
THE ECONOMIC BACKGROUND

THE INTERNATIONAL ENVIRONMENT

The outlook for world growth

The outlook for the economies of Scotland's trading partners continues to be bright. Recovery in the OECD area is gaining strength and growth of 2.6% is expected this year following a 1.2% rise in 1993. The English speaking economies are exhibiting the strongest recoveries due to the fact that these economies tended to overheat earlier and more severely than in Japan and Europe. At present, continental Europe is behind the US, UK, Canada and Australia in recovery but all countries have passed the trough of recession and are expected to perform strongly in 1995 and beyond.

World GDP is estimated to have grown by 2¼-2½% last year. This is significantly faster than in the OECD area reflecting strong performances in the Pacific Rim and Latin America. In Asia, GDP grew by circa 6½% last year and growth of 7% is likely this year. In Central & South America, GDP grew by 5¼% in 1993 but is expected to moderate this year to circa 4% pa. These regions have been little affected by the recessionary pressure facing the developed nations since 1990.

The present weakness in the European and Japanese systems is responsible for the moderation in world trade last year. In volume terms, the OECD estimate that global trade grew by 3.3% last year following a 5% rise in 1992. Intra OECD trade collapsed and declined by ½% whilst OECD exports to other regions grew by 8.6%. Imports into the OECD grew by 7.4%. Although exports out of the OECD region are likely to remain strong this year and beyond, it is the recovery of intra OECD trade which provides the motor of recovery in the coming period. Faster OECD growth is expected to engender a growth in internal trade of 5% this year and 6¼% in 1995. Growth of imports from other regions is projected to accelerate in the coming period.

The recently published Scottish input-output tables for 1989, suggest that 10.2% of Scottish output is placed in the rest of the UK whilst 7% is sold overseas. In the case of manufactures, 36% of output is destined for south of the Border whilst

33.1% is exported overseas. The most recent SCDI estimates indicate that 58.7% of Scottish manufacturing exports are destined for the European Union with a further 7.6% due to the EFTA area. North America accounts for 13.3% and the Far East 10.8%.

The growth profile for Scotland's major trading partners is set out in Table 1. This sets out the protracted recession and weak recovery experienced by the UK in the 1990-1993 period. Continental Europe remained in recession, with output declining by 0.4%. The OECD estimate that the volumes of goods and services imported by the EU member states fell by 4¼% last year as domestic demand fell by 1¾%. EU private and public consumption stagnated growing by 0.1% and 0.2% respectively. Fixed investment declined by 5% with business investment declining by 10% and residential investment by 1%. The level of stocks contracted by circa ½% of GDP.

This weakness in domestic demand was partially offset by a ¾% growth in goods and services. Those countries, such as the UK, Italy, Spain, Sweden and Finland, whose currencies depreciated against the ECU post White Wednesday experienced a 7¼% increase in exports with particularly strong growth in shipments to non Europe OECD countries and the Pacific Rim. This is largely due to the continuing strength of the yen. Those countries whose currencies remained linked together and thus appreciated, saw exports decline by 4¼%. This is despite strong but less impressive exports to more buoyant non EU markets. The data suggests that intra EU trade slumped dramatically but that the depreciators gained share at the expense of the large continental economies.

UK exports grew by 3.1% in 1993 which is less than the average of depreciating countries. UK domestic demand grew by 1½% largely inspired by a 2½% increase in consumers expenditure as UK investment and Government consumption remained weak. Placing this alongside the poor situation in key EU markets does not conjure up a backdrop against which an export oriented region such as Scotland was likely to thrive. With the exception of Electronics and Textiles, all Scottish manufacturing sectors are performing weakly relative to the UK in

recovery, if any recovery is evident. Fortunately, the outlook for this year and next is significantly better. OECD GDP is expected to grow by 2.6% this year and by 2.9% in 1995 with recovery becoming more firmly rooted in Europe. This year, EU growth is expected to be circa 2% accelerating to 2¾% next year due to the presently loose stance of monetary policy. Domestic demand is expected to grow 1¼% in 1994 and 2.6% in 1995 as increasing consumer and business confidence engenders stronger expenditure trends. However, the mainspring of recovery in Europe is expected to be exports which are projected to grow by 5¾% this year and by 7% in 1995.

