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Outlook and Appraisal

Overview

The growth of the Scottish economy continues to be weak, the labour market especially. GDP in constant prices fell by 0.4% in Scotland during the second quarter, the same loss of output as in the UK. Both the Scottish and UK economies have contracted for the three quarters up to the second quarter. But data for the third quarter show the UK economy to have expanded by 1%. We consider this to be an 'Olympics bounce' which is unlikely to affect Scotland to the same extent. Positive Scottish retail sales figures for the third quarter need to be set against the reports of several business surveys which depict growth as largely stagnating with household spending depressed and business confidence weak.

By the end of the second quarter Scottish GVA stood at -4.4% below the pre-recession peak four years ago. In contrast, the figure for UK GVA is -3.8%. This is despite the fact that the depth of the recession was a little greater in the UK, at -6.3%, than in Scotland, -5.8%. The recovery of UK GDP has been somewhat faster than in Scotland, all be it a weak recovery overall.

Manufacturing and electricity & gas supply contracted in the second quarter. The contraction in electricity & gas supply is likely to have been temporary for technical industry reasons. But the recent performance of manufacturing remains a cause for concern, especially in the light of recent weak export performance, with export volumes around 14 per cent below their 2007 peak and close to the 16.5 per cent fall experienced in the 2007-09 recession. The service sector has exhibited a more sustained recovery. But GVA is still nearly 3 per cent below pre-recession peak compared to 0.9 per cent below in the service sector in the UK as a whole. Within services there are some encouraging signs of a recovery developing in business and financial services. A look at the public sector shows government services GVA contributing to recent growth in the UK but not so in Scotland. The UK performance of government services appears anomalous. The construction sector appeared to halt its precipitate decline with growth of 2 per cent in the second quarter. But GVA in the sector still languishes 16 per cent below its pre-recession peak, much the same as UK construction.

The performance of the Scottish labour market and unemployment in particular is giving rise to increasing concern, both in itself and in comparison to the UK. Our analysis suggests that over the longer period of recession and partial

recovery, the main reasons for a rise in unemployment compared to the UK appear to be the somewhat stronger fall in output and the much greater decline in the demand for labour due, it would appear, to an economy-wide improvement - or lesser deterioration - in relative labour productivity. The reasons for this can only be speculated upon. One is the decline in oil and gas production which has high labour productivity and which is fully contained in the UK GDP data but only partially in the Scottish data. Another is the possibility that the internal labour markets of Scottish firms are less flexible on average than in the UK, with firms less willing to offer flexible working conditions and workers less willing to supply labour flexibly. This might also extend to a lesser willingness to seek and accept a reduction in real wages, or the price of labour, than their UK counterpart firms and workers. But we have no hard evidence for this.

The further deterioration of Scottish unemployment relative to the UK in the latest quarter to August seems, in the absence of published GDP data, to be because output growth was probably weaker here; productivity probably rose faster here, or fell by less, and hence jobs growth was disproportionately weaker here. Furthermore, the supply of labour rose disproportionately in Scotland relative to demand so worsening the outcome for unemployment.

Against this background of weakening domestic and foreign demand compared to earlier expectations we have revised down our forecasts. So, we are now forecasting GDP growth of -0.1% in 2012, 1.3% in 2013, and 2.2% in 2014. For employment, net jobs are forecast to contract by -1.1% in 2012, then grow by 0.8% in 2013, and by 1.3% in 2014. The number of employee jobs in Scotland is forecast to decline during 2012 by more than 25,000 jobs. The vast majority of these job losses are projected to be in the service sector (22,750) and construction (2,550). For unemployment, on the ILO measure we are projecting the number to reach 225,134 at the end of 2012. The unemployment position is expected to deteriorate slightly in 2013 compared to 2012 due to weaker output and employment growth. Unemployment is now forecast to be 234,603 by the end of 2013. In 2014, unemployment falls to 228,740 as growth and job creation pick up during the year.

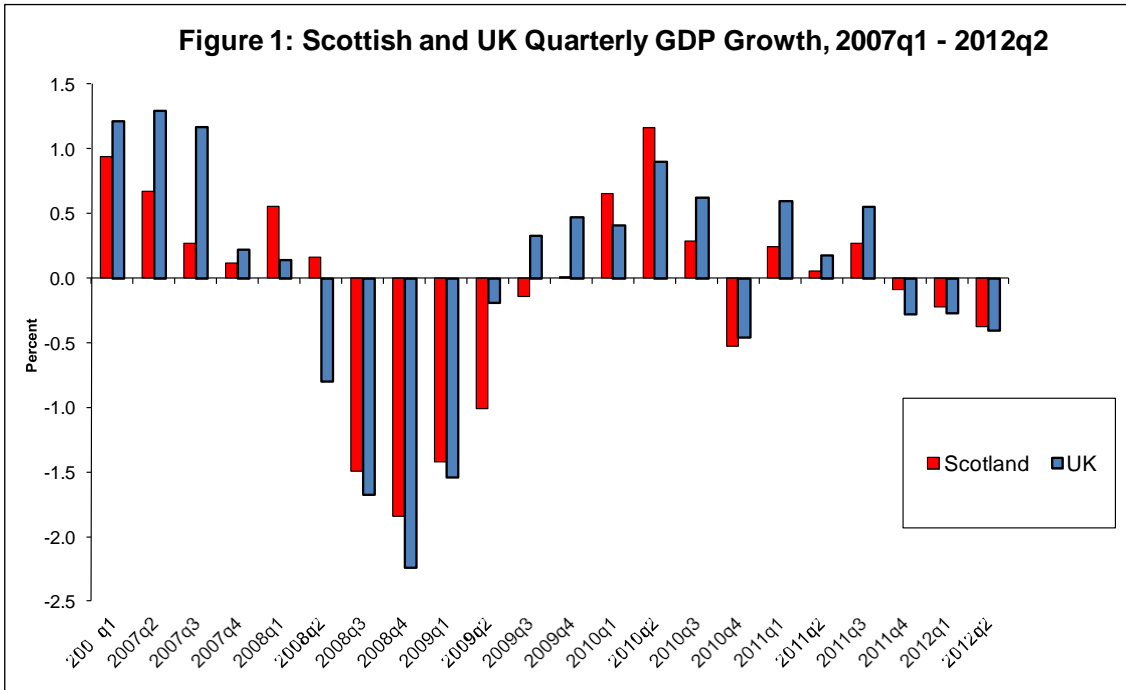
Recent GDP performance

GDP in constant prices fell by 0.4% in Scotland during the second quarter, the same loss of output as in the UK. Both the Scottish and UK economies have contracted for the three quarters up to the second quarter as Figure 1 shows.

This is clear evidence of a recession, although thankfully not as steep as 2008-09. We wouldn't expect it to be as steep of course. Because what we are experiencing is effectively an aftershock of that Great Recession.

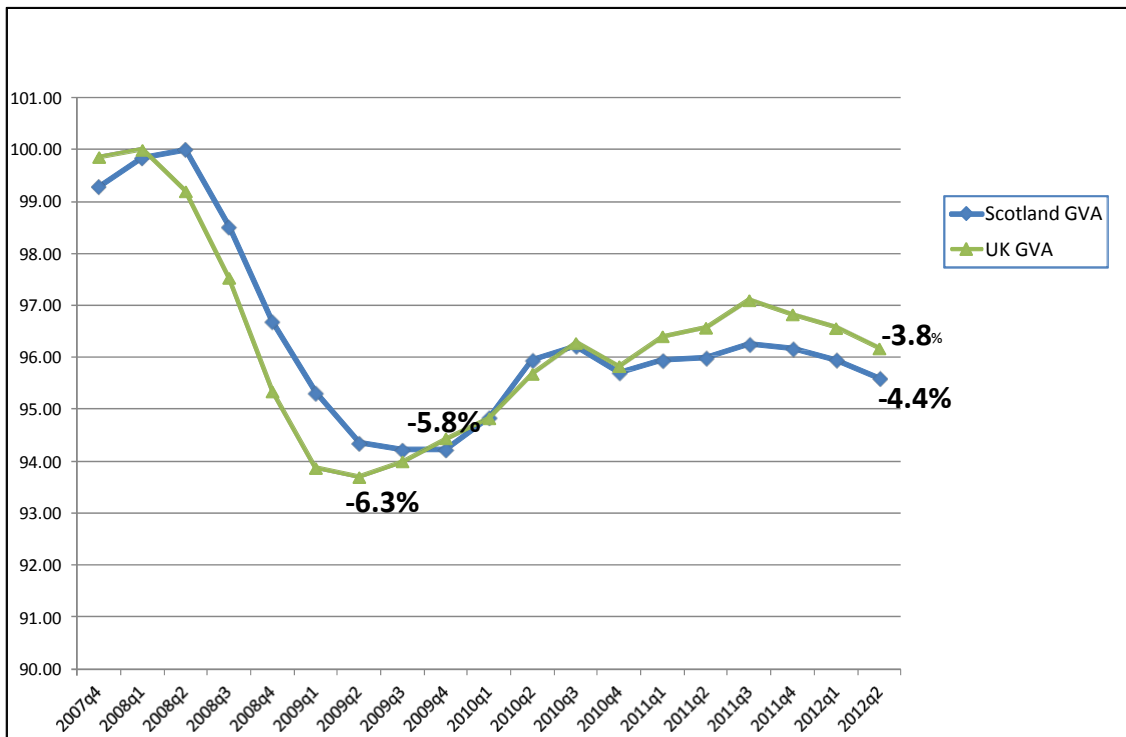
Over the year, the Scottish economy has experienced zero growth compared to slight growth of 0.4 per cent in the UK. It seems unlikely that there will be much improvement in that annual growth by the time we reach the end of the year, unless there is a mini-boom in output in the second half of the year. However, all the indications are, from surveys and casual empiricism, that that will not happen in Scotland. The provisional estimate for UK GDP growth in the third quarter was an encouraging 1%. However, around

0.2% to 0.3% points of this can be ascribed to the contribution to GDP of Olympic ticket sales. In addition, GDP growth was temporarily lower in the second quarter because of the Jubilee holiday. So, while subject to revisions, the data do suggest that the UK economy moved out of recession in the third quarter, it is likely that underlying growth is not strong. There are some straws in the wind but it is difficult to escape from the conclusion that the UK economy is largely stagnating, or bumping along the bottom, despite the evidence of a move out of recession.



