

Scotland economic report

Executive summary

Growth in activity in the Scottish economy is moderating. This trend is expected to continue during 2008 and 2009, with Scotland forecast to record its weakest expansion since 2002. The Scottish economy will also under perform the UK average.

Key trends

- **A moderation in activity in the Scottish economy is already underway.** GDP growth is expected to slow to 1¼-1½% in 2008 and then ease further to 1-1¼% in 2009. The Scottish economy will under perform the UK over the forecast period,

- **Activity in private sector services contracting.** Survey data indicates that activity in private sector services is now falling, with both sales and orders declining. This trend is expected to continue during the remainder of 2008 and into 2009.

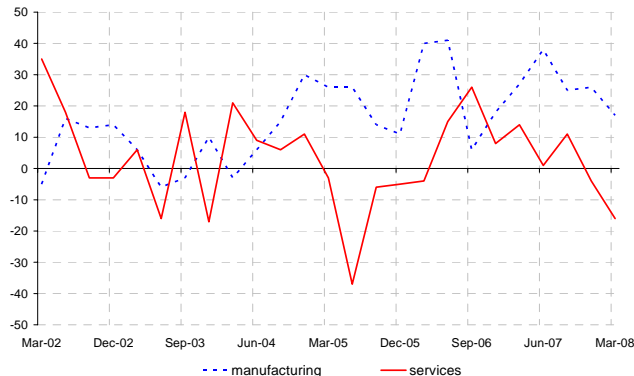
- **The outlook for manufacturing is more encouraging,** particularly in export markets, reflecting the recent depreciation of Sterling. That said, survey data indicates that growth in manufacturing has moderated.

- **The labour market is softening.** Growth in employment is softening. Survey data indicates that growth in jobs in both services and manufacturing is very weak. The weak housing market will result in further job losses in construction. The unemployment rate is expected to trend upwards from its recent historical lows.

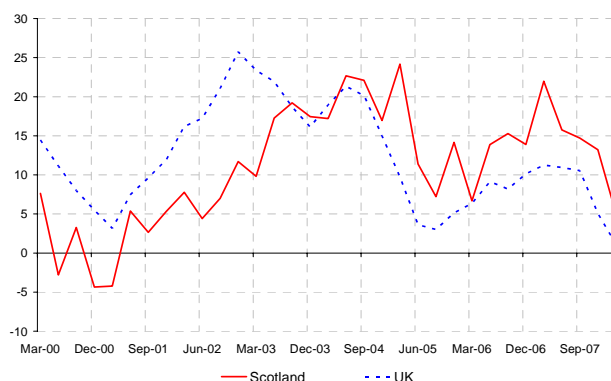
- **Housing market downturn gathers pace in 2008.** While Scotland is expected to retain its position as one of the best performing housing

markets, it will not escape the downturn which is occurring across the UK. House prices will remain under downward pressure during 2008 and 2009, reflecting weak buyer demand, stretched affordability and tighter lending criteria.

BCC Quarterly Economic Survey - Scottish home sales (net balance statistic)



Halifax house prices, percentage change, year on year



Regional economy to slow significantly

The Scottish national accounts 2007 confirmed that activity in the economy strengthened in the second half of last year. Scottish GDP rose by 0.8% in both the September and December quarters, outperforming the UK average. The strong performance by the Scottish economy in the latter half of the year reflected a pick up in activity in services and manufacturing. Construction activity, on the other hand, continued to contract. Over the year as a whole, however, the Scottish economy was outperformed by the UK. The Scottish economy expanded by 2.2% in 2007, below UK GDP growth of 3.0%.

Robust growth in Business services & finance, and Transport, communication & storage underpinned the strong expansion in services in 2007. Growth in public sector spending also picked-up strongly in the final three months of 2007.

Recent data points to decline in Scottish private sector activity in mid-2008, in contrast to soft growth in the UK. The Scottish labour market is weakening, with survey data showing small falls in employment in mid-2008. While the housing market has softened, it was the best performing market in the UK in March 2008.

We expect activity in the Scottish economy to slow significantly in 2008 and 2009, with GDP growth of 1¼-1½% and 1-1¼% in 2008 and 2009. Activity in the private sector will be sluggish and job creation is likely to cease. Growth in the previously buoyant real

estate, renting and business activity sector will moderate, reflecting the downturn in the housing sector. Consumer spending will slow, as consumers' disposable incomes are depleted by high borrowing costs, a deterioration in the labour market and the downturn in the housing market. The Scottish housing market is expected to retain its place as one of the best performing markets in the UK, however a modest downturn in house prices is anticipated for this year and next. We expect the Scottish economy to gradually recover in late 2009 in line with trends for the UK.

