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Outlook and appraisal

Overview

The Scottish economy is poised to come out of recession. But there is still uncertainty whether the exit will have occurred in the fourth quarter of last year as it did in the UK economy, all be it weakly. The UK economy went into recession one quarter ahead of Scotland and it may be that Scotland will come out of recession one quarter later than the UK. The survey evidence for the final quarter of 2009, which cast some doubt on the strength of the recovery, certainly leaves that possibility open.

Over the course of the recession total GVA in the Scottish economy has fallen by -6.13% compared to a slightly smaller contraction of -5.73% in the UK. The relative performance of the service sector largely accounts for the bigger impact of the recession in Scotland. Service sector GVA in Scotland fell by -4.76% while the contraction in UK services amounts to -4.59%. Manufacturing sectors have suffered more in the recession both in Scotland and the UK. But Scottish manufacturing GVA fell by -11.28% during the recession, less than the fall of -14.22% in UK manufacturing. Construction output has fallen by -13.08% in Scotland if the start of the sector’s recession is dated as 2008q2, which compares with a fall of -14.07% in the UK if the start of the sector’s recession is dated as 2008q1 to the trough of 2009q1. However, there is a good case for arguing that the recession, or structural downturn, in Scottish construction began after 2006q3, which was not mirrored in the UK. The loss of output in Scottish construction over this longer period amounts to -15.47%. UK construction, in contrast, has displayed a classic 'V' shape with a sharp and deep downturn followed by rapid recovery of 2.5% between 2009q1 and 2009q3.

One aspect of the present recession is that the labour market outcomes have been appreciably different from the impact on output. While Scottish GVA has fallen by

-6.13% over the recession, the number of employee jobs has fallen by only -2.67%. To the extent that it is more easy to cut labour hours via short-time working than it once was, then employers may be less likely to make workers redundant in the short-run. Productivity per hour will not drop by as much as productivity per worker and coupled with lower labour payments competitiveness will suffer less. But it is arguable that a flexible labour market also makes it easier to dispense with the services of workers. If the recession is expected to persist, or the recovery expected to be very sluggish, then job shedding could pick up and unemployment continue to rise.

The UK economy has a large public sector financial deficit and rising net debt levels and interest payment. The increase is largely a consequence of government policy action to deal with the recession as households and firms sought to adjust to high levels of pre-recession debt by increasing saving and lowering spending. There is a need for a sizable adjustment in the UK's fiscal position. It is reasonable to argue that the government needs to set out in its March Budget a more credible and more clearly specified programme of fiscal tightening over the next five years than it did in the 2009 Pre-Budget Report.

Yet, there is much uncertainty about household and corporate spending and because of this we have for some time urged caution about the timing of a fiscal consolidation in the UK. The UK and Argentina are the only two G-20 countries to have withdrawn their fiscal stimulus in 2010. The overall fiscal stance in 2010-11 is shown by the 2009 Pre-Budget Report to be negative. In our view this is dangerous given that UK households have the most adjustments to make to their balance sheets than households in other countries because the level of household debt was pre-crisis so high here. If the growth of world trade does start to pick up appreciably and this is likely later this year the UK should benefit disproportionately. Then there will be a real prospect of what the Bank of England and the government desires: a switch to export and investment led growth. But until that time given relatively flat household and corporate spending, a fiscal tightening in 2010, the ending of further quantitative easing this month, and the likely continuing sluggishness of bank lending, increases the risk of a double-dip recession this year.

Some commentators have suggested that the UK is much the same as Greece in terms of risk of default on its debts. But despite some superficial similarities, such as the relative size of the budget deficit, the UK fiscal position is much stronger. Nevertheless, there is a lesson to be learnt from the Greek experience and it is this: allowing countries/regions within a larger monetary union to retain fiscal autonomy may threaten the monetary union. It runs the risk of a fiscal crisis because the financial markets will not discipline fiscal laxity in any one country/region sufficiently early enough. The discipline needs to come from the political centre and that means that complete fiscal autonomy is ruled out, although some degree of fiscal devolution is clearly feasible.

We are forecasting that Scotland will return to positive growth in 2010. But the recovery over the year is weak whilst household spending strengthens overall it continues to fall. Exports to the rest of the world continue to recover and at a faster rate than predicted in November. This along with some recovery of investment, though still negative, helps raise the forecast to 0.6% growth compared to our prediction of 0.1% in November. Recovery is weaker in Scotland than in the UK for the reasons that were well rehearsed in the previous Commentary and we see no basis for altering that view. Scottish GVA growth is better than the UK on the High growth scenario only. Trend growth is realised on our Central scenario in 2012. Employee job losses are forecast to continue from 2009 into 2010, with a net 96,000 jobs lost in those two years and not fully matched by job gains of 63,000 in 2011 and 2012. ILO unemployment is expected to peak at

216,000 or 8.1% this year falling to just under 186,000 or 7.3% in 2011 and further to 144,000 or 6.3% in 2012. However, if the recent trend in Scottish unemployment continues, which we think less likely, the rate could rise on our low growth scenario to 9.9%, or 264,000, this year.

Recent GDP performance

GDP data for the Scottish economy for the third quarter of 2009 became available in late January. The Scottish economy continued in recession in the third quarter with output falling by -0.2% and -4.6% over the year, much the same as the UK. But the contraction in quarterly output is clearly getting less – see Figure 1.

Scotland's GDP has therefore contracted by -6.13% over the five quarters since the recession began in second quarter of 2008. This is a somewhat greater loss of net output than the drop in the UK as a whole, which amounts to -5.73% over the *six* quarters from the start of recession in the first quarter of 2008. The decline in GDP in Scotland continues to mirror the decline in the UK as Figure 1 shows but nonetheless, on the data so far, the recession in output continues to be slightly more severe here. In the 4th quarter 2009, the UK economy came out of recession growing by 0.1%. Scottish GDP figures for the fourth quarter are not available until April but the graph above does suggest that the economy is moving in the right direction.

In the 3rd quarter 2009 output in the *service sector* – accounting for 74% of overall GVA – fell by -0.3% in Scotland and by -0.2% in UK – see Figure 2. However, while the service sector performed less well in Scotland than in the UK in the third quarter, *manufacturing* (14% of GVA) did better. Manufacturing GVA *rose* by 0.8% in Scotland against a *fall* of -0.2% in manufacturing in the UK - see Figure 3.

The *construction* industry in Scotland continued to contract with GVA falling by -1.6% in the third quarter compared to an *increase* of 1.9% in the industry in the UK – see Figure 4.

Within services, the main sectoral drivers of contraction in the second quarter were *hotels & catering* (3% of overall GVA), *real estate & business services* (REBS) (18% of GVA) and *financial services* (8% of GVA). Activity in hotels & catering fell by -2.3%, compared to a contraction of -2.1% in the sector in the UK. This again confirms, perhaps, that tourism to Scotland has not benefited by much from the decline in value of the pound sterling and by the "Homecoming Scotland" events. REBS output fell by -1.5% in Scotland compared to a fall of -0.4% in the UK. This contrasts with the previous quarter where REBS output rose by 0.9% after falling for four successive quarters. Clearly, the notion that the recession had ended in this key sector was illusory. Financial services contracted by -1.3% in Scotland compared to a greater fall of -2.0% in the sector in the UK – see Figure 5. On this evidence the recession in financial services appears to be easing somewhat in Scotland but not so in the UK, although the sector went into recession much later in the UK.

Two service sectors experienced positive growth in the third quarter: *retail & wholesale* (11% of GVA), and *transport & communication* (7% of GVA). GVA in transport & communication services rose by 0.5% in Scotland, a little worse than the 0.7% increase experienced in the UK. Retail & wholesale GVA expanded by 1.5%, a little more than the 1.4%% expansion in the sector in the UK.

The stronger overall performance of Scottish manufacturing (0.8%) compared to UK manufacturing (-0.2%) in the third quarter was largely down to comparative strength in 4 sectors: *food*, *drink*, *metals*, *paper, printing & publishing. Food* (1.4% of GVA) grew by 2%, compared to a fall of -0.7% in the UK. The *drinks* industry (1.6% of GVA) grew by 5% compared to growth of 1.5% in the UK where the sector is relatively smaller (0.4% of GVA). The *metals* sector (1% of GVA) grew more strongly in Scotland in the quarter, by 1.6% compared to 0.3% in the UK. This stands in marked contrast to its performance in the second quarter when output fell by -8.8% in Scotland compared to a fall of -2.9% in the UK. Finally, *paper, printing & publishing* (1.4% of GVA) contributed to the overall stronger performance of Scottish manufacturing by growing by 1.6% in the quarter while its UK counterpart contracted by -3.6%. *Other manufacturing* (1.7% of GVA) contributed positively to overall Scottish manufacturing performance through growth of 2.6% but the sector in the UK also grew strongly, by 2.3%. Refined petroleum products also grew more strongly in Scotland, 5.7%, than the sector in the UK, 1.1%. But the contribution to better manufacturing performance in Scotland was small given its low share of GVA (0.2% of GVA).

