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Economic recovery at risk of faltering in 2011 as political and economic uncertainties increase

The current political upheaval in the Middle East could have a knock-on effect on the economic recovery of Scotland and the UK when combined with home-grown issues such as worsening inflation and continuing weakness in bank lending according to a report out today.

While the Scottish economy may be continuing to recover from recession, the rate of recovery appears to be slowing even when allowance is made for the difficult weather this winter, according to the latest Economic Commentary from the University of Strathclyde's Fraser of Allander Institute, sponsored by PwC.

In the latest quarter (Q3 2010 for which there is official data) Scottish GDP grew by 0.5% compared to an increase of 0.7% in UK. But with UK GDP contracting by -0.6% in the fourth quarter and the Office for National Statistics estimating that only -0.5% could be attributed to the bad weather, it is clear that the UK economy was stagnating at the end of the year.

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

> "The economic recovery in Scotland is faltering after the initial strong bounce-back. 2011 will be a difficult year but we do not expect the recovery to completely stall despite the slow growth of domestic household demand and the failure of exports and investment to pick up as quickly as hoped."

He added:

> "It is gratifying that unemployment is falling in Scotland, but we feel that the recovery will not be strong enough for the fall to be sustained throughout the year. The political upheaval in the Middle-East, worsening inflation, continuing weakness in bank lending and the uncertain impact of fiscal consolidation all serve to cloud the picture on future growth prospects."

According to Paul Brewer, senior partner at PwC in Edinburgh, 2011 will be a difficult year not only as a result of the looming public sector cuts but because of the ongoing unrest in the Middle East and the impact it could have on the global economy - and indeed the private sector. He said:

> "For Scotland, 2011 will be the year that spending cuts start to bite as the public sector faces up to the harsh realities that lie ahead. The scale of the financial challenge will be like nothing we have seen before. However, it does give us a unique opportunity to do things differently, innovating service delivery as we redesign our public sector services. Quite simply, we need to grasp the nettle now and not put off decisions until it is too late or rely on the Christie Commission for an answer."

Paul Brewer, senior partner at PwC in Edinburgh added:

> "The tenuous nature of the recovery and the continuing weakness of the consumer, investments and of exports leaves us vulnerable to external factors we can't influence. With ongoing instability in the Middle-East, global markets remain highly vulnerable to a major 'oil shock'. The impact is already being felt with the price of oil soaring to almost $120 a barrel in February, a rise of around 47% since the end of Q3 2010.

“This not only creates tremors across the global stock markets, but has real cost implications for businesses closer to home, particularly those in agricultural, retail, transport, construction and chemical sectors, with petrol and diesel pump prices at an all time high. On a more positive note, the demand for oil will provide a welcome boost to an already buoyant Aberdeen oil and gas 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 PwC.
2. PwC 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, 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/
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In their latest Economic Commentary, sponsored by PwC, the University of Strathclyde's Fraser of Allander Institute notes that the Scottish economy may be continuing to recover from recession but the rate of recovery appears to be slowing even when allowance is made for the difficult weather this winter.

In the latest quarter – 2010 q3 – for which there is official data Scottish GDP grew by 0.5% compared to an increase of 0.7% in UK. But with UK GDP contracting by -0.6% in the fourth quarter and the ONS estimating that only -0.5% could be attributed to the bad weather, it is clear that the UK economy was stagnating at the end of the year. In the absence of Scottish outturn data for the fourth quarter, survey data indicate a weakening of Scottish growth in that quarter and suggests that Scottish GDP performance may have been weaker than the rest of the UK.

The service sector is especially weaker in Scotland, the manufacturing sector less so, but construction activity is much stronger here, at least in the third quarter. Labour market conditions have improved with unemployment falling but this is unlikely to be sustained.

Significant uncertainty exists in the world economy due to: the political upheaval in the middle-east; worsening inflation; continuing weakness in bank lending; the uncertain impact of fiscal consolidation; continuing weakness of household demand; and exports and investment failing to pick up as quickly as hoped. Future growth issues are also considered.

Labour Market
There is a new puzzle in the labour market as unemployment falls in Scotland while it continues to rise in the UK. Employment growth also appears to be stronger in Scotland. Yet, the growth of output, from the GVA/GDP data, suggests a weaker Scottish recovery than in the UK. There are two possible explanations:

- It may be the consequence of the Scottish job loss being proportionately much greater in the recession than in the UK despite a slightly smaller output loss. It may follow that as the recovery began UK firms on average had plenty of spare labour resource due to labour hoarding and so did not need to hire additional workers compared to their Scottish counterparts. So, for this reason, employment could be rising in Scotland while remaining static or falling, due to the weak recovery, in the UK. Other things equal, this would be associated with falling unemployment in Scotland and static or rising unemployment in UK.

- A second possibility is due to the greater apparent shift to part-time working in Scotland, which opens up the possibility that while the number of jobs could be rising faster in Scotland than the UK, the provision of labour services may not be, and may be more in line with output change. Moreover, if to the end of 2010 the number of new part-time jobs offered was greater than the number of full time jobs lost then unemployment would fall and vary differently from the UK.

We consider the first explanation to be more significant but both may be playing their part.

Key Uncertainties

- The political upheaval in the middle-east. The price of oil is rising and is now in the $110 to $120 range. Such high levels will continue as long as the Libyan crisis is unresolved and the extent to which Saudi Arabia acts as a 'swing' producer seeking to meet some or all of any shortfall following a partial or complete shutdown of Libyan oil supply. Of course if the political upheaval spreads significantly to Saudi Arabia then the implications for the world economy will be enormous.

