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Forecasts of the Scottish economy

Summary

The Scottish economy has shown signs of growth through the first half of 2012, exceeding our expectations so far through the year and has grown slightly less than the UK economy as a whole in this period. In part, this appears due to higher than expected contribution from household spending growth. While survey indicators suggest firms are optimistic about prospects for the second half of the year, we are uncertain about the extent to which a recovery on the back of households facing slow income growth is sustainable. In particular, the recent evidence on the Scottish housing market suggests that any wealth effect from increasing house asset prices is not being felt across all regions of the UK. Recent Scottish export figures show the importance of a swift and positive resolution of the (on-going at time of writing) future of the Grangemouth chemicals and refinery facility for the Scottish economy.

Fiscal policy

The UK Chancellor, George Osborne, will make his 2013 Autumn Statement on the 4th of December 2013, however it is projected that government spending in Scotland will see real terms reductions for each of the next four years. As is noted in August 2013's State of the Economy report by Gary Gillespie, the Chief Economist at the Scottish Government, this "confirms the programme of fiscal consolidation is now expected to last 8 years. This will continue to constrain the impact of Government demand in the economy".

CPPR (August 2013) examined the recent UK Spending Review and, as part of their conclusions, calculated that the current year (2013-14) sees the realisation of 57% of the total fiscal consolidation in the Scottish Government budget over the period between 2009-10 and 2017-18. As understood before, with the major reductions in the initial period of consolidation falling largely on the capital budget, over 100% of the expected capital spending reductions have already taken place, while only 40% of the spending reductions on current spending have been made to date. The scale of reductions to current spending projected in 2016-17 appear to match or even exceed those in the "first wave" of fiscal consolidation in the early part of this decade.

In real terms, CPPR project Scottish current spending in 2017-18 to be £2.7 billion below its value in the current financial year. CPPR analysis suggests that since the Spending Review covered only an additional year, large reductions in spending are projected for the final two years in current UK government plans. Although it states that, it is possible that tax rises rather than spending reductions, post-election, could bring the shape of the fiscal consolidation closer to the Government's planned 80:20 split between spending reductions and tax increases.

The UK government has brought forward its Help to Buy Scheme, which provides government-backed guarantees for house equity for up to 15% of a property value, in exchange for a fee from the mortgage lender. The intention of the policy is to encourage people back into the property market without needing a deposit of more than 5% of the property value. While not targeted at new house purchases, or first time buyers, it appears that the policy offers limited scope to specifically target the areas of the property market to have been worst hit since the credit crunch and financial crises of the last five years. Property prices appear to have responded positively to this scheme, but many commentators have warned about the sustainability of a second house price bubble, the limited scope that this policy has to encourage the supply-side of the housing market through new building, and the regional pattern of recent house price changes. ONS figures suggest that Scottish house prices in the year to July 2013 fell by 2.0% while growing by 3.3% in the UK as a whole (and by 9.7% in London). While the policy is "spatially-blind" across the UK, it appears that (for instance) quite different dynamics are occurring in the London housing market than in the other regions of the UK. Scottish house prices remain around 8% below their 2008 peak, while UK prices have regained most of their ground, according to ONS figures.

Through the new "financial transactions" measures recently announced, the Scottish Government has introduced its Shared Equity scheme for New Build programme, which provides a Scottish-specific programme with similarities to the Shared Equity Scheme in England. These are both schemes in which the Government takes up to 20% equity stake in a new build property and so can allow buyers to purchase with a mortgage of 80%, and so lower risk to the mortgage lender and encourage lending and new buyers into the property market.

However, there are differences between the English and Scottish new build shared equity schemes. In Scotland, £220 million has been set aside over three years, while the England scheme has total funding of £3.5 billion; in Scotland co-owners can purchase the equity stake of Government in a minimum of 5% increments following a fair market valuation of the property, while in England it is 10%; the maximum property value in Scotland which can use the scheme is £400,000 while in England it is £600,000; additionally, in Scotland there is no charge for the equity scheme, while householders in England will face charges from year 6 onwards. Both maximum value figures are set so as to cover around 90% of new builds in those areas. Given current prices for new builds in Scotland, it appears likely that – while this directly addresses the issue of demand for new build properties – the scheme will help up to the low thousands of new home purchases over its duration (2013-2016. This compares to the approximately 13,500 new house starts annually in 2011 and 2012.

Monetary policy

When the Monetary Policy Committee (MPC) of the Bank of England met in October 2013, it noted that the CPI inflation rate had fallen to 2.7% in August 2013. This is slightly down from its previous figure and earlier expectations. This fall was partly explained by a fall in sterling oil prices of 8% in the month, suggesting that this important input would not contribute to price pressures over the next twelve months. They also noted the potential for domestic energy price increases to offset this. As of the time of writing, three of the big six energy have proposed increases in domestic energy prices above the 5% that the MPC had assumed in August.

