Outlook and Appraisal

Overview

Clearer signs of a recovery are now emerging within the Scottish economy. This is to be welcomed. But despite the recent good survey evidence the recovery is far weaker than would be expected 5 years after a recession, even a recession generated by a banking crisis. The reason for this stagnation and anaemic recovery is twofold: the UK government's fiscal consolidation programme and a weak export performance reflecting both supply-side structural problems in the UK and Scottish economies as well as weak global demand.

The latest Scottish GDP data for the fourth quarter of last year show that Scottish GDP rose by 0.5% in Scotland in the quarter, while falling by -0.3% in the UK. But once declining oil and gas production is removed - offshore activities are not included in Scottish GDP data but they are in the UK data - we find that Scottish and UK growth is largely identical. Moreover, in 2012 GDP ex oil and gas grew at 0.5% in the UK compared to 0.3% in Scotland. By the fourth quarter last year GDP was -1.9% below its pre-recession peak in the UK compared to -2.4% for Scotland. So, we can conclude that the recovery continues to be weak in the UK and little weaker still overall in Scotland.

The Scottish production sector was buoyant in the fourth quarter both absolutely and compared to the UK. Unfortunately, one-off technical production considerations in energy supply in Scotland and in mining and quarrying - North Sea oil and gas production - in the UK are probably providing a false picture of performance in the sector. This is made clear when we consider the performance of manufacturing. Manufacturing GVA contracted by -0.5% in the fourth quarter in Scotland and by far worse, -1.4%, in the UK. Scottish manufacturing GVA now stands at -5.5% below the 2008-09 pre-recession peak, while the figure for UK manufacturing is -9.5%. However, it is some small comfort that Scottish manufacturing is doing better than UK manufacturing. The downturn in the fourth quarter in Scottish manufacturing as well as in UK manufacturing takes some of the shine off the good overall Scottish GDP performance in the fourth quarter. This is reflected in the export performance of Scottish manufacturing where exports abroad (ex rUK) fell by 1.4% in the fourth quarter of last year so manufactured exports
now stand 13.1% below their pre-recession peak. The manufactured export position continues to be worse than the situation after the collapse of electronics production led to an exporting nadir in 2002.

Nevertheless, a more detailed look at the performance of the Scottish service sector reveals evidence of recovery in certain key sectors. Scottish services GVA grew by 0.3% here in the fourth quarter compared to zero - very slightly negative - growth in the UK. By the fourth quarter of this year, Scottish services GVA was still -1.6% below its pre-recession peak compared to a UK position where the sector now stands 0.5% above its pre-recession peak output. Yet, despite that there are some bright spots within Scottish services as well as some causes for concern.

The bright spots are the evidence that business service activities are now recovering strongly. After contracting by more than 6% during the recession, GVA in the sector languished until the second quarter 2011. From then on business services began to recover strongly, attaining its pre-recession peak between the first and second quarter of last year. By the end of the fourth quarter 2012 GVA stood 5.1% above its pre-recession peak. It is also evident that while real estate activities, accounting for just under 40% of business services, have recovered to stand at around 2.5% above pre-recession peak output, the remaining 60% element of business services - professional, scientific, administrative & support services, has been growing the fastest with GVA reaching nearly 6% above its pre-recession peak by the end of last year.

The cause for concern is the performance of financial services. When we disaggregate the data we find that that a structural decline appears to have been taking place in financial services in Scotland. GVA has now fallen more than 17% below its pre-recession peak, a loss of around one sixth of total output in the sector. There seems a strong likelihood that some of this lost output may never return.

In the labour market conditions continue to improve at a faster rate than GDP, suggesting deterioration in productivity. In the quarter January to March there was a surge in employment in Scotland. Jobs rose by 54,000 in the first quarter of this year compared to a fall of 43,000 in the UK as a whole. In addition unemployment fell by just under 7,000 to below the 200,000 mark to 199,000, or a rate of 7.3%. Scottish jobs are now -1.3% below their pre-recession peak, whereas in the previous quarter they were more than 3% below the pre-recession peak. This is still worse than the UK, where, despite the loss of jobs in the recent quarter the total is 0.6% above the pre-recession peak. But we shouldn't get carried away by the recent improvements in the Scottish jobs market and unemployment. Unemployment is falling but at 7.3%
it is still high compared to the 3.9% before the recession and it could begin to rise again. Moreover, when employment is compared to the 16 plus population we find that before the surge in jobs in the first quarter of this year this ratio stood at -6.2% below its pre-recession peak, identical to the position at the trough of the recession. After the surge it rose to -4.3% below. This suggests that the size of labour reserves in Scotland, and the extent of human misery at not having a suitable job, remains large.

