Chapter 1

Summary of the analysis

by

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1. The methodology of this study centres, as in our earlier reports, on the attempt to analyze past developments into their trend and short-term components, and then to project four years ahead (allowing for such changes in trend as can be anticipated) to provide a basis for exploring alternative possible courses of evolution of the economy. The tables in the Statistical Appendix which accompanies this report are the main source of quantitative estimates given in this and subsequent chapters. Sources and definitions of figures in the tables are also given in the Statistical Appendix, together with specifications of the adjustment models used both to estimate past trends and to construct alternative future projections.

2. To avoid tedious repetition of qualifications throughout the study, it must be emphasized here that all the results depend on the particular method of analysis used and on judgements which we have had to make in order to specify the system fully. Some of the most important uncertainties in the results cannot be adequately quantified. The reader is encouraged to take issue with us and doubt our results at any point where our assumptions and methods can be shown to be wide of the mark.

Short-term components and underlying trends

3. The main influences on the development of the economy whose short-term effects are explicitly accounted for are: the actual movement of domestic output or G.D.P.; fluctuations in the volume of world trade; deviations from trend in the rate of inflation of domestic labour costs per unit of output; and deviations from trend in the movement of unit labour costs relative to competitors (adjusted for exchange rate changes). In the case of domestic output the trend is defined and estimated so as to be consistent with a steady 2½ per cent level of unemployment. For the other three exogenous variables, trends are defined and estimated as smooth exponential paths fitted through past actual values.

4. To obtain what we term 'underlying trend' movements of endogenous variables, actual series for investment, stock-building, exports, imports, etc. are adjusted for the known or assumed effects of deviations from trend in all four exogenous variables. The definition of what is meant by the underlying trend is therefore precisely defined in every case. The success of our analysis is largely to be judged in terms of its ability to derive smooth and stable underlying trends from apparently erratic actual series.

Extensions of the analysis

5. This year our analysis is extended to pay special attention to the problems raised by physical shortages, and high cost, of petroleum imports (Chapter 2) and by wage and price inflation (Chapters 8 and 9). Past and prospective movements in the retail price index are analysed in the Appendix (Table 15). We have also introduced a new table (Appendix Table 16) showing an index of real national income which allows for the effects of changes in the terms of trade, as well as the volume of domestic output and net income from abroad, on the purchasing power of G.N.P.

6. Otherwise the order of discussion is much the same as in earlier reports. Chapter 3 examines productive potential from the point of view of labour supply and trend productivity, as a basis for predicting unemployment on alternative assumptions about the future growth of G.D.P. Chapter 4 examines the implications of the Public Expenditure White Paper and subsequent cuts for expected levels of public expenditure on goods and services. Chapter 5 analyses private house-building, fixed investment and stockbuilding. Chapter 6 looks at the possibilities for financing balance of payments deficits, taking account of opportunities for Euro-dollar borrowing and the new situation created by very large trade surpluses projected for oil-exporting countries. Chapter 7 then examines the prospects for achieving an external balance on goods and services which could be financed in the medium term, given different growth rates of G.D.P., world trade and unit labour costs relative to our competitors.

Main characteristics of the par economy

7. Despite the raising of the school leaving age, the size of the labour force is expected to change little up to 1977 (unless there is a shift in the trend of net migration); the proportion of married women in the total will continue to rise, though not as fast as in the past two years. There is now firm evidence that the trend growth of productivity outside the manufacturing sector had slowed down in the last four years, at least partly because of the removal of SET. The prospective par rate of growth of G.D.P., at which unemployment would remain steady, is still about 3% per year, provided that growth of productivity in service industries resumes at the rate achieved in the early 1960s before SET was introduced.

8. Ignoring the short-term problems caused by the miners' overtime ban, etc. the prospects for indigenous energy supply look favourable and the par growth of demand for energy in the U.K. is in any case only about 2% per year. It appears that there is no need to expect that productive potential will be constrained by energy shortages in the medium term.

9. High oil prices and abnormally high commodity prices do at the moment place a heavy, if temporary, burden on the balance of payments. We therefore allow the par

balance of trade to show temporary counterpart deficits, rising from £500 million (on goods and services) in 1973 to £1,800 million in 1974, but then falling back to £500 million in 1977.

10. The par growth in the volume of imports is nearly 8% in volume terms and from now on the par volume of exports needs to grow at about the same rate. Appendix Table 10 indicates that a large (10%) adjustment in relative costs to strengthen competitiveness seems to have been needed since 1971, but that this would suffice, in the par economy, for some time to come.

11. Public sector current expenditure and par investment are both projected to grow slightly slower than G.D.P. The resources available in the par economy would allow private consumption to grow at an average of 3% per year.

