Quarterly economic commentary

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Outlook and appraisal

Overview

Scottish growth strengthened throughout last year but despite outperforming the UK economy in the final quarter growth was weaker than in the UK over the year as a whole. The improvement in Scottish growth was led by the service sector although only one sector, hotels and catering, managed a significantly better performance than its UK counterpart for the year as a whole. Construction, agriculture, and mining & quarrying performed better in Scotland than in the UK during 2000, while manufacturing fared worse. Within manufacturing, the weakest sectors over the year relative to the UK were metals, chemicals, paper, food and electronics. Electronics, while still growing has begun to lag behind the sector in the UK, thus reversing a trend that has persisted since the mid-1990s at least. The sector is clearly experiencing a cyclical downturn but it is feared that structural problems in the industry may be affecting Scottish electronics disproportionately. The closure of Motorola's Bathgate plant may be a sad and depressing example of such problems. It appears likely that growth in the Scottish economy will have followed the slowdown experienced in the UK economy during the first quarter. Prospects for the Scottish economy in the second half of this year depend particularly on the extent of the slowdown in the world and UK economies, and the market conditions confronting Scottish electronics. We are now anticipating that Scottish GDP will grow by 1.6% this year with growth of 1.9% expected in 2002. Net employment is expected to fall over the year by 5,000 but should rise by about 10,000 in 2002. Despite this, the annual unemployment rate will continue to gradually decline, although we have revised upwards slightly our forecast for unemployment in 2001.

GDP and output

The provisional estimates for Gross Domestic Product (GDP) - excluding oil and gas - in the fourth quarter last year imply that the Scottish economy strengthened considerably. The Scottish Executive data indicate that GDP rose by 1% over the third quarter compared to a rise of 0.3% in GDP for the UK as a whole. However, as the 2001 edition of the Executive's *Scottish Economic Statistics* demonstrates, it is dangerous to draw conclusions about the comparative path of the Scottish economy from one quarter's GDP figures.[1] This is because the quarterly series is more volatile than its UK counterpart, due to the disproportionate impact on the Scottish statistic of the performance of large companies and technical sampling considerations. Nevertheless, sustained changes in two or more quarters may be indicative of a trend and there is little doubt that quarterly Scottish GDP growth strengthened throughout last year. GDP rose - on revised data - by 0.3%, 0.4% and 1% respectively in the final three quarters of 2000 from a stagnant position at the turn of the year. But for the year 2000 as a whole, Scottish GDP (ex oil and gas) growth was weaker than in the UK increasing by 1.5% and 2.8% respectively.

An examination of the data[2] at the principal sectoral level reveals that it is the service sector in Scotland – contributing 63% to total GDP - which mainly accounts for the surge in Scottish growth in the fourth quarter. Services grew by 1.7% during the quarter compared to growth of 0.7% in the UK, a rate that is almost three times the average quarterly growth in the sector of 0.64% over the previous 23 quarters. It is therefore unlikely that such a growth rate will continue into 2001, especially given the likely impact of the outbreak of foot and mouth disease on tourist demand. Nevertheless, the improvement in the performance of the Scottish service sector last year, with the value of output rising successively by 0.6%, 0.7% and 1.7% in the final three quarters of the year, is encouraging. But despite this improvement, the service sector in Scotland grew by only 1.7% in 2000 compared to growth of 3.4% in the UK, where the performance of services also strengthened considerably, at least during the second and third quarters.

Looking further into the performance of services reveals that all of the 7 sub-sectors for which the Executive publishes GVA data outperformed their UK counterparts in the fourth quarter of last year. Financial services grew by 4.3% compared to growth of 0.9% in the UK, while real estate and business services grew by 1.9%, which was more than twice the growth rate of its UK counterpart of 0.8%. The retail and wholesale sectors grew by 2.9% in Scotland but by only 1.4% in the UK, while hotels and catering expanded by 2.1% at the same time as the demand for such services was falling by 1.4% in the UK. These data perhaps give some support to the view that the Scottish high street and the hotel and catering industry enjoyed a better run up to Christmas and the New Year, with consumers being less restrained than those south of the border. Some special factors do appear to have been at work in the fourth quarter. When performance over the whole of 2000 is considered, the growth of the retail & wholesale sector is little different from that in the UK, while the outturn in transport storage & communication, financial, business and other services is much worse. Only the hotel & catering industry appears to have significantly outperformed its UK counterpart during the year.

