EY Scottish ITEM Club Autumn Forecast

November 2023

Building a better working world

The only non-governmental economic forecasting group

EY Scottish ITEM Club Forecast

EY is the sole sponsor of the ITEM Club, which is the only non-governmental economic forecasting group to use the HM Treasury model of the UK economy. Its forecasts are independent of any political, economic or business bias.

The report is based on data and information available before October 2023. The quarterly EY Scottish ITEM Club report is part of the EY Economics for Business 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

Ally Scott

EY Scotland Managing Partner and Corporate Finance Partner

Ernst & Young LLP

LinkedIn

Sue Dawe

EY Scotland Head of Financial Services

Ernst & Young LLP

LinkedIn

Welcome to the inaugural Scottish ITEM Club Autumn Forecast, with the forecast now moving to quarterly. This year has seen a similar pattern to 2022, with periods of growth punctuated with points of decline. The net result is that while Scotland's economy has avoided a technical recession so far this year – with a more resilient performance than expectations suggested – it was nevertheless slightly smaller at the end of Q2 2023 than it was a year earlier.

We expect to see promising signs in the economic outlook towards the end of 2024 into 2025 and 2026 as the economy gathers pace, lifting employment numbers above the COVID-19 pre-pandemic levels.

Scotland's major cities are likely to perform better than the Scottish average thanks in large part to their sector profiles, with Edinburgh and Glasgow running ahead of the rest of the country in each year of the forecast. This, along with a weaker expectation for Aberdeen, continues a five-year trend leading up to the COVID-19 pandemic. However, we will watch with interest to see if recent policy and project developments for the North East – especially on construction related to energy transition – deliver a positive impact for both the local and wider Scottish economy.

Many sectors experienced a see-saw of trading conditions as government, society and businesses navigate continued global uncertainty.

Manufacturing output and mining and utilities activities have fallen, which means overall output from Scotland's production industries shrank in the first half 2023. However, international goods exports have been more encouraging, with Scottish goods exports growth slightly ahead of the UK in value terms.

Continued economic strains have a broadly similar impact on Scotland's economy as they do on the rest of the UK and global markets, but the expected recovery of household finances later in 2024 will benefit consumer-facing sectors, as public services also bolster the rate of economic growth.

Highlights

- The Scottish economy may have avoided a recession, but economic growth has been flat since 2022 Q2. Sentiment among Scottish businesses and households remains frail against a backdrop of persistent inflation and high interest rates, although inflation has fallen more than expected recently to 4.6%. Whilst a recession should be avoided, output is expected to remain broadly flat for the remainder of 2023.
- In the face of a weak economy, the Scottish labour market has held up well but there are signs of softening. Whilst wages have grown ahead of inflation, employment growth faltered at the start of 2023. Recent indicators show that the growth in employees has levelled off, the number of vacancies in the economy has dropped, and unemployment has risen – albeit from a historically low base.
- The outlook is sluggish with Scottish GVA forecast to rise by 0.3% in 2024. Activity is expected to pick-up towards the end of the year as inflation eases, real incomes rise, and interest rates begin to fall. The prospects are better for 2025 and 2026 as the economy gains momentum, though Scottish growth will remain low in historical terms and is expected to lag the UK.
- The eventual recovery of household finances is likely to benefit some consumer-facing sectors including accommodation and food services. Though as the economy strengthens, it is the information and communication and business services sectors which will lead growth over the medium-term.
- Whilst the underlying weakness in economic activity will impact the labour market, we do not expect a significant fall in employment nor a sharp rise in unemployment. Rather, employment will remain broadly flat in 2024 before increasing in 2025 and 2026 as the pick-up in growth feeds through to jobs.
- The outlook for employment growth shows a broadly similar sectoral pattern, with consumer-facing sectors, information and communication and business services sectors underpinning job growth. We do however expect job losses in some sectors, most notably in manufacturing as the sector is expected to continue to automate, adopting new technology to increase productivity.
- The sector profile of growth means Scotland's major cities are likely to perform better than the Scottish average, with Edinburgh and Glasgow running ahead of Scotland in each year of the forecast. This expectation together with a weak outlook for Aberdeen is a continuation of trends observed in the five-year period prior to the pandemic.

