

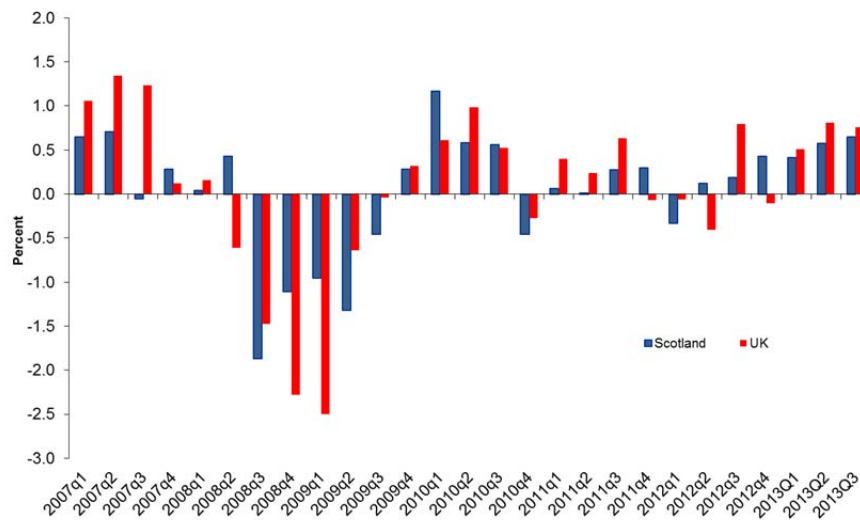
1 Outlook and appraisal

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Recent GDP performance

The latest Scottish GDP data for the third quarter of 2013 show that Scottish GDP rose by 0.7% in Scotland in the quarter, a little less than the 0.8% rise in the UK, see Figure 1.

Figure 1: Scottish and UK quarterly GDP growth, 2007q1 - 2013q3

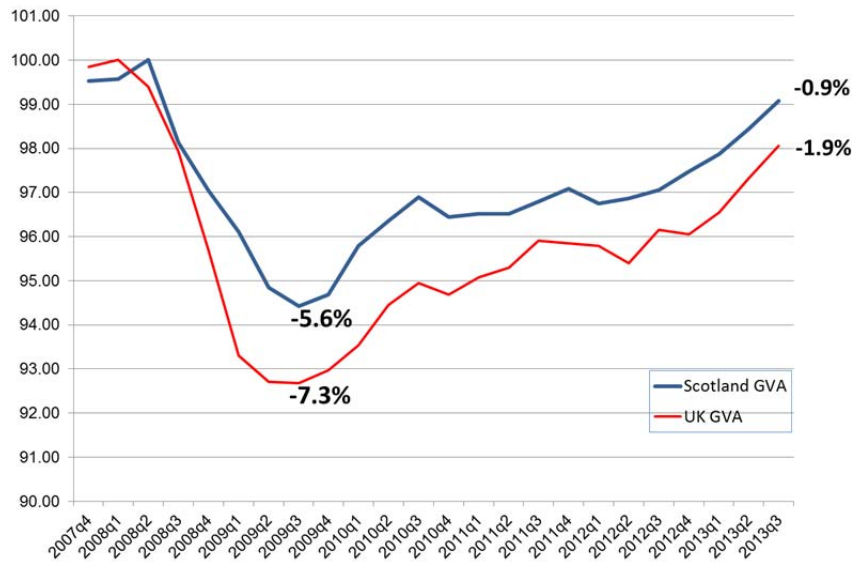


Source: Scottish Government unrounded GDP 2013 Q3 Tables, January 2014 and FAI calculations

Over the year to the second quarter - four quarters on previous four quarters - Scottish GDP grew at 1.3% identical to the outturn in the UK. These data provide further evidence of a strengthening recovery. Positive growth has now been recorded for the Scottish economy in the previous 6 quarters. Yet, as noted in the previous *Commentary* the recovery continues to be considerably weaker than from any recession in the last 70 to 80 years. The effect of the new data on Scotland's recovery from recession is shown in Figure 2.

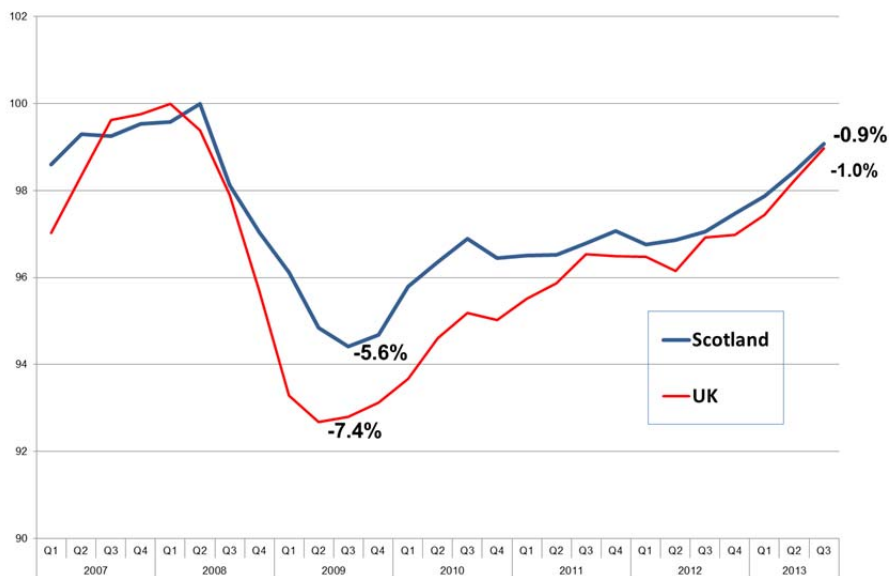
In the third quarter, GDP in Scotland was -0.9% below its pre-recession peak, whereas UK GDP stood at -1.9% below its pre-recession peak of more than 5 years ago. The scale of the recession was greater in the UK: a drop of -7.3% in GDP compared to a fall of -5.6% in the Scotland. A stronger UK recovery to late 2011 was replaced by a stronger Scottish recovery during 4 of the 5 quarters between 2011q4 and 2012q4 - the exception being the stronger 'Olympics effect' on rest of UK in 2012q3. But during 2013, the UK recovery has again been stronger in each of the three quarters of published data so far. Scottish GDP has recovered by 4.9% since the trough of recession while UK GDP has recovered by 5.8% from its trough, suggesting a somewhat weaker recovery overall in Scotland than in the UK.

Figure 2: GVA in recession and recovery Scotland and UK to 2013q3 (relative to pre-recession peak)



Source: Scottish Government unrounded GDP 2013 Q3 Tables, January 2014 and FAI calculations

Figure 3: GVA ex oil & gas, recession and recovery to 2013q3



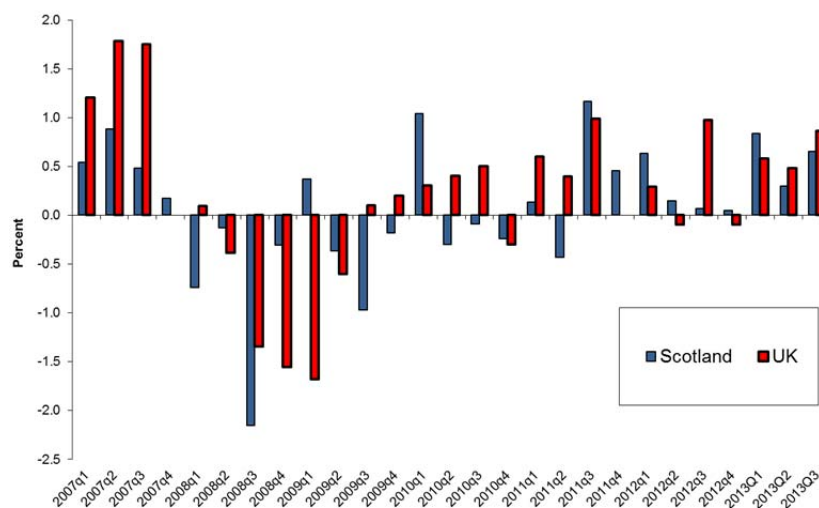
Source: Scottish Government unrounded GDP 2013 Q3 Tables, January 2014 and FAI calculations

However, as noted in previous *Commentaries* there is the complicating factor of oil and gas production which - offshore production - is included in the UK GDP data but not in the Scottish data. Removing oil and gas production gives us Figure 3.

