EY ITEM Club Scottish Spring Forecast

May 2024

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EY ITEM Club Scottish Forecast

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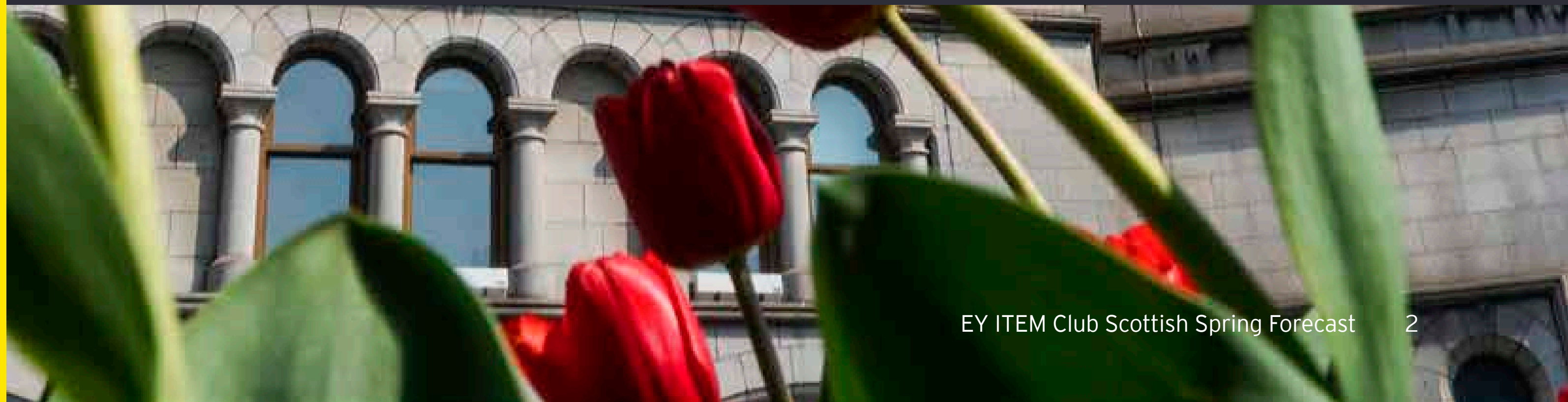
The report is based on data and information available before May 2024. The quarterly EY ITEM Club Scottish report is part of the EY Economics programme which provides knowledge, analysis and insight to help businesses understand the economic environments in which they operate, both in the UK and globally.

Contents

Foreword	3
Highlights	5
Latest developments	7
Economic outlook	13



Foreword

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As the Scottish business community anticipates a policy reset from new political leadership, our forecast shows the economy remains marginally behind, but largely tracks, trends we see at a UK level. The deterioration at the end of the year was most strongly felt in the manufacturing sector which suffered a sharp decline in Q4, and while the services sector was largely flat overall, some private service activities show signs of improvement.

Households and some business sectors appear to be gaining optimism about the year ahead, but recovery in household finances and spending will take time to feed through into growth. GVA growth is forecast to be weak this year, but momentum is predicted to build for a brighter outlook in 2025 and beyond.

Scotland's employment is expected to rise as conditions improve through the year with sustained growth both this year and next. While this is welcome news, Scotland's employment is predicted to lag the UK average.

Differences between Scotland and UK's employment growth prospects, in part, relates to underrepresentation in certain sectors that are expected to see stronger employment growth in the future. Our report predicts demographics will continue to play a key role in determining the scale of future jobs growth which shows why a competitive advantage is so important in attracting a highly skilled workforce. That's why having a shared vision, like the Scottish financial services growth strategy, is fundamental to constructive collaboration across industry and government, and the sector looks forward to deepening that dialogue with the incoming new government.

While political distraction and instability is never welcome within the business and entrepreneurial community, Scotland currently has an opportunity to reset the sluggish trajectory of what many of our reports imply and set a functional, pro-growth business agenda that can enable and accelerate a more vibrant and sustainable economy for the longer-term.

