1 Outlook and appraisal

Brian Ashcroft, Economics Editor, Fraser of Allander Institute

Overview

The Scottish and UK economies are now recovering at a reasonable rate from the greatest economic shock since the 1930s. This recovery has taken longer than from the 1930s Depression or any of the three other recessions experienced since the 1970s. The UK Coalition Government's austerity programme slowed the recovery considerably until the pace of fiscal consolidation was paused in 2012 and then slowed thereafter. Recovery picked up in 2013 as the pace of austerity slowed after the UK posted the slowest recovery from the global recession of any advanced country, with the exception of Italy and Greece. The recovery has taken hold as consumers raised their spending and investment picked up.

The jobs market and unemployment recovered more strongly than output, resulting in falling labour productivity and hence little improvement in real wages and real household incomes. The recovery in the labour market has been biased in favour of part-time employment, self-employment and temporary employment. Full-time employment still remains more than -4% below its pre-recession peak and the total numbers of hours worked is still lower in Scotland than before the recession, although that is not the case in the UK. With a growing working age population the growth in jobs has not managed to absorb the increasing labour supply and so Scotland's employment to working population ratio is more than -2% below pre-recession levels, whereas in the UK it is slightly above the pre-recession peak. The implication is that despite better headline unemployment figures in Scotland, there is still more 'slack' in the Scottish labour market than in the UK and so despite jobs growth there is little upward pressure on wages.

We ask: will the recovery continue? We identify several positive and negative influences that will impact on the pace of the recovery. We examine them under four headings: growth in markets; oil prices, inflation and deflation; UK fiscal and monetary policy; and Greece and the Eurozone.

Growth in markets

The key points here are that despite the steady growth in world trade the latest IMF and OECD forecasts suggest a slowing in key countries and Scotland's key export markets. The composition of Scottish and UK growth also continues to be unbalanced with household spending driving growth, and fixed investment making a variable contribution. There is little evidence of the attainment of the UK Government's objective of a rebalancing away from domestic spending on consumption. Consumption or household spending continues to be the principal driver of UK growth. And, as we have stressed in recent Commentaries, household spending is being fuelled by rising debt, which is almost certainly unsustainable. If the economy is to rely on continued growth in household spending it requires a sustained rise in the real wages and incomes of households. However, this is unlikely to occur unless labour productivity improves, which, as we are all now well aware, has been badly hit as a consequence of the Great Recession.

Oil prices, inflation and deflation

Inflation is falling right across the global economy. There is a clearly a risk of deflation – a sustained falling price level, leading to expectations of further price falls, postponed spending and reduced spending as the real value of household and corporate debt rises. However, while the risk is there for the UK and the US, at this stage it is more apparent than real. We are not witnessing a general deflation but a focused fall in oil prices and commodity prices, especially food. When energy and food costs are stripped out core inflation is around 1.6% in the US and close to 2% in the UK. However, the risk of deflation would appear to be greater and more general in the Eurozone prompting the European Central Bank (ECB) to begin a programme of expanding the money stock - quantitative easing or 'QE'.

The fall in oil prices has been large, around 50% at the time of writing, and the potential for a sizable boost to spending is significant with some respected analysts forecasting a 0.5% boost to UK GDP in 2015. The impact on Scottish GDP should be similar on that account. However, Scotland is also an oil producer and activity in the sector has already been hit by the significant fall in the price of oil. Yet, much of the activity in this sector takes place offshore and is assigned statistically to the UK Continental Shelf (UKCS) and not to Scotland's economy. Scottish GDP as currently officially measured and forecast by the Fraser of Allander Institute will only be affected on the production side from the oil price fall through its impact on onshore activities. Overall, we cannot draw a definitive conclusion on the impact on the wider Scottish economy of the fall in the oil price: there are both benefits and costs and the costs particularly are difficult to isolate given the present state of data on links between the UKCS and onshore. What we can say is that the growth of Scottish onshore GDP is unlikely to be seriously harmed in 2015 and in 2016. Indeed, growth might actually benefit if the income effects of a lower oil price on increased household spending, investment and net exports are large. That said, we would expect the Chancellor in his forthcoming Budget to seek to protect production and future exploration in the UKCS, for the period that low oil prices are sustained, by introducing changes to the fiscal regime.

UK fiscal and monetary policy

The base rate set by the Bank of England's Monetary Policy Committee (MPC) is likely to remain at 0.5% for the remainder of this year at least despite the strong growth and falling unemployment. It will not be changed because inflation is close to zero and may turn negative, however briefly. So monetary policy should remain accommodating to growth for the foreseeable future. The same cannot be said for fiscal policy in the UK. The Institute for Fiscal Studies in its IFS Green Budget 2015 highlights the scale of the UK government's recent and planned fiscal consolidation programme. A comparison of IMF forecasts for structural borrowing in 32 advanced economies shows that the UK has the largest planned fiscal consolidation between 2015 and 2019 and the 18th largest (or 15th smallest) planned structural deficit in 2019. A further £92 billion of fiscal tightening is planned. We estimate, that if the economy is to grow at around 2.5% per annum then the underlying growth rate in the face of such anticipated fiscal consolidation – which might change after the UK General Election in May - would need to be about 4% per annum: a big challenge for the private sector.

Greece and the Eurozone

The new Greek Government led by the Syriza party came to power with a mandate to renegotiate the terms of the 2012 bailout, which most analysts agree is imposing a severe burden on the Greek economy and society. The scale of the austerity imposed on Greece is severe with real non-debt interest government spending falling by more than 20% between 2007 and 2014. GDP has fallen by 25% since 2007 and unemployment is currently over 25%, with youth unemployment 50%! No other democratic country has endured austerity of such size and pace. If by June 2015 there is not agreement on a reduction in the pace of austerity, then there is a real risk of 'Grexit', that is a Greek exit from the Eurozone. This would have significant economic and political consequences for the Eurozone itself and for the global economy, including the Scottish economy. When the threat of Grexit was last posed in 2012, the Fraser of Allander Institute undertook a modelling exercise which estimated that a Greek exit would lower Scottish GDP by -1.2% and reduce employment by 49,000 and this is before estimating the potentially greater impact of a wider contagion of bank runs and possible further withdrawals of other peripheral countries from the Eurozone.

Notwithstanding the developments above, we are forecasting growth of 2.8% in 2014, 2.6% in 2015, and 2.4% in 2016; an upward revision to our November 2014 forecasts. These reflect our view of a strengthening of the recovery. We have also raised our forecasts for employee job creation compared to our November forecasts. On the central forecast, we are now forecasting that net jobs will increase by 53,850 in 2014, 51,350 in 2015 and 57,600 in 2016. Our unemployment forecasts have been revised down further again from November, reflecting higher economic activity. Our projection for unemployment on the ILO measure at the end of 2015 is 136,600 (5.0%), falling further to 125,250 (4.6%) by the end of 2016.

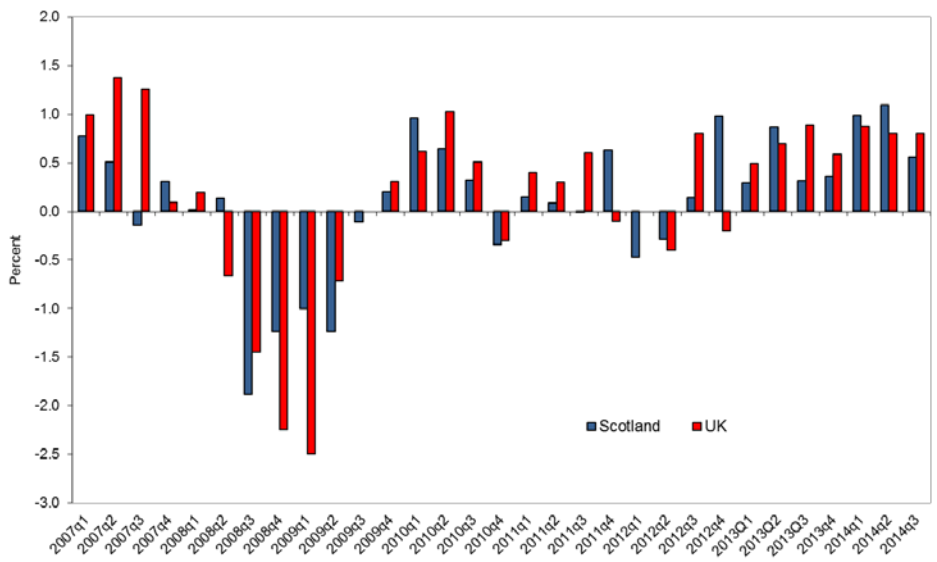
Recent GDP performance

The latest Scottish GDP data for the third quarter of last year (2014q3) show that GDP rose by 0.6% in Scotland in the quarter. This represents a reasonable growth performance but a further weakening from the 1.1% GDP growth recorded - on revised figures - in the second quarter and the 1% in the first quarter. However, it is worth noting that in 2014q3 Scotland played host to two major sporting events: the Glasgow 2014 Commonwealth Games and the 2014 Ryder Cup. Other services and accommodation & food services displayed stronger growth in the quarter, of 2.8% and 6.8% respectively, which is a likely reflection of the impact of these two major sporting events. So, while we do not have a specific figure to adjust for these events it is likely that Scotland's underlying growth would have been a little weaker in their absence.

Figure 1 charts Scottish and UK quarterly GDP growth to 2014q3. As we noted in the previous Commentary (Vol. 38, No. 2), we do not have strictly comparable GDP growth figures for Scotland and the UK for 2014q2 and 2014q3. 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). It follows that the two series - GDP for Scotland and the UK - will not be strictly comparable for the Scottish GDP releases of October 2014 and January 2015) because the

Scottish series will continue to be estimated on the old basis until the transition of the Scottish National Accounts system is complete. However, 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. It is not valid for longer-term comparisons. In the light of this, we have applied the UK aggregate and sector growth rates computed under the new system to the base indices for each sector in 2014q1, which is estimated under the old system. This allows us to continue to compare Scottish and UK performance to 2014q3 but the reader is warned that the method used is crude and may not accurately represent the actual comparative path of the two economies.

