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Fraser of Allander Institute

Economic Commentary

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Vol 42 No 2

Foreword

Signs that Scotland's economic tide is finally turning

Since 2015 Scotland's economic growth has failed to garner much in the way of significant momentum, a trend that has been compounded more recently by a decline in construction and sluggish growth in services. Yet there are now some signs that Scotland's economic performance is improving. Progress is slow and continues to lag behind the UK. However, there are grounds for cautious optimism with 2018 projected to be an improvement on the previous year.

The country saw considerable growth in exports in 2017. It enjoys an excellent reputation in food and drink. Furthermore, sentiment in the North Sea is at its highest level for five years, in what is welcome news for an industry emerging from a downturn more lean and efficient, and now hinting at resurgence.

What is important now, is that businesses across the board, from food and drink to Fintech and everything in-between, are primed to embrace, swiftly, the opportunities that will arise, and tackle any challenges head-on. For some time, an inability to improve productivity has been a barrier to strengthening the prospects of our economic growth. While the core reasons for sluggish productivity growth are difficult to identify, there is little doubt that continuing investment in areas such as innovation, digital and technology are vital to enable continuing progress in how work is done.

Similarly, it is also important that our business leaders and workforce have the ability to adapt to a rapidly evolving economy which has an increasing emphasis on digital. As our Digital Disruption Index from May this year shows, there is consensus that greater investment is required to ensure employees have the digital skills required to implement an organisation's digital strategy. Such skills and strategies are much needed to truly maximise the benefits of technology, particularly emerging technologies such as artificial intelligence, virtual and augmented reality, and blockchain. A productive, highly trained workforce is pivotal to the strength of a relatively small and open economy such as Scotland's.

Brexit remains the most immediate and complex of the challenges we face and the onus is on businesses to prepare as thoroughly as possible for a range of possible outcomes in the face of these circumstances.

Scotland has a resilient economy that has endured a tough few years. With improving confidence in business and a determination to capitalise on opportunities and prepare for challenges on the way, we should be confident the economy can improve on its growth rate in the next few years.

John Macintosh
Tax Partner
Deloitte

June 2018

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Deloitte's Digital Disruption Index was published in May 2018. For further information please see www.deloitte.co.uk/digitaldisruption



Fraser of Allander Institute

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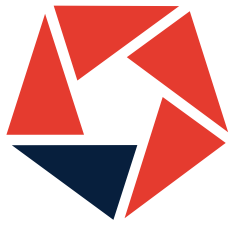
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Policy Context

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

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Summary

2017 was another year of weak growth in the Scottish economy. Output expanded by just 0.8% over the 12 month period, well below trend.

The near future remains challenging, with Brexit continuing to cast a shadow of uncertainty over the outlook.

That being said, we are cautiously optimistic about growth prospects for this year. Why?

While the UK Government still lacks a credible and coherent vision for life outside the EU, the agreed 2020 timetable for the UK's exit has helped shore up confidence amongst business in the short term.

More generally, indicators of household / business sentiment have picked up in recent times. And whilst UK economic growth is slowing, global growth remains strong.

Closer to home, the bad weather in March is likely to significantly dampen the Q1 Scottish growth figures, particularly for construction.

This should be temporary. It will be important therefore not to read too much into next week's GDP data but to wait until figures for Q2 are published. Only then will we have a full picture of the underlying health of the Scottish economy so far this year.

We forecast the Scottish economy will grow by around 1.2% in 2018 and by 1.3% in 2019 – still well below trend but more positive than the forecasts of the Scottish Fiscal Commission.

The Commission's recent revisions to their devolved tax forecasts, whilst small at the aggregate level, carry significant implications for the Scottish Budget.

The combination of lower tax revenues and a higher block grant adjustment has opened up a £389m gap in the government's finances for 2018/19 beyond its original plans.

Under the Fiscal Framework for the Scottish Budget, the effect of this is not immediate as monies have already been allocated. But it will have to be addressed at some point with contingency plans no doubt now being made.

This challenging outlook for the Scottish Budget will make the task of delivering on key policy priorities all that more challenging.

The new Scottish Government '5-year financial strategy' published last month sets out ambitious spending growth in key areas like the NHS, attainment, early years and social security.

But with the Strategy envisaging a decline in the resource budget in real-terms, other areas will have to bear the brunt. Unprotected areas are on track to be cut by around 8% in real terms over the course of this parliament (16/17 to 21/22). This picture is unlikely to change significantly, despite the recent announcement of additional spending by the UK Government.

