State of the Economy

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This presentation outlines recent developments in the global, UK and Scottish economies. Updates are provided on a periodic basis.

Data correct up to and including the 1 December 2014.

To view previous State of the Economy presentations please visit the following link: http://www.scotland.gov.uk/Topics/Economy/state-economy

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Economist-webgroup@scotland.gsi.gov.uk
Summary of Key Conclusions

Against a relatively subdued global economic environment, growth in output in Scotland in 2014 will record its strongest performance since 2007. This has been helped, in part, by a strong pace of growth in the UK and the US this year, and has occurred despite the challenging environment in the euro area and lingering risks globally.

As a result, many aspects of the economy in Scotland have now surpassed pre-recession levels, with continued growth in output and a strengthening labour market characterised by rising employment, and falling unemployment and economic inactivity. Business and consumer confidence also remain upbeat, helped on the consumer side by a recovery in house prices to pre-recession levels.

Evidence on rebalancing within the economy remains mixed, with an improving picture on investment this year offset to some extent by more difficult trading conditions for exporters. Household confidence and spending remain buoyant helped partly by improving credit conditions, but also by rising confidence in light of better employment prospects, rising house prices and indications that real wages are starting to rise after an unprecedented period of weakness.

Other aspects of the economy are qualitatively different. Notwithstanding the recent growth, real wages remain below pre-recession levels. This reflects, in part, the degree of spare capacity still evident in the labour market along with structural changes, particularly the greater participation of older workers and the growing prevalence of flexible work patterns. These issues have also contributed to the labour market response within this recession and recovery, which is noticeably different from previous periods.

How wage growth evolves and whether elevated underemployment persists beyond this year will be influenced by how much spare capacity remains within the labour market and the behaviour of firms in terms of recruiting and retaining key staff. However, we should see wage levels rise as the economy continues to grow in 2015.

Overall, the positive momentum is expected to continue in the second half of this year and economy is on track to grow in line with, or even to exceed, independent forecasts. Looking ahead to 2015, notwithstanding headwinds from the external environment, we should see further headway in the recovery and the economy stabilising at a pace of growth in line with historical trends.

Recent Global Economic Developments

- The global recovery has continued in 2014, although with heightened downside risk in the second half of the year. This led the IMF to nudge down its recent world growth forecasts, citing factors like geopolitical tensions and weak underlying demand.
US and UK expansion has continued apace and both are expected to see some of the strongest growth in the developed world this year and next. Meanwhile conditions in the euro area, Japan, and emerging markets – including China – have deteriorated due to a mix of cyclical and structural factors.

The result is that global macroeconomic conditions are somewhat subdued. Trade growth is positive but below historical averages and weak global demand – particularly from emerging markets – is pushing down commodity prices creating very benign core inflation conditions in advanced economies.

World growth is still forecast to pick up next year but the remaining downside risks mean that economic policy is likely to remain supportive of recovery for the time being.

Recent Scottish Economic Developments

The Scottish economy has now seen two years of continuous economic growth, with the pace of expansion particularly vigorous in the first half of 2014.

At a sectoral level, services is leading the pack but production output has also continued expanding to edge above pre-recession levels. Meanwhile, the recovery in construction has made inroads, with output on an upwards trajectory and the sector recording a particularly solid performance in Q2 2014.

The Scottish labour market has continued to benefit from the strength in demand. Solid jobs growth has increased employment and helped push down the headline unemployment rate towards its pre-crisis average. Moreover, participation rates have hovered around record highs, reflecting a rise in women entering the workforce. These trends have exerted upwards pressure on nominal wage growth which, combined with benign inflation, has resulted in the first (modest) growth in real wages since 2008.

Whilst conditions are stabilising they have yet to completely normalise. There is still not full utilisation of labour market capacity, especially around working hours and full-time employment. Also, conditions for younger workers remain challenging, although recent data has provided some signal of improvement.

More generally, the structure of the economy and the labour market has changed over the recession. The extent to which these changes are temporary or reflect a more fundamental shift will be important in shaping how economic conditions evolve and determining ‘the new normal’ in the post-crisis economy.
Future Prospects – Scottish Economy

- Recent business survey evidence indicates that the positive momentum in the economy has continued in the second half of the year, although quarterly growth rates in the remainder of 2014 may ease back slightly to be more in line with their historical average.

- The global outlook is more stable than in recent years although there are headwinds from the external environment that may particularly affect Scottish exporters.

- Overall, the Scottish economy is on track to achieve growth in 2014 in line with – or even exceeding – independent forecasts, which expect the strongest year of growth since before the recession.
The External Environment
Global Overview

Path to recovery continues but with lingering risks

- Global recovery has continued in 2014 but in October the IMF nudged down its forecasts for world growth this year and next. It cautioned that global economic and political risks still have the potential to disrupt recovery. Alongside this it urged countries to prioritise economic reforms to boost their growth potential.
- The IMF also highlighted increasing divergence in performance between countries and regions, discussed below.

Increasing variability in economic performance

- US and UK growth has continued apace, with the harsh weather earlier this year proving only a temporary setback to the US economy.
- Meanwhile, conditions in the euro area and Japan have weakened and their growth forecasts for this year and next have been revised down.
- Alongside a structural slowdown in growth there has been some divergence across emerging markets. The outlook for Brazil and Russia has worsened but confidence in the Indian economy has lifted helped by successful policy action to contain rising inflation, boosting investment.

Global macroeconomic conditions subdued

- World trade volume growth is still below pre-crisis trends. Alongside this, with markets well-supplied thanks to high prices in recent years, subdued global demand is pushing down prices across a broad spectrum of commodities, especially oil. The result has been very benign inflation in advanced economies.
- World growth is still forecast to pick up next year, but the remaining downside risks mean that economic policy (e.g. monetary policy) is likely to remain supportive of recovery for the time being.
United States

Expectation-beating growth in Q3
- The US economy followed up its strong rebound in Q2 with growth of 3.9% (annualised) in Q3.
- Admittedly, the growth in Q3 reflected a boost from short-term factors, including a sharp increase in defence spending. However, the consensus view is that the US economy is on track to achieve an overall performance in 2014 in line with, or even exceeding, forecasts.

