Outlook and appraisal

Overview

Scotland and the UK are lagging behind as the rest of Europe, Japan and the United States start to recover from recession. The UK remained in recession in the third quarter and it seems likely that will be the outcome for Scotland too. Consumer spending remains weak, which is in part a consequence of the internationally high levels of debt held by UK households before the recession and the impact of falling asset prices and lending restrictions. But in the UK there are a wide range of indicators that can be cited, which suggest that a recovery is now underway. There is a widespread expectation that the UK economy will come out of recession in the fourth quarter of this year exhibiting a small but positive growth rate. The situation in Scotland is more difficult to call.

The Scottish economy has contracted by slightly more than the UK over a shorter period. The evidence appears to suggest that the greater fall in Scottish GDP during the recession has been down to weaker service sector performance, principally financial services and real estate and business services. Recent surveys reveal rising expectations and an emerging recovery in Scottish manufacturing, but little sign in other sectors surveyed. Indications of recovery are weaker here than in many other UK regions. We therefore expect Scotland to emerge from recession in the fourth quarter, with likely growth around +0.2%, but less strongly than the rest of UK. And there remains a lower probability that the recession will not end in Scotland in the fourth quarter even though it does so in the UK economy as a whole.

It would be a mistake to conclude that the economy's troubles are over once growth resumes and the recession ends. The Scottish economy is likely currently to be at least 8% below where its GDP would have been in the absence of recession. As long as this output gap persists there will be a deflationary dynamic in the economy as aggregate supply exceeds aggregate demand and unemployment is likely to continue to rise or remain high. Research by NIESR in London reveals that in previous UK recessions recovery to pre-recession output has never taken less than 40 months, or three and one-third years, and in the 1930s depression and the 1980s recession recovery took around 50 months or just over 4 years. Secondly, with the exception of the 1990-93 recession all of the previous recessions exhibited “double-dip” behaviour to varying degrees, with the second downturn occurring 18, 28 and 30 months after the initial pre-recession peak. While recovery in growth is emerging it will clearly be some time before pre-recession output, employment and unemployment levels are restored.

Domestic Scottish and UK consumer and investment demand may remain weak for some time as both households and firms seek to strengthen their balance sheets. The availability of sufficient bank credit to fully finance the recovery remains a source of continuing concern. The significant fiscal consolidation that is in prospect as the UK government seeks to reduce its deficit and stabilise, possibly reducing its debt position will serve to reduce domestic demand and spending. There are clear concerns that the fiscal consolidation might occur too soon before the necessary switching to export-based growth can be achieved. In addition, concerns have been raised that the volume of money pumped into the world economy through quantitative easing, historically low, almost zero, interest rates and a declining US dollar, are fuelling a bubble in (risky) asset values. The concern is that the bubble will burst affecting real incomes and spending when monetary policy is tightened again and when the value of dollar stabilises. This also raises the issue whether monetary authorities should be targeting asset price bubbles directly. For all these reasons the prospect of a double-dip recession is therefore present.

We take the view that the Scottish recovery may be weaker than in the UK for several reasons. The bias in the structure of the Scottish economy towards the public sector – 22% of GVA against 18% in the UK – means that the base for expansion is smaller here. The anticipated fiscal consolidation could be greater and/or have a greater impact on activity in Scotland. More technically, purchasing linkages between activities in Scotland – and hence multipliers - tend to be lower than in the UK because the Scottish economy is smaller and more open. Direct increases in demand tend to ‘leak out’ more than at the UK level. This may be offset, though, if the Scottish economy enjoys a stronger export boost through its greater openness. But the increased exporting necessary to the recovery puts a premium on the performance of manufacturing. We remain concerned that Scottish manufacturing has the size, diversity and capability to take full advantage of a lower exchange rate and the recovery of global demand. If Scottish households seek to recover their net asset position by more than their UK counterparts then recovery will, other things equal, be weaker here. Finally, if the two main Scottish banks, key beneficiaries of tax-payer funded support, are less willing to lend because of the need to rebuild their balance sheets to stabilise and raise their share price, then the Scottish economy may recover more slowly for this reason.

Against this background our central forecast is for a decline in GDP/GVA of -5% this year. Compared with the Treasury’s average of new forecasts for the UK, we are now forecasting that the Scottish economy will perform less strongly than the UK in 2009 on all three scenarios. Our forecasts for 2010, 2011 and 2012 represent an improvement on our June position reflecting the evidence of stronger global recovery, allbeit with the UK lagging. By 2011, household spending will be rising again and will strengthen further in 2012, as do exports with investment also increasing from 2011. But we are forecasting large annual reductions in government spending from 2011. For these reasons growth rises to 1.1% and 1.6% in 2011 and 2012 but remains below trend. It is also worth noting that in 2010 in our central scenario we are allowing for one quarter of negative growth reflecting the headwinds buffeting the economy that we noted above. In the low growth scenario these headwinds are sufficient to produce two quarters of negative growth in the second half of 2010: a “double-dip” recession.

On jobs, employment continues to fall through this year and next by more than 160,000. Net jobs growth will return in 2011 strengthening in 2012 but net job creation over these two years of nearly 52,000 indicates a slower recovery, with a net loss of 108,000 jobs over the period. Nevertheless recovery is stronger than our forecast in June. Net job losses over the 2009-12 period mainly occur in the service sector and in financial services in particular.

On unemployment, we have made further upward revisions to our forecasts reflecting the lower GVA forecasts for 2009 and the evidence of fairly rapid falls in employment and rising employment in the first quarter of 2009. Our central forecast is for ILO unemployment to rise from 200,082 (7.6%) in 2009, to 234,105 (9.2%) in 2010, but then to fall to 212,661 (8.7%) in 2011 and 172,815 (7.7%) in 2012.

Recent GDP performance

The most recent official government GDP data for the Scottish economy were published on 21 October and refer to the second quarter of 2009. After the almost unprecedented contraction of -2.5% in the first quarter in both Scotland and the UK, Scottish gross value added at real basic prices fell by a further -0.8% between April and June compared to a smaller contraction of -0.6% in the UK – see Figure 1.

Scotland’s GDP has therefore contracted by 6% over the four quarters since the recession began in second quarter of 2008. This is a slightly greater loss of net output than the drop in the UK as a whole, which amounted to 5.8% over the *five* quarters from the start of recession in the first quarter of 2008. The decline in GDP in Scotland has largely mirrored the decline in the UK as Figure 1 shows but nonetheless, on the data so far, the recession in output has been more severe here.

Despite the larger drop in second quarter output in Scotland compared to the UK, the *service sector* – accounting for 74% of overall GVA – did better here. Service sector GVA fell by -0.4% in Scotland while UK services contracted by -0.6% – see Figure 2. But the other broad sectors *manufacturing* (14% of GVA), *construction* (7% of GVA) and *electricity, gas & water* (3% of GVA) performed worse in Scotland during the second quarter. Manufacturing GVA fell by -0.3% in Scotland against a fall of -0.1% in manufacturing in the UK – see Figure 3. The construction industry in Scotland has continued to experience further marked contractions with GVA falling by -2.8% in the second quarter compared to a fall of -0.8% in the industry in the UK – see Figure 4. Finally, output in electricity, gas & water fell by -11% during the quarter compared to a fall of -3.6% in the UK.

