Quarterly Economic Commentary

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QUARTERLY ECONOMIC COMMENTARY

* * * * * * CONTENTS* * * * * *

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OUTLOOK AND APPRAISAL

Output data are now available from the Scottish Office for the production and construction industries in the second quarter of 1994. These data indicate that output in the two sectors taken together fell by 1.1% on the first quarter. Output in the two sectors in the UK, in contrast, grew by 1.8%. Within these aggregates, construction industry output fell back considerably in Scotland, falling by 4.5%, compared with an increase of 0.9% in the UK, while the output of the production industries remained broadly unchanged as the sector expanded by 2.1% in the UK. The performance of the manufacturing sector was also worse in the second quarter, with output contracting by 0.5%, compared with a rise of 1.5% in the UK. A closer examination of the output performance of sectors within manufacturing reveals that the weaker Scottish performance was evident across all manufacturing sub-sectors with the exception of the engineering & allied industries where output increased by 3% while rising by only 1% in the UK. Within engineering there was a diversity of experience. Mechanical engineering contracted by 13%, compared with an increase of 1% in the UK, while electrical and instrument engineering (electronics) expanded by 9% against an increase of 3% in the UK, and transport equipment exhibited a 2% increase while the sector in the UK registered no change in output. At the other extreme, metals and metal products contracted by 16% in Scotland and Textiles etc. contracted by 6%; both sectors exhibited no change in the UK.

However, over the year to the second quarter 1994, Scotland's relative performance was considerably better. Output in production and construction grew by 3.3%, slightly less than the 3.4% exhibited in the UK. The output of the production industries expanded by 4%, against 3.8% in the UK. Construction output rose by 0.9% and manufacturing production increased by 5%, compared with a UK performance in the two sectors of 1.5% and 2.2% respectively. The general conclusion here is that the earlier stronger performance of construction and manufacturing in Scotland appears to have eroded in the most recent quarter, despite a continuing strong relative performance in the Scottish electronics industry.

The inclusion of the data for the second quarter 1994, with associated data revisions for earlier quarters, alters Scotland's relative and absolute performance over the longer recovery period (i.e. from the second quarter 1992), compared with that reported to the first quarter 1994 in the September **Commentary**. The production sector in Scotland now lags production in the UK as a whole with output increasing by 6% over the recovery period compared with an increase of 8.1% in the UK. The performance of the construction sector during the recovery has been broadly the same in Scotland and the UK, with output rising by 2.1% in Scotland and 2.2% in the UK. However, within the production sector, manufacturing continues to show a stronger recovery performance in Scotland than the UK, with output rising by 7.5% and 5.1% respectively. But, as before, this is almost exclusively due to the performance of the electronics sector. Output in electrical and instrument engineering has risen by 64.2% in Scotland during the recovery period, compared with an increase of 19.4% in the UK. Removal of the sector from manufacturing - a somewhat artificial exercise - results in manufacturing output in Scotland *falling* by 7.4% during the recovery, while the UK still registers an increase of 2.8%. Only 2 from the other 10 principal manufacturing sectors in Scotland have exhibited positive growth during the recovery: oil refining & nuclear fuel, and chemicals & fibres, while in the UK, 7 of the other 10 sectors are seen to have exhibited positive growth. The recovery in Scottish manufacturing therefore continues to be much more narrowly based than in manufacturing in the UK and as noted above in the discussion of the second quarter data, Scotland's advantage in manufacturing during the recovery may be beginning to erode.

Scotland and the UK regions

We noted in the last **Commentary** the strength of Scotland's economic performance relative to the UK throughout the current economic cycle, with the economy showing particular relative strength during the 1990-92 recession. It is instructive to take this comparison further and compare Scotland with the other regions of the UK. Between 1990 and 1992, Scotland was only one of three UK regions that experienced positive output growth. In Northern Ireland, output rose by 4.1%, while in Scotland there was a small increase of 0.8%, and in the North of England output increased by 0.3%. In contrast, UK output fell by 2.8% during the period, while output in the Rest of South East, and Greater London fell by 4.5% and 4.4%, respectively. The southern bias of the recession is clearly evident from these data. Similarly, when data on GDP per head are considered, only Northern Ireland and Scotland displayed positive growth of 2.7% and 0.6% respectively, compared with a contraction of 3.6% in the UK and 5.9% in Greater London and 5.7% in the Rest of South East, the two worst performing regions. In Britain, the civilian workforce rose in Scotland during the recession period June 1990 to June 1992, by 0.7%, while all other regions experienced a contraction, with the greatest falls registered in Greater London (-9.2%) and the Rest of South East (-7.3%). The relatively better performance of Scotland during the recession also extended to unemployment, as might be expected given the above data. Between the peak to trough of May 1990 and December 1992, unemployment rose by 23.3% in Scotland, compared with a rise of 85.1% in the UK, and increases of 223.9% in the South East and 147.2% in the South West, the two worst performing regions on unemployment.

