

The Scottish economy

Forecasts of the Scottish economy

Economic background

Growth in the world economy remains relatively strong despite a significant rise in oil prices and a slight slowing in the US. China and Indian continue to grow very strongly while Euro Area performance is better than was expected. Inflation in most economies has moderated since the third quarter of 2006 as energy prices have declined significantly. Survey evidence in the world economy is positive and encouraging. Exchange rates are of little concern just now and the main risks to the economy continue to be a further sustained rise in oil price, global imbalances and spillovers from the US housing market slowdown to asset markets. The latter would significantly affect growth across the developed economies.

In the UK real GDP growth was 2.7 per cent in 2006 and 0.8 per cent in the last quarter. This compares with 1.9 per cent in the previous year and 0.7 per cent in the previous quarter. The contribution to GDP is more likely to be broadly based in the coming years whereas it had been dependent upon consumption and government spending. CPI inflation was 3.0 per cent in 2006Q4 and may be the peak of inflation given that energy prices have declined significantly since September. Interest rates have remained at 5.25 per cent but it is likely they will rise to 5.5 per cent in 2007. The labour market remains buoyant in the UK. There are few concerns over the public finances or the current account.

The Scottish economy

The chained volume measure of GVA (2003 = 100) for Scotland grew by 0.5 per cent in the third quarter of 2006 compared to 0.6 per cent in the previous quarter and 0.5 per cent in the same quarter last year. On an annual basis GVA grew by 2.3 per cent up to 2006Q3. Trend growth for the Scottish economy is generally accepted as 1.9 per cent per annum (see Table A for growth comparisons with the UK) although it is often referred to as being lower than this. Given the historical performance of the Scottish economy the current growth rate is above average. However, in order to permanently raise the growth rate to a new higher trend level of growth a little more intelligent economic policy-making is required – similar to the objectives of a Smart, Successful Scotland. This is a frequent observation by many other commentators. When examining UK growth, it grew by 0.7 per cent for 2006Q3 on Q2 and the growth rate was unchanged from the previous quarter. Overall, UK GDP growth was 2.6 per cent in 2006Q3 and 2.7 per cent for 2006Q4 on an annual basis. This compares with UK

growth of 1.9 per cent in 2005 and 3.3 per cent in 2004 – the latter considerably stronger than Scottish GVA growth.

Table A, Trend growth in the Scottish and UK economies, 1960 to 2005

Time period	Scotland	UK
1963-2005	2.10	2.41
1965-2005	1.94	2.33
1975-2005	1.81	2.31
1960-69	-	2.93
1963-69	2.10	3.03
1970-79	1.89	2.31
1980-89	1.90	2.79
1990-99	2.08	2.28
2000-05	1.81	2.63

Source data: Scottish Executive GVA Quarterly Index

In the Scottish economy services increased by only 0.4 per cent in 2006Q3 compared to 0.8 per cent in the previous quarter. The latest four quarters on the preceding four quarters demonstrates that service sector growth was 2.8 per cent compared to 3.2 per cent for 2005 as a whole and also against growth of 0.7 per cent growth in UK services for 2006Q3 and 1.5 per cent for 2005. This underperforming of the service sector is probably the reason for the relatively weak employment growth, compared to other years.

Scottish manufacturing contracted by 0.4 per cent in 2006Q3 compared to a decline of 0.6 per cent in 2006Q2. For the latest four quarters on the preceding four quarters manufacturing contracted by 0.3 per cent. UK manufacturing grew by 0.6 per cent in 2006Q3 and increased by 0.1 per cent on an annual basis up to the third quarter. Manufacturing is still dogged by problems in electronics and the traditional manufacturing sectors. Construction grew by 2.4 per cent in 2006Q3 compared to only 0.4 per cent in the second quarter. Growth on an annual basis was very strong at 5.5 per cent. UK construction only increased slightly over the year at 0.3 per cent while quarterly growth for 2006Q3 was 0.7 per cent.

