Quarterly Economic Commentary

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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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QUARTERLY ECONOMIC COMMENTARY

***** COMMENTARY *****

***** VIEWS *****

ECONOMIC PERSPECTIVES

Outlook and Appraisal

The short-term outlook for the Scottish economy continues to be favourable. Output growth is expected to be greater in 1987 than in 1986 but will fall short of that achieved in the UK. Continued improvement into 1988 largely depends on developments in the world economy and on the extent to which the UK economy avoids overheating and an accelerating rate of inflation.

The significant fall in the price of oil from late 1985 to the middle of 1986 was largely responsible for the Scottish Index of Production and Construction (including petroleum and natural gas) falling by 3% during 1986, compared with an increase of 1.8% in the UK. By the fourth quarter of 1986, there was some evidence of a recovery with the Index rising by 0.5% over the previous quarter, compared with no change in the UK as a whole. Yet it was evident that some sectors were still suffering as a result (see **Mechanical Engineering, Transport Equipment** and other **Industry** sections).

Evidence of a continuing improvement in the Scottish economic outlook during 1987 is provided by both the **Scottish Business** and CBI surveys. In the February **Commentary** we noted that both surveys had reported a significant improvement in business optimism. In May we reported that the April surveys indicated a continuation of the trend, with expansion apparently more broadly based than before. The most recent surveys (see **Business Surveys** section) reaffirm the trend of increased optimism. Moreover, the July **Scottish Business Survey** (SBS) provides the most optimistic short-run outlook since the survey's inception in October 1984. Confidence has increased in all sectors following rising demand. In manufacturing, the growth of sales and orders remains strongest in export and rest of the UK markets but growth in domestic demand is expected to be of increasing significance in the coming months. Significant upward revisions in firms' investment intentions provide further indications of a sustained recovery.

Prospects for employment are encouraging. But, with firms under varying competitive pressures to minimise costs and raise productivity, coupled with the usual lags betwen output and employment growth, prospects are less certain and more fragmented than those for output. According to the recent **SBS**, a net 7% of manufacturing respondents reported an increase in employment during the preceding three months, with firms even more optimistic about employment prospects to September. Mechanical engineering, for example, experienced no major redundancy or closure announcements during the last quarter (see **Mechanical Engineering** section) and, surprisingly, was one of the most bullish sectors in respect of expected new orders and sales. In retailing, following significant growth in the volume of sales, employment rose by a modest amount to June and is expected to increase further in the three months to October (see **Distributive Trades** section). In the North Sea, the recent partial recovery of the oil price to around US$20pb is leading to renewed exploration and development activity (see **Oil and Gas** section) which is benefiting employment in the Grampian region, where the unemployment rate moved below 10% in June (see **Regional Review**). However, in construction, the **SBS** reports that total employment is expected to remain at best static, while in wholesaling, employment continues to fall with further reductions expected. Continuing job losses can also be expected in some of Scotland's traditional industries (see **Coal and Other Energy** and **Transport Equipment** sections).

Several key indicators of the state of the labour market are now clearly registering the effects of the upturn in economic activity (see **Labour Market** section). Redundancies in the first quarter of the year fell to 66% of their level in 1986. During the same period, the number of vacancies reached their highest quarterly level since the beginning of 1980 and continued to rise on average by 600 per month over the three months to July. Furthermore, the seasonally adjusted level of unemployment has fallen by 3,100 a month on average over the six months to July. The rate of decline in Scottish unemployment during this period is, however, only about two thirds of that in the UK, reflecting the residual effects of last year's oil price fall and, possibly, lags in the transmission of growth from the centre to the peripheral regions of the UK. The extent to which the Scottish economy can lag behind developments elsewhere in the UK is clearly seen in recent data from the construction industry. New private housing starts in Scotland in the first quarter of 1987 were nearly 17% **down** on the corresponding quarter in 1986, whereas in Great Britain they were 20% **higher** (see **Construction** section). Nevertheless, it is the external stimulii provided by developments in the world economy and particularly the UK economy that govern the prospects for the Scottish economy over the coming months.

With domestic demand in Japan and particularly West Germany failing to rise at a rate sufficient to compensate for the deflationary effects of the significant appreciation of the Yen and the D-Mark against the dollar, there appears little prospect of an improvement in the currently low rate of world economic growth (see **World Economy** section). Current OECD projections suggest that real GNP growth will be slightly lower in 1987, at 2.25%, compared with 2.5% in 1986. The prospects for further growth in world trade and hence Scottish exports are, therefore, on this account, not great. However, the exchange rate movements over the last eighteen months have largely benefited UK, and hence Scottish, industry. Sterling has fallen significantly against the D-Mark and even after some upward movement at the beginning of the year still remains under 3DM. The particular configuration of exchange rate movements of sterling against the D-Mark and the Dollar has, for example, clearly had a favourable effect on the performance of the steel industry (see **Metal Industries** section) and, as the May **Commentary** suggested, underpins the current improvement in Britain's economic growth. Other beneficial effects on the Scottish economy can also be seen in the apparent increase in Japanese inward investment in electronics, which must in part be due to the strength of the Yen (see **Electronics** section).

However, the future course of events in the Scottish economy remains principally dependent on the performance of the British economy as a whole. With real GDP growth expected to be above 3% and possibly nearer to 4% during 1987, the prospects are clearly favourable (see **British Economy** section). The major cause for concern is whether the rate of expansion is outstripping the supply capacity of the economy, leading to overheating and a possible inflationary end to the current 'boom'. The evidence on overheating is mixed, but the latest statistics on retail sales, consumer credit, earnings, house prices and the north-south differential, bank lending and money supply growth, are increasingly pointing in that direction.

The one percentage point increase in base rates at the beginning of August indicated the government's concern about the future course of inflation and the implications for future growth. Nevertheless, in view of the evidence of potential capacity constraints there must be concern about the effects of the increase on investment.

There are two clear implications for the Scottish economy. First, much needed local investment which is necessary to re-equip Scottish industry to take advantage of the growth in demand may now be that much more difficult to implement. Secondly, the increasing flow of mobile investment from other parts of the UK may be reduced. The prospects for more balanced growth in the UK may therefore be slightly less than before. Furthermore, while the increase may serve to damp down the growth of demand it may also have hindered the timely removal of capacity constraints. If the interest rate rise fails to have the desired effect on the growth of demand then it will have increased the risk of the current high rate of economic growth being dissipated in higher inflation and/or a balance of payments crisis.

The May **Commentary** suggested that when the authorities are concerned to moderate the effects of a too rapid rate of economic expansion and wish to keep the exchange rate competitive, then this can best be accomplished by fiscal contraction. The increase in base rates can probably be justified in terms of its impact on sterling and the competitiveness of British industry, given the recent downward movement of sterling. However, in view of the importance of investment to the maintenance of Britain's current rate of economic growth, future attempts to counter the likely continuing problems of overheating should be met by a further contraction of the public sector borrowing requirement. This can be best achieved by the government foregoing, or at least postponing, its plans to reduce the basic rate of tax to 25%.

18 August 1987