

Outlook and appraisal

Overview

The recovery continues to be weak in both Scotland and the UK. Our view of the performance of the economy has been distorted by the effects of the bad weather on production in December last year. However, once an allowance is made for weather effects it still looks as if GDP growth was stagnant over the last 6 months to the first quarter 2011. There are mixed messages on whether stagnation is continuing or whether the recovery has resumed again. It seems likely that the economy is still continuing to recover but at a fairly weak rate. Almost three years after the start of the recession the Scottish economy has only recovered about a quarter of the output lost, while the UK economy has recovered a third of lost output. These data support the evidence-based view that recovery from financially sourced recessions, particularly banking crises, are slow and painful. Exports are recovering slowly and business investment is fairly static with firms sitting on large piles of cash but unwilling to invest due to the uncertainty. So, the evidence seems to be moving in favour of those advocating a "Plan B" for the UK authorities to take some action to stimulate demand, it needs to be understood that while buttressing demand might be a necessary condition for a more rapid recovery it is not sufficient. We must be sure that our banking system is fit for purpose, able to freely lend to support the needs of the economy. It is not clear that we have presently reached that point. It is to be hoped that the final recommendations of the Independent Commission on Banking meet this requirement and that the proposals are adopted by the government.

Significant uncertainties cloud the prospects for future growth:

- contagion in the eurozone debt crisis as the fears of default on sovereign debt spreads from Greece to Spain and perhaps other peripheral eurozone countries, risks damaging bank lending, market and business confidence;
- fears of a slowdown in the growth of the Chinese economy as consumer price inflation takes hold;

- continuing uncertainty on the effects of the "Arab spring" with implications for oil prices and trade;
- the continuing weakness of the US economy and its effect on world trade;
- household expenditure is likely to continue to remain weak due to the continuing fiscal consolidation and the squeeze on real disposable incomes from the current high level of energy prices;
- consumer price inflation is above target and is likely to remain so for some time, household disposable incomes are being squeezed as a result. All of which runs the risk of a rise in inflationary expectations and strengthened wage claims, but there is little sign that this is happening with the demand for labour still relatively weak and earnings growth remaining at around 2% p.a.

Against this background we are forecasting that growth of GDP will be somewhat weaker in 2011 at 0.8%, than our forecast of 1% growth in March. Our forecasts remain below the OBR and consensus forecasts for the UK in 2011, 2012 and 2013, which largely reflects the weaker growth of household spending in Scotland and a sluggish outlook for private sector investment. Next year, we are forecasting growth of 1.5%, 0.1% points less than our March forecast, and an unchanged forecast of 1.9% for 2013. We expect that production and manufacturing output will continue to pick up reasonably strongly, but at a slightly lesser rate than in our previous forecast with production growing at 3.6% in 2012 compared to 4% in our March forecast. The service sector is forecast to continue on its weak growth path growing by 0.5% this year, 1.1% in 2012 and 1.3% in 2013, largely due to the weakness in the growth of household expenditure. Construction also continues to exhibit weak growth of 0.5% in 2011, 0.9% in 2012, and 1.1% in 2013, reflecting cut-backs in government capital spending and weak private sector investment.

We continue to expect net employment growth during this year and over the forecast horizon. Net jobs grow by 0.9% in 2011, 0.8% in 2012 and 1.7% in 2010. By 2013 total employee jobs are forecast to be 2,373,000, around 60,000 fewer

than in 2007 but up by 80,000 from the end of 2010. By sector, the largest percentage growth in job numbers is forecast for the production sectors, but the greatest number of jobs created will still be in services, despite the low forecast for output growth, due to the sheer scale of the sector.

Even though growth in output picks up it will not be sufficient to prevent some pickup in unemployment. Unemployment in Scotland this year is therefore forecast to rise to 8.3%, or 217,000 by the end of the year and be largely stable through 2012 with a slight further rise to 220,000 by the year end. After that, the rate should fall to 8.2% by end 2013. However, as previous quarters have demonstrated there is considerable uncertainty around the unemployment forecast.

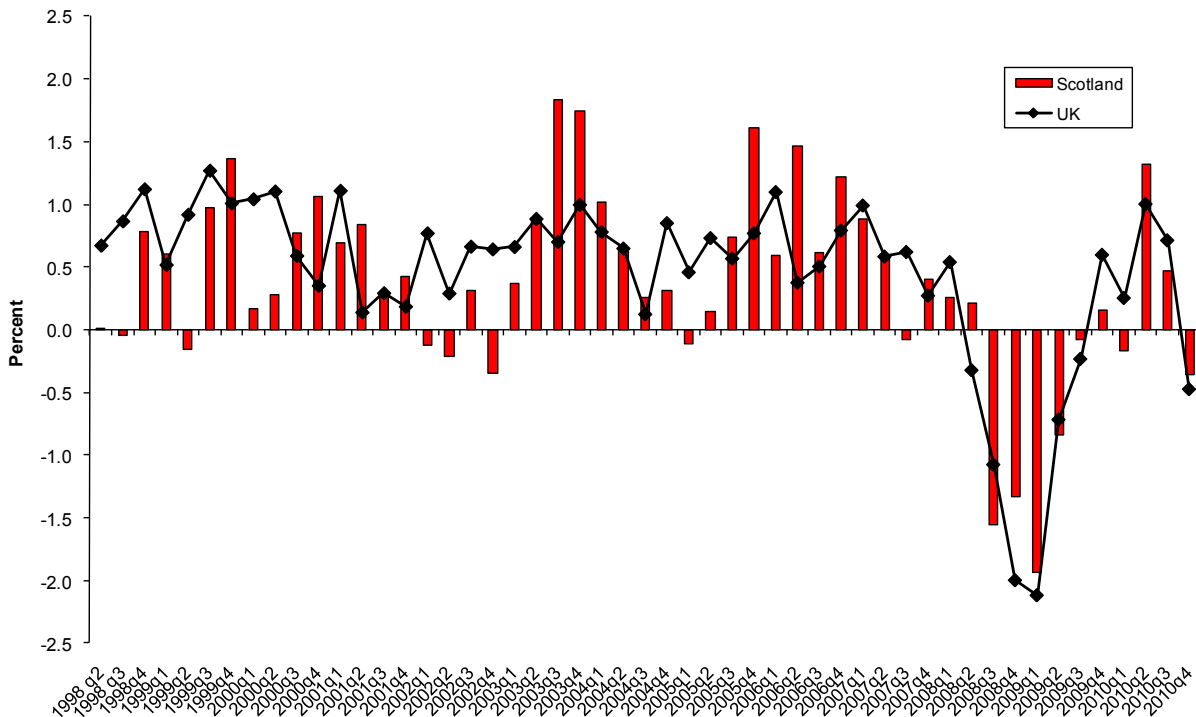
We also revisit the issue of the longer-term performance of the Scottish economy. We note the recent evidence of the rise in Scottish GDP per head relative to the UK during most of the last decade, which comes from UK Regional Accounts data published in December. Further analysis leads us to conclude that the evidence of an appreciably higher Scottish GDP per head relative to the UK by the end of the first decade of the new millennium is the result of both the differential effects of large cyclical movements and slower population growth on the relative. It does not appear to be explained by an improvement in Scotland's relative competitiveness, or underlying economic performance.

Recent GDP performance

The Scottish Government GDP data for the fourth quarter 2010 - released on 20th April - indicate that the Scottish economy suffered a marked decline in output, although a little less severe than the UK as a whole. Scottish GDP contracted by -0.4% while UK GDP fell, on revised figures, by -0.5% - see Figure 1.

The Office of National Statistics (ONS) estimate that -0.5% points of the UK GDP reduction was due to the unusually bad weather conditions in December in Britain, implying that growth in the British economy had stagnated after the strong recovery of the second and third quarters. As Figure 1 reveals, much the same can be said for the Scottish economy. Over the year to the fourth quarter, the Scottish economy grew by 0.8% compared to 1.4% in the UK, indicating a weaker recovery from recession here.

Figure 1: Scottish and UK quarterly GDP growth, 1998q2 to 2010q4



The comparative overall GDP performance of Scotland and the UK over the recession and subsequent recovery to 2010q4 is given in Table 1.

