Outlook and appraisal

Overview

Growth in Scotland continues at broad parity with UK growth, is well above trend and has been so for several quarters. The service sector continues to be the main sectoral driver of growth, outstripping the growth of UK services in the final quarter of last year. But in another welcome development manufacturing in Scotland also returned to positive growth during the last three months of 2006. Real estate and business services provided the main impetus to service sector growth outperforming its UK counterpart, while in manufacturing the return of electronics to positive growth is also encouraging.

Against a background of continuing growth in the World and UK economies, we are forecasting GVA growth of 2.5% in Scotland in 2007, a slight reduction on the 2.6% achieved in 2006. The growth rate is further expected to be a little weaker in 2008 at 2.3% but to remain above trend. Domestic consumption demand remains fairly robust even in the face of a rising interest rate profile while export growth strengthens particularly to the Euro Area in 2008. Net jobs growth is expected to remain strong with over 34,400 net new jobs forecast for this year and 29,700 jobs in 2008. Despite this there is little change in our forecast for unemployment as greater jobs growth is offset to some extent by a rising trend in the Scottish labour force as more people enter the labour market here. Overall, the outlook for the Scottish economy is good in the medium-term but with inflationary concerns deepening at the UK level the possibility of further increases in interest rates may cloud future growth prospects.

GDP and Output

In the final quarter of 2006 Scottish GDP rose by 0.6% compared to growth of 0.7% in the UK- see Figure 1. For 2006 overall, GDP rose by 2.6% compared to 2.7% in the UK. This was the highest growth over a calendar year since 1997 (2.7%) and the highest growth rate over 4 quarters since the third quarter of 2000 i.e. before the recession in electronics began. Current Scottish economic growth is therefore broadly at parity with the UK, is well above trend, and has been so for some time – 10 consecutive quarters if a low estimate of the trend is taken from the annual average between1976 - 2006, which is 1.8%.

At the level of principal sectors, both services and manufacturing achieved positive growth in the fourth quarter, with services growing by 1% compared to 0.7% in UK services and manufacturing growth of 0.9% as UK manufacturing stagnated. Construction sector GVA contracted by -0.4%, the first fall in Scottish construction output for 7 quarters. UK construction, in contrast, grew by 0.8%. Scottish agriculture, forestry and fishing, similarly, contracted its GVA by -1.7% while its UK counterpart cut back output by -0.5%. Mining and quarrying and electricity, gas and water also suffered output losses in the fourth quarter with GVA falling by -0.2% and -7.1%, respectively. This can be compared with the performance of their UK counterparts which reduced output by -0.6% and -1.6%, respectively.

In services, the growth of 1% in the fourth quarter – see Figure 2 – resulted in growth of 2.9% during 2006 compared to 3.6% in the UK. Weakness in Scottish services in the third quarter, where growth only reached 0.1%, mainly accounts for the comparative weakness of Scottish services over the year. Within services real estate & business services was the main driver of growth, growing by 3.4% in the 4th quarter and by 5.6% in 2006 compared to 1.1% and 5.7% in the sector in the UK. Other Scottish service sectors performing strongly in the 4th quarter were financial services (2.7% - and banking 5.5%), communications (7.7%) and transport (1.3%). Public sector GVA – admin, education and health – contracted by -0.3% in the quarter, with hotels and catering contracting by -2.2% and other services by -0.5%.

Scottish manufacturing grew by 0.9% in quarter 4 compared to no change in UK manufacturing – see Figure 3. For 2006 as a whole, Scottish manufacturing contracted by -0.1% while UK manufacturing grew by 1.5%. Engineering and allied industries was the main growth sector within Scottish manufacturing in the 4th quarter growing by 2.3%. Other industries contributing to the manufacturing growth but to a much lesser extent were metals & metal products (+1%), and food, drink and tobacco (+1.9%). Declining sectors during the quarter were: chemicals (-0.9%), textiles etc (-3.2%) and other manufacturing (-0.9%).

