



# The Dysfunctional UK Economy

A macroeconomic assesment of whether the UK economy is strong and secure

Margaret Cuthbert, June 2013

*a paper from the* The Jimmy Reid Foundation

## 1. Introduction

According to Better Together, which takes for granted that we have a strong and secure UK, “a separate currency would be a disaster for Scotland’s economy. It would be bad for jobs because we would have to change currency at the border with our biggest trading partner, the rest of the UK. It is bad for our mortgages and credit cards. It means higher interest rates because a new currency backed by a smaller economy would not command confidence in international markets.” (Alistair Darling, Blog)

Assertions are always interesting. They show how the person making the assertion wants the reader to focus on particular aspects where they believe the argument can be won. They also show, by exclusion, the parts which the asserter wants to avoid: which, it is hoped the reader will not think about.

This article challenges these assertions, and goes further. First, by examining the performance of the different parts of the UK economy over the past thirty years, it shows how dysfunctional the UK economy has been and that it has not operated as an optimal currency area – a condition which is regarded as necessary for the successful working of a monetary union. Second, by comparing Scotland and the UK with other economies it shows that the UK and Scotland have not been performing well, and that in dynamic terms the economy has been steered in a wrong direction: so much so that even a 29% devaluation in the £ has not resulted in a big boost in exports. And third, it shows the failures of the economic model, a neoliberal model, which successive UK governments have followed since 1980. In showing the failures of that economic model, the paper places itself firmly within the Commonweal Project of the Jimmy Reid Foundation which is examining and developing alternative social and economic models.

So, how good has the UK economy been under UK stewardship?

On the basis of the evidence presented here, the conclusion is that the UK has not been operating as an optimal currency area: that successive UK government policies have been more suited to the London area at the expense of most other countries and regions in the UK: that the UK has had no effective industrial or regional policy for more than thirty years, and as most industrial policy powers are reserved, Scotland has suffered accordingly: and finally, that it would not be advantageous for Scotland, in the long term, to continue to form a monetary union with the rest of the UK.

## 2. Key Findings

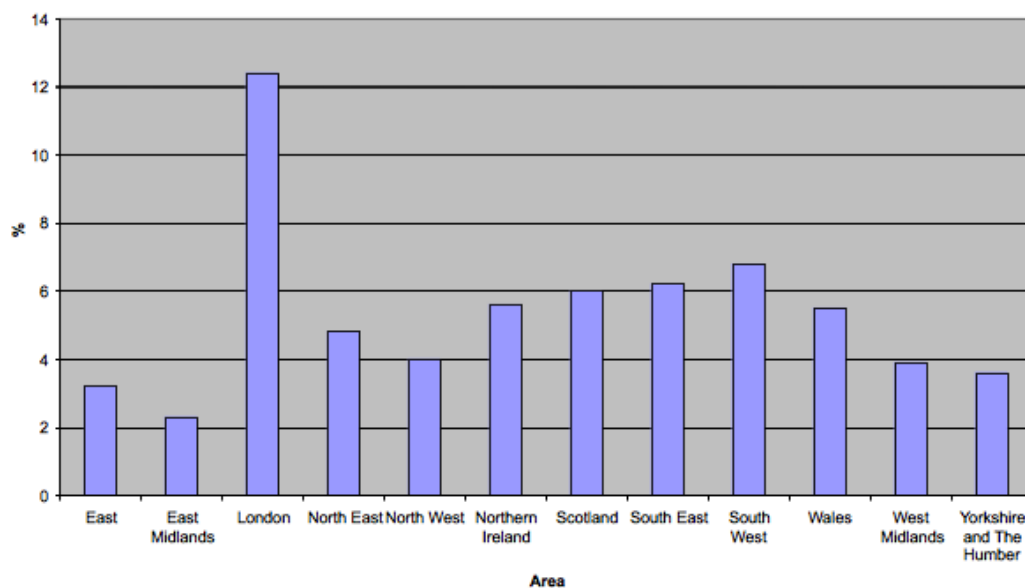
The detail and analyses upon which this report is based are laid out in Part II. The key findings are given here.

## Output

1. In GDP growth, Scotland has been underperforming relative to the UK average and relative to other EU countries of similar size since at least 1963. The data showed that, over the period 1963 to 2011, in real terms, UK GDP increased by 329.3%, while Scottish GDP increased by 263%. In terms of average growth rates per annum, that for the UK was 2.514%, while that for Scotland was 2.04%: an average annual difference of 0.5%. Had Scotland's GDP grown at the same rate as the average of the UK since 1963, Scotland's GDP would be 25% larger than it is today.

2. However, there are very large differences in GDP growth across the countries and regions that make up the UK. These differences have held over a long period of time, and if anything are becoming larger. The building block for statistics and regional policy in the EU is the Nomenclature of Territorial Units for Statistics, (NUTS) area. The UK has 12 such NUTS areas comprising the countries of Scotland, Wales and Northern Ireland and nine regions in England. As Chart 1 shows, between 2007 and 2011, and despite the economic downturn, London outperformed every other area by a considerable margin. Although the financial crisis had an immediate impact on London and the 'City'; the recession and the austerity programme have had a greater and longer lasting impact on Scotland, Wales and Northern Ireland, and the more peripheral regions of England.

Chart 1: %GDP Growth 2007 to 2011



Source: ONS: Region and Country Profiles.

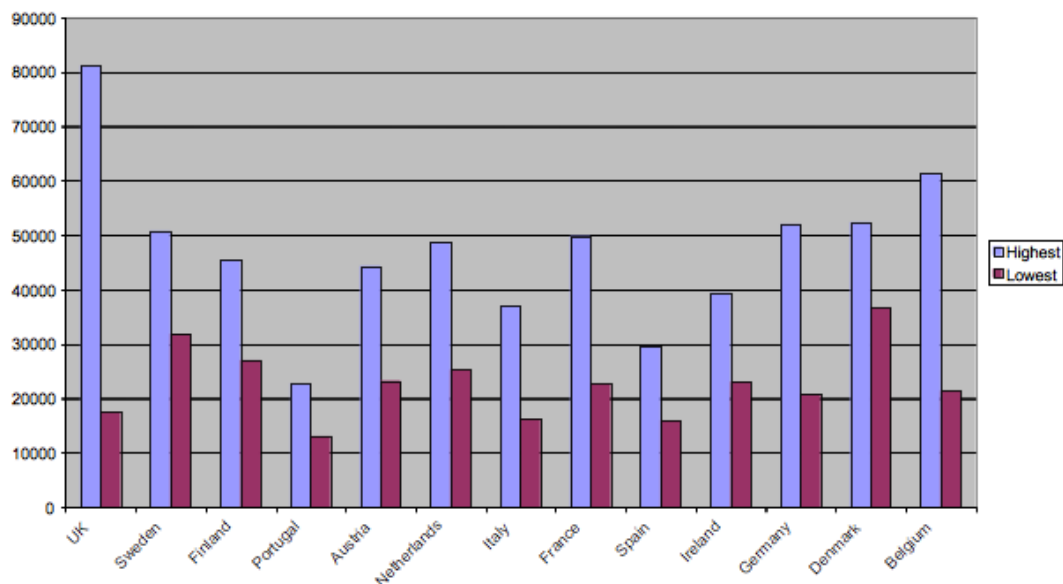
The rate of growth in Scotland was less than half that in London, with Wales, Northern Ireland, and six English regions having growth rates even lower than Scotland. What this broader picture tells us is that, leaving aside Scotland, there are marked differences in the performances of the UK countries and regions: and, above all, there is a huge imbalance in relation to London.

3. Five of the twelve areas which make up the countries and regions of the UK have less than half the GDP per head of London: the North East, North West, West Midlands, Wales and Northern Ireland fall into this category. Although Scotland is in third place, its GDP per head is only 58% of that for London.

4. This disparity among countries and regions of the UK is far greater than that of any other country in Europe. Chart 2 below shows the maximum variation in GDP per head in euros among the EU NUTS areas in each of 13 European countries. By far the greatest variation is in the UK with

GDP per head in inner London being almost 4.7 times higher than GDP per head in Wales and the Valleys. In France the maximum variation is between the Ile de France and Limousin, and is of a factor of just over 2. Sweden and Denmark are far more equitable in the distribution of GDP per head across their regions.

Chart 2: Variation in GDP per head at current market prices (euros) 2010



Source: Eurostat

5. And the disparity across the UK has only widened since the early 1980s. As Michael Kitson writes in his analysis of regional differences, "From the early 1980s, regional disparities widened – in part reflecting the Government's commitment to over-zealous monetary targeting and an overvalued exchange rate." (Kitson, 2013)

6. Neither is this disparity helpful to the economic prospects of the UK economy as a whole. In an OECD international comparison of output per head, the UK is 15th in international rankings, at 76.7% of US GDP per capita, which itself was behind Luxembourg, Norway, and Switzerland. Since 1970, Norway, Ireland, and Finland have all increased their rankings from being well behind the United Kingdom to now being in 2nd, 7th, and 14th place respectively in 2010.

*Overall, there are large and sustained variations in output indicators across the UK. Scotland's overall growth rate since 1963 has produced an economy which is 25% lower than it could have been if it had even matched average UK growth. And in output per head, the UK has been overtaken by a number of small European economies. The regional disparities which are noted above are not some short term phenomenon. Rather they are the result of the fast growing south, particularly London and the City, acting as a magnet for capital and labour from the other parts of the UK, and helping to stoke the growth further: at the same time, the peripheral areas, which are losing their labour and capital to the south, are thus held back even more.*

## Population

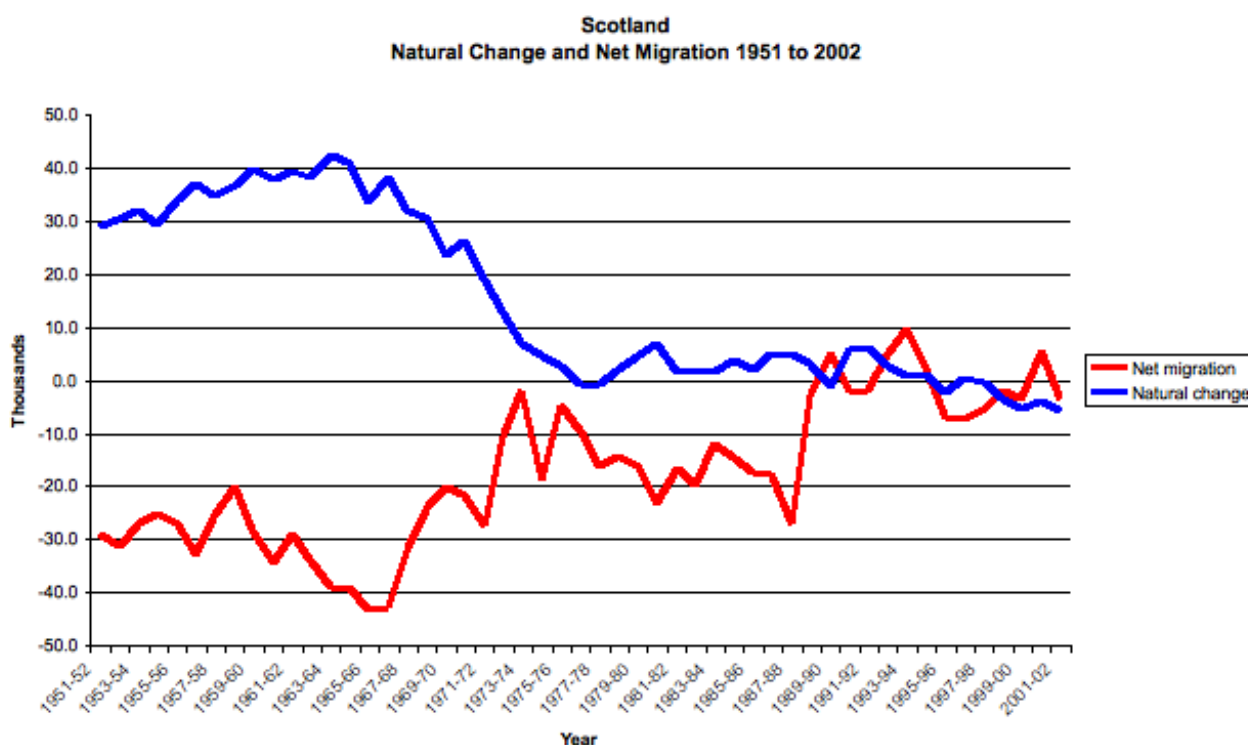
The next indicator discussed here is population. While one of the indicators commonly used to identify how well an economy is performing is unemployment. In Scotland's case, lack of demand in the economy has also been accompanied with emigration.

