2 Forecasts of the Scottish economy

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Abstract

Despite growth slowing in the final half of 2014, it still appears likely that the Scottish economy grew in 2014 at a faster rate than in any year since 2007. The outlook for continued growth remains mixed however, though survey indicators indicate relatively strong investment signals. It is likely that household spending and investment will contribute positively to growth through 2015 as real incomes rise due to a combination of falling energy prices, some signs of wage increases and increasing employment. For these reasons, we have revised up our forecasts for growth in 2015 and 2016 to 2.6% and 2.4% respectively (from 2.2% and 2.1%). There remain significant downside risks including a likely (perhaps brief) period of deflation in the first half of 2015, continued slow growth in Scotland's major European trading markets and the existential possibility of Greece exiting the Euro – which while not likely to have a direct impact on the Scottish economy, e.g. through exports, would have implications through Scottish banks and wider exposure to European markets.

Fiscal and monetary outlook

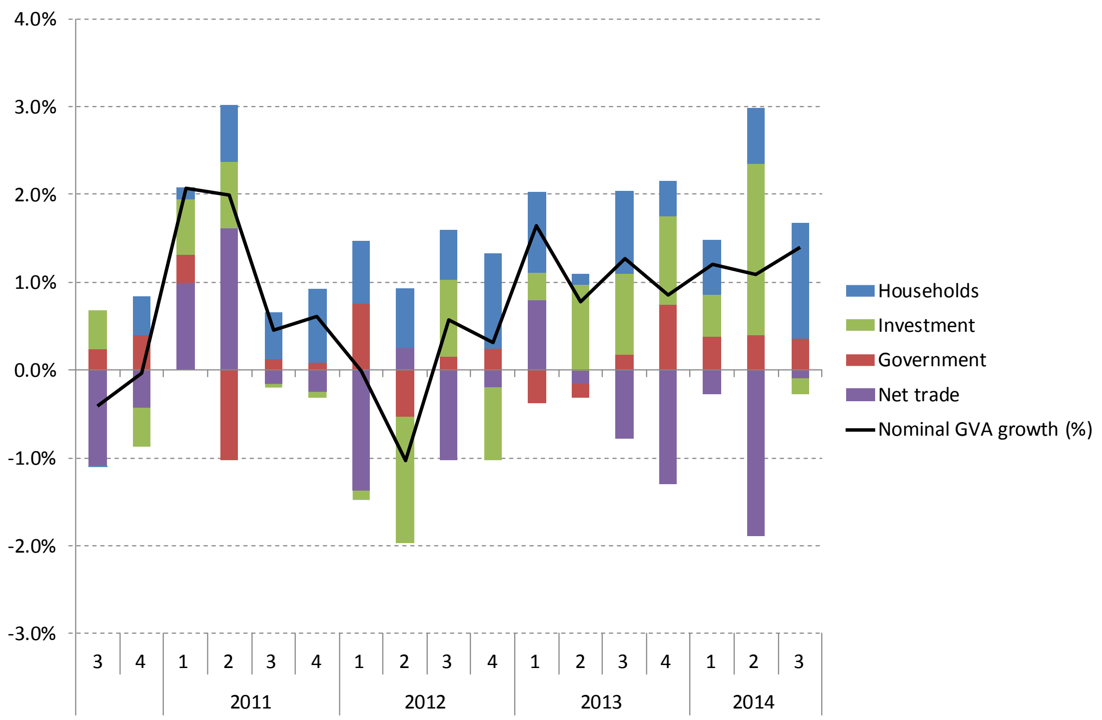
On the 4th of February 2015, John Swinney MSP set out the Scottish Government's final budget plans for year 2015-6 when total spending will about 1.6% less in real terms than 2014-5. Fiscal Affairs Scotland has examined the long-term projections to the Scottish budget over the coming years, and concluded that 20016-16 is likely to be one of the "milder" years for the Scottish budget which will see three years of accelerated real terms reductions from 2016-17 (Fiscal Affairs Scotland, 2014).

