

# The Scottish economy

## Forecasts of the Scottish economy

### **Economic background**

Growth in the world economy has clearly weakened but remains relatively strong. The outlook for 2005 and 2006 is for growth to return to trend although some economies are still growing above trend growth rates. The Euro Area remains a problem in that it has very weak domestic demand and in particular German demand is relatively poor. The good news is that Germany has come out of recession and there are signs, especially surveys and forward looking indicators, that suggest that during 2006 and 2007 the Euro Area will start to grow at a more measured pace. This is important for both the UK and Scottish economies. The US continues to drive the world economy but China is becoming an increasingly important player on the world stage. World trade is forecast to remain buoyant although below the levels seen in 2004. Again there are implications for both the UK and Scottish economies particularly for trade links with China and the Far East as European export markets remain depressed.

UK GDP growth has been disappointing in the first two quarters of 2005 after growth of 3.2 per cent in 2004. Most analysts and forecasters have revised downwards their UK GDP growth forecast to a range of 1.5 to 2.0 per cent for next year. The Chancellor in a recent speech signalled that the Treasury recognises that growth will probably be nearer to 2.6 per cent than the official Treasury forecast of 3 to 3½ per cent. Manufacturing grew by 1.9 per cent in 2004 while construction has provided the UK with a much needed boost of 3.4 per cent. The service sector grew by 3.7 per cent last year. Data for the first two quarters of 2005 however demonstrates the weakness of UK manufacturing and relatively low growth in services (0.3 per cent in 2005Q1 and 0.6 per cent in 2005Q2). Growth in UK consumption was also relatively weak with 0.1 per cent in the first quarter and 0.4 per cent in the second quarter.

### **The Scottish economy**

Scottish GVA grew by 1.9 per cent in 2004 and in 2005Q1 growth was flat. Over the last four quarters on the preceding four quarters growth was 2.0 per cent. Agriculture declined by 0.4 per cent in 2005Q1 compared to growth of 1.9 per cent at the same time last year. Construction growth was 0.3 per cent in the second quarter compared to 2.4 per cent for the same period in the previous year. Growth in the services sector was 0.6 per cent in 2005Q1 whereas it was flat in 2004Q1.

The UK outperformed Scottish services in all but two categories on an annual basis. The two exceptions were: financial services where Scotland grew by 9.6 per cent compared to 4.4 per cent in the UK and the public sector where Scottish growth was 3.0 per cent compared to growth of 2.3 per cent in the UK. Annual growth in Scottish hotels and catering was relatively weak at only 0.8 per cent but other services declined by 0.8 per cent. The other sectors with relatively strong growth in Scotland (using annual growth) were transport, storage and communications services (2.8 per cent) and real estate and business services (3.2 per cent). While the housing market may have slowed slightly it is less probable that this will have an important effect in Scotland. The same is probably true of retail sales and both these sectors have grown by 0.5 per cent and by 1.2 per cent respectively in 2005Q1. Hotels and catering grew by 2.4 per cent in the second quarter and these three sectors outperformed their UK counterparts in 2005Q1.

Construction output increased by 3.2 per cent on an annual basis (only 2.7 per cent in the UK) and growth in the first quarter was only 0.3 per cent (0.6 per cent in the UK). However, construction grew by 7.3 per cent in 2004 (only 3.7 per cent in the UK) and despite our previously over optimistic forecast in the last quarter a number of factors have slowed growth in this sector. There is undoubtedly a bottleneck in spending with significant delays in getting from the design, planning and contract stage of a major construction project to an operational phase. There are also some labour shortages as workers move to higher paid jobs within the industry. We remain optimistic about the construction sector but have factored into our forecast some of the constraints on growth.

Scottish manufacturing declined by 1.2 per cent in 2005Q2 and for the last four quarters on the preceding four quarters output declined by 0.3 per cent. Within manufacturing only food (4.2 per cent), transport equipment (6.3 per cent) and paper, printing and publishing (0.4 per cent) recorded positive growth in the first quarter of 2005. The UK also had three sectors that recorded positive growth in 2005Q1. Annual growth for these three sectors in Scotland was 1.3 per cent, 9.8 per cent and 0.2 per cent respectively. In Scotland metals (-5.2 per cent), mechanical engineering (-7.5 per cent), electronics (-2.7 per cent) and other manufacturing (-1.1 per cent) all showed significant declines in output in the first quarter of 2005. Overall manufacturing in Scotland remains weak. Undoubtedly the monetary policy committee's decision to raise interest rates to 4.75 per cent when they did hit both UK and Scottish manufacturing. The reduction in UK rates was a welcome break but has not been enough to stimulate a significant boost in demand or to increase investment. Manufacturing is more likely to grow steadily as demand builds elsewhere (in Scotland, the UK and in Europe) rather than to small cuts in the UK interest rate.

