2 Forecasts of the Scottish economy

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Abstract

This section provides an overview of recent changes in the drivers of economic activity in Scotland and provides the detailed forecasts for the Scottish economy to 2015 on key economic variables of GDP, employment and unemployment. In line with improving economic data and surveys of activity at the start of 2014, we are cautiously encouraged by the short term outlook for growth to 2015. As previously, we caution about the unbalanced nature of economic growth based upon consumption spending growth – when income growth is weak and part of the consumption growth comes as households reduce their savings rather than paying down debt levels. This has implications for the "balance", robustness and speed of recovery in the Scottish economy.

Fiscal and monetary outlook

Broadly, the UK Autumn Statement was fiscally neutral, and confirmed that the process of fiscal consolidation will continue up to 2018-19. As noted by the Chief Economic Advisor in the Scottish Government in his December report, "Government spending is not expected to make a significant contribution to growth in the medium term." (p. 15)

The minutes of the most recent Bank of England Monetary Policy Committee (MPC) make some interesting points regarding its decision to maintain both interest rates at their historical (low) level and the scale of its Quantitative Easing (QE) programme. Firstly, the Bank's "forward guidance" framework was argued to have been well known to businesses and to have contributed to increasing business confidence and spending plans in the latter part of 2013. Secondly, the Bank saw good conditions for increased business investment with improved access to credit, healthy balance sheets and information pointing to strong investment intentions (albeit that the latter does match with current investment data, see below).

In revisiting its "forward guidance", February's MPC minutes note that the unemployment rate is not the only measure of labour market "slack", with (in its view) there being potential to absorb spare capacity below an unemployment rate of 7% before raising interest rates. Additionally, these same minutes specified that potential increases in the interest rate would occur "gradually", when they did occur, and that the Bank's current expectation of the "appropriate" rate "was likely to be materially below the 5% level set on average by the Committee prior to the financial crisis".

Households

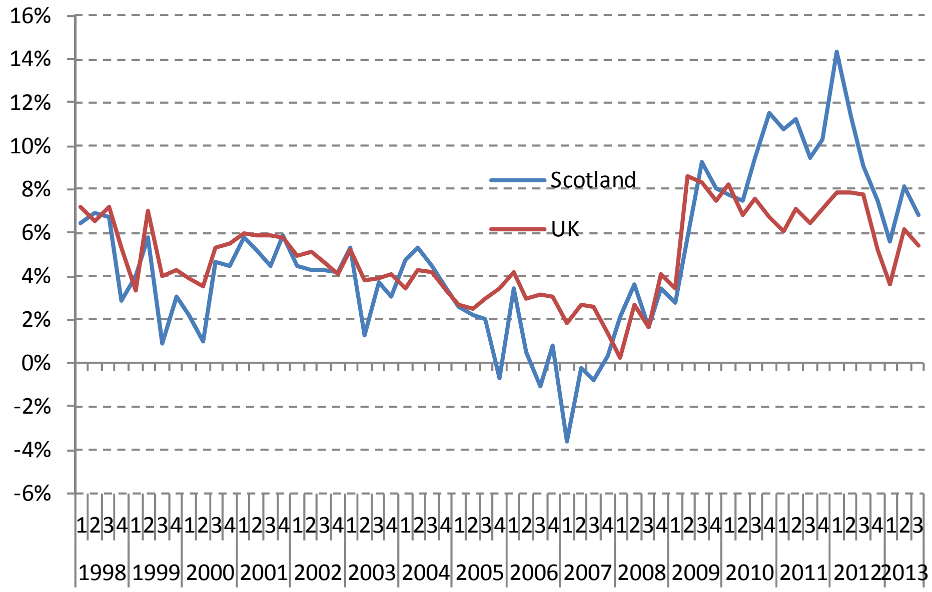
The Bank of England's February Inflation Report continues to suggest that income growth in the UK was broadly flat through 2013, while consumption growth has been driving much recent UK performance. During 2013 therefore the UK household savings ratio fell, partly due to improved credit conditions and improved income expectations. While it is possible that these data will be revised, estimates for the household savings ratio in Scotland moved in line with UK changes over 2013. The household savings ratio remains higher in Scotland than in the UK, as it has been since the third quarter of 2010 (Figure 1).

With the household savings ratio unable to decline indefinitely, it is unlikely that household consumption alone can sustain to economic growth and activity over the medium term. Rebalancing growth towards investment and exports remain the most important drivers for sustainable growth, in the absence of support from fiscal levers.

