Outlook and appraisal

Overview

Growth in the Scottish economy picked up in the second quarter and may have continued to strengthen along with an increasing buoyancy of the UK and world economies. But Scottish growth is being driven by the service sector with manufacturing in sustained recession. The principal underlying uncertainty is the growth path of Scottish manufacturing. As noted above there is little sign at present of any upturn in electronics or in manufacturing as a whole. Export growth should pick up as growth in the US economy accelerates and as the Euro area begins to pick up. But the recent strengthening of the pound against the dollar may dampen the growth of Scottish manufacturing somewhat. The key question to be answered over the next few months is whether the positive income effect of accelerating world growth is more than sufficient to offset the negative price effect of rising dollar export prices of Scottish goods in the US and linked markets.

Nevertheless, we feel sufficiently confident to raise our forecast for GDP growth to 1.3% this year, to 2.1% in 2004 and to 2.3% in 2005, While manufacturing is expected to show a significant fall in output this year of just over 5%, we are anticipating a modest rise of 1.4% in 2004 and somewhat stronger growth of just under 2% in 2005. The service sector meanwhile continues to be the engine of Scottish development with forecast growth of 2.9% this year, 2.5% in 2004 and 2.4% in 2005.

GDP and output

The outturn for the Scottish economy was better than anticipated in the second quarter of the year. The latest data from the Scottish Executive indicate that Gross Domestic Product (GDP) rose by 0.4% in the second quarter compared to an increase of 0.5% in the UK.[1] Figure 1 shows no obvious trend in recent quarterly growth performance either in Scotland or in the UK. After the sharp contraction of 0.8% in Scottish GDP during the first 3 months of 2002 some degree of recovery was evident over the next three quarters in parallel with a strengthening of the UK economy. But both Scottish and UK economies faltered in the first quarter of 2003, with Scottish GDP growth actually contracting by 0.1%. This weak performance is reflected in the annual growth data. So, over the year to 2003 Q2, Scottish GDP rose by only 0.5% much lower than the 1.8% increase registered in the UK.

The second quarter recovery in Scottish GDP performance was largely the result of recovery in the service sector from the unexpected weak outturn exhibited in the first quarter. The sector grew by 0.9% in Scotland during the second quarter after, on revised figures, registering no growth in the first quarter. UK services, in contrast, grew by only 0.3% after growth of 0.5% in the first quarter. In other principal sectors, agriculture, forestry and fishing and construction continued to display positive growth of 0.9% and 2.7% respectively. Growth in agricultural output remained the same as in the first quarter, while construction sector growth accelerated from the 1.2% recorded in quarter one. Production output, in contrast, continued to contract (-1.8%) and at a faster rate than in the first quarter (-0.9%). Over the year to the second quarter, service sector output grew by 2.8%, construction output by 2.7% and agricultural output by 1.9% but production output fell by 6.5% - a clear indication of the continuation of a two-speed economy.

Manufacturing accounts for the vast bulk of production output. During the second quarter gross value added (GVA) in the sector fell by 1.7%, while GVA in UK manufacturing rose by 0.5%. Scottish manufacturing has now experienced falling output for 13 consecutive quarters – see Figure 2. While the performance of manufacturing over the past 5 quarters is nowhere near as bad as in the dark days of the second half of 2001 and the first quarter of 2002, there is little sign from recent data of a recovery emerging. Readers will now be familiar with the role played by the downturn in ICT and in electronics production in the sustained recession in Scottish manufacturing. The latest data for electronics suggest that there is little if any light at the end of the tunnel. The output of electrical and instrument engineering – electronics – contracted by a massive 5.6% in the second quarter to a level that is now almost 50% (47.5%) down on its third quarter 2000 peak. It remains to be seen whether the recent marked pickup in US manufacturing performance will be soon reflected in an upturn in the largely US owned electronics sector in Scotland. Unfortunately, there must be some doubt about this in view of the increasing attractiveness of eastern European and Asian locations for electronics production, which we have noted in previous Commentaries. Our best judgement is that the downturn in Scottish electronics will reverse in 2004 but we are unlikely ever again to experience the growth rates seen in the sector in the mid-1990s. It will be a long time before the levels of production experienced in the sector in 2000 are regained and we may never see the levels of employment that we once enjoyed in electronics.

Elsewhere within manufacturing, performance continued to be weak in the second quarter. Output fell in most sectors for which data are published with the exception of the food, mechanical engineering and transport equipment sectors. It is difficult, if not impossible, to read anything into the positive performance displayed by these three sectors. Transport equipment has lost almost 40% of its production since its first quarter 2000 peak but there is little to suggest from the most recent data that output in the sector is bottoming out. Even chemicals, which is the only manufacturing sector of weight to have maintained levels of output above its 1995 position, has persistently cut back on production since the third quarter of 2001 with output falling by 14% over that period.

