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Dealing with the consequences of recession

Fraser of Allander Institute's Economic Commentary February 2009

"There is now almost complete certainty that not only is Scotland currently in recession but that the recession looks likely to be as severe as that in the 1980s and could even be worse."

As a result of the unprecedented scale and increasing severity of the global and UK recession, 2009 and 2010 will be the most difficult years the Scottish economy will have encountered since WWII. Scottish GVA is projected to fall by 2.57% in 2009 and will only grow by 0.52% in 2011, while it estimated up to 146,000 jobs could be lost and unemployment is forecast to increase from 5.1% to 7.9% in 2010 and remain above 7% through 2012.

Reflecting the speed and depth of the contraction in the last quarter, the latest Fraser of Allander Economic Commentary, supported by PricewaterhouseCoopers LLP, has forecast a significant downward revision in the expectations for Scottish growth over the next three years. Indeed, the Scottish economy will not return to 2008 levels of economic activity until at least 2012.

The Economic Commentary also suggests the recent UK fiscal stimulus appears to be 'too little too late' and 'relatively small compared to the US fiscal package'. The significant loosening of monetary policy continues to be thwarted by the liquidity trap as faced with falling asset prices banks hold cash rather than lend. This 'catch 22 scenario' further strengthens the case for temporary bank nationalisation and creation of a 'bad bank' for toxic assets in a further attempt to unfreeze bank lending.

There will undoubtedly be significant job losses as result of the merger to form Lloyds Banking Group. These could take up to three years to work through as back office and network consolidation takes place. The radical restructuring of RBS, announcement of which is expected tomorrow, could however have an equally significant impact on employment in the Scottish financial sector.

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

> "In November the Institute considered there was a 'high probability' that Scotland would go into recession in 2009. There is now almost complete certainty that not only is Scotland currently in recession but that the recession looks likely to be as severe as that in the 1980s and could even be worse."

The latest Economic Commentary also looks at how Scots can more effectively deal with the consequences of recession, as Paul Brewer, senior partner of PricewaterhouseCoopers LLP's Edinburgh office explained:

> "Scottish businesses are undoubtedly in for a tougher, longer ride in the downturn than was previously thought, and they should be under no illusion now as to how suddenly their trading position could change in the current volatile and uncertain climate. The Economic Commentary and Forecast point to a route map for business. It suggests key economic indicators that business leaders can refer to when evaluating options and adapting their plans and strategies in a rapidly changing economy.
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> "Businesses that are able to move quickly to either protect the downside against an unfolding 'worst case scenario' or to react rapidly to signs of an early recovery, are likely to be better placed than their competitors whenever economic and market conditions do improve.
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> "We have yet to reap the benefits of the fiscal measures already taken by central government to counteract the recession. It is also imperative that the Scottish government and organisations such as Scottish Enterprise put every effort behind supporting Scottish companies through use of their investment funds and through training programmes for those seeking work."

Fraser of Allander Institute's Economic Commentary February 2009

In their latest Economic Commentary, sponsored by PricewaterhouseCoopers LLP, the University of Strathclyde's Fraser of Allander Institute notes that there has been a considerable deterioration in the actual and forecast performance of all the major economies since the Commentary last reported.

In November the Institute considered there was a 'high probability' that Scotland would go into recession in 2009. There is now almost complete certainty that not only is Scotland currently in recession but that the recession looks likely to be as severe as that in the 1980s and could even be worse.

The tentacles of recession are spreading throughout the economy with construction and financial service activity subject to sustained contraction, hotels & catering turning down from the first quarter of last year and real estate & business services contracting appreciably after March 2008. Economy-wide GVA contracted by -0.8% in the third quarter and seems likely to have fallen markedly in the fourth quarter if the UK's performance is any guide. Third-quarter 2008 manufactured exports decreased by 1% in real terms and by 0.4% over the year.

Business surveys covering the fourth quarter period reinforce the expectation that the slowdown will be severe. In the labour market employment is falling and unemployment is rising.

Recession issues

We are in the midst of deepening world recession driven by significant falls in aggregate demand, as the effect of bursting asset prices bubbles in property and shares leads households to scale back demand. High levels of household and corporate debt are also influencing the scale of the cut back in aggregate demand. With world demand generally contracting, the principal exporting countries are likely to be disproportionately hit, other things equal. Conversely, those countries where exports count for a smaller proportion of production e.g. the US, and where the public sector is disproportionately bigger, might be expected, other things equal, to do less badly in the recession. France offers a possible example on both criteria. In these circumstances the impact of the recession on the UK and Scotland will not be the worst in the world as some have predicted.

The banking crisis and the apparent freezing of the credit supply function are secondary to the fall in aggregate demand. However, one should not minimise their importance. Lending has clearly dropped considerably, in part because individual countries have lost the lending previously provided by foreign banks. In the UK this amounted to about 30 percent of overall lending. Lending by UK banks has also declined as they seek to rebuild their balance sheets. The drop in the supply of credit has clearly accelerated the downturn in GDP as any monetary buffer that might have been available to provide working capital to help companies adjust more slowly to the downturn in demand has been removed.

