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REVIEW OF THE QUARTER'S ECONOMIC TRENDS

The World Economy

The present position and outlook might be depicted as follows. The recovery can be considered to be reasonably well established in the US, which alone in the developed world has seen a strong revival in business fixed investment. It is also the only major economy where unemployment, currently averaging 7% of the civilian labour force, seems unlikely to rise further in the next year. Real GDP growth is likely to be of the order of 5% annually during both 1977 and 1978. The current account of the balance of payments seems set to remain in substantial deficit up to the middle of next year. In part this reflects substantial oil imports, and so its effects on the trade balance of the developed world may not be large.

Activity in Germany has been almost stagnant during most of 1977, and earlier projections of 5% real GNP growth now seem at least one percentage point too high. Industrial production has scarcely grown since the beginning of the year, reflecting the weak performance of all components of final demand. The domestic consequences are likely to be a further contraction in overall employment. However, policy changes announced recently may lead to GNP growth of 5% in 1978. Most of the stimulus should come through increases in real take home pay, and an expanded public investment program. The annual rate of increase in consumer prices is likely to be of the order of 4% both this year and next.

Reflationary action has also been taken in Japan, where the GNP target of 6.8% in 1977 may be achieved. The policy changes will serve to increase public capital spending and to a lesser extent consumer spending. Their impact on import demand is unlikely to be large. The rise in consumer prices will be of the order of 10% this year, falling to perhaps 8% in 1978 under the influence of an appreciating yen and a moderate wage round this year. The OECD envisages that real GNP growth may be of the order of 6% annually till 1980.

In France, overall demand remains depressed. Government measures to stimulate investment and to initiate direct employment programs have recently been announced. The overall effect is likely to be a repeat of this year's low GNP growth of 3½% in 1978.

Nor is much progress likely in further reducing the rate of inflation, which is likely to average 9-10% annually during both years. Measures to reduce the age of retirement to 60, and cash grants for those who emigrate, seem unlikely to stem the current rise in unemployment, which may well stand at 5% of the labour force next year.

Growth in Italy is likely to be of the order of 2% in 1977, and somewhat lower still in 1978. Sustained deflation of domestic demand may bring the current account balance into equilibrium this year, and may reduce the annual rate of increase of consumer prices from its present level of 20% to something approaching 15% by the first half of 1978. Sweden, which foremost amongst the Scandinavian economies had maintained employment and production during the recession, is now faced with the necessity of making the real income adjustment thus postponed. Her problems are complicated by rising inflation, the highest unit wage costs in Europe, and as a consequence stagnant manufactured exports.

What then are the reasons for the faltering world-wide recovery? To an extent policies have been too successful. In many countries incomes policies have been too efficient in depressing real wages, with consequent effects on consumer demand. In turn this has led to slow recovery of corporate turnover and profits and consequently to a very sluggish revival of business fixed investment. Finally fiscal policy has been less stimulatary than expected owing to underestimation of the effects of fiscal drag, and a failure in many cases to meet government spending targets.

Unemployment Rates - Major World Economies

	June 1976	June 1977
United States	7.8	7.1
Japan	2.0	2.1
Germany	4.1	4.3
United Kingdom	5.5	5.9

Source: *OECD Main Economic Indicators, September 1977*

The UK Economy

Reference to what are generally regarded as 'key indicators' offers the temptation to be optimistic with regard to the present performance and future prospects of the UK economy. The trade figures for September show a strong current account surplus of £266 mil. with the visible balance of trade in surplus at £91 million and the underlying trend indicates a current account surplus for this year, with the prospects of an even greater surplus in 1978 assured by the impact of North Sea oil.

At the same time, the strengthening of an already firm pound has brought the Bank of England into the relatively unfamiliar role of acting to hold down the rate of exchange. The demand for the pound has been such as to result in the accumulation of foreign reserves to record levels ($17 billion) that compare favourably with those of Japan and the USA. While this state of affairs is encouraging, a note of caution is required: a substantial part of such reserves may be speculative in nature and prove to be extremely volatile, and could be repatriated fairly quickly.

There may also be a sense of optimism generated by the government remaining within the limits imposed by the IMF on the rate of increase in money stock (M3), and its Public Sector Borrowing Requirement (PSBR). With respect to the PSBR, the government may have about £1 billion of headroom available giving it a degree of purchase should it decide to act in a reflationary manner.