The service sector in Scotland could be described as 'bouncing back' from its unexpected flat performance in the first quarter. With growth of over 0.9% in the second quarter, the sector's performance exceeded its average quarterly growth rate of 0.72% over the period since the first quarter of 1996. This return to positive growth also reinstated its superior position vis a vis UK services, which has been an almost ever-present feature since the final quarter of 2000 – see Figure 3. What is interesting is that the recovery in service sector performance has come about through a surge in the growth of transport & communications and financial services. With second quarter growth of 2.4% and 2.5%, respectively, both sectors grew at rates appreciably above their quarterly averages (of 1.23% and 1.82%) for the period from the first quarter of 1996. And the banking sector, accounting for almost half of financial services, grew by nearly five per cent (4.9%) in the quarter. In addition, both hotels & catering (2.6%) and real estate & business services (1.7%) enjoyed strong growth, although at lower rates than in the first quarter. In contrast, the public sector grew slightly (0.1%), retail & wholesale contracted slightly (-0.1%) while other services cut back activity by 0.7%. However, within retail & wholesale, the retail component grew by 1.3% in the second quarter.

Figure 4 charts the relative importance of key Scottish growth sectors over the period from the first quarter 1996. The rise and fall of electronics is the most obvious feature. But there are other stories about the performance of the Scottish economy that are contained in this chart. First, to underline the relative demise of Scottish manufacturing, the chemicals sector, which along with electronics was the

leading sector in the third quartile of the 1990s, had fallen to fifth in the rankings by the latest quarter. Secondly, in terms of its growth performance, financial services and the banking sector within it is by far the most important sector. Moreover, business services, transport & communications and other services are now making a much greater relative contribution to output growth than they did even in the late 1990s.

The impact of these differences in sectoral growth performance on the structure of the Scottish economy can be seen from Figure 5, which charts estimates of the changing contribution to GDP of the key growth sectors identified in Figure 4. As would be expected, by the latest quarter the contribution to GDP of electronics had declined to 4.7% from 6.1% in 1996 Q1 and from 9.2% in 2000 Q3. The share of chemicals has risen slightly since 1996 Q1 from 2.2% to 2.3% of GDP but has fallen from its 2.7% peak in 2001 Q3. The balance of the economy has therefore swung in favour of services. But it should be noted that, in measured output terms at least, the switch is towards private sector services and not the public sector. The share of public sector services has fallen slightly from 20.9% in 1996 Q1 to 19.5% in 2003 Q2, although this amounts to a pickup from a low point of around 18.8% in the late 1990s when electronics in particular was growing strongly. With the exception of retail & wholesale and other services the remaining service sectors have continued to expand their share of GDP throughout the period. The share of financial services went from 4.1% in 1996Q1 to 6.1% in 2003 Q2; the share of hotels & catering went from 2.9% to 3.2%; transport & communications from 7.3% to 9.3%; real estate & business services from 15.5% to 18.2%; and financial services from 4.1% to 6.1%. Retail & wholesale stood at 11.7% compared to 12.2% at its peak in 2002 Q4 and 10.5% in 1996 Q1, while other services maintained a 5.3% share in 2003 Q2 compared to 5.4% at its peak in 2002 Q1 and 4.4% in 1996 Q1.

What is clear from these estimates is that the Scottish economy is now more than ever a private service sector economy principally characterised by business services, retail & wholesale, transport & communications and financial services. Public sector activity still accounts for around a fifth of GDP but is now only a little bigger than real estate & business services. In employment terms, however, the share of the public sector on the above sectoral definitions is greater. Table 4.3 of Scottish Economic Statistics 2003 indicates a 27% share of employee jobs in 2002, identical to the share in 1996. However, it should be noted that these data do not allow the identification of public sector output produced outside public administration, defence, education and health, with construction and transport/communication services being the obvious examples. Conversely, some private sector output e.g. in education and health will be included under the public administration, education and health heading.

Regional statistics and the Allsopp Report

The Institute has for some time expressed concern about the need for good quality regional economic statistics in the UK and for Scottish statistics in particular. The Office for National Statistics (ONS) has responsibility for producing UK regional statistics. In this year's Budget, the Chancellor of the Exchequer indicated an intention to develop regional price indexes so that local and regional conditions were better recognised in pay determination. The expression of this concern about the availability of specific regional data followed the Chancellor's earlier stated general concern about the appropriateness of the UK regional information and statistical framework. This concern led to appointment of Christopher Allsopp in February 2003 to undertake a wide-ranging review of UK regional statistics. Both initiatives have recently come to partial fruition and we consider it appropriate to offer some initial comments.

UK regional price levels

In November ONS published updated regional price indices, which are seen as part of the longer-term project announced by the Chancellor in his March Budget. In many respects these data are provisional but they do indicate the value of further developing our understanding of regional/country price differentials within the UK.

Figure 6 provides a summary of the differences between Scottish and UK consumer prices in the aggregate and for principal categories of consumer expenditure. The Figure provides estimates of the difference in terms of both UK weights and Scottish weights. The application of UK weights implies the retention of the same 'shopping basket' of goods and services across the regions of the UK and therefore provides an indication of the purchasing power in one region compared with another and with the UK. The use of regional/country – in this case Scottish – weights gives more of an indication of the 'cost of living' in the region/country with some account taken of differences in consumer spending patterns at the regional level.[2]

On this basis, the 'cost of living' in Scotland is about 7% cheaper than in the UK as a whole. The costs of housing and household services are the two expenditure categories where Scottish consumers enjoy the lowest costs, being 25% and 24% lower than the UK respectively. At the other extreme, the Scottish consumer bears the burden of fares and travel costs at a level 6% above their rest of UK counterparts.