After almost six months of disagreement within the Bank of England's Monetary Policy Committee (MPC) at its February 2015 meeting, the Committee unanimously agreed to leave interest rates unchanged at 0.5%. The minutes of this meeting (Bank of England, 2015) reveal that the Bank discussed its options in the face of continuing low rates of inflation (with CPI at 0.5% in December 2014) – below the Bank's target of 2%; these included: expanding its QE programme (beyond £375 billion) and making reductions (from 0.5%) to the Bank base rate. The same minutes show that all members of the Committee expect interest rates to increase over the next three years, though one member thought it equally likely that interest rates would be lowered as increased. The Bank is closely watching inflation expectations, in particular to see how low inflation becomes over the first half of 2015 and the extent of any deflation. In his presentation, the Bank's Governor, Mark Carney, was keen to emphasise the Bank's expectation that CPI inflation is likely to turn negative, but that this will be "brief" and will be localised to the impacts of food and fuel prices, largely affected by the reduction in the oil price. A prolonged period of deflation across many categories of prices, which feeds into inflation expectations, could be very damaging for a recovery which has seen the recent quarters' of growth driven largely by indebted household demand.

Households

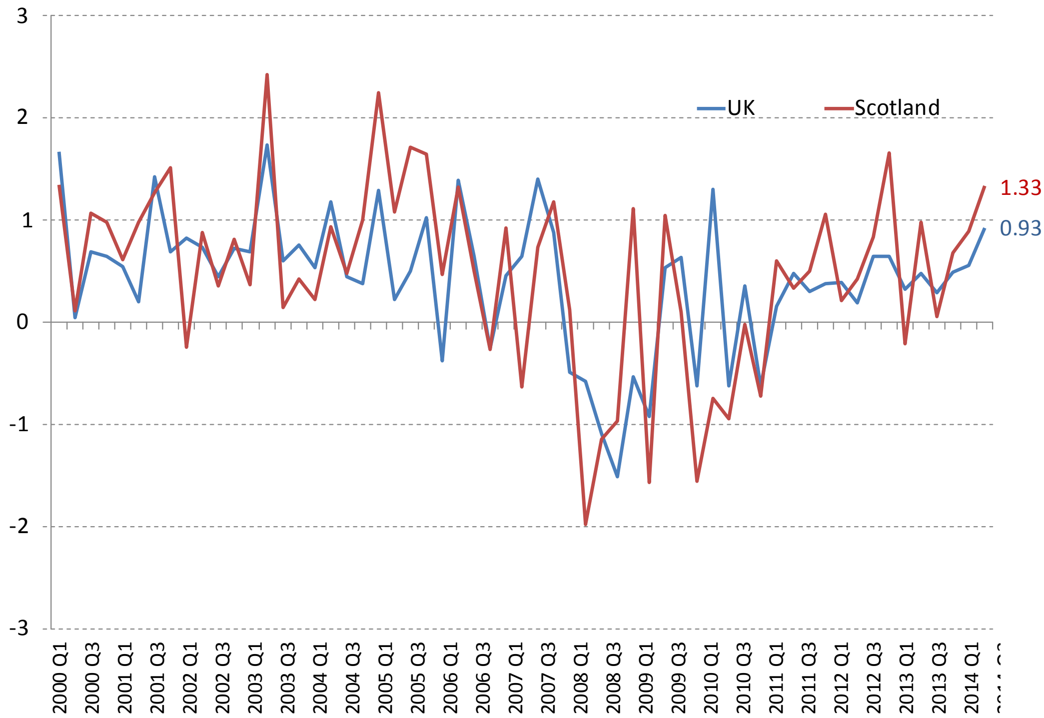
It is evident from Figure 1 that household spending has driven a considerably portion of economic activity in Scotland. On average, between Q1 2011 and Q3 2014, household consumption has contributed 0.7 percentage points to nominal quarterly growth, with Gross Fixed Capital Formation and Government (only) contributing 0.4 and 0.1 points respectively). Net trade has contributed an average of *minus* 0.3 percentage points over the same period indicating issues both of Scotland's narrow export base and the economic health particularly of Eurozone economies. What is also clear from Figure 2 is that the volatility of (real) consumption spending growth continues to be greater in Scotland that the UK as a whole, and that consumption expenditure since the start of 2011 has grown reasonably strongly. In the most recent quarter for which data is available (Q3 2014) consumer spending grew by 1.3% in Scotland and 1.0% in the UK as a whole. The household savings ratio for the UK has continued to be around 7% and about 2.5 percentage points below its pre-recession average. In Scotland, the savings ratio was 5.9% in Q3 2014, which is actually slightly higher than its long term average.

