State of the Economy

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The Scottish Government

State of the Economy Presentation

This presentation, the latest in the State of the Economy series, outlines the key recent developments in the Global, and UK economies and the potential implications for the Scottish economy. The presentation builds on the previous State of the Economy update, which was published on the 27th February 2009:

(http://www.scotland.gov.uk/Topics/Economy/economic-situation/state-of-economy)

All feedback and comments on this presentation would be warmly welcomed.

Structure of Presentation

This updated assessment considers two broad areas:

– recent developments in the global economy - in particular a range of new economic data and analysis released in the build up to the G20 Summit; and

– developments in, and prospects for, the Scottish economy

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Summary

Summary of Scotland's Economic Performance

- Evidence suggests that the Scottish economy has been in recession since mid-2008
- Future growth expectations across the world have been revised down repeatedly and significantly over the past year, not least in the UK
- Decline in output is expected to continue throughout 2009 and into 2010
- Employment has declined in recent months and is expected to continue to decrease through 2009 and 2010. This will be reflected in continuing upward trends in both unemployment and economic inactivity.
- Impact of the international monetary and fiscal response will be key as weak levels of global demand will continue to depress economic activity in Scotland

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Summary of the Performance of the Scottish Economy

There is clear evidence that Scotland's economic performance slowed in the second half of 2008, reflecting weaker conditions in the global economy. Future growth expectations across the world have been revised down repeatedly and significantly over the past year, not least in the UK.

Output in the Scottish economy contracted sharply in the third quarter of 2008 and the backward-looking business surveys highlight that Scottish firms have reported further declines in output in late 2008 and early 2009. Evidence suggests that the Scottish economy has been in recession since mid-2008.

This decline in economic activity has resulted in Scottish firms reducing their workforce and has had an increasingly marked impact on the labour market data. Working age employment in Scotland declined by 18,000 in the period November – January 2009 compared to the previous three month period. This was reflected in modestly rising unemployment in the quarter of 1,000, but equally importantly, in rising economic inactivity which rose by 17,000 over the quarter. The business surveys and independent economic forecasts suggest that further declines in employment can be expected in the coming months, with the unemployment rate potentially rising to between 7.5% and 8.5% in two years time.

Independent forecasters and the available survey evidence also suggest that the decline in output in Scotland will continue into 2009 - with the latest forecasts from the Fraser of Allander Institute and Cambridge Econometrics suggesting a fall of between 2.6% to 2.7% - which may spill over into 2010. However, there is still a significant degree of uncertainty over these forecasts, the scale of the downturn in the Scottish economy, and the timing of the recovery.

Summary

…the evidence of economic downturn

Recent expenditures		
	Current strength ?	Current trend ?
GDP	*considerably below potential growth rate*	*declining*
Business activity (PMI)	*very weak*	*recent sharp falls*
Consumption: retail sales	*flat in real terms*	*slight increase*
Government expenditure	*low real growth compared to 2000/7*	*flat*
Exports (manufactures)	*flat real growth 2004/8*	*decline over quarter*
Labour market		
	Current strength ?	Current trend ?
Employment	*strong*	*declining*
Unemployment	*strong*	*increasing*
Inactivity	*relatively good*	*increasing*
Other indicators		
	Current strength ?	Current trend ?
Housing market: transactions	*around half level of a year ago*	*sharp falls*
Housing market: prices	*clearly below peak*	*falling*
Credit: availability	*constrained*	*easing of rate of decline*
Credit: cost	*high relative to base rates*	*falling*
Future expenditures		
	Outlook ?	
GDP forecasts	*sharp downward revisions: -0.4% to -2.7% (2009)*	
Business confidence/optimism	*sharp falls: net balances in range of -40 to -50*	
Consumption: cons. confidence	*sharp falls: net balances around -30*	
Government expenditure	*weak real growth*	
Exports	*weakening*	

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Summary of Global Developments

- Synchronised decline in output, with export-orientated economies hardest hit
- Continued declines in employment and sharp rises in unemployment
- Slight rise in inflation, but expectation is for inflationary pressures to continue to ease
- Move to unconventional monetary policy
- Substantial declines in output forecast for 2009 and very modest growth in 2010

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Summary

The Importance of Global Developments

As global economic conditions have deteriorated, governments across the world have responded with unprecedented policy action. The initial response focused on measures to stabilise the banking system and traditional monetary policy measures such as reductions in base interest rates. More recently this has been supported by additional fiscal measures introduced to stimulate economic activity and more unconventional monetary policy measures (such as quantitative easing).

Many critical uncertainties remain that have significance for the timing and scale of the recovery of the Scottish economy:

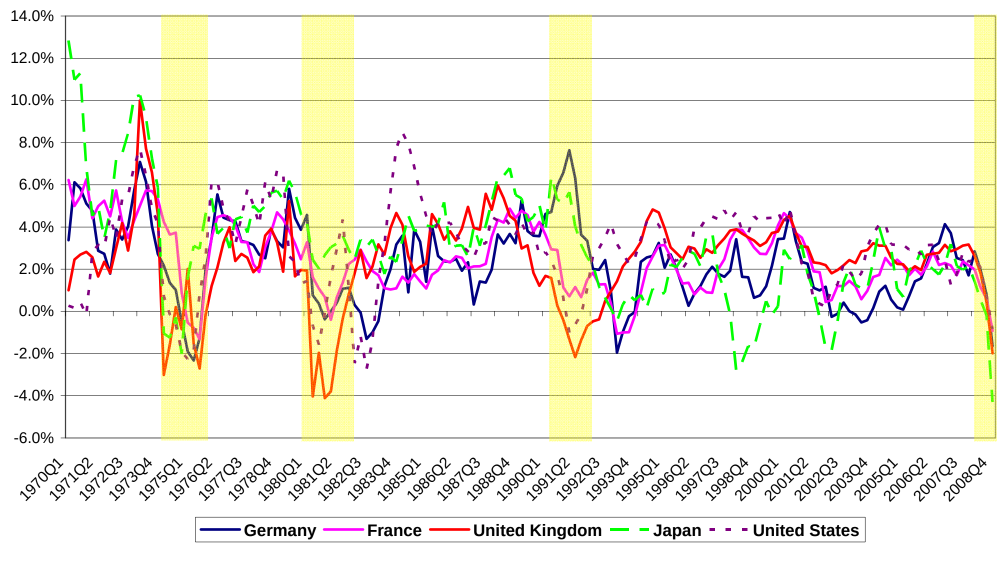
- What is the likely shape of the recession – its duration, depth and the rate of recovery?
- How rapidly and effectively will the global stimulus measures impact on global confidence and recovery?
- How rapidly will financial sector stability and the supply of credit be restored?
- Once financial stability develops, how rapidly will household and corporate confidence, and the demand for credit pick up?
- How rapidly will Scotland's key international markets recover from the global recession?
- What will the global recession imply for Scotland's long term competitiveness?

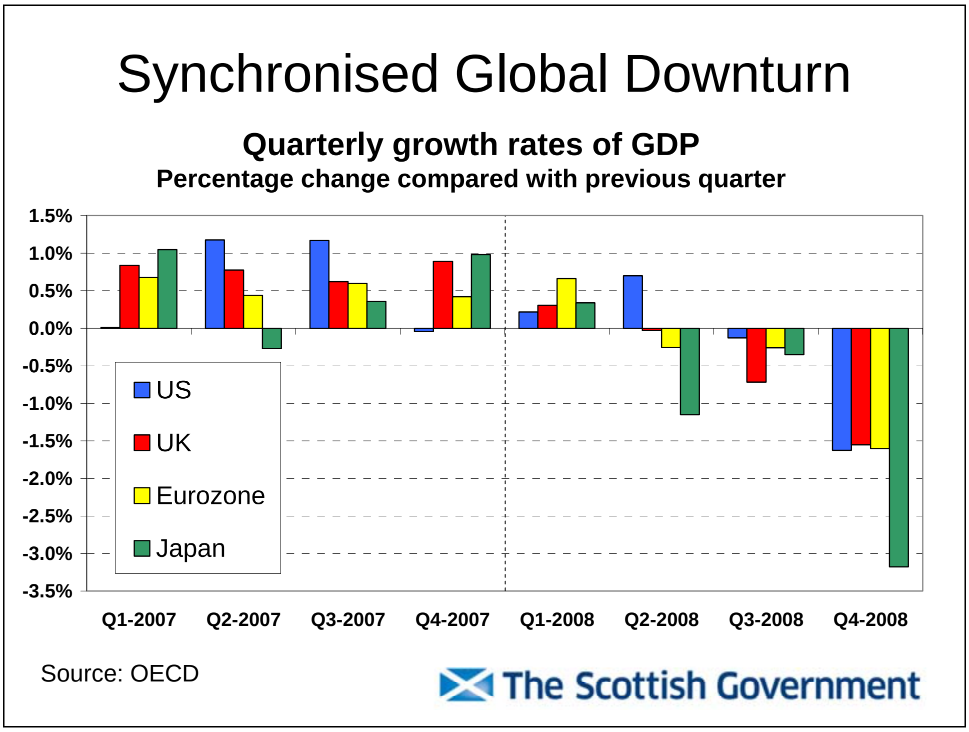
Developments in the Global Economy

The pace of the slowdown in the global economy accelerated towards the end of 2008 with nearly all major advanced economies confirmed to be in recession.

A defining characteristic of this downturn has been its synchronised nature, with all economies facing a rapid slowdown in economic growth. This has included emerging economies such as China whose annual rate of economic growth slowed to 9% in 2008, compared to a rate of 13% in 2007. The World Bank forecast annual growth of 6.5% in China in 2009. The synchronised downturn has resulted in considerable falls in world trade and global demand for goods and services. The impacts of these falls have had disproportionate effects on export-orientated economies such as Japan and Germany.

Recessions in the Global Economy (year-on-year growth rates to quarter)





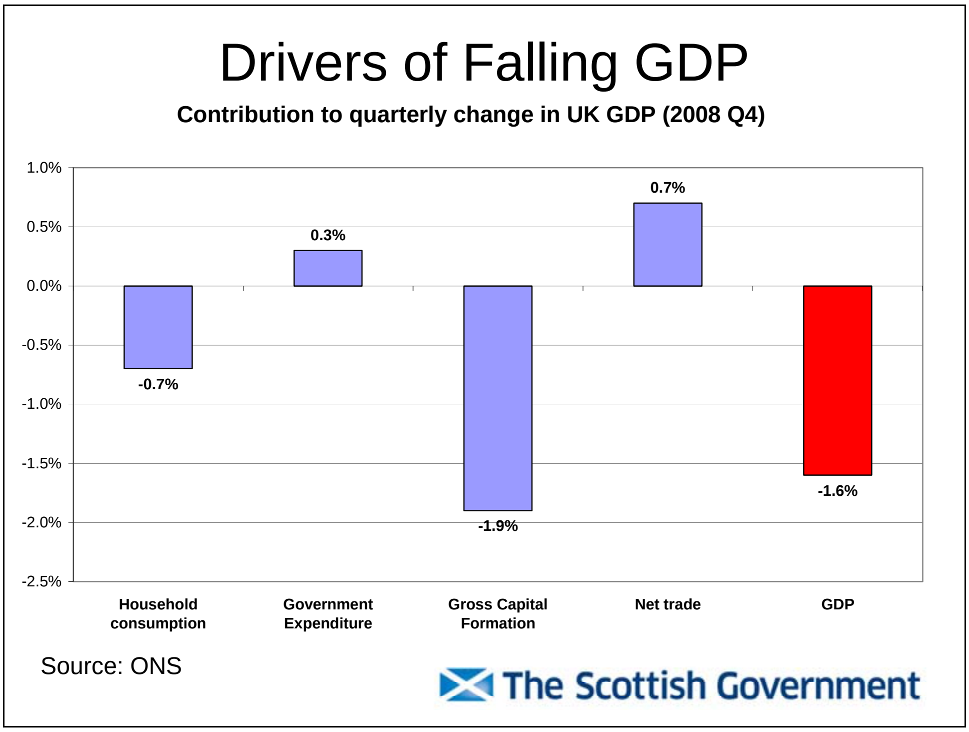
Synchronised Downturn in Global Output

Data for the final quarter of 2008 confirmed that the majority of advanced economies were in technical recession – defined as two consecutive quarters of negative GDP growth. The table below outlines when each economy moved into recession. Ireland, Iceland, and Sweden were amongst the first countries in recession. Of the G7 countries, only Canada and France are not currently in recession, although both experienced quarterly falls in output during 2008 Q4, of 0.8% and 1.1%, respectively.

