

Outlook and appraisal

Overview

Since we last reported in October there has been a considerable deterioration in the actual and forecast performance of all the major economies. In October we considered there was a 'high probability' that Scotland would go into recession in 2009. Now, we are certain that not only is Scotland currently in recession but that the recession looks likely to be as severe as that in the 1980s and could even be worse. The tentacles of recession are spreading throughout the economy with construction and financial service activity subject to sustained contraction, hotels & catering turning down from the first quarter of last year and real estate & business services contracting appreciably after March. Economy-wide GVA contracted by -0.8% in the third quarter and seems likely to have fallen markedly in the fourth quarter if the UK's performance is any guide. Third-quarter manufactured exports decreased by 1% in real terms and by 0.4% over the year. Business surveys covering the fourth quarter period reinforce the expectation that the slowdown will be severe. In the labour market employment is falling and unemployment is rising.

We are in the midst of a deepening world recession driven by significant falls in aggregate demand, as the effect of bursting asset prices bubbles in property and shares leads households to scale back demand. High levels of household and corporate debt are also influencing the scale of the cut back in aggregate demand. With world demand generally contracting the principal exporting countries are likely to be disproportionately hit, other things equal. Conversely, those countries with a productive structure where exports count for disproportionately less e.g. the US, and where the public sector is disproportionately bigger, might be expected, other things equal, to do less badly in the recession. France offers a

possible example on both criteria. In these circumstances the impact of the recession on the UK and Scotland will not be the worst in the world as some have predicted.

The banking crisis and the apparent freezing of the credit supply function are secondary to the fall in aggregate demand. However, one should not minimise their importance. Lending has clearly dropped considerably, in part because individual countries have lost the lending previously provided by foreign banks. In the UK this amounted to about 30 percent of overall lending. Lending by UK banks has also declined as they seek to rebuild their balance sheets. The drop in the supply of credit has clearly accelerated the downturn in GDP as any monetary buffer that might have been available to provide working capital to help companies adjust more slowly to the downturn in demand has been removed. It remains to be seen how quickly the UK government's injection of capital into many of the key British banks, the introduction of its loan guarantee or insurance scheme, and the lower interest rates and quantitative easing effected by the Bank of England's Monetary Policy Committee, mitigate the scale and duration of the recession. It is clearly the case that in the face of severe restrictions on the supply of credit any recovery in demand and GDP growth will be more difficult to engineer.

The developing scale of the global downturn suggests that the US fiscal package is unlikely to compensate for the depressing effect on world trade of the US recession, although it may mitigate it, and will not be sufficient to substitute for inadequate demand stimulus policies in the surplus countries. As world demand contracts there are rising protectionist fears and a clear need to develop a better global governance of the financial system. The UK fiscal injection appears to be too little too late, and relatively small compared to the US stimulus package. A case can be made for a further fiscal stimulus, although rising public sector debt and foreign exchange market pressure

on sterling may limit the government's options. The significant loosening of monetary policy in the UK, which is continuing, appears to be thwarted by a 'liquidity trap' as asset prices fall and economic agents seek to hold cash rather than invest or spend. The case for temporary bank nationalisation in the UK and the creation of a 'bad bank' for toxic assets appears to grow stronger as the only effective means of unfreezing lending.

With macroeconomic policy powers reserved to Westminster the Scottish economy will benefit from the UK fiscal injection. Yet, while the Scottish government action will contribute little to aggregate demand it can play a constructive role in helping the economy adjust to the consequences of the recession and mitigating the effects on long-term growth.

Against this background we have prepared new forecasts that significantly revise downwards our expectation for Scottish growth over the next three years. Again because of the heightened levels of uncertainty we present a range of forecasts. On this occasion, a central forecast, which is bracketed by 'optimistic' and 'worst' projections.

On our central case we predict that GVA will fall by around -2.6% this year and by -1.2% next year. Recovery does not begin to get underway until 2011 and remains below trend in 2012. Employment is forecast to decline by 14,200 in 2008, by 94,200 in 2009 and by 51,400 in 2010, a total net job loss of nearly 160,000 over the three years. Unemployment rises from 137,000 in 2008 to a peak of around 210,000 in 2010.

GDP performance in third quarter 2008

The latest official government outturn data for the Scottish economy refer to the third quarter 2008. Total Scottish gross value added at real basic prices fell by -0.8% in the quarter but rose by 1.4% over the year. The deterioration was worse in Scotland than in the UK – see Figure 1 - with UK GVA contracting by -0.6% in the quarter, while output over the year rose by 1.9%.

Service sector growth was appreciably weaker in Scotland during the quarter with an outturn of -1.1% here compared to -0.5% in the UK – see Figure 2. Over the year, Scottish services grew by 2%, while UK services expanded by 2.4%.

Within Scottish *services* the sector contributing most to the weak performance of Scottish services during the quarter was *real estate and business services* (REBS), which accounts for 18% of overall Scottish GVA compared to 23% in the UK. REBS contracted by -3.7% in the quarter compared to a much smaller fall of -1.2% in the UK. GVA in Scottish REBS has been declining from the first quarter of last year – see Figure 6 – while UK REBS began to contract only in the third quarter. It is difficult to understand precisely why the downturn is more severe in the Scottish part of the sector. *Real estate and property related services* account for a 45% share of Scottish REBS, so there may be a property market link to the weaker performance of REBS. But the difficulty with this view is that the scale of the downturn in the housing market is greater in the UK overall, although that may not be the case in commercial property. Pure *professional & business services* make up a 13% share of REBS and they may be contracting more rapidly in Scotland because of banking and financial service linkages and the weaker performance of that sector in Scotland – see Figure 5.

Elsewhere in services, the *retail & wholesale sector* contracted in both Scotland and the UK during the quarter, by -1.5% and -2.7% respectively. But the additional data produced by the Scottish government indicating that it was wholesaling and not retailing that weakened in Scotland. Scottish Retail GVA rose by 1.9% in the quarter and by 3.1% over the year. *Financial services* while weaker in Scotland grew by 0.5% in the quarter compared to growth of 1.1% in the UK. Figure 5 suggests that Scottish financial services has consistently underperformed UK financial services since the second quarter of 2006, with the exception of the fourth quarter 2006 and fourth quarter 2007. We only have Scottish data for GVA growth in *banking* and this series indicates a fall of -1.9% in the third quarter of 2008. Other weaker Scottish service sectors in the third quarter included the *public sector*, which grew by 0.1% here compared to an increase of 0.5% in the UK. Other services contracted by -1% compared to growth of 0.8% in the UK, while *hotels & catering* cut back GVA slightly by -0.1% compared to growth of 0.3% in the UK. The only service sector, apart from retail and wholesaling, which out performed its UK counterpart was *transport & communication* which grew slightly by 0.1% compared to a small fall of -0.1% in the UK.

