Quarterly Economic Commentary

we gratefully acknowledge the contribution of the
Buchanan and Ewing Bequest
towards publication costs

FRASER OF ALLANDER INSTITUTE

The Fraser of Allander Institute for Research on the Scottish Economy was established in the University of Strathclyde on 1 January 1975, as the result of a generous donation from the Hugh Fraser Foundation. Its principal function is to carry out research on the Scottish economy and its research programme includes the analysis of short term movements in economic activity. Along with the Quarterly Economic Commentary the Institute also publishes a series of Research Monographs and a series of Discussion Papers to provide an outlet for original research on medium term and long term aspects of the Scottish economy. The Institute is a research unit in the Strathclyde Business School, a faculty of the University of Strathclyde.

Information for subscribers

The Quarterly Economic Commentary is published in March, June, September and December. Annual subscription rates are £50.00, or £15.00 per single issue. Queries should be addressed to the Secretary, Fraser of Allander Institute.

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 a 3.5 inch disk in either WordPerfect or ASCII format.

Fraser of Allander Institute
University of Strathclyde
100 Cathedral Street
GLASGOW G4 0LN

Tel.: 0141-548 3958 Fax: 0141-552 8347
Email: FAI@STRATH.AC.UK

QUARTERLY ECONOMIC COMMENTARY

* * * * * * CONTENTS* * * * * *

EDITORS .... Brian Ashcroft, Eleanor Malloy and Sarah Le Tissier
GRAPHICS .... Eleanor Malloy
PRODUCTION .... Linda Kerr and Isobel Sheppard

OUTLOOK AND APPRAISAL

The most recent quarterly Scottish output data highlight the current strength of production here relative to the UK. In 1996 the production industries in the aggregate consistently outperformed the UK. While the strong performance of manufacturing still largely reflects the success of the electronics sector, there is now evidence of a relative improvement in the performance of non-electronics manufacturing. At this stage it is too early to say whether this improvement reflects systematic factors or is simply the outcome of a series of random or transitory events. In the UK, the balance of growth is clearly moving in favour of consumers' expenditure. But inflationary pressures remain subdued. The marked appreciation of sterling will pose problems for UK exports and manufacturing growth if the sterling increase is viewed as permanent. In view of the uncertainty we believe that the Bank of England should be cautious about further increases in interest rates and should ensure co-ordination with Treasury fiscal policy. A tighter fiscal policy would help to dampen down incipient inflationary pressure, improve the balance of the economy between tradable and non-tradable sectors, and deal with continuing weakness in the public finances. A tightening of some £3bn to £4bn would be appropriate in the Chancellor's July Budget.

OUTPUT

Scottish Office figures for the performance of the production and construction industries in the final quarter of 1996 suggest that this side of the Scottish economy is performing strongly compared with its UK counterpart. Output of the production and construction industries (excluding oil and gas) grew by 2.3% in the fourth quarter compared with a 0.6% increase in the UK. The manufacturing sector expanded by 1.9% which was considerably better than the 0.3% growth achieved by manufacturing in the UK. And the construction sector significantly outperformed UK construction, growing by 4.3% in Scotland compared with 1.3% in the UK.

The relatively stronger Scottish performance in the production and construction industries has been sustained over the past year. A comparison of the latest 4 quarters with the preceding 4 quarters demonstrates a clear margin of performance in favour of Scottish industry. Output of the production and construction industries (excluding oil and gas) grew by 3.6% compared to growth of 0.9% in the UK. Scottish manufacturing grew by 5% while UK manufacturing was almost stagnant registering 0.4% growth. However, the construction sector performed less well during this period than its UK counterpart, contracting by 1% compared with a small increase of 0.9% in the UK.

