The Scottish economy

Forecasts of the Scottish economy

Economic background

The global economy is experiencing a significant contraction due to the spreading effects of the sub-prime and financial crisis. This has greater effects in the main developed economies (US, UK, France, Germany and Japan) but the repercussions affect countries such as Russia, China and India, where a sharp downturn in global growth adversely impacts on their growth. Trade is down and both the IMF and the OECD have recently revised down their expectations for growth and trade. With global growth predicted to be only 0.5 per cent this year, the world is facing perhaps its deepest recession yet, although it is too early to call it a depression. Indeed the early co-ordinated response of the main economies to deal effectively with the situation will probably avoid a 1930s style depression. This does not mean however that there will be a quick recovery – it is more likely that the recession will be deeper and longer than any previous recession, certainly since the end of World War II.

The UK economy is not immune from this, and contracted by 1.5 per cent in the fourth quarter of 2008. The common expectation is that the first quarter of 2009 will also produce very weak data and that the economy will continue to shrink through 2009. Many forecasters expect the UK economy to contract by about 2.7 to 3.1 per cent this year. The UK recession is broad based affecting: banking, services manufacturing and construction. The Bank of England has lowered interest rates to 1 per cent – its lowest level ever since 1694 (the year of its founding) and is offering a number of other measures to support the economy: the Special Liquidity Scheme and it intends to operate 'Quantitative Easing' – a method of extending the money supply without printing extra money. This will involve swapping government gilts for corporate bonds – a key objective of this is to reduce the interbank lending rate (Libor) so that lending between banks becomes easier. In the UK CPI inflation is expected to be close to 1 per cent although in the second half of 2009 deflation cannot be discounted. Public sector borrowing was set to be £78 billion but this may grow to £87.5 billion by the end of the year as the government continues to support the economy. This weakens sterling considerably particularly against the Euro. In Oct-Dec 2008 UK unemployment hit an 11-year high at 1.97 million. It is unlikely that the UK will experience a V-shaped recovery and that 2010 will also be a very tough year. It is more probable that the UK will experience a longer recession with a slower recovery from the end of 2010 onwards.

The Scottish economy

Scottish GVA growth in 2008Q3 was -0.8 per cent leaving growth for the last four quarters on the preceding four quarters at 1.4 per cent. These data however are likely to be supplemented by very weak growth in 2008Q4 leaving growth for 2008 in the 0.5 to 0.7 per cent range. Exports are also likely to be poor. Manufacturing and services growth for 2008 are likely to be close to 1 per cent for the year based on the 2008Q3 data and assuming weaker data for 2008Q4 they may perform more poorly. Construction will probably contract by approximately 2.7 to 3 per cent in 2008. Most service sectors had negative growth in 2008Q3 and the expectation is for more of the same in 2008Q4.

The employment rate in Scotland fell by 1.1 per cent on a year ago to 75.4 per cent for the three months to December 2008. Unemployment rose to 137,000 (5.1 per cent), up 0.3 per cent on the year. The claimant count measure of unemployment was 101,100 (3.7 per cent) in January 2009, up by 1.2 per cent annually. So as there is weakening growth in the economy, falling exports and a deteriorating labour market: it is clear that Scotland is in recession. The forecasts for the Scottish economy are made in the context of this worsening economic situation.

Final demand

The drivers of the economy are consumption; government spending; investment; tourism and exports (to the rest of the UK and to the rest of the world). For all three scenarios the main effects from the current economic climate are:

- Investment declines sharply in 2009 and recovers slowly thereafter – in the central scenario this decline is slightly steeper and longer whereas in the last case the contraction is severe and growth is not seen until 2012;

- Traditionally Scottish consumption holds up relatively well in a UK downturn – in this recession Scottish consumption indicators point to a significant fall in 2009 with mild recovery following. In the worse case scenario the decline is slightly sharper but more importantly it lasts considerably longer and it is 2012 before consumption returns to about 1 per cent growth;

- Government consumption is held to be constant with a fixed budget to the Scottish Parliament. The UK government spending in Scotland will be substantial with increased benefit flows; a share of the fiscal stimulus (perhaps adding between 0.25 to 0.3 per cent to GVA in 2009 and 2010) and rescue packages for RBS and Lloyds Banking Group (for HBOS);

- Tourism is expected to perform poorly in terms of increased GVA – volumes might rise slightly but the assessment is that revenues from tourist expenditure will fall. Across the three scenarios this is reflected as a small negative effect except the last one where it is a large negative impact over two years and

- Exports fall considerably, particularly to the UK as its economy shrinks. The expectation is that in the optimistic scenario recovery of all exports will take place in 2011; in the central scenario exports to the rest of the world are better than that to the rest of the UK and in the last case that recovery is weak in 2011 and does not really impact until 2012.