Household debt-to-income measures have improved since the peak of the housing market in 2008, but remain above their historic values. The affordability of debt remains relatively good, albeit with interest rates at historic lows.

Consumer confidence measures for Scotland and the UK have moved upwards over the last four months, for instance in consumer discretionary expenditures. Growth in the Retail Sales Index for Scotland was stronger than Great Britain (GB) over the final quarter of 2013 in volume terms, while it was broadly in line with changes in the value of sales in GB over 2013 as a whole. If consumer confidence begins to weaken – perhaps from anticipated income increases not being realised - it could have implications for households' saving and expenditure decisions.

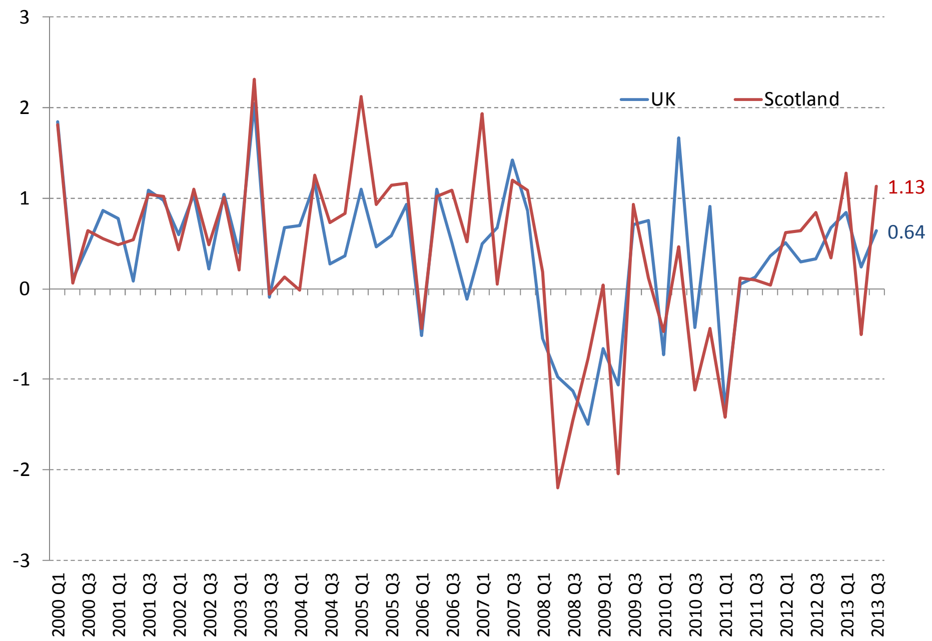
Figure 1: Household savings ratios, Scotland and UK, Q1 1998 to Q1 2013



Sources: (Experimental) Scottish National Accounts Project (SNAP) data (Scottish Government) and UK Quarterly National Accounts (National Statistics) and FAI calculations.

The Scottish housing market appears to have started 2014 strongly. The number of home loans obtained in the final quarter of 2013 was back to the levels seen in 2008, and there is evidence of an increase in the number of house sale transactions in Scotland. House price growth was seen in some surveys of the housing market at the end of 2013, though house prices remain around 6% below their pre-crisis peak. Across the UK as a whole house prices returned to their peak, however much of this was driven by price increases in London. Taking that region out of the data, UK house prices remain around 4% below their peak levels from 2008.

Figure 2: Household real consumption spending growth, Scotland and UK, Q1 2000 to Q3 2013



Sources: (Experimental) Scottish National Accounts Project (SNAP) data (Scottish Government) and UK Quarterly National Accounts (National Statistics) and FAI calculations.

Investment

Investment spending remains significantly below its pre-recession peak in both Scotland and the UK. As evidenced by Figure 3, the revised (since October 2013's Commentary) investment series for Scotland now shows that during 2010 there was a sharp return in the level of real investment to 2008 levels, which remained during 2011. However since the start of 2012 investment spending (which includes private and public actors) has declined again and now remains subdued below its pre-recession peak, more so than the same investment series for the UK as a whole.

There remains some uncertainty about measurement of business investment, which has become more volatile at the UK level as a whole, perhaps due to methodological reasons, and February's Bank of England Inflation Report argued that strong investment indicators during 2013 "suggest that investment… is more likely than not to be revised up" (p. 21).