The buoyancy of Scottish manufacturing over the longer 'recovery' period - from the first quarter 1992 to the fourth quarter 1996 - is clearly evident in Figure 1. Since the recession Scottish manufacturing has grown by 24.3% which is almost 15 percentage points faster than the 9.5% growth registered by UK manufacturing. The figure again highlights the importance of growth in the electronics industry to overall manufacturing growth in Scotland. However, while the removal of electronics still results in manufacturing growing more slowly over the recovery period, the gap is clearly narrowing. In the March **Commentary** we noted that during the recovery manufacturing in Scotland had grown 10 percentage points faster than in the UK but when electronics was taken out the growth gap was 10 percentage points *in favour of the UK*. Adding in the data for the fourth quarter 1996 results in a manufacturing (ex. electronics) performance gap in favour of the UK of 9 percentage points. Obviously this implies something of a revival in the relative performance of non-electronics manufacturing. Figure 2 follows recent convention in the **Commentary** and presents the 'smoothed' quarterly growth rates of non-electronics manufacturing in Scotland and the UK during the 1990s. Once data for the fourth quarter 1996 are added in and the Scottish Office data revisions for earlier quarters are incorporated, it is clear that manufacturing (ex. electronics) in

Scotland has been outperforming its UK counterpart since the middle of 1995. Moreover, the relatively stronger performance appears to have strengthened throughout 1996. Over the latest four-quarter period, 5 manufacturing sectors (from 10) other than electronics outperformed their UK counterparts. These were: the chemicals industry which grew by 6% in Scotland compared to 2% in the UK; textiles and clothing, 3% in Scotland and 0% in the UK; mechanical engineering, 1% against -1%; transport equipment, 8% compared to 4%; and refined petrol products and nuclear fuel, -1% against -10%. In the four-quarter period to the third quarter 1996 only 3 other Scottish manufacturing sectors had outperformed their UK counterparts.

It is difficult to identify any systematic factors which might account for the comparative revival in non-electronics manufacturing. There is no evidence, for example, that Scottish exports in these sectors have fared better than their UK counterparts in the face of the marked appreciation of sterling. Indeed, given the greater exposure of UK goods exports to North America (13%) compared with Scottish manufacturing exports to the region (10%), it might be expected that Scottish exports would have suffered more at the margin since a smaller share of our trade is to markets where sterling appreciation has been less. On the other hand, these sectors may have benefited from the gradual pick up in investment spending in the UK economy. The Scottish economy is more orientated towards investment goods production than the UK with 21% of industrial production being accounted for by such output compared to 17% in the UK. Some support for this view is reflected in the performance figures for the sector in the two areas during 1996, with Scottish investment goods production expanding by 12.3% compared to 2.6% in the UK. However, a large proportion of that favourable Scottish performance will be a reflection of the growth of the electronics industry here which cannot be removed from the comparison. We must, therefore, await further data before it can be established whether this relative improvement in the performance of non-electronics manufacturing is something more than a random event.

OUTLOOK

At the *international level* there are now widespread signs of recovery this year after the slight growth pause in 1996. Growth this year is expected to range between 2% to 2.5% in the three principal OECD areas: North America, Europe and Asia. Long-term interest rates are expected to remain at historically low levels due to diminished inflationary expectations, while fiscal consolidation is becoming more widespread as many developed economies seek to implement deficit reduction policies.

In the *United Kingdom* growth is likely to be stronger in 1997 at around 3%, following the slight slow down in growth to 2.3% in 1996 from 2.6% in 1995. During 1996 the composition of growth changed away from net trade and in favour of consumers' expenditure. Strong consumption growth is to be expected throughout 1997 due to the increased growth of labour income, the further impact of 'windfalls' from building society demutualisation, higher consumer confidence, increased mortgage equity withdrawal and greater consumer borrowing. Inflationary pressures remain largely subdued, as indicated by Figure 3. The growth of average earnings is slowly beginning to rise, but the significant fall in input prices during 1996 ensured that output prices remained broadly unchanged in the second half of the year. The favourable outturn on input prices is a reflection of the rapid rise in the effective rate of sterling which rose by 20% between December 1995 and April 1997.