The Scottish labour market remains buoyant with employment in Oct-Dec 2006 reaching 2,507,000, up 33,000 from 2,474,000 in Jul-Sep 2006. The employment rate was 76.1 per cent in Oct-Dec 2006 compared to 75.2 per cent in the previous period. In comparison the UK employment rate is only 74.5 for Oct-Dec 2006, unchanged from the previous period. In Scotland the economic activity rate rose to 80.3 per cent from 79.2 per cent in the previous period. The UK economic activity rate remained unchanged at 79.0 per cent. In Oct-Dec 2006 Scottish ILO

unemployment increased by 7,000, from 131,000 (5.1 per cent) to 139,000 (5.3 per cent). UK unemployment on the ILO measure remains higher than that in Scotland, at 5.6 per cent. Over the year Scottish employment has increased by 42,000 and unemployment has risen by 3,000. Other indicators of employment and economic activity were also positive for the third quarter period. Civilian workforce jobs increased by 18,000 in September over June 2006; employees rose by 44,000 over the year up to Oct-Dec 2006; full-time, part-time, workers with second jobs and temporary workers all increased over the period and the year. Claimant count peaked at 88,900 in June 2006 and has declined to 84,800 in December 2006. Provisional data suggest that it has fallen to 81,800 in January 2007. The rates for June 2006, December 2006 and January 2007 are 3.3 per cent; 3.2 per cent and 3.1 per cent respectively. Only the number of self-employed and the number of WRGTP declined in the period Oct-Dec contrary to other labour market movements. With respect to growth and previous employment conditions the outlook for the Scottish labour market remains promising.

Scottish manufactured exports decreased by 0.8 per cent for 2006Q3 but on an annual basis grew by 3.5 per cent. Positive quarterly growth in manufactured exports was observed in: transport equipment at 5.8 per cent (6.6 per cent annually); mechanical engineering at 5.7 per cent (7.4 per cent annually); chemicals at 2.5 per cent (2.7 per cent annually) and textiles at 2.1 per cent (-0.6 per cent annually). The weakest performing sector was food at -5.8 per cent (-6.1 per cent) although other manufacturing exports declined by 11.1 per cent in the third quarter whereas they grew by 3.7 per cent on an annual basis. We still remain optimistic about export performance given the pick-up in the Euro Area. Our trade is weighted towards the US, the rest of the UK and the main markets of Europe (in particular France and Germany). Given the balance of trade and growth we are relatively unconcerned about threats to export markets.

The Scottish Chambers of Commerce Business Survey for the fourth quarter of 2006 indicates a rising trend in demand, increased activity in manufacturing (work in progress) and a greater degree of occupancy in the tourism sector. There are also signs of increasing investment. There are some concerns over rising costs especially due to increased fuel costs and in some sectors skills appear to be a problem. Manufacturing appears to be running at only 75 per cent of capacity and construction at 80 per cent so even given the significant growth forecast in construction, there does not seem to be a binding capacity constraint. Manufacturing clearly has a significant degree of slack in the sector. Manufacturing export orders and optimism have now risen for nine months in a row and expectations on profitability and turnover remain strong in manufacturing. Although tourism reported a higher net occupancy rate, it did experience weaker than expected visitor numbers and a slight decline in confidence. Tourism also reported falling

employment, falling overtime and recruitment difficulties in finding the appropriate staff.

Again, we believe that the Scottish economy is performing relatively well, although manufacturing still gives us cause for concern. Forecast growth is slightly above trend for the next two years, which is promising. Although some of the most recent survey data has been mixed there are clear indications of strong retail sales growth, a general improvement in optimism despite a squeeze on prices due to increased energy costs and continued employment growth. The labour market continues to perform well with an employment rate that is significantly above that of the UK as well as relatively low unemployment. We remain optimistic about the outlook for the Scottish economy over the next few years.

The forecast in detail

GVA

Scottish GVA is forecast to be 2.3 per cent in 2006 and 2.2 per cent in 2007. It is forecast to grow slightly below this at 2.1 per cent in 2008. Within GVA the main driver of growth continues to be the service sector with a weight of 720 (2003 weights) and forecast growth of 2.9 per cent. Services are forecast to grow by 2.8 per cent in 2007 and by 2.6 per cent in 2008. Construction appears to be enjoying considerably strong growth in 2006 at 5.8 per cent and forecast to grow at 4.4 per cent in the next year. Agriculture remains weak with growth forecast to contract by 1.9 per cent in 2006 and by 0.8 per cent in 2007. The switch to a more broad-based growth (consumption, government, investment and exports) is a significant factor in keeping growth above 2 per cent per annum.