Quarterly Growth Rates by OECD Country

	Quarterly Growth Rates					
	2007 Q3	2007 Q4	2008 Q1	2008 Q2	2008 Q3	2008 Q4
Denmark	1.7%	0.3%	-1.2%	0.3%	-0.8%	-1.9%
Euro area	0.6%	0.4%	0.7%	-0.3%	-0.3%	-1.6%
Finland	0.5%	1.5%	-0.3%	0.1%	-0.3%	-1.3%
Germany	0.6%	0.3%	1.5%	-0.5%	-0.5%	-2.1%
Iceland	5.1%	-1.0%	-1.6%	-1.6%	2.9%	-0.9%
Ireland	0.2%	0.5%	-1.0%	-0.4%	1.1%	-7.1%
Italy	0.2%	-0.3%	0.3%	-0.6%	-0.7%	-1.9%
Japan	0.4%	1.0%	0.3%	-1.2%	-0.4%	-3.2%
Spain	0.6%	0.6%	0.4%	0.1%	-0.3%	-1.0%
Sweden	0.3%	1.5%	-0.6%	-0.5%	-1.0%	-2.4%
United Kingdom	0.7%	0.8%	0.4%	0.0%	-0.7%	-1.6%
United States	1.2%	0.0%	0.2%	0.7%	-0.1%	-1.6%
Scotland	0.2%	1.0%	0.2%	0.2%	-0.8%	-

Source: OECD, Scottish Government, ONS
Note: Highlighted cell indicates the second consecutive quarter of negative growth (i.e. when the economy was confirmed as being in recession)



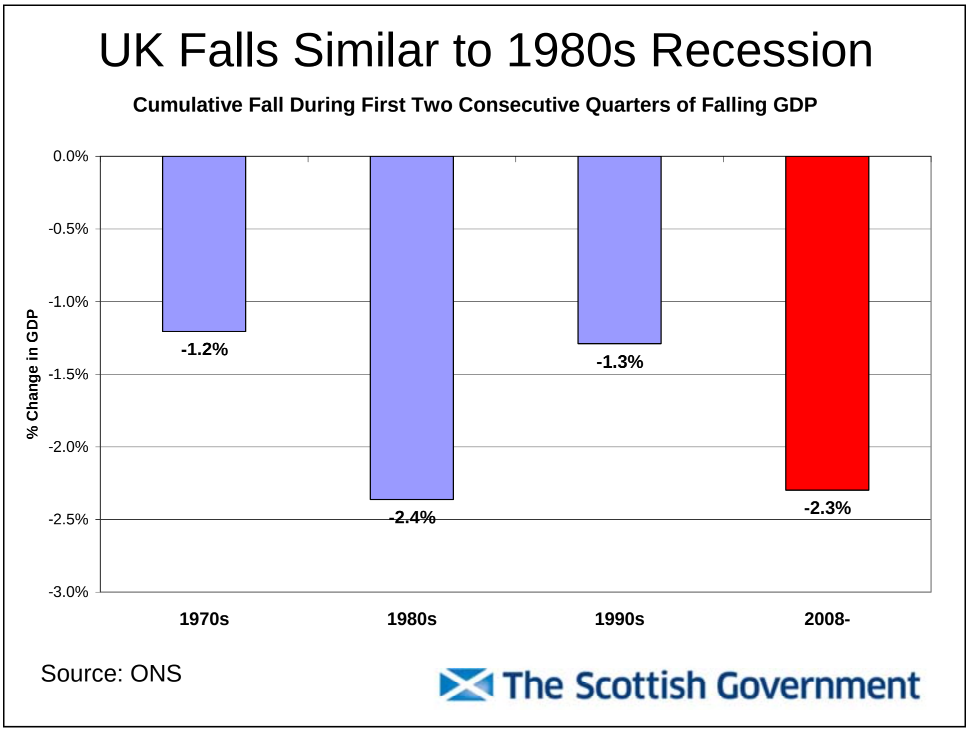
Decreasing Inventories driving falls in output

The expenditure measure of GDP shows that the largest contribution to the 1.6% quarterly decline in UK GDP came from falling levels of household consumption and a considerable run-down of inventories. Changes in inventories accounted for the majority of the change in Gross Capital Formation (around 85 per cent) in 2008 Q4, with the remainder of the change reflecting general declines in investment. The inventory effect is due to firms having adequate stock levels to meet current orders (in light of lower levels of demand) and therefore choosing to run these down before building stock levels up again. This also made a major contribution to the quarterly fall in GDP during 2008 Q3.

The positive contribution to quarterly growth from net trade is due to imports declining more rapidly than exports. This reflects the depreciation of sterling having a stronger impact on imports (through the increase in the price of imported goods and services) than exports (as weak global demand limits the opportunities for exporters to benefit from their increased competitiveness).

The output measure of GDP allows for identification of changes by industry sector. This shows that during 2008 Q4 there was an acceleration in the declines in output across all sectors in the UK, with Production falling by 4.5% (driven by a 4.9% decline in Manufacturing output), Construction by 4.9% and Services by 0.8%.

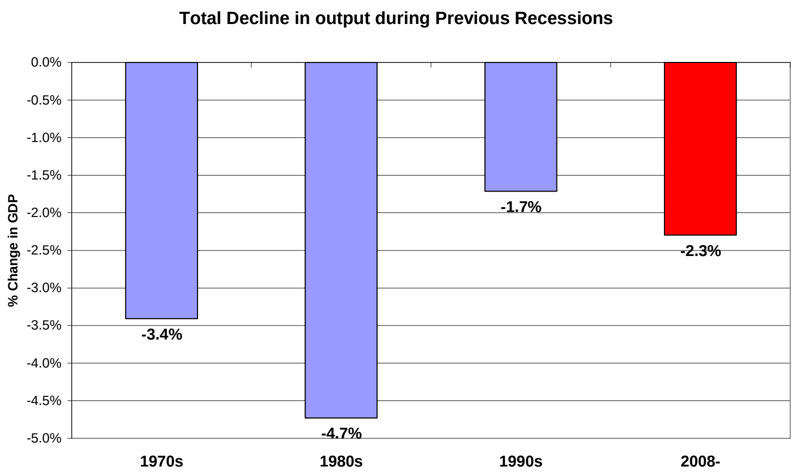
In the euro area, output declined by 1.6% during 2008 Q4, with the largest contribution coming from declines in investment and in net trade – the latter due to exports declining more rapidly than imports. However, changes in inventories made a positive contribution to euro area GDP growth indicating that at the end of 2008 firms were continuing to build up their stock levels.

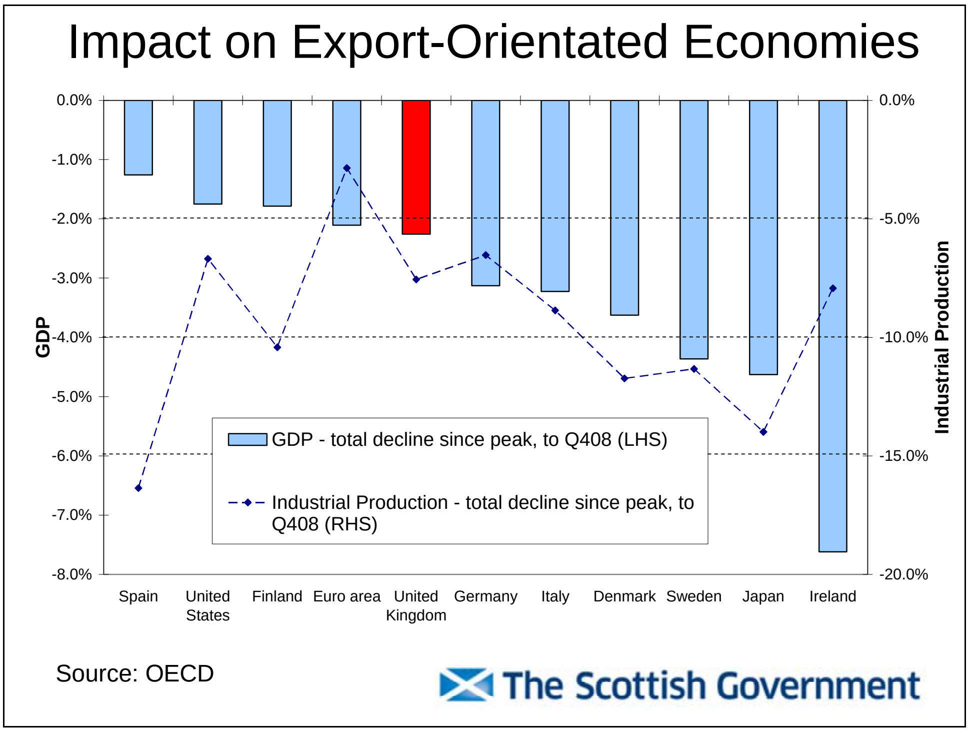


Initial falls in UK GDP similar to the 1980s recession

With UK GDP having now declined for two consecutive quarters, the initial impacts of the current recession can be compared with previous UK recessions in the 1970s, 1980s, and 1990s. To date, the cumulative falls in output during the current recession (2.3%) are considerably higher than the initial declines witnessed in the 1970s and 1990s recessions – and only marginally below the 1980s recession (where the cumulative decline in output during the first two quarters of the recession was 2.4%).

Of the most recent recessions in the UK, the 1980s recession resulted in the largest total decline in output – 4.7% in total over five consecutive quarters of negative GDP growth. The current cumulative contraction in GDP during 2008 Q3 and 2008 Q4 is already higher than the total decline during the 1990s recession (which also lasted for five quarters). It is worth noting that during the 1970s the UK entered into two periods of recession, 1973 Q3 to 1974 Q1 and 1975 Q2 to 1975 Q3 - the chart below only shows the cumulative impact of the initial recessionary period.





Impact on Export-orientated Economies

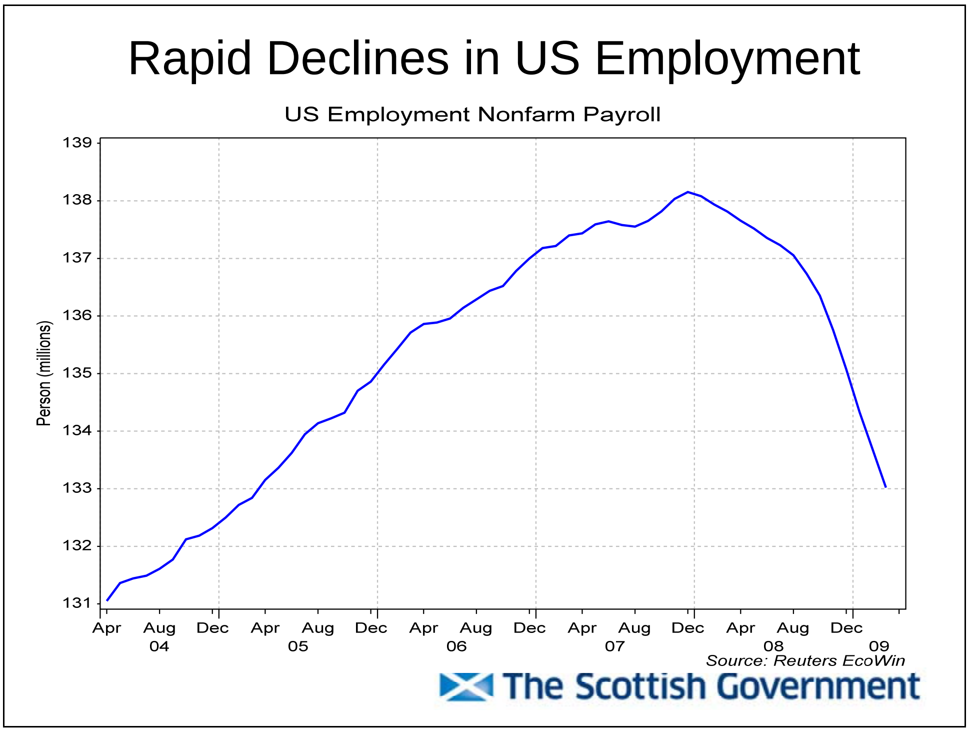
This chart plots the cumulative fall in GDP, and in industrial production, over the period from each country's peak level (i.e. the level prior to the contraction in output, and industrial production, respectively) to 2008 Q4. Only countries, which have been confirmed as being in recession have been included in the chart.

