Outlook and appraisal

Overview

In the June Commentary we stressed that the Scottish economy was threatened with stagnation as the rate of recovery slows. This threat is even more real today than it was then. Growth has continued to weaken in the global economy and is weaker in the UK and Scottish economies too. The UK economy has effectively stagnated over the last year, growing by only 0.5%. In Scotland growth was flat between April and June and business surveys suggest continuing weakness in the third quarter. The UK has recovered more strongly than Scotland, by nearly 3% compared to around 1% to 2% in Scotland, even though the recovery is weak overall. There is little comfort in the latest GDP data for both Scotland and the UK. This is underlined by the latest US real GDP figures which reveal an annualised growth rate of 2.5% for the third quarter of this year. Growth in the US is still weak by the standards of previous recoveries and insufficient to make much of a dent in the high levels of unemployment. Yet, it is notable that with the latest quarter's results, GDP in the US economy moved back above its pre-recession peak output, whereas the UK and Scotland are still - in the second quarter - 5% and 4%, respectively, below their pre-recession GDP. It will not go unnoticed that, unlike the UK, the US has only recently adopted an austerity programme, which has yet to kick in. We therefore welcome the Bank of England's decision to undertake a further expansion of the money stock through quantitative easing and note that there is still scope for some fiscal easing without damaging our fiscal credibility in the long-term.

Added to this are the consequences of the problems in the Eurozone which are affecting business confidence and if there is a disorderly Greek default will have damaging consequences for Scottish exports, investment and household spending as bank

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lending contracts further. The problems become much greater if there is a prospect of an Italian default, which, if it occurred, would probably throw the world economy into a recession as big, if not bigger than the Great Recession that started in 2008. On a gloomy note we consider that there is not a high probability that the Eurozone problems will be quickly resolved. Even if some headway is made in creating a sustainable financing mechanism for those member countries that are finding it difficult to fund their sovereign bonds at reasonable rates, such as the ECB becoming a full lender of last resort like any other central bank, there is still the issue of adjustment to deal with if the problems are not to recur. Peripheral member countries need to improve (lower) their prices and costs relative to Germany on a sustained basis. Being members of a currency union precludes own currency devaluation so the periphery must adjust by a relative internal deflation of wages and prices of significant proportions. We are not sanguine that this can be achieved without a higher level of inflation in the EZ core - Germany especially - being tolerated and that looks unlikely. The future of the present Eurozone looks bleak.

Against this background we are forecasting GDP growth of 0.4% this year, and 0.9% in 2012 compared to our June forecast of 0.8% and 1.5%, respectively. Our research on previous forecast errors – see the paper by Grant Allan – suggests the lower and upper bounds for growth in 2011 are expected to be 0.1% and 0.7% and for 2012, 0.4% and 1.4%. Forecasts for the UK have also been reduced by independent forecasters, reflecting the weakening in the UK and global economies. So, overall, we are projecting weaker growth than previously and continuing weaker recovery than the UK.

In the labour market we note the strong contribution of part-time employment to the recent recovery in jobs. On our central forecast, net jobs grow by 0.2% in 2011, 0.4% in 2012 and 0.7% in 2013. By end 2013 total employee jobs are forecast to be 2,324,000 around 80,000 fewer than at the end of 2008 but up by 60,000 from the end of 2009, and up by 30,000 from the end of 2010. By sector, the largest absolute growth in job numbers is forecast for the production sectors in 2011(2,400 against 2,250), but in services in 2012 (4,950 against 3,400 in production) and 2013 (9,350 against 6,100). Few jobs are created in construction or in agriculture over the forecast horizon. Unemployment, on the preferred ILO measure is forecast to rise to 8.3%, or 219,800 by the end of this year, rising further to 234,800 or 8.9% by the end of 2012. After that, the numbers unemployed will fall only slightly to 231,550 by the end 2013 but the rate stays the same at 8.9%.

Recent GDP performance

The latest quarterly growth data from the Scottish government for the second quarter 2011 reveal that GDP grew by 0.1%, the same as in the UK. Hence, growth was largely flat between April and June in both Scotland and the UK and weaker than in the first quarter where growth is now estimated to have been 0.2% - see Figure1.

Over the year to the second quarter GDP growth was weaker in Scotland with net output growing by 1.1% compared to 1.5% in the UK.

There was a boost to Scottish growth from a strong performance of Electricity, Gas Supply, with growth of just over 15% compared to a fall of -1.7% in the sector in the UK. But the sector only contributes about 2% to overall GVA. Both the major Services sector (73% of the economy) and Construction (8% of the economy) were weaker in Scotland compared to their UK counterparts in the quarter see Figures 2 and 3.

Services grew by 0.1% in Scotland but by 0.2% in the UK, while Construction contracted by -2.3% in Scotland but grew by 1.1% in the UK. Over the year, Service sector growth was weaker in Scotland at 0.1% compared to growth of 1% in UK Services. In contrast, Construction performance was stronger in Scotland with growth of 11.8% compared to 7.3% in the UK.

In the latest quarter, manufacturing grew by 0.2% in both Scotland and the UK, a bit better than the economy overall but still relatively weak growth - see Figure 4. Over the year, manufacturing output has grown by around 2% in Scotland but with growth of nearly 5%, the sector has grown more strongly in the UK.

When the latest data are looked at over the period since the start of the recession the challenge facing the Scottish

Figure 1: Scottish and UK Quarterly GDP Growth, 1998q2 to 2011q2

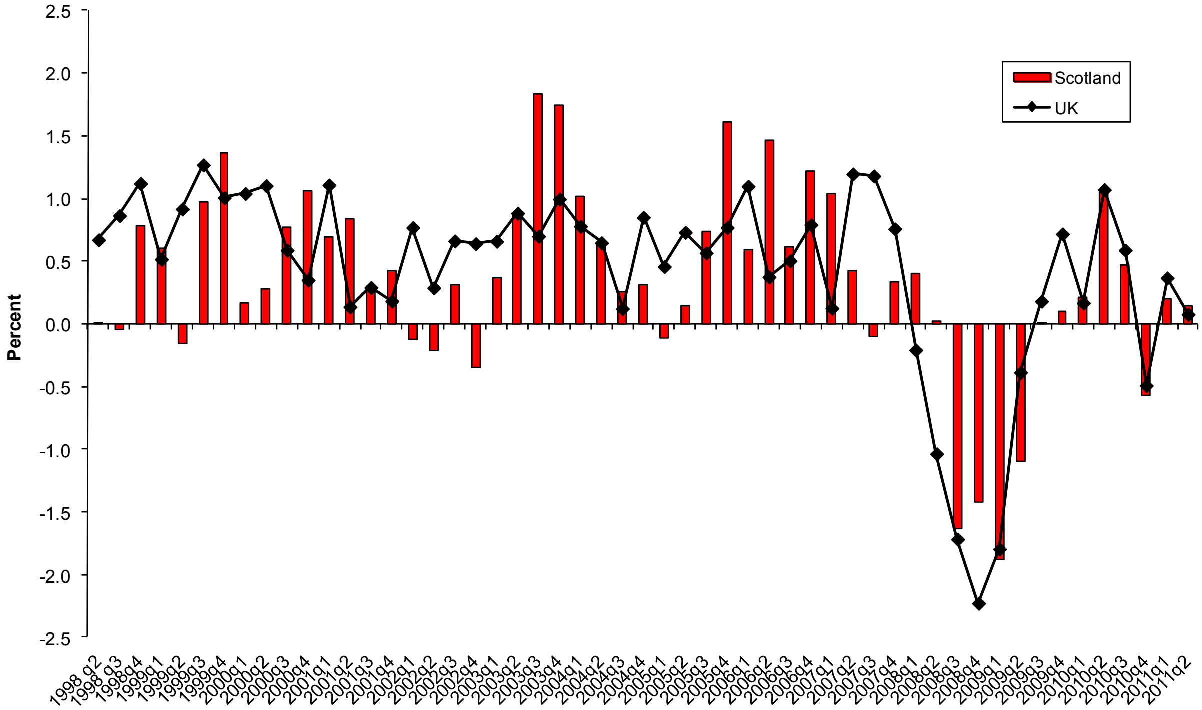


Figure 2: Scottish and UK Services GVA Growth at constant basic prices 1998q2 to 2011q2

