2 Forecasts of the Scottish economy

Grant Allan, Fraser of Allander Institute

Abstract

It appears likely that Scotland's economic activity will finally reach its pre-recession (2008) peak in the current quarter of 2014. The start of this year has seen an upswing in business confidence, particularly around new orders and intentions to invest, while the Bank of England's monetary policy continues to be unprecedented at this early stage of the recovery, and designed to accommodate an increase in economic activity, particularly investment, which remains subdued by historic standards. In this context, we have raised slightly our forecast for growth in this year. Downside risks to growth remain, with households – critical for the first phase of the recovery to date – continuing to face slow real income growth. While inflation pressures have eased, it appears likely that strong household earnings growth will not return until 2015. Rebalancing towards exports continues to be hampered by sluggish export performance, and external markets remain weak, although the outlook for the US – Scotland's largest single (non-UK) export destination – is forecast to grow strongly through 2014 and 2015.

Fiscal and monetary outlook

The UK Budget of March 2014 was broadly fiscally neutral in expenditure terms, meaning the path of continued fiscal consolidation remains. Analysis by the Institute of Fiscal Studies reported that around half of the planned "tightening" of fiscal consolidation has occurred between 2008 and 2013/4. Of the remaining half, much will come from cuts to nominal current spending, i.e. reductions in government spending on goods and services, rather than increases in taxation or capital spending reductions. The Centre for Public Policy for Regions analysed the longer term trend in spending for the Scottish Budget, in line with the 2013 spending review. It reported that the pace of fiscal consolidation would lessen in 2012-13, with reductions in the Scottish Government's budget of -2.1%, -1.1% and -1.5% in real (2012-13) terms for the three years from 2013-14 onwards. Significant further reductions in real terms expenditure under the control of the Scottish Government are anticipated in fiscal years 2016-17 (down-3.2%) and 2017-18 (down -3.6%).

UK monetary policy has evolved considerably since the end of 2013, while on the face of things, nothing much has appeared to change. The Bank's base rate and size of its QE asset purchase programme has remained the same, however, under Mark Carney the policy of "forward guidance" has sought to bring confidence and transparency to the timing and process for how (and when) the Bank will begin to raise interest rates. Carney initially proposed that the Bank would not consider raising rates until the unemployment rate reached 7%. However, a stronger than expected drop in this rate has seen an evolution of the guidance supplied, with the Bank indicating (in its February 2014 Inflation Report) that rates will be guided by a range of economic indicators, such as estimates of the spare capacity in the economy and the outlook for inflation. Additionally, it has been noted that future interest rates will return to a level below their previous average level. These measures, taken together, are intended to give confidence to business about the path of changes to the monetary policy stance.

