

# The Scottish economy

## Forecasts of the Scottish economy

### **Economic background**

The outlook for the world economy remains promising despite some slowing of growth in the US. The US, Japan and China all performed relatively well and world trade growth is also strong. Most emerging economies are also growing robustly. The most important development is the clear strengthening of economic activity in the Euro Area where manufacturing has grown relatively strongly for two consecutive quarters. There are still some concerns over why German consumption is not growing faster than it is but overall in the Euro Area there is a strengthening of domestic demand. Both investment and the relative contribution of exports compared to imports were significant factors in the 0.9 per cent rise in Euro Area real GDP for the second quarter. US GDP increased by 2.6 per cent (annualised) in the same quarter. While inflationary pressures remain modest they are not absent and the rise in fuel costs is being felt across the globe. Monetary policy however is appropriate for the moment and there is little risk of an inflation spiral feeding through into the wage bargain.

UK GDP growth was 0.7 per cent in 2006Q2 having been revised down from the preliminary estimate of 0.8 per cent. This compared with 0.7 per cent in the first quarter (and 2005Q4) and GDP is now 2.6 per cent higher than it was at the same time last year. These data indicate that the UK is growing close to trend. The labour market continues to perform well and the current account narrowed. Interest rates are at 4.75 per cent but are expected to rise to 5 per cent in November. There are few signs of inflation feeding through into the wage bargain in the UK but energy and transportation costs are the prime drivers of CPI at this time.

### **The Scottish economy**

Scottish GVA grew by 0.5 per cent in the first quarter of 2006 compared to 0.7 per cent in 2005Q4. GVA growth in the latest four quarters on the preceding four quarters was 1.9 per cent. GVA growth for 2005 as a whole was 1.8 per cent. GVA growth in the UK was 0.7 per cent on a quarterly basis and 1.9 per cent on an annual basis. UK GVA growth for 2005 was also 1.8 per cent. When GVA excluding oil and gas is considered then Scotland grew by 0.5 per cent in the last quarter (2.0 per cent on an annual basis) compared to the UK which grew by 0.7 per cent (2.1 per cent over the year). Services continue to drive the Scottish economy with growth of 0.4 per cent in the latest quarter or 2.9 on an annualised basis. This compares with UK growth

of 0.7 per cent and 2.9 per cent respectively. Clearly the Scottish economy is performing well. Manufacturing grew by 0.4 per cent in Scotland although over the year it has contracted by 0.9 per cent. Construction output increased by 3.6 per cent in 2006Q1 compared to only 0.9 per cent in the UK. On an annual basis Scottish construction grew by 3.1 per cent compared to 0.4 per cent in the UK.

Agriculture had a poorer performance contracting by 0.2 per cent in the first quarter whereas UK agriculture increased by 0.7 per cent. Scottish agriculture contracted by 2.1 per cent over the latest four quarters on the preceding four quarters while UK agriculture increased by 2.1 per cent.

Scottish labour market performance remains good although there are concerns about employment levelling off. As reported in the last quarter the employment rate (75.0 per cent for May-July 2006 is very close to that of last year (75.1 per cent in the same period 2005). At that time employment was 2,450,000 and it now stands at 2,460,000 although this is 12,000 down on the previous quarter. ILO unemployment has declined significantly since May-July 2004 (154,000) to 137,000 in May-July 2006. This gives unemployment rates of 6.1 per cent and 5.4 per cent respectively. The level of unemployment is down by 1,000 and the rate has remained the same when compared to the period February-April 2006. Claimant count in Scotland was 88,200 (3.3 per cent) in August 2006 compared to 88,600 (3.3 per cent) in the previous month. Last August, Scottish claimant count was 85,500 (3.2 per cent) showing that there has been little movement in unemployed claimants. If anything, over 2005 and early 2006 claimant count has edged upwards. The economic activity rate in Scotland for May-July 2006 was 79.2 per cent down from 79.8 per cent one in the previous period and down from 79.5 per cent one year ago. Despite some marginal slowing of performance the Scottish labour market remains relatively buoyant.

Scottish manufactured exports contracted by 2.0 per cent in 2005 but increased by 1.0 per cent for 2006Q1 on 2005Q4. For the latest four quarters on the preceding four quarters Scottish exports decreased by 0.5 per cent. Sectors with positive quarterly growth included: textiles at 3.0 per cent (-4.3 per cent annually); chemicals 3.0 per cent (-7.2 per cent annually); food at 0.5 per cent (-8.6 per cent); drink 2.3 per cent (4.6 per cent annually); mechanical engineering at 0.5 per cent (18.1 per cent annually) and transport equipment at 4.3 per cent (2.9 per cent annually). The weakest sector was; wood, paper, publishing and printing which contracted by 11.4 per cent on a quarterly basis but over the year grew by 6.8 per cent. It is expected that manufactured exports will indeed pick-up more strongly as the Euro Area activity strengthens. In saying that however; there is anecdotal evidence that Scotland could up its game with exports to China and some other fast growing economies. The Scottish Chambers of Commerce Business Survey demonstrated a significant rise across most sectors of the

Scottish economy for the third quarter of 2006. This is the sixth successive set of results that show an upward trend for business confidence, optimism, new orders and new business. The rising trends were reported by both small and large firms suggesting optimism is evenly spread across the sectors.

