

# Outlook and appraisal

## Overview

A stronger than anticipated growth performance in the 4th quarter of last year meant that GDP growth in Scotland had improved in 3 successive quarters since the technical recession at the end of 2001 and beginning of 2002. It appears unlikely from the business survey evidence that this progressive strengthening of the rate of growth will have carried over into the first quarter of the year. However, the fairly rapid resolution of formal hostilities in the war on Iraq has removed some of the uncertainties affecting the world economy. Several other factors are working in favour of recovery: falling oil prices, a pick-up in equity markets, incipient signs of recovery in business investment and further monetary policy easing. Against this background most forecasters are predicting that growth in all the major economies will be stronger this year than last. However, recovery will be slow and will only become more apparent in the second half of the year. Scotland is unlikely to diverge from the general pattern. We are now forecasting somewhat faster growth and greater job creation in Scotland in 2003 and 2004 than in our March Commentary. GDP growth is expected to reach 1.3% in 2003, compared to our March forecast of 1.1%, and 2.2% in 2004 against 1.8% in March. Strengthening service sector growth and recovery in manufacturing results in anticipated net job creation of over 33 thousand in 2003 and 44 thousand in 2004. Unemployment is projected to continue to fall slightly to 6.2% and 3.7% this year on the ILO and claimant measures respectively and 5.9% and 3.7% in 2004.

## GDP and output

Scottish GDP growth was stronger than anticipated in the final quarter of 2002, although there was no growth over the year. The latest data from the Scottish Executive indicate that Gross Domestic Product (GDP) rose by 0.7% in the fourth quarter compared to a growth of 0.3% in the UK. For 2002 as a whole, the level of GDP in Scotland remained the same as in 2001 whereas in the UK GDP grew by 1.3%. Removal of oil and gas to ensure comparison on a like for like basis does not change Scotland's overall performance but lowers UK growth in the fourth quarter to 0.2% while raising the growth rate for 2002 to 1.5%.

Figure 1 suggests that despite Scotland's relatively weak GDP performance growth has been picking up since the first quarter of last year, although with UK economic growth slowing in the first quarter of this year to its weakest outturn in 11 years there is no guarantee of a continuing improvement. However, what is also clear from the chart is that since 1995 the Scottish economy has been much more volatile on a quarterly basis than the UK as a whole. The average deviation from mean quarterly growth over the period is 0.57 percentage points in Scotland compared to 0.27 in the UK. This is important to remember because it suggests that quarterly growth outturns in Scotland are a poorer guide to average growth over the longer term than UK quarterly growth outturns. Over the period 1995 Q2 to 2002 Q4, Scottish quarterly growth averaged 0.51% while UK quarterly growth averaged 0.64%.

When GDP is disaggregated to the broad sectoral level, agriculture (1.2%), construction (0.3%) and services (1.3%) all displayed positive growth in the fourth quarter, with both agriculture and services growing faster than their UK counterparts, which grew at -0.5% and 0.5% respectively. The construction sector, in contrast grew by 1.9% in the UK during the quarter. Apart from the slower growth of construction, the main drag on Scottish growth in the fourth quarter was the performance of the production sector, which contracted by 1.1% compared to the 0.8% fall experienced by UK production. Manufacturing dominates the production sector and output fell by 1.6% in Scotland in the fourth quarter compared to a 1% fall in manufacturing in the UK.

