

Quarterly Economic Commentary

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OUTLOOK AND APPRAISAL

The latest Scottish Office production data for the third quarter 1995 indicate that generally Scottish industry performed strongly and better than its UK counterpart. In the third quarter, the output of the production and construction industries in Scotland rose by 1.2% compared with 0.3% in the UK. Removal of oil and gas further improves Scotland's relative position, with output increasing by 1.2% compared with a 0.1% rise in the UK. Within this overall performance, the construction industry grew by 2.1% as against a fall of 1.1% in the UK, manufacturing output expanded by 0.9% compared with a 0.4% UK increase, and production rose by 0.9% and 0.7% in Scotland and the UK respectively.

Further disaggregation of the third quarter's production figures, however, reveals Scotland's better performance to have been fairly narrowly based. Robust growth in the drinks industry (21%), in oil refining (9%) and to a lesser extent, in electronics (3%), largely accounted for the stronger Scottish manufacturing growth. Scottish manufacturing exhibited considerable volatility, with eight key sub-sectors: chemicals; mechanical engineering; metals; transport equipment; food and tobacco; textiles, footwear, leather & clothing; paper, printing and publishing; and other manufacturing, registering falls in output. In UK manufacturing industry, on the other hand, only three sub-sectors: textiles, footwear, leather & clothing; food and tobacco; and mechanical engineering, suffered a contraction.

The previous **Commentary** suggested that one method of removing the small, open economy volatility effect, which bedevils quarterly growth comparisons with the UK, is to compare three quarter moving averages of the quarterly growth rate in the two countries. These data are presented, revised and updated, in Figures 1 and 2.

The Scottish production data from 1990q4 have been considerably revised in the latest publication,

unlike their UK counterpart which exhibited almost no data revisions. These revisions have had the effect of worsening Scotland's relative performance in production and construction but the broad picture of Scotland outperforming the UK until 1994q2 still remains (Figure 1). What these data now clearly suggest is that the growth of production and construction in Scotland slipped below the UK rate in mid-1994 but again moved ahead of the UK in 1995. A similar picture emerges when the focus is solely on manufacturing (Figure 2). The growth of manufacturing in Scotland was generally ahead of its UK counterpart until 1994q2, apart from a brief period in 1992. Scottish manufacturing growth fell below the UK rate in the second half of 1994 but moved ahead of the UK again in 1995.

We cannot be completely certain why Scottish manufacturing moved ahead again of UK manufacturing in 1995. But the answer may lie, in part, in more robust export performance. Despite the slow-down in Scottish manufacturing export growth during 1995 (see **Economic Background** section) it would appear that Scottish exports held up better than in the UK. Scotland's share of UK manufacturing exports is reported by SCDI to have risen to a record 11.6% in fiscal year 1994/95 from 10.3% in 1993/94 and 10.1% in 1992/93. The strong production performance of the Scottish electronics, drinks (whisky), and chemicals industries, which both export a considerable proportion of their production and contribute significantly to Scottish exports, would appear to support this export-led growth explanation.

Outlook

Production data for the fourth quarter 1995 will not be available until May. To gauge how Scottish industry was performing at the end of last year we must turn to the business survey evidence. Both the Scottish Chambers' Business Survey (SCBS) and the CBI survey indicated that Scottish manufacturing continued to perform strongly, although there were some indications of a slow-down. It appears likely that the sector will again have outperformed UK manufacturing in the fourth quarter. However, one factor which makes the production data difficult to "read" as an indicator of the present and future growth of demand is the role

played by stock or inventory accumulation.

Most commentators agree that there has been a significant build-up of stocks of finished goods in UK manufacturing which has buttressed the production figures. It is believed that firms are beginning to cut back on production in an attempt to reduce this stock overhang and restore appropriate stock-output ratios. The inevitable consequence of this is that UK manufacturing output growth will slow below the growth of demand. Added to this is the expectation that the growth of export demand will slow during 1996, reflecting weakness in European, particularly German, and US markets. Growth is therefore expected to continue to slow during the first half of 1996. However, the prognosis is expected to be better from the middle of the year as a continuing revival in consumer spending begins to dominate the UK's growth performance. Several factors appear to be operating to support an upsurge in consumer spending: the "unwinding" of the tax increases of earlier Budgets; falling interest rates with further reductions in prospect; the maturation of many "TESSAs"; rising personal incomes; continuing reductions in unemployment; and an improvement in activity in the housing market. In addition, the prospects for inflation remain good, as earnings growth continues to be subdued, competition intensifies amongst food retailers, and the earlier surge in household goods inflation appears to have passed its peak.

