Need to know

- The Scottish economy continues to remain in a precarious position. Output declined in the final three months of 2016, and most business surveys and indicators of economic confidence suggest any growth in the first six months of 2017 has been fragile at best.
- Whether or not Scotland has formally entered technical recession (defined as two consecutive quarters of falling output) is in the balance.
- All things considered, we still expect the Scottish economy to grow this year and create more jobs – albeit at rates well below trend. A number of 'big' political factors – not least the Brexit negotiations – cast a shadow over the outlook.
- In such uncertain times, we continue to recommend that just as much attention is given to the range of estimates that underpin this outlook as well as our central estimates.
- Our central forecast is for **growth of 1.2% in 2017, 1.4% in 2018 and 1.6% in 2019** – broadly in line with our March forecast**.**
- Financial and business surveys are forecast to lead the return to growth, building on the momentum gained over the last year to eighteen months. Food & drink and tourism should continue to benefit from the low value of Sterling, although the retail sector will face further pressure as a result of falling household incomes.
- Unemployment is forecast to rise slightly as the recent sharp increase in inactivity levels off.

FAI forecast Scottish GVA growth (%) by sector, 2017 to 2019

	2017	2018	2019
GVA	**1.2**	**1.4**	**1.6**
Production	1.4	1.6	1.8
Construction	0.7	0.8	1.0
Services	1.2	1.3	1.6

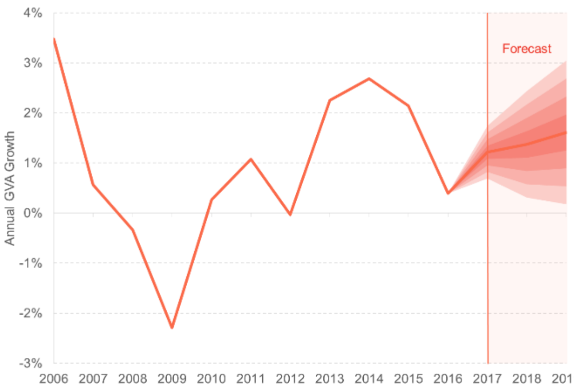
Source: Fraser of Allander Institute

FAI labour market forecast to 2019

	2017	2018	2019
Employee Jobs	2,436,450	2,476,450	2,514,700
Unemployment	117,000	134,300	143,750
Rate (%)	**4.4**	**5.0**	**5.3**

Source: Fraser of Allander Institute

GVA forecast range 2017 to 2019



Source: Fraser of Allander Institute

Summary

The economic news since our March Commentary has continued to paint a relatively disappointing picture of the performance of the Scottish economy.

Scotland's economy shrank in the final three months of 2016, with the slowdown evident across most key sectors.

The latest indicators of consumer confidence and business activity suggest that growth has returned during the first half of 2017 but remains fragile.

Such weakness can no longer be explained solely by the downturn in the oil and gas industry. Nor, given the relative resilience of the UK economy, can it be the result of Brexit (yet).

Instead it would appear that the economy is stuck in a cycle of low growth, weak investment and fragile confidence.

The one bright spot has been the labour market which continues to hold up remarkably well with unemployment at a record low and employment growing.

However, over the past two years there has been a movement from unemployment into inactivity, whilst the recent growth in employment has been largely in self-employment – some of which is likely to be relatively insecure.

At the same time, productivity growth remains poor not just by international standards but also by Scotland's own recent trends. This lack of improvement in productivity is feeding into weakened pay growth, putting further downward pressure on household incomes.

With the effects of any Brexit headwinds and rising inflation likely to become more significant in the coming months, the resilience of the Scottish economy is likely to be severely tested.

Whether or not Scotland formally enters recession when the next set of data are released is in the balance. We believe that the Scottish economy will still grow over the year as a whole (and more quickly than last year) but further negative quarters of growth are highly possible.

In such challenging economic times, it is vital that businesses focus on the long-term drivers of growth including: accessing new external markets, grasping the opportunities from the rapid expansion in new technology and improving firm specific efficiency and productivity levels.

It is also right that businesses demand much more of a policy effort from government. Recent debates have understandably focussed on the general election, the constitution and Brexit.

However, what our economy needs – more than ever – is clear policy strategies backed-up by concrete action.

The Scottish economy has been flat lining for two years. The EU referendum result was known 12 months ago.

But what genuinely new policy actions – with immediate effects – have been taken in response? And what has been their impact?

To what extent have both the Scottish and UK Government's changed their economic strategies to cope with a world where we will no longer be part of the EU?

With Brexit undoubtedly adding new risks *and* new opportunities, 'policy as usual' is no longer an option.

A renewed focus on how both the Scottish and UK Governments can use the powers at their disposal to support the Scottish economy is urgently needed.

Fraser of Allander Institute
June 2017

Outlook and Appraisal

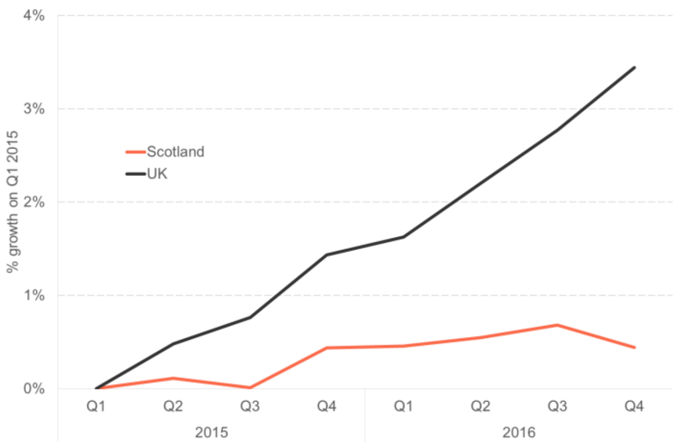
Scotland is on the brink of recession with most indicators suggesting economic activity during 2017 has been modest at best. Whether or not the data confirms a 'technical' recession when published next month is in itself – in our view – not especially important. Of greater concern is the lack of growth over the past two years and that what started as a downturn in oil and gas has become more widespread. All things considered, we still expect growth to pick-up this year but to remain well below trend.

Table 1: Scottish growth (%) by sector, Q4 2016

	GDP	Agriculture	Production	Construction	Services
Q4	-0.2	-0.2	-0.9	-0.8	+0.0
UK	*+0.7*	*+1.0*	*+0.4*	*+1.0*	*+0.8*
Annual	+0.0	+0.3	-4.6	-6.0	+1.6
UK	+1.9	+1.9	+1.9	+2.8	+2.9

Source: Scottish Government, Q4 GDP

Chart 1: Scottish & UK cumulative growth – since 2015



Source: Scottish Government, Q4 GDP

Table 2: Labour market, Feb-Apr 2017

	Employment (16-64)	Unemployment (16+)	Inactivity (16-64)
Scotland	74.1	4.0	22.7
England	75.2	4.6	21.1
Wales	72.9	4.8	23.2
N. Ire	68.8	5.4	27.2
UK	74.8	4.6	21.5

Source: ONS, Labour Force Survey

Introduction

The Scottish economy contracted in the final quarter of 2016. The poor figures were comprehensive. Production and construction output fell, whilst services remained flat.

During 2016, the Scottish economy did not grow at all, compared to growth of 1.9% in the UK.

This divergence is not new. Growth in Scotland has lagged the UK for 2 years (Chart 1).

In contrast, Scotland's labour market continues to hold up remarkably well (Table 2). Unemployment is at record lows. But we continue to urge caution against viewing these figures in isolation, particularly given recent increases in inactivity and less secure self-employment.

Businesses in Scotland are likely to face a tough trading environment for the foreseeable future. Weak domestic demand in Scotland, a cooling UK economy, inflation and ongoing political uncertainty, does not lend itself to a positive backdrop for growth.

In such times, seeking new opportunities in overseas markets alongside a relentless focus on the long-run drivers firms can control – such as efficiency improvements, strategic investments, staff training etc. – will be crucial.

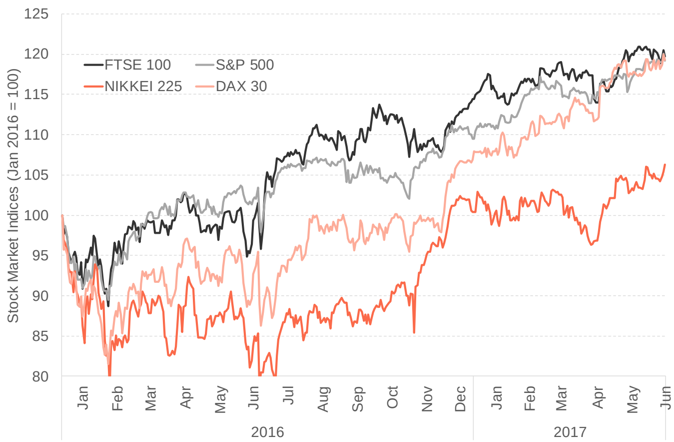
From a policy perspective, there is an urgent need for action to support Scotland's economy. Debates over Brexit and the constitution cannot be used as an excuse not to make full use of the levers that the Scottish and UK Governments do control.

