1 Outlook and appraisal

Brian Ashcroft, Economics Editor, Fraser of Allander Institute

Overview

The Scottish and UK economies are continuing to grow and recover from the Great Recession. With growth of 0.6% in the final quarter of last year (2014) – the latest data point - the Scottish economy has now enjoyed positive growth for the last 11 quarters (since 2012q1) while in the UK, also with growth of 0.6% in 2014q4, the sustained recovery period has been shorter at 8 quarters.

The introduction of a new system of accounts ESA 2010 has brought in to the production calculus some activities (such as research and development and military expenditure) that were not previously treated as outputs alongside the inclusion of previously uncounted ones (such as illegal activities). In consequence, the nominal value of GDP has risen by around 1 to 4% per year due to the addition of these new activities within the production boundary. A further consequence of these accounting changes is that the extent of the recovery from recession is now greater in both UK and Scotland but it is stronger in the UK. When oil and gas production is removed – to compare like with like, since offshore activity is included in the UK but not the Scottish GDP data - we find that the gap in the strength of the recovery widens further in the UK's favour. UK GDP stands 5.1% above the pre-recession peak compared to only 2.3% in Scotland. We speculate that the relatively stronger UK recovery under the new accounting system could be due to the recovery in R&D activity being stronger in the rest of the UK after the recession than in Scotland and, if so, may not augur well for Scotland's growth performance in the longer term. However, there may simply be a technical rather than an economic cause due, for example, to different sub-sectoral weights between Scotland and the UK.

When we examine the performance across different industries and sectors, we see that the pattern of growth between Scotland and the UK differed considerably in the fourth quarter. In the UK, the service sector was by far the main driver of growth, while in Scotland the sector made no contribution to growth. In contrast, the principal driver of growth in Scotland was the construction sector while the sector in the UK was a drag on growth. In addition, the production sector contributed about a third of the growth in Scotland but made no contribution to growth in the UK. Within production, manufacturing in both Scotland and the UK made no contribution to growth, while in Scotland it was mining & quarrying and electricity & gas that provided the contribution to growth.

The latest labour market data show that jobs continue to be created at a fairly fast pace, indeed in the latest February – April 2015 quarter at a faster rate in Scotland than the UK both in the quarter and over the year. However, the picture differs on unemployment with the numbers seeking work rising slightly in the latest quarter and the reduction over the year, while sizable, is proportionately less than in the UK. By the end of the fourth quarter, Scottish jobs as reported in the LFS household surveys were 2.6% above the pre-recession peak, while UK jobs were 4.6% higher than the peak. So, the latest data show the recovery in the labour market to be continuing but there is now some evidence that the rate of recovery is slowing in Scotland and despite recent stronger Scottish jobs growth overall the recovery remains stronger in the UK.

Now that the UK General Election is over and with the Holyrood elections less than a year away there may be a small window of opportunity for politicians, policymakers and others to reflect on the challenges facing the Scottish economy. One way of organising thoughts about the challenges is to separate them into short-term and long-term issues. More specifically we can distinguish between capacity utilisation and capacity growth. In the former, we are largely focusing on the issue of demand deficiency, while the longer-term capacity growth question is essentially about supply. In the present Commentary we focus on the short-term capacity utilisation issue returning to the more long-term capacity growth question in the next issue of the Commentary.

Our conclusion on capacity utilisation is that despite the recovery the Scottish economy still has spare capacity available, most notably in the labour market where the number of total weekly hours worked in Scotland was close to but still -0.4% below the pre-recession peak. Moreover, by January - March 2015, the ratio of employment to working population stood at -2.4% below the pre-recession peak, a worsening of the position in the final quarter of last year, compared to -6.7% at the trough of the recession. In the UK as a whole, in contrast the ratio is only -0.6% below its pre-recession peak but still below a peak that was attained 7 years ago. We note that there are clear positive influences boosting the demand for Scottish goods and services: domestic demand is still growing strongly, domestic inflation is close to zero, below nominal earnings/income growth and so boosting real income, and external demand remains reasonably strong, with growth in the euro area beginning to strengthen while US growth having faltered earlier in the year looks set to pick up again. Yet, there are continuing threats to the further recovery of demand which policy should seek to minimise.

First, growth remains unbalanced with household spending the key driver fuelled largely by rising household debt, which we fear may soon become unsustainable. The growth of imports continues to strongly outstrip the relatively weak growth of exports and so net trade acts as a drag on growth. Policy must seek ways to boost export performance because it is becoming clearer that a more competitive price through a lower sterling exchange rate is insufficient to boost export demand. Issues of product quality and marketing would appear to be at the root of this Scottish and UK problem. One bright spot in this picture of unbalanced growth of demand is the performance of capital investment, which is now contributing significantly to demand and the growth of output in Scotland. Infrastructure spending is playing a big role in Scotland – think of the new Forth Road Bridge – but also foreign direct investment where Scotland again enjoyed a successful year in 2014 with over 80 inward investment projects attracted.

Secondly, the victory of the Conservatives with a small majority in the May 2015 UK General Election appears likely to lead to a continuation and perhaps a tightening of the previous Conservative / Liberal Democrat Coalition austerity plans. We shall find out more in the Chancellor's forthcoming Budget. With more austerity households can expect a further reduction in their incomes, on average. What that means is that household spending will also be reduced and the fall is likely to be greater the more quickly the Chancellor seeks to bring the UK government's budget into balance. Austerity will continue to be a major drag on capacity utilisation and economic recovery in Scotland and the UK.

Finally, there is Greece. At the time of writing we do not know the outcome of the negotiations between the Greek government and its creditors. The risks of Greece both defaulting on its debt and leaving the euro have increased since we last reported. This issue is again fast becoming a major threat to the recovery not simply in the eurozone but perhaps, with the possibility of contagion, in the rest of the world, including Scotland.

It is against this background that we have prepared our latest forecasts.

Our GDP forecast for 2015 is 2.5%, which is revised down slightly from our forecast of 2.6% in March of this year due to the evidence of a slowing of the rate of growth through the first half of the year. For 2016, we have also revised down our forecast to 2.3% from 2.4% in March, in recognition that while the recovery is continuing the growth of demand is now anticipated to be slightly weaker than previously thought. We also are prepared to acknowledge that the negative effects of the oil price fall on the oil production and services, may be a little greater than we anticipated in March. We are forecasting 2017 for the first time and the underlying determinants suggest that growth will be little different from 2016 and so we retain the forecast of 2.3% for 2017.

The number of total employee jobs is forecast to continue to increase in each year of the forecast horizon 2015 to 2017, and at a faster rate than that seen during 2014 (although not as strongly as in 2013). Our forecast for the number of jobs added in 2015 has been revised down marginally since March's forecast, from 51,350 to 51,250. The number of jobs at the end of 2015 is now forecast to be 2,444,250, an increase of 2.1% in 2014. Our current forecast is that the Scottish economy will add 49,600 jobs in 2016, down by 8,000 from our March forecast, while we forecast the addition of 51,700 jobs in 2017.

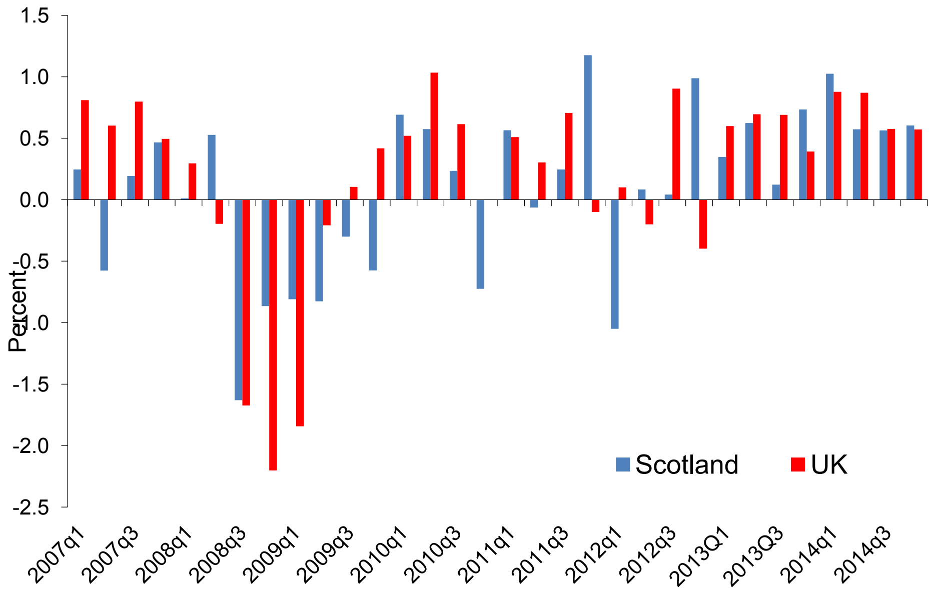
Given the small revisions to the growth in employee jobs over the next two years in our latest forecasts, there are only small revisions to the levels and rates of unemployment from our earlier forecasts. The improvement in the labour market is forecast to continue with unemployment rates and numbers falling to end 2017. Our projection for unemployment on the ILO measure at the end of 2015 is 138,200 (5.1%), falling further to 122,364 (4.5%) by the end of 2016, and 108,150 (3.9%) by end 2017. It is worth noting that our unemployment forecast for 2017 means that the unemployment rate finally falls to where it stood when the Great Recession started in 2008, nine long years ago.

Recent GDP performance

Scottish GDP data are now based on the European System of Accounts 2010 (ESA 2010). The Scottish data are now comparable with the UK GDP data, which moved from ESA 1995 to ESA 2010 in 2014q2. The key changes between ESA 1995 and ESA 2010 that are 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). As a result the revisions to the Scottish data are substantial. In general, the nominal value of GDP has risen by around 1 to 4% per year due to the addition of these new activities within the production boundary. The uplift to Scottish nominal GDP is less than for the UK because while illegal activities have been apportioned across the UK territories on a population share basis, the apportionment of R&D outputs reflects the lower level of R&D activity in Scotland compared to the UK as a whole.

