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Fraser of Allander Institute

Economic Commentary

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Vol 42 No 1

Foreword

As the financial year draws to a close, it is a good time to reflect on Scotland's economic performance over the past twelve months and perhaps more so, to consider the significant challenges that lie ahead.

Little has changed since December's Fraser Economic Commentary on Scotland's economic performance; there is growth, but the pace is slow with little expectation it will accelerate at any significant rate over the coming three years. As has been well established, increasing productivity has been, and remains, one of Scotland's key economic challenges.

As a relatively small and open economy, we must continue to strive to be agile and adaptable if we are to improve on our growth rate. We should seek to react positively and assertively to both the internal and external influences that shape our economy and look to seize new opportunities as they present themselves.

The biggest and most complicated challenge we face in the immediate term is Brexit. The 21 month 'status quo' transition period, whilst a welcome development for business, is still dependent on agreement being reached on the UK's withdrawal. This is not guaranteed – with a resolution still needed on the Irish border and definition on the role of the EU courts. Given the scale and complexity of some of the business issues related

to Brexit, it would be prudent for those businesses which have started to continue with their Brexit planning and for those who have not, to start now. This should help to ensure they are prepared for a range of potential outcomes. Time is short.

The final framework for Brexit has the potential to have a profound impact on many of Scotland's industries and sectors, and that impact should not be underestimated. In a year, we will leave the European Union and, on the current timetable, at the end of December 2020 we will be out of the transition period. As an illustration of the changes to come, EU Free Trade Agreements with as many as 50 countries from which we currently benefit, will no longer be available. At this stage we do not know what they will be replaced by or when.

Scotland has a robust economy and this is a challenge we can rise to under the right business environment and with the right mind-set. There are a range of steps businesses can take to prepare for Brexit effectively so they are well positioned to respond whatever the outcome. There will be opportunities and businesses need to be ready to seize them.

John Macintosh
Tax Partner
Deloitte

March 2018

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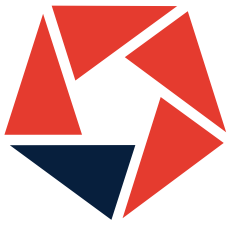
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Policy Context

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

www.fraserofallander.org



Summary

The Scottish economy continues to grow, but it does so at a slow pace.

Indeed, output per head in Scotland is now smaller than it was back at the start of 2015.

The key explanation for this had been the downturn in the oil and gas sector. But in recent months, there are signs that activity in the North Sea – and its supply chain – has been recovering.

Instead, it has been sluggish growth in services and a sharp decline in construction output that has acted as the brake on Scotland's economy.

Looking ahead, most indicators of business sentiment and consumer confidence suggest little possibility of a strong bounce-back in economic prospects in the near-term.

Despite this backdrop, employment and unemployment continue to perform much better than expectations. But as a result, productivity continues to be squeezed. Output per hour worked is now back at 2010 levels.

The global economy should provide a boost to growth prospects in 2018, with most of Scotland's major trading partners expected to have a strong year. Recent data suggests that Scottish exports have grown relatively strongly in 2017.

All things considered, our forecasts remain broadly the same as they were in December, with output expected to pick up this year and next.

Brexit remains the biggest challenge on the horizon. As we have argued on a number of occasions, we believe that the decision to leave the EU will damage Scotland's long-term growth prospects.

But like it or not, Brexit is happening.

Whilst it will be some time yet before we know the exact details of the UK's future economic relationship with the EU, this cannot be used as justification not to undertake appropriate preparatory and planning work.

Scotland has a strong and prosperous economy and this will continue no matter the constitutional structure. So businesses need to work now, not just on their vulnerabilities to different Brexit outcomes, but to seek new opportunities both at home and abroad.

There is arguably much more that both the Scottish and UK Governments could do to help businesses prepare for Brexit. Providing this support should not be viewed as inconsistent with Ministers' different political standpoints.

Finally, we argue that the scale of the challenge presented by Brexit – coupled with wider structural changes in our economy such as technological and demographic change – means that effective economic policymaking is more important than ever.

In 2007, the Scottish Government set out a new approach to policy centred upon a single economic strategy upon which all public sector initiatives were to align behind.

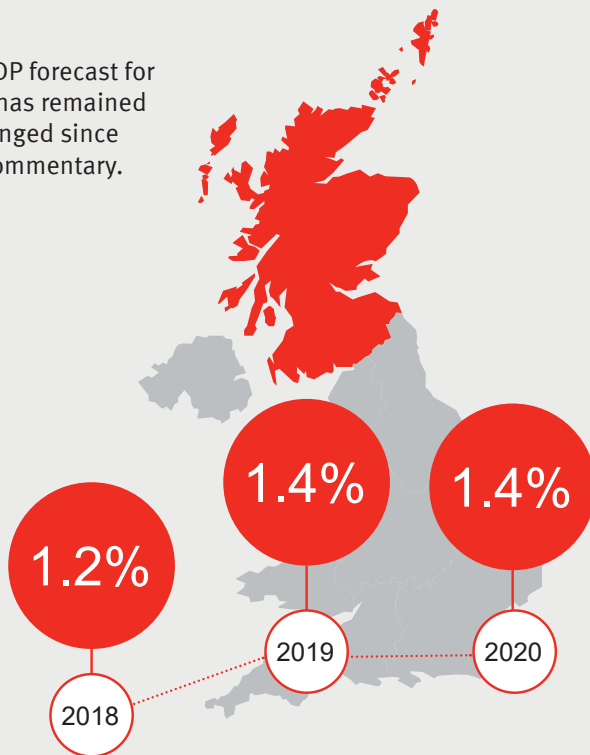
But over the past decade, this clarity of focus and delivery has arguably been lost, with a myriad of different strategies, advisory groups and bodies now cluttering the landscape.

With Brexit likely to test the resilience of the economy, rediscovering a single unified vision for economic policy might just be the most significant – and effective – step the Scottish Government could take in 2018.

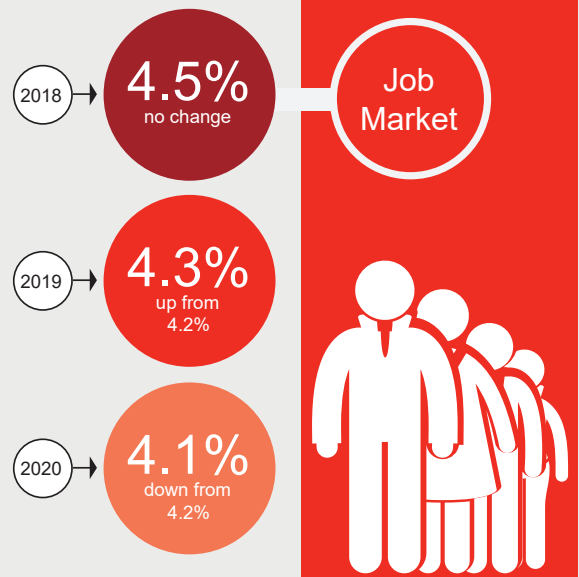
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March 2018

Scottish GDP growth forecast

Our GDP forecast for 2018 has remained unchanged since last Commentary.



Unemployment forecast



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At a glance

Chart: Scottish growth (since 2013) – year and quarter

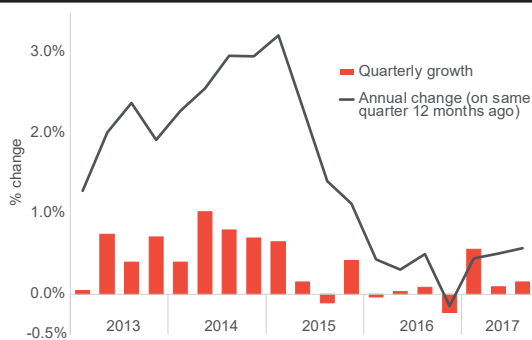


Chart: Scottish employment & unemployment rate, 2012 – 2018

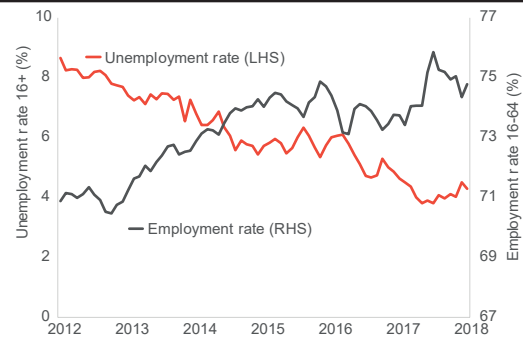


Chart: FAI forecast Scottish economic growth range

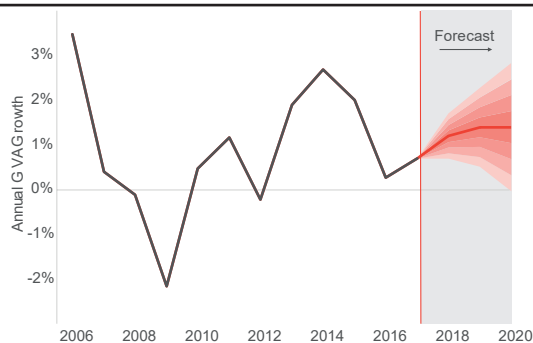


Table: FAI forecast Scottish economic growth (%), 2018 – 2020

	2018	2019	2020
GVA	1.2	1.4	1.4
Production	1.4	1.6	1.9
Construction	0.7	0.8	0.6
Services	1.1	1.3	1.4

Outlook and Appraisal

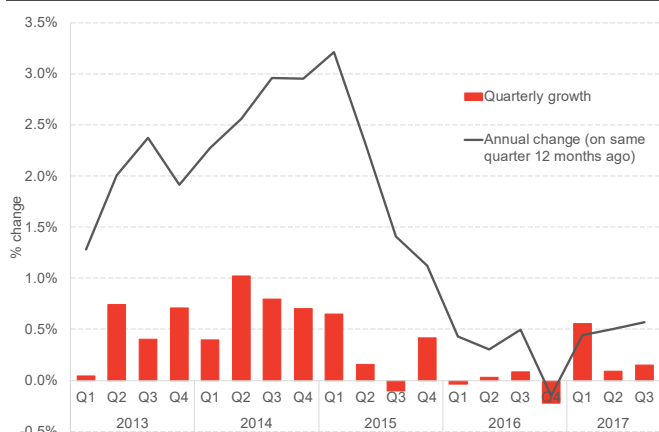
The latest data on Scotland’s economic performance continue to paint a weak picture, with growth still lagging behind the UK as a whole. But unpicking the data, we see that – with the exception of the construction sector – growth is actually stronger in many key sectors than the headline figures suggest. We predict that growth will pick-up in 2018 and 2019. However, Brexit continues to dominate the medium term outlook. In such times, a clarity of purpose and alignment in the policy process is crucial.

Table 1: Scottish growth (%) by sector, Q3 2017

	GDP	Agriculture	Production	Construction	Services
Q3	0.2	0.7	1.2	-2.9	0.2
UK	0.4	0.8	1.3	-0.5	0.4
Annual	0.6	1.2	2.6	-7.5	0.9
UK	1.7	0.6	2.4	4.8	1.4

SOURCE: Scottish Government

Chart 1: Scottish growth (since 2013) – year and quarter



SOURCE: Scottish Government

Table 2: Labour market headline statistics, change on same quarter year before, November 2017 – January 2018

	Employment (16-64)		Unemployment (16+)	
	Rate (%)	Year Change	Rate (%)	Year Change
Scotland	78.1%	▲	4.3%	▼
England	79.2%	▲	4.3%	▼
Wales	76.4%	▼	4.8%	▼
N. Ireland	72.2%	▲	3.2%	▲
UK	75.3%	▲	4.3%	▼

SOURCE: ONS, Labour Force Survey

Introduction

The latest data continues to show that whilst the Scottish economy is growing, it continues to do so at a relatively slow pace.

On an annual basis, growth of 0.6% is well below both Scotland’s long-term trend and the 1.7% rate of growth in the UK as a whole. (Table 1)

As Chart 1 highlights, the Scottish economy has been in a cycle of low growth for over two years now. Indeed, GDP per head is now lower than it was back in Q1 2015.

As we discuss in the report, it is increasingly clear that the downturn in oil and gas is not the only reason for this weak performance.

More recent indicators – including surveys and our own nowcasts – suggest that business activity continues to pick up. But expectations for future growth remain weak.

Despite this, unemployment fell by 9,000 over the year. That being said, there are signs of some weakening with employment falling by 8,000 over the 3-months to Feb 2018. (Table 2)

On the one hand, the increasing strength of the global economy should offer a boost to growth over this year and next. But on the other, Brexit continues to cast a shadow over the outlook.

It is vitally important that businesses and policymakers prepare for Brexit, and for all possible outcomes of the negotiations.