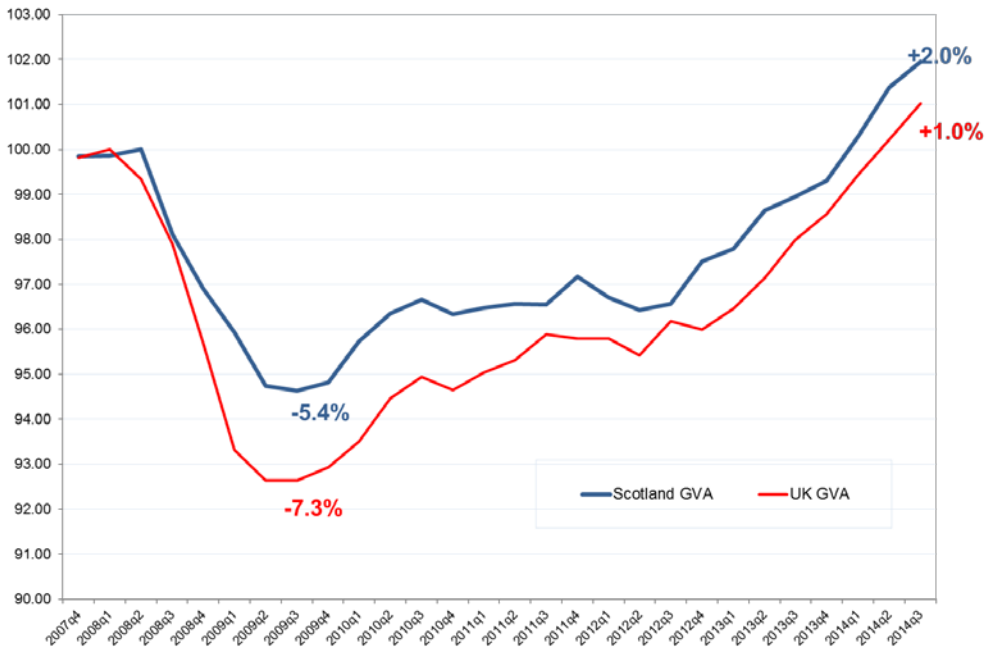
Figure 1: Scottish and UK Quarterly GDP Growth, 2007q1 - 2014q3



Source: Scottish Government GROSS DOMESTIC PRODUCT 3nd QUARTER 2014, UK GDP data sourced from http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-327798 and Fraser of Allander Institute (FAI) calculations

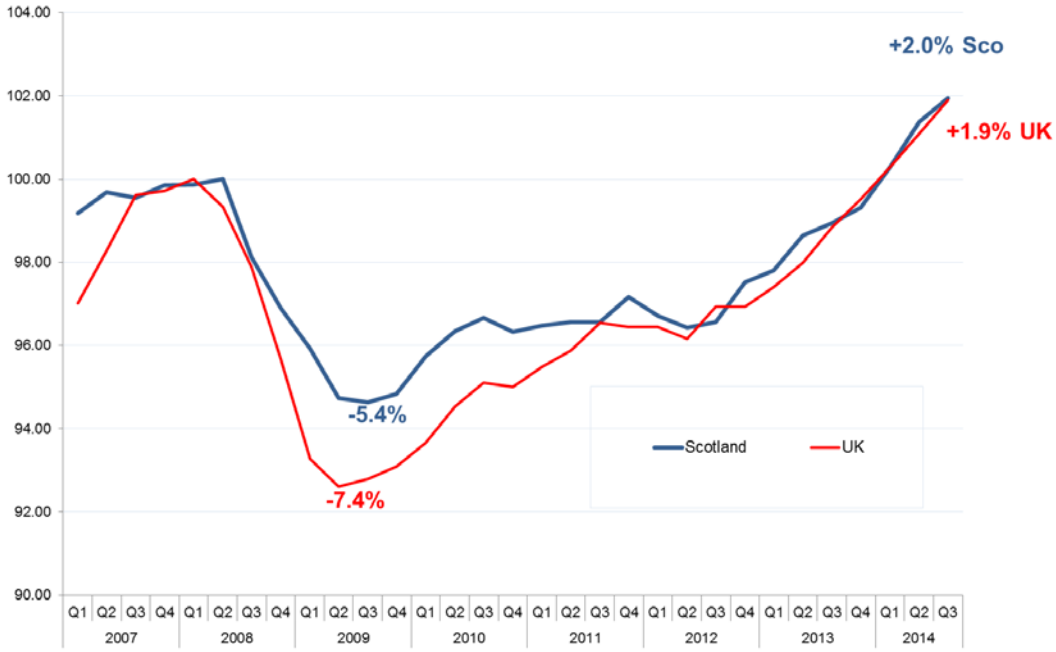
Under the new system, UK GDP rose by 0.8% in the third quarter a little faster than the 0.6% estimate for Scotland on the old basis. Over the year to the fourth quarter - four quarters on the previous four quarters - Scottish GDP grew at 2.5%, a growth rate that is above trend. We only have UK data under the new system for growth of GDP at constant market prices not the constant *basic* prices of the Scottish data but for the UK this shows growth over the year of 2.5%, identical to Scotland. These data provide a further indication that the recovery continued strongly into the third quarter of the year but with a hint of a slight easing in the momentum of growth. The effect of the latest data on Scotland and the UK's recovery from recession is shown in Figure 2.

Figure 2: GVA in recession and recovery Scotland and UK to 2014q3 (Relative to pre-recession peak)



Source: Scottish Government GROSS DOMESTIC PRODUCT 3nd QUARTER 2014, UK GDP data sourced from http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-327798 and FAI calculations

Figure 3: GVA ex oil & gas, recession and recovery to 2014q3



Source: Scottish Government GROSS DOMESTIC PRODUCT 3nd QUARTER 2014, UK GDP data sourced from http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-327798 and FAI calculations

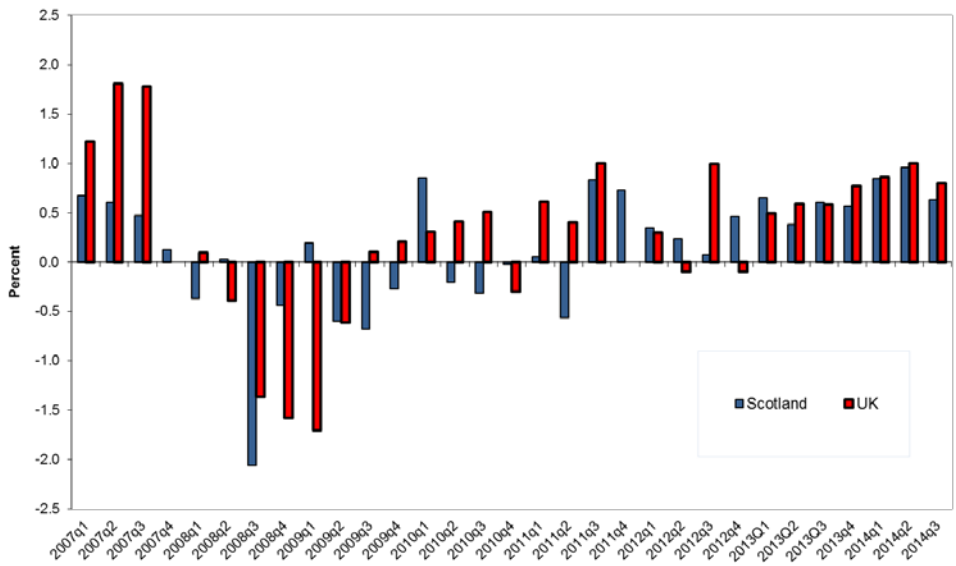
In the third quarter, GDP in Scotland was +2.0% above the pre-recession peak, while the UK was +1.0% above its pre-recession peak using the old accounts system as the base. It is likely that when the new accounts system is introduced for Scotland in the release for the fourth quarter of 2014 and compared with the UK under the new system, both GDP in Scotland and the UK will be much further above their pre-recession peaks. As noted in previous *Commentaries* there is, however, the complicating factor of oil and gas production which for offshore production is included in the UK GDP data but not in the Scottish data. Removing oil and gas production from UK GDP data gives us Figure 3.

When oil and gas production is removed, we find that both Scottish and UK GDP were about 2% above their pre-recession peaks. The long period of weak UKCS oil and gas production has slowed the recovery of UK GDP from recession. UK GDP - ex oil & gas - has had a stronger recovery from recession than Scottish GDP. Scottish GDP has recovered by around 8% since the trough of recession while UK GDP - ex oil & gas - recovered by around 10% from its trough by the previous quarter 2014q1. Again, the reader is reminded that these figures may change when the new system of accounts is introduced and a more accurate like-for-like comparison is possible within the UK.

Sectoral Components of GVA growth

Turning now to individual sectors of the economy. The Scottish service sector, which accounts for 72% of GDP in Scotland and 78% in the UK, grew by 0.6% in Scotland in the third quarter. Under the new system of accounting UK services output grew somewhat more quickly at 0.8% - see Figure 4.

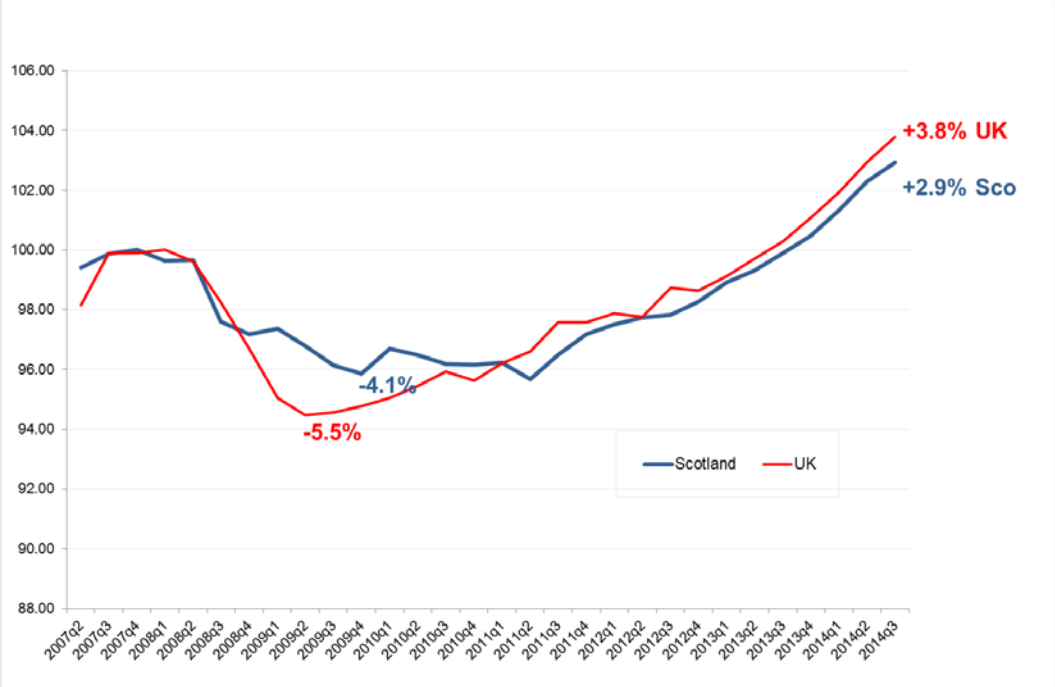
Figure 4: Scottish and UK Services GVA Growth 2007q1 to 2014q3



Source: Scottish Government GROSS DOMESTIC PRODUCT 3nd QUARTER 2014, UK GDP data sourced from http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-327798 and FAI calculations

Over the year to the third quarter - that is four quarters over the previous four quarters - the service sector in Scotland grew by 2.7% compared to 2.8% in the UK. The state of the recovery in Scottish and UK services is presented in Figure 5.

