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Growth weakens again but there is a hint of recovery

There are some tentative signs of recovery in the Scottish economy according to the latest Economic Commentary from the University of Strathclyde's Fraser of Allander Institute, supported by PwC, despite evidence that the economy continued to weaken towards the end of 2011.

There are some indications that the weakening growth may not be as bad as feared with some positive signals from surveys and the possibility that falling inflation may help growth to pick up in the second half of this year. The situation in the Eurozone remains the 'elephant in the room' as regards future growth prospects but the problem has eased for the time being.

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

> "Growth in the Scottish economy continues to slow down, employment is falling and unemployment is rising at a faster rate than in the UK. Yet, with falling inflation there are some signs of a recovery emerging in the second half of this year and the hope that the problems of the Eurozone, if not solved, are less likely to plunge the world economy into recession than when we last reported."

The UK economy contracted by 0.2% in the final quarter of last year and all the indications from the recovery so far is that Scottish growth will have been similar. Scottish GDP, after falling by 6% through the recession, is still -3.3% below the pre-recession peak nearly four years ago, while the figure for UK GDP is -3.6%. A return to pre-recession output is unlikely before the third quarter of 2014. This will be six years after the start of the recession and could coincide with the launch of the Commonwealth Games in Glasgow.

Impact on the public and private sectors

While the toughest year of budget reduction has passed for the public sector, it will nonetheless be increasingly harder to deliver the incremental cuts outlined in the Scottish budget over the next two years as the financial screws continue to turn ever tighter. Even the recent decision to shift spending from revenue to capital – a move that was widely welcomed – will have a limited impact on the economy until the bigger NPD projects start to impact in 2013/14.

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

"As we continue to bump along the bottom, businesses and households are continuing to adjust their expectations to account for this extended journey to growth.

"When a business is looking to expand, availability of finance can make the difference between success and failure and it is concerning that for private companies and smaller corporate, credit remains tight. On the flip side however, banks are also seeing less demand for finance to drive growth. Recent research revealing a significantly reduced appetite for risk-taking by Scottish firms during the recession may provide one explanation for this.

"With Government relying on an export-led recovery from recession, news that Scotland's biggest customers are found within the UK as well as seven out of ten countries in the Eurozone may make this seem like a challenge too far. However, there is a glimmer of light.

"With an Export for Growth event in March set to help firms achieve their export dreams, our research shows a renewed focus by over half of Scottish private businesses on growing markets in the emerging BRIC* economies with a further 11% eyeing up opportunities in Latin America and Mexico. Further emphasis on this could go some way to not only pulling the country out of its economic stagnation but in both retaining and creating jobs in the longer term."

Impact on employment

The labour market in Scotland is now clearly weaker than the UK, with employment falling and unemployment rising to 8.6% above the UK's 8.4% rate. With more than 100,000 young people estimated to be unemployed, this is a personal and social tragedy, which should be producing the strongest policy response. It is also an economic tragedy because of the risk that a generation of employees may lose, or fail to gain, key employment skills that would be of significant productive use to the economy.

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

> "The UK economy is labouring under a programme of fiscal austerity which is slowing growth and which may ultimately prove to be self-defeating. With unemployment in the UK rising towards 3 million and a quarter of a million in Scotland, a generation of young person's job prospects are under threat.
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> "This austerity policy is a serious economic policy mistake that will arguably be remembered for generations to come."

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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 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. 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.
4. * BRIC countries include Brazil, Russia, India and China.

Overview

In their latest Economic Commentary, sponsored by PwC, the University of Strathclyde's Fraser of Allander Institute notes that a snapshot of the Scottish economy reveals a weak recovery with a further weakening apparent towards the end of 2011, as the UK economy contracted by 0.2%. Despite that, there are some indications that the weakening growth may not be as bad as feared with falling inflation possibly helping growth to pick up in the second half of this year. But this does not remove the fact that the economy is labouring under a programme of fiscal austerity which is slowing growth and which may ultimately prove to be self-defeating.

