Outlook and appraisal

Overview

Scotland was in technical recession at the beginning of the year. Fortunately, on the evidence to date, this recession should not be sustained. The service sector continues to perform strongly and there are some signs that manufacturing is beginning to recover. The electronics sector lost more than a quarter of its output over the year to the first three months of 2002. Some slight comfort can be drawn from the fact that the downturn in UK electronics is now as bad as it is here. But there are few, if any, signs that a recovery in the sector is on the way. By contrast, other services, business services and financial services in Scotland are all outperforming their UK counterparts. The UK economy picked up in the second quarter and it is likely from business survey evidence that growth will pick up here. However, the turbulence in world equity markets following the corporate governance scandals in the US and the increasing prospect of war in the Gulf, have again put the world economic recovery into doubt. But signs of recovery are still

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evident. In the light of this, we have revised our forecasts for Scotland down slightly since we last reported in July. The Scottish economy will continue to recover but growth will remain below trend for the foreseeable future. The position in the labour market is more sanguine. Much needed jobs are being provided through sustained growth of the service sector, thus offsetting job losses in manufacturing. Unemployment will remain low and may fall further next year. But the growing uncertainties in the world political situation pose significant threats to the durability of the recovery in Scotland as elsewhere.

GDP and output

Real Gross Domestic Product (GDP) fell by 0.7% in the first quarter of the year, according to the most recent data from the Scottish Executive. Data for the final quarter of 2001 have now been revised indicating a fall of 0.3% on 2001 Q3. With two consecutive contractions in the volume of goods and services produced, Scotland is now in a technical recession. Whether this downturn can be understood as a ‘real' recession will depend on how long negative growth is sustained. Most recessions worthy of the name endure for several quarters and this appears, fortunately, to be unlikely in present circumstances.

While the Scottish economy was contracting as 2001 ended and 2002 began, the UK economy was largely flat exhibiting only 0.1% growth in each quarter. Yet the weaker position of the Scottish economy was largely confined to the production and construction sectors. The service sector grew more strongly here, both in the first quarter and over the preceding twelve months. It may seem trivial to make the point, but when 63 percent of the economy, by output, and about 70 percent of the economy, by employment, is enjoying positive growth then talk of recession would appear to be premature.

By contrast, the manufacturing sector in Scotland endured a further fall in output in the first quarter of this year. Gross value added at basic prices fell by 4.3% compared to a fall of 1.3% in the UK. This was the seventh consecutive quarter that manufacturing output had declined. Over the year to 2002 Q1, Scottish manufacturing output fell by 10.6% while the fall in UK manufacturing production was much smaller at 4.2%. The construction sector also performed poorly here. Construction activity contracted by 1.8% during the first quarter but in the UK the sector exhibited strong growth of 3.0%. Over the year to the first quarter, Scottish construction contracted by 4.1% while UK construction enjoyed positive growth of 5.6%.

Within Scottish manufacturing most sectors cut back on output during the first quarter. This was not the case in UK manufacturing where petroleum products, chemicals, metal products, food and tobacco, and other manufacturing all recorded positive growth. The contraction in Scottish manufacturing over the last seven quarters has largely been driven by the severe downturn in electronics activity. However, as noted above, the recession in Scottish manufacturing is now much more general. Electronics output in Scotland continued to fall, by 5.1% in the first quarter, but by less than the fall in UK electronics production, which contracted by 6.7%. However, over the year to the first quarter electronics production in Scotland fell by 26.3% compared to a 17.8% fall in the UK.

