Quarterly Economic Commentary

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

QUARTERLY ECONOMIC COMMENTARY

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 February, May, August and November. Annual subscription rates are £20.00, or £5.50 per single issue. Queries should be addressed to the Secretary, the 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.

Commentary Team

Editor :	Brian Ashcroft
Assistant Editor :	Jim Love
Contributors:	Harminder Battu, Stephen Boyle, Paul Draper, Stewart Dunlop, Janet Grehan, Frank Harrigan, John Heeley, Cliff Lockyer, Claire Monaghan, Peter McGregor, Iain McNicoll, Roger Perman and Jim Stevens.
Graphics:	Stephen Boyle (TSB Fellow)
Production:	Linda Nicolson and Isobel Sheppard

The Fraser of Allander Institute
Curran Building
100 Cathedral Street
GLASGOW
G4 0LN

041-552 4400 Ext. 3958

FRASER of ALLANDER INSTITUTE

* * * * * * COMMENTARY * * * * * *

* * * * * * VIEWS * * * * * *

Opinions expressed in signed contributions are those
of the authors and not necessarily those of the Fraser Institute

Outlook and Appraisal

The Scottish economy continues to perform well. Industrial production remains buoyant, although it is now clear that production has been growing at a lower rate than earlier statistics suggested. In the labour market, the improved output performance has yet to be reflected in a significant increase in net employment. Short term prospects for output growth are nonetheless favourable. But beyond the next three months, the outlook for the Scottish economy depends largely on the outcome of government actions to moderate the pace of growth of UK domestic demand. Policy action to date leaves some cause for concern. Swingeing increases in interest rates are questionable in terms of both the nature and the timing of their effects.

Performance and Prospects

In June we noted that production had risen by 5% in Scotland during the final quarter of last year. In the UK the figure was only 0.7%. We cautioned that with such a large difference it was not improbable that the Scottish Office would have to revise the figures downwards as new information came to light. This has, in fact, proved to be the case. Revised data now show that industrial production grew by 3.2% in Scotland and 1.1% in the UK during the period. Recent provisional data for the first quarter of 1988 also show that the favourable production differential has not been maintained. Between January and March, production in Scotland *fell* by 0.2% while activity increased by 0.1% in the UK overall. Yet taking the year to the first quarter of 1988 as a whole, industrial production in Scotland grew by 6.3%. The growth of production in the UK over this period was significantly lower at 3.9%. The index now stands at 110.5 in Scotland and 115.4 in the UK. There is therefore an even greater difference between the two indexes than when we last reported; a gap which widens when the construction industry is included - to 106.8 and 116.3, respectively. In June we noted that several quarters of consistently stronger Scottish growth were required for the two indexes to move into line and restore the position that Scotland had in 1980 relative to the UK. But we also noted that equalisation appeared to be unlikely in the foreseeable future. That view appears to have even more force today.

The absolute fall and relative deterioration in Scottish productive activity during the first quarter should not, however, be taken as indicating that the favourable production trend established in 1987 has now reversed. For the last three years there has been a tendency for Scottish production to fall between January and March. And the difference between UK and Scottish growth in the most recent period is sufficiently close to be removed by subsequent revisions. All the indications are that Scottish economic activity continues to flourish, although the rate of increase in activity may now be beginning to slow. But the absence to date of evidence of significant net job creation is a continuing cause for concern.

The July **Scottish Chambers' Business Survey (SCBS)** and the **CBI (Scotland) Survey** both reported a further increase in business optimism (see **Business Surveys** section). Sales, orders and exports were expected to rise during the next quarter. However, the CBI Survey reported findings which they interpreted as suggesting that the rate of growth of manufacturing output, while strong, was no longer accelerating as in previous surveys. And the SCBS found that in manufacturing only respondents in the Glasgow Chamber of Commerce area were more optimistic than three months ago. The Edinburgh area continues to be relatively depressed, with growth in the demand for the products of local firms coming largely from non-Scottish rather than home markets.

At the sectoral level, confidence in the construction industry is particularly high; indeed higher than in any other sector. From the beginning of 1987, the industry has been gradually climbing out of the recession which has depressed its performance, both absolutely and relative to the UK, since 1982. The upsurge in construction, which followed the house price boom in the South of England, is clearly moving north. This can be seen from the recent data on housing starts in Scotland (see **Construction** section). During the second quarter they were 32% higher than in the same quarter of 1987. Elsewhere in Scottish industry, optimism about future prospects also rose in the mechanical and electrical engineering sectors but fell - if the results of the two surveys are combined - in food, drink and tobacco, textiles, leather, clothing and footwear. Despite the lower level of optimism in the drink and tobacco sector, the whisky industry continues its steady revival (see **Whisky** section). In the first six months of the year exports were 4.6% higher than in the same period of 1987. This is the industry's best export performance during the first half of the year since 1982. Along with the increased optimism in electrical and instrument engineering recent developments have provided further evidence of moves to a more favourable productive structure (see **Electrical and Instrument Engineering** section). Investment decisions by Atex and Motorola indicate that the electronics industry in Scotland is now gaining design and product development functions as well as manufacturing facilities. This is more typical of the industry in the south of England and is considered by many economists to be an essential requirement for sustained future growth.

