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There is a high probability that the Scottish economy will go into recession in 2009. Recession is the likely outcome of the global financial crisis, which was triggered by the collapse of the house price bubble, initially in the United States, massive foreclosures in the US sub-prime mortgage market, and significant bank and hedge fund losses across the globe as the value of innovative investments based on sub-prime mortgages collapsed. The uncertain solvency of many financial institutions has generated a loss of confidence and trust in the banking system of sufficient scale to produce what one distinguished analyst and commentator has called the “consequent disintegration of the credit mechanism.”

An examination of previous recessions supports the view that cyclical fluctuations of Scottish GDP have less amplitude than in the UK economy. What this means is that the business cycle has tended to be effectively flatter in Scotland and so both upswings and downswings are less severe here than in the UK. We consider that the scale of the downturn confronting us will probably be less severe than the 1980/81 recession, principally because in that recession, monetary and fiscal policy effectively accommodated, even exacerbated, the recession and was not used counter-cyclically to combat it. That will not happen on this occasion as the recent swingeing cuts in interest rates in the UK and the US, and the willingness to borrow more and run up higher levels of public debt, indicate. However, we are less sure that the Scottish economy will weather the coming downturn better than the UK.

The impact of the present crisis will depend on the scale of the deflation of house and property prices in the Scottish market, the extent of the impact on local financial service
activities, and the mechanism governing the spread to the wider Scottish economy.

On the housing and property market effects, we judge that the absolute and relative fall in house prices is likely to be less in Scotland than in the UK. For this reason, and given also that the Scottish home ownership rate at 66%, despite strong growth in the five years to 2006, continues to be lower than in the UK at 70%, we expect that the impact on the Scottish economy of the end of the house price boom will be less than in the UK. We take the view that the impact on banking and financial services will be bigger here than in the UK and that there may be a lingering negative effect in the long-term. This is because the scale of the losses on sub-prime and impairments facing the two principal Scottish banks, RBS and HBOS, are considerable and exceptional compared to other UK banks. The losses have pushed RBS and HBOS to the brink of bankruptcy. This outcome underlines the extent to which the lending behaviour of the two banks had ceased to be underpinned by the traditional risk management practices that had led Scottish banking/bankers to be perceived as prudent and even ‘canny’.

The effect on the wider Scottish economy of the financial crisis will be mediated through the following key transmission mechanisms: direct demand; intermediate input demand; domestic household demand; external household demand; credit supply; inward investment; and confidence of businesses and consumers. Because of the heightened levels of uncertainty and the lack of evidence sufficient to give us a clear understanding of the strength and duration of the consequences for each of the transmission mechanisms noted above we publish a central or base forecast and three alternative scenarios.

Our central forecast reveals that from 2007 there will be five years of below trend growth and a fall in output, or recession in 2009. Scottish GDP growth will slow from 1.9% in 2007 to 0.7% in 2008. In 2009, we project that GDP will fall by 1.1%, but recession will only be evident in that year as growth picks up again to 0.7% in 2010, 1.2% in 2011 and 1.5% in 2012. For the first time in quite a few years Scotland experiences net job losses, with over 4,000 lost in 2008, more than 37,000 lost in 2009, and around 12,000 lost in 2010. In 2011, net jobs begin to be created again quite quickly with more than 14,000 net jobs, rising to net job creation of below 24,000 in 2012. The scale of the initial job losses is sufficient to push up unemployment from the historically low levels that the Scottish economy has enjoyed over the past few years. Unemployment on the ILO measure increases from 117,300, or 4.4%, peaks at 162,300, or 6.1% in 2010 then falls to 151,000, or 5.7%, in 2011, falling further to 137,300, or 5.2%, in 2012.

On our optimistic scenario, financial and housing market impacts are less severe, lending behaviour picks up more quickly, confidence is re-established sooner, and monetary policy is a little more aggressive. Here GDP growth slows down in 2008 but by less than in the base case falling to 0.8%. Similarly, in 2009 the scale of the fall in GDP is slightly less at –1% rather than –1.1%. In 2010, 2011 and 2012 there is a stronger recovery as growth rise to 1%, 1.6% and 1.8% respectively, returning almost to trend by 2012. Job losses are also less in this case and the recovery in the labour market stronger. This has a more favourable impact on unemployment than in the base case.