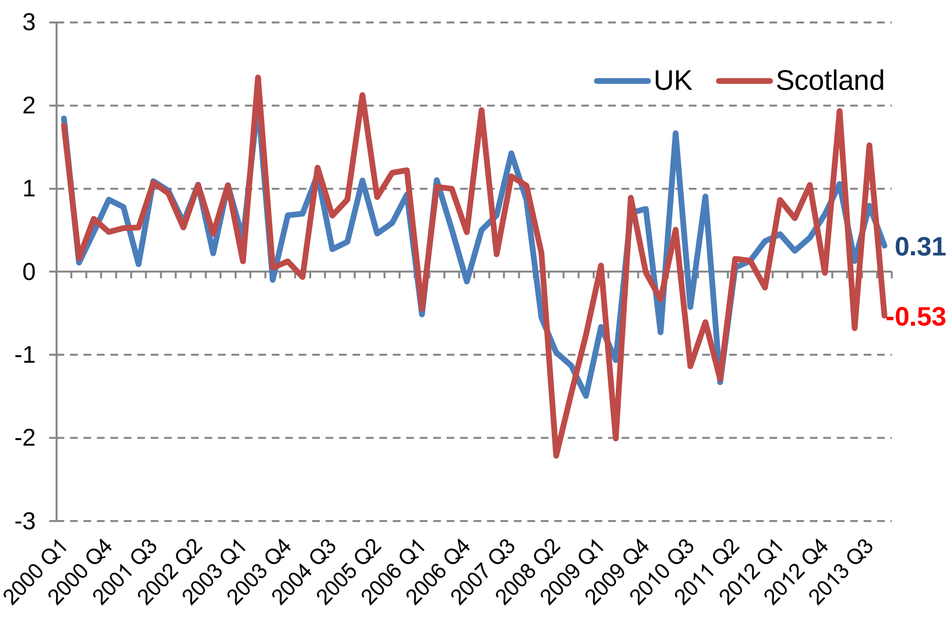
Households

Inflation has continued its decline since the middle of 2013 and CPI inflation stood at 1.8% in April 2014. This was slightly up from the previous month, however it was still below the Bank of England's target rate of 2%. The Bank of England's Inflation Report notes that CPI inflation is expected to pick up through Q2, but remain below target. Falling inflation appears to be positive for households, where nominal incomes have been struggling to rise more than (CPI) inflation, causing declining real incomes broadly since 2008. For almost all of the last six years for the UK - as a comparable Scottish series is not available – earnings growth have been outpaced by inflation, with (rare) exceptions only, for instance, where changes to the tax regime saw some incomes deferred between tax years.

Latest monthly data for the UK suggest that earnings growth has been stronger in the first half of 2014 than through much of 2013. The growth rate in earnings however remains below 2%, and indeed, has rarely been above 2% in the last eighteen months. It is the opinion of the Office for Budgetary Responsibility that a substantial pickup in earnings growth will not occur until 2015.

It is clear that quarterly household spending growth has varied significantly – and more for Scotland than the UK – however, since 2012, quarterly growth has typically been positive (Figure 1). (The most recent quarter, Q4 2013, saw a *decline* in spending in Scotland of 0.5%, while consumer spending *increased* by 3% in the UK as a whole).

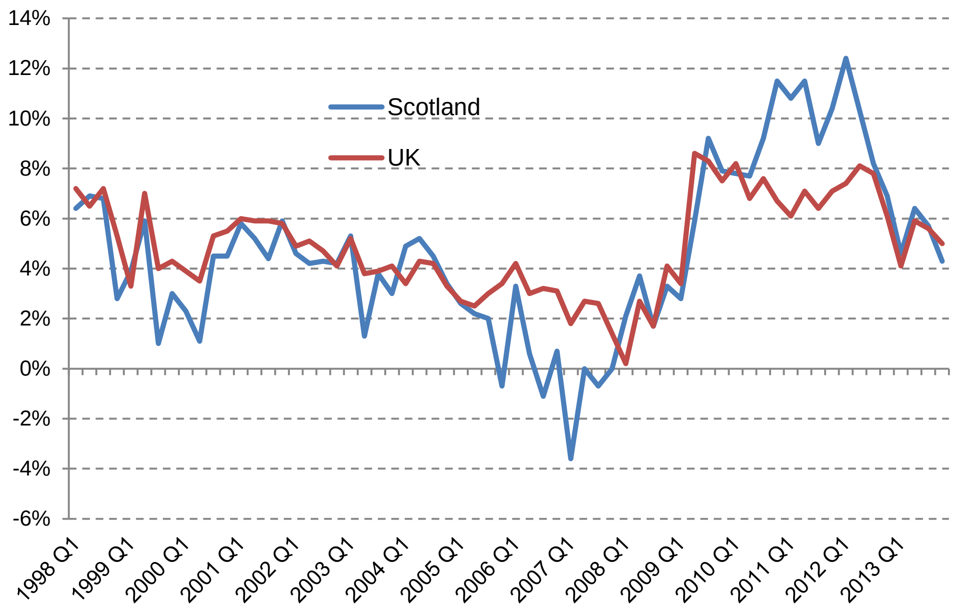
Figure 1: Household real consumption spending growth, Scotland and UK, Q1 2000 to Q3 2013, % q-on-q



Sources: *Scottish National Accounts Project (SNAP) data (Scottish Government) and UK Quarterly National Accounts (National Statistics) and Fraser of Allander Institute calculations.*

With household consumption supporting over half of the (UK) growth in 2013, in the absence of strong income growth, the unsustainability of this model for future growth is clear from the declining savings rate evident since the middle of 2012 (Figure 2). While UK and Scottish savings rates have been closely aligned over the last six quarters (i.e. since the middle of 2012) the fall in Scottish household saving rate has been more pronounced, coming after a stronger period of savings through 2010 to 2012.

