# Outlook and appraisal

## Overview

The Scottish economy continues to grow quite quickly compared to trend with growth of 2.3% anticipated for 2006. This buoyant growth occurs against a background of strong growth in the UK with GDP rising by 2.7% last year. Despite uncertainties over the US economy, rising oil prices in the short-run due to political uncertainties in the Middle East and some pick up in the UK inflation rate, which may prompt a further rise in UK interest rates to 5.5%, above trend growth is expected to continue in Scotland in 2007 and 2008. We are forecasting GVA growth of 2.2% this year and growth a shade lower in 2008 at 2.1%. These forecasts compare with the UK Treasury's latest (March) assessment of independent forecasts for the UK economy of an average 2.6% for 2007 and 2.3% in 2008.

These relatively robust output forecasts continue to drive job creation and a strong labour market in Scotland, although with some sectors managing to generate more output from a given jobs base our jobs forecast is less strong than might have been expected from the output growth projections.

Net jobs growth of 11,400 is forecast for 2006, 19,400 in 2007 and 15,600 in 2008. The employment rate is expected to continue above the UK rate, with in the 4th quarter of 2006 the Scottish rate standing at 76.1% and the UK rate at 74.5%. Unemployment continues therefore to remain low by historical standards with an ILO rate of 5.2% projected for both 2007 and 2008 and a claimant count of 3.3% and 3.2% respectively.

We also note the changing structure of the Scottish economy as manufacturing decline is associated with the increasing importance of the service sector. The relative decline of manufacturing is a phenomenon common to most advanced countries. Concern about the loss of connection to world markets as manufacturing declines is appropriate if the growth of tradable services fails to fill the gap. The Institute takes the view that a weakness in domestic private sector entrepreneurship, coupled with the obstacles of a small domestic market and a peripheral location, has meant that Scotland has failed to develop, to the same degree as the UK and other leading economies, the new tradable service sectors that are increasingly the mainspring of modern economic growth. Of particular concern is the comparative weakness in the growth of business services in Scotland, the main sectoral driver of economic growth in the UK and other leading economies. The Institute contends that we need to understand better why Scotland is not generating and attracting such activities in sufficient numbers. This is a necessary first step in the development of policy to improve the growth of business services here and hence raise further the growth of the wider Scottish economy.

### GDP and Output

The latest Gross Value Added (GVA) data from the Scottish Executive indicate that the Scottish economy was growing at around its trend rate of growth during the third quarter of 2006. GVA, or Gross Domestic Product (GDP) at basic prices, grew by 0.52% between July and September and by 2.3% over the year to the end of 2006 Q3. Despite a strong performance, the outturn for the Scottish economy was still weaker than for the UK where GDP grew by 0.65% in the third quarter and by 2.6% over the year. Interestingly, while Scottish growth of 0.52% in the third quarter outpaced its quarterly average growth rate since 1998 of 0.48%, UK growth of 0.65% was slightly below its average of 0.67% for the longer period. So some narrowing of the growth gap between Scotland and the UK is evident in the most recent quarter.

In the June 2006 Commentary we were heartened that Scottish GDP growth had managed to keep up with UK GDP growth as UK economic growth improved from a growth trough in the first quarter of 2005. We noted that normally Scotland has a flatter growth cycle, holding up well in a UK downturn and picking up less well in an upturn. We also conjectured that it remained to be seen whether this relative improvement would persist if growth in the UK economy continued to improve. The evidence from the first quarter suggested that Scotland's performance relative to the UK might be reverting to type as Scottish growth again began to lag behind the UK as fairly robust UK growth was sustained. What Figure 1 shows is that Scottish GDP growth in the second and third quarters of last year was reasonably strong, held up better than might be expected but had still failed to match the UK.

The October 2006 Commentary noted that in the first quarter of 2006 the growth of both Scottish and UK services slowed, with Scottish services slowing by more – see Figure 2. But in the second three months of last year while UK services picked up from 0.82% in the first quarter to 0.97%, Scottish services made a considerable recovery from 0.35% to 0.83%. But this again proved to be something of a false dawn because in the latest third quarter data Scottish services GVA growth slipped back to 0.40% while UK services slowed only slightly to 0.77%. Both these outturns are below the quarterly average service sector growth rates since 1998 of 0.69% for Scotland and 0.89% for the UK, although the relative weakening in Scottish services sector performance is more considerable. Nevertheless, during the year to the third quarter 2006 Scottish services grew by 2.8% compared to growth of 3.6% in UK services.

