

The Scottish economy

Forecasts of the Scottish economy

Economic background

Growth in the world economy is relatively strong (despite the weak data in the summer and a slight slowing in China). Strong growth in the US, China and Japan are driving the world economy. The Euro Area remains relatively weak but is expected to pick up in 2005-06. The world economy is expected to grow at a considerable pace (close to 4 per cent) in 2004 but growth is forecast to be slightly less in 2005. World trade is forecast to grow rapidly in both 2004 and 2005 (just below 10 per cent for both years). Chinese trade flows and the importance of trade in Asia are the most significant contributions to this growth.

The UK continues to enjoy the benefits of growth and trade accruing from the US and expanding new markets in the Far East, especially China. We are also expecting growth to benefit from the forecast recovery in the Euro Area and to reap rewards from domestic demand. When UK GDP growth for 2004Q3 was recorded as only 0.5 per cent this was unexpected. Fourth quarter growth appears to be much stronger at 0.7 per cent. Employment remains relatively strong while unemployment is low. Inflation is also low and stable despite recent surges in both house price inflation and the oil price. Interest rates appear to have stabilised at 4.75 per cent. Consumption, government spending and investment are the main drivers of UK growth.

The Scottish economy

Scottish GVA growth was 0.9 per cent in 2004Q3 compared to 0.6 per cent in the second quarter. For the latest four quarters on the preceding four quarters growth was 1.8 per cent in both 2004Q3 and 2004Q2. The UK grew by 0.5 per cent on a quarterly basis and by 3.2 per cent on an annual basis. Despite having outperformed the UK economy in the third quarter the UK will outperform Scotland over 2004 by a significant margin.

Services grew by 1.3 per cent in the third quarter and by 1.8 per cent on an annual basis. The UK figures are 0.9 and 3.8 per cent respectively. Although a strong performance by Scottish services, outperforming UK services, over the year they still lag UK service sector growth. Scottish manufacturing declined by 1.1 per cent in 2004Q3 but grew by 0.4 per cent on an annual basis because of the relatively strong performance in 2004Q1. UK manufacturing contracted by 0.8 per cent so Scottish performance was quite similar. For the latest four quarters on the preceding four quarters UK manufacturing grew by 1.5 per cent, which is quite different from the Scottish performance.

Construction output increased by 0.4 per cent in the latest quarter and by 8.4 per cent on an annual basis. This is stronger than UK construction, which grew by 4.5 per cent over the year. UK construction increased by 1.2 per cent in 2004Q3, ahead of Scottish construction. Scottish construction has given the Scottish economy a much-needed boost. Mining and quarrying declined by 1.5 per cent in the latest quarter and by 3.7 per cent on an annual basis. Electricity, gas and water supply grew very strongly in the third quarter (6.3 per cent) and growth on an annual basis is now 1.3 per cent. The first two quarters of 2004 suggested this sector would not contribute significantly to Scottish growth. UK mining and quarrying perform less well than its counterpart but UK electricity, gas and water supply grew at 2.8 per cent on an annual basis thus outperforming its Scottish equivalent. On a quarterly basis the UK sector only grew by 0.4 per cent, significantly below Scottish third quarter performance.

In the service sector financial services, real estate and business services and hotels and catering contributed significantly to quarterly growth. On an annual basis financial services growth is still very strong at 6.5 per cent with real estate and business services the next strongest at 2.9 per cent. Most services sectors grew at less than 2 per cent on an annual basis. Both communications and banking however remain strong. In manufacturing only food, drink, ORNF and transport equipment demonstrate annual growth. Only metals had significant quarterly growth.

Scottish manufactured exports fell by 0.7 per cent in 2004Q3 and by 5.8 per cent over the year. Since 2001 Scottish manufactured exports have fallen by 24 per cent in real terms. While the Index of Manufactured Exports (IME) was 100 in 2001 it has now fallen to 75.5. The Global Connections Survey has shown that for 2003 the value of manufactured exports was £9,975 million while service sector exports were £5,130 million and primary exports were £420 million. There have been significant revisions to the 2002 GCS exports value. The reasons for this are not yet available.