Table 1: Scottish and UK GDP: recession and recovery

	Scotland	UK
GDP fall in recession	-5.62%	-6.31%
Change from peak to 2010 Q4	-4.28%	-4.34%
GDP recovery to 2010 Q4	1.42%	2.11%

Table 1 shows that the recovery is clearly weak in both Scotland and the UK with both economies more than 4% below the previous peak before recession started in 2008q2 in Scotland and 2008q1 in the UK. So, almost three years after the start of the recession the Scottish economy has only recovered about a quarter of the output lost in recession, while the UK economy has recovered a third of lost output. These data support the evidence-based view that recovery from financially sourced recessions, particularly banking crises, are slow and painful¹. Indeed, Reinhart and Rogoff (2009) make the point that after severe banking crises "countries in crisis that fail to fix their financial systems - such as Japan in the 1990s - can find themselves going in and out of recession and performing below potential capacity for years. The evidence seems to be moving in

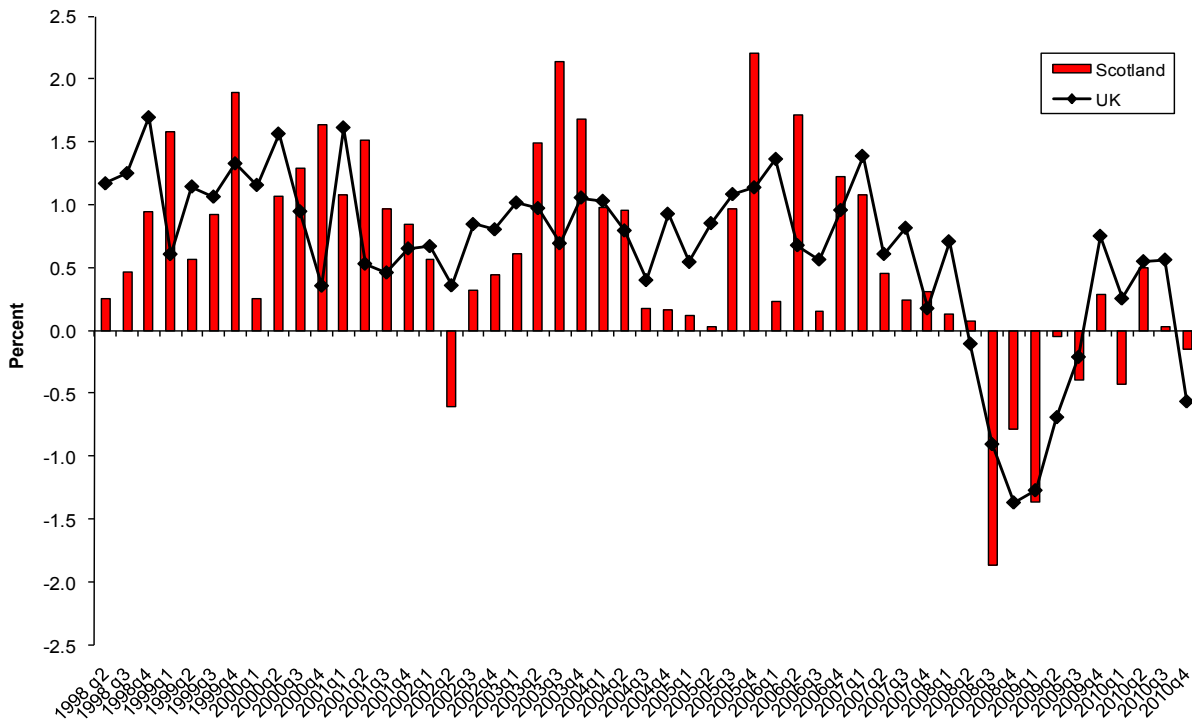
favour of those advocating a "Plan B" for the UK authorities to take some action to stimulate demand, it needs to be understood that while buttressing demand might be a necessary condition for a more rapid recovery it is not sufficient. We must be sure that our banking system is fit for purpose, able to freely lend to support the needs of the economy. It is not clear that we have presently reached that point. It is to be hoped that the final recommendations of the Independent Commission on Banking meet this requirement and that the proposals are adopted by the government.

In the 4th quarter of 2010, the service sector in Scotland – accounting for 74% of overall GVA on 2007 weights – suffered a fall in GVA of -0.1% while output in UK services fell much more by -0.6% - see Figure 2. Over the year to 2010q4, GVA in Scottish services fell by -0.1% compared to a rise of 1.1% in the UK. The comparative overall GVA performance of Scottish and UK services over the recession and subsequent recovery is given in Table 2.

Table 2: Scottish and UK Services GVA: recession and recovery

	Scotland	UK
GVA fall in recession	-4.39%	-4.48%
Change from peak to 2010 Q4	-4.17%	-2.99%
GVA recovery to 2010 Q4	0.23%	1.55%

Figure 2: Scottish and UK services GVA growth at constant basic prices 1998q2 to 2010q4



It is clear from Table 2 that while the loss of output in the recession in Scottish services was similar to UK services, the sector had hardly started to recover in Scotland nearly 3 years later with just 5% of output lost recovered by 2010q4. In the UK, in contrast, the service sector, while still recovering weakly had nonetheless recovered 35% of lost output by 2010q4.

Within services, the almost flat performance in the 4th quarter was associated with considerable variation in the performance of the seven principal sectors that comprise the sector. On the positive side, 3 sectors exhibited positive growth during the quarter, with retail & wholesale growing by 0.5% in the quarter and by 1.8% over the year. The comparable UK retail & wholesale figures were growth of 0.2% and 2.9%, perhaps one indication that Scottish household spending has been more subdued than its UK counterpart over the year. Real estate and business services (REBS) grew by 0.4% in the quarter and by 0.5% over the year, a stronger performance than its UK counterpart in the 4th quarter, which contracted by -0.7% but grew more strongly by 2.7% over the year. Public admin, education and health also exhibited some growth in the 4th quarter with GVA rising by 0.2% and 0.3% over the year. The UK public sector grew similarly in the 4th quarter but with 1% growth over the year continued to expand by more than its Scottish counterpart. Presumably, now that fiscal consolidation has begun in earnest we should expect to see some negative outcomes in the measured growth of the

public sector. On the negative side, other services contracted by -1.5% in Scotland in the quarter and by -3.9% over the year. This was a much bigger contraction in both time periods than other services in the UK which contracted by -1.2% in the fourth quarter but grew by 2.1% over the year. Hotels & catering, transport, storage & communication and financial services all contracted in the fourth quarter in Scotland by -0.3%, -0.8%, and -1.4%, respectively. This was somewhat better than their UK counterparts in Hotels & catering and Transport which contracted by -2.1%, -1.7% in the UK. Financial services in contrast contracted by -1.1% in the UK compared to -1.4% in Scotland - see Figure 3.

Table 3: Scottish and UK manufacturing GVA recession and recovery

	Scotland	UK
GVA fall in recession	-10.63%	-14.51%
Change from peak to 2010 Q4	- 8.17%	- 9.36%
GVA recovery to 2010 Q4	2.75%	.03%

It is evident from Figure 3 that Financial services continues in recession in the UK and with three successive quarters of negative growth has moved back into recession in Scotland. Hotels & catering can also be considered to be in recession

Figure 3: Scottish and UK financial services GVA growth at constant basic prices 1998q2 to 2010q4

