Quarterly Economic Commentary

we gratefully acknowledge the contribution of the Buchanan and Ewing Bequest toward publication costs
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.

Information for subscribers

The Quarterly Economic Commentary is published in March, June, September and December. Annual subscription rates are £30.00, or £8.00 per single issue. Queries should be addressed to the Secretary, the Fraser of Allander Institute.

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.

Commentary Team

Editor: Jim Love
Graphics: Eleanor Malloy
Production: Linda Kerr and Isobel Sheppard

The Fraser of Allander Institute
Curran Building
100 Cathedral Street
GLASGOW
G4 0LN

041-552 4400 Ext. 3958
Opinions expressed in signed contributions are those of the authors and not necessarily those of the Fraser Institute.

Fraser of Allander Institute 1990
With the continuation of a policy of high interest rates as a method of reducing consumer demand, Scotland continues to show clear signs of outperforming the UK. Confidence in manufacturing, and especially in retailing, has recovered over recent months because the expected downturn has failed to become reality as quickly as had been expected. The UK economy remains more resilient to high interest rates than expected by the Government, and increasingly worries about recession are giving way to concerns over the underlying rate of inflation.

Recent Scottish Performance

Scottish industrial output, as measured by the index of production and construction, rose in 1989 by 2.2%, compared with 1.3% for the UK as a whole. Much of this arises from the differential impact of the oil industry, and when this sector is removed from the calculations the situation looks rather less satisfactory; Scottish output growth during 1989 is now 2.1% compared with 4.1% for the UK. Much of this differential stems from the construction industry; according to official figures output in the construction industry in the UK rose by 4% during 1989, but fell in Scotland by 0.6%. The last Commentary drew attention to the fact that this result appears to be out of line with survey evidence. But even construction does not fully account for the difference between Scotland and the UK. In manufacturing output, too, Scotland continues to lag behind the UK, with growth of 3.7% for the year compared with 4.8%.

These figures indicate that while 1989 was satisfactory in terms of industrial output, it was far from being a vintage year. In the second half of the year, however, it was noticeable that Scotland was consistently outperforming the UK - that is, Scotland’s industrial output was slowing down less quickly than that of the UK - and it seems likely that this pattern has persisted into 1990. And this message now appears to have been recognised by Scottish industry and commerce, judging by the results of the latest Scottish Chambers’ Business Survey. The overall level of optimism in the latest Survey was noticeably higher than of late, particularly in retailing, which had been consistently negative about future prospects in the two previous surveys. In manufacturing there was evidence of increased orders overall in the last quarter, with further increases anticipated in the next quarter. Export markets continue to be the principal area of growth for the manufacturing sector, and employment prospects appear to have picked up markedly in all sectors except retailing. The April unemployment figures also made interesting reading, with Scotland continuing to show a modest decline while unemployment in the UK rose slightly.

All these indications suggest that the expected slowdown in economic activity in Scotland is occurring much more slowly than expected, and at least in the short term Scotland is likely to continue to outperform the UK. Whether this will be the case in the longer term depends largely on developments in the world and UK economies, and it is to these that we now turn.

Prognosis

Although the rate of economic growth in most industrialised countries is now slowing down, there is little immediate prospect of international recession. A significant factor in the orderly slowdown which has occurred in the last two years has been the buoyancy of world trade, which has allowed companies in most major countries to divert production to export markets as domestic demand begins to slow. This ability to switch to export markets has been an important element of UK policy, with the bonus that it should help to reduce the balance of payments deficit, a promise which as yet remains unfulfilled.

The main problem for the Government now is the failure of the economy to slow down as quickly as had been hoped, with official forecasts of between 1% and 1.25% growth in 1990 likely to be considerably exceeded unless the economy enters a sudden recession in the latter part of the year. Increasingly attention is being switched to worries about inflation, with a peak of double-digit inflation now likely before the autumn. Interestingly, the reaction of the Government to the slight rise in the April unemployment figures
was to raise the old early-1980s war cry of people pricing themselves out of jobs by demanding high wage settlements. There is no doubt that high pay rises do contribute to underlying inflationary pressures, and unit labour costs are still rising at a time when the rate of growth of productivity is slowing down; but it remains the fact that the decline in unemployment was unlikely to continue in the face of a policy designed to curb domestic demand unless British industry showed a very marked ability to switch to export markets. To some extent this has been achieved, and exports have risen; but the adjustment process inevitably takes time, and has not been helped by the recent strengthening of sterling.