Steady progress in labour market recovery
- The labour market has continued to strengthen. Employment is now above its pre-recession level, meaning the economy has created more jobs than it shed during the crisis.
- Whilst ‘normal’ conditions have not yet been completely restored to the US labour market, unemployment is approaching its long-run average and ‘under-utilisation’ of the workforce is on a downwards trajectory, implying slack is gradually being used up. This has been feeding through to positive real wage growth, helping consumer confidence and hopefully supporting spending, a key component of demand.

Monetary policy normalisation process begins
- With recovery progressing, the Federal Reserve officially ended asset purchases under QE in October 2014.
- It is also planning for the next phase of monetary policy normalisation, first by raising interest rates then, eventually, by reducing its securities holdings under QE.
- Current market expectations are for the first rate rise to occur in mid-2015. However, with some risks on the global horizon the Fed has made clear that any move to raise interest rates will only occur if warranted by the economic data.
Euro Area

Modest Q3 growth with divergence below headline
- Bucking speculation that the euro area economy might shrink in Q3, the flash estimate saw weak but positive growth of 0.2%. Performance across the EA has diverged recently, with subdued trends in most of the largest economies, including Germany, France and Italy, and stronger growth in Spain, Greece and Ireland. Encouragingly, the growth in Spain, Ireland and Greece is helping reduce their high jobless rates.

Further ECB action to bolster recovery
- Weak demand in the EA economy along with subdued global inflation has meant that so-called ‘lowflation’ has persisted across the EA.
- From a costs and prices perspective, this boosts export competitiveness and consumers’ real spending power. However, if it persists or turns into deflation it poses a risk to EA economies with high debt. It could also jeopardise recovery if, for example, households hold off on consumption in the expectation of further falls in prices.
- Against this backdrop the ECB further loosened monetary policy in September, with more cuts to interest rates and additional credit-easing. It hopes these actions will boost aggregate demand and inflation by stimulating investment and spending, and by further weakening the euro to support exports. Alongside this, the ECB continues to emphasise the need for supply-side reform in member states as a necessary, if not sufficient, condition for sustained recovery.

Muted outlook but further inroads expected in 2015
- With subdued domestic demand and external conditions, recent EA growth forecasts have edged down. However, the pace of growth is still expected to pick up slightly in 2015.
Japan, China, and Emerging Markets

Japan
- After healthy growth at the start of 2014, the Japanese economy is in recession with contraction in Q2 and Q3 2014, as spending fell sharply after a consumption tax rise in April.
- The IMF significantly downgraded its October forecasts for Japanese growth in 2014, with a slight deceleration expected next year. More recently, the Bank of Japan undertook more QE to boost growth and inflation, whilst prime minister Abe has signalled a desire to delay further fiscal tightening in order to avoid any additional detriment to demand.

China and Emerging Markets
- Chinese growth has continued to moderate, with the government describing recent quarterly growth rates as “the new normal”, in which both cyclical and structural factors are moving the world’s largest economy onto a slower growth path.
- The slowdown is not confined solely to China. The IMF has highlighted that we are seeing a protracted slowdown in growth across emerging markets (EM) in Asia, Europe and Latin America due to a range of factors (e.g. economies reaching the limits of existing growth models with a lack of structural reform to boost potential supply).
- The slowdown is broad-based, with the IMF noting that of the 25 EMs it examined (which included all the BRICS economies) only three will have returned to pre-recession growth rates by 2019.
- The slowdown in China and other EMs is a key driver of current global economic conditions. It is behind much of the current downturn in commodity prices, as well-supplied markets adjust to lower demand from EMs. Alongside this it is dampening world trade growth. For these reasons, the outlook for EMs represents a challenge to global recovery.
UK Growth performance solid and in line with forecasts

- UK GDP growth accelerated in the first half of the year, expanding 0.7% in Q1 and 0.9% in Q2. The pace moderated slightly in Q3 to 0.7%, consistent with forecasts. Indications are that growth in Q4 will ease further, with the vigorous growth of 2014 giving way to a pace of expansion in 2015 more in line with historical trend growth.

Investment helps rebalancing but exports still lagging

- Household consumption remains a key driver of aggregate growth, with spending buoyed in part by the sustained rise in employment. However, as it continues to run ahead of income growth this is likely to remain an area of concern until we see a substantial recovery in wage growth.

- Where most progress has been made in rebalancing is investment, which has made particularly strong contributions to growth this year. Investment was better over the recovery period than previously estimated (see section below), raising a slight risk that it could drop off heading into next year. However, although investment intentions have softened somewhat recently, they still point to healthy growth in the near term.

- With the UK government still just halfway through its fiscal consolidation programme, government spending will not make any significant contribution to growth in the near-to-medium term. In fact, the OBR is reporting a possible shortfall in the UK tax take compared to projections – a result of factors like weak wage growth – which may prompt a need for further fiscal tightening.

- Meanwhile, export performance has been disappointing, reflecting subdued global demand as well as the strength of the pound. Given current global trade conditions, this trend is likely to persist through the remainder of this year and possibly into next.
Robust demand for labour cuts unemployment further
- The strength of UK growth has meant that demand for labour has been high, pushing employment up and bringing about a sustained fall in unemployment.

But jobs market still operating below capacity
- Even with the strength of employment growth, there are signs of underutilisation of capacity in the labour market, with part-time working and underemployment still elevated. Meanwhile, population growth from increased net migration and improving participation have provided a boost to labour supply. The result is that there is still a degree of spare capacity in the UK labour market.
- In addition, there has been little sign of a recovery in productivity, with a further fall over the first half of 2014 and growth expected to remain below historical averages for some time.

Substantial pickup in wage growth yet to emerge
- Anaemic productivity growth, little inflationary pressure and an underutilised workforce mean that there is still little upward pressure on nominal wages. The composition of recent employment growth has also likely had an impact as it has been concentrated in lower-skilled/ lower paid work.
- However, encouragingly the most recent data saw the first modest increase in real wages since September 2009 and the hope is that this momentum can be maintained, although forecasts suggest it may be towards the end of this decade before earnings recover to pre-crisis levels.

