National Australia Bank

April 2007

Scotland economic report

Executive summary

The services sector remains the main driver of growth in the Scottish economy. The regional economy is forecast to outperform its long term trend during 2007 and 2008, but underperform the UK average.

Key trends

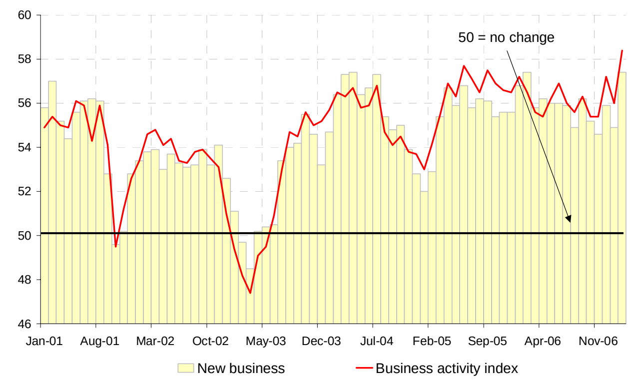
- **The Scottish economy is forecast to outperform its long-term average over the next two years.** Moderate growth is expected in the Scottish economy in the near term. We are forecasting growth of 2¼-2½% and 2-2¼% in 2007 and 2008 respectively.

- **Services continues to be the main driver of growth.** Survey data indicates that growth in services in early 2007 has remained robust, while growth in manufacturing has moderated from its recent high in mid-2006.

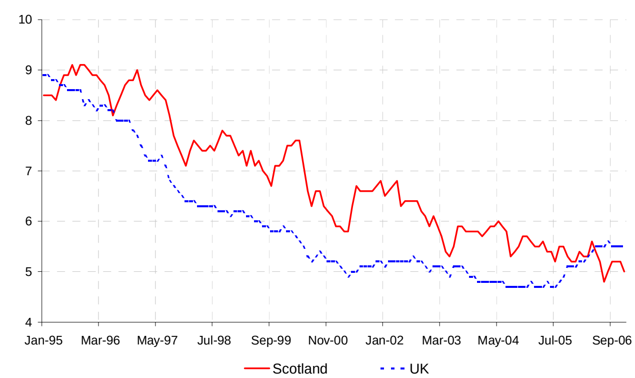
- **Job creation in services has offset declines in manufacturing employment.** The Scottish labour market remains tight, with the employment rate high and the ILO unemployment rate close to record lows. The Scottish unemployment rate is now below the UK average.

- **House price inflation picks-up.** The Scottish housing market has gathered momentum, with annual growth in house prices up by 19.5% in December 2006, above the UK average.

PMI Scotland Report - Services (50 = no change on previous month)



Scottish and UK ILO Unemployment rates (percent)



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Economy outperforming long term average

The performance of the Scottish economy has been on an upward trend recently. Business surveys paint a positive picture for the economy in early 2007 and suggest that the economy remains on track to outperform its 1.8% long term trend rate of growth this year and next. We are forecasting growth of 2¼-2½% and 2-2¼% for the Scottish economy in 2007 and 2008 respectively.

Services will remain the main driver of growth, while the performance of manufacturing will improve. That said, the performance of the Scottish economy is expected to lag the UK economy over the next two years. The under-representation of the faster growing private sector services in the Scottish economy and over-representation in public sector services, relative to the UK, will continue to limit the regional economy's growth prospects. The Scottish labour market will remain tight, with job creation in services offsetting declines in manufacturing employment. The ILO unemployment rate will also remain low. Moderate growth in consumer spending will be underpinned by a high employment rate and moderate growth in the housing market.

GVA growth, Scotland and UK (percent)

	Scotland	UK
2004	2.3	3.3
2005	2.1	2.0
2006 (f)	2¼-2½	2.8
2007 (f)	2¼-2½	2¾
2008 (f)	2-2¼	2½

Robust start to 2007 for private sector services

Recent RBS PMI Scotland reports indicate that activity in the Scottish private sector continued to increase at a moderate pace in early 2007. In particular, the rate of growth in services accelerated, underpinned by strong growth in new business. Activity rose sharply in each of Business and Financial services, and Travel, Tourism and Leisure. The rate of growth in order backlogs in services remained modest, suggesting that firms had sufficient capacity to meet current demand. Higher levels of new business were reflected in stronger employment growth, particularly in business and financial services firms. While the rate of growth in input prices faced by services firms continued to gradually ease from its peak in mid-2004, it remained well above the rates of growth recorded during 2001 and 2003. The rate of increase in average prices charged remained high as firms continued to raise their own prices in response to higher costs.