Figure 1: Contribution to nominal quarterly growth, Scotland, Q3 2010 to Q3 2014, % points q-on-q



Sources: *Scottish National Accounts Project (SNAP) data (Scottish Government) and Fraser of Allander Institute (FAI) calculations. The columns shows the percentage point contribution of each element to quarterly Scottish (nominal) GVA growth, while the solid black line shows nominal GVA growth for Scotland for each quarter, e.g. in Q3 2014, household and government spending contributed positively to GVA growth, while there were small negative contributions from investment (for the first quarter since Q4 2012 and net trade (for the six successive quarter).*

Figure 2: Household real consumption spending growth, Scotland and UK, Q1 2000 to Q3 2014, % q-on-q

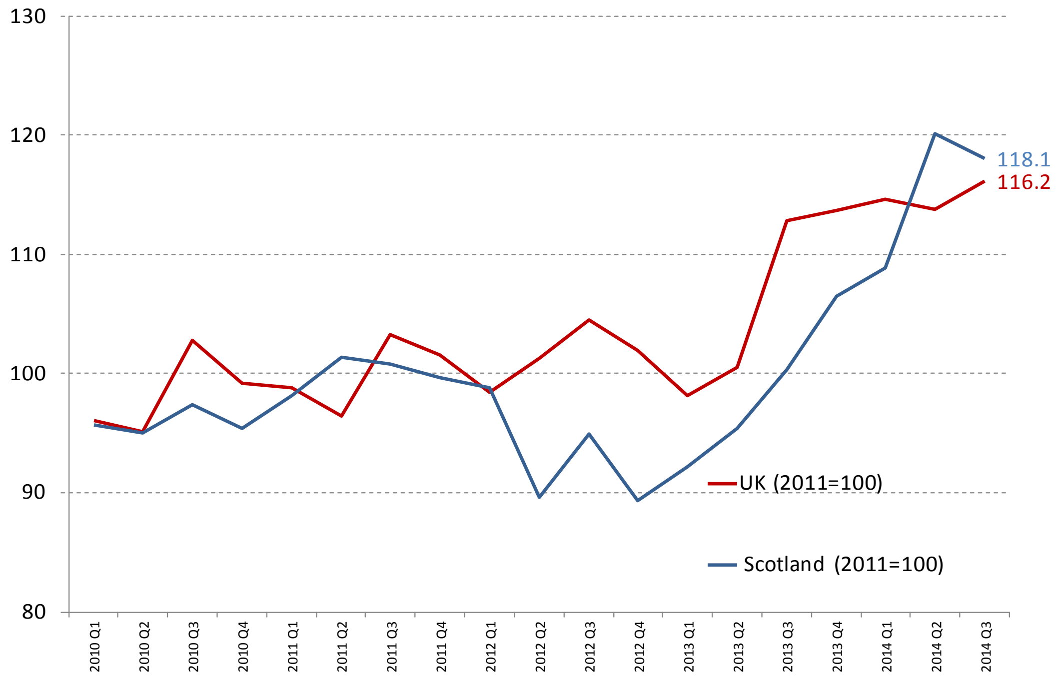


Sources: *Scottish National Accounts Project (SNAP) data (Scottish Government) and UK Quarterly National Accounts (National Statistics) and FAI calculations.*

