2 Forecasts of the Scottish economy

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Abstract

The latest figures indicate that the Scottish economy has picked up strongly in the first half of 2014, in line with a surge in leading indicators across business surveys. It is likely however that this has eased as we turned into the later part of this year, suggesting that the rate of growth will slow. Where 2014 has exceeded our earlier expectations, we have revised our forecasts for growth (upwards) and unemployment (downwards) from June's Commentary. It remains unlikely that we will see a renewed expansion in activity given the scope for potential downside risks from, in particular, weak growth and deflation fears in the Eurozone; weak export growth; debt constrained households unlikely to continue to support economic activity and only slowing improving outlook for investment through 2015. Revisions to the data for the UK, to be implemented in Scottish statistics next year, will make somewhat difficult to make direct comparisons about the recent trajectory of the UK and Scottish economic performances: however the general picture, of slow and unsteady growth for Scotland is likely to characterise developments through the coming years.

Fiscal and monetary outlook

Analysis by Fiscal Affairs Scotland from October 2014, carried out in the aftermath of the Scottish Draft Budget, suggests that the coming year (2015-16) will be "one of the milder years in terms of cuts", as the fiscal consolidation of the UK Government continues. They note a real terms reduction in Scottish Government spending in 2015-16 of the order of 1.7%. The milder year coming however is, in their analysis, likely to followed by reductions of over 3% in both 2016-17 and 2017-18. That the public investment consolidation has concluded, these future reductions in spending will fall hardest on current spending in these years.

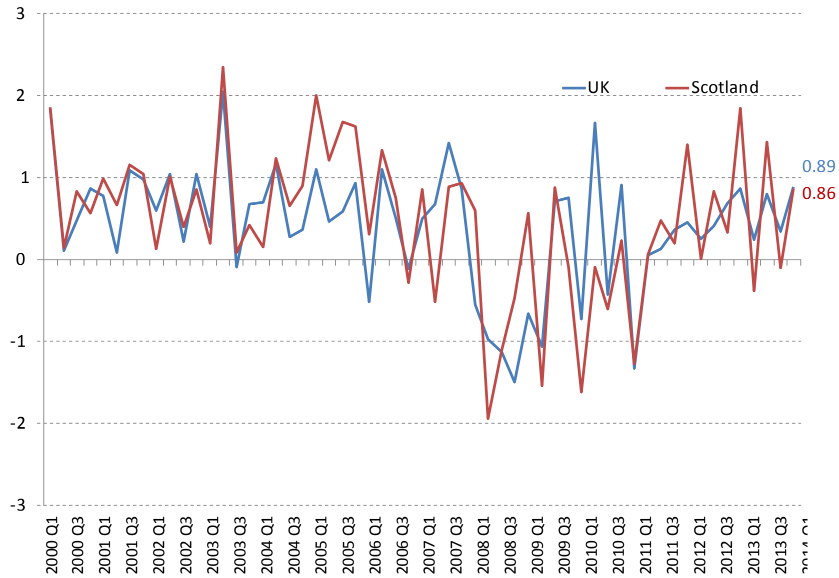
Monetary policy stance remains accommodative of activity – with no change in interest rates from 0.5%, and an unchanged QE asset purchase programme since we reported in June's commentary. That has moved considerably since the summer is the expected date (and pace at which) the Bank of England would seek to "normalise" interest rates. Current "forward-guidance" from the Bank indicates that with spare capacity in the economy and no breaches to its inflation target of 2%, it will not consider raising interest rates. Inflation had slowed in September to 1.2%, and so remains below the Bank's target. The QE programme will be maintained until the rise in the Bank's interest rate.

Since the August Monetary Policy Committee (MPC) meeting there have been signs of a disagreement within the group setting interest rates for the UK on the appropriate monetary policy stance. The minutes from October's meeting confirm that, as in August and September, two of the nine-member committee proposed to raise interest rates by 0.25% (to 0.75%). They argued that some signs of slack in, for example, the labour market had dropped rapidly, suggesting that prices could increase quickly. Given the lags in monetary policy therefore it would be, in their argument, sensible to act in advance to ensure inflation remain at the Bank's target over the medium term, and that increases in interest rates occurred gradually. The MPC voted 7-2 in favour of keeping interest rates at their current level.