Economic outlook positive but not without risk
- The UK economic outlook is positive overall, as households continue to spend alongside strong business investment.
- There are still risks on the horizon, both on the domestic side and in the external environment. As a result and with very low inflation, the MPC has signalled that monetary policy can and should remain loose, with markets not expecting the first rate rise until mid-2015.
Changes to National Accounts Methodology

- ONS has revised UK National Accounts methodology due to: a) the new ‘ESA 10’ accounting standard, which reclassifies some activities from expenditure to investment (e.g. R&D spending); b) better estimates of some economic activity, particularly investment; and c) other methodological changes (e.g. under ESA 95 updates household spending on illegal activities are included in GDP for the first time).

Impacts on GDP Levels and Growth Rates

- The changes have increased the level of UK GDP, which in turn affects other economic indicators (e.g. debt-to-GDP ratio) that are based on GDP levels.
- Real annual growth rates were less affected and changes were most evident during period before and during the recession, largely due to improved estimates of investment. Growth in 2007 was revised down so the pre-recession peak in GDP was lower, whilst the 2008-2009 recession was shallower than previously estimated (i.e. a loss in output of -6.0%, compared to -7.2% previously). However, the downturn was still the deepest, and the recovery the weakest, on record.

Additional Impacts

- The higher level of GDP has revised up estimates of productivity – i.e. GDP per hour worked – albeit not enough to reverse the weakness in productivity growth; the ‘productivity puzzle’ remains.
- A reclassification of pensions which affected households’ balance sheets caused an upwards shift in the savings ratio. However, the large fall in the savings ratio in the recovery period still remains.
- Internationally, the UK’s performance in terms of recession and recovery has improved (G7 chart).

Comparisons with Scotland

- Scotland will make the same changes to its National Accounts in 2015. Meanwhile, short-term comparisons between Scottish and UK GDP are still valid but we advise caution when making longer term comparisons (e.g. to the length and depth of recessions).
Recent Developments in the Scottish Economy – Overview and Detailed Analysis
Summary

Vigorous economic expansion over first half of 2014
- The pace of economic expansion was particularly strong in the first half of 2014. Output grew 1.0% in Q1 followed by 0.9% growth in Q2.
- At a sectoral level, services is still leading the pack, but production output also continued expanding edging output in the sector above pre-recession levels.
- Meanwhile, the recovery in construction has made headway, with the sector recording a particularly solid performance in Q2 2014.

Further inroads in labour market recovery
- The labour market has continued to benefit from the strength in demand. Solid employment growth over the last year has helped push down the headline unemployment rate to its pre-crisis average. Moreover, participation rates have hovered around record highs, boosting labour market capacity.
- However, there is still not full utilisation of workforce capacity. Also, youth labour market conditions are still challenging, although recent data has provided some signal of improvement.
- Encouragingly, this year real wages in Scotland saw their first (modest) increase since 2008.

Positive momentum to maintain in second half of 2014
- The positive momentum in the economy is expected to carry through into the second half of this year.
- Looking ahead, both business surveys and forecasts expect a slight softening of growth over the remainder of the year to quarterly rates more in line with historical averages, indicative of further stabilisation in the Scottish economy.
- Whilst headwinds remain (e.g. from weak demand in export markets) the economy is now on a more solid footing than at any time since the crisis and is on track to match or even beat forecasts this year.

Forecasts (Annual GDP)

<table>
<thead>
<tr>
<th>Fraser of Allander Institute (November 2014)</th>
<th>2013 (Outturn)</th>
<th>2014</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scottish ITEM Club (June 2014)</td>
<td>1.9</td>
<td>2.4</td>
<td>1.9</td>
</tr>
</tbody>
</table>
The first half of 2014 saw vigorous growth in the Scottish economy and the positive momentum is expected to continue in the second half of this year, with output on track to grow in line with or even exceed forecasts.

Output

Scottish GDP followed up its growth of 1.0% in the first quarter of this year with further expansion of 0.9% in Q2 2014.

Encouragingly, data from the Quarterly National Accounts Scotland\(^1\) which shows contributions to nominal GDP growth, highlights that investment has increased and was the principal driver of recent nominal growth in the Scottish economy (see chart).

As a result of the growth in Q1 and Q2, Scottish output has now moved 1.1% beyond its pre-crisis peak.

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\(^1\) Available here. Note, QNAS figures are expressed in nominal terms and should be viewed in light of the fact that, unlike headline the GDP growth rate, they have not been adjusted for changes in price.
Sectoral Trends

Positive growth was recorded across virtually all sectors of the Scottish economy over the first half of 2014.

The Service sector has continued to perform well with strong growth over the first half of this year. In Q2, Service sector output expanded 0.9% with growth recorded across most sub-sectors. Q2 saw particularly strong growth in one of the largest sub-sectors, Professional, Scientific, Administrative & Support Services, which includes businesses providing onshore services to the oil & gas industry.

Meanwhile, after a solid start to the year with growth of 2.1% in Q1 helped by the rebound in output volumes at the Grangemouth complex after its temporary closure at the end of 2013, the pace of growth in the Production sector moderated in Q2 to 0.3%. Contraction was recorded in two of the largest production sub-sectors, Manufacturing and Electricity & Gas Supply. In the latter, the slowdown was driven by unusually warm weather conditions in Q2, which weighed on demand for the sector’s output. Meanwhile, the contraction in Manufacturing output in Q2 was partly because of planned maintenance work in some parts of the Grangemouth refinery, which was concluded towards the end of the quarter. Given these factors, the reduction in the overall pace of growth in Production appears to have been due to temporary factors rather than an underlying weakening in conditions.

The recovery in the Construction sector has continued making headway over the first half of 2014. Construction saw particularly solid expansion in Q2 (3.6%), helped by both public infrastructure and private investment. Whilst Construction still has some way to go before making a full recovery, looking through quarterly volatility, output has generally remained on an upwards trajectory over the last eighteen months.

