

# The Scottish economy

## Forecasts of the Scottish economy

### **Economic background**

There are clear signs of a slowing in the world economy. Europe is a particular concern for the Scottish economy with no sign of pick-up in activity until 2007. The expected slow depreciation of sterling over the next two years will probably contribute to increased export growth for the UK. Growth in the world economy was very strong in 2004 and is expected to be relatively strong in 2005 although there are marked discrepancies across countries. The US and China, both have demonstrated working population growth and strong productivity gains. In Japan and the Euro Area where growth is poorer, neither of those factors was achieved. Euro Area growth is expected to be relatively modest in 2005 and labour market reforms are needed to boost growth.

The UK economy grew by 3.1 per cent in 2004 and by 0.4 per cent in the first quarter of 2005. Forecasts for the UK economy have been downgraded recently to 2.5 per cent for 2005 which is considerably below the Treasury forecast. The consensus forecast for 2006 is 2.4 per cent but we note that over the last two years that the Treasury forecast has outperformed the consensus forecast. Consumption slowed significantly in 2004 and this has probably continued into 2005. What is causing this in the first part of 2005 is unclear as the effects of slowing of house prices and increasing interest rates had their most significant impact in the latter half of 2004. The Bank of England state, in their most recent report, that they expect consumer spending to recover. This is largely because the future interest rate policy is relatively flat and it is possible UK interest rates might fall later this year. Clearly, these developments make the Chancellor's forecast much more difficult to achieve. UK retail sales, a slowdown in house prices and poor manufacturing performance have all contributed to slower growth.

The expectation for inflation is for it to remain close to target and is forecast to be 1.9 per cent in 2005 and 2.0 per cent in 2006. Interest rates have been held at 4.75 per cent. The UK labour market remains buoyant with a slight rise in employment and a slight drop in the numbers who are unemployed. We remained concerned about UK PSNB.

### **The Scottish economy**

Scottish GVA growth was 1.9 per cent in 2004 and by 0.6 per cent for 2004Q4 on 2004Q3. Agriculture grew by 4.1 per cent over the last year but declined by 0.7 per cent in

2004Q4. Construction grew very strongly, by 7.3 per cent in 2004, while growth was 0.7 per cent in the last quarter of the year. The service sector grew by 1.9 per cent in 2004 and by 0.6 per cent in the final quarter. Manufacturing was flat over 2004 but did increase by 0.8 per cent in 2004Q4. Perhaps this is a sign of some slight recovery but it is difficult to tell as for the last 12 quarters the manufacturing index has been close to 90 with very little movement away from this level.

Retail, communications, financial services (especially banking), REBS and public services have been the main drivers of the service sector last year. Within manufacturing, food, ORNF, mechanical engineering and transport-equipment were the best performers. Chemicals, textiles and electronics all declined significantly.

The Scottish labour market may be levelling off after buoyant recent performance. Employment for Feb-Apr 2005 was 2,441,000 which is an employment rate of 75 per cent. This is still slightly higher than the UK employment rate of 74.8 per cent. Unemployment fell by 9,000 over Feb-Apr 2005 to 144,000 giving a rate of 5.6 per cent (down 0.4 percentage points over the year). The claimant count is 86,900 for May 2005 (3.3 per cent). This is a decrease of 5,800 over the year and a decline in the rate of 0.2 percentage points.

The Scottish economy continues to perform relatively well with the exception of manufacturing. There has been a slight slowing in the service sector but this is forecast to pick-up again. We remain concerned about manufacturing however and particularly about export markets. Chemicals, drink, paper and electronics are all below expectations. Higher oil prices remain a distant threat for the UK and the Scottish economy. This is the context in which we are forecasting the Scottish economy.

## The forecast in detail

### GVA

We forecast that in 2004 GVA growth would be 1.9 per cent and this was indeed the outturn. We forecast that GVA growth will be 1.8 per cent in both 2005 and 2006. Scottish GVA growth is likely to stay close to trend and we believe, that in 2005, the gap between UK growth and Scottish growth will narrow. Agriculture has improved its performance considerably and is forecast to grow relatively strongly over the forecast period. Construction is forecast to grow very strongly over the next three years after growth of 7.3 per cent in 2004. The service sector, which has driven Scottish growth in the recent past, continues to be important but we note that growth is forecast to slow in 2005 to 1.8 per cent. Services are forecast to pick up in the next two years however. Manufacturing continues to disappoint and only growth of 0.6 per cent is forecast this year and next.

**Table 1, Main Forecasts of the Scottish Economy, 2004-2007**

	2004	2005	2006	2007
<b>GVA</b>	<b>1.9</b>	<b>1.8</b>	<b>1.8</b>	<b>2.0</b>
<b>Agriculture</b>	<b>4.1</b>	<b>1.0</b>	<b>1.2</b>	<b>0.9</b>
<b>Manufacturing</b>	<b>-0.4</b>	<b>0.6</b>	<b>0.6</b>	<b>1.0</b>
<b>Construction</b>	<b>7.3</b>	<b>5.5</b>	<b>3.1</b>	<b>4.3</b>
<b>Services</b>	<b>2.1</b>	<b>1.8</b>	<b>2.1</b>	<b>2.2</b>

Source: Fraser of Allander Institute, July 2005.

