

Quarterly
ECONOMIC
Commentary

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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. 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.

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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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Outlook

AND

Appraisal

The Scottish economy is at a turning point. For once this is literally true. The evidence of the Deloitte & Touche Scottish Chambers' Business Survey (DTSCBS) for the fourth quarter suggests that the economy may have reached a cyclical peak during the last three months of 1997. After six years of recovery and expansion this should come as no surprise. All mixed-market economies experience a cyclical pattern with the duration from peak to peak and trough to trough being on average about five years. The Institute, along with other independent forecasters, has forecast for some time that growth will slow in 1998 in line with the UK economy. Yet the evidence that a turning point has been reached is much less clear for Scotland than it is for the UK.

The latest production data indicate that manufacturing output rose by 0.9% in Scotland in the third quarter compared with an increase of 0.6% in the UK. The recent stronger performance of Scottish manufacturing is now beginning to be seen in several sectors and not just in electronics. Figure 1 indicates that manufacturing in Scotland has grown by 30% since the recovery began in the first quarter of 1992. UK manufacturing growth was just over

12% over this period. The removal of electronics leads to the sector in Scotland exhibiting a contraction of 1.2% compared with growth of 8.6% in UK manufacturing (ex electronics). However, the gap in favour of the UK has again narrowed to 9.8% points compared to a gap of 10.6% points in the second quarter. The stronger performance of non-electronics manufacturing in Scotland is highlighted by the March *Scottish Economic Bulletin* from the Scottish Office. Taking comparisons of the last four quarters with the previous four quarters, the *Bulletin* shows that in the year to 1997 Q3 growth was evident in 6 of the other 10 manufacturing sectors during the period. Over the year manufacturing excluding electronics grew by 1.4% in Scotland, which was only slightly below the 1.5% growth registered by the same sectors in the UK.

In the fourth quarter manufacturing output declined by 0.6% in the UK. No data are as yet available for Scotland for the fourth quarter and it may be that a strong performance from the electronics industry and one or two other sectors such as food & drink and chemicals may have been sufficient for Scottish manufacturing to continue to display positive growth. The SCDI Quarterly Export Index indicates further growth in the nominal value of Scottish manufacturing exports in the fourth quarter. A strong demand for exports in the office machinery component of electronics, food & drink and also in mechanical engineering appears to account for the continued expansion. However, the projection provided by the Index for the first quarter 1998 suggests a fall in the nominal value of exports by about 6%. Furthermore, in the fourth quarter Deloitte & Touche SCBS manufacturers expected that export demand would contract further in the first quarter although demand overall was expected to increase slightly. In addition, tourism respondents were fearful of a significant deterioration in demand, particularly from overseas tourists, in the first three months of 1998.

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Whatever the outcome in the final quarter of last year and the first quarter of 1998, there is little doubt that growth in the Scottish economy will slow this year. The effects of the high sterling exchange rate, which has appreciated by around 25% since August 1996 and, to a lesser extent, the consequences of the Asian crisis, will slow the rate of growth of manufacturing exports and hence output (see **International Environment** section). The Institute is forecasting GDP growth of 2.2% this year, which is broadly in line with UK forecasts. And, for 1999, we anticipate that growth could be above the 1998 figure, perhaps 2.5%, as the large inward investments that have come into Scotland over the past eighteen months start to reach full production capacity. However, this scenario effectively assumes a "soft landing" as the UK and Scottish economies experience a period of below trend growth followed by a return to trend. There is considerable uncertainty surrounding these forecasts and particularly the size of the contraction that will be imposed upon manufacturing due to the sustained high level of sterling and the Asian crisis. The National Institute for Economic and Social Research (NIESR) estimates that there is a one in four chance of a UK recession in 1998. Much the same odds must also apply to Scotland. One hope is that sterling will start to fall as the British economy slows and as decisions are made on the rates countries in the first wave of EMU agree to peg their domestic currencies to the EURO. However, by then it may be too late to prevent a recession, although such changes could well affect the duration of any recession (see **UK Economy** section).

It is clear that the Chancellor's recent Budget did little to help the short-run macroeconomic position of the British economy. He did not bring in a Budget that tightened the fiscal stance (see **UK Budget March 1998** section). This may in part reflect caution on the Chancellor's part about the size of the deflationary effects on manufacturing of the external economic situation. But it also clearly reflects the Chancellor's reluctance to use the

Budget for short-term macro management. In the event, the Budget was well received by the financial markets and particularly the foreign exchange markets where sterling rose to over 3 deutschmarks. An outcome that suggests an expectation of a further rise in interest rates. If the Monetary Policy Committee of the Bank of England becomes convinced that inflationary pressures, largely deriving from the growth of consumers' demand, are not soon to diminish then the prospect for a further quarter point rise in base rates is likely.