When oil and gas production is removed, we find that Scottish and UK GDP growth ex oil between the second and third quarters is the same as when oil is included in the UK data at 0.7% and 0.8% respectively. But over the year - four quarters on four quarters - UK GDP growth - ex oil & gas - was at 1.4% slightly stronger than the Scottish figure of 1.3%. The long period of weak oil and gas production has resulted in the UK GDP - ex oil & gas - having a much stronger recovery from recession than Scottish GDP. Scottish GDP has recovered by 4.9% since the trough of recession while UK GDP - ex oil & gas - has recovered by 6.8%. So, by the second quarter of this year UK GDP - ex oil & gas - was -1% below its pre-recession peak compared to -0.9% for Scotland. Scottish and UK GDP - ex oil & gas - are now almost identical in relation to their pre-recession peaks even though the scale of the recession was much greater in the UK as a whole.

Turning now to individual sectors of the economy. The Scottish service sector, which accounts for 72% of GDP in Scotland and 77% in the UK, grew by 0.7% in Scotland and 0.9% in the UK in the third quarter - see Figure 4.

Figure 4: Scottish and UK services GVA growth 2007q1 to 2013q3

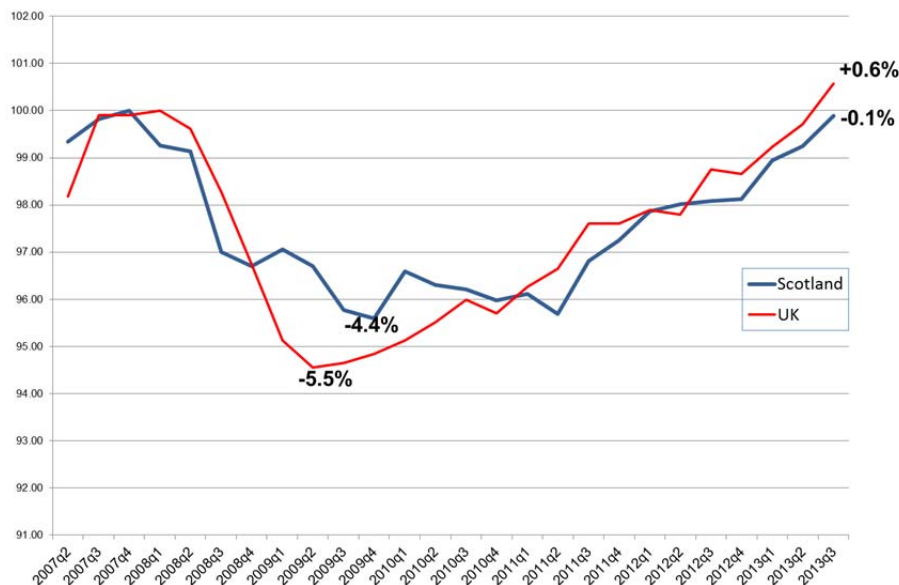


Source: Scottish Government unrounded GDP 2013 Q3 Tables, January 2014 and FAI calculations

Over the year - that is four quarters over the previous four quarters - the service sector in Scotland grew by 1.3%, less than the 1.6% achieved in UK services. The state of the recovery in Scottish and UK services is presented in Figure 5.

We can see from Figure 5 that UK services finally surpassed their pre-recession peak in the third quarter to stand at 0.6% above peak, fully five and one half years later. Scottish services GVA has almost reached its pre-recession peak being at -0.1% below peak. The recovery in Scottish services remains weaker than the UK with growth of 4.5% since the trough of the recession compared to 6.4% in UK services. Indeed, as noted in the October *Commentary* Scottish services' growth is underperforming the overall performance of the economy in the recovery whereas that is not the case in the UK where the recovery in services has been somewhat quicker. It is the production sector that has boosted Scottish growth, growing by nearly 10% in the recovery while it has been a significant drag on the recovery in the UK with zero growth since the trough of the recession, which is partly a consequence of the weakness of oil & gas production on the UK production and GDP figures.

Figure 5: Services GVA in recession and recovery Scotland and UK to 2013q3

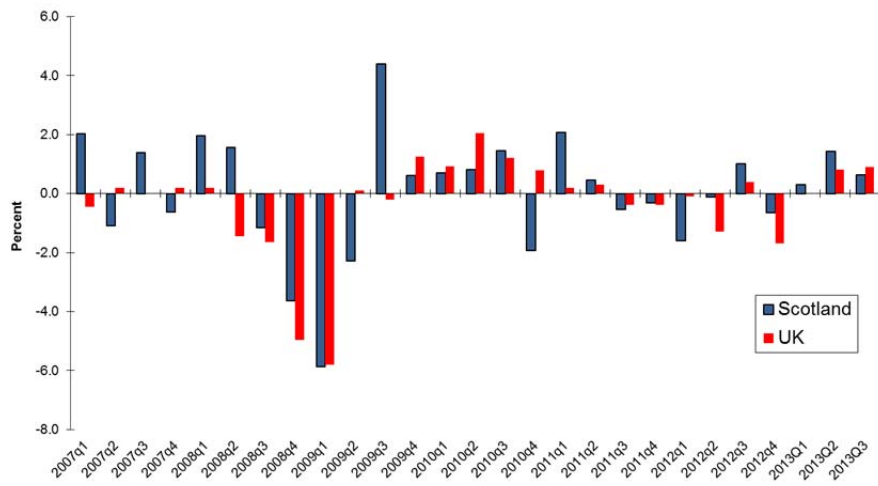


Source: Scottish Government unrounded GDP 2013 Q3 Tables, January 2014 and FAI calculations

In the Scottish production sector the growth of output slowed to 0.6% in the third quarter from 1% in the second quarter. UK production rose by the same percentage as in Scotland during the third quarter compared to 0.7% in the second quarter. Over the year - four quarters on the previous four quarters - production GVA rose by 1.9% in Scotland compared to a fall of -1.6% in the UK. The weakness of mining & quarrying, due in part to oil & gas weakness, and the erratic behaviour of electricity & gas supply are key reasons for the differential performance of the production industries in Scotland and UK. Mining & quarrying grew by 2.1% in the third quarter in Scotland while GVA rose by 6.8% over the year. In contrast, UK mining & quarrying rose 0.6% in the quarter but contracted by -7.1% over the year. Electricity & gas supply GVA fell by -2.3% in Scotland in the third quarter but rose by 0.8% over the year. In the UK the sector contracted by -5.9% in the quarter but GVA rose by 1.7% over the year. However, it is the performance of manufacturing, accounting in Scotland for 63% of production and 12% of total GVA, that is the main driver of the differential performance in production between Scotland and the UK.

In the third quarter, GVA in Scottish manufacturing rose by 0.6% and by 0.7% over the year. In UK manufacturing GVA rose by 0.8% in the quarter but fell by -1.4% over the year. Figure 6 charts the quarterly percentage changes in GVA in Scottish and UK manufacturing.

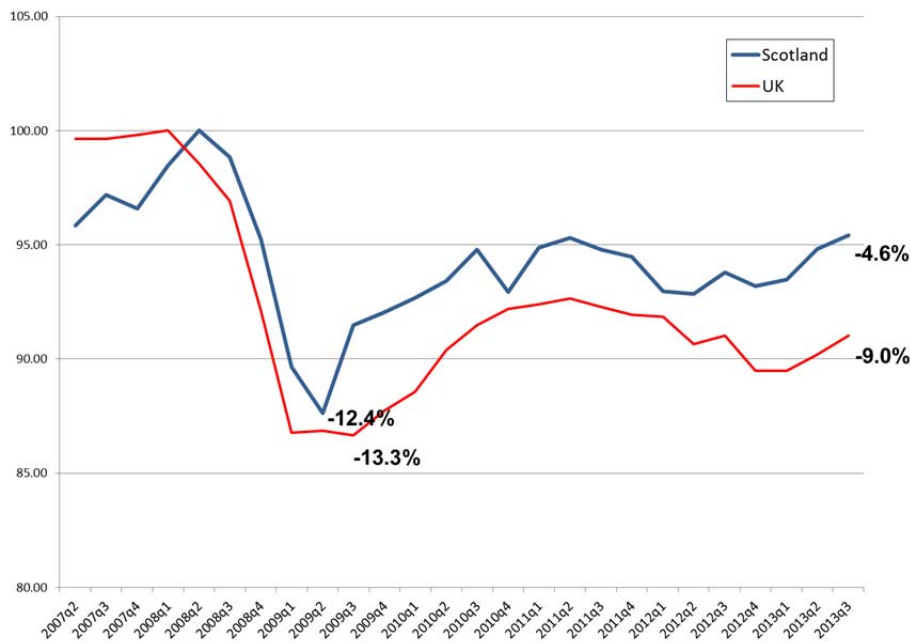
Figure 6: Scottish and UK manufacturing GVA growth at constant basic prices 2007q1 to 2013q3



Source: Scottish Government unrounded GDP 2013 Q3 Tables, January 2014 and FAI calculations

Figure 7 shows the impact of the latest data on the manufacturing sector's recovery from recession.

