Quarterly economic commentary

September 2001
Vol 26 No 3

Fraser of Allander Institute

The Fraser of Allander Institute is a research unit of the University of Strathclyde in Glasgow. The Institute carries out research on the Scottish economy, including the analysis of short term movements in economic activity. Its researchers have an international reputation in modelling regional economies and in regional development. The Institute provides a confidential six monthly Business Forecasting Service that includes detailed projections for Scotland by sector and local areas. One-off research projects can be commissioned by private and public sector clients. If you would like further information on the Institute's research or services, please contact Isobel Sheppard on 0141 548 3958 or e-mail the Institute at fraser@strath.ac.uk.

The Institute was established in 1975 as a result of a donation from the Hugh Fraser Foundation. We gratefully acknowledge the contribution of the Buchanan and Ewing Bequest towards the publication costs of the Commentary and sponsorship from Business a.m.

Business am

Business a.m. is Scotland's new national daily newspaper and online service.

Covering commerce, industry, finance and politics through Scottish eyes, Business a.m. provides a voice and a forum for Scotland's business community, its key opinion formers and decision makers.

Publishing five days a week, Business a.m. offers unrivalled coverage of Scotland's thriving economy, growing financial sector and devolved parliament.

Staffed by more than 70 journalists, it has offices in Edinburgh, Glasgow, Aberdeen, London and other key financial centres around the world, including Brussels, the US and the Far East.

Business a.m. is the business information provider for the new Scotland.

Information for subscribers

The Quarterly Economic Commentary is published four times a year. Annual subscription rates are £60.00 or £17.50 per single issue. Queries should be addressed to Isobel Sheppard, Fraser of Allander Institute, Curran Building, 100 Cathedral Street, Glasgow, G4 0LN, T: 0141 548 3958, Email: fraser@strath.ac.uk

Notes to contributors

The editors welcome contributions to the Economic Perspectives section. Material submitted should be of interest to a predominately Scottish readership and written in a style intelligible to a non-specialist audience. Contributions should be submitted to the editors.

Articles accepted for publication should be supplied electronically and conform to the Guidelines available from Linda Kerr, Fraser of Allander Institute.

Outlook and appraisal

Overview

The growth of the Scottish economy is clearly weakening. There is clear evidence of a "two-speed" economy, with growth in the service sector much stronger than in manufacturing. While over the year, service sector growth was weaker in Scotland than in the UK, in the latest 2 quarters for which we have data the sector was outperforming its UK counterpart, principally because of the strong growth displayed within financial services. Scottish manufacturing, in contrast, is in recession. Output in the sector has contracted for 3 successive quarters, with electronics growth slowing appreciably and contracting sharply in the latest quarter. Manufacturers generally in Scotland have cut prices and sacrificed profit margins in order to protect export share in the face of the high value of the pound against the euro. But by the first quarter there were signs that this was insufficient to protect against the slowdown in world trade resulting in exports falling in several manufacturing sectors. There appears to have been an unanticipated slowing of world demand in the second quarter, particularly in the US that will inevitably have negative consequences for Scotland both immediately in terms of export demand and as inward investment slows over a more extended period. Further uncertainties have been created for the US and world economies following the terrorist attacks in New York and Washington, although the recent co-ordinated interest rate cuts may partially offset any planned investment cutbacks following on from these uncertainties. Subject to those uncertainties, there is an expectation of a mild recovery during the course of 2002 in the US, Europe and Japan, but with growth below historical trend rates. Against this background, we have again revised downwards our forecasts for the Scottish economy over the next two years. We are now anticipating that Scottish GDP will grow by 0.9% this year with growth of 1.4% expected in 2002. Net employment is expected to fall by 7,400 this year but rise slightly by 4,700 in 2002. Unemployment will remain broadly stable. The economy appears now to be set for below trend growth for 3 years. On present evidence an overall recession should be avoided, but the probability of such an occurrence has undoubtedly risen.