Over the course of the recession service sector GVA in Scotland has fallen by -4.45% while the contraction in UK services amounts to -4.25%. Manufacturing GVA has fallen by -12.37% during the recession, which interestingly is slightly less than the fall of -13.81% in UK manufacturing. Dating the start of the recession in construction as 2008q2 in Scotland and 2008q1 in the UK, output in the industry has fallen by -13.24% and -13.73%, respectively. However, there is a good case for arguing that the recession, or structural downturn, in Scottish construction began after 2006q3 with output falling continuously apart from 2008q1 and 2008q2. This decline has not been mirrored in UK construction. The loss of output in Scottish construction over this longer period amounts to -15.73%. The data on manufacturing and construction in particular highlight the outcome of some of the key dimensions of the present recession: its roots in the bursting of a commercial property and housing bubble and the indirect world-wide consequences for trade significantly depressing manufacturing output due to the much greater importance of export activity in the sector.

Within services, the main sectoral drivers of contraction in the second quarter were *hotels & catering* (3% of overall GVA), *transport & communication* (7% of GVA), *financial services* (8% of GVA) and *retail & wholesale* (11% of GVA). Activity in hotels & catering fell by -3.3%, compared to a contraction of -1.2% in the sector in the UK. This provides one, all be it partial, indicator that tourism to Scotland has not benefited by much so far from the declining value of the pound sterling and by the “Homecoming Scotland” events. GVA in transport & communication services fell by -1.4%, a little better than the -1.8% contraction experienced in the

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

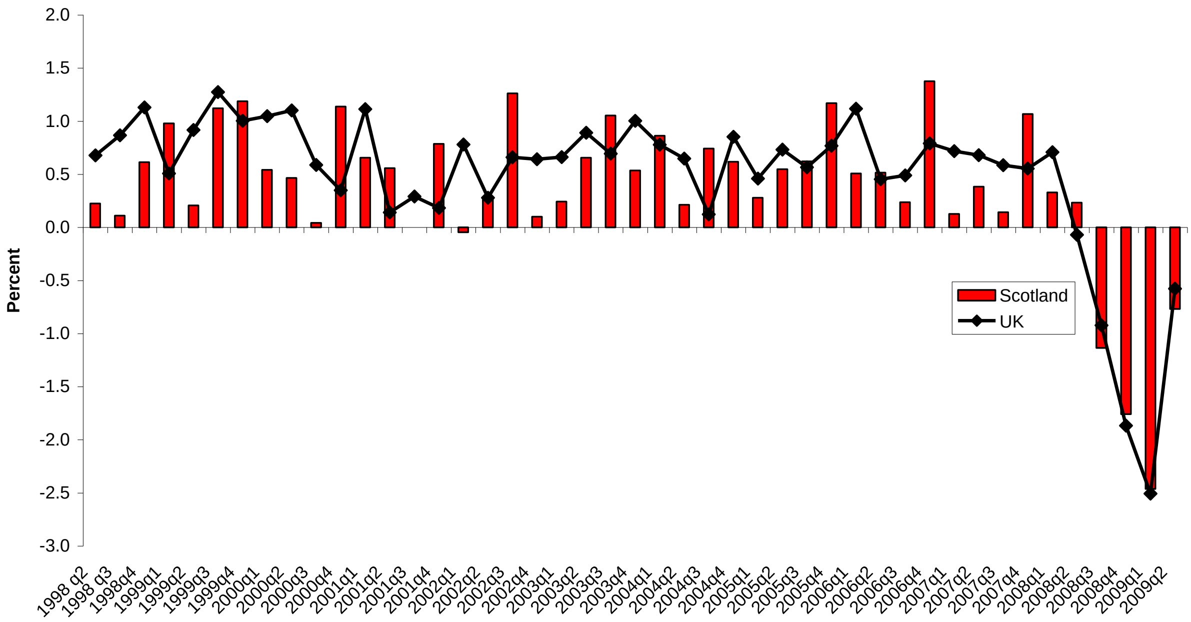


Figure 2: Scottish and UK Services GVA Growth at constant basic prices 1998q2 to 2009q2

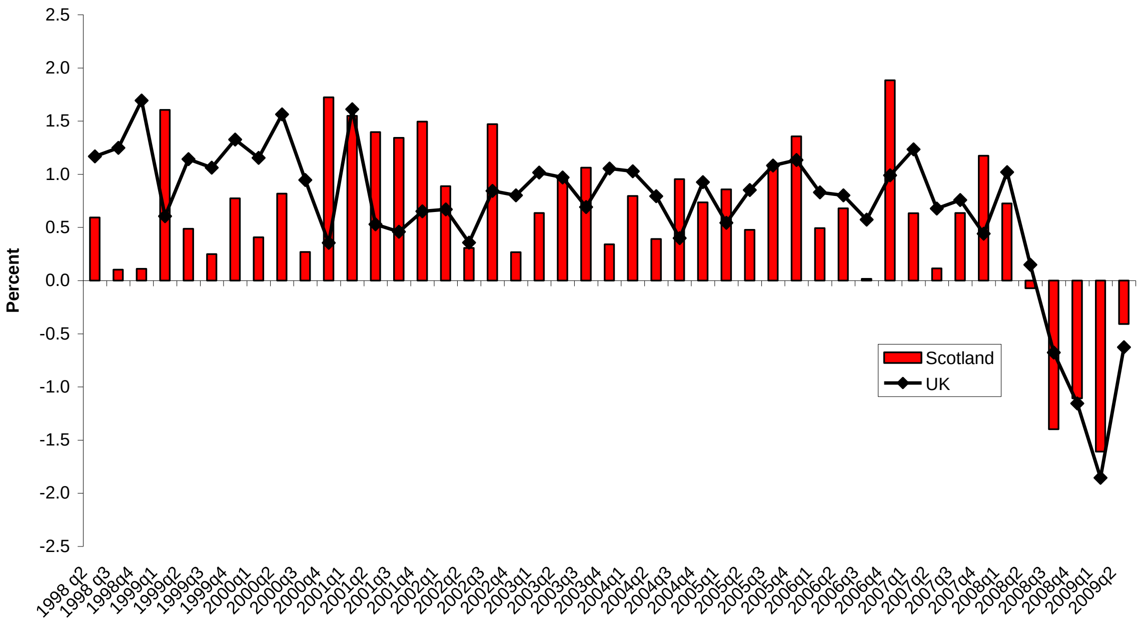


Figure 3: Scottish and UK Manufacturing GVA Growth at constant basic prices 1998q2 to 2009q2

