Forecasts of the Scottish economy

Summary

The Scottish economy has contracted in the first two quarters of 2012, marking three consecutive quarters of negative growth. While quarter three for the UK has seen an uplift of 1 per cent, this is not likely to be replicated in Scotland. It is therefore possible that the Scottish economy could contract in 2012 overall, and we now forecast a contraction of -0.1% over 2012 (down from 0.4% growth forecast in June 2012). Worsening forward-looking indicators on business confidence and export orders, in particular with trouble returning to major (core and periphery) economies of the Eurozone, continue to suggest that the return to pre-recession levels of economic activity is likely to be slow. Weak domestic demand from consumers and on-going fiscal consolidation are not sufficient to offset uncertainty around what was anticipated to be a recovery led by exports and investment. The silver lining appears to be that indexes suggest that a return to overall recession (a "triple-dip") appears to be unlikely. In our central forecast we have revised down growth in 2013 and 2014 to 1.3% and 2.2% respectively.

Fiscal policy

The Chancellor will make the Autumn Statement on the 5th of December. Before this, the OBR will produce its forecasts for the UK economy over the coming years. In Scotland, the Finance Secretary laid his draft budget plans for 2013-14 during September, committing £28.6 billion across current and capital spending projects. While spending continues to fall in real terms as the (coalition) UK government imposes its policy of fiscal austerity, the spending fall in 2012-13 is smaller (-1.7%) than the real terms reduction in 2011-12 (-5.3%) which was particularly focused on reductions in capital spending. As the Scottish budget document makes clear, with announcements that austerity could continue into 2016-17, it is possible that the annual spending available to the Scottish Government could be £5.3 billion less (in 2016-17) than it was in 2010-11 (in 2012/3 prices). By switching spending from current to capital spending the Scottish Government has set out its aim to offset some of the reductions in funds available for infrastructure and repair projects, while using other financing measures available to it. With public budgets squeezed at all government levels, the UK Government's Plan A continues to offer scant help to struggling economies across the UK.

The programme of welfare changes to start in April 2013, directly affecting the incomes of many households, will be examined in the next *Commentary*. Analysis by the IFS from March 2012 indicated that over £9 billion of spending reductions will hit in 2013-4, with the two largest negative impacts coming through reductions to Child Benefit eligibility and linking benefit and public pension increases to the Consumer Price Index (CPI).

Monetary policy

Inflation continues to fall as was expected in summer 2012, although recent energy price increases mean that the anticipated decline through to the end of 2012 might be slower than expected. Falling inflation had been anticipated to offset some of the slow nominal wage growth and help to support household spending in real terms. Higher oil prices continue to be the main culprit for these price increases, with a barrel of oil trading during September on spot markets around $95 dollars per barrel, up by around $10 since mid-2012 but down by the same amount from the higher prices during winter 2011-2012.

The Bank of England's Monetary Policy Committee met in the first week of October and, while holding the interest rate at 0.5% it unanimously agreed not to extend the asset purchase programme it has continued, and which has reached £375 billion. The minutes note that while "there were, as ever, limits to what monetary policy could be expected to achieve…there was agreement that there was little to be gained at this meeting in changing the current programme of asset purchases". It would not be inconceivable that were there to be continued weak data on UK economic activity that the bank could increase this programme.

Output

Scotland saw a third consecutive quarter of negative growth in the second quarter of 2012. The decline of 0.4% mirrored the latest estimate for growth across the UK in the same period. As noted elsewhere in the *Commentary*, the level of Scottish GDP is 4.4% below its pre-recession peak from the second quarter of 2008. Scotland has recovered slower than the UK as a whole, which is 3.8% below its pre-recession peak (which was one quarter earlier). Negative growth in both Scotland and the UK over the last three quarters has likely delayed the point at which the output lost during the Great Recession will be recovered.

At the sectoral level, the pattern of output decline in 2012Q2 was quite different from the two earlier quarters of negative growth (2011Q4 and 2012Q1). In earlier periods, construction declines led the

economic deterioration as business and private investment contracted (the path of investment is discussed in more detail later in this section). The other main categories of output in Scotland – production and services – did not decline in these quarters, but saw slow or flat output growth. Contradicting this recent pattern, the most recent quarter saw a rise in output in construction (2.0%) while output in production sectors (roughly 17 per cent of the Scottish economy) fell by 3.8%. Service sector output grew slowly (0.2%) in the same period.