LFS Employment rose by 44,000 over the year to 2,446,000 in Sep-Nov 2004 giving an employment rate of 75.2 per cent. This was only an increase of 1,000 over the last quarter. LFS employees increased from 2,189,000 in Jun-Aug 2004 to 2,196,000 in Sep-Nov 2004, an increase of 58,000 over the year. Self-employment declined by 16,000 over the year or by 7,000 over the quarter. Full-time employees decreased to 1,839,000 by 2,000 over the quarter but increased by 38,000 on an annual basis. Part-time employment increased by 1,000 over the year although the last quarter increase was 3,000. LFS unemployment declined from 147,000 to 142,000 in Sep-Nov 2004. This gives a rate of 5.5 per cent. This compares to claimant count unemployment of 87,900 in December 2004 or 3.3 per cent. The trend in employment appears to be rising and the trend in unemployment appears to be falling although neither figure is significantly different from that seen a year ago. The labour market performance is good and we expect this to continue.

The Scottish economy has performed well particularly the revival of service sector, however its poor service performance in the last three quarters of 2003 and in the first quarter of 2004 have held back economic growth overall. The collapse of manufactured exports and the decline of manufacturing impacted on Scottish growth as well. Construction has been strong and has added significantly to Scottish growth. The labour market remains buoyant and we expect labour market performance to remain good. We are cautiously optimistic for fourth quarter growth. The downside is clearly the weakness in manufacturing.

The forecast in detail

GDP

The forecasts of chain-linked GDP are now weighted according to the 2001 data. Fourth quarter forecasts for real GDP and broad sectoral output are presented in Table 1 for the period 2005 to 2007.

We are forecasting Scottish GDP growth of 2.0 per cent for 2004 but only 1.7 per cent for 2005. We believe that performance in the Scottish economy will be weaker than the UK during 2005-06 but we expect Scotland to perform more ably in 2007-08. Agriculture is forecast to grow above trend in 2005 but to weaken in the following year.

Table 1: Main forecasts of the Scottish economy, 2004-2006

	2004	2005	2006
	%	%	%
GDP	2.0	1.7	1.5
Agriculture	-0.5	1.6	0.9
Manufacturing	-0.5	0.5	0.9
Construction	7.5	4.8	3.7
Services	2.4	1.8	1.5

Source: Fraser of Allander Institute, January 2005

Manufacturing remains weak as forecast output is a decline of 0.5 per cent in 2004, modest growth in 2005 (0.5 per cent) and 0.9 per cent in 2006. The weakness of manufacturing is crucial to the economy. It is not that it is a very large part of the economy but that manufacturing drives productivity and technological change in manufacturing that is important. The service sector provides most of Scotland's jobs but many jobs that are being lost in manufacturing are highly skilled jobs. It must be noted however that although R&D is lower in Scotland than elsewhere in the UK, a recent survey (CIS 3 (2005)) demonstrates that Scottish firms make more effective use of the R&D that they buy in from universities, higher education or research institutes. There may also be a greater transfer of technology in Scottish manufactured plants but the data does not allow us to investigate this.

Final demand

Consumption and government expenditure are largely unchanged with investment expenditure becoming more important. Tourism performance has been mixed, although probably better than expected. Overseas demand remains the weakest sector and we are forecasting a gradual increase over 2005-07 for tourist demand.

Exports to the Rest of the World remain problematic especially electronics. We have downgraded our final demand for exports in line with the Scottish Executive data – some commentators had hoped to see growth in 2004 but sadly this is lacking. We expect Exports to the Rest of the UK to grow slowly over time. We know that manufactured exports performed very poorly over 2001-04. We do expect there to be stronger growth from a weak base in 2005 and 2006, particularly as the Euro Area recovers.

Output

Agriculture output is forecast to be relatively weak in 2004 but to grow by 1.6 per cent in 2005. Mining and quarrying is forecast to contract over 2004 and to grow by over 1 per cent in each of the following forecast years. Over the period 2004-06 electricity, gas and water supply is forecast to grow by around 1.5 per cent per annum. This probably relies however, on manufacturing increasing demand for fuel.

Manufacturing growth continues to disappoint and we expected a slight upturn in 2004 for manufacturing growth but instead we were confronted with yet another contraction in growth. We are now forecasting a slight rise (0.5 per cent) in 2005 with growth increasing to just under 1 per cent in 2006. Growth is forecast to increase more significantly in 2007 and 2008 (above 1 per cent) as the economy should have picked up by then and we believe that most of the slack in manufacturing will have dropped out of the sector. It may be however that we have a significantly reduced sector in terms of weight with respect to GDP compared to the late 1990s. The return to growth in electronics will also be a significant step on the road to recovery. At least at the moment some of the other exporting sectors are growing significantly but not enough to overcome the deficits in other sub-sectors.

