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Threat of Greek Exit and Euro Break-Up Hangs over Scottish Economy

A eurozone collapse or even a Greek exit from the eurozone threaten to halt and even reverse an already lacklustre Scottish recovery, according to the latest Economic Commentary from the University of Strathclyde's Fraser of Allander Institute, sponsored by PwC.

As Greece faces continued austerity following last weekend's election, Scotland's potential exposure to a Greek euro exit, or even the complete disintegration of the eurozone, is becoming clearer. Analysis in the Economic Commentary reveals that although the trading exposure to Greece is low – only around 0.3% of all Scottish exports are Athens bound - a further deterioration in the Greek economy could have far reaching consequences.

The analysis indicates that if Greece is forced to leave the eurozone, the impact could have the effect of shrinking Scottish GDP by around 1.2% and pushing the region well into recession. If the eurozone itself were to collapse - a much less likely scenario – the impact on the Scottish economy would be substantial, with GDP falling back by around 5.2% to the worst levels of the global financial crisis

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

> "Our analysis suggests that a Greek exit from the eurozone would provide a sizable shock to the Scottish economy. But the breakup of the euro would lead to a loss of output and jobs in Scotland comparable to the impact of the Great Recession of 2008 to 2009."

Morven Campbell, risk assurance partner at PwC in Scotland, commented:

> "Scottish businesses must understand and prepare for all of the potential Eurozone scenarios. This means stress testing all aspects of their business, from treasury to operations and exports to personnel, identifying vulnerable areas and developing contingency and mitigation plans to minimise any likely impact.
>
> "Businesses also need to act on the fact, even in the face of the crisis, that there are still significant growth and export opportunities outside Europe, particularly in the emerging markets for Scottish products and services."

A review of the Scottish economy and forecast

While survey data paints a more positive picture for the first three months of 2102, there is still a fear that the Scottish economy could go into recession again if it continues to track the UK, which entered recession in the first quarter.

Ongoing nervousness across the eurozone is also mirrored in Scotland, with survey data showing a clear deterioration in business and consumer confidence and growth in April and May.

Scottish GDP is still just under 4% below its pre-recession peak and employment is 3% below, with the UK figure sitting at -4.3% and -1% respectively.

The recovery of Scottish GDP relative to the UK is also being overstated by the effect of falling oil and gas production. When oil and gas production is removed from the data the Scottish recovery is relatively weaker than previously thought with UK ex oil and gas GDP -3.5% below its pre-recession peak while the Scottish figure is -3.6%.

In the Scottish labour market jobs are being created again but it is clear that full-time jobs are falling while part-time and temporary jobs are rising. It is, therefore, quite possible that labour demand has fallen with GDP even though the number of jobs rose recently and unemployment fell. This would be the case if the loss of labour input through the fall in full-time employment was greater than the gain in labour services from the rise in part-time employment.

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

> "The positive signs from surveys earlier in the year that the Scottish recovery was picking up have been undermined by the latest survey evidence. We appear to be condemned to a continuing period of low growth as fiscal austerity continues and the clouds over the Eurozone darken."

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

> "Over the last few months we have seen some strong Scottish business performances in terms of growth, markets and products. However, this is far from widespread with manufacturing, construction and retail sectors continuing to suffer from lack of confidence, growth and capital.
>
> "While the economic outlook appears almost as glum as the recent summer's weather, with little or no GDP growth to lift us out of double-dip territory, there is a glimmer of hope. The Government's injection of £80bn to, 'support the flow of credit to where it is needed in the real economy' will improve the access to finance for investment and business growth. But the real question is whether businesses will show the confidence to embrace this opportunity. It remains to be seen if this will be enough to navigate the choppy economic waters and raise business confidence."

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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.