The Scottish economy continues to perform relatively well and there is a strong basis for continued growth. Survey evidence is strong and there are clear signs of strengthening activity. It because of these promising domestic conditions and an improving external environment, that the forecast for the Scottish economy is slightly more optimistic than that of the previous quarter.

## The forecast in detail

### GVA

The forecast for GVA for 2006 is 2.2 per cent, slightly up from 2.1 per cent in the previous quarter. In 2007 the forecast is for growth of 2.3 per cent given the strength of the recent economic performance linked to the improving external environment, especially increased exports to the Euro Area. Services are forecast to grow by 2.8 per cent in 2006 following their strong performance in 2005. Services remain the key driver of the Scottish economy in terms of both output and employment. Services growth is forecast to be close to trend in 2007 but to decline slightly in 2008. Manufacturing is forecast to grow by 0.8 per cent in 2006 and by 1.1 per cent in 2007. This is due to increased exports in some sectors and a strong performance elsewhere. The UK export market remains crucial for Scottish manufacturing. Agriculture is forecast to contract by 1.2 per cent in 2006 and by 0.7 per cent in 2007. Construction growth is forecast to be very strong in 2006 after what appeared to be a sluggish start to the year.

**Table 1: Main forecasts of the Scottish economy, 2005-2008**

	2005	2006	2007	2008
GVA	1.8	2.2	2.3	2.2
Agriculture	0.2	-1.2	-0.6	0.4
Manufacturing	-0.9	0.8	1.1	1.5
Construction	1.3	4.8	2.4	2.0
Services	3.0	2.8	2.9	2.5

Source: Fraser of Allander Institute, October 2006.

### Final demand

Consumption, investment and government spending are still the main drivers of the economy in Scotland. Export growth is improving particularly as the prospects in the

Euro Area are improving and are expected to be much more significant in 2007 and 2008. The main factors affecting the forecast are given below:

Scottish economic performance is keeping pace with the UK and in some areas outperforms the UK economy; Investment has picked more strongly and earlier than expected – investment is forecast to be a key driver of output in 2006;

Tourism was relatively disappointing but numbers have recovered recently and is expected to make a significant contribution to both retail and hotels and restaurants and Scottish export performance has been disappointing but the significant strengthening of Euro Area economic activity is expected to provide a boost to Scottish exports.

## Output

Growth in the service sector is forecast to be 2.8 per cent in 2006 and 2.9 per cent in 2007. Towards the end of the forecast period growth of services is expected to moderate slightly. The growth of the sector is driven largely by the fast growing sectors of financial services and real estate and business services (REBS). Transport, storage and communications (TSC) services also make a significant contribution to growth in the earlier years of the forecast. The weight of the retail sector also means that the contribution it makes to private services is very significant. Hotels and restaurants; TSC services and other services make less of an impact due to their smaller weight.

Manufacturing contracted by 0.9 per cent in 2005 and the forecast for 2006 is growth of 0.8 per cent. The reality is that it has become very difficult to accurately assess how manufacturing will perform given that it has spent so long contracting and shedding jobs. It could grow within a range of 0.4 to 0.9 per cent in the year 2006. Our best estimate however, points to growth of 0.8 per cent. We consider this to be a robust forecast although we recognise it is not as consistent as we would prefer. In 2007 the forecast is for growth of 1.1 per cent and 1.5 per cent in 2008. The manufacturing sector has produced some very strong survey data over the recent past (see SCBS, CBI and RBS PMI). This coupled with anecdotal evidence all this points to increased activity in manufacturing that is robust and likely to persist. Electronics continues to be a problem sector as does textiles. PPP and ORNF are also disappointing. The strongest sectors are food, drink, metals, mechanical engineering and transport equipment.

## Employment

Our forecasts of employment are presented in Table 2 with the net employment change figure in brackets. The employment figures are calibrated on the employers' quarterly survey series as given in Table B.16 in Labour Market Trends, National Statistics. There have been a

number of revisions to this series and this is reflected in the employment forecasts.