12. Comparing the par economy with the actual position in 1973, unemployment was a little below the 2½% level,(1) and the G.D.P. therefore slightly above par. The volume of exports was about 5% below par, and the volume of imports 3% above. Personal consumption exceeded the par level by 6½% (equivalent to over two year's par increase). By the end of 1973 unit labour costs, relative to competitors, were probably nearly down to the par level. But they have come down too recently to afford an immediate shift to a par trading performance; and by 1977 the actual trade target must probably be above par to compensate for exceptionally large actual deficits on the balance of payments in the period 1973-75.

The implications of alternative growth rates, 1973-77

13. At 3% per year, G.D.P. growth would match productive potential, holding unemployment steady. At 2% per year, unemployment would rise to over 700,000 in 1977; and if output growth is only 1% per year, unemployment would exceed 700,000 in 1975 and 1,000,000 in 1977.

14. Prospects for the current balance of payments depend on the future movement of world trade and relative costs and on a number of uncertainties (such as the timing of arrivals of North Sea oil) about which assumptions have to be made. Given these, and assuming that relative costs remain at the end-1973 position and that world trade returns to trend, we obtain the following estimates: the volume of exports of goods and services will grow at an average of 8½% per year (slightly

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(1) The par level of unemployment, set at 2½%, is not intended to have any normative significance.

faster in the first year or two); the terms of trade on goods and services, having fallen another 8% between 1973 and 1974, will gradually recover to the 1973 level; the volume of imports of goods and services will grow at an average rate of between 4% per year (with 1% G.D.P. growth) and nearly 8% per year (with 3% G.D.P. growth); the overall balance of trade on goods and services will show a deficit exceeding £3,000 million in 1974, thereafter improving by 1977 to anywhere between a surplus of nearly £2,000 million (with 1% G.D.P. growth) and a deficit of over £2,500 million (with 3% G.D.P. growth). Detailed projections are given in Appendix Tables 11 and 12.

15. As explained in detail in Chapter 7, projections of the overall balance of trade on goods and services (as opposed to the individual movements of exports and the terms of trade) are hardly sensitive to changes in the assumptions about world trade - or, within the next three or four years, to assumed gradual shifts in relative costs. An immediate large improvement in relative costs (of the order of 5% or more) would increase the projected value of exports (and reduce the projected deficit on goods and services) by some £2,500 million in 1977. Also, it must be recognized that the projections of exports and imports may have quite wide margins of error.

16. The adverse movement of the terms of trade between 1973 and 1974 will reduce real national income relative to G.D.P. by about 2%. Thereafter, despite a gradual improvement in the terms of trade, real national income may not rise much faster than output because of an adverse movement in property income and transfers (including our net contribution to the E.E.C. budget).

17. Even with G.D.P. growth at 2% per year, the prospect is that private consumption would rise only 1% per year on average between 1973 and 1977. Slower growth of G.D.P. might actually involve a large fall in consumption over the four year period. The main reason for this rather surprising conclusion (see Appendix Table 13) is that the balance of payments deficit is very sensitive to the assumed growth of G.D.P. The 1% growth path implies a rapid improvement in the external balance after 1974. For such an improvement to materialize within the low resource availability set by slow growth of G.D.P., personal consumption would have to be cut very substantially.

Pay and prices

18. Without any formal breach of Phase 3, and excluding any effect from implementation of threshold agreements, average hourly earnings (corrected for changes in overtime) are likely to rise 13 - 14 per cent in the year to October 1974. Chapter 8 also draws attention to the changes in differentials between 1970 and 1974 which are likely to have been generated by successive phases of

policy, particularly the latest one. Forecasts of changes in the real pay (net of tax) of all manual workers and of selected 'winning' and 'losing' groups are provided; the figures suggest that significant numbers of people, including many employed in the public sector, will have suffered a considerable absolute reduction in real net pay over the four year period.

19. Chapter 9 considers the outlook for retail prices. A new quarterly econometric analysis confirms that the prices of manufactured goods and services are invariant to short run fluctuations in demand even under the conditions of 'overheating' in the second half of 1973. This analysis, rigidly applied, forecasts that the retail price index would cross the Phase 3 threshold point during the second quarter of 1974; after allowing for consequential additions to wage costs, it also forecasts an increase of 15 per cent in the year to October 1974. But the latter result is probably overoptimistic since, under the unusual circumstances of 1974, the lag in passing on cost increases may well be shorter than the model assumes.

20. After 1974 the rate of increase in retail prices should be lower than the rate of increase in unit labour costs because of the prospective improvement in the terms of trade (see Appendix Table 15). This implies that the exceptionally difficult inflationary situation we now face could well ease off after this year.