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Notes to contributors

The editors welcome contributions to the Economic Perspectives section. Material submitted should be of interest to a predominately Scottish readership and written in a style intelligible to a non-specialist audience. Contributions should be submitted to the editors.

Articles accepted for publication should be supplied electronically and conform to the Guidelines available from Linda Kerr, Fraser of Allander Institute.

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Overview

The Scottish economy was stronger in the second quarter of the year than expected. Revisions to the GDP data indicate that growth has been weaker in Scotland during recent years than previously believed. This poses a challenge for policy. The economy remains considerably weaker than its UK counterpart but there are signs that we may be over the worst of the cutbacks in electronics. Manufacturing remains in recession, while services continue to exhibit positive but below trend growth. The impact of the September 11th attacks and their aftermath are difficult if not impossible to quantify. A high degree of political and economic uncertainty persists. However, the best judgment on the impact of these events is that the downturn will be more prolonged with the recovery occurring later than previously expected. Prospects depend much on developments in the US and wider world economy. However, the relative buoyancy of the UK economy suggests that Scotland will to some degree be insulated from these wider developments. The insulation will be partial, though, due to the greater openness of the Scottish economy to trade and investment flows.

We therefore expect that the transmission mechanism for the effects of September 11th on the Scottish economy will be principally through reduced tourism demand, lower exports outside the UK, and a reduction in inward investment. We hold to our September GDP forecast for 2001 but have lowered our forecast for 2002 from 1.4% to 1.2%. The impact on the labour market will not be great but there will be some net job losses this year and unemployment will begin to rise before falling in 2003.
GDP and output

The latest output data – published in November – from the Scottish Executive indicate that Gross Domestic Product (GDP) rose by 0.8% in the second quarter of this year. GDP in the UK, in contrast, is estimated to have risen by only 0.4% in 2001 Q2 – see Figure 1. Comparisons of aggregate GDP can be misleading due to the assignment of oil and gas production in the North Sea to the Continental Shelf region, so that a more appropriate comparison of like with like is with oil and gas removed from the GDP figures. On this basis, GDP (ex oil and gas) rose by 0.7% in Scotland in 2001 Q2 while rising by 0.3% in the UK. In the September Commentary, we reported that the Scottish Executive GDP data revealed that Scottish GDP (ex oil and gas) grew by 0.5% during the first quarter, a rate of growth that was broadly similar to the 0.6% outturn in the UK. However, it would be a mistake to conclude from these two sets of quarterly figures that the Scottish economy is a strong as its UK counterpart. The year on year data for GDP (ex oil and gas) growth to 2000 Q2 indicate that net output in the Scottish economy grew by only 0.4% compared to growth of 2.6% in the UK.

The provisional Scottish GDP data have been subject to considerable subsequent revisions recently and this does make it difficult to draw firm conclusions about path the economy is taking from the initial estimates. The latest set of data is no exception. Indeed, the changes to the data published in August are extensive and wide ranging. The latest revisions are principally due to new and more accurate information from data suppliers on certain companies and sectors and to improvements in measurement methods. While we find these changes frustrating, particularly at a time when the economy may be approaching a turning point, we accept the need to incorporate the most accurate and up to date information and appreciate that the Executive statisticians publish their data in good faith based on the best information available to them at the time. We also welcome the Executive’s policy of publishing tables highlighting the revisions and the greater transparency surrounding the release of these data.

The net effect of the most recent revisions is that Scottish GDP (ex oil and gas) is now lower than previously believed, with the average quarterly growth rate from 1995 Q1 to 2001 Q1 falling from 0.59% to 0.49%. The revisions also imply that growth in the Scottish economy was much weaker relative to the UK. On an annual basis, the growth of Scottish GDP (ex oil & gas) falls from 2.20% to 1.91% over the period 1995 to 2000, while in the UK, the annual growth rate rises from 2.82% to 2.94%. So, from a relative performance of 78% of UK annual average growth, the latest revisions result in the Scottish/UK growth relative falling to 65%. This is clearly not good news for Scottish economic development policy and it emphasises the challenge facing the Executive and its development agencies in realising the aspirations outlined in the Framework for Economic Development and Smart Successful Scotland.

The most recent revisions also highlight the extent to which Scotland has developed a “two-speed” economy over the last few years. The average quarterly growth rate of manufacturing over the period 1995 Q1 to 2001 Q1 drops from 0.41% to 0.31%, while that for services falls from 0.70% to 0.56%. The proportionate downward revision for manufacturing is therefore somewhat greater at 24% than the downward revision for services of 20%. In the year to the second quarter, Gross Valued Added (GVA) at basic prices in Scottish manufacturing contracted by 4.8%, while the year on year figure for UK manufacturing indicated a rise of 0.6%. In services, Scottish GVA grew by 2.4% over the year compared to growth of 3.5% in its UK counterpart. Manufacturing and services constitute about 86% of overall GDP and so the relative weakness in these two sectors accounts for relative overall weakness of Scottish GDP. In other principal sectors, Scottish performance is generally favourable. Year on year to 2001 Q2, the construction sector in Scotland grew by 2.4%, while the sector in the UK grew by only 0.3%. Agriculture grew by 1.4% in Scotland but contracted by 3.5% in the UK, while Scottish mining and quarrying activities slipped back by 2.8% in Scotland but fell by 4.9% in the UK. The only exception to a stronger Scottish performance outside manufacturing and services was the electricity, gas and water supply sector, which experienced a fall in output of 9.8% compared to an increase of 2.5% in the UK.