Table 1 Main Forecasts of the Scottish Economy, 2005-2008

	2005	2006	2007	2008
GVA	2.1	2.3	2.2	2.1
Agriculture	-1.4	-1.9	-0.8	-0.3
Manufacturing	-0.6	-0.3	0.2	0.3
Construction	2.6	5.8	4.4	4.2
Services	3.3	2.9	2.8	2.6

Source: Fraser of Allander Institute, March 2007

Final demand

There is still evidence of strong consumption in Scotland with retail sales growth surging ahead. Consumption, investment and government spending remain the key drivers of Scottish GVA growth. Services in particular, also are key areas that have seen an upturn in demand. As the prospects in the Euro Area improve then Scottish export

growth is forecast to be much more significant in 2007 and 2008. Export growth may decline somewhat after that. The main factors affecting the forecast are given below:

- consumption remains robust particularly over 2007 and 2008;
- investment was relatively strong in 2006 and may become more important in 2008;
- Tourism was disappointing in 2006 and probably will improve in 2007 but remains a relatively poor contributor to Scottish GVA (using hotels and catering growth as a proxy) and
- Scottish export performance is still relatively poor, especially in manufacturing. Exports to the Rest of the UK are forecast to demonstrate steady growth whereas exports to the Euro Area (and the Rest of the World) are more likely to grow significantly from 2007 onwards. This is due to the increase in domestic demand in Europe as economic growth picks up.

Output

While Scottish growth is forecast to be relatively strong over 2006 to 2008 there are differing contributions to that growth. In the service sector growth is forecast to be 2.9 per cent in 2006, 2.8 per cent in 2007 and 2.6 per cent in 2008. Within services there are two important but contrasting forces driving growth and employment. High growth is forecast in transport, storage and communication services (TSC); financial services (FS) and in real estate and business services (REBS). However, with the exception of REBS, the weight of these sectors are; 77 and 70 respectively. REBS has a weight of 187 and public services has a weight of 218 therefore are a much bigger sector of the economy. REBS therefore is a very significant driver of the service sector. Public services continue to be an important source of employment in Scotland. In TSC because the weight of the sector is relatively low the growth is not such a vital consideration. The very high levels of growth forecast in the financial services sector however, do make it an important driver of overall growth.

Manufacturing declined by 0.6 per cent in 2005, is forecast to contract by 0.3 per cent in 2006 and finally to grow by 0.2 per cent in 2008. Manufacturing has for the last two years showed promising signs of recovery only to present a succession of contracting figures with a still, significant number of closures in each quarter. Electronics has not yet recovered sufficiently to bolster manufacturing output and transport equipment is the strongest growing manufacturing sector for 2006. Textiles and paper, printing and publishing are another two sectors that have contracted significantly over 2006 and are forecast to remain in decline.

Agricultural output was disappointing for 2006, although final data are not available. It is likely it will decrease by 1.9 per cent in 2006 and that a further decline in output will be seen in 2007. We do not expect any significant increase in

agricultural output until near the end of the decade. Electricity, gas and water supply (EGW) is forecast to grow by 5.2 per cent in 2006, partly due to resurgence in some industries (particularly chemicals and metals). It is likely

Table 2, Forecasts of Scottish Employment (000s) and Net Employment Change, 2005-2008

	2005	2006	2007	2008
Total Employment	2,327.8 (32,000)	2,339.2 (11,400)	2,358.6 (19,400)	2,374.2 (15,600)
Agriculture	30.8 (800)	31.0 (300)	30.3 (-700)	29.9 (-400)
Manufacturing	232.5 (-5,300)	226.3 (-6,200)	225.0 (-1,300)	223.5 (-1,500)
Construction	124.5 (2,300)	133.0 (8,500)	137.2 (4,100)	141.1 (4,000)
Services	1,901.5 (33,300)	1,908.8 (7,300)	1,926.2 (17,400)	1,939.8 (13,600)

Source: Fraser of Allander Institute, March 2007

that although growth will remain positive in the period 2007 to 2008, it will slow significantly. Construction growth has been very strong since 2003 and has grown at 5.5 per cent per annum over the period 2003 to 2006. It is also forecast to grow strongly over 2007 to 2008. The main reason for this is the number of public investment projects being delivered through the PPP initiative coupled to an already strong demand for private residential investment.