The new data show that in the fourth quarter of last year (2014q4) GDP rose by 0.6% in Scotland in the quarter. UK GDP also rose by 0.6% in the quarter but a little faster over the year – four quarters on four quarters – with growth of 2.8% compared to 2.7% in Scotland. The Scottish and UK quarterly growth rates back to 2007q1 are presented in Figure 1.

Figure 1: UK and Scottish Quarterly GDP Growth, 2007q1 - 2014q4

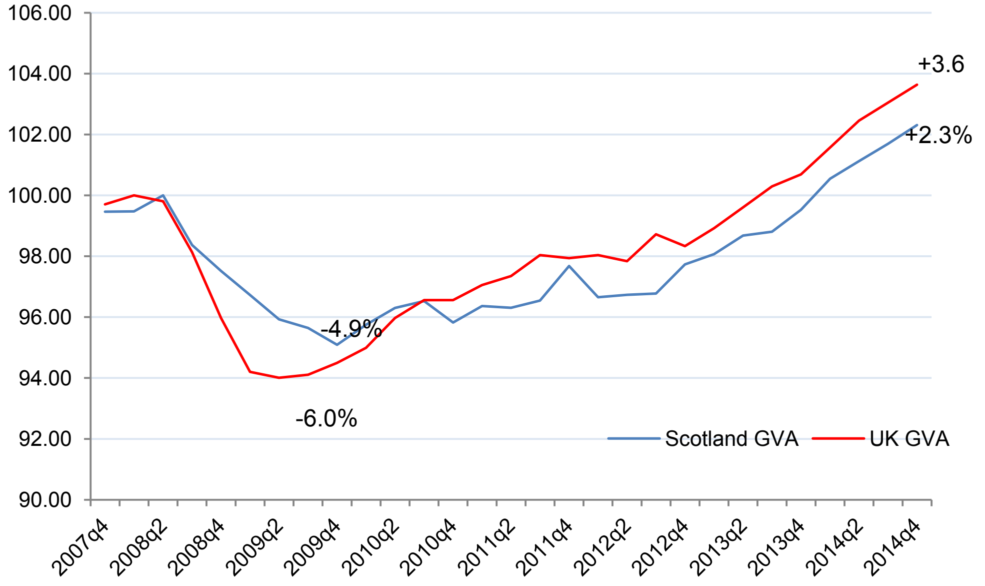


Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2014, and Fraser of Allander Institute (FAI) calculations

The Scottish economy has now enjoyed positive growth for the last 11 quarters (since 2012q1) while in the UK the sustained recovery period has been shorter at 8 quarters. But still the UK recovery from the Great Recession has overall been stronger than in Scotland as is shown in Figure 2.

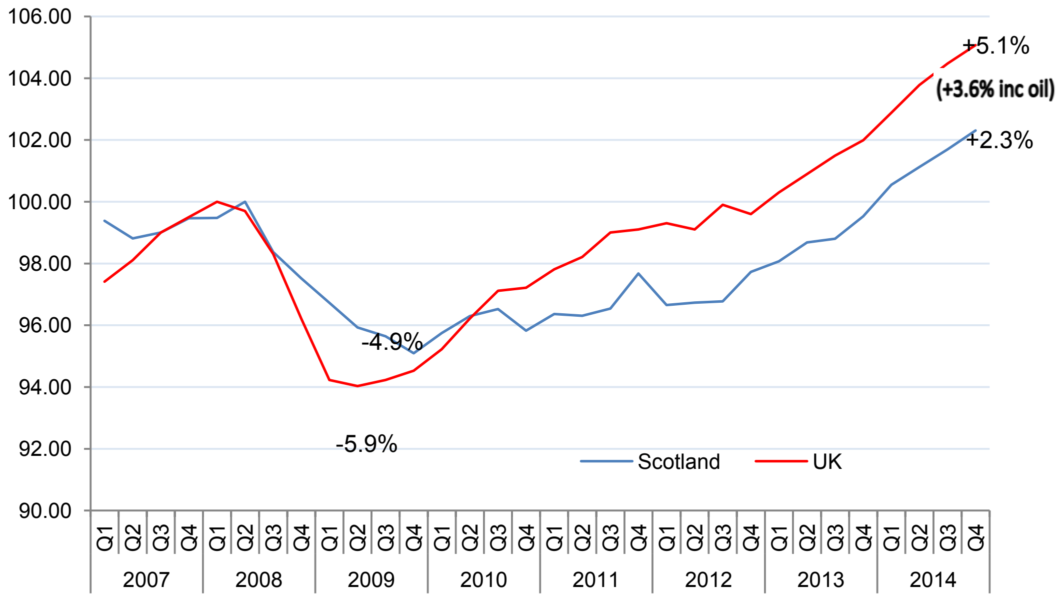
The impact of moving from ESA 1995 to ESA 2010 is clearly evident in Figure 2. Previously the peak to trough decline in GDP in the Great Recession was -5.4% in Scotland and -7.3% in the UK. Under the new accounting system, the contraction was less in both Scotland and especially in the UK with a loss of output of -4.9% in Scotland and -6.0% in the UK. Moreover, under the new system GDP was further above the pre-recession peak in recent quarters than under ESA 1995 in the UK but not in Scotland. So, for example, by the third quarter 2014, GDP was +2% and above the pre-recession peak in Scotland and +1% in the UK under EAS 1995 but was +1.7% and +3%, respectively, above the peak under ESA 2010. And by the latest fourth quarter GDP had risen further to 2.3% above the peak in Scotland and 3.6% in the UK. So, the recovery in GDP from recession was even stronger in the UK than Scotland under ESA 2010 than under ESA 1995, with GDP in Scotland rising by 7.6% from the trough to 2014q4 compared to 10.2% in the UK. This could be due to the recovery in R&D activity being stronger in the rest of the UK after the recession than in Scotland and, if so, does not augur well for Scotland's growth performance in the longer term. However, there may simply be a technical rather than an economic cause due, for example, to different sub-sectoral weights between Scotland and the UK.

Figure 2: GVA in recession and recovery: UK and Scotland to 2014q4 (Relative to pre-recession peak)



Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2014, and FAI calculations

Figure 3: GDP (ex oil & gas): Recession and Recovery to 2014q4



Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2014, and FAI calculations

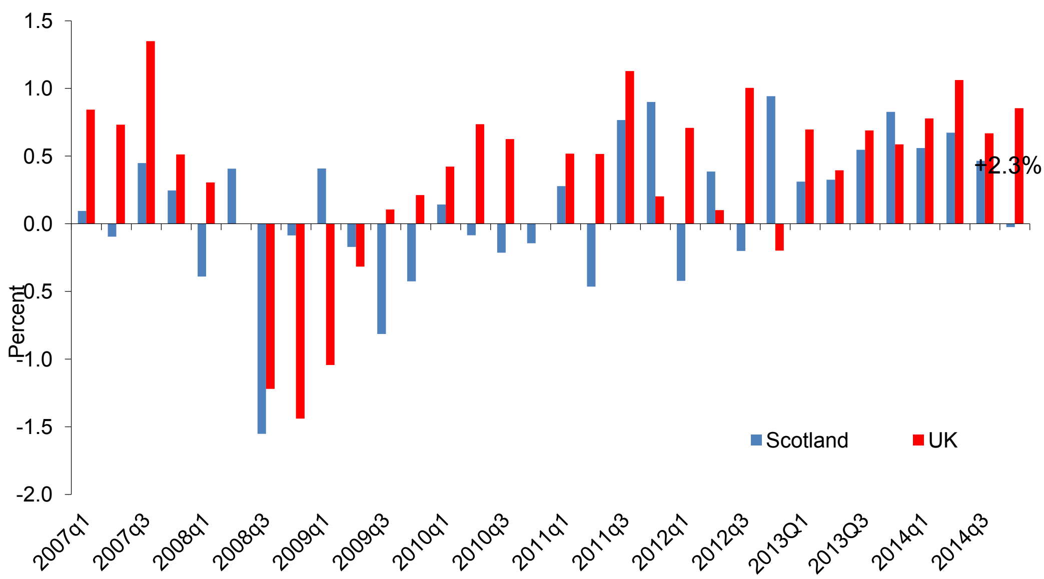
As noted in previous *Commentaries* there is, however, the complicating factor of oil and gas production which for offshore production is included in the UK GDP data but not in the Scottish data. Removing oil and gas production from UK GDP data gives us Figure 3.

When oil and gas production is removed, we find that the gap in the strength of the recovery widens in the UK's favour. UK GDP stands 5.1% above the pre-recession peak compared to 2.3% in Scotland. The long period of weak UKCS oil and gas production has slowed the recovery of UK GDP from recession. So, UK GDP - ex oil & gas - has had an even stronger recovery from recession than Scottish GDP. Scottish GDP has recovered by 7.6% since the trough of recession while UK GDP - ex oil & gas - recovered by 11.8% from its trough by 2014q4. In the latest quarter, UK GDP ex oil and gas rose by 0.6% and by 2.9% over the year – four quarters on four quarters.

Sectoral Components of GVA growth

Turning now to individual sectors of the economy, we see that the pattern of growth between Scotland and the UK differed considerably in the fourth quarter. In the UK, the service sector was by far the main driver of growth contributing +0.7% points, while in Scotland the sector made no contribution to growth. In contrast, the principal driver of growth in Scotland was the construction sector contributing +0.4% points while the sector in the UK was a drag on growth by -0.1% points. In addition, the production sector contributed +0.2% points to growth in Scotland but made no contribution to growth in the UK. Within production, manufacturing in both Scotland and the UK made no contribution to growth, while in Scotland it was mining & quarrying (+0.1% points) and electricity & gas (+0.1% points) that provided the contribution to growth.

