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The Scottish economy

Forecasts of the Scottish economy

Economic background

There has undoubtedly been a slight slowing in the world economy but it is more marked in the US than elsewhere. Japanese performance was better than expected however and has offset the deterioration in the US. While the Euro Area remains relatively weak there are clear signs of a strengthening of activity and a modest recovery is taking place. The US is forecast to grow by 2.9 per cent this year, Japanese growth is forecast to be 2.3 per cent and the Euro Area forecast is 1.9 per cent. Inflationary pressures have been building as oil prices have surged but there are few signs of this passing through to wage bargains and over the next year as monetary policy is further tightened; inflationary pressures are expected to abate. Labour markets remain relatively buoyant but there are serious concerns over global imbalances in the world economy with the US deficit in 2005Q3 reaching 6.2 per cent of GDP. The US trade deficit is forecast to exceed \$800 billion in 2006 and the Euro Area CA has shifted from a surplus position to a deficit. The outlook for China and non-Japan Asia remains very good with strengthening domestic demand.

UK GDP growth was 1.8 per cent in 2005 after 2005Q4 growth was reported as 0.6 per cent compared to 0.4 per cent in 2005Q3. Consumption and investment growth were robust but government spending growth was flat in the fourth quarter. Net trade made a negative contribution to GDP and as before the service sector leads the UK economy. The CA deficit has widened to -£10.5 billion in the third quarter while net debt increased to £6.5 billion in December. Overall debt increased to 37.2 per cent of GDP in 2005. The UK labour market remains relatively buoyant while inflation is close to the target. The UK economy is forecast to grow by 2.1 per cent in 2006 and by 2.5 per cent in 2007. Survey evidence remains upbeat about the prospects for the UK economy as confidence is steadily increasing. The main risks to the economy are imbalances in the global economy, a significant correction to the US or UK housing market, high oil prices that are sustained beyond the medium-term and oil price increases feeding through into the wage bargain.

The Scottish economy

GVA growth in the Scottish economy was 0.5 per cent for 2005Q3 on 2005Q2 or 1.7 per cent for the four latest quarters on the preceding four quarters. When oil and gas

are excluded quarterly growth remains the same but over the year growth is 1.9 per cent. Comparing Scotland to the UK, it slightly outperformed the UK over the quarter but had identical growth to the UK on an annual basis. Scottish services grew by 0.8 per cent in the last quarter compared to 0.7 in the second quarter and 0.4 per cent in the first quarter of 2005. For the four latest quarters on the preceding four quarters service sector growth was 2.7 per cent. This is again identical to the UK growth and is a good sign for the Scottish economy. Sadly manufacturing contracted by 0.7 per cent in the third quarter of 2005 following a decline of 0.2 per cent in the previous quarter. It was 1998 when manufacturing last grew in every quarter of the year. 2005 could be the first year since 2001 that manufacturing declines in all four quarters of the year. This does not happen often and within manufacturing it has only occurred in:

- Metals and metal products (1999 and 2003);
- Paper, printing and publishing (2001 and 2003)
- and
- Electronics (2001).

The signs are however that electronics may suffer four quarters of contracting output this year. Given the weight of this sector¹, it is clear that this would have a damaging effect on manufacturing performance as it is the largest sector within manufacturing.

The agriculture sector contracted by 0.6 per cent over the latest quarter but grew by 0.3 per cent on an annual basis. Construction increased by 1.4 per cent in 2005Q3 on 2005Q2 (with growth similar to that of the second quarter) and growth over the year stands at 1.2 per cent as it performed poorly in the first quarter of the year and the last quarter of 2004.

Labour market performance remains good even taking into account the slight dip in employment in Mar-May 2005. Scottish employment for Sep-Nov 2005 was 2,469,000 which is an employment rate of 75.5 per cent. This is an increase of 14,000 and 0.3 percentage points respectively over the year. This compares favourably with the UK employment rate of 74.5 per cent. ILO Unemployment in Sep-Nov 2005 was 138,000 or 5.3 per cent. This was a quarterly increase of 7,000 or 0.2 percentage points compared to a decline of 5,000 or -0.2 percentage points over the year. Looking at the claimant count where there was a slight slowing of outflows towards the end of the year there were 85,500 claimants (a decline of 2,200 on an annual basis) representing an unemployment rate of 3.2 per cent. August, September and October were all months where claimant count increased however from 85,200 in August to 85,900 in October. Economic activity increased by 9,000 on the year to 2,607,000 in Sep-Nov 2005.