Policy responses

Global

The developing scale of the global downturn suggests that the US fiscal package is unlikely to compensate for the depressing effect on world trade of the US recession, although it may mitigate it, and will not be sufficient to substitute for inadequate demand stimulus policies in the savings and current account surplus countries such as China, Germany, and Japan.

As world demand contracts there are growing protectionist fears. Surplus countries may be tempted to protect their market share by adopting increasingly protectionist measures such as subsidising domestic industry. This is already beginning to happen in deficit countries such as the US and UK e.g. the auto industry, in response to the initial fall in domestic demand due to the asset price deflation that accompanied the credit crunch. Financial protectionism is also on the increase as governments seek to encourage domestic banks to focus their lending on the domestic economy. Retaliation by both surplus and deficit countries will eventually serve to destroy world supply capacity in the medium to long-term even if there are short-term domestic supply benefits. A more prolonged recession and slower long-term growth is the likely result.

There is a clear need to develop a better governance of the global financial system to ensure that emerging economies with surplus savings can invest them productively in their own economies rather than in marginal investments, such as sub-prime mortgage securities, in the US.

The United Kingdom

The UK fiscal injection appears to be too little too late, and relatively small compared to the US stimulus package. A case can be made for a further fiscal stimulus, although rising public sector debt and foreign exchange market pressure on sterling may limit the government's options. The significant loosening of monetary policy in the UK, which is continuing, appears to be thwarted by a 'liquidity trap' as asset prices fall and economic agents seek to hold cash rather than invest or spend. The case for temporary bank nationalisation in the UK and the creation of a 'bad bank' for toxic assets appears to grow stronger as the only effective means of unfreezing lending.

Scotland

In considering policy issues for the Scottish Government it is useful to distinguish between: policies to counteract the recession, and policies to deal with the consequences of recession.

Counteracting the recession

While the Scottish Government has little power to influence aggregate demand in the short-term in the Scottish economy, it should be remembered that the current constitutional settlement reserves macro-economic stabilisation to Westminster. The Scottish economy should benefit from the £25 billion UK fiscal injection introduced in November's PBR by a direct boost to demand of up to 2% of GDP.

The Scottish Government has introduced a six-point stimulus plan: bringing forward some capital expenditure e.g. investment in affordable housing; enhanced support for tourism promotion; speeding up the planning process; increased support for energy efficiency; increased advice to businesses and individuals; and improved financial advice to vulnerable individuals. The package will bring a very small stimulus to aggregate demand in 2009 and 2010 as some expenditures are brought forward but the overall macro effect will negligible. Nevertheless, taken together with the UK government fiscal stimulus and the significant monetary easing introduced by the MPC the package is valuable. The information and advice elements of the package may offer some market adjustment assistance and some mitigation of recession effects.

There are other possibilities and imperatives for the Scottish Government in seeking to counteract the recession. The Scottish construction industry was first into recession and as noted above has been languishing for some time. The government needs to consider just how much public investment can be brought forward within the budget and how it may be best financed. In current recessionary circumstances PPPs may find it difficult to proceed given the difficulties of raising private finance. In such conditions there may be a case for bringing forward conventional procurement projects and temporarily delaying any planned PPPs, although conventional procurement raises its own financing issues. Further support for the construction industry might be possible if the government was willing to consider making advance payments to contracted companies that may be experiencing financial constraints, such as those undertaking government construction work.

Other actions to ease credit difficulties that the Scottish Government could consider include directly encouraging banks in Scotland to lend. The Scottish government will be a very large customer of the banks. It could seek to make its banking contracts conditional on a more pro-active stance on lending by the banks in Scotland. It could further ensure that the rule of ten-day payments of invoices to suppliers was adhered to in order to assist small firms.

Finally, perhaps more can be done to assist the labour market to more flexibly adjust to the recession by: encouraging the further and higher education sector to provide short-term but intense training courses for those coming on to unemployment register; and assisting redundant workers in starting their own firms.

Dealing with the consequences of recession

The policy objective here should be to try and ensure that the recession does not damage the long-term trend of Scottish growth. Further, there is the question whether the recession might provide an opportunity to raise the trend in Scottish GDP growth?

The government might, through Scottish Enterprise and related agencies, seek to minimise the impact of the recession on the Scottish growth trend. Existing investment funds should be examined to see if they could play a role in overcoming key firms' cash flow and liquidity problems due to credit constraints associated with the current recession. A debate should be encouraged on how Scottish Development International might deal with the expected decline in inward investment through the recession.

The recession may also offer possibilities for raising the trend rate of growth of the Scottish economy. We know R&D and innovation are critical to growth but there is also evidence that companies that raised their R&D spend during a recession improved their subsequent competitive position. There is clear need for the government and its agencies to publicise this message and examine what public policy in Scotland can do encourage R&D at a time when many firms will be under pressure to cut back on R&D outlays.