7. Scotland experienced major outflows of population throughout the 20th century. Scots were looking for opportunity – which was not available in their own country. (Devine).

8. The types of measures taken to stem the flow by UK governments did not meet requirements. The belief that UK wide policies were hindering the economies of areas outside of London was shared by senior figures in the Conservative Party. George Younger: "in encouraging, although we do not wish to do this, more people to emigrate by letting unemployment rise, we are inhibiting the future chances of growth in Scotland which will finally decrease the unemployment rate in Scotland."

9. Between 1950 and 2000, Scotland was the only country of similarly sized European countries, (Denmark, Finland, Norway, Sweden, and Ireland), to have a falling population, and the major factors affecting population in Scotland compared with many other European countries have been high out-migration and a relatively high death rate. Chart 3 presents a graph of the annual change in population due to natural causes of birth and death, and with it, a graph of net migration out of Scotland. It shows that the natural increase was around 30,000 or more each year between 1951 and 1970, but that this was matched by net out-migration.

Chart 3: Natural Change and Net Migration: Scotland, 1951-2002



Source: Review of the Registrar General, Scotland

10. Despite the recent increase in immigration from Eastern Europe, and a decline in out migration, Scotland still suffers from relative population decline compared with the rest of the UK.

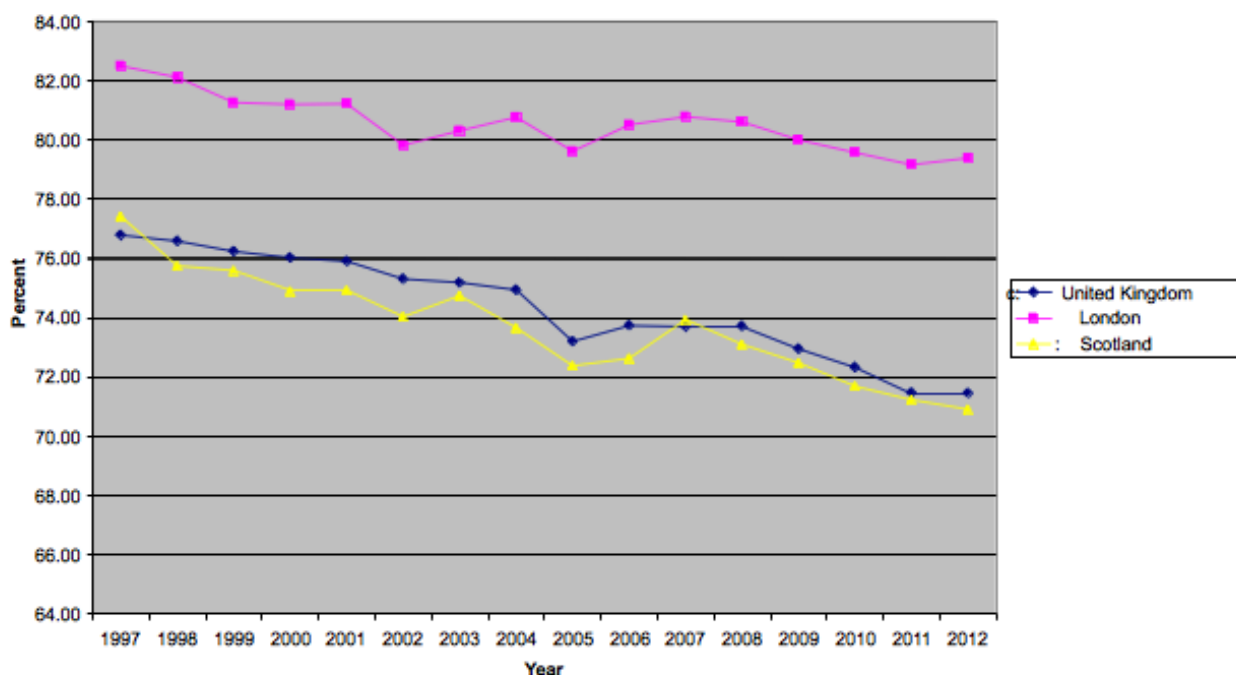
*Overall, population indicators show an economy which, far from moving in step with either the rest of the UK or European comparators, did not have sufficient buoyancy to give employment, and therefore a home, to its own natural growth in population. The policy instruments used within the UK were not finely enough tuned to Scotland's circumstances to make any lasting positive effect.*

## Employment

11. Over time the percentage of employees in full time work has fallen but the fall has been much steeper in Scotland and in the UK in general than it has been in London, so that by 2012,

there was an 8 percentage point difference in the percentage of employees in full time work between Scotland and London, as can be seen in Chart 4 below.

**Chart 4: % in full time employment**



Source: Nomis, ONS

12. There are marked variations across the UK with regard to occupations, with London having 14 percentage points more in the top employment categories of managers, professionals, and technical staff than Scotland, (Table 4 in the Part II), – and this imbalance has held for many years, (Chart 7 in Part II).

13. While the UK has performed reasonably well in the percentage of the workforce in employment (either employed or self employed), the percentage of the workforce which is in part-time work is higher in the UK than in most EU countries, although on a par with Sweden, Germany, and Norway.

14. Within the UK there is considerable variation, with London being very different from other areas in its having a higher percentage of men in employment and in having a much lower percentage of employees in part time work.

15. Among European comparators, the UK performs poorly in the percentage of young people in neither employment, education, or training, (NEET). (Chart 9 in Part II).

16. Within the UK there is considerable variation in the percentage of young people without employment, education or training post 16. (Table 5, Chart 8)

*Overall, UK and Scotland employment rates are comparable to those in Europe, but part time working is considerably higher in UK countries and peripheral regions outside London.*

*Jobs in high level occupations make up a smaller percentage of employment in areas outside of London and the incidence of young people with neither employment, education nor training varies widely across the UK: again with all other areas being worse than London. Scotland performs well in employment indicators relative to that part of the UK outside London.*

*These facts suggest that government policies, and in particular, heavy reliance on a monetary policy which targets inflation, have not had the effect of ironing out disparities between the different parts of the UK: in fact, this was more or less accepted by Eddie George, former Governor of the Bank of England, when he stated in an interview that job losses in the north were an acceptable price to pay for curbing inflation in the south. He added, "monetary policy can only target the economy as a whole, not particular regions or sectors, however uncomfortable that reality might be." (BBC News.)*

## **Manufacturing and Industrial Production**

17. An important component of a country's output is its industrial production, and within that, manufacturing. Manufacturing's share of total UK economic output has been in steady decline for forty years, from more than 30% in the early 1970s to 10.8% in 2011, and the sector now employs only 8% of the workforce.

18. Part of the reason for this decline was that, following major problems with inflation in the 1970s, monetary policy, which had been relatively passive, was tightened (1979 - 81), and interest rates and the exchange rate both rose dramatically (the rise in the exchange rate partly due to North Sea Oil). This had a large and negative impact on manufacturing due to high borrowing costs and loss of competitiveness in export markets.

19. In their article on the Deindustrial Revolution, Kitson and Michie argued that the UK's industrial performance since 1960 has been relatively poor. There has been an accompanying deindustrialisation which is now a serious problem for the whole economy, as other sectors are themselves dependent on the success of industry. And as yet, the consequences of continued economic decline have not been solved.

20. From between 650,000 and 700,000 employees in the 1950s and 1960s, employment in manufacturing in Scotland slowly fell to around 550,000 in 1979. 1980 saw a loss of around 50,000 and the slide downwards has continued thereafter, so that by 2010, there were only around 170,000 employed in the sector.

21. Early interventionist regional policies in Scotland were superseded first by the establishment of the Highlands and Islands and Scottish Development Agencies. Regional assistance was used but was counted as part of the Scottish Block grant. Not only did no extra funding come to Scotland but the existing Scottish budget was skewed towards providing the necessary 50% or so support required for regional assistance projects. The ability of the Development Agencies to fund industrial development other than in small research and development funds, was severely curtailed by "State Aid" regulations.

22. In almost all Western developed economies the importance of manufacturing, in terms of its percentage contribution to the country's value added and in employment, has shrunk. Comparing the UK to other OECD countries, however, it appears that the UK's decline in industrial production is greater than all others except Italy.

The industrial production index (IPI) measures real output and is expressed as a percentage of real output in a base year (currently 2005). IPI covers production output in mining, manufacturing and public utilities (electricity, gas and water), but excludes construction. The following table uses industrial production data presented in the United Nations Economic Commission for Europe statistical database, last updated in April 2013, (2005=100).

Table 1: Industrial Production

Country	Overall % change in industrial production between 1990 and 2011
Austria	99.8
Belgium	33.7
Canada	35.9
Denmark	22.6
Finland	83.8
France	4.4
Germany	32.7
Ireland	361.9
Italy	-2.2
Netherlands	33
Norway	12.5
Spain	3.3
Sweden	54.3
UK	-1.2
US	50.5

Source: UNECE

The table shows clearly that the decline in industrial production in the UK is not, in general, shared by other large Western developed economies. Both Canada and the United States have continued to grow their industrial production, with that in the US growing by 50.5% over the period. Some small economies have also increased their industrial production: in Ireland it grew by over 360%.

23. Pressures on manufacturing, and on industrial production in general, have come from a variety of different but often inter-related sources. The UK's monetary policy, at times focused on maintaining a high exchange rate, at others on inflation targets, has resulted in the currency being poorly managed, (Cuthbert, J., 2013), affecting the demand for manufacturing exports and making manufactured imports relatively cheaper than home produced goods. For much of the period studied, high interest rates have held businesses back from crucial investment. More recently, banks have made use of quantitative easing and low interest rates to recapitalise, and to invest in businesses with more profitable short term returns than manufacturing.

24. In addition, competition and regulation policy in the UK, a reserved and non-devolved area, has been far more benign to takeovers than is the case in Germany and France. Compare, for example, the French response and success to the threatened takeover of Danone to that of Kraft taking over Cadbury. There is no effective industrial policy in the UK to assist small and medium sized companies to grow generically. Sustainable generic growth of companies provides few pickings for investment banks, hedge funds etc. who are the life blood of the city.

## Competitiveness: Export Performance

25. The UK is one of the world's largest exporters of goods and services, ranking 7th in total exports and 10th in goods exports. It is industrial production, and manufacturing in particular, which form the basis of the majority of exports. In 2011, 46% of total exports were from manufacturing, and even as late as 1995, the figure was much higher at 62%.

