OUTLOOK AND APPRAISAL

The revival in economic activity in Scotland which occurred in 1978 is unlikely to be maintained during 1979. The fairly limited expansion which did occur in 1978 was largely a response to substantial increases in real disposable income. Between April 1977 and April 1978, average male earnings in Scotland rose from £78.3 to £88.5 per week, a rise of 13.0%. Over the same period, retail prices in the UK rose by only 7.9%, largely in response to the stability of the pound, which in turn reflected the more conservative monetary stance which the government had been forced to adopt. Tax handouts in the April 1978 budget amounting to some £2bn further boosted real disposable incomes. Consequently, retail sales expanded substantially and the average weekly expenditure of Scottish households rose considerably above the 1977 figure of £64.81.

During 1979, the opportunity to further expand real incomes will be considerably reduced. Earnings growth will be less than the 13% of 1978, unless the present difficulties cause a complete breakdown of wage restraint, and inflation will tend to rise slightly towards the end of the year. Further, there will be little, if any, scope for tax cuts if the public sector borrowing requirement is to be kept to its target of £8½bn for the fiscal year 1979/80. Indeed, some tax increases may be necessary, though they are unlikely to be implemented before an election.

Though consumption growth may be constrained, the outlook for investment appears to be more hopeful. The Scottish Council expect manufacturing investment to total £575m in 1979, which is a considerable increase on the most recent actual figure of £377.5m for 1976, even allowing for inflation. This is perhaps a response to increased levels of output requiring the installation of new capacity. Certainly the CBI Survey of October last shows 44% of firms working at full capacity. However, with MLR now at 12½% there are certainly strong financial disincentives to investment. Additionally, with corporate profits beginning to decline somewhat after a strong recovery at the beginning of the upswing, the scope for internally financed investment should begin to close down in the latter half of 1979.

Prospects for employment are only moderate. Between June 1977 and June 1978 there is estimated to have been an increase of only 1000 in total Scottish employment. As usual, the sectoral pattern of change has been a further decline in manufacturing employment being offset by an increase in the service sector. The results of the Scottish Council survey,coupled with the argument that employment tends to peak after production because of various inefficiencies in the operation of the labour market, provides some grounds for expecting a very slight increase in employment over the year. Consequently, unemployment should continue to decline very slowly, reaching around 157,000 (seasonally adjusted) by June. The most depressing feature of this forecast is that this may well be the minimum level of unemployment to occur during the current economic cycle, even though it exceeds the maxima of all previous post-war economic cycles in Scotland.

At the time of writing, industrial disruption is threatening seriously to reduce production and so cause significant short-term increases in unemployment. Perhaps it is surprising that such disruption should take place after a year in which real incomes increased substantially for the first time since 1973. However, since it has become clear that the government's 5% guideline carries no official sanction, a number of unions, some with justifiable grievances following the inequities of four years of pay policy, have sought pay increases which, on even the most pessimistic forecasts of inflation, would give increases in real wages substantially in excess of the growth of output. Assuming the government maintains a tight monetary policy, the inevitable result of acquiescence to these wage demands will be substantial increases in unemployment. Our current forecasts are based on the assumption that earnings will grow by about 10% in 1979. Should this figure be exceeded by a large margin, which now certainly seems possible, the outlook for unemployment is considerably more pessimistic.

The government is now in a very difficult position. Further attempts to curb wage demands are, following the settlement at Ford's, unlikely to meet with success. Deflationary policies would be very unpopular during an election year and, even though they might reduce earnings growth, almost inevitably would cause an increase in unemployment. Price controls are unlikely to be of much value in curbing price inflation except in the very short-run, and may cut deeply into investment programs. If there is an early election, deflation will probably appear to be the most effective option available to the new government. Growing exchange rate and balance of payments difficulties are likely to make its imposition inevitable anyway.

