

Quarterly **ECONOMIC** *Commentary*

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OUTLOOK *and* APPRAISAL

In the fourth quarter 1998, the production industries in Scotland began to grow again after stagnating in the third quarter, as electricity, gas and water, and mining and quarrying exhibited strong growth. But manufacturing slipped further into recession. These are the principal conclusions from the publication of the latest Scottish Office Index of Production.

Both total production and production less oil and gas grew by 0.2% in the fourth quarter, while their UK counterparts contracted by 0.9% and 1%, respectively. Mining and quarrying grew by 1.8% (c.f. 0.4% in the UK), while electricity, gas and water experienced growth of 4.2% (1.5% in the UK). The manufacturing sector, on the other hand, contracted by 0.4%, the fourth consecutive quarter of decline. In the UK, manufacturing contracted even more strongly, by 1.3%, although this represented only the second quarter of consecutive decline. Yet, for 1998 as a whole, manufacturing grew more quickly in Scotland, by 2.1%, compared to 0.3% in the UK, due to strong growth in Scottish electronics (7%) between the first and second quarters of 1997.

Within manufacturing, 3 sectors displayed positive growth in the fourth quarter: petrol & nuclear fuel (5.2%), transport equipment (4.5%), and electronics (0.7%). Of these sectors, only electronics failed to outperform its UK counterpart (1.8%). From the remaining 8 sectors, two displayed zero growth (mechanical engineering, and food & tobacco) and 6 suffered a contraction: textiles, clothing & footwear (-4.3%), other manufacturing (-3.4%), chemicals (-3.2%), drink (-2.2%), paper, printing and publishing (-1%) and metals (-0.9%). And of these 6 sectors,

only 2, metals and textiles, performed better than their UK counterparts.

So, in the fourth quarter, manufacturing performed better in Scotland than in the UK because of the superior relative performance of petrol & nuclear fuels, transport equipment, mechanical engineering, food & tobacco, metals and textiles. This stands in marked contrast to the situation for most of the 1990s up to the beginning of 1998, where Scotland's superior performance in manufacturing was almost wholly due to markedly stronger growth in electronics.

Table 1 compares the latest quarterly growth figures for sectors within manufacturing with their average estimated quarterly growth rates during the period Q2'94 to Q4'98.

Table 1: Quarterly Manufacturing Growth, Q4 '98 and Q2'94-Q4'98. Percentages. 1995=100

Sector	Q4 '98	Q2'94-Q4'98
Other Manufacturing	-3.37	-0.69
Paper, Print, Pub.	-0.97	0.21
Textiles	-4.26	-0.76
Drink	-2.15	-0.11
Food & Tobacco	0	-0.81
Trans. Equipment	4.55	-0.28
Mech. Engineering	0	-0.60
Metals & Products	-0.85	0.38
Chemicals	-3.23	0.81
Oil Refining	5.21	-0.54
Electronics	0.72	3.09
<i>Non-electronic Manf.</i>	-1.29	-0.53
MANUFACTURING	-0.45	0.72

Source: Index of Production and FAI calculations.

The table indicates that for almost all sectors performance in the fourth quarter was worse than average quarterly growth for the sector during the period Q2'94 to Q4'98. Sectors in which fourth quarter growth was appreciably below "trend" included, chemicals, textiles, other manufacturing and drink. However, 2 sectors, oil refining and transport equipment, significantly outperformed their "trend" growth rate in the fourth quarter.

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It is difficult to account for these variations in performance. It is highly probable that the general under performance across manufacturing sectors largely reflects the recessionary forces that have affected manufacturing during 1998. The sustained high level of sterling has clearly affected price sensitive and trade intensive sectors such as textiles and drink. Further analysis of Scottish manufacturing export performance is provided below. However, for the 2 sectors whose growth was superior to their average performance, it would appear that 'lumpiness' of production and large contract sales¹ account for the strong fourth quarter performance. Both sectors are extremely volatile comparing one quarter with another. It is interesting to note, however, that the three- quarter moving average of production growth suggests a decline in output in both sectors during the fourth quarter.

Scottish Manufactured Exports

May saw the publication by the Scottish Office of a new official series providing provisional estimates of Scottish manufactured exports by sector. The new index provides data on exports outside the UK from Q1'95 to the latest data point Q4'98. However, the data are currently presented in a non-seasonally adjusted form - due to an insufficient number of data points - but the Scottish Office plan to remedy this once five full years of data are available i.e. from Q1 2000.

It is clear from the data that quarterly export growth, in real terms, displays extreme volatility. At this stage it is difficult to determine the extent to which this volatility reflects real economic forces or is a product of the data collection process.

