Tony Mackay
Professor of Economics
Inverness
Sent by email

18 February 2021

Dear Tony,

Thank you for your letter. We understand your concern is that our forecast of Scottish GDP for calendar year 2021 looks low when compared to other forecasts, for example those in HM Treasury's summary of independent forecasts. The Finance and Constitution Committee raised a similar concern when we spoke with them on 10 February.

We acknowledge that our Scottish GDP forecasts are towards the lower end of the range when compared to other forecasts of GDP for Scotland and the UK. There are a number of factors behind this including: when forecasts were made; assumptions about when and how quickly COVID-19 restrictions will be lifted; the effect of using calendar year growth to summarise a volatile quarterly profile; and also generally slower GDP growth in Scotland, primarily related to slower population growth.

Overall, while at the lower end of the range, we believe our GDP forecasts are similar to those of other forecasters given the uncertainty around when COVID-19 restrictions will be lifted.

Differences in when forecasts were produced and assumptions about the recovery

When comparing our forecasts to those made in late 2020, our outlook is more pessimistic as we included the lockdown introduced at the start of 2021. The OBR published their latest forecasts in November 2020, before the January 2021 lockdown was anticipated. As they did not include the early 2021 lockdown in their forecasts, their outlook for 2021 was more optimistic. Other forecasts made around this time would have been similarly optimistic about 2021.

In our forecasts, with new lockdown restrictions introduced at the start of 2021, we expected GDP growth to be around -5 per cent in 2021 Q1. When we closed our forecasts in early January, we anticipated only a gradual easing of restrictions over the course of Q2, with restrictions significantly lightening by Q3. This is reflected in figure 2 below – a 5 per cent fall in GDP in Q1, economic activity remaining broadly flat in Q2, then GDP starting to rise again in Q3. The timing of the lifting of COVID-19 restrictions is very uncertain and has a large effect on our quarterly GDP forecast.

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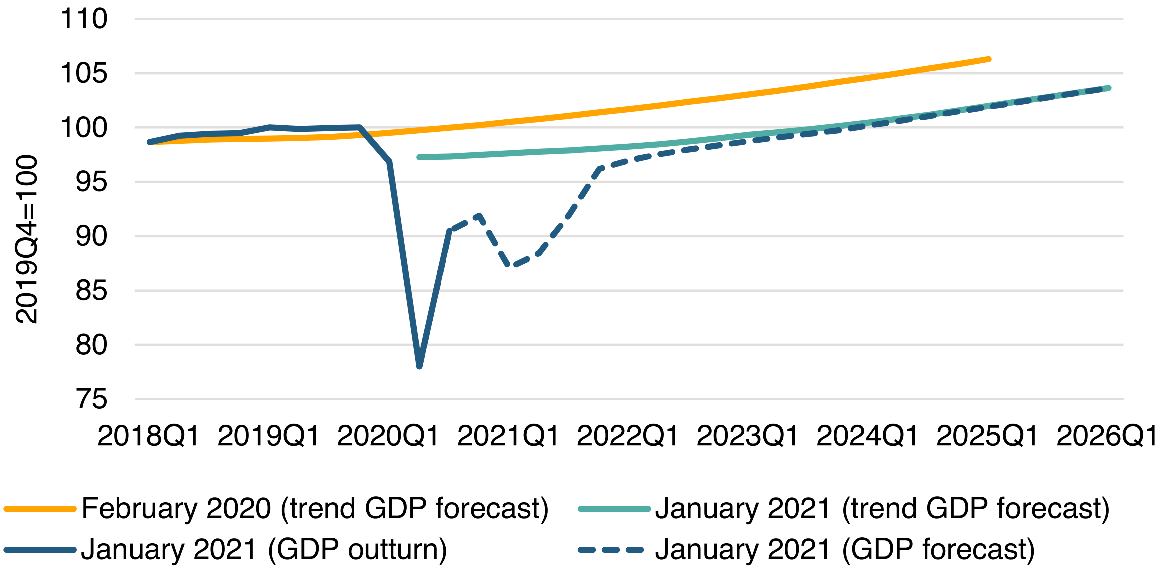
Figure 1: Trend and actual Scottish GDP, February 2020 and January 2021



Source: Scottish Fiscal Commission, Scottish Government (2020) First estimate of GDP: 2020 Q3.

