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CONTENTS

1. Review of the Quarter's Economic Trends

   The World Economy 1
   The United Kingdom Economy 4

2. The Scottish Economy

   Indicators of Economic Activity 7
   Current Trends 12
   Employment and Unemployment 20
   Outlook for the Future 23

3. Notes

   Population Drift in Scotland 26
   The Green Pound 29

4. Summary 32

5. Special Article

   Scottish Migration: Some Thoughts on a Human Capital Approach by D N F Bell and F X Kirwan 33

6. Publications of the Institute 44

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REVIEW OF THE QUARTER'S ECONOMIC TRENDS

The World Economy

There is now ample evidence that the pace of recovery in the major economies slackened during 1976. Published statistics, however, are as yet inadequate to document the full extent of the slowdown or to assert that it was a transient phenomenon. Available evidence would suggest that the growth in the major economies in 1977 may be somewhat slower than had earlier been forecast, and that in the short run further reductions in unemployment and inflation rates may be very difficult to achieve. Several threads may be drawn together in an attempt to justify this interpretation of likely future developments.

A resumption of stockbuilding and an upsurge in consumer demand, notably for cars and durables, provided the main impetus for recovery from the recession in mid-1975. These stimuli, however, were largely pump primers, and the maintenance and strengthening of the recovery required that their place be taken by fixed investment, and a more broadly based revival in consumer demand. This in turn, through the interaction of the international trade multiplier should have led to a sustained recovery. The reality has been somewhat different. Industrial investment has been slow to recover even in those economies which were the first out of recession. The reasons for this are not hard to find. Most economies appear to have ample excess capacity. In none of the major economies does the degree of capacity utilisation approach the levels of 1972-73. Unemployment, at best stagnant in most economies, testifies to ample available supplies of labour. Though profits have recovered cyclically; as wages have grown more slowly in line with incomes policies, and as firms have implemented price increases and enjoyed rapid productivity growth, the proceeds appear to have been used more to reduce corporate indebtedness than to increase investment. In part this may be due to the tight monetary policies now being implemented in many countries. To a certain extent a "crowding-out" effect may be in operation, manifesting itself not through a shortage of borrowable funds but through the high cost of borrowing. High nominal interest rates reduce the attractiveness of any given investment project and increase the incentive to reduce indebtedness. The increased investment required to sustain the recovery, has in general not been forthcoming. Nor has a more diversified pattern of consumer demand, save perhaps in the United States.

The consequences may be seen in industrial production statistics, whose course has been erratic during 1976 in the United States, Germany and Japan. In the United States, production grew strongly throughout the year to August but then appears to have fallen in September and October. New orders for industry fell in the third quarter, being most pronounced for durable goods. Unemployment, as a percentage of the labour force, whilst lower than in 1975 had begun to rise again in the autumn. In Japan, the upward trend in industrial production became erratic in the second and third quarters, most notably in investment goods. By end summer, unemployment had begun to rise again, reflecting the steady fall in manufacturing employment during 1976. In Germany the rise in unemployment may have levelled off, but the number of unfilled vacancies fell steadily during 1976. Investment demand appears strong but consumer and external demand appear to be weakening.

These and other factors have led the OECD to revise downwards its forecasts of GNP growth in the major economies in 1977. The table below presents OECD estimates for 1976, and forecasts for 1977, of changes in GNP and in consumer prices.

Percentage Changes

	GNP Growth		Consumer Prices	
	1976	1977	1976	1977
United States	6.75	4.5	5	5.25
Japan	6	6	9.5	9.5
Germany	5.5	3.5	4.75	4
France	5	3	9.5	8.75
Italy	4.5	-0.5	17	20.5

Source: OECD Economic Outlook Dec. 1976.

These forecasts are made on the basis of unchanged policies in 1977, and on the assumption of no rise in oil prices. Since the forecasts were finalised in November a number of important indicators have moved in a persistently weak direction. This must bear out the OECD's own caveat that the forecasts are likely to be in the upper range of probable outcomes for most economies other than Germany.