Within Scottish services in the third quarter, real estate & business services – accounting for 26% of service sector GVA - was the principal driver of growth, growing by 0.6% (but by 1.4% in the UK), followed by transport & communication, which grew at 1.8% (0.3% in the UK) and accounts for 11% of service sector GVA, then financial services with growth of 0.8% (1.5% in the UK) and a service sector GVA share of 10%. When further sectoral disaggregation is undertaken it is evident that retailing grew strongly at 1.4%, with banking and transport also performing well at 2.3% and 2.2% respectively. The weakest parts of the Scottish service sector in growth terms were the public sector, which contracted by 0.2% (but grew by 0.3% in the UK) in the quarter and other services where GVA fell back by 0.5%, whereas its UK counterpart grew by 1.1%.

Of the other principal industries, the construction sector – accounting for 7% of overall GVA – in Scotland grew by 2.4% during the third quarter and by 5.5% over the year. UK construction, however, only grew by 0.7% in the quarter and by 0.3% during the year. There is a clear link here to the recent robustness of the Scottish, compared to the UK, housing market and to commercial property developments in Scotland such as the Pollock shopping centre and expansion of the Braehead complex.

The production sector – accounting for 19% of overall GVA – was, in contrast, weak both in Scotland and the UK. Scottish production grew by 0.2% in the third quarter but contracted by 0.5% over the year, while UK production grew at the same rate of 0.2% in the quarter but contracted even more strongly over the year by 0.9%. Within production, the electricity, gas & water supply industry in Scotland – contributing 14% of production sector output – grew by 4.7% in the quarter and by 2.4% over the year. The comparable UK sector figures were for a fall of 0.2% in the quarter and fall of 0.9% over the year. Mining & quarrying, in contrast, – accounting for only 7% of production activity – cut back on output by 2.7% in the quarter and by 9.6% over the year, while the contraction in the sector in the UK was 3.8% and 8.1% respectively. Manufacturing, on the other hand, which accounts for the bulk of production activity – 79% –, suffered a decline of 0.4% in Scotland in the third quarter while expanding by 0.6% in the UK – see Figure 3. Over the year Scottish manufacturing still lost output, by 0.3%, while there was some slight growth in UK manufacturing of 0.1%.

Within manufacturing the main growth sector during the quarter was transport equipment, which grew at 9.5% compared to 1.2% in its UK counterpart. However, since the sector accounts for only 6% of manufacturing GVA in Scotland this strong performance had little influence on overall manufacturing growth in Scotland. Chemicals – accounting for 9% of manufacturing GVA – grew by 3.6% (1.9% in the UK), while the food sector – also 9% of manufacturing GVA - grew by 2.3% compared to growth of 0.8% in the UK food sector. Other sectors performed less well with paper, printing & publishing – accounting for 10% of manufacturing GVA - contracting by 3.1% over the three months and drink – also 10% of manufacturing GVA – reducing its output by 0.8%. But again the weakest performance was confined to electrical & instrument engineering or, more popularly, electronics, which with the move to 2003 weights accounts for 22% of manufacturing GVA. Electronics GVA fell by 7.2% in Scotland compared to a 0.8% fall in the UK. Figure 4 reveals that GVA growth in Scottish electronics has worsened over the last three quarters and much more so than in the UK. The view that Scottish electronics was beginning to recover from the shake-out consequent upon the 2000-2002 world ICT recession is not borne out by the evidence of the last three quarters.

Overall, we note that GDP growth in Scotland continues to be strong and above trend, is holding up better than might be expected but is still failing to match the UK. GVA growth in services and construction continue to drive Scottish economic growth, with construction markedly outperforming its UK counterpart. But service sector growth in Scotland, while strong, is still some way behind the UK. The manufacturing sector is again contracting and is in a technical recession – two successive quarters of negative growth – which is principally accounted for by the weakness in, and further deterioration of, growth in the electronics sector.

## Changing structure of the Scottish economy

The current Scottish Executive GDP figures are based on 2003 industry weights – GVA shares. Indeed, the *ONS Regional Accounts* data provide information on GVA shares in 2004 and these can be compared with earlier years. Figures 5 and 6 provide a comparison for Scotland and the UK, respectively, of the shares in overall GVA for key industries in 2004 and 1989. The Figures reveal significant changes in the composition of Scottish industry over the fifteen-year period. The key stylised facts are:

1. the decline in the GVA share of manufacturing;

2. the growing importance of producer services i.e. finance and real estate & business services;

3. the rise in all other service sector shares, excepting transport & communication, but including the public sector;

4. the broad similarity in the trends between Scotland and the UK.

For many people, the decline in the share of manufacturing will give rise to most concern. It is not a recent phenomenon and dates back to the mid 1970s after the stagnation and shakeout that followed the cyclical peak in the economy in 1973. After that, manufacturing GVA grew more slowly than the economy as a whole resulting in an inexorable decline in its GVA share, from a little over 30% in 1974, to 23% in 1989, and to just under 15% in 2004. But Figure 6 shows that this was in no way a unique Scottish phenomenon. In 1989, the GVA share of UK manufacturing was 24.7% in the UK compared to 23.4% in Scotland. By 2004, the share of UK manufacturing in overall GVA had fallen to 14.4% compared to 14.7% in Scotland. So, over the 15 years UK manufacturing lost share amounting to 10.3% points, while the share of Scottish manufacturing fell by 8.7% points.

