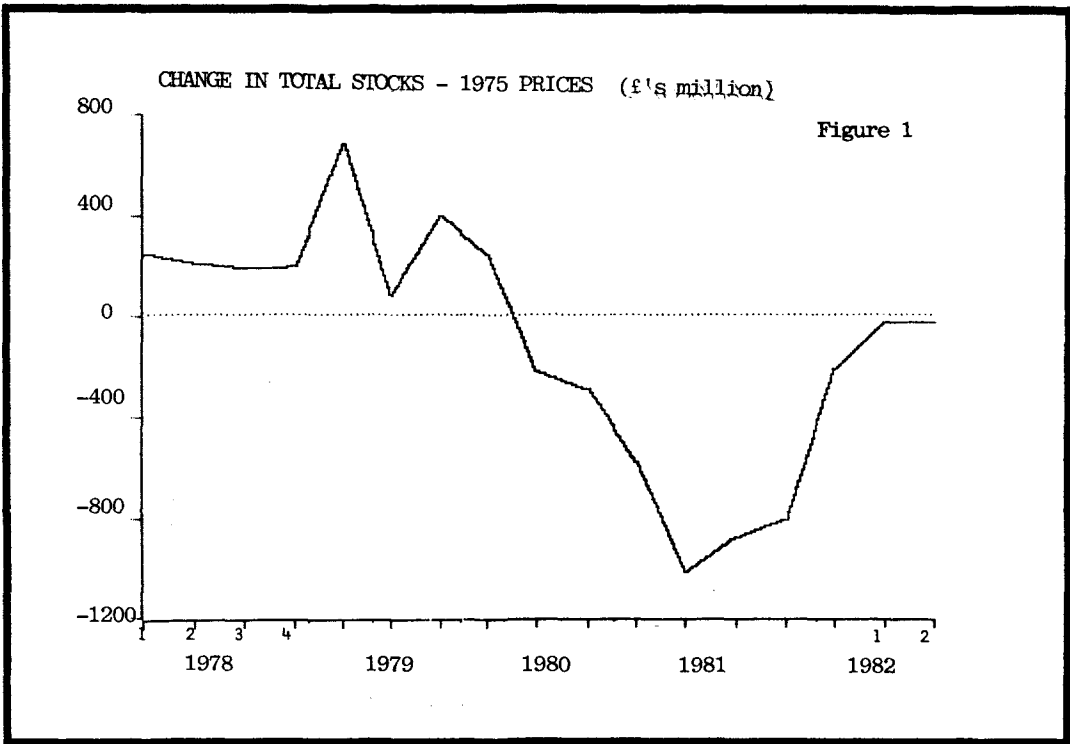


While the world economy has slowed down dramatically, the UK economy seems becalmed. Although industrial production fell in July at least GDP is not declining as it did during 1980 and 1981. However as yet there are no strong indications of a revival in economic activity.

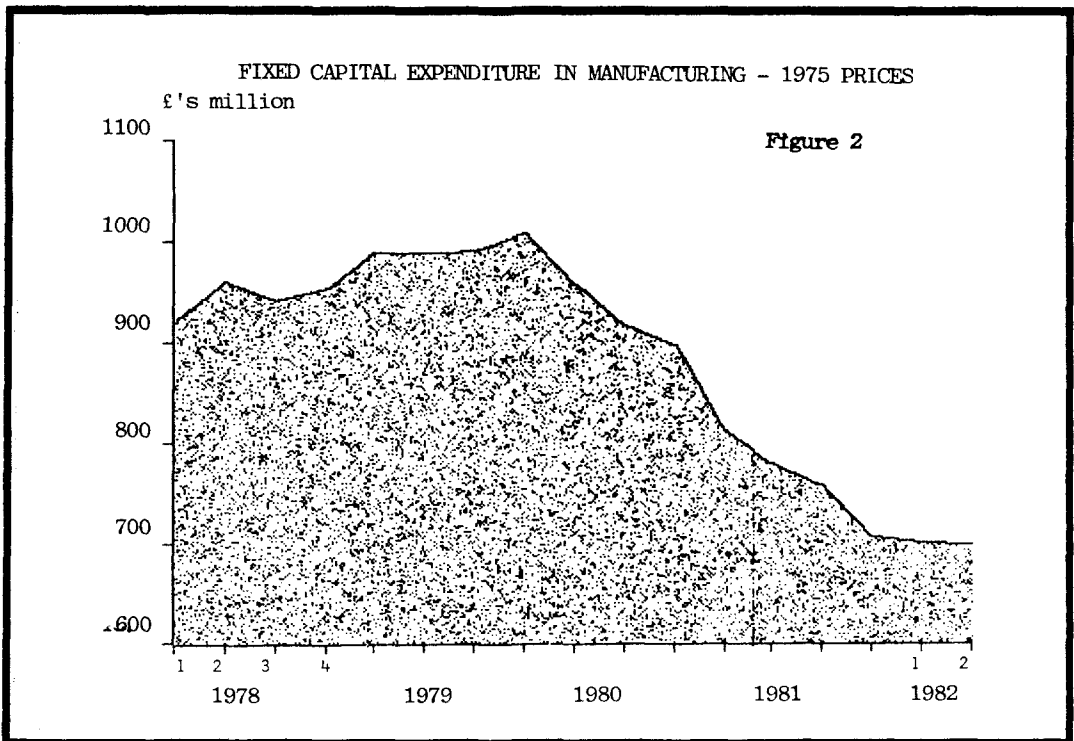
Consumer demand has remained fairly stable during the last three quarters though disposable income has been falling. Individuals have been prepared to reduce their savings and increase borrowing even though interest rates have been penally high. The inertia of consumption spending reflects consumer's unwillingness to accept lower living standards even though their income has been reduced. The declining rate of inflation will also have stabilised the value of consumers' liquid assets and consequently may have provided some small stimulus to consumption. The removal of