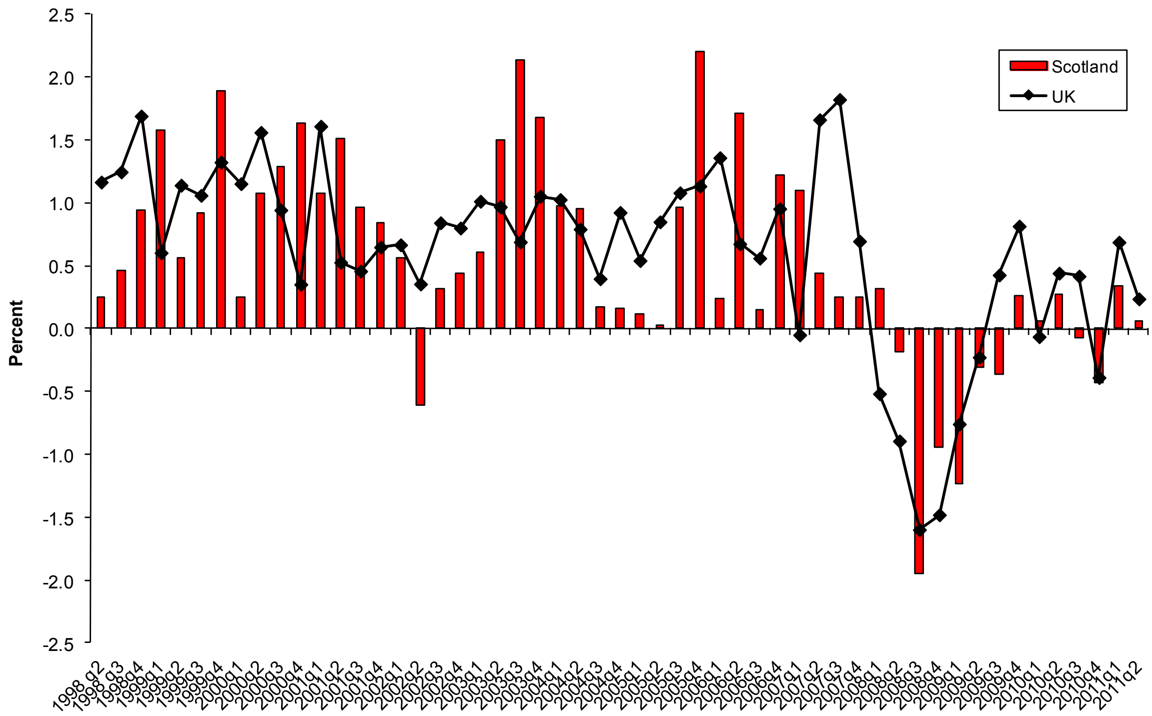
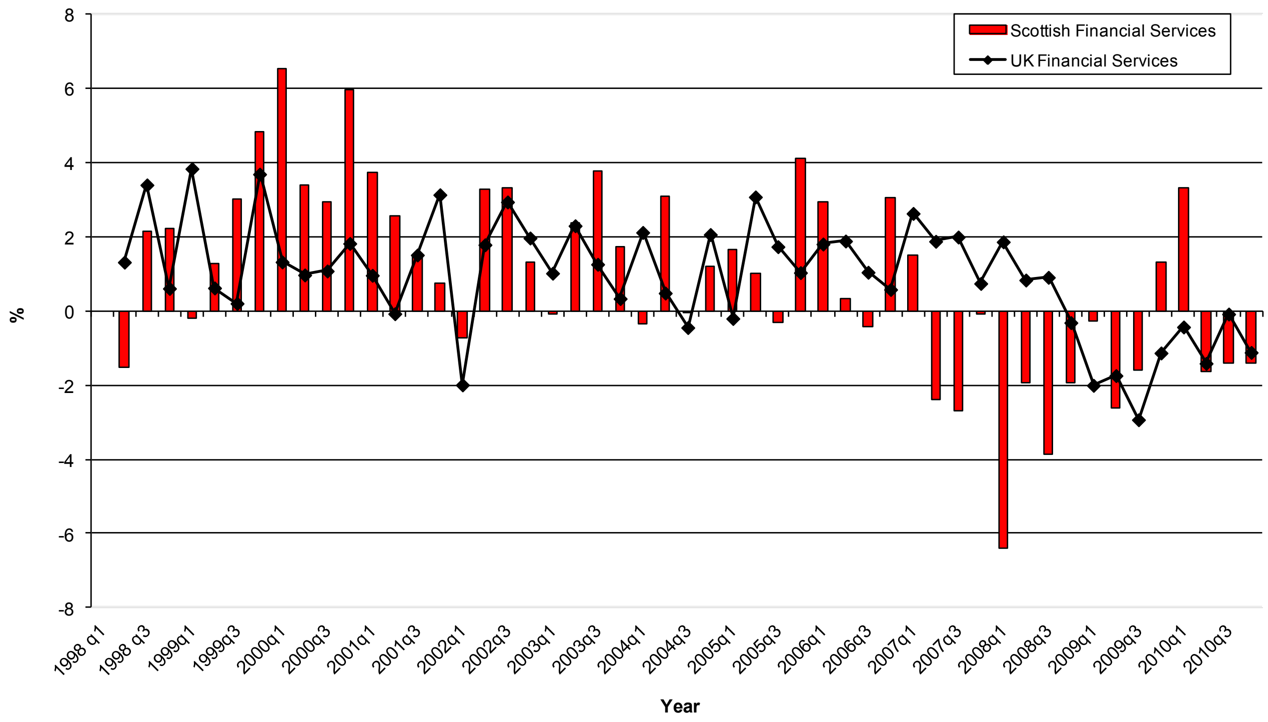


Figure 3: Scottish and UK Financial Services GVA Growth at constant basic prices 1998q2 to 2010q4



economy is clear. Scottish GDP is still more than 4% below where it was just before the recession started - see Figure 5. The UK economy is nearly 5% below from where it started. However, the depth of the recession was greater and sharper in the UK, with GDP falling by just over 7%, whereas in Scotland the drop was a little under 6%. But the UK has come back more strongly than Scotland, by nearly 3% compared to around 1% to 2% in Scotland, even though the recovery is weak overall. There is little comfort in the latest GDP data for both Scotland and the UK. This is underlined by the latest US real GDP figures which reveal an annualised growth rate of 2.5% for the third quarter of this year. Growth in the US is still weak by the standards of previous recoveries and insufficient to make much of a dent in the high levels of unemployment. Yet, it is notable that with the latest quarter's results, GDP in the US economy moved back above its pre-recession peak output, whereas the UK and Scotland are still - in the second quarter - 5% and 4%, respectively, below their pre-recession GDP. It will not go unnoticed that, unlike the UK, the US has only recently adopted an austerity programme, which has yet to kick in.

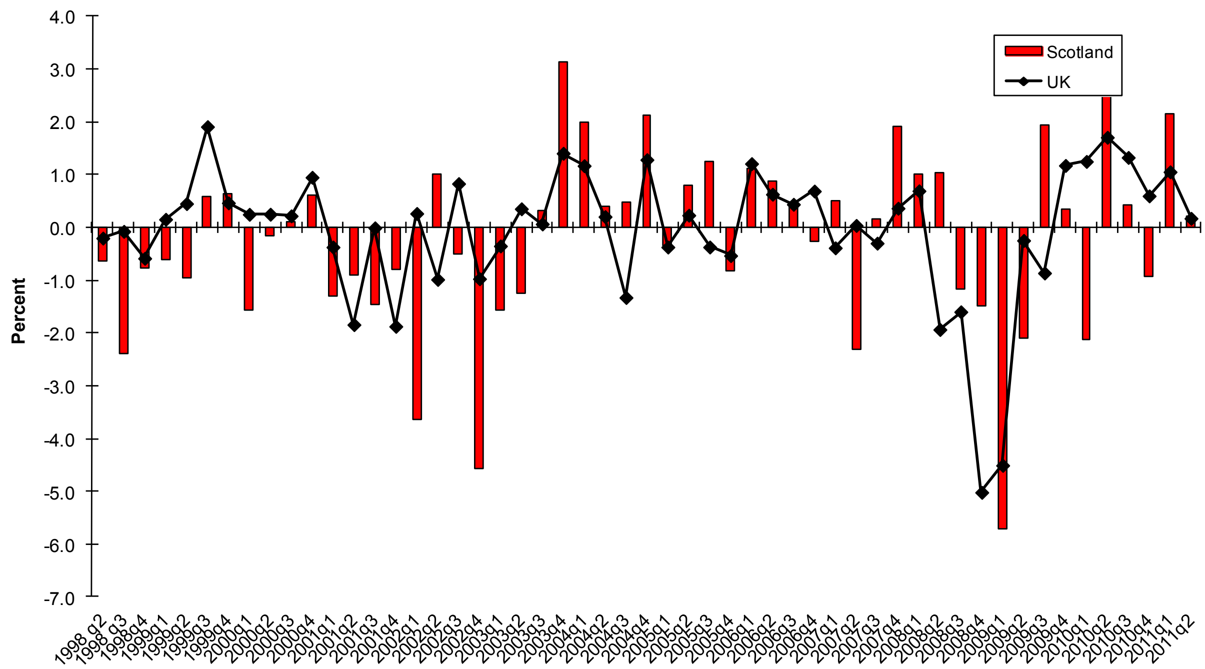
While in the second quarter Scottish GDP was 4% below its pre-recession peak, GDP is further below where it would have been if the recession had not occurred and the economy continued to grow at trend. Figure 6 provides the results of applying trend growth of 0.5% per quarter to the pre-recession peak. This suggests that Scottish GDP was 10.4% below where it would have been with no recession. However, we cannot be sure that the recession may not have destroyed capacity, so, for example, there may be financial service activities that will never return. Assuming that lost capacity is 2% of GDP - i.e. one third of the percentage drop in GDP due to the recession - we then apply the 0.5% quarterly trend rate, which leads to an 'output gap' of 8.5% by 2011Q2. A worst case scenario where the trend rate of growth is lower at 0.4% per quarter as well as a once and for all permanent loss of output leads to an output gap estimate of 7.3% by 2011q2.

What this analysis suggests is that the economy is much worse off than suggested by the current growth rate and by the extent to which GDP is below the pre-recession peak. Moreover, if the trend projection is anywhere near accurate it also suggests that the amount of spare capacity is large and there is much room for growth and therefore a demand stimulus without inflationary fears.

