The Scottish economy

Forecasts of the Scottish economy

Economic background

In the three months since our forecasts in November 2009, several notable developments have occurred which will impact on the short- and medium-term growth prospects for the Scottish economy. Within the Scottish economy, we have continued to see GVA falling, with the most recent data for Q3 2009 confirming six consecutive quarters of declining activity. These data confirm that Scottish GVA has declined 6.1% since Q2 2008, while the UK as a whole down 5.7% over the same period.

These figures have drawn an unprecedented monetary and fiscal response, which we have examined in detail in previous forecasts. In February 2010, the Bank of England (Bank of England, 2010a) kept interest rates at 0.5% (where they have been since March 2009), and announced that it was curtailing its programme of Quantitative Easing (QE) following the purchase of £200 billion of assets funded by the issuance of Central Bank reserves, which was introduced in Spring 2009. The Monetary Policy Committee, charged with maintaining price stability in the UK and with the power to set interest rates to deliver a medium-term inflation target of 2%, voted to stop extending the QE programme in February 2009, after previous meetings had increased the scale of the programme in stages from an initial £50 billion. It noted in the most recent inflation report (Bank of England, 2010a) that broad money growth remained low, although it argued that money growth without the QE programme would have been even lower. The overall assessment of the policy interventions of the Bank is likely to be made only in the fullness of time, however there is some evidence that the slowdown in the growth of money was lower given the slowdown in nominal GDP when compared to previous recessions.

On the fiscal policy side, as well as the temporary VAT reduction being reversed, with VAT returning to 17.5% from January 2010, the Chancellor of the Exchequer announced in November’s Pre-Budget Report (PBR) a series of programmes aimed at fiscal consolidation over the medium term (with the stated target of reducing Public Sector Net Borrowing from a forecasted 12.6% of GDP in 2009-10 to 5.5% of GDP in 2013-14). The headline measures announced in the PBR include an increase in the rate of National Insurance by 0.5% from April 2011, as well as a “temporary payroll tax” of 50% on discretionary bonus payments above £25,000, which is forecast to raise £550 million in the current financial year. Of direct relevance to Scotland, as we shall examine in detail later, is the timing and depth of the period over which fiscal consolidation is projected to occur. This will be of crucial significance for the ability of the public sector to continue to support activity and employment over the short and medium-term. At the start of February, the Scottish Parliament passed the Scottish Government's budget for 2010-11, setting in place spending plans for some £35 billion of Total Managed Expenditure for the coming financial year.

As noted in previous *Forecasts,* part of the significant rebalancing in the economy likely in the medium-term is that government net borrowing is likely to be reduced significantly. In 2009-10 it is forecast to be £178 billion in 2009-10, roughly 57% of UK GDP. Irrespective of the political party which wins the UK general election likely to fall in May 2010, as Bank of England Governor Mervyn King notes, "there is a broad consensus across all political parties on the need later this year to announce more clearly the measures required for fiscal consolidation" (Bank of England, 2010b, p. 16-17).

We discuss the likely implications of this fiscal consolidation for the scale of government spending in Scotland in a later section of this forecast. At this point we note that government spending in Scotland in each of our three scenarios presented forecast to see a real terms reduction from 2011 onwards. This is consistent with the figures presented in the most recent "State of the Economy" presentation by the Scottish Government's Chief Economic Advisor in December 2009. This is likely to have a contractionary impact on Scottish growth and employment compared to the UK, to the extent that public sector employment in Scotland is slightly higher than in the UK as a whole (as the analysis of James (2009) referred to in the last *Forecast* made clear). Figures also presented by Chief Economic Advisor show that the largest contributions to UK GDP growth from 2010 are predicted to come from Consumption and Investment expenditures, with Government playing a much reduced role.

The "State of the Economy" also noted the important role that the adjustment of personal balance sheets will make a vital contribution to the duration of the downturn. At the household level, paying down debts incurred for expenditure yesterday necessarily reduces spending available for consumption today. There are experimental data for Scottish households which indicate that, in aggregate, Scottish households have curtailed total spending more sharply than UK households as a whole. These data only run to Q2 2009, so the likely path of future consumption growth in Scotland, and that of the UK, remains uncertain. These same experimental data suggest that over the last decade there has been little difference between the growth in household consumption in Scotland compared to the UK as a whole.

It continues to be the case, however, that we might expect the recession-recovery path of Scotland to be different from that of the UK. Indeed, we would be surprised if Scotland was to recover at precisely the same rate as the UK as a whole. As well as the larger public sector in Scotland, with a greater share of employment in public sector than the UK as a whole, this has often been argued to insulate Scottish growth and employment, and so produce "flatter" growth – less pronounced troughs and less steep peaks. While this continues to be the case, we are reminded that the nature of the recent recession was profoundly different to any in recent history as it was linked with a shortage of credit availability – the so-called "credit crunch", which peaked in September 2008. This has had profound impacts on sectors where Scotland traditionally held a strong competitive position, including financial services and insurance. Further, Charles Bean (Deputy Governor of the Bank of England) in questions about the recent growth of the UK said that "the downturn that we've gone through is heavily manufacturing-centred, a sharp fall in investment and stocks. And the UK is somewhat less manufacturing intensive than some of our counterparts. That's meant that we didn't suffer as sharp a contraction in activity as, say, Japan's did, but equally the rebound hasn't been quite as strong" (bank of England, 2010b, p. 15). Taking this analogy to the Scotland, Scotland is more manufacturing intensive than the UK as a whole (14.1% compared to 13.3%), and so this could explain the larger fall seen in Scotland than the UK, between Q2 2008 and Q3 2009. The characteristics and features of the recession, and the differing impacts on the UK and Scotland will only become fully apparent in time, as sometimes substantial revisions seen to previous data reduce as more accurate information is available. We note the scale of previous revisions to aggregate GVA growth in Scotland in Box 1.

Across the world, the synchronised nature of this recession is clearly evident with most developed countries experiencing significant lost output through 2009. The OECD in November 2009's *Economic Outlook* project declines in GDP across the OECD countries, with output falling in the US (-2.5%), Japan (-5.3%) and the UK (-4.7%). Australia (0.8%), Korea (0.1%) and Poland (1.4%) are predicted to be the only OECD countries to escape a reduction in GDP in 2009. The recession is thus confirmed as a worldwide downturn, affecting countries in all corners of the world. Interestingly however, the IMF has recently revised up its projections for world growth in 2010 and 2011 (IMF, 2010). World trade is forecast to have contracted by 12.3% in 2009 but is now predicted to grow by 5.8% in 2010.

