Quarterly **ECONOMIC** *Commentary*

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Fraser of ALLANDER *Institute*

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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.

Articles accepted for publication should be supplied on a 3.5-inch disk in MS Word format or e-mailed as an MS Word attachment.

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Quarterly
ECONOMIC
Commentary

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OUTLOOK *and* APPRAISAL

The Scottish economy suffered a contraction in the fourth quarter 1999, in GDP as a whole and in the main service and manufacturing sectors. The UK economy, in contrast, displayed positive growth with both services and manufacturing outperforming their Scottish counterparts. But for 1999 as a whole, the Scottish economy grew more strongly than the UK reflecting stronger growth in the manufacturing and construction sectors. These are the principal conclusions of the latest quarterly GDP data from the Scottish Executive. Weakness in the transport, storage and communication, and public sectors appears mainly to account for the poorer Scottish service sector performance in the fourth quarter. Financial services was the fastest growing service sector in Scotland outperforming its UK counterpart. The downturn in Scottish manufacturing in the fourth quarter is a reflection of the near collapse in the demand for Scottish food and drink products. The relative performance of the metals and textiles industries also contributed to the weakness of Scottish manufacturing in the fourth quarter. The strength of sterling appears to be a major contributory factor to the weak performance of these sectors, with the service sector weakening because of knock-on effects. The drop in the external demand for manufactured products appears to have led to a cutback in the demand for local services such as transport, storage and communication, and business services. Electronics exhibited growth but at a slower rate than the industry in the UK. The latest GDP data contain significant revisions. However, they do not appear to contradict our earlier conclusion that recent relative improvements in the growth of Scotland's GDP are more a cyclical than a structural phenomenon, with the Scottish economy tending to perform relatively better when growth slows in the UK as a whole. The outlook for the Scottish economy remains favourable. Domestic demand has weakened in the UK and this will affect Scotland. But export growth is set to improve as sterling falls, as world trade picks up and as Scotland's principal export markets enjoy an upturn in domestic demand.

GDP and Output

In the fourth quarter 1999, GDP (excluding oil and gas) contracted by 0.1% compared to growth of 0.8% in the UK. Scottish manufacturing output declined, by 0.8%, for the first time since the third quarter of 1998, while UK manufacturing grew by 0.4%. The service sector, which accounts for 63% of total gross value added (GVA) in the economy, also contracted slightly, by 0.1%. The first quarterly contraction in the service sector in Scotland since the fourth quarter of 1996. UK services, on the other hand, exhibited strong growth of 1%. Of the other principal sectors, only construction significantly outperformed its UK counterpart, growing by 4.1% here compared to growth of 0.7% in the UK. Agriculture contracted by 0.8% in Scotland but grew by 0.9% in the UK. Electricity, gas & water supply contracted by 1.7% compared to a small decline of 0.2% in the UK. Finally, the mining and quarrying industry declined at similar rates in both Scotland (-1.8%) and the UK (-2%).

Disaggregation of the service sector into 7 principal sub-sectors, reveals that the principal reason for the slower growth of this sector in Scotland in the fourth quarter was due to the weakness of the transport, storage and communication sector. This sector, which accounts for 12% of service sector activity, contracted by 2% while the same sector in the UK grew by 2.5%. The performance of the public administration, education and health sector, accounting for 32% of service activity, and real estate and business services, accounting for 23% of service output, also contributed to the Scottish shortfall. Public sector output contracted by 0.3% in Scotland, while its UK counterpart grew by 0.5%. Business services, on the other hand, stagnated in Scotland but grew by 0.8% in the UK. However, the stronger Scottish performance of hotels and catering and financial services, which account for 5% and 6% of Scottish service sector output respectively, partially offset the weakness in other service sectors. The hotels sector grew by 1.4% in Scotland as against a fall of 0.5% in the UK. And financial services was the fastest growing service sector in Scotland with growth of 2.5% compared to 1.2% in the UK. The retail and other service sectors exhibited comparable performance in Scotland and the UK.