Aggregate data show that with weak export and investment data, there is little evidence of a rebalancing of the Scottish economy away from domestic private and public consumption spending to external private and domestic investment spending. Such a rebalancing is seen by many as a pre-requisite for a strong recovery.

Against this background we have maintained our GDP forecast for 2013 at 0.9%, the same as our March forecast. For the two years 2014 and 2015, we have revised down slightly our forecast for 2014 from 1.7% to 1.6%, and have revised up the forecast for 2015 from 1.9% to 2.1%. The forecasts reflect the continued weakness of domestic demand, in particular government spending and consumer expenditure, and weak anticipated growth in the rest of the UK and Eurozone markets to which Scottish exports are so reliant. Some may be surprised that we have not revised up our forecasts for 2013 and 2014 given the evidence of a recent pick up in the economy. We have not done this since our forecasts already contain gradual improvements to the growth rate. And so a recovery - all be it anaemic - is built in.

We have generally raised our forecasts for job creation compared to our March forecast. This reflects the stronger jobs performance noted in the recent data and reflects the sectoral rebalancing of our growth forecast more in favour of labour intensive services. On the central forecast, we are now forecasting that net jobs will rise by 12,150 in 2013, rising to 28,200 in 2014 and 38,700 in 2015. Our unemployment forecasts have been revised down somewhat from March, reflecting the weakness of productivity, and higher employment given the growth of output. Our projection for unemployment on the ILO measure at the end of 2013 is now 213,250. We continue to expect the unemployment position to deteriorate slightly in 2014 compared to 2013 due to relatively weak output and employment growth. Unemployment is now forecast to be 228,000 by the end of 2014 but then falls back to 189,350 by the end of 2015 as growth in the economy strengthens.
Recent GDP performance

The latest Scottish GDP data for the fourth quarter of last year show that Scottish GDP rose by 0.5% in Scotland in the quarter, while falling by -0.3% in the UK. However, growth in 2012 - calendar year - was at 0.3% identical in both Scotland and the UK, see Figure 1.

Figure 1: Scottish and UK Quarterly GDP Growth, 2007q1 - 2012q4

These data are quite encouraging and suggest that a recovery may finally be emerging, if at a halting pace.

Figure 2: GVA in recession and recovery Scotland and UK to 2012q4

(Relative to pre-recession peak)
The effect of the new data on Scotland's recovery from recession is shown in Figure 2. In the third quarter, GDP in both Scotland and the UK was just under 3% below the pre-recession peak, whereas in the previous quarter Scotland was more adrift from the UK. After the latest data Scottish GDP stands at -2.3% below its pre-recession peak, slightly better than the position of UK GDP, which continues at -2.9% below its pre-recession peak. So, despite some recovery we see a still largely stagnant economy with a long way to go before it gets back to where it was in GDP terms before the recession started in 2008.

There are two key factors that are complicating the assessment of the GDP performance of Scotland and the UK, both absolutely and relatively, during 2012. The first is the differential impact of the London Olympics. The second is the consequences of declining oil and gas production.

To a certain extent the weak performance of the UK economy in quarter four was a reflection of the temporary boost given to GDP by the Olympics in quarter three. If we look at the growth in GDP between quarters two and four in Scotland and the UK, we see that Scottish GDP rose by 0.8% while UK GDP rose by 0.6%. So, when we smooth out the effect of the Olympics the performance of Scotland and the UK is much closer.

But then there is the complicating factor of oil and gas production which - offshore production - is included in the UK GDP data but not in the Scottish data. Removing oil and gas production gives us Figure 3.

Once declining oil and gas production is removed, we find that both Scotland and the UK grew by 0.8% between the second and fourth quarter. Scottish and UK growth is identical. Moreover, in 2012 GDP ex oil and gas grew at 0.5% in the UK compared to 0.3% in Scotland. By the fourth quarter last year GDP was -1.9% below its pre-recession peak compared to -2.4% for Scotland. So, we can conclude that the recovery continues to be weak in the UK and little weaker still overall in Scotland.

Turning now to individual sectors of the economy, we see that the Scottish service sector, which accounts for 72% of GDP in Scotland and 77% in the UK, was stronger in Scotland in the fourth quarter after being weaker in the third quarter. Scottish service GVA grew by 0.3% here compared to zero - very slightly negative - growth in the UK as Figure 4 shows.
But over the year - that is four quarters over previous four quarters - the service sector in Scotland grew by 1.6%, which was better than UK service sector growth of 1.2%. We noted in the previous Commentary that the Scottish Government GDP/GVA data release has changed its yearly growth measures from the four quarter on four quarter usual method to growth between the corresponding quarters of the respective years. This seems to us a less satisfactory measure of annual growth than the four quarter approach. We shall persist with our own calculations of annual growth on a four quarter over four quarter basis.