Prof Richard Harris of the Centre for Public Policy for Regions in a recent lecture[i] argues for the importance of manufacturing to the Scottish economy. He suggests that as household incomes rise, the pattern of demand changes in favour of services and this is, in part, an explanation of manufacturing's declining share. But he notes that much of the loss of share is linked to the failure of Scottish and UK manufacturing to capture 'high value added' markets. Added to this is the pull of low production cost locations, such as

Eastern Europe, India and China, inducing multinational manufacturing enterprise to relocate their activities.

For Harris, the decline in manufacturing is worrying because he sees the sector as a key source of self-reliant growth. It is not dependent on local demand alone, unlike like many service activities, so by trading externally it provides a bridge into the wealth and prosperity of other markets. By laying down local intermediate input linkages, manufacturing growth is spread more widely and so the sector can play a more dominating role in the local economy than its direct contribution might at first suggest. Finally, manufacturing sectors are more likely to undertake R&D and have a high ability to innovate. And innovation is seen, from both theory and empirical evidence, to be the key to the growth of total factor productivity and sustained long-run economic performance.

Harris provides evidence that shows a rise in net imports into Scotland and a rising trade deficit as domestic manufacturing has declined. This in turn has had to be financed by increasing net transfers from other UK regions and specifically the UK Exchequer.

We agree with Harris that the decline in manufacturing shares needs to be understood better because of the significance of the sector to growth. The weakness in domestic manufacturing R&D, new firm formation and innovation has meant that Scotland has had to rely much more than the UK on inward foreign direct investment. Welcome and valuable though this inward investment has been, Scotland has to a degree been more vulnerable to a lower degree of embeddedness in purchasing linkages, a greater readiness to relocate internationally and a lack of domestically initiated innovation, than it would have been if domestic entrepreneurship had been more vibrant.

Moreover this weakness in domestic entrepreneurship, coupled with the obstacles of a peripheral location, has meant that Scotland has failed to develop, to the same degree as the UK and other leading economies, the new tradable service sectors that are increasingly the mainspring of modern economic growth. Harris also shows that the share of producer services, specifically business services and finance, has grown more slowly in Scotland than in the South East of England and implicitly the UK. Producer services in the South East rose from a 14.4% share of GVA in 1971 to 36.9% share in 2003, whereas in Scotland the sector started from a low base of 7.8% of GVA in 1971 rising to 27.7% in 2003.

But Figures 5 and 6 show that, between 1989 and 2004 at least, the problem for Scotland was not the slow growth of producer services as a whole but of its real estate & business services component.[ii] Over this period, the share of the finance sector in total Scottish GVA rose from 4.5% in 1989 to 8.2% in 2004. This was a better performance than the financial sector in the UK, which went from 6% of GVA in 1989 to 8.4% in 2004. However, the GVA share of real estate & business services rose by ‘only’ 5.6% points in Scotland over the period, from a 13.5% share to a 19.1% GVA share, whereas the sector in the UK increased its share by 9.8% points, from 16.4% to 25.2% of overall GVA.

Recent unpublished research by Scottish Enterprise[iii] reveals that GVA in real estate and business services in Scotland grew by 75% in real terms between 1989 and 2003, compared to growth of 30% in the Scottish economy as a whole. The finance and other services sectors grew faster by around 100% and under 120% respectively but due to its absolute size the real estate and business services sector contributed more than 35% of overall Scottish GVA growth over the period, more than any other sector. However, the fact that the share of real estate and business services increased by more in the UK than in Scotland implies that the sector grew faster in the UK. The Scottish Enterprise research suggests that since the sector sells 54% to other Scottish businesses producing in Scotland its overall growth performance depends in large degree on the growth of the wider economy.[iv] In addition, the rise of outsourcing has also contributed to the growth of the sector. This latter represents an effective substitution from one sector within the economy to another and so does not add much to overall growth. Moreover, the extent to which such outsourcing could occur would depend on the presence of headquarters (HQ) functions in Scotland, the relative lack of which is a particular concern for the Scottish economy. Indeed the presence of such HQ functions acts to some degree as a magnet for mobile business services and the loss of such possibilities is likely to have affected Scotland’s growth rate.

Nevertheless, within business services there are several activities that are inherently mobile and/or tradable and offer scope for the development of an export base to supplement and replace the decline in manufacturing. Activities such as labour recruitment services, business and management consultancies, architectural and engineering consultancies, legal activities, R&D, call centres, technical testing and analysis, hardware consultancy, other computer related activities, data processing, market research, software consultancy and software publishing, need not depend on the local business base. We need to understand better why Scotland is not attracting such activities in sufficient numbers as the first step in developing policy to improve the growth of business services in Scotland.