The *chemicals* industry continued to display negative growth in Scotland but with a drop in output of -0.3% compared to a fall of -0.8% in the UK, the significant contraction in output experienced in the 3 previous quarters appears to have halted. Finally, the *engineering* industry in Scotland (4.9% of GVA) appeared to slip back in the third quarter, with output falling by -2.1% compared to a fall of -0.1% in the sector in the UK. Within engineering, all three principal sectors experienced negative growth. *Electronics* (2.9% of GVA) cut back production by -3.3% while the sector in the UK contracted by only -0.5%. So any hope that the positive growth registered by the sector in the second quarter heralded the end of recession has been dashed. *Mechanical engineering* reduced its output by -1.4% in the quarter a better performance than the contraction of -2.9% experienced in the sector in the UK. Finally, transport equipment (1% of GVA) saw a further small fall in production of -0.1% in Scotland compared to *growth* of 2.4% in the UK.

Figure 1: Scottish and UK Quarterly GDP Growth, 1998q2 to 2009q3

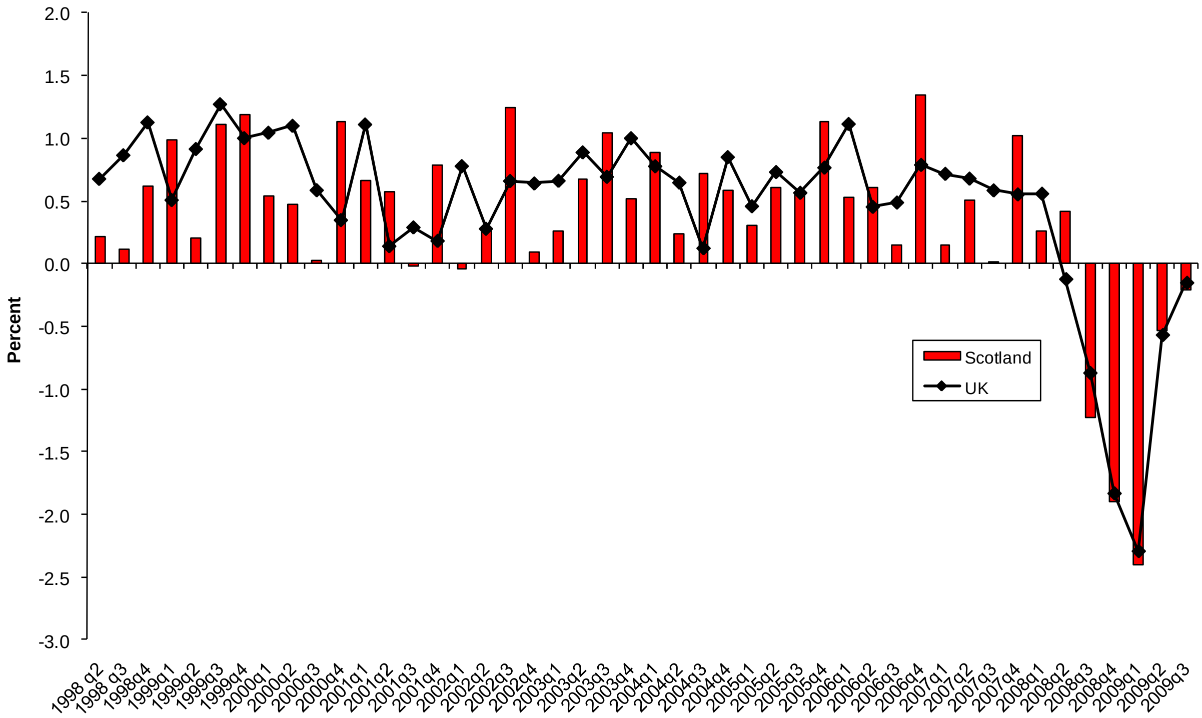


Figure 2: Scottish and UK Services GVA growth at constant basic prices 1998q2 to 2009q3

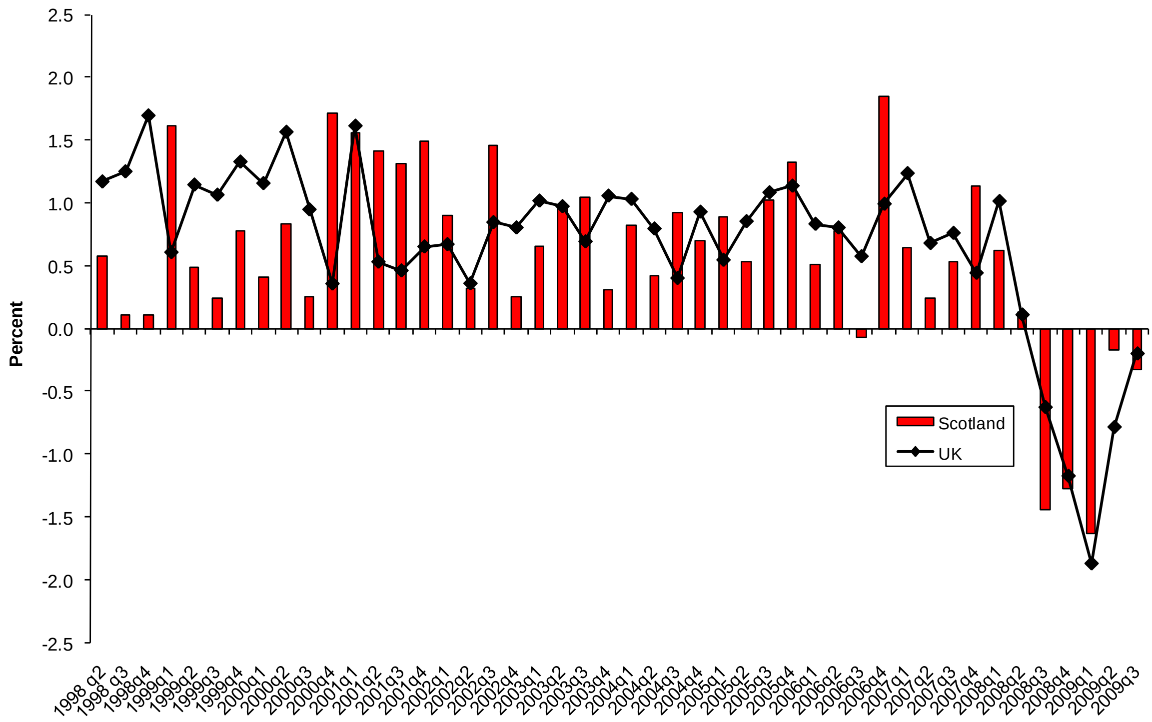


Figure 3: Scottish and UK manufacturing GVA growth at constant basis prices 1998q2 to 2009q3

