

1 Outlook and appraisal

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Overview

The Scottish economy is now enjoying a strong recovery, which is, however, subject to the risks of: a continuing unbalanced recovery; falling real wages; booming house prices in the London housing market, and deflation in the Eurozone.

In 2013 Scottish GDP grew at 1.6% a little less than the 1.7% outturn in the UK. This suggests that without the loss of output due to the dispute at Grangemouth in October 2013, Scottish growth would have equalled that of the UK. Positive growth has now been recorded for the Scottish economy in the previous 7 quarters. But to reiterate our previous warnings: the recovery continues to be considerably weaker than that of any recession in the last 70 to 80 years (i.e since the 1930's). In the fourth quarter, GDP in Scotland was -0.9% below its pre-recession peak, whereas UK GDP stood at -1.4% below its pre-recession peak of more than 5 years ago. However, due to the greater fall in UK output during the recession, recovery from the recession has been stronger in the UK.

At the sectoral level, Scottish services have now finally attained and surpassed – slightly – their pre-recession peak while UK services attained their pre-recession peak in the Q3 2013. Production and manufacturing in Scotland has tended to outperform their UK counterparts during the recovery, but in the fourth quarter both were weaker in Scotland. While this was principally due to the production lost owing to the Grangemouth shutdown, the performance of Scottish manufacturing was weak across the board. Construction activity weakened in the final quarter of last year and still remains around 13% below its pre-recession peak in both Scotland and the UK, with the sector in the UK now doing a little better than north of the border. Business and financial services taken together have posted strong growth over the year, though it has slowed a little in the final quarter. Nevertheless, the sector in both the UK and Scotland has now moved to +2% above its pre-recession peak. Nevertheless, financial services taken on its own remains weak with output falling in the final quarter of the year to stand just above -12% below its pre-recession peak. Output in Distribution, hotels & catering now stands at more than 1% above its pre-recession peak compared to -2.6% below in the UK, however the recession in the sector in the UK was much deeper. Finally the Transport, Storage & Communication sector in Scotland remains weak both absolutely and relatively and stands at -6.5% below its pre-recession peak compared to -3.4% in the UK.

The latest labour market data reveal a recovery in the Scottish and UK labour markets, which is almost unprecedented. The ILO unemployment rate now stands at 6.6% the same as in the UK, while the employment rate for the 16 to 64 age range is 70%. However, there continues to be plenty of slack for growth in the Scottish labour market despite the current strong jobs recovery: the ratio of employment to working population is -2.8% below its pre-recession peak, and it is clear that growth in employment is still being sustained by the growth of part-time work and the self-employment. Moreover, there are still a large number of part-time workers who are seeking and cannot find a full-time job.

There are four potential risks to a sustained recovery of the Scottish economy:

- a failure to achieve a balanced recovery (as between household consumption, business investment and export growth)
- weak or no growth in real wages
- an overheated housing market, especially in London and the South East of England and its potential impact on UK interest rates
- the risk of deflation in the Eurozone.

The evidence suggests that the UK and Scotland are still a long way off from a balanced recovery. Investment does seem to be picking up and it is to be hoped that this will continue, because the prospects of a marked improvement in the net trade position with sterling high and the European economies weak, does not augur well. And while household spending is currently strong, its underlying determinants appear weak.

A key reason for concern about the sustainability of household spending is that debt levels to income remain high and real wages are falling! Real wage growth needs to move into positive territory for the prospects of a *sustained* growth in UK household spending to be certain. One critical factor here is whether labour productivity can begin to grow strongly. Without a step-change in the rate of growth of productivity the likelihood is that the recovery - as the economy begins to approach capacity - will see rising nominal wages but little increase in real wages as the growth of product prices matches that of nominal wage growth. Yet, data suggest that real Scottish wage growth become positive in 2013 whilst UK growth has remained negative for the past three years. This could be due to a faster growth in labour productivity in Scotland than in the UK, but we have no up-to-date data on labour productivity on this matter. Nevertheless, the recent recovery in UK jobs growth has been faster than in Scotland whereas GDP growth has been more similar suggesting faster productivity growth here. So, on this basis, the prospects for Scottish household spending might be a little rosier than in the UK.

Arguably the biggest threat to the recovery in both Scotland and the UK comes from the housing market. House prices are rising at an annual rate of 8% in the UK but by 17% in London. Scotland's house prices were largely flat over the year to March 2014 with growth of only 0.8%. We believe there is a strong case for the Bank of England to exercise its currently limited macro-prudential policy powers through its new Financial Policy Committee by seeking to curb high loan to income ratios. The Bank of England should not seek to raise interest rates largely on this account. Rising house prices are essentially a London and South East England phenomenon. In Scotland, house prices are hardly rising overall. So, it would seem inappropriate for the recovery to be dampened right across the UK for what is clearly a local or regional issue centered on London.

The final obstacle to recovery is the risk of deflation in the Eurozone, with prices poised to begin falling, the Eurozone risks a decade or more of Japanese-style stagnation. This would lower demand for imports and limit foreign investment and would be very damaging to any export recovery in both Scotland and the rest of the UK.

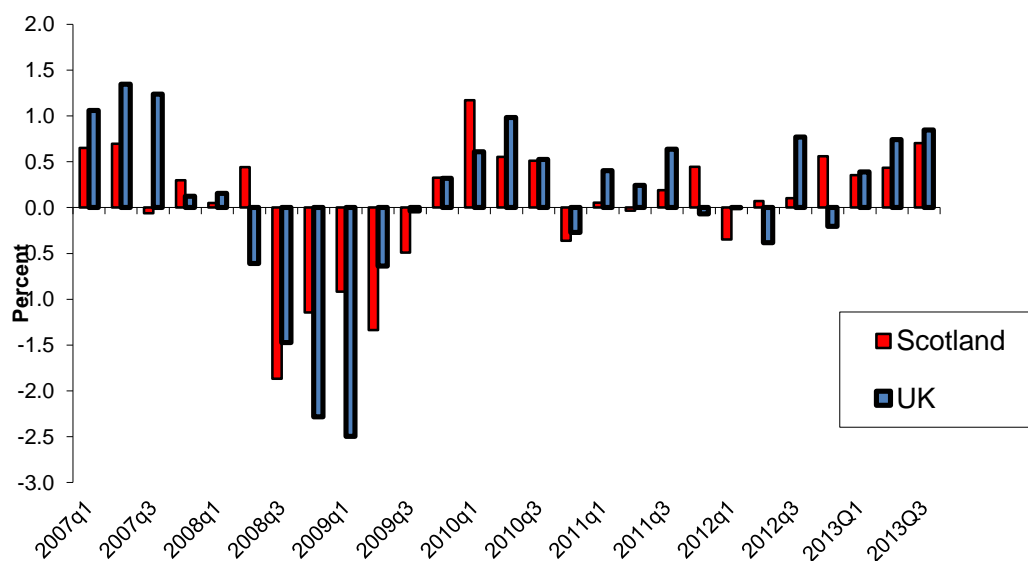
Against this background we are now forecasting growth in Scottish GDP of 2.5% in 2014, 2.2% in 2015, and 2.4% in 2016. This represents a slight increase for 2014 and a slight decrease for 2015 over our March 2014 forecast. Given our previous forecast errors the lower and upper bounds for growth in 2014 are expected to be 2.1% and 2.9%, for 2015, 1.7% to 2.7%, and for 2016, 1.3% to 3.5%.

Production and manufacturing continue to be the major sectors exhibiting the fastest growth in 2014, 2015 and 2016. Our forecasts for employee job creation are broadly similar to our March 2014 forecasts, with a slight upward revision for 2014 and small downward adjustment for 2015. On the central forecast, we are now forecasting that net jobs will increase by 43,100 in 2014, 42,900 in 2015 and 58,150 in 2016. Our projection for unemployment on the ILO measure at the end of 2014 is now 173,150 (6.4%). By the end of 2015, unemployment is now forecast to be 168,150 (6.2%) falling further to 157,200 (5.8%) by the end of 2016 as growth in the economy strengthens over 2015.

Recent GDP performance

The latest Scottish GDP data for Q4 2013 show that Scottish GDP rose by 0.2% in the quarter, significantly less than the 0.7% rise in the UK, see Figure 1.

Figure 1: Scottish and UK quarterly GDP growth, 2007q1 – 2013q4



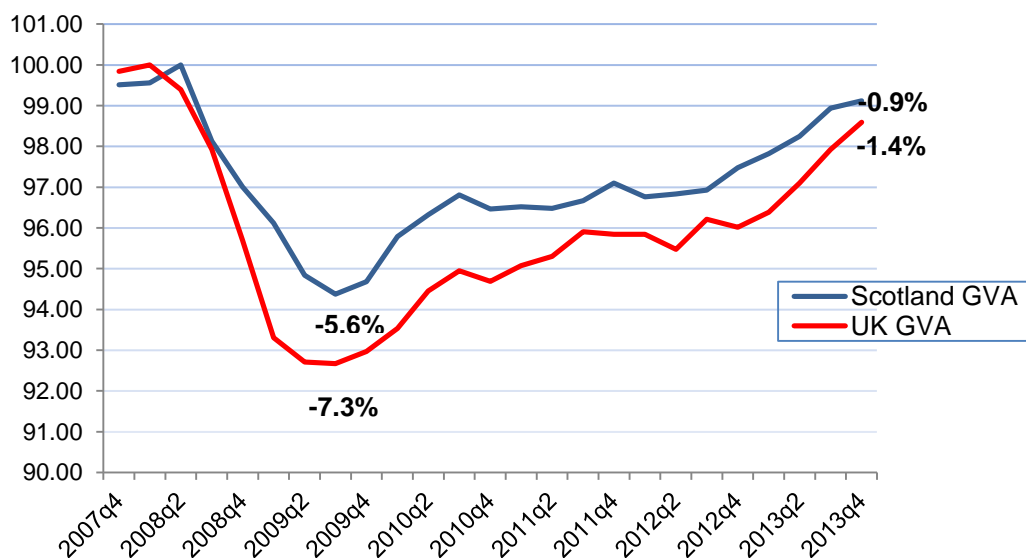
Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2013 and Fraser of Allander Institute calculations

However, the weakness of the Scottish economy compared to the UK during the quarter is more apparent than real. GDP in the Scottish economy was clearly affected by the dispute that shut down the Grangemouth refinery. Scottish Government statisticians estimate that this amounted to a direct loss of -0.2% of GDP in the quarter, a calculation with which we agree. Moreover, there will in addition be further secondary effects on suppliers of the shutdown and loss of spending from income, which using the

Scottish Input-Output tables is likely to have almost doubled the effect on GDP. Hence, we can conclude that the Grangemouth dispute was responsible for reducing GDP by about -0.4% in the Q4 2013, suggesting that the implicit growth of the Scottish economy in the quarter was about 0.6%, close to but a little less than UK GDP growth at 0.7%. This will of course also mean that the resolution of the dispute and the resumption of production in the Q1 2014 will mean that the GDP figure for the quarter – to be published in the third week of July 2014 - will inflate the true growth performance of the Scottish economy in Q1 2014.

