THE ECONOMIC BACKGROUND

RECENT TRENDS IN SCOTTISH EXPORTS

Exports are of critical importance to the Scottish Economy. In 1989, Scottish firms sold goods and services worth £64.7bn to final users, of which 21½% were to customers in the rest of the UK (RUK) and 14.7% to overseas (ROW) clients. In the case of manufacturing, final sales totalled £25.4bn, of which 35.3% were due to RUK and 32.5% to the ROW. Thus, two thirds of Scottish manufactured goods were sold out with Scotland illustrating the importance of non domestic markets to Scottish incomes and employment.

Since 1989, Scotland has become more export oriented. The Quarterly Index of Scottish Manufactured Exports prepared by the SCDI indicates that manufactured exports increased from £11½bn in 1993 to £14.1bn in 1994 and £15.6bn last year. This represents a growth of 22.2% in 1994 and 10.9% in 1995. The latest SCDI quarterly data are set out in Table 1. Examination of the quarterly index compared to the equivalent quarter one year previously indicates that manufactured exports increased sharply in the 2nd half of 1994 and 1st quarter of 1995 at which point exports were 40½% higher than 12 months previously. In 1995, export growth slowed to 13.6%pa in the 2nd quarter and 1.6%pa in quarter 3. Economists at the SCDI forecast exports of £4.13bn in the 4th quarter of last year which is 3¾% lower than in the 4th quarter of 1994. This may turn out to be a generous assessment.

However, Scottish exports remain at record levels and trade will continue to be of increasing importance to the Scottish economy which continues to experience a strong trend in greenfield and brownfield investment by multinational companies seeking a stable base for export marketing. The latest sectoral and geographical trends for the fiscal year 1994/95 have recently been released by the SCDI. In this period, Scottish manufactured exports totalled £14.3bn or £12.6bn in 1990 prices. In real terms, the SCDI estimate that Scottish manufactured exports grew by 22.8% between this period and the 1993/4 fiscal year, which compares favourably with a 9½% change posted in the UK. Thus, Scotland's share of UK manufacturing exports rose to a record 11.6%, up from 10.1% in 1992/3 and 10.3% in 1993/94.

The Electrical and Instrument Engineering sectors account for exports valued at £7.05bn, which constitutes 49½% of total overseas sales. Computer exports comprise £4.85bn which represents 69% of electrical and instrument engineering foreign sales and 34% of all Scottish manufactured exports. Whisky exports totalled £2.19bn or 15.4% of all manufactured exports whilst chemicals accounted for £14.65bn or 10.3%. Thus, these 3 activities account for circa ¾ of all Scottish exports with Mechanical Engineering contributing a further £871m or 6.1%. This illustrates that Scottish exports continue to be focused in a relatively small number of industrial sectors.

In the 2 years between 1992/3 and 1994/5, Scottish manufactured exports increased from £9.68bn to £14.26bn, in current prices. This represents a change of £4.58bn or 47.3%. In this period, exports from the electrical and instrument engineering sectors increased by £3.21bn which represents 70% of the increase recorded in exports. Chemicals exports grow by £325.1m or 6½% of the total change, whisky by £232.4m (5.1%), other transport equipment (ships and aeroplanes) by £220.5m (4.8%), mechanical engineering £136.5 (3%) and paper, printing and publishing £123.5 (2¾%). Together the aforementioned activities account for circa 92% of the increase in exports in the 1992-94 period.

In the year to 1994/95, Scottish manufactured exports rose by £2.72bn or 23.6%. Electrical and instrument engineering accounted for 76% of total export growth, chemicals for 6¾%, whisky for 3.6%, paper, printing and publishing by 2¾% and motor vehicles 1.9%. Again, these activities accounted for over 90% of the total change in exports. Thus, in the past 2 years, Scottish export growth has been dominated by sharp rises in the output of Silicon Glen, with chemicals and whisky providing a considerably smaller contribution. This can be seen in the Scottish office index of production, which indicates that output in electrical and instrument engineering grew by circa 25% in both 1993 and 1994. Clearly, exports have played a significant role in this impressive story.

