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QUARTERLY ECONOMIC COMMENTARY

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OUTLOOK AND APPRAISAL

The outlook for Scottish exports

Growth in key Scottish export markets continued to slow in 1996. EU GDP growth moderated to 1½% from 2½% in 1995 and 2¾% in 1994 whilst OECD growth averaged 2¼% up from 1.9% in 1995. The better performance of the OECD economies reflects recovery in Japan and the USA.

In 1997, EU GDP growth will accelerate to 2½% and to 2¾% in 1997. OECD growth is set to rise by 2.4% in 1997 and 2½% in 1998 reflecting a monetary tightening in Japan and the US which causes growth to moderate after this year.

In Japan, recovery is evident after 4 years in each of which output grew by less than 1% pa. Japanese GDP is expected to grow by 3¾% this year based on a 3% growth in consumer spending and 7% growth in private investment. Government consumption is expected to grow by less than 1% with public sector investment rising by 12½%. The Japanese balance of payments is likely to half this year despite a marked depreciation of the Yen. This is due to increased overseas purchases of manufactures and semi manufactures at a time when Japanese manufactures have been uncompetitive in the low cost Pacific Rim.

The fall in the Japanese exchange rate is likely to correct this trend and encourage fast growth in exports in 1997 and beyond. Import growth will slow and the perennial balance of payments surplus will begin to rise modestly. Next year Japanese domestic demand will moderate with rising interest rates checking both consumers expenditure and private investment. The fiscal stance is set to be progressively tightened and government spending is likely to decline next year and rise by less than 1% in 1998. Japanese GDP is forecast to grow by 2% in 1997 and by 2½% in 1998 with little adverse effect on inflation.

The US economy continues to perform solidly growing by 2½% in 1996. Until recently, US monetary policy had been loosened with short term interest rates falling to 5¼% at the beginning of the year. Interest rates are on the way up provoking a strengthening of the dollar, at least until Mr Greenspan engineered his recent correction. We expect the US growth to slow to 2¼% next year and to 2% in 1998.

In Europe, activity has slowed following the sharp recovery from the 1993 recession. In general terms, monetary policy has slackened at a time when fiscal policy remains tight. In Germany, GDP is estimated to have grown by 1% this year due to a modest trend in private and public consumption at a time when exceptionally weak business confidence caused investment to fall by 2¼%. The recent deterioration of the Mark has benefited export volumes and reduced import growth and this trend seems set to continue.

In 1997 and 1998, we expect Germany to recover modestly on the basis of export led growth. Domestic demand is forecast to rise by 2¼% in 1997 due to a strengthening of consumer spending and recovery of business investment, induced by falling interest rates. Government spending will grow by circa ¾% reflecting the need to meet the Maastricht criteria. A favourable trade performance based on lower exchange rates will result in German growth averaging 2½% next year.

Tighter monetary policy will halt the reverse of the fall in the Mark next year. This will constrain German exports in 1998 and cause import volumes to recover. The German domestic economy is likely to grow modestly with consumers expenditure and private investment both increasing by circa 2½% pa. Persistently high unemployment is likely to force the authorities to increase government consumption which is expected to rise by 2¼% in 1998. With a recovery in the domestic economy generating increased fiscal revenue, this is not likely to subvert the drive to attain the Maastricht convergence criteria. We expect German GDP to grow by 2.4% in 1998 and for German unemployment to remain above 10%.

Despite recent liberalisation of German labour markets, the Federal Republic will remain a high cost production area and will continue to export jobs and capital to lower cost systems in the EU and beyond. It is difficult to see German unemployment falling substantially in the foreseeable future as it is not apparent that the Germans are keen to pursue policies to reduce the social overheads placed on employers or to cut the costs of hiring and firing workers.

French GDP is expected to grow by 1¼% this year after having grown by 2¾% in 1994 and 1¼% last year. The Banque of France has been progressively lowering interest rates since mid 1995 but the Franc continued to appreciate until this summer. Export growth has slowed but so have import volumes yielding a net injection of export demand. Private consumption has recovered growing at 2½% this year. The slow growth in France is due to continued modest growth in public consumption, a ¼% fall in private investment and an ongoing run down of stocks.

Although the trend in public spending is poor, business confidence is expected to recover and investment will strengthen from next year. This is primarily due to the record low interest rates which France is currently experiencing. We expect private consumption growth to be circa 2% pa in both 1997 and 1998. French exports and imports are likely to increase sharply next year and beyond due to the resurgence in domestic demand. We expect French GDP to rise by 2½% in both 1997 and 1998. However, French unemployment will remain high falling to 11¾% by 1998. As in Germany, unemployment is not likely to drop sharply or quickly and the will to engage in supply side reforms appears missing.