Figure 4 indicates that the strong performance of engineering and allied industries and even manufacturing itself was due to an upturn in electronics performance. Scottish electronics grew by 1.2% in 4th quarter but contracted by -5.7% over the year, while UK electronics grew by only 0.4% in the quarter but by 1.4% in 2006. This was the first time for 6 quarters that Scottish electronics has exhibited positive growth. It remains to be seen whether this upturn is simply a small upward 'blip' in a process of further contraction of the sector in Scotland, or whether electronics can show sustained improvements over coming quarters.

Small nations, prosperity and economic growth

The SNP argued during the recent election campaign that small independent states promote prosperity and growth. Moreover, they contended that an independent Scotland would join an 'arc of prosperity' of small independent states that would include Ireland, Iceland, Norway and Denmark, with Finland and Sweden also providing positive examples. This is an interesting contention that deserves serious consideration both from a conceptual standpoint and through an examination of the evidence.

First, economic theory suggests that scale differences can lead to variations in economic performance largely due to the concept of 'economies of scale'. But that concept suggests that unit costs may be negatively related to scale so that bigger firms/organisations experience lower costs per unit of output than smaller entities. At the level of a region or nation the bigger the economy the greater the opportunity to enjoy economies of scale in sales to the domestic market and perhaps the number of trading opportunities may rise disproportionately in such 'thicker' markets to enhance profitability. In addition, a larger productive economy may offer a greater chance of positive knowledge and other spillovers between firms, especially in cities and urban agglomerations, which may serve to lower unit costs and raise profitability. None of this argues for growth being faster in larger economies but it is not inconsistent with such a possibility.

Smaller economies are also likely to be more vulnerable to given exogenous shocks such as the downturn in a key sector. Equally, they may benefit from the same phenomenon as, for example, a given inward investment contributes more absolutely to the Scottish economy than a larger economy such as the US or the UK.

What of the advantages to growth of smaller economies? A smaller, more compact, economy might offer greater opportunities for face-to-face contact, more extensive and rapid flows of knowledge and information, and the opportunity more easily to build trust so reducing transactions costs. Also policy might be more flexible and adaptive in a small state than in a large monolith, which could favour *small independent states* over *small regions* as well as over large states. Whether these potential advantages would outweigh the potential costs of the loss of internal and external economies is a moot point, which suggests that one cannot draw a specific conclusion *a priori*.

We might, however, expect that smaller economies would have a more dispersed performance than larger entities because of their greater vulnerability to both positive and negative exogenous shocks. It would appear that the issue cannot be resolved without recourse to empirical evidence. And this raises further issues of definition and measurement. On what basis do we distinguish small from larger economies? We have adopted the convention that a small state can be defined as one containing 10 million people or less. Given that assumption we have looked at measures of prosperity and growth across the OECD in an attempt to see what patterns, if any, emerge.

Table 1: GDP per head rankings 2004 at PPPs

Luxembourg	1	UK	9
USA	2	**Canada**	10
Norway	3	Australia	11
Ireland	4	Holland	12
Switzerland	5	*Belgium*	13
Iceland	6	***Finland***	14
Austria	7	***Sweden***	15
Denmark	8	**Japan**	16

Table 1 presents the results for 16, from 32, countries of a ranking of GDP per head at purchasing power parities (PPPs) in 2004 (OECD Fact Book 2006). Small countries with a population of 10 million or less are italicised and those in the claimed 'Arc of Prosperity' are italicised and in bold. What this casual empiricism suggests is that from rankings of a prosperity measure such as GDP per head some support is given to the "Arc of Prosperity" contention, although not the simple small state case.

However, GDP per head is not a good measure of the prosperity of a nation's citizens. The value of the production of goods and services in an economy may not match the income available to domestic citizens to the extent that there are income flows both into and out of the economy. It is therefore appropriate to calculate a national income measure that is based on the value of GDP adjusted for net income flows abroad. Clearly, if there are net income flows *from* abroad then the estimate of national income will be higher than GDP with the converse applying. So for example countries with large foreign investments should expect, other things equal, a net inflow of income from outside the economy. Conversely, economies that host large stocks of foreign direct and portfolio investments would, other things equal, be expected to experience a net outflow of income thus lowering the income-adjusted estimate of GDP.