Application of a single UK 'shopping basket' – UK weights – tells us more about price levels for a given basket of goods and therefore provides an indication of the purchasing power of a Scottish pound compared to the UK pound. Here prices are overall nearly 3.5% lower in Scotland, with house prices 21% lower and the price of household services about 10% beneath that in the UK. Fares and other travel costs

are 15% higher in Scotland, with catering prices 4% higher, clothing & footwear prices 3% higher, the price of fuel & light 3% greater, and the price of leisure services 3% higher.

One obvious question raised by these data is: what accounts for the price differences between Scotland and the UK in key expenditure categories? This is clearly a subject for further research. At this stage we can only speculate. The lower price of housing on average in Scotland is reasonably well understood but the lower price of household services less so. What is perhaps more interesting for an understanding of the performance of the Scottish economy are the reasons why prices in some categories are higher in Scotland. The answer must, to a considerable extent, lie in the structure of markets and costs.

Food prices are broadly the same in Scotland as in the UK because of the standard pricing policy adopted by UK national supermarket chains. Similarly, goods prices generally tend to show less variation possibly because there tends to be a more national market for such products and where prices are higher they may reflect differences in transport and distribution costs with the base – technically the f.o.b.[3] – price broadly the same. However, in contrast, the data appear to show that prices of services vary more markedly across regions. This would appear to be due to the greater presence of local markets in such products and therefore the greater significance of local supply and demand in the regional price. The use of national weights mutes to some extent variations in regional demand and so price variations on this measure may be more likely to reflect supply-side differences. One key difference is likely to be the degree of competition in regional markets. On this basis, we would suggest that there might be a prima facie case to argue that the Scottish market is less competitive than the UK market in fares & other travel costs, catering, fuel & light, and leisure services. Competition regulation in the UK is a reserved power but we would urge the Scottish Executive to consider requesting the Office of Fair Trading (OFT) to examine the degree of competition in such activities in Scotland, with a view to a possible reference to the Competition Commission if a prima facie case of restricted competition is established by the OFT.

The Allsopp Report

The Allsopp Report was published on the day the Chancellor presented his Pre-Budget Report. The report represents the first stage of a wide-ranging review of UK regional statistics. There is much of value in this Report, although it is too early for us to comment in detail on Allsopp's recommendations and we would hope to re-visit these at a later date.

However, it is encouraging if dispiriting that Allsopp concludes that the present ONS "estimates of regional GVA are not of sufficient quality to support analysis of the (UK) Government's policy objective to increase growth in the regions" (Page 93). This conclusion echoes the Scottish Executive's own July 2003 submission to the Allsopp review – published on the Treasury website – which notes that:

> "We would wish to note our serious concern that EU funding allocations decisions, and other distribution calculations within DAs (Devolved Administrations)) and regions are being made on the basis of insufficiently robust data."

The Scottish Executive's submission is given weight following the publication by ONS on 31 October 2003 of revised and updated estimates of sub-regional GVA for the period 1995 to 2001. What should concern us in Scotland are the estimates of GVA for the Highlands and Islands. The Highlands & Island lost Objective 1 funding status in 2000 because ONS data suggested that GDP per head in the region was above the eligibility mark of 75% of the EU average. The new data show that GVA or GDP per capita was significantly lower than the earlier estimates averaging, as Figure 7 indicates, 73% of the UK – broadly similar to the EU average – between 1995 and 1998, compared to 77% on the earlier figures. Moreover, as Figure 7 shows, relative GVA per head deteriorated further after 1998. While there is no possibility of the Highland's & Islands being re-instated as an Objective 1 region retrospectively it is to be hoped that the effect of Allsopp's recommendations will be to prevent such an occurrence in the future.

Outlook

There are now clear indications of an upturn in the world economy with annualised US growth rising to pre-2000 levels, strong growth in China and other parts of the Far East, although the Euro area remains sluggish - see World Economy section. The UK economy continues to perform well with growth expected to continue to rise through 2004. Business surveys offer a mixed picture but there is little doubt that the Scottish economy is experiencing an upturn too, although manufacturing is expected to remain in recession for some months yet. Nevertheless, we feel sufficiently confident to raise our forecast for GDP growth this year from 1.2% to 1.3% and to 2.1% in 2004 and 2.3% in 2005, compared to 2% and 2.2%, respectively in the October Commentary – see Forecasts of the Scottish Economy section. While manufacturing is expected to show a significant fall in output this year of just over 5%, we are anticipating a modest rise of 1.4% in 2004 and somewhat stronger growth of just under 2% in 2005. The service sector meanwhile continues to be the engine of Scottish development with forecast growth of 2.9% this year, 2.5% in 2004 and 2.4% in 2005.

The jobs market in Scotland is expected to remain buoyant, with net new job creation of around 24 thousand this year, 48 thousand in 2004 and 43 thousand in 2005, a slight increase on our previous forecasts. Unemployment continues at historically low levels with ILO unemployment forecast at 5.8% this year and 5.5% in 2004.