Of the remaining principal sectors, both construction and agriculture outperformed their UK counterparts in the fourth quarter, with respective growth of 1.4% and 0.4% compared to 0.9% and -1.8% in the UK. The production sector contracted by 0.6% in both Scotland and the UK but, within production, the principal activity, manufacturing, contracted by 0.2% in Scotland while growing by 0.6% in the UK.

The problems of Scottish manufacturing worsened during the second half of last year and deteriorated further during the first half of this year, following the recent plant closure and job contraction announcements from Motorola and other electronics firms such as Compaq. GVA in Scottish manufacturing contracted by 0.5% in the third quarter 2000 and by 0.2% in the fourth quarter. For 2000 as a whole, the sector did grow but only by 0.4% compared to 1.6% in the UK. We noted in the January 2001 Commentary that the tendency for Scottish manufacturing to outperform UK manufacturing ceased from about the middle of 1999. By the end of the fourth quarter of last year, UK manufacturing had grown faster than Scottish manufacturing in five of the six previous quarters.

The relative malaise affecting Scottish manufacturing is, however, not present in every sub-sector for which the Executive publishes quarterly data. Of the 11 manufacturing sub-sectors, 5 exhibited a stronger performance in Scotland than in the UK during the fourth quarter: oil refining, drink, food, mechanical engineering and transport equipment, while in one sector, metals and metal products, the rate of contraction (-0.3%) was the same. Growth in the remaining 5 sub-sectors was weaker in Scotland and in terms of their weight in overall manufacturing output, the most significant differences were in the electronics sector, paper, printing & publishing, other manufacturing, chemicals and textiles. In electronics, GVA fell by 0.4% (2.8% rise in the UK); paper output fell by 3.7% (0.1% rise in the UK); other manufacturing contracted by 1.1% (0.4% fall in UK); chemicals production fell back by 1.4% (2% rise in UK); and textiles output fell by 4.2% (2.9% fall in UK).

For 2000 as a whole, the comparative performance of Scottish manufacturing is somewhat worse, with only drink, mechanical engineering, other manufacturing and transport equipment outperforming their UK counterparts. Of particular concern is the relative performance over the year of metals, chemicals, paper, food and electronics. In metals, which still accounts for almost 9% of Scottish manufacturing output, GVA contracted by more than 12% over the year compared to almost no change (a fall of 0.1%) in the UK. In chemicals, which also accounts for about 9% of manufacturing production, output fell by 1.5% in 2000 but increased by 4.6% in the sector in the UK. In paper, Scottish output fell by 2.3% over the year while remaining stagnant (fall of 0.1%) in the UK. In food, production in Scotland contracted by 4.2% compared to a much smaller contraction of 0.7% in the UK.

The performance of Scottish electronics

We noted above that output in the electronics sector in Scotland contracted by 0.4% in the fourth quarter while rising by 2.8% in the UK. Over the year, Scottish electronics raised its production by 6.4% but the sector in the UK enjoyed significantly greater growth of 13.4%.

In previous editions of this Commentary we have raised the question whether the relative weakness in the performance of the Scottish electronics industry was simply the outcome of a cyclical downturn, which would on previous evidence soon be reversed, or whether more long-term structural factors were operating. However, from the Scottish standpoint there are the further questions of whether Scottish electronics is suffering disproportionately and, if so, from what cause? Table 1, which compares recent quarterly growth in Scottish electronics with the performance of UK electronics, shines some light on these questions.