The state of the recovery in Scottish and UK services is presented in Figure 5.
By the fourth quarter of this year, Scottish services GVA was still -1.6% below its pre-recession peak compared to a UK position where the sector now stands 0.5% above its pre-recession peak output. The loss of Scottish service sector output in the recession was -4.3% a little more than the -4.1% output loss in services in the UK. So, it is clear that despite the stronger growth performance of Scottish services in the latest quarter and over the year to the 4th quarter, the sector is weaker than its UK counterpart. Some recovery is evident but unlike UK services there is still some way to go before pre-recession peak output is regained. But it is not all gloom in the Scottish service sector, as we note below.

Output in the Scottish production sector continued to recover. Output rose by 1.1% in the quarter compared to a fall of -2.1% in the UK. Over the year - four quarter on four quarter - production GVA fell slightly by -0.2% in Scotland compared to a large fall of -2.4% in the UK. A key reason for this was strong growth of 8.8% in electricity and gas supply in Scotland compared to a rise of 2.2% in the UK. This may be due to structural reasons such as a power plant coming back on stream after a maintenance shut down. If so, a fall in output or flat growth might be expected in the first quarter. Over the year, the GVA of the electricity and gas sector contracted by -2.9% in Scotland but rose by 0.9% in the UK. Mining & quarrying also performed more strongly in Scotland with growth of 1.3% in the quarter and 5% over the year. In contrast, UK mining & quarrying contracted by 10.7% in both the quarter and over the year. This appears to be structural due to oil production issues in the North Sea.

One hope of the UK Government and many commentators is that the UK economy will recover from the Great Recession by re-balancing away from domestic demand to external or foreign demand, from consumption to investment, and from public to private production. A key factor in this is the desired shift in favour of manufacturing, which is a major exporter. The latest data show that very little progress is being made here.

Manufacturing GVA contracted by 0.5% in the quarter in Scotland after strong growth in the third quarter - Figure 6. UK manufacturing, in contrast, fared worse with output falling by -1.4%. Over the year, both UK and Scottish manufacturing GVA fell by -1.1% in Scotland less than the -1.5% fall in the UK. Figure 7 shows the impact of the latest data on the manufacturing sector's recovery from recession.
Scottish manufacturing GVA now stands at -5.5% below the 2009-09 pre-recession peak, while the figure for UK manufacturing is -9.5%. However, it is some small comfort that Scottish manufacturing is doing better than UK manufacturing. The downturn in the fourth quarter in Scottish manufacturing as well as in UK manufacturing takes some of the shine off the good overall Scottish GDP performance in the fourth quarter.

Within manufacturing, the main boost to growth in the fourth quarter came from other manufacturing and the food and drinks sector. GVA rose by 2.7% and 0.3%, respectively in the quarter but fell by -1.8% and -0.3%, respectively, over the year - four quarter on four quarter. Textiles and clothing grew by 3.8% during the quarter but the sector contributes little to manufacturing output - about 2.5% - since the
structural contraction has resulted in the volume of output falling by two thirds since 1998. The main sectors holding back manufacturing growth in the fourth quarter were refined petroleum, chemical and pharmaceutical products, and computer, electrical and optical products, which contracted by -4% and -6.5% respectively during the quarter.

Turning now to construction, the latest data are presented in Figure 8. Scottish construction GVA rose by 0.6% in the quarter but fell by -9.7% over the year. UK construction, in contrast, grew a little more strongly in the quarter at 0.8% but contracted by a little less, -8.1%, over the year. The sector still continues to be languishing despite the strong pick-up in the second quarter. Figure 9 shows the state of the recovery in the construction sector in Scotland and UK.

We noted in the previous Commentary that the weakened state of the construction industry in both Scotland and the UK is very likely to be due to the UK government's fiscal consolidation programme. The contraction from the third quarter of 2010 in Scotland may well be related to fiscal consolidation where, so far, the bulk of the cuts have fallen on capital expenditure and buildings especially. In the UK where there have been similar cutbacks in government capital expenditure, the impact on overall construction output might have been somewhat muted by the expenditure on construction projects associated with the Olympics. And in Scotland the onshore effects of investment in renewables and in the oil industry could be responsible for the recent upturn. In addition, since we now may be seeing a slow general recovery in output this is likely to have positive implications for construction. But it is still worth noting that at -15.5% and -16.7% below their pre-recession peak Scottish and UK construction output is not much higher than it was at the trough of the recession.

