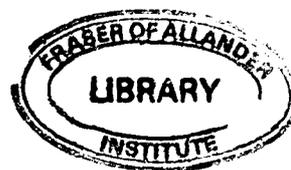


Quarterly economic commentary

January 2001

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Notes to contributors:

The editors welcome contributions to the Economic Perspectives section. Material submitted should be of interest to a predominately Scottish readership and written in a style intelligible to a non-specialist audience. Contributions should be submitted to the editors.

Articles accepted for publication should be supplied electronically and conform to the Guidelines available from Linda Kerr, Fraser of Allander Institute.

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**Fraser of Allander Institute
University of Strathclyde
Curran Building
100 Cathedral Street
Glasgow G4 0LN

Tel (0141) 548 3958
Fax (0141) 552 8347
Email: fraser@strath.ac.uk**

Outlook and appraisal

Overview

Despite some improvements in Scotland's growth performance in the second quarter of last year, the economy continued to be weaker than the UK. A strong growth performance from financial and business services led to growth in the Scottish service sector equalling that in the UK. But in manufacturing, a weak performance relative to the UK was mainly explained by continuing problems in the Scottish electronics sector. The food industry, mechanical engineering and chemicals were also relatively weak. Growth in the world economy is slowing, although the outlook for the UK economy is relatively benign. The expected US downturn should have a limited direct impact on UK growth because trade between the UK and the US is now much less important than trade between the UK and Euro zone countries. In addition, the potential for financial contagion from falling asset prices in the US is limited by the lesser importance of direct equity holdings in the UK compared to the US and the healthier financial position of the UK private sector. Moreover, domestic demand remains fairly strong, although the growth of household consumption is slowing but government spending is set to rise by 4% in real terms in

2001. Scottish prospects, particularly relative to the UK, depend on: the fortunes of the electronics industry; the general exposure of the economy to developments in the US; the extent to which tourism recovers following the re-rating of the Euro relative to the pound; and the growth of domestic demand, especially public expenditure. Scottish trade is less exposed to the US than the UK, however we rely on the US to a large degree for inward investment, particularly in electronics. The continuing problems of the electronics industry, the additional effect on that sector of the slowdown in US growth and weaker public expenditure growth relative to the UK, are the principal reasons why we are forecasting somewhat slower growth in Scotland this year and next year of 2% and 2.3% compared to forecasts of 2.5% and 2.6% for the UK. However, net employment will continue to grow and the unemployment rate will remain stable during this period.

GDP and Output

The most recent GDP statistics from the Scottish Executive indicate that the economy picked up in the second quarter as predicted in the October 2000 Commentary. GDP (excluding oil & gas) is estimated to have risen by 0.6% in the quarter running from April to June last year. Moreover, revisions to the Scottish GDP statistics suggest that the economy stagnated in the first quarter rather than exhibiting negative growth, although the data now reveal that GDP fell in the fourth quarter of 1999. Despite these revisions it is still the case that the Scottish economy has continued to be weaker than the UK economy over the last three quarters for which data are available. This is clearly shown in Figure 1. In the fourth quarter of 1999, UK GDP (ex oil & gas) rose by 0.8% (compared to a contraction of 0.1% in Scotland), it then slowed down to 0.4% growth (0.1% in Scotland) during the first quarter of 2000 but grew faster again in the second quarter exhibiting growth of 0.8%. The result of this is that annual GDP growth in Scotland slipped further behind the UK. Over the four quarters to 2000Q2 Scottish GDP (ex oil & gas) grew by 2% compared to 2.7% in the UK.

