

The Fraser of Allander
Institute

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Commentary**

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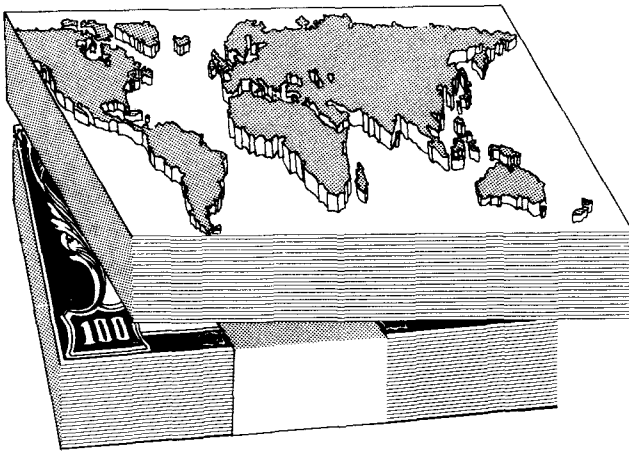
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The views expressed in the Special Article are those of the author and not necessarily those of the Fraser of Allander Institute.

The World Economy

Economic developments throughout the world this year have been dominated by reactions to increases in the price of crude oil which have taken place over the last two years. These reactions will continue to dominate events in 1981.



It has been estimated that the total price increase of some 130% in nominal terms will lead to a cumulative loss of output in the industrialised countries of around 5% by the end of 1981, and will add an additional 11% to consumers' prices. The oil price rise is the principal cause of the present world recession which began in the first quarter of 1980, and is unlikely to end until the last quarter of 1981. There are, however, significant differences between the major countries in the timing, depth and duration of their own recessions. Countries such as West Germany, Japan and France are likely to emerge at the end of 1981 with nothing worse than a slowing down of their rate of growth and a temporary acceleration in their rate of inflation. The United States

and the United Kingdom, on the other hand, are expected to experience an absolute fall in output.

The diversity in the performance of the industrialised economies in the present recession contrasts with the apparent unanimity of the reactions of their governments. Both in deeds and in words, the leaders of the Western countries have made it clear that, faced with an apparent choice between greater inflation or greater unemployment, they have chosen greater unemployment. All have adopted monetary and fiscal measures of greater or lesser degree of severity. They are giving preference to the objective of reducing the rate of inflation, regardless of the cost in terms of higher unemployment.

In general, the Western leaders believe that their economies will weather the current recession more readily than they did the recession of 1974/75. Behind this view, lies the assumption that there will be no further increases in the real price of crude oil over the next two years. Given the present conflict in the Gulf, such a belief is perhaps questionable. Nevertheless, if the assumption is correct then the first part of the necessary adjustment has already been achieved: rates of inflation have already peaked in most of the industrialised countries and are expected to continue falling throughout 1981. Unemployment, on the other hand, is expected everywhere to continue rising.

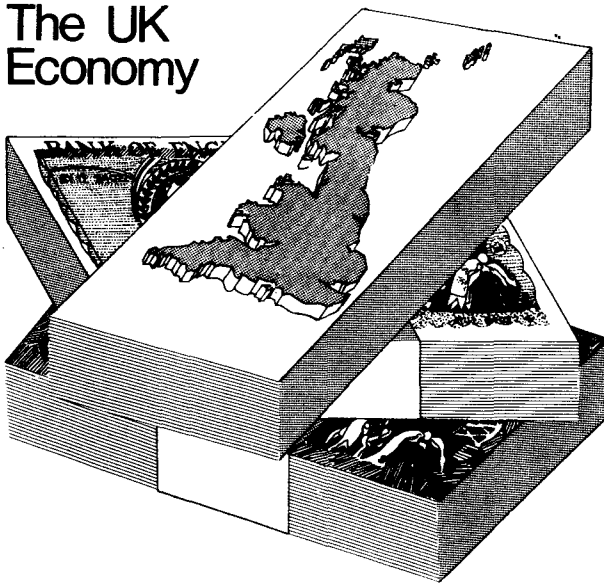
In the **United States**, despite conflicting signals which emerge from different indicators, the best estimates still are that the recovery of the economy as a whole may get underway in the last quarter of 1980. There still remains a widespread fear that the rising trend in interest rates, following a recent upturn in the money supply, may yet choke off the recovery before it gets fully underway. The sharp rise in mortgage rates within the last month has already put the housing recovery in jeopardy. Perhaps the most worrying feature of the US economy at the present time, as the trough of the recession is approached, is that the rate of inflation has still not moderated. Consumer prices are still running at 13%-14% above the level of twelve months ago.

Japan's adjustment to the latest round of oil price increases has been a model one. At the bottom of the recession which is expected to come towards the end of this year or beginning of 1981, the rate of growth of real GDP will slow to not less than 3%, and by the second half of 1981 the economy should be restored to its long-run trend rate of growth of 4% or 5%. At the same time, the rate of increase of consumer prices has been held to single figures. While Japan recorded the largest external current account deficit in its history in the first half of 1980, this balance should be restored to surplus by the second half of 1981. Japan's rapid adjustment has been facilitated by the willingness of its labour force to accept a standstill in real wages in the spring of this year. It has also been facilitated by its government's long standing programme of structural change away from labour intensive and energy intensive industry towards high technology industries.

