
The **ECONOMIC** *Background*

THE INTERNATIONAL ENVIRONMENT

The global economy continues to perform well with steady growth, low inflation and rising trade. The US, growing at above trend level, still continues to provide much of the stimulus to world growth. NAFTA growth is expected to outstrip that of the EU and OECD Asia. As expected OECD Asia inflation is very low. The volume of world trade is expected to grow by 9% in 1997 after the slowdown last year. Inflation is projected to rise to only 2.1% this year in the OECD.

The US

US growth is forecast to be 3.3% in 1997 and 2.0% for 1998 and 1999. In Q1 1997 growth accelerated to 1.4% giving growth of 4.1% on an annual basis. This was mainly due to a rise in consumers' expenditure and a build up of stocks. Inflation is expected to be 2.4% in 1997 and 2.6% in 1998 and 1999. Unemployment fell to its lowest level for twenty-four years. The recent appreciation of the dollar will reduce net exports over the next two years. Industrial production increased by 1.1% in the three months to May with capacity utilisation rising steadily. Real short-term interest rates have remained at 3.5% for eighteen months while long term rates have stabilised around 6.7%. The outlook for the US is favourable.

Europe

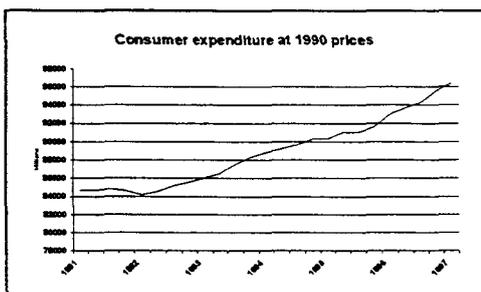
EU GDP growth was 1.5% in 1996 against growth of 2.5% in 1995. Both private consumption (2.1%) and a rise in net exports (0.3%) contributed to GDP growth. Investment is weak and stocks have declined while government consumption grew at only 0.6% due to fiscal consolidation programmes which are widespread across Europe at the

moment. EU inflation remained at 1.5% which is significantly lower than 2.6% one year earlier. Business, consumer and industrial confidence have all increased. Capacity utilisation is 82% giving rise to expectations of capacity constraints over the next twelve months. Unemployment stood at 10.8% (18.2 million people) in May. There seems to be little respite for the larger European economies; Denmark, Spain, Ireland, Netherlands, Portugal and the UK will continue to improve but France, Germany, Italy and Sweden will all experience an increase in unemployment. German GDP growth is projected to be 2.5% this year and next although private consumption will be weak. Investment has fallen recently but manufacturing orders have gradually improved since 1996. Export growth is expected to rise to about 1% this year and domestic demand will be stronger next year. In an attempt to cut the budget deficit by 1.8% of GDP, measures worth DM66.5 million were introduced in the budget. The government still faces embarrassment over the fiscal position and meeting the target of 3% of GDP looks increasingly hard. Unemployment continues to be a major problem with 1.2 million people unemployed for over one year. France has GDP growth of 0.6% for 1997 and 0.4% for 1998. The change in government has resulted in employment creation becoming the key policy. It is not clear however if the government will obstruct EMU although they do want a greater focus on real targets rather than nominal targets. French unemployment remains high, 12.5%, with private consumption growth slowing to 1.5%.

Japan and Asia

Economic recovery is well underway in Japan with GDP growth forecasts for 1997 and 1998 estimated to be 2.3% and 2.6%. GDP growth was 1.6% in the first quarter of 1997 giving growth of 2.6% over 1997. Output increased by 3.7% last year supported by 11.5% growth in government investment. The growth of consumers' expenditure has accelerated sharply and this has allowed government consumption to reduce steadily. Interest rates are very low in Japan both in the short term and for the long term. The Yen has also depreciated over the last eighteen months especially against the dollar. Net export growth is forecast to be 1% in 1997 but will reduce significantly in 1998. Interest rates may rise very slightly in the short term but

consumers' expenditure compared to personal income.