Figure 5: Services GVA in recession and recovery Scotland and UK to 2014q3



Source: Scottish Government GROSS DOMESTIC PRODUCT 3nd QUARTER 2014, UK GDP data sourced from http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-327798 and FAI calculations

Services sector

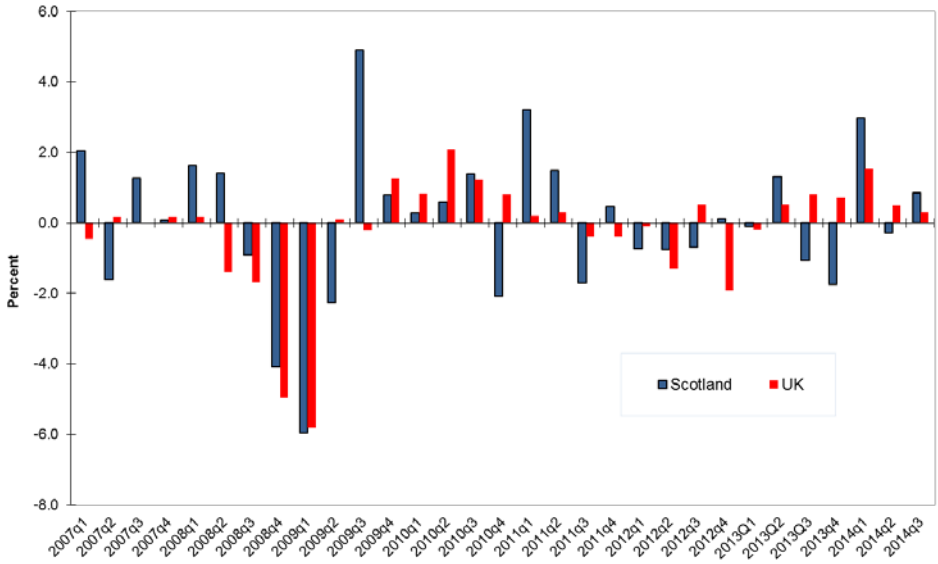
Figure 5 indicates that by the third quarter output in Scottish services stood at 2.9% above its previous peak, while output in UK services was 3.8% above. The data suggest that up to the third quarter the recovery in Scottish services continued to be weaker than in the UK with growth of just over 7% since the trough of the recession compared to just under 10% for UK services. The data for the third quarter reveals that the recovery in Scottish services is continuing to strengthen but the recovery is still slightly weaker than for GDP in the economy as a whole. In contrast, the service sector recovery in the UK still continues to outstrip, to some degree, the overall recovery in GDP but is broadly similar to UK GDP as a whole when oil and gas extraction is excluded.

Production / Manufacturing sector

The production sector in Scotland continues to boost Scottish growth, growing by nearly 11% over the recovery, while the sector remains a significant drag on the recovery in the UK with growth of 1.3% to 2014q3 since the trough of the recession. Nevertheless, Scottish production output fell in the third quarter by -0.7% while UK production output grew by 0.2%. Over the year - four quarters on four quarters – Scottish production GVA rose by 0.9%, while UK production output rose by 1.8% to the third quarter. Within production, Mining & quarrying GVA grew by 1% in the third quarter and rose by 5.8%

over the year (UK mining & quarrying changed by -1.6% and +2.3%, respectively). Electricity & gas supply GVA fell by -10% in the third quarter and also fell by -3.7% over the year (UK electricity & gas supply +2.8% and -5.2%, respectively). In the third quarter, GVA in Scottish manufacturing rose by 0.9% and by 0.3% over the year. Figure 6 charts the quarterly percentage changes in GVA in Scottish and UK manufacturing.

Figure 6: Scottish and UK Manufacturing GVA Growth at constant basic prices 2007q1 to 2014q3



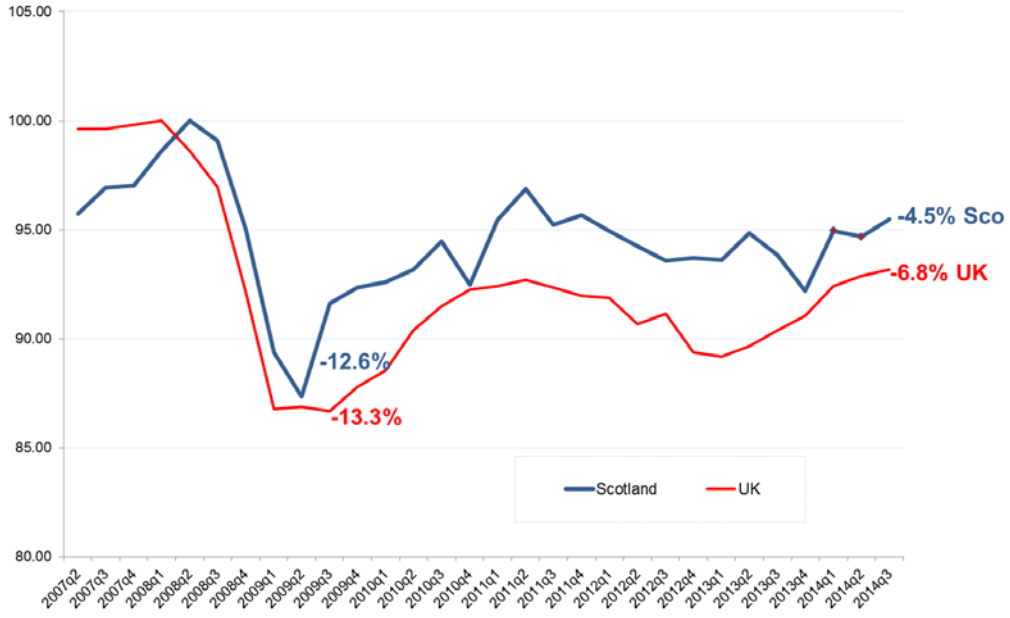
Source: Scottish Government GROSS DOMESTIC PRODUCT 3nd QUARTER 2014, UK GDP data sourced from http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-327798 and FAI calculations

By the third quarter Scottish manufacturing GVA was still -4.6% below its pre-recession peak, compared to -6.8% for manufacturing in the UK. UK manufacturing has enjoyed a more sustained recovery since the first quarter of 2013, while the recent performance of Scottish manufacturing has been more erratic, no doubt in part influenced by the shutdown and reopening of the Grangemouth refinery in the final quarter of 2013 and the first quarter of 2014.

Within manufacturing, four of the seven principal sectors experienced growth in the third quarter: metals, metal products & machinery n.e.c. (which accounts for 17% of manufacturing GVA) grew by 2.2% in the quarter and by 5.6% over the year; food & drink (accounting for 28% of manufacturing GVA) grew by 1.7% in the quarter but contracted by -2.3% over the year; other manufacturing industries, repair & installation (accounting for 20% of manufacturing GVA) grew by 1.7% in the quarter and by 2.1% over the year; and computer, electrical and optical products (electronics) (accounting for 8% of manufacturing GVA), grew by 0.9% in the quarter but contracted by -6.0% over the year.

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 2014q3



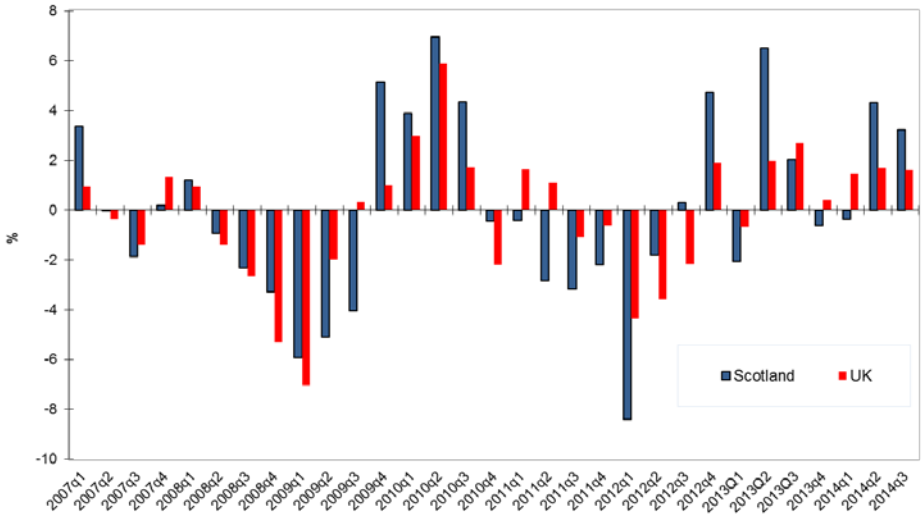
Source: Scottish Government GROSS DOMESTIC PRODUCT 3nd QUARTER 2014, UK GDP data sourced from http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-327798 and FAI calculations

The three manufacturing sub-sectors that contracted in the quarter were: refined petroleum, chemical & pharmaceutical products (accounting for 15% of manufacturing GVA) which contracted by -2.0 in the quarter and by -0.9% over the year; transport equipment (accounting for 7% of manufacturing GVA) which contracted by -1.4% in the quarter but grew by 0.6% over the year; and finally textiles, clothing & leather products (accounting for only 3% of manufacturing GVA) which suffered a slight loss of output of -0.3% in the quarter but grew by 2.0% over the year.

Construction sector

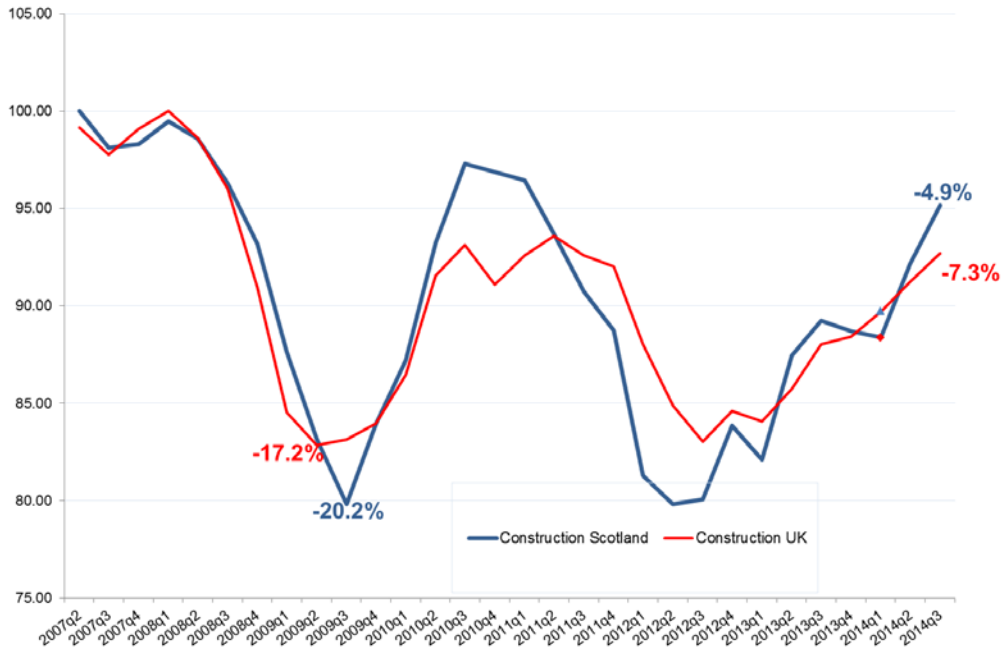
Scottish construction GVA picked up considerably in the second and third quarters of 2014 growing – on revised figures - by 4.3% in the second quarter after falling by -0.4% in the first quarter and then rising further by 3.2% in the third quarter of 2014. UK construction GVA also experienced positive but weaker growth with GVA rising by 1.7% in the second quarter and by 1.6% in the third quarter. Over the year – four quarters on four quarters - Scottish construction grew by 6.3%, almost identical to the 6.4% growth in UK construction output. Figure 9 displays the recession and recovery performance of both the Scottish and UK construction sectors. Turning now to construction, the latest data are presented in Figure 8.

