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# Quarterly Economic Commentary

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# QUARTERLY ECONOMIC COMMENTARY

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.

## Commentary Team




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

041-552 4400 Ext. 3958

# FRASER of ALLANDER INSTITUTE

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# Outlook and Appraisal

The Scottish economy is standing up surprisingly well to last year's interest rate rises. Retailing and wholesaling are showing signs of reduced optimism but sales remain strong if below expectations. Manufacturing and Construction remain buoyant. Investment is particularly strong. However, with demand in both the World and British economies falling during 1989, Scotland should be similarly affected. But there are indications that Scottish economic performance might hold up better to such a downturn than on previous occasions. Nevertheless, the outlook does very much depend on whether the current inflationary pressure in Britain can be reduced without the economy being tipped into recession. The probability of a stagflationary outcome appears somewhat greater than when we last reported.

## Recent Performance

Industrial production figures are now available for the second quarter of 1988. These data and those for preceding quarters back to 1983, are presented for the first time rebased to 1985 - rather than 1980 = 100 - and revised to improve their reliability. The net effect of the changes is to *lower* the annual percentage rate of growth of industrial output in the Scottish economy between 1983 and 1987 from 1.6% to 1.2%. However, at the UK level, the effect of the revisions and rebasing has been to *raise* the average annual rate of growth from 2.8% to 3%. A significant part of the Scottish economy - Production and Construction account for around 40% of GDP - was therefore growing more slowly over this period, both absolutely and relative to the UK, than the earlier statistics indicated. (Further details on the rebasing of the Index are presented in the **Scottish Economy** section below).

Nevertheless, the most recent data make clear that Scottish industrial output performed well in the first half of last year. Production and Construction rose by 7.5% in the first half of 1988 compared with the same period a year earlier. In the UK, the comparable figure was 5.1%. With the removal of oil and related production, industrial output in Scotland is estimated to have risen by 7.7% compared with 6.5% in the UK. Our earlier predictions that during 1988 growth in the Scottish economy would move up into line with growth in the UK are clearly supported by these data.

The February **Scottish Chambers' Business Survey (SCBS)** indicates that both retailers and wholesalers were less optimistic in the final quarter of last year than they were three months before (see **Business Surveys** section). This is compatible with the expected effects on consumption of a tightened monetary policy. But it is clear that there is no sign of a collapse of confidence, nor is there any evidence in the survey of sales being hit. Indeed, +62% of retail respondents expected sales volumes to rise again over the next three months, which is not markedly lower than the +76% of respondents who held the same expectation in October. We must conclude from these figures that the Scottish retail sector remains cautiously optimistic about the effect of the interest rate rises on their sales.

In the **SCBS**, manufacturing respondents were generally more optimistic about their business situation than three months earlier. The strong growth in output and orders noted in the previous survey was being maintained and was expected to continue into the subsequent quarter, fuelled principally by export growth. In the **CBI (Scotland) Survey**, manufacturers were less optimistic about the future outlook than their counterparts in the **SCBS**. And anecdotal evidence suggests that some companies serving markets in the south have lost orders following the rise in interest rates. But, both the **CBI Survey** and the **SCBS** indicate that the investment intentions of

Scottish manufacturers have not been affected by higher interest rates. Investment intentions in both surveys have been revised upwards. Further evidence in support of the buoyancy of Scottish investment, in a year when UK investment rose by over 12%, comes from the strong trend in advances by the Scottish financial institutions to the corporate sector. A substantial percentage of this increase in corporate credit is expected to be used to finance investment. The need for a continued growth in investment is particularly pressing in view of the finding in both surveys that capacity constraints are beginning to bite in some parts of manufacturing.

Elsewhere in Scottish industry, Construction remains buoyant and may be starting to outperform the industry in other parts of the UK (see **Construction** section). Output in the first half of last year was 11.1% above the same period in 1987. In the UK the comparable figure was 10.1%. Evidence that the sector's performance is improving relative to the UK is also provided by the **NHBC** data on dwelling completions and starts. The outturn for Scotland and the UK during 1988 showed increases of 16% and 11%, respectively, for completions, but the margin for starts was wider at 40% against 15%. In the **SCBS**, Construction respondents were more optimistic than in the previous quarter, but with a positive balance of +23% this is significantly lower than the +59% of respondents more optimistic in the previous survey. The feared effect on demand of higher interest rates clearly hangs over Construction firms as well as retailers, but as with retailing the effects on confidence have so far been rather limited.

Other sectors which appear currently to be bullish include: Food, Drink and Tobacco, where investment intentions are strong; Metal Manufacturing, where the steel industry is working at high levels of capacity; Mechanical Engineering, where, after last year's depressed output performance, optimism is high as demand grows strongly both from abroad and elsewhere in the UK; and, after a difficult year, the Oil industry, where recovery looks likely with seven new developments expected during 1989 (see **Food, Drink & Tobacco, Metal Manufacturing, Mechanical Engineering** and **Oil and Gas** sections). The Textiles industry stands at the other extreme where, after a good year in 1988, there is currently a marked degree of pessimism. This seems likely to be due to the fairly high level of Sterling and upward pressures on costs, both of which are critical to companies competing in a market subject to vigorous international competition (see **Textiles etc.** section).

