

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.

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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

Growth of output in the Scottish economy continues to be strong. Current performance mirrors the brisk rate of economic growth in the rest of the UK. Manufacturing in Scotland now appears to be sharing in the growth which for so long has principally been enjoyed by the service sector. Construction is now the most buoyant sector in Scotland, with the effects of the recent rapid growth in house prices south of the border spreading north, and the strong growth of investment in the UK leading to increased orders for new buildings and works. Within Scotland, it is the Glasgow area - or at least parts of it - that appears to show signs of strong growth in key sectors. But, further evidence of limited net job creation adds weight to the view that, in the jobs market at least, Scotland's recent economic recovery may be dominated by a longer-run decline in employment opportunities. Prospects for the Scottish economy in 1989 depend largely on developments elsewhere; on the size of the expected decline in world demand and growth; whether the dollar depreciates significantly; the future course of oil prices; and whether the British economy can achieve the 'soft landing' that the Treasury predicts.

Recent Performance

The recent **Scottish Chambers' Business Survey (SCBS)** and the **CBI (Scotland) Survey** both show that the strong growth suggested by earlier surveys is continuing (see **Business Surveys** section). Manufacturing is doing particularly well by historical standards. More specifically, it is manufacturers in the Glasgow Chamber of Commerce area, producing capital goods for export

to the rest of the UK and the world, who appear to be benefiting the most. Investment now appears to be the principal driving force behind the current robust performance of the world economy (see **World Economy** section) and investment demand is high in Britain too (see **British Economy** section). The local effects of this world-wide drive to replace and augment productive capacity are now clearly apparent.

At the sectoral level, the performance of the construction industry is the most worthy of note (see **Construction** section). In the recent SCBS a significant plus 59% of respondents were more optimistic than three months previously. Construction respondents were the most optimistic in the whole survey, a far cry from last year when we reported the industry to be "stubbornly in recession". The industry is increasingly benefiting as the effects of the earlier rapid growth in house prices south of the border spread north, and the strong growth of investment in the UK, leads to housing starts - 41% higher in the first nine months of this year - and increased orders for new buildings and works. But while the outlook for construction appears brighter than in recent years, the industry in Scotland still lags well behind construction in the UK. Moreover, the run down of capacity in the industry, coupled with shortages of appropriately skilled labour, is beginning to exert a restraining effect on output which could develop into a serious bottleneck in the coming months.

Elsewhere in Scottish industry, both retailing and wholesaling are buoyant, although one interpretation of the evidence in the SCBS is that retailers expect the increased cost of borrowing soon to have an impact on orders and sales (see **Distributive Trades** section). The whisky industry is undergoing a robust revival despite demand in the domestic market being fairly flat. The industry has now experienced its fourth consecutive year of growth in export volumes and in the first three quarters of 1988 export volumes were 2.6% higher than during the same period of 1987 (see **Whisky** section). In Electrical and Instrument Engineering, a decline in output of 8% in the first quarter of 1988, coupled with a downward revision of the figures for growth in the fourth

quarter of 1987, led to a very modest recorded growth rate of 3% between the first quarters of 1987 and 1988 (see **Electrical and Instrument Engineering** section). The reasons for, and the extent and impact of, revisions to the Scottish Index of Industrial production are discussed with reference to mechanical engineering in the **Mechanical Engineering** section. The value of oil production remains low, with the September figure of £17.1m the second lowest daily average recorded since 1983. This low value reflects the output lost as a result of the Piper Alpha tragedy and a \$1.63 drop in the price of Brent crude over the month. The effect of the fall in the oil price on sterling oil revenues was only partially offset by a 1.7% depreciation of sterling against the dollar during the period (see **Oil and Gas** section). Finally, following further depressing developments during the last quarter, the outlook for the Scottish coal industry can only be described as bleak (see **Coal, Electricity and Other Energy** section).

The Jobs Market

In the last **Commentary** we drew attention to the weak performance of employment in Scotland compared with the high levels of business confidence and estimated output growth. Our concern about the lack of net job creation has deepened since then (see **Labour Market** section). During the year to June, net employment rose by 2,000 jobs, an increase of 0.1%. The UK in contrast experienced a jobs growth rate of 1.3%. Both Scotland and the UK exhibited a slower rate of jobs growth in the year to June compared with the year to March, but the slowing down was relatively more significant in Scotland. Moreover, once allowance is made for part-time jobs it can be demonstrated that full time equivalent employment actually *fell*, by 3,000, in the year to June 1988. Self employment is estimated to have increased but only by 3,000 in the year to March. If other things remained equal, this is not what one would expect in a period when the rate of growth of output in the Scottish economy is moving into line with a high rate of growth elsewhere in the UK.

It still remains possible that lags in the adjustment of employment to output may yet generate a substantial change in net employment which will be present in the employment statistics, when

published, for the remainder of this year. This interpretation is consistent with recent business survey evidence, where a positive balance of respondents in most sectors report that employment either has risen or is expected to rise. But as the time since the signs of renewed business confidence and output growth increases, other interpretations become increasingly plausible.

