

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

The growth of the Scottish economy is now moving into line with the rest of the UK. Industrial production is buoyant. The growth of demand is becoming more broadly based between domestic and external sectors. Yet, construction output still remains relatively depressed, and in a significant number of other industries the ratio of Scottish to UK output remains below that of 1980. As yet there is little indication of the favourable changes in unemployment and vacancies during 1987 being reflected in the most recent employment data. But short-term prospects are more favourable than for several years, while growth forecasts for the medium term compare favourably with those for the UK as a whole.

Recent Performance

The performance of the Scottish economy diverged significantly from that of the UK as whole following the fall in the price of oil which began in late 1985. Thereafter the Index of Industrial Production in Scotland fell from 108.4 in the third quarter of that year to a low of 102.8 in the second quarter of 1986, compared with 109.5 in the UK. In the subsequent five quarters industrial production grew more quickly in Scotland on three occasions. But the modest differences in performance meant that by the third quarter of 1987 the index stood at 106.8 in Scotland and 114 in the UK. However, the provisional estimates of production for the fourth quarter of 1987 show that industrial production rose by 5% in Scotland compared with only 0.7% in the UK. The index now stands at 112.1 and 114.8 in Scotland and the UK respectively. But, the poor relative performance of the construction industry in Scotland (see **Construction** section), which accounts for nearly 25% of industrial production, has since 1982 served to retard overall performance. Thus by the fourth quarter of 1987, the combined Index of Production and Construction stood at only 107.4 in Scotland, compared with 114.8 in the

UK.

The aggregate production figures disguise a diversity of experience within Scottish industry. For example, electrical and instrument engineering, and chemicals displayed significant growth in the fourth quarter of 15% and 10%, respectively. Conversely, output of coal and coke declined by 9%, and metal manufacture by 5%. However a better indication of where Scottish industry currently stands can be obtained by comparing, for each Scottish and UK industry, the difference in the recent quarterly growth figures with the difference in the fourth quarter index of production (1980=100). These are shown in Table 1.

Table 1: Index of Production Scotland-UK

| | Difference in % change 1987 ₃ -1987 ₄ | Difference in Index 1987 ₄ |
|--|---|---|
| Production Industry | | |
| Elect & Inst Eng | +14 | +90 |
| Chemicals | + 9 | -15 |
| Other Energy | + 8 | - 6 |
| Drink & Tobacco | + 3 | -23 |
| Food | + 3 | - 3 |
| Other Minerals | + 2 | -12 |
| Paper, Printing etc | + 2 | 0 |
| Textiles & Leather | + 2 | - 3 |
| Metal Goods | 0 | + 3 |
| Other Manufacturing | - 2 | + 8 |
| Mechanical Eng | - 3 | -21 |
| Metal Manufacture | - 6 | -47 |
| Transport Equipment | - 6 | - 6 |
| Coal & Coke | - 8 | -36 |
| Total Production | + 5 | - 2.7 |
| Construction | - 1 | -22 |
| Total Production & Construction | - 1.6 | - 7.4 |

The fourth quarter industrial production figures shown in the table are the clearest indication to date – although they may be subject to substantial revision (see **Mechanical Engineering** section) – that the benefits of the persistent growth experienced by the UK economy in recent quarters are now being felt significantly north of the border. The relatively faster growth of the other energy sector clearly reflects the recovery of oil and gas exploration which became evident in 1987 (see **Oil and Gas** section). But with seven other industries experiencing a favourable growth differential, the improved production performance evidently reflects more than the effects of offshore activity moving back to pre-1985/6 levels. It is, however, also clear from the table that *relative* output levels in eleven of the fifteen Scottish industries shown still remain below those achieved in 1980. And in seven of those industries: coal and coke, mechanical engineering, metal manufacture, drink and tobacco, other minerals, construction, and transport equipment, production is *absolutely* lower than in 1980. Three industries: electrical and instrument engineering, other manufacturing, and metal goods, have improved their position relative to the UK since 1980 and the first named, via the rapid growth of output in electronics, dramatically so. But their combined weight in Scottish industrial production is currently only around 14%. This suggests that for a rapid restoration of even the overall 1980, UK/Scotland relativity, faster growth must be more broadly based across several sectors. It must, therefore, encompass Scotland's more traditional industries.