The forecasts set out in the table above mask an expected slowdown in the economies of Japan, the United States, and Germany in the latter half of this year. In all three cases the inventory cycle should have run its course by that time, but only in the United States are there indications that private fixed investment will adequately support final demand. The outlook is somewhat similar for the European economy. A sustained recovery in business investment is unlikely in 1977 as levels of unused capacity remain historically high and consumer demand depressed. Real disposable income is likely to contract further in most of the

European economies under the combined influence of fiscal drag and anti-inflation policies. The year is unlikely to see a reduction in overall levels of unemployment, and this, coupled with the downward stickiness of inflation rates may serve to maintain savings ratios at high levels, further depressing the level of demand.

It is not yet known whether activity strengthened in the three major economies in the fourth quarter of 1976. In making its forecasts the OECD assumed that it had. Nor is the exact composition of President Carter's fiscal stimulus known. Its effects on the world economy will be unlikely, however, to be felt much before the second half of this year, and can hardly qualify the OECD view that:

"the worst postwar recession is likely to be followed by the slowest postwar recovery, except in the United States and Canada",

Foreign Trade Volumes, OECD Area. Annual % Change

	1975	1976*	1977**
Imports	- 6.9	13.5	6.25
Exports	- 4.2	11.0	6.50

* Provisional

** Forecast

Source: *O E C D Economic Outlook December 1976*

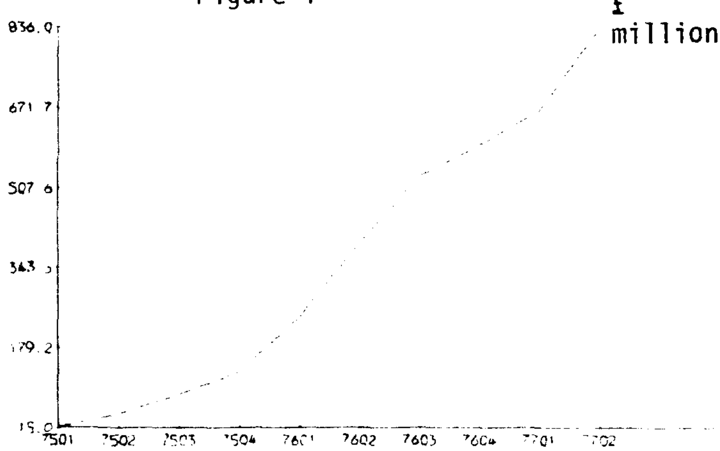
The UK Economy

Over the last quarter, three events of major economic significance to the UK have occurred: firstly, the government has secured a \$3.9 billion loan from the IMF which will be paid in instalments during 1977 and 1978: secondly, in order to gain the consent of the IMF for this loan, the Chancellor delivered a mid-December mini-budget intended to reduce the public sector borrowing requirement by £1.8 billion in 1977/78 and £2.9 billion in 1978/79: lastly, agreement was reached in Basle on a plan to reduce the role of sterling as a reserve currency (although it has already been substantially reduced, simply by a reduction in foreign holdings of sterling from £4 billion at the beginning of 1976 to £2.76 billion by September). The scheme provides \$3billion as a 'safety net' to cover withdrawals of sterling balances from London. The intention is that such a scheme will protect the exhange rate from large fluctuations in these balances which do not necessarily reflect the domestic circumstances of the British economy.

The IMF loan is likely sufficiently to restore confidence in foreign exchange markets to stabilise the pound for a few months, perhaps even until North Sea oil begins to have a significant favourable impact on the balance of payments in the second half of 1977. The first instalment of the loan, \$1.15 billion, has already been paid, with \$1 billion more to come before the end of 1977. The remainder will be payable at the beginning of 1978 - if IMF officials are satisfied that the UK has adhered to its commitments to reduce the public sector borrowing requirementand to ensure that domestic credit expansion is not more than \$9 billion in the 12 months to April 1977. However, if, as we expect, the UK balance of payments current account has moved into surplus by the end of 1977 due to the combined effects of the recent devaluation and North Sea oil,

