Forecasts of the Scottish economy

Summary

Despite continued challenges in the domestic and external environment, there are little signs that some of the downside risks to growth in 2013 are likely to materialise. There is growing evidence of a recovery in the United States, and while some Eurozone countries have seen their growth forecasts downgraded in recent months, forecasts by major institutions for the Euro area as a whole have not been revised down as significantly as they have been on occasions over the last four years. Following revisions to some of the (experimental) national accounts data for Scotland, an interesting pattern of pre-recession divergences in income and expenditure between Scotland and the UK as a whole has emerged, which will require further examination to explore its consequences for the future path of consumer spending growth in Scotland. We have kept our forecast for growth in Scotland through 2013 at 0.9%, with a minor revision of our forecast for 2014 to 1.6% from 1.7%. Our forecast for growth in 2015 is now 2.1%, up by 0.2 percentage points. The jobs outlook for Scotland is forecast to improve relative to our previous forecasts with modest growth in net employee jobs each year through the forecast horizon.

Households

Figures for wage growth across the UK as a whole – a comparable figure for Scotland is not available - show that (private sector) average weekly earnings growth slowed markedly at the end of 2012 and into 2013, growing at 1.4% in the final quarter of 2012 and 0.8% in the first two month of 2013. With inflation remaining above this rate, and the Bank of England's expectations for it to remain so through the medium-term, earnings continue their real terms decline. Falling real wages are likely to prolong the point at which households feel their finances to be "sustainable", although some respite in Scotland could come from the restatement of some increases in public sector earnings, although these are capped at 1% which remains below cost of living increases.

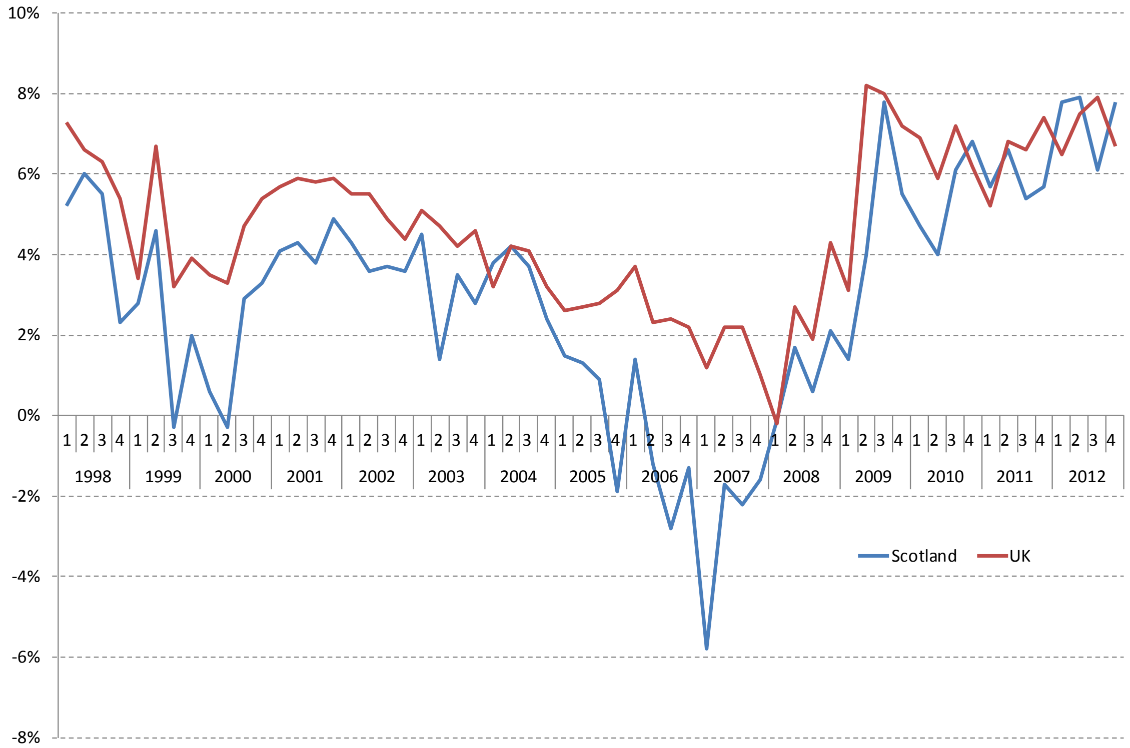
Short term house price indices have recorded smaller falls in house prices in Scotland than the UK as a whole, and the average house price has remained stable since the start of 2010. The UK House Price Index reports that house prices in Scotland to February 2013 were down by 1.2% in a year, less than the fall in Northern Ireland (-7.7%) but house prices in Wales rose by 4.1% and prices in England rose by 2.1% in the same period. Taking out London and the South East of the UK, UK prices still rose by 0.6%.