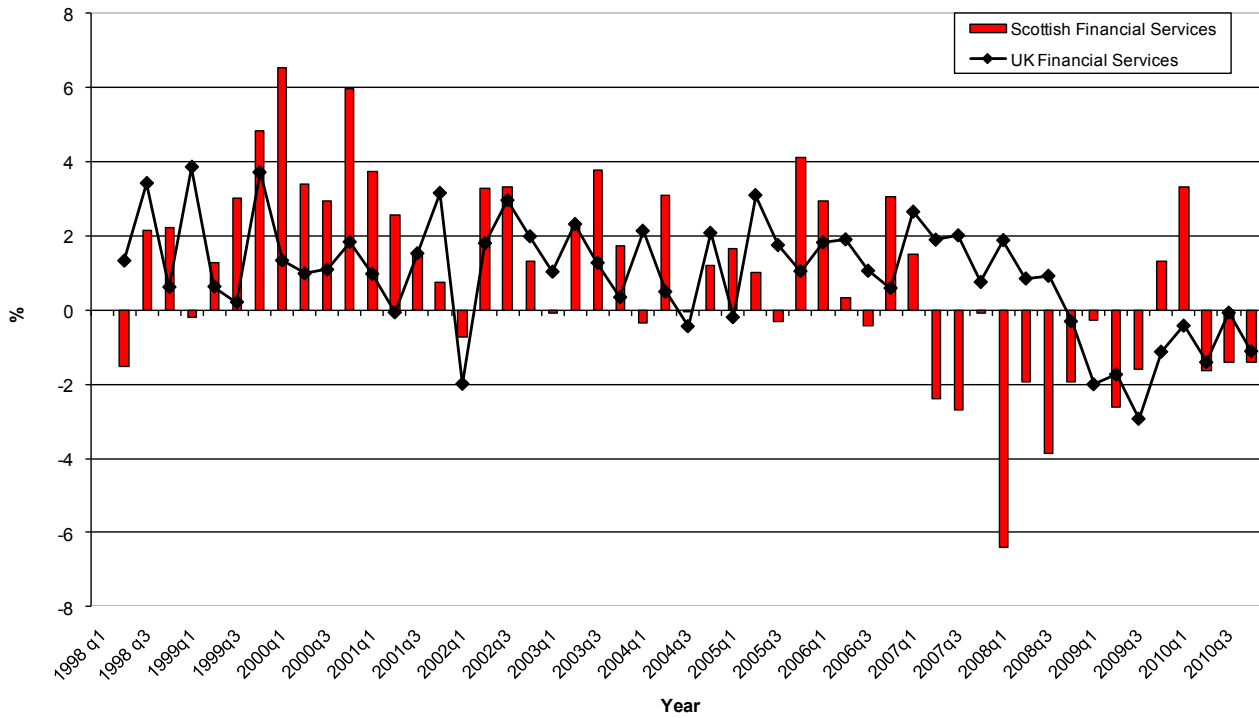
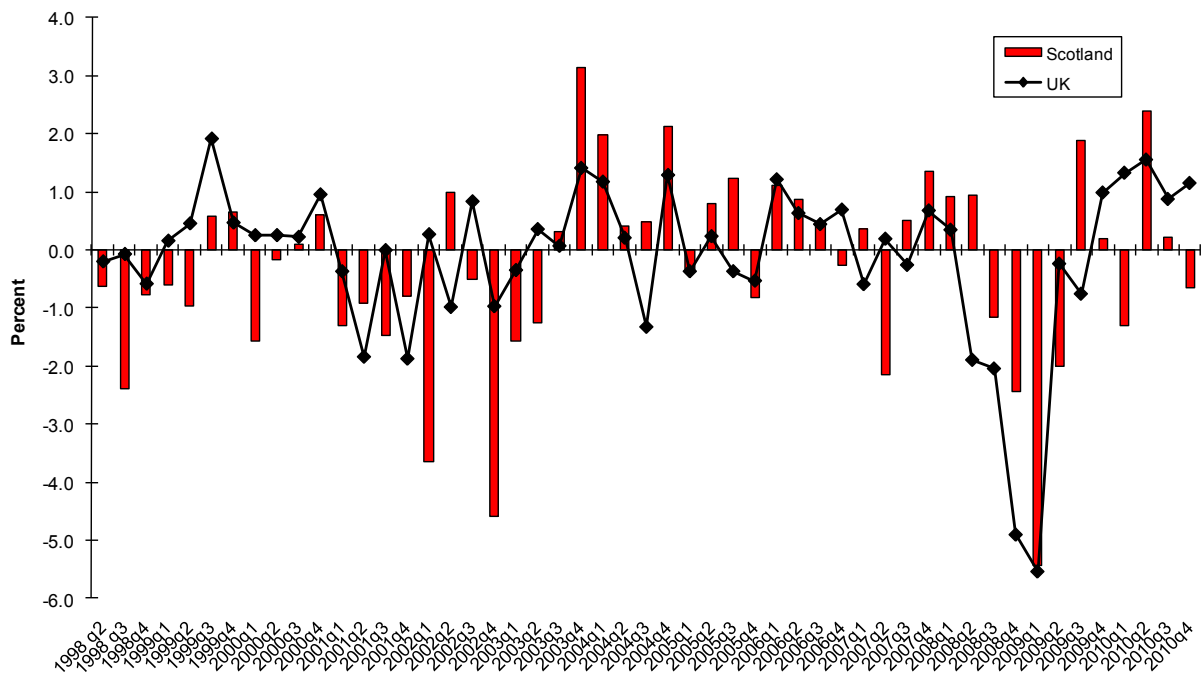


Figure 4: Scottish and UK manufacturing GVA growth at constant basic prices 1998q2 to 2010q4

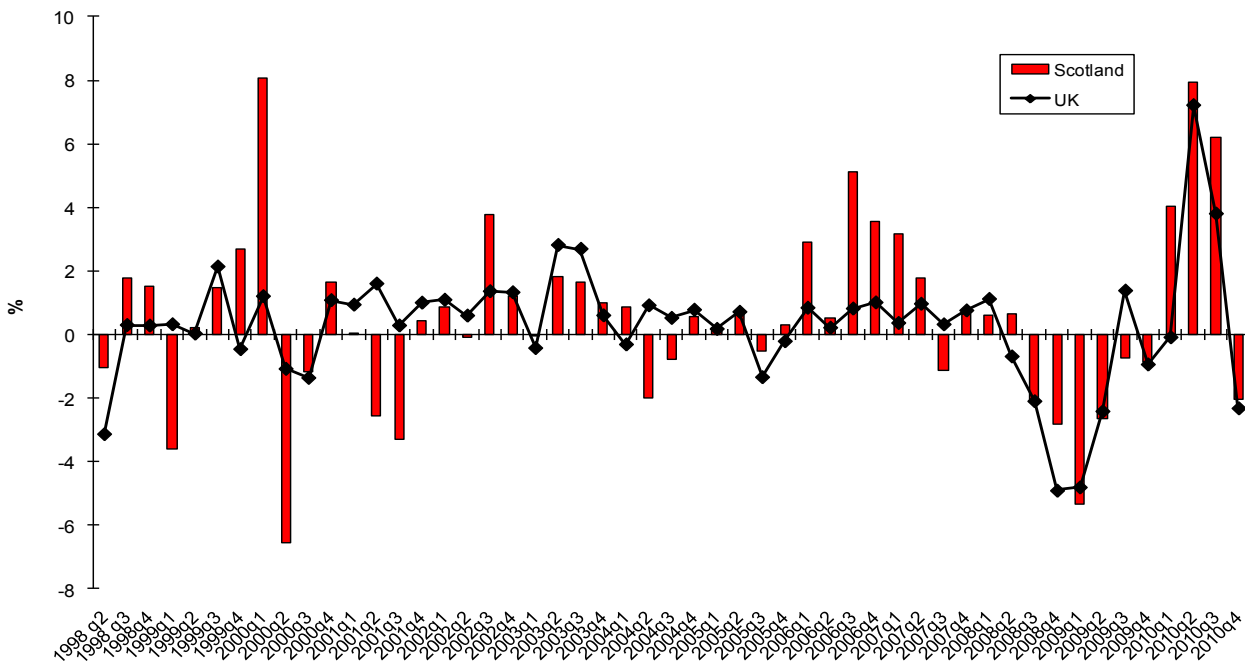


The manufacturing sector in Scotland contracted by -0.6% in the fourth quarter while UK manufacturing grew by 1.1% - see Figure 4. Over the year, the sector grew by 1% in Scotland compared to 3.6% in the UK, again suggesting a weaker recovery here than in the UK. Table 3 reveals the extent of the recovery in manufacturing in Scotland compared to the UK. The recession in UK manufacturing was much greater than in Scotland. To the fourth quarter UK manufacturing had recovered 42% of the output lost while Scottish manufacturing had only recovered 26% of the production lost in recession.