Within production, there was a sharp reduction in electricity and gas output (-15.1%) while manufacturing contracted by 2.2%. The manufacturing change is more important for the aggregate figures, given its relative share of the Scottish economy (12.4%). Across all the categories of manufacturing which are reported, output contracted – with the exception of the food and tobacco sector, which saw growth of 1.7%. Worryingly, there was a second quarter of negative growth in the "Engineering and allied industries" and a third consecutive quarter of decline in output in the "drinks" sector (the drink sector currently displays growth over the year, but will only preserve this with strong performance to the end of 2012).

While we do not have figures for Scotland during the third quarter of 2012, preliminary figures for the UK as a whole showed that the UK economy grew by 1.0 per cent. This exceptional single-quarter growth rate, however, comes with health warnings attached, due to two "special factors". The first is the one-off value of sales of Olympics tickets purchased in earlier periods, and is estimated by the Office of National Statistics to contribute 0.2 per cent to Q3's figures. Secondly, the extra bank holiday for the Queen's Diamond Jubilee in June is likely to have resulted in some "time-switching" of GDP into quarter three's figures that would otherwise have been in quarter two.

We do not anticipate the Scottish GVA figures for Q3 to be affected by the Olympics in the same way as the UK figures as a whole, principally due to the relatively low total value of tickets sold for activities occurring in Scotland. The additional work day however in Q3 would similarly be expected to positively boost Scottish activity in the third quarter.

The OBR will update its forecasts for UK growth in 2012 before the Autumn Statement on the 5th of December 2012. The earlier forecast of 0.8% growth is likely to be revised downwards, perhaps significantly. Forecasts for the UK as a whole have been markedly reduced since the OBR last forecast in March 2012. For example, the IMF cut their 2012 and 2013 growth forecasts by 0.6% and 0.3% respectively, and now predicts growth of -0.4% and 1.1% in each year. Similar revisions were made by the OECD. The Treasury report that the median of UK forecasts made prior to March 2012 was 2.0%. In October 2012, the median of new forecasts for 2012 was -0.3%, with a range from -0.6% to 0.3%.

Households

Figures for wage growth across the UK as a whole – a comparable figure for Scotland is not available - show that (private sector) average weekly earnings growth continues to be muted at around 2%. With inflation falling but remaining above this rate, earnings continue their real terms decline. As households repair their balance sheets by cutting expenditures and paying down (or not increasing) credit, falling real wages are likely to prolong the point at which households feel their finances to be "sustainable".

While the UK stock market has generally continued to record rises in the prices of equities since we last reported, other measures of household financial wealth, in particular housing assets, show a more sombre picture. Data suggest that individuals across the UK have little confidence in house prices increasing in the short or medium term. Survey evidence confirms little expectation of the current value of homes increasing, and since March 2012 it appears that households have generally become less optimistic about the change in value of their homes over the next year.

On a positive note, respondents to this survey in Scotland were among the most optimistic across the regions of the UK with regard to recent changes in their house prices, but across all regions there was consensus that recent house prices were falling.

Some recent data produced for UK households– also not available for Scottish households'– show the relationship of households' financial liabilities to household disposable income. This shows that from 1988 to 2001, this ratio was broadly constant between 1.0 and 1.2. Over the mid-2000s this increased rapidly to a peak of 1.75 in the first quarter of 2008. Since then, steadily declining household liabilities and (slowly) rising household income has brought this ratio down to a value of 1.5. This remains above previous long-term values. Two principle factors might contribute to this decline since 2008, which coincides with the peak of house prices in both Scotland and the UK. Principally, the household savings ratio (defined as gross savings divided by gross disposable income) has increased sharply as households have restrained their consumption spending and paid down debts (reducing the value of liabilities).

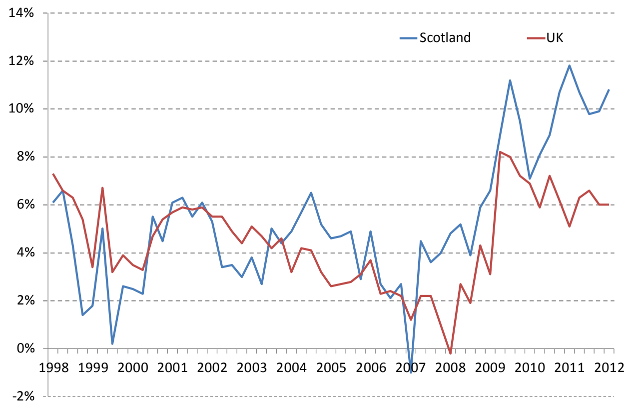
Figure 1 shows how the savings ratio has evolved in both Scotland and the UK. These data imply that Scottish households have made more significant adjustments to their savings pattern than UK households.

What is interesting is that the savings rate has been increasing in Scotland while for the UK as a whole this has been falling in recent quarters.