Investment

Figure 3 shows comparable figures for Scotland and the UK for investment spending between Q1 2010 and Q3 2014. These suggest that investment spending in Scotland and UK are both about 17% above its average from 2011. The contribution made by investment spending through 2013 and the first half of 2014 is clear also from Figure 1 (before a small nominal decline in investment spending in Q3 2014). Over a longer time horizon, real current investment spending is broadly at the same level as previous highs in 2007. Recent survey evidence – covered in the *Review of Business Surveys* section – suggests that a number of sectors are bullish about investment plans for 2015. The Bank of England's November Inflation Report (Bank of England, 2014, p. 20) noted that the outlook for business investment was robust, supported by "conducive financing decisions and expanding domestic demand". Though demand uncertainty was again important, it appeared to have "receded" over 2014. The Bank had previously warned of the chance that excess capital in firms was potentially holding back new investment. Recent survey results however suggest that this fear is not restraining investment.

Figure 3: Real gross fixed capital formation, Scotland and the UK, Q1 2010 to Q3 2014



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

Trade

Exports from Scotland were reported on the 26th of January 2015 in the Global Connections Survey. These are not timely nor robust data in that the latest figures relate to 2013 and are denominated in nominal terms, however they do provide a good breakdown of the sectoral composition of Scotland's exports (i.e. what industries export in Scotland) and the destination markets for Scottish products. The headline numbers showed a nominal increase in international (i.e. ex-UK) exports of £1,860 million (7.2%) between 2012 and 2013. While there were reductions in some sectors (including a small reduction of £15 million in the value of whisky exports), there were strong performances in refined petrol and chemical products, computer, transport and machinery equipment, as well as in transportation. The top two export sectors remain dominantly food and drink and refined petroleum, which jointly are responsible for over 30% of Scotland's international exports. The five top destinations for Scotland's international exports are, by value, respectively the USA, Netherlands, Germany, France and Denmark. In all, over 55% of Scotland's international exports are to European markets. Encouragingly exports to European Union countries increased strongly (12.4%), while there were actual reductions in the value of exports to Asia (down £45 million, or 1.5%). Scotland's exports to the rest of the UK rose more slowly than its international exports, increasing by 2.7% (£1,200 million).

The most recent statistics on Scottish exports to the rest of the world – covering manufacturing exports alone (roughly 60% of Scottish exports outside of the UK) – show that there was quarterly growth of 1.8% in the final quarter of 2014, the third such consecutive quarterly increase. Exports were helped by a continuing rebound of exports from refined petroleum activities (up 8.9% in Q4, following 14.4% and 4.4% increases in Q1 and Q32 respectively). The export figures remain affected by the shutdown of the Grangemouth facilities through the end of 2013; however the level of exports for this sector has now almost returned to the levels of Q3 2013. Data for the drinks sector – which saw a decline in 2013 as reported above – suggests more positive news through 2014 with (small) positive growth in the first three quarters of the year.

In terms of key markets for Scottish products, the latest figures suggest little room for optimism about the short-term trajectory of Scottish exports. Markit's PMI for the Eurozone in February 2015 (20th February) suggested a further improvement in activity – three consecutive months of improving business activity measures – and it noted that the Eurozone economy as a whole appeared to be gaining some growth momentum, in part driven by the strongest growth fin France in almost four years. Growth in the US is forecast to strengthen, though it is the only one of Scotland's major international export markets to have its growth forecasts for 2015 and 2016 revised up by the International Monetary Fund (IMF) since its October 2014's forecasts. Indeed, it appears that without growth in US markets, Scotland's export performance would be significantly worse. Table 1 shows the forecasts for growth in key global markets for Scottish products through 2015 and 2016. Since our last forecasts in November 2014, economic forecasts for the UK as a whole have been revised down slightly for 2014. The average of 2015 forecasts in February 2015 is 2.6%, and range between 2.1% and 3.0% - a very small range given how early in the year we are currently. Forecasts for 2016 average 2.3%, and range between 1.2% and 3.0% (HM Treasury, 2015).

