

Outlook and Appraisal

Overview

There was evidence of some genuine growth in the Scottish economy in the third quarter of last year. Also the new GDP methodology and revisions have meant the fit with the UK economy during recession and recovery is closer. The recovery has been a little stronger than the earlier data suggested but still a little weaker than the UK as a whole. But survey evidence suggests a weakening in the final quarter of 2012 and uncertain prospects for 2013. It is quite clear the main components of aggregate demand in the Scottish economy remain weak. Moreover, there is little or no evidence of rebalancing away from household consumption toward investment and net exports. From the latest Scottish National Accounts Project (SNAP) data it is evident the contribution of components of demand to growth between the second and third quarters came almost exclusively from Scottish household consumption and to a small extent from government spending. Net trade and investment made a negative contribution.

Despite the strong contribution of private consumption there is little doubt that household spending in Scotland remains weak and will continue to be weak. The fourth quarter retail sales index reported falling sales volumes and flat nominal expenditures, with spending weaker than in the UK. Earnings growth remains low at around 2% per annum which is less than the rate of inflation and so indicates falling real earnings, now back to 1999 levels. The labour market in Scotland shows falling measured unemployment but from the middle of last year employment is falling and the number inactive continues to rise. The 'real' level of unemployment is clearly higher and that will contribute to weak household spending on goods and services. The housing market is flat with no growth in house prices and therefore offering no boost to household wealth and increased spending. Equity prices are rising 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 and the likely transience of the equity 'boom'. The Scottish household saving rate is high and rising and at 11.1% is 3.4 percentage points higher than in the UK. For all these reasons household spending is likely to continue to be weak.

Government fiscal consolidation is set to increase as the UK Government strives to meet its target of balance in its structural (cyclically adjusted)

current budget in five years. Most of the future adjustments concern spending rather than taxation with 68% of planned benefit cuts and 78% of current departmental spending cuts still to come after April this year. These cuts will depress household demand as well as reducing government spending directly.

Investment and net trade contributed negatively to growth in the third 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 Britain and abroad and there is no guarantee given all the negative influences that the expected pick up will emerge. As the latest SNAP data reveal, since the second quarter of 2011 investment spending in Scotland has fallen relative to its level in 2008. And the prospects for a growth in the contribution of net trade depend much on the recovery of demand and output in the eurozone from the current recession and wider growth of world trade. Huge uncertainties exist over eurozone prospects. The main beacon of hope is recovery in the US economy but this is not without its uncertainties.

Finally, while we might see some further and perhaps innovative monetary policy loosening when the new Governor Mark Carney takes up his post in July, we shouldn't expect much from monetary policy in directly boosting growth. While the economy continues at zero nominal interest rates there is little that traditional monetary policy can do to boost growth. But it can lower real rates by allowing, or acquiescing in, a higher inflation rate, and charging for holding bank deposits (negative interest rates). It can also participate in pumping money directly in the economy by financing the government deficits by printing new money (helicopter money). This is essentially fiscal policy rather than monetary policy but we shall see if there are any innovations forthcoming from the new Governor that might help the British economy escape its liquidity trap, while bearing the burden of fiscal consolidation.

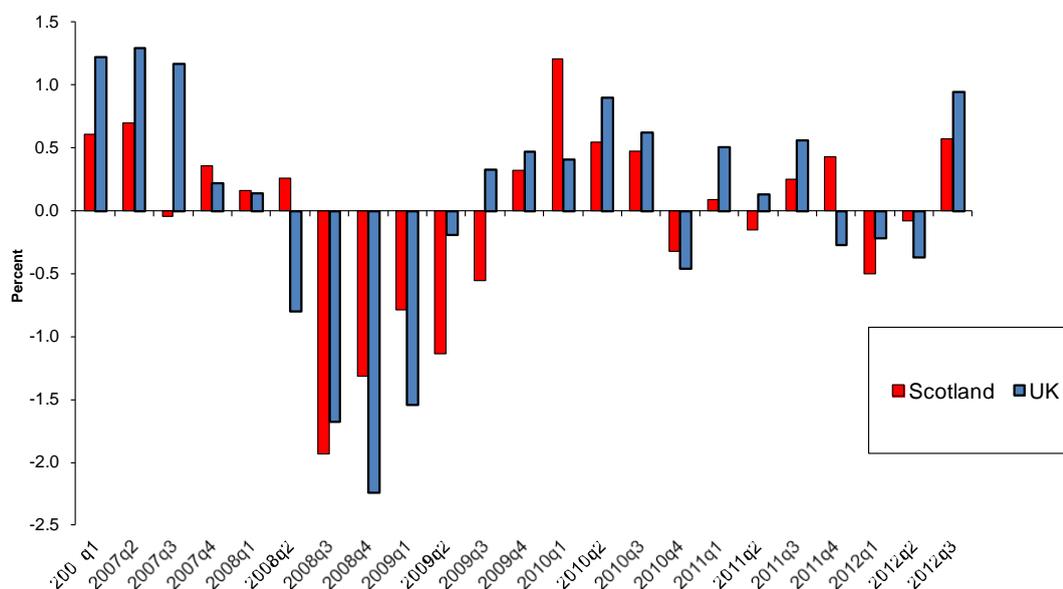
The more rational policy approach, however, would be for the Chancellor in his Budget in March to slow the pace of fiscal consolidation, and undertake a massive infrastructure investment programme while borrowing costs remain so low. Ironically, the UK lost its AAA credit rating not because of fiscal profligacy but because of austerity. The austerity has severely lowered growth prospects, hence low tax revenue prospects and continuing lack of progress in dealing with the deficit. This is exactly what many world class Keynesian economists had predicted. The only silver lining in the credit rating downgrade is that it will from previous evidence e.g. Japan, and the US, have no effect on the UK long-term borrowing rate. The financial markets do not rate highly the credit agencies ability to judge sovereign debt default prospects. And they are

right. The way is still open for a massive boost to infrastructure spending in the UK. If only the government would take it.

Against this background we have reduced our forecasts for GDP growth in 2013 and 2014 to 0.9% and 1.7%, respectively. We now forecast 2015 for the first time and expect growth to be higher in that year, at 1.9%, as recovery finally, and hopefully, takes hold. Job creation remains high in 2012 as many part-time, self-employed jobs, were created offering low hours as full-time jobs were lost as output growth remained weak. We predict net job creation of 9,400 this year, rising to 19,150 in 2014 and 31,800 in 2015. The bulk of the net job creation is in the production sector, with the service sector contributing much more to job creation in 2014 and 2015. Our projection for unemployment on the ILO measure at the end of 2012 is now 204,050. We continue to expect the unemployment position to deteriorate slightly in 2013 and 2014 compared to 2012 due to weaker output and employment growth. Unemployment is now forecast to be 218,300 by the end of 2013 and 228,500 in 2014. By the end of 2015 we project that unemployment will have fallen back to 204,100 as the economy recovers more strongly. But we would warn that many workers are leaving the labour market probably because of an inability to find work. Hence, the measured unemployment rate is becoming a less and less accurate measure of the extent of labour reserves and the underlying misery of job loss.