The initial impacts of the global slowdown have been strongest in the more export-orientated economies, which have been disproportionately affected by the collapse in global demand. This includes Japan, where output contracted by 3.2% during 2008 Q4, and Germany, where output fell by 2.1% over the same period.

Falling demand for exports is likely to be reflected in declining levels of industrial production. Japanese production had fallen by 14% from its peak to Q4 2008, and by 30% in the year to January 2009. German industrial production fell by almost 10% from peak to Q4 2008, and by 19% in the year to January.

However, it is important to note that whilst the export-orientated economies have been amongst the hardest hit by the slowdown, they are also likely to be the best placed to benefit from a recovery in global demand.

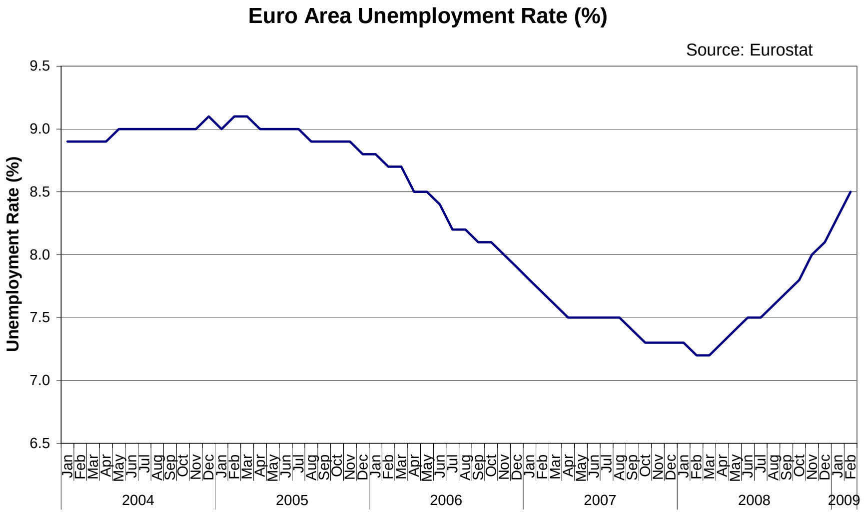
Economies with a relatively high reliance on construction (and housing) activity and the financial services sector have also been badly affected. However, in these countries a large fall in GDP may not go hand in hand with a significant decline in industrial production. An example is Ireland, where output has declined by 7.6% from its peak and where the unemployment rate increased to 10% in February 2009, but where industrial production has fallen by only 7% from peak to 2008 Q4. In contrast output in Japan has declined by 4.6% from its peak, but, in 2008 Q4, industrial production was 14% below its peak.

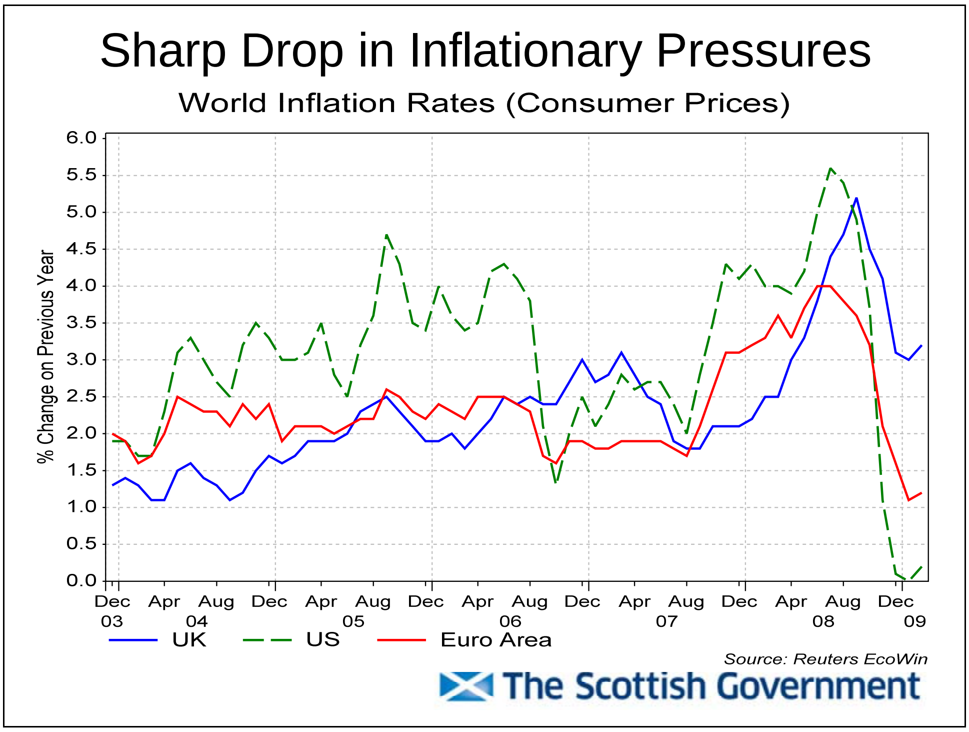


Continuing Declines in US Employment

The US economy fell into recession at the end of 2008. However, the economic downturn started to feed through to the US labour market in early 2008, as this marked the start of the decline in the number of people in employment. This decline accelerated towards the end of 2008 and during early 2009. During the first quarter of 2009, US employment fell by over 2 million, with an average of 685,000 jobs lost each month. As a result of the falls in employment there has been a sharp rise in unemployment, with the unemployment rate rising from 5.1% to 8.5% over the year to March 2009.

Unemployment rates in the euro area started to rise in early 2008, increasing from 7.2% in March 2008 to 8.5% in February 2009. The labour market impact of the economic downturn has varied between euro area economies, with rates increasing rapidly in Spain (up from 9.3% to 15.5% over the year to February) and Ireland (up from 4.8% to 10% in the year to February), whilst unemployment rates in Germany are relatively unchanged (7.4% in February 2009, compared to 7.6% a year earlier).



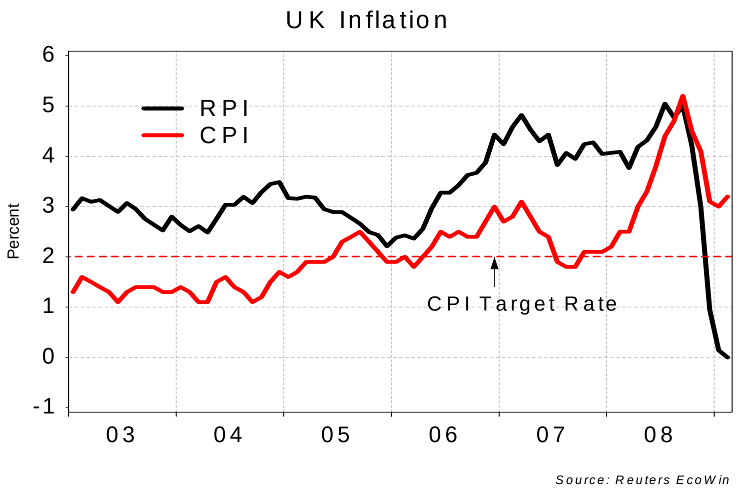


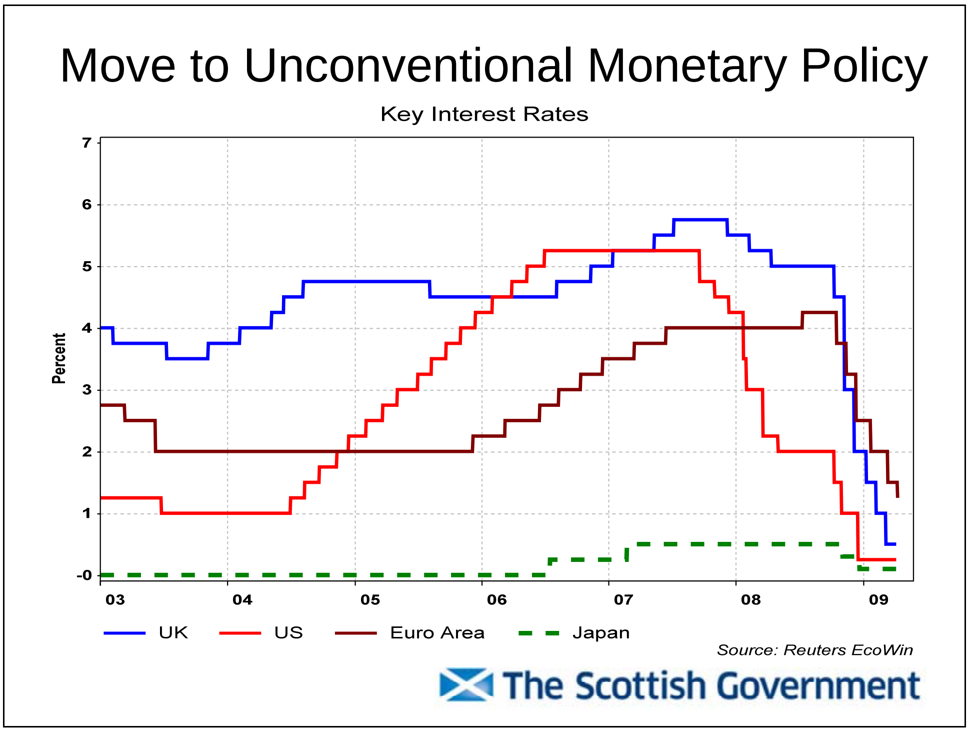
Sharp Drop in Inflationary Pressures

Inflation, measured through the Consumer Price Index (CPI), edged up slightly in February. Annual US inflation increased from 0.0% to 0.2% partly due to a substantial rise in gasoline prices, and increases in clothing prices. Annual euro area inflation increased from 1.1% in January to 1.2% in February – partly due to rising fuel costs as well as increased clothing prices. However, the expectation is for inflationary pressures to continue to fade in the short term as global demand slows.

Annual UK CPI inflation increased from 3.0% in January to 3.2% in February. Rising food and non-alcoholic beverage prices provided the main contribution to this increase. Part of the monthly rise reflects the increased price of imports, whilst there is also anecdotal evidence to suggest that some retailers reversed the 2.5% VAT cut in February. CPI inflation is currently above the UK Government's target rate of 2%. However, the Bank of England's central projection is for CPI to fall significantly below target in 2009, given weakening domestic and global demand.

Annual RPI (Retail Price Index) inflation, which unlike CPI includes house prices and mortgages, fell from 0.1% in January to 0.0% in February as falling mortgage interest payments and energy prices were partially offset by rising motoring and food prices.





Response to the Global Slowdown

Central banks throughout the world have continued to reduce interest rates in an attempt to improve the availability and price of credit, and to counter deflationary pressures. Interest rates have now reached historic lows in many economies. For example, the US Federal Reserve is currently targeting a rate in a range of 0.0% to 0.25%, the Swiss National Bank is targeting 0.25%, and the Bank of England has cut rates to 0.5%, the lowest in the Bank's 300 year history.