At the rates experienced in the fourth quarter of 1987 it is true that Index of Production and Production for Scotland would move into line with that for the UK during the third quarter of this year. However, it appears unlikely that such a favourable growth differential can be sustained and it is not improbable that the fourth quarter figures will be revised downwards as new information comes to light. Perhaps the best hope is that the average growth differential of the last three quarters of 1987 will be sustained. With Scottish production growing at 2.5% per quarter and UK production at 1.1% then then two indexes would be broadly equal in the first quarter of next year. Our judgement is that such a sustained period of differential growth is unlikely, bearing in mind that the growth of the Scottish and British

economies is expected to be broadly similar during the current year (see below). It is therefore probable that the Scottish Index of Production and Construction will remain below the UK index for the foreseeable future.

As yet there is little indication of the favourable changes in unemployment and vacancies being reflected in the most recent employment data (see **Labour Market** section). Unemployment fell by 38,700 in the year to December 1987. Total employment, on the other hand, rose by only 4,000. Male employment actually *fell* by 10,000 even though the unemployment of males reduced by 24,400. Self employment increased by an estimated 12,000 during the period but it would appear that the fall in unemployment in Scotland during 1987 was not the outcome of an increase in net labour demand.

Short-Term Prospects

The April **Scottish Chambers' Business Survey (SCBS)** and the **CBI (Scotland) Survey** provide the latest guide to the short-term prospects of the Scottish economy. In the SCBS, respondents were more optimistic than at any time since the inception of the survey three and a half years ago. This is the sixth consecutive survey in which the balance of optimism has risen among Scottish firms. The main features of the surveys (see **Business Surveys** section) were as follows:

- the retailing and wholesaling sectors continue to be highly buoyant, with substantial positive balances of respondents expecting further increases in sales during the subsequent three months. Employment prospects were also considered to be favourable, although the emphasis was on part time employment growth;
- in manufacturing output growth is more broadly based with strong growth in Scottish orders. Export orders and sales show no sign of abatement. Investment demand remains vigorous with firms largely investing to expand capacity and increase efficiency rather than simply replacing existing capital stock. Firms appear to be taking on new employees and unlike earlier quarters firms are now employing more males. In view of the higher fixed costs of hiring male labour

this suggests that firms expect sustained growth in future orders and sales;

- in the Scottish financial institutions credit expansion is continuing with advances to the corporate sector showing strong growth, particularly for working capital in the distributive and service sectors;
- the location of output and employment growth in Scotland appears to be favouring the Glasgow and Dundee areas, with activity in Edinburgh and Aberdeen, in particular, remaining depressed by both Scottish and UK standards.

The Scottish economy is relatively small and open so its short-term prospects must be viewed against a background of developments elsewhere. Growth in the UK economy (see **British Economy** section) may be slowing down compared with 1987 but the rate of growth of domestic demand remains strong and growth is still expected to reach 3.1% this year. Interest rates are likely to rise further during the year to regulate domestic demand and with diminishing net export demand growth will almost certainly be lower in 1989. Growth in the world economy (see **World Economy** section) appears to be continuing at a brisk rate. Recent forecasts suggest that output should expand by about 3% this year compared with 3.1% in 1987. US domestic demand is projected to slow down this year, growing by 2% compared with 2.5% in 1987. This coupled with the effects of the appreciation of sterling against the dollar: 25% during 1987, might be expected to affect British, and particularly Scottish, exports to the US market. The productivity gains and the relatively high profits enjoyed by British and Scottish manufacturing firms have probably provided some cushion against loss of competitiveness. But the harmful effects on exports are unlikely to be avoided if sterling continues to appreciate further.

