Outlook and appraisal

Overview

The Scottish economy weakened appreciably in the first quarter of this year. Of particular note was the extreme weakness of the service sector, which has helped support the Scottish growth rate through the difficult period since 2000 of global recession in electronics and in related IT industries. Scottish manufacturing remained in recession at the beginning of the year continuing the decline that has persisted for 12 consecutive quarters. UK manufacturing in contrast appears to have arrested its decline even if it has not properly begun the process of recovery. Yet, the balance of later data suggests that the world economy is recovering led by the US and the non- Japanese Asian economies. But the growth performance of the Euro area remains weak. The UK economy after dicing with recession in the first quarter showed clear signs of picking up in the second quarter and subsequent developments have led to expectations that interest rates will have to rise if not at the end of this year then soon after the beginning of the next. Recent Scottish survey data also appear to suggest that growth is returning to the Scottish economy. Against this background we have again slightly revised down our forecast for 2003 with recovery becoming better established in 2004.

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GDP and output

As expected, the Scottish economy weakened considerably in the first three months of the year. Data published by the Scottish Executive on 30th July reveal that Gross Domestic Product (GDP) fell by 0.3% in the first quarter. This weakening was to a large extent paralleled in both the world and UK economies with UK GDP, on revised data, falling by 0.1%, the UK's weakest quarterly growth performance for 11 years. Over the year to 2003 Q1, Scottish GDP remained unchanged, while UK GDP rose by 1.7%.

The weak Scottish growth performance in the first quarter was evident across all sectors with the exception of agriculture. The output of the construction sector fell by 2.2%. Service sector output contracted by 0.1%, while in the production industries there was a cutback of 0.9%. Agriculture, forestry and fishing, in contrast, grew by 4.9%. In the UK, all principal sectors, with the exception of agriculture, were stronger than their Scottish counterparts. Construction industry output contracted by 1.9%, service sector activity grew by 0.4%, and the production sector experienced a reduction of only 0.4% in its output.

Activity in Scottish services weakened considerably in the first quarter. The first quarter contraction of 0.1% was preceded by quite robust growth of 0.6%, 1.1% and 1% consecutively in the last three quarters of 2002. Service sector performance has tended to be weaker in the first quarter of each year since 1998, and while the data are seasonally adjusted there may be several systematic factors operating in this period that lower trade in that quarter. Over the year to the first quarter, Scottish services continued to outperform UK services with growth of 3.3% compared to 2.6% in the latter.

The weakening of Scottish services in the first quarter appears to be principally explained by a marked downturn in the performance of retail and wholesale as activity fell by 3.7%. Transport, storage & communication was the only other service sector – from the 7 principal service sectors for which data are published – to perform worse than the average for the sector. Further disaggregation of these data by the Scottish Executive reveal that retailing contracted by 6% in Scotland during the quarter and communications reduced output by 6.4%, with transport services enjoying growth of 3.3%. In addition, banking grew by only 0.3%, which while stabilising the fall in output of 2.5% that occurred in the fourth quarter is only a pale reflection of the strong quarterly growth exhibited by Scottish banking over the past few years. Unfortunately, no UK comparators for retail, transport, communications and banking are published.

The stronger performance of UK services in the first quarter was mainly due to activity in retailing & wholesaling holding up much better than in its Scottish counterpart. The sector grew by 0.1% during the quarter in the UK compared to a fall in activity of 3.7% in Scotland. In addition, the public sector – administration, education and health - grew quite strongly in the UK, at 0.9% compared to 0.2% in Scotland. On a more positive note, despite the weaker overall performance of Scottish services compared to the UK, four sub-sectors: hotels & catering (3.1%), financial services (0.3%), real estate & business services (1.6%) and other services (0.3%), outperformed their UK counterparts, which exhibited growth of –0.1%, -0.1%, 0.7% and –1.2%, respectively. This only serves to highlight the significance of the decline in retailing and the slower growth in public services to the relative weakness of Scottish services during the first quarter.

Scottish manufacturing output contracted by 1.4% in the first quarter compared to a small increase of 0.1% in UK manufacturing. Output in Scottish manufacturing has therefore continued to fall for 12 consecutive quarters. However, while UK manufacturing output appears to have stopped falling it has largely remained in a trough since the second quarter of last year. Over the year to the first quarter, Scottish manufacturing output fell by 10% while output in UK manufacturing dropped by 2.6%.