Figure 8: Scottish & UK Construction GVA Volume Growth 2007q1 - 2014q3



Source: Scottish Government GROSS DOMESTIC PRODUCT 3nd QUARTER 2014, UK GDP data sourced from http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-327798 and FAI calculations

Figure 9: Construction, Recession and Recovery to 2014q3



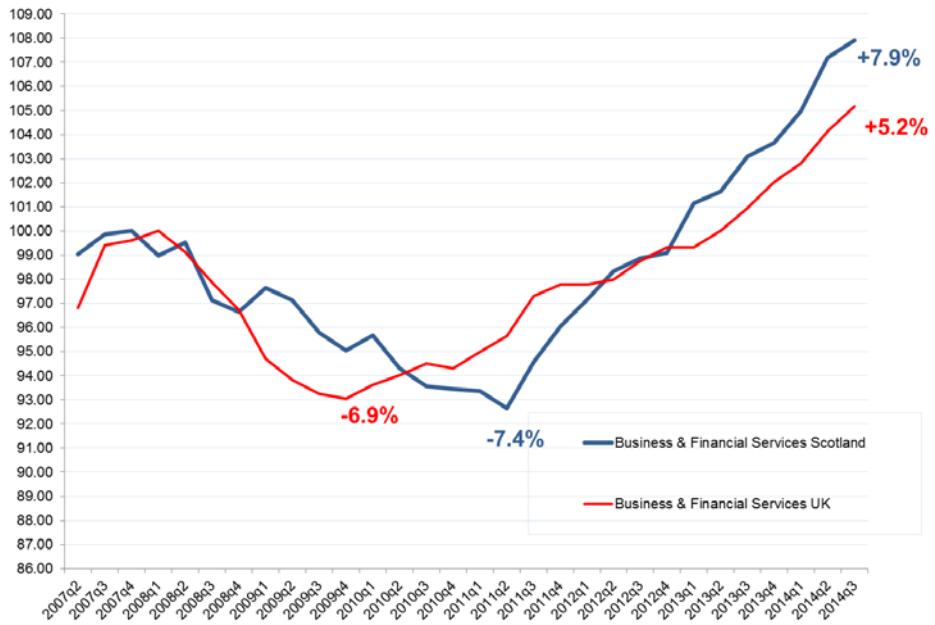
Source: Scottish Government GROSS DOMESTIC PRODUCT 3nd QUARTER 2014, UK GDP data sourced from http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-327798 and FAI calculations

Figure 9 highlights the recent recovery in Scottish construction after the downturn for two quarters in Q4 2013 and Q1 2014. By the Q3 2014 Scottish construction had moved to -4.9% below its pre-recession peak compared to UK construction, which was -7.3% below its pre-recession level.

Components of private services sector growth

Within services, two of the three principal sub-sectors in the private sector displayed positive growth in the fourth quarter. Business and financial services grew by 0.7% in the quarter and by 4.6% over the year. Figure 10 shows the growth of the sector in Scotland and UK during the recession and recovery.

Figure 10: Business & Financial Services: Recession and Recovery to 2014q3

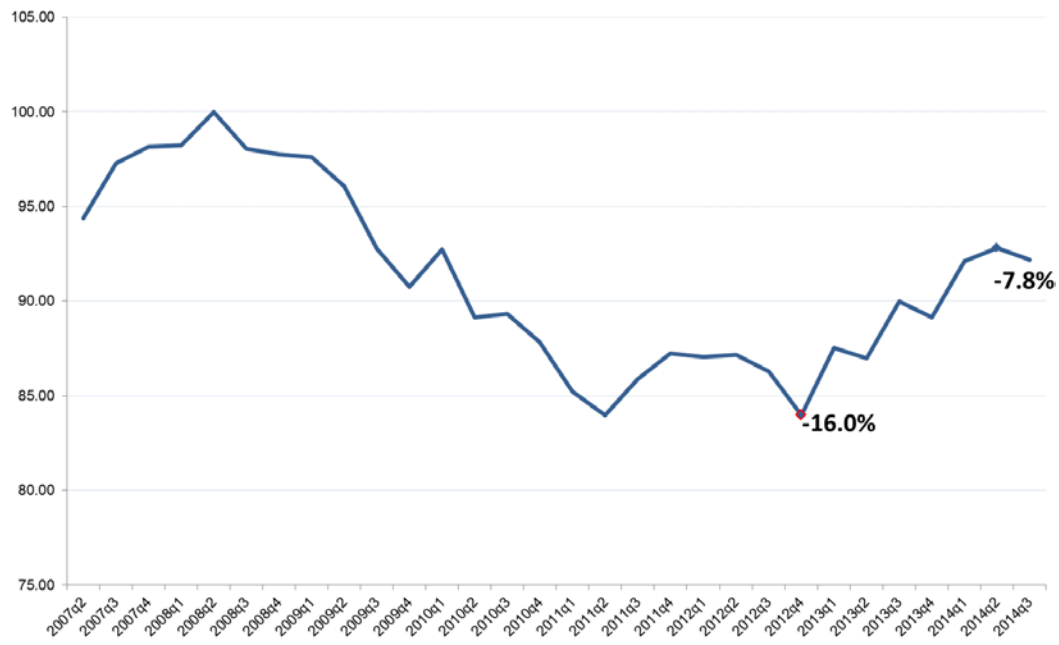


Source: Scottish Government GROSS DOMESTIC PRODUCT 3nd QUARTER 2014, UK GDP data sourced from http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-327798 and FAI calculations

By the third quarter, output or GVA in the sector had moved to +7.9% above its pre-recession peak in Scotland compared to +5.2% in the UK further underlying the stronger recovery of this sector in Scotland compared to the UK. As noted in previous Commentaries, 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.

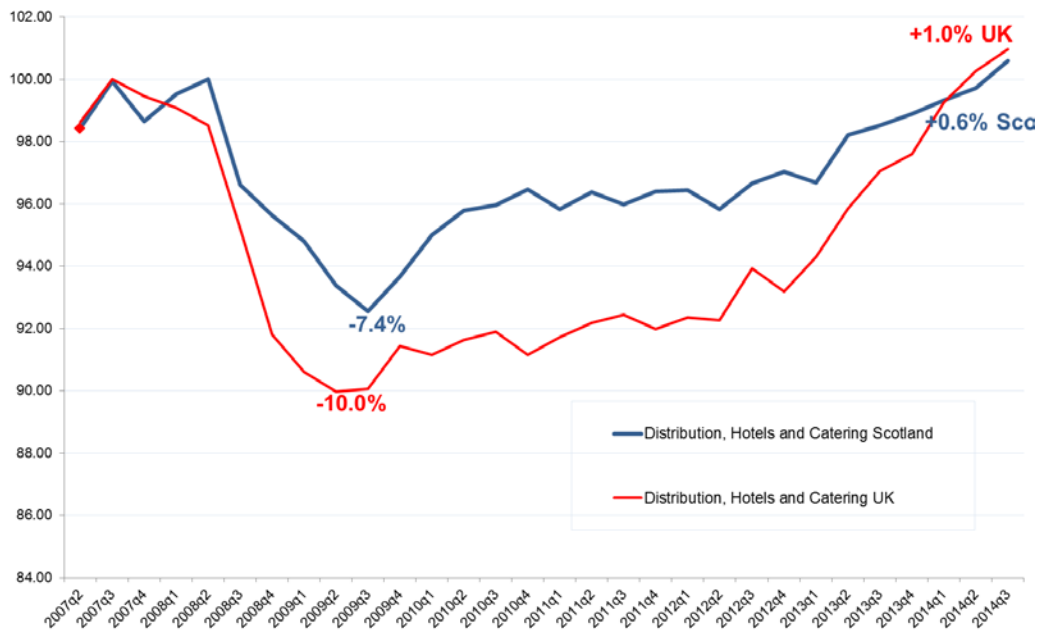
The chart shows that the recovery in the sector appears to be continuing but somewhat erratically with quarterly increases followed by smaller quarterly falls in output. By the third quarter of last year GVA in the sector was -7.8% below the pre-recession peak compared to the trough of -16.0% in 2012q4. The continuation of the recovery in financial services, all be it erratically, offers some hope that despite the structural change that occurred in the banking sector in particular after the Great Recession, output is continuing to move back closer towards pre-recession levels – see Jeremy Peat's article on Scottish financial services in the *Economic Perspectives* section of this Commentary.

Figure 11: Financial Services, Recession and Recovery 2007q2 to 2014q3



Source: Scottish Government GROSS DOMESTIC PRODUCT 3nd QUARTER 2014, UK GDP data sourced from http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-327798 and FAI calculations

Figure 12: Distribution, Hotels & Catering: Recession and Recovery to 2014q3



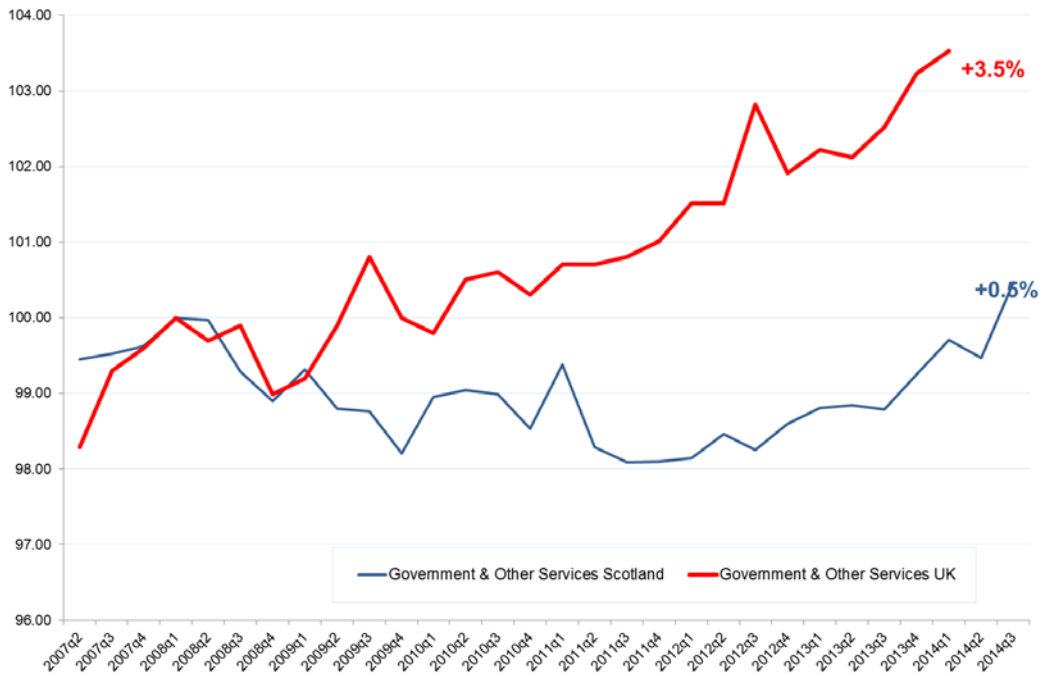
Source: Scottish Government GROSS DOMESTIC PRODUCT 3nd QUARTER 2014, UK GDP data sourced from http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-327798 and FAI calculations

The other principal sub-sector in private services displaying positive growth in the third quarter was distribution, hotels and catering (accounting for 18% of services sector output in Scotland), which grew by 0.9%. 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 by the third quarter the sector in the UK was +1% above its peak, while the sector in Scotland was doing a little worse at just +0.6% above. It should again 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 -10.0% in the UK. The track of the recovery in the sector picked up strongly during 2013 and 2014 in both Scotland and the UK, but more strongly in the UK.