We discuss these in more detail where we lay out our assumptions about the growth rate for Scottish exports to the rest of the world later in this *Forecast*. For Scotland, it will be crucial that exports are able to recover, although this could well be helped by the significant reduction in the Sterling exchange rate (down about a quarter from mid-2007 levels (Bank of England, 2010a)) improving the competiveness of UK exports. The Bank of England (2010a) report that the contraction in world demand has not been offset by improved competitiveness since "a large part of the depreciation appears to have fed through to higher margins

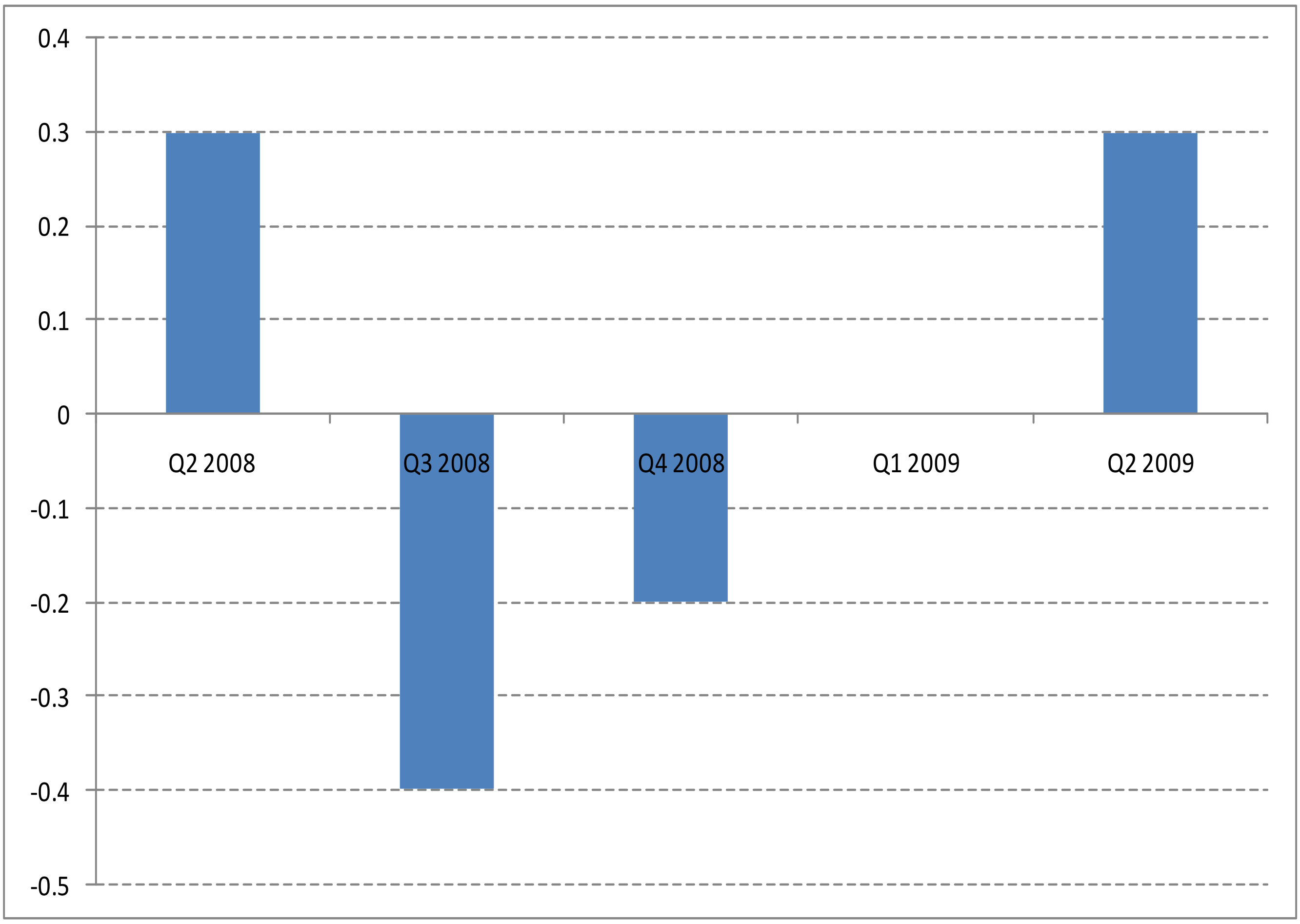
Box 1: Recent revisions to GVA growth

Revisions to the data on GVA growth for Scotland make forecasting the future path more uncertain, when even in smoother economic waters we would expect forecasted values to differ from the outturn variables observed. Preliminary estimates rely on less data than is available over time so we would expect some revisions. As Mervyn King noted, concerning the UK GDP published by the ONS, “the data published are not… the truth, they are estimates. They are the single best estimate we’ve got from the ONS of GDP, but inevitably new information comes along with a lag and that leads them to revise their data” (p. 22).

Typically since the start of the recent recession, GVA estimates for Scotland have been revised upwards, with initial estimates being worse that those revealed by later estimates. In the most recent estimates of Scottish GVA (released in January 2010, for instance), Q3 and Q4 of 2008 were revised down 0.1% and 0.2% respectively, Q1 2009 was revised down 0.1%, and Q2 2009 revised up by 0.1% compared to what had been published three months earlier. This had the impact of making Scotland’s entry to recession in 2008 more sudden than previously estimated, but reducing the depth of that recession slightly.

Figure 1 shows the differences between estimates of GVA change for Scotland compared to most recent estimates of GVA growth for the same quarter since Q2 2008. Positive changes here show that the GVA change has been revised upwards, while negative changes show that most recent estimates are lower than the first estimates.

Figure B1: Differences between first estimates and most recent estimates of GVA change in Scotland between Q2 2008 and Q2 2009



instead". Over time this should boost exports, and encourage increased supply of goods for export, although this could happen slowly as world demand growth recovers sluggishly.

When thinking about the forecasts presented in this section, we agree with the caution of Mervyn King, who recently stated that "forecasts are not numbers which say this will happen. They are judgements about the relative probabilities of various outcomes occurring. And of course there is always a possibility of these outturns. Many things can happen" (Bank of England, 2010b, p. 11).

The Scottish economy

In the last quarter for which data are available (Q3 2009, published on 20th January 2010), the Gross Value Added (GVA) in Scotland fell by 0.2% from the previous quarter (Q2 2009), which had fallen by 0.5% compared to Q1 2009. Since Q2 2008, GVA in Scotland is down 6.1%, while the UK is down 5.7% over the same period.

Scotland entered recession following the second consecutive quarterly decline in GVA in Q4 2008 and has now seen five quarters of negative GVA growth. The worsening economic performance is perhaps alleviating, with significant negative quarterly growth outcomes receding from view (despite some recent revisions to GVA). Although the future is by no means certain, downside risks remain to Scotland's future growth prospects, we suggest that the size of the downturn seen through 2009 appears to be unlikely to continue through 2010. While the next years will be likely to see a cautious return to growth, it remains to be seen how much the experiences from 2008-2009 will damage confidence across domestic and overseas consumers.