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

		2015			2016		
	Share of total (i.e. international and rest of the UK) exports, % 2013	IMF (January 2015)	Revision since October 2014	OECD (November 2014)	IMF (January 2015)	Revision since October 2014	OECD (November 2014)
USA	5.3	3.6	+0.5	3.1	3.3	+0.3	3.0
Netherlands	2.8	-	-	1.4	-	-	1.6
Germany	2.6	1.3	-0.2	1.1	1.5	-0.3	1.8
France	2.5	0.9	-0.1	0.8	1.3	-0.2	1.5
Denmark	1.9	-	-	1.4	-	-	1.8
Norway	1.5	-	-	1.8	-	-	2.5
United Kingdom	62.4	2.7	0.0	2.7	2.4	-0.1	2.5
China	0.8	6.8	-0.3	-	6.3	-0.5	-
Japan	0.4	0.6	-0.2	0.8	0.8	-0.1	1.0
Euro area	-	1.2	-0.2	1.1	1.4	-0.3	1.7

Sources: *World Economic Outlook Update (International Monetary Fund, IMF, January 2015) and Economic Outlook (Organisation for Economic Cooperation and Development, OECD, November 2014) Notes: "-" indicates a country forecast is not produced.*

Forecasts for the Scottish economy: Detail

In June 2014 we identified that there was an apparent cooling of the Scottish economy as it entered the second half of the year. This has been borne out by the data we have currently, and it is likely that the Scottish economy as a whole grew by around 0.6% in the final quarter of 2014 – broadly similar to its growth in Q3 but down from growth of 1.0% and 1.1% seen in Q1 and Q2 2014 respectively. This growth outturn would suggest that 2014 saw growth of around 2.9%, the highest annual growth since 2007. While there are a number of positives from most recent surveys of the Scottish economy, it is likely that growth in the first quarter of 2015 will be in line with the performance of the second half of 2014, rather than the preceding six months.

Looking to the longer term, it appears (again) that household spending is likely to continue to drive much of the developing economic recovery. Wage growth for the UK as a whole increased by 1.7% in the final three months of 2014, and with the low rate of CPI inflation, real incomes are likely to rise further as wage growth increases through 2015. Business investment intentions remain in growth territory and there appears to be some stability to the recovery in the rest of the UK – Scotland's largest trading market.

Additionally, the recent fall in the oil price, and subsequent rapid fall in CPI inflation would be expected to reduce input costs to business and act as an effective wage increase to households (in particular where energy prices reflect these significant falls (for example in petrol/diesel prices, and domestic electricity and gas bills). The Bank of England (2015b) notes that while businesses may see a fall in their costs, the impact on business investment is unclear: some investment could be encouraged by the lower oil price but there may also be reductions in investment in the UK Continental Shelf (UKCS). This is clearly not positive news for all parts and sectors of the Scottish economy, however it is too early to say what the impact could be over the medium or longer term on the oil and gas sector and activity in the UKCS and the North East of Scotland economy. In the absence of the oil price rebounding significantly, many have speculated that there could be a period of low oil prices over the next couple of years or so. In the absence of a period of deflation for the UK – which the Bank of England has suggested could arise, but is likely to be only brief – a relatively brief period of low oil prices could be likely to have a *net positive impact* on Scotland's onshore economy (i.e. the basis on which quarterly figures on Scottish GDP is calculated and reported, which does not directly include activity in the UKCS).

However we would anticipate there remain significant risks to the downside on these forecasts, and that these are not solely related to the uncertainty around the future oil price. It is clear that downside risks to Eurozone economic activity cannot be ignored – indeed, the Quantitative Easing ("bazooka") announced by the European Central Bank (ECB) on 22nd January 2015 with a larger than expected scale of €1.1 trillion– is an explicit attempt to boost struggling economic conditions and prevent the Eurozone entering deflation. The success of this policy, and the existential threat from Greek debt negotiations and possible Euro-exit, reveal some of the significant downside risk that remains to these major markets for Scotland. The Institute for Fiscal Studies notes that half the Government's fiscal consolidation relative to 2008 remains to be implemented after 2014/15, and that it is likely to be made through further government expenditure reductions.