But other Scottish manufacturing sectors were also confronting a downturn in activity. Within engineering, the transport equipment sector was particularly weak, contracting by 14.1% in the first quarter and by 16.1% over the previous twelve months. The same sector in the UK suffered much less, with production falling by 2.8% during the quarter and by 2.0% over the year. The drinks sector contracted by 5.4% in the first quarter but production fell by only 1.4% in the UK. Metals and metal products experienced a 6.0% cut in production in Scotland while the sector grew by 1.9% in the UK. Paper, printing and publishing was subject to a 4.9% fall in its output in Scotland but production remained little changed - a 0.1% fall - in the UK. Other manufacturing reduced its output by 2.9% in Scotland yet grew by 0.5% in the UK. Apart from electronics, the only Scottish manufacturing sector to outperform its UK counterpart was mechanical engineering, which suffered a 0.4% fall in output in Scotland but a 2.7% cut back in the UK.

The stronger growth of the service sector in Scotland in the first quarter was concentrated in three sectors: other services, business services and financial services. All three sectors significantly outperformed their UK counterparts during the quarter with growth of 3.4%, 2.4% and 1.8% respectively, compared to respective growth in the UK of a fall of 0.9%, a rise of 0.3% and a fall of 0.9%. The weakest sectors in services in Scotland during the quarter were transport, storage and communication, hotels and catering, and retail and wholesale. Gross value added fell in each of these sectors by 2.2%, 1.6% and 0.7% respectively. In the UK, in contrast, transport services grew by 1%, retail and wholesale grew by 0.2%, while hotels and catering reduced output by 0.5%. When the year to the first quarter is compared to the preceding four quarters, other services (15.5%), business services (10.4%), transport services (12.8%) and hotels and catering (5.5%) exhibited the strongest growth and much in excess of their UK counterparts, which displayed growth of 2.9%, 5.1%, 2.4% and a fall of 3.4%, respectively. Financial services in Scotland grew by 3.2% over the year, somewhat less than the growth achieved by the sector in the UK as a whole (3.7%).

So, at the beginning of the year, the service sector in Scotland was continuing to perform creditably despite the general recession in manufacturing and weak performance of construction. Overall, the economy could be described as being in recession because of the fall in GDP in two consecutive quarters. But from later evidence it appears unlikely that such negative growth will be sustained throughout the year.

Of course, we are very dependent in drawing conclusions about the performance of the economy on the official GDP series provided by the Scottish Executive. These data are constructed to the highest professional standards set out in the National Statistics Code of Practice. The small size of the survey base in Scotland and the absence of different sources of GDP estimates, as in the UK, inevitably mean that the Scottish data will be less reliable and more subject to revision than the comparable data for the UK. While this is understood, the Institute is concerned at the size and frequency of the revisions to the Scottish GDP data.

The first quarter data release is a case in point. The data for two sectors agriculture and transport services were revised upwards appreciably in the latest data release. The net effect of these revisions was that GDP in the fourth quarter of last year was 1% higher in the latest data release compared to the 2001 Q4 release. However, it is not so much the uplift in the index that poses a problem for the interpretation of Scottish growth but rather the extent of the variation in the revision to the index quarter by quarter. The nature of the revisions in the latest data release were such as to markedly alter the recent growth path of the economy, with the result that while the economy had been reported as growing slightly (0.1%) during 2001 Q4 in the data release for that quarter, the revisions introduced in the first quarter release meant that growth in 2001 Q4 was now reported as a fall of 0.3% instead of a rise. Clearly, with movements of such magnitude one has to be even more careful about drawing firm conclusions about the path of the economy on the basis of one, and even two, quarter's data.

In view of the importance of the GDP data to both policy formulation and public discourse on the Scottish economy, we take the view that the Executive should consider devoting more resources to the construction of the series. The two-quarter lag in publication is longer than for the comparable UK data. Informed comment is therefore limited by the greater lag and uninformed speculation fuelled. It is understood that in a small economy data series are likely to be subject to more frequent revision. But we consider that the Executive should seek cost-effective ways to minimise this problem with some urgency.

The growth of the Scottish economy

The publication of the first quarter data along with the inference from the data that the economy was in a technical recession promoted much debate about the growth of the Scottish economy. The Institute welcomes debate on the performance of the Scottish economy and we see our role as helping to inform that debate as much as possible. Against that background, we feel from the research and evidence that is at our disposal that the following points need to be borne in mind.