Figure 2 highlights the depth of recession experienced by Scottish manufacturing, with output falling for 11 successive quarters, a drop of 22% on the 2000 Q1 peak, with UK manufacturing contracting by about 6% over the same period. The crisis in the world electronics industry has played a key role in the contraction of both Scottish and UK manufacturing as Figure 3 shows. Production in electronics peaked in the third and fourth quarters of 2000 in Scotland and the UK respectively, with output then falling by 43% in Scotland and 30% in the UK during the period to 2002 Q4. But, as John McLaren's article in this edition of the Commentary makes clear, the weak performance of Scottish manufacturing was further compounded by a marked downturn in the output of transport equipment, textiles and

paper, printing & publishing. Transport equipment reached peak output in 2000 Q1 and then contracted by almost 40% during the subsequent 11 quarters to 2002 Q4. The transport equipment industry in the UK contracted by only 9% over the same period. The paper industry similarly reached peak output in both Scotland and the UK in 2000 Q2 and then contracted by 20% in Scotland over the period to the final quarter of last year but the industry in the UK lost less than 1% of output during the same period. Only in textiles where production had been falling for much longer, since 1997 Q1, was the fall in output from 2000 Q1 large but broadly similar in Scotland and the UK at 23% and 24%, respectively.

The contraction in Scottish manufacturing since the beginning of 2000 represents a significant hollowing out of the Scottish economy both absolutely and relative to the UK. What has helped soften the blow is that the much bigger service sector – accounting for 63% of the economy compared to manufacturing's 24% - has tended to perform better in Scotland since the first quarter of 2000, following weaker growth in the earlier period from 1995. Figure 4 indicates that quarterly growth in Scottish services exceeded growth in UK services in 8 of the 11 quarters since 2000 Q1 growing by over 13% in Scotland compared to growth of just below 9% in UK. McLaren ascribes this faster growth to catch-up in the transport & communications and real estate and business service sectors after weaker growth in the 1995 to 2000 period. But in addition, financial services and hotels & catering continuously outperformed their UK counterparts during the period both before and after the first quarter of 2000. This coupled with the greater labour intensity of services has meant that the economy could experience such a significant output contraction in one of its key sectors - electronics - with almost little or no impact on overall unemployment. Indeed, allowing for a lagged effect on the labour market, over the broadly comparable period of September–November 2001 to December 2002–February 2003, LFS employment rose by 24,000.

Figure 5 summarises the changing growth performance of key sectors - with their respective weights given - in the Scottish economy between 1996 Q1 and 2002 Q4. The rise and dramatic fall of electronics is clearly evident, as is the lesser rise and fall of chemicals. In the service sector, the sustained growth of financial services dominates followed, especially since 2000, by strong growth in other services, transport & communication, real estate & business services and, to a lesser extent, hotels & catering, with retail & wholesale growing steadily throughout the period. In contrast, public administration, education and health remained relatively flat, exhibiting less than 5% growth since the beginning of 1996 whereas growth in the UK public sector is estimated at just under 12%. The public sector accounts for more than one fifth of the Scottish economy and so changes in its performance have an appreciable impact on Scotland's overall economic performance.

It is in this context that one of the findings of John McLaren's article is of particular interest. His analysis separates out the performance of health & social work from the rest of the public sector and finds that that it has significantly under performed its UK counterpart. There is no obvious economic or political justification for such a large gap of 31 percentage points over the period 1995 to 2002 Q3. The explanation appears to be primarily due to methodological inconsistencies in the estimation of health & social work output between Scotland and the UK, with the Scottish approach less preferred. Application of the UK growth rate to Scottish health & social work removes half (3% points) of the growth gap between Scotland and the UK during 1995 to 2002 Q3. In view of the importance of the growth issue to the political debate in Scotland there can be no better example of the importance of accurate statistics.

### Scottish statistics: a proposal

The general quality of Scottish statistics is beyond doubt. Since devolution the Scottish Executive has *inter alia*:

- agreed that statistics by or for the Executive will embrace the aims and objectives of National Statistics, including adherence to the National Statistics Code of Practice;
- signed up to a Concordat on statistics, which sets out an agreed framework for co-operation among the UK Government and devolved administrations;
- produced a detailed Scottish Statistics Plan;
- produced the Scottish Economic Statistics Programme (SESP), as part of that Plan, which is updated annually;
- established a detailed consultation mechanism SCOTSTAT to take into account views of users and providers.