At the principal sectoral level, gross value added (GVA) at constant basic prices in the service sector in Scotland grew by 0.9% during the second quarter, the same growth rate as in the sector in the UK. Growth in the Scottish service sector picked up in both the first and

second quarters of last year. This followed a contraction in output during the fourth quarter of 1999, although over the four quarters to 2000 Q2 Scottish service sector output grew by 1.8%, just above half the rate of 3.2% for service sector growth in the UK during this period. Nevertheless, the sector in Scotland is now growing above its average quarterly rate of 0.62% for the 21-quarter period 1995Q2 to 2000 Q2. Whether this will be sustained is open to question. Service sector growth is generally weaker in Scotland as Figure 2 indicates. The average quarterly growth rate of UK services over the last 21 quarters is 0.87%, with the UK sector outperforming its Scottish counterpart on 14 occasions.

An examination of the growth performance of the 7 sub-sectors within services, for which the Executive provides data, suggests that a pickup in growth in both financial services and business services accounts for both the absolute and relative improvement in the performance of the service sector in Scotland. Real estate & business services grew by 3.2% in Scotland during the second quarter compared to growth of 1.7% in the sector in the UK, while financial services grew by 2.2% in Scotland compared to a fall of 0.2% in the UK. Retail & wholesale performed similarly in Scotland and the UK, exhibiting growth of 0.6% in the former and 0.5% in the latter. Elsewhere in the service sector, Scottish performance was generally weaker than in the UK. Other services contracted by 3.2% while its UK counter-

part grew slightly by 0.1%. Hotels & catering experienced a fall in output of 1.4% here but grew by 2.3% in the UK, while output in transport, storage and communication fell by 1.2% in Scotland but rose by the same percentage in the UK. Finally, while the performance of the public sector was weak across the UK with growth of 0.3%, the increase in public service provision was less in Scotland at 0.1%.

In the remaining principal sectors, agriculture, forestry and fishing grew more strongly in Scotland in the second quarter, by 1.8% compared to growth of 0.2% in the UK. Similarly, electricity, gas and water supply while exhibiting strong growth generally grew by 8.9% in Scotland compared to 6% in the UK. In contrast, mining & quarrying cut back production by 1.1% in Scotland but expanded output by 4.9% in the UK and the construction sector contracted by 5.1% here compared to a fall of 1.7% in the UK. Nevertheless, all 4 sectors still outperformed their UK counterparts over the four quarters to 2000 Q2. Agriculture grew by 1.5% over the year, while the industry in the UK contracted by 0.4%. Electricity, gas and water supply grew by 3% in Scotland but by only 2.3% in the UK. Mining & quarrying increased production in Scotland by 5.4% but only managed 2.6% in the UK, and the construction sector, despite the severe contraction in the second quarter, grew by 8.1% over the year in comparison to growth of 2.7% in the sector in the UK.

Turning now to manufacturing, the performance of the sector in Scotland during the second quarter provides further cause for concern. Manufacturing GVA fell by 0.2% compared to a rise of 0.4% in the UK. Figure 3 indicates that 2000 Q2 was the fourth consecutive quarter in which UK manufacturing outperformed its Scottish counterpart. Over the year to the second quarter UK manufacturing grew by 1.4% compared to growth of 1% in Scottish manufacturing. As we noted in previous Commentaries, manufacturing growth has tended to be stronger in Scotland than in the UK in recent years. This is underlined in Figure 3, where from the 17 quarters between 1995 Q2 and 1999 Q2, Scottish manufacturing is seen to exhibit stronger growth than UK manufacturing on 12 occasions. However, the weakening in the performance of Scottish manufacturing is not general. Of the 11 sub-sectors for which the Executive reports information, 5 sectors outperformed their UK counterparts in the second quarter. Metals and metal products grew by 2.2% while the same industry in the UK contracted by 1.5%. Textiles, despite its recent problems, turned in a small positive growth rate of 0.2%, while UK textiles cut back production by 1.9%. Paper, printing & publishing in-

creased its output by 2.7% in Scotland but only managed 0.4% growth in the UK, while other manufacturing performed similarly with growth of 2.2% in Scotland compared to 0.3% in the UK. Finally, GVA in the drinks industry fell back slightly by 0.2% in Scotland but contracted by 2.5% in the UK. These data would appear to refute the notion that Scottish industry has suffered disproportionately due to the effects of the high pound.