Figure 2: Household savings ratio, Scotland and UK, Q1 1998 to Q4 2013



Sources: *Scottish National Accounts Project (SNAP) data (Scottish Government) and UK Quarterly National Accounts (National Statistics) and Fraser of Allander Institute calculations.*

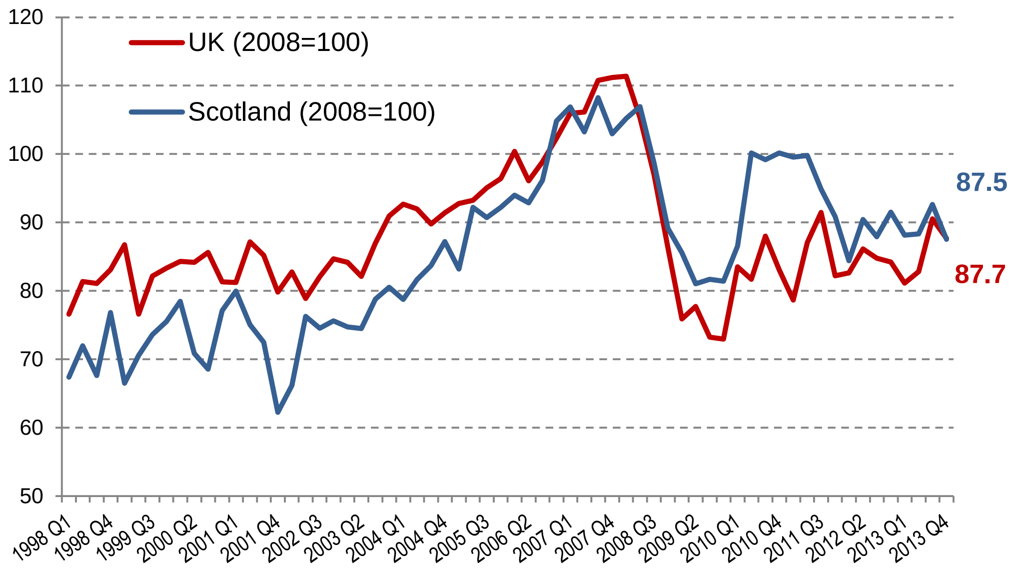
Investment

There remains concern around the lack of growth in investment over the last couple of years, both for the UK and Scotland. In the recent (March 2014) State of the Economy report, the Scottish Government's Chief Economic Adviser noted that "business investment remains weak relative to pre-recession levels". Investment spending remains weak in Scotland and lies significantly below pre-recession levels. These data suggest that investment spending in Scotland has broadly stagnated in level terms through 2012 and 2013 (Figure 3). May 2014's Inflation Report by the Bank of England noted that "the pre-conditions for a recovery [in investment] have been in place for some time"; however this has not translated itself into a much-anticipated surge in investment. Clearly, in the continued absence of public investment, policy has been targeted at encouraging private investment.

The Bank's report notes that three factors have improved the outlook for investment. First, demand uncertainty appears to have receded over the last six months, with downside fears easing and a (slow) return to growth now anticipated to persist for the medium term. Second, there appears to be increased confidence in new orders from business surveys: a useful "forward-indicator" for private investment intentions. Third, it notes improved cost of and access to finance for investment purposes, as well as many firms having retained earnings which they are free to invest.

Investment intentions from the latest surveys (summarised more broadly in the *Review of Scottish Business Surveys* section of this Commentary) note that, even with strong signals for output and employment, there remain doubts about the persistence and sustainability of the recovery, with knock-on impacts for the level and growth in investment expenditures. Within manufacturing, around 30% of firms surveyed by the Scottish Chambers Business Survey in Q1 2014 reported “expansion” as a reason for new investment, up from earlier surveys, while there is optimism in the Scottish Engineering Quarterly Review from, in particular, small and medium-sized companies. Construction sector survey indexes remain strong at the start of 2014, although appear to have eased in Q2 2014 compared to Q1 (and housebuilding remains a relatively weak area).