Manufacturing in Scotland contracted by -0.6% in the third quarter, a smaller contraction than in UK *manufacturing*, which cut back output by -1.6% - see Figure 3. Over the year, GVA in Scottish *manufacturing* rose by 1.9% whereas UK manufacturing output fell by -0.5%.

Within manufacturing, the relatively stronger Scottish performance in the third quarter was essentially driven by *chemicals*, - accounting for 10% of manufacturing GVA - which grew by a staggering 9.5% in the quarter, while UK chemicals expanded by only 0.5%. Such a large change suggests a one-off adjustment of some description and is, therefore, unlikely to be sustained. *Refined petroleum products* also turned in a very strong growth performance in Scotland compared to the UK, expanding by 6.8% while its UK counterpart contracted by -2.9%; however, the sector accounts for only 1.4% of Scottish manufacturing GVA. Most other principal manufacturing sectors displayed weak or negative growth in Scotland during the third quarter. The *food industry* grew by 0.3% here compared to 0.1% in the UK. The *drinks sector* experienced a fall in GVA of -0.7% in Scotland but registered a fall of -1.5% in the UK. *Engineering* overall contracted markedly both in Scotland and the UK by -2.3% and -2.5% respectively. Within engineering, the *electronics* sector cut back considerably in Scotland with GVA falling by -4.6%, while its UK counterpart registered a lesser but still marked fall of -2.9%. In contrast, both *mechanical engineering* and *transport equipment* grew by 0.1% and 0.4% in Scotland while contracting by -1.3% and -3.1%, respectively, in the UK. Finally, *paper, printing & publishing* and *other manufacturing* cut back production appreciably with the former contracting by -2.1% and the latter by -4.9%. The comparable UK figures were -2.1% and -2.8%.

Despite the relative buoyancy of the housing market in Scotland, the construction sector in Scotland has effectively been in recession for some time – see Figure 4. This clearly reflects a drop-off in demand for major project activity from both the public and commercial property sectors. GVA fell by -1% in Scottish construction in the quarter, while UK construction activity dropped by -0.2%. GVA in Scottish construction has now dropped by more than 6% since its peak in the fourth quarter of 2006.

Figure 6 brings together the GVA indexes for 10 key sectors that are, or have been, significant for the growth of the Scottish economy. The figure reveals the continuing strength in *chemicals* and *transport & communication services*, the weakness in *financial services*, *electronics*, and deterioration in *REBS* and *hotels & catering*.

Figure 7 provides a clearer picture of how the downturn is affecting the Scottish economy. It does so by charting the scale of the decline in sectoral GVA from the last peak in GVA in the sector. Clearly, we can't be certain whether the peaks identified actually do represent a cyclical peak and so the analysis could change once later data become available. It appears to be the case that the downturn started in construction from 2006q3, which by 2008q3 had lost -6.3% of GVA in the sector. *Financial services* began to turn down two quarters later in 2007q1 and then contracted more sharply, with GVA falling by -8.5% by 2008q3. In the next quarter 2007q2 *mining & quarrying* started to turn down and by 2008q3 it had lost -2.5% of its

GVA. Of course, whether the downturn in mining & quarrying is related to wider forces promoting the recession in Scotland is a moot point and could well be unrelated. From the fourth quarter of 2007 *electronics* started to turn down suggesting perhaps that export demand for manufactures was starting to be affected by falling demand conditions across the globe. Then from the first quarter of last year *hotels & catering* and *REBS* registered falling output. The former will clearly have been affected by both slowing domestic demand and the effect on tourism of falling foreign as well as domestic demand. We discussed above some of the likely drivers of the downturn in REBS.

Recession issues and policy responses

What is driving the recession?

There is now much agreement that the ultimate cause of the global slowdown lies in the large financial imbalances in the world economy that built up over the past decade. Burgeoning current account surpluses from mid to late 1990s in China, other emerging market economies, oil exporting economies, Germany and Japan, led to significant flows of surplus savings mainly to the United States (70%), a little to the UK and an array of smaller economies such as Spain, Ireland and Iceland. These surplus savings served to lower long-term real and nominal interest rates across the world economy and fostered a boom in credit aided by the financial de-regulation that occurred in the US, UK and elsewhere in the early 1980s.

The boom in credit growth facilitated higher personal consumption and spending on a range of perceived high yielding assets, with associated growth in investment banking activities, hedge funds and private equity funds across the globe. Asset price bubbles began to emerge especially in housing and property markets in US, UK and some other European countries. The bubbles burst in 2007, as the US fed funds rate rose some 4 percentage points to 5.25% between 2004 and 2006, and the extent of credit excess began to be evident, e.g. failed repayments and foreclosures in US sub-prime mortgage market. Banking losses were initially triggered by the defaults on sub-prime-mortgages. But such losses were then magnified dramatically throughout the banking and financial system on a global scale due to the creation and rapid growth of complex financial instruments that were perceived to diversify risk and returns. Examples of such instruments include mortgage backed securities such as collateralized mortgage obligations (CMOs), collateralized debt obligations (CDOs) based on all types of assets including mortgages, and credit derivatives, especially the credit default swap (CDS), a way of insuring against losses on a loan portfolio, CDOs of CDOs and synthetic CDOs.

The complexity of these instruments meant that the losses generated by the deflation of house prices, commercial property prices, other asset prices, and associated loan repayment defaults, could not easily be gauged or located. Banks began to lose trust in one another and inter-bank

lending rates rose. Then, to dramatise the narrative, the major US and world investment bank Lehman Brother was allowed to go into administration by the US government on 15th September 2008. This sent a signal round the financial world that insolvent banks would not necessarily be bailed-out by governments, so inter-bank lending largely ceased and the wholesale money markets effectively froze. The consequent loss of confidence and trust in the banking and other parts of financial system led to a breakdown in the credit supply mechanism within and outside the system - the so-called "credit crunch". The scale of the losses also meant that banks had to restructure their balance sheets resulting in loans being called in, overdrafts reduced, reduced possibilities for re-financing of corporate loans, and a general cut back in lending, further exacerbating the credit crunch.

There would appear to be some uncertainty about the specific drivers of the current downturn and hence the predicted consequences for national economies. There is a body of opinion that sees the bursting of the housing market bubble in the US, the extensive defaults on 'sub-prime' mortgages, the subsequent banking losses and insolvencies as locating the main incidence of the global downturn in those countries, such as the US and the UK, with previously highly buoyant housing markets, significant household borrowings and large banking and financial sectors. Hence, the OECD and the IMF and others have forecast that the UK will be one of the countries most affected by the downturn.

We take a somewhat different view and do not necessarily accept that the UK and Scotland will be the worst affected in terms of the size of the GDP contraction, although the downturn will be sizable here and perhaps unprecedented.