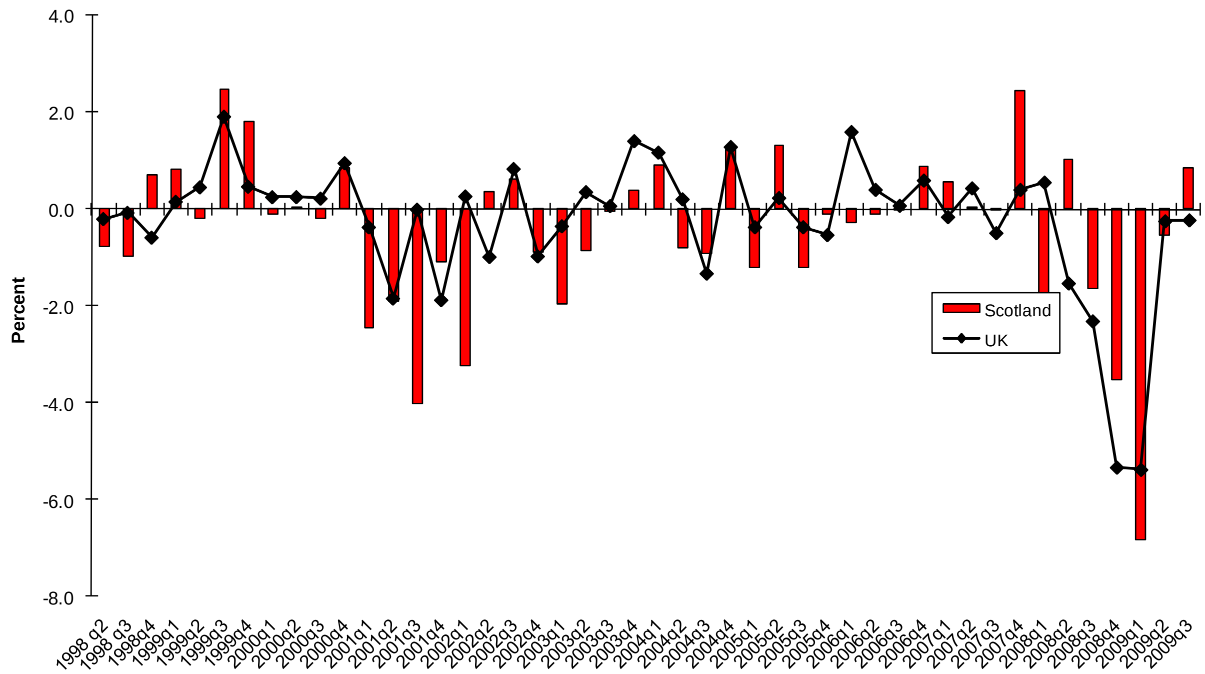
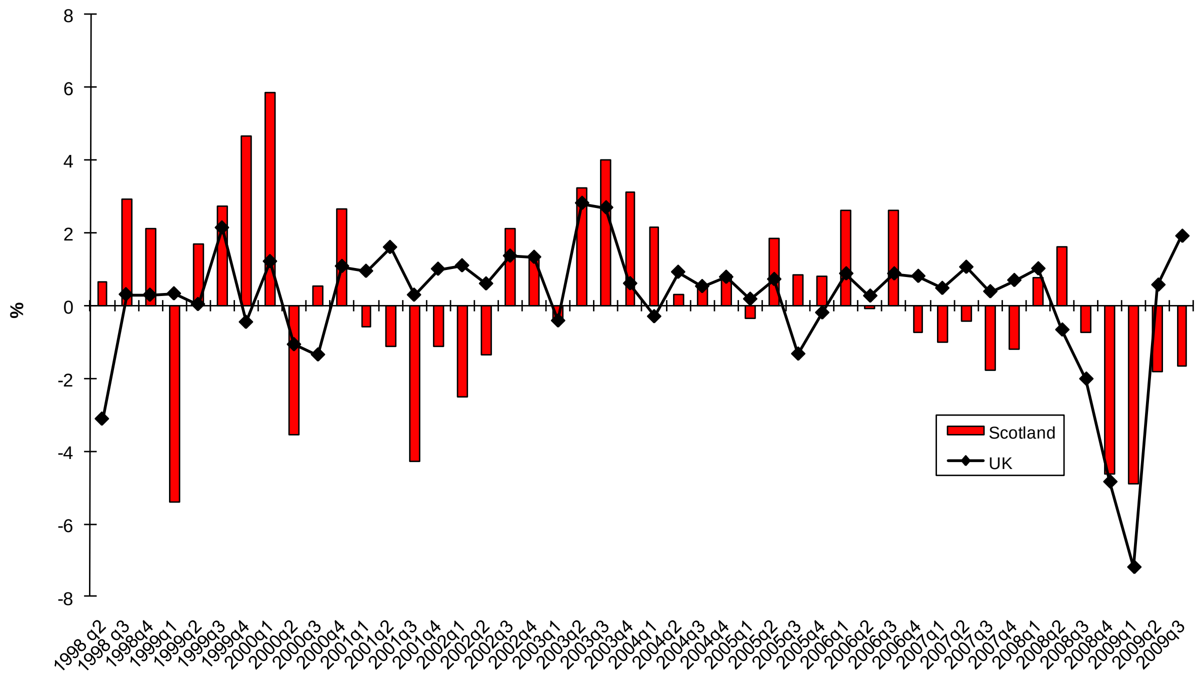


Figure 4: Scottish and UK construction GVA volume growth 1998q2-2009q3



Output and employment in the recession

Figure 6 charts the performance of key Scottish sectors over the past 12 years. The chart indicates that almost all of these key growth sectors have been affected by the recession with the exception of the public sector. Some appear now to be recovering: transport & communication; retail & wholesale; other services; and food & drink. But there are likely to be set backs just as there was in electronics and REBs in the third quarter.

Figure 7 indicates that over the course of the recession total GVA in the Scottish economy has fallen by -6.13% compared to a slightly smaller contraction of -5.73% in the UK. The figure makes clear that it is the relative performance of the *service sector* that largely accounts for the bigger impact of the recession in Scotland. Complicating this picture is the fact that some sectors began to recover sooner in the UK such as *construction* and in Scotland, such as *manufacturing* and *other services*.

Service sector GVA in Scotland fell by -4.76% while the contraction in UK services amounts to -4.59%. Within services, the sectors that performed worst over the recession relative to their UK counterparts were: *financial services* (-18.16% in Scotland compared to -6.42% in the UK); *REBS* (-11.60% in Scotland, -6.34% in the UK); and *hotels & catering* (-11.26% in Scotland, -8.81% in the UK). In contrast, 3 service sectors did better over the recession than their counterparts in the UK: *retail & wholesale* (-3.80% in Scotland, -6.45% in the UK); *transport & communication* (-3.72% in Scotland, -6.93% in the UK); and *other services* (-6.64% in Scotland, -10.06% in the UK).

Construction output has fallen by -13.08% in Scotland if the start of the sector's recession is dated as 2008q2, which compares with a fall of -14.07% in the UK if the start of the sector's recession is dated as 2008q1 to the trough of 2009q1. However, there is a good case for arguing that the recession, or structural downturn, in Scottish construction began after 2006q3, which was not mirrored in the UK. The loss of output in Scottish construction over this longer period amounts to -15.47%. UK construction, in contrast, has displayed a classic 'V' shape with a sharp and deep downturn followed by rapid recovery of 2.5% between 2009q1 and 2009q3.

Manufacturing sectors have suffered more in the recession both in Scotland and the UK. Scottish manufacturing GVA fell by -11.28% during the recession, less than the fall of -14.22% in UK manufacturing. Within manufacturing, *electronics* lost -15.33% of its Scottish GVA but -17.12% of its UK GVA in the recession. The chemicals industry in Scotland was the biggest affected with GVA dropping by -25.48% in just four quarters compared to the UK where GVA fell by -6.49% in six quarters.

As we noted in the previous **Commentary** these data highlight some of the key dimensions of the present recession: its roots in the bursting of a commercial property and housing bubble and the indirect world-wide consequences for trade significantly depressing manufacturing output due to the much greater importance of export activity in the sector.

One aspect of the present recession is that the labour market outcomes have been appreciably different from the impact on output. This is illustrated in Figure 8.

What Figure 8 shows is that while Scottish GVA has fallen by -6.13% over the recession, the number of employee jobs has fallen by only -2.67%. In these circumstances you would expect the average productivity of workers to fall. There is evidence that this has happened in the UK and that the drop in worker productivity parallels the fall in previous UK recessions (See Myers 2009, cited in **Labour Market Review** section below.) As that section notes, the apparently smaller impact of the recession on jobs than on output has been linked to the 'flexible' labour market. There is clear evidence that many employers have introduced more flexible working, reducing overtime and, to a lesser extent, implementing short-time working. Some of the impact of this can now be seen in official statistics, with for example, the average weekly hours of work falling in Scotland across most categories of employment. So, the average for all workers has dropped from 32.2 hours to 32 hours, a fall of -0.6%, while the average for full-time workers has dropped from 36.9 hours to 36.7 hours, a fall of -0.5%.

To the extent that it is more easy to cut labour hours via short-time working than it once was, then employers may be less likely to make workers redundant in the short-run. Productivity per hour will not drop by as much as productivity per worker and coupled with lower labour payments competitiveness will suffer less. But it is arguable that a flexible labour market also makes it easier to dispense with the services of workers. If the recession is expected to persist, or the recovery expected to be very sluggish, then job shedding could pick up and unemployment continue to rise. Moreover, given that many workers are now on reduced hours and worker productivity low then a recovery in demand for goods and services and rising output may be met, initially at least, more by a rise in hours worked per worker than an increase in job creation.