Highlights

- Scotland's economy shrank in the last quarter of 2023 and growth over the entire year was flat. Much like the UK, Scotland's economy has not grown in two years, and there is also growing evidence that labour market demand is softening including falling employment, fewer job adverts, and easing pay growth even as unemployment remains low.
- The deterioration at the end of the year was most strongly felt in the manufacturing sector which suffered a sharp decline in Q4, and whilst the services sector was largely flat overall, some private service activities showed signs of improvement.
- Households and businesses are optimistic about the year ahead, but the recovery in household finances and spending will take time to feed through into growth. GVA growth is forecast to be weak this year as momentum builds for a brighter outlook for 2025 and beyond. Consumer-facing sectors are set to benefit, and together with the human health & social care sector and key private services sectors, they will experience some of the strongest rates of growth.
- The underlying weakness in economic activity will have only a modest impact on Scotland's labour market in 2024. Although we forecast a modest rise in unemployment to 4.2% this year, it will unwind quickly with the rate returning to 4.0% in 2025. As conditions improve through the year, employment is expected to rise, and growth of around 0.8% should be sustained both this year and next.
- The outlook for employment growth shows a broadly similar sectoral pattern, with consumer-facing sectors, human health & social and administrative & support services underpinning job growth. We do, however, expect job losses in some sectors, most notably in manufacturing and mining & quarrying.

Latest developments

Scotland's economy declined at the end of last year but there are signs it is returning to growth

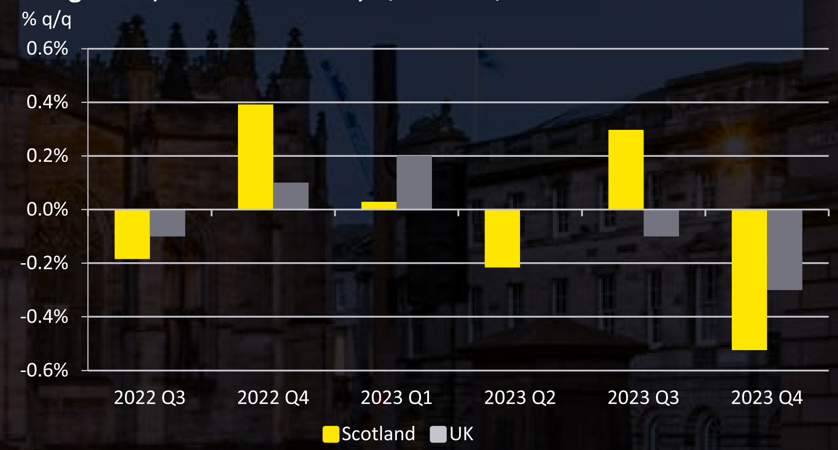
The latest quarterly GDP data shows that the Scottish economy shrank at the end of last year, with output falling by 0.5% in Q4. The outcome meant Scottish GDP fell over the second half of 2023 and a decline of 0.2% was near identical to the 0.4% GDP fall suffered by the UK overall. Looking back over the entire year, Scotland's economy grew by just 0.1% in 2023, the same as the UK. Ultimately, at the end of 2023, Scotland was almost exactly the same size as it was at the end of 2021 in GDP terms.

Whilst growth last year was disappointing, monthly data indicate that the Scottish economy has returned to GDP growth in 2024, and in the three months to February, GDP is estimated to have increased by 0.4% compared to the previous three-month period. Although encouraging, a degree of caution is required given the somewhat erratic nature of the monthly GDP estimates, which are subject to future revision. Indeed, the estimate for the month of February shows a 0.3% contraction in Scotland. However, there are other signs of cautious optimism including estimates of positive UK GDP growth in January and February and more upbeat business surveys.

Further economic developments likely helping Scotland's economic performance come from inflation and pay. The Consumer Prices Index (CPI) measure dropped to a 30-month low of 3.2% in March, down from a peak of nearly 11% in late 2022. And indications suggest that pay growth has continued to outstrip price rises, building on the recovery of real wages that began in mid-2023, which should help to ease the pressure on household budgets.

Meanwhile, interest rates remain unchanged at 5.25% and whilst we believe that April's cut in household energy bills took inflation below the Bank of England's (BoE's) 2% target, the BoE remains concerned about the stickiness of services inflation and pay growth.

GDP growth, Scotland and UK, Q3 2022-Q4 2023



Source: Scottish Government/ONS

Manufacturing woes weigh on growth as services activity shows signs of improvement

The decline in output in Q4 was most significant in manufacturing. The sector which accounts for around 10% of total Scottish output, fell by 3.2% in Q4 compared to the previous quarter. But struggles are nothing new to the Scottish manufacturing sector—output growth had plateaued in the period prior to the COVID-19 crisis, and manufacturing GVA on a quarterly basis has been on a broadly downward trend since the middle of 2021. Overall, manufacturing GVA in 2023 was 8.3% lower than it was in 2019. Monthly GDP data suggest a pick-up in output from the industry in February, but despite this, output shrank by 1.1% compared to a year previous.