Scotland and UK output growth (percent)

	Scotland	UK
2006	2.6	2.9
2007	2.2	3.0
2008	1¼-1½	1.7
2009	1-1¼	1.6

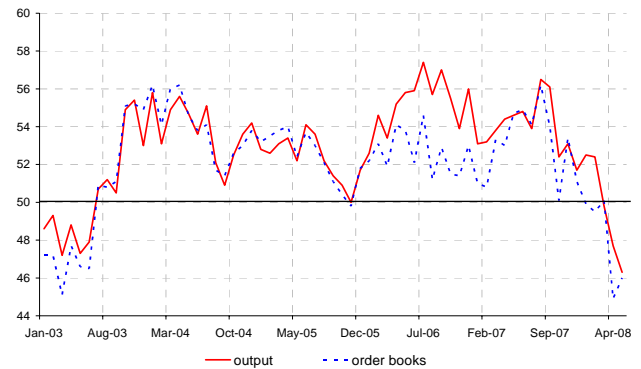
Private sector activity is softening

Results from the BCC Quarterly Economic Survey indicate that conditions in Scottish manufacturing moderated in the first quarter of 2008. Survey respondents indicated that conditions in the domestic market softened, with the rate of growth in both sales and orders easing. In overseas markets, sales strengthened while orders eased back. Investment in plant and machinery moderated and confidence in turnover and profitability softened. Employment fell during the quarter and a further decline is expected over the coming three months.

Scotland's service sector struggled again in the March 2008 quarter, with both sales and orders in the domestic market declining. Employment growth was very weak although expectations were positive for employment over the coming three months. Firms' confidence in their turnover remained positive but profitability weakened.

Recent survey results from the PMI Scotland Report indicate that activity in the Scottish private sector began contracting in the June 2008 quarter. Survey respondents indicated that the decline in output, which began at the start of the second quarter, gained momentum in May. Output fell in both services and manufacturing, with the latter posting the steeper rate of decline. Inflows of new business declined, with respondents citing uncertainty surrounding weakness in the financial and property markets as a key factor depressing demand. Outstanding business also fell, resulting in spare capacity at Scottish firms increasing at its fastest pace since 1998. Despite these falls in output and new orders, Scottish manufacturers reported a small increase in their workforce. Firms in Scottish services, on the other hand, continued to shed jobs.

PMI Scottish Manufacturing (50 = no change on previous month)



PMI survey respondents reported that their input costs are rising at the fastest rate in the survey's history. Increasing oil prices were reported to be the main factor behind higher prices, while metals and foodstuffs were also reported to have increased in price. Prices charged by the Scottish private sector continued to increase at a marked rate. Margins remained under pressure, however, as the rate of increase in input cost inflation continued to exceed output price rises.

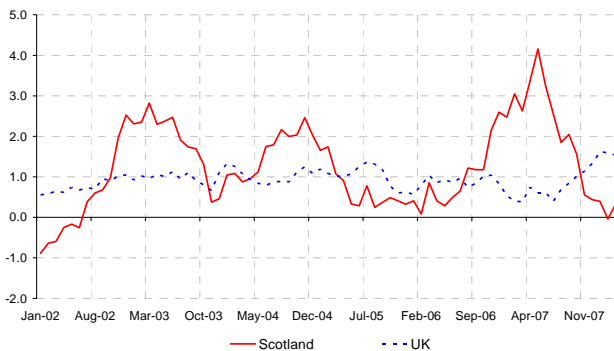
Comparison of the regional PMI Output indices for the UK shows that Scotland was one of the weakest performing regions in the three months to May 2008. Scotland recorded a decline in private sector output in the three months, in contrast to the small increase in output for the UK. The strongest regional expansions were recorded in the North West and South West.

Labour market softening

In contrast to a gradual upward trend in annual employment growth across the UK since mid-2007, the Scottish Labour Force Survey points to a gradual easing in Scottish employment over the period. By the three months to March 2008, growth in Scottish employment was flat. The number of self employed in Scotland over the past year is estimated to have risen while the number of employees has fallen. Full-time worker numbers have increased while part-time worker numbers -have decreased.

