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The Scottish economy

Forecasts of the Scottish economy

Economic background

While the world economy slowed slightly in 2005 it is now clear that strong growth remains in the US, Japan, China, India and several other non-OECD countries. While the Euro Area has been a slow performer there are now signs of a broad based recovery even in Germany. We suggest that there is still a problem translating increased activity into higher incomes and therefore Germany could be losing out on some consumption gains. The US is forecast to grow by 3.3 per cent in 2006 and by 2.9 per cent in 2007 with Japan growing by 2.9 and 2.3 per cent respectively. However across the Euro Area domestic demand is strengthening and this bodes well for UK exporters. The only significant downward effect on demand in Europe is likely to come from the VAT increase in Germany. The forecast for the Euro Area is 2.1 per cent in 2006 and 2.0 per cent in the following year. Global inflationary pressures are relatively subdued but not absent as there is a decreased dependency on oil on behalf of the major economies of the world. There is little expectation that the recent high oil price will be transmitted into a wage-price spiral. The indications are that there will be further monetary tightening in the world economy as economic activity gathers pace. Labour markets are also expected to perform well over the forecast horizon. The outlook for non-OECD countries especially China and India remains very healthy.

UK GDP growth was 0.6 per cent in 2006Q1 after 2005Q4 growth of 0.6 per cent. Growth of GDP over the four latest quarters was 2.2 per cent. GVA at basic prices also grew by 0.6 per cent in the latest quarter. Consumption growth slowed dramatically to 0.2 per cent in 2006Q1 after growth of 0.7 per cent in 2005Q4. This may be temporary, resulting in average consumption growth of around 0.5 per cent but it could be a signal that the composition of spending is changing towards investment and trade. The contribution made by net trade recently has been relatively neutral but this is expected to improve modestly. UK inflation is close to target and interest rates have been maintained at 4.5 per cent although there are increasing signs that a further 25 basis point rise is coming this year. The UK labour market has performed strongly although unemployment and long-term unemployment are rising. The economy simply is not creating enough jobs for those joining the labour force. The main risks to the economy remain imbalances in the global economy, a significant correction to the US or UK housing market although it is unlikely that high oil prices will feed through into the wage bargain in an adverse manner. The UK economy is gaining

momentum with the balance of risks shifting towards the positive. UK survey evidence is promising and the forecast for UK GDP growth is 2.3 and 2.5 per cent in 2006 and 2007 respectively.

The Scottish economy

GVA growth in the Scottish economy was 0.6 per cent for 2005Q4 on 2005Q3 or 1.8 per cent for the four latest quarters on the preceding four quarters. Comparing the Scottish GVA index to the UK index it can be seen that both economies grew by 1.8 per cent in 2005. If oil and gas are excluded however the UK marginally outperforms Scotland with growth of 2.0 per cent compared to 1.9 per cent in Scotland. The service sector grew by 0.7 per cent in the latest quarter compared to 1.0 per cent in the UK while annual growth was 2.8 per cent, identical to that of UK services. Scottish manufacturing contracted by 0.2 per cent in 2005Q4 (-1.1 per cent in the UK) and over the year the decline was 0.8 per cent (-1.1 for the UK). Agriculture decreased by 0.8 per cent in the latest quarter compared to a contraction of 0.6 per cent in the UK. The annual figures were 0.5 per cent and -0.8 per cent for Scotland and the UK respectively. Although we had previously warned of four consecutive quarters of decline in electronics in 2005, the sector had significant data revisions that saw no change in the second quarter and growth in the third quarter. Growth in Scottish construction was 2.1 per cent in 2005Q4 compared to 1.3 per cent in the UK. On an annual basis the figures were 0.2 and 1.1 per cent respectively.

Labour market performance remains strong despite the fact that the recent trend in employment is broadly flat. The employment rate is close to that at the same time last year. Unemployment is decreasing but similarly is not significantly different from this time last year. Scottish employment declined by 4,000 in January-March 2006 and over the year only grew by 3,000 whereas UK employment increased by 127,000 (up 0.6 per cent) in January-March 2006 and by 217,000 (up 1.3 per cent) over the year. Scottish employment was 2,464,000 in January-March 2006 or an employment rate of 75.3 per cent. For January-March 2005 the data were 2,606,000 and 75.3 per cent. The UK employment rate is currently 74.7 per cent and one year ago was 74.9 per cent. ILO unemployment in Scotland was 1,586,000 in January-March 2006, an increase of 44,000 (up 2.9 per cent) over the quarter and a rise of 177,000 (up 12.6 per cent) over the year. The unemployment rate is similar to the UK rate at 5.3 per cent (UK is 5.2 per cent) and one year ago the rates were 5.6 per cent and 4.7 per cent respectively. Claimant count in Scotland was 88,000 (3.3 per cent) in April 2006 compared to 945,500 (3.0 per cent) in the UK. Last year Scottish claimant count was 86,100 (3.2 per cent) compared to 839,200 (2.7 per cent) in the UK. Clearly, UK claimant count is lower than the Scottish rate. The economic activity rate in Scotland for January-March 2006 was 79.6 per cent compared to 79.9 per cent one year ago. In the UK these data are 78.8 per cent and 78.6 per cent respectively. The Scottish labour market continues to slightly outperform the

UK in some respects (higher employment rate, maintaining the unemployment rate, UK relative deterioration in claimant count and a marginally better economic activity rate).