Within services, the most important private sector by contribution to GDP, business and financial services - 25% of overall GDP and 35% of service sector GVA - contracted by -0.3% in Scotland while growing by 0.5% in the UK during the fourth quarter. But over the year, four quarter on four quarter, the sector grew by 4.5% in Scotland compared to weaker growth of 1.5% in the UK. Figure 10 shows the path of GVA in the sector during the recession and recovery relative to its pre-recession peak.
By the latest quarter the sector in the UK was -0.5% below its pre-recession peak while its Scottish counterpart was still -2.5% below. However, the aggregate GVA data for business and financial services in Scotland mask significant differences between the performance of financial services on the one hand and business services on the other. Currently, we only have disaggregated data for Scotland. Figure 11 shows what has been happening to financial services since peak output in the second quarter of 2008.

Despite the upturn in output between the second quarter of 2011 and the first quarter of 2012, there is a strong indication in the chart that a structural decline has been taking place in financial services in
Scotland. GVA had fallen more than 17% below its pre-recession peak, a loss of around one sixth of total output in the sector. There seems a strong likelihood that some of this lost output may never return. When we now turn to business services on its own - a combination of real estate activities and professional, scientific, administrative & support services - we see a very different picture as Figure 12 reveals.

It is clear from the figure that a recovery is now taking place in business services. After contracting by more than 6% in the recession from the middle of 2007 to the final quarter of 2008, GVA in the sector...
languished until the second quarter 2011. From then on business services began to recover strongly, attaining its pre-recession peak between the first and second quarter of last year. By the end of the fourth quarter 2012 GVA stood 5.1% above its pre-recession peak. It is also evident that while real estate activities, accounting for just under 40% of business services, have recovered to stand at around 2.5% above pre-recession peak output, the remaining 60% element of business services - professional, scientific, administrative & support services, has been growing the fastest with GVA reaching nearly 6% above its pre-recession peak by the end of last year.

Elsewhere in private services, the main sector is distribution, hotels and catering, accounting for 19% of services sector output in Scotland, grew by 0.8% in the fourth quarter compared to a fall of -0.6% in the UK. Over the year, the sector grew by 0.9% in Scotland compared to 0.6% in the UK. Figure 13 shows the performance of the sector during recession and recovery.

What is clear from Figure 13 is that the sector, after the latest data and revisions, has performed much better in Scotland throughout both recession and recovery. It certainly looks as if retailing and spending in the high street may have held up better in Scotland than in the UK. But we don’t have access to the disaggregated data to confirm that. One supporting piece of evidence, from ONS data published on 13 May, is that household property debt appears to have been much lower in Scotland through recession and recovery than in the UK as a whole and most other areas of the UK. In 2008/10 Scotland had at £55,000 the lowest median property debt of any UK region or nation. And Scotland contained the fewest households considering their property debt to be “a heavy burden” (8.2%).

Government & Other Services GVA rose by 0.4% in Scotland compared to a contraction of -0.9% in the UK. Over the year measured value added in the sector was almost flat at 0.1% growth in Scotland compared to a rise of 1.6% in the UK. Figure 14 shows performance in recession and recovery.

Figure 14: Government and Other Services: Recession and Recovery to 2012q4

We continue to find the strong growth in the sector in the UK difficult to understand, while the Scottish sector’s performance is more intuitively reasonable. In the earlier Commentaries we noted that “in view of the fact that Government accounts for about 88% of the output, how has such an increase come about at a time of fiscal consolidation? Is it a genuine increase in the real value of UK government output over the period? Is it due to measurement differences between the UK and Scottish government production? Or, is it due to measurement error? Either way it is important to resolve this issue because the comparative size of the government sector means that the difference in performance is a not
insignificant factor in the aggregate GVA differential between Scotland and the UK. We are still no further forward in resolving these questions.

Finally, Figure 15 highlights the performance of transport, storage & communication in Scotland and UK in recession and recovery. The sector accounts for nearly 8% of total GVA and about 11% of service sector output.

![Figure 15: Transport, Storage & Communication: Recession and Recovery to 2012Q3](chart)

It is clear from the chart that the sector experienced a worse recession in Scotland and the recovery that was occurring has fallen away so that by the end of last year GVA was still more than 7% below the pre-recession peak compared to 4% in the UK.

The Labour Market

The latest labour market data (see Overview of the labour market below) reveal that conditions in the Scottish labour market continue to improve. In the quarter January to March there was a surge in employment in Scotland. Jobs rose by 54,000 in the first quarter of this year compared to a fall of 43,000 in the UK as a whole. In addition unemployment fell by just under 7,000 to below the 200,000 mark to 199,000, or a rate of 7.3%.

