ECONOMIC PERSPECTIVE 1

THE SCOTTISH ECONOMY: 1990-96

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(a) Introduction

The present forecast covers the initial recovery phase from the early 1990s recession and was conducted using the FAI's Medium Term Model (MTM) of the Scottish economy and was prepared in July 1992.

Following this short introduction, the remainder of the paper is in 4 further parts. Section (b) sets out our projections of Scottish final demand. These are purposefully sanguine in order to illustrate the most favourable outcomes likely for Scottish output and employment. These projections are relatively invariant to the recent upheavals in the foreign exchange markets and monetary policy excepting that the new macro profile makes the attainment of this performance more likely. Section (c) sets out our estimates of Scottish output, employment and unemployment for the 1990-96 period. Section (d) discusses how Black Wednesday and subsequent developments are likely to affect the forecast. Our argument is that this forecast is essentially a projection of maximum Scottish growth potential. Devaluation without supply side policy is no panacea. Section (d) sets out our concluding remarks whilst detailed sectoral projections are appended.

Scottish output growth, in real terms, has exceeded that of the UK during the recession. In 1990, Scottish GDP is estimated to have grown by circa 3.0% which compares favourably with that of the UK. In 1991, we estimate Scottish GDP to have declined in real terms by circa 1% which is a considerably less sharp decline than the 2.2% decrease experienced by the UK. Labour market data supports this conclusion with employment declining less and unemployment increasing less than for the UK as a whole. Thus, it is clear that Scotland has come through the recessionary phase of the 1990s cycle more strongly than for the UK.

The reasons for Scotland's better performance are fourfold.

(i) Demand for Scottish goods and services from North Sea markets have grown sharply since the late 1980s.

(ii) Scotland is more export intensive than the rest of the UK which resulted in Scottish firms being more exposed to the relatively buoyant overseas markets than the UK as a whole.

(iii) Scottish consumers' and business did not assume the high levels of gearing evident in other regions of the UK. This is because the Scottish economy did not perform relatively well in the mid to late 1980s in part due to the turndown in North Sea demand in the middle of the decade. Thus, the Scottish personal and corporate sector did not form unrealistic views of the future course of asset prices, product markets and earnings levels on which to base high levels of borrowing. As a result, the Scottish economy did not suffer markedly from the boom and bust monetary policy conducted in the late 1980s. Lower levels of gearing mitigated the falls in consumers' expenditure and fixed investment across the recession. Any rebound in activity will be necessarily weak relative to the more adversely affected UK regions.

(iv) Scottish government consumption increased sharply in both 1990 and 1991 as did public sector employment.

It is thought that the beneficial effects of these factors will dissipate in the coming period and as the UK economy recovers.

(b) The profile of Scottish demand: 1992-96

We project that demand will rally this year but that recovery will become more strongly rooted in 1993. Stronger growth of all key aggregates is expected in the 1993-96 period.

Consumer expenditure is likely to grow by 1.2% this year and by 2.5% in 1993. We project that consumers' expenditure growth will average 2.7% pa in the 1992-96 period. In the short term, expenditure on non-durables and services is relatively strong but demand for durables is not expected to recover until 1994. This is due to continuing uncertainty concerning unemployment and a moderate trend in earnings. In the 1992-96 period, consumers' expenditure on services is likely to average 3.5% pa whilst durable consumption is expected to average circa 4% pa. Growth of non-durable consumption is set to average 2.2% in the 1992-96 period.

Fixed investment has not collapsed in Scotland to the same extent as in the UK. Following a 8.6% decline in 1991 we expect a further decrease of circa 2.2% in real terms this year. Although investment recovers in 1993, the full turnaround is not evident until 1994. In the 1992-96 period, investment growth averages 4.7% pa.

Government expenditure increased sharply in both 1991 and 1992. However, the medium term outlook is not good at either the UK or Scottish level due to a need for government to address the public deficit. Thus, government expenditure is forecast to grow modestly after next year and average 0.6% pa in the 1992-96 period. The case for fiscal stringency is far from obvious at the present time.