The principal underlying uncertainty in these forecasts is the growth path of Scottish manufacturing. As noted above there is little sign at present of any upturn in electronics or in manufacturing as a whole. Export growth should pick up as growth in the US economy accelerates and as the Euro area begins to pick up. But the recent strengthening of the £ against the $ may dampen the growth of Scottish manufacturing somewhat. The key question to be answered over the next few months is whether the positive income effect of accelerating world growth is more than sufficient to offset the negative price effect of rising dollar export prices of Scottish goods in the US and linked markets. The outcome of these opposing forces should be more evident the next time we report.

Brian Ashcroft
15 December 2003

Endnotes

1. From the second quarter 2003, UK GDP and Gross Value Added (GVA) data are now chained volume measures (i.e. sectoral weights varying through time) with 2000 as the base year. Scottish GDP and GVA estimates, in contrast, are still being produced using 1995 sectoral weights and 1995 as the base year. UK estimates are, therefore, not directly comparable with the Scottish data. The Scottish estimates will adopt the same methodology as the UK measures in the near future.
2. However, the current exercise does not provide an exact measure of the 'cost of living' because no attempt is made to price different items in different regions to reflect differences in the individual items purchased within each category of expenditure.
3. Free on board.

Figure 1: Scottish and UK GDP, quarterly growth at constant basic prices 1996Q2 to 2003Q2

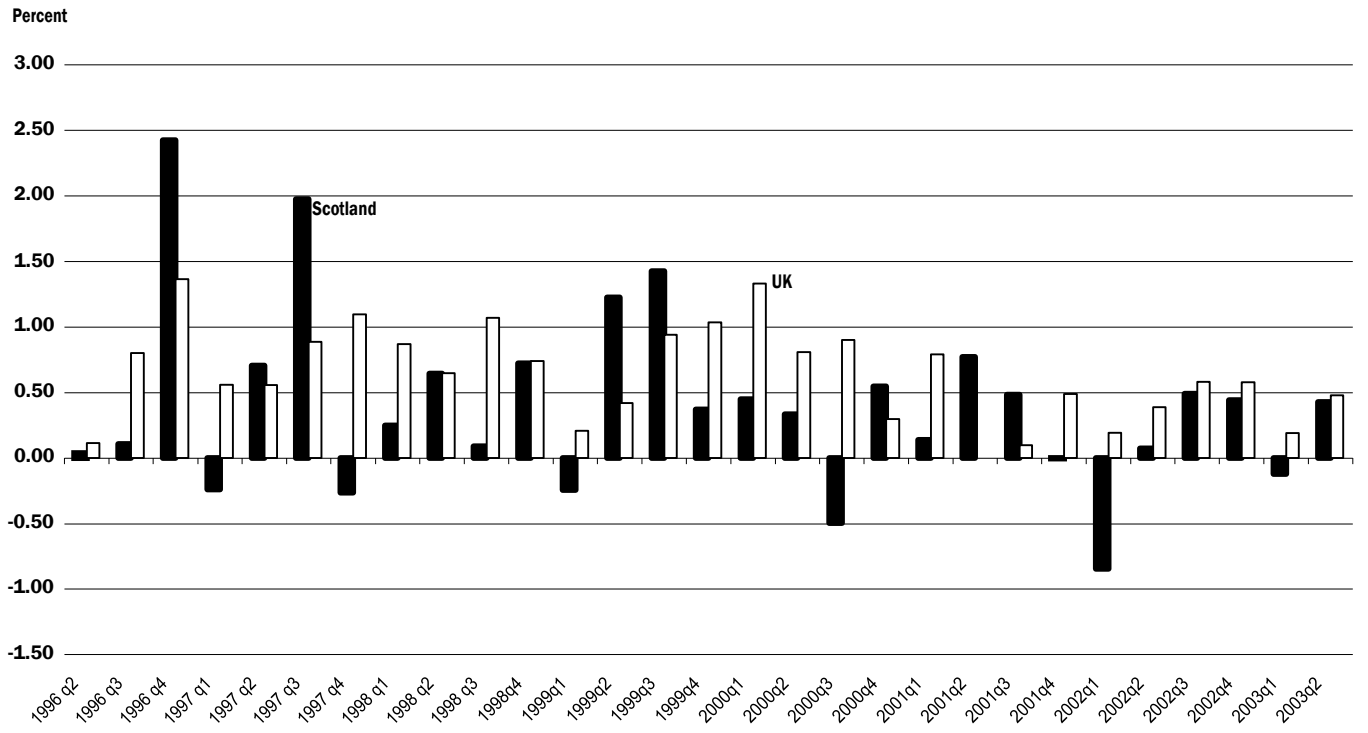


Figure 2: Scottish and UK manufacturing sector GVA growth at constant basic prices 1996Q2 to 2003Q2