The Scottish manufacturing sector, accounting for 14.1% of Scottish GVA, was up slightly (0.3) over the third quarter of 2009, albeit that this sector has seen a decline of 9.6% over the year to Q3. The manufacturing sector is down 11.9% from its Q2 2008 peak. Within production sectors more generally, the largest yearly decline is in the mining and quarrying industries (down 12.4%) and down 15.8% from Q2 2008.

Construction in Scotland (accounting for 6.5% of GVA) was down 1.6% on Q2 2009, and down 8.9% on the year. In all, the sector was down 13.0% on the peak seen in Q2 2008.

The aggregate Services sector is down 0.3% on the previous quarter, down 3.5% over the year to Q3, and down 4.7% from the Q2 2008 peak. This would suggest that the major impact to date of the Scottish recession has affected on manufacturing and production sectors in the Scottish economy. While the services sector has seen high profile causalities in the banking and business services sector, and the "credit crunch" originated in these industries, it has been the Manufacturing and Production sectors which have, to date, seen the biggest falls in GVA. This would indicate that Charles Bean's assertion that, at the UK level, "the downturn that we've got through is heavily manufacturing centred, a sharp fall in investment and stocks. And the UK is obviously less manufacturing intensive that some of our counterparts. That's meant that we didn't suffer as sharp a contraction in activity as, say, Japan did, but equally the rebound hasn't been quite as strong" (p. 15). Within the UK, the manufacturing sector is a larger share of activity in Scotland than the UK (14.1% compared to 13.3%) which could be a contributing factor for Scotland performing more weakly than the UK as a whole.

Labour market developments in Scotland to the end of November 2009 (published in January 2010) showed falling employment and increasing unemployment over the year; however the quarterly change was not negative on all measures. Employment of those aged over 16 between September and November stood at 2,511 thousand, down 28,000 (or 1.1%) on the same period one year previously, and actually up 6 thousand on the previous quarter. The employment rate for those of working age (16 to 59 (for women) and 16 to 64 (for men)) was up slightly from the previous three month period, standing at 74.0%, however this was lower than the 75.5% seen in the same quarter one year previously.

Looking at unemployment, the number of people over the age of 16 who were unemployed rose by 9,000 compared to the three months previous, and up 61,000 over the last year, approximately twice the rise reported in the last commentary for the year to April 2009, and as of September to November 2009, the ILO level of unemployment stood at 202 thousand. The preliminary estimate of those receiving unemployment-related benefits stood at 136,200 in December 2009. The claimant count figure is up 36,700 since September 2008, and the claimant count rate has risen from 3.6% at the start of 2009, and now stands at 4.9%. We present our forecasts for the Scottish labour market for 2009, and through 2010 to 2012 later in this section.

Final demand and recent trends

The Fraser of Allander Institute (FAI) forecasting model acknowledges the drivers of economic activity in the Scottish economy to be consumption, government spending, investment, tourism and exports (to the rest of the UK and the rest of the World). For all three scenarios considered the recent trends in each of these measures, as well as recent survey evidence, are discussed below.

Consumption

- Data being developed by the Scottish Government through the Scottish National Accounts Project (SNAP) were published on the 5th of February 2010. These showed that Q3 2009 saw a small upward rebound in household expenditure, following three quarters of reductions. These figures are in Nominal terms however, so the real increase in spending will be lower, and may be negative. This confirms the evidence from previous quarters that the reduction in household expenditure is moderating, but it is unlikely that this small positive growth in nominal expenditure is signalling a return to strong positive growth in household consumption expenditure.

- As previously noted in *Forecasts*, household credit facilities have been crucial for the recent growth of expenditure, and the movement of the Scottish economy towards a more service-oriented structure. The decline in the availability of credit facilities to households, as well as households continued reluctance to take on credit in uncertain economic conditions, will continue to dampen household spending. The link between house price growth and household spending is anecdotally important, and recently house prices have fallen by less than in earlier quarters. Total house sales remain weak, with sales down roughly one half.

- Figures released by the Scottish Retail Consortium reported the worst January for four years, with like-for-like sales falling by 0.6% compared to January 2009. Non-food sales were down 1.8% on the previous year. The SRC noted the impact of the reinstatement of VAT after its temporary reduction, with the possibility of sales being brought forward from January to the end of 2009. This, combined with the poor weather conditions for much of January, saw consumers appearing to reduce spending on discretionary items. It will be crucial for the path of the retail sector, and consumer expenditure more generally, that February and future months' figures indicate if January's figures are a blip or part of a longer term correction to household balance sheets. Recent survey evidence, largely capturing small and independent retailers, indicates falling business confidence and expecting declining sales through the first quarter of 2010.

Government spending

- As noted above and in previous *Forecasts*, fiscal policy measures provided a stimulus designed to support activity and employment through the declines in growth seen in late 2008 and 2009. The UK stimulus package was estimated by the IMF to be of the order of 1.6% of GDP in 2009.There continues to be considerable uncertainty over the impact that the removal of these packages, necessary to restore confidence in the sustainability of the budgets of governments across the world, will have on economic activity. What will be crucial will be the speed at which private sector and consumption growth can provide a counterbalance to the removal of the government stimulus. A recent report by the IMF noted, for the G20 countries, 2010 will see the removal of the fiscal stimulus in only the UK and Argentina.

- Bearing this in mind, in his December 2009 "State of the Economy" report, Scotland's Chief Economic Advisor noted that for spending controlled by the Scottish Government through the Departmental Expenditure Levels, which make up the principal element of discretionary spending by the Scottish Government, will grow by over 4% in 2009/10, but will fall in real terms in 2010/11. The next three years are within the period of the next Spending Review, but, based on Institute of Fiscal Studies analysis, are predicting real terms reductions of more than 2% from 2011/12 to 2013/14. Work by CPPR, published since the State of the Economy report, forecast real terms reductions in Scottish DEL of 4.2% in 2011/12 on the previous year, with subsequent budgets falling by 3.2% for the next two years in real terms.

Investment

- As previously noted, there are no separate national statistics on investment in Scotland. Business investment figures reported for the UK, which may typically be expected to be indicative of the path of investment in Scotland, show continued large declines in investment through 2009. Total business investment in Q3 2009 was down 19.9% on the same quarter one year previously, although Q3 had seen a small upward trend, largely driven by a 10% increase in investment in Distribution services (although business investment was down 27.5% in this sector on Q3 2008). Private sector manufacturing continued to see a decline in investment, down 4.4% in Q3 on Q2, and down 29.9% on Q3 in 2008.

Tourism

- Figures from the International Passenger Survey showed that the number of international trips to Scotland was down 0.3% in July to September 2009 compared to the same period in 2008. This is the largest quarter for tourism in Scotland, with almost half of the trips to Scotland in 2009 made in these three months. We noted in November's *Forecast* that the occupancy figures had been maintained or improved from those from the same periods in 2008, and that this may have been at the expense of discounting of hotel accommodation. The most recent GVA figures for Scotland indicate that there has indeed been a small decline in GVA over the most recent quarter (-2.3%), while GVA in this sector is down 5.2% in the last four quarters on the previous four quarters. The Q3 decline in this sector is less than that seen in Q2 2009, with most recent survey evidence indicating that business optimism in the sector is significantly higher than the same period in 2008.

