

# The Scottish economy

## Forecasts of the Scottish economy

### **Economic background**

There has been little change to the world economy since July. There is evidence of relatively strong growth in the US, Japan and China for this year and next. The Euro Area is expected to pick up in 2005. Employment is rising and unemployment is forecast to fall gradually across the OECD. World trade is forecast to grow at 8.9 per cent this year and 10.1 per cent next year. Inflationary pressures are also building in the global economy due to capacity constraints and high oil prices. There have been some weak data in the US but many attribute this to higher oil prices and believe that this will be a temporary phenomenon. The outlook remains good for 2004 and 2005.

There are some slight concerns about UK growth. This stems from the preliminary third quarter estimate of UK GDP where growth was only 0.4 per cent, nearly half the rate seen in the previous two quarters. This makes the upper limit of the Chancellor's forecast less likely but current forecasts still show that 3.3 per cent GDP growth could be attained in 2004. Services continue to drive growth but we suggest that UK manufacturing will have declined slightly in the third quarter because UK production fell by an estimated 1.2 per cent. We believe this because manufacturing accounts for 79 per cent of production and the previous figures show manufacturing and production moving in a similar fashion. CPI inflation remains relatively low at 1.1 per cent in (see The UK Economy for a fuller discussion of this). Interest rates have been held at 4.75 per cent. The UK labour market is showing signs of tightness but employment is still rising although this is now mainly due to increases in employees as self-employment fell in the third quarter. Average earnings only rose by 4.3 per cent in the latest twelve months and is on track to meet the forecast of 4.5 per cent for 2004. This level of growth is consistent with non-inflationary wage pressure. Unemployment remains low. There are still concerns over the UK PSNB.

### **The Scottish economy**

Scottish GVA growth was 0.9 per cent in 2004Q2 and that was exactly the same as UK GVA growth in the second quarter of 2004. When oil is excluded then Scotland actually grew by 1.0 per cent compared to 0.9 per cent for the UK, a marginally better performance. However, the latest four quarters over the preceding four quarters indicate that Scottish GVA grew by 1.8 per cent but the UK grew by 2.8 per cent. The latest UK data also shows a significant drop in the rate of UK growth in the third quarter and unless these data are revised or there is a marked increase in the fourth quarter then UK growth may not be

significantly above 3 per cent for the year. Service sector growth was 1.2 per cent in the second quarter compared to 2.0 per cent growth over the latest four quarters on the preceding four quarters. This was particularly encouraging given the relatively flat performance seen in the previous three quarters. It is still a different picture in Scottish manufacturing – this grew by 0.4 per cent in 2004Q2 but over the year declined by 0.3 per cent. This is in stark contrast to UK manufacturing which grew by 1.2 per cent in the second quarter and on an annual basis grew by 1.3 per cent. Construction only increased by 0.1 per cent in the second quarter but over the latest four quarters on the preceding four quarters growth was 9.3 per cent, outperforming the UK at 6.3 per cent. Agriculture grew by 0.1 per cent in the second quarter of 2004 but rose by 1.8 per cent on an annual basis.

For the latest four quarters on the preceding four quarters the strongest performers within services were: financial services (6.2 per cent), retail (4.5 per cent), banking (4.3 per cent) and real estate and business services (3.5 per cent). Both public services and other services grew close to 2.5 per cent leaving only hotels and catering as well as transport, storage and communications services with low growth over the same period. The quarterly data was more encouraging for hotels and catering with growth of 2.1 per cent perhaps reflecting better tourism performance than we expected. Real estate and business services (1.3 per cent), public services (0.3 per cent), other services (0.5 per cent) and transport (1.1 per cent) all demonstrated relatively low growth in the second quarter.

Scottish manufactured exports grew by 2.9 per cent in real terms in 2004Q2 compared to growth of 2.0 per cent in the first quarter. Over the year to 2004Q2 however Scottish exports declined by 8.2 per cent. Although most of the decline is driven by electronics over the year chemicals, metals and mechanical engineering all contributed to a fall in exports. All these sectors with the exception of mechanical engineering have demonstrated positive growth in 2004Q2. Drink, transport equipment, textiles, PPP and other manufacturing all grew above 2 per cent on an annual basis. Electronics still accounts for just over 50 per cent of Scottish exports and therefore remains the key export sector. Chemicals (15 per cent) are the next most important exporting sector followed by drink (7 per cent). Clearly there are signs of recovery in export orientated activity. As we had previously forecast, the food, drink, textiles and PPP sectors would lead the way in export growth. This has transpired to be true, with electronics performing relatively better than expected although the contribution of food (-11.0 per cent) in the second quarter was disappointing, leaving growth over the year at 0.7 per cent.