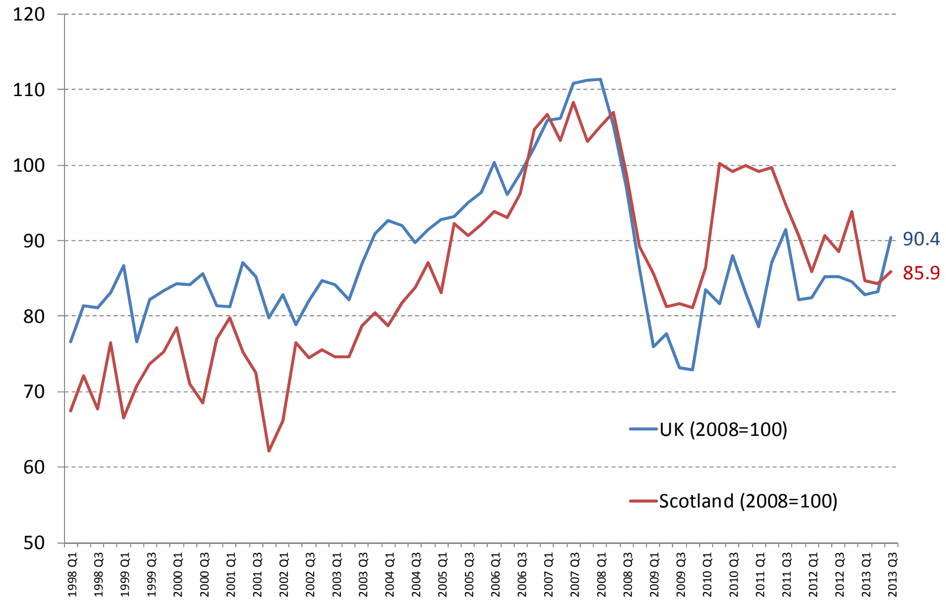
As identified in the Review of Business Surveys section, recent survey evidence on investment in Scotland is favourable and has improved significantly in the last four months. New evidence from the construction sector in the Scottish Chambers Business Survey identifies the first positive net balance to optimism since 2007, while there was also an uptick in total new orders and contracts, principally driven by an increase in private commercial orders.

Trade

The latest data on exports from Scotland to the (non-UK) rest of the world was published on the 22nd of January 2014 with the release of the "Index of Manufactured Exports" (published by the Scottish

Government). These latest data relate only to manufacturing exports during the third quarter of 2013, and so lag the release of the GDP series for the same quarter by a week.

Figure 3: Real gross fixed capital formation, Scotland and UK, Q1:1998 to Q3:2013



Sources: (Experimental) Scottish National Accounts Project (SNAP) data (Scottish Government) and UK Quarterly National Accounts (National Statistics) and FAI calculations.

These showed that during the third quarter of 2013, the volume of international exports from Scotland fell by 2.2% in real terms and were down 0.9% on an annual basis. This follows two previous quarters of growth, emphasising that this series, and its subcomponents of sectoral exports, does appear to be particularly volatile on a quarterly basis. However, the latest figures reveal Scottish manufacturing export volumes 10.1% below their pre-recession peak.

The 19th of January 2014 saw the release of the Scottish Government's annual Global Connections Survey. This reports on total exports from Scotland – to the rest of the UK and rest of the world – and across all industrial sectors, making it the most complete database on Scotland's exports. However, this completeness comes at the price of timeliness, with the data relating to the calendar year for 2012 released 13 months later. The nominal increase in Scottish exports was the headline result, with total international (i.e. non-UK) exports increasing by £1,445 million (5.9%) between 2011 and 2012. This was less than the (nominal) increase between 2010 and 2011.

Looking at this further, there was a faster rate of growth for exports to areas outside the EU (8.0%) than inside (4.8%), with manufacturing exports to non-EU destinations increasing by 16%. In absolute amounts, the increase in manufacturing exports to non-EU destinations was two-thirds of the increase in international exports from Scotland (£1,090 million out of total growth of £1,445 million). Of the non-EU destinations, exports to other European destinations rose by 17.3% while North American exports increased by 7.1%. The USA with 14% of all international exports remains the top international first destination for Scottish goods and services.

The same publication reports exports to the rest of the UK: these totalled £47,570 million in 2012 and grew by 4.3% over the year. The rest of the UK market therefore is worth around two-thirds of total exports from Scotland.