## Prospects

Activity in both the World and UK economies is forecast to turn down this year. A general tightening of both monetary and fiscal policy is expected to contribute to a lowering of world economic growth from the 4% achieved last year to around 3% in 1989 (see **World Economy** section). Similarly in the UK a tightening of monetary policy following the interest rate increases last year is forecast to reduce the rate of growth of GDP in 1989 from last year's high of 4.5% to 2.5% (see **British Economy** section). In view of the openness of the Scottish economy it is clear that Scotland will not escape the cooling economic breeze that is blowing in from outside. Indeed, some companies have already experienced a tailing-off of orders from the rest of the UK. Nevertheless, there are indications that Scottish economic performance might hold up better to such a downturn than on previous occasions.

The effect of the interest rate rises may be dampened in Scotland because first, the earlier slower rate of house price inflation in Scotland has resulted in an average level of household debt that is at least half that in the rest of the UK and the South East in particular. Second, currently more rapid house price inflation in Scotland raises net wealth and so should provide a relative stimulus to consumption. Third, to the extent that a reduced growth rate is due to a downturn in the demand for consumer durables owing to higher interest rates - and economic research suggests that this is likely - then Scotland should fare better than the UK. This is because durable good production constitutes a smaller proportion of industrial output in Scotland than the UK: 2.3% compared with 3.8%. However, if the balance of reduced consumption affects non-durables to any significant degree then Scotland could fare worse since the respective proportions are 20.5% for Scotland as against 16.8% for the UK. Fourth, Scottish export performance appears relatively strong and so may be better placed to take up the slack as domestic demand declines.

So, to the extent that interest rate rises work to lower domestic demand via net wealth effects on the demand for consumer durables then the Scottish economy is well placed this year to avoid the extremes that are likely to be experienced in the south. On the other hand, if higher interest rates and the consequent higher exchange rate have their principal impact on demand by lowering investment and exports, then the Scottish economy could suffer disproportionately. Investment goods production is more important to industrial output in Scotland than to production in the UK: 21.2% compared with 16.6%, and the relative importance of exports to the Scottish economy is well known. Moreover, the structure of Scottish industry is such that probably more capital intensive production processes are employed here than in other regions of the UK. Nevertheless, our judgement is that the balance of forces favours an outturn for economic growth in Scotland during 1989 which is no worse than that for the UK. Indeed, we would not be surprised by an outturn which showed a growth rate 0.5 percentage points above that achieved in the UK.

But, overall, the outlook does very much depend on whether the current inflationary pressure in Britain can be reduced without the economy being tipped into recession. That is, whether the British economy can achieve a hard rather than a soft landing. The macroeconomic significance of the recent Budget is whether the fiscal stance embodied within it, coupled with the government's interest and exchange rate policy, are sufficiently appropriate to avoid the former outcome. Our view is that, despite the clear indications of inflationary pressure in the national economy, the current stance of policy could prove to be unduly resthictive.

With hindsight it seems clear that the fiscal stance was too lax in the last - 1988/89 - fiscal year even though an unplanned public sector debt repayment (PSDR) of £14bn occurred due to the rapid growth of the economy. This **Commentary** argued consistently last year that tax rates should have been higher. Public sector saving was necessary to offset the growing dissaving in the private sector. The governmant's chosen fiscal stance, coupled with what in retrospect turns out to have been inappropriate interest rate reductions in the first half of last year, undoubtedly contributed to the rapid growth in domestic demand, the increase in price inflation and the deterioration on current account. The PSDR is forecast to remain broadly similar during 1989/90. But the irony is that this year the fiscal stance might come to be too resthictive if interest rates are kept for too long at the present high levels. Pressures from the foreign exchange markets following continuing high monthly deficits on current account are likely to induce the Chancellor to protect Sterling and the financing of the deficit by keeping rates high. Price inflation should begin to moderate as a result. But at the same time the combined effect of a tight monetary and fiscal policy will be tending to lower activity in the real economy. It is arguable that the same outturn for inflation could be secured with the current level of interest rates but with a smaller PSDR having a less depressing effect on the real economy. The Chancellor in following his current path has abandoned any monetarist principles he might have had and is using fiscal as well as monetary policy as an inflation reducing device. In other words he is prepared to take risks with the real economy because of the primacy of the inflation objective. The economy could therefore be in for a hard landing. That would be particularly distressing for a Scottish economy which, to continue the metaphor, struggled hard to reach take-off speed and is not long off the ground.

31 March 1989