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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. Along with the Quarterly Economic Commentary, the Institute also publishes a series of Research Monographs and a series of Discussion Papers to provide an outlet for original research on medium term and long term aspects of the Scottish economy. The Institute is a research unit in the Strathclyde Business School, a faculty of the University of Strathclyde.

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Notes to contributors
The editors welcome contributions to the Briefing Paper, Feature Article and Economic Perspective sections. Material submitted should be of interest to a predominantly Scottish readership and written in a style intelligible to a non-specialist audience. Footnotes and references should conform to recent issues of the Commentary. Contributions should be typed and two copies submitted to the Editor.

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Since the last Commentary was published the Gulf War has come and gone, and without the widely expected effect of higher oil prices in the short-to-medium term. Indeed, the OPEC countries have had difficulty securing the $21 per barrel price which they fixed last year and to which they have since reasserted their commitment, even with a certain premium during the hostilities. At least in part this was the result of the inability of Iraq to seriously disrupt the supplies of any major producer other than Kuwait, but also shows that the fundamentals of supply and demand in the market for oil favour a relatively low price at the moment.

Against the background of a moderate and relatively stable oil price the idea of a 'global recession' seems unduly pessimistic. Growth in Japan and Germany, the main powerhouses of the major industrialised countries (the G7), is undoubtedly slowing down, largely the result of tightening monetary policy in the wake of increased inflationary pressure. But outright recession is largely confined to the English-speaking world, and especially to the United States and the UK (see World Economy section). While this is unpleasant, its effects should not be overstated. Assuming the GATT talks do not end in complete disarray, world trade growth, an important component of economic growth, should be between 4% and 5% in 1991. This is below the growth rates recorded in 1989 and 1990, but should still ensure modest GDP growth for the G7 countries as a whole, with the prospect of a reasonable recovery in 1992.

The UK Economy

Turning now to the UK, there has also been a marked change in attitude during the last quarter. As late as November the Government was still denying that there would be a recession, despite the mounting evidence to the contrary. The GDP figures for the third quarter of 1990 and provisional figures for the fourth quarter removed any lingering doubt. Real GDP fell by 1.3% in the third quarter and (provisionally) by a further 0.9% in the final quarter. Manufacturing led the way into recession, with output falls in the third and fourth quarters of 2.9% and 1.8% respectively; but the service sector, the main growth area of the 1980s, has also now joined in the trend, with a modest 0.5% fall in output in the final quarter of 1990.

Further output falls seem inevitable in the first quarter of 1991, and quite possibly in the second quarter also, with manufacturing again bearing the brunt. Manufacturing investment has also been badly hit by high interest rates and the accompanying drop in orders; capital expenditure in manufacturing in the final three months of 1990 was a full 15% below the level attained in the corresponding period a year earlier. This is also reflected in the composition of output changes in manufacturing in recent months. Production of investment goods in the UK fell by 4.4% in the final quarter compared with a more modest decline of 0.9% for production of consumer goods.

All of this points firmly to the first recession of any consequence since 1980-81. To suffer such a self-induced recession in a decade may be considered unfortunate, but a second does rather smack of carelessness. Now, however, the official line is that the UK will bottom out in the middle of the year and will experience a rapid recovery in the second six months of this year.

Interestingly, the CBI, among the most pessimistic forecasters six months ago, recently argued that the gloom and doom was in danger of being overdone, and that we should now concentrate on recovery. This argument is not without merit. Inflation is now falling rapidly, and fairly modest interest rate cuts have been possible so far with the promise of more to come if the fall in inflation continues, which it inevitably will.

The difficulty, of course, is that sterling's entry into the ERM means that interest rates may have to stay higher than conditions in the domestic economy warrant in order to maintain the value of the pound. The crucial currency here is the D-Mark, and the German authorities have made it clear that they are prepared to raise interest rates and maintain a high D-Mark as a defence against the inflationary consequences of unification with East Germany. If this means forcing their ERM partners to match increases in interest rates or to forego cuts which would be warranted by domestic considerations, then this is...
a consequenc e which the Germans are prepare d t o
countenance. T o thi s exten t th e Germa n
authorities are in a position to export the cost s
of unificatio n t o other ER M membe r countries ,
which is unlikely to be to Britain's advantage i n
the short run.

