1 Outlook and appraisal

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Overview

The Scottish economy delivered strong economic growth in the first half of the year in the run up to the referendum but there are signs that growth may be beginning to slow. Growth in the wider global economy and the UK economy appears also to have begun to slow recently. The IMF Managing Director Christine Lagarde fears we may be entering a phase of weak growth which she has called the 'new mediocre'. Others such as ex US Treasury Secretary and leading economist Larry Summers go further and argue that the world economy now faces a situation of secular stagnation, a permanent deficiency of demand – caused, for example, by a permanent slow-down in the growth of working population - which can't be overcome even with near-zero interest rates. The recent indicators of slowing demand both at home and abroad, falling real wages, rising levels of household debt, the prospect of more substantial UK fiscal austerity to come, and the deeper concerns about secular stagnation raise several questions. Questions that can be posed but cannot be definitively answered, such as whether the Scottish and UK economies are now poised for a period of slower but sustainable growth, or whether growth will slow and then slip back into recession? Are we at a turning point or are we on a knife-edge?

The Nobel Laureate economist Paul Krugman has recently argued that if we are faced – as we are - with a persistent shortfall in demand then Government measures to boost spending including sustained spending on public works are appropriate. And borrowing can finance such investment because we should be less concerned about borrowing and the level of public debt when interest rates are likely to remain low and close to zero for a long period. The IMF in its October 2014 *World Economic Outlook* echoed Krugman by urging Governments to undertake increased public infrastructure investment. Such investment the IMF argued raises output in both the short and long term, particularly during periods of economic slack and when investment efficiency is high. So, in countries with infrastructure needs, it considered the time was right for an infrastructure push as borrowing costs are low and demand is weak. Debt-financed projects could have large output effects without increasing the debt-to-GDP ratio, if clearly identified infrastructure needs are met through efficient investment.

The *Outlook* shows that the estimated quality of UK infrastructure overall has been improving in recent years but still remains below that of the major advanced countries - Germany, France, Japan and Canada. The July 2013 report of the McKinsey Global Institute highlighted infrastructure investment as one of the top 5 catalysts for economic growth. It is also a major factor in the attraction of foreign investment. The UK Government appears to agree since at the time of writing it is unveiling plans for £15 billion of new infrastructure projects this week to make it "easier than ever" to invest in the UK. Such public investment is to be welcomed. However, we contend that in the light of slowing growth, the risks of secular stagnation, the need to boost competitiveness, net trade and inward foreign investment, that there is strong case that Government, and the UK Government in particular, should invest *much more* in infrastructure in and for Scotland. For example, more needs to be done to improve the infrastructure of road and rail, especially, between Scotland and the UK. Raising the borrowing levels available to the

Scottish Government would also help to support and encourage its own plans for infrastructure investment within Scotland. An expanded programme of public investment would appear to be essential when the real volume of private investment continues to be markedly below pre-recession peak levels in both Scotland and UK, even though private investment has picked up in recent quarters.

With the signs that the growth of productive activity may be slowing, we note also the strong performance of the Scottish labour market in recent months, with 52,000 jobs created over the year and unemployment on the ILO measure falling to 151,000 or 5.5%. However, despite the strong recent 'headline' recovery in the labour market, we are still some way from the conditions that maintained prior to the start of the Great Recession. Much of the recovery in jobs has been driven by the growth of part-time and self-employment. Full-time employment still remains considerably below its pre-recession peak, although there has been some pick up in recent quarters. An indication that there is still a deficiency of demand in the Scottish labour market, irrespective of whether the shift to part-time and self-employment is structural or cyclical, is provided by data on the number of weekly hours worked. These data show that the total number average weekly hours worked is at the latest data point -2.4% below the pre-recession peak. Finally, when jobs are compared to the potential labour supply as measured by the employment to adult population ratio we find that by June-August 2014, the ratio stood at -1.5% below the pre-recession peak, compared to -5.7% at the trough of the recession. This suggests that even when we consider jobs alone and not hours worked there is still plenty of slack in the Scottish labour market compared to the pre-recession peak, despite the recent strong jobs recovery. (The post-crash labour market is the subject of two articles in this Commentary).

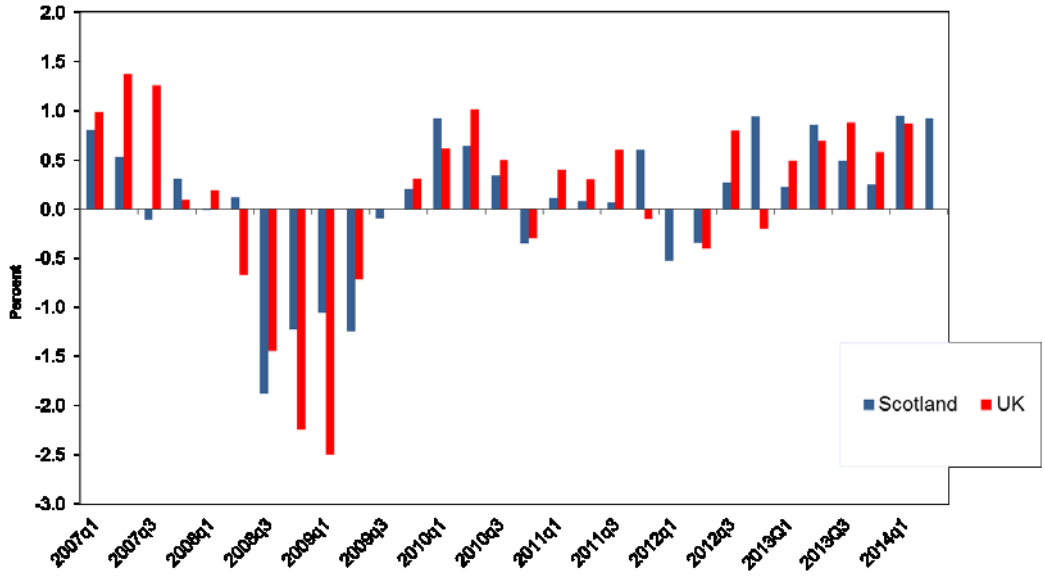
It is against this background that we have prepared our latest forecasts. We are now forecasting GDP growth in Scotland of 2.7% in 2014, 2.2% in 2015, and 2.1% in 2016. Given our previous forecast errors the lower and upper bounds for growth in 2014 are expected to be 2.4% and 3.0%, for 2015, 1.7% to 2.7%, and for 2016, 1.0% to 3.2%. We have therefore *revised up* our forecast for 2014 from 2.5% to 2.7% due to the strong growth in the first half of the year. We have held our forecast for 2015 at 2.2% but have *revised down* our forecast for 2016 from 2.4% to 2.1% in the light of concerns about secular stagnation and a persistent weakness of aggregate demand. Production and manufacturing continue to be the major sectors exhibiting the fastest growth in 2014, 2015 and 2016. Our forecasts for employee job creation and unemployment are similar to June 2014, with some revisions. On the central forecast, we are now forecasting that net jobs will increase by 46,560 in 2014, 41,600 in 2015 and 48,900 in 2016. Our projection for unemployment on the ILO measure at the end of 2014 is 124,700 (5.3%). In 2015, unemployment is now forecast to be 157,300 (5.8%) falling further to 151,800 (5.6%) by the end of 2016.

Recent GDP performance

The latest Scottish GDP data for the second quarter of this year (2014q2) show that Scottish GDP rose by 0.9% in Scotland in the quarter. This represents a strong growth performance but a slight weakening from the 1% GDP growth recorded in the first quarter. However, as anticipated in the June 2014 *Commentary* first quarter growth in Scotland is likely to have been inflated by the resumption of production at the Grangemouth refinery, after the resolution of the dispute that shut it down during the fourth quarter 2013. UK GDP grew by 0.9% in the first quarter. If the Grangemouth shutdown reduced Scottish GDP by -0.2% to -0.4%, as suggested in the previous *Commentary*, in the fourth quarter then

we can conclude that underlying Scottish GDP growth might have been slightly weaker than the UK in the first quarter of 2014.