Figure 3: Real gross fixed capital formation, Scotland and the UK, Q1 1998 to Q4 2013



Sources: *Scottish National Accounts Project (SNAP) data (Scottish Government) and UK Quarterly National Accounts (National Statistics) and Fraser of Allander Institute calculations.*

Trade

It is hard to read too much into the latest aggregate figures on Scotland’s manufacturing (non-UK) exports, which show a decline of 4% in real terms in the final quarter of 2013. This is largely due to the closure of the Grangemouth refinery and chemical plant which was closed for a period during the quarter, contracting its exports by 20%, and which is responsible for almost one quarter of Scotland’s exports. This single event was estimated to have perhaps reduced growth in the final quarter of 2014 by as much as 0.2%. A large decline in the food and drinks sector: with exports by the drinks sector falling by 5.8%, largely explain the recent quarter’s data. However, future quarters will likely see a return of activity and exports from Grangemouth, which will have a one-off (positive) effect on the rate of growth in Q1 2014.

On a rolling annual basis, the 1.9% growth for manufacturing exports would have been higher, but for the points above, indicating that there are some reasons to be positive about the overseas performance of Scottish firms. The continued dependence upon a small number of industrial sectors is evident when one considers that two sectors identified above – chemicals and food and drink – are responsible for over half of Scotland's manufactured exports.

In terms of key markets for Scottish products, latest figures suggest some room for cautious optimism about the short-term trajectory. Markit's PMI for the Eurozone in June 2014 suggested growth across the Eurozone has continued for the previous year, and across both manufacturing and service sectors. Eurozone imbalances remain with the strong German economy contrasting with a weak domestic economy in France, still rooted in contraction territory on its overall output measure. Growth in the US is forecast to remain strong, while the forecasts for the UK as a whole have been revised up by a range of forecasters since the start of 2014. Table 1 shows the forecasts for growth in key global markets for Scottish products through 2014 and 2015.

Table 1: Economic growth forecasts for 2014 and 2015 for major Scottish export markets, plus UK, China, Japan and Euro area, % p.a.

	2014		2015	
	IMF (April 2014)	OECD (May 2014)	IMF (April 2014)	OECD (May 2014)
USA	2.8	2.6	3.0	3.5
Netherlands	0.8	1.0	1.6	1.3
France	1.0	0.9	1.5	1.5
Belgium	1.2	1.5	1.2	1.9
Germany	1.7	1.9	1.6	2.1
Ireland	1.7	1.9	2.5	2.2
United Kingdom	2.9	3.2	2.5	2.7
China	7.5	n/a	7.3	n/a
Japan	1.4	1.2	1.0	1.2
Euro area	1.2	1.2	1.5	1.7

Sources: *World Economic Outlook (International Monetary Fund, IMF, April 2014) and Economic Outlook (Organisation for Economic Cooperation and Development, OECD, May 2014) Notes: "n/a" indicates forecast not produced.*

Reductions in import prices have led some to argue that this will bring down UK CPI inflation from its current (low) level – as seen above – and into deflation territory, i.e. a negative rate of inflation. Two factors are likely to have a significant impact on whether this threat manifests itself. First, a continued rise in the value of Sterling (in particular, with respect to the Euro: a major market for UK imports) means that – with import prices constant – UK firms will experience reductions in their costs. Second, the extent to which firms pass on these cost reductions in terms of lower prices for customers. It appears to be the opinion of the Bank's Monetary Policy Committee that the fall in import prices *will* be passed on in full to households over their forecast horizon, with implications for a downward pressure on the level of CPI inflation.

Forecasts for the Scottish economy in detail

In the March 2014 Commentary, we saw signs of cautious optimism returning to the short-term economic outlook for Scotland, largely driven by better than expected household spending figures, and positive signs returning to business investment through the end of 2013 and continuing into the start of 2014. These trends appear to have been borne out by survey data on the first quarter, with some stabilization (slightly down on Q1, but still positive) in the early business surveys through Q2 2014. The signs from the Bank of England suggest that in general monetary policy is set to continue being accommodative with low interest rates persisting through until later in 2015. However – as discussed above – we have concerns about the impact on the UK (excluding London and the South East) and Scotland's economic recovery of the Bank's (hypothetical) use of its interest rate lever to subdue the growing bubble in housing prices in parts of the UK, such as London.