The short-term prospects for the UK economy depend very much on the effect on the real economy of this marked rise in the exchange rate. If the rise is viewed as permanent then growth will be lower than previously forecast. If it is viewed as temporary then UK producers of tradables are likely to protect market share by adjusting profit margins downwards. Companies are in a position to sustain this for some little time given that profits currently stand at fairly high levels after the strong profits growth in 1996 which allowed company saving to rise and corporate debt to fall, even though dividend distributions increased. We take the view that there will be some downward movement of sterling in the near future and a gradual decline thereafter so that growth will not be damaged as might otherwise be the case. Nevertheless, in view of the uncertainty we believe that the Bank of England should be cautious about further increases in interest rates and seek to co-ordinate any future monetary policy change with Treasury action on fiscal policy. Stabilisation cannot solely be the responsibility of the Bank. Continuation of high sterling levels necessitates a tighter fiscal policy stance which would help dampen down incipient inflationary pressure, improve the balance of the economy between the tradable and non-tradable sectors, and deal with the continuing weakness of the public finances. We would therefore like to see the Chancellor tighten fiscal policy by some £3bn to £4bn in his budget on July 2nd.

Despite the uncertainties posed by the sustained rise and the high level of sterling we take the view that UK growth will be above 3% this year falling back in 1998 as capacity constraints and policy tightening begin to bite.

We forecast *Scottish GDP* to rise by 3.2% this year and average 2.6% per annum between 1997-2001. The growth of the electronics sector plays a key role in the forecast boosting the annual average GDP (ex. elect.) from 2.1% per annum. The forecast annual average growth of manufacturing including electronics is 4.3% p.a. Within manufacturing, oil refining & nuclear fuel, chemicals & man made fibres, and other manufacturing also make a considerable contribution to growth. Service sector output growth is predicted to be slower than in manufacturing, averaging 2% per annum over the forecast horizon. Unfortunately, given the expected growth in productivity, these forecast changes in output translate into very little net job creation.

The *Scottish workforce in employment* is projected to grow at only 0.04% per annum between 1997-2001, while *employees in employment* declines by 3,661 or 0.05% per annum. These changes comprise a rise in service sector employment of 4343 (0.07% p.a.), with falls in manufacturing employment of 6793 (-0.053% p.a.) and other employees of 1211 (-0.16% p.a.). *Self-employment*, on the other hand, is forecast to rise 8,246 (0.87% p.a.), a much slower rate of growth than in the first half of the 1990s.