This brings Scottish jobs performance since before the recession more into line with the UK as Figure 16 shows.

Scottish jobs are now -1.3% below their pre-recession peak, whereas in the previous quarter they were more than 3% below the pre-recession peak. This is still worse than the UK, where, despite the loss of jobs in the recent quarter the total is 0.6% above the pre-recession peak.

The unemployment position is shown in Figure 17 below. The figure shows that unemployment is now faring better in Scotland than the UK.

It is difficult to explain the recent strong Scottish job creation performance while GDP growth appears to be weaker. There are several possibilities.
First, we cannot discount the possibility that the Scottish data reflect measurement or sampling error, more so than the UK data where samples are relatively bigger. The latest ‘surge’ may reflect a correction of earlier errors, or a large error in the latest measurement. Only later data will help clarify that.

Secondly, if we assume no measurement error, the explanation could be as follows.
Since the fourth quarter of 2009 when there was a large loss of jobs in Scotland, the Scottish jobs market has been weaker than the jobs market in the UK as a whole. Yet, GDP growth has been very similar in Scotland and the UK. On the face of it, that meant that productivity worsened more in the UK than Scotland. Again we also cannot discount measurement error affecting the GDP estimates both in Scotland and the UK. There may also be different industrial/structural reasons, including the relative number of ‘zombie’ firms in Scotland and the UK, which would affect the relation of employment to output in Scotland and UK - we assume that the contribution of such firms to GDP is much less than their contribution to employment, other things equal.

But setting all those possible explanations aside, it could be the case that Scottish employers took a more pessimistic view of the course of the recession and recovery than their UK counterparts. Hence, employment was cut back here but not in the UK. Now we may be seeing a correction as Scottish employers revise their expectations up considering that conditions are not as bad as they expected. Conversely, UK employers may be in the process of revising their expectations downward: the recovery is not as strong as they anticipated, hence cutback on employment.

This is speculation and only a theory, but it does reconcile the different Scotland-UK jobs market behaviour with the similar output/GDP behaviour.

Finally, we shouldn’t get carried away by the recent improvements in the Scottish jobs market and unemployment. When employment is compared to the 16 plus population we get the following chart of quarterly data to Jan - Mar 2013.

Before the surge in jobs in the first quarter of this year this ratio stood at -6.2% below its pre-recession peak, identical to the position at the trough of the recession. After the surge it rose to -4.3% below. The numbers economically inactive that genuinely do not wish to work may have risen somewhat since 2007 due to population ageing. But we know from discussion in previous Commentaries that the recession appears to have produced a discouraged worker effect with many leaving the labour market because they have given up on getting a job. The working population is also rising. This, coupled with the fact of the evidence of a shift from full-time to part-time and self-employed working with diminished hours overall - see Overview of the labour market below - suggests that the size of labour reserves in Scotland, and the extent of human misery at not having a suitable job, remains large.
Forecasts

Background

The second estimate for UK GDP growth in the first quarter reported a rise of 0.3% in UK GDP unrevised from the previously published estimate. This followed the -0.3% fall in the fourth quarter of 2012, 1% rise in the third quarter, and the 0.9% rise in the third quarter, which was much influenced by the Olympics and lower output in the second quarter due to the Queen's Jubilee. Total growth in the UK in 2012 over 2011 was 0.3%. The economy continues to stagnate five years after the onset of recession. Recent signs of a recovery in output do little to alter that basic truth.

Despite the pick-up in growth in the first quarter, the main components of UK aggregate demand remain weak. Household expenditure in the first quarter contributed positively to growth even though it weakened compared to growth in household spending in the previous four quarters. But the main contributor to UK real GDP in the first quarter was stock building, or inventories. There continues to be little or no evidence of rebalancing away from household consumption toward investment and net exports. In the first quarter, both investment and net trade contributed negatively to growth. Taking the year to the first quarter, the main drivers of growth were again domestic household consumption (0.8%), inventories and a small contribution (0.1%) from business investment. The main negative contributions to GDP growth over the year came from net trade (-0.6%) and government final consumption (-0.2%). It seems probable that the boost from inventories reflects firms' expectations of growth in future demand. Clearly, to the extent that such growth fails to emerge to the degree anticipated then we should expect cut backs in inventories and a negative impact on GDP growth.