Recent GDP performance

Figure 1: Scottish and UK Quarterly GDP Growth, 2007q1 - 2012q3



The latest Scottish GDP data for the third quarter of last year show that the Scottish economy grew by 0.6% in the third quarter, compared to growth of 0.9% in the UK see Figure 1. This is a commendable Scottish performance. It is commendable because the so-called 'Olympic bounce' was expected, and is

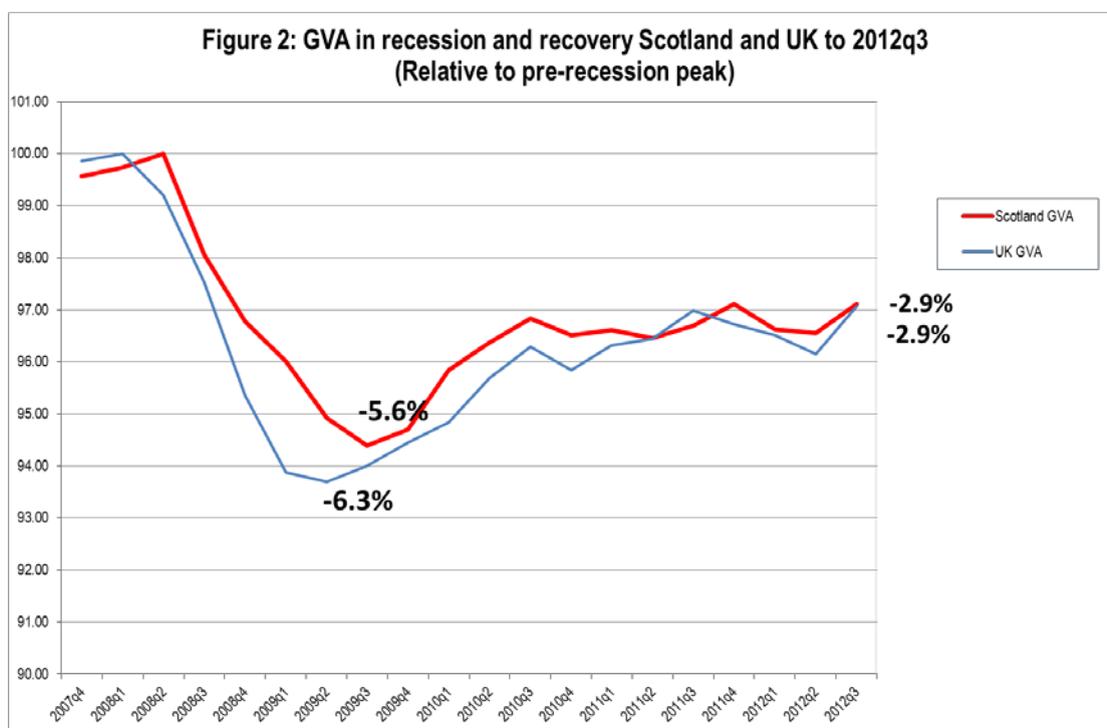
likely to have been, much weaker here than in the UK. So, it is probable that the 0.6% figure represents 'genuine' growth in Scotland whereas the 0.9% UK figure contains a large transient element.

But what is perhaps more interesting than the third quarter results is the effect of methodology and data source revision on the nature and profile of Scotland's recovery from recession.

The Release states that

"This publication incorporates a number of updates to methodology and source data. This is the first Scottish GDP publication fully based on the Standard Industrial Classification (SIC) 2007, which is a major revision to the previous SIC 2003. As part of this process, annual GVA weights since 1998 for each industry have been updated following their estimation in a SIC 2007 based Supply-Use framework. The most recent annual GVA weights now relate to 2009, updated from 2007 in the previous publication. This update means that the latest estimates better reflect the current structure of the Scottish economy."

It also means that there is a more accurate like-for-like comparison with the UK. The effect on Scotland's recovery from recession is marked as Figure 2 shows.

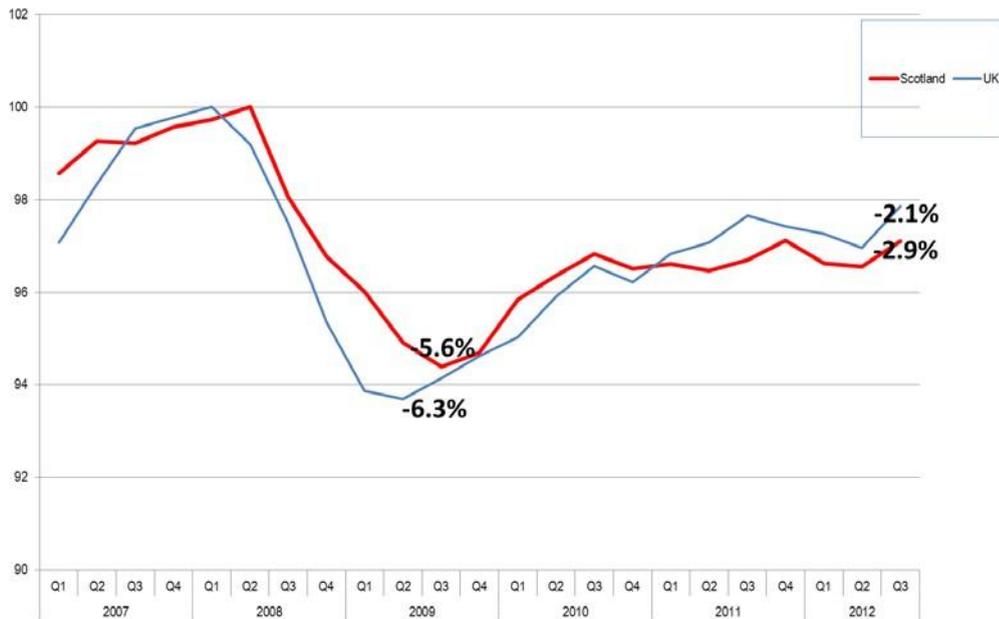


The three quarters of negative growth to the second quarter evident in the previous release have now reduced to two. The scale of the Great Recession is slightly reduced to a drop of -5.6% rather than -5.8%. And now Scotland stands with the UK in being just under 3% below the pre-recession peak, whereas in the previous quarter Scotland was more adrift from the UK.

The Scottish recovery is still slightly weaker than the UK but not by much. Later expected revisions to the UK GDP data may change the relative picture again.

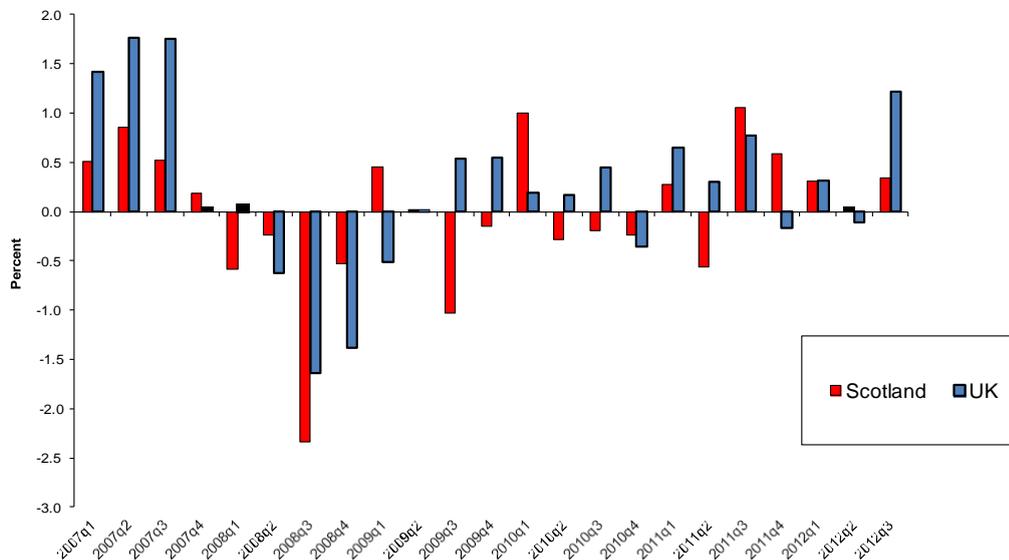
But as we noted in earlier *Commentaries* the aggregate output figures flatter the Scottish recovery because of the statistical quirk that the UK figures include all of oil production whereas the Scottish data do not. With oil production weak this has affected the Scottish-UK GDP relative as CPPR previously pointed out. As the data excluding oil and gas production show, presented in Figure 3, the Scottish recovery from the Great Recession is still clearly weaker than the UK.

