University of Strathclyde

The Fraser of Allander Institute

Quarterly Economic Commentary

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. The results of this work, carried out in conjunction with the Department of Economics, are published in the Institute's 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.

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The editor welcomes 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.

Editor: James Love

Contributors: Stephen Boyle, Paul Draper, Frank Harrigan, John Heeley, Iain Jenkins, Cliff Lockyer, Jim H Love, Peter McGregor, Iain McNicoll, David Simpson, and Jim Walker.

Graphics: Stephen Boyle

Production: Sheelagh Blackhall and Isobel Sheppard

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

041-552 4400 Ext. 3958

QUARTERLY ECONOMIC COMMENTARY

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Outlook and Appraisal

The results of the July **Scottish Business Survey** suggest that optimism about the general business climate improved for retailers but deteriorated for manufacturers, wholesalers and construction companies. Overall, the Survey suggests that activity remains constrained by a shortage of sales and orders and that there is fairly widespread spare capacity. Prospects for employment are reported to be poor.

During 1985 there were signs of an ending to labour-shedding in Scottish manufacturing. That pattern has been reversed this year with manufacturers now reporting continuing actual and anticipated job losses among both male and female workers. Construction companies report further lay-offs. Total employment also continues to fall in wholesaling. Even in the relatively buoyant retailing sector, job losses are now being reported. Retailing job losses over the last quarter were substantial and were concentrated heavily on full-time employees with some limited reductions in part-time employment. Further job losses are anticipated in retailing in the present quarter.

This pessimistic outlook for employment prospects comes when Scottish unemployment is at a historically high level. In July 1986 Scottish unemployment, seasonally adjusted and excluding school leavers, stood at 344,200. Such unemployment represents an enormous waste of Scotland's economic potential as well as imposing private costs on those unemployed. Unemployment constitutes the single, major economic problem in Scotland.

Since 1979 Government policy has been based around the Medium Term Financial Strategy (MTFS), the primary objective of which is the control of inflation. The MTFS seeks to tackle unemployment indirectly, the underlying argument, simply put, being that lower inflation resulting from greater monetary control will improve the UK's international competitiveness which will in turn lead to an expansion in employment and, hence, a reduction in unemployment. Unemployment in Scotland is now, however, greater than in 1979 by a factor of 2.3.

Much of the increase in unemployment in Scotland and in the rest of the UK took place during the period 1979/81 when the conjuncture of the high interest rates required to achieve monetary contraction and of increasing North Sea oil exports raised the sterling exchange rate. The resulting contraction of manufacturing was rationalised in official circles as necessary to place manufacturing industry on a "leaner and fitter" footing. However, despite decelerating inflation and a cyclical upswing in the world economy during the period 1981 to early 1985, Scottish manufacturing continued to shed labour. Increases in output which did take place were achieved by higher levels of productivity from a declining number of employees.

Despite manufacturing contraction and rising unemployment, if has repeatedly been contended in official circles that total employment has been expanding as a consequence of employment growth in the service sector. This ignores, however, the implications of the shifting balance of employment (see November 1985 **Commentary**) and is largely a statistical artifact based on a simple head-count of numbers employed, a procedure which implicitly values a part-time job as equivalent to a full-time one. Employment growth in the service sector has been predominantly part-time. Using the generous convention of equating part-time with half-time working, total full-time equivalent service sector employment is little changed from 1979 (for a full discussion see the Labour Market section of this and earlier **Commentaries**).

Against this background, Government Ministers have increasingly advocated the need for wage restraint to reduce unit labour costs and, thereby, to "price people into jobs". While moderation of wage settlements would undoubtedly help reduce costs this argument requires considerable qualification. First, unit labour costs are determined not only by wage costs but also by non-wage costs such as Employers' National Insurance Contributions, and provision for redundancy schemes and holiday payments.

Logically, as with moderation of wage costs, reductions in non-wage costs could help price people into jobs. Yet, despite beginning a restructuring of National Insurance Contributions in the 1985 Budget, the Chancellor, favouring his commitment to restraining the PSBR, did not take the opportunity of this year's Budget to reduce this component of non-wage costs which is under his direct control.

Secondly, and particularly since the Chancellor has placed such emphasis on the need for wage moderation, lower wage settlements might well induce an appreciation of sterling, offsetting, at least partially, any competitive gain. Thirdly, wage negotiations are not conducted by individuals but by unions whose bargaining is likely to be influenced by the going rate. In addition, there is no indication that the Chancellor is prepared to provide a fiscal boost to the economy to counteract any short-run contraction in demand resulting from lower wage settlements

In this year's Budget the Chancellor asserted that responsibility for achieving lower wage settlements now rests squarely with management. It is difficult to see how such exhortation can deliver a reduction in wage inflation. The Chancellor has sought, however, to exert indirect pressure on management. Since early 1985 the exchange rate has been elevated to an important role in the conduct of policy. Following the sterling crisis of February 1985, UK interest rates were raised substantially inducing an appreciation of sterling. Sterling appreciation operates to reduce inflationary pressures in two ways: by reducing import costs; and by subjecting UK producers to greater competitive pressure in both domestic and foreign markets, thereby increasing the need for management to secure lower wage settlements. However, it also diminishes competitiveness and, thus, damages prospects for output and employment expansion.

Of the three sets of key prices in the economy, namely, labour costs, exchange rates against the currencies of our major trading partners and interest rates, the Chancellor has laid the burden of achieving improved competitiveness on the first, and there, squarely on wages. With little sign of sufficiently low wage settlements, the Chancellor should now look more closely at policy with respect to exchange rates and interest rates.

Given present circumstances, it is unlikely that sterling depreciation from present levels would generate much inflationary pressure. First, inflation rates in important suppliers of imports into the UK such as West Germany and Japan are already lower than in the UK. Secondly, much of the reduction in industrial costs resulting from recent lower prices for oil and non-oil commodities have yet to feed through into output prices.

Thirdly, the prices of many important imports and raw materials are denominated in US dollars in international markets and the continuing weakness of the dollar will offset any impact on their UK prices of sterling depreciation. Fourthly, as has been happening in the US, exporters to the UK may be able to absorb much of the sterling depreciation in lower profit margins rather than by raising prices.

Fifthly, many sectors of industry could increase output without encountering the potentially inflationary consequences of capacity constraints. The results of recent Surveys, including the July **Scottish Business Survey,** indicate spare capacity across a range of sectors. Sixthly, lower interest rates would reduce costs for householders holding mortgages and other forms of debt, for those borrowing for investment and for Government borrowing. Lower mortgage rates would lower the Retail Price Index.

Sterling has been depreciating gradually against major currencies other than the US dollar during the first part of 1986. Over the past two months that depreciation has gained momentum in response to slowing UK growth, increasing pessimism about prospects for the non-oil visible trade balance and uncertainty about developments in the oil market. The Chancellor should now permit fuller exchange rate adjustment to market realities through downward movements in interest rates. Failure to do so will postpone adjustment to a perhaps less favourable international climate with respect to inflationary pressures and will not improve the prospects for output and employment in a small, open economy like Scotland's.

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