In its latest meeting the MPC decided to keep interest rates at 0.5% and the size of the Quantitative Easing programme unchanged at £375 billion. It noted that under the redesigned – “forward guidance” – framework for monetary policy instigated under the new Governor of the Bank of England, Mark Carney, none of the three “knockouts” to its policy had been delivered. The current stance on forward guidance suggested by the Governor is that the Bank Base Rate will not be raised in the absence of unemployment rate below 7% for the UK, so long as those three conditions are not breached. These conditions are expectations for inflation exceeding 2.5% in 18-24 months; medium term inflation expectations becoming unstable; and financial stability becoming affected by the monetary policy stance.

Households

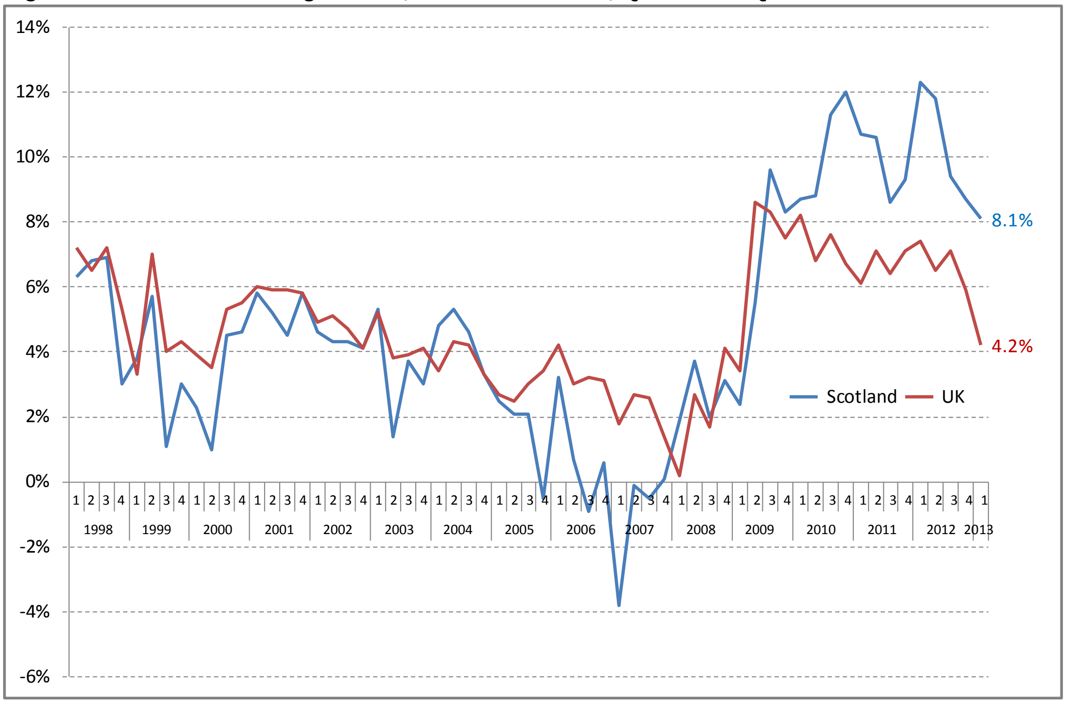
The latest pay figures for the UK show that in the last twelve months, private sector incomes had grown by 1.2% to July 2013. Figures for the whole economy for income growth below the rate of inflation suggest a continued worsening of real incomes for households through the second half of 2013. Without strong wage growth, absent from recent data for Scotland and the UK, the squeeze of real incomes will continue through 2013 and into 2014.

Figures from the Council for Mortgage Lenders report that household demand for credit for house purchase and re-mortgaging has strengthened through 2013, while the latest quarter has seen quarterly and annual increases in the number of advances for home purchases in Scotland. These are largely driven by strong growth in the number of first time buyers entering the housing market, albeit from a base that is much reduced on previous levels. Housing affordability has also improved with lower house prices and continuing low interest rates, although barriers to first time buyers in terms of deposits required remain significant.

The latest Markit Household Finance Index for the UK in October was published on the 21st of this month. While remaining firmly in “downbeat” territory (below the neutral 50.0 mark), it remains close to the “relative” high seen at the start of 2012, but still under pressure through to the end of 2013. Expectations for the next twelve months were for households finances to deteriorate, however those at the highest income quintile were most bullish about their prospects, with the opposite true for those on the lowest income group.