Figure 3: GVA ex oil & gas, recession and recovery to 2012Q3



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 weaker in Scotland in the third quarter. Scottish service GVA grew by 0.3% here compared to growth of 1.2% in the UK as Figure 4 shows.

Figure 4: Scottish and UK Services GVA Growth 2007q1 to 2012q3



But over the year - that is four quarters over previous four quarters - the service sector in Scotland grew by 1.5%, which was slightly better than UK service sector growth of 1.2%. It is worth noting that the latest 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. (See below in *Forecasts of the Scottish Economy* section, Box 1).

The state of the recovery in Scottish and UK services is presented in Figure 5.

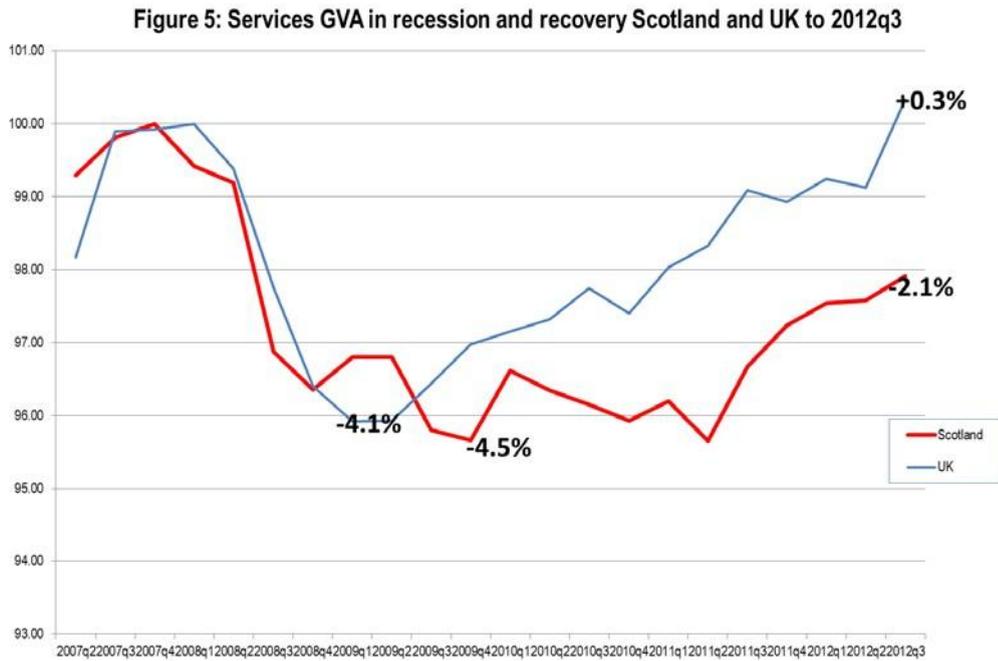
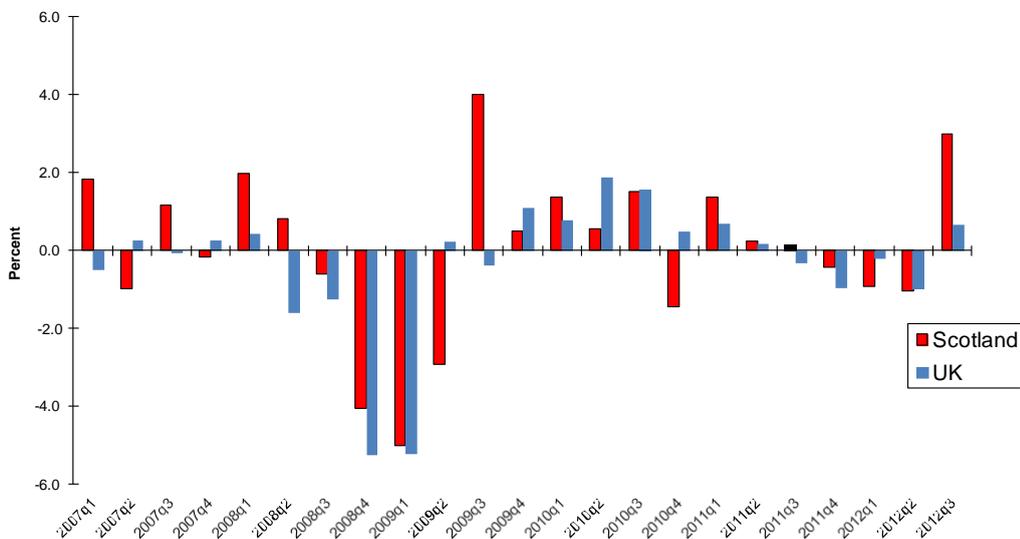


Figure 6: Scottish and UK Manufacturing GVA Growth at constant basic prices 2007q1 to 2012q3



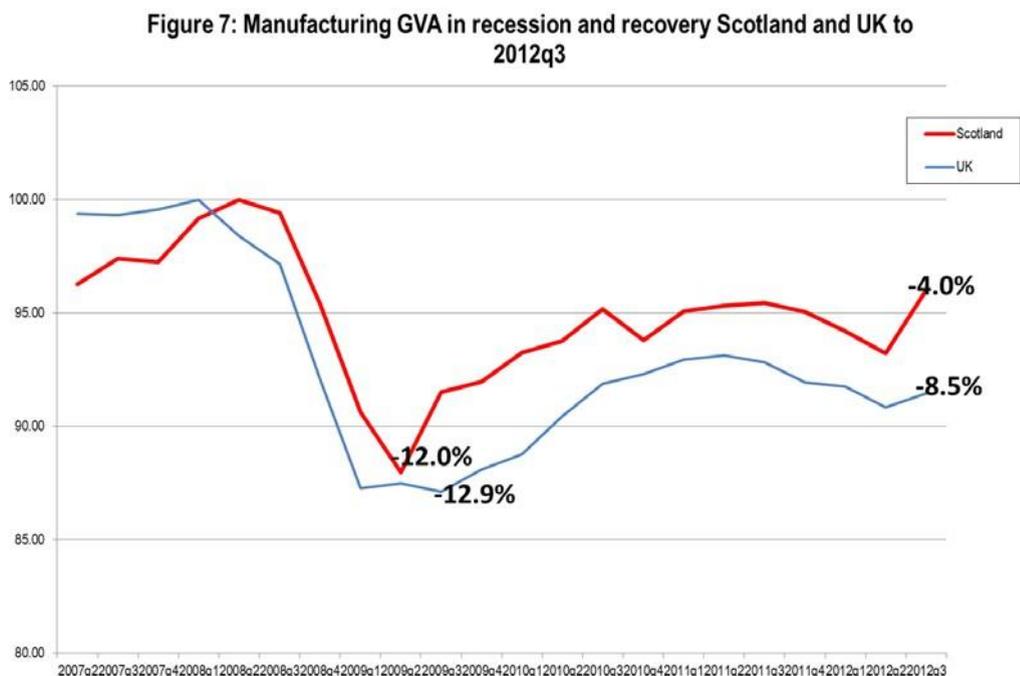
By the third quarter of this year, Scottish services GVA was still -2.7% below its pre-recession peak compared to a UK position where the sector has finally recovered its pre-recession peak output to stand 0.3% above that level. The loss of Scottish service sector output in the recession was -4.5%, a little more than the -4.1% output loss in services in the UK. So, it is clear that despite the slightly stronger growth performance of Scottish services over the year to the 3rd quarter, the sector is very weak compared to its UK counterpart. Some recovery is evident but unlike UK services there is still a long way to go before pre-recession peak output is regained.