First, the cyclical performance of an economy is in principle distinct from its trend growth performance. However, macroeconomic instability may damage confidence and expectations and so may affect the longer-run rate of growth. The recent downturn in the Scottish economy has many of the hallmarks of a cyclical downturn caused by a temporary slowdown in the growth of world trade and a recession in the world ITC industry. However, the sustained weakness of the electronics sector that has so badly affected Scotland has a structural dimension due to the maturation of the products produced by the industry here. It follows that the strength of the cyclical upturn when it emerges will not return us to the growth levels seen in the electronics industry in Scotland in 1990s. Other activities could emerge as demand rises to pick up the slack but there is no guarantee of that.

Secondly, it would be wrong to believe that the growth rate of Scotland languishes permanently in the basement of world economic growth. Over the last twenty years the comparative growth performance of Scotland has fluctuated considerably. During the period 1980 to 2000, real Scottish GDP growth averaged 1.6% per annum. Figure 1 indicates that Scotland's growth during this period placed it in the bottom three from 27 OECD countries, with only Greece and Switzerland performing worse. However, as Figure 2 makes clear, Scotland's growth performance improved during the 1990s, averaging 2.2% per annum. This pushed Scotland up the rankings to 23rd out of 31 separate OECD countries, with countries such as Finland, France, Sweden, Germany and Italy performing less well than Scotland. When growth performance is compared during the first and second five-year periods in the 1990s, Scotland's relative performance is seen to diverge significantly. Figures 3 and 4 reveal that Scotland's ranking was considerably higher during the earlier than in the later period: 11^{th} from 31 between 1990 and 1995 and 26^{th} from 31 between 1996 and 2000. What is interesting about this finding is that Scotland's annual growth averaged 2.2% in both periods. It would appear that the reason for our much-improved comparative performance during the early 1990s was that Scotland avoided the recession that occurred between 1990 and 1992, unlike many other countries, including the UK.

Yet, Scotland's growth performance was absolutely stronger during the 1990s than in the 1970s and 1980s and this must, in no small measure, be due to the large inflow of inward investments, particularly in electronics. It is therefore legitimate for concern to be expressed about the future course of Scotland's growth in a world where such investments may be less probable than before. Against that background, a debate about how to improve the performance of domestic Scottish industry and develop strategies to grow different sectors becomes increasingly more urgent.

There appears to be a developing consensus around the Executive's ***Smart Successful Scotland*** agenda of seeking to grow domestic Scottish businesses, enhance Scottish global connections and improve learning and skills. This agenda is in turn informed by the academic evidence that productivity growth depends on business R&D and innovation, enterprise, competition, and both public and private investment in skills, physical capital and infrastructure.[1] However, there is room for more research and debate about the precise nature of the policies to be adopted, the focus, scale and balance of intervention, and appropriate delivery mechanisms. The answers to these questions in part depend on the underlying character and problems of the Scottish economy as well as an understanding of the critical factors in economic growth. The relative responsibilities in promoting economic development of the private sector and the Executive, including its delivery agencies such as Scottish Enterprise and Highlands and Islands Enterprise, also need to be better understood.

From the research that is available it is reasonable to conclude that the weaknesses in Scotland's economic growth record are a problem ***for*** government but are much less a problem ***of*** government. The critical differences in economic performance between Scotland and comparator OECD economies are to be found in the weakness of domestic Scottish business in starting new firms, in investing in R&D and in introducing new products, and in weaknesses in the wider economy including the proportion of 16-19 year olds not in education, training or employment, and in population loss.[2]

Against this background, the debate is not well served by the promulgation of a belief that there are simple solutions to Scotland's mediocre growth and productivity performance. There is no simple panacea that will guarantee a smart successful Scotland in the future EU and global competitive environment.