Households

It is clear that household spending has driven a considerably portion of economic activity in Scotland and the UK. What is also clear from Figure 1 is that the volatility of (real) consumption spending growth has been greater in Scotland that the UK as a whole, as evidenced by two quarters of real terms reductions in spending growth during 2013. In the most recent quarter for which data is available (Q1 2014) consumer spending grew by 0.86% in Scotland and 0.89% in the UK as a whole. Data for Q2 2014 will be available on 12th November 2014. While savings ratios are not currently comparable for the UK and Scotland due to data compatibility it appears likely that the pattern of a declining savings ratio has continued for the UK as a whole, indicating that consumption is continuing to be funded from reductions in savings in the absence of wage growth. With the rate of increase in consumer prices (CPI) at 1.9% in June 2014, there is continued slow growth to wages in the UK (with no comparable series for Scotland available). Average weekly earnings growth during the second quarter of 2014 was 0.9% for regular pay (i.e. not including bonuses).

Figure 1: Household real consumption spending growth, Scotland and UK, Q1 2000 to Q1 2014, % q-on-q



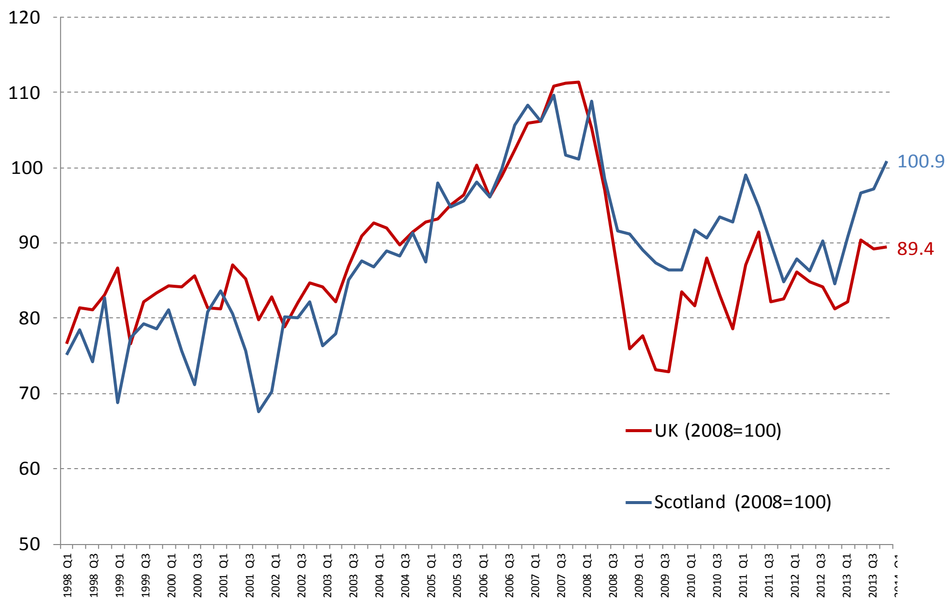
Sources: Scottish National Accounts Project (SNAP) data (Scottish Government) and UK Quarterly National Accounts (National Statistics) and FAI calculations.

Investment

Classification changes mean that – until the Scottish data is consistent with changed UK data – it will be difficult to directly compare trends in investment spending. (For example, reclassifications to investment spending now mean that some Research and Development activity is classified as “Investment”, while this will not be so in the Scottish series on investment until data is comparable). These changes are likely to have an impact on the path of investment spending over the recession. Figure 2 – which gives comparable figures for Scotland and the UK to Q1 2014 - suggests that investment spending in Scotland had returned its level in 2008, while UK series was about 10% below its earlier (2008). Revisions to the UK series however now show a different profile to investment, so we hesitate to draw broad conclusions about the relative strength in investment spending in Scotland and the UK, based purely on this diagram (which relates to the first quarter of the year only).

The Bank of England's latest Inflation Report noted that business investment outlook between May and September was largely unchanged. Demand uncertainty was again important, but appear to have "receded" in the last year. They also point to excess capital in some sectors as potentially impacting on the scope for investment growth to grow sharply: since those sectors would not need to invest to expand output if demand conditions ease.

Figure 2: Real gross fixed capital formation, Scotland and the UK, Q1 1998 to Q1 2014



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

Trade

The latest statistics on Scottish exports to the rest of the world – covering manufacturing exports alone (roughly 60% of Scottish exports outside of the UK) – showed that in the second quarter of 2014 there was growth of 2.8% on Q1, and the second consecutive quarterly increase. In constant price terms, exports were helped by a rebound of exports from refined petroleum activities for the second consecutive quarter (up 4.4% in Q2, following a 14.5% increase in Q1), following the sharp contraction in Grangemouth activity during Q4 2013. There was a reduction in drink exports, continuing the weak overseas exports performance for that sector since the start of 2013.

