

Quarterly Economic Commentary

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FRASER OF ALLANDER INSTITUTE

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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

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OUTLOOK AND APPRAISAL

The recession has officially ended with a second quarter rise in non-oil Gross Domestic Product of 0.1%, the first quarterly rise since 1990 Q3. Subsequent events in the ERM will provide a boost to the real economy but recent unemployment figures suggest that any significant upturn will be delayed until 1993.

The position of the Scottish economy has changed considerably in the last three months. Since the second half of last year the short term model has been expecting a modest upturn in production in the first quarter. Unfortunately, the latest figures from the Scottish Office show that this has failed to materialise. In the three months to March the total index of Production and Construction fell by 1.3% compared with the 0.6% decline experienced by the United Kingdom. The downturn seems to have been most potent in the manufacturing industry. When construction and energy & water are stripped out the quarterly decline increases to 2.7% compared with growth of 0.5% in the U.K. as a whole. Under normal circumstances a dramatic downturn of this nature would warn of impending gloom and hardship. However, these first quarter figures immediately precede the UK General Election and may not accurately represent the state of the Scottish Production and Construction industries.

Annualized data provide more evidence that the recession is stronger south of the border. Over the year the total Scottish index fell by 1.0% while the UK contracted by 2.6%. The annualized contraction in Manufacturing measured at 1.8% is some 2.5% less than in the UK. Once again Scottish construction industry is moving in the opposite direction to its UK counterpart. Annualized growth of 3.1% in Scotland contrasts with the 8.8% decline in the UK.

Scotland's unemployment performance is still superior to the UK Total unemployment rose by a seasonally adjusted 2700 in August, a rate of 9.6%. Since August 1991 the count has risen by 16,000 although this month's increase was dampened by a

decline in female unemployment which fell by 200.

The UK economy

The latest available UK statistics give an inconsistent picture of the current state of the economy. Moreover, the statistics which showed an improvement in the last Commentary are now included in the 'gloomy' collection.

Encouragement can be taken from the 0.1% rise in non-oil GDP in the first quarter but there are four additional indicators which offer good news. Firstly, the volume of consumer credit repayments fell again in May to a figure of only £19bn, compared to the average repayment of £44bn in the preceding quarter. Secondly, average earnings have fallen dramatically since the beginning of the decade to stand at a 12 year low. Annual growth of only 6.0% was recorded in June 1992. Thirdly, overall industrial production grew by 1.0% in July, mainly the result of a substantial increase in energy production. Lastly, the decline in real gross fixed investment has come to a halt with its first rise since early 1990.

True to current form, though, for every positive figure there are counteracting influences on perceptions. The latest index of production reveals that output of manufactured goods fell by 0.9% in the year to July and remained flat over the previous three months. This comes after positive growth in the first half of the year. The seasonally adjusted volume of retail sales fell by 0.3% in July after remaining largely unchanged over the previous three months, more evidence that the post election boom was a knee jerk reaction and had little substance. Stockbuilding by manufacturers fell in the three months since the last Commentary, supplementary evidence that demand is not expected to be maintained in the near future.

The balance of payments deteriorated once again in July. Over the year exports rose by 1.5% and imports rose by 8%, a disturbing trend given that Britain has only just, technically, emerged from long recession. One would have expected the economy to be well into the upswing of the cycle before seeing significant increases in import demand. Unemployment increased by a seasonally

adjusted 47,000 in August - a rate of 9.9% - and represents the second monthly acceleration in the count. This will surely halt the fall in the savings ratio and dampen consumers' expenditure plans. Indeed a recent survey by PA Economic Consultants shows that consumer confidence has collapsed since the post election euphoria and household spending intentions are at a lower level than at any time in the past 18 months.

Crisis in the ERM

The effective devaluation of Sterling within the ERM coupled with the misfortunes of the Italian Lira and the Spanish Peseta has more or less removed any anti-inflationary credibility that Britain commanded from the foreign exchange markets.

Following decades of successful low inflationary growth the Bundesbank acted historically and pursued its objective of low German inflation by refusing to substantially reduce interest rates when weaker ERM currencies, including Sterling, came under pressure from speculators. Continued foreign exchange intervention would have increased the stock of foreign reserves held by the Bundesbank and forced German M3 in the opposite direction to its own policy objective. In all probability, continued German intervention would have resulted in increased German interest rates, increased European interest rates and a prolonged European recession.