Up to the second quarter both the Scottish and UK economies have still a considerable way to go to reach peak output prior to the 2008-2009 recession as Figure 2 shows.

Figure 2: GVA in recession and recovery Scotland and UK to 2012q2 (Relative to pre-recession peak)



By the end of the second quarter Scottish GVA stood at -4.4% below the pre-recession peak four years ago. In contrast, the figure for UK GVA is -3.8%. This is despite the fact that the depth of the recession was a little greater in the UK, at -6.3%, than in Scotland, -5.8%. The recovery of UK GDP has been somewhat faster than in Scotland, all be it a weak recovery overall.

Figure 3: GVA ex oil & gas, recession and recovery to 2012Q2

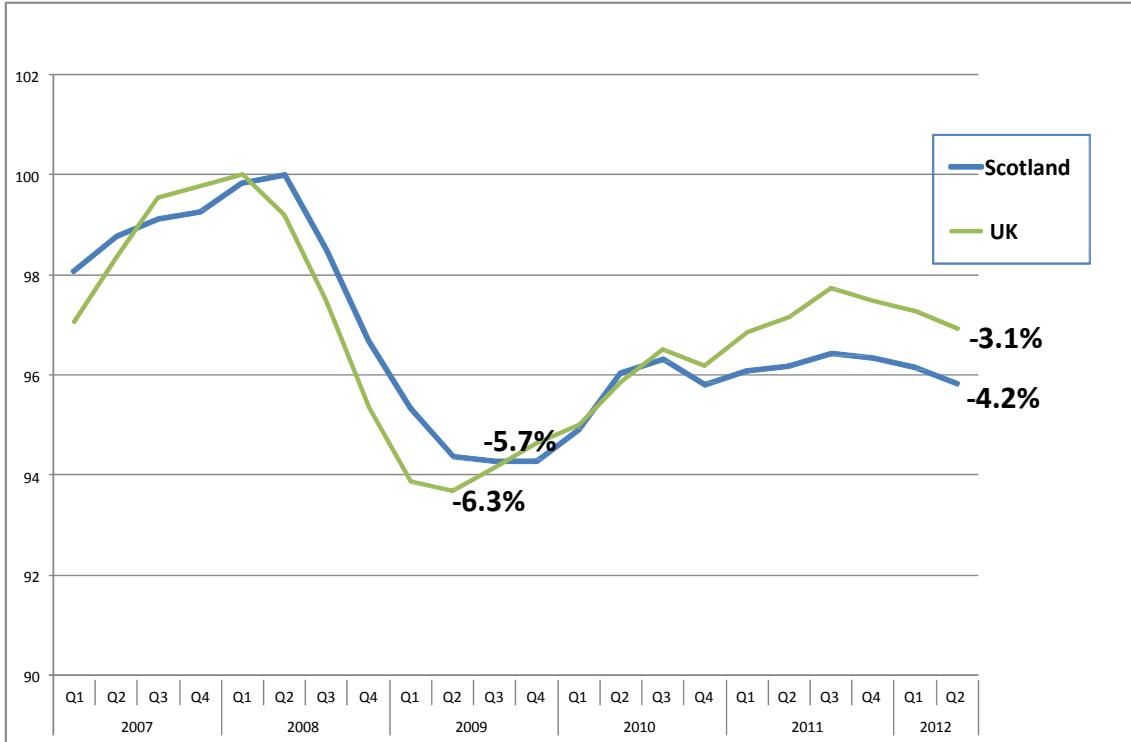
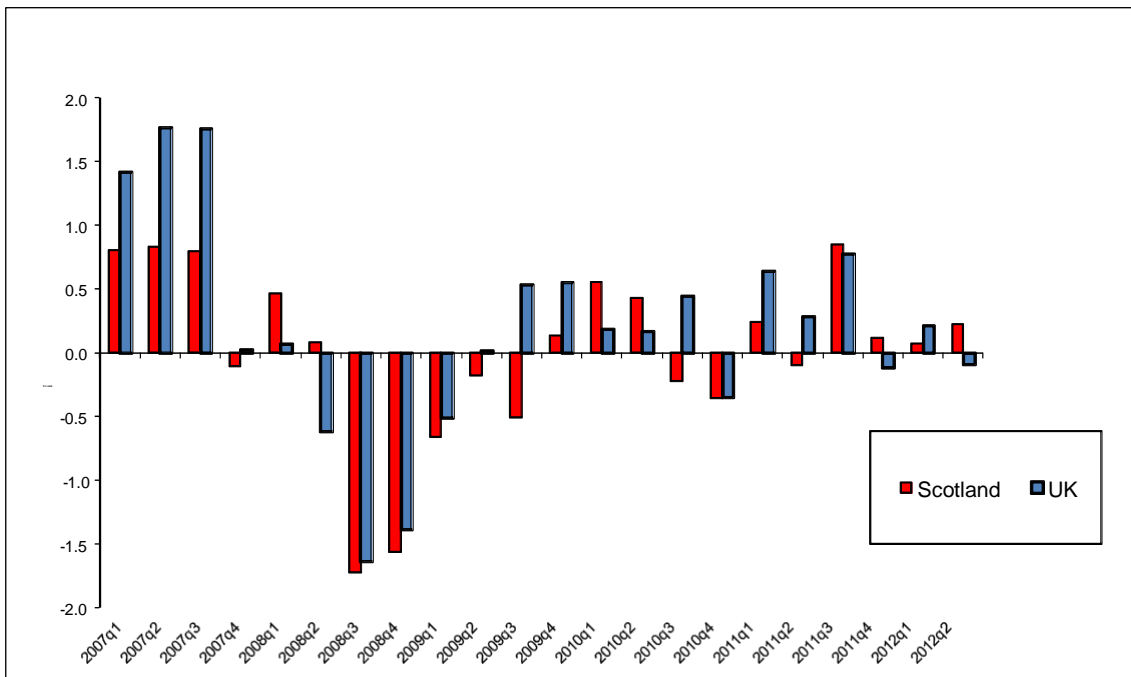


Figure 4: Scottish and UK Services GVA Growth 2007q1 to 2012q2



A final point on the aggregate output figures is that, as we noted in the previous *Commentary*, the Scottish recovery is flattered by the statistical quirk that the UK figures include all of oil production whereas the Scottish data do not. With oil production weak this has affected the Scottish-UK GDP relative as CPPR

previously pointed out. As the data excluding oil and gas production show, presented in Figure 3, the Scottish recovery from the Great Recession has more evidently been weaker than the UK.

Turning now to individual sectors of the economy, we see that the Scottish service sector, which accounts for 73% of GDP, grew by 0.2% in the second quarter, compared to a fall of -0.1% in UK services - see Figure 4. But UK services sector grew by 1.2% over the year while the growth of Scottish services was a little weaker at 1%. This underlying weakness of the recovery in Scottish services is again highlighted in Figure 5.