Table 1: Average Quarterly Growth in the Scottish and UK Electronics Industries

	Scotland %	*UK* %
1995 Q1 to 1999 Q2	2.87	1.21
1999 Q2 to 2000 Q4	1.35	3.73

Source: National Statistics and Scottish Executive

The table indicates that average growth in Scottish electronics over the 17 quarters from 1995 Q1 to 1999 Q2 was clearly ahead of growth in the sector in the UK. But in the most recent 6 quarters, average quarterly growth in Scottish electronics more than halved, while the growth of UK electronics rose to three times its earlier average! If the world electronics industry has suffered a downturn recently, and there is much evidence to support the contention, the slowdown has particularly affected Scottish electronics but appears to have left UK electronics unscathed. However, the 2001 Q1 production figures for the UK - unavailable in Scotland until August 1st – reveal a quarterly fall of 3.3% in the output of electronics and optical equipment (see UK Economy section), perhaps suggesting that the downturn has had a delayed effect on UK electronics compared to Scotland.

Given Scotland's historical attractiveness to mobile investment in electronics it is clear that a cyclical downturn would slow both the growth of demand for the products of plants already located here and also reduce inward investment. Hence, the growth of Scottish electronics would fall for both reasons and therefore the slowdown would be greater than in the UK where inward investment is somewhat less important. But this is evidently not the whole story because recent developments suggest that structural shifts may be occurring that are also working to Scotland's disadvantage. The announcement by Motorola in April of its decision to close its mobile 'phone plant at Bathgate with the loss of 3,100 jobs may be an example of such a shift.

As discussed elsewhere in this Commentary, the market for current generation mobile 'phones may be reaching saturation, while a similar outcome may be affecting the demand for personal computers and their principal components. Scotland has become disproportionately specialised in the assembly of PCs, mobile 'phones and other electronic components. When products become mature considerations of costs and production flexibility increase in importance. Alternative locations offering lower wage rates, available skills and more permissive production environments become more attractive. Such factors may begin to override considerations of product quality and productive efficiency. For an existing production base to be protected against the consequences of product maturation it must offer competitive advantages that are less available elsewhere; examples might include special labour skills, differentiated management and production skills, specialised research and development capabilities, new product possibilities and new market potential. These attributes offer the scope for further product differentiation and specialisation, the local adaptation of new products and the generation of new products.

Against this background, Scotland is less well placed to resist the consequences of product maturation in the electronics industry. The labour skills employed in Scottish electronics tend to be of a lower order than those found in the sector in the rest of the UK (see later section on electronics). Comparatively little R&D is undertaken in the industry in Scotland, with the consequent reliance on product innovation occurring elsewhere in the industry outside Scotland. Technology transfer from the universities and research institutes to the sector in Scotland is limited. Horizontal collaboration with other electronics firms located here - both domestic and external - is also limited and the local supply chain to the main inward investors is not well developed. This reflects an insufficient appreciation of the returns to collaboration and joint ventures, a low rate of spin-out of new local supplying firms from the sector, and a failure to develop substantial linkages to existing local suppliers thus embedding the sector more into the local economy. Some of these problems are well recognised in the industry and the Executive has in place, through Scottish Enterprise, policies that are seeking to improve the situation. The current cyclical downturn should soon pass, but only time will tell whether the industry in Scotland can develop sufficiently to survive successfully the structural changes that are increasingly affecting the sector.

Outlook

Both the world and UK economies slowed down in the first quarter of 2001 and GDP growth for 2001 overall appears certain to be generally lower (see World and UK Economy sections). It appears likely that growth in the Scottish economy will have followed the slowdown experienced in the UK economy during the first quarter. No outturn data are as yet available for Scotland but the Scottish Chambers' Business Survey (SCBS) for the first quarter reported declining trends in business confidence across all sectors and in manufacturing the outturn in orders was worse than anticipated. The trend in actual orders and sales was generally positive across sectors but appear indicative of a low rate of growth.