Over the year to the fourth quarter - four quarters on the previous four quarters - Scottish GDP grew at 1.6% a little less than the 1.7% outturn in the UK, suggesting that without the loss of output due to Grangemouth annual performance would have been no worse than in the UK. These data continue to offer further evidence of a strengthening recovery. Positive growth has now been recorded for the Scottish economy in the previous 7 quarters. But to reiterate our previous warnings: the recovery continues to be considerably weaker than from any recession in the last 70 to 80 years. The effect of the latest data on Scotland and the UK's recovery from recession is shown in Figure 2.

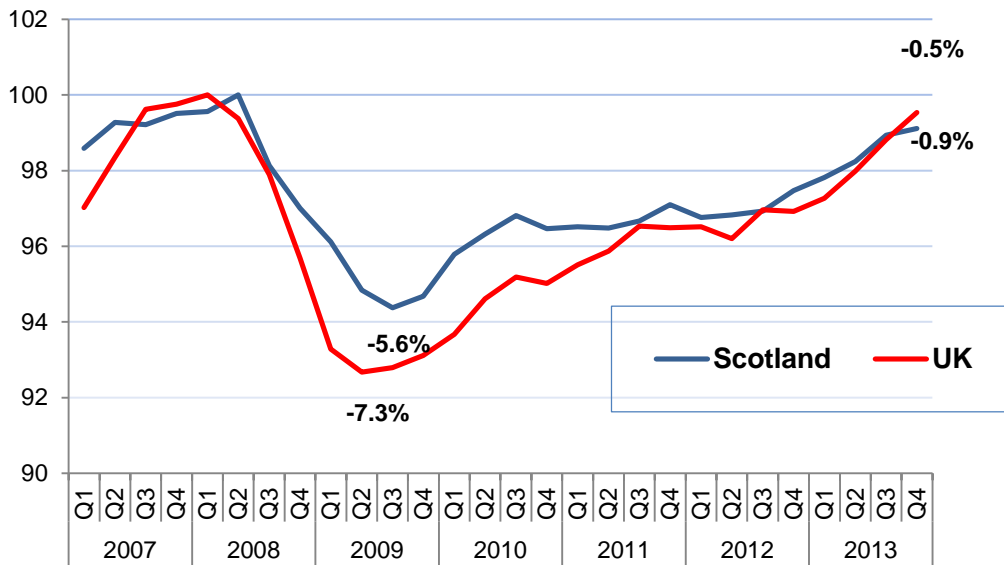
Figure 2: GVA in recession and recovery, Scotland and UK to 2013q4 (relative to pre-recession peak)



Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2013, ONS and Fraser of Allander Institute calculations

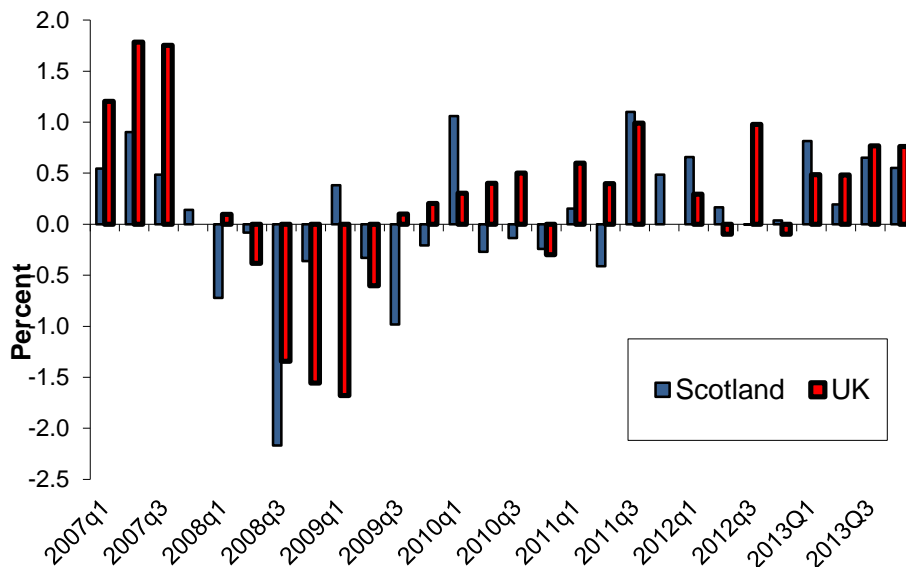
In the fourth quarter, GDP in Scotland was -0.9% below its pre-recession peak, whereas UK GDP stood at -1.4% below its pre-recession peak of more than 5 years ago. While the scale of the recession was greater in the UK: a drop of -7.3% in GDP compared to a fall of -5.6% in Scotland, the overall strength of the recovery has been stronger in the UK than in Scotland. Hence, UK GDP has grown by 6.34% from the trough of the recession compared to 5.02% in Scotland. However, as noted in previous *Commentaries* there is the complicating factor of oil and gas production - offshore production - which is included in the UK GDP data but not in the Scottish data. Removing oil and gas production gives us Figure 3.

Figure 3: GVA ex oil & gas in recession and recovery to 2013q4



Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2013, ONS and Fraser of Allander Institute calculations

Figure 4: Scottish and UK services GVA Growth 2007q1 to 2013q4



Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2013 and Fraser of Allander Institute calculations

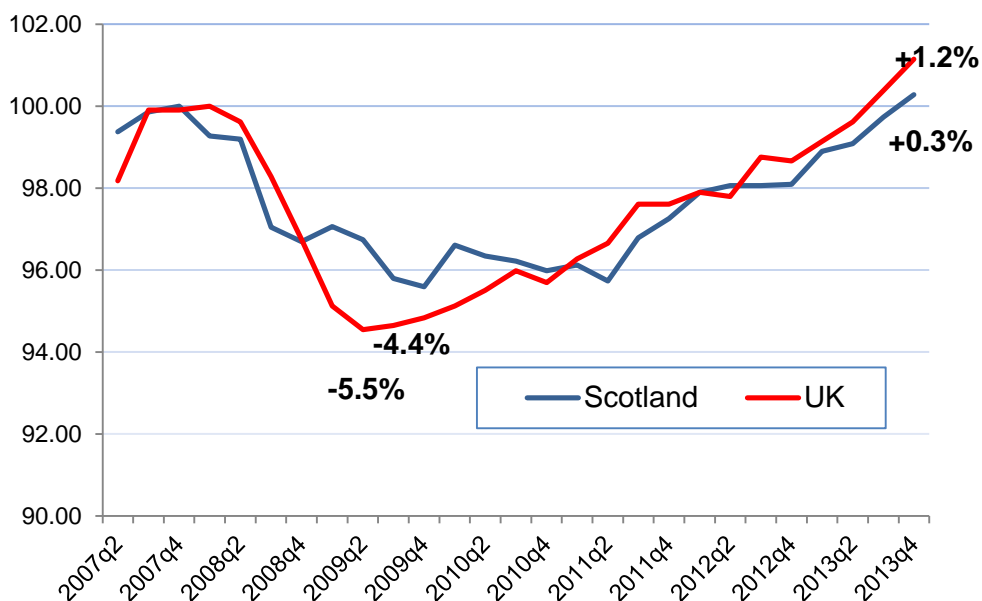
When oil and gas production is removed, we find that the respective Scottish and UK growth rates remain the same for the latest quarter but over the year – four quarters on four quarters – UK growth rises to 1.8%. The long period of weak oil and gas production has resulted in the UK GDP - ex oil & gas - having a

much stronger recovery from recession than Scottish GDP. Scottish GDP has recovered by 5.02% since the trough of recession while UK GDP - ex oil & gas - has recovered by 7.41% from its trough. So, by the final quarter of last year UK GDP - ex oil & gas - was -0.5% below its pre-recession peak compared to -0.9% for Scotland.

We now turn 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 0.6% in Scotland and 0.8% in the UK in the fourth quarter - see Figure 4.

Over the year - that is four quarters over previous four quarters - the service sector in Scotland grew by 1.5%, less than the 1.8% achieved in UK services. The state of the recovery in Scottish and UK services is presented in Figure 5.