## Outlook

Despite rising oil prices and concerns about the effect on growth of a slowdown in the US housing market the overall growth of the world economy remains relatively strong. Inflation has moderated in most countries as the oil price fell back after the third quarter of last year. However, recent political uncertainties in the Middle East have served to push the oil price up again, although most analysts believe that economic fundamentals of emerging excess productive capacity warrant lower prices in the medium term. RBS are forecasting a crude oil price of $45 per barrel by 2011.

The UK economy grew by 2.7% in 2006 and by 0.8% in the 4th quarter of last year, but revised down to 0.7% in March indicating a continuation of a reasonably strong output and domestic demand performance. Business investment is strong, reflecting appreciable investment activity in the oil and gas sector, although whole economy investment is relatively weak. The data are mixed on consumer spending with the index on retail sales falling by 1.8% in January but surveys and anecdotal evidence appear to contradict that outturn. CPI inflation of 2.8% is currently (February) above the 2% target but the Bank of England expects the rate to fall below target this year settling at the target rate over the medium term. After raising interest rates to 5.25% in January the Bank has held the rate in subsequent months but rates are expected to rise soon to 5.5% as the MPC seeks to adjust to an above target inflation rate. The recent budget was fiscally neutral, with no net injection or net withdrawal of demand from the UK economy.

Data on GVA growth in the 4th quarter of 2006 for Scotland are not due to be released until April 25th. We therefore must rely on business survey and other evidence to form a judgement on the performance of the Scottish economy in that quarter and in the first three months of this year. The Scottish Chambers Business Survey for the 4th quarter suggested that demand was on a rising trend, with increased activity in manufacturing, rising export orders and increased optimism. But this was against a background of significant spare capacity in sector. As we moved into 2007, the Scottish high street remained robust with retail sales performance strong in February and stronger than in the UK. The RBS *Retail Sales Monitor* in March noted that "overall, these are good figures …... it is clear that the effects of the two recent interest rate rises have yet to influence consumer spending and that consumers in Scotland remain more resilient than those in the UK."

The CBI Industrial Trends survey reported in January that respondent manufacturing companies had experienced a modest growth in orders over the previous three months and that the growth of orders was somewhat weaker than in the UK as a whole. The report also noted that output and domestic prices were weaker in Scotland where they had been falling compared to rises in the UK. But the Scottish PMI surveys published by RBS continue to suggest that the Scottish economy is performing well with private sector output growth strong and the rate of job creation at a new survey high in February. This evidence was supported by the HBOS Labour Market Report for February, which reported that the labour market was tighter in Scotland than in the UK.

Against this background we continue to forecast above trend (2%) GVA growth for the Scottish economy in 2006, 2007 and 2008. We expect that the outturn for 2006 will be growth of 2.3%, an improvement on the 2.1% growth achieved in 2005. In comparison the growth of real GDP in the UK in 2006 was 2.8%. Looking forward to the rest of 2007 and 2008, we expect growth will be much the same in Scotland this year just a shade lower at 2.2% and a shade lower again in 2008 at 2.1%. These forecasts compare with the UK Treasury's latest (March) assessment of independent forecasts for the UK economy of an average 2.6% for 2007 and 2.3% in 2008. Service sector growth particularly in real estate and business services and in financial services continues to drive the Scottish growth forecasts. But as we saw earlier in this piece real estate and business service growth in Scotland while strong has tended to be weaker than in the UK. Manufacturing is forecast to have contracted by 0.3% in 2006, displays weak growth (0.2%) in 2007, and much the same performance in 2008 (0.3%). In contrast we expect construction to continue to grow strongly over the forecast horizon while agricultural output remains weak and in decline.

These relatively robust output forecasts continue to drive job creation and a strong labour market in Scotland, although with some sectors managing to generate more output from a given jobs base out jobs forecast is less strong than might have been expected from the output growth projections. Net jobs growth of 11,400 is forecast for 2006, 19,400 in 2007 and 15,600 in 2008. Within these forecast the manufacturing sector continues to shed net jobs: -6,200 in 2006, -1,300 in 2007 and -1,500 in 2008. The employment rate is expected to continue above the UK rate, with in the 4th quarter of 2006 the Scottish rate standing at 76.1% and the UK rate at 74.5%. Unemployment continues therefore to remain low by historical standards with an ILO rate of 5.2% projected for both 2007 and 2008 and a claimant count of 3.3% and 3.2% respectively.

