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The Fraser of Allander Institute

Quarterly Economic Commentary

July 1981

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.

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The Commentary is edited by N Fraser with contributions by

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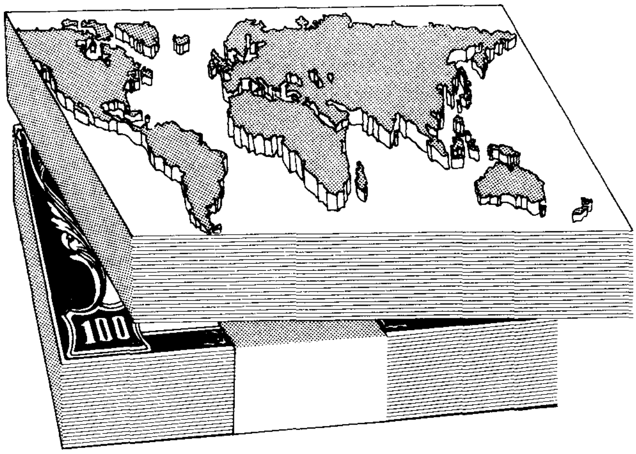
F Harrigan	L Moar	E Tait
A Jowett	N O'Donnell	J Walker

Signed articles express the views of the authors and not necessarily those of the Fraser of Allander Institute.

The World Economy



The industrialised countries as a whole are emerging more slowly than had earlier been thought from the recession brought on by the 1979/80 round of oil price rises combined with tighter monetary and fiscal policies. The growth rate for those countries as a group is expected to average about 1% to 1.5% for each of the years 1981 and 1982, with the prospect of some 2% in 1982. However, such an aggregate view conceals widely divergent performances amongst the major economies, as we shall see below.

While the aggregate balance of payments deficit of the industrialised countries, largely created by the oil price rises, is expected to shrink from some \$44b in 1980 to around \$30b in 1981, that of the non-oil developing countries is likely to deteriorate by a further 20% in the same period, the absolute size of the figure depending upon whether one accepts an IMF or OECD estimate. The IMF suggests that while these countries as a group have actually managed to improve their volume external trade performance over the past twelve months, (exports up 8%, imports up 6%), a combination of lower export prices and higher interest rates has meant that their external debt service payments are estimated to absorb 21% of export earnings in 1981, compared with 17% in 1978.

A key requirement for the continued progress of the economies of the countries is unrestricted access to the market of the industrialised countries. At the same time, the European industrialised countries, faced with high and rising unemployment, are under increasing political pressure to move further in the direction of protection. Already, individual European countries operate restrictive import policies in several manufacturing sectors, and there are multilateral restrictive agreements such as the Multifibre Arrangement, which is shortly up for renewal. There are moves to extend and systematise these restrictive practices to such an extent that there is some danger that the GATT framework, within which post-war international trade has operated, may be by-passed altogether.

Needless to say, the European countries are most acutely aware of competitive imports, not so much from the developing countries, as from Japan. And it is undeniable that an important element in Japan's remarkably swift and smooth recovery from the effects of the oil price rises is her highly successful export performance.

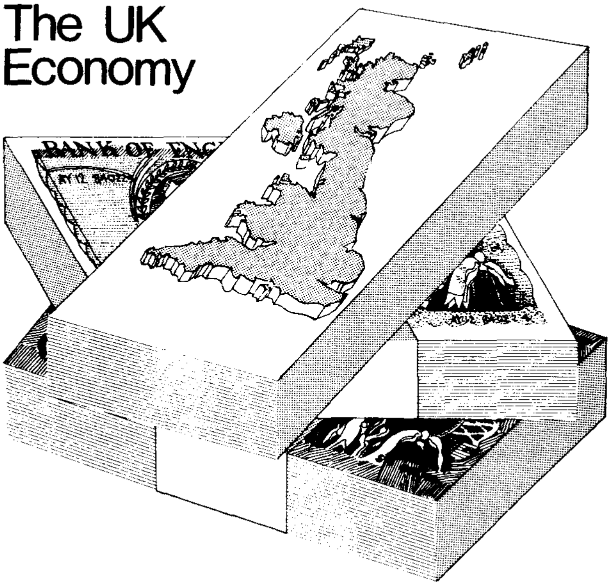
While the successful performance of **Japan** may be measured in macro-economic aggregates, 5% growth, inflation falling to 6%, expenditure on plant and equipment at 15% of GNP, a surplus on the balance of trade, and low unemployment, it cannot be explained by them. This success is due to the willingness, at the level of the individual firm and the individual worker to adapt to a changing external environment. A particular illustration was the introduction of new energy-saving and labour-saving technology in the wake of the first round of oil price increases, and the development of new products thus creating new jobs.