In the recession plus slow recovery case there is both a stronger downturn and slower recovery than in the central or base case. In this scenario, lowered confidence, depression in the housing market, contraction in the construction and financial service sectors are more severe than in the base case. Lending behaviour does not improve significantly from present levels, and monetary policy remains cautious after the recent rate cuts. GDP falls by –1.2% in 2009 there are considerable job losses of over 46,000 and the ILO unemployment rate increases to 6.3%. Growth hardly recovers in
2010 as GDP expands by only 0.6%, nearly 16,000 net jobs are lost and the unemployment rate increases further to 6.4%. In 2011 and 2012 there is GDP growth of 1% and 1.2%, which are well below trend. Net jobs begin to be created in these final two years by 9,000 and 17,000 respectively and the unemployment rate recovers somewhat to 6.1% and 5.5%.

Our final case is, a worst-case scenario of sustained recession. Here, the seizure of the financial system continues for an extended period, bank illiquidity persists, lending continues to be severely constrained, and business confidence remains low. A greater contraction in household and investment demand follows, leading to negative growth for two consecutive years of –1.6% in 2009 and – 0.4% in 2010. Growth turns weakly positive at 0.3% in 2011 and continues no better than the 2008 expected growth rate of 0.7% in 2012. Under this scenario net job losses are considerable as the downturn is sufficient to produce a shakeout of hoarded labour. Net employment falls by 73,000 in 2009, and by 44,000 in 2010, with some improvement thereafter. ILO unemployment deteriorates to 6.5% in 2009, peaking at 7.1% or 187,000 in 2010. In 2011 and 2012 there is some improvement as the rate falls to 6.2% and 5.8%.

GDP Performance in first quarter 2008

The latest official outturn data for the Scottish economy refer to the second quarter 2008. Total Scottish gross value added at real basic prices rose by 0.1% in the quarter and by 1.8% over the year. The comparable UK figures were 0.0% and 2.5%. So, Scotland’s exhibited a marginally stronger growth performance than the UK during the quarter, but essentially the UK economy was stagnating in the second quarter and Scotland’s performance was little different, as Figure 1 indicates.

Service sector growth was weaker in Scotland during the quarter with an outturn of 0.1% here compared to 0.2% in the UK – see Figure 2. Over the year, Scottish and UK services grew at broadly the same rate of 3% and 3.1% respectively.

Within Scottish services the sector performing the most strongly in the second quarter was transport & communication with growth of 2.6% compared to 1% in the UK. Retail & wholesale grew by 1.7% as against 0.7% in the UK and other services grew by 1% compared to zero growth in the UK. The remaining four aggregated service sectors for which data are published all cut back production in the quarter. Hotels & catering, financial services and real estate & business services all contracted by 1%, compared to mixed performance in their UK counterparts of – 1.9%, 0% and +0.2%. The public sector contracted slightly, by 0.1% in Scotland, compared to an increase of 0.1% in the UK. Over the year, other services grew most quickly at 7.6% (3% in the UK), followed by transport & communication 6.7% (1.9% in the UK), retail & wholesale 4.8% (2.9% in UK) and hotels and catering 0.5% (0.7% in the UK). Financial services was the weakest sector over the year, contracting by 4.8% compared to a 7.7% rise in the UK.

Manufacturing in Scotland grew by 0.7% in the second quarter, in contrast to UK manufacturing, which cut back output by 0.9% – see Figure 3. While over the year, GVA in Scottish manufacturing rose by 0.7% compared to a rise of 0.2% in the UK.

Within manufacturing, the relatively stronger Scottish performance in the second quarter was driven by engineering, chemicals, and other manufacturing. In engineering, transport equipment grew by 3.9% (-4.4% over the year), mechanical engineering by 1.5% (5.3% over the year) and electronics by 0.8% (1.2% over the year). The comparable UK figures were, 1% (-0.7%) over the year, -0.8% (3.6% over the year), and -2% (-0.6% over the year), respectively. Chemicals & man-made fibres exhibited growth of 1.4% in Scotland in the second quarter, while contracting by 0.4% in the UK. Other manufacturing in Scotland grew by 0.9%, while its UK counterpart reduced output by 1.4%. At the other extreme the weakest manufacturing sectors in Scotland during the quarter were, paper, printing & publishing which contracted by 2.7% and by 3.2% over the year (-0.2% and 0.6% in the UK, and food & drink, which cut back output by 1.5% in the quarter but raised output by 3.2% over the year (-2.1% and -1.3% in the UK).