Figure 1: Scottish and UK Quarterly GDP Growth, 2007q1 - 2014q2 (UK to 2014q1)

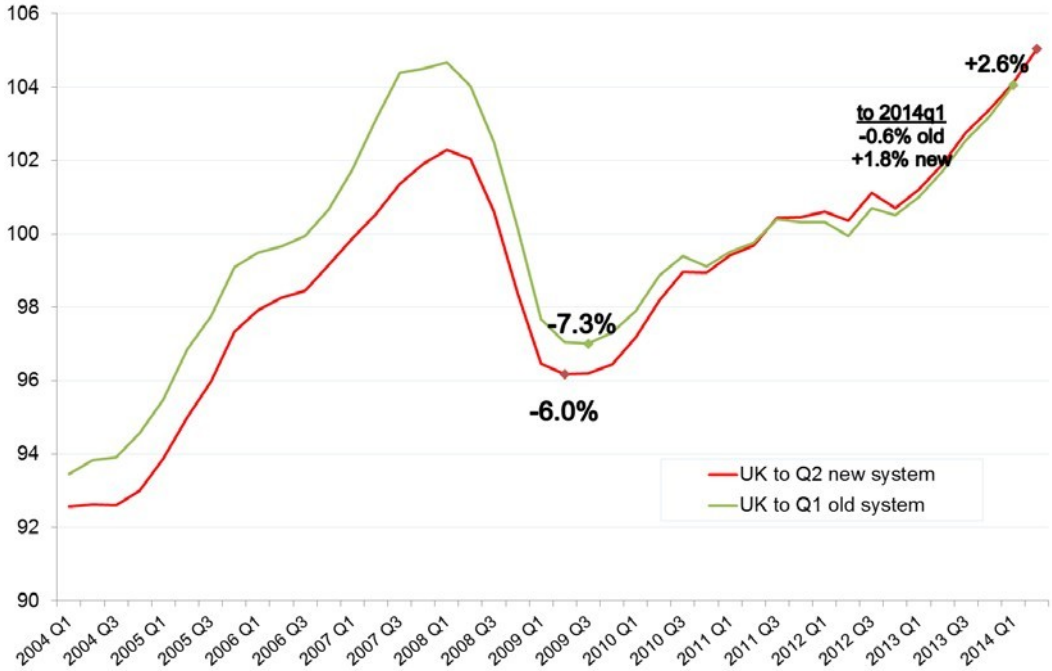


Source: Scottish Government GROSS DOMESTIC PRODUCT 2nd QUARTER 2014 and 1st quarter 2014 and FAI calculations

Figure 1 charts Scottish quarterly GDP growth to the 2014q2 and UK quarterly GDP growth to 2014q1. We do not have comparable GDP growth figures Scotland and the UK for 2014q2. This is because the ONS have from the 2014q2 introduced changes to the UK National Accounts to comply with the European System of Accounts 2010. The key changes relevant to the estimation of aggregate GDP include the treatment of some activities (such as research and development and military expenditure) as outputs alongside the inclusion of previously uncounted ones (such as illegal activities). These changes are currently estimated to raise the level of annual current price GDP in the UK by between 2.6 and 4.6 per cent, though the impact will vary across individual years. It follows that the two series - GDP for Scotland and the UK - will not be strictly comparable for the next two Scottish GDP releases (i.e. October 2014 and January 2015) as the Scottish series will continue to be estimated on the old basis until the transition of the Scottish National Accounts system is complete. The Scottish Government's advice to users is that the Quarterly GDP series remains a valid measure of short-term growth of the Scottish economy and in particular short-term comparisons over the quarter and the year between Scotland and the UK are still meaningful despite these methodological differences. However, it is not valid for longer-term comparisons.

Under the new system, UK GDP rose by just under 0.9% in the second quarter much the same as the estimate for Scotland on the old basis. However, the impact of the changes on the level of UK GDP is quite large as Figure 1a shows.

Figure 1a: UK GDP under old and new system of accounts

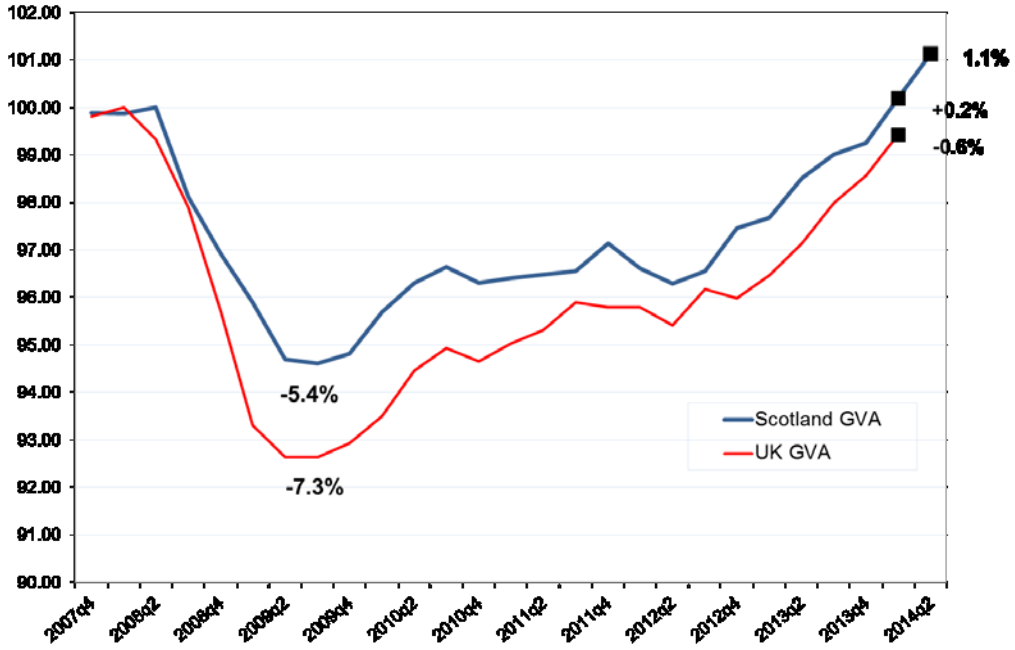


The scale of the recession in the UK is reduced from a contraction of -7.3% to -6.0% now much closer to the -5.4% contraction experienced in Scotland. By the first quarter of this year UK GDP was still -0.6% below its pre-recession peak under the old accounts system but +1.8% above the peak after the changes that are contained in the new system. So, UK GDP reached its pre-recession peak in the third quarter of 2013 under the new system compared to the old system where the peak had not been reached by the first quarter of this year.

Over the year to the fourth quarter - four quarters on previous four quarters - Scottish GDP grew at 2.4%, a growth rate that is above trend. These data indicate that the recovery continues at a strong rate and faster in the first half of this year than we had anticipated. Positive growth has now been recorded for the Scottish economy in the last 8 quarters. The effect of the latest data on Scotland and the UK's recovery from recession is shown in Figure 2.

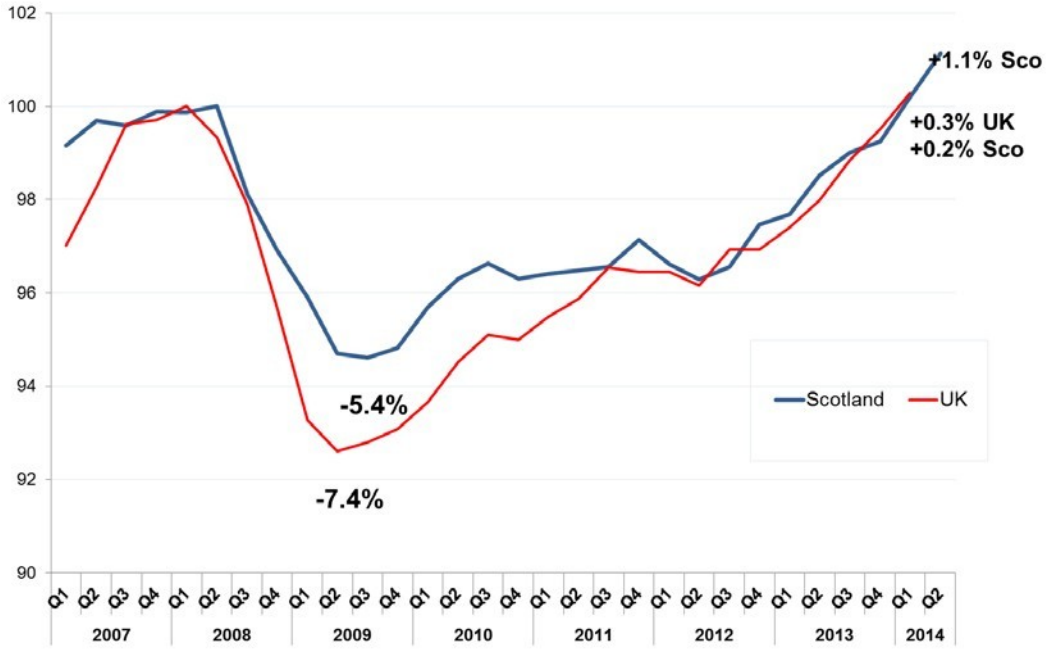
In the second quarter, GDP in Scotland was +1.1% above the pre-recession peak, having finally passed the peak in the first quarter of this year 6 years later. We await the publication of the Scottish GDP series next year under the new system to see if the revisions and additions to the data raise the level of GDP and bring forward the time when the pre-recession peak was reached as it did in the UK. Despite the recent strong Scottish growth performance, the overall strength of the recovery is still greater in the UK than Scotland. By 2014q2 Scottish GDP had grown by 6.9% since the trough of the recession compared to 7.3% in the UK to the earlier quarter 2014q1. However, as noted in previous *Commentaries* there is the complicating factor of oil and gas production which - offshore production - is included in the UK GDP data but not in the Scottish data. Removing oil and gas production gives us Figure 3.