The first point to note, perhaps obviously, is that it is falling aggregate demand that is driving the contraction of GDP. Secondly, the banking crisis and the apparent freezing of the credit supply function are secondary to the fall in aggregate demand. However, one should not minimise their importance. Lending has clearly dropped considerably, in part because individual countries have lost the lending previously provided by foreign banks. In the UK this amounted to about 30 percent of overall lending. Lending by UK banks has also declined as they seek to rebuild their balance sheets. The drop in the supply of credit has clearly accelerated the downturn in GDP as any monetary buffer that might have been available to provide working capital to help companies adjust more slowly to the downturn in demand has been removed. It remains to be seen how quickly the UK government's injection of capital into many of the key British banks, the introduction of its loan guarantee or insurance scheme, and the lower interest rates and quantitative easing effected by the Bank of England's Monetary Policy Committee, mitigate the scale and duration of the recession. It is clearly the case that in the face of severe restrictions on the supply of credit

any recovery in demand and GDP growth will be more difficult to engineer.

Thirdly, as Martin Wolf notes¹ drawing on work by Richard Koo² on the Japanese deflation in the 1990s, falling asset prices will have a greater impact on demand the more assets have been funded by debt. This is because the evidence from Japan suggests that as asset prices fall borrowers will seek to pay down their debts so increasing saving and reducing consumption by more than would be the case from a simple wealth effect of the falling asset price. If this analysis is correct then significant falls in asset prices after a major credit boom and debt inflation are likely to precipitate large falls in aggregate demand. Moreover, the UK and the US where levels of household borrowing are high should, other things equal, experience a disproportionate drop in demand compared to those countries where household borrowing is lower even if asset prices have fallen similarly. And some asset prices such as those for houses and commercial property are likely to fall further in the US and UK. Added to this, the relatively greater size of the banking and financial sectors in the UK and US and the scale of the insolvency present in such banks offers a further reason, both in terms of direct demand reduction and restricted credit supply, why the UK and the US might suffer a more severe downturn.

So, the analysis so far might appear to suggest that the US and the UK are likely to experience a more deep and prolonged recession than other principal economies. But there is another issue that needs to be considered.

Fourthly, the downturn in aggregate demand is clearly worldwide, even though the incidence might vary *inter alia* according to the extent that asset price falls and household and corporate debt vary across countries. The worldwide contraction in demand is not of course confined to demand for domestic goods and services. Demand for imports is much affected and growing protectionist tendencies, including attempts to encourage domestic banks to lend locally rather than abroad, may serve to worsen the deterioration in import demand. However, import demand is not met evenly from the world economy. Countries such as Germany, Japan, China, and export 'platforms' such as Taiwan, Ireland and Singapore that serve world trade disproportionately through their export activity are likely to experience a sizable contraction in the demand for their goods and services. A simple numerical example should make the point. Suppose there are ten, equal-sized countries and each experience an initial drop in domestic demand of 5 percent. Now assume that in nine of those countries the drop in import demand amounts to a fifth or 1 percent point of the drop in domestic demand and they all import from the tenth country, which imports nothing. GDP falls by 4 percent in the nine but by 14 percent in the tenth country.

The conclusion is that with world demand generally contracting the principal exporting countries are likely to be

disproportionately hit, other things equal. Conversely, those countries with a productive structure where exports count for disproportionately less e.g. the US, and where the public sector is disproportionately bigger, might be expected, other things equal, to do less badly in the recession. France offers a possible example on both criteria.

The latest GDP growth figures for the fourth quarter of 2008 appear both to offer some support for this contention and to underline the seriousness of the crisis. In Japan GDP fell by -3.3% in the quarter, in Germany GDP contracted by -2.1% in the quarter, in Italy the decline was -1.8%, while in the UK the fall was -1.5% the same rate of contraction as euro area (EA15) and the EU27. At the same time the US economy contracted by 1%, and French GDP fell by -1.2%. Even the Chinese economy, for so many years a key engine of global growth, slowed to 6.8%, at an annualised rate, in the fourth quarter, from an annualised rate of 9% in the third quarter and growth of 13% in 2007 as a whole. Chinese GDP growth over the year to the fourth quarter was 9%, the lowest rate since 2001, when an annual rate of 8.3 percent was registered, and it was the first time China's growth fell into the single figures since 2003.

Policy responses

We consider successively issues for global, UK and Scottish policy responses to the recession.

Global

It might appear to be a truism to suggest that the global nature of the downturn requires a global solution. However, there is a danger that some countries while acknowledging the global nature of the recession may seek to pass responsibility for dealing with it to other countries and/or international bodies such as the IMF. Countries such as China, Germany, Japan that have tended to produce much more than their domestic demand, so running significant savings surpluses and current account surpluses, will find it easy to blame countries such as the US, UK and Spain where domestic demand has far outrun supply. If such feelings translate into a policy stance in Germany, China and Japan that refuses to recognise their own obligation to take responsibility for maintaining global aggregate demand by expanding their own domestic demand, then the world economy will in all likelihood experience a depression. It is, in any event, in the direct interest of these countries to avoid a significant contraction in world supply because they will bear the brunt of it as the drop in world trade disproportionately reduces demand for their exports³

The \$800 billion fiscal stimulation package that is being introduced by the new Obama administration in the US is a welcome development notwithstanding the flaws in the package. While this package – equivalent to about 5% of US GDP - may help to promote confidence in the world economy generally its effect on world trade flows will be limited. A rough calculation suggests that if the stimulus

package raises US aggregate demand by an equal amount – unlikely given that there will be some flow into savings and taxes - US imports will expand by around 14% of the GDP expansion and given the level of world exports - \$16.34 trillion according to the CIA World Factbook - the stimulus to world exports will be less than one percent. However, before the stimulus package was enacted the US Congressional Budget Office was forecasting that US GDP would fall by 7% over the next two years. So, the package is unlikely to compensate for the depressing effect on world trade of the US recession, although it may mitigate it, and will not be sufficient to substitute for inadequate demand stimulus policies in the surplus countries. Moreover, in the medium to longer-term the post-recessionary equilibrium in the US will require reduced fiscal and current account deficits, which implies that the US demand for world exports must fall.

There is of course also the fear that surplus countries may be tempted to protect their market share by adopting increasingly protectionist measures such as subsidising domestic industry. This is already beginning to happen in deficit countries such as the US and UK e.g. the auto industry, in response to the initial drop in domestic demand due to the asset price deflation that accompanied the credit crunch. Financial protectionism is also on the increase as governments seek to encourage domestic banks to focus their lending on the domestic economy. Retaliation by both surplus and deficit countries will eventually serve to destroy world supply capacity in the medium to long-term even if there are short-term domestic supply benefits. A more prolonged recession and slower long-term growth is the likely result.