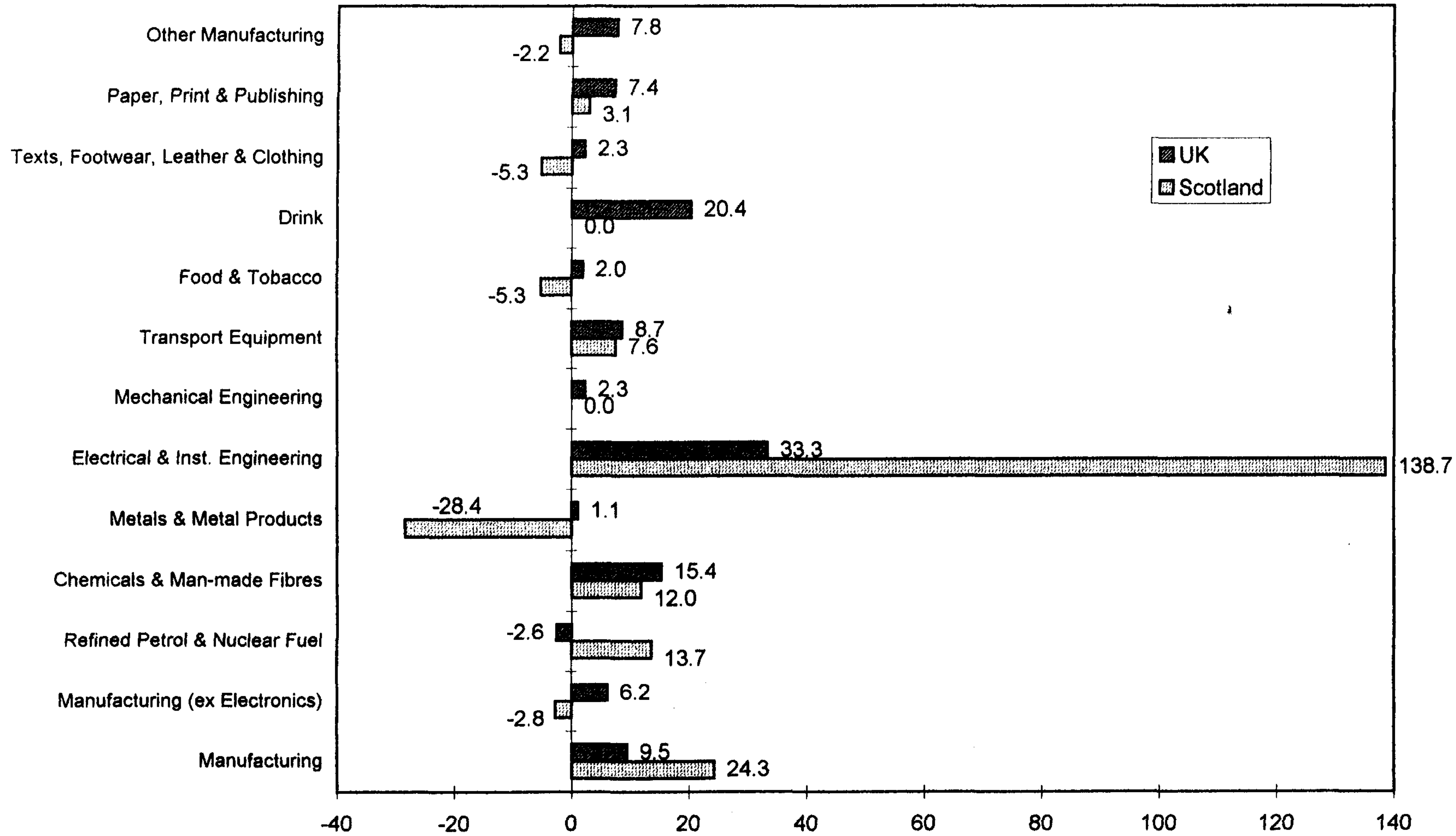
Scottish unemployment will remain more or less stable over the forecast horizon at around 7%, with the number out of work reaching its lowest level over the period in 1998: a total of 169,860 or a rate 6.9%. The fall in unemployment in Scotland is not expected to match that in the UK., reflecting poorer job creation prospects.

At the level of the *Scottish regions and LECs* we expect Lanarkshire, Lothian and Renfrewshire to enjoy the strongest growth in the medium term, reflecting the favourable impact of growth and inward investment in the electronics sector. Growth will be weakest in Glasgow and the rural hinterland. Fife will also benefit from a resurgence of coal production, whilst strong growth in oil refining and pharmaceuticals work to the advantage of Forth Valley.

Overall, the Scottish growth profile in the medium term remains similar to the UK. The principal differences being the disproportionate impact of the strength of electronics, a weaker service sector, and relatively poorer job creation and unemployment prospects. While the Scottish economy is expected to cool in 1998 and be subject to a slight growth pause in 1999, levels of output will continue to rise, so that in the medium term Scotland is set to experience above trend growth led by manufacturing exports.

