Outlook and Appraisal

Overview

Growth in the Scottish and UK economies is weakening as the pace of consumer demand growth slows. However, the relative buoyancy of the housing market in Scotland may be supporting consumption and hence the growth of retail sales compared with the rest of the UK. Manufacturing performance has strengthened a little in Scotland, with some recovery relative to manufacturing in the UK. Transport equipment, chemicals, mechanical engineering and metals have performed strongly in Scotland recently, helping to overcome the continuing weakness of electronics. But the service sector is performing less strongly than the UK, all be it after some growth improvement from weak growth between 2003 and 2004.

A ‘boom’ in the Scottish service sector during the three years from 2000 to 2003 is now evident from the data. This ‘boom’ was not present in the UK and was present in three key sectors: other services, business services & real estate, and transport & communication. It is suggested that such an improvement reflects the research findings of colleagues here at Strathclyde that such an outcome is not inconsistent with a once-and-for-all ‘Headquarters Effect’ following the creation of the Scottish Parliament.

We continue to forecast weaker Scottish growth in 2005 compared to 2004. For our central forecast, we are projecting Scottish GDP growth of 1.8% in 2005, 1.8% in 2006 and 2% in 2007. On the basis of the present published consensus, the UK should grow at 2.4% this year but, in view of the latest evidence, we consider that growth closer to 2.1% in 2005 is more likely. Hence, these forecasts imply that the gap between Scottish and UK growth should certainly narrow this year. We would expect UK growth to pick up again in 2006 to around 2.4% to 2.5%, and still below trend. Associated with our central projection of slowing GDP growth over the next two years is a fairly buoyant Scottish labour market. We are forecasting net job creation of over 20k per annum during the next two years as there are further shifts in favour of the service sector with its greater reliance on part-time, lower productivity jobs.

In view of the recent public interest in migration, we offer additional GDP forecasts based on high and low migration projections. What we see in these different scenarios is that an upsurge in migration does have the potential do boost Scottish GDP growth to parity with the UK this year but not above it. Secondly, a successful *Fresh Talent Initiative* generating around 8, 000 additional net migrants would appear to boost growth by no more than 0.1% points to 0.2% per year. Thirdly, the early years of a high migration scenario can not be held with a great deal of confidence due to the very small sample from the International Passenger Survey from which half of the net in-migration prediction for 2004 is derived. Hence, we have greater confidence in our central projection. But it does appear to be the case that net migration into the Scottish economy has clearly improved and that this will be to the benefit of the Scottish population and economic growth to a lesser extent. We doubt, however, that such an improvement will be sufficient to stabilise the Scottish population in the longer run. This is only likely to come about if there are improvements to Scotland’s birth and total fertility rates.

GDP and Output

The most recent data on the growth of Scottish GDP were published on the 27 April by the Scottish Executive and cover the fourth quarter of 2004. Scottish GDP at basic prices, or Gross Value Added (GVA), rose by 0.6% in the fourth quarter, compared to slightly faster UK growth of 0.7%. And, over 2004 as a whole, Scottish GDP increased by 1.9%, while UK GDP rose by 3.1%.

GDP growth of 0.6% was as forecast in the previous *Commentary* and brings to an end the improvement in quarterly growth that began in the second quarter. During 2004, the economy grew 0.2%, 0.5%, 0.9% and 0.6% in successive quarters. Growth during the last three quarters of 2004 was therefore faster than the quarterly average of 0.45% between 1998Q2 and 2004Q4. But as Figure 1 makes clear, Scottish growth has been consistently below UK GDP growth in 7 of the last 10 quarters.

In the most recent fourth quarter, the weakening of Scottish growth both absolutely and relative to the UK reflected a slowdown in the growth of the service sector here, from 1.3% in the third quarter to 0.6%. The growth of UK services also slowed but by less: from 1% to 0.8%. Manufacturing, on the other hand, improved its performance with growth moving from a 1.3% fall in the third quarter to a 0.8% rise in the fourth quarter. UK manufacturing also improved its growth performance but to a lesser extent, with output falling by 0.7% in the third quarter changing to positive growth of 0.3% in the final quarter of the year. But as Figure 2 shows, Scottish manufacturing performance, despite some volatility, has been strengthening compared to the dark days of 2001 when the whole sector was reeling from the blows of the downturn in IT and electronics production. Its performance remains weak but it has outperformed its UK counterpart in three of the last five quarters. However, this may say more about the problems faced by manufacturing in the UK as a whole rather than indicating a renaissance of Scottish manufacturing. This view is reinforced by the fact that growth in the Scottish sector had deteriorated in three successive quarters prior to the fourth quarter.