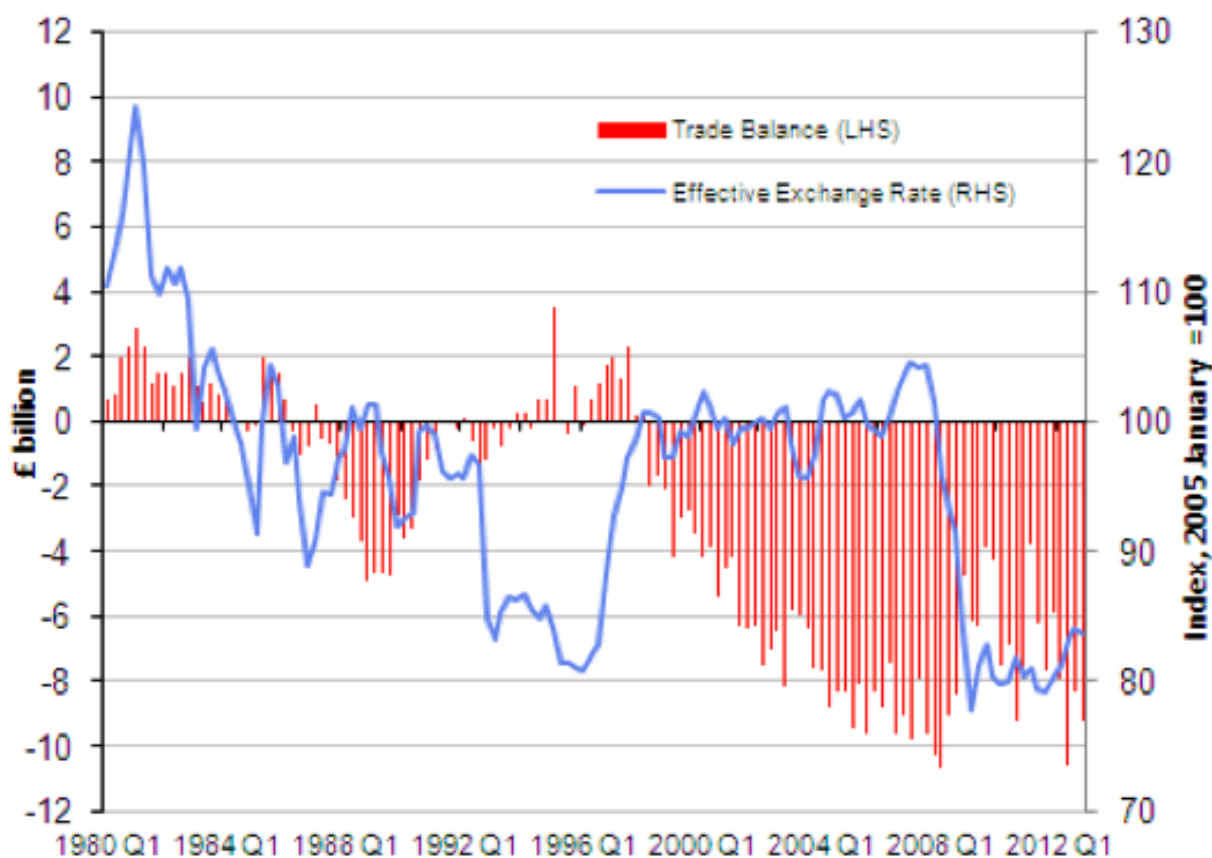
26. However, the UK imports far more manufactured goods than it exports. In 2011, imports of manufactured goods reached £285.4 billion compared to £225.1 billion in exports: and this



deficit is particularly high in trade with manufacturing countries such as Germany: in 2011, the UK imported in total £41.107 million from Germany but exported £27.359 million to Germany.

27. As can be seen from Chart 5, the UK has run a trade deficit since 1986, with the exception of 1994-1997, when it benefited from a devaluation on leaving the exchange rate mechanism. The deficit is mainly due to a negative balance of trade in goods only partly offset by a surplus in services. Between 1986 and 2008 there was a negative correlation between the balance of trade and the exchange rate, such that, it could be argued that, other than 1994-1997, the exchange rate was too high and held back the sale of manufactured goods abroad while making imports cheaper. However during 2007 and 2008 there was a 19% depreciation of sterling's effective exchange rate, and as can be seen, the exports of goods did not respond strongly to this fall, rising by just 4.9% between 2008 and 2012. This may be explained by the difficulty of the UK's manufacturing base to borrow from banks, and by the lack of demand, particularly in Europe, one of the UK's biggest markets.

Chart 5: UK trade performance (balance of trade in goods and services, current prices)



Source: ONS

*Although the UK and Scotland are successful exporting economies, the decline in the manufacturing base in the UK from 30% of GDP in 1970 to around 10% today, a decline mirrored in Scotland, has been accompanied by a weakening in our export positions, balance of payments difficulties, a greater dependence on borrowing, and issues for the sterling currency.*

## Competitiveness: Productivity

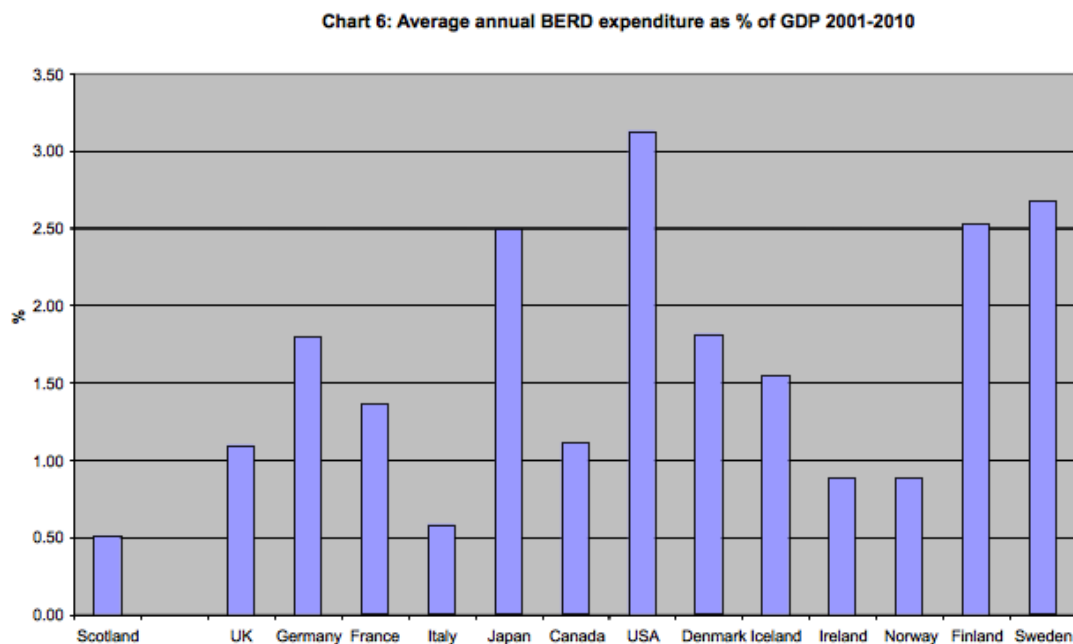
28. In 2011, UK output per hour worked was 16 percentage points below the average for the rest of the G7 major industrialised economies: only Japan was lower. And on an output per worker basis, UK productivity was estimated as being 21 percentage points lower than the rest of the G7. (ONS).



Overall, the UK cannot be seen as a successful economic entity keeping up with its competitor countries.

## Competitiveness: Innovation in Research, Development

29. Innovation is one of the drivers of manufacturing output, and of exports in manufactured products. However, as can be seen from Chart 6, over the ten years 2001 to 2010, Scotland, and indeed the UK, spends far less of its annual GDP on business research and development than many of its competitors –



Source: OECD

30. Business R&D in the UK is concentrated in the East and South East of England, and this pattern has held since at least 1990. Scotland has a very low business R&D spend at 0.5% of GDP. In addition, business R&D expenditure in Scotland is concentrated in a small number of large companies. In 2011, the top 5 R&D firms (out of 1,995) accounted for almost a third of Scottish R&D expenditure: and USA owned firms were responsible for 41 % of all business R&D spend. (Source: Scottish Government).

31. UK Government policy on encouraging infrastructure development to be funded by the private sector through the Private Finance Initiative, and the Treasury accounting system for Scottish Water have encouraged infrastructure projects in Scotland to be carried out by large private sector contractors. These contractors are not only generally headquartered outside Scotland, but the R&D they do or commission also tends to be sourced outside Scotland. As a result, not only has Scotland lost the primary business R&D but the potential for home grown R&D to percolate through the rest of the economy.

32. It is not, of course, only businesses who carry out research and development, although they carry out 64% of the total. Higher Education Institutions, government establishments and private non-profit making organisations all fund research and development. Almost 40% of higher education institutions spend on research and development is in London and the South East. Scotland comes in third place with 13% of the spend. Even here, however, although Scotland performs well in world rankings in research, the main government financial assistance

for research and development is through Research Councils, a reserved matter. Linkages with firms in Scotland to assist economic development are therefore not prioritised. Studies indicate poor interconnectivity with firms in Scotland. While the stated aim of the research councils is “to maximise the impact of research on economic growth and societal wellbeing”, this is at a UK level. Thus, it is in no way necessary that the original area to be researched, the industrial partners found, and the final results, need have any direct relevance to Scotland. Indeed, a study of the LINK initiative showed this to be the case, with Scottish HEIs tending to find industrial partners outside Scotland and thus benefiting other UK areas rather than Scotland, (Cuthbert, 2001). And the situation is even more extremely skewed in spending on R&D by government establishments. There, more than a third of the total budget is spent in the South East, 12% in Scotland but only just over 1% in Wales.

## Competitiveness: Skills and Training

33. In 2006, Lord Leitch conducted a comprehensive review of skills in the UK comparing them with those in all other OECD countries. (Leitch, 2006). His report made grim reading. He found that the UK’s skills base was mediocre by international standards. Using OECD data comparing 30 countries, he found that, while Germany had around 16% of its adult population in the low skills bracket, the UK had close to 35% and was in the 13th poorest position on this measure, out of the 30 OECD countries. Where around 35% of adults in the UK had intermediate level skills, this was 60% in Germany. The UK on the other hand had a higher percentage of adults with high level skills: 30% compared to Germany’s 27%. Over 10% of adults in the UK were functionally illiterate; and around 15% were functionally innumerate. The percentage of adults in the UK with low or no qualifications was more than double that in Sweden, Japan and Canada.

34. Looking at the 2012 OECD report “Education at a Glance”, shows that in 2010 the UK had fallen further in the league tables on low skills, but had improved its position in high skills alongside two other countries.

35. Scotland performs well in the percentage of young people taking part in higher education. However, it has not been so successful at benefiting from this investment in terms of attracting its graduates to work in Scotland. For example, in 2011, only 38.5% of Scottish male students leaving Scottish HEIs with a first degree went into employment in a graduate level job in Scotland.

36. Against comparator countries with apprenticeship schemes, the number of apprentices per 1000 workers in the workforce in the UK as a whole is low. In a report on international comparisons on apprenticeships in 2010 for the Apprenticeship Ambassadors Network, Hilary Steedman found that England had far fewer apprentices per 1,000 employed than the comparator countries studied.

Austria	39
Australia	33
England	11
France	17
Germany	40
Ireland	11
Switzerland	43

36. Within the UK, the percentage of the working population with HND, Degree and Higher Degree level qualifications or equivalent is highly variable: 38.5% in Scotland, compared to 47.5% in London, and 26.9% in the North East.

37. Scotland has a higher percentage of its workforce with trade apprenticeships (5.3%) than London (1.5%) or the average UK (3.7%). However, it is likely to be poor in international comparisons. In an international study in 2010, England was found to have only 11 apprentices per 1,000 employed, compared with Germany which had 40 per 1,000.

It might be thought that a decline in industrial production is a natural feature of advanced economies as they move into a supposed post-industrial, service based mode. What the data show however, is that it is the UK, almost alone among advanced economies, which has experienced a sharp decline in industrial production. Industrial production in Western economies has been affected adversely by the rise of production and improved competitiveness of Asian economies. But the absolute fall in industrial production experienced in the UK is not a necessary feature of highly developed economies.

*Skill levels and higher education provision in Scotland do offer a labour resource and potential which is world class, but much of this potential has permanently moved South or emigrated: the long term benefit to the Scottish economy has therefore been weakened.*

## Income

38. Throughout the period studied, 1997 – 2011, gross disposable household income per head in Scotland lies below but close to the UK average. (Source: ONS). In fact, Scotland does better than most English regions and Wales and Northern Ireland. However, in London, and especially in inner London, gross disposable income is so high relative to all other areas that it skews the average for the UK upwards. Gross disposable income per head in inner London was more than half again the level in Scotland. According to the latest data released by ONS (April 2013), Nottingham had an average income of £10,834 in 2011 compared to inner London-West with an average income of £32,823. The skewed nature of disposable income across the UK has worsened over the period studied, with disposable incomes in London pulling well ahead from the rest of the UK.

39. Welfare measures, which have operated on a level playing field basis across the UK to address personal unemployment, disability, long term sickness etc., have had strong country/regional effects. (Note that these are measures aimed at the individual and do not, for example, address lack of demand or creating employment opportunities). The table below shows the incidence of a range of benefits in the UK, and shows that as a percentage of the working population, the numbers receiving attendance allowance and incapacity benefit in Scotland are higher than in London. In particular, the percentage for disability allowance is much higher.

