

Quarterly
ECONOMIC
Commentary

FRASER OF ALLANDER INSTITUTE

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Quarterly **ECONOMIC** *Commentary*

***** CONTENTS*****

Page

i	OUTLOOK AND APPRAISAL.....	Brian Ashcroft
	THE ECONOMIC BACKGROUND	
1	The International Environment.....	Kenneth Low
2	UK Macroeconomic Trends	Brian Ashcroft
3	UK Labour Market	Kim Swales
4	UK Outlook	Brian Ashcroft
	THE SCOTTISH ECONOMY	
6	Short-term forecasts.....	Kenneth Low
6	Deloitte & Touche Scottish Chambers' Business Survey.....	Sarah Le Tissier
9	Construction.....	Sarah Le Tissier
10	Energy.....	Kenneth Low
11	Utilities	Kenneth Low
11	Food, Drink and Tobacco.....	Stewart Dunlop
12	Electrical and Instrument Engineering.....	Stewart Dunlop
12	Chemicals	Sarah Le Tissier
13	Textiles, Leather, Clothing and Footwear.....	Stewart Dunlop
14	Paper, Printing and Publishing.....	Richard Marsh
15	Mechanical Engineering	Karen Turner
16	Distribution.....	Sarah Le Tissier
17	Transport	Kenneth Low
19	THE LABOUR MARKET	Kenneth Low
	ECONOMIC PERSPECTIVE	
28	The Numbers of Scottish Businesses and Economic Policy	Alexander Dow and Catherine Kirk
	ECONOMIC PERSPECTIVE	
35	Response to the Paper by Alexander Dow and Catherine Kirk.....	Brian McVey
	ECONOMIC PERSPECTIVE	
38	Devolution and Public Spending: Arguments and Evidence.....	Arthur Midwinter
	EDITORS.....	
	GRAPHICS.....	Brian Ashcroft and John Ireland
	PRODUCTION.....	Linda Kerr
		Linda Kerr and Isobel Sheppard

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OUTLOOK *and* APPRAISAL

The Scottish economy experienced a further contraction in output in the first quarter of the year. Growth was considerably weaker than in the UK. The service sector exhibited no growth, while manufacturing output fell markedly. In contrast, Scottish construction outperformed its UK counterpart, as did agriculture and mining & quarrying. Within services, retail & wholesale and transport services were the strongest performing sectors, while business and financial services were weak. It is suggested that continuing weakness in the performance of Scottish business services should be a cause for policy concern. In manufacturing, Scottish performance was mixed, with about half of the sub-sectors doing as well as, or worse than, their UK counterparts. The transport equipment and food sectors performed strongly both absolutely and compared to the same sectors in the UK. At the other extreme, the drink and metals sectors suffered sharp contractions, reflecting the continuing effects of the strength of sterling. The electronics sector also contracted in Scotland, perhaps due to weakness in the general demand for computers in which the Scottish economy specialises. The fall in electronics output appears to be a key reason for the overall weakness of manufacturing. New regional accounts data from National Statistics suggests that GDP per head in Scotland relative to the UK fell between 1995 and 1998. This appears to contradict the conclusion that would be drawn from the Scottish

Executive GDP statistics and raise concerns as to which dataset is correct. The resolution of this question has clear implications for economic development policy in Scotland. The poor Scottish GDP performance in the last two quarters is not sufficient to warrant a conclusion that the Scottish economy is in recession. Growth in the UK economy picked up in the second quarter and much the same should be expected here. Nevertheless, growth in the Scottish economy will be weaker than in the UK this year. This is principally because of the disproportionate effect on Scotland of the strength of sterling and continuing weakness in the demand for electronics products.

GDP and Output

The latest GDP statistics from the Scottish Executive reveal that the economy contracted in the first quarter of this year. GDP (excluding oil & gas) fell by 0.2% compared to a rise of 0.4% in the UK. Gross value added (GVA) at constant basic prices in the service sector exhibited no growth, while its UK counterpart grew by 0.6%. The outturn in Scottish manufacturing was relatively worse. Manufacturing GVA fell by 1.7% here compared to a 0.5% fall in the UK. Elsewhere in the production sector, electricity, gas & water supply suffered a reduction in output both in Scotland and the UK, although the contraction in Scotland was much greater: a fall of 6.5% compared to 2.7% in the UK. In contrast, the mining and quarrying sector grew by 1.4% here but contracted by 1.8% in the UK. In the two other principal sectors: construction and agriculture, Scottish producers outperformed their UK counterparts. GVA in Scottish construction grew by 5.1% compared to a 3% rise in the UK, while agriculture exhibited growth of 1% in Scotland but fell by 1.2% in the UK.