Output in Government & Other Services rose in Scotland in the third quarter by 1%. Over the year, output in the sector also grew by 1%, In the UK the public sector grew by 0.3% in the quarter and by 1.1% over the year. Figure 13 shows the performance of GVA in the sector in recession and recovery.

Figure 13: Government & Other Services: Recession and Recovery to 2014q3

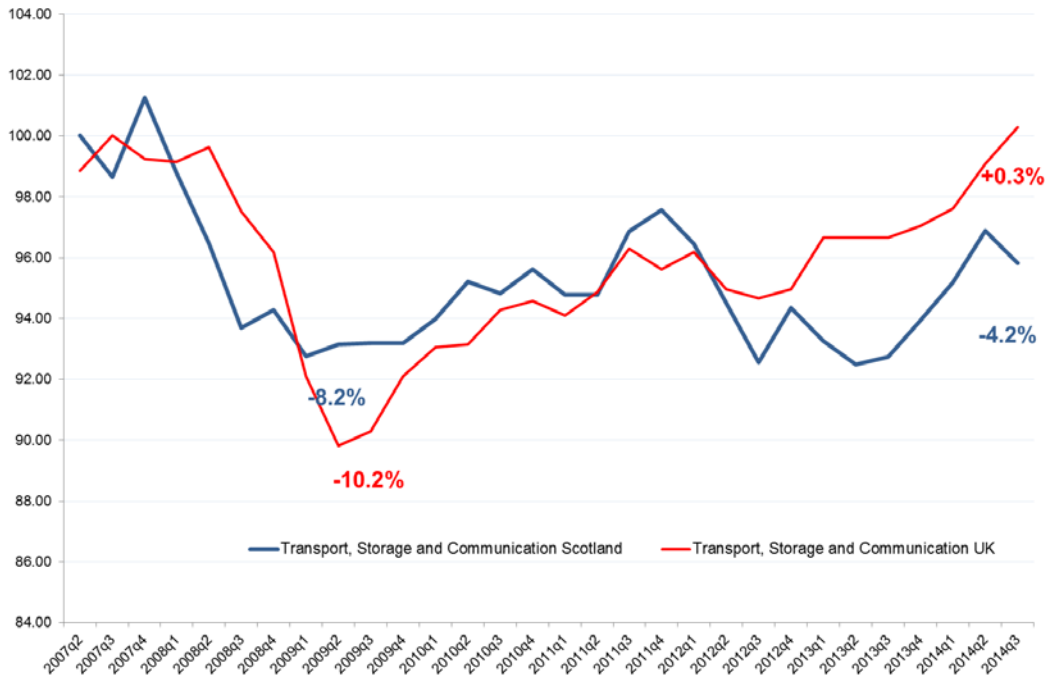


Source: Scottish Government GROSS DOMESTIC PRODUCT 3nd QUARTER 2014, UK GDP data sourced from http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-327798 and FAI calculations

By the third quarter GVA in the sector in the UK was 3.5% above the pre-recession peak, which as we have noted in many earlier *Commentaries* is difficult to understand at a time of fiscal consolidation, whereas output in the sector in Scotland was only 0.5% above its pre-recession 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 10% of service sector output.

Figure 14: Transport, Storage & Communication: Recession & Recovery to 2014q3



Source: Scottish Government GROSS DOMESTIC PRODUCT 3nd QUARTER 2014, UK GDP data sourced from http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-327798 and FAI calculations

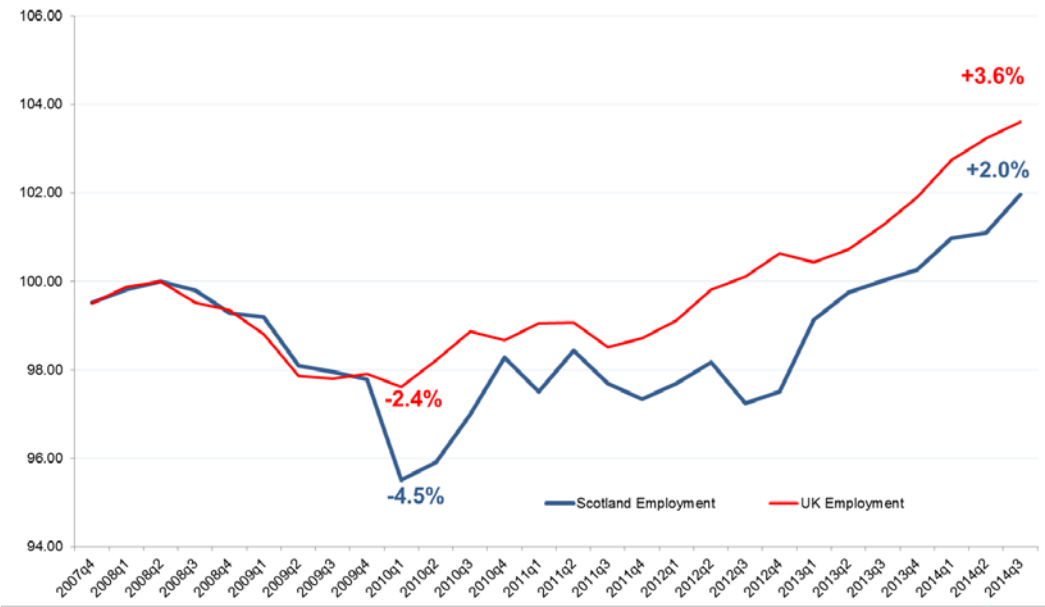
The pick-up in the performance of the sector in Scotland ceased in the third quarter with GVA falling by -1.1%. Over the year, the sector grew by 2.4% in Scotland and by 1.9% in the UK. By the end of the third quarter GVA in the Scottish sector was -4.2% below its pre-recession peak compared to +0.3% above in the UK.

The Labour Market

The latest labour market data (see *Scottish Labour Market* section below) show that the recovery continues strongly. In the quarter October – December 2014, employment rose by 0.8% in Scotland and by 0.3% in the UK. In terms of numbers, jobs in Scotland rose by 20,160 in the quarter, compared to an increase of 103,440 in the UK as a whole. Over the year, Scottish jobs rose by 63,000, a rise of 2.5%, while UK jobs rose 608,000, or 2.0%. As employment continued to rise during the quarter, unemployment in Scotland fell, by -15,000, or -9.3%, to 149,000, or a rate of 5.4%, while in the UK, unemployment fell less rapidly by -97,000, or -5.0%, to a rate of 5.7%. Over the year, unemployment in Scotland fell strongly by -48,000, or -24.4%, while in the UK unemployment also fell strongly but a little more slowly by -486,000, or -20.7%.

Figure 15 shows the performance employment in Scotland and the UK during recession and recovery to 2014q3.

Fig 15: Total Employment: Scotland and UK Pre-recession peak to 2014q3



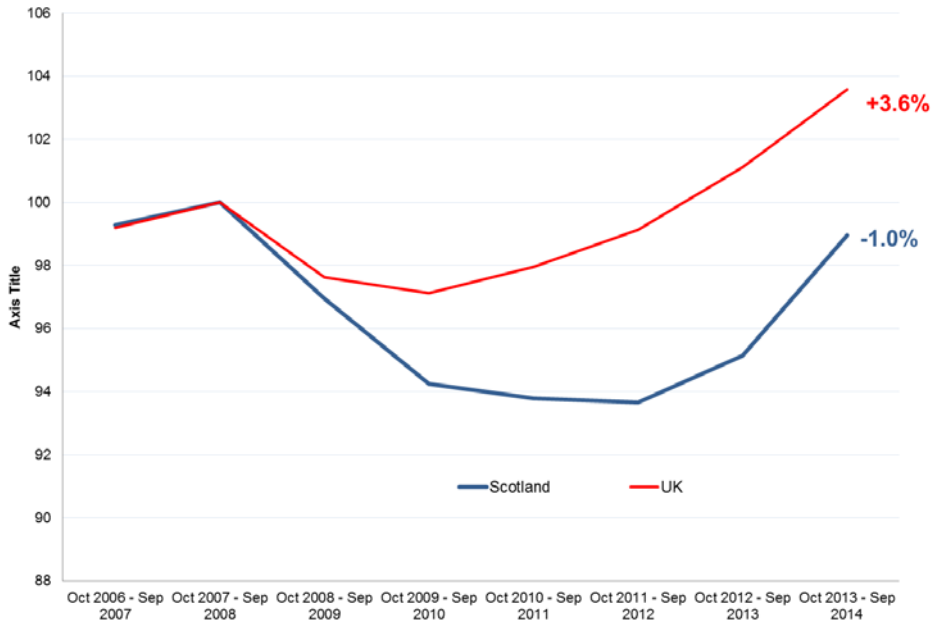
Source, ONS Regional Labour Statistics and FAI calculations

By the end of the third quarter, Scottish jobs as reported in the LFS household surveys were 2.0% *above* the pre-recession peak, while UK jobs were 3.6% higher than the peak. So, despite the good recent performance of the labour market in Scotland, its overall performance in the recovery continues to lag that of the UK and as we note below, there appears to be more 'slack' in the labour market in Scotland compared with the UK.

An indication that there is still a deficiency of demand in the Scottish labour market in relation to the situation before the recession is provided by data on the number of weekly hours worked. Figure 16 charts this statistic from 2007 for the total weekly hours worked compared to the pre-recession peak for Scotland and the UK.