In the first quarter, the main sectoral contribution to GDP growth of 0.3% came from services (0.4%) and the extraction industries (0.1%). Construction made a negative contribution to growth (-0.1%). Manufacturing production continued to be weak with GVA falling by -0.3% after falling -1.4% in the fourth quarter of last year. But recent Markit PMI surveys for May indicate a strengthening is occurring in the growth of construction, manufacturing and services. But it must be remembered this strengthening is from a low base in a weak and stagnant economy. The PMI for construction rose from 49.4 in April to 50.8 in May. This was the first time since October that the index had climbed above the 50 mark that divides expansion from contraction. House building activity has strengthened considerably but civil engineering projects show little signs of improvement due to public sector capital spending cutback as part of the UK government's fiscal austerity policy. Retail sales grew by 3.4% between May 2012 and 2013. Industry data suggest much of the recent growth was fuelled particularly by on-line sales. The US manufacturing PMI index PMI index rose from 49.8 in April to 51.3, suggesting a return to growth. The Markit/CIPS UK Services PMI for May was particularly encouraging, given that services account for more than 70% of the economy. The index rose from April's 52.9 to 54.9 in May signalling a strengthening in the rate of growth. This jump in the index was the sharpest since March 2012. However, we must caution that last year's jump in the index in March did not come to much and growth remains low for this stage of the 'recovery'.

Finally on the UK, an indication that the financial markets believe a recovery of sorts is now getting underway is provided by the yield on 10 year UK Treasury bonds. The yield has risen from around 1.75% at the beginning of May to 2.04% by 5 June. Similarly, in the US the yield on 10 year generic Treasury bonds has risen from around 1.75% to 2.12% over the same period, perhaps suggesting that the US recovery is perceived to be stronger. The point here is that if markets expect improved growth prospects they will move away from (sell) fixed interest securities towards (buy) equities which are expected to offer a greater return. In addition, a pickup in the recovery also leads to an expectation that quantitative easing might soon cease, which will have a depressing effect on the price of bonds and a reverse effect on the yield.

In Scotland, we will not have first quarter GDP data until the third week in July. In the fourth quarter, we noted above that real GDP rose by 0.5% in Scotland in the quarter, while falling by -0.3% in the UK. From the latest Scottish National Accounts Project (SNAP) data published on 22 May Scottish GDP in
current market prices rose by 0.1% in the fourth quarter. When we disaggregate this change into the contribution of the different (expenditure) components of aggregate demand, we obtain Figure 19 below.

Figure 19: Expenditure Components Percentage Contribution to Nominal Scottish GDP Growth in 4th Quarter 2012

Figure 19 shows that the situation is very similar to the UK. Household consumption, central government spending and gross capital formation (investment) all made a positive contribution. But again net trade abroad made a large negative contribution. The contribution of investment may be somewhat illusory since the data will contain inventory accumulation, or stock building, which may have been rising, as noted above for the UK, in the expectation of a future increase in demand. So, as with the data from the third quarter, reported in the previous Commentary, there is limited evidence of a rebalancing of the economy away from domestic private and public consumption spending to external private and domestic investment spending.

In the absence of official GDP and other data for the first quarter in Scotland we must rely on survey information for the first five months of this year. The Review of Scottish Business Surveys below notes that

"Overall demand remains weak and a number of Q1 surveys took the view that the Scottish economy was stagnating and bumping along the bottom of the recession, however by May there was more of an emerging sense that that the worst of the recession is over, but that the recovery will be hard."

Despite the positive contribution of household consumption in the fourth quarter there is little doubt that household spending in Scotland remains weak in 2013. Nevertheless, the first quarter 2013 retail sales reported rising sales volumes and rising nominal expenditures, with the volume of retail sales stronger than in the UK. Wage growth in the UK and presumably Scotland remains low slowing markedly at the end of 2012 to 0.8% which is less than the rate of inflation and so indicates falling real wages, which in turn must affect household spending. The housing market continues to be weak - see Forecasts of the Scottish Economy section below. Scottish house prices fell by -1.2% in the year to February and prices are 9% below their 2008 peak having fallen by 12% in the downturn. With no growth in house prices there is no boost to household wealth and increased spending. Equity prices are rising, despite a setback in recent days, as risk assets have come back into favour. But it is unlikely that this will have much impact on consumer spending because of the low levels of share ownership. The Scottish household saving rate remains high as debt continues to be paid down. For all these reasons household spending is likely to continue to be weak.
Investment continues to be weak despite its positive contribution to Scottish GDP growth in the fourth quarter of 2012; as noted above it is likely that this was due to the effect of stock building in anticipation of growth in future demand. As the Forecasts of the Scottish Economy section below notes, investment spending in the fourth quarter was 18.8% below its pre-recession peak, having fallen by 22.9% from peak to trough in the recession. The comparable UK figures are 19.8% and 28.5%. There has been some pickup in construction sector, which is much affected by investment spending but we must expect the growth of investment to continue to be weak during 2013.