House prices on average are around 9% below their 2008 peak, having fallen 12% from their peak by the start of 2009. Price expectations have increased in the last four months, while housing transactions are around half of the numbers seen before 2008. Mortgage advances in the final quarter of 2012 were up 6% from the same quarter of the previous year in both Scotland and the UK. At the same time, the level of new housing completions remains stubbornly below pre-recession levels. Private new build completions fell between 2011 and 2012 to 9,862 over the year, down by around half from the levels seen between 1997 and 2008.

Markit's Household Finance index for the United Kingdom followed its fall earlier in 2013 with a positive movement in the most recent (May) release. This index has moved up from its lowest levels and has recorded the slowest deterioration seen since May 2010. While still some distance away from the 50 base line of "no change", this movement was explained by positive movements in future income expectations.

Figure 1 shows how the household savings ratio has evolved to the final quarter of 2012 in both Scotland and the UK. These data – which have been significantly revised since the last publication of SNAP earlier in 2013 – now imply that Scottish households had a number of quarters of negative savings in the pre-recession period, and have since increased savings ratios to the same levels as for the UK as a whole. The previously observed (positive) difference between Scottish and UK households savings ratios for much of the last decade, has been reduced markedly in these most recent data. One possible avenue which may explain some of the observed divergence between the Scottish and UK figures comes in the latest Bank of England's Inflation Report. This reports figures from the (UK) living costs and food survey which show that high-debt mortgagors (those with a mortgage of more than twice annual disposable income) had negative savings ratios in the period prior to 2008, and that these households have made significant reductions in spending since. While the UK figures are not broken down to the regional level, it would be revealing – as well as being useful for tracking the extent of household debt deleveraging to have occurred since 2008 – for the evolution of household financial debt in Scotland over the last decade to be examined in more detail.

Figure 1: Household savings ratios, Scotland and UK, Q1 2000 to Q4 2012



Sources: (Experimental) Scottish National Accounts Project data (Scottish Government) and UK Quarterly National Accounts (National Statistics).

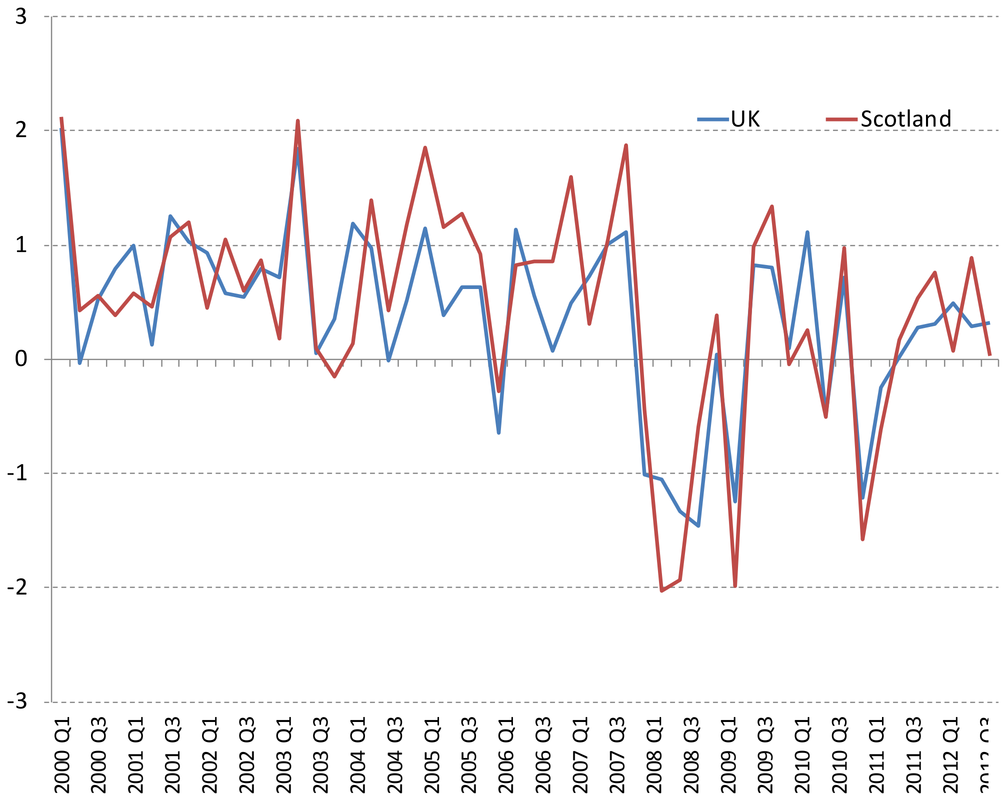
The Scottish Retail Index published on the 1st of May reported that volume of retail sales in Scotland rose by 0.3% in the first three months of 2013, while the value of sales was up 0.6% from the last quarter. The volume of retail sales in Scotland on this measure was stronger in Scotland than Great Britain as a whole.

