10 November 2010

AN EMERGING ECONOMIC RECOVERY BUT MAJOR UNCERTAINTIES REMAIN

Scotland's economic recovery is forecast to be weaker than the UK's according to the latest Economic Commentary from the University of Strathclyde's Fraser of Allander Institute, sponsored by PricewaterhouseCoopers LLP.

The Institute's new revised central case forecast is for GDP growth of 1.0% this year – 0.3% higher than the June forecast – growing to 1.1% in 2011 and 1.9% in 2012. There is a fear, however, that the greater welfare spending cuts may dampen growth in 2012 compared to the previous forecast. When put alongside the UK figures, these forecasts suggest that the recovery continues to be weaker in Scotland, especially in 2011.

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

> "The Scottish economy strengthened appreciably in its recovery from recession in the 2nd quarter of this year. However, there are reasons to believe that an unsustainable bounce back in construction and re-stocking were key factors in the strength of the recovery in the second quarter and this will tend to fade away in later quarters."

Following the Comprehensive Spending Review the cut in the Scottish government's budget is now expected to be around 11% by 2014-15. The Institute estimates that such a cut could produce economy wide job losses of between 49,000 to 113,000 and between 60,000 – 71,100 public sector jobs.

He added:

> "It is clear that the Scottish government has options other than simple spending cuts. If these are exercised in the forthcoming Budget, the GVA and job loss could be less than our estimates. Whilst cuts in spending will have to be made the Scottish government should focus on protecting economic stabilisation, economic growth and social justice as the key elements in a rational process that links fiscal consolidation to its objectives."

According to Paul Brewer, senior partner at PwC in Edinburgh, unprecedented concerns over the economy and a focus on spending cuts has put the economy at the top of the political agenda. The economy remains fragile however signs are that liquidity in the debt market is starting to ease. He said:

> "The severity of the cut in spending allocation to Scotland will undoubtedly have far reaching impacts, particularly when combined with the deferral of the current year's spending cuts and a near £1bn cut in the investment budget. In short, Scotland cannot afford to be wasteful in any aspects of public service delivery.
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> "The challenge will be to ensure that resultant cuts are made in the right places in order to preserve vital front line services and free resources in order to build and invest in sustainable infrastructure and job creation which is crucial to economic growth. We have already come to anticipate the heavy job losses that are likely to arise in the public sector due to the greater reliance on this sector for employment in Scotland however, what has become clear is that the private sector will not be immune either.

“There will also be challenges ahead for our private sector as they try to make up for the magnitude of cuts that are on the way in Scotland. Sectors such as construction, due to its exposure to public sector capital investment projects, and business services will undoubtedly be hit harder, while others, such as outsourcing and manpower services, may find opportunities as government and public sector organisations seek to reduce their non-core and fixed cost operations by shifting delivery of front-line services to private and third sector organisations.

“Over recent years we have seen an increased reliance on flexible working within the private sector, from reduced working hours to deferred pay increases, and creativity in securing efficiencies, all of which has impacted their ability to move quickly to capitalise on market opportunities as and when they arrive. As the public sector rises to the challenge of implementing the cuts required, there are perhaps some lessons that can be learned from the private sector.”

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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. PricewaterhouseCoopers, in association with FAI, produces a Business Review which considers some of the implications of the Economic Commentary trends for Scottish business. The Business Review can be downloaded from: http://www.strath.ac.uk/frasercommentary/businessreviews/
4. 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.

Fraser of Allander Institute's Economic Commentary November 2010

In their latest Economic Commentary, sponsored by PricewaterhouseCoopers, the University of Strathclyde's Fraser of Allander Institute notes that the Scottish and UK economies strengthened appreciably in their recovery from recession in the 2nd quarter of this year. Preliminary UK data for the 3rd quarter indicates some weakening but at 0.8% over the quarter growth exceeded expectations. Scottish GDP growth fell again in the first quarter, by -0.2%, and with zero growth in 2009q3 and 0.1% growth in the final quarter of 2009, there is a case for arguing that the Scottish economy did not emerge from recession until the 2010q2, two quarters after the UK. The Scottish economy went into recession one quarter later than the UK. The fall in Scottish GDP during the 'recession' to 2010q1 was therefore -5.81% compared to a fall of -6.32% during the recession in the UK, still less severe than the UK. But with growth of 1.3% in the 2010q2, compared to 1.2% in the UK, the Scottish bounce back was considerable. However, there is reason to believe that an unsustainable bounce back in construction and re-stocking were key factors for the strength of the recovery in the second quarter which would tend to fade away in later quarters. The 0.8% preliminary estimate of UK 3rd quarter growth in part appeared to contradict that assumption, but construction growth remained strong to the incredulity of many associated with the industry. We still await further data to ascertain the spending composition of the 3rd quarter UK growth rate and whether temporary re-stocking was still a principal driver, or whether there had been a pick-up in more sustainable export and investment growth. Meanwhile there is a recovery in global trade and economic growth but despite the recent jobs figures the US economy remains weak as the Fed embarks a on a further monetary stimulus.

