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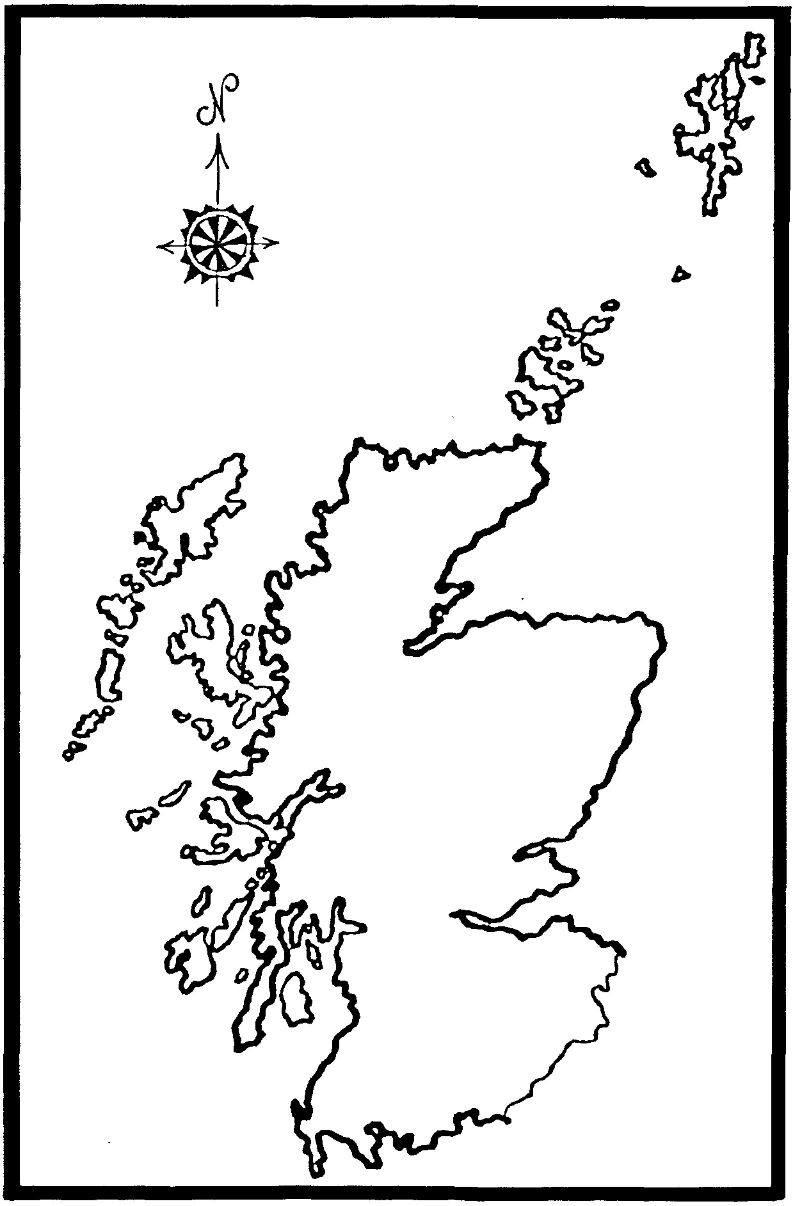
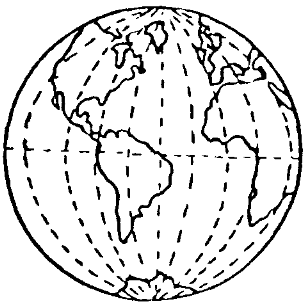
QUARTERLY ECONOMIC COMMENTARY



January 1978

REVIEW OF THE QUARTER'S ECONOMIC TRENDS



THE WORLD ECONOMY

In their Economic Outlook of December 1976 the OECD expressed the fear that "the worst postwar recession is likely to be followed by the slowest postwar recovery, except perhaps in the United States and Canada". Events during 1977 have tended to confirm this point of view. A generalised reduction in price inflation, and an improvement in the current balance of payments position of many of the major economies cannot disguise the fact that in terms of output and employment, 1977 was a year of near-stagnation. The United States alone amongst the major world economies saw a sustained advance in industrial production over 1976 levels. Not surprisingly, the US also recorded the most significant decline in unemployment. The year of stagnation experienced elsewhere is a direct consequence of the primacy accorded to the reduction of inflation by policy-makers, and of the insistence by each individual economy on an export and investment led recovery. While this may be a feasible strategy for an individual economy acting in isolation, it becomes unworkable when adopted by all bar one, in this case the US. The experience of the past year provides ample support for this view. Those countries which deflated real domestic demand, such as Italy, France and the United Kingdom have seen their current balance of payments move towards surplus, while the United States has incurred a substantial deficit. The result has been considerable instability on foreign exchange markets with the dollar weakening against most major currencies.

