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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. The results of this work, carried out in conjunction with the Department of Economics, are published in the Institute's 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.

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Editor:	James Love
Editorial Assistant:	Joan Bennett
Contributors:	Paul Draper, John Heeley, Iain Jenkins, Cliff Lockyer, Jim H Love, Peter McGregor, Iain McNicoll, Noreen O'Donnell, Jim Stevens, David Simpson, Elizabeth Tait and Jim Walker.
Graphics:	John Blackhall and Elizabeth Tait
Production:	Sheelagh Blackhall and Isobel Sheppard

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

041-552 4400 Ext. 3958

QUARTERLY ECONOMIC COMMENTARY

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Outlook and Appraisal

During the course of 1986 economic growth in Scotland and in the rest of the UK is likely to proceed less rapidly than in 1985. Moreover, changes in the Scottish pattern of growth will reflect those taking place in the UK generally and in other European economies.

Growth in 1985 was influenced in part by two factors which have now largely worked their way through the system. The first was the "rebound" effect associated with the ending of the miners' dispute. The second factor was the bringing forward of investment projects in the first quarter of 1985 in response to the April reduction in capital allowances. While some incentive remains to bring forward investment before the shift to a new system in April of this year, companies have probably already taken as much advantage as possible of the more favourable features of the old regime. This, along with continuing high real interest rates, suggests that investment expenditure in Scotland is likely to grow by something of the order of 2% this year as against around 3% in 1985. Deceleration of export growth is also likely to contribute to slower growth. The strength of sterling and the slowing of the world economy from its period of substantial expansion in 1983/84 are likely to depress Scottish export growth by 1% from the rate of around 4% in 1985.

While the scope for income tax reductions in the March Budget has all but been effectively eliminated by the effects on the Exchequer's revenues of falling oil prices, growth of consumer expenditure will assume a dominant role in determining aggregate demand. The principal source of higher consumer spending will be continuing increases in real earnings. Expansion of consumer spending is unlikely, however, to offset slower growth elsewhere and overall Scottish growth is likely to be of the order of 2% for 1986.

The most recent **Scottish Business Survey** again confirms the pattern of change in the economy. As in all five previous **Surveys**, retailing respondents in January 1986 report considerable optimism about trading conditions. This fully reflects the influence of rising consumer spending but contrasts sharply with the continuing pessimistic outlook among construction companies resulting from further declines in public sector capital expenditure. In manufacturing there has been a return to the cautious optimism detected in the first three quarters of 1985, most probably as a consequence of the depreciation of sterling against European currencies such as the Deutsche Mark in recent months. Nevertheless, Scottish manufacturing remains characterised, as is construction, by considerable spare capacity and a deficiency of orders remains the most important constraint on activity. Disappointingly after the apparent end to labour-shedding to September 1985, Scottish manufacturers reported job losses in the last thee months of 1985 which they expect to be repeated in the first part of this year. Large and continuing reductions were reported in construction employment. Only slight increases in employment are occurring in retailing and job gains are concentrated exclusively among part-time staff, with full-time staff being laid-off.

Against this background, Malcolm Rikfkind has now taken over as Secretary of State for Scotland. He faces formidable difficulties on a number of fronts, including the teachers' dispute, the continuing debate on rates reform (see **Economic Perspective**), uncertainty over the futures of Ravenscraig (see **Economic Perspective**) and of shipyards such as Hall-Russell and Scott-Lithgow, the emerging oil price threat to North Sea developments, and rising unemployment.

During the term of office of Mr Rifkind's predecessor, Mr George Younger, the Scottish economy experienced considerable change. Adjustment must take place in response to advances in technology and changes in demand patterns and the most successful development during Mr Younger's tenure occurred in electronics.

Although, as is inevitably the case where the pace of technological advance is rapid, not all companies prospered, Scotland has succeeded in attracting inward investment. New investments in electronics are, however, capital-intensive and some uncertainty exists as to the extent of the sector's net employment generation (see Electrical and Instrument Engineering). Undeniably, however, the jobs created were limited in relation to the heavy job losses elsewhere. Continuing net loss of employment proved an intractable problem for Mr Younger. Despite repeated assertions of the "high priority" he assigned to tackling unemployment, Mr Younger saw the Scottish unemployment rate rise from 7% in 1979 to 16.4% in January 1986. This reflected the substantial erosion of Scotland's manufacturing base. Partial solution to the problem was sought in the promotion of the service sector. The shortcomings and limited impact of that strategy are discussed in the November **Commentary** and elsewhere in this **Commentary** (see Labour Markets).

In attempting to resolve the problems he inherits, Mr Rifkind is constrained by a number of related factors. First, there have been recent improvements in Scotland's relative positions in regional comparisons of unemployment and income per head. These improvements have largely resulted from more widespread contraction in other regions such as the West Midlands. Scotland's unemployment, although beginning from a high base, has risen less rapidly than that in some other regions and Scottish income per head has been boosted by oil-related developments. The significance of these improvements is that Scotland is no longer perceived as a region in need of special consideration. "Special pleading" on regional grounds is likely to be of no avail.

Secondly, the Government's economic strategy explicitly precludes certain options. Mr Rifkind can expect at best only a limited stimulus from public expenditure. While there are some signs of slight fiscal relaxation (see UK Economy), the Government continues to pursue what it regards as a "cautious and prudent" approach to public spending. Faith in the efficacy of the market remains a fundamental element of policy. The market has failed, however, to provide a self-correcting mechanism capable of resolving the problems of manufacturing decline and unemployment. Moreover, despite its free market philosophy, the Government actively intervenes by means of interest rate adjustment to regulate a price which has a considerable bearing on manufacturers' prospects, namely the exchange rate. Exchange rate depreciation is not in itself, however, a sufficient solution. This was apparent in the period 1981 to 1985. Despite marked reductions in sterling's trade-weighted index between 1981 and 1984 and substantial growth in world trade, UK exporters, although achieving higher export levels, failed to make gains in market shares. Maintenance of a strong pound, however, intensifies the competitive pressure on UK exporters.

The difficulties imposed by policy towards the exchange rate are compounded by the third constraint, namely the absence of a positive industrial strategy. With good reason, the Government shies away from protectionist policies. Rejection of protectionism need not be synonomous, however, with abrogation of support to industry. Indirect state aids to industry on energy, labour and transport are widespread among our European competitors. The relative paucity of such support in the UK further exacerbates the competitive pressures facing UK companies.

To Mr Rifkind's advantage, there is within Scotland a clearer semblance of an industrial strategy than exists at the national level. The Scottish Development Agency seeks to perform a "catalytic" role in promoting investment in certain areas of the economy. Other UK regions tend to regard the existence of a separate regional agency as giving Scotland an unfair advantage, a view likely to be received sympathetically by Government, given the narrowing of UK regional disparities and the desire to constrain public expenditure. From a Scottish perspective, there is a case for a broadening and strengthening of the SDA's industrial role. At the moment the SDA's emphasis is heavily on attraction of foreign investment and promotion of small business. Arresting the process of industrial decline requires expansion of the SDA's services to encompass companies already established, medium to large companies, and indigenous companies. Securing such an outcome would be an important first step in Mr Rifkind's defence of the Scottish economy.

15 February 1986