With interest rates nearing zero and with the traditional mechanism through which interest rates influence economic activity impaired by the on-going financial crisis, attention has turned to alternative monetary policy tools which central banks can use to further support the economy during the current downturn.

For instance, at its meeting on 5th March, the Bank of England's Monetary Policy Committee agreed to pursue a policy of "quantitative easing"; increasing the money supply to help meet the 2% CPI inflation target. It will do this by initially purchasing £75 billion of financial assets – mainly gilts – through the creation of central bank reserves. This is intended to stimulate lending and reduce bond yields, which should both ease firms' access to credit. In turn, this should boost economic activity, thereby mitigating the economic downturn; moving the economy towards recovery, and preventing deflation.

The first £2 billion of QE purchases was carried out on 11th March 2009. This prompted a significant fall in both government and corporate bond yields. Triple-A rated 10 year corporate bond yields stood at 4.19% on 6 April 2009, over 15% below their average in the 6 months to March.

An increasing number of central banks, including those in the USA, Switzerland and Japan, have announced a move to 'quantitative easing'. In contrast, Yves Mersch, from the European Central Bank, has said that the Bank's institutional architecture may make QE exceptionally hard to implement in the euro area.

World Output Forecast to Fall in 2009

Country	2009 (annual % GDP growth)	2010 (annual % GDP growth)
World	-1.0 to -0.5	1.5 to 2.5
Advanced Economies	- 3.5 to -3.0	0 to 0.5
United States	- 2.6	0.2
Euro Area	- 3.2	0.1
Japan	- 5.8	-0.2

Source: IMF, *Global Economic Policies and Prospects, 19 March 2009*

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World Output Forecast to Fall for the first time in 60 years

Ahead of the meeting of the G20 Finance Ministers and Central Bankers on 14th March, the International Monetary Fund (IMF) produced provisional forecasts for the global economy and a select number of advanced economies. These forecasts suggest that world output will contract between 0.5% and 1% in 2009 – the first such fall in 60 years. Output in the advanced economies is forecast to fall between 3.0% and 3.5% - with the largest impacts in Japan due to its reliance on exports, and also due to weak domestic demand. The IMF will publish a full list of forecasts on 22nd April 2009.

The OECD published an updated set of GDP forecasts for the G7 countries on the 31st March. They forecast that world output will decline by 2.7% in 2009. They have also forecast considerable falls in output in 2009 in G7 countries, particularly in the export-orientated economies, with output forecast to fall by 6.6% in Japan, and by 5.3% in Germany. The OECD forecast that the UK economy will decline by 3.7% in 2009 and by 0.2% in 2010.

Country	2009 GDP Growth Projection (%)	2010 GDP Growth Projection (%)
France	-3.3	-0.1
Germany	-5.3	0.2
Italy	-4.3	-0.4
Japan	-6.6	-0.5
Canada	-3.0	0.3
United Kingdom	-3.7	-0.2
United States	-4.0	0.0

Source: OECD, *Interim Economic Outlook*, March 2009

G20 London Summit – Key Announcements

Following their Summit on 2nd April 2009 the leaders of the G20 countries announced a $1.1 trillion programme of support “to restore credit, growth and jobs in the world economy” consisting of:

- An increase of up to $500 billion to the IMF to lend to struggling economies;
- $250 billion to boost world trade through the support of trade finance;
- Special Drawing Rights allocation for the IMF, which will increase global money supply by $250 billion; and
- $100 billion increase in lending by the Multilateral Development Banks to support low income countries.

Not all of the $1.1 trillion is “new money”, with some of the programme including previously announced actions. For example, it is reported that much of the $250 billion in trade finance will come from existing programmes of export guarantees.

The leaders stated that they are taking “unprecedented and concerted fiscal expansion” – which, by the end of 2010, will amount to $5 trillion and will raise output by 4%. However, whilst the G20 countries are “committed to deliver the scale of sustained fiscal effort necessary to restore growth”, there was no agreement on a new round of global fiscal stimulus measures. Members also reconfirmed their commitment to ensuring long-term fiscal sustainability and price stability.

Measures were introduced to strengthen financial supervision and regulation, including the establishment of a new Financial Stability Board (FSB), which will have a stronger mandate than the current Financial Stability Forum. Regulation and oversight will be extended to all “systemically important financial institutions, instruments and markets”, which includes hedge funds.

The Leaders stated that they “will not repeat the historic mistakes of protectionism of previous eras”, and agreed to refrain from raising new barriers to investment or to trade in goods and services.

Discretionary Stimulus Packages

Stimulus Packages in the G7 Countries (% of GDP)				
	2008	**2009**	**2010**	**Total**
Canada	0.0	1.5	1.3	2.7
France	0.0	0.7	0.7	1.3
Germany	0.0	1.5	2.0	3.4
Italy	0.0	0.2	0.1	0.3
Japan	0.4	1.4	0.4	2.2
United Kingdom	0.2	1.4	-0.1	1.5
United States	1.1	2.0	1.8	4.8
G7 – Unweighted Average	0.2	1.2	0.9	2.3

Source: IMF (2009) – The Size of the Fiscal Expansion: An Analysis for the Largest Countries
Results may not sum due to rounding

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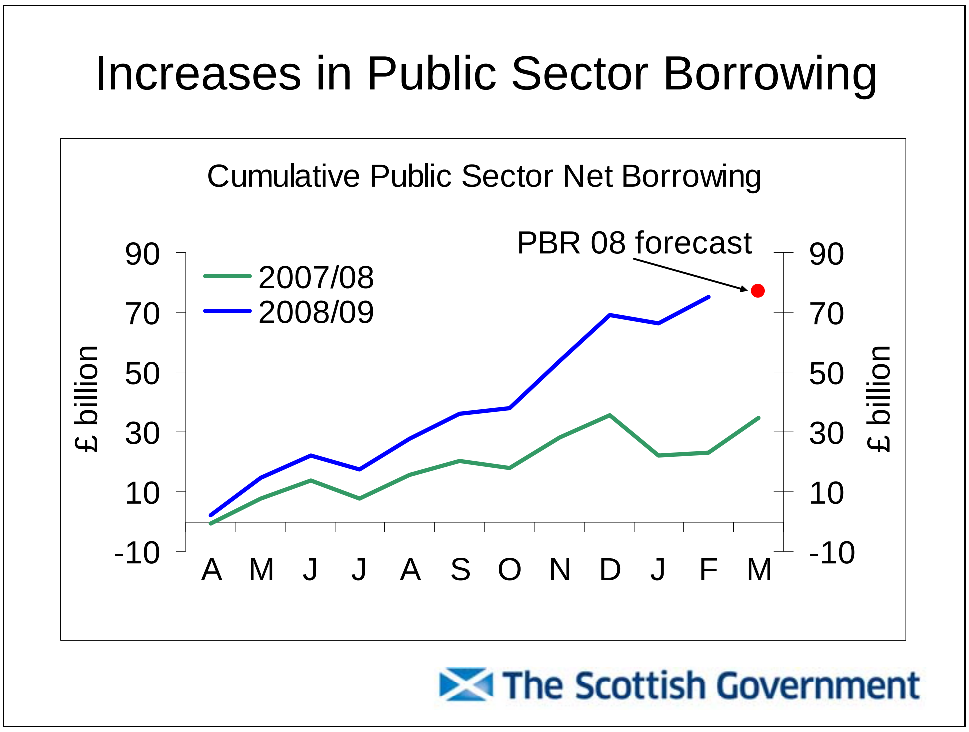
Fiscal Stimulus Packages

The IMF has analysed the discretionary fiscal stimulus packages introduced by G20 countries. They report that the UK fiscal stimulus is equal to approximately 1.5% of GDP over the period 2008 to 2010. This is lower than the stimulus packages introduced in a number of other countries over the same period, including the United States (4.8%), Germany (3.4%) and Canada (2.7%).

However, during a downturn government spending generally rises due to increased social benefits payments (as unemployment increases) and falling tax revenues. These effects are referred to as 'automatic stabilisers', the size of which varies between economies, and reflects the relative generosity of social protection schemes – they tend to be higher in European countries and lower in the US. The IMF suggests that when estimates of the automatic stabilisers in each country are added to the announced discretionary measures, the gap in government spending across G7 countries narrows in 2009, with the UK only slightly below the US.

Estimated Size of Automatic Stabilisers and Discretionary Measures in the G7 (% of GDP)		
	2008	**2009**
Canada	0.8	2.9
France	0.6	2.6
Germany	-0.2	3.2
Italy	0.6	1.6
Japan	1.0	2.8
United Kingdom	0.9	3.4
United States	1.5	3.5
G7 – Unweighted Average	0.7	2.9

Source: IMF (2009) – Global Economic Policies and Prospects and IMF (2009) – The Size of the Fiscal Expansion: An Analysis for the Largest Countries.



Public Sector Borrowing to continue to increase

The UK public sector finances continued to deteriorate in February. Public Sector Net Borrowing (PSNB) was £9bn in February 2009 - nearly £8bn higher than in the same month last year. Tax receipts were almost 10% lower in February 2009 compared to February 2008, due mainly to lower VAT revenues. Government expenditure also increased by 6.5% over the same period.

Cumulative net borrowing in the financial year to end of February 2009 stands at £75bn – and on current trends the Institute for Fiscal Studies estimate that this is likely to rise to £95bn for 2008/09, around £17bn more than forecast at November's PBR. As a share of national income, this would be the highest level of annual public sector net borrowing for 15 years. At the end of February, UK net debt increased to 49% of GDP (excluding the re-allocation of bank liabilities).

The IMF has estimated that the UK and the US will face the largest increases in their fiscal deficits due both to the impacts of the economic downturn, and to the costs of discretionary fiscal stimulus and automatic stabilisers.

Fiscal Balance in G7 Countries (% of GDP)

	2007	2008	2009	2010
Canada	1.4	0.4	-3.2	-3.7
France	-2.7	-3.1	-6.0	-6.2
Germany	-0.2	-0.1	-4.0	-5.2
Italy	-1.5	-2.7	-4.8	-5.2
Japan	-3.4	-5.0	-8.1	-8.3
United Kingdom	-2.7	-5.5	-9.5	-11.0
United States	-2.9	-5.9	-7.7	-8.9

Source: IMF (2009) – Global Economic Policies and Prospects

Summary of Global Developments

- Synchronised decline in output, with export-orientated economies hardest hit
- Continued declines in employment and sharp rises in unemployment
- Slight rise in inflation, but expectation is for inflationary pressures to continue to ease
- Move to unconventional monetary policy
- Substantial declines in output forecast for 2009 and very modest growth in 2010

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Summary of Global Developments

As global economic conditions have deteriorated, governments across the world have responded with unprecedented policy action. The initial response focused on measures to stabilise the banking system and traditional monetary policy measures such as reductions in base interest rates. More recently this has been supported by additional fiscal measures introduced to stimulate economic activity and more unconventional monetary policy measures. However, there will be a time-lag before these measures fully impact on economic activity.

The focus has now turned towards estimating the duration and depth of the global economic downturn and to understanding what implication the restructuring of economies across the world will have on long-term growth rates. This requires a number of key questions to be examined and monitored in the coming months to consider the implications for Scotland of developments in the global economy:

- What is the likely shape of the recession – its duration, depth and the rate of recovery?
- How rapidly and effectively will the global stimulus measures impact on global confidence and recovery?
- How rapidly will financial sector stability and the supply of credit be restored?
- Once financial stability develops, how rapidly will household and corporate confidence, and the demand for credit pick up?
- How rapidly will Scotland’s key international markets recover from the global recession?
- What will the global recession imply for Scotland’s long term competitiveness?

