2 Forecasts of the Scottish economy

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Abstract

The latest figures on economic growth in Scotland confirm that the Scottish economy grew by 2.7% during 2014: the fastest annual rate of growth since 2006. Recent evidence supports the view that much of the growth during 2014 was however from increases in household consumption, although there were signs of much welcomed growth in investment (largely from public infrastructure projects). Surveys point to a slowing of growth in the first half of 2015, while the extent to which growth will be sustained through 2016 and 2017 is critically dependent on the return of stronger real wage growth and an easing of household debt to income ratios, and the measures announced in the UK Government budget in July (and the outcomes of progress of further powers to the Scottish parliament). On the back of recent evidence, we have slightly revised down our forecasts for growth in 2015 and 2016 by 0.1 percentage points since March. Critically, Scottish export performance remains weak, and the possibility of fundamental change in the Eurozone driven by the outcome of Greek debt discussions - which are coming to a head at the time of writing - will be critical for the external economic environment facing Scotland in the short and medium term.

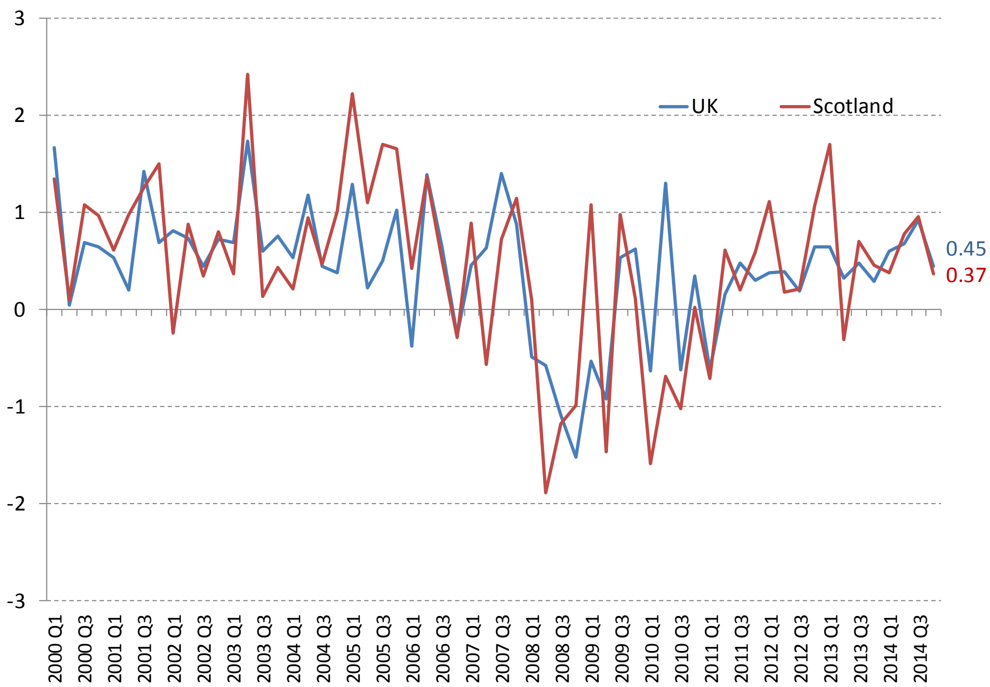
Survey context and recent trends

Households

Household spending continues to be important for the level of activity in the Scottish economy. On average, between 2013 and 2014, household spending contributed 0.60 percentage points to nominal quarterly growth, with Gross Fixed Capital Formation and Government contributing 0.47 and 0.15 points respectively per quarter. Net trade has contributed an average of *minus* 0.1 percentage points over the same period indicating issues both of Scotland's narrow export base and the economic health particularly of the Eurozone economies. The data on which these calculations are based – produced by the Scottish Government – are currently not available on the same basis as previously, so we will further examine trends in the Commentary later this year, when these data are available. The data that we do have suggests that the household element is diminishing as a source of growth, but that the domestic household sector remains the major driver of Scottish growth.

