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The Scottish economy in 2010:
A weak recovery subject to considerable risk

Scotland's economy should return to positive growth in 2010 with the central forecast showing GVA 0.6% - a 0.5% rise from the November 2009 forecast - and growing to 2.2% by 2012, according to the latest University Strathclyde Fraser of Allander Economic Commentary, supported by PricewaterhouseCoopers LLP (PwC).

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

> "A weak recovery for the Scottish economy is in prospect, supported by a gradual improvement in the growth in exports and investment. But, given relatively flat household and corporate spending, the ending of quantitative easing this month, and the likely continuing sluggishness of bank lending, the prospect of a further fiscal tightening in 2010, all increase the risk of a double-dip recession later this year and perhaps next."

Over the next few years significant public expenditure cuts are planned by the UK Government. These will impact on Scottish public spending including local government. Paul Brewer, senior partner of PricewaterhouseCoopers LLP's Edinburgh office outlined the consequences for local authorities:

> "Councils need to reduce their costs by around 25 per cent over the next few years to help address their funding constraints. However finding successful solutions that maintain services at the level their electorate expects will be exceptionally challenging.
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> "Much of local authority spending is locked in for significant periods, for example pension liabilities, Private Public Partnership arrangements and statutory obligations, effectively tying their hands. This inevitably means that the solution will involve significant restructuring and potentially sharing of activities such as back office and support functions in order to minimise any reduction in the range and extent of services.
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> "The rest of government may have a little breathing space before significant spending reductions start to bite but unless cost levels are addressed now, hard decisions will also need to be made as to the extent to which traditionally 'free' public services can be sustained and which services will have to be restricted."

While the Scottish economy is clearly in a better position that it was a year ago, it is crucial that businesses do not lose focus, as Bruce Cartwright, head of business recovery services at PricewaterhouseCoopers LLP in Scotland explained:

> "Traditionally, we see more businesses failing coming out of recession than on entering which is why we advocate that cash management should remain top of most business agendas. Business leaders need to maintain a focus on cutting back costs and driving revenues back up as well as planning for the longer term, identifying ways in which they can maximise on opportunities as we exit recession. Companies and their advisors should also not underestimate the importance of honest dialogue with stakeholders

"It is important to recognise, however, that despite making the headlines, insolvency is not necessarily the end of a business. It can be a constructive mechanism to salvage and revitalise ailing operations and indeed, used in the right circumstances and with transparency, insolvency procedures such as administration or creditors' voluntary arrangements can help to rescue a company, saving jobs, and preserving value for the company and continuity for suppliers."

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Contact:
Lynn Hunter, PR Manager Scotland, PricewaterhouseCoopers LLP
Tel: +44 (0)141 355 4015, Mobile: 07841 570487, Email: lynn.m.hunter@uk.pwc.com

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.
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. 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/
4. PricewaterhouseCoopers provides industry-focused assurance, tax, and advisory services to build public trust and enhance value for our clients and their stakeholders. More than 163,000 people in 151 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.

Fraser of Allander Institute's Economic Commentary February 2010

In their latest Economic Commentary, sponsored by Price Waterhouse Coopers, the University of Strathclyde's Fraser of Allander Institute notes that The Scottish economy is poised to come out of recession. But there is still uncertainty whether the exit will have occurred in the fourth quarter of last year as it did, all be it weakly, in the UK economy. The Scottish economy went into recession one quarter later than the UK and it may be that Scotland will come out of recession later too. The survey evidence for the final quarter of 2009, which cast some doubt on the strength of the recovery, certainly leaves that possibility open.

Output and employment in the recession

Over the course of the recession total GVA in the Scottish economy has fallen by -6.13% compared to a slightly smaller contraction of -5.73% in the UK. The relative performance of the service sector largely accounts for the bigger impact of the recession in Scotland. Service sector GVA in Scotland fell by -4.76% while the contraction in UK services amounts to -4.59%. Manufacturing sectors have suffered more in the recession both in Scotland and the UK. But Scottish manufacturing GVA fell by -11.28% during the recession, less than the fall of -14.22% in UK manufacturing. Construction output has fallen by -13.08% in Scotland if the start of the sector's recession is dated as 2008q2, which compares with a fall of -14.07% in the UK if the start of the sector's recession is dated as 2008q1 to the trough of 2009q1. However, there is a good case for arguing that the recession, or structural downturn, in Scottish construction began after 2006q3, which was not mirrored in the UK. The loss of output in Scottish construction over this longer period amounts to -15.47%. UK construction, in contrast, has displayed a classic 'V' shape with a sharp and deep downturn followed by rapid recovery of 2.5% between 2009q1 and 2009q3.

One aspect of the present recession is that the labour market outcomes have been appreciably different from the impact on output. While Scottish GVA has fallen by -6.13% over the recession, the number of employee jobs has fallen by only -2.67%. To the extent that it is easier to cut labour hours via short-time working than it once was, then employers may be less likely to make workers redundant in the short-run. Productivity per hour will not drop by as much as productivity per worker and coupled with lower labour payments competitiveness will suffer less. But it is arguable that a flexible labour market also makes it easier to dispense with the services of workers. If the recession is expected to persist, or the recovery expected to be very sluggish, then job shedding could pick up and unemployment continue to rise.