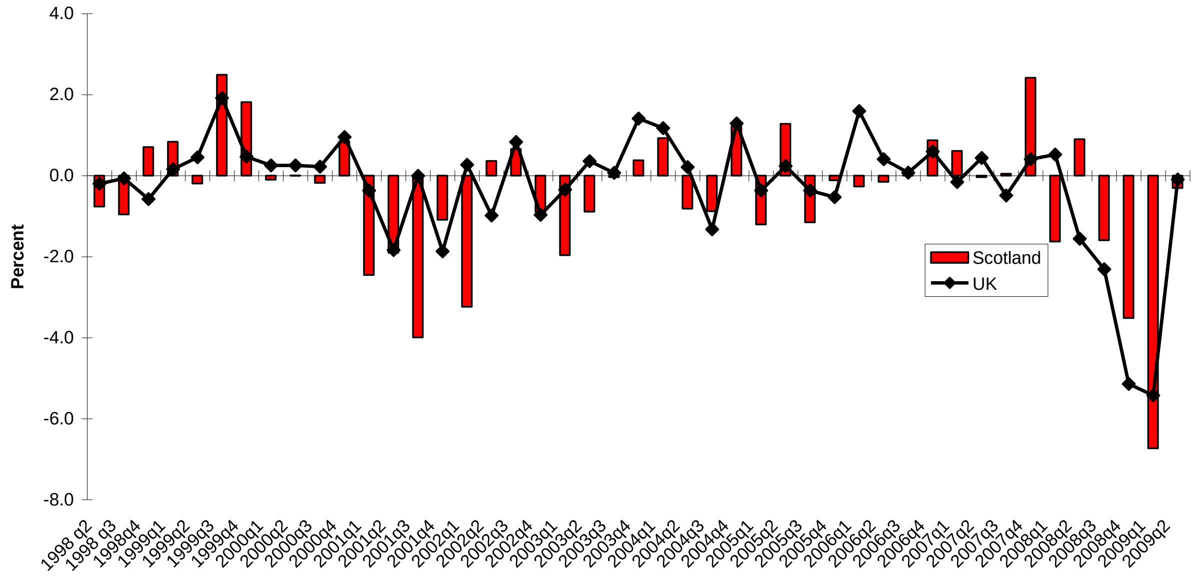
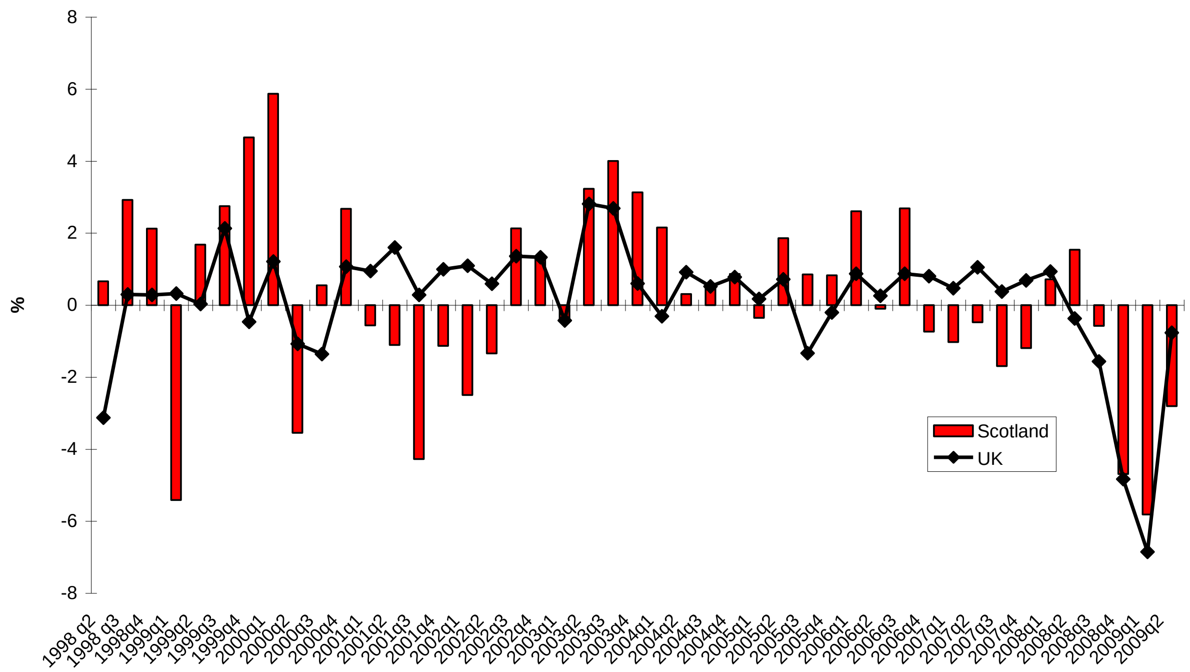


Figure 4: Scottish and UK Construction GVA Volume Growth 1998q2 - 2009q2



UK. Retail & wholesale GVA contracted by -0.4%, a little more than the -0.3% fall in the sector in the UK. But financial services contracted by 1% in Scotland compared to a *rise* of 0.2% in the sector in the UK – see Figure 5.

The main reason for the outturn in services being more favourable in Scotland than in the UK is largely explained by the stronger performance in Scotland during the quarter of *real estate & business services* (REBS) and *public administration, education and health*. These two sectors together account for 40% of Scottish GVA with REBS contributing 18% and the public sector 22%. REBS grew by 0.2% in the second quarter whereas its UK counterpart contracted by -1%. It is difficult to explain why this heterogeneous sector should have grown more strongly in Scotland during the quarter. However, approximately one half of the sector is property related and so the recent pickup in housing market transactions might have been reflected in greater activity amongst Scotland's estate agents.

Within manufacturing there were some interesting variations in sectoral performance both absolutely and relative to the UK in the second quarter. The weaker overall performance of Scottish manufacturing (-0.3%) compared to UK manufacturing (-0.1%) in the quarter was largely down to weakness in 4 sectors. *Other manufacturing* (3% of overall GVA), which includes *paper, printing & publishing*, contracted by -0.2% compared to growth of 1.2% in the sector in the UK. The chemicals industry continued to suffer badly in Scotland with a drop in output of -4.2% compared to an increase of 0.9% in the UK. The *chemicals* industry in Scotland has now lost a quarter (-25.1%) of its GVA over the three quarters since 2008q3. The *metals* sector (1% of GVA) also experienced a significant cutback in the second quarter with output falling by –8.5% in Scotland compared to a fall of -3.2% in the UK. Finally, transport equipment (1% of GVA) saw a fall in production of -5.3% in Scotland compared to *growth* of 4% in the UK.

But while manufacturing performance was generally weak in the second quarter and weaker than UK manufacturing, there were perhaps unexpected exceptions. We noted the weakness in transport equipment but other parts of engineering, and engineering as a whole, performed well. Electronics (3% of GVA), which has lost more than 16% of its output in Scotland during the current recession exhibited positive growth of 5.8% compared to a *fall* in GVA of -0.9% in the sector in the UK. In addition, mechanical engineering (1% of GVA) also recorded positive growth of 0.1% while its UK counterpart contracted by -3.1%. Overall, Scottish engineering grew by 1.6% in the quarter compared to 0.1% in the sector in the UK. One other manufacturing sector, food & drink, performed strongly in the quarter displaying growth of 2.3% compared to 0.1% growth in the sector in UK. Most of this growth occurred in the food sector.

An end to Scotland's recession?

Background

Figures 6 and 7 chart the performance of key sectors in Scotland both before and during the recession. Figure 6 indicates that all key growth sectors have been affected by the recession with the exception of the public sector.

Figure 7 reveals the percentage decline by sector during the recession from the peak reached before the downturn. In sectors such as construction and financial services where there have been some fluctuations in GVA during the decline we have made a judgement as to the start of the recession in the sector. The latest data allow us to reaffirm some of our earlier conclusions about the course of the recession in Scotland and make a judgement on when we expect the recession to end.

First, the recession began in construction, spread to financial services, then to manufacturing, with electronics and other manufacturing initially affected. Other service sectors such as REBS, other services and transport & communication then started to turn down. Latterly, sharp falls in GVA in other manufacturing sectors such as Chemicals and mechanical engineering occurred.

Secondly, against a background of a fall in Scottish GDP of 6% during the recession to date it is evident that some sectors have suffered disproportionately. One must be careful of a direct numerical comparison with the aggregate Scottish performance because the downturn began earlier or later in several sectors. Nevertheless, two sectors, chemicals and other manufacturing have lost more than 20% of their GVA, 25% and 21% respectively. And the loss of output in chemicals has occurred in just three quarters. Of the six sectors experiencing contractions between 10% and 20% in the recession, three are export-oriented, manufacturing sectors: electronics, transport equipment and mechanical engineering. The other three are strongly associated with the property/finance cause of the recession: construction, financial services and REBS. The sectors declining between 0% and 10% are mainly in the service sector: hotels & catering, retail & wholesale, other services, and transport & communication. The remaining sector is in manufacturing: food & drink. Overall, the global impact of the property bubble burst and credit crunch has been on international trade and hence principally on manufacturing. Clearly, indirect impacts from reduced manufacturing output and from lower domestic household expenditure will affect output in local services.