Finally, looking to the longer term, the governance of the global financial system must change. Specifically, the system must be able to facilitate the channelling of surplus savings into investment opportunities in emerging countries rather than fund debt expansion in the advanced countries such as the US and UK. The IMF needs to become more responsive to the needs of emerging country borrowers and help provide more effective insurance against systemic risks than at present.⁴

The United Kingdom

In the November 2008 Pre-Budget Report (PBR) the government introduced a fiscal stimulus in an attempt to counter the recession, which amounts to a £25 billion injection of demand over the two fiscal years 2009 -10 and 2010 –11. A £12.5 billion temporary – for one year – VAT cut and proposals to bring forward capital spending mean, according to the IFS Green Budget, that government borrowing will rise by £9.3 billion this year and £16.3 billion next year. This therefore amounts to an injection of additional demand equivalent to roughly 0.6% of GDP this year and 1.1% of GDP next year. The fiscal injection should be viewed in the context of a developing consensus that GDP may contract by -3% or more this year – in

February a consensus of new forecasts averaging -2.8% for 2009 - and by low or zero growth in 2010 – new forecast consensus in February of 0.5%.⁵ Against this background the fiscal injection looks like too little too late, and relatively small compared to the US stimulus package. It is also assumed that the injection will actually raise aggregate demand as hoped for by the government. It may not do so, of course, if households fully anticipate that they will have to pay higher taxes and experience lower public spending in order to fund the current stimulus.⁶

We contend that there is a case for the government to go further and introduce a new fiscal stimulus, front ended as far as is feasible on the 2009-10 fiscal year. The orders of magnitude required are for about a further £20 billion for the two fiscal years 2009-10 and 2010-11, with reversal of the overall £45 billion injection progressively after that to restore the public finances. This would amount to an approx stimulus to aggregate demand of 3%, which would, therefore, be closer to the anticipated decline in GDP over the two years and a little closer to the relative scale of the US fiscal stimulus package.

The deteriorating state of the UK's public finances and the rising yield on 10-year government bonds – now at 3.41%, 40 basis points above 10-year German government bonds – suggests that a further fiscal stimulus could be destabilising. Moreover, the greater the delay the greater the risk that the stimulus will become irrelevant while the risk of a loss of confidence in sterling in the foreign exchange markets and the threat of future inflation will weigh more heavily. All of these factors need to be weighed carefully but in our view the most pressing need is for further injections of aggregate demand from the public sector to offset the apparent continuing and perhaps worsening downward spiral in private sector demand across the global economy.

Since we last reported in October 2008 the Monetary Policy Committee (MPC) of the Bank of England (BOE) has cut bank rate from 5% to 1%. There is an expectation that interest rates will fall further to zero. With interest rates close to zero and prices rises turning negative, real interest rates will effectively be increasing and expectations will generally be for nominal interest rates to rise⁷. The expectation will also be for bond prices to fall. There will be no incentive to hold monetary assets that are falling in value for speculative/investment purposes and so economic agents will seek to hold cash – a 'liquidity trap'. In such circumstances a policy of boosting liquidity and interest rate cuts will fail to influence the real economy. There is evidence that this is happening in the UK with narrow measures of the money supply showing some growth following the efforts of the BOE to raise liquidity. But this does not appear to be passing through into lending and growth in the broader money supply. For example, non-seasonally adjusted M4 lending – which includes private sector bank and building society deposits – fell by -0.1% and -0.3% in November and December respectively. It is in

this context that the BOE is expected to seek to expand the money supply by directly buying up public and private assets – so-called ‘quantitative easing’ – and so bypass the banking system.

It is also in this context that calls for the government to temporarily nationalise the main UK banks should be viewed with increasing sympathy. There may also be a further case for the removal of the toxic assets currently residing in these banks and their placement in a ‘bad bank’, where they can be priced and subsequently sold off when market conditions allow. The UK government has already done much. New capital has been brought into the main banks – with the exception of Barclays and HSBC – in two successive tranches of £37 billion and £20 billion. Loan guarantees representing contingent liabilities of up to £600 billion have also been given. But there is a view increasingly gaining acceptance that the government should go further and nationalise the key banks, all be it temporarily.

The case for temporary nationalisation rests on four propositions:

- There is a positive externality to the wider economy from increased bank lending. The profit maximising objectives of shareholders require balance sheet restructuring and reduced lending risk. Banks are withdrawing loans and are applying tighter lending conditions to new lending. The existence of a non-priced externality offers a classic example of market failure and prima facie justification for government intervention. The government’s majority shareholding does not appear to be changing current bank behaviour in the interests of the minority private shareholders and so temporary nationalisation may be justified.
- Despite falls in the inter-bank lending rates, there is still uncertainty about whether British banks are insolvent. This uncertainty and lack of trust will continue until toxic assets are taken out of the banks.
- Relatedly, issues of capital adequacy of the banks seem likely to continue as long as they remain outside complete government ownership.
- The need to focus on more traditional forms of lower return/less risk banking may be opposed by existing private shareholders.

The case against nationalisation appears to offer the following key points:

- There would be a significant further rise in public debt, which might encourage a loss of confidence in the UK’s credit rating, damage sterling and even the City of London’s reputation.

- Private sector banks not taken into public ownership may be ‘crowded out’ by what is in effect a government subsidy.
- A so-called ‘temporary’ nationalisation may be difficult to unravel.
- Non-market considerations may begin to dominate the behaviour of the banks as politicians interfere to put social objectives, even short-term political objectives, above corporate efficiency and private shareholder returns.

We recognise the case against but, on balance, believe that current circumstances give greater weight to the case for a temporary nationalisation of the main British banks.

Scotland

In considering policy issues for the Scottish government it is useful to distinguish between:

- policies to counteract the recession, and
- policies to deal with the consequences of recession

Counteracting the recession

While the Scottish government has little power to influence aggregate demand in the short-term in the Scottish economy, it should be remembered that the current constitutional settlement reserves macro-economic stabilisation to Westminster. The Scottish economy should benefit from the £25 billion UK fiscal injection introduced in November’s PBR by a direct boost to demand of up to 2% of GDP. A significant injection. But leakages from a small open economy are greater than from a larger economy and so both the direct and indirect stimulus to demand will be less.

The Scottish Government has introduced a six-point stimulus plan: bringing forward some capital expenditure e.g. investment in affordable housing; enhanced support for tourism promotion; speeding up the planning process; increased support for energy efficiency; increased advice to businesses and individuals; and improved financial advice to vulnerable individuals. The package will bring a very small stimulus to aggregate demand in 2009 and 2010 as some expenditures are brought forward but the overall macro effect will be negligible. Nevertheless, taken together with the UK government fiscal stimulus and the significant monetary easing introduced by the MPC the package is valuable. The information and advice elements of the package may offer some market adjustment assistance and some mitigation of recession effects.

There are other possibilities and imperatives for the Scottish government in seeking to counteract the recession. The Scottish construction industry was first into recession and as noted above has been languishing for

some time. The government needs to consider not just how much public investment can be brought forward within the budget. The government has been criticised by opposition parties for the delays to public investment allegedly caused by the development and introduction of the Scottish Futures Trust to replace Public Private Partnerships (PPPs). But in current recessionary circumstances PPPs will find it difficult to proceed given the difficulties of raising private finance. In such conditions there may be a case for bringing forward conventional procurement projects and temporarily delaying any planned PPPs, although conventional procurement raises its own financing issues.