- The expectation of a downturn next year in both the world and British economies, coupled with the shorter duration of the present recovery in Scotland, may have resulted in Scottish firms discounting the gains from increased employment more heavily than their UK counterparts. If so, Scottish firms would be more likely to continue to meet the increased demand for their goods and services by an increase in overtime working rather than by hiring additional staff. In these circumstances, the impact on net job creation could be proportionately lower than in the UK. The present Scottish economic recovery might be too short-lived to warrant a significant expansion of jobs.
- Alternatively, or additionally, the lack of net job creation may reflect longer-term trends in the Scottish economy. The gap between the employment performance of Scotland and Britain has worsened since the late 1960s. As the traditional industries contracted and new industries such as electronics came into the economy, a large number of low productivity jobs were replaced by a small number of highly productive jobs. This process accelerated during the 1980s. Productivity rose at above UK average rates but net job creation remained either negative or low and worse than the UK because of the historic concentration of traditional activities here. This was reinforced by the relatively poor performance of the service sector in Scotland, the sector that has been the main source of UK and Scottish employment growth in recent years. These trends continued into the year to June 1988, with production jobs contracting by 3.2% and service employment rising by 1.2%. Construction, with an

increase of 2.9%, moved against its long-term trend, reflecting the current upsurge in activity in that sector. With significant numbers of low productivity jobs being shed it is perfectly feasible that an estimated 1987/'88 GDP growth rate of 3 to 3.5% could be associated with *net* job creation of only 2,000 jobs, or even a net decline in full time equivalent employment. Moreover, if the decline in such jobs was at a faster rate than the rest of the UK then this would account for net employment creation in the UK being proportionately greater than the GDP growth differential.

Prospects for 1989

Prospects for the Scottish economy in 1989 depend largely on developments in the world and British economies. Specific issues of importance to Scotland are: the size of the expected decline in world demand and growth and the prospects for the dollar; the outcome for oil prices and sterling; and whether the British economy can achieve the 'soft landing' that the Treasury predicts.

Recent evidence from the Scottish Council Development and Industry (SCDI) suggests that Scottish manufacturing exports are performing well, rising 13% by value in 1987-'88. Earlier evidence from business surveys reported in this **Commentary** suggested that Scottish firms were doing better in non-Scottish markets and that the stimulus to higher growth was coming from external demand. The SCDI data confirm that earlier evidence. But the world economy is forecast to turn down in 1989 after a stronger than expected performance in 1988. Real GNP growth in the major seven countries is expected by most forecasters to fall from 4% this year to 3% in 1989 (see **World Economy** section). Scottish exports will almost certainly be affected, although with world trade in manufactures still expected to rise by about 7.5% next year compared with 8.5% in 1988, exports from Scotland should remain fairly buoyant. One problem is that the distribution of world demand can be altered by exchange rate movements. The current volatility of the dollar and the dollar/sterling exchange rate is of particular significance. If the dollar falls significantly next year

then it will become that much harder for Scottish firms to sell to North America, our biggest single export customer. Whether the dollar will fall further, depends on the rate at which the US current accounts improves, the policy adopted by the incoming Bush Administration to the still large Budget deficit, and the response of the foreign exchange markets to these developments.

The price of oil has been on a downward trend since the third quarter of 1987 when the price was averaging around \$18 per barrel. The principal cause has been production by OPEC countries above agreed quotas. Oil prices are expected to remain weak during 1989, despite the recent OPEC agreement to restrict output and peg prices at the probably unrealistic level of \$18. If the price does stabilise at around even present levels of \$14 per barrel then the sterling value of oil output should hold up through the year, with production returning to more normal levels as the Flotta pipeline comes back on stream. The main area of uncertainty, apart from the future course of oil prices, is the sterling/dollar exchange rate. A collapse of the dollar and appreciation of the sterling/dollar rate would have a harmful impact on the sterling revenues obtained from sales of oil priced in dollars. The Scottish economy would be likely to suffer as a result. However, the outcome would differ if sterling were to depreciate and this cannot be ruled out in view of the large UK deficit on current account which, in turn, is a symptom of high domestic demand and inflationary pressure.

The Treasury is forecasting a 3% GDP growth rate in 1989 compared with an estimated 4.5% outturn for 1988. But underlying this forecast are some very optimistic assumptions (see **British Economy** section.) Domestic demand is expected to moderate, resulting in a reduction in the demand for imports and a transfer of domestic resources to export production. World demand is expected to be appropriate to an increase in export demand. The current account deficit is thus predicted to fall back to £11bn with sterling remaining close to recent levels. At the same time inflation is expected to peak at around 7% - 7.5% and then turn down. The economy is thus forecast to achieve the proverbial "soft landing" with limited policy intervention i.e. only the interest rate rises. If this forecast is realised then the Scottish economy should also perform very well next year. Growth would be somewhat lower than

in 1988 but at a rate which would be quite respectable by past standards.

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. Either way, the outlook for the Scottish economy during 1989 is less sanguine than current government forecasts imply.

14 December 1988