Figure 2: GVA in recession and recovery Scotland and UK to 2014q2 (Relative to pre-recession peak) UK to 2014q1



Source: Scottish Government GROSS DOMESTIC PRODUCT 2nd QUARTER 2014, ONS and FAI calculations

Figure 3: GVA ex oil & gas, recession and recovery to 2014q2 (UK to 2014q1)

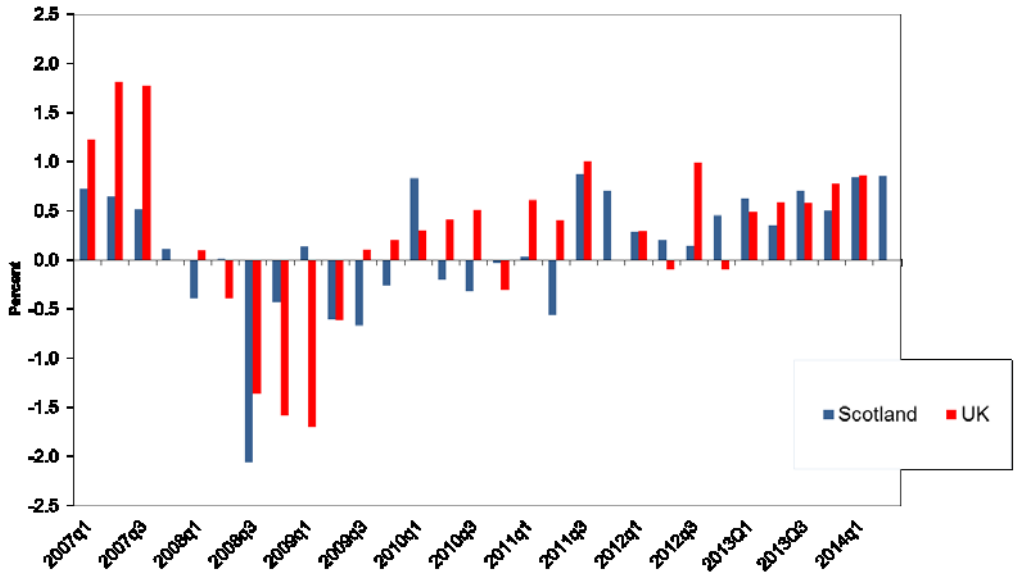


Source: Scottish Government GROSS DOMESTIC PRODUCT 2nd QUARTER 2014, ONS and FAI calculations

When oil and gas production is removed, we find that on the old data series UK GDP was 0.3% above the pre-recession peak by 2014q1 compared to 0.2% in Scotland. 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. As noted above, Scottish GDP has recovered by 6.9% since the trough of recession while UK GDP - ex oil & gas - recovered by 8.3% from its trough by the previous quarter 2014q1.

Turning now to individual sectors of the economy. The Scottish service sector, which accounts for 72% of GDP in Scotland and 77% in the UK, grew by 0.9% in Scotland in the second quarter; this followed growth of 0.8% in Scotland and 0.9% in the UK in the first quarter - see Figure 4. Under the new system of accounting UK services output grew by 1.1%, faster than in Scotland.

Figure 4: Scottish and UK Services GVA Growth 2007q1 to 2014q2 (UK to 2014q1)

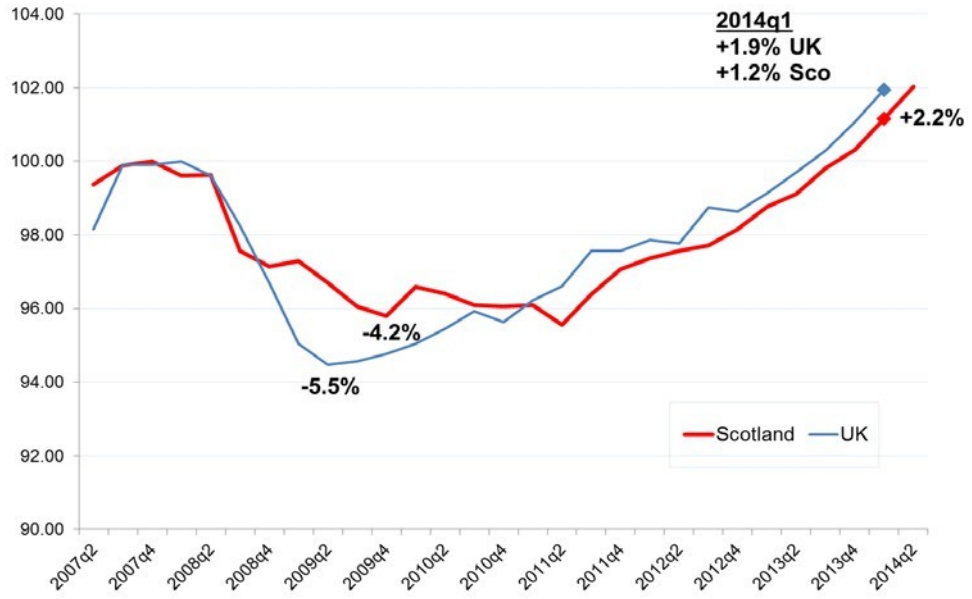


Source: Scottish Government GROSS DOMESTIC PRODUCT 2nd QUARTER 2014 and FAI calculations

Over the year - that is four quarters over previous four quarters - the service sector in Scotland grew by 2.4%. The state of the recovery in Scottish and UK services is presented in Figure 5. Figure 5 indicates that by the second quarter output in Scottish services stood at 2.2% above the previous peak. By the first quarter output in Scottish services stood at 1.2% above the previous peak while output in UK services was 1.9% above. The data suggest that up to the first quarter the recovery in Scottish services continued to be weaker than in the UK with growth of 6.5% since the trough of the recession compared to 7.9% in UK services. In the previous three *Commentaries* we noted that the recovery in Scottish services' growth continues to underperform the overall performance of the economy in the recovery, whereas that was not the case in the UK where the recovery in services has been somewhat quicker. However, the data for the first and second quarters reveals that the recovery in Scottish services is strengthening both absolutely and relatively with growth of 6.5% since the trough compared to 6.9% for GDP in the economy as a whole. The service sector recovery in the UK still continues to outstrip, to some degree, the overall recovery in GDP. The production sector in Scotland still continues to boost

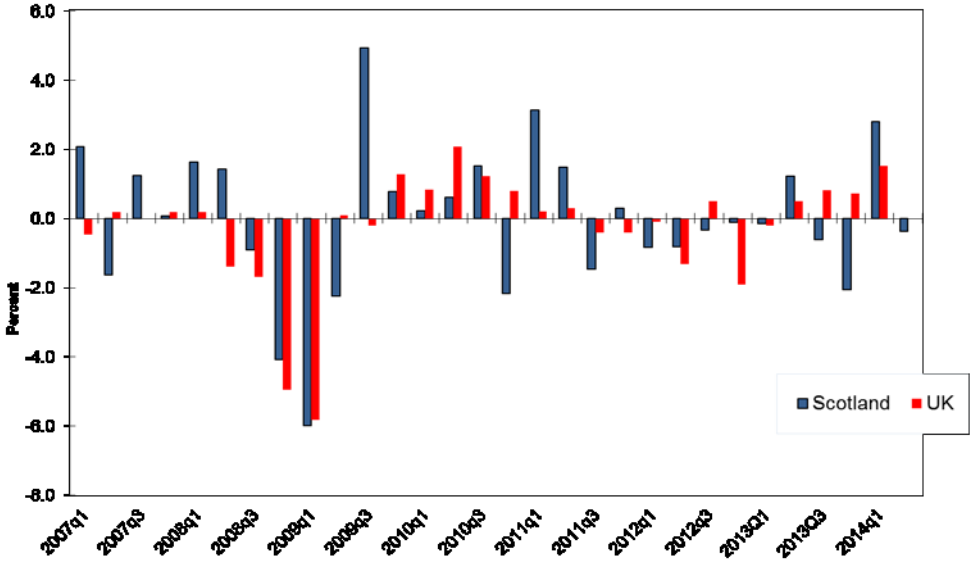
Scottish growth, growing by a little over 11% over the recovery, while the sector remains a significant drag on the recovery in the UK with growth of less than 1% to 2014q1 since the trough of the recession.

Figure 5: Services GVA in recession and recovery Scotland and UK to 2014q2 (UK to 2014q1)



Source: Scottish Government GROSS DOMESTIC PRODUCT 2nd QUARTER 2014 and FAI calculations

Figure 6: Scottish and UK Manufacturing GVA Growth at constant basic prices 2007q1 to 2014q2 (UK to 2014q1)

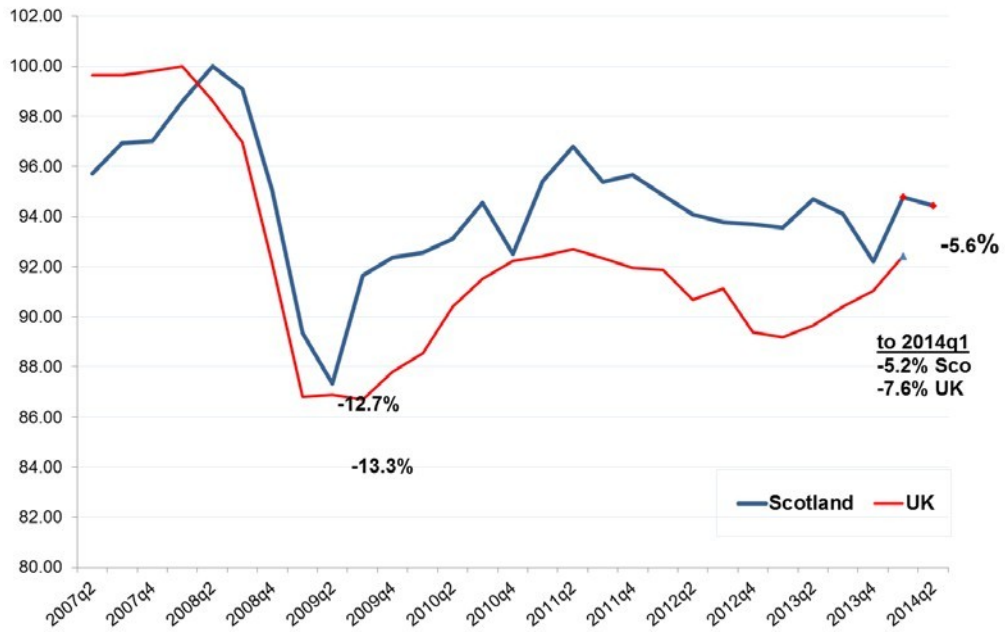


Source: Scottish Government GROSS DOMESTIC PRODUCT 2nd QUARTER 2014 and FAI calculations