Figure 7: Manufacturing GVA in recession and recovery Scotland and UK to 2013q3

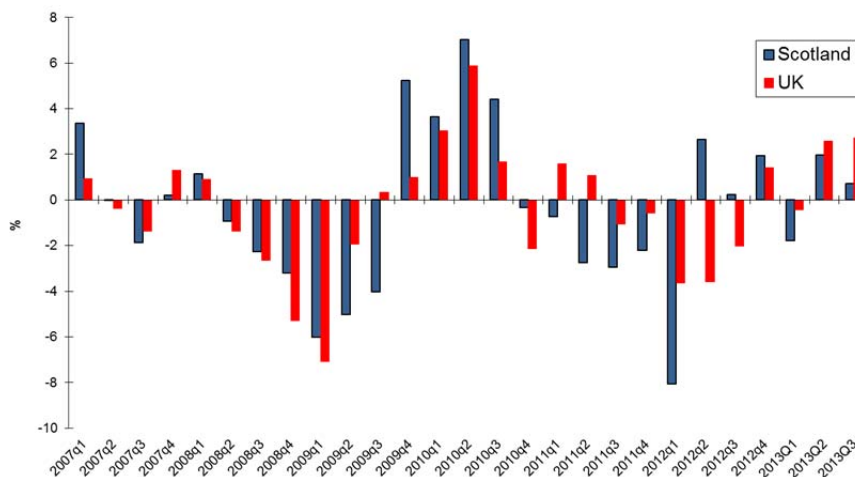


Source: Scottish Government unrounded GDP 2013 Q3 Tables, January 2014 and FAI calculations

Because of the small amount of movement in manufacturing GVA in the third quarter the chart looks much the same as after the second quarter. Scottish manufacturing GVA continues to stand at -4.6% below its 2008-09 pre-recession peak, while the figure for UK manufacturing has dropped slightly to -9% from -9.8% in the second quarter. The favourable gap between Scotland and UK manufacturing performance during the recovery therefore continues to be large.

Within manufacturing, the main drivers of growth in the third quarter came from other manufacturing industries; repair & installation (accounting for 21% of manufacturing GVA) with growth of 1.3% in the quarter and 0.7% over the year. Metals, metal products & machinery n.e.c. [not elsewhere classified] (accounting for 19% of manufacturing GVA) grew by 1.1% in the quarter and 4.1% over the year. And refined petroleum, chemical & pharmaceutical products (accounting for 12% of manufacturing GVA) grew by 3.9% in the quarter while contracting by -0.6% over the year. The main sectors holding back manufacturing growth in the third quarter were, computer, electrical and optical products (electronics) (accounting for 9% of manufacturing GVA), and food & drink (accounting for 28% of manufacturing GVA) which contracted by -4.5% and -0.3%, respectively, during the quarter. 'Electronics' also contracted by -4.6% over the year, while food & drink grew by +1.3%. Turning now to construction, the latest data are presented in Figure 8.

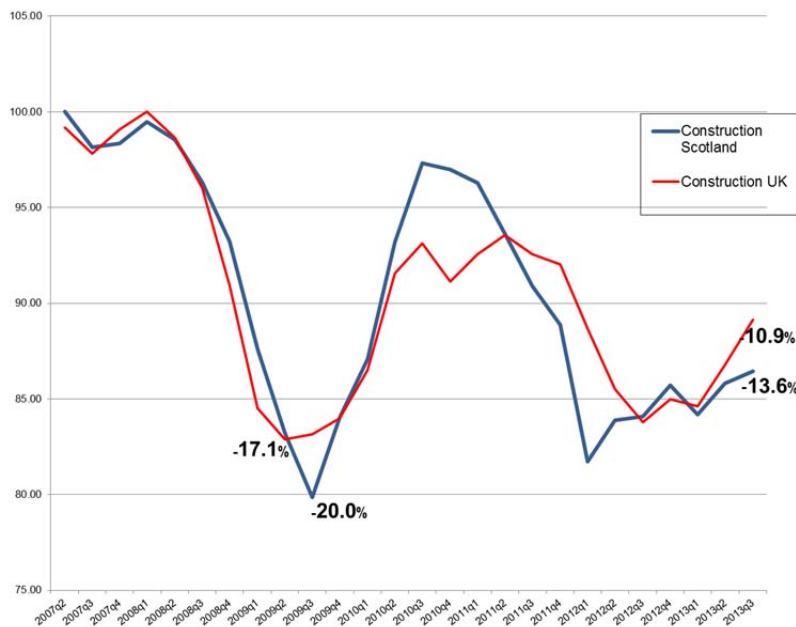
Figure 8: Scottish and UK construction GVA volume growth 2007q1 - 2013q3



Source: Scottish Government unrounded GDP 2013 Q3 Tables, January 2014 and FAI calculations

Scottish construction GVA rose by 0.7% in the quarter and by 1.1% over the year. UK construction, in contrast, grew more strongly in the quarter at 2.6% but contracted -1.3%, over the year. While growth in the sector has picked up since the heavy recession period of 2010q4 to 2012q1 Scottish construction's performance appears to have weakened relative to the UK from the start of 2013. Figure 9 charts the recession and recovery performance in both Scottish and UK construction.

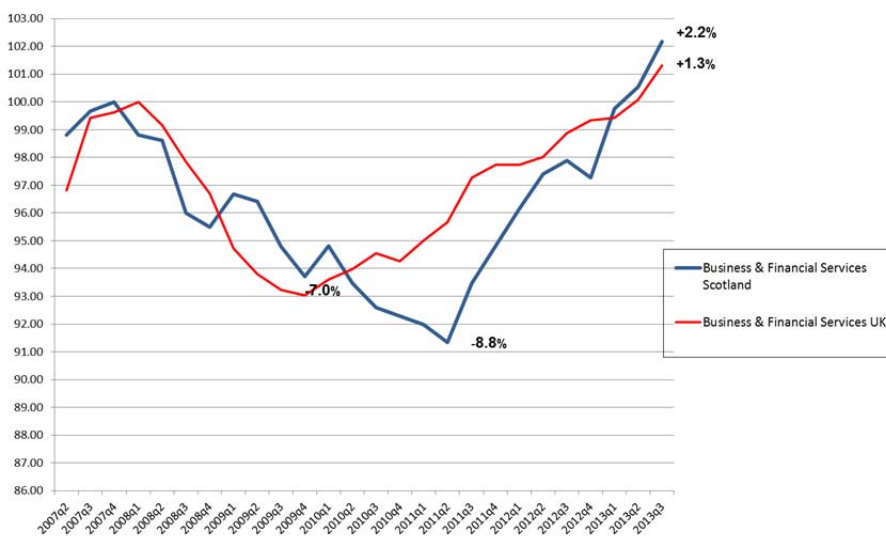
Figure 9: Construction, recession and recovery to 2013q3



Source: Scottish Government unrounded GDP 2013 Q3 Tables, January 2014 and FAI calculations

Figure 9 makes clear that the sector is still very much depressed in both the UK and Scotland. However, the recent stronger performance of UK construction is evident with GVA in third quarter at -10.9% below its pre-recession peak compared to -13.6% in Scotland.