### Those Receiving Particular Benefits as Percentage of Working Population

	London	Scotland	UK
Attendance Allowance	2.44	3.97	3.80
Disability Allowance	5.85	10.12	8.00
Incapacity Benefit	2.55	3.32	2.58
Income Support	3.81	3.59	3.19

Source: DWP

40. There has been a fall in recent years in all parts of the UK in the numbers receiving welfare benefits, however differences across countries and regions in the UK have persisted.

*In part, welfare benefits have formed part of the transfers which are needed in monetary union to counter the pull of those areas which are doing well. In fact, they have not succeeded in this:*

*a point conceded by Nick Clegg in October 2012, when he said "You can't revive the regions just through handouts from Whitehall. Certainly not now, when the Treasury's coffers are bare. And even if we did have lots of money, the previous approach was fundamentally flawed. Revenues from the financial services sector were recycled round the rest of the country through the long arm of the state, creating the illusion of strong, national growth."*

## **Housing**

41. House prices in the UK in 2012 were, on average, 6.78 times what they were in 1986, but across the UK, the increase was far from uniform. In 1986 the average price of a house in Scotland was 51% of one in London: by 2012, the average price of a house in Scotland was 44% of one in London.

42. Average outstanding debt due to housing in London in 2012 was £250,000: twice or more than that of all other UK areas with the exception of the East, South East and South West of England.

43. From the mid 1990s until 2007, house owners' outstanding debt due to housing rose 25% faster per annum than mortgage debt due to housing in Scotland. The large correction in debt in London (of 15.6% over 2007 and 2008) was not mirrored in Scotland where levels barely altered. Since 2009, outstanding debt due to housing in London has once again resumed its high rate of growth, while that for Scotland has levelled off.

*As a study by Dow and Montagnoli shows, within a monetary union, monetary policy will have different effects in different areas if there are major differences in factors such as indebtedness. Areas with relatively high levels of personal housing debt will react quickly to changes in interest rates: areas with relatively low indebtedness will be more sluggish in their reaction but the dampening effect is longer lasting. Where this situation arises, as it has in the UK, the monetary union is not working to the advantage of all.*

Part II to this paper presents a series of additional indicators covering output, demography, employment, housing, export markets, research and development, income and productivity. For each of these groups of indicators it provides information on Scotland's performance relative to other parts of the UK and also relative to a group of European competitor countries of similar size.

## **3. Conclusions**

The findings and analyses presented in this paper show clearly that, although Scotland performs well relative to all other parts of the UK with the exception of London, there is considerable variation in performance across the different countries and regions of the UK. The London area outperforms all central, western, eastern and northern English regions, as well as Scotland, Wales and Northern Ireland. Thus London heavily skews the averages of most indicators, so that, overall, Scotland tends to be below, although close to, average UK performance. Relative to other European countries of similar size, Scotland performs less well, as, indeed, does the UK. For more than thirty years the UK has lacked coherent regional and industrial policies. The decline in local industrial production, particularly in the smaller countries and regions of the UK, has been allowed to continue, helped on by competition policies which have benefited companies in the City, such as investment banks, and by government infrastructure policies such as PFI which have reduced local R&D. Devolution has not given Scotland the powers to tackle these issues. And finally, in the UK, monetary policy has had a differential impact on the different countries and regions of the UK.

The observed marked and long standing disparities in economic performance between the

different countries and regions of the UK are extremely relevant to the vexed question of whether the UK approximates to being an optimal currency area. Conventional wisdom would be that, within an optimal currency area, what would be expected through time would be deepening economic convergence between the different parts of the currency area. The fact that this is not happening in the UK in itself suggests that the UK is not an optimum currency area.

But when we look at the criteria for an optimal currency area, we see that the UK does indeed violate some of the key requirements.

Standard theory of an optimal currency area says that for an area to constitute an optimal currency area there needs to be a number of factors in place. These are:

- free movement of labour within the area,
- free movement of capital,
- wage and price flexibility,
- transfer payments should be available to counter the effects of labour and capital flows and to help restore balance among the different areas,
- similar business cycles
- similar economic structures so that monetary policy changes have similar effects across the monetary union area.

What has been seen from the analysis presented in this paper is that the last condition is grossly violated for the UK, with the dominant London area having a markedly different, finance dominated economic structure from the rest of the UK. Condition 4 above is also violated, in that the UK does not have an effective mechanism of transfer payments to counteract and correct regional imbalances.

So if the UK looks like a duck, in the sense of not showing the convergence in economic performance expected of an optimal currency area, and quacks like a duck, in the sense of not meeting the requirements for an optimal currency area, then it is clearly not an optimal currency area. Joining a currency union with the rest of the UK

would condemn Scotland to continuing to share in the chronic underperformance which the dysfunctional UK currency area has exhibited in the past – and will continue to exhibit in the future unless, as is unlikely, the London imbalance is corrected.

## References

Anderson, M., "Population and Family Life" in T Dickson and JH Treble (1992) "People and Society in Scotland" 1914-1990".

Cuthbert, J.R.: "The Mismanagement of Britain: A Record of the UK's Declining Competitiveness, and Why it Matters": report published by the Jimmy Reid Foundation, 15th April 2013

Cuthbert, M., "Developing a Knowledge Economy in Scotland: Lessons from the Operation of the LINK Programme", Fraser of Allander Institute Quarterly Economic Commentary, (2001).

Dow, Sheila and Montagnoli Alberto: (2007) "The Regional Transmission Of UK Monetary Policy ", Regional Studies

Devine, T., The Royal Society of Edinburgh RSE Christmas Lecture 2011, "To the Ends of the Earth: Scotland's Global Diaspora", December 2011

Devine, T., The Scottish Nation: 1700 to 2000 (Penguin, London, 2006)

Eurostat: Gross domestic product (GDP) per inhabitant, in purchasing power standard (PPS), by NUTS 3 regions, 2009 (1) (% of the EU-27 average, EU-27=100) figure.png" - Statistics Explained (2013/5/2)

Family Search: [familysearch.org/learn/wiki/en/Scotland\\_Emigration\\_and\\_Immigration](http://familysearch.org/learn/wiki/en/Scotland_Emigration_and_Immigration)

Kitson, M., "The Great Divergence: the State of the Regions in the UK", February, 2013. <http://michaelkitson.org/2013/02/18/the-great-divergence-the-state-of-the-regions-in-the-uk/>

Kitson, M., Michie, J., "The Deindustrial Revolution: The Rise and Fall of UK Manufacturing, 1870-2010" October 2012

Leitch, S., "Prosperity for all in the global economy- world class skills", Dec. 2006

McCarthy, A., 2004, "Personal Accounts of Leaving Scotland 1921-1954", Scottish Historical Review, vol.83, pp196-215.

Steedman, Hilary (2010), "the State of Apprenticeship in 2010: International Comparisons: Australia Austria England France Germany Ireland Sweden Switzerland", A Report for the Apprenticeship Ambassadors Network

Svensson, Lars E.O., (2012), "The Relation between Monetary Policy and Financial Policy", Sveriges Riksbank, Stockholm University, CEPR, and NBER

## Part II

### Scotland: the Importance of Getting the Macroeconomic Framework Right

Part II examines how well the UK has performed relative to other countries and how well it has performed as an economic and monetary union. It considers a wide range of major economic indicators.

#### 1.1 Output Performance Indicators

##### 1.1.1 Gross Domestic Product: Scotland relative to the UK

One of the most common measures of how a country is doing in economic terms is its Gross



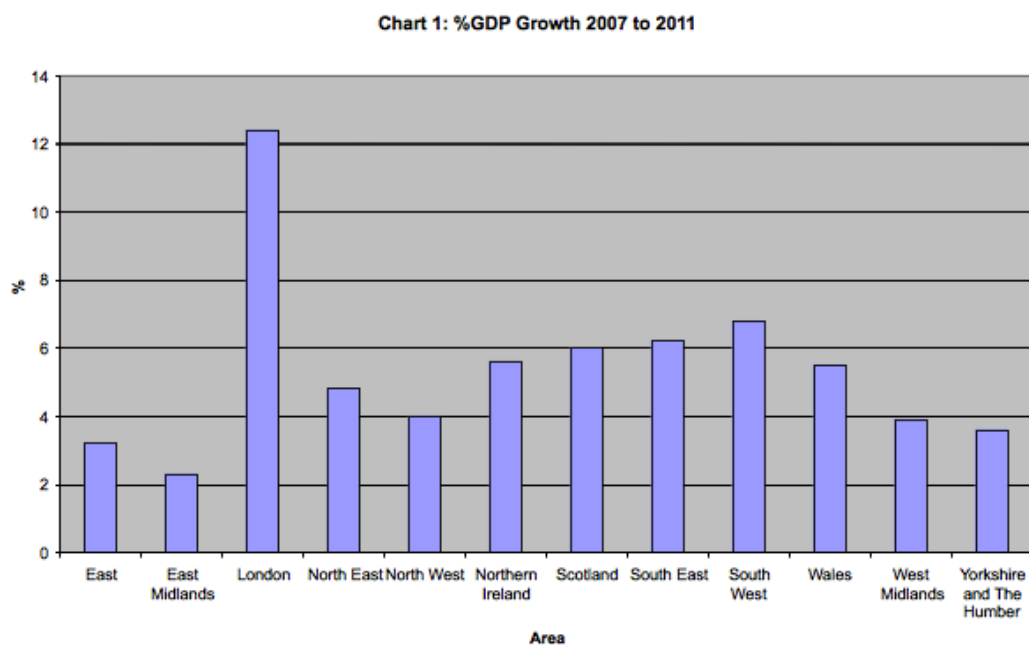
Domestic Product (GDP). GDP measures the value of goods and services produced each year in a country. It is equal to the contribution or value added by each producer, industry, or sector to the economy. (This is also termed Gross Value Added (GVA) at basic prices).

The data we use here was obtained from Scottish government statisticians and goes back to 1963. In fact, there is data available from 1951 onwards which shows the same picture as we depict here. Difficulties in aligning industrial sectors over such a long time period, however, have meant that we concentrate, in this instance, on the time range from 1963 onwards.

Our approach was to compare the Scottish data with UK data for the same period from the Blue Book prepared by the Office of National Statistics. The data showed that, over the period 1963 to 2011, in real terms, UK GDP increased by 329.3%, while Scottish GDP increased by 263%. In terms of average growth rates per annum, that for the UK was 2.514%, while that for Scotland was 2.04%: an average annual difference of 0.5%. An annual difference of 0.5% seems small, but looking at the cumulative growth effects since 1963, if Scotland had achieved the same growth rate as even the average for the UK the Scottish economy would be some 25% larger than it is now. In other words, although the underperformance of the Scottish economy, (at a growth disadvantage of 0.5% per annum), may sound fairly immaterial when expressed in annual terms, this underperformance has been maintained for so long that the cumulative effects are hugely important.

### 2.1.2 GDP: Variations within the UK

It is also relevant to look at the performance of the various countries and regions within the UK: here there are very large differences in GDP growth. For example, between 2007 and 2011, and despite the economic downturn, London outperformed every other area by a considerable margin as is shown in Chart 1 below.



Source: ONS: Region and Country Profiles.

The rate of growth in Scotland was less than half that in London, yet Scotland performs well relative to many of the English regions. What this broader picture tells us is that, leaving aside Scotland, there are marked differences in the performances of the UK countries and regions: and, above all, there is a huge imbalance in relation to London. This, as we will argue, is extremely significant when it comes to the question of whether the wider UK performs well as a monetary union.

### 1.1.3 GDP: International Comparisons

For international comparisons, World Bank data is available on the annual percentage real growth rate of GDP by country for the years 1963 to 2011. By taking, for each country, the geometric mean of these annual growth rates, we can obtain average growth rates. Table 1 below shows the average growth rates for Scotland and the UK, together with to those countries in Europe of smaller or similar size to Scotland.