<table>
<thead>
<tr>
<th>Quarterly Growth (i.e. Q2 2014 compared to Q1 2014)</th>
<th>Scot</th>
<th>UK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service Sector</td>
<td>0.9</td>
<td>1.1</td>
</tr>
<tr>
<td>Distribution, Hotels &amp; Catering</td>
<td>0.2</td>
<td>1.0</td>
</tr>
<tr>
<td>Transport, Storage &amp; Comms</td>
<td>1.3</td>
<td>1.5</td>
</tr>
<tr>
<td>Business Services &amp; Finance</td>
<td>2.0</td>
<td>1.5</td>
</tr>
<tr>
<td>Government &amp; Other Services</td>
<td>-0.2</td>
<td>0.3</td>
</tr>
<tr>
<td>Production Sector</td>
<td>0.3</td>
<td>0.2</td>
</tr>
<tr>
<td>Mining &amp; Quarrying</td>
<td>5.4</td>
<td>-0.3</td>
</tr>
<tr>
<td>Electricity &amp; Gas</td>
<td>-3.1</td>
<td>1.5</td>
</tr>
<tr>
<td>Water Supply &amp; Waste Mgmt</td>
<td>0.0</td>
<td>-2.5</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>-0.4</td>
<td>0.5</td>
</tr>
<tr>
<td>Construction</td>
<td>3.6</td>
<td>0.7</td>
</tr>
<tr>
<td>Agric., Forestry &amp; Fishing</td>
<td>-1.5</td>
<td>-0.3</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Annual Growth (i.e. Q2 2014 compared to Q2 2013)</th>
<th>Scot</th>
<th>UK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service Sector</td>
<td>2.9</td>
<td>3.2</td>
</tr>
<tr>
<td>Distribution, Hotels &amp; Catering</td>
<td>1.7</td>
<td>4.4</td>
</tr>
<tr>
<td>Transport, Storage &amp; Comms</td>
<td>4.4</td>
<td>2.5</td>
</tr>
<tr>
<td>Business Services &amp; Finance</td>
<td>5.3</td>
<td>4.2</td>
</tr>
<tr>
<td>Government &amp; Other Services</td>
<td>0.6</td>
<td>1.5</td>
</tr>
<tr>
<td>Production Sector</td>
<td>0.9</td>
<td>2.4</td>
</tr>
<tr>
<td>Mining &amp; Quarrying</td>
<td>7.9</td>
<td>1.4</td>
</tr>
<tr>
<td>Electricity &amp; Gas</td>
<td>-3.3</td>
<td>-6.6</td>
</tr>
<tr>
<td>Water Supply &amp; Waste Mgmt</td>
<td>1.4</td>
<td>1.3</td>
</tr>
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<tr>
<td>Construction</td>
<td>5.2</td>
<td>5.7</td>
</tr>
<tr>
<td>Agric., Forestry &amp; Fishing</td>
<td>-3.0</td>
<td>1.4</td>
</tr>
</tbody>
</table>
Index of Manufactured Exports (IME)

The volume of Scottish manufactured exports (a subset of total international exports) also grew strongly over the first half of 2014, expanding 2.8% in both quarters. In Q2, export volumes were up across most of the largest exporting sectors, with the exception of Food and Drink, where there was a slight quarterly contraction.

The -0.2% contraction in Food & Drink export volumes was largely from Drinks (chiefly Scotch Whisky) as Food exports actually increased. Whisky exports to China fell sharply last year as the Chinese government was reported to have tightened rules on purchases by government officials. However, the Q2 contraction in Drinks was only slight (0.2%) and followed a quarter of expansion in Q1 (1.5%), suggesting that conditions for whisky exporters may be stabilising.

Exports from the Refined Petroleum Chemical & Petroleum Products sector increased 4.4% in Q2 2014 driven by the sale of previously built-up refinery stocks to overseas markets. The effect on volumes from both the temporary Grangemouth closure at the end of 2013 as well as the planned maintenance in Q2 is evident in annual figures, which show RPCPP export volumes contracting (-5.7%).

<table>
<thead>
<tr>
<th>Manufactured Exports, Scotland, Q2 2014</th>
<th>Quarterly Growth (%)</th>
<th>4Q-on-4Q Growth (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food, Beverages &amp; Tobacco</td>
<td>-0.2</td>
<td>-4.6</td>
</tr>
<tr>
<td>Engineering &amp; Allied Industries</td>
<td>4.7</td>
<td>0.9</td>
</tr>
<tr>
<td>RPCPP</td>
<td>4.4</td>
<td>-5.7</td>
</tr>
<tr>
<td>Non-metallic Products, Other Manufacturing &amp; Repair</td>
<td>7.7</td>
<td>11.4</td>
</tr>
<tr>
<td>Metals &amp; Metal Products</td>
<td>0.6</td>
<td>20.3</td>
</tr>
<tr>
<td>Wood, Paper &amp; Printing</td>
<td>-1.2</td>
<td>-4.0</td>
</tr>
<tr>
<td>Textiles, Clothing &amp; Leather</td>
<td>-6.5</td>
<td>10.6</td>
</tr>
<tr>
<td><strong>Total Manufactured Exports</strong></td>
<td><strong>2.8</strong></td>
<td><strong>0.5</strong></td>
</tr>
</tbody>
</table>

The growth in Engineering & Allied Industries (4.7%) was due to a robust performance in the Transport Equipment sub-sector - reflecting a rise in export volumes in motor vehicles and civil aerospace – as well as a quarterly rise in overseas sales from the Mechanical Engineering and Electrical & Instrument Engineering sub sectors.

The positive performance in manufactured export volumes over the first half of 2014 was encouraging since prevailing conditions have been somewhat unfavourable given the strength in sterling and relative weakness in some export markets. As these trends have persisted into the second half of the year Scottish manufacturers, along with their UK counterparts, are likely to continue to face challenging conditions throughout the remainder of 2014.
Business Surveys

Reflecting the strength of economic growth over the first half of the year, the Scottish business surveys\(^2\) were also registering some markedly high readings in the first two quarters of 2014.