GDP data are not yet available for the recovery period. However, some indication of Scotland's relative regional performance can be obtained from the DOE labour market data. Between June 1992 and June 1994, the civilian workforce contracted in Scotland by 2.2%, despite the recovery in output. The workforce contracted generally, by 1.6% in Britain, but only three regions displayed a poorer performance than Scotland: the North West, the West Midlands, and the Rest of South East, where the workforce fell by 3.5%, 3.3%, and 2.3%, respectively. In terms of the number of employees, Scotland's performance was relatively better, which, given Scotland's strong self-employment performance during the period, indicates that a larger proportionate fall in government training places accounts for the greater contraction of the workforce in Scotland. Employment contracted by 2.3% in Scotland, which was much the same as the fall in Britain of 2.2%. Across the UK regions, the South East, the West Midlands, Greater London, and the North West, all performed worse than Scotland, with employment falling by 3.4%, 3.3%, 3.2% and 2.8%, respectively during the period. These same regions tended to perform worse than Scotland in both manufacturing and service sector employment change, with the exception of Greater London which did slightly better than Scotland in manufacturing employment change. During the recovery period from January 1993 to October 1994, unemployment fell by 11.7% in Scotland compared to 17.2% in the UK. All regions experienced a greater percentage reduction in unemployment with the exception of the North where the fall was 7.5%. As a result of this poorer relative unemployment performance, the unemployment rate in Scotland moved back to the UK average in July of this year after being below the UK average rate since January 1992.

These data therefore paint a picture of an economy (Scotland) which for various structural reasons associated with the source and nature of the recession, outperformed all other British regions during the downturn but which has gradually begun to slip back as the recovery proceeded to something like its pre-recessionary ranking. The recovery is now being led by manufacturing, with export sales becoming increasingly prominent. It is likely that the regions doing particularly well such as East Anglia, have a concentration of the strongest performing manufacturing sectors such as electronics and a relatively better performance than the sectoral average in other industries. A favourable structural composition has also worked in Scotland's favour and is likely to result in a relatively stronger output growth in Scotland than its comparative regional employment and unemployment performance suggests. However, outside electronics Scotland is relatively weak in other high growth manufacturing sectors such as other manufacturing and paper, printing and publishing. Moreover, the evidence on the low levels of firm formation, innovation and entrepreneurship generally in Scottish manufacturing, account in part for the poorer performance of some of the high growth sectors in Scotland compared with their counterparts elsewhere in the UK and Europe.

Short-term outlook

The world economy continues to recover and inflation remains low. The US economy, however, shows signs of overheating, reflected in long bond yields, which are likely to remain relatively high during 1995 and could spark a decline in world equity markets adding to the upward pressure from the recovery on short-term interest rates (see **Economic Backgound: World Economy** section). In the British economy GDP growth continues above trend, with output rising by 4.2% in the year to the third quarter and by 3.7% when North Sea oil and gas are excluded. The source of the recovery began to shift during the past year away from consumption towards exports, and so far net trade accounts for about half the growth in 1994. While the "output gap" appears to be reducing it is not clear to what extent the present level of utilisation represents a constraint on expansion (see **Economic Background: British Economy** section). Labour shortages do not yet appear to be much of a problem and there is a large pool of available labour in spite of the large fall in unemployment which has occurred since the end of 1992. As a result the underlying rate of inflation is historically low at around 2%. Investment is growing only slowly and is not expected to grow by more than 2% next year. Nevertheless, after the restructuring of companies' balance sheets in the recession, many firms have large financial surpluses which should facilitate the rapid expansion of investment next year. Our view is that the recent half point rise in nominal interest rates will have only a marginal effect on investment in 1995.

The Government is forecasting GDP growth of 4% this year and 3.25% in 1995, a significant upward revision to its summer forecast of 2.75% in each year. In contrast, the Treasury's Panel of Independent Forecasters is more conservative, predicting on average an increase of 3.6% this year and 3% in 1995. Much the same can be said for the Government's forecasts of inflation and the current account. The economy is therefore seen, at least for the short-run, to be in an almost virtuous cycle enjoying rapid export-led growth, low inflation and a disappearing current account deficit.

It is against this background that our forecasts for Scottish manufacturing output over the next five quarters are based. Output is forecast to rise by 3.9% in 1994 over 1993 (compared with 2.6% in 1993 over 1992) and this is partly driven by strong growth in UK manufacturing. Nevertheless, we expect that Scottish manufacturing output growth will be seen to have been relatively weak in the second half of this year, for the reasons outlined above. A further contraction of 1.4% is predicted for the third quarter, rising to 1.6% in the fourth quarter. Thereafter, the momentum of growth should pick up during 1995 as Scottish industry takes advantage of sustained growth in the UK economy and faster growth in the world economy, particularly in Germany and France, as overall world growth rises to 3.5% in 1995 compared with about 3% in 1994.

13 December 1994.