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Growth weakens as Eurozone crisis threatens recession

There is a new risk of recession in Scotland as the economy continues to weaken and the Eurozone crisis worsens, according to the latest Economic Commentary from the University of Strathclyde's Fraser of Allander Institute, sponsored by PwC.

Growth in the global economy weakened in the middle of the year, the UK economy stagnated over the past year and growth in the Scottish economy is little different.

Despite measures being put in place to deal with the wide range of shocks to the global and European economies, such as a second bout of quantitative easing in the UK this autumn, it is anticipated that Scotland will only grow (GVA) by 0.4% in 2011 – half the central forecast figure in June 2011 - growing to 0.9% in 2012 (downgraded from 1.5% in the summer).

In short, Scottish GDP is still 4% below and the UK 5% below its pre-recession peak. The US, in contrast, attained its pre-recession GDP peak in the third quarter of this year.

Positive jobs growth over the past year in Scotland offers little comfort in a labour market that is more than 3% below its pre-recession jobs peak, compared to 1.5% in the UK. Full-time working is falling and labour market inequality is rising especially to the disadvantage of young people

Brian Ashcroft, Professor of Economics at the University of Strathclyde, says:

> **"**Sadly, the weakening in the global economy that we feared in June has come to pass, leading us to half our forecast for Scottish GDP growth this year. Our central forecast is for growth to continue, just. But the avoidance of recession as the crisis in the Eurozone deteriorates is becoming less and less likely.
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> **"**It is a tragedy that the Eurozone crisis, which threatens the well-being of the whole global economy, is worsening when clear policy solutions exist. That they are not being adopted is due to national hubris and policy error on a grand scale."

Focusing on business

The business and financial services sectors, which account for 26% of overall Scottish GDP, have been significantly impacted by the recession and the markets and banks are desperately seeking greater certainly. According to Lindsay Gardiner, head of assurance services at PwC in Scotland, until the Greek problem is resolved, the medium-term funding markets for banks are likely to remain frozen. He says:

> "The financial services industry is a major driver in Scotland's economic engine, so any slowdown in the pace of growth is concerning. A combination of ongoing uncertainty of Eurozone contagion, potentially worsening banks' balance sheets, volatility in the global debt markets and continued concern over the level of regulation is having a massive impact on financial results and overall confidence.
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> "The recent Q3 results of life insurers and asset managers, which are generally below market forecasts, clearly demonstrates this.

"Uncertainty can also stifle job creation. While overall employment figures for Scotland may appear better than for the rest of the UK at the moment, we still expect to see further job losses in the public sector as the full impact of the spending review is felt. The private sector is not immune either; as the financial services industry continues to negotiate the challenges that lie ahead we are likely to see a freeze on recruitment in the short to medium term and even job losses.

"Perhaps the biggest economic impact, however, is on enterprise. After all, when a business is looking to expand, availability of finance can make the difference between success and failure and while some businesses have increased their cash reserves, the reluctance of banks to lend is still a major concern, particularly within the private business sector.

"The Chancellor's proposals for a credit easing scheme may help, but much will depend on the level of finance available and scheme details, including ease of access and the cost to the borrower."

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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. 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.
3. 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 the June Economic Commentary the University of Strathclyde's Fraser of Allander Institute warned that the Scottish economy was threatened with stagnation as the rate of recovery slowed.

In their latest Economic Commentary sponsored by PricewaterhouseCoopers LLP they note that the threat is even more real today than it was then. Indeed, with the added problems in the Eurozone, the threat of another major recession has risen appreciably. Furthermore, the Institute highlights several myths influencing policymaking that threaten recovery and enhance the risk of recession (see the Outlook & Appraisal section).

- Growth has continued to weaken in the global economy and is weaker in the UK and Scottish economies too. The UK economy has effectively stagnated over the last year, growing by only 0.5%.
- In Scotland growth was flat between April and June and business surveys suggest continuing weakness in the third quarter.
- The UK has recovered more strongly than Scotland, by nearly 3% compared to around 1% to 2% in Scotland, even though the recovery is weak overall.
- There is little comfort in the latest GDP data for both Scotland and the UK.
- This is underlined by the latest US real GDP figures which reveal an annualised growth rate of 2.5% for the third quarter of this year. Growth in the US is still weak by the standards of previous recoveries and insufficient to make much of a dent in the high levels of unemployment.
- Yet, it is notable that with the latest quarter's results, GDP in the US economy moved back above its pre-recession peak output, whereas the UK and Scotland are still - in the second quarter - 5% and 4%, respectively, below their pre-recession GDP.
- It will not go unnoticed that, unlike the UK, the US has only recently adopted an austerity programme, which has yet to kick in.
- The Institute therefore welcomes the Bank of England's decision to undertake a further expansion of the money stock through quantitative easing and notes that there is still scope for some fiscal easing without damaging our fiscal credibility in the long-term.

The Eurozone

- The problems in the Eurozone are affecting business and investor confidence right across the globe.
- A disorderly Greek default will have damaging consequences for Scottish exports, investment and household spending as bank lending contracts further.
- The problems become much greater if there is a prospect of an Italian default, which, if it occurred, would probably throw the world economy into a recession as big, if not bigger than the Great Recession that started in 2008.
- The Eurozone's problems embrace both *financing* and *adjustment*.
- The present proposals and policies mainly focus on financing but we contend that they are insufficient to produce a sustainable financing mechanism for those member countries unable to fund their sovereign bonds at reasonable rates.
- What is required is that the ECB becomes a full lender of last resort like any other central bank and declares itself to be so.
- In the present close-to-zero interest rate conditions the inflation risk of the ECB using its balance sheet to finance sovereign debt is minimal. Moral hazard is more of a problem for such a policy as governments would have an incentive to issue too much debt. And that is why the Zone must ensure that it has adequate regulations to constrain member governments from issuing debt.
- The creation of an effective financing mechanism is necessary to stop contagion and raise investor confidence but it does not solve the Eurozone's problems for the long term.
- There is still the issue of adjustment to deal with if the problems are not to recur.