Research also suggests that in a recession many unemployed workers will wish to start their own firms. The Enterprise Allowance scheme in the 1980s was introduced to help workers made redundant in the early 1980s recession start their own firms. This was superseded by a shift away from start-up support as an unemployment measure. But there may now be a case for policymakers in Scotland to examine the possibility of using existing business birth rate support policies to encourage the newly redundant to consider starting their own firm.

Forecasts

Our new forecasts significantly revise downwards our expectation for Scottish growth over the next three years. Because of the heightened levels of uncertainty we present a range of forecasts. On this occasion, a central forecast, which is bracketed by 'optimistic' and 'worst' projections.

GVA or net output

On our *central case* we predict that GVA will fall by around -2.6% this year and by -1.2% next year – see Table 1. Recovery does not begin to get underway until 2011 and remains below trend in 2012. On the *worst case* the global recession and financial sclerosis continues well in to 2011 and while there may be some recovery in the latter part of 2011 growth remains weak and significantly below trend in 2012. Only in the *optimistic case* does recession effectively end next year but with a weak then strengthening recovery in 2011 and 2012.

Table 1: Forecast Scottish GVA Growth in Three Scenarios, 2008-2012

GVA Growth (% per annum)	2008	2009	2010	2011	2012
Optimistic	0.65	-1.90	-0.43	1.08	1.73
Central	0.59	-2.57	-1.21	0.52	1.14
Worse	0.51	-3.07	-1.65	-0.13	0.55

In our *central case* projection, we now take the position that Scottish economy will perform a little stronger than expected UK growth. We take this view because the impacts of the systemic drop in global aggregate demand resulting from falling asset prices and financial sclerosis will be sufficient to outweigh specific sectoral outcomes such as the contraction of financial service and banking activities. Experience shows that the Scottish economy is more robust than the UK to a sharp contraction in aggregate demand as we noted in the previous Commentary. In the circumstances of the causes of the present recession the factors of relevance include: the somewhat bigger public sector and higher degree of social security payments in Scotland, while lower asset ownership e.g. houses and shares, means less exposure to asset price bubbles and bursts. On the other hand, Scotland's relatively higher export propensity may make Scotland a little more vulnerable to a drop in global demand. But overall, we now consider that the circumstances of the recession make it more likely than we previously thought that the Scottish economy will hold up relatively better than the UK. On our *worst-case scenario* this may not be the case.

Employment

Table 2 outlines our net job change projections on the three cases. In the *central forecast* employment is forecast to decline by 14,200 in 2008, by 94,200 in 2009 and by 51,400 in 2010, a total net job loss of nearly 160,000 over the three years. This is bracketed by an anticipated net job loss of nearly 130,000 in the *optimistic case* and by 186,000 in the *worst case*. To the worst case must be added a further 6,600 net job loss as the contraction in the labour market runs into 2011.

Table 2: Forecast Scottish Net Jobs Growth in Three Scenarios, 2008-2012

Net job no's	2008	2009	2010	2011	2012
Optimistic	-14,200	-73,007	-42,400	7,923	25,089
Central	-14,200	-94,179	-51,440	3,037	14,476
Worse	-14,200	-108,984	-63,064	-6,639	10,734

It remains unclear how the more flexible and deregulated labour market that has emerged over the past 25 years will impact on the level of jobs and the level of unemployment during the current recession. We note that there are strong signs that the downturn may affect more adversely those employed on more flexible employment terms, with companies and co-operating unions making much effort to retain key skills and expertise.

Unemployment

Table 3 presents a summary of our ILO unemployment forecasts under the three scenarios. With such significant job losses forecast then it is inevitable that forecast unemployment will rise appreciably. But the effect of job losses will not wholly be registered by a growth in measured unemployment. Some unemployed workers will leave the labour market either by ceasing to offer themselves for work, a drop in the activity rate, or by leaving the economy all together, migration. Our forecasts of unemployment reflect an average pass through from job loss to the measured increase in unemployment of around fifty per cent on average in any one year. On this basis unemployment in the *central case* rises from 137,000 in 2008 to a peak of around 210,000 in 2010. On the *worst case*, unemployment peaks at 226,000 in 2011 and 195,000 in 2010 in the *optimistic case*. When expressed in rate terms these forecasts suggest that unemployment will rise to a 7.3% average in 2010 on the *optimistic case*, 7.9% in 2010 on the *central case* and 8.4% in 2010 and 8.5% in 2011 on the *worst-case* scenario. It is worth stressing that unemployment is a lagging indicator of economic performance and continues to rise for some months, even quarters, after output has begun to recover.

Table 3: Forecast Scottish ILO Unemployment in Three Scenarios, 2008-2

ILO 16+ no's and rate%	2008	2009	2010	2011	2012
Optimistic	137.2	173.3	194.5	191.0	176.3
	5.1	6.5	7.3	7.2	6.6
Central	137.2	184.4	209.9	207.4	199.9
	5.1	6.9	7.9	7.8	7.5
Worse	137.2	191.6	223.1	226.1	220.4
	5.1	7.2	8.4	8.5	8.3

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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) 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;

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/