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Strengthening Recovery Threatened by Imbalances

Scottish economic recovery is accelerating with forecasted growth of 2.3% for 2014 – 0.5% more than predicted just four months ago.

However, weaknesses in both the Scottish and UK economies could still threaten future growth according to the latest *Economic Commentary* from the University of Strathclyde's Fraser of Allander Institute, sponsored by PwC.

The *Economic Commentary* forecasts that the Scottish economy will grow by 2.3% in 2014, up from the October forecast of 1.7%, with estimated growth for 2015 up 0.2% to 2.3%.

The upbeat forecasts reflect higher than expected household spending, a pick-up on investment, improving trade conditions and increasingly optimistic business surveys.

According to the *Commentary*, growth is currently being driven by three key factors: household consumption; activity in the service sector; and part-time and self-employment.

In order to sustain growth over the longer term, an increase in investment and net exports as well as manufacturing and construction activity is needed. More full-time jobs will also need to be created.

Brian Ashcroft, Emeritus Professor of Economics at the University of Strathclyde, believes that an increasingly unbalanced recovery across the regions and nations of the UK could hinder future growth. He said:

> "After six years since the start of the Great Recession we are now witnessing a stronger recovery, although this one is weaker than almost all previous recoveries. While there is room for considerable optimism, the continuing imbalances in both the Scottish and UK economies means the future path of the recovery is by no means certain.
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> "In the light of continuing weak investment and rising UK regional inequality in growth and income per head, the Chancellor should use his forthcoming Budget to introduce a programme of private sector investment incentives, such as accelerated depreciation, with differential regional incentives, to reflect specific regional challenges.
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> "Academic evidence on the impact of regional policy in the 1960s shows that it works best when the national economy is recovering and firms are thinking about investing. So now would be the right time. "

Paul Brewer, senior office partner, PwC in Edinburgh said:

> "We need stronger investment to underpin a sustained recovery. Investment is contributing more to growth but needs to accelerate, and the weak performance of the Scottish construction industry in the last quarter is disappointing.
>
> "We'd like to see this week's UK Budget focus on stimulating both domestic and inward investment. This is the right time for The Scottish Government to step up the pace here too, sustaining its own investment programme, making the most of EU investment

support and by supporting our cities develop as great places to invest and do business by investing in their infrastructure and business locations."

As Scotland's leading publication on the Scottish economy, the *Economic Commentary* has published policy articles by the *Yes Scotland* and *Better Together* campaigns, setting out their respective economic cases for and against independence.

The *Economic Commentary*, which is neutral on the issues, offered both camps the opportunity to stimulate debate around the 'six tests' as outlined in Prof. Andrew Goudie's 2013 book; *Scotland's Future; the economics of constitutional change*

Reflecting on the *Commentary's* new policy section, Paul Brewer, senior partner, PwC in Edinburgh said:

> "This September, the people of Scotland will be asked to make the decision on whether or not Scotland should be an independent country.
>
> "We believe transparency, openness and wide-ranging consultation on the issues will help individuals reach informed conclusions and businesses understand what it means for them.
>
> "We welcome the inclusion of this new policy section which has given both campaigns the opportunity to state their respective cases on an issue vital to Scotland's economy and its people."

The *Commentary* also includes articles on: a diverse recovery across the European Union and its implications for UK macroeconomic stability (and the Bank of England's use of its 'macro-prudential policy toolbox') – Julia Darby (University of Strathclyde); Scotland's competitiveness in the EU (economists from BAKBASEL, a Swiss-based, private economics research institute); and a first-ever analysis of Employee Owned Businesses (EBOs) in Scotland (Ross Brown and others, University of St. Andrews and Edinburgh Napier University).

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. PricewaterhouseCoopers 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 are drawn from consensus forecasts.

1. Overview and Appraisal of the Scottish Economy (March 2014)

In its latest *Economic Commentary*, sponsored by PricewaterhouseCoopers, the University of Strathclyde's Fraser of Allander Institute notes the further evidence of a strengthening recovery, but suggests that this may be threatened by continuing imbalances in the Scottish and UK economies between: consumption versus investment and foreign trade; manufacturing versus services growth; differential growth across UK regions and divergences within the labour market. Though the track of Scottish business surveys is positive, the current largely consumption-driven recovery may threaten growth into the medium term unless accompanied by stronger investment and export growth. Nevertheless, the Institute has raised its forecasts from last October and its latest economic forecasts for Scottish GDP are, for: 2013:1.8% (up from 1.3%); 2104: 2.3% (up from 1.8%); 2015: 2.3% (up from 2.1%). Net job creation is forecast to continue and strengthen, while unemployment is projected to fall.