In other principal sectors, construction output rose by 0.7% in the fourth quarter and by 7.3% during 2004, compared to 1.2% and 3.7% respectively in the UK. Both electricity, gas and water, and mining and quarrying contracted in the fourth quarter in Scotland and the UK at much the same rates: -0.2% and -2.6% respectively in Scotland and –0.3% and –2.8% in the UK.

Within manufacturing, stronger overall growth in the final quarter of last year was reflected in several sectors, with transport equipment growing by 3.5%, chemicals by 3.2%, mechanical engineering 2.7% and metals 1.3%. However, the important drinks sector contracted by 0.8% and electronics production again declined by 0.7%. Over 2004, the strongest manufacturing sectors of any significance were transport equipment, with growth of 11.1%, followed by food at 1.7%, and mechanical engineering at 1%. The value of electronics production fell 2.7% over the year, while both chemicals and textiles reduced out by 5.5% in 2004.

Within services, the main growth sectors were transport & communications, which grew by 2.5% in the fourth quarter and by 1.7% over the year; hotels & catering, with growth of 1.7% in the quarter and 0.8% over the year; other services, 1.5% and –1%; and retail and wholesale, 0.9% and 2.8%. The weakest service sectors during the quarter were real estate & business services and the public sector with growth of 0.3% and 0.2%, respectively, while the weakest sector over the year was other services, which contracted by 1%. Within financial services, the banking sector continued to exhibit strong growth: 9.7% in the quarter and 15.1% over the year. However, these figures need to be taken together with the *negative* financial services adjustment[i] which for the sector as whole was 2.7% in the quarter and 11.1% over the year. Hence growth of value added in the sector is likely to have been lower.

The 'boom' in Scottish services

Figure 3 compares the growth of services in Scotland and the UK. The most recent performance of the sector in Scotland suggests that it has recovered from the doldrums experienced in the second half of 2003 and the first quarter of 2004. However, our main concern is that, overall, the service sector performance has been weaker relative to the UK over the past eighteen months. Over a period of nearly seven-years from the first quarter 1998, the growth of services averaged 0.7% per quarter in Scotland as against 0.87% in the UK. Yet during the period from 2000Q3 to 2003Q2, or just under three years, service sector growth averaged 0.98% per quarter in Scotland compared to 0.62% in the UK. But in the succeeding period – from 2003Q2 to 2004 Q4 - services grew at only 0.48% per quarter in Scotland compared to 1.01% in the UK.

What accounted for the three-year 'boom' in Scottish services and why did it cease?

Quarterly service sector growth improved by 0.44% points in the three-year 'boom' period 2000Q3 to 2003Q2, and the most obvious 'proximate' cause of this improvement are growth improvements within specific service sectors. An analysis of these changes suggests that growth improvements in 3 sub-sectors: other services, business services & real estate, and transport & communication accounted for the bulk of the change with each of the sectors contributing 38%, 33% and 27% respectively of the overall improvement. And the 'proximate' reason for the cessation of the 'boom' is that the growth improvement in the same three sectors ended, with deterioration in the performance of other services, business services & real estate, and transport & communication contributing 32%, 36% and 23% respectively of the overall deterioration in services.

We cannot be certain why the service sector boomed. But it is interesting that the boom came from just three sectors: other services, business services & real estate, and transport & communication, and that the same three sectors accounted for the worsening after the boom. This suggests that there may have been some common influence on the three Scottish sectors. And there is no similar effect in the UK, either on services in the aggregate, or on the same three sectors.