For some time there was evidence of unwillingness among companies to pass on price rises to the consumer at a time when domestic demand was beginning to weaken, especially true for companies which are heavily dependent on the home market. However, there is now some evidence that this behaviour may not persist in the longer run; the index of output prices (factory gate prices) rose by 6.2% in the year to May, despite a drop in input prices, notably fuel costs. This would appear to indicate a distinct willingness to pass price rises on to the consumer in order to pay for substantial wage increases, and the 1.1% rise in provisional retail sales figures for May indicates that the consumer is prepared to pay. High interest rates are obviously taking a long time to have a clear effect on high street spending, and this is scarcely surprising. Many people are net lenders, and are made wealthier by interest rate rises; however, to the extent that they do not treat this windfall gain as income and tend, on average, to have lower consumption propensities than net borrowers, a policy of high interest rates will eventually have some effect on consumer demand. But once again it all takes time, and time is short in the battle against inflation. Inflationary expectations are already rising sharply, and are likely to continue to do so throughout the summer.

One of the reasons for Scotland's relatively good performance of late probably springs from natural thriftiness. Scotland is one of the few regions of the UK which is a net lender to building societies, for example, and so the disposable income of Scots as a whole is less adversely affected by high interest rates than that of our southern neighbours. And since most wage bargaining is carried out nationally, Scots are sharing in the substantial wage increases now being negotiated, and are in a position to maintain their level of high street spending even in the face of price rises. In fact, it could be argued that Scotland would be more adversely affected by the other possible response of companies to increasing cost pressures, that is to absorb increased costs in reduced profit margins. The problem here would arise from companies' desire to cut back on investment, an important issue for Scotland because of the country's relative dependence on the production of investment goods. Recent performance here is not encouraging, with production of investment goods in Scotland during 1989 growing at a little over one-third of the rate of the UK as a whole. Fortunately, there is no evidence yet of a slump in UK investment, at least among manufacturing companies. In the year to March manufacturing investment rose by 8%, and while it may decline sharply during the year, overall manufacturing investment is still expected to rise in real terms during 1990. Unsurprisingly, the situation is rather different in retailing, with a recent CBI/FT survey indicating that retailers are now planning to cut back on investment. By contrast, the latest Scottish Chambers' Business Survey suggests that Scottish retailers are no worse than neutral about investment intentions for the next quarter.

By a happy coincidence of circumstances, therefore, most of the modest slowing down in the UK economy has been felt by the overheated south-east, with little effect as yet in Scotland. Historically it is rare for Scotland to outperform the UK for extended periods of time, but for the moment the omens remain favourable.

One of the reasons for Scotland's relatively good performance of late probably springs from natural thriftiness. Scotland is one of the few regions of the UK which is a net lender to building societies, for example, and so the disposable income of Scots as a whole is less adversely affected by high interest rates than that of our southern neighbours. And since most wage bargaining is carried out nationally, Scots are sharing in the substantial wage increases now being negotiated, and are in a position to maintain their level of high street spending even in the face of price rises. In fact, it could be argued that Scotland would be more adversely affected by the other possible response of companies to increasing cost pressures, that is to absorb increased costs in reduced profit margins. The problem here would arise from companies' desire to cut back on investment, an important issue for Scotland because of the country's relative dependence on the production of investment goods. Recent performance here is not encouraging, with production of investment goods in Scotland during 1989 growing at a little over one-third of the rate of the UK as a whole. Fortunately, there is no evidence yet of a slump in UK investment, at least among manufacturing companies. In the year to March manufacturing investment rose by 8%, and while it may decline sharply during the year, overall manufacturing investment is still expected to rise in real terms during 1990. Unsurprisingly, the situation is rather different in retailing, with a recent CBI/FT survey indicating that retailers are now planning to cut back on investment. By contrast, the latest Scottish Chambers' Business Survey suggests that Scottish retailers are no worse than neutral about investment intentions for the next quarter.

By a happy coincidence of circumstances, therefore, most of the modest slowing down in the UK economy has been felt by the overheated south-east, with little effect as yet in Scotland. Historically it is rare for Scotland to outperform the UK for extended periods of time, but for the moment the omens remain favourable.

14 June 1990