Scottish manufactured exports grew by 1.9 per cent in 2005Q4 but declined by 1.9 per cent over the year. The sectors with the strongest growth include: metals at 9.0 per cent (5.6 per cent annually); transport equipment at 8.0 per cent (3.2 per cent annually); chemicals 7.8 per cent (-4.7 per cent annually) and other manufacturing at 5.5 per cent (1.3 per cent over the year). The weakest sectors were drink, contracting by 5.9 per cent (growth of 7.1 per cent over the year); textiles declined by 4.3 per cent (decreased by 3.9 per cent over the year) and electronics which grew by 2.5 per cent in 2005Q4 but over the year contracted by 11.5 per cent.

The Scottish Chambers of Commerce Business Survey demonstrated a rise in business confidence in construction and retail, a level rate in wholesale and an easing in manufacturing and retail. The rising trends were reported by both small and large firms which, indicates that this optimism is evenly spread across these sectors. Tourism respondents reported better than anticipated activity while the service sector reported increased demand for wholesale and logistics. Manufacturing respondents reported a modest rise for work in progress but average capacity remained at 79 per cent although the number working below optimum levels eased to 39 per cent. The main concerns expressed related to raw material and transport costs and to a lesser extent fuel costs. Pay increases in the first quarter ranged from 3.2 per cent in retail to 5.2 per cent in construction. Recruitment activity was higher in manufacturing and tourism but was lower in construction, retail and wholesale. Respondents were more cautious about the next twelve months with regard to turnover and profitability. Price pressures also appear to be getting stronger.

The Scottish economy continues to perform relatively well and the signs for the manufacturing sector are now much more positive. Several manufacturing sectors have steady output growth although the annual trend in textiles, ORNF and electronics remains a cause for concern. The stimulus from European export markets is expected to strengthen as activity picks up in the Euro Area and this will have significant benefits for the Scottish economy. This is the context to our forecasts for the Scottish economy.

The forecast in detail

GVA

The forecast for GVA for 2006 is 2.1 per cent. In 2006 the forecast is for growth of 2.1 per cent followed by 2.3 per cent in 2007. Services are forecast to grow by 3.0 per cent in 2006 and by 2.8 per cent in 2007. Manufacturing is forecast to grow by 0.1 per cent in 2006 and by 1.5 per cent in 2007. Agriculture is forecast to increase by 1.1 per

cent in 2006. Growth in this sector is forecast to be relatively mediocre over the forecast horizon. Construction growth appears to be hampered by supply constraints.

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

| | 2005 | 2006 | 2007 | 2008 |
|---------------|------|------|------|------|
| GVA | 1.8 | 2.1 | 2.3 | 2.2 |
| Agriculture | 0.5 | 1.1 | 1.0 | 0.6 |
| Manufacturing | -0.8 | 0.1 | 1.5 | 1.3 |
| Construction | 1.3 | 0.8 | 1.2 | 2.4 |
| Services | 2.8 | 3.0 | 2.8 | 2.6 |

Source: Fraser of Allander Institute, June 2006

Final demand

Consumption, investment and government spending remain the key drivers of the economy in Scotland. Export growth is improving and is expected to be much more important in 2007 and 2008. The main factors affecting the forecast are given below:

The Scottish economy does not appear to have experienced the same sort of slowing as the UK economy at the end of 2005 consequently it is unlikely that Scottish consumers have cut back on consumption as that reported in 2006Q1 in the UK where consumption growth slowed to 0.2 per cent from 0.7 per cent in 2005Q4;

Investment growth is forecast to pick-up more strongly in 2007 and 2008 than we previously expected;

Tourism has been better than anticipated but there is still a significant pick-up in tourism which may come when the Euro Area growth strengthens further in 2007 and 2008 and

Exports have grown at 1.9 per cent in 2005Q4 but contracted by 1.8 per cent over the year. Exports are still affected significantly by electronics but textiles and food also contracted their activity in 2005.

Output

Agriculture has continued to be a mediocre performer and the forecast for 2006 is 1.1 per cent and a similar rate of growth is expected in 2007. There are several challenges facing the sector in the short and medium-run. Electricity, gas and water supply is forecast to contract although at a decreasing rate over the forecast horizon. A significant expansion in the manufacturing sector and a solution to the energy question (nuclear or renewables) will reduce the uncertainty that surrounds this sector. Construction only grew by 1.3 per cent in 2005 and it is forecast that if the

housing market does not slow down and the number of PPP projects remain at the current level then growth will be constrained by the lack of supply of labour, finance and equipment. The contributions of both construction and manufacturing to Scottish GVA would normally be expected to be more significant.