hire purchase restrictions should provide a further boost to demand. Even though credit advances were already at record levels in the first half of 1982, early indications suggest that the removal of restrictions will result in even higher levels during the second half.

During the last few quarters the rate of decline in stock levels has been dramatically reduced (see Figure 1). This has been the most significant factor bringing about a stabilisation in total expenditure. As yet, however, there is no evidence of any return to significant stockbuilding as one might expect at this stage of an economic cycle. When real rates of interest were extremely low, industrialists were not too concerned about maintaining a fairly high stock/output ratio to meet any unanticipated fluctuations in demand. With real rates of interest now much higher, the costs of such a strategy seem to have outweighed the benefits. The implications of this development are twofold: firstly, without a return to lower real rates of interest, the upward impetus normally generated at this stage of the cycle by the rebuilding of stocks will be drastically reduced. Secondly, if British businesses now expect to work with permanently lower/stock output ratios their capacity to meet unforeseen changes in demand will be reduced. If domestic suppliers are unable to meet sudden increases in orders, purchasers will inevitably turn to foreign suppliers to fulfill their requirements. Without a parallel increase in the flexibility of production, any move to permanently lower stock/output ratios is potentially very dangerous.



Source: British Business



Source: British Business

The level of investment was fairly steady throughout 1981. There was an increase of £210m to £5.1bn in the first quarter of 1982. However, this improvement came about largely as a result of increased capital expenditure in the service and distribution sectors. While some of the assets purchased by these sectors may subsequently be leased to manufacturers, the raw figures for the manufacturing sector (see Fig 2) are extremely gloomy. With the demand for their goods falling, industrialists naturally have become more reluctant to invest in new plant and equipment. Again, high interest rates may have been a contributory factor even though many industrialists can obtain considerable government assistance in the purchase of equipment.

Exports declined by 5.3% in the first quarter of 1982 though even at this level they were still 2.9% above the figure for the equivalent quarter of 1981. The trade balance, with the assistance of North Sea oil, is still in healthy surplus. Many of the pundits, however, see increased exports as the most plausible and desirable means of recussitating the UK economy. The most favoured means of bringing this about would be to use interest rate reductions to force a decline in the exchange rate. The perceived advantage of this strategy is that, like the removal of HP restrictions, it satisfies the monetarist shibboleth that there should be no increase in government spending which could possibly be interpreted as stimulating demand. Unfortunately it neglects some of the lessons of the past and the realities of the present.

All previous experience suggests that it takes some time for a reduction in the exchange rate to affect the volume of exports. Indeed, in the short-run there may be a perverse effect on the balance of trade depending on the respective rates at which export and import prices are realigned. Treasury estimates suggest that it will take between two and four years before the effects of a change in competitiveness peak. Though this result may be consonant with one's beliefs in regard to order and delivery lags, it certainly can give little comfort to those who believe in the efficacy of exchange rate reductions as a means of escaping from the immediate economic problems.

Further, as is clear from the previous section, the rest of the major world economies are also experiencing recessionary problems at present. It is logically impossible for each of these countries to escape these problems by simultaneously holding down domestic demand and expanding exports. While individual governments may see this as desirable, it is only concerted action to increase demand which will pull the world economy out of recession. Those countries with very large trade surpluses will come under most pressure to take action to reflate. The UK, at present, has the largest current account balance in the developed world.

Finally, those who currently advocate exchange rate reductions seem to have forgotten the argument that the price level is not independent of such reductions. The prices of those traded goods for which demand is inelastic are bound to rise to compensate for the fall in the exchange rate. In an economy as open as that of the UK it is absurd to believe that conditions in the trade sector will not affect the price level.

Perhaps the fixation with exchange rate reductions will disappear in the same way that interest in month-to-month fluctuations in the money supply has declined. Certainly, such a policy can provide no panacea for the present stagnation in the British economy. There are no stimulatory policies which do not carry a risk of increasing the rate of price inflation, even policies which do not involve government spending. The government must surely be aware of this and the likelihood that it will be prepared to run such risks must be increasing as an election looms ever closer.