

This is the Bank of Scotland Index of Leading Indicators report. Compiled by Markit for Bank of Scotland, the quarterly leading indicator is designed to provide an indication of turning points in the economic cycle up to three quarters in advance of official data.

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ECONOMIC RECOVERY IN SCOTLAND SET TO SLOW AT THE END OF 2010

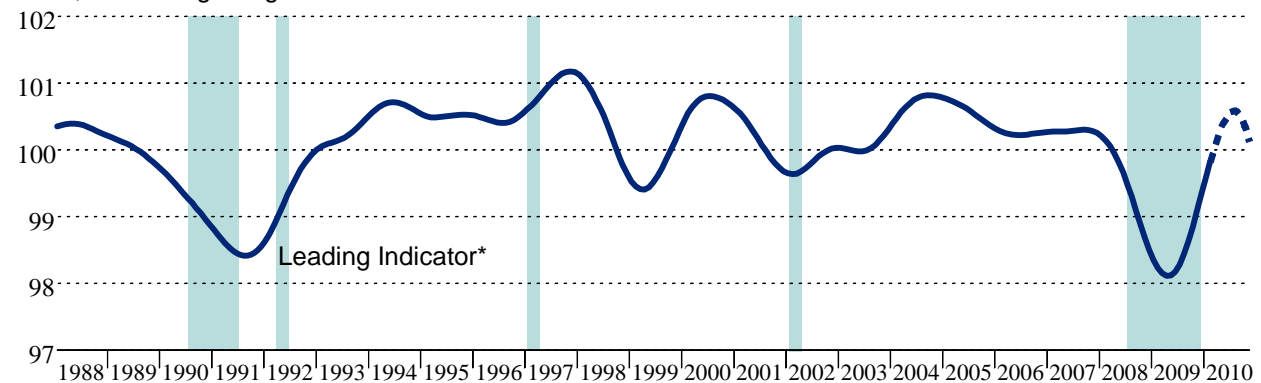
The recovery underway in the Scottish economy is set to slow at the end of Q3, after hitting a peak in July, according to the Bank of Scotland Index of Leading Indicators. The latest data subsequently points to a slowdown in economic growth in the final quarter of the year.

A key driver of economic growth remains low interbank lending rates which, despite creeping up in recent months, remain at historically low levels, and will help incentivise investment. New order levels are also rising, which continues to increase capacity pressures, notably in the manufacturing sector. This is borne out in firms demand for staff, which has improved in each of the past eight months.

However, the latest data flow highlights looming headwinds facing the recovery. Historically low interest rates are yet to stimulate new housebuilding activity and consumers remain markedly pessimistic with regards to current economic conditions. Inevitably, consumers are reluctant to purchase big ticket items, highlighted by declining new car sales in June and July. Weakening business sentiment is also dampening the outlook for the economic recovery over the remainder of the year.

Bank of Scotland - Index of Leading Economic Indicators

Index, 100 = long-run growth



* Shaded areas indicate periods of negative quarter-on-quarter GDP growth.

Sources: Markit; Bank of Scotland; Scottish Government

Donald MacRae, chief economist at Bank of Scotland, commented:

“The Scottish economy emerged from recession at the end of 2009 but growth then stalled in the first three months of this year. The Bank of Scotland PMI showed that the Scottish private sector has been growing for thirteen successive months, beginning in July of last year.

“This latest update of the Index of Leading Indicators shows the tentative recovery slowing in autumn as both consumer and business confidence continue to be dented by widespread concerns over the effect on jobs and contracts of future cuts in government spending.”

More.../

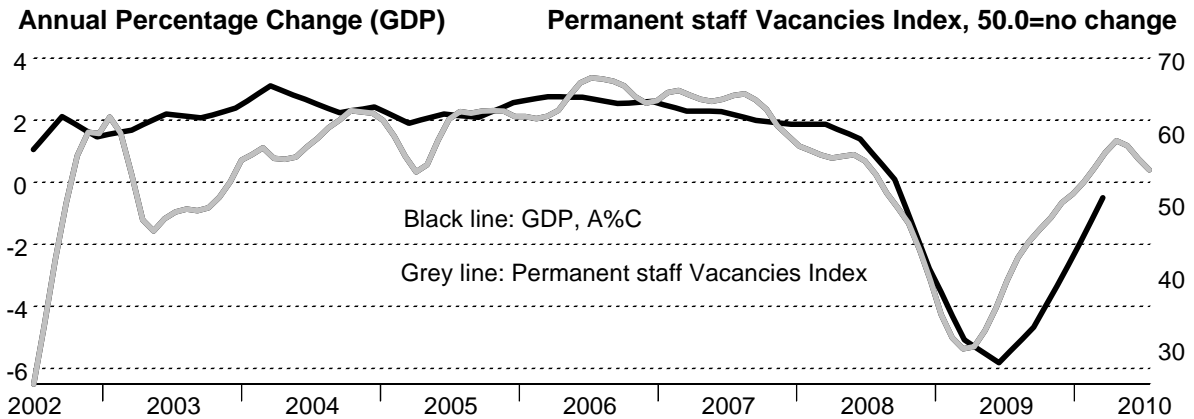
Donald MacRae added,
 “Growth may be reduced but not extinguished. Manufacturing continues to display robust growth and an equally robust expansion of exporting activity. Travel, tourism and leisure growth outstrips business and financial services. However the uncertainty caused by concerns over government spending cuts can only be dispelled by clarity on their scope, extent and size – the sooner the better.”