What is also clear from Figure 1 is that consumption expenditure since the start of 2011 has grown reasonably strongly – only in the second quarter of 2013 does there appear to have been a quarterly (real terms) fall in household spending. Most recently, it appears that Scottish consumption has grown almost identically to the UK as a whole, with growth of 0.37% in the most recent quarter in Scotland, and 0.45% in the UK. The household savings ratio for the UK has continued to remain below historic averages for the last twenty years, and for the UK was 5.9% in the fourth quarter of 2014. Comparable data for the fourth quarter in Scotland are not available, but Figure 2 shows that the lower savings rate of the UK as a whole through 2013 and 2014 has been mirrored in Scotland. Recent data on household spending, for instance the Retail Sales Index for Scotland, show that in the first quarter of 2015, spending in Scotland grew by less than in Great Britain as a whole, and fell in nominal terms over the year (while GB consumer spending in nominal terms increased). The latest figures on house price growth in the UK show a slowing from the previously high rates of growth, led by a weakening in price growth in London after a sustained period of significant growth. Transactions and therefore house price indices in Scotland were affected by the introduction of Land and Buildings Transactions Tax from the 1 April 2015 (with a greater number of high value house sales seeming to be brought forward in advance of its introduction).

Figure 1: Household real consumption spending growth, Scotland and UK, Q1 2000 to Q4 2014, (% quarter-on-quarter)



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 Q4 2014. These suggest that investment spending in real terms in Scotland and UK are, respectively, 13.3% and 14.1% above their 2011 value. This compares broadly with the GDP figures for the Construction sector in Scotland, which has risen sharply through the second half of 2014 and were 17.0% higher at the end of 2014 than their average during 2011. As noted above, investment spending is contributing positively to overall growth in Scottish economy, and in greater amounts than in the immediate aftermath of the recession period. Over a longer time horizon, investment spending remains broadly at the same level as 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. Confidence levels from recent surveys, for instance, the Scottish Construction Monitor, show high levels of confidence.

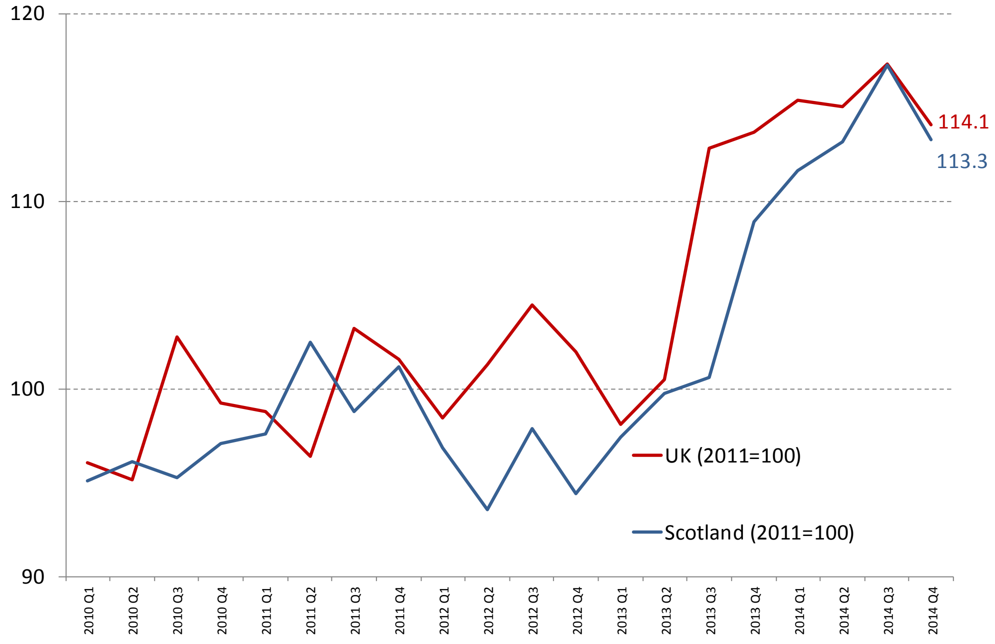
Figure 2: Household saving ratio, Scotland and UK, Q1 2008 to Q4 2014, %

Sources: *Scottish National Accounts Project (SNAP) data (Scottish Government) and UK Quarterly National Accounts (National Statistics) and FAI calculations. Note: Comparable Scottish saving ratio figures are only currently available to Q3 2014.*

Trade

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) – were published on the 22 April 2015, and cover the last three months of 2014. They show that on a quarterly basis, the volume of exports fell by -0.8% in the quarter (2014q3), and that on an annual basis (i.e. the four quarters of 2014 compared to the four quarters of 2013) there had been growth of this key measure of only 1.0%. This quarterly contraction was caused chiefly by disappointing figures that showed a fall of -1.5% in Food and Drink exports, with Drink exports – worth some 28% of all Scottish manufactured exports - falling by -2.0% in the quarter, and by -3.0% on an annual basis. Much of this decline was however caused by a sharp contraction during the first three quarters of 2013; since then the exports of the Drinks sector has been showing small increases before the most recent quarterly fall. There was also a continued quarterly contraction in Engineering exports from Scotland (down by almost -2% in the quarter, and in volume terms worth about one-quarter of all manufactured exports).