Figure 4 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 transport & communication services, the weakness in financial services since the 2007q1, the upturn in activity in retail & wholesale, and the downturn in hotels & catering, real estate & business services, and food & drink from 2008q1.

Looking into the abyss

It is now nearly 5 months since we last reported on the Scottish economy. Along with most analysts and forecasters we failed to anticipate the scale of the subsequent change and deterioration in the world economy generally and the financial markets specifically. We saw that the US economy
was teetering on the brink of recession and that with high
and rising oil and commodity prices both the US and the
developed economies faced the spectre of stagflation. We
also saw the oil price rising further from the then $139 price
peaking at close to $200 possibly within twelve months and
then falling to a more sustainable level of $80 to $90 per
barrel. But we were not sure of the timescale over which
such a movement would occur. In the event the oil price
peaked at $147 and has since fallen back to below, and now
around, $70.

Hence, in the short term, inflation is now much less of a
problem, while the threat to demand and real output in both
the US and the major economies, including the UK and
Scotland, is much greater than we anticipated. On the key
factors influencing the prospects for the real economy it is
worth repeating what we said last time:

"It is now well understood that the trigger events in
the US slowdown stemmed principally from the
housing market: ending of the house price boom;
house price falls and higher interest rates; massive
foreclosures in the sub-prime mortgage market;
significant bank and hedge fund losses as the value
of innovative investments based on sub-prime
mortgages collapsed; and the subsequent drying up
of liquidity in financial markets, or ‘credit crunch’ as it
is now popularly known. The loss of trust occasioned
by the sub-prime crisis has thrown a huge spoke in
the wheel of the global financial system. Moreover,
the credit crunch is exceptionally serious because
……. the problem with the markets isn’t just a lack of
liquidity, as in many previous financial crises, there’s
also a fundamental problem of solvency that is still
not fully identified. Scotland cannot be insulated from
wider forces. What is still uncertain is the extent of
the sub-prime losses in the global banking system
and because of that the degree to which the financial
system is pulling back from traditional lending
activities. If that pull back is marked then there is little
doubt that growth will slow considerably."

What we did not appreciate was that the collapse of the
asset price bubble, which was what happened to the
housing markets in the US and UK, would lead to insolvency
in so many key financial institutions, the effective
disintegration of the credit supply mechanism in the global
economy, and a major pull back from traditional lending
activities both between the banks and to the wider economy.

There is now almost universal agreement – a possibly
dubious phenomenon – that the ‘collapse’ of the housing
market, the scale of the losses experienced by banks and
other financial service sector firms, and the breakdown of
credit supply are producing a slowdown in the ‘real’
economy of considerable severity. The likely size of such a
slowdown for any economy is exceptionally difficult to call
because it depends on the scale of the deflation of house
and property prices in the domestic market, the scale of the
impact on local financial service activities, and the spread to
the wider domestic economy.

Against the background of unprecedented upheaval in the
financial sector, financial markets and the global economy
generally, recent economic performance data on GVA and
employment offer little or no guide to future outcomes.
Forecasting becomes even more difficult at such times.
However, we are not completely in the dark. There are
some guidelines on which we can draw.

First, to derive some sense of the prospects for the Scottish
economy it is worth looking at what a recession has meant
in UK and Scottish terms. This should provide a benchmark
and perhaps framework against which the expected
downturn can be set. We then turn to the property market
impacts, the effect on financial services in Scotland, and
finally, wider economy considerations.

Lessons from previous recessions
It has now become something of a stylised fact that cyclical
fluctuations of Scottish GDP have less amplitude than in the
UK economy. What this means is that the cycle is
considered to be effectively flatter and so both upswings
and downswings are less severe here.

Figure 5 indicates that since 1963 there have been 3 severe
recessions in the UK, defined here as a downturn sufficient
to make annual growth negative for at least one year, in
1974/75, 1980/81 and 1991. In the UK, there was a
technical recession of two quarters in 1961 but it lasted no
more than that. In 1974/75, there were 3 quarters with
successive negative growth running from the third quarter
1973, followed by negative growth in the fourth quarter of
1974, then negative growth again in the second and third
quarters of 1975. In 1980/81, the recession in the UK was
altogether more severe both in terms of the scale of output
contraction and its duration. Output fell by 2.8% and 1.4%
respectively in 1980 and 1981 and growth was negative for
5 successive quarters from the first quarter of 1980.
However, it is worth noting that there was negative growth in
the first and third quarters of 1979 too. Finally, in 1991
growth turned negative in the third quarter of 1990 and
negative growth continued for four further quarters, with
GVA dropping by 1.5% in 1991 overall.

