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

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OUTLOOK AND APPRAISAL

The United Kingdom economy grew by 2% in 1993. The Scottish performance was less prolific and the effects of the 1993 budgets will continue to depress growth in 1994 and 1995.

The UK economy remains the driving force behind Scotland's potential for 1994. As we have documented in the past, the South East and London regions are dominant in determining the speed of recovery throughout the UK. Activity is focused in the south and gradually emanates northwards as confidence rises and that is why the economic cycle in the south is much more violent. Energy dissipates with distance from the source.

The latest UK evidence is supportive of the non-inflationary but very slow recovery perspective. In the fourth quarter 1993 real Gross Domestic Product - including oil and gas - grew by 0.8%, leaving the year on year increase at 2%, exactly the figure that had been predicted by the National Institute for Economic and Social Research. Most other forecasters were expecting growth of much less, and some of a more monetarist persuasion had been expecting GDP to grow by only 0.2% in 1993.

As we outlined in the Economic Background section, the recovery to date has been at its strongest in the service sector; hence most activity to date has been in expenditure by consumers rather than investment designed to expand the productive capacity of manufacturing industry - real inflation adjusted interest rates in the UK are still at European levels. Consumers' expenditure rose by 3% over the year and retail sales volume rose for the six consecutive month despite the personal sector still facing the threat of negative equity and the potential that unemployment will start rising again[1].

One area where a much needed improvement has occurred is in the export market where - as you would expect from a competitive devaluation - the trend in the trade deficit has eased off. One would expect this to happen since a lower exchange rate and low inflation relative to other countries will boost the competitiveness of UK exports. But even so, this is a very welcome sign for those who worry about balance of payments constrained growth.

The UK labour market continues to confound those held in authority. After nine falls from the 2.98m peak of January 1993 - the exceptions being July and August - the market again registered a rise of 15,000 in January of this year. But how can falling unemployment before Christmas and the rise the January count be explained. What is the relationship between manufacturing and service employment trends?

The latest employment figures relate to the third quarter of last year and they provide a feasible story. In the second and third quarters, service sector employment rose heavily and manufacturing employment continued to fall. The resulting balance was a rise in the outflow rate and a fall in the unemployment count. But since Christmas, employment in both the manufacturing and service sectors has fallen and the overall level of unemployment has subsequently risen.

The Scottish Economy

The erratic behaviour of the Scottish manufacturing and construction sectors continued into the third quarter 1993. In the first six months of the year output in the manufacturing sector had fallen by over 3%. Judging by the most recent evidence to come from the Scottish Office there was a fantastic turn around in fortunes in the three months to September. According to the new index released in mid-February - measured at 1990 prices and incorporating the new 1992 standard industrial classifications - manufacturing output rose by 5%. Construction output followed the usual trendless path and fell by 2.2% in the third. In the year to the fourth quarter it grew by 3.6%. Production rose by 4.5% or by 1.3% in the year to the end of September.

A review of the index of manufacturing output for the third quarter 1993 leads to a more confident statement on the state of the economy. In the previous two editorials the Institute noted that recovery in Scotland seemed very asymmetric - biased towards the electronics industry and little growth in evidence elsewhere. But by the autumn of last year the recovery was beginning to spread into other sectors of manufacturing. Refined Petroleum products and nuclear fuel output grew by 9% over the quarter, although this was a significant slowdown from the 25% recorded for the second quarter. Electrical and Instrument engineering grew by 11%. Within manufacturing, the only sectors which did not register positive growth were the drinks industry (0%) and transport equipment (-1%).

On the longer time period, the performance of the Scottish manufacturing sector has improved and overtaken the United Kingdom economy. The standard means of comparison are the growth of the latest fourth quarters over the previous four. On this basis the UK sector grew by 1.5% to the third quarter while the Scottish industry grew by 2%. But cynics will already have noticed that this outcome is entirely the result of the electronics sector. At a lower level of disaggregation, the electronics sector is the only one which has outperformed its UK counterpart, not quite the original rosy picture. However, this is just the evidence for the manufacturing sector. What of the whole Scottish economy?

In order to look at all the sectors the only contemporary source of information is survey based and comes in the guise of the Scottish Chambers Business Survey and the various publications from the Confederation of British Industry. Both are telling the same story. Growth in Scotland is less prolific than in the UK.

The SCBS databank provides information on the trend in optimism, demand, investment and employment. The results of the latest two surveys, covering the third and fourth quarters, show that optimism has been rising in all sectors other than retailing. Ironically, at the end of 1993, it was the construction sector which experienced the sharpest rise in confidence. Information on the other three indicators show that - with the exception of retailing - demand conditions improved in the latter half of 1993 and manufacturers continued to run down stock levels in an attempt to meet their requirements. Looking forward, there was also evidence from the SCBS databank that operators were increasing investment in plant and machinery in an attempt to increase efficiency and their productive capacity. So, there are signs of life in all sectors, it's just not as bright as the South of England.

But why is non-electronics growth in Scotland less than in the United Kingdom. Given the already documented fact[2] that Scotland is one of the last-in-last-out-of-recession regions, we have identified three reasons for the poor performance of the Scottish economy.