General government final consumption fell by 0.1% in the first quarter of 1997. Government consumption in the first quarter was 0.9% higher than in the corresponding quarter of 1996. Provisional estimates for the second quarter suggest a rise of 0.1% to a level 0.7% higher than in the second quarter of 1996. The contribution to GDP growth was almost zero in both quarters.

Real gross fixed investment or Gross domestic fixed capital formation rose by 0.9% in the first quarter to a level 3.7% higher than in the first quarter of 1996. The provisional estimate for the second quarter 1997 indicates that spending was 0.1% higher than in the previous quarter and 1% higher than in the second quarter of 1996. Investment made a small positive contribution to GDP growth in first quarter and almost no contribution in the second quarter. In manufacturing, investment is estimated to have risen by 10% to a level 26% higher than in the second quarter of 1996. In other sectors, capital expenditure rose by 11% in other production, by 48% in construction and remained broadly the same in services compared with the first quarter. Over the year to the second quarter 1997, capital expenditure rose by 7% in other production, by 2% in services and by 19% in construction.

Turning to the **balance of payments**, the **current account** for the first quarter 1997 registered, after seasonal adjustment, a surplus of £1.5 billion, following the surplus, on revised figures, of £0.5 billion in the fourth quarter of 1996, a deficit of £0.4 billion in the third quarter, a surplus of £0.7 billion in the second quarter, and a deficit of £1.2 billion in the first quarter. The current account registered a small deficit, on revised figures, of £435m, in 1996 overall, compared with a deficit of £3.7 billion in 1995. For trade in

goods and services, the *deficit* improved to £14 million in the first quarter from £0.5 billion in the fourth quarter, £1.2 billion in the third quarter, £1.3 billion in the second quarter and £2.4 billion in the first quarter of 1996. For **investment income and transfers**, there was a *surplus* of £1.5 billion in the first quarter 1997, compared with a surplus, on revised figures, of £1 billion in the fourth quarter 1996, £0.8 billion in the third quarter, £2 billion in the second quarter and £1.2 billion in the first quarter. Net trade made a positive contribution to GDP growth in the first quarter of this year, following a negative contribution in the fourth and third quarters of 1996. However, in the second quarter net trade made a negative contribution to GDP growth, lowering the growth rate in the quarter from 1.2% to 0.9%.

UK LABOUR MARKET

Employment and Unemployment

Seasonally-adjusted UK claimant unemployment fell by 104,400 in the quarter to July and by 576,000 over the full year (though figures in the period October to May have been affected by the introduction of the Jobseeker's Allowance). UK unemployment now stands at 1,550,000, giving an overall unemployment rate of 5.5%, with a male and female rate of 7.6% and 2.9% respectively. Whilst the level of unemployment has shown a persistent downward trend, UK employment has, in the past, had a rather more variable performance. However, over the last year there has been a consistent increase in employment. Total employment in March stood at 26,209,000, an increase of 87,000 (0.3%) in the quarter from December, and 360,000 (1.4%) in the full year from March 1996. Unusually, female employment showed a small fall in both of the last quarters from September 1996, so that 70% of the increase in employment over the last year has gone to men. Within the various sectors of the UK economy, employment in manufacturing has fallen by 20,000 (0.5%) in the year to March, although the more recent figures for British manufacturing show a similar increase in employment of 25,000 (0.6%) over the year to June, with an increase of 14,000 in the last quarter. Employment gains therefore have been almost exclusively restricted to the service sector. The general improvements in the unemployment figures in the last quarter have

been accompanied by a rise in the number of vacancies registered at Jobcentres. In the quarter to July, the number of registered vacancies rose by 9,800 (3.5%) and in the full year from July 1996 the figure increased by 54,300 (23.6%).