Figure 10: Business & financial services: recession and recovery to 2013q3



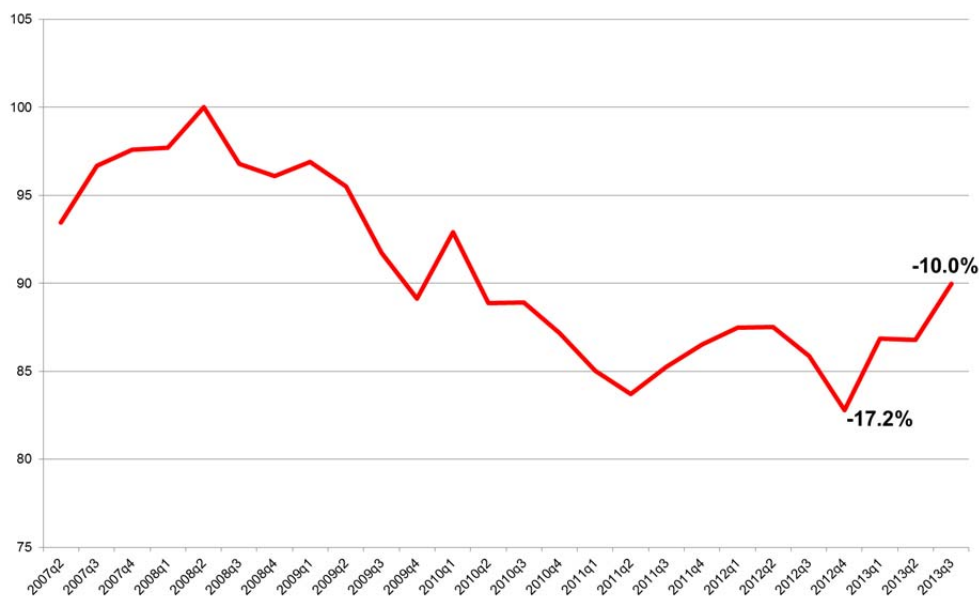
Source: Scottish Government unrounded GDP 2013 Q3 Tables, January 2014 and FAI calculations

Within services, business and financial services continue to contribute positively to the growth of the Scottish economy. In the third quarter of 2013, the sector grew by 1.6% and by 3.5% over the year. In the UK, the sector grew at a slower rate of 1.2% in the quarter and 2% over the year. Figure 10 shows the growth of the sector in Scotland and UK during the recession and recovery.

By the latest quarter (2013q3), the sector in the UK had moved to +1.3% above its pre-recession peak from -0.4% in the previous quarter, while its Scottish counterpart moved further ahead to stand at 2.2% above its pre-recession peak. In the previous two *Commentaries*, we noted that the aggregate GVA data for business and financial services in Scotland masked significant differences between the performance of financial services on the one hand and business services on the other. What is clear now is that the difference is not so marked and financial services in particular have managed something of a revival. Figure 11 shows what has been happening to financial services since peak output in the second quarter of 2008.

These data show that the sector has enjoyed a sustained recovery since the fourth quarter 2012. Now GVA in the sector is -10% below its pre-recession peak compared to -17.2% in 2012q4. We noted in earlier *Commentaries* that there is a strong likelihood following the structural change that occurred after the Great Recession that some of this lost output may never return. This could still be the case despite the recent recovery. Moreover, with the recent RBS announcement of significant further cut backs in activity and jobs losses in the bank are to be expected, the recovery shown in Figure 11 may fail to be sustained.

Figure 11: Financial services, recession and recovery 2008q2 to 2013q3



Source: Scottish Government unrounded GDP 2013 Q3 Tables, January 2014 and FAI calculations

Elsewhere within private services, the main sector is distribution, hotels and catering which account for 19% of services sector output in Scotland: this sector grew by 0.9% in the third quarter compared to an increase of 1.1% in the UK. Over the year, the sector grew by 1.8% in Scotland compared to 2.7% in the UK. Figure 12 shows the performance of the sector during recession and recovery.

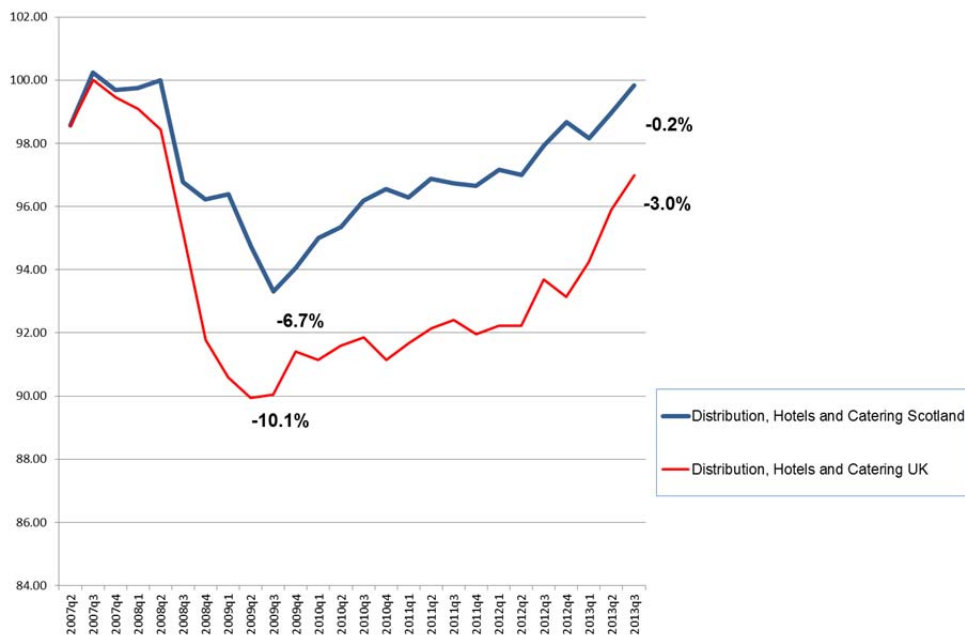
From Figure 12 we can note that the sector had a less serious recession in Scotland than in the UK with output falling by -6.7% here compared to -10.1% in the UK. The track of recovery has been a little faster in Scotland despite weakness towards the end of 2012. By the third quarter of last year GVA in the sector was almost at its pre-recession peak in Scotland (-0.2%) compared to -3% below in the UK.

Government & Other Services GVA exhibited no growth in Scotland in the third quarter compared to a small rise of 0.4% in the UK. Over the year, measured value added in the sector fell slightly in Scotland by -0.1% compared to a rise of 0.6% in the UK. Figure 13 shows the performance of GVA in the sector in recession and recovery.

GVA in the sector in the UK is 2.7% above the pre-recession peak, which continues to be difficult to understand at a time of fiscal consolidation, whereas output in the sector in Scotland is -0.5% below its pre-recession peak, which is more intuitively reasonable.

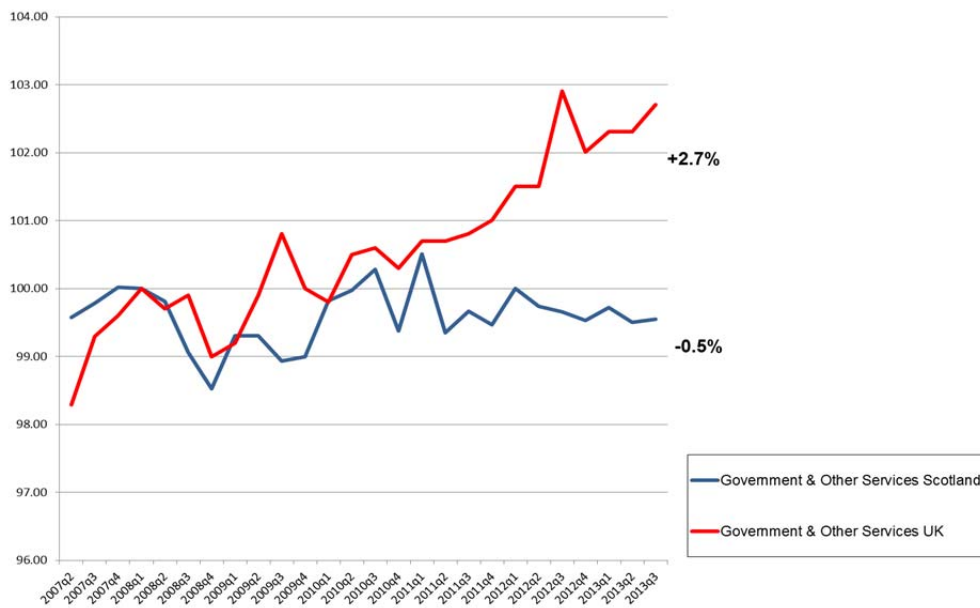
Finally, Figure 14 highlights the performance of transport, storage & communication in Scotland and UK in recession and recovery. The sector accounts for nearly 8% of total GVA and about 11% of service sector output.

