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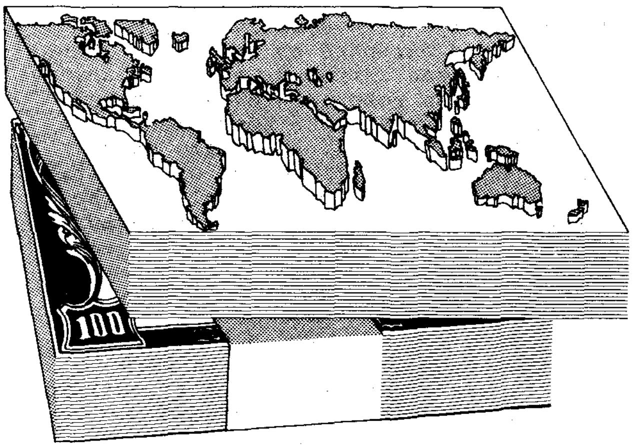
The views expressed in the Special Article are those of the author and not necessarily those of the Fraser of Allander Institute.

The World Economy

There are some signs to suggest that the world economy will withstand the 1979 oil price shock better than it did in 1973/74. The main difference is that the 1979 price rise was not super-imposed on as severe an inflation as that which occurred on the previous occasion. The present rate of increase in the world prices should not reach the levels of the last cycle when the twelve month increase in manufacturing prices peaked at 23%. Advance warning by US economists that 1979 was going to be a year of difficulty did not go unnoticed by businessmen in that country who took steps in 1978 to avoid a repetition of the inventory boom and bust cycle which had proved so costly in the recession of 1973/74. Also, consumer expectations are adjusting towards a continuing rise in the price of oil.



Official forecasts for the OECD area predict that GNP might grow by about 1% between 1979 and 1980 if there is no further substantial rise in the real price of oil. A deceleration of growth of GNP in the first half of the year to an annual rate of around ½% is forecast, perhaps being followed by a recovery in the second half to about 1½%. These forecasts should be treated with some caution, however, given present political uncertainties concerning the relations between Iran and the United States.

All industrial countries are experiencing accelerating inflation this year, although the rate of increase differs from country to country. Interest rates have increased substantially, influenced by the desire to control domestic inflationary pressures and in some cases to protect exchange rates. There has been a generalised tightening of monetary policies in nearly all OECD countries.

In the United States, the Consumer Price Index suddenly took off in January and February at an annual rate of nearly 20%. The main short-term causes were December's OPEC price increases and high domestic interest rates. President Carter's fourth anti inflation package announced in March is considered to be far from adequate.

Forecasts of GNP in the US predict a negative growth rate of 2.4% for the first half of 1980, followed by some recovery in the second half of the year. Industrial production is expected to decline by 2% in 1980 over 1979 levels.

There is growing concern in the United States about the country's declining industrial performance. It has been pointed out that capital formation in the American economy at only 13% of GDP during the 1970's compares unfavourably with Japan's 20%, France's 16% and even the UK's 15%.

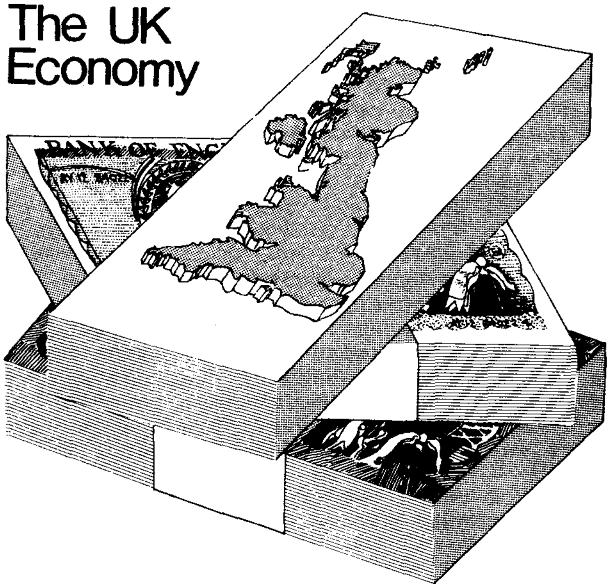
West Germany is heading for slower economic growth in 1980, combined with higher inflation. The rate of inflation in March rose to 5.8%, the highest yearly rate since October 1975. The authoritative IFO institute expects overall production in manufacturing industries to grow this year by only 2%, compared with a 5% increase in 1979. There is likely to be a current account deficit in 1980 of close to DM20bn compared with DM9bn last year. This deficit, caused primarily by the higher oil price, has led ministers to appeal for moderation in the current wage round. One optimistic development is that the powerful public service union has agreed to a modest 6.3% wage increase. Most German research institutes agree that the investment climate is good and this will increase demand for capital goods and benefit such sectors as the electronics industry.

