Outlook and appraisal

Overview

The Scottish economy appears to have grown more quickly in the second half of last year. A further strengthening in the growth of the service sector, led by finance, real estate & business services and transport services, appears mainly to account for the improvement. Manufacturing remains weak and with falling output its contribution to growth is negative. Electronics output growth further deteriorated in the third quarter of 2004 falling by 4.1% giving greater cause for concern as to the future prospects of the industry in Scotland. Over the year Scottish growth remained much weaker than UK growth at 1.8% compared to 3.2%.

A detailed analysis is provided of Scotland's economic growth performance between 1998 and 2004, both before and after the onset of the recession in electronics and manufacturing post 2000. The main conclusions of this analysis are that:

Vol.29 No.4, pp.3-11.

- Scottish growth averaged 70% of the UK growth rate; in both Scotland and UK business services/real estate was the principal driver of growth;
- the public sector grew at the same rate in Scotland and UK but played a stronger role in Scottish growth due to its greater weight and the slower growth of the private sector here;
- both Scottish and UK economies experienced a slower rate of growth after the third quarter 2000 when the electronics industry and wider manufacturing went into recession, a recession that was much more severe in Scotland;
- during this latter period Scottish growth paradoxically held up better than UK growth because improvements in the growth of business services/real estate, other services, the public sector, transport, hotels & catering and retail & wholesale more than compensated for the effect on growth of the manufacturing downturn;
- a weakening of financial services, utilities & mining and construction growth accounted for the overall slower growth in the 2000 to 2004 period;
- the implications of this analysis for policy are considered, with policy encouraged to capitalise on the success of financial services and the potential offered by business services as well as maintaining efforts to encourage manufacturing to invest in Scotland.

Growth in the world economy remains relatively strong, although some slowdown is expected in 2005 from the near 4% growth rate achieved last year. UK growth appeared to falter markedly in the third quarter of last year but picked up again in the final quarter. Scottish growth was relatively strong in the second half of the year but concerns about manufacturing persist. With this in mind, we are forecasting growth of 2% in Scotland in 2004 with slightly lower growth of 1.7% in 2005 and 1.5% 2006, followed by a return to trend growth. Net job creation remains positive and low rates of unemployment continue.

GDP and Output

The latest Scottish Executive GDP data were published on 26 January and cover the third quarter of last year. Scottish GDP at basic prices, or Gross Value Added (GVA), rose by 0.9% in the third quarter, faster than UK growth of 0.5%. But over the year to the third quarter Scottish GDP growth was weaker at 1.8% compared to 3.2% in the UK. Yet, the latest data indicate that Scottish growth improved consistently during 2004, with successive quarterly growth rates of 0.1%, 0.6% and 0.9%.

The improvement in Scotland's growth performance in the third quarter is largely explained by a robust performance from the service sector, which grew by 1.3% compared to 0.8% in the second quarter and an almost stagnant outturn (0.03%) in the first three months of 2004. With UK services growing by 0.8% in the third quarter, the strength of services also appear to account for Scotland's overall better growth performance than the UK during this period. Construction, in contrast, only grew by 0.4% in Scotland compared to 1.2% in the UK. However, weaker Scottish growth in the third quarter was not sufficient to erode Scottish construction's growth advantage over the year to the third quarter with growth of 8.4% contrasting favourably with growth of 4.5% in UK construction.

Sadly, manufacturing in Scotland made no contribution to the overall improvement in the growth of the Scottish economy in the third quarter. Indeed, with GVA falling by 1.1%, compared to a fall of 0.8% in UK manufacturing the contribution of manufacturing was negative both to absolute Scottish growth and to performance relative to the UK. Moreover, the performance of Scottish manufacturing has deteriorated progressively over the last four quarters with successive growth rates of +1.3%, +0.2%, -0.2% and -1.1%. In contrast, the performance pattern of UK manufacturing is much more mixed, with growth of +0.6%, -0.3%, +1.2% and -0.8% respectively in the last four quarters. The progressive deterioration in the performance of Scottish manufacturing during 2004 is clearly a cause for concern.