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*.

In terms of key markets for Scottish products, the latest figures suggest positive growth is continuing, but with major downside risks largely from the political discussions about the future of the Eurozone. On a number of measures, including Markit's PMI for the Eurozone in April 2015, suggest a slight weakening of activity, however it is an economy which is on average displaying "growth" signals. Clearly, as noted elsewhere in this *Commentary*, the massive "elephant" in discussions of the Eurozone's future is the outcome of current Greek debt negotiations. For the reasons noted in earlier Commentaries, these decisions will have a major impact on the economic future of major trading partners of Scottish firms, and not directly on the sales of exports from Scotland *per se*. Additionally, Scottish banks have major exposure to Eurozone borrowing, and will feel the outcome of any significant movements on this front. Writing in mid-June (and with a "immoveable object" of Greece "bundling up" debt repayments from throughout the month into one single payment at the end of the month) it seems likely that any movement on Greece and the Eurozone will occur quickly and will have profound consequences firstly for the Greek economy, the economies of the Eurozone – absent a major plan to move faster on greater sharing of debt risks – and the UK and Scottish economies.

Growth in the US is forecast to continue to strengthen, with continued strong business and consumer confidence and positive labour market signals including, in the IMF's language, "steady job growth". The low oil price – although massively damaging for shale producers and specific regions across the US that had previously enjoyed an energy "boom" - is likely to aid production and consumer spending through 2015. In the longer term in the US, however there is uncertainty around the pace and trajectory for interest rates. "Liftoff" – the point at which interest rates are expected to begin to be raised – is forecast by many to occur in the third quarter of 2015, and will have consequences for the continued growth through 2016. As the single largest destination for Scottish exports outside the UK, this will have a direct consequence for many of Scotland's key exporting companies.

The IMF also noted there was scope for advanced economies to bolster policy support for growth, highlighting opportunities for infrastructure investment and supply-side policies to speed up medium-term prospects. Developing countries, on the other hand, continue to see a slowing of growth prospects, and while a number will be affected significantly as major oil producers, the factors affecting the oil price do not affect other commodities and reflect market specific consequences. Overall, the IMF model that global output could be between 0.5% and 1% higher during 2016 as a result of the lower price of oil – although this depends crucially on the extent to which low oil prices translate into lower costs of energy to households and industries. As we noted in our March 2015 *Commentary*, the consequences for Scotland – while likely to be less positive than for the UK as a whole – will not be uniform, with already signs of lower activity in the North East of Scotland, where many firms active in the UK Continental Shelf are based. The Scottish Government's Chief Economic Advisor argued in June 2015's State of the Economy publication that its economic modelling work found that the "overall net effect on the economy in 2015 and 2016 should be broadly neutral".

Table 1: Economic growth forecasts for 2015 and 2016 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 (April 2015)	Revision since January 2015	IMF (April 2015)	Revision since January 2015
USA	5.3	3.1	-0.5	3.1	-0.2
Netherlands	2.8	1.6	-	1.6	-
Germany	2.6	1.6	+0.3	1.7	+0.2
France	2.5	1.2	+0.3	1.5	+0.2
Denmark	1.9	1.6	-	2.0	-
Norway	1.5	1.0	-	1.5	-
UK	62.4	2.7	0.0	2.3	-0.1
China	0.8	6.8	0.0	6.3	0.0
Japan	0.4	1.0	+0.4	1.2	+0.4
Euro area	-	1.5	+0.3	1.6	+0.2

***Sources:** World Economic Outlook (International Monetary Fund, IMF, April 2015). Notes: "-" indicates a country forecast is not produced, "n/a" indicates that the share of exports from Scotland to Euro area countries is not available from official sources..*

Table 1 shows the forecasts for growth in key markets for Scottish exports through 2015 and 2016. Since our previous forecasts in March 2015, economic forecasts for the UK this year have remained broadly flat. The average of 2015 forecasts in February 2015 was 2.6%, and range between 2.0% and 3.0%. The Office for Budget Responsibility forecast growth in this year of 2.5% in March 2015. Forecasts for 2016 averaged 2.3% in March, with a range between 1.2% and 3.0% (HM Treasury, 2015), while in May the average of forecasts made in the last 3 months is 2.4% (with the range the same as earlier in the year).