Comparable Scottish and UK data on household income and consumption growth are available up to the final quarter of 2012. These show that in the final quarter of 2012 consumer spending in Scotland rose by only 0.03% - the smallest amount since the second quarter of 2011. UK consumer spending grew by only 0.32% in the same quarter (See **Figure 2**). Relative to its pre-recession peak, the levels of consumer spending in the final quarter of 2012 are 3.4% and 2.8% below in Scotland and the UK respectively.

Investment

The output of the Scottish construction sector – the sector most heavily affected by investment spending – rose in the final quarter of 2012, recording three successive quarters of growth. Growth over 2012 was however down from 2011 due to a sharp fall at the start of 2012. In output terms, short of an unlikely rapid pickup in new investment projects it seems likely that 2013 will see continued slow growth. Domestic private house building remains flat, while there is no sign of housing market confidence reappearing soon.

Figure 2: Household real quarterly consumption spending growth, Scotland and UK, Q1 2000 to Q4 2012



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

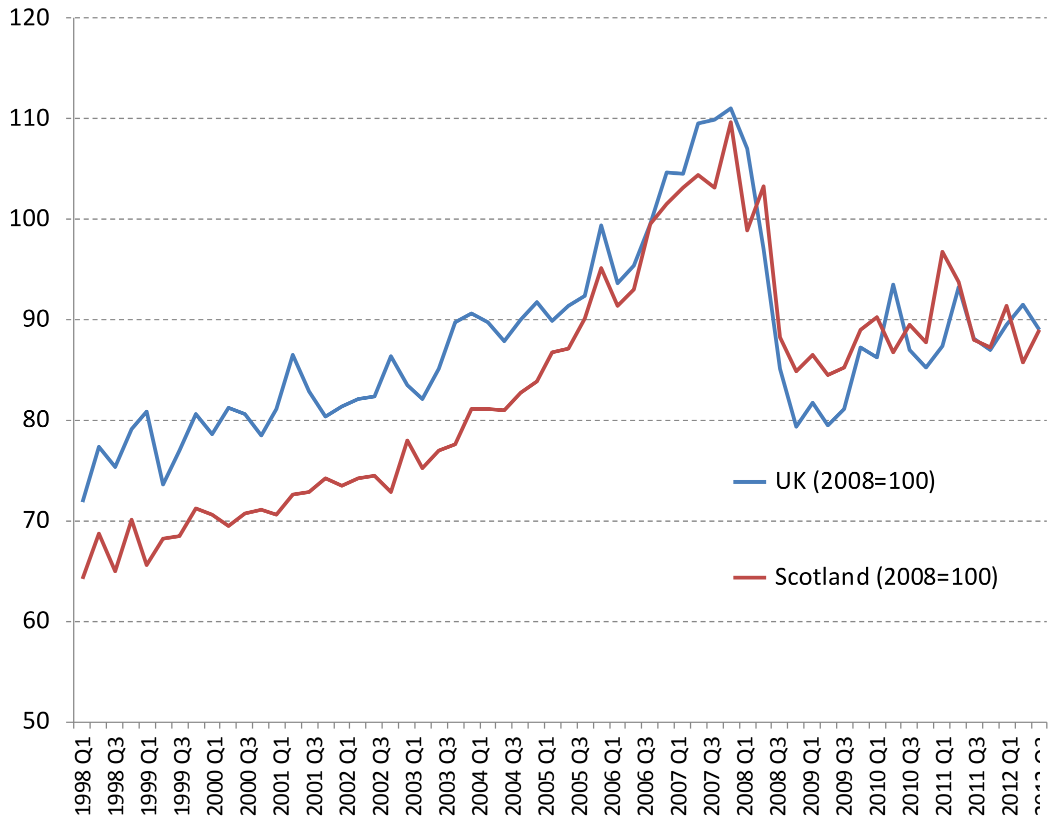
In the UK as a whole the most recent figures on output in the construction sector indicated that the volume of sectoral output was at its lowest level since the final quarter of 1998. “Private-commercial other new work” remains stubbornly below pre-recession levels.

