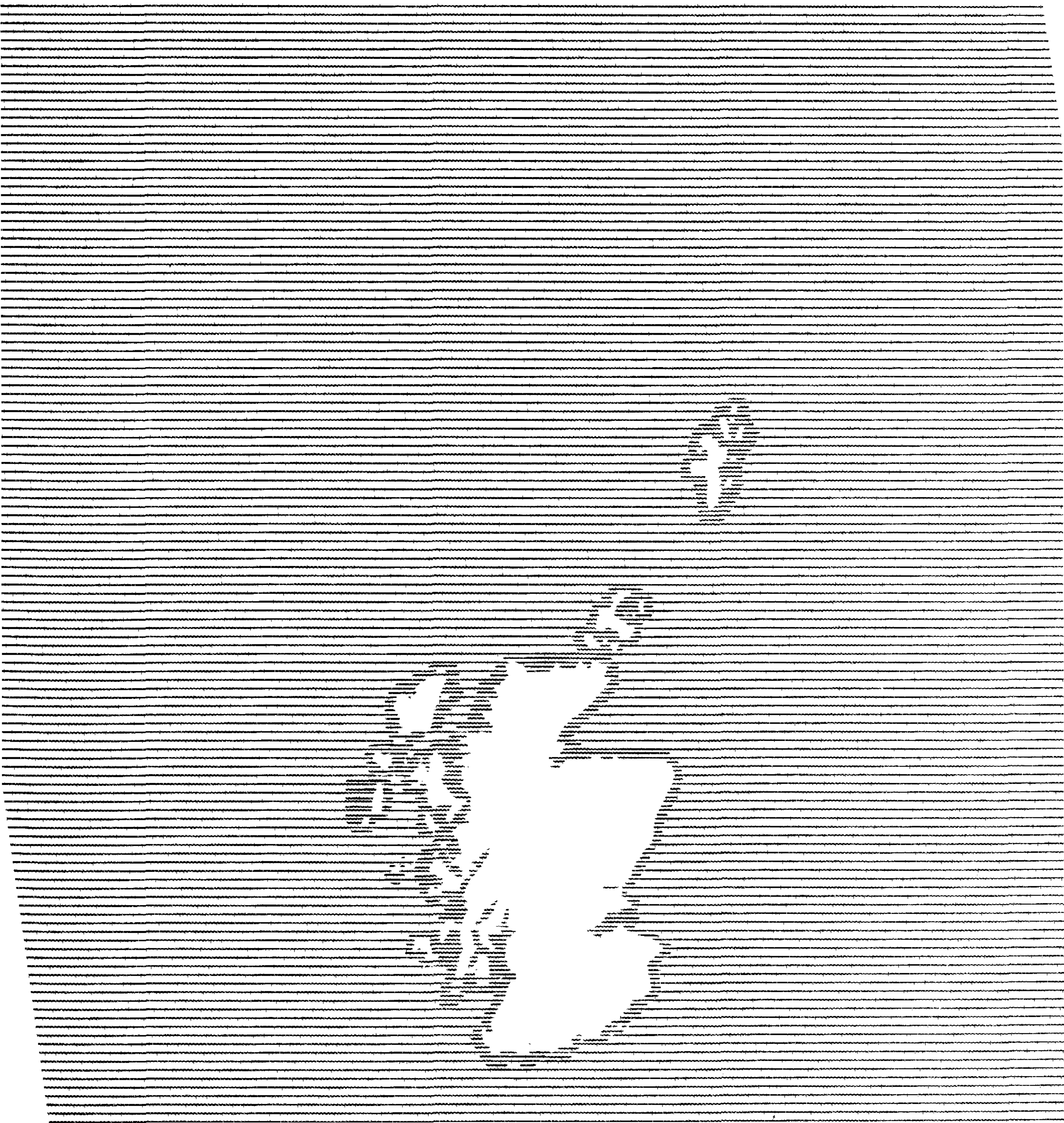
Quarterly Economic Commentary

October 1979



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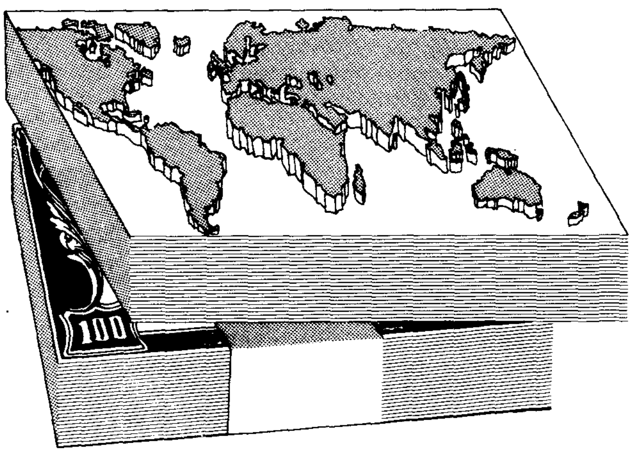
The views expressed in the Special Article are those of the author and not necessarily those of the Fraser of Allander Institute.

The World Economy

It is to be hoped that the response in the industrialised economies of the world to this year's rise in the price of oil will differ from the response to the 1973/74 increase in two important respects. On that occasion, there followed a significant and prolonged recession, the greatest since the war. Further increases in the price of oil were deterred by the fall in demand, and as a result there was very little movement on the part of producers to invest in oil or energy-saving plant and equipment. Nor were consumers' expectations adjusted towards a continuing rise in the relative price of oil.



While there may be further increases in the price of oil before the end of the year, there are some grounds for hoping that the 1979 price increases will not occasion a decline in world output. For one thing, movements in domestic demand are no longer synchronised in the major economies. The more restrictive monetary and fiscal policies now being applied in Western Europe and Japan to counteract inflation may be expected to have their initial effect on output during the first quarter of 1980, at a time when the United States may be beginning to emerge from its current recession. At that time, too, increased demand from the OPEC countries for manufactured goods from the industrialised economies should be making itself felt. The net result is that both the IMF and OECD are agreed that real GNP growth in the industrialised countries in 1980 will be of the order of 2%, although the terms of trade loss will mean that real income growth will be slightly less (1½%).