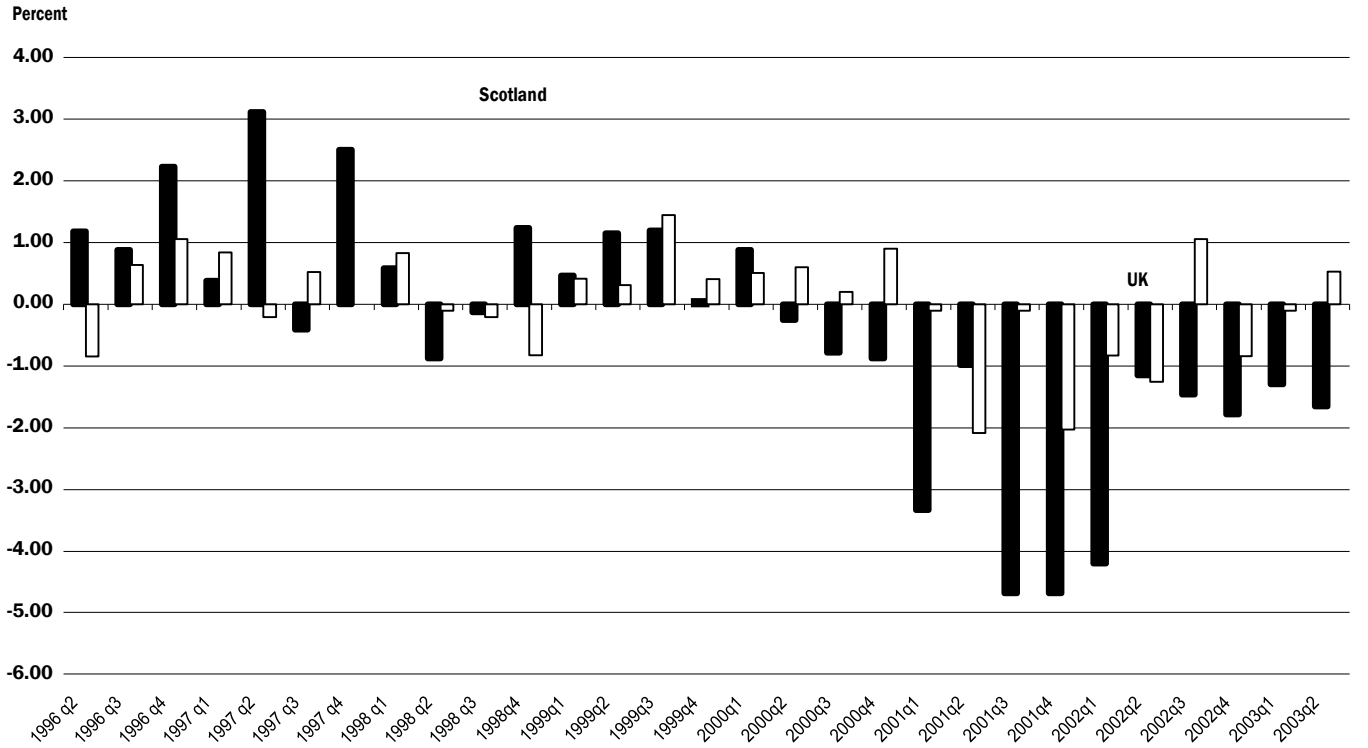


Figure 3: Scottish and UK service sector GVA growth at constant basic prices 1996Q2 to 2003Q2