Macro policy and the UK and Scottish economies

We hold the view that without the significant injection of demand made possible by a monetary and fiscal policy expansion, the UK and Scotland, along with the US and many other key economies, would in all likelihood have experienced a loss of output comparable to that of the Great Depression in the 1930s as households and firms sought to make massive adjustments to high levels of pre-recession debt by increasing saving and lowering spending. The significant fiscal intervention has left the UK economy with a large public sector financial deficit and rising net debt levels and interest payment.

On present policies the *2009 Pre-Budget Report UK* net debt is forecast to be around 80% of GDP in 2014-15. But this is not wholly unusual by historical standards. For half of the twentieth century net debt levels in the UK were above 80% of GDP. The IMF estimated in November 2009 that on current policies UK net interest payments will rise from 1.6% of GDP in 2007 to 3.1% in 2014. This is not trivial and would amount to around £50 billion per year from £35 billion in 2009. Yet, the IMF forecasts that 6 of the G-20 countries would have a net interest payment share of GDP in 2014 greater than the UK: Italy (6.2%), India (5.6%), Turkey (5.4%), United States (4.5%) Brazil (4.3%), and France (3.2%). The average for all the advanced G-20 countries is also forecast to be greater (3.5%). Net interest payments of at least 3% of GDP per annum existed for seventy five years in the UK between 1916 and 1991, which should put the present crisis into context. And, some experts argue that it is only when debt interest payments rise to 12% of GDP that a government is likely to default.

In view of this background we believe it is incorrect, as some commentators have done, to suggest that the UK is in the same category as Greece in terms of risk of default. Despite some superficial similarities, such as the relative size of the budget deficit, the UK fiscal position is much stronger. The main differences are:

- the debt to GDP ratio is currently well over 110% in Greece and under 60% in the UK;
- Greek debt servicing costs are now just under 12% of GDP, in the UK current debt costs are under 3% of GDP;
- the average maturity of UK sovereign debt is 14 years, much greater than France and Germany, never mind Greece. So, despite the size of the UK budget deficit, Germany, France and Italy, will all issue absolutely more sovereign debt on the markets than the UK in 2010;
- Greece has a severe competitiveness problem, which the country is unable to address independently through a downward exchange rate adjustment. Greece has a current account deficit of 11% of GDP, compared to 2.5% in the UK, and no way of addressing this, if it remains within the euro zone, other than domestic downward adjustment of wages, other costs and prices. The UK has experienced a 25% devaluation since before the recession in mid 2007, it therefore has a basis for recovery to higher GDP, higher tax revenues and lower public spending on transfer payments, which is denied Greece.

But there is a lesson to be learnt from the Greek experience and it is this: allowing countries/regions within a larger monetary union to retain fiscal autonomy may threaten the monetary union. It runs the risk of a fiscal crisis because the financial markets will not discipline fiscal laxity in any one country/region sufficiently early enough. The discipline needs to come from the political centre and that means that complete fiscal autonomy is ruled out, although some degree of fiscal devolution is clearly feasible.

None of this is to deny that there is a need for a sizable adjustment in the UK's fiscal position. It is reasonable to argue that the government needs to set out in its March Budget a more credible and more clearly specified programme of fiscal tightening over the next five years than it did in the 2009 Pre-Budget Report. But a significant fiscal tightening this year would be unwise. There is much uncertainty about household and corporate spending and because of this we have for some time urged caution about the timing of a fiscal consolidation in the UK. The UK and Argentina are the only two G-20 countries to have withdrawn their fiscal stimulus in 2010. The overall UK fiscal stance in 2010-11 is already shown by the 2009 Pre-Budget Report to be negative. In our view this is dangerous given that UK households have the most adjustments to make to their balance sheets than households in other countries because the level of household debt was pre-crisis so high here. If the growth of world trade does start to pick up appreciably, and this is likely later this year, the UK should benefit disproportionately. Then there will be a real prospect of what the Bank of England and the government desires: a switch to export and investment led growth. But until that time, given relatively flat household and corporate spending, the ending of quantitative easing this month, and the likely continuing sluggishness of bank lending, the prospect of a further fiscal tightening in 2010, would add to the risk of a double-dip recession later this year and perhaps next.

Forecasts

The underlying economic situation has not changed significantly since we last reported in late November 2009. The UK economy crept out of recession in 2009q4. Scottish outturn data for the fourth quarter will not be available until April, so we must rely on surveys for information on the most recent performance.

The Scottish economy is in a better position than it was a year ago. But it is also clear that business sales and optimism trends in the fourth quarter were not as strong as the third quarter. There is concern that the Scottish economy faltered in the fourth quarter and this concern has carried over into the first quarter of this year with weaker retail sales data than south of the border, and unemployment, in the latest data for the final quarter of last year, rising at a faster rate, not only than the rest of the UK, but also western Europe. Mixed messages are also coming from the housing market with both the Lloyds TSB Scotland and Halifax Bank of Scotland producing surveys indicating falling Scottish house prices. In contrast, the UK Department of Communities and (English) Local Government announced on the same day that Scottish prices in the year to the end of December had risen.