Within the service sector, retail & wholesale grew the most strongly of the 7 service sub-sectors for which the Executive provides data. The sector grew by 2.2% in the first quarter compared to 1.1% growth in retail & wholesale at the UK level. Of the remaining 6 service sub-sectors, only one other, transport, storage & communication grew faster than its UK counterpart: 1.5% compared to 1.2%. The weakest performing sub-sector within Scottish services was real estate & business services where output fell by 1.5% compared to a rise of 0.4% in the UK. We have noted before the persistent relative weakness of the business service sector in Scotland. In view of the increasing importance of

business services to the 'new economy' this continuing under performance must be a cause for policy concern. Somewhat unusually, the financial service sector was also weaker in Scotland in the first quarter contracting by 0.6% compared to growth of 2% in the UK. Financial services has been one of the main drivers of Scottish growth in recent years and the weak performance of both this sector and business services appears principally to account for the relative weakness of Scottish services in the first quarter.

Within manufacturing, 5 of the 11 sub-sectors for which the Executive reports information outperformed their UK counterparts. The strongest absolute growth performance in the first quarter was exhibited in the refined petroleum products and nuclear fuel sector, which grew by 6.5% compared to 4.7% in the sector in the UK. However, this industry is very volatile and contributes little to GDP. Of greater significance, was the performance of the transport equipment and food sectors, which grew by 5.6% and 1.4%, respectively, compared to falls in output in the comparable UK sectors of 0.6% and 0.2%. At the other extreme, the weakest manufacturing sectors in the first quarter were drink and metals. Both these sectors suffered a marked fall in output in the region of 10%. Drinks output contracted by 10.9%, while the industry in the UK suffered only a 0.5% decline. The metals sector cut back its output by 9.7% even though the same sector in the UK grew by 0.3%. The poor performance of these sectors clearly contributed to the weak overall performance of Scottish manufacturing in the quarter. But perhaps the principal reason for the weakness in Scottish manufacturing between January and March was the performance of electrical & instrument engineering or electronics, which accounts for almost a quarter of manufacturing output. GVA in electronics fell back by 1.2% during the quarter, yet output in UK electronics remained unchanged.

In the July 2000 Commentary, we ascribed the weakness in fourth quarter 1999 manufacturing performance largely to the effects of the high pound. The latest data suggest that a broader set of reasons is responsible for the continuing weakness in the sector. It seems likely that the strength of sterling continued to account for the retrenchment in the drink and metals sectors, although the much greater contractions in Scotland raise concerns about the adaptability of Scottish management to the shock compared to their UK counterparts. But, in contrast, the other main price sensitive sectors, food and textiles, enjoyed positive growth during the quarter, with the latter industry growing by 0.6% while the sector in the UK experienced a fall in output of 3.7%. Whether this indicates that the

Scottish management in these sectors is 'learning to live' with the high pound, by for example seeking to compete more on product characteristics and less on price, is a moot point. It might, in contrast, simply indicate that these traditional Scottish sectors were amongst the first in Scotland to benefit from the pick up in world trade. The reasons for the continuing weakness in Scottish electronics also seem to transcend a simple strength of sterling effect. There is evidence that the demand for computers is currently weak generally and this is clearly having an impact on the sector in Scotland, which accounts for a high proportion of European computer production. The prospect that the weak demand for the principal electronics products produced in Scotland may continue for some time is clearly a cause for concern. It highlights the need for inward investment policy to seek to capture a broader range of electronics products and for the industry in Scotland to speed up its efforts to diversify. Finally, another point that is worth remembering is that the UK economy as a whole experienced a slowdown in the rate of growth of domestic demand during the first quarter of the year. Scottish industry will have been no less affected by this than industry elsewhere in the UK.

The weakness of Scottish GDP growth in general and manufacturing performance in particular is a recent phenomenon. Scottish GDP growth was broadly equal to UK GDP growth when the rate is calculated for the latest 4 quarters on the preceding 4 quarters (2.2% for Scotland and 2.3% for UK GDP growth ex. oil). Figure 1 presents the quarterly GDP growth rates for Scotland and the UK between 1995Q2 and 2001Q1. These data incorporate the latest data revisions, which are substantial. The figure shows the stronger UK performance during the last 2 quarters. However, there have been earlier periods when UK performance outstripped Scottish performance. This happened for 4 successive quarters from 1997Q3 to 1998Q2. But equally there have been periods of stronger Scottish growth such as from 1995Q2 to 1995Q4. Over the 20 quarters shown, UK GDP growth outstripped Scottish growth on 11 occasions, while Scotland did better in the remaining 9. The broadly similar but slightly weaker Scottish GDP performance over the last 5 years is confirmed by figures for average quarterly growth, which are 0.66% for Scotland and 0.67% for the UK. Similarly, average annual growth between 1995 and 1999 amounts to 2.57% for Scotland and 2.78% for the UK.