Figure 12: Distribution, hotels & catering: recession and recovery to 2013q3



Source: Scottish Government unrounded GDP 2013 Q3 Tables, January 2014 and FAI calculations

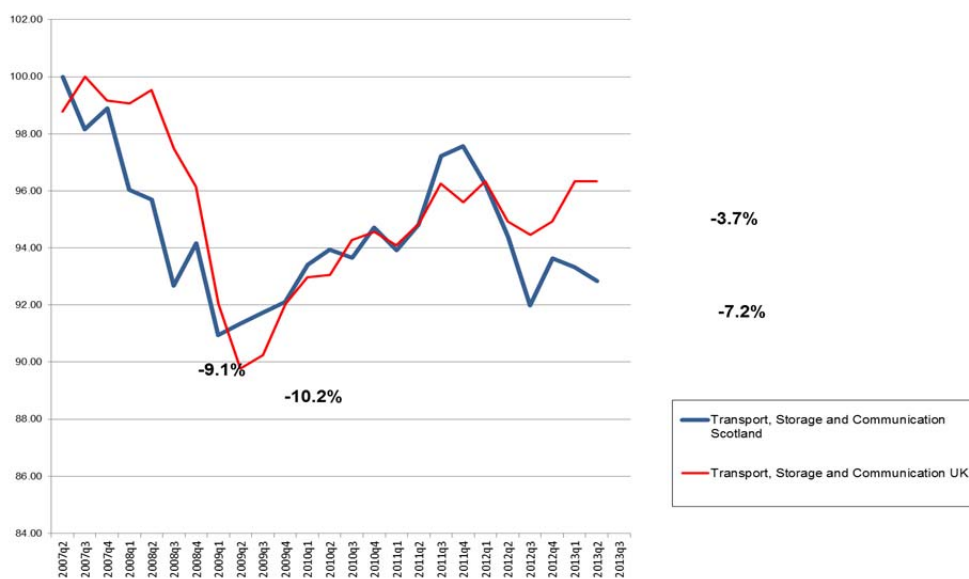
Figure 13: Government and other services: recession and recovery to 2013q3



Source: Scottish Government unrounded GDP 2013 Q3 Tables, January 2014 and FAI calculations

The recent weakness of the sector in Scotland continued in the third quarter with GVA falling by -1% and by -2.2% over the year. In contrast, the sector in the UK contracted slightly in the quarter, by -0.2% but grew by 0.6% over the year. By the end of the third quarter GVA in the Scottish sector was -7.2% below pre-recession peak compared to -3.7% in the UK.

Figure 14: Transport, storage & communication: recession and recovery to 2013q3



Source: Scottish Government unrounded GDP 2013 Q3 Tables, January 2014 and FAI calculations

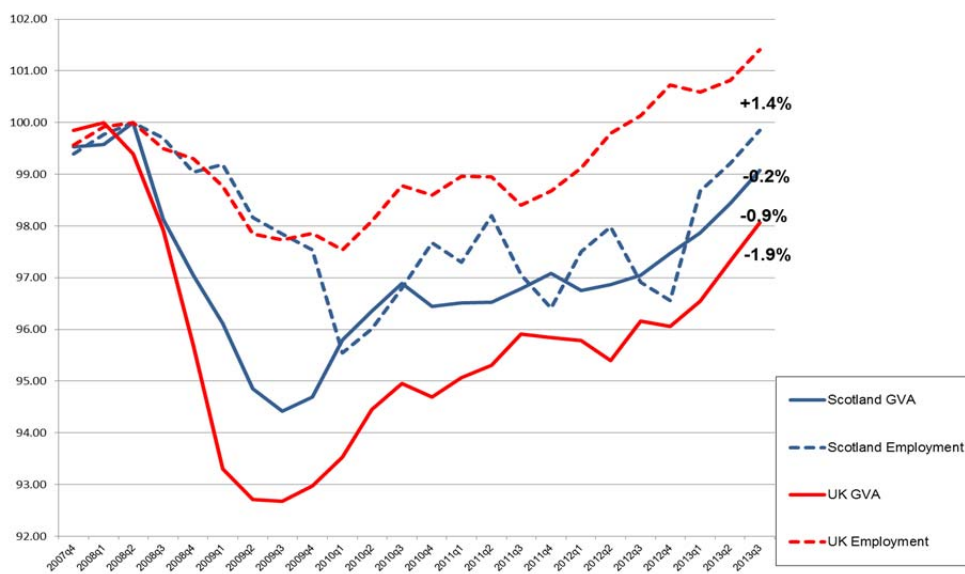
The Labour Market

The latest labour market data (see *Overview of the Scottish labour market* below) provide further welcome evidence of an improvement in conditions in the Scottish labour market. In the quarter October to December 2013 employment rose at the same rate as in the UK but at a faster rate over the year. Jobs rose by 9,000, or 0.3%, in the quarter, compared to a rise of 193,000, a rise of 0.3%, in the UK as a whole. Over the year, Scottish jobs rose by 92,000, a rise of 2%, while UK jobs rose 396,000, or 0.6%. Moreover, during the quarter unemployment fell by 3,000, or -0.1%, to 195,000, or a rate of 7.1%, while in the UK, unemployment fell more rapidly by 125,000, or -0.4%, to a rate of 7.2%.

Figure 15 shows the performance of GDP and employment in Scotland and the UK during recession and recovery up to 2013q3 while Figure 16 shows total employment for Scotland and the UK over the same period.

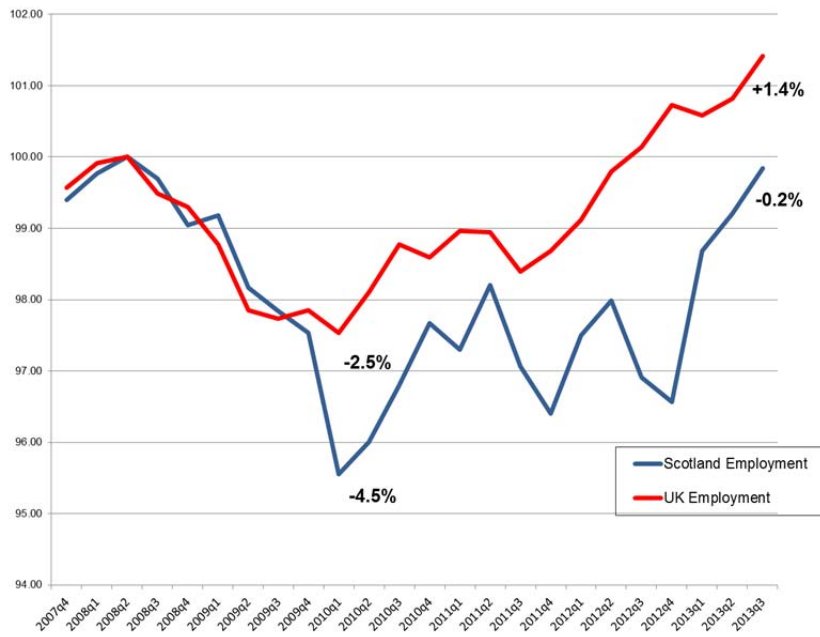
Scottish jobs are now -0.2% below their pre-recession peak, which continues to be worse than the UK, where the jobs total is 1.4% above the pre-recession peak. However, Figure 15 makes clear that the productivity gap between the UK and Scotland still persists. With a gap of +3.3% between the UK's GDP and jobs position in relation to pre-recession peak (i.e. 1.4% - (-1.9%)) compared to +0.7% (i.e. -0.2% - (-0.9%)) in Scotland. This suggests that productivity has fallen relatively more in the UK than in Scotland. The weak labour productivity position in both Scotland and UK is underlined by evidence provided in Table 6 and Figure 2 of the *Overview of the Scottish labour market* below which shows that increasing numbers of workers are taking part time employment in the absence of full time work. The employment 'recovery' continues to be driven by an increase in part time work and self-employment, although this may now be starting to moderate.

