# Quarterly Economic Commentary

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# 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.

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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

Since the beginning of 1990 the Scottish economy has shown a marked resilience to the downturn which has recently become so marked in the southern part of the United Kingdom. Arguments about the reliability of certain data notwithstanding, there is a considerable array of appropriate statistics which make a strong case when considered together.

Despite an apparent slump in the second quarter, the Scottish index of production and construction showed annual growth in the year to June of 4.8%, almost five times that of the UK. In manufacturing, provisional estimates indicate annual growth of 6.2% compared with UK growth of 1.6%. Evidence from the Scottish Chambers' Business Survey and from more anecdotal evidence indicate that throughout much of the year consumer spending in Scotland has remained more buoyant than for the UK as a whole, and house prices have continued to show modest gains in Scotland compared with marked falls in southern Britain. However, perhaps the most impressive performance has come in the labour market, an area in which Scotland has traditionally fared relatively poorly. Scottish unemployment has continued to decline modestly for fully seven months after UK unemployment began to rise in April, and while UK vacancies fell by one-third in the year to October the corresponding Scottish decline in vacancies was only 5%. Scottish unemployment was still 1.9 percentage points above that of the UK in October, but the gap has narrowed considerably over the last year.

<u>The UK Economy</u>

So far so good. The problem arises when we allow for the fact that most of this satisfactory Scottish performance took place against a background of a UK economy whose rate of growth was steadily slowing; what has changed since the last Commentary is clear evidence that growth ceased in the middle of 1990 and the UK then entered a recession which will continue into 1991. Provisional estimates of Gross Domestic Product indicate a fall of 1% in the third quarter (0.25% excluding oil and gas), and further falls are expected in the final quarter of 1990 and probably into 1991. The evidence indicates that manufacturing industry bore the brunt of this fall and is likely to do so in the near future. Manufacturing output in the UK fell by 1.8% in the third quarter while the service sector showed marginal growth, and the Autumn Statement forecast an overall 0.5% fall in manufacturing output during 1991. As indicated earlier, UK unemployment started rising in April, and while October's rise of 32,000 in the number of unemployed was only half the average monthly increase experienced in the 1980-81 recession, there is every reason to expect an acceleration in this rate of increase as the economy slows further.

The question is how long and how deep the recession will be. The Treasury view is that the recession will bottom out in the middle of next year and will be followed by fairly sharp recovery, so that GDP growth for 1991 will be slightly positive (0.5%). The CBI is markedly more pessimistic, expecting a deeper and longer recession with negative GDP growth during 1991 (-1%). It should be pointed out that the Government's longer leading indicator, which purports to show turning points one year in advance, was still in decline as recently as September, and was unchanged in October. This is important because this indicator has tended to be a reasonably accurate predictor of likely turning points recently, and may indicate a slightly longer recession than that officially forecast. The other great imponderable is, of course, the situation in the Gulf. The outbreak of war would tend to deepen the impact of recession and also increase inflationary pressure, largely through rapid increases in the price of oil but also as a result of possible disruptions to world trade. At the time of writing the Gulf situation is still extremely fluid, and in the absence of clear information on that issue it seems reasonable to expect no clear upturn in UK economic activity until the latter half of 1991.

The new Chancellor's scope for cutting interest rates in response to the deepening recession is heavily circumscribed by entry to the European exchange rate mechanism, and it is not at all clear that either the City or industry has yet realised how important targeting the exchange rate now is for interest rates. One of the expected effects of ERM entry is to remove the 'easy option' of maintaining competitiveness by devaluation, and the Government sees this as a means of imposing discipline on firms to keep costs - especially wage costs - down. Entering the ERM at a fairly high rate and at a time of rising unit labour costs was bound to put a great deal of pressure on manufacturing industry, especially those sectors geared towards exports which are crucial in providing an outlet for UK-produced goods at a time of faltering domestic demand. In the long run the entry mid-point level of DM2.95 may prove unsustainable, and in the short run Britain's exporters feel doubly penalised. Even in a slackening labour market they are forced to accede to high wage demands to recruit and keep the skilled workers they require, and are then faced by an exchange rate regime which is unlikely to accommodate their desire to remain competitive.

## The Outlook for Scotland

Let us first review recent evidence on the performance of the Scottish economy. The latest index of production and construction figures show a slump in the second quarter as dramatic as the jump in output in the first. According to the provisional figures, Scottish manufacturing output fell in the second quarter by 2.9% at the same time as UK manufacturing output rose by 1%, with chemicals, engineering and textiles particularly badly hit in Scotland. Quarterly data on production do tend to be somewhat erratic, and it is not yet clear whether this represents the beginning of an earlier than expected recession or simply a levelling out of the first quarter's reported surge in output. What is now clear, however, is that the construction industry has gone into sharp decline, as previously indicated by successive Scottish Chambers' Business Surveys. However, the 13.6% fall in construction output in the second quarter was surprising not only for the extent of the decline, but for its announcement being preceded by a Scottish Office press release on 30 October which claimed (inter alia) that construction output was still rising, when all the indications were to the contrary.

The most up-to-date indicator of the Scottish economy is the latest Scottish Chambers' Business Survey. In manufacturing, business optimism has been in decline since the beginning of the year, and in the latest SCBS a net balance of -19% of respondents were less optimistic than was the case three months ago. There was evidence of a slackening in export markets for manufacturers, the area in which considerable growth was being achieved earlier in the year, although the net balance of respondents remained positive. Not surprisingly, sales to the rest of the UK remained depressed. Construction is clearly in depression, except around Aberdeen where demand for labour remains buoyant. Retail and wholesale sales trends over the three months of the survey remained positive, and little changed from the previous survey, although the expected trend in sales and new orders is downward.

The general tone of the SCBS is that, in common with the UK as a whole, construction and manufacturing companies are bearing the brunt of economic slowdown, with the service sector still showing signs of growth. This is reflected to some extent in employment figures for the year to June (the latest period for which data are available); total Scottish employment grew by 41,000 (2.1%), with 32,000 of this increase being attributable to the service sector. However, as we approach the turn of the year the indications are that the labour market will begin to slacken considerably, with unemployment starting to rise again following a long period of steady decline. This is likely to be accompanied by further evidence of weakness in manufacturing industry, partly because of reduced domestic demand and partly because of lower investment activity throughout the UK. Scotland is more oriented towards the production of investment goods than is the UK as a whole, and in the third quarter of 1990 capital expenditure by UK manufacturing was almost 7% below the level of the corresponding period in 1989.

Scotland is intimately connected to a recession-bound economy, and it would be too much to hope that we can forever escape the marked slowdown in the south. For this reason we can expect to see signs in the early part of 1991 that Scotland will start to move more into line with the performance of the UK economy as a whole.

6 December 1990