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Stagnation threat rises

The Scottish economy continues to recover from recession but is threatened with stagnation as the rate of recovery slows, according to the latest Economic Commentary from the University of Strathclyde's Fraser of Allander Institute, sponsored by PwC.

Almost three years after the start of the recession the Scottish economy has only recovered about a quarter of the output lost, while the UK economy has recovered a third of lost output. The main hopes for recovery, exports and business investment are recovering slowly or fairly static while household spending is weighed down by debt overhang and declining real incomes.

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

> "We are teetering on the brink of what could be a considerable period of stagnation. We have to hope that the forces driving recovery secure the upper hand against the pressures fuelling stagnation, including public spending cutbacks, falling real household incomes, rising energy prices and the spectre of a fragmenting eurozone."

He added:

> "With the weaker growth of household spending in Scotland, greater fiscal consolidation in 2011 and a sluggish outlook for private sector investment, I find it hard to see how the Scottish economy can continue to track the UK economy as it has done in recent quarters."

The Institute has shaded down its forecasts for 2011, by 0.2% points, and for 2012, by 0.1% points, compared to the March release. The lowering of the forecast reflects the weakening in the economy that has been observed in recent months. Household spending is being hit by the debt overhang, the decline in real disposable incomes as inflation moves further ahead of earnings, and uncertainties about job prospects as the fiscal consolidation starts to bite, especially in Scotland, and the economy slows. In addition, the export and investment recovery is weaker than earlier hoped

Paul Brewer, senior partner at PwC in Edinburgh, said:

> "With the Scottish Government delaying the full impact of the spending cuts, beleaguered public sector organisations have had some much-needed breathing space to deal with the funding shortfalls. But time has run out. Now the public sector must start to implement the hard decisions that will determine the quality and shape of service delivery.
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> "As Scotland confronts the reality of these hard choices, it is vital that Holyrood and local authorities keep citizens engaged and informed. With strong leadership and open and effective communication, it is much more likely that people will understand the tough issues and give Holyrood and local authorities the 'permission' to make the hard choices that will impact them personally."

Paul Brewer, senior partner at PwC in Edinburgh, added:

> “Tackling lacklustre growth and driving economic recovery is a priority for the Scottish Government. Public sector investment has a key part to play though the proposed step-up in investment will arrive late in the day. Earlier this month the UK Government also agreed in principle to Holyrood issuing bonds to raise new funds from capital markets.
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> “However, this increased fiscal freedom is not without risks. Today, the eyes of the financial world are on Greece, where the impact of a potential default on its sovereign debt will have repercussions well beyond the Eurozone and the global financial community. For Scotland, the question would be who in the financial world would buy new bonds from the auld country and at what price?”

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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. 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. 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.

A summary of the outlook and appraisal is on pages 3 – 7 of this document.

Overview

In their latest Economic Commentary, sponsored by PricewaterhouseCoopers, the University of Strathclyde's Fraser of Allander Institute notes that the recovery continues to be weak in both Scotland and the UK.

- Our view of the performance of the economy has been distorted by the effects of the bad weather on production in December last year. However, once an allowance is made for weather effects it still looks as if GDP growth was stagnant over the last 6 months to the first quarter 2011.
- There are mixed messages on whether stagnation is continuing or whether the recovery has resumed again. It seems likely that the economy is still continuing to recover but at a fairly weak rate.
- Almost three years after the start of the recession the Scottish economy has only recovered about a quarter of the output lost, while the UK economy has recovered a third of lost output.
- These data support the evidence-based view that recovery from financially sourced recessions, particularly banking crises, are slow and painful.
- Exports are recovering slowly and business investment is fairly static with firms sitting on large piles of cash but unwilling to invest due to the uncertainty.
- So, while the evidence seems to be moving in favour of those advocating a "Plan B" for the UK authorities to take some action to stimulate demand, it needs to be understood that while buttressing demand might be a necessary condition for a more rapid recovery it is not sufficient.
- We must be sure that our banking system is fit for purpose, able to freely lend to support the needs of the economy. It is not clear that we have presently reached that point. It is to be hoped that the final recommendations of the Independent Commission on Banking meet this requirement and that the proposals are adopted by the government.
- A weaker recovery than expected, with household spending weak, exports and investment recovering more slowly than hoped, the service sector especially lagging the UK, and significant future uncertainties have led us to revise downwards our forecast for 2011 and 2012.

Key Uncertainties

- Contagion in the eurozone debt crisis as the fears of default on sovereign debt spreads from Greece to Spain and perhaps other peripheral eurozone countries, risks damaging bank lending, market and business confidence.

- Fears of a slowdown in the growth of the Chinese economy as consumer price inflation takes hold.

- Continuing uncertainty on the effects of the "Arab spring" with implications for oil prices and trade.

- The continuing weakness of the US economy, the deteriorating fiscal position, and their effect on world trade and investor confidence.

- Household expenditure is likely to continue to remain weak due to the continuing fiscal consolidation - especially strong in Scotland in 2011 - and the squeeze on real disposable incomes from the current high level of energy prices.

- Consumer price inflation is above target and is likely to remain so for some time, household disposable incomes are being squeezed as a result. All of which runs the risk of a rise in inflationary expectations and strengthened wage claims, but there is little sign that this is happening with the demand for labour still relatively weak and earnings growth remaining at around 2% p.a.

