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Scottish economy showing genuine growth – but is it sustainable?

- Prospects of improved growth clouded by weak demand and further austerity

According to the latest Economic Commentary from the University of Strathclyde's Fraser of Allander Institute, sponsored by PwC, the Scottish economy showed evidence of genuine growth in the third quarter of 2012.

However, doubts still linger on whether this improvement can be sustained, with survey evidence suggesting a weakening in the final quarter of last year and uncertain prospects for 2013.

GDP growth is now forecast to be 0.9% in 2013 and 1.7% in 2014, a lowering of the Institute's forecast in November, rising further to 1.9% in 2015.

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

> **"**We expect to see some modest growth in the Scottish economy this year. However, growth should be a lot higher than it is given we are now five years on from the start of the Great Recession. Household demand, net trade and investment demand remain weak while fiscal austerity continues with 68% of planned benefit cuts and 78% of current departmental spending cuts still to come after April this year."

According to PwC, the report highlights the important role both the UK and Scottish Governments play in creating an environment that not only stimulates business growth, nurtures entrepreneurship and creates new services and jobs, but drives an economic momentum that inspires confidence, delivers investment and improves export activity to emerging markets.

Paul Brewer, Senior Partner at PwC in Edinburgh, commented:

> "Two aspects of our sectoral performance stand out in the Commentary. Firstly, our business and financial services sector has shown continued recovery in the past year, with a growth rate of 3.9%, over double the UK rate. And reflecting the Scottish Government's focus on infrastructure spending, the Scottish construction sector has strongly outperformed the, admittedly weak, performance in the UK as a whole.
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> "The challenge will be maintaining this momentum in an economic environment that shows limited prospects of growth in the short term and an increasingly tightening fiscal squeeze."

Influencing factors

According to the Economic Commentary, the main components of aggregate demand - private investment, household demand, net trade and government spending - in the Scottish economy remain weak.

Government fiscal consolidation is set to increase as the UK Government strives to meets its target of balance in its sectoral (cyclically adjusted) current budget in five years. And the prospects for a growth in the contribution of net trade depend much on the recovery of demand and output in the eurozone and wider growth of world trade. Huge uncertainties exist over eurozone prospects. The main beacon of hope is recovery in the US economy but this is not without its uncertainties.

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

> "Ironically, the UK lost its AAA credit rating not because of fiscal profligacy but because of austerity. The austerity has severely lowered growth and tax revenue prospects as affirmed by the IMF. The only silver lining is that it will, from previous evidence e.g. Japan and the US, have no effect on the low UK long-term borrowing rate.
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> "The ability of credit agencies to judge sovereign debt default prospects is not highly rated by financial markets. And they are right. The way is still open for a massive boost to infrastructure spending in the UK financed through additional borrowing at exceptionally low rates. If only the Chancellor would take it in his Budget on March 20th."

Paul Brewer, Senior Partner at PwC in Edinburgh, added:

> "Aside from the notable exception of the oil and gas sector, overall investment levels still weak. The Chancellor needs to look at all opportunities to stimulate investment and focus on the drivers of healthy sustainable growth in the Scottish and UK economy."

Labour Market

Projected net job creation is 9,400 this year, rising to 19,150 in 2014 and 31,800 in 2015. The Institute continues to expect the unemployment position to deteriorate slightly in 2013 and 2014 compared to 2012 due to weaker output and employment growth.

Unemployment is now forecast to be 218,300 by the end of 2013 and 228,500 in 2014. By the end of 2015 unemployment is forecast to have fallen back to 204,100 as the economy recovers more strongly. But the Institute warns that many workers have left the labour market, probably because of an inability to find work, they are not claiming benefits. As a result, the measured unemployment rate is becoming a less and less accurate measure of the extent of labour reserves and the underlying misery of job loss.

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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, in association with FAI, produces a Business Review which considers some of the implications of the Economic Commentary trends for Scottish business. The Business Review can be downloaded from: http://www.strath.ac.uk/frasercommentary/businessreviews/
4. PwC firms provide industry-focused assurance, tax and advisory services to enhance value for their clients. More than 161,000 people in 154 countries in firms across the PwC network share their thinking, experience and solutions to develop fresh perspectives and practical advice. See pwc.com for more information.

