18 June 2014

Burgeoning boom risks bust

Fraser Institute cautions Bank of England against raising interest rates

As the Scottish and UK economic recoveries gather pace, the risks of a reverse have widened and increased according to the latest Economic Commentary from the University of Strathclyde's Fraser of Allander Institute, sponsored by PwC

The Scottish economy is now enjoying a strong recovery, with employment and productivity up and strong growth forecast in production and manufacturing. The surge in jobs and output is, however, subject to real risks of:

- a continuing unbalanced recovery (between household spend, business investment and export growth);
- falling UK real wages;
- the boom in London house prices; and
- deflation in the Eurozone.

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

> **"**The Grangemouth dispute which shut down the refinery plant last October lowered Scottish GDP growth in the final quarter of last year and masked the strength of the recovery, while the recovery in the Scottish and UK labour markets is almost unprecedented.
>
> **"**However, we are concerned that the risks to the recovery have widened and deepened. Household spending is too reliant on further borrowing as real wages have fallen, net exports continue to contribute little to growth and business investment is only just beginning to pick up.
>
> "But it is the boom in the London housing market that causes us most concern. We believe the Bank of England must avoid raising interest rates on that account. With Scottish house prices hardly rising at all, it is inappropriate for the recovery to be dampened across the UK for what is clearly a local or regional issue centred on London."

In the final Economic Commentary before the independence referendum, the Fraser of Allander Institute forecast for GDP growth is 2.5% for 2014, up from its March forecast of 2.3%. For 2015, it has revised the forecast down marginally to 2.2% (2.3% - March commentary).

The rise in the 2014 forecast is a result of the generally better than expected improvement in performance, optimism in business surveys and an improved outlook, especially for investment. However, the business surveys also contain doubts about the sustainability of the recovery. This reflects the risks examined in detail within the report and is the reason for the 2015 forecast being lower than in March.

The Institute's 2016 GDP forecast of growth of 2.4% reflects a reasonably optimistic view that the risks will be overcome; but if they are not, growth could be as low as 1% in 2016.

Paul Brewer, Partner at PwC in Edinburgh, said:

> "There's a consistent trend of improving business optimism as the recovery takes hold but it's yet to feed through into the investment that will help balance the recovery.

> "We don't see access to finance as a major constraint on investment, certainly for larger companies, so other factors such as the time for investment decisions to be fulfilled and pre-Referendum uncertainty will be in play, and we would look for significant step up in investment through the rest of 2014."

One bright spot for the Scottish economy is the evidence that real Scottish wage growth appears to have become positive in 2013 whilst UK real wage growth has remained negative for the past three years.

Professor Ashcroft added:

> "This may be due to a faster growth in labour productivity in Scotland. If so, the prospects for Scottish household spending might be a little rosier than in the UK."

The Economic Commentary also finds:

- Projected net job creation is 43,100 in 2014, falling slightly to 42,900 in 2015 and rising to 58,150 in 2016
- The majority of jobs created continue to be in the service sector
- The unemployment forecast has been revised down further again from March, reflecting strong jobs growth given rising output
- Unemployment on the ILO measure at the end of 2014 is now projected to be 173,150 (6.4%). By the end of 2015, unemployment is now forecast to be 168,150 (6.2%) falling further to 157,200 (5.8%) by the end of 2015 as growth in the economy strengthens

As Scotland's leading publication on the Scottish economy, the *Commentary* also publishes articles of topical interest to the Scottish economy and more widely. This issue includes articles on:

- **Key issues in the economic and political debate on Scotland's future economic governance** – Prof Andrew Goudie;
- **A new Social Accounting Matrix (SAM) for Scotland** – Tobi Emonts-Holley, Andrew Ross and Prof Kim Swales;
- **Geography, Firm Location and the Corporate Tax Debate** – Profs Julia Darby, Ian Wooton and Dr Ben Ferrett
- **How to predict the winner of the 2014 World Cup (in one simple equation): a new methodology –** Dr Nicolas Scelles and Prof**.** Wladimir Andreff

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Contacts:

Lynn Hunter, PR Manager Scotland, PricewaterhouseCoopers LLP
Tel: +44 (0)141 355 4015, Mobile: 07841 570487, Email: lynn.m.hunter@uk.pwc.com

Kat Hannah, Corporate Communications Manager, University of Strathclyde,
Tel: +44 (0)141 548 4123, Mobile : 07967 796 503, Email: kat.hannah@strath.ac.uk

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 have been drawn from consensus forecasts.