Table 3: An improving global outlook – World growth forecasts (% change on a year earlier)

	2016	2017	2018
World Output	3.1	3.5	3.6
G7	1.7	2.0	2.0
US	1.6	2.3	2.5
Euro Area	1.7	1.7	1.6
Emerging & Developing	4.1	4.5	4.8
China	6.7	6.6	6.2
World Trade	*2.2*	*3.8*	*3.9*

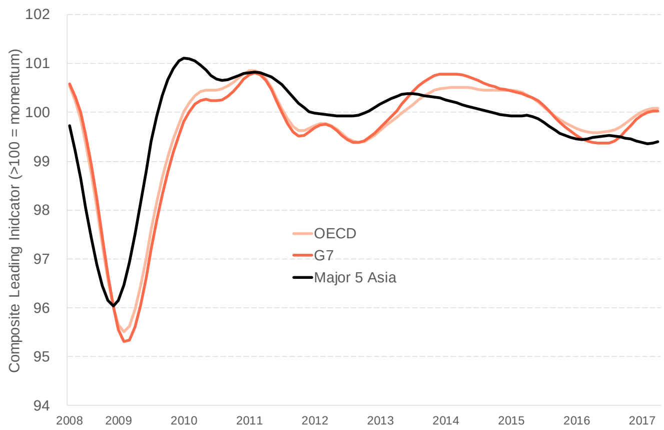
Source: IMF, World Economic Outlook

Chart 2: Global stock markets at near record levels (Jan 16=100)



Source: Thomson Reuters Datastream

Chart 3: OECD composite leading indicator – above 100 = conditions above long-term trend (and vice versa)



Source: OECD, Leading indicators and tendency surveys

The global economy

The fundamentals of the global economy are stronger than they have been for many years.

World economic activity is picking up with a long awaited recovery in investment and trade.

The IMF forecast global growth to rise from around 3% in 2016 to nearer 3.5% this year and next – not too far away from long-term average growth rates.

Encouragingly, growth in international trade is expected to move ahead – once again – of growth in the global economy. Faster trade growth is generally seen as a good indicator of robust activity.

Financial markets have also held on to gains made in early 2017 and levels of business and consumer confidence are, on the whole, positive (Chart 2).

The keenly watched 'OECD Leading Indicator' points to the major advanced economies continuing to grow close to their long-term average in the near term (Chart 3).

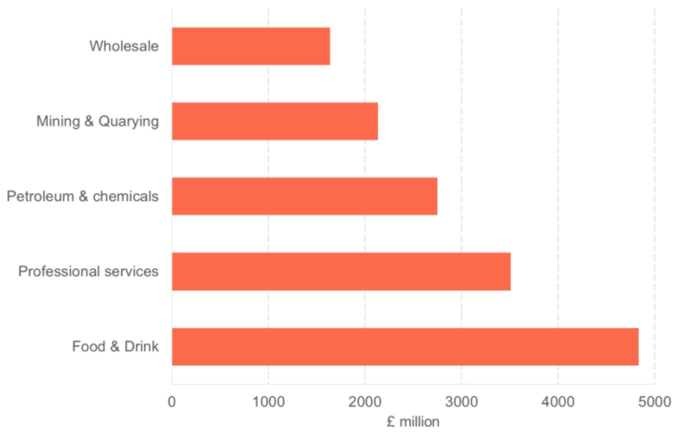
In terms of Scotland's two main international export markets, the outlook is more positive than in recent years.

Firstly, whilst the US economy has posted relatively modest results so far this year, strong job market data and an anticipated fiscal stimulus should lead to faster growth this year and next.

Secondly, the recovery in Europe continues to build and has now reached all Euro Area countries. But whilst unemployment continues its downward trend, it remains high with painful structural adjustments still needed. Even by 2018, Euro Area unemployment is still projected to be close to 8%.

The greatest risk to the global economy remains policy uncertainty, from President Trump through to Brexit. And there are also a number of imbalances and vulnerabilities in financial markets – not least in China – which pose their own risks to the global outlook.

Chart 4: Scottish exports by sector 2015



Source: Scottish Government, Export Statistics Scotland

Table 4: International exports by size of company: 2014-15 (£ million)

	2014	2015	*change*
Scottish International Exports	27,740	28,740	*+3..6%*
Large	14,910	15,585	*+4.5%*
Medium	7,515	8,350	*+11.2%*
Small	5,315	4,805	*-9.6%*

Source: Scottish Government, Export Statistics Scotland

Table 5: World's top 10 economies, 2016 and 2050 (GDP at PPPs): highlighted denotes E7 country

	2016	2050	
China	1	1	China
US	2	2	India
India	3	3	US
Japan	4	4	Indonesia
Germany	5	5	Brazil
Russia	6	6	Russia
Brazil	7	7	Mexico
Indonesia	8	8	Japan
UK	9	9	Germany
France	10	10	UK

Source: IMF & PWC 'The World in 2050'

On balance however, the global outlook should provide a positive source of demand for Scottish businesses over the near term.

Disappointingly, we have yet to see much evidence of this spilling over into Scottish exports and overall, our trade performance remains poor.

If we are to see a fundamental shift in Scotland's long-term economic prosperity we need to improve both the depth and breadth of our export base.

Just five sectors account for over half of all Scottish international exports, with whisky accounting for a significant chunk of that – Chart 4.

Just 100 companies are believed to account for around 60% of total Scottish international exports.

A particular challenge appears to be encouraging small businesses to seize opportunities overseas.

The most recent Small Business Survey Scotland figures show that just 12% of Scottish SMEs are exporters, compared to 19% in the UK as a whole.

Worryingly, the latest statistics reported a near 10% fall in exports from small companies in Scotland – Table 4.

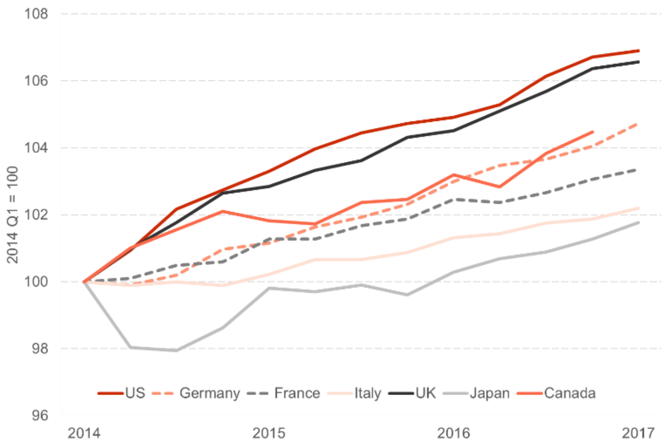
If Brexit forces policymakers and businesses to do anything, then it might be to put greater effort into seeking new opportunities in global markets.

And there is much to be gained.

Analysis by PWC (Table 5) – based upon current growth and population trends – highlights the changing global economic order over the coming decades. By 2050, 6 of the 7 largest economies in the world will be from outside the G7. If Turkey is added to complete the list of E7 countries, their combined output will be double that of the G7.

Despite their economic potential, Scotland's export record to E7 countries remains poor. Scotland's trade with Ireland is 60% more than with China and its trade with India is the same as with Luxembourg. So clearly there is potential but much still needs to be done.

Chart 5: The UK has performed well in comparison to other G7 economies in recent years

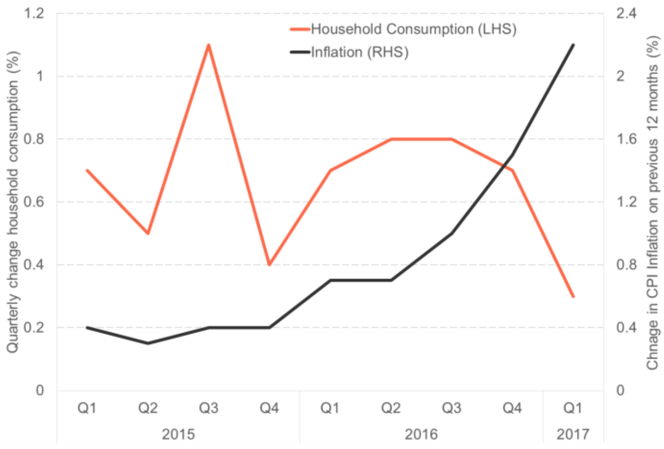


Source: ONS, National Accounts & OECD, Economic Outlook

Chart 6: UK average weekly earnings: 3-month average on same time a year ago

Source: Thomson Reuters Datastream, ONS

Chart 7: Strong growth in consumption beginning to ease



Source: Thomson Reuters Datastream, ONS

The UK Economy

The health of the UK economy has an important bearing on Scotland's economic outlook. Around £11.5bn of Scottish exports are sold to rUK each quarter – supporting around 530,000 jobs.

The UK grew relatively strongly through 2016, apparently confounding predictions of a post-EU referendum hangover.

And at first glance, many of the UK's macroeconomic fundamentals are in relatively good health. For example, employment levels continue to reach new highs.

Indeed since 2014, the UK has been one of the strongest performing G7 economies – albeit on the back of the slowest recovery since the 1920s (Chart 5). But as we have outlined before, underneath the headline figures there have been concerns about the sustainability of this growth.

In particular, recent UK growth has been almost entirely reliant on rising household consumption driven by increased borrowing and reduced savings (rather than rising incomes).

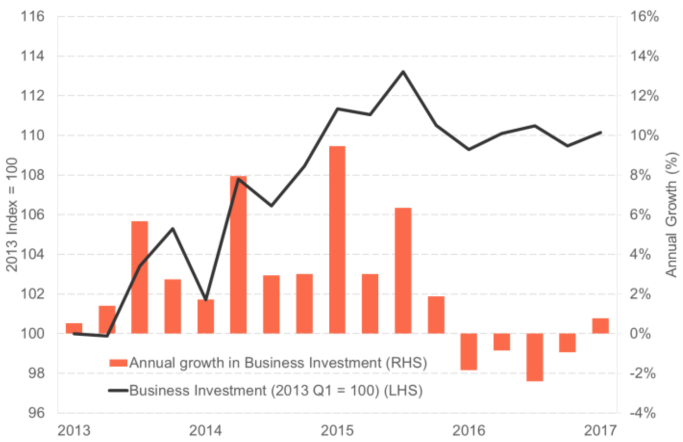
With inflation rising and earnings growth still weak – Chart 6 – it is no surprise that the growth in consumption has started to ease off. During Q1 2017, consumption grew by just 0.3% – its weakest rate since late 2014 (Chart 7).