We can get a deeper understanding of the strength of the recovery in Scotland, absolutely and compared to the UK, by looking at the real GDP performance of the principal sectors since the beginning of the recession.

Figure 7 charts the recession and recovery in the Service sector in Scotland and the UK. Services account for 73% of total Scottish value added or GDP. The figure shows that UK services had a steeper recession than Scottish services with GVA falling by -5.35%, while GVA in Scottish services fell by -4.89% during the recession. However, recovery from recession has been much stronger in UK services. By the second quarter of this year, UK services were -2.88% below

Figure 4: Scottish and UK Manufacturing GVA Growth at constant basic prices 1998q2 to 2011q2



the pre-recession peak, whereas Scottish services were -4.42% below. What this suggests, and what the figure shows, is that there has been hardly any recovery in Scottish services at all. After the drop in services GVA in the recession it has stagnated thereafter for nearly two years and can be described as "bumping along the bottom".

The explanation for this stagnation is because services depend much more on local domestic demand than sectors such as manufacturing. It is now well known that household consumption in the UK was badly affected during and after the recession. This was the consequence of the legacy of high levels of household borrowing for mortgages and personal credit that was a contributory factor in the credit crunch and subsequent collapse of demand. Moreover, as is revealed in the discussion of the household spending data in the Forecasts of the Scottish Economy section in this Commentary below, income growth in Scotland is slightly weaker than in the UK as a whole which along with consequences of the debt overhang is likely to account for the overall weakness in Scottish household spending and hence service sector growth.

The financial services and business services sectors taken together account for 26% of overall Scottish GDP and 29% in the UK. Figure 8 charts the recession and recovery in this combined sector in Scotland and the UK. What is evident from the chart is that the recession in this sector was much greater in Scotland than in the UK, and this might in part reflect the greater incidence in Scotland of the banking problems that precipitated the credit crunch and recession. It is also clear from the chart that there has been hardly any recovery from recession in the sector. UK business and financial services have contracted further and GVA in the sector stands more than 7% below the pre-recession peak. In Scotland, while there has been some recovery in the sector during the last two years it is marginal with GVA now standing less than 11% below the pre-recession peak.

The UK government hopes that rapid growth of exports and investment will underpin the recovery from the Great Recession. Exports and investment must grow appreciably to offset weakness in household spending, labouring under a debt overhang and squeezed disposable income, and weakness in government spending, due to fiscal consolidation. Exports are mainly of manufactured goods. So, while manufacturing directly contributes only about 12% to GDP in Scotland and 10% in the UK as a whole it is expected to play a crucial role in the recovery. Stronger manufacturing export growth will contribute to GDP growth directly but also indirectly through an increased demand for service sector inputs and from the spending of higher earned incomes. We noted above the comparatively weak recent growth in manufacturing in both Scotland and the UK and the weaker growth in Scotland over the year. Figure 9 charts the recession and recovery in the manufacturing sector in Scotland and the UK. The very large falls in manufacturing output in both Scotland and the UK are