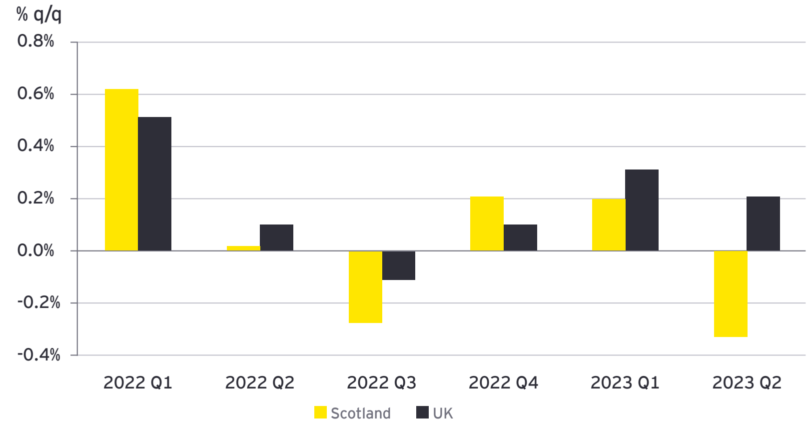
Latest developments

Scotland has avoided recession in 2023 but the economy is flat

The Scottish economy failed to grow in the first half of 2023 against a backdrop of high inflation and rising interest rates. GDP fell by 0.3% in Q2, wiping out the 0.2% expansion achieved in the first quarter. A similar pattern was observed throughout 2022, with periods of growth punctuated with points of decline. The net result is that whilst Scotland's economy has avoided a technical recession so far this year, against our expectations, it was nevertheless slightly smaller at the end of Q2 2023 than it was a year earlier. The 2023 Q2 Quarterly National Accounts data showed that investment bounced back from a slump at the end of 2022, and indicates that, as in the wider UK, business investment has been strong in Scotland in the first half of 2023. Consumer spending also made a positive contribution to growth in the first quarter of the year which was sustained through Q2. However, net trade made a negative contribution to GDP growth in recent quarters and is likely to have been a drag on Scotland's growth in the first half of the year.

This faltering pattern of growth is not unique to Scotland – the UK experienced an equally mixed economic performance during 2022. The UK economy has since grown by 0.5% in 2023 H1, with sustained growth, albeit modest, in the first two quarters of the year. However, the data for July 2023 indicated a 0.6% monthly decline in UK GDP, with industrial action and poor weather impacting output in the month. And whilst a modest 0.1% rise in August offset some of July's losses, a further small rise in GDP in September meant the UK economy flatlined in Q3. Strikes were less of an issue in Scotland (just 4% of businesses reported an impact on their activity from industrial action in July 2023, compared to 7.5% in the UK, according to the ONS Business Insights and Conditions Survey). Nevertheless, we doubt Scotland's economy will have achieved any meaningful growth over the summer. The recent Scottish Government monthly estimates suggests Scottish GDP grew by just 0.2% in July and 0.1% in August. The latest sizeable drop of inflation rate to 4.6% is however welcome news, with inflation predicted to head down further as we enter 2024.

GDP growth, Scotland and UK, Q1 2022-Q2 2023



Source: Scottish Government/ONS

Construction, transport and storage, and accommodation and food are bright spots, but the services sector is broadly flat, and the production industries are smaller than they were a year ago

The sectoral data offers some insight into the faltering performance of Scotland's economy, with the production sectors in particular weighing on overall growth. Manufacturing output contracted by 1.8% in Q2, following a decline of 0.6% in the previous quarter. Activity in the mining and utilities sectors dropped, which means overall output from Scotland's production industries shrank in H1 2023 and was 3.7% smaller than it was a year previous. At face value, data on international exports of goods has been more encouraging for Scotland's manufacturing sectors with a 13% increase in the value of goods exports (excluding oil and gas) in the year to June 2023, supported by particularly strong growth in exports of power generating machinery and drinks. However, the data only provides trade values in nominal terms and includes the effects of inflation. And whilst Scottish goods exports growth in value terms was slightly ahead of the UK, this was insufficient to lift the manufacturing sector overall.

