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## Fraser of Allander Institute's Economic Commentary November 2008

*'There is a higher probability that Scotland will go into recession in 2009 and that the effects may be felt harder here than the rest of the UK.'*

In the latest Economic Commentary, supported by PricewaterhouseCoopers LLP, the University of Strathclyde's Fraser of Allander Institute argues that there is a high probability that the Scottish economy will go into recession in 2009.

The Economic Commentary, the first full Scottish-focused economic forecast investigates four potential scenarios for the Scottish economy – from optimistic to sustained recession over the period 2009 – 2012.

The current recession is the likely outcome of the global financial crisis. This was triggered by: the collapse of the house price bubble, initially in the United States; massive foreclosures in the US sub-prime mortgage market; and, significant bank and hedge fund losses across the globe as the value of innovative investments based on sub-prime mortgages collapsed. The uncertain solvency of many financial institutions has created an unprecedented loss of confidence and trust in the banking system resulting in a major breakdown in the credit supply mechanism.

### **Lesson from earlier recessions**

An examination of previous recessions supports the view that cyclical fluctuations of Scottish GDP have less amplitude than in the UK economy. Therefore the business cycle has tended to be effectively flatter in Scotland and so both upswings and downswings are less severe here than in the UK. We consider that the scale of the downturn now facing Scotland will probably be less severe than the 1980/81 recession. This is principally because on that occasion, monetary and fiscal policy effectively accommodated, even exacerbated, the recession and was not used counter-cyclically to combat the downturn.

That this will not happen on this occasion is indicated by the recent swinging cuts in interest rates in the UK and the US, and the willingness of government to borrow more and run up higher levels of public debt. However, we are less sure that the Scottish economy will weather the coming downturn better than the UK.

### **Factors determining the impact of the financial crisis**

The impact of the present crisis will depend on the scale of the deflation of house and property prices in the Scottish market, the extent of the impact on local financial service activities, and the mechanism governing the spread to the wider Scottish economy.

On the *housing and property market effects*, we judge that the absolute and relative fall in house prices is likely to be less in Scotland than in the UK. For this reason, and given also that the Scottish home ownership rate at 66%, despite strong growth in the five years to 2006, continues to be lower than in the UK at 70%, we expect that the impact on the Scottish economy of the end of the house price boom will be less than in the UK.

We take the view that the *impact on banking and financial services* will be bigger here than in the UK and that there may be a lingering negative effect in the long-term. This is because the scale of the losses on sub-prime and impairments facing the two principal Scottish banks, RBS and HBOS, are considerable and exceptional compared to other UK banks. The losses have pushed RBS and HBOS to the brink of bankruptcy. This outcome underlines the extent to which the lending behaviour of the two banks had ceased to be underpinned by the traditional risk management practices that had led Scottish banking/bankers to be perceived as prudent and even 'canny'.

The financial crisis will impact the *wider Scottish economy* as a result of key factors including: direct demand; intermediate input demand; domestic household demand; external household demand; credit supply; inward investment; and confidence of businesses and consumers.

## Forecasts

Because of the heightened levels of uncertainty and the lack of evidence sufficient to give us a clear understanding of the strength and duration of the consequences for each of the transmission mechanisms noted above we publish a central or base forecast and three alternative scenarios.

**The central forecast:** This reveals that from 2007 there will be five years of below trend growth and a fall in output, or recession in 2009. Scottish GDP growth will slow from 1.9% in 2007 to 0.7% in 2008. In 2009, we project that GDP will fall by 1.1%, but recession will only be evident in that year as growth picks up again to 0.7% in 2010, 1.2% in 2011 and 1.5% in 2012.

For the first time in quite a few years Scotland experiences net job losses, with over 4,000 lost in 2008, more than 37,000 lost in 2009, and around 12,000 lost in 2010. In 2011, net jobs begin to be created again quite quickly with more than 14,000 net jobs, rising to net job creation of below 24,000 in 2012. The scale of the initial job losses is sufficient to push up unemployment from the historically low levels that the Scottish economy has enjoyed over the past few years.

Unemployment on the ILO measure rises from 117,300, or 4.4%, in 2008 to 152,300, 5.7% in 2009, and peaks at 162,300, or 6.1% in 2010. The effect of the slowdown in GDP and jobs growth has a lagged effect on unemployment. By 2011, the unemployment rate has begun to fall to 151,000, or 5.7%, falling further to 137,300, or 5.2% in 2012.