Table 1: Economic growth forecasts for 2013 and 2014 for major Scottish export markets, plus UK, China, Euro area and world, including changes from earlier forecasts where available, %

	2014			2015		
	IMF (January 2014)	Revision from October 2013	OECD (October 2013)	IMF (January 2014)	Revision from October 2013	OECD (October 2013)
USA	2.8	+0.2	2.9	3.0	-0.4	3.4
Netherlands	0.3	-	-0.1	-	-	0.9
France	0.9	=	1.0	1.5	=	1.6
Belgium	1.0	-	1.1	-	-	1.5
Germany	1.6	+0.2	1.7	1.4	+0.1	2.0
Ireland	1.8	-	1.9	-	-	2.2
UK	2.4	+0.6	2.4	2.2	+0.2	2.5
China	7.5	+0.3	-	7.3	+0.2	-
Euro area	1.0	+0.1	1.0	1.4	+0.1	1.6

Source: World Economic Outlook Update, International Monetary Fund (January 2014) and Economic Outlook, No. 93, OECD (October 2013). = means forecasts is unchanged, - means that forecast of growth for that country in that year is not featured in that publication.

Turning to international developments, February's Markit PMI for the Eurozone as a whole, showed acceleration in the rate of expansion compared to January's report. This series now stands at a 32-month high, driven particularly by production activity. Looking across the Eurozone, national divergences continue, suggesting that growth trajectories will be different, with a widening gap in particular between the strong performance of Germany and weaker activity in France. This divergence, together with very low rates of inflation, arguably makes rebalancing growth within the Eurozone more challenging, a point noted by the Bank of England. The other major Eurozone countries, Italy and Spain, registered encouraging figures, suggesting that 2014 could begin with some strong growth figures for these economies.

Most recent growth forecasts see positive growth in 2014, and have largely been revised upwards in the last quarter. Growth forecasts for Scotland's major trading partners are identified in Table 1, including the size and direction of revisions from earlier publications, where available.

The IMF's recent update to forecasts pointed to an upside potential for the economic outlook from strengthening activity during the latter half of 2013, with signs of growth returning to both the Euro area and the US budget deal likely to boost US domestic demand through 2014 in that country, with important implications for exporters to the US. The minutes from February's MPC discussions note that "the downside risks to a continued steady expansion of global activity had shifted somewhat away from the advanced economies and towards the emerging economies" (p. 2).

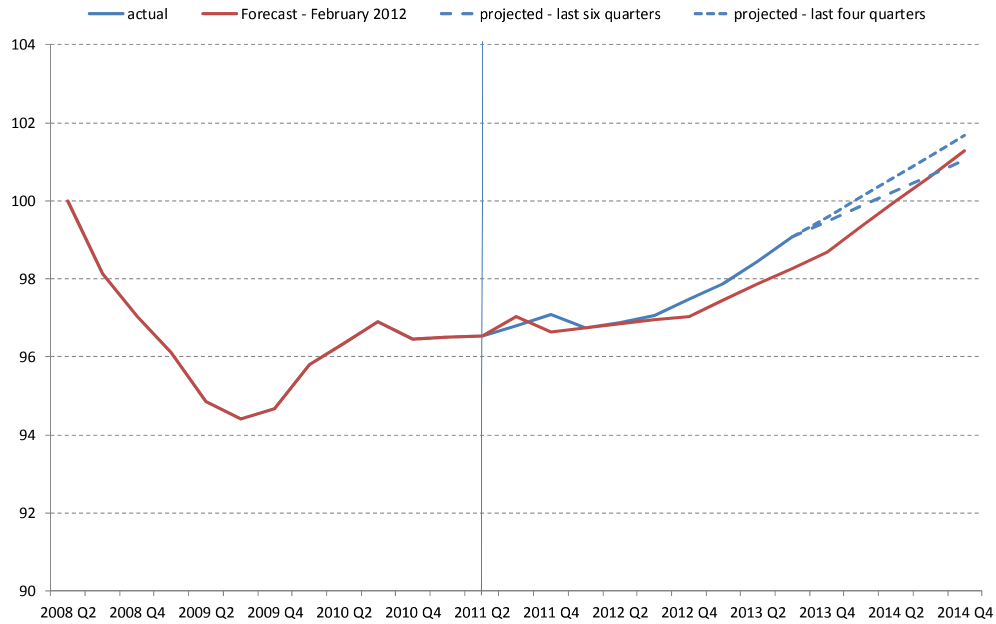
Box 1: Return to pre-recession peak: forecast against possible outturn

One of the stories about the performance of the UK economy in the great recession has been the duration that output has been below its pre-recession peak. It has been the longest recession in modern economic history, and indeed the last data for Scotland show that the Scottish economy in the third quarter of 2013 is 0.9% below its peak of the second quarter of 2008.