This investment-export led growth in Europe will engender faster growth in intra EU trade which is likely to pick up considerably from the 2nd half of 1994 onwards. In 1994, we expect that the combined import volumes of EU countries will rise by 3¾ and by 6.1% in 1995. These volumes are likely to comprise a lower levels from non EC sources due largely to the displacement of US and Japanese imports by domestic production and higher levels of imports from EU partners. The former is due to a booming US domestic market which is sucking in imports, leaving little capacity with which to serve external markets whilst the latter reflects a reduction in Japanese competitiveness due to an appreciating yen.

Thus, import volume growth due to intra EU trade is likely to be significantly faster than the projected rise in import volumes. It is our confident expectation that Scottish business is well placed to benefit within such an environment. Recent evidence suggests that UK productivity levels remain below that of Europe. However, in exporting sectors we estimate that Scottish manufacturers are extremely competitive in the EU context. Thus, when key UK and export markets recover from mid 1994 on, we expect that the demand for Scottish traded goods will expand and that Scottish manufacturers will increasingly take advantage of these opportunities.

The outlook for world inflation

Table 2 sets out the recent and projected inflation performance in the G7 bloc, the EU and in 5 major economies. As pointed out in the last Commentary, the English speaking economies tended to overheat first and go into policy induced recession before continental Europe whose recessions were more due to rises in interest rates transmitted by German borrowing to finance the underestimated costs of re-

unification. At present, inflation rates have converged around a new low global rate of circa 3%.

We set out a variant of what has become known as the 'rosy scenario' in which most countries experience fast growth and low inflation in the forthcoming period. We analysed the likely trend in oil and commodity prices concluding that rising world output would raise demand and prices, particularly for metals and oil, and that this posed some threat to medium term price stability. In the short term, we suggested that sizeable output gaps and high unemployment would moderate inflationary pressure implying that margins and earnings growth would remain weak. Our broad conclusion was that policy would have to tighten in anticipation of inflationary pressure in 1996 and beyond when economies would be working close to potential and that 'stable inflation will continue to demand unspectacular growth and high unemployment.'

We have no strong reason to change our basic analysis. The lag between changes in monetary policy and aggregate demand appears to vary both across countries and for a given country in different situations. It is likely to be of the order of 15-30 months. This suggests that the period of declining nominal interest rates is drawing to a close. For those English speaking economies whose recoveries are well underway, the pressure on interest rates is already evident. In Japan and continental Europe, interest rate rises are a more distant prospect.

The recent rise in long term bond prices gives some indication of where the inflationary risk is felt to be greatest. Long term rates are the average of expected future short term rates. If real returns, inflation or both are expected to increase across the long term then one might expect to see long rates increasing relative to short rates. In addition, long rates may rise because of increased uncertainty about the future course and conduct of macro policy stance or because the dynamic properties of an economy are not well understood following structural change.

Long term rates began to rise in the US in October and elsewhere in January. Analysis by the OECD suggests that the general rise is best viewed as two consecutive phases. From January to March there was a generalised and well correlated rise in long yields. From that point on there has been regional divergence. In general the largest swings in long yields are evident in the English speaking

economies which are ahead in recovery and in Sweden which is experiencing fast export led growth on the basis of a 20% devaluation of the Krona in late 1992. Two things require explanation. First, why have the markets chosen to increase bond yields since the beginning of the year. Second, is there any consistent message in the differential effect visited upon the global markets.

According to NIESR, the rise in long rates reflects both a re-assessment of inflationary risk and of likely real interest rates. Central to this view is the argument that the output gap has been significantly overstated by both the IMF and the OECD in the December 1993 Economic Outlook. The output gap is the difference between actual and potential GDP and is used in assessments of how quickly growth can develop without engendering inflationary overheating. It is usually expressed as a proportion of potential GDP. Potential GDP is extrapolated from the peak of the cycle by rolling forward peak output according to the actual GDP growth experienced over the previous cycle(s). There are various ways of doing this none of which are perfect, leading to varying estimates. Until recently these output gaps were thought to be extensive outside the USA.