So, severe recessions in the UK would appear to be
associated with an annual fall in output of between 1.5%
and 3% and a duration of negative growth lasting for 5 to 7
quarters, although not necessarily consecutive quarters.

The data in Figure 5 confirm the view that recessions have
tended to be less severe in Scotland compared to the UK
and in 1991 Scotland did not experience a recession. 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.

So what help does this analysis provide in helping to forecast the scale of the expected downturn in both Scotland and the UK?

We think it unlikely that the recession in prospect will be as severe as 1980/81, although we cannot say this with certainty. In that recession, monetary and fiscal policy effectively accommodated, even exacerbated, the recession and was not used counter-cyclically to combat it. That will not happen on this occasion as the recent swingings cuts in interest rates in the UK and the US, and the willingness to borrow more and run up higher levels of public debt, indicate. Yet, we are unsure about the scale of the exogenous demand shock that will hit the economy. A key source of the expected downturn is global rather than local in nature. This is somewhat different from previous recessions and could make the outcome more severe than a recession due to a fall in domestic demand.

**Will Scotland suffer by more or less than the UK?**

The evidence is clear that recessions have tended to be weaker here for some of the reasons noted. But on this occasion we are less sure. We suggested above that the impact of the present crisis depends on the scale of the deflation of house and property prices in the domestic market, the scale of the impact on local financial service activities, and the spread to the wider domestic economy. On each of these the effect is likely to differ between Scotland and the UK. We look at each in turn.

**Housing and property market**

The root of the credit crunch lies in the bursting of the asset bubble in housing and property markets in the US, UK and now in several other countries. The ending of the house and property price boom would be expected to affect activity in house building and construction and with declining net asset values promote a slowdown in household spending. As Figure 6 indicates, the construction sector has been weak in Scotland for some time, with GVA falling from the 2006q3. The same has not applied to UK construction, which peaked in the first quarter of this year followed by a fall in GVA of 0.5% in the 2008q2 compared to a fall of 0.4% in Scotland. Data from the latest Scottish Chambers’ Business Survey (SCBS) suggest that the sector continued to contract in the third quarter of this year with a large proportion of firms expecting lower sales, jobs and profits over the next twelve months. The percentage of firms reporting declining business confidence was the highest since the survey began.

An examination of data on house prices should offer some indication of the likely comparative UK and Scottish impact of the ending of the house price boom. Figures 7 and 8 chart the change in house prices since 1983. Figure 7 reveals that UK house prices more than tripled from the previous trough in house prices in 1993 to the latest peak in 2007 whereas Scottish house prices rose by just under 2.5 times the 1993 figure. From Figure 8, it is clear that house prices are likely to have fallen by proportionally less in Scotland (-3.4%) than in the UK (-8.3%). The figure also shows that changes in Scottish house prices lag changes in the UK and that the degree of change in house prices here tends to be less. We judge from this that both the absolute and relative fall in house prices is likely to be less in Scotland than in the UK. For this reason, and given also that the Scottish home ownership rate at 66%, despite strong growth in the five years to 2006, continues to be lower than in the UK at 70%, we expect that the impact on the Scottish economy of the end of the house price boom will be less than in the UK.

**Financial services and banking**

We noted in the June 2008 Commentary that financial services (8% of economy GVA), for a long time a key driver of the Scottish economy, began to stutter in the post 2005Q1 period with quarterly growth averaging 0.98% compared to 2.03% in the earlier period. The weakening performance of financial services was much influenced by the downturn in the second and third quarters of 2007 with GVA falling by 3.4% and 1.8% respectively – see Figure 9. What remained unclear was how much this weaker performance was related to the “credit crunch” and/or whether other factors contributed. In the final quarter of last year the sector grew appreciably by 3.8%. However, in the first quarter of 2008 the measured GVA of financial services fell dramatically by 9.1% and this was followed by a further fall of 1.0% in the second quarter. On the face of it this suggests that the ‘credit crunch’ was having a significant impact on Scottish financial services in the first half of the year. It is worth entering a note of caution here, though, because UK financial services grew by 2.7% in the first quarter of the year and was essentially stagnant exhibiting zero growth in the second quarter. To muddy the waters further, the Scottish Government’s GVA data on banking reveals that the sector grew by 3.6% in the second quarter, with the brunt of the contraction in financial services being born by the insurance sector, after contracting by more than 11% in the first quarter.