This improving economic climate forms the background to our current forecasts. Downside risks remain in both the short and medium term, though we continue to be concerned about the robustness of the recovery. Since March 2014, however, there is increasing evidence that the return of increases in real wages may arise earlier than we had anticipated, albeit that productivity growth remains sluggish and it is likely to be at least 2015 before we see a return to increases in real wage growth. It remains to be seen what the consequence of five years of falling real wages will mean for household balance sheets coming out of the recession, particularly as a large part of the recent recovery has been fueled by the use (and decline) of falling household savings.

Several factors will weigh on the true outturn for growth and labour market performance in Scotland over the years of our forecasts. First, is likely that the figures for Scottish growth in Q1 2014 will be "distorted" by the disruption to the Grangemouth facility during the final quarter of 2014, as we discussed in the Commentary of November 2013 (Vol 37, No 2). The plants' closure meant that output in this important sector will have been unusually low in Q4 and the recovery in that facility's operation will cause Q1 2014 activity to be stronger than it would otherwise have been. The latest State of the Economy report noted that Q4 2013 the plant's closure could have led to growth in Q4 being reduced by as much as 0.4 percentage points, and "a reversal of this effect [is] expected in subsequent quarters" (p. 22). Second, key survey indicators – such as the Bank of Scotland PMI for May 2014 - suggests that the growth in business confidence evident in Q1 of 2014 has not persisted into the second quarter. Although still in expansion territory, the growth rate appears to have slowed towards the summer of 2014.

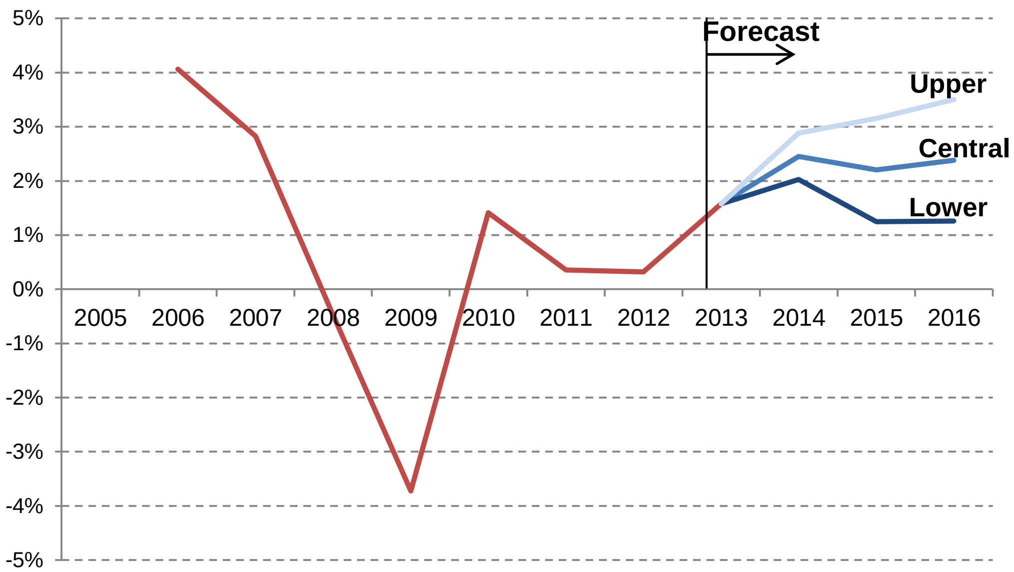
Thirdly, we remain concerned about the strength of the external environment for Scottish goods and products. Growth forecasts for Scotland's major trading partners remains subdued in 2014, with only the US – of Scotland's top-five (non-UK) export destinations – forecast to growth by more than 3% in 2015. There is growing evidence of a strong performance in tourism figures and expenditures by visitors in 2013, which will have important impacts through 2014 and 2015, in part from any ongoing impact from tourism demands stimulated by the range of international sporting events – such as the 2014 Commonwealth Games in Glasgow and the Ryder Cup – in the second half of 2014.

