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NEW ECONOMIC HORIZON OR FALSE DAWN

Fraser of Allander Institute's Economic Commentary June 2009

"The Scottish economy will contract significantly this year and the recovery is likely to be slower than the UK economy."

With current data suggesting that the UK recession may have bottomed out as early as March 2009, and some signs of positive growth predicted for April and May, businesses could be forgiven for thinking that the worst of the recession was behind them.

There is a developing view that the UK may move out of recession and experience growth in 2010 on the background of a favourable exchange rate and the benefits of the significant monetary and fiscal policy interventions but, as the Governor of the Bank of England has noted, this recovery may be slow and protracted.

However, the evidence for Scotland is less clear, but the Institute expects there will be a significant contraction this year. Whilst we forecast that the Scottish economy will perform better than the UK in 2009, we believe that it is more likely that the Scottish recovery will be slower than that of the UK.

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

> "It is likely the recession may have bottomed out, but what is unclear is the timing of the recovery. Credit availability in the medium term remains uncertain and unemployment will continue to rise in the medium term. The adjustments required to ensure a favourable long-term recovery pose a challenge to Scottish government policy as well as to the private sector in Scotland."

Over the last decade Scotland had evolved into a more service sector based economy and more reliant on domestic demand. Future growth may depend more on exports and external demand. The Scottish economy may therefore experience difficulties in adjusting to a situation of higher household savings, lower domestic consumption growth, possible higher taxation, and severe cutbacks in public spending.

Paul Brewer, senior partner of PricewaterhouseCoopers LLP's Edinburgh office added:

> "There are some signs that confidence is slowly re emerging in the corporate sector, but the economic contraction over the past nine months has been particularly severe in a number of sectors.

“Looking to the future we can expect lower domestic demand and cuts in public sector expenditure in the medium term which poses both a challenge to Scotland in improving its performance in manufacturing and exports and a risk that failure to meet these challenges will mean further job cuts..

“As predicted in our February Business Review, the refinancing of corporate debt over the next three to four years continues to be of concern. Already this week, we have seen a major transport company forced to revert to tighter lending limits as it tries to resolve the issues caused by its £1.2bn debt. And with little evidence from Scottish companies that they feel any benefit of increased credit in the economy it looks like this will continue to act as a drag on recovery as wider economic conditions improve.”

Ends

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Fraser of Allander Institute's Economic Commentary June 2009

In their latest Economic Commentary, sponsored by Price Waterhouse Coopers, the University of Strathclyde's Fraser of Allander Institute notes that recession in the UK economy may be over. The National Institute for Economic and Social Research in London called the end of the recession as occurring in March and is estimating small positive growth in April and May of this year. Due to lack of data the position in Scotland is much less clear. There is a clear danger of a "false dawn", since it is not unknown for previous UK recessions to have one or two positive quarters of growth before growth turned negative again.

Factors influencing the recovery

To the extent that the slowdown in economic activity is moderating and may be past its turning point, three reasons are offered for the turn round: re-stocking after considerable stock run-downs, short-time working and temporary plant closures from late 2008; a more price competitive UK economy due to the 20% fall in the value of sterling since the summer of 2007; and the effect of the significant policy stimulus through monetary and fiscal injections.

But recovery is likely to be slow and protracted. Households are reducing debt and raising savings so that consumer demand remains weak. Companies similarly faced with high debt levels and declining demand are also running down debt and cutting back significantly on investment. Export markets remain fragile with the IMF forecasting an 11% decline in world trade this year. But even as demand growth recovers there is concern that the banking sector has insufficient equity capital to enable credit to be supplied on a sufficient scale to support the recovery.

In the Scottish economy consumption remains weak, proxies for consumer confidence suggest the possibility of improvement as the decline in house prices which has been less in Scotland than in the rest of the UK appears to be moderating. Government spending is expected to remain strong in the current fiscal year but will begin to decline in real terms in 2010-11. Investment is falling in the UK and in the absence of specific Scottish data we assume the UK experience is mirrored in Scotland as in previous recessions. Tourism in Scotland is resilient buoyed perhaps by a weak sterling exchange rate, the events associated with "Homecoming Scotland" and the prospect of good weather. Scottish exports both to the UK and the rest of the world have been badly affected as worldwide demand contracted in the recession. There is some survey evidence on exports to the rest of the UK that the rate of decline is moderating. But the overall export position is difficult and likely to remain so for several months, with the benefit from lower sterling levels only beginning to fully emerge once world trade picks up.