We conclude that the impact of the ‘credit crunch’ has been evident in the financial services sector data for Scotland and the effect will become even more clear in the next few quarters. But will the impact on financial services be bigger here than in the UK as a whole?

We take the view that the impact will be bigger here and that there may be a lingering negative effect in the long-term. This is because the scale of the losses on sub-prime and impairments facing the two principal Scottish banks, RBS
and HBOS, are considerable and exceptional compared to other UK banks. The losses have pushed RBS and HBOS to the brink of bankruptcy. This outcome underlined the extent to which the lending behaviour of the two banks had ceased to be underpinned by the traditional risk management practices that had led Scottish banking/bankers to be perceived as prudent and even 'canny'.

There is much evidence for this. The new CEO of RBS Stephen Hester, in interviews following his appointment, made it clear that the bank had lent far too much in good times and had fostered a ‘bull market culture’. The position at HBOS was even worse with the company seeking to become the ‘Tesco of UK banking’ with an emphasis on sales growth and cost efficiency. The company firmly believed that such a strategy was not at the cost of additional risk, with Phil Hodkinson Group Finance Director, stressing that "(t)he combined ratio of cost and impairments to income has … fallen over time at HBOS … despite a period of worsening impairments in the UK unsecured market." With hindsight that statement must be viewed as over optimistic at the very least. Added to this it would appear that HBOS corporate lending was over focused on property and house building companies. So, it is being hit by a triple whammy of losses on collateral debt obligations (CDOs), based on sub-prime, and rising impairments on both the demand and supply sides of the housing and property markets.

There will be a short to medium term impact of all of this on Scottish banking. Output and jobs will be cut back. The government sponsored takeover of HBOS by Lloyds/TSB is likely to lead to a rationalisation of the two banks high street, back office and HQ operations. But it would be a mistake to believe that the prospective job losses are the consequence of the takeover. Rather they are the consequence of the policies of HBOS management. In the absence of the Lloyds/TSB takeover it is almost certain that HBOS would have become insolvent and would have had to be directly nationalised. Job losses and output contraction would have been the inevitable outcome as the UK government sought to make it an attractive proposition for an eventual buyer. And it might be argued that since Lloyds/TSB has significant retail banking overlap with HBOS in Scotland, the potential for rationalisation and cost reductions is high and so Lloyds/TSB may be able to offer a higher bid price than other likely bidders.

Further to these direct effects, the two Scottish banks are also going to be affected by the rising impairments consequent upon a slow down in the wider economy and HBOS would appear to be especially exposed to this as we note above due its lending focus on property and house building businesses. Finally, the banks current unwillingness to lend plus a reduction in the demand for loans as the economy slows will also help to reduce banks’ income. The scale of this will depend on the extent of the slowdown in the wider economy, to which we turn in the next section.

One further point. We should not underestimate the damage in the longer term this episode has done, and may yet do, to Scotland’s reputation for banking excellence. It seems unlikely that RBS will adopt such an aggressive lending and growth policy in the future but it might also find it harder to win new business when the upturn in the economy eventually occurs unless and until confidence in its management is fully restored. For an independent HBOS, the same problem would apply, and might be worse. But absorbed into Lloyds/TSB, which has managed to maintain its banking reputation, such problems will be much less.

The wider economy

The main mechanisms through which the present crisis is spreading outside the property and financial markets are through falls in:

- intermediate demand impacts on suppliers to financial service companies, property developers, house builders and construction companies;
- domestic household demand due to the impact of asset price deflation – e.g. houses and shares – on spending plans, plus the secondary multiplier effects of reduced spending by workers and shareholders in financial service and property related companies;
- external household demand for Scottish goods and services – including tourism – as the crisis spreads throughout the world economy lowering trade flows;
- credit supply from banks to investing firms and households, as banks seek to rebuild their balance sheets via loan restriction and higher charges;
- inward investment from non-Scottish companies abroad due to own product demand contraction and credit supply restriction;
- confidence of business managers and households, a lowering in confidence is likely to reduce investment and spending plans independently of the direct and secondary demand and price effects of the property and financial crisis.