The weakness of the production sector here noted in the previous Commentary now seems to have ceased. Output rose by 1.9% in the quarter compared to a rise of 0.7 per cent in the UK. Over the year -

four quarter on four quarter - production GVA rose by 0.2% in Scotland compared to a large fall of -2.5% in the UK. A key reason for this was the markedly improved performance of Scottish manufacturing as Figure 6 shows.

Manufacturing grew by 3% in the quarter but fell by -0.3% over the year. This can be compared with the performance of UK manufacturing which grew by only 0.7% in the quarter and contracted by -1.4% over the year.

Figure 7 shows the impact of the latest data on the manufacturing sector's recovery from recession.



Scottish manufacturing GVA now stands at -4% below the pre-recession peak, while the figure for UK manufacturing is -8.5%. The effect of the new weights, revised methodology and revised data has been to significantly change the nature of the recession and recovery in Scottish manufacturing. The depth of recession at -12% is now much the same as in the UK at -12.9%. Previously, the Scottish manufacturing recession had been large but shallower at -10.6%. And the recovery is now stronger than previously estimated with the position at the latest data point contrasting with the earlier data when at the end of the second quarter Scottish manufacturing was some -7.2% below its pre-recession peak. Clearly, the strong third quarter performance also helped to lower that.

Within manufacturing, the main boost to growth in the third quarter clearly came from the food and drinks sector. GVA rose by 10.2% in the quarter but fell by -1.7% over the year - four quarter on four quarter. Computer, electrical and optical products grew by 3.4% in the quarter while other manufacturing grew by 3.9%. However, the other key sectors in manufacturing all contracted during the quarter: textiles and clothing (-7.6%), refined petroleum, chemicals, pharmaceuticals (-2.3%), and transport equipment (-2.8%). So, the pick-up in manufacturing is by no means general and very much influenced, we would guess, by buoyant whisky sales.

Turning now to construction, the latest data are presented in Figure 8. Scottish construction GVA fell by -0.4% in the quarter and by -10.1% over the year. But UK construction contracted even more in the quarter, by -2.5%, but by less, -6.1%, over the year. The sector still continues to be languishing despite the pick-up in the second quarter which appears to have evaporated by the 3rd quarter. Figure 9 shows the state of the recovery in the construction sector in Scotland and UK.

Figure 8: Scottish and UK Construction GVA Volume Growth 2007q1 - 2012q3

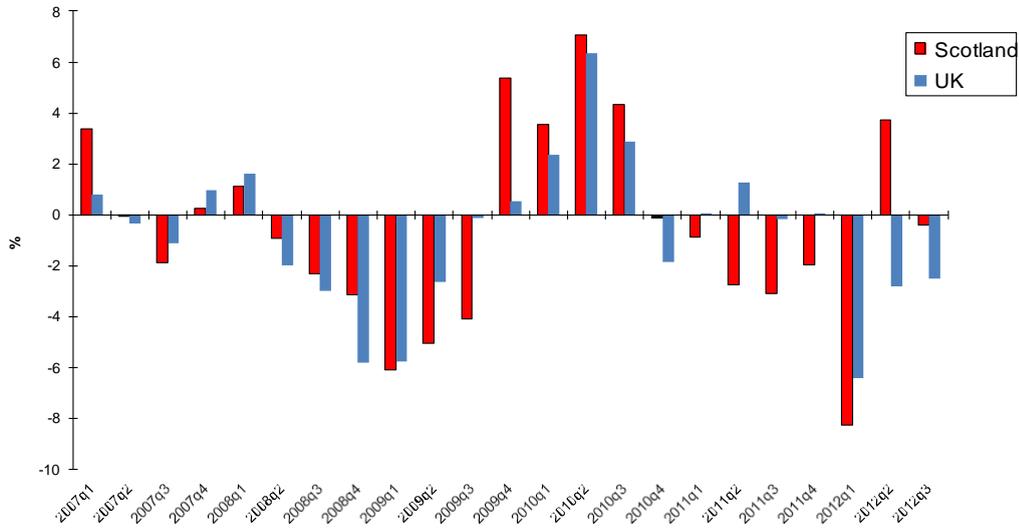
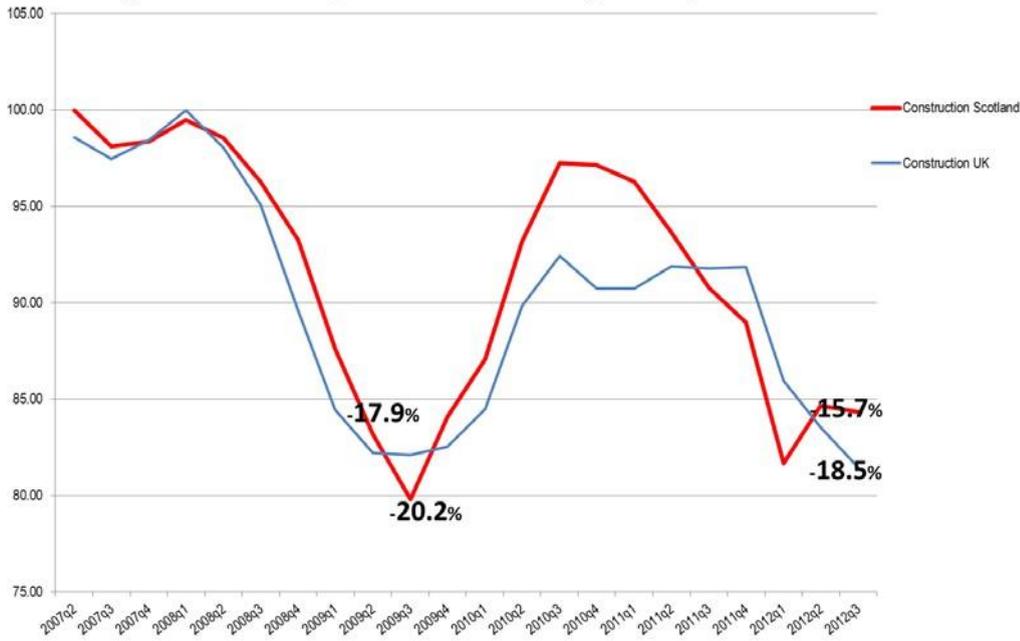
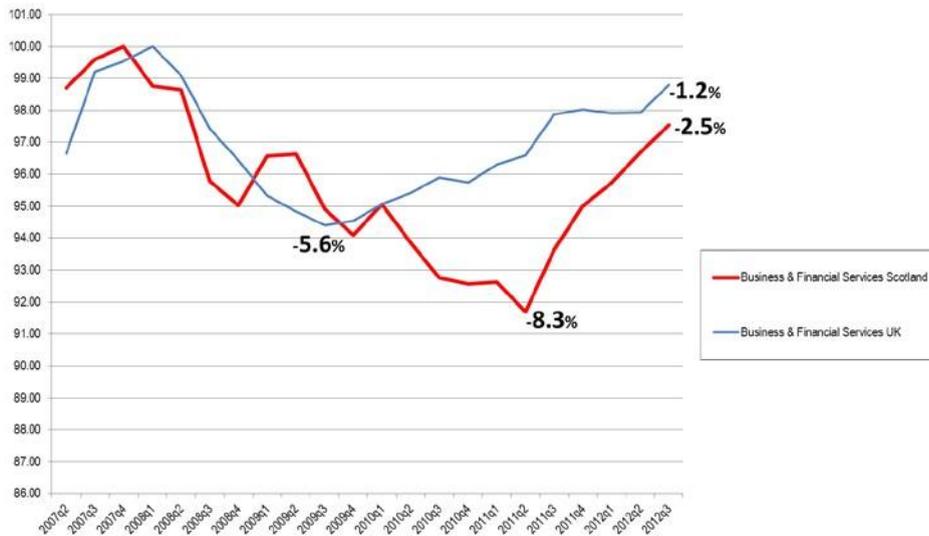