Recent figures reveal that Japan's real economic growth in the last quarter of 1979 was 1.3%. The annual growth rate of 5.3% should be maintained throughout the first half of 1980 after which it is expected to fall to around 4%. The latest GNP figures show that the bulk of last quarter's growth derived from the external sector. Exports grew by 6.6% while imports expanded by only 1%. The trend is liable to accelerate due to the weaker Japanese currency, thus rekindling fears of trade tensions. The annual rate of inflation rose to 7.6% in February and could be 9% by the end of this year. This has prompted the government to introduce a package of anti-inflation measures which is likely to centre on a slowdown in the growth of public expenditure and a further tightening of credit. The balance of payments deficit is expected to have widened considerably in the second half of 1979 to an annual rate of around $13½billion but may be reduced during 1980.

In France, real GDP and industrial production growth may not exceed 2% in 1980. The rate of increase in consumer prices might rise from about 10·75% in 1979 to around 11.5% in 1980. The visible trade deficit may widen from about $1.5billion in 1979 to $4¾billion in 1980. However the balance on invisibles should stabilise in 1980 with a surplus of about $3billion resulting in an overall current account deficit of around $1½billion.

Economic growth in Italy is likely to come to a halt in the second half of this year with unemployment rising above 8%. The cost of living is expected to rise by an average 19%.

The UK Economy



The bare bones of the official outlook for the UK economy over the next six months was published in the Financial Statement which appeared with the Budget on 27 March.

Real GDP is expected to fall by 2½% from mid-year 1980. Thereafter, it is assumed to grow at an average annual rate of 1% for the next four years.

The retail price index is expected to increase by 16½% from the fourth quarter of 1979 to the fourth quarter of 1980. This rate of increase is expected to fall to 13½% between the second quarter of 1980 and the second quarter of 1981. Beyond this period, the Government are unwilling to make their expectations about price increases known.

The money supply (M3) is expected to grow by 9% from mid-February 1980 to mid-April 1981.

The Government, however, clearly attaches very much greater importance to the next few years than it does to the next twelve months. The Chancellor announced in his Budget speech what he called "a medium-term strategy" to cover the period until the end of the financial year 1983/84. The objections of this strategy are two-fold:

(a) to reduce the rate of inflation

and (b) to provide a sufficient surplus of government revenue over expenditure to make possible substantial cuts in personal taxation during the years 1982/83 and 1983/84.

The characteristic features of the strategy are equally simply stated:

(1) A progressively lower annual rate of growth on the money supply (M3), to some 6% by 1983/84.

(2) A progressively lower annual PSBR (public sector borrowing requirement), to some £2½billion by 1983/84.

(3) Total Government expenditure to fall at an annual rate of some 1% from 1980/81 to 1983/84.

The figures quoted in the last two items are in real terms (constant 1978/79 prices) and it is assumed that tax rates will remain unchanged and allowances adjusted for inflation.