Services are forecast to grow by 2.4 per cent in 2004, by 1.8 per cent in 2005 and by 1.5 per cent in 2006. We believe they will return to trend growth in 2007-08. Services continue to be driven by financial services and real estate and business services. The strong growth in the service sector also drives employment growth. Our forecast for services in 2006 may be slightly weak and this may need to be adjusted upwards by a couple of percentage points but there has to come a time in the Scottish economy where service sector growth slows slightly compared to that in the UK. At the moment growth in services is strong and relatively consistent.

Construction growth in 2004 is forecast to be 7.5 per cent and 4.8 per cent in the following year. This is very strong growth

and is driven by public sector investment (schools, hospitals and transport infrastructure – mostly PFI projects), private housing demand, which despite a slowing in house price growth, demonstrates solid growth compared to financial investments. There is a realisation that the economy is moving forward and commercial property is becoming more important.

Employment

Our medium-term forecasts of employment are presented in Table 2 with the net employment change figure in brackets. The employment figures are calibrated on the employers quarterly survey series as given in Table B.16 in Labour Market Trends, National Statistics.

Table 2: Forecasts of Scottish employment and net employment change, 2004-2005

	2004	2005	2006
Total employment (000s)	2,269.3 (25,900)	2,300.3 (31,000)	2,327.4 (27,100)
Agriculture	35.3 (-900)	35.4 (100)	35.3 (-100)
Manufacturing	247.9 (-5,100)	246.1 (-1,800)	245.8 (-300)
Construction	147.0 (3,500)	150.4 (3,000)	153.5 (4,200)
Services	1,796.7 (23,500)	1,825.4 (28,700)	1,849.2 (23,800)

Source: Fraser of Allander Institute, January 2005

Table 3: Forecasts of Scottish unemployment, 2004-2006

	2004	2005	2006
ILO Unemployment (levels)	143,000	141,500	141,400
Rate	5.4%	5.2%	5.1%
Claimant count (levels)	92,500	91,300	91,000
Rate	3.4%	3.4%	3.4%

Source: Fraser of Allander Institute, January 2005

Employment is forecast to increase to 2,269,300 in 2004 and to 2,300,300 in 2005. This is a net job change of 25,900 and 31,000 respectively. Employment gains across the period 2006-08 are close to trend. The service sector still drives employment gains across the forecast horizon.

Clearly services dominate employment growth with employment gains that are on average six times stronger than its nearest competitor (construction). Manufacturing is forecast to lose jobs over the period 2004-06. Construction is forecast to contribute significantly to employment gains across the forecast horizon. The job change in agriculture is generally negative with many people leaving rural areas for urban areas and the increasing use of technology in agriculture or leaving land fallow to earn subsidies, therefore needing less labour. The fall in manufacturing employment is slightly concerning but we expect the sector to stabilise by 2006 or 2007. There are significant job gains forecast in electricity, gas and water supply of around 500 in each year of the forecast up to 2006. Mining and quarrying is forecast to lose 1,000 jobs in 2004 then have marginal gains in the next two years.

Agricultural employment is forecast to be 35,300 in 2004 and to decline slowly thereafter. Construction employment is forecast to be 147,000 in 2004 and to rise to 150,400 in 2005. In next two years construction is expected to add between 3,000 to 4,000 jobs per year to employment. Manufacturing is forecast to lose 5,100 jobs in 2004, a further 1,800 jobs in 2005 and stabilise over 2006-07. Manufacturing employment is forecast to drop by 58,000 jobs from 305,000 in the year 2000 to 245,800 in the year 2006. The service sector is forecast to add 23,500 jobs in 2004 and a further 28,700 jobs in 2006. Service sector employment is forecast to

rise from 1,796,800 in 2004 to 1,849,200 in 2006. It is estimated that over 2004 to 2006 the service sector will have added 75,900 jobs to the economy or 25,300 jobs per year.

Once again the outlook for the Scottish economy is good while services remain the key sector driving growth and employment. We expect a marginal moderation of consumption next year and we believe investment, tourism and exports will strengthen the economy. Government spending is as before an important driver of the economy. We are forecasting a slight dip in growth in 2005-06 but thereafter we are forecasting that growth will be close to trend for the rest of the period. Construction growth is strong and forecast to remain so until 2007. Manufacturing is weak and unlikely to recover until 2006. A pick-up in the Euro Area and a depreciation of sterling will help exporters. We remain optimistic about the labour market and continue to forecast rising employment and low and stable unemployment.

Kenneth Low
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