During the second quarter, services grew slightly quicker in Scotland (1.4%) than in the UK (0.9%) – see Figure 2. But, as noted above, the sector grew more slowly in Scotland over the year. Within services, the strongest performing sectors year on year to 2001 Q2 continued to be financial services and real estate and business services. The former grew by 9.6% in Scotland but grew by only 3.3% in the UK, while the latter expanded by 8.6% compared to a rise of 4.7% in the UK. Of the five remaining service sectors for which data are published, only hotels and catering outperformed its UK counterpart, growing by 2.9% compared to a fall of 3.6% in the UK. Both retail & wholesale and transport, storage & communication contracted by 1.9% over the year while the same sectors in the UK grew by 4.2% and 6.4%, respectively. The public sector exhibited little growth over the year with growth of 0.8% and 1.2% in Scotland and the UK. Other services, on the other hand was largely stagnant in Scotland, with growth of 0.4%, but grew strongly in the UK by 4.2%.

Scottish manufacturing contracted by 0.4% in the 2001 Q2, the fifth successive quarter during which output in the sector has fallen – see Figure 3. UK manufacturing, in contrast, experienced a reduction in output of 2.1% in the second quarter but this was only the second successive quarter that output had fallen in the sector. As a result, the year on year performance of Scottish manufacturing was much weaker than its UK counterpart. Manufacturing is generally weak in Scotland with only 3 of the 11 sectors for which data are published reporting positive growth over the year. Of these 3, other manufacturing grew by only 0.2%,
while chemicals and drink both grew by 1.4%. Only drink, transport equipment and other manufacturing outperformed their UK counterparts over the year and transport equipment did so by virtue of the fact that its contraction of 3.4% was less than the fall of 7% exhibited by the sector in the UK.

Despite the general weakness across Scottish manufacturing, it is the performance of electronics given its relative scale that principally accounts for the recession within Scottish manufacturing. Year on year to 2001 Q2 the sector contracted by 7.4% in Scotland compared to growth of 10.4% in the UK. Figure 4 presents the quarterly growth rates of Scottish and UK electronics. What is evident from these revised figures is that electronics output in Scotland was weakening considerably long before the announcement of cutbacks in key electronics firms. The weaker performance of UK electronics in the second quarter suggests the possibility that the downturn in the sector may be hitting the UK later than Scotland. Moreover, now that the output loss associated with the announced closures and cutbacks has largely taken place we might expect to see the sector in Scotland begin to pick up again, if not in the 2001 Q3 then in the final quarter of the year. Further comfort is given by the export data for 2001 Q2, where electronics exports at constant prices fell by 0.8% during the quarter but were up by 23.1% over the year, a strengthening of the year on year performance to 2001 Q1. With electronics exports accounting for just under 62% of overall Scottish manufacturing exports, the export performance of manufacturing improved year on year to the second quarter rising by 10.2% compared to an 8.5% increase in the year to 2000 Q1.

**Outlook**

Contrary to expectations, growth in the Scottish economy improved in 2001 Q2. However, the Scottish GDP data have been subject to considerable revision and we cannot be certain that the second quarter figures will not be revised downwards. What is clear from the most recent revisions is

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**Impact on Scotland of the September 11th attacks and aftermath**

The impact on Scotland of the September 11th attacks and their aftermath was considered in the report to the First Minister prepared by Dr. Andrew Goudie, Chief Economic Adviser and published on 4th October 2001. The main conclusions of the Goudie Report were that:

- quantification of the scale of the impact was impossible;
- there would be serious immediate impacts on travel and communications due to a reduced preference for air travel, the reduced availability of flights, and the increased transactions costs of such travel;
- the immediate consequences would affect certain sectors:
- tourism from abroad to Scotland but this may be partially offset by favourable substitution effects;
- aviation and the viability of some Scottish routes;
- electronics where recovery may be postponed until 2003-04, presumably due to the spillover effect from the impact of the US economy and the consequences for business investment and consumer confidence;
- the financial sector should not be directly affected, although fund management may suffer from the volatility of financial markets;
- a reduction in trade and investment flows would affect the Scottish economy
- annual growth will decelerate but should remain positive.