Figure 3 shows that real investment spending (including public and private spending) in the UK and Scotland remains significantly below its pre-recession values. Additionally, it also indicates that while the two quarters to Q3 2012 saw increases in investment spending in the UK, since the second quarter of 2011 investment spending in Scotland has fallen relative to its level in 2008. Changes to the SNAP data from which these data on investment comes has moved the Scottish series much closer to that of the UK than had previously been observed from the available data. The revised series shows a peak to trough fall in real investment of 22.9% in Scotland and 28.5% in the UK as a whole, while investment spending is 18.8% and 19.8% below its pre-recession peak in Scotland and the UK respectively.

Trade

The rest of the UK provides the largest market for goods produced in Scotland outside the Scottish economy. The latest (preliminary) growth data indicate that UK GDP growth was 0.3% in the first quarter of 2013, indicating that UK output has been broadly flat over the last 18 months. The most recent Index of Production figures for March 2013 supported this picture, with production up 0.2% on the quarter but down 1.4% compared to the level one year earlier.

Figure 3: Real gross fixed capital formation, Scotland and UK, Q1 1998 to Q4 2012



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

The latest data on exports from Scotland to the (non-UK) rest of the world show that during the fourth quarter of 2012 Scottish exports fell by 1.4%. Exports from Scotland in real terms fell between 2011 and 2012 by 2.9%. This quarter on quarter decline came despite growth in exports by four industries– "Food and Drink", "Textiles, clothing and leather", "Wood, pulp, paper, publishing and printing" and "Metal and non-metal products". Exports by the "Food and drink" sector were the only area in which growth over the year was seen, and its growth was 0.6%.

The latest Bank of England Inflation Report notes that while world trade growth was slower in 2012 than in any year since 2008, the UK's share of world trade fell, in particular caused by UK financial services exports declining.

The most recent forecasts for the international environment suggest a continued worsening of countries' prospects as we begin 2013. The International Monetary Fund, OECD and European Commission have all significantly cut their growth forecasts again, after doing so through the latter half of 2012. Latest forecasts for GDP growth in major Scottish international export markets and revisions from earlier forecasts are shown in Table 1. The National Institute's latest forecasts for the UK as a whole conclude that UK export volumes will actually decline during 2013. In particular this will be driven by a fall in exports to the Euro Area and broadly flat growth in exports to non-EU countries. The significant reduction in growth prospects for the Eurozone suggests that the European export market will remain generally weak for Scottish producers over the next couple of years.

Advance estimates of US GDP growth in the first quarter of 2013 revealed growth of 2.5% on an annualised rate, up from 0.4% growth at an annual rate in Q4 2012 (when growth was principally affected by a significant decrease in federal defence spending). US consumer spending grew by 2.2%

on an annual rate in the quarter, reflecting strong spending in services, while the household savings rate fell to 2.6% - its lowest rate since the start of 2009. Private investment growth slowed, but remained positive, but there was a significant upturn in both inventory investment and exports. Goods exports rose in the quarter although imports also rose, so trade did not directly contribute to the change in real GDP seen in the first quarter.

The very latest Eurozone PMI revealed that while still in overall contraction territory, the index had eased for the second month running in May 2013. New order business fell for the 22nd successive month, indicating the continued and ongoing weakness of new business in the Euro area. Again there was some divergence between nations, with the index for Germany easing into expansion territory, while those for Spain, Italy and France remaining in contraction. The survey evidence appeared consistent with continued recession for the Eurozone through 2013 as both the IMF and OECD continue to forecast. As Table 1 indicates, for the Euro area as a whole, growth forecasts for 2013 have been revised down by both these organisations in the last six months, with a sharp deterioration in the forecasted growth for France - which is Scotland's third largest (non-UK) export market.