Results

In this section of the *Commentary*, we forecast year-on-year real growth in Scotland's key economic and labour market variables. In this issue, we forecast all variables for 2014, 2015 and 2016. (The growth of the Scottish economy in the final quarter is published in mid-April 2015 which will complete our first understanding of Scottish economic performance during 2014). Our forecasts cover Scotland's Gross Value Added (GVA), employee jobs and unemployment. The model used is multi-sectoral, and where useful, results are reported to broad sectoral categories.

We begin with the forecasts for GVA growth in the Scottish economy. The growth performance of Scotland between 2010 and 2013 and our forecasts for the period to 2016 are shown in Figure 4. This also includes our upper and lower forecasts growth. As previously, the range around the central forecast is based on our past forecast accuracy of the first release of growth data for the year.

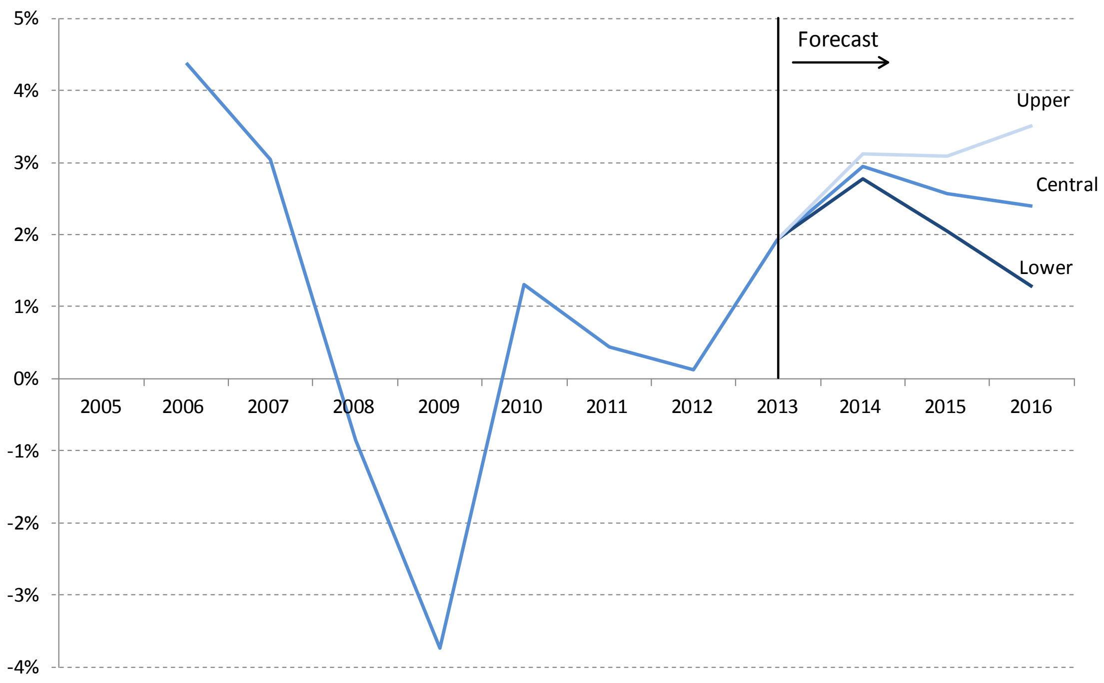
Based on earlier forecasts since 2000, the mean absolute error of forecasts in the spring period and growth in the year previous (i.e. 2014 in this forecast) is 0.18 percentage points. Growth forecast errors made in spring for the year currently in progress are 0.52 percentage points. This gives the range for the upper and lower bands in 2014 and 2015. Some recent forecast evaluations for the OECD found that that organisations average absolute error for current year UK growth forecasts, made in May of the year in progress, was 0.5 percentage points (Pain *et al*, 2014). Our past forecast errors for the longest forecast horizon is 1.120 percentage points, so this is used to give the range around our central forecast for 2016.

