A11/R

THE ECONOMIC OUTLOOK meeting

at CRD, January 9th, 1975.

Guests:	P. Blackaby	NIESR
	P. Ormerod	
	P. Neild	Philips & Drew
	T. Burns	London Business School

For some time it has been normal CRD practice to arrange an informal discussion with the NIESR economists responsible for the economic forecasts in the Institute's Review. Latterly Paul Neild and Terry Burns have joined us and their combined forces assure an illuminating debate. The latest meeting was of more than usual interest. This note records the main points made by each participant in his assessment of the outlook; some general conclusions which emerged; and some of their wider economic and political implications.

Paul Neild began by expressing optimism about the Government's counter-inflationary policy. A Stage II could be feasible with 8-10 per cent annual growth in average earnings (including drift) and there might well be scope for increasing living standards in 1977, though after a period of further austerity. The economy would start to turn up before long, though destocking (in the short run) and the certainty of another year of feeble investment would ensure that the upturn was later and less vigorous than Ministers are suggesting. Although no-one could claim that the public spending decisions likely in the next few weeks would be compatible with the degree of monetary restraint which is desirable, there was no serious likelihood of an early or violent inflationary upsurge. 1977 would look better than 1976. In all probability history would in time reveal that the inflationary pressures might not emerge till 1978 unless some unforeseen revolt against the Government occurred.

The most frightening problem was the balance of payments. Even allowing for North Sea oil, a chronic trade deficit of £1½ billion or more seemed likely for several years. The first problem would be to borrow more foreign exchange. If, as Neild fears, our needs will outrun the funds available on acceptable terms, then the pressure for import controls would mount to unheard of levels.

Blackaby and the NIESR take a distinctly gloomier central view of the course of the domestic economy and of the balance of payments, but stress that the margins of error surrounding forecasts of the latter are so vast that a dramatic improvement could not be totally ruled out over the next year or two. They suspect that the foreign exchange we need can probably be obtained somehow or other, but that the economy will have to hold to a much more modest growth path in the next upswing than in the past, whatever it may be capable of, since the trade deficit will otherwise be unacceptable large. [Blackaby and Neild are both keen that the exchange rate should depreciate fully to maximise our longer term chances of a healthy trade balance. However, the time-lags between exchange rate changes and subsequent B of P improvements are 2-4 years, which make it very late to do much about 1976 or 1977.] Even if the balance of payments can somehow or other be financed, the NIESR believe the Government face grave problems in their relations with the unions. The cause of it will be a combination of the high level of unemployment experienced in 1976 and the fear - correctly felt - that little can be done to get the level down to any marked degree in 1977 or later. The Chancellor will have difficulties over the timing of the negotiation of Stage II. He will want it tied up before the Budget both so that he knows where he stands and so that he can use the measures he introduces in the Budget to "buy" some commitments from the unions. [All our guests, incidentally, agreed that the Budget was likely to be mildly reflationary and would go for some easing of the income tax burden via thresholds etc.] Yet the unions will want to bargain as late as possible, and will want assurances about employment which the Government can scarcely give whether the bargaining takes place tomorrow or in the autumn.

NIESR believe - drawing, I suspect on their official contacts - that the Price Commission is certain to have to police Stage II in the same way as Stage I, and that if agreement can be reached over pay norms, these will involve an "£X + Y %" formula operated for large groups of workers such as plants or firms.

Blackaby (who is a staunch anti-monetarist) prophesised that 1976 would be a year in which PSBR and money supply disputes would dwindle into insignificance.

Terry Burns did not disagree fundamentally with the other outsiders, but put forward a number of more fundamental propositions about the way the economy behaves and is likely to develop. The IBS have recently been analysing the longer-term outlook (indeed they will publish some of their work in the Sunday Times Business News before very long). Two key propositions emerge.

Unemployment is likely to reach at least 1.35 million (GB, s. adj.) this year and is unlikely to fall much below 1.2 million in 1977. On almost any set of assumptions about policy it will stay at over 1 million throughout the next economic cycle. The balance of trade is likely to be worse in 1976 than in 1975 and to remain chronically in substantial deficit. Furthermore, it is not obvious that the latter problem can be dealt with by allowing the exchange rate to fall. For beyond the short term the increases in domestic prices consequent upon higher import prices will, when allowed to work themselves out freely (i.e. if there is no effective incomes policy, or if the wage norm is allowed to adjust to higher prices as under the social contract), lead ultimately to a commensurate increase in home prices which totally wipes out the initial restoration of competiveness. If, on the other hand, there is some kind of incomes policy, then that will be undermined as old Stages II and III were by rising import prices outside our control. So whatever assumptions one makes about counter-inflationary policy, the economy appears to the LBS to be "locked in" with a frightening balance of payments weakness. The LBS stated in their last published Forecast that "Fundamentally, the problems of unemployment and payments deficit are structural ones. They will not be changed by fiddling around with the instruments of macro-economic policy".