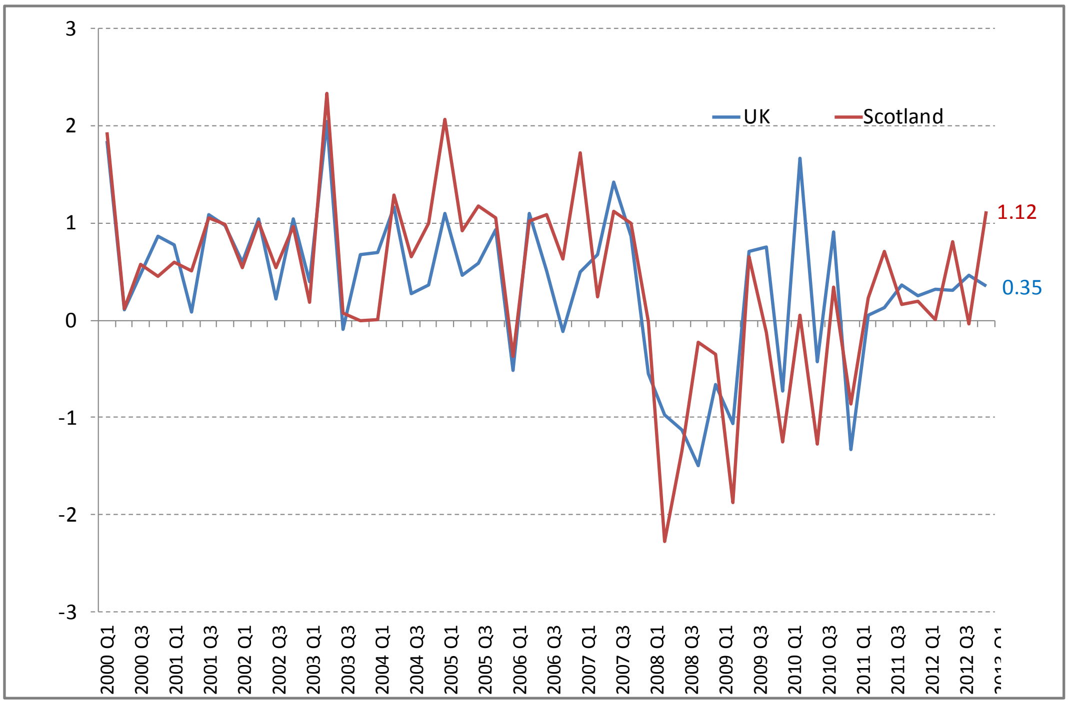
Figure 1 shows how the household savings ratio has evolved to the first quarter of 2013 in Scotland and the UK. These data imply that Scottish households have made more significant adjustments to their savings pattern than UK households. While through 2011 the gap between Scottish and UK savings ratios was closing, in the first half of 2012 this widened further. It has not yet reached the same gap as during the end of 2010, although the current savings ratio of 8.1% in Scotland is 3.9 percentage points higher than in the UK.

Figure 1: Household savings ratios, Scotland and UK, Q1 1998 to Q1 2013



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

Figure 2: Household real consumption spending growth, Scotland and UK, Q1 2000 to Q1 2013



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

Comparable Scottish and UK data on household income and consumption growth are available up to the end of the first quarter of 2013. These show that after a real terms contraction in Q2, spending in Q3 grew by 0.9% in the quarter. UK consumer spending grew by only 0.23% in the same quarter (See **Figure 2**). Relative to their pre-recession spending peaks, Scotland and the UK are respectively 4.5% and 3.8% below the peak seen in the final quarter of 2007.

