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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.

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* * * * * * COMMENTARY * * * * * *

* * * * * * VIEWS * * * * * *

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Outlook and Appraisal

The measures included in this year's budget have not led to the significant tightening of the fiscal stance which was widely expected. The overall tax burden was marginally increased, mainly through increases in excise duties, with virtually no change occurring in direct taxation. Presumably the Chancellor feels that the continuing policy of high interest rates is sufficient on its own to curb domestic demand, and did not want to increase the risk of recession by tightening fiscal policy just as the economy begins to slow down. The evidence on domestic demand remains mixed, although Mr Major can take some encouragement from the February statement of the Committee of London & Scottish Bankers. The CLSB monthly statement indicated that personal lending fell in February for the first time since last October, and 'lending for consumption' fell more than twice as much in February as it did in the same month in 1989.

There is a certain irony in the fact that the Chancellor, who has been reluctant to push interest rates above 15%, may find himself forced to do exactly that as a result of downward pressure on the pound induced by the financial markets' unhappiness about the budget. In attempting to tread the fine line between slowing the growth of domestic demand and avoiding an outright recession, the Government now runs the danger of achieving the worst of both worlds in stagflation, a recession coupled with rising inflation. Potential problems arise here because of the method by which Mr Major chose to bring about his modest increase in tax revenue. Higher duty payments on petrol, alcohol and cigarettes feed directly into inflation, and it could be argued that this is precisely the wrong way to achieve what is at best a marginal fiscal tightening when much is being made about the dangers of inflation. The Government has, with some justification, pointed to problems in the future arising from accelerations in the level of wage settlements. The underlying increase in weekly earnings for the year to December 1989 was 9.25%, and coupled with a slump in the growth of labour productivity across the whole economy this has had a detrimental effect on unit labour costs which rose by 9.6% in the year to September 1989. Whether the recent weakness in Sterling can offset this rise in unit labour costs sufficiently to maintain the necessary increase in the value of exports is not yet clear.

Recent Scottish Performance

Data on production and construction for the third quarter of 1989 indicate that the growth in both Scottish and UK production continues to slow, but that there are some interesting differences between them. In the twelve months to September the Scottish index of production and construction rose by 2.2% compared with 1.7% for the UK as a whole, apparently indicating that the Scottish economy is slowing down more slowly than elsewhere in Britain. However, this is not the case in manufacturing; in the year to September UK manufacturing grew considerably faster than did that of Scotland - 5.7% compared to 3.6%. The enduring importance of the oil sector to Scotland is also made clear from this data. When oil and natural gas are excluded from the index of production and construction Scotland again appears in a less favourable light, with growth of 2.2% for the year to September compared to 5.2% for the UK. One bright spot here, however, is that in the third quarter the index fell by 0.6% in the UK but rose in Scotland by 0.5%.

Matters are further complicated by the apparently very divergent performance of the construction sector in Scotland compared with that of its UK counterpart. According to the official index, the Scottish construction industry underwent a marked recession in the middle period of 1989 which resulted in a fall in output of 0.6% in the year to September compared to a rise of 6.0% for the UK as a whole. This does appear to be somewhat out of line with anecdotal and survey evidence about the construction industry, but the true situation will not become apparent until the index of construction is published for the final quarter of 1989 and the first quarter of this year.

The last **Commentary** mentioned the importance to Scotland of the production of investment goods, which highlights the importance of the prospects for investment in the light of continuing high interest rates. Third quarter data here are slightly worrying; while in the UK production of investment goods rose by 2.9% between the second and third quarters and by 10.2% in the twelve months to September, in Scotland there was a fall of 0.4% between the second and third quarters, and the annual rise was only 2.8%. As has been mentioned before, it is important not to read too much into a single quarter's figures, and the production of investment goods does tend to be fairly volatile, so it would be premature to draw conclusions at this stage.

There was very little in the budget of specific relevance to Scotland, with the exception of the increase of duty on fuel and spirits. The Scotch Whisky Association in particular was enraged at the increase of 54p on the duty of a bottle of whisky. At first sight this may seem rather churlish, given that it was the first increase in duty on whisky since 1985. But the whisky industry is particularly upset at the fact that what it sees as discrimination between whisky and other alcoholic drinks such as wine and beer is being increased at a time when the industry has been lobbying hard in Europe to have appropriate harmonisation of duty payments on all alcoholic drinks. While the duty on table wine and beer was raised in line with inflation, the duty on spirits was raised by 10%, which will do little to assist an already virtually static home market for Scotch whisky. Whisky producers may simply have to redouble their efforts in export markets, where considerable success has been achieved recently (see Whisky section).

Focusing attention on the budget and the short-term performance of the economy should not blind us to important longer-term considerations which are at work in certain sectors. The whisky industry, for example, is not immune from the reorganisation on a global scale which is occurring in the market for alcoholic drinks, where important recent changes in ownership and control have taken place (see Food, Drink & Tobacco section). There are also the continuing problems being experienced in the textiles sector (see Textiles), and although output has risen rapidly in the paper and printing sector during 1989, some fears are already being expressed about the possibility of having reached the top of the cycle, with the attendant risk of over-capacity and the need for further rationalisation (see Paper, Printing & Publishing section).

Future Prospects

The latest Scottish Chambers' Business Survey offers some pointers to the likely short-term performance of the economy. The February survey revealed a markedly less pessimistic outlook than that of the previous survey, although there is no clear sign of marked optimism among respondents. The most encouraging aspects of the survey were to be found in manufacturing and construction, both of which experienced net increases in new orders over the preceding three months and anticipated further net increases over the next quarter. In manufacturing, export markets remained the most buoyant, very much in line with recent surveys. Perhaps the most interesting element of the survey was the increase in central government and other public sector orders experienced by the construction industry, with more increases expected over the next quarter. This is the first occasion for some time for which this has been the case, and is accompanied by positive responses on both actual and expected employment in the construction sector. The retail sector continues to produce apparently conflicting evidence; optimism remains low, but sales were well up in the last quarter and expected to rise further in the three months to come, as if the sector keeps anticipating the downturn which has apparently yet to materialise in Scotland at least.

As is so often the case, the outlook for the Scottish economy is dependent on the outcome of external events. Our recent medium-term forecast for Scotland indicated a period of respectable growth following a very sluggish 1990, as long as the growth in world trade remained strong, inflation could be held in check, and there was no outright recession in the UK. While the outlook for the first of these remains promising, for reasons stated above it is by no means clear that either of the latter two assumptions can be taken for granted, and the failure of either or both of them to hold could jeopardise the resilience which Scotland has so far shown to the Chancellor's medicine.

26 March 1990