Table 2: GNI per head rankings 2003 at PPPs

Luxembourg	1	Holland	9
USA	2	**Canada**	10
Norway	3	*Iceland*	11
Switzerland	4	Australia	12
UK	5	***Sweden***	13
Denmark	6	**Japan**	14
Austria	7	France	15
Belgium	8	***Finland***	16
		Ireland	17

From Table 2 it is clear that when a measure of national income is computed the simple small state case continues not to hold, while the "Arc of Prosperity" contention also breaks down. GNI per head is much lower relatively in Iceland and Ireland than GDP per head. Ireland, for example, falls in the rankings from 4th to 17th and this is principally because of the large stock of foreign investment present in the country generating a large net outflow of income in the form of profits and dividends to ultimate owners abroad.

Finally, an examination of the *growth* of GDP per head – there are insufficient data to look at the growth of GNI - across 30 OECD countries between 1990 and 2004 offers no support for the contention that small states tend to enjoy faster growth. Figure 5 indicates that for countries with a population of 10 million or less growth performance is widely dispersed across the four quartiles. The first quartile contains 5 small countries; the second quartile contains 2, the third quartile 5 and the fourth quartile 2. Further consideration reveals that the greater concentration of small countries in the first quartile an be ascribed in part to a 'catch-up' phenomenon affecting the transition economies of the Slovak Republic and Hungary, with the strong performance of the Irish economy also exhibiting similar characteristics.

On the basis of this, admittedly simple, analysis there appears to be little evidence that ‘small’ independent states necessarily grow faster and are more prosperous simply because they are ‘small’. There does appear to be a group of nations to the west, north and east of Scotland that conform to an “Arc of Prosperity” in terms of GDP per head, although not in terms of GNI per head. If smallness *per se* cannot account for such an ‘Arc’ then it is hard to believe that there is some specific geographic advantage to small *independent* states located in north-west Europe. And in the absence of such a geographic advantage it must be concluded that the ‘Arc’ is a random outcome.

Outlook

Growth in the world economy remains comparatively strong, despite a slowing in growth in key countries. Strong growth continues in Asian markets, with China continuing to be a major driver and Japan beginning to recover steadily. Growth in the Euro Area is reasonably strong by recent standards. The upside risk continues to be rising prices, with inflationary pressures increasing after a further surge in oil prices during April and May accompanied by the risk of knock-on effects on earnings and wage settlements. On the downside, the slowdown in the US housing market is affecting US growth but this appears unlikely to produce a marked slowdown in growth.

After growth of 3.1% in 2006 the OECD countries are forecast to grow by 2.5% in 2007 and 2.7% in 2008, with inflation expected to be stable at 2.1% this year but rising to 2.3% in 2008. US growth is expected to slow from 3.3% in 2006 to 2.6% in 2007 and 2.6% in 2008. Euro Area growth rose from 1.5% in 2005 to 2.8% in 2006 but is expected to reduce slightly to 2.5% in 2007 and 2.3% in 2008. Of the major economies, only Japan is expected to increase its growth rate, all be it slightly, from 2.2% in 2006 to 2.3% in 2007 and 2.4% in 2008.

In the UK, growth also remains strong with inflationary concerns deepening as pay settlements are seen to be rising. Scottish growth at 2.6% in 2006 was much the same as the UK growth rate, with manufacturing as well as services generating positive growth in the final quarter of the year. By the end of the year Scottish service sector growth was outstripping its UK counterpart led by strong growth in real estate and business services. The Scottish Chambers’ Business Survey for the first quarter of this year reported rising confidence levels in manufacturing, construction, and tourism, a level trend in wholesale and an easing in retail confidence. The trends in demand and sales were stronger in the first quarter of 2007 than in 2006. Investment plans were being revised upwards in most sectors, although cost and pay pressures were rising. The CBI Scottish Industrial Trends Survey for the first quarter reported rising optimism and sales, particularly exports, in manufacturing and despite a modest fall in output growth was expected to pick up strongly in the second quarter. Yet, the bi-annual Regional Economic Trends Survey from the CBI, published in June, suggested that Scottish firms were less optimistic about the overall business situation than they were last autumn. While a small balance of firms expected the business situation to improve over the next six months it appeared that firms elsewhere in the UK were faring better than Scottish firms on many of the key metrics.