Within manufacturing, performance was generally weak in the third quarter. The main exceptions to this pattern were the metals, drink, mechanical engineering, and paper, printing and publishing sectors, which grew by 2.6%, 1.6%, 1.2%, and 0.5% respectively. But at the other extreme, electronics contracted by 4.1% in the quarter, transport equipment reduced its output by 3.1%, food production fell by 2%, other manufacturing suffered a 0.8% fall, chemicals lost 1.8% of its output and textiles experienced a decline of 3.8%. Given that electronics accounts for 22% of manufacturing, the weakness of that sector played a key role in the overall weakness of manufacturing in the third quarter. With electronics growth of +2.8%, +1.1%, -3.2%, and -4.1% in the last four quarters there was a more marked weakening than in manufacturing as whole. Hence, the deteriorating performance of Scottish electronics gives rise to an even greater cause for concern.

In services, the financial sector turned in the strongest performance in the third quarter growing at 3.5%, with the banking sector, accounting for around 45% of GVA in finance,

growing by 7.2%. Real estate and business services, which contributes 26% of service sector output and is the largest private sector component of services, grew by 1.7%. Transport services grew by 1.7%, hotels & catering by 1.5% and public admin, education and health grew by 0.8%. With the exception of retail and wholesale, and other services all the principal service sectors grew faster in Scotland than in the UK in the third quarter. UK retail and wholesale grew by 0.9% whereas the sector in Scotland could only manage 0.5% and other services grew by 0.4% in Scotland but by 1.1% in the UK. Finally, over the year to the third quarter Scottish sectors were generally weaker with the exception of financial services and the public sector. Financial services grew by 6.5% over the year in Scotland compared to 4.1% in the UK, while public admin, education and health grew by 2.4% here and by 1.9% in the UK.

GDP growth between 1998 and 2004

With the recent publication of the GDP data for the third quarter of last year, it is now four years since the electronics sector began to go into recession (Figure 1). Within six quarters – 2000Q3 to 2002Q1 – the sector lost 38% of its output volume and since then the industry has largely stagnated, in fact cutting back output volumes by a further 4% on the 2000Q3 peak. Over those four years, 2000Q3 to 2004Q3, the GVA of manufacturing fell by 14% and Scottish GDP growth averaged 0.44% per quarter compared to 0.54% per quarter in the UK, or 81% of the UK average. So, can we with confidence conclude that the recession in electronics slowed the growth of the Scottish economy?

The answer to this question is more complicated than might appear at first sight.

Using the published Scottish Executive GVA data, we estimate that the average quarterly growth of GDP in the Scottish economy between 1998Q1 and 2000Q3 was 0.48% compared to 0.82% in the UK. These average rates for the sub-period and the whole period 1998Q3 to 2004Q3 are presented in Table 1.

Table 1: Average quarterly GDP growth rates: percentages

	1998Q1 to 2000Q3	2000Q4 to 2004Q3	1998Q1 to 2004Q3
Scotland	0.48	0.44	0.46
UK	0.82	0.54	0.64

So, the UK was growing more than 70% faster than Scotland in the 10 quarters prior to the onset of the electronics recession. In the subsequent 16 quarters, while both economy's slowed down, Scotland improved its performance – on these data – relative to the UK, with the UK only growing 23% faster. Moreover, despite the contraction in electronics and manufacturing being so much greater in Scotland than in the UK, it was the UK growth rate that slowed down more rapidly than the Scottish rate. In the period 2000Q4 to 2004Q3, the UK's rate of quarterly growth was only 66% or two thirds of the earlier period while Scotland's rate of growth held up relatively better at 92% of the earlier rate.

These changes in the aggregate rate of growth at both Scottish and UK levels beg the questions: what were the sectoral drivers of growth and what changes emerged between the two periods?

Figure 2 highlights the relative sectoral contributions to overall GDP growth in Scotland and the UK during the first period: 1998Q1 to 2000Q3. The figure indicates that in both jurisdictions real estate and business services was the principal sectoral driver of growth, contributing 31% and 38% to growth in Scotland and the UK respectively. In moving to the second most important driver, the importance of financial services to Scotland is clearly signalled, with a 27% contribution to growth compared to only 6% in the UK. With a 21% contribution to UK GDP growth transport and communication services were clearly much more important to growth in the UK as a whole than in Scotland where the relative contribution of the sector was 8%. Of the remaining sectors, public admin, health and education – the "public sector" – contributed 18% to growth in Scotland, more than the 15% contribution of the sector in the UK. Yet, the growth of the public sector was more or less equal in Scotland and the UK averaging 0.57% per quarter in both jurisdictions between 1998Q1 and 2004Q3. It is worth noting the strength of Scottish construction and the relatively small contribution from manufacturing of 5% to Scottish growth and 6% to UK growth, even before the onset of the electronics recession.