Forecasts

In this section of the *Commentary*, we forecast year-on-year real growth in Scotland's key economic and labour market variables. In this issue, we forecast all variables for 2014, 2015 and, for the first time, 2016. Our forecasts cover Scotland's Gross Value Added (GVA), employee jobs and unemployment. The model used is multi-sectoral, and where useful, results are reported to broad sectoral categories.

We begin with the forecasts for GVA growth in the Scottish economy. The trend for annual growth in Scotland between 2005 and 2013 and our new forecasts are shown in Figure 4. This also includes our upper and lower growth forecasts for the period to 2016. As with previous *Commentary* forecasts, the range around the central forecast is based on our past forecast accuracy (and now updated to include the first estimate of growth in 2013). Our March 2014 Commentary forecast GVA growth of 1.7% in 2013, while the first estimate was 1.6%. Based on earlier forecasts since 2000, the mean absolute error of forecasts in the summer period and growth in the same year is 0.43 percentage points. Growth forecast errors for the following year are 0.95 percentage points. This gives the range for the upper and lower bands in 2014 and 2015. Our past forecast errors for the longest forecast horizon is 1.12 percentage points, so this is used to give the range around our central forecast for 2016.

Figure 4: Fraser of Allander Institute forecasts of annual real GVA (%) growth for 2013 to 2015: Scotland



Source: *Fraser of Allander Institute forecasts, June 2014*

We have revised our central forecast for GVA growth for both 2014 and 2015, which now stand at 2.5% and 2.2% respectively in 2014 and 2015. Our March 2014 growth forecast for 2014 was 2.3%, and we have revised this year's growth forecast up by 0.2 percentage points to 2.5%. Our previous forecast for 2015 was for growth of 2.3%, and latest forecast has shaded this downwards by 0.1 percentage points. In our first forecast for 2016, we forecast growth of 2.4% in that year.

For comparison purposes, the UK's Office for Budgetary Responsibility (OBR) and the median of independent growth forecasts for the UK made during the last three months have forecast growth in 2014 or 2.7% and 2.9% and 2015 of 2.3% and 2.5% respectively.

In addition to the aggregate growth forecasts in our central scenario, Table 2 presents our forecasts for GVA growth in 2014, 2015 and 2016 for a broad sectoral grouping, i.e. the "production", "construction" and "services" sectors of the Scottish economy. With recovering private sector investment evident in recent surveys, we are now forecasting construction sector growth of 1.9% in 2014 – up from March 2014's forecast of 1.8% - while forecasts for the production and services sectors have also been raised by 0.1 percentage points.

Table 2: Fraser of Allander Institute Scottish GVA growth (%) by sector, 2013 to 2015

	2014	2015	2016
GVA	2.5	2.2	2.4
Production	2.9	2.6	2.7
Construction	1.9	1.4	1.5
Services	2.3	2.1	2.3

Source: *Fraser of Allander Institute forecasts, June 2014*

Employment and unemployment

Detailed commentary on recent developments in the Scottish labour markets can be found in the Overview of the Scottish Labour Market section of this *Commentary.* Here we present our forecasts 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 2014, 2015 and 2016 respectively, as well as the ILO measure of unemployment over the same period.

The most up to date 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 it is still 137,000 jobs (5.5%) lower than the peak of employee jobs in Scotland in Q3 2008 (2,480,000).

Our new forecasts for employee jobs are shown in Table 3, alongside a detailed sectoral breakdown of employee job numbers. The number of total employee jobs is forecast to increase in each year, and have been revised up slightly since our March 2014 forecasts. The number of jobs is now forecast to increase by 1.8% in 2014 (up from 1.7%) with a slightly upward revision to the net annual change in employee jobs from 39,600 to 43,100 through the current year. Our forecast is that the number of employee jobs will breach its previous 2008 high by the end of 2016. The net change in employee jobs consistent with our upper, central and lower forecasts are shown in Table 4.