Scottish manufactured exports fell by 1.0 per cent in 2005Q2 and by 2.7 per cent over the year. This compares with a decrease of 2.5 per cent in 2005Q1 and an annual decline of 2.7 per cent. Food exports have grown by 21.8 per cent on annual basis in 2005Q2 compared to a decline of 12.7 per cent for 2005Q2 on 2005Q1. In the first quarter food exports grew by 10.4 per cent. On a quarterly basis for the second quarter exports of drink grew by 2.3 per cent; mechanical engineering by 4.4 per cent and transport equipment by 3.4 per cent. Electronics exports declined by 3.6 per cent in 2005Q2. It is clear that food is the fastest growing export sector but only has a weight of 1.7 per cent. The weight of electronics is 44.5 per cent and drink (mostly whisky) is 15.8 per cent. It is these two sectors that have a significant effect on total exports.

LFS Employment rose by 18,000 over the year to 2,462,000 in June-August 2005 giving an employment rate of 75.5 per cent. LFS employees increased from 2,194,000 in March-May 2005 to 2,228,000 in June-August 2005, an increase of 34,000 over the quarter and 32,000 over the year. Self-employment declined by 12,000 over the year and by 2,000 over the quarter. Full-time employment increased to 1,871,000 by 36,000 over the quarter but increased by 24,000 on an annual basis. Part-time employment decreased by 4,000 over the year and by 3,000 in the last quarter. LFS unemployment declined from 147,000 to 131,000 in June-August 2005. This gives a rate of 5.1 per cent. This compares to claimant count unemployment of 85,700 in September 2005 or 3.2 per cent. The trend in employment appears to be rising and the trend in unemployment appears to be falling. The number of economically active people is 2,594,000 (79.5 per cent), an increase of 2,000 on the year but was a decline of 11,000 on the quarter. The labour market performance is relatively good and we expect this to continue.

The Scottish economy has had a mixed performance over the recent months. Construction growth has boosted growth with services sector growth being disappointing and manufacturing has been weak. We are still looking to the Euro Area to improve domestic demand significantly before we will see a considerable improvement in manufacturing particularly in drink and electronics.

## The forecast in detail

### GVA

The forecasts of chain-linked GVA are presented in Table 1 for the period 2005 to 2007.

We are forecasting Scottish GDP growth of 1.8 per cent for 2005 and 1.9 per cent for 2006. Despite weaker data for 2005 Q1 (and probably Q2) for Scotland and for both quarters in the UK we believe that activity will pick up in the second half of 2005, particularly in the fourth quarter. We also believe that the service sector will deliver stronger

growth and that manufacturing will only pick up in 2006. Even then recovery will be slow and gradual as we rely on European markets to stimulate demand for manufactured exports. We are forecasting that Scottish growth will be just below long-run trend growth in the years 2005 to 2006 but to grow slightly above trend in the next two years. The Scottish service sector has significant drivers of growth in it notably financial services, real estate and business services but also the important public sector and transport and communications services. Growth is expected to pick up in these sectors and to remain relatively strong in retail and hotels and catering in the second half of 2005.

**Table 1 Main Forecasts of the Scottish Economy, 2005-2007**

	2005	2006	2007
GDP	1.8%	1.9%	2.0%
Agriculture	0.8%	1.6%	0.5%
Manufacturing	-0.4%	0.7%	1.4%
Construction	3.7%	2.0%	1.6%
Services	2.4%	2.2%	2.2%

Source: Fraser of Allander Institute, October 2005

### Final demand

Consumption remains an important driver of final demand in Scotland and consumption may not have declined in Scotland to the same extent as it has in the UK. Government expenditure remains important to the Scottish economy and we expect investment to pick up more strongly in 2007 and 2008. Tourism performance has been mixed, although probably better than expected. Overseas demand remains the weakest sector and we are forecasting a gradual increase over 2005-07 for tourist demand. Export markets remain problematic and it will probably be 2007 before Euro Area domestic demand is strong enough to stimulate this sector significantly.

### Output

Agriculture output is forecast to grow by 0.8 per cent in 2005 and by 1.6 per cent in 2006. Mining and quarrying is forecast to grow by over 0.4 per cent in 2005 and decline by 0.2 per cent in 2006. In 2005 electricity, gas and water supply is forecast to contract by 3.3 per cent but to grow by 1.6 per cent in 2006. The latter sectoral growth forecasts do however depend on the strength and depth of recovery in Scottish manufacturing. There are also clearly uncertainties over Scottish Power and their HQ functions if a hostile bid were made for the company.