Employment

Our forecasts of employment are presented in Table 2 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 jobs are forecast to rise from 2,327,800 in 2005 to 2,339,200 in 2006. In 2007 the forecast is for there to be 2,358,600 jobs rising to 2,374,200 in 2008. The net job gain for 2006 is forecast to be 11,400 which is surprisingly low given the growth rate in GVA (2.3 per cent) but this may be due to the very strong employment growth in 2005 (32,000 jobs) that helped boost GVA in 2006.

There may be yet some revision to the employers' quarterly survey, as the latest data present a net job loss in retail (large contraction in this sector) and in hotels and catering.

Migration has undoubtedly boosted both economic and employment growth in 2006 in Scotland. It is difficult to ascertain whether migrants add to the labour market

across all sectors or whether they boost low wage sub-sectors significantly more than high wage sub-sectors as the data does not exist to measure this.

Services are not such a strong driver of jobs growth in 2006 as in previous forecasts. This is primarily due to the forecast decline in retail of 4,700 jobs along with the loss of 2,500 jobs in hotels and catering. TSC services are forecast to lose 700 jobs and other services are only forecast to increase by 500 jobs. Overall in 2006, jobs are forecast to increase to 1,908,800 from 1,901,500 in 2005. This is a net change of 7,300 compared to our net change forecast of 16,000 in 2006Q4. Service sector employment growth is forecast to increase significantly in 2007 and 2008 by 17,400 and 13,600 respectively. The public sector and REBS continue to be the main sectors driving employment growth.

Manufacturing jobs are forecast to decline by 6,200 in 2006 after losing 5,300 jobs in 2005. The job loss in 2007 and 2008 is forecast to be 1,300 and 1,500 respectively.

Electronics continues to suffer closures and job losses in 2006 and paper, printing and publishing; textiles; chemicals; metals; food and other manufacturing are forecast to have significant job losses in 2006. Looking

forward to 2007 and 2008 some sectors improve slightly but given that manufacturing productivity growth has recently been substantial then it is more likely that investment in capital will continue and consequently job

losses will continue into the near future.

Table 3 Forecasts of Scottish Unemployment, 2005-2008

	2006	2007	2008
ILO Unemployment	138,100	131,200	130,000
Rate	5.3%	5.2%	5.2%
Claimant Count	87,200	84,400	80,200
Rate	3.3%	3.3%	3.2%

Source: Fraser of Allander Institute, March 2007

Agriculture is forecast to gain 300 jobs in 2006 despite growth being -2 per cent while jobs losses of 700 and 400 are forecast for 2007 and 2008 respectively. Construction offers a welcome boost to employment as above trend growth has been responsible for strong net job creation in the sector. The forecast is for an increase in the number of jobs from 124,500 in 2005 to 133,000 (up by 8,500) in 2006. The forecast for 2007 is a net gain of 4,100 and for 2008 the number of jobs is forecast to rise to 141,100 (up 4,000).

Unemployment

We present our forecasts of unemployment in Table 3. Both the ILO measure and claimant count measure are given. The preferred measure of unemployment however is ILO unemployment as given by the LFS.

Unemployment in Scotland is forecast to remain at historically low levels with the ILO unemployment forecast for 2007 being 131,200 (5.2 per cent) and for 2008 130,000 (5.2 per cent). The unemployment rate is virtually unchanged at just above 5 per cent across the forecast period. Unemployment has increased slightly from 131,000 in Jul-Sep 2006 to 139,000 in Oct-Dec 2006. It is expected to decline however during 2007. Claimant count was 87,200 (3.3 per cent) in 2006. It is forecast to fall to 84,400 in 2007 (3.3 per cent) and 80,200 (3.2 per cent) in 2008. There is little evidence to suggest that unemployment will deviate from its trend in the foreseeable future.

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