Quarterly
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Commentary

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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 latest quarter quarterly GDP data from the Scottish Executive for the second quarter 1999 indicate that growth strengthened in both Scotland and the UK. Overall, the Scottish economy outperformed the UK economy in the second quarter and generally did so over the preceding four quarters in all principal sectors with the exception of the service sector. In the labour market, the latest employment and unemployment data indicate that there has been a continuing improvement in the Scottish labour market since the second quarter of 1999. The outlook remains favourable. Although there are legitimate concerns about the effect of the recent interest rate rises on the growth of the Scottish economy, the evidence suggests that the economy is performing as least as well as the UK when one year is taken with another. We expect this to continue for the foreseeable future. Growth is forecast to be weaker in Scotland this year than in the UK, but stronger in 2001 and similar to the UK in 2002.

GDP and Output

In the second quarter of 1999, GDP (excluding oil and gas extraction) grew by 0.8% in Scotland compared to 0.5% in the UK. Manufacturing output also grew more quickly than its UK counterpart, expanding by 0.5% compared to 0.3% in the UK, while the performance of the service sector was somewhat weaker here. Gross value added in the service sector increased by 0.5% in Scotland as against 0.6% in the UK. However, the construction sector staged a strong recovery, considerably outperforming the sector in the UK (+5.2% compared to +0.6% in the UK). The agricultural sector, perhaps surprisingly, also displayed moderate growth above the UK rate for the industry (+1.2% compared to -1%).

Within services, the financial sector grew rapidly in Q2 by 7.4% compared to a small contraction of 0.1% in the UK. Other services also exhibited stronger performance in Scotland, displaying growth of 1.4% while its UK counterpart contracted by 0.2%. In the remaining principal service sectors, hotels and catering performed the weakest with output falling by 3.4% while the same sector in the UK grew slightly by 0.2%. The transport, storage and communication sector was also much weaker in Scotland contracting by 0.4%, while the same activities in the UK grew by 2.2%. In most other service sectors, Scottish and UK performance was broadly comparable.

Within manufacturing, the textiles, chemicals and electrical and instrument engineering (electronics) sectors performed the most strongly in Q2, both absolutely and compared to the same sectors in the UK. Perhaps surprisingly, the textiles sector grew by 3% in Scotland compared to a small contraction of -0.1% in the UK. This suggests that the sector is beginning to pick up here after the significant contractions associated with the earlier rise in sterling. Chemicals grew by just under 3% in Scotland compared to 1.8% in the UK, while electronics expanded by 2.1% even though output in the sector in the UK fell by -0.2%. The weakest performing Scottish manufacturing sectors in Q2, were mechanical engineering (-3.4%), petroleum and nuclear fuel (-3.2%) and transport equipment (-2.4%). Apart from petroleum, the performance of these sectors in Scotland was much worse than their UK counterparts.

Quarterly movements in output provide only a limited indication of the direction of change and may simply reflect short-term or random influences. When growth over the four quarters to the second quarter 1999 is compared with the preceding four quarters, the stronger performance of the Scottish economy is still evident. During this period GDP (excluding oil and gas extraction) grew by 2.2% in Scotland compared to 1.9% in the UK. Manufacturing also grew more quickly, 1.2% compared to a contraction of -0.7% in the UK. Agriculture, mining, and electricity, gas and water, all grew more quickly in Scotland, while of the principal sectors only services significantly under performed the UK with growth of 2.5% compared to 3%.

Over the year to the second quarter, electronics continued to be the strongest growing sector in Scotland (+8.4%), followed by financial services (+6.4%), metals and metal products (+5.2%), mining (+5.1%), retail and wholesaling (+4.8%) and transport etc. (4.4%). With the exception of transport, all of these sectors out performed their UK counterparts and significantly so in financial services, (+6.4% compared to +0.2% in the UK) and in retailing and wholesaling (+4.8% compared to 1.5%).

The weakest performing sector in Scotland over the year to the second quarter was textiles, which contracted by 10% in both Scotland and the UK. This provides an indication of how badly the sector was affected by the tightening of price competition following the earlier hike in sterling. Other sectors demonstrating weak performance over the period included, other manufacturing (-6.8%), chemicals (-4.3%), drink (-4.1%), food (-3.4%), mechanical engineering (-1.4%) and paper, printing and publishing (-0.4%). Of these manufacturing industries, only mechanical engineering and paper etc. did better in Scotland than in the UK. The weakest service sector was hotels and catering, where real gross valued added expanded by only 0.2% over period, compared to growth of 1.4% in the UK.

The Labour Market

The latest employment and unemployment data indicate that there has been a continuing improvement in the Scottish labour market since the second quarter of 1999. Net jobs were being created in the second half of the year, all be it at a fairly slow rate; more people appeared to be moving from temporary to permanent employment; full-time employment was growing more quickly than part-time engagements; although net job creation continued to be mainly concentrated in the service sector. Unemployment continued to fall on both principal measures.

Total employment from the Labour Force Survey in Scotland grew to 2,316,000 for August-October 1999 an increase of 0.9% on the previous year and 0.7% on the quarter. During this quarter, Scotland had the second largest increase in employment in the UK territories and regions (up 15,000), with the largest increase occurring in the North West up (27,000). The employment rate rose to 72.1% from 71.4% a year earlier.

Of employees in employment in the June-August period, 1,734,000 were in full-time employment with 578,000 part-time workers. This represented an increase of 25,000 and 3,000, or 1.5% and 0.5% respectively, over the previous quarter. Over the year to June-August, full-time employment fell by 35,000 jobs (-2.0%) and part-time work increased by 32,000 jobs (+5.8%). There were 103,000 workers with second jobs, an 8.7% rise over the year but a 0.5% fall over the quarter. There were 167,000 temporary workers in the June-August period, a fall of 6.4% over the year but an increase of 12,000 (7.7%) over the quarter.