West Germany, too, has also been experiencing historically high balance of payments deficits. However, policymakers have accepted that this is a normal consequence of the oil price rise, and are content to finance the current deficit with capital inflows. The rate of growth of output is likely to slow to under 2% in 1981, but the government can look forward to a continuing slowdown in the rate of inflation from an average of around 5% in 1980 to between 3% and 4% in 1981. As elsewhere in Europe, unemployment is rising, and is expected to reach 3.6% in 1981.

The oil price rise shows no sign of deflecting the government of **France** from pursuing the conservative economic policy which was set in motion with the appointment of M Raymond Barre as Prime Minister four years ago. The stated objectives of this policy are to bring down the rate of inflation, to maintain a strong franc, and to promote steady economic growth. The rate of inflation peaked at around 14% in the first half of 1980, but it is expected that it will fall to around 10%-11% in 1981. The rate of growth of GDP is also slowing down, with an expected 2% growth in 1980 and about 1.5% in 1981. Over the past decade France has succeeded in reducing its national energy consumption, thus containing its current account deficit to around \$4 billion.

The UK Economy



The UK economy remains in recession with no immediate prospect of a revival in activity. Demand continues to be depressed on both domestic and external markets, with consequent liquidation of inventories and curtailment of output. The labour market is characterised by an increasing excess supply as job opportunities contract at a time of labour force growth.

Recent economic indicators provide no grounds for optimism. The level of industrial production (excluding oil and gas) fell below its average 1975 level during the second quarter. Employment in manufacturing industries fell by 80 thousand between May and July to 6615 thousand, 6.1% lower than for the corresponding month of 1979.

All components of final expenditure declined in volume during the second quarter. The decline was most significant in exports which fell 4% below their first quarter volume, imports in contrast declining less rapidly by only 2%. Consumers expenditure, reflecting falling real personal disposable incomes, dropped by 2.5% compared to the previous quarter. The most

buoyant component of final demand, paradoxically, was central government consumption which remained almost unchanged in real terms. Significant destocking occurred during the first two quarters. Indeed this effect accounted for practically all of the fall in GDP in the first quarter. In the second quarter inventory liquidation continued at much the same rate, but given the weakness of the other components of final demand, amounted to just over 25% of the second quarter GDP fall.

In spite of the depressed state of the economy, nominal earnings accelerated during the first half of the year. The annual rate of earnings inflation appears to have peaked at almost 22% in June. Provisional figures for July suggest a deceleration to 19%. The rate of price inflation has also moderated somewhat, falling from a peak of 22% in May to just over 16% in August. This rapid improvement is somewhat illusory however, as over 4% of the slowdown results from the consolidation of the VAT increases of the 1979 Budget into the base figure.

The balance of payments on current account, having been in deficit during the first two quarters, moved into surplus in June. In September, the surplus reached £440 million and a surplus over 1980 as a whole now seems assured, the deficit of £240 million on visible trade for the year up to

September easily being offset by the invisibles surplus of £928 million.

While the government's policy stance remains largely unchanged, a question mark must be raised over whether intention and implementation coincide. The recent money supply figures are a case in point. While the distorting effects of the corset must be acknowledged, there is little doubt but that the rate of monetary expansion, as measured by the authorities chosen indicator, M , has been increasing at a rate significantly above the upper limit of the target range. To the extent that increases in the broad money supply determine, with a lag, the rate of change of prices, - and this is after all the authorities own view - the prospects for stable single digit inflation, and all its supposed attractions, must have receded.

The prospects for the UK economy on all fronts; output, employment and inflation, are dismal. At current wage and price levels there is a deficiency of demand. This deficiency may be remedied in two ways: by standard Keynesian fiscal measures, (or by neo-Keynesian attempts to restrict imports on the assumption that the rest of the world won't notice), which aim to boost domestic demand, (or in the latter case the share of it met by domestic products). Either set of measures will produce the required results to some degree in the short run. Each carries the seed of long term failure. The first in its implied monetary expansion, the second in retaliation by trading partners.

But there is altogether another way to square the circle. If demand is deficient at current wage and price levels, policy may be directed not at inflating the level of demand, but at provoking an adjustment to more appropriate wage and price levels. It is to this end that government policy is directed. This is probably an equally valid way of attaining the objectives of high employment and low inflation - in the long run. The intervening years will be characterised by chronic underutilisation of not only labour but of all factors of production. The process of adjustment is far from costless. It may indeed be unattainable in a society in which a government espousing such a strategy must submit itself for re-election at regular intervals.

With standard Keynesian remedies, the harvest (of sorts) is reaped almost immediately, the whirlwind later. Present policies schedule the whirlwind first and demand a certain measure of faith that there will be much left to harvest in its wake.