Within manufacturing, some key sectors did enjoy positive growth in the fourth quarter despite the overall fall of -0.6% in Scottish manufacturing GVA. Engineering grew by 1.4% in the quarter and by 1.3% over the year. But within engineering the electronics sector contracted by -1.4% in the quarter and by -4.1% over the year. In contrast,

transport equipment grew by 7.1% in the quarter and by 10.1% over the year, while mechanical engineering grew by 0.4% in the quarter and by 2% over the year. Outside engineering textiles, footwear and clothing grew by 2.5% in the quarter and by 7.9% over the year. The food & tobacco sector also grew by 0.3% and by 4% over the year. On the negative side, significant fourth quarter contractions were evident in refined petrol products & nuclear fuel where GVA fell by -9.1% in the quarter and by -3.7% over the year. Fortunately, the sector only accounts for 0.3% of overall GVA. In paper, printing and publishing GVA fell by -5.6% in the quarter but rose by 2.6% over the year. It is worth noting that, in the fourth quarter in manufacturing chemicals and electronics slipped back into recession displaying two quarters of negative growth, while refined petrol products & nuclear fuel has been in recession for 4 consecutive quarters.

Figure 5: Scottish and UK construction GVA volume growth 1998q2-2010q4



Finally, in this survey of the performance of the key productive sectors in Scotland we note that the construction sector weakened considerably in the fourth quarter as the effects of the poor weather caused work on activity to cease or be postponed. The sector contracted by -2% in the quarter compared to a similar contraction of -2.3% in the UK - see Figure 5. Over the year, Scottish construction performed more strongly than its UK counterpart growing by 11.2% compared to 6%.

Table 4 indicates that Scottish construction has tended to outperform its UK counterpart during both recession and recovery. Indeed, it continues to be the only principal sector in Scotland that has recovered the output lost in recession having recovered 122% of the GVA lost, whereas by the fourth quarter UK construction had only recovered 64% of the GVA lost in the recession, although this is still better than the performance of most other sectors.

Table 4: Scottish and UK construction GVA: recession and recovery

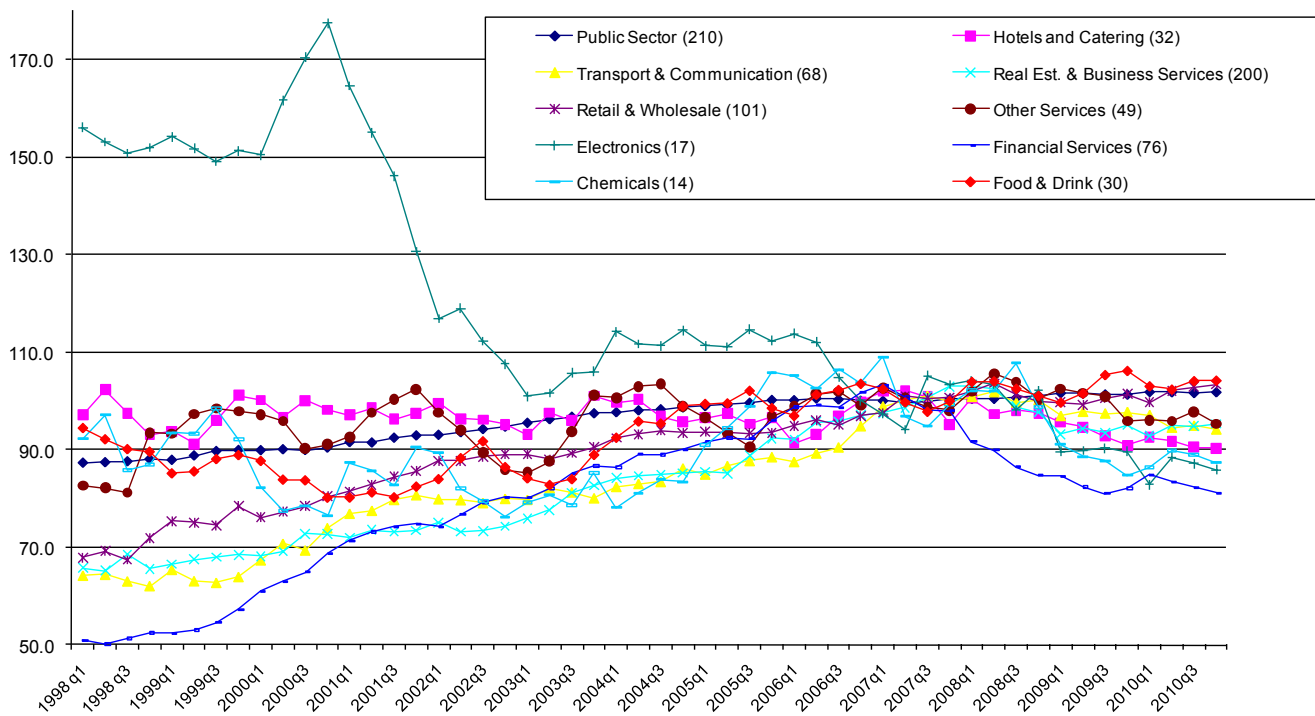
	Scotland	UK
GVA fall in recession	-13.71%	-14.08%
Change from peak to 2010 Q4	0.78%	-6.31%
GVA recovery to 2010 Q4	16.79%	9.05%

What is clear from this survey of industrial performance in Scotland is that the evidence points to a slowing of the recovery by the fourth quarter which looks to be more than simply weather related. Figure 6 presents the GVA performance of key Scottish growth sectors which we usually examine each quarter. What is clear from the figure is that growth in many sectors is weakening. Indeed, excluding the public sector 4 of the 10 private sectors were in recession by the fourth quarter for 3 successive quarters: financial services and hotels & catering, or for two

successive quarters: electronics and chemicals. Given the need for the economy to export and invest its way to recovery the fact that two key manufacturing sectors have slipped back into recession is worrying.

The overall aggregate position in the economy during recession and recovery is presented in Figure 7. This figure contains the latest employment data for the UK and Scotland up to the first quarter of 2011. Overall, as noted above, the Scottish economy had by the fourth quarter of last year recovered only about a quarter of the GVA lost in recession compared with a third for the UK. This is not a dramatic difference as the graph of Scottish and UK GVA in Figure 7 shows. However, it does hide the fact that the strength of the recovery of Scottish output has been largely driven by construction and to a lesser extent manufacturing. With 5% output recovered the service sector has hardly shown any recovery at all. Moreover, even when allowing

Figure 6: Growth of key sectors in Scotland 1998q2 to 2010q4



for the weather in the fourth quarter of last year the recovery appears to be weakening and this looks as if it has continued into 2011. This especially appears to be the case with job creation, which as Figure 7 indicates went into reverse in Scotland between the final quarter of 2010 and the first quarter of this year. It is true that there has been stronger job creation in Scotland in recent quarters than in the UK, but as we argued in previous Commentaries, the stronger Scottish jobs growth has probably been a reflection

of the large shake-out of jobs that occurred between the final quarter of 2009 and the first quarter of 2010. The Scottish unemployment rate - ILO - measure - has fallen again by 10,000 in February to April compared with the previous three months to 7.7%, which places the rate on a par with the UK, where the unemployment rate also fell, even though employment in Scotland dropped by 7,000. But by the first quarter of this year total employment was still nearly 3% below the last peak before recession, whereas

