Quarterly ECONOMIC *Commentary*

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OUTLOOK and APPRAISAL

At the beginning of September the Scottish Executive published a new quarterly series of Gross Domestic Product (GDP) in Scotland. This is an important development in the statistical base of the Scottish economy and is to be welcomed. The new series introduces for the first time quarterly data on the service sector, which accounts for 63 percent of Scottish GDP. Before the publication of this new series, analysis of quarterly movements in the Scottish economy had to rely principally on the official production and construction series, covering only about 34 percent of Scottish GDP. Judgements about the performance of the service sector were based on the survey data provided by the Deloitte & Touche, Scottish Chambers' Business Survey.

The new quarterly series is based on much improved sources. Previous annual estimates of service sector activity were derived from UK indices adjusted for Scotland's relative employment share. The new series is derived from survey returns from businesses with bases in Scotland. However, caution must be exercised in interpreting the new data. First, while the series is seasonally adjusted, the adjustment is based on information from only 12 quarters starting in 1996q1. It is arguable whether such a short time period is sufficient to capture accurately the seasonal factors influencing the quarterly movements in Scottish GDP. Secondly, the data will generally be less reliable than comparable estimates for the UK for two reasons. The UK data are produced by balancing 3 independent sets of estimates covering output, income and expenditure, whereas the Scottish series is derived from only one source. Revisions to the Scottish data are likely to be greater and more frequent than for the comparable UK series. Moreover, the Scottish economy is small scale and a relatively small number of units participate in the survey. Consequently, the Scottish data are more likely to be affected by random fluctuations from events such as expansions, contractions, and openings and closures than would be the case in the UK. All of which implies that movements over one quarter provide little guide to future change or to the comparative performance of the Scottish economy.

Quarterly Movements in Scottish GDP

The new series provides data for the first quarter 1999 and a run of data back to 1996q1. The data, which are presented for GDP (Ex. oil & gas) in Figure 1, imply that growth in the Scottish economy was slowing at the end of last year and at the beginning of 1999. However, the slowdown appears to have been less pronounced in 1998q4 in Scotland than in the UK, with both services and manufacturing holding up better here. The suspicion that the seasonal adjustment factors might not yet be appropriate is reinforced from the evidence of a much stronger performance in the retail, wholesale and hotel and catering sectors in Scotland compared to the UK during both 1998q4 and 1999q1.

When performance over the four quarters to 1999q1 is considered, the growth of GDP (ex. oil & gas) is identical to the UK at 2.3 per cent, with manufacturing growth stronger (1.5% compared to –0.1%) and service sector growth weaker (2.9% compared to 3.3%) in Scotland. In addition, the Scottish agricultural sector appears to have held up better over the past year than its UK counterpart (2.9% compared to –1.2%), while the contraction in Scottish construction was greater (–1.4% compared to –0.9%).

A better understanding of the relative performance of the Scottish economy can, however, be obtained from an examination of the change occurring during the period since the commencement of the new series, that is since 1996q1. Figure 1 indicates that the quarterly growth of Scottish GDP tends to be more volatile than the comparable UK series. However, despite this, the Scottish series does appear to move broadly in line with the UK, with growth tending to slow from early in 1997. This highlights the importance for Scotland of trade with the rest of the UK and the shared macroeconomic policy environment within the UK monetary union.

Figure 2, charts the average quarterly growth of gross value added by category of output over the period 1996q1 to 1999q1. Average GDP growth is almost identical in Scotland and the UK. However, significant differences exist at more disaggregated output categories.

At the broad sectoral level, the production sector – including manufacturing, electricity, gas and water, and mining and quarrying – exhibited much stronger growth in Scotland, with growth averaging 0.86 per cent per quarter here compared to 0.07 per cent in the UK. All three sub-sectors grew more strongly than their UK counterparts. The service sector, on the other hand, exhibited somewhat stronger growth in the UK averaging 0.89 per cent per quarter compared to 0.72 per cent here. The construction sector in Scotland experienced a marked decline contracting at a rate of 0.69 per cent per quarter, compared to growth of 0.37 per cent in the UK. At this level, only the agricultural sector behaved similarly in Scotland and the UK. The well-known problems experienced by the industry, from BSE to the effects of the increase in sterling, resulted in an average quarterly contraction in the former of 0.34 per cent and 0.26 per cent in the latter.