Figure 4: UK and Scottish Services GVA Growth 2007q1 to 2014q4



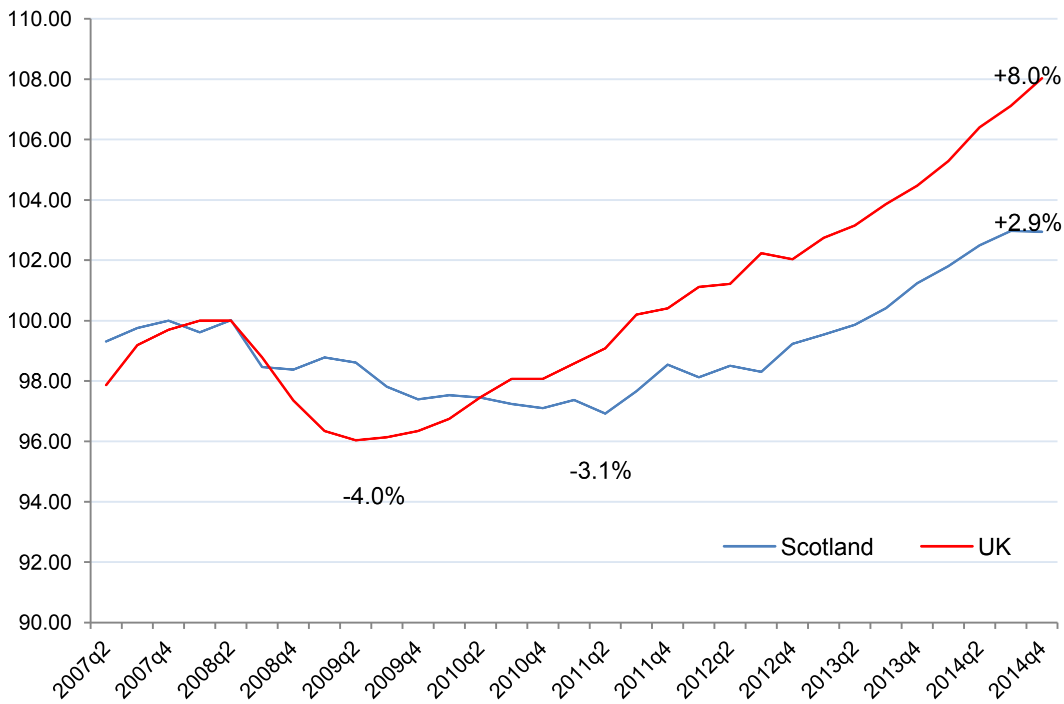
Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2014, and FAI calculations

Services sector

The Scottish service sector, which – on 2012 weights - accounts for 75% of GDP in Scotland and 78% in the UK, exhibited zero growth in Scotland in the fourth quarter and produced 2.3% growth over the year. UK services output registered positive growth of 0.9% in the quarter - see Figure 4 – and 3% over the year.

The state of the recovery in Scottish and UK services is presented in Figure 5. The adoption of ESA 2010 has clearly widened significantly the gap between the recovery in services in the UK and Scotland, with the UK recovery now seen to be much stronger. The possible stronger performance of R&D activity in the rest of the UK during the recovery may be explanation. After experiencing as shallower but more drawn out recession in Scotland of -3.1% compared to -4% in the UK, output the sector stood at just under 3% above its pre-recession peak by the fourth quarter of last year significantly less than the 8% above peak attained in the UK.

Figure 5: Services GVA in recession and recovery, UK and Scotland to 2014q4



Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2014 and FAI calculations

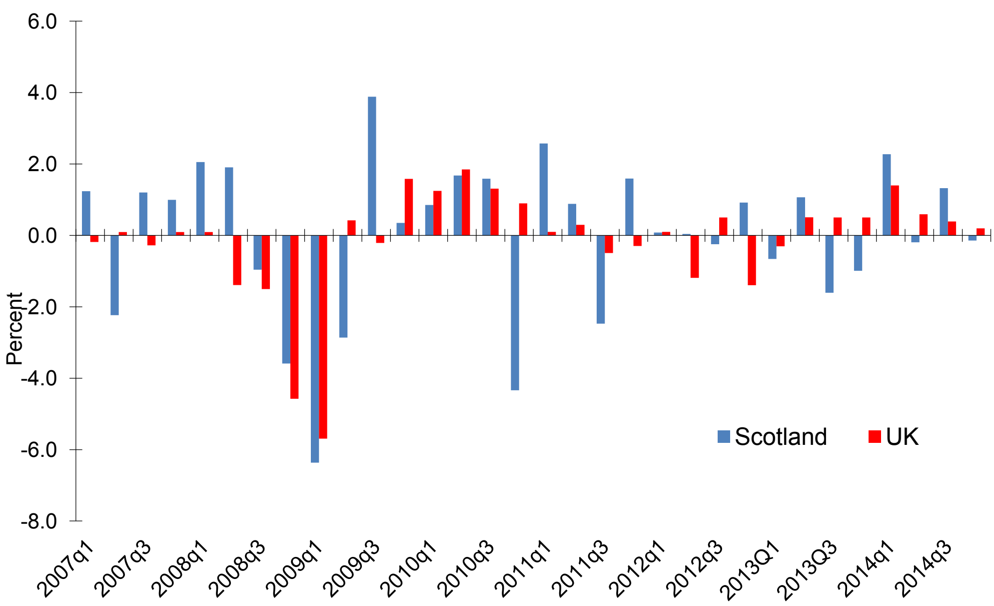
The data for the fourth quarter reveal that the recovery in Scottish services faltered. However, as the latest *State of the Economy* report from the Scottish Government's Chief Economist notes, this was partly due to the anticipated fallback in activity after the boost it received in the previous quarter from the Commonwealth Games and Ryder Cup. The recovery in the sector is - under ESA 2010 - now slightly stronger in Scotland than for GDP in the economy as a whole. In the UK, in contrast, the service sector recovery continues to outstrip, by a fair margin, the overall recovery in GDP when oil and gas extraction is excluded and by a large margin when oil & gas is added back into the mix.

Production / Manufacturing sector

The production sector in Scotland further continued to boost Scottish growth, growing by nearly 10% over the recovery, compare to nearly 8% for overall GDP. In the UK the sector remains a drag on the recovery with growth of 1.5% to 2014q4 since the trough of the recession compared to the 10% growth of overall GDP. Scottish production output rose in the fourth quarter by 1% while UK production output grew by 0.2%. Over the year - four quarters on four quarters – Scottish production GVA rose by 1%, while UK production output rose by 1.6%.

Within production, Mining & quarrying GVA grew by 3.2% in the fourth quarter and rose by 5.4% over the year (UK mining & quarrying changed by 0.8% and -0.6%, respectively). Electricity & gas supply GVA rose by 4.1% in the fourth quarter but fell by -7.2% over the year (UK electricity & gas supply -2.6% and -5.5%, respectively). In the fourth quarter, GVA in Scottish manufacturing fell slightly by -0.1% but rose by 1.4% over the year, which is very weak given that we are in a supposedly strengthening recovery phase. UK manufacturing output rose by 0.2% in the quarter and by 2.9% over the year. Figure 6 charts the quarterly percentage changes in GVA in Scottish and UK manufacturing.

Figure 6: UK and Scottish Manufacturing GVA Growth at constant basic prices 2007q1 to 2014q4

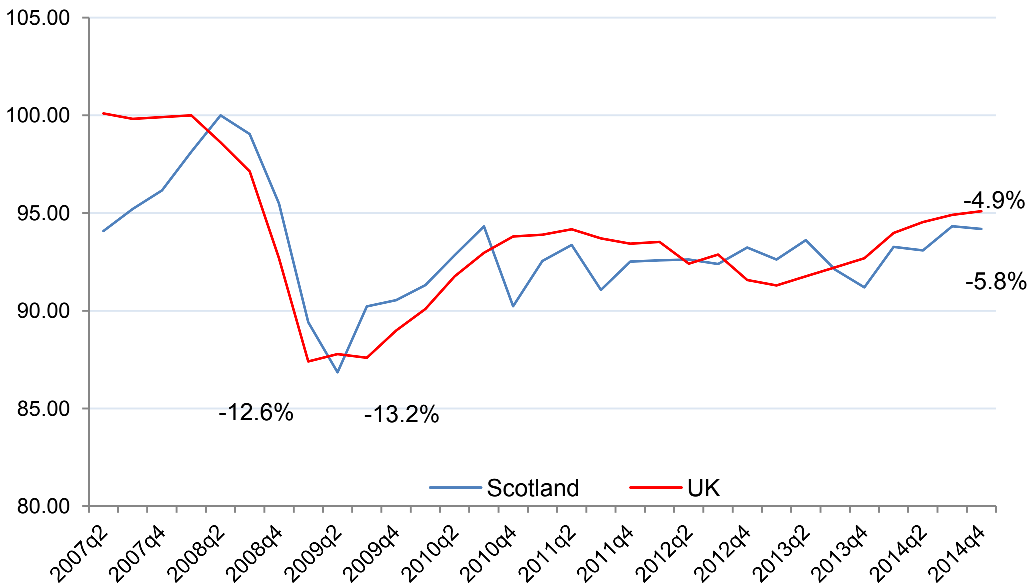


Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2014, and FAI calculations

Under the new ESA2010 data system the recovery in manufacturing is now weaker in Scotland than in the UK compared to the situation under ESA 1995. By the fourth quarter Scottish manufacturing GVA was -5.8% below its pre-recession peak, compared to -4.9% 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, in part influenced by the shutdown and reopening of the Grangemouth refinery in the final quarter of 2013 and the first quarter of 2014. But the fact that manufacturing output in Scotland has exhibited no growth since 2010q3 must be a cause for concern. The UK is a little better with around 2% growth since the second half of 2010 but that too is worrying.

