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 Quarterly Economic Commentary is published in February, May, August and November. Subscription queries should be addressed to the Secretary, the Fraser of Allander Institute.

Notes to contributors

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.

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QUARTERLY ECONOMIC COMMENTARY

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Outlook and Appraisal

During the first part of 1986 developments in the Scottish economy took place against a background of: further reductions in oil prices; some slight reductions in the high levels of UK real and nominal interest rates; and continuing weakness in non-oil commodity markets. In addition, the Chancellor in the March Budget remained committed to the general direction that UK economic policy has followed over the past few years. The March Budget also provided a further stimulus to consumer spending through the reduction of the standard rate of income tax.

The effects of certain of these factors are readily discernible in the results of the latest **Scottish Business Survey.** Encouragingly, manufacturing firms in Scotland are now slightly more optimistic about the general business situation than three months ago. This return to the pattern of cautious optimism evident in the first half of last year reflects expected increases in orders and sales. High interest rates were employed last year to engineer an appreciation of sterling as part of the Chancellor's anti-inflation strategy. In recent months, however, although sterling has remained strong against the dollar, it has depreciated against the major European currencies. This latter development improves the competitive standing of Scottish companies in the European Community, which represents the major overseas market for Scottish exports. Scottish manufacturers are, however, still operating with considerable spare capacity and orders or sales remain the most important constraint on activity.

The importance of consumer spending in determining growth continues. Retailers and wholesalers report greater optimism about trading conditions. While the Budget tax reductions and the underlying growth of real incomes will help sustain the role of consumer spending, Scottish financial institutions also expect, despite high interest rates, healthy increases in demand for personal advances. In contrast to the optimism in manufacturing and services, construction activity continues to be depressed by public expenditure restraint. The decrease in optimism in construction is much less marked, however, than in oil and oil-related activities where in the face of lower oil prices there has been a widespread deterioration in optimism. Companies involved in oil and gas recovery anticipate a downward trend in the total volume of output. Service and supply companies similarly expect a downward trend in orders/contracts. Total oil and oil-related employment is forecast to fall further over the next three months and investment intentions have been revised downwards.

While the price reductions since the end of last year have been precipitous, prices have been falling steadily in recent years from the high levels of 1979/80. To a considerable extent UK companies have been protected against this downward trend by changes in the tax regime. With regard to new projects, for example, the Chancellor in the 1983 Budget abolished the Advanced Petroleum Revenue tax and allowed costs of exploration and appraisal to be set against Petroleum Revenue Tax. The resulting stimulus to investment activity was then reinforced by the Chancellor's reform of the system of capital allowances in the 1984 Budget.

The downward trend in oil prices reflects the weakening of the OPEC cartel's influence as a consequence of two main factors. First, the demand for oil has been affected by conservation measures and economies in oil use and by the recession in industrial economies following the dramatic price increases dictated by OPEC during the 1970s. And, secondly, there have been increases in oil supplies from non-OPEC producers such as the UK and Norway.

The recent sharp falls in prices are attributable to Saudi Arabia's abrogation of its role as OPEC's "swing" supplier. Having failed to achieve greater compliance with output and price targets among OPEC members and to persuade non-OPEC producers to restrict output, Saudi Arabia is no longer prepared to accept the residual OPEC production quota necesssary to maintain prices. While no doubt seeking to impose greater discipline within OPEC and to penalise other suppliers, Saudi Arabia seems to be concerned that a period of lower market prices is necessary to revive the medium- to longer-term market for oil.

As a net oil exporter the UK stands to lose from lower oil prices in terms of reduced activity levels and of lower revenues to the Exchequer. This latter element is already operative as witnessed by the reduced scope available to the Chancellor for tax cuts in the March Budget. In contrast, lower oil prices also generate a number of actual or potential benefits in the form of: lower industrial costs; reductions in the rate of inflation; lowering of inflationary expectations; and improved prospects for international trade as a consequence of reversal of at least some of the depressing effects of the earlier OPEC price rises. This last factor may be made more significant for UK producers by lower oil prices, the greater is the associated downwrd pressure on sterling. Such benefits are enjoyed by agents in the UK economy generally.

From the Scottish perspective, the difficulty is that the costs in terms of reduced activity are borne mainly within Scotland, where unemployment is currently running at over 16%. Some reduction in oil and oil-related employment over the next few years could be expected as North Sea activity recedes from its peak levels. The speed of that adjustment has been accelerated, however, by the extent of recent price reductions.

In the immediate future production from already operative fields is unlikely to be dramatically affected since the marginal costs associated with production in the North Sea are probably still well below current prices. Much more problematic is the impact of lower oil prices on exploration and development. Given the costs involved and the steep rise in costs as companies move into "frontier" areas, present levels of oil prices may not be sufficiently high to render exploration and development commercially viable. Indeed, that is already proving to be the case.

Reconsidering development projects and seeking to minimise operating costs are options being pursued by companies involved in the North Sea: Amoco has suspended its North Sea exploration activity; Britoil is reducing its exploration budget and shedding 250 white-collar workers; Burmah and Enterprise have reduced their exploration budgets; BP has sought to redesign facilities for the Miller Field; and plans to undertake a £2bn development of the Gannet Field complex have been shelved by Shell/Esso.

Contraction of development activity will have considerable secondary effects. Likely to be the worst affected of the oil-related companies are those in the mechanical engineering and construction industries (see **Labour Market** section). In addition, many other Scottish companies which benefit indirectly from the oil industry's operations will be adversely affected by contraction of demand consequent upon reductions in oil-related employment.

The fall in oil prices seems to have brought added pressure for rationalisation on the NCB (See **Energy: Coal, Electricity and Water** section). In effect, this intensifies the threat of closure of some of the least efficient pits currently in production. The Scottish area of the NCB is the second highest-cost coalfield in the UK, after South Wales, and as such is obviously vulnerable. That vulnerability is heightened by the availability to the electricity generating hoards of coal imports at lower cost than that of UK supplies.

Oil prices will recover. The experience of recent months has, however, thrown a considerable element of uncertainty about the stability of the future course of oil prices into business calculation. Consequently, even an early rise in prices is unlikely to convince oil companies that an upward trend in prices has been resumed. In the meantime some contraction in oil and oil-related employment looks unavoidable. It remains to be seen whether the general stimulus to activity from lower oil prices will provide an offset for those employment losses.

16 May 1986