Activity in the services sector, which accounts for over three quarters of Scotland's economy, fell by 0.1% in Q2, following only marginal growth in Q1. Within the sector, performance was mixed. Information and communication reported a surprise decline in Scotland across the first two quarters of the year, whilst in the UK the sector has been one of the stronger performers with sustained growth in H1. Activity was more encouraging in accommodation and food services, which posted growth in both quarters of 2023 H1. Many other service sectors had an encouraging Q1 only to see output falter in Q2. This included professional, scientific, and technical services, administrative and support services, and financial and insurance activities. However, the government sector contributed positively to growth over the first half of the year. Together, these trends mean Scotland's service sector was no larger in Q2 2023 than it was a year earlier.

Scotland's construction sector provided a welcome boost in the first half of the year, with output expanding by 0.9%, although the latest monthly GDP figures show a 0.6% fall in output in August compared with July.

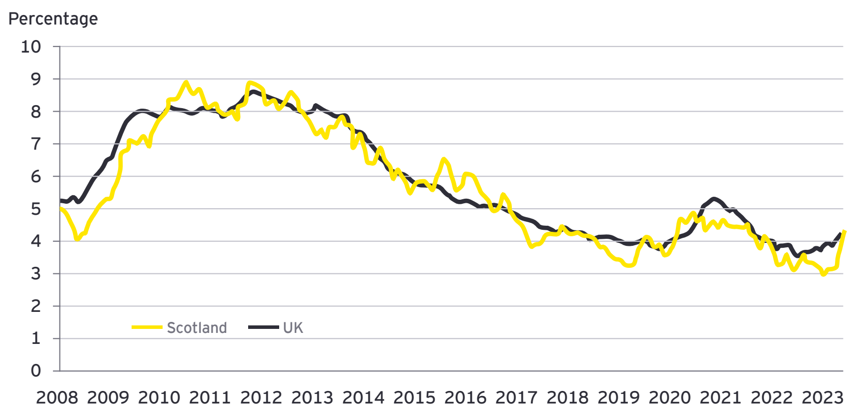
There are emerging signs that the labour market isn't as buoyant as it was with unemployment rising, but worker shortages persist

Scotland's labour market has remained resilient in the face of a broadly flat economy so far in 2023. Indeed, the most recent quarterly data shows a rise in the employment rate and sustained growth in pay. Together these factors indicate that the Scottish labour market is still relatively tight. Yet there is also evidence that it is becoming looser than it has been in the recent past. Most notably, unemployment rose to 4.3% in Q2, 1.2 percentage points above the rate in the previous quarter and represents a larger increase than seen in the UK. Scotland's unemployment rate is now on a par with the UK, after tracking lower for much of the post-pandemic period.

Whilst the employment rate is up in the most recent quarter, it remained below its pre-pandemic level, having peaked at the end of 2022 and fallen in the first quarter of 2023. Part of the story here relates to the type of employment, with the number of pay-rolled employees continuing to rise during the first half of 2023. It is likely therefore that self-employment, which has not recovered the losses from a sharp decline during the pandemic, is responsible for some of the volatility in overall employment in Scotland, a trend mirrored across the UK. The most recent data for August also shows the number of pay-rolled employees levelling off, and permanent vacancies also fell for the first time in over two years in August, according to the latest reading of the Royal Bank of Scotland Permanent Vacancies Index, adding to signs that the labour market is loosening.

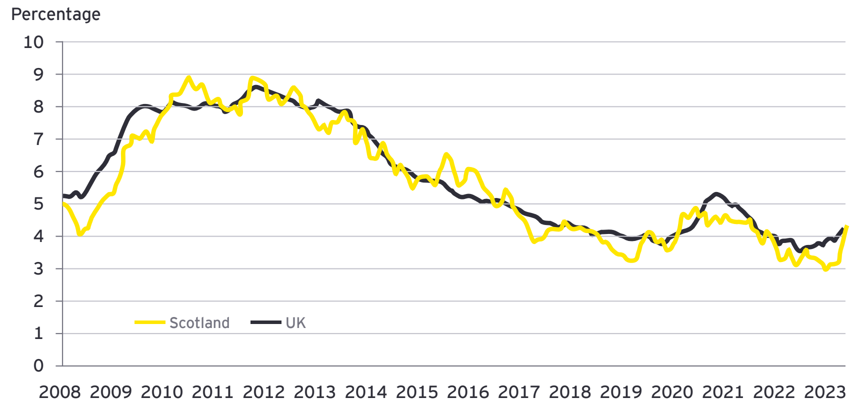
Yet the recent Scottish Government Business Insight and Conditions Survey (BICS) Scotland Weighted estimates reported that 31.5% of Scottish businesses experienced worker shortages in September, with accommodation &and food services (44.5%), construction (39.1%) and arts, entertainment and recreation (34.9%) the most impacted sectors.which i In most cases, worker shortages meant employees were working longer-than-normal hours, b. But it also suggested over a third of affected businesses were unable to meet customer demand. This supports the notion that whilst there are signs that Scotland's jobs market is cooling following a sustained period of post-pandemic growth, it remains tight in historical terms and underlying issues with supply persist.