In the remaining 6 manufacturing sub-sectors, Scottish performance was weaker than in the UK during the second quarter. The biggest growth disparities were to be found in refined petroleum & nuclear fuel and in transport equipment. The former contracted by 9.3% in Scotland compared to a fall of 0.9% in the UK, while the latter suffered a 7.9% fall in output in Scotland and a 4.2% fall in the UK. However, neither of these two sectors contributes much to overall manufacturing output, about 7% taken together. GVA in the chemicals sector reduced by 1.5% in Scotland, while its UK counterpart grew by 0.5%. Food & tobacco output fell by 0.9% in Scotland but remained unchanged in the UK, while mechanical engineering grew more slowly, 1.6%, in Scotland when compared to the sector in the UK, 2%. These three sectors taken together account for 25% of manufacturing output, so the weaker Scottish outturn will clearly have contributed to the poorer overall performance of Scottish manufacturing. However, the principal reason for the weakness in Scottish manufacturing in the second quarter is again to be found in the performance of the electronics industry, which accounts for more than 27% of manufacturing output.

We noted in the October 2000 Commentary that the demand for computers and key components such as silicon chips was relatively weak. Many major electronics firms have issued profits warnings and at this stage it is difficult to determine whether the slowdown in the industry is a repetition of an historical cyclical pattern or whether structural factors are at work. One possibility is that the market penetration of personal computers is close to saturation level, so that growth in the future will be more reliant on replacement demand than it has been in the past. However, new uses for microchips and computers are being discovered all the time and the rate of obsolescence through technical change is if anything increasing. So, it is perhaps premature to characterise the sector as "mature" and therefore too early to conclude that the era of rapid growth within the industry is drawing to a close. Whatever the reasons for the current weakness of the sector it is clear that the Scottish part of the industry has been more affected than its UK counterpart. In the second quarter of last year GVA in the sector contracted slightly, by 0.3%.

compared to a sizeable increase in output in the UK of 5.8%. Figure 4 indicates that the growth performance of electronics in the UK has been better than, or equal to, Scottish performance for the last four quarters to 2000 Q2. The figure also highlights the generally stronger performance of the industry in Scotland since 1995Q2 with quarterly growth averaging 2.4% each quarter compared to 1.6% in the UK. The stronger growth of Scottish electronics during this period is probably mainly due to our relative success in attracting inward investment in the sector. The worry for the future is that if the industry is coming closer to maturity then inward investment is likely to diminish as trend growth falls and cost considerations become more important in locational choice. Moreover, in the short-term, the projected decline in IT spending by US companies – see World Economy section – may induce US electronics firms to halt or postpone planned overseas investment decisions.

Outlook

The outlook for the Scottish economy is complicated by recent developments in the world economy particularly the marked weakening of the US economy – see World Economy section. Growth in the global economy is now expected to slow in 2001 and 2002. Oil prices, while having fallen back from the September peak, rose steadily during 1999 to the summer of 2000. Monetary policy tightened in the US and Europe over the past eighteen months in response to fears about rising inflation, while asset prices are showing signs of weakness, particularly in the US. All of these developments potentially endanger the financial position of firms and households and the sharp easing of US interest rates in early January indicated the sudden concern felt by the monetary authorities that these and other developments might be precipitating a recession. Despite this background the outlook for the UK economy continues to be relatively benign – see UK Economy section. The expected US downturn should have a limited direct impact on UK growth because trade between the UK and the US is now much less important than trade between the UK and Euro zone countries. In addition, the potential for financial contagion from falling asset prices in the US is limited by the lesser importance of direct equity holdings in the UK compared to the US and the healthier financial position of the UK private sector. Moreover, domestic demand remains fairly strong, although the growth of household consumption is slowing but government spending is set to rise by 4% in real terms in 2001.