One explanation that is not inconsistent with above facts is that the 'boom' was the consequence of the creation of the Scottish Parliament, which may have generated a once-and-for-all 'Headquarters Effect', as public relations, lobbyists, media and other service providers raised the level of their activities in Scotland. Growth would increase for a while until the desired equilibrium activities were established and would then return to its earlier position. Research by Ashcroft, McGregor and Swales, here at the University of Strathclyde, suggests that a model of Scottish economic growth breaks down after 1999, with the expected economy-wide recession due to the manufacturing downturn failing to emerge in 2001 and 2002. However, once allowance is made statistically for an 'exogenous event' post 1999 the anomaly is removed and the model explains Scottish growth well again. The only 'exogenous event' that fits with the changes in the data is political devolution.[ii]

What is disappointing about all this evidence is that the effect of the 'exogenous event' on the growth of services has now ceased and since the second quarter of 2003 the sector has been growing at roughly its trend, or historic, rate of 0.5% per quarter. So, the hope that renewed vigour in business services, communications and other services along with sustained growth in financial services might serve to shift the Scottish economy to a higher growth path, appears to have been dashed. Only time will tell whether such a conclusion is warranted.

Outlook

There is little doubt that growth in the UK is slowing as the growth of domestic demand slows due to a marked slowdown in consumer spending, some moderation of government consumption spending and a weakening of domestic investment. GDP growth is further dampened as net trade (exports minus imports) continues to contribute negatively to growth. The growth of world trade remains relatively buoyant but fairly weak growth in the Euro zone, the UK's principal export market, will dampen any improvement in exports.

The Treasury's comparison of independent forecasts in June suggests an average expectation of 2.5% growth during 2005 and 2.4% in 2006. However, the 'new' forecasts alone predict slower growth of 2.4% and 2.3%, respectively, reflecting later information on the slower growth of consumer demand. The latest revisions to data on the UK economic aggregates suggest that the slowdown in UK domestic demand and UK economic growth since the third quarter of last year has been greater than previously thought. The latest *Blue Book* from the ONS indicates stronger UK growth in 2002 and 2003 and early 2004 but slightly weaker growth thereafter. GDP growth for the first quarter of this year was revised down to 0.4% with growth over the year averaging 2.1%, down from 2.7%. Underpinning this decline is a sharp slowdown in the growth of consumer spending, with growth now estimated to have been 0.1% during the first three months of the year, compared to the earlier estimate of 0.3%. This was the lowest growth in nearly four years. Other indicators show consumer confidence declining into the second quarter. All of which suggests that UK growth will almost certainly be below trend in 2005 and may not be much more than 2%.

We do not as yet have data on Scottish GDP growth for the first quarter of 2005. The PMI Scotland Report produced by the Royal bank of Scotland and the Scottish Chambers' Business Survey (SCBS) both suggest that the Scottish economy continued to exhibit positive growth in the first quarter. For the monthly PMI, growth slowed in January but then picked up in February, March and April, with some slowdown indicated in May. For the SCBS, demand strengthened in tourism, especially, as well as in construction and manufacturing. In the CBI survey of manufacturing for the three months to April the growth of new orders slowed almost to a halt but output growth held up at a slower rate than in the fourth quarter of 2004.

Both the SCBS and the SRC/RBS Retail Sales Monitor suggest that the growth of retail sales slowed during the first few months of the year. However, while growth appears to be slowing Scottish retail sales may be holding up better than in the rest of the UK. One possible reason for this is the strength of the housing market in Scotland compared to the rest of the UK. Empirical evidence has indicated that the link between consumer spending and house price inflation in the UK was not strong but the latest data for the UK suggests that the relation may be stronger than previously thought. If so, this suggests a clear reason for the better Scottish retail sales performance.

Against this background there are several conflicting forces influencing Scotland's growth performance relative to the UK. Manufacturing and retailing may be strengthening in Scotland relative to the UK but tradable services appear weaker here. For these reasons our model continues to forecast slightly weaker growth in 2005 compared to 2004. For our central forecast, we are projecting Scottish GDP growth of 1.8% in 2005, 1.8% in 2006 and 2% in 2007. On the basis of the present published consensus, the UK should grow at 2.4% this year but, in view of the latest evidence, we consider that growth closer to 2.1% in 2005 is more likely. Hence, these forecasts imply that the gap between Scottish and UK growth should certainly narrow this year. We would expect UK growth to pick up again in 2006 to around 2.4% to 2.5%, and still below trend

Associated with our central projection of slowing GDP growth over the next two years is a fairly buoyant Scottish labour market. We are forecasting net job creation of over 20k per annum during the next two years as there are further shifts in favour of the service sector with its greater reliance on part-time, lower productivity jobs.