Scottish production output strengthened in the first quarter of the year as production at Grangemouth came back on stream. Output rose in the first quarter by 2.1% then rose again by 0.3% in the second quarter. UK production sector output grew by only 0.2% in the quarter. Over the year - four quarters on four quarters - production GVA rose by 0.6%. Within production, Mining & quarrying GVA grew by 5.4% in the second quarter and rose by 2.6% over the year. Electricity & gas supply GVA fell by –3.1% in the second quarter and also fell by -0.6% over the year. In the second quarter, GVA in Scottish manufacturing fell by -0.4% after rising by 2.8% in the first quarter, again largely due to the impact of Grangemouth restarting production. Over the year to the second quarter, Scottish manufacturing contracted slightly by -0.1%, indicating a flattening of the recovery in the sector. Figure 6 charts the quarterly percentage changes in GVA in Scottish and UK manufacturing.

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 to 2014q2, UK to 2014q1



Source: Scottish Government GROSS DOMESTIC PRODUCT 2nd QUARTER 2014 and FAI calculations

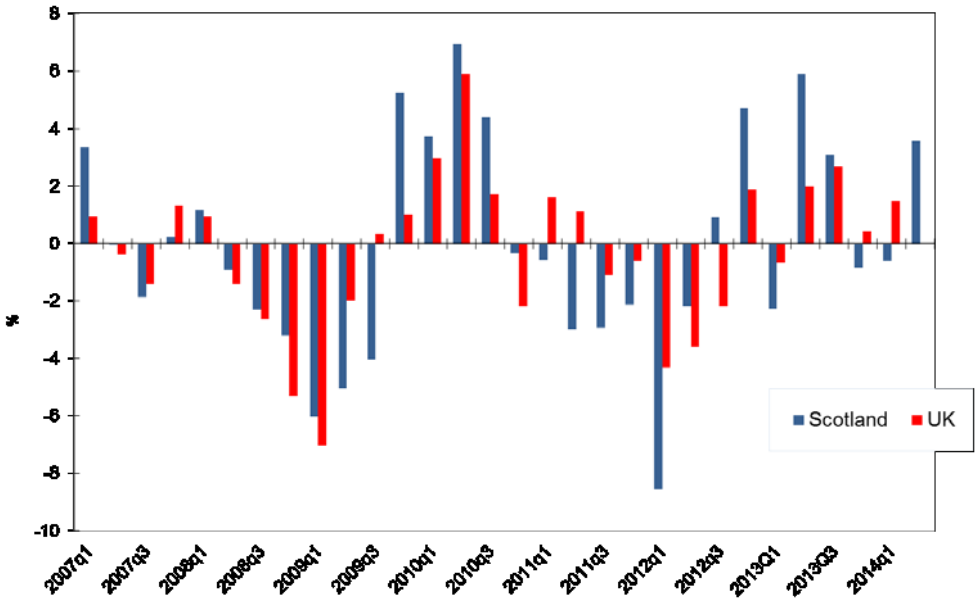
By the second quarter Scottish manufacturing GVA was still -5.6% below its pre-recession peak. The chart makes clear that the recovery in both Scottish and UK manufacturing effectively stalled in 2011q2, three years before the latest data point. UK manufacturing has demonstrated a stronger recovery since the first quarter of 2013. However, by the first quarter of this year UK manufacturing was -7.6% below its pre-recession peak compared to -5.2% in Scotland, reflecting the greater fall in UK manufacturing output in the recession and the stronger recovery in Scottish manufacturing before 2011q2.

Within manufacturing, four of seven principal sectors experienced growth in the second quarter: computer, electrical and optical products (electronics) (accounting for 9% of manufacturing GVA), which grew by 3% in the quarter but contracted by -10.0% over the year; transport equipment (accounting for

8% of manufacturing GVA) which expanded by +1.5% in the quarter but reduced output by -1.0% over the year; metals, metal products & machinery n.e.c. (accounting for 19% of manufacturing GVA) which grew by 0.9% in the quarter but by 6.5% over the year; and other manufacturing Industries, repair & installation (accounting for 22% of manufacturing GVA) which grew by 0.3%% in the quarter while growing by 2.2% over the year. The three manufacturing sub-sectors that contracted in the quarter were: textiles, clothing & leather products (accounting for only 2% of manufacturing GVA) which suffered a loss of output of -3.0% in the quarter but grew by 2.9% over the year; food & drink (accounting for 28% of manufacturing GVA) which contracted by -1.9% in the quarter and by -2.5% over the year; and finally, refined petroleum, chemical & pharmaceutical products (accounting for 12% of manufacturing GVA) which contracted by -2.0 in the quarter and by -0.8% 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 - 2014q2 (UK to 2014q1



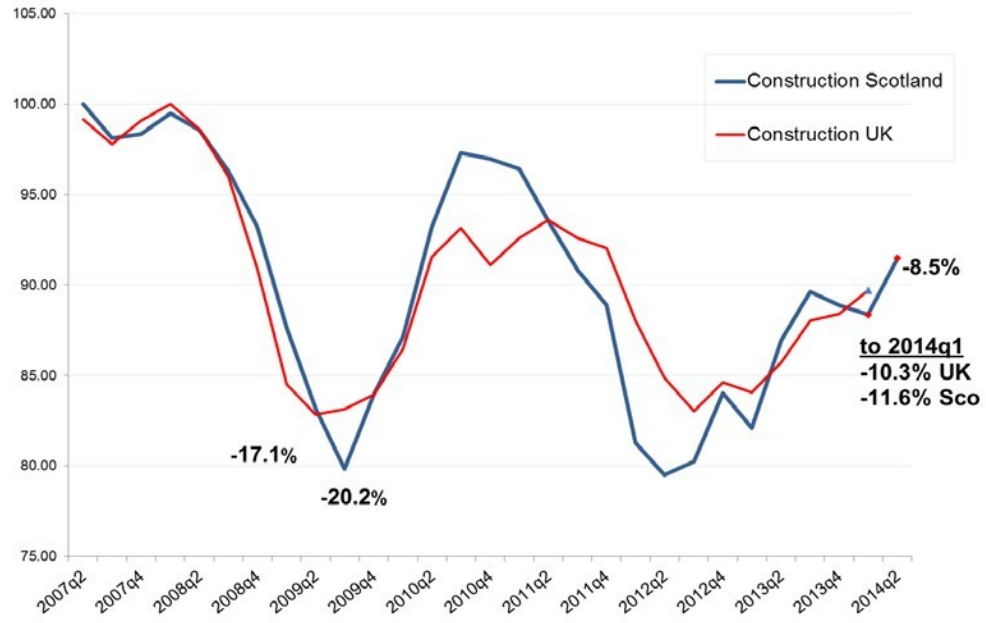
Source: Scottish Government GROSS DOMESTIC PRODUCT 2nd QUARTER 2014 and FAI calculations

Scottish construction GVA picked up considerably in the second quarter growing by 3.6% after falling by -0.6% in the previous quarter and falling by -0.8% in the final quarter of 2013. UK construction GVA in contrast rose by 0.7% in the second quarter. Over the year – four quarters on four quarters - Scottish construction grew by 7.5%. Figure 9 displays the recession and recovery performance in both Scottish and UK construction.

Figure 9 highlights the recent recovery in Scottish construction after the downturn for two quarters. By the second quarter Scottish construction was still -8.5% below its pre-recession peak. By the end of the first quarter UK construction was -10.3% below peak and Scottish construction -11.6% below its peak.