Figure 3 takes the sectoral analysis of the 1998Q1 to 2000Q3 period a stage further by revealing the absolute contribution of each sector to Scottish and UK growth, where the sum of the growth in each sector gives economy wide growth. Since the UK grew 70% faster than Scotland during the period the length of the UK bars is generally higher relative to their Scottish counterparts but not in every sector. This analysis further highlights the strength during the period of business services/real estate, transport services, retail & wholesale and other services in the UK compared to Scotland, and finance and construction in Scotland compared to the UK.

Moving now to the second period: 2000Q4 to 2004Q3, Scotland's overall growth held up relatively better than the UK, despite a much deeper recession in electronics and manufacturing as a whole. Why was this so? Figures 4 and 5 provide some answers.

First, we note from Figure 4 that in Scotland the measured contribution of the public sector to growth almost doubled between the two periods, from an 18% contribution in the first period to a 34% contribution in the second. Secondly, the contribution of business services/real estate rose to almost 50%, much the same as the contribution made by the sector to UK growth in the period. The powerful effect of the fall in electronics and wider manufacturing activity on Scottish growth

is clearly signalled by the negative 38% contribution of the sector to growth in the period. But what is interesting is that the performance of other sectors improved enough to more than compensate for the negative effect of the manufacturing recession on Scottish growth. This is made clear in Figure 5.

A comparison of Figure 5 with Figure 3 reveals that 6 sectors from the 11-sector disaggregation improved their average performance and absolute contribution to Scottish growth between the two periods. These were: business services/real estate (+0.07% points), other services (+0.07% points), the public sector (+0.06% points), transport & communication (+0.05% points), hotels & catering (+0.04% points), and retail & wholesale (+0.02% points). The combined effect of improvements in growth in these sectors was to raise average quarterly growth by 0.31 percentage points. The electronics and manufacturing recession cut growth by 0.18 percentage points but a deterioration in the growth of financial services (-0.06% points), utilities & mining (-0.05% points), construction (-0.04% points) and the financial services adjustment factor (-0.03% points) - made for technical reasons – resulted in Scottish GDP growth being 0.04% points to 0.05% points lower in the later period.

In the United Kingdom, in contrast, only three sectors improved their average performance and absolute contribution to growth: construction, hotels & catering, and retail & wholesale, with the only significant improvement occurring in construction (0.08% points). Of the other sectors experiencing deteriorating performance, all be it from a strong growth performance in the first period, the biggest slowdown was in transport services, which while still growing reduced its contribution to growth by more than manufacturing. Three other sectors made a reduced contribution to growth in this later period while their counterparts in Scotland improved their role in growth: business services/real estate, the public sector and other services.

In conclusion, there are several important messages in these data both for an understanding of the recent performance of the Scottish economy and for policy.

First, throughout the period Scottish GDP growth was weaker than UK GDP, on average about 70% of the UK growth rate over the six and a half years.

Secondly, in both Scotland and the UK, and throughout the period, business services/real estate was the principal sectoral driver of growth.

Thirdly, the public sector, and finance, play a stronger role in growth in Scotland than they do in the UK. The growth of the public sector was not unimportant in the UK – rank 3rd over whole period – while transport & communication services played a strong role in both jurisdictions over the period: rank 4th in both Scotland and UK. Retail & wholesale contributed more strongly to UK growth - rank 2nd – than Scottish growth – rank 5th. Weaker overall growth of incomes might explain the relative weakness of retail & wholesale in Scotland, which largely serves local markets but planning restrictions might also be a factor as well as market wealth and size.

Fourthly, both Scottish and UK economies experienced a slower rate of growth after the third quarter 2000 when the electronics industry and wider manufacturing went into recession, although the recession was much more severe in Scotland. But manufacturing was making only a small contribution to overall growth before that recession in both the UK, 6%, and Scotland, 5%. Moreover, the performance of other sectors improved enough to more than compensate for the negative effect of the manufacturing recession on Scottish growth. Chief amongst these were performance improvements in business services/real estate, other services, the public sector and transport & communication services.

Fifthly, deterioration in the growth performance of financial services, utilities & mining, and construction, as well as the large shock from the decline of manufacturing, accounted for the weaker growth rate of the Scottish economy after 2000Q3. But it would have been much worse if business services/real estate, other services, the public sector and transport & communication services had not "raised their game." What is not understood is the extent of the causal link, if any, between the recession in electronics and manufacturing and the weaker performance of finance, utilities & mining, and construction.