None of this bodes well for the growth of Scottish household spending. It is likely, however, that the Scottish Retail Consortium data for January are much influenced by one-off events such as the reinstatement of the temporary reduction in VAT at the end of the year, which may have led to some spending being brought forward. Moreover, the poor weather after Christmas in the New Year may have curtailed spending in January. But with weak house prices, rising unemployment and many households still seeking to adjust their personal balance sheets through higher saving, it seems unlikely that there will be much revival in spending in the first quarter of this year and perhaps the second quarter as well. We have noted that public spending will begin to tighten this year, although after allowing for automatic stabiliser effects it is not predicted to begin falling until 2011. Investment looks to be weak, although some improvement in investment trends was noted in the latest Scottish Chambers Business Survey (SCBS) but not in the CBI and Scottish Engineering surveys. However, there is stronger evidence that exports are beginning to pick up. In the latest Scottish business surveys rising trends in export orders are observed, although in the SCBS the trend was weaker in the fourth quarter than in the third quarter 0f 2009.

Our latest forecasts for the Scottish economy have been prepared against the economic and policy background considered above.

GVA Forecasts

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

GVA Growth (% per annum)	2009	2010	2011	2012
High growth	-4.7	1.7	2.2	2.8
November forecast	*-4.9*	*1.6*	*1.8*	*2.1*
Central	**-4.8**	**0.6**	**1.6**	**2.2**
November forecast	*-5.0*	*0.1*	*1.1*	*1.6*
Low growth	-4.9	-0.7	-0.3	0.8
November forecast	*-5.2*	*-0.7*	*-0.1*	*0.5*

The key forecasts are summarised in Table 1 along with our November forecasts for comparison. We shall primarily focus on our central forecast here. It is clear that we have revised upwards slightly our GVA forecast for 2009 to -4.8%. The narrow gap between the forecasts on the three scenarios for 2009 is mainly due to the fact that we already have three of the four quarters of outturn data. Scotland is forecast to return to positive growth in 2010. But the recovery over the year is weak, household spending strengthens but continues to fall. Exports to the rest of the world continue to recover and at a faster rate than predicted in November. This along with some recovery of investment, though still negative, helps raise the forecast to 0.6% growth compared to our prediction of 0.1% in November. Recovery is weaker in Scotland than in the UK for the reasons that were well rehearsed in the previous Commentary and we see no basis for altering that view. Scottish GVA growth is better than the UK on the High growth scenario only. Trend growth is realised on our Central scenario in 2012.

Employment Forecasts

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

	2009	2010	2011	2012
High growth	-60,488	-9,785	30,253	57,213
June forecast	-62,827	-23,152	33,584	45,174
Central	**-64,218**	**-32,264**	**18,277**	**44,612**
June forecast	-84,399	-51,451	11,301	26,824
Low growth	-77,861	-57,002	-16,538	13,631
June forecast	103,579	-66,894	-3,722	6,847

The key forecasts are summarised in Table 2. Employee job losses continue from 2009 into 2010, with a net 96,000 jobs lost in those two years and not fully matched by job gains of 63,000 in 2011 and 2012. At the sectoral level, services experiences the greatest decline in jobs in 2009 and 2010 with 42,000 net jobs lost. Job losses in financial services accounts for 16,500 of the service sector job losses.

Construction job losses amount to nearly 27,000 over the two years and as with services the number of construction jobs in 2012 remains below 2008 levels but there is recovery in 2011 and 2012 of more than 3,000 jobs.

Finally, the production sector which principally includes manufacturing sheds more than 17,000 jobs in 2009 and 2010 but through strong export growth net job creation in 2011 and 2012 of 26,000.

Unemployment Forecasts

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

	2009	2010	2011	2012
ILO unemployment rate				
High growth	7.6%	7.3%	5.6%	3.6%
Central	**7.6%**	**8.1%**	**7.3%**	**6.3%**
Numbers	200,082	216,200	185,700	144,200
Low growth	7.6%	9.9%	10.1%	9.8%
Claimant count rate				
High growth	4.9%	4.4%	3.4%	2.4%
Central	**4.9%**	**5.4%**	**4.6%**	**3.7%**
Numbers	136,821	148,000	127,000	99,000
Low growth	4.9%	6.8%	7.0%	6.7%

The key unemployment forecasts are summarised in Table 3 above. On our Central forecast ILO unemployment is expected to peak at 216,000 or 8.1% this year falling to just under 186,000 or 7.3% in 2011 and further to 144,000 or 6.3% in 2012. However, if the recent trend in Scottish unemployment continues, which we think less likely, the rate could rise on our low growth scenario to 9.9%, or 264,000, this year, reaching a rate peak of 10.1%, or 257,000, in 2011 and then falling to 9.8%, or 224,000, in 2012.

Contact: Professor Brian Ashcroft
Tel: 0141 548 3957
Mob: 07850 551004
e-mail: b.k.ashcroft@strath.ac.uk

Cliff Lockyer
Tel: 0141 548 3198
e-mail: c.j.lockyer@strath.ac.uk