The previous absence of data on quarterly movements in the service sector suggests that a more detailed examination of movements within the sector is appropriate. Figure 2 decomposes the sector into 7 principal categories of output. The transport and communications sector has the strongest performance in both Scotland and the UK, although the industry in Scotland performed worse than its UK counterpart. Hotels and catering, and retailing and wholesaling were the service sectors exhibiting the next strongest average quarterly growth rates in Scotland but not in the UK. These data perhaps offer some reassurance to those concerned about the diminishing attractiveness of Scotland as a holiday and short-break destination. However, recent developments in catering and retailing in Scotland with the opening of new restaurants and shopping facilities may represent a once-and-for-all supply-side adjustment to unmet demand, which, if correct, would suggest that the stronger relative performance would be unlikely to continue. Note should also be taken of the earlier comment about the appropriateness of the seasonal adjustments in these two sectors, since a large part of the stronger Scottish growth is accounted for by change in 1998q4 and 1991q1.
The financial services sector grew more strongly in Scotland and while this may offer support for the perception that Scotland has a traditional and continuing comparative advantage in the sector, the growth rate is hardly remarkable and much the same as the average for Scottish manufacturing.

What accounts for the slower rate of growth of the service sector in Scotland during the period?

No definitive answer can be given to this question. However, it is clear that the weakest performing sub-sectors in Scotland were public administration, education and health; other services; and real estate and business services. Of these three, public administration etc. and business services are the most important, accounting for 21 per cent and 15 per cent of Scottish GDP, respectively. The weaker growth of public sector activities in Scotland appears likely to reflect the changing spatial distribution of UK public expenditure. The more strict application of the Barnett formula, and the strong growth of expenditure on comparable programmes subject to the formula e.g. health and education, has resulted in the slower growth of public expenditure in Scotland.

On the other hand, the weaker growth of real estate and business services may reflect, in part, the recent relative strength of the housing market in the rest of the UK. However, the weaker performance of business services in Scotland is probably evidence of a more fundamental problem. The Scottish economy lacks corporate headquarters. The takeover of Scottish firms by companies with headquarters outside Scotland has been a persistent feature, although of varying intensity, of the last thirty years. There is evidence to suggest[1] that the subsequent loss of HQ functions and local sourcing had a knock-on effect, particularly for the Scottish suppliers of business services. Scotland's low business birth rate and a relative failure to 'grow' independent Scottish firms have also compounded the problem. This has meant that Scottish business service suppliers have not shared to the same extent in corporate growth as their UK counterparts, a problem that has undoubtedly been accentuated by the increase in the outsourcing of services from independent local suppliers.

Finally, Figure 3 highlights the oft-repeated point that the stronger growth of Scottish manufacturing, averaging 0.86 per cent per quarter over the period compared to 0.04 per cent in the UK, is not evenly spread across the sector. Without the strong contribution made by the electronics industry in Scotland, manufacturing in Scotland would have performed much less well than in the UK. However, the relative weakness of non-electronics manufacturing in Scotland has been much less pronounced in recent quarters. This can be seen from the stronger quarterly performance in Scotland, on average over the last three years, of oil refining, chemicals, metals, and paper, printing and publishing in particular.

[1] Ashcroft, B and Love J H (1993) **Takeovers, Mergers and the Regional Economy**, Edinburgh University Press.

Outlook

As Figure 1 indicates, the UK economy effectively experienced a growth pause during the final quarter of last year and the first quarter of 1999. A recession did not materialise and GDP growth began to pick up again in the second quarter. The principal impetus to growth is coming from accelerating household expenditures and government final consumption. Private sector investment is also picking up. However, adverse movements in net trade are tending to lower the rate of growth. Imports are growing strongly while export volumes have been declining in recent quarters and are likely to remain fairly flat during the remainder of the year.

The inflation rate has fallen below its target. Nominal pay growth has eased. Much of this decline probably reflects lower inflationary expectations and the decline in profits, productivity and output growth, in the recent slowdown rather than the direct impact of labour market conditions. Growth in real unit labour costs has continued to pick up but is less, at given rates of unemployment, than it was at a similar point in the previous cycle. This might reflect the labour market reforms and structural change that are alleged to have made the labour market more flexible and could indicate a lower equilibrium or 'natural' rate of unemployment. Input price growth while still remaining low may now be beginning to pick up again, after the stabilisation of non-oil commodity prices, the recent rise in oil prices and the unwinding of the dampening effect of the earlier appreciation of the pound.

However, the growth of average earnings is set to pick up as the economy expands and as spare labour capacity diminishes. This coupled with the expected upward movement in the growth of input prices is likely to increase inflationary pressure. Against this background, the recent decision of the Monetary Policy Committee to raise interest rates by a quarter per cent point to 5.25% may well be timely.

