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THE FRASER OF ALLANDER INSTITUTE

QUARTERLY ECONOMIC COMMENTARY

October 1976

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. In co-operation with the Scottish Council Research Institute and IBM United Kingdom Scientific Centre the Institute is compiling a set of input-output tables for Scotland. The Institute also wishes to thank The Scotsman Publications Limited for its financial support in the appointment of a Research Fellow to work on the construction of forecasting models.

Additional copies of this Commentary, and of all Fraser of Allander Institute publications may be obtained from the Secretary, The Fraser of Allander Institute, University of Strathclyde, 100 Montrose Street, GLASGOW G4 OLZ, or through leading booksellers.

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REVIEW OF THE QUARTER'S ECONOMIC TRENDS

The World Economy

The leading economies have now reached a stage where many economists and policy makers are questioning the staying power of the recovery. Following the first quarter surge of activity reported in our last Commentary, the second quarter of 1976 brought a marked slowing down in the growth of industrial production particularly in the US, and the latest indications are that this slowdown has continued into the third quarter. Much of the initial impetus out of recession stemmed from the turnaround in stockbuilding, but this adjustment of stocks would now seem to be largely completed.

Forecasts for 1976 made earlier in the year for the OECD countries have not been revised to any significant extent. Real GDP growth of 5-6%, 9% consumer inflation, and a continued worsening of their balance of payments positions due to OPEC current account surpluses expanding again are expected. However, the apparent slowdown in the growth of industrial production in the second and third quarters is not encouraging. Price inflation also appears to be accelerating due to an increased demand for raw materials and employment has not picked up in the way hoped for in some countries. On the more optimistic side, the volume of world trade should increase by 10-12% this year, private investment has been improving in most countries, profits are rising, and a significant increase in capital spending is expected in 1977.

Some considerable divergence of opinion has now emerged over the future prospects of the United States economy. According to one New York bank, economic advance may be tending to stall rather than just slow down. An annual real GDP growth of 4½% in the second quarter of 1976 was only half that of the first quarter. Retail sales levels have been somewhat depressed, and profit levels have not improved much since the first quarter. Unemployment has been creeping up again in June and July to 7.8% , and so has consumer price inflation.

From fears of a renewed bout of inflation due to first quarter experience (see the July Commentary) we have now turned full circle to fears of

stalling in recovery. However, the official forecast for real GDP has been raised to 6½% for 1976 and it has been suggested in the business sector that the US has room to expand faster. Clearly, this slowing down can be attributed to the downturn in the stockbuilding cycle and to a lesser extent fairly strict fiscal and monetary measures. Hence the future course of output will be determined by other components of demand. In this light the retail sales experience may be construed as a little disappointing.

On the other hand, another New York bank has emphasised that the continuing growth in incomes implies that the lull is only temporary as the economy changes gear into a new phase of the cycle which they feel is likely to be more sustainable. Even so, the index of leading indicators pointed to a further slowdown in the third quarter of this year, although a retail sales rise in August of 2% is encouraging.

The West German economy, which has played a vital role in West European recovery still displays the most promising short-term growth prospects. Expected real GDP growth is unchanged at 6%. The wage settlement norm now appears to be as low as 5½% and,given the increased productivity of the recovery,labour cost increases may be as low as 2%. Employment trends have not lived up to expectation and the slight rise in the July unemployment figure was perhaps reflected in the survey of business opinion in West German industry which was rather disappointing. This may to some extent be due to an ending of investment incentives in the second quarter of 1976. Export prospects are still favourable, although the trade surplus is expected to be similar to last year. Some deceleration in activity is probable reflecting to some extent the slowdown in the US and Japan.

An annual rate of 15% real GNP growth was experienced in Japan in the first quarter of this year which has led to an upward revision of the real GDP forecast to 6½%. However, there is some indication that domestic activity is slowing down and significantly the savings ratio has risen again. However, the norm for wage increases has fallen considerably and is now in the region of 9% which should help ease unit cost pressure, and continue to enhance profitability. Exports have continued to expand, although there is some foreign opposition to Japanese trading activities. It has been suggested that the yen is being kept undervalued, and that export dumping has been taking place.

Most other industrialised countries have been making progress, although reflecting the slowdown in the world economy. In some, like the UK and Italy, future prospects are still dependent on the ability to keep reducing their inflation rates in line with competitors (see previous

issues of the Commentary) and also to make room for productive growth at the same time. The recovery in industrial countries is also significantly advanced to benefit the non-oil developing countries, whose exports increased in the first quarter of this year, both in price and in volume. It would now appear that world industrial activity may be slowing down, perhaps to a more sustainable pace. Clearly though the divergence of opinion must sound a note of caution on future prospects.

