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

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

Outlook and Appraisal

OVERVIEW

The medium-term prospects for both the Scottish and British economies have clouded considerably during the last few days as it became clear that holders of sterling are beginning to lose confidence in the British economy. This loss of confidence reflects doubts about both the Chancellor's economic strategy and the ability of the economy to sustain an improvement in the current account of the balance of payments at the going sterling exchange rate. In the short-term the Scottish economy continues to bear up relatively well to the earlier interest rate rises. The growth rate is slowing down but less so than expected with sectors such as retailing and construction still remaining relatively buoyant up here compared with the UK as a whole. However, the low level of business confidence in manufacturing does not augur well for the prospects of avoiding a recession; prospects which have undoubtedly worsened following the increase in base rates to 15% and the blow to business confidence of falling share prices. Finally, further revisions to the employment data are less favourable to the government's view that employment in Scotland has benefited considerably from the upsurge in economic activity in 1987 and 1988.

PROGNOSIS

It is quite clear that the rate of growth of output is slowing in both the world (see World Economy section) and the British economies (see British Economy section). The slowdown is however less than expected and the form of the deceleration gives some cause for concern.

In last year's Autumn Statement it was evident that the Treasury expected domestic demand growth to moderate during 1989 and that this would result in a reduction in the demand for imports and a transfer of domestic resources to export production. On this view, the current account deficit was expected to fall back to 11bn with sterling remaining close to levels current at that time. Inflation was also forecast to peak at 7% during the year and then turn down. This was the basis of the Treasury's "soft-landing" forecast: an optimal slowing of the economy's rate of growth would be achieved by the limited policy intervention of the 1988 base rate rises.

In the Commentary of December 1988 we noted that: "None of this can be guaranteed. Our view is that on present policies, the British economy is unlikely to produce, unless by chance, an optimal balance between a reduction in domestic demand and the necessary switch of expenditure from foreign to domestic production. The more probable outcomes are a depreciation of sterling during 1989-'90, with all the attendant inflationary implications that that would produce, and/or, further interest rate rises or other measures to depress domestic demand, which would further reduce the rate of growth of output." To date this appears to be precisely what has happened. While demand pressures in the economy have reduced and growth has slowed down, it is quite clear that the slow-down has been less than expected and that cost-push inflationary pressures have been greater than the government anticipated. And, partly because of this, the changes in the structure of domestic demand and supply that are necessary for a "soft landing" have not yet materialised sufficiently.

A relative expansion of the domestic production of tradeables - largely manufacturing and the traded services such as insurance, other financial services and tourism - and a contraction of the non-traded sector - principally construction and a large proportion of services - constitute the necessary requirements. These adjustments are required if a reasonable rate of GDP growth is to be maintained alongside a significant improvement in the deficit on current account at an unchanged sterling exchange rate. In fact, production in the non-traded sector appears to be holding up better than the production of tradeables. And this appears particularly true of activity in Scotland, where, against a background of a general deterioration in business confidence, the construction and retail sectors remain fairly buoyant while optimism in manufacturing is at its lowest level since July 1986 (see Business Surveys section). The recent trade statistics, which clearly reflect the lack of a switch in demand in favour of tradeables, served, along with uncertainty about the Chancellor's interest rate policy, to further undermine confidence in sterling. The resulting depreciation represents an effective devaluation of the currency of nearly 10% since December 1988.

Now that the Chancellor appears to have forfeited, at least for the moment, the confidence of the foreign exchange markets his room for manoeuvre is heavily circumscribed. He cannot allow the markets to believe that base rates have reached a ceiling because that would precipitate an even greater depreciation of sterling which, in view of the government's inflation objective, he is very keen to avoid. Accordingly, there is the prospect of a further base rate rise, especially if there is little improvement in the next set of monthly trade statistics. Moreover, it is a moot point whether the inflation dampening effects of ever higher base rates - via reduced domestic demand and stabilised sterling import prices - will offset their inflation generating effects in inducing cost-push pressures in both labour and intermediate product markets. The probability that we will experience a recession with continuing inflation - a so-called "hard landing" - has therefore increased over the last few days and has been reinforced by the falls in share prices which can only serve further to undermine business confidence.

THE JOBS MARKET

In the June Commentary we noted that the publication of the results of the Spring 1988 Labour Force Survey (LFS) indicated that recent job creation in Scotland had been much greater than previously estimated. Specifically, employment in September 1988 was estimated to be 47,000, or 2.5%, higher than earlier calculations. We cautioned, nonetheless, that the LFS estimates were not the last word on recent job change in Scotland. For that we required to see the results of the more accurate triennial Census of Employment which provides a benchmark for the short-term employment estimates derived from monthly and quarterly sample enquiries. The results for the 1987 Census were expected to be published before the end of the year.

These data are now available and indicate that employment in Scotland is generally lower than the LFS suggested. Employees in employment in Scotland in September 1988 is now estimated to be 37,000, or 2%, higher than earlier pre-LFS calculations, that is 10,000 below the LFS estimate. By the first quarter of 1989, the LFS is seen to have overestimated the civilian workforce and employees in employment in Scotland by 23,000, 1.1%, and 22,000, 1.2%, respectively. During the year to the first quarter the civilian workforce and employees in employment are now estimated to have risen by 42,000, 2%, and 14,000, 0.7%, respectively, compared with previous estimates of 55,000 and 26,000. Clearly, employment has been growing over the past year but less strongly than had been suggested by earlier estimates. Overall, employees in employment rose by 0.7% in Scotland during the year to the first quarter of 1989, which amounts to half the rate, 1.4%, experienced by Britain as a whole. The service sector in Scotland continued to grow poorly, increasing by 0.5% while in Britain a growth rate of 2.1% was recorded. Some comfort can be gained, however, from the fact that manufacturing grew more rapidly here, at nearly 2% compared with only 0.2% in Britain as a whole. This reflects the substantial growth in manufacturing output experienced by the Scottish economy last year, which, at 8%, was 1% point above the UK rate.

16 October 1989