Unemployment rate (aged 16-64), Scotland and UK, 2008-2023



Source: ONS

Unemployment rate (aged 16 plus), Scotland and UK, 2008-2023



Source: ONS

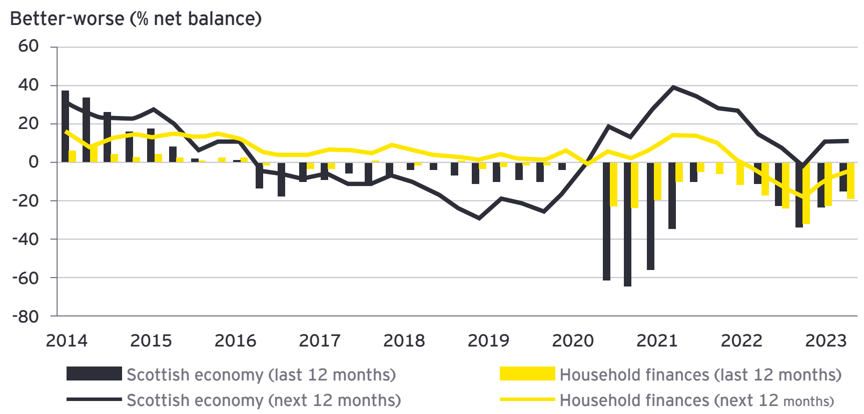
The Scottish economy has avoided recession, but businesses and households are pessimistic about the future

Together, the latest GDP and labour market data paints a picture of a Scottish economy carrying little momentum into the second half of 2023. And recent businesses and household surveys suggests neither are particularly optimistic about the short-term outlook.

The latest PMI Scotland Business Activity Index revealed a fall in output in September 2023 following no change in August, and firms also reported a modest fall in new business. The survey indicated that Scottish businesses expectations for future activity were among the least optimistic of UK regions and nations. October's Scottish Government Business Insights and Conditions Survey shows that the main concerns for Scottish businesses in Scotland are energy prices and inflation in goods and services prices, followed closely by falling demand for goods and services.

The pessimism of businesses and the underlying weakness of the Scottish economy is mirrored by the views of households. The Scottish Consumer Sentiment Indicator remains weaker than at any point prior to COVID-19. True, the latest survey results were published back in July and represent the views of Scottish households in Q2. But whilst the majority of respondents surveyed on behalf of the Scottish Government were optimistic about future economic performance, this was the only measure with a positive score, and one which fell marginally compared with the previous quarter. In addition, Scottish households are expecting their finances to deteriorate in the year ahead. Meanwhile, house prices, a key influence on consumer confidence, have flatlined – rising just 0.1% over the year to July 2023.

Consumer indicator scroes and expectations, Scotland, 2014-2023



Source: Scottish Government

Economic outlook

Stagnation is expected to continue well into 2024 with growth picking-up in the second half of the year and gaining momentum into 2025.

We expect Scottish economic activity to continue to be sluggish throughout the rest of 2023 and into 2024. We currently see GVA growth of 0.3% in 2024, only marginally stronger than our 2023 estimate of 0.2%. The comparable figures for the UK are slightly stronger, with GVA growth of 0.6% forecast in 2023 and 0.5% in 2024.

This represents an upgrade to our 2023 estimate since we last reported in March 2023. We no longer think the Scottish economy will suffer a recession this year, mainly thanks to consumer spending being more resilient than anticipated. But the economy is carrying little momentum and the outlook for growth in 2024 has been cut, with growth slowly recovering in the second half of 2024 but at a lower rate than previously expected.