REDUCTION OF IMPORTS BY NORTH SEA OIL

Figure 1



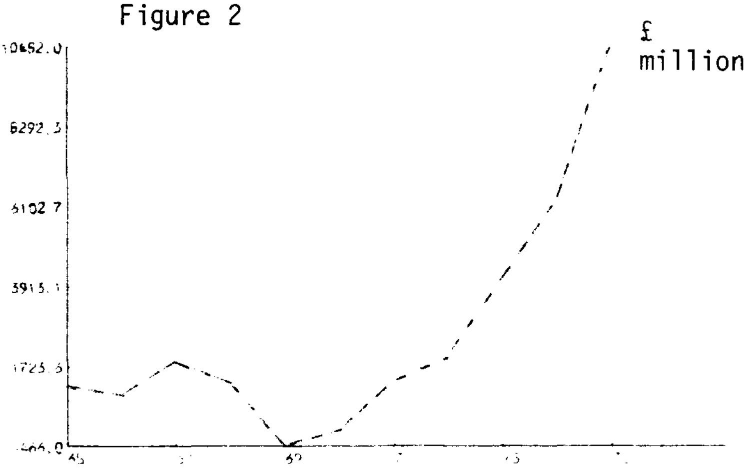
Source: NIESR, November 1976

there will be no need for a third instalment. Thus, the government may be able to avoid a repetition of the close scrutiny to which its policies were subjected at the end of 1976. Unfortunately, the absence of this restraint may not prove to be unequivocally beneficial to the long-term well being of the British economy.

The mini-budget was notable in its sharp divergence from the pattern of previos post-war budgets. Its novel feature was the use of the public sector borrowing requirement not in the Keynesian sense as

PUBLIC SECTOR BORROWING REQUIREMENT

Figure 2



Source; National Income and Expenditure 1965-75

an instrument but rather as an important target of economic policy. The principal provisions of the budget were cuts in planned government spending which are to total £1 billion in 1977-78 and £1.5 billion in 1978-79. On Treasury forecasts these measures should cut the PSBR from £10.5 billion in 1977-78 to £8.7 billion and from £11.5 billion in 1978-79 to £8.6 billion. A Keynesian remedy for Britain's chronically low levels of resource utilization would have required some expansion of government spending, rather than a contraction - indeed, one effect of the budget will surely be to raise unemployment above 1.5 million for some time. However, it was apparent that a deflationary policy was required by the IMF as a pre-requisite for its loan and that, should this loan not have been forthcoming, the effects on unemployment would have been even more serious.* The insistence of the IMF on public spending cuts

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* The arguments regarding the 'appropriate' level of government spending have been discussed in our last Commentary - see J McGilvray, The Debate on Public Expenditure. Fraser of Allander Institute Quarterly Economic Commentary, October 1976.

was due to a belief that this policy would restrain money supply expansion, thus decreasing the rate of inflation and stabilising the pound. An alternative rationalisation, that the size of the public sector is diverting productive resources from the private sector into unproductive activity seems untenable at this time of considerable resource underutilization. However, though there may be an overall surplus of capacity, new firms and rapidly growing firms may be deterred from investment by the high interest rates resulting from the government's necessity to fund the public sector borrowing requirement. Thus, the high level of public spending may be detrimental to dynamic growth in the private sector. Having said that, one must recognise that empirical studies, conducted when interest and inflation rates were substantially lower, have generally shown investment to be unresponsive to changes in interest rates. Much more important, it is claimed, are changes in income. With a recent improvement in corporate profits an upturn in investment in 1977 does seem likely. However, the results of the latest DTI survey (taken before the December measures), suggest that firms intend to increase investment in 1977 by considerably less than the Treasury expected. This confirms the findings of the latest CBI survey.

Consumption expenditure changed little between September and November, though seasonal factors and expectations of a VAT increase will undoubtedly have boosted the December figures. With the reduction in food subsidies, rise in import prices and the effectiveness of the social contract in restraining wages there is little scope for an expansion of consumption during 1977. The fall in real incomes together with restrictions imposed by government on credit expansion is likely to severely squeeze personal liquidity during 1977.

As a result, pressure to abandon the social contract and return to free collective bargaining will build up over the year. However, as with last year's negotiations, the Chancellor may be able to offer tax concessions in return for agreement with the TUC. Although such an agreement is desirable, its achievementwill depend on the ability of the TUC to harmonise the views of craft unions seeking a restoration of differentials and those unions with substantial numbers of low income members trying to maintain real incomes.

The principal forecasting organisations (Treasury, NIESR and London Business School) expect, on average, a GDP growth rate of 1.8% in 1977 for the UK economy. Most optimistic is the Treasury (2.2%) and most pessimistic, the OECD (1.5%). Expansion is expected to be concentrated on exports, where the recent downward float of the pound will take effect. However, as mentioned in the previous section, the general sluggishness of world trade will restrain the extent of this expansion.