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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.

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QUARTERLY ECONOMIC COMMENTARY

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Outlook and Appraisal

The Scottish economy is a small open economy and because of this it is very much affected by changing economic circumstances in the UK and the world economy.

Despite the persistence of imbalances in the world economy there are signs of recovery in Europe which many commentators believe should intensify and spread to the US and Japan next year. (See **World Economy** section). The UK economy also appears to be experiencing an improvement in growth, although the effects of the oil price fall on economic activity and inflation are expected to be broadly neutral. The lowering of nominal interest rates, partly reversed by the 1% point increase in base rates in October, the Budget tax cut, strong growth in earnings and real personal disposable incomes, a falling savings ratio and increases in the availability of credit, are the main influences on the growth of UK domestic demand, primarily through increases in consumer spending. Export volumes are also improving following the depreciation of sterling. (See **British Economy** section).

These developments in the external economic environment are affecting the Scottish economy in a number of significant ways.

First, and most obviously, the decline in oil prices is likely, in the short to medium term at least, to have a harmful effect on the Scottish economy. The **Feature Article** by Salmond and Walker presents the results of an impact study of the falling oil price and concludes that the direct impact on the oil supply industry and indirect job loss could be in the range of 22,000 to 30,000 over the next few years. If other things remain equal, the predicted job loss will cause the Scottish unemployment rate to rise by 0.9% points to 1.3% points, thus widening the differential between Scottish and UK unemployment. The effect of the oil price fall on the Scottish economy is not simply a future possibility, since several indicators are already registering the initial effects of the price change. Redundancies (see **Labour Market** section) in Scotland rose to 14% of the GB figure in the second quarter of the year, the highest percentage recorded since the exceptional figure of 17.7% in 1979. By October unemployment in Grampian region had reached 10% for the first time during the post-war period (see **Regional Labour Market** section). Both the **CBI Industrial Trends** and the **Scottish Business Survey** (SBS) report that a significant balance of firms were less optimistic in October than they were in July. The CBI Survey goes further and attributes the overall results to be almost entirely due to the 'confidence crisis' intitiated by depressed conditions in the oil industry (see **Business Surveys** section).

The fall in the oil price and the related depreciation of sterling should not be viewed as being exclusively harmful to the Scottish economy, although it may be so on balance. The non-oil sector within Scotland will benefit in several ways. First, falling oil prices reduce the unit costs of production, contributing to lower domestic inflation and higher output. However, the demand for labour and hence employment may not rise by much especially if firms take the opportunity to substitute more energy- intensive production processes when they make new and replacement investment decisions. Secondly, any increase in the growth of the industrialised countries due to the income effects of the oil price fall will stimulate Scottish non-oil exports. Finally, the associated depreciation of sterling effectively amounts to a relative price adjustment in favour of the non-oil sector. This adjustment would be expected to lead to increased profit margins for Scottish non-oil sector exports and eventually to raise the demand for those products in international markets. The **SBS** and **CBI** surveys can be interpreted as providing some indication that these effects are already beginning to occur. In the **SBS**, orders and sales (demand) were expected to pick up in UK and world markets but not in Scottish markets. In the **CBI Survey**, larger firms (with 500 employees or more) were more optimistic because, as suggested in the **Business Surveys** section, such firms are more likely to sell in export markets.

If the oil price does indeed stabilise in the US$14-US$17 range, or only moves slightly above that level, then clearly the future development of the Scottish economy will depend proportionately more on the fortunes of the non-oil sector. In view of the openness of the Scottish economy the prospects for this sector will largely depend on the performance of the wider UK economy and the forces influencing the Scottish share. And, both UK performance and the Scottish share will be heavily dependent upon the policy stance of central government.

If the slowdown in the growth of the UK economy has been reversed and the growth of GDP rises to between 2.5% and 3% next year then it is likely that growth will occur in the consumer goods and related sectors, via increases in consumer spending, as well as in the export and traded goods sectors. The **CBI Survey** indicated that consumer goods industries have recently been faring better than other sectors in Scotland. The **SBS** found that in contrast to most other sectors a 1% balance of firms in retailing were more optimistic than in July, although this must be compared with a +2.5% balance in October 1985. Other sectors largely producing goods for final consumer demand show relatively greater optimism than elsewhere in industry. (See **Business Surveys** section). This evidence, when combined with the relatively superior performance of the consumer goods industries in Scotland, compared with the rest of the UK, during the year to the third quarter of 1985, and the current weakness of the consumer goods industry in the UK as a whole (see **British Economy** section), suggests the possibility that Scotland may gain relatively more, on this account, from the anticipated small increase in growth. There could, in consequence, be some, all be it limited, offset to the net effect of the oil price fall in widening the disparity between Scottish and UK economic activity.

However, in the UK as a whole, non-oil imports are increasing rapidly, at a fairly competitive exchange rate, inflation is rising, there is increasing evidence of skill shortages as vacancies rise, and capacity utilisation is not much below the peak experienced as a result of the boom in 1974. Some commentators therefore argue that the UK economy may be experiencing the first symptoms of overheating. In these circumstances further increases in UK domestic demand may lead to growth faltering as domestic inflation rises, either directly, or indirectly through downward movements in the exchange rate. There would then be little offset to the harmful effects on Scotland of the oil price fall. Moreover, the widening disparity between the UK and Scotland on account of the oil price fall and the imbalance in demand for other reasons between the South East of England, in particular, and the peripheral regions of the UK, may actually be increasing the propensity for the UK economy to overheat. The inflation rate is thus higher than it otherwise would be. It is a well-documented phenomenon that when the level of demand in the economy is high in relation to capacity, the more demand is spatially unbalanced the greater the impact on inflation. To put it another way, the level of output compatible with a given rate of inflation, will be lower than otherwise would be the case. The most obvious current example of this phenomenon is the impact of the current boom in mortgage lending which has had a disporportionate impact on house prices in the south east of England. This not only contributes directly to inflation but also contributes indirectly by reducing labour mobility between the peripheral regions of the UK, such as Scotland, and the south east. Skill shortages therefore appear more quickly largely because of the imbalance between the demand and supply for labour in different parts of the country.

The Government has, since it took office, conducted its macro-economic policy, through the Medium Term Financial Strategy (MTFS), largely to secure the objective of a substantial reduction in inflation. Currently fashionable arguments that the Government should seek to announce a target for sterling as a means of containing the current incipient inflationary pressure are persuasive. However, the adoption of such a policy will do little to remove the factors which may be leading the economy to overheat. For the longer term, policies should be adopted which encourage the build-up of capacity and remove aggregate skill shortages. But in the shorter term the Government should consider reintroducing policies which work to reduce the spatial imbalance in demand. The most obvious example is regional policy which has been radically cut back under the present Government (see **Commentary**, February 1985). Increased spending on regional policy incentives and the reintroduction of Industrial Development Certificate policy for certain categories of expansion in the south east of England, would not only help to forestall overheating in the UK economy but would also help Scotland weather the serious short-run implications of the oil price fall.

18 November 1986