Growth in other elements of the economy remains fragile at best. Business investment has for example, continued to flat-line since the EU referendum (Chart 8).

And the hoped for bounce in the UK's trade position in the light of a more competitive pound appears to be sporadic at best. Whilst elements of manufacturing have done well, overall the UK's balance of trade position remains poor (Chart 9).

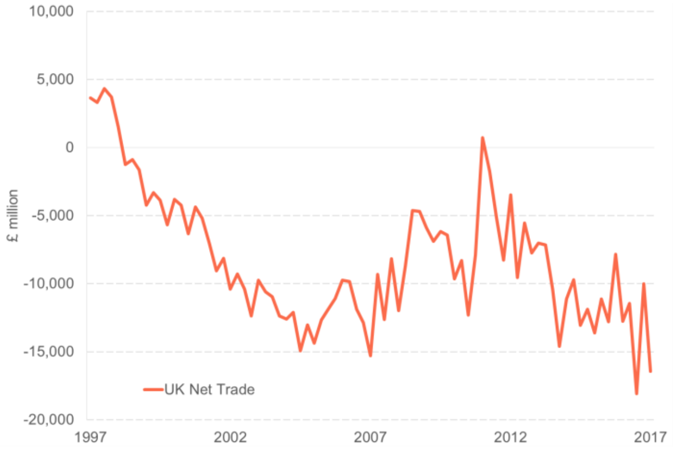
At least in the short-run, the process of leaving the EU does not offer much hope that trade or investment will be able to pick up all of the shortfall as consumption returns to more sustainable levels.

Chart 8: Weak business investment will continue to act as a drag on long-term economic growth



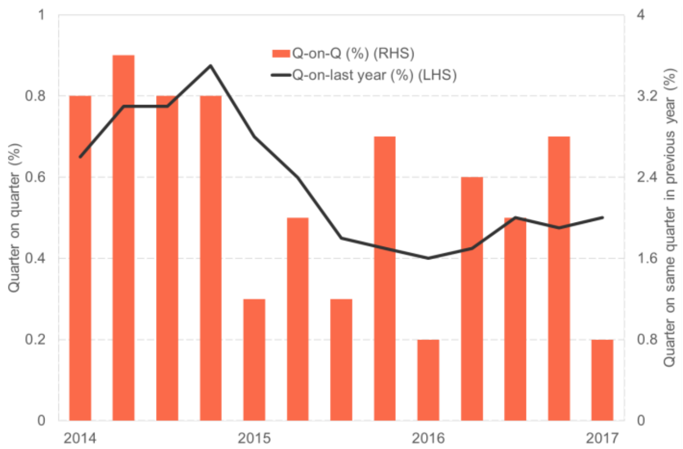
Source: Thomson Reuters Datastream, ONS

Chart 9: UK Net trade balance remains dire



Source: Thomson Reuters Datastream, ONS

Chart 10: UK growth slowing in Q1 2017



Source: Thomson Reuters Datastream, ONS

With the UK Government still keen on restoring the public finances to a degree of health, it is easy to see why there has been a cooling in the UK economy – with growth falling from 0.7% in Q4 2016, to 0.2% in Q1 2017 (Chart 10).

The UK Economic Outlook

Looking forward, there remains a fair degree of uncertainty over the immediate outlook for the UK economy.

None of this is helped by ongoing policy uncertainty.

The recent General Election has only served to add to the lack of clarity with regard to the long-term policy objectives of the UK Government.

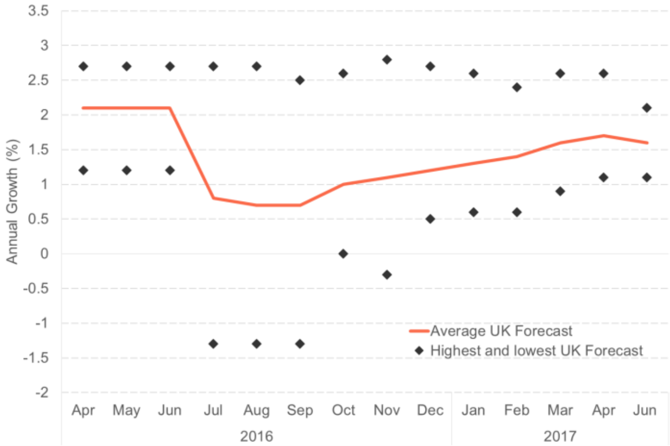
It would appear however – and admittedly this remains a fluid situation – the prospects of a hard Brexit may have receded somewhat in the past few weeks. But there clearly remains much uncertainty about what any final deal may look like and the market access that the UK will have to its largest trading partner.

The Chancellor has also signalled an openness to ease back on levels of austerity to help support the economy in the near term but it will be the new Autumn Budget before we find out what this will mean in practice.

Most forecasters predict that the UK economy will slowdown in 2017, but will be much more healthy than initially thought immediately following the EU referendum – Chart 11.

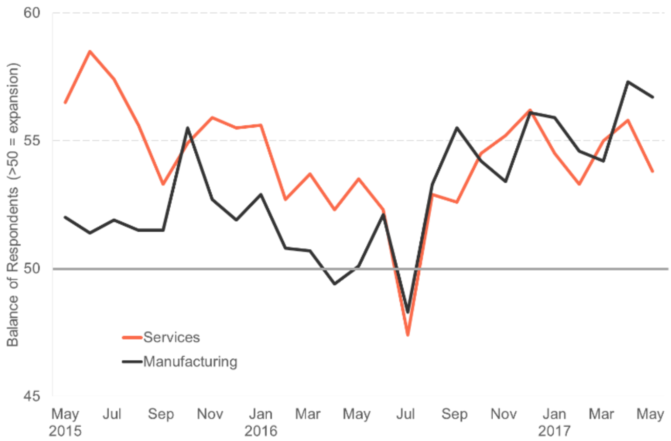
This position is supported by most measures of business activity which continue to indicate relatively health trading conditions in both services and manufacturing.

Chart 11: Evolution of UK forecasts for 2017



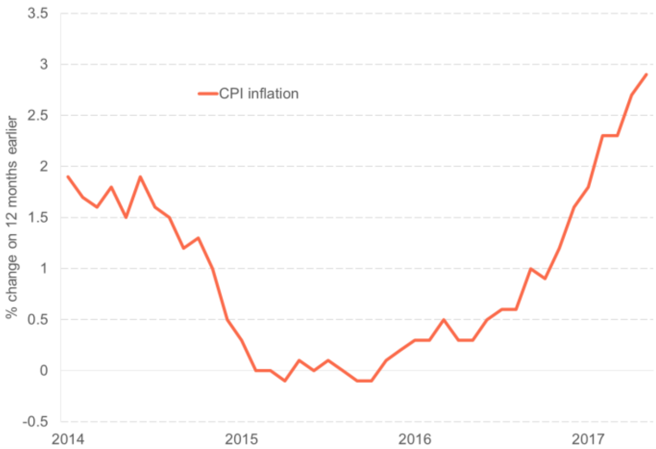
Source: HM Treasury

Chart 12: PMI for UK remains positive – although services have started to report a less confident outlook



Source: IHS Markit

Chart 13: Inflation rising (and likely to exceed 3% in the next few months)



Source: Thomson Reuters Datastream, ONS

The keenly watched IHS Markit PMI index, remains above its cut-off value of 50, which marks the boundary between expansion and contraction. The manufacturing sector appears to be particularly strong (Chart 12).

Levels of business confidence have fallen back a little. The CBI Business Optimism index fell back significantly during Q2 2017 whilst the ZEW Economic Sentiment Index is not too far away from the lows reported at the height of the financial crisis in 2008.

However, one thing last year's reaction to the EU referendum taught us was to avoid reading too much into short-term swings in economic sentiment as these are often not reflected in the actual decisions businesses take. But if such trends were to persist then it would clearly become more of a concern.

Overall, the underlying picture has not changed significantly since the OBR's economic and fiscal outlook in March 2017.

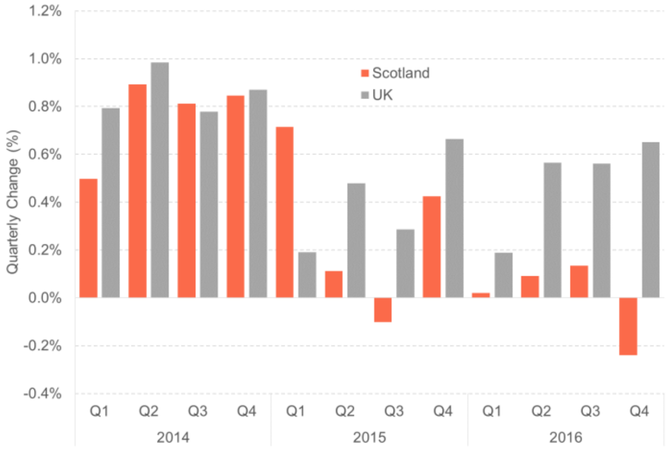
Looking ahead, there is likely to be less support from domestic demand, as further falls in real earnings – and an easing in the draw-down of savings and growth in borrowing – impact on household spending.