Firstly, Scotland is 24% more export orientated than the UK and its main market, the European Union, languished in recession throughout 1993. The OECD has estimated that the EU economy contracted, for the first time since 1975, by 0.3%. The main reason of course is the strict monetary example being set by the Bundesbank in Germany. Targeting money supply is an imprecise business at the best of times - and liable to break down once a specific instrument is targeted - but German M3 has become the pulse of Europe. Secondly, the rebound in oil production following the price collapse of 1986 and post Piper Alpha investment led to a rise in demand in the late 1980s. Demand peaked in 1992 but now it has fallen away, leaving the Grampian economy in the same position as the rest of Scotland. Thirdly, the housing market remained buoyant in 1992 and 1993 when the south faced the threat of negative equity and receivership. In the third quarter 1993 house prices began to fall in Scotland for the first time, in the 1990s, and contributed to the financial worries facing Scots. Taken together, these factors represent a severe impediment to the short term fortunes of the Scottish economy, not with standing the effects that the new financial year might bring.

Of course, it could also be argued that, because Scottish unemployment continued to rise for longer than the UK in early-mid 1980s, the threat of job insecurity and the subsequent depressing effect on consumer spending plans might be greater at present in Scotland than in the south where there are clear signs of improvement in labour market fortunes.

The outlook for Scotland

It's nearly April and the new financial year is looming. What are the most important factors which will shape growth in the next year - or two?

Firstly, there is the effect of the rise in VAT and excise duties on consumer and business confidence. In April, at the start of the new tax year, the new VAT legislation covering fuel and heating bills will come into effect. Consumers will face higher heating bills in the winter months - although the government has promised to issue compensation to the needy. Whether compensation will be allocated on an equal basis or whether it is weighted towards the most needy remains to be seen.

Secondly, government expenditure for fiscal years 1994 and 1995 has been reigned back and defence spending is the most significant loser in the case of Scotland. There are three directions in which this will affect Scotland. The 1994/95 Defence budget will be cut by 3.5% and once again arouses fears for the naval base at Rosyth and other Scottish operations. The proportionally larger Public sector in Scotland will suffer heavily - in both a pecuniary and psychological sense - from the austerity of government plans for pay bargaining. Furthermore, the government spending cut backs will have a disproportionate effect in Scotland since there is a higher incidence of long term sickness and invalidity benefits.

Thirdly, the effects of lower lending rates since Sterling left the ERM should begin to feed through into a greater demand for credit - provided conditions in the housing market begin to improve - given that monetary policy acts with lag of one to two years. Whether credit demand will rise in 1994 or in 1995 will depend entirely confidence in economic policy making and the movement in interest rates. Since February's peculiar 0.25% cut most commentators are expecting the next interest rate movement to be upwards. In addition, it seems very unlikely, now that US rates are beginning to rise, that the Bank of England will allow an interest rate cut and risk a further bout of stop-go inflation. But full effects of cutting interest rates from double figures to 5.25% have yet to come through.

Lastly, the international climate is looking much more healthy for Scottish exporters. The rejuvenation of the European economy will continue as Germany reduces interest rates and December's GATT agreement will enhance the prospects for whisky and textiles manufacturers.

On the whole, the short term outlook for Scotland is dependent on a two-way set of counteracting forces. Growth will expand with an improvement in the international climate and the effects of lower interest rates should boost credit demand now that interest rates, on debt, have reached the lowest levels for decades. But, especially in Scotland where climatic factors have to be considered, the result of higher taxation on household heating bills and a pessimistic outlook for the public and defence sectors will serve to depress GDP growth in Scotland below that of the UK for the next two years. The 1993 budget measures have already depressed consumer spending - especially in Scotland - and they will reduce UK GDP growth by up to 0.5% in 1994 compared with a scenario in which they were absent.

The short-term forecast is predicting that the manufacturing sector grew by around 2.2% in 1993 after contracting by 1.9% in 1992. In 1992 and 1993, the UK industry registered growth rates of -0.8% and 1.9%. Over 1994, the sector should grow by 3.3% as recovery drifts north from its epicentre in the South, where there has been a sharp rise in service sector vacancies in recent months. For 1994, manufacturing will be the fastest growing sector in Scotland. For the other sectors - Construction and Services - we are expecting variable performances. Construction will contract by anything up to half of one percent, the result of declining private sector orders and the expected cut back in government spending. The service sector will expand by just under 2% with only business and financial services growing at over 2.5%.

We are also expecting to see around 20,000 more unemployed by the end of 1994 as the Scottish labour market adjusts to maintain its competitive position in the UK and international markets. This will represent a rate of 10.1% of the workforce. The largest declines will in be services which will lose over 11,000 jobs and manufacturing which is expected to reduce its workforce by between 4,500 and 5,500.

In the medium term, the most important factors affecting Scotland are inflationary expectations and investment in R&D expenditure and training. We have already outlined the need for greater investment in the September 1993 issue of the *Quarterly Economic Commentary* and in our view the problem remains of primary importance if Scotland is to maintain its low unit wage costs and compete in world markets which are increasingly being dominated by the low cost countries of the Pacific Rim. On the inflation front, we should expect to see a rise in average earnings as pay rounds seek to gain compensation for higher indirect taxes and national insurance contributions. This will lead to a higher rate of inflation and trigger further higher interest rates to offset any rise in expectations which would have further deleterious effects in the labour market.

The outlook for 1995 and beyond depends on investment expenditure, the outcome of the budgetary adjustments changes taken in 1993 and the effects of greater world competition following the GATT trade agreement of December 1993.

Notes:

1. Consumer's worries were on display in the results of the recent Gallup poll, in the Daily Telegraph, where over 50% of respondents felt that the economic situation was not about to get manifestly better, and that it was perfectly feasible that things might actually get worse - a reference to more than just the impending tax and excise duty hikes pencilled in for April..

2. See *Quarterly Economic Commentary* - December 1992