The Scottish labour market is still doing well although there are some signs of slight tightening. LFS total employment increased by 32,000 in the year to Jun-Aug 2004. This equates with an employment rate of 75.0 per cent (up by

0.6 percentage points) and higher than the 74.7 per cent recorded in the UK. There have now been significant rises in both employees and in the self-employed although self-employment fell marginally. Economic activity increased by 28,000 over the year to Jun-Aug 2004 giving an economic activity rate of 80.5 per cent, compared to 78.4 per cent in the UK. ILO unemployment remains at historically low levels: 147,000 (5.8 per cent) in Jun-Aug 2004. Claimant count declined by 8,600 over the year to 91,000 (3.5 per cent) in September 2004, marginally up on August but 0.3 percentage points below the rate in September 2003.

There were mixed results from the Scottish Chambers Business Survey for the third quarter of 2004 with confidence falling in manufacturing and retailing. There is a rising trend in sales and orders in manufacturing and construction but this moderated in the third quarter but grew strongly in the retail sector. Pay settlements varied from 3.6 per cent in retail to 5.7 per cent in construction. Overall the signs are for growing demand in the fourth quarter but that signs of caution are emerging. Some of the drivers of these are anticipated higher costs associated with transport, higher oil prices and energy costs. There appears to be little concern over wage pressure. The results in construction are in keeping with demand patterns in the industry. The CBI Industrial Trends Survey demonstrated a similar picture but was slightly more pessimistic over manufacturing and costs but also expressed concerns over fourth quarter demand.

Overall the Scottish economy has done relatively well particularly the revival of service sector growth, the increase in exports, a buoyant labour market and a cautious but optimistic outlook for fourth quarter growth. The downside is clearly the weakness in manufacturing. Some other risks are the downturn in UK third quarter growth, the effect of higher interest rates and oil prices. This is the context in which, we are forecasting the Scottish economy.

## The forecast in detail

### GDP

Our forecasts for the third quarter of 2004 for real GDP and broad sectoral output are presented in Table 1 for the period 2004 to 2006. Real GDP growth is forecast to be 2.1 per cent in 2004 and 1.9 per cent in 2005. Construction is forecast to have strong growth in 2004 and 2005. We have revised up our forecast for construction given the strong growth that has already taken place this year. We expect GDP growth to be close to trend in 2006. Our forecasts remain similar to those of last quarter with some minor adjustments. We believe that the forecast is both consistent and robust. This is mainly due to the properties of the model and the judgements that we make that are in line with annual changes rather than adjusting rapidly to quarterly changes that may be subject to official revisions later on.

**Table 1 Main forecasts of the Scottish economy, 2004-2006**

	2004	2005	2006
GDP	2.1%	1.9%	1.8%
Agriculture	1.8%	-0.3%	0.9%
Manufacturing	1.0%	1.2%	1.6%
Construction	5.2%	4.7%	3.1%
Services	2.3%	1.9%	1.9%

Source: Fraser of Allander Institute, October 2004

### Final demand

We have made only a few changes to the profile of final demand from the last quarter. The main changes are:

- Æ Consumption has been decreased marginally in 2005 as consumers may contract spending slightly in response to increased interest rates and higher levels of debt;
- Æ Tourism has increased due to the better than expected performance of the industry this year and
- Æ Exports to the UK (XRUK) have decreased slightly in 2004 but are forecast to pick up again in 2005.

### Output

Following the latest data release from the Scottish Executive we have upgraded growth in agriculture to 1.8 per cent in 2004. The sector is still forecast to decline in 2005 but only by 0.3 per cent as opposed to 0.5 per cent in the previous forecast. Electricity, gas and water supply is now forecast to increase by 1.2 per cent in 2004 and by 1.7 per cent in 2005 because of the disappointing manufacturing data. The forecast for construction has also been upgraded to 5.2 per cent in 2004 and to 4.7 per cent in 2005. This is because of the very strong performance in the sector to date. We also believe that both private and public investment will continue to stimulate the construction industry in the next two years.

While overall there has been little change in our GVA forecast there has been a realisation that manufacturing is doing less well than expected and that the service sector has picked up again. Basically we believe that there has been a compensating transfer of activity between the sectors. This is the main reason that overall activity has remained similar. Our forecast for manufacturing is now 1.0 per cent growth in 2004 followed by 1.2 per cent in 2005. We believe in the face of current monetary policy (see the UK economy section) that manufacturing will grow more slowly over the next few years. We are encouraged

however, by the performance of the exporting sectors (see above, Scottish economy). The growth in these sectors will undoubtedly stimulate manufacturing in the short-run. We believe that we will require further growth in electronics, other manufacturing, chemicals and food before manufacturing growth picks up more strongly. We are also forecasting stronger growth in transport equipment manufacture from 2006 onwards due to defence and bus orders. It is difficult to estimate accurately at the moment the effect of this work on the economy.