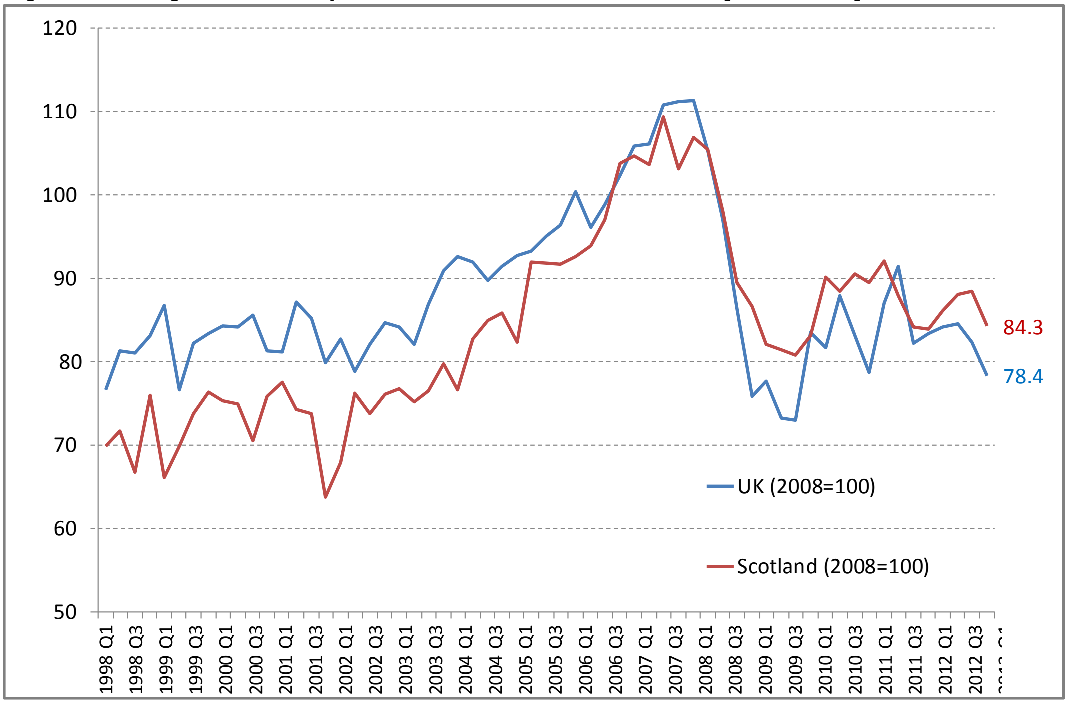
The latest Scottish Retail Sales Index shows a second consecutive quarter of real terms growth in the volume of sales in the second quarter of 2013. While growth was again lower than in Great Britain as a whole, the positive trend suggests some signs of a potentially returning consumer confidence, however there is no detailed breakdown of these purchases in the official series. Positive trends in car sales have been widely reported, with a 14% growth in new car registrations in Scotland in September 2013 (on September 2012). This was higher than growth in the UK as a whole (12.1%). Without further information on the bodies making these registrations – and "live" indexes of car purchases either by individuals or companies for fleet purposes – it is difficult to unpick the content of these as a measure of consumer confidence.

The Scottish Retail Sales Monitor for August 2013 reported an exceptional summer performance continuing into August, and suggesting a strong Q3 2013 is likely. While some of this is weather driven, the trend in like-for-like sales exceed its 12-month trend indicating that the sector continues to grow, albeit at levels slightly below that seen in the UK in the last month. An itemised breakdown suggests that food purchases rose strongly, while there were mentions for strong growth in non-food items including furniture and flooring. The report noticeably warned of retailers "hoping that the uplift in consumer confidence is sustainable".

Box 1: Accounting for the economic impacts of the 2014 Commonwealth Games

Many Scottish households will have found out whether they were successful in obtaining tickets for next year's Commonwealth Games in Glasgow, which run from the end of July into August 2014. Although tickets are being purchased in the final quarter of 2013, standard national accounting practice means that this does not show up in the GDP measures for Scotland until the event takes place – and the "product" (i.e. the event) occurs. This will mean that Q3 of 2014 will see an uptick in GDP due to the Commonwealth Games occurring then. That doesn't mean that there have been, or are no impacts, on the Scottish economy before then, as a direct result of the Commonwealth Games. Firstly, construction of stadia and the athletes village will have impacted on GDP in the quarter in which that activity took place. Secondly, there may be some impact on GDP in the current quarter to the extent that there were transactions fees on the purchases of tickets for the events. These are likely to be small in aggregate however, and significantly lower than the value of ticket sales themselves.

Figure 3: Real gross fixed capital formation, Scotland and UK, Q1:1998 to Q1:2013



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

Investment

Figure 3 shows that real investment spending (including public and private spending) remains significantly below its pre-recession values. The relative reduction from peak is around 6 points more in the UK than Scotland. While it appeared that the Scottish economy had seen rising investment through 2012, the latest figures suggest that the fall in UK investment in the last two quarters has spread to the latest quarter of Scottish data. Overall investment levels remain stubbornly close to their trough at the end of 2009.

The latest figures from the Scottish Chambers' Business Survey and Scottish Construction Monitor see improvements in construction sector activities and optimism, despite continued net balances below the 50% no change level. New build activity remains a weakness, although there is increasing optimism consistent with the house funding schemes encouraging new activity in the sector. Increasing recruitment and recruitment difficulties in attracting staff at all levels (supervisory and junior) point to evidence of less pessimistic sentiment in the sector.

Trade

The most recent figures on Scottish exports were released on the 23rd of October. The Index of Manufactured Exports results for the second quarter of 2013 revealed growth of 3.5% in real terms on the first quarter of 2013, the second consecutive quarter of positive growth of exports in real terms (and following a quarter of zero per cent growth). On a "rolling annual" basis exports of manufactured goods had declined by 1.8%. This index is the most timely official estimate of overseas trade for Scottish products, although it does not cover non-manufactured goods, it still captures of the order of 60% of all exports from Scotland to the rest of the world.