Figure 5: Services GVA in recession and recovery Scotland and UK to 2013q4



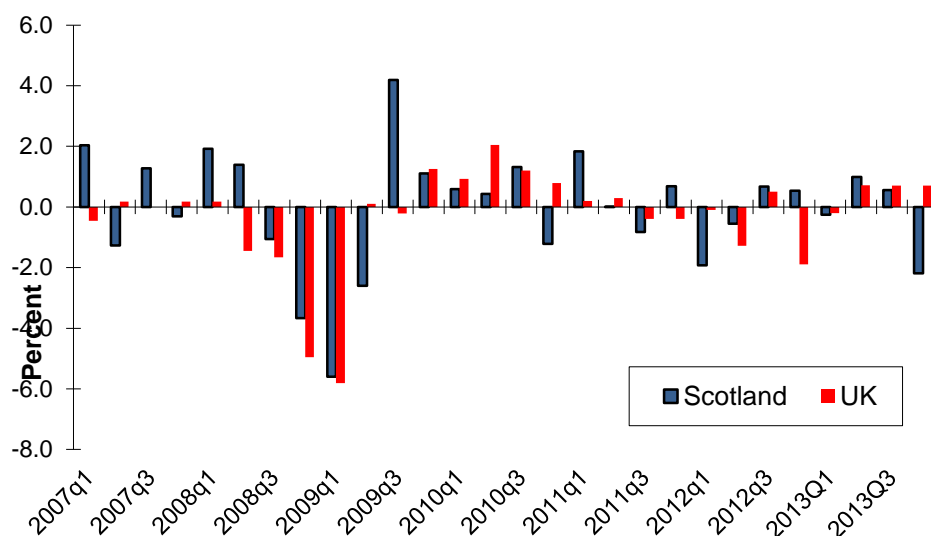
Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2013 and Fraser of Allander Institute calculations

We can see from Figure 5 that Scottish services have now finally attained and passed – slightly – their pre-recession peak. UK services attained their pre-recession peak in the Q3 2013. So, UK services now stand at 1.2% above the previous peak, while for Scottish services it is 0.3%. The recovery in Scottish services continues to be weaker than in the UK with growth of 4.33% since the trough of the recession compared to 6.98% in UK services. As we noted in the previous two *Commentaries* Scottish services' growth continues to underperform the overall performance of the economy in the recovery whereas UK services growth has been somewhat ahead of UK GVA growth. The production sector continues to boost Scottish growth, growing by a little over 9% in the recovery. This contrasts markedly with the UK situation where the sector has been a significant drag on the UK recovery with growth of less than 0.5% since the trough of the

recession. This is partly a consequence of the weakness of oil & gas production on the UK production and GDP figures.

However, Scottish production output weakened in the final quarter of 2013, largely due to the 'Grangemouth effect'. Output fell in the quarter by 0.7% compared to a rise of 0.5% in the UK. But over the year - four quarters on four quarters - production GVA rose by 1.7% in Scotland compared to a fall of -0.3% in the UK. Mining & quarrying GVA grew by 2.9% in the fourth quarter in Scotland and rose by 6.2% over the year. In contrast, UK mining & quarrying fell 1.8% in the quarter and contracted by -2.1% over the year. Electricity & gas supply GVA rose by 2.4% in Scotland in the fourth quarter but fell by -0.6% over the year, almost the complete opposite of performance in the previous quarter. In the UK the sector grew by 1.8% in the quarter while contracting by 0.3% over the year. It is the performance of manufacturing, though, accounting in Scotland for 63% of production and 12% of total GVA, that is the key driver of the differential performance in production between Scotland and the UK. In the fourth quarter, GVA in Scottish manufacturing fell, largely because of the Grangemouth effect, by -2.2% but rose by 0.8% over the year. In UK manufacturing GVA rose by 0.6% in the quarter but fell by -0.6% over the year. Figure 6 charts the quarterly percentage changes in GVA in Scottish and UK manufacturing.

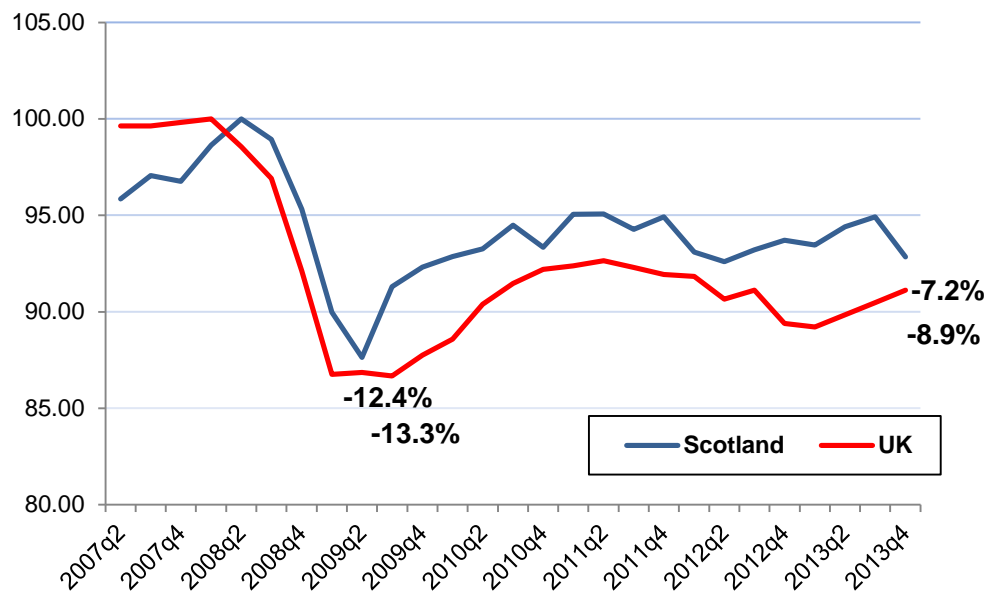
Figure 6: Scottish and UK manufacturing GVA growth at constant basic prices 2007q1 to 2013q4



Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2013 and Fraser of Allander Institute 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 2013q4

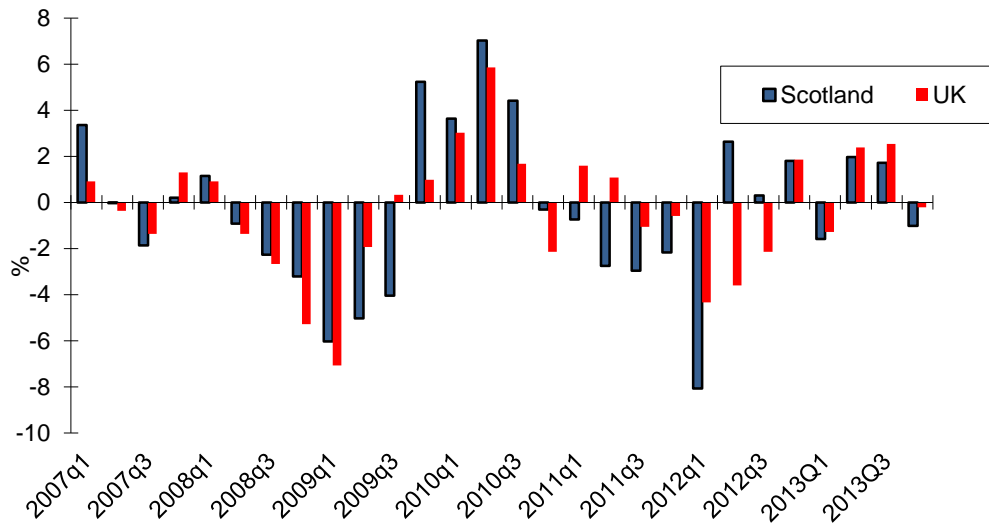


Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2013 and Fraser of Allander Institute calculations

Largely, but not wholly, because of the Grangemouth effect, Scottish manufacturing GVA went from 4.6% below the 2009-09 pre-recession peak in the third quarter to -7.2%. The figure for UK manufacturing improved slightly because of the small rise GVA in the quarter from -9% in the third quarter to -8.9% in the latest quarter. We should expect the recent favourable gap between Scotland and UK manufacturing performance during the recovery to be restored in the next quarter's data - 2014q1 was a result of the Grangemouth plant coming back on stream.

Within manufacturing, there was only one principal sector that experienced growth in in the fourth quarter: metals, metal products & machinery n.e.c. (accounting for 19% of manufacturing GVA) which grew by 0.3% in the quarter and by 4.8% over the year. We have already mentioned the Grangemouth driven - 10.8% drop in refined petroleum, chemical & pharmaceutical products (accounting for 12% of manufacturing GVA) in the quarter and a small increase of 0.1% over the year. Given the weight of this sector, this accounted for about sixty per cent of the -2.2% fall in manufacturing GVA in the quarter. The remaining forty per cent came from the following sectors: computer, electrical and optical products (electronics) (accounting for 9% of manufacturing GVA), which contracted by -3% in the quarter and by -9.8% over the year; other manufacturing Industries; repair & installation (accounting for 22% of manufacturing GVA) which contracted by -2.1% in the quarter but grew by 1% over the year; textiles, clothing & leather products (accounting for only 2% of manufacturing GVA) suffered a loss of output of -3.5% in the quarter and also contracted by -3.4% over the year; food & drink (accounting for 28% of manufacturing GVA) which contracted by -0.3% in the quarter but grew by 1.2% over the year; and finally, transport equipment (accounting for 8% of manufacturing GVA) contracted by -0.75% in the quarter but grew by 4.1% over the year. Turning now to construction, the latest data are presented in Figure 8.