Figure 5: GVA and Jobs in Recession and Recovery: Scotland and UK

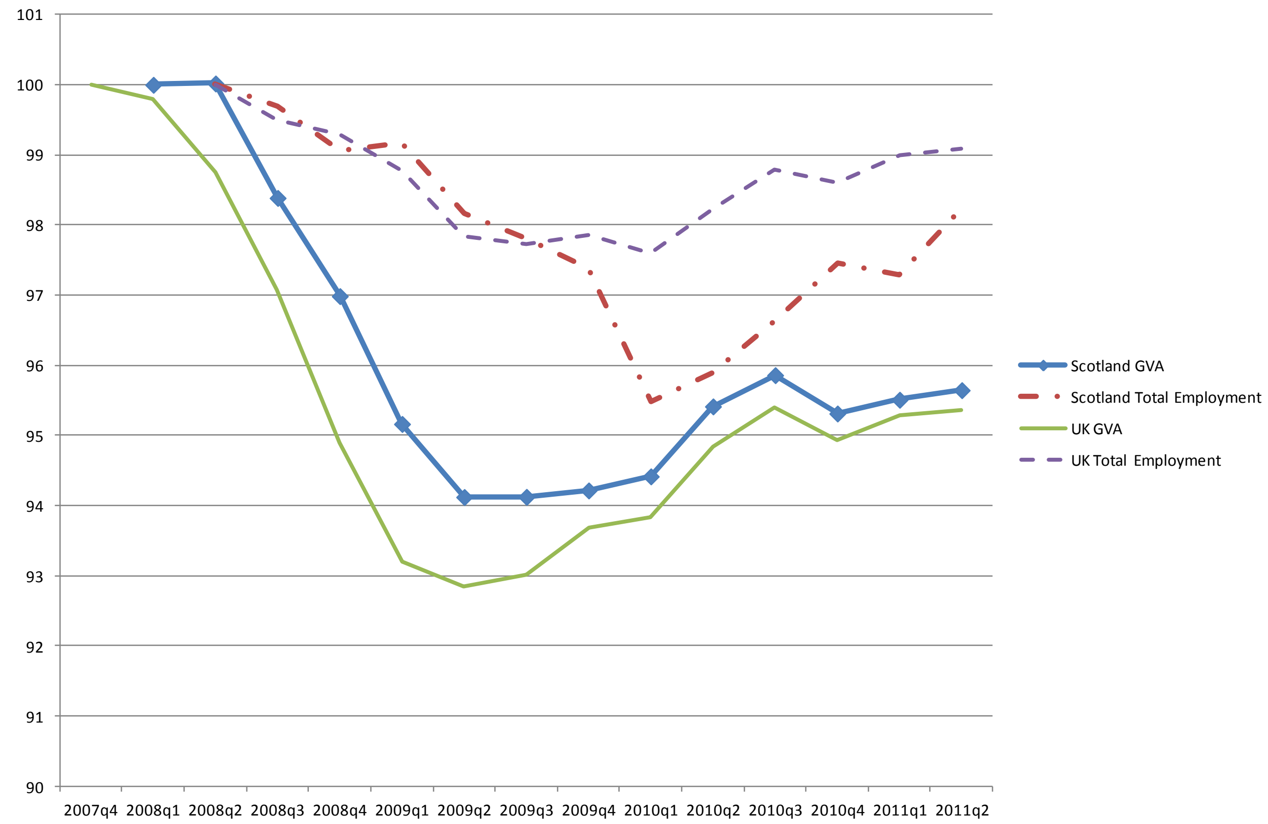


Figure 6: Scottish 'Output Gap' under different assumptions

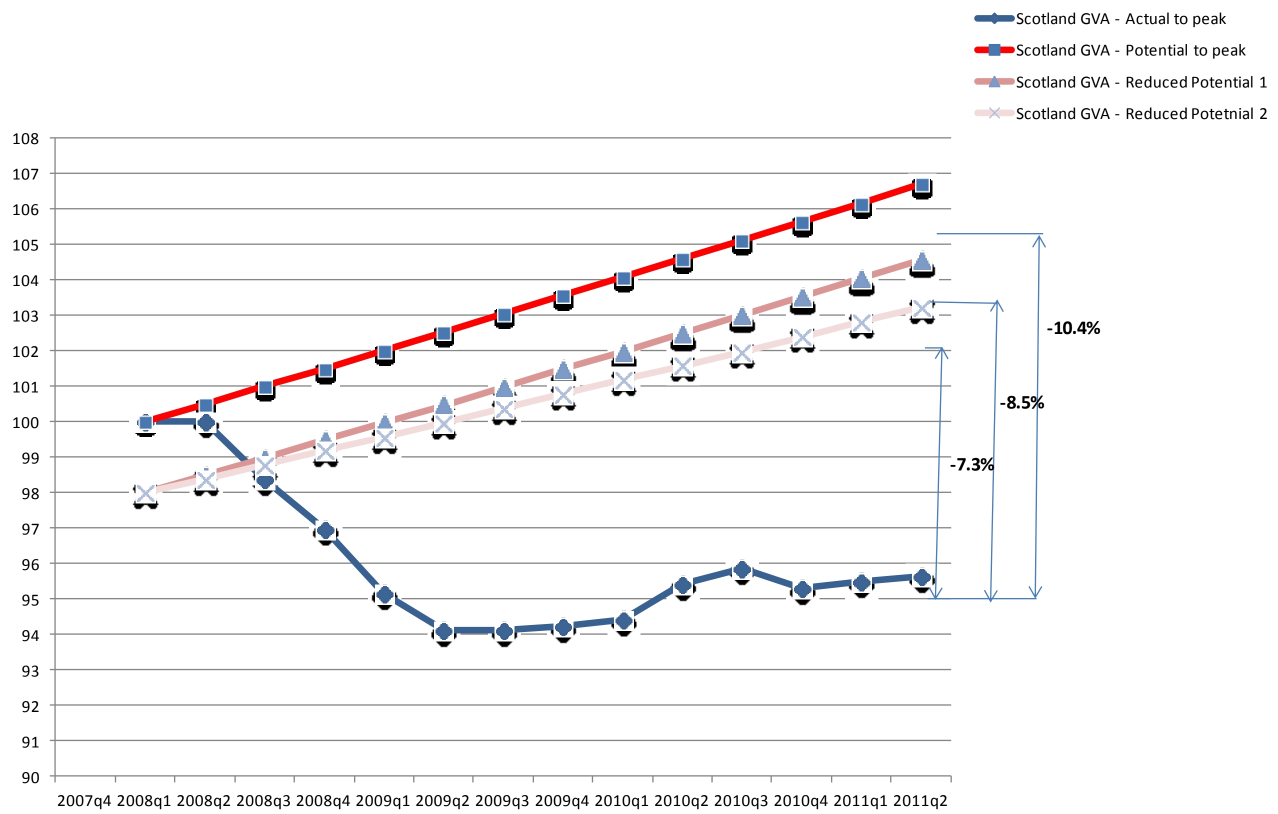


Figure 7: The Service Sector: Recession and Recovery in Scotland and UK

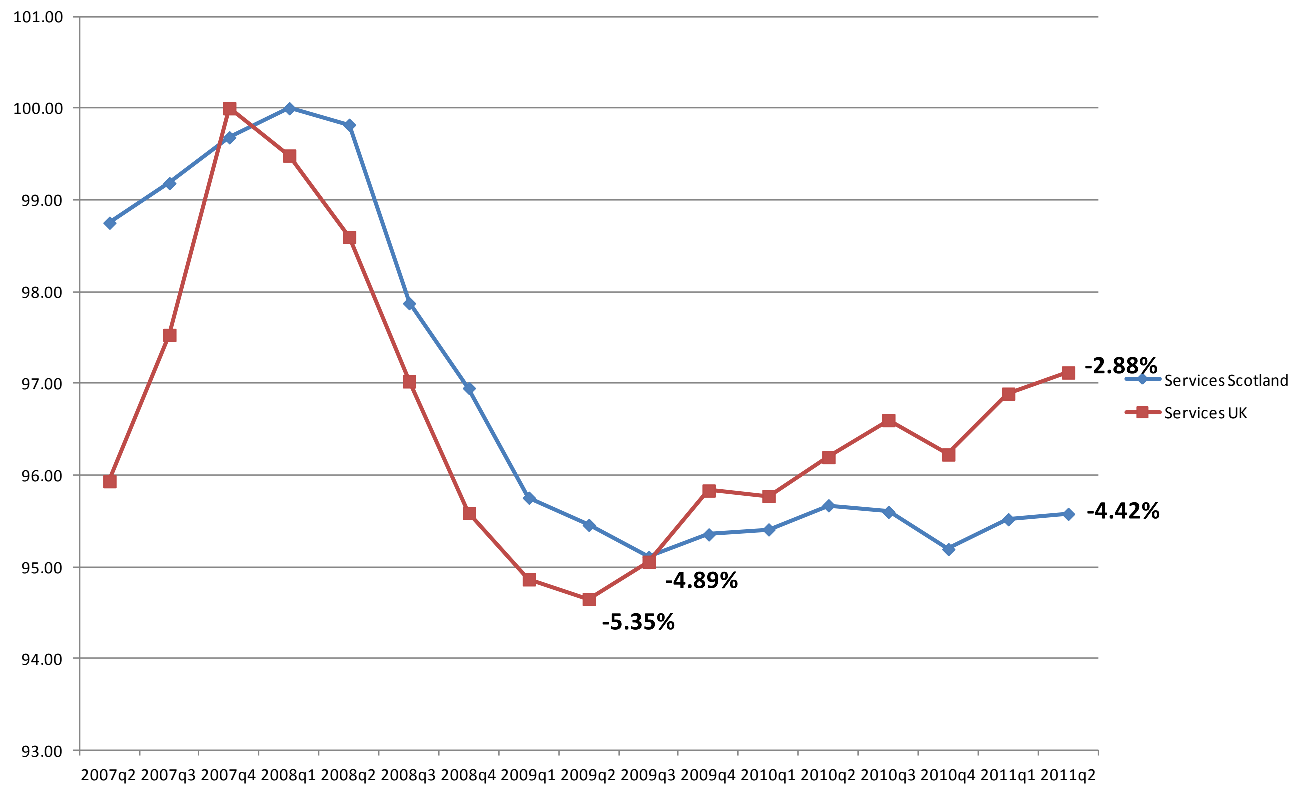


Figure 8: Business & Financial Services: Recession and Recovery in Scotland and UK

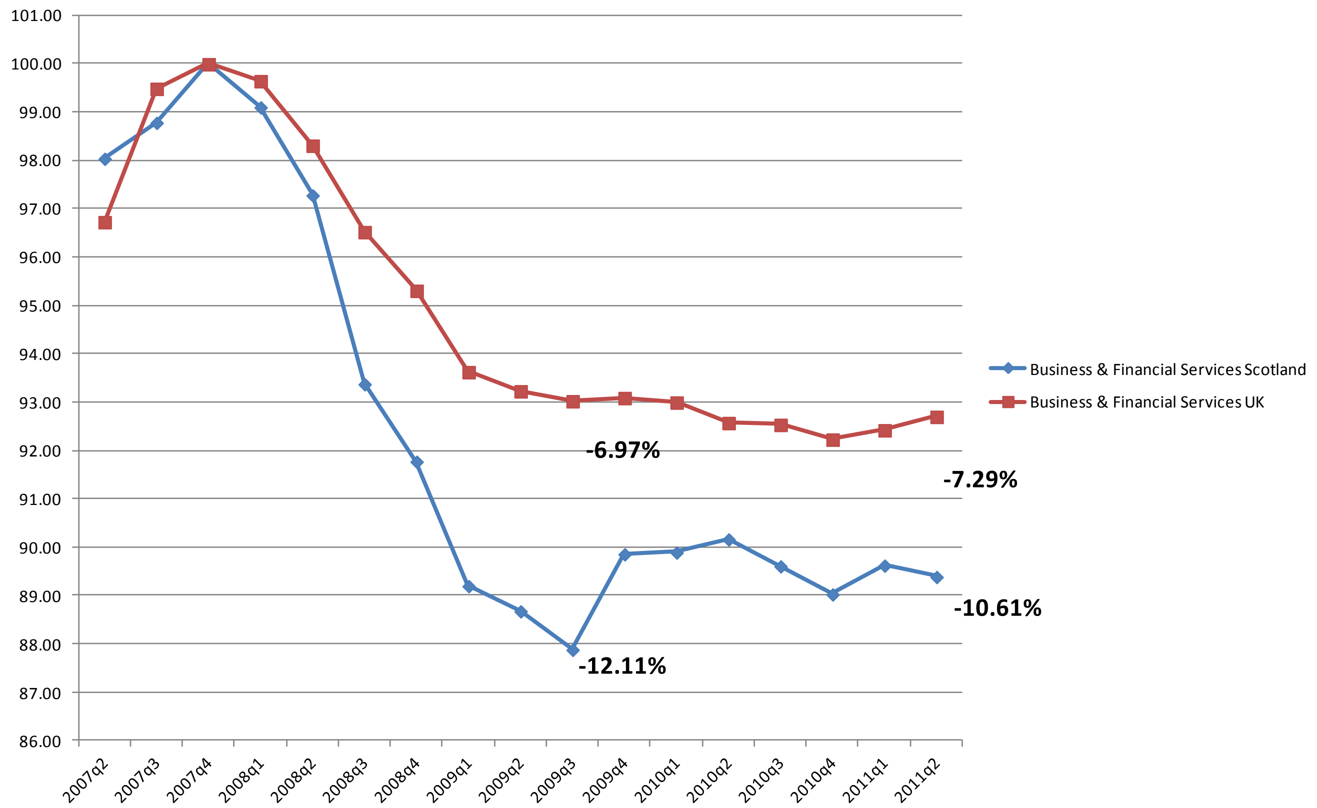
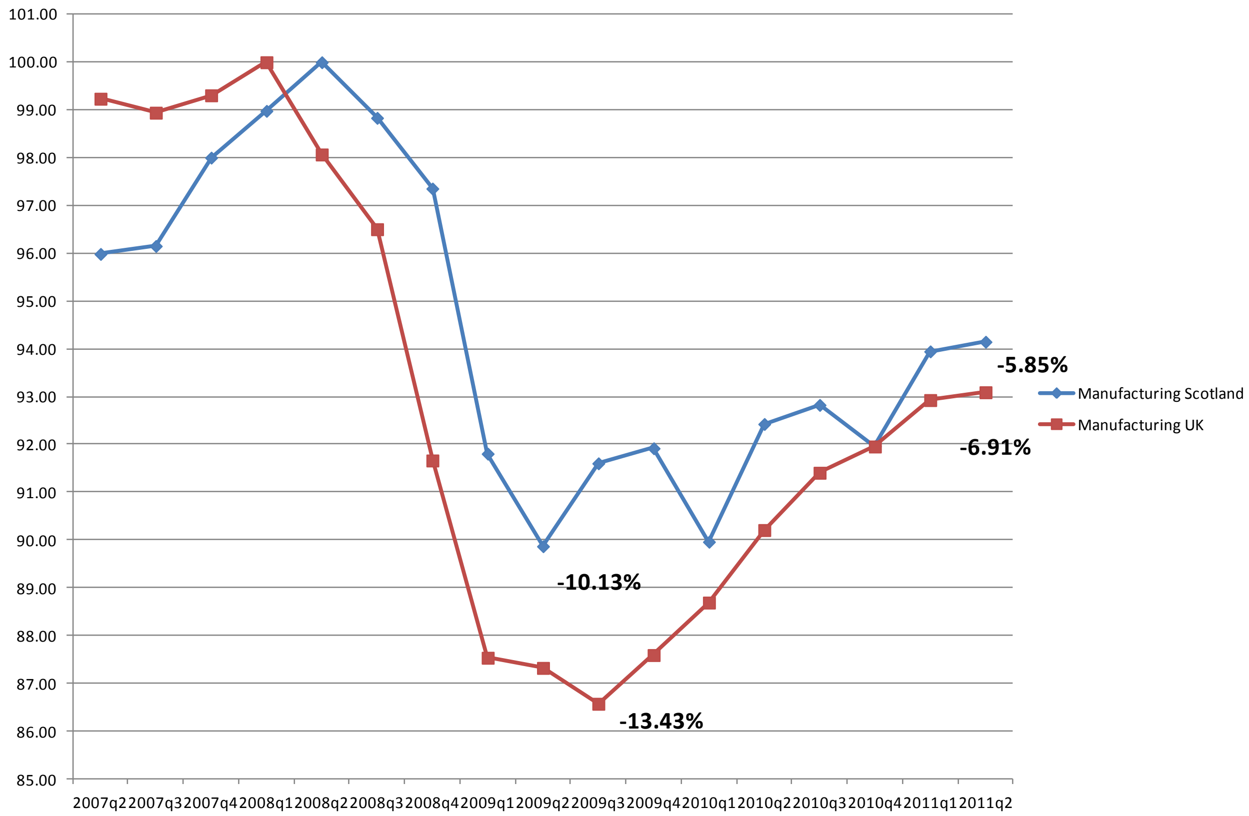