We saw in Figure 4 that and the GVA in real estate & business services, hotels & catering, and food & drink had turned down during the second quarter of this year. Activity in real estate has been clearly affected by the slowdown in the property market. The slowdown in hotels and catering, and food and drink may reflect the effect of the crisis on export sales, with the demand for luxury products such as foreign holidays and whisky tending to be cut back early as the growth of household incomes worldwide slows. The manufacturing export figures for the second quarter support this view with foreign exports of food, drink and tobacco falling in real terms by 2.5%. It might also be expected that Scotland’s production of upmarket textiles products, and
clothing would also be hit. Again the export figures for the second quarter appear to confirm this with a real fall in sales of 6.6%, but this did not affect the production data with GVA in the sector rising by 1.8% in the quarter. Overall, the level of Scottish manufactured exports was unchanged in 2008q2 suggesting that the expected slowdown in world incomes and trade had only just begun to lap at our shores. The impact on domestic household incomes and demand of the crisis would be expected to effect retailing activity fairly quickly in the downturn. And this appears to have been occurring during the second quarter. For while retail & wholesale experienced an upturn in GVA (+1.7%) during the quarter, at the level of the retail sector alone GVA fell (-1.8%), all be it against a background of an increase of over 4% over the year to the second quarter.

We have no official outturn data on production after the second quarter. However, survey data are available for the third quarter and these are reviewed in the Commentary below: A Review of Scottish Business Surveys. These surveys broadly confirm the fear that domestic demand, production and labour market performance and business confidence are deteriorating appreciably. While our Review warns that survey results such as these can easily lend themselves to an over pessimistic interpretation, and so must be treated with caution, there is strong evidence of a general slowdown in activity and rising spare capacity with inflationary pressures beginning to ease.

Forecasts

Forecasting is hedged around with considerable uncertainty at the best of times. The best times for forecasting are when the economy is exhibiting steady growth, sustained over long periods. The worst time, is probably a situation like the present where there is clear evidence of a shock to the system but insufficient evidence to gain a deep understanding of the strength and duration of the consequences for each of the transmission mechanisms noted above: direct demand; intermediate input demand; domestic household demand; external household demand; credit supply; inward investment; and confidence of businesses and consumers. Because of these heightened levels of uncertainty we are publishing a range of forecasts based on different scenarios. These are:

- a central or base case;
- an optimistic case;
- a recession and slow recovery case;
- a sustained recession case

We deal with our central forecast first and then summarise the alternative scenarios, with further detail provided in the Scottish Forecasts section of this Commentary.

Central forecast

This is our central case and in our judgement has the highest - but unspecified -probability of occurring. In this case the growth of the principal components of aggregate demand slows down significantly in 2009 but begin to pick up again in 2010 returning to pre-crisis levels in 2011 or 2012. Falling asset prices, lowered confidence, the depression in the housing market, and contraction in the construction and financial service sectors lead to the growth of consumer/household demand falling by 0.6% next year. Lower business confidence, rapidly slowing aggregate demand and credit supply restrictions lead to investment demand becoming slightly negative in 2008 (-1.8%), and significantly negative in 2009 (-6%). Export growth slows but remains positive as weaker sterling offsets to a limited extent the slowdown in the growth of world demand and trade.

In these circumstances, we are forecasting - see Figure 10 - that Scottish GDP growth will slow from 1.9% in 2007 to 0.7% in 2008. Next year, 2009, we project that GDP will fall by -1.1%, but recession will only be evident in that year as growth picks up again to 0.7% in 2010, 1.2% in 2011 and 1.5% in 2012. So this forecast suggests that we shall have from 2007, five years of below trend growth and a fall in output, or recession in 2009.

Such a slowdown in GDP has implications for the labour market. For the first time in quite a few years Scotland experiences net job losses, with over 4,000 lost in 2008, more than 37,000 lost in 2009, and below 12,000 in 2010. In 2011, net jobs begin to be created again quite quickly with more than 14, 000 net jobs, rising to net job creation of below 24,000 in 2012 – see Figure11.