In terms of key markets for Scottish products, latest figures suggest little room for relaxed optimism about the short-term trajectory. Markit's PMI for the Eurozone in October 2014 suggested a broad stability (indeed a small improvement) in activity however it was noted that the eurozone was "teetering on the edge of another downturn" with stagnation in new orders and declining employment, a contraction in business confidence and continued deflation. The Bank of England's MPC minutes from October note that "there was mounting evidence of a loss of momentum in the euro area, including in Germany". It is clear that downside risks to Eurozone economic activity cannot be ignored, and showing the dependence of an export-driven recovery on developing new international markets. Growth in the US is forecast to strengthen and is the only one of Scotland's major international export markets to have seen upward revisions to growth for 2014 and 2015 since Summer 2014. Again, it appears that without US markets, Scotland's export performance would be significantly worse. Table 1 shows the forecasts for growth in key global markets for Scottish products through 2014 and 2015.

In September the OECD identified slow growth in the Eurozone as principally due to "anaemic" demand, suggesting that additional steps were required to increase demand in the Eurozone – such as "more vigorous monetary stimulus" - and avoid the possibility of damaging period of deflation (a risk also noted by the IMF). With significant debt across Eurozone members, deflation would be particularly harmful. The OECD cautioned against seeing more recent increases in inflation expectations as a sign of the path of inflation, given there had been little sign of the period of deflation in Japan prior to its damaging period of deflation in the early 1990s. Interestingly, October's World Economic Outlook appraised the macroeconomic benefits of public infrastructure projects. They report that for advanced economies – and depending on the degree of slack, the stance of monetary policy and the way in which the investment is financed – such projects could have significantly positive impacts on output.

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 (October 2014)	OECD (September 2014)	IMF (October 2014)	OECD (September 2014)
USA	2.2	2,1	3.1	3.1
Netherlands	0.6	-	1.4	-
France	0.4	0.4	1.0	1.0
Belgium	1.0	-	1.4	-
Germany	1.4	1.5	1.5	1.5
Ireland				
United Kingdom	3.2	3.1	2.7	2.8
China	7.4	7.4	7.1	7.3
Japan	0.9	0.9	0.8	1.1
Euro area	0.8	0.8	1.3	1.1

Sources: *World Economic Outlook (International Monetary Fund, IMF, October 2014) and Interim Economic Assessment (Organisation for Economic Cooperation and Development, OECD, September 2014) Notes:a "-" indicates a country forecast is not produced.*

Forecasts for the Scottish economy: Detail

While in June we reported on a return of optimism evident through surveys at that point, we warned that these appeared to be driven by stronger than expected household spending growth. Data now available for the second quarter of 2014 suggests that the first half of the year saw strong growth, however there remains limited evidence of a recovery in (private) investment spending or exports. Data for Q2's (manufacturing) exports performance suggests a second quarter of positive growth however there were continued declines in drink exports, worth around 25% of Scottish exports.

Details from the latest Scottish GDP results for Q2 2014 suggest that in that quarter Scotland grew in line with the UK rate. Construction activity in Scotland in Q2 appeared to be more robust than in the UK as a whole (growing by 3.6% in Scotland and 0.7% in the UK) however this reversed three consecutive quarters where UK construction sector activity had been stronger. Service sector growth rates were broadly similar. Definitional changes to GDP make longer term comparisons between UK and Scottish economic activity at aggregate and sectoral level more difficult to draw.

Survey evidence points to some continued activity through the first half of 2014, consistent with the strong estimates for these two quarters. Most recent surveys for Q3 suggest that the rate of growth has eased into the second half of the year.

We note that export markets for Scottish goods appear to be facing continued growth problems with price deflation and continuing risk to the Eurozone countries, which are some of Scotland's major overseas markets. Domestic demand – specifically household consumption, with continued public austerity – appears to be robust however, we caution that households cannot continue to support economic activity in absence of real wage growth, and recent growth in the level of private debt suggests that consumption is increasing faster than wage income. As public austerity policy continues to reduce real (government consumption) spending through the next (Westminster) Parliament, this will continue to depress government spending as a driver of economic activity. The IFS note that around half of the planned Government's fiscal consolidation has taken place at the time of writing.

Results

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 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 sectoral categories.