Figure 9: Manufacturing: Recession and Recovery in Scotland and UK



clearly evident. Moreover, the drop in output was much greater in the UK, at over -13%, than in Scotland, at a little above -10%. However, it is also evident that UK manufacturing has recovered more rapidly than Scottish manufacturing. By the second quarter of this year UK manufacturing GVA was just under 6% below its pre-recession peak, while UK manufacturing was just under 7% below its pre-recession peak. So, by the second quarter UK manufacturing had recovered nearly 50% (48.5%) of the GVA lost in the recession, while Scottish manufacturing had recovered just over 40% (42.3%). The recovery is weak in both UK and Scottish manufacturing but the challenge confronting Scottish manufacturing is clearly evident, given the weakness of Scottish household demand and the lack of recovery in the Scottish service sector.

Finally, Figure 10 charts the recession and recovery in the construction sector in Scotland and the UK. The drop in output in the recession was sizable and at just above -18% broadly the same in Scotland and the UK. The figure reveals that construction recovered more quickly from recession in Scotland than in the UK, and we noted above that construction performance has been stronger in Scotland over the past year. This will offer comfort to the Scottish government that its decision to front-load capital investment last year may have had a positive outcome on construction output. However, we are not convinced that the timing of the upsurge fits with the outlay of additional government capital investment. An alternative, albeit anecdotal, view is that the boost to Scottish construction in 2010 came from projects in the pipeline that were held back or the start-date postponed because of the recession. Whatever, the explanation for the upsurge, the downturn again in the sector over the last three quarters must be a cause for concern.

The labour market

The latest labour market data for Scotland show falling employment in the latest quarter (-24,000) and rising employment over the year (+20,000) - see *Overview of the Labour Market* section below. Unemployment rose by 7,000 in the quarter but has fallen by 17,000 over the year. The Scottish unemployment rate now stands higher at 7.9% but remains below the UK unemployment rate of 8.1%. In addition, the rate of employment of the population aged between 16 and 64 fell to 71.2% but is still above the UK employment rate of 70.4%.

These data have, quite reasonably, been interpreted as indicating that the Scottish labour market continues to be robust both absolutely and relative to the UK, despite the latest evidence of weakening. However, we must be careful about the conclusions that we draw from these data.

First, total UK ***employment*** is currently about 1.5% below its pre-recession peak while total Scottish employment is more than 3% below its pre-recession peak - see Figure 11.

Secondly, strong growth in jobs in Scotland of 70,000 between the first quarter of 2010 and the first quarter of this year masks the fact that Scotland endured a large shake-ou

Figure 10: Construction: Recession and Recovery in Scotland and UK

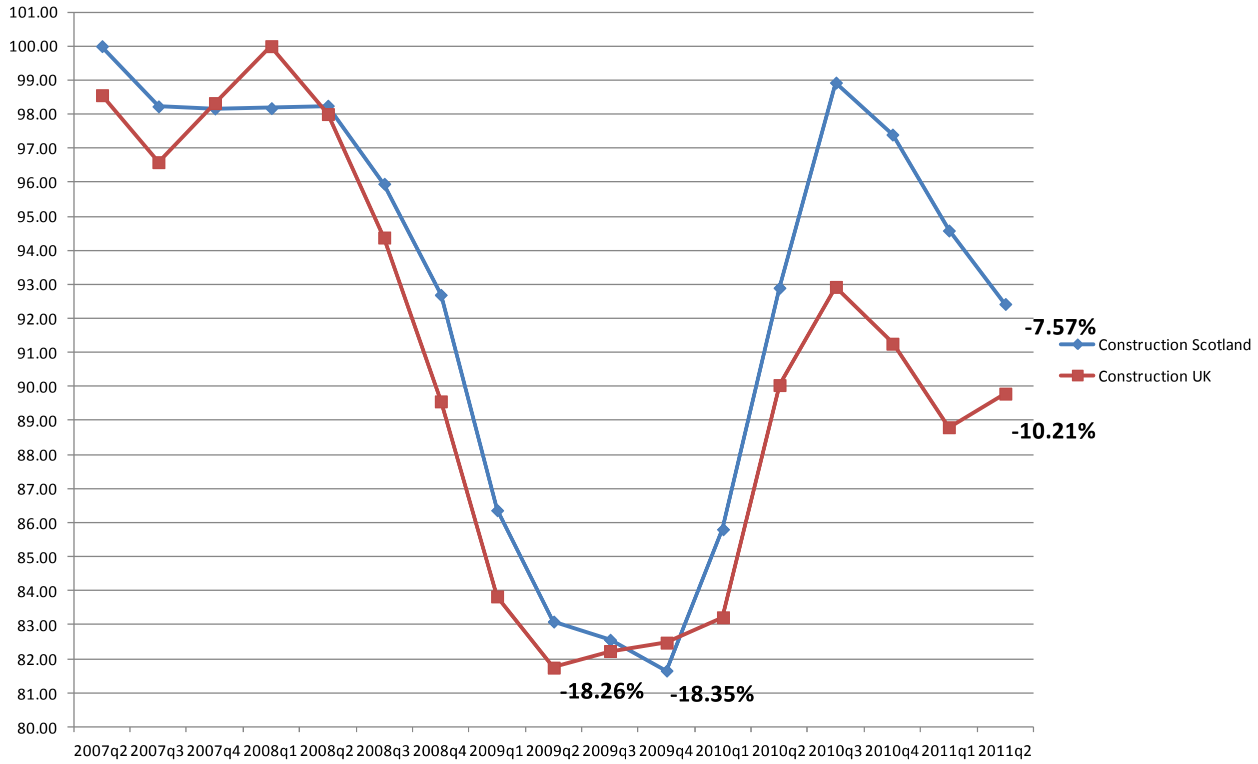
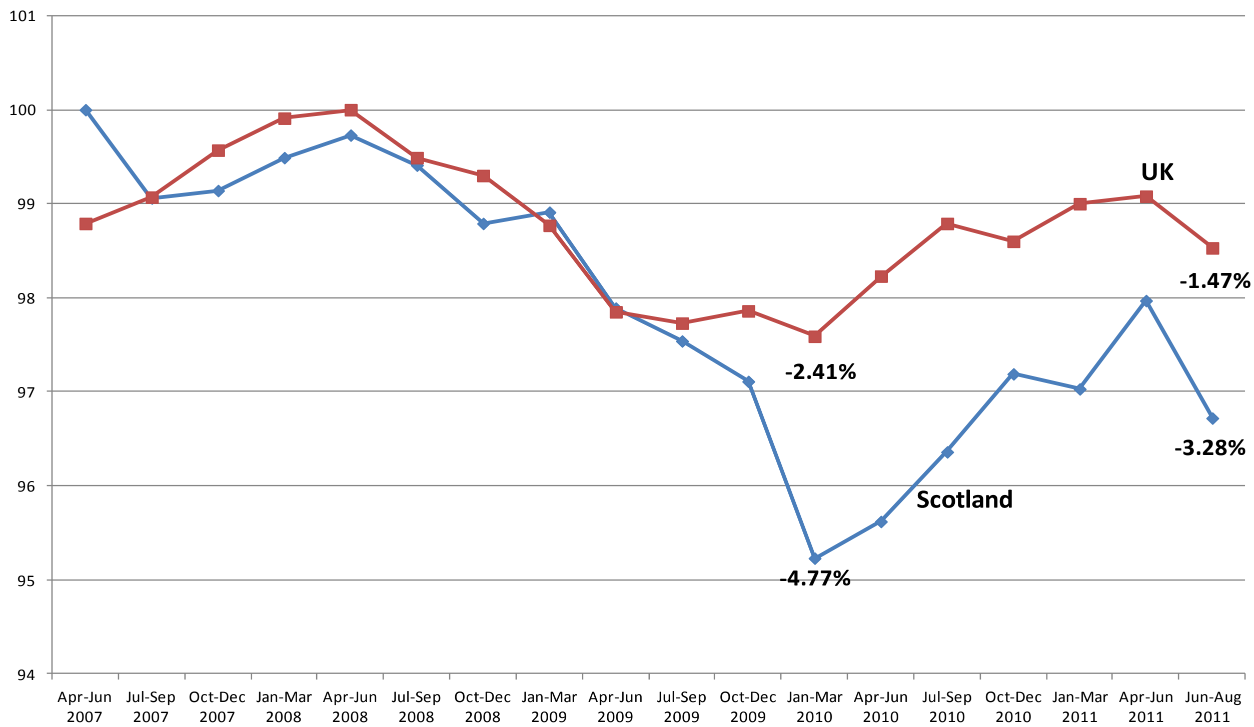