Forecasts for the Scottish economy: in 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 now have on the performance of the Scottish economy in 2014. The first release, published on the 15 April 2015, shows that growth in the final quarter of 2014 was 0.6% and annual growth in 2014 was 2.7%: the fastest annual growth rate for the Scottish economy since 2006. This meant that after Q1 2014 there were three consecutive quarters of 0.6% growth for Scotland during 2014. The annual growth outturn figure was therefore slightly higher than our forecast made in March 2015, with an absolute forecast error of 0.2 percentage points, and so slightly higher than our forecast error over that forecast horizon (0.164 percentage points) for all FAI forecasts since 2000.

Moving to 2015, for the UK as a whole the official “Preliminary estimate” of UK growth in the first quarter (published on the 28 April 2015) was 0.3%, down from 0.6% in the final quarter of 2014. In a separate and new ongoing piece of research, Fraser of Allander Institute “Nowcasts” of the Scottish economy also reveal a slight slowing in Scottish growth for the first half of the year compared to the end of 2015. This research currently “nowcasts” quarterly growth of 0.52 per cent for both Q1 and Q2. As well as suggesting a pattern of growth in the first half of 2015 consistent with the second half of 2014, they are also consistent with no significant adjustments to the growth outlook since our forecasts in March 2015.

Looking to the longer term, it appears that household spending will continue to play a major role in the next year, although since March, the figures on the growth in investment appear to have improved: in line with earlier surveys of investment intentions. On the consumption side, the Monetary Policy Committee noted at its May meeting that the inflation rate on the CPI measure was precisely zero (0.0%) in March, largely due to persisting low energy prices. It also noted that it was likely that productivity and hence real wage growth would remain low during 2015, with total pay growth likely to return to levels of around 4% seen prior to the great recession from mid-2016 onwards. Private sector pay growth has risen in the recent figures, but at 2.2% is around half of its pre-2008 level. The recent Markit Economics Report on Jobs provides some evidence of higher growth in salaries in Scotland than in the UK, driven as much by worsening labour availability as by increased demand. The Bank of England noted that there was little evidence that low inflation was feeding into inflation expectations.

Early in February 2015, the Cabinet Secretary for Finance and Sustainable Growth John Swinney MSP set out the Scottish Government’s final budget plans for year 2015-6, including (a headline measure) total spending about 1.6% less in real terms than the previous year. Fiscal Affairs Scotland has examined the long-term projections to the Scottish budget over the coming years, and concluded that 2015-16 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). More recent work however examining the funding for Scottish local authorities – which is around 10% lower in the current financial year than compared to 2009-10, and in (indicative) real terms, comparable to financial year 2003-4 (Fiscal Affairs Scotland, 2015). (This is only indicative as much activity which was previously within Local Government budgets – such as police and fire and rescue services – is now funded separately).

The outlook for overall UK government spending will be confirmed in the new Conservative government's Budget on 8 July 2015. Some measures have already been announced, including a reduction of £12 billion to the social security budget which could include reductions in tax credits and housing benefits for both private and social tenants. Additionally, reductions in (non-protected) areas of Department spending will have consequences for public spending in Scotland – although the powers devolved through the Scotland Act and Smith Commission proposals could lead to policy divergence between Scotland and UK over the longer term. The IFS for example project a fall in the block grant to Scotland of less than 6.6% between 2015-16 and 2018-19. More will be known on the specific immediate path of spending in Scotland after July's Budget, and this will continue to have an impact upon economic activity in Scotland.

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 2015, 2016 and 2017. This is the first time that we have forecast growth for 2017. 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.