Finally, there are some implications for policy.

The public sector appears to have played a positive role in Scottish growth throughout the period and through an acceleration of growth after 2000Q3 in mitigating the effects of manufacturing recession. This gives rise to two concerns. First, the measurement of public sector outputs is notoriously difficult and as far as we understand Scottish public sector output is still measured by the volume of input, whereas in the UK some tentative steps have been taken to measure output and productivity. So, in comparing the performance of the public sector in Scotland and the UK we may not be comparing like with like. Secondly, the growth of the public sector in the medium term is unlikely to be as strong as in the period of the present analysis. Despite the public sector growing at the same rate in Scotland as the UK Scotland has relied relatively more than the UK on public sector growth because the private sector on average grew more slowly here and because the share of the public sector – on this definition – is greater: 22% compared to 18% in UK. The question therefore arises whether Scotland can find sources of private sector growth to compensate for a slowdown and possible decline in the volume of public sector output.

Table 2 presents the results of simulations of Scottish economic growth over the period 1998q2 to 2004q3.

The simulations operate to suggest what the Scottish GDP growth rate would have been over the period if certain UK characteristics had applied rather than the specific Scottish ones. Row b indicates that Scottish GDP growth would have been 5 percent points faster than the actual rate if Scotland

had had the UK industrial structure rather than its own. By and large, the application of UK industrial weights makes little difference to Scottish growth suggesting that Scotland's slower growth relative to the UK is not due to the structure of Scottish industry being biased towards slow growth sectors. However, as we shall see below, there is one key growth sector, which is significantly under represented in Scotland.

Table 2: Scottish average quarterly growth 1998q2 to 2004q3

Simulations		UK = 100
a.	Actual	70
b.	At UK sectoral weights	75
c.	At UK sectoral growth	93
d	At UK manufacturing growth	85
e.	At UK Retail etc growth	78
f.	At UK Transport Service growth	73
g.	At UK Business Service growth	75
h.	At UK Business Service growth & weight	81
i.	At UK Manufacturing, Retail, & Wholesale, Business Services/Real Estate & Transport growth	99
k.	At UK Manufacturing, Retail & Wholesale, and Business Services/Real Estate growth	97
l	At UK Manufacturing, Retail & Wholesale, and Business Services/Real Estate growth & Business Service/RE weight	101
m	At UK Manufacturing, Retail & Wholesale, Business Services/Real Estate, and Transport growth and Business Service/RE weight	104

Row c indicates that Scottish growth would have risen from 70% to 93% of UK growth during the period if all of its industries had grown at the same rate as its UK counterparts. This analysis therefore suggests, what many would accept, that Scotland suffers from a "growth problem" not an "industrial structure problem", which is due, for the most part, to given sectors tending to grow more slowly here than their counterparts in the UK as a whole. But we know that there are clear exceptions to this general picture, for example financial services has consistently grown faster in Scotland than in the UK.

Rows d, e, f, and g, suggest what would have happened to Scottish growth if a key Scottish industry had enjoyed the growth experienced by its UK counterpart. Row d confirms the sizeable effect that the electronics recession and weak Scottish manufacturing growth had on overall growth. When Scottish manufacturing growth is replaced by the growth rate of UK manufacturing, Scottish growth rises from 70% to 85% of the UK rate. When the same procedure is applied to growth in retail & wholesale, transport services and business services/real estate, Scottish growth increases to 78%, 73% and 75% of the overall Scottish growth rate, respectively.

Row i indicates that with UK growth rates of manufacturing, retail & wholesale, transport and business services applied together, overall Scottish growth would have almost equalled, 99%, UK growth during the period.

Rows h, l and m make one further adjustment. The share of business services/real estate in total UK GDP is almost 24% whereas in Scotland the share contributed by the sector to overall GDP is just above 18%. Since this sector is also the fastest growing sector, the significantly smaller share in Scotland is a key reason for slower overall Scottish growth. Hence row m applies the UK business service/real estate weight to Scotland as well as the UK growth rates in the other mentioned sectors. This is sufficient to push Scottish growth 4% above UK growth. Even with the replacement of the UK growth rate of transport services by the Scottish rate, row l, produces an overall Scottish growth rate 1% above the UK rate.

So, what might this mean for policy?

