Quarterly Economic Commentary

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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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QUARTERLY ECONOMIC COMMENTARY

****** COMMENTARY ******

****** VIEWS ******

Opinions expressed in signed contributions are those
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Outlook and Appraisal

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 does also show that the fundamentals of supply and demand in the market for oil favours 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 pessimstic. 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 one 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 consequence which the Germans are prepared to countenance. To this extent the German authorities are in a position to export the costs of unification to other ERM member countries, which is unlikely to be to Britain's advantage in the short run.

Prognosis for Scotland

Recent evidence on the performance of the Scottish economy does not, at first sight, inspire much optimism. According to official figures, output in the production and construction industries fell by 3.2% in the third quarter of 1990, with manufacturing experiencing a slump of over 7% in that three month period. Most of this was accounted for by a 14% fall in engineering output; within this sector, electronics fared even worse, undergoing an eyebrow-raising 22% decline in output in just three months. Production of investment goods in Scotland has also slumped since the early part of last year. The more up-to-date Scottish Chambers' Business Survey for the final quarter indicated further falls in confidence in manufacturing, construction, retailing and tourism, with confidence in construction falling to its lowest level in the history of the survey. One important change in the fourth quarter was the information on orders and sales. In previous surveys most major sectors reported increased sales and orders despite deteriorating levels of business optimism. In the last survey, however, the trend in sales and orders was significantly negative for both manufacturing and construction, with further declines expected in the present quarter. Even export orders, the most buoyant element among manufacturers in recent surveys, showed clear evidence of faltering.

This information is consistent with the view expressed in the last Commentary that the Scottish economy would start to show signs of falling more into line with that of the UK as a whole; but this does not mean that Scotland must suffer the pain of the Southern part of Britain. Much of the apparent slump in production can be attributed to data revisions and to the vagaries of quarterly Scottish data; it is worth bearing in mind that, according to the Scottish Office, in the year to September 1990 Scottish manufacturing output rose by 5%, seven times the increase recorded in the UK as a whole. Scotland may well suffer a recession, in the technical sense of two consecutive quarters of falling total output, but it is unlikely to be of the scale experienced in the UK as a whole.

We now expect the UK to show negative GDP growth of around 0.5% in 1991, but by contrast we expect Scotland to show modest but positive growth of around 0.4% during the year. The reasons for this contrast are well rehearsed, and are essentially those which delayed the slowdown in Scotland during 1990. First, the policy of high interest rates has not had the same effect in Scotland as in England because of the relatively low borrowings of consumers, which has kept consumer demand in Scotland running at a healthy level. Second, Scotland has performed fairly well in export markets, and is relatively export intensive. This remains the case despite evidence from the Scottish Council that UK manufactured export growth exceeded that of Scotland in 1989 (9.1% and 1.6% respectively), perhaps a reflection of UK producers' success in turning to overseas markets as the domestic market began to falter. As indicated earlier, the outlook for world trade growth is reasonably bright, from which Scotland ought to benefit. Third, North sea exploration and development is going through a mini-boom which should continue for some time. The longer-term prospects for this industry are less certain, and depend to a large extent on there being no collapse in the price of oil as occurred in 1985-86, an event which put paid to Scotland's modest economic recovery at that time.

Clearly, the timing of further interest rate cuts and possibly the measures contained in the budget will have some effect on the time pattern of the recession. However, our general expectation is that both the Scottish and UK economies will resume growth in the latter part of 1991 in terms of output, but that employment growth (and falls in unemployment) will be postponed until 1992.

14 March 1991