However, the story within the manufacturing industry is more nuanced. The food & drink sector increased its output above pre-COVID-19 levels through 2022 and maintained higher output levels in 2023. However, the subsector experienced a sharp decline in Q4 2023, with output falling by 7.0%. The latest exports data show that the value of drinks exports, Scotland's second most valuable export after oil, rose by 5.5% in the year to Q3 2023, and were valued at £5.6bn. But the growth in value has been heavily impacted by inflation, and drink exports have decreased in volume terms in the year to Q3 2023. Monthly GDP data show that food and drink output recovered slightly in February after a sharp decline in January. The fortunes for the sector are heavily dependent on the continued recovery of the Scottish economy, as well as improved international demand.

Though much smaller in output terms, the manufacture of transport equipment sector has been expanding rapidly in recent quarters, and alongside food and drink and textiles, it was the only manufacturing subsector operating above pre-COVID-19 output levels in Q3 2023. However, it too suffered a sharp decline in Q4 2023, falling by 6.1% compared to the previous quarter. Yet, there is cause for optimism as export values have grown strongly in the year to Q3 2023, rising by 50% to £1.2bn, and the output estimate for February 2024 shows strong growth compared to the previous month (12.3%).

Meanwhile, the value of Scotland's oil and gas exports rose sharply in 2022 as a result of rising energy prices following Russia's invasion of Ukraine. The value of gas exports reached £3.4bn in 2022, more than seven times its 2019 value. The value of oil exports also increased and was estimated at £9.3bn in Q3 2023. However, despite rising as a result of oil price increases, the value of oil exports remained below the 2019 level of £13.6bn. Both oil and gas export values have eased in recent quarters as prices have stabilised and volumes have continued to fall back. Indeed, output from Scotland's mining & quarrying sector fell by almost 14% in 2023 compared to the previous year.

Away from the production sectors, activity in the construction sector improved significantly in 2023 after experiencing a larger contraction in 2020 and a subsequent slower recovery than the wider economy. Indeed, construction output expanded by 2.1% on average last year compared to 2022, with growth sustained through the first three quarters of the year. However, in Q4 output fell, declining by 0.9%, and in fact, the monthly output data show that the sector declined in each month of the last quarter of 2023. Encouragingly, the monthly data also show a return to growth in January, but data for February suggests that heavy rainfall impacted building activity, and construction output fell by 1.3%.

Throughout much of 2023, there was little evidence that the service sector gained any real momentum. At the aggregate level, this remains true: output declined by 0.1% in the final quarter of the year and the service sector, like the whole economy, was essentially the same size it had been in the preceding year. But the Q4 data still provide some hopeful signs that certain important subsectors have turned a corner. Professional, scientific, & technical services, grew rapidly, expanding by 1.4% in Q3 and a further 3.4% in Q4.

Elsewhere in the services sector, wholesale, & retail suffered a difficult year as inflation eroded consumer spending—output from the sector shrank by 3.1% in 2023. However, recent ONS retail sales figures suggest a return to growth for the UK at the start of the year, whilst monthly Scottish GDP data show a sector output growth of 0.9% in February building on 2.3% seen in January. With household incomes primed to improve, there is good reason to expect that the sector should experience growth this year.

There are signs that the Scottish labour market is cooling

Despite weak economic output and activity over recent periods, the Scottish economy maintained a very low rate of unemployment and continued to create new jobs. However, the most recent data provide tentative evidence that demand is starting to ease. The number of PAYE payrolled employees fell in both February and March 2024, the first time the level has fallen in two consecutive months since the end of 2020. Meanwhile, the number of job vacancies in the UK has also fallen sharply, and whilst comparable data for Scotland are unavailable, ONS data for online job adverts show a sharp fall at the end of 2023 and at the start of April 2024 for the country. Although this is equal to the pre-COVID-19 level, it is notable that this is higher than the equivalent UK measure, which is now around 15% below its pre-COVID-19 norm.

