The Scottish economy

Forecasts of the Scottish economy

Economic background

While global growth is forecast to slow this year this will be more marked in the developed economies whilst growth is expected to continue more strongly in China and India. The US economy in particular is slowing due to concerns over their housing market and the impacts of the financial crisis. The main concern for the world economy over the short-term is the strength of inflationary pressures as oil prices and commodity prices continue to rise. Even now the risks to the global economy are weighted on the downside as there may be a further unwinding in financial markets or a prolonged slowing of growth (perhaps into late 2009) due to the combined stagflationary mix felt in the US. Some economies however, will be more resilient than others in the face of prolonged price pressure and the response of governments and monetary authorities will be crucial in determining the outcome in the second half of 2008.

UK real GDP growth for 2008Q1 was 0.4 per cent compared to 0.6 per cent in 2007Q4. GDP growth was 2.5 per cent higher than at the same time last year. Real UK GDP is forecast to grow by 1.7 per cent in 2008 and by 1.6 per cent in 2009 HM Treasury, Consensus Forecasts). Output increased in services, manufacturing and construction in the latest quarter 2008Q1. In addition consumption grew by 1.3 per cent in 2008Q1, more than in any quarter of 2007, but investment expenditure fell by 1.6 per cent. The Bank of England has cut interest rates to 5.0 per as UK house prices continue to decline. UK inflation was 3.0 per cent in April, up from 2.5 per cent in March. This is driven by oil, commodity and food prices as core inflation (excluding food and energy) was only 1.4 per cent in April while energy and food inflation was 8.4 per cent. The UK employment rate increased to 74.9 per cent (up by 117,000 in 2008Q1) but unemployment also increased by 14,000 in the first quarter although it was down by 83,000 over the year. The ILO unemployment rate is currently 5.2 per cent.

The Scottish economy

Scottish GVA grew by 0.9 per cent in 2007Q4 compared to 0.8 per cent in the previous quarter. Annual growth was 2.2 per cent in 2007 compared to 2.6 per cent in 2006. Services continued to drive Scottish growth increasing by 1.3 per cent in the latest quarter and by 3.4 per cent over the year. Growth in services was 2.9 per cent in 2006 and 2.7 per cent per annum over 2002 to 2006. Construction has been growing at 5.7 per cent per annum for the period

2002 to 2006 however in 2007 output declined by 1.7 per cent. Manufacturing grew by 0.9 per cent in 2007, the second year of positive growth.

Within the service sector the main drivers of fast growth continue to be transport, storage and communications (TSC), financial services and real estate & business services (REBS). TSC grew by 6.91 per cent per annum for the period 2002 to 2007 compared to 6.29 per cent per annum for financial services and 5.17 per cent per annum for REBS. In terms of growth the most important sector is REBS due to its significantly larger share of value added. Financial services demonstrated significantly stronger growth in the last quarter of 2007 compared to the contraction experienced in the second and third quarters.

The trend in employment and in unemployment is almost flat and there is little difference from one year ago. The Scottish employment rate is 76.5 per cent for Jan-Mar 2008, significantly better than the UK rate (74.9 per cent). The ILO unemployment rate is 4.7 per cent (124,000 persons) for the same period and is down by 7,000 over the year. The economic activity rate has slipped slightly since Jan-Mar 2007. Claimant count unemployment for April 2008 fell by 8,900 to 70,000 or 2.5 per cent (the rate in April 2007 was 2.9 per cent). Self-employment and the number of full-time workers also increased in the latest survey period. These indicators demonstrate that the labour market is relatively healthy. The resilience of the Scottish labour market will be a key factor in how the Scottish economy performs over the next two years.

Scottish manufactured exports grew by 3.0 per cent in 2007 but declined by 2 per cent in 2007Q4. Strong annual growth was recorded in wood, paper & publishing and in drink. In 2007Q4 chemicals & oil refining and other manufacturing expanded briskly. In the same quarter drink and metals contracted sharply. As the Euro Area picks up in 2009 then Scottish exports should benefit and become more important to GVA growth. In addition, since July 2007 the sterling ERI has depreciated by 12 per cent and the contribution of net trade is adding significantly to UK GDP (0.2 percentage points in the first quarter – half of all UK GDP growth in 2008Q1). Sterling is down 15 per cent against the Euro but only 4 per cent down on the dollar. The importance of trade to both the UK and to Scotland is likely to increase in the second half of 2008 and in 2009.

