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The Fraser of Allander Institute

Quarterly Economic Commentary

February 1983

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Signed articles in the **Commentary** express the views of the authors, and not necessarily those of the Fraser of Allander Institute.

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Notes to Contributors

The editor welcomes contributions to the Students Brief, Feature Article and Economic Perspective sections. Material submitted should be of interest to a predominantly Scottish readership and written in a style intelligible to a non-specialist audience. Footnotes and references should conform to recent issues of the Commentary.

Contributions should be typed and two copies submitted to:

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PUBLICATIONS OF THE INSTITUTE

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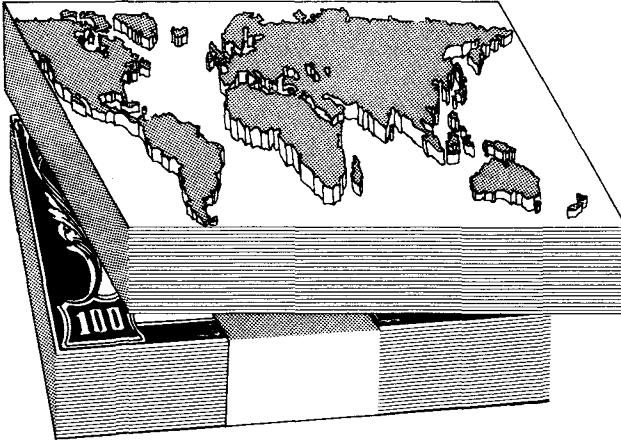
The World Economy



The recent 'nervousness' displayed by foreign exchange markets is symptomatic of the uncertain economic prospects facing most industrial nations. After a year in which the average output of OECD member countries fell by 0.5%, (by 4.5% in the seven major economies), only a marginal recovery is expected for member states during 1983. The wide-spread uncertainty arises from the divergence of current economic indicators. Positive influences suggesting the end of the world-wide recession include the fall in interest rates, the less restrictive monetary policies being adopted by governments, the prospect of lower oil prices, the rise in non-oil commodity prices and the lower levels of inflation. On the other hand, such factors as the continuing liquidity pressures on both domestic industries and on borrowing countries, a general lack of confidence, continuing high unemployment and the prospects for successive rounds of competitive currency depreciations, would all be expected to prolong the current recession.

The OECD and most other economic forecasters do not believe that the general falls in inflation and interest rates will be sufficient to pull the world economy out of recession - although these may be necessary prerequisites contributing to recovery. The legacy from the years of tight monetary control aimed at the inflation problem has been growing unemployment in most countries. Throughout the OECD area unemployment averaged 8.5% but there were wide differences with Japan at 2.4% unemployment, USA with 9.5%, Canada 11%, Germany 7% and UK around 12.5%.

Of course foreign exchange markets have not yet seen enough to assess how the policies of the major economies are likely to change as the respective governments re-assess their policy packages in light of falling inflation. One view is that existing policies, predominantly of a monetary nature, will be maintained because of the fears that any dramatic switch to other expansionary measures will re-introduce inflationary pressures and further dampen growth. Indeed the US administration has already informally indicated that, although they think the recovery is already underway, policies will take a less rigid view with regard to the achievement of money supply targets. This could still mean that pressures will arise from time to time to increase US interest rates although they would be unlikely to rise to 1981/82 levels now that inflation is lower.

The alternative scenario would be that the monetary authorities have achieved their aims, namely reducing and controlling inflation, and hence existing policies should be replaced by an expansionist demand-oriented strategy. If unemployment refuses to fall, despite the incentive effects from lower inflation, then there will be mounting pressures within individual countries to introduce policies aimed at protecting domestic employment by reducing imports. This will be achieved by introducing higher and selective tariffs or quotas. In addition, it is likely that even more generous export credits will be made available to domestic firms to encourage them to expand via exports. Export led growth has the advantage of sidestepping inflationary pressures as long as production costs are contained. Unfortunately, it is likely that most countries will also attempt to engineer devaluations in their currencies. In short, the adoption of protectionist measures on a worldwide scale is unlikely to be successful, with few, if any, countries able to gain any significant net trading advantage.