Net trade contributed negatively to growth in the fourth quarter of last year and there is little sign of an upturn in the near future, although prospects should pick up during 2014. But it all depends on the state of household demand in the rest of the UK, where two thirds of Scottish exports go, and abroad. UK GDP growth may be picking up slightly but it will be far from a sustained recovery during 2013 and this will affect Scottish exports. Scottish manufactured exports abroad (ex rUK) fell by 1.4% in the fourth quarter of last year so manufactured exports now stand 13.1% below their pre-recession peak as Figure 20 shows.

The manufactured export position continues to be worse than the situation after the collapse of electronics production led to an exporting nadir in 2002. There is little hope of much improvement in the short run. The Eurozone remains in recession. The IMF, OECD and EU Commission have all cut their GDP forecasts for the major economies. The growth of world trade was slower in 2012 than in any year since 2008 and the UK’s share fell due to the contraction of financial services. Scottish exports are unlikely to recover by much, if at all, in 2013.

GDP growth may be starting to recover more strongly but we should not forget the burden that continues to be imposed upon the UK economy by the Coalition Government’s programme of fiscal consolidation. In this context it is worth quoting the Institute for Fiscal Studies:

"The UK is in the fourth year of a planned eight-year fiscal tightening. Following further announcements made in Budget 2013, this fiscal consolidation is now forecast to total £143 billion by 2017–18. The UK is intending the fourth largest fiscal consolidation among the 29 advanced economies for which comparable data are available. By the end of this financial year, half of the total consolidation is expected to have been implemented. However, within this tax increases and cuts to investment
spending have been relatively front-loaded, while cuts to welfare spending and other non-investment spending have been relatively back-loaded."

So by the end of this financial year more than £70 billion has still to be taken out of the economy and taken from those, such as welfare recipients, who have high spending propensities. In this context, it will be hard for the UK economy to generate the rate of growth required to generate a full recovery back to the growth trend. As we noted in the previous Commentary:

"The more rationale policy approach .... would be for the UK government to slow the pace of fiscal consolidation, and undertake a massive infrastructure investment programme while borrowing costs remain so low. ..... The way is still open for a massive boost to infrastructure spending in the UK. If only the government would take it."

We see no reason to change that view.

It is against this background that we have prepared our latest forecasts.

GVA Forecasts

For our latest GVA forecasts we continue the presentational procedure adopted in earlier Commentaries. We present only a central forecast but use estimated forecast errors to establish the likely range that the true first estimate of the growth of Scottish GVA will lie between. We have updated our forecasting model to SIC2007 industries and have accommodated the latest release of the Scottish Input-Output tables.

Table 1 presents our forecasts for Scottish GVA - GDP at basic prices - for 2013 to 2015. The forecasts are presented in more detail in the Forecasts of the Scottish Economy section of this Commentary below.

Table 1: Forecast Scottish GVA Growth, 2013-2015

<table>
<thead>
<tr>
<th>GVA Growth (% per annum)</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
</tr>
</thead>
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<tr>
<td>Central forecast</td>
<td>0.9</td>
<td>1.6</td>
<td>2.1</td>
</tr>
<tr>
<td>March forecast</td>
<td>0.9</td>
<td>1.7</td>
<td>1.9</td>
</tr>
<tr>
<td>UK mean independent new forecasts (May)</td>
<td>0.8</td>
<td>1.5</td>
<td>2.1</td>
</tr>
<tr>
<td>Mean Absolute Error % points</td>
<td>+/- 0.440</td>
<td>+/- 1.031</td>
<td>+/- 1.204</td>
</tr>
</tbody>
</table>

Table 1 shows that our GDP forecast for 2013 at 0.9% is the same as our March forecast. For the two years 2014 and 2015, we have revised down slightly our forecast for 2014 from 1.7% to 1.6%, and have revised up the forecast for 2015 from 1.9% to 2.1%. The forecasts reflect the continued weakness of domestic demand, in particular government spending and consumer expenditure, and weak anticipated growth in the rest of the UK and Eurozone markets to which Scottish exports are so reliant. Some may be surprised that we have not revised up our forecasts for 2013 and 2014 given the evidence of a recent pick up in the economy. We have not done this since our forecasts already contain gradual improvements to the growth rate. And so a recovery is built in. But it must be stressed that this recovery is fairly anaemic and not what one would have expected 5 years after a recession, even a recession generated by a banking crisis. As we argued before the reason for this stagnation and anaemic recovery is twofold: the UK government’s fiscal consolidation programme and a weak export performance reflecting both supply-side structural problems in the UK economy as well as weak global demand.
Table 1, also compares our GVA forecasts with the median of latest independent forecasts for the UK in 2012 and 2014 and the average of the new independent medium-term forecasts for 2015 that are published by the UK Treasury. These show that we expect Scottish growth to continue to be a little stronger than UK growth this year and next year, and the same growth as the UK in 2015. So, we are now forecasting growth of 0.9% in 2013, 1.6% in 2014 and 2.1% in 2015. Given our previous forecast errors the lower and upper bounds for growth in 2013 are expected to be 0.46% and 1.34%, for 2014, 0.57% to 2.63%, and for 2015, 0.90% to 3.30%.