Migration scenarios

It is becoming increasingly evident that there is growing uncertainty about the prospect for net migration into the Scottish economy. Our central GDP projection is based on the Government Actuary Department's (GAD) 2003 central projection for Scotland. This projects net migration into Scotland of 12,000 in 2004, 7,500 in 2005, 3,000 in 2006 and –1,500 per annum thereafter. It appears highly likely that later this year GAD will revise upwards their post 2006 projections. Net migration into Scotland has strengthened in the last few years. One estimate for the year to mid 2004 is that net migration into Scotland was 26,000, comprising principally 15,000 NHS patient movements and 11,700 in-migrants from abroad. But, the latter figure is based on a sample of only 130 from the International Passenger Survey. Added to this the inflow of NHS patient transfers dropped considerably in the first quarter of 2004. It is therefore understandable that the GAD central projections are more conservative.

Nevertheless, in view of the interest in migration, the increasing uncertainty about the outturn for net migration and the publicity surrounding the First Minister's *Fresh Talent Initiative*, we have decided to offer additional GDP forecasts based on a high and low migration projections. We assume, rather simplistically, that migrants have the same characteristics as the Scottish population as a whole and therefore contribute to GDP at the same rate as the average GVA per head of the population, with a one-year lag. Obviously, other things equal, different migration characteristics will have a different impact on GDP. Moreover, we are neutral about the impact of migrants on the Scottish labour market, ruling out negative displacement effects and positive multiplier/spill-over effects. No doubt the research funded by the ESRC and the Scottish Executive on the impact of migration on the Scottish economy that is currently being undertaken by academic colleagues will test and refine these assumptions.

High migration projection

Under this scenario net migration into Scotland amounts to 26,000 in 2004, 13,000 in 2005, 6,000 in 2006 and 7,000 in 2007 and thereafter. The GROS concur with this high projection for 2005 and 2006 and we draw on GAD's 2002 high projection for 2007 and 2008. The longer-term implications of this projection imply a successful *Fresh Talent Initiative*, assuming that the counterfactual is GAD's central projection, with around 8,000 plus extra migrants attracted into Scotland each year. On this basis, we predict that Scottish GDP would grow at 2.1% in 2005, 1.6% in 2006 and 1.9% in 2007. This projection therefore suggests that on the basis of 26,000 net migrants in 2004, Scottish economic growth could equal UK growth. However, growth weakens in 2006 and 2007 because GDP in the previous year is higher and the size of expected net in-migration is falling from the 26,000 in-migrant peak. Thereafter the extra migrants add between 0.1% and 0.2% to Scottish GDP growth and this would appear to be a broad order of magnitude for the GDP growth dividend from a successful *Fresh Talent Initiative*, subject to the validity of the assumptions noted above.

Low migration projection

Under this scenario net migration into Scotland amounts to 6,000 in 2004, 3,000 in 2005, -1,500 in 2006 and -5,000 in 2007 and thereafter. In the light of the upturn in migration we have adjusted upwards GAD's low projection of 2002. The effect on GDP growth is largely insignificant, with the projected growth rate for 2005 reducing to 1.6% and growth being much the same as the central forecast thereafter – lying within 0.1% points.

What we see in these different scenarios is that first, the upsurge in migration does have the potential do boost Scottish GDP growth to parity with the UK this year but not above it. Secondly, a successful *Fresh Talent Initiative* generating around 8, 000 additional net migrants would appear to boost growth by no more than 0.1% points to 0.2% per year. The impact could be greater but it would have to be demonstrated how the net contribution of an additional migrant would add more to GDP than the average GDP per head. Thirdly, the early years of the high migration scenario can not be held with a great deal of confidence due to the very small sample from the International Passenger Survey from which half of the net in-migration prediction for 2004 is derived. Hence, we have greater confidence in our central projection. Finally, net migration into the Scottish economy has clearly improved and this will be to the benefit of the Scottish population and economic growth to a lesser extent. We doubt, however, that such an improvement will be sufficient to stabilise the Scottish population in the longer run. This is only likely to come about if there are improvements to Scotland's birth and total fertility rates.