Developments in the Scottish Economy

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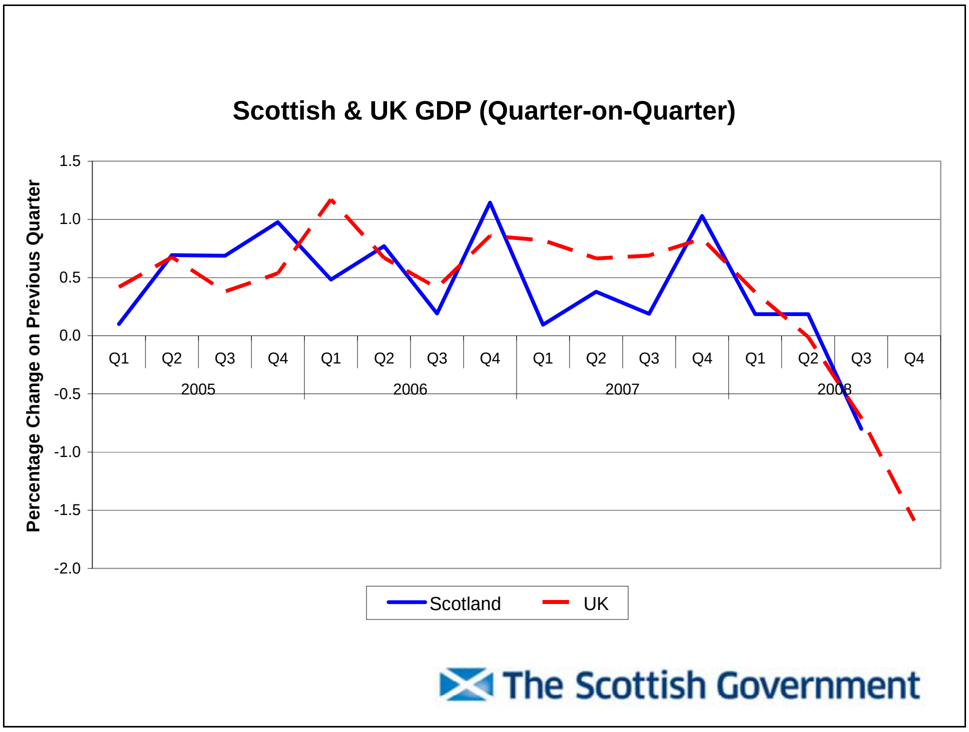


Sharp Decline in Scottish GDP

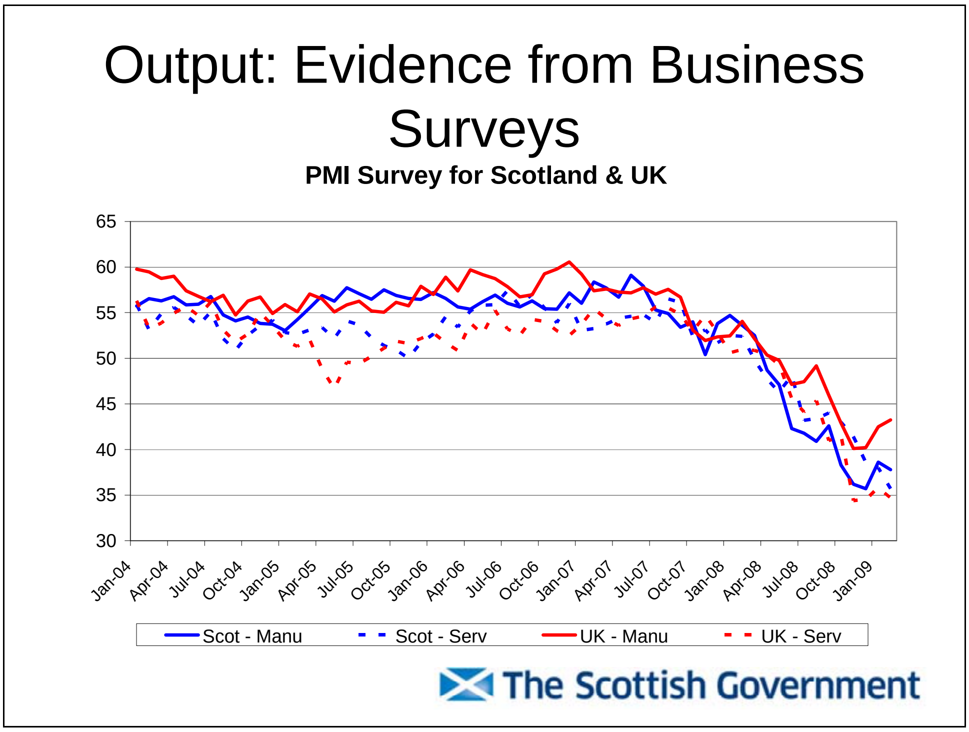
From the end of 2007, the growth in Scottish GDP has continued to slow, and output contracted sharply in 2008 Q3 by 0.8% on the previous quarter. This slowdown has been broadly in line with the UK economy, which experienced a decline in GDP in 2008 Q3 of 0.7%, followed by a 1.6% decline in the final quarter of 2008. Over the year to 2008 Q3, Scottish GDP rose by 1.4% compared to 2.0% growth for the UK as a whole.

The decline in Scottish GDP in 2008 Q3 was driven by the service sector, which experienced its sharpest quarterly contraction - by 1.1% - since the series began in 1995. Although the financial services sector grew marginally during 2008 Q3 (by 0.5%), it has declined by 4.8% over the year. Within the service sector real estate and business services output was the worst hit over the quarter, falling by 3.7%.

The construction sector in Scotland has weakened over the past year, and was down 1.0% over 2008 Q3. Over the year, there has been a divergence between the performance of the construction sector in Scotland compared to the UK, with contraction in Scotland and expansion in the UK. Elsewhere, the production sector has experienced growth over the quarter, mainly due to the sharp recovery of the Electricity, Gas and Water Supply sector, which has returned to 2006 levels of output. However, manufacturing output declined by 0.6% during the 2008 Q3.

The decline in Scottish GDP over 2008 Q3 reflects the challenging conditions in the global economy and is broadly in line with the declines in activity experienced by other economies (for example, Germany and Japan both contracted by around 0.5 percent in 2008 Q3).

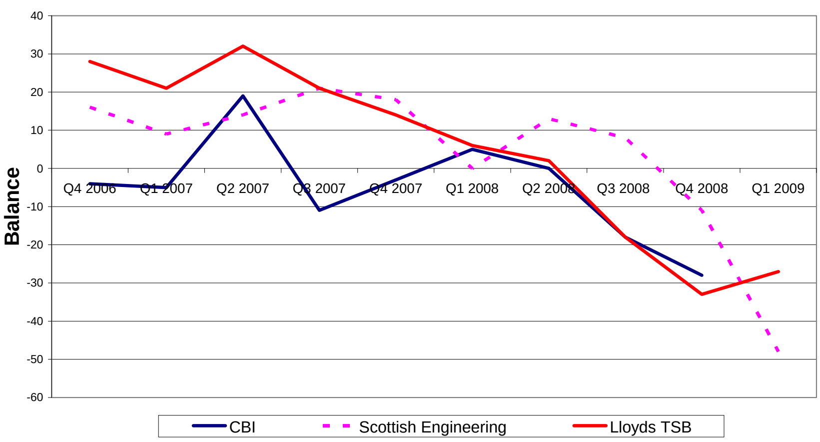
2008 Q4 GDP data for Scotland will be published on 22nd April, and it is anticipated that this release will confirm that the Scottish economy was in recession in late 2008.



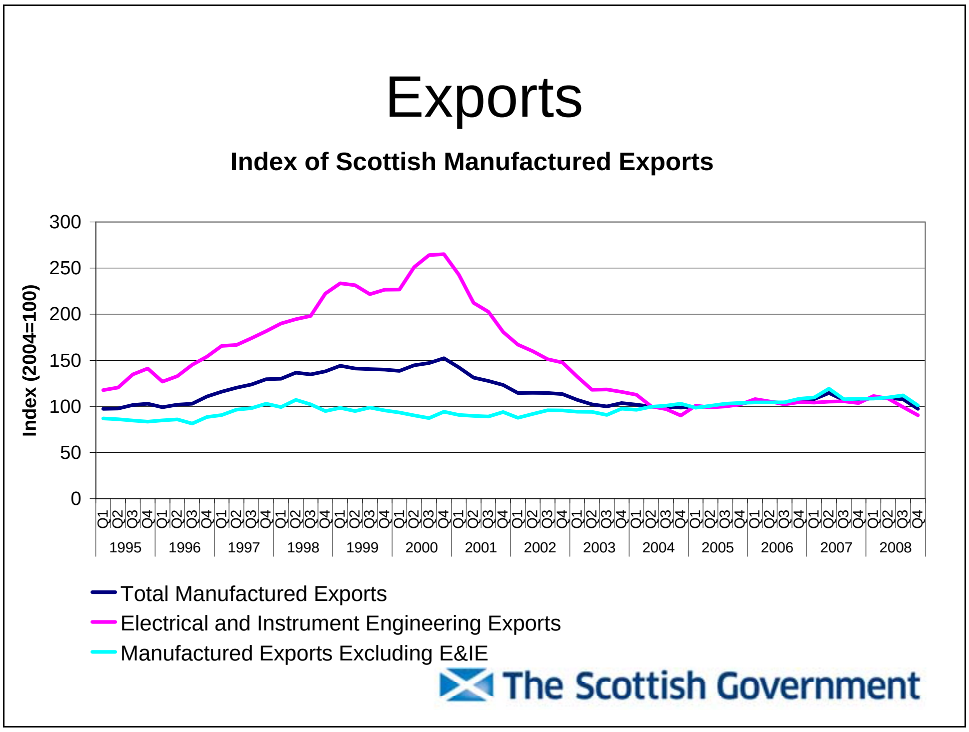
Output: Evidence from the Backward-Looking Business Surveys

The Purchasing Managers' Index indicates the level of economic activity in the private sector. A figure below 50 suggests the private sector is contracting, and a figure above 50 suggests expansion. The latest results for Scotland and the UK, for February 2009, indicate that private sector output has fallen sharply over the year, with the Scottish figure falling from 53.1 to 36.8. The slight recovery in the PMI index in January 2009 was short-lived, with the survey now again reporting record declines in private sector output.

Business Surveys: Volume of Output



The Scottish Engineering Quarterly review and the Lloyds TSB Business Monitor for Q4 09 both report a similar decline in output to the PMI, although the Lloyds TSB survey has indicated that private sector output declined at a slightly slower rate than in Q4 08.



Decline in Scottish Manufacturing Exports

The international financial crisis has severely affected Scotland's key export markets. The largest consumers of Scottish exports – the UK and USA – saw GDP decline by 1.6% in 2008 Q4. Amongst Scotland's top five export markets, GDP contracted by 7.1% in Ireland, by 2.1% in Germany, by 1.1% in France, and by 1.0% in the Netherlands in 2008 Q4. The European Union, destination for over 45% of all Scotland's exports in 2007, saw a contraction of 1.6% over 2008 Q4.