First, if we assume that the IT and manufacturing recession, which in the UK context was largely specific to Scotland, was a one-off event then we might expect over the medium to longer term that the growth performance of the sector would move back towards the UK average, either somewhat above or below, which has been the historical pattern. It is unlikely that the future gap between the performance of Scottish and UK manufacturing will be as large as it was between 1998 and 2004. Yet policy needs through RSA, Jobs for Growth and other measures to continue to encourage manufacturing to invest in Scotland, to overcome the relative peripherality of Scotland and offset to some degree the attractions of lower labour cost locations.

Secondly, the importance of the financial sector in boosting Scotland's economic performance has perhaps not been stressed enough in the above analysis. However, one simulation should make this clear. If as in row c we apply UK sectoral growth rates to Scottish industry across the board but excepting financial services – in other words continue to apply the Scottish rate in that sector – then overall Scottish growth rises not to 93% but to 101% of the UK. It follows that the Executive needs to continue to work with the industry to ensure that there are no future impediments to sustained growth, for example, in the supply of suitably skilled labour, and the availability of appropriately serviced land for development. This requires integrated policies focused on growth in general and the financial sector in particular, embracing housing, transport, planning and the labour market.

Finally, the contribution to Scottish growth of raising the growth of retail & wholesale, transport services and business services to UK levels is clear. However, what is less clear is the extent to which some of these services will only grow faster if the economy as a whole grows faster. One would expect that this is the case for retail & wholesale, although planning restrictions may be an exogenous factor limiting growth that policy, in principle, could overcome. In general, it would appear to be the

tradable or mobile elements of business services and transport that offer the greatest scope for policy encouragement.

If the UK experience is anything to go by then business services/real estate offer the most scope for expansion if the Scottish conditions are right. Around 45% of the activity in the Scottish sector comprises real estate activities, both domestic and commercial. A further 5% embraces the renting of machinery and equipment. Most of these activities will tend to be driven by local economic development rather than a driving factor in themselves. Business services per se account for the remaining 50% of the sector. Such services, which embrace computer and related activities, research and development, professional and business services, architectural, engineering and testing activities, advertising and other, are inherently more mobile and tradable. Scotland has suffered over the years from a loss of HQ functions and a failure to develop business R&D on a scale comparable to the UK and the south of England in particular. It may be the case that Scotland's peripherality will continue to work against it. But the evidence presented here suggests that it is the promotion and development of business services that offers some of the best opportunities for policy to raise Scotland's overall rate of growth.

Outlook

Growth in the world economy remains relatively strong, although some slowdown is expected this year from the near 4% growth rate achieved last year (see World Economy section). The US is forecast to have grown at around 4% last year, with growth continuing towards the end of the year but with some unanticipated weakening of exports, suggesting weaker than expected growth elsewhere. Growth in the US is forecast to slow to around 3.4% in 2005. The Japanese economy remained weak in the middle of the year, although forecasts suggest growth of 3.8% over the year but falling to 2.6% in 2005. Elsewhere in Asia growth appears to be slowing but from fairly high rates, with Chinese growth after slowing slightly in 2004 still expected to be close to 10% in both 2004 and 2005.

Growth in the Euro area remains weak but with the expectation of some improvement in 2005 to 2.1% from a forecast 1.8% last year. So, overall the world economy remains fairly buoyant, with trade forecast to grow strongly in 2005 as in 2004. The terrible human consequences of the Tsunami earthquake on Boxing Day last year appear unlikely to be followed by any significant wider impact on world economic performance. High levels of oil prices pose a threat to sustained growth at low inflation but at this stage concern about the effects on future output growth is limited.

UK growth appeared to falter markedly in the third quarter of last year, with an outturn of 0.4% significantly below expectations (see UK Economy section). However, growth during this period has now been revised up to 0.5%, which in turn was followed by growth of 0.7% in the fourth quarter. The consensus of independent forecasts, as reported by the Treasury, is for growth of 3.1% in 2004 falling to 2.6% this year, as the growth of domestic demand slows. Inflation is low and stable despite recent pickups in both house price inflation and the oil price. Interest rates appear to have stabilised at 4.75 per cent. Consumption, government spending and investment are the main drivers of UK growth.