Overview

In their latest Economic Commentary, sponsored by PricewaterhouseCoopers, the University of Strathclyde's Fraser of Allander Institute notes that growth in the Scottish economy appears to be weakening again after some survey evidence of a pickup in the first quarter of the year. Considerable slack remains in the Scottish labour market, although the main indicators of unemployment, activity and employment rates have moved into line with the UK. The Institute further suggests that it is now clear that the recovery in output stalled after mid-2010 and is strongly of the belief that the UK government fiscal austerity programme is the main culprit. Added to this are the effects of the developing problems in the Eurozone and the impact of rising commodity price driven inflation on real incomes and consumption. Growth will remain weak this year but there should be some pickup in 2013 and then in 2014, with forecast GDP growth of 0.4%, 1.6% and 2.5% in the three years respectively. The Institute's analysis of the potential impact on the Scottish economy of a Euro breakup suggests that it would be a major economic event for Scotland even though we are not in the Euro. With an estimated drop in GDP of -5.3% and loss of -144,200 jobs, the effect would be comparable in scale to the effects of the recent Great Recession and worse than our simulation estimate of the effect of fiscal consolidation.

GDP Performance

- Scottish GDP is still just under 4% below its pre-recession peak and employment 3% below. The UK figures are -4.3% and -1%.
- The recovery of Scottish GDP relative to the UK is also being overstated by the effect of falling oil and gas production. When oil and gas production is removed from the data the Scottish recovery is relatively weaker than previously thought with UK ex oil and gas GDP -3.5% below its pre-recession peak while the Scottish figure is -3.6%.
- By the end of last year the output position of key Scottish sectors was as follows:
    - Scottish services GVA was still -2.9% below its pre-recession peak compared to -1.7% in the UK.
    - Manufacturing GVA in Scotland stood at -5.9% below its pre-recession peak compared to -8.3% in the UK.
    - Construction GVA was -10.8% below its pre-recession peak while UK construction was -7.6% below its peak.
    - Business and financial services GVA was -6.1% below its pre-recession peak while its UK counterpart was only -3.0% below its peak.

Labour Market

- Considerable slack remains in the Scottish labour market, although the main indicators of unemployment, activity and employment rates have moved into line with the UK.
- It should be remembered that at the start of the Great Recession the Scottish unemployment rate was well below the UK rate at 3.9% compared to 5.5%.
- Even with the recent one-quarter rise in employment the level of jobs in Scotland is still 3% below the pre-recession peak. UK employment, in contrast, stands at 1% below its pre-recession peak.
- Furthermore, the ratio of employment to working population is 5.5% below the pre-recession peak. That is only a little above the situation at the trough of the recession when the ratio fell to 6.4% below the pre-recession peak. The implication of this statistic is that there are significant unused labour reserves in the Scottish labour market and in relation to the available labour supply the recovery of employment has been exceptionally weak.
- Jobs are being created again but it is clear from the data to September 2011 that full-time jobs are falling while part-time and temporary jobs are rising.
- It is quite possible that labour demand has fallen with GDP even though the number of jobs rose recently and unemployment fell. This would be the case if the loss of labour input through the fall in full-time employment was greater than the gain in labour services from the rise in part-time employment.

Drivers of Recovery

- It is quite clear that the Scottish and UK economies were beginning to recover from the recession by mid-2010. But after that the recovery faltered.
- What the data show between 2010 and 2011 is that there was a switch in growth away from domestic spending to net trade as the UK government had hoped.
- However, that wasn't sufficient to offset the absolute fall in government and investment spending and the slowdown in private consumption growth. There was a 1.7 percentage point switch in favour of net trade against falls of 1.3 percentage points in private consumption, 0.7 percentage points in government expenditure and 0.3 percentage points in investment.

- We are strongly of the belief that the UK government fiscal austerity programme is the main culprit for the faltering recovery, with the added effects of the impact on business confidence of the developing problems in the Eurozone and the impact of rising commodity price driven inflation on real incomes and consumption.

