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QUARTERLY ECONOMIC COMMENTARY

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ERRATUM In Vol 18, No 2 we published an article by R Kerley who currently works at the Scottish Local Authorities Management Centre at the University of Strathclyde and not the Department of Government.

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OUTLOOK AND APPRAISAL

The end of the recession is at hand, but the size and timing of proposed tax increases may limit the speed of recovery and so reduce further the prospects for the three million unemployed in Britain.

The latest activity indicators for Scotland give a very conflicting account of how Scotland has dealt with latest UK recession. On the one hand we have two surveys, the Scottish Chambers Business Survey and the CBI Scotland survey, which report falls in activity in the third quarter followed by a slight relative improvement in the fourth. On the other, the official data suggest that any recession in Manufacturing was transient and much less destructive than its UK counterpart.

The latest index of production and construction from the Scottish Office covers the third quarter of 1992 and shows a healthy upturn in the production industries. It would appear, contradictory to our earlier forecasts, that the recession visited Scotland only fleetingly and that the movements of the Scottish and UK economies are more synchronised.

On a quarterly basis the Production and Manufacturing industries grew by 0.9% and 0.2% respectively compared with UK growth rates of 0.8% and -0.1% respectively. As usual one should also analyse longer trends rather than relying exclusively on snapshot instances which often require ex post revision. Growth in the production industry in the latest four quarters was -1.4% when compared with the preceding four. Then UK industry contracted by only 0.7%. Over the same time period, Manufacturing industry contracted by 2.2% in Scotland whereas output dropped by less (1.9%) in the United Kingdom.

The pattern observed in the third quarters figures is roughly the same for both Scotland and the UK. The major growth areas in Scotland were in Energy and water supply (3.4%) - although the supply of Coke and Coal fell by 13% - the production of Intermediate goods (1.2%) and in Electrical and Instrument engineering (5.0%). The related figures for the UK show growth of 3.4%, 1.4% and 1.0% for respective products.

Two other points on the index require some space. Firstly, the index of construction continues its trapeze act and has defied gravity once again. Contrary to all the forward and backward looking evidence from the SCBS and CBI data the Scottish Office estimate construction growth of 3.8% in the third quarter, somewhat in contrast to the relentless decline suffered by the South East. For the UK the CSO report a fall of 0.9% on an quarterly basis and 6.4% on the fore mentioned four quarters method. Compare that with Scottish four-quarterly growth of 3.1% and one can easily gauge the scale of how misleading the official index would appear to be. Secondly, the index measuring the production of consumer goods grew in Scotland by 0.8% in contrast to the UK where the CSO estimated a decline of 0.4%. This may be evidence that the smaller debt overhang north of the border leaves the way open for a recovery in consumer spending once there is an upturn in the general economic climate.

The performance of the Scottish labour market both in recent months and over the recession as a whole has been encouraging. Since April 1990 the level and rate of seasonally adjusted claimant unemployment in Scotland has risen least in the UK from 203,500 or 8.2% to 248,400 or 9.9%. This compares very favourably with the 86.2% increase in UK claimant unemployment which now stands at an indefensible 2,971,100 or 10.5% of the workforce.

The primary increase in benefit claims has been focused in the South East, South West, East Anglia and London. In Scotland total unemployment has risen by 8.6%, three and a half points below the GB average. In fact, the growth of female unemployment in Scotland was the second smallest of any region in the UK.

In February seasonally adjusted unemployment fell, unexpectedly, in all regions except London and the north. The largest percentage declines were recorded in the South East, East Anglia and the South West. The total level of unemployment in Scotland declined by 0.7% and was made up entirely of falls in male unemployment.

The general picture coming from the official data,

such as the index of production and claimant unemployed, seems to suggest that Scotland's recessionary woes lasted a mere six to nine months. However a more balanced use of all available information would suggest that we are only now beginning to see an upturn in activity and optimism and not before Black Wednesday as the index of production would tend to suggest.

The UK economy

Indicators for the whole UK economy are a little more encouraging this quarter although the UK's medium term prospects are the subject of intense debate. It is widely believed that lower interest rates have produced an upturn in prospects. While the economy remained flat in 1992, Gross Domestic Product at factor cost contracting by around 0.5%, there does appear grounds for optimism that a recovery, albeit very sluggish and fragile, is beginning to take hold.

Industrial production fell by 0.4% in January although a large portion is due to oil and gas extraction falling back to its post 1988 first quarter average. The production of investment goods rose strongly rising to its highest level since the first quarter of 1991. Within the manufacturing industry output rose very slightly in all sectors other than chemicals and man-made fibres (sic 25-26) which fell back to its pre-Christmas level.

