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Infrastructure investment boosts Scottish growth as further austerity looms

- *Institute urges the Chancellor to do more to minimise the threats to the recovery*
- *Forecast for GDP growth is 2.5% in 2015, 2.3% in 2016, and 2.3% in 2017; a slight downward revision from its March 2015 forecasts.*

Scottish output growth is being fuelled by a combination of capital investment - particularly infrastructure spending - and consumer spending, according to the latest Economic Commentary from the University of Strathclyde's Fraser of Allander Institute, sponsored by PwC

However, threats to recovery remain, including the UK Government continuing, or even tightening, planned austerity measures in the forthcoming Budget on 8 July, and the growing threat of a Greek exit from the euro with the risk of contagion to other economies including Scotland.

Brian Ashcroft, Emeritus Professor of Economics at the University of Strathclyde, said:

> **"**In his forthcoming Budget, it is crucial that the Chancellor takes action to minimise the threats to the recovery by encouraging productivity and real-wage enhancing investment. He should also consider increased incentives to exporters and, at a minimum, a slowing in the pace of his fiscal consolidation plans."

The Institute also warns that sustainable recovery is being threatened by a combination of unbalanced growth that relies unduly on household spending that depends mainly on rising and potentially unsustainable personal debt, and the UK's overall weak trade performance.

Glimmer of positive influences

The latest *Economic Commentary* outlines a number of positive influences on the Scottish economy that are collectively stimulating demand for Scottish goods and services. Infrastructure spending, with projects such as the Forth Road Bridge and M8 completion, are complemented by a steady stream of foreign direct investments, with over 80 inward investment projects coming to Scotland in 2014.

Domestic inflation remains close to zero and, combined with even modest earnings/income growth, is helping to boost real incomes. External demand remains reasonably strong, with growth in the Eurozone beginning to strengthen while US growth, which faltered earlier in the year looks set to pick up again.

Brian Ashcroft, Emeritus Professor of Economics at the University of Strathclyde, added:

> "We should not underestimate the threats to the recovery from rising household debt, little growth in real wages, the dark shadow of further austerity and the rising possibility of Greece leaving the euro."

But variances are emerging

While the Scottish and UK economies continue to grow and recover from the Great Recession and, despite some recent evidence of a slowdown, there are some variances beginning to emerge:

- The Scottish economy has now enjoyed positive growth for the last 11 quarters (since Q1 2012) while in the UK the sustained recovery period has been shorter at 8 quarters. Nevertheless, the UK recovery in output and jobs is still stronger than in Scotland. UK GDP, ex oil & gas, is 5.1% above the pre-recession peak compared to only 2.3% in Scotland, while jobs in the UK are 4.6% higher than the peak compared to 2.6% in Scotland.
- The service sector has been a significant driver of growth in the UK, but made no contribution in Scotland during Q4 2014. And in contrast, the Scottish construction sector was a principal driver of growth while in the UK, it acted as a drag.

The Institute speculates that the stronger UK recovery may, in part, be a reflection of a stronger recovery of R&D activity in rest of UK compared to Scotland.[1]

Paul Brewer, Government and Public Sector partner, PwC in Scotland, said:

> "There is some real evidence of recovery across Scotland, with infrastructure and construction in particular, making a real contribution to growth, reflecting both growing business confidence and the impact of major projects like the Forth Crossing and M8 completion.
>
> "While we hope that these trends continue, the service sector has not demonstrated the levels of growth experienced in other UK regions and that remains a cause for concern.
>
> "The impending referendum on UK membership of the EU remains on the horizon and, while it has not apparently made any significant impact on investment and foreign direct investment, there is little doubt that, as 2016 and the referendum loom, so-called 'Brexit' will become a concern, particularly for the financial services sector."

Economic forecast and the wider Commentary

The Fraser of Allander Institute forecast for GDP growth is 2.5% in 2015, 2.3% in 2016, and 2.3% in 2017; a slight downward revision from its March 2015 forecasts. The downward adjustment reflects the evidence of a slight slowing in the recovery in the first half of 2015.

The Economic Commentary also includes the second part of the Commentary's Catalogue (1991 – 2000) plus the second instalment of Alf Young's 'Forty Turbulent Years' (1999-2000), Scotland's recent economic history seen through the pages of the Fraser Economic Commentary. It also includes topical articles on:

- TTIP - the Transatlantic Trade and Investment Partnership (Wooton);
- 'Jobs polarisation' in the Scottish labour market (Rogers and Richmond);
- a 20 year analysis of Scotland's population health and economic activity status (Miller, (Harry) Burns and Morton); and,
- The Barnett formula under the Smith Commission proposals (Cuthbert).