Figure 7: GVA and jobs in recession and recovery: Scotland and UK

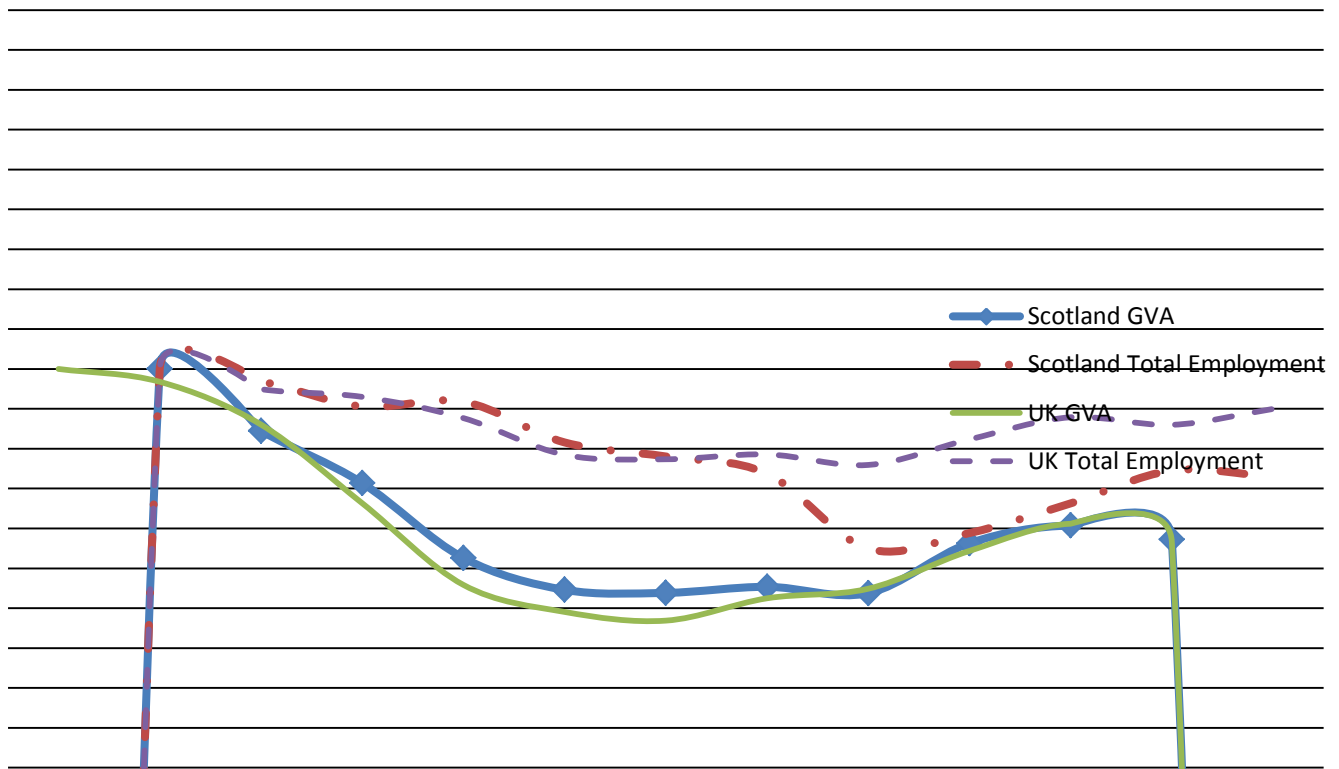
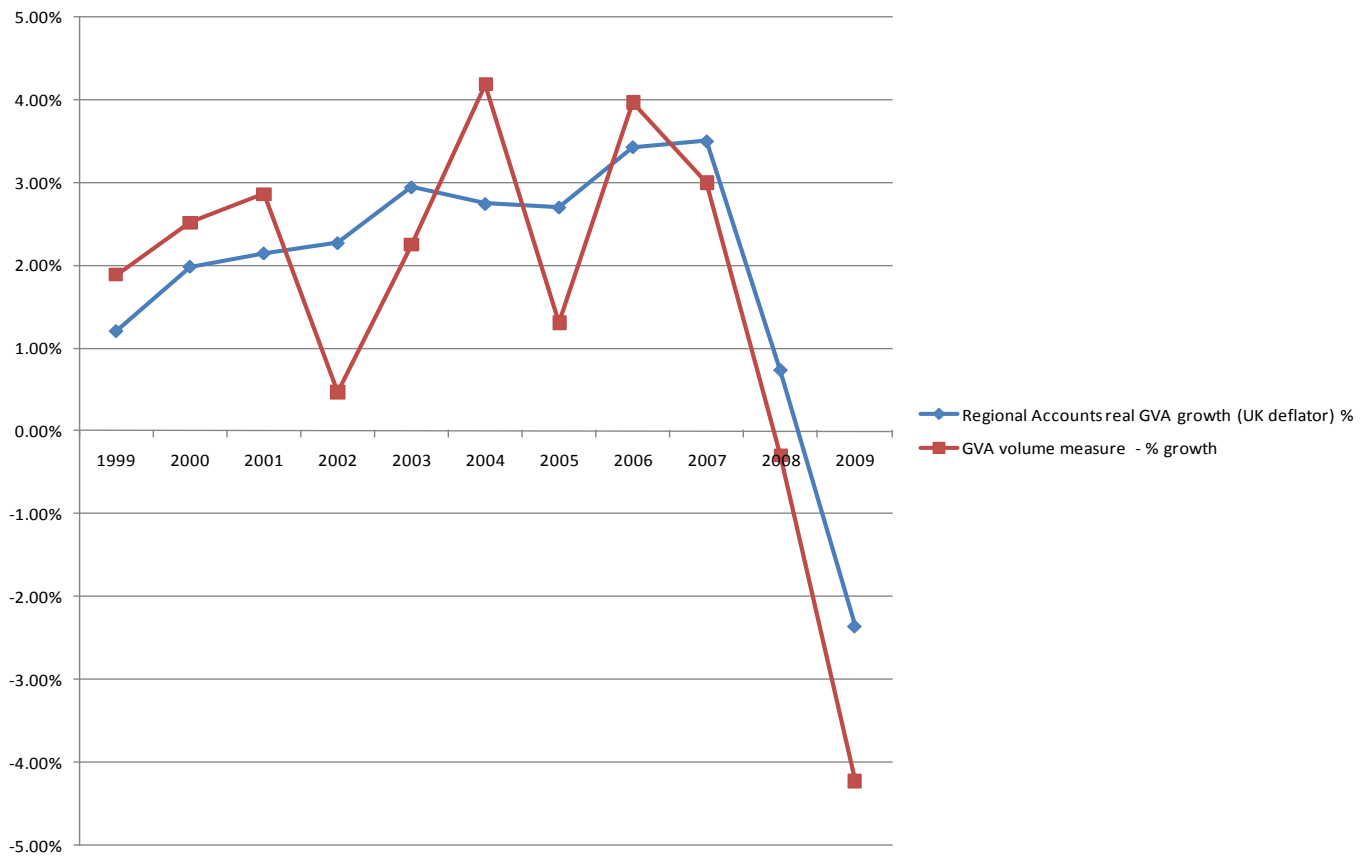


Figure 8: Scottish real GDP growth 199-2009 using regional accounts and volume measure – percent per annum



UK employment was only 1% below its pre-recession peak. That is a mark both of the greater job loss in the recession and the weaker recovery in Scotland; there can be no complacency about the state of the jobs market in Scotland.

Scottish Growth and GDP per head

In the March Commentary we analysed Scotland's growth performance over the last 50 years and came to the following conclusions:

- Scottish growth over almost 50 years is comparable to UK growth – a little lower in absolute terms – but middling by international standards. Trend growth in GDP per head is slightly higher in Scotland but largely due to weaker population growth;
- Mature economies tend to display similar trend growth close to 2%. Although, small open economies have scope for faster growth and decline due to significance of resource mobility e.g. capital and labour, into and out of the economy;
- Until the recent recession, the most important sectors for Scottish growth were real estate & business services, financial services, retailing & wholesaling, and transport & communication, much the same as in the UK;
- Ranking fifth in importance the public sector was much less important to growth than has often been suggested and no more important in Scotland than in the UK;
- The analysis suggested that if Scotland could move closer to the UK industrial structure it would get a growth dividend, because Scotland is somewhat less specialised in fast growing sectors such as business services & real estate, retail & wholesale and transport & communication;
- But the analysis also suggested that the performance of Scottish industry has been generally weaker than UK industrial counterparts and that suggests an intrinsic competitiveness problem;
- This is supported by evidence that Scottish labour productivity growth is weaker than UK. But unit labour costs are, on average, about 3% lower here, which suggests that we have a problem of lower total factor productivity: it is not simply low investment and low capital per worker that is the problem;
- Scotland's export base is narrowly focused, is declining, and may have been eroded further in the recession;

- To raise Scotland's growth rate we argued that there was a need to grow the export base by developing companies of scale and attracting inward investment, and enhancing its competitiveness through innovation, R&D and improved business sophistication, including promoting leadership and enterprise;
- Scotland's strong university research base, technological and sectoral know-how, graduate supply, high social capital and amenity, are strengths that offer a basis for future growth in key sectors;
- Small firms have a low export propensity but policy can raise economy-wide value added both by seeking raise the exports of SMEs and by encouraging new and small firms to seek to link into the supply-chains of the key 400 firms in the Scottish export base.