For example, the view that a significant improvement to Scotland's economic performance can be secured by a large increase in spending on transport infrastructure flies in the face of the evidence. Napier University's Professor Ron McQuaid and Malcolm Greig in their forthcoming report for the Scottish Economic Policy Network (Scotecon) on ***Transport and the Scottish Economy***, note that the evidence suggests that investment in transport infrastructure is most effective in stimulating economic growth where the existing system is not well developed, as in many underdeveloped countries and regions. It is clearly a matter of judgement whether the well-known problems with transport in Scotland come into that category. But it is not unreasonable to argue that the weaknesses and differences noted above in Scotland's comparative economic structure and performance are more salient.

It would appear to be even more bizarre to argue, as some have done, that large additional increments to transport spending in Scotland, or other proposed one-off solutions, should be funded by reducing the budget of, or even abolishing, Scottish Enterprise. The case for a government development agency rests on the existence of market and institutional failures on the supply-side of the economy, which offer a rationale for policy intervention by professional staff with experience and understanding of development issues. It is quite clear on most benchmarks that Scottish business under performs significantly, that there are clear market and institutional failures underlying Scotland's weak growth performance and that Scotland requires a well-resourced and efficiently run development agency that can be more market facing than government itself. The need for such an agency is accepted in almost all countries and regions with development aspirations or challenges. Scotland had the foresight to get into the game early, as highlighted by the recent establishment of Regional Development Agencies in the English regions. The returns from far-sighted, supply-side interventions are potentially great but inevitably long-term. To retreat now from the development agency concept would be a retrograde step with little or no support from theory, evidence and practice.

Outlook

After the evidence that Scotland was in a technical recession during the final quarter of last and the first quarter of this year, subsequent data initially suggested that the economy was beginning to pick up again. The UK economy grew by 0.6% in the second quarter after a flat performance in the previous two quarters (see UK Economy section). Given the importance to Scotland of trade with the rest of the UK it seems probable that Scotland would have benefited to some degree from the UK upturn. The findings of the Scottish Chambers' Business Survey (SCBS) for the second quarter also appeared to support that view. Scottish manufacturers reported actual or expected rising trends in orders and sales during the current quarter, the next three months and over the succeeding twelve months. In key service sectors sales trends were also rising, although there was evidence of some moderation in retail sales trends.

However, the subsequent turbulence in world equity markets following the corporate governance scandals in the US and the increasing prospect of war in the Gulf, have again put world economic recovery into doubt (See World Economy section). Nevertheless, signs of recovery are still evident in the US, if more muted than anticipated. Asian regions, other than Japan, appear to be recovering relatively well, while recovery in Europe appears to be evident but at a very early stage. In the UK, growth strengthened in the second quarter and importantly exports began to pick up, as the growth of consumer demand began to moderate slightly. But considerably uncertainty remains as to future prospects.

Against this background, forecasters of the UK economy have tended to revise their forecasts downwards somewhat compared to the position when we last reported in July. We believe that it is prudent to do the same for Scotland. We are now forecasting growth (see Forecasts of the Scottish Economy section) of 0.7% in 2002 compared to our July forecast of 0.9%. Since, the available evidence suggests that the recovery is essentially being delayed rather than stalled, we have raised our forecast for 2003 slightly to 1.4% from 1.3% in July. The delay effect is magnified further in 2004 so that we are now forecasting growth of 1.9% for that year compared to our July forecast of 1.6%.

Scottish growth will therefore continue to be below trend for the foreseeable future. Manufacturing will not fully escape from recession until 2004 but the service sector will continue to grow quite strongly.

The labour market in Scotland (see Overview of Labour Market section) has held up better than might have been expected given the marked slowdown in growth experienced by the economy in recent quarters. Over the year to May-July 2002 employment fell slightly by 4,000 but rose by 7,000 in the three months to May-July. The employment rate stood at 73.3% in May-July, which is close to historically high levels. Continued employment growth in financial and other services has helped to offset the job losses in manufacturing. The ILO unemployment level increased slightly over recent months but the rate has changed little standing at 6.4% during May-July.