Forecasts

- GDP will grow by 0.8% this year, 1.5% in 2012 and 1.9% in 2013. (See Forecast Tables).

- We have shaded down our forecasts for 2011, by 0.2% points, and for 2012, by 0.1% points, compared to our March release.

- The lowering of the forecast reflects the weakening in the economy that has been observed in recent months. Household spending is being hit by the debt overhang, the decline in real disposable incomes as inflation moves further ahead of earnings, and uncertainties about job prospects as the fiscal consolidation starts to bite, especially in Scotland, and the economy slows. In addition, the export and investment recovery is weaker than earlier hoped.

- Our forecasts remain below the OBR and consensus forecasts for the UK in 2011, 2012 and 2013, which largely reflects the weaker growth of household spending in Scotland, greater fiscal consolidation in 2011 and a sluggish outlook for private sector investment.

- We find it hard to see how the Scottish economy can continue overall to track the UK economy as it has done in recent quarters.

- Production and manufacturing output will continue to pick up reasonably strongly, but at a slightly lesser rate than in our previous forecast with production growing at 3.6% in 2012 compared to 4% in our March forecast.

- The service sector is forecast to continue on its weak growth path growing by 0.5% this year, 1.1% in 2012 and 1.3% in 2013, largely due to the weakness in the growth of household expenditure.

- Construction also continues to exhibit weak growth of 0.5% in 2011, 0.9% in 2012, and 1.1% in 2013, reflecting cutbacks in government capital spending and weak private sector investment.

- Yet even with the weak recovery we still expect net jobs to be created in the Scottish economy. Net jobs grow by 0.9% in 2011, 0.8% in 2012 and 1.7% in

2013. By 2013 total employee jobs are forecast to be 2,373,000 around 60,000 fewer than in 2007 but up by 80,000 from the end of 2010.

- The largest percentage growth in job numbers is forecast for the production sectors, but the greatest number of jobs created will still be in services, despite the low forecast for output growth, due to the sheer scale of the sector.

- Within services, total employee numbers are forecast to rise, however there are forecast declines in employee numbers in Public administration and defence, Education, and the Financial services sector. Some of the jobs lost in 2011 in the Financial services are forecast to be recovered during 2012 with employee jobs at the end of 2013 in this sector up slightly compared to the end of 2010.

- We continue to expect that the Scottish GDP recovery will continue to be weaker and at a rate below that which is required to stabilise unemployment. We therefore continue to expect that there will still be some pickup in unemployment even as growth in output picks up. Unemployment in Scotland this year, on the ILO measure is therefore forecast to rise 8.3%, or 217,000 by the end of the year and be largely stable through 2012 with a slight further rise to 220,000 by the year end. After that, the rate should fall to 8.2% by end 2013.

Scottish Growth and GDP per head

- The latest Commentary also revisits the issue of the longer-term performance of the Scottish economy.

- We note the recent evidence of the rise in Scottish GDP per head relative to the UK during most of the last decade, which comes from UK Regional Accounts data published in December.

- We note that the UK Regional Accounts data give a quite different estimate of Scottish GDP growth over the period from the GVA at basic prices volume data produced by the Scottish government, and which is normally used to provide a picture of the growth of the Scottish economy.

- The GDP per head series is also affected by population movements as well as GDP change and differences between the two jurisdictions - UK and Scotland - can distort the GDP per head relative. The data indicate that during the devolution period Scottish population growth was consistently less than UK population growth, so tending to push up the Scottish GDP per head relative on that account alone.

- Differences in the cyclical behaviour of the UK and Scotland also distort the picture of the GDP per head relative and the last decade was a period of marked short-term cyclical movements with a boom occurring in the middle part of the decade followed by a recession the scale of which was greater than anything we have experienced since the Great Depression of the early 1930s.

- Application of growth trends to the data largely remove any improvement in the GDP relative over the last decade.

- We therefore conclude that the evidence of an appreciably higher Scottish GDP per head relative to the UK by the end of the last decade is the result of both the differential effects of large cyclical movements and slower population growth on the relative.

- It does not appear to be explained by an improvement in Scotland's relative competitiveness, or underlying economic performance.

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Annex: Forecast Tables

Table 1: Forecast Scottish GVA Growth in Three Scenarios, 2011-2013

		2011	2012	2013
High growth		1.6	2.7	2.8
	March forecast	*2.1*	*2.4*	2.6
Central		**0.8**	**1.5**	**1.9**
	March forecast	*1.0*	*1.6*	*1.9*
Low growth		0.3	0.8	1.0
	March forecast	*0.3*	*0.6*	*0.9*

Table 2: Forecast Scottish Net Jobs Growth in Three Scenarios, 2011-2013

		2011	2012	2013
High growth		36,317	41,882	60,675
	March forecast	*42,626*	*51,025*	*57,262*
Central		**20,600**	**18,548**	**39,849**
	March forecast	*19,780*	*31,741*	*39,808.*
Low growth		9,621	2,661	21,431
	March forecast	*5,895*	*11,586*	*19,256.*

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

	2011	2012	2013
ILO unemployment			
Rate	**8.3%**	**8.5%**	**8.2%**
Numbers	216,723	220,350	213,308
Claimant count			
Rate	5.0%	5.5%	5.3%
Numbers	143,037	158,652	155,714