Table 1: Growth forecasts for top five export markets for ROW exports from Scotland, % year on year change, plus United Kingdom and Euro Area

				2010			2011
		IMF (Oct2009)	IMF (Jan2010)	OECD	IMF (Oct2009)	IMF (Jan2010	OECD
1	United States	1.5	2.7	2.5	n/a	2.4	2.8
2	France	0.9	1.4	1.4	n/a	1.7	1.7
3	Germany	0.3	1.9	1.4	n/a	1.9	1.9
4	The Netherlands	0.7	n/a	0.7	n/a	n/a	2.0
5	Ireland	-2.5	n/a	-2.3	n/a	n/a	1.0
	United Kingdom	0.9	1.3	1.2	n/a	2.7	2.2
	Euro Area	0.3	1.0	0.9	n/a	1.6	1.7

Sources: International monetary Fund, Regional Economic Outlook: Europe, Securing Recovery, October 2009, and World Economic Outlook Update, January 2010, and OECD Economic Outlook, November 2009.

Table 2: Main forecasts of the Scottish economy (Central scenario), 2009-2012

	2009	2010	2011	2012
Gross Value Added	-4.8	0.6	1.6	2.2
Manufacturing	-10.2	0.9	4.0	5.8
Construction	-8.1	2.8	3.3	1.7
Services	-3.1	0.3	0.8	1.3

Table 3: Forecasts for aggregate GVA growth in the Scottish economy under three scenarios, 2009-2012, %

	2009	2010	2011	2012
High growth	-4.7	1.7	2.2	2.8
Central	-4.8	0.6	1.6	2.2
Low growth	-4.9	-0.7	-0.3	0.8

Table 4: Forecasts of Scottish employment (jobs, 000s) and net employment change in central scenario, 2009-2012

		2009	2010	2011	2012
Total jobs (000s)		2,321	2,289	2,307	2,351
Net annual change (jobs)		-64,218	-32,264	18,277	44,612
% change from previous year		-2.7	-1.4	0.8	1.9
Agriculture (jobs, 000s)		23.2	23.5	24.1	25.1
	Annual change	-9850	309	628	1061
Production (jobs, 000s)		240.0	234.6	244.9	260.7
	Annual change	-11971	-5411	10260	15797
Construction (jobs, 000s)		121.4	113.3	114.4	116.3
	Annual change	-18577	-8135	1143	1905
Services (jobs, 000s)		1936.2	1917.2	1923.4	1949.2
	Annual change	-23820	-19027	6246	25850

Note: Figures are numbers of employee jobs, by industry, and not the numbers in employment, therefore these figures differ slightly from those reported in the labour market section of the *Economic Commentary*.

Table 5: Forecast Scottish net jobs growth in three scenarios, 2009-2012

	2009	2010	2011	2012
High scenario	-60,488	-9,785	30,253	57,213
Central scenario	-64,218	-32,264	18,277	44,612
Low Scenario	-77,861	-57,002	-16,538	13,631

Table 6: Forecasts of Scottish unemployment, central scenario 2009-2012

	2009	2010	2011	2012
ILO unemployment	200,082	216,200	185,700	144,200
Rate[1]	7.6%	8.1%	7.3%	6.3%
Claimant count	136,821	148,000	127,000	99,000
Rate[2]	4.9%	5.4%	4.6%	3.7%

Notes: [1] = rate calculated as total ILO unemployed divided by total of economically active 16+ population. [2] = rate calculated as claimant count divided by sum of claimant count and total jobs. The latest estimates of the 2009 figures forecast in November's commentary were published in January 2010 in the Labour Market Statistics First Release for Scotland. These estimated the ILO unemployment levels and rates for the three months to November 2009 as 202,000 and 7.4%, respectively. We leave the forecasts for 2009 unchanged from that forecast in November's commentary. The same publication gave preliminary estimates of the claimant count and rate for December 2009 as 136,200 and 4.9%. Again, our figures in Table 6 above for the claimant count and rate are left unchanged from those published in November 2009's commentary.

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

	2009	2010	2011	2012
ILO unemployment rate				
High growth	7.6%	7.3%	5.6%	3.6%
Central	7.6%	8.1%	7.3%	6.3%
Low growth	7.6%	9.9%	10.1%	9.8%
Claimant count rate				
High growth	4.9%	4.4%	3.4%	2.4%
Central	4.9%	5.4%	4.6%	3.7%
Low growth	4.9%	6.8%	7.0%	6.7%

While demand remains weak, however, Chamber of Commerce respondents indicated that discounting is set to continue in the first quarter of 2010.

Exports to the rest of the UK

- Preliminary estimates of GDP for the UK, published on the 26th of January 2010, revealed that Q9 2009 saw the first quarter of positive growth (0.1%) since Q1 2008, with many analysts and commentators predicting the end of the UK recession. With the rest of the UK being the most important trading partner for Scottish industries, the future for demand for Scottish exports will depend crucially on the path of growth which occurs in the UK. As noted previously, Scottish IO tables for 2004 showed that exports to the rest of the UK were approximately double exports from Scotland to the rest of the World. With regard to the estimate of GDP growth in the UK, we note however, that many analysts were predicting stronger growth in Q4 2009 than the observed 0.1%, and that (as we saw above for Scotland, but also for the UK) there have been sometimes significant revisions to GDP estimates over the last two years.

- Recent forecasts for GDP growth in 2010 in the UK show a strong rebound from the declines seen in 2009. The Treasury's December 2009 forecasts predict growth between 1.0% and 1.5%. This range also includes the median forecast made in the last three months (1.3%), however the range of recent forecasts for the UK is from 0.7% to 2.2%. The range of UK forecasts has been revised upwards from those we reported in November's *Commentary*, while the median new independent forecast has remained the same.

- As noted elsewhere in this edition of *the Fraser Economic Commentary*, Scottish Chamber and CBI respondents reported in Q4 2009 rising trends in expected export orders, although demand from the rest of the UK remains fragile.

Exports to the rest of the world

- The IMF headlined its January 2010 forecasts for the global economy with the statement that "Real activity is rebounding, supported by extraordinary policy stimulus". Their report pointed to rising confidence, with strong signs of the end of destocking and an increase in production, albeit with the recovery being "sluggish" in most advanced economies. World output is forecast to increase by 3.9% in 2010, and 4.3% in 2011, following a decline of 0.9% in 2009. Interestingly, and largely driven by revisions to their forecasts for the US, China and other important economies, these world forecasts have been revised upwards from October 2009's forecasts. World trade as a whole was forecast in October 2009 to increase by 2.5% in 2010, but the IMF is now forecasting a 5.8% increase, with a 1.1% upwards revision to world trade forecast for 2011. The IMF's forecasts for the UK was similarly increased in this period, and now stands at 1.3% - the same as the independent new median forecast discussed above.