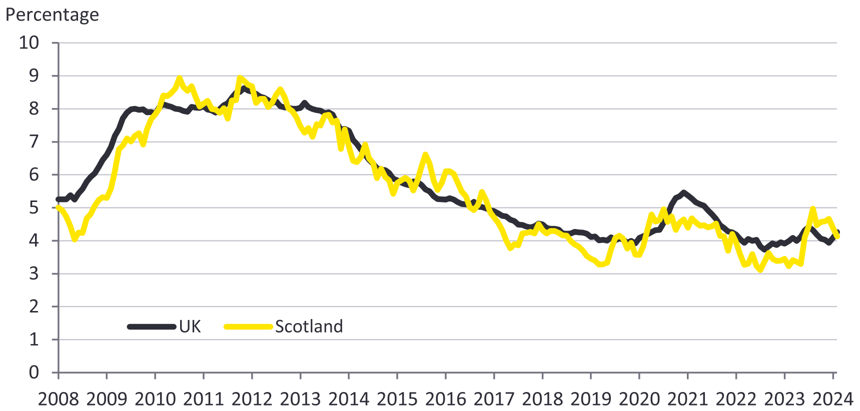
The empirical evidence is supported by recent survey results, such as the latest Royal Bank of Scotland Report on Jobs, which reported that Scottish recruiters recorded a fourth consecutive monthly fall in permanent staff for March.[1] The report cited fewer vacancies, companies looking to cut costs, and increased market uncertainty as the drivers behind the decline. Meanwhile, the ONS Business Insights and Conditions Survey[2] reports that 22.4% of businesses in Scotland employing 10 or more employees experienced difficulties recruiting employees in February 2024. This was down on the previous survey period in January and the lowest proportion since the question was introduced in April 2022. On a sector basis, construction and manufacturing were suffering the highest rates of recruitment difficulties, whilst the businesses in the accommodation & food sector (which had previously struggled to recruit) are now reporting below the economy-wide average.

Further evidence on pay from the PAYE payroll data show that the rate of wage increases has also eased in recent months. Median pay for Scottish workers rose by an average of 6.3% in the year to March 2024, down from the 7.2% rise seen in the year to December 2023. On the same basis, salary growth in the UK has cooled from 6.2% in December 2023 to 5.6% in March 2024.

1 https://www.natwestgroup.com/news-and-insights/news-room/press-releases/economic-analysis/2024/apr/royal-bank-of-scotland-report-on-jobs-march-2024.html
2 https://www.gov.scot/publications/bics-weighted-scotland-estimates-data-to-wave-104/pages/recruitment/

The weight of evidence suggests that the Scottish labour market is cooling, even if the ONS Labour Force Survey indicates the opposite and shows that the unemployment rate decreased over the December 2023 to February 2024 period compared with the previous quarter. It also shows that the economic inactivity rate ticked down by 0.2 percentage points to 22.6%, above the UK rate of 22.2%. However, the LFS data have achieved much smaller sample sizes, which has introduced significant volatility into the data, and the ONS has cautioned not to read too much into quarter-to-quarter changes. So, looking at the longer-term movements and putting the short-term fluctuations aside, the LFS suggests that over the past year, unemployment has increased by 0.9 percentage points. But given there has been no spike in claimant count numbers for Scotland, it seems likely that unemployment remains low and changes in either direction have been small.

Unemployment rate (aged 16-64), Scotland and UK, 2008-2024

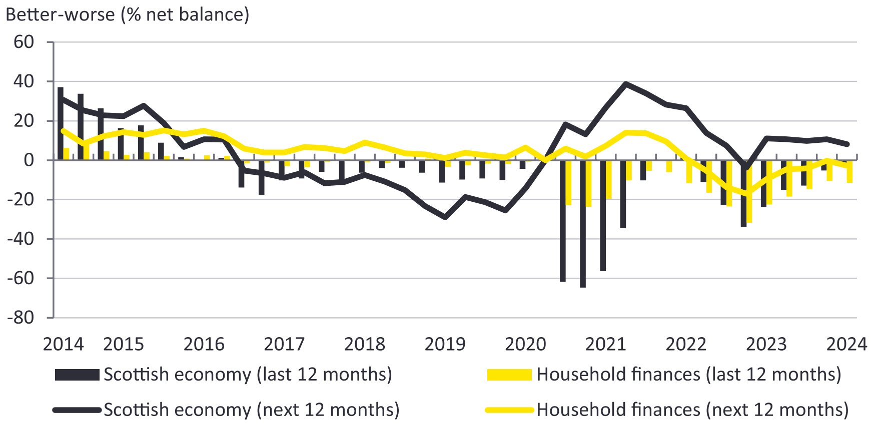


Source: ONS

Scottish household and business sentiment remains fragile

The Scottish Consumer Sentiment Indicator remained positive in Q1 2024. Households remain strongly positive (+8.1) about prospects for the Scottish economy in the next 12 months, a slight weakening on the previous quarter, but their expectations for household budgets over the next year deteriorated (-2.8) having been in negative territory since Q2 2022. Overall, however, confidence remains negative at -6.2 in Q1, down from Q4 2023 indicating a weakening in sentiment. News that annual house prices rose by 3.7% on average in the year to March 2024 (compared to the UK average of 1.0%) should help to boost Scottish household confidence.