Forecasts

We are forecasting *GVA growth* of 1% this year, which is greater than our June forecast of 0.7% (See Forecast Tables) Household spending is recovering but increases only marginally this year, then increases slightly in 2011 and is close to trend in 2012. The rise in planned welfare cuts since our last forecast will take out nearly £2bn of demand from Scottish households by 2014-15. The timing is uncertain but we expect it to contribute to the weak growth of household spending. Export growth picks up this year as the growth of world trade recovers. There is strong positive growth for Scottish exports both to rest of world and rest of UK, with the latter weaker due to the fiscal consolidation. Private sector investment growth in 2010 is revised up from our June forecast and the rebound continues into 2011 and 2012 after a recession that produced one of the most severe contractions in private investment in modern times. All these reasons taken together lead to a forecast of 1.1% GDP growth in 2011 and 1.9% in 2012. That is the same as the June forecast for 2011 but slightly lower for 2012. Our fear is that the greater welfare spending cuts may dampen growth in 2012 compared to our previous forecast. Compared to the UK these forecasts suggest that the recovery continues to be weaker in Scotland than the UK, especially in 2011.

In the *labour market*, net jobs grow by -0.6% in 2010, +1.0% in 2011, and +1.8% in 2012. By 2012, total jobs are forecast to be around 47,000 lower than the last peak in 2008. By sector, the burden of jobs losses is borne by the service sector in 2010 with net job losses of just under 14,000. Construction loses just above 900 jobs this year, while jobs are gained - just under 2,000 - in production as manufacturing especially expands. Positive but fairly weak jobs growth occurs in all aggregate sectors in 2011 and 2012. We predict that unemployment will continue to rise into next year peaking at around 286,000 before falling to just under 262,000 in 2012.

Labour Market Puzzles

GDP has fallen by about the same proportion in Scotland as the UK during the recession but Scottish unemployment has risen more to a rate above the UK. From an analysis of the data this puzzle may be 'explained' as follows.

1. A comparable GDP fall, other things equal, might have been expected to push up the Scottish unemployment rate by more than the UK for simple arithmetic reasons since the Scottish rate was initially appreciably below the UK rate.

2. Unemployment rose more quickly than the UK after 2009q2 because inactivity rose more quickly in the UK.

3. There was significant measured job loss in Scotland in 2010q1. Inactivity rose strongly in Scotland dampening the rise in unemployment but suggesting that Scottish unemployment may continue to rise relative to the UK if some or all of the increased numbers of inactive workers decide to return to the labour market.

4. There is the possibility that measurement error is clouding the outcome. If some of the measured surge in Scottish job losses actually occurred before 2009q4 then that in itself would account for some of the faster rise in unemployment.

5. By 2010q1 the contraction in Scottish jobs over the recession was, at -4.47%, a lot greater than the UK contraction of -2.54%. Total Scottish employment had fallen by -114,000, Scottish unemployment had risen by 112,000 and Scottish and UK inactivity had moved to comparable levels. So, maybe there isn't a puzzle at all!

6. And while considerable personal and family pain lies behind such job losses there may be a silver lining for the Scottish economy. The greater Scottish job loss and comparable GDP change suggests a relative rise in Scottish productivity. If so, average Scottish competitiveness will have risen.

Fiscal Consolidation and the CSR

Following the Comprehensive Spending Review the cut in the Scottish government's budget is expected to be around 11% by 2014-15. We have reestimated the impact of this cut in DEL, which in the previous Commentary we took to be 14%.

1. Total job losses range from -49,000 in the flex-price case to -113,000 in the fixed-price case, with GVA falling by just over -1% and just under -3.5%.

2. Public sector job losses range from just under 60,000 to a little under 71,000.

3. Private sector job losses are moving towards 43,000 in the fixed price case but when wages and prices are flexible there is a private sector job gain of 10,500.

4. In this latter case, as before, there is a 'crowding-in' effect on private sector activity due to the fall in wages and intermediate input prices improving the competitiveness of the sector. However, the 'crowding-in' effect is relatively weak and certainly insufficient to offset the public sector job losses.

5. In terms of the fiscal consolidation overall, we estimate the same aggregate impact as forecast in June.

Scottish Government Budget Options

Following the excellent *Independent Budget Review* it is clear that the Scottish government has options other than simple spending cuts which may change the measured Scottish structural and behavioural relationships that are present in our model. If these are exercised in the forthcoming Budget, the GVA and job loss could be different. Nevertheless, cuts in spending will have to be made:

- We argue that the government should adopt a rational process that links fiscal consolidation to the objectives of the Scottish government.

- Economic stabilisation, economic growth and social justice would appear to be key. And these objectives may be mutually exclusive to some degree: a potential trade-off between equity versus efficiency and growth. But how much one should trade-off equity for growth and efficiency is a value judgement and hence a political decision.

- We argue that spending cuts should be applied according to the rules of a rational choice model.