During the recovery household spending has been the main driver of growth with some positive but erratic contributions to growth from net trade, while gross fixed capital formation, i.e. investment, is now belatedly starting, as it is in the UK, to make a positive contribution to growth. The Institute believes that there is no substantive reason why Government should accept this weak investment profile. In addition to increased UK government spending on capital investment, we contend that there is a strong argument for the Chancellor to introduce a programme of private sector investment incentives, such as accelerated depreciation, in his forthcoming Budget. Moreover, rising regional inequality in growth and income per head in the UK may threaten the recovery, which suggests that there should be differential regional investment incentives as well. In addition, the Scottish Government should consider raising the funding for its Regional Selective Assistance (RSA) programme and other investment funds administered by Scottish Enterprise. Of course adopting such incentives is a bit of a policy minefield because of the EU State Aid rules. However, the EU's General Block Exemption Regulation (GBER) allows for regional incentive programmes under certain criteria. Furthermore, academic evidence on the impact of regional policy in the 1960s shows that it works best when the national economy is expanding or recovering and firms are thinking about investing.

2. Key Points

GDP Performance

- The latest Scottish GDP data for the third quarter of this year show that Scottish GDP rose by 0.7% in Scotland in the quarter, a little less than the 0.8% rise in the UK.
- In the 3rd quarter, GDP in Scotland was -0.9% below its pre-recession peak, whereas UK GDP stood at -1.9% below its pre-recession peak – fully more than 5 years ago.
- But during 2013, the UK recovery has again been stronger in each of the three quarters of published data so far.

- Once declining oil and gas production is removed - offshore activities are not included in Scottish GDP data but they are in the UK data - we continue to find that the UK recovery has been stronger.
- By the third quarter of this year UK GDP - ex oil & gas - was -1% below its pre-recession peak compared to -0.9% for Scotland. But Scottish GDP has recovered by 4.9% since the trough of recession while UK GDP - ex oil & gas - has recovered by 6.8% from its trough.
- In the Scottish production sector the growth of output slowed to 0.6% in the third quarter from 1% in the second quarter. UK production rose by the same percentage as in Scotland during the third quarter compared to 0.7% in the second quarter. Over the year - four quarter on four quarter - production GVA rose by 1.9% in Scotland compared to a fall of -1.6% in the UK.
- GVA in Scottish manufacturing rose by 0.6% and by 0.7% over the year. In UK manufacturing GVA rose by 0.8% in the quarter but fell by -1.4% over the year. Scottish manufacturing GVA now stands at -4.6% below the 2009-09 pre-recession peak, while the figure for UK manufacturing is -9%.
- The Scottish service sector, which accounts for 72% of GDP in Scotland and 77% in the UK, grew by 0.7% in Scotland and 0.9% in the UK in the third quarter. UK services finally surpassed their pre-recession peak in the third quarter to stand at 0.6% above, fully five and one half years later. Scottish services GVA has almost reached its pre-recession peak at -0.1% below. The recovery in Scottish services remains weaker than the UK with growth of 4.5% since the trough of the recession compared to 6.4% in UK services
- Business and financial services (B&FS) continue to contribute positively to the growth of the Scottish economy. In the third quarter of this year, the sector grew by 1.6% and by 3.5% over the year. In the UK, it grew at a slower rate of 1.2% in the quarter; 2% over the year. By the end of the third quarter, B&FS in the UK had moved to +1.3% above its pre-recession peak from -0.4% in the previous quarter, while the Scottish B&FS sector moved further ahead to stand at +2.2% above its pre-recession peak.
- While the performance of financial services continues to give cause for concern, the sector has enjoyed a sustained recovery since the fourth quarter 2012. Now GVA in the sector is -10% below the pre-recession peak compared to -17.2% in 2012q4.
- Distribution, hotels and catering, accounting for 19% of services sector output in Scotland, grew by 0.9% in the third quarter compared to an increase of 1.1% in the UK. Over the year, the sector grew by 1.8% in Scotland compared to 2.7% in the UK.
- The recent weakness of the transport, storage & communication sector in Scotland continued in the third quarter with GVA falling by -1% and by -2.2% over the year. In contrast, the sector in the UK contracted slightly in the quarter, by -0.2% but grew by 0.6% over the year. By the end of the third quarter GVA in the Scottish sector was -7.2% below pre-recession peak compared to -3.7% in the UK