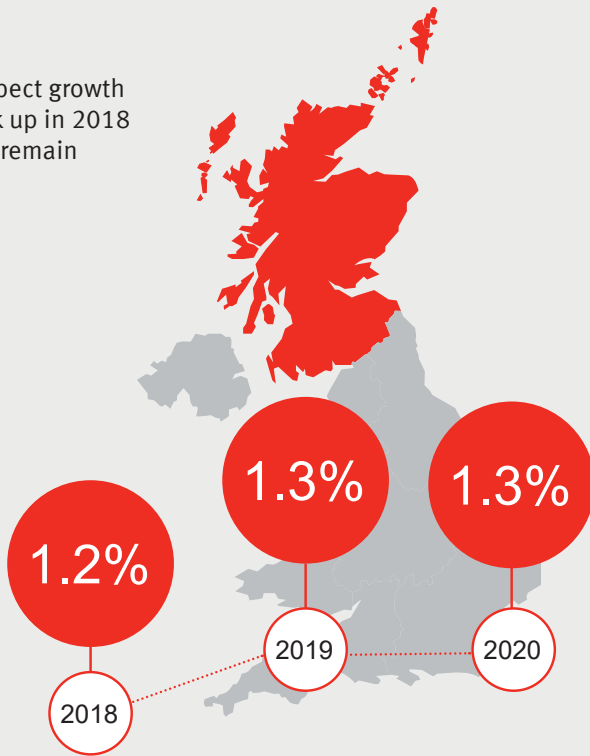
The greatest risk to the economic outlook remains Brexit. With just 9 months to go until the UK leaves the EU, the apparent lack of agreement within the UK Cabinet on basic issues like membership of the Customs Union is a major concern.

But Brexit cannot be used as an excuse for all our economic challenges. Hopefully the recent debates on Scotland's economic future sparked by the Sustainable Growth Commission and others have illustrated the value of fresh thinking and new ideas irrespective of the constitutional settlement.