The scale of the job losses is sufficient to push up unemployment from the historically low levels that the Scottish economy has enjoyed over the past few years – see Figure 12. Unemployment on the ILO measure rises from 117,300, or 4.4%, in 2008 to 152,300, 5.7% in 2009, and peaks at 162,300, 6.1% in 2010. The effect of the slowdown in GDP and jobs growth has a lagged effect on unemployment. By 2011, the unemployment rate has begun to fall to 151,000, or 5.7%, falling further to137,300, or 5.2% in 2012.

Alternative scenarios

Figures 10, 11 and 12 graph the expected outturn for GDP growth, net jobs change and the ILO unemployment rate over the forecast horizon under our alternative scenarios.

On our optimistic scenario financial and housing market impacts are less severe, lending behaviour picks up more quickly, confidence is re-established sooner, and monetary policy is a little more aggressive. Here GDP growth slows down in 2008 but by less than in the central case falling to 0.8%. Similarly, in 2009 the scale of the fall in GDP is slightly less at –1% rather than –1.1%. In 2010, 2011 and 2012 there is a stronger recovery as growth rise to 1%.
1.6% and 1.8% respectively, returning almost to trend by 2012. Job losses are also less in this case and the recovery in the labour market stronger, with net job change of -32,470 in 2009, -4,992 in 2010, 23,668 in 2011 and 29,876 in 2012. This has a more favourable impact on unemployment than in the central case.

In the recession plus slow recovery case there is both a stronger downturn and slower recovery than in the central or base case. In this scenario, lowered confidence, depression in the housing market, contraction in the construction and financial service sectors are more severe than in the central case. Lending behaviour does not improve significantly from present levels, and monetary policy remains cautious after the recent rate cuts. GDP falls by – 1.2% in 2009 there are considerable job losses of over 46,000 and the ILO unemployment rate increases to 6.3%. Growth hardly recovers in 2010 as GDP expands by only 0.6%, nearly 16,000 net jobs are lost and the unemployment rate increases further to 6.4%. However, by 2011 and 2012 GDP growth increases further to 1% and 1.2% but remains well below trend. Net jobs begin to be created in the final two years by 9,000 and 17,000 respectively and the unemployment rate recovers somewhat to 6.1% and 5.5%.

Our final case is, in our view, a worst-case scenario of sustained recession. Here, the seizure of the financial system continues for an extended period, bank illiquidity persists, lending continues to be severely constrained, and business confidence remains low. This leads to a greater contraction in household and investment demand, with negative growth for two consecutive years of –1.6% in 2009 and –0.4% in 2010. Growth turns weakly positive at 0.3% in 2011 and continues no better than this year's expected growth rate of 0.7% in 2012. Under this scenario net job losses are considerable as the downturn is sufficient to produce a shakeout of hoarded labour. Net employment falls by 73,000 in 2009, and by 44,000 in 2010. Weak net job creation occurs in 2011 of just over 2,000 jobs and 8,000 jobs in 2012. ILO unemployment deteriorates to 6.5% in 2009, peaking at 7.1% or 187,000 in 2010. In 2011 and 2012 there is some improvement as the rate falls to 6.2% and 5.8% but these rates remain well above present levels.

Brian Ashcroft
10 November 2008

Endnotes:
2 From speech by HBOS Group Finance Director, Phil Hodkinson, Goldman Sachs Conference, 15 June 2007.
3 Ibid
Figure 1: Scottish and UK Quarterly GDP Growth, 1998q2 to 2008q2

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

Figure 3: Scottish and UK Manufacturing Quarterly GVA Growth at constant basic prices 1998q2 to 2008q2
Figure 4: Growth of key sectors in Scotland 2002q1 to 2008q2

Figure 5: GVA Growth Recessions in the UK and Scotland 1963 to 2007
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Figure 7: Annual Average House Prices in Scotland and UK, 1983 to 2008, 1983 = 100
Figure 8: Change in Average House Prices in Scotland and UK, 1983 to 2008, 1983 = 100

Source: Halifax House Price Index

Figure 9: Scottish and UK Financial Services GVA Growth at constant basic prices 1998q2 to 2008q2

Source: Halifax House Price Index
Figure 10: Forecast Scottish GVA Growth 2008 to 2012 - Different Scenarios

Figure 11: Forecast Net Jobs Change, 2008 to 2012 - Different Scenarios
Figure 12: ILO Unemployment Rate Forecast, 2008-2012 - Different Scenarios