Comparable Scottish and UK data on household income and consumption growth are available up to March 2012 (the end of the first quarter of this year). These show that spending increased through the first quarter, making two periods of positive growth in aggregate household expenditure for the first time since the first half of 2010 (See **Figure 2**).

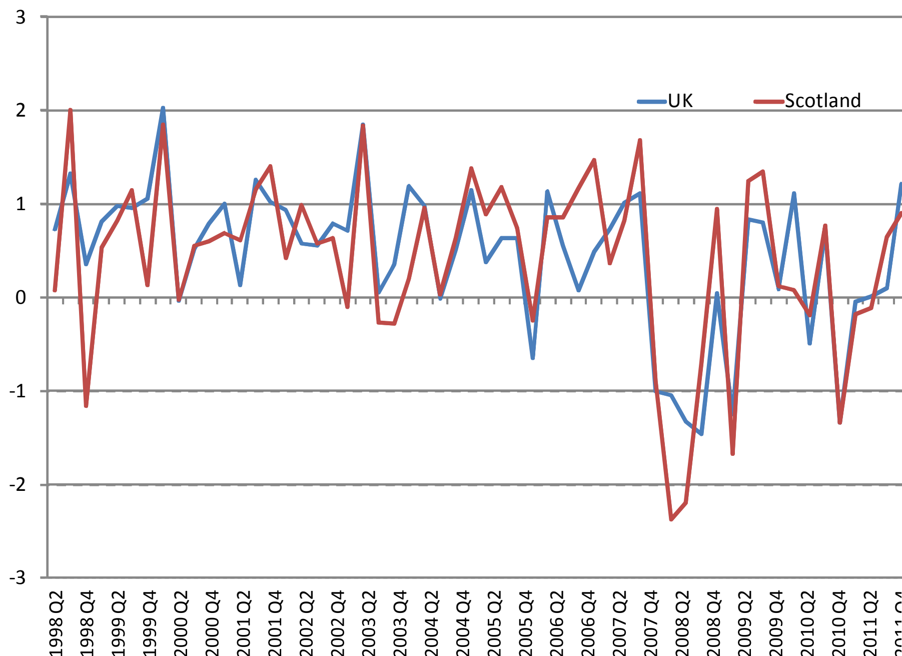
The Scottish Retail Sales monitor reported that sales in September 2012 were flat in real terms and that overall sales growth in Scotland has been slower than the UK as a whole for 18 months in a row, demonstrating a considerable weakness in Scottish household spending. It remains in the "big ticket" durable goods market that households are postponing purchases, which demonstrates unwillingness to use store credit for such items: a key indicator of a persisting lack of consumer confidence about future income prospects.

Figure 1:
Household savings ratio, UK and Scotland, 1998Q1 to 2012Q1



Sources: (Experimental) Scottish National Accounts Project data (Scottish Government) and UK Quarterly National Accounts (National Statistics).

Figure 2:
Quarterly growth in real household consumption, Scotland and UK, 1998Q1 to 2012Q1



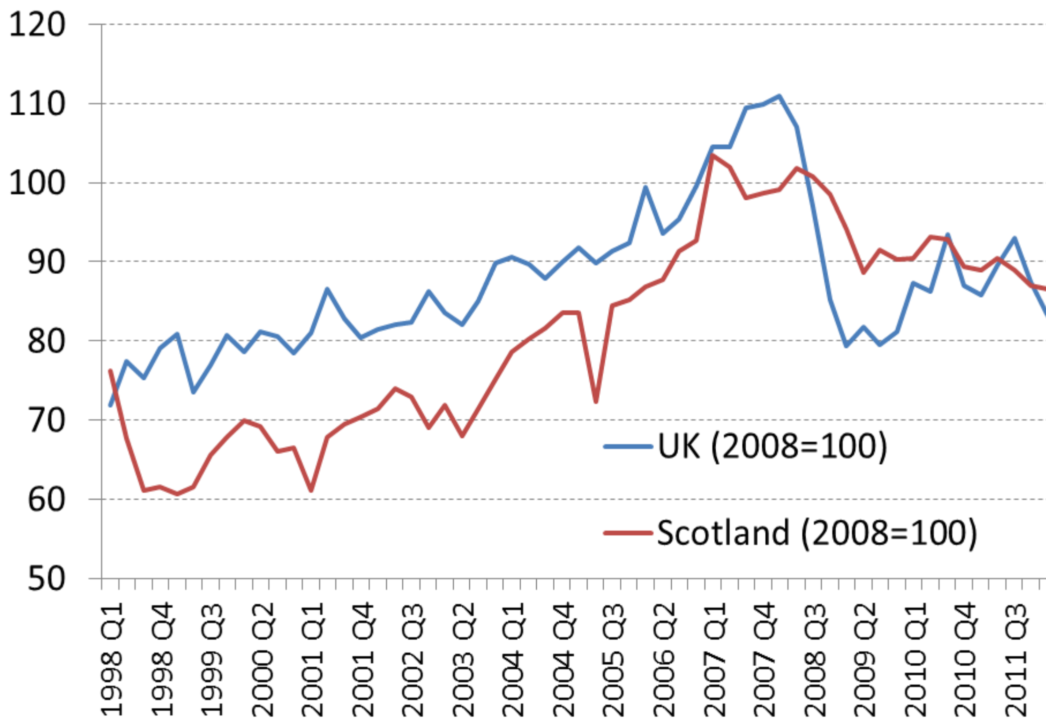
Sources: (Experimental) Scottish National Accounts Project data (Scottish Government) and UK Quarterly National Accounts (National Statistics).