- As noted before, Scotland traditionally exports to EU and other "advanced economies", which the IMF forecast will grow by 2.3% in 2010 and 2.4% in 2011. The major traders for Scotland, and the recent forecasts for growth in these areas, are given in Table 1, as well as revisions from recent forecasts.

- Despite these upward revisions for the major (non-UK) destination for Scottish exports, growth continues to be forecast to be relatively slow to return in 2010, particularly for the EU economies. It is in developing countries that the highest forecasts for growth through 2010 and 2011 are found, and the success of an export-led recovery for Scotland may depend on the speed at which new markets in these previously less important export destinations can be found.

- Experimental statistics have been published by the Scottish Government for manufacturing exports to the rest of the World to Q3 2009. These data showed that Q3 2009 saw the first positive quarterly change in the aggregate real value of exports since Q1 of 2008, and followed five consecutive quarters of negative growth for aggregate exports. Within this aggregate however, the most recent quarter saw growth in exports in the important Food, Drink and Tobacco sector (up 5.5% in real terms), as well as Chemicals, Coke, Refined Petroleum Products & Nuclear fuel (up 9.94%). The important Engineering sectors, however, saw exports decline almost 8% in Q3, and are down almost 19% on Q3 2008.

The forecasts: Background

As with the forecasts published in the last four Economic Commentaries, we give three alternative scenarios for growth, employment and unemployment in the Scottish economy between 2009 and 2012. We give a "Central" case, with "High growth" and "Low growth" as two respectively upper and lower growth alternatives. We intend that these three scenarios capture the range of outcomes that are possible, given that there are considerable uncertainties surrounding any specific single or point estimates to the "Central" forecast. The significant revisions to GVA growth forecasts discussed above and seen over the last year, suggest that using a scenarios approach is sensible when first estimates of growth may be revised (sometimes, significantly) some quarters into the future.

While we do not give explicit probabilities for each of these outcomes, we forecast that the "Central" scenario is that which is most likely, while "High growth" and "Low growth" reveal the range of possible outcomes for the Scottish economy from 2009 through to 2012. We will know the first estimates of Q4 2009 GVA for Scotland when the data are released in April 2010, allowing comparison between our three scenarios for the outturn of 2009 against the real economic data.

The forecasts: Detail

In the three scenarios considered, the following features are assumed to influence the factors of demand, and economic activity, across the Scottish economy:

Household

In the "Central" scenario, we forecast that the significant reduction in Household spending seen in 2009 moderates, but overall expenditure growth remains negative. Aggregate

Figure 1: GVA growth 2008 and forecasts to 2012, Scotland and the UK

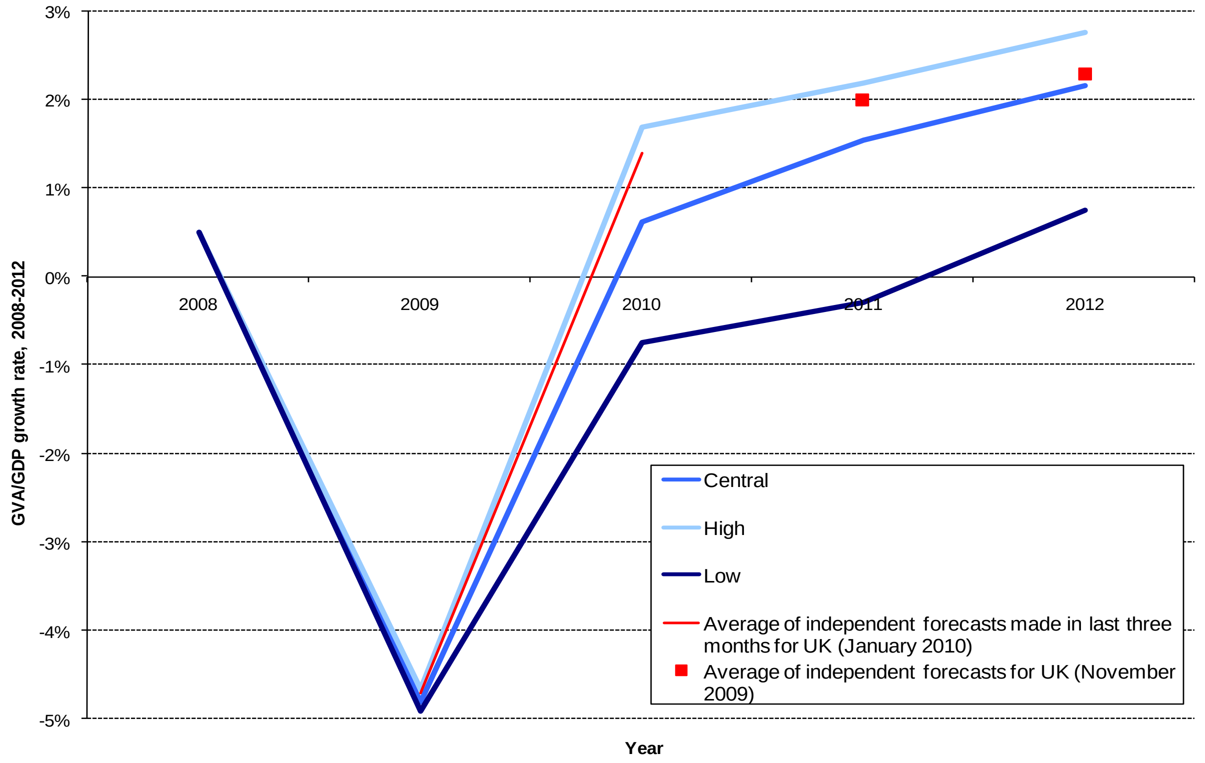
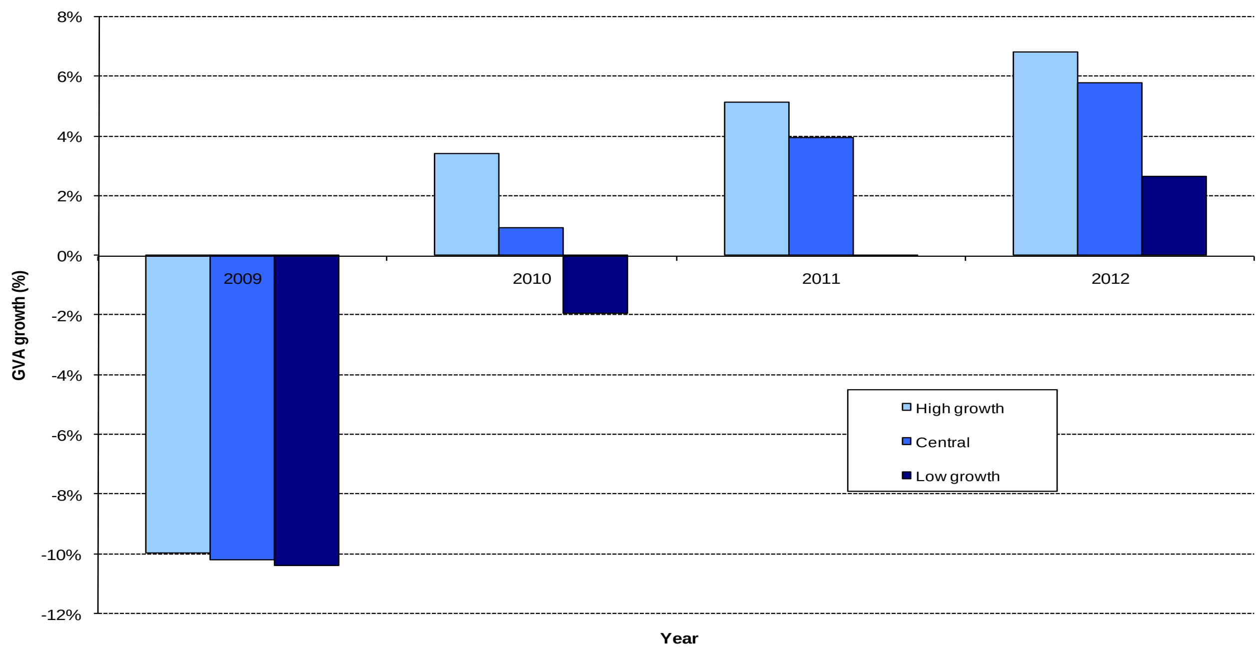