Table 2 sets out the geographical distribution of Scottish manufactured exports for the period 1992/3 to 1994/95. In 1994/5, the EU accounted for 55% of exports, EFTA 10¾%, North America 11½% and the Far East, including Japan, a further 13.1%. Thus, mainland Europe accounted for circa two thirds of total Scottish exports. The share due to the EU is down from 58¾% in 1992/93 but up from the 52.9% posted in 1993/93. In 1993, the EU economy contracted by 0.4% but recovered in 1994 to grow by 2¾% and by 2.8% in 1995. Thus, export performance in EU markets follows the pattern of output growth in that area. In addition, the share of manufactured exports shipped to Japan fell from 4½% in 1992/3 to 3.4% in 1994/5, again reflecting the sluggish nature of the Japanese economy which grew by 1.1% in 1992, fell by -¼% in 1993 and grew by a ½% in 1994.

Between 1992/3 and 1994/5, Scottish manufactured exports grew by £4.58bn or 47.3%. The EU accounted for a rise of £2.17bn or 47.1% of the total increase, with EFTA accounting for 17¼% and the Pacific tiger economies a further 17%. Within the EU, France accounted for nearly ¼ of the total rise in exports and 52% of the rise in shipments to the EU. Across this period, France replaced Germany as the top market for Scottish manufactured exports. Germany remains the 2nd largest destination for Scottish exports accounting for 11% of the total. Between 1992 and 1994, exports to Germany rose £118m which represents 2.6% of the total growth in exports of £4.58bn. The USA remained our 3rd largest export market in the 1992-94 period accounting for 10¾% of overseas shipments and 7¾% of the total rise in the this period.

Holland ranked as our 4th largest export market with sales of £1.38bn in 1994/5. Dutch sales increased by £444m in the 1992/3 to 1994/5 period, representing 9¾% of the total increase. Italy remains Scotland's 5th largest foreign market with sales of £800m or 5.6% of total exports. In the 1992-94 period, sales to the Italian market increased by £193m which accounts for 4¼% of the total rise in manufactured exports. Exports to the EFTA countries rose by £794m or 108.2% to comprise 10.7% of overseas sales and account for 17.3% of the growth in exports. Exports to the orient, excluding Japan, rose by £778m or 128% which represents 9.7% of Scottish exports and 17% of the increase in overseas trade in manufactures. Although small in terms of the share of Scottish export sales, shipments to Australasia rose by 105.8% and to Eastern Europe by 162.2%.

PROSPECTS FOR SCOTTISH EXPORT MARKETS

The world economy slowed in 1995 following strong growth in 1994. In 1994, world output rose sharply following a period of weak growth and recession. Thus G7 GDP grew by 1½% in 1992, 1.1% in 1993 before advancing by 2.9% in 1994, whilst EU income rose by 1% in 1992, declined by 0.4% in 1993 before rising strongly by 2¾% in 1994. In the case of the OECD industrialised countries, GDP grew by 1½% in 1992, 1% in 1993 and 2.8% in 1994. In 1993, Japan, Germany, France and Italy all experienced recessions which lagged behind those experienced by the US in 1991 and the UK in 1990 to 1992. With the exception of Japan, all the major economies recovered strongly in 1994.

In this period, consumer price inflation fell across the industrialised world. In the OECD, inflation fell from 3.5% in 1992 to 2.3% in 1994 whilst in the EU inflation tumbled from 4.9% in 1992 to 3½% 2 years later. Similarly, G7 inflation tumbled from 3.2% in 1992 to 2% in 1994. The falls in inflation reflect the fiscally induced slowdown across the industrialised world and are evident in most countries in Europe, North America and Asia. However inflation has continued to abate as growth has resumed reflecting sizeable output gaps in most countries.