We believe the Bank of England and other forecasters, looking at the latest economy and COVID-19 data now available, may have taken a more optimistic view than we did in our forecasts of the speed with which restrictions could be lifted and the economic recovery resume, with the recovery starting earlier in their forecasts in Q2. We believe this difference in the quarterly profile around Q2 and Q3 of 2021 explains a lot of the difference in headline calendar year growth figures between our latest forecasts and those of the Bank of England.

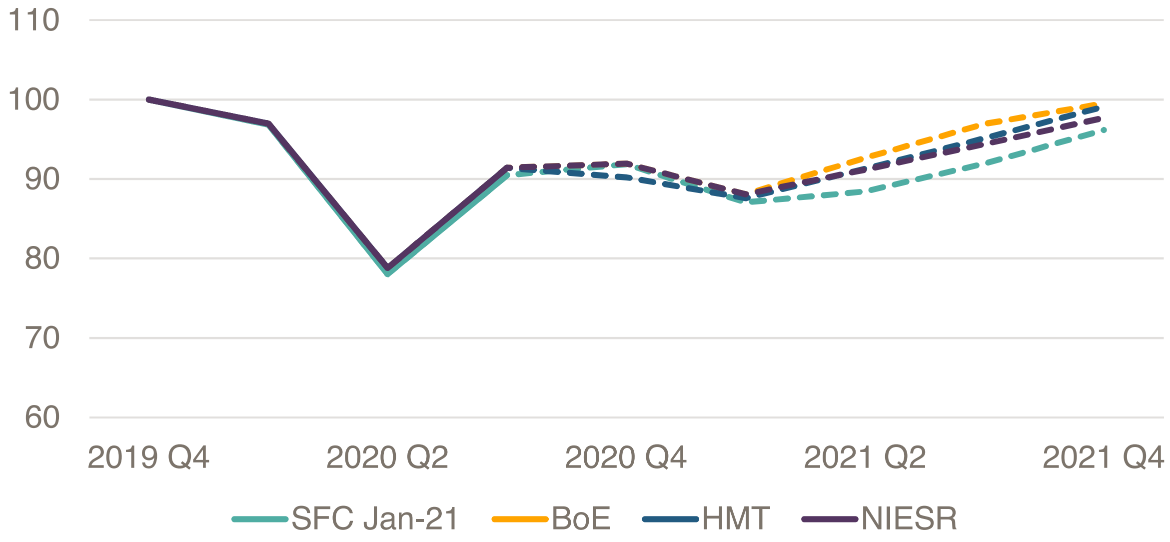
Taking a broad view, this timing difference does not have a significant effect on the level of GDP over time. Over the long run, we assume a similar amount of COVID-19 related scarring in the Scottish economy as the OBR assume for the UK – we both assume productivity will be around 2 per cent lower in 2025 than it would have been without COVID-19. While the quarterly profiles may differ, in levels terms we end up in a similar place to the OBR.

In addition, the slower GDP forecast only has a limited effect on our fiscal forecasts. For example, the job retention schemes have protected employment and incomes from the full effect of COVID-19 restrictions, and therefore the effect of the economic shock on the labour market is less than on headline GDP. This also means the effect of GDP on income tax revenues is limited.

Calendar year growth rates compared to quarterly levels

The calendar year growth figures are only one way of summarising the GDP forecast and they do not tell the full story. We believe the calendar year growth rates somewhat exaggerate the differences between us and other forecasters. This year in particular, with quarterly GDP growth so volatile, small timing differences in the quarterly profile of GDP growth can lead to large swings in the headline calendar year GDP growth figures, making more or less growth appear in the 2021 or 2022 figures. The material effect of this shifting between calendar year summary figures is limited, as it is the level of GDP that matters. As you can see in Figure 2 in levels terms our forecasts are similar to others.

Figure 2: GDP forecasts for Scotland and UK, index 2019 Q4 = 100



Source: Scottish Fiscal Commission, Bank of England, HMT, NIESR
Note: HMT is HMT summary of independent forecasts – quarterly profile implied by 2021 calendar year growth of 4.4 per cent. BoE, NIESR and HMT are forecasts of the UK. SFC is forecast of Scotland.

Given the significant uncertainty around the effect of COVID-19 on the economy, it is not unreasonable to see some dispersion in forecasts. In our forecasts published on 28 January 2021, we anticipated that quarterly GDP growth would pick up in 2021 Q3. If instead we had assumed the recovery would begin strongly in Q2 rather than Q3, our calendar year GDP growth estimate for 2021 would increase from 1.8 per cent to 3.0 per cent – closer to the estimates of other forecasters.

Please do feel free to get in touch if you have any further questions or comments.

Yours sincerely

Susan Rice DBE