Figure 2: Forecasts of GVA growth in Manufacturing, 2009-2012



Household expenditure in 2011 and 2012 is forecast to increase from weak 2010 levels. In “Low growth”, household expenditure is damaged through lower consumer confidence and persisting job security fears. Spending falls by more in 2010 in the low growth scenario than the central case, however less than all scenarios saw in 2009, and again falls (slightly) in 2011. It isn’t until 2012 that household spending sees a return to positive growth in “Low growth”. In “High growth”, consumer confidence (and spending) responds faster than in “Central”, returning to slightly positive growth in 2010 before seeing a return to pre-2008 trend expenditure growth through 2011 and increasing marginally above trend in 2012. This scenario could be consistent with outturn unemployment increases being lower than anticipate, and household spending recovering through access to, and increased demand for, credit facilities for household spending.

Government
In “Central” we forecast an increase in government spending in Scotland through 2009 on 2008 levels, with a smaller increase in spending seen in 2010. From 2011, we forecast annual real terms reductions in aggregate Government spending in Scotland, which are reduced by over four per cent in 2012 compared to 2011. In “High growth”, government spending is still lower in 2011 and 2012 compared to the previous year’s total, in part supported by additional economic activity keeping taxation income higher than is assumed in “Central”. Across all scenarios however, government spending in Scotland is lower.

Exports
In “Central” we anticipate a slow return to growth in world trade in 2010, with a return to strong positive growth in demand for Scottish exports from the rest of the world returning through 2011 and 2012. Such a response could be indicative of Scottish exports securing markets in developing economies, which are forecast to see high levels of economic growth over the coming years, while more developed countries are predicted to see slower increases in growth. Recent changes in growth forecasts for developed countries, and Scotland’s current exports to these countries, are discussed in the section above. In “High growth” and “Low growth”, this return to positive growth in exports to the rest of the world from Scotland takes less and more time, respectively. Exports to the rest of UK follow a similar pattern in the central case, returning to slowly positive growth in 2010. In “Low growth” we forecast a small increase in export demand from the rest of the UK in 2010.

Tourism
Tourism is forecast to recover slowly from the challenging conditions seen through 2008 and 2009, largely driven by (non-Scottish) households reducing expenditure on travel and tourism activities (in line with domestic households experiences of reduced overseas travel). In “Central”, tourism spending in aggregate is forecast to see a small decline in 2010, seeing a return to growth by 2011 continue through 2012. Under “High growth”, small positive growth in aggregate tourism spending is forecast for 2010, reflecting faster than anticipated recoveries in growth in markets important for Scottish tourism.

Investment and stocks
As discussed above, 2009 has seen significant reductions in investment demands. As we have previously stated, the recovery in investment will be partly driven by the supply of credit, but also the demand for credit from companies, which will be linked with returning business confidence. Recent survey evidence for manufacturing, responsible for much of the investment activity in the Scottish economy, give some ground for optimism with more respondents reporting upwards trends in investment than reported downward trends, for the first quarter since Q1 of 2008. This would suggest at the very least that the large falls in investments seen in 2009 will not be seen in 2010. We forecast in “Central” that aggregate investment levels will not recover significantly through 2010, but will begin to increase from 2011 and through 2012. “High growth” sees investment increasing from 2009 levels in 2010, although the increase is forecast to be small.

Results

Gross Value Added
The forecast GVA for Scotland in 2009 under all three scenarios is negative, and significantly so. We forecast the GVA change at the end of the year when compared to the four quarters of the year before. All three scenarios forecast out to 2012, by which time Scottish GVA growth in all scenarios is forecast to be positive. As before, the recovery to positive economic growth occurs faster in the High growth scenario, and more slowly in the Low growth scenario. As stated above, we forecast that the Central scenario represents the most likely outcome for the Scottish economy given the current economic position and outlook at the start of 2010. Scotland is forecast to return to positive growth in 2010 in both the Central (0.6%) and High growth (+1.7%) scenario, but the Low growth scenario sees negative growth in 2010 and 2011 (of -0.75% and -0.3% respectively). As noted above, considerable and multiple downside risks remain to the strength of the expected economic recovery for Scotland.

These scenarios are presented in Figure 1, alongside (for comparison) the average of new forecasts (i.e. those made in the last three months to January 2010) for the UK as a whole in 2009 and 2010. Forecasts for the (medium-term) economic growth of the UK in 2011 and 2012 were collected by HM Treasury in November 2009, and these are also shown in Figure 1.