Table 1: Economic growth forecasts for 2013 and 2014 for major Scottish export markets, plus UK, China, Euro area and world, including changes from earlier forecasts where available, %

	2013				2014			
	IMF (April 2013)	Revision (since January)	OECD (May 2013)	Revision (since Dec 2012)	IMF (April 2013)	Revision (since January)	OECD (May 2013)	Revision (since Dec 2012)
USA	1.9%	-0.2%	1.9%	-0.1%	3.0%	-0.1%	2.8%	0.0%
Netherlands	-0.5%	n/a	-0.9%	-1.1%	1.1%	n/a	0.7%	-0.8%
France	-0.1%	-0.4%	-0.3%	-0.6%	0.9%	0.0%	0.8%	-0.5%
Belgium	0.2%	n/a	0.0%	-0.5%	1.2%	n/a	1.1%	-0.5%
Germany	0.6%	0.1%	0.4%	-0.2%	1.5%	0.0%	1.9%	0.0%
Ireland	1.1%	n/a	1.0%	-0.3%	2.2%	n/a	1.9%	-0.3%
UK	0.7%	-0.3%	0.8%	-0.1%	1.5%	-0.3%	1.5%	-0.1%
China	8.0%	-0.1%	7.8%	-0.7%	8.2%	-0.3%	8.4%	-0.5%
Euro area	-0.3%	-0.2%	-0.6%	-0.5%	1.1%	0.0%	1.1%	-0.2%

Source: World Economic Outlook, International Monetary Fund (April 2013), World Economic Outlook Update, International Monetary Fund (January 2013), Economic Outlook No. 93, OECD (May 2013) and Economic Outlook No. 92, OECD ***(December 2012).***

Forecasts for the Scottish economy: Detail

On the domestic side of the economy, the fiscal contraction at the UK level and new changes to the household income through welfare changes starting in April 2013 is likely to make a negative contribution to household spending growth. The distributional consequences of wage and welfare changes will be important for the growth of overall household expenditures, but we are unable to capture this within our forecasts. Household spending growth slowed at the end of 2012, and although retail sales measures suggest an increase in Scotland compared to GB as a whole, it is likely that retail sales will be largely flat in the continued presence of weak household income growth and with the higher household saving rates in Scotland compared to the UK.

In our central forecast, we have retained the forecasted slow overall growth in household consumption growth through 2013, which is in line with current surveys of the domestic outlook. Government expenditure growth is forecast to continue its real terms contraction through the forecast horizon.

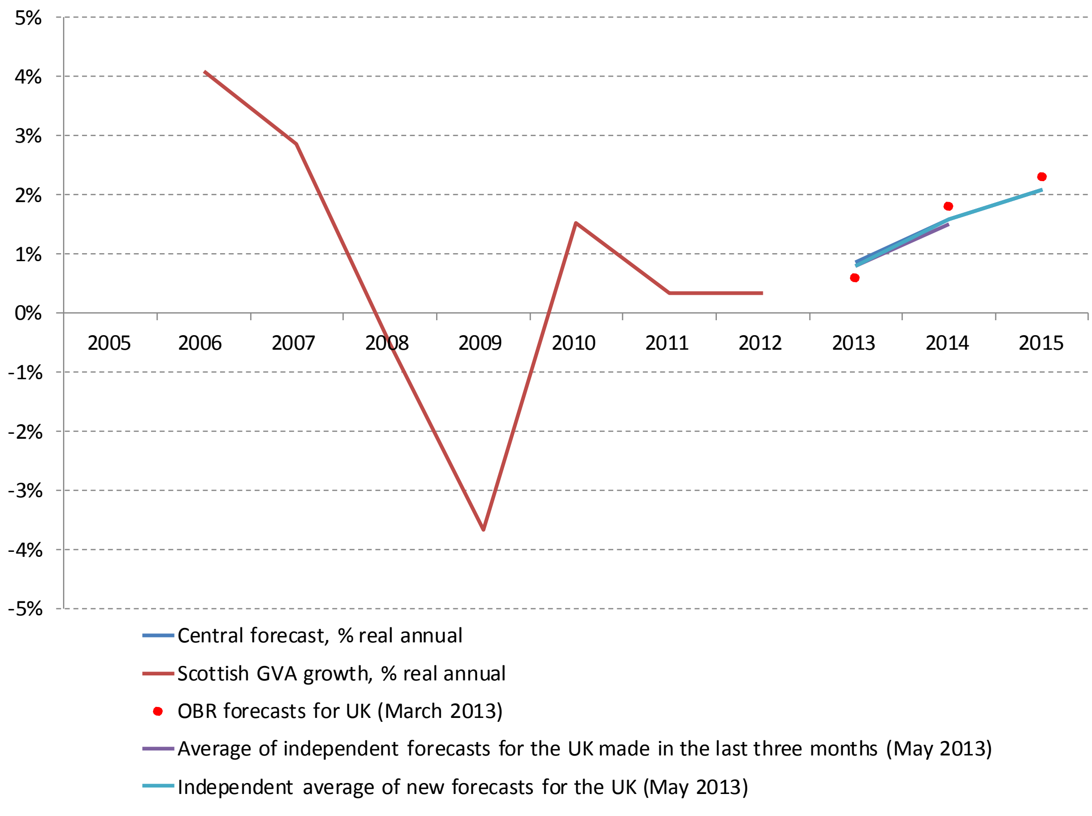
The most recent survey evidence for manufacturing in Scotland and UK reported a slight improvement across many sectors, with capital expenditure particularly strong in the UKCS. Survey data for the construction sectors suggests that there may be tentative signs of growth in future quarters. Commercial construction activity remains weak, but growing, through 2013 on our central forecast.