Table 3: Fraser of Allander Institute forecasts of Scottish employee jobs ('000s, except where stated) and net change in employee jobs in central forecast, 2014 to 2016

	2014	2015	2016
Total employee jobs, Dec	2,386,100	2,429,000	2,487,150
Net annual change (jobs)	43,100	42,900	58,150
% change from previous year	1.8%	1.8%	2.4%
Agriculture (jobs, 000s)	39	42	46
Annual change	3,300	3,100	3,600
Production (jobs, 000s)	253	257	263
Annual change	1,850	4,500	6,150
Construction (jobs, 000s)	121	122	124
Annual change	1,503	1,650	2,350
Services (jobs, 000s)	1,974	2,007	2,053
Annual change	36,500	33,650	46,050

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

Table 4: Net annual change in employee jobs in central, upper and lower forecast, 2014 to 2016

	2014	2015	2016
Upper	52,850	66,050	87,200
Central	43,100	42,900	58,150
Lower	33,400	19,900	29,900

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

We present out forecasts for unemployment at the end of 2014, 2015 and 2016 in our central scenario in our central forecasts 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 (ILO) 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 it is a better measures of the level of spare capacity in the Scottish labour market.

The recent labour market data at time of writing (10 June 2014) indicates that the ILO unemployment rate in Scotland is 6.4% in the first quarter of 2014, down 0.9 percentage points on the first quarter in 2013. Our forecast for the end of 2014 is for the broadly positive labour market outcomes in Scotland to continue through 2014 and 2015, in line with our March 2014 forecast.

In line with our slight upward revisions to economic activity in Scotland in 2014, we have revised down our forecasts for the level and rate of unemployment from those in March's Commentary. Our new forecasts for the unemployment rate in Scotland at the end of 2014 and 2015 are 6.4% and 6.2%

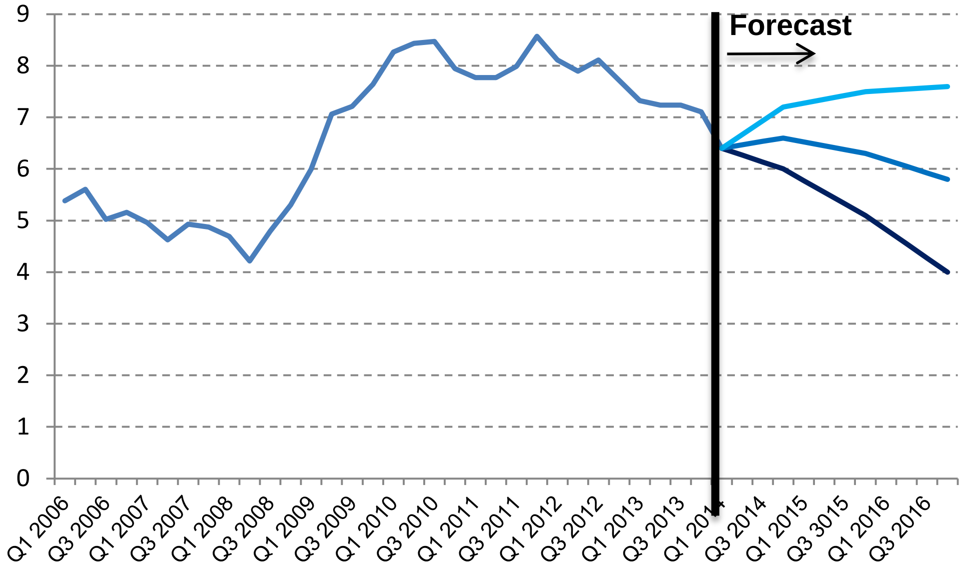
respectively (down from 6.6% and 6.3%). Figure 5 shows both the history of the ILO measure of the Scottish unemployment rate since 2006 and our central, upper and lower forecasts for the ILO unemployment rate, now extended out to 2016.

Table 5: Fraser of Allander institute forecasts of Scottish unemployment in central forecasts, 2014 to 2016

	2014	2015	2016
ILO unemployment	173,150	168,150	157,200
Rate (%)[1]	6.4	6.2	5.8

Note: Absolute job numbers are rounded to the nearest 50. 1 = Rate calculated as total ILO unemployment divided by total of economically active population aged 16 and over.
Source: Fraser of Allander Institute forecasts, June 2014

Figure 5: Scottish ILO unemployment rate, 2006 to 2016 including forecasts from 2014



Sources: ONS and Fraser of Allander Institute forecasts, June 2014