Figure 15: GDP and employment, Scotland and UK, recession and recovery to 2013q3



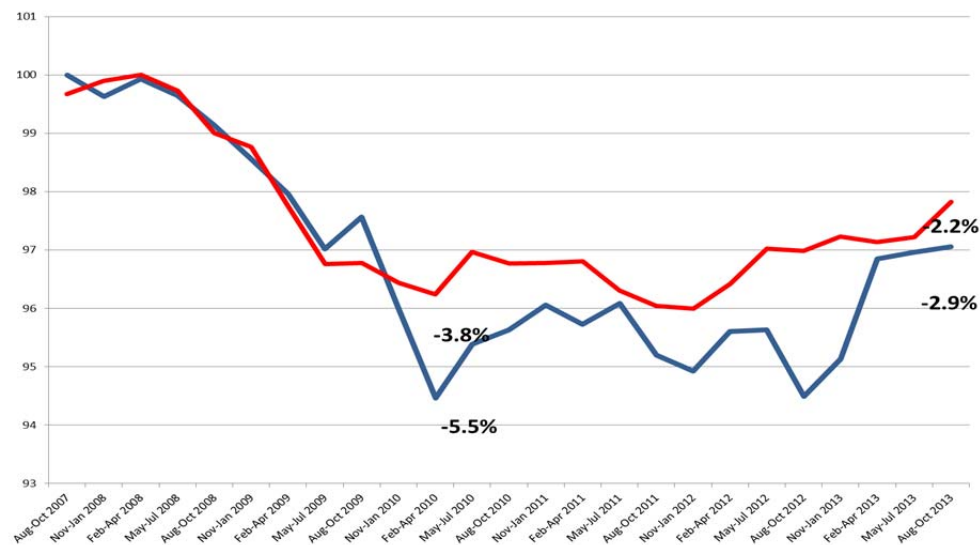
Source: Scottish Government unrounded GDP 2013 Q3 Tables, January 2014 and ONS Labour Market Statistics and ONS Regional Labour Market Statistics, February 2014 and FAI calculations

Figure 16: Total employment: Scotland and UK pre-recession peak to 2013q3



Source: ONS Labour Market Statistics and ONS Regional Labour Market Statistics February 2014 and FAI calculations .

Figure 17: UK and Scotland ratio of employment to population (16 plus) - recession and recovery to Aug-Oct 2013



Source: ONS Labour Market Statistics and ONS Regional Labour Market Statistics February 2014 and FAI calculations .

Finally, it would appear that there is still plenty of 'slack' in the Scottish labour market and more than in the UK as Figure 17 shows. Figure 17 charts the employment to working population ratio relative to pre-recession peaks for Scotland and UK.

By August - October 2013, the ratio in Scotland stood at -2.9% below the pre-recession peak compared to 2.2% in the UK. With earnings growth almost flat, and inflation falling, these data offer further evidence that there is still no justification for the Bank of England to apply the brakes, in the form of a rise in interest rates. This is likely to remain the case even when the UK unemployment rate falls below the Bank of England's 'forward guidance' target of 7%.

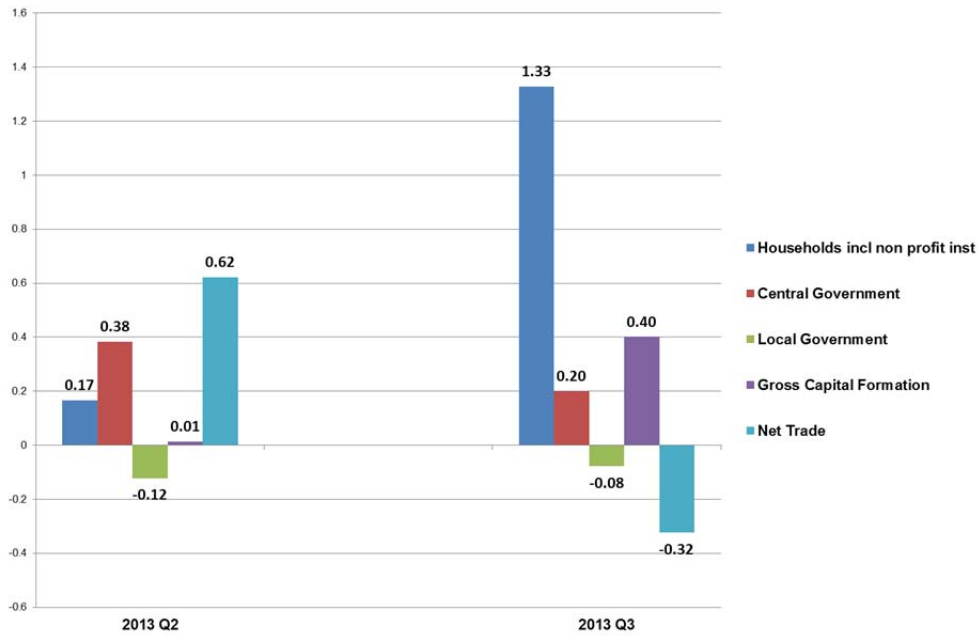
Driving the Recovery

We argued in the previous *Commentary* that the recovery had a better chance of being sustained if growth was broadly based. Moreover, given that households in the aggregate had to reduce their debt levels and government had embarked on a programme of fiscal consolidation in order to improve its own debt position, which had worsened following the bail-out of the banks and the loss of revenue in recession, there was a need to rebalance growth away from private domestic consumption to external demand and capital investment. This had certainly not been achieved up to the first quarter 2013, where growth was still being driven by household consumption and a belated improvement in the net trade position. But there was no evidence that capital investment was contributing to growth, although there was some evidence that it was starting to make a positive contribution to UK growth in the second quarter. It remained to be seen - in the absence of data - what would happen to investment in Scotland in the second quarter.

We now have *Scottish National Accounts Project* (SNAP) data for the second and third quarters of 2013. SNAP reports that nominal GDP, i.e. in *current market prices*, rose by 1.07% in the second quarter and by 1.52% in the third quarter. When we disaggregate this change into the contribution of the different (expenditure) components of aggregate demand, we obtain Figure 18, which shows the *percentage point* contribution to nominal growth while Figure 19 shows the *percentage* contribution to nominal growth.

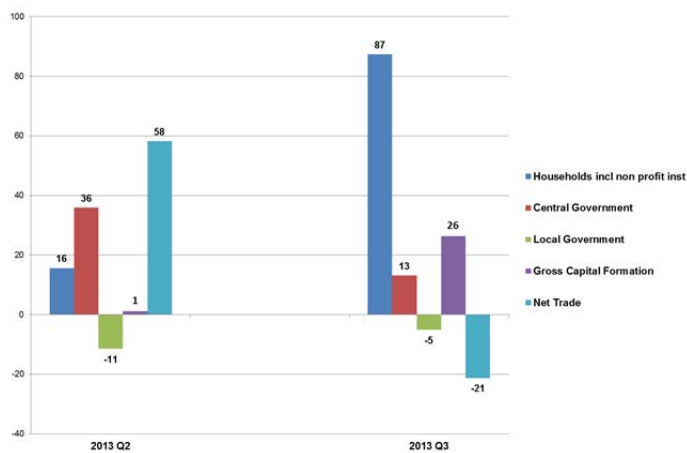
What is clear from Figures 18 and 19 is that the behaviour of the expenditure components is fairly erratic with, for example, household spending contributing 16% of nominal GDP growth in the second quarter rising to 87% in the third quarter. In contrast, net trade accounted for 58% of growth in the second and -21% in the third quarter. What we can say is that household spending has been the main driver of growth and that we are seeing some positive contributions to growth from net trade, as in the first and second quarters, but this has not been sustained as the third quarter negative contribution shows. The drivers of both household spending and net trade remain hesitant and weak, although as noted below there are some signs of improvement. However, it does appear that gross fixed capital formation, i.e. investment, is now tentatively starting, as it is in the UK, to make a positive contribution to growth: 1% in quarter 2 and 26% in quarter 3.

Figure 18: Expenditure components: percentage point contribution to nominal Scottish GDP growth in 2nd and 3rd quarters 2013



Source: SNAP 12 February 2014 and FAI calculations

Figure 19: Expenditure components: percentage contribution to nominal Scottish GDP growth in 2nd and 3rd quarters 2013