Figure 9: Construction, Recession and Recovery to 2012q3



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. We noted in the previous *Commentary* that 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. But even here the decline in construction output after the second quarter last year has led to both UK and Scottish construction output being not much higher than it was at the trough of the recession.

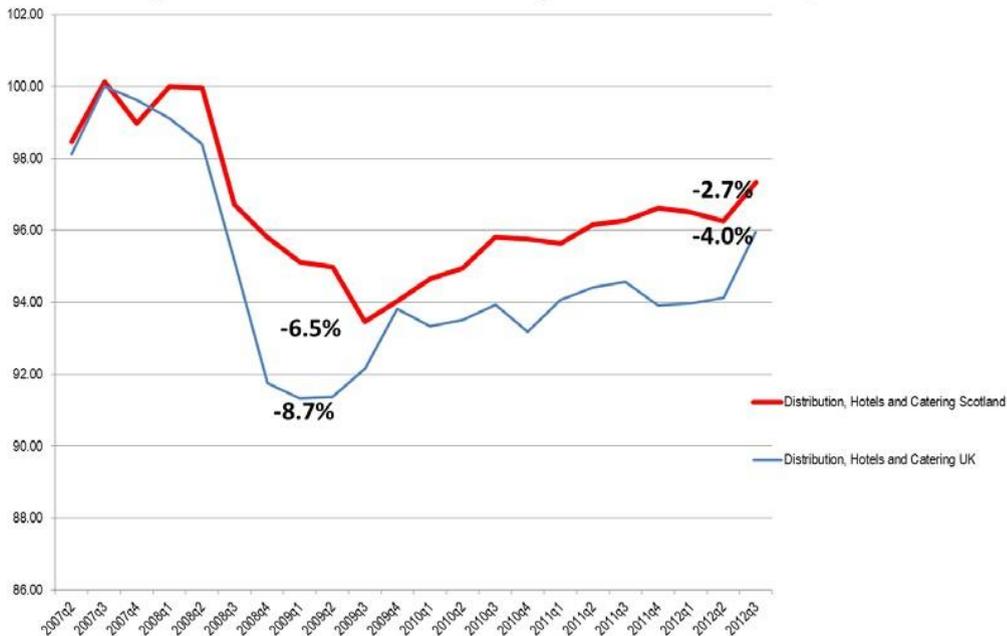
Figure 10: Business & Financial Services: Recession and Recovery to 2012q3



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 - grew by 0.9% in both Scotland and the UK during the third quarter. But over the year, four quarter on four quarter, the sector grew by 3.9% in Scotland compared to slightly weaker growth of 1.6% in the UK. Figure 10 shows the path of GVA in the sector during the recession and recovery relative to its pre-recession peak.

The revised data still show that this sector experienced a stronger recession in Scotland than the UK. But the downturn is now seen as shallower but more protracted with the trough at -8.3% not being reached until the second quarter of 2011. This has to be compared with a trough of -9.5% in the third quarter of 2009. It is now clear that after the contraction to 2011Q2 the recovery has been much stronger in the Scottish arm of the sector. By the latest quarter the sector in the UK was -1.2% below its pre-recession peak and its Scottish counterpart was -2.5% below.

Figure 11: Distribution, Hotels & Catering: Recession and Recovery to 2012Q3

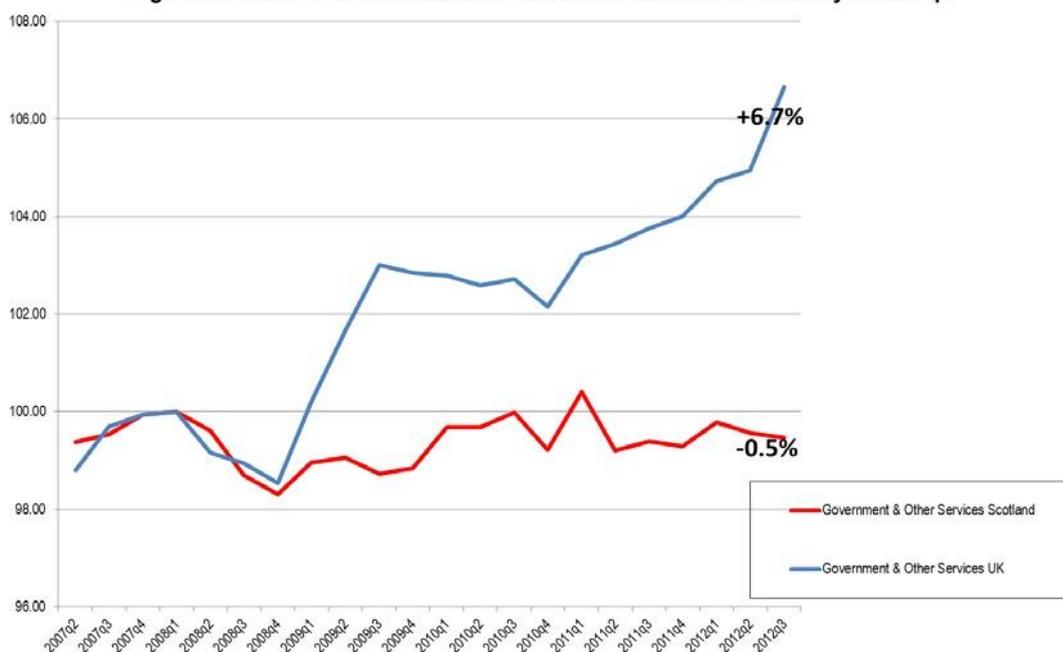


Elsewhere in private services, the main sector is distribution, hotels and catering, accounting for 19% of services sector output in Scotland, grew by 1.1% in the third quarter compared to 1.9% in the UK. But over the year, the sector grew by 0.8% in Scotland compared to 0.5% in the UK. Figure 11 shows the performance of the sector during recession and recovery.

What is clear from Figure 11 is that this sector has broadly performed better in Scotland throughout both recession and recovery. While we don't have more disaggregated data to compare Scotland and the UK, it looks as if retailing and spending in the high street may have held up better in Scotland than in the UK. But we can't be certain about that.

Government & Other Services GVA contracted by -0.1% in Scotland compared to growth of 1.6% in the UK. Over the year measured value added in the sector was flat in Scotland compared to a rise of 1.9% in the UK. Figure 12 shows performance in recession and recovery.

Figure 12: Government and Other Services: Recession and Recovery to 2012q3



We find the strong growth in the sector in the UK difficult to understand. The Scottish sector's performance is more intuitively reasonable. In the previous *Commentary* 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 no further forward in resolving these questions.

