The Fraser of Allander Institute

Quarterly Economic Commentary

February 1982

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 and Shell UK for their financial assistance in the production of the Quarterly Economic Commentary.

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NOTE:

The publication dates of the Commentary have been moved to February, May, August and November. This is to ensure a more effective analysis of the various published statistics on the Scottish economy.

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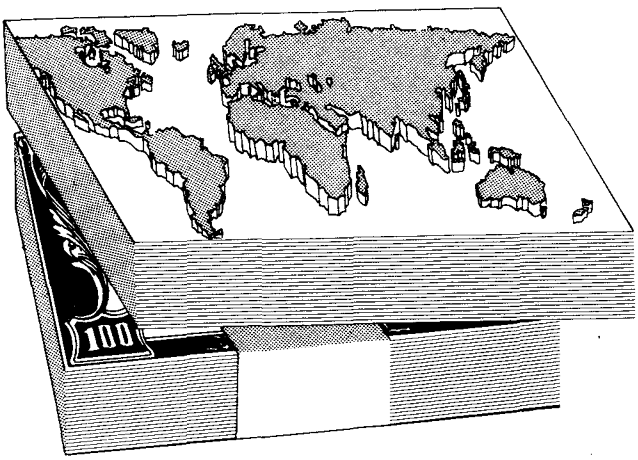
The World Economy



While there are some encouraging signs, among them a further fall in the price of crude oil, a sustained recovery in the world economy is unlikely to materialise before the end of this year. If this prediction proves to be correct, the recession will have lasted some twelve months longer than was anticipated. Despite tight monetary policies in most of the industrialised countries, interest rates have remained high, reflecting the scepticism of financial markets concerning the ability of governments to reduce significantly rates of inflation. So far, this scepticism has been justified by events. The unwillingness of the US Government to reduce its prospective budget deficit by raising taxes illustrates the extent to which democratic governments are vulnerable to internal political pressures. These same pressures underlie the increasing tendency of governments to resort to protectionist measures. Should the recession be prolonged still further, such pressures could become irresistible. By inviting retaliation, they could do lasting damage to the world economy which is founded on the principle of multi-lateral trade with a minimum of restrictions. In this respect, the fate of the world economy is in the hands of the governments of the United States, Japan, and the EEC countries.

In the **United States**, the latest estimates are that GDP fell at an annual rate of 5.2% in the last quarter of 1981, with a further fall of 2% annually expected in the first quarter of this year. On the outlook for the rest of 1982, expert opinion is sharply divided. A sustained fall in interest rates seems to be a precondition of recovery, but, even if this should occur, there seems little prospect of the strong upturn which the Administration had been hoping for in 1982. On the positive side, there is the fact that the index of leading indicators rose by 0.6% in December, the first significant rise in the index since last April. On the negative side, there is the size of the prospective Budget deficit, which leads many commentators to believe that interest rates will remain high.

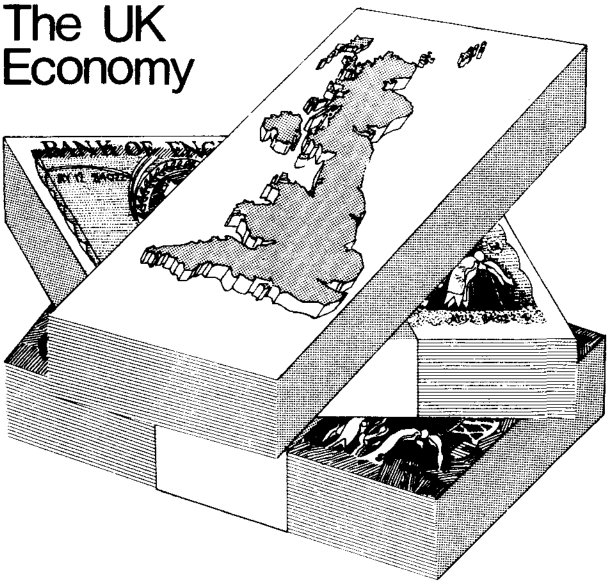
The gradual recovery of output which took place last year in **Japan** is expected to continue in 1982, with the growth rate of real GDP reaching about 4% in the second half of the year. However, the demand factors influencing the rate of growth are expected to be different this year. The rate of growth of exports, which provided the main driving force for the 1981 expansion, is expected to slow down sharply, because of the appreciation of the yen and the increasing protectionism of the other industrialised countries. With consumer price inflation moderating further to about 4%, private consumption expenditure is expected to increase by about 3% in real terms, after an estimated 1% rise in 1981, and a standstill in 1980. It may be significant that Japan, which, in its response to the world recession, has proved itself to be the most resilient of the industrialised countries, has throughout maintained a tight fiscal policy accompanied by a relaxed monetary stance.

Real GDP is believed to have fallen by about 1% in **West Germany** in 1981, for the first time in thirty years, but positive growth of output of about the same amount is expected for 1982. A substantial reduction is anticipated in the country's external current account deficit, led by an increase in exports of capital goods. While the rate of inflation is expected to fall below 5%, the level of unemployment is expected to continue to rise, reaching about 7% of the labour force during the year.