3. Labour Market

- In the quarter October to December 2013 employment rose at the same rate as in the UK during the quarter but at a faster rate over the year. Jobs rose by 9,000, or 0.3%, in the quarter, compared to a rise of 193,000, a rise of 0.3%, in the UK as a whole. Over the year, Scottish jobs rose by 92,000, a rise of 2%, while UK jobs rose 396,000, or 0.6%.

- During the quarter unemployment fell by -3,000, or -0.1%, to 195,000, or a rate of 7.1%, while in the UK, unemployment fell more rapidly by 125,000, or -0.4%, to a rate of 7.2%.In addition unemployment fell by more than 3,000 to 201,000, or a rate of 7.3%. In the UK, unemployment fell more slowly by 18,000 maintaining the same unemployment rate of 7.7%.
- Scottish jobs are now -0.2% below their pre-recession peak, which continues to be worse than the UK, where the jobs total is 1.4% above the pre-recession peak.
- Labour productivity has fallen relatively more in the UK than in Scotland since the start of the recession. The weak labour productivity position in both Scotland and UK is underlined by the evidence of the increasing numbers of workers that are taking part time employment in the absence of full time work. The employment 'recovery' continues to be driven by an increase in part time work and self-employment, although this may now be starting to moderate.
- By August - October 2013 the employment population ratio in Scotland stood at -2.9% below the pre-recession peak compared to 2.2% in the UK. This suggests that there is still plenty of slack in the Scottish labour market.

4. Forecasts

- Our GDP forecast for 2013 at 1.7% has again been revised upwards from our October forecast of 1.3%. For the 2014 we have also revised up our forecast from the 1.8% predicted in October to 2.3%. Similarly, for 2015, we have revised the forecast up from 2.1% to 2.3%.
- The forecasts for 2013 and 2014 are higher than in October because of better than expected outturn data on the growth of household spending, a pick-up in investment, improving trade conditions and increasingly optimistic business surveys..
- We are now predicting that growth will move above trend next year. After 6 years since the start of the Great Recession we are now witnessing a stronger recovery, although weaker than almost all previous recoveries from recession. There are good reasons to be cautious about the future path of the recovery.
- In the labour market, we predict further increases in employment, and falling unemployment.
- On the central forecast, we are now forecasting that net jobs will rise by 31,450 in 2013, rising to 39,600 in 2014 and 42,800 in 2015. The majority of jobs created will be in the service sector.
- Our unemployment forecasts have been revised down further again from November, reflecting higher employment given the growth of output.
- Our projection for unemployment on the ILO measure at the end of 2013 is now 195,000 (7.1%). By end-2014 unemployment is now forecast to be 179,900 (6.6%) falling further to 170,214 (6.3%) by tend-2015 as growth in the economy strengthens.

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Annex: Fraser of Allander Institute (FAI) Forecast Tables

Table 1: FAI Forecast Scottish GVA Growth, 2013-2015

GVA Growth (% per annum)	2013	2014	2015
Central forecast	**1.7**	**2.3**	**2.3**
October forecast	*1.3*	*1.8*	*2.1*
UK mean independent new forecasts (February)	1.9	2.7	2.4
Mean Absolute Error % points	+/- 0.19	+/- 0.50	+/- 1.21

Table 2: FAI Forecast Scottish Net Jobs Growth in Three Scenarios, 2013-2015

	2013	2014	2015
Upper	35,450	51,050	71,900
October forecast	*27,900*	*38,100*	*68,750.*
Central	**31,450**	**39,600**	**42,800**
October forecast	*21,200*	*27,200*	*38,400*
Lower	26,350	36,700	13,350
October forecast	*15,750*	*16,450*	*11,400.*

Table 3: FAI Forecasts ILO unemployment 2013-2015

	2013	2014	2015
ILO unemployment			
Rate (ILO un/TEA 16+)	**7.1%**	**6.6%**	**6.3%**
October forecast	7.6%	8.3%	6.9%
Numbers	**195,000**	**179,900**	**170,214**