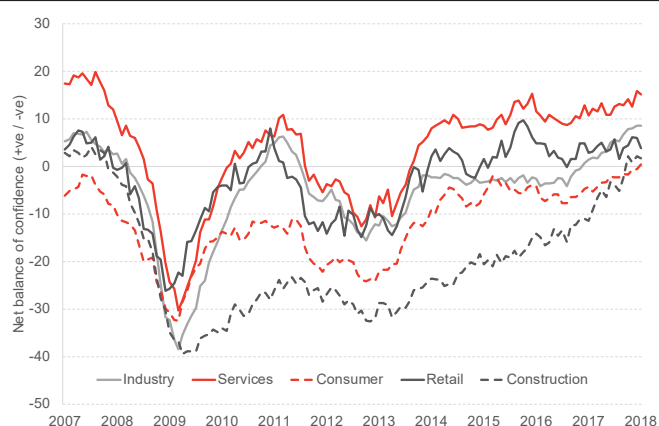
Table 3: OECD forecasts for G7 growth to 2019

	2017	2018	2019
UK	1.7*	1.2	1.1
US	2.2	2.5	2.1
Japan	1.5	1.2	1.0
Canada	3.0	2.1	1.9
Euro Area	2.4	2.2	1.9
Germany	2.5	2.3	1.9
France	1.8	1.8	1.7
Italy	1.6	1.5	1.3

* Actual.

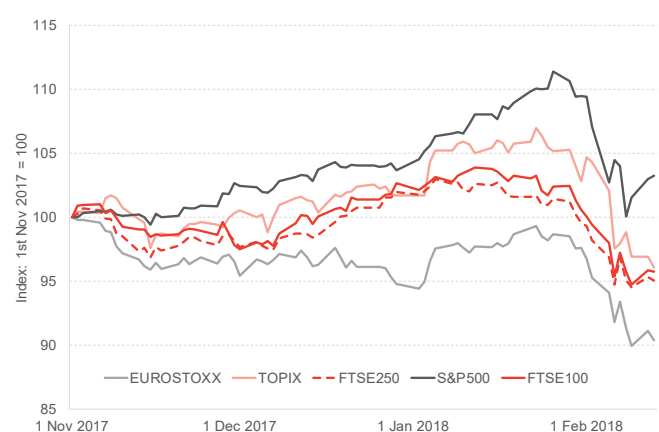
SOURCE: OECD

Chart 2: Market confidence in EU – highest since Euro crisis



SOURCE: European Commission

Chart 3: Stock market performance since November 2017



SOURCE: OBR

The global economy

Global economic activity remains relatively buoyant.

World economic output is estimated to have grown by 3.7% in 2017 – half a percentage point higher than in 2016.

The IMF estimate that some 120 economies, accounting for 3/4 of world GDP, have seen an increase in growth in 2017. This is the most synchronised upswing since 2010.

Recent indicators point to this expansion continuing into 2018 and 2019 – albeit perhaps not at the same (above trend) rate. (Table 3)

The US economy continues to perform strongly, supported by recent tax reforms.

And as discussed in December’s Commentary, one particular bright spot has been the turnaround in the European economy over the past year.

Expected Euro Area growth in 2017 of 2.4% is the fastest since 2010 and employment is now back above its pre-crisis level.

Confidence is improving across all sectors of the European economy. (Chart 2)

Despite this positive outlook, global stock markets have been volatile. Following a year of gains, early February saw a sharp sell-off in assets. For example, the Dow Jones fell 10%. (Chart 3)

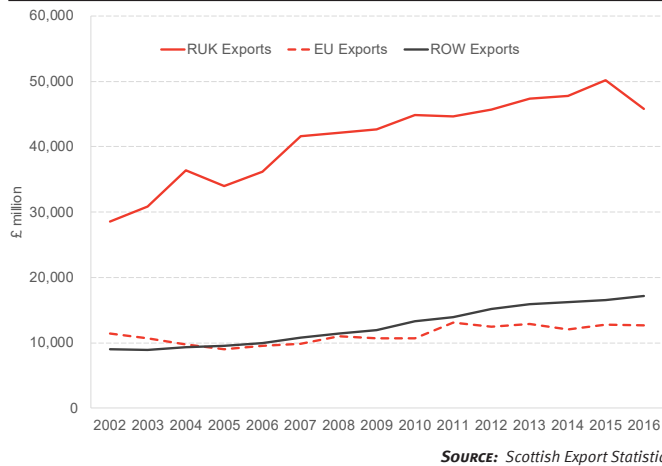
So far however, this appears to be a short-term market correction rather than a sustained deterioration in sentiment.

That being said, risks are not difficult to identify. Weak productivity growth is a challenge for many countries. And policy uncertainty remains heightened.

The decision by the Trump administration to impose tariffs of 25% on steel and 10% on aluminium has fuelled fears of a rise in protectionist sentiment across the world.

Whilst talk of a ‘trade war’ – most notably between the USA and China – is premature, future multi or bilateral trade deals (for any country) look less likely.

Chart 4: Scottish exports by destination, 2002 – 2016



The latest official export figures for Scotland were published in January.

Scotland’s international exports amounted to around £29.8 billion in 2016. Exports to the rest of the UK were nearly £45.8 billion.

The latest figures show a fall in Scottish exports of £3.9 billion between 2015 and 2016 – driven by a sharp decline in rUK exports. (Chart 4)

Whilst Scotland has key strengths in many areas, it is widely accepted that there is a need to develop a stronger and more diverse export base.

International exports account for a lower share of overall Scottish output than for the UK as a whole (20% vs. 27%). The EU and OECD average is 44% and 28% respectively. If Scotland was to export internationally the same share of its economy as the UK does, this would be equivalent to an extra £12 billion in Scottish exports.

Looking at the experience of similar sized nation states, we also find that Scotland depends more upon one market (i.e. rUK) than they do.

Chart 5 compares Scotland with Denmark and Ireland – two countries that Scotland often seeks to emulate – both in terms of overall exports and the relative contribution of different markets.

Broadening Scotland’s export base – particularly to emerging markets – offers a significant growth opportunity.

As always, the immediate outlook for Scottish growth will depend, in part, upon global oil prices.

As indicated in our December commentary, the latest assessment of the industry undertaken as part of our oil and gas survey suggests that optimism is at its highest since 2013.

Some of this reflects action taken to reduce costs, improve production efficiency and diversify to help support long-term sustainability. But it also reflects recent increases in oil prices. (Chart 6)

The OBR now expect oil revenues to raise an additional £400m on average each year up to 2022-23 compared to their November forecasts.

Chart 5: Percentage of total exports by market, 2016

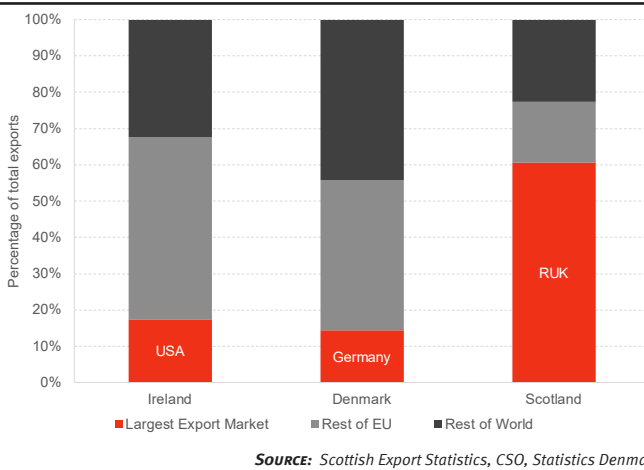
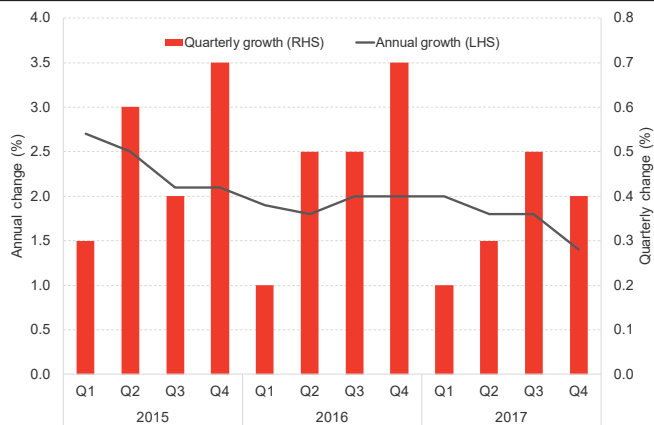


Chart 6: Crude oil prices, US\$/BBL, 2013 – 2018

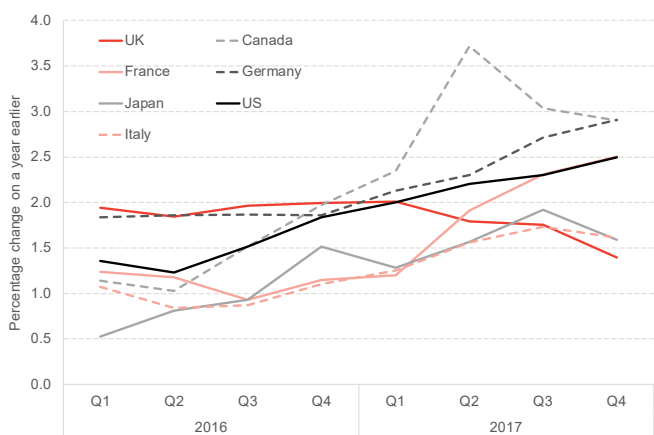


Chart 7: UK quarterly and annual economic growth, Q1 2015 – Q4 2017



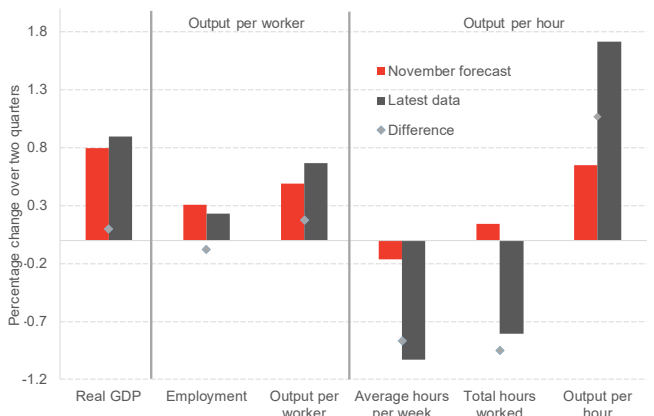
SOURCE: ONS

Chart 8: GDP growth in the UK and other G7 countries, Q1 2016 – Q4 2017



SOURCE: OBR

Chart 9: Real GDP, output per worker and output per hour, Q2 2017 – Q4 2017



SOURCE: OBR

The UK economy

The UK economy has performed slightly better than expected during the 2nd half of 2017. (Chart 7)

Output rose by 0.4% between Oct-Dec, with business & financial services (up 0.9%) and manufacturing (up 1.3%) leading the way.

Construction output fell for the 3rd quarter in a row.

Despite this somewhat better than expected performance, growth is now weaker than in many competitor countries. (Chart 8)

Whilst some of this reflects temporary factors, there are concerns that the UK is entering a slower period of growth more generally.

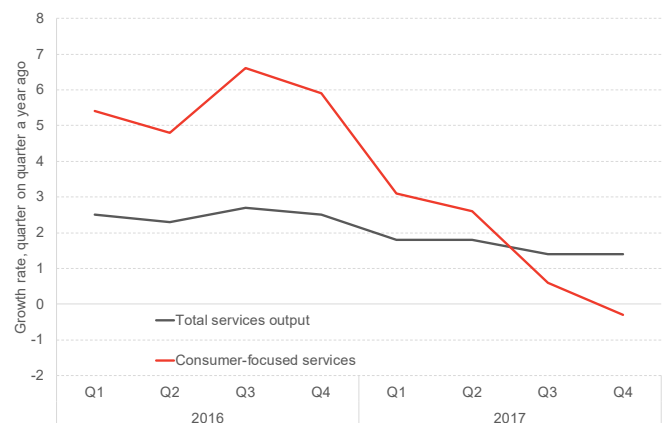
As we discuss below, the OBR remain relatively pessimistic about the outlook for UK productivity in the coming years. This is despite productivity having grown strongly – and above forecast – in recent months.

But as Chart 9 highlights, this improvement stems, not from faster output growth, but a decline in hours worked.

Weak productivity growth continues to feed through to low real earnings. Whilst nominal wages have picked up in recent months – rising 2.5% in Q4 – they continue to lag behind inflation which remains above target at 3%.