Further support for the construction industry might be possible if the government was willing to consider making advance payments to contracted companies that may be experiencing financial constraints, such as those undertaking government construction work.

Other actions to ease credit difficulties that the Scottish government could consider include, directly encouraging banks in Scotland to lend. The Scottish government will be a very large customer of the banks. It could seek to make its banking contracts conditional on a more pro-active stance on lending by the banks in Scotland. It could further ensure that the rule of ten-day payments of invoices to suppliers was adhered to in order to assist small firms.

Finally, perhaps more could be done to assist the labour market to more flexibly adjust to the recession by: encouraging the further and higher education sector to provide short-term but intense training courses for those coming on to unemployment register; and assisting redundant workers in starting their own firms (see below).

Dealing with the consequences of recession

The policy objective here should be to try and ensure that the recession does not damage the long-term trend of Scottish growth. Further, there is the question whether the recession might provide an opportunity to raise the trend in Scottish GDP growth? We plan to deal with the question what post-recession Scottish economy might look like and related policy issues in a later edition of the Commentary. We confine ourselves to a few observations here.

The government should through Scottish Enterprise and related agencies seek to minimise the impact of the recession on the Scottish growth trend. Existing investment funds such as the *Seed Fund*, *Co-investment Fund* and *Venture Fund* should be examined to see if they can play a role in overcoming key firms' cash flow and liquidity problems due to credit constraints associated with the current recession. A debate should be encouraged on how Scottish Development International might deal with the expected decline in inward investment through the recession e.g. Increased marketing? Increased corporate targeting? Greater flexibility in provision of Regional Selective Assistance?

It might seem fanciful but the recession could offer possibilities for raising the trend rate of growth of the Scottish economy. We know R&D and innovation are critical to growth but there is also evidence that companies that raised their R&D spend during a recession improved their subsequent competitive position. A US study of a large sample of firms over 20 years, which included the 1990-91 recession, found that many industry leaders at end of period were those increasing their R&D during recession.⁸ There is clear need for the government and its agencies to publicise this message and examine what public policy in Scotland can do encourage R&D at a time when many firms will be under pressure to cut back on R&D outlays.

Research also suggests that in a recession many unemployed workers will wish to start their own firms. The Enterprise Allowance scheme in the 1980s was introduced to help workers made redundant in the early 1980s recession start their own firms. This was superseded by a shift away from start-up support as an unemployment measure. But there may now be a case for policymakers in Scotland to examine the possibility of using existing business birth rate support policies to target the newly redundant who may be encouraged to start their own firm.

Forecasts

Since we last reported in October there has been a considerable deterioration in the actual and forecast performance of all the major economies. In October we considered there was a 'high probability' that Scotland would go into recession in 2009. Now, we are certain that not only is Scotland currently in recession but that the recession looks likely to be as severe as that in the 1980s and could even be worse. The tentacles of recession are spreading throughout the economy with construction and financial service activity subject to sustained contraction, hotels & catering turning down from the first quarter of last year and real estate & business services contracting appreciably after March. Economy-wide GVA contracted by -0.8% in the third quarter and seems likely to have fallen markedly in the fourth quarter if the UK's performance is any guide. Third-quarter manufactured exports decreased by 1% in real terms and by 0.4% over the year. Business surveys covering the fourth quarter period reinforce the expectation that the slowdown will be severe.

In the Scottish labour market net job creation is falling and unemployment is rising – see *Labour Market Issues* section of this Commentary. In the final three months of 2008, employment fell by 0.2% to 2.53 million, while unemployment, on the preferred ILO measure rose by 9.2% to 137,000. The rate of increase in unemployment was faster than in the UK but at 5.1% of the labour force the level of unemployment remains below the UK rate of 6.3%.

Table 1: Forecast Scottish GVA growth in three scenarios, 2008-2012

GVA Growth (% per annum)	2008	2009	2010	2011	2012
Optimistic	0.65	-1.90	-0.43	1.08	1.73
Central	0.59	-2.57	-1.21	0.52	1.14
Worse	0.51	-3.07	-1.65	-0.13	0.55

Table 2: Forecast Scottish net jobs growth in three scenarios, 2008-2012

Net job no's	2008	2009	2010	2011	2012
Optimistic	-14,200	-73,007	-42,400	7,923	25,089
Central	-14,200	-94,179	-51,440	3,037	14,476
Worse	-14,200	-108,984	-63,064	-6,639	10,734

Table 3: Forecast Scottish ILO unemployment in three scenarios, 2008-2

ILO 16+ no's and rate%	2008	2009	2010	2011	2012
Optimistic	137.2	173.3	194.5	191.0	176.3
	5.1	6.5	7.3	7.2	6.6
Central	137.2	184.4	209.9	207.4	199.9
	5.1	6.9	7.9	7.8	7.5
Worse	137.2	191.6	223.1	226.1	220.4
	5.1	7.2	8.4	8.5	8.3

Against this background we have prepared new forecasts that significantly revise downwards our expectation for Scottish growth over the next three years. Again because of the heightened levels of uncertainty we present a range of forecasts. On this occasion, a central forecast, which is bracketed by 'optimistic' and 'worst' projections. These forecasts and the underlying scenarios are discussed in detail in the Commentary section: *Forecasts of the Scottish Economy*.

GVA

On our central case we predict that GVA will fall by around -2.6% this year and by -1.2% next year – see Table 1. Recovery does not begin to get underway until 2011 and remains below trend in 2012. On the worst case the global

recession and financial sclerosis continues well in to 2011 and while there may be some recovery in the latter part of 2011 growth remains weak and significantly below trend in 2012. Only in the optimistic case does recession effectively end next year but with a weak then strengthening recovery in 2011 and 2012.

In our central case projection, we now take the position that Scottish economy will perform a little stronger than expected UK growth. We take this view because the impacts of the systemic drop in global aggregate demand resulting from falling asset prices and financial sclerosis will be sufficient to outweigh specific sectoral outcomes such as the contraction of financial service and banking activities. Experience shows that the Scottish economy is

more robust than the UK to a sharp contraction in aggregate demand as we noted in the previous Commentary. In the circumstance of the causes of the present recession the factors of relevance include: the somewhat bigger public sector and higher degree of social security payments in Scotland, while lower asset ownership e.g. houses and shares, means less exposure to asset price bubbles and bursts. On the other hand, Scotland's relatively higher export propensity may make Scotland a little more vulnerable to a drop in global demand. But overall, we now consider that the circumstances of the recession make it more likely than we previously thought that the Scottish economy will hold up relatively better than the UK. On our worst-case scenario this may not be the case.

Employment

Table 2 outlines our net job change projections on the three cases. In the *central forecast* employment is forecast to decline by 14,200 in 2008, by 94,200 in 2009 and by 51,400 in 2010, a total net job loss of nearly 160,000 over the three years. This is bracketed by an anticipated net job loss of nearly 130,000 in the *optimistic case* and by 186,000 in the worst case. To the *worst case* must be added a further 6,600 net job loss as the contraction in the labour market runs into 2011.