Through the SESP we now have a range of appropriate economic statistics that arguably is superior to that produced in other territories of the UK – for example, Northern Ireland does not produce quarterly GDP statistics and does not have official Input-Output tables.

Yet, perhaps because of the importance and relevance of some of the statistics produced, the quality of some key statistics and data publications has been at the centre of much political and media debate. The most obvious examples are the *Government Expenditure and Revenues* (GERS) document, which provides estimates of the balance of public finances in Scotland, and the quarterly GDP series. It is our view that official Scottish statistics should, as far as possible, be removed from the political arena. Furthermore, we believe that the critical issue is one of establishing public confidence in, rather than any intrinsic problem with, the quality of Scottish statistics.

One way of establishing and maintaining public confidence in official Scottish statistics would be to create an independent statistical agency along the lines of the Northern Ireland Statistics and Research Agency (NISRA). However, we are not convinced that such a large organisational change in the production of Scottish statistics would necessarily produce the desired effect on public confidence that would warrant the cost and upheaval. A more cost effective approach, with perhaps a more positive effect on public confidence, would be to 'regionalise' the UK Statistics Commission by the creation of a Statistics Commission for Scotland (SCS).

The SCS would advise on the quality, quality assurance, the needs of users and objective setting and the procedures designed to deliver statistical integrity. It would do so in a fully transparent fashion producing an annual report to the Minister, which could be debated by the Scottish Parliament. It should be a non-departmental public body (NDPB) of, say, no more than 10 members, which would be independent of both ministers and the producers of official Scottish statistics. The chair and member would be appointed by the Minister of Finance, who is responsible for the co-ordination of UK National Statistics in Scotland, in accordance with the Code of Practice published by the Commissioner for Public Appointments. The SCS would be properly resourced, would have a small staff and would meet regularly, perhaps no less than 6 times a year. In addition, aspects of the current SCOTSTAT consultation mechanism might be better incorporated into the structure of the SCS. Further work would be required on the detail but in the words of the White Paper *Building Trust in Statistics* that set up the UK Statistics Commission such a body would "... provide the appropriate safeguards in relation to the quality of the statistics and their freedom from political interference and ... advise Government on such issues if it believes further measures are necessary" (Para 2.8, page 5).

### Outlook

Both the world and UK economies weakened in the first quarter of this year. The revised outturn figure of 0.1% amounted to the weakest quarterly growth performance for 11 years. Construction and production output fell, although manufacturing posted a slight increase of 0.1%. Perhaps most worrying was the slowdown in the service sector, which grew by 0.4% compared to 0.8% in the final quarter of last year. After the divergence between Scottish and UK growth in 2002 Q4 and the greater volatility of quarterly Scottish GDP, it is difficult to be certain about how the Scottish economy will have performed in the first quarter. Both the Scottish Chambers' Business Survey and the CBI Survey suggest a deteriorating performance on the fourth quarter of 2002. These survey results are echoed in the Royal Bank of Scotland's PMI Scotland report, where the index remained below 50 during the first 3 months of the year. However, the output index for April and May suggested a slowing in the rate of decline, which may be reflected in

an improvement in the outturn growth figures for the second quarter. The likelihood would appear to be that growth in Scotland remained flat in the first quarter, as the uncertainties surrounding the political situation in Iraq were building.

The fairly rapid resolution of formal hostilities in the war on Iraq has removed some of the uncertainties affecting the world economy. While there are legitimate concerns about the prospect of deflation in some key economies such as Japan and Germany there are several factors working in favour of recovery. These include: reduced uncertainty, falling oil prices, a pick-up in equity markets – although there is some uncertainty about whether this will be sustained – incipient signs of recovery in business investment and further monetary policy easing.

It is against this background that most forecasters are predicting that growth in all the major economies will be stronger this year than last. However, recovery will be slow and will only become more apparent in the second half of the year.