In Scotland, growth was relatively strong in the third quarter of last year (see above) at 0.9%. No outturn data are as yet available for the fourth quarter. But from the business surveys the performance of the economy appears to have been relatively robust in the fourth quarter. The CBI reported that there was robust growth in manufacturing output volumes in the fourth quarter, while the Scottish Chambers' Business Survey (SCBS) reported rising demand in all sectors except retail. However, in the SCBS business confidence continued to decline in manufacturing, retail and wholesale, while rising in construction and tourism. The CBI survey, in contrast, found rising optimism by manufacturers about the business situation and export prospects. The latest Bank of Scotland Index of Leading Economic Indicators suggests improving performance in Scotland during the first half of the 2005 before easing back to trend by the final quarter of the year. Business sentiment and consumer spending were seen to be easing suggesting a moderation in growth.

With all this in mind, we are forecasting growth of 2% in Scotland in 2004 with slightly lower growth of 1.7% in 2005 and 1.5% 2006, followed by a return to trend growth (see Forecasts of the Scottish Economy section). In the coming year, the growth of consumer demand is expected to moderate but this will be offset somewhat by a strengthening of investment, exports and tourism demand. But manufacturing performance will remain weak and is unlikely to recover until 2006. To attain our forecast for 2004 implies growth of around 0.6% in the final quarter. We anticipate that growth could be a little higher than that. But we consider that growth of 2.7% in the final quarter, which is what would be required to obtain a forecast growth rate of 2.5% for Scotland in 2004 overall, as suggested by at least one other independent forecaster, is unlikely.

In the jobs market, we expected continued net jobs growth of 25,900 in 2004, 31,000 in 2005 and 27,000 in 2006, with almost all of these net new jobs being created in services and construction. Unemployment is expected to remain at around 5.2% on the ILO rate and 3.4% on the claimant count.

