

University of Strathclyde

**THE FRASER OF ALLANDER
INSTITUTE**

**QUARTERLY
ECONOMIC
COMMENTARY**

VOL. 4

July 1978

No. 1

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.

The Institute wishes to thank The Scotsman Publications Limited for its financial support in the appointment of a Research Fellow to work on medium-term forecasting.

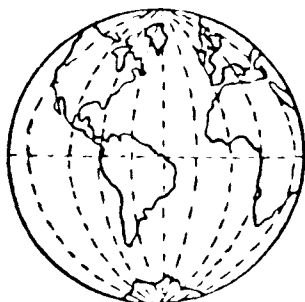
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THE WORLD ECONOMY

Developments in the early part of this year suggest that in general most countries are likely to experience a further period of sluggish growth. None of the leading forecasting bodies predict a significant improvement in the performance of the major economies. The long awaited recovery in business fixed investment has not materialised except in the United States. More generally, the level of activity has been depressed by the unintentionally restrictive stance of monetary policies. The rate of growth of the real money supply contracted in many cases as unexpectedly high inflation rates eroded target rates of nominal money supply growth during 1977. Reasoning along such lines, the London Business School foresees another eighteen months of below trend growth for the world economy. They expect the trough of the present cycle to be reached by the middle of next year, with a rapid recovery in the following year, 1980. The National Institute concurs in expecting somewhat faster growth in Europe over the next twelve months to be balanced by a deceleration in the rate of growth of the United States. A similar outlook holds for price inflation. Further reductions are expected in most of the major European economies, but the effect of these on the worldwide rate of inflation will be offset to some extent by a continued acceleration in the rate of the United States.

GDP growth in the United States was of the order of 4.9% in 1977. This represented a slow-down from the 1976 rate of 5%, and a further slow-down is expected by the National Institute which predicts rates of 4% and 3½% in 1978 and 1979 respectively. Little fiscal stimulus is likely this year as increased payroll taxes and social security contributions absorb the major part of the planned tax rebates. A further substantial deficit in the balance of payments on current account seems likely this year. The consequent weakness of the dollar, combined with increases in minimum wages and payroll taxes, and a low rate of productivity growth will cause the rate of price inflation to further accelerate. The associated rises in interest rates are likely to restrain investment and residential construction. Overall, the lower monetary expansion targets, coupled with an

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accelerating rate of price inflation will exert a depressing influence on the level of activity. Unemployment, which has fallen rapidly over the last two years, may remain stable for the remainder of this year, but is likely to rise in 1979 as rapid labour supply growth coincides with a sluggish volume of derived demand.

No significant acceleration in the rate of growth is expected in Japan where the National Institute predicts a rate of 5.5% compared to 5.3% in 1977. The level of investment is likely to be stagnant, leaving government expenditure and exports as the only important sources of buoyancy. The budgetary stance is expansionary, but its import content is low and a further substantial balance of payments surplus is likely this year. The consequent appreciation of the yen will contribute to a further reduction in the rate of price inflation.

In Germany, all components of demand lack buoyancy, and growth is unlikely to exceed 3% for the second year in succession. Exports may be somewhat restrained as the continued appreciation of the Deutschmark erodes the competitiveness of domestic firms. The levels of both unemployment and vacancies have remained fairly steady over the past year, and only a mild deterioration in labour market conditions is expected as the year progresses.

Some acceleration in economic growth is expected in France this year. There are signs of a revival in output after the March elections. The sources of increased demand are to be found primarily in a revival in consumer expenditure, as a result of rising real personal disposable incomes, and a strengthening of investment trends. Nevertheless, the situation in the labour market is deteriorating with unemployment rising in the early months of this year, while at the same time, the level of unfilled vacancies declined. Further reductions in price inflation appear unlikely as general price controls are relaxed and prices of public utilities unfrozen.

In Italy, GDP is forecast to rise by 2% this year, with a somewhat more rapid rate of expansion expected in 1979. Last year's 28% rate of wage inflation seems unlikely to be repeated and the more moderate 1978 awards should lead to a reduction in the rate of price inflation to perhaps 13% this year compared to over 18% in 1977.

The EEC as a whole may return a somewhat better growth performance this year. The Commission predict an increase of 3% in Community GDP compared to 2% in 1977. However this forecast is contingent upon a more expansionary stance being adopted by the German authorities, an undertaking which appears increasingly uncertain.



THE UK ECONOMY

The British economy is now expanding at a relatively rapid rate. Provisional estimates suggest that GDP rose by 1% during the first quarter of this year, fuelled largely by a sustained recovery in the volume of consumer expenditure. The tax changes of the April budget will sustain this trend for some time. In this section we examine the most recent batch of economic indicators, and assess the recovery in the light of the government's professed economic strategy. We also present and contrast the latest predictions of the major forecasting organisations.

Real personal disposable income is now growing rapidly with consequent effects on the volume of retail sales, the average seasonally adjusted level of which during the first five months of this year exceeded that of the fourth quarter of 1977 by some 2.4%. This revival in consumption has affected with a lag, the volume of industrial production and consequently imports of raw materials and consumer goods. As a result the most recent batch of economic indicators have not been uniformly favourable. A rise of 1% in the volume of industrial production in the first quarter coincided with a renewed deficit on the current account of the balance of payments. A deterioration on both visible and invisible accounts has resulted in a marginal deficit for the first five months of this year, in contrast to a surplus of £1 billion during the latter half of 1977.