Background to the forecast

The previous forecast was scenario based with a number of factors that potentially impact on economic performance. It was clear that if the banks returned to the government for more money for re-capitalisation then the worst case situation from the previous forecast would apply. That occurred in February and it also fits with poor bank lending conditions. On the up-side monetary policy has been quick to respond and is supportive as is fiscal policy. The Scottish labour market remains more buoyant than its UK counterpart but the rate of job shedding is accelerating. This may indicate that Scotland is simply catching up with the rest of the UK. Traditionally however, the Scottish economy does relatively better than the rest of the UK in a downturn but this particular recession appears to be much tougher and deeper than expected. It is the speed and the depth of the contraction that has taken most people by surprise. This is why most forecasters have shifted their expectations down considerably. The outcome of this may be that Scotland does not outperform the UK economy but different paths are possible thus a scenario forecast is the best tool to use in the current economic situation. The forecast is presented in three scenarios to reflect the very different paths that the economy could take, given particular events occurring. These scenarios are:

- Optimistic;
- Central and
- Worst.

The factors that support these scenarios are described briefly in each section. The scenarios are determined by the same variables used in the last forecast. As they were discussed in significant depth in the last FEC the factors are more succinctly presented here.

The forecast

The optimistic scenario

This is the most probable result if the following outcomes actually prevail. The main influences under this scenario are:

- The labour market in Scotland remains relatively buoyant and outperforms that of the UK with the employment rate being higher and the unemployment rate being lower than their UK counterparts;

- Businesses can secure funding from banks and other financial institutions relatively more easily as bank lending improves significantly resulting in a smooth flow of funds in the Scottish economy;

- Confidence holds up more in Scotland as spending in retail; investment and exports hold up. Manufacturing makes a significant contribution to the economy;

- External demand is a key factor here and supports export growth while tourism is not severely affected and

- House prices are not depressed for too long and the expectation is for recovery to start by mid-2010 but definitely by 2011.

Critically appraising the above, it is clear that at the beginning of 2009, there are not many signs of lending becoming more efficient and similarly confidence is very weak at the moment. There are few indications of a quick recovery although in places the rate of decline in house prices has slowed significantly, and some companies are announcing jobs growth. The upside includes the labour market is in a relatively good state (compared to the UK) while monetary and fiscal policy remain supportive of economic recovery. These initial observations perhaps make it less likely that this outcome will prevail compared to the central forecast.

The central forecast

In this scenario the main drivers are:

- A further tranche of money has gone to re-capitalise the banks but lending behaviour remains sticky;

- Confidence is very low and firms face considerable constraints while trying to continue trading;

- External demand is also weak thus exports perform weakly and tourism revenues fall. The weakness of sterling cannot offset the poorer external demand;

- The labour market is hit by a series of job losses but a significant number of workers remain in employment and this supports basic consumption;

- The impact on the financial sector is quite sharp in 2009 and 2010 and is felt across the rest of the economy and

- House prices in Scotland are not as weak as that elsewhere in the UK and there are some early signs of some housing market segments showing growth as interest rates fall – this is the discerning and opportunistic buyer effects.

This scenario is perhaps closest to what is happening at the moment but of course there are many other variables that could change the course of the economy. This is why the worst case scenario is considered below.

The worst case scenario

This scenario is presented because the impact of the financial crisis, and a sharp drop in the labour market, are important drivers. This early and sharp collapse of activity has repercussions for the path of recovery, as it tends to have a deeper recession with a slower recovery. The main factors here include:

- The impact of the finance sector across the whole economy is severe and job losses in the economy come earlier in 2009 thus the support from the labour market weakens significantly;

- Confidence collapses early in 2009 and it is very difficult to stimulate the economy;

- External demand is very weak up to the end of 2010 and perhaps into 2011;

- Investment contracts substantially and there is little expectation of growth here until 2012 and

- House prices in Scotland remain depressed for a longer period of time and as a result private housing investment continues to shrink until 2012.

The outcome here is very disappointing and if this scenario were to come about there would be little growth in the economy until 2012 – a much longer and deeper recession than previously expected would take place.

GVA

The forecast for Scottish GVA is negative for 2009 and 2010 in all the scenarios. Table 1 presents the forecasts for each of the scenarios for the years 2008 to 2010. Data for growth per annum is also given for the period 2005-07 and for 2009-12, which demonstrates the marked difference between the two periods as the economy experiences a recession. Figure 1 plots the probable paths of GVA over the period 2008 to 2012 for the three scenarios. Figure 1 demonstrates that in the worst case that the recession could last until 2011 with only weak growth thereafter. In the best possible outcome the recession lasts until 2010 and growth of 1 per cent is achieved in 2011 and by 2012 growth is approaching 2 per cent.