Overview

In their latest Economic Commentary, sponsored by PricewaterhouseCoopers, the University of Strathclyde's Fraser of Allander Institute notes that there was evidence of some genuine growth in the Scottish economy in the third quarter of last year. Also the new GDP methodology and revisions have meant the fit with the UK economy during recession and recovery is closer. The recovery has been a little stronger than the earlier data suggested but still a little weaker than the UK as a whole. But survey evidence suggests a weakening in the final quarter of 2012 and uncertain prospects for 2013. It is quite clear the main components of aggregate demand in the Scottish economy remain weak.

Government fiscal consolidation is set to increase as the UK Government strives to meets its target of balance in its structural (cyclically adjusted) current budget in five years. Most of the future adjustments concern spending rather than taxation with 68% of planned benefit cuts and 78% of current departmental spending cuts still to come after April this year. These cuts will depress household demand as well as reducing government spending directly. And the prospects for a growth in the contribution of net trade depend much on the recovery of demand and output in the eurozone from the current recession and wider growth of world trade. Huge uncertainties exist over eurozone prospects. The main beacon of hope is recovery in the US economy but this is not without its uncertainties.

The labour market in Scotland shows falling measured unemployment but from the middle of last year employment falling, and the number inactive continues to rise. The 'real' level of unemployment is clearly higher and that will contribute to weak household spending on goods and services.

Against this background we have reduced our forecasts for GDP growth in 2013 and 2014 to 0.9% and 1.7%, respectively. We now forecast 2015 for the first time and expect growth to be higher in that year, at 1.9%, as recovery finally, and hopefully, takes hold. Projected net job creation is 9,400 this year, rising to 19,150 in 2014 and 31,800 in 2015. Unemployment is forecast to be 218,300 by the end of 2013, 228,500 in 2014 and 204,100 by the end of 2015.

GDP Performance

- GDP in constant prices rose by 0.6% in Scotland during the third quarter, compared to a 0.9% increase in the UK.
- The effect of methodology and data source revision has been that the scale of the Great Recession in Scotland is slightly reduced to a drop of -5.6% rather than -5.8%. And now Scotland stands with the UK in being just under 3% below the pre-recession peak, whereas in the previous quarter Scotland was more adrift from the UK.
- The Scottish recovery is still slightly weaker than the UK but not by much.
- However, the aggregate output figures flatter the Scottish recovery because of the statistical quirk that the UK figures include all of oil production whereas the Scottish data do not. With oil production weak this has affected the Scottish-UK GDP relative as CPPR previously pointed out. With oil and gas excluded the UK stands at 2.1% below its pre-recession peak while Scotland is just under 3% below. The Scottish recovery from the Great Recession is still clearly weaker than the UK once this adjustment is made.

- The Scottish service sector, which accounts for 72% of GDP in Scotland and 77% in the UK, was weaker in Scotland in the third quarter. Scottish service GVA grew by 0.3% here compared to growth of 1.2% in the UK.
- By the third quarter of this year, Scottish services GVA was still -2.7% below its pre-recession peak compared to a UK position where the sector has finally recovered its pre-recession peak output to stand 0.3% above that level.
- Manufacturing grew by 3% in the third quarter but fell by -0.3% over the year. This can be compared with the performance of UK manufacturing which grew by only 0.7% in the quarter and contracted by -1.4% over the year. Scottish manufacturing GVA now stands at -4% below the pre-recession peak, while the figure for UK manufacturing is -8.5%.
- Scottish construction GVA fell by -0.4% in the quarter and by -10.1% over the year. But UK construction contracted even more in the quarter, by -2.5%, but by less, -6.1%, over the year. Construction output in Scotland is 16% below its pre-recession peak while it is 19% below in the UK.