Country	Average Annual Growth Rate GDP %, 1963-2011
Denmark	2.2
Finland	3.7
Ireland	4.3
Luxembourg	3.7
Norway	3.2
Scotland	2.0
United Kingdom	2.5
European Union	2.7

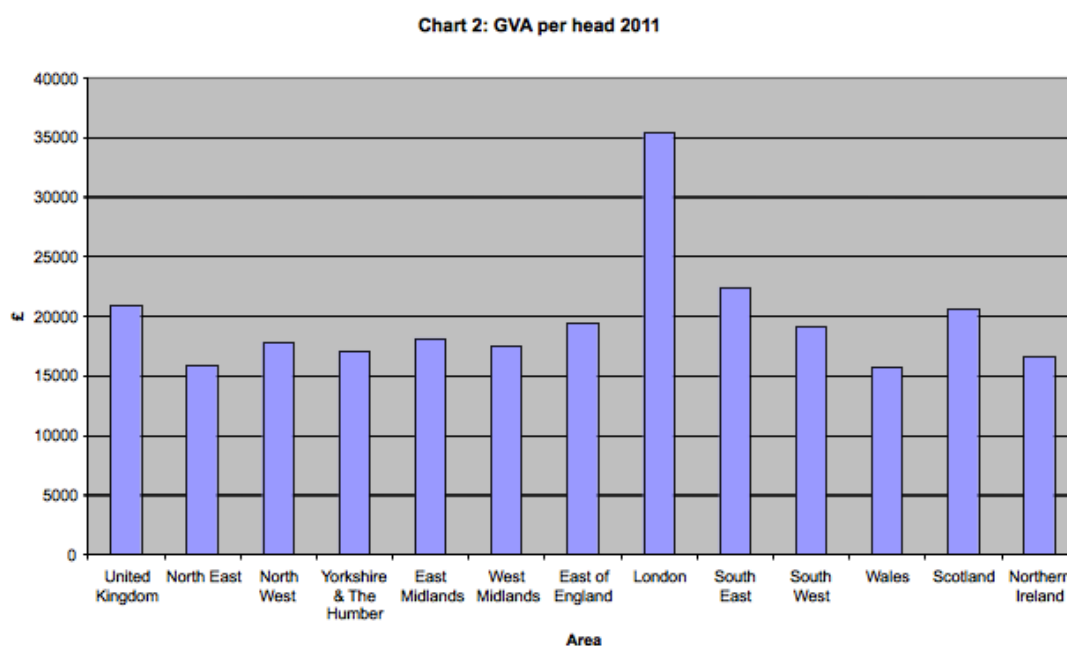
(Source: World Bank: apart from Scotland where data is from Scottish government)

Scotland has been outperformed by all countries considered over the period 1963 to 2011.

In summary, the evidence shows that Scotland has been underperforming relative to the UK average and relative to other EU countries of similar size since at least 1963. It is also of interest that the UK itself has not performed as well as these countries.

### 1.1.4 Gross Value Added per Head within the UK

Chart 2 below shows GVA per head across the countries and regions of the UK.



Source: Office for National Statistics

All data exclude extra regio, that is, they exclude North Sea oil and any contributions from off shore activities. What is striking in the figure is the range in GVA per head. A few areas are less than half the GVA per head of London: the North East, North West, West Midlands, Wales and Northern Ireland fall into this category. Although Scotland is in third place, its GVA per head is only 58% of that for London.

### **1.1.5 GDP per Head: International Comparison**

In the OECD analysis the UK comes out as ranked fifteenth in GDP per head among member states. Using data from Scotland adjusted to include a geographical share of North Sea oil, and estimating the resulting GDP per head on a similar basis to that used in the OECD international comparisons, the Scottish Government has estimated that Scotland would lie in sixth position.

However, this comparison, more than most, highlights the dangers of too much reliance on GDP figures. Only a fraction of the profits from the output of North Sea oil actually come to Scotland, and unless major changes are made, this will continue to be the case. Changes could include making it attractive for oil firms to do their R&D in Scotland, and to move more head office functions to Scotland.

### **1.1.6 Overall Findings on Output Performance Indicators**

The above output indicators demonstrate that Scotland has experienced a prolonged period of lower GDP growth than the UK as a whole. If Scotland had achieved the same growth rate as even the average for the UK since 1963, the Scottish economy would be some 25% larger than it is now. There are marked differences in the performances of the UK countries and regions: and, above all, there is a huge imbalance in relation to London. Over the period 1963 to 2011, the UK has performed less well than the average of the European Union, and Scotland has not performed as well as a set of European comparator countries. In terms of output per head of population, a few areas in the UK have less than half the GVA per head of London: the North East, North West, West Midlands, Wales and Northern Ireland fall into this category. Although Scotland is in third place, its GVA per head is only 58% of that for London.

Overall, the large and sustained variations in output indicators across the UK would suggest that the UK is not acting as an optimal currency area. Rather than the economy being self correcting and business returning to depressed areas as London overheats, the indicators suggest that the UK regions and countries have remained for a long time well below potential.

## **1.2 Population Indicators**

There are few sets of indicators which give a better feel for the health and prosperity of a nation than those indicators concerning population.

### **1.2.1 Population Growth: Scotland**

The major factors affecting population in Scotland compared with many other European countries have been high out-migration and a relatively high death rate.

Between 1946 and 1950, the population averaged around 5.05 million. Since then it rose gradually to reach a peak of 5.24 million in 1974 before fairly steadily declining to 5.05 million in 2002. The relative flatness of the trend in total population up to 2002, however, masked some large movements that were going on in its component parts.

Chart 3: Natural Change and Net Migration: Scotland, 1951-2002

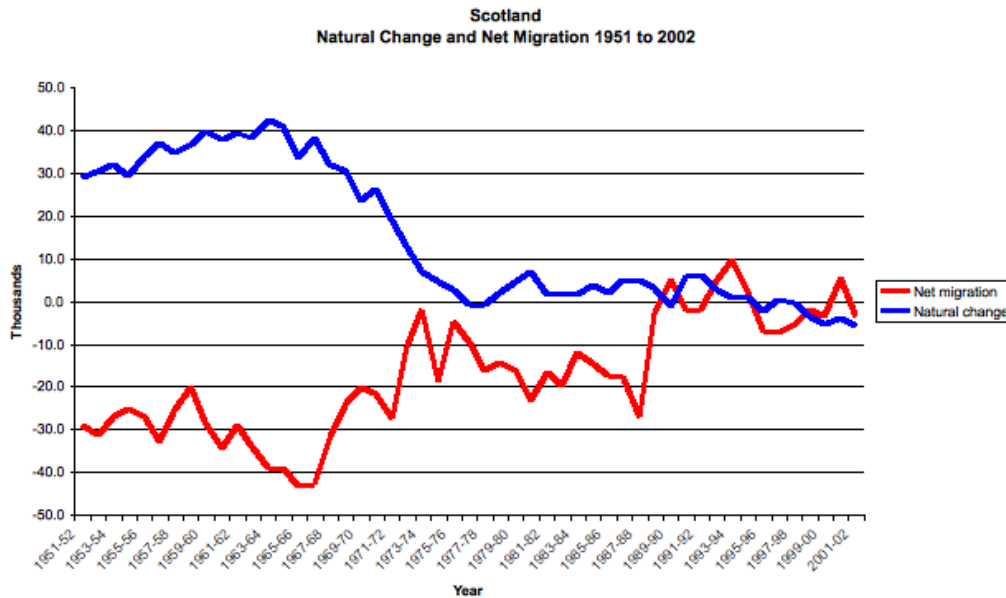


Chart 3 presents a graph of the annual change in population due to natural causes of birth and death, and with it, a graph of net migration out of Scotland. It shows that the natural increase was around 30,000 or more each year between 1951 and 1970, but that this was matched by net out-migration. By 1974 the natural increase had fallen to less than 7,000. Although there were falls in the death rate, the birth rate also fell. Over the same period there were large flows of population out of the country, whether to the rest of the UK or overseas.

The process of large scale out-migration was nothing new. Professor Tom Devine estimates that a total of 2.3 million people left Scotland to go overseas between 1815 and 1939: a further 600,000 migrated to England. (Devine, 2011). One of the main factors he cites was that Scots were looking for opportunity – which was not available in their own country. Scotland, he says was a “very uneven society”. Emigration was encouraged. From 1815 to 1900, qualified emigrants received passage money or land grants in the destination country as an alternative to receiving poor relief. (Family Search).

Between 1921-30, a proportionately greater number of Scots emigrated than from any other European country, and, as the graph shows, the trend continued in the 1950s and 1960s. Academic researchers have estimated that at least half a million people left Scotland in this period. (Anderson, 1992).

Net outmigration peaked in the post war period in the mid 1960s, in one year reaching 47,000, that is 0.9% of the population. This loss was taken extremely seriously by Parliament, and led to a debate on Scotland emigration in March 1967. George Younger, the then Conservative MP for Ayr led the debate: “no one will dispute that a persistently high rate of net emigration from a country is a serious obstacle to economic growth.” Younger pointed to UK wide policies which he believed were hindering the economies of “development areas”, whether in Scotland or other parts of the UK, and asked for the government of the day, (Labour), to adopt different tax regimes and different policies in the different areas of the United Kingdom. He found himself at one with the Chairman of the Scottish T.U.C., who in commenting on the latest rise in the unemployment figures which had just been announced, said that the Scottish unemployment figure of 4.1 % did not include the increase in emigration from Scotland which had risen from 40,000 to 47,000 in the past year. Younger believed that “in encouraging, although we do not wish to do this, more people to emigrate by letting unemployment rise, we are inhibiting the future chances of growth

in Scotland which will finally decrease the unemployment rate in Scotland.”

This debate was interesting for two reasons. First, it shows that even in Westminster in the 1960s there was a full consciousness of the importance of the interplay between the state of the economy in Scotland and population movement. Second, it is ironic that it was actually a Conservative MP, George Younger, who had come to the realisation that different parts of the UK were being handicapped by uniform UK policies, and who was advocating that variable treatment, including variable tax treatment, be given to in order to improve the balance in the economy and stem the net out-migration.

### 1.2.2 Population Trends: International Comparison

The table below shows Scotland’s population trend relative to similarly sized European countries.

Table 2: Population Statistics 1950-2010

Country	Population 1950	Population 2010	Annual % change 1950-2000	Annual % change 2000 – 2010
Denmark	4271	5516	0.46	0.37
Finland	4009	5255	0.52	0.18
Ireland	2963	4623	0.52	2.14
Norway	3265	4676	0.65	0.45
Sweden	7014	9074	0.49	0.19
Scotland	5114	5222	-0.02	0.35
UK	50127	62348	0.34	0.59

Between 1950 and 2000, Scotland was the only country of these similarly sized European countries to have a falling population. Since 2002, Scotland has experienced an inflow of migrants, many from Eastern Europe benefiting from the opening of the labour markets in Ireland and the UK before those of other EU countries. This large influx relates to the anomalous factors, which may be relatively short lived, surrounding the succession of Eastern European countries to the European Union. The influx has brought about a recent increase in Scotland’s population to 5.295 million: an increase of 0.35% per annum over the year 2000 to 2010. Over the same period, the population of the UK rose from 56.2 million to 63.182 million: an increase of 0.59% per annum: so that despite the recent increase, Scotland still suffers from relative population decline compared with the rest of the UK.

### 1.2.3 Overall Performance of Population Indicators

The above population indicators show that Scotland experienced a consistent population decline relative to the UK. Further, that Scotland’s population has also been in consistent decline relative to comparator countries. Over the earlier period studied, when Scotland’s population was experiencing a natural increase, a balancing number was exported, and this resulted in harmful effects on Scotland’s demographic structure. These population indicators show an economy which, far from moving in step with either the rest of the UK or European comparators, does not have sufficient buoyancy to give employment, and therefore a home, to its own natural growth in population.