Table 1: Forecast GVA Growth in the three scenarios, 2008-2012

GVA Growth (%)	2008	2009	2010	2005-07[1]	2009-12[1]
Optimistic	0.65	-1.90	-0.43	2.32	0.79
Central	0.59	-2.57	-1.21	2.32	0.15
Worse	0.51	-3.07	-1.65	2.32	-0.45

Source: Fraser of Allander Institute, February 2009
Note: [1]This is per cent per annum

Table 2: Main forecasts of the Scottish economy (central scenario), 2008-2012

	2008	**2009**	**2010**	**2010-12**
GVA	0.59	-2.57	-1.21	0.15
Agriculture	0.60	-2.85	-1.10	-0.14
Manufacturing	0.60	-2.28	-1.34	-0.11
Construction	-2.73	-3.01	-1.21	0.14
Services	0.98	-2.31	-1.30	0.17

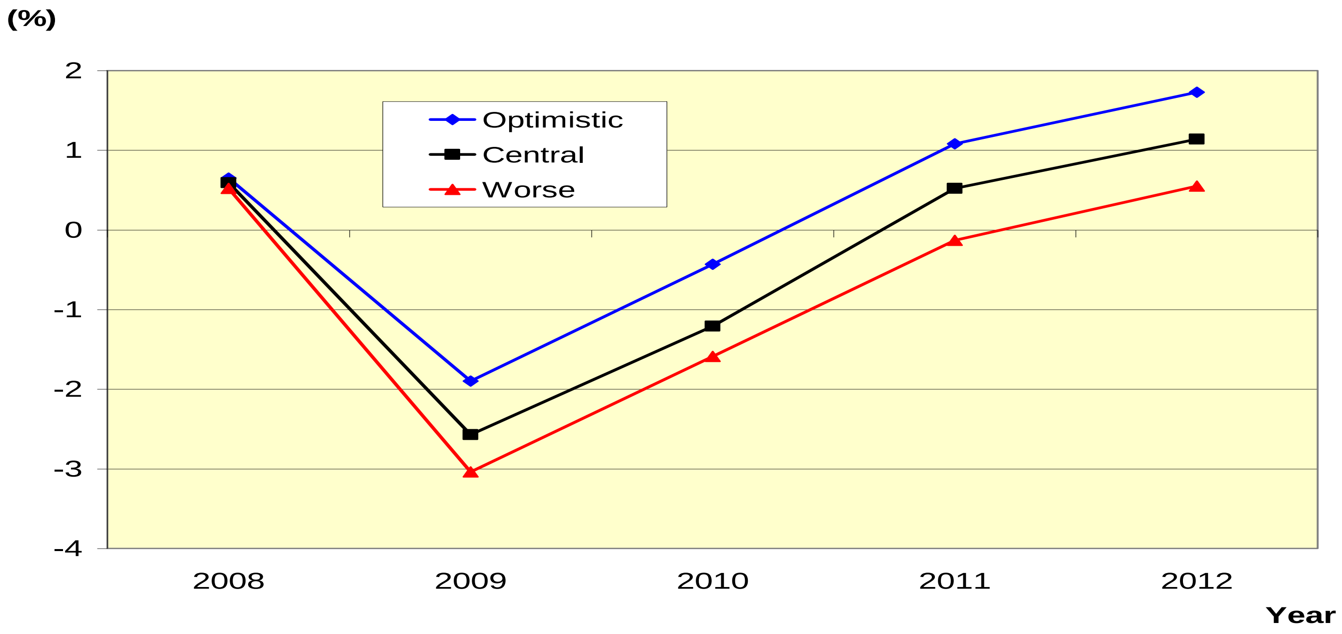
Source: Fraser of Allander Institute, February 2009
Note: [1]This is per cent per annum.

In the central forecast the recession lasts until 2010 and Table 2 presents forecasts for the sectors under this scenario. All sectors are forecast to have negative growth in 2009 and 2010 and to return to positive growth in 2011. In 2009 the forecast is for all sectors to contract by more than 2 per cent with construction declining by just over 3 per cent. In 2010 the picture is similar – most sectors shrink by just over 1 per cent. This reflects the broad base of the current recession. Previous recessions have left the service sector relatively unscathed, not so this time as the downturn affects the whole economy. Within services the expectations are for financial services, retail, tourism, business services and other private services to do worse while the public sector and transport, communication services do relatively better. The crucial importance of a strong public sector is clearly seen at this time when it will support employment and provide spending in areas where private consumption and investment are severely curtailed.