Relative to our November 2014 forecasts we have now revised up our central forecast for GVA growth in 2014 from 2.7% to 2.8% (i.e. an upward revision of 0.1 percentage points) and largely driven by better than expected growth outcomes through the first half of 2014, in particular the stronger than expected performance in the second quarter. Our forecast for 2015 has been revised up from 2.2% to 2.6%, largely as a result of upward improvements in investment signals at the start of 2015. Our new forecast for 2016 is 2.4%, revised up from 2.1% in November 2014, and the same as our initial estimate for 2016 made in the June 2014 Commentary.

For comparison purposes, the UK's Office for Budgetary Responsibility (OBR) forecast for growth in 2015 (made in December 2014) and the median of new independent growth forecasts for the UK in 2015 are 2.4% and 2.6% respectively, while for 2016 the respective figures are of 2.2% and 2.4% respectively.

In addition to the aggregate growth forecasts in our central scenario, Table 2 presents our forecasts for GVA growth in 2014, 2015 and 2016 for three broad sectoral groupings: the "production", "construction" and "services" sectors of the Scottish economy.

Figure 4: Forecasts of annual real GVA (%) growth for Scotland, 2010 to 2016



Sources: Fraser of Allander Institute forecasts, March 2015

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

	2014	2015	2016
GVA	2.9%	2.6%	2.4%
Production	3.4%	2.9%	2.8%
Construction	2.2%	1.5%	1.4%
Services	2.7%	2.5%	2.3%

Source: Fraser of Allander Institute forecasts, March 2015

Employment and unemployment

Detailed commentary on recent developments in the Scottish labour markets can be found in the Overview of the Scottish Labour Market section of this *Commentary*. Here we present our forecasts for the number of employee jobs in the Scottish economy. We forecast the number, sectoral breakdown and percentage changes in employee jobs at the end of 2014, 2015 and 2016 respectively, as well as the ILO measure of unemployment over the same period.

The most up to date employee jobs series for Scotland shows that there were 2,403,000 employee jobs in Scotland in the third quarter of 2014, an increase of 46,000 jobs from the end of 2013. This level of employee jobs is now 78,000 jobs short of the peak of employee jobs in Scotland in Q3 2008 (2,480,000).

Our new forecasts for employee jobs are shown in Table 3, alongside a sectoral breakdown of employee job numbers. The number of total employee jobs is forecast to increase in each year, and they have been revised up slightly since our November 2014 forecasts. The number of jobs at the end of 2014 is now forecast to be 2,409,850, an increase of 2.3% in 2014 (up from 2.0%) with an upward revision of just over 7,000 jobs since November's forecast. Our new forecast is that the Scottish economy will add 51,350 jobs in 2015, up by 10,000 from our November forecast, and 57,600 jobs in 2016, up by almost 9,000 from our November forecast. We now forecast the number of employee jobs in Scotland will be about 1.6% above its previous peak by the end of 2016. The net change in employee jobs, consistent with our upper, central and lower forecasts, is shown in Table 5.

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

	2014	2015	2016
Total employee jobs, Dec	2,409,850	2,461,200	2,518,800
Net annual change (jobs)	53,850	51,350	57,600
% change from previous year	2.3%	2.1%	2.3%
Agriculture (jobs, 000s)	39	42	46
Annual change	3,750	3,400	3,550
Production (jobs, 000s)	243	248	254
Annual change	2,900	5,150	6,100
Construction (jobs, 000s)	133	135	138
Annual change	2,050	2,100	2,450
Services (jobs, 000s)	1,995	2,036	2,081
Annual change	45,150	40,650	45,450