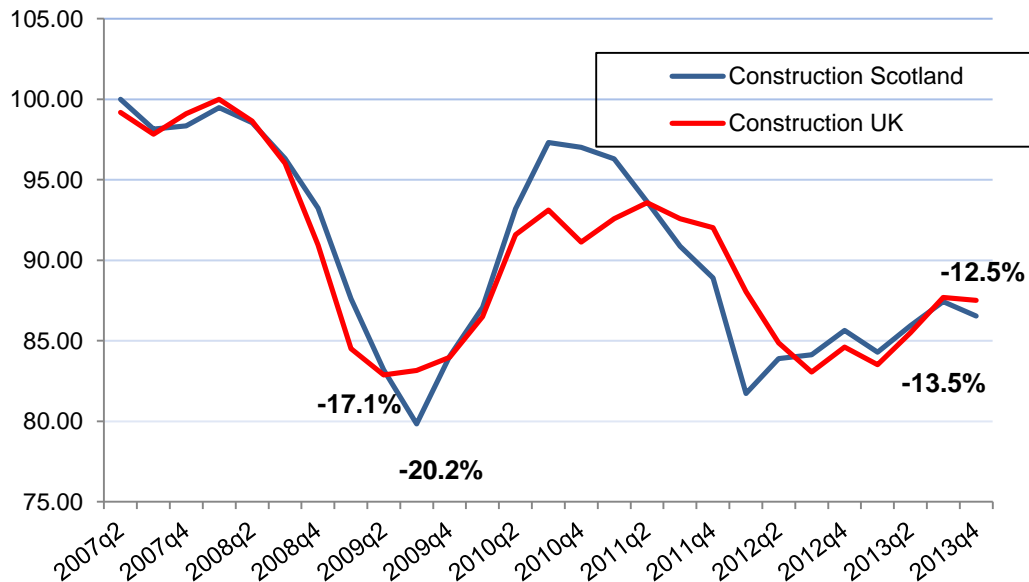
Figure 8: Scottish and UK construction GVA volume growth 2007q1 - 2013q4



Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2013 and Fraser of Allander Institute calculations

Scottish construction GVA fell by -1.0% in the quarter but rose by 2.6% over the year. UK construction GVA also contracted, but by less at -0.2% than in Scotland, with GVA rising by 1.1% over the year. Scottish construction's performance has been weaker than its UK counterpart for the last three quarters. Figure 9 displays the recession and recovery performance in both Scottish and UK construction.

Figure 9: Construction, recession and recovery to 2013q4

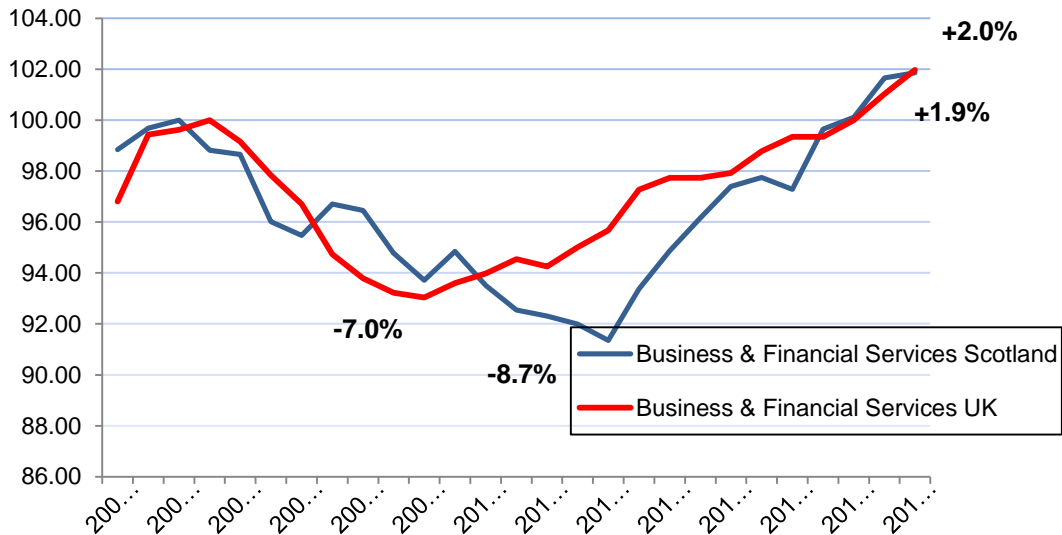


Source:

Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2013 and Fraser of Allander Institute calculations
 Figure 9 shows that the sector despite the general recovery remains considerably depressed in both the UK and Scotland. The recent stronger performance of UK construction means that GVA in the sector stood in the fourth quarter at -12.5% below its pre-recession peak with the sector in Scotland in a worse position at -13.5% below its peak.

Within services, the principal sub-sectors all displayed positive growth in the fourth quarter. However, growth in business and financial services slackened somewhat in the quarter with GVA growing by only by 0.2% compared to 1% in the UK. Over the year, the sector grew at 3.8% in Scotland and 2.2% in the UK. Figure 10 shows the growth of the sector in Scotland and UK during the recession and recovery.

Figure 10: Business & Financial Services: recession and recovery to 2013q4

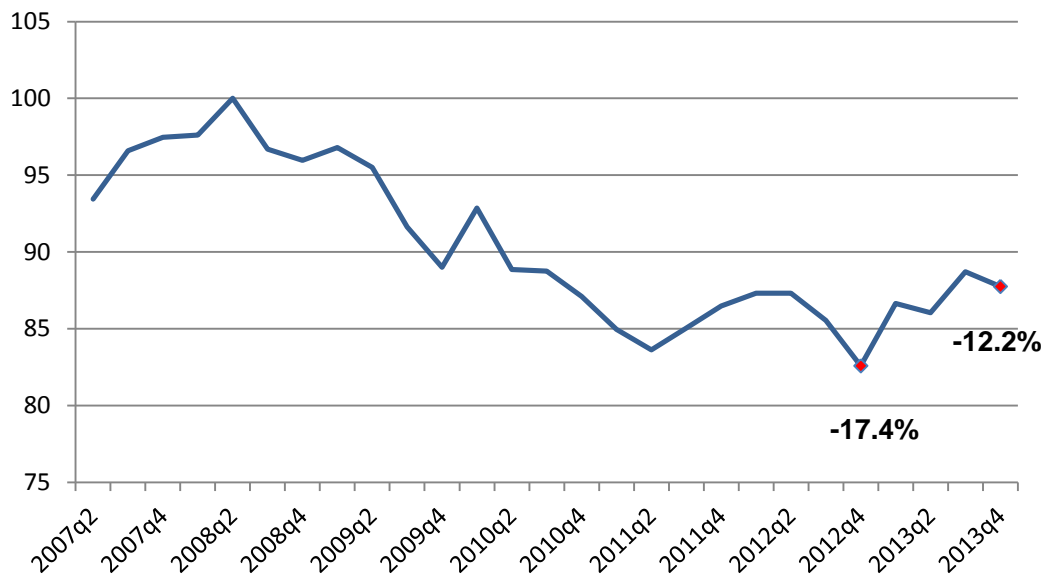


Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2013 and Fraser of Allander Institute calculations

By the latest quarter, the sector in both the UK and Scotland had moved to +2% above its pre-recession peak. We noted in previous *Commentaries*, 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. Figure 11 shows what has been happening to financial services since peak output in the second quarter of 2008.

These data show that the recent sustained recovery enjoyed by the sector since the fourth quarter 2012 came to an end in the final quarter of last year, with GVA falling by -1.1% in the quarter while rising by 1.9% over the year. Now GVA in the sector is -12.2% below the pre-recession peak compared to the trough of -17.4% in 2012q4. We await further data to assess whether the recovery will resume or whether, following the structural change that occurred after the Great Recession, some of that lost output may never return and so continue to be drag on the sector's recovery.

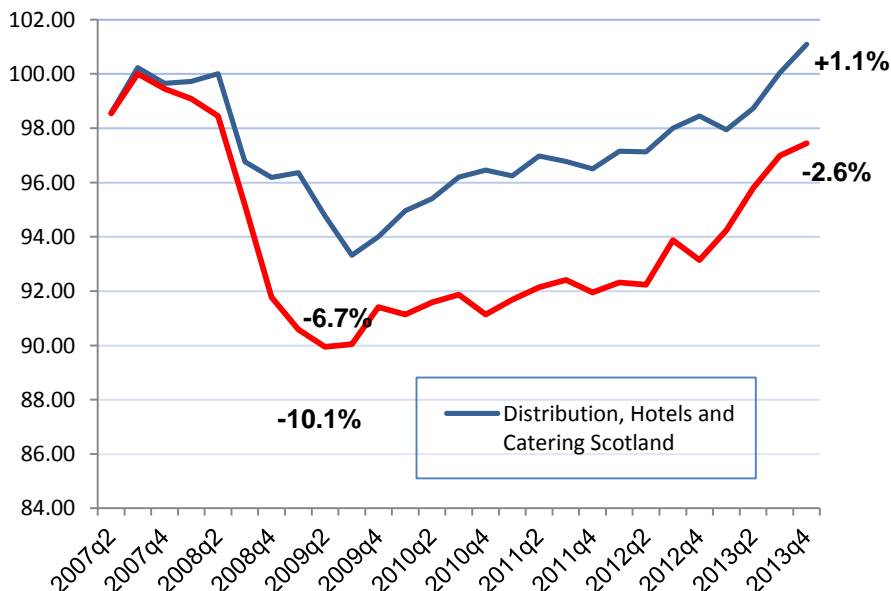
Figure 11: Financial Services, recession and recovery 2008q2 to 2013q4



Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2013 and Fraser of Allander Institute calculations

Elsewhere, in private services, distribution, hotels and catering (accounting for 19% of services sector output in Scotland), grew by 1% in the third quarter compared to an increase of 0.5% in the UK. Over the year, the sector grew by 1.8% in Scotland compared to 3.5% in the UK. Figure 12 shows the performance of the sector during recession and recovery.

