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An end to Scotland's recession?

Expectations are rising that Scotland will join the UK in emerging from recession by the end of the fourth quarter however the road to pre-recession levels of output, employment and unemployment will remain long and bumpy with a potential of a double dip on the horizon.

In the latest Economic Commentary, sponsored by PricewaterhouseCoopers, the University of Strathclyde's Fraser of Allander Institute revealed that Scotland will likely emerge from 2009 with +0.2% growth in the final quarter.

Paul Brewer, senior partner of PricewaterhouseCoopers LLP's Edinburgh office commented:

> "While this is undoubtedly positive news, it is important that we don't get ahead of ourselves. The recession bit deeply and sharply, perhaps more so than on previous occasions and as a result the Scottish economy may take a little longer than the rest of the UK to recover.
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> "For businesses, a key area of concern continues to be around credit – and getting their hands on it. While banks are beginning to release credit to both medium and large companies, there is growing evidence that they are still being selective and risk-averse, seeing concerns around credit quality as they remain focused on the need to build balance sheets.
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> "Evidence on the ground suggests that Finance Directors and senior executives, particularly within smaller businesses, are continuing to find renewing and refinancing facilities difficult to obtain especially if they wish to change lender. Terms are also less attractive, out of kilter to those offered only two years ago.
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> "By spending significant amounts of time on this part of their business, they are in danger of taking their eye off the 'strategy' ball - something that is particularly risky as we enter the upturn, a period when historically more companies become distressed. If a double dip is indeed on horizon, it could be a rocky road for these vulnerable, cash-strapped businesses."

Reflecting on the global position, the Commentary notes that Scotland and the UK is still lagging behind as the rest of Europe, Japan and the United States start to recover from recession.

The UK remained in recession in the third quarter and it seems likely that will be the outcome for Scotland too. Consumer spending remains weak, which is in part a consequence of the internationally high levels of debt held by UK households before the recession and the impact of falling asset prices and lending restrictions.

But in the UK a wide range of indicators suggest that a recovery is now underway. There is a widespread expectation that the UK economy will come out of recession in the fourth quarter of this year exhibiting a small but positive growth rate. The Institute is forecasting weaker growth in 2009 than previously but a stronger recovery in 2010 and 2011 as growth in the world economy picks up more rapidly.

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

> “We expect Scotland to emerge from recession in the fourth quarter of 2009, although there is a chance that it might not do so even though recovery begins in the UK economy as a whole. Rapidly recovering growth in the global economy should support faster growth in Scotland in 2010 than previously forecast. But it won’t be plain sailing.
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> “The economy is facing severe headwinds that may cause demand growth to falter in 2010: if the availability of bank lending is insufficient, if fiscal consolidation occurs too soon, and if the recovery in asset prices in the world economy is abruptly halted by the expected tightening of monetary policy later next year. The risk of a double-dip recession remains.”

The commentary also expressed concerns that fiscal consolidation may occur in advance of the required switch to export-based growth and indeed whether Scottish manufacturing has the size, diversity and capability to take full advantage of the current low exchange rate or a recovery of global demand.

Ends

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Fraser of Allander Institute's Economic Commentary November 2009

The Scottish economy has contracted by slightly more than the UK over a shorter period. The evidence appears to suggest that the greater fall in Scottish GDP during the recession has been down to weaker service sector performance, principally financial services and real estate and business services.

UK GDP contracted by -0.6% in the second quarter, and then contracted further, by -0.4%, during July to September. The UK economy is clearly lagging other major economies. GDP in the OECD area stabilised in the second quarter of the year and major countries such as France, Germany and Japan returned to positive growth. The United States returned to positive growth in the third quarter. The 16-country eurozone grew by 0.4% in the third quarter, the 27 country EU grew by 0.2% in the quarter and the lead EU economy, Germany, grew by 0.7%.

From a UK standpoint both external and domestic demand are currently rising and domestic demand is likely to receive a boost right across the UK in the current quarter as household spending rises temporarily in anticipation of the reinstatement of the VAT reduction at the end of the year. So, there is a strong expectation that it will be the fourth quarter when the UK economy is seen to emerge from recession.

Recent surveys reveal rising expectations and an emerging recovery in Scottish manufacturing, but little sign in other sectors surveyed. Indications of recovery are weaker here than in many other UK regions. We therefore expect Scotland to emerge from recession in the fourth quarter, with likely growth around +0.2%, but less strongly than the rest of UK. And there remains a lower probability that the recession will not end in Scotland in the fourth quarter even though it does so in the UK economy as a whole.