In February 2012, the Commentary forecast when the Scottish economy would return to its pre-recession peak. The prediction then was for growth through 2012, 2013 and 2014 with the peak being attained during Q3 of 2014. The figure below shows how this forecast has fared in the two years since it was made. The blue line in Figure B1 shows the actual outturn growth for Scotland over the period while the red line shows our February 2012 forecast. Note that the forecast was made when Q3 2011 growth was known, but growth for 2011 as a whole was not.

Taking the path to the latest data – i.e. for Q3 2013 – we have then projected two alternative developments about the continued growth prospects. If growth continues on the same (quarterly average) basis as the last six quarters then we will see a return to the pre-recession peak in the second quarter of 2014 (and therefore one quarter earlier than we forecast two years ago). However, if growth continues at the same rate as the last year, the pre-recession point will be reached during the first quarter (two quarters earlier than predicted two years ago).

Figure B1: Forecasts of Scottish economy return to pre-recession peak



Source: FAI calculations

Forecasts for the Scottish economy: Detail

Following our discussion above, we now see cautious optimism returning to Scotland's short term economic outlook, albeit that a reliance on solely consumption-led growth is unsustainable over the medium term. The outlook for business investment in Scotland and the UK looks significantly stronger than it was during 2013, and survey indicators for both new orders and new contracts in construction suggest that this pick up will feed through to the real economy. Downside fears to growth in Scotland's major (non-UK) trading partners appear to have reduced, while growth forecasts for the US in 2014 have been revised up. The (rest of the) UK economy, Scotland's largest trading partner shows robust growth in Q4 2013 and this is likely to continue through 2014. Recent developments in the Scottish labour market have led us to revise our assumptions about productivity growth going forward, with consequences for the unemployment rate over our forecast horizon.

Box 2: Growth across regions of the UK

Commentators have argued that as well as rebalancing away from services to manufacturing and production activity, regional 'rebalancing' would be desirable. There continues, for instance, to be debate around whether growth in the London economy helps or hinders growth in the UK as a whole. The implications for policy of the answer to that question is critical, and has implications across housing, transport and industrial policies (at least).

Some initial findings can be sought from (nominal) GDP figures for the regions of the UK (including Scotland), for which consistent and comparable GDP figures. These were published in December 2013. Figure B2 below shows the average (compound) annual growth rate in nominal GVA for each UK region for three time periods: the period 1997 to 2012 ("Whole period") and two sub-periods, 1997 to 2008 and 2009 to 2012.

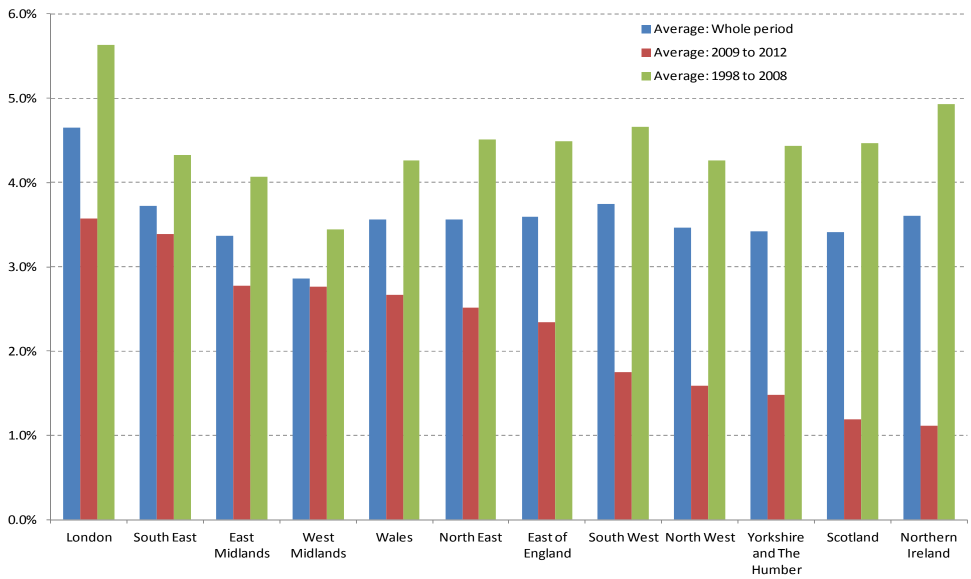
Several points can be noted. First, London and the South East grew in excess of 5% per anum on average over period between 1998 and 2008, with the South West, East of England and Scotland in 3rd, 4th and 5th respectively. In the period since 2009, London and the South East continued their strong performance, growing by over 2.5%.