Thirdly, we also note in Figure 7 that four sectors appear to have reached a trough in their activity in the first quarter of this year. So, in these sectors the recession may already be over: electronics, REBS, food & drink, and mechanical engineering. Yet, the probability that the Scottish economy as a whole will have moved out of recession in the third quarter is low. We shall not have outturn data for third quarter Scottish GDP until January 2010, and so for the

Figure 5: Scottish and UK Financial Services GVA Growth at constant basic prices 1998q2 to 2009q2

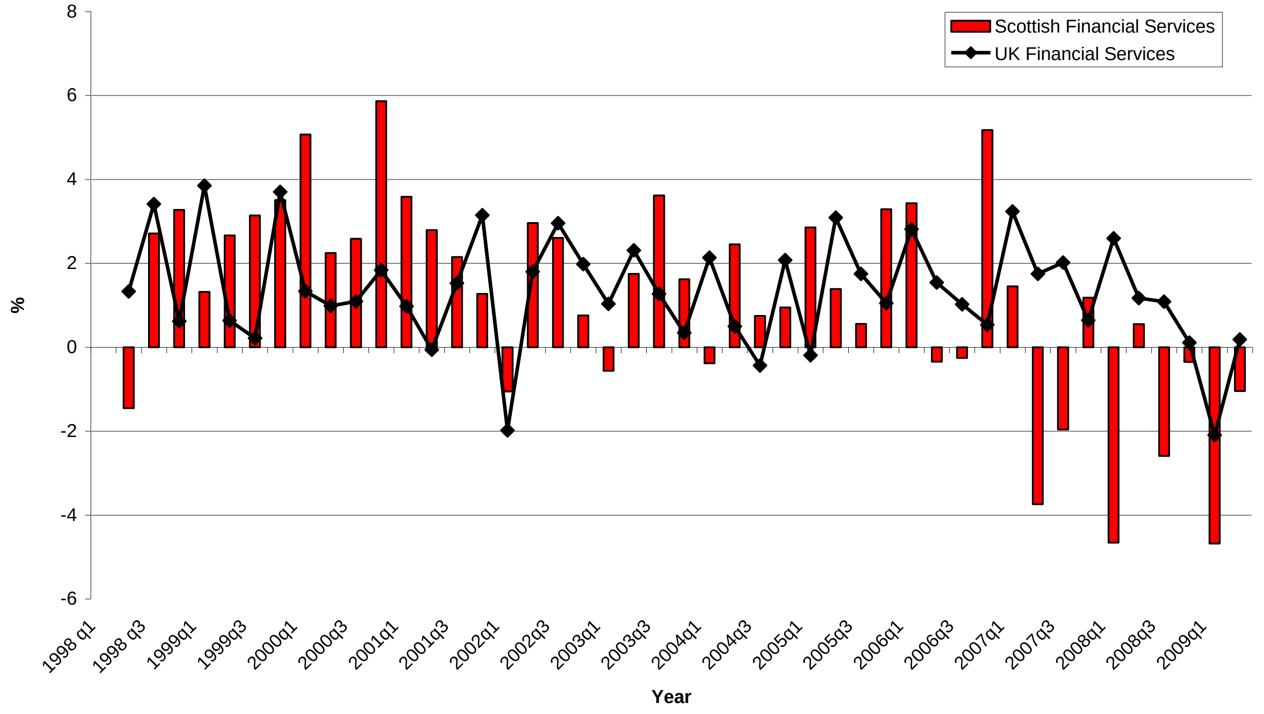


Figure 6: Growth of key sectors in Scotland 1998q2 to 2009q2

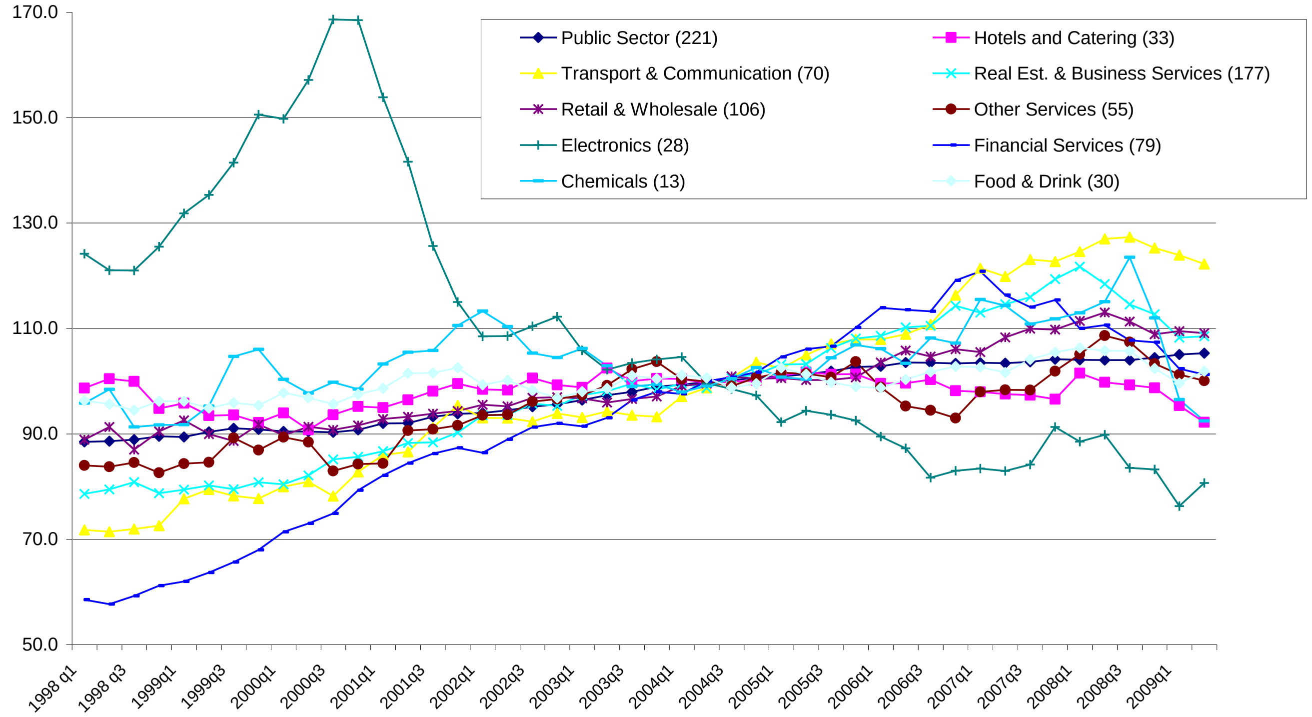


Figure 7: GVA percentage decline to 2009q2, or to trough, from latest peak, by sector