Scottish production will clearly not be immune to the downturn in export demand in 1996. Institute estimates suggest (see **Economic Background** section) that GDP in Scottish export markets will rise by 2.6% this year, compared with a 3% increase in 1995 and a 3.3% rise in 1994. The key uncertainty is whether the Scottish economy, given the relative importance of exports to production, will be affected more by this slowdown in demand than the rest of the UK. On the other hand, it is not so clear that Scottish production figures have been buoyed by inventory accumulation to the same extent as in the UK. The CBI Scottish survey indicates only a very weak build-up of stock of finished goods in manufacturing in the early part of last year, while the SCBS shows no increase until the fourth quarter. Moreover, the recent SCBS data suggests that any build-up of stocks was not due to unintended stock accumulation since the outturn for sales in the fourth quarter was better than expected in the third quarter.

We therefore expect Scottish growth to slow in the

first half of 1996 and then move to a higher growth path thereafter. The two principal causes of the slowdown in early 1996 would appear likely to affect the Scottish economy more and less, respectively, than the rest of the UK, making it difficult to predict Scotland's relative performance during the first half of the year. However, the re-balancing of UK growth thereafter in favour of consumption may result in a narrowing in the growth gap which has favoured Scotland for much of 1990s and particularly during the period since Britain's exit from the Exchange Rate Mechanism.

16 February 1996

Figure 2: Quarterly Growth in Scottish and UK Manufacturing 1990q4 to 1995q3

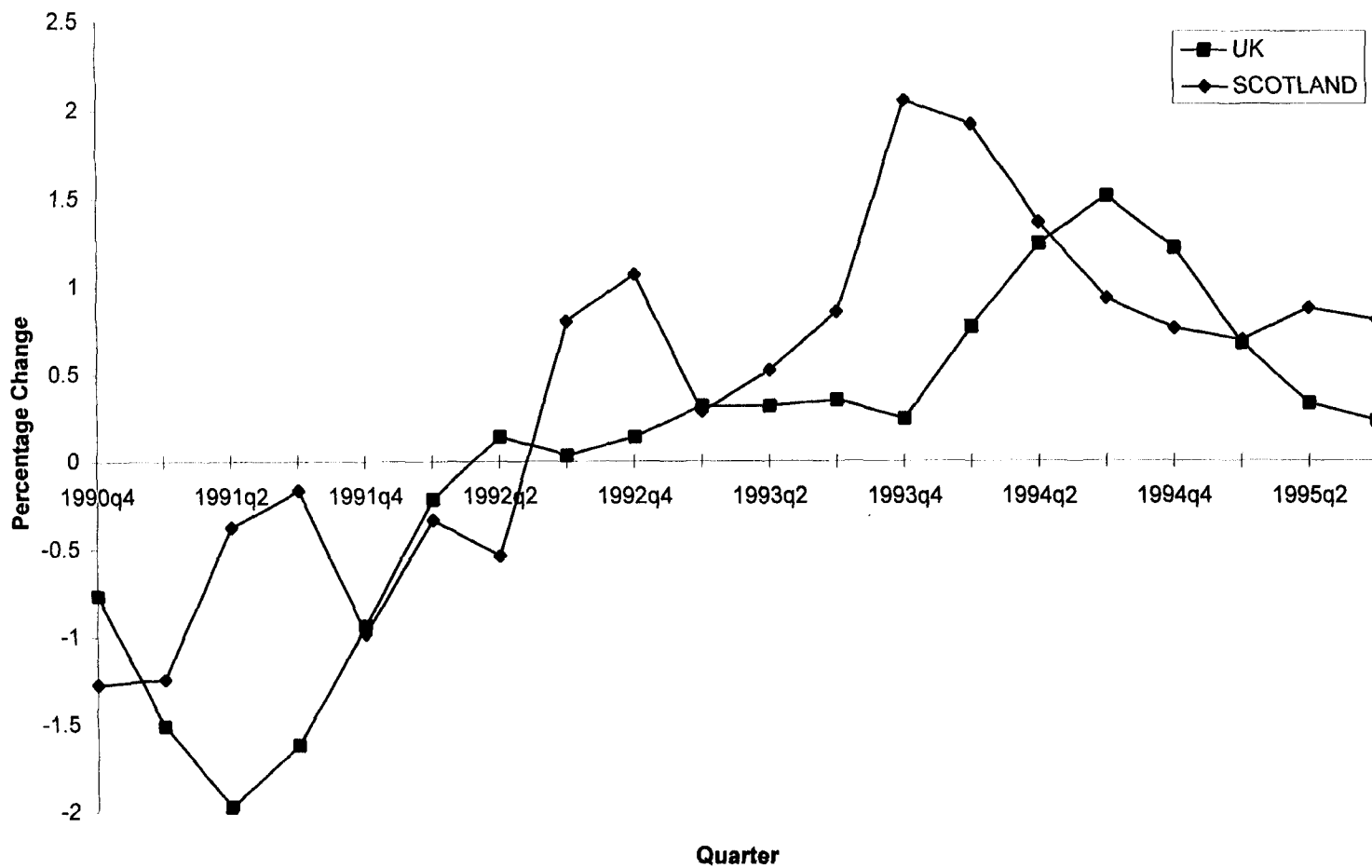


Figure 1: Quarterly Growth in Scottish and UK Production & Construction (less oil & gas) 1990q4 to 1995q3