In 1993, the US output gap was estimated by both the IMF and OECD to be circa ¾%. In Japan, both place the gap at circa 4½% whilst the assessments of the UK provide figures of 5¼-5½%. The estimates of the gaps evident in continental Europe diverge more substantially. The German gap is estimated by the IMF at 2¾% whilst the OECD estimate is 0.6%. In France, the IMF predict a 4% gap compared with a 5½% estimate by the OECD whilst, in Italy, the gap is put at 3¾% by the former and 4.1% by the latter. NIESR note that recent OECD projections imply that output gaps are significantly lower in both Europe and Japan.

The recent OECD estimates use a further method of assessing trend output and imply that the output gap in Germany was zero last year and North America is less than 1%. In Japan, the gap is circa ½% and about 2% in France and Italy. The UK has the biggest gap of 2½-3%. NIESR report that their in house assessment supports the view that the previous IMF and OECD estimates were 'optimistic' and argue that it is this revision of output gaps which is driving the upward trend in long rates.

Uncertainty about the true level of the output gap and a growing belief that economies were closer to full capacity than previously supposed would affect

both the inflation and real returns components of long bond yields. If output gaps are low, then the inflationary implications of present growth trends are understated. Indeed, even if the markets retain IMF and prior OECD estimates as their broad assessment, increased uncertainty about the mid point would similarly induce a risk premium in long yields. If output gap estimates are lowered then present and projected fiscal deficits contain a greater structural element and a lower cyclical component which implies higher future interest rates than previously supposed.

If revision of output gaps accounts for the general upwards trend in long rates, it is a short step to arguing that the pattern of revision reflects a rational re-assessment of the differing prospects for individual economies. NIESR concludes that better estimates of this gap are required in order to inform evaluation of the fiscal stance and of macro policy and attempts no such exercise. An adjustment of the size of the output gap is only one factor.

In general, the pattern of long rate movements seems to favour economies with a favourable and credible counter inflationary record. The upward swings are greater in the English speaking countries who engaged in unwarranted monetary and fiscal expansions in the late 1980s and in countries such as Sweden and the UK who experienced substantial currency depreciations in the period around White Wednesday. Although these countries are experiencing recovery there is little sign of short term inflationary pressure. What may be worrying the markets is the capacity of policy makers to choke off medium term inflationary potential by taking sufficient steps early enough to minimise cyclical fluctuations. Such assessments are likely to consider how much scope given politicians have to engage in pre-election booms and how seriously their commitment to long run price stability will fare along the electoral cycle.

This is the worrying message for the Conservative government in the UK. The UK has one of the lowest debt to GDP ratios in the industrialised world and according to the OECD the UK public finances appear to be on "a sustainable medium term path" following the recent tax increases. There is presently a loose monetary policy over which politicians exercise considerable influence and a portmanteau of monetary, inflation and exchange rate targets. The UK output gap, although revised downwards remains high and there is little scope for arguing that this effect accounts for the whole of the long rate adjustment. Following the fiscal

binge prior to the 1992 election and the perceived failure to maintain parity with the DM it is apparent that a the revision in the extent of output gaps have concentrated the minds of the markets upon the credibility of policymakers and that the UK government has been found wanting.

In addition, markets will take account of whether the economy in question is inherently inflation prone. In the context of the UK this involves separating out the issue of whether UK bargaining institutions are more likely to deliver greater upward pressure on settlements whatever the stance of policy. Irresponsible monetary policy may feed a wage price spiral but it is the institutional features of the system which determine the pace at which wages and prices are bid up. Markets looking at recent events may conclude that the UK is simply inflation prone and demand a higher risk premium. Again this would be an unflattering comment on 15 years of Conservative labour market reform. It would also suggest the need for structural reform encompassing co-ordinated pay bargaining taking place within a structured national assessment.

A popular interpretation of the UK swing in long rates and the recent rise in base rates is that the credibility the government seeks can only be restored by returning to the ERM and maintaining a clear exchange rate target as an visible external discipline. This may indeed be the view subscribed to by the markets. However, since the advent of the Bretton-Woods system the UK has maintained a high exchange rate as a prime objective of policy and has manipulated the real economy in order to maintain parity. A strong anti inflation culture did not arise in the UK. Perhaps before any rush to return to the rock of a formal exchange rate target, emphasis on policies to improve internal discipline might be appropriate. This would imply consideration of the reform of pay bargaining as outlined above and whether the UK central bank needs to be more free from direct political control.