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 UK and Scotland to 2014q4



Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2014, and FAI calculations

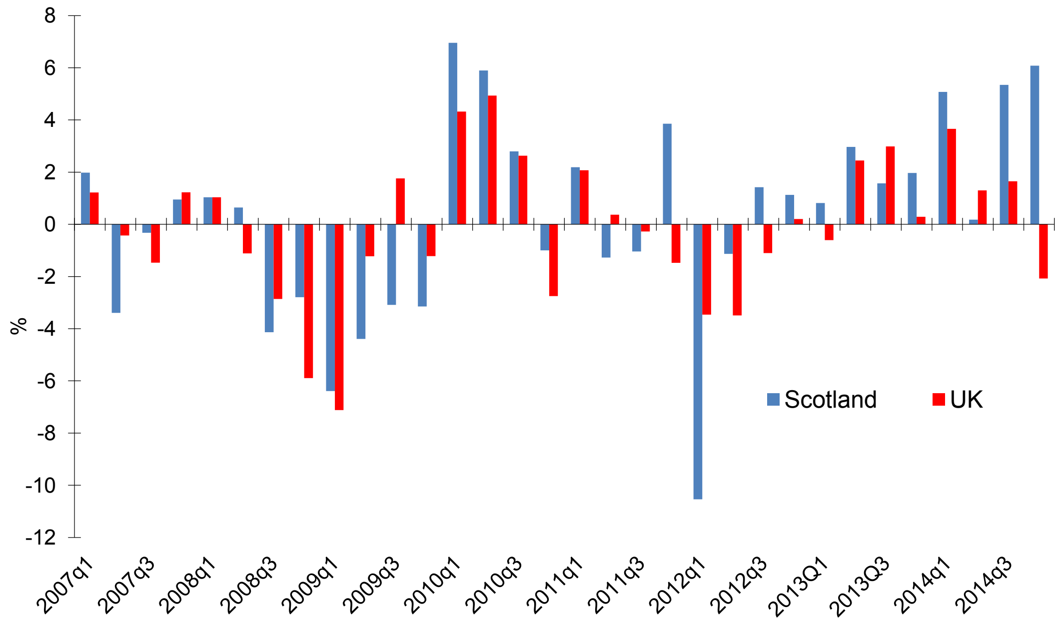
Within manufacturing, only three of the seven principal sectors experienced growth in the fourth quarter: food & drink (accounting for 27% of manufacturing GVA) grew by 2.7% in the quarter but contracted by -0.4% over the year; refined petroleum, chemical & pharmaceutical products (accounting for 13% of manufacturing GVA) which grew by 1.7% in the quarter and by 3% over the year; and transport equipment (accounting for 6% of manufacturing GVA) which grew by 1.2% in the quarter and by 0.1% over the year

The four manufacturing sub-sectors that contracted in the quarter were: clothing & leather products (accounting for 4% of manufacturing GVA) which contracted -0.3% and by -2.5% over the year; metals, metal products & machinery n.e.c. (which accounts for 17% of manufacturing GVA) contracted by -2% in the quarter but grew by 5.3% over the year; other manufacturing industries, repair & installation (accounting for 23% of manufacturing GVA) contracted by -0.9% in the quarter but grew by 1.4% over the year; and electrical and optical products (electronics) (accounting for 10% of manufacturing GVA), contracted by -5.1%% in the quarter and by -1.2% over the year.

Construction sector

Turning now to construction, the latest data are presented in Figure 8.

Figure 8: UK & Scottish Construction GVA Volume Growth 2007q1 - 2014q4



Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2014, and FAI calculations

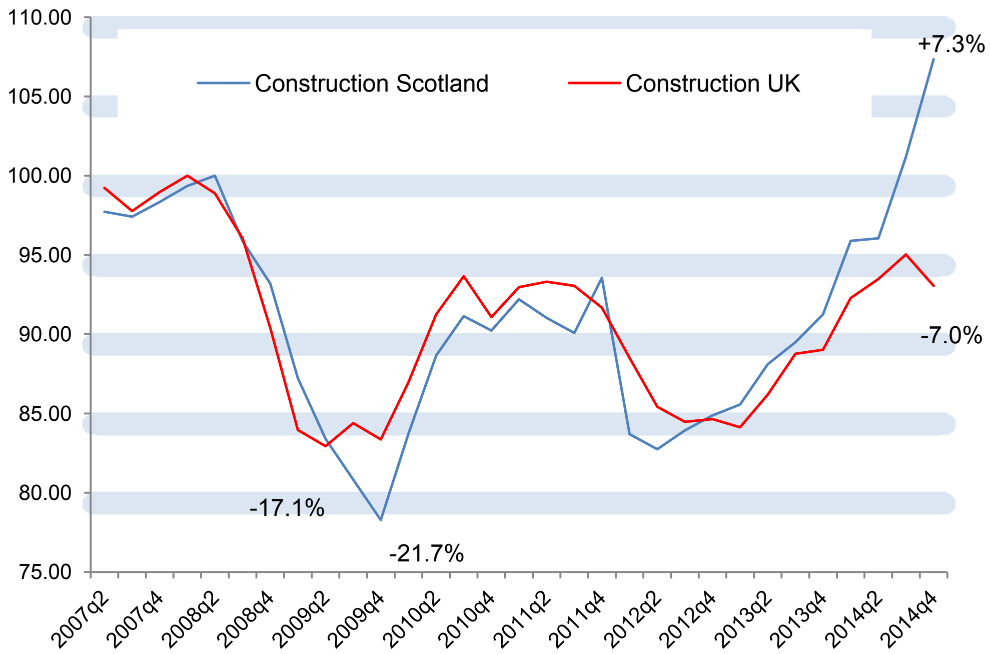
Scottish construction GVA grew strongly in 2014q4 by 6.1% and by 13% over the year, so that in the latest quarter it was the principal driver of growth in Scotland contributing +0.4% points. In contrast in the UK, construction contracted by -2.2% in the fourth quarter and grew by 7.4% over the year. Figure 9 displays the recession and recovery performance of both the Scottish and UK construction sectors.

Figure 9 highlights the variability of construction sector output during and since the Great Recession. The adoption of ESA 2010 has changed both the scale of the recession and the scale and path of the recovery. Under the new system the decline in GVA in the recession of -21.7% was a little greater than the -20.2% recorded under ESA 1995. The contraction in GVA in the UK was broadly the same. Post recovery volatility is also more muted under the new system but with a stronger recent recovery. Clearly the 'lumpiness' of construction investments especially in structures makes volatility inevitable with some of the recent burst in growth in Scotland down to activity in building the second Forth road bridge (The Queensferry Crossing). By the 2014q4 Scottish construction had moved to 7.3% *above* its pre-recession peak compared to UK construction, which was -7% below its pre-recession level.

Components of private services sector growth

Within services, one of the three principal sub-sectors in the private sector displayed negative growth in the fourth quarter. Business and financial services unusually contracted by - 0.2% in the quarter but grew by 3.4% over the year, compared respectively, to growth of 1.3% and 3.9% in the UK. Figure 10 shows the growth of the sector in Scotland and UK during the recession and recovery.

Figure 9: Construction, Recession and Recovery UK and Scotland to 2014q4

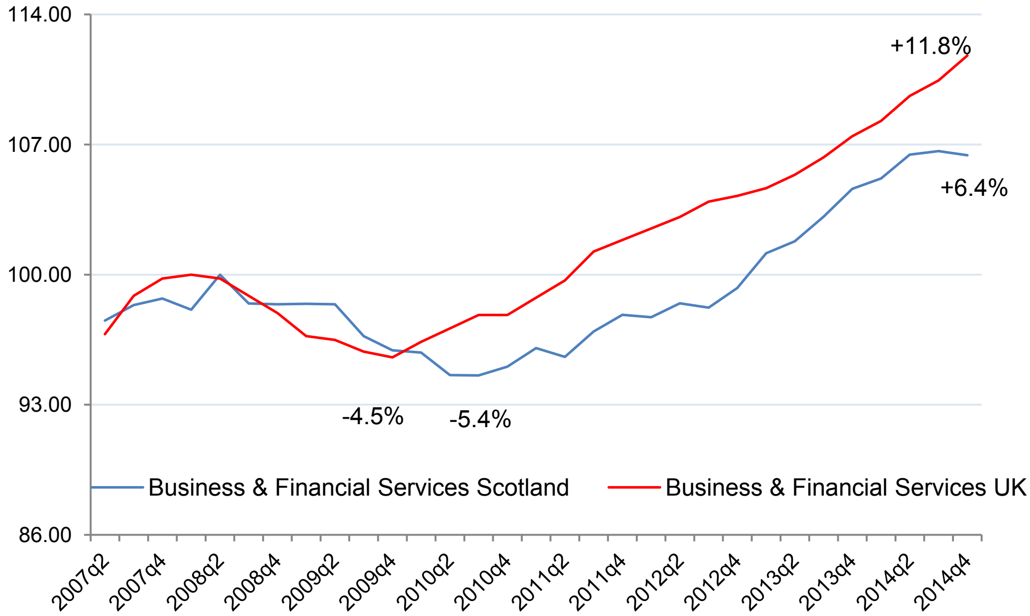


Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2014, and FAI calculations

Under ESA 2010 there has been a significant improvement in UK business & financial services activity both absolutely and relative to the UK. Whereas under ESA 1995 the sector in Scotland had recovered much faster than in the UK, the new system almost reverses the position. The scale of the recession now looks to have been less severe in both Scotland and UK with the new data showing a fall in GVA of -5.4% in Scotland and -4.5% in the UK compared to -7.4% and -6.9%, respectively, under ESA 1995. By the fourth quarter, output or GVA in the sector had moved to +6.4% above its pre-recession peak in Scotland compared to +11.8% in the UK and the recovery in the sector in Scotland appears to have slowed in the last two quarters. As noted in previous Commentaries, the aggregate GVA data for business and financial services in Scotland have recently masked significant differences between the performances of financial services on the one hand and business services on the other, where the former has been doing considerably worse than the latter. Figure 11 shows what has been happening to financial services in Scotland since peak output in the second quarter of 2008.