Figures 2a to 2c demonstrate the impacts on the construction, manufacturing and service sectors for each of the scenarios. For each broad sector the pattern of the scenarios is the same, all show longer recovery as the scenarios worsen. Previously in the Scottish economy key sectors including manufacturing, electronics, financial services or REBS have driven growth in the economy. It is likely in the near to medium future that this will not be the case. Growth will be more broadly balanced and the influence that ‘key’ sectors may have, will not be as strong as in previous years. Manufacturing is hit by both the severe slowing in domestic demand and the deterioration in external demand. Key exports like food, whisky, paper, electronics etc. have all seen activity and orders drop sharply. The construction sector has suffered and continues to experience a considerable downturn due to the lack of private residential demand as house prices have collapsed and the bulk of that market remains stagnant. Public sector investment continues to provide some stimulus to the economy but the current tranche of PPP schools, hospitals etc. are coming to an end. The new funding arrangements for major public works are not in place yet and projects of this nature take a long time in the planning stage.

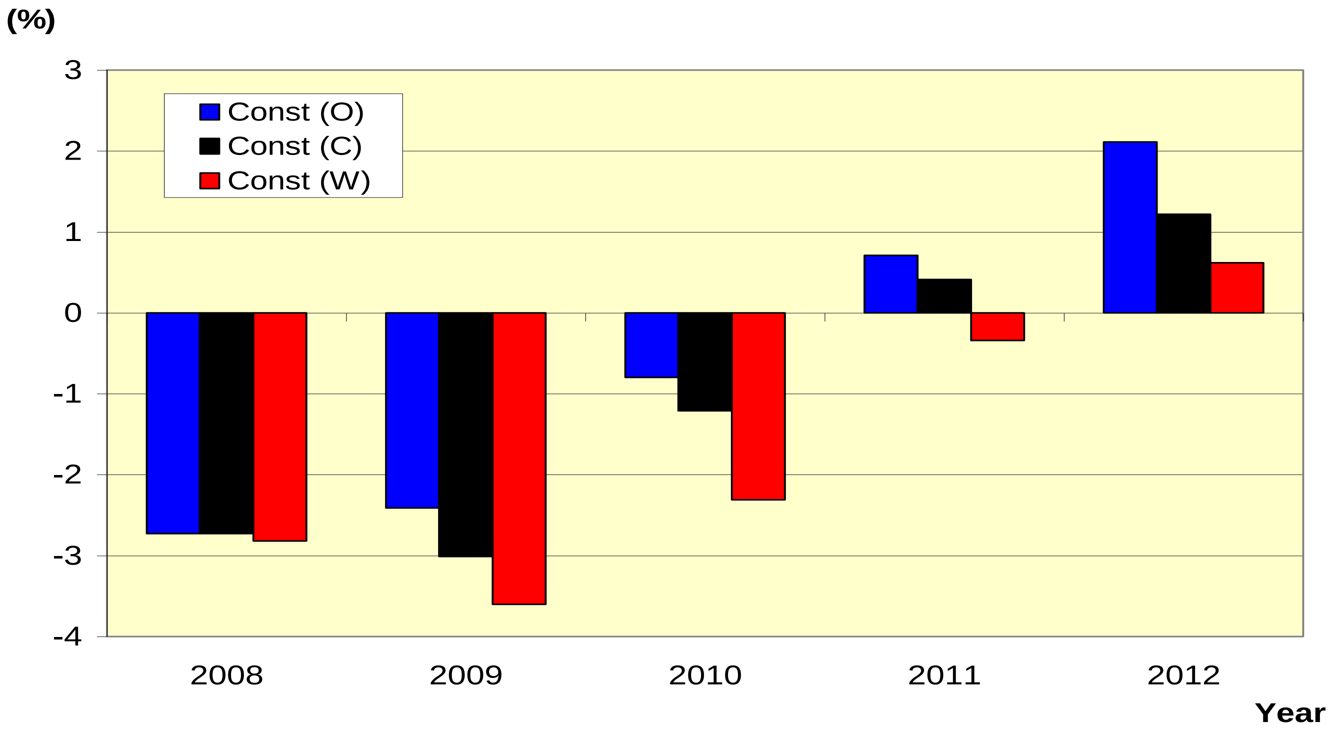
Services are badly hit because of the sharp downturn in economic activity in the economy. Retail sales data is confounding as it shows the sector holding up to a degree but in truth is due to heavy discounting. Large expenditures are not being made as people see the drop in interest rates as a continued run so in part it is having the opposite effect. People believe rates will fall further thus hold off spending. Similarly companies postpone investment. These actions simply exacerbate the situation where minimal spending takes place. Tourism is weak as incomes and demand in foreign countries decline. Visitor spend is down as is business conferencing. Other private services, services related to housing are all down. Business services are likewise adversely affected. Without doubt however the most significant impact is on the financial sector in Scotland. The losses posted by RBS and HBOS are massive and it is difficult to see these banks returning to the large profits and aggressive acquisitions strategy that previously existed. This does not mean that these two major banks will revert to simply retail banking. They will maintain a large degree of specialist services and where