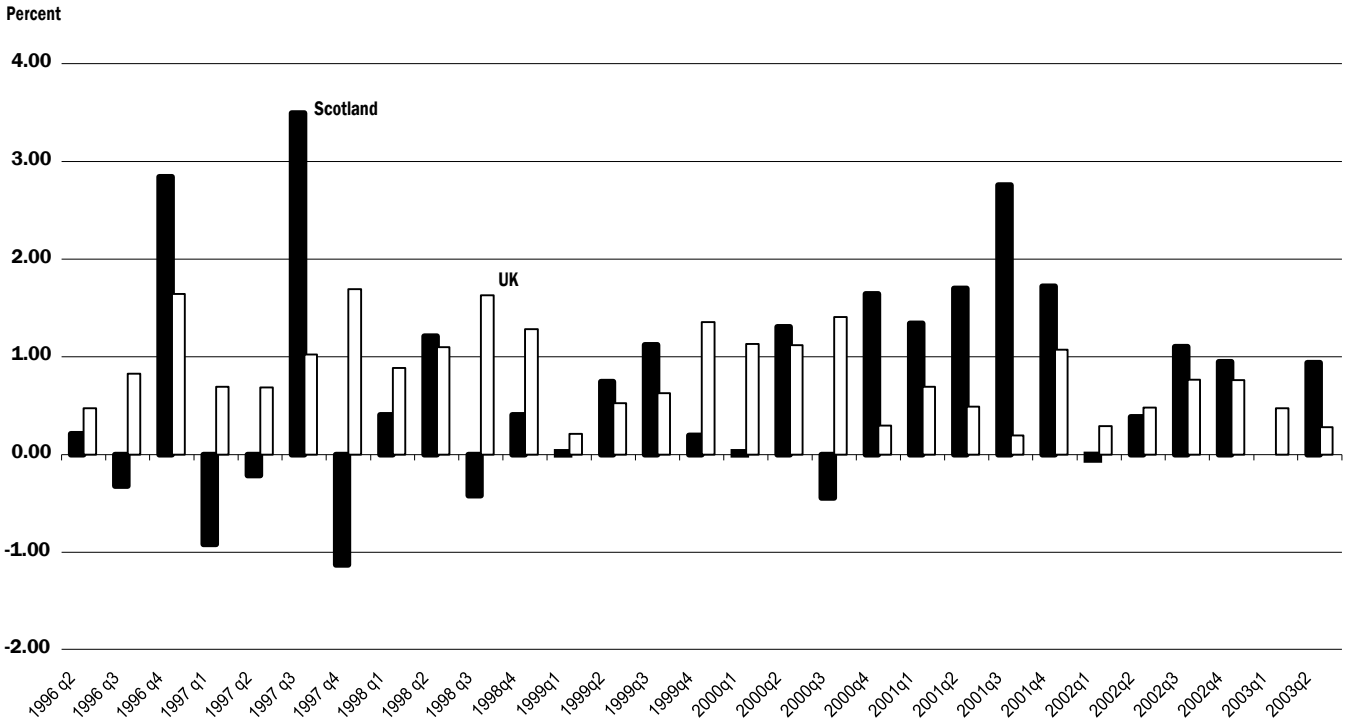


Figure 4: Key growth sectors 1996Q1 to 2003Q2

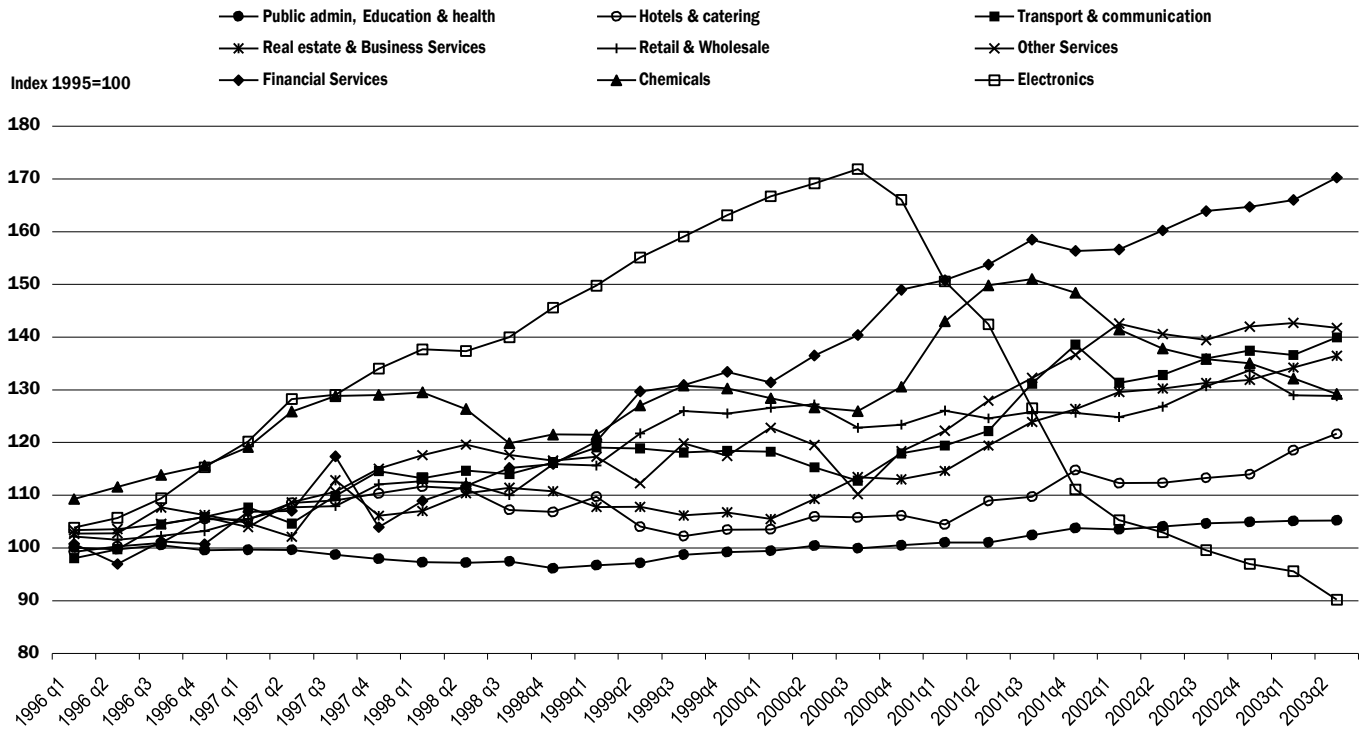


Figure 5: Key sector