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Overview

In its latest Economic Commentary, sponsored by PricewaterhouseCoopers, the University of Strathclyde's Fraser of Allander Institute notes that the Scottish economy is now enjoying a strong recovery. However, the Institute cautions that the recovery is subject to the risks of: a continuing unbalanced recovery; falling real wages; booming house prices in the London housing market, and deflation in the Eurozone. Nevertheless, the Institute has raised its forecasts from March and its latest economic forecasts for Scottish GDP are, for: 2014: 2.5% (up from 2.3%); 2015: 2.2% (down from 2.3%); and for 2016: 2.4%. Net job creation is forecast to continue and strengthen, while unemployment is projected to fall.

The Institute sees that there are four potential risks to a sustained recovery of the Scottish economy:

- a failure to achieve a balanced recovery (as between household consumption, business investment and export growth)
- weak or no growth in real UK wages
- an overheated housing market, especially in London and the South East of England and its potential impact on UK interest rates
- the risk of deflation in the Eurozone

The evidence suggests that the UK and Scotland are still a long way off from a balanced recovery. Investment does seem to be picking up and it is to be hoped that this will continue, because the prospects of a marked improvement in the net trade position with sterling high and the European economies weak, does not augur well. And while household spending is currently strong, its underling determinants appear weak.

A key reason for concern about the sustainability of household spending is that debt levels to income remain high and real wages are falling! Real wage growth needs to move into positive territory for the prospects of a *sustained* growth in UK household spending to be certain. One critical factor here is whether labour productivity can begin to grow strongly. Without a step-change in the rate of growth of productivity the likelihood is that the recovery - as the economy begins to approach capacity - will see rising nominal wages but little increase in real wages as the growth of product prices matches that of nominal wage growth. Yet, data suggest that real Scottish wage growth become positive in 2013 whilst UK growth has remained negative for the past three years. This could be due to a faster growth in labour productivity in Scotland than in the UK, but we have no up-to-date data on labour productivity on this matter. Nevertheless, the recent recovery in UK jobs growth has been faster than in Scotland whereas GDP growth has been more similar suggesting faster productivity growth here. So, on this basis, the prospects for Scottish household spending might be a little rosier than in the UK.

Arguably, the biggest threat to the recovery in both Scotland and the UK comes from the housing market. House prices are rising at an annual rate of 8% in the UK but by 17% in London. Scotland's house prices were largely flat over the year to March 2014 with growth of only 0.8%. **We believe there is a strong case for the Bank of England to exercise its currently limited macro-prudential policy powers through its new Financial Policy Committee by seeking to curb high loan to income ratios. The Bank of England should not seek to raise interest rates largely on this account.** Rising house prices are essentially a London and South East England phenomenon. In Scotland, house prices are hardly rising overall. So, it would seem inappropriate for the recovery to be dampened right across the UK for what is clearly a local or regional issue centred on London.

The final obstacle to recovery is the risk of deflation in the Eurozone, with prices poised to begin falling, the Eurozone risks a decade or more of Japanese-style stagnation. This would lower demand for imports and limit foreign investment and would be very damaging to any export recovery in both Scotland and the rest of the UK.