The weaker performance of Scottish manufacturing in the fourth quarter 1999 appears to have been mainly due to a near collapse in the demand for Scottish food and drink products. This sector, which accounts for 15% of Scottish manufacturing output, contracted by 8.2%, whereas the sector in the UK grew by 0.1%. Both food and drink sectors suffered equally, with the former contracting by 7.9% and the latter by 8.6%. It is tempting to ascribe the decline in output in these industries to the effect of the high pound on export demand for these price sensitive products, given the different structure of the Scottish food and drinks sector. However, the latest manufacturing export statistics for the fourth quarter reveal only a modest decline in the value of real exports, by 0.4%. The Scottish Executive's new export series are not presently seasonally adjusted, so one must be careful in interpreting the data. The demand for food and drink products tends to increase in the fourth quarter for obvious seasonal reasons, so perhaps a better indication is a comparison of export demand between the fourth quarters of 1998 and 1999. On this comparison, food and drink exports fell by 17% and by 8.7% when the latest 4 quarters are compared with the preceding 4. So, it would appear that the strong pound is a likely candidate for the fourth quarter decline in food and drink production. This conclusion is reinforced by the findings of the *Deloitte & Touche Scottish Chambers' Business Survey* for firms in this sector in the fourth quarter. Around 50% of respondents cited the strength of sterling as a greater cause of concern during the period.

The relative performance of the metals and textiles industries also contributed to the weakness of Scottish manufacturing in the fourth quarter. The metals sector, which accounts for 9% of manufacturing output, contracted by 5.3% in Scotland compared to growth of 0.5% in the UK. Textiles output fell by 3.3% in Scotland but fell by only 0.7% in the UK. Textile exports fell by 20% in the fourth quarter but by 4% over the fourth quarter 1998, with 67% of textile respondents to the *Deloitte & Touche Scottish Chambers' Business Survey* citing the strength of sterling as a greater cause of concern during the period. Metals exports, on the other hand, rose by 7% in the fourth quarter but fell by 6% over the fourth quarter 1998.

Of the manufacturing sectors exhibiting positive growth during the fourth quarter, the electronics sector remained comparatively weak in Scotland, increasing output by 1.3% compared to growth of 1.7% in the UK. Electronics accounts for 27% of Scottish manufacturing output and so the weaker performance of the sector has contributed materially to the slower overall growth of Scottish manufacturing. Chemicals grew by 1% in Scotland during the fourth quarter compared to growth of 2.9% in the UK. But the two remaining sectors both considerably outperformed their UK counterparts. Mechanical engineering grew by 4.2% during the quarter, while the output of transport equipment expanded by 5.1%. The two industries in the UK contracted by 0.4% and grew by 1.1%, respectively.

Despite the weakening of Scottish economic performance during the fourth quarter, growth in the Scottish economy in 1999 was generally stronger than in the UK. GDP (excluding oil and gas) rose by 2.4% against growth of 1.8% in the UK. Service sector growth stood at 2.4% in the two economies, while manufacturing output rose by 1.9% in Scotland yet stagnated in the UK. The construction sector also exhibited stronger growth here, expanding by 2.6% compared to 0.6% in the UK.

Charts 1, 2 and 3 display the quarterly growth rates of GDP, and manufacturing and service sector output for Scotland and the UK over the period 1996q1 to 1999q4. In the April 2000 **Commentary**, where the same tables were presented with data to 1999q3, we noted that Scottish GDP had grown more strongly than UK GDP in 7 of the previous 14 quarters and Scottish GDP growth had been faster in the last 5 quarters. The latest data from the Executive contain significant revisions to the Scottish GDP series that have the effect of worsening Scotland's quarterly GDP performance relative to the UK. Chart 1 indicates that, on the revised figures to 1999q3, Scottish GDP has grown more strongly than GDP in the UK on 6 out of 14 occasions. Moreover, the distribution of Scotland's more favourable quarterly GDP outturns is less heavily skewed towards the most recent quarters. Yet, the basic argument of the April **Commentary** still appears to hold. Which is that recent relative improvements in the growth of Scotland's GDP are more a cyclical than a structural phenomenon, with the Scottish economy tending to perform relatively better when growth slows in the UK as a whole. In the first five of the ten quarters from 1997q2 to 1999q3, UK and

Scottish GDP growth averaged 0.77% and 0.78% respectively per quarter. But in the subsequent five quarters when UK average quarterly growth dropped to 0.46%, Scottish GDP growth averaged 0.70%. It is interesting that when the data for 1999q4 are included, average quarterly GDP growth in the UK - over the last 6 quarters - rises to 0.51%, while the Scottish quarterly average falls to 0.56%. The Scottish economy is therefore seen to move more in line with the UK, although the growth slowdown is still somewhat less here than in the UK.