We are still forecasting services to grow by 2.3 per cent in 2004, but as consumption slows slightly in 2005 then we forecast growth will be 1.8 per cent. The key sector is still financial services. Growth in real estate and business services will also probably slow in 2005 as interest rates take the heat out of the housing market. Already we have seen a slight slowing of house price growth. Retail remains important but again in 2005 this may slow slightly. Growth in public services remains steady while other services have had very strong growth and are likely to slow slightly but still remain a driver of private services growth. Tourism has had a better year in 2004 and this is reflected in our forecast of the hotel and catering sector (as well as its impact on retail). There are few reasons to suggest that tourism cannot continue this into 2005.

### Employment

Our forecasts of employment are presented in Table 3 with the net employment change figure in brackets. The employment figures are calibrated on the employers' quarterly survey series as given in Table B.16 in Labour Market Trends, National Statistics.

Our forecast for employment (jobs) is 2,266,900 in 2004 and to 2,296,000 in 2005. This is a net job change of 23,500 and 29,100 respectively. As stated before, services drive employment across the forecast horizon. The increase seen in the latest labour market release from ONS has been incorporated into our forecast (where the current employment rate is 75 per cent, higher than the UK).

The service sector is forecast to have employment of 1,792,300 (an increase of 19,100 jobs) in 2004 and in 2005 employment of 1,818,000 (up by 26,500). Services are forecast to contribute 81 per cent of new jobs in 2004 and 91 per cent in 2005. Public services and retail are the main contributors to service sector employment but hotels and catering and other services are also important. There are clear signs that more flexible working; older workers and self-employment are becoming increasingly important in the labour market. Migration is also showing signs that it is becoming relatively important.

Manufacturing employment is forecast to lose 1,600 jobs in 2004 and another 900 in 2005. The level of employment is forecast to fall to 250,100 in 2006. We still believe however, that when manufacturing output increases

significantly that employers will take on more workers. We also believe that following recent changes in the US economy we may see a higher degree of productivity and technical progress in this sector as it struggles to compete with low cost locations. Undoubtedly the manufacture of high quality products remains the main strategy of developed economies rather than trying to compete with mass manufacturers in price sensitive markets when they have clear cost advantages.

Construction employment is forecast to rise by 5,900 in 2004 and by 3,300 in 2005. Agriculture is forecast to lose 300 jobs in 2004 and a further 500 in the following year. There are negligible job gains forecast in mining and quarrying but electricity, gas and water supply could have an employment gain of around 500 in each year of the forecast. These two sectors have seen employment forecasts decline marginally since the last quarter.

**Table 3 Forecasts of Scottish Employment and Net Employment Change, 2004-2006**

	2004	2005	2006
Total Employment (000s)	2,266.9 (23,500)	2,296.0 (29,100)	2,326.1 (30,100)
Agriculture	35.9 (-300)	35.4 (-500)	35.3 (-100)
Manufacturing	251.4 (-1,600)	250.5 (-900)	250.1 (-400)
Construction	143.9 (5,900)	147.2 (3,300)	149.3 (2,100)
Services	1,792.3 (19,100)	1,818.8 (26,500)	1,846.8 (28,100)

Source: Fraser of Allander Institute, October 2004

## Unemployment

We present our forecasts of unemployment in Table 4. Both the ILO measure and claimant count measure are given. The preferred measure of unemployment however is ILO unemployment as given by the LFS. The forecast for ILO unemployment is 147,400 (5.5 per cent) in 2004 and 145,500 in 2005 (5.3 per cent). Our forecast for claimant count in 2004 is 93,800 (3.6 per cent) and for 2005 it is 91,400 (3.4 per cent). There is very little change in the unemployment forecast. The main change is that there are more people entering the labour market. We remain optimistic about the outlook for the Scottish labour market with a gradually rising employment and activity rate.

**Table 4 Forecasts of Scottish Unemployment, 2004-2006**

	2004	2005	2006
ILO Unemployment (levels)	147,400	145,500	143,400
Rate	5.5%	5.3%	5.3%
Claimant Count (levels)	93,800	91,400	91,200
Rate	3.6%	3.4%	3.4%

Source: Fraser of Allander Institute, October 2004

Clearly the outlook for the Scottish economy is promising with services remaining the key sector. While we expect a marginal moderation of consumption next year we believe investment, tourism and exports will strengthen the economy. Government spending is as before an important driver of the economy. We are forecasting that growth will remain close to trend across the forecast horizon with strong growth in construction although manufacturing may be relatively weaker. We remain optimistic about the labour market and continue to forecast rising employment, a slow decline in unemployment and increasing activity rates.

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29 October 2004

