Outlook and appraisal

Overview

Scottish economic growth improved in the third quarter of last year on the latest Executive data. UK growth slowed in the fourth quarter and this coupled with Scottish business survey evidence suggests a slowing of Scottish growth in that period. It is therefore probable that Scottish GDP will have fallen slightly in 2002 as a whole. Evidence for both the Scottish and UK economies suggests a further weakening of growth during the first two months of 2003. Yet the underlying position in the world economy, with the UK performing above the EU average and better than most OECD countries, suggests a gradual strengthening of demand with recovery occurring during the remainder of 2003 and full recovery in 2004. However, the prospects in the short and perhaps medium run are clouded considerably by the war in Iraq. In view of this uncertainty, we offer three forecasts for the Scottish economy that reflect different assumptions about the outturn of the war: a benign

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scenario, which forms our baseline forecast, an intermediate scenario, and a worst scenario. In the baseline case, where the war concludes fairly quickly with minimal disruption to oil supplies and tourism, we are predicting that Scottish GDP will grow by 1.1% this year and 1.8% in 2004. Our forecast for 2003 has been revised downwards by 0.3% points in recognition of the weakening of the economy during the first two months of this year. The intermediate and worst scenarios assume that the war produces progressively greater damaging effects on the world economy and hence on Scottish economic performance. In the worst-case the war effectively pushes the Scottish economy into recession. There are clearly significant uncertainties in the days ahead, but our best judgement is that the benign scenario is the most likely.

GDP and output

The growth of the Scottish economy picked up a little in the third quarter of last year. The latest data from the Scottish Executive reveal that Gross Domestic Product (GDP) rose by 0.6% compared to a rise of 0.8% in the UK. However, the data for the 3 previous quarters have been revised downwards and this has had the effect of lowering the estimate for growth in 2002 Q2 from 0.3% to 0.2% and raising the estimate of the fall in output in 2001 Q4 from -0.2% to -0.3%. The net effect of these changes when combined with the latest data for the third quarter 2002 is that Scottish GDP rose by only 0.1% for the latest four quarters on the previous four quarters, compared to growth of 1.3% in the UK. Nevertheless, the Scottish economy has exhibited positive and rising growth for two consecutive quarters after the successive falls in output in the final quarter of 2001 and the first quarter of 2002.

At the broad sectoral level, agriculture (1.6%), construction (2.5%) and services (0.9%) all displayed positive growth in the third quarter and at rates faster or no less than their UK counterparts, which grew at rates of 0.4%, 1.7% and 0.9% respectively. However, with the exception of mining and quarrying, production sectors were much weaker in Scotland than in the UK. Manufacturing, which accounts for 83% of production activity, continued to contract with output falling by 0.8% compared to growth of 1% in manufacturing in the UK. Output in Scottish manufacturing has therefore fallen over 10 consecutive quarters, although the rate of contraction did slow down during 2002 compared to 2001.

Over the year to the third quarter, when compared to the previous year, Scottish services (5%) grew twice as quickly as UK services (2.5%). But in the other principal sectors Scottish growth was much weaker. Agriculture contracted by 0.9% compared to a rise of 0.9% in the UK, while construction activity fell by 4.6% in Scotland as the sector grew by 7.1% in the UK. However, by far the biggest downturn was registered in Scottish manufacturing, which cut back production by 12.7% during the year, more than twice as much as the 5.2% fall in UK manufacturing output.

While Scottish and UK services grew at the same rate of 0.9% in 2002 Q3, there was considerable variation in performance at the sub-sectoral level. With growth of 3.4%, the retail and wholesale sector in Scotland considerably outperformed its UK counterpart, which grew at 0.8%. The growth of other services (1.3%) was also stronger than in the UK (0.7%). But the important financial and business service sectors performed less strongly in Scotland, with growth of 0.9% and 0.4%, compared to 1.3% and 1% respectively in the UK. Transport services (0.8%) and hotels and catering (-0.8%) were also weaker here than in the UK as a whole (1.4% and 0.1%, respectively). Further sectoral decomposition, however, reveals that banking, an important component of financial services, grew by just under 6% in the third quarter while communications, a key element of transport services, grew by 2.3%.