In Scotland, the manufacturing sector has held up much better than in the UK bolstered, in part, by the electronics sector, which grew by 8.3 percent over the year to the 1999q1 compared to 6 per cent in the UK. We therefore continue to forecast stronger manufacturing growth in Scotland than in the UK, with the Institute's Short Term Forecasting Model predicting 0.9 per cent growth in 1999 and 2.4 per cent in 2000. In contrast, the service sector is comparatively weaker here for some of the reasons noted above. Accordingly, in view of the importance of the service sector to overall growth, we expect that the Scottish economy will grow more slowly than the UK during 1999 but will pick up strongly in 2000.

Table 1. GDP and Jobs Forecast 1999 to 2001

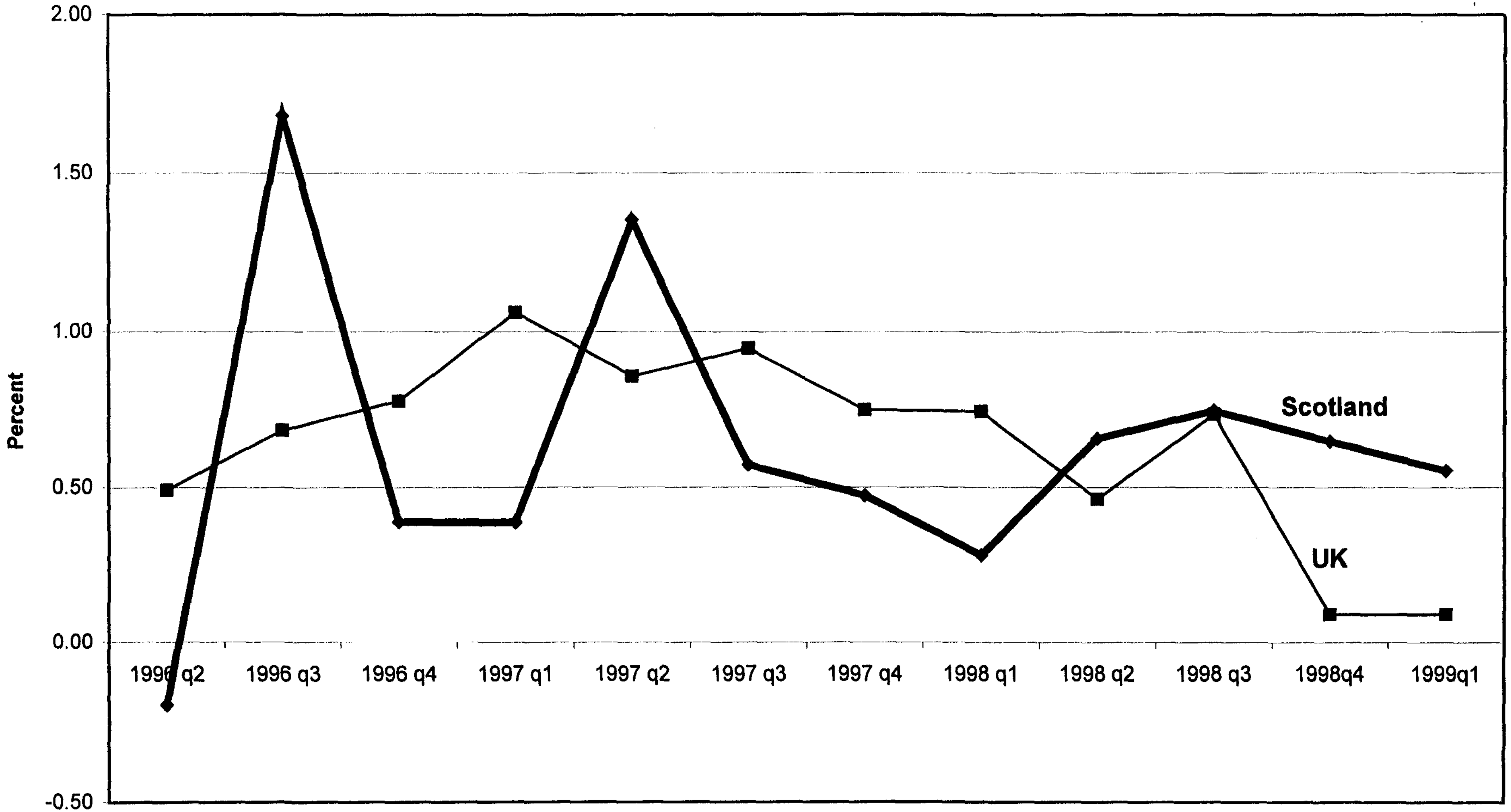
	1999	2000	2001
GDP % change	0.7	2.2	3.2
Job Change	-14,000	21,000	14,000

The latest forecasts from the Institute's Medium Term model are presented in Table 1.