GDP Performance

- Scottish GDP is still -3.3% below the pre-recession peak nearly four years ago, while the figure for UK GVA is -3.6%.
- However, while the depth of the recession was greater in the UK, at -7.2%, than in Scotland, -5.9%, the recovery of UK GDP has been slightly faster than in Scotland.
- The National Institute in London has noted that the time taken in returning to the pre-recession peak is now greater than in the Great Depression in the 1930s.
- Our new forecast - see below - suggests that overall Scottish GDP will not return to its pre-recession peak - the level of GDP the economy was at just before it went into recession - until the third quarter of 2014, just in time for the Commonwealth Games in Glasgow (23rd July to 3rd August 2014). That is, six years after the recession began.
- On a brighter note, the weakening in growth in the economy towards the end of last year does not appear to be as bad as many feared.
- There are some indications that growth is beginning to pick up and after a weak first six months growth may pick up towards the end of the year.
- The rate of inflation is falling as last year's VAT increase falls out of the statistic and the rise in import prices especially commodities and energy costs have moderated. Although the recent increase again in the price of oil to above $120 per barrel, driven by events in Iran, leads us to be cautious about the prospect for a rapid fall in inflation.
- The mainstream view is that a lowering of the inflation rate back to target will give a relative boost to real incomes and so encourage a rise in household demand. But this view might be misplaced. If the pressing need of households is to pay down debt and present real incomes mean that their actual saving is below the precautionary saving desired to pay down debt. Then a rise in real income could lead to higher savings with little or no impact on household demand.

Labour Market

- The labour market in Scotland is now clearly weaker than the UK. Recent employment losses have taken the Scottish jobs market to a position 3.9% below its pre-recession employment peak. This is not that much different from the trough of the recession after employment had fallen by -4.8%.

- The UK jobs market is, in contrast, creating net new jobs, all be it slowly and at an insufficient rate to stop unemployment rising. The result is that employment in the UK is now only -1.38% below its pre-recession employment peak. Of course that in itself is nothing to be complacent about since recession in the UK labour market began four years ago.
- Moreover, the situation in the Scottish labour market is worse than that implied by the employment figures. This is because the supply of labour is rising as working population increases. An examination of the amount of jobs on offer compared to the available labour supply reveals that the situation is now identical to the trough of the recession.
- Hence unemployment has been rising strongly recently to 231,247 or 8.6% and above the UK rate of 8.4%. The number unemployed is very close to number reached at the trough of the recession in May-July 2010 when unemployment reached 236,819.
- Within that total more than 100,000 young people are estimated to be unemployed (including those in full-time education but seeking employment). This is a personal and social tragedy, which on most people's values should produce the strongest policy response. Moreover, it is also an economic tragedy because of the risk that a whole generation of employees may lose, or fail to gain, key employment skills that would be of significant productive use to the economy. Potential output will fall.

The Eurozone

- The situation in the Eurozone remains the 'elephant in the room' as regards future growth prospects but the problem has eased for two reasons.
- First, the agreement secured by EZ finance ministers on the much-postponed €130bn second bail-out for Greece.
- Secondly, the role the ECB has recently played in acting as *de facto* lender of last resort. By buying securities from EZ banks the banks have been able to use the increased liquidity to fund some of the debt of the peripheral sovereigns.
- These developments offer only temporary respite to the EZ balance of payments and debt crisis. But there is still a risk of a disorderly Greek default ad exit from the EZ, which will put at risk some of the other sovereigns such as Portugal and Spain.
- Moreover, the balance of payments financing and adjustment issues have hardly been tackled even if some progress has been made on debt.