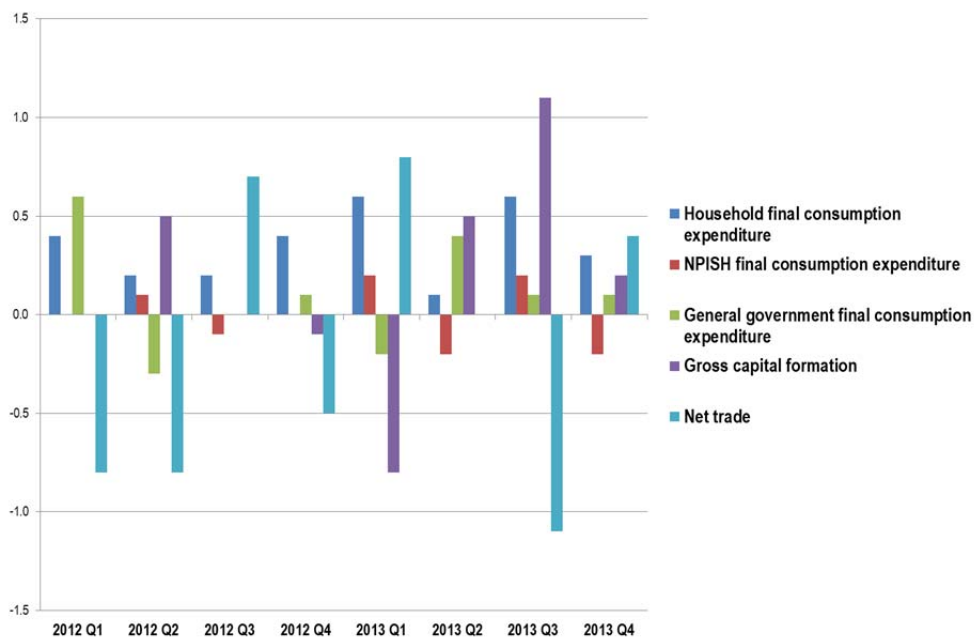


Source: SNAP 12 February 2014 and FAI calculations

We have argued for some time that there is a strong case for the UK Government and the Chancellor in his Budgets to promote capital investment, by public infrastructure investment. This would add to demand in the economy, thereby helping the recovery and would help longer-term growth by improving

the scale and efficiency of the supply-side of the economy. The increasing evidence that the recovery is now underway in no way removes the need for such a policy: it is now six years since the Great Recession began and the UK economy is still more than one percent below its pre-recession peak; the Great Recession has clearly removed capacity permanently from the British economy, and the quality of the existing infrastructure, especially transport, communications and energy, is poor by the standards of our main international competitors. In 2010 McKinsey and Company identified investment in transport and energy infrastructure as one of seven key priorities to help the UK move from austerity to prosperity¹. We therefore believe that there is a strong case for more public investment for both supply and demand-side reasons. Moreover, this argument can be extended to the private sector where investment remains weak, is doing little to help the recovery and by its absence is doing little to address the UK's weaknesses in productivity and hence competitiveness. In the *Forecasts of the Scottish Economy* section below Figure 3 shows that following the recession there was a sharp pick up in investment but that since the start of 2012 it declined again so that by the third quarter of last year overall UK gross fixed capital formation was around 10% below its pre-recession peak. In Scotland the situation is worse with investment currently 14% below pre-recession peak. There are issues of measurement and suggestions that the investment data may yet be revised upwards. In addition, we note above that investment does appear now to be contributing positively to growth in Scotland and recent survey data suggests a pick-up in investment intentions.

Figure 20: Expenditure components percent point contribution to UK GDP growth 2012Q1 to 2013Q4



Source: ONS Second Estimate of GDP, Q4 2013, Reference Tables

¹ See http://www.mckinsey.com/insights/economic_studies/seven_priorities_for_the_uk_economy

There is no substantive reason why Government should accept this weak investment profile. In addition to increased UK Government spending on capital investment, we believe there is a strong argument for the Chancellor to introduce a programme of private sector investment incentives, such as accelerated depreciation, in his forthcoming Budget. Moreover, rising regional inequality in growth and income per head in the UK - see *Forecasts of the Scottish Economy* section and the article by Julia Darby below - suggests that there should be differential regional investment incentives as well. In addition, the Scottish Government should consider raising the funding for its Regional Selective Assistance (RSA) programme and other investment funds administered by Scottish Enterprise. Of course adopting such incentives is a bit of a policy minefield because of EU State Aid rules. However, the EU's General Block Exemption Regulation (GBER) allows for regional incentive programmes under certain criteria.² Furthermore, academic evidence on the impact of regional policy in the 1960s shows that it works best when the national economy is expanding or recovering and firms are thinking about investing³. So now would be the right time.

Forecasts

Background

The second estimate for UK GDP growth in the fourth quarter of 2013 was a rise of 0.7%. This followed an increase of 0.8% in the third quarter, a 0.7% rise in the second quarter, a 0.4% rise in the first quarter of this year, and a -0.1% fall in the final quarter of 2012. GDP growth in the UK in 2013 was 1.8%, its strongest annual growth since 2007. The second estimate also provides data on the contribution of the individual components of aggregate demand to growth. Figure 20 charts the contribution of the principal components over the 8 quarters since 2012Q1: the final consumption expenditure of Households, non-profit institutions serving households (NPISH), and General Government, as well as Gross capital formation and Net trade.

Household spending has been the main driver of growth over the period, it has grown for nine consecutive quarters and as the ONS notes has accounted for more than 75% of expenditure growth since the fourth quarter of 2011. It is also evident that investment began to make a positive contribution to growth in each of the last three quarters, accounting for around one half of expenditure growth in the final quarter of last year. Net trade on the other hand has behaved erratically: four quarters with a negative contribution to growth, three quarters with a positive contribution and one quarter where the contribution was neither positive nor negative. It is also interesting to compare Scotland with the UK in the second and third quarters (Figures 18 and 20). The contribution of household spending to growth is similar while investment is weaker in Scotland with a lesser contribution and the contribution of net trade is somewhat stronger. Overall, in the UK, the fourth quarter data suggest that expenditure growth is becoming more balanced with investment and net trade playing a greater role and household spending a lesser role. This is to be welcomed, at long last, almost four years since the UK Government articulated

² See *The State Aid Guide* Department for Business Innovation and Skills, at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31700/11-1040-state-aid-guide.pdf

³ Ashcroft B Taylor J. 1977. *The movement of manufacturing industry and the effect of regional policy*. *Oxford Economic Papers*, 29. Moore B , Rhodes J. 1973. *Evaluating the effects of British regional policy*. *Economic Journal*, 83

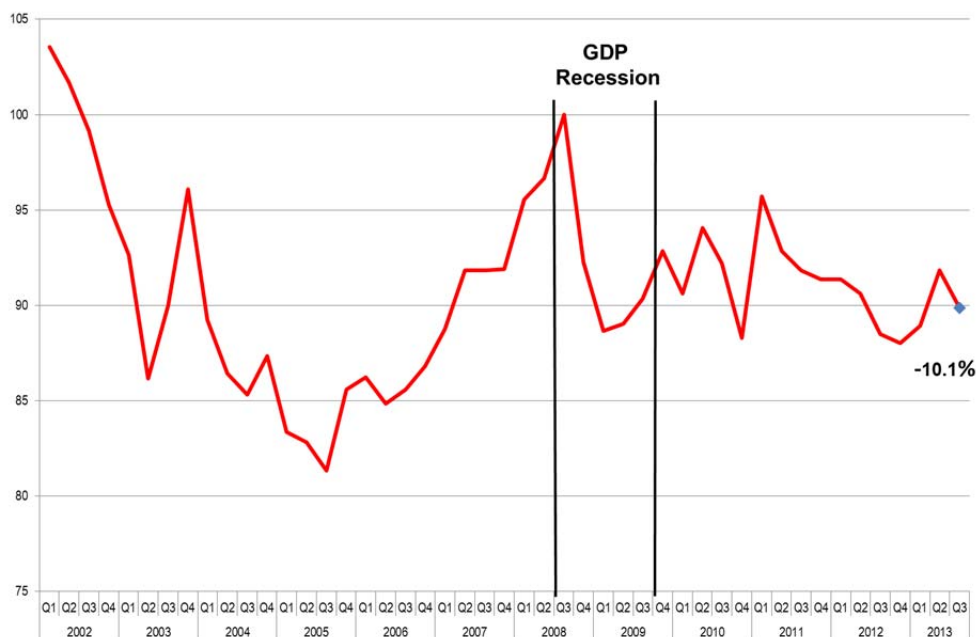
the need for a rebalancing of spending. The hope is that it continues with stronger contributions from investment and net trade.

In Scotland, we will not have 2013 fourth quarter GDP data until mid-April 2014. In the third quarter, we noted above that real GDP rose by 0.7% in Scotland, while rising by 0.8% in the UK. The Scottish economy has now been growing for the previous 6 quarters and the indications are that the growth rate will continue to rise in the near term. The latest business surveys - see *Review of Scottish Business Surveys* below - generally have a positive outlook in the short term. Many of the surveys showed that trends in key indicators are stronger than a year ago and net balance figures are returning to pre-recession levels of late 2007. Previous surveys have indicated a stagnating economy but these latest results indicate a return to pre-recession levels. The sense is that the pace of the recovery in the Scottish economy is accelerating and becoming broader based than previously. However, for some sectors, such as manufacturing and construction trading conditions are still harsh suggesting that the recovery remains fragile and policy action may be required to ensure that it is sustainable.