Macro policy and the UK and Scottish economies

We hold the view that without the significant injection of demand made possible by a monetary and fiscal policy expansion, the UK and Scotland, along with the US and many other key economies, would in all likelihood have experienced a loss of output comparable to that of the Great Depression in the 1930s. In the UK the programme of monetary expansion, known as quantitative easing, has injected around £200 billion into the UK economy. Yet, as the Governor of the Bank of England, Mervyn King, pointed out in his speech at the University of Exeter on 19 January 2010, the growth in stock of broad money in the UK

Figure 5: Scottish and UK financial services GVA growth at constant basic prices 1998q2 to 2009q3

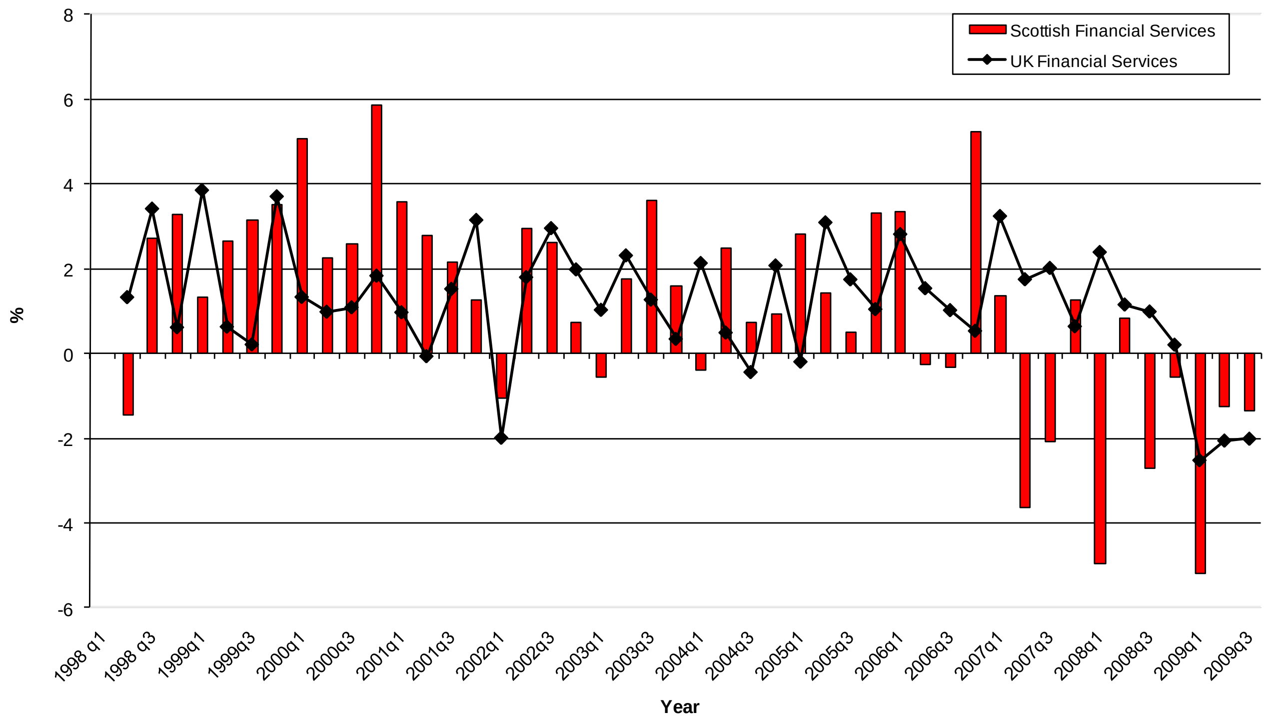
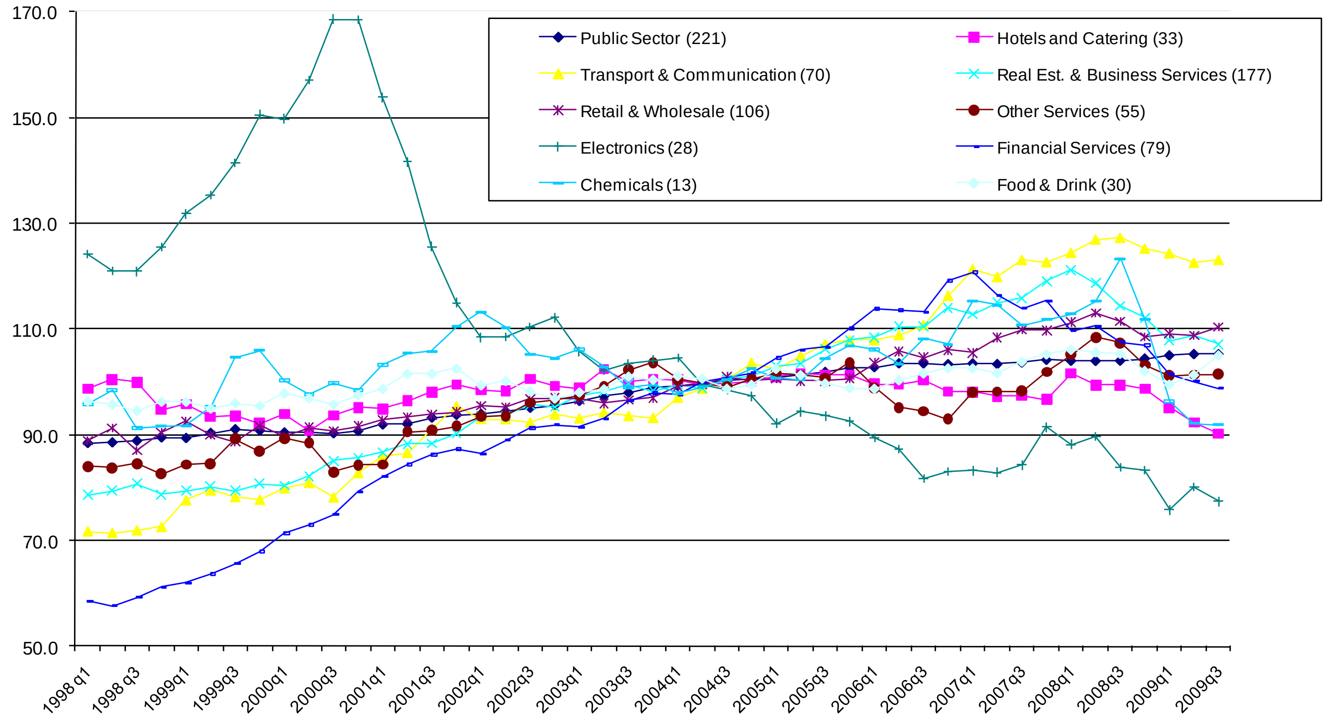


Figure 6: Growth of key sectors in Scotland 1998q2 to 2009q3



economy, while positive, is still much below the 5% to 10% annual rate of growth experienced in normal circumstances. In the United States the growth of money stock is virtually static and in Europe it is slightly negative. These figures provide an indication of the scale and significance of the contraction in bank balance sheets due to the 'credit crunch'. Without the programme of quantitative easing the monetary squeeze on the UK economy would have been, in the Governor's words, 'potentially disastrous'.

Similarly, the fiscal injection has sought to compensate for the significant drop in private sector demand for British goods and services as households and companies sought to reduce their high indebtedness. The most striking example of this is the rapid rise in the household saving ratio, which is shown in Figure 9. The ratio was negative in the first quarter of 2008 (-0.7%) but as recession started to bite it rose sharply, so that by in 2009 Q3 it had risen by 7.7 percentage points above the same quarter a year earlier to 8.6%. This was, as the Bank of England notes in its February *Inflation Report:* "the largest four-quarter increase in the saving ratio since records began in 1955." This outcome is further underlined by Figure 10, which shows the financial balances of the public, private and foreign sectors as a percentage of UK national income since 1955. In accounting terms all balances sum to zero. From the figure it is clear that the foreign surplus or deficit on UK current account has persisted for some time, at least since the late 1990s. But the big recent movements are the rapid growth in the public sector deficit as the private sector balance went from negative to positive, paralleling the rise in the household saving ratio. The figure shows that much the same happened in the early 1990's UK recession.