The most recent data on Scottish consumption – the Retail Sales Index from October 2012 – suggests that household spending growth picked up in the third quarter, and at a faster rate than in Great Britain as a whole, although slower than GB over the last year.

Investment

While the most recent quarter showed an increase in the output of the construction sector, activity in construction had been significantly damaged by the concurrent downturns in private as well as public capital spending through 2011-12. As the Fiscal policy section above notes, the largest decline in public spending on capital appears to have past, although it is likely to take some time before projects are contributing to activity in the sector. Domestic house building remains flat, while, as is noted in the *Business Surveys* section of this Commentary, the market appears to be firmly in “contraction territory” through the third quarter of 2012, and there was limited expectation of significant improvements in the market over the next twelve months. Figure 3 shows that real investment spending (including public and private spending) remains significantly below its pre-recession values.

Figure 3: Real gross fixed capital formation, Scotland and UK, Q1:1998 to Q1:2012



Sources: (Experimental) Scottish National Accounts Project data (Scottish Government) and UK Quarterly National Accounts (National Statistics).

Trade

The latest data on non UK exports from Scotland – available from the Index of Manufactured Exports, published in October 2012 – show that during the second quarter of 2012 Scottish exports fell by 4.0 per cent, and rose 1.7 per cent over the year. This was the sharpest contraction in (this portion of) Scottish exports since the final quarter of 2008, and marks the third consecutive quarterly decline in Scottish manufacturing exports. With the exception of the (small) “wood, pulp, etc.” exports, all categories of manufacturing exports saw a decline in the second quarter. This includes sectors which had previously performed reasonably well since 2009, including “Food, drink and tobacco” (down 5.4% in Q2 2012), and “other manufacturing” (down 3.0%).

As these most recent data suggest, the international market for goods is showing major distress signs as we end 2012. The International Monetary Fund, OECD and European Commission have all significantly cut their growth forecasts for the Euro area and its constituent member since forecasts earlier this year as business and consumer confidence has ebbed away and forward indicators of economic activity have moved downwards. October’s Purchasing Managers Index survey for the Eurozone continued the recent trend of major trauma in the European markets; falling for a third consecutive month, registering a new 40 month low, and with manufacturing and services sectors (combined) falling at their fastest rate since June 2009. While Germany appears to only be suffering “mild” (output) downturn by this measure, France appears to be recording its steepest decline since the start of the Great Recession. Markit (who collate and report on the PMI index) note that indicators at the start of the fourth quarter are consistent with a contraction of over 0.5% across the Eurozone. It is especially in the “periphery” countries of the Euro area where it appears likely that recession has returned, including Spain and Italy. These are both far larger markets than Greece placing the Euro area under its greatest test since the start of the Great Recession in 2008.

Aside from being the world's largest economy, the US is also the largest (first) destination for non-UK exports from Scotland. The most recent US GDP figures showed an (annualised) rate of growth of 2.0% in the third quarter of 2012, up from 1.3% growth in Q2. Consumer and government spending helped this quarterly increase, while investment spending and exports fell. Labour market indicators in the US have continued a slow positive trend since the turn of the year, with employment increasing and the unemployment rate declining below 8% for the first time since 2009. In addition, as noted by the Bank of England, there were positive signs across production indices into autumn in the US, while the US housing market appeared to be recovering some of the (massive) contraction since 2008. Consumer confidence indices for the US appear to have rebounded positively since the end of 2011, however slow income growth could dent increased consumer spending through 2013.

One of the first jobs for the US president after November's election is to address the fiscal changes coming into US law on the first of January 2013. After this point a series of tax increases and spending cuts will reduce the US government deficit by over $600 billion in a single year. At around 4.1% of US GDP, this will withdraw a huge amount of spending from the economy and impact on US growth in 2013.