6 June 1997

Figure 1: Manufacturing Output in Scotland and the UK during the Recovery: Q1 1992 to Q4 1996 (Percentage Change)



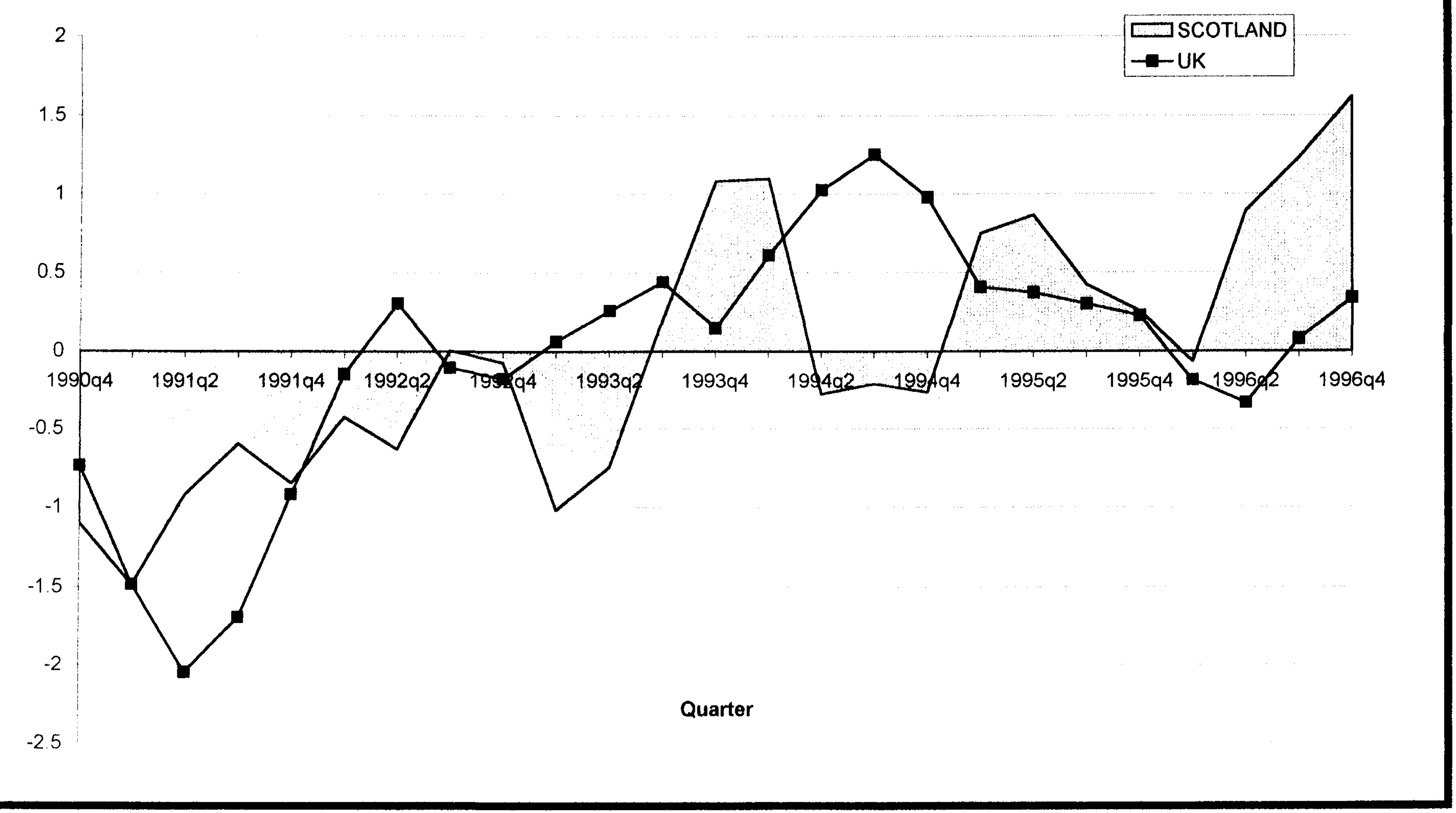


Figure 2: Quarterly Growth in Scottish and UK Non-Electronics Manufacturing 1990q4 to 1996q4