contribution to GDP 1996Q1 to 2003Q2

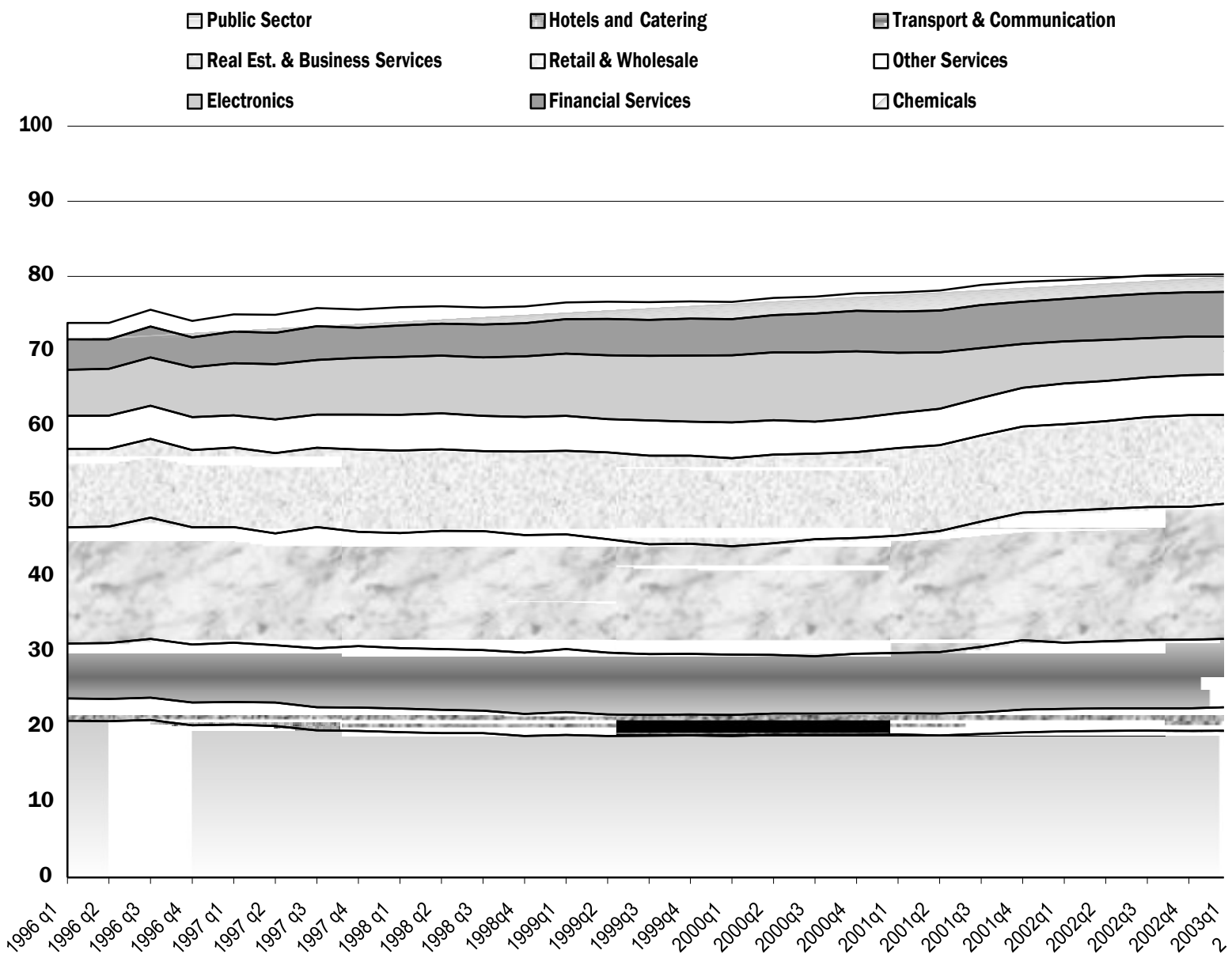


Figure 6: Scotland - UK relative prices 2003

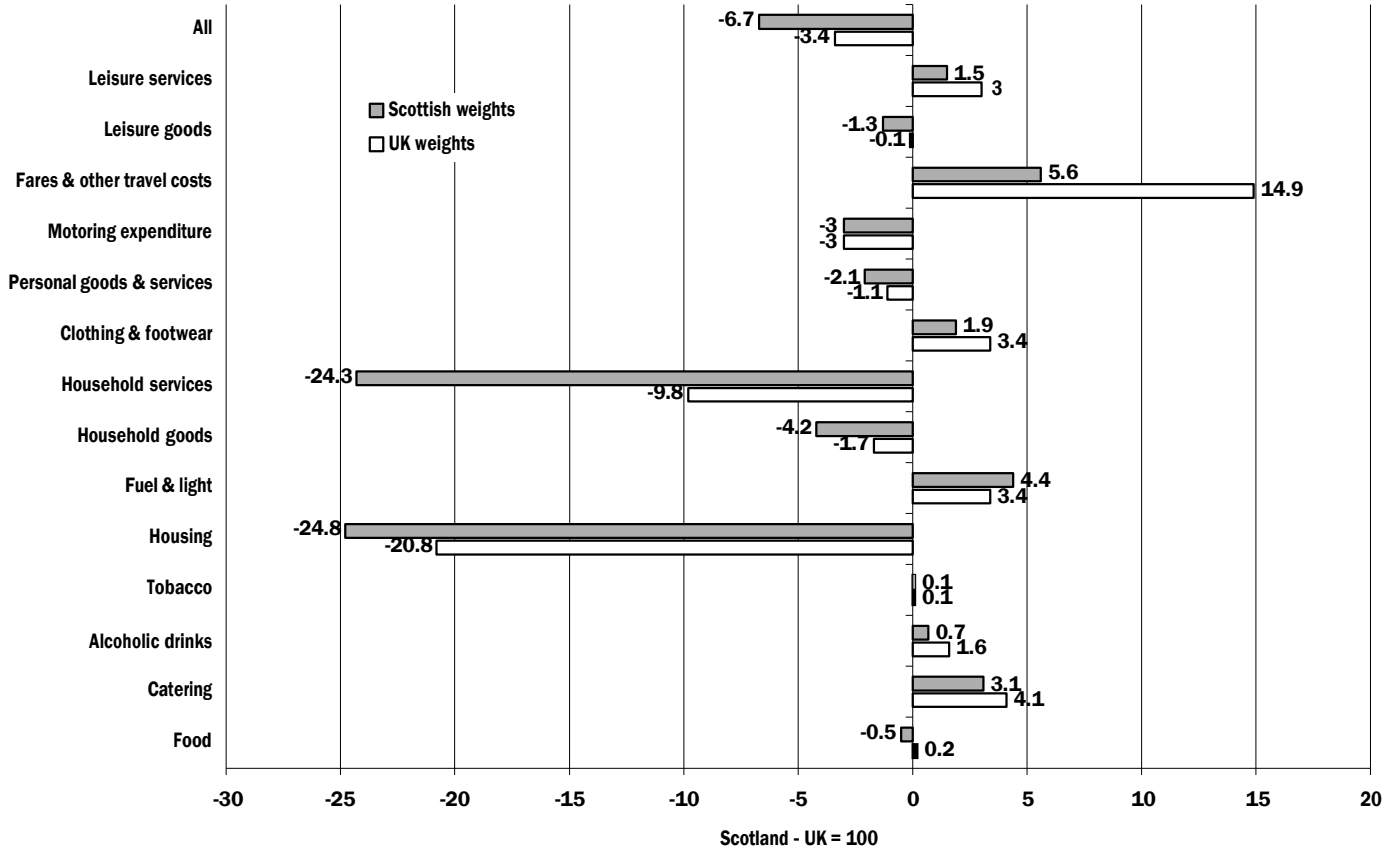