Figure 1 Forecast GVA growth for all three scenarios, 2008-2012



Source: Fraser of Allander Institute, February 2009

Figure 2a: Forecast construction GVA growth, three scenarios, 2008-2012



Source: Fraser of Allander Institute, February 2009 profitable, retain some of their overseas operations. Investment banking and dealing in derivatives and securities may continue but there will be more stringent limits and supervision put in place both nationally and hopefully internationally, to ensure the risks of such a catastrophe taking place again are minimised. A mark of the international banking crisis is the extent to which most governments have taken substantial ownership of banks and nationalisation is widely accepted as necessary. As it is, this is what has happened and the interesting question is 'how does the economy move forward so that this is not repeated and a situation of sustainable growth is achieved?'

In going forward there are two key factors to consider:

- The strength of external demand – if this picks up then it will feed into exports and help manufacturing significantly. Tourism would also benefit if as predicted sterling remains weak. This would help stimulate retail and hotels & catering as well as other private services and

- The speed and number of jobs lost in the beginning of 2009 is absolutely crucial. As time goes on the more people who remain in employment means that incomes are supported, as is consumption. Large numbers of people being ejected from the labour market will lead to a double whammy of a bigger strain on public finances (less taxes and more benefit spending) as well as the reduction on income thus weakening consumption and investment. On a large scale these have significant impacts on the economy going forward and have potentially very serious effects on the economy.

Overall, the forecast for the Scottish economy is cautious but realistic. There is no clear way forward that indicates that the economy will go in a particular direction or grow at a particular rate. Each of the scenarios indicates a probable path that the economy could take. The central forecast is the most likely of them all. The downside risks would lead to the worse case scenario while it is unlikely that the Scottish economy can achieve the most optimistic case. If external demand remains very weak for a prolonged period and labour shedding is quick and jobs growth is sluggish for a couple of years then the worst case scenario could become reality.

Employment

Our forecasts of employment (for the central scenario) are presented in Table 3 with the net employment change figure in brackets. The employment figures are calibrated on the latest Employers' Quarterly Survey Series as given in Table 6.06 in Economic and Labour Market Review, National Statistics.

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. If this were to happen the economy would be facing one of the most serious job loss periods it has experienced. The forecast job loss for the period 2009-12 in this scenario is 128,100 compared to 82,400 in the optimistic scenario. If the economy has a deep and prolonged recession (the worst case) then job loss over 2009-12 is forecast to be 168,000. It appears that it will be impractical for the economy to shed this quantity of jobs without impacting adversely on unemployment (the forecasts of unemployment are presented in Table 4).

In all the scenarios the service sector sheds a significant amount of jobs. The forecast is for services to lose 74,400 in 2009 and a further 39,600 in 2010. This represents 78.9 per cent of all job losses in 2009 and the comparative figure for 2010 is 77 per cent. The most significant jobs loss comes in services comes from the financial services sector. The assumption of the central forecast is that there is a significant jobs loss in both 2009 and 2010 from financial services. This could total 24,700 in 2009 and 18,900 in 2010. This is because the sector will have some immediate costs to cut and these come mostly in 2009. As banks consolidate and review their activities then efficiency savings will bite in 2010 as cost-cutting continues. REBS also faces a major shakeout in 2009 with the forecast loss of 28,700 jobs. In the worst case scenario the jobs loss is considerable in both years, with a shedding of 25,200 and 22,400 in 2010 for financial services. Elsewhere in this service sector the jobs loss is weighted towards 2009 and REBS is forecast to lose 33,000 jobs but only 11,200 in the year 2010. Similarly, retail is forecast to lose 16,300 jobs in 2009 but less in 2010; 10,900.