Second, the nominal nature of these data makes comparisons to real growth problematic. Ideally, real GVA would be used to remove the effects of regional inflation, but the lack of region-specific GVA deflators makes this impossible.

Third - and critical for examining Scottish growth over the period since 2009 - there are significant discrepancies between the ONS and the Scottish Government series for GVA growth in Scotland over this period. *Scotland's apparent low rate of nominal growth is not consistent with the official GVA series used for Scotland or with other indicators of Scottish activity*. Indeed, using the figures for nominal GVA from the Scottish National Accounts Project (SNAP) restores Scotland's performance over the period. Those data place Scotland's performance over the 1998 to 2012 period as second only to London, and in line with other UK regions over the period since 2009, with the exception of London and the South East.

Albeit illustrative, this brief analysis demonstrates that the recent (to 2012) growth performance of London and the South East follows their strong performance as the UK's leading growth regions over the past fifteen years. This suggests that rebalancing is not occurring. More recent indicators, including on the housing market, suggest that London has continued its status as the highest growth region of the UK.

Figure B2: Nominal average (compound) annual growth rates for UK regions, 1997 to 2012.



Sources: ONS and FAI calculations

Results

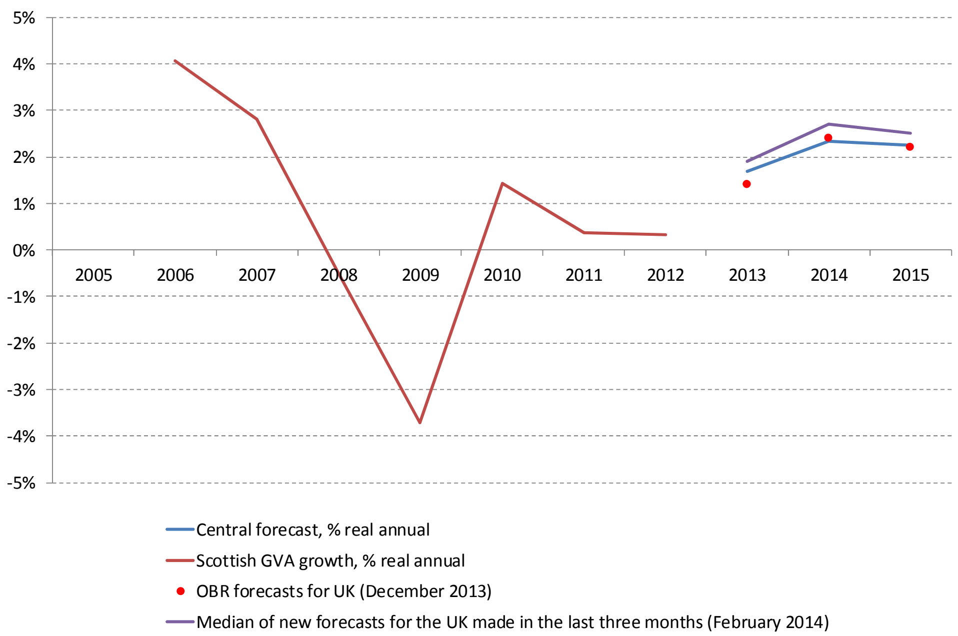
As in the October 2013 *Commentary*, we continue to forecast year-on-year real growth in Scotland's key economic and labour market variables over the period 2013 to 2015. Our forecasts cover Scottish Gross Value Added (GVA), employment and unemployment. The model used is multi-sectoral, and where useful, results are reported at the broad sectoral level.

We begin with the (central) forecasts for GVA growth in the Scottish economy. Our new forecasts for 2013, 2014 and 2015 are shown in Figure 4. This also shows – for comparison purposes only – a number of other forecasts for the UK over the same period. These are taken from the Office for Budgetary Responsibility (OBR) and the median of independent growth forecasts for the UK made during the last three months.

We have revised our forecasts for GVA growth in Scotland through 2013 to 2015. We now forecasts growth in 2013 and 2014 of 1.7% and 2.3% (up from our October 2013 forecasts of 1.3% and 1.8%). Our forecasts for 2015 are also revised up, to 2.3%, from 2.1% in October's forecast.