Manufacturing growth eases

The rate of growth in manufacturing output, on the other hand, continued to trend down in early 2007 to be running at a modest pace, well down on its peak in mid-2006. The rate of growth in manufacturing has been restricted by export demand, with growth in new export orders having declined for the past six consecutive months. Moreover, the rate of decline in new export orders has gradually increased over the period, reflecting the strength of Sterling and reports of weaker demand from the US. Employment in manufacturing has remained largely unchanged. While the rate of increase in input price inflation continued to ease, it remained above the rate of growth in factory gate prices, suggesting that firms' margins remain under pressure.

Growth in the Scottish manufacturing engineering sector moderated during the March 2007 quarter, according to the Scottish Engineering survey. Growth in output and new orders moderated from their recent highs, while growth in exports strengthened. Survey respondents reported that small companies were performing strongly, while the performance of medium and large companies had slipped.

RBS PMI survey respondents from Scotland's New Economy, which includes technology, media and telecoms firms operating in both the manufacturing and services sectors, reported modest output growth in early 2007, well down on the rates of growth recorded during the first half of 2006. Growth in new orders eased while the rate of contraction in backlogs of work increased. Employment has been stable.

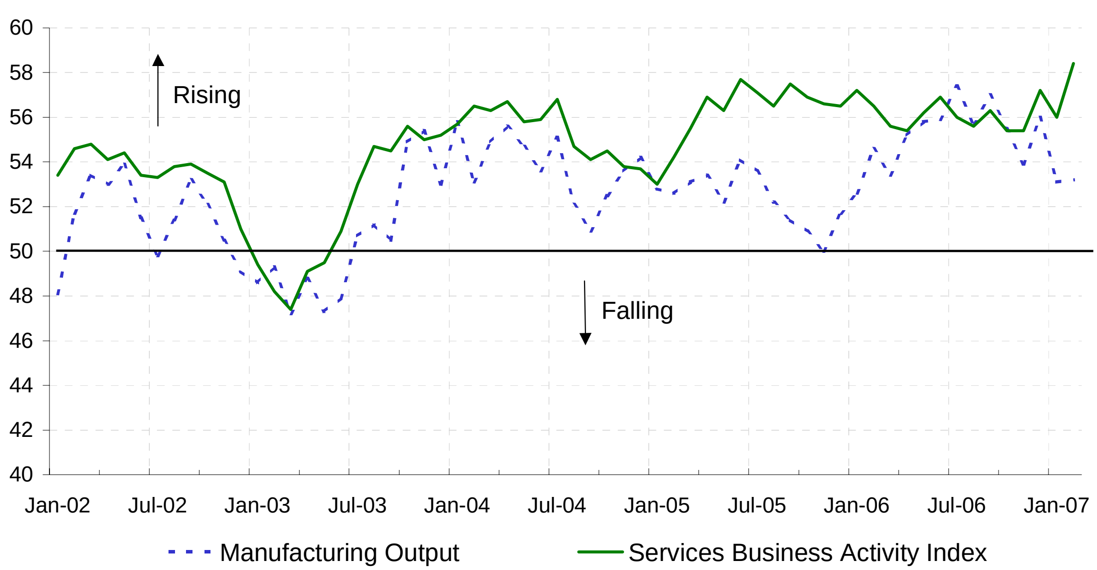
Firms' margins remain under pressure, with the rate of growth in input prices stabilizing above the rate of growth in output prices.

A comparison of the regional PMI output indices for the UK shows that in the three months to February 2007, Scotland had the second fastest rate of growth in private sector business activity. Compared with the other UK regions, however, employment growth in Scotland was weaker than the UK average in the three months to February 2007.