Chart 2 reveals that the data revisions in Scottish manufacturing have tended to raise the performance of the sector over the last 6 quarters. Scottish quarterly manufacturing growth has outpaced the UK in 10 of the 15 quarters shown. But despite the strong upward revision to the estimate 1999q3 manufacturing growth, from 0.4% to 1.1%, the outturn was still slower than the growth of manufacturing in the UK. Furthermore, the chart highlights the stronger performance of UK manufacturing in the last two consecutive quarters, the first occurrence of such a sequence in the previous 15 quarters.

The revisions to the Scottish service sector data have served to raise the quarterly performance of the sector relative to the UK. Chart 3 indicates that Scottish services outperformed their UK counterparts in 6 of the 14 quarters to 1999q3, compared to a score of 4 from 14 in the earlier unrevised data. The performance of the service sector tends to be weaker here but less than the previous data release would have us believe.

Outlook

The marked slowdown in the growth of the Scottish economy in the final quarter of last year, prompts the question whether the outturn was something of an aberration or is likely to be sustained. The strength of sterling does appear to have played a role in the slowdown, producing a greater impact on the price sensitive goods of the Scottish food, drink, textiles and possibly metals, than on their UK counterparts. Business survey evidence suggests that electronics sales may also have been affected by the strength of sterling. Yet, the service sector also experienced a slowdown, led by sectors that generally serve Scottish and UK rather than foreign demand. The best judgement is that the service sector weakened because the drop in the external demand for manufactured products led to a cutback in the demand for local services such as transport, storage and communication, and business services. The output of the public administration and health sector also weakened, which after the upward data revisions for the first half of 1999, performed much less strongly in the second half of 1999 than appeared to be the case when we last reported in April.

The difficulties of the oil and gas industry in Scotland should also not be ignored. Despite a rising oil price, exploration and total oil-related activity are on a downward trend and this is now clearly affecting the fortunes of both offshore and onshore contractors (see **Scottish Economy - Oil and Gas** section). But while the sector has symbolic significance, oil and gas extraction directly account for only about 1% of total Scottish GDP, although the inclusion of oil-related activities increases the figure somewhat.

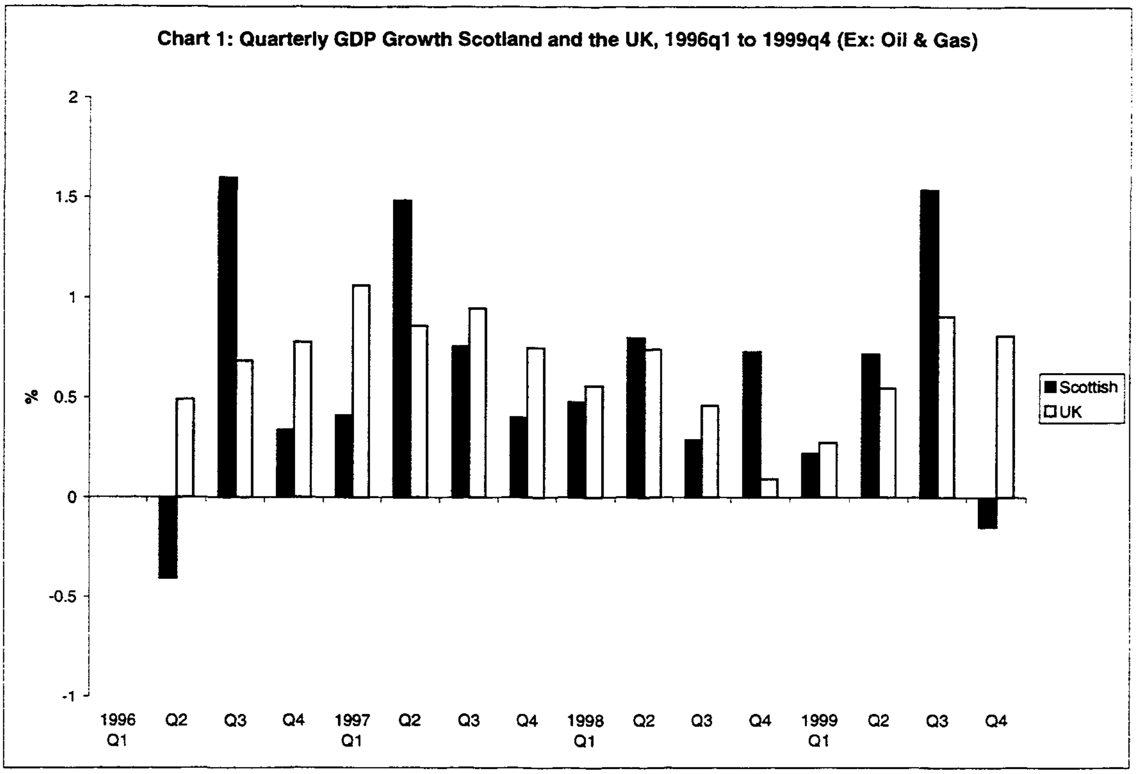
The UK economy experienced a slowdown in the rate of growth of domestic demand in the first quarter of this year (see **Economic Background - UK Outlook** section). It appears likely that this general weakening of domestic expenditure, affecting consumption, investment, stock building and the rate of growth of imports, will have similar consequences for the Scottish economy. Yet, the demand for UK exports was relatively buoyant in the first quarter, so we might expect to see some moderation of the export led decline that appears to have characterised the Scottish economy in the final quarter of last year. With sterling weakening, world trade on an upward trend and Scotland's principal export markets in Europe enjoying an upturn in domestic demand (see **Economic Background - The International Environment** section) the export picture might be expected to improve further. The most recent Scottish business survey evidence which points to a rising trend in export orders supports this.