The United Kingdom Economy

In our last Commentary we noted that the turnround in world trade, together with the devaluation of the pound, provided the opportunity for a strong expansion of exports. Since then the pound has dropped a further 12 cents against the dollar and in so doing has precipitated a further sterling crisis. A substantial improvement in the balance of payments position is a necessary condition for the restoration of confidence in sterling. However, recent export performance has not been encouraging. The seasonally adjusted volume index of UK exports fell by 2½% between March and August whereas the imports index rose by 2½% over the same period. Although no doubt there are substantial lags before the full effects of a devaluation are realised, one would have expected at least a partial improvement since the exchange rate has now been falling for a period of eighteen months.

As a short term expedient to overcome the current difficulties the Government is probably considering some more general type of import restriction such as import deposits. Last introduced in 1968, this measure, whereby importers are required to deposit a proportion of the value of imported goods with the Government as an interest-free loan, would have the dual benefits of making imports more expensive and reducing the rate of growth of the money supply. However, the application of such measures would depend on the reaction of our trading partners and, in particular, on the IMF. Without its support, the pound would collapse further, so it is in a strong position to dictate the current course of economic policy and may insist that no restrictions be placed on trade.

The rising cost of imports is likely to contribute toward an acceleration of the rate of inflation toward the end of the year. Although the longer-term effect of the rise in minimum lending rate will be deflationary, the immediate effect will be to increase the cost of mortgages and overdrafts - so adding to inflationary pressure in the short run. The Government is trying to prevent a sharp increase in the cost of imported food by opposing devaluation of the green pound. However, pressure from the EEC, which is currently subsidising UK food consumers at a rate of £1.2m per day because no devaluation has occurred, cannot be resisted indefinitely. The combined effect of these pressures makes the Chancellor's aim of 7% inflation by the end of 1977 seem unattainable.

The authorities are taking a determined stand on the growth of the money supply. Following a sharp increase in the money supply in the summer months the Bank of England raised minimum lending rate to an

unprecedented 15% on 7th October. Special deposits totalling £1050m have been called in to bring money supply growth back to the Chancellor's 12% target. Though these measures may encourage the IMF to believe that Britain is taking positive effects to reduce inflation, industrialists will not be heartened by the cost of funds for investment rising to a minimum 16%. Many firms, especially smaller ones, will go bankrupt, unable to meet the higher cost of overdrafts.

The key to long-term recovery from Britain's economic ills lies in a substantial expansion of productive investment. Although some rise in the level of investment is expected to occur in the short-run, the real level of investment in 1976 is likely to be less than any year since 1964. That industry is still unwilling to invest is borne out by the fact that advances to private industry from the clearing banks fell by £500m during August-September. The revival of profits may have enabled an expansion in the internal financing of investment but, on the other hand, it may be that firms are simply unwilling to invest when the average real rate of return on capital, as the Department of Industry admits, has fallen, from over 10% fifteen years ago, to 3.9% in 1975.

An immediate rise in investment is not likely to cause more than a marginal reduction in the level of unemployment, which stood at 1.4 million in September. Further, the recent increase in employers' National Insurance contributions has increased the employers' incentive to increase utilization of the existing labour force rather than take on additional labour. Even though unemployment attained a record post-war level in July, 32% of all operatives in manufacturing industry were working an average of 8.6 hours overtime per week. The cost to firms of employing additional staff has increased substantially as a result of new legislation and increased employer contributions - with detrimental effects on employment.

In our last issue we noted the recent fall in the level of real earnings. Although the unions have implicitly accepted the necessity for this by their acceptance of the current pay policy, it is not yet clear what agreement, if any, will replace it. If, as we believe, an increase in investment and a lowering of unit costs is a necessary condition for a long-term improvement in Britain's growth rate then the growth of consumption must be kept below the rate of growth of GDP to permit an expansion of investment. Whether it is politically feasible to allow the gap between the expectations and experience of private and public consumers alike to continue to widen is open to doubt. Further cuts in public expenditure are likely to be stoutly resisted, especially by the local authorities.

Industrial production in the UK has fallen marginally during 1976, standing at 100.8 in July (seasonally adjusted) against 101.0 in January. Both the Bank of England and National Institute, writing before the recent sterling crisis, expected output to grow and growth to accelerate. Obviously, prospects for such an acceleration have been reduced by the imposition of the credit squeeze. Nevertheless, we expect some recovery before the end of 1976 - real GDP growth should be approximately 3% in 1976 and will continue at that rate during the first two quarters of 1977.