In the third quarter of last year, the UK economy continued to grow above trend, which with quarterly growth of 0.7% represented a slight weakening on the previous quarter. With industrial production weakening in October and November it appears likely that GDP growth will be found to have slowed down in the fourth quarter. The National Institute of Economic and Social research is presently estimating fourth quarter growth to be in the region of 0.4%. It appears likely that the growth of Scottish GDP will weaken similarly. The Scottish Chambers' of Commerce Business Survey (SCBS) for the third quarter indicated that business confidence was continuing to decline, although at a slower rate in manufacturing but at a faster rate in the service sector in comparison with the second quarter. The outturn in orders and sales was weaker than anticipated in all principal sectors except construction, and capacity utilisation was generally lower. However, manufacturing firms anticipated an improvement in trading conditions in the fourth quarter and this may have been realised as the Euro strengthened and oil prices moved down from their September peak. In contrast, service sector firms responding to the SCBS expected that trading conditions would continue to deteriorate in the final three months of the year.

On the basis of the present information set, we are therefore forecasting that Scottish GDP growth will be lower in 2000 than in the UK at 2.1% – see Forecasts of the Scottish Economy section.

The prospects for 2001 and 2002 are clearly dependent upon the course of events in the world economy and the US in particular. However, with growth in the Euro zone expected to hold up even in the face of a US recession and UK domestic demand still expected to maintain some buoyancy, total expenditure growth in the UK is unlikely to slow appreciably. The latest independent forecasts reported by the Treasury – see UK Economy section – suggest that UK GDP growth will fall to 2.5% in 2001 and be much the same at 2.6% in 2002.

Scottish prospects, particularly relative to the UK, will be affected by several factors:

- The outturn in the fortunes of the electronics industry, which as noted above is experiencing continual difficulties;
- The success of the financial sector in avoiding exposure to the difficulties in the US market and in capitalising on the market opportunities in both the rest of the UK and the Euro zone;

- The general exposure of the Scottish economy to developments in the US;
- The extent to which tourism to Scotland recovers following the re-rating of the Euro relative to the pound; and
- The growth of Scottish domestic demand and especially public expenditure.

The Scottish economy is somewhat less exposed to the direct effects of a possible recession in the US since only about 10% of manufacturing exports are sold to the US compared to 15% for the UK as a whole. The service sector here has a greater exposure than manufacturing, with US trade accounting for 28% of exports. However, with the scale of manufacturing exports some 8 times greater – at £19.3bn in 1998 – than service sector export sales, it is the manufacturing sector that bears the brunt of developments in external markets. In addition, given the importance of inward investment from the US to the Scottish economy and particularly to electronics, there is the possibility that if the US economy does turn down appreciably that foreign investment and re-investment plans will be postponed or even halted altogether. Here a US downturn and recession could disproportionately affect Scotland.

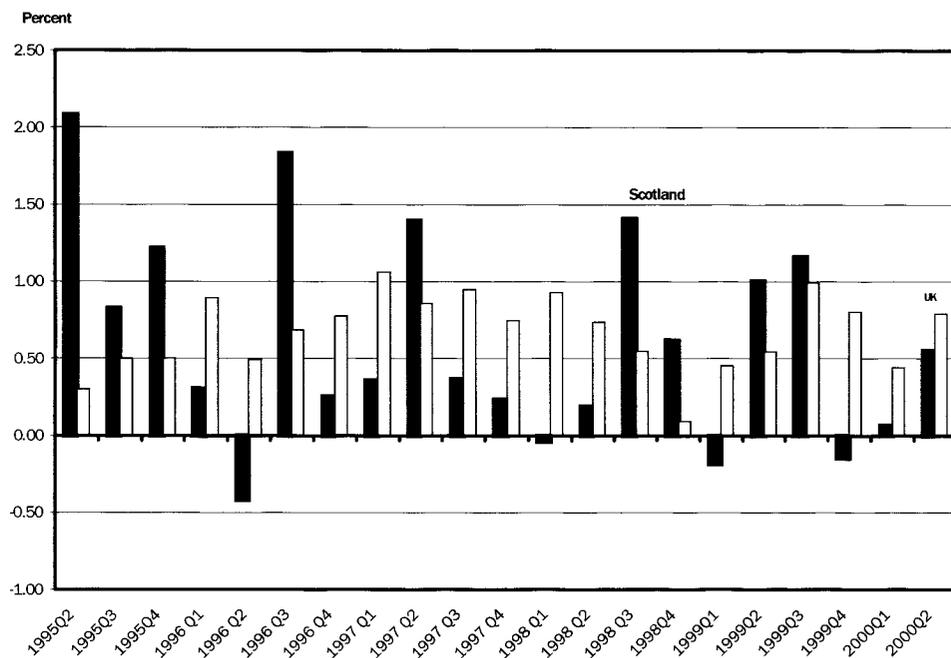
Against this background, we are forecasting that GDP growth in Scotland will be slightly lower in 2001 at 2%