The housing market also shows signs of picking up. Mortgage lenders have reported a rise in the value of new commitments to mortgages. In February it rose to £2.72bn up from £1.55bn in January. Housing starts grew strongly in January after faltering in the run up to Christmas. The seasonally unadjusted index is currently at its highest level since July last year.

Retail and price indicators are looking healthy. 'All retail' sales volume rose by 0.3 points in February leaving its level higher than any month in 1992.

The effects of a lower value of Sterling do not seem to have fed through into higher prices, although one should be cautious since February's rise in the RPI was due to higher drink and tobacco prices. The retail price index (excluding mortgage interest payments) stands at 3.4% some 0.6% below its target range and earnings growth has fallen to its lowest rate for over 25 years. The current growth rate of 4.5% would seem to represent a major anti-inflationary success given that in previous recessions earnings growth failed to fall below 7%. With recovery we can expect some further increase in productivity, and assuming wage demands remain subdued, unit labour costs should fall even lower obviating the need for higher factory gate prices.

The monetary indicators, which are more forward looking than those monitoring the real economy continue to provide a mixed picture. M0 growth continued unabated into February, growing at an annual rate of 4.8%, by far its highest level during the recession. However M4 growth declined again to 3.2%, some 0.8% below its pre-budget monitoring level. Bank lending to the private sector in February fell from +£1,100m (revised) to below £200m. According to the British Association of Bankers consumers are still paying off debt. Even after nearly three years of recession the overhang from the late 1980s credit explosion still figures heavily in the short term spending plans of the average consumer.

Once again we feel ourselves compelled to discuss the number of jobless in the UK and the medium term indications coming from the balance of payments data.

Regardless of the freak reduction in unemployment rate to 10.5% in February there is a massive failure in the British labour market. Total seasonally adjusted claimant unemployment has risen by 1.375m since April 1990 and stands close to the politically sensitive three million mark on its present definition. In fact, contrary to popular perception, the most affected groups are those aged between 18-19 and 20-24 years who are sporting rates of close to 20%. In addition, long term unemployment has risen steadily and now traps more than one third of those unemployed in the UK. This is a scandalous waste of human capital in a developed country and is surpassed only by two countries in the EC, namely Ireland and Spain.

The balance of payments figures are still moving in the wrong direction. Post December figures consider only non-EC trade but show a rise in the volume, not just value, of import penetration. We should be seeing a rise in non-EC trade with our biggest market, the USA, but this does not appear to be happening. When one compares the latest three months with the preceding three, and excluding oil, exports have grown by 9.5% and imports by 17.5%. Since devaluation initially increases the price of imported goods it should improve the balance of trade in volume terms and increase the value deficit. In fact we are seeing a worsening of both the value and volume deficit. Why this should be happening

in an anaemic economy and how the government proposes to fund a current account deficit which comprises both public and private sector deficits, a feature deemed unthinkable only a few years ago, should be part of the public debate on the structural inadequacies of the British economy.

Prospects for the Scottish economy

The structural problems facing the economy were set out in the previous Commentary's editorial. In this prospects section we will review the effects of the budget and its likely impact on the long term prosperity of the United Kingdom and Scotland.

Following the budget in mid-March the Scottish economy like its UK counterpart faces an uncertain future. The budget, in its attempt to redress the fiscal imbalance evident in the latest PSBR figures, produced a series of changes to the tax structure.

The chancellor introduced five measures which will directly benefit Scotland. Firstly, he did not levy duty on Whisky and so reduced the competitive disadvantage faced by Scotch Whisky manufacturers in the UK drinks market. Secondly, export credit premiums were lowered by 7% with an extra £1.3bn in credits to less developed markets promised in the next few years. This move will aid UK and Scottish exports which currently face higher premiums than their main competitors. Thirdly, the chancellor proposed an investigation into changing the level of tax relief on insurance sales. This will be of benefit to Edinburgh's financial centre. Fourthly, the measures to help the long term unemployed, as set out in the Regional Review, must be seen as a shift in policy and move towards tackling the unacceptable rise in joblessness throughout the UK. Lastly, the government will introduce a loan guarantee scheme to help foster small business growth. This is an issue which we discussed in the previous Commentary, Vol 18.2.

Unfortunately, there are some proposals which will not favour Scotland. Firstly, the introduction of 15p on leaded and 12.5p on unleaded petrol will certainly act against Scotland, a spatially diffuse country with large distances between the major trading centres, especially in the north. Businesses who wish to trade with companies in the south will now be faced with higher road transport costs. Secondly, the imposition of VAT on fuel and power will have a more potent effect on budgets in Scotland where the average heating bill is some 50% higher than in more southern climes. Thirdly, changes made to Petroleum Revenue tax may reduce the expansion of Scottish oil interests since drilling exploration can no longer be offset against tax. It is thought that exploration costs may rise by up to 400%. Just one week on from the budget there are already reports of cancelled exploration projects and threatened job losses.