For the currency dealers it plainly became impossible to believe in the survival of a UK economic policy that seemed to promise a perpetuating recession, ever rising unemployment - up 47,000 in August - and progressive fiscal deterioration. In time a reduction in the price of Sterling became a formality because from the offset the British government did not appear to understand the rules of the ERM game. The UK should have raised short term interest rates in December 1991 and in July 1992 - every other ERM member state followed Germany monetary policy - as this would have signalled complicity. Unwisely, the Government boasted its intention of lowering interest rates below Germany's and by doing so implicitly highlighted the inherent weaknesses in the British economy and its structural inability to play the credibility game of raising interest rates in response to the leader, Germany. As a result, when the foreign exchange markets were informed that Britain would raise interest rates to any level necessary they simply did not believe in Sterling and Britain's ability to cope with continued

recession. So, on September 16, Sterling joined the Lira and the government opted to float, rather than pushing up interest rates by 5% and crushing the real economy.

Sterling and Britain's anti-inflation policy collapsed as a result of insufficient credibility, structural weakness and Britain's own insistence that it would not join until all member states had abolished their own exchange controls. Evidence from the early years of the ERM suggest that had exchange controls existed the speculative attack on Sterling might not have had the momentum to carry it below DM2.7780 and ultimately out of the system.

Outlook

Macroeconomic policy

What of Britain's ERM anti-inflationary policy? Assuming that Britain's commitment to the ERM is genuine and the system survives the referendum in France, what options are available to the domestic monetary authorities.

The government can boost the real economy by lowering interest rates - some say a 4% cut is needed for recovery - and then floating with the intention rejoining the ERM sometime in the future. Unfortunately this renders even more vacuous the UK government's promise of, "... no devaluation ..," and seriously undermines the prospect of regaining credibility in the short term. However, the lowering of UK rates may deliver a low enough exchange rate to convince the market that it has fallen to its equilibrium level and remove the likelihood of further speculation and the need for dealers to hold a risk premium. Rigid adherence to the mechanism could then provide low inflationary growth in the medium to long run via lower real interest rates. Lowering interest rates would have beneficial effects in the housing market, stunt the rise in unemployment and increase investment intentions. A consumer led recovery could then get underway, aided by greater export competitiveness.

Alternatively, Sterling could re-enter the mechanism shortly after the French referendum at some level which is not considered a devaluation, possibly around DM 2.75 / 2.80. This is non-option since any attempt to return to the parity from which Sterling fell in humiliation would simply introduce the probability of a renewed speculative attack implying that current high real interest rates would be sustained into the medium term with the obvious deleterious effects for the real economy.

An additional headache is the current state of fiscal policy and the excess £14bn spending demands from government departments. (The government's target is £244.5bn). This has special reference to Scotland as the Goshen-Barnett formula (which ensures that the Scottish Office receives 10/85s of approved expenditure on equivalent English programmes) is under threat following a downturn in Scotland's population trend relative to the rest of the UK.

The current economic wisdom advises a further slackening in monetary policy and fiscal rectitude. The combined effect will reduce real interest rates, borrowing costs and provide a much needed stimulus to the UK economy which will then feed into Scotland.

Prospects for the Scottish economy

The ERM devaluation and withdrawal will have conflicting effects on the future growth of the UK and Scottish economies.

On the one hand, the devaluation will help exporters and reduce the value of imports, giving the real economy a much needed boost. This effect could be greater in Scotland given the greater importance of tradeables to the home economy. Economic history confirms that eventually increased inflationary expectations - via higher raw materials prices and wage costs - will erode any competitive gain, but given that average earnings have fallen to a 12 year low (6%) this is unlikely to occur until the medium term when recovery is well under way.

Conversely, while yields on short term bonds have fallen, reflecting the markets belief that interest rates can be cut following the float, yields on long bonds have risen as future inflation is discounted. Rising long term yields will probably result in some downward revisions in investment intentions thereby crowding out some of the demand stimulus provided by a lower exchange rate. This could work to the detriment of Scotland given the concentration of investment goods in production.

On the whole, figures for the last three months are of little relevance now that policy has changed. The events of mid September are likely to have beneficial effects for Scotland and the United Kingdom as monetary policy, given the lower exchange rate, is now much looser than in August.

The appreciation of Sterling vis-a-vis the US dollar will improve the profits of North Sea oil traders,

given that trade is conducted in US dollars, giving a boost to Gross Domestic Product in the fourth quarter of this year. The housing market may start to recover by the beginning of next year as real interest rates fall and house prices begin to increase.

Our short term model is predicting a year on year contraction in production of 1.1% for Scotland in 1992, a larger figure than most forecasts assume for the UK. Undoubtedly the events of September 16, should reduce this figure to just under 1.0% as Scotland is more likely to be one of the first regions to emerge from recession given that the burden of household debt is much less severe here than south of the border. (see Commentary Vol.17 No.3)

18 September 1992