In 1995, growth abated as countries responded to previous fiscal tightening. G7 output growth averaged circa 2½%, the EU averaged 2.7% and OECD growth is estimated at 2½%. Growth was checked most dramatically in Germany where the outturn is expected to have been between 2% and 2¼%pa last year. The US also experienced a slowdown with output rising by 3.2% compared with 4.1% in 1994. In Holland and France, output remained firm although both economies were weakening at the end of the year. With no major inflationary worries, countries have responded by cutting base rates, most recently in Germany and the UK. It is this slowing of the pace of growth in all markets which has prompted the slowdown in Scottish export growth evident in 1995.

This year we expect growth to slow further. The situation is particularly worrying in Scotland's 3 largest export markets. In France, consumer and business sentiment has collapsed on the back of considerable disillusion with the stance of the Chirac administration. We expect French GDP to grow by under 2%, constrained by modest growth in both public and private consumption. Although French interest rates are expected to fall, there remains a substantial premium compared with other countries which will serve to stem an run on the franc. We expect French GDP to increase by 2¼% next year as consumers expenditure recovers modestly and investment grows more strongly. However, the former will be constrained by ongoing rises in unemployment which is expected to average 12½% in 1997. As elsewhere inflation is forecast to remain subdued.

The German economy faced a difficult period in the 2nd half of 1995 and commentators have been busy scaling down forecasts for German activity. At the time of writing, business and consumer sentiment is weakening rapidly. We expect further falls in German interest rates which will help stabilise output at a time of ongoing fiscal tightening designed to keep Germany on track relative to the EMU convergence criteria. This suggests a slackening of the growth in public consumption to under 1½%. The DM will remain strong restricting the scope for export growth, whilst investment is likely to increase only modestly with a firm trend in plant and equipment offset by a torrid outlook for construction. We expect that private consumption growth will fall to under 2% this year and that stockbuilding will resume extremely modestly. Thus, we expect the German economy to grow by a little under 2% this year.

The outlook for Germany in 1997 is better. We expect that public consumption will be reined back further and grow by less than ½%. However, private consumption will recover firmly and investment growth will average 2¾% on the back of a 5% increase in spending on plant and equipment and a modest recovery in the housing market. German GDP is forecast to grow by 2.3% next year whilst German unemployment is expected to fall slightly in 1997 to 9% from 9.4% in 1996. In the next two years we expect average earnings to rise by under 4% pa and German inflation to rise slightly next year.

A strong recovery is expected in Japan following a period of weakness. Growth in the Japanese economy is expected to be 2.7% both this year and next whilst growth in the rest of Asia is likely to increase from 8% this year to 8½% in 1997. In America, fiscal policy remains tight and real interest rates high. US growth is likely to abate from 3¼% last year to 2% this year before recovering to 2½% in 1997. The slowdown in the US is due to faltering private consumption and expected cuts in public consumption, at a time when the fast growth in capital formation is likely to fall sharply from the 12¼% evident in 1994 and the 10¼% posted last year. The slowdown is evident in all sectors but likely to be particularly strong in residential construction.

CONCLUDING REMARKS

World growth is generally expected to further weaken in 1996 before recovering in 1997. In the G7, GDP is forecast to rise by 2.1% in 1996, by 2.3% in the EU and by 2¼% across the OECD. In 1997, G7 growth is projected at 2½% whist output is expected to rise at a similar rate in the EU. The OECD industrial economies are forecast to advance by 2.6%. As an exercise, we have constructed a GDP growth measure for Scottish export markets. This is derived by weighting overseas countries growth rates by the Scottish export shares posted in 1994/5. This indicates that Scottish export markets grew by 3.3% in 1994 and by 3% in 1995 which is consistent with the export slowdown expected last year.

This year, we expect GDP in Scottish export markets to rise by 2.6% before growing by 3% in 1997. Ceteris paribus, this suggests that Scottish export growth should slow further this year compared with 1995 before accelerating again in 1997.

The lacklustre prospects for overseas trade will also affect the performance of the UK economy where the Treasury expect the non oil economy to grow by 2¾% this year. This is based on the interaction between a strengthening of consumers expenditure and sentiment, a recovery in the housing market, a strong trend in business investment and a 5¾% increase in overseas exports. The latter appears optimistic in light of our analysis and may affect the achievement of the growth forecast both directly and through the impact on business confidence. However, we believe that the UK, like other countries is on track for a high growth low inflation outcome in 1997 and beyond.