The financial position of Scottish households and their ability to maintain or increase spending is an important influence on overall growth. Here there are competing forces. Household incomes will be supported by real pay growth and inflation slowing to 2.9% in 2024 from an average of 7.4% in 2023. It is also likely that interest rates have already peaked, and we anticipate rates will be cut from May 2024. Nevertheless, the full impact of rising mortgage rates is yet to be felt by households and the labour market is faltering, which will lead to higher unemployment. Overall, we forecast Scottish consumer spending growth of 0.5% for 2024.

It is not just weak consumer spending that's set to hold back overall activity in 2024. Lacklustre growth across the rest of the UK and globally, including in key European and US export markets, will provide another headwind. The IMF forecasts overall global growth to slow to 3% next year, well below the 2000–19 average of 3.8%. In turn, sluggish growth and higher borrowing costs will provide a difficult backdrop for companies to justify expensive investment projects.

Activity is expected to pick-up in the second half of 2024, rising as inflation eases, real incomes rise and interest rates begin to fall from May onwards, prospects are better for 2025 and 2026, with GVA growth set to increase by 1.3% and 1.4% but this is still low in historical terms and is expected to lag the UK.

Key economic indicator outlook, Scotland, 2020-2026, % y/y (unless otherwise stated)

	GVA	Personal disposable income	Consumers' expenditure	Population 000s	Employment 000s	Unemployment rate %	Migration aged 16-64 (000s)
2020	-12.2	-0.4	-13.6	5,466	2,761	4.5	14.0
2021	8.4	0.2	10.0	5,480	2,784	4.2	23.0
2022	4.9	-0.9	3.4	5,511	2,844	3.3	44.3
2023	0.2	0.5	0.6	5,512	2,886	3.9	19.3
2024	0.3	0.9	0.5	5,513	2,882	4.2	15.8
2025	1.3	1.6	1.5	5,521	2,909	3.8	18.7
2026	1.5	1.6	1.8	5,528	2,938	3.7	19.7

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

The outlook for next year is weak across most sectors of the economy

With the economic malaise expected to impact most of the key drivers of growth, the sector outlook is weak across the board. No sector is expected to gain any real impetus next year, with perhaps the exception of the energy sector that is expected to recover output lost in 2023. Elsewhere on the production side, the weak UK and global outlook offers little encouragement to Scotland's manufacturers hoping to drive growth through exports. We expect GVA growth in the manufacturing sector to mirror the economy-wide average of 0.3% in 2024. Within manufacturing there are some highlights, notably the transport equipment sector which has the potential to grow strongly, reflecting easing supply disruptions and recent buoyant domestic and international demand.

But this is likely to be the exception, rather than the rule, with declines expected in electrical and instrument engineering, metals and machinery and textiles. Prospects for the manufacturing sector are better for 2025 but again in line with economy wide average.

Scotland's mining and quarrying sector has been volatile over the past decade. Oil and gas extraction accounts for a large proportion of sector output and the permanent closure of many old mature fields in the North Sea and previously low oil prices have accelerated a withdrawal by some producers. However, after sharp contraction between 2016 and 2018, output from the mining and quarrying sector increased in both 2021 and 2022. The emphasis on energy security following international conflict has resulted in government initiatives to exploit domestic sources more fully which have provided a short-term boost to production. Nonetheless, we expect the mining and quarrying sector to return to its structural decline and we forecast output to fall by 3.8% in 2024 and 1.9% in 2025.

Output from the construction sector in Scotland has held up well so far in 2023, despite the weak economic environment. Whilst the rate of output growth is expected to slow next year, it is expected to accelerate in 2025 and should outperform the economy wide average over the forecast period.