The Labour Market

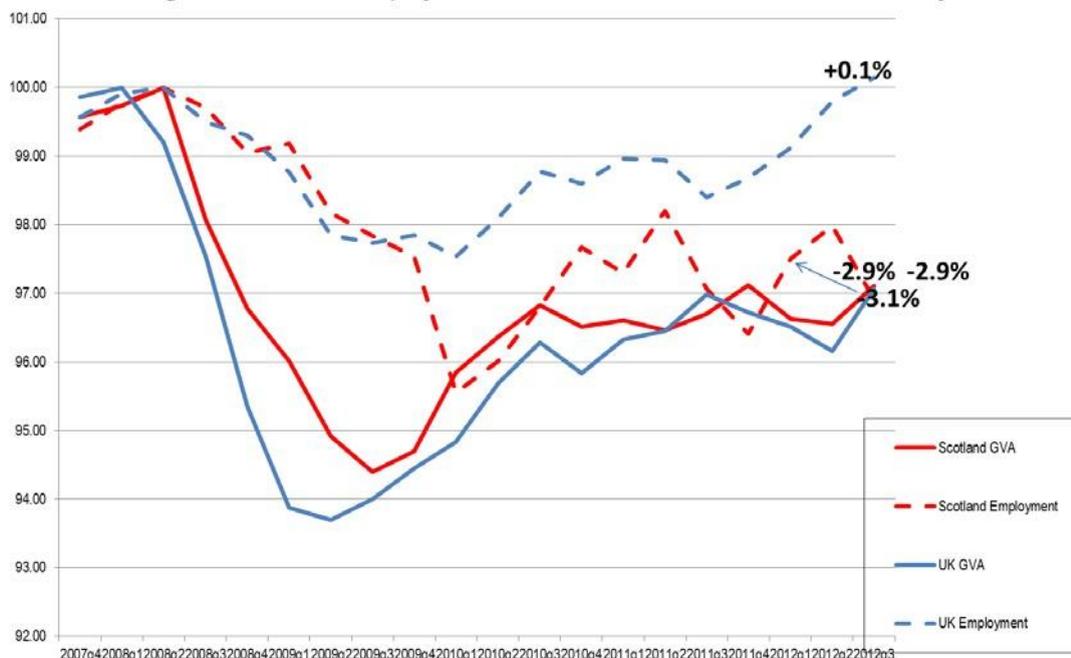
The latest labour market data (see *Overview of the labour market* below) show jobs in Scotland falling by 11,000, and unemployment fell by 13,000 in the latest quarter to December. Over the year, jobs were up by just 2,000 while unemployment was lower by 25,000. In the UK employment rose, resulting in the 16-64 employment rate rising over the year to 71.5 per cent above Scotland's 70.7 per cent which fell slightly over the year.

Figure 13 charts the performance of GDP and employment in Scotland and UK from the pre-recession peak to the latest data point in the third quarter of last year - the latest data point for the GVA data. By

the latest quarter Scottish GDP was just under -3% below its pre-recession peak, now, after the data revisions and methodology change, a shortfall that is identical to the UK. The same, however, cannot be said when it comes to the labour market.

Scottish employment stands at around -3.1 per cent below its pre-recession peak. In the UK, in contrast, employment is now 0.1% above the previous peak.

Figure 13: GDP and Employment, Scotland and UK, Recession and Recovery



As noted in the previous Commentary, these figures suggest that productivity per worker has fallen significantly in the UK since the recession began. But what is now different from the last time when we reported is that productivity per worker in Scotland is now much the same as before the recession.

The 'productivity puzzle' appears essentially to be a UK, not a Scottish, problem. Yet, that is not wholly correct because while worker productivity does not appear to have fallen markedly in Scotland as it has done in the UK, there has been no upturn in productivity. An upturn in productivity is normally associated with recovery from recession as labour hoarded in the recession i.e. working fewer hours and/or less intensively, works more hours and or more intensively in the recovery. So there is still a puzzle about productivity here in Scotland but less marked than in the UK. Some discussion of this is provided in the *Overview of the labour market* below.

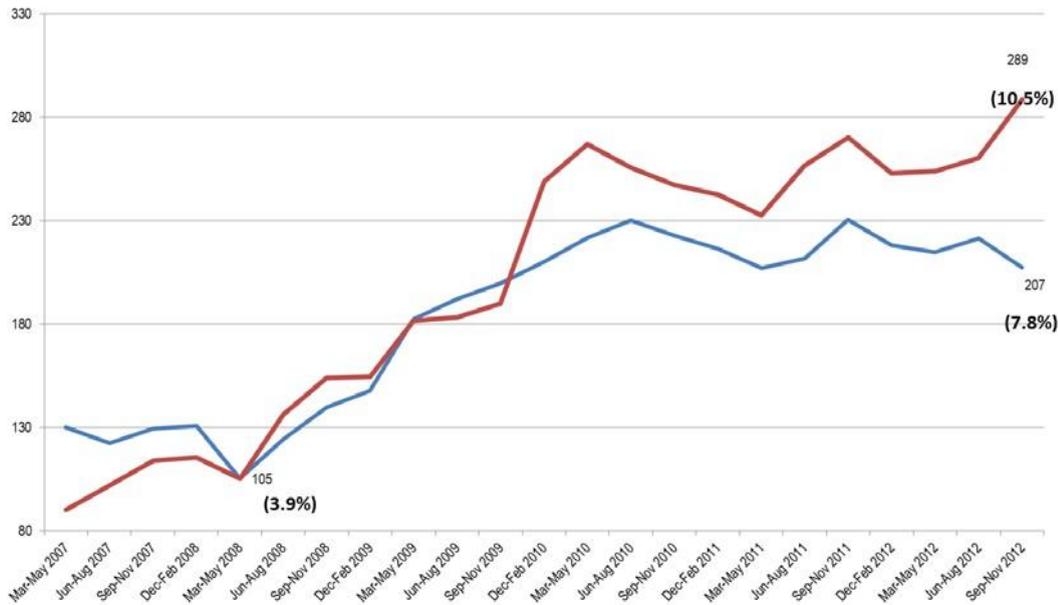
Meanwhile, we see falling employment *and* falling unemployment in Scotland. And that is quite a different picture from the UK. We noted in the last *Commentary* that if jobs are falling unemployment will rise unless workers leave the labour force. Workers might leave the jobs market for demographic reasons such as retirement, having a baby, moving into full-time education etc. Such influences are usually fairly stable or may exhibit a rising or falling trend. But workers might also leave the labour market because they can't find work. Frustrated job seekers may simply stop looking for work and declare themselves to not be seeking working to the Labour Force Survey, the source of our unemployment data. Economists call this a 'discouraged worker' effect. It is evidenced in the data by rising numbers of self-declared inactive workers.