### Final demand

With respect to final demand we believe that consumption, government and investment remain the most important drivers of growth in the Scottish economy. Export performance is very poor while tourism remains disappointing. The main factors affecting the forecast are given below:

- Consumption is forecast to decrease slightly in 2005 as consumers may contract spending slightly in response to increased interest rates and higher levels of debt;
- Investment growth is forecast to be stronger from 2007 onwards;
- Tourism is expected to be poor this year and to pick up only slowly over the medium-term and
- Exports of electronics continue to be a problem. Food and wood products exports have increased significantly but not enough to offset the downturn in total exports. Whisky and paper remain important exports and we believe that in 2007 stronger export growth will stimulate the Scottish economy.

### Output

Agricultural growth over 2002 to 2004 has been quite strong and is forecast to grow although at a lower rate than in 2004. Growth of 1 per cent and 1.2 per cent is forecast for 2005 and 2006 respectively. Electricity, gas and water supply is forecast to grow by 1.5 per cent in 2005 and by 1.1 per cent in 2006. This sector requires stronger growth in manufacturing to see higher growth rates materialise. Construction is expected to grow strongly in the medium-term with growth of 4.3 per cent per annum for the period 2004 to 2006. We are forecasting growth of 5.5 per cent this year and 3.1 per cent in 2006. Private housing demand does not show any significant signs of slowing (certainly not to the same degree of that seen in the UK) and public-private investment remains strong. In the medium-term we also expect a stronger contribution to construction from the transport sub-sector.

Manufacturing was flat for 2004 but grew by 0.8 per cent in the last quarter – perhaps a sign that manufacturing might

be picking up. However we note that the index of Scottish manufacturing has been very close to 90 for the last 12 quarters. Within manufacturing ORNF, food, mechanical engineering and transport equipment have made significant contributions to growth in 2004. Electronics contracted by 2.7 per cent however in 2004 and both chemicals and textiles declined by 5.5 per cent in 2004. We are forecasting that manufacturing will grow by 0.6 per cent in 2005 and in 2006. We do not expect the sector to grow more significantly until 2007. Investment and a pick-up in export growth should revive the sector slightly although growth is only forecast to be close to 1 per cent in 2007.

Services are forecast to grow at 1.8 per cent this year and by 2.1 per cent in 2006. In the following year we forecast growth of 2.2 per cent before dipping again. Hotel and catering have not performed that well but this is due to poor tourism performance. The data on retail sales seems encouraging as growth in the sector was around 1.5 per cent in 2004. Public services, financial services and real estate and business services remain important in the Scottish economy. Other services may experience strong growth this year if consumers continue to spend on themselves ignoring credit, debt and interest rates. Taking all of this into account we forecast service sector growth of 1.8 per cent this year and 2.1 per cent next year. Service sector growth is forecast to be 1.9 per cent per annum over the period 2004-06.

## 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 B.16 in Labour Market Trends, National Statistics.

Our forecast for employment (jobs) is 2,279,800 in 2005 following our forecast of 2,258,600 for 2004. This is a net job change of 21,200 and 15,700 respectively. We are forecasting a net job change of 26,100 taking employment to 2,305,900 in 2006. Scottish employment is still driven by the service sector although we note this has been less in 2004 and 2005 than in previous years.

The service sector is forecast to have employment of 1,783,700 (an increase of 10,500 jobs) in 2004 and in 2005 employment of 1,800,700 (up by 17,000). For 2006 and 2007 the jobs forecast is 1,824,600 (23,900) and 1,856,400 (31,800) respectively. The public sector is forecast to have 35 per cent of service sector jobs, retail to have 20.7 per cent and REBS 15.2 per cent. These are the only three sub-sectors with a share of employment greater than 10 per cent. If tourism performance increased then the hotel and catering sector could also be in this group. As we stated previously in the Commentary migration is becoming relatively important to the labour market. We include this as a separate scenario below.

We forecast that manufacturing lost 3,400 jobs in 2004 and will lose another 1,000 this year. Only small gains are expected in the next two years as productivity improvements become more important to manufacturers.

**Table 3, Forecasts of Scottish Employment (000s) and Net Employment Change, 2004-2007**

	2004	2005	2006	2007
<b>Total</b>				
<b>Employment</b>	2,258.6	2,279.8	2,305.9	2,342.4
	(15,700)	(21,200)	(26,100)	(36,500)
<b>Agriculture</b>	36.8	36.7	36.7	36.6
	(500)	(-100)	(0)	(-100)
<b>Manufacturing</b>	249.6	248.5	248.7	248.9
	(-3,400)	(-1,000)	(100)	(200)
<b>Construction</b>	146.7	151.3	153.5	158.1
	(8,700)	(4,500)	(2,200)	(4,600)
<b>Services</b>	1,783.7	1,800.7	1,824.6	1,856.4
	(10,500)	(17,000)	(23,900)	(31,800)

Source: Fraser of Allander Institute, July 2005.