Retail sales indicators show that growth in April has slowed to 0.2 per cent compared to the Feb-Apr average of 1.4 per cent and to April 2007 growth of 4.6 per cent. Scottish engineering orders intake has been positive now for 19 successive quarters. Indicators for output volume, staffing and investment also remain firm. CBI data indicate that orders are being driven by export demand whereas domestic demand has cooled. The latter point is confirmed by the SCBS survey. RBS PMI data indicate that in April there was an overall decline in activity with price inflation remaining high. Manufacturing and services output indicators have fallen concurrently in April for the first time since May 2003. The PMI also shows a decline in employment, higher input costs and a decline in new business. The most recent PMI (May) indicates that there has been a second monthly decline in activity and the rate of contraction was the greatest since Oct 1998. The index fell from 48.3 in April to 46.8 in May. Both SCBS and CBI Scotland data indicate that prices are rising sharply. These data indicate some positive trends but also demonstrate the likelihood of weaker future economic performance anticipated in some sectors. Overall the surveys show a slowing of activity in the first half of 2008 and rising cost pressures.

Nevertheless, the Scottish economy is still performing relatively well given the external environment and the relatively healthy labour market. If exports pick up and there are no further adverse impacts from financial markets or prolonged inflationary pressures then economic performance may pick up in late 2008. It is more likely though that the slowdown will be felt slightly later on in the Scottish economy and will continue into the first half of 2009. The impact is also likely to be less severe than elsewhere in the UK as traditionally the Scottish economy tends not to have sharp peaks and troughs and is generally less sensitive to interest rate changes.

Final demand and assumptions

In this forecast consumption for 2008 and 2009 has been significantly reduced (see Table 1). There is also a sharp slowing in investment spending. Government spending is taken from the Scottish Budget and the estimates of demand for exports are for those exports to the rest of the world. Given that the Scottish economy does not suffer the same volatility as the UK (in cyclical terms) there is little expectation of a sharp contraction in Scottish growth. It is more likely that activity will slow gradually and recover in early to mid 2009 rather than towards the end of 2008. Further shakedowns in financial markets or prolonged price inflation have also been considered. Overall the central expectation is for little further serious adverse impacts from the financial markets. The probability is that there are still some losses to be announced and further rights issues are likely to take place. Firms in the financial sector that have moved quickly to correct the situation are more likely to do well in the future. There is no forecast of the oil price here although there are a plethora of forecasts out on the market. As with many other commentators the rising futures curve has been noted. It looks likely that the price may remain above $100 per barrel for some time but as to how long this may be is not known. The assumption here is that in the next two years supply increases slightly, speculation reduces and investment in productive capacity rises, particularly in marginal oil fields. These factors are likely to ease the situation.

Table 1: Forecasts of Final Demand, 2007-2010

	2007	2008	2009	2010
Consumption	1.8	1.4	1.2	1.6
Government	4.2	1.0	1.6	1.0
Investment	2.5	1.6	1.4	1.9
Exports	2.4	5.0	6.1	5.3

Source: Fraser of Allander Institute, June 2008.

The forecast in detail

Gross Value Added

The forecast for Scottish GVA growth is 1.9 per cent in 2008 and 1.7 per cent in 2009. In 2010 it is probable that real GVA growth will decrease marginally to 1.8 per cent and over the period 2009-12, growth is forecast to be 1.9 per cent per annum.

The service sector continues to drive Scottish growth and is forecast to increase by 2.5 per cent in 2008. Services are forecast to grow by only 1.9 per cent in 2009, primarily due to the uncertainty in financial services, but to recover to 2.2 per cent in 2010 with medium term growth of 2.3 per cent per annum. Manufacturing is forecast to continue to be positive through 2008 to 2010 as manufactured exports grow significantly. In both 2008 and in 2009 manufacturing growth is forecast to be more than 1 per cent. Construction output growth has been very strong recently but the decline in house prices and the impact of the credit crunch is likely to weigh upon the private residential and buy-to-let markets. The forecast is for the sector to contract by 2.1 per cent in 2008 before picking up in 2009 to 1.4 per cent. There are still a considerable number of public infrastructure projects that will contribute significantly to the sector. Agriculture, forestry and fishing is forecast to grow by 1.6 per cent in 2008 but thereafter performance is expected to weaken.

