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Economic recovery on a knife-edge?

Fraser Institute urges Chancellor to invest more in Scotland

The Scottish economy delivered strong economic growth in the first half of 2014 in the run-up to the referendum – but there are signs growth may be beginning to slow, according to the latest Economic Commentary from the University of Strathclyde's Fraser of Allander Institute, sponsored by PwC.

Slowing demand, falling real wages, rising levels of household debt, weak international trade – and the prospect of further substantial fiscal austerity to come – raise the question of whether the Scottish economy is poised for a period of slower but sustainable growth, or whether this slow-down in growth will lead to recession.

The authors say the economy may be at a turning point – but warn it may also be on a knife-edge.

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

> "The Scottish economy powered ahead in the first half of 2014 with GDP growing strongly, rapid job creation and falling unemployment. But with signs of a slowdown appearing both at home and abroad, we fear that the recovery may soon be running on empty unless there is a new boost to demand."

He added:

> "With little or no growth in real wages, rising household debt and house price growth moderating, the drivers of consumer demand are weakening. Private investment is picking up but is still below its previous pre-recession peak. UK interest rates are low and in view of pressing infrastructure needs, now is the time for the Chancellor to step up to the plate and invest more in Scotland."

He noted further:

> "The IMF recently called for Governments to undertake more public infrastructure investment through increased borrowing, which can stimulate present and future growth without increasing countries' public debt burden. It is time for the Chancellor to follow that lead. "

In the first Economic Commentary after the referendum, the Fraser of Allander Institute forecast for GDP growth is 2.7% 2014, up from its 2.5% forecast in June. For 2015, it has kept its forecast at 2.2% in 2015, but has revised its forecast for 2016 down to 2.1%, from 2.4%.

The rise in the forecast for 2014 is due to the strong growth in the first half of the year. The forecast for 2016 has been revised down because of concerns about a persistent weakness of overall demand in the economy.

Paul Brewer, PwC's Scottish Government and Public Sector Leader, said Scotland's economic recovery was at a crossroads and, despite the UK austerity programme, there was further opportunity to stimulate growth:

“There is no one-size-fits-all economic policy answer to overcoming the slowdown in growth impacting Scotland and the rest of the UK. We need policies and powers to address territorial problems and opportunities and identifying those is one of the challenges facing the Smith Commission – for example, increased freedom to borrow.

“As we approach the Autumn Statement, there is scope for the Chancellor to offer the Scottish Government and local Authorities more flexibility to invest in strategic infrastructure programmes aimed at improving digital and transport connectivity, skills, productivity and the competitiveness of Scotland as a business location.

“As we move forward post-referendum to create a Scotland that is confident, competitive and bold, government in Westminster and Holyrood must look to the real benefits that further decentralisation can bring to Scotland and indeed to the other nations and regions of the UK.”

The Commentary also includes several articles on a range of economic and policy issues, including:

- The Scottish NHS: meeting the affordability challenge;
- Policy challenges of the ‘post-crash’ labour market;
- Reflections on the Scottish independence referendum.

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, 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 refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details.

5. 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: Fraser of Allander Forecast of Scottish GVA Growth, 2014-2016

GVA Growth (% per annum)	2014	2015	2016
Central forecast	**2.7**	**2.2**	**2.1**
June forecast	*2.5*	*2.2*	*2.4*
UK mean independent new forecasts (October)	3.1	2.7	n.a.
Mean Absolute Error % points	+/- 0.29	+/- 0.49	+/- 1.12

Source: Fraser of Allander Institute

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

		2014	2015	2016
Upper		53,000	53,450	76,750
	June forecast	*52,850*	*66,050*	*87,200*
Central		**46,560**	**41,600**	**48,900**
	June forecast	*43,100*	*42,900*	*58,150*
Lower		33,400	19,900	29,900
	June forecast	*33,400*	*19,900*	*29,900*

Source: Fraser of Allander Institute

Table 3: Fraser of Allander Forecasts ILO unemployment 2014-2016

	2014	2015	2016
ILO unemployment			
Rate (ILO un/TEA 16+)	**5.3%**	**5.2%**	**5.0%**
June forecast	6.4%	6.2%	5.8%.
Numbers	**124,700**	**141,019**	**135,537**

Source: Fraser of Allander Institute

Overview

In its latest Economic Commentary, sponsored by PricewaterhouseCoopers, the University of Strathclyde's Fraser of Allander Institute notes that in the first half of the year the Scottish economy delivered strong economic growth, increased job creation and falling unemployment. However, there are signs that growth may be beginning to slow. Growth in the wider global economy and the UK economy appears also to have begun to slow recently. There are fears that the global economy faces a situation of secular stagnation, a permanent deficiency of demand, which can't be overcome even with near-zero interest rates. The recent indicators of slowing demand both at home and abroad, falling real wages, rising levels of household debt, the prospect of more substantial UK fiscal austerity to come, and the deeper concerns about secular stagnation raise several questions. Questions that can be posed but cannot be definitively answered, such as whether the Scottish and UK economies are now poised for a period of slower but sustainable growth, or whether growth will slow and then slip back into recession? Are we at a turning point or are we on a knife-edge?