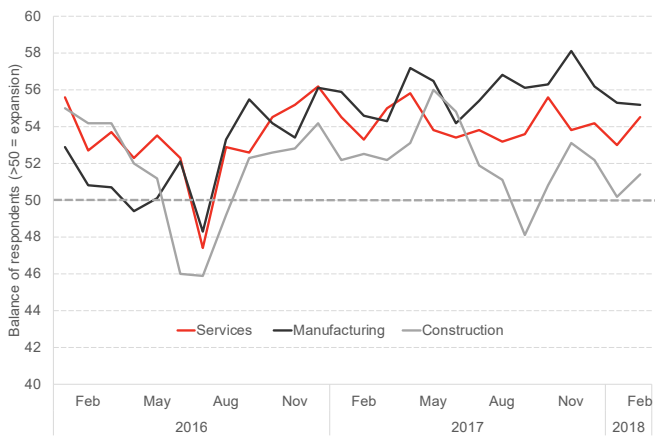
It is no surprise therefore that the parts of the economy tied to the fortunes of the consumer have been squeezed. (Chart 10)

Chart 10: Growth rate of consumer-focused services output and total services output, Q-on-Q a year ago, Q1 2016 – Q4 2017



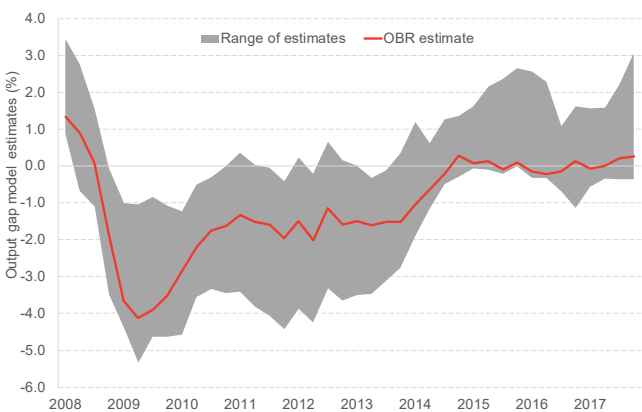
SOURCE: ONS

Chart 11: Purchasing Managers Index (PMI) for UK*



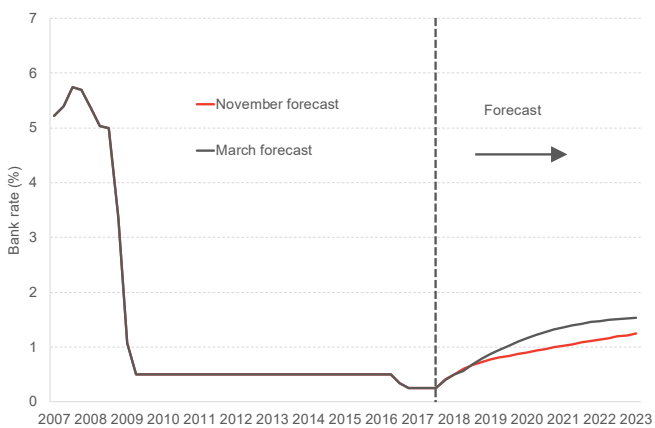
* >50 indicates an expansion in business activity. **SOURCE:** IHS Markit

Chart 12: Range of output gap model estimates, Q1 2008 – Q4 2017



SOURCE: OBR

Chart 13: Bank rate forecasts, Q1 2007 – Q1 2023



SOURCE: OBR

Nevertheless, indicators of day-to-day economic activity remain relatively positive.

The UK PMI's for services, manufacturing and construction, all continue to show UK businesses reporting relatively robust growth. (Chart 11)

In February, the Bank of England's team of agents found that both utilisation of machinery and recruitment difficulties (an indicator of high demand) were above their historical average.

Such evidence has led the OBR to conclude that the UK economy is operating at close to capacity. (Chart 12)

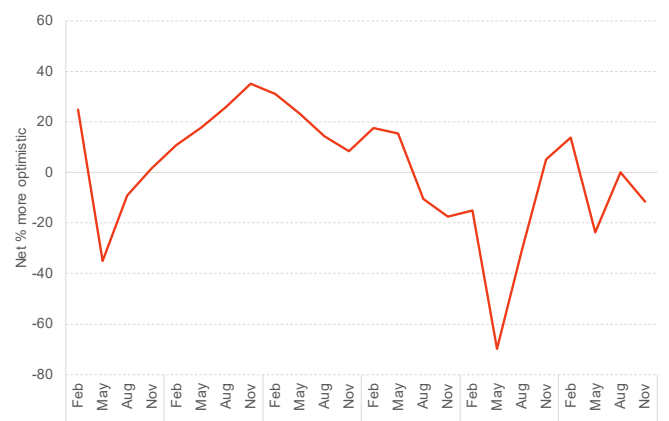
With this in mind – and with inflation still well above target – it is no surprise that speculation over further increases in interest rates have intensified. (Chart 13)

Despite this, there remains a heightened degree of nervousness about the outlook for the UK economy, particularly given ongoing Brexit uncertainty.

Indicators of *sentiment* within the business community remain skewed toward the downside.

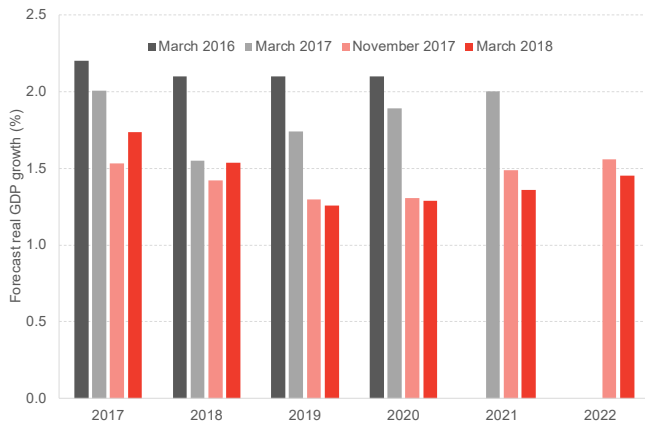
For example, a study by Deloitte of prospects as perceived by Chief Financial Officers, suggests a net balance are now relatively pessimistic about the outlook compared to just three months ago. (Chart 14)

Chart 14: Perception of prospects compared to 3 months ago – net percentage more optimistic



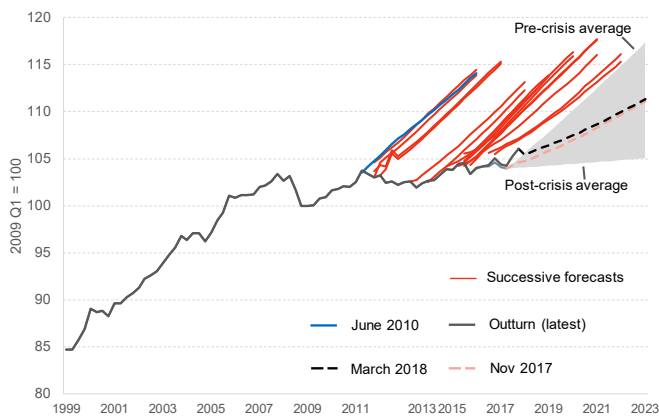
SOURCE: Deloitte

Chart 15: Changes in OBR forecasts of real GDP growth, 2017 – 2022



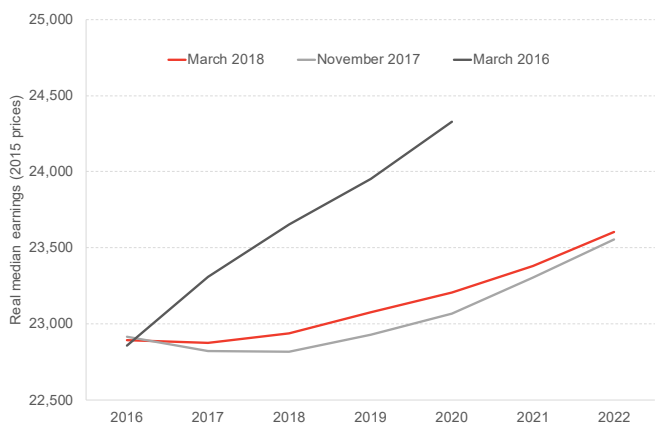
SOURCE: OBR

Chart 16: Successive OBR forecasts for productivity growth, 1999 – 2023



SOURCE: OBR

Chart 17: Changes in OBR forecasts of real, average annual employee earnings, 2016 – 2022



SOURCE: OBR, ASHE

It is against this backdrop that the Office for Budget Responsibility published their latest forecasts on 13th March.

Back in November, the OBR significantly revised down their UK economic forecasts for the next few years citing a weak outlook for productivity growth.

In the end, growth in 2017 has turned out to be slightly better than the OBR had expected – 1.7% vs. 1.5%. This has also led them to revise up their forecasts for 2018.

But these revisions in the early years of their forecast horizon are mirrored by slight declines in later years – effectively reassessing where the UK is in the ‘economic cycle’.

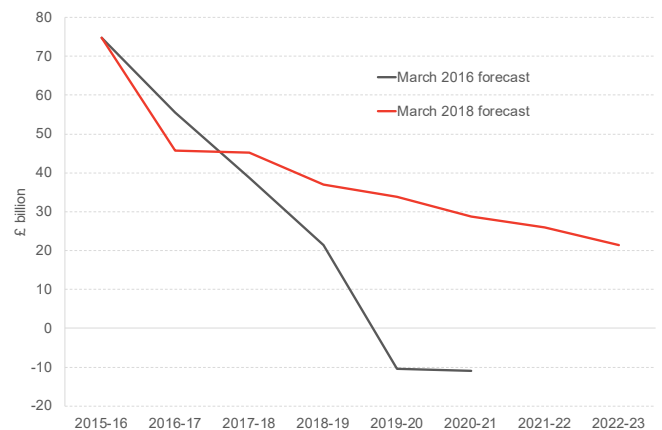
Moreover, the outlook remains much more pessimistic than the forecasts from just two years ago. Growth is forecast to be less than 1.5% per annum from next year right up to 2022 (Chart 15).

The key driver of this outlook is not Brexit, but weak forecasts for productivity. (Chart 16)

Unsurprisingly, with productivity crucial for wage growth, the date at which real earnings will return to their pre-financial crisis peak has been pushed even further back. (Chart 17)

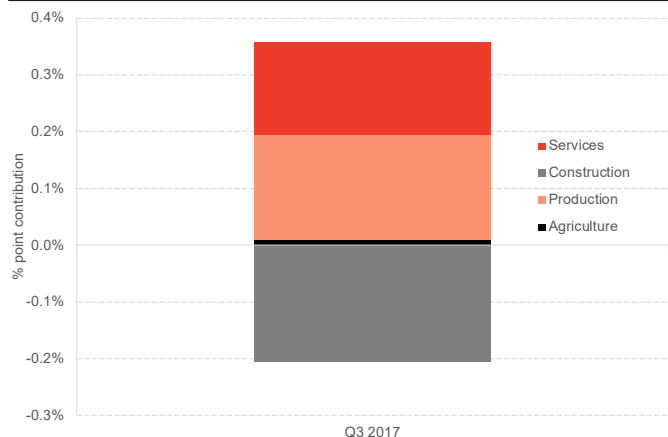
And whilst the Chancellor has been able to welcome the fact that the UK Government is – after nearly 10 years of cuts – now only borrowing to invest, the public finances remain much weaker than George Osborne had planned for in his last Budget in March 2016. (Chart 18)

Chart 18: Changes in OBR forecasts of public sector net borrowing, 2015/16 – 2022/23



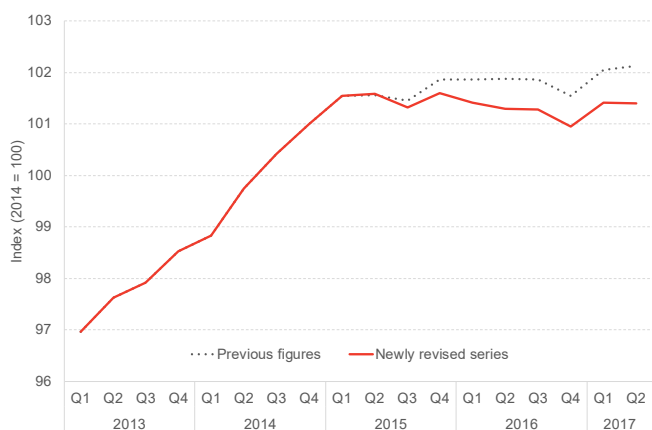
SOURCE: OBR

Chart 19: Q3 2017 GDP – contributions by sector



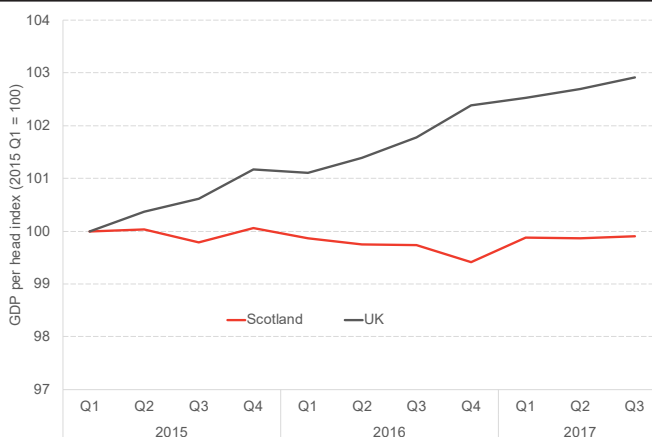
SOURCE: Scottish Government

Chart 20: Revisions to GDP – Q3 2017 publication vs Q2 2017 publication



SOURCE: Scottish Government

Chart 21: Indexed GDP per head in Scotland and UK, Q1 2015 = 100



SOURCE: Scottish Government

Recent Scottish economic data

The latest figures for Scottish GDP cover the period to Q3 2017 – and showed growth of just 0.2% over the 3-month period.