Similarly, encouragement can be derived from the slow down in the rate of inflation - the Bank of England forecasts it to be under 13% by the end of this year. And, given the obvious weight it attaches to it, the government might also derive some encouragement from the fact that the TUC leadership prevented outright rejection of its vision of a Phase 3 - 12 months between settlements and an upper limit of 10% - in the face of considerable rank-and-file dissatisfaction with the workings of Phases 1 and 2. But government optimism on this will be tempered by the realisation that pressures from the shopfloor may prove irrestible to the union leaders. Indeed, the government's wages 'policy' will be tested soon by Ford, British Leyland, and others such as the lorry drivers.

There is, however, another side to what Mr H J Witteveen of the IMF has recently called the "astonishing" success of British government financial policies. It is clear that the real economy remains in crisis. Unemployment has been allowed to rise to post-war record levels : an unadjusted total of 1.61 million (which would be over 1.8 million except for stop-gap attempts at job preservation and creation), or 6.1% of the workforce. The National Institute expects unemployment to continue to rise into 1978. Alongside this rise in unemployment, there has been a fall of some 6% in real disposable incomes over the last year.

On the production side, productivity remains low compared with our main competitors, and in the first half of 1977, the level of economic activity as measured by GDP fell to a level 7% below the 1973 peak, with manufacturing activity particularly depressed. In addition, UK industry is operating with levels of excess capacity which,according to the Bank of England, are the highest in 30 years, and is undergoing a significant rise in unplanned stockbuilding. Further, at the sectoral level the UK economy has heavy commitments in terms of employment and capital employed in areas that are experiencing chronic world over-capacity, e.g. steel, shipbuilding, synthetic textiles, and which will not lend themselves to any short-run solutions.

It seems clear then, given the overall conditions of excess capacity, the deep flaws in the UK industrial structure, and current low levels of demand, that we cannot realistically look to an investment-led recovery from industry itself. And, since any stimulus from the world economy seems equally remote, then stimulation of the economy must come from the government in the first instance.

The indications are that now the IMF has given the word, the Chancellor is now seriously considering the introduction of some fiscal measures of a mildly reflationary nature comprising a cut in direct taxes and possibly some attempt at a winter works programme. However, there are solid grounds for believing that this will amount to too little and too late to stem the rise in unemployment.

Firstly cuts in direct taxes are likely to be delayed so that any expenditure-stimulating effects will seep through in the Spring of 1978 at the earliest. Secondly, it is possible that any cuts in direct taxes will initially result in people readjusting their savings and not spending the extra money in their pockets - as seems to have been the case in Germany since the recession set in. A final, and more general, retarding influence on attempts at demand-side stimulation aimed at increasing employment lies in the existing situation of unplanned stockbuilding experienced by manufacturers and distributors in 1977, along with excess capacity: thus even if consumer demand should rise with tax cuts, there will be a substantial lag before this is reflected in a sustained expansion of production and employment. This analysis is reinforced if there has been a significant degree of labour hoarding - that is if firms have held on to workers in the recession because they are skilled or expensive to pay-off, and whom they would expect to require in the upturn - and where workers have been retained under such measures as the Temporary Employment Subsidy, who would otherwise have been laid-off. The existence in significant numbers of such groups of workers means that in the upturn of the economy or industries affected, there will be no immediate tendency to hire new workers as the existing workers are capable of coping with expansion at the outset. Indeed, given the scale of fixed costs incurred per worker (insurance contributions etc.), companies may for a time prefer to expand production on the basis of the existing labour-force working overtime. All of these factors call into question the efficacy of relying on direct tax cuts to cure a problem that needs tackling now.

Given these clear limitations of direct tax adjustments and given that stimulation of the economy is required now if there is to be any hope of reversing the trend in unemployment by mid-1978, then we have to look at alternatives. A general reduction in VAT would have the immediately visible effect of reducing prices. But this would be merely a cosmetic effect in that the same employment-creation constraints apply as with cuts in direct taxes, and in that the effect on the rate of inflation would be a once-and-for-all effect, and would go no way to tackling the roots of inflation.