Output in the four major West European economies, West Germany, the United Kingdom, France and Italy is expected to fall this year. With no further increase expected in the real price of oil, all are confident of a recovery in 1982, accompanied by lower rates of inflation. But all have in common high levels of unemployment, which show no signs of abating when growth rates start to rise again. The outlook in **West Germany** is particularly uncertain. Despite high interest rates and a falling exchange rate, improvement in the balance of payments has not been as rapid as had been hoped. Nevertheless, at 5%, the rate of inflation remains low by the standards of other European countries.

The results of the recent elections in **France** have led to a further extension of state ownership of industry in that country. In the course of the next seven years, the new Government is likely to introduce policies designed to achieve a redistribution of income and wealth. It is unlikely, however, to alter significantly the present stance of monetary and fiscal policy, since inflation is running at about 13%.

In the **United States**, the situation is quite different from either Europe or Japan. After a sharp increase in output in the first quarter, there are strong indications of a further downturn in GDP before the end of the year. It is clear that the new Administration is determined to give priority to the reduction of inflation above all other objectives of economic policy. To this end, it is pursuing a restrictive monetary policy which has led to high interest rates. These, in turn, have influenced the movement of exchange rates amongst other industrialised countries, in such a way as to underline the fragility of the European Monetary System.

The UK Economy



The annual rate of inflation, as measured by the rate of increase of the retail price index, slowed from 12% to 11.7% in May. The government's own tax and price index, which allows for tax changes in assessing the cost of living, paints a somewhat more gloomy picture and fell only slightly from 15.7% to 15.3% in the same period. The maintenance by government of the real tax take combined with the recession induced slowdown in the growth of wages and salaries has culminated in a sharp drop in living standards, with a fall in the seasonally adjusted measure of disposable income for the first quarter of 1981 of 1.4% (5.6% on an annual basis). The volume of consumer expenditure however continues to exhibit bouyancy with previous high levels of savings providing an important source of finance.

Depending on which particular view is taken of how the economy works, the prospects for recovery may be either seen as encouraging (Liverpool), modest (London Business School), unlikely (National Institute) or abysmal (Cambridge Economic Policy Group). The relative optimism displayed by the first two groups stems from their belief that the bottom of the destocking cycle has now been reached, and for the Liverpool group, at least, that the imminent success of the government's financial strategy will herald a growth in consumption. The view taken by the CEPG is that a secular decline in the competitiveness of UK exports combined with a policy stance which inhibits demand and results in a contracting tax base leads to an impasse which only massive reflation combined with import and exchange controls can break.

Whilst it is generally conceded that restocking must take place soon and that this will provide a boost to economic activity, this will be a **once and for all** effect. The major impact of restocking will be on output and imports and is likely to make little impression on employment. After stocks return to normal levels in relation to output, any additional impetus to the economy must come from one or more of the other components of final demand: consumption, gross fixed capital formation, exports or government expenditure.

Like restocking, the much publicised **real balance effect**, which predicts a fall in the ratio of savings to disposable income as the rate of inflation slows (see April 1981 Commentary), can only provide a transient and quantitatively marginal stimulus to economic activity. With a decline in the real take home pay of wage and salary earners being an essential ingredient in the government's strategy there would seem to be little scope for more permanent increases in autonomous consumption expenditures. For those persons for whom unemployment benefit and supplementary payments replace the wage or salary cheque, the squeeze on disposable income and consumption will be even greater.