## 1.3 Employment Indicators

The indicators examined for this paper were as follows:

- Employment: full time and part time, Scotland, UK, London, 2012
- Employment rates by country and region across the UK, 2012
- Employment differentials, 1997 onwards.
- International comparisons
- Employment by occupation, across countries and regions of the UK and through time
- Young People Not in Education, Employment or Training (NEET): within the UK and across OECD countries

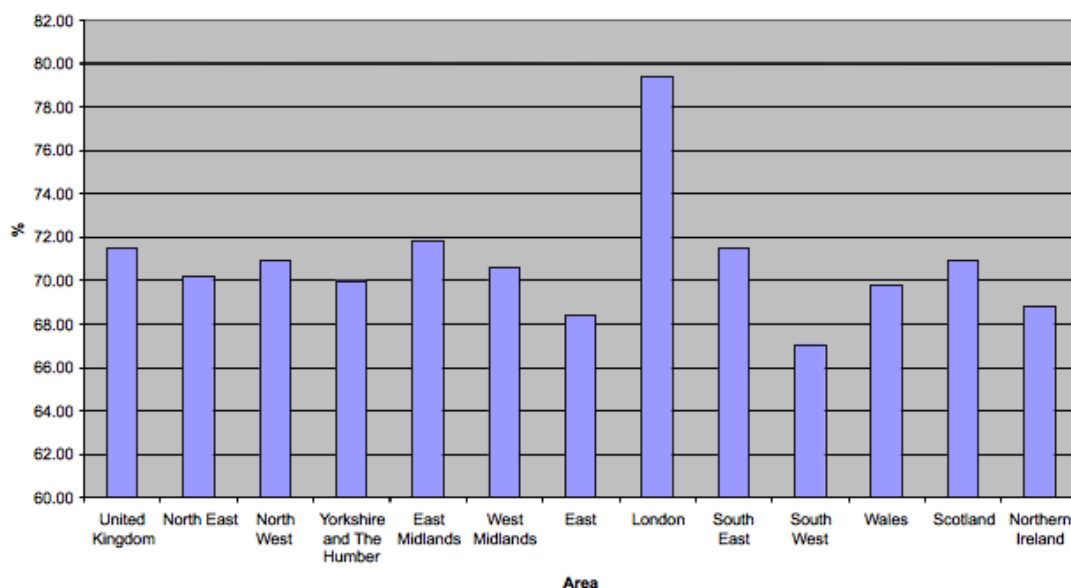
### 1.3.1 Full time and Part time Work

Data are available from 1997 to 2012 on employees in employment in the UK by country and region, gender, and whether the work is full or part time. Of the 3.45 million people in Scotland in 2012 in the age range 16 to 64, 1.7 million were men, 1.75 million women: around 2.2 million of the total were employees in employment. Column 2 of Table 3 shows the population aged 16 to 64 in each of the three areas considered, namely, Scotland, London, and the UK. Column 3 shows the percentage of this population who are employees. This percentage is higher in Scotland than in London or the UK average. Column 4, however, which gives the percentage of employees who are male, shows that Scotland is below both the UK average and substantially below London. Finally column 5, which gives the percentage of employees who are in full time employment shows Scotland's to be smaller than the UK average and considerably smaller than London

Table 3: Employment Statistics, 2012

	Population 16-64	% of total who are employees	% of employees who are male	% of employees who are full time
Scotland	3,449,100	63.1	48.6	70.9
London	5,664,000	62.4	53.9	79.4
UK	40,895,000	60.1	50.6	71.5

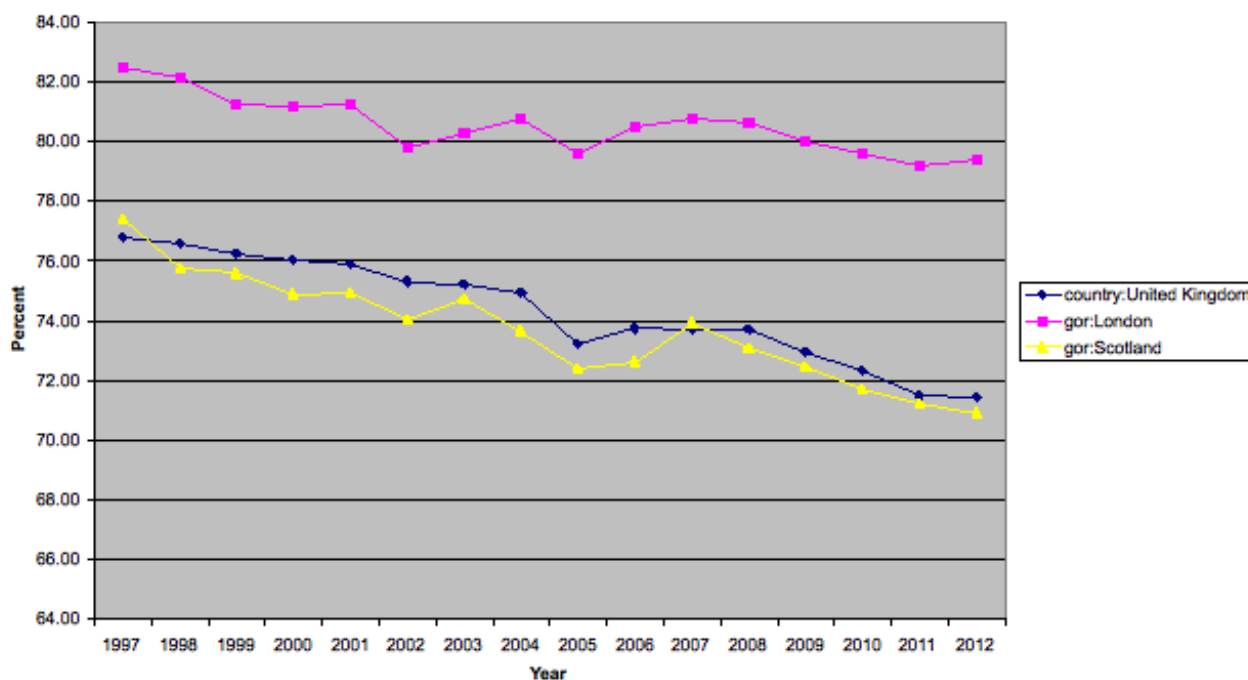
In fact, as can be seen from Chart 4, the percentage of employees in full time employment in the different parts of the UK is very variable, with a difference of as much as 13 percentage points between the South West of England and London. .





Further, the difference in the percentage of employees in full time employment between London, and the average for the UK, and also between London and Scotland, has widened over the period since 1997 from 5 to 8 percentage points, as shown in Chart 5.

**Chart 5: Percent in full time employment**



Source: Nomis, ONS

### 1.3.2 International Comparisons

Eurostat publishes information on employment rates by country, and on part time employment rates, male and female. In 2012, the UK was one of the better performing European countries for male employment, but was well behind Norway, Sweden, Germany and Denmark for female employment. In terms of part time male employment, The UK was almost double the rate for France and 3 percentage points higher than Germany but lay below Norway, Denmark, Sweden and Ireland. The highest proportion of part-time workers was found in the Netherlands (49.1 % in 2011), followed by the United Kingdom, Germany, Sweden, Denmark and Austria, where part-time work accounted in each case for over a quarter (25 % to 27 %) of those in employment. (Eurostat).

### 1.3.3 Employment by Occupation

Table 4 compares employment by occupation in Scotland with that in London and the UK in general. The table shows clearly that the balance of high earning, highly skilled jobs is very much towards London.

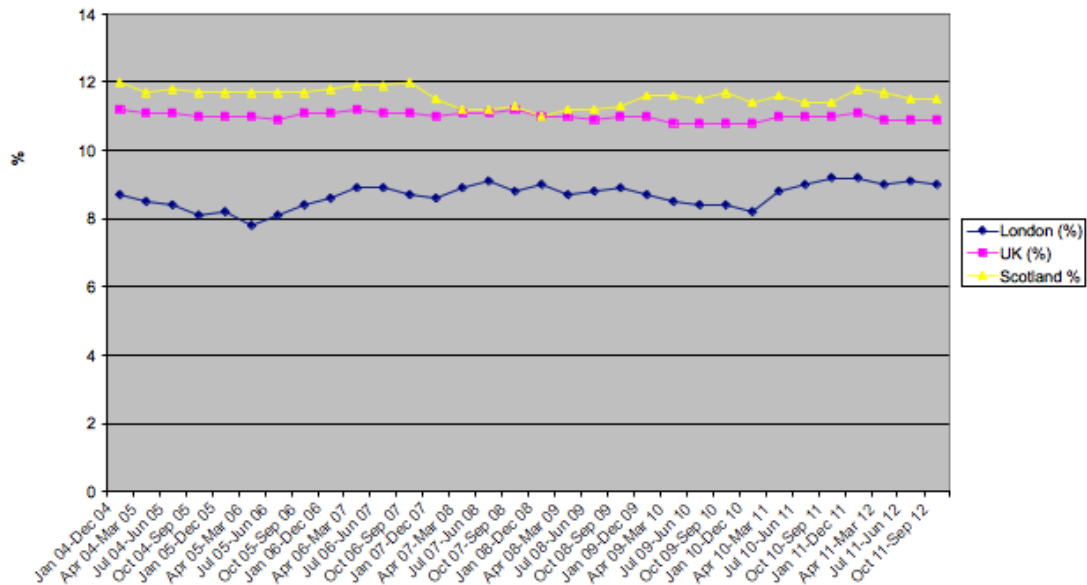
Table 4: Employment by Occupation: (Oct 2011-Sep 2012)

	Scotland (%)	London (%)	UK (%)
Managers professionals technical	40.9	54.9	43.6
Admin. Secretarial, Skilled	22.1	18.0	21.8
Caring, leisure, sales, service occupations	18.8	13.5	17.3
plant & machine operatives, unskilled	18.2	13.6	17.3

Source: Nomis: ONS annual population survey

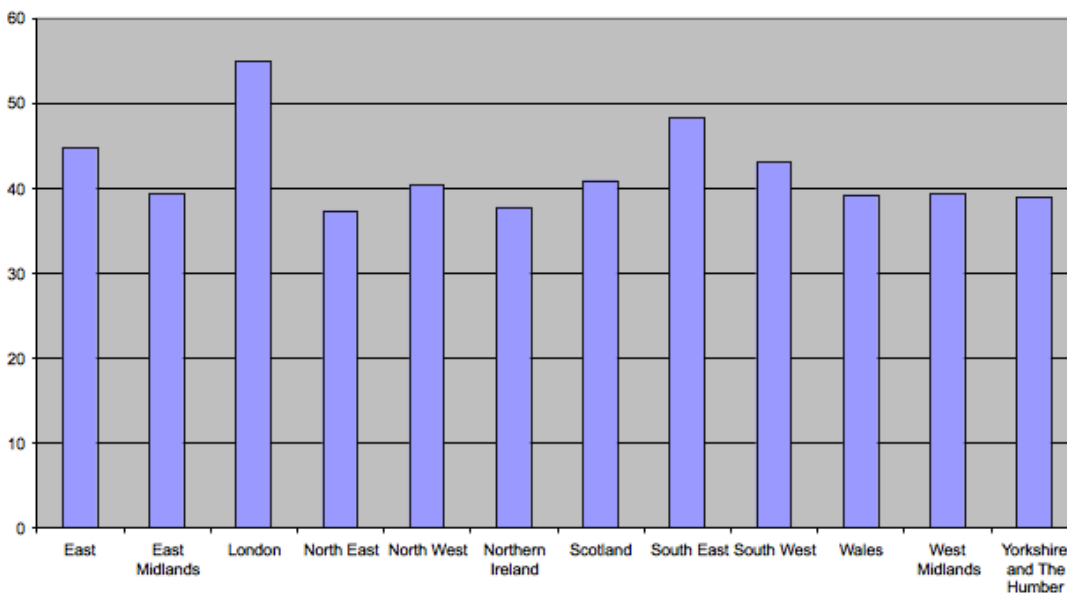
Over the UK as a whole it is in London, and in the East, South East and South West of England that management and professional occupations are at their highest.

Chart 7: Unskilled as % of all people in employment



Further, the percentages of the workforce in the different occupational categories has changed little over the last ten years, as shown by chart 6 which shows the percentage in the groups, plant & machine operatives, unskilled, comparing Scotland with London and the UK as a whole.

