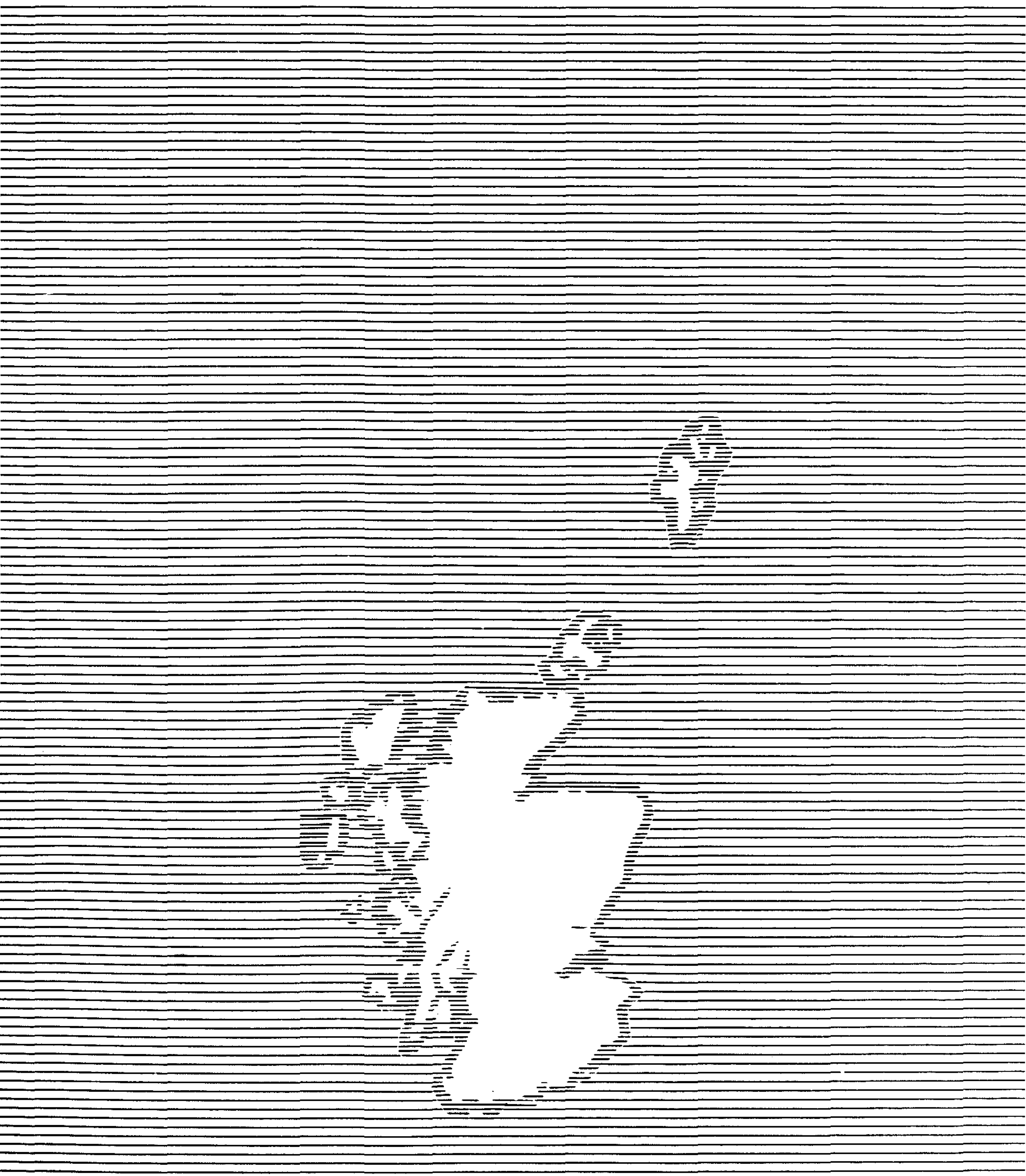
The Fraser of Allander Institute

Quarterly Economic Commentary

April 1981



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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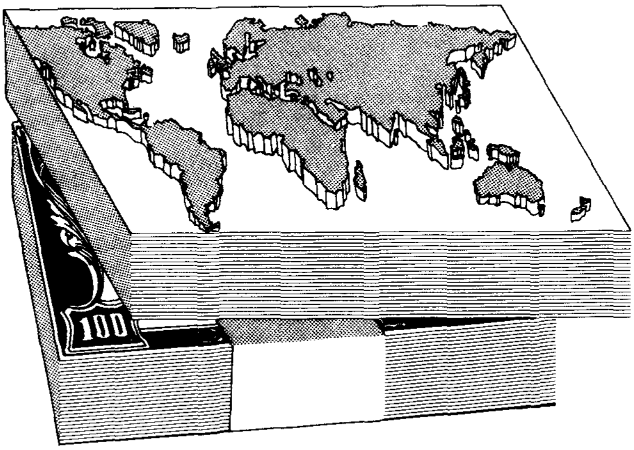
The World Economy