Yet recent evidence from the April CBI Industrial Trends survey might be taken to indicate that Scottish exports are holding up better than British exports to an appreciating exchange rate. During 1987 British export volumes rose by 7.1% but in the first quarter of this year the volume of visible exports fell by 6.5% to a level 2.6% lower than in the first quarter of 1987. These data may reflect under recording due to changes in the method of recording trade flows and so may subsequently

be revised upwards. But it is clear that British exporters are now much less optimistic about export prospects than previously, yet Scottish exporters appear to be more sanguine. In April, a balance of -5% of British exporters were less optimistic about export prospects and a balance of only +2% rated their export order book above normal. The equivalent Scottish figures were -2% and +35%, respectively. Similarly, when asked which factors were likely to limit export orders over the next four months, 70% of British exporters indicated prices, compared with only 45% of Scottish exporters.

The differences between the responses of Scottish and British exports may be simply a statistical aberration given the small size of the Scottish sample. But with the British and Scottish responses being similar in answers to other questions such as the trend in unit costs and export prices, this appears less likely. Differences in the structure of Scottish exports may also account for the varying response. Exports to the US market are proportionately more significant to the Scottish economy but with sterling rising by 25% against the dollar during 1987 compared with only a 10% increase in the trade weighted sterling index, the present findings are the reverse of what might have been expected. We therefore appear to be left with the possibilities of more favourable Scottish productivity growth during the time period in question and/or the greater or increased significance of non-price factors (quality, prompt delivery, better marketing) to Scottish exports. Whatever the reason, Scottish exports currently appear to be holding up better than those from the rest of the UK.

Medium-Term Forecasts

The latest forecasts for the Scottish economy from the Institute's **Medium-Term Forecasting** model have been revised upwards compared with those reported in the **March Commentary**. We now expect GDP to grow by 3.2%, compared with our previous forecast of 2.9%. Given the post-Budget forecasts of UK growth in 1988 of 3.3% from the London Business School and 3.5% from the National Institute, Scottish GDP is now predicted to grow broadly in line with the UK this year. For the period 1988-93 we are predicting that the annual growth of Scottish GDP will average around 2.9%. This represents a 0.2%

points increase on our earlier forecast. The upward revisions reflect increases in our forecast of final demand for the early years of the forecast period. Specifically, our estimate of consumers' expenditure has been raised to reflect the continued buoyancy of earnings growth. Private non-residential investment is also expected to be greater due to the strong profits performance of the corporate sector. And exports to the rest of the UK have been revised upwards for technical reasons.

At the sectoral level, the computer and electronics industry is again forecast to display the highest rate of growth over the period to 1993. At a forecast annual average rate of growth of 10.20% this is greater than our previous forecast of 8.76% per annum. Oil and gas exploration is the only other sector with a forecast growth rate above 5% per annum and the predicted rate of 5.72% is lower than our previous forecast. At the other extreme, only two sectors are forecast to grow at 2% per

year: brewing and soft drinks, and public administration and defence. Overall, 33 of the 43 sectors considered are expected to grow at an annual average rate of between 2.5% and 3.5%.

Employment growth is also expected to be fairly buoyant by past standards. Total employment in Scotland is expected to rise from 1.89 million in 1988 to 1.96 million in 1993, an increase of 3.46% or an average annual rate of 0.58%.

In summary, both short-term and medium-term prospects for the Scottish economy continue to be favourable. Industrial production is buoyant but the ratio

of Scottish to UK industrial output is likely to remain below 1980 levels for some time. The performance of Scottish exports appears to be encouraging. But evidence of the effects of improved economic activity on employment has still to emerge.

22 June 1988

| Summary Forecasts | |
|----------------------------|------|
| Scottish GDP Growth | |
| 1988 | 3.2 |
| 1988 to 1992 | 2.9 |
| Employment Growth | |
| 1988 to 1992 | 0.58 |