Re-balancing the Scottish economy

The shock to the economy of the Great Recession continues to reverberate. Not only has the recovery been weak, there are fears both that a large proportion of supply has been permanently lost and that there has been a desired permanent shift in the composition of demand away from one set of productive activities to another. How will this affect the Scottish economy? The institute has undertaken analysis and empirical work to address this question. We draw the following conclusions:

- It appears likely that the future growth of the Scottish economy will depend more on tradables - goods and services produced locally that can readily be sold outside the country or region - than non-tradables than it has done in the past. Policy needs to recognise this. Although, recent evidence suggests that the rebalancing process is already underway.

- The growing importance of tradable service exports from Scotland suggests that export promotion policies should not simply assume that manufacturing is the only source of strong export growth.

- Equally, the weak performance of Scottish exports to the rest of the world (ROW) and the weak performance of manufacturing exports within that total, while concerning should not produce a counsel of despair.

- The weak Scottish export performance to ROW over the past 8 to 10 years is mainly down to the significant loss of electronics production at the beginning of the period and the effects of recession at the end of the period.

- Policy needs to recognise the importance of the rest of UK (RUK) market as a legitimate target for 'export' promotion policy.

- However, the continuing weakness of UK household demand might also suggest that the recent shift in the balance of exports in favour of the rest of the UK could hamper the necessary rebalancing of Scottish industry in favour of the production of tradables and exports.

Forecasts

- We have revised down our forecast of *GDP growth* for 2012 to 0.4% from 0.9%.
- But we expect growth to be a little stronger in 2013 at 1.7% instead of 1.6%.
- By 2014 we predict a stronger recovery with growth of 2.6% taking us back to the pre-recession GDP peak by the third quarter. Six years after the start of the recession.
- We expect Scottish growth to continue to be weaker than the UK but growth in the two jurisdictions is now expected to be much closer together, in line with the evidence from the recovery to date.
- For *employment*, our central forecast is for net jobs to fall by -1.8% in 2011, and by -0.7% in 2012, rising by 1.0% in 2013 and by 1.7% in 2014.
- The number of employee jobs in Scotland is forecast to decline during 2012 by just less than 16,000 jobs. Through 2013 and 2014 we forecast increases in employee jobs in our central forecast, with annual increases of over 23 thousand and 38 thousand respectively.
- There are job increases across all the main sectors.
- However, we forecast 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 265,250 by the end of this year, or 9.8%. That is a rise of 34 thousand from the level reached at the end of 2011.
- As with our last forecast, we are expecting the unemployment position to improve through 2013, and are now forecasting unemployment at the end of that year of 253,950, 9.3%, falling further to 234,300, 8.8%, by the end of 2014.

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Annex: Forecast Tables

Table 1: Forecast Scottish GVA Growth, 2011-2014

GVA Growth (% per annum)	2011	2012	2013	2014
Central forecast	**0.7**	**0.4**	**1.7**	**2.6**
November forecast	*0.4*	*0.9*	*1.6*	*na*
UK median independent new (February)	0.9	0.5	1.8	*na*
Mean Absolute Error % points	+/- 0.153	+/- 0.548	+/- 1.216	+/- 1.216

Table 2: Forecast Scottish Net Jobs Growth in Three Scenarios, 2011-2014

	2011	2012	2013	2014
Upper	-37,377	-4,816	47,244	63,745
November forecast	*11,150*	*18,850*	*41,100*	*na*
Central	**-40,401**	**-15,988**	**23,213**	**38,023**
November forecast	*4,900*	*8,750*	*16,200*	*na*
Lower	-43,437	-27,695	-1,853	12,126
November forecast	*-1,550*	*-1,350*	*-9,250*	*na*

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

	2011	2012	2013	2014
ILO unemployment				
Rate (ILO un/TEA 16+)	**8.6%**	**9.8%**	**9.3%**	**8.8%**
Numbers	**231,200**	**265,250**	**253,950**	**234,300**
Claimant count				
Rate (CC/CC+total job)	5.3%	6.1%	6.5%	6.1%
Numbers	141,500	164,450	177,750	166,350