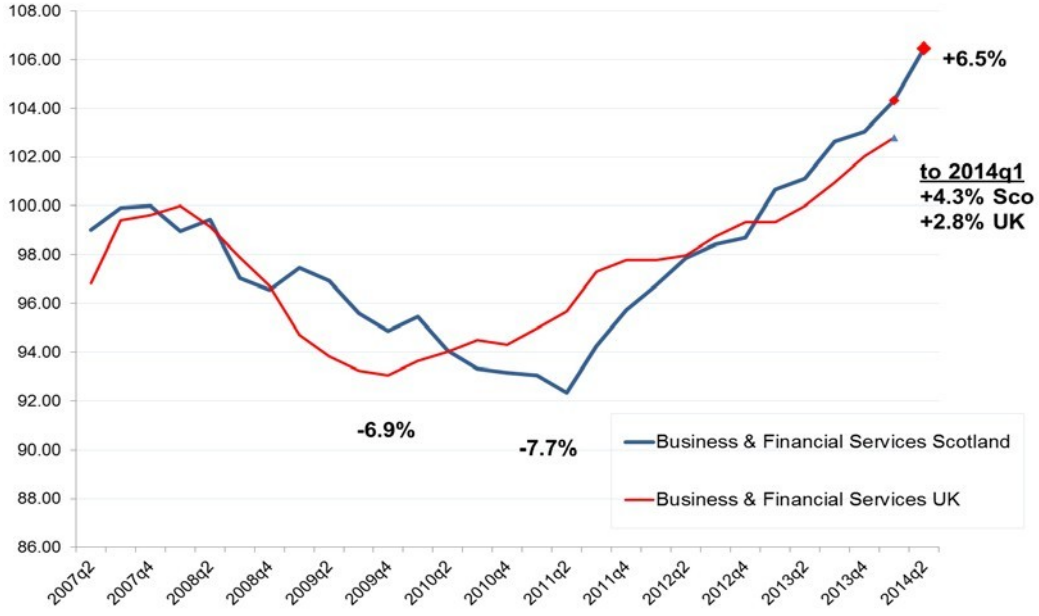
Within services, the principal sub-sectors in the private sector all displayed positive growth in the fourth quarter. Business and financial services grew strongly by 2%. Over the year, the sector grew at 4.4%. Figure 10 shows the growth of the sector in Scotland and UK during the recession and recovery.

Figure 9: Construction, Recession and Recovery to 2014q2 (UK to 2014q1)



Source: Scottish Government GROSS DOMESTIC PRODUCT 2nd QUARTER 2014 and FAI calculations

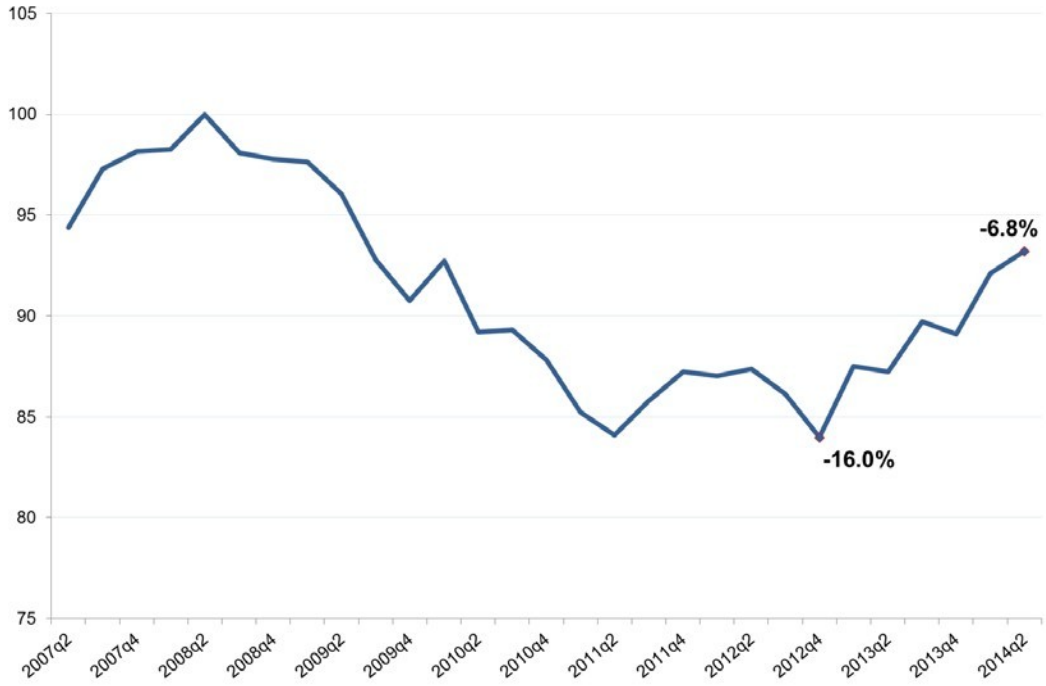
Figure 10: Business & Financial Services: Recession and Recovery to 2014q2 (UK to 2014q1)



Source: Scottish Government GROSS DOMESTIC PRODUCT 2nd QUARTER 2014 and FAI calculations

By the first quarter, output or GVA in the sector had moved to +4.3% above its pre-recession peak in Scotland compared to +2.8% in the UK underlying the stronger recovery of this sector in Scotland compared to the UK. By the second quarter of this year output in the sector in Scotland stood at +6.5% above the previous peak. The aggregate GVA data for business and financial services in Scotland have recently 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.

Figure 11: Financial Services, Recession and Recovery 2007q2 to 2014q2



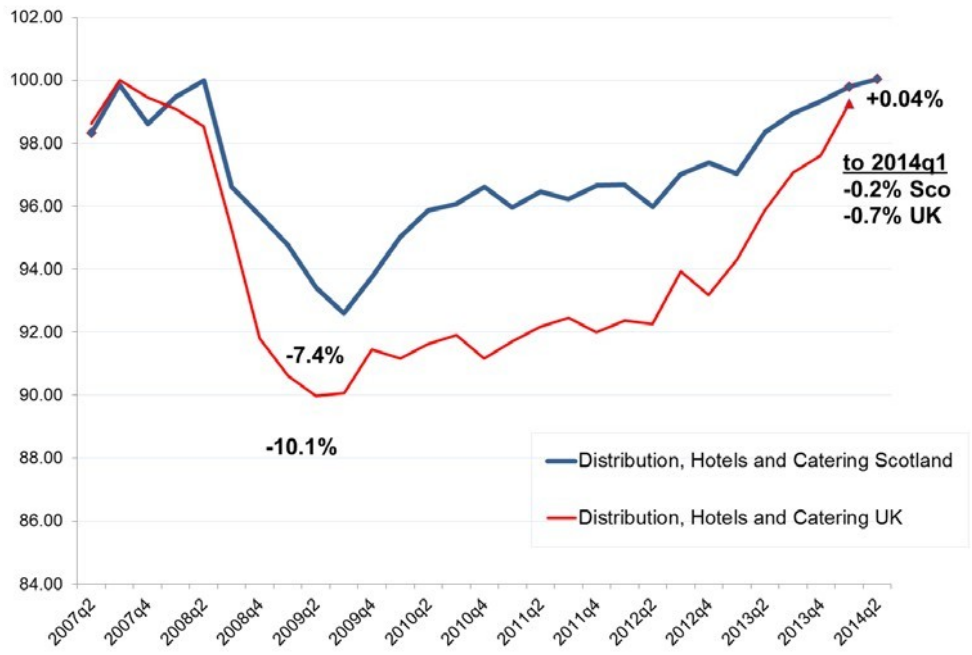
Source: Scottish Government GROSS DOMESTIC PRODUCT 2nd QUARTER 2014 and FAI calculations

These data show that the recovery in the sector is continuing this year after the weak performance in the second half of 2013. Now GVA in the sector is -6.8% below the pre-recession peak compared to the trough of -16.0% in 2012q4. The continuation of the recovery in financial services raises the hope that despite the structural change that occurred in the banking sector in particular after the Great Recession, output does now seem to be moving back slowly towards pre-recession levels.

Elsewhere, in private services, distribution, hotels and catering (accounting for 19% of services sector output in Scotland), grew by only 0.2% in the second quarter. Over the year, the sector grew by 2.1%. Figure 12 shows the performance of the sector during recession and recovery.

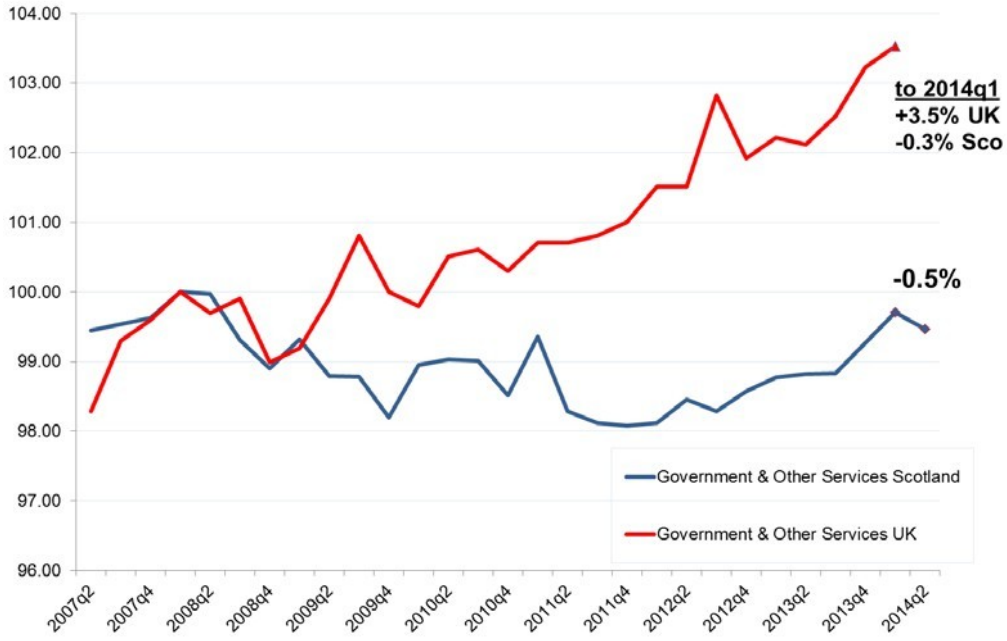
Figure 12 reveals that after data revisions the sector in Scotland just attained its pre-recession and is +0.04% above. By the first quarter the sector in the UK was still -0.7% below its peak, while the sector in Scotland was doing slightly better at just -0.2% below. However, it should be noted that the sector had a less serious recession in Scotland than in the UK with output falling by -7.4% here compared to -10.1% in the UK. The track of the recovery in the sector picked up strongly during 2013 and 2014 in both Scotland and the UK.