Following on from this analysis our colleagues in the Centre for Public Policy for Regions (CPPR) published independently an analysis of Scotland's relative economic performance since devolution compared to the UK and Wales and Northern Ireland. Using data from the Regional Accounts database CPPR analysed Scottish GDP per head relative to the UK over the period of devolution. They note "... the growth rate on this measure has been above that of the UK every year since 2004 (and, since 2001, it has been faster than the UK in every year bar one, 2004). This apparent out-performance of the UK economy, both in good times as well as bad, is little commented upon by government(s) or academia².

We welcome the opportunity both to comment on the performance of Scotland's GDP per head relative and to take the analysis further.

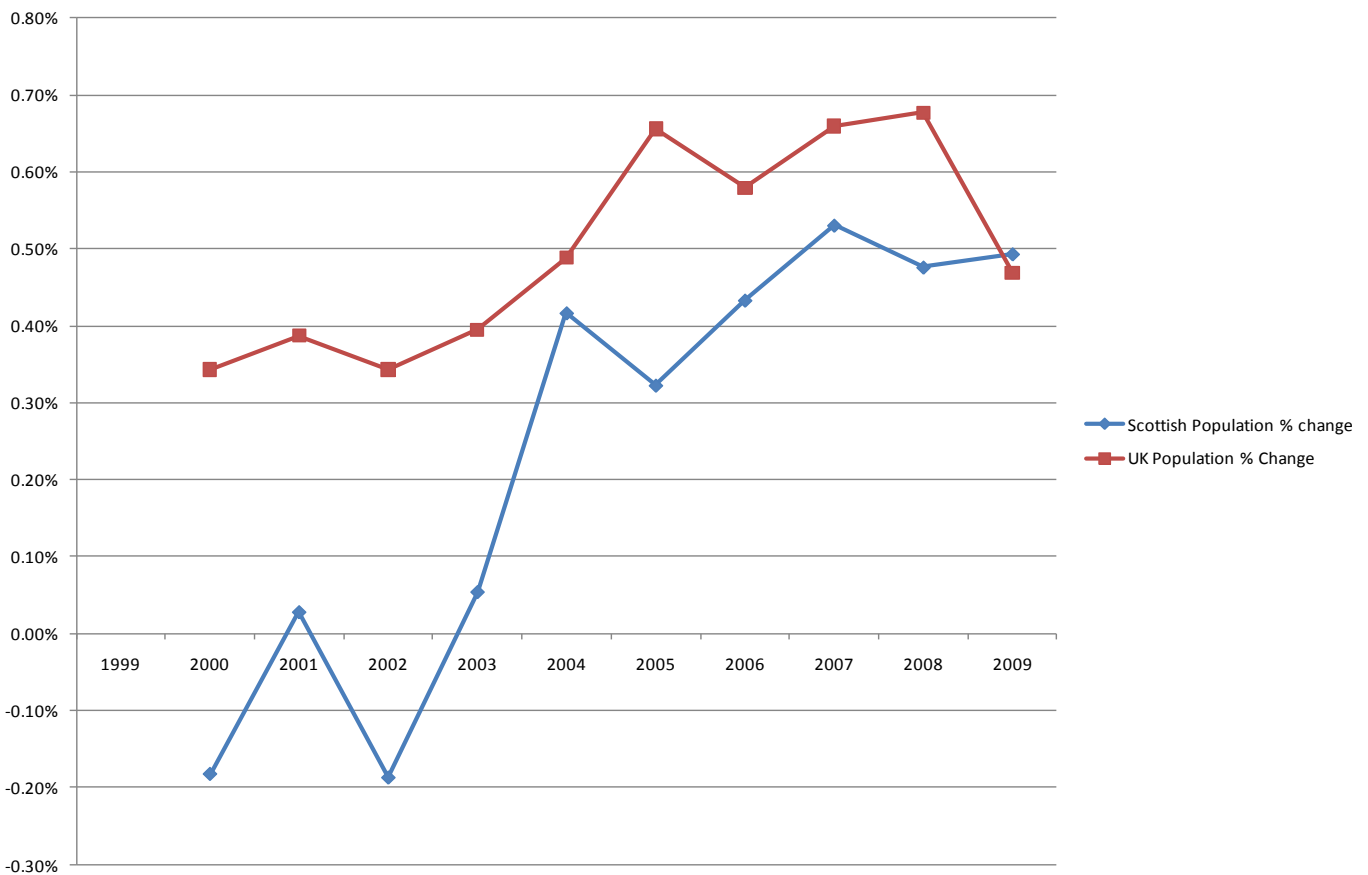
CPPR correctly note that using the UK Regional Accounts data, which estimates GVA at current basic prices by utilising data on incomes, Scotland's GDP per head relative to the UK has risen for most of the period between 2001 and 2009 - excepting 2004. So, in 2000, the first full year of devolution, the relative stood at 94 - i.e. average produced income amounted to 94% of the UK average. By 2009 this had risen to 99, or almost par with the UK. For the relative to rise it is correct to argue that GDP per head had risen faster than in the UK but the conclusion that the Scottish economy outperformed the UK during this period needs to be heavily qualified, for several reasons.

First, the UK Regional Accounts data give a quite different estimate of Scottish GDP growth over the period from the GVA at basic prices volume data produced by the Scottish government, and which is normally used to provide a picture of the growth of the Scottish economy. Figure 8 graphs the two series. It is evident that they are quite a bit different. The Regional Accounts Series is based on a weighted five year

moving average and so is a "smoothed" series whereas the volume measure employs no smoothing. In addition, the income based approach might be less robust than a production based approach as used by the Scottish government in their series, this is because of the difficulty of tracking incomes but also because comparison with the UK implies that a UK price deflator is used to deflate Scottish incomes. While a Scottish price deflator could be similar to the UK series it need not be the same. Yet, there is some merit in using a smoothing technique but it might not be the best way to remove the impact of short-term shocks to GDP such as a recession. So, we see that the smoothing has

worked in Scotland's favour by producing a contraction at 2009 UK prices of GDP in 2009 of -2.36% but a much greater contraction of -3.68% in the UK (less extra-regio) series. The Scottish volume series shows that the Scottish economy contracted by less in the recession overall by -5.62% compared to -6.31% in the UK. The difference was not as marked as implied by the Regional Account series. The fact that Scotland did better in the recession relative to the UK says little or nothing about Scotland's long-run growth performance. Ideally, the series should be adjusted by a long-term growth trend rather than a moving average. We do this below.

Figure 9: Scottish and UK annual population growth 2000-2009



Secondly, while economists stress the importance of GDP per head as a measure of welfare and prosperity one needs to be careful about drawing conclusions on relative economic performance, in terms of say productive efficiency, from such series. This is because the series is affected by population movements and differences between the two jurisdictions can distort the GDP per head relative. Figure 9 indicates that during the devolution period Scottish population growth was consistently less than UK population growth, was negative in two of the years 2000 and 2002 but improved over the period to parity with the UK in 2009. The effect of weaker Scottish population growth is to boost GDP per head growth relative to the UK.

In order to deal with these issues we have recomputed the Scottish GDP per head relative to the UK using first the Scottish government's GVA series, we have also applied both Scottish and UK population growth rates to the two series to standardise for the differential movements in population on the GDP per head relative. The results are presented in Figure 10.