The National Institute for Economic and Social Research (NIESR) has noted further consequences of the increased uncertainty following on from the attacks. NIESR argue that the response of financial markets to uncertainty is to mark down expected future profits and to increase the risk premium on the discount factor they use to calculate the present value of future income streams. This last effect is particularly worrying, as it will inevitably lead to further weaknesses in equity markets as share prices fall. An idea of the size of these effects can be obtained from some simulation results reported in the NIESR’s October Review. Using their world economic model the Institute look at the effects of an increase in the risk premium of the order of magnitude required to generate the falls in equity prices seen between July and October this year. Both the US and the euro area suffer reductions in output growth of nearly 1 percentage point in the first year and of over 1.5 percentage points in the second year.
that the Scottish economy has been growing more slowly than originally believed. Over the year to the 2001 Q2 the economy here was weak absolutely and compared to the UK. Nevertheless, there is a strong possibility that we may have seen the worst of the cutbacks in electronics and that, from the fourth quarter of this year at least, the sector may begin to pick up. But it is likely that it will be some time before we see growth get back to the levels of the late 1990s, if such an outcome occurs at all.

Growth in the world economy continues to be weak (see World Economy section) and prospects of recovery have clearly been set back by the consequences of the September 11th attacks. Most forecasters are predicting that growth in 2002 in the OECD and the major economies will be as weak as, if not worse than, in 2001. Recovery closer to trend growth is now unlikely to occur until 2003. Moreover, there are considerable downside risks that may prevent even the current more pessimistic forecasts from being realised. These include: the possibility of higher oil prices; wealth effects due to the possibility of further falls in equity prices following the political and economic uncertainty created by the September 11th attacks and their aftermath, including the worsening Arab/Israeli crisis; and increased transactions costs due for example to rising insurance premiums, and increased opportunity costs of travel.

The outlook for UK economy also continues to weaken but there appears to be a consensus that the UK is better placed to ride out the effects of the global slowdown that was occurring before September 11th and which has worsened subsequently (see UK Economy section). The monetary policy stance remains favourable with interest rates now at 4% and the prospects for inflation such that further cuts may be feasible in the New Year if the situation warrants. Household consumption, while weakening, is continuing to hold up well. Fiscal policy continues to provide a net stimulus to the economy, although the fiscal position is expected to deteriorate as growth weakens. In contrast, export demand is slackening and fixed investment is being cut back. Current independent forecasts for the UK suggest stronger growth than the OECD average for 2001 and 2002 but with growth following the OECD pattern and significantly marked down next year to 1.9% from 2.6%.

Growth in the Scottish economy will not escape these developments in the wider UK and world economies. However, the relative buoyancy of the UK economy will to a limited extent insulate Scotland from the greater extremes of the downturn that might occur elsewhere in the world economy. Nevertheless, the greater openness of the Scottish economy to world trade and investment flows implies that any insulation provided by the greater buoyancy of the UK economy will only be partial. The likely impact on Scotland of the aftermath of the September 11th attacks is noted in the accompanying box.

What is clear is that there will be some negative effect on output growth and that the timing of recovery is likely to be pushed back possibly into 2003. However, the specific effect on output and growth is difficult if not impossible to quantify.

The significance of September 11th and its aftermath have led us to further revise down our forecasts for the Scottish economy next year while holding to our September forecast for 2001 (see Forecasts of the Scottish Economy section). For Scotland, the main transmission mechanism of the aftermath of the attacks is via reduced tourist demand, lower exports outside the UK, and reduced inward investment. Our forecast for GDP growth in 2001 remains at 0.9%, while we now expect growth in 2002 to be 1.2% compared to 1.4% in our September forecast. We take the view, however, that Scottish performance will still improve next year over 2001. This is because the evidence appears to suggest that the downturn in Scotland occurred earlier than in the UK with the result that there should be some small pick up in electronics during latter part of 2002. The financial and business service sectors provides the other main motor of economic growth in Scotland and we believe that activity in these sectors will be less directly affected by the events of September 11th although they will not escape the indirect effects of a general slow down. Because of this both manufacturing and service sector growth will strengthen next year. However, growth in manufacturing will remain flat or slightly negative compared to the fall of 1.9% this year, while service sector growth although positive will still remain below trend. Trend growth should be re-established in services in 2003 but this may not be the case in manufacturing.

In the labour market, we expect net employment to fall by about 5,000 this year followed by a small rise of 3,500 in 2002. Jobs growth, particularly part-time jobs will continue in services but further net job losses can be expected in manufacturing. ILO unemployment is expected to increase this year to 6.7% rising further to 6.8% in 2002. A rise in the claimant count year on year should not be evident until 2002 when we expect a rate of 4.3%. Unemployment should begin to fall again in 2003.

We still hold to the view that annual GDP growth rates will remain positive and so in that sense we expect that Scotland will avoid a recession. Below trend growth will continue for longer than previously expected. However, the continuing high level of political and economic uncertainty suggests that our forecasts should be viewed cautiously in that light.

Brian Ashcroft
6 December 2001
Figure 1: Scottish and UK GDP (exc. oil and gas), quarterly growth at constant basic prices, 1995q2 to 2001q2

Figure 2: Scottish and UK service sector GVA growth at constant basic prices, 1995q2 to 2001q2
Figure 3: Scottish and UK manufacturing sector GVA growth at constant basic prices, 1995q2 to 2001q2

Figure 4: Scottish and UK electronics sector GVA growth at constant basic prices, 1995q2 to 2001q2