There is less evidence to suggest that there will be a rapid substitution against oil in the near future, or a significant movement towards the conservation of energy in general. One of the difficulties facing policy-makers is that the most effective signal which can be sent to users, i.e. allowing the relative price of oil to continue to rise, may also have adverse effects on supplies from some OPEC countries like Saudi Arabia. For such countries, the higher is the price of oil, the less they need to export to meet any given foreign exchange requirement. The only way for the industrialised countries to avoid too complete a dependence on such discretionary suppliers is for them to achieve such a rate of substitution against oil that overall consumption of oil in these countries will actually begin to fall by 1985. The next five years are likely to be critical ones, therefore, for the world economy.

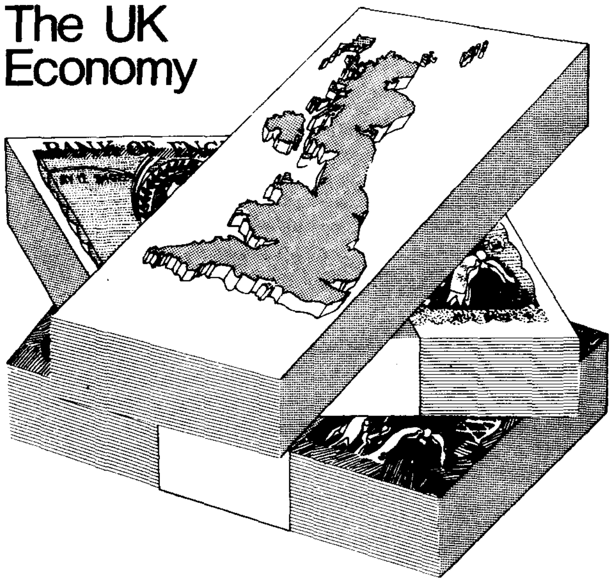
The implications for the non-oil producing developing countries are, of course, extremely serious. Although they have, as a group, achieved ecouraging rates of growth in the past decade, the 1979 oil price rise is expected to contribute to their overall current balance of payments deficit with the rest of the world, (i.e. with OPEC and the industrialised countries), of some $40 billion in 1979. This should be compared with the flow of capital from the International Development Agency - the World Bank's Soft Loan arm-of around £3 billion.