In addition to the aggregate growth forecasts, Table 2 presents our forecasts for GVA growth in each year by broad sectoral grouping, i.e. for the "production", "construction" and "services" sectors of the Scottish economy. Compared to October's Commentary, the largest upward revisions for growth in 2014 are in "production" and "services": up by 0.6 and 0.5 percentage points respectively.

Figure 4: Forecast annual real GVA (%) growth for 2013 to 2015: Scotland and UK



Sources: Fraser of Allander Institute forecasts, Office for Budgetary Responsibility and HM Treasury (February 2014)

We use outturn forecasts errors (i.e. the difference between our annual growth forecasts and the outturn growth figures for Scotland) to show the potential range of outcomes around our central forecast.

Improved accuracy at shorter forecasts' horizons means that any forecasts' errors are larger for years further into the future. Over the period since 2000, for forecasts made during the Spring (January to April) period of the year, FAI forecasts of the first estimate of GVA growth in the year just completed (i.e. 2013 in this case) have an average absolute forecast error of 0.19 percentage points.

Please note that statistics confirming the final quarter of 2013, and hence the first annual estimate of growth in the year is not realised until April 2014. For the year in progress (i.e. 2014) our Spring forecasts have an absolute forecast error of 0.50 percentage points, while for the following year, our past errors have been 1.21 percentage points. These historical forecast errors give the ranges around our central estimate of Scottish GVA growth, and are shown around the central estimate in Figure 5. Our estimate therefore of Scottish GVA growth in 2013 is between 1.5% and 1.9%, while growth in 2014 and 2015 is forecast to lie in the range of 1.8% to 2.8% and 1.0% to 3.5% respectively.

Table 2: Scottish GVA growth (%) by sector, 2013 to 2015

	2013	2014	2015
GVA	1.7	2.3	2.3
Production	2.0	2.8	2.7
Construction	1.3	1.8	1.4
Services	1.6	2.2	2.2

Source: Fraser of Allander Institute forecasts, March 2014

Employment

Detailed commentary on recent developments in the Scottish labour market can be found in the Overview of the Scottish Labour Market section of this *Commentary*. Here we focus on our forecasts for the levels and trends for the number of employee jobs in the Scottish economy. We forecast the number, sectoral breakdown and percentage changes in employee jobs at the end of 2013, 2014 and 2015 respectively.

The most recent employee jobs data show that there were 2,277,000 employee jobs in Scotland in the final quarter of 2012. This is 35,000 fewer than was estimated for the same period in the last set of data available in October 2013. This indicates that there have been revisions to the underlying dataset, which makes it impossible to directly compare the level of employee jobs with past forecasts.

As a consequence of the altered base line figures for employee jobs, our forecast for the net number of jobs created during 2013 has been revised up since October's *Commentary*, and now stands at 31,450 (up from 21,200). However given the scale of these revisions, we are now forecasting a lower number of employee jobs at the end of 2013 than we did in October.

Our forecasts for employee jobs at the end of 2013, 2014 and 2015 are shown in Table 3, alongside a detailed sectoral breakdown of job numbers. The number of total jobs is forecast to increase in each year of our forecast, and have been revised up since our forecasts in October 2013. The number of employee jobs is now forecast to increase by 31,450 between December 2012 and December 2013, with an increase of 1.4%. This is up from our October forecast of a 21,200 (0.9%) increase in job numbers in 2013. In 2014 and 2015 we forecast employee job numbers in Scotland to increase each year, by 39,600 and 42,800 (1.7% and 1.8%) respectively. The employee jobs forecast consistent with our central, upper and lower growth forecasts is given in Table 4.

Table 3: Forecasts of Scottish employee jobs ('000s, expect where stated) and net change in employee jobs in central forecast, 2013 to 2015

	2013	2014	2015
Total employee jobs, Dec	2,308,450	2,348,050	2,390,836
Net annual change (jobs)	31,450	39,600	42,800
% change from previous year	1.4%	1.7%	1.8%
Agriculture (jobs, 000s)	34	36	39
Annual change	1,650	2,650	2,700
Production (jobs, 000s)	243	244	249
Annual change	1,550	1,650	4,700
Construction (jobs, 000s)	115	117	118
Annual change	400	1,400	1,650
Services (jobs, 000s)	1,917	1,951	1,984
Annual change	27,850	33,900	33,750

Note: Absolute numbers are rounded to the nearest 50.
Source: Fraser of Allander Institute forecasts, March 2014