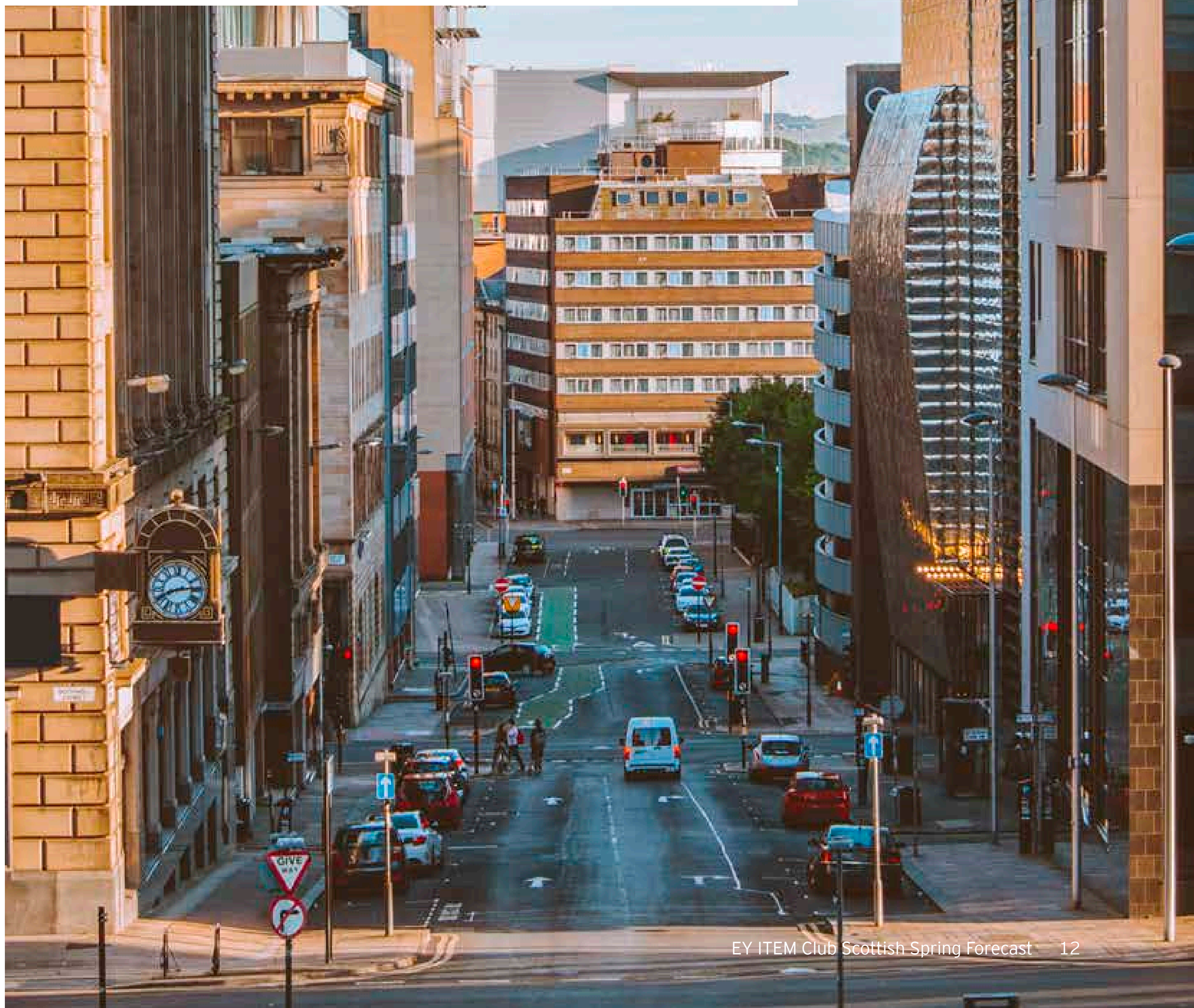
Consumer indicator scores and expectations, Scotland, 2014-2024



Source: Scottish Government

And whilst households' confidence (albeit still somewhat fragile) is positive, the latest PMI Scotland Business Activity Index shows a third consecutive monthly expansion in private sector output during March to reach 53.6. This is a marked improvement on the figure reported in December (49.4) when the index had been below 50 for the fourth consecutive month in a row. Encouragingly, having lagged the UK for an extended period, activity in Scotland is reported to be ahead of the UK and is only behind London and Northern Ireland.

