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

The Quarterly Economic Commentary is published in March, June, September and December. 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.

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

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

Outlook and Appraisal

Recent production data suggest that the Scottish economy grew at a similar rate to the UK in 1988. However, in the fourth quarter of last year Scottish production fell while UK production rose. Revised employment data reveal that employment growth during 1987 and 1988 was much more buoyant than previously estimated. Jobs growth in the Scottish economy now more clearly reflects the estimated changes in output and unemployment. The evidence from the latest business surveys is consistent with the expectation that growth in the Scottish economy - as in the British economy - will slow during 1989. Retail sales, wholesaling and construction activity still remain fairly buoyant and perhaps more so than in the UK. But the short-term outlook for manufacturing appears less sanguine, which, when coupled with the recent rise in interest rates and increased inflationary pressure, reduces the prospect of a 'soft landing' in both Scotland and the rest of the UK.

The Index of Production and Construction

Production figures for the fourth quarter of 1988 were published by the Scottish Office in late May. These show that in 1988 production and construction rose by 5.9% in Scotland compared with 4.2% in the UK. Broadly similar rates, of 6% and 6.3% respectively, are produced when the petroleum and natural gas sector is removed from the index. The evidence to date, on non-service sector growth at least, is that the growth of the Scottish and UK economies during 1988 was in line with our earlier predictions. However, the broadly similar performance of the Scottish economy resulted from a faster rate of growth during the first and third quarters and a slower rate in the second and final three months of the year. In both the second and third quarters production and construction activity actually fell in Scotland while in the UK a positive growth rate was experienced in all quarters. So, in the final quarter of 1988 production and construction fell by around 3.5% in Scotland but rose in the UK by 0.3%, or 0.7% when petroleum and natural gas is excluded.

A closer inspection of the recent production data suggests that the fourth quarter fall in Scottish activity was due largely to production cut-backs in only a few sectors: construction in particular (an 8.7% fall), but also in engineering and allied (5%), in drink and tobacco (3%) and in food industries (2%). We cannot therefore conclude from these data that the Scottish economy began to turn down sooner and more rapidly than the UK as a whole. The smaller scale of the Scottish economy makes it more vulnerable to given random shocks and so industrial activity tends to fluctuate more here than in the UK. Data are required for several quarters before we can be sure of a trend. Moreover, the data are also subject to often quite marked revisions as new information becomes available. For both these reasons, the quarterly production and construction data should be viewed with caution.

Employment

The same critical comment can be made about employment data. In recent **Commentaries** we have drawn attention to the apparent discrepancy between indicators which show rising GDP and falling unemployment on the one hand, and largely static employment on the other. Employment is measured by a full census every three years, the last published being for 1984. Sample surveys of firms are used to revise the data in the intercensal years. In addition, surveys of households as opposed to firms are also undertaken which provide valuable information on labour supply, self employment and, to a lesser degree, the number of jobs. The publication of the Spring 1988 Labour Force Survey (LFS) of households in April revealed significant under-recording in the previous estimates of individuals in employment. As a result, the government's estimate of jobs in the UK, including Scotland, has been revised upwards significantly (see **Labour Market** section).

Scottish employment in September 1988 is now estimated to be 47,000, or 2.5%, higher than previously. Estimates of the recent change in Scottish employment are now more closely in line with the fall in unemployment in Scotland and employment change in the UK. Unemployment fell by 37,000 between September 1987 and 1988, yet the number of employees in employment was previously estimated to have risen by only 5,000 over the same period. Following the LFS revisions, employees in employment are now estimated to have risen by 37,000, during the period, while the self employed and people in work-related training schemes rose by 20,000 and 7,000, respectively, in the year to June 1988. The workforce in employment in Scotland rose by 65,000 or 3.1% in the 12 months to June 1988, compared with a 3.4% rise in the UK. During the same period employees in employment rose by 2% in Scotland and 3.1% in the UK, while the self employed rose by 10.8% as against a rise of only 4.5% in the UK.

Clearly, job creation in Scotland has recently been much greater than previously estimated. However, two caveats are worth recording. First, the LFS estimates are not the last word on the recent employment change. The LFS, being a survey of households, does not provide the best source of information on the number of jobs in the economy. The triennial Census of Employment, being a full survey of firms, provides a better guide and the 1987 Census will be published before the end of the year. Secondly, even after allowance has been made for the LFS upward revisions, employment is still significantly down over a longer period compared with the UK. Between June 1979 and June 1988 the total of employees in employment was 173,000 lower in Scotland, a fall of 8.2%. This compares with a fall of only 2.6% over the same period in the UK.