Quarterly growth in the series of 3.5% in the last quarter is the highest quarterly change since the first quarter of 2011, and indeed the third highest quarterly change since the second half of 2008. On a sectoral basis – despite the small sample and therefore high volatility to these figures – the food and drink sector was the only category to see a reduction in its exports, driven by a contracting in food exports in the quarter. Over the last year however, that sector has been an important driver of Scotland's export performance, and is responsible for of the order of 30% of Scotland's overseas (i.e. non-UK) exports. The volatility of the series for another major exporting industry in Scotland – Refined petroleum, chemical and pharmaceutical products – itself worth almost a quarter of Scottish exports to the rest of the world, is evident from the recent series.

The threatened closure of the Ineos petrochemicals facility could have impacted on the Scottish economy through a number of channels, which are discussed in the Outlook and Appraisal. The consequences for Scottish exports could have additionally been critical. The latest Input-Output tables (for 2009) show that around two-thirds of the output of the "Coke, petroleum and petrochemicals" sector is sold to markets outside Scotland.

This uptick in exports to the rest of the world is consistent with improving activity indicators for Scotland's major export markets through 2013.

Table 1 shows the latest growth forecasts for Scotland's major (non-UK) export markets in 2013 and 2014. The picture has improved since our June forecast, with the latest IMF forecasts for some of these markets improving, while the downward revisions to US and China growth are relatively small (but clearly important given the scale of these economies, and their positions as the two largest economies in the world). While China is forecast by the IMF to see slower growth in 2014 than 2013, this is the exception among the areas reported in Table 1.

Markit's Eurozone Composite PMI survey for September 2013 rose to 52.2, up from its August value of 51.5, with figures below 50 indicating a contraction. This has typically been a good predictor of Eurozone GDP activity, albeit that some of the most recent movements appear to be tracking GDP measures with a slight lag. This index has moved up steadily since March 2013 and has been above the 50.0 mark of expansion throughout the third quarter of 2013, giving the strongest quarterly growth rate since the second quarter of 2011.

Across the manufacturing and service sectors this index showed consistent movements, with expansion indicated in both measures, underpinned by a rise in new orders. Of the major economies of the Eurozone, only Spain (49.6) had an index in contraction and there were signs of stabilisation in both

France and Italy. Germany economic expansion continued to drive the recent growth of the Eurozone as a whole, although these data suggest that the other major economies will pick up towards the end of 2013.

The latest minutes of the MPC commented on the mixed evidence from the US economy over the last month, after some stronger signs earlier in the year. With some strengthening in the manufacturing index, and some signs of slowing in US consumer spending growth the picture was mixed. The federal shutdown showed the potential for political uncertainty to impact on economic activity – as it will when figures for the final quarter of 2013 are available, but its overall impact is likely to be small. Prospects in Japan appeared to be stronger than previously anticipated, with strong upswings in business confidence. However, the MPC notes that inflation expectations had rose, as intended, and that structural reforms to the labour market would be required to strengthen the Japanese economy in the medium term.

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

	2013			2014		
	IMF (October 2013)	Revision from July 2013	OECD (June 2013)	IMF (October 2013)	Revision from July 2013	OECD (June 2013)
USA	1.6%	-0.1%	1.9%	2.6%	-0.2%	2.8%
Netherlands	-1.3%	n/a	-0.9%	0.3%	-	0.7%
France	0.2%	0.3%	-0.3%	1.0%	0.1%	0.8%
Belgium	0.1%	n/a	0.0%	1.0%	-	1.1%
Germany	0.5%	0.2%	0.4%	1.4%	0.1%	1.9%
Ireland	0.6%	n/a	1.0%	1.8%	-	1.9%
UK	1.4%	0.5%	0.8%	1.9%	0.4%	1.5%
China	7.6%	-0.2%	n/a	7.3%	-0.4%	n/a
Euro area	-0.4%	0.1%	-0.6%	1.0%	0.0%	1.1%

Source: World Economic Outlook, International Monetary Fund (October 2013) and Economic Outlook, No. 93, OECD (June 2013).

Forecasts for the Scottish economy: Detail

The latest GDP, trade and major business confidence survey figures for Scotland point to improving economic conditions in Scotland into the second half of 2013. However, surveys also highlight the weaknesses remaining in a sustainable recovery continuing to gather momentum. The expected "surge" out of recession from rebounding investment and business confidence continues to prove elusive, while evidence from anticipated "rebalancing" away from domestic to non-Scottish markets appears weak, albeit that since we last forecast in June the leading indicators for the UK as a whole (Scotland's largest trading partner) have tended to move in a positive direction. Such developments – positive movements in reported indicators and business survey figures through the third quarter of 2013, but continued wariness about the strength of the recovery – underpins our revisions to forecasts for growth and unemployment in the Scottish economy over the next few years.