Services continues to be the main source of job creation in Scotland with real estate, renting and business services sector recording robust growth in jobs in late 2007. That said, the rate of growth in services employment is now weakening. The number of jobs in construction is declining, reflecting falling output in the sector, and jobs in manufacturing and agriculture are also declining.

Scottish and UK employment (percentage change, year on year)



The unemployment rate in Scotland was 4.4% in the three months to April 2008, a new record low and well below the UK average of 5.3%. While employment growth has slowed, it continues to outpace growth in the labour force. On a claimant count basis, the unemployment rate in Scotland was a very low 2.6% in May 2008.

Results from the recent PMI surveys, however, indicate that conditions in the labour market are weakening, with employment declining during the June 2008 quarter. The regional PMI employment indices indicate that employment in the UK was unchanged in the three months to May 2008, while employment in Scotland fell. In the three months to May, seven of the twelve UK regions recorded falling levels of employment.

Housing market softening

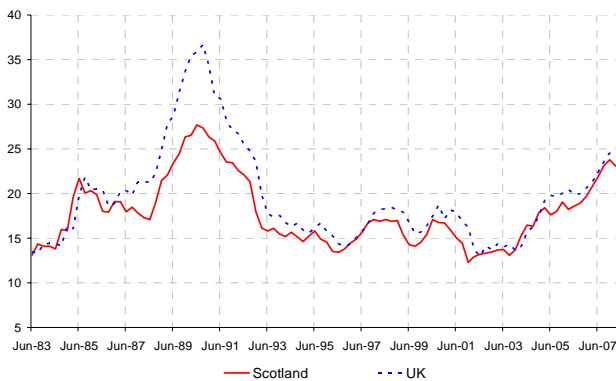
The Halifax Bank of Scotland house price index shows that the Scottish housing market was the best performing market in the UK in the first three months of 2008. The annual rate of house price inflation in Scotland in the March 2008 quarter was 5.3%, compared with a 1% fall in prices across the UK. That said, annual growth in Scottish house prices is well below its recent peak of 22% yoy in March 2007.

Affordability has been a key factor underpinning the increase in Scottish house prices. At £145,531, the average price of a house in Scotland is 25% less than the UK average. Data collected by Halifax shows that the house price to earnings ratio for Scotland was well

below the UK average in the first quarter of 2008. The average house price to earnings ratio for Scotland for all houses and all buyers was 4.7 times, compared with 5.7 times for the UK. The Halifax data shows that this marked spread between the ratios has existed since late 2000 - during the 1990s the difference between the ratios was smaller.

Data from Halifax on mortgage payments as a percentage of income, on the other hand, suggest that the Scottish housing market may not be as affordable, relative to the UK average, as first thought. In March 2008, average Scottish mortgage repayments accounted for 23.1% of income, compared with 24.7% for the UK. These figures also indicate that housing affordability is at its lowest level since the 1990, when mortgage repayments as a percentage of income reached highs of 27.7% in Scotland and 36.7% in the UK.

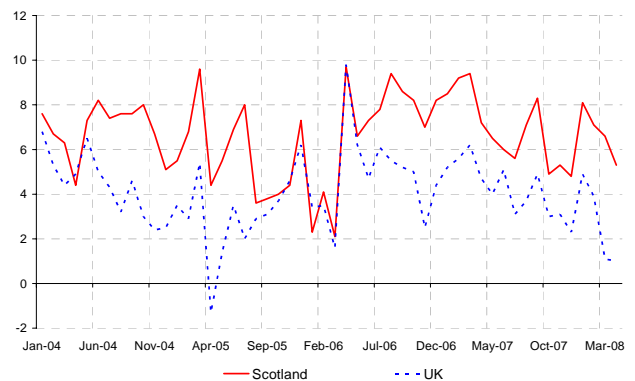
Halifax average mortgage repayments as a percentage of income (percent)



Softer growth in consumer spending

Weaker growth in house prices, and higher fuel and utility bills look to have dampening growth in Scottish consumer spending in the first four months of the year. The SRC Scottish Retail Sales Monitor suggests that while growth in Scottish sales moderated in early 2008, the Scottish retail market continues to outperform the UK average. In April 2008, total Scottish retail sales were up by 5.3% on year earlier sales, underpinned by moderate growth in both food and non-food sales. Retail sales in UK, on the other hand, were up by only 1.0% on year earlier levels.

SRC Scottish Retail Sales Monitor, total sales, three month average compared with previous year



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