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[1] *The new ESA 2010 accounting system now adopted by Scotland as well as the UK includes R&D activity as outputs when previously they were treated as inputs. The UK's recovery is stronger relative to Scotland under ESA 2010 than under the old data system.*

ENDS
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Notes to Editors:

1. The University of Strathclyde's Fraser of Allander Institute (FAI) issues its Economic Commentary with the support of PricewaterhouseCoopers LLP.
2. PwC supports the production of this report but it has had no control of its editorial content, including in particular the economic forecasts. FAI's comments on the future performance of the UK economy have been drawn from consensus forecasts.
3. PwC helps organisations and individuals create the value they're looking for. We're a network of firms in 157 countries with more than 195,000 people who are committed to delivering quality in assurance, tax and advisory services. Find out more and tell us what matters to you by visiting us at www.pwc.com.
4. The University of Strathclyde is a leading international technological university which is recognised for its strong research links with business and industry, commitment to enterprise and skills development, and knowledge sharing with the private and public sectors. The University was named UK University of the Year in the 2012 Times Higher Education (THE) Awards. In the 2013 THE Awards, the University was named Entrepreneurial University of the Year.

Annex: Forecast Tables

Table 1: Forecast Scottish GVA Growth, 2015-2017

GVA Growth (% per annum)	2015	2016	2017
Central forecast	**2.5**	**2.3**	**2.3**
March forecast	2.6	2.4	n.a.
UK mean independent new forecasts (June)	2.4	2.4	
Mean Absolute Error % points	+/- 0.41	+/- 0.95	+/- 1.11

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Table 2: Forecast Scottish Net Jobs Growth in Three Scenarios, 2015-2017

	2015	2016	2017
Upper	62,100	72,650	80,600
March forecast	*64,215*	*85,790*	*n.a.*
Central	**51,250**	**49,600**	**51,700**
March forecast	*51,350*	*57,600*	*n.a.*
Lower	40,400	26,550	22,800
March forecast	*38,500*	*30,750*	*n.a..*

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Table 3: Forecasts ILO unemployment 2015-2017

ILO unemployment	2015	2016	2017
Rate (ILO un/TEA 16+)	**5.1%**	**4.5%**	**3.9%**
March forecast	5.0%	4.6%	n.a.
Numbers	**138,200**	**122,364**	**108,150**

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I Overview

In its latest Economic Commentary, sponsored by PricewaterhouseCoopers, the University of Strathclyde's Fraser of Allander Institute notes that the Scottish and UK economies are continuing to grow and recover from the Great Recession. With growth of 0.6% in the final quarter of last year – the latest data point - the Scottish economy has now enjoyed positive growth for the last 11 quarters (since 2012q1) while in the UK, also with growth of 0.6% in 2014q4, the sustained recovery period has been shorter at 8 quarters. But the recovery continues to be stronger in the UK.

When oil and gas production is removed – to compare like with like, since offshore activity is included in the UK but not the Scottish GDP data - we find that the gap in the strength of the recovery widens further in the UK's favour. UK GDP stands 5.1% above the pre-recession peak compared to only 2.3% in Scotland. We speculate that the relatively stronger UK recovery under the new accounting system ESA 2010, under which the latest data were generated, could be due to the recovery in R&D activity being stronger in the rest of the UK after the recession than in Scotland and, if so, may not augur well for Scotland's growth performance in the longer term. However, there may simply be a technical rather than an economic cause due, for example, to different sub-sectoral weights between Scotland and the UK.

II Industries and sectors

When we examine the performance across different industries and sectors, we see that the pattern of growth between Scotland and the UK differed considerably in the fourth quarter. In the UK, the service sector was by far the main driver of growth, while in Scotland the sector made no contribution to growth. In contrast, the principal driver of growth in Scotland was the construction sector while the sector in the UK was a drag on growth. In addition, the production sector contributed about a third of the growth in Scotland but made no contribution to growth in the UK. Within production, manufacturing in both Scotland and the UK made no contribution to growth, while in Scotland it was mining & quarrying and electricity & gas that provided the contribution to growth.

III The labour market

The latest labour market data show that jobs continue to be created at a fairly fast pace, indeed in the latest February – April 2015 quarter at a faster rate in Scotland than the UK both in the quarter and over the year. However, the picture

differs on unemployment with the numbers seeking work rising slightly in the latest quarter and the reduction over the year, while sizable, is proportionately less than in the UK. By the end of the fourth quarter, Scottish jobs as reported in the LFS household surveys were 2.6% above the pre-recession peak, while UK jobs were 4.6% higher than the peak. So, the latest data show the recovery in the labour market to be continuing but there is now some evidence that the rate of recovery is slowing in Scotland and despite recent stronger Scottish jobs growth overall the recovery remains stronger in the UK.