With respect to investment (excluding stock accumulation), the outlook is equally bleak. The view taken by the government is that once inflationary pressures recede forces on the 'supply side' of the economy will come into their own. Given the tax incentives, which are yet to be delivered, and the climate of enhanced certainty which follows from a lower rate of inflation, entrepreneurs will be better equipped to perceive and exploit profitable investment opportunities. The problem with this proposition is quite simply that other conditions in the domestic and external economy are not conducive to investment. Depressed demand and profits, now around 2% on capital employed, are not the type of signals which instil in investors the bullish spirits necessary for dynamism and expansion. Whilst lower interest rates and wage settlements and the increased productivity which will follow from reduced manning levels are likely to bolster profits in the near future, the reliance on the acceleration of gross fixed capital formation as the motor for growth must be considered more an article of faith than a well grounded economic hypothesis.

Given the recent volatility in the dollar value of sterling and the opaque nature of the government's exchange rate policy, it is exports which present the great imponderable in the income, output and employment equations. The maintenance of a sterling dollar parity of around $1.90 will certainly make UK exports more competitive in dollar markets (about 10% - 15% more so) and should lead to levels of real GDP and employment above those which would have otherwise occurred in the absence of the depreciation. If the government is prepared to tolerate the lower value of sterling, the cost of the growth in the real volume of domestic activity will be an increased rate of inflation, which is bound to thwart the government's target of 8% by 1982. If a wage price spiral can be avoided, however, the impact of the depreciation on the rate of inflation will be of a temporary nature.

There are a number of reasons for believing that the recent depreciation of sterling vis-a-vis the dollar will, in itself, be insufficient to restore income growth and employment to more acceptable levels. Firstly, the fall in sterling against the dollar has been accompanied by a fall in the dollar value of all other non-dollar pegged currencies, including those of most of our OECD and EEC partners. The net effect of this has been to leave the value of sterling largely unaltered in relation to the deutschmark, yen and franc. The setback in competitiveness which followed the interest rate induced appreciation of sterling in 1980, therefore, in large part, remains unabated. Secondly, to the extent that the depreciation of the pound leads to further surplus on the current account of the balance of payments, the underlying pressure on the pound must be upwards. Thirdly, any inflationary consequences of the fall in the pound will further undermine our ability to compete in world markets and may provoke government to attempt to check the trend through an interest rate policy which aggravates the secular decline in the competitiveness of UK manufacturing. Finally, it should be borne in mind that it is far easier to lose export markets than to regain them, and that there is a considerable lag beween the placement of export orders and their subsequent manifestation in terms of increased output and employment.

To recapitulate, it would seem the outlook for the UK economy remains depressed. Whilst there may be an ephemeral boost to activity which follows from the rebuilding of stocks and the (less certain) restoration of normal savings behaviour, there is little reason to believe that other demand aggregates will recover sufficiently to avoid unemployment passing the three million mark by the end of this year. As much is conceded by the Treasury. The impotence of government policy in the face of this disarray should come as no surprise. There is no reason to believe that a purely financial policy can restore growth. This was the lesson of the 1920's and 1930's. In one sense, however, the government's emphasis on the supply side of the economy is correct. It has been the UK's inability to compete successfully in world and domestic markets which lies at the root of our present problems. A senile industrial structure and an institutional setting, which encourages and requires inward looking attitudes on the part of management, investors and unions are partly blame. Policies which look only at a few select macro aggregates cannot begin to ameliorate the consequences which follow from these rigidities. What is urgently required is industrial, regional and social policies which encourage innovation and flexibility. This particular brand of supply-side economies should not ,however, be confused with that favoured by the present government. Public expenditure, whether it be channelled into labour retraining schemes, infrastructural and inner city renewal or for the subsidisation of socially profitable capital expenditure, would seem to be a necessary catalyst for growth. Such a reorientation of policy must necessarily call into question the scope of, and relationship between, economic targets and instruments. This would therefore seem an appropriate juncture for the government to reappraise the arguments for and against incomes and price policies, import controls, fixed exchange rates and more overt industrial planning strategies.