Figure 12: Distribution, Hotels & Catering: Recession and Recovery to 2014q2 (UK to 2014q1)



Source: Scottish Government GROSS DOMESTIC PRODUCT 2nd QUARTER 2014 and FAI calculations

Figure 13: Government and Other Services: Recession and Recovery to 2014q2 (UK to 2014q1)



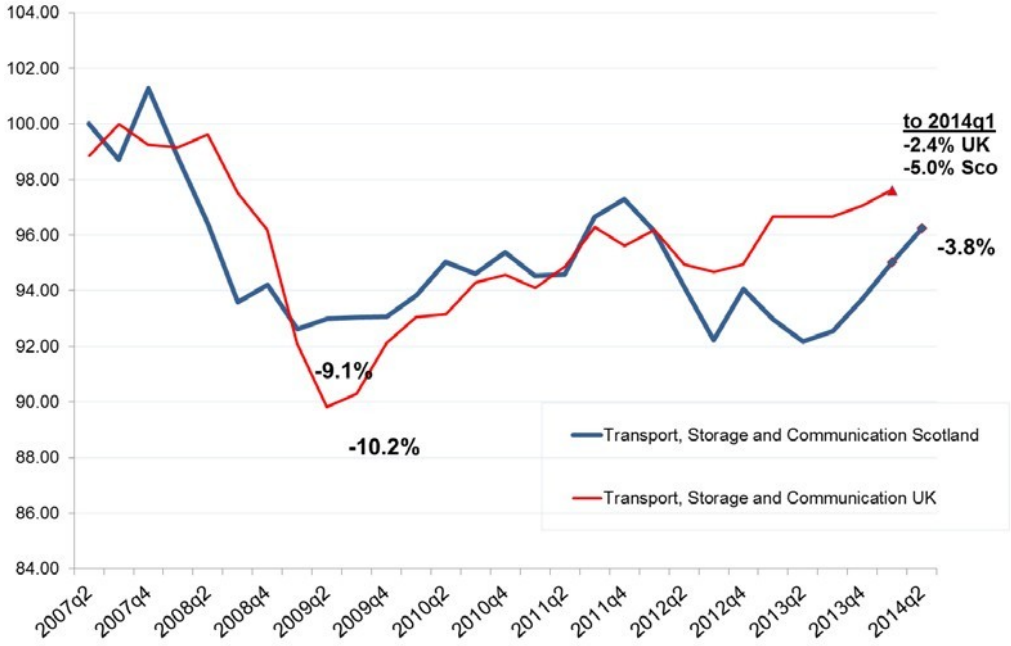
Source: Scottish Government GROSS DOMESTIC PRODUCT 2nd QUARTER 2014 and FAI calculations

Output in Government & Other Services fell slightly in Scotland in the second quarter by -0.2%. Over the year, output in the sector grew slightly in Scotland by 0.7%. Figure 13 shows the performance of GVA in the sector in recession and recovery.

By the first quarter GVA in the sector in the UK was 3.5% above the pre-recession peak, which as we have noted in several earlier *Commentaries* is difficult to understand at a time of fiscal consolidation, whereas output in the sector in Scotland was -0.3% below its pre-recession peak, which seems more reasonable. In the second quarter output in the sector in Scotland was -0.5% below peak.

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

Figure 14: Transport, Storage & Communication: Recession and Recovery to 2014q2 (UK to 2014q1)



Source: Scottish Government GROSS DOMESTIC PRODUCT 2nd QUARTER 2014 and FAI calculations

The pick-up in the performance of the sector in Scotland continued in the second quarter with GVA rising by 1.3%. Over the year, the sector grew by 1.6% in Scotland. By the end of the first quarter GVA in the Scottish sector was -6.2% below pre-recession peak compared to -2.4% in the UK. By the second quarter, output in the sector in Scotland stood at -5.0% below pre-recession peak.

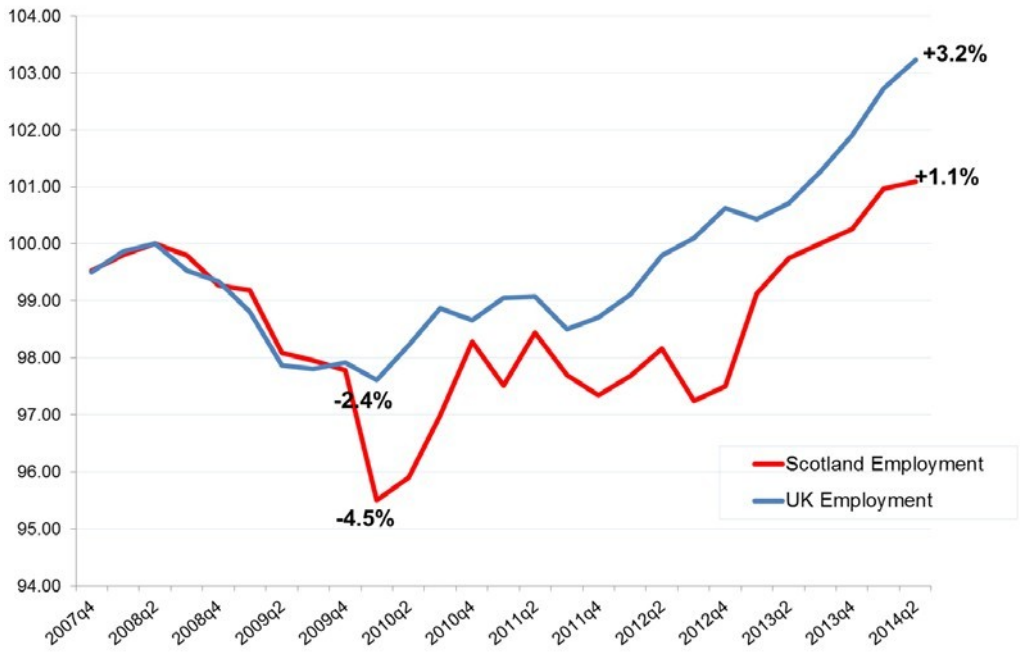
The Labour Market

The latest labour market data (see *Scottish Labour Market* section below) show a continuing strong recovery. In the quarter June – August 2014, employment rose by 1.4% in Scotland and was 0.0% in the UK. In terms of numbers, jobs rose by 35,000 in the quarter, compared to a 46,000 in the UK as a whole. Over the year, Scottish jobs rose by 52,000, a rise of 2.0%, while UK jobs rose 736,000, or 2.5%.

During the quarter unemployment in Scotland, in a further reflection of jobs growth , fell by -40,000, or -21.0%, to 151,000, or a rate of 5.5%, while in the UK, unemployment fell less rapidly by -154,000, or -7.2%, to a rate of 6.0%. Over the year, unemployment fell strongly by -54,000, or -26.2%, while in the UK unemployment also fell strongly but a little more slowly by -538,000, or -21.4% (See Figure 1 in the *Scottish Labour Market* section below, which shows the track of quarterly unemployment in Scotland and the UK from 2000 to August 2014.)

Figure 15 shows the performance employment in Scotland and the UK during recession and recovery to 2014q2.

Fig 15: Total Employment: Scotland and UK Pre-recession peak to 2014q2



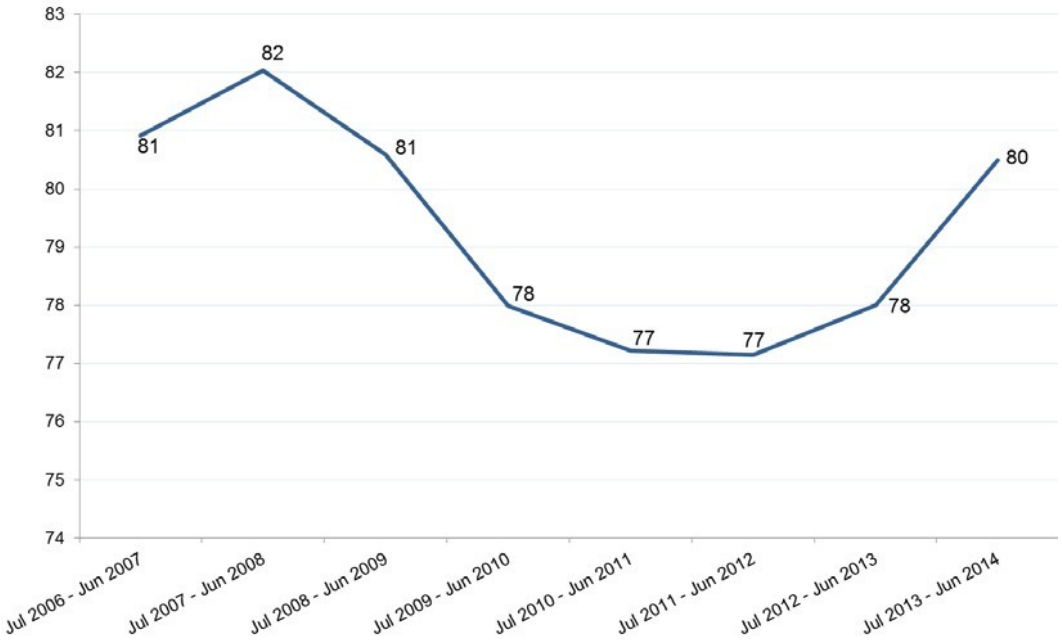
Source, ONS Regional Labour Statistics and FAI calculations

Scottish jobs as reported in the LFS worker surveys have now passed their pre-recession peak. Yet, despite the good recent performance of the labour market in Scotland overall performance in the recovery continues to be worse than the UK. By the end of the second quarter while Scottish employment was 1.1% *above* the pre-recession peak, in the UK jobs were 3.2% higher than the peak.