It is worth pointing out, as the *Labour Market Issues* section of this Commentary indicates, that it remains unclear how the more flexible and deregulated labour market that has emerged over the past 25 years will impact on the level of jobs and the level of unemployment during the current recession. We note that there are strong signs that the downturn may affect more adversely those employed on more flexible employment terms, with companies and co-operating unions making much effort to retain key skills and expertise.

Unemployment

Table 3 presents a summary of our ILO unemployment forecasts under the three scenarios. With such significant job losses forecast then it is inevitable that forecast unemployment will rise appreciably. But the effect of job losses will not wholly be registered by a growth in measured unemployment. Some unemployed workers will leave the labour market either by ceasing to offer themselves for work, a drop in the activity rate, or by leaving the economy all together, migration. Our forecasts of unemployment reflect an average pass through from job loss to the measured increase in unemployment of around fifty per cent on average in any one year. On this basis unemployment in the *central case* rises from 137,000 in 2008 to a peak of around 210,000 in 2010. On the *worst case*, unemployment peaks at 226,000 in 2011 and 195,000 in 2010 in the *optimistic case*. When expressed in rate terms these forecasts suggest that unemployment will rise to a 7.3% average in 2010 on the *optimistic case*, 7.9% in 2010 on the central case and 8.4% in 2010 and 8.5% in 2011 on the *worst-case* scenario. It is worth stressing that

unemployment is a lagging indicator of economic performance and continues to rise for some months, even quarters, after output has begun to recover.

Brian Ashcroft
23 February 2009

Endnotes

¹ Martin Wolf, Japanese lessons for a world of balance-sheet deflation, Financial Times, 18 February 2009.

² Richard Koo, The Holy Grail of Macroeconomics, John Wiley, 2008.

³ Such points have been consistently stressed by Martin Wolf in several of his FT articles and reflect the excellent analysis of global financial imbalance in his recent book Fixing Global Finance.

⁴ M Wolf (2008) Fixing Global Finance

⁵ HM Treasury (2009) Forecasts for the UK economy: A comparison of independent forecasts February

⁶ The so-called 'Ricardian equivalence' argument.

⁷ Zero will be regarded as the interest rate floor, although it need not be so if the authorities are prepared to effect negative interest rates by offering subsidies to borrowers and taxing lenders. This would of course be completely uncharted waters for the monetary authorities and the money supply implications would be unclear.

¹¹ Richard N. Foster (2003) "Corporate Performance and Technological Change Through Investors' Eyes", Research-Technology Management, Volume 46, Number 6, 1 November pp. 36-43(8)

Figure 1: Scottish and UK Quarterly GDP Growth, 1998q2 to 2008q3

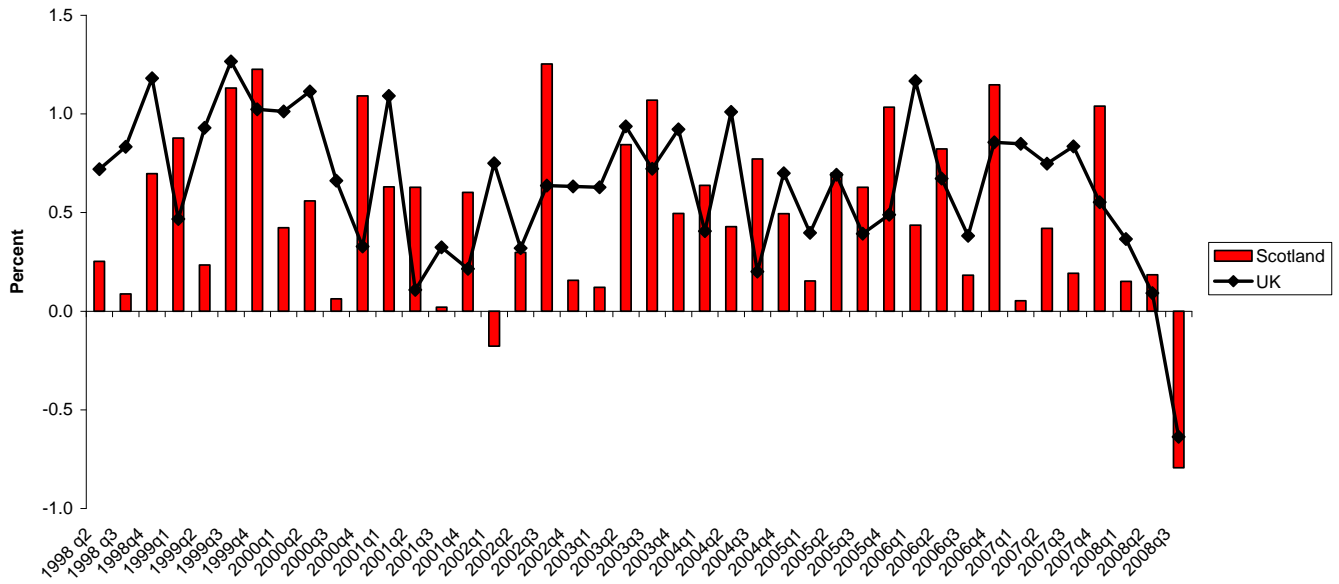


Figure 2: Scottish and UK Services GVA Growth at constant basic prices 1998q2 to 2008q3