GDP and output

In the May Commentary we reported that provisional Scottish Executive estimates of Gross Domestic Product (GDP) for the fourth quarter 2000 indicated that the economy had strengthened considerably. Scottish GDP was reported as rising by 1% over the third quarter compared to 0.3% in the UK. We also noted that it is dangerous to draw conclusions about the comparative path of the economy from one quarter's figures. Estimates from the Scottish Executive for GDP in the first quarter of this year are now available and they are accompanied by significant revisions to the 2000 Q4 data. Both GDP and GDP (ex oil and gas) in 2000 Q4 are now estimated to have risen by only 0.6% and the estimate of growth for the year has been cut from 1.5% to 1.4%. Moreover, manufacturing is now seen to have been in a worse situation in October to December, while the outturn for services is better than originally reported. Manufacturing is now estimated to have contracted by 1.2% in 2000 Q4 compared with the earlier estimate of a 0.2% fall. Services, in contrast, grew by 2% whereas the earlier estimate put fourth quarter growth at 1.7%. This change to the 4th quarter growth estimate for services is very largely the result of a staggering 13 index points upward revision in the growth of financial services. However, the effect on the overall growth of services in the 4th quarter is somewhat muted by an upward revision of 8 percentage points for financial services output in 2000 Q3. These changes serve to highlight the dangers of using the provisional estimates of quarterly Scottish output to draw firm conclusions about the growth performance of the Scottish economy. So after these revisions it can be seen that the "two-speed" economy in Scotland in 2000 Q4 was much more pronounced than originally believed.

During the first quarter of this year, GDP (ex oil and gas) grew by 0.5% in Scotland compared to similar growth of 0.6% in the UK. But over the year to the first quarter, the Scottish economy grew by only 1.2% while GDP (ex oil and gas) rose by 2.8% in the UK.

A consideration of performance at the principal sector level provides some indication where the comparative weaknesses in Scotland's economic performance lie. Year on year to 2001 Q1, Scottish agriculture grew by 1.2%, while UK agriculture contracted by -0.9%. The construction sector in Scotland exhibited 1.2% growth at the same time as output in its UK counterpart fell slightly, by -0.1%. However, agriculture and construction account for only 3% and 6% respectively of overall Scottish GDP. Production and services, in contrast, account for 27% and 63% of Scottish GDP and both these principal sectors performed considerably worse than their UK counterparts over the year to the first quarter. Production output fell by -2.2% in Scotland but rose by 1.3% in the UK, while in services, gross value added increased by 2.5% in Scotland compared to a 3.5% rise in the UK.

Nevertheless, during the first three months of this year, the service sector in Scotland actually outperformed UK services with growth of 1.4% compared to 0.9% in the UK. The service sector has now been stronger in Scotland for 2 consecutive quarters. But little can be read into this. Even if this superior performance were to continue into the second quarter it would have to considerably outperform UK services for the significant absolute and comparative weakness of Scottish manufacturing to be offset. Manufacturing experienced a very sharp contraction of output in 2001 Q1, falling by -2.9% in Scotland compared to a fall of -0.7% in UK manufacturing: the third successive quarter during which manufacturing output has contracted in Scotland. Year on year to the first quarter, Scottish manufacturing output fell by -1.7%, while the sector in the UK grew by 1.4%.

Within services, the financial sector contracted slightly by -0.5% in the first quarter but grew by 6.9% year on year. The comparable figures for UK financial services were 0.2% and 3.8%. It is worth noting that the considerable revisions to financial services output for the third and fourth quarters last year result in the quarterly growth rates for the sector rising to 3.4% and 7.5% respectively, compared to the earlier estimates of -2.5% and 4.3%. Performance in the retail and wholesale sector in 2000 Q4 has now been revised downwards by 3 percentage points, which, when combined with some revisions to performance in 2000 Q3, reduces the growth estimate for that quarter to 0.9% from 2.9%. This revision effectively removes the supposition, suggested in the May Commentary, that the outturn data supported the view that Scottish consumption was more buoyant than UK consumption in the run up to Christmas and the New Year. During 2001 Q1 retail and wholesale output in Scotland is estimated to have risen by 1.3% compared to growth of 0.7% in the UK, but year on year to the first quarter the sector contracted here by -1.2% compared to an expansion of 3.9% in the UK. With the exception of hotels and catering, all other principal sectors within services performed better than their UK counterparts in 2001 Q1. However, year on year, the only service sectors in addition to financial services to do better in Scotland were real estate and business services (6.7% in Scotland against 4.7% in the UK) and hotels and catering (3.4% against -2.4%).