Forecasts

GVA or net output

Our GVA/GDP forecasts are presented in Table1

Table 1: Forecast Scottish GVA Growth in Three Scenarios, 2009-2012

GVA Growth (% per annum)	2009	2010	2011	2012
High growth	-1.9	-0.5	1.6	2.1
February forecast	*-1.9*	*-0.4*	*1.1*	*1.7*
Central	**-2.9**	**-0.9**	**0.6**	**1.4**
February forecast	*-2.6*	*-1.2*	*0.5*	*1.53*
Low growth	-3.8	-1.7	-0.2	0.4
February forecast	*-3.1*	*-1.7*	*-0.1*	*0.6*

Our central forecast is for a decline in GDP/GVA of -2.9% this year. Compared with the Treasury's average of new forecasts for the UK, we are forecasting that the Scottish economy will perform in 2009 more strongly than the UK on our central and high growth forecast but slightly worse than the UK on our low growth forecast. Our forecasts for 2010 and 2011 represent an improvement on our February position reflecting the UK evidence that a trough to the recession may have been reached in the first half of 2009. However, for 2012 we are a little less optimistic than we were in February. This is because while we anticipate a recovery in Scottish GDP growth we do not expect it to be robust. Indeed, in the light of the evidence from earlier recessions we are projecting the recovery to be weaker in Scotland on all three scenarios than the average of independent forecasts for the UK. Nevertheless, Scotland returns to weak positive growth on the central scenario of 0.6% in 2011 led by manufacturing and somewhat stronger growth of 1.4% in 2012 but this is still some way below the 1.9% growth trend.

Jobs

Our forecast for jobs is presented in Table 2.

Table 2: Forecast Scottish Net Jobs Growth in Three Scenarios, 2009-2012

Net job no's	2009	2010	2011	2012
High growth	-62,827	-23,152	33,584	45,174
February forecast	*-73,007*	*-42,400*	*7,923*	*25,089*
Central	**-84,399**	**-51,451**	**11,301**	**26,824**
February forecast	*-94,179*	*-51,440*	*3,037*	*14,476*
Low growth	-103,579	-66,894	-3,722	6,847
February forecast	*-108,984*	*-63,064*	*-6,639*	*10,734*

Our central scenario predicts losses this year and next amounting to nearly 137,000. Net jobs growth returns in 2011 strengthening in 2012 but net job creation over these two years of just over 28,000 indicates the extent to which we expect the recovery to be slow and protracted.

Unemployment

Our forecast for unemployment is presented in Table 3.

Table 3: Forecast Scottish ILO Unemployment in Three Scenarios, 2009-12

ILO 16+ no's and rate%		2009	2010	2011	2012
High growth	%	4.9	4.8	3.8	3.5
Central	**Nos**	**186,800**	**212,600**	**202,300**	**207,900**
	%	**5.5**	**6.2**	**5.9**	**5.5**
Low growth	%	6.0	7.1	7.2	7.4

Our central forecast is for a rise in the ILO measure to a peak of 212,600 in 2010 or 6.2% of the workforce and then a gradual fall after that. The Scottish labour market has been outperforming the UK when measured by the employment and unemployment rates. However, this masks a significant switch, until the most recent quarter, from job losses into increased numbers of ex workers who are not available for work i.e. labour inactivity, rather than measured unemployment. Scotland's measured and forecast unemployment performance will depend crucially on the extent of this switch in future quarters.

Recovery and post-recession issues

Scotland's economy faces many challenges in successfully recovering from recession and establishing a favourable growth path. Analysis of structural change over the past decade reveals that Scotland became more of a service sector economy as the manufacturing share and electronics production fell. The Scottish economy effectively turned inwards and relied more on financial services, construction, property related and business services, and the public sector as manufactured exports played a smaller part in the demand for Scottish goods and services.

Because of this Scotland may have difficulty in adjusting to a situation post recession of higher household savings, lower domestic consumption growth, and severe cutbacks in public spending and/or higher taxation. This will require the economy to become more export and private sector orientated over the medium to long term. The required switch towards exports puts a premium on the competitiveness of manufacturing, since goods still account for the bulk of exports.

A key question here is whether Scottish manufacturing in particular has the size, diversity and capability to take advantage of a recovery. This poses a policy challenge to the Scottish government and its economic development agencies as well as to the private sector in Scotland. New products embodying green technologies, life sciences, digital and creative media, have been mentioned as likely to make a significant contribution to Scotland's export led recovery. But the development of such products may not happen if left to the market alone and, in any event, are unlikely to be sufficient on their own to generate the required growth of the Scottish economy.

The expansion in Scotland's export base necessary to secure the desired increase in growth is unlikely to be achieved without significant successes in attracting inward investment. There are obvious difficulties in the attraction and retention of high quality foreign direct investment. But Scotland won't make the transition from recovery to a higher growth path without it, given that Scotland's domestic business birth rate remains stubbornly low and business R&D is amongst the lowest in the western world. The issue of how we can attract the required high value, inward investment to rapidly boost our export base should be a key topic of public debate in Scotland over the next few years.

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