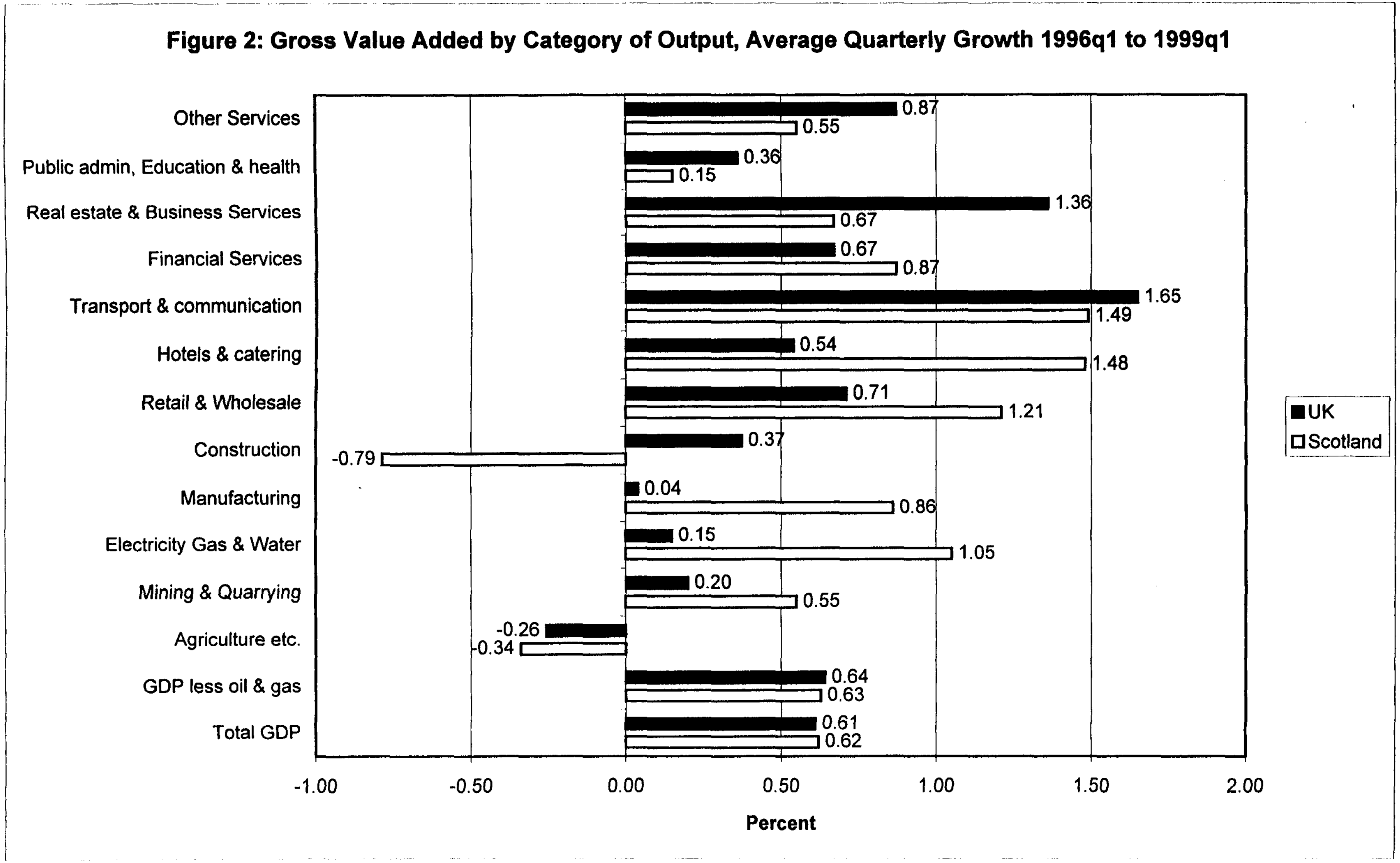
While we expect that there will be a net loss of jobs in Scotland during 1999, we do not anticipate that this will have much affect on the unemployment rate because of the likelihood of further falls in the labour force activity rate. The percentage of the Scottish labour force that are economically active fell by 21,000 (0.8%) over the year to the first three months of this year and by 6,000 (0.3%) during the year to April-June. The unemployment rate therefore appears set to continue for some time at historically low levels, which, on the latest figures, was 7.1% on the ILO count and 5.2% on the claimant count.