Figure 5: Services GVA in recession and recovery Scotland and UK to 2012q2

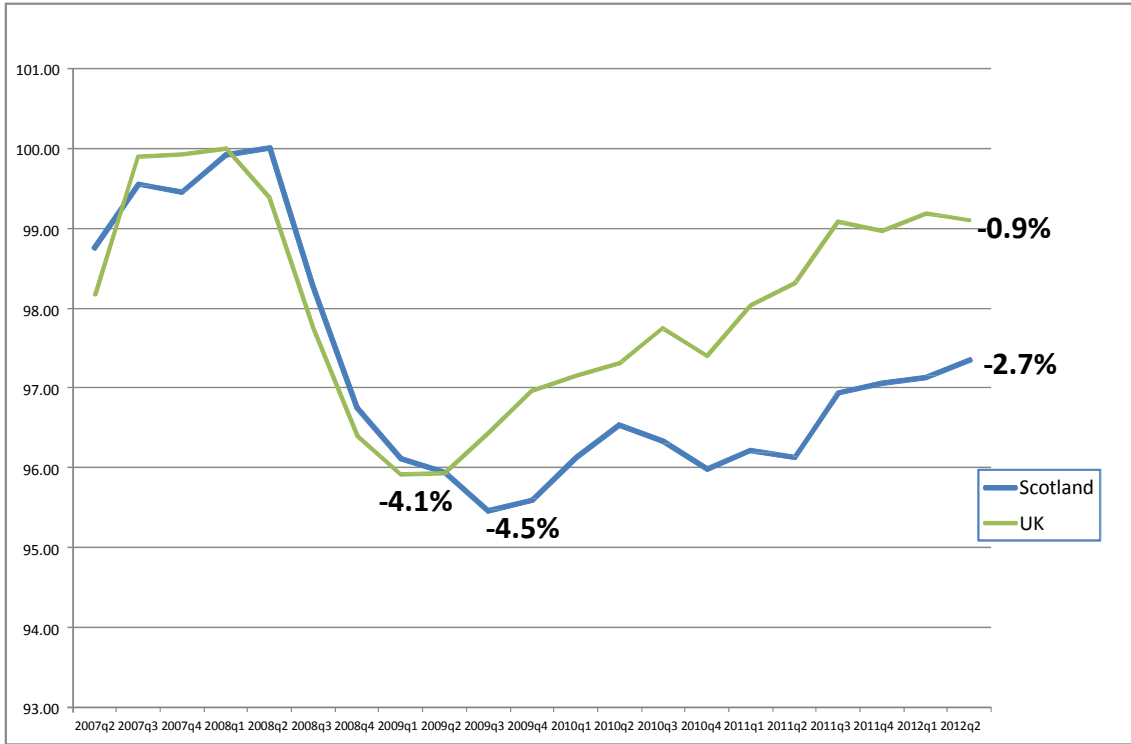
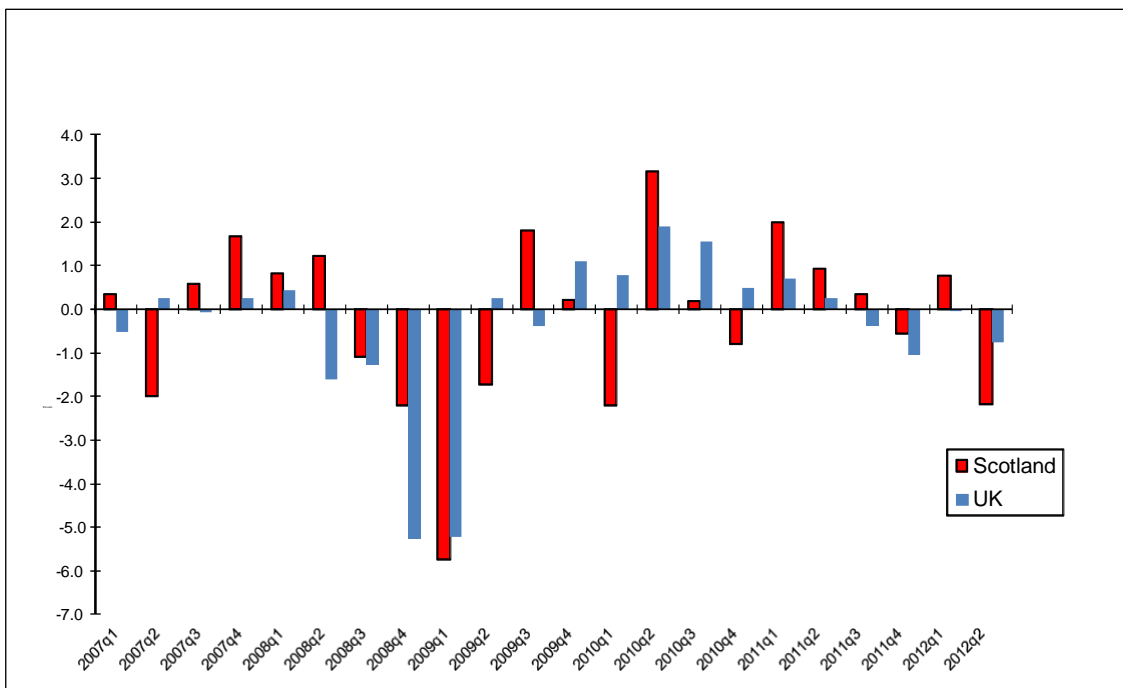


Figure 6: Scottish and UK Manufacturing GVA Growth at constant basic prices 2007q1 to 2012q2

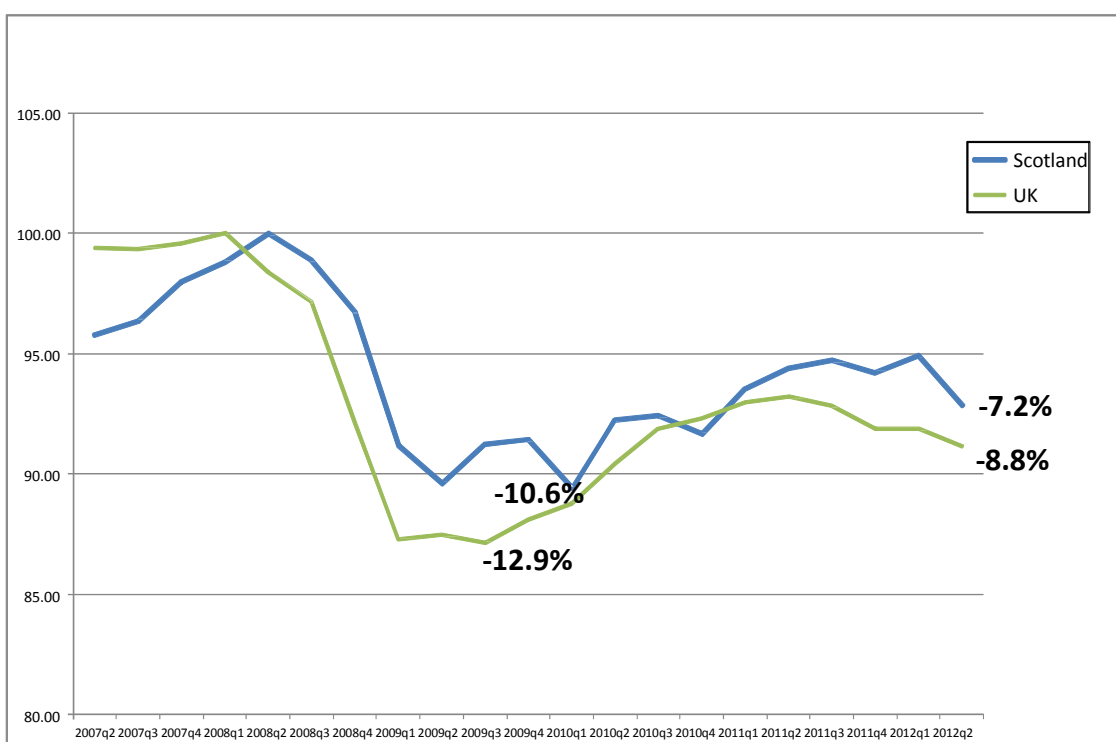


So, by the second quarter of this year, Scottish services GVA was still -2.7% below its pre-recession peak compared to -0.9% in the UK. On revised data the loss of Scottish service sector output in the recession was -4.5% a little more than the -4.1% output loss in services in the UK.

One issue that stands out from the latest Scottish data is the weakness of the production sector here. Output fell by 3.8 per cent compared to a fall of 0.7 per cent in the UK. The key reason for this was that the performance of Scottish manufacturing weakened considerably in the quarter as Figure 6 shows.

Manufacturing GVA fell by 2.2% in Scotland whereas in the UK the fall was 0.8%. In addition, Electricity and Gas Supply, which accounts for around 13% of production output in Scotland, fell by 15.1% in the quarter compared to a rise of 5.1% in the UK. This may have been due to the effect of high gas prices making Scottish gas fired power plants more marginal to UK energy supply. As the weather gets colder output should pick up again in this sector as more capacity is brought on stream as demand rises. So, it is the weakness of Scottish manufacturing that is the biggest concern after a stronger performance than UK manufacturing over the previous five quarters. As Figure 7 shows the fruits of that stronger recent recovery have been eroded by the latest setback. Scottish manufacturing GVA now stands at -7.2% below the 2009-09 pre-recession peak, while the figure for UK manufacturing is -8.8%.

Figure 7: Manufacturing GVA in recession and recovery Scotland and UK to 2012q2



The recent second quarter weakness in Scottish manufacturing appears to have been mainly due to a fall in production in the engineering sector, specifically Electronics (-5.5%), Textiles, Leather & Clothing (-3.8%), Other Manufacturing Industries including Repair (-3.1%), and Refined Petroleum, Chemical & Pharmaceutical Products (-2.4%). Within manufacturing, only mechanical engineering, transport equipment and food production showed positive growth in the second quarter in Scotland.

We noted in the previous *Commentary* that the construction sector was going through a very difficult time in both Scotland and the UK. Figure 8 charts the recent growth performance.

The good news is that after six quarters of negative growth Scottish construction bounced back in the second quarter with growth of 2% compared to a fall of 3% in the UK. But over the year, Scottish construction output fell by 10% compared to a fall of 3.2% in the UK. Figure 9 shows the performance of GVA in construction in Scotland and UK during the recession and recovery.

On revised data, the 2008-09 recession in construction was larger in Scotland than the UK with GVA falling 18.6% here and by 17.9% in the UK. Scottish construction did bounce back more strongly than its UK counterpart, until 2010 quarter 3 and then contracted for 6 successive quarters. If the stronger Scottish bounce back was the consequence of the Scottish government bring capital spending forward then it clearly didn't last. The subsequent fall in Scotland may well be related to fiscal consolidation where, so far,

the bulk of the cuts have fallen on capital expenditure and buildings especially. In the UK where there have been similar cutbacks in government capital expenditure, the impact on overall construction output might have been somewhat muted by the expenditure on construction projects associated with the Olympics. But even here the decline in construction output after the second quarter last year has led to both UK and Scottish construction output being not much higher than it was at the trough of the recession.