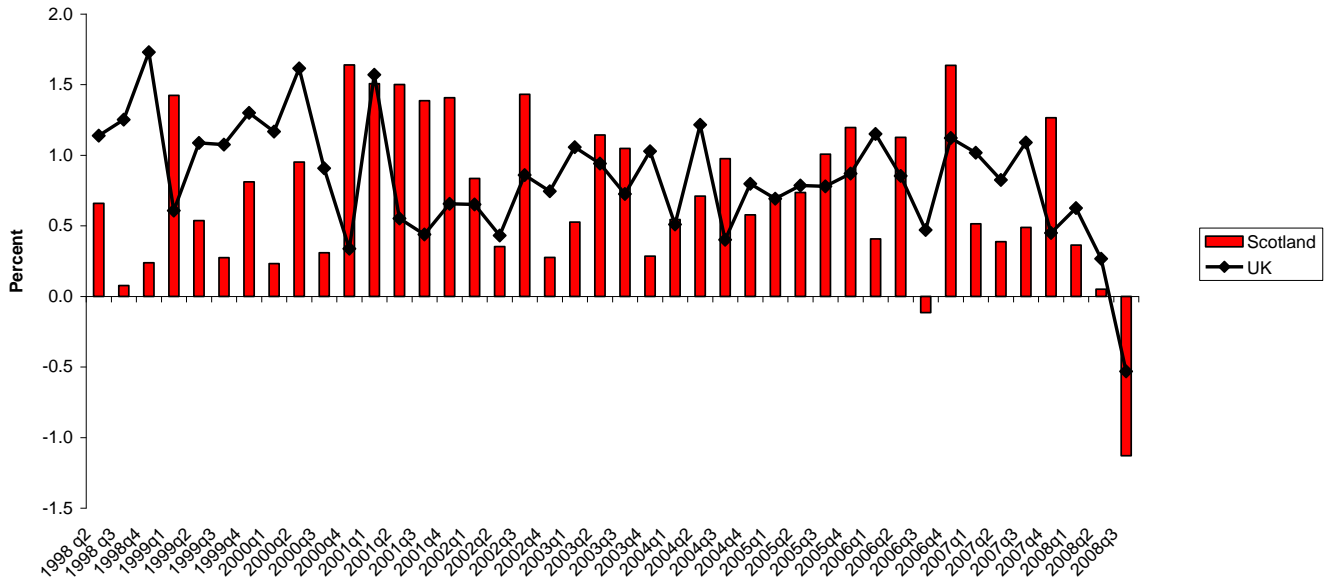


Figure 3: Scottish and UK Manufacturing GVA Growth at constant basic prices 1998q2 to 2008q3

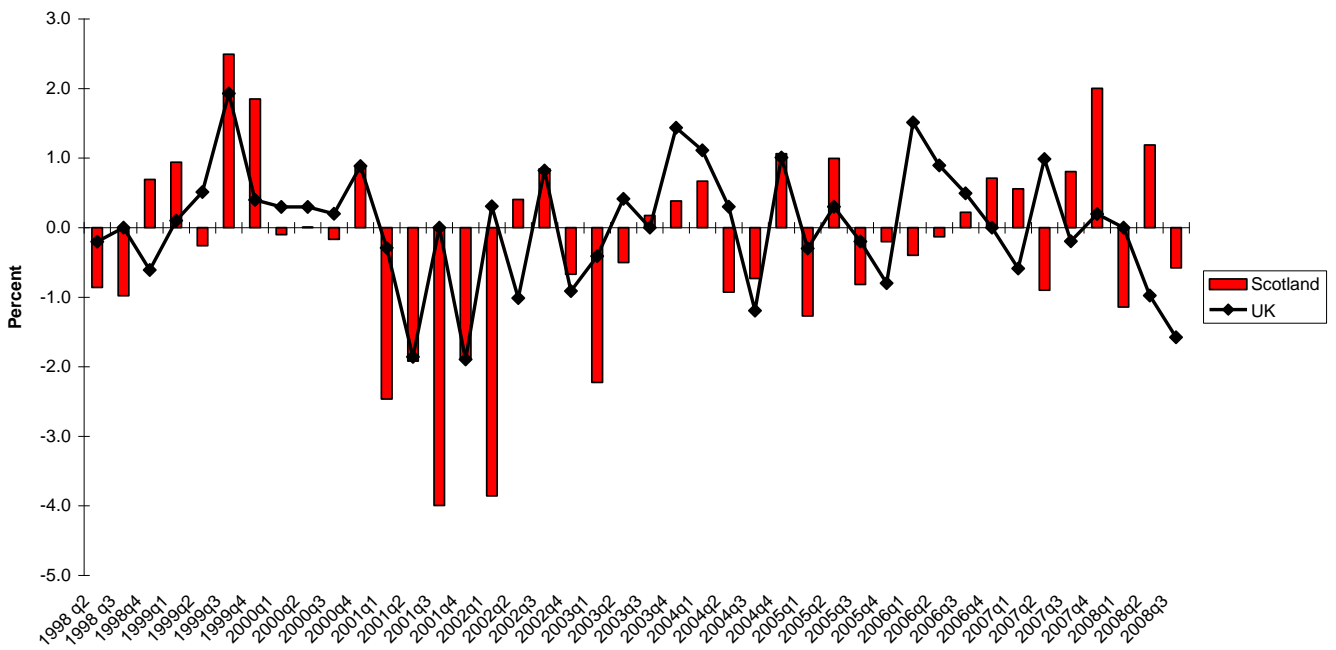


Figure 4: Scottish and UK Construction GVA Volume Growth 1998q2 - 2008q3

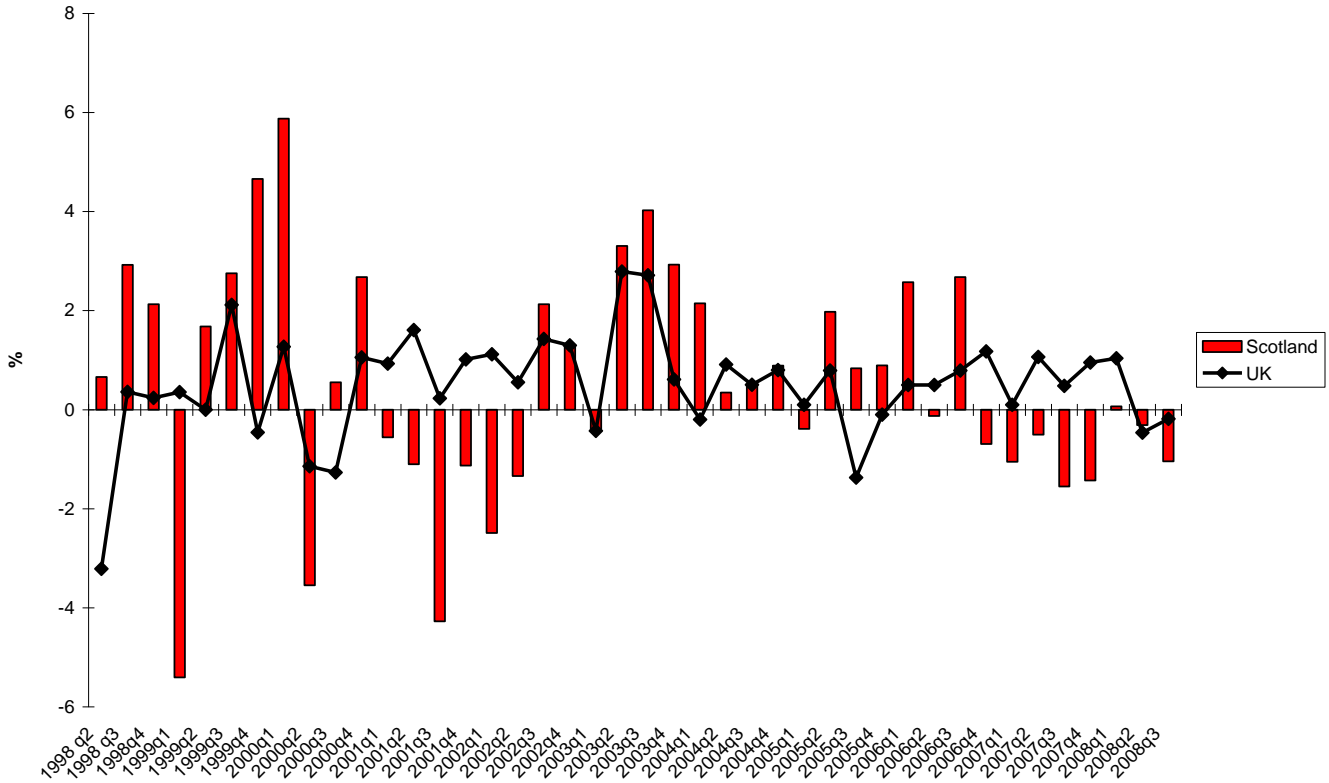


Figure 5: Scottish and UK Financial Services GVA Growth at constant basic prices 1998q2 to 2008q3