The Scottish economy continues to perform well with the exception of manufacturing, although there are signs that it may improve in the future. The decline in electronics output has been a considerable concern of late. Sustained high oil prices would be damaging to the Scottish economy as would any sudden downturn in the US or UK economies. If European export markets do not recover relatively strongly, because of a lack of strong European domestic demand (primarily consumption and investment) this could also threaten the prospects for the Scottish economy. These are the main threats to the Scottish economy. This is the background to our forecasts for the Scottish economy.

The forecast in detail

GVA

The forecast for GVA for 2005 is 1.7 per cent, down 0.1 percentage points from our last forecast. In 2006 the forecast is for growth of 1.9 per cent followed by 2.1 per cent. Services are forecast to grow by 2.7 per cent in 2005 and by 2.5 per cent in 2006. Manufacturing is forecast to decline by 0.4 per cent in 2005 but this may be greater than this due to the number of job losses and rationalisation in the electronics sector. Agriculture is forecast to decline by 0.8 per cent in 2005 (our previous forecast was for growth in this sector but the data has continued on a downward trend). Agriculture is forecast to have relatively poor growth in the next three years. Construction appears to have run out of steam after strong growth in recent years and is forecast to grow by 1.7 per cent in 2005 and by 2.3 per cent in 2006.

Table 1 Main Forecasts of the Scottish economy, 2005-2008

	2005	2006	2007	2008
GVA	1.7	1.9	2.1	2.3
Agriculture	-0.8	0.4	0.6	0.2
Manufacturing	-0.4	0.4	1.0	1.3
Construction	1.7	2.3	2.5	1.9
Services	2.7	2.5	2.4	2.6

Source: Fraser of Allander Institute, February 2006.

Final demand

Consumption, investment and government spending remain the key drivers of the economy in Scotland. Export growth is still disappointing although it is improving. The main factors affecting the forecast are given below:

- The assumption about consumption is the same as the last quarter as there does not appear to be

the same slowing of consumption in Scotland as seen elsewhere;

- Investment growth is forecast to pick-up more strongly in 2007;
- Tourism has not fulfilled expectations and it is difficult at the moment to make a clear judgement on when there will be a substantial and sustained improvement in performance and
- Exports have picked up recently with 0.7 per cent growth recorded for 2005Q3 on 2005Q2 although over the year they declined by 3.6 per cent. Undoubtedly exports are hampered by the electronics sector as there have been signs of recovery in food and drink, wood and wood products, metals and metal goods and other manufacturing.

Output

Agriculture has declined in each of the quarters since 2004Q3. Prior to this growth, especially in 2004, was relatively strong. The outlook for the sector is mediocre with growth of 0.4 per cent forecast in 2006 and 0.6 per cent in 2007. Electricity, gas and water supply is forecast to contract by 1.6 per cent in 2005 and to be relatively static in 2006. Growth is forecast to pick up from 2007 onwards. Manufacturing remains important to this sub-sector. Construction grew by 5.5 per cent in 2004 and in 2003. It was surprising to see that the sector has only grown by 1.2 per cent for the latest four quarters on the preceding four quarters. This has made a significant contribution to the slowing of Scottish growth as has the deterioration in agriculture and the lack of growth in manufacturing.

Although manufacturing grew by over 2 per cent per annum in both 1999 and 2000; it declined in the following three years; by 4.5 per cent in 2001, by 7.9 per cent in 2002 and by 2.3 per cent in 2003. Growth in 2004 was a modest 0.3 per cent. The most recent data demonstrates three successive quarters of falling output and the forecast is for a contraction of 0.4 per cent this year. 2006 and 2007 are forecast to have accelerating growth in this hard pressed sector. Within manufacturing food has been a strong growth sector but only has a weight of 16 thousandths while drink, chemicals, ORNF and transport equipment have all had significant periods of growth. Textiles, paper, printing and publishing (at times), metals and metal products, electronics and mechanical engineering have all had periods of considerable or continual decline. Manufacturing will not gather pace until export growth is recaptured and is sustained. We don't expect this to happen until 2007.