Figure 11: Employment in UK and Scotland relative to Apr-June 2007 Scottish peak and Apr-June 2008 UK peak



of nearly 50,000 jobs between the 2009q4 and 2010q1. This was probably an over-reaction by Scottish employers so there might have been an element of catch up last year as employers sought to establish a proper balance between jobs and output. Alternatively, there is a parallel with the rapid surge in GVA in construction which rose in the first three quarters of 2010 with the rise in jobs coming plausibly one quarter later in the second, third and fourth quarters. So, if the job surge was due to the rapid increase in construction activity, this leaves open the question whether it was the Scottish government's decision to front-load capital investment that caused it. As we noted above it is not clear to us that the timing fits and there are other candidate explanations for the upsurge in construction activity. What cannot be denied, however, is the evidence that the Scottish labour market shed -4.77% of its jobs in the recession while the UK shed only -2.41% and job levels are still more than 3% below the pre-recession peak in Scotland but only 1.5% below in the UK.

Thirdly, one must also look at the movement within the overall jobs total, particularly what is happening to jobs in the both the private and public sectors. The public sector jobs figures released in September show that public sector employment in Scotland fell by 25,200 in the year to the second quarter of 2011, while there were 57,700 more jobs in the private sector over the period. The performance of the private sector job creation is clearly going to be of crucial importance to the future jobs prospects of the Scottish labour market as fiscal consolidation bites.

Finally, we need to bring in a fourth factor when considering the state of the Scottish labour market. This is that one should not judge the state of the labour market by job creation alone but by the creation of jobs in relation to available labour reserves. Working population has been rising in Scotland by a little more than 100,000 since the start of the recession. When that is taken into account we see - Figure 12 - that the total employment-working population ratio is still more than -5.5% below its pre-recession peak while the ratio fell by -6.35% from peak to the trough of the recession.

These figures do not indicate a tight labour market but one that is still suffering from a severe lack of demand, nearly four years after the start of the recession . Moreover, job creation in Scotland appears to be more biased towards part-time working than in the UK, so relatively less labour services may be being demanded than is apparent from the simple job numbers. The numbers of full time workers in Scotland has declined by 120,000 since the pre-recession peak, whilst part time employment, in contrast, fell by only 7,000 during the recession then recovered quickly to be 40,000 higher between April 2010 - March 2011 than the pre-recession peak. When expressed in terms of full time equivalents the recent stronger Scottish employment growth is much more muted.

Another labour market issue that should not be forgotten is the degree of inequality between participants and areas that appear to have worsened in the recession and the limited recovery. The 18-24 year old age group has been badly hit with its employment rate dropping from 68.1% between April 2007 and March 2008, to 61.7% between April 2010 and March 2011. During the past year the deterioration in job losses amongst young people - 18-24 - has continued. In addition, the employment rate for men has fallen by more than that for women except in the 50 - 64 age group. North Ayrshire and Glasgow continue to suffer high unemployment rates of 12.1% and 11.2%, respectively, compared to the national average of 7.9%, almost twice the rates that existed before the recession. Inactivity rates were also high in the two areas, as well as Eilean Siar, at 29.8%, 29.4% and 31.4%, respectively, compared to the national average of 22.9%

Overall, it appears that the growth of private sector output remains weak and insufficient to offset the effects of fiscal consolidation to produce falling or stable unemployment. The growth of part-time employment appears to be masking a decline in full-time employment. Levels of inequality in the labour market are worsening particularly to the disadvantage of young workers and areas such as North Ayrshire, Glasgow and Eilean Siar. The latest data are consistent with our expectation that we should expect unemployment in Scotland to begin to rise again.

Persistent macro-economic policy myths

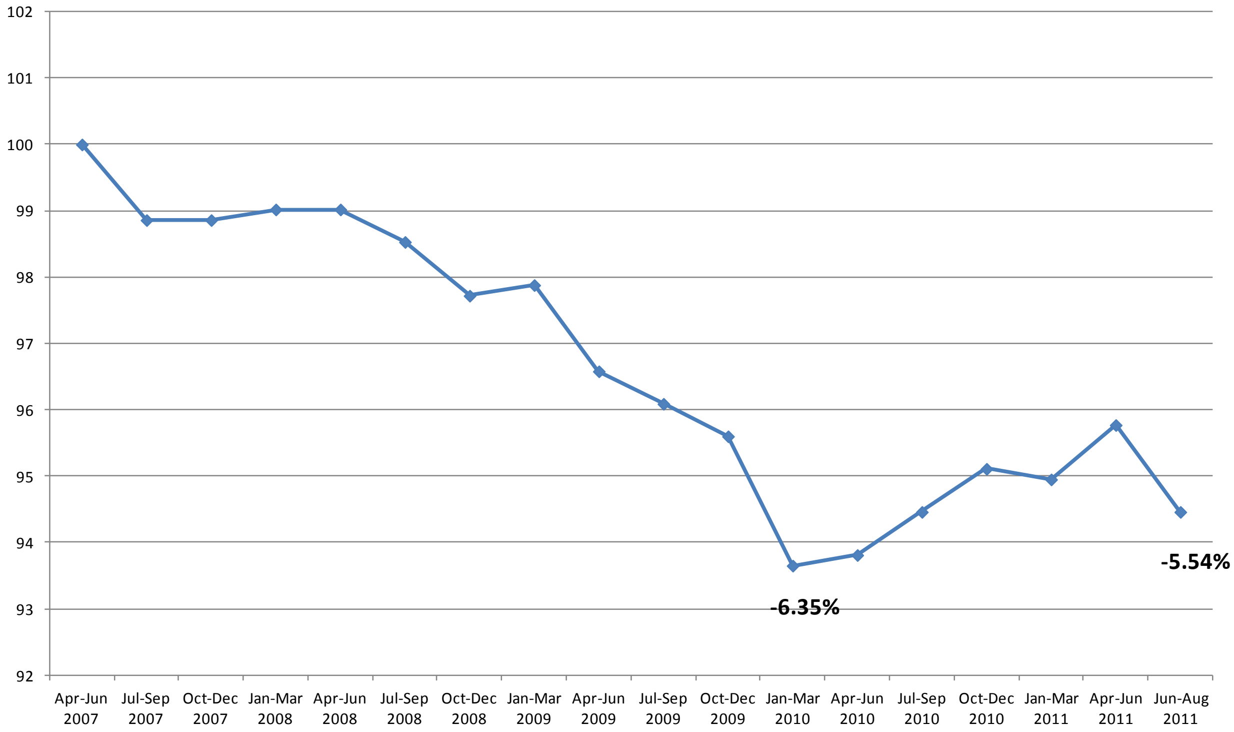
There are several myths that have gained currency with key policymakers, and opinion formers across the world that are seriously limiting appropriate policy responses to the aftermath of the Great Recession and the Eurozone crisis.

General

Myth 1: Reducing government budget deficits and debt levels - "fiscal consolidation" - will enhance growth - "expansionary austerity"

This is the obverse of the view that high levels of government borrowing and rising debt will lead to higher interest rates, yields on long-term (10 year) bonds, thereby slowing growth and risking higher inflation. While there may be some truth in this view if the economy is close to full-employment it is definitely not the case when there is a large degree of spare capacity and unemployment is high. In this situation any consequences for the interest rate and its effect on demand will be more than outweighed by the countervailing change in aggregate demand due to the net change in government spending. So, cutting government spending may lower interest rates to some degree as well as input costs, including wages, for the private sector. Some boost to demand may come from that. But it will be more than outweighed by the loss of output and jobs caused by the cut back in government spending.

Figure 12: Employment in Scotland to Working Population relative to Apr-Jun 2007 peak



Recent research by IMF staff looked at the impact of fiscal consolidation using data over the past 30 years, covering 173 episodes in 17 advanced countries. Their conclusion is stark, " ..fiscal consolidations typically have the short-run effect of reducing incomes and raising unemployment. A fiscal consolidation of 1 per cent of GDP reduces inflation-adjusted incomes by about 0.6% and raises the unemployment rate by almost 0.5 percentage points .. within two years, with some recovery thereafter. Spending by households and firms also declines, with little evidence of a handover from public to private sector demand. In economists' jargon fiscal consolidations are contractionary, not expansionary."[1] Added to this, the authors find that long-term unemployment increases and inequality rises with the burden mainly falling on wage earners rather than on recipients of profits and rents.[2]

When it is remembered that the fiscal consolidation occurring in Britain is planned to take 6% out of GDP by 2015-16 then on the above estimates real GDP is likely to be nearly 4% lower and unemployment 3% points higher as a result. Moreover, while in more normal times there might be some favourable effect on interest rates and private sector activity due to fiscal consolidation that is much less likely today following the Great Recession because interest rates are almost zero. This is a situation where there is an excess of desired savings and individuals/institutions have more than enough liquidity - a situation economists describe as a 'liquidity trap'. The effect is that interest rates will tend not to rise following a fiscal stimulus, nor fall following fiscal consolidation. Krugman (2011)[3] shows that 10 year US Treasury bond yields actually fell over the period since 2008, when there was a $4 trillion rise in US federal debt held by the public.