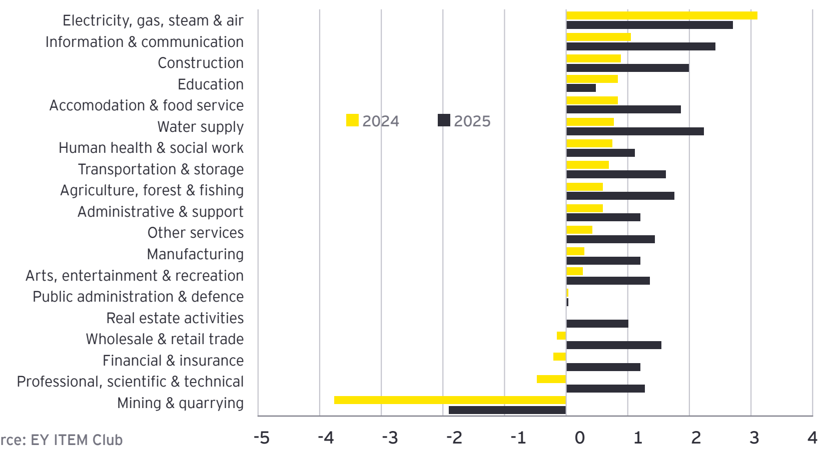
The recovery of household finances later in 2024 will benefit consumer facing sectors, with accommodation and food forecast to see above-average growth, though the projected rate of expansion is modest in historical terms. Improving consumer sentiment will gradually feed into retail activity and output from wholesale and retail should pick-up in 2025, with the increase in consumer spending in the year also benefitting the arts, entertainment, and recreation sector.

Public services will bolster the rate of economic growth somewhat, particularly next year, with the health sector providing the largest contribution and education too outperforming the average in 2024. However, public finances remain tight and the public administration & defence sector, which makes a relatively large contribution to the Scottish economy, is not expected to show any meaningful growth either this year or next.

The outlook is somewhat mixed for the business services sectors, particularly in the near term. The professional, scientific and technical services sector is forecast to experience a shallow decline in output on average next year before growing in line with the overall economy in 2025. A similar trend is also evident for the financial and insurance sector, an industry that showed only weak growth last year following its recovery from COVID-19-related decline the year before, and lagging stronger growth seen in the UK over the same period. Despite stronger growth anticipated for 2023, we expect a small decline in output next year before growth returns in 2025.

The short-term outlook is rather more encouraging for information and communication and administrative and support services, but even here the rates of growth will be low by historical standards. However, over the medium-term, it is the business service sectors that should begin to pull ahead, with information and communication leading the way.

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



Source: EY ITEM Club

Lacklustre growth will have a relatively limited impact on the labour market

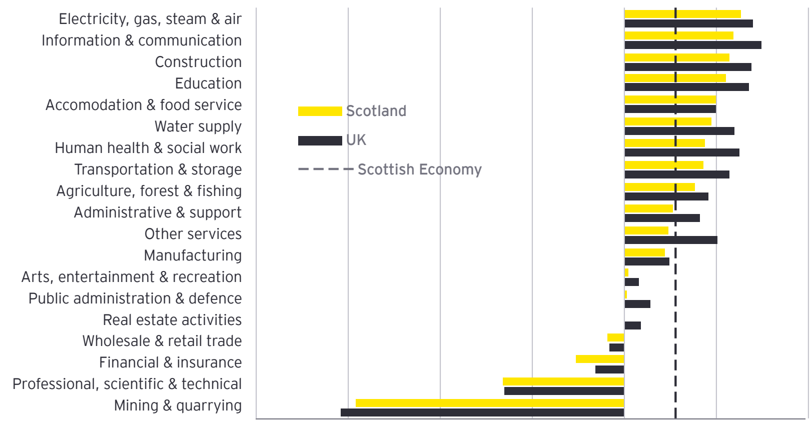
Whilst the underlying weakness in economic activity will impact the labour market, we don't anticipate a sharp rise in unemployment nor a significant fall in employment. The tightness of the Scottish labour market and reported ongoing skills shortages is likely to encourage employers to hold on to staff as they ride out the period of weak demand. Employment prospects should improve in 2025 as stronger growth feeds through to jobs. Overall, we anticipate a slight rise in unemployment in 2024 to 4.2%, lower than the 4.5% forecast for the UK, whilst employment will remain broadly flat through 2024. Over the period 2024 to 2026 we forecast total employment to grow by an average of 0.6% per year, lagging the UK average of 0.9%.

This profile plays out at a sector level, with employment in most, though not all, expected to remain flat or experience a small decline in employment in 2024. The main exceptions are in human health and social work and education, both of which should see relatively robust jobs growth in 2024, consistent with stronger output activity next year. The energy sector too will see some pick up in employment over the next 12 months.

As the economy gains momentum and employment prospects improve across most sectors and over the medium-term, it is service sectors that are set to drive overall growth in jobs, continuing a long-established pattern. Between 2024-26, information and communication show the fastest rate of increase, closely followed by professional, scientific and technical services and other services. Whilst these sectors will comfortably outperform the Scottish economy average, their employment growth is expected to lag the UK average for each, with the gap in growth for professional services the most notable.