As a result of this, the UK now has public sector deficit that stands at 12.6% of national income and according to IMF estimates the structural, or permanent non-cyclical, component amounts to 7.8% points. A structural deficit of nearly 8% of GDP is clearly unsustainable. UK public sector net debt stands currently just under 60% of GDP and with present assumptions of GDP growth and likely interest rates the net debt position would reach 100% of GDP in 5 or six years. While net debt of 100% of GDP, if stabilised, need not be unsustainable, the level of interest payments on the debt will begin to crowd out other public sector expenditure. On present policies the *2009 Pre-Budget Report* UK net debt is forecast to be around 80% of GDP in 2014-15, which as Figure 11 shows is not wholly unusual by historical standards.

Figure 11 reveals that for half of the twentieth century net debt levels were above 80% of GDP. This of course embraces extreme circumstances such as both World Wars but those events led to net debt levels considerably above 100%, which is no way currently in prospect for Britain.

The IMF estimated in November 2009 that on current policies UK net interest payments will rise from 1.6% of GDP in 2007 to 3.1% in 2014. This is not trivial and would amount to around £50 billion per year from £35 billion in 2009. Yet, the IMF forecasts that 6 of the G-20 countries would have a net interest payment share of GDP in 2014 greater than the UK: Italy (6.2%), India (5.6%), Turkey (5.4%), United States (4.5%), Brazil (4.3%) and France (3.2%). The average for all the advanced G-20 countries is also forecast to be greater (3.5%). (Greece is not included in the analysis). A 3.1% net interest payment share of GDP would according to the IMF amount to 8.3% of UK fiscal revenues. Figure 12 indicates that net interest payments of at least 3% of GDP per annum existed for seventy five years between 1916 and 1991, which should put the present crisis into context. Some experts argue that it is only when debt interest payments rise to 12% of GDP that a government is likely to default (see http://www.ukpublicspending.co.uk/debt_brief.php). This may be too high and it seems not unlikely that a default could occur before interest payments reached a third of fiscal revenues - the likely analogue of 12% of GDP.

In view of this background we believe it is incorrect, as some commentators have done, to suggest that the UK is in the same category as Greece in terms of risk of default . As the BBC's Economics Editor, Stephanie Flanders, has pointed out, the fact that the UK has a budget deficit that's comparable to Greece is not sufficient to put the UK into the same category as Greece. The main differences are:

- the debt to GDP ratio is currently well over 110% in Greece and under 60% in the UK;
- Greek debt servicing costs are now just under 12% of GDP, in the current debt costs are under 3% of GDP;
- the average maturity of UK sovereign debt is 14 years, compared to 4 years in the US, 6 or 7years in France and Germany, and in Greece it is even lower with 10% of debt maturing in a few months. So, despite the size of the UK budget deficit, Germany, France and Italy, will all issue absolutely more sovereign debt on the markets than the UK in 2010;
- Greece has a severe competitiveness problem, which the country is unable to address independently through a downward exchange rate adjustment. The UK current account deficit stands at only 2.5% of GDP and we have experienced a 25% devaluation since before the recession in mid 2007. Greece has a current account deficit of 11% of GDP and no way of addressing this, if it remains within the eurozone, other than domestic downward adjustment of wages, other costs and prices. The UK has a basis for recovery higher GDP, higher tax revenues and lower public spending on transfer payments, which is denied Greece.

The UK is not Greece. But there is a lesson to be learnt from the Greek experience and it is this: granting full fiscal autonomy to a country/region within a larger monetary union

Figure 7: GVA Change over the recession to Q3 2009 or latest trough

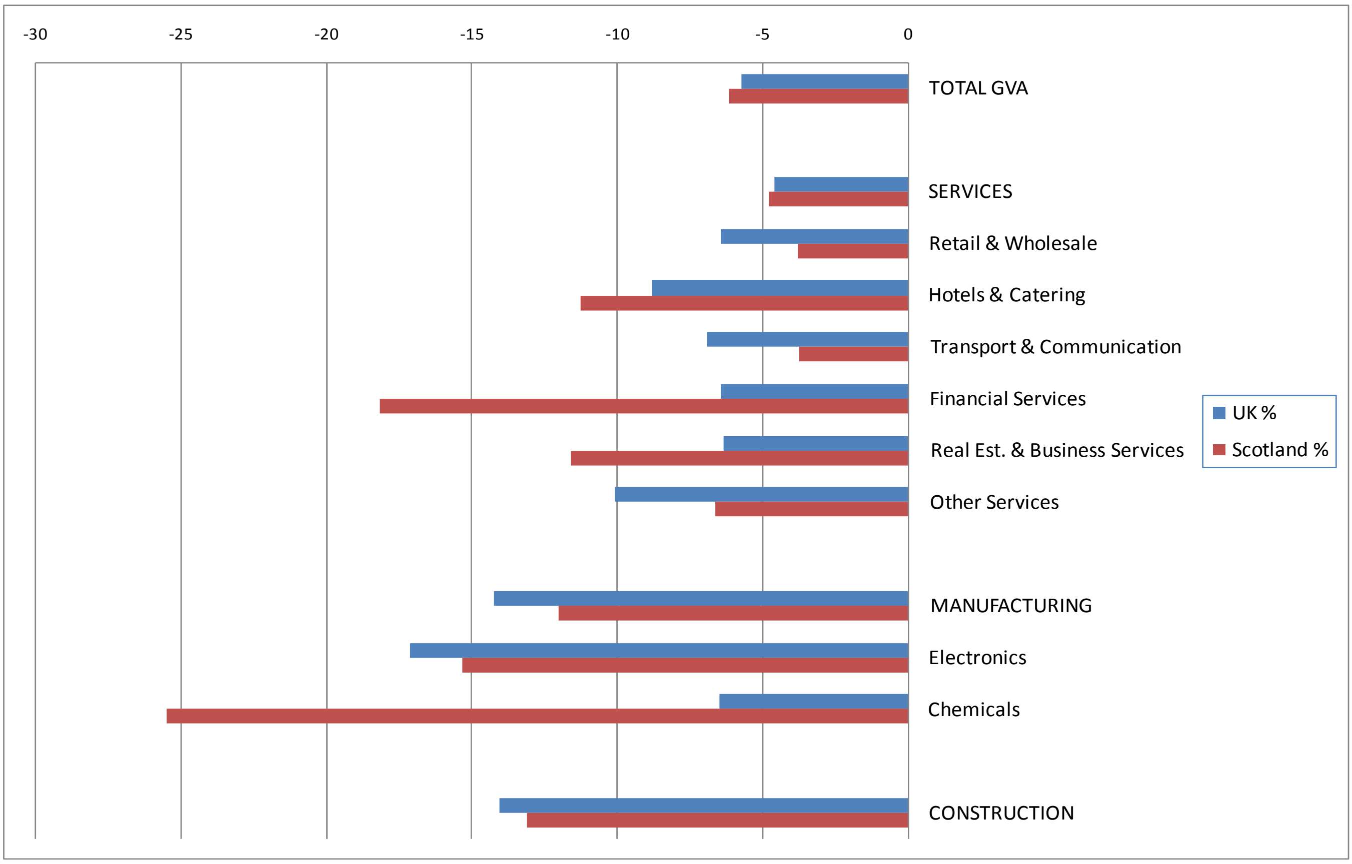
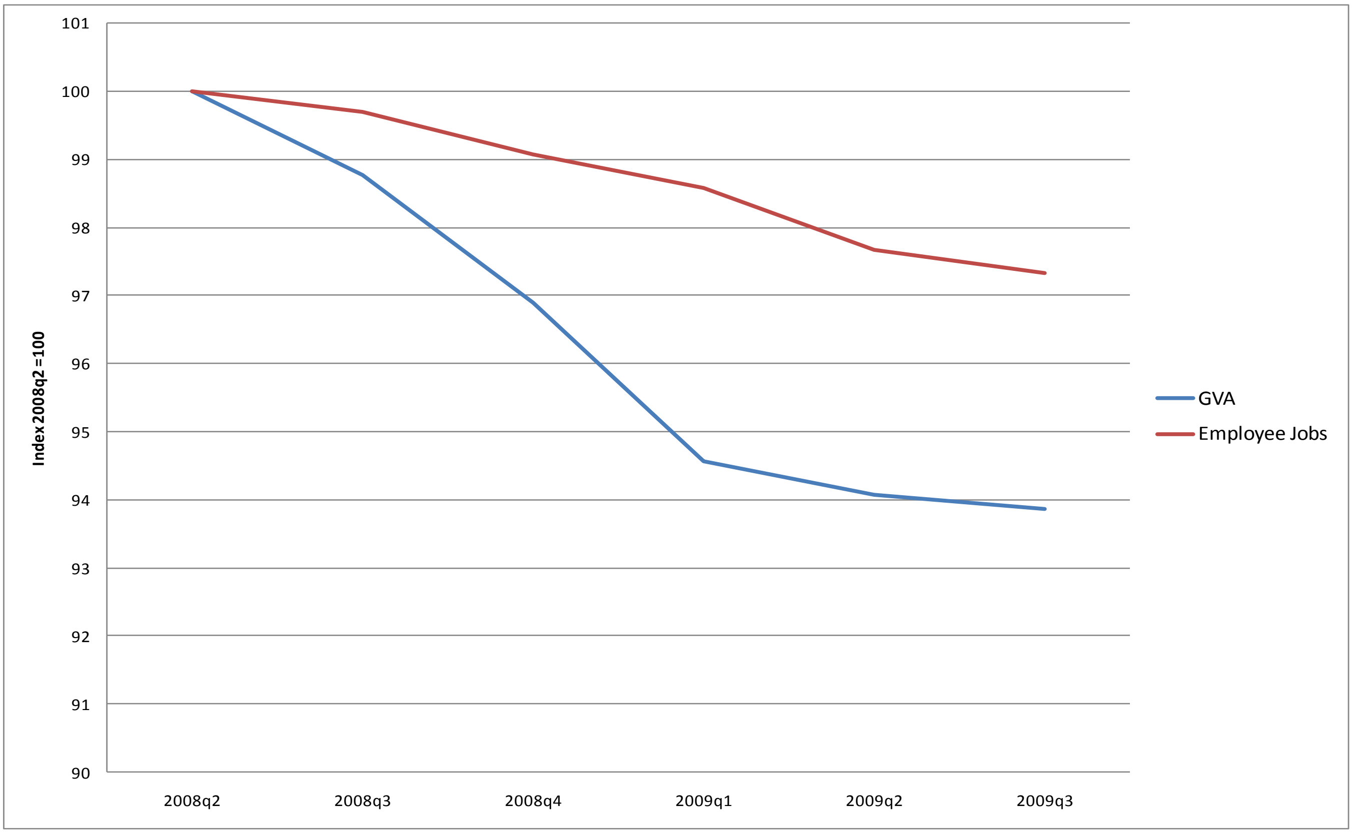