A closer look at Scottish manufacturing performance in the first quarter reveals that it is almost exclusively weakness in the engineering and allied industries that accounts for the poor performance compared to the UK. The textiles sector contracted by 6.8% in the quarter compared to no change in the UK. But textiles only account for 7% of overall manufacturing output in Scotland. All other Scottish manufacturing sectors tended to perform at least as well as comparable UK sectors, although there were variations at the sub-sectoral level. Engineering and allied industries experienced a fall in output of 2.8% in the first quarter compared to an increase of 1% in the UK, while over the year output fell by 16.6% in Scotland but only by 6% in the UK. The most significant part of the engineering sector is electrical & instrument engineering or, more popularly, electronics. During the first quarter, electronics production contracted by a further 1.9% in Scotland while rising by 1.8% in the UK. Electronics production has now been contracting for 10 consecutive quarters in Scotland since the fourth quarter of 2000. UK electronics, in contrast, began contracting in the first quarter of 2001 and may now be beginning to climb out of recession, although we must await later data for confirmation.

Added to the weaknesses of Scottish electronics is the poor performance of the other two sectors that form part of the engineering sector: mechanical engineering and transport equipment. Mechanical engineering cut back production by 5.4% in Scotland in the first quarter but contracted by only 1.4% in the UK. However, over the year production fell by 3.5%, which was less than the fall in the UK of 4.8%. The difference in performance of the transport equipment sector was even more marked. During the first quarter output fell by 4.8% in Scotland but rose by 2.6% in the UK, while over the year output dropped by just over 18% in Scotland but remained largely unchanged – fall of 0.1% - in the UK.

Growing Scotland's economy

The First Minister in his speech to the CBI's Fresh Talent Seminar on 24th September reaffirmed the Executive's paramount commitment to growing Scotland's economy. We believe that he was correct in asserting that the Scottish economy is no basket case. The revised regional GVA figures, which were published by ONS in August for the period 1989 to 2001, demonstrate that by 1991 the Scottish economy had attained parity with the UK in terms of produced income per head of population and then moved ahead of the UK for the next four years (Figure 1). This echoes the case made by John McLaren in the June Commentary that relative to the world over the last 40 years Scotland's performance in terms of GDP per head improved in comparison to other 'developed' economies - in part due to our relative population decline. However, from 1996 onwards we began to slip back again as overall growth slowed. This relative decline became even more marked as the recession in the electronics and IT industries began to bite from the end of 2000.

The decline in Scotland's relative growth performance after 1995 is clearly more than a cyclical phenomenon. Major changes in the world economy as globalisation deepens are affecting the comparative competitiveness of economies and Scotland appears to be losing out. Capital embodied in mobile establishments whether it be service industry call centres, or manufacturing electronics plants, are increasingly being attracted to Eastern Europe, India and China. This results not only in lost jobs but a loss of knowledge and technologies as well.

Faced with these changing economic circumstances and the increasing difficulty of Scotland competing as a place to 'do business' as well as 'to live and work' it is understandable that a desire for improved growth should move up the policy agenda and become the centre of political debate. However, while there is now a developing consensus on the need for Scotland to raise its growth rate there is much less agreement on what is to be done.

It would seem self evident that the flight of mobile capital and jobs to 'less developed' economies cannot be significantly countered by corporate cost-cutting strategies and government subsidies. Equally, while *a priori* high taxes might diminish the incentives that foster growth there is uncertainty at which point, if any, the tax burden becomes critical. There is little evidence that taxation is stifling growth in Scotland and the UK, nor evidence that low taxes are a sufficient condition for higher growth. Figure 2 plots the average tax burden in 30 countries between 1990 and 2001 against the annual average GDP growth over the period. The plot reveals a weak negative relationship but it is not statistically significant and in any event the UK and Scotland lie squarely in the middle, ranking 15th in terms of tax burden but 19th in terms of growth. If an appropriate tax regime has a role to play it is clearly only one factor and may be much less significant than the quality of factor supply within the economy. Moreover, since the tax burden is essentially the same across Britain it can hardly account for the increasing weaker performance of Scotland relative to the UK