Against this background, we expect that manufacturing will pick up a little in the first quarter of 2000. The Institute's Short-Term Forecasting model is predicting manufacturing growth of 0.2% in the first quarter (see **Scottish Economy - Short-Term Forecast** section). This is below our previous forecast and reflects the unanticipated weakening of UK domestic demand in the first quarter. Thereafter, we expect manufacturing activity to strengthen between the second and first halves of this year, with forecast growth for the second quarter of 0.4%, followed by 0.7% and 0.4% in the third and fourth quarters, respectively. Overall, manufacturing growth this year is forecast to be around 1.2%, which is less than the outturn in 1999 of 2%.

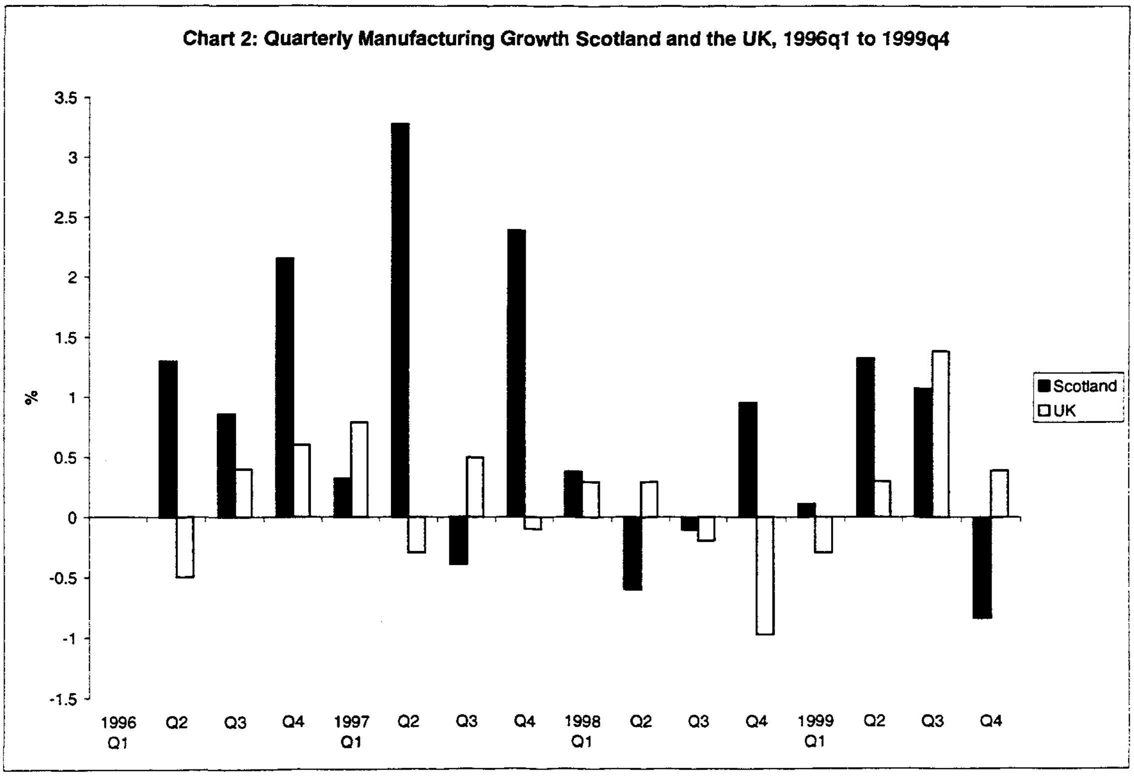
Our medium-term forecasts remain much the same as those presented in April. We still expect growth to be lower in Scotland this year than in the UK, a little above 2%, whereas the Treasury's most recent comparison of independent forecasts reveals an average expectation of 3.1% GDP growth for the UK this year. We have revised downwards our forecast for Scottish GDP growth in 2001 from 3.3% to 2.9% due to a lower forecast for the growth of domestic demand. This compares with the Chancellor's Budget forecast for the UK of 2.25% to 2.75% and the views of independent forecasters which reveal an average expectation of 2.6% GDP growth for the UK in 2001. Our forecast for 2002, remains unchanged at 2.5%, which is within the range of the Chancellor's expectation for the UK.