Prognosis for Scotland

Recent evidence on the performance of the Scottish
economy doe s, at first sight, inspir e muc h
optimism. Accordin g to official figures, outpu t
in the production and construction industries fell
by 3.2 % i n th e thir d quarte r o f 1990 , wit h
manufacturing experiencin g a slump of over 7% i n
that thre e mont h period . Mos t o f thi s wa s
accounted for by a 14% fall in engineering output;
within this sector, electronics fared even worse ,
undergoing a n eyebrow-raisin g 22 % declin e i n
output i n jus t thre e months . Productio n o f
investment good s i n Scotland ha s als o slumpe d
since th e early part of last year. Th e more up -
to-date Scottish Chambers' Business Survey for the
final quarte r indicate d furthe r fall s i n
confidence i n manufacturing , construction ,
retailing an d tourism , wit h confidenc e i n
construction fallin g to its lowest level i n th e
history o f the survey. On e important chang e i n
the fourt h quarter was the information on order s
and sales. I n previous surveys most major sectors
reported increase d sale s an d order s despit e
deteriorating levels of business optimism. I n the
last survey , however , th e trend i n sale s an d
orders wa s significantl y negativ e fo r bot h
manufacturing an d construction , wit h furthe r
declines expecte d in the present quarter . Eve n
export orders , th e most buoyan t elemen t amon g
manufacturers i n recen t surveys , showe d clea r
evidence of faltering.

This informatio n i s consisten t wit h th e vie w
expressed in the last Commentary that the Scottish
economy would start to show signs of falling mor e
into line with that of the UK as a whole; but this
does no t mean that Scotland must suffer the pai n
of th e Souther n par t of Britain. Muc h o f th e
apparent slump in production can be attributed t o
data revision s and to the vagaries o f quarterl y
Scottish data ; it is worth bearing in mind that ,
according t o the Scottish Office, in the year t o
September 1990 Scottish manufacturing output ros e
by 5%, seven times the increase recorded in the UK
as a whole. Scotlan d may well suffer a recession,
in the technical sense of two consecutive quarters
of falling total output, but it is unlikely to b e
of the scale experienced in the UK as a whole.

We no w expect the UK to show negative GOP growt h
of around 0.5% in 1991, but by contrast we expec t
Scotland t o sho w modest but positive growt h o f
around 0.4% during the year. Th e reasons for this
contrast ar e well rehearsed, and are essentiall y
those whic h delaye d th e slowdow n i n Scotlan d
during 1990 . First , the policy of high interes t
rates ha s not had the same effect in Scotland a s
in Englan d becaus e o f th e relativel y lo w
borrowings o f consumers, which has kept consume r
demand i n Scotlan d running at a health y level .
Second, Scotlan d ha s performed fairl y wel l i n
export markets , an d i s relativel y expor t
intensive. Thi s remains the case despite evidence
from th e Scottis h Council that U K manufacture d
export growt h exceeded that of Scotland i n 198 9
(9.1% and 1.6% respectively), perhaps a reflection
of U K producers' success in turning t o oversea s
markets a s the domestic market began t o falter .

As indicated earlier, the outlook for world trad e
growth i s reasonably bright, from which Scotlan d
ought t o benefit. Third , North se a exploratio n
and development is going through a mini-boom which
should continu e for some time. Th e longer-ter m
prospects for this industry are less certain, an d
depend t o a  larg e exten t o n ther e bein g n o
collapse in the price of oil as occurred in 1985 -
86, a n event which put paid to Scotland's modes t
economic recovery at that time.

Clearly, the timing of further interest rate cut s
and possibly the measures contained in the budge t
will hav e some effect on the time pattern of th e
recession. However , our general expectatio n i s
that bot h th e Scottis h and U K economie s wil l
resume growth in the latter part of 1991 in term s
of output , but that employment growth (and fall s
in unemployment) will be postponed until 1992.