Chart 6: Percentage in Managerial, Professional and Technical Occupations



Source: Nomis

### 1.3.4. Unemployment

Between December 2012 and February 2013 the unemployment rate in Scotland was 7.3%, the fourth lowest among the twelve countries/regions that make up the UK. Between 1995 and 2006, however, Scotland’s unemployment rate was consistently above that for the UK. As noted earlier,

in the section on population indicators, Scotland has experienced long periods of considerable outmigration. Unemployment figures, therefore do not give a comprehensive picture of the effect of lack of employment opportunities in Scotland.

### 1.3.5. Young People Not in Education, Employment or Training (NEET)

In Scotland, the Scottish Government’s indicator of young people not in education, employment or training is calculated for those aged 16 to 19 years, this being the age group at which the Scottish Government targets its policies. In 2011, the Annual Population Survey (APS) estimated that there were 31,000 young people aged 16 to 19 not in education, employment or training, representing 12.2% of all 16 to 19 year olds. Table 5 shows the male/ female incidence of NEET and how NEET has changed over the period 2004 to 2011. Throughout the period, the incidence of NEET among young men is higher than that among young women. Rates were falling until the economic crisis, since when they have risen substantially for young men.

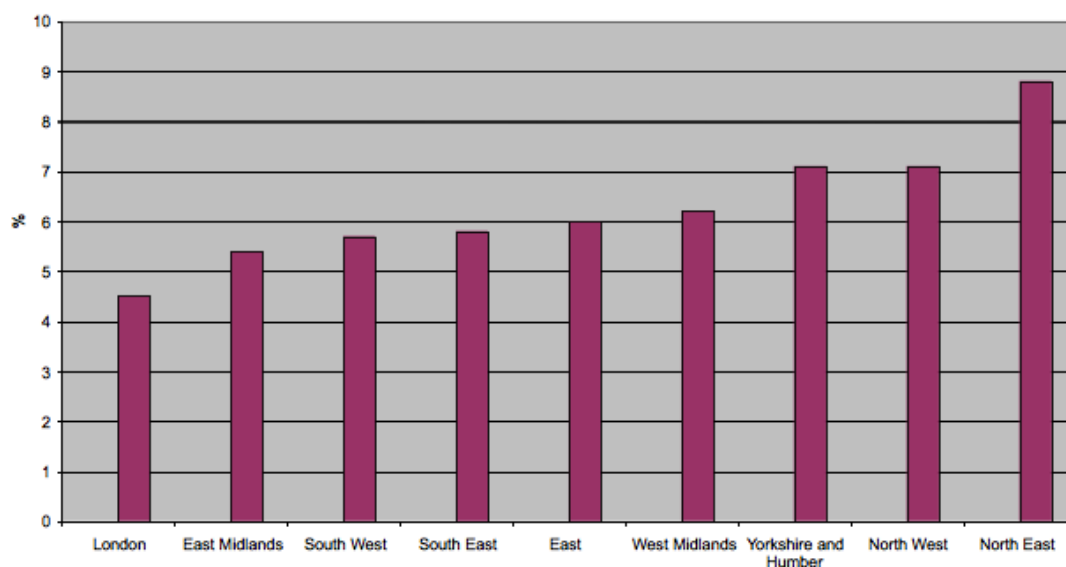
Table 5: Percentage and level of 16 to 19 year olds NEET, Scotland, 2004-2011

Year	Male		Female		All	
	Percentage	Level	Percentage	Level	Percentage	Level
2004	11.9%	16,000	11.5%	15,000	11.7%	31,000
2005	14.4%	19,000	13.3%	17,000	13.9%	36,000
2006	13.0%	17,000	10.3%	13,000	11.7%	30,000
2007	11.3%	15,000	10.7%	14,000	11.0%	29,000
2008	11.6%	16,000	11.2%	14,000	11.4%	30,000
2009	14.2%	19,000	11.3%	14,000	12.8%	33,000
2010	15.0%	20,000	12.4%	16,000	13.7%	36,000
2011	14.6%	19,000	9.8%	12,000	12.2%	31,000

Source: Annual Population Survey, Jan-Dec.

The age band used in England for NEET is 16 to 18 years, and the percentage of 16 to 18 year olds in this category is shown in Chart 8.

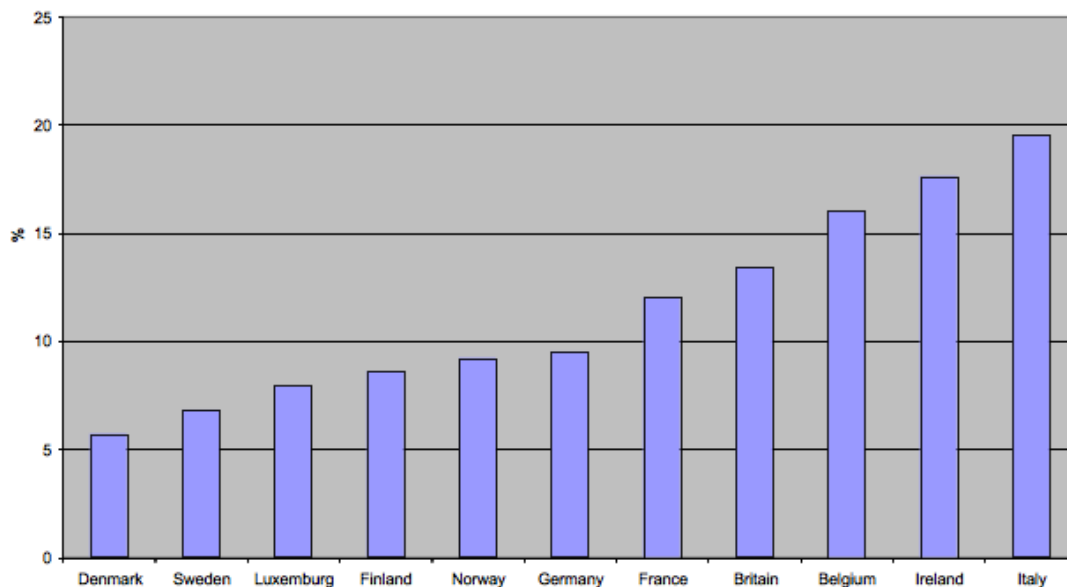
Chart 8: NEET 16 to 18 year olds England November 2011 to January 2012



The percentage of young people in neither employment, education or training in the North East of England is almost double that in London. The age band for Scotland cannot be directly compared with that used in England but note that the rate for 16 to 19 year olds in Scotland is 12.2% for 2011.

Finally, the OECD produces a table showing NEET rates across OECD countries for 16 to 24 year olds. At 13.4% Britain is more than twice that of Denmark and that of Sweden.

Chart 9: NEET, 16 to 24 year olds Q1 2011



The above analysis indicates that,

(a) Among European comparators, the UK has performed reasonably well in the percentage of the workforce in employment (either employed or self employed).

(b) The percentage of the workforce which is in part-time work is higher in the UK than in most EU countries but is on a par with Sweden, Germany, and Norway. (c) Within the UK there is considerable variation, with London being very different from other areas in its having a higher percentage of men in employment and in having a much lower percentage of employees in part time work.

(d) Over time the percentage of employees in full time work has fallen but the fall has been much steeper in Scotland and in the UK in general than it has been in London, so that by 2012, there was an 8 percentage point difference in the percentage of employees in full time between Scotland and London: largely due to the lower percentage of men in employment in Scotland.

(e) With regard to occupations, again there are marked variations across the UK with London having 14 percentage points more in the top employment categories of managers, professionals, and technical staff than Scotland – and this imbalance has held for many years.

(f) Among European comparators, the UK performs poorly in the percentage of young people in neither employment, education, nor training.

(g) Within the UK there is considerable variation in the percentage of young people without employment, education or training post 16.

## 1.4 Business Indicators

### 1.4.1 Business Birth Rates

The business birth rate in all countries and regions in the UK was fairly buoyant between 2004-2007, although London outstripped the others. The greatest differential in the business birth rate for that period was between London and Northern Ireland where the difference was 3.5 percentage points. With the financial crisis, the position changed differentially across the UK. Although all areas became less buoyant, London's average business birth rate for this later period fell from 14.1% to 13.7%: in Scotland, it fell from 11.6% to 10.4%: and in the worst performing area, Northern Ireland, it fell from 10.5% to 7.6%.

The data suggests that the performance of the business birth rate varies considerably across the UK and has worsened differentially in the economic crisis with the peripheral areas suffering far more than London.

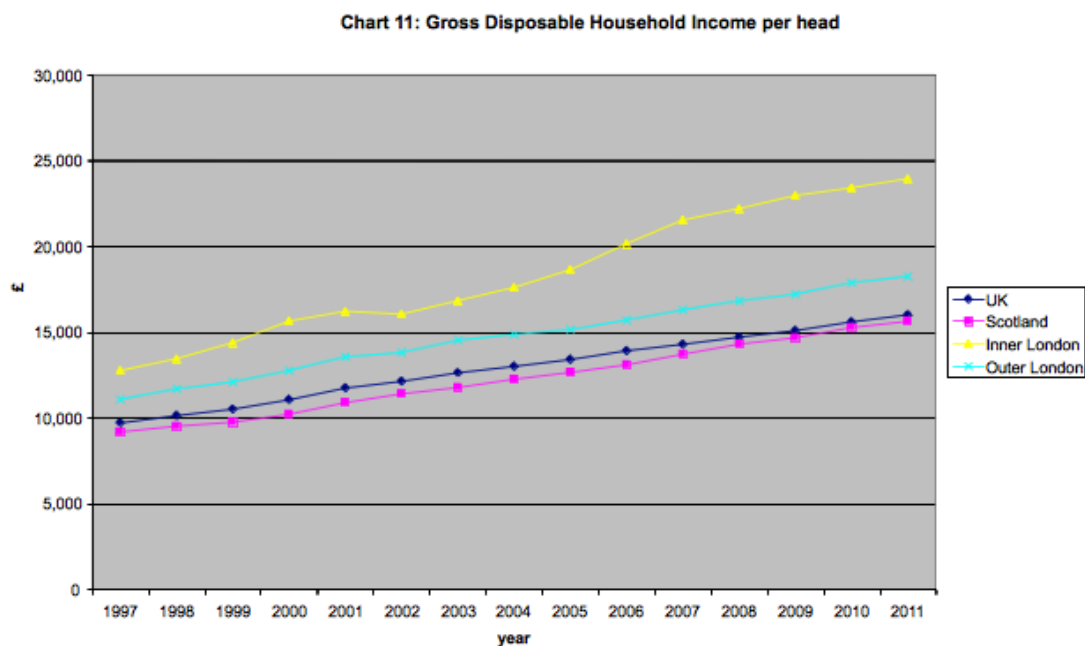
## 1.5 Household Income

The indicators used here are:

- Gross disposable household income per head, UK, Scotland, Inner London, Outer London, 1997 onwards.
- The contribution of benefits to income.

### 1.5.1 Gross Disposable Household Income

The chart below shows gross disposable household income per head at current basic prices from 2007 onwards in Scotland, the UK as a whole, inner London and outer London. (ONS, April 2013).