Figure 8: Scottish and UK Construction GVA Volume Growth 2007q1 2012q2

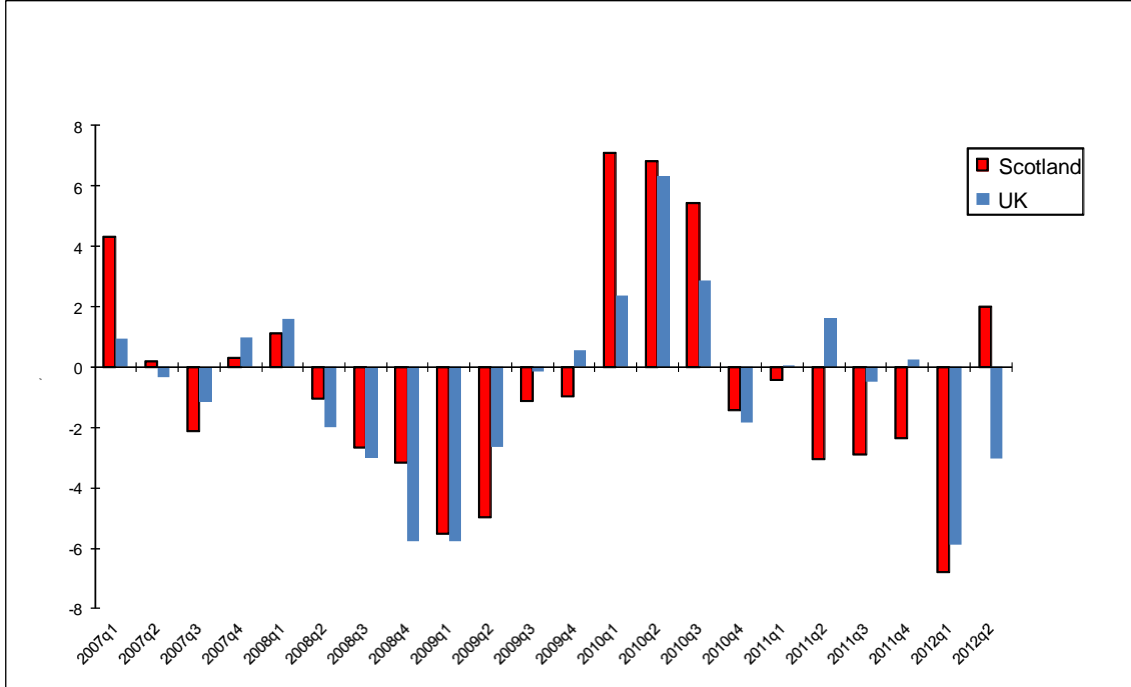
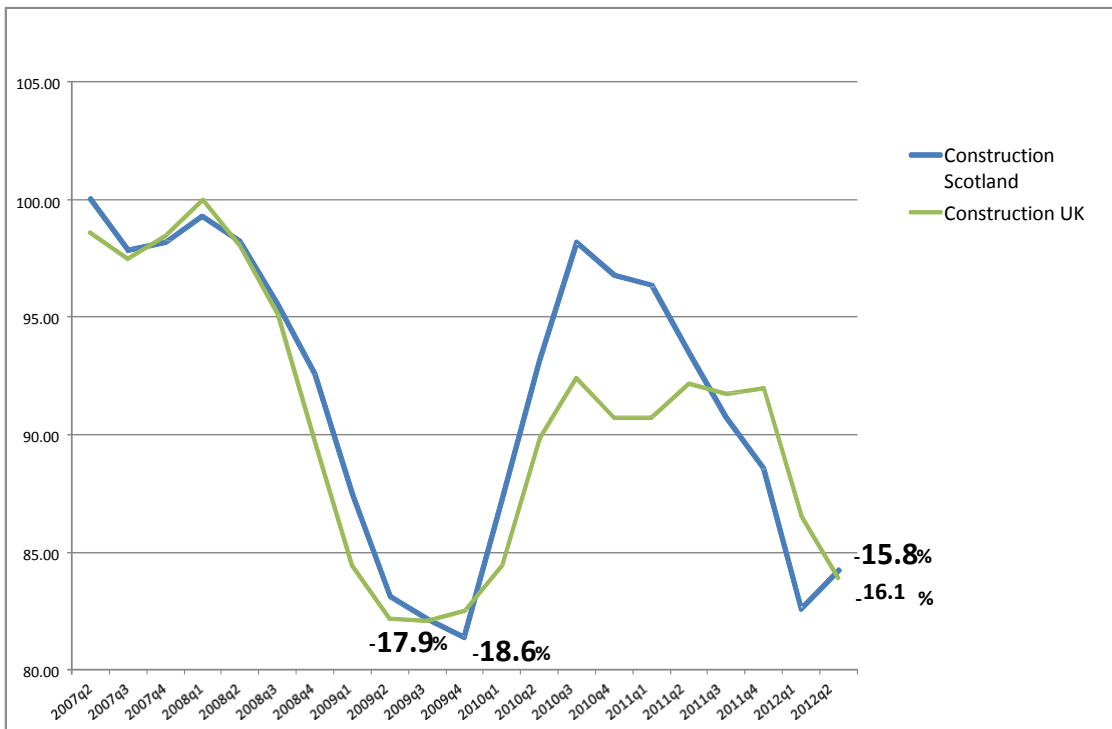


Figure 9: Construction, Recession and Recovery to 2012q2



Within services, the most important sector by contribution to GDP, business and financial services - 26% of overall GDP and 36% of service sector GVA - grew by 1.9% in Scotland while remaining flat in the UK during the second quarter. Over the year, the sector grew by only 2.6% in Scotland compared to slightly

weaker growth of 1.8% in the UK. Figure 10 shows the path of GVA in the sector during the recession and recovery relative to its pre-recession peak.

Figure 10: Business & Financial Services: Recession and Recovery to 2012q2

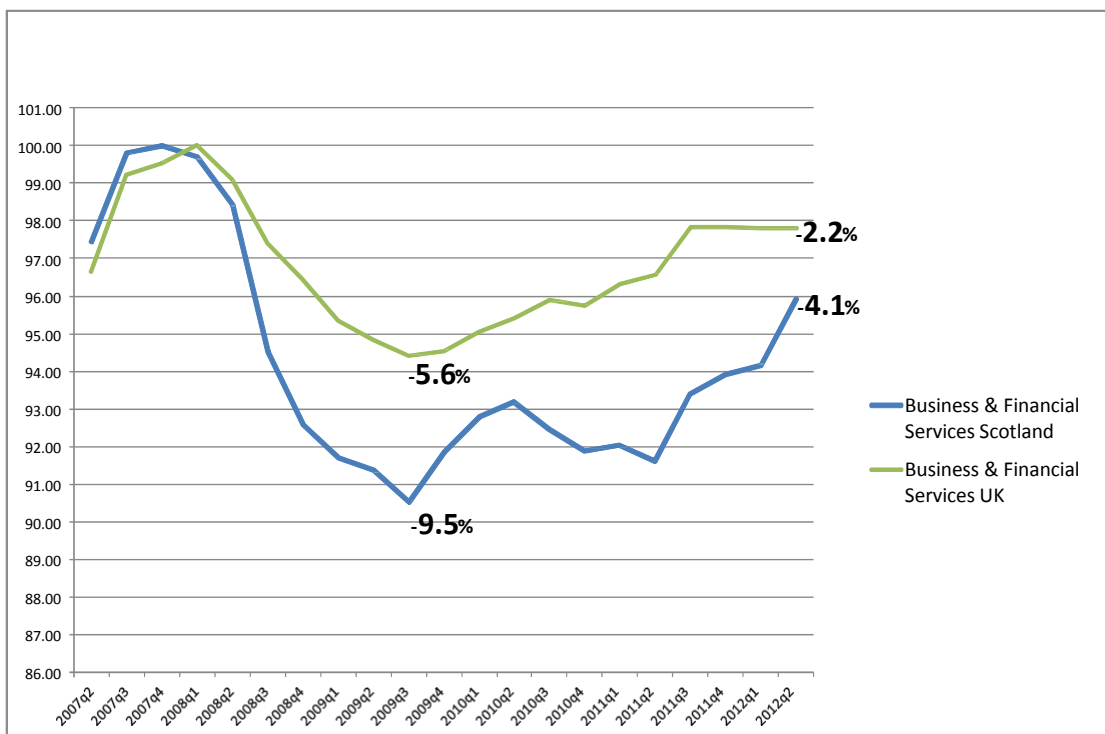
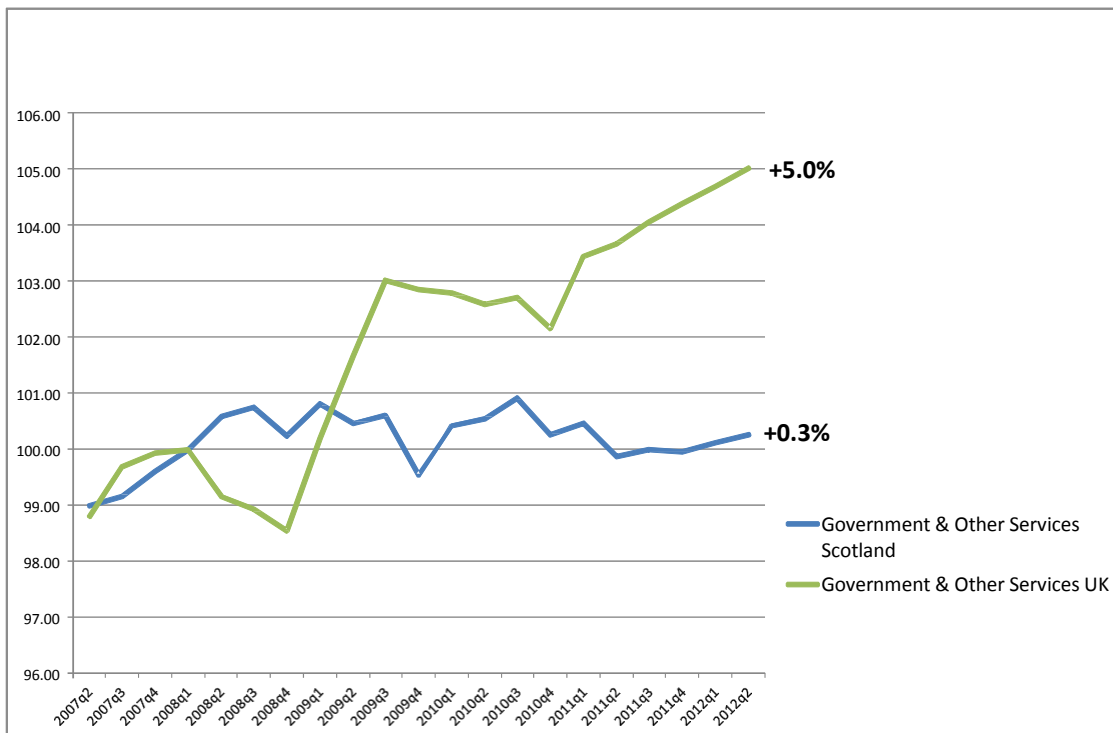