Two wider issues

Our visitors came extremely close to agreeing that the structure of the economy had now evolved toward a pathological state in which conventional reflation has become nearly impossible under normal circumstances. As Terry Burns put it, our import propensity is now so great that adding to demand increases imports by as much or more than it stimulates output. Given this truth, or one of the many overlapping versions of it, then a chronically high level of unemployment emerges as an inevitable consequence and prospect for years to come. A frail and unbalanced economy like the British one cannot get back on the road without some major repairs. or import controls.

An explanantion of the underlying structural problem

It is all very well to diagnose "structural" weakness in the economy. But to leave the matter there is as unhelpful as when a doctor attributes an unidentifiable infection to 'a' virus. One needs to know something about why the situation has arisen and what, if anything, can be done about it. My own explanation (I should add that I find the diagnosis is pretty persuasive) which our visitors seemed to accept, is on the following lines.

The combination of public sector growth, overvalued exchange rate, stop-go, monetary imprudence, price control and the oil/commodity price crisis has led to the well-known phenomenon of declining profitability in industry, particularly in the internationally competing sector, which is, essentially, manufacturing industry. Since retained profits are the central determinant of capital expenditure, both on new plant, product development and marketing, each of these areas of activity suffers. Furthermore, when the average rate of return is diminished, the whole distributive curve of profits is lowered. High profit activities earn an average profit; average profit activities become marginal; and marginal activities move into the red. The firms which plan wisely respond to this profit squeeze by withdrawing from marginal and unprofitable activities and product lines, thus preserving their viability but depriving the country of export or import-substituting capacity. Foolish firms carry on regardless, often in ignorance, and end up in liquidation or are taken over and rationalised (i.e. slimmed down). This managerial response exposes the domestic consumer to more import competition and leads to the withdrawal of our exporters from overseas markets (e.g. British Leyland volume cars no longer sold in the USA). Most though not all of this withdrawal process will be focussed on older products and activities.

The shortage of cash for capital expenditure and product development will in a similar way reduce the flow of innovations, new products and inroads on new markets.

The maintenance of our international competitiveness in the fullest sense depends not merely on ensuring that our prices stay in line with those of our competitors, but also that the flow of new products from our internationally competing manufacturers should match and, perhaps, exceed the decay and withdrawal from sale of old products. If this does not happen, then though we may sell what we produce at a profit at home and overseas, there will simply be too little of it. without innovation Importers will have much of the field to themselves, exporters will be few and far between and we shall have a chronic trade deficit.

It will also follow that, though the overall productivity trend in internationally competing manufacturing industry may well rise (since the activities and products discarded will tend to be at the less efficient end of the spectrum) the growth of production may falter and employment is likely to contract. The political consequences of this are obvious. Unemployment rises. The Government then expands its activity to fill the gap. This activity has, before long to be financed, and the diminished private sector is faced with a rising tax burden. And at that point the cycle can repeat itself.

The Political Economy of the next few years

The discussion with the forecasters and the hypothesis built up from it, which is outlined above, suggest a number of important political possibilities.

The first is that there is no very immediate risk of an outburst of inflation if one accepts the assumption that the Government can cling on to some kind of effective incomes policy until the end of Stage II sometime in 1977. Indeed, even on either a money supply or the judgement that a large explosion is likely in 1977, prices are unlikely to get seriously out of hand till 1978.

Early election.

The second is that unemployment, long term and short term, is going to appear the biggest and most fundamental economic problem for some time. The Government will be under growing pressure to reflate or "take action". This must make it a far from foregone conclusion that the union leaders will believe that they can persuade their members to accept a Stage II, however desirable they may believe a moderation of wage claims to be. Stage III must be more speculative still.

The third is that the connection between the dangers and impossibility of reflation (and the assumption of fast and sustained growth) and the state of the balance of payments will create immensely powerful pressure for import controls and/or a more active industrial policy aimed particularly at reversing our balance of payments weaknesses. There will, of course, be strong pressures in any case for a massive stimulus to profits throughout industry, but a growing fear/recognition that this might bring about results too slowly in balance of payment payments terms and, a fortiori, far too slowly for employment to be restored to a tolerable level within a tolerable time scale. If it is realised that a generalised stimulus to profits will only take serious effect over a timescale of 4 years or more, if it is clear that the alternative is indefinite stagnation and unemployment nearer 2 million than 1 million, neither electorate nor workers will be content with a purely macro-economic strategy.

Timing of the next election

There are two conflicting arguments which suggest themselves. One is that the latter half of 1977 will be the best period to go to the country by normal economic standards. The upswing will be well under way; unemployment falling, even if not quickly; prices still growing very slowly in comparison with 1975; and investment turning up.

The other argument is that the long-term direction of the UK economy is unprecedentedly frightening, and the longer one delays the clearer this will be to the public and the greater the problems of preserving a clean record in Government. On this basis one would choose to fight an early "opportunist" election in the classic Wilson style. When?

The signs are that the Chancellor and his economic colleagues believe their own propoganda about the recovery and are convinced that they can ultimately win at the polls. But can one be sure that their counsels will prevail?

ANR

Conservative Research Department,
24 Old Queen Street, London, SW1

ANR/VA
14.1.76