TABLE 1 SCOTTISH MANUFACTURING EXPORTS: 1993-95 QUARTERLY TRENDS

(i) Quarterly Estimates				
Quarter	Index	£bn	Quarterly Change (%)	Annual Change (%)
93/1	100.0	2.57		
93/2	111.7	2.87	11.7	
93/3	109.3	2.82	-2.1	
93/4	126.9	3.28	16.1	
94/1	114.7	2.95	-9.6	14.7
94/2	127.9	3.29	11.5	14.5
94/3	138.1	3.55	8.0	26.3
94/4	167.0	4.29	20.9	31.6
95/1	161.2	4.14	-3.5	40.6
95/2	145.2	3.73	-9.9	13.6
95/3	140.2	3.60	-3.4	1.6
95/4 (Forecast)	160.8	4.13	14.7	-3.7

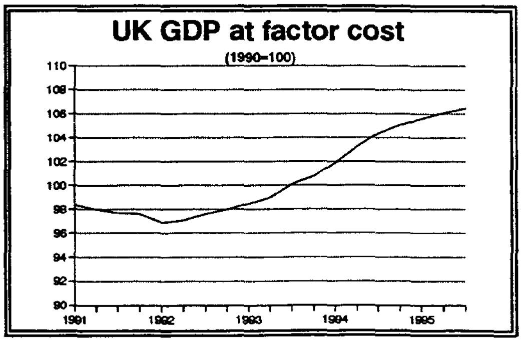
(ii) Annual Averages			
	Index	£bn	Annual Change
1993	112.0	11.54	
1994	136.9	14.08	22.2
1995 (Forecast)	151.9	15.60	10.9

TABLE 2 SCOTTISH MANUFACTURING EXPORTS: 1992/93 - 1994/95 GEOGRAPHICAL DISTRIBUTION

	Exports £m			Shares			Changes (%)		
	1992	1993	1994	1992	1993	1994	92/93	93/94	92/94
EU	5687	6101	7843	58.7	52.9	55.0	7.3	28.6	37.9
France	1218	1542	2338	12.6	13.4	16.4	26.6	51.6	92.0
Germany	1445	1520	1563	14.9	13.2	11.0	5.2	2.8	8.2
Holland	937	947	1381	9.7	8.2	9.7	1.1	45.8	47.4
Italy	607	622	800	6.3	5.4	5.6	2.5	28.6	31.8
Spain	474	450	529	4.9	3.9	3.7	-5.1	17.6	11.6
North America	1291	1555	1644	13.3	13.5	11.5	20.4	5.7	27.3
USA	1174	1430	1530	12.1	12.4	10.7	21.8	7.0	30.3
EFTA	734	1291	1528	7.6	11.2	10.7	75.9	18.4	108.2
Other Far East	608	911	1386	6.3	7.9	9.7	49.8	52.1	128.0
Japan	436	453	492	4.5	3.9	3.4	3.9	8.6	12.8
Latin America	306	421	450	3.2	3.6	3.2	37.6	6.9	47.1
Middle East	265	352	334	2.7	3.1	2.3	32.8	-5.1	26.0
Australasia	103	134	212	1.1	1.2	1.5	30.1	58.2	105.8
Eastern Europe	74	120	194	0.8	1.0	1.4	62.2	61.7	162.2
Africa	178	202	181	1.8	1.8	1.3	13.5	-10.4	1.7
	9682	11540	14264	100.0	100.0	100.0	19.2	23.6	47.3

UK MACROECONOMIC TRENDS

In the third quarter of 1995, the provisional estimate of **GDP at market prices** - 'money' GDP - rose by 0.8%. After allowing for inflation and adjusting for factor costs, GDP grew by 0.4% during the quarter, compared with the 0.5% increase recorded in the second quarter of 1995. Over the year to the third quarter, **'real' GDP** is estimated to have risen by 2.1%. When oil and gas extraction are excluded 'real' GDP is estimated to have risen by 0.3% in the third quarter and by 2.1% over the same period a year ago. Output of the production industries in the third quarter is estimated to have risen 0.5%, with output rising by 1.2% compared with the same period a year ago. Within production, **manufacturing** experienced an increase in output of 0.2% in the third quarter, output of the **other energy and water** supply industries rose by 0.9%, and **mining & quarrying, including oil & gas extraction** rose by 2.3%. Manufacturing output in the third quarter was 1.2% above the same period a year ago. The output of the **service sector** rose by 0.6% in the third quarter and by 3.2% over the third quarter 1994.