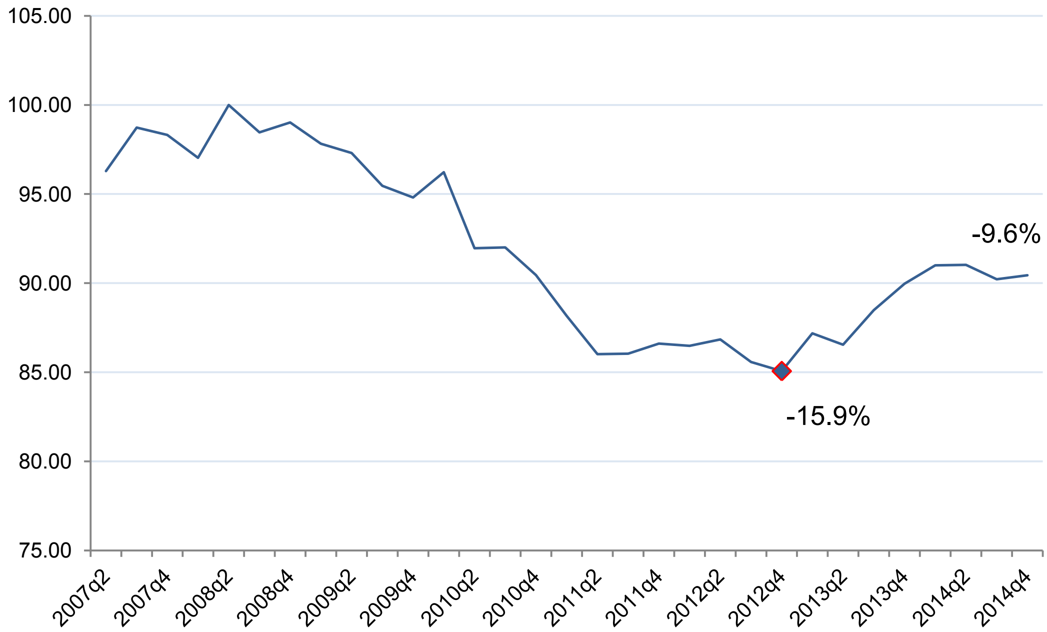
The chart shows that the latter recovery in the sector has faltered recently while the revisions under ESA 2010 now indicate that the sector is further away from its pre-recession peak than appeared to be the case under ESA 1995 e.g. -9.8% in 2014q3 on ESA 2010 compared to -7.8% in 2014q3 on ESA 1995. By the fourth quarter of last year GVA in the sector was -9.6% below the pre-recession peak compared to the trough of -15.9% in 2012q4.

Figure 10: Business & Financial Services UK and Scotland: Recession and Recovery to 2014q4



Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2014, and FAI calculations

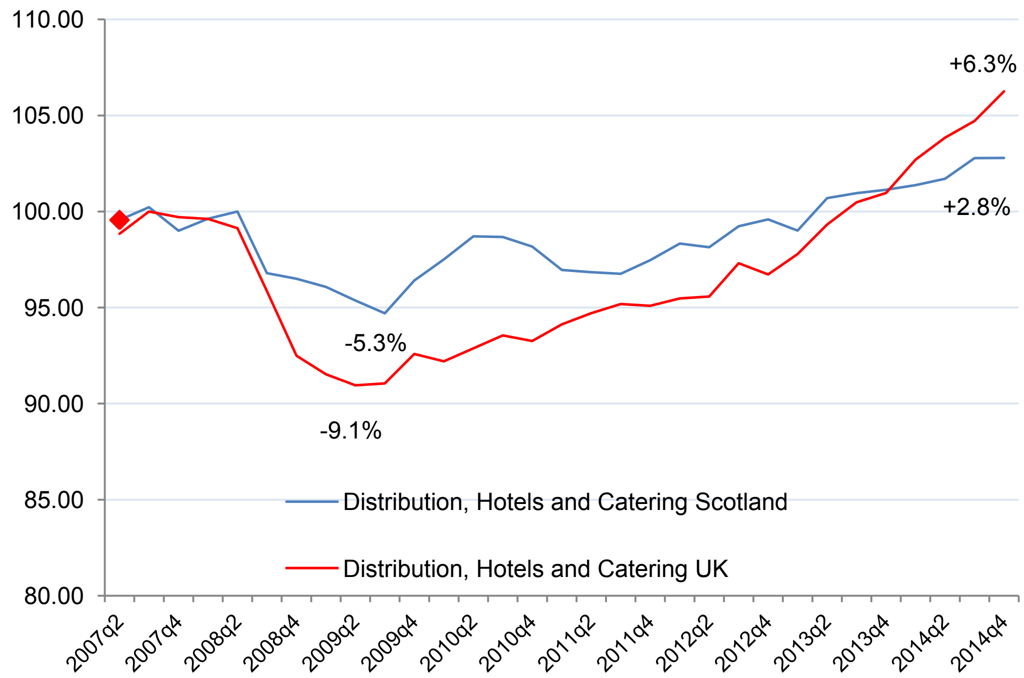
Figure 11: Financial Services in Scotland, Recession and Recovery 2007q2 to 2014q4



Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2014, and FAI calculations

The first of the two principal sub-sectors in private services *not* displaying negative growth in the fourth quarter was distribution, hotels and catering (accounting for 18% of services sector output in Scotland), where output was unchanged. Over the year, the sector grew by 1.7%. In the UK, the sector grew by 1.4% in the quarter and by 4.8% over the year. Figure 12 shows the performance of the sector during recession and recovery.

Figure 12: Distribution, Hotels & Catering: Recession and Recovery to 2014q4



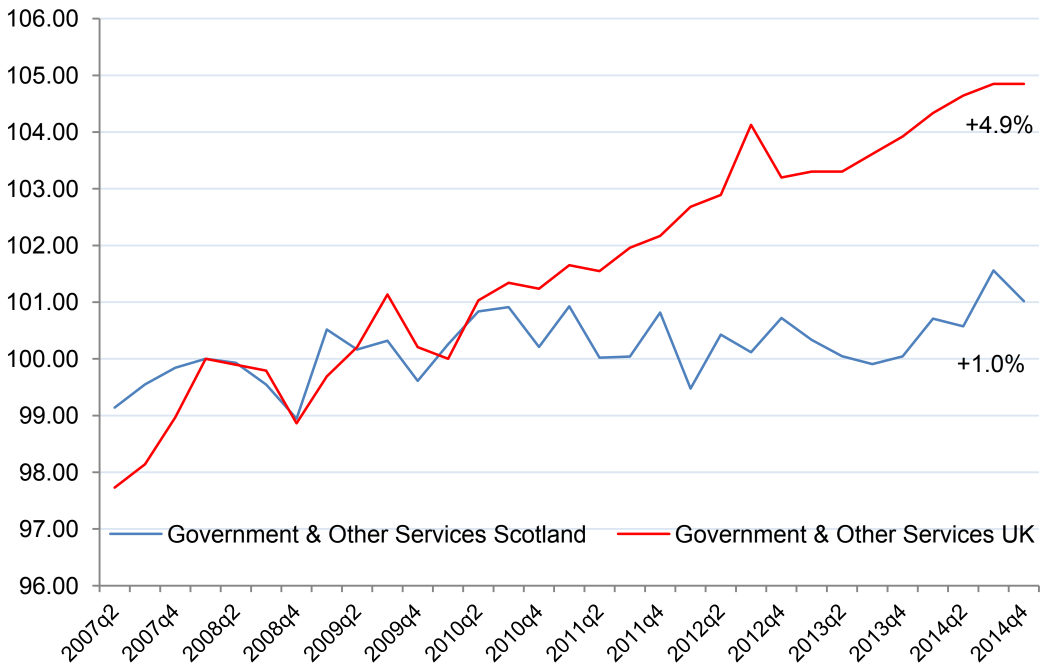
Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2014, and FAI calculations

Figure 12 reveals that by the fourth quarter the sector in the UK was +6.3% above its peak, while the sector in Scotland was doing much worse at only +2.8% above peak. The introduction of ESA 2010 looks again to have favoured output more in the UK sector than in the sector in Scotland, so again under ESA 1995 2014q3 GVA in the sector was 1% above peak in the UK and only +0.6% above peak in Scotland but under ESA 2010 GVA was +4.7% above peak in the UK and +2.8% in Scotland. The scale of the recession in the sector in both Scotland and the UK is less under ESA 2010 than under ESA 1995 with output falling in Scotland by -5.3% compared to -7.4% and in the UK by -9.1% compared to -10.0%. The track of the recovery in the sector picked up in the UK during 2013 and 2014 but not in Scotland.

Output in Government & Other Services fell in Scotland in the fourth quarter fell by -0.5% compared to no change in the UK. Over the year, output in the public sector grew by 0.9% in Scotland and by 1.1% in the UK. Figure 13 shows the performance of GVA in the sector in recession and recovery.