The dynamics of recovery

Domestic Scottish and UK consumer and investment demand may remain weak for some time as both households and firms seek to strengthen their balance sheets. The availability of sufficient bank credit to fully finance the recovery remains a source of continuing concern. The significant fiscal consolidation that is in prospect as the UK government seeks to reduce its deficit and stabilise its debt position will serve to reduce domestic demand and spending. There are clear concerns that the fiscal consolidation might occur too soon before the necessary switching to export based growth can be achieved. In addition, concerns have been raised that the volume of money pumped into the world economy through quantitative easing, almost zero interest rates and a declining

US dollar are fuelling a bubble in (risky) asset values. The concern is that the bubble will burst affecting real incomes and spending when monetary policy is tightened again and when the value of dollar stabilises. This also raises the issue whether monetary authorities should be targeting asset price bubbles directly. For all these reasons the prospect of a double-dip recession is therefore present.

We take the view that the Scottish recovery may be weaker than in the UK for the following reasons:

- The bias in the structure of the Scottish economy towards the public sector – 22% of GVA against 18% in the UK – means that the base for expansion is smaller here.
- The anticipated fiscal consolidation could be greater and/or have a greater impact on activity in Scotland. This depends on a number of unknowns such as: where the UK cuts fall in relation to reserved and non-reserved activities; the scale of the UK cuts, which in part depend on future GDP growth and interest rates; the nature of any tax increases; and the decisions of the Scottish Government.
- More technically, purchasing linkages between activities in Scotland - and hence multipliers - tend to be lower than in the UK because the Scottish economy is smaller and more open. Direct increases in demand tend to ‘leak out’ more than at the UK level. This may be offset, though, if the Scottish economy enjoys a stronger export boost through its greater openness.
- But we noted our concerns in the June 2009 Commentary that the increased exporting necessary to the recovery puts a premium on the performance of manufacturing (68% of exports abroad from Scotland are manufactured goods). We remain concerned that Scottish manufacturing has the size, diversity and capability to take full advantage of a lower exchange rate and the recovery of global demand.
- If Scottish households seek to recover their net asset position by more than their UK counterparts then recovery will, other things equal, be weaker here.
- Finally, if the two main Scottish banks, key beneficiaries of tax-payer funded support, are less willing to lend because of the need to rebuild their balance sheets to stabilise and raise their share price, then the Scottish economy may recover more slowly for this reason.

It would be a mistake to conclude that the economy’s troubles are over once growth resumes and the recession ends. The Scottish economy is currently at least 8% below where its GDP would have been in the absence of recession. As long as this output gap persists there will be a deflationary dynamic in the economy as aggregate supply exceeds aggregate demand and unemployment is likely to continue to rise or remain high. Research by NIESR in London reveals that in previous UK recessions recovery to pre-recession output has never taken less than 40 months, or three and one-third years, and in the 1930s depression and the 1980s recession recovery took around 50 months or just over 4 years. Secondly, with the exception of the 1990-93 recession all of the previous recessions exhibited “double-dip” behaviour to varying degrees, with the second downturn occurring 18, 28 and 30 months after the initial pre-recession peak. While recovery in growth is emerging it will clearly be some time before pre-recession output, employment and unemployment levels are restored.

Forecasts

GVA or net output

The key GVA forecasts are summarised in Table 1 along with our June forecasts for comparison.

Table 1: Forecast Scottish GVA Growth in Three Scenarios, 2009-2012

GVA Growth (% per annum)	2009	2010	2011	2012
High growth	-4.9	1.6	1.8	2.1
June forecast	*-1.9*	*-0.5*	*1.6*	*2.1*
Central	**-5.0**	**0.1**	**1.1**	**1.6**
June forecast	*-2.9*	*-0.9*	*0.6*	*1.4*
Low growth	-5.2	-0.7	-0.1	0.5
June forecast	*-3.8*	*-1.7*	*-0.2*	*0.4*

We shall primarily focus on our central forecast here. We have revised downwards considerably our GVA forecast for 2009 to -5.0%. The narrow gap between the forecasts on the three scenarios for 2009 is mainly due to the fact that we already have two of the four quarters of outturn data. The predicted contraction of output in 2009 is appreciably lower than the June central forecast due to a significant reduction in household spending, weaker tourism expenditure and a larger reduction in investment demand. The growth of government spending is positive this year and export demand is recovering. In 2010, there is some recovery in Scottish household spending but it still remains below 2009 levels. Government spending continues to rise but at a reduced rate. Tourism demand begins to recover but aggregate investment remains low. In contrast, export demand to both the rest of the world and rest of UK picks up. GVA is forecast to be largely flat in 2010 with 0.1% growth projected. Demand in the global economy is recovering more quickly than anticipated in June and so we are forecasting stronger growth in 2010.