The stronger rate of growth of Scottish services over the year to the third quarter was principally focused on business services, transport services, other services and hotels and catering. Business services grew by 9.8% over the year in Scotland compared to 3% growth in the UK. Similarly, transport services grew by 9.6% here while its UK counterpart was largely stagnant growing by only 0.3%. Other services in Scotland exhibited 11.8% growth while the sector in the UK grew by 3.3%. Hotels and catering grew by 5.4% in Scotland while contracting by 0.3% in the UK.

Financial services exhibited much the same growth rate at 2.5% in Scotland and 2.6% in the UK. In contrast, only two service sectors exhibited appreciably weaker growth here over the year: retail and wholesale (2.1% in Scotland compared to 4.7% in the UK), and the public sector (1.2% compared to 2.5%).

Within manufacturing, most Scottish sectors were weaker than their UK counterparts in 2002 Q3, the only exception being other manufacturing, which grew by 2.8% compared to 0.7% growth in the UK. The drinks sector was especially weak, with output falling by 8.6% in the quarter compared to a fall of 1.5% in the UK. The chemicals sector, which traditionally has been a mainstay of Scottish growth, contracted by 2.6%, while its UK counterpart grew by 0.9%. The electronics industry continued to contract in the third quarter by 0.5%, much the same as the 0.4% fall in output in the sector in the UK. While the recession in the industry appears to be easing this is at the cost of a 28% reduction in output over the year to the third quarter and a 40% loss of output from peak production two years earlier in the third quarter of 2000. Transport equipment was the other manufacturing sector where output was cut appreciably over the year: by just under 25% compared to a 4% reduction in the UK.

In earlier years, the Commentary drew attention to the extent to which Scotland's economic performance depended on growth in the electronics industry. For much of the 1990s Scottish manufacturing outperformed UK manufacturing but this was mainly due to the strong performance of Scottish electronics. Removal of electronics led to weaker manufacturing growth in Scotland compared to the UK and a lower overall rate of growth of GDP. Now that the weak performance of electronics in Scotland is dragging down the overall performance of the Scottish economy it is useful to redo the procedure and assess Scotland's absolute and comparative economic growth with the sector removed. When this is done, Scotland's GDP growth over the year to the third quarter rises from 0.1% to 2.4%, while UK GDP growth increases from 1.3% to 2%. Although this is an artificial figure it does highlight the extent to which the downturn in the electronics sector, given its relative importance, is pulling down the growth of the Scottish economy both absolutely and relative to the UK. It should be emphasised, though, that manufacturing sectors out with electronics are also performing weakly and that the superior Scottish GDP growth relative to the UK when electronics is removed is a reflection of the stronger performance of the Scottish service sector over the year.

Outlook

The outlook for the Scottish economy and indeed the global economy is, in the short-run at least, much affected by the uncertainties resulting from the war with Iraq. At the time of writing (21 March) initial attacks have commenced and the war is likely to be well underway by our publication date (26 March). In these matters events can move swiftly and quickly make any predictions out of date. This of course applies to businesses seeking to make production and investment decisions as well as to forecasters, hence the large degree of uncertainty. Against this background of unprecedented uncertainty we offer below a baseline forecast with the highest probability, which assumes a short war with little material impact on the Scottish economy as a result. Two further forecasts are provided, which make different assumptions about the severity of the war and the international economic effects. The forecasts are based on scenarios devised by the Center for Strategic and International Studies.

Growth in the world economy faltered towards the end of 2002 (see World Economy section). Uncertainties about the international political situation and further falls in equity markets have contributed to a weakening in growth. In the US and Japan, GDP growth slowed in the final quarter of last year, while the Euro area remained weak. In the UK, growth also slowed in the fourth quarter to 0.4% from 0.8% in the third quarter (see UK economy section). Data on Scottish GDP growth in the fourth quarter will not be available until early May. But from the Scottish business survey evidence that is available for that quarter it would appear that Scottish growth also weakened. Against that background, we now anticipate that Scottish GDP will have fallen by a small amount in 2002 reflecting a growth rate over the year of -0.2%.