Without any agreed changes to US fiscal policy the US Congressional Budget Office estimate that the impact on US growth, particularly in 2013, will be profound. At one extreme, if policymakers decided to reverse all of the tax increases and spending cuts the CBO predict the US could grow by 4.4%. At the other extreme, if the "fiscal cliff" is reached with no agreement, growth during 2013 is forecast at 0.5%, with a recession in the first half of 2013.

Table 1: Economic growth forecasts for 2012 and 2013 for major Scottish export markets, plus UK, China, Euro area and world, including changes from earlier forecasts where available, %

	2012		2013	
	IMF (October 2012)	Change from July 2012	IMF (October 2012)	Change from July 2012
USA	2.2	+0.1	2.1	-0.1
Netherlands	-0.5	n/a	0.4	n/a
France	0.1	-0.2	0.4	-0.5
Belgium	0.0	n/a	0.3	n/a
Germany	0.9	0.0	0.9	-0.5
Ireland	0.4	n/a	1.4	n/a
UK	-0.4	-0.6	1.1	-0.3
China	7.8	-0.2	8.2	-0.2
Euro area	-0.4	-0.1	0.2	-0.5

Source: World Economic Outlook, International Monetary Fund (October 2012). The OECD publishes its Economic Outlook on the 27th of November 2012.

Forecasts for the Scottish economy: Detail

On the domestic side of the economy, with continued fiscal contraction at the UK level, we must focus on the outlook for household and investment expansion. Household spending growth continues but remains weak, as employment falls slightly and earnings growth remains slower than the rate of increase in prices. In our central forecast, households continue to unwind their debt levels from the unprecedented highs at the start of the Great Recession, leading to continued slow spending growth, and decreased activity across the high streets of Scotland. Recent surveys point to continued depressed levels of household spending growth.

Business confidence remains dented through to the end of 2012, with weak signs of increasing private investment in the final half of the year. Construction indexes point to continued weak demand and low rates of orders growth, both from the public and private sector intentions. Commercial construction activity remains weak through 2012 and into 2013 on our central forecast, albeit with an increase towards the end of 2013 as capacity is expanded in advance of a return to (close to) trend growth in household spending in 2014.

The external market for Scottish goods and services has considerably worsened since June 2012 when we last reported. Major indexes indicate that the Euro area may have entered recession in the second half of 2012, driven by declines in production and construction sectors across major periphery economies of Spain and Italy. Rapidly worsening growth and labour market data indicates that the optimism of summer 2012 has passed and that growth through 2013 and 2014 will be weaker than was anticipated earlier in the year. We anticipate however a return to growth in the Euro area in 2013 and 2014, however the reduced

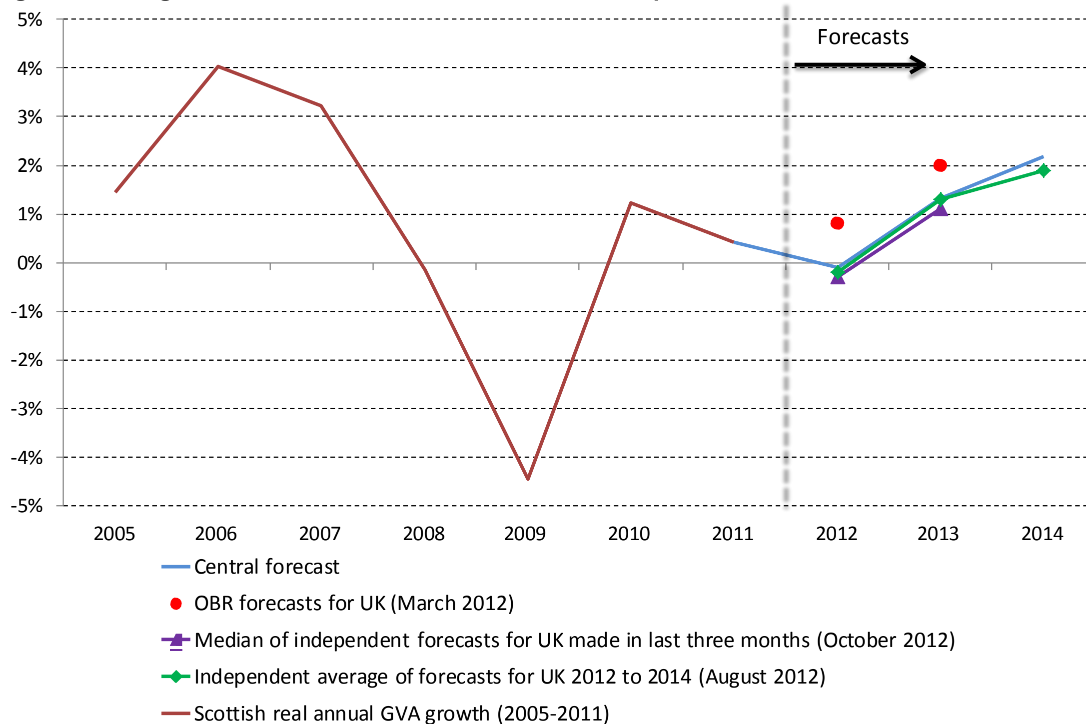
growth rate, particularly due to household spending contraction amid on-going uncertainty about incomes, is likely to continue to have a depressing effect on Scottish exports.