The downwards pressure on oil prices should benefit the world economy especially the net importing countries. Most countries are now classified relative to their developing and oil production status. The liquidity problems are most serious in some of the fast developing oil producing nations, notably Mexico, where the oil revenues are being used to speed up the process of industrialisation. But international borrowing has been based on the expectation of ever-increasing oil prices. As interest rates have risen developing countries have had severe problems meeting their loan repayments. Western banks, having over-committed resources to international debt financing, are now finding that their own survival is threatened by the possible default of some countries. They have been forced to agree to a number of re-scheduling arrangements with certain countries. If the oil price falls, perhaps down to around $25 per barrel, then the ability of these countries to service their debts is further threatened. Secondly, as debt problems continue to dominate international markets it is unlikely that the developing countries will be able to fuel a recovery in industrial economies by increasing their demand for manufactured goods.

The years of high oil prices have highlighted the problems of over dependence on primary exports. Indeed the threat of lower oil prices has shown some producers that oil is as vulnerable to the laws of supply and demand as any other commodity. The need, as it has always been, is for the developing countries to try to expand their export base. Even the non-oil countries have been affected by the extended recession keeping commodity prices low whilst oil prices were high, making it virtually impossible for them to accelerate the industrialisation process. Uganda, for example, continues to rely on coffee and Zambia on copper. These countries will remain vulnerable to any further set-backs in a world-wide recovery unless they can diversify their exports.

Oil producing countries have relied on the oil revenues to offset the need for even stricter economic policies to finance budget deficits. With prices likely to fall the exchange rates will fall relative to trading partners and hence will be consistent with the desire for an export led recovery. Further in the typical developed economy, where oil might represent around 5% of total expenditure, then a 30% fall in the price should add around 1.5% to GNP in a manner which increases domestic demand yet does so without fuelling inflation.

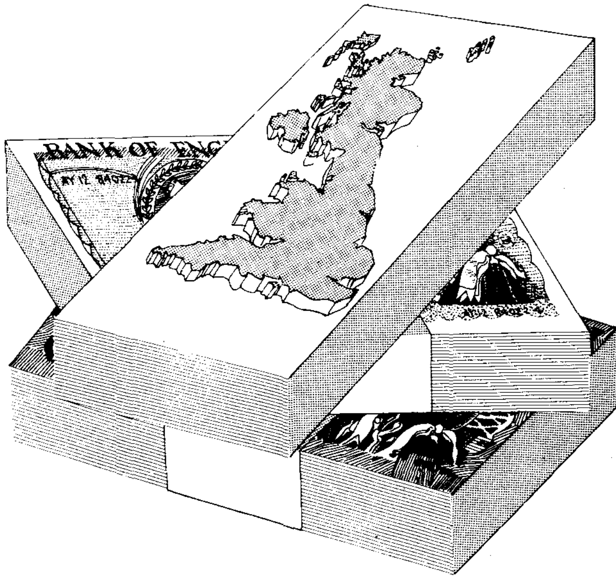
In recent weeks the dollar has been strong on the foreign exchange markets. In times of widespread uncertainty the dollar is the traditional haven. Its present strength reflects the optimistic forecasts for the **United States** despite the burgeoning borrowing requirement. The producer price index increased by only 0.1% in December 1982 and by 3.5% during the year, the lowest increases since 1972. Although output dropped by only 0.1% in December, forecasts suggest that the economy has bottomed out, especially as the automobile sector, which has been responsible for the improved output figures, will be raising production further. The strong dollar and the central role of the US economy, if it does indeed recover, should promote the prospects for a more widespread recovery.

The strong dollar appears to disregard the problems the administration will experience when greater efforts are made to reduce the level of the fiscal deficits, which in a single year are higher than all the cumulated budget deficits of the Carter administration - yet the Carter presidency foundered on the handling of the economy. Ironically, the present administration was elected on the promise of a balanced budget. Thus despite this being at odds with Reagan's views regarding the management of the economy net government expenditures have grown exponentially. Under these circumstances the US economy can expect significant increases in taxation and perhaps a re-assessment of the dollar parities against other currencies over the coming months.

The **West German** economy has been experiencing the familiar problem of an economy in recession. Industrial production in 1982 was down 5% and real GNP down 1.2% whilst unemployment had risen to 2.5million. The poor performance of the economy and the imminent general election on 6 March have kept interest away from the mark. It is not at all clear that the ruling centre-right coalition of Chancellor Kohl can convince the electorate that the economy will turn around over the coming year. For example, they are trying to persuade voters to accept a further cut in real wages in the 1983 wage bargaining round between trade unions and employers. Irrespective of the results of the election, exchange dealers are likely to return to the mark.