- Peripheral member countries need to improve (lower) their prices and costs relative to Germany on a sustained basis. Being members of a currency union precludes own currency devaluation so the periphery must adjust by a relative internal deflation of wages and prices of significant proportions.
- We are not sanguine that this can be achieved without a higher level of inflation in the Eurozone core - Germany especially - being tolerated and that looks unlikely.
- The Institute believes that the probability that the Eurozone problems will be quickly resolved is low and that the future of the present Eurozone looks bleak.

Scottish Labour Market

- Care should be taken in the conclusions drawn from the latest labour market data, which show rising employment over the year and an unemployment rate lower than in the UK.
- First, total UK employment is currently about 1.5% below its pre-recession peak while total Scottish employment is more than 3% below its pre-recession peak.
- Second, strong growth in jobs in Scotland of 70,000 between the first quarter of 2010 and the first quarter of this year obscures the fact that Scotland endured a large shake-out of nearly 50,000 jobs between the 2009q4 and 2010q1.
- Third, the Scottish labour market shed -4.77% of its jobs in the recession while the UK shed only -2.41% and job levels are still more than 3% below the pre-recession peak in Scotland but only 1.5% below in the UK.
- Fourth, the state of the labour market should not be judged by job creation alone but by the creation of jobs in relation to available labour reserves. Working population has been rising in Scotland with the result that the total employment-working population ratio is still more than -5.5% below its pre-recession peak. This is not much different from where it was at the worst of the recession after it had fallen by -6.35%.
- Fifth, job creation in Scotland is more biased towards part-time working than in the UK. The number of full-time workers in Scotland has declined by 120,000 since the pre-recession peak, whilst part time employment, in contrast, fell by only 7,000 during the recession then recovered quickly to be 40,000 higher between April 2010 - March 2011 than the pre-recession peak. When expressed in terms of full time equivalents the recent stronger Scottish employment growth is much more muted.
- Finally, levels of inequality in the labour market are worsening particularly to the disadvantage of young workers and areas such as North Ayrshire, Glasgow and Eilean Siar.

Forecasts

- We forecast **GDP growth** in Scotland of 0.4% in 2011, and 0.9% in 2012 compared to our June forecast of 0.8% and 1.5%, respectively.
- The lower forecasts reflect particularly a weakening in Scottish household spending and export growth compared with the position in June.
- Given new Institute research on the accuracy of our GVA forecasts, previous forecast errors suggest that the lower and upper bounds for growth in 2011 are likely to be 0.1% and 0.7% and for 2012, 0.4% and 1.4%.
- Independent forecasters are predicting on average UK growth of 1% and 1.5% in 2011 and 2012.
- So, overall, we are projecting weaker growth than previously and a continuing weaker recovery than the UK.
- We expect production and manufacturing output to continue to be the main industry drivers of growth.
- For **employment**, net jobs are forecast to grow by 0.2% in 2011, 0.4% in 2012 and 0.7% in 2013.

- By end 2013 total employee jobs are forecast to be 2,324,000, around 80,000 fewer than at the end of 2008 but up by 60,000 from the end of 2009, and up by 30,000 from the end of 2010.
- By sector, the largest absolute growth in job numbers is forecast for the production and service sectors. Few jobs are created in construction or in agriculture over the forecast horizon.
- For unemployment, the number out of work on the preferred ILO measure is projected to rise further compared to our June forecast as GDP growth and job creation weakens.
- Unemployment in Scotland this year is forecast to rise to 8.3%, or 219,800 by the end of this year, rising further to 234,200 or 8.9% by the end of 2012. After that, the numbers unemployed will fall only slightly to 231,550 by the end 2013 but the rate stays the same at 8.9%.

Annex: Forecast Tables

Table 1: Forecast Scottish GVA Growth, 2011-2013

GVA Growth (% per annum)	2011	2012	2013
Central forecast	**0.4**	**0.9**	**1.6**
June forecast	*0.8*	*1.5*	*1.9*
UK median independent last 3 months (October)	1.0	1.5	na
Mean Absolute Error % points	+/- 0.296	+/- 0.492	na

Table 2: Forecast Scottish Net Jobs Growth in Three Scenarios, 2011-2013

	2011	2012	2013
Upper	11,150	18,850	41,100
June forecast	*36,317*	*41,882*	*60,675*
Central	**4,900**	**8,750**	**16,200**
June forecast	*20,600*	*18,548*	*39,849*
Lower	-1,550	-1,350	-9,250
June forecast	*9,621*	*2,661*	*21,431*

Table 3: ILO unemployment rate and claimant count rate measures of unemployment under each of the three forecast scenarios

	2011	2012	2013
ILO unemployment			
Rate (ILO un/TEA 16+)	**8.3%**	**8.9%**	**8.9%**
Numbers	**219,800**	**234,200**	**231,550**
Claimant count			
Rate (CC/CC+total job)	5.4%	6.0%	5.9%
Numbers	149,500	166,300	164,400