Brian Ashcroft
April 2007

## Endnotes:

iThis section draws, in part, on this lecture to the Institution of Shipbuilders in Scotland "The Role and Importance of Manufacturing in Scotland" which was given on 14 November 2006 and is published by the Centre for Public Policy for Regions (CPPR) at http://www.cppr.ac.uk/media/media_7683_en.pdf

iiThis sector includes the following sub-sectors Real Estate (SIC 70), Renting of Machines & Equipment (SIC 71), and Other Business Activities SIC (72-74). The latter includes Computer & Related Activities (SIC 72), Research & Development (SIC 73), Professional & Business Services (SIC 74.1), Architectural, Engineering & Testing Activities (SIC 74.2 74.3), Advertising (SIC 74.4), and Other (SIC 74.5 - 74.8), which mainly comprises industrial cleaning, recruitment agencies, security services and call centres.

iiiThe Business Services Sector in Scotland", November 2006.

ivThis calculation excludes the letting of dwellings, which is treated as a component of final demand and reflects in large degree the imputed rental values of domestically owned dwellings. When lettings are included this lowers the sales percentage to intermediate demand from 54% to 40%.

**Figure 1: Scottish and UK Quarterly GDP Growth, 1998q2 to 2006q3**

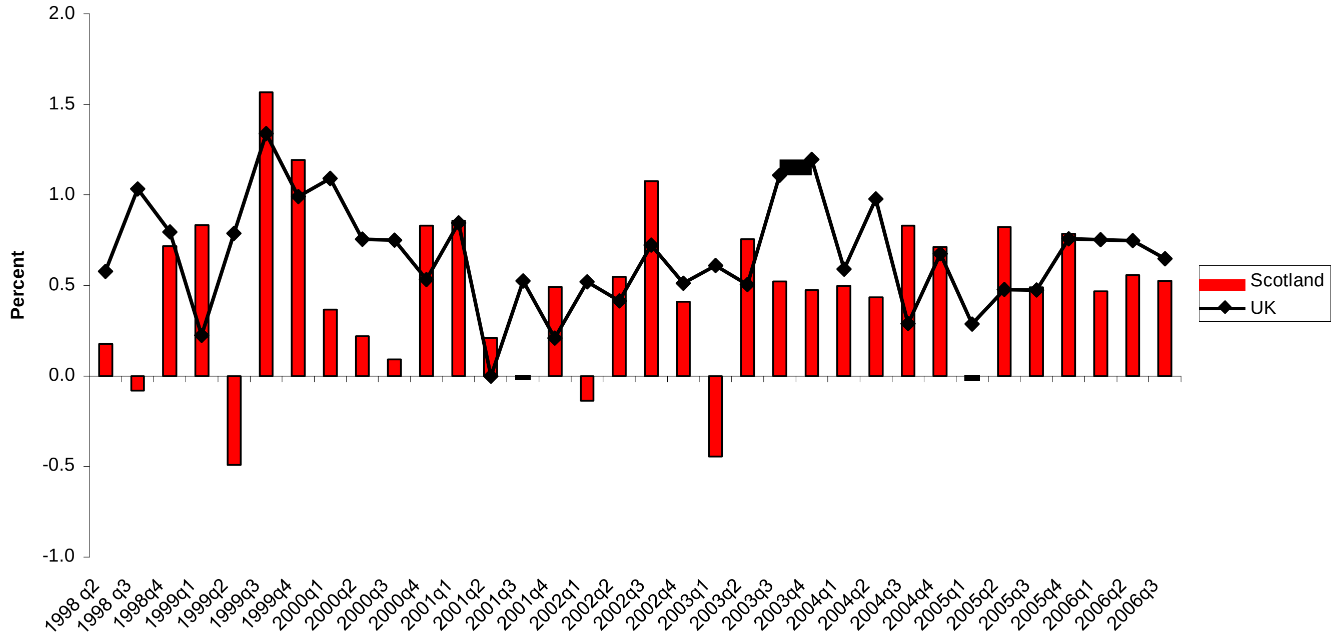



**Figure 2: Scottish and UK Services GVA Growth at constant basic prices 1998q2 to 2006q3**

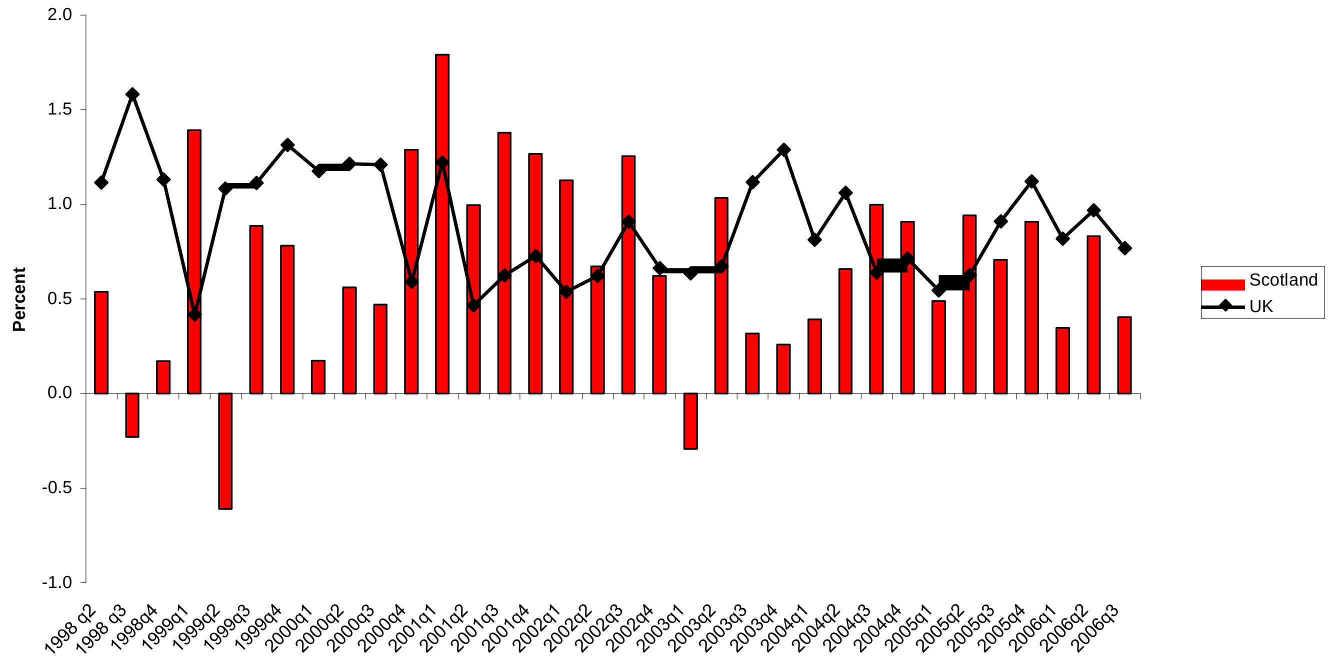


**Figure 3: Scottish and UK Manufacturing GVA Growth at constant basic prices 1998q2 to 2006q3**

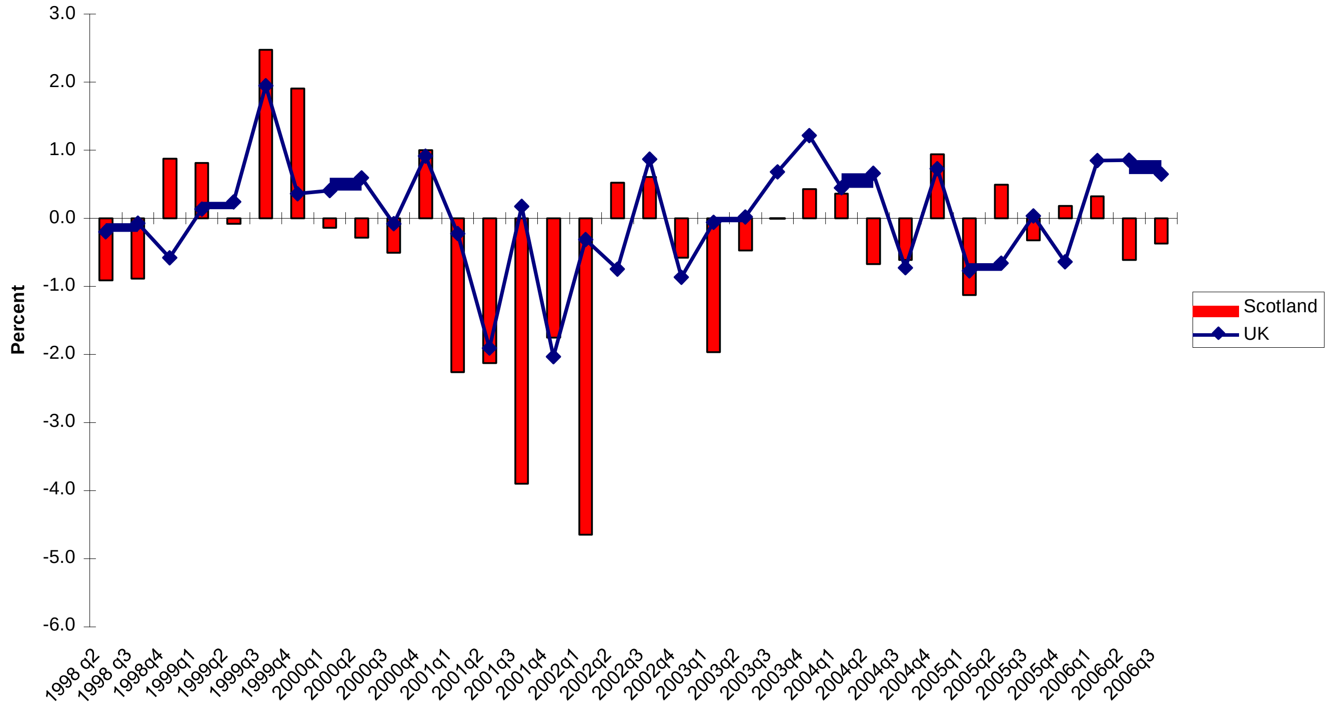
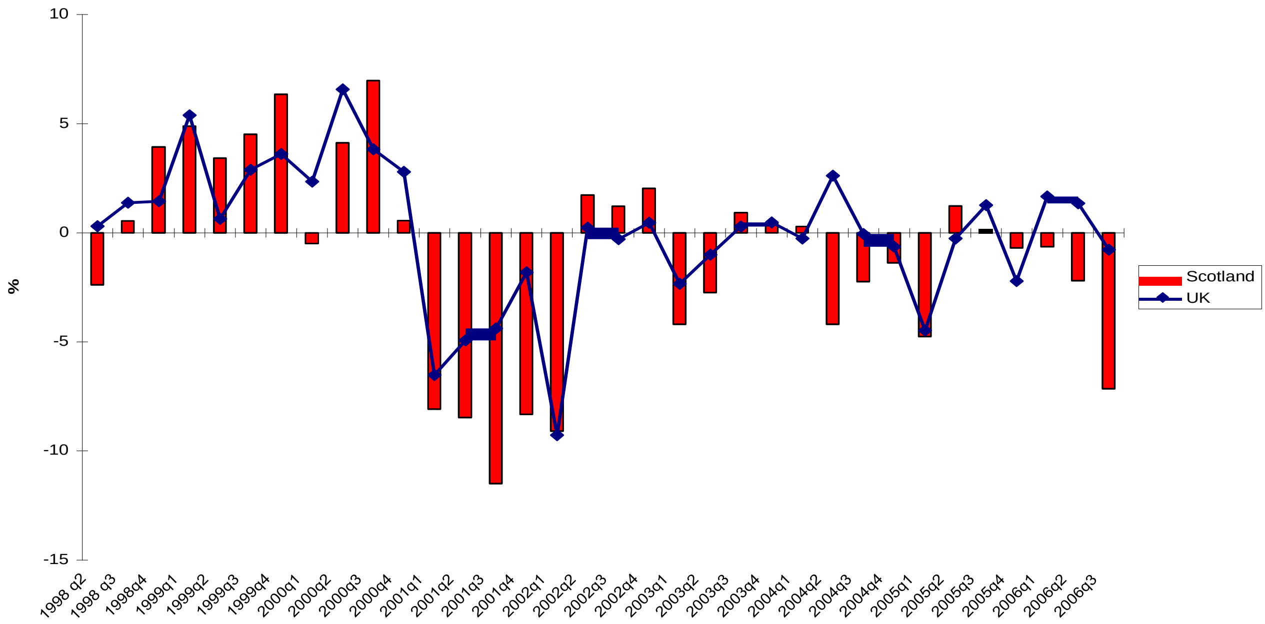
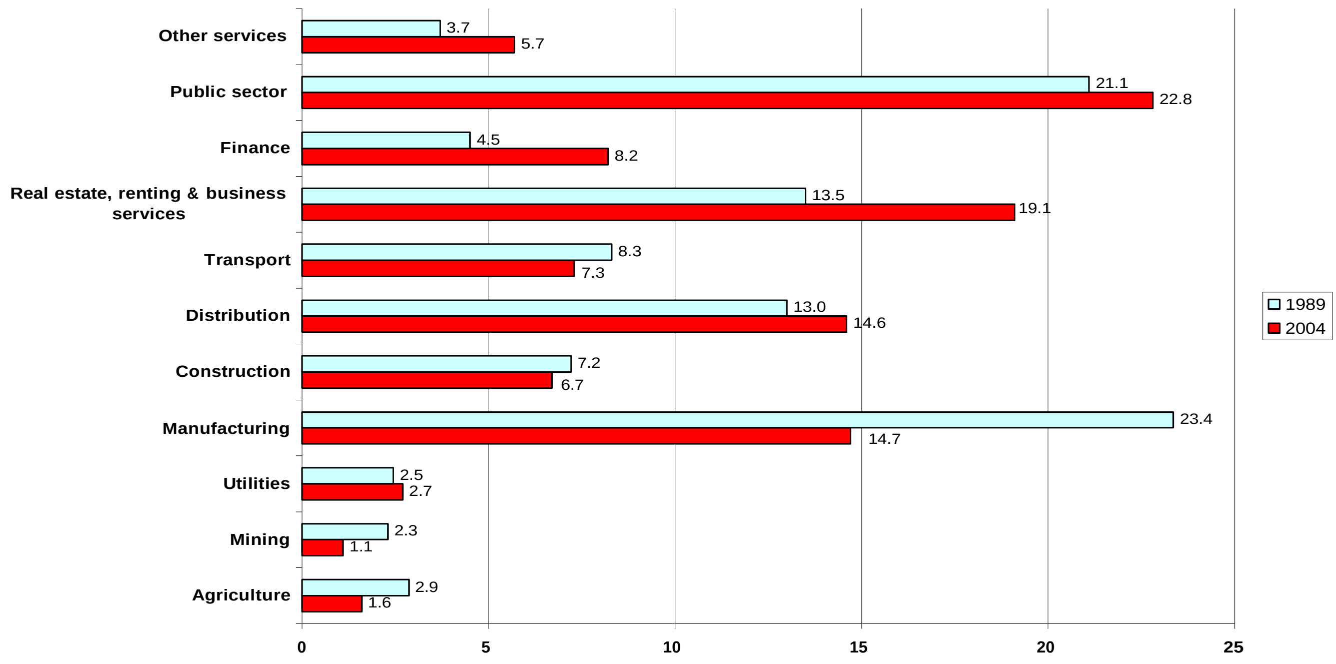