Exports to the North Sea sector are expected to peak in 1992 and decline modestly in real terms to the end of the forecast horizon. This year, we project that North Sea demand will grow 1.3% but to decline by 2.3% next year. A modest rally is expected in 1995 but the overall medium term expectation is of a clear moderation in such demand from this quarter.

Overseas exports are projected to grow by 2.8% in 1992 and to recover sharply next year. In the 1992-96 period export growth will average over 5.2% pa. It is the expectation of strong export growth in both Scotland and the UK which provides the basis for growth in the 1993-96 period.

Exports to the UK are thought likely to **decline** by circa 2.6% in real terms in 1992. As the UK economy shows clearer signs of recovery next year, Scottish exports to the UK are projected to increase by 3.1% and average growth of 3.4% thereafter in the 1992-96 period.

Import growth of circa 1.2% is likely this year following a recessionary decline of 5.0% in 1991. In the 1992/96 period, total Scottish imports are likely to increase by an average 3.8%.

(c) The Scottish economy: 1990-96

The aforementioned projections were input into the FAI medium term model of the Scottish economy. Table 1 sets out output growth at the broad sectoral level.

The 1979/90 period constitutes peak to peak activity across the 1980s economic cycle whilst the 1990-96 period may well represent the corresponding phase of the first 1990s cycle. Table 1 indicates that:

- **Scottish GDP** growth is projected to average 1.8% pa in the 1990-96 period which is broadly in line with the experience across the 1980s.
- **Primary** sector output (2.2% pa) is forecast to grow broadly in line with the 1980s performance. However, growth is slowing at the end of the period due to the moderation of Oil and Gas exploration activity.
- **Manufacturing** (2.0% pa) is set to grow at double the annual rate achieved in the 1980s. This is achieved largely by key sectors in export markets.
- **Construction** (2.2% pa) is set to fare well in comparison with the previous decade in which an overall decline of 0.6% pa was evident. This is based on a strong trend of public sector and housing activity across the recession and a recovery of other activity thereafter.
- **Service sector** (1.8% pa) is forecast to be slower than previously due to a weak performance over the present recession. In previous shakeouts the service sector has tended to advance. This time is different. Services activity, particularly in Business, Financial and Personal services, has been over-expanded. In Retailing, there remains significant overcapacity in clothing, electrical goods, food and drink. The present recession will engender a service sector restructuring which is likely to be more modest in Scotland.

The Scottish economy in the first 1990s cycle is expected to be dominated by strong manufacturing growth based upon export activity. The trend in inward investment from both UK and overseas sources is projected to be slower than in the recent period. In the South, the present recession has resulted in:

- large numbers of skilled, professional and managerial unemployed.
- a weak housing market with falling prices and low turnover.
- an overhang of commercial and light industrial property with generous deals available on leases.

The previous difficulties of recruitment and retention of labour have evaporated. In terms of public and private sector dispersal and relocations, the calculations have altered dramatically for both employer and employee alike. Scotland and the North can expect no significant transfers of service jobs from the south East in the present forecasting horizon.

Service sector growth will be more endogenous to the Scottish system. Growth will be grounded upon 4 factors.

- Strong growth of tourist expenditure in the

1994-96 period. Favours transport, hotels and catering.

- Trend in contracting out services by the production industries. Favours business services.

- Trend in contracting out services by the public sector which constitutes transfers between service activities. Favours the non public sector component of SIC Division 9.

- trend in internationalisation of Scottish business. Favours, Transport and Telecommunications as well as specialised hotels and catering services.

However, overall service growth will be adversely affected by the slow growth of public expenditure across the 1990-96 period and the initial weakness of consumption. In addition, it is clear that a wholesale sell off of public assets is underway in response to the mounting budgetary pressures. This is likely to adversely affect the level of service available in transport and postal services.

In manufacturing, Scotland's export oriented industries are projected to prosper in an environment where trade continues to grow 2 to 3 times faster than output. As we will see below, there is a price in terms of employment. In addition, many of these industries are dominated by UK or foreign headquartered companies. In steel, electronics, ceramic products and textiles, we have recent examples of how ostensibly successful Scottish plants can be vulnerable to corporate restructuring and rationalisation. There are specific threats to the whisky industry, aerospace, electronics, chemicals and offshore and certain mechanical engineering activities which could engender weak growth amidst the generally favourable set of export circumstances.