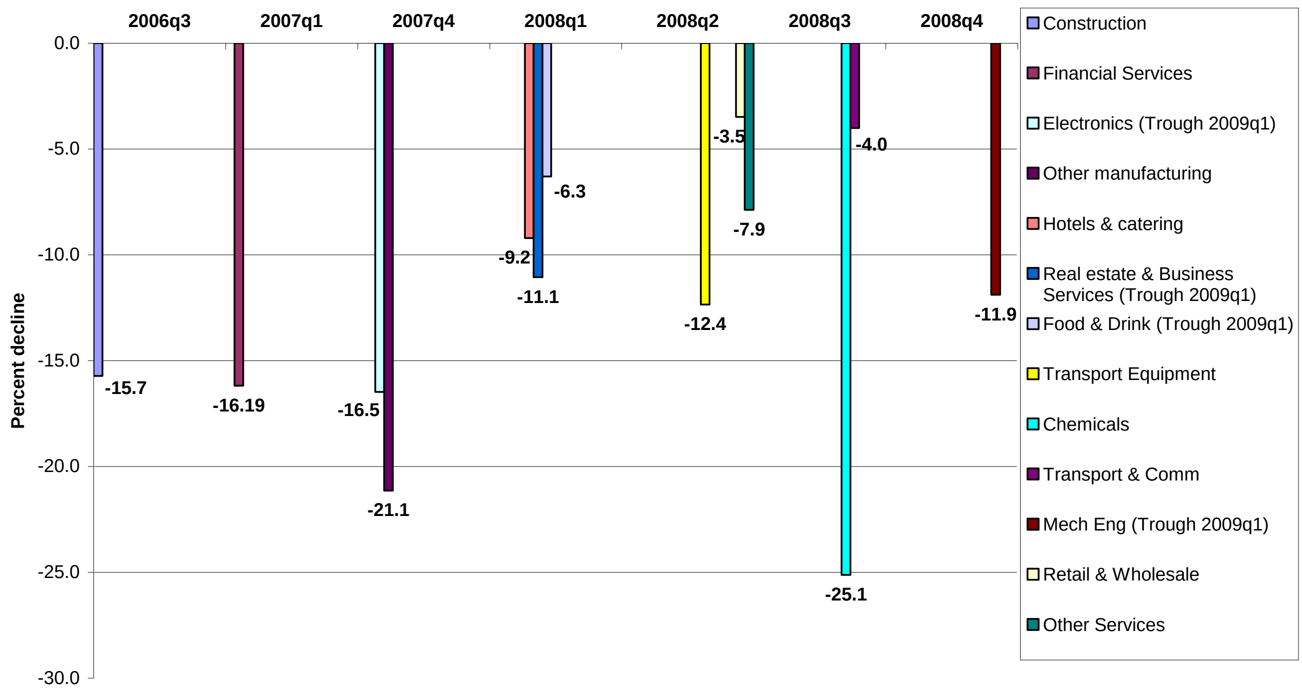
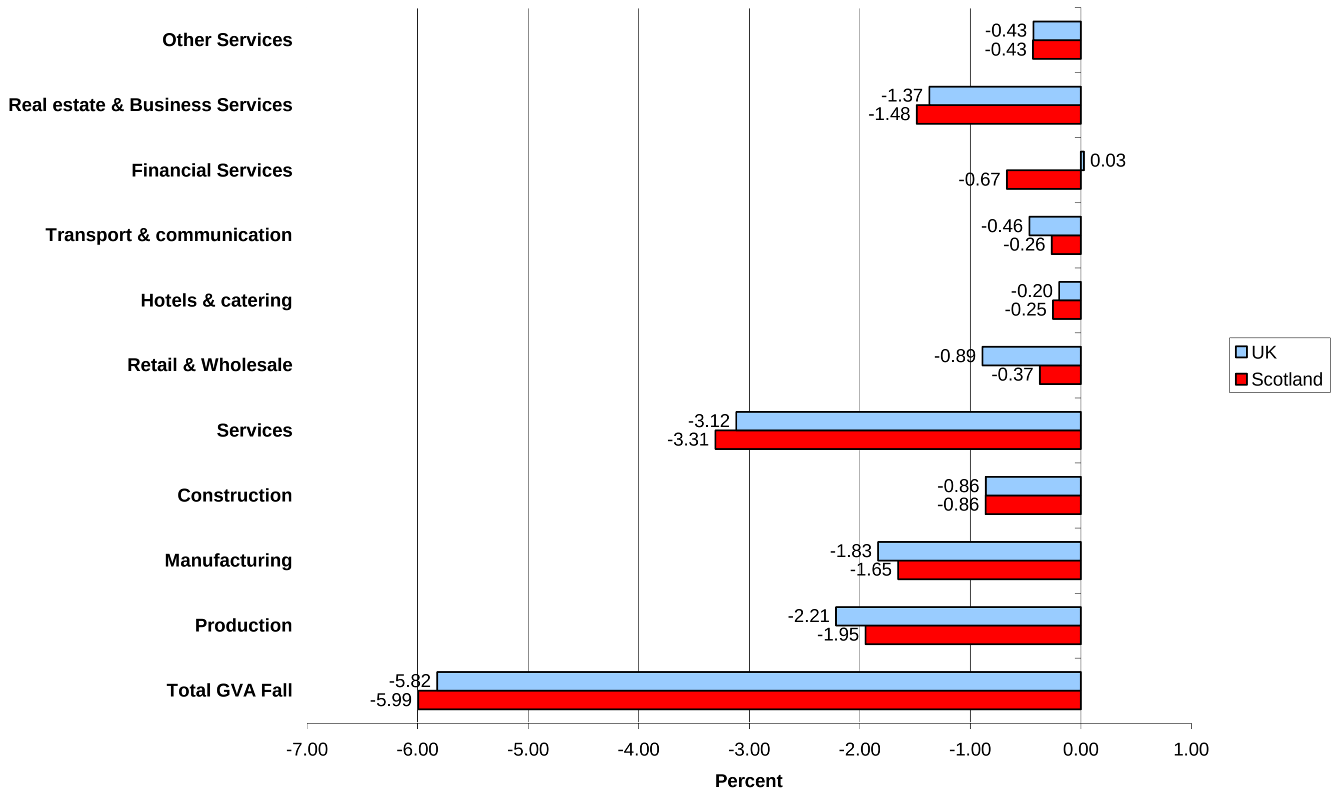


Figure 8: Weighted Sectoral contribution to GVA decline in recession to 2009q2 in Scotland and UK



moment we must make a prediction drawing on a range of indicators.

Likely third and fourth quarter outcomes

GDP in the OECD area stabilised in the second quarter of the year and major countries such as France, Germany and Japan returned to positive growth, although not Italy and the United States. However, UK GDP contracted by -0.6% in the second quarter, and then contracted further, by -0.4%, during July to September. In contrast, the United States returned to positive growth in the third quarter. There was much shock in the City when the UK third quarter figures were published because there was a widespread expectation that the UK either would come out of recession, or stabilise with close to zero growth. While the size of the continuing downturn was surprising, a fall in GDP was not unexpected. Indeed, the OECD in September had suggested an annualised fall in GDP in the UK in the third quarter of around -1%. There remains the strong possibility that the third quarter UK figure may be revised upwards as with the second quarter data, which were revised from -0.8% to -0.6%. This would move the outturn data more into line with the survey data for the period. However, it seems unlikely that the revision would be sufficient to bring the UK out of recession in the third quarter suggesting that the UK economy is clearly lagging other major economies. The latest data reveal that the 16-country eurozone grew by 0.4% in the third quarter, the 27 country EU grew by 0.2% in the quarter and the lead EU economy, Germany, grew by 0.7%. From a UK standpoint both external and domestic demand are rising and domestic demand is likely to receive a boost right across the UK in the current quarter as household spending rises temporarily in anticipation of the reinstatement of the VAT reduction at the end of the year. So, there is a strong expectation that it will be the fourth quarter when the UK economy is seen to emerge from recession.

The survey evidence for Scotland (See **Review of Scottish Business Surveys** in this Commentary) reveals rising confidence and improvements in orders and sales growth. Manufacturing activity appears to have strengthened considerably ahead of expectations in the third quarter in almost all of the surveys. The Scottish Chambers' Business Survey (SCBS) revealed a positive balance on total new orders for the first time since the first quarter of 2008. The small positive balance on expected new orders reported in the second quarter strengthened further in the third quarter. Capacity utilisation was rising, although the net balance on investment intentions continued to be negative all be it at a lower rate and employment trends continued to be negative. In the SCBS for the third quarter, tourism trends were better than expected with a positive net balance on total visitor demand for the first time since the fourth quarter 2007. However, the trends in construction and retail & wholesaling were less buoyant. Negative net balances on orders or sales suggest that demand was continuing to fall. In retail and wholesale the declining negative net balance suggests that the decline in demand was slowing in the third quarter. But in construction a larger negative net balance on total new contracts and new orders suggests little slowing in the rate of decline.