The Bank of Scotland PMI results for September continue to suggest a strengthening performance through 2013 for private sector activity, reporting a recovery "gaining momentum" between the second and third quarters of the year. The survey indicated a rise in export orders and new business orders for manufacturing, however the same results suggested a decline in the rate of growth of manufacturing in the same period, partly driven by a significant fall in backlogs of new work. It appears that the survey picture would support a view that growth appeared to be returning to some parts of the economy, however downside risks remain as the drivers of that growth appear to be uncertain and potentially unsustainable.

On the domestic side of the economy, with extended fiscal contraction at the Scottish level projected to 2017-18, and some 60% of the reduction in Scottish Government current spending still to occur, we must focus on the outlook for household and investment expansion. Household spending growth appears to have increased over the last few quarters, however this appears to be alongside slow growth in real incomes and declining savings ratio. These suggest that a consumer-led recovery is far from sustainable over the medium-term. In our central forecast, we have revised up our forecast for household consumption growth through 2013, but held steady our forecast for household consumption growth in 2014. Government expenditure is forecast to fall in real terms over the forecast horizon and beyond.

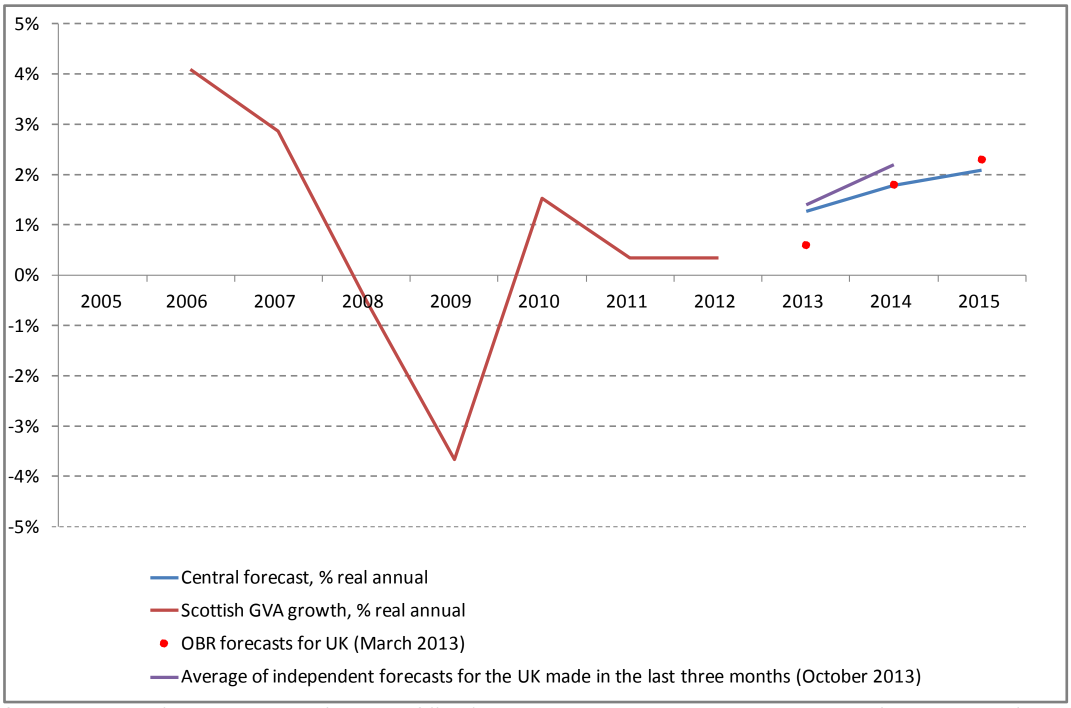
The latest results from surveys suggest that there are continued weaknesses in the short term outlook for investment intentions. Export markets overall show some signs of improvement through 2013, although the recent performance of the Scottish economy in generating products for exports remains weak, despite some promising figures in the second quarter of 2013. The Eurozone economies appear to be slowly recovering, but there are continued downside risks from the strength of the recovery across the major economies of Euro, with the exception of Germany. The robustness of the recovery in the UK as a whole, which is the largest market for Scottish goods and services, will be critical for the ability of Scotland's economy to generate exports and grow. With the possibility of disruption to chemical and refinery exports, or at worst closure to Scotland's largest manufacturing facility, there is significant potential for the level of Scottish exports to adjust rapidly through the end of 2013 and into 2014.

Results

In this issue of the *Commentary*, we are forecasting 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 at the sectoral level.

We begin with the (central) forecasts for growth in the Scottish economy. Our new forecasts for 2012, 2013 and 2014 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 and the median of recent forecasts produced by professional forecasts for each year of the forecast window.