Preliminary estimates of **4th quarter GDP** indicate a 0.4% increase compared with the third quarter and a 1.8% rise over a year earlier. **GDP excluding oil and gas extraction** is estimated to have risen by 0.4% in the fourth quarter and by 1.7% over the fourth quarter of 1994. **Output of the production industries** is estimated to have changed little in final quarter of 1995, with the output of the **service sector** estimated to have grown at a similar rate to earlier quarters of 1995. **GDP** for the year is estimated to have risen by 2.6% compared with 1994 and by 2.5% when oil and gas production is excluded.

The CSO's **coincident cyclical indicator** for October 1995, which attempts to show current turning points around the long-term trend, remained largely unchanged. The index reached its above-trend peak in April 1995, fell back slightly in May, June and July, picked up again in subsequent months and still remains above trend. The **shorter leading index**, which attempts to indicate turning points about six months in advance, showed little movement in November. The index peaked in January 1994 and has fluctuated on a gradual downward trend ever since. The **longer leading index**, which purports to indicate turning points about one year in advance, fell slightly in November 1995 so continuing the steady fall in the series since mid-1994.

In the third quarter of 1995, **real consumers' expenditure** rose by 0.7% after increasing by 0.8% in the second quarter. Spending during the third quarter rose by 2.6% on the same period a year earlier.

The official **retail sales** volume figures seasonally adjusted for December 1995, were 0.4% above the November figure. Over the year to December, the volume of seasonally adjusted sales rose by 1.7%. Taking the three months to December, the volume of retail sales rose by 0.8% over the preceding three months and by 1.2% over the same period a year earlier.

There are indications that consumer demand should pick up during 1996. The amount of outstanding **consumer credit** continued to rise in the third quarter of 1995 and then expanded more rapidly than generally expected in October. The **personal saving ratio** fell from 10.2% in the first quarter 1995 to 9.3% in the second quarter and then to 8.6% in the third quarter. The underlying increase in **average weekly earnings** in the year to November 1995 is provisionally estimated to have been 3.25%, an annual increase which has remained the same since July. **Real personal disposable income** rose by 1.6% in the third quarter over the same period in 1994 and is estimated to be 2% higher in 1995 over 1994.

General government final consumption rose by 0.3% in the third quarter 1995. Government consumption in the third quarter was 0.9% higher than in the corresponding quarter of 1994.

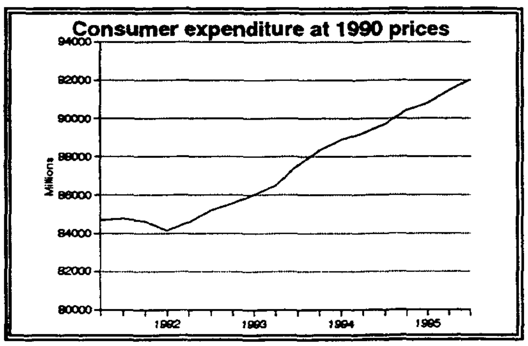
Real gross fixed investment or Gross domestic fixed capital formation *fell* by 2.2% in the third quarter to a level 0.6% higher than in the third quarter 1994. Capital expenditure by manufacturing industries rose (in real terms) by 2.3% in the third quarter and by 12.3% over the third quarter 1994.