- The growing threat of inflation, but core inflation especially earnings growth is largely stable.

- Continuing weak bank lending as the banks continue to deleverage, have significant amounts of debt to re-finance and face the prospect of further losses due to the risk of sovereign debt default especially, for British and Scottish banks, in Ireland.

- The impact of fiscal consolidation.

- Continuing weakness of household demand as households continuing to run down debt and as real incomes and wealth fall.

- Business investment and export growth, which are the hoped-for mainstay of recovery, but both remain stubbornly weak.

Forecasts

We are forecasting that:

- GDP will grow by 1% this year, 1.6% in 2012 and 1.9% in 2013. (See Forecast Tables).

- We have shaded down our forecasts for 2011 - by 0.1% points - and 2012 - by 0.3% points - compared to our November release.

- The lowering of the forecast is in part due to the worsening outlook for consumer confidence in both Scotland and the UK, while the much greater weakness relative to UK in 2011, with UK forecasts around 2%, is very largely due to the stronger public spending cuts in Scotland this year.

- But while the recovery is weak, jobs are being created in the Scottish economy. Net jobs grow by 0.9% in 2010, 0.9% in 2011, 1.4% in 2012 and 1.7% in 2010. By 2013 total employee jobs are forecast to be around 60,000 fewer than in 2007 and broadly the same as at the end of 2004 .

- With the recovery in both output and employment comparatively weak, we predict the recovery this year will be insufficient to lower or even stabilise unemployment. Accordingly, unemployment is expected to rise in Scotland again during this year reaching 8.8% , or 234,000 by the end of the year. After that, though, the recovery should be sufficiently strong to make a more sustained dent in the rate and so we are forecasting lower rates of 8.4% and 7.9% in 2012 and 2013 respectively.

Future Growth

In the latest Commentary we also look more closely at the growth issues confronting the Scottish economy over the longer term, beyond our forecasting horizon. This is done in the light of Scotland's past growth performance and an analysis of strengths and weaknesses. The principal findings are:

- Scottish growth over almost 50 years is comparable to UK growth – a little lower in absolute terms – but middling by international standards. Trend growth in GDP per head is slightly higher in Scotland but largely due to weaker population growth.
- Yet, mature economies tend to display similar trend growth close to 2%. Although, small open economies have scope for faster growth and decline due to significance of resource mobility e.g. capital and labour, into and out of the economy.
- Until the recent recession, over the period 1998 to 2008, the most important sectors for Scottish growth were *real estate & business services, financial services, retailing & wholesaling*, and *transport & communication*, much the same as in the UK.
- Ranking fifth in importance the *public sector* was much less important to growth over the period than has often been suggested and no more important in Scotland than in the UK.
- The analysis suggests that if Scotland could move closer to the UK industrial structure it would get a growth dividend, because Scotland is somewhat less specialised in fast growing sectors such as business services & real estate, retail & wholesale and transport & communication.
- But the analysis also suggests that the performance of Scottish industry has been generally weaker than UK industrial counterparts and that suggests an intrinsic competitiveness problem
- This is supported by evidence that Scottish labour productivity growth is weaker than UK. But unit labour costs are, on average, about 3% lower here, which suggests that we have a problem of lower total factor productivity: it is not simply low investment and low capital per worker that is the problem.
- Scotland's export base is narrowly focused, is declining, and may have been eroded further in the recession.
- To raise Scotland's growth rate there is a need to grow the export base by developing companies of scale and attracting inward investment, and enhancing its competitiveness through innovation, R&D and improved business sophistication, including promoting leadership and enterprise.

- Scotland's strong university research base, technological and sectoral know-how, graduate supply, high social capital and amenity, are strengths that offer a basis for future growth in key sectors.

- Small firms have a low export propensity but policy can raise economy-wide value added both by seeking to raise the exports of SMEs and by encouraging new and small firms to seek to link into the supply-chains of the key 400 firms in the Scottish export base.

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Annex: **Forecast Tables**

Table 1: Forecast Scottish GVA Growth in Three Scenarios, 2010-2013

GVA Growth (% per annum)	2010	2011	2012	2013
High growth	1.1	2.1	2.4	2.6
November forecast	*1.3*	*2.1*	*2.4*	*n.a.*
Central	**1.0**	**1.0**	**1.6**	**1.9**
November forecast	1.0	1.1	1.9	*n.a.*
Low growth	0.9	0.3	0.6	0.9
November forecast	*0.5*	*0.3*	*1.0*	*n.a.*

Table 2: Forecast Scottish Net Jobs Growth in Three Scenarios, 2010-2013

	2010	2011	2012	2013
High growth	22,267	42,626	51,025	57,262
November forecast	*-7,000*	*42,300*	*50,404*	*n.a.*
Central	**20,113**	**19,780**	**31,741**	**39,808**
November forecast	*-12,794*	*21,224*	*39,124*	*n.a.*
Low growth	18,357	5,895	11,586	19,256
November forecast	*-22,700*	*4,400*	*21,100*	*n.a.*

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

	2010	2011	2012	2013
ILO unemployment rate				
High growth	7.9%	7.8%	6.6%	5.4%
Central	**8.0%**	**8.8%**	**8.4%**	**7.9%**
Numbers	**215,000**	**234,072**	**224,945**	**212,657**
Low growth	8.1%	9.4%	9.8%	10.1%
Claimant count rate				
High growth	4.8%	4.7%	4.0%	3.2%
Central	**4.9%**	**5.3%**	**5.0%**	**4.7%**
Numbers	138,300	150,849	144,967	137,048
Low growth	4.9%	5.7%	5.9%	6.1%