The short-run impact of the Budget has therefore been to increase the prospects for recession in manufacturing. However, it is difficult to disagree with the Chancellor's contention that the economic role of the Budget should be orientated more towards influencing the long-run performance of the economy i.e. promoting microeconomic efficiency and equity rather than macro management, against a background of prudent management of the public finances. The British economy has been highly unstable during the last fifty years and this is in part due to inappropriate macroeconomic management by governments of both political persuasions. At the same time, and partly in consequence, short-run considerations have tended to dominate. This has been at the expense of the development of a coherent strategy to deal with the inherent structural weaknesses of the British economy: macroeconomic instability, low productivity and investment, low R&D and innovation, a low skills base and significant disadvantaged groups. This is not to say that the Chancellor should be dogmatic about the economic purpose of the Budget. One can envisage situations where an adjustment of the fiscal stance for short-term macroeconomic reasons is clearly appropriate and may become increasingly so as sterling becomes tied to the EURO and Britain eventually joins EMU.

But the desire to put in place a stable macroeconomic framework with appropriate incentives to encourage work, investment and enterprise should be welcome in Scotland. The

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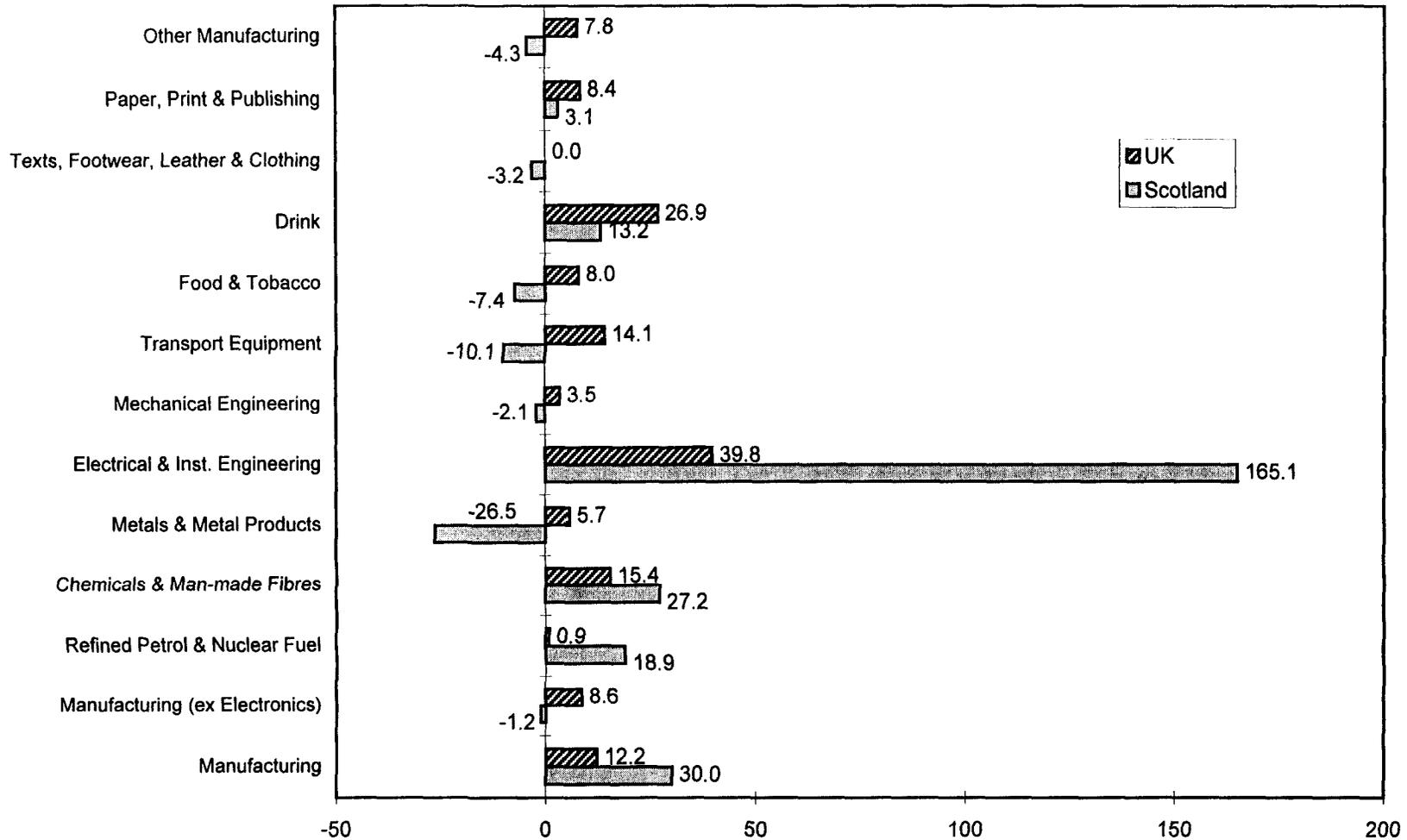
Scottish economy suffers from the same structural weaknesses as the British economy but to a much greater degree. The work of Scottish Enterprise to promote technology ventures, innovation and improve the business birth rate is a recognition of this fact. The most up to date data on firm formation rates in Scotland suggests that Scotland has still a long way to go to catch up with the rest of the UK despite the efforts of SE's *Business Birth-rate Strategy*. Figure 2 would appear to suggest that there was little improvement in the Scottish relative during the 1990s, although it is too early to pass judgement on the *Business Birth-rate Strategy* which might in any event have been successful in maintaining the relative. In Figure 3, the absolute VAT registration rate per capita in Scotland is compared with the rates in southern England, traditionally the UK regions with best firm formation performance. The data contained in Figure 3 provide no evidence of an improvement in Scottish firm formation compared with regions of southern England during the 1990s, while Figure 4 suggests that Scotland's position has deteriorated compared to Northern Ireland and improved somewhat compared to Walesⁱ. Much the same story is likely to be told for R&D and innovation in Scotland.