The service sector continues to drive growth and employment in Scotland. Growth in 2004 was 2.1 per cent

just below the previous year's growth rate. This followed two years of strong service sector growth. The forecast is for strong service sector growth this year and for growth of 2.5 per cent in 2006. At no time over the forecast horizon (2005-2008) does the service sector forecast drop below 2 per cent. Over the period 1998 to 2004 the strongest performers were; financial services (64.4 per cent); real estate and business services (26.9 per cent); transport and communication services (26.0 per cent) and other services (21.0 per cent). The data shows that this trend is likely to continue and these are the strongest growing sectors within the service sector forecast. The forecast for the service sector is 2.5 per cent in 2006 and 2.4 per cent in 2007.

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.

The employment (jobs) forecast for 2005 is 2,323,000 in 2005 and 2,353,100 for 2006. This is a net job change of 31,500 and 29,400 respectively. The outlook beyond this remains promising with forecast job change of 30,100 in 2007 and 32,700 in 2008. The service sector remains the critical driver of employment across the medium-term although manufacturing employment will become more important from 2007 onwards. Employment growth in construction is likely to moderate towards the end of the forecast period.

The service sector is forecast to have employment of 1,896,700 (an increase of 28,700 jobs) in 2005 and 1,921,600 (a rise of 24,900) in 2006. In 2007 and in 2008 service sector employment is forecast to grow by 24,300 and 28,500 respectively. This will take employment in the service sector to 1,974,500 in the year 2008.

The forecast for employment in manufacturing is 233,300 in 2005, which is down significantly on the forecast of last quarter and is a loss of 4,400 jobs (compared to the forecast loss of 3,300 presented in the last quarter). In 2006 employment is forecast to rise by 600 to 233,900 and to have a further increase of 1,500 in 2007.

Construction employment is forecast to be 124,300 in 2005 (an increase of 2,100 jobs) and 127,400 in 2006 (a rise of 3,100 jobs). In 2007 employment is forecast to increase to 130,200 and to 131,400 in 2008. Agricultural jobs are forecast to increase by 1,000 in 2005 but by a smaller amount in 2006. Employment in agriculture is also forecast to have a significant increase in 2007. Employment in the other industries is forecast to steadily increase over the period although much of this will depend upon the recovery in manufacturing being sustained and construction activity remaining relatively buoyant.

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

	2005	2006	2007	2008
Total				
Employment	2,323.0	2,353.1	2,383.2	2,415.9
	(31,500)	(29,400)	(30,100)	(32,700)
Agriculture	31.0	31.4	32.6	33.0
	(1,000)	(400)	(1,200)	(400)
Manufacturing	233.3	233.9	235.4	237.2
	(-4,400)	(600)	(1,500)	(1,800)
Construction	124.3	127.4	130.2	131.4
	(2,100)	(3,100)	(2,800)	(1,200)
Services	1,896.7	1,921.6	1,945.9	1,974.5
	(28,070)	(24,900)	(24,300)	(28,500)
Other Industries	38.3	38.7	39.0	39.8
	(830)	(400)	(300)	(750)

Source: Fraser of Allander Institute, February 2006.

Table 3 Forecasts of Scottish Unemployment, 2005-2008

	2005	2006	2007	2008
ILO Unemployment				
	140.8	139.9	138.2	136.3
Rate	5.4%	5.4%	5.3%	5.2%
Claimant Count	85.3	84.8	82.4	81.2
Rate	3.3%	3.3%	3.2%	3.2%

Source: Fraser of Allander Institute, February 2006.

The forecast for employment in this quarter is slightly different from previous quarters due to model calibration. This has meant service sector employment is actually higher than previously estimated while employment in agriculture, manufacturing and construction are all slightly lower. Overall the forecast remains consistent and robust.

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.

The forecast continues to demonstrate a benign outlook for unemployment. We are forecasting unemployment of 5.4 per in 2005 and in 2006 but a slight decrease in the next two years. The forecast for the ILO unemployed is 140,800 in 2005 and 139,900 in 2006. The claimant count is also forecast to decline across the forecast period from 3.3 per cent in 2005 to 3.2 per cent in 2008. Our forecast for claimant count in 2005 is 85,300 and for 2006 it is 84,800. As we have been previously, we are upbeat about Scottish unemployment remaining at historically low and stable levels. Given the strong trend in employment (and the drive of the service sector) we see little reason to change our expectations over the prospects for the labour market.

Kenneth Low
15th February 2005

Endnote

¹ The weight of electronics in 2002 was 33 compared to 161 for manufacturing and 1,000 for total GVA. The next largest sector to electronics is other manufacturing (excluding paper, printing and publishing) with a weight of 18.