Table 4: Net annual change in employee jobs in central, upper and lower forecast, 2013 to 2015

	2013	2014	2015
Upper	35,450	51,050	71,900
Central	31,450	39,600	42,800
Lower	26,350	36,700	13,350

Source: Fraser of Allander Institute forecasts, March 2014

Unemployment

We present our forecasts for unemployment at the end of 2013, 2014 and 2014 in our central forecast in Table 5. In line with the forecasts produced since June 2013, we report the forecasted number (and rate) of those unemployed under the International Labour Organisation definition of unemployment. This is preferred to the claimant count measure as it gives a more complete picture of the extent of labour resources available for work but unable to find work, and so is a better measure of the level of spare capacity in the labour market.

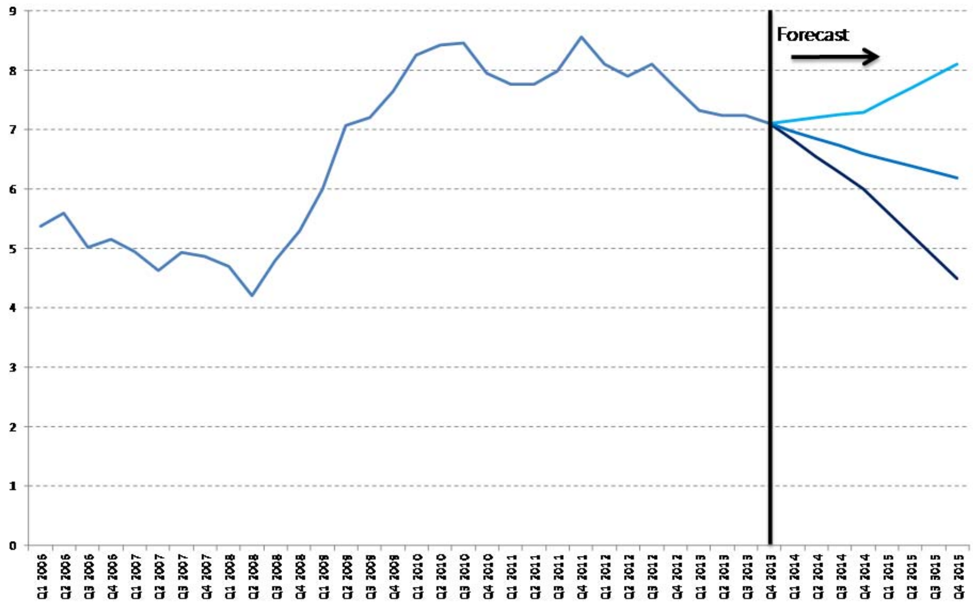
Our October forecast for the unemployment level for the end of 2013 was 204,550, with a rate of 7.6%. February's outturn data for Scotland revealed we had overestimated the number of unemployed by less than 9,000 and 0.5 percentage points.

Table 5: Forecasts of Scottish unemployment in central forecast, 2013 to 2015

	2013[1]	2014	2015
ILO unemployment	195,000	179,900	170,214
Rate (%)[2]	7.1	6.6	6.3

Notes: Absolute numbers are rounded to the nearest 50. [1]
2013 figures in Table 5 refer to outturn figures from February 2014's first release of labour market data for Scotland. [2]
Rate calculated as total ILO unemployment divided by total of economically active population age 16 and over. The most recent labour market figures are detailed in the Labour Market Section of the Fraser Economic Commentary.
Source: Fraser of Allander Institute forecasts, March 2014

Figure 6: Scottish ILO unemployment rate, 2006 to 2015 including forecast range from 2013



Source: ONS and Fraser of Allander Institute forecasts, March 2014

We have revised down our forecasts for the Scottish ILO unemployment level and rate for 2014 and 2015 since our October forecast. Our new forecasts for the unemployment rate in Scotland at the end of 2014 and 2015 are 6.6% and 6.3% respectively. The Bank of England's most recent Inflation Report notes how their own forecasts of the unemployment rate have been significantly affected by changes not just in the employment rate, but also in the participation rate for the UK (largely through increased participation rates for older workers, driven by increased longevity and low rates on annuities discouraging retirement). It is possible that increased labour market participation may ease through

2014, making it possible that the unemployment rate could fall more sharply for given employment changes.

We show the history of the Scottish ILO measure since 2006, and our central and upper and lower forecasts for this variable to 2015 in Figure 6.