Myth 2: Printing money - "quantitative easing" - will necessarily lead to inflation, even hyper-inflation

The view that expanding the monetary base - via the purchase by the central bank of long-term bonds - will promote inflation depends on a complicated transmission mechanism that sees a lowering of interest rates, rising asset prices, increased spending, rising nominal GDP with rising prices, promotion of inflationary expectations and an inflationary spiral. However, interest rates are effectively zero - the 'zero bound' - so that banks, financial institutions and corporates may be quite happy to swap one store of value, a bond, for another store of value, money, with no further consequences. It is only if the trade gives the banks etc. desired liquidity that there is likely to be a carry-though to spending and a rise in nominal GDP. Furthermore, if there is much spare capacity in the economy and high unemployment, as at present, the likelihood is a rise in output and not prices. So on this basis under present conditions expansion of the monetary base is unlikely to promote inflation and given almost zero interest rates and a 'liquidity trap' may not have much impact on demand - nominal GDP - at all. The current evidence that growth in

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the monetary base has not led to growth in the broader definition of money (M4) which includes bank deposits, the continuing weakness of bank lending, low levels of 'core' inflation - wage growth is no more than 2% - as opposed to 'headline' inflation and weak inflation expectations would appear to offer support for these points.[4]

Eurozone

Myth 3: Large government budget deficits and high levels of sovereign debt are the result of government profligacy.

The Eurozone (EZ) crisis is the most significant for the world economy since the events of late 2008 following the collapse of Lehmans. Yet, much media discussion and the pronouncements of the ECB, and key member governments such as Germany[5] and France seek to source the crisis to the irresponsible 'local' behaviour of the governments of peripheral countries such as Greece, Ireland, Portugal, Spain and Italy. The implication is that if such governments begin to behave responsibly then after some adjustment the problems of the EZ will be resolved. Nothing could be further from the truth. The problems of the EZ are largely 'systemic' although the behaviour of some governments and private sector agents in individual countries such as Greece has not helped. Kash Mansor[6] demonstrates that the explanation is more 'systemic' than 'local'. The creation of the EZ made it more attractive for investors in the rest of Europe to buy assets in the peripheral countries, where there were, on the face of it, significant investment opportunities. Governments in the periphery were able to borrow at near German rates because the financial markets believed, and were implicitly led to believe by the ECB and Germany and France, that peripheral country sovereign bonds had the backing of the EZ authorities. This led to significant flows of capital from the centre to the periphery and a crisis was precipitated when these flows suddenly stopped.

The evidence for this is in the data presented by Mansor and in his words " The factor that crisis countries have in common is that, without exception, they ran the largest current account deficits in the EZ during the period 2000-2007. The relationship between budget deficits and crisis is much weaker; some of the crisis countries had significant average surpluses (e.g. Spain and Ireland) during the years leading up to the crisis, while some of the EZ countries with large fiscal deficits (e.g. France and Germany) did not experience crisis. This is one piece of evidence that a surge in capital flows, not budget deficits, may have been what laid the groundwork for the crisis." Moreover, " ... the capital flow bonanzas in evidence ... were directly the result of the adoption of the euro by the peripheral EZ countries, which made it easier for capital in the core EZ countries to find investment opportunities in the periphery."[7]

Several of the periphery countries such as Greece, Portugal and Spain have real efficiency and competitiveness problems, which makes it difficult for them in a monetary union, led by Germany, that has high levels of productivity growth. One saving grace might have been if these investment flows had facilitated an economic adjustment in the periphery sufficient to raise their productivity and competitiveness towards German levels. The evidence shows that the capital flows were associated with investment spending rising in the periphery countries (with the exception of Portugal), and for consumption to fall. So, no evidence of local irresponsibility there. However, the capital flows in addition tended to fuel rising domestic prices in the periphery, hence a rising real exchange rate and deteriorating competitiveness, which improved little relative to Germany.

Myth 4: "fiscal and structural reforms" in the periphery will solve the current problems of the Eurozone .

This seems to be the view of the ECB and the core EZ states, Germany and France. There are two issues that need to be addressed: financing and adjustment of the peripheral states with high and unsustainable debt levels. The model of financing adopted by the EZ is to use the EFSF with leveraged funding up to 1,000bn Euros, bank recapitalisation and where necessary, as in the Greek case, debt relief: a 50% write-down of Greek debt is on offer. The financing package relies to a large extent on private sector support: voluntary debt write-downs and voluntary bank recapitalisation, as well as hoped for financial support for the EFSF from China. In addition, the peripheral economies are expected to make significant structural adjustments: budget deficit reductions and steps taken to improve the competitiveness of their economies through, effectively, internal devaluation of wages, prices and cost reductions relative to the EZ core.

There is little likelihood that these measures will solve the problems of the EZ. On financing, while the scale of support on offer might be sufficient to support Greece it is unlikely to be sufficient to support Italy because the scale of its indebtedness and its refunding requirements is so much greater. The only real solution to the financing problem is for the ECB to take on the true role of a central bank, which is not simply aiming for price stability but also acting as lender of last resort. If ECB acted as a lender of last resort it would start to buy individual sovereign bonds where there was a market shortfall. This is what the Bank of England would do in the UK or the Fed in the US. However, to fulfil this function would require the ECB to print Euros and hence increase the money stock. Given German sensitivities over inflation this is unlikely to happen and so the EZ crisis will continue until eventual breakup and reconstitution in some new form with perhaps a core Germany, France, Holland, Belgium, Luxembourg monetary union.

Added to this is the question of adjustment. The overriding goal of the ECB and the core countries of the EZ is that the burden of adjustment must be borne by the current account deficit countries in the periphery. But to secure adjustment in the absence of individual national currencies requires internal devaluation: price and wage reductions relative to the core. This is almost impossible to secure. Countries such as Ireland and Latvia which might be described as the poster boys of internal devaluation have hardly achieved any real internal reduction in wages and prices. We can say with some certainty that Germany and the ECB need to accept that current account surplus countries within the EZ are part of the problem. They must adjust too. They can adjust by allowing an expansion of domestic demand sufficient to promote a rise in domestic inflation to 3% to 4%. If that happens then it will be easier for the periphery to adjust through a much less stringent internal devaluation. If that does not occur there is little hope for the survival of the EZ as presently constituted.

UK

Myth 5: Fiscal austerity is necessary to secure business and financial market confidence.

A special case of Myth 1. Here we have the belief, frequently articulated by the UK government, that fiscal consolidation will not only free up private sector resources for growth but is necessary to encourage financial markets to accept lower interest rates - yields - on government bonds and hence borrowing. Lower bond rates make the debt easier to fund, make it more sustainable, and require less diversion of public spending to fund it. The coalition government's view is that current low yields on UK 10 year bonds represent a vote of confidence in the UK government's fiscal austerity policy. Hence, austerity was necessary even when the UK economy was relatively depressed. The alternative view is that stabilisation and reduction of debt levels through reduced structural budget deficits is necessary within a medium term fiscal framework. On this view, a fiscal stimulus may be required in the short-term to boost aggregate demand and protect tax revenues, with deficit reduction and reduced debt levels occurring in the medium term when the economy has more normal levels of aggregate demand.

What the evidence seems to show is that low UK government 10 year bond yields are more a reflection of expectations by the financial markets of low growth, and hence a flight from 'risk assets' such as equities into less risky assets such as UK, US and German sovereign debt. Neither the US nor Germany has put in place austerity measures on the scale of the UK government.

Myth 6: Britain's current weak current growth performance is a consequence of the Eurozone crisis

There is a sense from some of the comments of UK government ministers to recent UK growth figures that the crisis in the Eurozone is being blamed for the current weakness of UK growth. While it is certainly the case that the crisis is affecting confidence and may be leading to a reluctance to invest by some companies in the UK, the reason for a loss of confidence is that the crisis portends the risk of sovereign default, contagion to other sovereigns, bank runs, bank failures, and a drop in aggregate demand and GDP. If and when any of those events occur then the harmful impact on the global economy, including the UK, will be dramatic. But in the meantime the explanation for weaker UK growth largely rests at home: the continuing consequence of the debt overhang for household spending, low expectations of growth by firms leading to weak investment, insufficient pickup in net exports and the impact of the sizable fiscal consolidation. It is revealing that the US while experiencing a weak recovery from the Great Recession nevertheless returned to its pre-recession peak level of GDP in the third quarter of this year. The UK, in contrast, is still 4% below its pre-recession peak although the UK's unemployment rate is slightly lower at 8.1% compared to 9.1% in the US.

Forecasts

Background

The weakness of the global economy continued into the third quarter although there were some brighter spots. First, the US economy grew by 0.6%, or an annual rate of 2.5%. This is still weak growth for a recovery phase but it was better than expected and, as noted above, it took US real GDP back to its pre-recession peak. But the US economy is still not creating enough jobs to reduce its unemployment rate which is still at the high level of 9.1%. Secondly, the UK reported real GDP growth of 0.5% in the third quarter which was above the anticipated 0.3%. However, the special factors that temporarily reduced growth: the Royal wedding; two bank holidays; and the effects on supply of the Japanese Tsunami, have now unwound, so that the ONS recommends that the two quarters should be taken together. On that basis growth averaged 0.3% in the two quarters, with real GDP largely stagnant over the past year rising by only 0.5% over the year to the third quarter.