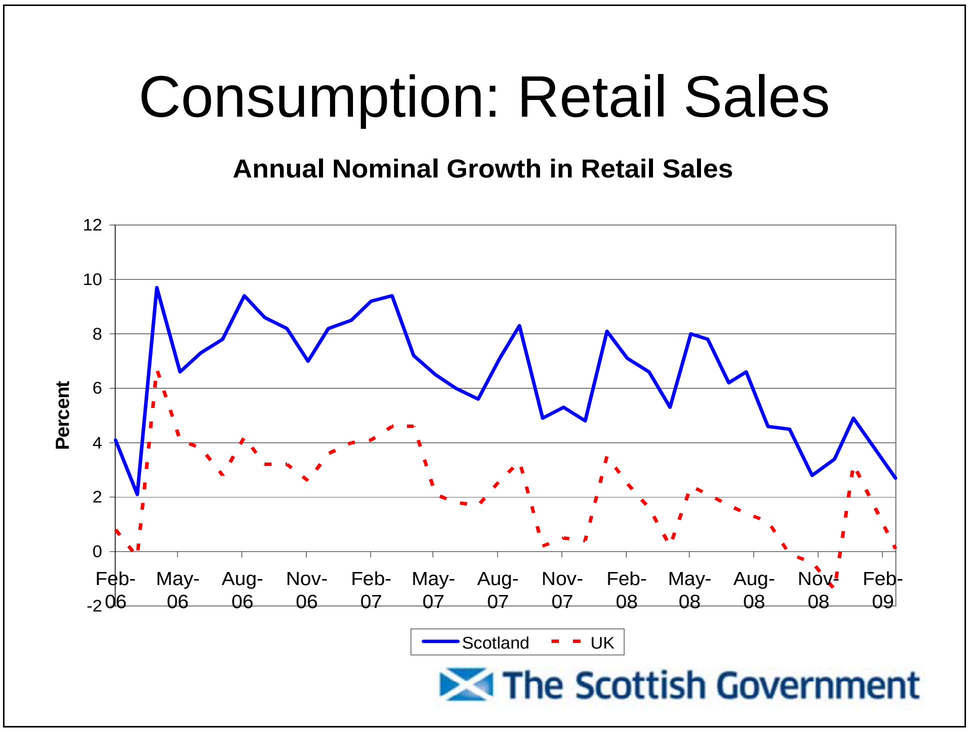
These factors contributed to a quarterly decline in Scottish manufactured exports, by a real, seasonally adjusted 9.6% in 2008 Q4. This follows a quarterly fall of 1.0% in 2008 Q3. Comparing the most recent four quarters with the previous four, exports fell by 2.8%. These statistics indicate that the beneficial effects of recent sterling depreciation were outweighed by a decline in external demand.

Comparing quarter four with the previous quarter, the seasonally-adjusted value of exported goods fell by 16% in Japan, by 20% in Germany, and by 21% in the euro area. The equivalent figure for the UK was 24%. Although these OECD data are not directly comparable to Scotland's IME, they illustrate the extent to which falling demand has hit exports globally.

Scotland's Key Non-UK Export Markets - 2007

Rank	Destination	Total Export Value (£m)	Share of Scottish exports
1	USA	2765	13%
2	France	1475	7%
3	Netherlands	1420	7%
4	Germany	1335	6%
5	Eire	1040	5%
6	Spain	895	4%
7	Italy	685	3%
8	Belgium	510	2%
9	Switzerland	485	2%
10	Norway	485	2%

Source: Scottish Government Global Connections Survey



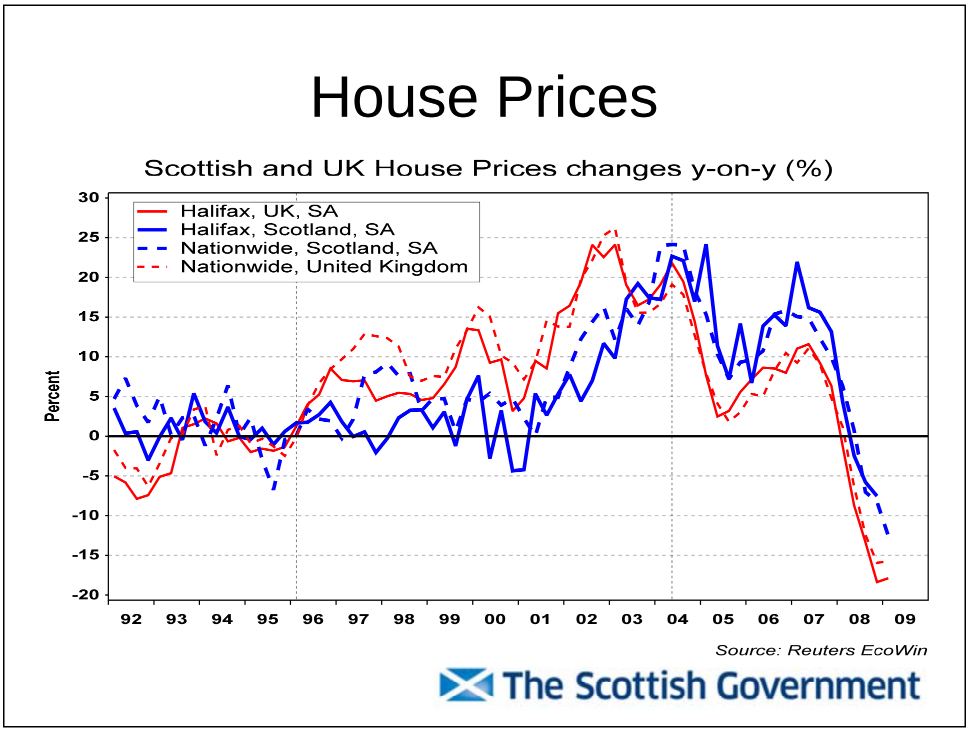
Consumption: Retail Sales

The latest Scottish Retail Consortium Retail Sales Monitor reported that retail sales, an indicator of consumer spending, grew by 2.7% in February 2009 compared to a year ago.

The equivalent figure for the UK was an increase in retail sales of 0.1% in February 2009 compared to a year earlier.

February's growth rate was the lowest since early 2006 and was primarily driven by strong growth in the food sector which grew by 9.7% compared to February 2008. Non-food sales actually declined by 3.8% compared to the previous year. This represents the biggest fall in over nine years, and confirms that January's surprise sales-led improvement in retail sales was not sustainable.

The growth in retail sales is in nominal terms (i.e. not accounting for inflation). However, given that RPI was 0.0% in February 2009, the 2.7% rise represents the real value of retail sales in February 2009.



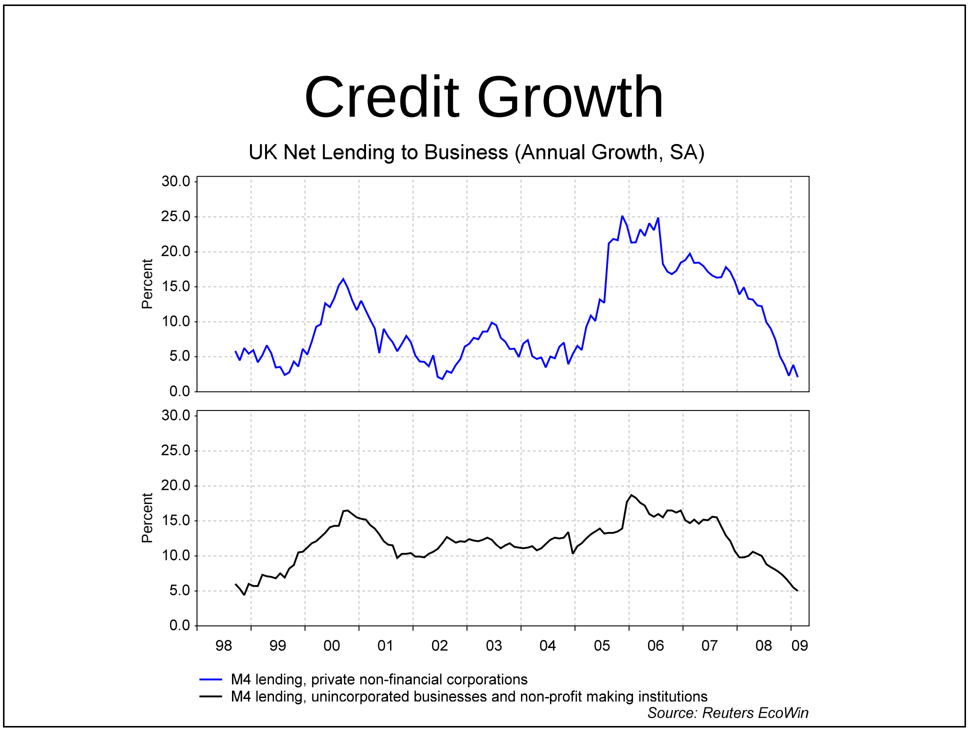
House Prices

The graph illustrates clearly the more rapid growth of UK house prices over the 1996-2003 period compared to those in Scotland, reflecting the familiar pattern of earlier cycles. From late 2003, as UK price increases slowed sharply, Scottish price increases exceeded those in the UK.

Notwithstanding the decreasing growth rate, until the middle of 2008 Scottish house prices appeared relatively resilient. However, since this point house prices have declined significantly. After revising their data downwards, the Department for Communities and Local Government (DCLG) now note that August 2008 was the month when annual house price changes first became negative in Scotland (a fall of 0.2%).

House prices in Scotland have continued to trend downwards. According to the range of available sources, prices had fallen between 3% and 8% in 2008 Q4, compared to a year earlier. The latest data from Nationwide, covering the first quarter of this year, show that the fall in Scottish house prices may have accelerated, and are now closer to the UK average. According to this source, over the year to 2009 Q1 prices fell by 12.6% in Scotland compared to 16.5% UK-wide.

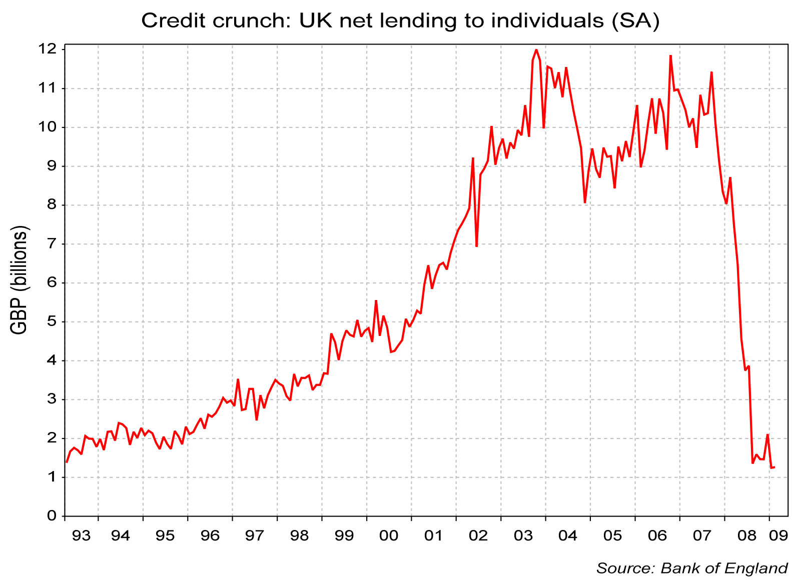
Both Scotland and the UK have experienced a significant slowdown in housing market activity. The Council of Mortgage Lenders report that Scottish mortgage approvals for house purchase – a proxy for housing market activity – were down by 52% in 2008 Q4 compared to a year earlier. The equivalent figure for the UK was a reduction of 53%.



Credit Conditions in the UK

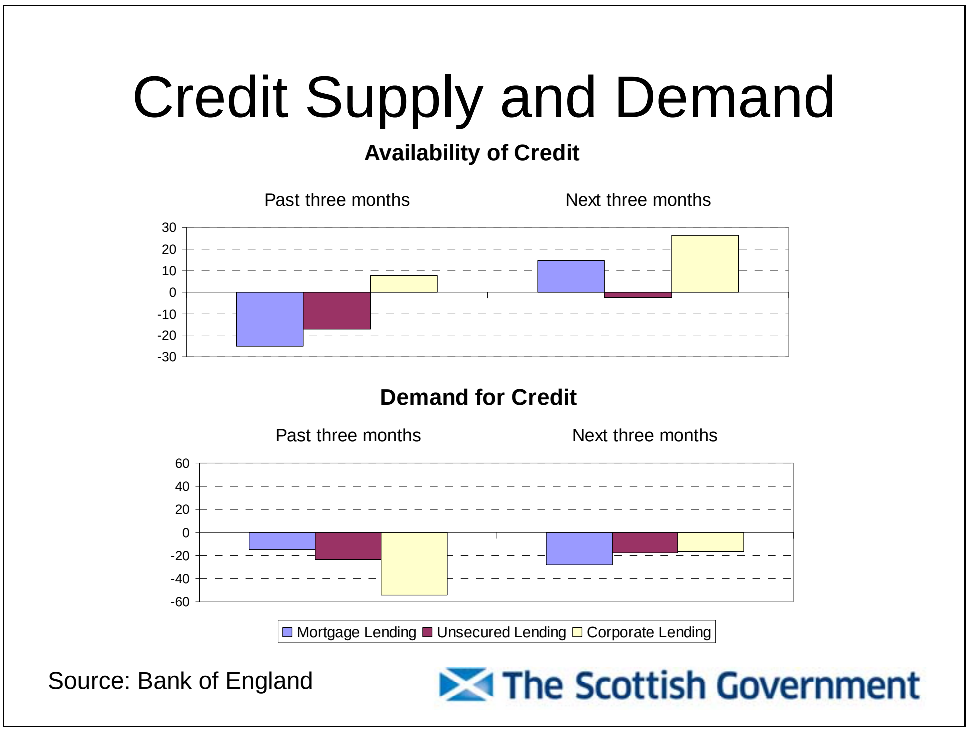
Since 2006, the rate of lending to businesses[1] (both large and small) has declined, with this decline accelerating since the start of the credit crunch in mid-August 2007. The rate of lending has declined further since the credit crunch intensified at the end of September 2008.