It certainly appears that this is what has been happening in Scotland since the recession began. In the latest quarter to December inactive numbers rose by 9,000 and by 27,000 over the year, a rise in the inactivity rate of 0.3% points and 0.8% points, respectively. In the UK, in contrast, the inactivity rate fell

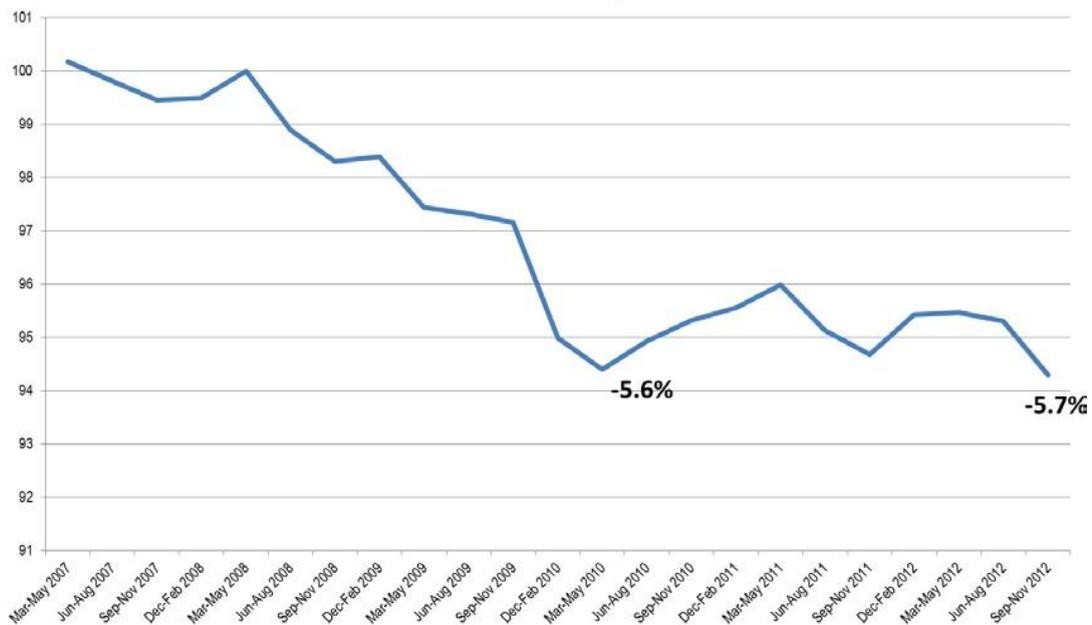
-0.2% points in the quarter and by -0.8% points over the year. It looks as if the measured Scottish unemployment rate is not providing an accurate picture of the state of the Scottish labour market.

We, therefore, hypothesise that the rising inactive numbers in Scotland is a consequence of disproportionate weakness in the Scottish jobs market. Workers are discouraged by the lack of available jobs to cease looking for work and leave the labour market. If we also assume that the labour market was in equilibrium at the start of the recession then we can compute a 'real' level and rate of unemployment by adding back in this 'discouraged worker' effect. This is done in Figure 14 below.

**Figure 14: 'Real' and Measured Unemployment Numbers '000s:
Recession and Recovery to Sept - Nov 2012**



**Figure 15: Employment-Working Population Ratio - (16+)
Pre-Recession Peak to Sept-Nov 2012**



The hypothesised 'real' level of unemployment is some 80,000 higher than the official rate and on a rising trend. In addition, we have noted that employment is -3.1% below its pre-recession peak.

However, that is not the end of the story. The working population is rising in Scotland so if you express employment over the total number of workers economically active and inactive we get Figure 15.

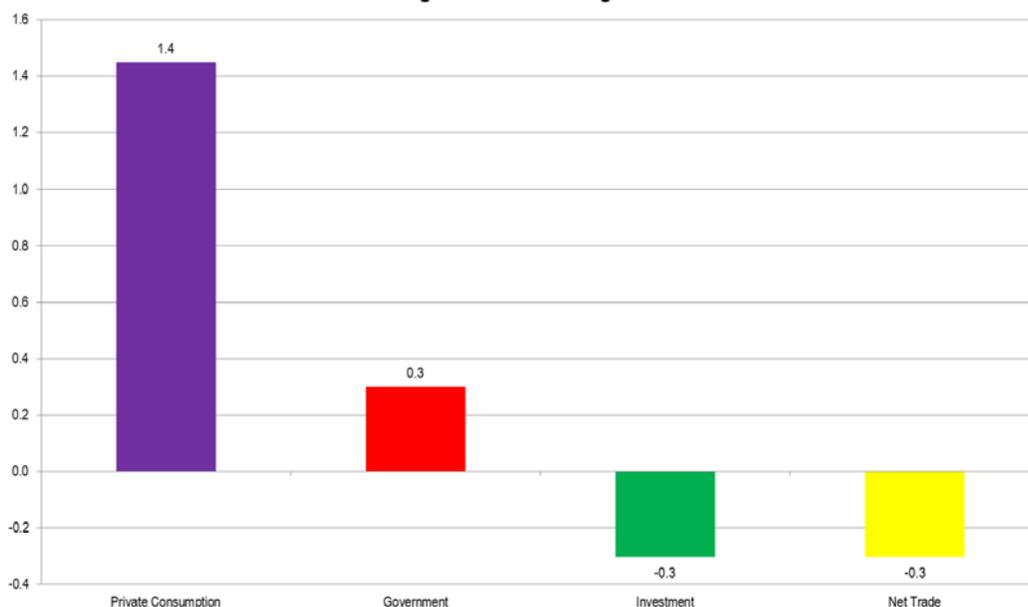
The situation is now worse than at the worst of the recession with employment - working population ratio now -5.7% below its pre-recession peak compared to -5.6% in the trough of the recession. There are clearly real and continuing problems in the Scottish jobs market.

Forecasts

The second estimate for UK GDP growth in the fourth quarter reported a fall of -0.3% in UK GDP unrevised from the previously published estimate. This followed the 1% 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. According to ONS the fall was due to "maintenance at the UK's largest North Sea oil field, a 'fall-back' effect from the Olympic and Paralympic Games and underlying weak domestic demand."

Manufacturing production was particularly weak with GVA falling by -1.3%. But service sector output also contracted by -0.1%. Construction reported a welcome increase with growth of 0.9% but output in the sector fell by -8.2% over the year. Manufacturing GVA contracted by -1.8% over the year, while service sector output rose by 1%. Total growth in the UK in 2012 was 0.2%.

Figure 16: Expenditure components of 3rd quarter 2012 nominal Scottish GDP growth - Percentages



Notwithstanding special factors, it is quite clear the main components of aggregate demand remain weak. Moreover, there is little or no evidence of rebalancing away from household consumption toward investment and net exports. In the fourth quarter, the main contributors to growth were government consumption and household consumption. Investment (-0.4%) and exports (-0.5%) made a large negative contribution. The decline in exports was offset to some extent by a fall in the demand for imports so the contribution of net exports to growth while negative was, at -0.1%, fairly small. Taking the year to the fourth quarter the main drivers of growth were again domestic household consumption (0.9%) and government final consumption (0.7%). There was almost no contribution from investment (0.1%) and a negative contribution from net trade (-0.9%). So, there is no indication here that the British

economy is re-balancing as the UK government desires away from household spending on domestic goods to net exports and investment.

In Scotland, the new GDP methodology and revisions have meant the fit with the UK economy has been closer. The recovery has been a little stronger than the earlier data suggested but still a little weaker than the UK as a whole. The same cannot be said however for employment and labour demand. GDP rose by 0.6% in the third quarter. But from the latest *Scottish National Accounts Project* (SNAP) data published 28 February it is evident the contribution of components of demand to growth between the second and third quarters came almost exclusively from Scottish household consumption and to small extent from government spending. Net trade and investment made a negative contribution. So, the situation is largely identical to the UK. The specific expenditure components are presented in Figure 16 - note the chart shows the quarterly growth of the component *not* its contribution to GDP growth.