In particular, the peace dividend continues to cast a shadow across Scotland's central belt. The European Fighter Project has become a political aircraft with an auction taking place as to the numbers and technical specifications of the aircraft. Scottish firms were successful in securing contracts for the control radar and missile systems and a cancellation or scaling down of this project could have serious implications for Electronics firms in Fife and Lothian.

Thus, Scottish manufacturing performance is fragile and vulnerable to ongoing corporate and political decisions which are taken outwith Scotland and, in some cases, the UK. This forecast assumes that things go well and can be regarded as defining a profile close to the best possible, but plausible, outcome.

If, as forecast, overseas trade is to be the cornerstone of Scottish and UK growth in the 1990s, then firms will require to improve the efficiency of operations. This is particularly the case in the light of the Single European Market which presages a period of restructuring in sectors central to Scotland's strong manufacturing performance. Thus, with a strong currency, Scottish exporters and their suppliers will require to increase labour productivity within a wider drive to sustain and enhance international competitiveness. Table 2 sets out our projected trends in labour productivity (FTE basis).

Table 2 indicates that, during the recession, productivity growth in all sectors falls sharply as firms hoard labour and under utilise capacity. In some cases, this is during the planning phase of rationalisation. In theory, the recession should punish the most inefficient operators causing exit from industries and activities. This will raise overall sectoral productivity. However, in the early 1980's recession, it was not the case that the most, technically obsolete and over-manned establishments closed. Thus, as growth resumes we expect sharp rises in productivity which will be evident across the whole economy in the 1992-96 period. In some sectors this will be an abrupt process rather than a monotonic trend.

The consequences for employment of the projected growth and productivity trends are set out in Table 3. Across the first 1990s cycle, Scotland is projected to shed circa 73,900 FTEs or 78,200 'real' jobs. In the case of FTEs, this constitutes an annual average decline of 0.8%. All broad sectors are forecast to lose FTEs.

Manufacturing employment declines by circa 40,000 FTEs or by 1.85% pa and accounts for 54.4% of the expected job loss.

In **Services**, employment is expected to fall by circa 17,600 FTEs. The Services shakeout accounts for 28.8% of total FTE loss, the bulk of which occurs in the 1992-96 forecast horizon.

In the **Primary** sector, employment is expected to decline by 7,950 FTEs which constitutes an annual decline of 1.6%. Oil and Gas exploration accounts for a loss of 4,900 FTEs or 65% of the total primary sector fall. This underlines the extent of the expected turndown in North Sea operations and the need to cut costs amidst weak and oversupplied oil markets.

In **Construction**, we project that circa 8,150 FTEs will be lost between 1990 and 1996. However, this subsumes an estimate lost of 17,180 FTEs in the current recession and subsequent offset of 8,130 FTEs thereafter. Across the first 1990s cycle, as a whole, construction FTEs are lost at a rate of 0.9% pa. The loss in terms of 'real' jobs is 8,370.

This employment performance suggests that:

- **Scottish unemployment** will rise from 202,200 in 1990 to peak at 282,350 in 1993. Thereafter, unemployment falls to stand at

255,150 in 1996. Over the cycle, Scottish unemployment is projected to rise by nearly 53,000.

- The **workforce based unemployment rate** increases from 8.2% in 1990 to peak at 11.4% in 1994. At the end of the period we expect the rate to have fallen back to 10.4%.

- The **narrow based unemployment rate** similarly rises from 9.3% to peak at 13.0% in 1994. Thereafter, the rate falls back to stand at 11.9% in 1996.

(d) The implications of recent developments

The forecast set out above was constructed at a time when the £ was in the ERM at a central parity of DM2.95. In the interim period, sterling has left the mechanism, the pound is floating and monetary policy has been relaxed. This will clearly affect the projections outlined above but not unduly.