The external market for Scottish goods and services has evolved slightly in the last quarter. There is continued weakness in the economies of the Eurozone – Scotland's major non-UK market for exports – as well as most forecasters revising down growth expectations for the UK economy over 2013 and 2014. The most recent survey evidence however, points to increased confidence if not orders in the Eurozone, and more positive signs of recovery in the United States.

Results

In this issue of the *Commentary*, we are forecasting the year-on-year real growth in key economic and labour market variables, including aggregate Gross Value Added (GVA) and employment and unemployment, over the period 2013 to 2015. The model used is multi-sectoral, and where useful, results are reported for sub-aggregate sectors. Given the release of Input-Output tables – showing the pattern of production and consumption in the Scottish economy, and links to other economies – we have updated the model to SIC2007 industries, and to operate at the same classification as sectors which are reported in the GDP figures for Scotland.

Figure 4: GVA growth for Scotland, 2013 to 2015, and comparisons to UK forecasts, annual real %



Sources: Fraser of Allander Institute forecasts, Office for Budgetary Responsibility and HM Treasury (various months).

We begin with the (central) forecasts for growth in the Scottish economy. Our new forecasts for 2013, 2014 and 2015 are shown in **Figure 4**. This also shows for comparison purposes only, a number of different sources forecasts for the UK over the same period. These sources are the Office for Budgetary Responsibility (OBR) which last forecast in March 2012, and will release new forecasts later in November 2012, the median of recent forecasts produced by professional forecasts for each year of the forecast window.

Our forecasts for real GDP growth in Scotland in 2013, 2014 and 2015 are now 0.9% and 1.6% and 2.1% respectively. Our forecast for growth in 2013 is slightly lower than that forecast in our last Commentary, but rounding to a single decimal means that it remains at 0.9% for the year. Our forecasts for growth in 2014 is 0.1 percentage points lower than we forecast in March 2013 while our forecast for 2015 is revised up by 0.2 percentage points.

In particular, a slightly weaker outlook for household spending through 2013 is partially offset by increased expectations for business investment growth and only modest changes to (trade weighted) non-UK export markets for Scottish products.

In addition to these aggregate growth forecasts, **Table 2** presents the GVA forecasts by broad industrial grouping, i.e. for the “production”, “services” and “construction” sectors.

Table 2: Growth (%) by sector in the Scottish economy, 2013 to 2015

	2013	2014	2015
Gross Value Added	0.9%	1.6%	2.1%
Production	1.1%	1.9%	2.5%
Construction	0.7%	1.2%	1.3%
Services	0.8%	1.5%	2.0%

Source: Fraser of Allander Institute forecasts

We use our calculated past forecast errors (e.g. the difference between aggregate growth forecasts and what outturn figures were) to show the potential range of outcomes around our central forecast.

For forecasts made in the summer period, our forecasts for growth in that year have had a mean absolute error of 0.440 percentage points. The same error in forecasts for the following year (i.e. 2014) is 1.031 percentage points.

Again, we use the mean absolute error for the longest forecast period for the longest forecast – in this issue, to 2015 - as we do not yet have a long history of forecasts of growth made over a three year horizon. These historical errors give the ranges around our central estimates of Scottish GVA growth shown in Table 2 above. The estimated range around our central forecasts of GVA growth in each year is shown in **Figure 5**.