Against this background we are forecasting GVA growth of 2.5% in Scotland in 2007, a slight reduction on the 2.6% achieved in 2006. The growth rate is further expected to be a little weaker in 2008 at 2.3% but to remain above trend. Domestic consumption demand remains fairly robust even in the face of a rising interest rate profile while export growth strengthens particularly to the Euro Area in 2008. At the sectoral level, agriculture remains weak with GVA continuing to fall slightly in 2007 and 2008 after the large fall of -2.3% in 2006. Manufacturing is now expected to return positive GVA growth this year of 0.8% after a fall of –0.2% in 2006 rising to growth of 1.2% in 2008. But the principal drivers of Scottish growth over the next two years will continue to be the service sector, with growth of 2.8% and 2.6% expected in 2007 and 2008 respectively, and the construction sector, which will continue to grow above 5% over the next two years.

With this growth profile net jobs growth is expected to remain strong with over 34,400 net new jobs forecast for this year and 29,700 jobs in 2008. Despite this there is little change in our forecast for unemployment as greater jobs growth is offset to some extent by a rising trend in the Scottish labour force as more people enter the labour market here. The ILO rate is expected to stand at 5.1% in 2007 and 5% in 2008 compared to 5.3% in 2006, with an expected claimant count rate of 2.9% this year and next compared to 3.3% last year. Overall, the outlook for the Scottish economy is good in the medium-term.