Table 2: Main Forecasts of the Scottish Economy 2007-2012

	2005-2007[1]	2008	2009	2010	2009-2012
GVA	2.4	1.9	1.7	1.8	1.9
Agriculture	0.0	1.6	0.6	-2.3	-1.9
Manufacturing	0.5	1.4	1.8	0.8	0.9
Construction	1.8	-2.1	1.4	1.6	2.0
Services	3.2	2.5	1.8	2.2	2.3

Source: Fraser of Allander Institute, June 2008.

[1]Note: 2005-07 and 2009-12 are per cent per annum while the years 2008-2010 are per cent.

Output

The strongest service sectors for 2008 are forecast to be transport and communication services (6.5 per cent) and REBS (2.8 per cent). After growth of only 2 per cent last year in financial services considerable uncertainty exists as to how that sector will perform this year and next. The forecast for 2008 is for growth of 1.8 per cent, which is considerably below the sector's historical average (8.2 per cent per annum) for 1998 to 2007. Similarly the forecast for REBS is significantly below its average of 4.1 per cent per annum (for the same period). The decline in retail sales has also resulted in a sharp decline in its forecast falling from 3.6 per cent in 2007 to 1 per cent in 2008. This is mainly due to the expected downturn in consumption as households become more nervous about their finances and as credit conditions become tougher. Looking to 2009 it is possible that retail will contract as may hotels and catering due to poor tourism performance. Retail is expected to pick up towards the end of the forecast becoming positive again in 2010. By 2010 the forecast is for financial services, transport services and REBS to recover and grow more strongly. Overall services will continue to drive economic growth, with growth only dipping below 2 per cent in 2008. In the medium-run growth in services is forecast to be 2.0 per cent per annum in 2009-12 with the strongest contributions coming from financial services (3.1 per cent per annum) and REBS (3.8 per cent per annum).

In manufacturing the best performing sectors in 2008 are forecast to be oil refining & nuclear fuel (7.1 per cent); chemicals (4.2 per cent) and metals (3.4 per cent); with textiles and wood, paper & publishing forecast to be the weakest sectors. Manufacturing growth is forecast to peak at 1.8 per cent in 2009 with oil refining (6.6 per cent); chemicals (3.6 per cent); mechanical engineering (2.9 per cent) and transport equipment (3.7 per cent) making relatively important contributions to growth. Transport equipment is forecast to make a much more telling role in manufacturing during the years 2009-12 when growth is forecast to be 7.3 per cent per annum, due to MoD orders in shipbuilding. In the medium-term manufacturing is forecast to grow by 0.9 per cent per annum, which is good given its previous performance.

The forecast for agriculture is optimistic for 2008 but recognising the weakness of the sector the growth pattern weakens over the years. Over each year of 2009 to 2012 the sector is forecast to contract. The outlook for construction is better. The sector had being growing at quite a fast rate, over 2002-06 it grew by 5.7 per cent per annum and is forecast to grow by 2 per cent per annum for 2009-12. This reduction in activity again stems from the uncertainty in financial markets and in particular the housing market. As house prices have fallen then so has activity in the market as credit conditions worsen. The assumption is that the sector will pick up again but going forward banks will re-price risk thus deposits, income multipliers and value-to-loan ratios will tighten making lending restrictions tighter. From the financial sectors'

Table 3: Forecasts of Scottish Employment (000s) and Net Employment Change, 2007-2010

	2007	2008	2009	2010
Total Employment	2,382.4	2,391.2	2,401.1	2,418.8
	(8,500)	(8,800)	(9,900)	(17,900)
Agriculture	32.3	32.3	30.3	29.4
	(1,100)	(0)	(-2,000)	(-900)
Manufacturing	222.2	223.3	224.1	224.3
	(-1,100)	(1,100)	(800)	(200)
Construction	139.1	135.1	138.5	141.2
	(0)	(-4,000)	(3,400)	(2,700)
Services	1,949.7	1,961.4	1,972.7	1,990.1
	(5,200)	(11,700)	(11,300)	(17,400)

Source: Fraser of Allander Institute, June 2008

viewpoint however this is a prudent move that will ensure stability in the market. By 2010 construction is forecast to grow by 1.6 per cent and improve in both 2011 and 2012. Private investment, public works and commercial property will all contribute to the expansion from 2009 onwards.

