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Growth slows as Scotland's performance diverges from UK

- *Forecast for Scottish GDP growth is 1.9% in 2015, 2.2% in 2016, and 2.5% in 2017; downward revisions to 2015 and 2016 and upward revision for 2017 from the Fraser of Allander Institute's June 2015 forecasts.*
- *For the longer term, the Institute is concerned about Scotland's weak productivity and poor export performance*

Growth in Scotland has begun to diverge quite markedly from the UK despite being boosted by public investment in infrastructure, according to the latest Economic Commentary from the University of Strathclyde's Fraser of Allander Institute, sponsored by PwC.

While domestic demand is clearly driving growth across Scotland and the UK, the Commentary reveals a divergence in the underlying factors

Construction provides the main impetus in Scotland, with public spending on infrastructure underpinning growth. Conversely, the service sector has been weakened by the onshore impacts of lower for longer oil prices, hitting business services in particular, as well as mining and quarrying. This picture is reversed in the UK: the service sector is the main driver with construction weakening.

According to the Commentary authors, domestic demand continues to be boosted by low inflation, net immigration into the UK, low interest rates, and some pick up in wages and earnings.

But actual and potential *threats* to this growth remain. Further austerity measures planned by the UK Government is a key factor as well as continuing high levels of household debt, which for some households paying a variable interest rate will become an increasing burden if rates rise in the near future.

Analysis in the latest Commentary also causes the Institute to express concern about Scotland's weak productivity and poor export performance, which it suggests could have long-term growth implications.

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

> "With growth slowing right across the UK and especially in Scotland, now is the time for the Chancellor to rethink his cuts to tax credits and for the Bank of England to continue to hold rates.
>
> **"**Scotland's weak productivity and poor export performance necessitates that the Scottish Government tackle these issues more directly if it is to raise the long-term growth rate of Scotland's economy."

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

> "While it is encouraging to see Scottish Government's ongoing focus on infrastructure investment and hard evidence of the positive impact this is having on our construction industry, unless this is sustained over a long period of time there is a risk we will become increasingly exposed to shortfalls in the service sector.

“Productivity is also key to future economic success and it’s vital that issues such as enhancing skills, particularly in relation to Scotland’s core and emerging sectors, and innovation are addressed if we are to see any meaningful and sustained uplift.

“We are also seeing the effects of the low oil price manifesting themselves across other onshore sectors from engineering to hospitality – this is no longer the preserve of the oil and gas industry. Indeed, our latest UK hotel report noted a double-digit fall in occupancy levels and revenue per room across Aberdeen in the year to July 2015.

“With oversupply in the oil market looking likely to continue in the medium-term, it’s crucial that the oil and gas industry swiftly adjusts to this ‘lower for longer’ scenario, working closely with the regulator and Government to protect the long term future of Aberdeen as a global hub.”

Economic forecasts and the wider commentary

Ongoing export difficulties, as a result of a relatively high pound sterling and lingering effects of the low oil price on Scottish onshore activity, has stilted growth in 2015.

This slowdown in recovery during the first half of the year has resulted in a significant downward revision in GDP growth to 1.9% **-** a 0.6% drop from the June forecast. The forecast for 2016 is 2.2% with 2017 expected to reach 2.5%.

Weakening export demand and the strength of sterling has also had an adverse impact on manufacturing growth, both in Scotland and the UK, with the current crisis in the UK steel industry a case in point.

And this could be exacerbated by existing and potential risks such as China’s structural reforms which will lead to slower growth and an increase in US interest rates will have global repercussions, which will serve to slow growth especially in emerging markets.

On a positive note, the Commentary does note the potential for a boost in external demand for goods and services following a gradual pick-up in growth across the Eurozone as problems in Greece are resolved, in the short term at least, and risks of deflation recede.

The wider commentary

In addition to its Outlook and Analysis of the Scottish economy, the Fraser Economic Commentary also includes topical articles on **Scottish productivity**; **the ‘circular’ economy**; **international export performance**; and the final part of **‘Forty Turbulent Years’ (2000-present)** a review of Scotland’s recent economic history as viewed through the pages of the Fraser Economic Commentary.

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 PwC.
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.