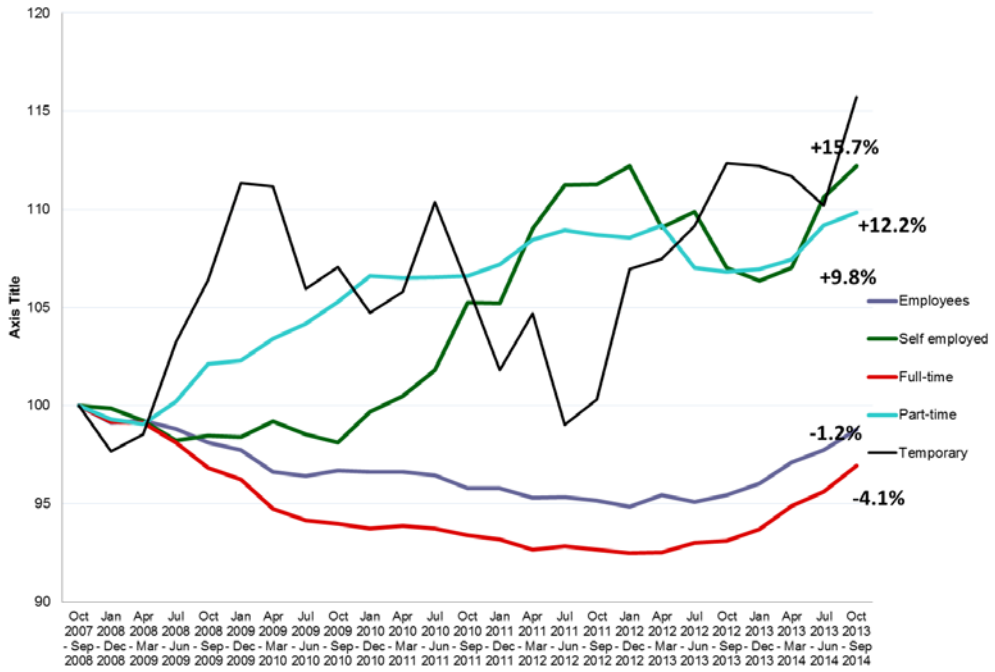
By the period October 2013 – September 2014, the number of total weekly hours worked in Scotland was still -1.0% below the pre-recession peak. So despite the number of jobs being higher than before the recession, the demand for labour as measured by hours worked is still lower. This is also a reflection, as the *Scottish Labour Market* section below notes, of the recovery in the labour market continuing to be driven by a shift - since the recession - away from full-time, permanent, employees towards part-time, temporary, and self-employment, as Figure 17 shows.

Figure 16 LFS Total weekly hours worked: Scotland-UK in recession & recovery (Compared to Pre-recession peak)



Source, ONS Regional Labour Statistics and FAI calculations

Figure 17 Scotland's Recession and Recovery by Type of Employment

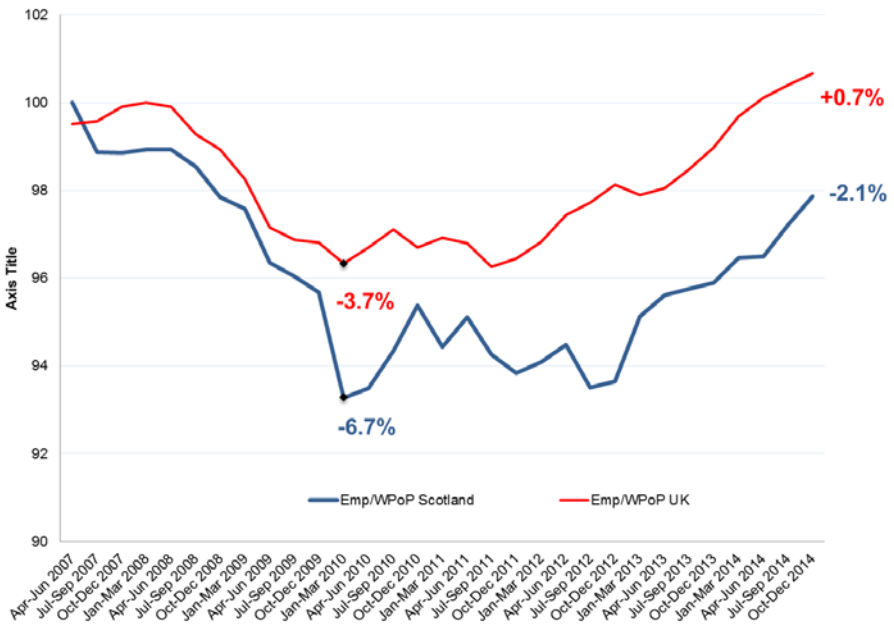


Source, ONS Regional Labour Statistics and FAI calculations

By the middle of last year total employment in Scotland was back to its pre-recession peak, yet the above labour market shifts appear to be continuing. However, this is not the whole picture as it is also clear that full-time employment is recovering. But we cannot be certain whether the labour market will automatically move back to its pre-recession state. The growth in temporary and self-employment is large in percentage terms but small in absolute numbers: an increase of 19,000 and 33,000 respectively since the start of the recession. While some might argue that the growth in self-employment is an indication of greater entrepreneurship in Scotland, this has still to be proved. Many of these self-employed jobs appear likely to be more 'needs must' for people who have lost full-time jobs. The growth of temporary jobs suggest that high levels of uncertainty exists amongst employers but it may also be something of a reflection of a developing 'zero hours' culture.

Finally, as we noted in the previous Commentary, not only is the demand for labour still lower than pre-recession but demand – as measured in terms of jobs – is still considerably deficient when compared to the supply of labour. Figure 18 charts the employment to population (aged 16 and over) ratio relative to pre-recession peak for Scotland and the UK to October - December 2014.

Figure 18 Employment to population (16 & over) Scotland-UK in recession & recovery (Compared to Pre-recession peak)



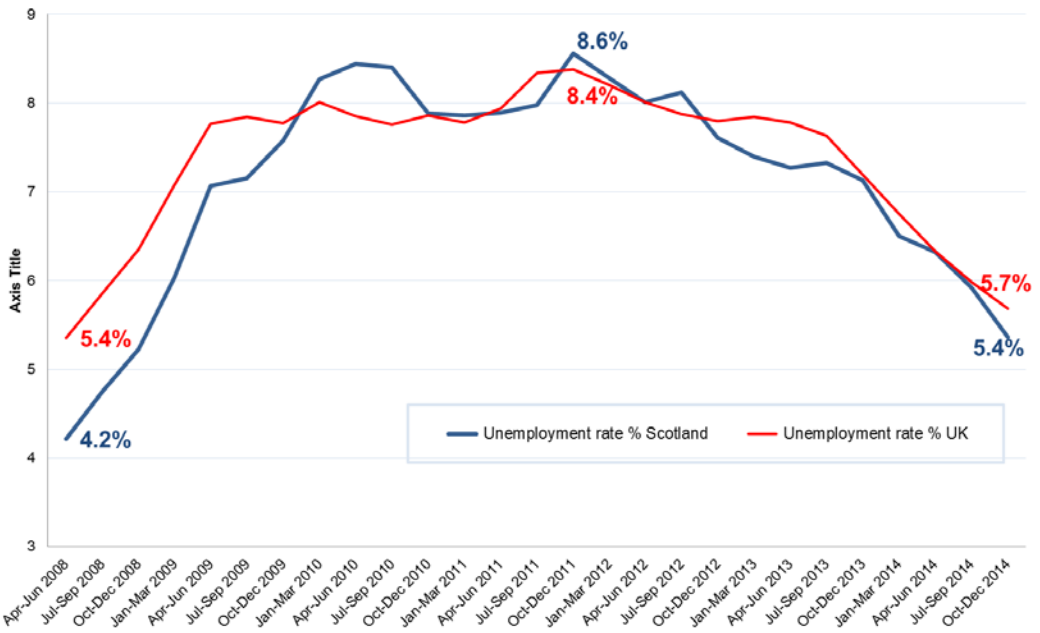
Source, ONS Regional Labour Statistics and FAI calculations

By October - December 2014, the ratio stood at -2.1% below the pre-recession peak, compared to -6.7% at the trough of the recession. In the UK as a whole, in contrast the ratio is only 0.7% above its pre-recession peak. All of this suggests that while the jobs market has recovered substantially, the recovery has been weaker in Scotland both in relation to the situation before the recession and in relation to the growth of labour supply. In the UK, in contrast, a strong jobs recovery is evident compared to the situation before the recession and the recovery has just managed to keep pace with the growth of the

labour supply. We might venture to suggest from the data in Figure 17 that sustained pressures on wages to rise should be starting to occur in the UK, but not so in Scotland.

The conclusion that there is still spare capacity in the Scottish labour market is also echoed in the unemployment rate data as shown in Figure 19.

Figure 19: LFS Unemployment rate % in Scotland and UK: Recession and Recovery



Source, ONS Regional Labour Statistics and FAI calculations

While the unemployment rate is currently lower in Scotland, at 5.4% compared to 5.7% in the UK, the UK rate is approaching its pre-recession rate of 5.4%, whereas there is still some 1.2% points to go before that situation is reached in Scotland.

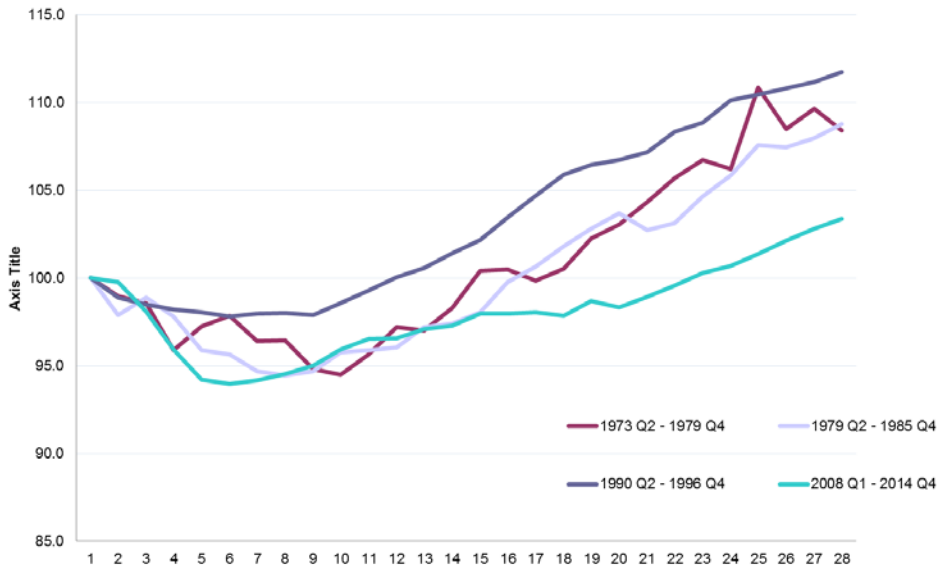
Forecasts

Will the recovery continue?

There are now reasonably strong indications that the recovery of GDP, jobs and unemployment in Scotland and the UK is set fair. However, we must be cautious: the latest data for UK GDP growth in the fourth quarter of last year indicates growth of 0.5% which represents a clear slowing of the growth momentum evident in the first three quarters of 2014. We noted above that in the third quarter Scottish GDP growth was weaker than in the first two quarters and this cooling of the recovery is likely to have continued into the fourth quarter if the latest UK data can be taken as a guide. Moreover, data from the latest business surveys for the fourth quarter and into 2015 – see *Review of Scottish Business Surveys* section - in Scotland support the impression of some slowing in the rate of recovery but expectations for 2015, while cautious, remain fairly robust.

Alongside the latest UK GDP figures the ONS has published data comparing the present recovery with those from earlier UK recessions. These data are graphed in Figure 20.