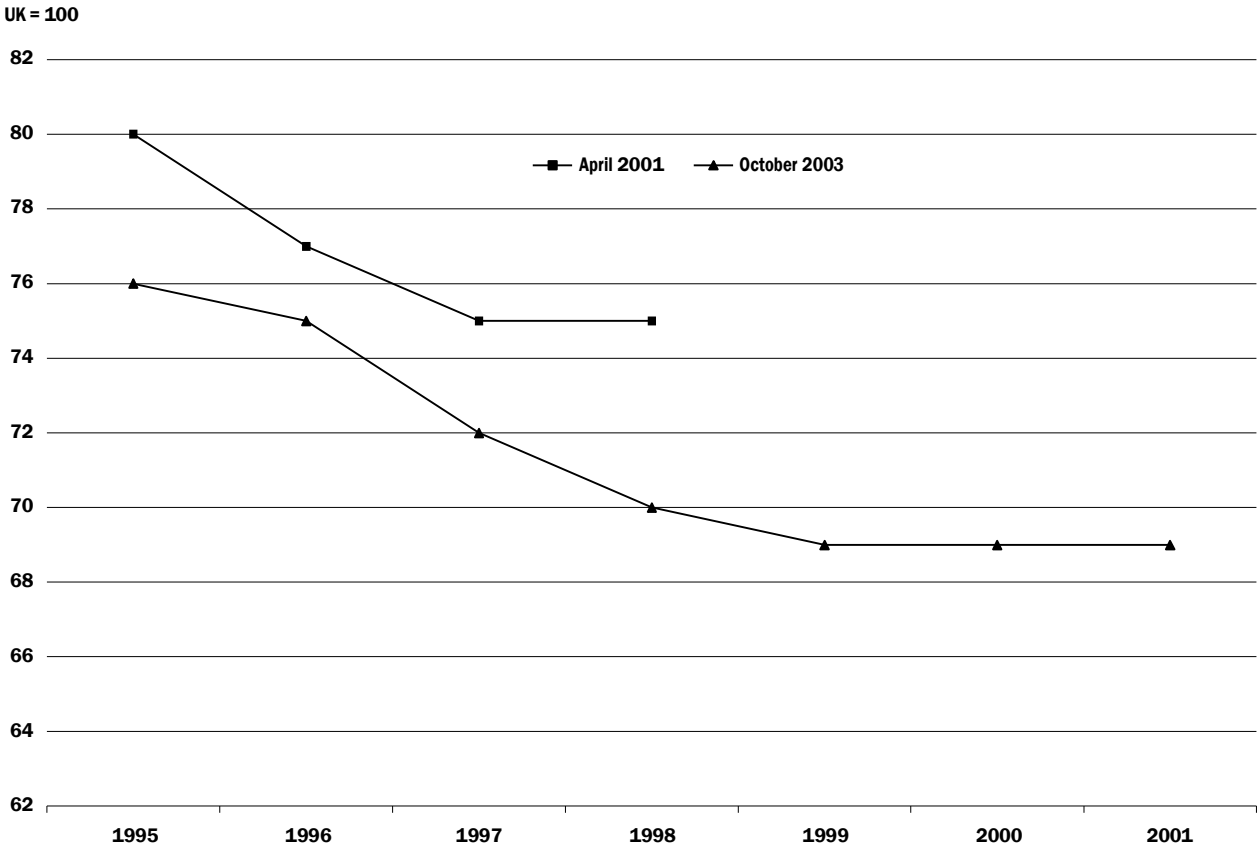


Figure 7: GVA Highland's and Islands relative to UK = 100



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