Against this background it comes as a surprise to learn from the latest UK regional accounts, published in the August edition of *Economic Trends* by National Statistics, that GDP per head in

Scotland relative to the UK has been declining since 1995. This is shown in Figure 2, where Scotland's GDP per head relative is seen to decline from 101.3 of the UK level to 95.6 in 1998, lower than at any time since 1990. What is interesting about the National Statistics data is that the GDP estimates for the regions are now compiled on a similar basis to the Scottish Executive's GDP estimates to conform with the European System of Accounts 1995 (ESA95) i.e. in terms of GVA at basic prices. However there the similarity ends, with the Scottish Executive estimate based on an aggregation of industry outputs, while the National Statistics estimates are based on summing factor incomes. In theory the two approaches should produce the same result. But in practice they clearly do not. An examination of the National Statistics data suggests that Scottish GDP grew at an annual average rate of only 0.49% between 1995 and 1998, with the rate for UK averaging 2.95%. The Scottish Executive's estimates for real GDP growth over this period are broadly similar for the UK, 3%, but substantially higher for Scotland at 2.66%.

The size of the difference between the two sets of data for Scotland is substantial and begs the question: which dataset is correct, or more nearly correct? If Scotland's GDP per head relative is declining as the National Statistics data suggest, then this undermines the argument that the Scottish economy has been relatively buoyant since the mid 1990s. Moreover, such a decline must pose questions for economic development policy. If, on the other hand, the Scottish Executive data are more accurate, then our preliminary estimates suggest that Scotland has at least maintained its 1995 GDP per head relative to the UK. This is because estimated Scottish GDP growth has been only a little lower than the growth of UK GDP while Scottish population has been falling. Our estimates of the relative on the Scottish Executive data are included in Figure 2, and they indicate that Scotland has improved on its 1995 position of a higher GDP per head than the UK average. The difference between the two estimates highlights the need for accurate data, for without which policy can only fumble in the dark.

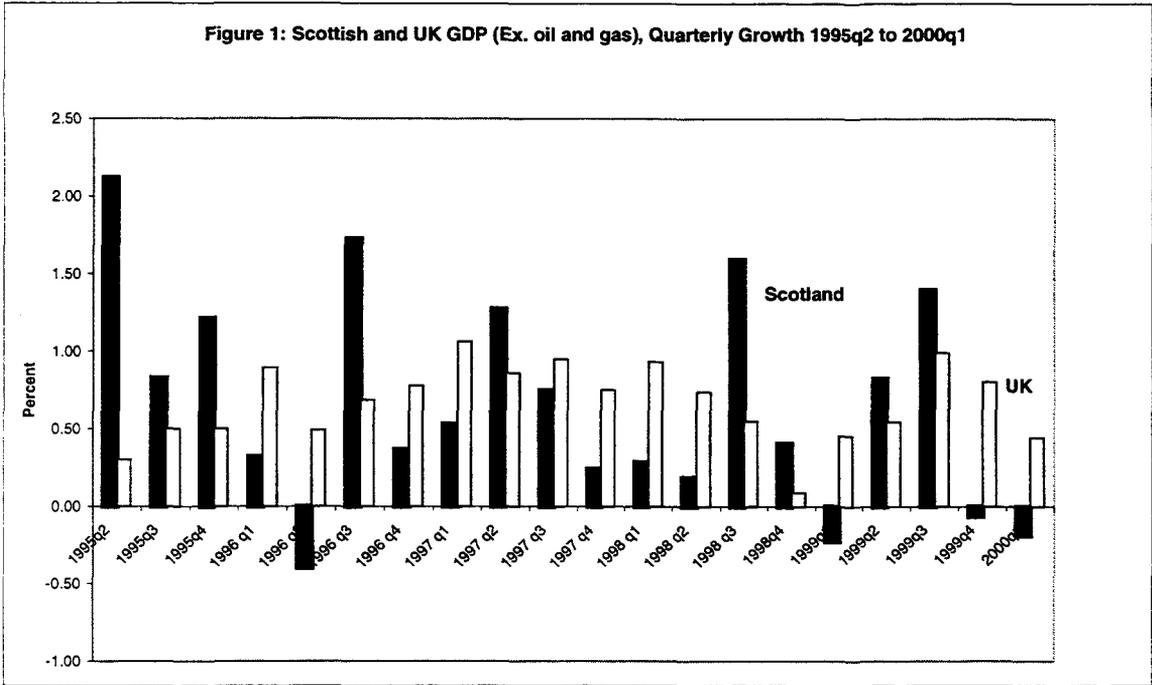
Outlook

The concern expressed in the Scottish media following the publication of the latest GDP statistics that the economy is in recession is in our view misplaced. While a recession has been defined as constituting two successive quarters of negative growth, the definition is arbitrary. Experience shows that recessions are very rarely, if ever, two-quarter affairs. The more usual outcome is negative or near-zero growth for several quarters.