Moving into Q3, whilst some survey net balances remained close to the highs seen in the previous quarters, there was a degree of softening in others (see table). Nevertheless, in most surveys net balances remained robust compared to historical averages and stayed in positive territory. The surveys therefore point to continued expansion across the Scottish economy as a whole in Q3, perhaps with a degree of moderation in quarterly growth rates similar to that seen in the UK economy as a whole in Q3.

<table>
<thead>
<tr>
<th>Business Surveys - New Orders ((&lt;0 = \text{contraction}))</th>
<th>Average pre-recession value (i.e. all quarters available up to Q4 2007)</th>
<th>Average value (i.e. all quarters available up to Q3 2014)</th>
<th>Q4 13</th>
<th>Q1 14</th>
<th>Q2 14</th>
<th>Q3 14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scottish Chambers: Manufacturing</td>
<td>14.8</td>
<td>6.7</td>
<td>13.1</td>
<td>30.5</td>
<td>37.7</td>
<td>30.6</td>
</tr>
<tr>
<td>Construction</td>
<td>17.8</td>
<td>-11.8</td>
<td>28</td>
<td>17.8</td>
<td>40.8</td>
<td>17.7</td>
</tr>
<tr>
<td>Retail</td>
<td>-13.2</td>
<td>-29.9</td>
<td>18.8</td>
<td>-18.5</td>
<td>-7.8</td>
<td>-5.6</td>
</tr>
<tr>
<td>Tourism</td>
<td>21.5</td>
<td>2.2</td>
<td>47.6</td>
<td>20.7</td>
<td>26.7</td>
<td>38.3</td>
</tr>
<tr>
<td>CBI</td>
<td>n/a</td>
<td>n/a</td>
<td>6</td>
<td>23</td>
<td>43</td>
<td>3</td>
</tr>
<tr>
<td>Scottish Engineering</td>
<td>7.5</td>
<td>5.3</td>
<td>12</td>
<td>16</td>
<td>20</td>
<td>-4</td>
</tr>
<tr>
<td>Bank of Scotland Business Monitor</td>
<td>17.4</td>
<td>9.5</td>
<td>13</td>
<td>22</td>
<td>25</td>
<td>23</td>
</tr>
</tbody>
</table>

Although the surveys suggest a generally positive outlook one area of risk that they have highlighted is in exports, particularly from the manufacturing sector. Whilst some of the surveys are still pointing to an upbeat picture for exports, the PMI and Scottish Engineering indicators for manufacturing exports have moved into negative territory. These figures underline the mixed global picture, with conditions relatively buoyant in some of Scotland’s key export markets (US, UK) and much weaker in others (Europe). Interestingly, forward expectations for overseas sales have been more consistent across the surveys, with firms anticipating a pickup in export orders at the end of this year.

<table>
<thead>
<tr>
<th>Exports ((&lt;0 = \text{contraction})</th>
<th>Q4 13</th>
<th>Q1 14</th>
<th>Q2 14</th>
<th>Q3 14</th>
<th>Expectations for Q4 2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>CBI: Volume of export orders</td>
<td>9</td>
<td>6</td>
<td>0</td>
<td>-10</td>
<td>17</td>
</tr>
<tr>
<td>Scottish Engineering: Exports</td>
<td>-2</td>
<td>-3</td>
<td>-6</td>
<td>-23</td>
<td>27</td>
</tr>
<tr>
<td>Scottish Chambers: Export order (Manu)</td>
<td>1.4</td>
<td>15.4</td>
<td>17.4</td>
<td>17.9</td>
<td>16.9</td>
</tr>
<tr>
<td>Bank of Scotland Business Monitor (trends in actual export activity)</td>
<td>-14</td>
<td>12</td>
<td>14</td>
<td>13</td>
<td>32(^3)</td>
</tr>
</tbody>
</table>

\(^2\) The CBI Industrial Trends Survey (CBI), Scottish Engineering Quarterly Review, Bank of Scotland Business Monitor and Scottish Chambers of Commerce Quarterly Business Survey (SCC)

\(^3\) Export expectations for next six months i.e. Q4 2014 and Q1 2015.
Conclusion

There is a clear and sustained strengthening in the Scottish economy. Last year growth was at its fastest since before the financial crisis and the economy returned to pre-recession levels in the first half of this year helped by particularly strong rates of expansion.

Business survey evidence suggests that growth has continued into Q3 2014. Survey figures have eased back and are mainly at, or above, where they were before the recession, signalling further stabilisation in the Scottish economy.

Challenges remain, for example around weak global trade conditions. However, the underlying data and trends – along with the independent economic forecasts – indicate that the Scottish economy is on a more solid footing that at any time since the crisis, and growth is expected to continue throughout this year into 2015.
The Scottish labour market has continued to benefit from strengthening demand within the economy. Solid jobs growth increased employment to new record levels during the year helping to push down the headline unemployment rate towards its pre-crisis average.

**Recent Labour Market Developments**

**Employment and Participation**

Latest statistics (Jul - Sep 2014) show Scottish employment levels up 50,000 over the year to reach 2,605,000. Alongside this, Scotland’s employment rate also rose 1.1 percentage points to 73.8%. Although employment is now higher than before the recession in absolute numbers, boosted somewhat by an increase in people aged 65 and over who are working, the rate is still slightly below its pre-crisis peak, due partly to population growth and also because people aged 65+ are not included in rates.

Meanwhile, labour market participation has been rising and has hovered around record highs throughout 2014. The economic activity rate is currently 78.6%, well above the recession low of 76.2% in Feb-Apr 2010.
Unemployment

Unemployment has continued its sustained fall since a peak of 8.6% in Nov-Jan 2012. The Scottish ILO unemployment rate now stands at 5.9% (UK 6.0%) following a 1.4 percentage point fall over the year to the latest quarter (Jul-Sep 2014). Underpinning this, unemployment levels were down 38,000 over the year and 10,000 over the quarter.