The recovery in household confidence and spending over the medium term will support jobs growth in consumer facing services, with accommodation, food services and arts, entertainment and recreation both posting above average employment growth over the 2024-26 period. This is also true for wholesale and retail, though there is a degree of risk of new technology eroding jobs in the sector going forward. New technology is the main explanation for the continued decline in manufacturing jobs, with increased productivity achieved through automation, with greater use of robots and other technology, resulting in job losses despite an increase in output from the sector.

Employment growth by sector, Scotland, 2024-2026, % (3-year annual avg)



Source: EY ITEM Club

Local growth prospects

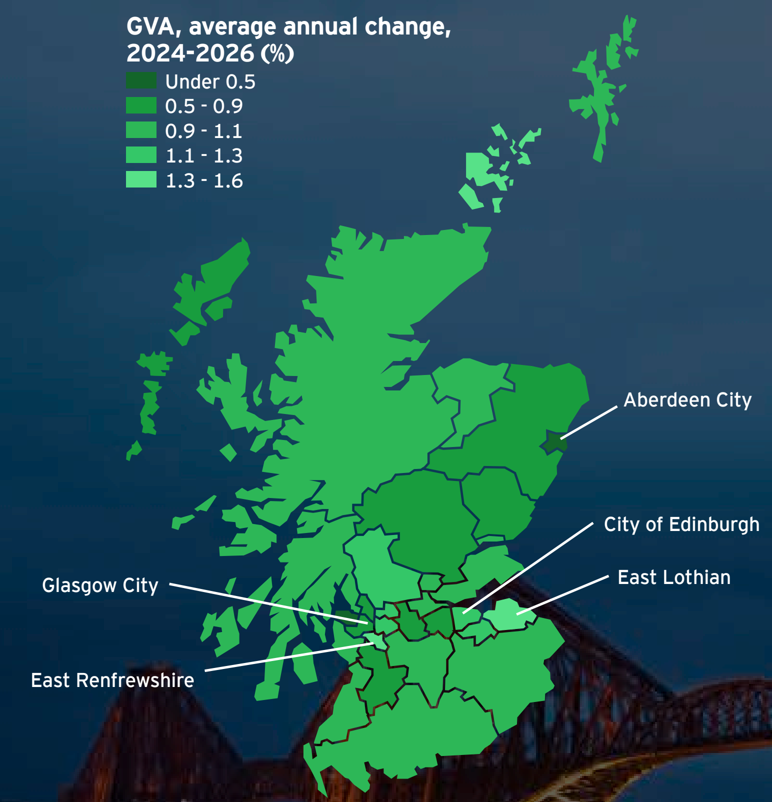
Scottish cities are expected to record above average growth with some local authority areas set to struggle, particularly in the near-term