It is clear that the government must face up to the need for an immediate start on a programme of public works. This would include the building of roads, but especially the building and rennovation of hospitals, schools, technical colleges, sheltered housing for the elderly, and local authority housing to meet the needs of the poorest sections of society who are generally priced-out of the private sector. Such a programme could be met in part by the estimated £1 billion headroom available in the government's PSBR as defined by the IMF. Indeed, the net cost to the exchequer would be low when consideration is taken of the savings on welfare and social security payments, and the recoupment of taxes and insurance contributions from those who were formerly unemployed and who become employed as a direct or indirect result of such a programme.

Apart from the fiscal advantages of a public capital-works programme, there are others related to the nature of the building and construction industry. Firstly, the industry is in severe distress with unemployment at more than double the national average. If it is to be saved from further deterioration then it needs the reinstatement of the projects which were shelved under the public expenditure cuts of the last year or two. Secondly, this sector is relatively labour-intensive and stimulation should meet some early success in reversing the trend in unemployment in that industry at least (though a potential bottleneck in job expansion here is the apparent shortage of craftsmen, a problem not confined to the construction industry). Thirdly, the construction industry is relatively low in import content and would not place any great strain on the balance of trade. Finally, such a programme has the advantage of producing what is needed in this society.

However, the indications are that the Chancellor intends to retain his present conservative fiscal and monetary policies together with considerable reliance on wage restraint. Such a course of action will ensure a continuing rise in unemployment in the coming year. No amount of wage restraint on its own will engender the necessary structural changes required if the UK economy is to develop the levels of productivity and international competitiveness enjoyed by our main trading partners and competitors.

Indeed, even a programme of public works, with or without tax cuts, is on its own merely a return to the familiar short-run orthodoxy whose limitations are expressed in the history of post-war economic crises. Unaccompanied by major fiscal and institutional changes of a long-term nature, the economy will lurch along in a stop-go manner, with unemployment falling, but to a new higher 'natural' rate only to be subjected to further cyclical increases; balance of payments problems will recur and inflation will continue to distort economic relations.

The actual form and content of a long-term strategy would require a greater consideration than is possible here. However, some indication can be given of just a few of the issues that should be subjected to critical analysis. For example in the area of regional policy, there must be questions asked of a policy framework that apparently acts in a manner unfavourable to the expansion of employment - that is, a system of grants that encourges more capital-intensive projects and proves to be an expensive method of creating jobs (e.g. see July 1977 issue of the Commentary on the cost of jobs at Moss Morran). The corollary of this is that the abolition of the Regional Employment Premium (REP) should be reviewed with the aim of restoring it in some form.

At the same time there should be a more critical attitude adopted to the role of the giant corporations in the economy; for one thing, they favour capital-intensive methods to such an extent that there must be a question mark placed against their ability to offer future job expansion opportunities; and secondly, given the calls from all parts of the political spectrum for a greater role to be given to small businesses in the economy, there has to be an evaluation of whether the existence and activities of the multinational and state monopolies impinges on the ability of small businesses to identify and make use of growth opportunities. The existence of such concentrations of corporate capital questions the notion that small businesses will prosper and grow in economic importance by the mere manipulation of the tax system: there are more fundamental barriers ranged against small businesses, and it will require institutional changes in conjunction with fiscal change to engender growth from this area.

Other problems that require to be tackled as part of a long term plan aimed at revitalising and restricting the British economy include the question of training and technical education. At the moment we are in the position of having record-levels of unemployment coupled with a shortage of skilled manpower in certain sectors. At the same time and related to the question of training and retraining is the human and material waste involved in the uncontrolled decline of firms and industries.

For example, when a steel works closes, skills are suddenly written-off and the worker finds difficulty in getting a suitable job. Clearly what is required is a policy for identifying those industries and firms where phased withdrawal is required and a re-training, and if necessary, a re-location scheme, for servicing the requirements of growth industries.

It is of course easier to indicate these problems than it is to actually draw up the means of implementing such a long-term strategy. There would be great costs involved, and mistakes would continue to be made. And yet it is now, when the problems are clearest and revealed by the extent of the industrial depression, that the opportunity to finance a new deal that would modernise and restructure British industry, is being presented in the form of oil revenues. Such an opportunity will pass quickly and will not come again. A question mark must be raised as to whether the institutional preconditions exist that would permit such an industrial revolution today.