Forecasts

- We have maintained our forecast of *GDP growth* for 2012 at 0.4%.
- But we expect growth to be a little weaker in 2013 at 1.5% instead of 1.7%.
- By 2014 we predict a stronger recovery with growth of 2.5%.
- We expect Scottish growth to remain close to UK growth in line with the evidence from the recovery to date.
- For *employment*, our central forecast is for net jobs to fall by -0.7% in 2012, rising by 0.9% in 2013 and by 1.6% in 2014.
- The number of employee jobs in Scotland is forecast to decline during 2012 by just less than 15,000 jobs. Through 2013 and 2014 we forecast increases in employee jobs in our central forecast, with annual increases of less than 20 thousand and more than 36 thousand respectively.
- In 2012 there are significant net job losses in the service sector of -15,500 and more than 2,000 construction job losses.
- In 2013 and 2014 there are job increases across all the main sectors.
- A "rebalancing" of employment within the service sectors towards non-public activities as fiscal consolidation continues. Construction employment is forecast to increase in 2013 and 2014 as spending on (private) investment projects returns with renewed confidence in the recovery.
- *Unemployment* is forecast to continue to rise on both key measures this year.
- On the preferred ILO measure unemployment is predicted to reach 246,100 by the end of this year, or 9.3%.
- The unemployment position now deteriorates further into 2013, with unemployment at the end of that year forecast to 252,400, or 9.5%, then falling to 238,200, or 9%, by the end of 2014.

Impact of Breakdown of the Eurozone

- The situation in the Eurozone complicates the forecasting picture considerably.

- We assume in our central forecast that for the medium term there is an essential "muddling through" process, with further support given first to peripheral country banking systems and then to their sovereigns if necessary.
- Through this process confidence remains low and growth is weak as austerity policies are not, or are insufficiently, relaxed. Moreover, complete steps to full fiscal union with Eurobonds and sizable fiscal transfers between countries, which would finally resolve the crisis, seem unlikely.
- But there remains the risk of a Greek default and even exit from the Euro in the near term and the break-up of the Euro in the medium term.
- We have therefore considered these two outcomes as possible scenarios to assess their likely impact on the Scottish economy.
- This is therefore not a forecast but a 'what-if' impact study, with the impact on the Scottish economy assessed at the end of three years after each event occurs.
- Our main conclusions are:
    - First, a Greek exit leads to a drop in GDP in Scotland of -1.2% and a loss of just under fifty thousand jobs. This is not trivial but small compared to the other events major events considered.
    - Secondly, the consequences of the breakup of the Euro would be a major economic event for Scotland even though we are not in the Euro.
    - The break up of the Euro leads to an estimated drop in GDP of -5.3% and loss of -144,200 jobs, after three years.
    - This is comparable in scale to the effects of the recent Great Recession and worse than our previous simulation estimate of the effect of fiscal consolidation.

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Annex: Forecast Tables

Table 1: Forecast Scottish GVA Growth, 2012-2014

GVA Growth (% per annum)	2012	2013	2014
Central forecast	**0.4**	**1.5**	**2.5**
November forecast	*0.4*	*1.7*	*2.6*
UK median independent new (May)	0.4	1.7	2.2
Mean Absolute Error % points	+/- 0.495	+/- 1.06	+/- 1.216

Table 2: Forecast Scottish Net Jobs Growth in Three Scenarios, 2012-2014

	2012	2013	2014
Upper	-5,200	41,000	61,750
February forecast	*-4,816*	*47,244*	*63,745*
Central	**-14,950**	**19,950**	**36,050**
February forecast	*-15,988*	*23,213*	*38,023*
Lower	-25,350	-1,700	10,450
February forecast	*-27,695*	*-9,250*	*12,126*

Table 3: ILO unemployment rate and claimant count rate measures of unemployment under each of the three forecast scenarios 2011-2014

	2012	2013	2014
ILO unemployment			
Rate (ILO un/TEA 16+)	**9.3%**	**9.5%**	**9.0%**
Numbers	**246,100**	**252,400**	**238,200**
Claimant count			
Rate (CC/CC+total job)	5.7%	6.5%	6.1%
Numbers	152,550	176,700	169,100