Despite the strong recent recovery in the labour market, we are still some way from the conditions that maintained prior to the start of the Great Recession. One indicator of this is the balance between full-time, part-time and self-employment. Figure 2 in the *Scottish Labour Market* section below reveals that much of the recovery in jobs has been driven by the growth of part-time and self-employment. Full-time employment still remains considerably below its pre-recession peak, although there has been some pick up in recent quarters. Whether this represents a continuing deficiency in the demand for labour or a more structural change heralding greater continuing shares in part-time and self-employment and a smaller share for full-time employment remains a moot point. An indication that there is still a deficiency of demand in the Scottish labour market, irrespective of whether the shift to part-time and self-

employment is structural or cyclical, is provided by data on the number of weekly hours worked. Figure 16 charts this statistic from 2007.

Figure 16: Total weekly hours worked in Scottish labour market (millions)



Source, ONS Regional Labour Statistics and FAI calculations

Figure 17: Employment to population (16 and over) July-Sep 2007 to Jun-Aug 2014 in recession and recovery

Source, ONS Regional Labour Statistics and FAI calculations

During the year July 2013 to June 2014 total weekly hours worked averaged 80 million that is 2 million, or -2.4%, below the pre-recession peak average weekly hours worked. So despite the number of jobs being higher than before the recession, the demand for labour as measured by hours worked is still lower

Finally, not only is the demand for labour still lower than pre-recession but demand -measured in terms of jobs - is still considerably deficient when compared to the supply of labour. Figure 17 charts the employment to population (aged 16 and over) ratio relative to pre-recession peak for Scotland to June-August 2014.

By June-August 2014, the ratio stood at -1.5% below the pre-recession peak, compared to -5.7% at the trough of the recession. This suggests that even when we consider jobs alone and not hours worked there is still plenty of slack in the Scottish labour market compared to the pre-recession peak despite the recent strong jobs recovery.

Forecasts

Background

Global and UK economies

In the June 2014 *Commentary* we suggested that there were 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; and the risk of deflation in the Eurozone.

At the present conjuncture only the overheating in the housing market has moderated, with house price growth slowing and, as the October 2014 minutes of the Bank of England's Monetary Policy Committee (MPC) notes: "Having risen strongly in the second half of 2013, mortgage approvals for house purchase had turned down in the early part of 2014 and had since failed to recover." However, there is little evidence of a more balanced recovery; indeed, the latest data suggest that growth in the UK still remains unbalanced. Real wage growth is still in negative territory, although there is some evidence that median real wages may now be rising in Scotland. Moreover, despite part-time and self-employment driving the recent growth in jobs, self-employment income appears to be stagnating and the decline in Trade Union membership and the diminishing influence of unions over pay setting may be contributing to the weakness of real wages (for more discussion see the *Scottish Labour Market* review below and the article by Boyd). The stagnation in the Eurozone has if anything worsened since we last reported. There would appear to be a real risk of deflation unless the ECB takes counter monetary policy measures in the absence of a loosening of fiscal policy, in Germany in particular. Quarterly growth in Germany averaged only 0.3% in the first half of the year, while industrial production fell by over 4% in August. Outside the Eurozone the US economy is displaying reasonable growth, perhaps justifying the Fed's decision to cease its policy of quantitative easing. Growth also appears to be slowing in emerging economies especially China. To be set against that is the impact of the recent substantial falls in the price of oil. Oil prices have slumped this year falling nearly 25 per cent over the past five months. Brent crude was trading as high as $115 in June 2014 and at the time of writing Brent crude futures are below

$85 per barrel. The Bank of England MPC suggests that the fall in the price of oil reflects subdued global demand against a background of rising supply. Moreover, the MPC notes that the upward-sloping oil price futures curve is consistent with some of the weakness in oil prices being expected to be temporary. Nevertheless, lower oil prices should produce a favourable income effect in net oil importing countries, which should help support the growth of demand.

Against this background the UK Government points to the strong growth of the UK economy as an exception to a picture of depressed demand outside the US in the wider global economy. While this is correct, the strong growth we have witnessed recently is substantially a delayed reaction to a recovery from recession that was significantly subdued by the UK Government's fiscal austerity policy and weak export performance. Of all the major OECD countries the UK was almost the last – with the exception of Italy - to begin to recover.

The key question is whether UK growth can be sustained. There seems little doubt that growth has begun to slow. The preliminary GDP estimate for the third quarter reported growth of 0.7% compared to 0.9% in the second quarter. Retail sales volumes in September 2014 fell 0.3% on August but this was mainly due to lower clothing sales reflecting the unseasonably warm autumn weather. There appeared to be no general slowdown in household demand.

Construction activity expanded at its weakest pace in five months in October due to a sharp slowdown in residential building growth but remained well above the long-term average, according to the latest purchasing managers' index from Markit/CIPS. Finally, the latest Markit/CIPS purchasing managers' survey for the service sector in October fell for the second consecutive month to its lowest level in 17 months. The survey indicated that growth was still occurring in the sector but at slower rate. To be set against these indicators of slowing overall and key sectoral growth, the latest Markit/CIPS survey of purchasing managers in the UK's manufacturing sector suggested that the sector expanded at its fastest rate in three months in October, fuelled by domestic demand.

In the light of these recent indicators, the key question is whether the UK economy is now poised for a period of sustainable growth, or whether growth will slow and then slip back into recession? Are we at a turning point? The IMF Managing Director Christine Lagarde has recently worried that the global economy is poised to slip into what she calls "the new mediocre". Others such as ex US Treasury Secretary and leading economist Larry Summers believe that the world economy now faces a situation of secular stagnation, a permanent deficiency of demand – caused, for example, by a permanent slow down in the growth of the working age population - which can't be overcome even with near-zero interest rates. As Paul Krugman says at its root it is "the problem of building consumer demand at a time when people are less motivated to spend" And that applies to investment too. If we are faced with a persistent shortfall in demand the policy implications are, as Krugman further notes, " … measures to boost spending — higher inflation, maybe sustained spending on public works (and less concern about debt because interest rates will be low for a long time)."

UK growth is increasingly reliant on domestic demand as the net trade position continues to be weak. While there has been a clear pickup in investment in the UK, growth is very dependent on household demand. And the growth of household demand it must be said is not based on solid foundations. Jobs

are being created in large numbers so boosting aggregate labour income, a key factor in household spending. But real wages are still not rising, which must be serving to dampen household spending. Households are clearly resorting more to credit and borrowing but it is difficult to believe that this can be sustained for very long. House price growth appears to be moderating. Rising asset/house prices allow households to borrow more knowing that the increased borrowing is 'covered' by the rising value of the assets they hold. Borrowing therefore becomes more risky if the growth in house prices starts to moderate, as it has. On top of this, household debt appears to be rising again to potentially dangerous levels. The recent *Credit Suisse Global Wealth Report 2014* notes that in the UK household debt grew quickly as a multiple of income from 1980 to reach 180% of income in 2008. During and after the Great Recession - which many economists believe was triggered by levels of private, including household, debt that had become unsustainable - household debt fell to 150% by 2013. However, in the last year the ratio has risen again to 170%. Moreover, a too soon increase in base rate by the Bank of England could prove to be the catalyst that leads to retrenchment: a sharp increase in the household saving rate and a sudden drop in spending.

Finally, we must not forget that the British economy is still subject to significant fiscal austerity. The *Institute for Fiscal Studies* has estimated that by the current fiscal year April 2014 to 2015 only 50% of the planned cuts in current spending will have been implemented, or 53% of overall – capital and current – spending cuts. The tax rises were more front-loaded so that 80% of these will have been implemented. But overall, with planned fiscal austerity amounting to 10% of UK national income by 2018-19, not much more than half of that has been achieved to date.