Turning to the **balance of payments**, the **current account** for the third quarter 1995 was, after seasonal adjustment, in *deficit* to the tune of £1.3bn, compared to revised estimates of deficits of £1.2bn in the second quarter, and £0.9bn in the first quarter. The surplus on **invisible trade** amounted to £2bn, almost the same as in the second quarter. On **visible trade**, the visible deficit deteriorated to £3.4bn from £3.2bn in the second quarter and £1.9bn in the first quarter. The surplus on the **oil account** fell to £0.904bn from £1.126bn in the second quarter and £1.278bn in the first quarter.

UK LABOUR MARKET

Employment and Unemployment

Seasonally-adjusted UK claimant unemployment fell by 28,400 in the quarter to December 1995, and by 181,600 over the full year. UK unemployment now stands at 2,236,900, giving an overall unemployment rate of 8.0%, with a male and female rate of 10.8% and 4.4% respectively.



Although the number of unemployed continues to decline, the rate of decline is now small and this was accompanied by a slight reduction of 0.7% in the number of unfilled vacancies in the quarter to December. Total UK employment in September 1995 was 25,700,000, a reduction of 22,000 (0.1%) in the quarter from June, though an increase of 81,000 (0.3%) in the year from September 1994. Though the number of employees in employment has shown a slight rise since March, the numbers of self employed and those on work-related government training schemes has been falling. UK employment in manufacturing and the mining, energy and water supply industries fell in the quarter to September, but this was offset by an employment increase in services. Data for the British non-service industries are available to November and these figures show a small increase for manufacturing, but a small fall in the other non-service sectors. These employment, unemployment and vacancy figures for the end of 1995 suggest some stability in the labour market, though obviously at a rather high level of overall unemployment.

Earnings and Productivity

In November, overall underlying annual wage inflation stood at 3.25%, though the actual growth was a little higher at 3.5%. For the last two years the annual wage inflation figure has remained very stable, lying within a narrow 3-4% band. There continues to be a discernable differential between manufacturing and service sector wage increases: though this has narrowed a little in the last quarter. The underlying year-on-year increase in average earnings to November was 4.0% in manufacturing and 2.75% in services. The rate of growth of labour productivity in the whole economy has been falling since the second quarter of 1994, when it reached a level of 3.8%: in the third quarter of 1995 productivity was 1.6% above productivity in the same quarter of 1994. This process is even more marked for manufacturing. Here labour productivity is actually falling, being 0.5% lower in November 1995 than it had been a year earlier. The implication for unit labour costs for the whole economy is that in the third quarter of 1995 these were 0.8% higher than for the same quarter in the previous year. However, for manufacturing, the increase in unit labour costs is higher and growing. In the third quarter manufacturing unit labour costs were 3.7% above their level for the same quarter in 1994: the comparable figures for the first two quarters had been 2.0% and 3.1% respectively.

UK OUTLOOK

The growth of the UK economy, particularly manufacturing output, continued to slow towards the end of 1995. GDP growth in 1995 is now provisionally estimated to have been 2.6%, lower than Treasury forecasts earlier in the year and lower even than the Chancellor's 2.75% forecast in the recent Budget. The consensus of independent forecasters is that the Government's forecast of GDP growth of 3% in 1996 will also prove to be too high. However, there is little support for the view that the economy is sliding towards recession.

Growth slowed even further during the second half of 1995 principally because of a sharp fall in net exports, as export growth declined and import growth rose. This further slow-down in growth was compounded by a build up of stocks particularly, in manufacturing. The creation of a stock overhang has naturally raised fears that growth will contract further as firms, particularly in manufacturing, seek to restore appropriate stock-output ratios. However, it would appear that about two-thirds of the value of the increase in stocks was accounted for by a rise in raw-materials and work in progress as manufacturing firms built up these stocks in anticipation of further price rises. This suggests that the burden of adjustment to optimal stock-output ratios will be borne more by reduced import growth than a lowering in the rate of growth of output.

Nevertheless, output growth is expected to be weak in the first half of this year as UK firms adjust to the overhang in stocks of finished goods and cope with the continuing weakness of demand in export markets. Both the European and US markets are weak. The German market is especially weak as German firms also seek to adjust to an unanticipated build up in inventories during the year.

However, the prognosis should 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; 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.