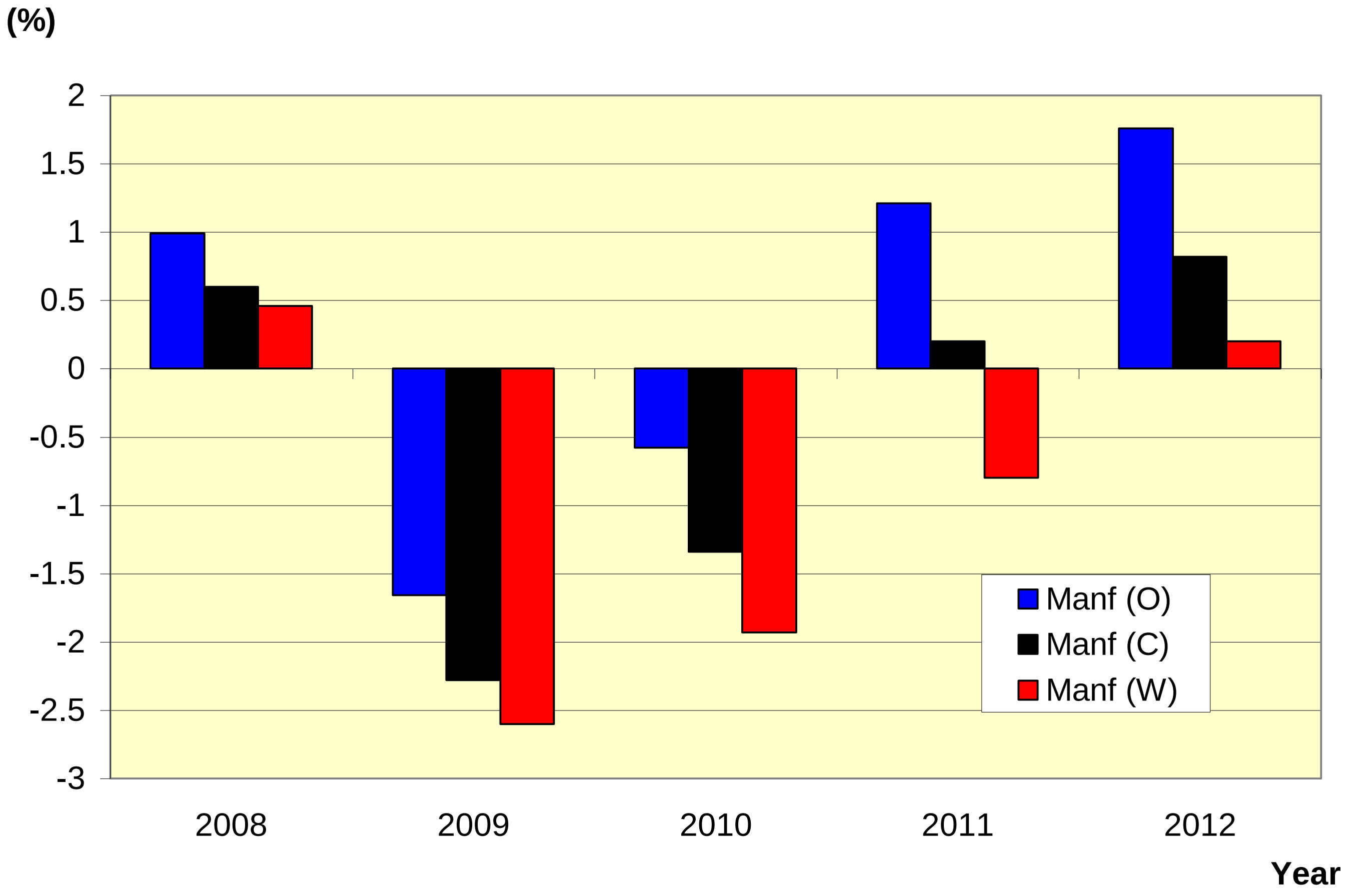
The construction sector is forecast to lose 8,000 jobs in 2009 under the central forecast but this could be as high as 8,800 in the worst case scenario. Under this scenario it loses 4,300 jobs in 2010 compared to 2,900 in the central case.

Manufacturing job losses are spread across the sector relatively evenly. The exceptions to this are: ORNF, chemicals and transport equipment. The former two shed only a small number of jobs while transport equipment is buoyed by positive job growth of 1,600 in 2009 due to shipbuilding orders for naval vessels on the Clyde and at Rosyth. Over the forecast period manufacturing is forecast to shed 14,400 jobs in the central scenario but this could be as high as 20,100 if the worst case prevails. The other sectors, especially those with export markets, tend to have much higher job losses forecast as activity reduces sharply. It is unlikely that firms will hoard labour for a longer time and this is a key danger as skills will be lost as jobs are shed swelling the ranks of the unemployed.