Figure 12: Distribution, Hotels & Catering: recession and recovery to 2013q4

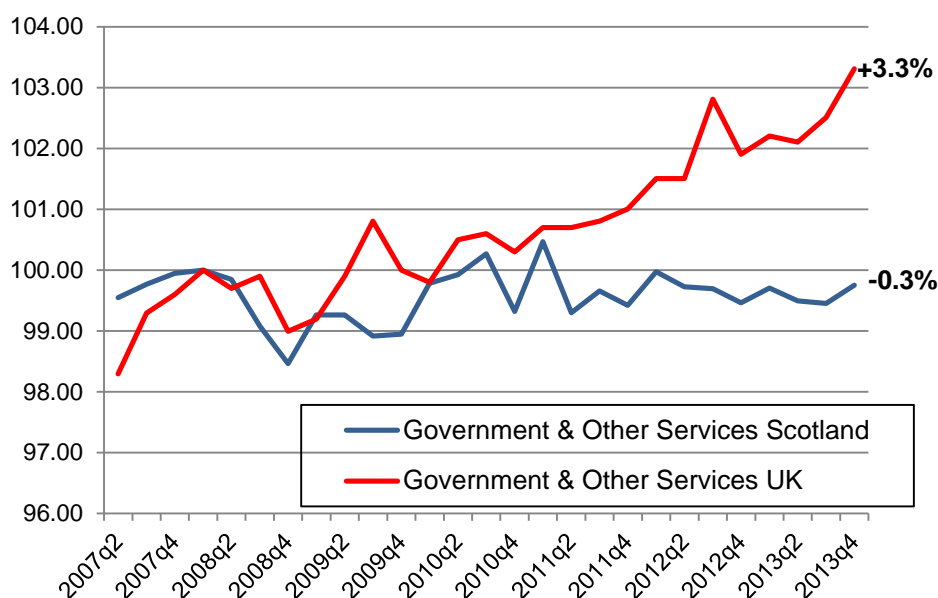


Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2013 and Fraser of Allander Institute calculations

Figure 12 reveals that the sector in Scotland has now passed its pre-recession and is 1.1% above, while the sector in the UK is still -2.6% below the peak. However, it should be noted 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 the recovery in the sector picked up strongly during 2013 in both Scotland and the UK. Government & Other Services GVA grew slightly in Scotland in the fourth quarter by 0.3% and somewhat faster in the UK at 0.8%. Over the year, output 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.

Figure 13: Government and Other Services: recession and recovery to 2013q4



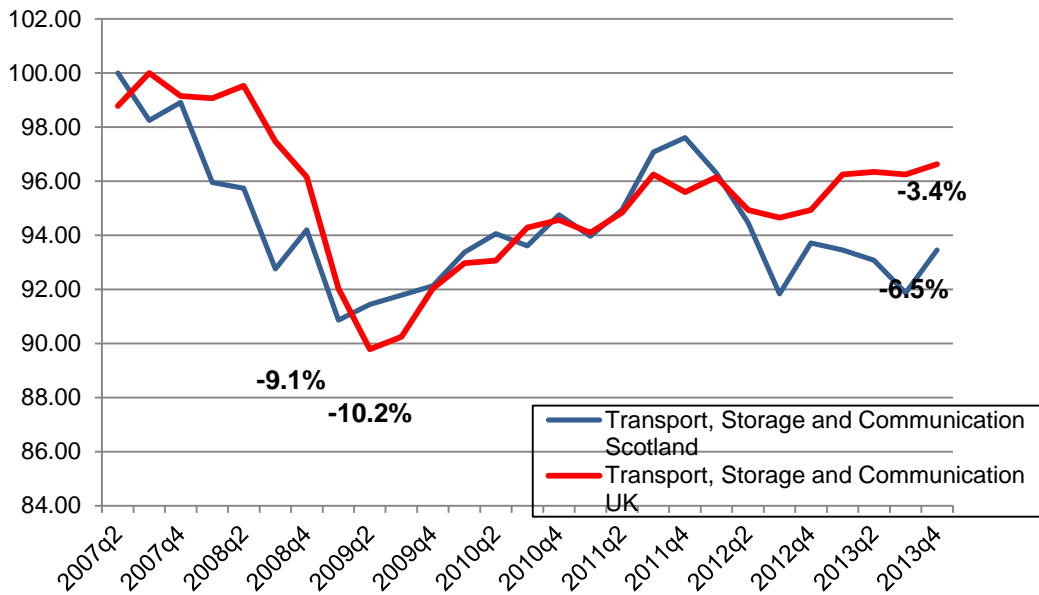
Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2013 and Fraser of Allander Institute calculations

GVA in the sector in the UK is 3.3% above the pre-recession peak, which as noted in several previous *Commentaries* is difficult to understand at a time of fiscal consolidation, whereas output in the sector in Scotland is -0.3% below its pre-recession peak, which seems more 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.

The recent weakness of the sector in Scotland ended in the fourth quarter with GVA rising by 1.7% compared to 0.4% in the UK. Over the year, the sector has contracted by -1.2% in Scotland while rising by 1.3% in the UK. By the end of the fourth quarter GVA in the Scottish sector was -6.5% below pre-recession peak compared to -3.4% in the UK.

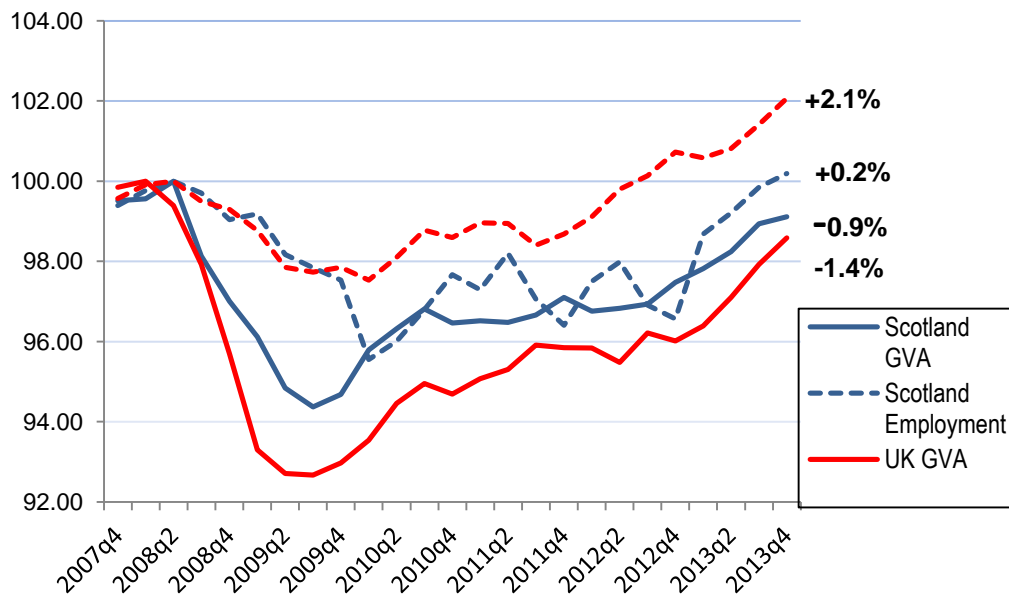
Figure 14: Transport, Storage & Communication: recession and recovery to 2013q4



Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2013 and Fraser of Allander Institute calculations

The Labour Market

Figure 15: GDP and Employment, Scotland and UK, recession and recovery to 2013q4

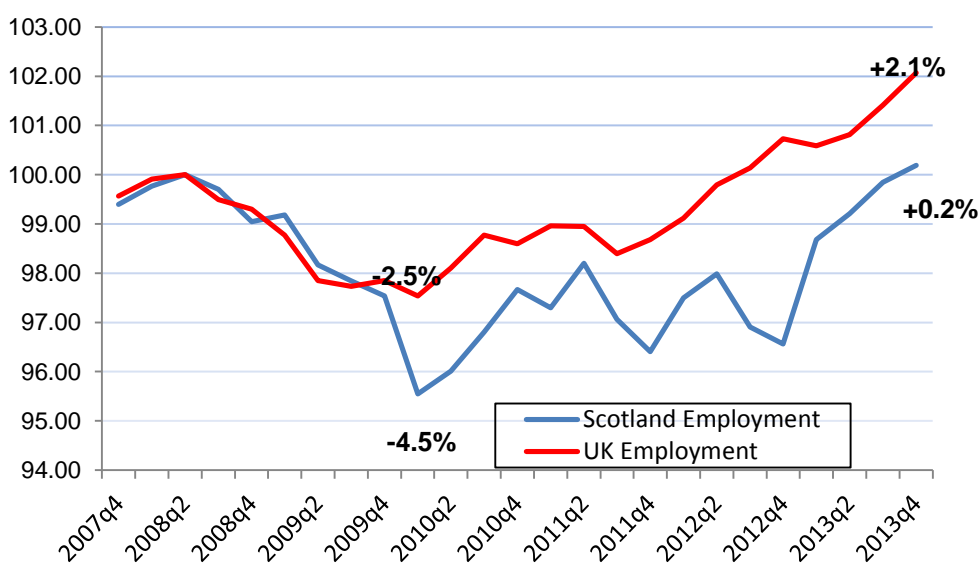


Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2013, ONS Regional Labour Statistics and Fraser of Allander Institute calculations

The latest labour market data (see *Overview of the Scottish labour market* below) reveal a recovery in the Scottish and UK labour markets, which is almost unprecedented. In the quarter February to April 2013, employment rose by 0.6% in Scotland and 1.1% in the UK. In terms of numbers, jobs rose by 16,000 in the quarter, compared to a remarkable rise of 345,000 in the UK as a whole. Over the year, Scottish jobs rose by 48,000, a rise of 1.9%, while UK jobs rose 780,000, or 2.6%. During the quarter unemployment in Scotland, in a reflection of the jobs increase, fell by -7,000, or -3.6%, to 183,000, or a rate of 6.6%, while in the UK, unemployment fell more rapidly by -161,000, or -6.9%, to a rate of 6.6%.