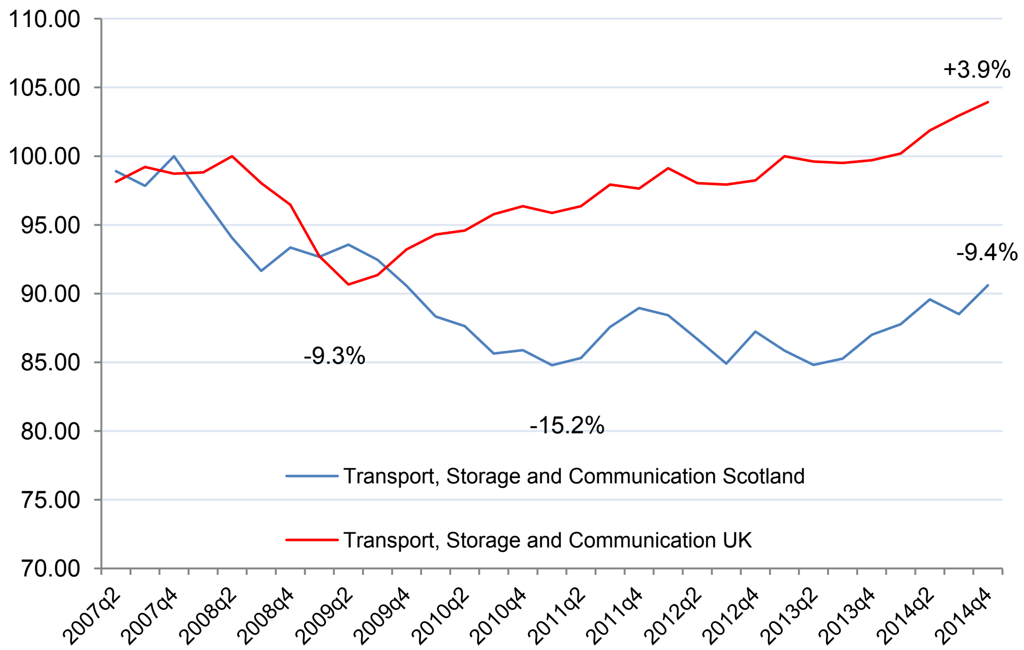
By the fourth quarter GVA in the government sector in the UK was 4.9% above the pre-recession peak, which as we have noted in many earlier *Commentaries* is difficult to understand at a time of fiscal consolidation, whereas output in the sector in Scotland was only 1% above its pre-recession peak.

Figure 13: Government & Other Services UK and Scotland: Recession and Recovery to 2014q4



Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2014, and FAI calculations

Figure 14: Transport, Storage & Communication UK and Scotland: Recession & Recovery to 2014q4



Source: Scottish Government GROSS DOMESTIC PRODUCT 4th QUARTER 2014, and FAI calculations

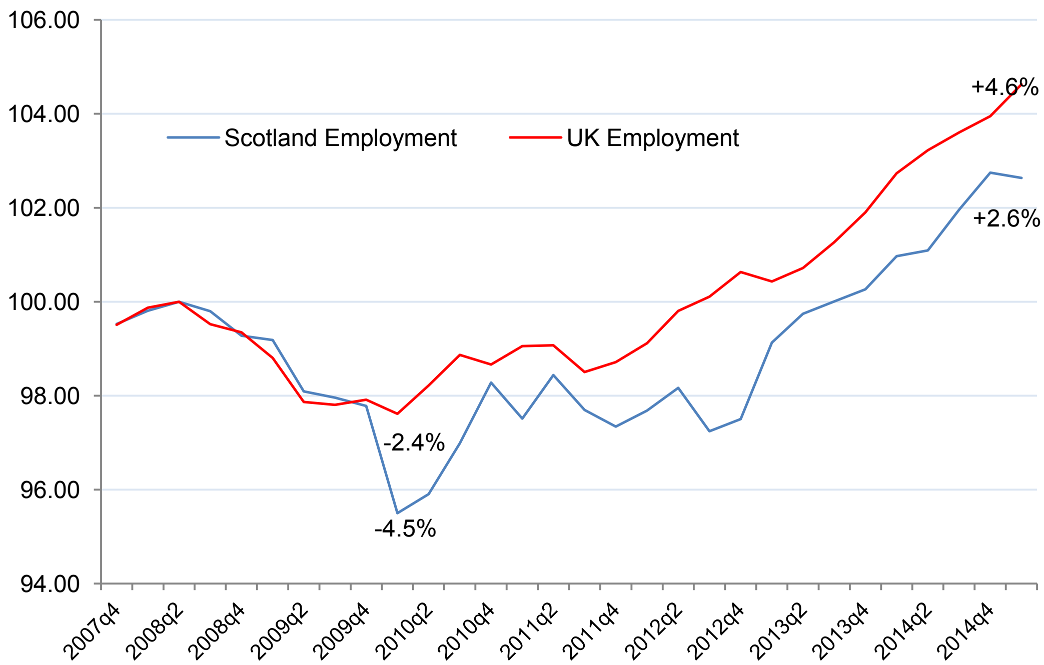
Finally, Figure 14 highlights the performance of transport, storage & communication in Scotland and UK in recession and recovery. The sector accounts for nearly 8% of total GVA and about 10% of service sector output.

The sector grew by 2.4% in Scotland in 2014q4 and by 0.9% in the UK. Over the year, growth was 3.9% in Scotland and 2.5% in the UK. On that basis it might appear that the sector is recovering more strongly in Scotland. However, under the new ESA 2010 system as Figure 14 shows, the sector has performed significantly differently than under ESA 1995 and much worse in Scotland. The recession was stronger and much more drawn out in the Scottish sector with output falling by -15.2% up to as late as 2011q1 whereas in the UK sector the recession was over by 2009q2. By the end of the fourth quarter GVA in the Scottish sector was -9.4% below its pre-recession peak compared to +3.9% above in the UK, a dramatic difference in the performance of the sector between Scotland and the UK.

The Labour Market

Figure 15 shows the performance employment in Scotland and the UK during recession and recovery to 2014q4.

Fig 15: Total Employment, UK and Scotland: Pre-recession peak to 2015q1



Source, ONS Regional Labour Statistics and FAI calculations

The latest labour market data for February – April 2015 published on 17 June 2015 (see *Scottish Labour Market* section below) show that the recovery has faltered slightly while employment rose as did unemployment. Specifically, employment rose by 14,000 (0.5%) in the quarter while unemployment rose again by 1,000 (0.7%) with the rate remaining unchanged at 5.9%. In the UK, employment rose a little more slowly, with 11,400 jobs created or a rise of 0.4%, while unemployment again fell by 43,000 (-2.3%) to a rate of 5.5%. Over the year, Scottish jobs rose by 53,000, a rise of 2%, while UK jobs rose

424,000, or 1.4%. Unemployment in Scotland fell by -19,000 over the year, or -10.6%, while in the UK unemployment also continued to fall even more strongly by -349,000, or -16.1%.

By the end of the fourth quarter, Scottish jobs as reported in the LFS household surveys were 2.6% *above* the pre-recession peak, while UK jobs were 4.6% higher than the peak. So, the latest data show the recovery in the labour market to be continuing but there is now some evidence that the rate of recovery is slowing in Scotland and overall the recovery remains stronger in the UK.

Challenges facing the Scottish economy

Now that the 2105 UK General Election is over and with the Holyrood elections less than a year away there may be a small window of opportunity for politicians and policymakers to reflect on the challenges facing the Scottish economy. It should not of course be concluded that any identified challenges confronting the economy are simply for the politicians and policymakers to deal with. Many of these challenges require a social consensus and community action or action by one or more key groups of actors in Scotland: for example, the business community, the unions, the voluntary sector etc. We would like to contribute to this process by highlighting some of the issues and challenges that we consider to be worthy of consideration and reflection.

One way of organising thoughts about the challenges is to separate them into the short-term and long-term. More specifically we can distinguish between capacity utilisation and capacity growth. In the former, we are largely focusing on the issue of demand deficiency, while the longer-term capacity growth question is essentially about supply. In the present *Commentary* we focus on the short-term capacity utilisation issue returning to the more long-term capacity growth question in the next issue of the *Commentary*.

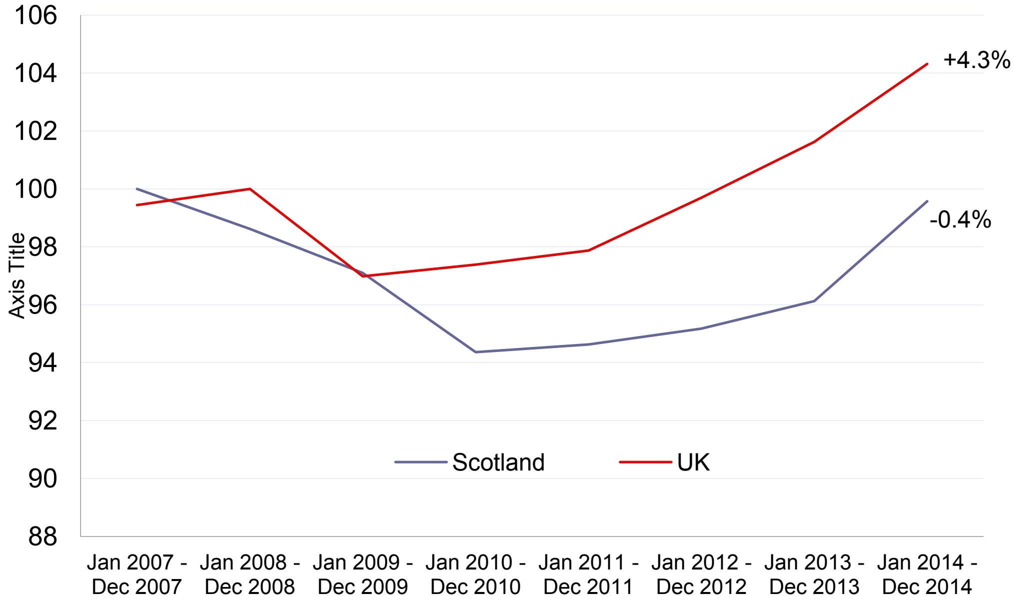
Capacity Utilisation

In considering the issue of capacity utilisation, we essentially seek to ask whether there is any room to expand output and create jobs before running up against a supply constraint and the risk of raised inflation. Once we hit that constraint then further growth with stable inflation can only be achieved by a sustained expansion of capacity. Despite the recovery taking hold more strongly after 2013 there is still spare capacity available in the Scottish economy and there are question marks about how sustainable the growth of demand is given that it still remains fairly unbalanced. A role for policy exists in both areas.