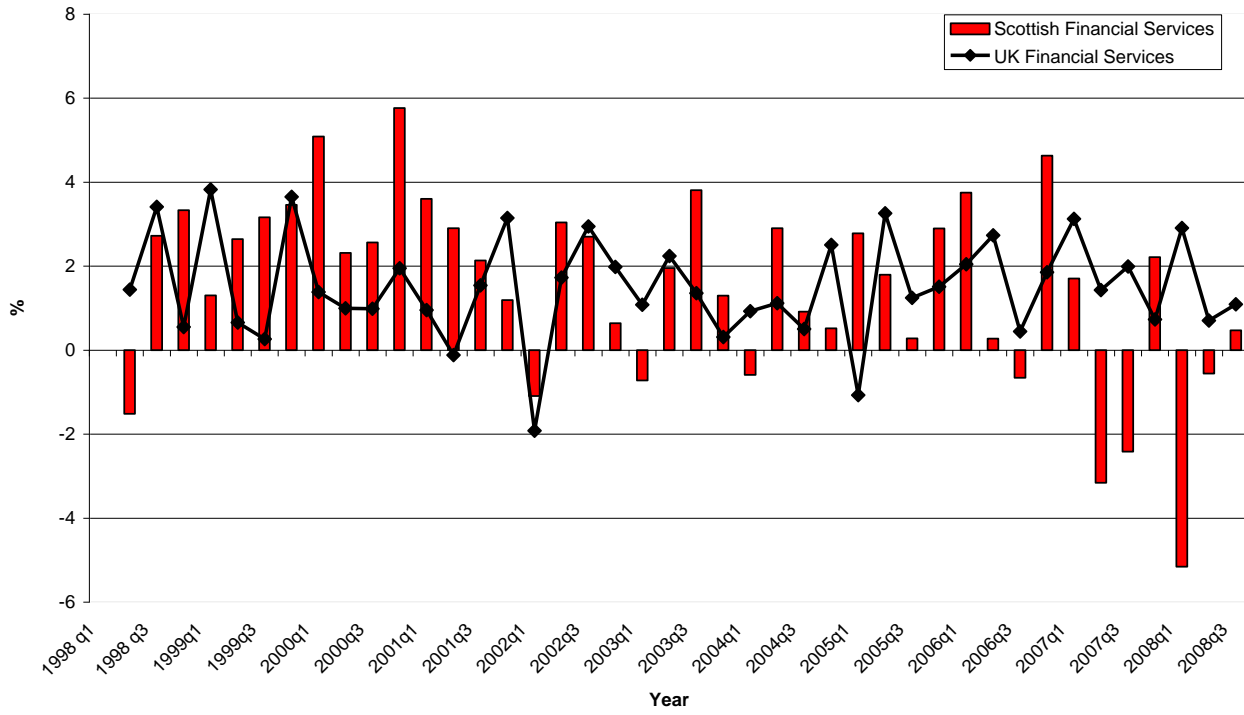


Figure 6: Growth of key sectors in Scotland 1998q2 to 2008q3

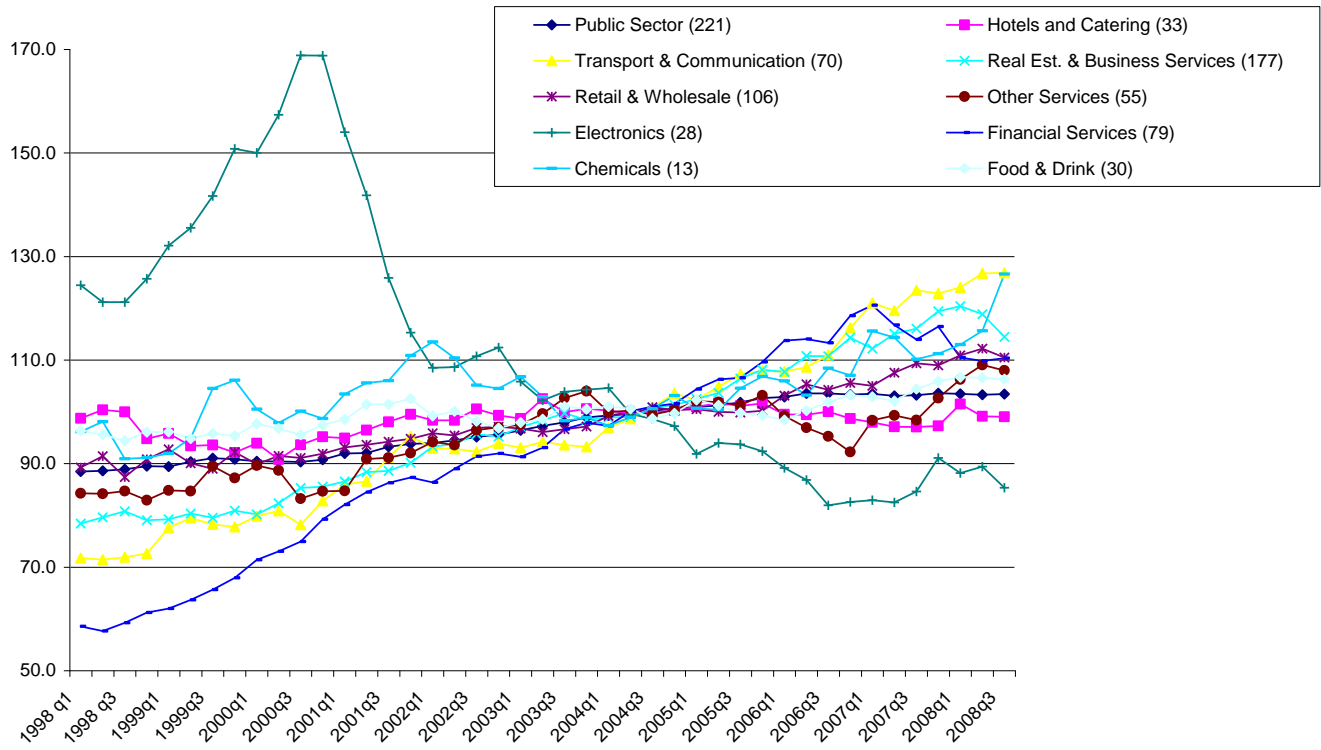


Figure 7: GVA percentage contraction to 2008q3 from latest peak by sector