The First Minister, in our view, again rightly stressed that economic performance depends on productivity and international competitiveness. And most economists would accept his emphasis on skills, investment, innovation and entrepreneurship as key drivers of productivity. However, a successful recipe requires more than a list of ingredients, it requires an understanding of the relative importance of each, how each ingredient relates to one another, a specified process for their combination and an appropriate (cooking) environment. The ***Smart Successful Scotland*** approach not only identifies key ingredients but also offers some guide as to process: commercialisation of ideas from universities as the basis for innovation and global connections as a means of encouraging technology transfer and knowledge flows into and out of Scotland. But ***Smart Successful Scotland*** represents a beginning not an end to the creation of a suitable recipe for Scotland's economic growth. Moreover, the strategy needs to be revised and updated to take account of the burgeoning economic problems that face the Scottish economy as international competitionincreases. These include an ageing population structure, likely population decline, capital flight, inadequate domestic competition e.g. anecdotal evidence of imperfections in commercial property markets and inflexible bureaucratic practices e.g. in planning, which affect the value for money obtained from our public services.

What Scotland needs is a better understanding of the critical processes required in growing local businesses, developing skills and in linking to the global economy. We need to understand more about the role of innovation, entrepreneurship, skills, technology transfer and investment in order to develop better policies to encourage growth. Similarly, key influences in the external environment such as the degree of competition, the role of planning and regulation, the structure, conduct and performance of the bureaucracy and the wider public sector, the role of social capital and social justice, need to be better understood if effective policies are to be developed.

Often it is very difficult to properly understand the critical strengths, weaknesses, opportunities and threats that play upon a society when one is a daily participant. It is for this reason that in creating the Allander Series, which is launched this week, we sought to go beyond these shores and attract some of the world's best economists to look at Scotland, as it were, from the outside. The seminars focus on growth, social opportunity and the efficiency and effectiveness of our governance structures. These are viewed not as isolated issues but as increasingly interdependent dimensions of the growth process in modern economies.

Outlook

While uncertainty abounds, the balance of data suggests that the recovery in the world economy is strengthening (see World Economy section). The US appears to be leading the recovery but the Asian economies, other than Japan, are also beginning to make a not insignificant contribution. However, the growth performance of the Euro area remains comparatively weak and recovery is lagging behind the other principal economies. Within Europe, the German, Italian and Dutch economies are showing little signs of an upward momentum, while the French economy is somewhat more buoyant.

UK GDP growth was weaker than expected in the second first half of the year (see UK Economy section). Yet, after dicing with recession in the first quarter, with growth of 0.1% the weakest outturn for 11 years, the economy began to pick up again in the second quarter exhibiting growth of 0.3%. Growth in 2003 is now expected to be 1.7%, which is a slight downward revision on earlier expectations. Nevertheless, while there are no immediate inflationary pressures a consensus is emerging that the prospect for UK interest rates is now more on the upside than down, with rates likely to rise in the first quarter of next year if not before.

In Scotland, July's PMI Scotland Report, published by the Royal Bank of Scotland suggested that the private sector had begun to grow again after six successive months of contraction. The Scottish Chambers' Business Survey, which was conducted in June, indicated that orders and sales were weak in all sectors but that confidence may be starting to turn round with larger manufacturing firms in particular anticipating rising trends in turnover and profitability over the next twelve months. Most recently, the new Monthly Labour Market Report published by the Bank of Scotland on 29 September provided further evidence that the outlook for the Scottish economy is improving, with employers reporting rising levels of recruitment and the tentative emergence of some skill shortages.

The recent survey evidence accords with our view expressed in the June Commentary that the signs of recovery in the Scottish economy would begin to emerge during the second half of the year. The labour market has continued to be buoyant (see Labour Market section), with jobs rising by 55 thousand during the year to May/July and the employment rate progressively higher. However, the weakness of the service sector in the first quarter is a cause for concern although the overall weakness of the Scottish economy in the first quarter was not unexpected. But the construction sector has weakened and manufacturing is more sluggish than earlier expectations.

Against this background we have again revised down our expectations of Scottish economic performance for the first half of this year but maintain the view that some degree of recovery will be present in the second half of the year. Accordingly, we are now forecasting that Scottish GDP will grow by 1.2% this year compared to our forecast of 1.3% in the June Commentary. The full effect of the recovery is now expected to come through later, with growth of 2% forecast for 2004 (cf 2.2% in the June Commentary) and 2.2% in 2005. Both manufacturing and construction are forecast to exhibit negative growth rates this year of –1.9% and –2.4%, respectively, while the service sector should grow at 2.3%. These forecasts are all lower than those presented in the June Commentary. One brighter note is the stronger than expected performance of agriculture, which reflecting recent outturn data is now forecast to contract by only 1% in 2003 compared to our June forecast of a 1.9% contraction.