Figure 11: Government and Other Services: Recession and Recovery to 2012q2



As noted in the previous *Commentary* it is clear from the chart that this important sector experienced both a stronger recession in Scotland and a weaker recovery. On revised data, GVA fell by -5.6% in UK business and financial services during the recession whereas in Scotland the contraction was -9.5%. But since the end of last year, and since we last reported, it does appear that the sector in Scotland has

started to recover more strongly, which is encouraging. By the latest quarter the sector in the UK was -2.2% below its pre-recession peak but its Scottish counterpart was -4.1% below.

Elsewhere in services Distribution, Hotels and Catering was weaker in Scotland in the second, contracting by 1.5% compared to unchanged output in the UK. However, over the year the Scottish sector grew faster, by 1.9%, compared to 0.2% in the UK. Transport, Storage, Information & Communication contracted similarly in Scotland and the UK in the second quarter, with GVA falling by 1.5% in the former and 1.3% in the latter. But over the year output fell by 1.1% in the sector in Scotland while rising by 0.6% in the sector in the UK.

Government & Other Services GVA grew slightly by 0.1% in Scotland compared to growth of 0.3% in the UK. But over the year measured value added in the sector fell by 0.3% in Scotland compared to a rise of 1.5% in the UK. A closer look at the data for this sector reveals the UK position to be somewhat anomalous.

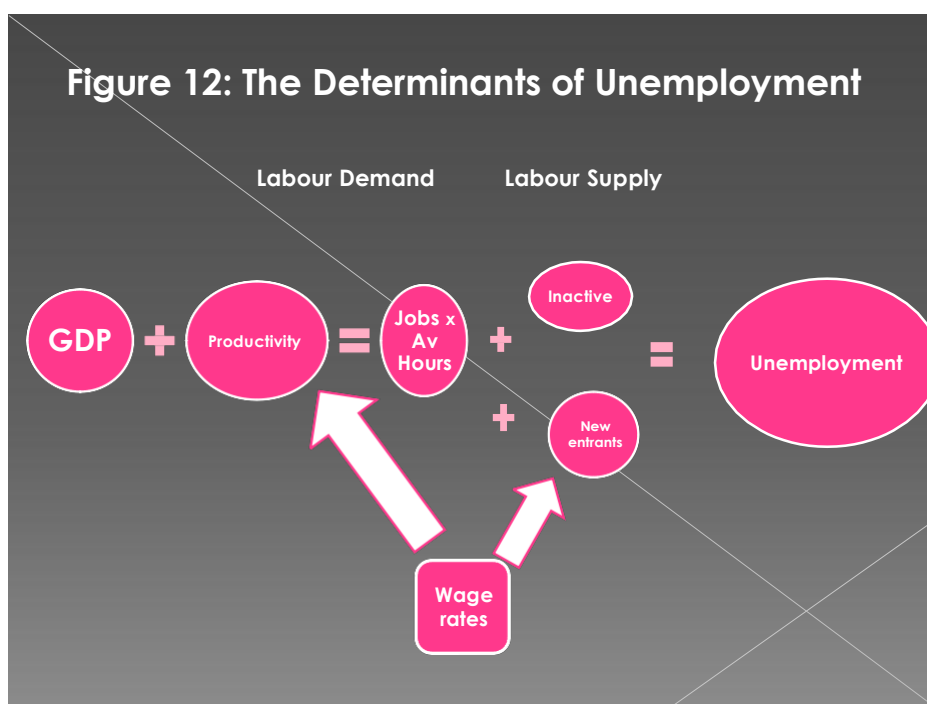
Since the first quarter 2008 output in the sector has grown by 5% in real or volume terms whereas in Scotland output is about the same at 0.3% higher. Now, in view of the fact that Government accounts for about 88% of the output in the sector, we need to ask how has such an increase come about at a time of fiscal consolidation? Is it a genuine increase in the real value of UK government output over the period? Is it due to measurement differences between the UK and Scottish government production? Or, is it due to measurement error? Either way it is important to resolve this issue because the comparative size of the government sector means that the difference in performance is a not insignificant factor in the aggregate GVA differential between Scotland and the UK.

The Labour Market

The latest labour market data (see *Overview of the labour market* below) show jobs in Scotland falling by 1,000, and unemployment rising by 7,000 in the latest quarter to August. Over the year, jobs were up by 16,000 but unemployment was higher by 10,000. In the UK employment rose, resulting in the 16-64 employment rate rising over the year to 71.3 per cent, above Scotland's 71.2 per cent which remained unchanged over the year. The contrast in the unemployment performance between Scotland and the UK in the most recent quarter is even more marked. Unemployment in Scotland rose by just over 3 per cent. In the UK, in contrast, unemployment fell by 50,000, a fall of just under 2 per cent.

What accounts for the difference in the labour market performance between Scotland and the UK both during recession and recovery, and in the most recent quarter?

We start to answer these questions by considering a framework within which to place the factors that generally determine changes in the labour market in general and unemployment in particular. This in turn helps us to draw some, we hope, interesting conclusions.



What Figure 12 suggests is that changes in unemployment reflect movements in both labour demand and labour supply. Taking demand first, we can see that when GDP changes - let's say falls - then jobs will fall proportionately if productivity remains unchanged. And productivity can change due to new technology but also if the price of labour - wage rates - changes relative to the price of other factors used in the production process. The fall in jobs, with average hours worked unchanged, will then translate into an equal rise in unemployment providing there are no changes on the supply side: the numbers active/inactive and new entrants, including individuals deciding to take on more than one job, both influenced in part by any changes in the return from work i.e. wage rates.

Therefore, holding productivity and supply factors constant, a comparable fall in GDP in Scotland and the UK should result in a comparable fall in jobs and a comparable rise in unemployment. There may be lags as employment adjusts to output change and unemployment to job change but for simplicity we abstract from those.

So, in principle, a rise in Scottish unemployment relative to the UK should be explained by differential movements between Scotland and the UK in one or more of the following:

- GDP,
- productivity (with differential movements in jobs and/or hours), and
- labour supply (influenced by wage payments, job opportunities.)

Specifically, weaker GDP growth, faster productivity growth, and a faster growth in the supply of labour should, severally, or collectively, account for the relative rise in Scottish unemployment.

We consider labour market performance in Scotland and the UK during the Great Recession and recovery and begin by looking at labour demand.