Table 4: Forecasts of Scottish Unemployment, 2007-2010

	2007	2008	2009	2010
ILO				
Unemployment	128,800	122,000	118,300	114,100
Rate (16+)	4.8%	4.6%	4.4%	4.2%
Rate (15-59/64)	5.0%	4.8%	4.6%	4.4%
Claimant Count	78,100	65,200	62,700	57,100
Rate	2.8%	2.3%	2.2%	2.0%

Source: Fraser of Allander Institute, June 2008

Overall, the forecast for the Scottish economy is optimistic but that is primarily because current data indicate that the economy is on an upward trend and has been for some time. The economy should experience a slowdown in 2008 and 2009 but the slowdown is not marked and the economy will recover thereafter.

Employment

Our forecasts of employment are presented in Table 3 with the net employment change figure in brackets. (The employment figures are calibrated on the employers' quarterly survey series as given in Table 6.06 in Economic and Labour Market Review, National Statistics.)
Employment is forecast to increase to 2,391,200 in 2008 from 2,382,400 in 2007. This is a net job gain of 8,800, which is similar to that of last year. In 2009 employment is forecast to be 2,401,100, a net gain of 9,900 jobs. In 2010 the net job gain is forecast to be 17,700 and over the period 2009-2012 the forecast is for 93,800 jobs to be added to the economy.

The service sector again continues to drive employment gains. In 2008 the net job gain is forecast to be 11,700 and to be 11,300 in 2009. This increases to 17,400 in 2010 and for the period 2009 –12; 90,500 jobs are forecast to be created in the service sector. The public sector, REBS and TSC services are expected to be the largest providers of jobs. For each of these sectors for 2009 -12 the forecast job gains are: 16,500; 38,200 and 15,400 respectively. The only years where there are contractions in service sector employment are 2008 (hotels & catering, other services and financial services); in 2009 (retail, other services and financial services) and 2010 (hotels and catering). The pattern of growth and employment change reflects anticipated patterns in consumption expenditure and disposable income.

Manufacturing has experienced a steady decline in employment in recent years. The forecast is that this will be reversed in 2008 when nearly 1,100 jobs will be created. Job gains are forecast to continue in the years 2009 until 2010 but a net job loss is forecast to occur in 2012. Productivity is stronger in manufacturing than in services and this contributes to lower job gains in the later years of the forecast particularly as investment rises. Other manufacturing and metals are forecast to have a positive change in each year of the forecast. The food and drink sectors are forecast to gain jobs in each year except 2012. The weakest sectors will probably be textiles; wood, paper and publishing and mechanical engineering with job losses over 2009-12 of 3,100; 2,300 and 1,700 respectively.

Agriculture employment is forecast to be flat in 2008 and to lose 1,100 jobs in 2009. Thereafter the sector is expected to lose jobs as workers move to other sectors. Mining and quarrying as well as electricity, gas and water supply are also forecast to lose jobs in most years of the forecast.

Construction experienced strong net job gains in 2006 (4,700) and in 2007 (12,500). However with the drop in growth the sector is forecast to lose 4,000 jobs in 2008 taking the number of employees to 135,100. In each year thereafter the net job gain is forecast to be positive and the forecast for 2009-12 is for 14,100 jobs to be created in this sector. This forecast relies on the assumptions discussed above with regard to the recovery of private housing demand and no further serious adverse impacts from the housing or financial markets. It also assumes that there is not a prolonged period of high oil prices that transmits into high UK inflation.

Unemployment

The forecasts of unemployment are presented in Table 4. Both the ILO measure and claimant count measure are given. The preferred measure of unemployment however is ILO unemployment as given by the LFS using the 15-59/64 age group.

Scottish unemployment is relatively low by historical standards (5 per cent in 2007). The forecast is for a steady reduction in unemployment to 4.2 per cent in 2010. There is more uncertainty about the forecast for 2009 as there is not enough information about the degree of recovery in the economy or any further adverse impacts. In the first quarter of 2008 unemployment did not rise as it did in mid 2007. Despite fears of the impact of an economic slowdown, there are few signs neither that there will be significant job losses nor that any job losses will translate into large increases in unemployment. The trend in unemployment is currently flat. It is likely that as economic performance improves (either the second half of 2008 or in 2009) then unemployment will reduce more significantly than in 2008. The downside to this is that the indications are that those who lose their jobs are more likely to enter economic inactivity or if they are migrants leave the labour market by returning home. There is little evidence to suggest unemployment should deviate away from its medium-term trend as opposed to remaining close to its current trend. One of the main factors here is the absence of sharply rising pay pressures although firms are undoubtedly facing rising costs elsewhere

Kenneth Low
10 June 2008