European Monetary System

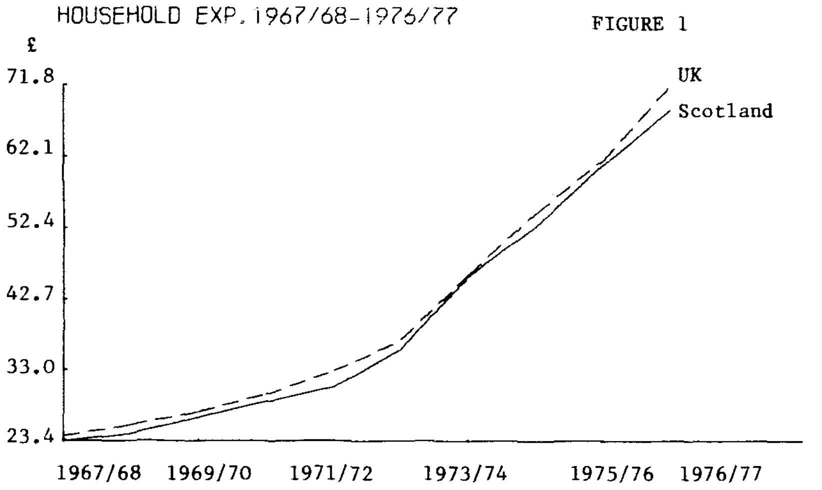
In a special article in this Commentary, Bill Stewart of the Economics Department, University of Strathclyde, discusses the background to, and the structure of, the European Monetary System. In Scotland, this issue may seem rather remote, especially since the UK government has decided not to enter the scheme, at least initially. Certainly, the structure of the system is labyrinthine in its complexity. Nevertheless, EMS and the prospect of further monetary integration in Europe are of fundamental importance to the Scottish economy.

As the article shows, the balance of advantage between entry to EMS and the status quo is by no means clear-cut. Which particular strategy one favours depends on one's view of the future performance of the British economy and the ability of the government to deal with economic problems, particularly inflation. For instance, if the UK government could reduce inflation to West German rates there would be little pressure on the exchange markets to sell sterling and buy Deutschmarks. Consequently, the pound would be able to remain within the limits prescribed in EMS and the country might well benefit because stability would boost investors' confidence. Conversely, if the UK entered EMS and found itself unable to reduce its relative inflation rate, pressure on sterling might force deflationary measures on an unwilling government. These might involve restrictive monetary policies such as increases in interest rates to attract foreign exchange into sterling and/or tight fiscal policies to deflate the domestic economy. Some would argue that deflation would be inevitable no matter what structure the international currency markets take. But opinion on this matter is divided, especially with regard to the extent and timing of the adjustment.

Past experience has shown that deflationary policies do not affect each part of the country evenly. The 'development areas', of which Scotland is one, generally suffer more acutely during a recession, especially in terms of higher unemployment. Those of the 'demand deficiency' school of regional analysis would argue that what is required to restore these regions to full-employment is a reduction in real wages so that product prices drop and consequently, output (due to increased external demand) rises. In effect, this is identically what happens to a country as a whole when it devalues its currency. Relative to other states, the devaluation reduces costs, enabling price cuts and consequent export expansion. Of course, since all the UK regions form a monetary union, devaluation is not an available option for the depressed regions. However, the UK government has pursued policies which can be looked on as a 'transfer of resources' from the wealthy to the poorer regions or alternatively as an effective devaluation of their 'currency'. For instant, the Regional Employment Premium reduced relative manufacturing costs by subsidising labour costs in the development areas, so giving producers freedom to reduce relative prices. Investment grants effectively transfer resources from central government to expanding firms in the poorer regions, again partly with the intention of reducing their relative costs.

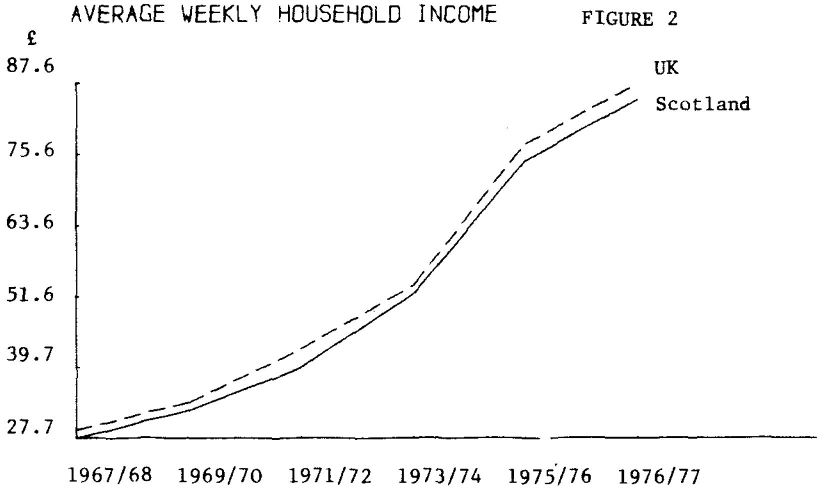
It is probably the case that, in the absence of resource transfer to the development areas, severe strain would be put on the political cohesion of the United Kingdom, simple because, rightly or wrongly, the concensus opinion now is that it is the government's duty to maintain a reasonable degree of equity between regions. Such a concensus on resource transfer has yet to emerge in Europe as a whole. Until it does, the political commitment of the poorer European nations (especially the UK) to the European Monetary System will be understandably weak.

FIGURE 1



Source: *Family Expenditure Survey*

FIGURE 2



Source: *Family Expenditure Survey*