The rest of the UK remains Scotland's largest export market. The outlook for the UK is particularly favourable. This year UK GDP is forecast to grow by 2.3% with consumers expenditure rising by 3%, private investment by 4½% and exports by 7¼%. Domestic demand is constrained by a modest rise in government consumption of ¾%. Despite falling interest rates, the pound has appreciated and import volumes have increased sharply, in part due to the need to import investment goods. UK manufacturing output grew by circa ¾% in 1996.

In 1997 and 1998 we expect UK GDP to grow by circa 3.4% and 3.1%, respectively. Low interest rates, rising employment and fast growth in earnings will engender growth in consumers spending of 4% in 1997. Consumption slows to 3½% in 1998 reflecting previous rises in interest rates and increases in the overall personal sector tax burden. Investment is likely to grow by 5% next year and by 2¾% in 1998. Public consumption growth will remain weak in 1997 but will rise more quickly in 1998. UK exports will grow by 7½% in 1997 and 6¾% in 1998 with imports growing less quickly. UK manufacturing output is set to increase by 3¾% in 1997 and by 4¼% in 1998.

This forecast assumes that no serious inflationary difficulties will arise, that UK interest rates will remain low and the UK exchange rate will not appreciate excessively. The recent strengthening of the exchange rate will moderate export potential from mid 1997 onwards but export growth will remain strong due to an ongoing but modest recovery in EU markets. However, in the coming period the underlying mainstay of growth will be the personal sector where fast earnings growth and a declining savings ratio will engender a strong trend in consumers expenditure. From mid 1997, rising interest rates will be required to check the domestic economy in order to secure attainment of the governments inflation targets. However, we are not arguing that the UK will face a serious inflationary problem and do not expect any necessary slowdown in activity in 1998 and beyond to be severe.

Activity in major Scottish external markets has tended to slow this year causing a moderation in Scottish exports growth. We estimate that Scottish exports grew by 3¼% in 1996, down from 6% in 1995. Exports will grow rapidly in 1997 and 1998. This is due to the recovery in demand in export markets and the continued location of export dedicated capacity in Scotland. Thus, although Scottish exports remain over represented in Electronics and Whisky, investment in high tech manufacturing capacity will cause Scotland's share of rising OECD trade to increase. In 1997, Scottish exports are forecast to rise by 7¾% and by a further 11% pa in 1998.

The Scottish domestic market

The outlook for external markets for Scottish goods and services is strong as are the likely trends in Scottish domestic demand. Scottish consumers expenditure rose by 2¾% this year with a 4% rise in durables and a 3¾% growth of spending on services. Expenditure on other goods rose by 1.8%. Consumers expenditure growth is rising due to low interest rates, increased employment and a strong trend in earnings. Next year, we expect personal consumption to rise by 3¾% with a 9% rise in spending on durable goods, a 4¾% rise in spending on services and a 2½% growth in expenditure on other goods.

Consumption growth will moderate in 1998 to 3.4% due to the effects of rising interest rates required to keep inflation within government targets. However, these will not engender a sharp contraction but will continue to bite after 1998. Expenditure on durables will grow by 6½% in 1998 with spending on other goods rising by 2.4% and consumption of services by 3¾%.

Scottish tourism is estimated to have grown by 4¼% in 1996 following growth of 2½% in 1995. This represents the turning of a corner after yearly falls across the early 1990s. The recovery appears due to the ostensible increased exposure given to Scotland by a series of Hollywood films and an improvement in tourist infrastructure. We expect Scottish tourism to increase by a 2½% in 1997 and 2¾% in 1998 due to the upswing in activity in Europe and the continuing strength of North American economies.

The trend in Government consumption will continue to be weak. In 1996, Government consumption fell by circa 1% with a further fall of ¾% likely next year. Growth of ½% is forecast for 1998 although this may prove conservative. We await details of the disposition of this year's Scottish spending settlement. However, it is already apparent that there will be a sharp contraction of grants to Scottish local authorities and some real increase in spending on health, education and law and order. The industry and enterprise budgets are expected to come under pressure. Overall, a fall in public sector employment is inevitable given the real falls in the general government budget in Scotland.

