Economic Perspective 3

THE EFFECTS OF IRAQ ON THE SCOTTISH ECONOMY

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There seems to be something of a consensus around that the Scottish economy has been performing better than the UK average over the past twelve months or so, is still doing so, and may well go on doing so for a little while yet. This view is reinforced by nearly all the indicators we can lay our hands on - total output, manufacturing output, employment and unemployment, high street sales, property prices. It is of course difficult to pick out where exactly we are at the moment, or when a turning point is or even if it has been reached. Numbers of the available indicators are lagging ones, and nearly all of them are notoriously out of date. But the weight of evidence supports the relative buoyancy view. Our own internally-generated information, which may be rather more timely, also gives support to this view, however. Each month we survey our regions, to get a feel for what is happening in each area. It has been clear that, for some months now, the slowdown has really been biting south of the border. Starting in London and the South East, and gradually spreading outwards, the reports have been of slowdown, downturn and difficulty in many sectors. By contrast, Scotland has remained much more optimistic. Recently some indications of a change in tone can be discerned, but the Scottish reports are only now saying what we heard from England nine months ago.

Given this, what can we expect as a consequence of the Iraqi takeover of Kuwait? First of all, we unfortunately need to make some gigantic political assumptions. Doug McWilliams at the CBI has helpfully sketched out a number of possible options. These envisage, inter alia: -

- A negotiated withdrawal by Iraq which would bring Kuwaiti and Iraqi oil back into world markets. This would be the optimal solution economically and in other ways, but I have to say it seems very unlikely.
- A short and successful, if bloody, war on the part of the allied forces in Saudi Arabia, which would at a minimum restore Kuwaiti supplies, and might even change the regime in Iraq so that Iraqi supplies came back on stream too.
- A prolonged stalemate in situ, waiting until economic sanctions finally produced concessions from Iraq which would release Kuwait.

Either of the latter two, which unfortunately look more likely, have somewhat unfortunate consequences for oil prices - "unfortunate" that is, from the viewpoint of the developed world. The first - successful war - would put at risk Saudi supplies. Even if in the end no damage were done to them (which seems unlikely), market reaction would be to hoist prices. And physical damage would be a racing certainty in Kuwait and Iraq, keeping their supplies shut in for some time. The second would tend, at a minimum, to keep prices where they are now for a long time and perhaps to push them up from time to time depending on market information: how far, or not, sanctions are biting; the likelihood of hostilities; or whether in the end, the world would throw in its hand and leave Saddam Hussein in possession.

I would propose, therefore, that we take as our starting point an assumption that we can probably expect, say, at least a year of "high" oil prices, in the \$35 to \$40 per barrel (pb) range, with the possibility of some brief temporary "spikes" well above that level in the event of hostilities. The longer term implications of the crisis are in my view rather different, as will be seen later. Meanwhile, in examining the short-term consequences of this kind of model, several points stand out:-

- It wouldn't do to get over-excited about these levels of prices. In the first place, it is true that recent price levels, averaging say, $35 pb, represent an increase of 100% over the immediate pre-invasion price of $17.50 pb, and 70% on the January figure. But, compared with the two previous oil shocks this is still pretty small beer. In the space of two weeks in October 1973, prices rose 70%, and twelve weeks later they rose by a further 131%. In the 1979/80 price rise, the increase was 155%, to about the same level as at present in nominal terms.

- Secondly, higher volatility in markets is to be expected now as compared with the 1970s. Effective prices are now influenced much more by spot market prices than by long-term contracts which in turn are influenced more by short-term expectations. Consequently, they are subject to acute but reversible over-reactions, in similar manner to, for example, currency rates.

- Thirdly, if we look at things in real terms, adjusted for inflation, recent prices of some $35 pb, are still worth only a little over 60% of the average for the peak year of 1981. To equal the 1981 price in real terms would require a current price of between $55 pb and $60 pb.

- Fourthly, joint Iraqi/Kuwaiti production amounted to around 4.5m bpd, before the crisis. This is capable in the short-term of being largely made up by other OPEC producers, (mainly Saudi) and they have agreed to raise their daily production. In addition, non-OPEC producers have some scope for higher output. The British North Sea in August had an output level of 1.7m bpd. This is likely to fall over the winter due to maintenance, repair and safety programmes pre-planned, perhaps to 1.4m bpd. But by early in 1991, it should have bounced back, on our estimates, to around 2.2m bpd, producing a net gain of 0.5m bpd. On top of all this are strategic stocks around the world totalling 3,500m barrels, or more on some estimates.

- One is thus led to conclude that the crisis is liveable with - the basic supply/demand position has not altered disastrously. There ought to be a notice above every spot dealer's screen reading, in Large, Green, Friendly letters, "Don't Panic".

- That said, we can expect what I suppose could be called the "Fear Premium" in the price to persist until a settlement of whatever kind is reached in the Gulf. Hence my earlier suggestions of prices persisting in the present range.