Source: ONS, April 2013

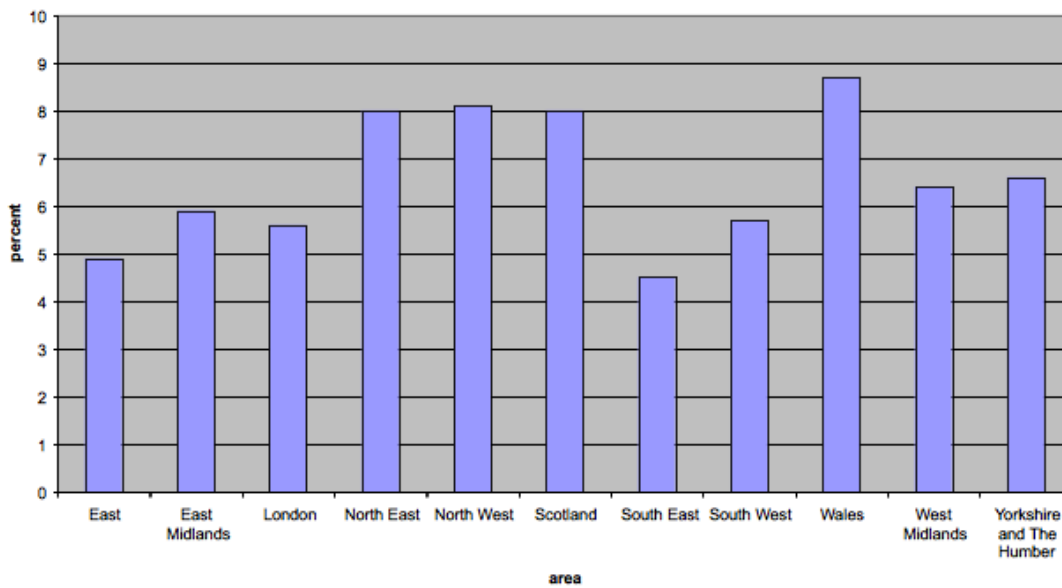
Throughout the period studied, gross disposable household income per head in Scotland lies below but close to the UK average. In fact, Scotland does better than most English regions and

Wales and Northern Ireland. However, in London, and especially in inner London, gross disposable income is so high relative to all other areas that it skews the average for the UK upwards. According to the latest data released by ONS (April 2013), at NUTS level of regional disaggregation within the UK, Nottingham had an average income of £10,834 in 2011 compared to inner London-West with an average income of £32,823.

### 1.5.2 Contribution to Income: Benefits

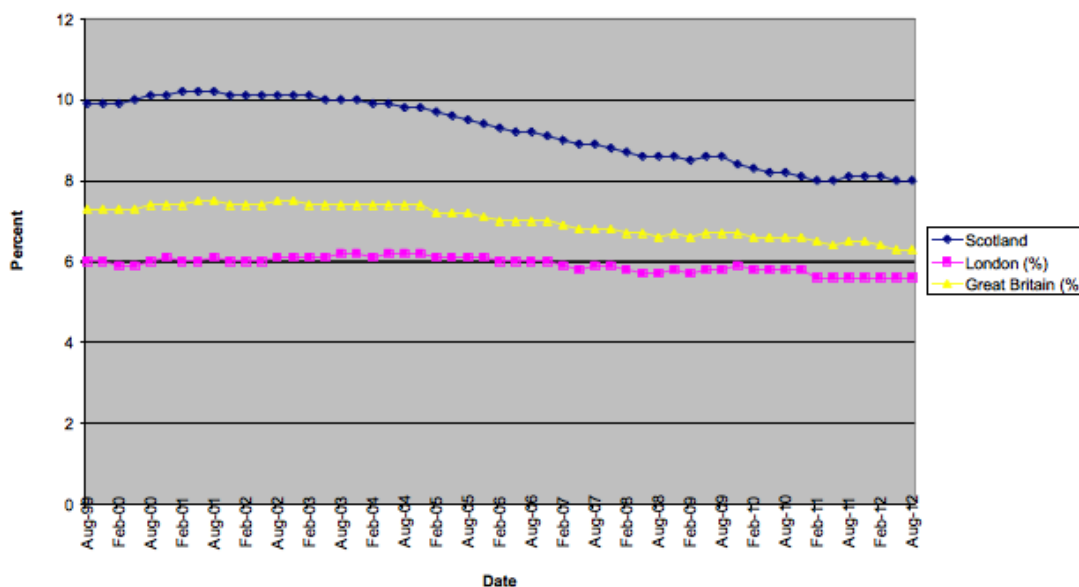
A range of benefits have been available to mediate problems of low income, poor health, disability, and deprivation. All of the indicators, such as the percentage of the working population on employment support and incapacity benefit, both given below, show that there is considerable regional variation, and that this variation has existed for a considerable length of time.

**Chart 12: % of working population on employment support and incapacity benefit August 2012**



Source: DWP benefit claimants - working age client group [August 2012]

**Chart 13: Percentage of Working Population on Employment Support and Incapacity Benefit**





## 1.6 House Inflation Indicators

### 1.6.1 Trends in house prices.

House prices in the UK in 2012 were, on average, 6.78 times what they were in 1986. The increase in prices across the UK was far from uniform: in Northern Ireland, prices rose by a factor of 5, and in London by a factor of 7.5.

In 1986, house prices in Scotland averaged £28,200 and in London £54,803 – a difference of £26,603. By 2012, average house prices in London were over £410,000 and in Scotland £180,494 – a difference of £229,885. Looked at in percentage terms, in 1986 the average price of a house in Scotland was 51% of one in London: by 2012, the average price of a house in Scotland was 44% of one in London.

There are various ways in which rising house prices affect the economy. First, the rise in prices has been far greater than the rise in the consumer price index, so that paying for housing can take up a greater share of household income, depending on what is happening to interest rates. Second, mortgages play a very large role in financing the purchase of houses: the relative increase in the price of houses has therefore increased personal debt levels. Third, the rise in house prices meant that those who were already on the housing ladder saw the value of their property rise faster than their mortgage payments, so that they were seriously adding to their capital stock solely by the act of owning a house. This fuelled the perception that owners were increasing their wealth and could therefore afford to take out more debt. This perception depended on the buoyancy of the housing market. A rise in interest rates, leading to a rise in mortgage rates was likely to lead to a choking off of demand for new mortgages, difficulty in mortgage repayments, a fall in house prices, and a general lowering of consumption as house owners realised they were less well off than they had thought.

Differences, therefore in house price inflation across the countries and regions of the UK, and differences in the levels of indebtedness due to housing, are therefore likely to lead to different responses to changes in interest rates, that is to UK monetary policy decisions. Areas with relatively high levels of personal housing debt will react quickly to changes in interest rates: areas with relatively low indebtedness will be more sluggish in their reaction but the effect may be longer lasting. They may find their savings being used in areas with high indebtedness, rather than being invested in the local economy. (Dow, Montagnoli, 2007)

Chart 14 shows differences in the levels of personal indebtedness due to housing across the countries and regions of the UK, where personal indebtedness is the amount of debt outstanding by individuals due to housing. London's indebtedness is twice or more than that of all other areas with the exception of the East, South East and South West of England.

Chart 14: Personal Indebtedness due to housing 2012

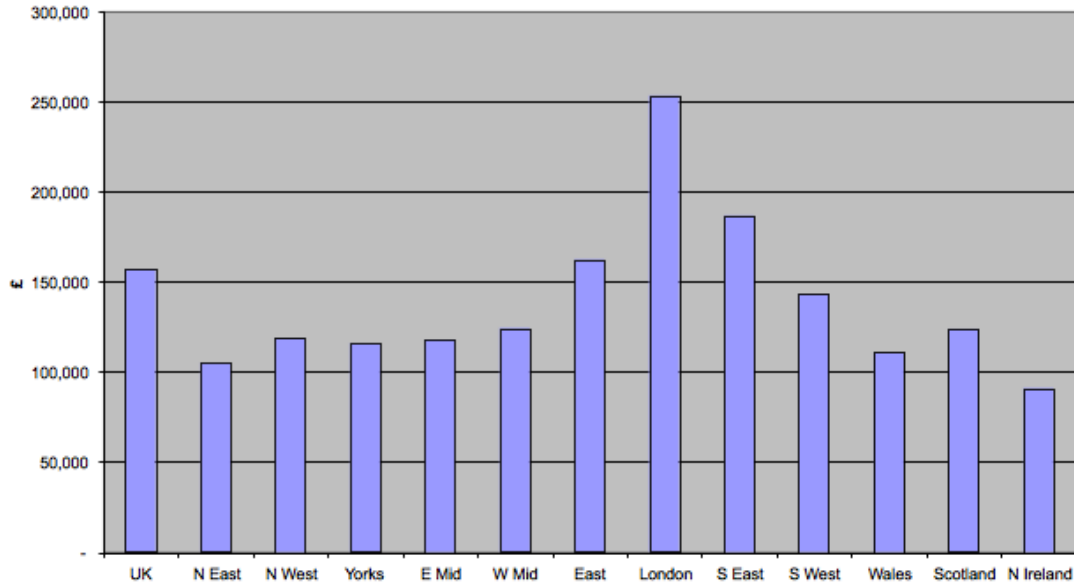
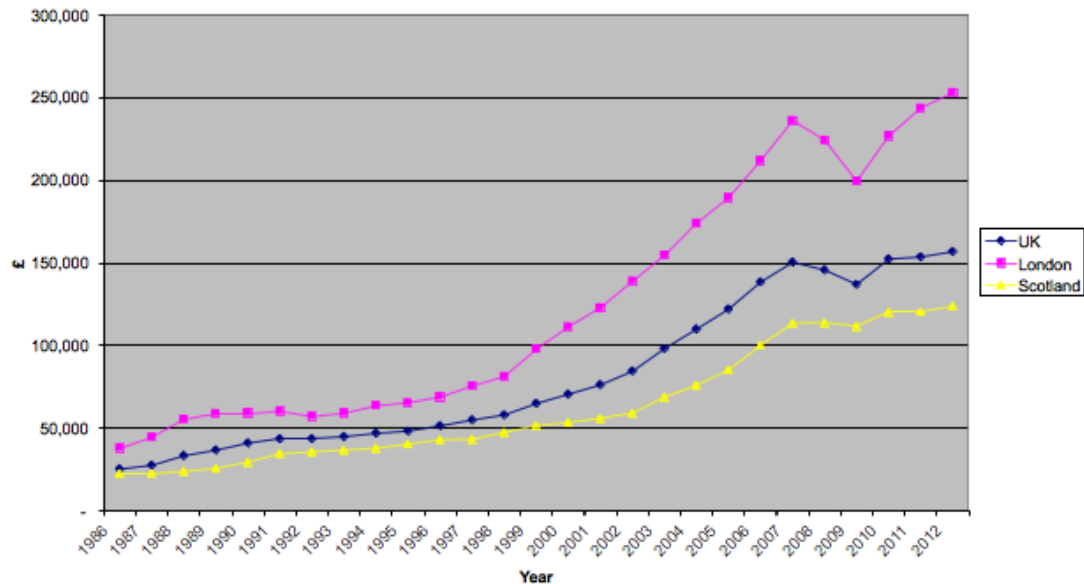


Chart 15 shows how the levels of indebtedness due to housing have changed in Scotland, the UK and London since 1986. From the mid 1990s until 2007, London’s indebtedness due to housing rose 25% faster per annum than indebtedness due to housing in Scotland. The large correction in debt in London (of 15.6% over two years) was not mirrored in Scotland where levels barely altered. Since 2009, indebtedness in London has once again resumed its high rate of growth, while that for Scotland has levelled off.

Chart 15: House Price Average Advance 1986 to 2012



In their 2007 paper Dow and Montagnoli examined how actions taken in monetary policy are transmitted regionally across the UK, and in particular are transmitted to Scotland, (Dow and Montagnoli, 2007). The data shows an immediate effect of monetary policy on the South East and a damped but longer lasting effect on all other parts of the UK, lasting after the South East has recovered. They begin by observing that unemployment and the wage rate in the South-East exhibit a much stronger negative correlation (-0.67) than is the case in Scotland (-0.27) or Wales

(-0.11). Further, one of the main items of spending, housing, has a much higher price in the South East leading to increased debt in that area relative to other areas. Suppose now there is excess demand, leading to inflation in the South East, and monetary policy is used to raise interest rates and dampen demand and inflation. With the higher level of mortgage payments in the South East, there will be an immediate effect on disposable income with the rise in interest rates, but a less marked immediate effect elsewhere, as the other areas had not been experiencing the same excess demand and will not have the same exposure to interest rates. However, the rise in interest rates will nevertheless have a longer term effect on the other areas. "There will be long experience in peripheral regions of periodic rises in interest rates, addressed to booms elsewhere, having the effect of choking off the potential for a boom. This encourages a generally more cautious attitude to expansion in peripheral regions, and therefore prevents the higher growth rates which might reduce regional disparities."

As can be seen from the Charts on housing indicators above, house price inflation and indebtedness in the London area suffered a sharp setback in the financial crisis in 2008, but the housing market there is now back on track with sharply increasing prices and debt. In contrast, in Scotland, the crisis did not produce the sharp impact which it did in London but has resulted in a much more sluggish market since.