A key determinant of the future outlook will be what happens to inflation. The Bank of England now expects inflation to be even higher this year than they initially thought (Chart 13).

At 2.9% in April, inflation is well above the Bank's target of 2%. Higher inflation not only erodes real earnings but as it is largely being driven by rising producer prices from more expensive imports, and this imposes a cost on businesses.

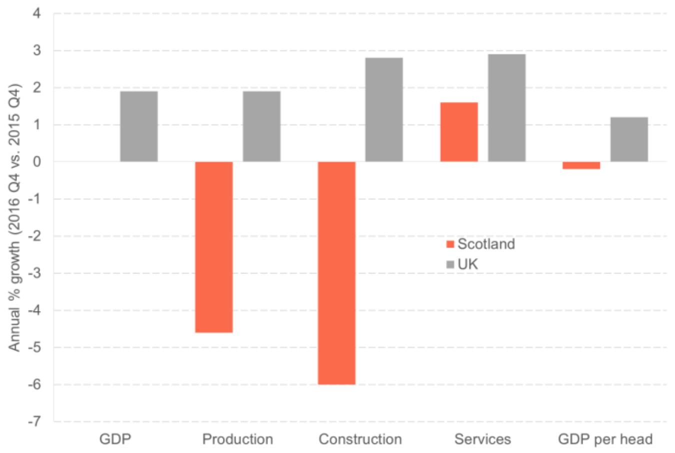
The Bank of England's MPC appears to be increasingly split on the prospects of a rise in interest rates to dampen inflationary pressures. If they do raise rates, this will be the first increase since before the financial crisis.

Chart 14: Scottish vs. UK economic performance



Source: Scottish Government, Q4 GDP

Chart 15: Weakness across sectors evident over the year in the Scottish economy



Source: Scottish Government, Q4 GDP

Chart 16: Business activity in the north east – as a result of downturn in oil and gas – lagging behind Scotland

Source: RBS/FAI Scottish Business Monitor

Recent Scottish Economy Data

The Scottish economy contracted in the final 3-months of 2016. As Chart 14 highlights, there is little doubt that the recent data is part of a sustained trend.

Of particular concern is the weakness across the economy (Chart 15). In the final 3 months of 2016, both production and construction output fell, whilst the all-important services sector remained flat.

We have now seen two years of low (or in some Q's, no) growth. Indeed, between Q4 2015 and Q4 2016, the Scottish economy did not grow at all, compared to growth of 1.9% in the UK.

As an aside, the Scottish Government now references the 4Q-on-4Q measure which shows an expansion of 0.4% over the year. The 4Q-on-4Q measure is the sum of the entire 4 quarters this year compared to last. In a period of weakening growth, this approach will initially give a more positive assessment than simply comparing the output at the same point from one year to the next.

Whatever cut of data is used, what is clear is that the Scottish economy is barely growing (if at all).

So much so that the Scottish economy now satisfies the criteria for 'emergency borrowing' that was built in to the new Fiscal Framework to unlock temporary funds during an asymmetric shock.

The conditions for this funding (via borrowing from HM Treasury) were –*"should the Scottish economy grow 1 percentage point more slowly than the UK as a whole and have growth of less than 1%"*.

So what explains this lack of growth?

A key driver has undoubtedly been the downturn in the North Sea. Whilst North Sea output does not actually enter the Scottish figures (which only cover the onshore economy), the supply chain that supports the oil and gas industry does.

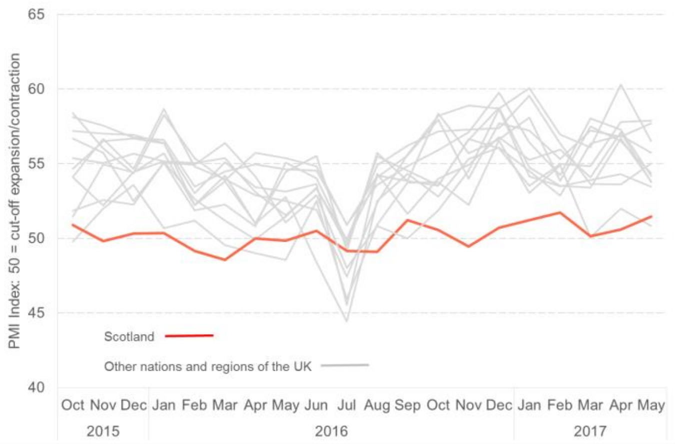
As a result, measures of economic activity in the North East have unsurprisingly been much weaker than for the economy as a whole (Chart 16).

Table 6: Downturn in manufacturing – not just oil and gas

	Change over last 12 months	Change over last 24 months
Total Manufacturing	-7.3%	-10.4%
Food & Drink	-6.6%	-2.1%
Textiles	-11.6%	-10.2%
Refined petroleum & chemicals	-8.3%	-2.1%
Metals & metal products	-6.3%	-25.0%
Computer & electrical products	-5.9%	-13.3%
Transport equipment	-8.8%	-8.2%
Other manufacturing – including repair & installation	-6.7%	-11.4%

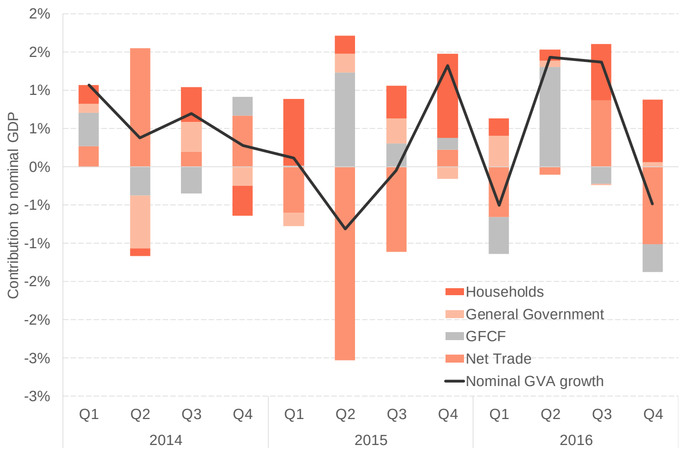
Source: Scottish Government, Q4 GDP

Chart 17: Scotland vs. the rest of the UK: PMI



Source: Markit IHS

Chart 18: Drivers of nominal GDP: households remain key



Source: Scottish Government, Q4 National Accounts

But there is increasing evidence that the North Sea is only part of the explanation of the difference in economic fortunes between Scotland and the UK.

For example, whilst engineering firms and oil support services have been hit, every single one of Scotland's principal manufacturing sectors contracted during 2016 (Table 6).

Some have suggested that Brexit may be a factor. But it is hard to argue that this explains the Scot/UK divergence. Moreover, services – around 75% of the economy and less likely to be exposed to external conditions – grew nearly twice as fast in the UK as in Scotland last year.

Others have argued that the prospects for a 2nd independence referendum may be having an impact, although there is little robust data to formally test this hypothesis (and indicators of international investment remain positive).

Taken together though, it is possible to argue that such effects may have had a greater cumulative effect on Scotland, especially to confidence.

The Scottish Government has argued that the UK results might be impacted by the strength of London.

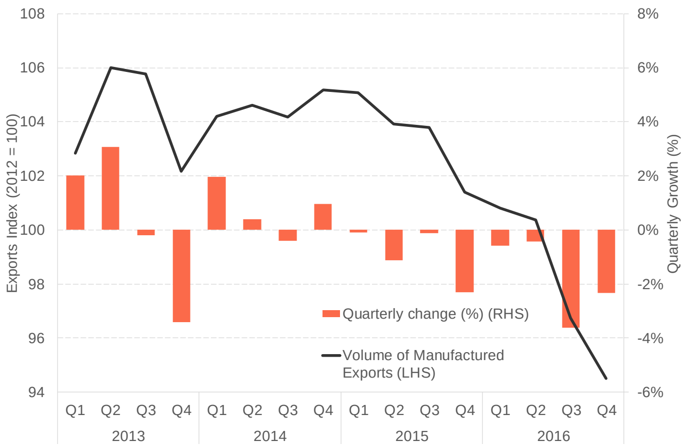
Whilst up-to-date indicators of performance within the UK are few and far between, those that do exist – such as the PMI – tend to suggest that Scotland has been lagging behind other parts of the UK and not just London (see Chart 17).

And whether you accept this argument or not, it is important to remember that the Scottish Government signed up to a new fiscal framework where what matters is Scotland's relative performance vs.the rUK as a whole (*including London*).

Drivers of growth

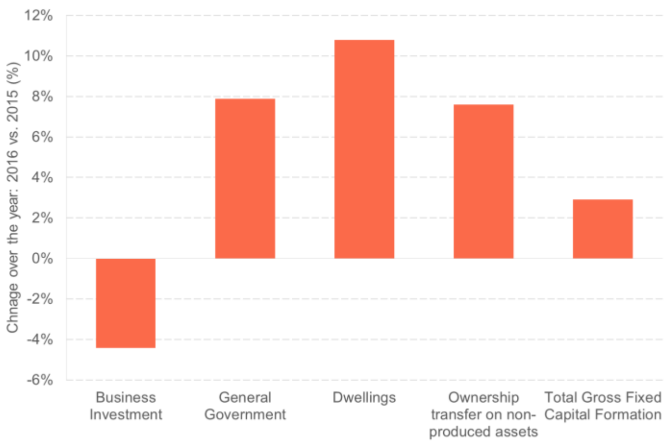
Similar to in the UK, household spending has continued to make the main positive contribution to Scottish growth in recent times. Indeed, it was by far the greatest source of nominal growth in Q4 2016 (Chart 18).