Key Points

GDP Performance

- The latest Scottish GDP data for Q4 2013 show that Scottish GDP rose by 0.2% in the quarter, significantly less than the 0.7% rise in the UK.
- However, it is clear that the Grangemouth dispute was responsible for reducing GDP by about -0.4% in the Q4 2013, suggesting that the implicit growth of the Scottish economy in the quarter was about 0.6%, close to but a little less than UK GDP growth at 0.7%.
- Over the year to the fourth quarter - four quarters on the previous four quarters - Scottish GDP grew at 1.6% a little less than the 1.7% outturn in the UK, suggesting that without the loss of output due to Grangemouth annual performance would have been no worse than in the UK.
- In the fourth quarter, GDP in Scotland was -0.9% below its pre-recession peak, whereas UK GDP stood at -1.4% below its pre-recession peak of more than 5 years ago. While the scale of the recession was greater in the UK: a drop of -7.3% in GDP compared to a fall of -5.6% in the UK, the overall strength of the recovery has been stronger in the UK than in Scotland.
- When oil and gas production is removed, to ensure a like-for-like comparison, the respective Scottish and UK growth rates remain the same for the latest quarter but over the year UK growth rises to 1.8% with Scotland at 1.6%. The long period of weak oil and gas production has

resulted in the UK GDP - ex oil & gas - having a much stronger recovery from recession than Scottish GDP.

- Scottish GDP has recovered by 5.02% since the trough of recession while UK GDP - ex oil & gas - has recovered by 7.41% from its trough. So, by the final quarter of last year UK GDP - ex oil & gas - was -0.5% below its pre-recession peak compared to -0.9% for Scotland.
- The Scottish service sector, which accounts for 72% of GDP in Scotland and 77% in the UK, grew by 0.6% in Scotland and 0.8% in the UK in the fourth quarter. Over the year, the service sector in Scotland grew by 1.5%, less than the 1.8% achieved in UK services.
- Scottish services have now finally attained and passed – slightly – their pre-recession peak. UK services attained their pre-recession peak in the Q3 2013. So, UK services now stand at 1.2% above the previous peak, while for Scottish services it is 0.3%. The recovery in Scottish services continues to be weaker than in the UK with growth of 4.33% since the trough of the recession compared to 6.98% in UK services.
- GVA in Scottish manufacturing fell, largely because of the Grangemouth effect, by -2.2% but rose by 0.8% over the year. In UK manufacturing GVA rose by 0.6% in the quarter but fell by -0.6% over the year.
- Hence, Scottish manufacturing GVA went from 4.6% below the 2009-09 pre-recession peak in the third quarter to -7.2%. The figure for UK manufacturing improved slightly because of the small rise GVA in the quarter from to -9% in the third quarter to -8.9% in the latest quarter.
- Scottish construction GVA fell by -1.0% in the quarter but rose by 2.6% over the year. UK construction GVA also contracted, but by less at -0.2% than in Scotland, with GVA rising by 1.1% over the year. Scottish construction's performance has been weaker than its UK counterpart for the last three quarters.
- However, despite the general recovery construction remains considerably depressed in both the UK and Scotland. The recent stronger performance of UK construction means that GVA in the sector stood in the fourth quarter at -12.5% below its pre-recession peak with the sector in Scotland in a worse position at -13.5% below its peak.
- Within services, the principal sub-sectors all displayed positive growth in the fourth quarter. However, growth in business and financial services slackened somewhat in the quarter with GVA growing by only by 0.2% compared to 1% in the UK. Over the year, the sector grew at 3.8% in Scotland and 2.2% in the UK.
- However, in financial services alone the recent sustained recovery enjoyed by the sector since the fourth quarter 2012 came to an end in the final quarter of last year, with GVA falling by -1.1% in the quarter while rising by 1.9% over the year. Now GVA in the sector is -12.2% below the pre-recession peak compared to the trough of -17.4% in 2012q4.
- The recent weakness of the transport, storage & communication sector in Scotland ended in the fourth quarter with GVA rising by 1.7% compared to

0.4% in the UK. Over the year, the sector has contracted by -1.2% in Scotland while rising by 1.3% in the UK. By the end of the fourth quarter GVA in the Scottish sector was -6.5% below pre-recession peak compared to -3.4% in the UK.