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[i] This is necessary because the nature of commercial transactions by financial institutions differs from most other sectors. Much of the income for such institutions, and especially banks, does not come from direct charges for service but from the difference between interest paid and received. This difference is added into the value added calculation but overstates value added because the unknown cost of purchases is included. The financial services adjustment allows for the inflating effect of this in overall GDP by subtracting the imputed charge.

[ii] B Ashcroft, P McGregor and J K Swales "Devolution and the Scottish Economy" paper presented to ESRC Devolution20 Theme Conference, Edinburgh, 18 March 2005.

Figure 1: Scottish and UK Quarterly GDP Growth, 1998q2 to 2004q4

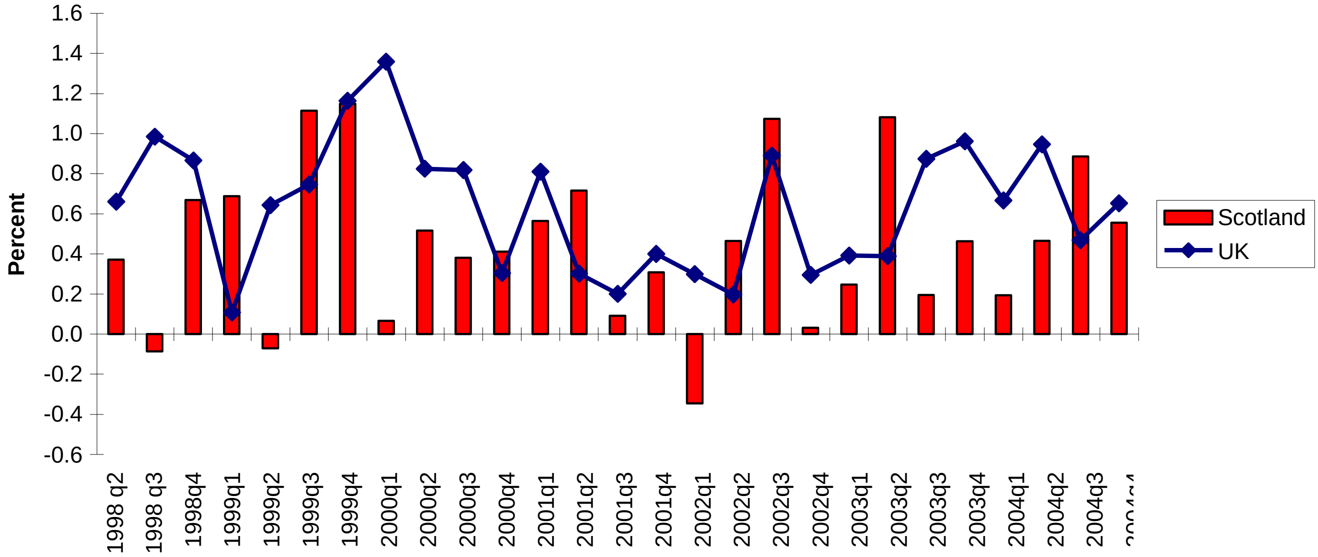

Figure 2:Scottish and UK Manufacturing GVA Growth at constant basic prices 1998q2 to 2004q4