Annual growth is currently 0.6%. To put that in context, growth had been averaging between 2 to 2½% per year in the decade prior to the financial crisis.

In the most recent quarter, production grew 1.2% whilst services grew 0.2%. Construction fell once more, down nearly 3% (and by 7.5% over the year).

One interesting feature of the latest statistics were the revisions to past data releases.

As Chart 20 highlights, statisticians have revised down their assessment of how Scottish GDP per head has tracked over the past few years.

The new figures estimate that since 2015 – despite overall Scottish GDP growing 1.1% – GDP per head has actually *fallen* by 0.1%. Over the same period, UK GDP per head grew nearly 3%. (Chart 21)

What explains this weak performance?

Following the fall in the oil price, sectors tied to the North Sea supply chain – most notably manufacturing – had entered a sharp recession.

However, we have started to see some encouraging signs in these sectors. Manufacturing rose 0.4% this quarter and by 2.9% over the year. (Table 4)

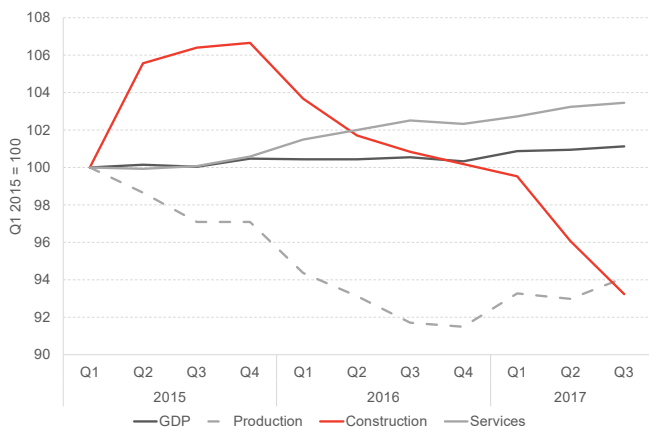
So the weak figures in recent times cannot be explained just by oil and gas.

Table 4: Growth in manufacturing, Q3 2017 on Q3 2016

Manufacturing industries	Growth over last 12 months
Food & drink	-2.9
Textiles	-0.4
Petroleum/pharma	7.2
Metals & machinery	6.8
Computers etc.	1.7
Transport	4.7
Other	5.6
Total manufacturing	2.9

SOURCE: Scottish Government

Chart 22: Indexed sector changes since 2015, Q1 2015 = 100



SOURCE: Scottish Government

The biggest drag on growth in 2017 has been construction – which has fallen for 7 consecutive quarters. (Chart 22)

As we have discussed before, the Scottish construction series has been displaying some odd characteristics in recent times.

There was strong growth during 2014 and early 2015 with construction output up 30%. Since then, the series has fallen sharply as it returns to more normal levels. (Chart 23)

The Scottish Government believe that this is the result of a number of infrastructure projects being completed. But with capital budgets rising through 2017, this cannot fully explain recent trends.

Whatever the explanation – methodological or real – the volatility in the construction series has a significant impact on aggregate Scottish GDP.

In Chart 24, we strip out construction activity from the headline GDP series.

Firstly, growth in 2014 and 2015 is lower than reported.

Secondly, and perhaps of most interest, the recent performance of the Scottish economy has not been as bad as the headline figures suggest. Indeed, growth in Scotland would be much closer to trend.

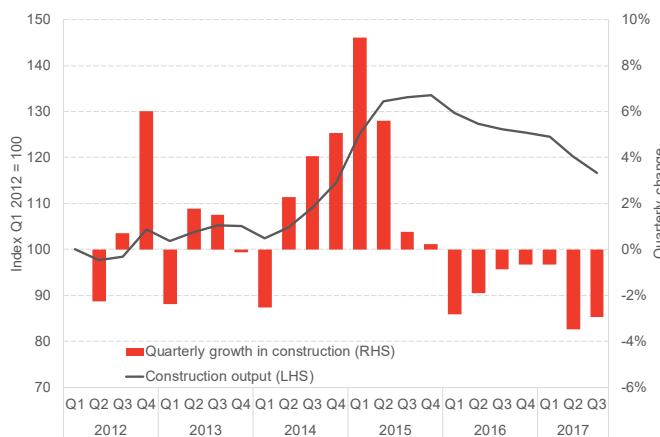
The latest ONS figures for construction activity suggest that the Q4 will continue to see a decline once more. The Scottish Government should do more to unpick this data to understand better the reason for these swings in construction output.

The Scottish National Accounts data provides a useful breakdown of changes in the expenditure components of our economy over time. (Chart 25)

The most recent figures show that, alongside household spending, net exports (both to RUK and ROW) have made the greatest positive contribution to Scottish growth in 2017.

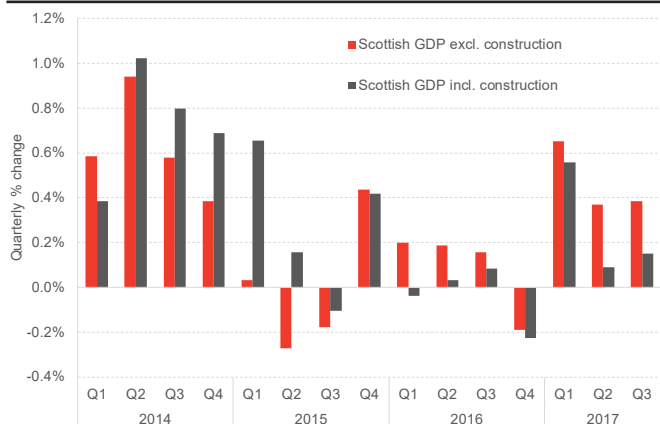
The same data however, also shows a sharp fall in business investment – down 15% over the year.

Chart 23: Construction sector performance in Scotland since 2012, index and quarterly change



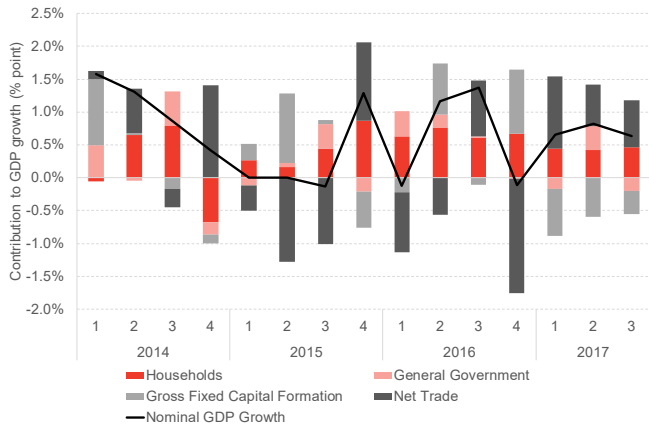
SOURCE: Scottish Government

Chart 24: Scottish GDP since sharp rise in construction in 2014 – aggregate GDP with and without construction sector series



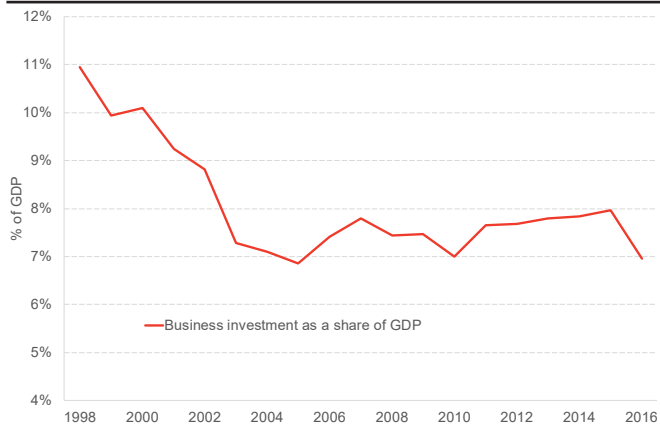
SOURCE: Scottish Government

Chart 25: Expenditure components of nominal GDP, Q1 2014 – Q3 2017



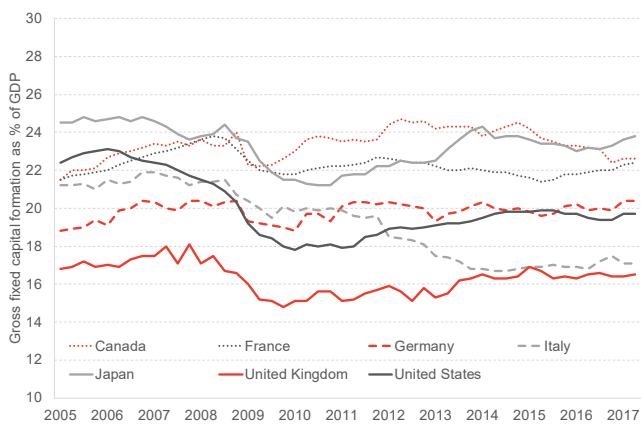
SOURCE: Scottish Government

Chart 26: Scottish business investment as a share of GDP, 1998 – 2016



SOURCE: Scottish Government

Chart 27: G8 Gross fixed capital formation as a percentage of GDP, Q1 2005 – Q2 2017



SOURCE: ONS

Is this a Brexit effect?

Possibly. But falling investment has been a feature of the Scottish economy for years. (Chart 26)

And Scotland is not alone.

Total investment in the UK by business, government and households (i.e. Gross Fixed Capital Formation) lags behind our key competitors. (Chart 27)

This impacts upon a number of economic outcomes. For example, whilst business R&D has risen in recent years, Scotland still ranks only 9th in the UK in terms of R&D spend per head. (Chart 28)

The Scottish Government's National Investment Bank is the latest initiative to try to tackle this.

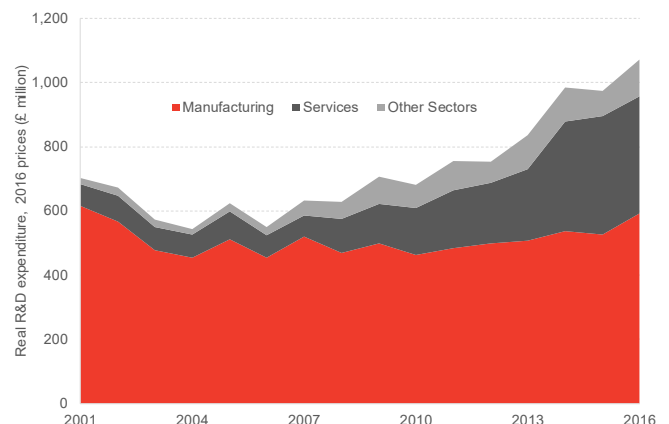
Whilst welcome, we should be wary of expecting too much from the new institution early on.

Clearly there can be a role for a state led investment vehicle – to plug gaps in the market and to support patient capital – but it needs to be matched by demand. Past initiatives, like the Scottish Growth Fund, have struggled to find companies in Scotland willing to put forward proposals for investment.

And even if this is the case, the planned capitalisation of £350 million over two years is modest. Although, if successful it should leverage in further monies.

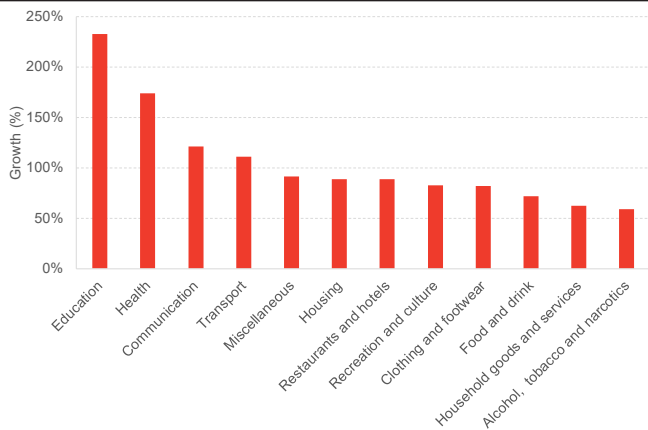
One quick-win for the new Bank should be the creation of a single gateway through which firms can access funds and receive joined up advice on finance options.