Brian Ashcroft
11 February 2005

Figure 1: Growth of key sectors 1998Q1 to 2004Q3

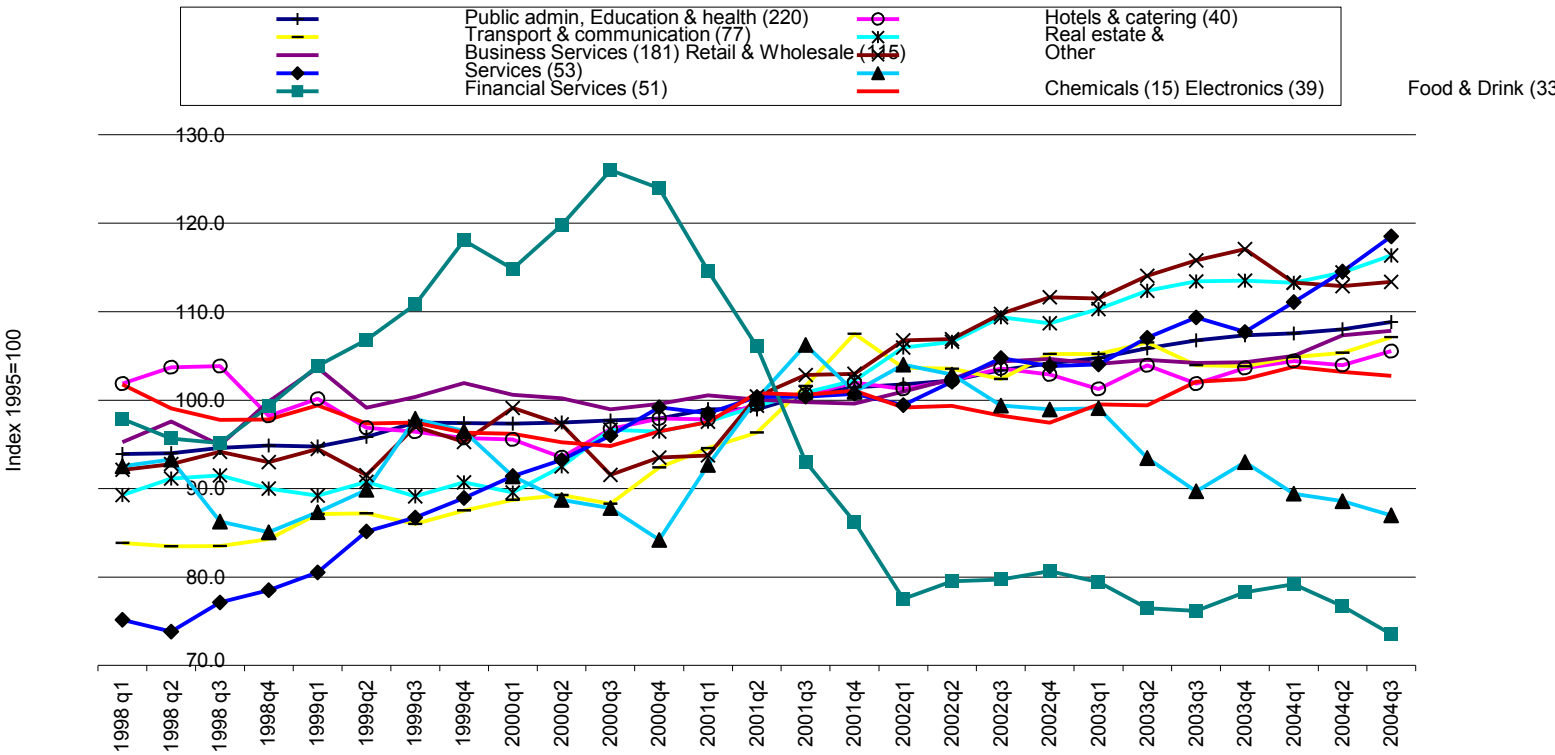

Figure 2: Relative Sectoral Contributions to Scottish and UK Growth 1998Q1 to 2000Q3

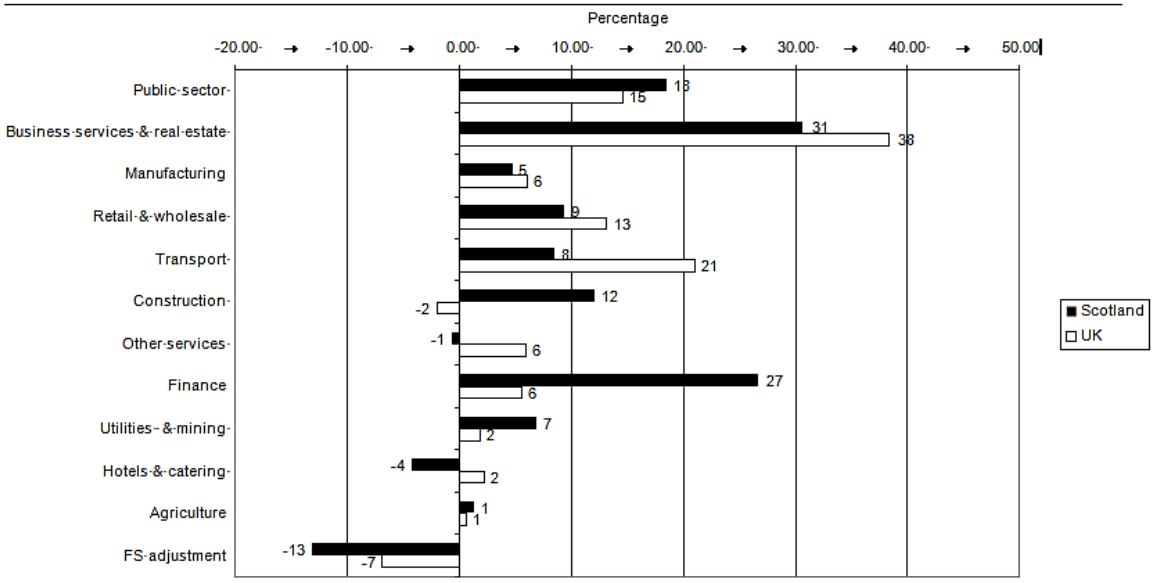

Figure 3: Absolute Sectoral Contributions to Scottish and UK Growth 1998 Q1 to 2000Q3