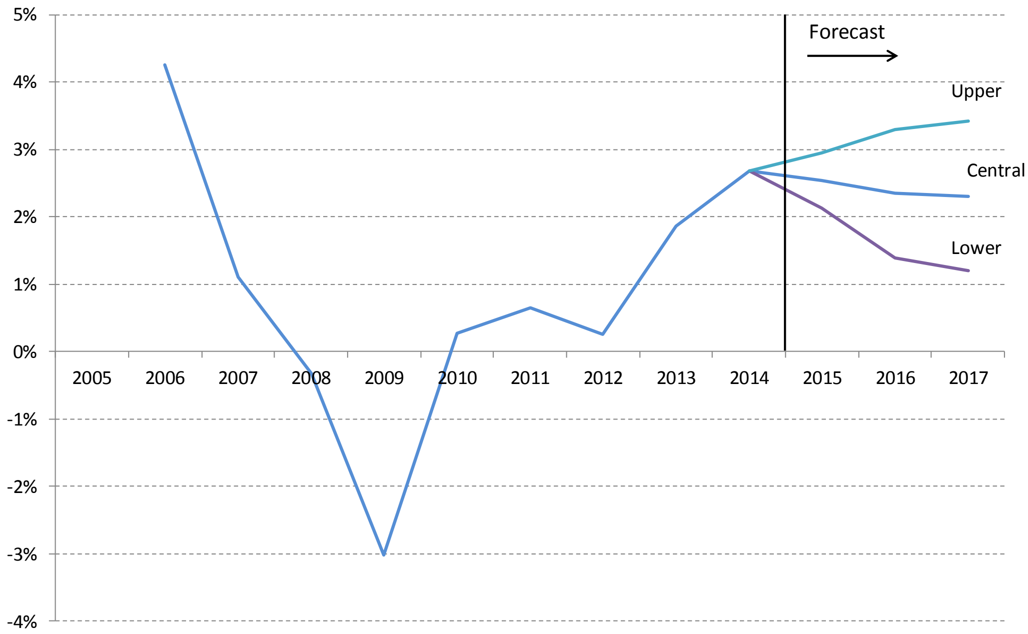
We begin with the forecasts for GVA growth in the Scottish economy. The growth performance of Scotland between 2010 and 2014 and our forecasts for the period 2015 to 2017 are shown in Figure 4. This also includes our upper and lower forecasts of growth. As previously, the range around the central forecast is based on our past forecast accuracy of the first release of growth data for the year.

Based on FAI forecasts since 2000, the mean absolute error of forecasts (i.e. the difference between forecast and "outturn" annual growth) made in the summer for growth in that same year is 0.41 percentage points, while for the following year the average absolute forecast error is 0.95 percentage points. This gives the range for the upper and lower bands in 2015 and 2016. Our past forecast errors for the longest forecast horizon is 1.111 percentage points, so this is used to give the range around our central forecast for 2017.

Relative to our March 2015 forecasts we have now revised down slightly our central forecast for GVA growth in 2015 from 2.6% to 2.5% (i.e. a downward revision of 0.1 percentage points since our March 2015 Commentary) and this is largely driven by evidence of a slightly slowing of the rate of growth through the first half of the year so far. Our forecast for 2016 was 2.4% and we have similarly revised this down by 0.1 percentage points, to 2.3% annual growth. Our first forecast for 2017 is 2.3%. We are therefore, on our central forecast predicting the same rate of growth in both 2016 and 2017.

For comparison purposes, the UK's Office for Budgetary Responsibility (OBR) forecast for growth in 2015 (made in March 2015) and the median of new independent growth forecasts for the UK in 2015 are 2.5% and 2.6% respectively, while for 2016 the respective figures are of 2.3% and 2.4%.

Figure 4: **Actual and forecasts of annual real GVA (%) growth for Scotland, 2015 to 2017**



Sources: *Fraser of Allander Institute forecasts, June 2015 ©*

In addition to the aggregate growth forecasts in our central scenario, Table 2 presents our forecasts for GVA growth in 2015, 2016 and 2017 for three broad sectoral groupings: the "production", "construction" and "services" sectors of the Scottish economy.

Table 2: **Forecast Scottish GVA growth (%) by sector, 2015 to 2017**

	2015	2016	2017
GVA	2.5	2.3	2.3
Production	2.9	2.8	2.6
Construction	1.4	1.3	1.4
Services	2.4	2.2	2.2

Source: Fraser of Allander Institute forecasts, June 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 2015, 2016 and 2017 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 2,393,000 employee jobs in Scotland in the final quarter of 2014, an increase of 37,000 jobs from the end of 2013, only slightly lower than the number of jobs forecast in March 2014 to be added during the year (39,000). This follows the addition of 76,000 jobs in the Scottish economy during 2013.