An indication that there is still a deficiency of demand in the economy comes from the Scottish labour market. We can look at the number of weekly hours being worked currently compared to the situation at the peak of capacity utilisation before the recession. Figure 16 charts this statistic from 2007 for the total weekly hours worked compared to the pre-recession peak for Scotland and the UK.

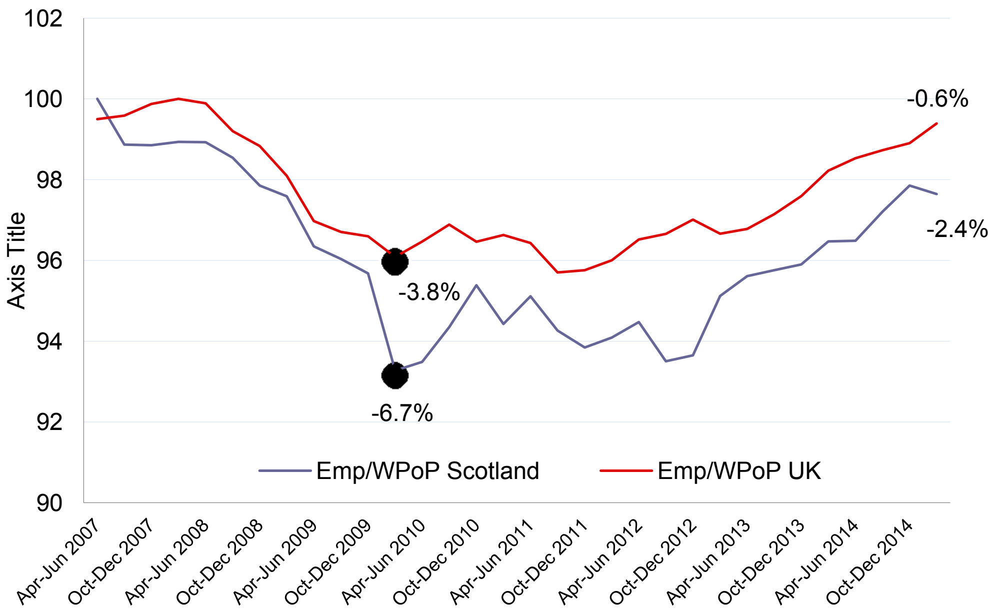
By the period January 2014 – December 2014, the number of total weekly hours worked in Scotland was close to but still -0.4% below the pre-recession peak. So despite the number of jobs being higher than before the recession, the demand for labour as measured by hours worked is still lower and appreciably lower relative to the UK which has expanded by 4.3%.

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



Source, ONS Regional Labour Statistics and FAI calculations

Figure 17: **Employment to population (16 & over) ratio, UK and Scotland in recession & recovery (Compared to pre-recession peak)**



Source, ONS Regional Labour Statistics and FAI calculations

But, of course, capacity utilisation depends not only on demand but also on demand in relation to supply. The demand for labour may be growing but if the supply of labour is growing more quickly then capacity utilisation will fall. One appropriate labour market measure is the employment to population (aged 16 and over) ratio. Figure 17 charts this ratio relative to pre-recession peak for Scotland and the UK to January - March 2015.

By January - March 2015, the ratio stood at -2.4% below the pre-recession peak, a worsening of the position in the final quarter of last year, compared to -6.7% at the trough of the recession. In the UK as a whole, in contrast the ratio is only -0.6% below its pre-recession peak but still below a peak that was attained 7 years ago. So while the jobs market has recovered substantially there is still a reasonable amount of slack in the labour market - especially in Scotland - and the need for a continuing growth of demand before capacity level are reached.

Yet, as we note above and have done in previous *Commentaries*, the growth of demand in the Scottish and UK economies continues to be unbalanced and because of that (and for other reasons) it may fail to be sustained. In the previous Commentary (Vol. 38, No. 3, March 2015), we highlighted the following positive and negative influences on the future growth of demand in the Scottish economy:

Positive influences:

- Currently strong and above-trend growth in Scotland and UK but now may be beginning to slow.
- 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, with demand growth depending on investment and household spending mainly fuelled by rising debt, which raises 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) though overall it will have 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.

Continuing positive influences

There have been only small changes to these positive and negative influences since we last reported. On the positive side, growth in the Eurozone economy picked up in the first quarter of this year with GDP rising by 0.4%, which while not fast growth may help to settle fears that a deflationary process has been set in train. US data offer a mixed picture with growth weak in the first quarter but evidence – retail sales - that household demand was strengthening in May 2015. The still low employment-population ratio and weak nominal wage growth all suggest that capacity utilisation is sub-optimal with clear evidence of spare capacity and that it will be a little time yet before the Fed raises interest rates in the US, although some are suggesting that the Fed rate could rise in September followed by a slow rise in small increments over several years. Against this background, the IMF has raised its forecast for GDP growth in the Eurozone in 2015 by 0.3% points to 1.5% and in 2016 by 0.2% points to 1.6%. Conversely, it has lowered its forecast for the United States in 2015 by -0.5% points to 3.1% and in 2016 by -0.2% points to 3.1%. Its forecast for overall world output remained unchanged for 2015 at 3.5% and rose very slightly – by 0.1% - to 3.8% for 2016. The latest UK CPI inflation data show that UK prices rose slightly – by 0.1% - over the year to May after the -0.1% fall in April, as fuel prices rose and falls in the price of food moderated. This also should put to rest the admittedly lesser deflationary concerns in the UK. House price growth appears to be moderating, especially in London, and inflation overall is expected to remain close to zero over the next few months until the large fall in fuel prices falls out of the annual calculation. Low inflation should help the growth of real wages to support household spending as nominal wages rise but only weakly by pre-recession standards with little productivity growth evident.

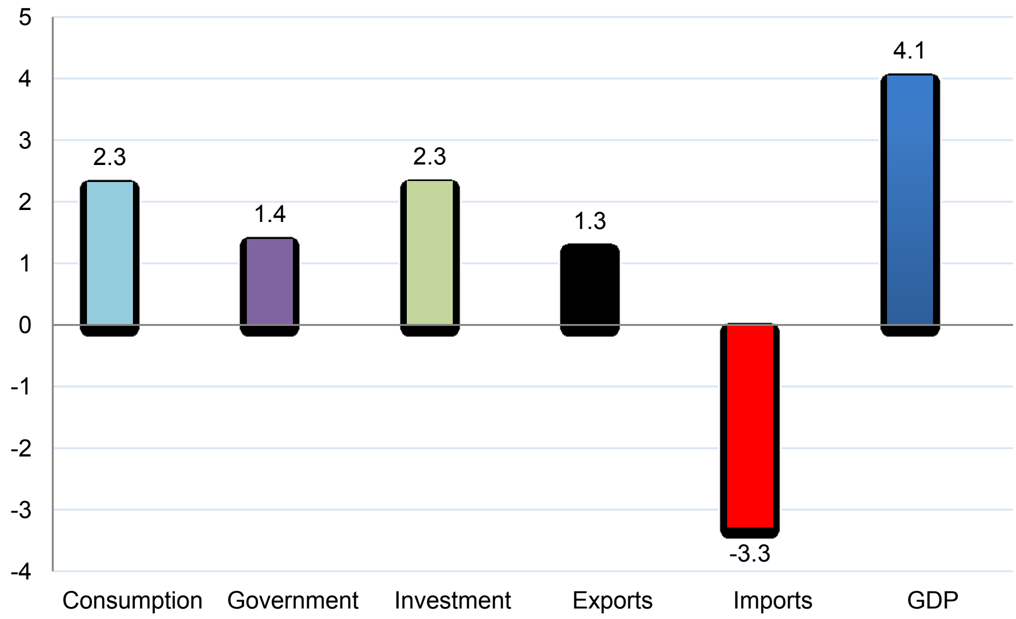
Continuing negative influences

On the negative side, the latest Scottish business surveys (see Business Surveys section) suggest that activity in the Scottish economy slowed in the first quarter of the year mirroring performance in the UK. The apparent slowdown may have been the result of the bad weather in January, the initial negative effects on the oil supply chain of the fall in the price of oil, and weakness in export markets exacerbated by the rise of sterling against the euro. However, expectations from the surveys remain positive and point to improved performance in the second quarter.

Growth remains unbalanced as Figure 18 shows and we have argued that the sustainability of the recovery will depend on a more balance recovery.

The data in Figure 18 are drawn from the latest *Quarterly National Accounts Scotland – Supplementary Tables*. The expenditure elements of these accounts are still based on ESA 1995 rather than ESA 2010 and so may be subject to change when they are so revised. However, it seems to us that it would be unlikely that the changes attendant upon the introduction of ESA 2010 would have much of an effect on the relative size and direction of the expenditure components, with the possible exception of investment. Household spending – consumption – and investment were the main drivers of Scottish nominal GDP growth in 2014. The significantly larger negative contribution of imports compared to the positive contribution from exports indicates that net trade was a major drag on Scottish growth in 2014. While exports are growing, they are not growing as quickly as other components of aggregate demand such as household spending and investment, a proportion of which is spent on imports, and so this effective net leakage in spending from the Scottish economy is a drag on growth. The continuing growth in consumption is to be welcomed but with the growth of real wages being close to zero spending is being sustained by rising household debt as noted in the previous Commentary. Figure 19 shows the latest OBR forecasts for the ratio of household gross debt to income.