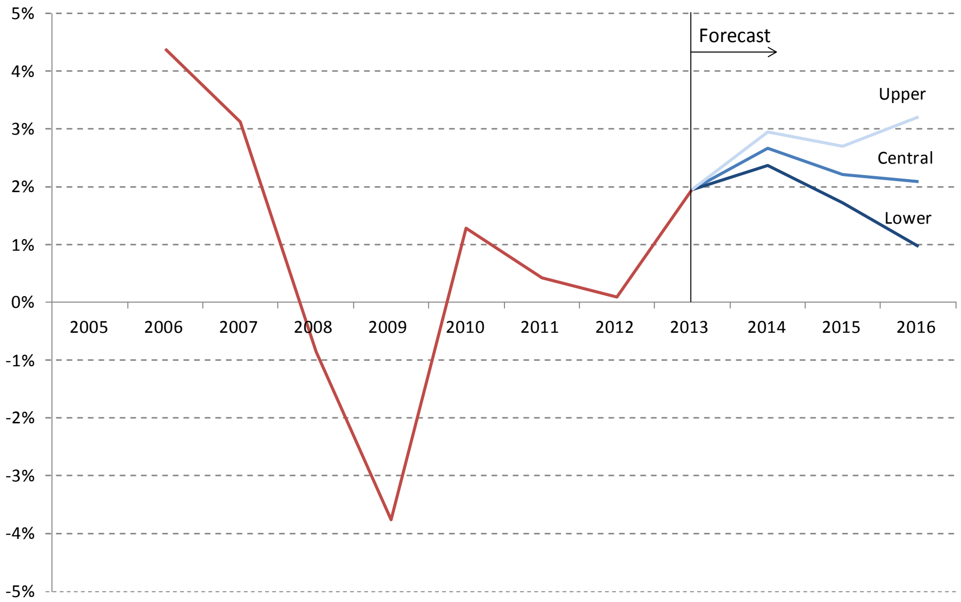
We begin with the forecasts for GVA growth in the Scottish economy. The trend for annual growth in Scotland between 2005 and 2013 and our forecasts for the period to 2016 are shown in Figure 3. This also includes our upper and lower forecasts growth. As previously, the range around the central forecast is based on our past forecast accuracy of the first release of growth for the year. The changing basis for growth described above means that – following the release during 2015 of backdated growth figures for years which have been forecast – it is likely that earlier forecasts may appear to have larger errors. We will reflect on the changing profile to Scotland economic growth and the implications for the assessment of our previous forecasts once the updated and revised Scottish data is produced.

Based on earlier forecasts since 2000, the mean absolute error of forecasts in the winter period and growth in the same year is 0.288 percentage points. Growth forecast errors for the following year are 0.494 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 1.120 percentage points, so this is used to give the range around our central forecast for 2016.

Relative to June 2014's forecasts we have now revised up our central forecast for GVA growth in 2014 from 2.5% to 2.7% (i.e. a revision upwards up by 0.2 percentage points) and largely driven by better than expected growth outcomes through the first half of 2014, in particular the stronger than expected performance in the second quarter. Our forecast for 2015 remains at 2.2%, while we have revised our forecast for 2016 down from 2.4% to 2.1% in light of the weaker domestic and global environment for growth beyond the short term.

For comparison purposes, the UK's Office for Budgetary Responsibility (OBR) forecast for growth in 2014 (made in March 2014) and the median of independent growth forecasts for the UK made during the last three months for 2014 are 2.7% and 3.1% respectively, while for 2015 the respective figures are of 2.3% and 2.6% respectively.

Figure 3: Forecasts of annual real GVA (%) growth for Scotland, 2014 to 2016



Sources: *Fraser of Allander Institute forecasts, November 2014*

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 three broad sectoral groupings: the "production", "construction" and "services" sectors of the Scottish economy. Much of the reduction in growth forecast for 2016 is in the services sector, as household spending is projected to recover more slowly than previously anticipated and with slower growth in Scottish export markets.

Table 2: Scottish GVA growth (%) by sector, 2014 to 2016

	2014	2015	2016
GVA	2.7%	2.2%	2.1%
Production	3.1%	2.6%	2.5%
Construction	2.0%	1.3%	1.2%
Services	2.5%	2.1%	2.0%

Source: *Fraser of Allander Institute forecasts, November 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 2,358,000 employee jobs in Scotland in the second quarter of 2014. This was an increase of 13,000 jobs from the end of 2013 and saw an additional 5 thousand jobs created in the second quarter of 2014. The level of employee jobs is now 122,000 jobs (4.9%) lower than the peak of employee jobs in Scotland in Q3 2008 (2,480,000). This has improved from a trough in the second quarter of 2013 when there were 203,000 fewer jobs (8.5%) than at the pre-recession peak.