Fraser of Allander Institute Forecast Tables

Table 1: Forecast Scottish GVA Growth, 2015-2017

GVA Growth (% per annum)	2015	2016	2017
Central forecast	**1.9**	**2.2**	**2.5**
June forecast	2.5	2.3	2.3
UK mean independent new forecasts (October)	2.5	2.3	
Mean Absolute Error % points	+/- 0.26	+/- 0.80	+/- 1.37

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

	2015	2016	2017
Upper	54,950	65,500	88,800
June forecast	*62,100*	*72,650*	*80,600.*
Central	**49,400**	**45,000**	**54,650**
June forecast	*51,250*	*49,600*	*51,700*
Lower	43,800	24,450	20,500
June forecast	*40,400*	*26,550*	*22,800*

Table 3: Forecasts ILO unemployment 2015-2017

ILO unemployment	2015	2016	2017
Rate (ILO un/TEA 16+)	**6.2%**	**5.7%**	**4.6%**
June forecast	5.1%	4.5%	3.9%
Numbers	**169,150**	**155,450**	**118,400**

I Overview

In its latest Economic Commentary, sponsored by PricewaterhouseCoopers, the University of Strathclyde's Fraser of Allander Institute notes that Growth in both the Scottish and UK economies is slowing and in the second quarter a gap opened up between Scotland and the UK. The chained volume measure of GDP rose by 0.1% in Scotland in the quarter, while UK GDP rose by 0.7%. UK GDP (ex oil & gas) stands 6.9% above the pre-recession peak compared to 3.0% in Scotland. UK GDP - ex oil & gas - has had an even stronger recovery from recession than Scottish GDP. Scottish GDP has recovered by 8.4% since the trough of recession while UK GDP - ex oil & gas - recovered by 13.8% from its trough by 2015q2, compared to 12.8% when oil and gas output is included. In the latest quarter, UK GDP ex oil and gas rose by 0.5% - less than the 0.7% when oil & gas is included, suggesting a pick up in offshore activity - and by 2.7% over the year – four quarter on four quarter.

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 again differed considerably in the fourth quarter. In Scotland it is the construction sector that is providing the main impetus with public spending on infrastructure underpinning growth. In the UK in contrast, the service sector is the main driver with construction weakening. In Scotland, weakness in the service sector has been affected by the onshore implications of the fall in the price of oil hitting business services in particular as well as mining and quarrying. Manufacturing growth is weak in both Scotland and the UK, which seems to be a reflection of weakening external demand for UK exports reinforced by the strength of sterling, the current crisis in the UK steel industry being a sad, example.

III The labour market

The latest labour market data show that the recovery in the labour market is slowing in both Scotland and the UK, while the recovery remains stronger in the UK. In the quarter to August 2105 employment fell by -6,000 (-0.6%) to 2,610,000 while unemployment rose again by 18,000 (0.6%) to 170,000 with the rate rising to 6.1%. In both the jobs market and in output the recovery has been stronger in the UK than in Scotland. On jobs, employment was 2.2% *above* the pre-recession peak in Scotland at the end of the second quarter, while UK jobs were 4.4% higher than the peak.

IV Factors influencing the recovery and growth

(i) Domestic demand

Domestic demand in Scotland and the UK continues to be *boosted* by: low inflation; net immigration into the UK; low interest rates; and some pick up in wages and earnings. To be set against these positive influences are actual and potential *threats* to the growth of domestic demand: further planned austerity by the UK Conservative Government exemplified by the planned cuts to tax credits; and the continuing high levels of household debt, which for some households paying a variable interest rate will become an increasing burden if rates rise in the near future.

(ii) External demand

External demand for Scottish and UK goods and services are being *boosted* by:

- the continued resilience of the US economy;

- a gradual pick up in growth in the Eurozone as the risks of deflation appear to recede while the problems of Greece are, for the short term at least, resolved;
- and the world economy is forecast by the IMF to grow by 3.1% this year and by 3.6 % in 2016.