The future path of GDP in Scotland will, in the short to medium term, depend on the growth of the components of aggregate demand discussed above and their specific determinants. As we note in the UK in the fourth quarter spending became more balanced with a greater role played by investment and net trade complementing the significant contribution from household spending. In Scotland spending remained as unbalanced in the third quarter as in the UK. So we need to gauge the immediate future prospects for each of the principal components in Scotland. This is set out in some detail in the *Forecasts of the Scottish Economy* section below so we summarise briefly here.

The growth of real household income is largely flat even though household spending has been rising. This is explained by the drop in the saving ratio, which has behaved similarly in Scotland to the UK, although it has remained higher in Scotland since late 2010. Sustained growth of household spending cannot rely on a falling savings ratio. Households may borrow more but this cannot be sustained indefinitely especially given the already high levels of household debt which remain above historical levels even though they have fallen somewhat since the start of the Great Recession. What is required is rising real incomes and/or the value of asset holdings. Nominal earnings may now be starting to pick up as hinted at in the Scottish business survey evidence but such growth is little different from consumer price inflation implying that real earnings remain stagnant. The housing market is definitely picking up but house prices remain around 6% below their pre-recession peak in Scotland, so while rising house prices may be giving some boost to household spending the effect is unlikely to be great at this stage at least.

Investment is now beginning to contribute to Scottish growth but large companies continue to hoard cash and are still uncertain about the prospects for consumer demand despite rising confidence. We noted above that investment is weaker in Scotland than in the UK at 14% compared to 10% below its pre-recession peak. Without policy support it seems unlikely that there will be a great surge in investment in the immediate future.

Figure 21: Scottish manufacturing export volumes to 2013q3, seasonally adjusted - 2008q3 = 100

Source: Scottish Government Index of Manufacturing Exports 3rd Quarter 2013, January 2014 and FAI calculations.

Similarly, with net trade which is contributing more positively to growth in Scotland than in the UK. But Scottish export performance is still weak by historical standards. The fall in sterling has, as in the UK, not produced the boost to exports that was hoped and now sterling is rising again. The performance of Scottish manufacturing exports outside the UK weakened in the third quarter of last year as Figure 21 shows.

Manufacturing exports are now languishing at slightly more than -10% below their pre-recession peak and not much higher than the trough of around -12% below the peak that the series has experienced on three occasions (2009q1, 2010q4 and 2012q4) since the start of the Great Recession. Trading conditions in the wider world economy are improving as growth slowly returns. The IMF revised its growth forecasts up in January 2014 for the US, China and the Euro area, although there is some concern that growth may slow again in China and other emerging economies. So, we are hopeful that the recovery is gathering pace. However, we share the view of the Financial Times, which in responding to recent Bank of England forecasts said in its editorial of 13 February 2014

"... the bank's hyper-bullish growth forecasts may well be too optimistic. The government's austerity programme will continue to weigh on growth and, as sterling keeps appreciating, net exports are unlikely to pick up. Since real wages are still stagnant there is only so much more consumers can do to boost the economy. Were companies to continue hoarding cash rather than investing, growth may well disappoint."

It is against this background that we have prepared our latest forecasts.

GVA Forecasts

For our latest GVA forecasts we continue the presentational procedure adopted in earlier *Commentaries*. We present only a central forecast but use estimated forecast errors to establish the likely range that the true first estimate of the growth of Scottish GVA will lie between.

Table 1 presents our forecasts for Scottish GVA - GDP at basic prices - for 2013 to 2015. The forecasts are presented in more detail in the *Forecasts of the Scottish Economy* section of this Commentary below.

Table 1: FAI Forecast Scottish GVA growth, 2013-2015

GVA Growth (% per annum)	2013	2014	2015
Central FAI forecast	1.7	2.3	2.3
<i>October FAI forecast</i>	<i>1.3</i>	<i>1.8</i>	<i>2.1</i>
UK mean independent new forecasts (February)	1.9	2.7	2.4
Mean Absolute Error % points	+/- 0.19	+/- 0.50	+/- 1.21

Source: Fraser of Allander Institute forecasts, March 2014

Table 1 shows that our GDP forecast for 2013 at 1.7% has again been revised upwards from our October forecast of 1.3%. For the 2014 we have also revised up our forecast from the 1.8% predicted in October to 2.3%. Similarly, for 2015, we have revised the forecast up from 2.1% to 2.3%. The forecasts for 2013 and 2014 are higher than in October because of better than expected outturn data on the growth of household spending, a pick-up in investment, improving trade conditions and increasingly optimistic business surveys. We are now predicting that growth will move above trend next year. After 6 years since the start of the Great Recession we are now witnessing a stronger recovery, although weaker than almost all previous recoveries from recession. Moreover, as discussed above there are good reasons to be cautious about the future path of the recovery.

Table 1, also compares our GVA forecasts with the median of latest independent forecasts for the UK as published by the UK Treasury. These show that we expect Scottish growth to continue to be a little weaker than UK growth over the forecast period. So, we are now forecasting growth of 1.7% in 2013, 2.3% in 2014 and 2.3% in 2015. Given our previous forecast errors the lower and upper bounds for growth in 2013 are expected to be 1.5% and 1.9%, for 2014, 1.8% to 2.8%, and for 2015, 1% to 3.5%.

Production and manufacturing continue to be the major sectors exhibiting the fastest growth in 2013, 2014 and 2015. In 2013, production is projected to grow by 2%. Services and construction display positive growth this year at 1.6% and 1.3% respectively. This relative performance continues in both 2014 and 2015 as forecast growth across all sectors increases. Production grows by 2.8% and 2.7% in 2014 and 2015, while service growth is projected to be 2.2% in both years. The construction sector continues to lag but picks up to 1.8% and 1.4%. We have therefore revised up again the forecast of growth in all the major sectors for the forecast period.

Employment Forecasts

Table 2 presents our forecasts for net employee jobs for the years 2013 to 2015 in terms of a central and upper and lower forecast.

Table 2: FAI Forecast Scottish Net Jobs Growth in Three Scenarios, 2013-2015

	2013	2014	2015
Upper	35,450	51,050	71,900
<i>October forecast</i>	<i>27,900</i>	<i>38,100</i>	<i>68,750</i>
Central	31,450	39,600	42,800
<i>October forecast</i>	<i>21,200</i>	<i>27,200</i>	<i>38,400</i>
Lower	26,350	36,700	13,350
<i>October forecast</i>	<i>15,750</i>	<i>16,450</i>	<i>11,400</i>

Source: Fraser of Allander Institute forecasts, March 2014

We continue to raise our forecasts for job creation over the forecast horizon. This reflects our raised GVA forecast and weak forecast productivity implying that more jobs are required to produce the greater output. On the central forecast, we are now forecasting that net jobs will rise by 31,450 in 2013, rising to 39,600 in 2014 and 42,800 in 2015. This year, we now expect just under 28,000 service sector jobs will be created, with around 1,550 to be added in production due to expected productivity increases given the growth in output, and somewhat stronger jobs growth of 1,650 in agriculture. Construction jobs are now forecast to rise this year by 400. In 2014/2015, the bulk of the jobs created are again expected to be in the service sector with an additional 33,900/33,750 jobs forecast, while 1,650/4,700 are added in production, 2,650/2,700 in agriculture and 1400/1,650 in construction.

Unemployment Forecasts

The key unemployment forecasts are summarised in Table 3 below.

Table 3: FAI forecasts ILO unemployment 2013-2015

	2013	2014	2015
<i>ILO unemployment</i>			
Rate (ILO un/TEA 16+)	7.1%	6.6%	6.3%
October FAI forecast	7.6%	8.3%	6.9%
Numbers	195,000	179,900	170,214

Source: Fraser of Allander Institute forecasts, March 2014

The ILO rate is our preferred measure since it identifies those workers who are out of a job and are looking for work, whereas the claimant count simply records the unemployed who are in receipt of

unemployment benefit. Our unemployment forecasts have been revised down further again from October, reflecting higher employment given the growth of output. Many workers have re-entered the labour market as job prospects improve. The upshot is that unemployment has not fallen as much as the job creation figures might suggest but may fall more quickly if this rise in participation in the labour market begins to ease. Furthermore, the high rate of job creation as productivity growth remains stubbornly weak contradicts our model-based expectation that growth would not be fast enough to absorb new entrants into the labour force hence we are now forecasting a progressive but slow reduction in the unemployment rate over the next three years. Our projection for unemployment on the ILO measure at the end of 2013 is now 195,000 (7.1%). By the end of 2014 unemployment is now forecast to be 179,900 (6.6%) falling further to 170,214 (6.3%) by the end of 2015 as growth in the economy strengthens.

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