Chart 28: Business research & development real expenditure in Scotland, 2001 – 2016



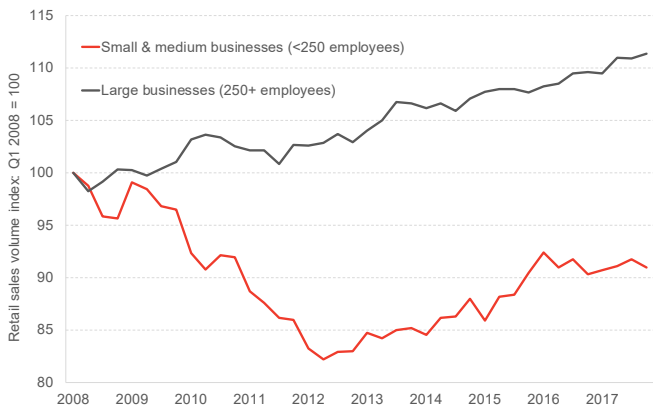
SOURCE: Scottish Government

Chart 29: Household final consumption growth by expenditure, 1999 – 2016



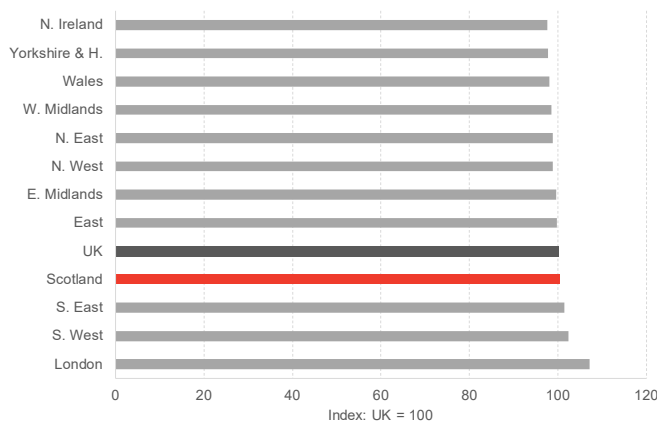
SOURCE: Scottish Government

Chart 30: Indexed Scottish retail sales volume by size of company, Q1 2008 = 100



SOURCE: Scottish Government

Chart 31: Price level index in different parts of the UK, UK 2016 = 100



SOURCE: ONS

Trends in consumer spending in Scotland

In previous commentaries we have discussed the challenges faced by the retail sector.

These can be summarised as follows.

Firstly, the trend in Scotland – as in other parts of the UK – has been for faster growth in spending on items like health and education than on traditional retailers. (Chart 29)

Secondly, we have seen a significant rise in online sales – which has changed both the way we shop and the profitability of many retail outlets.

Overall, it would appear that these trends have had a greater impact on smaller retailers as opposed to larger stores. (Chart 30)

In a related development, last month the ONS published updated figures on relative price levels across the UK.

The results found that Scotland – alongside the SE, the SW and London – has an overall price level higher than the UK average.

Very simply, this means that every £1 someone earns in Scotland, on average, purchases fewer goods and services than it would if they spent that same £1 in Wales (for example).

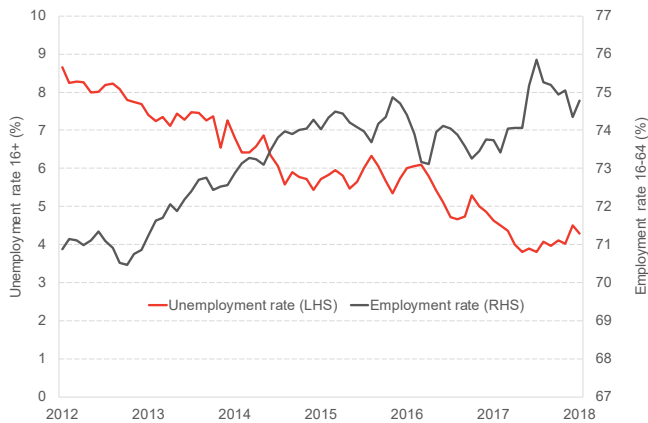
Table 5 shows the breakdown of spend by activity as per the ONS study. A number of interesting points emerge including the fact that Scottish households spend a larger share of their expenditure on transport than elsewhere, including London.

Table 5: Household budget shares of different goods/ services, 2016

Division	London	England ex. London	Scotland
Food & non-alc drink	15.1	15.6	15.5
Alcohol & tobacco	2.3	3.2	4.0
Clothing & footwear	6.3	6.1	6.0
Housing & housing services	11.6	11	11.6
Furniture & household goods	10.1	9.2	8.6
Transport	19.4	21.6	22.3
Communication	4.2	4.1	3.9
Recreation & culture	10.0	10.4	10.2
Restaurants & hotels	17.1	14.8	14.1
Misc. goods & services	3.9	3.9	3.9

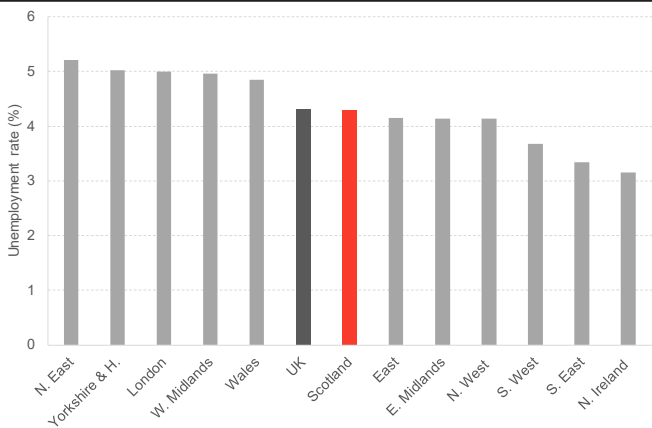
SOURCE: ONS

Chart 32: Scottish employment & unemployment rate, 2012 – 2018



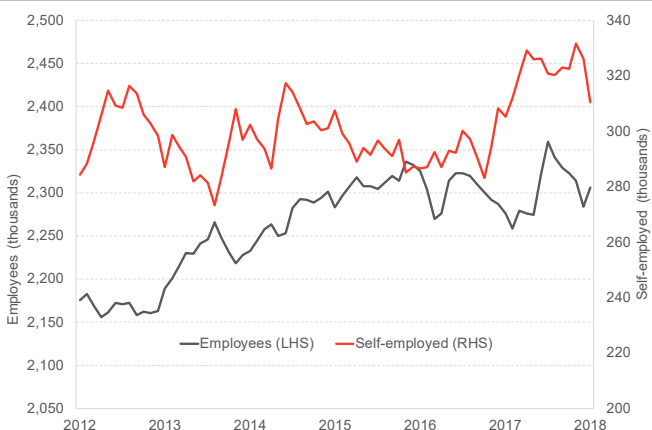
SOURCE: ONS, LFS

Chart 33: Unemployment rate in different regions and devolved nations in the UK, November 2017 – January 2018



SOURCE: ONS, LFS

Chart 34: Scottish employment & self-employment, 2012 – 2018



SOURCE: ONS, LFS

The labour market

As we have written in past commentaries, Scotland’s labour market has held up relatively well despite a challenging growth environment.

Unemployment – at 4.3% – remains low by historical standards and there are 9,000 fewer people unemployed than this time last year. (Chart 32)

This is a trend evident across the UK, and Scotland remains in the middle in terms of its UK rank by unemployment. (Chart 33)

The most recent data shows something of a fall-back, however, in outcomes. Employment fell by 8,000 whilst unemployment rose by 5,000 during the 3 months Nov-Jan.

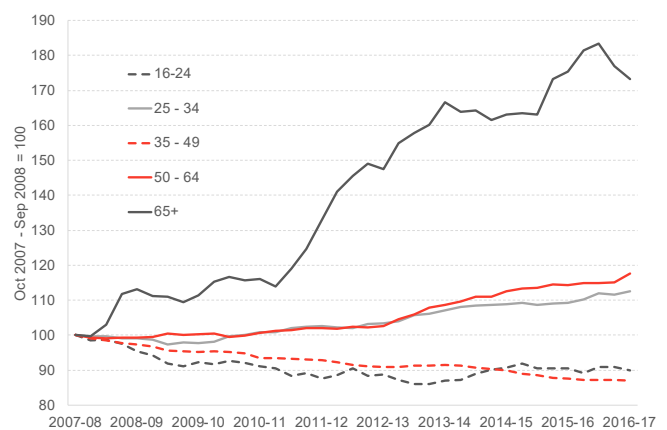
It is *possible* that this represents some early signs of Scotland’s weak growth performance starting to feed through to the labour market.

But given the volatility in the data, it is too early to judge with confidence – at this stage – if this is a blip or the start of a trend.

As we have discussed in our companion report – [Scottish Labour Market Trends](#) – our labour market continues to change markedly over a longer time horizon.

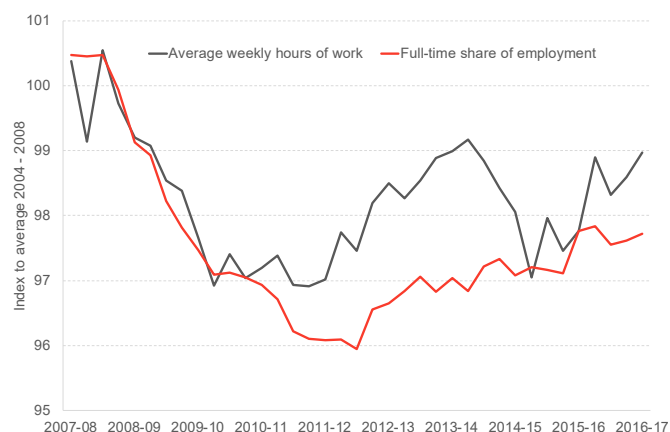
Whilst there 86,000 more people in employment now than a decade ago, 52% of that increase has been in self-employment. How much of this reflects a positive choice or a response to less secure employment opportunities is still unclear.

Chart 35: Employment rates by age, 2008 – 2017



SOURCE: ONS, Annual Population Survey

Chart 36: Average hours worked and full-time share of employment, indexed to pre-recession average, 07/08 – 16/17



SOURCE: ONS, Annual Population Survey

Similarly, our labour market is ageing quite markedly.

One reason – perhaps – why the growth in the number of people in work has eased off in recent times has been because the amount of hours being worked by people already in employment has been rising. (Chart 36)

Rising employment and/or rising hours worked has meant that productivity in Scotland has continued to be squeezed.

Labour productivity – output per hour – fell by 0.7% during the 3 months Jul-Sep 2017. (Chart 37)

This was the 8th quarter in a row of falling productivity. On this measure, Scottish productivity is back at 2010 levels.

Why is this the case?

Labour productivity measures how well output is performing relative to changes in how much labour is being used to produce that output.

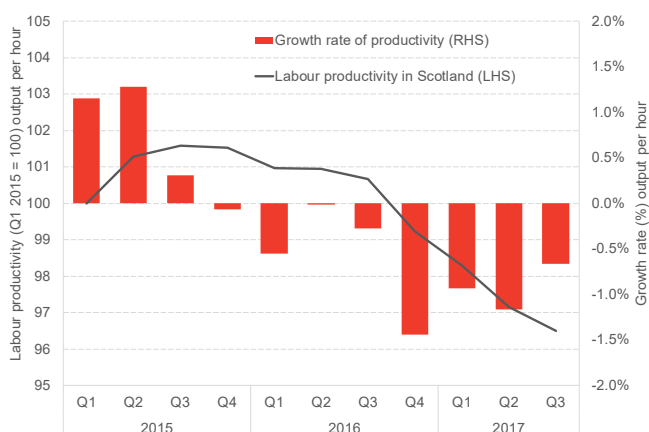
If we are able to produce more for the same number of hours worked then we are ‘more productive’. On the other hand, if we are working longer but not producing much more, then our productivity has fallen.

Chart 38 compares growth in the economy with the growth (inverted) in hours worked. It shows that the growth in hours has significantly outpaced that in the overall economy in recent times.

So in other words, the strong labour market results observed in recent times has come at the expense of falling productivity.

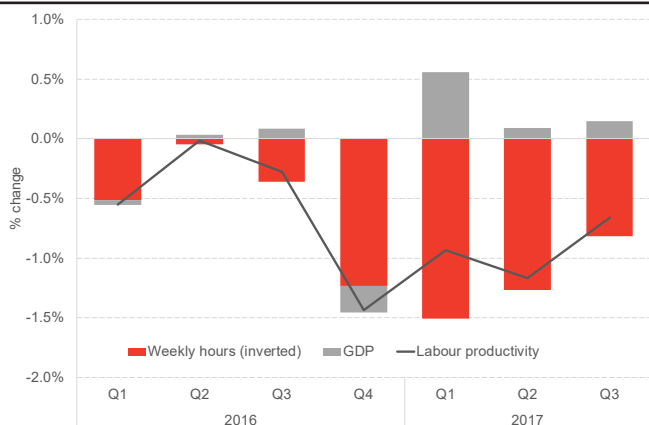
In a recent blog (www.fraserofallander.org) we argued that government targets for productivity have become increasingly irrelevant. Back in 2007, the target was for Scotland to be in the top OECD quartile by 2017. As at 2016, Scotland remains in the third quartile. (Chart 39)

Chart 37: Labour productivity in Scotland since 2015



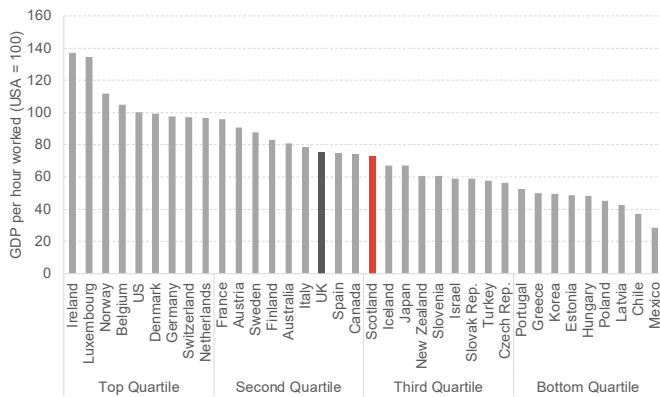
SOURCE: Scottish Government

Chart 38: Changes in hours worked and output in Scotland since Q1 2016



SOURCE: Scottish Government

Chart 39: International productivity levels 2016 (USA = 100)



SOURCE: Scottish Government

Policy discussions have tended to focus upon how best to generate high value productivity jobs and investment – i.e. in firms at the cutting edge of innovation and technology.