We nevertheless expect that the weak performance of the Scottish economy during 2002 will be associated with net job losses. Our forecast is for a net job loss of 5,800 this year. But we expect the pick up in growth in 2003 and 2004 to be associated with net job creation and the forecast numbers are 35,200 and 23,700, respectively. Growth in the service provides the principal impetus to net job creation. The ILO unemployment rate is forecast to be 6.6% for 2002 falling to 6.4% in 2003 and 6.2% in 2004 as economic growth improves.

Endnotes

1. See H M Treasury "Productivity in the UK: The Evidence and the Government's Approach", 2000.

2. Scottish Executive "Measuring Scotland's progress towards a Smart Successful Scotland", 2002.

Brian Ashcroft
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Figure 1: Annualised OECD growth at 1995 prices and PPPs, 1980-2000

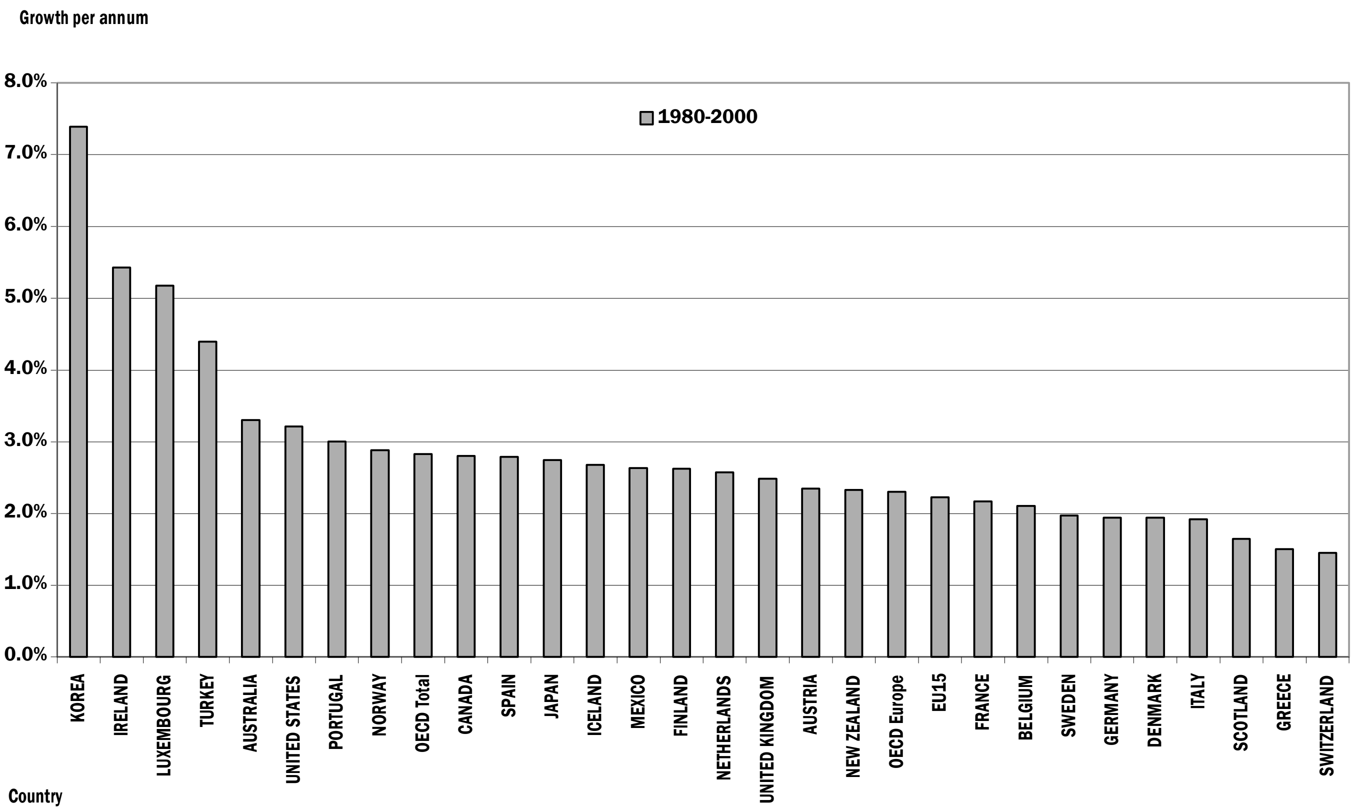


Figure 2: Annualised OECD GDP growth at 1995 prices and PPPs, 1990-2000