There has also been a significant reduction in the value of net lending to individuals[2] from the beginning of the credit crunch in mid-August 2007. This partly reflects the significant slowdown in the number of new mortgages taken out in the past year.



[1] Net lending to businesses refers to gross lending less loan repayments and other adjustments (e.g. for bad debt write-offs).

[2] Net lending to individuals refers to gross lending less loan repayments. This captures mortgage and credit card lending. For more information, see the following link:
http://www.bankofengland.co.uk/statistics/li/lending_to_individuals.pdf



Demand & Supply of Credit in the UK

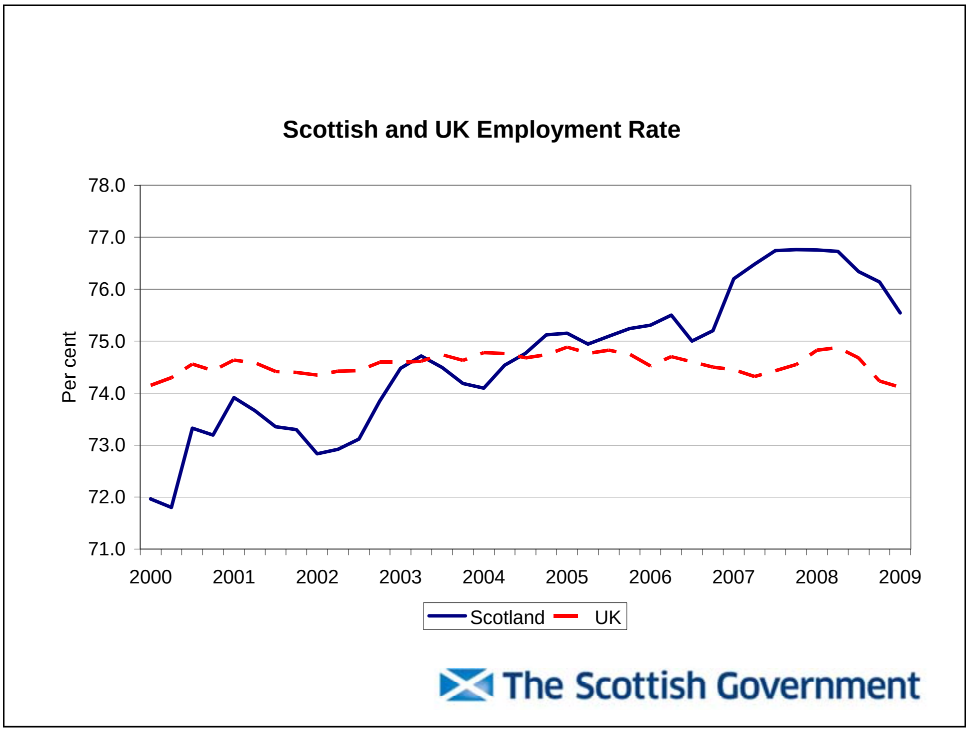
The deceleration in the growth of credit can be broken down into a reduction in both the availability of credit, and in the demand for credit. The Bank of England Credit Conditions Survey indicates that, in 2009 Q1, lenders further restricted mortgage availability, and reduced the level of unsecured credit to households and small businesses. A reduced appetite for risk and expectations of falling house prices were cited as the factors driving down lending. However over the same period corporate credit availability increased slightly, contrary to expectations and for the first time since mid-2007.

Household demand for secured credit for house purchase and remortgaging was reported to have declined by less than expected over the three months in 2009 Q1. Demand for remortgaging fell particularly sharply, which some lenders indicated may be due to low standard variable rates reducing the incentive to remortgage when current deals expire. Looking forward, a net balance of lenders expect to increase the availability of both mortgage and corporate lending, as a result of improvements in the cost of their funds.

Despite this increase in supply lenders expect demand for credit to continue falling for most firms and households, as activity in the real economy contracts.

Demand & Supply of Credit in Scotland

There are limited data on the availability and demand for credit in Scotland. Recent business surveys highlight that private sector concerns over the availability of credit remain at historically high levels. The reduction in lending has also been due to a reluctance to borrow due to uncertainty over the economic outlook. Furthermore, the surveys reveal that despite a rise in the cost of borrowing for Scottish businesses, it was concerns over the economic outlook rather than the cost of borrowing which was affecting demand for credit from Scottish businesses.



Employment Rate

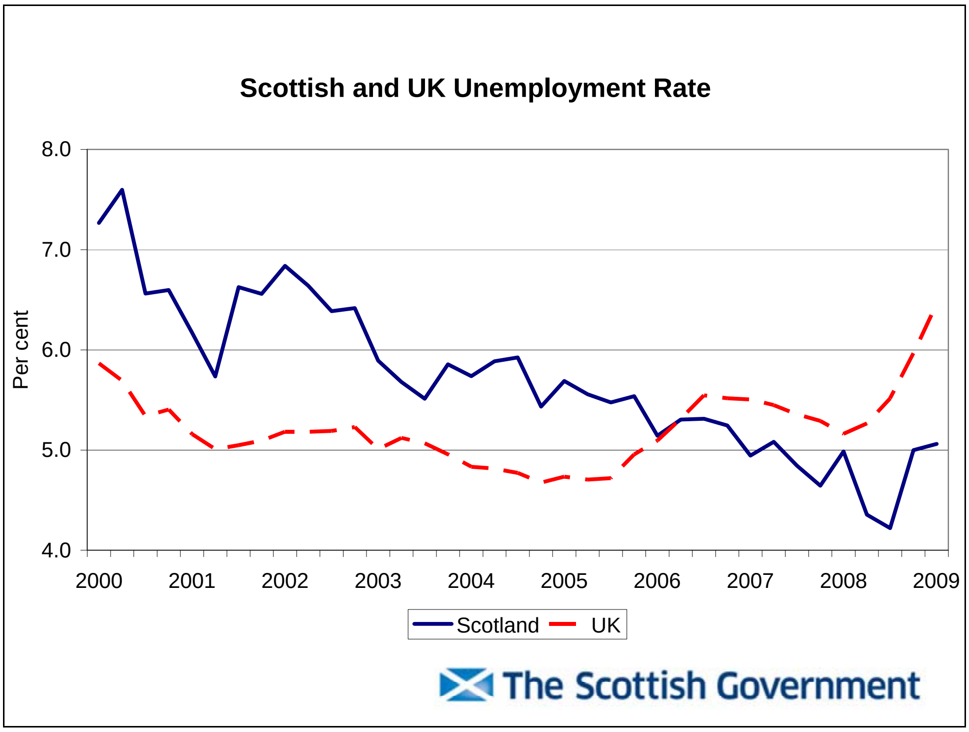
The Scottish labour market has demonstrated considerable strength in recent years and remains buoyant relative to both historical standards and relative to most countries and regions of the EU. However, the labour market has displayed recent signs of weakening, as the effects of the global downturn are now being felt in Scotland.

The chart shows that in 2007, Scotland's employment rate peaked at around 77% compared with 74.9% in the UK as a whole. Although the employment rate has since fallen to 75.5% in the November – January 2009 quarter, it remains historically high.

The Scottish rate has remained consistently above the employment rate in the UK (74.1% in the November – January 2009 quarter) and other parts of Europe, in recent years. The rate in Scotland exceeded that of the UK for the first time in mid-2003 and a gap of around 1.0 percentage points has since been maintained.

In the November – January 2009 quarter working age employment in Scotland stood at 2,428,000, with a fall in employment of 18,000 quarter-on-quarter and 37,000 year-on-year. Working age employment in the UK declined by 8,000 over the quarter and by 141,000 over the year and now stands at 28,039,000.

In terms of employment in the different sectors of the Scottish economy, over the year to December 2008 employment in Manufacturing, and in the Mining, Energy & Water Supplies have experienced the largest decline, falling by 3.4% and 2.6% respectively. Distribution, Transport, Finance & Business services, the largest sector in terms of employees, fell by 2.2% in the year to December 2008.

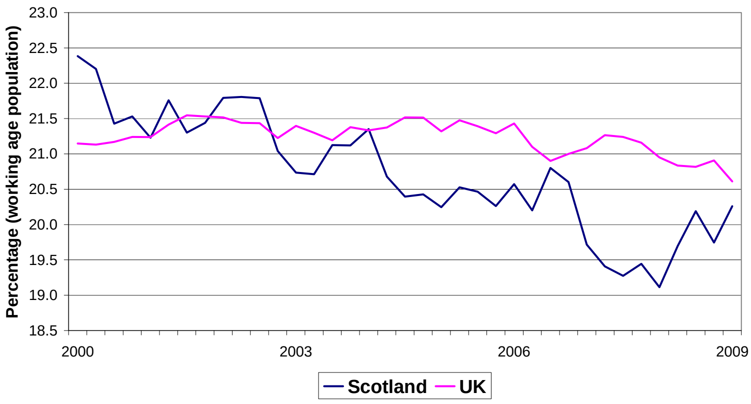


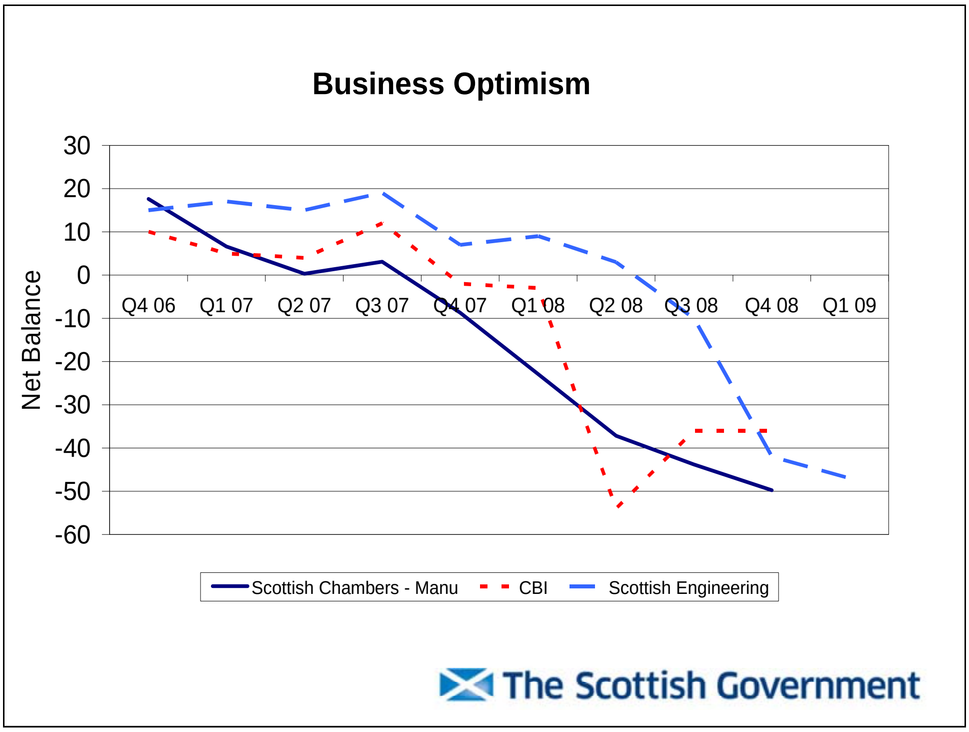
Rise in Scottish Unemployment

Unemployment in Scotland has continued to rise since Spring 2008, with the latest figures showing that working age unemployment increased by 1,000 in the November – January 2009 period, a 0.1 percentage point rise in the unemployment rate compared to the previous three month period. Over the year, unemployment in Scotland has risen by 3,000. The Scottish unemployment rate, which is currently 5.1%, is still low by historical standards and remains considerably below a number of advanced economies including the UK (6.5%).