Scotland is unlikely to diverge from the general pattern. The effects of the contraction of the electronics industry have hit the economy hard but even here there appears to be some light at the end of the tunnel. Venture capital appears to be coming back into the high-technology sector and the more favourable rate of sterling should benefit exporters

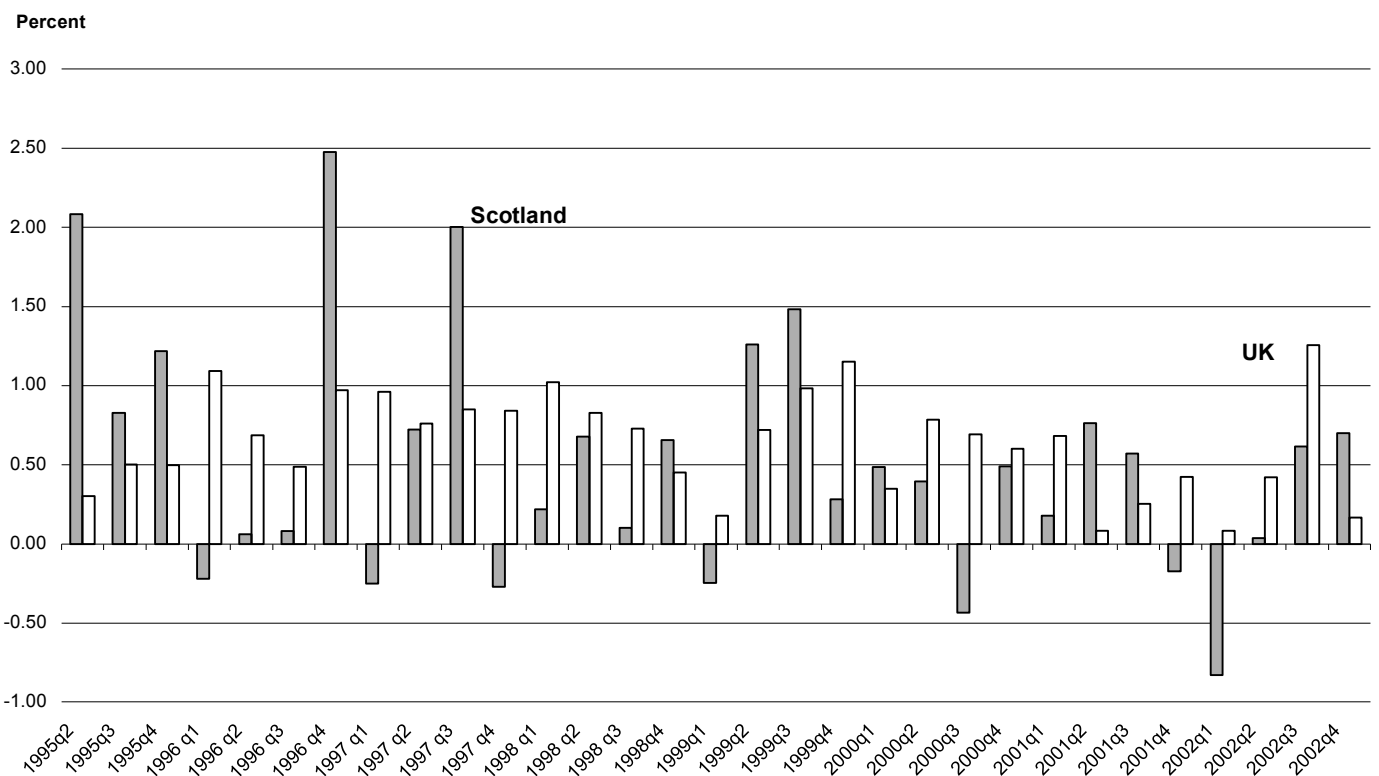
right across Scottish industry. The other bright spot in Scotland is the relative strength of consumer demand as indicated in the SRC/Royal Bank of Scotland Retail sales Monitor with retail sales currently more buoyant here than in the UK.