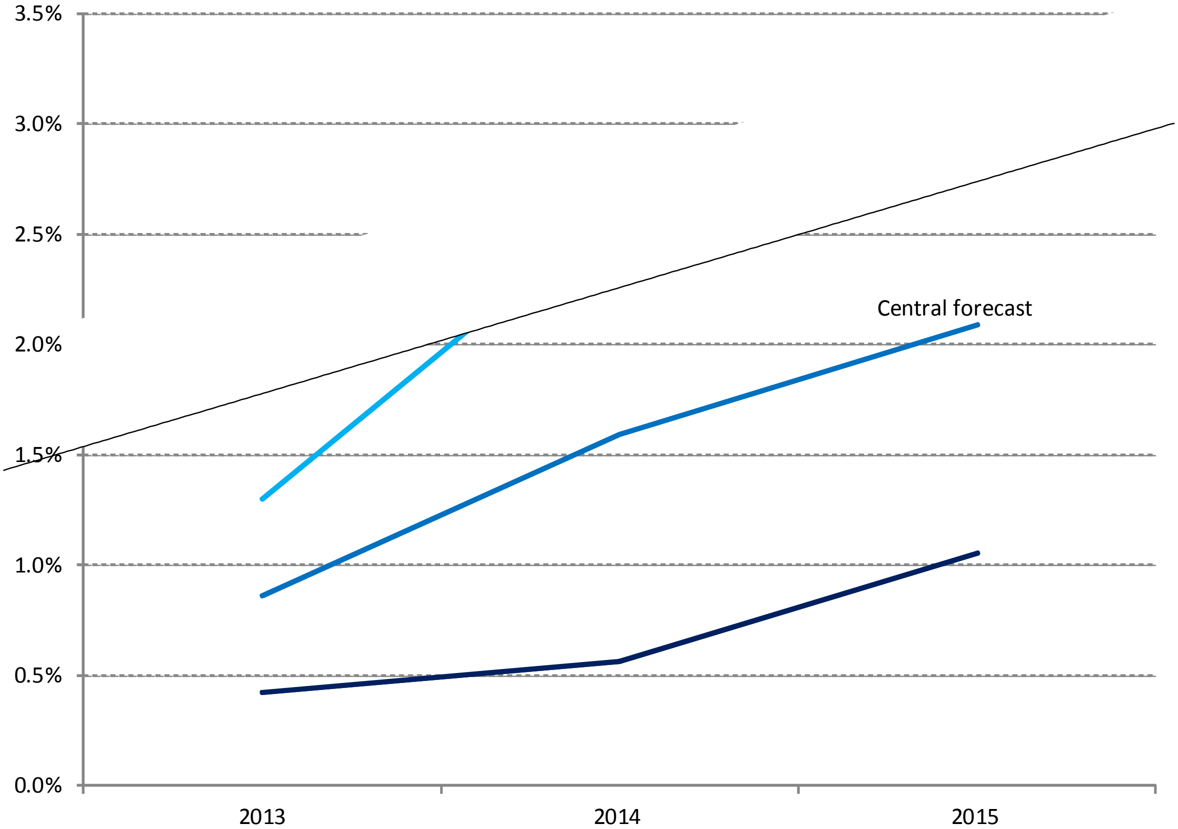
Employment

Detailed commentary on recent developments in the Scottish labour market is available in the *Labour market* section*.* In this section we focus on trends and forecasts for the number of (employee) jobs in the Scottish economy.

The most recent data on the number of (employee) jobs in Scotland are available to the end of the fourth quarter of 2012. These indicate that the number of jobs in Scotland at the end of 2012 was 2316 thousand, an increase of 38,000 since the end of 2011. In March’s Commentary, we had forecast an increase in employee jobs between the end of 2011 and 2012 of 32,650. The level of employee jobs forecast was 2,294 thousand, while the outturn data currently estimated that there were 2,316 thousand jobs in Scotland at the end of 2012, indicating that the employee jobs series itself had been revised up since our last forecast.

Our forecasts for employee jobs in 2013, 2014 and 2015, including a breakdown by broad sectoral groups, are shown in **Table 3**. The number of employee jobs in 2013 is forecast to increase by just over 12,000 from the end of 2012, and up from almost 9400 increase forecast in March 2012. Most of this increase in job numbers through 2013 is due to a forecast rise in the number of jobs in “Service” industries. Through 2014 and 2015 we expect the number of jobs to increase each year (by 1.2% and 1.6% respectively), revised up from 0.8% and 1.4% growth in employee jobs forecast in March 2013.

Figure 5: GVA growth for Scotland, 2013 to 2015, possible range of outturn growth



Source: Fraser of Allander Institute forecasts

Table 3: Forecasts of Scottish employee jobs (000s, except where stated) and net change in employee jobs in central forecast, 2013 to 2015

	2013	2014	2015
Total employee jobs (000s), Dec	2,328	2,356	2,395
Net annual change (jobs)	12,150	28,200	38,700
% change from previous year	0.5%	1.2%	1.6%
Agriculture (jobs, 000s)	30	31	33
Annual change	650	1,600	2,250
Production (jobs, 000s)	250	252	257
Annual change	-350	2,550	4,350
Construction (jobs, 000s)	121	121	123
Annual change	-450	750	1,550
Services (jobs, 000s)	1,928	1,952	1,982
Annual change	12,200	23,300	30,550

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

The employee jobs forecasts consistent with our upper and lower forecasts for GVA growth are given in **Table 4**.

