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.

Articles accepted for publication *must* be supplied on 3.5 inch or 5.25 inch disks in either WordPerfect or ASCII format.

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QUARTERLY ECONOMIC COMMENTARY

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OUTLOOK AND APPRAISAL

The Scottish Economy: Short term economic trends

The level of activity in the Scottish Manufacturing sector remains, to some extent, at the mercy of the United States and the European Community.

Growth has been very slow in both markets and the latter is expected - by the IMF - to contract by around 2% in 1993. The IMF had been forecasting EC growth of 2% but the tussles over the ERM have led to forecasts being revised downwards by 4% points.

Given the stagnant state of the world export markets, what is the current state of the Scottish economy?

The latest index of production for the first quarter 1993 contains quite a few revisions. Figures for the fourth quarter 1992 which had previously indicated a quarterly rise of 4.7% have been revised downwards and figures for the previous three revised up. The production industry is now estimated to have grown by only 2.2% in the fourth quarter 1992, leaving the annual growth rate at -0.5% compared with 0.4% in the United Kingdom economy.

The new data set calculates that the production sector grew by 1.9% in the first three months of this year; very encouraging news given that the UK industry only managed 0.2% growth. Within production, the boom sectors were Transport equipment, Electrical & Instrument Engineering and Energy & Water Supply. which grew by 17%, 8% and 2.9% respectively.

Unfortunately for Scotland, though, the manner in which the two economies are growing gives us some cause for concern. The UK production sector appears to have *green shoots* appearing in all sectors of production other than Mechanical engineering and Energy & Water Supply whereas growth in Scotland remains dependent on a few sectors - Electronics and Transport equipment. This is borne out by looking at the annualized figures - the latest four quarters compared with the previous four - which show a contraction in all Scottish production sectors other than these two. In the UK economy - while growth is pretty flaccid - there are signs that recovery is more stable and broadly based.

One could argue, quite naturally, that in the first quarter 1993, the UK recovery was by no means a certainty and therefore the northern regions would take time to emulate the greater optimism reported in the south of the country. Evidence from the July SCBS partly supports this viewpoint. Manufacturing optimism rose throughout the first half of this year. In the first and second quarters, the trend in new orders and sales in the Manufacturing sector rose in both the Scottish and Rest UK markets. Investment intentions were revised upwards in manufacturing, distribution & tourism sectors. The level of stocks in the manufacturing sector fell again and the rate of labour shedding appeared to recede. These factors all point to a resurgence of activity which gathered momentum as the year progressed.

One final aspect leads us to think that recovery is under way, except that it is not impacting in Scotland as readily as in the south. The July 1993 **seasonally unadjusted** unemployment figures revealed a very interesting pattern. The size of the rise in the number of female unemployed rose steadily with distance from the south east. The rise in the number of unadjusted female unemployed rose by 15% in Scotland and by only 4% on average in the southern regions.

Now, it is quite plausible to argue that this reflects a rising level of consumer confidence in the United Kingdom retail sector since better economic news is likely to bring women back into the job market in search of work. Since the south produces the majority of vacancies in the first phase of an upswing the largest number of successful applicants will be there. Consequently, such a huge jump in the number of unemployed which occurred in Scotland could be construed as evidence that the unemployed are becoming more confident of finding work and are making themselves economically active. The forces of economic recovery are at work.

The labour market position in general is still much healthier in Scotland than the GB or UK markets. In July 1993, seasonally adjusted claimant unemployment - the more news-worthy count - rose by 2100 or 2.1%. This left Scotland with 9.7% of the workforce unemployed compared with 10.4% in the UK. In fact this was the largest monthly rise in the count since December 1992 - unemployment had fallen in February, March and May. Table 5 in the Labour market section shows that the six monthly average trend in unemployment is falling. That said, a rise of 1% would put us back on a rising trend. Table 4 - in the same section - shows that inflows and outflows are of the same magnitude and therefore reflect a large amount of slackness in the labour market.