IV Progress of the recovery

Our conclusion on capacity utilisation is that despite the recovery the Scottish economy still has spare capacity available, most notably in the labour market where the number of total weekly hours worked in Scotland was close to but still -0.4% below the pre-recession peak. Moreover, by January - March 2015, the ratio of employment to working population stood at -2.4% below the pre-recession peak, a worsening of the position in the final quarter of last year, compared to -6.7% at the trough of the recession. In the UK as a whole, in contrast, the ratio is only -0.6% below its pre-recession peak but still below a peak that was attained 7 years ago.

(i) Positive influences on the recovery

We note that there are clear positive influences boosting the demand for Scottish goods and services:

Domestic demand is still growing strongly boosted by investment (see below);

Domestic inflation is close to zero, below nominal earnings/income growth and so boosting real income; and

External demand remains reasonably strong, with growth in the euro area beginning to strengthen while US growth having faltered earlier in the year looks set to pick up again.

Yet, there are continuing threats to the further recovery of demand which policy should seek to minimise.

(ii) Threats to the recovery

First, growth remains unbalanced with household spending the key driver fuelled largely by rising household debt, which we fear may soon become unsustainable. The growth of imports continues strongly outstripping the relatively weak growth of exports and so net trade acts as a drag on growth. Policy must seek ways of boosting exporting performance because it is becoming clearer that a more competitive price through a lower sterling exchange rate is insufficient to boost export demand. Issues of product quality and marketing would appear to be at the root of this Scottish and UK problem. One bright spot in this picture of unbalanced growth of demand is the performance of capital investment, which is now contributing significantly to demand and the growth of output in Scotland. Infrastructure spending is playing a big role in Scotland – think the new Forth Road Bridge – but also foreign direct investment where Scotland again enjoyed a successful year in 2014 with over 80 inward investment projects attracted.

Secondly, the victory of the Conservatives with a small majority in the May UK General Election appears likely to lead to a continuation and perhaps a tightening of the previous Conservative / Liberal Democrat Coalition austerity plans. We shall find out more in the Chancellor's forthcoming Budget. With more austerity households can expect a further reduction in their incomes, on average. What that means is that household spending will also be reduced and the fall is likely to be greater the more

quickly the Chancellor seeks to bring the UK government's budget into balance. Austerity will continue to be a major drag on capacity utilisation and economic recovery in Scotland and the UK.

Finally, there is Greece. At the time of writing we do not know the outcome of the negotiations between the Greek government and its creditors. The risks of Greece both defaulting on its debt and leaving the euro have increased since we last reported. This issue is again fast becoming a major threat to the recovery not simply in the eurozone but perhaps, with the possibility of contagion, in the rest of the world, including Scotland.
It is against this background that we have prepared our latest forecasts.

V Forecasts

(i) Output

Our GDP forecast for 2015 is 2.5%, which is revised down slightly from our forecast of 2.6% in March of this year due to the evidence of a slowing of the rate of growth through the first half of the year. For 2016, we have also revised down our forecast to 2.3% from 2.4% in March, in recognition that while the recovery is continuing the growth of demand is now anticipated to be slightly weaker than previously thought. We also are prepared to acknowledge that the negative effects of the oil price fall on the oil production and services, may be a little greater than we anticipated in March. We are forecasting 2017 for the first time and the underlying determinants suggest that growth will be little different from 2016 and so we retain the forecast of 2.3% for 2017.

(ii) Jobs

The number of total employee jobs is forecast to continue to increase in each year of the forecast horizon 2015 to 2017, and at a faster rate than that seen during 2014 (although not as strongly as in 2013). Our forecast for the number of jobs added in 2015 has been revised down marginally since March's forecast, from 51,350 to 51,250. The number of jobs at the end of 2015 is now forecast to be 2,444,250, an increase of 2.1% in 2014. Our current forecast is that the Scottish economy will add 49,600 jobs in 2016, down by 8,000 from our March forecast, while we forecast the addition of 51,700 jobs in 2017.

(iii) Unemployment

Given the small revisions to the growth in employee jobs over the next two years in our latest forecasts, there are only small revisions to the levels and rates of unemployment from our earlier forecasts. The improvement in the labour market is forecast to continue with unemployment rates and numbers falling to end 2017. Our projection for unemployment on the ILO measure at the end of 2015 is 138,200 (5.1%), falling further to 122,364 (4.5%) by the end of 2016, and 108,150 (3.9%) by end 2017. It is worth noting that our unemployment forecast for 2017 means that the unemployment rate finally falls to where it stood when the Great Recession started in 2008, nine long years ago.

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