but should be somewhat stronger in 2002 at 2.3%. Total employment in the economy will continue to rise, with increases of more than 6,000 and just under 10,000 net jobs in 2001 and 2002 respectively. Most of the net job creation will be in the service sector and in construction, with manufacturing continuing to shed jobs due to slow growth and continuing increases in labour productivity. After allowing for changes on the supply side of the labour market as well as forecast net job creation, we expect that the unemployment rate will continue to average just above 7% on the ILO definition.

The continuing problems of the electronics industry and the additional effect on that sector of the slowdown in US growth are the principal reasons for a projected growth performance that is somewhat weaker than forecasts for the UK. In addition, despite the recent discussion in the media about the differential expenditure commitments of the Scottish Executive compared to the UK Government, the real growth of the Scottish public expenditure block will be slower over the next two years due the operation of the Barnett formula.

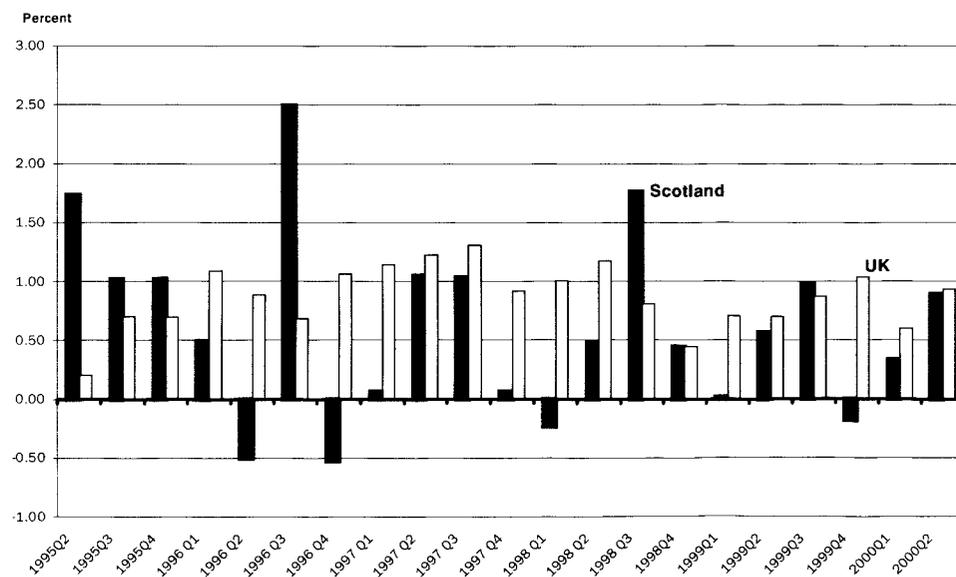
Brian Ashcroft
17th January 2001

Figure 1: Scottish and UK GDP (Ex. oil and gas), quarterly growth at constant basic prices, 1995 Q2 to 2000 Q2