Since February the discovery and spread of foot and mouth disease will have affected the performance of the economy but only to a limited extent. The agriculture impact is largely confined to the borders and the Dumfries and Galloway region in particular. While the impact of the disease has been particularly upsetting for many farmers and the wider rural community, the direct effects on Scottish GDP of the fall in agricultural output will be small. The impact on tourism is much less certain and potentially more serious from the standpoint of the wider economy. While tourist trips to the rural communities containing the affected farms will have reduced it is highly likely that trips to more urban areas, or other forms of consumer spending, will have been substituted instead. This suggests that the spatial incidence of the impact of foot and mouth will clearly differ from the overall Scottish impact. However, to the extent that tourist trips to Scotland fell as a result of the disease then the wider Scottish economy will have been affected. No estimates are publicly available of the effect of the disease on the demand for Scottish tourism, although it is clear from the responses to the first quarter SCBS that business confidence has generally collapsed in the sector. There is evidence that tourist trips to the UK have fallen, with Heathrow experiencing a 3.6% fall in passenger volume in April compared to the same month last year. Similar reductions are not present in the passenger volume data to BAA's Scottish airports, although it is possible that deterred tourists would have entered Scotland by other routes. In the UK Economy section we note that the National Institute for Economic and Social Research estimate that foot and mouth disease will lower UK GDP growth by 0.2 to 0.3 percentage points in 2001. The impact of the disease on Scottish GDP growth should be no more than this and may be somewhat less.

Prospects for the Scottish economy in the second half of this year depend particularly on the extent of the slowdown in the world and UK economies, and the market conditions confronting Scottish electronics. Since the January 2001 Commentary the extent of the likely slowdown in the world economy during 2001 has become clearer. The US economy should pick up during the second half of the year, encouraged by an aggressive series of interest rate cuts in the first half of this year, but it is expected that growth will not return in the near term to the levels experienced in 2000 and 1999. European growth is expected to be somewhat more buoyant but still weaker than in 2000, while the Japanese economy will exhibit little growth during 2001. Against this background, Scotland's foreign exports are expected to weaken further both on 2000 and compared to our expectation in January. The prospects for the UK economy have also weakened slightly since January, with anticipated growth for 2001 down to 2.4% from the 3% achieved last year. This slowdown will affect Scottish exports to the rest of the UK.

The difficulties confronting Scottish electronics are expected to continue throughout the year, with output markedly affected by the loss of Motorola's West Lothian plant, weaker export sales right across the sector and inward investment especially weak. The weakness of international trading conditions will ensure that the manufacturing sector generally in Scotland will largely stagnate during 2001. The main momentum behind growth will come from the service sector, where financial[3] and business services are expected to continue to be relatively strong, with the retail sector holding up in response to a reasonably strong Scottish consumption profile. The main concern within the service sector is the prospect for tourism and how quickly the problems caused by foot and mouth disease can be overcome.

In January we forecast growth in the Scottish economy of 2% in 2001 and 2.3% in 2002. For the reasons discussed above, we have revised these forecasts downwards and we are now anticipating that Scottish GDP will grow by 1.6% this year with growth of 1.9% expected in 2002 (see Forecasts of the Scottish Economy section). Total employment is expected to fall by 5,000 this year but rise by 10,000 in 2002. Unemployment is therefore expected to be slightly higher during 2001 than forecast in January at 4.7% on the Claimant Count and 6.7% on the ILO measure. But unemployment should continue to fall slowly into 2002, with the Claimant Count standing at 4.5% and the ILO measure at 6.5%. In sum, growth will slow below trend this year but should move back on trend in 2002 as growth in all the major economies begins to pick up.

Endnotes

1 "The Interpretation of the Scottish Quarterly GDP Series" pp. 14 to 24, *Scottish Economic Statistics 2001*.

2 Gross value added (GVA) at constant basic prices.

3 The performance of financial services could be less strong if the decline in equity markets lowers turnover.

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