During the first two months of 2003, there was further evidence of weakening in both the UK and Scottish economies. UK Retail sales growth appeared to slow in February, while The Purchasing Managers Index (PMI) in both the UK and Scotland was below 50 for successive months in February. International uncertainty appeared particularly to be affecting key service sector activities such as tourism and financial services. Rising oil and house prices have also served to push up the underlying rate of inflation to 3%. Yet the underlying position in the world economy, with UK performing above the EU average and better than most OECD countries, is a gradual strengthening of demand with recovery occurring during the remainder of 2003 and full recovery in 2004 (see World Economy section). However, the prospects in the short and perhaps medium run are clouded considerably by the war in Iraq.

Forecasts of the Scottish economy against a background of war with Iraq

We examine the effects of 3 alternative scenarios (see Forecasts of the Scottish Economy section): a benign scenario, which forms our baseline forecast; an intermediate scenario, and a worst scenario. Our focus is on the economic impact of the war. No account is taken here of the inevitable human cost. The assumptions underpinning each scenario are outlined in an Appendix to the Scottish forecasts section. The war is likely to have an impact on oil prices, exchange rates, equity markets, consumer and business confidence and their consequent effects on domestic and external demand. In the Institute's forecasting model these outcomes principally affect the Scottish economy through changes in domestic consumption, tourism and exports.

Benign scenario

In this scenario, we assume a rapid and decisive victory for the US and its allies, with no significant disruption to oil supplies and minimal effects on tourism. This scenario is considered to have a 40% to 60% probability of occurrence and so stands as our baseline forecast. On this basis we are predicting that Scottish GDP will grow by 1.1% this year. This represents a reduction of 0.3% points on our forecast for 2003 in the December Commentary and reflects the weakening of the Scottish economy noted in the first two months of the year. However, in line with forecasts for the UK and other economies, we expect that Scotland will benefit from the recovery in the global economy that is widely forecast. Accordingly, we are forecasting that GDP growth will be 1.8% in 2004, a slight reduction on our December forecast of 1.9%. Manufacturing output will continue to decline in 2003 (-1.7%), with positive growth expected to reappear in 2004 (1.8%). Services on the other hand will continue to display positive growth in 2003 (2%) and 2004 (1.8%), but at a slower rate than in recent years. Associated with these forecast changes in output is an anticipated net employment change of around 19,000 in 2003 and 31,000 in 2004. Unemployment will continue its gradual drift downwards falling on the ILO measure to 6.2% this year and 5.9% in 2004, and to 3.7% in both years on the claimant count statistic.

Intermediate scenario

This scenario is considered to have a 30% to 40% probability. The war continues for 7 to 12 weeks, there is stiffer military resistance from Iraq, oil production and exports are affected through damage to oil production facilities and no active expansion of oil production elsewhere, by Saudi Arabia in particular. Scottish tourism demand is cut back by 7% in 2003 and by 3.5% in 2004. Oil prices rise above $40 per barrel and then settle back to an average of $30 in 2004. As a result Scottish exports suffer, falling by 0.4% in 2003 and by 0.2% in 2004. GDP growth falls to 0.8% in 2003 and 1.6% in 2004 compared to our baseline forecast. Net job creation is just under 17,000 in 2003 and just above 19,000 in 2004. Unemployment remains at around 2002 levels in 2003 at 6.3% on the ILO measure and 3.9% on the claimant count, falling to 6.2% and 3.8% in 2004 on the two measures respectively.

Worst scenario

This scenario is considered to have only a low probability of occurrence of 5% to 10%. The war continues for 13 to 26 weeks, there is protracted military resistance from Iraq and severe disruption of oil supplies with prices rising to $80 per barrel in the first three months before falling back to an average of $40 in 2004. Scottish tourism demand falls by 7% in both 2003 and 2004. The real value of exports falls by 0.8% points in 2003 and by 1.6% in 2004 reflecting the effects of a sustained rise in the price of oil. GDP growth turns negative in 2003 falling by 0.2% and then rising slightly, by 0.2%, in 2004. Net job losses of 8,000 occur in 2003 and of 2,500 in 2004. Unemployment rises, to 6.6% in 2003 and 6.9% in 2004 on the ILO measure and 4% and 4.3% on the claimant count.

In sum, the worst-case scenario effectively pushes the Scottish economy into recession. There are significant uncertainties in the days ahead, but our best judgement is that the benign scenario is the most likely.

Brian Ashcroft
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