Labour Market

- In the quarter February to April 2013, employment rose by 0.6% in Scotland and 1.1% in the UK. In terms of numbers, jobs rose by 16,000 in the quarter, compared to a remarkable rise of 345,000 in the UK as a whole. Over the year, Scottish jobs rose by 48,000, a rise of 1.9%, while UK jobs rose 780,000, or 2.6%.
- During the quarter unemployment in Scotland, in a reflection of the jobs increase, fell by -7,000, or -3.6%, to 183,000, or a rate of 6.6%, while in the UK, unemployment fell more rapidly by -161,000, or -6.9%, to a rate of 6.6%.
- Scottish jobs as reported in the LFS worker surveys have now reached their pre-recession peak, which continues to be worse than the UK, where the jobs total is 2.1% *above* the pre-recession peak, compared to 0.2% in Scotland in the final quarter of last year.
- However, it is worth noting that the ONS employee jobs series for Scotland shows that there were 2,343,000 employee jobs in Scotland in the final quarter of 2013. This was an increase of 66,000 jobs from the end of 2012, but 137,000 jobs (5.5%) lower than the peak of employee jobs in Scotland in Q3 2008 (2,480,000).
- By January - March 2013 the employment population ratio in Scotland stood at -2.8% below the pre-recession peak. This suggests that there is still plenty of slack in the Scottish labour market. **The evidence is that the growth in employment is still sustained by the growth of part-time workers and the self-employed provides a further indication of slack in the labour market. Moreover, there are still a large number of part-time workers that cannot find a full-time job.**

Forecasts

- We are forecasting growth in Scottish GDP of 2.5% in 2014, 2.2% in 2015, and 2.4% in 2016. This represents a slight increase for 2014 and a slight decrease for 2015 over our March 2014 forecast. Given our previous forecast errors the lower and upper bounds for growth in 2014 are expected to be 2.1% and 2.9%, for 2015, 1.7% to 2.7%, and for 2016, 1.3% to 3.5%.

- **Production and manufacturing continue to be the major sectors exhibiting the fastest growth in 2014, 2015 and 2016**.
- Our forecasts for employee job creation are broadly similar to our March 2014 forecasts, with a slight upward revision for 2014 and small downward adjustment for 2015.
- On the central forecast, we are now forecasting that net jobs will increase by 43,100 in 2014, 42,900 in 2015 and 58,150 in 2016. Our projection for unemployment on the ILO measure at the end of 2014 is now 173,150 (6.4%).
- By the end of 2015, unemployment is now forecast to be 168,150 (6.2%) falling further to 157,200 (5.8%) by the end of 2016 as growth in the economy strengthens over 2015.

Contact: **Professor Brian Ashcroft**
Outlook and Appraisal and Economics Editor
Tel: 0141 548 3957
Mob: 07850 551004
E-mail: b.k.ashcroft@strath.ac.uk

Kevin Kane
Economic Commentary Managing Editor
Tel: 0141 548 2752
E-mail: k.kane@strath.ac.uk

Grant Allan
Forecaster
Tel: 0141 548
Email: g.allan@strath.ac.uk

Annex: Forecast Tables

Table 1: Forecast Scottish GVA Growth, 2014-2016

GVA Growth (% per annum)	2014	2015	2016
Central forecast	**2.5**	**2.2**	**2.4**
March 2014 forecast	*2.3*	*2.3*	*n.a.*
UK mean independent new forecasts (May)	2.9	2.5	2.4
Mean Absolute Error % points	+/- 0.43	+/- 0.50	+/- 1.12

Table 2: Forecast Scottish Net Jobs Growth in Three Scenarios, 2014-2016

	2014	2015	2016
Upper	52,850	66,050	87,200
March 2014 forecast	*51,050*	*71,900*	*n.a..*
Central	**43,100**	**42,900**	**58,150**
March 2014 forecast	*39,600*	*42,800*	*n.a.*
Lower	33,400	19,900	29,900
March 2014 forecast	*36,700*	*13,350*	*n.a.*

Table 3: Forecasts ILO unemployment 2014-2016

	2014	2015	2016
ILO unemployment			
Rate (ILO un/TEA 16+)	**6.4%**	**6.2%**	**5.8%**
March 2014 forecast	6.6%	6.3%	n.a.
Numbers	**173,150**	**168,150**	**157,200**