Manufacturing contracted by 0.8 per cent in 2005 and the forecast for 2006 is 0.1 per cent and for 2007 it is 1.5 per cent. Survey data and anecdotal evidence all point to a stronger degree of confidence in the sector and European demand is expected to help stimulate exports from the sector in 2007. The strongest sectors within manufacturing in 2005 were: chemicals (7.0 per cent growth on an annual basis) transport equipment (3.2 per cent) and both drink and mechanical engineering (1.5 per cent). ORNF remains volatile and the weakest performers were textiles (-12.9 per cent); electronics (-8.2 per cent) and ORNF (-7.8 per cent). For 2006 and 2007 the sectors with the strongest forecasts include transport equipment, chemicals and food.

Services drive growth and employment in Scotland, more recently and are forecast to continue to do so. The forecasts for services for 2006 and 2007 are 3.0 per cent and 2.8 per cent respectively. Within services the fastest growing sectors include financial services and real estate and business services. Public services are very important with respect to employment. Both stronger expected tourism flows and increased retail sales drive forward increases in service sector growth. Financial services and the housing market are two key drivers of growth in this sector. Growth in the service sector is forecast to be 2.7 per cent per annum for 2006 to 2008 compared to 1.4 per cent per annum in manufacturing in the same period.

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 B.16 in Labour Market Trends, National Statistics.

The employment (jobs) forecast for 2006 is 2,288,500 and 2,309,200 for 2007. This is a net job change of 16,700 and 20,700 respectively. The employment forecast for 2008 is 2,329,700 which is a net job change of 20,700. Services are the critical driver of employment across the medium-term although manufacturing employment will become more important from 2007 onwards. Employment growth in construction is likely to be more significant towards the end of the forecast period.

The service sector is forecast to have 1,814,000 jobs in 2006 (an increase of 14,700 jobs) and 1,830,300 jobs in 2007 (a rise of 16,300). In 2008 the service sector will provide 1,844,700 jobs (a net change of 14,400 on the previous period).

In manufacturing we forecast a net gain of 1,400 jobs in 2006 taking the number of jobs to 250,100. In the following year we are forecasting 3,300 new jobs in manufacturing giving 253,400 jobs overall. Manufacturing output and employment is mainly driven by the exporting sectors in 2007 and 2008.

Construction employment is forecast to be 146,400 in 2006 (an increase of 700 jobs) and 147,600 in 2007 (a rise of 1,200 jobs). In 2008 employment is forecast to increase to 150,000. Construction employment gains may be limited because of the supply constraints on the industry. Agricultural jobs have little change in this forecast.

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

| | 2005 | 2006 | 2007 | 2008 |
|------------------|---------------------|---------------------|---------------------|---------------------|
| Total Employment | 2,271.8 (13,200) | 2,288.5 (16,700) | 2,309.2 (20,700) | 2,329.7 (20,500) |
| Agriculture | 36.8 (0) | 36.9 (100) | 37.1 (200) | 37.1 (0) |
| Manufacturing | 248.7 (-900) | 250.1 (1,400) | 253.4 (3,300) | 257.2 (3,800) |
| Construction | 145.7 (-1,000) | 146.4 (700) | 147.6 (1,200) | 150.0 (2,400) |
| Services | 1,799.3 (15,600) | 1,814.0 (14,700) | 1,830.3 (16,300) | 1,844.7 (14,400) |

Source: Fraser of Allander Institute, June 2006

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.

Table 3 Forecasts of Scottish Unemployment, 2006-2008

| | 2006 | 2007 | 2008 |
|------------------|---------|---------|---------|
| ILO Unemployment | 139,000 | 136,900 | 134,200 |
| Rate | 5.3% | 5.3% | 5.2% |
| Claimant Count | 84,200 | 83,700 | 82,900 |
| Rate | 3.2% | 3.2% | 3.1% |

Source: Fraser of Allander Institute, June 2006

As in previous forecasts the outlook for unemployment is relatively upbeat. Our forecasts of unemployment for 2006-08 demonstrate a gradual downward trend despite the recent small rise in unemployment. The forecast for the ILO unemployed is 139,000 (5.3 per cent) in 2006 and 136,900 (5.3 per cent) in 2007. The claimant count is also forecast to decrease across the forecast horizon. The 2006 forecast is for claimant count of 84,200 (3.2 per cent) and only moving down marginally to 82,900 (3.1 per cent) by 2008. We remain convinced that Scottish unemployment will be at low and stable levels over the forecast period. Given the recent performance of the Scottish labour market we do not see any reason to change our opinions over unemployment.

Kenneth Low
26th June 2005