The government of **France** hopes to achieve a rate of growth of GDP of about 2.5% in 1982, partly by means of an expansionary fiscal policy. However, the risks attached to this policy are significant; the external current account deficit rose substantially throughout 1981, and the present rate of inflation, at 14%, is more than twice that of France's principal trading partner, West Germany. It is also an objective of policy to increase employment by shortening the working week; thereby, it is hoped to contain unemployment within its present level of 8%. However, such an objective will be negated if the shorter working week is unaccompanied by corresponding reductions in unit labour costs.

The economic outlook for 1982 in the rest of the non-communist world follows broadly the trends of the past few years. Most of the OPEC countries are increasing their imports until their trade surpluses are almost eliminated. The so-called newly industrialised countries, together with those developing countries with indigenous supplies of energy, also continue to prosper. The majority of sub-Saharan African countries show little signs of progress: in many cases, there is actual decline.

The UK Economy



With unemployment having now passed the critical 3 million level there is intense pressure on the Chancellor to adopt a more reflationary stance in the coming Budget. Even within the confines of the present strategy there appears to be some scope for a limited expansion. For, somewhat uncharacteristically, the government is on the brink of achieving one of its major Budgetary targets. In the nine months to December 1981 the government borrowing requirement was £10.2bn. Given that tax payments are generally high in January and that the authorities are still owed around £3.5bn in revenues delayed by the civil service dispute, the target of £11.5bn for the central government borrowing requirement in fiscal year 1981/82 seems likely to be attained. With this achievement under his belt, the Chancellor may be prepared to provide a mild stimulus to the economy.

By controlling total public sector borrowing (PSBR), the authorities believe that the growth of the money supply can be moderated and thence downward pressure on the rate of price inflation exerted. However, recent events, such as the 15.5% growth rate of sterling M3 in 1981, suggest that there are no stable short-run relationships between these variables. It is also evident that fluctuations in the monetary aggregates can and do have profound short-run effects on output and employment. There seems therefore to be no particular rationale for rigid adherence to monetary targets irrespective of their effects on the level of activity in the economy. Sugh rigidity could be taken to indicate an indifference to these effects.

If the Chanceller does relax the monetary and public spending targets as set out in the Medium Term Financial Strategy, he must decide the extent and the incidence of his reflationary package. Any increase in nominal demand will be divided between increases in prices and increases in output. Any stimulus to demand should therefore be aimed at sectors where there exists a substantial degree of overcapacity. The brunt of the recession has clearly been borne by the manufacturing sector. While GDP in the UK fell by about 6% between 1979 and 1981, manufacturing output fell by about 14%. There is therefore a strong case for ensuring that budgetary tax reductions should be particularly aimed at this sector. However, it would be wrong to assume that a stimulus to manufacturing output will have a negligible inflationary effect because of the large excess of physical capacity in this sector. One must carefully distinguish between excess physical capacity and excess economic capacity. There are many plants and factories in the UK operating below capacity or lying idle, which are unable, under the present price structure, to produce goods which are competitive at going market rates.

Estimates of the extent of economic overcapacity will influence the size of the reflation which the authorities are prepared to envisage. From recent pronouncements it seems likely that the Chancellor will tend to err on the side of caution, with an expansionary package of around £1.5bn to £2.0bn. This would be a very modest proposal, only just offsetting last year's rise in National Insurance contribution rates and going nowhere near the £4bn which would be required to abolish the much-hated National Insurance surcharge. Concentration of reductions in the surcharge on the manufacturing sector would be cheaper and might redress some of the damage inflicted on this sector.

Yet, even though such a measure would have some beneficial impact on employment, its effect on the total level of unemployment would be insignificant according to calculations carried out at the National Institute of Economic and Social Research. Simulations with the NIESR model suggest that a £5bn reflationary package would reduce unemployment by, at most 330,000 over the next five years. Conventional reflation will therefore be inadequate to deal with the current unemployment problem. The implication is that the government will have to undertake more direct action in the labour market to deal with the problem. This might take the form of subsidies for additional workers hired or some further schemes of public works. The inescapable fact is that, without such intervention, unemployment will remain at very high levels for the foreseeable future.

Although the labour market remains in the doldrums, the modest improvement in industrial production is continuing. Manufacturing production rose by 1% in the third quarter of 1981, and final figures for the fourth quarter are likely to exhibit some further gains. The rate of stock reductions is also declining: a fall of £167m (1975 prices) in the third quarter compares with falls of £968m and £888m in the first and second quarters respectively. Retail sales in the final quarter, however, were down by 2% on their level at the beginning of 1981, reflecting the steady decline in consumers' expenditure over the period.

Retail prices increased by 11.9% during 1981. There is no prospect of a return to single figures in the first half of 1982. The Chancellor could influence the inflation rate in the third and fourth quarters by reducing indirect taxes at the budget. This would have a beneficial impact on inflationary expectations. Yet such a policy is likely to prove expensive and the government may prefer to wait until closer to the election before its introduction.