At the principal sectoral level, between June 1998 and June 1999, services created the most jobs (i.e. both part-time and full-time), with employees in employment rising by 11,000 net jobs (+1.3%). This was followed by construction where 5,000 (+3.9%) were created. Of the other principal sectors, agriculture (+ 3,000 or +8.7%) and other industries (+1,000 or +0.1%) exhibited net job creation, while manufacturing continued to shed jobs with a net reduction of 14,000 (-4.6%). Mining and energy also lost about 1,000 jobs (-3.6%) over the period.

The ILO measure of unemployment stood at 168,000 for August-October 1999 or 6.8%, a fall of 1% point on the previous year. For men and women, the rates were 8.0% and 5.4% respectively. The claimant count of the unemployed for November 1999 was 124,900 or 5.1%, down from 5.2% in October and from 5.6% in November 1998. The rates of male and female claimants were 7.4% and 2.5% respectively. When the inflows and outflows of unemployment are examined, we find that in November 1998 inflows were 29,100 compared to 28,600 in November 1999. Outflows were 28,600 last year and for November 1999 were 29,200. Within Scotland, Aberdeen City, Shetland Islands and Aberdeenshire continue to have the lowest unemployment with rates below 3%. The highest unemployment rates are found in West Dunbartonshire (9.7%), North Ayrshire (9.1%), East Ayrshire (8.4%) and both Eilean Siar and Clackmannanshire had a rate of 8.2% in November 1999.

Outlook

Growth in Scotland is picking up and by the middle of last year the economy was growing more strongly than the UK reflecting sustained growth in electronics, financial services, retail and wholesaling, and metals. The labour market also began to show signs of a turnaround from the middle of 1999 as net job creation increased and unemployment continued to fall.

It would be tempting to conclude that this upturn in performance continued and strengthened during the remainder of last year. The Deloitte & Touche Scottish Chambers' Business Surveys (SCBS) for the third and fourth quarters of 1999 indicated returning confidence and rising orders above expectations in manufacturing and construction. Manufacturing exporters were also more optimistic with orders increasing and further growth anticipated in the first quarter of this year. This would appear to indicate that Scottish exporters have overall learned to cope with the high pound and are taking advantage of the increased opportunities for trade as growth in the principal European economies picks up. However, retailing and wholesaling were much less robust, with confidence declining and sales falling by more than anticipated.

Against this background, it is difficult to judge the effect of the three interest rate rises, each of 0.25% points, that occurred in September, November and most recently earlier this month. The growth of domestic demand in Scotland appears to be relatively weak, although recent data from the Scottish Retail Consortium show that sales were up 0.6% in December over the year and ahead of sales growth in the UK. But non-food sales were still giving cause for concern in both Scotland and the UK. Inflationary pressures are almost wholly absent, with pay increases reported in the SCBS averaging between 3% and 4% in the fourth quarter. Yet, the Monetary Policy Committee (MPC) of the Bank of England has to set interest rates with a view as to what inflation is likely to be a year or more hence. Forecasters are, on average, predicting an RPIX rate for the UK of 2.9% in the fourth quarter of this year, which is above the government's target rate of 2.5%. The recent decision of the Monetary Policy Committee to raise interest rates by another quarter per cent point therefore appears prudent from the standpoint of the overall UK economy.
However, in the absence of separate price inflation data and inflation forecasts for the Scottish economy it is difficult to form a judgement on the extent to which real, rather than 'money' or nominal, GDP growth will be affected. In principle, if the pressure of demand *is* lower in Scotland then the probability that the recent rate rises will affect real GDP growth as well as nominal GDP growth should be greater here than in the rest of the UK.

In forecasting, the future course of the Scottish economy we are strongly influenced by the outturn evidence, which indicates that the Scottish economy is performing at least as well as the rest of the UK. Nevertheless, we do expect that the growth of domestic demand will be weaker in Scotland than in the rest of the UK over the course of the next year. But this will to a certain extent - although not completely - be counterbalanced by the relative buoyancy of demand from Scotland's principal export markets, which will have a more favourable impact here than in the rest of the UK.

The Institute's Short-Term Forecasting model for manufacturing is predicting continued stronger performance in manufacturing in Scotland compared to the UK. After a projected strong performance in the second half of 1999, we expect that quarterly growth will slow to 0.5% in Q1 of this year, rising to 0.9% in Q2 and then falling away again to 0.5% and 0.4% in Q3 and Q4, respectively. The National Institute for Economic and Social Research (NIESR) is, in contrast, forecasting UK manufacturing growth of 0.4% in Q1 this year, 0.3% in Q2, 0.3% in Q3, and 0.3% in Q4. For the medium term, we are forecasting GDP growth of 2.2% last year, 2.3% this year, 3.3% in 2001 and 2.4% in 2002. These forecasts from our Medium Term Model (MTM) compare with NIESR's forecasts for the UK of 1.8% in 1999 and 2.9% in 2000, and with the Treasury's November *Pre-Budget Report* projections for the UK of 2.25% to 2.75% in 2001, and 2.25% to 2.75% in 2002.

These favourable Scottish GDP forecasts, which are above the historic trend, are associated with improvements in the Scottish labour market compared to the forecast outturn in 1999. Total employment is forecast to grow by 12,000 in 2000, by 15,000 in 2001 and by 7,000 in 2002. However, considerable uncertainty attaches to the jobs forecast because of the difficulty in predicting the rate at which companies based in Scotland will adopt and invest in productivity enhancing techniques and processes.

20 January 2000