Note: Absolute job numbers are rounded to the nearest 50.
***Source:** Fraser of Allander Institute forecasts, March 2015*

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

	2014	2015	2016
Upper	57,000	64,215	85,790
Central	53,850	51,350	57,600
Lower	50,600	38,500	30,750

Note: Absolute job numbers are rounded to the nearest 50.
Source: Fraser of Allander Institute forecasts, March 2015

We present out forecasts for unemployment at the end 2015 and 2016 in our central scenario in our central forecasts in Table 5. In line with the forecasts produced since June 2013, we report the forecast number (and rate) of those unemployed using the International Labour Organisation definition of unemployment. This is preferred to the claimant count measure as it gives a more complete picture of the extent of labour resources available for work but unable to find work, and so is a better measures of the level of spare capacity in the Scottish labour market.

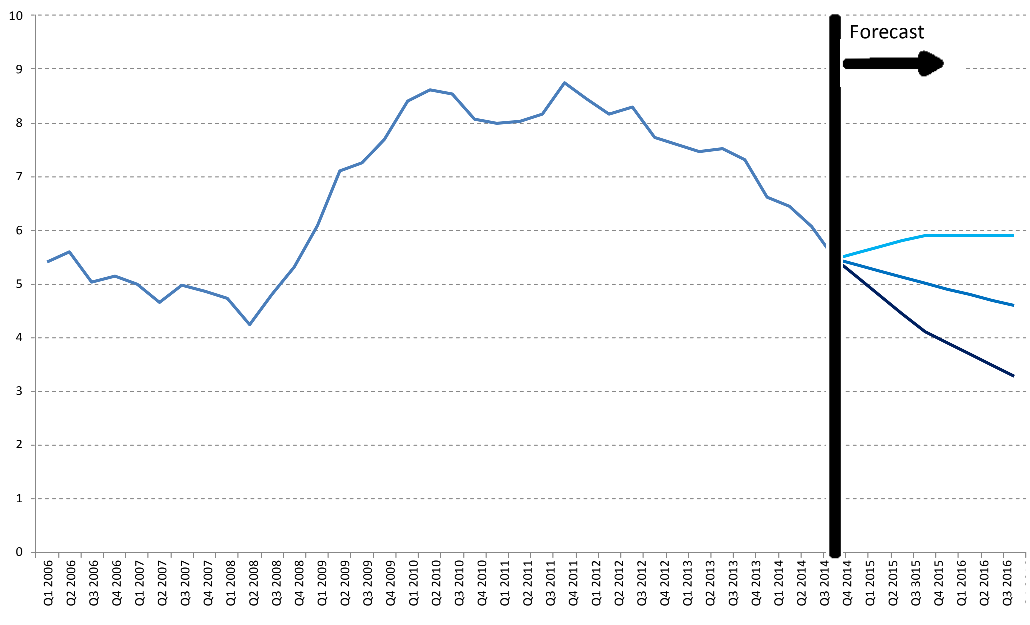
In November 2014 we forecast that the unemployment rate would fall to 5.3% by the end of 2014. The recent labour market data at time of writing (22nd February) indicates that the ILO unemployment rate in the final quarter was 5.5%. Our new forecasts for the unemployment rate in Scotland at the end of 2015 and 2016 are 5.3% and 5.2% respectively. Figure 4 shows both the performance of ILO Scottish unemployment rate since 2006 as well as our ILO unemployment rate central, upper and lower forecasts to 2016.

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

	2014	2015	2016
ILO unemployment	149,000	136,600	125,250
Rate (%)[1]	5.5	5.0	4.6

Note: Absolute numbers are rounded to the nearest 50. 1 = Rate calculated as total ILO unemployment divided by total of economically active population aged 16 and over. The most recent labour market statistics are detailed in the Labour Market section.
Source: Fraser of Allander Institute forecasts, March 2015

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



Sources: ONS and Fraser of Allander Institute forecasts, March 2015

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22nd February 2015

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