Figure 18: Expenditure components of Scottish nominal GDP growth 2014: percentage contribution to GDP change



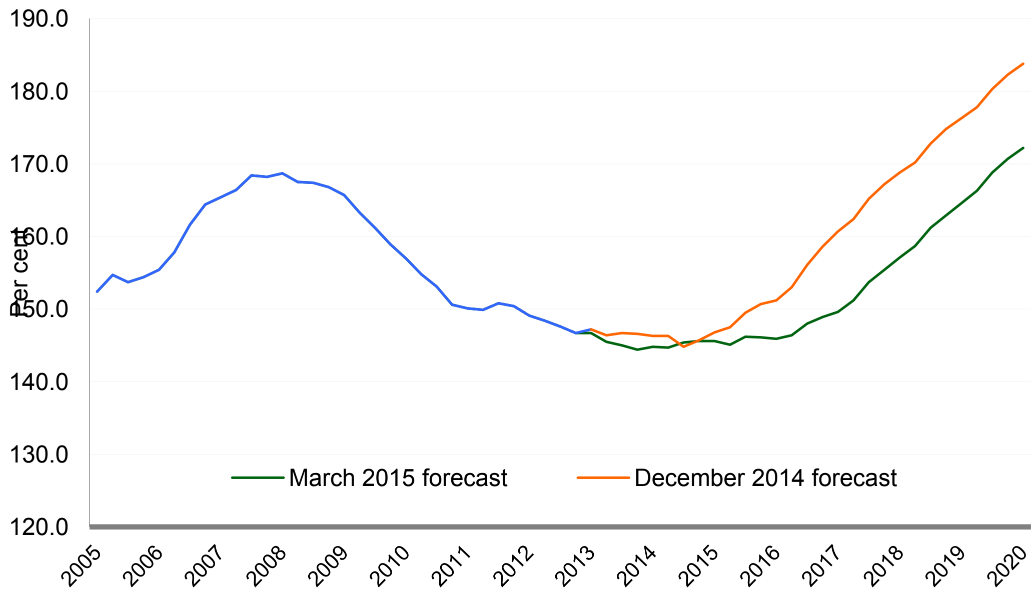
Source : Quarterly National Accounts Scotland - Supplementary Tables - ESA 1995 and FAI calculations.

What is clear from Figure 19 is that despite the downward revision between the December 2014 and March 2015 forecasts, the burden of gross household debt is still expected to rise *above* pre-crisis peak household debt before the end of the forecast period. While these are forecasts of gross debt and so take no account of the asset position of UK households it is nonetheless worrying that the Scotland and the UK's future growth over the medium term is forecast to depend on rising debt and debt that is predicted to rise above the level that was strongly associated with the financial crash and the onset of the Great Recession.

However, the one positive in the data presented in Figure 18 is that capital investment is recovering in Scotland. In 2014 there was strong investment in structures and particularly infrastructure as work intensified on the new Forth road bridge. In addition, the recent survey by Ernst and Young of investment into the UK including Scotland showed Scotland continued successfully to attract inward investment in 2014. According to the report, Scotland secured its third best year on record for Foreign Direct Investment:

- 80 projects in 2014, with scientific research, financial services and manufacturing the key activities (with interestingly manufacturing projects up from 15 to 31 projects)
- 2014 was Scotland's most successful year attracting investments from the US (46% - above trend), though the report suggests that Scotland needs a higher profile in Asia (particularly India and China where the UK performed well)

Figure 19: UK household gross debt to income: OBR forecasts (Dec. '14, March '15)



Source: Office of Budget Responsibility

An investor perception study also undertaken by Ernst and Young confirms Scotland's brand was boosted globally in 2014 by high-profile events such as the Commonwealth Games and the Ryder Cup. The report concludes that in an uncertain world, Scotland continues to punch above its weight in securing global FDI. Its challenge is to build further on its achievements to date, and tackle areas where it can do better.

In its latest State of the Economy Report, the Scottish Government's Chief Economist argues that its analysis suggests that the fall in the price of oil should have a broadly neutral effect on the Scottish economy in 2015 and 2016. This falls within the range of projected outcomes that we discussed in the March 2015 *Commentary*. Our feeling was that there was a strong chance there could be net benefits to the Scottish economy with the boost to real incomes and spending offsetting the negative effects on the oil industry supply chain and wider knock-on spending effects. The evidence to date is insufficient to draw any conclusions, although the softening of Scotland's economic growth suggested by the business surveys in the first quarter may be, in part, a reflection of the early incidence of the negative supply-side effects on the oil industry in Scotland.

The victory of the Conservatives with a small majority in the May UK General Election appears likely to lead to a continuation and perhaps a tightening of the previous Conservative / Liberal Democrat Coalition austerity plans. We shall find out more in the Chancellor's forthcoming Budget. The IFS noted in the its pre-election analysis of the parties' public finance plans for government that

"With significant deficit reduction still to come, households can expect the tax and benefit changes implemented over the next parliament to reduce their incomes, on average."

What that means is that household spending will also fall due to further austerity and the fall is likely to be greater the more quickly the Chancellor seeks to bring the UK government's budget into balance. Austerity will continue to be a major drag on capacity utilisation and economic recovery in Scotland and the UK.

Finally, a note about Greece. At the time of writing negotiations between the Greek government and its creditors appear to have broken down. The risk of Greece both defaulting on its debt and leaving the euro have increased since we last reported. This issue is again fast becoming a major risk to the recovery not simply in the eurozone but perhaps, with the threat of contagion effects, the rest of the world.

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: Forecast Scottish GVA Growth, 2015-2017

GVA Growth (% per annum)	2015	2016	2017
Central forecast	**2.5**	**2.3**	**2.3**
March forecast	2.6	2.4	n.a.
UK mean independent new forecasts (June)	2.4	2.4	
Mean Absolute Error % points	+/- 0.41	+/- 0.95	+/- 1.11

Source: Fraser of Allander Institute forecasts ©

Table 1 presents our forecasts for Scottish GVA - GDP at basic prices - for 2015 to 2017. 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 2015 is 2.5%, which is revised down slightly from our forecast of 2.6% in March of this year. The downward revision is due to the evidence of a slowing of the rate of growth through the first half of the year. For 2016, we have also revised down our forecast to 2.3% from 2.4% in March, in recognition that while the recovery is continuing the growth of demand is now anticipated to be slightly weaker than previously thought. We also are prepared to acknowledge that the negative effects of the oil price fall on the oil production and services, may be a little greater than we anticipated in March. We are forecasting 2017 for the first time and the underlying determinants suggest that growth will be little different from 2016 and so we retain the forecast of 2.3% for 2017.

Table 1, also compares our GVA forecasts with the median of latest independent forecasts for the UK as published by the UK Treasury in June 2015. These show that as forecasts are being generally revised down for the UK and Scotland we now expect Scottish growth to be slightly better this year than the UK, reflecting the relatively stronger investment in infrastructure north of the border. So, we are now forecasting growth of 2.5% in 2015, 2.3% in 2016 and 2.3% in 2017. Given our previous forecast errors the lower and upper bounds for growth in 2015 are expected to be 2.1% and 2.9%, for 2016, 1.3% to 3.3%, and for 2016, 1.2% to 3.4%.

Production and manufacturing continue to be the major sectors exhibiting the fastest growth in 2015, 2016 and 2017. Growth of production is forecast to be 2.9% in 2015, 2.8% in 2016 and 2.6% in 2017. Service sector growth is projected to be 2.4% in 2015, 2.2% in 2016, and 2.2% in 2017. The construction sector again continues to lag with growth of 1.4% in 2015, 1.3% in 2016 and 1.4% in 2017.

Employment Forecasts

Table 2: Forecast Scottish Net Jobs Growth in Three Scenarios, 2015-2017

	2015	2016	2017
Upper	62,100	72,650	80,600
March forecast	*64,215*	*85,790*	*n.a.*
Central	**51,250**	**49,600**	**51,700**
March forecast	*51,350*	*57,600*	*n.a.*
Lower	40,400	26,550	22,800
March forecast	*38,500*	*30,750*	*n.a..*

Source: Fraser of Allander Institute forecasts ©

Table 2 presents our forecasts for net employee jobs for the years 2015 to 2017 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.

The number of total employee jobs is forecast to continue to increase in each year, and at a faster rate than that seen during 2014 (although not as strongly as in 2013). Our forecast for the number of jobs added in 2015 has been revised down marginally since March's forecast, from 51,350 to 51,250. The number of jobs at the end of 2015 is now forecast to be 2,444,250, an increase of 2.1% in 2014 (the same percentage growth forecast as in March's Commentary). Our current forecast is that the Scottish economy will add 49,600 jobs in 2016, down by 8,000 from our March forecast, while we forecast the addition of 51,700 jobs in 2017. This year, we expect 28,150 service sector jobs to be created, with around 7,150 added in production, and growth of 950 in agriculture. Construction jobs are now forecast to rise this year by 14,962, reflecting the surge in activity in the sector. In 2016, the bulk of the jobs created are again expected to be in the service sector with an additional 41,000 jobs forecast, while 5,600 are added in production, 950 in agriculture and 2,050 in construction. In 2017, job creation in the service sector is projected to be even stronger at 43,300 jobs, with production adding 5,450, agriculture 700, and construction just under 2,200, *Unemployment Forecasts*

The key unemployment forecasts are summarised in Table 3 below.

Table 3: Forecasts ILO unemployment 2015-2017

ILO unemployment	2015	2016	2017
Rate (ILO un/TEA 16+)	**5.1%**	**4.5%**	**3.9%**
March forecast	5.0%	4.6%	n.a.
Numbers	**138,200**	**122,364**	**108,150**

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. The most recent figures (published on 17th June 2015) show an ILO unemployment rate of 5.9% for the three months to April 2015 – down from 6.6% on the same period one year ago. The level of unemployment stands at 163,000 in the same period this year, up 1,000 on the previous three months and down 19,000 over the last year. Given the small revisions to the growth in employee jobs over the next two years in our latest forecasts, there are only small revisions to the levels and rates from our earlier forecasts. Yet, the improvement in the labour market is forecast to continue with unemployment rates and numbers falling to end 2017. Our projection for unemployment on the ILO measure at the end of 2015 is 138,200 (5.1%), falling further to 122,364 (4.5%) by the end of 2016, and 108,150 (3.9%) by end 2017. It is worth noting that in our unemployment forecast for 2017, the unemployment rate finally falls to the rate it stood at when the Great Recession started in 2008, nine long years previously.

Brian Ashcroft
18 June 2015