The most recent labour market data for Scotland indicate that the Scottish labour market remains stable with continuing employment growth (see **Labour Market** section). The ILO measure of unemployment has risen recently while the claimant count continues to fall. Recent business surveys suggest that pay pressures are largely absent, indicating that the labour market in Scotland has further room for employment growth without wage inflation accelerating. We are therefore forecasting that overall employment will grow by around 15,000 this year, by 10,000 in 2001 and by 4,000 in 2002. This should result in some further falls in ILO unemployment before the series turns up again next year.

28 June 2000



Source: Scottish Executive and FAI Calculations



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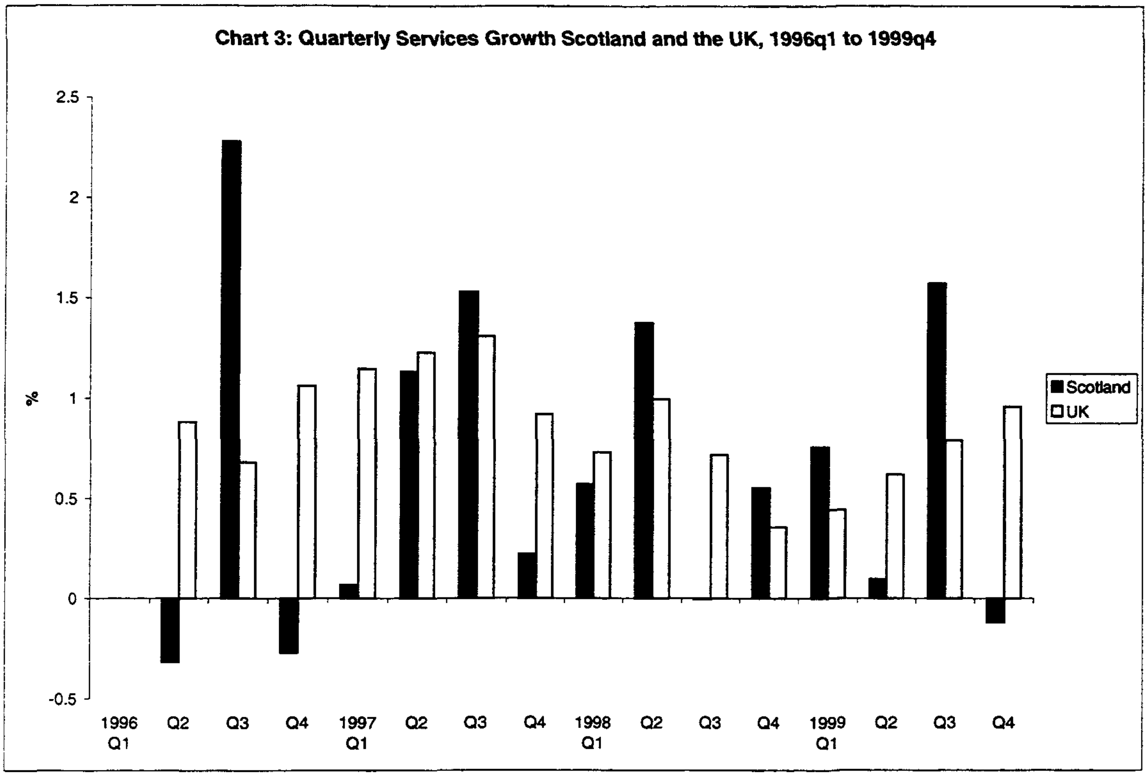

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