To be set against these positive influences are actual and potential *threats* to the growth of external demand:

- the high sterling exchange rate against the Euro, which appears to have been boosted by the short-term market expectation of an imminent increase in UK interest rates;
- the IMF's forecast for global growth in 2015 and 2016 represents a slowdown from the 3.4% achieved in 2014;
- China's transformation from dependency on high domestic investment, forced saving and a disproportionate reliance on external demand to a greater reliance on household consumption and associated structural reforms will lead to slower growth; and
- the effect of what the IMF calls 'policy normalisation' of monetary policy in the United States as interest rates begin to rise is expected to have global repercussions, which will serve to slow growth especially in emerging markets.

(iii) Growth

Analysis by the Institute on the long-term growth performance of the Scotland's economy leads to the following conclusions:

***On long-term growth performance**, the main conclusions are:*

- *Scottish 'trend' GDP* growth over last 50 years is identical to UK growth at 2.3% p.a;
- Scottish 'trend' GDP per head growth over last 50 years is 2.2% p.a. faster than UK's 2% p.a. – due to falling or slower population growth in Scotland.
- So, while in comparison with the UK and indeed many other small and large countries Scotland's economic performance is 'not too bad', we note that there has been a relative weakening of the Scottish economy since 2010.
- It follows, that if Scotland is to prevent a further deterioration in performance compared to the UK and secure a sustained increase in the growth rate overall the economy will have to raise its competitiveness.

On raising competitiveness, we show that Scottish labour productivity while growing is weaker than in UK.

- We cite recent research evidence from Durham University's Professor Richard Harris and Dr. John Moffat that Total Factor Productivity (TFP) - the productivity of all factors: labour, capital and land – is also lower in Scotland than UK.
- They find that on average Scotland has had significantly lower productivity compared to the rest of the UK since the end of the 1990s. Overall, the 'gap' was around 11% across all sectors in 2012 (and 22% below the leading UK region).
- There is an academic and policy consensus that we get stronger productivity growth through improvements in: innovation/R&D; exporting (especially in small open economies); skills; investment, and enterprise.
- Scotland is shown to be weak in varying degrees on all of these determinants of competitiveness.
- We look particularly at export performance and find that there has been a long-term decline – since the early 2000's - in manufacturing exports abroad.
- This has affected the performance of overall exports to the rest of the world.
- In addition, there is clear evidence of the growing importance of exports to the rest of the UK, which peaked at 68% of total Scottish exports before the recession.
- Exports to rest of UK are heavily dominated by service sector exports and financial services in particular. That importance dipped during and

immediately after the Great Recession to 2012 with the contraction of financial services activity but picked up again after that.

- Another pointer is that exports to the rest of UK track GDP much better than exports to the rest of the world. This in part reflects the scale of rest of the UK exports to both GDP and total Scottish exports.

V Forecasts

(i) Output

Our GDP forecast for 2015 is 1.9%, which is revised down from our forecast of 2.5% in June of this year due to the evidence of a slower than expected rate of growth in the second third quarters of 2015. For 2016, we have also revised down our forecast to 2.2% from 2.3% in June, in recognition that the slow down in the rate of recovery will continue into 2016 as exporting continues to be difficult due to the high pound sterling and because of the lingering effects on Scottish onshore activity of the low price of oil. On our central forecast, we are forecasting a pick up in the rate of growth in 2017 as the economy rides out the challenges of 2016. We have therefore raised our forecast for 2017 to 2.5% from 2.3% in our June forecast.

(ii) Jobs

The number of total employee jobs is forecast to continue to increase in each year, 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 since June's forecast, from 51,250 to 49,400. The number of jobs at the end of 2015 is now forecast to be 2,433,400, an increase of 2.1% on 2014 (the same percentage growth forecast in June's Commentary). Our current central forecast is that the Scottish economy will add 45,000 jobs in 2016, down by 4,600 from our June forecast, while we forecast the addition of 54,650 jobs in 2017, an increase of nearly 3,000 on our June forecast.

(iii) Unemployment

On unemployment, the most recent figures show that unemployment rose again by 18,000 (0.6%) to 170,000 with the rate rising to 6.1%. Unemployment in Scotland rose by 19,000 over the year, or 0.7%. 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 from our earlier forecasts. Despite the recent increases, 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 169,150 (6.2%), falling further to 155,450 (5.7%) by the end of 2016, and 118,400 (4.6%) by end 2017.

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