Production and manufacturing continue to be the major sectors exhibiting the fastest growth in 2013, 2014 and 2015. In 2013, production is projected to grow at 1.1% but this is a reduced forecast from the 2% projected in March. Services and construction display positive growth this year at 0.8% and 0.7% respectively. This relative performance continues in both 2014 and 2015 as forecast growth across all sectors increases. Production grows by 1.9% and 2.5% in 2014 and 2015, while service growth is projected to be 1.5% and 2.0%. The construction sector continues to lag but picks up to 1.2% and 1.3%. This forecast has therefore revised down the growth of production and manufacturing, and revised up the forecast growth of services. As noted above a recovery is now evident in certain parts of services especially business services while manufacturing remains weaker than expected.

**Employment Forecasts**

Table 2 presents our forecasts for net employee jobs for the years 2013 to 2015 in terms of a central and upper and lower forecast.

**Table 2: Forecast Scottish Net Jobs Growth in Three Scenarios, 2013-2015**

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Upper</td>
<td>22,600</td>
<td>50,500</td>
<td>64,300</td>
</tr>
<tr>
<td>March forecast</td>
<td>21,400</td>
<td>44,950</td>
<td>59,100</td>
</tr>
<tr>
<td>Central</td>
<td>12,150</td>
<td>28,200</td>
<td>38,700</td>
</tr>
<tr>
<td>March forecast</td>
<td>9,400</td>
<td>19,150</td>
<td>31,800</td>
</tr>
<tr>
<td>Lower</td>
<td>2,450</td>
<td>4,450</td>
<td>16,400</td>
</tr>
<tr>
<td>March forecast</td>
<td>-3,700</td>
<td>-5,750</td>
<td>5,150</td>
</tr>
</tbody>
</table>

We have generally raised our forecasts for job creation compared to our March forecast. This reflects the stronger jobs performance noted in the recent data and reflects the sectoral rebalancing of our growth forecast more in favour of labour intensive services. On the central forecast, we are now forecasting that net jobs will rise by 12,150 in 2013, rising to 28,200 in 2014 and 38,700 in 2015. This year, we now expect just over 12,000 service sector will be created, with only small numbers of net jobs added in other sectors. In 2014/2015, the bulk of the jobs created are expected to be in the service sector with an additional 23,000/30,500 jobs forecast, while 2,550/4,350 are added in production, 1,600/2,250 in agriculture and 750/1,550 in construction.

**Unemployment Forecasts**

The key unemployment forecasts are summarised in Table 3 below.

The ILO rate is our preferred measure since it identifies those workers who are out of a job and are looking for work, whereas the claimant count simply records the unemployed who are in receipt of unemployment benefit. Our unemployment forecasts have been revised down somewhat from March, reflecting the weakness of productivity, and higher employment given the growth of output. As the
analysis above in the section on the Labour Market implies, the variation in the link between output and labour demand and the unanticipated changes in labour supply makes unemployment a difficult number to predict. We also see many workers leaving the labour market so that the measured unemployment rate becomes a less and less accurate measure of the extent of labour reserves and the underlying misery of job loss. Our projection for unemployment on the ILO measure at the end of 2013 is now 213,250. We continue to expect the unemployment position to deteriorate slightly in 2014 compared to 2013 due to relatively weak output and employment growth. Unemployment is now forecast to be 228,000 by the end of 2014 but then falls back to 189,350 by the end of 2015 as growth in the economy strengthens.

Table 3: Forecasts ILO unemployment 2013-2015

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>ILO unemployment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rate (ILO un/TEA 16+)</td>
<td>7.9%</td>
<td>8.4%</td>
<td>7.0%</td>
</tr>
<tr>
<td>March forecast</td>
<td>8.3%</td>
<td>8.6%</td>
<td>7.7%</td>
</tr>
<tr>
<td>Numbers</td>
<td>213,250</td>
<td>228,000</td>
<td>189,350</td>
</tr>
</tbody>
</table>

Brian Ashcroft
7 June 2013