Labour Market Considerations

The labour market is still failing to register fully the expected benefits of increased growth (see **Labour Market** section). Seasonally adjusted unemployment fell by 48,700, or 13.3%, in the year to July. But employment is hardly growing at all. In the year to March, total employment rose by 6,000, or 0.3%, while male employment fell by 7,000, or 0.7%. Over the same period male unemployment fell by 30,800, suggesting that the drop was more than fully accounted for by an increased flow of labour to retirals, migration, participation in government training schemes, self employment and membership of the armed forces. The relative significance of each cannot be quantified. What is clear though is that the labour market in Scotland continues to be relatively depressed. While employees in employment in Scotland increased by 0.3% in the year to March, the UK experienced a growth rate of 1.8%. And lest anyone should forget, by March of this year employment in Scotland was 234,000 lower than in 1979, a drop of 11.1%, with male and female employment lower by 17.8% and 2%, respectively. The comparative figures for the UK, indicate a 5.2% fall in total employment, with male employment lower by 12.1% and female employment *higher* by 3.6%.

It might be argued that the weak Scottish employment performance during 1987 simply reflects the lower Scottish rate of growth. Scottish GDP growth is tentatively estimated by the Scottish Office to have been around 3% in 1987. UK GDP growth reached 4.75%. The difference, 1.75 percentage points, is not dissimilar to the 1.5 percentage point gap in employment growth, allowing for a three month lag in employment response. However, the implied incremental GDP-labour ratio of £134,000 per additional employee in Scotland is over three times greater than the implied £41,000 incremental GDP-labour ratio for the UK. While Scotland's productive structure may be biased towards more capital intensive industries than the UK, resulting in higher marginal value added per employee, we are not aware of evidence that the marginal productivity of the Scottish workforce is greater by a factor of three. The June **Scottish Economic Bulletin** would therefore appear to be incorrect in suggesting that the 1987 " ....employment information seems broadly in line with expectation from the output indicators". At UK marginal productivity levels, the estimated rate of Scottish GDP growth would have generated around 20,000 jobs instead of the 6,000 actually recorded.

What accounts for the discrepancy? The following would appear to be relevant.

- If it is safe to assume that the marginal productivity of Scottish employment is much lower than three times that of UK employment, then one possibility is that GDP growth during 1987 may have been lower than the Scottish Office's "very tentative early estimate". This remains a possibility but cannot be a principal explanation since, at equal marginal productivity levels, it requires Scottish GDP to have grown by a little less than one percent.

- Conversely, the estimated change of 6,000 employees in employment may be a relative underestimate of the change in productive employment in Scotland. Apart from errors in the estimation of employees in employment, the figures do not include changes in the self-employed, membership in HM Forces and participants in work-related government training schemes. To account for some of the "missing" 14,000 jobs, these other components of productive employment change would have had to have grown more quickly in Scotland than the UK. Unfortunately, we lack information on the relative significance of these changes.

- Finally, and perhaps most importantly, there are lags in the adjustment of employment to output. Increased growth is a more recent phenomenon in Scotland than in the rest of the UK. If Scottish firms initially adjusted to the higher demand by increasing overtime working before taking on additional staff then more substantial employment increases should be evident in the statistics from the second quarter onwards. But if Scottish firms are more pessimistic than UK firms about the duration of the current upturn then either the lags may be more protracted or the proportionate increase in employment may remain lower than the rest of the UK.

Wider Influences and Policy Background

The performance of an open economy such as Scotland depends heavily on economic developments elsewhere. The world economy has been surprisingly buoyant in recent months (see **World Economy** section). This should have helped Scottish exports somewhat, although the effects of the higher sterling exchange rate over the last eighteen months may have lowered external demand. In 1989 demand in the world economy is expected to turn down following a tightening of fiscal policy in key countries. UK and, therefore, Scottish economic growth will be lower in 1989 and immediately following years. Yet even with some lowering of external demand it is clear that the current rate of growth of UK domestic demand is too great (see **British Economy** section). The £9bn plus deficit on the UK current account in the first eight months of the year is the most obvious symptom of this demand pressure.

The current strategy of the government is to raise interest rates to a level which will moderate the growth of demand. Higher interest rates also serve to keep the exchange rate high, so helping to finance the current account deficit while applying downward pressure to price inflation. The government appears prepared to accept some loss of foreign competitiveness for the benefit of reduced domestic demand and inflationary expectations. But this approach only stands up if high interest rates are the only effective way to reduce demand and inflationary pressure. Many economists would argue that changes in fiscal policy produce a more rapid and effective impact on demand. We agree with this view. An increase in taxation, whether it be via increased national insurance contributions or a higher basic rate, would allow both interest rates and the exchange rate to be somewhat lower than they are currently. Competitiveness would be increased and the prospects for exports - so important to the Scottish economy - would improve. Moreover, relatively lower interest rates would be less of a constraint on investment in new capacity. The more rapidly capacity increases the lower the necessary fall in domestic demand and the more quickly any tax increase can be reversed. So, with a policy of interest rate adjustment alone there is no guarantee that the approach will more quickly reduce the rate of growth of domestic demand than a mixture of tax and interest rate changes. But in pursuing his chosen path, the Chancellor runs the risk of seriously damaging the balance of growth in the economy.

28 September1988