Figure 10 shows first the GDP per head relative using the Regional Accounts series with Scottish population as used by CPPR. The second series replaces Scottish population growth with UK population growth and the Scottish relative falls and is on average 1.7 percentage points lower over the

Figure 10: Scottish GDP per head, 1999 to 2009, with alternative GVA growth estimates and Scottish and UK population growth, (UK=100)

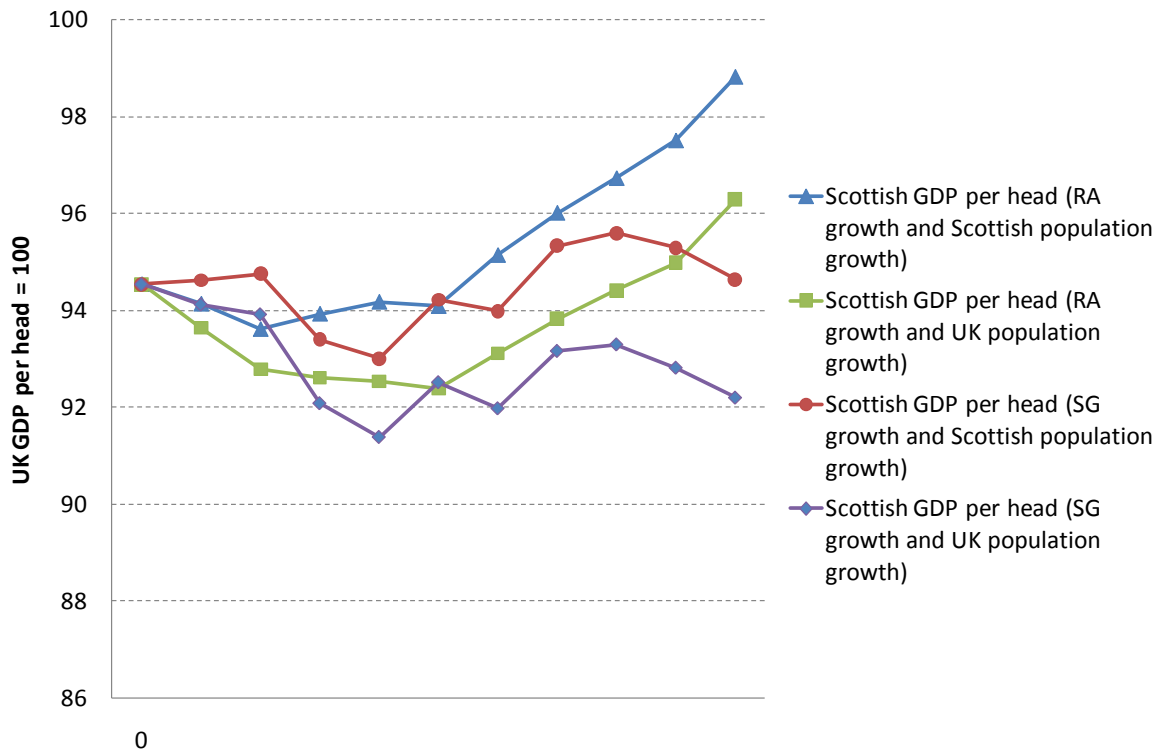
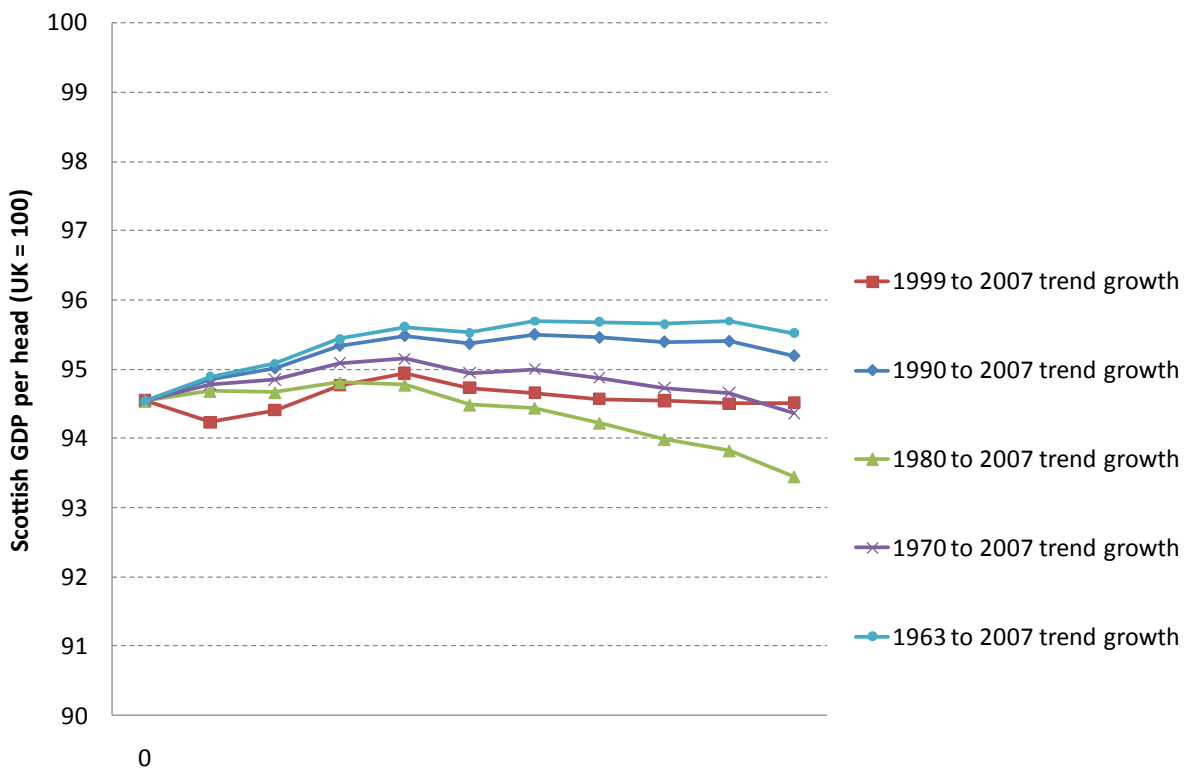


Figure 11: GDP per head in Scotland (UK=100) 1999 to 2009 applying historic trend growth to 1999 GDP per head for Scotland and UK, and dividing by actual population for Scotland and UK in these years



period from 2000-2009 averaging 93.7 against 95.4 before. The third series takes the Scottish government's GVA series and Scottish population growth to compute the relative. Here the average is 94.5, 0.8 percentage points below the Regional Accounts series. Finally, we apply UK population growth to the Scottish governments GVA data to get the final series, which has an average of 92.8 or 2.6 percentage points below the original Regional Accounts series. It is worth noting that it is only when the Regional Accounts series is used that there is any rise in the Scottish GDP per head relative between 1999 and 2009, when we standardise for population growth the series rises slightly from 94.5 to 96.3. However, when we use the Scottish government volume GVA series the relative is largely unchanged between 1999 and 2009 going from 94.5 to 94.6. However, when we standardise for population the relative falls over the period from 94.5 to 92.2. On this basis, it does not seem appropriate to characterise the Scottish economy as outperforming the UK economy between 1999 and 2009. The last decade was, of course, a period of marked short-term cyclical movements with a boom occurring in the middle part of the decade followed by a recession the scale of which was greater than anything we have experienced since the Great Depression of the early 1930s. It is a stylised fact that Scotland has a flatter business cycle than the UK, suffering less in recessions and recovering less strongly. These movements can therefore mask longer-term performance trends and their effect on the GDP per head relative. In Figure 11 we apply different GDP trends based on the (geometric) average Scottish and UK growth experience over different time periods prior to the severe recession of 2008 and 2009.

The first point to note is that the GDP per head relative changes little over the ten years. It rises slightly if Scottish trend growth is the 1963 to 2007 and the 1990 to 2007 trend. In the former, Scottish GDP averaged 2.24% p.a. against a UK average of 2.40%. In the 1990 to 2007 period growth averaged 2.38% p.a. in Scotland and 2.58% p.a. in the UK. For the other three trends the relative either remains the same or falls over the period.

So, we can conclude that the evidence of an appreciably higher Scottish GDP per head relative to the UK by the end of the first decade of the new millennium is the result of both the differential effects of large cyclical movements and slower population growth on the relative. It does not appear to be explained by an improvement in Scotland's relative competitiveness, or underlying economic performance.