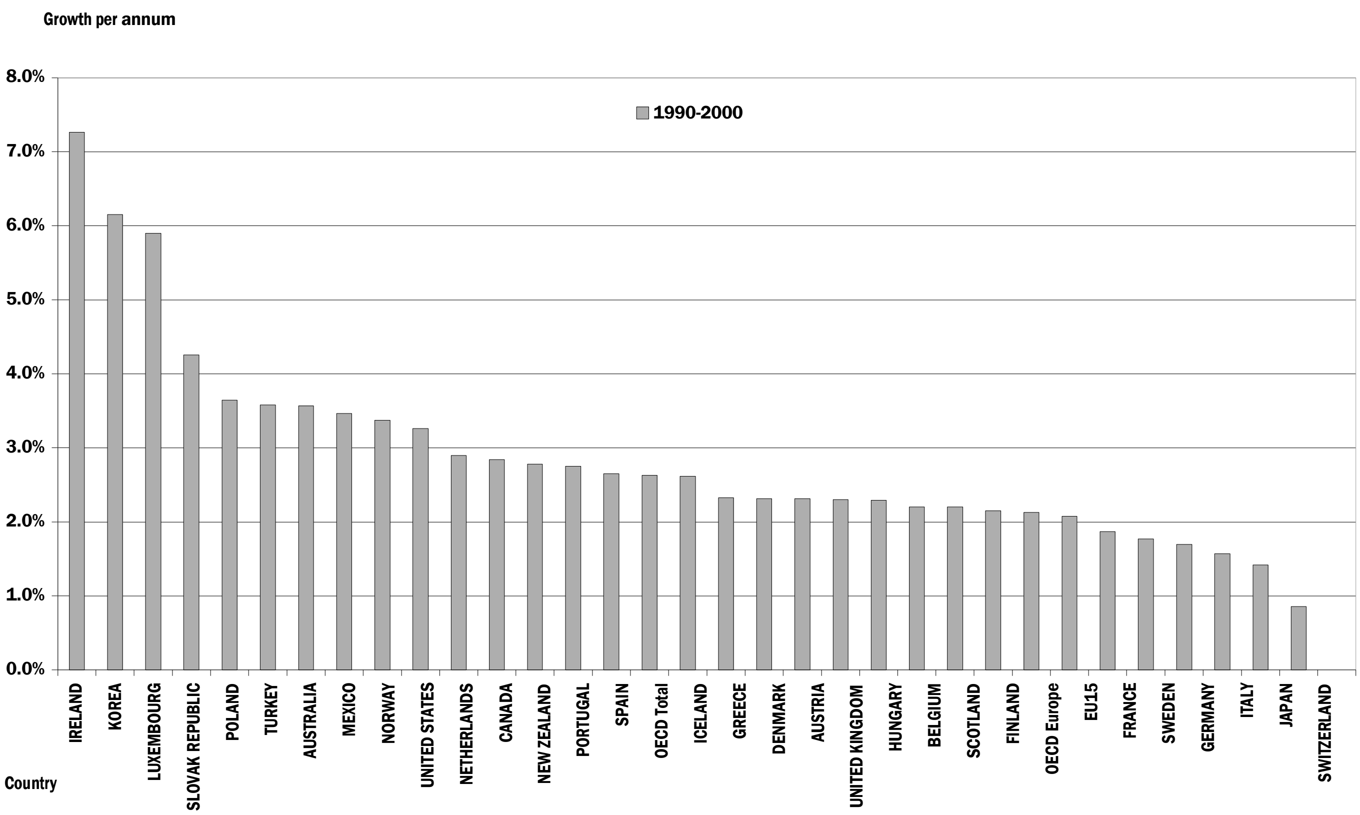


Figure 3: Annualised OECD GDP growth at 1995 prices and PPPs, 1990-1995

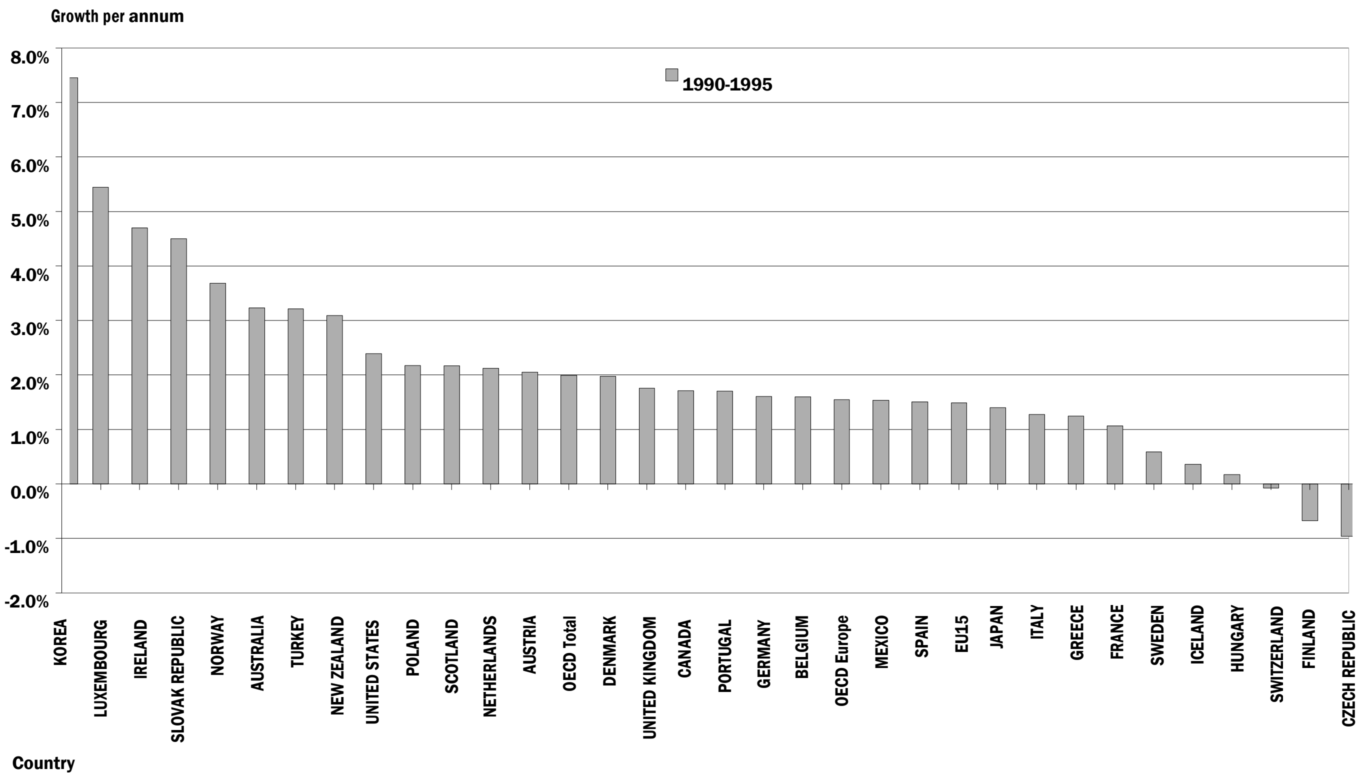
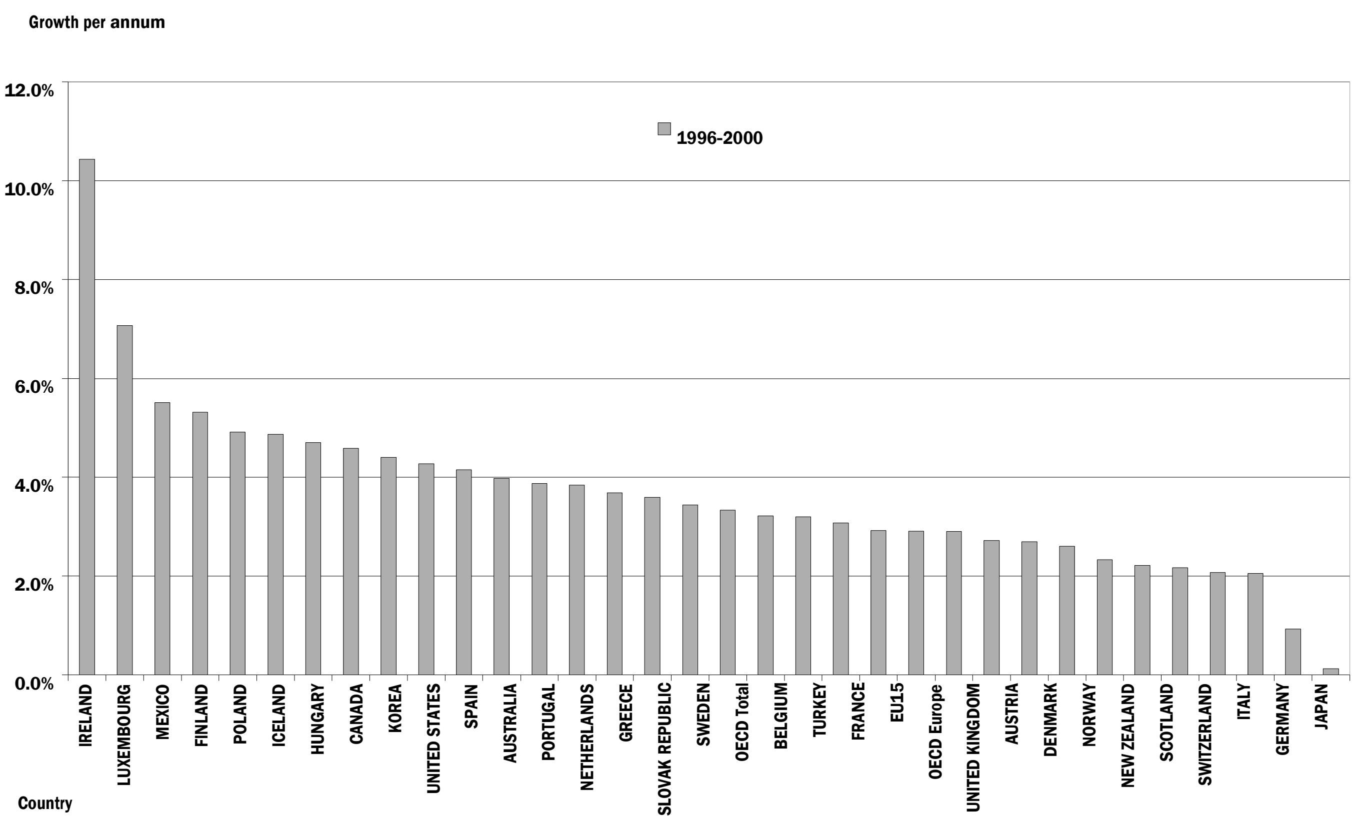


Figure 4: Annualised OECD GDP growth at 1995 prices and PPPs, 1996-2000



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