While the recent poor performance of UK GDP is due to weak domestic demand, the problems of the Eurozone (EZ) are likely to diminish future growth prospects even further. The 25 basis point cut in the ECB funds rate is very welcome but this reverses what was clearly an ECB policy error in raising the rate by the same amount in July. For most advanced economies on most key indicators, such as GDP, jobs and wage incomes, the recovery is worse than the average from previous recessions - see the FRED - Federal Reserve of St Louis - database.[8] This supports the Reinhart Rogoff (2010) research findings that economies subject to a recession precipitated by financial and banking crises in particular experience a very weak recovery.[9]

The latest forecasts from the London-based NIESR - The National Institute for Economic and Social Research suggest continuing weakness in UK GDP growth for the next eighteen months at least, with growth of 0.9% this year and 0.8% in 2012. They noted in their October GDP estimate release that this recovery will be the weakest of any since the end of the First World War and that includes the 1930s Depression. Against that background, we welcome the decision by the Monetary Policy Committee(MPC) of the Bank of England in October to begin a further programme of "Quantitative Easing" by increasing the purchase of, largely, government bonds with long-term maturities (more than 3 years) by £75 billion to £275 billion. But with the difficulties confronting monetary policy when interest rates are close to zero in getting carry through to nominal GDP, we still believe there is scope for more fiscal easing. This view is held by NIESR too, who in publishing their latest forecasts argue " .. it remains our view that in the short-term fiscal policy is too tight and a modest loosening would improve prospects for output and employment with little or no negative effect on fiscal credibility."[10]

Table 1: Forecast Scottish GVA Growth, 2011-2013

GVA Growth (% per annum)	**2011**	**2012**	**2013**
Central forecast	**0.4**	**0.9**	**1.6**
June forecast	*0.8*	*1.5*	*1.9*
UK median independent last 3 months (October)	1.0	1.5	na
Mean Absolute Error % points	+/- 0.296	+/- 0.492	na

Scotland cannot help being touched by weak household spending in the rest of the UK as well as the deteriorating conditions in the EZ. For example, more than half of Scotland's exports outside the UK are to EU economies mostly within the EZ.

Domestically, wage income growth has been weaker in Scotland than the UK, but UK income growth slowed in 2011 possibly moving the two more into line - see discussion of SNAP data in Scottish Economy Forecasts section below. Household spending fell by more in the UK during the recession, 6.5% compared to a fall of 4.5% in Scotland - a fall of 5% in the UK over the same period. Perhaps as a result, the UK savings rate stayed above the Scottish savings rate until the end of last year when the Scottish rate moved above the UK rate. We do not have data for much of 2011, nor do we know whether the Scottish data may be revised in the light of revisions to the UK data published on October 25th, so we don't know for certain whether there was an absolute and/or relative weakening in Scottish household expenditure. What is beyond doubt is that household spending in both Scotland and UK remains very weak, along with investment and exports.

Some light on the performance of the Scottish economy in the third quarter can be shed from survey data - see Review of Business Surveys section below. The third quarter surveys of output, jobs and retail spending broadly suggest a slowdown in activity with the expectation of a further slowdown and perhaps a complete halt to the recovery in the winter months. The Scottish Engineering Review is something of an exception, retaining a positive outlook but even here firms responding to the survey reported rising uncertainty. Overall, we consider that the demand for Scottish goods and services both currently and in the near term has weakened since we published the last Commentary in June.

GVA Forecasts

For our latest GVA forecasts we adopt a new presentational procedure. Since 2008 we have presented a high and low forecast as well as the central forecast. This was done in recognition of the high degree of uncertainty confronting the economy at the time and since. However, following recent work in the Institute reviewing the accuracy of FAI forecasts - see Grant Allan's paper later in this Commentary - we are now able to use the 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 2011 to 2013. The forecasts are presented in more detail in the Forecasts of the Scottish Economy section of this Commentary below.

Table 1 shows that we have revised downwards our forecast for all years. The lower forecasts reflect a weakening in household spending and export growth particularly compared with the position in June. The OBR forecasts for the UK are now out of date since they were produced in March and almost certainly will be revised downwards this month. Our forecasts are therefore compared with the median of latest independent forecasts for the UK in 2011, 2012 that are published by the UK Treasury. We are now forecasting growth of 0.4% in 2011, and 0.9% in 2012 compared to our June forecast of 0.8% and 1.5%, respectively. Given our previous forecast errors the lower and upper bounds for growth in 2011 are expected to be 0.1% and 0.7% and for 2012, 0.4% and 1.4%. Forecasts for the UK have also been reduced by independent forecasters, reflecting the weakening in the UK and global economies. So, overall, we are projecting weaker growth than previously and continuing weaker recovery than the UK.

Table 2: Forecast Scottish Net Jobs Growth in Three Scenarios, 2011-2013

		2011		2012		2013	
Upper		11,150		18,850		41,100	
	June forecast		*36,317*		*41,882*		*60,675*
Central		**4,900**		**8,750**		**16,200**	
	June forecast		*20,600*		*18,548*		*39,849*
Lower		-1,550		-1,350		-9,250	
	June forecast		*9,621*		*2,661*		*21,431*

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

		2011		2012		2013
ILO unemployment						
Rate (ILO un/TEA 16+)	**8.3%**		**8.9%**		**8.9%**	
Numbers		**219,800**		**234,200**		**231,550**
Claimant count						
Rate (CC/CC+total job)	5.4%		6.0%		5.9%	
Numbers		149,500		166,300		164,400

We expect that production and manufacturing output will continue to be the main sectoral drivers of growth, with Production forecast to grow by 1.2% this year compared to service sector and construction growth of 0.2% which are largely flat-lining. In 2012, production continues to be the main sectoral driver of growth with growth of 2.2%. Stronger growth is projected for services and construction of 0.6% apiece but the two sectors remain comparatively weak. It is not until 2013 that we see much pick-up in growth. GDP is forecast to rise by 1.6%, still about 0.4% points below historic trend, while production growth rises to 3.7%, service sector growth moves up to 1.1% and the growth of construction GVA reaches 1%.

Employment forecasts

Table 2 presents our forecasts for net employee jobs for the 3 years 2011 to 2013 in terms of a central and upper and lower forecasts.

Table 2 indicates that our year-end employee jobs forecast are much reduced from the forecasts presented in the June Commentary. The lower forecasts reflect data revisions, revised productivity estimates and the impact of a weakening economy. On the central forecast, net jobs grow by 0.2% in 2011, 0.4% in 2012 and 0.7% in 2013. By end 2013 total employee jobs are forecast to be 2,324,000 around 80,000 fewer than at the end of 2008 but up by 60,000 from the end of 2009, and up by 30,000 from the end of 2010. By sector, the largest absolute growth in job numbers is forecast for the production sectors, in 2011(2,400 against 2,250) but in services in 2012 (4,950 against 3,400 in production) and 2013 (9,350 against 6,100). Few jobs are created in construction or in agriculture over the forecast horizon.

Unemployment forecasts

The key unemployment forecasts are summarised in Table 3 below.

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. Unemployment is projected to rise further compared to our June forecast as GVA growth and job creation weakens. The recovery of Scottish GDP is expected to continue to be weaker and at a rate below that which is required - from the estimated Okun relationship - to stabilise unemployment. Hence unemployment is projected to rise even with positive output growth. Unemployment in Scotland this year is forecast to rise to 8.3%, or 219,800 by the end of this year, rising further to 234,200 or 8.9% by the end of 2012. After that, the numbers unemployed will fall only slightly to 231,550 by the end 2013 but the rate stays the same at 8.9%. However, as previous quarters have demonstrated there is considerable uncertainty around the unemployment forecast due to the extent to which output change maps into job change, changes in working population and independent variations in activity rates.

Brian Ashcroft
4 November 2011

Endnotes

[1]L. Ball, D. Leigh, and P. Loungani (2011) "Painful Medicine" , Finance and Development, September, page 22; and J. Guajardo, D. Leigh and A. Pescatori (2011) "Expansionary Austerity: New International Evidence" IMF Working Paper 11/158.

[2]L. Ball, D. Leigh, and P. Loungani (2011) op cit pp. 22-23.

[3]P. Krugman (2011) "Mr Keynes and the Moderns" Paper presented at the Cambridge conference commemorating the 75th anniversary of the publication of The General Theory of Employment, Interest, and Money, June.

[4]See A. Posen (2011) "How to do more" Speech given by Adam Posen, External Member of the MPC, Bank of England, September.

[5]Wolfgang Schauble, Germany's Finance Minister writing in the FT on 5 September 2011 " Whatever role the markets have played in catalysing the sovereign debt crisis, it is an undisputable fact that excessive state spending has led to unsustainable levels of debt and deficits that now threaten our economic welfare." cited by Kash Mansor (2011) " What Really Caused the Eurozone Crisis? (Part 1)" Street Light Blog, 22 September, http://streetlightblog.blogspot.com/

[6]Kash Mansor (2011) op cit

[7] Kash Mansor (2011) op cit

[8]http://research.stlouisfed.org/economy/

[9]Reinhart, C. and K. Rogoff (2010), This Time is Different, Princeton

[10]http://www.niesr.ac.uk/pdf/031111_83237.pdf

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