**The optimistic scenario:** The financial and housing market impacts are less severe, lending behaviour picks up more quickly, confidence is re-established sooner, and monetary policy is a little more aggressive. Here GDP growth slows down in 2008 but by less than in the base case falling to 0.8%. Similarly, in 2009 the scale of the fall in GDP

is slightly less at –1% rather than –1.1%. In 2010, 2011 and 2012 there is a stronger recovery as growth rise to 1%, 1.6% and 1.8% respectively, returning almost to trend by 2012.

Job losses are also less in this case and the recovery in the labour market stronger, with net job change of -32,470 in 2009, -4,992 in 2010, 23,669 in 2011 and 29,876 in 2012. This has a more favourable impact on unemployment than in the base case.

**The recession plus slow recovery:** In this case there is both a stronger downturn and slower recovery than in the central or base case. In this scenario, lowered confidence, depression in the housing market, and contraction in the construction and financial service sectors are more severe than in the base case. Lending behaviour does not improve significantly from present levels, and monetary policy remains cautious after the recent rate cuts - GDP falls by – 1.2%.

In 2009 there are considerable job losses of over 46,000 and the ILO unemployment rate increases to 6.3%. Growth hardly recovers in 2010 as GDP expands by only 0.6%, nearly 16,000 net jobs are lost and the unemployment rate increases further to 6.4%. However, by 2011 and 2012 GDP growth increases further to 1% and 1.2% but remains well below trend. Net jobs begin to be created in the final two years by 9,000 and 17,000 respectively and the unemployment rate recovers somewhat to 6.1% and 5.5%.

**Sustained recession:** The final case is, in our view, a worst-case scenario. Here, the seizure of the financial system continues for an extended period, bank liquidity persists, lending continues to be severely constrained, and business confidence remains low. This leads to a greater contraction in household and investment demand, with negative growth for two consecutive years of –1.6% in 2009 and – 0.4% in 2010. Growth turns weakly positive at 0.3% in 2011 and continues no better than this year's expected growth rate of 0.7% in 2012.

Under this scenario net job losses are considerable as the downturn is sufficient to produce a shakeout of hoarded labour. Net employment falls by 73,000 in 2009, and by 44,000 in 2010. Weak net job creation occurs in 2011 of just over 2,000 jobs and 8,000 jobs in 2012.

ILO unemployment deteriorates to 6.5% in 2009, peaking at 7.1% or 187,000 in 2010. In 2011 and 2012 there is some improvement as the rate falls to 6.2% and 5.8% but these rates remain well above present levels.

## Summary Forecast Scenarios

<b>GDP Growth %</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
Optimistic	0.81	-1.03	0.99	1.61	1.81
<b>Central (base)</b>	<b>0.72</b>	<b>-1.14</b>	<b>0.70</b>	<b>1.20</b>	<b>1.53</b>
Recession plus slow	0.72	-1.24	0.62	0.98	1.19
Sustained recession	0.72	-1.56	-0.44	0.27	0.73
<b>Net Job Change</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
Optimistic	-4,230	-32,470	-4,992	23,669	29,876
<b>Central (base)</b>	<b>-4,230</b>	<b>-37,244</b>	<b>-11,638</b>	<b>14,222</b>	<b>23,605</b>
Recession plus slow	-4,230	-46,498	-15,662	9,081	17,318
Sustained recession	-4,230	-72,639	-43,776	2,236	8,371

<b>ILO Unemployment Rate (16+)</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
Optimistic	4.4%	5.6%	5.9%	5.4%	5.0%
<b>Central (base)</b>	<b>4.4%</b>	<b>5.7%</b>	<b>6.1%</b>	<b>5.7%</b>	<b>5.2%</b>
Recession plus slow	4.6%	6.3%	6.4%	6.1%	5.5%
Sustained recession	4.4%	6.5%	7.1%	6.2%	5.8%

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**Notes to editors:**

1. The University of Strathclyde's Fraser of Allander Institute (FAI) has relaunched its Economic Commentary with the support of PricewaterhouseCoopers LLP. PricewaterhouseCoopers ([www.pwc.com](http://www.pwc.com)) provides industry-focused assurance, tax and advisory services to build public trust and enhance value for its clients and their stakeholders. More than 146,000 people in 150 countries across our network share their thinking, experience and solutions to develop fresh perspectives and practical advice. "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity;
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. PricewaterhouseCoopers produces its own regular review of UK and international economic prospects, the current issue of which was published at the beginning of November on our website: [http://www.pwc.co.uk/eng/publications/uk\\_economic\\_outlook.html](http://www.pwc.co.uk/eng/publications/uk_economic_outlook.html);
3. PricewaterhouseCoopers, in association with FAI, produces a Business Review which considers some of the implications of the Economic Commentary trends for Scottish business. The first edition of the Business Review was issued in mid October and can be downloaded from: <http://www.strath.ac.uk/frasercommentary/businessreviews/>