Quarterly Economic Commentary

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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

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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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Outlook and Appraisal

The economic prospects for 1990 appear very uncertain, following a year in which the Scottish economy has shown signs of out-performing the UK on some indicators.

The index of production for the second quarter of 1989 makes encouraging reading. In the year to the end of June production and construction industry output rose by 4.5% compared with 2.2% for the UK as a whole. When only production industries are included (i.e. construction is ignored), Scotland's relative performance looks even better, with growth of 5.1% in the year to June compared with UK growth of just 1.6%. When the petroleum and natural gas sectors are removed, however, the relative performance is less impressive; 4.5% for Scotland compared with 6% for the UK. Most of this favourable performance stems from fairly rapid output growth in the second quarter of the year in Scotland, a rise of 3.2% while the index of production and construction fell for the UK by 0.9% during that quarter. This fall arose from poor output performance in several individual sectors, such as coal, mechanical engineering, metal manufacture and transport equipment, all of which registered declines in UK output during the March to June period. By contrast, each of these industries exhibited healthy growth during the same period in Scotland. As was pointed out in the June Commentary when the figures for the final quarter of 1988 were discussed, quarterly data must be interpreted with caution in terms of deducing a trend. Nevertheless, these figures do give some support for our previous assertions that Scotland could out-perform the UK on some indicators during 1989.

Since the last Commentary we have seen the arrival of a new Chancellor, and with him some evidence of a change in economic policy. This certainly appears to be the case with regard to the exchange rate; against the D-mark the pound depreciated by almost 15% between January and mid-December, with a fall of over 9% between September and December alone. This development is consistent with Mr Lawson's departure signalling the end of attempts to shadow the D-Mark using interest rates to target the exchange rate. Mr Major, although claiming to be in favour of a "strong pound", has strenuously resisted efforts to put a precise value on this concept, and has been unwilling to raise interest rates further in the face of strong downward pressure on the pound for fear of tipping the UK economy into recession. The problem here lies in the impact which a substantial depreciation of sterling will have on inflation, through more costly imports. To some extent Mr Major may feel that this is a chance he has to take, hoping that, as consumer demand slackens in 1990, companies with imported inputs will be less able to pass on price rises to the customer for fear of losing their competitive edge. There is some leeway for companies to absorb higher input prices in profit margins - company profits over the last two years have been at historically very high levels - but there is a limit to this, and the fall in sterling is bound to have some adverse effect on inflation.

The publication in November of the Autumn Statement gave details of the official view of how the UK economy is expected to perform next year. Clearly a rapid slowing of economic growth, but not a recession, is expected. The growth of gross domestic product (GDP) is expected to be around 2% in 1989, slowing to a mere 1.25% in 1990, compared with 4% growth in 1987 and 1988. The easing of domestic demand is expected to have some beneficial impact on the current account deficit, which is nevertheless expected to run at £15 billion in 1990. Growth is also expected to slow in the other major industrialised countries during 1990 in response to tightened monetary conditions in 1988 and 1989, although fears of recession are, with the exception of the United States, less evident than is the case in the UK.

Prospects

What effect can the slowing of growth in the UK and elsewhere be expected to have on the Scottish economy? To a large extent this depends on whether the UK economy does go into outright recession; it is still not clear that this will not happen, and some of the assumptions on which the "soft landing" scenario is based are open to doubt (see British Economy section). However, even if a slowdown is achieved without recession, the implications for Scotland depend on how this is achieved. Scotland is less dependent than the UK on production of consumer durables, an important consideration because the Government expects much of the fall in the rate of growth to result from lower consumers' expenditure; consumer expenditure is expected to grow by only 1.25% in 1990 compared with around 4% in 1989.

Problems may arise, however, if there is more of a downturn in investment expenditure than is expected in official quarters. Continuing high interest rates are now expected to reduce investment to 4.5% growth in 1990, less than half the growth rate achieved in 1989 although still respectable by the standards of the past. Scotland is more heavily dependent than the UK on the production of investment goods and on construction, which makes investment spending of great significance. It should be pointed out that at least until the second quarter of 1989 production of investment goods in Scotland was holding up well; the index of production in this sector rose by 8.8% in the second quarter compared with a fall of 0.7% in the UK, although the UK nevertheless out-performed Scotland in the twelve months to June (9.8% growth compared with 8.0% in Scotland). These figures do not, however, take account of the rise in base rates to 15%, and should official estimates of investment spending prove over-optimistic in the face of continued tightness in monetary conditions then Scotland would suffer as a result. This effect could be exacerbated by the existence in Scotland of a slight over-representation of industries which are highly susceptible to interest charges (see Briefing Paper).

Some hints as to the likely future direction of the economy in the short term can be gained from the latest Scottish Chambers' Business Survey (SCBS). Previous Commentaries have mentioned the declining confidence of the manufacturing sector while retailing and wholesaling remained optimistic - quite the reverse of the pattern expected if a "soft landing" was to be achieved for Scotland. The latest SCBS shows quite a different pattern, however, with virtually every sector showing a marked degree of pessimism about immediate economic prospects. The manufacturing sector continues to be most markedly pessimistic, with a balance of 35% of respondents feeling less optimistic than at the time of the previous survey. Within manufacturing there is some diversity of experience, with textiles being least optimistic (-68% more optimistic - see textiles section), and food, drink and tobacco most optimistic (-5%). However, construction (-23%), retailing (-27%) and wholesaling (-38%) have now fallen more into line with the figures for manufacturing. The retailing and wholesaling figures are consistent with the persistence of high interest rates having a depressing effect on consumer expenditure; however, this effect is clearly anticipated rather than actual. A balance of +46% of surveyed retailers experienced a growth in sales in the quarter to October, and a much reduced balance of +3% expected increased sales in the three months to January. In construction too the pessimistic mood appears to be in anticipation of less healthy times ahead, rather than the expectation of a slump to match that experienced in the south of England.

However, the manufacturing sector results are the most worrying. A balance of -35% on business confidence is the lowest ever recorded by the SCBS, far lower even than that recorded in 1986 in the aftermath of the collapse in the price of oil and the recession which resulted in Scotland. As with the other sectors this pessimism has yet to manifest itself as a slump in new orders or sales, and it should be noted that in most sectors the most buoyant actual and expected markets are exports, an important consideration when there is a marked downturn in domestic demand and production has to be more oriented towards overseas markets. Nevertheless, such a marked and uniform downturn in business confidence cannot be lightly dismissed, and, if proved to be correct, may indicate that Scotland's welcome improved performance relative to the UK may be short lived; 1990 already shows signs of being a difficult year for Scotland.