The world economy is in a precarious condition. There are a number of tendencies present, any one of which, if intensified, could precipitate a major disruption of international trade. All of them flow, directly or indirectly, from the oil price increases of 1979 and 1980. The first is that the external trade surpluses realised by the OPEC countries mean that other countries have incurred large counterpart trade deficits. For the *non-oil* developing countries the additional burden of debt will slow their growth and in some cases will lead to default, as has already happened with Poland. The lending banks may have been overgenerous with their loans, but they will not be alone in suffering the effects of financial disruption. Confidence is an essential, even if a fragile and intangible, ingredient in the effective operation of the world economy; when it is destroyed, the effects on all forms of trade are catastrophic. As for the developed countries, as we have noted before, governments in all the major countries are pursuing much tighter monetary and fiscal policies than they did last time round. As a result, real interest rates have risen sharply and are still rising. Whether this is the right policy to pursue is keenly debated. What seems more certain is that oil and energy prices paid by consumers in the developed countries have still not risen sufficiently to encourage energy saving practices. Faced with trade deficits plus domestic unemployment, many governments of developed countries may be tempted to introduce protectionist measures. If the government of any major industrialised country were to give in to such pressures extensive trade wars could ensue which might severely damage the health of the world economy. Finally the current surplus of crude oil is partly the result of Saudi Arabia's decision to increase its rate of production. Should this decision be reversed, the price of oil could rise once again with harmful short-run effects on confidence, although perhaps with desirable long-term re-allocation effects. France and Germany have jointly announced public investment programmes in energy-saving technologies. The world as a whole is rapidly becoming aware of the new investment opportunities created by improvements in information technology. How quickly these will be realised depends on their being no further disruptions to the world economy in the near future.

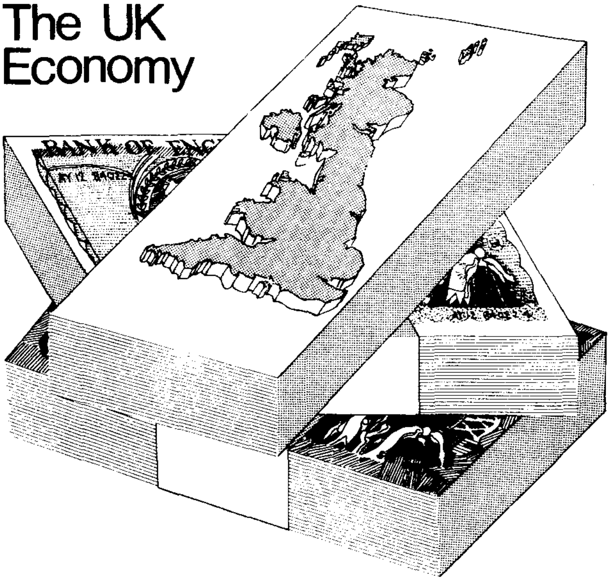
In the **United States**, the Federal Reserve Board have reaffirmed the continuation of tight monetary policies, which has contributed to the present high level of interest rates. However, a return to lower rates is expected later in the year in response to slower economic growth. In the new Administration's budget, real growth of little more than 1% was anticipated for the year 1981. Expectations of slower growth in the latter half of the year are supported by the behaviour of the index of leading indicators. Having increased in each of six consecutive months to November 1980, it has experienced a decline of less than 1% in each of the three subsequent months. The similarities between President Reagan's proposals for tax and expenditure cuts and the policies introduced by the Conservatives in the UK in 1979 are sufficiently strong for most independent observers to be sceptical of their chances of success.

Because of its faster adjustment to the 1979 oil price increases, **Japan** has been able to lower its interest rate at a time when rates elsewhere are still rising. A 1% cut in the bank rate to 6.25% was announced in mid-March, the third decrease in the past twelve months. The inflation rate is falling from a peak of 8%, while the trade balance has moved back into a substantial surplus. The growth rate of GNP is expected to fall from over 4.5% in 1980 to around 3% in 1981.