The present forecast was based around the May 1992 NIESR medium term reference scenario for the UK economy. This forecast assumed that the former ERM medicine both "hurt and worked". In particular, UK firms were successful in making adjustments necessary to remain to the fore in export markets and the NIESR forecast is based upon strong export led growth. In addition, the NIESR forecast of consumers' expenditure in both the short and medium run appeared generous given the likely effects of the former policy on domestic demand. In our view, the UK NIESR forecast is more likely to be validated by the new more favourable macro profile.

The present Scottish forecast, is based upon the sanguine view of the National Institute and represents the best outcome likely for the Scottish economy. In short, this forecast is a projection of Scottish growth potential. The projections subsumes a strong growth in Scottish exports which is not likely to be improved upon by the likely lower exchange rates.

Scottish exports are narrowly based in a small number of sectors which are projected to grow exceptionally quickly. We do not expect this growth to increase at the new exchange rates to a significant extent. The problem for the Scottish economy is how to encourage more export activity in other firms and sectors. Clearly, the macro background is now more favourable although Scottish Enterprise and the LECs have some way to go.

In the UK and Scottish context, devaluation is not a panacea. Strong and coherent policy measures are needed to assist the diversification and internationalisation of the Scottish economy. These will bear fruit, if at all, in the middle of the decade and beyond.

Thus, the new profile of exchange rates and interest rates will make our export and consumption projections more readily attainable. In the medium term output and employment growth may be marginally faster than suggested here. However, the coherence, thrust and implications of the present exercise remain in force. The projections set out above are about the best we are likely to achieve and remain broadly so, post black Wednesday.

(e) Concluding remarks

Unemployment is expected to rise across the 1990-96 period. In addition, the duration of unemployment is likely to increase as displaced manufacturing workers find it difficult to find suitable employment. In 1991, the previous experience of Scotland's unemployed workforce was adversely out of line with the present and likely occupational structure of employment. In particular, the jobless pool was over-represented in unskilled labourers, process operatives and craft related tradesmen. These occupations are projected by IER to decline across the 1990s. The Scottish unemployed were under-represented in the expanding managerial, professional, clerical and secretarial occupations. The process of industrial change across the cycle will increase the length of dole queues and swell the ranks of unwanted blue collar workers. In aggregate, there will be insufficient jobs for the available labour pool. This implies a requirement to reconsider whether a scheme like the former Community Programme is now warranted and whether the financial arrangements for those attempting to shift from blue collar backgrounds to white collar occupations are satisfactory. The formal educational requirements necessary for this transition make ET inappropriate in many cases. Clearly, a shake up of Scottish and UK labour market policy is now becoming urgent and should be addressed by Scottish policy makers.

Table 1 Scottish sectoral growth: 1990-96: % pa				
	90/92	**92/96**	**90/96**	**79/90**
Primary	**2.2**	**2.2**	**2.2**	**2.3**
Manufacturing	**-1.9**	**4.1**	**2.0**	**1.0**
Construction	**-0.6**	**3.5**	**2.2**	**-0.6**
Services	**0.7**	**2.4**	**1.8**	**2.4**
GDP	**0.1**	**2.6**	**1.8**	**1.8**

Source: FAI MTM, Scottish Office

Table 2 Labour productivity: 1990-96: % pa			
	90/92	92/96	90/96
Manufacturing	1.8	4.7	3.7
Non manufacturing	0.7	3.1	2.2
Production	1.5	4.8	3.7
Services	0.4	2.9	2.1
Total output	0.5	3.3	2.4

Table 3 Scottish employment change: 1990-96: FTEs			
	90/92	92/96	90/96
Primary	-960	-6,980	-7,940
Manufacturing	-29,800	-10,410	-40,210
Construction	-17,180	+ 9,050	- 8,130
Services	- 3,470	-14,150	-17,620
Total	-51,410	-22,480	-73,890

Table 4: Output and employment change: 1992-96% pa				
SIC	Description	%	%	FTEs
0	Agriculture	2.5	-1.4	-1,400
1	Energy & Water	2.0	-2.6	-5,580
2	Chemicals & Metals	2.1	-0.6	- 950
3	Engineering	5.2	-0.5	-2,940
4	Other manufacturing	3.4	-1.0	-6,510
5	Construction	3.5	1.9	9,050
6	Dist, Hotels, Catering	2.9	-0.0	- 30
7	Transport & Communications	3.2	-0.3	-1,200
8	Business & Financial	3.8	0.8	4,750
9	Mainly Public Services	0.8	-0.9	-17,670
0-9	Total	2.6	-0.35	-22,480

Appendix

Detailed sectoral outlook: 1992-96

The prospects for output and employment at the SIC digit level are set out in Table 7.