We are now forecasting somewhat faster growth and greater job creation in Scotland in 2003 and 2004 than in our March Commentary. GDP growth is expected to reach 1.3% in 2003, compared to our March forecast of 1.1%, and 2.2% in 2004 against 1.8% in March. This improvement in growth is present across all principal sectors, with manufacturing still expected to contract this year (-1.1%) but at a much lower rate than in 2002, before returning to a positive but low growth rate of 0.5% in 2004. Service sector output growth is forecast to be 2.4% in 2003 and 2.6% in 2004, with retail and wholesale, financial services and other services the strongest performing sectors.

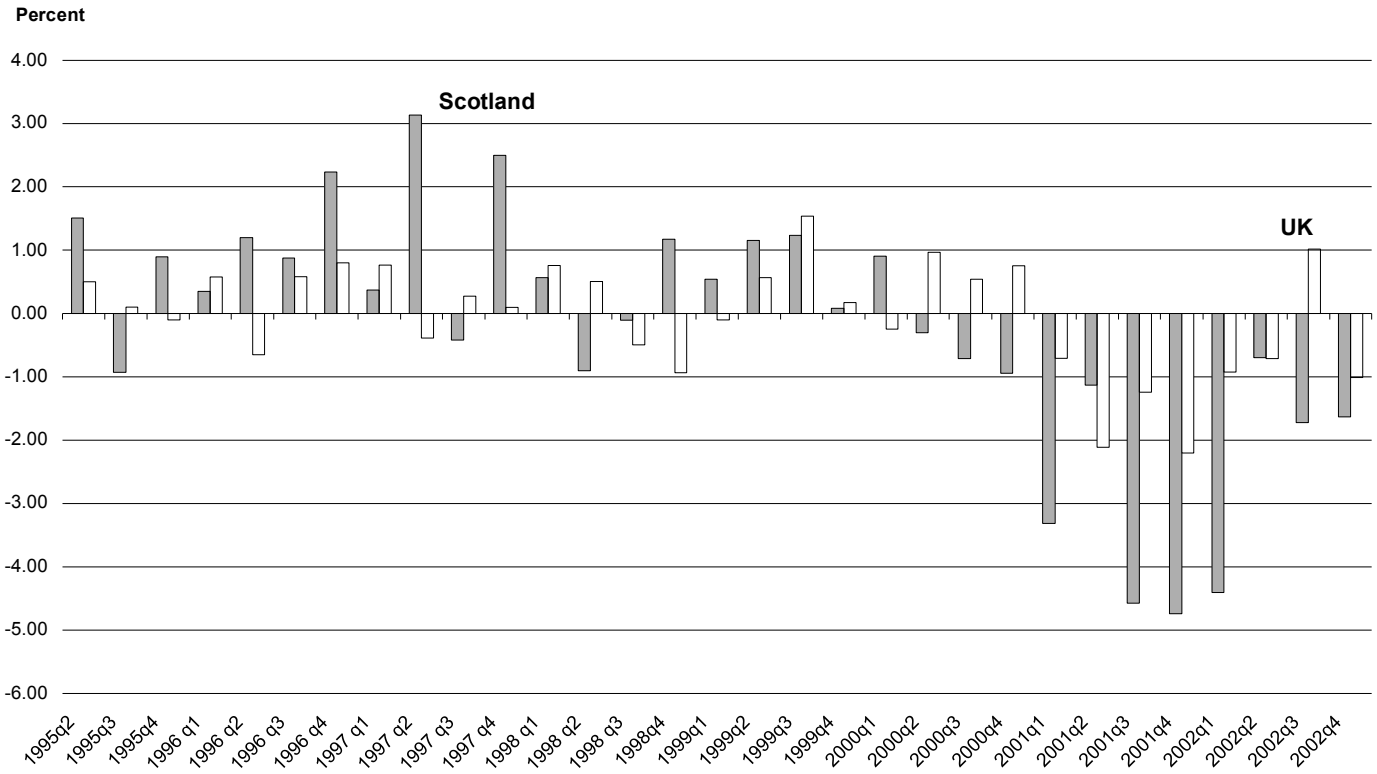
In the labour market, strengthening service sector growth and recovery in manufacturing results in anticipated net job creation of over 33 thousand in 2003 and 44 thousand next year. Unemployment is projected to continue to fall slightly to 6.2% and 3.7% this year on the ILO and claimant measures respectively and 5.9% and 3.7% in 2004.