The United Kingdom: Short term economic trends

For the first time it is possible to begin by confidently stating that the UK recession is finally over. The economy - while understandably weak given the uncertainty over unemployment, household debt burdens, the budget deficit and weak export markets - grew by 0.3% in the fourth quarter 1992, 0.5% in the first of this year and is provisionally estimated to have expanded by 0.5%.

Over the year to end June the UK economy is estimated to have grown by about 1.5%. If this growth path continues then we can expect an annual expansion of about 1.5% - 1.75% in the current year. This is in the region of the latest Treasury forecast but is also close to the forecast for 1993 made in February of this year by the National Institute for Economic and Social Research.

Current short-term trends reveal what can only be regarded as the first signs of recovery, nothing fully fledged as yet. Industrial production rose by 1.5% in the first quarter. In the second it fell back to only 0.8%. In the same period Manufacturing output rose by 1.4% and the Service sector by 0.5%, although this latter figure is a provisional estimate.

Retail information provided by the CBI suggest that sales are continuing to rise, steadily as opposed to rapidly. Consumer credit rose by £400m in the first quarter, up £174 on the fourth quarter. The savings ratio fell by 1% percentage point in the first quarter to stand at 10.3% and the latest consumer confidence survey suggests that confidence is rising again. In addition, average weekly earnings growth remains subdued. In May 1993 the CSO estimated annual wage inflation of only 3.75% compared with 4% in the year to April.

On the downside there are many indications that the recovery is precarious. Real investment growth, as detailed in *The British Economy* section, is still patchy - even with lowest nominal interest rates for many years. House prices are still very weak. Provisional estimates for the year to July suggest that prices have fallen by 3% in the UK market. The Balance of Payments deficit, a prime example of structural weakness in the UK economy, continues to widen. In the first quarter, the trade deficit rose from £4.05bn in the fourth quarter to £4.35bn in the first 1993.

The Labour Market: Falling unemployment?

The seasonally adjusted count rose for the first time in five months in July, leaving 2,912,200 or 10.4% of the workforce officially unemployed. After five very strange months of unemployment behaving like a co-incident indicator, the labour market reverted to behaviour historically consistent with this stage of the economic cycle.

Why was there a drop in the seasonally adjusted level of unemployment? Has there been any change in the behaviour of the labour market?

On the first count there are a number of possible reasons why unemployment fell in February to June 1993. These can be grouped into two camps; those concerned with the workings of the market and the interaction between supply and demand and those that seek to imply that the Employment Department has been indulging in some form of numerical massaging.

Those advocating the labour market explanation provide a fourfold reason for the drop in unemployment. One: the drop in the count could be explained by an increase in labour demand resulting from more favourable economic conditions. The withdrawal of Sterling from the ERM could have resulted in over sacking as employers became increasingly gloomy about the short to medium-term prospects. Two: the recovery in activity seemed to be coinciding with a fall in the growth of the labour force. According to the Employment Policy Institute the labour force is expected to shrink by about 100,000 between mid-1992 and mid-1993. This would certainly reduce the upward pressure on unemployment as the number of potential claimants would automatically fall. Three: labour market reforms introduced in the mid 1980s reduced hiring and firing costs to employers to the extent that they could fire employees more freely in the recessionary cycle and re-employ sooner in the upswing. In other words the labour market reforms had reduced labour hoarding and made the behaviour of the labour market more co-incident with activity. Four: the fall in wage inflation has led some commentators to argue that employees are now pricing themselves into employment.

Others have tried to argue that the actual unemployment numbers have been distorted in two ways. One: the managers of job centres could have been attempting to meet year-end performance targets by refusing benefits to new claimants. Two: The medical service could have been extending - informally - the scope for invalidity benefit, thereby reducing the number of people eligible for unemployment benefit.

On the whole, the picture is quite clouded because we cannot say whether employment grew in the relevant period. Unfortunately, the data will not become available until later in September. With that in mind, the most likely reason for the fall in claims is a combination of the labour market theories. The conspiracy theories do not really hold water, for two reasons, suggested by the Employment Policy Institute. Firstly, the invalidity benefit argument would require an increase in the out-flow rate at the time. In fact, it was the in-flow rate which dropped. Secondly, the performance-target theory would imply that unemployment started rising again after the end of the financial year. Since it did not, consistently for three months, the theory is not credible.