Spare Capacity and Wages

Whilst the headline indicators of employment and unemployment are around or above their pre-recession averages, the legacy effects from the recession have still not fully worked their way out of the labour market. For example, the chart indicates that the workforce is still not being fully utilised – working hours and levels of full-time employment remain below pre-recession norms, indicating that underemployment remains elevated.

However, with the strength in employment and with unemployment close to its pre-recession average rate, we have started to see some upward movement in nominal wage growth. Recently published\(^4\) Annual Survey of Hours and Earnings data shows that median weekly wages for full-time workers in Scotland rose 2.1% over the year to April 2014. Combined with the benign inflation environment, with CPI inflation standing at 1.7% in the same period, the result has been the first increase in average real wages.

\(^4\) ONS (2014) Annual Survey of Hours and Earnings Provisional Results, available here.
(0.3%) in Scotland since 2008. Whilst this is encouraging, this pace of nominal wage growth remains below its historical average and wages are still well below pre-recession levels in real terms. Looking ahead, the degree of slack in the labour market and the rate at which it is used up with the strength in demand will be important factors in determining whether this momentum is maintained and whether the pace of earnings growth accelerates.

*Structural Changes in the Labour Market*

Alongside cyclical effects from the recession and recovery, recent years have also seen some important changes to the structure of the Scottish labour market and some of these trends are outlined in this section. The important point to note is that whilst some of these may unwind as the economy continues to recover, others represent longer term structural shifts. As a consequence, it is still not fully clear what will constitute ‘normal’ labour market conditions in the post-crisis economy.

Labour market participation has been rising, with the economic activity rate currently at 78.6%, a near record high and well above the recession low of 76.2% in Feb-Apr 2010. Rising participation is due mainly to female participation, which has experienced a longer trend increase as well as an uptick in recent years. Some of the increase that is due to cyclical factors (e.g. pressure on household incomes) may unwind as wages and economic conditions continue to improve. However, this is generally a positive development, both for the economy as a whole and since increasing female participation is regarded as key to improving gender equality.

Alongside rising participation there have been marked changes in employment rates for different age groups. Rates for older workers, particularly those 65 and over, have increased throughout the recession and recovery period (see chart). Whilst this may be due partly to individuals working longer to plug shortfalls in pension incomes, it also reflects people living longer healthier lives and choosing to work beyond 65, helped by the abolition of the compulsory retirement age. The balance between these factors will determine whether this becomes an enduring feature of the labour market. In the meantime, the rise in older workers is having an impact on labour market conditions, for example forming at least part of the explanation for elevated levels of part-time working and self-employment.
As highlighted in previous editions of State of the Economy, the crisis particularly affected young people, with a marked fall in employment rates for 16-24 year olds along with a rise in youth unemployment. This has justifiably received considerable attention because of the potential long term implications for the individuals affected as well as the economy (e.g. in terms of lost productivity and lower future participation). Encouragingly, recent data has shown signs of improvement in the youth labour market indicators. The fall in employment has started to stabilise and youth unemployment has fallen. Alongside this the youth claimant count rate is now back at pre-recession levels and the historical relationship between the two measures suggests that unemployment will follow a similar path. Overall, a full recovery may take time to embed and the youth labour market may have changed in fundamental ways. For example, increasing participation in education, which is a positive development, may result in lower equilibrium youth employment rates than before the crisis.

Looking across the course of the recession and recovery, the relationship between unemployment and GDP has differed markedly from the previous recession of the early 1990s. Since unemployment data for Scotland is only available back to 1998, this is shown using UK data (see charts below).
In 1990, UK GDP fell with the onset of the recession and recovered to its pre-recession level after eight quarters. Meanwhile, unemployment rose sharply and continued to rise after GDP had recovered, peaking ten quarters after the start of the recession then starting to fall and taking more than two years to move back to its pre-recession rate. This gave rise to the expression the “jobless recovery”.

With the onset of the 2008 recession GDP fell much more sharply than in the 1990s. Like in the previous recession the unemployment rate also shot up and remained elevated, taking a considerable time to recover. However, it did not increase by as much as in the 1990s recession.

This shows the well-documented phenomenon that whilst the 2008 recession was much more severe and protracted than the 1990s recession in terms of the fall in output, its impact on unemployment was comparatively less. A number of factors are likely to have played a role in this.

- A greater tendency by employers to respond to the weakness in demand by cutting or freezing pay and/or reducing working hours, rather than shedding labour.

- Many individuals have responded to fewer job opportunities by becoming self-employed, likely facilitated by the relatively lower costs of starting a micro-business now compared to in the 1990s (e.g. because of technological advancements, changes in taxes and regulations).

- Common to many advanced economies, a greater use of active labour market policy than in the 1990s, along with welfare reform that has been characterised by a strong focus on conditionality related to labour market participation.

The 2008/09 recession undoubtedly had a significantly negative impact on the labour market and individual outcomes, both in the UK and Scotland. However, the jobs market has shown greater resilience than initially feared due to structural changes in the wider economy, which have facilitated a more flexible and differentiated response to the crisis than was seen in the previous recession.

Conclusion

Against the backdrop of two years of sustained recovery we have seen a robust strengthening in the Scottish labour market, with increases in employment, and reductions in unemployment and economic inactivity.

A degree of underutilisation of our workforce remains, wage growth is picking up but is still below historical rates, and youth labour market conditions remain challenging. Alongside this, there have also been some important changes to the structure of the labour market. Whilst some of these may unwind as the economy continues to
recover, others may represent longer term structural shifts. As a consequence, it is still not fully clear what will constitute 'normal' labour market conditions in the post-crisis economy.
## Future Prospects

<table>
<thead>
<tr>
<th>Annual GDP Forecasts</th>
<th>Scotland</th>
<th>UK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fraser of Allander Institute (June 2014)</td>
<td>1.9</td>
<td>2.7</td>
</tr>
<tr>
<td>Scottish ITEM Club (June 2014)</td>
<td>1.9</td>
<td>2.4</td>
</tr>
<tr>
<td>OECD (November 2014)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>HMT Average UK Independent Forecast (November 2014)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>European Commission (November 2014)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>IMF (October 2014)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>OBR (March 2014)</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

### Future Prospects – Scotland

The recent data and forecasts point to a particularly strong pace of growth in the Scottish economy during 2014. Next year is expected to see further stabilisation, with overall growth settling back to a pace more in line with its long term average.