Q3 2010 – Leading Indicator Components Summary

- Latest data from the Bank of Scotland PMI signposted a sixth successive rise in the level of **new business** received by firms operating across Scotland’s private sector economy. Nonetheless, rates of expansion have slowed in recent months and remain below those recorded for the UK as whole.
- Despite the ongoing improvement in demand, **Scottish businesses’ sentiment** regarding the current economic climate slipped markedly during Q2. The Confederation of British Industry’s index monitoring Scottish manufacturers’ sentiment fell from +20 in Q1, to 0 in Q2.
- Scottish **consumer confidence** remained in negative territory in July, thereby extending the current period of pessimism to thirty-five months. The Gfk NOP Consumer Confidence Index posted a net balance of -22 in July. Although up from -25 in June (an eleven month low), the index pointed to a considerable degree of negative sentiment.
- Further highlighting weak consumer sentiment, the Scottish Motor Trade Association reported a second straight reduction in the number of **new car registrations** at forecourts across Scotland during July. New car sales were 9.5% lower in July (on a year-on-year basis), following a 6.0% drop in May.
- Despite weaker sentiment, Scottish firms raised their employment intentions in July. This was indicated by the Bank of Scotland Report on Jobs’ seasonally adjusted Permanent Vacancies Index signposting higher **demand for long-term workers**, as has been the case in each of the past eight months. However, the pace of vacancy growth has slowed in recent months.
- The **ratio of new orders to inventories** at manufacturing plants, as signalled by the Bank of Scotland PMI, remained above parity in July. This indicated that new orders are rising at a faster pace than inventories, meaning that manufacturers will need to raise output to satisfy higher demand, as stocks of finished goods become depleted. The ratio hit a six-month high of 1.19 in June, but fell slightly to 1.17 in July.
- Latest data from the Bank of England indicated that **UK short-term interest rates** have risen in each of the past three months, to reach an eleven-month high of 0.75% in July. Nevertheless, short-term interbank lending rates remain historically low.
- Official data from the Scottish Government pointed to a 7.7% year-on-year decline in **new housing starts** in Q1. This was mildly sharper than the 7.5% annual fall in housing starts during the final quarter of 2009.

| Leading Indicator Component | | Latest | One year ago |
|---|--|--------|--------------|
| CBI Scotland - Business Optimism | % balance of optimists less pessimists | 0 | -44 |
| Scotland Consumer Confidence | % balance of optimists less pessimists | -22 | -25 |
| Scotland Index of Production | Annual % Change | -0.4% | -8.2% |
| Scotland New Housing Starts | Annual % Change | -7.7% | -6.9% |
| Scotland Composite PMI - New Orders | Index, 50.0 = no-change | 51.2 | 50.1 |
| UK Short-term Interest Rates | % | 0.75 | 1.03 |
| SMTA Scottish New Car Registrations | Annual % Change | -9.5% | 14.3% |
| Scotland Demand for Permanent Staff | Index, 50.0 = no-change | 53.2 | 43.4 |
| Scotland Manufacturing PMI - New Orders:Inventory | Ratio | 1.17 | 1.03 |
| UK Yield Curve | % spread (long-term – short-term interest rates) | 3.42 | 3.42 |

Focus on... Demand for Permanent Staff



Source: Scottish Government; Markit/Bank of Scotland

Demand for permanent workers tends to be a leading indicator of turning points in the economic cycle, primarily as a gauge of business confidence and secondly, as an indicator of future employment trends. As a sentiment indicator, higher demand for staff indicates that firms are confident that demand for their products or services will rise, hence greater capacity is required. Conversely, lower demand for staff indicates that firms are looking to cut capacity and output.

As a secondary impact, higher vacancies imply that workforce numbers are set to rise. Increased employment levels and greater job security will subsequently lead to higher consumer confidence and spending, which is a key driver of overall economic activity.

The chart above clearly illustrates a sharp improvement in demand for permanent staff from early-2009 to mid-2010. This has been followed by a strong recovery in GDP. Recent data from Markit and Bank of Scotland, however, indicates that the pace of increase in permanent vacancies has slowed in recent months. This in turn suggests that the economic recovery is set to slow.

Notes to editors

The Scottish Index of Leading Economic Indicators is derived from data that is available to 10th August 2010. The report is available online at: <http://www.lloydsbankinggroup.com/media.asp>

Sources:

| | |
|---|---|
| New Housing Starts/ Industrial Production | Scottish Government |
| New Car Registrations | Scottish Motor Trade Association |
| Consumer Confidence | GfK NOP on behalf of the European Commission |
| Yield Curve | Bank of England; Office for National Statistics |
| Business Optimism | Confederation of British Industry |
| Short-term Interest Rates | Bank of England |
| Demand for Permanent Staff | Bank of Scotland Report on Jobs |
| New Orders / New Orders:Inventory ratio | Bank of Scotland PMI |

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Bank of Scotland

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