22 September 1999

Figure 1: Scottish and UK GDP (Ex. oil and gas), Quarterly Growth 1996q2 to 1999q1

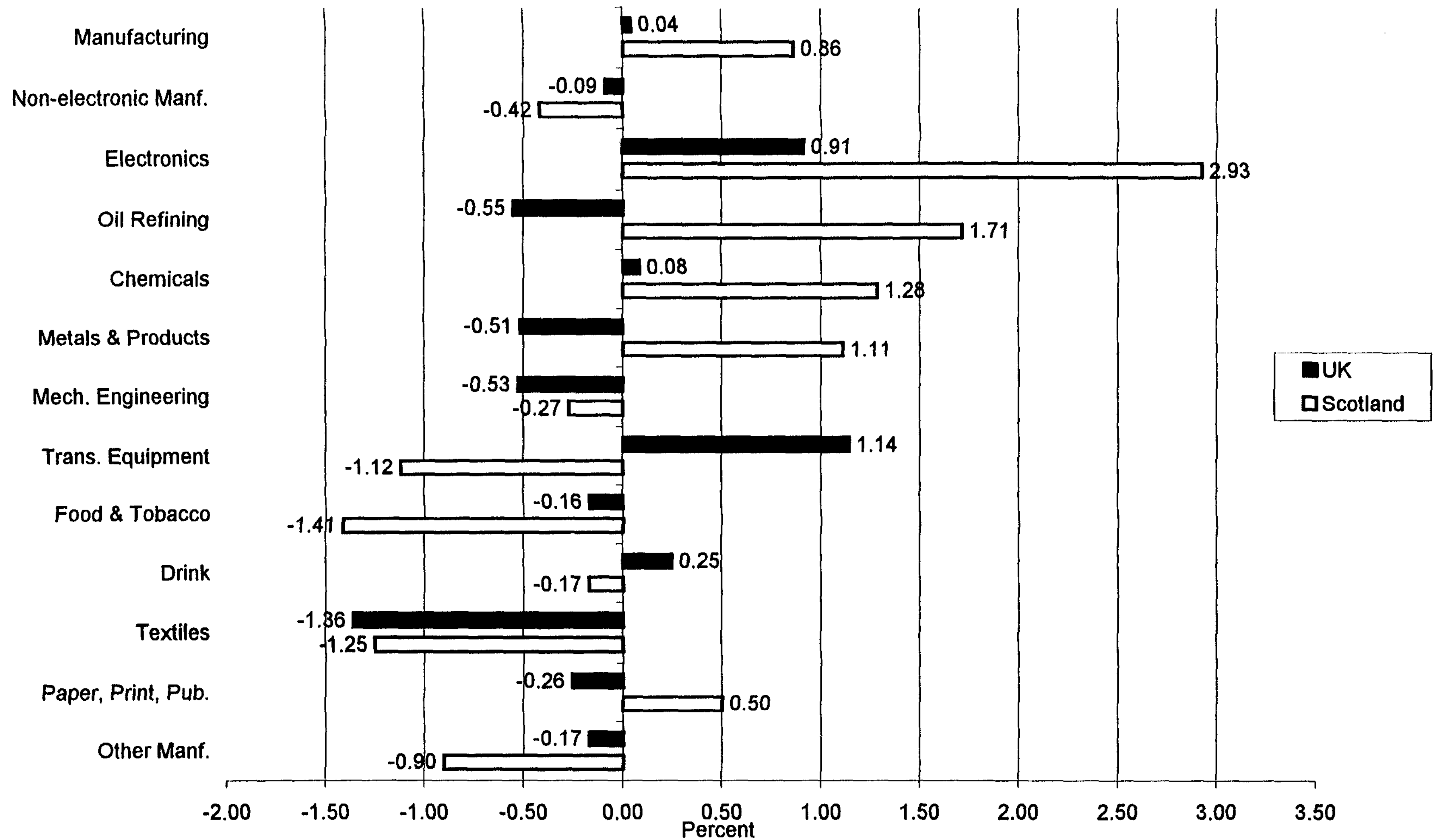


Source: Scottish Executive and FAI Calculations



Source: *Scottish Executive and FAI calculations.*

Figure 3: Gross Value added by Manufacturing Sector, Average Quarterly Growth 1996q1 to 1991q1



Source: Scottish Executive and FAI Calculations