General Review

The World Economy

Prospects for the world economy are considerably brighter at the start of 1976 than they were at the beginning of 1975. In our last Commentary we argued that the key to world recovery lay in a strengthening of the American economy, but that a number of factors could jeopardise the US recovery.

Firstly,it seemed possible that the rate of inflation would remain above 10%, thus forcing the government to slow down its expansionary policy. Secondly, the impending bankruptcy of New York City threatened to deal a serious blow to investors' confidence. These problems have been, at least temporarily, overcome. The rate of increase in consumer prices slowed to around 4% toward the end of the year,giving a total rise during 1975 of just under 8%. After much altercation New York City escaped the immediate threat of bankruptcy. The Federal authorities intervened in late November to grant the city an annual loan of up to $2.3 billion, which should relieve New York's cash flow problems at least until mid-1978. Whether financial markets will be prepared to once again lend to the city after this time depends on how much progress the city makes in dealing with its problems in the interim period.

Further encouraging news on the American economy came when it was announced that during the third quarter of 1975 GNP had risen by 11.2%. Although much of this rise was attributable to a slowdown in the rate of industrial destocking there still seems to have been an underlying growth trend of around 6% Most forecasters now expect growth will continue at about this level during 1976. This will ensure a gradual reduction in the rate of unemployment although at the end of the year it may still be high by historical standards.

The authorities ought to be wary of introducing further expansionary measures in the near future, although there will be temptation to do so since 1976 is an election year. The danger is that the economy will overheat and recurring inflation will quickly bring the 'boomlet' to a halt.

Recovery in the other industrial nations, especially those in Western Europe, is currently lagging behind that of the United States. Many of these countries, especially those whose currency has depreciated vis-a-vis the dollar, will be hoping for an expansion of exports to the US as a means to stimulate growth. During 1975 the US accumulated a substantial surplus on its balance of payments so it is unlikely to react in the short term to an increase in imports.

Japan will probably be the next country after the United States to effect a recovery from the current recession. In the last few months industrial production in Japan has moved ahead sharply. This will be to some extent due to the large increase in government spending recently and the government's attempt to increase investment by reducing bank rate and loosening controls on the commercial banks.

In the EEC countries prospects are less certain. Both West Germany and France have introduced expansionary measures to combat the recession, but these are unlikely to have much impact in reducing the high levels of unemployment in these countries. In December the German unemployment rate was 5.3%. This compares with a peak level during the 1971/72 recession of 1.7%. Although the level of unemployment is high by historical standards the German authorities will be unwilling to further expand domestic demand because of their fear of inflation. The Germans are among the strongest opponents of recent IMF measures to relax international credit restrictions which are intended to facilitate financing of the large balance of payments deficits incurred by some developing countries. The ensuing expansion of international liquidity will, the Germans fear, trigger a worldwide inflation.

World trade is likely to remain sluggish in the first six months of 1976 perhaps picking up somewhat in the second half of the year. If the developing countries make use of their enlarged borrowing facilities with the IMF, demand for industrial goods from the developed nations is likely to increase. The oil producers will continue to accumulate a substantial trade surplus during 1976. This should enable the developed nations to further expand their exports to the oil producers.

The United Kingdom

The principal economic indicators which are now available suggest that the rate of decline in economic activity has begun to slow down. But it is too early to be sure that the decline has halted, or even to speak of any general upturn in production. A marked recovery cannot be expected to take place before the second half of 1976.

Provisional estimates of GDP suggest that there was a fall of ½ per cent in total UK output of goods and services in the 3rd quarter of 1975. This was significantly smaller than the fall between the first and second quarters. A similar slowdown in the rate of decline is to be found in new orders for the engineering industry. After two years of rapid decline, the decrease in new orders appears to have levelled out in recent months. And surveys of business opinion indicate that respondents are more confident about the general outlook for the UK economy than they have been for a long time.

Amongst the components of aggregate demand, consumers' expenditure and exports fell while public consumption continued to rise (in volume terms) in the 3rd quarter of 1975. An increase in the volume of fixed investment reflected deliveries of production platforms to the North Sea Oil operations and concealed a fall of 6% in manufacturing investment in the same period. However, it is the change in the level of stocks upon which the Bank of England focusses its attention. It argues that the decline in stocks earlier this year was "unprecedented" and must soon give place to positive stock building as stocks become exhausted. The Bank sees stockbuilding as one of the two main elements influencing the timing of the recovery of aggregate demand in 1976, the other being the rate of recovery abroad. The Bank's assessment suggests that the recovery of the UK economy might 'gather momentum' by the end of the year.

The National Institute gives a similar view of the prospects for 1976 to the Bank of England, but fills out its forecast with figures.

While it does not expect the midyear GDP estimate for 1976 to be much higher than 1975, it anticipates a GDP growth rate of about 2% from the beginning to the end of the year. Unemployment is seen as levelling off at 1¼ million around the end of 1976, and prices in the last quarter of the year are expected to be 10% above the level prevailing in the last quarter of 1975. It may be more realistic to allow for a 15% rise in the same period.

Describing these prospects as the "most depressing" since it began its forecasts seventeen years ago (Review, November 1975, p.5) and "far from acceptable" the Institute devotes considerable space to discussing the question of whether present government policies, whose continuation it assumes as a basis for its forecasts, are appropriate. Nearly all of its discussion is given over to rival views on the manipulation of aggregate demand, and it devotes only a few sentences to "supply-side" policies, which it clearly regards to be of slight importance.

On the other hand, we take the view that the difficulties recently experienced by the British economy arise primarily from problems on the supply side.

There is good reason to believe, for example, that the relatively low rate of investment which has characterised the UK economy in recent years has owed more to a low rate of return on capital than to a recession of aggregate demand. Calculations of the rate of profit net of capital depreciation on the basis of the replacement cost rather than historic cost suggest that the rate of profit has fallen in the last three years to about one half the level obtaining in the early nineteen-sixties. Past profits provide both the incentive and the means for present investment, which in turn provides the means for future employment. While there may be arguments about the efficacy and propriety of profits as an incentive, there can be no argument about the dependence of investment on past profits for a source of funds. This relationship is inescapable, whatever the political environment. In the present circumstances of the UK economy it can best be expressed by stating that future employment at non-decreasing real wages can be expanded only by increasing the present level of profits.

Yet the Government does not seem to regard this simple fact as an essential part of its economic strategy. Rather, it appears to accept the view that employment can be expanded at some unspecified time in the future by once again "reflating" the level of aggregate demand when "inflationary pressures have abated", (whenever that may be). One had hoped that the view that the mere expansion of aggregate demand produced economic growth rather than inflation had been discredited by the events of the past three years.

Increasing the level of profits can only be realised by holding down the level of current consumption (whether public or private). The only components of demand where expansion must be encouraged are investments and exports. In the present circumstances, UK recovery must be expected to lag behind that of the EEC and the United States. Meanwhile, the government should regard retraining of the unemployed as a continuing full-time activity and not simply as a haphazard response to unforeseen events. The occupational mobility of labour is a precondition of full employment if real wages are to rise in line with general expectations.