Construction employment is forecast to be 151,300 in 2005 (a net increase of 4,500 jobs). In 2006 we forecast that employment will be rise by 2,200 to 153,300. Agricultural jobs are forecast to decrease from 36,800 to 36,700 in 2005 and remain stable into 2006. A further slight weakening in employment is forecast for 2007.

## Migration

We include this scenario here because of the recent change in the migration pattern and this subsequent debate over this. We should be clear at the outset however that migration is not the main change in the components of change analysis of Scottish population – it is the natural change. Our view remains that Scottish population is an ageing population and that the long-term problem is one of a declining working population combined with that ageing population. Our main concern over the migration data for Scotland is the very small sample number for the International Passenger Survey (IPS) at 130. However our purpose here is to illustrate the impact on GVA of the migration scenarios described below.

Our main forecast (see above) takes into account the central population projections of the Government Actuaries Department (GAD). The migration figures for these years are as follows:

- 2004 12,000;
- 2005 7,500;
- 2006 3,000;
- 2007 -1,500  
and
- 2008 -1,500.

We lag the impact of migration on GVA by one year so that migration in 2004 affects 2005 GVA. We also assume that the migrants have a similar characteristic to the home population therefore we use the same GVA per head in our calculations. Our estimates of these effects are presented in Table 4 below.

Table 4, Forecasts of Scottish GVA with Different Migration Assumptions, 2004-2008

<b>Central Projection</b>					
	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
<b>Migration</b>	<b>12,000</b>	<b>7,500</b>	<b>3,000</b>	<b>-1,500</b>	<b>-1,500</b>
<b>Growth</b>	<b>1.9%</b>	<b>1.8%</b>	<b>1.8%</b>	<b>2.0%</b>	<b>1.8%</b>
<b>High Migration Projection</b>					
	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
<b>Migration</b>	<b>26,000</b>	<b>13,000</b>	<b>6,000</b>	<b>7,000</b>	<b>7,000</b>
<b>New Growth</b>		<b>2.1%</b>	<b>1.6%</b>	<b>1.9%</b>	<b>1.9%</b>
<b>Change in Growth</b>		<b>0.3%</b>	<b>-0.2%</b>	<b>-0.1%</b>	<b>0.1%</b>
<b>Low Migration Projection</b>					
	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
<b>Migration</b>	<b>6,000</b>	<b>3,000</b>	<b>-1,500</b>	<b>-5,000</b>	<b>-7,000</b>
<b>New Growth</b>		<b>1.6%</b>	<b>1.8%</b>	<b>2.0%</b>	<b>1.8%</b>
<b>Change in Growth</b>		<b>-0.1%</b>	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>

Clearly the increased migration that took place in 2004 could increase GVA growth by 0.3 per cent. Due to other changes in the economy however it could detract from growth in subsequent years but on the other hand it could add to growth towards the end of the forecast period. It is clearly uncertain exactly how a given group of migrants impact upon the economy. We do not take into account any displacement or multiplier/spillover effects here and indeed assume that everyone contributes to GVA. In the low migration scenario there is an initial drop in growth in 2005 but largely the scenario has a neutral impact on GVA.

## Unemployment

We present our forecasts of unemployment in Table 5. Both the ILO measure and claimant count measure are given. The preferred measure of unemployment however is ILO unemployment as given by the LFS.

There is little to say about unemployment really as the forecast continues to be for low and relatively stable unemployment in Scotland. We are forecasting unemployment of 5.4 per cent this year and 5.2 per cent next year. The claimant count is also forecast to decline across the forecast period from 3.4 per cent in 2004 to

3.2 per cent in 2007. We see that in 2005 there may be a slight upturn in claimant count but this is not forecast for ILO unemployment. The forecast for ILO unemployment is 144,300 (5.4 per cent) in 2005 and 140,000 in 2006 (5.2 per cent). Our forecast for claimant count in 2005 is 91,000 (3.5 per cent) and for 2006 it is 86,400 (3.3 per cent). There is very little change in the unemployment forecast. The main change is increased activity in the labour market. We remain optimistic about the outlook for the Scottish labour market.

Table 5, Forecasts of Scottish Unemployment, 2004-2006

	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
<b>ILO</b>				
<b>Unemployment</b>	<b>149.0</b>	<b>144.3</b>	<b>140.0</b>	<b>138.0</b>
<b>Rate</b>	<b>5.6%</b>	<b>5.4%</b>	<b>5.2%</b>	<b>5.1%</b>
<b>Claimant Count</b>	<b>90.3</b>	<b>91.0</b>	<b>86.4</b>	<b>84.2</b>
<b>Rate</b>	<b>3.4%</b>	<b>3.5%</b>	<b>3.3%</b>	<b>3.2%</b>

Source: Fraser of Allander Institute, July 2005

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5<sup>th</sup> July 2005