Figure 13: GDP and Employment, Scotland and UK, Recession and Recovery

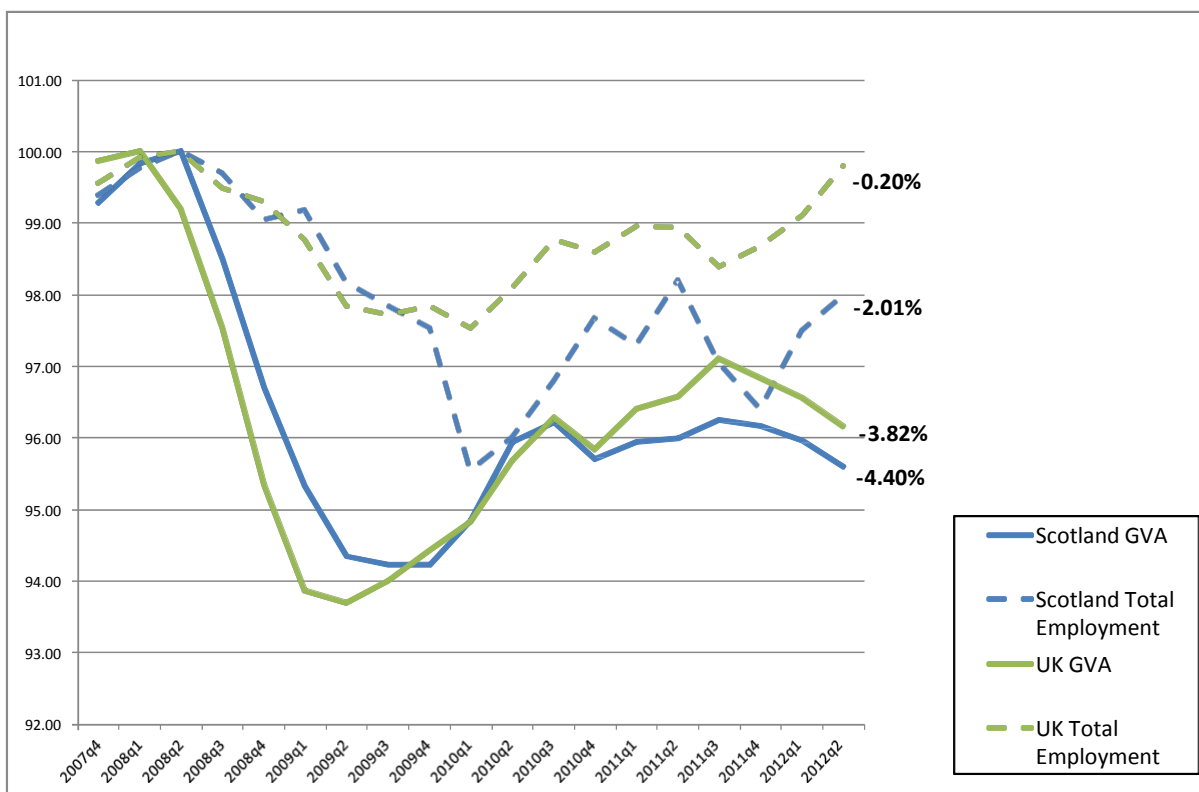


Figure 13 charts the performance of GDP and employment in Scotland and UK from the pre-recession peak to the latest data point in the second quarter of this year. We see the weaker recovery of Scottish GDP compared to UK GDP as shown in Figure 2. By the latest quarter Scottish GDP was more than 4 per cent below its pre-recession peak, a somewhat bigger shortfall than the UK where GDP is less than 4 per cent below the previous peak. But not that much differences between the two. The same, however, cannot be said when it comes to the labour market, except that the jobs position is stronger in both the UK and Scotland than output.

Scottish employment stands at around 2 per cent below its pre-recession peak. In the UK, in contrast, employment is almost back to the previous peak and is currently only 0.2 per cent below.

On the face of it, these figures suggest that productivity per worker has fallen by much more in the UK than in Scotland: that is, a larger amount of jobs are required to produce a given output in the UK than in Scotland compared to the pre-recession position.

But as Figure 12 shows, jobs are not the only dimension of labour demand. Average hours worked is also critical. Jobs may rise and fall but if average hours fall and rise proportionately the demand for labour will be unchanged. So can we reconcile the apparent UK-Scotland difference in labour demand from the jobs position alone by looking at total hours worked? One ingredient here could be the evident switch from full-time to part-time and self-employment as noted in the *Overview of the labour market* below. A greater switch away from full-time employment in the UK could bring the demand for labour in terms of total hours worked more into line with the change in output and between Scotland and the UK. But Figure 14 shows this not to be the case.

Figure 14: Total Hours Worked, Scotland and UK compared to Pre-Recession peak - Oct 2007- Sep 2008 = 100

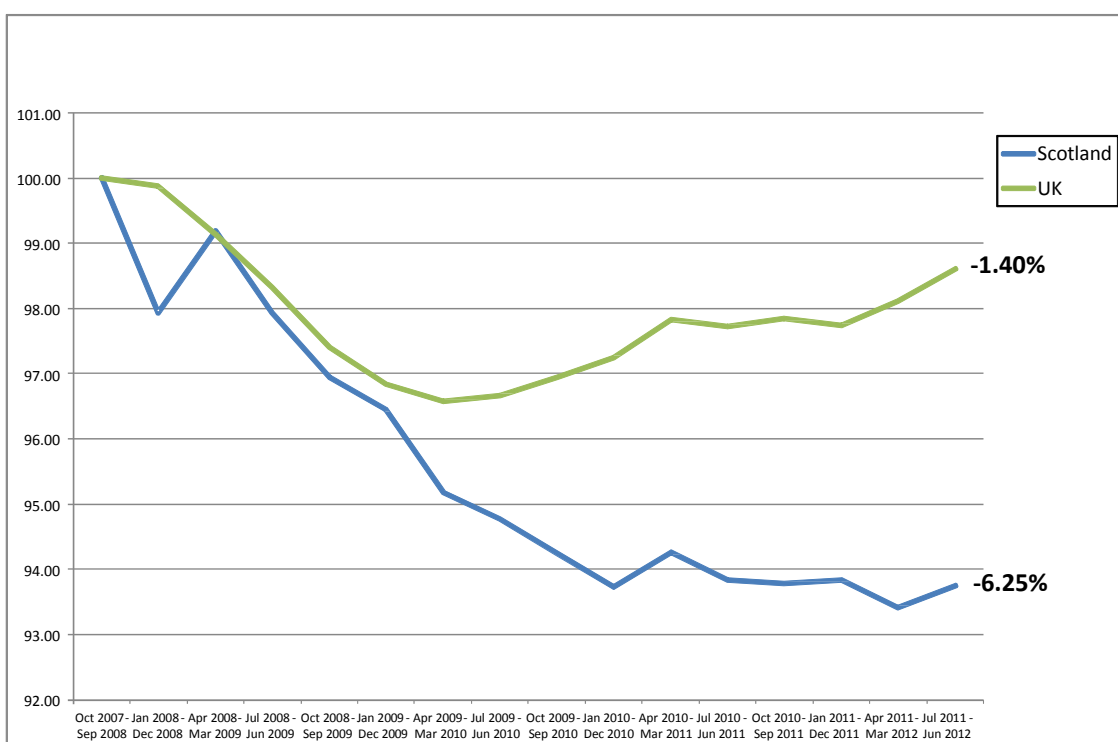
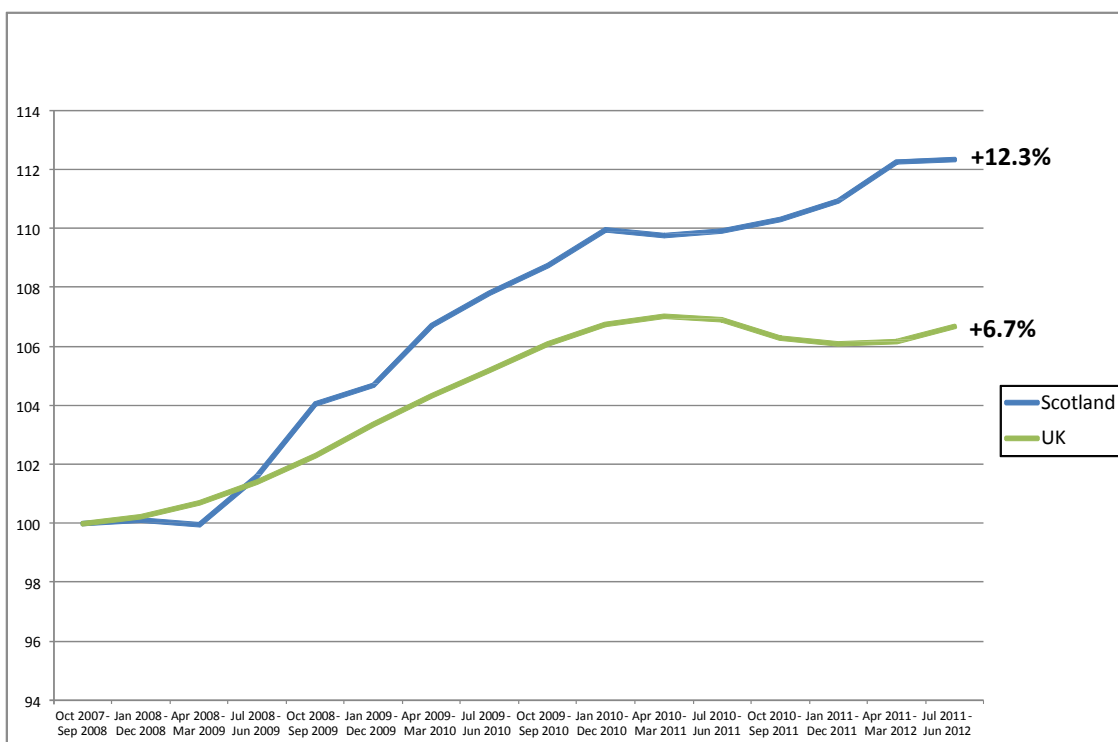


Figure 14 reveals that total hours worked in the UK dropped by 1.4 per cent compared with the previous peak, which is clearly greater than the 0.2 per cent fall in jobs suggesting a fall in average hours and therefore likely switch away from full-time employment. But with GDP 4 per cent below its peak this is certainly evidence of a fall in labour productivity per hour worked as well as productivity per worker. Moreover, the drop in total hours worked in Scotland is significantly greater at 6.25 per cent.

This suggests firstly, that the fall in the demand for labour in Scotland since the pre-recession peak is much larger than in the UK. Second, the drop in the demand for labour in Scotland is greater than the drop in GDP, suggesting that productivity per hour has risen even when productivity per worker has fallen. Third, compared to the UK, Scotland's productivity per worker has fallen by less. Fourth, compared to the UK, Scotland's productivity per hour worked appears to have risen while it has fallen in the UK. Fifth, for whatever reason, there is no evidence of a sustained recovery in the demand for labour in Scotland, which contrasts markedly with the UK. Sixth, the stronger Scottish productivity position compared to the UK cannot be explained by a greater move to part-time working in the UK. This is because it appears from our preliminary analysis of the data that the growth in part-time workers (employees working part-time and self-employed working part-time) has been greater in Scotland not the UK. Figure 15 illustrates.

Figure 15: Share of part time workers in total, Scotland and UK compared to pre-recession peak period

Seventh, a fall in labour productivity may be due falling real wages leading to labour being substituted for capital and other factors of production. It is possible that there has been a greater relative fall in real wages in UK than in Scotland. This is a subject for further work. But we doubt that this 'pricing into' work effect is sufficient to explain the fall in labour productivity in the UK because of the technical difficulties of substituting labour for capital in production processes that often require a fairly rigid balance of labour to capital. However, even given that there could be substitution at the aggregate level in favour of more labour intensive activities. So, it is a possibility, but unlikely to be of sufficient scale to produce the changes in relative labour demand and productivity identified. Nor does it seem a likely candidate to explain the differences between Scotland and the UK.