The prospects for the major world economies in 1978 might be summarised as follows: The UNITED STATES is likely to experience another year of rapid growth of the order of 4½% in GDP. Fiscal policy remains expansionary, and as a result the current balance of payments will remain in substantial deficit. Buoyant domestic demand and the slow progress of the Carter energy policy have inflated the volume of imports, while exports of capital goods are depressed owing to the stagnant state of world demand. A continuing decline in unemployment is expected and price inflation is unlikely to exceed that of 1977 at 5.5%. High levels of capacity utilisation now in evidence should provoke a revival in business fixed investment, the major restraining factor being uncertainty over energy and taxation policies.

In JAPAN export performance deteriorated in the latter half of 1977. The OECD expects this trend to continue into 1978 under the combined influence of an appreciating yen and sluggish world trade. These factors may to a considerable extent affect the expansionary fiscal stance adapted domestically. As a result GDP growth in 1978 is unlikely to exceed 6%, a similar performance to that of 1977. The OECD counsels stronger fiscal measures to avert a slowdown in the latter half of this year.

GDP growth in GERMANY appears to have been of the order of 3% in 1977, and most forecasts do not predict a substantial acceleration during the coming twelve months. The continuing decline in industrial production since the middle of last year has led to a rising level of unemployment, a trend which the OECD expect to persist in 1978. Tax reforms and the unblocking of enforced savings may provide a stimulus to consumption in the latter half of the year, but business fixed investment is likely to remain weak. Industrial production has also stagnated in FRANCE during 1977, and GDP growth was of the order of 2½%. Prospects for 1978 remain unclear owing to the forthcoming general election, however, neither the National Institute nor the OECD expect the rate of growth to exceed 3½%. In ITALY, the policy of domestic deflation has brought the balance of payments into surplus on current account. The OECD expects this policy stance to be maintained in 1978 and predicts GDP growth of 2½% compared with 2% last year. The continuing weakness of domestic demand components is likely to leave the NORDIC COUNTRIES depressed in 1978, with growth rates of the order of 0.5%-1.5%. The exception is NORWAY, where growth may be significantly higher. This is due solely to the effects of oil, shipping and gas. Once excluded, the performance of the remainder of the economy is unlikely to equal that of 1977.

The prospects for the OECD area as a whole appear poor in the absence of further stimulatory action. Aggregate GDP growth is forecast at 3½% by the OECD, a rate insufficient to prevent further rises in unemployment and a deteriorating labour market. The only buoyant component in final demand, personal consumption, is expected to weaken during the year as present fiscal stimuli are exhausted.

Real GDP Growth Rates

	1977*	1978**
United States	5.0	4.3
Japan	6.0	6.0
Germany	3.0	3.5
France	2.5	3.5
Italy	2.0	2.0

* estimate

** forecast

Source: National Institute Economic Review 4/77

THE UK ECONOMY

Nine months ago, in the April 1977 issue of the Commentary, it was suggested that the most likely outcome of this winter's wage bargaining would be "an annual rate of increase of the monthly wage of the order of 15 to 20%, a rate of price inflation in a similar range, a distribution of the wages increment more in favour of the better-paid, and a level of unemployment in the region of 1.7 million by the end of 1978". Subsequent developments appear to call for only a slight modification of this view. To be specific, we envisage average earnings will rise by about 15% and retail prices by about 10% from the last quarter of 1977 to the last quarter of 1978, while unemployment may reach a level of 1.5 million. But we anticipate that by the end of 1978 the rate of increase of prices will once again be rising, while the numbers unemployed will show no significant fall.

In the year just ended, no growth in the aggregate level of output in the UK economy was discernible. Nevertheless, there were significant shifts in the composition of output. Exports increased by some 7% in volume terms, while the volume of manufacturing investment in the first three quarters of the year was about 6% higher than in the similar period of 1976. The performance of electronics, oil, and the chemicals sectors contrasted favourably with disappointing results in other parts of the economy.