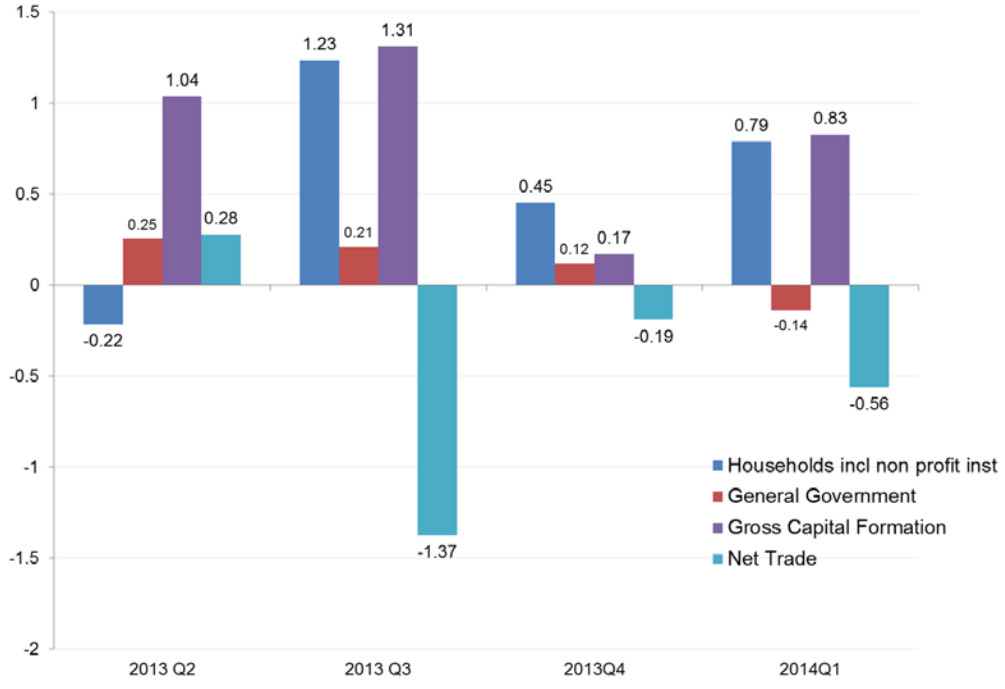
The brake imposed on domestic demand by this future austerity will be considerable. This, coupled with weakening export markets and a potential pull back in household spending, could see the UK economy slip back into recession. And Scotland would, obviously, not be immune.

The Scottish Economy

The Scottish National Accounts Project (SNAP) data from the Scottish Government allows us to gauge the extent to which the recovery in Scotland is becoming more balanced. Data published in August 2014 go up to the first quarter of this year. 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 components to nominal Scottish GDP growth in the final three quarters of 2013 and the first quarter of 2014.

What is heartening about these data is that investment – Gross Capital Formation – is playing a much more positive role in driving growth than in earlier quarters. Indeed, over the four quarters the contribution of investment was greater than the contribution of household demand to nominal GDP growth. The downside is that net trade made a negative contribution to Scottish growth during the second half of last year and the first quarter of this.

Figure 18: Expenditure Components Percent Point Contribution to Nominal Scottish GDP Growth in 2nd, 3rd, 4th Quarters 2013 and 1st Quarter 2014



Source: SNAP 13 August 2014 and FAI calculations

So, we can conclude that elements of a balanced recovery are falling into place. Investment has clearly picked up. But with the net trade position consistently negative in the last three quarters and a weakening global market the prospects that external demand will serve to sustain growth appear unlikely. Hence the prospects for sustained investment spending would appear to depend on the growth of domestic demand and household spending in particular. Household spending is continuing to make a positive contribution to growth but its underling determinants remain weak, as the discussion on the UK economy above make clear.

Investment in Scotland has picked up with inward foreign direct investment playing a role. So, in the light of slowing growth, the risks of secular stagnation, the need to boost competitiveness, net trade and inward foreign investment, we do believe there is strong case that Government, and the UK Government in particular, should invest more in infrastructure in and for Scotland. The IMF in its recent *World Economic Outlook* published in October makes the following plea to Governments:

> *" …. increased public infrastructure investment raises output in both the short and long term, particularly during periods of economic slack and when investment efficiency is high. This suggests that in countries with infrastructure needs, the time is right for an infrastructure push: borrowing costs are low and demand is weak in advanced economies ….. Debt-financed projects could have large output effects without increasing the debt-to-GDP ratio, if clearly identified infrastructure needs are met through efficient investment."*

The *Outlook* shows that the estimated quality of UK infrastructure overall has been improving in recent years but still remains below that of Germany, France, Japan and Canada, of the major advanced countries. The July 2013 report from McKinsey Global Institute highlighted infrastructure investment as one of the top 5 catalysts for economic growth. It is also a major factor in the attraction of foreign investment.

The UK Government appears on the face of it to agree since at the time of writing it is unveiling plans for £15 billion of new infrastructure projects this week and to make it "easier than ever" to invest in the UK. This is to be welcomed. However, more needs to be done to improve the infrastructure of road and rail, especially, between Scotland and the UK. Raising the borrowing levels available to the Scottish Government would also help to support and encourage its own plans for infrastructure investment within Scotland.

Scottish GDP growth in the first half of this year was somewhat faster than previously forecast. However, as noted above, UK GDP growth slowed to 0.7% in the third quarter from 0.9% in the second quarter. We do not have GDP outturn data for the third quarter for Scotland. However, we do have some partial indicators and business surveys. According to the Scottish Retail Consortium retails sales in September 2014 fell sharply. The suggestion that the referendum was a key factor in the downturn seems implausible. The unseasonal warms weather affecting clothing sales seems a better structural explanation but we must not rule out the possibility that we are seeing a slowing in the growth of domestic demand for some of the reasons discussed above. The third quarter *Quarterly Business Survey* from the Scottish Chambers of Commerce conducted by the Fraser of Allander Institute confirms the impression that growth is slowing down while still remaining positive. Orders and sales grew in the quarter but at a slower pace than in the second quarter while the increase in business optimism was more muted than between April and June 2014.

It is against this background in Scotland, the UK and the global economy that we have prepared our latest forecasts.

GVA Forecasts

For our latest GVA forecasts we continue the presentational procedure adopted in previous 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.

Table 1 shows that our GDP forecast for 2014 is 2.7%, which is revised up from our forecast of 2.5% in June 2014, due to the strong growth performance exhibited in the first half of the year. For 2015, we have maintained our June forecast of 2.2%. We have revised down our forecast for 2016 to 2.1% from 2.4% in June. This reflects an anticipation of a further weakening of the recovery than already forecast due especially to continuing weakness of the Eurozone economies.

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 weaker than UK growth over the forecast period. So, we are now forecasting growth of 2.7% in 2014, 2.2% in 2015, and 2.1% in 2016. Given our previous forecast errors the lower and upper bounds for growth in 2014 are expected to be 2.4% and 3.0%, for 2015, 1.7% to 2.7%, and for 2016, 1.0% to 3.2%.

Table 1: Forecast Scottish GVA Growth, 2014-2016

GVA Growth (% per annum)	2014	2015	2016
Central forecast	**2.7**	**2.2**	**2.1**
June forecast	*2.5*	*2.2*	*2.4*
UK mean independent new forecasts (October)	3.1	2.7	n.a.
Mean Absolute Error % points	+/- 0.29	+/- 0.49	+/- 1.12

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 3.1%. Services and construction display positive growth this year at 2.5% and 2.0% 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 2.5% in 2015 and 2016, while service growth is projected to be 2.1% in 2015 and 2.0% in 2016. The construction sector continues to lag with growth of 1.3% in 2015 and 1.2% in 2016.

Employment Forecasts

Table 2 presents our forecasts for net employee jobs for the years 2013 to 2015 in terms of a central and upper and lower forecast. Note that in forecasting employee jobs we are not forecasting self-employment, which has been an important component of the recent jobs recovery.

Our forecasts for employee job creation are similar to our June forecasts, with a slight upward revision for this year and further downward adjustments for 2015 and 2016. On the central forecast, we are now forecasting that net jobs will increase by 46,560 in 2014, 41,600 in 2015 and 48,900 in 2016. This year, we now expect nearly 40,000 service sector jobs to be created, with around 2,100 added in production due to expected productivity increases given the growth in output, and somewhat stronger jobs growth of 3,600 in agriculture. Construction jobs are now forecast to rise this year by 1,600. In 2015/2016, the bulk of the jobs created are again expected to be in the service sector with an additional 32,600/38,300 jobs forecast, while 4,400/5,400 are added in production, 3,050/3,300 in agriculture and 1,550/1,900 in construction.

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

	2014	2015	2016
Upper	53,000	53,450	76,750
June forecast	*52,850*	*66,050*	*87,200*
Central	**46,560**	**41,600**	**48,900**
June forecast	*43,100*	*42,900*	*58,150*
Lower	33,400	19,900	29,900
June forecast	*33,400*	*19,900*	*29,900.*

Unemployment Forecasts

The key unemployment forecasts are summarised in Table 3 below.

Table 3: Forecasts ILO unemployment 2014-2016

	2014	2015	2016
ILO unemployment			
Rate (ILO un/TEA 16+)	**5.3%**	**5.2%**	**5.0%**
June forecast	6.4%	6.2%	5.8%.
Numbers	**127,700**	**141,019**	**135,537**

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, reflecting higher economic activity. Our projection for unemployment on the ILO measure at the end of 2014 falls to 124,700 (5.3%). In 2015, unemployment is now forecast to fall slightly to 5.2% but to increase in terms of numbers to 141,019 as the workforce increases. Falling again, to 135,537 (5.0%) by the end of 2016.

Brian Ashcroft
7 November 2014