Brian Ashcroft
2 July 2007

Figure 1: Scottish and UK Quarterly GDP Growth, 1998q2 to 2006q4

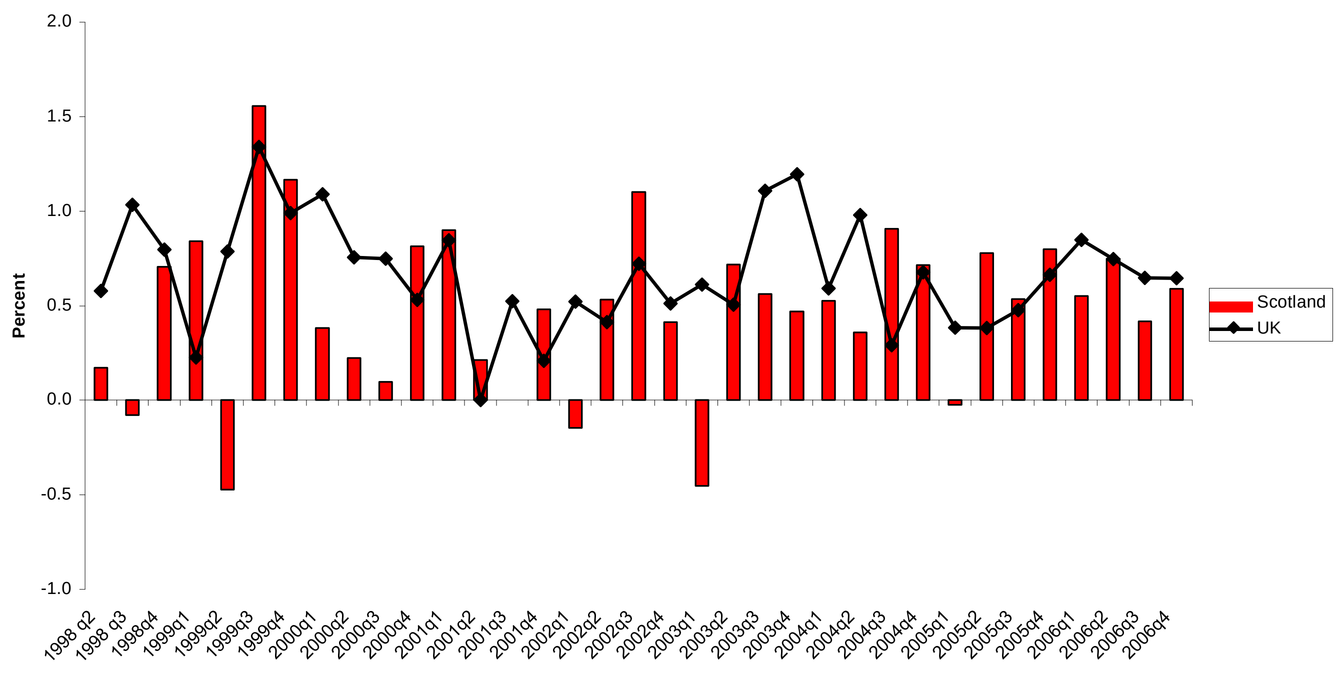


Figure 2: Scottish and UK Services GVA Growth at constant basic prices 1998q2 to 2006q4

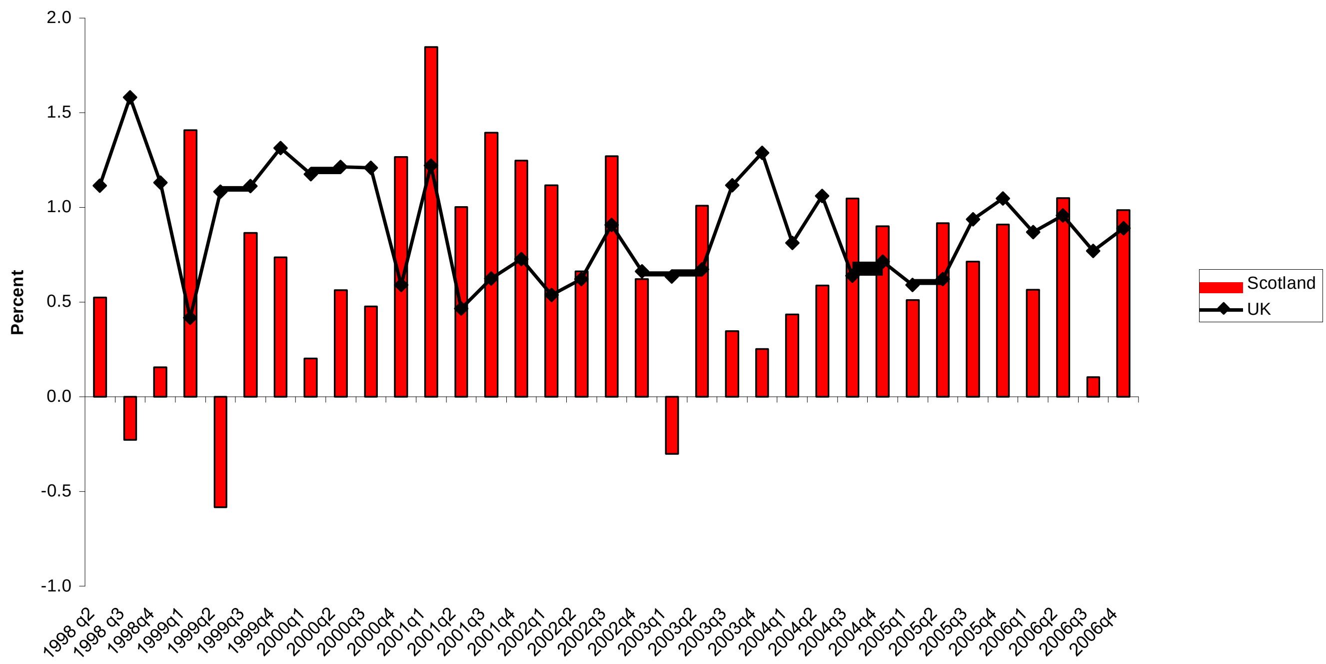


Figure 3: Scottish and UK Manufacturing GVA Growth at constant basic prices 1998q2 to 2006q4