Prospects

The evidence from the latest business surveys is consistent with the expectation that growth in the Scottish economy - as in the British economy - will slow during 1989 (See **Business Surveys** section). The April/May **Scottish Chambers' Business Survey (SCBS)** provides indications of this slow-down but identifies a clear distinction between retailing, wholesaling and construction on the one hand, and manufacturing on the other.

The former continue to be surprisingly buoyant with all three sectors registering an increase in optimism over the previous quarter. In construction (see **Construction** section) the evidence is consistent with the view that the recent buoyancy of the housing market in Scotland is continuing to feed strongly into the construction of new houses. The levelling-off of construction activity in England is not yet evident in Scotland. In retailing and wholesaling (see **Distribution** section) the upward revision in optimism would seem to reflect the fact that the trend in the volume of sales broadly matched previous expectations. Moreover, a comparison of the behaviour of UK retail sales volumes and the trend in sales in Scottish retailing, with the latter holding up better than the former in the final three months of last year and the first three months of this, suggests that consumer spending has recently held up better here than in the UK. So all three sectors are continuing to stand up well to the rise in base rates. Nevertheless, it is reasonable to interpret the survey data as indicating that the rate of growth of activity in these sectors will fall back over the next few months since the expected trend in orders and sales, while remaining positive, is generally lower than the actual trend.

In manufacturing, the position appears to be more serious. The recent **SCBS** shows that firms' optimism about their general business situation has suffered a severe reversal. From a net 12% of respondents more optimistic in December, the latest survey reports that a net 13% are now *less* optimistic than they were three months previously. This is the lowest level of optimism recorded in the survey since July 1986 when business confidence in Scotland was hit by the oil price collapse. It now appears clear that manufacturers optimism about their business situation peaked in April of last year. The March/April **CBI** survey is if anything even less optimistic than the **SCBS** about the prospects for manufacturing. In the **CBI** survey the growth of output and export orders are expected to slacken whereas in the

SCBS, despite the marked drop in confidence, a significant net percentage of respondents, 32% and 36% respectively, expect output and exports to rise. However, both surveys expect employment in the sector to fall in the subsequent three months. And both report some weakening of manufacturing investment intentions, although there is no evidence so far that the steep rise in base rates has had much adverse impact on investment intentions in Scotland. Indeed, the evidence from financial sector respondents to the **SCBS** is that firms are switching the financing of their investments away from borrowed funds towards internal finance. After several years of high profits firms generally have substantial cash reserves, but while these reserves might cushion investment expenditures in the short run, investment will not for long remain at current levels if the present level of base rates persists or rises to even higher levels.

In summary, retailing, wholesaling and construction appear to be holding up better than might have been expected to the steep rise in interest rates. In recent months the performance of these sectors may have been better than their UK counterparts. But the rate of growth, and possibly the level, of output now looks set to decline as demand in the British and world economies (see **World Economy** section) contracts. The manufacturing sector appears to be responding more rapidly to the downturn than other sectors in Scotland, contrary to what one would expect from the 'soft landing' thesis (see **British Economy** section). Industries especially affected include textiles, food, drink and tobacco, chemicals and engineering (see relevant **Industry** sections). On the other hand, metal manufacturing in Scotland is doing particularly well as the boom in steel demand continues unabated (see **Metals** section).

The continued buoyancy of retailing, wholesaling and construction relative to the UK offers some support for our view in the March **Commentary** that if base rate increases largely lower domestic demand via net wealth effects on consumer durables, then the Scottish economy might this year avoid the extremes that are likely to be experienced in the south. On the other hand, we noted that if higher interest rates and the consequent higher exchange rate have their principal impact on demand by lowering investment and exports, then the Scottish economy, with its emphasis on investment good production and exports, could suffer disproportionately. In this latter connection it is worth highlighting the 9.6% fall in investment goods production in Scotland in the fourth quarter of 1988 compared with a 1.7% rise in the UK as a whole. This may simply be an example of the Scottish economy being more vulnerable to random shocks but along with the recent evident decline in manufacturing confidence it could be of greater significance. Further evidence is required before we can judge the balance of these trends.

26 June 1989