Table 4: Net annual change in employee jobs in central, upper and lower forecast, 2013 to 2015

	2013	2014	2015
Upper	22,600	50,500	64,300
Central	12,150	28,200	38,700
Lower	2,450	4,450	16,400

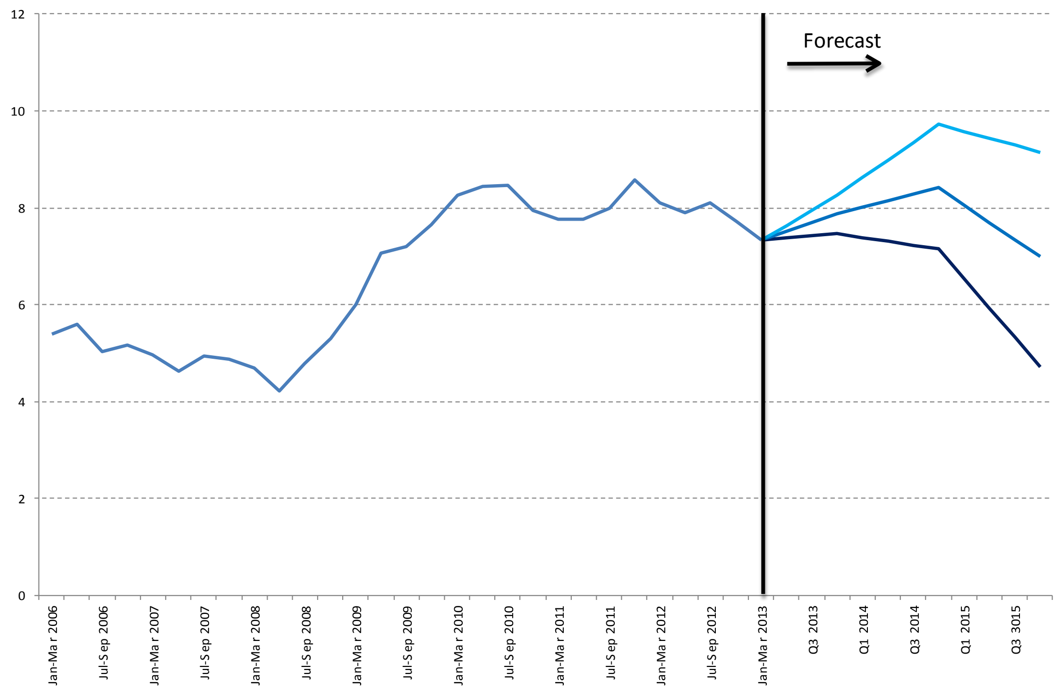
Note: Absolute numbers are rounded to the nearest 50.
Source: Fraser of Allander Institute forecasts

Table 5: Forecasts of Scottish unemployment in central forecast, 2013 to 2015

	2013	2014	2015
ILO unemployment	213,250	228,000	189,350
Rate[1]	7.9%	8.4%	7.0%

Notes: 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 figures are detailed in the Labour market section of the Fraser Economic Commentary.

Figure 6: Scottish ILO and claimant count unemployment rate, history and forecast: 2006 to 2015



Source: Fraser of Allander Institute forecasts

Unemployment

We present our forecasts for unemployment at the end of 2013, 2014 and 2015 in our central forecast in **Table 5**. As with previous forecasts we report the ILO unemployment measure and the number forecast to receive unemployment benefits ("claimant count"). The ILO measure is preferred as it gives a more complete indication of the extent of labour resources available for work but unable to find work, and so is a better measure of the level of spare capacity in the labour market.

We have revised these down – both in levels and rates – as the Scottish labour market continues to display unusual (low) productivity changes – e.g. more robust employment measures while output has been declining over recent quarters. We are now forecasting a level of ILO unemployment at the end of 2013 at 7.9% (down from 8.3% forecast in March) and 8.4% and 7.0% in 2014 and 2015 (down from March's 8.6% and 7.7% forecasts respectively). We show the history of ILO unemployment rate since 2006, and our central and upper/lower forecasts for this variable from Q2 2013 to 2015 in **Figure 6**.

Grant Allan

8th June 2013