Figures 15 and 16 show the performance of GDP and employment in Scotland and the UK during recession and recovery to 2013q4.

Figure 16: Index of total employment: (Scotland and UK) pre-recession peak to 2013q4



Source, ONS Regional Labour Statistics and Fraser of Allander Institute calculations

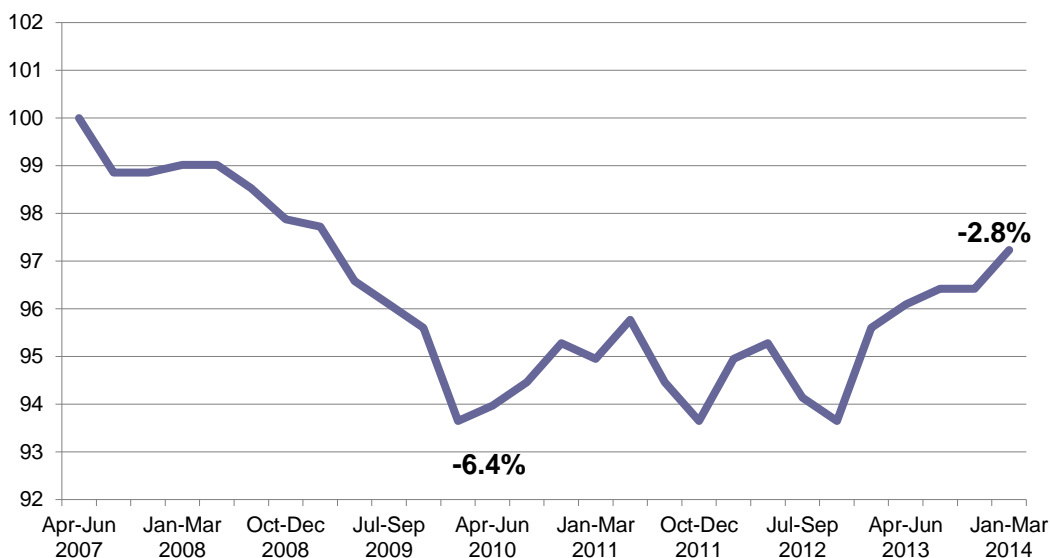
Scottish jobs as reported in the LFS worker surveys have now reached their pre-recession peak, which continues to be worse than the UK, where the jobs total is 2.1% above the pre-recession peak, compared to 0.2% in Scotland in the final quarter of last year. However, it is worth noting that the ONS employee jobs series for Scotland shows that there were 2,343,000 employee jobs in Scotland in the final quarter of 2013. This was an increase of 66,000 jobs from the end of 2012, but 137,000 jobs (5.5%) lower than the peak of employee jobs in Scotland in Q3 2008 (2,480,000).

Finally, it would appear that there continues to be plenty of slack for growth in the Scottish labour market despite the current strong jobs recovery. Figure 17 charts the employment to working population ratio relative to pre-recession peak for Scotland to Jan-Mar2014.

By January-March 2014, the ratio stood at -2.8% below the pre-recession peak. A further indication that there is still substantial slack in the Scottish labour market is revealed in the *Overview of the Scottish labour market* below where it is clear that growth in employment is still sustained by the growth of part-time

workers and the self-employed. Moreover, there are still a large number of part-time workers that cannot find a full-time job.

Figure 17: Scottish Employment to Working Population ratio compared to pre-recession peak in April-June 2007 to Jan-Mar 2014



Source, ONS Regional Labour Statistics and Fraser of Allander Institute calculations

Obstacles to a Sustained Recovery

There are four potential obstacles to a sustained recovery of the Scottish economy:

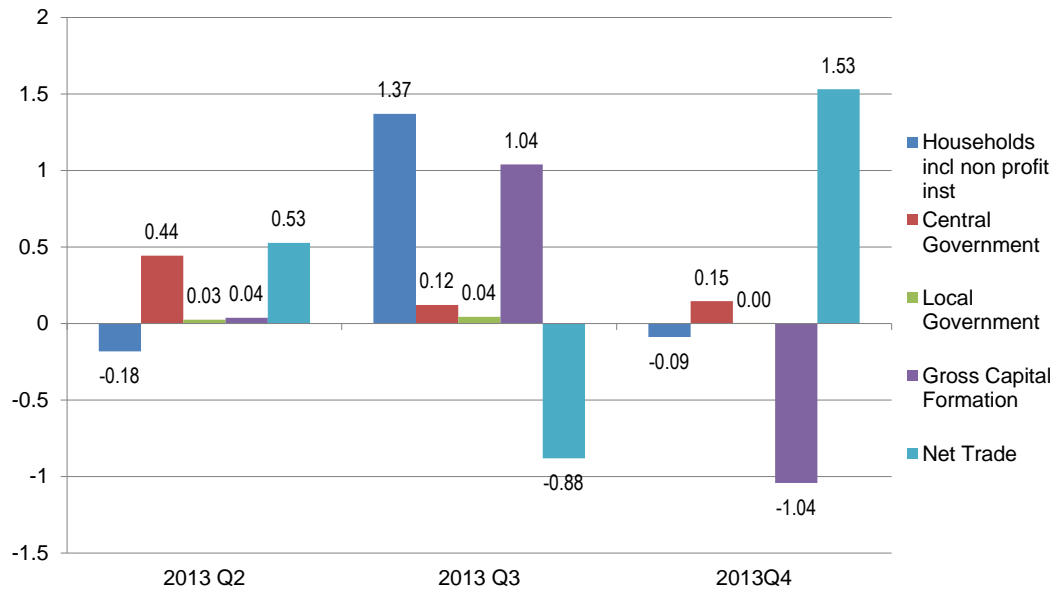
- A failure to achieve a balanced recovery
- Weak or no growth in real wages
- An overheated housing market, especially in London and the South East of England.
- The risk of deflation in the Eurozone

We deal with each of these in turn.

Balanced Recovery

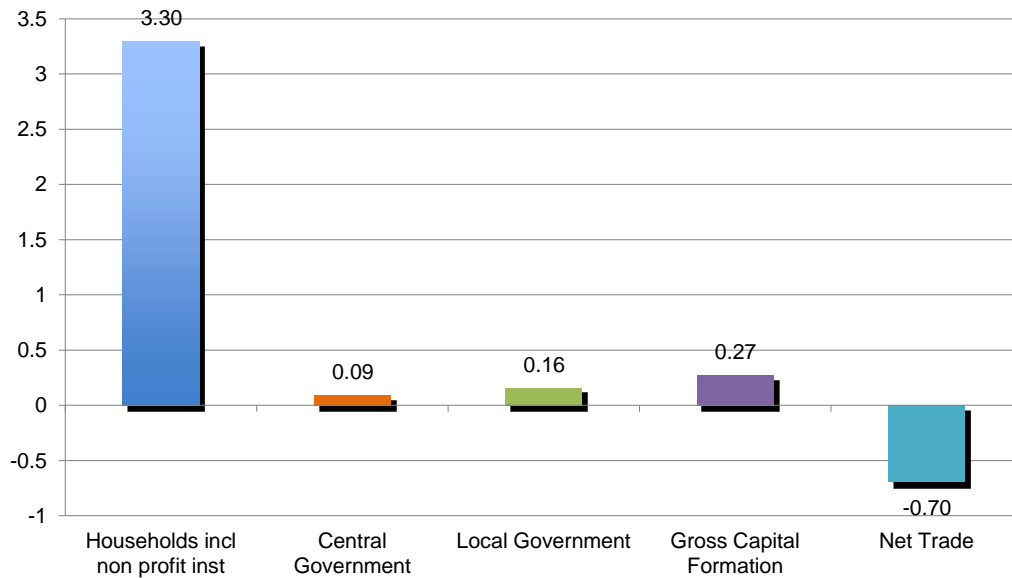
We have argued in previous Commentaries that the recovery has a better chance of being sustained if growth is broadly based. And by this we mean more broadly based across the expenditure components of aggregate demand. We now have Scottish National Accounts Project (SNAP) data from the Scottish Government for the final quarter of 2013 and for 2013 as a whole. These data have been revised for the earlier quarters in 2013 compared with data presented and discussed in the previous Commentary. Figure 18 presents our estimates of the contribution of each expenditure component to nominal Scottish GDP growth in the final three quarters of 2013.