Unemployment

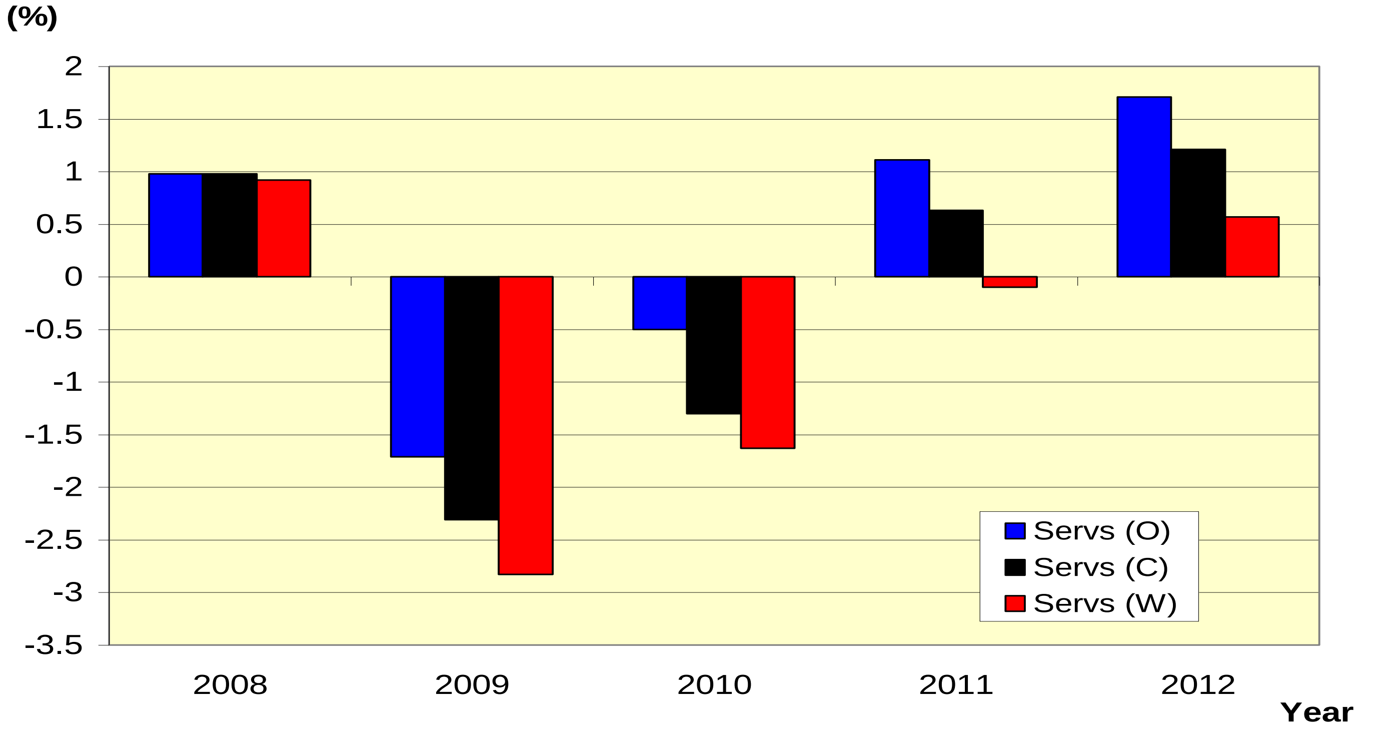
We present our forecasts of unemployment in Table 4. Both the ILO measure and claimant count measure are

Figure 2b: Forecast manufacturing GVA growth, three scenarios, 2008-2012



Source: Fraser of Allander Institute, February 2009

Figure 2c: Forecast services GVA growth, three scenarios, 2008-2012



Source: Fraser of Allander Institute, February 2009

Table 3: Forecasts of Scottish employment (000s) and net employment change, (central scenario) 2008-2012

	2008	2009	2010	2009-12
Total Employment	2,384.6	2,290.4	2,239.0	
	(-14,200)	(-94,200)	(-51,400)	(-128,100)
Agriculture	33.3	31.1	29.0	
	(4,000)	(-2,200)	(-2,100)	(-2,400)
Manufacturing	216.3	207.4	201.4	
	(-4,700)	(-8,900)	(-6,100)	(-14,400)
Construction	137.2	129.3	126.3	
	(-2,000)	(-8,000)	(-3,000)	(1,500)
Services	1,955.8	1,881.4	1,841.8	
	(-10,800)	(-83,500)	(-48,500)	(-100,900)