Due to the pessimistic view of the output gap, the NIESR projections of growth and inflation are less sanguine than the OECD estimates outlined above. NIESR projects a greater need for a general rise in short term interest rates and seem likely to be correct. However, in the period to 1995, we still expect to see fast UK, EU and world trade and output growth with few inflationary implications. The NIESR analysis suggests that, if low inflation is to be maintained then the output growth achievable in the latter part of the decade is likely to slower than either the IMF or OECD suggest and

reinforces our conclusion that stable prices will continue to require modest growth and high unemployment.

The outlook for world unemployment

Table 3 sets out the trend in unemployment in the G7, European Union and in 5 major economies. Unemployment in the OECD area rose to 33½ million in 1993 which represents 8.2% of the workforce. In 1993, the jobless rate has risen in Germany, France, the UK and Japan but declined in the USA and Italy. In the UK, the rise in unemployment last year was moderated by a sharp fall in labour market participation as the demand for labour weakened substantially. In the EU, 17½ million people were unemployed last year which represents a rate of 11.3%. This compares unfavourably with averages of 6.8% in the USA and an artificially low 2½ in Japan.

This year OECD unemployment is expected to increase to 35.3 million or 8.5%. Unemployment in the Europe Union is projected to increase to 18.6 million or 12%. OECD unemployment is projected to rise 2.6% despite net employment growth of 0.8%. The bulk of the expected employment creation is due to the English speaking world. Employment in the EU is forecast to decline by a further ¾% with only the UK, Holland and Denmark exhibiting expansion. Particularly sharp falls in employment are expected in Germany and Italy.

Next year OECD unemployment is expected to fall to 34.7 million or 8¼%. OECD employment is expected to grow by a little over 1%. Again, the fastest growth in jobs is projected in the English speaking economies although increases are evident across the whole industrialised world. The US economy is projected to slow to 3% growth next year but employment is projected to rise by 1.8%. In Japan, real growth of 2-2½% is expected to result in a 0.9% rise in jobs and a fall in unemployment to 2.8%. In Europe, GDP growth is likely to accelerate to 2¾% engendering a 0.6% expansion in jobs. Unemployment is projected to fall back to 18.4 million or 11.9%. Within the union, the strongest performances in terms of job creation are expected in Ireland and the UK. Elsewhere growth tends to be more moderate reflecting the fact that the cycle on the Continent is behind that in the British Isles. However unemployment across the Union will fall next year but modestly.

The implications for unemployment and job creation of present growth forecasts are alarming. In Europe, it appears that GDP growth of circa 2½% is only sufficient to maintain employment. Indeed as productivity growth increases in the upswing the tradeoff may become more adverse. Whilst the US is capable of generating fast net employment expansion, the prospects for the EU are poor. Fast technological change seems certain to wreak continuing havoc on jobs as productivity increases. In a dynamic sense this is to be welcomed as it ultimately creates greater incomes which provide new demand for goods, services and jobs, provided they are not imported. In Europe, unlike Japan and the US, the system seem capable of adjusting better to such change. Until Europeans learn new tricks, the outlook for the Unions jobless remains particularly poor.

Prospects in key Scottish export markets

We would not wish to amend the detailed assessment that is set out in the previous Commentary. We continue to project that the US will slow next year and that recovery will become more general across the continent. Our assessment remains that there is little short term inflationary threat but are now less sanguine about the growth prospects latter in the UK. If output gaps are narrower than previously supposed, then output is likely to require to be slowed more quickly and more severely. The prospects of a more significant global recession in the latter part of the decade seem greater.

The strength of the YEN is set to slow Japanese exports and promote strong outward flows of investment capital. To the extent that this focuses on Europe as opposed to the US and Pacific Rim, this seems set to disproportionately benefit the UK. The slow growth in Japanese export volumes seems set to facilitate export growth from Europe to both the Pacific Rim and North America where domestic demand remains strong. We expect the YEN to appreciate further than entertained last quarter giving further grounds to our view that the second half of 1994 and whole of next year will provide a strong platform for export led growth.