Manufacturing is forecast to contract by 0.4 per cent in 2005 and to grow by 0.7 per cent in 2006. Stronger growth

is forecast for 2007 and 2008 (close to 1.5 per cent per annum). Within manufacturing textiles and electronics remain significant concerns. ORNF, chemicals and other manufacturing are the sectors most likely to have a steady but slower growth profile. Food, drink, paper, printing and publish and transport equipment are more likely to provide significant growth within manufacturing.

Services are forecast to grow by 2.4 per cent in 2005 and by 2.2 per cent in both 2006 and 2007. Services may grow above trend growth in 2007-08. Services continue to be driven by financial services and real estate and business services. The strong growth in the service sector also drives employment growth. Tourism remains important for services growth and we expect that to improve in 2007 and 2008. We also believe that the retail and hotel and catering sectors are more resilient than their UK counterparts in the current economic slowdown but we do not expect them to grow as fast as the UK sectors when growth upturns again.

Construction growth in 2005 is forecast to be 3.7 per cent and 2.0 per cent in the following year. This strong growth is driven by public sector investment and private housing demand. There is no significant sign of a slowing for housing demand and we expect this to pick up in the future.

### Employment

Our medium-term forecasts of employment are presented in Table 2 with the net employment change figure in brackets. The employment figures are calibrated on the employer's quarterly survey series as given in Table B.16 in Labour Market Trends, National Statistics.

Employment is forecast to increase to 2,285,300 in 2005 and to 2,313,700 in 2006. This is a net job change of 26,700 and 28,400 respectively. Employment gains across the period 2006-08 are close to trend. The service sector still drives employment gains across the forecast horizon. Already the Scottish economy has on an annual basis created 15,000 jobs according to the workforce series or using LFS data, 18,000 jobs up to the period June 2005.

As in previous forecasts and labour market analysis it is clear from Table 2 that job creation is largely delivered by the service sector. In 2005 we forecast 31,700 jobs and in 2006 a further 26,300 jobs. Manufacturing is forecast to shed 3,200 jobs in 2005 and only to create 400 jobs in 2006. There will be a considerable increase in jobs in 2007 with a net job gain of 35,600 forecast. Job creation in construction is not so significant now as it was in our previous forecast. Agriculture, electricity, gas and water supply and mining and quarrying are forecast not to have any major net job change.

**Table 2 Forecasts of Scottish Employment and Net Employment Change, 2005-2007**

	2005	2006	2007
Total employment (000s)	2,285.3 (26,700)	2,313.3 (28,400)	2,349.4 (35,600)
Agriculture	36.6 (-100)	36.8 (200)	36.5 (-200)
Manufacturing	246.3 (-3,300)	246.7 (400)	248.1 (1,400)
Construction	150.4 (2,000)	153.5 (600)	157.7 (600)
Services	18,15.5 (31,700)	1,841.4 (26,3000)	1,874.7 (32,900)

Source: Fraser of Allander Institute, October 2005

## Unemployment

Our forecasts of unemployment are given in Table 3. Both the ILO measure and claimant count measure are presented. The preferred measure of unemployment however is ILO unemployment as given by the LFS. Our forecast for ILO unemployment is 140,000 (5.3 per cent) in 2005 and 136,000 in 2006 (5.2 per cent). The claimant count measure of unemployment (those registered and receiving Job Seekers Allowance (JSA)) is forecast to be 90,000 (3.6 per cent) in 2005 and 86,100 (3.4 per cent) in

2006. The outlook for unemployment is relatively low and stable. Unemployment remains at historically low levels. There are no significant movements in unemployment predicted in the near future. The UK and Scottish labour markets are both performing well. Despite a possible build.

Once again the outlook for the Scottish economy is good while services remain the key sector driving growth and employment. We expect a marginal moderation of consumption next year and we believe investment, tourism and exports will strengthen the economy. Government spending is as before an important driver of the economy. We are forecasting a slight dip in growth in 2005-06 but thereafter we are forecasting that growth will be close to trend for the rest of the period. Construction growth is strong and forecast to remain so until 2007. Manufacturing is weak and unlikely to recover until 2006. A pick-up in the Euro Area and a depreciation of sterling will help exporters. We remain optimistic about the labour market and continue to forecast rising employment and low and stable unemployment.

Kenneth Low  
18th October 2005

of inflationary pressure due to higher oil prices there are no signs of wage pressures that are not in line with non-inflationary output growth.

**Table 3 Forecasts of Scottish Unemployment, 2005-2007**

	2005	2006	2007
ILO Unemployment (levels)	140,000	136,400	130,000
Rate	5.3%	5.2%	5.1%
Claimant count (levels)	90,000	86,100	81,900
Rate	3.6%	3.4%	3.3%

Source: Fraser of Allander Institute, July 2005