So, the partial survey data from the production side would appear to imply that it is unlikely that the overall Scottish economy will have experienced positive growth in the third quarter. There is evidence of a clear improvement compared with the second quarter but our judgement would be that the outturn for GVA growth in the third quarter will closely parallel the UK outturn of -0.4%. On the balance of probabilities, a high growth scenario would be likely to see zero growth in the third quarter, or a bottoming out, while a low growth expectation would see continued negative growth of perhaps -0.6%, a little better than the second quarter outturn.

There is a widespread expectation that the UK economy will come out of recession in the fourth quarter of this year exhibiting a small but positive growth rate. We agree with this view since there are a wide range of indicators that can be cited on both the demand and supply sides, which suggest that a recovery is underway. However, the situation in Scotland is more difficult to call. The SCBS in October saw clear signs of rising expectations and an emerging recovery in manufacturing, but little sign in the other sectors surveyed. Some surveys that include a rest of UK comparison, such as the Markit Regional PMI for September reveal that the indications of recovery are weaker here than in many other UK regions. In contrast, the CBI Industrial Trends survey in October suggested that Scottish manufacturing had been more buoyant than its UK counterpart over the preceding three months, with stronger growth in orders and output predicted for the fourth quarter. Against this background we take the view that there is a good chance that Scotland will emerge from recession in the fourth quarter, with likely growth around +0.2%, but less strongly than the rest of UK. But there also remains a lower probability that the recession will not end in Scotland in the fourth quarter even though it does so in the UK economy as a whole.

Scotland versus UK performance

We noted in earlier *Commentaries* that the Scottish economy tends to experience a shallower contraction during recession than the UK as a whole. In the November 2008 *Commentary* we observed that the reasons for this are complex, reflecting the different structure of the Scottish economy, the behaviour of key actors in the economy and the source of the recession. Other things equal, a somewhat bigger public sector in Scotland and fairly high levels of income compensating social security payments have helped the economy weather downturns in private sector market demand for goods and services. In addition, the higher Scottish household propensity to save has tended to relatively protect Scottish household expenditure from interest rate hikes as it did in 1991.

Moreover, the lower degree of home ownership, lesser willingness to take on debt also helped Scotland to avoid recession in that year.

But the evidence to date in the present recession is that GVA has contracted by slightly more than the UK even though the Scottish economy was a quarter later into recession. The phrase "slightly more" should be stressed because the gap is unlikely to be statistically significant and so commentators such as ourselves should not make too much of it. We also note that the Scottish GVA data are recognised by the Office of the Chief Economic Adviser as "generally … less reliable than the equivalent estimates for the UK, primarily because the UK figures are produced by balancing three independent sets of estimates." [i] The possibility of revisions is therefore great. In addition, Colleagues at the Centre for Public Policy for Regions have noted some difficulties and possible errors in the Scottish GVA estimates[ii]. But accepting the Scottish GVA statistics as published, what is different about the present recession?

In November 2008 we raised the possibility that Scotland might do worse than the UK in the recession that was then in prospect. This was principally because we took the view that the impact on banking and financial services would be bigger here than in the UK due to the scale of the losses on sub-prime and impairments facing the two principal Scottish banks, RBS and HBOS, compared to other UK banks. This prediction has, so far, proved to be correct, with GVA of financial services in Scotland contracting by -5.7% between the fourth quarter of last year and the second quarter of 2009, while GVA in UK financial services only fell by -1.9% over the same period. Moreover, financial services in Scotland was contracting some time before the fourth quarter of last year – see Figure 7– which was not the case in the UK. Whether this can be attributed to the recession or a structural adjustment in the industry disfavouring Scotland is a moot point. In addition, further contraction in Scottish banking is set to come although it may affect employment more than output if efficiency savings are secured through restructuring. It should be also noted that financial services are slightly more important in Scotland, 8% of GVA, than in the UK, 7% of GVA, hence the significance to the Scottish economy of a given percentage change in financial services GVA is marginally greater. The application of those weights to the respective reductions in GVA in financial services in Scotland and the UK, for the period of the downturn in overall Scottish and UK GDP suggests that aggregate Scottish GVA/GDP would have fallen by 0.7% more than UK GDP – see Figure 8. Other things equal that is more than sufficient to account for the gap in favour of UK GDP.

However, other things were not equal as Figure 8 reveals. Production and construction GVA contracted by more in the UK than in Scotland during the recession, which would have served to reduce the gap by 0.26% and so reinforce the point that greater decline in financial services here is sufficient to explain the marginally greater loss of output in Scotland during the recession. But against that must be set the weaker performance of REBS in Scotland during the recession, which served to worsen the gap in Scottish GDP relative to the UK by 0.11%.

So, overall, there is a strong case to make that the marginally greater fall in Scottish GDP during the recession has been down to weaker service sector performance, principally financial services and real estate and business services (REBS) to a lesser extent.

There may be additional and complementary reasons why the overall contraction in GVA has been greater in Scotland, which can be offered as hypotheses:

a) Scottish banks may be lending less to Scottish based firms than other banks.

b) Scottish households may have cut back spending more than their rest of UK counterparts.

There is little evidence to support any of these as far as their effect on the scale of the downturn relative to the UK.

On a) while there is some anecdotal evidence that it has been easier to get loans and better financial terms from the banks in Scotland that have not been heavily supported by the state following the 'credit crunch', there is no indication from the GVA data to the second quarter that the reduction in the level of GVA in Scotland has been systematically greater across sectors than in the UK. The more rapid rate of decrease in Scottish GVA, which has affected many sectors, may, though, be partly a consequence of greater restriction on overdrafts, provision of working capital, and tighter terms on new credit. Across the UK there has clearly been a fall in bank lending, in part because of a flight of lending from foreign banks but also as UK banks have sought to restructure their balance sheets following the impairments and losses incurred in the 'credit crunch'. But what cannot be established is whether in both Scotland and the UK the lower level of lending is simply, as the banks contend, a *consequence* of the recession, or whether it is a principal *cause*. These competing views will be put to the test as demand in the economy recovers.

On b) given that Scottish households have a historic tendency to save proportionally more of their income than their UK counterparts, there is the fear that the cutback in Scottish household spending would be more severe in the present recession. This reflects the view that Scots households would make a more prudential response to scaling down debt levels in response to tightening credit availability and falling asset prices. However, the comparative buoyancy of retail and wholesale in Scotland during the recession to 2009q2 – see Figure 8 – suggests that this affect has not been present so far. However, business surveys such as the SCBS highlight the weakness in orders and sales to the domestic Scottish market compared to rest of UK and abroad, although this may reflect a weakness in demand from other producers in Scotland rather than Scottish households. Furthermore, the hypothesised greater tendency of Scottish households to limit spending may be more relevant to the recovery than the downturn. In this connection, the finding in the Markit Regional PMI in September that the rate of improvement was slower in Scotland than in other UK regions could be salient.