Labour Market

- The latest labour market data show jobs in Scotland falling by 11,000, and unemployment fell by 13,000 in the latest quarter to December.
- Over the year, jobs were up by just 2,000 while unemployment was lower by 25,000. In the UK employment rose, resulting in the 16-64 employment rate rising over the year to 71.5 per cent above Scotland's 70.7 per cent which fell slightly over the year.
- Scottish employment stands at around -3.1 per cent *below* its pre-recession peak. In the UK, in contrast, employment is now 0.1% *above* the previous peak.
- When compared with the GDP data the jobs figures suggest that productivity per worker has fallen significantly in the UK since the recession began. But what is now different from the last time when we reported is that from the latest jobs and GDP data productivity per worker in Scotland is now much the same as before the recession.
- With employment and unemployment falling in Scotland while the numbers inactive rise, the likelihood is that the measured unemployment rate does not capture the real extent of unemployment since many have left the labour market because they cannot find a job.
- Our hypothesised 'real' level of unemployment is some 80,000 higher than the official rate and on a rising trend.
- Moreover, as jobs fall and working population rises the employment- working population ratio now stand -5.7% below its pre-recession peak compared to -5.6% in the trough of the recession. Employment is 3.1% below its pre-recession peak.

Forecasts

- Against a background of continuing weakness in domestic and foreign demand we have revised down our forecasts compared to November.
- We are now forecasting *GDP growth* in 2013 and 2014 of 0.9% and 1.7%, respectively. We now forecast 2015 for the first time and expect growth to be higher in that year, at 1.9%, as recovery finally, and hopefully, takes hold.
- We therefore expect Scottish growth to continue to be a little weaker than UK growth this year, a little stronger next year and a little weaker in 2015.

- Given our previous forecast errors the lower and upper bounds for growth in 2012 are expected to be -0.26% and 0.06%; for 2013, 0.36% and 1.44%; for 2014, 0.50% to 2.90% and for 2015, 0.70% to 3.10%.
- After the predicted fall in output in all major sectors in 2012, production and manufacturing continue to be the main sectoral drivers of growth in 2013, 2014 and 2015. But both services sector and construction growth do pick up by end of the forecasting horizon.
- On *employment* projected net job creation is 9,400 this year, rising to 19,150 in 2014 and 31,800 in 2015.
- The bulk of the 9,400 net job creation this year will be in the production sector, where we expect some 7,800 extra net jobs to be created. The service sector sheds some -850 jobs but construction adds just under 2,000 jobs and 450 jobs are created in agriculture. In 2014 and 2015, the service sector begins to create many more jobs, 4,250 and 13,600 respectively. Yet, this is still less than the production sector, largely driven by manufacturing jobs growth, where 10,850 and 14,050 jobs are forecast in the two years. Construction is projected to add around 3,000 jobs in each of those years.
- Unemployment is forecast to be 218,300 by the end of 2013, 228,500 in 2014 and 204,100 by the end of 2015.
- We also see many workers leaving the labour market so that the measured and forecast unemployment rate becomes a less and less accurate measure of the extent of labour reserves and the underlying misery of job loss.

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Annex: Forecast Tables

Table 1: Forecast Scottish GVA Growth, 2012-2015

GVA Growth (% per annum)	2012	2013	2014	2015
Central forecast	-0.1	0.9	1.7	1.9
November forecast	*-0.1*	*1.3*	*2.2*	*n.a.*
UK median independent new (February)	0.0	1.0	1.6	2.1
Mean Absolute Error % points	+/- 0.159	+/- 0.543	+/-1.204	+/- 1.204

Table 2: Forecast Scottish Net Jobs Growth in Three Scenarios, 2012-2015

	2012	2013	2014	2015
Upper	36,850	21,400	44,950	59,100
November forecast	*-19,350*	*27,100*	*53,350*	*n.a.*
Central	32,650	9,400	19,150	31,800
November forecast	*-25,750*	*16,950*	*29,450*	*n.a.*
Lower	29,950	-3,100	-5,750	5,150
November forecast	*-32,050*	*5,500*	*5,850*	*n.a.*

Table 3: ILO unemployment rate and claimant count rate measures of unemployment in central forecast 2012-2015

	2012	2013	2014	2015
ILO unemployment				
Rate (ILO un/TEA 16+)	7.8%	8.3%	8.6%	7.7%
Numbers	204,050	218,300	228,500	204,100
Claimant count				
Rate (CC/CC+total job)	5.0%	5.2%	5.3%	4.7%
Numbers	137,650	141,900	148,511	130,192