But increasingly, policymakers at both the UK and Scottish level are realising the importance of boosting productivity across the economy more generally.

As Chart 40 highlights, taking Glasgow and Edinburgh as an example, we see that vast majority of firms in the economy are in the middle to low end of the productivity spectrum. There are far fewer firms in the high-end of the spectrum.

Finding ways to shift the entire distribution up the value chain will be crucial. A focus on better management, skills across the workforce, process and workforce innovation, fair work and adoption of technology will be key.

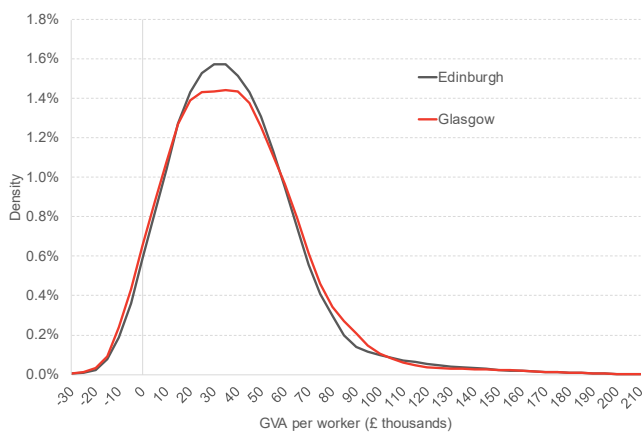
Current economic conditions

The most up to date economic data for Scotland has remained relatively mixed.

On the one hand, the FAI-RBS Business Monitor for Q4 2017 showed an increase in the net balance of firms reporting a rise in new and repeat business. (Chart 41)

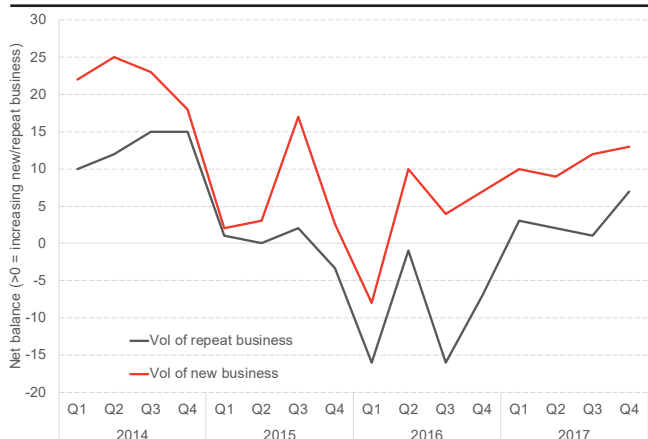
Indeed, the figures for new business are the highest since 2015.

Chart 40: Distribution of firm productivity in 2014



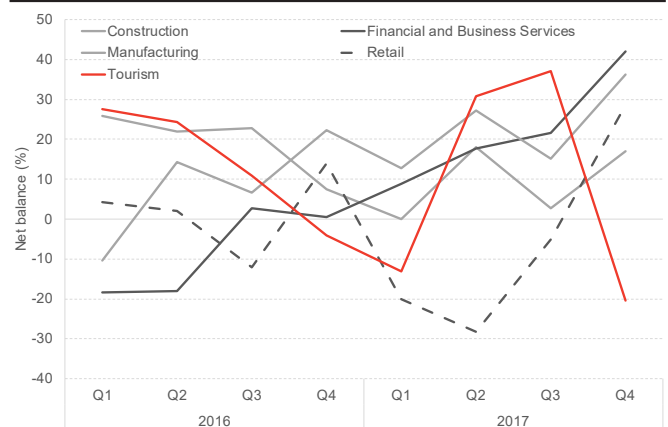
SOURCE: ONS

Chart 41: Scottish Business Monitor suggests growth continuing in Q4



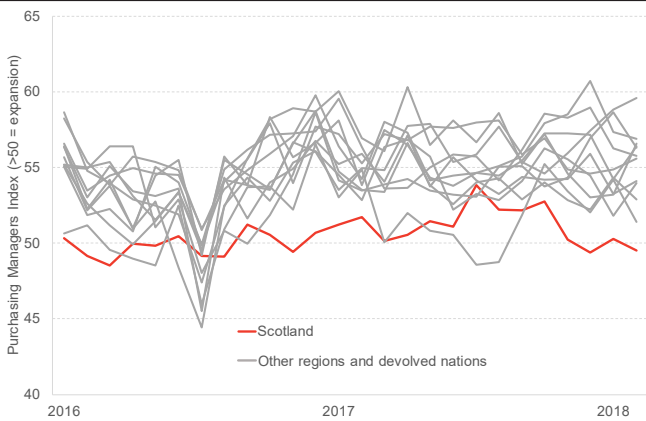
SOURCE: FAI/RBS Business Monitor

Chart 42: Business optimism by sector, Q1 2016 – Q4 2017



SOURCE: Scottish Chambers of Commerce

Chart 43: Scottish PMI continues to lag other parts of the UK



SOURCE: Lloyds PMI

The latest Scottish Chambers of Commerce Quarterly indicators have also been positive with most sectors – with the exception of tourism – reporting an upturn. Some slippage in the tourism sector was not unexpected given the strong performance in early 2017.

In contrast, the latest PMI indicator points to a more negative outlook. The indicator (where above 50 marks an expansion and below 50 a contraction) fell to 49.5 – the 2nd time in 3 months that this measure has shown private sector activity declining. Scotland once again lags behind other parts of the UK. (Chart 43)

As highlighted above, low levels of business investment has been a feature of recent times.

The latest Scottish Business Monitor shows that capital investment intentions of Scottish firms have remained negative throughout 2017.

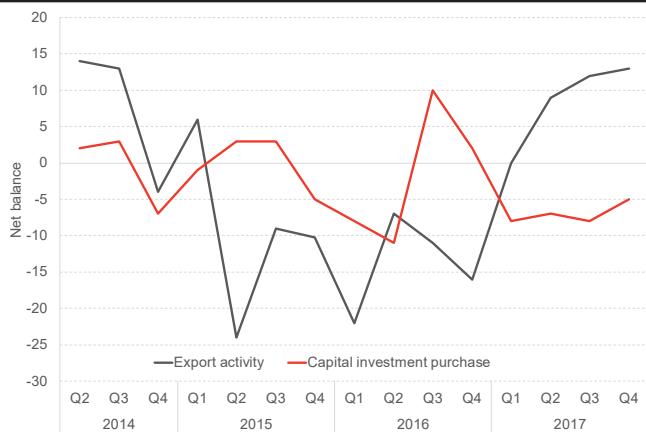
Export intentions have, however, become much more buoyant no doubt fuelled by the ongoing competitive value of Sterling. (Chart 45)

Overall, levels of consumer confidence remain weak.

The GfK consumer confidence indicator for Scotland was -13 in February and remains well below the UK (Chart 46).

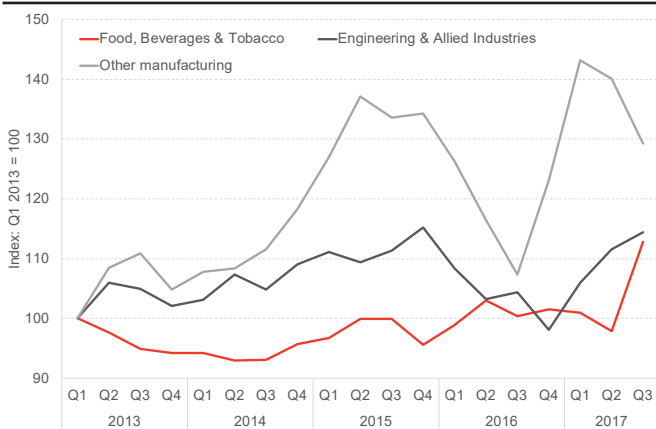
A similar story emerges in the Scottish Government’s consumer sentiment measure. (Chart 47)

Chart 44: Net balance of firms investing and/or increasing exports (>0 = expansion), Q2 2014 – Q4 2017



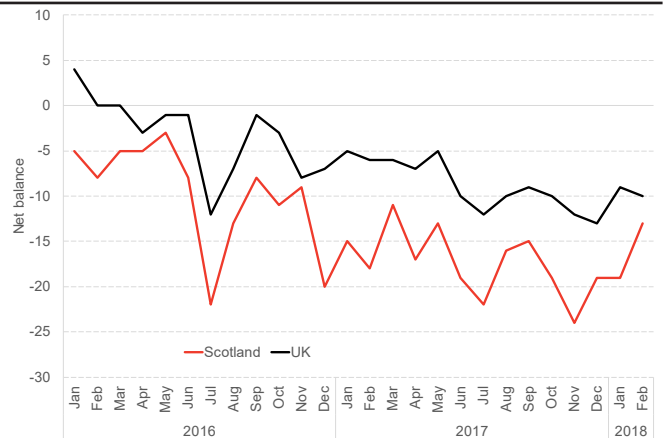
SOURCE: FAI/RBS Business Monitor

Chart 45: Index of manufacturing exports, Q1 2013 = 100



SOURCE: Scottish Government

Chart 46: Consumer confidence remains negative and worse than for the UK as a whole (>0 = more optimistic)



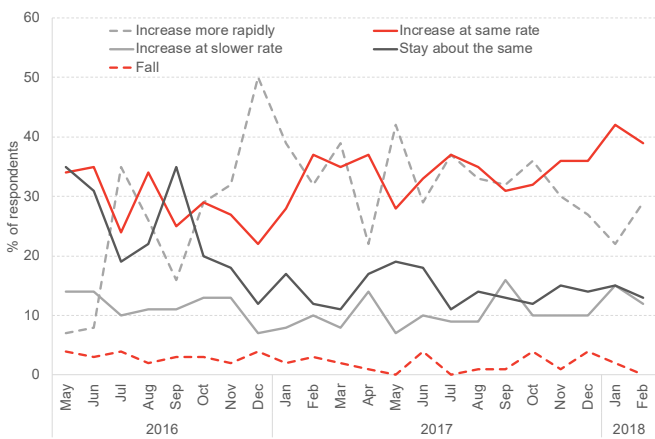
SOURCE: GfK

Chart 47: Consumer sentiment in Scotland, Q2 2013 – Q4 2017



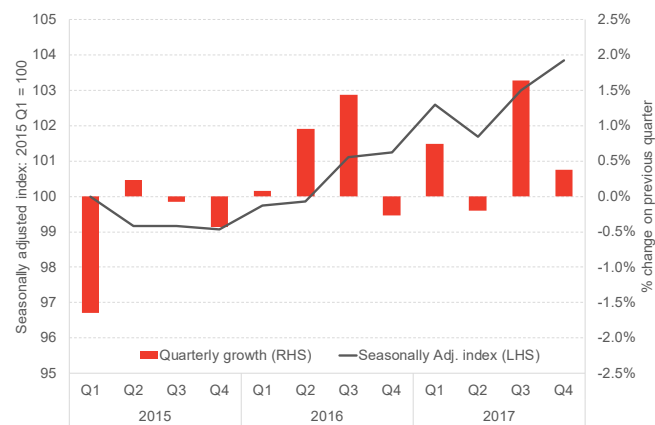
SOURCE: Scottish Government

Chart 48: Household expectations for prices over the next 12 months



SOURCE: GfK

Chart 49: Index and annual change in Scottish house prices, 2015 Q1 = 100



SOURCE: Nationwide

Some of this concern appears to stem from the rise in inflation over the past year.

Most surveys continue to point to households citing rising costs, particularly on food and fuel, as a key drag on spending. (Chart 48)

Although inflation is likely to remain elevated for some time yet, it should start to fall back as the spike in import prices caused by the sharp fall in Sterling continues to dissipate. This should help ease the pressure on households and help to restore confidence.