Results

In this issue of the *Commentary*, we are forecasting the year-on-year real growth in key economic and labour market variables, including aggregate Gross Value Added (GVA) and employment and unemployment, over the period 2012 to 2014. The forecasting model used is multi-sectoral, and where useful, results are reported for sub-aggregate sectors.

We begin with the (central) forecasts for growth in the Scottish economy. Our new forecasts for 2012, 2013 and 2014 are shown in **Figure 4**. This also shows for comparison purposes only, a number of different sources forecasts for the UK over the same period. These sources are the Office for Budgetary Responsibility (OBR) which last forecast in March 2012, and will release new forecasts later in November 2012, as well as the median of recent forecasts produced by professional forecasts for each year of the forecast window.

Figure 4: GVA growth for Scotland, 2012 to 2014, and comparisons to UK forecasts, annual real %



Sources: Fraser of Allander Institute forecasts, Office for Budgetary Responsibility and HM Treasury (various months).

We have revised down our forecasts for 2012 to -0.1% (from 0.4%). We noted in June 2012 that survey evidence indicated that there might be a quarter of negative growth in the first half of 2012. The GVA data now available indicates that in both Q1 and Q2 the output of the Scottish economy contracted. The scale of the contraction in activity through the first half of 2012, combined with weaker survey evidence for business intentions through to the end of 2012 and into 2013 (described elsewhere in this Commentary) means that – on the balance of probabilities – we think it is now likely that output will contract over 2012 on an annual basis. This will be confirmed with the release of Q4 2012 data in April 2013.

With worsening evidence of business and consumer leading indicators through 2013, we have also revised down our forecasts for Scottish output growth in that year. We have revised this to 1.3% (from 1.5% forecast in June 2012). As we have mentioned consistently the upturn in Scottish economic performance will be significantly affected by growth returning to export markets for Scottish goods. Outside of the UK, this means the US and the Eurozone countries, principally (see our discussion in June 2012's commentary). It is worrying for the short-and medium-term outlook for Scottish exports that there have been recent downturns to output and employment indicators, as well as forward-looking surveys of business and consumer confidence, in core, as well as peripheral Eurozone countries.

In addition to the aggregate growth forecasts, Table 2 also presents our forecasts for GVA growth by broad industrial grouping, i.e. for the "production", "services" and "construction" sectors.

Table 2: Growth (%) by sector in the Scottish economy, 2012 to 2014

	2012	2013	2014
Gross Value Added	-0.1	1.3	2.2
Production	-0.2	3.3	5.1
Services	-0.1	0.9	1.5
Construction	-0.1	0.9	1.4

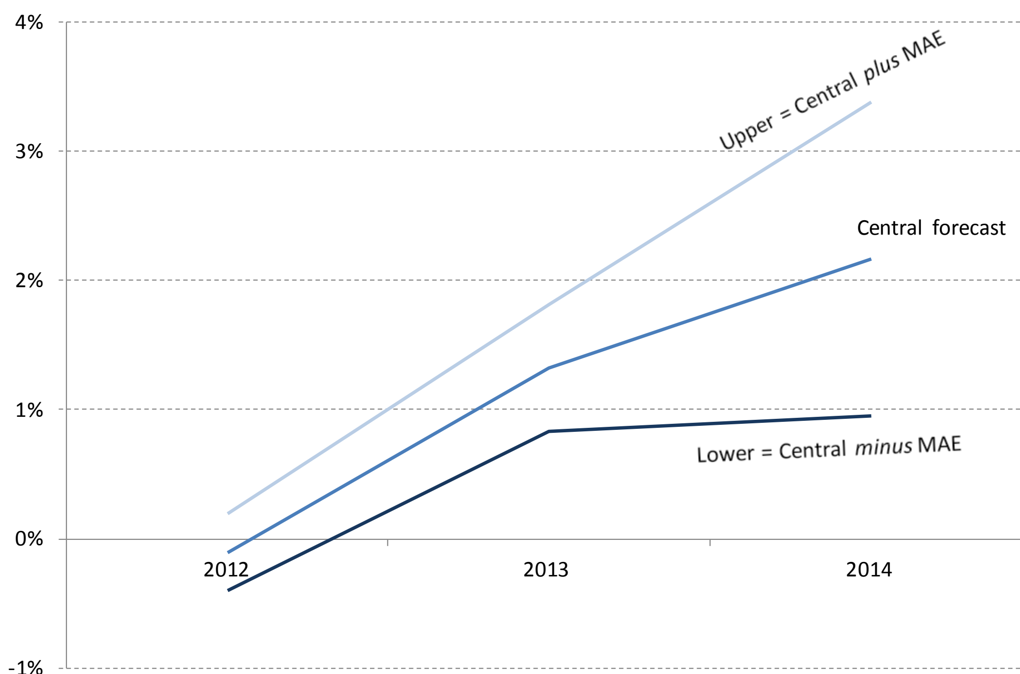
Source: Fraser of Allander Institute forecasts