Figure 4: Forecast annual real GVA (%) growth for 2013 – 2015: Scotland and UK



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

Our forecasts for real GDP growth in Scotland in 2013 and 2014 are now 1.3% and 1.8% respectively, up from our June forecasts of 0.9% and 1.6% respectively. However, these new forecasts are higher than our forecasts from earlier in 2013 in part due to better than expected outturn data on household expenditure growth, and increasingly optimistic surveys for growth through 2013. The forecast for growth in 2015 has been held at 2.1%.

In addition to the aggregate growth forecasts, Table 2 presents our forecasts for GVA growth for each year by broad industrial grouping, i.e. for the "production", "services" and "construction" sectors of the Scottish economy.

Table 2: Scottish GVA growth (%) by sector (2013 to 2015)

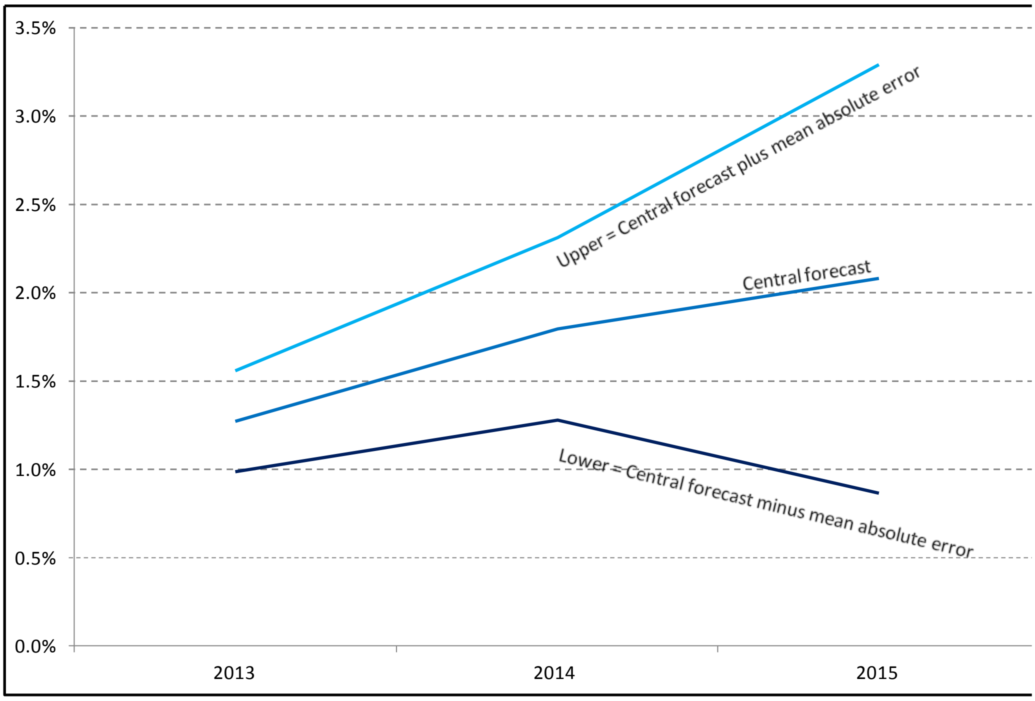
	2013	2014	2015
GVA	1.3%	1.8%	2.1%
Production	1.5%	2.2%	2.5%
Construction	1.0%	1.4%	1.3%
Services	1.2%	1.7%	2.0%

Source: Fraser of Allander Institute forecasts, October 2013

We use our calculated historical 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 autumn (September to December) period of year, FAI forecasts of the first estimates of GVA growth in that year have had an average absolute error of 0.287 percentage points (i.e. 2013 in this case). While for the following year (i.e. 2014 in this case), our autumn forecasts have an average absolute error of 0.516 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. The estimated range around our central forecasts of GVA growth in each year is shown in **Figure 5**.

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



Source: Fraser of Allander Institute forecasts

Employment

Detailed commentary on recent developments in the Scottish labour market can be found in the *Overview of the Scottish Labour Market* section of this Commentary. Here we focus on the forecasted trends and levels for the number of employee jobs in the Scottish economy.

The most recent data show that in the second quarter of 2013, there were 2,343 thousand employee jobs in Scotland, an increase of 31,000 on the end of 2012. It also showed than on a seasonally adjusted basis, the number of such jobs declined in the first quarter of this year.