Despite weaknesses on the output side of the economy, the jobs market continues to be buoyant. Following data revisions to the employers' quarterly survey series and allowing for a greater than anticipated weakness in the labour intensive construction and service sectors, we are now forecasting net jobs growth of 22 thousand in 2003, 43 thousand in 2004 and 40 thousand in 2005. Unemployment is set to remain at historically low levels with ILO unemployment forecast at just over 131 thousand in 2003, 5%, and just below 129 thousand in 2004, 4.8%. Claimant count unemployment is forecast to stand at just above 98 thousand in 2003 and just above 96 thousand in 2004.

In sum, the outlook for the Scottish economy in the short term is somewhat less favourable than when we last reported but despite this the available evidence suggests that a recovery is beginning to get underway with a return to trend growth likely in 2004 and 2005.

Brian Ashcroft
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Figure 1: GVA per head Indices 1989 to 2001

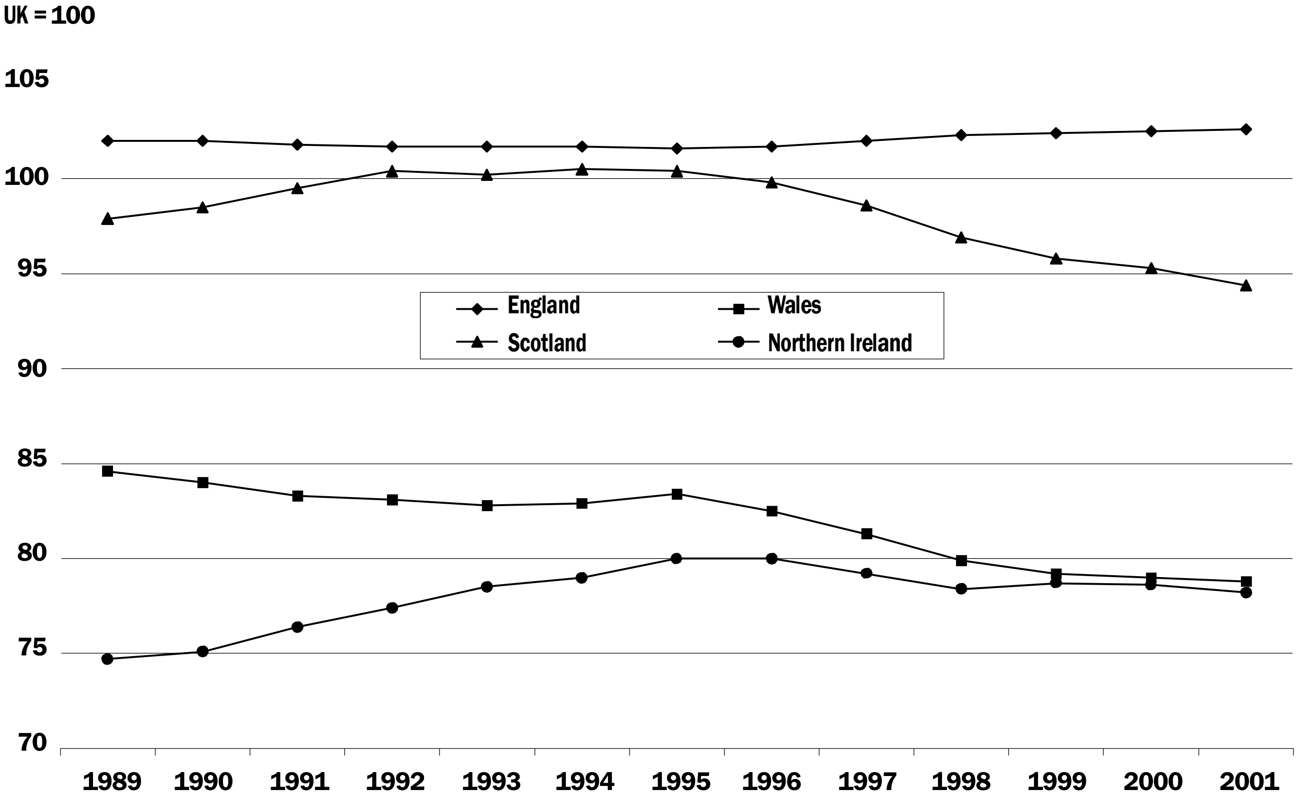

Figure 2 Tax Burden and GDP Growth in 30 Countries: 1990 to 2001