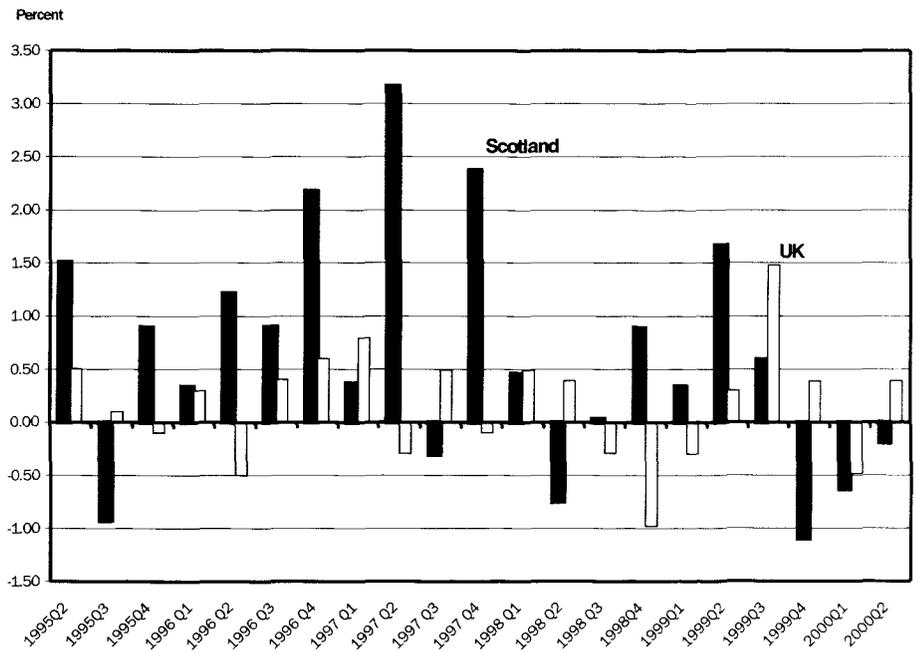
Source: Scottish Executive

Figure 2: Scottish and UK service sector GVA quarterly growth at constant basic prices, 1995 Q2 to 2000 Q2



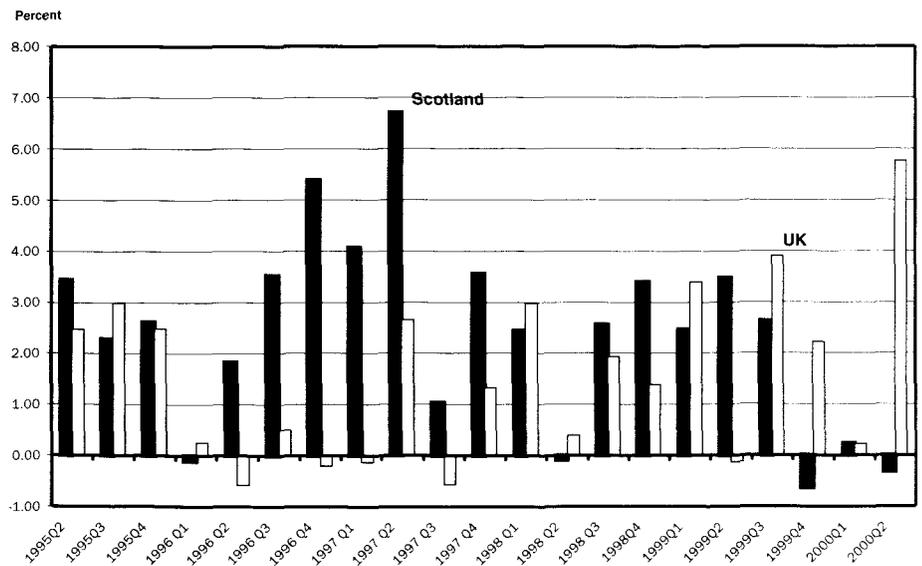
Source: Scottish Executive

Figure 3: Scottish and UK manufacturing sector GVA growth at constant basic prices, 1995 Q2 to 2000 Q2



Source: Scottish Executive

Figure 4: Scottish and UK electronics sector GVA growth at constant basic prices, 1995 Q2 to 2000 Q2



Source: Scottish Executive