As recent GVA data for Scotland suggests, the impacts of the on-going recession are being felt across the Scottish economy, i.e. in many manufacturing sectors, as well as more cyclical downturns in construction and household spending on durable goods. This is occurring concurrently with continued consolidation of UK public finances and real terms spending reductions through to the end of our forecast horizon. As we noted in June's commentary, the construction sector is likely to respond quickly to upturns in private investment, where this occurs, but recent survey evidence indicates a continued weak outlook for Scottish corporate sector making significant new investments – above those already announced.

We use our calculated past forecast errors (e.g. the difference between aggregate growth forecasts and what outturn figures were) to show the potential range of outcomes around our central forecast.

We use the estimated errors for "Winter" forecasts published over the last ten years (Allan, 2011). The mean absolute error for forecasts previously made within the last third of the year for growth in that year is 0.296 percentage points, while for growth the following year we have had mean absolute errors of 0.492. These give the ranges around the central estimates of Scottish GVA growth shown in Table 2 above. Again, we use the mean absolute error for the longest forecast period from Allan (2011) for 2014, of 1.216, as we do not yet have a long history of forecasts of growth over a three year horizon. The estimated range around our central forecasts of GVA growth in each year is shown in **Figure 5**.

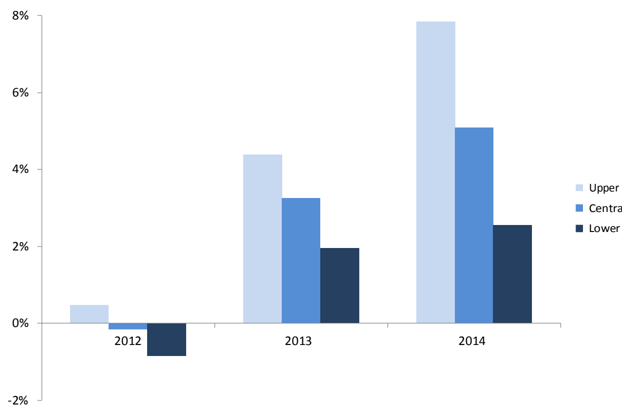
Figure 5: GVA growth for Scotland, 2012 to 2014, possible range of outturn growth



Source: Fraser of Allander Institute forecasts

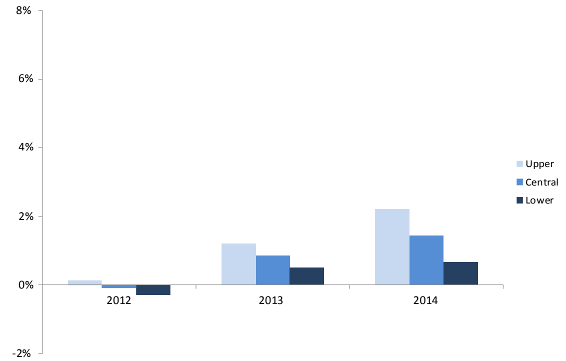
Figure 6, **Figure 7** and **Figure 8** show the forecasts of GVA growth in each of the aggregated sectors ("production", "services" and "construction") in each year under the central and the lower and upper forecasts.

Figure 6:
GVA growth forecasts for "Production" sector in central, upper and lower cases, 2012 to 2014



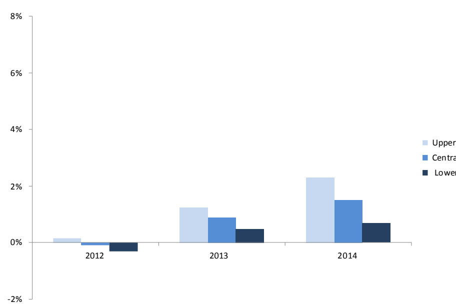
Source: Fraser of Allander Institute forecasts

Figure 7:
GVA growth forecasts for "Construction" sector in central, upper and lower cases, 2012 to 2014



Source: Fraser of Allander Institute forecasts

Figure 8:
GVA growth forecasts for "Services" sector in central, upper and lower cases, 2012 to 2014



Source: Fraser of Allander Institute forecasts

Employment

The most recent data for employment indicate that the Scottish labour market has weakened since improving during the first half of 2012. Employment of people of working age fell by 6000 in the most recent three month period, while the unemployment rate rose above 8 per cent and there was a 7000 increase in the numbers in the labour market but out of work. Detailed commentary on recent developments in the Scottish labour market is available in the *Labour Market* section.