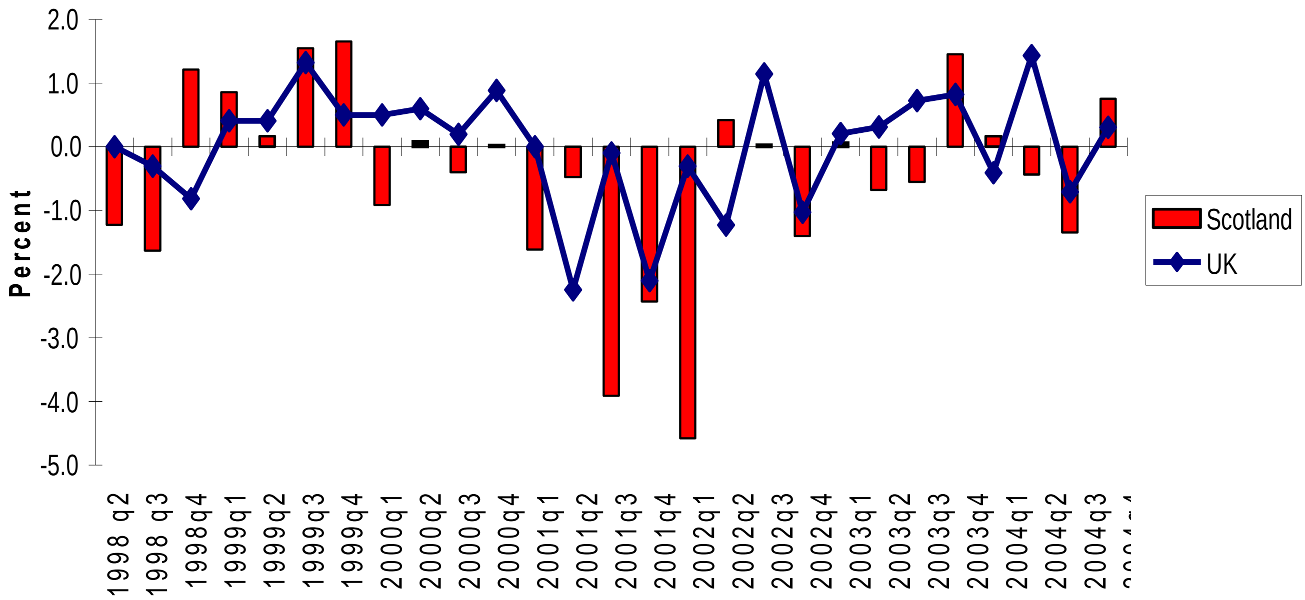

Figure 3: Scottish and UK Services GVA Growth at constant basic prices 1998q2 to 2004q4

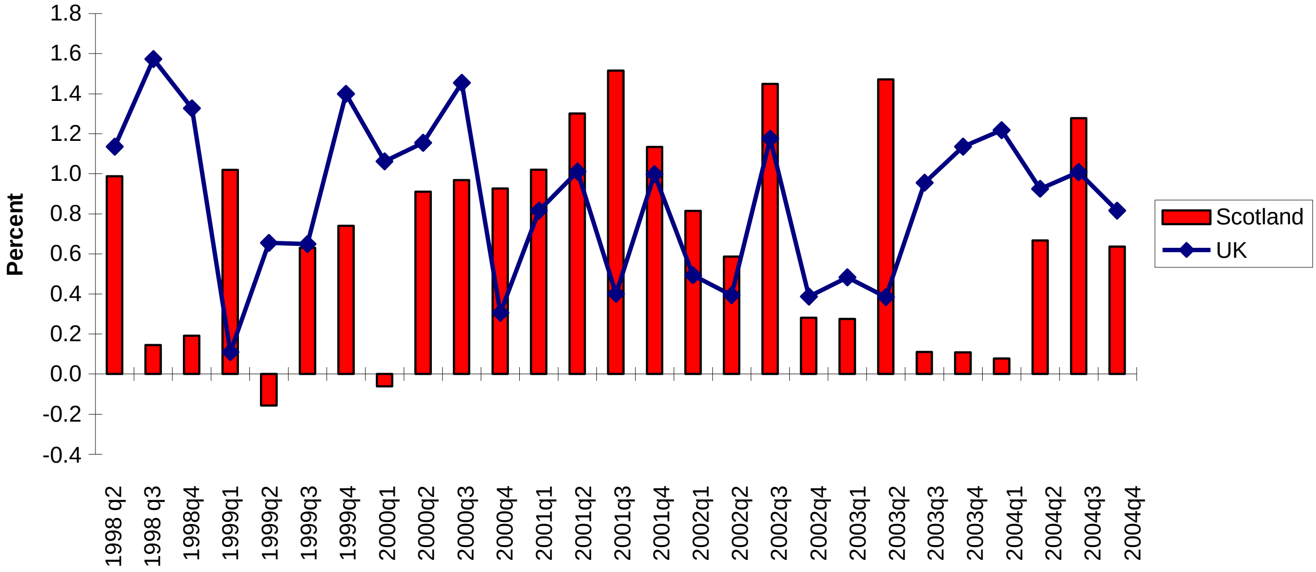

Figure 4: Growth of Key Sectors 1998Q1 to 2004Q4