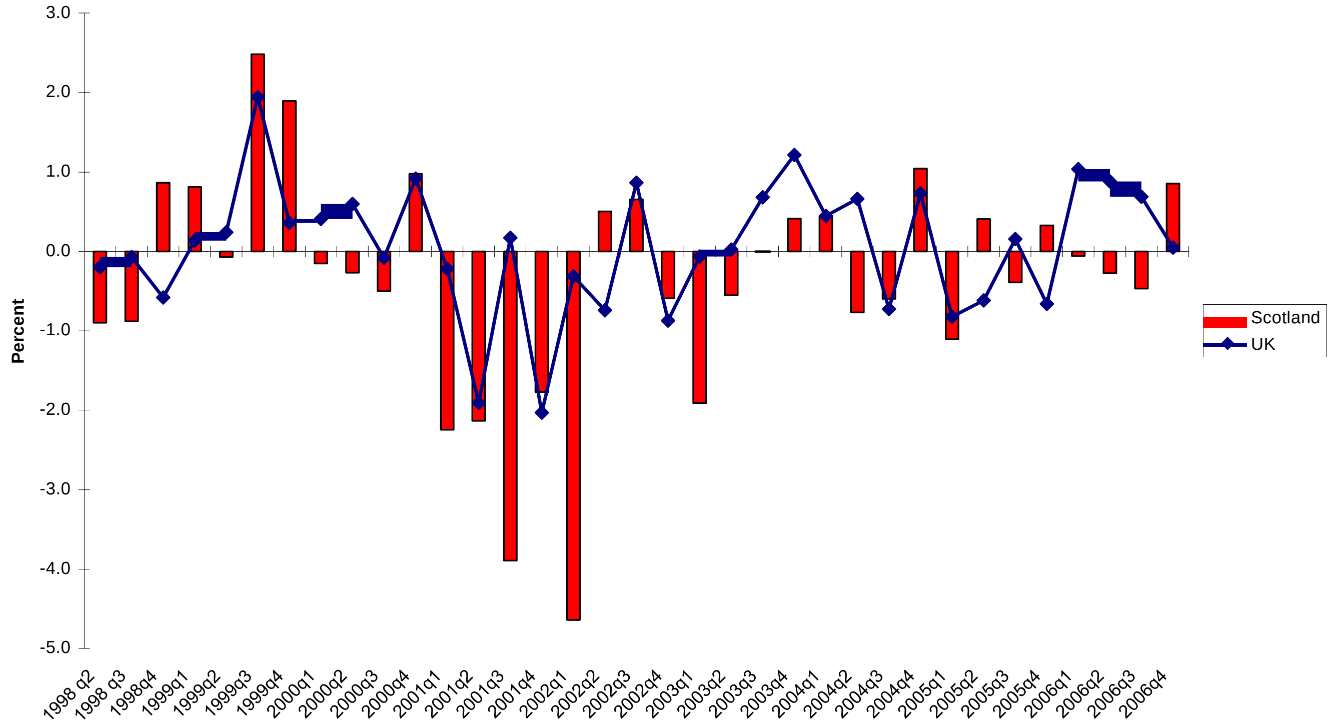


Figure 4: Scottish and UK Electronics GVA Volume Growth 1998q2 - 2006q3

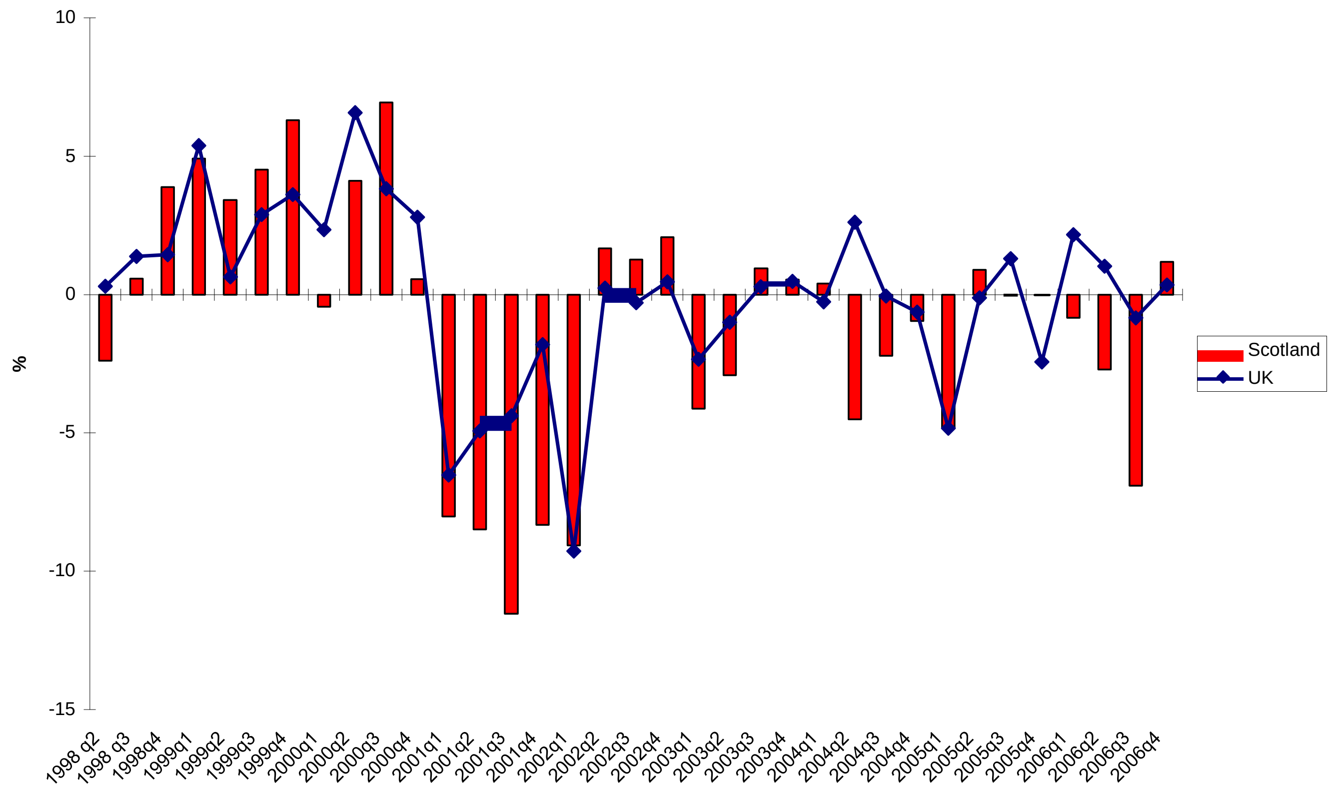