Labour market remains tight

Job creation in services has continued to offset job losses in manufacturing. Annual growth in Scottish employment picked-up in late 2006 and in the three months to January 2007 employment was up by 2.1% yoy, well above the UK average of 0.8% yoy. While the number of people in full-time employment rose over the past year, the strongest growth was recorded in part-time employment. In the twelve months to

PMI Scotland Report - Manufacturing and Services Output
50 = no change on previous month



December 2006, the number of people in part-time employment rose by 41,000, compared with a 5,000 increase in full-time employment. Growth in employment helped to push the employment rate to 76% by end 2006. At 5% in the three months to January 2007, the Scottish ILO unemployment rate remains very close to its record low and is now below the UK average.

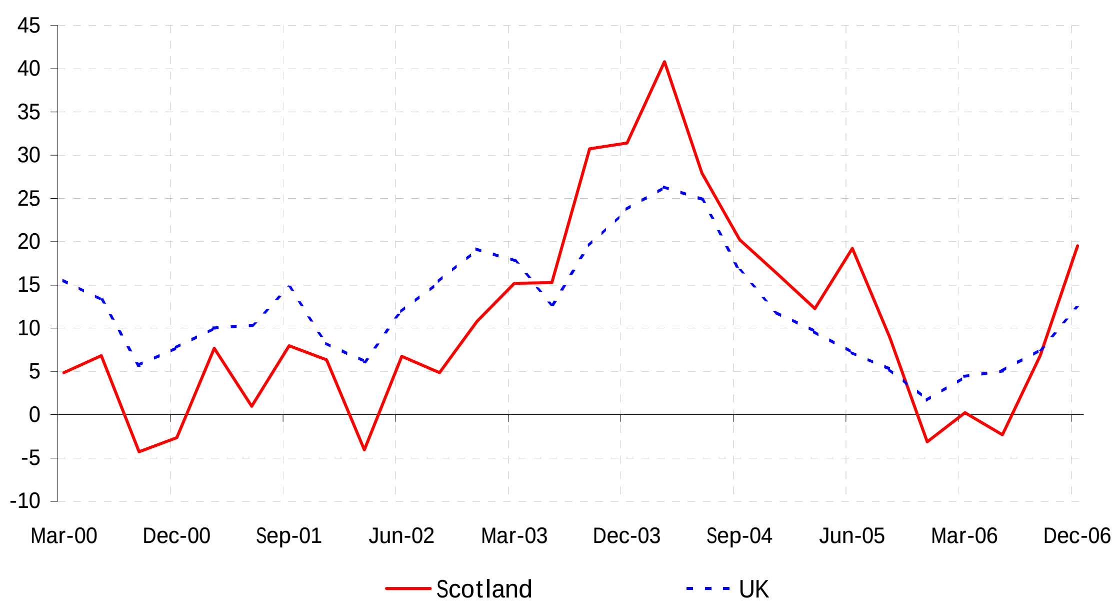
Recent Bank of Scotland Labour Market Reports have also pointed to a firm labour market in Scotland. Demand for staff remains robust while the availability of candidates is tight. Wages and salaries continue to rise as firms look to attract high quality candidates.

Housing market picks up

The housing market in Scotland outperformed the UK average in the December 2006 quarter. After exceeding the UK average between June 2003 and September 2005 , average annual growth in Scottish house prices dipped below the UK average in late 2005 before picking-up again in late 2006. Data from the Department for Communities and Local Government showed that average house prices in Scotland rose by 19.5% yoy in December 2006, compared with 12.4% yoy for the UK. Thus over the past five years, average house prices in Scotland have almost doubled.

Scotland also remains one of the most affordable regions of the UK in which to buy a house. Scottish average house prices are almost one-third less than the UK average. The DCLG data also shows that the average house price-to-income ratio for the UK was 4.1 in December 2006, compared with 3.5 for Scotland.

DCLG house prices (% chg year on year)



Consumer spending remains resilient

Strong growth in Scottish retail sales in early 2007 suggests that the recent increases in interest rates have not yet had any material effect on consumer spending. The Scottish Retail Consortium/Royal Bank of Scotland reported that total retail sales increased by 9.2% yoy in February. That said, the growth rates in early 2007 have been boosted by weak growth in sales a year ago. Heavy discounting has also driven gains in non-food sales. On a like-for-like basis, which takes into account any changes in retail floor space, retail sales were up by 4.1% in February 2007, above the 3.1% average for the fourth quarter.

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