The coincidence of petrol shortages with sharply rising consumer prices in the United States led to a sharp fall in sales of automobiles between the first and second quarters of this year, and thus triggered the recession at a time which had for long been anticipated, (by this Commentary amongst others). The depth and duration of the recession have yet to be established, but there is so far no reason to doubt the earlier expectations that it will not extend beyond the first quarter of 1980. Indeed, the year on year change in GNP of 1979 over 1978 is likely to show an increase of some 1½%, despite the declines expected in the last three quarters of the year. While the consumer price index for 1979 will almost certainly reveal an increase of more than 10% over the 1978 level, the rate of inflation is expected to fall to 7% in the first half of 1980. The current account of the US balance of payments has shown a marked improvement during 1979, in response to the falling external value of the dollar.

In West Germany there has also been a movement of the external current account towards balance, although from the opposite direction. The balance of payments surplus of 17.5 DM billion which the country experienced in 1978 is expected to be reduced to 5 DM billion in 1979, according to a Commerzbank forecast. The Bundesbank have revised upwards their estimate of next year's inflation rate to around 4%, once the initial impact of the oil price increases has worn off. The same source expects a growth rate of real GDP in 1980 of some 3%, compared with 4% expected for 1979. However, the respected Institute for Economic Research at Kiel expects only 1.5% growth.

In Japan, traditionally the other major balance of payments surplus country, the current surplus practically disappeared in the early part of this year. This was the result of an actual fall in the volume of exports and a rise in the import of manufactures, which was in turn due to the appreciation of the yen which occurred up to the fourth quarter of 1978. The rise in consumer prices is expected to be around 2%. Because of the recent depreciation of the yen, and the rise in the price of oil and other primary commodities, the wholesale price index has been rising steadily throughout the year, and this has prompted the authorities to adopt a less expansionary policy so far as domestic demand is concerned. GNP growth which has remained fairly steady at 5½% since 1977 is not expected to change significantly.

The UK Economy



The second quarter of this year saw a rapid recovery of activity from its depressed first quarter level. The preliminary output based estimates suggest that GDP (including oil) rose some 3% between the two quarters. Nonetheless, GDP for the first half of 1979 was only ½% higher than in the latter half of 1978, most of this increase being due to increased North Sea production and a higher level of activity in the motor and distributive trades. Little further growth is likely over the remainder of this year and GDP may actually decline in 1980.

This section reviews recent developments in the major macro-economic aggregates and concludes with a cautious appraisal of the present outlook.

Consumer Expenditure

The recent rapid rise in the Retail Price Index to levels approaching, or in some cases exceeding, the rate of earnings inflation has reduced the growth of real personal income to almost zero. Earnings growth over the last three pay rounds appears to have stabilised at approximately 15% per annum. This growth in earnings coincided with a period of single digit inflation with consequential growth in real earnings. While this period has come to an end, real disposable income will be stimulated over the next few months by the implementation of the income tax measures introduced in the last Budget.

The rapid growth of real earnings experienced over the last eighteen months, compounded by anticipatory buying in advance of indirect tax changes, has led to strong growth in the volume of consumer's expenditure, raising it for the first time above its 1973 peak. The rise between the first halves of 1978 and 1979 was just under 6%, the bulk of this growth occurring in the second quarter of this year. Growth in certain components of consumers expenditure was even more rapid, with household durable goods, and cars and motor cycles increasing in volume by 14% and 19% respectively between the first halves of 1978 and 1979.

The high volume of retail sales attained in June is unlikely to be maintained as the rate of growth of real earnings falls. Income tax rebates will help to maintain demand in the final quarter, the volume of consumer's expenditure showing perhaps a rise of 2½% for 1979 as a whole, with considerably slower growth in 1980.

Private Fixed Investment

Preliminary estimates suggest that the volume of private fixed investment in the first half of 1979 was 2% higher than in the corresponding period of last year. If the declining shipbuilding sector is excluded the rise was somewhat greater at 4%. This aggregate growth rate however masks radically different sectoral performances. Investment in the manufacturing sector (ex North Sea activities) showed no increase and indeed fell by ½% from the level of the latter half of 1978. Investment in manufacturing industry is currently running at the same levels as in 1971. Some caution is necessary however in interpreting these figures, as manufacturing industry has in recent years leased an increasing volume of capital goods from companies in the services and distributive sectors. Investment in these sectors rose by 6% between the first halves of 1978 and 1979, and currently stands some 35% above its average 1971 level.