Figure 20: GDP quarter-on-quarter growth from peak for previous and latest UK economic downturns (Chained volume measure, seasonally adjusted)

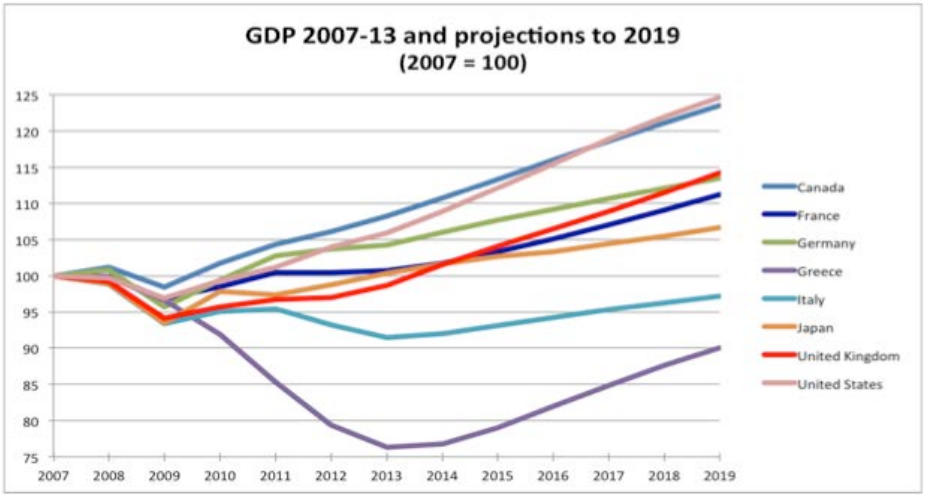


Source, ONS http://www.ons.gov.uk/ons/dcp171778_394742.pdf

Figure 20 clearly shows the scale of the recent UK recession to have been greater than the three previous recessions. The Figure also shows that the pace of recovery from the recession began to slow after 10 quarters (2010q3) and only began to pick up after 20 quarters (2013q1), with the result that the pre-recession peak level of GDP was only reached after 22 quarters compared to 11, 15 and 16 quarters in the previous three recessions shown in Figure 20. We have argued in previous Commentaries that this was a direct result of the UK Government's austerity programme. One corollary of this is that the UK recovery from this global recession was slower than most of the advanced countries with the exception of Italy and Greece. This is clearly shown in Figure 21, which draws on data from the IMF and includes projections to 2019.

The IMF projections show the level of UK GDP in relation to peak beginning to pass several of the other countries so that by 2019 only Canada and the United States are ahead of the UK. However, to get to that position in 2019 the IMF has, it would appear, simply extrapolated recent growth rates. Whether such an outturn will occur depends crucially on the factors influencing UK and Scottish growth both positively and negatively. We list these positive and negative influences and then deal with some of them in more detail below.

Figure 21 GDP 2007-2013 and projections to 2019



Source: IMF World Economic Outlook

Positive influences:

- Currently strong and above trend growth in Scotland and UK
- Growth in the US is strong and improving.
- Inflation is falling, helped by a sharp fall in the price of oil and some other commodity prices, with the fall in the oil price being key.

Negative influences:

- Growth is unbalanced both domestically and across the globe, raising the risk that the recovery might falter.
- The fall in the price of oil will have a negative impact on the Scottish economy as an oil producer as well as a favourable impact
- Further planned austerity will, if implemented, act to slow growth unless the private sector grows more quickly to compensate.
- The continuing problems in the Eurozone, with the risks of deflation and a Greek exit (Grexit).
- A small downside risk of deflation of prices in the UK economy.

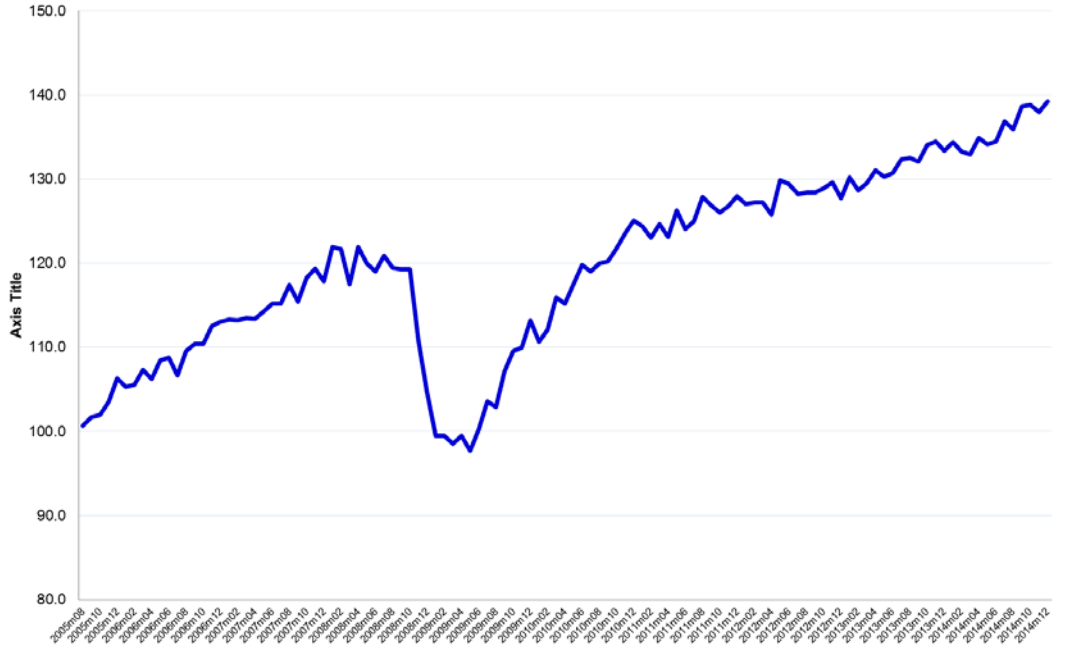
We discuss these positive and negative influences under 4 headings:

- growth in markets;
- oil prices, inflation and deflation;
- UK fiscal and monetary policy
- Greece and the Eurozone

Growth in markets

Independent forecasts for the growth of UK GDP in 2015 suggest a range of between 2.1% to 3% and an average of 2.6%. For 2016, growth is predicted to slow to a range of 1.2% to 3% with an average of 2.3%. For the global economy, the monthly *World Trade Monitor* produced by the Netherlands Bureau for Economic Policy Analysis (CPB) shows in Figure 22 that world trade has been growing at a steady but fairly slow pace since late 2009 when it began to recover from the slump caused by the Great Recession.

Figure 22: Merchandise world trade 2005 - 2014, (Monthly volumes, seasonally adjusted, 2005=100)

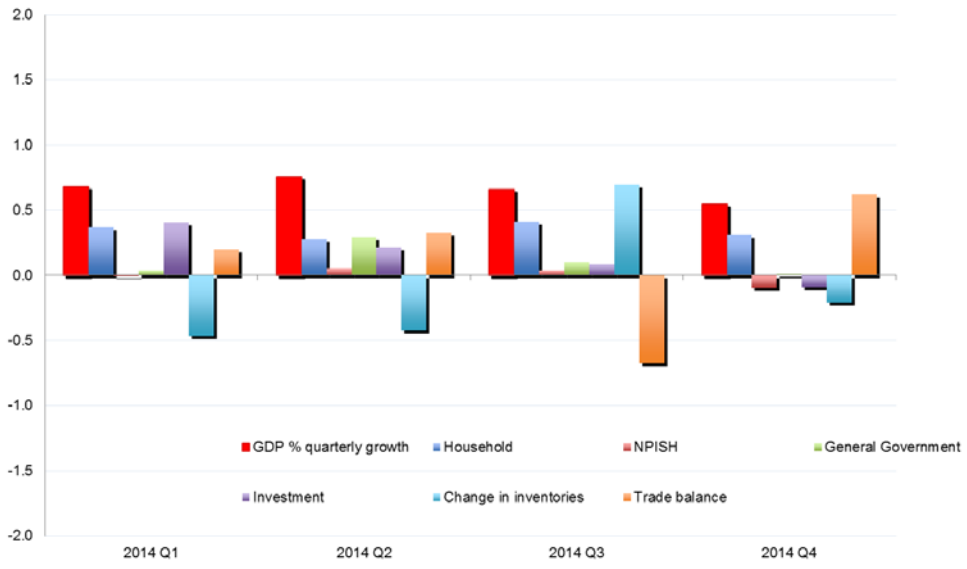


Source: CPB, World Trade Monitor

However, the latest forecasts by the IMF and the OECD – see *Forecasts of the Scottish Economy* section – suggest a slowing in the growth of GDP in key countries and Scotland's key export markets. In the IMF's January forecast only the forecast for the growth of US GDP was raised. The forecasts for China, Japan and the Eurozone were cut back. The composition of Scottish and UK growth also continues to be unbalanced. Figure 1 in the *Forecasts of the Scottish Economy* section highlights the dominating importance of household spending to nominal GDP growth in Scotland, with fixed investment being the next most important but with a contribution only around half as much. Moreover, the contribution from investment was negative in the third quarter of last year, while net trade has made a

consistently negative contribution to growth apart from the odd quarter. The position at the UK level is similar as Figure 23 indicates.

Figure 23: Expenditure components percent contribution to UK GDP growth, quarter-on- quarter (Chained volume measure, seasonally adjusted)



Source, ONS http://www.ons.gov.uk/ons/dcp171778_394742.pdf

Net trade makes a stronger contribution at the UK level and investment a lesser contribution. Moreover, the contribution of investment to real GDP growth declined during 2014. So, from these data there is little evidence of a rebalancing away from domestic spending on consumption and, consumption or household spending continues to be the principal driver of growth. And, as we have stressed in recent Commentaries household spending is being fuelled by rising debt, which is almost certainly unsustainable. If the economy is to rely on continued growth in household spending it requires a sustained rise in the real wages and incomes of households. However, this is unlikely to occur sustainably unless labour productivity improves, which as we are all now well aware has been badly hit as a consequence of the Great recession.

Oil prices, inflation and deflation

Inflation is falling right across the global economy. Indeed, the latest data show prices actually to be falling both the US and the Eurozone and, as the *Forecasts of the Scottish Economy* section notes, the Governor of the Bank of England, Mark Carney, has recently suggested that UK inflation might soon turn negative but only for a brief period. There is a clearly a risk of deflation – a sustained falling price level, leading to expectations of further price falls, postponed spending and reduced spending as the real value of household and corporate debt rises. However, while the risk is there for the UK and the US, at this stage it is more apparent than real. We are not witnessing a general deflation but a focused fall in oil prices and commodity prices, especially food. When energy and food costs are stripped out *core* inflation is around 1.6% in the US and close to 2% in the UK. However, the risk of deflation would

appear to be greater and more general in the Eurozone prompting the ECB to begin a programme of expanding the money stock – via quantitative easing or QE.

Box 1 Estimates of the impact of fall in oil price on GDP and jobs, Scotland and UK

1. The income effect

- The fall in the price of oil will raise disposable incomes; lower production costs and lead to increased spending on UK and Scottish produced goods and services, thus raising GDP.
- Oxford Economics estimate that UK GDP will rise by a further 0.5% as a result of the price fall – see *IFS Green Budget 2015*[1].
- If we assume that a) the % GDP change from the income effect is same in Scotland as UK; b) employment rises in the same proportion, or c) that the impact on jobs stands in the ratio of OE's estimate of overall 2015 jobs growth to GDP growth: 1.3%/2.8% = 0.46. Then to get percent jobs change: 0.46 x 0.5 = 0.23% jobs growth impact of oil price fall.
- Given UK employment of 30,896,000 this gives a range of 154,000 to 71,000.
- Given Scottish employment 2,625,000 this gives a range of 13,000 to 6,000.