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 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 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. The net change in employee jobs, consistent with our upper, central and lower forecasts for GDP growth, is shown in Table 4.

Table 3: Forecasts of Scottish employee jobs ('000s, except where stated) and net change in employee jobs in central forecast, 2015 to 2017

	2015	2016	2017
Total employee jobs, Dec	2,444,250	2,493,850	2,545,550
Net annual change (jobs)	51,300	49.600	51,700
% change from previous year	2.1	2.0	2.1
Agriculture (jobs,000s)	26	27	30
Annual change	950	950	700
Production (jobs, 000s)	244	250	255
Annual change	7,150	5,600	5,450
Construction (jobs, 000s)	149	151	153
Annual change	14,962	2,050	2,199
Services (jobs, 000s)	2,025	2,066	2,110
Annual change	28,150	41,000	43,342

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

We present out forecasts for unemployment at the end 2016 and 2017 in our central scenario in our central forecasts in Table 5. 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.

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

	2015	2016	2017
Upper	62,100	72,650	80,600
Central	51,250	49,600	51,700
Lower	40,400	26,550	22,800

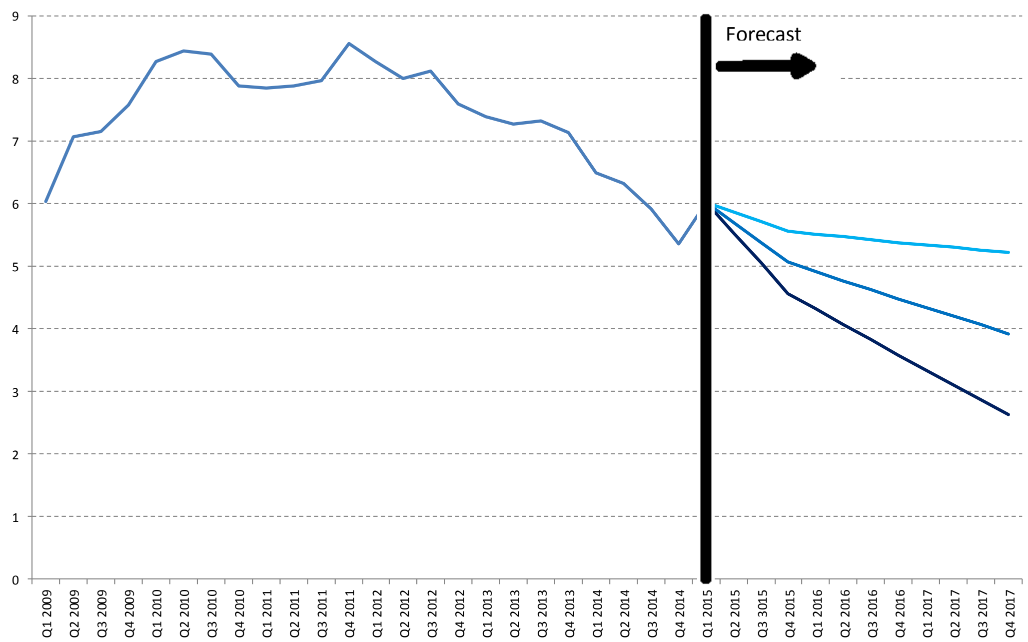
Note: Absolute job numbers are rounded to the nearest 50.
Source: Fraser of Allander Institute forecasts, June 2015 ©

Table 5: Forecasts of Scottish unemployment in central forecasts, 2015 to 2017

	2015	2016	2017
ILO unemployment	138,200	122,364	108,150
Rate (%)[1]	5.1	4.5	3.9

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, June 2015 ©

Figure 4: Scottish ILO unemployment rate, 2009 to 2017 including forecasts from 2015



***Sources:** ONS and Fraser of Allander Institute forecasts, June 2015 ©*

More detail on recent trends in the Scottish labour market can be found in the Labour Market Section of this *Commentary*. In March 2015, we forecast that the unemployment rate would fall to 5.0% by the end of 2015, and 4.6% at the end of 2016 in our central scenario. 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. The most recent figures (published on 17 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. Our new forecasts for the unemployment rate in Scotland at the end of 2015 and 2016 are 5.1% and 4.5% respectively. We forecast the improvement in labour market outcomes to continue, with the level and rate of unemployment falling to the end of 2017, but the decline in absolute numbers unemployed falling by less than in 2016. 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.

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16th June 2015

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