The reduction in employment numbers over the year has led to both an increase in those moving into unemployment (not in employment but actively seeking work), but also an increase in people moving into economic inactivity (not in employment and not actively seeking work). The Scottish economic inactivity rate has risen by 0.5 percentage points over the three month period November-January 2009 and by 1.2 percentage points over the year. Despite this increase, the inactivity rate in Scotland currently stands at 20.3% which compares favourably to historic levels. This contrasts with the experience in the UK as a whole, where the economic inactivity rate declined by 0.3 percentage points over the quarter to 20.6%.

Economic Inactivity Rates Nov-Jan 2000 to Nov-Jan 2009

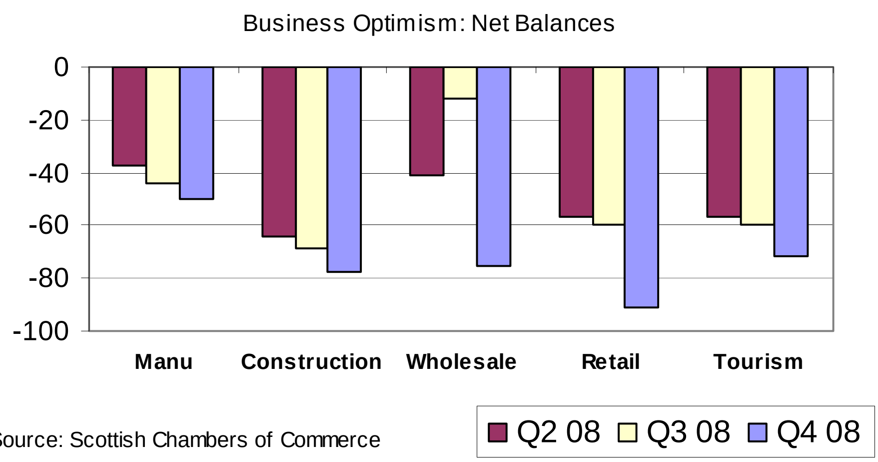




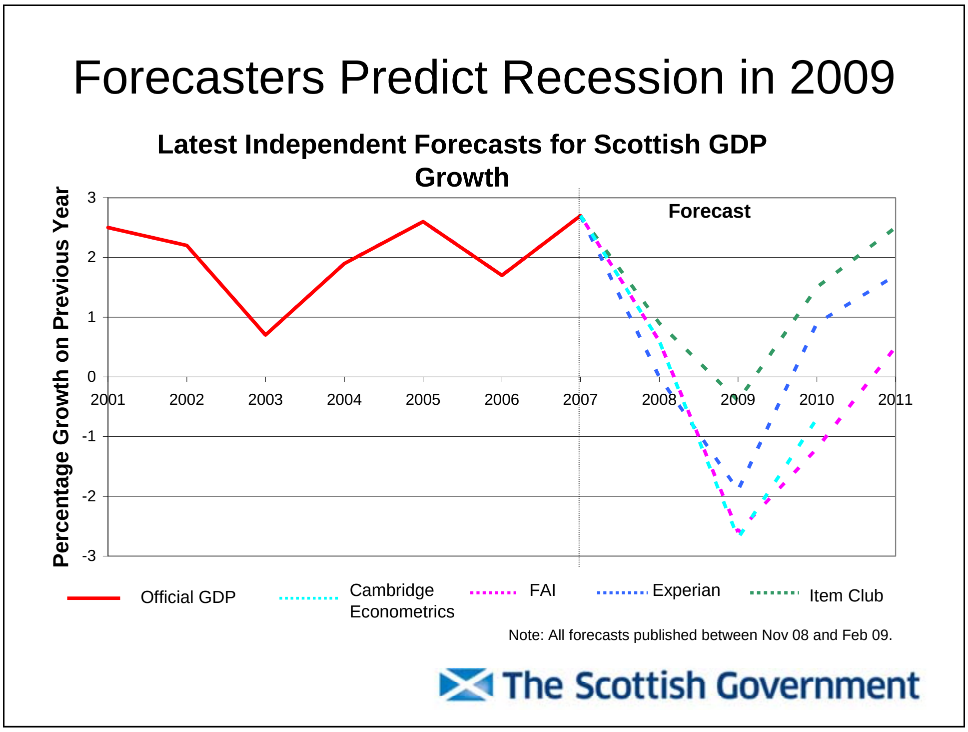
Business Optimism

Over the past year, there has been a clear deterioration in business optimism regarding both current economic conditions and the conditions expected in the future. The forward-looking business surveys have highlighted that this is due to concerns over the global economic slowdown and tighter lending conditions as a result of the international financial crisis. The Scottish Engineering Quarterly Review showed a rapid deterioration in optimism in the last quarter of 2008, with further declines in 2009 Q1 taking levels close to a ten year low.

This deterioration in business optimism has been evenly spread across businesses in all sectors of the Scottish economy, as highlighted by the latest Scottish Chambers of Commerce Business Survey.



Source: Scottish Chambers of Commerce

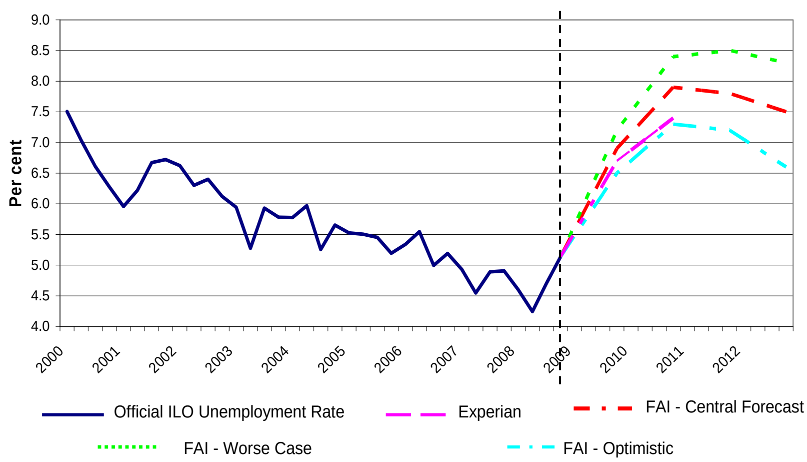


Forecasts for Scottish GDP Growth

The latest forecasts from both the Fraser of Allander Institute (FAI) and from Cambridge Econometrics predict a deeper and more prolonged recession compared to their previous forecast back in late 2008. FAI's central projection is for Scottish GDP to contract by 2.6% in 2009 and by 1.2% in 2010, before recovering in 2011 with growth of 0.5%. The decline in Scottish GDP is projected not to be as marked as for the whole of the UK, due to a less pronounced property bubble, a larger public sector and relatively larger welfare payments. The recent forecasts from Cambridge Econometrics, released in March 2009, project similar levels of decline as the FAI, with the Scottish economy forecast to contract by 2.7% in 2009 and by 0.7% in 2010.

The FAI also forecast further weakening in the Scottish labour during 2009 and 2010. Under their central projection, they forecast that Scottish unemployment rates will rise to 7.9% in 2010.

Forecast Unemployment Rates for Scotland



…the evidence of economic downturn

Recent expenditures		
	Current strength ?	**Current trend ?**
GDP	*considerably below potential growth rate*	*declining*
Business activity (PMI)	*very weak*	*recent sharp falls*
Consumption: retail sales	*flat in real terms*	*slight increase*
Government expenditure	*low real growth compared to 2000/7*	*flat*
Exports (manufactures)	*flat real growth 2004/8*	*decline over quarter*
Labour market		
	Current strength ?	**Current trend ?**
Employment	*strong*	*declining*
Unemployment	*strong*	*increasing*
Inactivity	*relatively good*	*increasing*
Other indicators		
	Current strength ?	**Current trend ?**
Housing market: transactions	*around half level of a year ago*	*sharp falls*
Housing market: prices	*clearly below peak*	*falling*
Credit: availability	*constrained*	*easing of rate of decline*
Credit: cost	*high relative to base rates*	*falling*
Future expenditures		
	Outlook ?	
GDP forecasts	*sharp downward revisions: -0.4% to -2.7% (2009)*	
Business confidence/optimism	*sharp falls: net balances in range of -40 to -50*	
Consumption: cons. confidence	*sharp falls: net balances around -30*	
Government expenditure	*weak real growth*	
Exports	*weakening*	

The Scottish Government

Assessment of the Current Performance of the Scottish Economy

We can assess the performance of the Scottish economy in terms of two dimensions:

1. the current ***level*** of performance for key indicators compared to their historical levels and
2. the current ***trend*** in these key indicators over recent months (i.e. rate of change).

This table highlights that the level of a number of key indicators compares favourably to previous performance (particularly in the labour market), but the recent trend has been for flat or a weakening in performance. Further weakening is expected in the coming months, as the pace of the global economic downturn is expected to accelerate.

Summary of Scotland’s Economic Performance

- Evidence suggests that the Scottish economy has been in recession since mid-2008
- Future growth expectations across the world have been revised down repeatedly and significantly over the past year, not least in the UK
- Decline in output is expected to continue throughout 2009 and into 2010
- Employment has declined in recent months and is expected to continue to decrease through 2009 and 2010. This will be reflected in continuing upward trends in both unemployment and economic inactivity.
- Impact of the international monetary and fiscal response will be key as weak levels of global demand will continue to depress economic activity in Scotland

The Scottish Government

Summary of the Performance of the Scottish Economy

There is clear evidence that Scotland’s economic performance weakened in the second half of 2008, reflecting the weaker conditions in the global economy. Future growth expectations across the world have been revised down repeatedly and significantly over the past year, not least in the UK.

Output in the Scottish economy contracted sharply in the third quarter of 2008 and the backward-looking business surveys highlight that Scottish firms have reported further declines in output in late 2008 and early 2009. Evidence suggests that the Scottish economy has been in recession since mid-2008.

This decline in economic activity has resulted in Scottish firms reducing their workforce and has had an increasingly marked impact on the labour market data. Working age employment in Scotland declined by 18,000 in the period November – January 2009 compared to the previous three month period. This was reflected in modestly rising unemployment in the quarter of 1,000, but equally importantly, in rising economic inactivity which rose by 17,000 over the quarter. The business surveys and independent economic forecasts suggest that further declines in employment can be expected in the coming months, with the unemployment rate potentially rising to between 7.5% and 8.5% in two years time.

The independent forecasters and the available survey evidence also suggest that the decline in economic activity will continue into 2009 - with the latest forecasts from the Fraser of Allander Institute and Cambridge Econometrics suggesting a fall of between 2.6% to 2.7% - which may spill over into 2010. However, there is still a significant degree of uncertainty over these forecasts and the scale of the downturn in the Scottish economy and the timing of the recovery will depend upon:

1. when credit conditions begin to improve;
2. the length and depth of the global economic downturn; and
3. the impact of the fiscal and monetary response across the global economy.

State of the Economy

Dr. Andrew Goudie
Chief Economic Adviser
9 April 2009

All feedback or comments on this presentation would be warmly welcomed.

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The Scottish Government