The dynamics of recovery

It would be a mistake to conclude that economy's troubles are over once growth resumes and the recession ends. We have seen that both Scottish and UK economies have lost around 6% of GDP since the recession began and for Scotland at least a little more output may be lost before the recession ends. A key issue, then, is how quickly will the economy get back to pre-recession levels of output. A further issue is when the economy will get back to where it would have been in the absence of recession. Here we need to take into account trend growth prior to the start of recession. So, a 2% per annum trend growth means that a further 2% of GDP will have been foregone for each year of the recession and subsequent below trend growth in the recovery. Assuming that the recession has not lowered trend growth – which is a possibility - then to the latest data point, 2009q2, the Scottish economy is likely to have been 8% below where its GDP would have been in the absence of recession. As long as this output gap persists there will be a deflationary dynamic in the economy as aggregate supply exceeds aggregate demand and unemployment is likely to continue to rise or remain high.

Recent work by the National Institute for Social and Economic Research in London charts the percentage fall in UK GDP from the pre-recession peak until output fully recovered in the Depression of 1930-34 and the recessions of 1973-76, 1989-83, 1990-93 and the current recession. The data are graphed in Figure 9.

The chart reveals two key issues that are worthy of consideration: the length of time taken to fully recover and the frequency of setbacks in the recovery, especially a "double-dip". First, recovery to pre-recession output has never taken less than 40 months, or three and one-third years, and in the 1930s depression and 1980s recession recovery took around 50 months or just over 4 years. Secondly, with the exception of the 1990-93 recession all of the previous recessions exhibited "double-dip" behaviour to varying degrees, with the second downturn occurring 18, 28 and 30 months after the initial pre-recession peak.

The key question is whether this historical evidence has any relevance to recovery from the present recession both in the UK and Scotland, for which we do not have comparable data to conduct a similar exercise to that undertaken by NIESR for the UK.

The Governor of the Bank of England in his Inflation Report press conference on 11 November 2009 draws conclusions about the present recession that reflect the historical experience charted by NIESR. It is worth quoting some of his words:

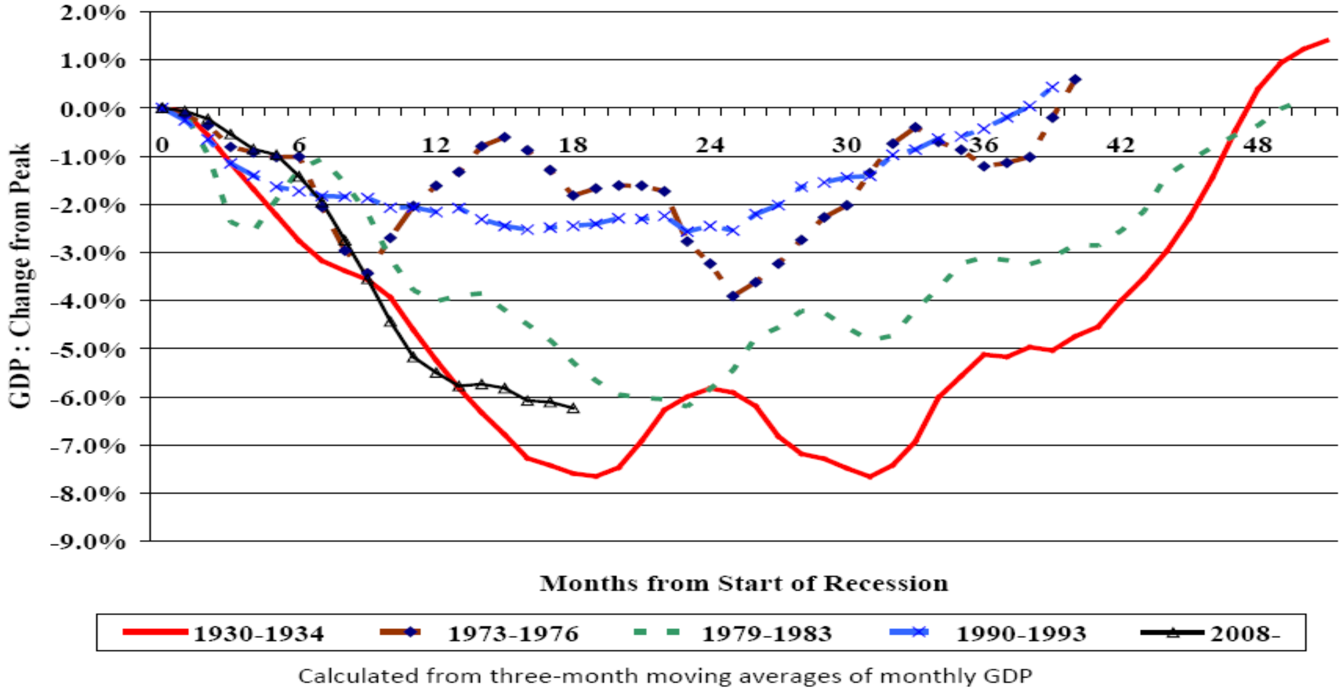
"…small movements in quarterly growth rates will not alter the extent of the challenges now facing the economy, such is the scale of the fall in output over the past eighteen months. The UK economy is facing a prolonged period of balance sheet adjustment. That will not be achieved in a few quarters. …. Despite a recovery in economic growth, output is unlikely, at least for a considerable period, to return to a level consistent with a continuation of its pre-crisis trend."[iii]

Growth is returning right across the world economy, even though world trade and economic activity remain below pre-recession levels. Indeed, while recovery in the UK and Scotland may be lagging, global indicators of recovery are ahead of expectations in much the same way as the scale and rapidity of output decline confounded earlier expectations. The significant monetary and fiscal stimuli is clearly having a positive effect on demand in many countries, even though there are concerns, especially in Britain, that the impact of quantitative easing may be muted by sub-optimal bank lending. The openness of the Scottish economy to trade and investment flows should ensure that the benefits accrue to Scotland even if domestic investment and consumer demand continues to remain weak. A near 25% fall in the value of sterling makes the Scottish and rest of UK economies well placed to take advantage of the upturn in global demand. Yet, as the Bank's recent Inflation Report notes: "… there are a number of headwinds that are likely to impede the recovery."

Domestic Scottish and UK consumer and investment demand may remain weak for some time as both households and firms seek to strengthen their balance sheets. The availability of sufficient bank credit to fully finance the recovery remains a source of continuing concern. The significant fiscal consolidation that is in prospect as the UK government seeks to reduce its deficit and stabilise, possibly reducing its debt position will serve to reduce domestic demand and spending. There are clear concerns that the fiscal consolidation might occur too soon before the necessary switching to export-based growth can be achieved. In addition, concerns have been raised that the volume of money pumped into the world economy through quantitative easing, historically low, almost zero, interest rates and a declining US dollar, are fuelling a bubble in (risky) asset values. The concern is that the bubble will burst affecting real incomes and spending when monetary policy is tightened again and when the value of dollar stabilises[iv] This also raises the issue whether monetary authorities should be targeting asset price bubbles directly. For all these reasons the prospect of a double-dip recession is therefore present.

Figure 9: The Profile of the Depression: Months from the Start of the Depression and UK Recessions

Source: National Institute for Economic and Social Research 5 November 2009
http://www.niesr.ac.uk/pdf/051109_144552.pdf



We take the view that the Scottish recovery may be weaker than in the UK for the following reasons:

- The bias in the structure of the Scottish economy towards the public sector – 22% of GVA against 18% in the UK – means that the base for expansion is smaller here.
- The anticipated fiscal consolidation could be greater and/or have a greater impact on activity in Scotland. This depends on a number of unknowns such as: where the UK cuts fall in relation to reserved and non-reserved activities; the scale of the UK cuts, which in part depend on future GDP growth and interest rates; the nature of any tax increases; and the decisions of the Scottish Government.
- More technically, purchasing linkages between activities in Scotland – and hence multipliers - tend to be lower than in the UK because the Scottish economy is smaller and more open. Direct increases in demand tend to 'leak out' more than at the UK level. This may be offset, though, if the Scottish economy enjoys a stronger export boost through its greater openness.