And April's Scottish Government Business Insights and Conditions Survey (BICS) provides further evidence that pressures on businesses are beginning to ease. The proportion of businesses citing no concerns for their company rose from 12.2% in December to 17.3% in April. Furthermore, there was a shift in the concerns for businesses since the previous quarter, with the proportion of companies reporting inflation as a main concern falling to 10.5%, from 16.6% previously. This figure has been replaced as the primary concern by falling customer demand for goods and services – although this too has eased, falling from 16.6% in December to 12.5% in April. The BICS survey also found that 37.3% of respondents thought their business performance would increase over the next 12 months, and only 5.6% expected performance to decrease. Furthermore, the NatWest Regional PMI shows that Scottish businesses are optimistic about the next 12 months, even if their New Business score, at 51.1, is towards the lower end compared to other UK regions and nations.



Economic outlook

The short-term growth outlook is slightly weaker, but momentum will build through 2024

Whilst there has been encouraging economic news, the weak ending to 2023 has slightly dampened our expectations for Scottish economic growth this year. We now expect Scottish GVA to rise by 0.4%, slightly down on the forecast from the previous quarter but marginally stronger than last year (0.2%). Part of the explanation for weaker growth is purely mathematical: the contraction in output in Q4 implies a lower starting point for the output level in 2024, and this mechanically will shave a few tenths of a percentage of GVA growth this year. Prospects for the UK economy are also slightly weaker than before, with GVA growth now forecast at just 0.6% for the year.

We continue to expect that lower inflation will support a steady recovery in real incomes, which in turn will spur growth in consumer expenditure. However, this will be a gradual process, and the effect of past rises in interest rates on mortgage costs has yet to come through in full. Despite the further reduction in National Insurance Contributions in the UK government's Spring Budget, fiscal policy is tightening. This is because of past tax hikes (particularly as seen in the ongoing freeze in income tax thresholds and allowances), and the introduction of the additional income tax bracket (the advanced rate) in the Scottish budget in December. Meanwhile, concerns about stickiness in services inflation and pay growth mean the BoE has been wary about signalling the prospect of interest rate cuts, but timelier measures of both have come down significantly. And with the Bank's next set of forecasts in May likely to show a prolonged period of below-target inflation, we think rate cuts will commence the following month and expect Bank Rate to fall by a total of 75 basis points this year.

As a result, personal disposable income is forecast to grow by 1.3% in Scotland this year and 1.8% in 2025. Consumers' expenditure is expected to show weak growth this year before accelerating to reach 1.9% the following year. Accordingly, the forecasts for Scottish GVA for 2025 are now a little stronger, at 1.7%, compared to 1.4% last quarter. This rate of growth is expected to be sustained in following years. However, we continue to expect Scotland's economic growth to lag the UK, which is forecast to grow by 1.8% a year in 2025 and 2026, increasing to 1.9% in 2027—but the gap is small.

Key economic indicator outlook, Scotland, 2020-2027, % y/y (unless otherwise stated)

	GVA	Personal disposable income	Consumers' expenditure	Population 000s	Employment 000s	Unemployment rate %	Migration aged 16-64 (000s)
2020	-12.0	-0.2	-12.7	5,466	2,760	4.5	13.8
2021	9.2	0.3	7.6	5,480	2,785	4.2	21.2
2022	5.9	-1.4	5.0	5,513	2,808	3.3	24.2
2023	0.2	0.4	-0.5	5,537	2,824	4.0	51.1
2024	0.4	1.3	0.2	5,565	2,846	4.2	48.8
2025	1.7	1.8	1.9	5,593	2,868	4.0	46.0
2026	1.7	1.6	1.8	5,616	2,894	3.9	41.0
2027	1.7	1.3	1.8	5,631	2,913	4.0	36.0

Source: EY ITEM Club
Note: GVA is chain linked 2019 prices. Personal disposable income and consumer expenditure are also 2019 prices. Unemployment rate is the ILO unemployment rate using Labour Force Survey data