Investment is recovering, but only slowly prompting the International Monetary Fund (IMF) to urge Governments to undertake increased public infrastructure investment. Such investment the IMF argued raises output in both the short and long term, particularly during periods of economic slack and when investment efficiency is high. So, in countries with infrastructure needs, it considered the time was right for an infrastructure push as borrowing costs are low and demand is weak. Debt-financed projects could have large output effects without increasing the debt-to-GDP ratio, if clearly identified infrastructure needs are met through efficient investment. The IMF notes that the estimated quality of UK infrastructure overall has been improving in recent years but still remains below that of the major advanced countries - Germany, France, Japan and Canada.

The UK Government appears to agree since at the time of writing it is unveiling plans for £15bn of new infrastructure projects this week to make it "easier than ever" to invest in the UK. Such public investment is to be welcomed. However, we contend that in the light of slowing growth, the risks of secular stagnation, the need to boost competitiveness, net trade and inward foreign investment, that there is strong case that Government, and the UK Government in particular, should invest much more in infrastructure in and for Scotland. For example, more needs to be done to improve the infrastructure of road and rail, especially, between Scotland and the UK. Raising the borrowing levels available to the Scottish Government would also help to support and encourage its own plans for infrastructure investment within Scotland. An expanded programme of public investment would appear to be essential when the real volume of private investment continues to be markedly below pre-recession peak levels in both Scotland and UK, even though private investment has picked up in recent quarters.

With the signs that the growth of productive activity may be slowing, we note also the strong performance of the Scottish labour market in recent months, with 52,000 jobs created over the year and unemployment on the ILO measure falling to 151,000 or 5.5%. However, despite the strong recent 'headline' recovery in the labour market, we are still some way from the conditions that maintained prior to the start of the Great Recession. Much of the recovery in jobs has been driven by the growth of part-time and self-employment. However, there is still slack in the Scottish labour market: full-time employment remains considerably below its pre-recession peak, although there has been some pick up in recent quarters; the total number of average weekly hours worked is at the latest data point -2.4% below the pre-recession peak; and, the employment to adult population ratio in June-August 2014 stood at -1.5% below the pre-recession peak, compared to -5.7% at the trough of the recession.

Against this background, we have prepared our latest forecasts. We are now forecasting GDP growth in Scotland of 2.7% in 2014, 2.2% in 2015, and 2.1% in 2016. Given our previous forecast errors the lower and upper bounds for growth in 2014 are expected to be 2.4% and 3.0%, for 2015, 1.7% to 2.7%, and for 2016, 1.0% to 3.2%. We have therefore revised up our forecast for 2014 from 2.5% to 2.7% due to the strong growth in the first half of the year. We have held our forecast for 2015 at 2.2% but have revised down our forecast for 2016 from 2.4% to 2.1% in the light of concerns about secular stagnation and a persistent weakness of aggregate demand. Production and manufacturing continue to be the major sectors exhibiting the fastest growth in 2014, 2015 and 2016. Our forecasts for employee job creation and unemployment are similar to June 2014, with some revisions. On the central forecast, we are now forecasting that net jobs will increase by 46,560 in 2014, 41,600 in 2015 and 48,900 in 2016. Our projection for unemployment on the ILO measure at the end of 2014 falls to 124,700 (5.3%). In 2015, unemployment is now forecast to fall slightly to 5.2% but to increase in terms of numbers to 141,019 as the workforce increases. Falling again, to 135,537 (5.0%) by the end of 2016.

Key Points

GDP Performance

- The latest Scottish GDP data for Q2 2014 show that Scottish GDP rose by 0.9% in the quarter, much the same as in the UK.
- Over the year to the fourth quarter - four quarters on the previous four quarters - Scottish GDP grew at 2.4%, a growth rate that is above trend.
- In the second quarter, GDP in Scotland was +1.1% above its pre-recession peak. Because of changes to accounting practices in the UK, which have yet to be introduced in Scotland, we do not have comparable UK data to Scotland in the second quarter. So, up to the first quarter of the year UK GDP was still -0.6% below its pre-recession peak compared to +0.2% in Scotland.
- The overall strength of the recovery has, nevertheless, been stronger in the UK than in Scotland because the depth of the recession was greater in the UK. By 2014q2 Scottish GDP had grown by 6.9% since the trough of the recession compared to 7.3% in the UK to the earlier quarter 2014q1.
- When oil and gas production is removed, we find that on the old data series UK GDP was 0.3% above the pre-recession peak by 2014q1 compared to 0.2% in Scotland. 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. As noted above, Scottish GDP has recovered by 6.9% since the trough of recession while UK GDP - ex oil & gas - recovered by 8.3% from its trough by the previous quarter 2014q1.
- The Scottish service sector, which accounts for 72% of GDP in Scotland and 77% in the UK, grew by 0.9% in Scotland in the second quarter; this followed growth 0.8% in Scotland and 0.9% in the UK in the first quarter. Over the year, the service sector in Scotland grew by 2.4%.
- Scottish services output in the second quarter stood at 2.2% above its pre-recession peak. UK services attained their pre-recession peak in the Q3 2013. By the first quarter output in Scottish services stood at 1.2% above the previous peak while output in UK services was 1.9% above.
- GVA in Scottish manufacturing fell by -0.4% after rising by 2.8% in the first quarter largely due to the impact of the Grangemouth oil refinery restarting production. Over the year to the second quarter, Scottish manufacturing fell -0.1% indicating a flattening of recovery in the sector.