**Figure 4: Scottish and UK Electronics GVA Volume Growth 1998q2 - 2006q3**

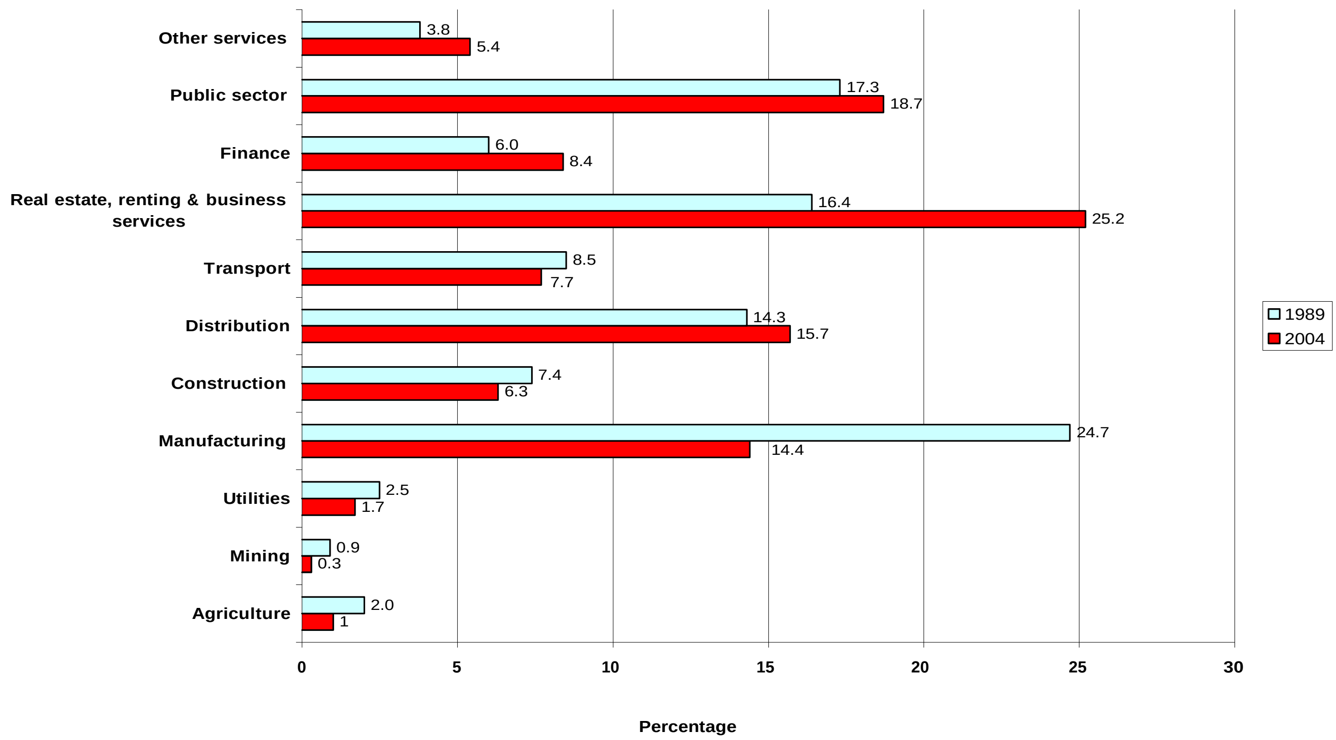


## Figure 5: Scottish Sectoral GVA Shares 1989, and 2004, percentages




Source: ONS Regional Accounts and FAI calculations

## Figure 6: UK Sectoral GVA Shares 1989, and 2004, percentages




Source: ONS Regional Accounts and FAI calculations