2. The oil industry effect

- This will be negative.
- The impact in Scotland would have to be greater than 13,000 to 6,000 jobs in 2015 for the effect on the Scottish economy to be negative.
- Unlikely that the impact on UK would be greater than 154,000 to 71,000, so can say oil price impact on UK will be positive.
- 1,435 job losses announced in the sector could mean – with multiplier[1] of 7.5 from Oil and Gas UK (2014) - the loss of more than 10,000 jobs across the UK as a whole, taking account of direct and indirect effects.
- For Scotland, we have a Type II multiplier for oil and gas extraction from the 2011 Scottish I-O tables[1] of 2.3, which would give a job loss of 3,300 jobs.
- If in 2015 the job losses doubled to 2,870 the total negative effect on Scottish economy jobs would be 6,600.
- These job losses are unlikely to occur completely in 2015, while job gains, in contrast, are estimated to occur in 2015.

3. Conclusion

- The (crudely) estimated net impact of the fall in the price of oil in 2015 on the Scottish economy ranges, *in employment terms,* from *plus 9,700 jobs to minus 600 jobs in the best and worst case scenarios.*

[1] *Oxford Economics assume an oil price of $55/barrel in 2015 and $67/barrel in 2016; on 28th February 2015 the price was $62.58/barrel*
[1] *The employment multiplier is the ratio of direct plus indirect (plus induced if Type II multipliers are used) employment changes to the direct employment change.*
[1] *http://www.gov.scot/Topics/Statistics/Browse/Economy/Input-Output/Downloads/IO1998-2011L2*

Falling food, and especially oil, prices will raise the real disposable income of energy and food users, almost everyone! Rising real incomes will promote increased spending and hence provide a boost to growth. Moreover, the fall in oil prices has been large, around 50% at the time of writing, and since household spending on energy and transport is around 4% of income, the potential for a sizable boost to spending is significant. In addition, companies input costs will also be lower as fuel is cheaper. Oxford Economics' model-based analysis for the *IFS Green Budget 2015* suggests that UK GDP will rise by a further 0.5% in 2015 at an assumed oil price of $55 a barrel. They assume that oil prices will average $67 in 2016, so the impact on GDP growth would be a little less.

Scottish household spending and company input costs will get much the same boost as the UK and so, other things equal, GDP should also rise by an additional 0.5% in 2015 as a result of the fall in the oil price. However, for Scotland, other things are not equal. Scotland is an oil producer and activity in the sector has already been hit by the significant fall in the price of oil. Yet, much of the activity in this sector takes place offshore and is assigned statistically to the UK Continental Shelf (UKCS). Scottish GDP as currently officially measured and forecast by this Institute will only be affected on the production side from the oil price fall through its impact on onshore activities. As Grant Allan makes clear in his note on: *The price of oil and the Scottish economy*, the economic links – supply chain, foreign import content, employees resident in Scotland and spending from value added - from the UKCS to the onshore Scottish economy need to be more researched and better understood. Furthermore, it is difficult to establish with certainty what the direct effects on the UKCS will be over the forecast horizon to 2016 because that will depend on producers' expectations of the price of oil in the future.

So, we cannot make a definitive conclusion on the impact on the wider Scottish economy of the fall in the oil price: there are both benefits and costs and the costs particularly are difficult to isolate given present data. What we can say is that the growth of Scottish onshore GDP is unlikely to be seriously harmed in 2015 in 2016 and may actually benefit if the income effects of household spending, investment and net exports are large. That said, we would expect the Chancellor in his forthcoming Budget to seek to protect production and future exploration in the UKCS for the period that low oil prices are sustained by introducing changes to the fiscal regime.

UK fiscal and monetary policy

The base rate set by the Bank of England's Monetary Policy Committee (MPC) is likely to remain at 0.5% for the remainder of this year at least despite strong growth and falling unemployment. It will not be changed because inflation is close to zero and may turn negative, however briefly. Indeed, if inflation turns negative and price falls begin to affect core inflation then the rate could be cut to zero, or a negative value following the Swedish and Swiss examples. In such circumstances further QE is also possible. So monetary policy should remain accommodating to growth for the foreseeable future. The same cannot be said for fiscal policy in the UK. The Institute for Fiscal Studies in their *IFS Green Budget 2015* highlight the scale of the UK government's recent and planned fiscal consolidation programme. The IFS analysis shows that by 2014 £110bn of fiscal tightening measures had been implemented. A further £92bn of fiscal tightening is currently planned. So, on this measure 55% of planned fiscal consolidation has been completed with 45% still to come. Of the further planned fiscal tightening, a comparison of IMF forecasts for structural borrowing in 32 advanced economies shows that the UK has the largest planned fiscal consolidation between 2015 and 2019 and the 18th largest (or 15th smallest) planned structural deficit in 2019. Some £200 billion of fiscal tightening is nearly 13% of GDP. If we assume a multiplier of 1.5 – not unreasonable when interest rates are close to zero and there is no scope for countervailing monetary policy - the policy would have served to have reduced GDP by 10% up to 2014 and by a further 9% by 2019. This doesn't mean that GDP will fall by 9% between now and 2019 but does imply that private sector output must rise by a substantial amount if GDP growth is to remain in positive territory. Specifically, if the economy is to grow at around 2.5% per annum then the underlying growth rate of the private sector in the face of such anticipated fiscal consolidation would need to be of the order of 4% per annum: a big challenge for the private sector. The outcome will also be

dependent on the result of the General Election in May 2105 because the Labour and Liberal Democrat parties are planning a slower pace of fiscal consolidation and a Conservative or indeed an unspecified Coalition government might alter the scale and pace of current plans or bias any consolidation more towards tax rises than via spending cuts, which could have a different impact on growth.

Greece and the Eurozone

The new Greek Government led by the Syriza party came to power with a mandate to renegotiate the terms of the 2012 bailout, which most analysts agree is posing a severe burden on the Greek economy and society. The scale of the austerity imposed on Greece is severe with real non-debt interest government spending having fallen by more than 20% between 2007 and 2014. GDP has fallen by 25%, since 2007, unemployment is currently over 25% and youth unemployment 50%! No other democratic country has endured austerity of that size and at such a pace. The Syriza government wants the pace of austerity to be relaxed so that they do not have to deliver a primary surplus as high as 4.5% required by the Troika (IMF, EC, ECB) – after debt interest payments – which they rightly contend will twist the screw of austerity to impossible levels. A slower pace of austerity and a smaller required primary surplus would allow the Greek Government to boost growth in the economy through increased spending on reform measures and infrastructure investment.

Despite the recent agreement for the bailout to continue while Greece firms up its programme of internal reforms, the issue of a relaxation in the scale and pace of austerity has effectively been postponed from consideration until June 2015. If there is no agreement on this issue then there is a real risk of Grexit, that is a Greek exit from the Eurozone. This would have difficult to predict consequences for the Eurozone itself and the global economy, including the Scottish economy. When the threat of Grexit was last posed in 2012, the Fraser of Allander Institute undertook a modelling exercise which estimated that a Greek exit would lower Scottish GDP by -1.2% and reduce employment by 49,000 and such an estimate ignores the potentially greater impact of wider contagion of bank runs and further possible exits of other peripheral euro countries.

GVA Forecasts

Table 1: Forecast Scottish GVA Growth, 2014-2016

GVA Growth (% per annum)	2014	2015	2016
Central forecast	**2.8**	**2.6**	**2.4**
November forecast	*2.7*	*2.2*	*2.1*
UK mean independent new forecasts (February)	2.6	2.6	2.3
Mean Absolute Error % points	+/- 0.18	+/- 0.52	+/- 1.12

Source: Fraser of Allander Institute 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 2.8%, which is revised up from our forecast of 2.7% in November 2014. (Official outturn data for 2014 will not be available until mid-April this year.) The upward revision is again due to the strong growth performance exhibited in the first half of the year. For 2015, we have raised our forecast to 2.6% from 2.2% in November, which is largely the result of evidence signalled in business surveys, for example, that investment in 2015 is picking up faster than anticipated last November. This is more than sufficient to offset any negative effects on the oil production and services, or more generally the supply-side, from the lower price of oil. We have also revised up our forecast for 2016 from 2.1% back to our June 2014 prediction of 2.4%. This reflects *inter alia* some of the demand-side benefits of a lower price of oil helping to boost exports and domestic consumption.

Table 1, also compares our GVA forecasts with the median of latest independent forecasts for the UK as published by the UK Treasury in February 2015. These show that we now expect Scottish growth to be broadly similar to UK growth over the forecast period. So, we are now forecasting growth of 2.8% in 2014, 2.6% in 2015, and 2.4% in 2016. Given our previous forecast errors the lower and upper bounds for growth in 2014 are expected to be 2.6% and 3.0%, for 2015, 2.1% to 3.1%, and for 2016, 1.3% to 3.5%.

Production and manufacturing continue to be the major sectors exhibiting the fastest growth in 2014, 2015 and 2016. Last year production is projected to have grown by 3.4%, with services and construction displaying positive growth of 2.7% and 2.2%, respectively. This relative performance continues in both 2015 and 2016 even though forecast growth diminishes across all sectors in 2015 and 2016. Production grows by 2.9% and 2.8% in 2015 and 2016, while service growth is projected to be 2.5% in 2015 and 2.3% in 2016. The construction sector continues to lag with growth of 1.5% in 2015 and 1.4% in 2016.

Employment Forecasts

Table 2 presents our forecasts for net employee jobs for the years 2014 to 2016 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. Moreover, employee jobs can differ from the self-reported employment in the monthly Labour Force Survey.

Our forecasts for employee job creation have been raised compared to our November forecasts. On the central forecast, we are now forecasting that net jobs will increase by 53,850 in 2014, 51,350 in 2015 and 57,600 in 2016. This year, 2015, we expect nearly 40,650 service sector jobs to be created, with around 5,150 added in production given the stronger growth in output, and growth of 3,400 in agriculture. Construction jobs are now forecast to rise this year by 2,100. In 2016, the bulk of the jobs created are again expected to be in the service sector with an additional 45,450 jobs forecast, while 6,100 are added in production, 3,550 in agriculture and 2,450 in construction.

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

	2014	2015	2016
Upper	57,000	64,215	85,790
November forecast	*53,000*	*53,450*	*76,750*
Central	**53,850**	**51,350**	**57,600**
November forecast	*46,560*	*41,600*	*48,900*
Lower	50,600	38,500	30,750
November forecast	*33,400*	*19,900*	*29,900.*

Source: Fraser of Allander Institute forecasts ©

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+)	**5.5%**	**5.0%**	**4.6%**
November forecast	6.0%	5.8%	5.6%.
Numbers	**149,000**	**136,600**	**125,250**

Source: Fraser of Allander Institute forecasts ©

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 November, reflecting higher economic activity. Our projection for unemployment on the ILO measure at the end of 2015 is 136,600 (5.0%), falling further to 125,250 (4.6%) by the end of 2016.

Brian Ashcroft
27 February 2015