- By the second quarter Scottish manufacturing GVA was still -5.6% below its pre-recession peak. By the first quarter UK manufacturing was -7.6% below its pre-recession peak compared to -5.2% in Scotland, reflecting the greater fall in UK manufacturing output in the recession and the stronger recovery in Scottish manufacturing before 2011q2.
- Scottish construction GVA picked up considerably in the second quarter growing by 3.6% after falling by -0.6% in the previous quarter and falling by -0.8% in the final quarter of 2013. UK construction GVA in contrast rose by 0.7% in the second quarter. Over the year – four quarters on four quarters - Scottish construction grew by 7.5%.
- Despite the recent recovery construction remains considerably depressed in both the UK and Scotland. By the second quarter Scottish construction was still -8.5% below its pre-recession peak. By the end of the first quarter UK construction was -10.3% below peak and Scottish construction -11.6% below its peak.
- Within services, the principal sub-sectors all displayed positive growth in the second quarter. Business and financial services grew strongly by 2%. Over the year, the sector grew at 4.4%. By the second quarter of this year output in the sector in Scotland stood at +6.5% above the previous peak.
- In financial services, the recovery is continuing this year after the weak performance in the second half of 2013. Now GVA in the sector is -6.8% below the pre-recession peak compared to the trough of -16.0% in 2012q4. The continuation of the recovery in financial services raises the hope that despite the structural change that occurred in the banking sector in particular after the Great Recession, output does now seem to be moving back slowly towards pre-recession levels.
- Output in the transport, storage & communication sector in Scotland continued to pick up in the second quarter with GVA rising by 1.3%. Over the year, the sector grew by 1.6% in Scotland. By the end of the first quarter GVA in the Scottish sector was -6.2% below pre-recession peak compared to -2.4% in the UK. By the second quarter, output in the sector in Scotland stood at -5.0% below pre-recession peak.

Labour Market

- The latest labour market data show a continuing strong recovery. In the quarter June – August 2014, employment rose by 1.4% in Scotland and changed little in the UK. In terms of numbers, jobs rose by 35,000 in the quarter, compared to a 46,000 in the UK as a whole. Over the year, Scottish jobs rose by 52,000, a rise of 2.0%, while UK jobs rose 736,000, or 2.5%.
- During the quarter unemployment in Scotland, in a further reflection of jobs growth, fell by -40,000, or -21.0%, to 151,000, or a rate of 5.5%, while in the UK, unemployment fell less rapidly by -154,000, or -7.2%, to a rate of 6.0%. Over the year, unemployment fell strongly by -54,000, or -26.2%, while in the UK unemployment also fell strongly but a little more slowly by -538,000, or -21.4%.
- Scottish jobs as reported in the LFS worker surveys have now passed their pre-recession peak. Yet, despite the good recent performance of the labour market in Scotland overall performance in the recovery continues to be worse than the UK. By the end of the second quarter while Scottish employment was 1.1% above the pre-recession peak, in the UK jobs were 3.2% higher than the peak.
- However, the Scottish labour market is still some way from the conditions that maintained prior to the start of the Great Recession. Much of the recovery in jobs has been driven by the growth of part-time and self-employment. Full-time employment still remains considerably below its pre-recession peak, although there has been some pick up in recent quarters.
- Moreover, an indication of the degree of slack still remaining in the labour market is provided by the evidence that the total number of average weekly hours worked is at

the latest data point -2.4% below the pre-recession peak; and, the employment to adult population ratio in June-August 2014 stood at -1.5% below the pre-recession peak, compared to -5.7% at the trough of the recession.

Forecasts

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- Production and manufacturing continue to be the major sectors exhibiting the fastest growth in 2014, 2015 and 2016.
- Our forecasts for employee job creation and unemployment are similar to June 2014, with some revisions. On the central forecast, we are now forecasting that net jobs will increase by 46,560 in 2014, 41,600 in 2015 and 48,900 in 2016.
- Our projection for unemployment on the ILO measure at the end of 2014 falls to 124,700 (5.3%). In 2015, unemployment is now forecast to fall slightly to 5.2% but to increase in terms of numbers to 141,019 as the workforce increases. Falling again, to 135,537 (5.0%) by the end of 2016.

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