Investment expenditure in Scotland has been weak due to subdued activity in both public and private housing and a collapse in public investment due to the hiatus in projects caused by the introduction of the Private Finance Initiative (PFI). Manufacturing investment has remained strong due to foreign direct investment. In 1996, we expect total Scottish investment to rise by 2½%, by 4½% in 1997 and by a further 4% in 1998. The recovery will be led by the manufacturing sector although private sector housing activity will increase after a lean spell in 1995 and 1996. We expect that private sector build and repair of industrial and commercial property will increase sharply. The outlook for public sector housing investment is poor with both local authorities and Scottish Homes experiencing substantially reduced capital consents. The ultimate emergence of the many PFI projects will improve the poor trend in public sector capital spending in some areas although the prospects for Scotland's civil engineer's can only be described as poor.

Scottish output, employment and unemployment: 1996-1998

The above projections of Scottish final domestic and external demand were used to drive the FAI Medium Term Model of the Scottish economy. This model uses such inputs to derive projections of sectoral output and employment. The recent performance of Scottish output and forecasts for the 1996-1998 period are set out in Table 1. Table 2 presents the recent and prospective trends in sectoral employment and our projections for self employment, government trainees and Scottish unemployment.

This year

In 1996, Scottish GDP grew by 2¼% which is marginally slower than the 2.3% growth expected in the UK. Thus, as in 1994 and 1995, Scotland continues to grow less strongly than the UK as a whole. Output of Electrical and Instrument Engineering grew by 9½% between 1995 and 1996 although activity across the year was muted due to a turndown in export markets. In consequence, Scottish GDP, excluding electronics, grew by 1½% pa.

Manufacturing output increased by 3.9% which compares favourably with the ¾% growth likely in the UK. If electronics is excluded, Scottish manufacturing output is projected to rise by circa 1%. In manufacturing, Electrical and Instrument Engineering is the best performing sector with projected growth of 9½%. This results from increased capacity coming on stream at a time of cyclically slack demand for electronics goods. The downturn is ending and strong export led demand is in prospect.

Chemicals output is expected to rise by 7.6% in 1996, reflecting strong export growth in fine chemicals and pharmaceuticals. Output in Transport Equipment is forecast to increase by 5.4%. This is due to a recovery in output in aerospace, a strong demand for buses and strong markets for the axles and assemblies produced by Albion. Growth in shipbuilding has been more modest due to weak demand and disruption to the build cycle caused by the delays in defence orders. Output in Textiles, Clothing and Footwear is projected to grow by 2%, reflecting the upturn in consumers expenditure in both Scotland and the RUK.

Other manufacturing sectors performed more modestly. Metals and Metal Goods fell by ¼% and Mechanical Engineering grew by 1.4%. This reflects the weakness in demand for investment goods in both the EU and UK. Food and Tobacco output rose by ¾% following a period of yearly declines since 1990. The stronger trend in Scottish and national consumption is the mainstay of this performance. Drinks output fell by 1¼% due to a fall in exports occasioned by weak consumer spending in the EU. Other markets remained firmer. In the UK, whisky continues to be the victim of high duties both in absolute terms and relative to substitutes such as beer and wine. This constrains the growth of whisky consumption even at times of fast rising consumers spending.

We estimate that construction output fell by 1% this year. This is due to the continued weakness in housing starts and a poor trend in civil engineering. There is a dearth of new public infrastructure projects due to problems with the PFI. Service sector output grew by 2½% in 1996 with Distribution, Hotels and Catering growing by 3.3%, Transport and Communication by 3.1% and Other Services by 2%.

In Distribution, Hotels and Catering and Transport and Communications, output growth has accelerated because of the growth in consumers and tourist expenditure but has been constrained by the slowness of many of the more land transport intensive heavy manufacturing activities. In air transport, output has weakened due to the increased trend in both scheduled and package international passengers departing from non Scottish airports. Other Services comprises Business and Financial services, Personal Services and the public sector. It is the latter which has slowed growth. Output growth in financial intermediation remains strong although growth in business services has been constrained by the poor performance of the non electronics economy.

Table 2 sets out the trend in the Scottish labour force. The Civilian Workforce in Employment (CWE) rose by 4,210 in 1996 at a time when the working age population fell by 1,190 Unemployment fell by 7,950 to stand at 192,330 or 7.9% of the workforce. The 3,750 fall in labour market participation accounts for a significant proportion of the fall in unemployment. The economic activity rate fell further to 77.0% from a peak of 78.6% in 1992. There are less jobs in the Scottish economy in 1996 than in 1992, working age population has increased but unemployment has fallen steadily from 243,317 in 1993 to 192,330 in 1996.