Chart 19: Ongoing challenges with Scottish exports – falling manufactured exports for 8 quarters



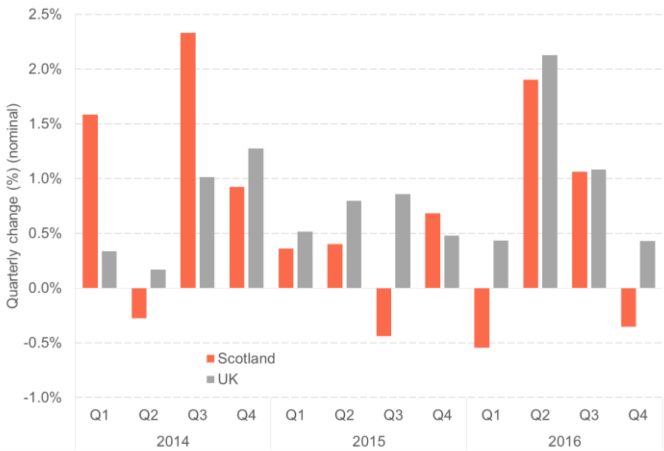
Source: Scottish Government, Q4 National Accounts

Chart 20: Fall in business investment over the year



Source: Scottish Government, Q4 National Accounts, Exp' Data

Chart 21: Compensation of employees weaker in Scotland – less growth in employment and slower growth in wages



Source: Scottish Government, Q4 National Accounts

In contrast, Scotland's trade balance remains weak, with the net trade position once again contributing negatively to overall growth. On this occasion, the weakness appears to be a fall-back in exports to the rest of the UK.

But international trade also remains generally weak (Chart 19).

Scotland's international manufactured exports are, for example, down 7% on the year. Engineering exports – around 1/3 of the total – have fallen by nearly 20% since the start of 2015.

The same National Accounts data reveals that one of the reasons for the slowdown in Scotland is because firms have cut back on investment.

Business investment not only has an important immediate impact on the economy through supporting demand, but also through its long-term impact on the efficiency and productivity of firms (and the overall economy).

As highlighted above, business investment has been weak across the UK. But it still did manage to increase in cash terms over the year (up by 0.1%).

In contrast, business investment fell in Scotland over the past year – Chart 20.

Taken all together, it is clear that the little growth we have had in Scotland has been relatively unbalanced.

Growth remains largely concentrated in household spending, as Chart 18 highlights, but the income going to employees has been growing much more weakly in Scotland than in the rest of the UK (Chart 21).

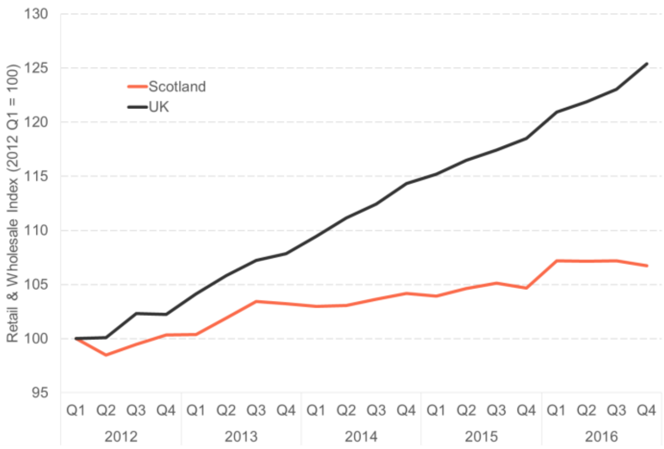
This is likely to be a combination of both weaker employment growth in Scotland and lower earnings.

The reason that households have been able to support growing consumption has therefore been because they have been running down their savings (and increasing their borrowings).

Chart 22: Net savings ratio and value of personal loans

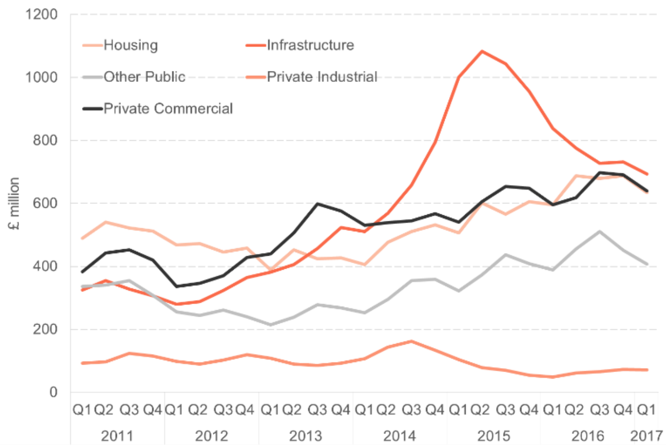
Source: Scottish Government, Q4 National Accounts and BBA

Chart 23: Retail & wholesale – Scotland vs. UK



Source: Scottish Government, Q4 GDP & ONS

Chart 24: Construction output (nominal): New Work



Source: ONS, Output in the construction industry

As a result, Scotland's estimated saving ratio is now at a record low (whilst personal loans are rising) (Chart 22).

With a highly uncertain outlook for the economy, the ability of households to keep using reduced savings and higher levels of indebtedness as a buffer to protect spending is a key risk to growth.

Sectoral performance

Growth across the Scottish economy has been relatively weak across the board.

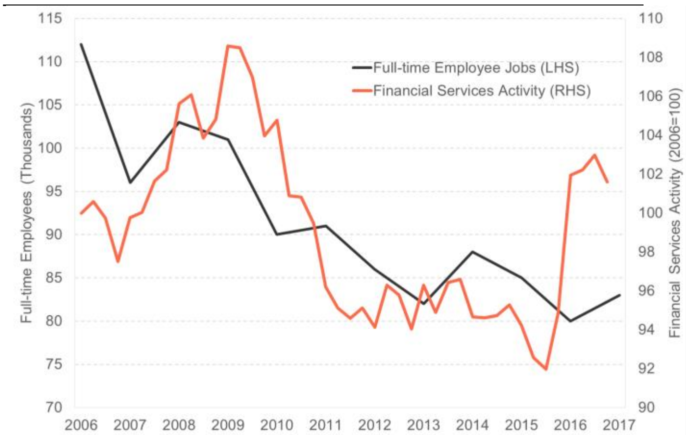
One area of concern appears to be retail and wholesale which, as we discuss later, is likely to be linked to a low level of consumer confidence (Chart 23).

Construction has continued to act as a drag on growth – with the sector down 6% over the year. Recent data for 2017 suggests little turnaround just yet – with total construction work 2% lower in cash terms in Q1 2017 compared to a year ago (Chart 24).

As highlighted above, manufacturing has slowed down significantly (Table 6).

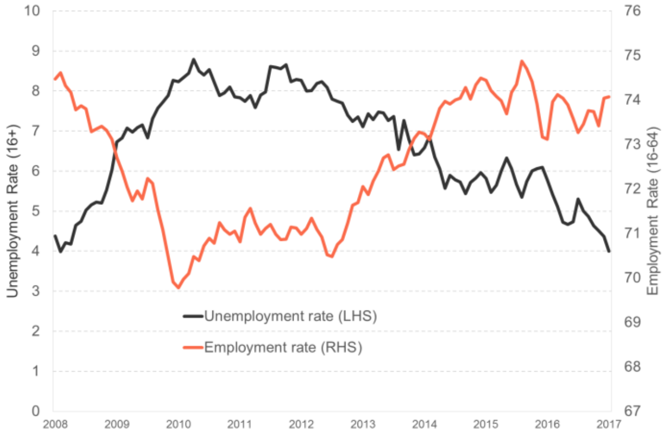
One bright spot has been financial services. Whilst output slipped back a little in Q4 2016, growth over the past two years has been encouraging. The sector is still 6% off its pre-financial crisis peak and jobs remain down, but given the challenges faced in recent years this is a welcome return to growth.

Chart 25: Financial Services in Scotland



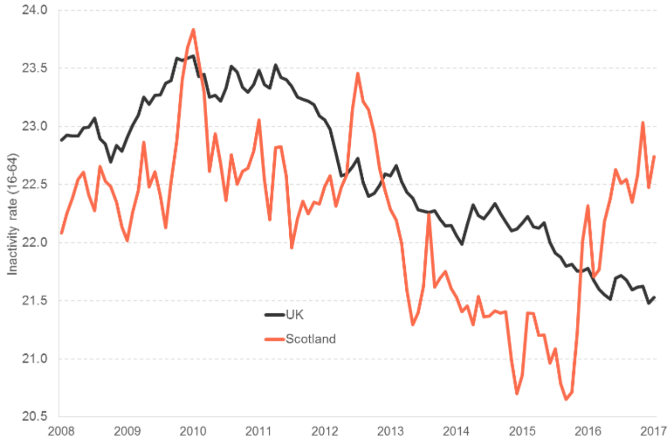
Source: Scottish Government, Q4 GDP, ONS

Chart 26: Scottish employment & unemployment rate



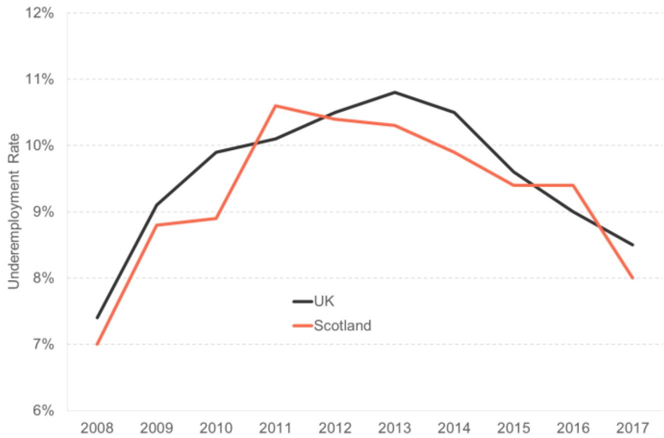
Source: ONS, Labour Force Survey

Chart 27: Scottish & UK inactivity rates since 2008



Source: ONS, Labour Force Survey and FAI calculations

Chart 28: Scottish & UK underemployment (hours) since 2008



Source: ONS, LFS Supplementary Data

The Scottish labour market

Despite apparently very little growth in the overall economy, Scotland's labour market continues to hold up remarkably well.