- But we noted our concerns in the June 2009 Commentary that the increased exporting necessary to the recovery puts a premium on the performance of manufacturing (68% of exports abroad from Scotland are manufactured goods). We remain concerned that Scottish manufacturing has the size, diversity and capability to take full advantage of a lower exchange rate and the recovery of global demand.
- If Scottish households seek to recover their net asset position by more than their UK counterparts then recovery will, other things equal, be weaker here.
- Finally, if the two main Scottish banks, key beneficiaries of tax-payer funded support, are less willing to lend because of the need to rebuild their balance sheets to stabilise and raise their share price, then the Scottish economy may recover more slowly for this reason.

Forecasts

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

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

GVA Forecasts

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

GVA Growth (% per annum)		**2009**	**2010**	**2011**	**2012**
High growth		-4.9	1.6	1.8	2.1
	June forecast	*-1.9*	*-0.5*	*1.6*	*2.1*
Central		**-5.0**	**0.1**	**1.1**	**1.6**
	June forecast	*-2.9*	*-0.9*	*0.6*	*1.4*
Low growth		-5.2	-0.7	-0.1	0.5
	June forecast	*-3.8*	*-1.7*	*-0.2*	*0.4*

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

Net job no's		**2009**	**2010**	**2011**	**2012**
High growth		-126,915	-352	36,025	44,154
	June forecast	*-62,827*	*-23,152*	*33,584*	*45,174*
Central		**-130,776**	**-29,615**	**20,292**	**31,467**
	June forecast	-84,399	-51,451	11,301	26,824
Low growth		-134,864	-46,593	-3,409	6,788
	June forecast	*-103,579*	*-66,894*	*-3,722*	*6,847*

Table 3: Forecast Scottish ILO and Claimant Count Unemployment in Three Scenarios, 2009-12

		2009	**2010**	**2011**	**2012**
ILO unemployment					
High growth %		7.2%	7.6%	6.5%	5.0%
Central %		**7.6%**	**9.2%**	**8.7%**	**7.7%**
	Numbers	200,082	234,105	212,661	172,815
Low growth %		8.2%	10.5%	11.0%	11.0%
Claimant count					
High growth		4.5%	4.6%	3.7%	2.8%
Central %		**4.9%**	**5.8%**	**5.2%**	**4.2%**
	Numbers	136,821	160,087	145,423	118,175
Low growth %		5.3%	6.7%	6.8%	6.5%

“central” scenario is that which is most likely, while the “high growth” and “low growth” scenarios reveal the range of possible outcomes for the Scottish economy foreseen for future developments from November 2009 through 2010 to 2012

The key GVA forecasts are summarised in Table 1 along with our June forecasts for comparison. We shall primarily focus on our central forecast here. It is clear that we have revised downwards considerably our GVA forecast for 2009 to -5.0%. The narrow gap between the forecasts on the three scenarios for 2009 is mainly due to the fact that we already have two of the four quarters of outturn data. The predicted contraction of output in 2009 is appreciably lower than the June central forecast due to a significant reduction in household spending, weaker tourism expenditure and a larger reduction in investment demand. The growth of government spending is positive this year and export demand is recovering. In 2010, there is some recovery in Scottish household spending but it still remains below 2009 levels. Government spending continues to rise but at a reduced rate. Tourism demand begins to recover but aggregate investment remains low. In contrast, export demand to both the rest of the world and rest of UK picks up. GVA is forecast to be largely flat in 2010 with 0.1% growth projected. However, the discussion above and in the **Forecasts of the Scottish Economy** section below suggests that demand in the global economy is recovering more quickly than anticipated in June and so we are forecasting stronger growth in 2010.

By 2011, household spending will be rising again and will strengthen further in 2012, as do exports with investment also increasing from 2011. But we are forecasting large annual reductions in government spending from 2011. For these reasons growth rises to 1.1% and 1.6% in 2011 and 2012 but remains below trend. It is also worth noting that in 2010 in our central scenario we are allowing for one quarter of negative growth reflecting the headwinds buffeting the economy that we noted above. In the low growth scenario these headwinds are sufficient to produce two quarters of negative growth at the in the second half of 2010: a “double-dip” recession.

Employment forecast

The principal forecasts for net jobs growth are presented in Table 2. On our central scenario employment continues to fall through this year and next by more than 160,000. Net jobs growth will return in 2011 strengthening in 2012 but net job creation over these two years of nearly 52,000 indicates a slower recovery, with a net loss of 108,000 jobs over the period. Nevertheless recovery is stronger than our forecast in June.

Even on the high growth scenario net jobs in Scotland in 2012 are around 47,000 lower than in 2008. On the low growth scenario, the number is 177,000. At the sectoral level in the central scenario, the burden of jobs losses is born by the service sector, which might be expected given its relative size. In services, we expect some 95,000 net jobs to be lost during 2009 and 2010, with jobs growth returning thereafter. Of these lost jobs, around 26,000 are expected to occur in financial services. Manufacturing and construction job losses are projected to amount to nearly 39,000 jobs and 23,000 jobs, respectively, with net job creation beginning again in both sectors in 2011.

Unemployment forecast

Table 3 presents our main forecasts for unemployment over the 2009 to 2012 time horizon.

We have again revised upwards our forecasts for unemployment compared with the previous Commentary in June. This reflects the lower GVA forecasts for 2009 and the evidence of fairly rapid falls in employment and rising unemployment in the first quarter of 2009. Unemployment has been rising more rapidly in Scotland than in the UK, but this shouldn’t necessarily be taken as indicating that Scotland is doing worse in recession. A recession that affects different parts of the country equally would, other things equal, tend to raise the rate of unemployment more quickly in those regions with lower unemployment rates. The ILO unemployment rate in Scotland is currently 7.2% and remains below the UK rate of 7.9%. What happens to the future course of unemployment in Scotland depends not only on the loss of jobs but on the extent to which people who lose their jobs switch into inactivity, or migrate, rather than switch into unemployment.

We have previously taken the view that the recession in jobs and unemployment may be weaker than the recession in output. This is because the Scottish and UK labour markets are more “flexible” than they were in the 1980s. Employers will seek to hold on to core workers and will do so if there is the prospect of introducing short-time working, cutting wages, salaries and bonus payments, and letting go of part-time and temporary workers. The **Overview of the Labour Market** section below notes that in the year to March 2009 the percentage declines in part-time and temporary workers were higher than the decline in full-time employees. However, the section notes that there are limits to flexibility and that these limits may be approaching. A quick recovery in GVA growth will make it easier for companies to hold on to staff but a more slow recovery will make that task more difficult. In addition, we are likely to see rising job losses in the public sector with the flow of announcements of actual and planned job reductions in local government currently rising and set to rise further in 2010.

Brian Ashcroft
13 November 2009

Endnotes

[i]*GDP for scotland for the 2nd Quarter of 2009*, **Statistics publication Notice**, Scottish Government, page 2.

[ii]Centre for Public Policy for Regions
http://www.cppr.ac.uk/centres/cppr/analysisofthescottisheconom/

[iii]Inflation Report Press Conference, Wednesday 11 November 2009, Opening Remarks by the Governor.
http://www.bankofengland.co.uk/publications/inflationreport/irspote111109.pdf

[iv]Nouriel Roubini "Mother of all carry trades faces an inevitable bust", Financial Times, 1 November 2009.

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[i] Inflation Report Press Conference, Wednesday 11 November 2009, Opening Remarks by the Governor.
http://www.bankofengland.co.uk/publications/inflationreport/irspnote111109.pdf