Despite the strong contribution of private consumption there is little doubt that household spending in Scotland remains and will continue to be weak. The fourth quarter retail sales reported falling sales volumes and flat nominal expenditures, with spending weaker than in the UK. Earnings growth remains low at around 2% per annum which is less than the rate of inflation and so indicates falling real earnings, which the *Forecasts of the Scottish Economy* section of this Commentary below notes are now back to 1999 levels. The housing market is flat with no growth in house prices and therefore offering no boost to household wealth and increased spending. Equity prices are rising 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 and the likely transience of the equity 'boom'. The Scottish household saving rate is high and rising and at 11.1% is 3.4 percentage points higher than in the UK. For all these reasons household spending is likely to continue to be weak.

Government fiscal consolidation is set to increase as the UK Government strives to meet its target of balance in its structural (cyclically adjusted) current budget in five years. Most of the future adjustments concern spending rather than taxation with 68% of planned benefit cuts and 78% of current departmental spending cuts still to come after April this year. These cuts will depress household demand as well as reducing government spending directly.

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Finally, while we might see some further and perhaps innovative monetary policy loosening when the new Governor Mark Carney takes up his post in July, we shouldn't expect much from monetary policy in directly boosting growth. While the economy continues at zero nominal interest rates there is little that traditional monetary policy can do to boost growth. But it can lower real rates by allowing, or acquiescing in, a higher inflation rate, and charging for holding bank deposits (negative interest rates). It can also participate in pumping money directly in the economy by financing the government deficits by printing new money (helicopter money). This is essentially fiscal policy rather than monetary policy but we shall see if there are any innovations forthcoming from the new Governor that might help the British economy escape its liquidity trap, while bearing the burden of fiscal consolidation.

The more rational policy approach, however, 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. Ironically, the UK lost its AAA credit rating not because of fiscal profligacy but because of austerity. The austerity has severely lowered growth prospects, hence low tax revenue prospects and continuing lack of progress in dealing with the deficit. This is exactly what many world class Keynesian

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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 the previous Commentary. 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.

Table 1 presents our forecasts for Scottish GVA - GDP at basic prices - for 2012 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, 2012-2015

| GVA Growth (% per annum) | 2012 | 2013 | 2014 | 2015 |
|---|-------------|------------|------------|-------------|
| Central forecast | -0.1 | 0.9 | 1.7 | 1.9 |
| <i>November forecast</i> | <i>-0.1</i> | <i>1.3</i> | <i>2.2</i> | <i>n.a.</i> |
| UK median independent new (February) | 0.0 | 1.0 | 1.6 | 2.1 |
| Mean Absolute Error % points | +/- 0.159 | | +/- 1.204 | +/- 1.204 |

Table 1 shows that we have revised down our GDP forecast from the November forecast for the two years 2013 and 2014. For 2012, the forecast remains the same at -0.1%, a little weaker than the UK. The lower forecasts reflect the continued weakness of domestic demand, in particular government spending and consumer expenditure, and weaker than anticipated growth in the rest of the UK and Eurozone markets to which Scottish exports are so reliant. The forecast for growth in 2013 has been revised down by 0.4%, while 2014's growth forecast is 0.5% lower. Any further delay from the political process leading to potentially critical disruption to activity in the euro area is likely to produce downside risks to growth throughout the forecast horizon.

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 weaker than UK growth this year, a little stronger next year and a little weaker in 2015. So, we are now forecasting growth of -0.1% in 2012, 0.9% in 2013, 1.7% in 2014 and 1.9% in 2015. Given our previous forecast errors the lower and upper bounds for growth in 2012 are expected to be -0.26% and 0.06%, for 2013, 0.36% and 1.44%, for 2014, 0.50% to 2.90%, and for 2015, 0.70% to 3.10%.

After the predicted fall in output in all major sectors in 2012, production and manufacturing continue to be the main sectoral drivers of growth in 2013, 2014 and 2015. Production is forecast to contract by -0.1% in 2012 the same as in both services and construction. In 2013, production is projected to grow at

2% but this is a reduced forecast from the 3.3% projected in November. Services and construction display positive growth this year at 0.7% and 0.6% respectively, less than half the rate in production. This relative performance continues in both 2014 and 2015 as forecast growth across all sectors increases. Production grows by 3.3% and 3.8% in 2014 and 2015, while service growth is projected to be 1.2% and 1.3%. The construction sector continues to lag but picks up to 1.1% and 1.3%.

Employment Forecasts

Table 2 presents our forecasts for net employee jobs for the 4 years 2012 to 2015 in terms of a central and upper and lower forecast.

Table 2: Forecast Scottish Net Jobs Growth in Three Scenarios, 2012-2015

| | 2012 | 2013 | 2014 | 2015 |
|----------------------|---------------|--------------|---------------|---------------|
| Upper | 36,850 | 21,400 | 44,950 | 59,100 |
| <i>June forecast</i> | -19,350 | 27,100 | 53,350 | <i>n.a.</i> |
| Central | 32,650 | 9,400 | 19,150 | 31,800 |
| <i>June forecast</i> | -25,750 | 16,950 | 29,450 | <i>n.a.</i> |
| Lower | 29,950 | -3,100 | -5,750 | 5,150 |
| <i>June forecast</i> | -32,050 | 5,500 | 5,850 | <i>n.a.</i> |

The most obvious point about these forecasts is the revisions for 2012. As in the UK we have seen a disjoint between what is happening to job creation and what is happening to output. Net jobs have been created even as output was flat or falling. Labour productivity has fallen and many of the new jobs are part-time with low hours. But since we forecast jobs and not full time equivalents then we must accommodate these changes. Hence, on the central forecast, we are now forecasting that net jobs rose by 32,650 in 2012, rather than a fall of -25,750. However, job creation weakened in the Scottish labour market from the middle of last year so we do not expect such strong jobs growth in 2013 and 2014 even though GDP is forecast to rise more quickly. We predict net job creation of 9,400 this year, rising to 19,150 in 2014 and 31,800 in 2015. The bulk of the 9,400 net job creation this year will be in the production sector, where we expect some 7,800 extra net jobs to be created. The service sector sheds some -850 jobs but construction adds just under 2,000 jobs and 450 jobs are created in agriculture. In 2014 and 2015, the service sector begins to create many more jobs, 4,250 and 13,600 respectively. Yet, this is still less than the production sector, largely driven by manufacturing jobs growth, where 10,850 and 14,050 jobs are forecast in the two years. Construction is projected to add around 3,000 jobs in each of those years.

Unemployment Forecasts

The key unemployment forecasts are summarised in Table 3.

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. We have again revised down our forecasts for unemployment at the end of 2012, despite the deteriorating labour market conditions. 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 2012 is now 204,050. We continue to expect the unemployment position to deteriorate slightly in 2013 and 2014 compared to 2012 due to weaker output and employment growth. Unemployment is now forecast to be 218,300 by the end of 2013 and 228,500 in 2014. By the end of 2015 we project that unemployment will have fallen back to 204,100 as the economy recovers more strongly.

Table 3: ILO unemployment rate and claimant count rate measures of unemployment in central forecast 2012-2015

| | 2012 | 2013 | 2014 | 2015 |
|-------------------------|----------------|----------------|----------------|----------------|
| <i>ILO unemployment</i> | | | | |
| Rate (ILO un/TEA 16+) | 7.8% | 8.3% | 8.6% | 7.7% |
| Numbers | 204,050 | 218,300 | 228,500 | 204,100 |
| <i>Claimant count</i> | | | | |
| Rate (CC/CC+total job) | 5.0% | 5.2% | 5.3% | 4.7% |
| Numbers | 137,650 | 141,900 | 148,511 | 130,192 |

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