Improved spending will start to feed through to consumer facing sectors in 2025

Improvements to household incomes will take time to feed through to improved spending, and this is reflected in the forecasts for consumer-facing sectors. GVA for both accommodation & food and wholesale & retail is forecast to expand in 2024, but growth is expected to be considerably stronger in 2025 as consumer confidence and spending gathers pace. However, despite its high dependence on consumer spending, the arts, entertainment & recreation sector is expected to grow rapidly this year, building on strong growth seen in 2023. Part of the explanation here is that the sector remains short of its pre-COVID-19 level in GVA terms, so stronger growth in part represents the sector's relatively slow recovery to pre-COVID-19 norms. Indeed, despite the above average forecast, we do not expect sector GVA to return to 2019 levels until in 2026.

The administrative & support sector is another bright spot for 2024 and activity is expected to continue to build throughout the year, with growth reaching 2.4% in 2025. Transport and storage is another, with the sector responding to the uptick in activity. Generally, we expect private services sectors to begin to come to the fore in 2025; professional, scientific & technical services should strengthen, and the information & communications sector should return to growth after a loss of output forecast for this year.

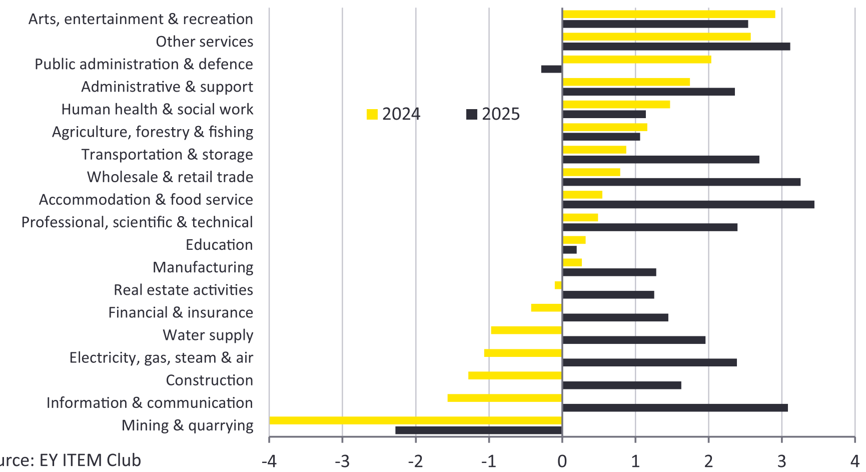
Public sector services should continue to support Scotland's growth this year, and GVA from public administration & defence (which accounts for 7% of total Scottish GVA) is expected to be one of the fastest growing sectors, expanding by 2%. However public finances are set to tighten, and this is likely to result in a small contraction in public administration GVA next year. Elsewhere, there is sustained growth in the human health & social work sector as it continues to respond to post-COVID-19 demand and will expand by 1.5% in 2024 and 1.1% in 2025. Finally, the prospects for the education sector are much weaker, and GVA growth for the sector is expected to lag the economy-wide average both this year and next.

The forecast for the construction sector for this year has been downgraded, reflecting the downturn in the sector at the end of 2023 and an expectation that interest rate reductions will take time to filter through to increased activity. However, construction activity should rebound as the year progresses, and prospects are much brighter for 2025.

The outlook for the embattled manufacturing sector has improved somewhat in the latest forecasts as the prospects for Scotland's major international trading partners have become more promising. Activity is expected to improve in the EU in the second half of 2024, and the continued strength of the US economy and the likelihood that central banks will gradually lower rates from the middle of this year should support global demand. Within the manufacturing sector, the brighter international outlook favours Scotland's exporting sectors, particularly transport equipment, chemicals, and pharmaceutical products, alongside the drinks sector.

Finally, we anticipate that GVA from the mining sector will decline in each year of the forecast period. This reflects an assumption that oil and gas extraction will continue to fall as facilities in the North Sea are decommissioned.

GVA growth by sector, Scotland, 2024 and 2025, % y/y



Source: EY ITEM Club

Scotland's employment prospects improve but growth will lag the UK

We maintain our view that the underlying weakness in economic activity will have only a modest impact on Scotland's labour market in 2024. We now expect a slightly more modest rise in unemployment to 4.2% this year, which will unwind quickly with the rate returning to 4.0% in 2025. As conditions improve through the year, employment is expected to rise, and growth of around 0.8% should be sustained this year and next. Indeed, we forecast total employment to grow by an average of 0.8% a year over the 2024-27 period. Employment growth at this level will see Scotland lagging the UK average, which is expected to grow by an average of 1.1% over the same period.