Forecasts

Background

Both the Scottish and UK economies had clearly weakened by the end of last year and this was due to more than just the effect of bad weather. The surge in job creation, which followed the shakeout of jobs at the beginning of 2010 appeared to have come to an end by the beginning of 2011 as job creation in Scotland fell in the first quarter even

though unemployment continued to fall (See Labour Market section in this Commentary below). In the first quarter of 2011, UK GDP rose by 0.5% but there is general agreement that this largely reflected a catch-up of activity postponed in the bad weather of the final quarter of 2010. UK growth had effectively been stagnant for 6 months. First, quarter GDP/GVA data for Scotland are not available until the third week of July. In the absence of outturn data we must rely on the business surveys for information on the performance of the Scottish economy in recent months.

Scottish business surveys (see Business Surveys section in this Commentary below) generally suggest a continuing weakness in the demand for their goods and services against a background of increasing cost pressures, with rising raw material and energy costs of particular concern. Consumer confidence and domestic demand remains weak with export markets key for manufacturers. Despite this the latest Lloyds TSB Scotland Business Monitor, for the three months to the end of May, reports that the economy is continuing to recover with a third of firms reporting increased turnover, and expectations of improving trade over the next six months at their highest level for more than three years. But the survey concludes that "the economy remains fragile as consumer spending is constrained by low confidence as a result of rising inflation, which is squeezing disposable incomes."

Yet, there are considerable clouds on the horizon:

- contagion in the eurozone debt crisis as the fears of default on sovereign debt spreads from Greece to Spain and perhaps other peripheral eurozone countries, risks damaging bank lending, market and business confidence;
- fears of a slowdown in the growth of the Chinese economy as consumer price inflation takes hold;
- continuing uncertainty on the effects of the "Arab spring" with implications for oil prices and trade;
- the continuing weakness of the US economy and its effect on world trade;
- household expenditure is likely to continue to remain weak due to the continuing fiscal consolidation and the squeeze on real disposable incomes from the current high level of energy prices;
- consumer price inflation is above target and is likely to remain so for some time, household disposable incomes are being squeezed as a result, all of which runs the risk of a rise in inflationary expectations and strengthened wage claim, but there is little sign that this is happening with the demand for labour still relative weak earnings growth remain at around 2% p.a.

It is against this background that we have prepared our latest forecasts.

GVA forecasts

Table 5 presents our forecasts for Scottish GVA - GDP at basic prices - for 2011 to 2013. As before we present a central forecast, which we hold to be most probable and high growth and low growth forecasts which define the range of outcomes in which Scottish growth is likely to fall. In the subsequent discussion we concentrate mainly on the

central forecast. The full forecasts are presented in the *Forecasts of the Scottish Economy* section of this Commentary below.

Positive growth continues to be forecast in all years and on all 3 scenarios. However, Table 5 shows that we have revised downwards our central forecast for 2011 and 2012 reflecting the weakening in the economy that has been observed in recent months. Household spending is being hit by the debt overhang, the decline in real disposable

Table 5: Forecast Scottish GVA growth in three scenarios, 2011-2013

GVA Growth (% per annum)		2011	2012	2013
High growth		1.6	2.7	2.8
	<i>March forecast</i>	2.1	2.4	2.6
Central		0.8	1.5	1.9
	<i>March forecast</i>	1.0	1.6	1.9
Low growth		0.3	0.8	1.0
	<i>March forecast</i>	0.3	0.6	0.9

Table 6: Forecast Scottish net jobs growth in three scenarios, 2011-2013

GVA Growth (% per annum)		2011	2012	2013
High growth		36,317	41,882	60,675
	<i>March forecast</i>	42,626	51,025	57,262
Central		20,600	18,548	39,849
	<i>March forecast</i>	19,780	31,741	39,808
Low growth		9,621	2,661	21,431
	<i>March forecast</i>	5,895	11,586	19,256

incomes as inflation moves further ahead of earnings, and uncertainties about job prospects as the fiscal consolidation starts to bite and the economy slows. Our forecasts remain below the OBR and consensus forecasts for the UK in 2011, 2012 and 2013, which largely reflects the weaker growth of household spending in Scotland and a sluggish outlook for private sector investment. This year, we are forecasting growth of 0.8%, and 1.5% in 2012 both less than our March forecast. We expect that production and manufacturing output will continue to pick up reasonably strongly, but at a slightly lesser rate than in our previous forecast with production growing at 3.6% in 2012 compared to 4% in our March forecast. The service sector is forecast to continue on its weak growth path growing by 0.5% this year, 1.1% in 2012 and 1.3% in 2013, largely due to the weakness in the growth of household expenditure. Construction also continues to exhibit weak growth of 0.5% in 2011, 0.9% in 2012, and 1.1% in 2013, reflecting cut backs in government

capital spending and weak private sector investment. Finally, our forecast for 2013 continues to predict growth of 1.9%, just below trend. Over the whole period, the recovery continues to be weaker in Scotland than the UK.

Employment forecasts

Table 6 presents our forecasts for net employee jobs for the 3 years 2011 to 2013 on the 3 scenarios.

Table 6 indicates that our year-end employee jobs forecast for 2011 is broadly similar to our central forecast in March. As noted in the previous Commentary after the considerable shake-out of jobs at the start of 2010 job creation in Scotland has been reasonable buoyant. However, this came to an end in the first few months of 2011. Nevertheless, we do expect net jobs growth during this year and over the forecast horizon. Net jobs grow by 0.9% in 2011, 0.8% in 2012 and 1.7% in 2013. By 2013 total employee jobs are

forecast to be 2,373,000 around 60,000 fewer than in 2007 but up by 80,000 from the end of 2010. By sector, the largest percentage growth in job numbers is forecast for the production sectors, but the greatest number of jobs created will still be in services, despite the low forecast for output growth, due to the sheer scale of the sector. Within production, the largest forecast increases are in the Other manufacturing industries sector, with smaller increases in Mining and quarrying industries, Food and tobacco, Metals and metal products, and Electricity, gas and water supply. Within services, total employee numbers are forecast to rise, as noted above, however there are forecast declines in employee numbers in Public administration and defence,

Education, and the Financial services sector. Some of the jobs lost in 2011 in the Financial services are forecast to be recovered during 2012 with employee jobs at the end of 2013 in this sector up slightly compared to the end of 2010.

Unemployment forecasts

The key unemployment forecasts are summarised in Table 7 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

Table 7: ILO unemployment rate and claimant count rate measures of unemployment under each of the three forecast scenarios

		2011	2012	2013
<i>ILO unemployment</i>				
	Rate	8.3%	8.5%	8.2%
	Numbers	216,723	220,350	213,308
<i>Claimant count</i>				
	Rate	5.0%	5.5%	5.3%
	Numbers	143,037	158,652	155,714

who are in receipt of unemployment benefit. We noted in the discussion of unemployment in the previous Commentary that the degree of labour hoarding may be less in Scottish firms. This could be the consequence of the bigger employment shakeout here in the recession and so the recovery to date has had a bigger effect on unemployment in Scotland than in the UK. Another factor affecting the change in unemployment is the change in the inactivity rate. This has been rising in Scotland in recent quarters and so has further contributed to falls in unemployment despite weak output and, even negative, jobs growth. But we continue to expect that the Scottish GDP recovery will continue to be weaker and at a rate below that which is required - from the estimated Okun relationship - to stabilise unemployment. We therefore continue to expect that there will still be some pickup in unemployment even as growth in output picks up. Unemployment in Scotland this year is therefore forecast to rise 8.3%, or 217,000 by the end of the year and be largely stable through 2012 with a slight further rise to 220,000 by year. After that, the rate should fall to 8.2% by end 2013. However, as previous quarters have demonstrated there is considerable uncertainty around the unemployment forecast due to independent variations in inactivity rates and the extent to which output change maps into job change.

¹ "... what we have really shown here is that severe banking crises are associated with deep and prolonged recessions ..." C M Reinhart and K S Rogoff "This Time is Different : Eight Centuries of Financial Folly", 2009. Princeton University Press, Page 173.

² "The relative economic performance's of Scotland, Wales and Northern Ireland since devolution" by John McLaren, Richard Harris, and Jo Armstrong. Scottish Parliamentary Elections 2011, CPPR Briefing No. 1, March 2011. (The quote is from page 4).

References

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17 June 2011