Our new forecasts for employee jobs are shown in Table 3, alongside a 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 June 2014 forecasts. The number of jobs is now forecast to increase by 2.0% in 2014 (up from 1.8%) with a slightly upward revision to the net annual change in employee jobs from 43,100 to 46,560 through to the end of 2014. Our forecast for 2015 is for the Scottish economy to add 41,600 jobs in 2015, down slightly from our June forecast. We continue to forecast the number of employee jobs in Scotland to 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.

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 definition of unemployment. This is preferred to the claimant count measure as it gives a more complete picture of the extent of labour resources available for work but unable to find work, and so is a better measures of the level of spare capacity in the Scottish labour market.

Table 3: Forecasts of Scottish employee jobs ('000s, expect where stated) and net change in employee jobs in central forecast, 2014 to 2016

	2014	2015	2016
Total employee jobs, Dec	2,391,560	2,433,179	2,482,058
Net annual change (jobs)	46,560	41,600	48,900
% change from previous year	2.0%	1.7%	2.0%
Agriculture (jobs, 000s)	41	44	47
Annual change	3,600	3,050	3,300
Production (jobs, 000s)	252	257	262
Annual change	2,100	4,400	5,400
Construction (jobs, 000s)	121	122	124
Annual change	1,600	1,550	1,900
Services (jobs, 000s)	1,978	2,011	2,049
Annual change	39,250	32,600	38,300

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

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

	2014	2015	2016
Upper	53,000	53,450	76,750
Central	46,560	41,600	48,900
Lower	33,400	19,900	29,900

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

The recent labour market data at time of writing (7th November) indicates that the ILO unemployment rate in Scotland was 6.4% in the second quarter of 2014, down 0.2 percentage points on Q1 2014.In June we forecast that the unemployment rate would fall to 6.4% by the end of 2014. In light of stronger than anticipated growth in the first half of 2014 we have revised down our forecasts for the unemployment rate for the end of this year (although in line with an easing of growth in activity, we anticipate the rate of decline to slow).

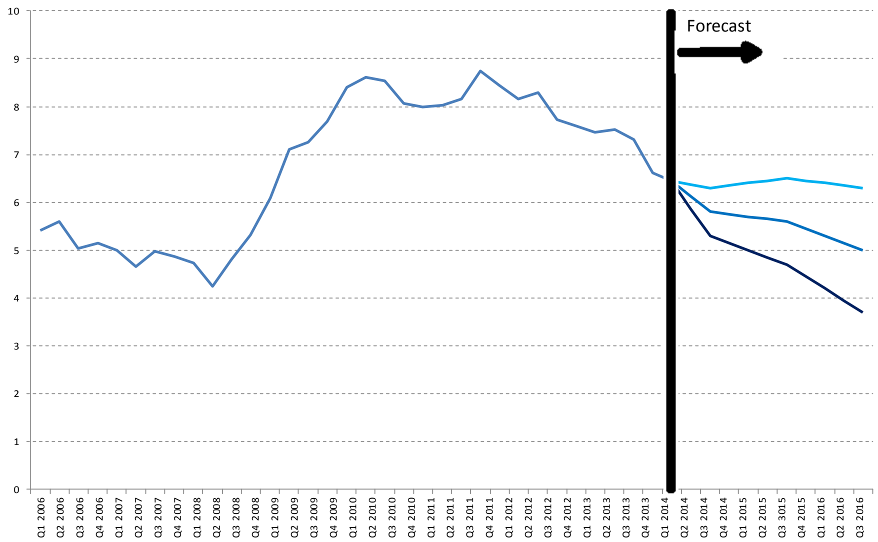
Our new forecasts for the unemployment rate in Scotland at the end of 2014 and 2015 are 5.3% and 5.2% respectively. Figure 4 shows both the history of the ILO measure of the Scottish unemployment rate since 2006 and our central, upper and lower forecasts for the ILO unemployment rate, now extended out to 2016.

Table 5: Forecasts of Scottish unemployment in central forecasts, 2014 to 2016

	2014	2015	2016
ILO unemployment	124,700	141,019	135,537
Rate (%)[1]	5.3	5.2	5.0

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. The most recent labour market statistics are detailed in the Labour Market Section of the Fraser of Allander Economic Commentary.
Source: Fraser of Allander Institute forecasts, November 2014

Figure 4: Scottish ILO unemployment rate, 2006 to 2016 including forecasts from 2014



Sources: *ONS and Fraser of Allander Institute forecasts, November 2014*

Grant Allan

7th November 2014