Table 1		Real GDP Growth (% change pa)						
	G7	USA	Japan	EU	Germany	France	UK	
1985	3.3	3.2	5.0	2.5	2.0	1.9	3.8	
1986	2.9	2.9	2.6	2.9	2.3	2.5	4.3	
1987	3.2	3.1	4.1	2.9	1.5	2.3	4.8	
1988	4.5	3.9	6.2	4.2	3.7	4.5	5.0	
1989	3.2	2.5	4.7	3.5	3.6	4.3	2.2	
1990	2.4	1.2	4.8	3.0	5.7	2.5	0.4	
1991	0.8	-0.7	4.3	1.5	1.0	0.7	-2.2	
1992	1.7	2.6	1.1	1.0	2.1	1.4	-0.6	
1993	1.4	3.0	0.1	-0.4	-1.2	-0.7	1.9	
1994(F)								
OECD	2.7	4.0	0.8	1.9	1.8	1.8	2.8	
NIESR	2.4	3.5	1.0	2.0	1.5	1.4	3.1	
Barclays	2.6	3.4	1.4	2.0	1.9	1.6	3.0	
1995(F)								
OECD	2.9	3.0	2.7	2.8	2.6	2.9	3.2	
NIESR	2.3	2.3	2.0	2.2	2.0	2.5	2.9	
Barclays	3.0	3.0	3.2	2.7	2.7	2.5	3.2	

Table 2		Inflation (Private Consumption Deflator change % pa)						
	G7	USA	Japan	EU	Germany	France	UK	
1985	4.0	3.9	2.2	5.7	1.8	5.7	5.3	
1986	2.6	3.1	0.4	3.7	-0.6	2.7	4.0	
1987	3.1	4.2	0.2	3.5	0.5	3.2	4.3	
1988	3.2	4.2	-0.1	3.7	1.3	2.6	5.0	
1989	4.2	4.9	1.8	4.8	2.9	3.4	5.9	
1990	4.3	5.1	2.6	4.6	2.7	2.8	5.5	
1991	4.2	4.3	2.5	5.3	3.7	3.2	7.4	
1992	3.3	3.3	2.1	4.5	4.7	2.4	4.8	
1993	2.6	2.7	1.0	3.8	4.0	2.1	3.5	
1994(F)								
OECD	2.0	2.1	0.3	3.1	3.1	1.7	2.9	
NIESR	2.2	2.5	0.6	3.4	2.9	1.7	3.0	
Barclays	2.3	2.7	1.0	3.0	2.8	1.8	2.6	
1995(F)								
OECD	2.3	3.1	0.3	2.5	1.9	1.4	2.9	
NIESR	2.8	3.9	0.7	3.1	1.8	1.5	3.8	
Barclays	2.8	3.8	1.0	2.9	2.3	2.0	3.5	

Table 3		Unemployment Rates (National Definitions)						
	G7	USA	Japan	EU	Germany	France	UK	
1985	7.4	7.2	2.6	11.1	8.0	10.3	11.6	
1986	7.4	7.0	2.8	11.2	7.7	10.4	11.7	
1987	7.0	6.2	2.9	10.9	7.6	10.5	10.3	
1988	6.3	5.5	2.5	10.3	7.6	10.0	8.2	
1989	5.8	5.3	2.3	9.3	6.9	9.4	6.2	
1990	5.8	5.5	2.1	8.7	6.2	8.9	5.9	
1991	6.6	6.7	2.1	9.2	6.7	9.5	8.3	
1992	7.3	7.4	2.2	10.3	7.7	10.4	10.0	
1993	7.3	6.8	2.5	11.3	8.9	11.7	10.3	
1994(F)								
OECD	7.4	6.3	2.9	12.0	10.0	12.3	9.6	
NIESR	n/a	6.3	2.9	n/a	9.3	12.3	9.5	
Barclays	n/a	n/a	n/a	n/a	n/a	n/a	n/a	
1995(F)								
OECD	7.1	5.8	2.8	11.9	10.0	12.2	8.9	
NIESR	n/a	6.6	3.1	n/a	9.4	11.6	8.7	
Barclays	n/a	n/a	n/a	n/a	n/a	n/a	n/a	