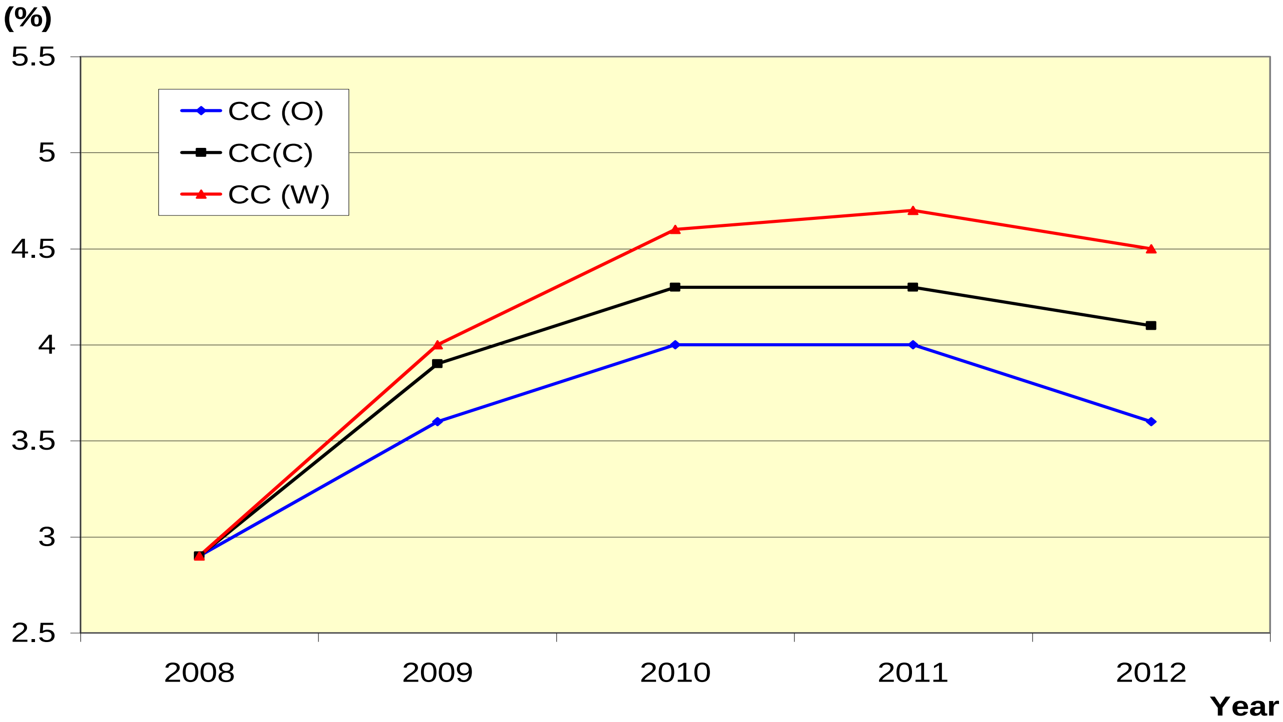
Source: Fraser of Allander Institute, February 2009

Table 4: Forecasts of Scottish Unemployment (Central Scenario), 2008-2010

	2008	2009	2010
ILO Unemployment	137,200	184,400	209,900
Rate	5.1%	6.9%	7.9%
Claimant Count	77,800	110,600	125,900
Rate	2.9%	3.9%	4.3%

Source: Fraser of Allander Institute, February 2009

Figure 3: Forecast claimant count unemployment, three scenarios, 2008-2012



Source: Fraser of Allander Institute, February 2009 given. The preferred measure of unemployment however is ILO unemployment as given by the LFS. Figure 3 illustrates the different outcomes for claimant count unemployment in the three scenarios.

The forecast for unemployment has changed somewhat over the most recent period. It had been the case that the Scottish labour market had been outperforming the UK labour market and still does in relative terms. This had led to an employment rate that was higher than that of the UK and unemployment that was at historically low levels. The forecast for the central scenario is that unemployment will rise from 5.1 per cent in 2008 to 7.9 per cent in 2010 before falling at a much slower rate to 7.5 in 2012. In the worst case scenario unemployment is forecast to peak at 8.5 per cent in 2011 indicating the different profile of unemployment in this situation. The claimant count forecast is for unemployment to peak at 125,900 (4.3 per cent) in 2009 whereas the forecast for the worst case scenario is that it is at its highest in 2011 at 135,700 (4.7 per cent). Claimant count unemployment currently stands at 77,800 (2.9 per cent) for 2008.

Figure 3 show the likely paths unemployment could take, where the first two scenarios plateau over 2010 to 2011. The change in the worst case scenario is that it continues to rise but does not have a flat portion. Using the claimant count measure more people will fall into inactivity and stop claiming benefits over protracted periods of time. Data from previous recessions indicate that in a severe recession (say that of the 1980s in Scotland) unemployment continues to rise after such a deep and long recession. So in the case of the worst scenario unemployment may continue to climb even after growth and jobs creation takes place. Deskilling, jobs mismatch and discouraged workers all add to this.

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20th February 2009