Most recently, the Fraser of Allander Institute raised its 2014 Scottish growth forecasts to 2.7% (previously 2.5%) on the back of the strength of growth over the first half of this year. As with the UK, Scottish forecasts predict that the pace of expansion will ease slightly next year as the economy stabilises to a more sustainable pace of growth driven by a mix of household consumption and investment.

Recent results from the CBI, Scottish Engineering Quarterly Review, Bank of Scotland Business Monitor and Scottish Chambers of Commerce (SCC) surveys are consistent with the independent forecasts. Following particularly strong recordings for business optimism and future expectations over the first half of 2014, measures softened a little in Q3 2014 but remained in positive territory. Encouragingly, the most recent Scottish Engineering, CBI and SCC surveys also indicated that firm’s investment
plans were strong, with the SCC investment measure recording the second highest reading since 2007.

<table>
<thead>
<tr>
<th>Investment Intentions - Scottish Business Surveys</th>
<th>Q2 2013</th>
<th>Q3 2013</th>
<th>Q4 2013</th>
<th>Q1 2014</th>
<th>Q2 2014</th>
<th>Q3 2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>5</td>
<td>7.9</td>
<td>11.1</td>
<td>15.7</td>
<td>20.0</td>
<td>18.1</td>
</tr>
<tr>
<td>Construction</td>
<td>n/a</td>
<td>5.2</td>
<td>n/a</td>
<td>0</td>
<td>n/a</td>
<td>4.5</td>
</tr>
<tr>
<td>Wholesale Distribution</td>
<td>-21.4</td>
<td>6.7</td>
<td>0</td>
<td>17.6</td>
<td>13.3</td>
<td>n/a</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>CBI - respondents' 12 month forecast of spend on:</th>
<th>Jul-13</th>
<th>Oct-13</th>
<th>Jan-14</th>
<th>Apr-14</th>
<th>Jul-14</th>
<th>Oct-14</th>
</tr>
</thead>
<tbody>
<tr>
<td>product/ process innovation</td>
<td>24</td>
<td>28</td>
<td>20</td>
<td>27</td>
<td>32</td>
<td>25</td>
</tr>
<tr>
<td>training/ re-training</td>
<td>20</td>
<td>33</td>
<td>26</td>
<td>26</td>
<td>27</td>
<td>27</td>
</tr>
<tr>
<td>buildings</td>
<td>-23</td>
<td>-20</td>
<td>-1</td>
<td>-6</td>
<td>-1</td>
<td>-14</td>
</tr>
<tr>
<td>plant/ machinery</td>
<td>-1</td>
<td>-8</td>
<td>4</td>
<td>16</td>
<td>6</td>
<td>5</td>
</tr>
</tbody>
</table>

nb: figures refer to percentage balances of respondents (i.e. positive responses less negative responses)

In terms of the labour market, the business surveys readings for employment point to a continued expansion in private sector job creation over the final quarter of this year into 2015, which should support further increases in employment and decreases in unemployment.

<table>
<thead>
<tr>
<th>Business Surveys: Net Balances</th>
<th>Q4-13</th>
<th>Q1-14</th>
<th>Q2-14</th>
<th>Q3-14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scottish Engineering: staffing forecasts for next 3 months</td>
<td>16.0</td>
<td>9.0</td>
<td>26.0</td>
<td>20.0</td>
</tr>
<tr>
<td>CBI Scotland Industrial Trends: numbers employed next 3 months</td>
<td>7.0</td>
<td>32.0</td>
<td>28.0</td>
<td>7.0</td>
</tr>
<tr>
<td>Scottish Chambers: Manufacturing sector expected employment trends next 3 months</td>
<td>10.9</td>
<td>18.7</td>
<td>19.1</td>
<td>19.0</td>
</tr>
</tbody>
</table>
Introduction

Earlier this year State of the Economy highlighted initial work to develop a Scottish consumer sentiment indicator. This section sets out preliminary results from the underlying consumer survey, as well as next steps in developing an indicator.

Background

The consumer sentiment indicator is part of a wider programme to enhance Scottish Government capacity to model and analyse the economy. The indicator will potentially perform two functions: first, it will offer a timely, qualitative gauge of consumer sentiments in the economy. Second, to the extent that changes in consumer sentiments correlate with changes in consumption and/or GDP, it will be used as a ‘leading indicator’ of economic conditions.

In Scotland, consumer sentiments are being measured through a quarterly survey which asks households for their views about the current and future performance of the Scottish economy and their household finances. The questions about household finances are included because research suggests that individuals’ reports of their own economic situation - as opposed to the macro-economic situation - display less volatility over time, may be more robust (as it is assumed households have better information about their own circumstances than the economy as a whole) and may correlate better with their eventual spending behaviour.

Alongside this, in collaboration with behavioural economics researchers at the University of Stirling the Scottish Government is testing a novel approach. One half...
of survey participants is asked about the wider economy in the format typically adopted in these types of surveys (known as the ‘direct’ format) while the other half is asked in an alternative format (the ‘indirect’ format). The objective is to test a theory from behavioural research that the alternative format reduces a possible form of bias in these survey, which appears to manifest itself in two ways. First, people may be excessively pessimistic in assessing the economy during a downturn and vice versa when the economy is buoyant. Second, depending on personality traits, individuals may have a consistent tendency to be overly optimistic or overly pessimistic when assessing the economy. If the alternative format is successful in reducing this bias it could have implications for the improving the reliability of the consumer sentiments indicator. Examining this in collaboration with the University of Stirling will be part of the indicator development process.