Earnings and Productivity

The underlying level of annual wage inflation in both May and June was 4.25%, slightly lower than the figures at the beginning of the year. Throughout 1996 there was a gradual increase in wage inflation, but this peaked in December 1996 and January 1997 at a rate of 4.75%. Since that time there has been a gradual decline in UK wage inflation. From the second quarter of 1991, wage increases in manufacturing have been persistently higher than those in service sectors. In 1996, this sectoral differential narrowed and since February 1997 the underlying wage growth in services has been higher than that in manufacturing, with the June figure being 4.25% in manufacturing as against 4.5% in services. The rate of growth of labour productivity in the whole economy in the first quarter of 1997 was 1.9%. Whilst the figures for whole-economy labour productivity have jumped about a little over the last couple of years, the current value is relatively high. However, the figures for manufacturing productivity in the year to June 1997 are lower, at 1.4%, and are below the figures for earlier in the year. Given the gap between the increase in wages and the increase in labour productivity, unit labour costs have been rising in both the whole economy and the manufacturing sector. In the fourth quarter of 1996, the rise in whole-economy unit labour costs over the previous year was 2.8%, the highest value since the last quarter of 1992. In manufacturing the annual increase in unit labour costs in the second quarter to June was also 2.8% which, whilst slightly higher than the value for the previous quarter, is low as against the comparable UK figures for the previous two years.

UK OUTLOOK

Mixed signals are coming from the UK economy about the likely future growth path. At present the economy is clearly growing above trend (2.25% to 2.5% per annum), which suggests that a slow down is likely. However, there is considerable uncertainty about the timing of the slow down. On one

reading of the GDP statistics it could be argued that the deceleration is already under way, with quarterly GDP growth reaching a peak of 1.07% in the fourth quarter of 1996, then falling to 0.95% in the first quarter 1997 and 0.87% in the second quarter. Yet these growth rates imply annual rates of around 4% and the year on year growth rate to the second quarter and the first half of 1997 stood at 3.4% and 3.3% respectively, which is rapid growth by historical standards.

Yet, the depressing effect of the continuing high level of sterling is quite clearly being felt. Output in manufacturing fell slightly in the second quarter to register growth a little above 1.5% over the year, and net exports contributed negatively to growth. But export volumes grew strongly in the second quarter (by 5%) while imports grew more quickly, reflecting the strength of consumer demand, suggesting that manufacturers are responding to the effect of the high exchange rate by reducing margins. Moreover, manufacturing investment picked up considerably in the second quarter with spending rising by 10% over the previous three months to a level 26% higher than in the second quarter of 1996. The export and manufacturing investment data therefore appear to suggest that manufacturers do not anticipate that the high level of sterling will persist for too much longer.

The strong growth of consumer spending, which grew at a 7% annual rate in the second quarter to a level 4.4% above the second quarter 1996, has been primarily responsible for the sustained growth of output witnessed in the service sector and the pick up in construction. The service sector grew year on year by 4.3% in the first half of this year, while the construction sector grew by 4% over the same period reflecting the buoyancy in the housing market where prices are now at their highest level for nearly six years after rising by almost 7% in May over the year. Consumer confidence now appears to be back to the levels experienced in the late 1980s with consumers increasingly willing to take on new debt as spending outstrips the growth in personal income, and the saving ratio falls. Over the year to the first quarter, the growth of consumer spending registered 3.7% compared with growth of 0.9% for income.

The outlook for the remainder of the year and 1998 still remains far from clear. One view, probably the consensus, is that the effect of the

high level of sterling, the contractionary effects of the July Budget, higher base rates, and a diminishing impact from the windfall gains resulting from the de-mutualisation of building societies, will result in a slow down of growth in the second half of 1997 and in 1998. Conversely, some take the view that the price of sterling will have little impact on growth in the immediate run, that consumer confidence remains high and rising and that further significant spending effects have still to come through from de-mutualisation. On this scenario growth will strengthen further in the second half of 1997 and in 1998. This view, if correct, raises the prospect of a 'hard landing' in late 1998 or 1999, as further monetary and fiscal tightening is required to quell the consumer boom.