Table 2 compares the latest quarterly export growth data for sectors within manufacturing with their average estimated quarterly export growth rates during the period Q2'95 to Q4'98. In the fourth quarter 1998, the range of variation in performance across sectors is immense, with, for example, electronics exports growing by more than 43 per cent, while exports of textiles contracted by 31 per cent.

The fourth quarter export data do display some degree of correlation with the production data for the

same quarter, but the correlation coefficient is low (0.42) reflecting marked disparities between output and export performance in sectors such as electronics, metals, food & tobacco, other manufacturing and chemicals.

Table 2: Quarterly Manufacturing Export Growth, Q4'98 and Q2'95-Q4'98. Percentages. 1995=100 @ 1995 prices

Sector	Q4 '98	Q2'95-Q4'98
Other Manufacturing	8.36	0.79
Paper, Print, Pub.	0.60	1.08
Textiles	-31.00	1.19
Drink	-6.58	5.17
Food & Tobacco	26.34	0.21
Trans. Equipment	1.59	0.17
Mech. Engineering	13.21	-0.22
Metals & Products	24.85	2.72
Chemicals	7.60	-1.07
Electronics	43.84	4.55
Non-electronic Manf.	15.14	1.90
MANUFACTURING	25.04	2.97

Source: Index of Scottish Manufactured Exports and FAI calculations.

The second column in Table 2 presents estimates of average quarterly export growth by sector over the period Q2'95 to Q4'98. As might be expected, these data display much less variation than the data for a single quarter. The strong export performance of both the drink and electronics sectors is clearly evident, with the growth of exports in the former averaging over 5 per cent per quarter while electronics exports averaged just under 5 per cent. No other sector did better than the average for manufacturing as a whole. On the other hand, chemicals and mechanical engineering exhibited declining export growth over the period, while in food & tobacco and transport equipment export growth was almost static.

Finally, a comparison of average quarterly output and export growth by manufacturing sector over the fifteen-quarter period Q2'95 to Q4'98 reveals a very low correlation (0.23). This would appear to suggest that the relationship between export and output performance in Scottish manufacturing is much more complicated than is implied by this simple comparison.

¹ Many of the series that make up the Index of Production use deflated sales to provide quarterly estimates of production.

Outlook

The growth of world trade is set to slow again in 1999, which, coupled with the poor competitive position of the British traded goods sector, is likely to result in a further deterioration of the UK trade balance. However, the deterioration is not expected to be as great as during 1998. Sterling is expected to depreciate slightly from the second quarter after the recent cut in base rate to 5% and as the growth of imports slows. This is likely to produce the result that the negative effect of net trade on growth should diminish but will remain substantial.

The growth of domestic demand in the UK, on the other hand, is expected to continue to pick up during the remainder of this year. Surveys reveal that confidence is beginning to return to both the household and the corporate sectors, a reflection of earlier cuts in base rates and the realisation that the problems that affected emerging markets in 1998 have not been so damaging to the world economy as originally anticipated. In addition, government consumption should make a positive contribution to growth reflecting the slight loosening of fiscal policy in the Budget.

UK GDP growth is expected to be at least 1% this year, and may be higher. The National Institute for Economic and Social Research (NIESR) is currently forecasting growth of 1.25% this year having revised upwards their earlier forecast of 1%. Inflationary pressures remain largely absent. Employment should continue to grow slowly, as productivity growth remains weak, while unemployment remains stable or falls slightly.

In Scotland, we continue to predict that GDP growth will be somewhat slower than in the UK during 1999. Our forecast of GDP growth of 0.89% in 1999 remains unchanged. However, we expect that growth within the Scottish economy will be less unbalanced than in the UK, with manufacturing doing somewhat better here and the service sector somewhat worse.

Scottish manufacturing was firmly in recession during 1998, with output contracting over four successive quarters. In our view, the recession in manufacturing arrived earlier in Scotland than in the rest of the UK. Growth in the Scottish electronics industry ground to a halt in the second quarter of last

year and the subsequent performance of the sector was weak by past standards. But the sector has at no time displayed negative growth and appears unlikely to do so in the foreseeable future. Electronics accounts for around 30 per cent of manufacturing output in Scotland compared to about 12 per cent in the UK. In view of the importance of electronics and its above average expected growth performance, we anticipate that the recession in manufacturing will be less intense in Scotland and the upturn earlier than in the UK.

This intuition is supported by the forecasts for manufacturing that are produced by our Short-Term Forecasting Model. We anticipate that the statistics when published in August will reveal no growth in Scottish manufacturing in the first quarter of this year. However, we expect manufacturing growth to pick up in the second and third quarters and then begin to slow again until the middle of next year. Overall, we are forecasting manufacturing to grow by about 0.8% this year rising to 2.1% in 2000. These forecasts should be compared with those produced by the NIESR for UK manufacturing, which is expected to contract by 1.8% this year and exhibit no growth in the first year of the new millennium.

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