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**Figure 1: Scottish and UK GDP (Ex. oil and gas), Quarterly Growth at constant basic prices 1995q2 to 2002q4**



**Figure 2: Scottish and UK Manufacturing Sector GVA Growth at constant basic prices 1995q2 to 2002q4**



**Figure 3: Scottish and UK Electronics Sector GVA Growth at constant basic prices 1995q2 to 2002q4**

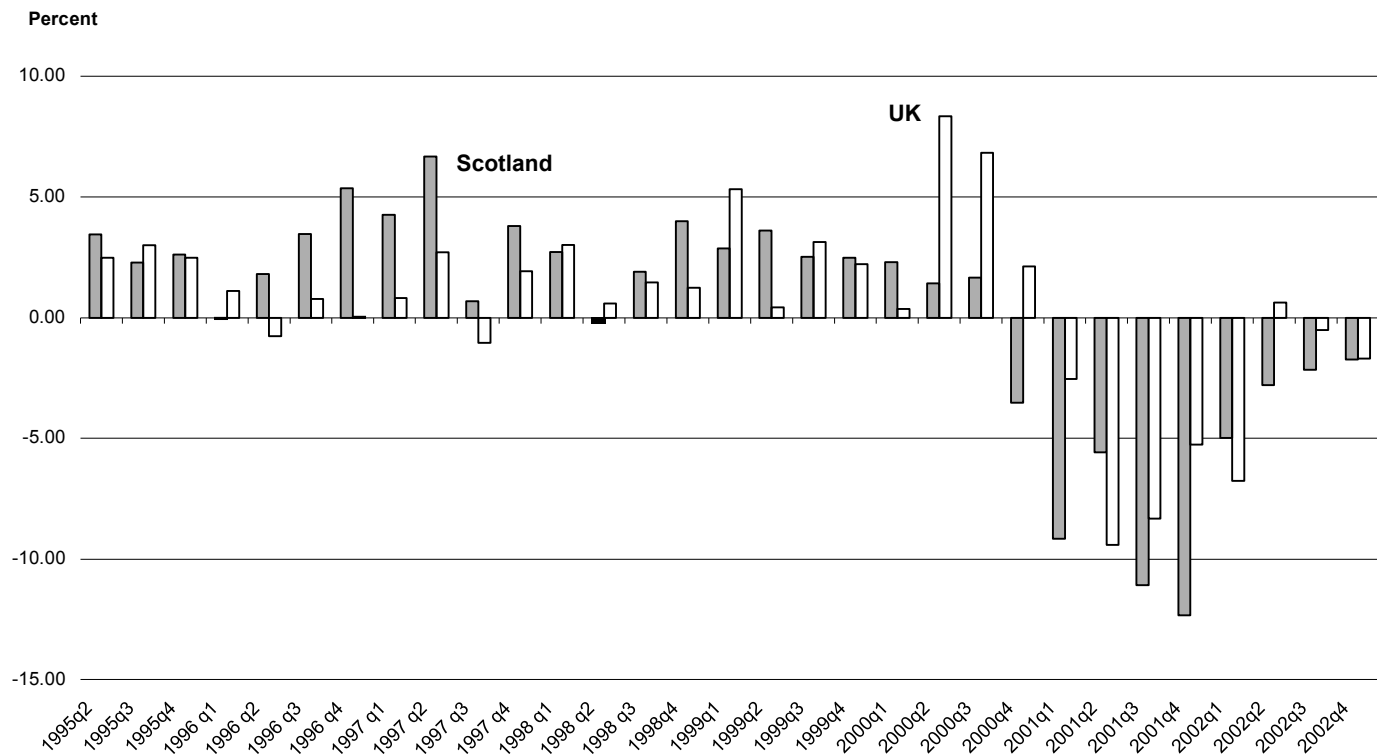


Figure 4: Scottish and UK Service Sector GVA Growth at constant basic prices 1995q2 to 2002q4

