Economic summary

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The latest economic data provide further evidence of a strengthening recovery. Positive growth has now been recorded for the Scottish economy in the last 6 quarters. In the third quarter, GDP in Scotland was -0.9% below the pre-recession peak, whereas UK GDP stood at -1.9% below its pre-recession peak 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. When oil and gas production is removed from the UK figures to make UK GDP comparable to the Scottish data, which do not include offshore production we find that 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 4.9% since the trough of recession while UK GDP - ex oil & gas - has recovered by 6.8% from its trough.

At the industry level, Scottish services' growth is underperforming the overall performance of the economy in the recovery whereas that is not the case in the UK where the recovery in services has been somewhat quicker. It is the production sector that has boosted Scottish growth, growing by nearly 10% in the recovery while it has been a significant drag on the recovery in the UK with zero growth since the trough of the recession, which is partly a consequence of the weakness of oil & gas production on the UK production and GDP figures. It is the performance of manufacturing that is the main driver of the differential performance in production between Scotland and the UK. Scottish manufacturing GVA continues to stand at -4.6% below the 2008-09 pre-recession peak, while the figure for UK manufacturing has dropped slightly to -9% from -9.8% in the second quarter. The favourable gap between Scotland and UK manufacturing performance during the recovery therefore continues to be large. In Scottish construction while growth in the sector has picked up since the heavy recession period of 2010q4 to 2012q1 performance appears to have weakened relative to the UK from the start of last year. The sector is still very much depressed in both the UK and Scotland. However, the recent stronger performance of UK construction is evident with GVA in the sector in the third quarter -10.9% below its pre-recession peak compared to -13.6% in Scotland. Business and financial services continue to contribute positively to the growth of the Scottish economy. By the latest quarter, the sector in the UK had moved to +1.3% above its pre-recession peak from -0.4% in the previous quarter, while its Scottish counterpart moved further ahead to stand at 2.2% above its pre-recession peak. In the previous two Commentaries, we noted that the aggregate GVA data for business and financial services in Scotland masked significant differences between the performance of financial services on the one hand and business services on the other.

What is clear now is that the difference is not so marked and financial services in particular have enjoyed a sustained recovery since the fourth quarter 2012. However, we note that there is a strong likelihood following the structural change that occurred after the Great Recession that some of this lost output may never return. This could still be the case despite the recent recovery in financial services. Moreover, with the recent RBS announcement that significant further cut backs in activity and jobs losses in the bank are to be expected the recent recovery in the sector might not be sustained.

The latest labour market data provide further welcome evidence of an improvement in conditions in the Scottish labour market. The unemployment rate now stands at 7.1% compared to 7.2% in the UK. 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. The greater gap between the UK's GDP and jobs position in relation to pre-recession peak compared to the position in Scotland suggests that productivity has fallen relatively more in the UK. The weak labour productivity position in both Scotland and UK is underlined by evidence which shows that increasing numbers of workers 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.

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. In Scotland and the UK the contribution of household spending to growth is similar, but the contribution of net trade is stronger in Scotland while that of investment is weaker. By the third quarter of last year overall UK gross fixed capital formation was around 10% below its pre-recession peak, while in Scotland the situation is worse with investment currently 14% below pre-recession peak. 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 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. So now would be the right time.

Overall, the pace of the recovery in the Scottish economy is accelerating and becoming more broadly based than previously. However, for some sectors trading conditions are still harsh suggesting that the recovery remains fragile and policy action may be required to ensure that it is sustainable. Against this background our GDP forecast for 2013 at 1.7% has again been revised upwards from our October forecast of 1.3%. For 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 June 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. On jobs, we continue to raise our forecasts for job creation over the forecast horizon. This reflects our raised GVA forecast and weak forecast productivity implying that more jobs are required to produce the greater output. 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. On unemployment, our forecasts have been revised down further again from October, 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 the end of 2014 unemployment is now forecast to be 179,900 (6.6%) falling further to 170,214 (6.3%) by the end of 2015 as growth in the economy strengthens.

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 is room for considerable optimism but there are also reasons to be cautious about the future path of the recovery.

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