Construction and Business and Financial services are the only 2 divisions projected to experience a rise in employment in this period. The public sector is responsible for the relatively slow services growth and for the lions share of the total FTE loss. Engineering constitutes the fastest growing sector in output terms.

In terms of output change, the leading and lagging activities, based upon the 43 industries in the FAI Medium Term Model are set out in Table 5.

Production industries occupy the top 12 rankings in terms of output growth. The fastest growing service activity is other services which is the non-public element of SIC 9 and which benefits from contracting out of public services to private employers. Public administration and Defence is projected to grow modestly due to budgetary austerity and the peace dividend. Oil and Gas exploration is expected to be the worst performing activity.

Details of employment change for the 36 sectors set out in the FAI Regional employment model were estimated. The 10 leading and lagging industries from this exercise are set out in Table 6.

The construction sector is expected to show the largest overall gain in FTE employment. At present, the labour intensive commercial, residential and industrial sectors are laying off workers whilst large capital intensive projects are supporting output. In the 1992-96 period, the former recover and the latter tends to slow. However, this raises employment in the sector as a whole. Service industries complete the top 5 positions. It should be noted that the employment gains are less than previously forecast and smaller than those projections furnished by other regional forecasters. Shipbuilding benefits due to a rehiring of personnel at GEC Yarrows following a large pay off in the 1990-92 period. The coal industry gains are due to the reopening of Monktonhall and the assumption that Scottish power continues to burn Scottish coal at present levels.

Public Administration, Defence and Social Services are expected to shed 24,129 FTEs in the 1990-96 period. This reflects the peace dividend, contracting out and a sharp rise in public sector productivity induced by budgetary pressure. The turndown in North Sea exploration and development affects the sector directly and induces the bulk of the losses in industrial plant/fabrication. It appears that the likely shock may be greater than posited here. Post and Telecom lose jobs due to ongoing demanning at BT whilst the weakness in Chemicals is mainly due to restructuring and rationalisation at ICI's Scottish sites, most notably at Ardeer. The outcome for Distribution reflects a gain in Wholesaling and a sharp decline in retailing which is over-expanded in many parts of the country.

Table 5

Rank	Industry	Output growth % pa 1992/96
1	Aerospace	6.9
2	Mechanical engineering	6.5
3	Spirits and Whisky	5.3
4	Electrical engineering	5.2
5	Shipbuilding	5.2
6	Computers and Electronics	5.0
7	Paper and Paper products	4.7
8	Oil refining	4.3
9	Other manufacturing	4.2
10	Coal	4.2
34	Agriculture	2.3
35	Gas	2.2
36	Bread and Confectionary	2.1
37	Clothing and Footwear	2.0
38	Fish processing	1.9
39	Other Food and Tobacco	1.9
40	Meat products	1.8
41	Metals and Aluminium	1.4
42	Public Administration and Defence	0.7
43	Oil and Gas exploration	-1.6

Table 6

Rank	Industry	Employment change FTEs
1	Construction	9,051
2	Other services	6,462
3	Other Business services	3,398
4	Banking, Insurance and Finance	1,354
5	Hotels and Catering	796
6	Shipbuilding	312
7	Coal and Coke	309
8	Paper, Printing, Publishing	274
9	Aerospace	98
10	Bricks, Cement	60
27	Drink	- 679
28	Chemicals	- 781
29	Distribution	- 830
30	Post and Telecom	-1,218
31	Agriculture	-1,315
32	Food and Tobacco	-2,272
33	Industrial Plant/Fabrication	-2,565
34	Textiles, Leather, Clothing, Footwear	-3,700
35	Oil and Gas exploration	-4,916
36	Public Administration and Defence	-24,129