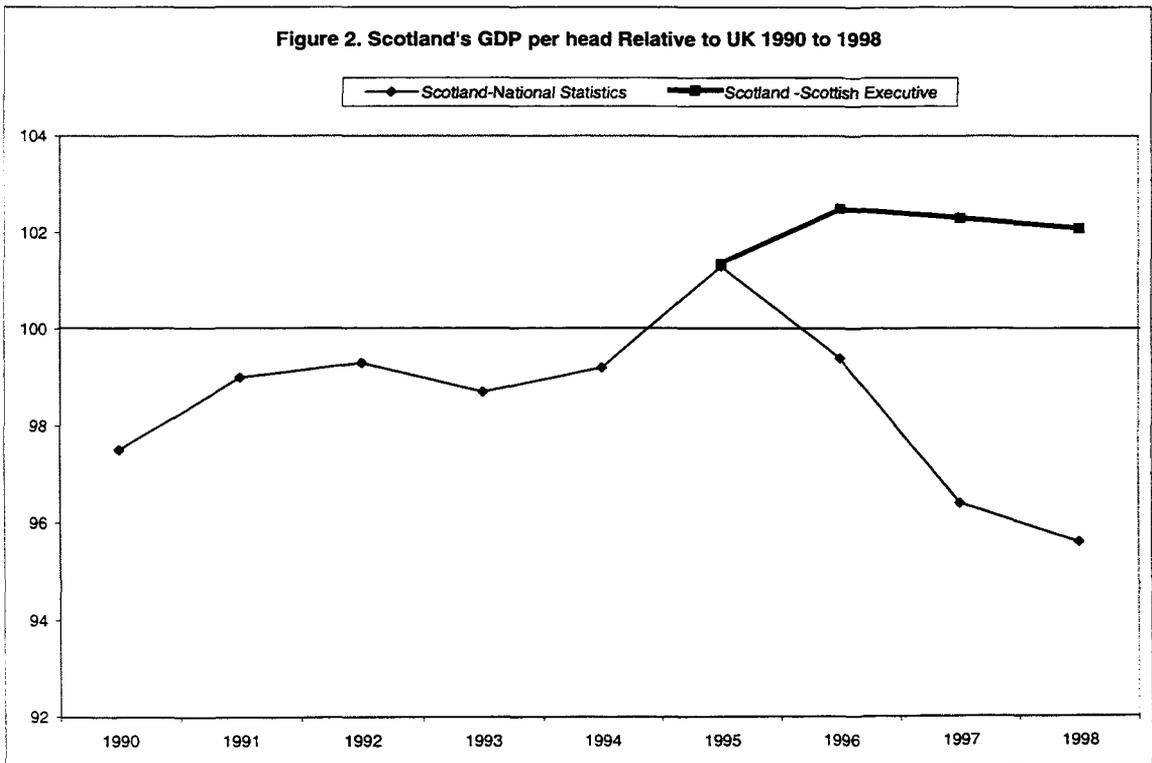
The prospect of such an outturn depends on the factors influencing economic growth and on present information these factors do not point to a recession.

The weak performance of the economy in the fourth quarter 1999 appears to have been mainly due to the strength of sterling. The July **Commentary** noted that domestic demand in the UK economy had weakened considerably in the first quarter and suggested that this would "have similar consequences for the Scottish economy" (p.iii). The weaker Scottish GDP outturn in the first quarter was therefore consistent with that expectation coupled with the continuing effects of the high pound on certain sectors and the added influence of structural demand factors such as those affecting electronics. However, in the UK economy in the second quarter there was a revival in the growth of domestic expenditure as both private and government consumption picked up appreciably. In addition, export volumes grew strongly, with such growth expected to continue as world trade picks up further tending to partially offset the effects of a weaker but still strong pound. Against this background, the main concerns are the continuing weakness of investment demand and the effect of high oil prices on the costs and competitiveness of Scottish firms. In contrast, the higher price of oil is beginning to have a favourable effect on exploration in the North Sea.

We, therefore, expect that Scottish GDP growth should be stronger in the second quarter and that over the year the economy will exhibit positive growth. Nevertheless, the economy will continue for some time to be weaker than the UK economy. This is because of the disproportionate effect on Scotland of the strength of sterling and continuing weakness in the demand for electronics products.



Source: Scottish Executive and FAI Calculations



Source: National Statistics, Scottish Executive and FAI Calculations