We are therefore left with the tentative conclusion that a relative rise in labour productivity for structural reasons over the period of recession and limited recovery is the main explanation for the difference in the pattern of labour demand between Scotland and the UK given the relative similarity of the path of output in the two jurisdictions.

But we still have to get from labour demand to unemployment. And for that we need to allow for changes in labour supply as well as labour demand.

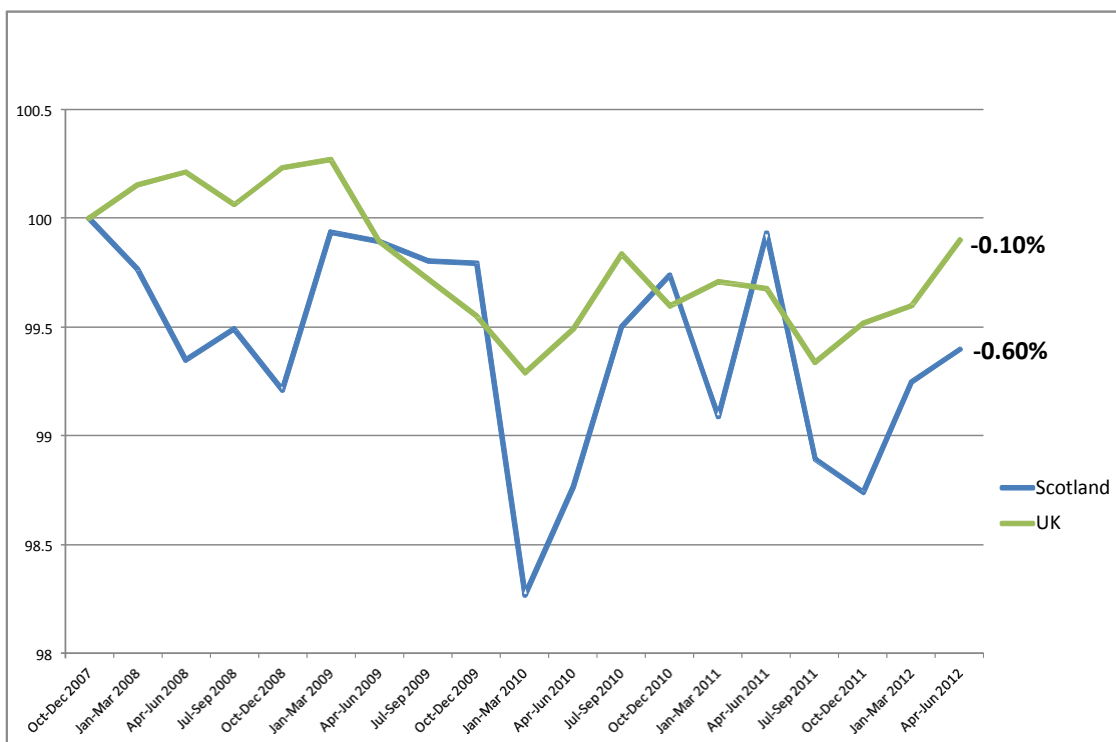
Figure 16 charts the activity rate of 16 plus individuals in Scotland and the UK compared to the pre-recession peak.

What Figure 16 shows is that labour supply, as measured by the activity rate, fell slightly in both UK and Scotland since the start of the recession. The Scottish rate has been more volatile but appears to have fallen a little more than in the UK. So, to the extent that unemployment has progressively moved higher than in the UK it does not appear to be because of supply side reasons. (It is worth noting that we have no accurate and up-to-date measure of working population to gauge the relative scale of new entrants to the labour market.)

Over this longer period, the main reasons for a rise in unemployment relative to the UK appear to be the somewhat stronger fall in output and the much greater decline in the demand for labour due, it would appear, to an economy-wide improvement - or lesser deterioration - in relative labour productivity. The reasons for this can only be speculated upon. One is the decline in oil and gas production which has high labour productivity and which is fully contained in the UK GDP data but only partially in the Scottish data - see above. Another is the possibility that the internal labour markets of Scottish firms are less flexible on average than in the UK, with firms less willing to offer flexible working conditions and workers less willing to supply labour flexibly. This might also extend to a lesser willingness to seek and accept a reduction in real

wages, or the price of labour, than their UK counterpart firms and workers. But we have no hard evidence for this. (For a similar argument and more for the UK as a whole see Chris Dillow's recent article in the Investors' Chronicle [here](#).) Clearly, we require more evidence and thinking before we can fully understand this issue.

Figure 16: Activity Rate of 16 plus, Scotland and UK Pre-recession peak to Apr- Jun 2012



A final comment on the unemployment figures in the latest quarter which to recapitulate show unemployment rising by 7,000 in the latest quarter to August, an *increase* of just over 3 per cent. In the UK, in contrast, unemployment *fell* by 50,000, a fall of just under 2 per cent.

There has been speculation in the media that this is due to an 'Olympic bounce' favouring London and the South East but not Scotland. Others cite the different movements in part-time and full-time employment between Scotland and the UK. Some mentioned weaker Scottish growth, measurement error and the effect of lags.

All of these explanations may hold some truth. And, we certainly can't give a definitive explanation either. In the latest quarter, on the demand side the employment rate fell in Scotland by 0.1 per cent while rising by 0.5 per cent in the UK. On the supply side, the activity rate in the UK rose by 0.3 per cent as more people offered themselves for work in the UK but it also rose very slightly in Scotland. In the UK, the rise in the activity rate was less than the rise in employment, so unemployment fell. But in Scotland the rising activity rate meant that a weak fall in employment translated into a bigger rise in unemployment.

Finally, we can't be definitive about the recent changes. The latest jobs and unemployment data published refer to the period June - August. Unfortunately, we don't have GDP data for this period. The latest Scottish GDP data cover the second quarter, that is April - June. There is only an overlap of 1 month. So, we must await the third quarter data to see if there is evidence of an 'Olympic bounce' because, if it exists, it will be picked up in the GDP figures. So, the strong jobs growth of 0.72 per cent in UK employment in the quarter, compared to a fall of 0.06 per cent in Scottish jobs, might be largely the result of a strong output differential due to the Olympics.

We can conclude, tentatively, that the explanation of the large rise in unemployment in the most recent quarter in Scotland compared to the UK is as follows: output growth was probably weaker here; productivity probably rose faster, or fell by less, here, hence jobs growth was disproportionately weaker here. Moreover, the supply of labour rose disproportionately in Scotland relative to demand so worsening the outcome for unemployment.

The third quarter GDP data release, when it arrives, should throw more light on this important issue.

Forecasts

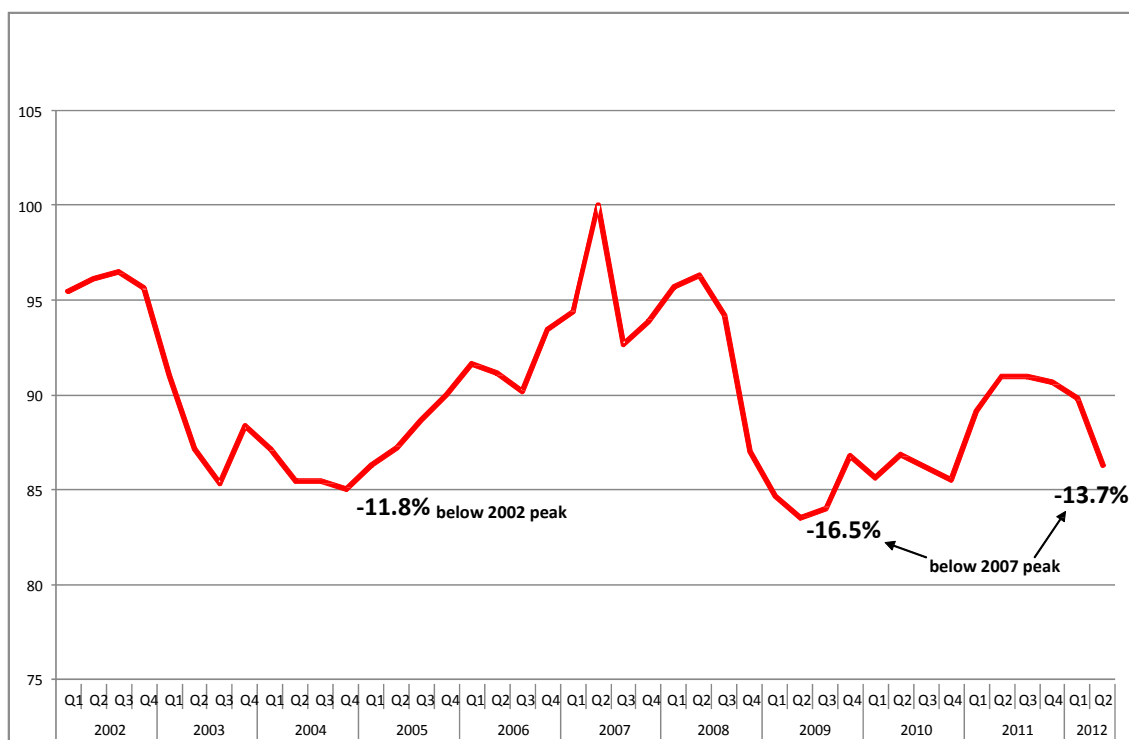
Background

The provisional estimate for UK GDP growth in the third quarter was an encouraging 1%. However, underlying growth is likely to have been appreciably weaker. Around 0.2% to 0.3% points of this can be ascribed to the contribution to GDP of Olympic ticket sales. In addition, GDP growth was temporarily lower in the second quarter because of the Jubilee holiday. So, while subject to revisions, the data do suggest that the UK economy moved out of recession in the third quarter, it is likely that underlying growth is not strong.