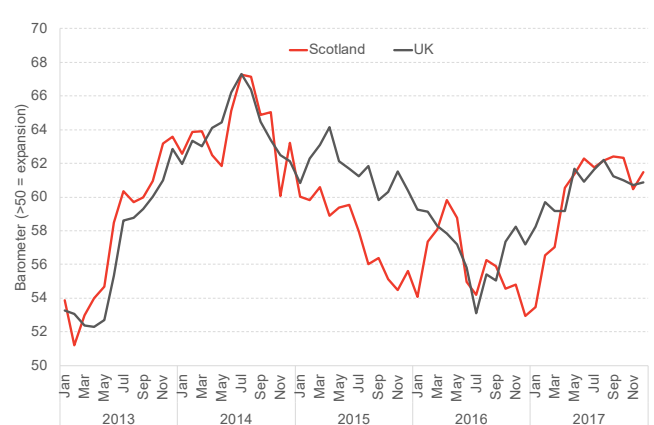
Like the wider economy, house prices have been growing in Scotland but at a relatively slow pace. Prices are up 2.6% over the past year. (Chart 49)

Despite these challenging conditions for households, the demand for labour remains strong. (Chart 50)

The Bank of Scotland's labour market barometer – which captures various measures of activity in the Scottish jobs market such as demand for new staff etc. – continues to perform well above its long-term average and to track the UK.

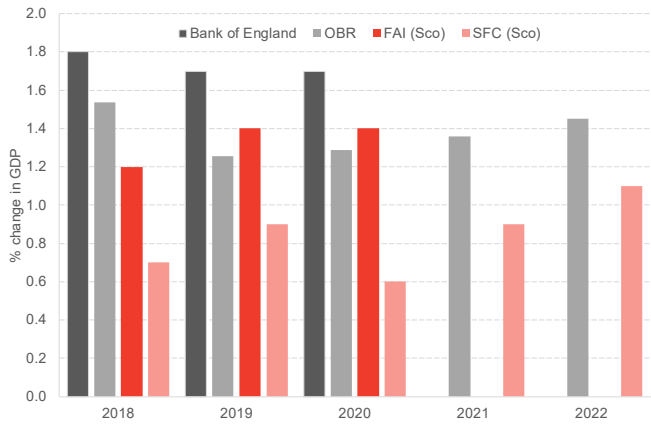
This suggests that the apparent disconnect between a resilient labour market and a weaker economic outlook is likely to continue for some time yet.

Chart 50: Bank of Scotland employment indicator – continues to show robust labour market demand



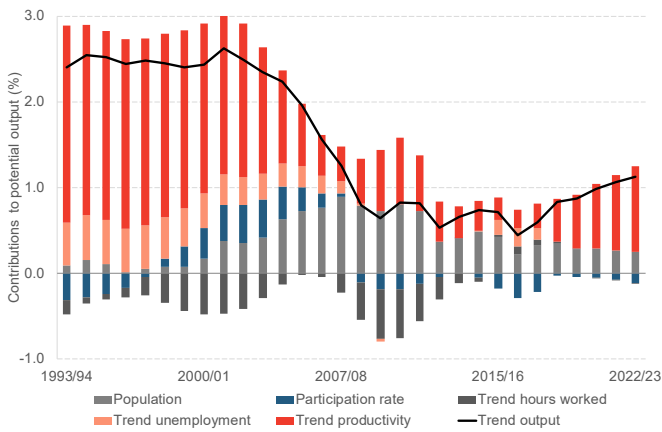
SOURCE: IHS Markit/ Bank of Scotland

Chart 51: Scotland and UK GDP growth forecasts, 2018 – 2022



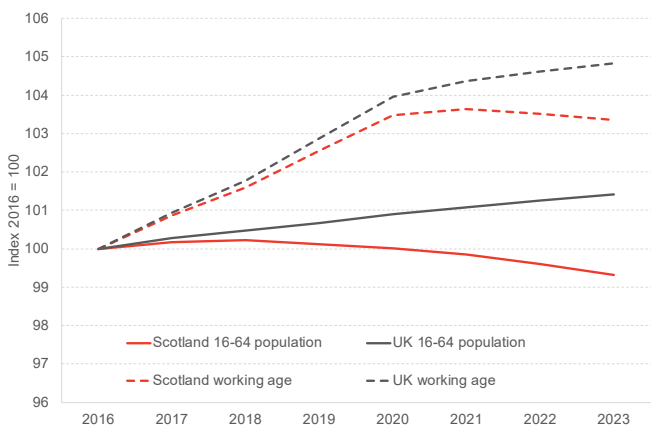
SOURCE: Fraser of Allander Institute

Chart 52: Contributions to SFC GDP growth forecast, 1993/94 – 2022/23



SOURCE: Scottish Fiscal Commission

Chart 53: Scottish and UK 16-64 and working age population projections, 2016 – 2023



SOURCE: Scottish Fiscal Commission

Scottish Fiscal Commission forecasts

Before our own forecasts, it is worthwhile reflecting on the projections of the new Scottish Fiscal Commission (SFC).

As is now well known, the SFC are predicting a weaker outlook for Scotland than most other forecasters. (Chart 51) On their projections, growth will not rise above 1% per year until 2022.

If this forecast turns out to be correct, this will be weakest run of growth in 60 years.

Why are the SFC more pessimistic?

Firstly, they estimate that – despite recent weak growth – the economy is currently operating at close to capacity.

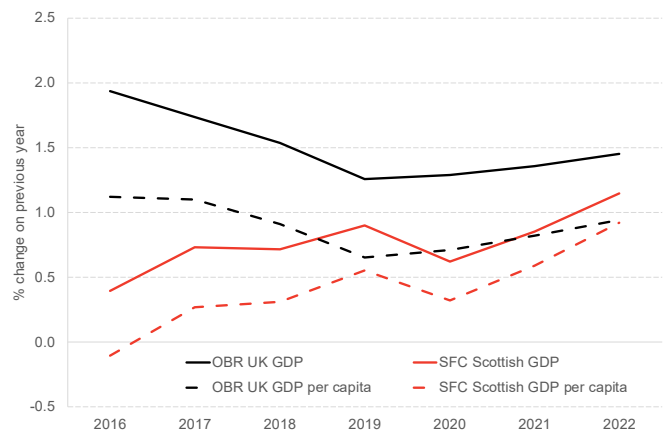
Secondly, like the OBR, they believe that the slowdown in productivity of the last few years will continue for the foreseeable future. (Chart 52)

Thirdly, they use projections for population that predict a decline in Scotland’s working age population over the next decade. (Chart 53)

This means that whilst there is a gap in GDP per head between the SFC and OBR forecasts for the UK, it is much narrower than for total GDP. (Chart 54)

It is important to note however that the SFC are still predicting that Scottish growth will pick-up, and be broadly on a par with average growth rates over the past decade.

Chart 54: SFC December 2017 and OBR March 2018 forecasts comparisons, GDP and GDP per capita



SOURCE: Scottish Fiscal Commission

Our forecasts

Chart 55: Evolution of FAI forecasts for 2017 (June 2016 to September 2017)

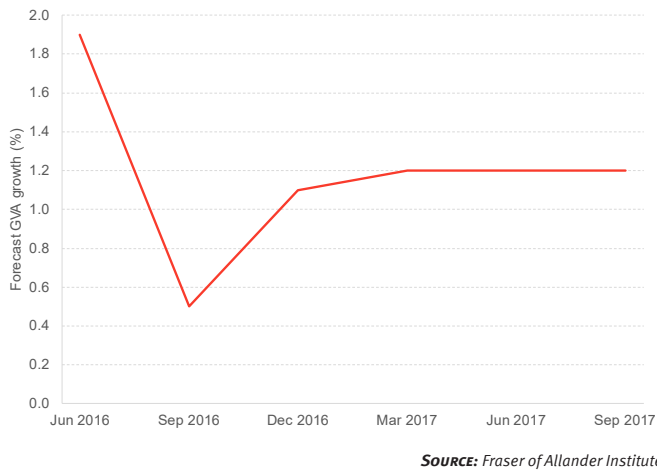


Table 6: Nowcasts for Q4 2017 and Q1 2018 for Scotland

	Q4 2017	Q1 2018
Quarterly Growth	0.36%	0.34%
Annualised Growth	1.47%	1.38%

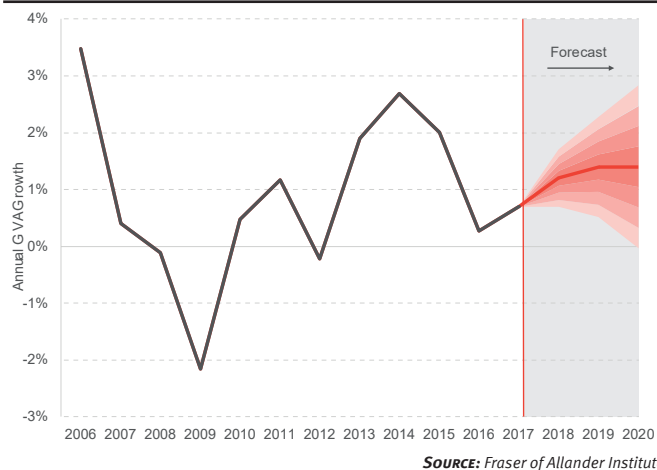
SOURCE: Fraser of Allander Institute

Table 7: FAI forecast Scottish Economic growth (%) 2018 to 2020

	2018	2019	2020
GVA	1.2	1.4	1.4
Production	1.4	1.6	1.9
Construction	0.7	0.8	0.6
Services	1.1	1.3	1.4

SOURCE: Fraser of Allander Institute

Chart 56: Growth to remain below trend through forecast



* Actual data to Q3 2017, central forecast with forecast uncertainty for 2018 – 2020. Uncertainty bands sourced from accuracy of past forecasts at different forecast horizons.

Chart 55 shows the evolution of our forecasts for 2017.

How does this compare to the official data?

We will get data for the final quarter of 2017 early next month (April 2018). Our latest nowcasts predict growth of between 0.3% and 0.4% for the 3-month period. (Table 6)

If the official statistics for Q4 come in close to this value (or even near to Scotland's long-term trend), this will mean that growth for 2017 as a whole will be around 0.7%.

This will be below our expectations and will mark the 2nd year of less than 1% growth.

In fact, the closure of the Brent oil pipeline in December could mean that the Q4 GDP figure for Scotland comes in even lower.

We believe however, that the official GDP statistics could be revised up in the future to make them more consistent with a healthier labour market and key business surveys. As discussed, we find the spike and then contraction in construction difficult to explain given other indicators for the sector.

Turning to our forecasts for the next three years, as in the past, we report a central forecast but also uncertainty bands that set out a likely range within which we predict Scottish economic growth will lie.

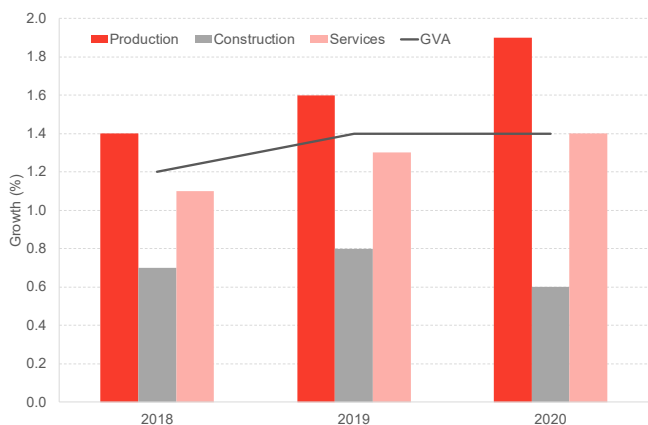
In other words, it is entirely possible that the economy could grow close to 2% this year, but our assessment is that the probability of that happening is lower than our central projection.

Overall, our forecasts are unchanged to those from December. (Table 7 and Chart 56)

Our forecast is for growth of 1.2% in 2018 followed by growth of 1.4% in 2019 and 2020.

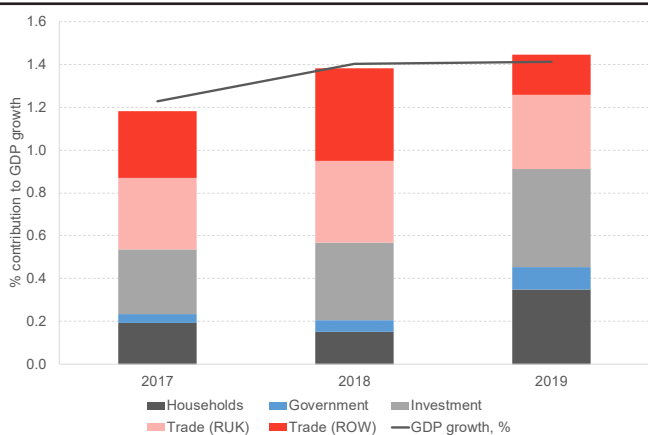
In short, we believe that the Scottish economy will grow this year, will quicken over the forecast horizon, but growth will remain below trend.