Figure 8: Output and jobs in the recession



runs the risk of a fiscal crisis that can threaten the union because the financial markets will not discipline fiscal laxity in any one country/region sufficiently early enough. The discipline needs to come from the political centre and that means that complete fiscal autonomy is ruled out, although some degree of fiscal devolution is clearly feasible.

All of this is not to deny the need for a sizable adjustment in the UK's fiscal position. There is a case to argue that the government needs to set out in its March Budget a more credible and more clearly specified programme of fiscal tightening over the next five years than it did in the 2009 Pre-Budget Report. The IMF points out that removal of a structural deficit of the scale present in the UK - just under 8% of GDP - is not unprecedented. More than 20 advanced economies achieved improvements in their structural fiscal balances of 5% of GDP or more at least once in the past 40 years, while 10 countries achieved improvements in excess of 10% of GDP in that period. The UK government can and must do this. But there is room for debate around timing.

As Andrew Sentance of the Bank of England notes, the current problem of an imbalance between a large private surplus on the one hand and a large budget deficit on the other, is very similar to the situation that faced the UK in 1993 after the previous recession. The deficit in 1993 stood at 7.8% of GDP and this was reduced to 2% of national income in 1997 and a small surplus in 1998. A series of budgets raised taxes and restricted public expenditure but the process was also helped by reasonable GDP growth of 3% per annum. A more competitive pound sterling, as now, assisted the recovery along with a strong recovery in domestic private spending. The principle difference between now and then is that private spending is likely to be more constrained now due to the legacy of the financial crisis. The household sector has had to adjust from the significant deficit that emerged in the mid-2000s. It has now moved back to balance, as evidenced by the rise in the savings ratio noted above. But the question is how much further does the sector have to go in building up a financial surplus before it starts to raise its spending relative to income again? This is a key difference from the early 1990s when households were already in surplus having recovered from a move into deficit in the late 1980s. In addition, corporate surpluses are bigger than at the end of the 1990s recession and there is a question to be raised about how long these will be sustained before spending on re-stocking and new investment occurs.

It is because of this uncertainty about household and corporate spending that we have for some time urged caution about the timing of a fiscal consolidation. The UK and Argentina are the only two G-20 countries to have withdrawn their fiscal stimulus in 2010. The UK will still benefit from the effects of the automatic stabilisers but the overall fiscal stance in 2010-11 is shown by the *2009 Pre-Budget Report* to be negative. In our view this is dangerous given that UK households have the most adjustments to make to their balance sheets than households in other countries because the level of household debt was pre-crisis so high here. If the growth of world trade does start to pick up appreciably and this is likely later this year the UK should benefit disproportionately. Then there will be a real prospect of what the Bank of England and the government desires: a switch to export and investment led growth. But until that time given relatively flat household and corporate spending, a fiscal tightening in 2010, the ending of further quantitative easing this month, and the likely continuing sluggishness of bank lending, increases the risk of a double-dip recession this year.

Forecasts

The underlying economic situation has not changed significantly since we last reported in late November 2009. The UK economy crept out of recession in 2009q4. Scottish outturn data for the fourth quarter will not be available until April, so we must rely on surveys for information on the most recent performance.

The **Review of Business Surveys** section makes clear that the Scottish economy is in a better position than it was a year ago. But the review also makes clear that business sales and optimism trends in the fourth quarter were not as strong as the third quarter. There is concern that the Scottish economy faltered in the fourth quarter and this concern has carried over into the first quarter of this year with weaker retail sales data than south of the border, and unemployment, in the latest data for the final quarter of last year, rising at a faster rate, not only than the rest of the UK, but also western Europe. Mixed messages are also coming from the housing market with both the Lloyds TSB Scotland and Halifax Bank of Scotland producing surveys indicating falling Scottish house prices: -6.8% in the quarter to the end of January compared with a year before in the former, and -7% over the year to the end of December, nearly agrees, in the latter. In contrast, the UK Department of Communities and (English) Local Government announced on the same day that Scottish prices in the year to the end of December had risen by 3.8%.

None of this bodes well for the growth of Scottish household spending, which accounts for 42% of Scottish final demand. It is likely, however, that the Scottish Retail Consortium data for January are much influenced by one-off events such as the reinstatement of the temporary reduction in VAT at the end of the year, which may have led to some spending being brought forward. Moreover, the poor weather after Christmas in the New Year may have curtailed spending in January. But with weak house prices, rising unemployment and many households still seeking to adjust their personal balance sheets through higher saving, it seems unlikely that there will be much revival in spending in the first quarter of this year and perhaps the second quarter as well. We have noted that public spending will begin to tighten this year, although it is not predicted to begin falling until 2011. Investment looks to be weak, although some improvement in investment trends was noted in the latest Scottish

Figure 9: UK household savings ratio 2008q1 to 2009q3 (% of household income)