The **Japanese** economy has always seemed relatively immune from the economic difficulties experienced by other industrialised nations. However, the rise in unemployment to 1.4million or 2.4% in 1982 represents the highest annual rate in Japan for 27 years. For some time now the Japanese economy has relied on the undervalued yen to protect export markets. By refusing to allow an appreciation in the currency exports are vulnerable to protectionist policies by major customers. Recently the US administration have introduced quotas on Japanese car imports. The fact that these may be seen as the major factor helping to rejuvenate the US economy may encourage other countries to adopt similar forms of restriction.

The U.K. Economy



Most forecasters, including the Treasury itself, predict a modest recovery in the economy this year. The emphasis is however on "modest", with predictions for GDP growth in the range of 1.5%-2.5%, and a further rise in unemployment. In the past month however there have been more favourable indications of renewed growth in the international economy, particularly in the United States, and this, combined with the recent depreciation of sterling, will improve the prospects for UK exports. Actual growth in GDP may be therefore nearer the upper end of the recent range of forecasts.

A number of factors are conducive to an upturn in the economy this year. Whether or not due to Mr Shore, sterling has depreciated and this will improve competitiveness on home and export markets, provided such gains are not offset by higher price inflation and/or higher profit margins. Despite last month's rise due to the pressure on sterling, interest rates are softening and this should encourage consumer durable expenditure and investment, especially stockbuilding. Finally, the sharp fall in the rate of price inflation may prompt a less severe fiscal and monetary stance by the Government, particularly in what is likely to be an election year.

Despite these propitious signs the prospects are still very uncertain. The long-awaited recovery in the international economy is not yet confirmed, and is threatened by the precarious state of the international monetary system. A number of major developing countries, including Brazil, Argentina and Mexico, are technically in or near default in loan repayments, and unless suitable debt rescheduling arrangements can be worked out the hoped-for recovery in world trade could be jeopardised. On the domestic front, the length and severity of the recession has made businessmen extremely cautious about expanding output and capacity, and announcements that the recession is over are being greeted with reserve, if not scepticism. Moreover, should inflation show signs of accelerating again, interest rates would rise, money supply would be tightened and the nascent recovery would be stillborn. For these reasons, there is a marked absence of the degree of business confidence which would stimulate new investment and the rebuilding of stocks, which are an essential prerequisites of a sustained recovery. The attitude is very much a case of "wait and see".

In these circumstances much depends on the balance struck in the forthcoming Budget. There seems little doubt that in an economy like the UK a significant recovery in output is unlikely to materialise in the absence of

a direct and positive lead by the public sector. This is not only because of the importance of state industries in the economy but because of the weakened state of the private sector, which cannot be expected to lead a recovery unaided. While some tax concessions are desirable on both practical (to take some people out of tax brackets, to offset fiscal drag and to encourage consumer spending) and psychological (to give credence to better economic times ahead) grounds, within what is considered to be a judicious level of PSBR an expansion of public capital expenditure would be the most effective means of stimulating growth. Preferably this should be in physical infrastructure projects or investments in nationalised industries which can be shown to yield a positive rate of return. A Budget which simply comprises £2-£3 billion in personal tax concessions is unlikely to have a significant impact on domestic output.

Scope for manouevre in the Budget is constrained by the potential effects of the PSBR on inflation (via domestic credit expansion - though the effects here must be uncertain given the current levels of unemployed resources) and on interest rates and the exchange rate. While there is a plausible theoretical case for arguing that the exchange rate should be allowed to fall to a level commensurate with a fuller utilisation of domestic resources (this was the case argued for years by proponents of floating rates), there are disadvantages; there is an immediate impact on inflation through higher prices for raw materials, and pressures on wage inflation as people try to restore real income levels. If the government is not prepared to accept the rules of the game implied by a floating exchange rate, it would be more sensible to stabilise its level by joining the European Monetary System.

The need to maintain confidence in sound financial management and the long-term aim of shifting resources into more productive sectors of the economy limits the scope for higher deficit financing and will probably result in a "giveaway" of around £2.5 billion in this year's Budget. The predicted growth in output this year, of around 2% will not reduce unemployment, which indeed is forecast to continue rising. Productivity growth (ie output per person or per man-hour) has been remarkably high in the past three years, as firms have shed labour, and so long as this continues rates of growth of output of 2% will be insufficient to create extra employment. Thus while 1983 may mark a real improvement in the economy, the prospects for unemployment remain unambiguously bleak.