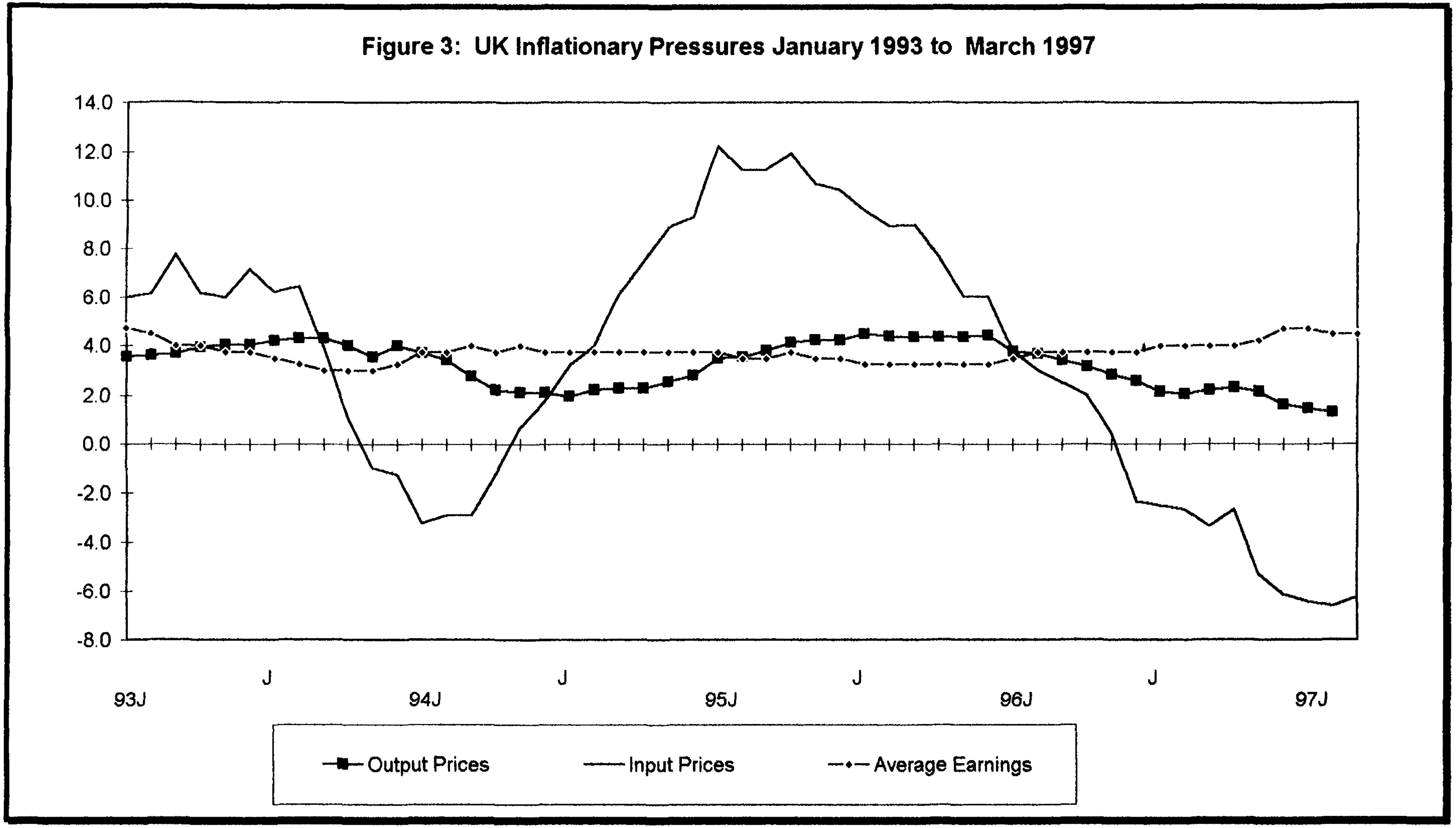


Figure 3: UK Inflationary Pressures January 1993 to March 1997
14.0
12.0
10.0
8.0
6.0
4.0
2.0
0.0
-2.0
-4.0
-6.0
-8.0
93J
J
94J
J
95J
J
96J
J
97J
Output Prices
Input Prices
Average Earnings