The 16+ unemployment rate has fallen to 4% (or 4.1% for 16-64 year olds), the lowest since May 2008, and jointly the lowest since 1992.

These improvements continue the trend since 2012 of a strengthening labour market (Chart 26).

For most of the past decade, Scotland had a better employment and unemployment rate than the UK as a whole. Now, Scotland's employment rate is 0.7% points lower than the UK rate. Against that, Scotland's unemployment rate is slightly better by a similar margin.

This apparently odd result – stronger on unemployment but weaker on employment – is explained by Scotland's higher inactivity rate (i.e. those not in work nor seeking work).

As Chart 27 highlights, Scotland had been tracking the fall in inactivity rates witnessed across the UK up to 2016.

However, since then, inactivity rates have increased in Scotland. Whilst this rise has stabilised in recent months, Scotland's inactivity rate is now over a full percentage point higher than that of the UK.

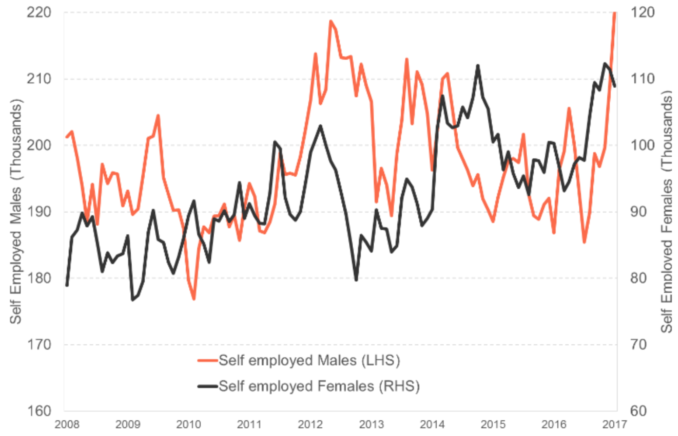
Levels of underemployment – that is people in work but who would prefer to work longer hours – have fallen back towards pre-recession levels (Chart 28).

And Scotland's youth unemployment rate continues to outperform all other parts of the UK and compares favourably internationally.

However, as we highlighted in our most recent Scottish Labour Market Trends report, the headline figures do hide some challenges.

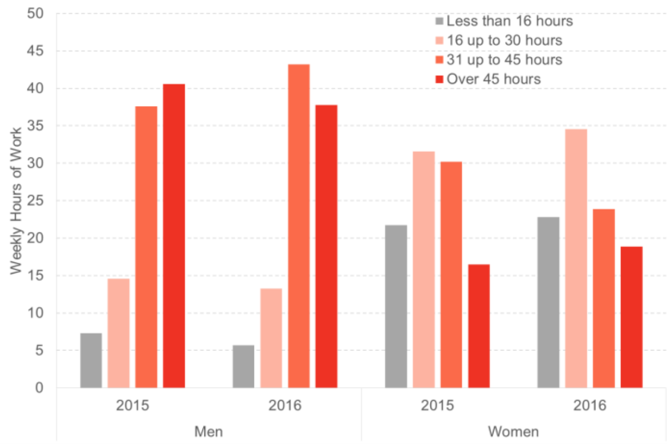
Firstly, the type of employment being created appears to be less secure in many instances.

Chart 29: Sharp rise in self-employment



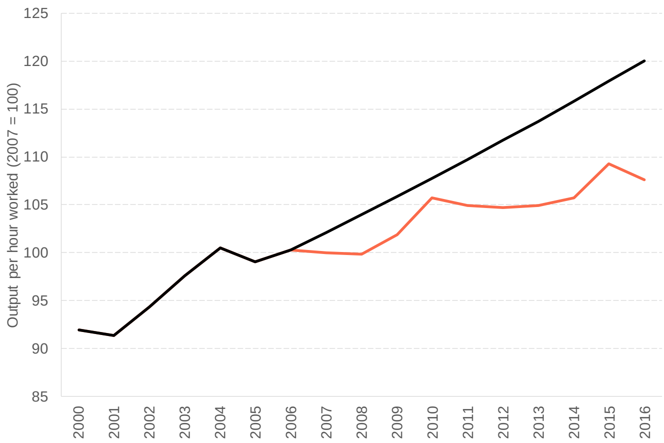
Source: ONS, Labour Force Survey

Chart 30: Weekly hours of work of the self-employed



Source: ONS, Labour Force Survey

Chart 31: Scotland's productivity growth since 2008



Source: Scottish Government & FAI calculations

Since the financial crisis there has been a rise in part-time employment (up around 8% over the past decade). Within this, there has been a 45% increase in the number of people who say the reason they are working part-time is that they cannot find a full-time job.

Self-employment has also risen – up around 29%. This trend appears to be continuing. Indeed, nearly all of the Scottish employment growth over the past year was in the form of self-employment – and concentrated amongst men.

Sometimes when thinking about self-employment people have in mind someone starting businesses and creating jobs. However, partly as a result of technological innovation, the self-employed are now a much more diverse group.

A concern that exists about this increase is that whilst, for some, the greater flexibility that self-employment brings is welcome, for others, it may come with less stable and rewarding opportunities and fewer employment protections.

More work needs to be done to understand the characteristics of this surge in self-employment (e.g. by skill level and age), and to understand the types of work being entered into.

One consequence of rising employment in an environment of weak economic growth is that the amount produced per worker will be stagnant or falling.

Productivity in Scotland – as measured by output per hour worked – fell 1.5% during 2016. This was on the back of strong growth in 2015 (of 3.4%).

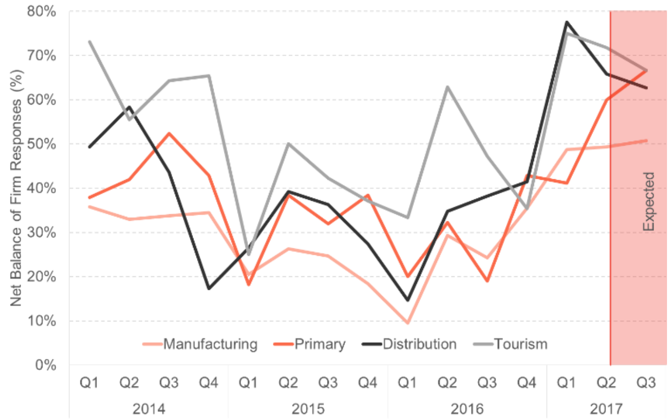
Scottish and UK productivity has been weak since the financial crisis. Between 1998 and the end of 2006, productivity in Scotland grew by an average of 1.8% per annum. Since then, growth has averaged half that at 0.7% (Chart 31).

Productivity is not only crucial for long-term growth but also household income. Whilst a tight labour market can put upward pressure on wages, if there is little wealth created more generally, the scope for businesses to award pay increases is limited

Chart 32: RBS/FAI Business Monitor shows some tentative signs of improved conditions

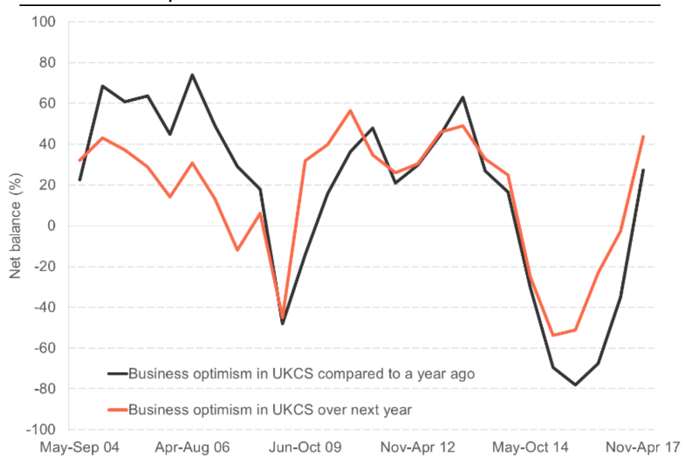
Source: FAI/RBS Scottish Business Monitor

Chart 33: Net balance of firm responses to costs



Source: FAI/RBS Scottish Business Monitor

Chart 34: Oil and Gas sector optimism 2010-2016: Grounds for cautious optimism?



Source: FAI/A&GCC

Outlook

If the data for the tail-end of 2016 was disappointing, more up-to-date indicators suggest that the economy did grow in early 2017, albeit at a slow pace.

The FAI-RBS Business Monitor for Q1 2017 shows an increase in the net balance of firms reporting improving repeat business and new business volumes. That being said, the net balance figures of below +10 are still low by historical standards (Chart 32)

As Chart 17 highlighted, the Bank of Scotland PMI has continued to remain positive but well behind the UK. Similarly, the Federation of Small Business confidence index, whilst improving in Scotland, was still negative overall, and at -3.8 points was below the UK value of +15 points.