Preliminary Results from the Consumer Sentiments Survey

The survey has now been completed for six quarters (Q2 2013 - Q3 2014) and this section sets out preliminary results. It is important to note that at this stage we cannot determine if the quarterly and annual changes are statistically significant or if the data displays seasonal effects. Nonetheless, the preliminary results allow us to monitor emerging trends in the data.

The charts show results under both question formats (where relevant) displaying the share of respondents in each quarter who reported that: the current or future performance of the economy – or the security of their household finances/ how relaxed they are about spending – was improving, deteriorating or was unchanged. The charts also show ‘net balances’ for each question (i.e. the share of positive responses minus negative responses). This is a summary indicator which gives a feel in each quarter for how far, and in which direction (positive/ negative), responses differed from ‘no change’.

Wider Economy

In terms of the general trend in the data over the six quarters, coinciding with an improving economic outlook the net balances rose. This reflects a rising share of households who thought the economy was performing better than a year ago. The net balances dipped in Q4 2013, which was also a relatively weak quarter in the Scottish economy, partly due to the temporary closure of the Grangemouth plant. More recently, Q3 2014 (indirect format only) saw another downturn in the net balance, driven by the proportion who thought the economy was performing better falling with an equivalent rise in the share of ‘no change’ responses so that the net balance remained positive overall. This may reflect the gradual stabilisation in wider economic conditions feeding through to people’s perceptions.

Note that questions on personal finances are asked in the indirect format. These are not thought to be prone to the bias partly because individuals have better information about the state of their own finances than conditions in the economy.

For more information on the behavioural collaboration, see State of the Economy, April 2014, available here.
Turning to expectations for the economy over the next 12 months, the overall picture is less clear than for current performance, with more volatility during the six quarters under the direct format and greater stability under the indirect format. For this reason, we focus solely on the quarters where there is data for the same quarter of the previous year. In Q2 2014, the net balances were more positive than in 2013 as both the share of positive responses was up and the share of negative responses was down under both formats. Moving on to Q3 2014, the net balances remained positive but to a slightly lesser degree than in 2013 under both formats, as the share of positive responses was down and the share of neutral responses was up with little change in negative responses. Again, this is suggestive of a degree of levelling off in households’ expectations, in line with the gradual stabilisation in economic performance and therefore an expectation that conditions a year ahead will be similar to conditions currently.

Comparing Responses to Questions about the Economy Under Different Formats

Looking at differences under the different question formats, a number of interesting trends have emerged. If the biases discussed earlier (e.g. overly optimistic/pessimistic assessments) do exist we might expect them to manifest themselves in a
larger share of positive or negative, rather than neutral, responses about the economy under the direct format. Also, if people are overly-pessimistic when economic conditions are bad, there might be a stronger tendency towards negative responses under the direct format in the earliest quarters, since the survey commenced during the initial recovery from a severe recession. Both these are visible in preliminary results.

- In each quarter the direct format respondents were less likely to give a neutral response about the current economic performance than those asked in the indirect format. The difference was also evident in questions about the future performance of the economy, although was less marked.
- Moreover, in the question about current conditions, respondents in the direct format were more likely to give negative responses, particularly in the earliest quarters. However, this difference is not as visible in expectations for the future performance of the economy.

The preliminary results therefore lend some tentative support to the University of Stirling’s earlier conclusion (see State of the Economy April 2014) that the indirect format may serve to reduce these particular types of response bias.

**Household Finances**

Over the six quarters the net balance for the question about household finances relative to a year ago has moved into positive territory, driven by a rise in the share of households responding that their finances had become more secure. This may reflect to some extent the improvement in the outlook for both the Scottish and UK economies and labour markets. There was also a shift into positive territory in the net balance for how relaxed households felt about spending, but driven more by a reduction in negative responses alongside an increase in neutral responses.

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\(^7\) Note, as questions regarding household finances and attitudes towards spending are asked in the indirect format, they are only compared to wider economy estimates under the indirect format, not the direct format.
Turning to expectations about household finances a year ahead, the net balance rose generally up to Q2 2014, driven by a fall in negative expectations. In Q3 2014 the net balance remained in positive territory but dipped slightly due to a fall in positive expectations and a rise in the share who thought household finances would be less secure. The reasons for this are not clear, although the UK consumer confidence sub-indicator indicator for ‘personal financial situation over the next twelve months’ also dipped in Q3 2014.

As discussed earlier, questions about household finances are included because research suggests these estimates should be less volatile over time as individuals’ information about their own economic situation may be better than their information on the economy. This effect is visible in the preliminary results. In general, quarterly changes in the questions on current household finances and attitudes towards spending were smaller than those to questions about the economy. The effect is less evident in future expectations, which is perhaps intuitive as future predictions are more difficult both for household finances and for economic performance.

An additional point of note is that when looking at their current circumstances, households’ appraisal is generally less positive than their assessment of the wider economy. In other words, in each quarter a smaller share of households thought their finances were getting more secure, or felt more relaxed about spending, than the share who thought the wider economic situation was improving. Simultaneously, a larger share thought their finances were getting less secure and were less relaxed about spending than the share who reported that the wider economic situation was worsening. These results are in line with conditions in the wider economy, in which the strength of recovery in conditions that directly affect households’ finances (i.e. wages and full-time employment) have lagged behind the recovery in overall economic output over the last two years.

Interestingly, when responding with expectations about their household finances, households tended to be more neutral (i.e. reporting no change) compared to their expectations of the wider economic performance. This may indicate that they
generally expect less change (either positive or negative) to their personal circumstances in the future than they do in the wider economy. However, it may also indicate that households are naturally less willing to share information on their personal circumstances.

**Further Developments**

As noted, the intention is to develop the data further and a Scottish consumer sentiment indicator, once developed and assessed, will be used for two purposes: as a qualitative gauge of consumer sentiments; and, if it is found to have predictive power for economic variables such as GDP growth, as a ‘leading indicator’ of economic conditions.

The Scottish Government, in collaboration with the University of Stirling, will continue work to develop and assess a Scottish consumer sentiment indicator, with updates in future editions of State of the Economy.