In the manufacturing sector, Scottish electronics suffered a marked contraction in output of -5.9% during the 2001 Q1. UK electronics also contracted but at the slower rate of -4.3%. Year on year to 2001 Q1, electronics in Scotland grew by 1.7%, while UK electronics, in contrast, exhibited growth of 14.6%. The world downturn in technology sectors and in electronics in particular has compounded the negative effects on Scottish manufacturing of the high value of sterling against the euro. Sectors that appear to be suffering disproportionately (i.e. by more than the average for Scottish manufacturing of -1.7%) from the effects of a loss of competitiveness and falling orders include metals, textiles, transport equipment, paper printing and publishing, and food. Over the year to 2001 Q1, metals production in Scotland contracted by -12% (compared to a -1% fall in the UK), textiles contracted by -9.4% (-7.2% in the UK), transport equipment contracted by -7.9% (-6.6% in the UK), paper printing and publishing contracted by -4.1% (-0.3% in the UK), and food contracted by -3.5% (-0.4% in the UK). Five sectors outperformed the average for Scottish manufacturing over the year: electronics (1.7%), other manufacturing (1.7%), mechanical engineering (0.9%), drink (0.8%), and chemicals (-0.6%). Electronics still remained, with other manufacturing, the fastest growing manufacturing sector, but this is because the sector continued to grow, all be it at a reduced rate, in the second and third quarters of last year, with contractions in output only emerging in the 4th quarter and in the first quarter 2001.

Exports

The Scottish Executive's manufacturing export figures for the first quarter 2001, which are now seasonally adjusted, reveal that exports abroad have held up better than might have been expected, given the strength of sterling and the slowdown in the growth of world demand. In the year to the first quarter, manufacturing exports at 1995 constant prices grew by 8.5%. Electronics exports grew by 18.6%, food exports grew by 17.1% and textiles etc exports grew by 7%. However, exports fell over the year in several key sectors. Other manufacturing exports contracted by -13.1%, drink exports fell by -10.7%, paper printing and publishing exports fell by -10.4%, chemicals by -8.3%, metals by -4.6% and mechanical engineering by -4.5%. It is evident from the data that Scottish exporters have cut prices and sacrificed margins in order to retain market share. But it remains doubtful whether overall manufacturing export growth can be maintained at current levels in the face of a further slowing in the growth of world demand.

Labour market

Gaining an understanding of developments in the labour market in Scotland is complicated by the different surveys, over differing time periods and samples, from which to draw. The Labour Force Survey covers private households, student halls of residence and NHS accommodation. These data indicate that both employment and unemployment has been broadly stable over the year to May-July of this year.

For employment, numbers rose by 14,000 over the year to May-July. However, the relatively small nature of the sample produces a sampling variability of plus or minus 60,000. Perhaps a better indication of the state of employment can be derived from the ONS survey of businesses of employee *jobs*, as opposed to people in employment. These data are available up to March 2001 and show that the change on the year amounted to a fall of -12,000. These data can be further decomposed by sector. They show that following the now traditional pattern and the general trends in production manufacturing jobs fell by -9,000 while service and other jobs rose by 4,000. Construction and agricultural jobs fell by -3,000 in each sector, while mining and energy jobs fell by -1,000. However, employee jobs do not provide the whole picture of changes in the civilian workforce in Scotland. For that, we require information on self-employment jobs from the Labour Force Survey and Government supported trainees from DfEE Training Data Systems. These surveys show that self-employment rose by 15,000 over the year, while the number of trainees fell by -2,000. Overall, then, civilian workforce jobs are estimated to have remained broadly stable over the year to March, increasing by just 1,000. This performance would appear to be rather better than that implied by the GDP data, which exhibited below trend growth of 1.2% year on year to the first quarter. However, employment tends to respond with a lag to production trends and so we are likely to see some deterioration in employment performance in future quarters.