The budget statement, of which these are the central features, has marked a watershed in post-war British economic policy. For this reason, we believe it is worth devoting the whole of this section to a discussion of its main features. This budget can be said to represent a watershed for two distinct but related reasons. First, it implicitly repudiates the economic reasoning upon which all budgetary policy (of both parties) has been built since 1945. Post-war doctrine has always been that when faced with a decline in economic activity, government should provide a stimulus to aggregate demand by acting to increase its expenditure and/or lower its tax revenues. Faced with the largest expected downturn in economic activity since the war, the present government is acting to lower its expenditure and increase its tax revenues, and says it will continue to do this for the next three years. Secondly, the budget statement is deliberately vague about numerical estimates. No forecasts are offered of the rates of inflation or of unemployment beyond the next twelve months. Other than the money supply, and the PSBR, it is clear that the government attaches slight importance to even its own estimates of other economic variables. It is significant that the Chancellor refers to his policy, not as a plan or a forecast, but a strategy. Pressed for his estimate of future rates of inflation or unemployment, the Chancellor will reply that he simply does not know.

These two novel features of the 1980 budget are related by the fact that the development of "Keynesian economics" as the post-war budgetary doctrine came to be known, was closely associated with the development of forecasting models according to which economists specified the ways in which aggregate variables in the economy would behave in relation to each other. Aggregate consumer spending, aggregate investment spending, total output, total government spending, the average level of consumer prices, and the average rate of unemployment were all moved in a systematic way with respect to each other, a way which was understood and represented in a range of macro economic models. The government is now saying, in effect, that it does not believe in some of the most important of these relationships, and that the margins of probable error in others are so great that little of certainty can be said*.

Questioned on some assumptions behind the budget by the House of Commons Treasury and Civil Service Committee, a senior Treasury official replied that if the growth rate of the economy failed to match the government's expectations, its response would be to raise tax rates by whatever amount was necessary to raise the necessary tax revenues. This reply summarises three themes which run through the Chancellor's Speech, the Financial Statement, and the Public Expenditure White Paper. First, it is anti-Keynesian, secondly it is anti-quantitative and, thirdly, it reveals the priority attached to the monetary target above all others.

Such a sweeping change of direction in economic policy has implications which require more space than can be afforded to discuss them here. Three points will be raised, however, which seem to be the most important.

First, assuming that the Government's strategy is broadly correct, (and no convincing alternative has yet been advanced), does it have the political will to carry it through? The recent award of an 18% pay increase to civil servants, coming on top of last year's award of 25% suggests that it either cannot or will not cut government expenditure in certain areas.

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*It is ironic that the government appointed as its Chief Economic Adviser someone who was the longest-running forecaster in the business!

Secondly, the public expenditure white paper reveals that the government is aiming at halting the drain of the nationalised industries upon the Exchequer by eliminating their overall deficits (presently some £2.2 billion) over the next three years. If this is done, as in the past, by requiring them to raise the prices of their products, then of course that will directly contradict the ultimate objective of reducing the rate of inflation. If, on the other hand, it is done by improving the aggregate productivity of their industries, then this will require quite radical changes in some of their organisation, incentives and attitudes, about which neither the government nor the relevant civil service departments have had (apparently) any thoughts.

Thirdly, in their obsession with aggregate monetary and fiscal variables, the government are in danger of falling into the same trap as their "Keynesian" predecessors. As Professor Bain pointed out in his special article in the last Commentary* it is not so much the size of the PSBR which matters. If, as he says, it were acting as a channel through which private saving would flow into investment, a high PSBR could be positively advantageous. In the last decade, this has not happened, and indeed the present government is planning to cut severely government investment at a time when even the most dedicated anti-Keynesian would agree that it should be increased.

The third point, then, is that very little about the performance of the economy can be deduced from the aggregates themselves. There are very serious institutional and fiscal obstacles to the efficient allocation of resources in both the private and the public sectors of the economy. Aside from a commendable package of measures to induce the growth of output and employment in smaller firms, the budget makes no reference to this problem. Even if the government were to succeed in every particular in realising the objectives stated in this budget, it would still leave untouched the fundamental problems inhibiting the performance of the economy. However, it need not worry. By 1983/84 the annual oil revenues from the North Sea will amount to some 6% of the Gross Domestic Product of the United Kingdom, and should serve to conceal these problems for a further five to ten years.

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*A D Bain, "Is Public Sector Borrowing too High?" Quarterly Economic Commentary Vol 5 No 3, January 1980.