By 2011, household spending will be rising again and will strengthen further in 2012, as do exports with investment also increasing from 2011. But we are forecasting large annual reductions in government spending from 2011. For these reasons growth rises to 1.1% and 1.6% in 2011 and 2012 but remains below trend. In all four forecast years, output growth is weaker than in the UK. In 2010 in our central scenario we are allowing for one quarter of negative growth, which reflects the headwinds buffeting the economy noted above. In the low growth scenario these headwinds are sufficient to produce two quarters of negative growth in the second half of 2010: a “double-dip” recession.

Jobs

The principal forecasts for net jobs growth are presented in Table 2.

Table 2: Forecast Scottish Net Jobs Growth in Three Scenarios, 2009-2012

Net job no's	2009	2010	2011	2012
High growth	-126,915	-352	36,025	44,154
June forecast	*-62,827*	*-23,152*	*33,584*	*45,174*
Central	**-130,776**	**-29,615**	**20,292**	**31,467**
June forecast	*-84,399*	*-51,451*	*11,301*	*26,824*
Low growth	-134,864	-46,593	-3,409	6,788
June forecast	*-103,579*	*-66,894*	*-3,722*	*6,847*

On our central scenario employment continues to fall through this year and next by more than 160,000. Net jobs growth returns in 2011 strengthening in 2012 but net job creation over these two years of nearly 52,000 indicates a slower recovery, with a net loss of 108,000 jobs over the period. Nevertheless recovery is stronger than our forecast in June.

Even on the high growth scenario net jobs in Scotland in 2012 are around 47,000 lower than in 2008. On the low growth scenario, the number is 177,000. At the sectoral level in the central scenario, the burden of jobs losses is born by the service sector, which might be expected given its relative size. In services, we expect some 95,000 net jobs to be lost during 2009 and 2010, with jobs growth returning thereafter. Of these lost jobs, around 26,000 are expected to occur in financial services. Manufacturing and construction job losses are projected to amount to nearly 39,000 jobs and 23,000 jobs, respectively, with net job creation beginning again in both sectors in 2011.

Unemployment

Table 3 presents our main forecasts for unemployment over the 2009 to 2012 time horizon.

Table 3: Forecast Scottish ILO and Claimant Count Unemployment in Three Scenarios, 2009-12

	2009	2010	2011	2012
ILO unemployment				
High growth %	7.2%	7.6%	6.5%	5.0%
Central %	**7.6%**	**9.2%**	**8.7%**	**7.7%**
Numbers	200,082	234,105	212,661	172,815
Low growth %	8.2%	10.5%	11.0%	11.0%
Claimant count				
High growth	4.5%	4.6%	3.7%	2.8%
Central %	**4.9%**	**5.8%**	**5.2%**	**4.2%**
Numbers	136,821	160,087	145,423	118,175
Low growth %	5.3%	6.7%	6.8%	6.5%

We have again revised upwards our forecasts for unemployment compared with the previous Commentary in June. This reflects the lower GVA forecasts for 2009 and the evidence of fairly rapid falls in employment and rising unemployment in the first quarter of 2009. Unemployment has been rising more rapidly in Scotland than in the UK, but this shouldn't necessarily be taken as indicating that Scotland is doing worse in recession. A recession that affects different parts of the country equally would, other things equal, tend to raise the rate of unemployment more quickly in those regions with lower unemployment rates. The ILO unemployment rate in Scotland is currently 7.2% and remains below the UK rate of 7.9%. What happens to the future course of unemployment in Scotland depends not only on the loss of jobs but also on the extent of switching into inactivity, or migration rather than into unemployment.

We have previously taken the view that the recession in jobs and unemployment may be weaker than the recession in output. The Scottish and UK labour markets are more "flexible" than they were in the 1980s. Employers will seek to hold on to core workers and will do so if there is the prospect of introducing short-time working, cutting wages, salaries and bonus payments, and letting go of part-time and temporary workers. There is some evidence of such outcomes. However, there are limits to flexibility and these limits may be approaching. A quick recovery in GVA growth will make it easier for companies to hold on to staff but a more slower recovery will make that task more difficult. In addition, we are likely to see rising job losses in the public sector with the flow of announcements of actual and planned job reductions in local government currently rising and set to rise further in 2010.

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