The Department of Industry Investment Intentions Survey suggests that these sectoral differentials in investment will continue into 1980. For manufacturing industry a fall of 3% in the volume of investment is expected this year, with a further large fall over the coming year. By contrast the intentions data suggest an increase of 8% in the investment of the services and distributive sectors in 1979, followed by a somewhat smaller rise in 1980.

Meanwhile, the Department of Industry's most recent estimates of the real rate of return on capital employed in manufacturing industry in 1978 present a mixed picture. For large quoted companies, the rate of return showed a further increase above its trough of 1976, but still remained well below the levels of the early 1970's Estimates based on broader national accounts data however, suggest a marginal fall below the 1977 rate of return last year. Neither set of figures is encouraging, suggesting that the real rate of return on capital employed is of the order of 5% in UK manufacturing industry, compared with 7% in 1970 and 10% in 1965. While real rates of return appear to have fallen internationally, the British experience has been one of the worst. It is not surprising that the volume of investment remains depressed in the light of these figures.

Trade and the Balance of Payments

Interpretation of figures in this area is complicated by the distortion to trade patterns caused by the road haulage dispute and by the distortion to trade statistics caused by civil service industrial action. Nonetheless, available data are not at all encouraging.

The volume of exports was some 2% lower in the first half of 1979 compared to the latter half of 1978. However, as oil exports rose by some 16% during this period, the performance of the non-oil exporting sectors is even more diappointing than the 2% figure suggests. Factors contributing to this poor performance were, disruption in Iranian and Nigerian markets, the declining competitiveness of British exports owing to strength of sterling, and the effects of industrial action in the early months of this year.

Imports by contrast increased by over 6% in volume between the first six months of 1979 and the latter half of 1978 even though oil imports fell by 8% during this period. Import growth was most rapid in motor vehicles and in semi-manufactured goods, a consequence of the buoyant level of consumer demand during this period, and of stockbuilding by firms taking advantage of the strength of sterling.

Such disparate performance of imports and exports manifests itself in a deteriorating balance of visible trade. The first half of 1979 recorded a deficit of £2.7 billion compared with a deficit of £0.4 billion in the second half of last year. However, whereas the balance on invisibles was strongly in surplus to the tune of £1.4 billion in the latter half of 1978 this situation has now been reversed. Increased UK net contributions to the EEC budget coupled with the remittance abroad of oil-related profits caused the surplus on invisibles to decline to £0.4 billion in the first half of 1979, with no improvement likely over the remainder of this year. The deficit on current account for the first eight months of 1979 amounts to £2.4 billion compared to a surplus of £1.00 billion for 1978 as a whole.

The Labour Market

The level of total employment fell marginally in the first quarter of 1979 following six successive quarterly increases. This decline, which was associated with the industrial unrest of the winter months, took place almost entirely in male employment, which reached its lowest level this decade. Female employment by contrast was little affected. The recovery in output in the second quarter will probably have reversed these trends. However, the strength of any revival in employment, particularly in male employment, must remain problematical given the flat profile of future output. It is unlikely therefore that 1980 will see a reversal of the present two year long decline in levels of registered unemployment.

Appraisal

With a mild world recession possible, a reduction in the rate of growth of real personal incomes in the UK and a non-expansionary fiscal policy in prospect for the immediate future, the outlook for all components of aggregate demand, both domestic and external is not encouraging. This virtual stagnation of aggregate demand will also affect the derived demand for labour, though only with a lag. The performance of the UK economy may be further weakened however if the government's avowed PSBR targets are not "fine-tuned" to take account of the automatic stabilising elements in government receipts and expenditure. Rigid adherence to a PSBR target appropriate to a period of positive growth is wholly inappropriate if economic growth becomes negative. A widening of the PSBR in such circumstances does not represent a retreat from the Chancellor's stated policy as the PSBR will contract in turn as the economy recovers. The PSBR is not an appropriate indicator of the stance of fiscal policy; the PSBR corrected for cyclical factors, ie the full employment PSBR, is. The outlook for the immediate future would be somewhat less gloomy if there was convincing evidence that the Chancellor accepts this view.