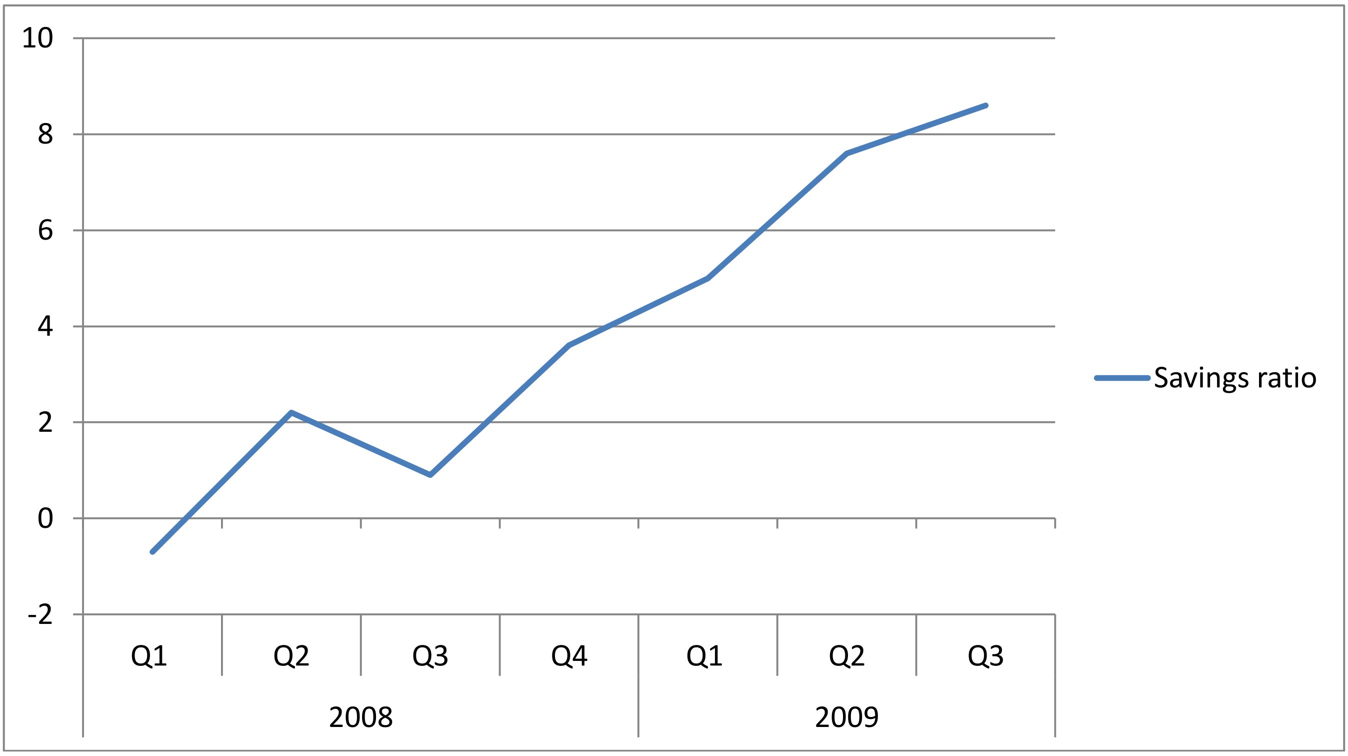
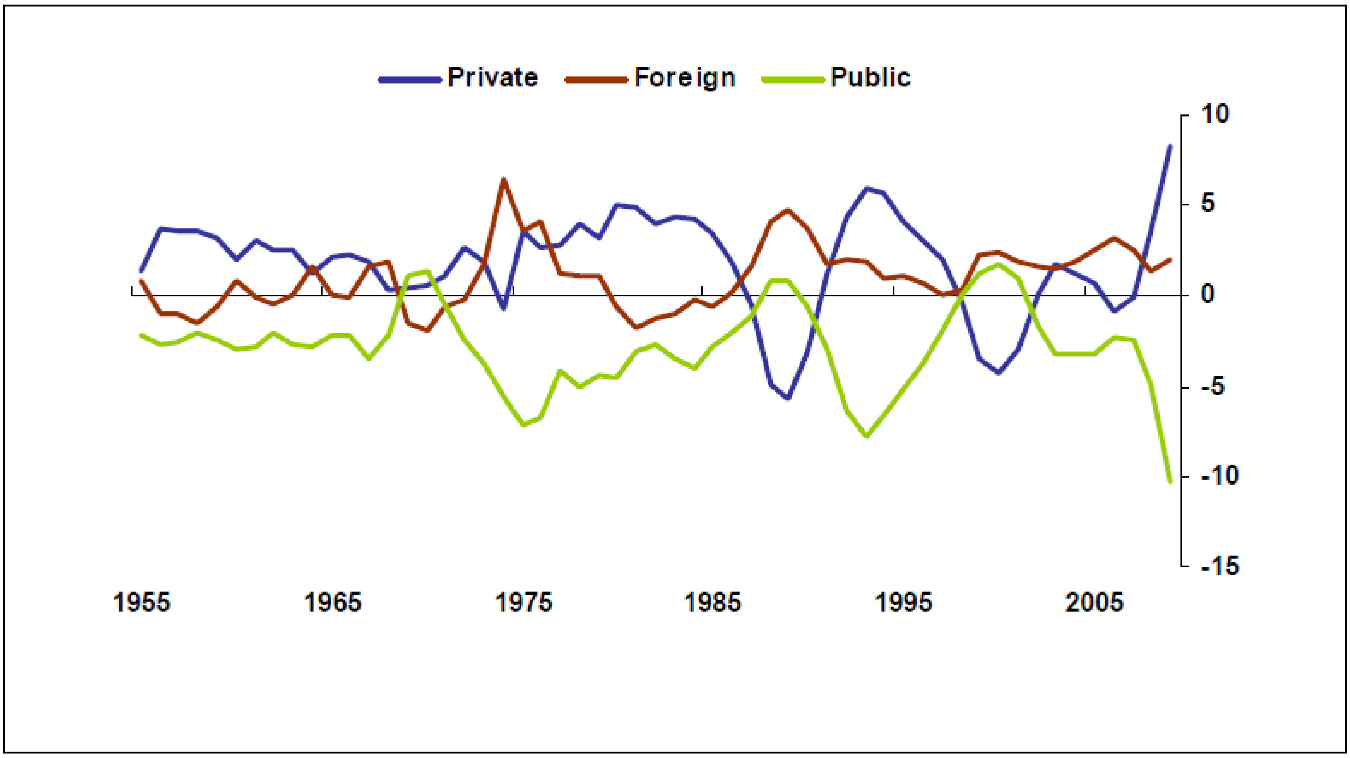