So what do we expect for the Scottish economy against this background? We need first to consider the wider effects on our principal markets around the world. Doug McWilliams, Economic Adviser to the CBI, has modelled the effects of the scenarios outlined above and estimated their world economic effects.

His predictions for effects on world growth and inflation on even the worst scenarios are bad, but not desperately dramatic, certainly not on the scale of what we experienced in the 1970s and early 1980s. On the worst possible case, he envisages leaving Iraq in the driving seat for the whole of the Middle East, and in control of all its oil supply. This produces world economic stagnation by 1992 and only a sluggish recovery thereafter. Unemployment in the west could rise from the present 26m to 32m. Inflation would rise to an average of 6% for 1991-93 (as against a current 4%).

On a more likely scenario, a lengthy stand-off, akin to the one outlined above, world growth slows to 1.6% in 1992 from the present 3%, inflation rises to 5.5%. All major economies slow down, with Japan and Western Europe, the biggest importers, doing worst. Even so, world growth recovers after 1992.

A war scenario (assumed very short and successful in every way) causes a sharp rise in inflation, to 7%, and a sharper drop in growth, to slightly negative in 1991-92, but both of these are very brief, and are followed by a striking recovery, to over 5% growth (excellent by historical standards) and "normal" inflation of 4% by 1994.

In the short-run, averaging out these scenarios and settling on figures akin to the middle one, Scotland of course shares to a good degree the fate of the United Kingdom. Here the position is mixed. The UK is currently in a weaker position than the majority of Western European countries. On any scenario, it is going to have to grow much more slowly than average over the next couple of years. ERM entry only emphasises this. An initial rise in inflation caused by oil prices would be taking place from a much higher base than in the rest of Europe. The subsequent slowdown in domestic growth would start from a lower point than in the rest of Europe.

There are two compensations, however. The first relates to government revenues. On a rough rule of thumb, the increase to the mid-30s in the dollar price of oil since July should be worth about an extra £700m or £800m in fiscal year 1991/92. The second relates to the Current Account of the Balance of Payments, where slightly larger annual benefits could be expected to accrue.

For Scotland, neither of these two mean very much, except insofar as they ease fiscal pressures on the UK government and help improve a poor current account position. To that extent, they may contribute to making interest rates lower than they otherwise might have been, and so mitigating the severity of the UK economic recession in 1990/91.

What seem to me more important are the direct effects of the crisis on the Scottish economy. We can group these into bad news and good news. The bad news is that the crisis will, on a net basis, make worse the growth position of the UK as a whole next year. There will be some form of recession. Scotland has so far been shielded, but to the extent that this has been the effects of traditional "lags" - from consumption to investment, in the housing cycle and so on - this is unlikely to continue. Secondly, overseas markets in Europe, the USA and Japan are all likely to grow more slowly next year, and Scotland is still more export-intensive than the UK average, according to available survey data. A further, specific, piece of bad news needs to be added here, in the shape of the trade embargo on Kuwait and Iraq. Scottish Council Survey data do not suggest that these countries are key markets for Scottish exporters. Indeed, they suggest that they are marginal. However, CBI telephone enquiries conducted after the crisis broke suggested that the effect is likely to be bigger than the Scottish Council figures suggest. There appears to be a considerable number of sub-contractors to English and German lead producers who are already beginning to feel the pinch of suspended orders. Unfortunately, this is unquantifiable on any meaningful basis. But it is reasonable to expect that the better performance of the Scottish economy witnessed over the past year or so will tend to converge down towards the average UK performance.

The good news relates to the effect of the crisis on North Sea exploration, development and production activity and associated onshore work. The recovery in North Sea activity since 1987 has already been having a beneficial effect on the entire Scottish economy. It is unlikely that the higher oil prices resulting from the Gulf Crisis will themselves have much of an immediate effect on the North Sea industry over and above present plans, except insofar as they persuade producers to pump as much as they can from existing wells. To make major upgradings in exploration and development plans, operators would have to be convinced of a higher permanent price post-crisis. I think this is not yet the case.

However, looking further ahead than the present crisis and the present price, it seems reasonable to speculate on the likelihood of higher sustainable level of activity. Having been "bitten" three times now by crises arising from the fundamental political instability of the Middle East, it would be surprising if Western governments did not now turn, jointly and severally, to consider means of how in the long-run to marginalise the Middle East as a key source of energy. Moves in this direction of course would include the whole panoply of energy conservation, alternative sources, reconsideration of nuclear programmes and so on. But for those countries with indigenous oil reserves, inducements, probably fiscal, to get more of them out of the ground over the next few years should probably have a high priority. To that extent, special pleading by oil companies and operators to the Department of Energy and HM Treasury should now fall on more receptive ears. Thus, in the short run the Scottish economy is likely to suffer along with the rest of the UK in a situation where the oil price hike merely turns the screw on an existing economic slowdown. However, the medium term picture may be more palatable particularly if greater government incentive is forthcoming to encourage even more intensive exploration, development and production from the North Sea.