The pressure is on the UK government to alter its fiscal stance after the IMF Outlook report in early October suggested that the fiscal multipliers used behind projections in the advanced countries were too low in the present conjuncture. A fiscal multiplier of 0.5 tended to be the norm in such projections. This implies approximately that a fiscal consolidation amounting to a 1% cut in GDP should lower GDP by 0.5%, which in turn under conventional assumptions should raise the fiscal deficit by 0.2%, resulting in a net fall in the fiscal deficit of 0.8% of GDP. However, if as the IMF suggests the fiscal multiplier lies in the range 0.9 to 1.7 then fiscal consolidation is more likely to promote low growth and possible recession with only limited improvement in the fiscal balance. For example, a multiplier of 1.7 would lead to a drop in GDP of 1.7% given a 1% GDP cut in fiscal outlays. This in turn should raise the fiscal deficit by 0.68% thus producing only a small net fall in the fiscal deficit of 0.32%. The result is low growth, a probable recession and little improvement in the deficit. On these figures the approximate 6% fiscal consolidation being applied by the UK government would lower GDP by more than 10% and only improve the deficit by under 2% of GDP.

The econometrics underpinning the IMF work have been challenged but the conclusion vindicates those who subscribe to the Keynesian view that in the aftermath of a severe financially based recession, with interest rates at the zero bound, fiscal policy will have high leverage on GDP. This is because there will be no offsetting change in interest rates as the monetary authority seeks to attain its monetary target. Put bluntly, in these circumstances there is a big GDP bang for the fiscal buck and only limited GDP benefits from monetary policy. This would appear to precisely describe the situation we are presently in. But UK government macroeconomic policy seems reluctant to acknowledge this to say the least.

Figure 17: Scottish Manufacturing Export Volumes since 2002 - Seasonally Adjusted - 2007q2 =100



In Scotland, GDP has been broadly tracking the UK if a little weaker, but as we discussed above the same cannot be said for labour demand. GDP fell by 0.4% in the second quarter. Domestic demand was clearly weak if retail sales is a proxy, while fell in volume terms by -0.2%. So too was foreign demand, with manufacturing exports falling by a huge 4% after rising by 1.7% over the year. The situation in manufacturing exports does raise concerns as Figure 17 shows, especially given the likely continuing distress in the Eurozone economies and general weakness in international markets.

Manufacturing export volumes now stand at just under 14% below the 2007 peak, close to the 16.5% drop experienced in the 2007-09 recession. Moreover, it can be seen that the present situation is worse than the position in the early 2000s after the shock to Scotland's manufacturing exports of the collapse of the electronics industry. Although, in mitigation the downturn then was structural affecting mainly one sector, whereas today the malaise is more general.

We do not have GDP data for the third quarter until January next year. What we do have are the recently published data on retail sales, business survey evidence and anecdote. Retail sales bounced back in the third quarter rising by 0.9%. This is close to the 1% growth in GDP experienced in the UK. But it seems unlikely, though, that GDP will grow by as much as 1% in Scotland in the third quarter as it did in the UK. The 'Olympic bounce' seems likely to be less strong in Scotland, for fairly obvious reasons, principally because the vast bulk of the events were located in London and the south east and so presumably were the visitors.

Business surveys support the view of weak growth in the Scottish economy in the third quarter (see *Review of Scottish Business Surveys* below) with depressed household spending and business confidence weak. The oil and gas sector appears to be an exception but this is after a period of significantly declining output. From the PMI surveys Scottish performance appears weak compared to the UK, Wales and most English regions. The latest Lloyds TSM PMI suggests that Scottish economic activity is at a 21 month low compared to a 2 month low in the UK. The short-term prospects do not seem good either with further weak growth expected in a stagnating economy. It is against this background that we have prepared our latest forecasts.

GVA Forecasts

For our latest GVA forecasts we continue the presentational procedure adopted in the previous Commentary. We present only a central forecast but use estimated forecast errors to establish the likely range that the true first estimate of the growth of Scottish GVA will lie between.

Table 1 presents our forecasts for Scottish GVA - GDP at basic prices - for 2012 to 2014. The forecasts are presented in more detail in the *Forecasts of the Scottish Economy* section of this Commentary below.

Table 1: Forecast Scottish GVA Growth, 2012-2014

GVA Growth (% per annum)	2012	2013	2014
Central forecast	-0.1	1.3	2.2
<i>June forecast</i>	<i>0.4</i>	<i>1.6</i>	<i>2.5</i>
UK median independent new (October)	-0.3	1.1	1.9
Mean Absolute Error % points	+/- 0.296	+/- 0.492	+/- 1.216

Table 1 shows that we have revised down our GDP forecast for the three years 2012, 2013, and 2014. For 2012, we have revised down our forecasts for to -0.1% (from 0.4%). We noted in the previous *Commentary* that survey evidence suggested the possibility of a quarter of negative growth in the first half of 2012. In the event the GVA data revealed that in both Q1 and Q2 the output of the Scottish economy contracted. The scale of the contraction in activity through the first half of 2012, combined with weaker survey evidence for business intentions through to the end of 2012 and into 2013 means that – on the balance of probabilities – we think it is now likely that output will contract over 2012 on an annual basis.

Table 1 also compares our GVA forecasts with the median of latest independent forecasts for the UK in 2012 and 2013 and the average of the new independent medium-term forecasts for 2014 that are published by the UK Treasury. These show that we expect Scottish growth to continue to be a little stronger than UK growth. So, we are now forecasting growth of -0.1% in 2012, 1.3% in 2013, and 2.2% in 2014. Given our previous forecast errors the lower and upper bounds for growth in 2012 are expected to be -0.4% and 0.2%, for 2013, 0.8% and 1.8%, and for 2014, 1.0% to 3.4%.

After the predicted fall in output this year in all major sectors, production and manufacturing continue to be the main sectoral drivers of growth in 2013 and 2014. Production is forecast to contract by 0.2% this year compared to a fall of -0.1% in both services and construction. In 2013, production is projected to grow at 3.3% but this is a reduced forecast from the 3.6% projected in June. Stronger growth is projected for services and construction of 0.9% apiece but the two sectors still continue to recover slowly and the forecast is reduced from 1% in June. Again, it is not until 2014 that we see much pick-up in growth. GDP is forecast to rise by 2.2%, while production growth rises appreciably to 5.71%. But the growth of the service and construction sectors, while increasing to 1.5% and 1.4% respectively, still remains moderate in 2014.

Employment Forecasts

Table 2 presents our forecasts for net employee jobs for the 3 years 2012 to 2014 in terms of a central and upper and lower forecasts.

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

	2012	2013	2014
Upper	-19,350	27,100	53,350
<i>June forecast</i>	-5,200	41,000	61,750
Central	-25,750	16,950	29,450
<i>June forecast</i>	-14,950	19,950	36,050
Lower	-32,050	5,500	5,850
<i>June forecast</i>	-25,350	-1,700	10,450

Table 2 indicates that our year-end employee jobs forecast are much reduced compared to the June Commentary. This reflects the lower GDP forecast and the clear weakening of the Scottish labour market that is evident in the recent data. On the central forecast, net jobs contract by -1.1% in 2012, then grow by 0.8% in 2013, and by 1.3% in 2014. The number of employee jobs in Scotland is forecast to decline during 2012 by more than 25,000 jobs. The vast majority of these job losses are projected to be in the service sector (22,750) and construction (2,550). The production sector loses 400 jobs, while agriculture sheds 100 jobs. Through 2013 and 2014 we continue to forecast (lower) increases in employee jobs in our central forecast, with annual increases of around 17 thousand and just under 30 thousand respectively. In 2013 there are job increases across all the main sectors, with a majority (10,200) being created in the production sector, compared to 3,800 in services. Service sector jobs growth strengthens in 2014 with more than 10,000 forecast while production jobs grow by 14,000. Construction employment is forecast to rise in 2013 and 2014 by 2,300 and 3,300, respectively, as spending on (private) investment projects begins to return as confidence builds in the recovery.

Unemployment Forecasts

The key unemployment forecasts are summarised in Table 3 below.

Table 3: ILO unemployment rate and claimant count rate measures of unemployment under each of the three forecast scenarios 2012-2014

	2012	2013	2014
<i>ILO unemployment</i>			
Rate (ILO un/TEA 16+)	8.5%	8.8%	8.7%
Numbers	225,354	234,603	228,740
<i>Claimant count</i>			
Rate (CC/CC+total job)	5.1%	5.3%	5.3%
Numbers	139,720	147,800	148,681

The ILO rate is our preferred measure since it identifies those workers who are out of a job and are looking for work, whereas the claimant count simply records the unemployed who are in receipt of unemployment benefit. We have again revised down our forecasts for unemployment at the end of 2012, despite the deteriorating labour market conditions. As the analysis above in the section on the Labour Market implies, the variation in the link between output and labour demand and the unanticipated changes in labour supply

makes unemployment a difficult number to predict. Our projection for unemployment on the ILO measure at the end of 2012 is now 225,134. We are expecting the unemployment position to deteriorate slightly in 2013 compared to 2012 due to weaker output and employment growth. Unemployment is now forecast to be 234,603 by the end of that year. In 2014, unemployment falls to 228,740 as growth and job creation pick up during the year.

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2 November 2012