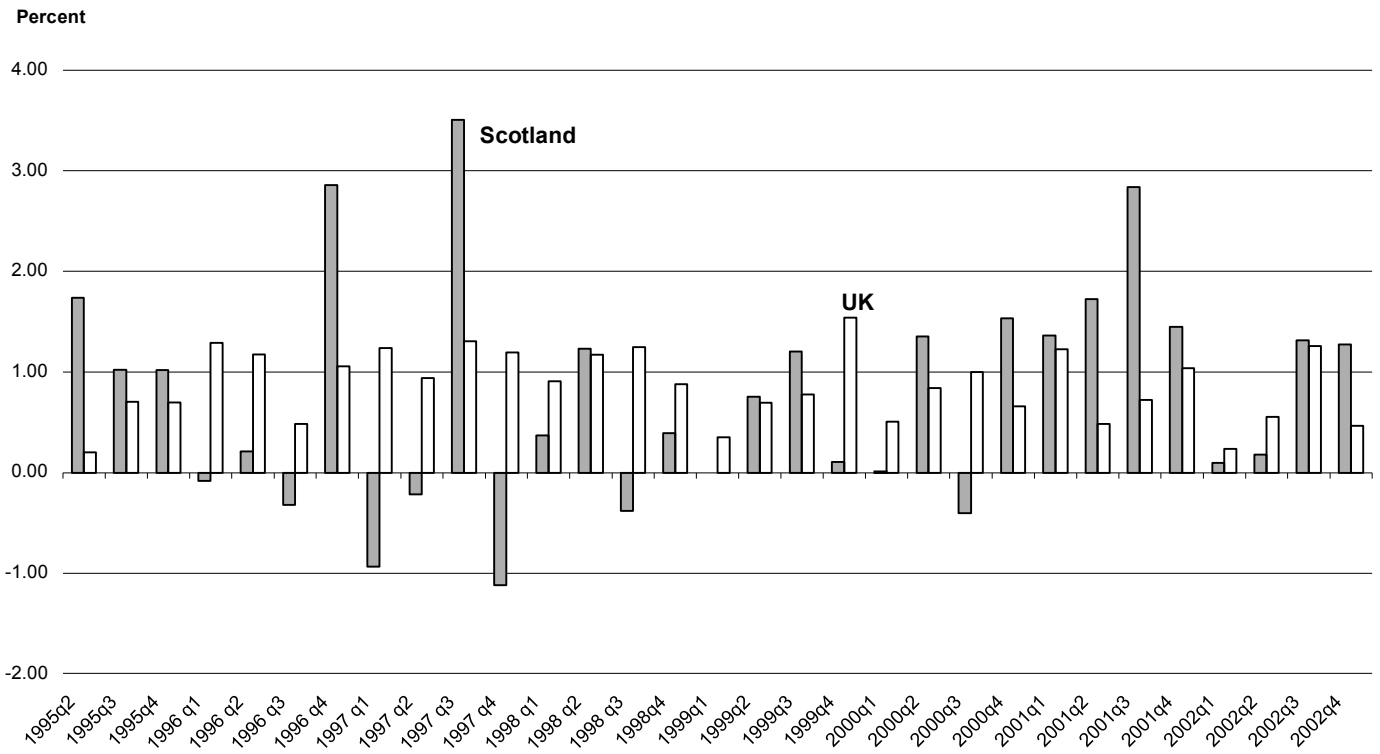


Figure 5: Key Growth Sectors 1996Q1 to 2002Q4