The most recent data on the number of (employee) jobs in the Scottish economy are available to the end of June 2012. These currently suggest that the number of jobs in Scotland has increased during the first half of 2012 by over 50,000, increasing in both Q1 and Q2. We forecast – and this is supported by more recent data on changes in employment – that there will be a decline in the number of jobs through the second half of 2012. Our 2012 forecast is for the number of jobs at the end of 2012 to be down by 25,750 from the end of 2011.

Our forecasts for employee jobs in 2012, 2013 and 2014, including a breakdown by broad sectoral groups, are shown in Table 3. The number of employee jobs in 2012 is forecast to fall in 2012, largely due to a fall in jobs in the "services" sector, but with reductions in jobs seen across all broad categories. Through 2013 and 2014 we expect the number of jobs to increase each year (by 0.8% and 1.3% respectively), with most of the job gains seen in the "Production" sector as the domestic-facing services sector continues to struggle to create employment opportunities in the face of slow or zero household spending growth.

The employee jobs forecasts consistent with our upper and lower forecasts for GVA growth are given in Table 4.

Table 3: Forecasts of Scottish employee jobs (000s, except where stated) and net change in employee jobs in central forecast, 2012 to 2014

	2012	2013	2014
Total employee jobs (000s), Dec	2,232	2,249	2,279
Net annual change (jobs)	-25,750	16,950	29,450
% change from previous year	-1.1%	0.8%	1.3%
Agriculture (jobs, 000s)	32	32	34
Annual change	-100	650	1,500
Production (jobs, 000s)	237	248	262
Annual change	-400	10,200	14,050
Services (jobs, 000s)	1,841	1,845	1,855
Annual change	-22,750	3,800	10,550
Construction (jobs, 000s)	122	125	128
Annual change	-2,550	2,300	3,300

Note: Absolute numbers are rounded to the nearest 50. Source: Fraser of Allander Institute forecasts

Table 4: Net annual change in employee jobs in central, upper and lower forecast, 2012 to 2014

	2012	2013	2014
Upper	-19,350	27,100	53,350
Central	-25,750	16,950	29,450
Lower	-32,050	5,500	5,850

Note: Absolute numbers are rounded to the nearest 50. Source: Fraser of Allander Institute forecasts

Unemployment

We present our forecasts for unemployment in Scotland for 2012, 2013 and 2014 in our central scenario in Table 5. As with previous forecasts we report the ILO unemployment measure and the number forecast to receive unemployment benefits ("claimant count"). The ILO measure is preferred as it gives a more complete indication of the extent of labour resources available for work but unable to find work, and so is a better measure of the level of spare capacity in the labour market.

As is discussed elsewhere in the *Commentary* in the most recent quarter the level of unemployment has risen on the ILO measure, while the claimant count measure continues to record declines in the numbers receiving unemployment benefits.

Table 5: Forecasts of Scottish unemployment in central forecast, 2012 to 2014

	2012	2013	2014
ILO unemployment	225,354	234,603	228,740
Rate[1]	8.5%	8.8%	8.7%
Claimant count	139,720	147,800	148,681
Rate[2]	5.1%	5.3%	5.3%

Notes: Absolute numbers are rounded to the nearest 50. [1] = rate calculated as total ILO unemployment divided by total of economically active population aged 16 and over. [2] = rate calculated as claimant count divided by sum of claimant count and total workforce jobs. The most recent labour market figures are detailed in the Labour market section of the Fraser Economic Commentary.

Our forecasted levels and rates of unemployment in Scotland at the end of 2012, 2013 and 2014 are given in Table 5. We have again revised these down – both in levels and rates – as the Scottish labour market continues to display unusual (low) productivity changes – e.g. more robust employment measures while output has been declining over recent quarters.

We show the history of both ILO and Claimant count unemployment rates, and our forecasts for these variables, between 1992 and 2014 in **Figure 9**.

Figure 9: Scottish ILO and claimant count unemployment rate, history and forecast: 1992 to 2014

Source: Fraser of Allander Institute forecasts

Grant Allan
1st November 2012