The rising trend of real personal disposable income is the outcome of several factors, the major ones being; a rising rate of wage inflation which exceeds the currently falling rate of price inflation, and a series of adjustments to the personal income tax code. In the twelve month period up to the end of May the retail price index increased by 7.7% while in the year to April average earnings rose by between 15.6% on the old index or by 12.5% on the new, more broadly based one. By mid-May, over one third of all employees had still to settle in the three remaining months of the current pay round, and it appears unlikely that average earnings will increase by less than 15-16% under Phase Three in stark contrast to the government's 10% guideline.

The rising trend in money earnings has generated fears of a revival in price inflation in the latter half of this year. This, coupled with

disappointing trade figures, and suggestions of inconsistency between the government's fiscal and monetary policies has led to downward pressure on the exchange rate. In trade weighted terms the decline in sterling over the five months to May was of the order of 9.4%. The depreciating exchange rate has been mirrored in manufacturing industry's input prices, which, while some 1.7% lower in May than a year earlier, had risen by 5.2% over the five months since January.

In the financial markets recent developments have not accorded with official expectations. The consequences of attempting to hold down the exchange rate in the face of substantial reserve inflows during the closing months of 1977 can be seen in the money supply figures. Difficulties in financing the 1978-9 public sector borrowing requirement are in part cause and in part consequence of this unrestrained monetary growth. The net result has been that the target of 9-13% growth of the broad money supply in the year to April last was exceeded by several percentage points. In an attempt to reassert control over the monetary aggregates, minimum lending rate, which stood at 6½% prior to the budget, has been raised to 10%, with concurrent rises in short term interest rates. The "corset" has been reimposed to restrain growth in commercial bank deposits, while employer's national insurance contributions are to rise from October in a direct attempt to reduce the size of the public sector borrowing requirement.

In assessing these recent developments it becomes clear that there has been a substantial, but little noted, shift in the government's economic strategy. The present recovery is characterised by many features against which the government set its face over the years 1976 and 1977. The avowed aim of those years was to achieve investment and export led recovery rather than the present inevitably short-lived boom fuelled by consumer expenditure. On the government's own criteria, its strategy appears to have failed.

The level of investment in manufacturing industry actually fell in the first quarter of this year, while the buoyant investment intentions of the most recent CBI and government surveys reflect entrepreneurial views prior to the recent sharp rise in interest rates, the impending rise in employer's national insurance contributions, and the shift to a more restrictive monetary policy. These recent measures are in no way calculated to induce a recovery in investment. By their indirect effects on the competitiveness of British firms, the contribution of the trade balance to GDP growth, already under pressure as a result of the high impact content of the recovery in consumption, has been reduced still further. The forecasts presented below suggest that the government's avowed aim

Table 1 1978 Forecasts - % Change at 1970 Prices

	London Business School	National Institute	HM Treasury	Euromoney Magazine	Economist Magazine
Consumer's Expend.	4.6	4.7	5.0	5.3	3.8
Fixed Investment	4.1	3.4	3.8	4.0	4.6
Govt. Current Expend.	2.2	1.6	2.3	1.1	2.2
Exports	2.9	3.5	3.7	2.6	4.1
Imports	7.6	4.8	7.5	5.9	6.9
GDP	2.4	2.5	2.0	2.0	2.2
Retail Prices	8.8	9.4	7.0	7.3	7.6
Average Earnings	13.0	13.4	11.0	12.2	NA
Unemployment (million)	1.33	1.40	NA	1.52	1.50

Table 2 1979 Forecasts

Consumer's Expend	2.5	2.1	NA	4.4	2.1
Fixed Investment	1.2	2.5	NA	- 0.3	- 0.3
Govt. Current Expend.	2.3	2.6	NA	1.4	3.5
Exports	4.7	3.0	NA	3.4	4.9
Imports	6.4	3.4	NA	10.3	6.9
GDP	1.8	1.8	NA	1.7	1.8
Retail Prices	11.7	11.4	NA	8.4	9.3
Average Earnings	12.2	12.5	NA	9.7	9.0
Unemployment (000's)	1.38	1.50	NA	1.70	1.64

Sources: *London Business School : Economic Outlook 1977-81 Vol.2, No.9*
National Institute Economic Review No.2 1978
Financial Statement and Budget Report 1978-79
Euromoney, April 1978
The Economist, 8 April 1978

of financing debt repayment in the years ahead through substantial surpluses on the current account of the balance of payments appears unattainable.

Tables 1 and 2 set out forecasts of GDP components over the years 1978 and 1979 produced by the Treasury and by four independent organisations. All of the forecasts are based on large scale econometric models and of necessity reflect their proponents' views of the functioning of the economy.* They also embody each organisation's assumptions about factors, such as the rate of growth in world trade, and the rate of change of earnings which are determined outside the model. Only the broadest details of the forecasts are presented, for further information the interested reader is referred to the original source. All of the forecasts were carried out in April, except that of the London Business School which dates from June.

The forecasts are in broad agreement on developments during 1978, the common features being a rate of GDP growth of the order of 2%, arising primarily from a sharp recovery in consumer's expenditure. The Treasury forecast suggests somewhat higher import penetration and somewhat lower price inflation than the other bodies, but its average earnings figure is too low in the light of the most recent statistics. All expect a current account surplus this year, but with the exception of the National Institute, all expect it to be reduced in 1979.

The Treasury has not published a forecast for next year, but those which are available suggest a slow-down in GDP growth. Even on the assumption of some moderation in the rate of increase of average earnings, all expect an acceleration of price inflation though with the exception of the National Institute and the London Business School, the rate remains in single figures. All predict a slow-down in consumption growth and none a sustained recovery in investment, or any fall in unemployment between the two years.

The general prognosis can hardly be described as encouraging, but the extent of the slow-down is unlikely to become apparent in the remaining months prior to a possible autumn election.

* Two bodies, The Economist and Euromoney, actually use a version of the Treasury model.