An official forecast earlier this year suggested that **West Germany** might experience a fall of real GNP of up to 1% during the year. However, this would be accompanied by a slowdown in the rate of inflation to less than 5%. The country's external account deficit has proved more intractable than had earlier been supposed. The government are hoping that the lower inflation rate accompanied by "responsible" wage settlements will lead to an investment-led recovery later in the year.

In **France**, inflation continues to run at over 11% and unemployment remains high. However a positive rate of growth of real GNP of over 1.5% is still expected. It is unlikely that there will be any major shift in economic policy until the Presidential elections in May are over.

The UK Economy



The recent budget is likely to further depress the level of activity in the UK economy. The degree and duration of the induced deflation are a matter for debate, but amongst the short-run effects are the following:

1. a further reduction in aggregate demand.

2. the addition of 2% to retail prices.

3. a sharp increase in the burden of direct taxation.

4. further reductions in public **capital** spending.

All seem ill-advised, and their claimed justification - the restoration of order to the public finances - highly questionable. The deflationary measures introduced far outweigh any possible stimulus to the level of activity stemming from the MLR led reduction in interest rates.

Nonetheless, the Treasury predicted "upturn" consists not of growth in the volume of activity, but merely of a deceleration in its rate of contraction. This deceleration can be predicted with a reasonable measure of confidence as it reflects the conclusion of the destocking cycle and a return to a more normal stock output ratio. But the cessation of destocking is unlikely to induce a return to positive growth. Nonetheless the government remains confident that this will occur spontaneously. This confidence is founded on the assumed existence of a significant **real balance effect** and of an **interest elastic investment** demand schedule. However, in the present context of the British economy, neither of these presumptions seem particularly plausible.

In concept the real balance effect is straightforward. Its lineage is impressive, stretching back to the last of the great classical economists, Pigou. Pigou pointed out that when prices fall, the real value (ie purchasing power) of peoples savings (their balances) increases. People feel better off and spend more, lifting the economy out of recession. Its quantitative importance is questionable, particularly since the reduction in inflation implies a reduction in the rate of increase of prices, rather than a fall in the price level per se. It might alternatively be argued that the reduction of inflation gives consumers more confidence to increase their expenditures due to the increased certainty with which their real incomes can be predicted. Again, however, the quantitative effect is unlikely to be strong.

The belief that a reduction in interest rates will provoke a spontaneous recovery in investment is equally ill-founded. The weight of econometric evidence suggests that investment expenditures are not significantly interest elastic. Other factors appear to be of considerably greater importance. Amongst such factors are expectations of future trends in output and the adequacy of the existing capital stock. The evidence on both counts suggests that a significant recovery of investment is unlikely. Domestic and external demand are both likely to remain depressed in the short-run, the former because of the sharp increase in direct taxation, the latter because of the high level of sterling.

Present policies seem highly unlikely to return the UK economy to even the dismal growth path of the sixties and early seventies. This conclusion, unwelcome though it is, is made even more so by two additional factors. The first is the government's refusal to call their chosen strategy into question even in the face of an ever deepening recession and of a sustained logical onslaught on its theoretical underpinnings. The second is the absence of a coherent alternative strategy which carries the prospect of anything more than short-term amelioration of present problems.

The chosen strategy lies in ruins. The UK's inflation performance, the prime official target, has not been significantly better than that of other nations which have adopted less deflationary measures. Money supply targets have been missed by considerable margins. The PSBR, which as has been argued here in the past is a most undesirable concept to control, has not surprisingly been consistently above target. Public sector monopolies continue to secure the largest pay settlements, while public sector investment is continually reduced in volume. The cost of the chosen strategy in terms of output foregone has been much greater than expected, the returns to date almost zero. As argued above, maintenance of present policies promises only stagnation.

Some elements of an alternative strategy exist including some that don't run against the grain of Tory economic philosophy. Indeed one might legitimately ask what has happened to the policy of increased incentives to companies and individuals. The assistance extended to small businesses in the budget is unlikely to provide a significant overall boost to the economy. Further there is no convincing reason why trading enterprises in the public sector, such as British Telecom, British Gas, BR etc should not be allowed to borrow on the open market to fund capital expenditure. Remove the state guarantee from such borrowings and they need no longer artificially inflate the PSBR (and induce the Chancellor to deflate the economy). If the proposed projects offer an economic rate of return, the market will fund them. If they do not, the project should be scrapped unless the government is prepared to make a contribution to its cost in reflection of any benefits to society.