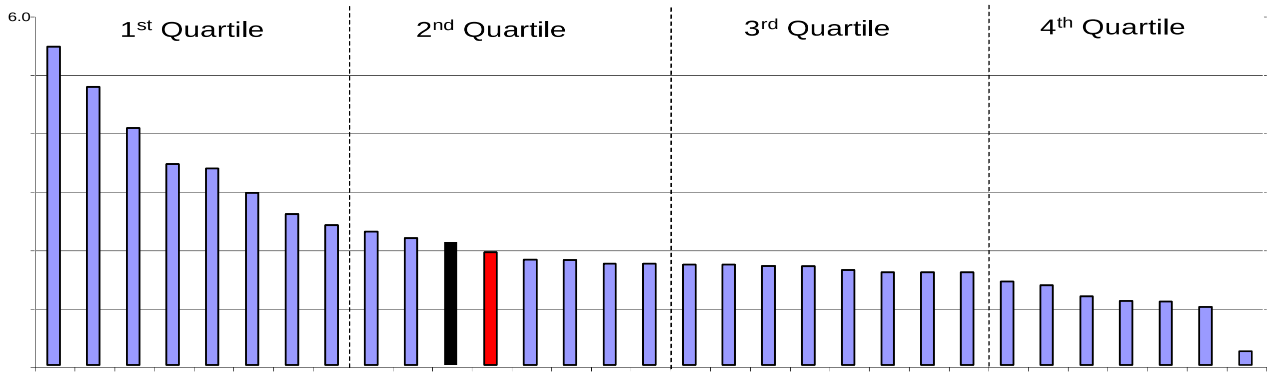


Figure 5: GDP per head annual average growth 1990-2204, OEC countries (2000 prices and PPPs)



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