The employment (jobs) forecast for 2006 is 2,346,300 and 2,361,800 for 2007. This is a net job change of 18,500 and 15,600 respectively. In 2008 employment is forecast to be 2,372,800 which is a net job change of 10,900. As before services drive Scottish employment throughout the forecast period. Manufacturing is forecast to shed a further 5,300 jobs this year before gaining just over 1,000 jobs in each of the two following years. Construction employment is forecast to be very strong (a gain of 7,500 jobs) in 2006.

Service are forecast to have employment of 1,917,500 jobs in 2006 (an increase of 16,000 jobs) in and 1,931,000 jobs in 2007 (a rise of 13,500). The key drivers of the service sector are still financial services and real estate and business services but the most important sectors in terms of employment are public services; retail and wholesale and REBS. Most of these jobs are located in urban areas helping to drive growth in cities and urban economies. The biggest job gains service in 2006 come from public services and REBS. Both, retail and transport, storage and communication services are forecast to make a more significant contribution to employment in 2007.

It is disappointing to see that it is more probable that manufacturing will lose more jobs again this year. The forecast for manufacturing employment is 227,200 jobs in 2006 and 228,500 jobs in 2007. The big boost to manufacturing employment is likely to come from transport equipment manufacture in 2008 and 2009. Food and drink are forecast to contribute about 500 jobs each in 2007.

**Table 2: Forecasts of Scottish employment (000s) and net employment change, 2005-2008**

	2005	2006	2007	2008
<b>Total</b>				
<b>Employment</b>	<b>2,327.8</b>	<b>2,346.3</b>	<b>2,361.8</b>	<b>2,372.8</b>
	<b>(32,000)</b>	<b>(18,500)</b>	<b>(15,600)</b>	<b>(10,900)</b>
<b>Agriculture</b>	<b>30.8</b>	<b>30.0</b>	<b>29.7</b>	<b>29.5</b>
	<b>(800)</b>	<b>(-700)</b>	<b>(-300)</b>	<b>(-200)</b>
<b>Manufacturing</b>	<b>232.5</b>	<b>227.2</b>	<b>228.5</b>	<b>229.6</b>
	<b>(-5,300)</b>	<b>(-5,300)</b>	<b>(1,300)</b>	<b>(1,100)</b>
<b>Construction</b>	<b>124.5</b>	<b>132.0</b>	<b>133.2</b>	<b>134.6</b>
	<b>(2,300)</b>	<b>(7,500)</b>	<b>(1,200)</b>	<b>(1,400)</b>
<b>Services</b>	<b>1,901.5</b>	<b>1,917.5</b>	<b>1,931.0</b>	<b>1,939.8</b>
	<b>(33,300)</b>	<b>(16,000)</b>	<b>(13,500)</b>	<b>(8,800)</b>

Source: Fraser of Allander Institute, October 2006

Agriculture is forecast to lose jobs over the period 2006 to 2008 after a healthy gain of 800 jobs in 2005. The main decline is likely to happen this year. Construction

employment is forecast to be 132,000 in 2006 (an increase of 7,500 jobs) and 133,200 in 2007 (an increase of 1,200 jobs). Construction is being heavily stimulated by the PPP programme especially for schools and transport at the present time. There are few sign that private house-building is slowing despite interest rates increases and land shortages. The demand for new housing is attributed to steadily rising incomes and changes in household formation patterns. One of the problems for the industry may be a shortage of workers but perhaps the increased migration we have seen will offset or dampen these effects.

## Unemployment

We present our forecasts of unemployment in Table 3. Both the ILO measure and claimant count measure are given. The preferred measure of unemployment however is ILO unemployment as given by the LFS.

**Table 3: Forecasts of Scottish unemployment, 2005-2008**

	<b>2006</b>	<b>2007</b>	<b>2008</b>
<b>ILO Unemployment</b>	<b>136,300</b>	<b>135,700</b>	<b>134,400</b>
<b>Rate</b>	<b>5.3%</b>	<b>5.3%</b>	<b>5.2%</b>
<b>Claimant Count</b>	<b>87,100</b>	<b>85,600</b>	<b>83,800</b>
<b>Rate</b>	<b>3.3%</b>	<b>3.2%</b>	<b>3.1%</b>

Source: Fraser of Allander Institute, June 2006

Our forecasts for unemployment remains benign and over 2006-08 there is a slow decline forecast. ILO unemployment dropped significantly in the November- January period to 133,000 but has gained some ground since then, back up to 138,000. The forecast for the ILO unemployed is 136,000 (5.3 per cent) in 2006 and 135,700 (5.3 per cent) in 2007. Claimant count is forecast to decrease to 87,100 (3.3 per cent) in 2006 and to 85,600 (3.2 per cent) in 2007. Wage pressure is not high and there are a considerable number of migrants flowing to Scotland keeping the labour market in a buoyant but competitive position. There are few reasons to suggest that Scottish unemployment will not continue on its current downward trend.

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