Part of the difference in employment growth prospects relates to sector profiles, with Scotland underrepresented in certain sectors that are expected to see stronger employment growth in the future. This is the case for professional, scientific & technical services and the administrative & support sector. Another reason is demographics, which play a key role in determining the scale of future jobs growth. We expect population growth in Scotland to be relatively weak, with migration only just offsetting decline from natural change (births minus deaths). The result is that the population outlook for Scotland is somewhat weaker than the UK average, largely as a result of lower net migration. This impacts both the labour supply in Scotland and overall levels of demand, contributing to lower employment growth.

Even more pertinent to employment prospects is the weak growth of the working age population: Scotland's working age population is forecast to grow relatively slowly in the short term and is even expected to decline in the longer term. This is not a problem unique to Scotland, and most UK regions and nations will likely experience a fall in labour supply as the UK population continues to age and, if and as expected, international migration is lower in the future than it has been in the past. The exceptions are London and to a lesser extent, East of England, but even in these regions the rate of working age population growth is expected to slow over the course of the forecast. Over time, productivity improvements will become increasingly important to drive future economic growth across the UK.

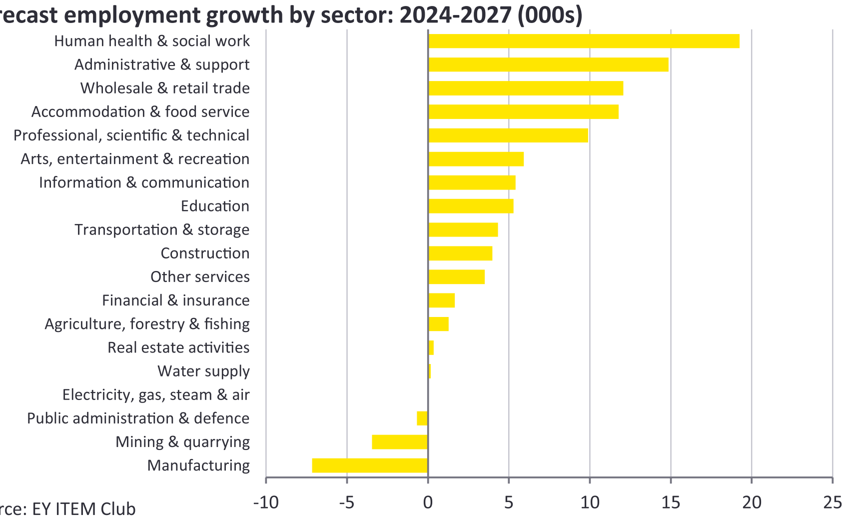
Services will support employment growth as manufacturing and mining continue to shed jobs

Following a pick-up in activity this year, we anticipate that jobs growth will be strongest in the administrative and support sector, creating around 5,000 additional jobs. Similarly, the rebound in activity in the arts, entertainment & recreation sector is expected to support a further 1,600 jobs in 2024. However, given its overall size, we also estimate that employment in the human health & social work sector will expand by 6,700 workers this year, accounting for around a third of the 21,400 total new jobs in Scotland this year.

With employment prospects looking somewhat rosier this year compared with our Winter forecast, most sectors are expected to grow their workforces. Mining (which includes the extraction of oil and gas), manufacturing, and construction are the only sectors forecast to reduce headcount, and in each case, this is reflective of declining output projected this year. For manufacturing, it is symptomatic of weak demand but also the ongoing long-term automation in the industry. Construction employment should pick up from 2025 onwards, but manufacturing and mining are set to decline between 2024 and 2027.

Over the 2024 to 2027 period, sustained demand for health services should support steady growth in employment in the large human health & social work sector, at an average of 1.1% a year (ahead of the economy-wide average). The sector employs 14.9% of Scotland's workforce, which will increase to 15.1% by 2027. The recovery of consumer spending will support the creation of jobs across wholesale & retail, accommodation & food, and arts, entertainment & recreation. Together, these sectors will account for a third of jobs created over the period. The growth in private services activity will be the other main source of additional employment growth in Scotland, with administrative & support leading the way, followed by professional, scientific & technical services and information & communication. These sectors are also expected to create a third of Scotland's additional jobs between 2024 and 2027.

Forecast employment growth by sector: 2024-2027 (000s)



Source: EY ITEM Club

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