Figure 18: Expenditure components percent point contribution to nominal Scottish GDP growth in 2nd, 3rd and 4th Quarters 2013



Source: SNAP 14 May 2014 and Fraser of Allander Institute calculations

Figure 19: Expenditure components percent point contribution to nominal Scottish GDP growth in 2013



Source: SNAP 14 May 2014 and Fraser of Allander Institute calculations

Figure 18 provides no systematic picture of the drivers of growth. The main components of household spending, gross capital formation and net trade have behaved erratically across over the three quarters. While in the second quarter investment appeared to be beginning to make a major contribution this was reversed in the fourth quarter. The reverse applies with net trade, and while household spending made a

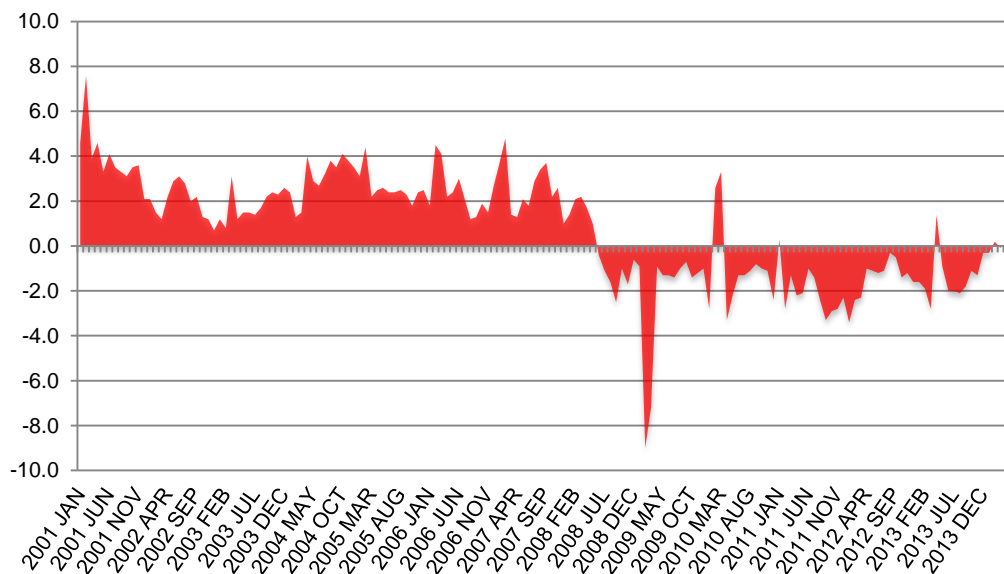
strong contribution to growth in the third quarter this was not the case in the second and fourth quarters. It might be the case that the Grangemouth shutdown influenced net trade in particular in the fourth quarter with imports reducing appreciably but we can't be certain. To get clearer picture Figure 19 looks at the contribution of the expenditure components to nominal GDP growth in 2013 over 2012.

The picture is much clearer in Figure 19. The main driver of growth during the year was household spending. Investment – Gross Capital Formation – made a small positive contribution while the contribution from net trade was negative. Net trade will have been affected by the weakness in the Eurozone economies but also by the rise in sterling, which has strengthened as the current UK recovery began to outpace - in growth terms - the performance of the main OECD countries.

So, we can conclude that we are still a long way off from a balanced recovery. Investment does seem to be picking up and it is to be hoped that this will continue, because the prospects of a marked improvement in the net trade position with sterling high and the European economies weak, does not look promising. And while household spending is currently strong its underlying determinants appear weak, as the next section makes clear.

Real Wage Growth

Figure 20: UK Real Wage Growth January 2001 to March 2014



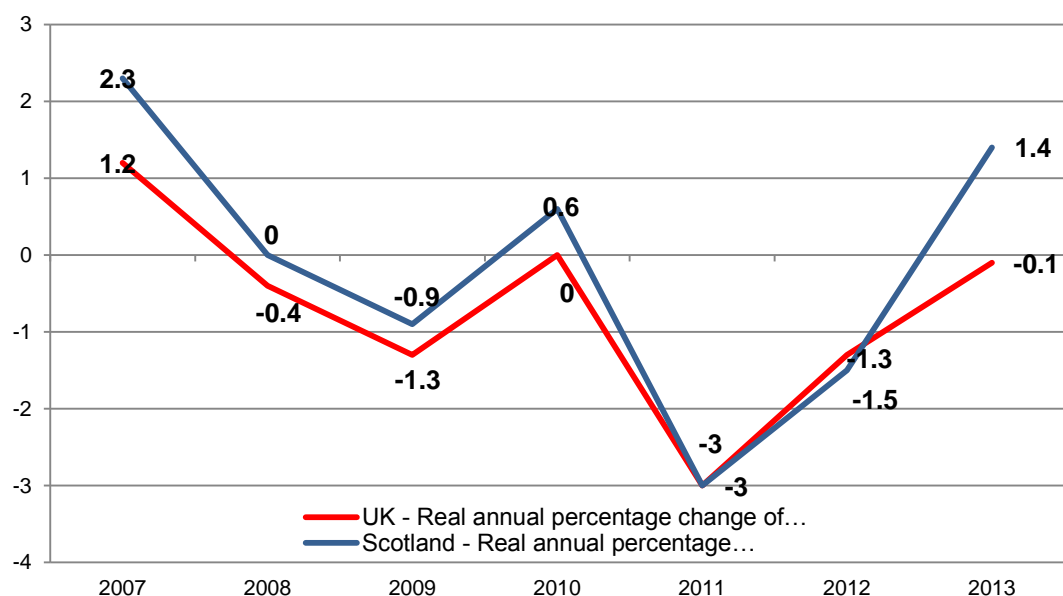
Source: ONS and Fraser of Allander Institute calculations

Households in Scotland and in the rest of the UK still remain highly indebted. We argued in recent Commentaries that many households were turning again to borrowing and for some to less traditional means such as cash generators, payday loan companies and pawnbrokers. This is in part because traditional sources of lending such as banks are themselves adjusting their balance sheets and are lending less, under tighter credit restrictions and more stringent credit checks. Clearly, the more indebted a household the more likely it is to fall foul of these tightened credit conditions. House price rises may be

improving the net asset position of households and this will encourage consumption but the main incidence of house price rises is in London and the South East and the rise in prices is likely to slow as we discuss below. This leaves growth of earnings as the principal source for funding a sustained increase in household spending. And that's the problem - there isn't any growth in real earnings!

Figure 20 shows the growth in UK real wages¹ - UK Average Weekly Earnings - total pay (% changes year on year) deflated by CPI (annual % change) – since 2001. Until this series moves into positive territory the prospects for a sustained growth in UK household spending must remain uncertain. One critical factor here is whether labour productivity can begin to grow strongly. Without a step-change in the rate of growth of productivity, the likelihood is that the recovery as the economy begins to approach capacity will see rising nominal wages but little increase in real wages as the growth of product prices matches that of nominal wage growth.

Figure 21: Real annual percentage wage growth in Scotland and UK, 2007 to 2013



Source: Annual Survey of Hours and Earnings (ASHE)

However, from the data we have for Scotland things appear a little rosier, although the data leave much to be desired and may not be accurate². Figure 21 gives data on real wage growth for Scotland and the UK.

While we do have some concerns about the quality of the data underlying Figure 21, the chart does show that Scotland's annual percentage change of median wages (for all employee jobs) has gained significant

¹ The peak in April 2013 is due to a one-off effect of bonus payments being postponed until April 2013 to take advantage of the fall in the top rate of income tax.

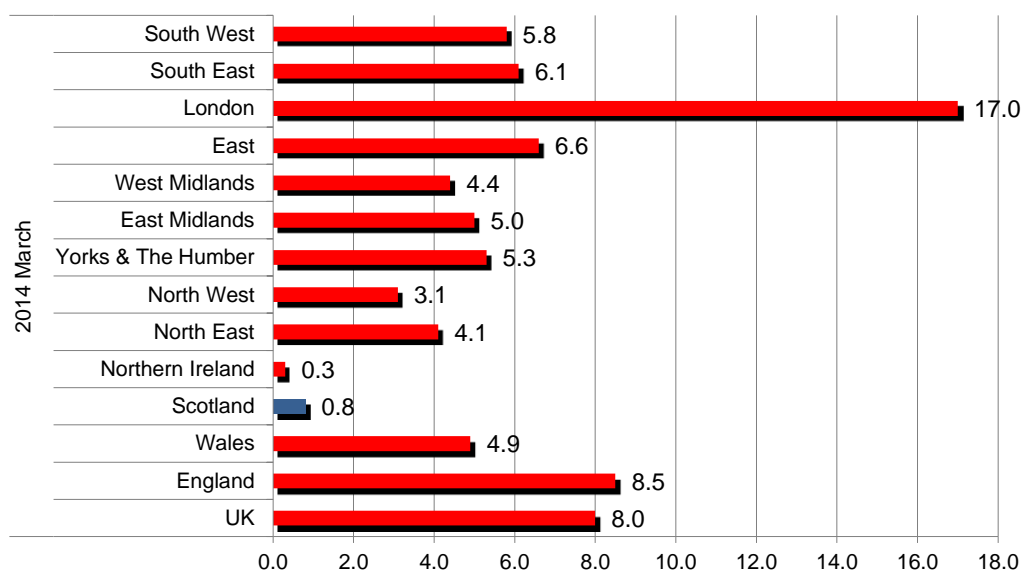
² The wage data presented in Figures 20 and 21 are derived from the Annual Survey of Hours and Earnings (ASHE) of which several entries are based on revised results whilst some are based on provisional releases and are hence likely to be revised. Given the lack in FTE employment growth in Scotland, data for 'For all employee jobs' was used instead of analysing data for 'For full-time employee jobs'. The calculation of real wage growth is based on the assumption that CPI inflation in Scotland is the same as in the UK. Thus, these results must be interpreted with caution.

momentum. The growth has outpaced both UK median wages for all employees and, more important, CPI growth. Thus, the real Scottish wage growth has become positive whilst UK growth has been negative for the past three years. This could be due to a faster growth in labour productivity in Scotland than in the UK. We have no up-to-date data on labour productivity in Scotland. The Scottish Government recently published revised annual data but this only went up to 2012. Nevertheless, we can see from Figure 15 that in the recent recovery UK jobs growth has been faster than in Scotland whereas GDP growth has been more similar suggesting faster productivity growth here. So, on this basis, the prospects for Scottish household spending might be a little rosier than in the UK.

The Housing Market

Arguably the biggest threat to the recovery in both Scotland and the UK comes from the housing market. Figure 22 shows the latest ONS data on house price increases for the UK and its component countries and regions.

Figure 22: All dwellings annual house price rates of change: UK, country and regions - 12 month percentage change for March 2014



Source: ONS House Price Index, March 2014.