- Blocks of spending should be defined at least to Level 4, but ideally, in certain areas, below this level. Cuts should then be applied first to those spending areas where the marginal value per pound spent to government – and hence the electorate and wider community – is least.

- This would rule out ‘salami slicing’ and suggests that some functions/services with low marginal value should be removed altogether.

- The application of this principle would rule out ring-fencing Level 1 spending areas such as the health budget, and hopefully, would also rule out ring-fencing of Level 2 and 3 spending areas. This is because ring fencing implies that every activity upon which money is spent in the health budget has a higher marginal value per pound spent than spending activity under all other budgets - an unlikely proposition. However, some health spending will have a very high marginal value, perhaps spending on treatment of cancer and heart disease. It is rational to protect such areas, subject to the scale of the overall reduction in the assigned budget.

The government will not want the fiscal adjustment to destabilise the economy or damage long-run economic growth, which it is seeking to raise. The Institute offers the following guidance to help protect these important objectives.

Stabilisation

- The aim should be to minimise the effect of fiscal consolidation on demand in the economy, so reducing secondary job losses.

- There is a limited role here for the government of a small open economy. But where cuts have to be made, or charges and taxes introduced, the changes should focus on spending areas with lower employment effects and income effects e.g. public administration rather than social work activities; on recipients who have lower marginal spending propensities from income received e.g. the rich as opposed to the poor, and on consumption rather than investment expenditures.

- Cutting public investment can contribute to a reduction in aggregate demand in the economy as well as affecting growth. High quality academic research by Alesina and Perotti in 1996 notes that “ … fiscal adjustments relying primarily on tax increases and cuts in public investment tend not to last and are contractionary.”

- It is, therefore, disappointing to note that capital spending has been cut disproportionately at the UK level as part of the fiscal consolidation. The Scottish government's capital budget is being cut by 36% to 38% by 2014-15.

- It is essential that the government explores all means possible to protect public capital investment, including the most effective funding mechanisms. One possibility would be for funds to be transferred from the resource - or current spending - budget to capital spending, which is allowed within the rules.

Economic Growth

- The aim here should be to protect the supply potential of the Scottish economy and the drivers of growth.

- Research suggests that innovation and R&D are critical to growth with investment especially in infrastructure, enterprise, and skills also having an important role to play. Therefore the government should consider how best to focus and protect spending in such areas.

- *Innovation and R&D*: The government should continue to do everything it can to help the private sector undertake R&D and innovate, include facilitating technology transfer. This requires the protection of university research and policies to enhance commercialisation.

- *Infrastructure projects and investment*: Investment is important to growth as well as stabilisation. But the issue isn't simply about trying to protect public investment. It is important to continue to encourage private sector investment and seek to remove any market or institutional obstacles that stand in its way. Inward FDI and related export promotion must continue to play a crucial role in Scottish economic growth allowing us to link into world growth hubs. Policy effort in this area should not be reduced.

- *Enterprise*: Scottish Enterprise and the enterprise network is an easy target for many people. Yet, Scotland has a sustained history of a low-business birth-rate and weak business enterprise: viz. low innovation and R&D. There may be legitimate questions about how the SE and the network secures it's goals but abolishing and returning the function to the civil service is not the answer as the Welsh experience shows.

- *Skills*: Are important to regional competitiveness, to attracting FDI and hence to growth. But they are necessary for growth not sufficient. A dynamic economy with high productivity firms will attract in skilled workers from other regions and nations. All of which should promote debate on the appropriateness of the skills development policy infrastructure that we currently have?

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Annex: **Forecast Tables**

Table 1: Forecast Scottish GVA Growth in Three Scenarios, 2010-2012

	2010	2011	2012
GVA Growth (% per annum)			
High growth	1.3	2.1	2.4
June forecast	*1.4*	*2.1*	*2.8*
Central	**1.0**	**1.1**	**1.9**
June forecast	*0.7*	*1.1*	*2.1*
Low growth	0.5	0.3	1.0
June forecast	*0.0*	*0.1*	*0.7*

Table 2: Forecast Scottish Net Jobs Growth in Three Scenarios, 2010-2012

	2010	2011	2012
High growth	-7,000	42,300	50,404
June forecast	*-20,399*	*35,142*	*53,059*
Central	**-12,794**	**21,224**	**39,124**
June forecast	-33,546	*14,856*	*44,612*
Low growth	-22,700	4,400	21,100
June forecast	*-48,129*	*-6,036*	*6,615*

Table 3: ILO Unemployment Rate and Claimant Count Rate in Three Scenarios

	2010	2011	2012
ILO unemployment rate			
High growth	9.1%	9.6%	8.2%
Central	**9.3%**	**10.7%**	**9.7%**
Numbers	**245,056**	**286,821**	**261,730**
Low growth	9.8%	11.8%	11.5%
Claimant count rate			
High growth	4.8%	5.1%	4.3%
Central	**5.2%**	**5.9%**	**5.4%**
Numbers	**143,214**	**167,623**	**152,959**
Low growth	5.9%	7.2%	7.0%