On a macroeconomic scale the budget has done little to alleviate the structural problems that exist within the UK economy. What it has done however is to signal and apparent change in government employment policy an introduces the possibility that Major's Conservative party may, if the price is right, consider intervention to reduce the deleterious effects of market failure.

The uncertainty faced by the Scottish economy revolves around the near perpetual rise in the number of claimant unemployed and whether the proposed increases in direct and indirect taxation hinder the recovery (see The UK economy). With one third of the unemployed in Scotland facing another year on the dole the budget has targeted 3.5% of the UK unemployed. Since long term unemployment robs workers of skills, productivity and dignity, their ability to compete for vacancies dissipates very quickly. The result is upward pressure on wage settlements and lower employment as employed workers (insiders) can demand higher wage increases knowing that their unemployed counterparts (outsiders) are skills deficient and unlikely candidates for employment.

A coherent set of proposals, in addition to those in the budget, to deal with 'UK sclerosis' must be laid out before the United Kingdom becomes a permanently low skilled economy whose only access to international investment arises from a low paid workforce. In the past year the 'Commentary' has spelt out the need[1] for more active employment measures a return to the original principles of the Community Programme as set out in the Regional Review instead of indefinite benefit payments. Samuel Brittan[2] exposes the disturbing employment prospects for Britain if sustained medium term growth proves elusive. If treasury growth projections are reliable and a ballooning budget deficit raises long term interest rates, it may be 1997 before actual output catches up with trend growth and employment creation resumes.

The short-term forecast for production in the present year has been revised up to 1.1% from 0.5% in the previous commentary. This is due to the improvement in the growth rate of the US export market and beneficial effects of lower UK

interest rates. We feel that the Scottish economy on average will benefit from a South East biased budget which lowered export premiums and left Whisky duty unchanged as this should open up export prospects to the rest of the United Kingdom. The medium term outlook is hazy given the uncertainty over Regional policy. A clear statement on policy within Scotland would certainly help Scottish industry to plan for the future.

March 25 1993

Notes

1."Stopping Unemployment", Layard & Philpott (1991), Employment Policy Institute

2.Financial Times, March 18th 1993

The Budget Deficit: Opposing viewpoints

This year's fashionable subject of debate has been the size and funding of the Public Sector Borrowing Requirement and its potential to raise long-term interest rates and effects on long-term growth.

Competing policy solutions to this problem can be illustrated by splitting the economic debate into the polemics of the orthodox Keynesian and extreme monetarist schools of thought.

The orthodox Keynesian school views a budget policy as a means of stabilising the economy. If the economy falls into recession the reduction in income wrought by unemployment will cause a reduction in government tax revenue and a rise in spending through welfare payments to the unemployed. The size of the deficit will expand. For the Keynesian school this increase is desirable because it reduces the withdrawal of funds from the economy caused by government taxation thereby maintaining demand in times of recession. As recovery takes hold, income and therefore tax revenue increases, allowing the government to pay off their debt commitments undertaken during the recession. In this way the deficit should automatically move back towards zero.

The extreme monetarist school takes the opposing view that a very large budget deficit is likely to produce either higher interest rates, higher inflation or both. Higher interest rates would occur because the deficit is made up of two parts, the structural deficit and the interest payments to those who are funding the deficit by buying government debt. As the structural deficit increases the government needs to sell more and more debt to fund its spending. In doing so it must offer higher rates of return so that investors are willing to buy additional debt. Hence an expanding deficit is likely to produce a rise in interest rates on government debt. Alternatively, higher inflation is a possibility because the authorities have the option of partially funding the deficit through reducing its real value. This can be done by boosting inflation.

The policy prescriptions from the two schools are therefore different. Those who view the deficit as a cyclical abberation, the orthodox Keynesian school, would do nothing and wait for the deficit to subside as the economy recovers. The extreme monetarist school would advocate tackling the deficit by tightening fiscal policy to reduce the structural deficit and loosening monetary policy to reduce interest payments.

The outcome of the debate produced a policy consensus somewhere in the middle. The majority of the seven 'wise men' favoured a fiscally neutral budget so that the recovery could gain momentum. The deficit could then be tackled in the medium term by increasing the tax burden by £6.5bn in 95/94 and £10.5bn in 96/95. Given that the Bundesbank still seems reluctant to significantly lower interest rates it was felt that UK rates could fall no farther without inciting a further run on the pound. This would be undesirable given the inflationary consequences of higher import prices.

In addition the government relaxed its 'overfunding' rule which precluded the purchase of debt by the banks and building societies. Since the budget, however, the purchase of bonds by the banking sector will now count as funding the Public Sector Borrowing Requirement. The implication of this is that debt sales will be recorded as assets on commercial banks balance sheets and these can then be used as backing for increased lending.