We estimate that the sustained rise in self employment paused this year. The numbers of self employed are forecast to fall by circa 450 due to the weakness in construction, the slow growth in non electronics production and the remorseless decline of the family owned retailer. The numbers of government trainees rose by 1,850 to stand at 30,235. The numbers of employees increased by 3,600 to total 1,989,627. Of these, 50.8% are female and 27.8% work part time.

Service sector employment increased by a modest 250. This comprises a 4,500 rise in Distribution, Hotels and Catering, a 1,000 rise in Business & Financial Services, a 3,300 rise in personal services workers and a 3,500 fall in transport and communication and a 5,050 fall in public sector workers. Manufacturing jobs rose by 5,390 with a rise of 2,160 electronics workers and 3,230 rise in non electronics manufacturing employees. In other activities, employment fell by 1,075 which subsumes 1,300 fall in construction workers. This reflects an upturn in more labour intensive activities such as residential, commercial and industrial building.

The outlook for 1997 and 1998

Next year, we expect Scottish GDP to increase by 3½% which is faster than the 3¼% growth expected in the UK. In 1998, we expect Scottish growth to average 3¼% compared with 3½% expected in the UK. However, if electronics is excluded, Scottish GDP is forecast to grow by a modest 2.6% in 1997 and 2¼% in 1998.

Manufacturing output is forecast to increase by 6.2% pa or by 2.9%, exluding Electronics. Electrical & Instrument Engineering is forecast to grow by 12.3% next year and by 13.4% in 1998. This is due to the recovery of UK and overseas export markets and an increase in overseas owned capacity. Projects such as ChungHwa, LiteOn and

Hyundai have already been announced. This will both reduce import penetration and increase exports on the back of a strong general performance in the sector.

All manufacturing sectors are expected to grow strongly in a favourable domestic and external environment. Oil Refining is expected to grow by 4½% in 1997 and by circa 6% in 1998. This reflects an upturn in demand from exports and increased capacity at Grangemouth. Transport equipment is expected to grow by 4.9% next year and by 3.4% in 1998. Motor Vehicles and Parts will grow strongly because of high demand for buses at Volvo, Alexanders and growing Leyland and non Leyland business at Albion. We expect continuing growth in aerospace as air transport markets recover and options become orders. The market for refurbishment of engines will grow in tandem. In shipbuilding, we are on the verge of a strong trend in civilian orders but the prospects for defence work remain limited.

Chemicals growth is likely to remain strong with a rise of 3.5% expected in 1997 and 3.2% in 1998 This subsumes a faster general performance constrained by the run down of the ICI facility in Ayrshire. The explosives plant was scaled down substantially in 1995 and is expected to be phased out across the forecast horizon. Output growth in Metals and Metal Goods will remain weak as do the prospects for Mechanical Engineering. Limited UK markets for our large niche engineering players and an increasing tendency to manufacture in non Scottish locations will cause company and sectoral performance to diverge. The Food, Drink, Textiles and Paper all show sign of recovery and seem set to perform well in 1997 and 1998.

Construction output is expected to rise by 2% in 1997 and 2½% in 1998. We project a rise in residential, industrial and commercial new build and repair but a poor outlook for civil engineering projects and other public sector projects reliant on PFI. Service sector growth is forecast to at 2¾% in 1997 and 2.2% in 1998. Activity moderates in 1998 due to the slowing of personal consumption growth although output in Distribution, Hotels and Catering is expected to average 4% in 1997 and 3% in 1998. Overall service sector activity is constrained by a poor trend in public services due to budgetary restraint.

The CWE is forecast to grow by 23,150 in 1997 and by 11,000 in 1998. Working age population is expected to fall by 2,650 and 3,600 in this period. Thus there will be more jobs available for a smaller working age population. Unemployment should drop sharply and we project falls of 17,000 in 1997 and 4,750 in 1998. In 1997, unemployment will stand at 175,250 or 7.1% of the workforce before falling further to 170,500 or 6.9% in 1998. The fall in unemployment will be checked by increases in labour market participation of 6,075 and 4,750. The economic activity rate is projected to rise to 77¼% in 1997 and 77½% in 1998.

Growth in self employment will resume with a rise of 4,150 in 1997 and 3,550 in the following year. The strong boost to self employment is due to increased construction activity but also to the greater support available to new start ups in the network of business shops and enterprise trusts. We forecast a decrease of 750 government trainees in 1997 and a further 2000 in 1998. The number of employees is expected to rise by 19,750 next year and by 9,450 in 1998. Females will account for 50.6% of employees in 1997 and 50.8% in 1998. Part time workers will represent 28¼% of employees next year and 28.4%, one year later.