Figure 3: Forecasts of GVA growth in Services, 2009-2012

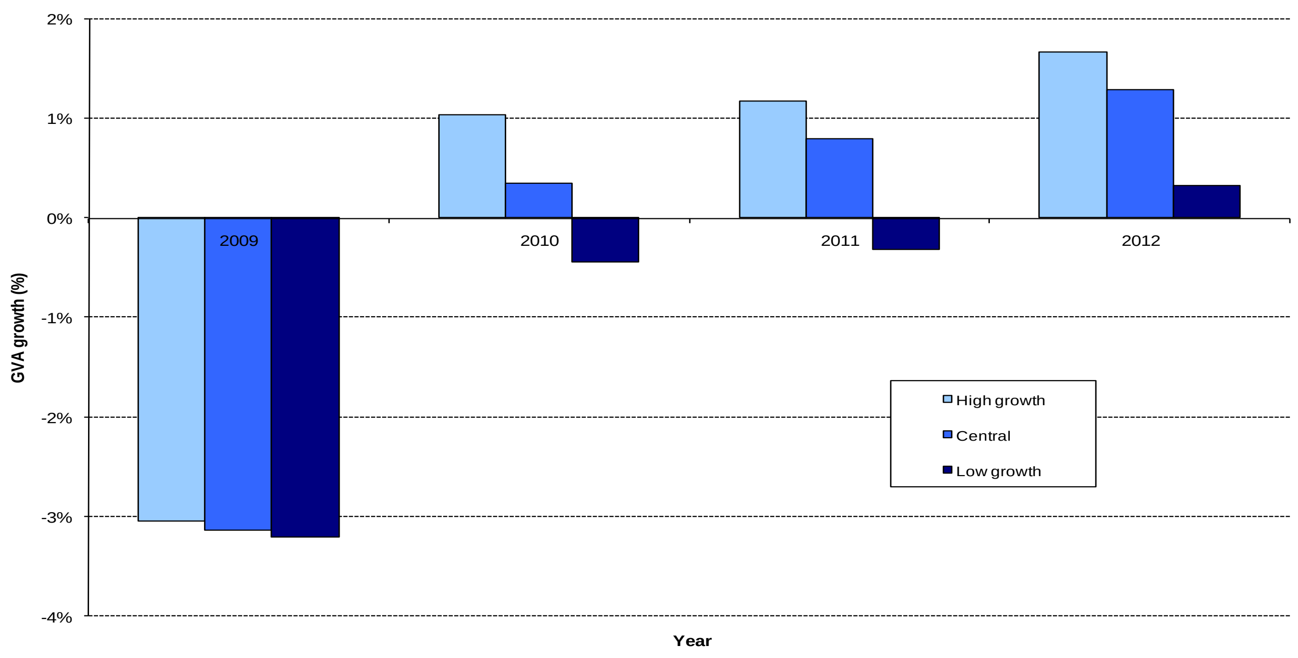
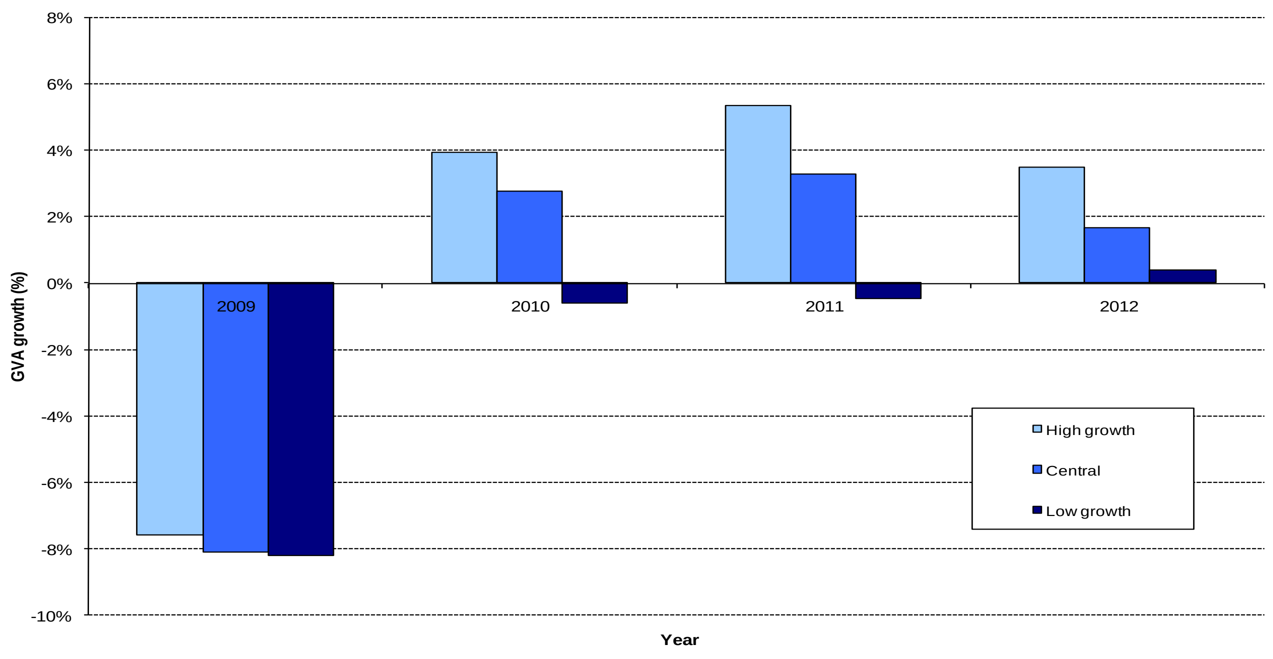


Figure 4: Forecasts of GVA growth in Construction, 2009-2012



We are forecasting that the Scottish economy will perform better than the forecasts of the UK in 2009 and 2010 under the High growth scenario only, but less well under the most likely Central scenario. The average of recent independent forecasts for growth of the UK economy in 2010 is 1.4%, which, while a strong rebound from the declines seen in 2009, is within our range of forecasts for Scotland. As with previous experience of recessions (discussed in detail in June 2009's *Fraser Economic Commentary*), we anticipate the most likely outcome is for a slower return to growth in Scotland than the UK as a whole, with our Central scenario forecasting lower growth in Scotland than the average of independent forecasts for the UK in each year from 2010 to 2012.

Under the Central scenario, GVA growth returns to positive annual growth in 2010 (+0.6%) and 2011 (+1.6%). In 2012, Scottish growth is forecast to be 2.2%, slightly above long-term trend growth for Scotland. Our central scenario for 2009, and the forecast for the sectors under this scenario are given in Table 2. Table 3 shows the GVA forecasts under each of the three scenarios. Under the Low growth scenario, negative growth is also seen in 2009, 2010 and 2011, with the Scottish economy not returning to positive growth in this scenario until 2012.

We also present forecasts for GVA change in Scotland at broad industry levels for manufacturing and services, as well as the construction sector, under each of the three scenarios – Central, High growth and Low growth. Figure 2 shows the GVA change in Manufacturing under each of these three scenarios, while Figure 3 shows the GVA change in Services. Figure 4 shows the change in forecasted GVA in the Construction sector between 2009 and 2012.

Across Manufacturing (shown in Figure 2), a recovery from the observed declines in GVA in 2009 occurs in 2010 in the Central scenario, although there is GVA growth of 3.4% forecast for 2010 under the High growth scenario. In 2011 and 2012, all three scenarios forecast positive GVA growth in the manufacturing sector, with growth ranging from 0.0 to 5.1% in 2011 and 2.7 to 6.8% in 2012. As noted in previous *Forecasts*, the speed the growth of external demand for products will be key to the short- and medium-term future for Scottish manufacturing.