In manufacturing, the latest CBI Industrial Trends survey pointed to relatively robust growth in output but cost pressures from rising prices are beginning to pose a concern.

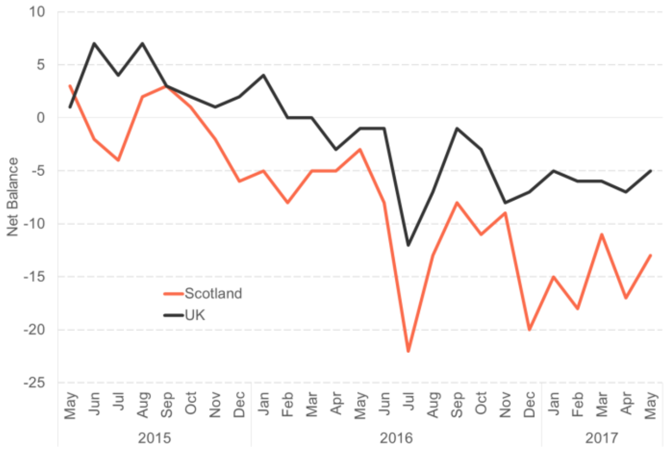
This is now a common theme. The upcoming FAI-RBS Scottish Business Monitor for Q2 2017 indicates rising costs for 56% of businesses while only 6% reported a fall. Cost pressures were most acute in tourism and distribution – see Chart 33. A net balance of 49% of firms expect costs to increase in the next six months.

The outlook for oil and gas companies is a little more positive than in recent months.

We are now well into the third year of the current low oil price cycle. Investment has fallen significantly and exploration levels remain low.

There are signs however, that the restructuring in the sector has led to some modest improvements in sentiment – as demonstrated by the latest results from our regular Oil and Gas Survey. Our judgement is that the outlook for the North Sea is slightly more positive – or at least less negative – than 12 months ago (Chart 34).

Chart 35: Consumer Confidence remains negative in Scotland and gap with UK remains wide

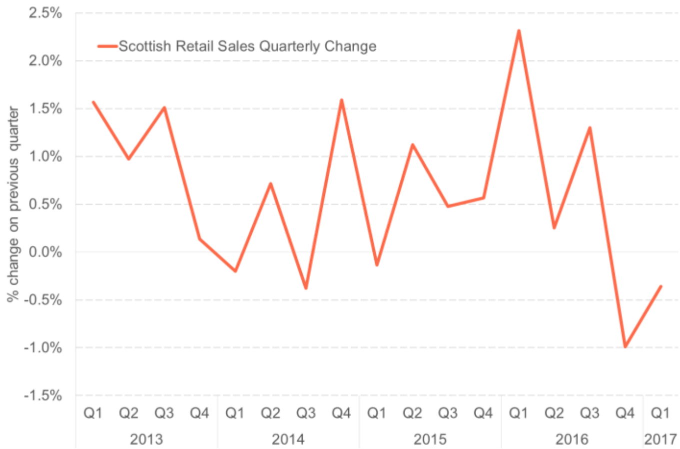


Source: GfK

Chart 36: Key driver of lower consumer confidence appears to be deterioration in expectations for economic outlook

Source: Scottish Government, State of the Economy Report

Chart 37: Fall in retail sales index – Q4 2016



Source: Scottish Government, Q1 Retail Sales Index

In contrast to the slightly more positive sentiment within the business community, levels of consumer confidence in Scotland have continued to slide.

The GfK Consumer Confidence Index (where 0 = balance) was -13 in May, well below the UK index (which whilst also negative was -5).

The Scottish Government's own indicator of confidence fell again in Q1 2017 (Chart 36).

As mentioned above, this does not just appear to be a London factor. Lord Ashcroft included questions of economic confidence in an opinion poll of around 40,000 households across the UK - 3,500 in Scotland – during the UK General Election. Scotland had the lowest proportion of respondents positive about the economic outlook of any part of GB (NB: the survey did not include Northern Ireland).

It's therefore unsurprising that retail sales figures for Scotland – one early component of the Scottish GDP series – declined in early 2017 pushing that sector into recession for the first time since 2012 (Chart 37).

Uncertainty will continue to have an impact on the performance of the Scottish economy. How the big political issues – and in particular, the Brexit negotiations and prospects of an independence referendum – play out will have a material impact on the outlook.

This is not to say that one particular outcome is better than the other. It is simply that with uncertainty of such a magnitude in play, we cannot expect the processes themselves not to have an impact, irrespective of the end result.

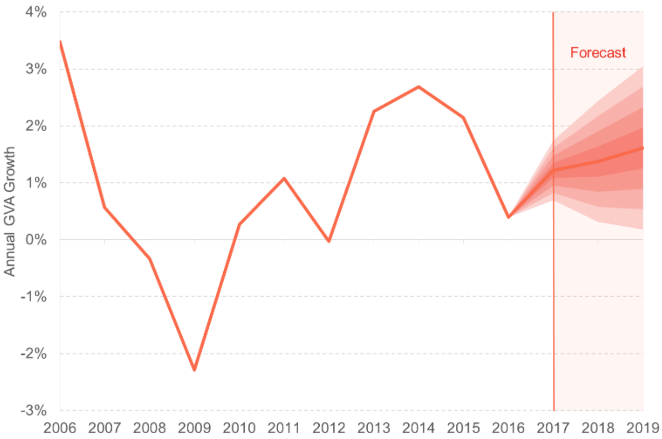
Our latest nowcast – which utilise the most up to date 'hard' and 'soft' data on the Scottish economy – currently estimates growth in 2017 Q1 of between 0.2% and 0.3%. That is within the margin by which our nowcast model has tended to be more optimistic than the 1st estimate of GDP produced by the Scottish Government during 2016. If this continues to hold, this would suggest that next week's GDP estimate for Q1 could well be pretty close to zero.

Table 8: FAI forecast Scottish GVA growth (%) 2017 to 2019

	2017	2018	2019
GVA	**1.2**	**1.4**	**1.6**
Production	1.4	1.6	1.8
Construction	0.7	0.8	1.0
Services	1.2	1.3	1.6

Source: Fraser of Allander Institute

Chart 38: Growth to remain below trend through forecast



Source: Fraser of Allander Institute

* Actual data to Q4 2016, central forecast with forecast uncertainty for 2017 – 2019

Uncertainty bands sourced from accuracy of past forecasts at different forecast horizons

Table 9: FAI revised forecast %-point change from March 2017 forecast by sector, 2017 to 2019

	2017	2018	2019
GVA	**+0.08**	**+0.09**	**+0.03**
Production	+0.03	+0.12	+0.04
Construction	+0.09	+0.07	+0.02
Services	+0.10	+0.08	+0.03

Source: Fraser of Allander Institute

More in depth forecasts – including by sector and region – are available as part of our new FAI Membership Scheme. Email: fraser@strath.ac.uk for more info.

Our forecasts

As in the past, we report a central forecast but calculate uncertainty bands to set out a likely range within which we predict Scottish economic growth will lie. In our view, it is this range that should be just as much the focus of discussion as specific point estimates.

In other words, it is entirely possible that the Scottish economy could grow close to 2% this year, but our assessment is that the probability of that happening is lower than our central projection.

Overall, our forecasts are little changed on March.

Our assessment is still the same - we believe that the Scottish economy will grow this year, but predict that such growth will remain below trend for the foreseeable future.

We expect that growth figures for 2016 are likely to be revised up slightly when new data becomes available to be more in line with business surveys and other indicators of activity.

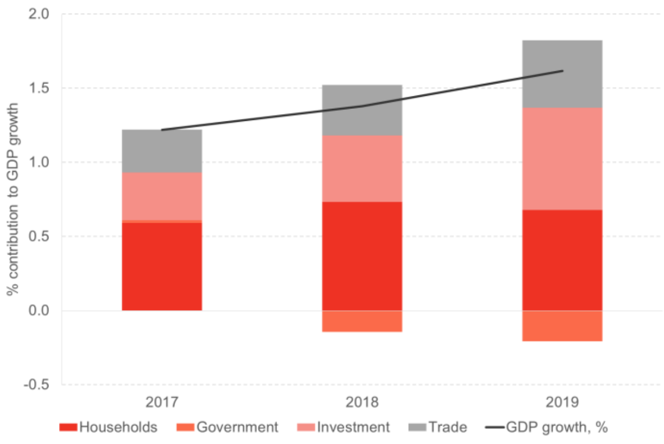
The two major judgement calls continue to be the outlook for the oil and gas sector and the impact of any Brexit-induced uncertainty impacting more sharply on investment and economic confidence.

A technical adjustment means that we now expect 2017 growth to be marginally stronger than we forecast in March as the economy makes up some lost output from a weaker 2016 than anticipated. **Our central forecast is for growth of around 1.2% this year.**

Services will continue to make the greatest overall contribution to growth over the next few years. Financial services and business services in particular should benefit. Tourist facing services – such as hotels – should also do well from both increased overseas visitors and a rise in staycations. In contrast, retail is likely to continue to be squeezed by falling household incomes.

We also expect a pick-up in production as both the oil and gas supply chain stabilises and the recent downturns in manufacturing begin to ease off.