The bulk of the growth in employees will take place in Services where there will be 16,800 new jobs in 1997 and 6,125 in 1998. However, this rise conceals an ongoing decline of 8,000 public sector workers in 1997 and a further 5,000 in 1998. Most of these will be taken by females who will account for 60% of all service sector jobs by 1998. This compares with 58% in 1993. In addition, 36% of service sector jobs will be part time in 1998 compared with 33½% in 1993.

Manufacturing employment is expected to rise by circa 2,000 next year and by 1,800 in 1998. However, electronics employees are expected to rise by 3,475 next year and by 4,150 the year after. This suggests that non electronics manufacturing jobs will decrease 1,485 in 1997 and by 2,350 in 1998. Jobs in other activities are projected to rise by 950 and 1,500 which subsumes an increase in construction employees of 1,900 in 1997 and 2,950 in 1998. Jobs in energy, water, mining and agriculture are expected to fall sharply.

Appraisal

Since the late 1980's until 1994, the Scottish economy performed better than the UK. Indeed, Scotland did not experience a recession in the 1990-92 period but has recovered more modestly. If one abstracts from electronics, the performance of Scotland is less impressive than the broad aggregates imply. Many sectors have shown little or no recovery since 1992.

In addition, Scottish unemployment has fallen but this is largely due to a decline in male labour market participation which was evident in between 1992 and 1996. At present, Scottish unemployment continues to fall but not by as much as in the rest of GB. The Scottish relative unemployment rate has began to rise sharply although we do not expect the high relatives evident in the 1980's to return.
Although the Scottish economy has been substantially restructured across the 1980's and 1990's, and appears to be performing relatively well at the aggregate level, analysis of the underlying data makes less impressive reading.

The next 2 years will be a period of strong growth in output and employment which will engender a fall in Scottish unemployment to less than 7% of the workforce. A number of well established trends will continue as the Scottish employment profile shifts further towards female, part time, white collar, entrepreneurial and private sector activity. The labour market for males will continue to experience decreasing participation and high unemployment and long term unemployment. Unemployment will continue to be concentrated in urban and semi urban black spots although rural unemployment will be high in the south west of Scotland and across much of the Highlands. Improving the competitive position of those males unemployed, long term unemployed and marginally employed will remain a key requirement of properly functioning labour market policy. It remains to be seen how the public sector budgets for such measures survive amidst a trend of real cuts in Scottish Government consumption.

The Scottish economy is becoming increasingly branch plant in nature with many of the fastest growing sectors dominated by overseas and other non domestic firms. This has been the product of successful government policy to target inward investment. However, in the fastest growing sector, electronics, wages for assembly workers remain relatively low as do other entitlements, reflecting global competitive pressures. In late 1995, one third of the workers in Silicon Glen were on temporary contracts. Local share of non labour inputs into Silicon Glen stood at 23% in 1993, up from 14% in 1989 with a sharp expansion of domestic and other concerns engaged in sub contract manufacture for the multinationals.

Such concerns have prompted questions about whether the attraction of FDI of this type is a proper use of public funds whilst others complain of bias against domestic concerns. The Regional Selective Assistance (RSA) and other assistance given to inward investors is a small part of the industry and enterprise budget. Although academic evidence suggests that such subsidies affect location decisions only at the margin, it is evident that Scotland is in a beauty parade with Ireland, Wales, the English regions, Spain, Portugal and Eastern Europe for such projects. To some extent we are buying jobs for Scottish people.

Those who question the use of funds in this respect should reflect that such subsidies can produce a more certain outcome than funds allocated to activities such as new firm formation, small and medium enterprises or export promotion. In addition, these inward investors import capital and technology not available in Scotland and may create a world class local supply chain. The emphasis on electronics may limit the extent to which this is possible in Scotland.

It remains the case that it is often easier for multinationals to demonstrate that their projects are additional, ie would not go ahead or would be delayed without state support. Thus, there may be a bias towards inward investors in the discretionary UK system of RSA which was not evident with the former automatic payouts from the defunct RDG programme. However, Scottish Enterprise have recently established a number of programmes specifically designed to help new and existing Scottish businesses form and grow.

The key tasks of economic development in the medium term will be to continue to improve Scotland as a location in which to do business, to develop a strong business culture, improve our rate of new firm formation and enhance the potential of Scottish firms to win business both at home and elsewhere. This requires increased investment in people and in infrastructure and involves doing a range of things both well and better. Sadly, recent budgets have shifted resources away from public investment towards public consumption making it difficult to expand investment programmes in the near future.

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