Quarterly Economic Commentary

we gratefully acknowledge the contribution of the
Buchanan and Ewing Bequest
toward publication costs

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.

Information for subscribers

The Quarterly Economic Commentary is published in February, May, August and November. Annual subscription rates are £20.00, or £5.50 per single issue. Queries should be addressed to the Secretary, the Fraser of Allander Institute.

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.

Commentary Team

The Fraser of Allander Institute
Curran Building
100 Cathedral Street
GLASGOW G4 OLN

041-552 4400 Ext. 3958

QUARTERLY ECONOMIC COMMENTARY

***** COMMENTARY *****

***** VIEWS *****

ECONOMIC PERSPECTIVES

Outlook and Appraisal

The prospects for both the Scottish and UK economies have clouded considerably following the dramatic collapse in share prices in London and other major financial centres. During the last three months Scottish economic performance has been buoyant reflecting the continued strong growth of the UK economy. The labour market appears to be registering the effects of stronger growth but the absence of up-to-date employment data makes it difficult to gauge the likely impact on employment. The depressing effects of the fall in oil prices during 1986 are receding: exploration activity in the North Sea is high, output in supplying industries has increased and the Aberdeen area appears to be experiencing an upturn in activity. However, the reduction in net personal wealth following the collapse in equity prices will limit the growth in consumer demand next year leading to output being lower than previously expected. But, if other things remain equal, the fall in the rate of growth of output should be small but may be greater than for the UK as a whole. Continuing uncertainty surrounding policies to remove the structural imbalances in the world economy, particularly the US Budget deficit, suggests that instability in the financial markets will continue. The key imponderable concerns the effect of the fall in equity prices, financial instability and policy inertia, on business confidence, especially in the US. If recent events are the prelude to a major recession emanating from the US then the UK government must be prepared to take appropriate action to limit the domestic impact of a drop in external demand.

Evidence of a continuing improvement in the Scottish economic outlook during the last three months is provided by both the **Scottish Chambers' Business Survey (SCBS)** and the **CBI Survey** (see **Business Surveys** section). The surveys, which were conducted in late September and early October before the events in the world stock markets, again reported an improvement in business optimism. Indeed, in the **SCBS** respondents were more optimistic about the short term outlook than at any time since the survey's inception in October 1984. Both surveys suggest that the Scottish economy is emerging from the effects of the 1979-81 recession and the depressing effects of the fall in oil prices last year. As might be expected, output and orders are responding more strongly than employment to the growth in demand but in service activities such as retailing and wholesaling (see **Distributive Trades** section) there is clear evidence that jobs are being created.

The combined evidence (see **Labour Market** section) of falling unemployment - including long term unemployment - and increasing vacancies confirms the judgement in the August **Commentary** that the labour market in Scotland is registering the effects of the upturn in economic activity. However, since employment data are only available to March of this year we cannot be certain of the extent to which increased growth is feeding through into net job creation. Investment appears to be increasing but the evidence from the surveys suggests that many more firms are investing to raise efficiency than to increase the level of their capacity. Such investments may actually be associated either with a decline in labour demand and/or an increased demand for more highly skilled workers. The article by **Jenkins & Boyle** (see **Views** section), which reports and analyses the responses to additional questions on firms' recruitment activity contained in the recent **SCBS**, indicates that 66% of respondents had attempted to recruit labour during the last three months. Half of these firms reported that they had experienced some difficulty in finding suitable employees and of these 83% reported that the problem had existed for more than three months. Skilled labour posed the most recruitment problems, particularly professional, managerial and technical staff. This apparent mismatch in the supply and demand for labour is not a new phenomenon in regional labour markets but it does raise questions about the appropriateness of current training policies, and the extent to which key staff have been 'forced' to migrate as posts and functions have been removed from local companies following their takeover by companies based outwith Scotland.

The depressing effects of the fall in oil prices are now clearly receding. The stabilisation of the Brent Crude oil price in the US$18-US$20 dollar range has led to a further recovery of exploration activity in the North Sea and there are indications that exploration is proving successful with more discoveries this year than in any other since 1975 (see **Oil and Gas** section). Improved North Sea oil prospects have also raised the demand for Scottish steel products and the UK and Scottish steel industries are continuing to benefit from a favourable configuration of exchange rates (see **Metal Industries** section). Elsewhere, the whisky industry recorded its highest quarterly production since 1980 in the second quarter of the year (see **Whisky** section), the electronics industry has benefited from more Japanese inward investment, reflecting the continuing high levels of the Yen (see **Electronics** section) and the textile industry appears to have experienced a turnround in performance with much improved expectations reported in the October **SCBS** (see **Textiles** section).

Whether the continuing improvement in Scotland's economic performance will be sustained depends currently on three factors: the extent of the wealth effects of the fall in world equity prices on the demand for Scottish products; whether the recent events in the world's financial markets are a prelude to a recession emanating primarily from the US; and finally, the policy stance adopted by the UK government in the event of a decline in external demand.

Current estimates suggest that the effects of the reduction in net personal wealth will be relatively small, at most reducing GDP growth in the UK by about half a percentage point during 1988 (see **British Economy** section). The effect on GDP growth in the US is likely to be greater - perhaps by as much as one percentage point - because share ownership is more widespread there than in the UK.

The most recent forecast prepared by the OECD suggests that after allowing for the wealth effects the economic growth of member countries should fall from 2.75% this year to 2.25% in 1988. However, these forecasts must be subject to more than the usual degree of uncertainty. Expectations of further declines in stock market prices and increased uncertainty about the prospects for removing the structural imbalances in the world economy could lead to a significant deterioration in business confidence, particularly in the US but also elsewhere in the world economy. Moreover, a too rapid contraction of the US Budget deficit with an absence of reflationary measures in the surplus economies of Japan and West Germany could also have seriously depressing effects. A world recession largely emanating from the US could occur on either account (see **World Economy** section).

The vulnerability of the Scottish economy to a major downturn in aggregate demand was clearly underlined during the 1979-81 recession and its aftermath. On all economic indicators Scotland suffered by more than the UK. It is therefore probable that the Scottish economy will be more seriously affected by recent events and the prospect of world recession than the UK economy as a whole. First, exports are more important to the Scottish economy than to the rest of the UK economy. Secondly, the US, the likely source of any recession, is a more significant market for Scottish products eg high quality textiles, tourism and whisky. Thirdly, the recent revival of Scottish economic activity has been export led, domestic demand has been slow to respond and so is unlikely to be much of an alternative source of growth in the event of a downturn in external demand. Finally, a higher proportion of Scottish firms are foreign, and particularly US, owned. These firms may be particularly vulnerable to rationalisation and closure in the event of a contraction of operations at parent plants in other parts of the world.

The policy stance of the British government will also be crucial if both the Scottish and UK economies are to avoid the worst effects of a major downturn. The two half percentage points cuts in interest rates will go some way to ease the liquidity pressures on institutions and the increased cost of equity finance faced by firms following the fall in share prices. However, if a recession from abroad appears likely to materialise then a further relaxation of both monetary and fiscal policy will be appropriate. Further cuts in interest rates would be necessary. Buoyant tax revenues mean that the Chancellor has considerable scope for the adoption of a contra-cyclical fiscal policy. But we continue to urge that the interests of the economy would be better served by an expansion of public expenditure rather than tax cuts (see **British Economy** section). Finally, if the government does seriously desire to spread the benefits of economic growth to all parts of the United Kingdom then, under present circumstances, a decision to abolish or cut back the already small package of regional incentives would be ill-judged to say the least.

18 November 1987