While there is some evidence from the dataset of a slight slowdown in the rate of growth of prices; for example the UK increase in the year to February was 9.2%, the rapid growth of house prices both in the UK but in London in particular is a clear threat to the recovery. The Governor of the Bank of England, the European Commission and the IMF have all expressed concerns recently about the potential consequences of booming UK house prices. Some, on the other hand, such as Ben Broadbent of the Bank of England, argue that the current strong increases in house prices differ from previous booms. The present surge, he contends, is not based on rapid growth of risky mortgage debt and may reflect more fundamental factors such as limited housing supply in relation to demand. If it is the latter then Broadbent contends there is no role for the Bank's exercise of macro-prudential policy, which has the principal task of

guarding against financial market risks, caused by excessive debt. However, there is concern that lending to finance house purchase is leading to a growth of risky mortgage debt with anecdotal evidence of loans being granted at 4 to 5 times the borrowers' income. The Chancellor is also promising to give the Bank new powers to prevent the housing market from overheating and it is believed these will include capping the size of mortgage loans compared to income or the value of homes. But at the moment the powers of the Bank's new Financial Policy Committee (FPC) are limited and confined to making recommendations to the regulators, the Prudential Regulation Authority and the Financial Conduct Authority that banks either ration very high loan-to-income mortgages, or that they be banned. However, it is for the regulators to act and they may refuse. There is a strong feeling, though, that the booming and probably overheating London housing market – as well as the strength of the labour market – is driving the Bank's gradual movement towards increasing interest rates. The Governor signaled in his recent Mansion House speech that the first rise could now come during 2014, whereas most analysts had expected the rate to rise in 2015. A look back at Figure 22 should remind us that rising house prices are essentially a London and South East England phenomenon. In Scotland, house prices are hardly rising overall. So, it would seem wholly inappropriate for the recovery to be dampened right across the UK to address what is clearly a local or regional issue centered on London.

Risks of Eurozone Deflation

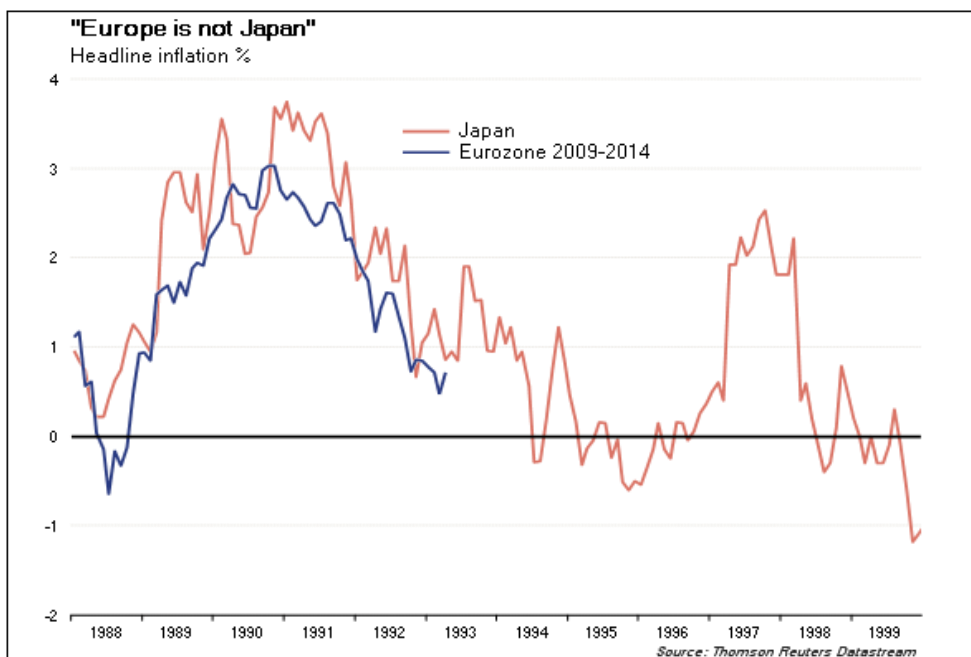
The *Forecasts of the Scottish Economy* section below highlights in Table 1, the Euro area remains one of the weakest regions in the global economy, with the IMF forecasting growth of 1.2% this year and 1.5% in 2015. Only Japan has a lower forecast. There is a real fear that growth in the Eurozone may be depressed for some time with the prospect of stagnation similar to that endured by the Japanese economy since the early 1990s. As Mario Draghi Governor of the ECB defines it:

“Deflation is a protracted fall in prices across different commodities, sectors and countries. In other words, it is a generalised protracted fall in prices, with self-fulfilling expectations. Therefore, it has explosive downward dynamics.”

Falling prices while making goods and services cheaper to buy *inter alia* increase the burden of debt so favouring creditors over debtors; it increases real interest rates, makes investment more costly and serves to reduce the demand for goods and services generally. A prolonged period of stagnation is the likely result. Given that 50% of UK exports go to EU countries, many of whom are in the Euro, it is clear that a sustained slowdown in activity in the area will be damaging to Scottish and rest of UK exports and hence to the recovery.

The following chart – Figure 23 - from the Financial Times illustrates how close the present track of inflation is in the Eurozone to the experience of Japan in the 1990s

Figure 23: Inflation in the Eurozone and Japan



Source: *Financial Times*

The ECB has recently cut its base rate and gone into negative territory on its deposit rate but this may not be enough. Further measures are likely to be necessary including expanding the money supply – quantitative easing. It is to be hoped that the ECB takes decisive action and that its actions work!

Forecasts

It is against the above background of a rapid recovery in employment and now output subject to the risks of: a continuing unbalanced recovery; falling real wages; booming house prices in the London housing market, and the risks of deflation in the Eurozone, 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 2014 to 2016. The forecasts are presented in more detail in the *Forecasts of the Scottish Economy* section of this Commentary below.

Table 1 shows that our GDP forecast for 2014 is 2.5%, which is revised *up* from our forecast of 2.3% in March 2014. Similarly, for 2015, we have revised the forecast *down* slightly from 2.3% to 2.2%, as we allow for some small negative impact of the risks discussed above. The forecasts for 2014 is higher than in March 2014 because of the generally better than expected improvement in performance, optimism in business surveys (see *Review of Scottish Business Surveys* section below) and an improved outlook,

especially for investment; although the business surveys also contain doubts about the persistence of the recovery.

Table 1: Forecast Scottish GVA Growth, 2014-2016

GVA Growth (% per annum)	2014	2015	2016
Central forecast	2.5	2.2	2.4
<i>March 2014 forecast</i>	2.3	2.3	<i>n.a.</i>
UK mean independent new forecasts (May)	2.9	2.5	2.4
Mean Absolute Error % points	+/- 0.43	+/- 0.50	+/- 1.12

Fraser of Allander Institute – June 2014

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 again expect Scottish growth to continue to be a little weaker than UK growth over the forecast period. So, we are now forecasting growth of 2.5% in 2014, 2.2% in 2015, and 2.4% in 2016. Given our previous forecast errors the lower and upper bounds for growth in 2014 are expected to be 2.1% and 2.9%, for 2015, 1.7% to 2.7%, and for 2016, 1.3% to 3.5%.

Production and manufacturing continue to be the major sectors exhibiting the fastest growth in 2014, 2015 and 2016. In 2014, production is projected to grow by 2.9%. Services and construction display positive growth this year at 2.3% and 1.9% respectively. This relative performance continues in both 2015 and 2016 even though forecast growth diminishes across all sectors in 2015 and then rises again in 2016. Production grows by 2.6% and 2.7% in 2015 and 2016, while service growth is projected to be 2.1% in 2015 and 2.3% in 2016. The construction sector continues to lag with growth of 1.4% in 2015 and 1.5% in 2016.

Employment Forecasts

Table 2: Forecast Scottish Net Jobs Growth in Three Scenarios, 2014-2016

	2014	2015	2016
Upper	52,850	66,050	87,200
<i>March 2014 forecast</i>	51,050	71,900	<i>n.a.</i>
Central	43,100	42,900	58,150
<i>March 2014 forecast</i>	39,600	42,800	<i>n.a.</i>
Lower	33,400	19,900	29,900
<i>March 2014 forecast</i>	36,700	13,350	<i>n.a.</i>

Fraser of Allander Institute – June 2014

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.

Our forecasts for employee job creation are broadly similar to our March 2014 forecasts, with a slight *upward* revision for this year and small *downward* adjustment for 2015. On the central forecast, we are now forecasting that net jobs will increase by 43,100 in 2014, 42,900 in 2015 and 58,150 in 2016. This year, we now expect 36,500 service sector jobs to be created, with around 1,850 added in production due to expected productivity increases given the growth in output, and somewhat stronger jobs growth of 3,300 in agriculture. Construction jobs are now forecast to rise this year by 1,500. In 2015/2016, the bulk of the jobs created are again expected to be in the service sector with an additional 33,650/46,050 jobs forecast, while 4,500/6,150 are added in production, 3,100/3,600 in agriculture and 1,650/2,350 in construction.

Unemployment Forecasts

The key unemployment forecasts are summarised in Table 3 below.

Table 3: Forecasts ILO unemployment 2014-2016

	2014	2015	2016
<i>ILO unemployment</i>			
Rate (ILO un/TEA 16+)	6.4%	6.2%	5.8%
March 2014 forecast	6.6%	6.3%	n.a.
Numbers	173,150	168,150	157,200

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 March 2014, reflecting higher economic activity. Our projection for unemployment on the ILO measure at the end of 2014 is now 173,150 (6.4%). By the end of 2015, unemployment is now forecast to be 168,150 (6.2%) falling further to 157,200 (5.8%) by the end of 2016 as growth in the economy strengthens over 2015.

Brian Ashcroft
13 June 2014