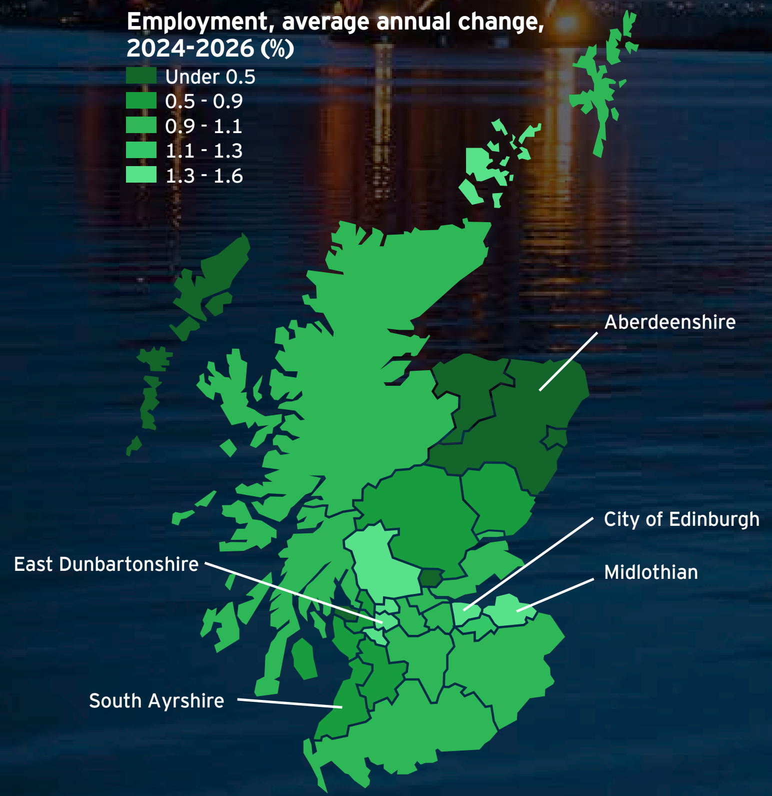
The sector profile of growth means Scotland's major cities are likely to perform better than the Scottish average, with Edinburgh and Glasgow running ahead of Scotland in each year of the forecast. This is a continuation of pre-pandemic trends, with both cities experiencing faster GVA and employment growth between 2013 and 2019. Edinburgh has a particularly high concentration of key private services activity such as financial and insurance services and information and communication, with tourism and hospitality also an important part of its economy. The city also hosts a relatively large public services sector, particularly in public administration and human healthcare but education also, whilst manufacturing is less important locally. This combination means that the Edinburgh economy is less exposed to the weak outlook in the short term but also well placed to benefit from the pick-up in services growth anticipated in the medium-term. Total GVA is forecast to grow by an average of 1.3% a year between 2024-26 compared to Scotland's 1.0%. Above average growth in information and communication, professional, scientific and technical activities, and administrative and support services, will support employment growth of 1.1% per year over the period.

Glasgow also will also perform better than Scotland over the medium-term, although it is less well represented in some of the typically higher value business services sectors, such as professional services and information and communication compared with Edinburgh. However, it has a high representation in public services and whilst financial services is not as significant as in Edinburgh, it accounts for over 5% of local employment compared to 3% in Scotland. Glasgow also has a particularly large administrative and support services sector, a sector which includes activities such as recruitment and facilities management. The sector accounts for 12% of total employment, second only to human health and social work. Growth in these two sectors will contribute to the average jobs growth of 0.8% a year between 2024-26, maintaining a gap on Scotland's 0.6% growth rate over the medium-term.

However, stronger rates of GVA and employment growth are not limited to the core of the larger city areas in Scotland. Some of the fastest growth is expected in districts that form part of Glasgow city region, including East Renfrewshire and East Dunbartonshire and areas that form part of the Edinburgh city region, including East Lothian and Midlothian. Familiar to all these areas is the expected strong outturn in information and communications.

Medium-term GVA and employment growth by local authority





Whilst city regions are likely to be the main highlights, the growth picture across Scotland's 32 local authorities is mixed, and we estimate that some will see their economies shrink in 2023. Examples include South Ayrshire, where GVA is expected to decline by 1.5% in 2023, with the largest output decline seen in real estate, wholesale, and retail and manufacturing. West Dunbartonshire is another example with transport and storage and manufacturing both acting as a drag on growth and contributing to an overall decline in GVA in the year. However, whilst GVA in these areas should recover over the medium-term, employment prospects look weak compared to the Scotland average. Employment growth in South Ayrshire is forecast at 0.3% a year over the 2024-26 period, equivalent to the creation of just 400 jobs in total, with expectations only slightly better in West Dunbartonshire.

Aberdeen City and neighbouring Aberdeenshire are set to struggle according to the latest forecasts, as the anticipated continued decline in the oil and gas sector is likely to undermine wider growth prospects. Whilst Aberdeenshire is somewhat less dependent on oil and gas, it has a large manufacturing sector that is anticipated to decline in the future. Against a backdrop of weak GVA growth, employment is expected to grow by just 0.1% a year over the 2024-26 period in Aberdeen City and 0.2% per year in Aberdeenshire. However, whilst Aberdeen's prospects are heavily tied to the oil and gas sector, it has a large base of professional, scientific, and technical activities. These activities could help support new exploration activities and the development of new and renewable energy technologies, including carbon capture and storage and hydrogen in the region, and offer a potential upside to the forecast over the longer-term.

EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

EYSCORE 010781-23-UK
UKC-030837.indd (UK) 11/23. Artwork by Creative UK.

ey.com/uk/economics