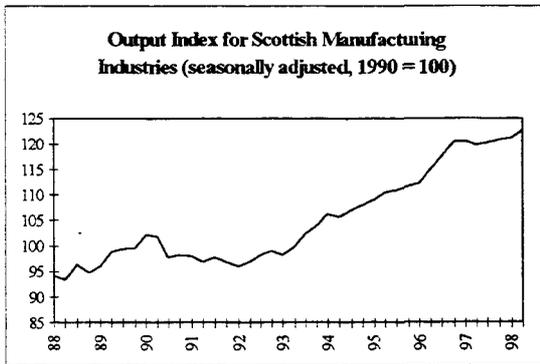
Our view is that growth will be in excess of 3% this year, but we doubt whether it will go above 4% as some are predicting. We expect growth to slow next year but perhaps not by as much as the first scenario suggests, with the result that the outturn will in our view be somewhat above the trend rate of growth. Inflationary pressures are expected to remain subdued, even though job creation and employment growth picks up through output growth with fairly weak investment and as the 'welfare to work' programme begins to provide jobs for the young and the long-term unemployed. There is much evidence that the creation of jobs for the long-term, as opposed to the short-term, unemployed adds little to wage pressure.

Finally, while the July Budget was contractionary in fiscal terms, we still hold to the view that the economic situation required an even tighter Budget. Interest rates are now higher and will continue to be higher than they otherwise might have been, with the likely outcome being that manufacturing will bear the burden of the eventual slow down and that interest rates will rise further. This situation increases the probability that the Bank of England's new Monetary Policy Committee may overdo future increases in base rates as it attempts to win credibility, thus risking the prospect of a sharp slow down in economic activity in 1998 and/or 1999.

The SCOTTISH Economy

SHORT-TERM FORECASTS*

This section presents short-term forecasts for the quarterly growth rates of Scottish manufacturing (Division D of the 1992 SIC) output.



The present forecasting period extends to 1998Q2. In making the Scottish forecasts, the past performance of the Scottish and UK manufacturing outputs are considered, and the National Institute's quarterly forecasts for UK manufacturing output are used for the Scottish forecasts. Figure 1 depicts the actual growth rates for Scottish manufacturing output from 1988Q1 to 1997Q1 and the forecasts for 1997Q2 to 1998Q2. The latest Scottish Office News Release (6 August 1997) made substantial revisions to the output index for the UK manufacturing output back to 1989. Moreover, given the recent rises in the

* Development of the short-term model of the economy was made possible by the funding of a three-year research fellowship by TSB Bank Scotland.

interest rates, the National Institute's latest forecasts for the UK manufacturing output in the coming quarters have been reduced substantially. Accordingly the present forecast shows that the strong growth in Scottish manufacturing industries in 1996 is unlikely to maintain in 1997 and the annual growth rate for Scottish manufacturing output for 1997 is predicted to be around 3.5%. Further details of growth rates are presented in the following table.

92/91	0.3
93/92	3.6
94/93	5.6
95/94	3.5
96/95	5.3
95Q1/94Q4	0.7
95Q2/95Q1	1.4
95Q3/95Q2	0.5
95Q4/95Q3	0.7
96Q1/95Q4	0.5
96Q2/96Q1	2.6
96Q3/96Q2	2.2
96Q4/96Q3	2.5
97Q1/96Q4	0.2
FORECAST	
97Q2/97Q1	-0.7
97Q3/97Q2	0.3
97Q4/97Q3	0.5
98Q1/97Q4	0.4
98Q2/98Q1	1.2
97/96	3.5

THE DELOITTE & TOUCHE SCOTTISH CHAMBERS' BUSINESS SURVEY: SECOND QUARTER OF 1997

The Deloitte & Touche Scottish Chambers' Business Survey, which is conducted by Strathclyde University's Fraser of Allander Institute together with the Chambers of Commerce of Aberdeen, Central, Dundee, Edinburgh, Fife and Glasgow, is the largest and most comprehensive regular survey of business, employment and other issues affecting the Scottish business community. In the present survey,