Chart 39: Contribution to forecast – growth picking up toward end of forecast horizon



Source: Fraser of Allander Institute

Table 10: Latest growth forecasts for the UK economy

	2017	2018	2019
Bank of England	1.9	1.7	1.8
OBR	2.0	1.6	1.7
NIESR	1.7	1.9	2.0
European Commission	1.8	1.3	n/a
IMF	2.0	1.5	1.6
Oxford Economics	1.7	1.4	1.6
ITEM Club	1.8	1.2	1.4
CBI	1.3	n/a	n/a

Source: HM Treasury

Table 11: FAI labour market forecast to 2019

	2017	2018	2019
Employee Jobs	**2,436,450**	**2,476,450**	**2,514,700**
% employee job growth over year	+0.3%	+1.6	+1.5
ILO unemployment	117,000	134,300	143,750
Unemployment Rate (%)[1]	**4.4**	**5.0**	**5.3**

Source: Fraser of Allander Institute

Notes:

Absolute numbers are rounded to the nearest 50.

[1] Rate calculated as total ILO unemployment divided by total of economically active population aged 16 and over.

Food and drink should continue to perform strongly as the low value of Sterling continues to help support competiveness.

We have broadly maintained our central forecast for growth of 1.4% in 2018 (up from 1.3%) and revised up slightly our outlook for 2019 to 1.6% (from 1.4% in March). Some of the revisions for later years are driven, in part, by more positive projections for the UK economy (Chart 11) which spill-over into Scotland and a slightly more positive outlook for investment and exports toward the end of the forecast horizon.

We expect the growth gap between Scotland and the UK to remain over the next three years, but to close slightly as the effects of the slowdown in oil and gas are reduced (Table 10).

On the components of demand, we continue to expect uncertainty to dampen investment this year but by slightly less than previously thought. Some of this will reflect delayed plans as firms await the details of the Brexit negotiations. Once this is resolved, a pick-up is likely.

Consumption will remain the biggest contributor to growth, although it will not be as healthy as in the last couple of years as higher inflation, combined with low earnings growth, feeds through to lower household spending.

Net exports will continue to benefit from the depreciation in Sterling, although, as we highlighted above, the scale of any pick-up will depend upon able Scottish companies are to take advantage of the opportunity that this provides.

We expect unemployment to rise slightly toward a level consistent with the medium-term trend of around 5%. Growth in the number of jobs is forecast to continue, but to be weak compared to historical levels.

As we highlight above, recent unemployment numbers have been driven by a sharp rise in inactivity. To the extent that this is reversed, the unemployment rate may rise more sharply.

Policy Context

The Scottish Parliament enters recess at the end of June. When it returns it will face a number of important policy decisions, not least in the Programme for Government and the Budget to follow later on in the year.

As we have highlighted, these decisions will take place at a time of ongoing economic challenge, not just here in Scotland but across the UK as the negotiations for Brexit reach a crucial phase.

During such times, it will be easy for the debate about Scotland's economy to be side-tracked by constitutional wrangling.

This cannot be used as a justification – from across the political spectrum – for not undertaking an urgent and frank assessment of the best policies to support the Scottish economy.

The fragile economic backdrop means that this is a necessity. But even more importantly, in our view, debate over the long-term economic challenges and opportunities facing Scotland has been pushed to the side-lines.

And this is a concern. Over the last ten years, output per head in Scotland increased by just 1.2% (that is in total not per year). In the preceding seven years, it had grown 17%.

Moreover, Holyrood's new powers means that Scotland's economic performance matters more than ever before. Even small variations in relative performance will translate into hundreds of millions of pounds in tax revenues within a short period of time.

Scotland is without question a successful nation. It is in the OECD top 20 in terms of income per head and near the top in the UK on most long-term indicators behind London and the South East.

The country has substantial natural resources, a skilled workforce and strengths in many sectors.

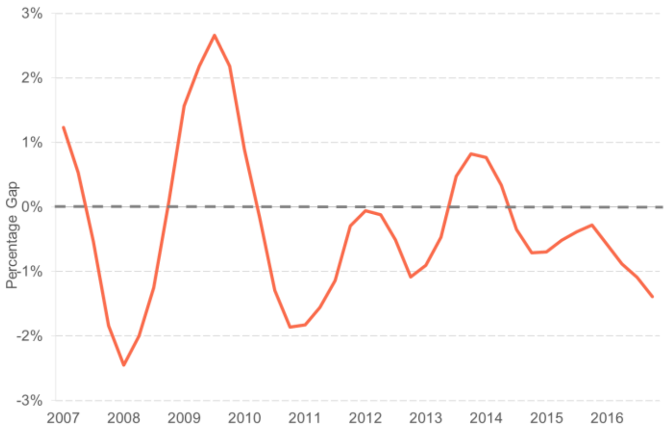
But it has been widely recognised by successive Scottish administrations that we lag our competitors in key areas.

Back in 2007, the Scottish Government published an economic strategy which aligned the public sector toward sustainable economic growth.

It contained a series of targets – for growth, productivity, participation and population; and for levels of inequality and sustainability.

10 years on, on most targets – with the exception of population where we now have a record number of people living in Scotland and climate change – the economy is arguably treading water.

Chart 40: Scotland vs. UK growth differential – above line = Scotland growing more quickly than UK



Source: Scottish Government/FAI calculations

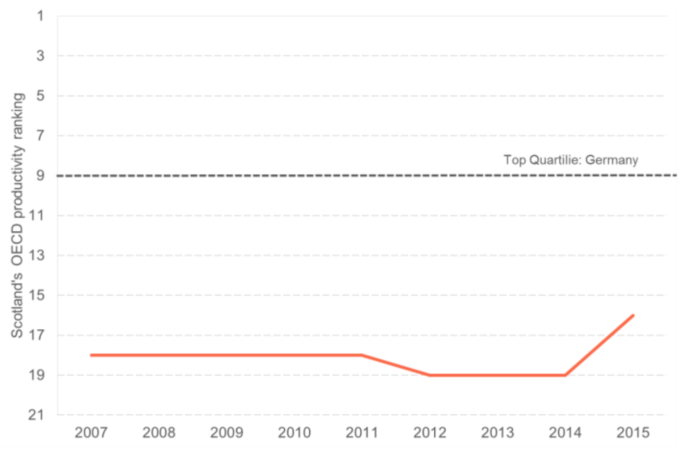
For example, in terms of the key target to match the UK's growth rate, this has only been achieved 30% of the time since 2007.

We see little evidence that productivity in Scotland has fundamentally improved. Yes, the gap with the UK has narrowed but this is down to the UK's exceptionally weak performance and the fact that Scotland has created fewer jobs in recent years. And whilst we have 'moved into the 2nd quartile' in the OECD, this is simply because we fell into the 3rd quartile a few years ago.

Scotland is likely to fall back down the ranking with productivity falling in 2016. And even then, the gap with the top performing OECD countries is still 20%.

Whilst we have seen a rise in innovation activity, on business R&D, Scotland ranks 9th out of the 12 English regions or devolved nations in the UK and 9th in terms of new business registrations.

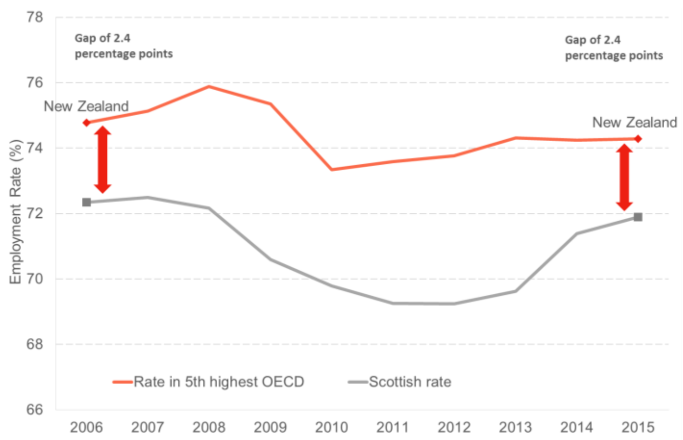
Chart 41: Scotland's productivity ranking in the OECD



Source: Scottish Government, OECD/FAI calculations

On the labour market, the gap between the top and worst performing local authorities is still a massive 15%-points and the gap with the top performing countries in the OECD remains.

Chart 42: Scotland's labour market ranking



Source: Scottish Government, OECD/FAI calculations

Given recent challenges – from the upheaval in financial services and oil and gas – the fact that Scotland has maintained its position on many international rankings can be viewed as a success.

But the ambition must be to do better than that.

A renewed focus on how the Scottish and UK Governments can use the powers at their disposal to support the economy is needed.

We also need a robust evaluation of existing policy priorities and their success (or otherwise).

Government action plans and strategies are all well and good, but we often struggle to really know 'what works'.

And even when we do, the task of delivery and, quite often, the need to shift scarce resources from one area to the next, is a challenge

In our view, a greater role for independent analysis will help. The Scottish Government's recent proposals as part of Phase 2 of its Enterprise and Skills Review to improve analytical capacity across the enterprise and skills system is welcome, up to a point.

Better sharing of data and coordination of research will clearly be beneficial.

But the current proposals come with a risk of duplication and/or simply re-presenting existing material in a new way, in a new format to a new body. What bite will it have?

In our view, the policy making process should be improved by insisting that *every* policy intervention – not just those of agencies but of the Scottish Government itself – be underpinned, as a matter of course, by a transparent evaluation framework.

This would help avoid policies being designed, expanded, and defended upon assertion rather than evidence.

At the same time, as every major policy is developed, policymakers should set out how progress will be monitored and assessed (with a dedicated budget ring-fenced for such purposes).

Having better data is one thing, what you do with it is even more important. Productivity commissions – such as in Australia and New Zealand – are designed to do just that with more independent research, advice and performance monitoring than we do in Scotland.

With the right ambition there is an opportunity to take a fresh look at how best to address Scotland's long-term economic challenges (and to take advantage of new opportunities that will emerge).

For regular analysis on the Scottish economy and public finances please see our blog:

www.fraserofallander.org