Chart 57: Sector components of FAI growth forecasts for 2018 to 2020



SOURCE: Fraser of Allander Institute

Chart 58: Contribution to FAI forecast 2018 to 2020: household contribution to fall back



SOURCE: Fraser of Allander Institute

Table 9: FAI Labour Market forecasts to 2020

	2018	2019	2020
Employee jobs	2,461,900	2,487,350	2,529,350
% employee job growth over year	+0.9%	+1.0%	+1.7%
ILO unemployment	121,400	116,200	113,250
Bank of England - UK unemployment rate (%)	4.3	4.2	4.1
OBR - UK unemployment rate (%)	4.4	4.5	4.6
Fraser of Allander Institute - Scottish unemployment rate (%) ¹	4.5	4.3	4.1

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.

Weak earnings growth should mean that household spending – and the industries it supports (e.g. retail) – will continue to be under pressure, although this should start to ease as inflationary pressures fall back.

Our forecasts assume some bounce-back in investment. With Brexit uncertainty this is arguably the element of our forecast with the greatest risk.

Net exports and tourism are on track to continue to benefit from the low value of Sterling.

We expect unemployment to rise slightly toward a level consistent with more medium-term trends. So any reported rise in unemployment in the coming months should pose little concern.

Of course, there remains uncertainty about any forecasts at the current time.

On balance, our forecasts are more optimistic than those of the Scottish Fiscal Commission.

Our reading of the labour market data – and in particular the indicators below the headline employment and unemployment statistics – suggests that there is a degree of spare capacity in the Scottish economy that could help support growth if demand picks-up.

We are also slightly more optimistic on the outlook for productivity. Finally, we take the view that whilst Scotland's 16-64 population may decline, a combination of in-migration from the rest of the UK and an increase in those working into retirement age will help to mitigate that somewhat in the short-term.

While the growth gap between Scotland and the UK is likely to remain over the next couple of years, we expect it to narrow.

Table 8: Forecast UK GDP growth (%) 2018 to 2020

	2018	2019	2020
Bank of England	1.7	1.8	1.7
OBR	1.5	1.3	1.3
NIESR	1.9	1.9	1.7
European Commission	1.4	1.1	n/a
IMF	1.5	1.6	1.7
ITEM Club	1.7	1.7	1.9

SOURCE: HM Treasury

Policy context

2018 will be an important year for the Scottish economy.

As the analysis earlier highlights, early indications are that 2018 will be another year of relatively muted growth.

Opportunities

But Scotland retains clear economic strengths.

Therefore, the recovery in the global economy, coupled with the long-term growth potential of emerging markets, offers significant opportunities for Scottish exporters to expand into new markets and increase their presence in existing ones.

The exponential growth in technology also provides the potential for new investment and innovation, particularly given Scotland's strong skills base and the research output of its universities.

At the same time, developing sustainable and productive business models for sectors of our economy that will grow significantly in the years ahead – such as in health and social care – will provide major new employment opportunities.

Of course, there are areas where Scotland can do better, for example in boosting levels of productivity across the economy as a whole. But even small improvements here, e.g. through increased rates of innovation in the workplace, has the potential to lead to major long-term benefits.

Risks

Clearly Brexit remains the greatest likely headwind for the Scottish economy.

The long-term risks are well known.

Over 40% of Scotland's international exports are to the EU and many of our firms operate in supply chains which rely upon the flow of goods and services across borders.

At the same time, with Scotland's working age population projected to fall over the next decade, any loss of EU migrants could have serious implications for individual sectors and the public

finances. On top of this, no-one yet knows the impact on domestic and international investment, productivity or the UK's status in the global economy.

As the table below highlights, the estimates in the UK Government's impact analyses are broadly in line with both our own analysis and that of the Scottish Government.

Table 10: Change in Scottish GDP relative to baseline of full EU membership by 2030

	EEA	FTA	WTO
UK (2018)*	-2.5%	-6.0%	-9.0%
SG (2018)	-2.7%	-6.1%	-8.5%
FAI (2018)	NA	-4.9%	-7.5%

* internal results as reported by media.

Source: Fraser of Allander Institute

In recent days, important progress appears to have been made with regard to the transition period the UK and the EU will operate within up to December 2020.

Whilst this creates space for further discussion, most of the major economic issues with respect to the UK's relationship with the EU post-Brexit remain unanswered.

It is understandable that exact details of the UK-EU settlement cannot be set out until a final agreement is reached. However, in 2018 businesses will look for much greater evidence that the UK Government has a clear vision for life outside the EU that not only satisfies business but can also secure the necessary parliamentary support.

Finding a solution to the Irish border issue which reconciles with the basic economics of how a Customs Union works is just one example where clarity seems to be lacking. The process for the transfer of powers to the devolved nations is another.

But like it or not, Brexit is happening.

So the sooner that businesses prepare for this reality the better.

According to a recent CBI survey published in January of this year, over 40% of UK businesses have yet to do any scenario planning for Brexit.

President Eisenhower’s famous quote – “*In preparing for battle I have always found that plans are useless, but planning is indispensable*” – has arguably never been more appropriate.

No-one knows with certainty the outcome of the negotiations. What will our trading relationship with the EU be; will there be tariffs, non-tariff barriers or a customs border to navigate; how closely aligned will UK regulations be with the EU; and how accessible will EU wide resources be?

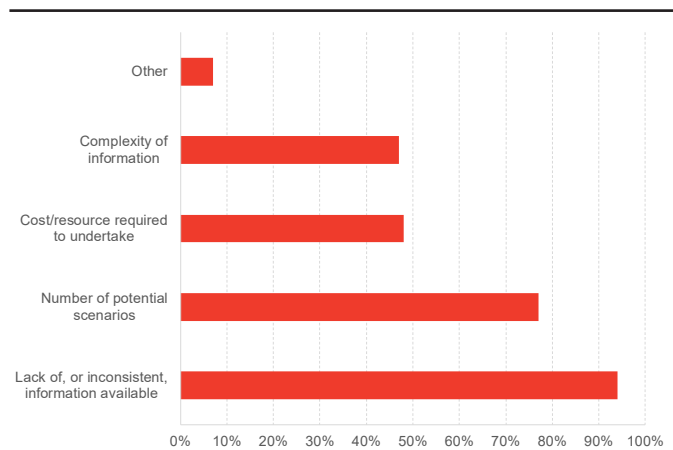
But the process of working through the potential implications of different scenarios on business models, supply chains, access to markets and sources of funding will be invaluable.

Effective preparations will ensure that – whatever the outcome – firms will be able to make the best of the new business environment.

In the same vein, there is arguably much more that both the Scottish and UK Governments could do to help Scottish businesses understand and prepare for Brexit. Providing this support should not be viewed as somehow inconsistent with Ministers’ different political standpoints.

As Chart 59 highlights, the lack of information is a key concern for many firms.

Chart 59: Of firms that have done scenario planning, what are the main difficulties faced?



SOURCE: CBI

Economic policy in Scotland

In recent commentaries, we have argued that there is an opportunity to use the challenge posed by Brexit to undertake a fundamental review of economic policy in Scotland.

The Scottish Government has started to set out its emerging thinking, with the creation of the new Strategic Board for Enterprise and Skills and new initiatives, such as an implementation plan for a new Scottish Investment Bank.

But if Brexit is going to make the economic outlook even more challenging than it was already, government policy is going to need even sharper focus. This means targeting resources where they will have the greatest impact and stopping doing things that either do not work or do not provide value for money.

Central to this is an effective strategy and delivery programme.

When first coming to power in 2007, the Scottish Government had one objective – a Purpose of “*delivering faster sustainable economic growth*” supported by an overarching Economic Strategy. This Purpose was supported by a transparent National Performance Framework that was designed to monitor progress. All parts of the public sector were to be aligned behind this Purpose and single Economic Strategy.

The Strategy explicitly stated that the “*call to action for all arms of the public sector to support increasing sustainable growth is not an invitation for a proliferation of initiatives, however well intentioned*” that all interventions would be “*appraised on the basis of sound analysis and evidence*” and that more effective government would assist in “*reducing duplication, bureaucracy and overlap across the public sector in pursuit of greater efficiency, effectiveness and, importantly, speed of delivery*”.

10 years later – in our view – this clarity of focus has arguably been lost.

Here is a snapshot of the current landscape.

Across the Scottish Government and its agencies, we now have an Economic Strategy; Digital Strategy; Energy Strategy; Circular Economy Strategy; Climate Change Plan; Trade and Investment Strategy; Labour Market Strategy; Social Enterprise Strategy; Hydro Nation Strategy; Strategy Action Plan for Women in Enterprise; STEM Strategy; Manufacturing Action Plan; Youth Employment Strategy; an Innovation Action Plan; a National Islands Plan; an Agenda for Cities; and even an Arctic Strategy.

Sitting alongside these we have numerous sector specific strategies – including Food and Drink; Tourism; Textiles; and Life Sciences. Not to mention an Infrastructure Investment Plan and an annual budget and programme for government process.

On top of this, most local authorities have their own form of economic development plan; all major sectors have a skills investment plan; there will soon be 7 City Deals; a new regional inclusive growth hub; and an updated National Performance Framework.

All of this overseen by the Scottish Government; Scottish Enterprise; Skills Development Scotland; Scottish Funding Council; Visit Scotland; Highlands and Islands Enterprise; South of Scotland Enterprise Agency; Scottish Futures Trust; Scottish National Investment Bank; and thirty two local authorities.

In turn they are informed by numerous advisory boards including the Council of Economic Advisers; Strategic Board for Enterprise and Skills; five independent boards of Scotland's enterprise and skills agencies; National Economic Forum; Scottish Leaders Forum; Scottish Business Growth Group; Strategic Labour Market Group; Consumers and Markets Taskforce; Hydro Nation Forum; Inward Investment Forum; Regulatory Review Group; Scotland CAN DO Innovation Forum; Fair Work Convention; Advisory Panel on the Collaborative Economy; and numerous industry groups – such as the Scottish Tourism Alliance and the Financial Services Advisory Board.

Of course, this list does not include the various programmes and activities of the UK Government in Scotland.

All of these initiatives are well intentioned. But is such a structure the best way to support coherent policy intervention in a country of Scotland's size?

More importantly, where is the evidence that this complex structure has had – or will have – a positive impact on Scotland's economic performance or deliver the systems-wide reforms required to help meet Scotland's long-term economic challenges?

Whilst many will undoubtedly have improved Scotland's economic performance, do we know which ones?

What evidence underpins each initiative and what systems for monitoring, evaluation and feedback are in place to assess their success (or otherwise)?

Strategies and advisory groups are no substitute for good policy delivery based upon evidence and data.

Back in 2007, the Scottish Government promised a streamlined and effective policy landscape for the economy. Ten years later it may be time to look at this again.

Rediscovering a single unified vision for the economy where all policies are aligned might just be the most significant – and effective – step the Scottish Government could take in 2018.

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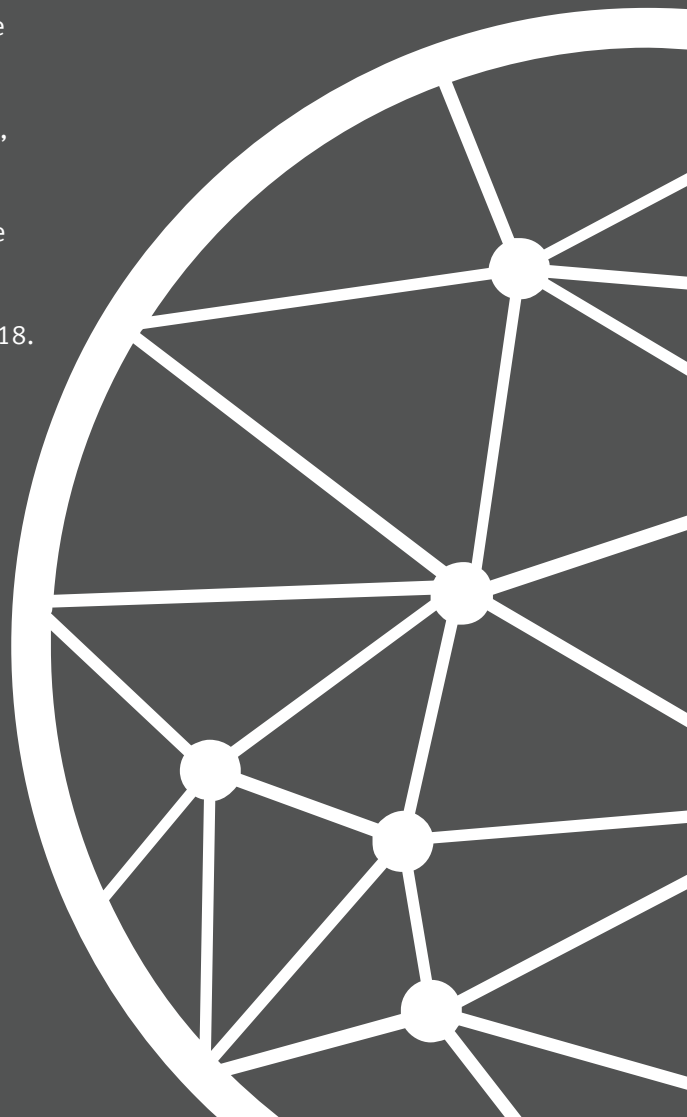
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