Figure 3 shows that Service sector GVA growth across the three scenarios is more insulated to the economic downturn than the Manufacturing figures seen in Figure 2. GVA growth in 2009 ranges from -3.0% to -3.2%, while in 2010 GVA growth is forecast in the range from -0.5% to 1.0%. This range of outcomes has been revised slightly downwards from that presented in November's *Forecast*. As previously noted, the recovery in consumer confidence and household spending (both in Scotland and in major, or new, export markets, particularly the rest of the UK) will drive the speed and duration of the recovery across the aggregate Service sector. One key area within the service sector will be the future performance of financial services (which together with Business Services is worth almost 25% of Scottish GVA). We forecast this sector sees a small return to positive growth in 2010, although this is also the year when significant job reorganisation is predicted for the aggregate financial services sector. We expect that we will see continuing changes in the size and scope of the financial services sector well into 2011, and the future shape of the sector will be considerably different than prior to 2008.

Figure 4 estimates that declines in GVA in the Construction sector are largest again in 2009, and by as much as -8.2% in the Low growth scenario. Even in 2011 "Low growth" forecasts slightly negative GVA growth with positive growth recovering only in 2012. Vital for the recovery of this sector will be the pace by which consumer sentiment is restored in the housing market, as well as the demand for public sector investment projects. We noted above, the recent positive trends in construction activity have appeared over recent weeks, and the rate of house price declines has slowed. However, given the speed of the decline, and the massive uncertainties regarding the future shape of the sector as a whole, it is too soon to conclude whether the corner has been turned in the housing market. As we have previously stated, it is likely that the housing market will continue to see only slow growth in sales volumes over the next few years as slowly rising house prices restrict householders ability to move, either through lower than necessary equity holdings or through decreased availability of mortgage finance, particularly at previously available loan-to-value ratios.

Employment

Our forecasts for employment for each of the three scenarios are given in Table 4, along with the net aggregate employment change over the year. The employment figures relate to jobs, not FTEs, and are calibrated on the end-year (December) figures from the Employers' Quarterly Survey Series, as given in Table 6.06 of the Economic and Labour Market Review, published by National Statistics. This gave total jobs in Scotland at the end of 2008 as 2,385,000. As we have previously forecast, we anticipate in our Central scenario that total job numbers in Scotland will fall in aggregate in during both 2009 and 2010, and see a recovery to positive job growth in 2011.

In "Central", employment is forecast to decline by 64,200 jobs in 2009 and by 32,300 jobs in 2010. Total job numbers, and jobs in all of these broad industrial sectors, are forecast to then increase in 2011 and 2012. Total jobs in 2012 are forecast to be around 34,000 lower than the jobs total for 2008 (a year when historic highs and lows respectively for the employment rate and unemployment rate were seen in Scotland). With the exception of Construction, the other broad sectors of the Scottish economy are forecast to see employment in 2012 higher than in 2009.

In all scenarios, total job numbers in Scotland are forecast to decline in 2009 and 2010. “Low growth” sees around 77,900 jobs being lost in 2009, and a further 57,000 in 2010. In that scenario, total jobs lost between 2009 and 2012 are around 137,800, while in “High growth”, the recovery in 2011 and 2012 sees job numbers recover towards their previously measured historical highs, and job numbers in 2012 are around 17,193 higher than their level in 2008.
Table 5 shows the net annual growth in jobs in each of the three scenarios, and shows how these have changed since our June 2009 forecast. The most recent Economic and Labour Market Review, to September 2009, has jobs in Scotland at 2,331,000, down roughly 56,000 on the situation one year earlier. We are forecasting in our central scenario that the rate of job decline seen through 2009 alleviates slightly in the last three months to December 2009, while in the “Low growth” scenario, this continues through 2009 and into 2010.

Looking at the sectoral breakdown for these employment changes, in all scenarios the Services sector sees the largest decline in job numbers in both 2009 and 2010. Overall, the number of service sector jobs are forecast to fall by 23,800 in 2009 and a further decline of 19,000 in 2010. Financial services is forecast to be especially badly affected, losing almost 16,500 jobs between 2009 and 2010 (with the majority of these lost in 2010), but large job losses in 2009 are also forecast in retail and wholesale.

The Construction sector is forecast to lose around 18,500 jobs in 2009, and a further 8,100 in 2010, and see a slow recovery through 2011 and 2012. As with the aggregate jobs total, the total jobs in construction in 2012 remain below levels of 2008. In the High growth scenario, lob losses in construction are smaller in 2009, and fall by almost 16,000 while recovering to positive annual job growth of 1,800 and 2,500 in 2011 and 2012. As mentioned in previous *Commentaries*, the construction sector has tended to see both quicker, and earlier, declines than the rest of the economy, and in previous upswings would be likely to see increased activity ahead of much of the economy. The sluggishness of a return to growth in the private housing sector may contribute to the growth of employment in the upswing being less than in following previous recessions in Scotland.

Production jobs fall in 2009 by over 12,000 in the Central scenario, with a range from 11,000 to 13,000 in “High growth” and “Low growth” scenarios respectively. Within this broad sector, the most heavily hit sectors in 2009 will be those which rely upon export markets for the destination of their output, and so falls in employment are forecast in metals and non-metal products (down 1,300), electrical and electronic engineering (down 1,500) and mining and quarrying (down 1,000). Key to the response in the labour market will be the extent to which labour hoarding continues in the face of the recession. Reducing staff working time, and freezing pay increases have arguably contributed to the smaller than previously seen declines in employment for large changes in GVA. It remains to be seen however how long employees are retained before demand begins to recover, and employment growth can be seen. As with previous forecasts, it may be beyond 2012 before we see the job numbers in Scotland reaching the highs for employment seen before the recent recession.

Unemployment

We present our forecasts for unemployment for 2009-2012 in Scotland, as measured by the ILO definition as well as those claiming unemployment benefit, in Table 6. The preferred measure of unemployment is the ILO definition, as given by the Labour Force Survey. This measure is preferred as it reveals the extent of labour which is unemployed and available for work, rather than that portion of the available Scottish labour force which is currently in receipt of unemployment benefit.

The forecasts for unemployment in 2009 and through 2010-2012 have been revised upwards from forecasts published in the last *Fraser Economic Commentary*. Until the recent economic downturn, the Scottish labour market had been outperforming that of the UK when measured by the employment rate, and had seen historically high levels of employment and low levels of unemployment. Of crucial importance to the realised levels of unemployment will be the extent to which people who lose employment switch into the unemployed, or move into labour inactivity, i.e. are unemployed but not available for work. The most recent data from February 2010 confirms that unemployment had risen and a rising unemployment level and rate would continue to be consistent with our “low growth” scenario.

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