Figure 10: UK financial imbalances since 1955 – percent of national income



Source: Andrew Sentence speech, November 2009, Bank of England

Figure 11: UK net debt to GDP 1900 to 2011

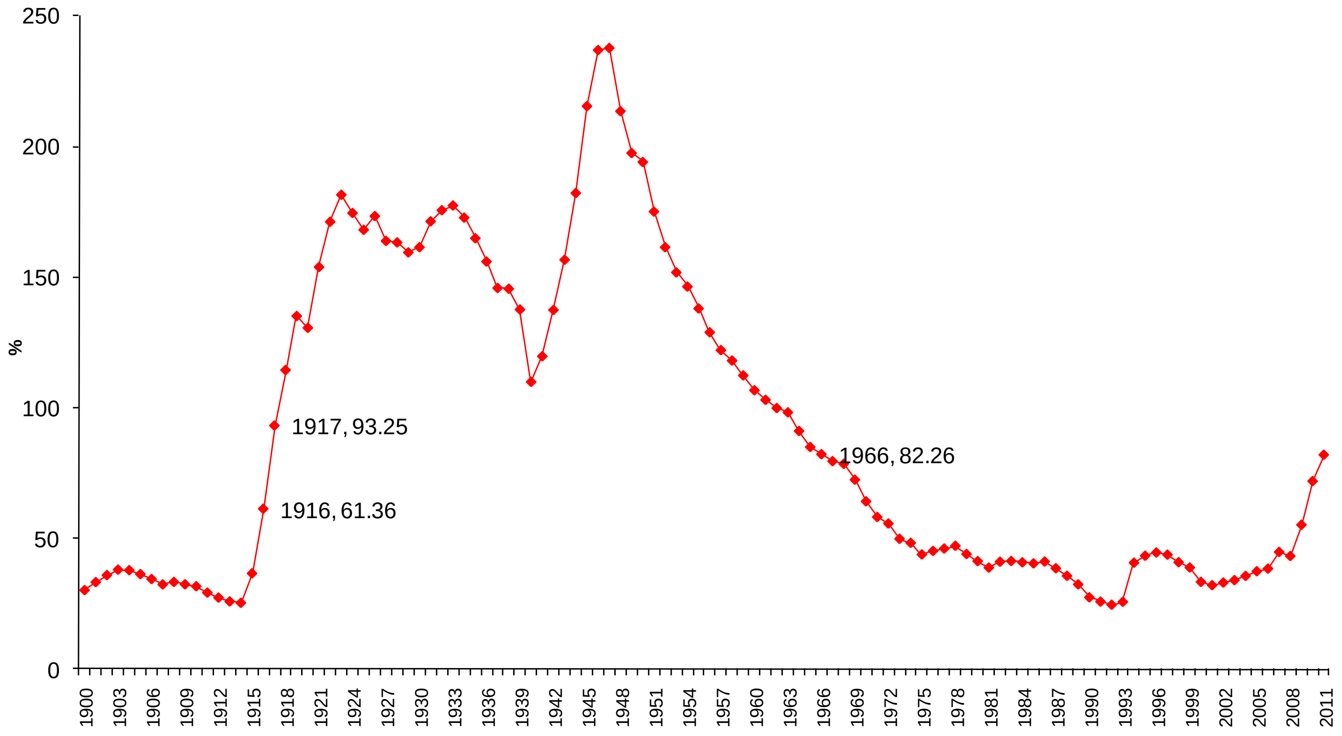
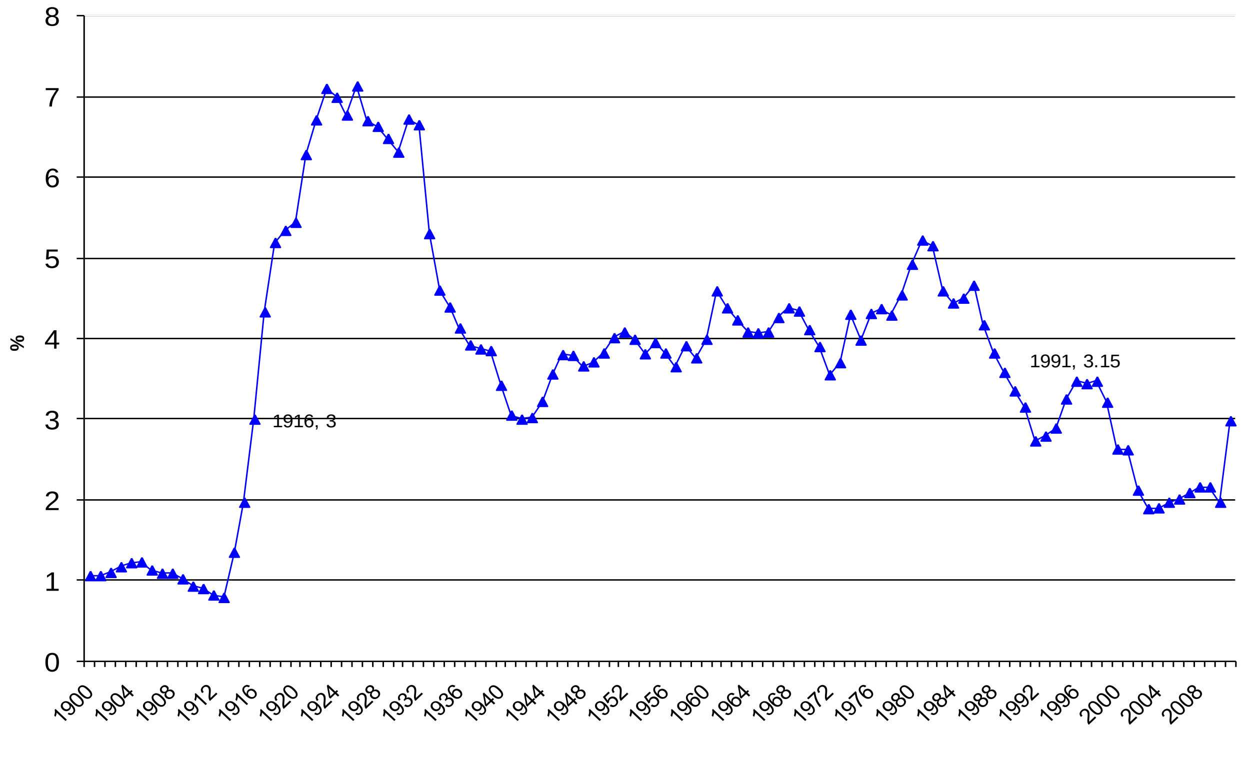


Figure 12: UK debt interest to GDP 1900 to 2011



Chambers' Business Survey (SCBS) but not in the CBI and Scottish Engineering surveys. However, there is stronger evidence that exports are beginning to pick up. In the latest Scottish business survey rising trends in export orders are observed, although in the SCBS the trend was weaker in the fourth quarter than in the third quarter 0f 2009.

Our latest forecasts for the Scottish economy have been prepared against the economic and policy background considered above and discussed in considerable detail along with the forecasts in the section on **Forecasts of the Scottish Economy** below.

Given the continuing climate of uncertainty and the significant data revisions to both Scottish and First Release UK data, we adopt the practice of recent **Fraser Economic Commentaries** and present three alternative scenarios for growth, employment and unemployment in the Scottish economy: we label the scenario that we feel is most likely "central", with "high growth" and "low growth" as two respectively upper and lower growth alternatives. The "central" scenario is that which is most likely, while the "high growth" and "low growth" scenarios reveal the range of possible outcomes for the Scottish economy foreseen for future developments from 2009 through 2010 to 2012.

GVA Forecasts

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

GVA Growth (% per annum)		**2009**	**2010**	**2011**	**2012**
High growth		-4.7	1.7	2.2	2.8
	November forecast	*-4.9*	*1.6*	*1.8*	*2.1*
Central		**-4.8**	**0.6**	**1.6**	**2.2**
	November forecast	*-5.0*	*0.1*	*1.1*	*1.6*
Low growth		-4.9	-0.7	-0.3	0.8
	November forecast	*-5.2*	*-0.7*	*-0.1*	*0.5*

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

		2009	**2010**	**2011**	**2012**
High growth		-60,488	-9,785	30,253	57,213
	June forecast	*-62,827*	*-23,152*	*33,584*	*45,174*
Central		**-64,218**	**-32,264**	**18,277**	**44,612**
	June forecast	*-84,399*	*-51,451*	*11,301*	*26,824*
Low growth		-77,861	-57,002	-16,538	13,631
	June forecast	*103,579*	*-66,894*	*-3,722*	*6,847*

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

		2009	**2010**	**2011**	**2012**
ILO unemployment rate					
High growth		7.6%	7.3%	5.6%	3.6%
Central		**7.6%**	**8.1%**	**7.3%**	**6.3%**
	Numbers	200,082	216,200	185,700	144,200
Low growth		7.6%	9.9%	10.1%	9.8%
Claimant count rate					
High growth		4.9%	4.4%	3.4%	2.4%
Central		**4.9%**	**5.4%**	**4.6%**	**3.7%**
	Numbers	136,821	148,000	127,000	99,000
Low growth		4.9%	6.8%	7.0%	6.7%

The key forecasts are summarised in Table 1 along with our November forecasts for comparison. We shall primarily focus on our central forecast here. It is clear that we have revised upwards slightly our GVA forecast for 2009 to
-4.8%. The narrow gap between the forecasts on the three scenarios for 2009 is mainly due to the fact that we already have three of the four quarters of outturn data. Scotland is forecast to return to positive growth in 2010. But the recovery over the year is weak, household spending strengthens but continues to fall. Exports to the rest of the world continue to recover and at a faster rate than predicted in November. This along with some recovery of investment, though still negative, helps raise the forecast to 0.6% growth compared to our prediction of 0.1% in November. Recovery is weaker in Scotland than in the UK for the reasons that were well rehearsed in the previous Commentary and we see no basis for altering that view. Scottish GVA growth is better than the UK on the High growth scenario only. Trend growth is realised on our Central scenario in 2012.

Employment Forecasts

The key forecasts are summarised in Table 2. Employee job losses continue from 2009 into 2010, with a net 96,000 jobs lost in those two years and not fully matched by job gains of 63,000 in 2011 and 2012. At the sectoral level, services experiences the greatest decline in jobs in 2009 and 2010 with 42,000 net jobs lost. Job losses in financial services accounts for 16,500 of the service sector job losses. Construction job losses amount to nearly 27,000 over the two years and as with services the number of construction jobs in 2012 remains below 2008 levels but there is recovery in 2011 and 2012 of more than 3,000 jobs. Finally, the production sector which principally includes manufacturing sheds more than 17,000 jobs in 2009 and 2010 but through strong export growth net job creation in 2011 and 2012 of 26,000.

Unemployment Forecasts

The key unemployment forecasts are summarised in Table 3 above. On our Central forecast ILO unemployment is expected to peak at 216,000 or 8.1% this year falling to just under 186,000 or 7.3% in 2011 and further to 144,000 or 6.3% in 2012. However, if the recent trend in Scottish unemployment continues, which we think less likely, the rate could rise on our low growth scenario to 9.9%, or 264,000, this year, reaching a rate peak of 10.1%, or 257,000, in 2011 and then falling to 9.8%, or 224,000, in 2012.

Brian Ashcroft
19 February 2010