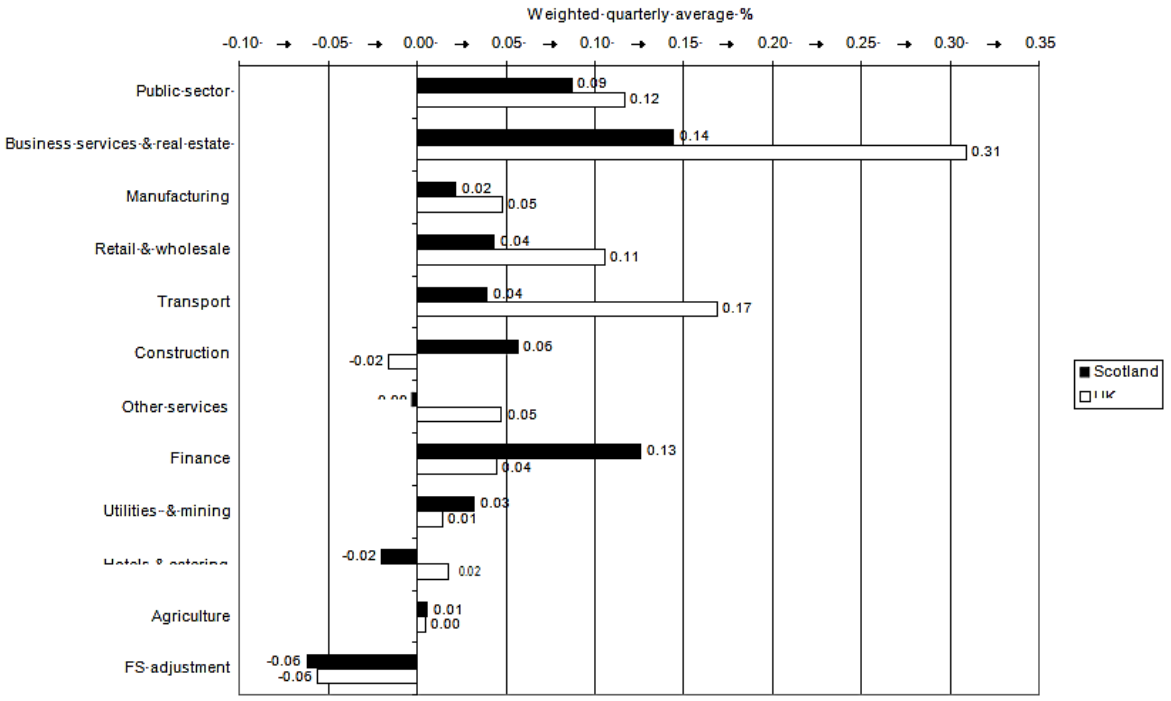

Figure 4: Relative Sectoral Contributions to Scottish and UK Growth 2000Q4 to 2004Q3

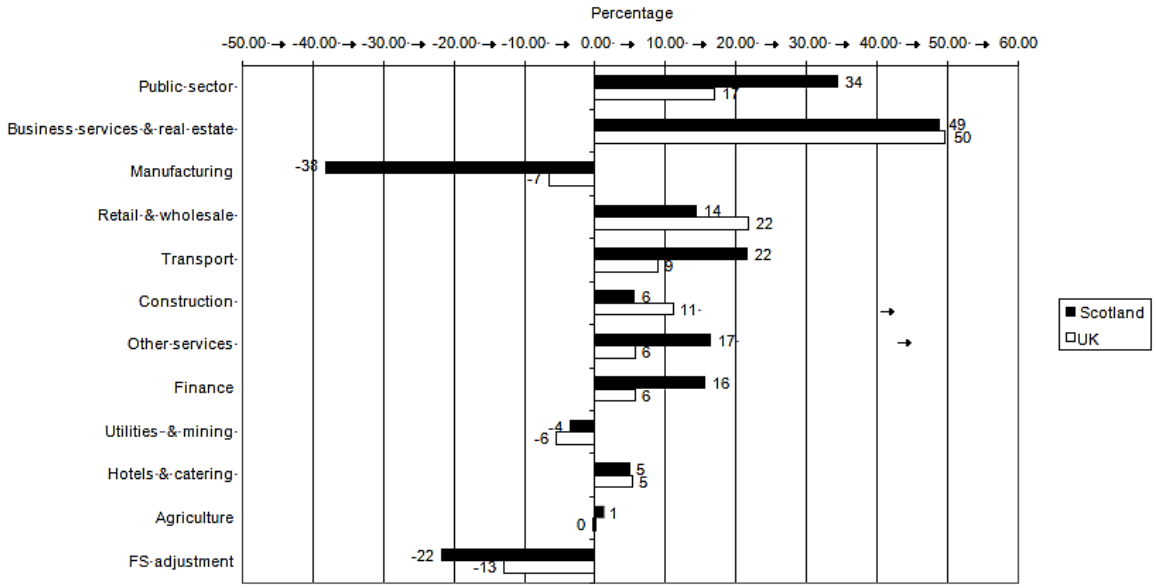

Figure 5: Absolute Sectoral Contributions to Scottish and UK Growth 2000Q4 to 2004Q3