The Institute therefore endorses the purpose behind the Chancellor's Budget as a welcome step towards remedying the structural problems of the Scottish economy.

25 March 1998

ⁱ Note that the absolute fall in VAT registration rates in the 1990s is associated with an increase in VAT registration thresholds.

**Figure 1: Manufacturing Output in Scotland and the UK during the Recovery: Q1 1992 to Q3 1997
(Percentage Change)**



**Figure 2: VAT Registrations per capita in Scotland relative to the UK
1980 to 1996**

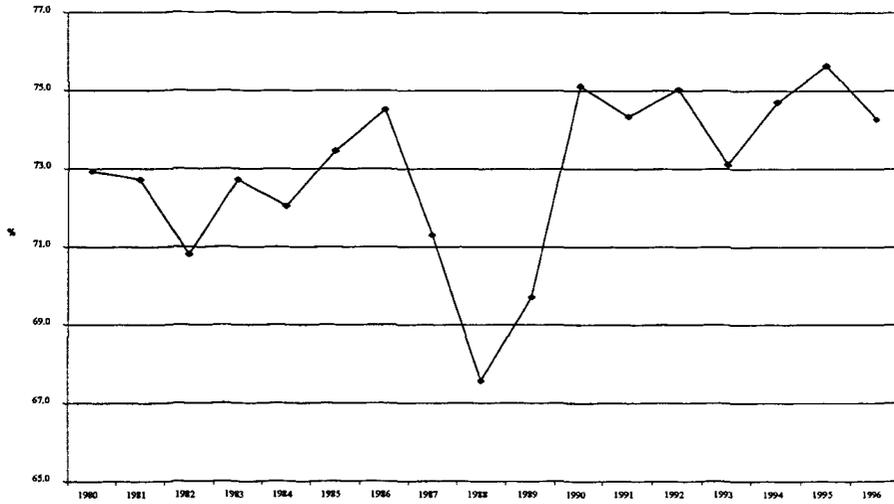


Figure 3: VAT Registration Rates per capita in Scotland and Southern England 1980 to 1996

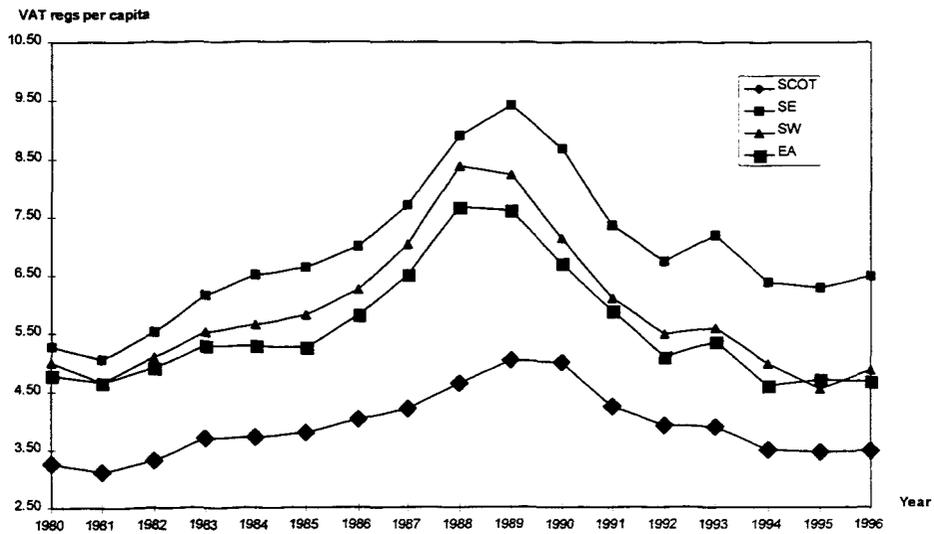


Figure 4: VAT Registration Rates per capita in Scotland, Wales and Northern Ireland 1980 to 1996