For unemployment, the preferred ILO measure for May-July stood at 164,000 or 6.4%, a fall of 5,000 on the year. In contrast, the more narrowly based claimant count for August 2001 stood at 102,700, or 4.1%, a fall of 10,200 on the year. While unemployment tends broadly to follow changes in employment it may not do so, due to supply-side changes such as variations in the numbers choosing to be economically inactive, migration and other changes in population.

Outlook

By the first quarter of this year, GDP growth in the Scottish economy was below trend and slowing. There was clear evidence of a two-speed economy, with growth in the service sector much stronger than in manufacturing. While over the year, service sector growth was weaker in Scotland than in the UK, in the latest 2 quarters for which we have data the sector was outperforming its UK counterpart, principally because of the strong growth displayed within financial services. Scottish manufacturing, in contrast, is in recession. Output in the sector has contracted for 3 successive quarters, with electronics growth slowing appreciably and contracting sharply in the latest quarter. Manufacturers generally in Scotland have cut prices and sacrificed profit margins in order to protect export share in the face of the high value of the pound against the euro. But by the first quarter there were signs that this was insufficient to protect against the slowdown in world trade resulting in exports falling in several manufacturing sectors.

Outturn data are as yet unavailable for the second quarter of this year but it appears likely that GDP will slow further and possibly markedly in both the second and third quarters. The loss of output following the closure of Motorola's West Lothian mobile 'phone plant and the contractions in other electronics companies will begin to affect the output data in these quarters. In addition, there appears to have been an unanticipated slowing of world demand in the second quarter, particularly in the US (see World Economy section) that will inevitably have negative consequences for Scotland both immediately in terms of export demand and as inward investment slows over a more extended period. Further uncertainties have been created for the US and world economies following the terrorist attacks in New York and Washington, although the recent co-ordinated interest rate cuts may partially offset any planned investment cutbacks following on from these uncertainties. Subject to those uncertainties, there is an expectation of a mild recovery during the course of 2002 in the US, Europe and Japan, but with growth below historical trend rates (see World Economy section).

These expectations are in part confirmed by the results of the Scottish Chambers' Business Survey (SCBS) for the second quarter of this year. The growth in orders and sales was less than anticipated in manufacturing and the overall trend in manufacturing was the weakest since the second quarter of 1999. But in the service sector, the trends in sales were the strongest since the fourth quarter of 1997 and the sales outturn in distribution was better than anticipated. These data are supported by other data on retail sales in Scotland and new car registrations, which indicate that consumer spending in Scotland remained quite buoyant up to the middle of the year. Expectations for the third quarter from the SCBS, indicate that manufacturers are anticipating a further slowing of orders and sales, while service sector respondents are more bullish. What seems clear is that the "two-speed" economy is set to continue for some time yet.

Against this background, we have again revised downwards our forecasts for Scotland for both this year and the next (see Scottish Forecasts section). The growth of export demand and investment is expected to slow further, although consumption and general government expenditure still remain fairly buoyant. We are now projecting GDP growth of 0.9% this year and 1.4% in 2002. These figures compare with our May forecast of 1.6% and 1.9%, respectively. We expect construction to remain fairly buoyant, reflecting principally investment in the education and health sectors. The service sector is expected to weaken slightly but still remain comparatively strong, while manufacturing is expected to contract markedly this year but begin to recover in 2002, although growth in the sector is still expected to remain negative. Total employment is now expected to fall by 7,400 this year but rise slightly by 4,700 in 2002. Jobs growth will continue in services, while manufacturing will persist in shedding jobs. The ILO unemployment rate is expected to rise slightly in 2001 to 6.8%, while the claimant count will fall slightly to 4.3%. In 2002, ILO unemployment is expected to decline slightly again to 6.6%, with the claimant count standing at 4.2%. The limited impact of the slowdown on unemployment is partly a consequence of the shift away from higher productivity manufacturing jobs to lower productivity service employment.

In sum, the Scottish economy is now expected to slow down more in 2001 and to recover later than originally anticipated. The economy appears now to be set for below trend growth for 3 years, although at this point in time and on present evidence an overall recession should be avoided, but the probability of such an occurrence has undoubtedly risen.

Brian Ashcroft
18 September 2001