The rapid and unexpected movement of the current account balance of payments into surplus in the middle of 1977 was due as much to the non-oil visible items as it was to the increased output of oil from the North Sea. The improvement in the non-oil balance was due to a combination of factors, notably relatively low wage costs, and favourable terms of trade, which are unlikely to continue. Thus, it is expected that in the course of 1978, the non-oil current balance will return to a deficit position. While this movement will not bring the overall balance into deficit, it may be sufficient to reduce the external value of the pound from its present level.

The principal stimulus to the growth of output in 1978 is expected to come from consumer spending which is forecast to rise by about 3%. Such an increase would be insufficient to restore the standard of living obtaining in 1973, since real consumption fell in 1974 and 1975 and was virtually stationary in 1976 and 1977. The Chancellor will have an opportunity, in his April budget, to influence the size and timing of the spending increment if, as is widely believed, he reduces personal taxation. If he does so, this might preclude any substantial increase in the level of public expenditure, current or capital. But investment in manufacturing industry is expected to increase by about 10%. The size and composition of the investment increment will very much depend on expectations concerning the rate of inflation in the near future, which in turn will depend on the level of wage settlements and the content of the budget.

The rate of growth of real GDP is expected to be between 2½% and 3½% from the last quarter of 1977 to the last quarter of 1978. This may be sufficient to stabilise the level of unemployment, but it is unlikely to reduce it significantly. Unlike previous postwar cycles, there is unlikely to be a balance-of-payments constraint upon a prolonged expansion of consumer demand. Thus, even if domestic capacity were to be fully utilised, demand could be satisfied by increased imports. However, the behaviour of the UK economy over the past decade does not support the view that unemployment can be reduced to "frictional" levels simply by a general expansion of aggregate demand. This is a necessary but not a sufficient condition for the achievement of full employment.

The number of unemployed in the UK, at around 1.4 million, is still only the small difference between two very much larger aggregates, viz. the working population, about 26 million, and the number in employment, about 24.5 million. When the size and composition of these two aggregates is changing the relationship between unemployment and the level of demand is unlikely to be a stable one. Changes in technology and in product market conditions continuously alter the demand for labour, while shifts in demographic factors and in the participation rate, (particularly of women), affect the number seeking work.

While there is underutilisation of capacity in most sectors of the UK economy at the present time, the difference between potential supply and actual demand seems particularly evident in labour markets. It is not necessary to look beyond these markets themselves to see at least one type of distortion, contributing to unemployment, which is open to correction by government action. This is the large discrepancy which exists for any given job, between the wage-cost to the employer and the take-home wage of the employee. Added to this are recent, uncompensated increases in the non-wage costs to the employer of offering additional employment.

Taken together, these factors must aggravate any others causing a discrepancy between the supply and demand for labour. Perhaps in recognition of this fact, the French Government have just announced their intention to abolish the employer's national insurance contribution for the first year of employment of people under the age of twenty-five. Decreases in taxation like this are no different from payroll subsidies in their effect on the demand for labour, and the precedent for payroll subsidies in the UK was established by the introduction of the regional employment premium. In previous issues of the Commentary we have argued for the reintroduction of an amended form of REP to increase the demand for labour in Scotland.

It should be noted that such measures have income as well as substitution effects. However, if a further stimulus to aggregate demand were required, then, as we have also argued previously, a programme of public capital expenditure, preferably adding to the stock of productive assets in such sectors as agriculture, forestry and communications, would be appropriate.

Whatever specific measures are adopted, one can sympathise with the sentiment expressed by the National Institute in its November Review, when it says that "a coherent government policy is very much needed - and the sooner the better".

The so-called "industrial strategy" which was announced by the Government in November 1975 is neither a strategy nor a policy. It is a system of committees through which industrialists can make representations to government about the problems and opportunities facing their particular industry. As such, it can provide a major part of the informational basis on which government might construct a policy for the development of the economy. The establishment of the industry working parties marked a significant turning-point in government thinking about the economy. Up to November 1975, a crude macro-economic view was combined with indifference or hostility towards legitimate business concerns. Since that time, there has been a greater willingness to see the economy as a micro-economic process in which the proper functioning of individual agents was worthy of respectful attention. This is an improvement, but it does not yet add up to a policy.