Our forecasts for employee jobs at the end of 2013, 2014 and 2015, including a breakdown by broad sectoral groups, are shown in Table 3. The number of employee jobs is forecast to increase by just over 21,000 over the year to the end of 2013, to rise to 2,332 thousand. This is up from our June 2013 forecast of employee job numbers rising by just over 12,000 during the year. As with previous forecasts, and outturn data for employee jobs in Scotland, much of the increase in the forecast period is anticipated to come in the service industries. Through 2014 and 2015 we expect the number of employee jobs to increase each year (by 1.2% and 1.6% respectively), which is in line with our latest forecast. The higher base for employee jobs means that the absolute number of jobs created in each year is slightly raised from our forecasts from Summer 2013. The employee jobs forecast consistent with our central, upper and lower growth forecasts are given in Table 4.

Table 3: Forecasts of Scottish employee jobs ('000s, except where stated) and net change in employee jobs in central forecast, 2012 to 2014

	2013	2014	2015
Total employee jobs (000s), Dec	2,332	2,359	2,398
Net annual change (jobs)	21,200	27,200	38,400
% change from previous year	0.9%	1.2%	1.6%
Agriculture (jobs, 000s)	29	31	33
Annual change	1,100	1,800	2,150
Production (jobs, 000s)	248	248	252
Annual change	650	400	4,250
Construction (jobs, 000s)	121	122	123
Annual change	-50	958	1,550
Services (jobs, 000s)	1,935	1,959	1,989
Annual change	19,500	24,050	30,450

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

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

	2013	2014	2015
Upper	27,900	38,100	68,750
Central	21,200	27,200	38,400
Lower	15,750	16,450	11,400

Note: Absolute numbers are rounded to the nearest 50.
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. In line with the forecasts from June 2013, we report the forecasted level (number) of those unemployed by the ILO definition. This is preferred to the claimant count measure, for example, 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.

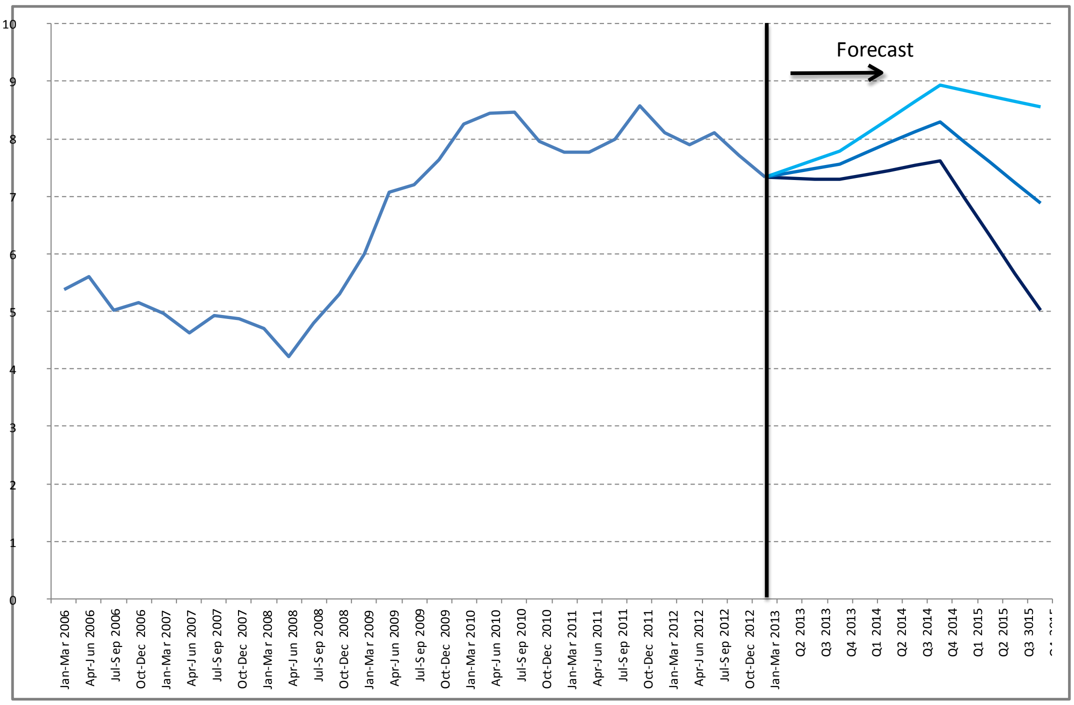
We have revised these down from our latest forecast, and are now forecasting a level of ILO unemployment at the end of 2013 of 7.6% (down from 7.9% forecast in June) and 8.3% and 6.9% in 2014 and 2015 (down from 8.4% and 7.0%) respectively. We show the history of the ILO unemployment rate since 2006 and our central and upper/lower forecasts for this variable to 2015 in Figure 6.

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

	2013	2014	2015
ILO unemployment	204,550	224,800	186,450
Rate (%)	7.6%	8.3%	6.9%

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 9: Scottish ILO unemployment rate, history and forecast: 2006 to 2015



Source: Fraser of Allander Institute forecasts

Grant Allan

Fraser of Allander Institute

22nd October 2013