On the whole it seems likely that the behaviour of the UK labour market, in the first half of 1993, can be explained entirely in terms of labour market arguments. Those arguments couched in terms of demand and supply factors are very plausible - and the most likely since they occurred at the same time as unemployment began to fall - and the flexibility argument is a reasonably plausible complement.

Prospects for the Scottish economy

In the current quarter the short term prospects for the economy are generally thought to be slightly better than in the three months to June. This comes mostly from the Rest of UK market rather than the sluggish world economy, although we are holding out for a world recovery in the not too distant future. In the rest of the UK, increased levels of consumer confidence, renewed UK import demand for Scottish products and low inflation provide a welcome platform for expansion in the short term.

In Scotland, the general economic climate should be more healthy than in the south of the country since there is a much smaller level of personal debt and house prices are continuing to rise, unlike in the UK. From this position we should see a continuation of the upward trend in retail sales and personal advances which were reported in the first and second quarter by the Scottish Chambers Business Survey.

In the medium term what we need to discuss - rather than the ubiquitous subjects of the budget deficit and the likelihood of another balance of payments crisis - is the need for an adequate training and industrial policy, one which will not lower productivity and reduce the potential for growth in the UK. What is at issue here are two things.

Firstly, do we have an adequate education and training policy in this country to deal with the rapidly increasing levels of technology at use in production? A series of studies[1] have suggested that there is a skills deficiency in the United Kingdom, one which could be eradicated and one which was responsible for lowering productivity in the 1980s in the United Kingdom relative to its potential. If the workforce is not adequately trained not then this may preclude the introduction of new technology which would have increased productivity. This is a more satisfactory approach than attempting to make the labour market more flexible, so reducing the skills level to the lowest common denominator.

The second question facing the UK is the size of the output gap - the amount that the economy can grow before there is a resurgence in inflation. Estimates[2] of its size range from 2% to 8%. If long-term unemployment continues to rise in the near future then the size of those estimates at the lower end will be more in tune with reality, since workers skills depreciate when they are not being used in the workplace. That would mean we have two, maybe three years before interest rates must rise again to quell inflationary pressures.

To counter this, an adequate training policy coupled with an industrial policy which promotes investment for Research and Development in industries which are seeking to break into new markets would certainly help to provide a more stable platform for medium-term growth and prosperity.

Our short-term forecast for the Scottish Production industry predicts growth of 2.9% in 1993. This is a substantial upward revision, and the reason for this is two fold. Firstly, the data revisions contained in the latest Index of Production show that growth in the first three months of last year was even lower than previously thought. This will automatically make this years growth figures look better. Secondly, UK data released since the last Commentary makes us more optimistic about the Scottish economy in the short term.

The major assumption that underlines this forecast is the belief that the world economy will start to recover. Interest rate reductions in Frankfurt would go a long way to helping the Scottish economy.

Notes:

1. O'Mahony (1992) - suggests that eradicating the skills gap between the UK and Germany could reduce the productivity gap between the two countries by some 4% to 20%, depending on how the skills acquisition is measured.

   Haskel & Martin (1993) firstly document the magnitude of skills shortages in the UK and go on to estimate their effects on productivity growth. Their results suggest that annual productivity growth could have been 10% higher, per annum, in the period 1980 - 1989 had there not been a shortage of skilled labour.

2. Bank of England Quarterly Review - August 1993

References:

M O'Mahony - 'Productivity and human capital formation in UK and German manufacturing' - National Institute for Economic and Social Research Discussion Paper No. 28, October 1992

J Haskel & C Martin - 'Skills shortages, productivity growth and wage inflation in UK manufacturing' - Paper presented to the Centre for Economic Policy Research on 'The Skills Gap and Economic Activity,' 19-20 April 1993