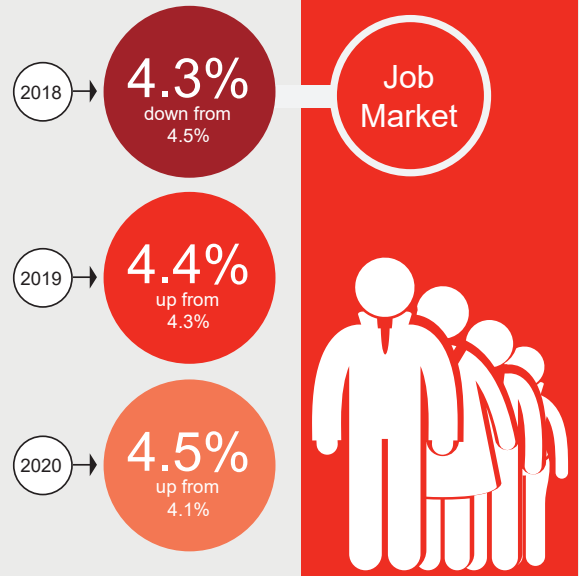
Fraser of Allander Institute
June 2018

Scottish growth forecast

We expect growth to pick up in 2018 but to remain fragile



Unemployment forecast



Fraser of Allander Institute

At a glance

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

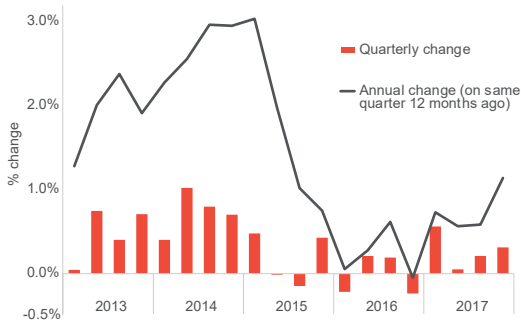


Chart: Scottish employment & unemployment rate, 2008 – 2018

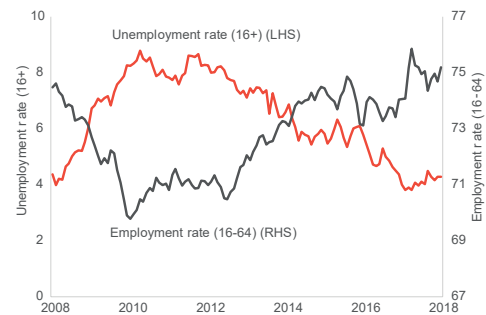


Chart: FAI forecast Scottish economic growth range

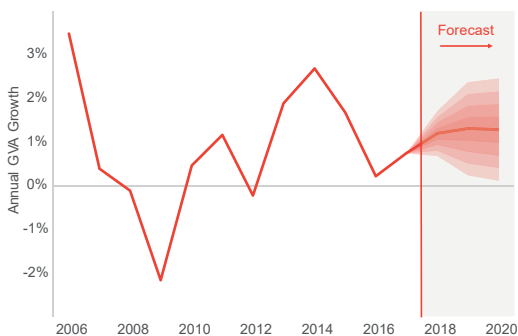


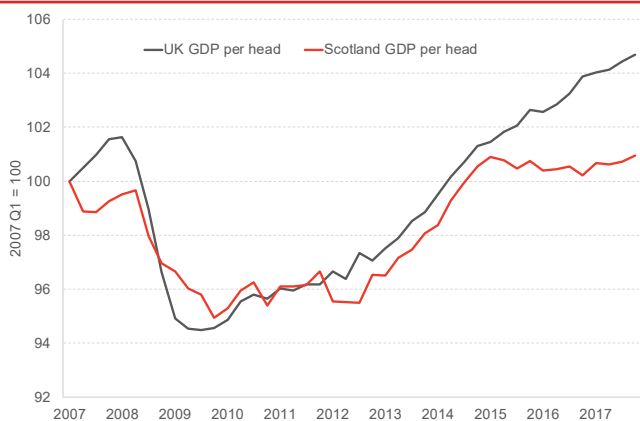
Table: FAI forecast Scottish economic growth (%), 2018 – 2020

	2018	2019	2020
GVA	1.2%	1.3%	1.3%
Production	1.4%	1.5%	1.5%
Construction	0.8%	0.9%	0.9%
Services	1.2%	1.3%	1.2%

Outlook and Appraisal

The Scottish economy continues to lag behind the UK and to grow much more slowly than in ‘normal’ times. Whilst Brexit risks remain, and a combination of bad weather and poor construction sector figures may have a temporary impact on GDP during the first few months of the year, we believe that there are grounds to be cautiously optimistic for the rest of 2018.

Chart 1: Scottish and UK economic performance (GDP per head) since 2007



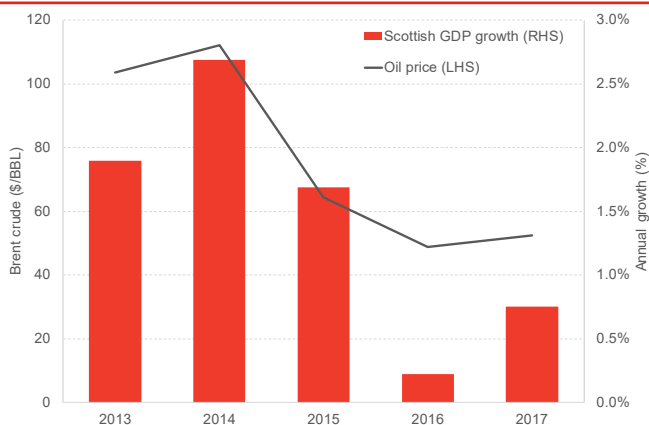
Source: Scottish Government

Table 1: UK labour market, Feb-Apr 2018

	Employment (16-64)	Unemployment (16+)	Inactivity (16-64)
Scotland	75.2	4.3	21.4
England	76.0	4.2	20.6
Wales	73.3	4.4	23.2
N. Ireland	69.7	3.3	27.9

Source: ONS

Chart 2: Scottish GDP growth and average annual oil price since 2013



Source: Scottish Government & Thomson-Reuters Datastream

Introduction

The latest data shows the Scottish economy grew by just 0.8% during 2017 – marking the 3rd year of weak growth. (Chart 1)

The Scottish Fiscal Commission predicts growth of just 0.7% in 2018 and for it remain below 1% until at least 2024.

Whilst we share the view that the outlook remains fragile and uncertain, we are slightly more optimistic about Scotland’s near-term prospects.

Our central view is that – on balance – the Scottish economy is showing signs that it will grow more quickly this year than last but is likely to still remain below trend. Why?

First, whilst there are structural headwinds facing our economy we believe that the labour market will provide much needed resilience in the short-term with capacity still not fully utilised. (Table 1)

Second, the outlook for oil and gas in 2018 – and its all-important supply chain – is more positive than it has been in almost three years. (Chart 2)

Third, there are signs that businesses and consumers are relatively more positive about the outlook. This should help boost demand.

Growth is still likely to be modest by historical standards and there remain significant risks. Chief amongst them is Brexit. With 9 months until the UK leaves the EU, the lack of clarity over even the basic elements of our future relationship with the EU is a concern.

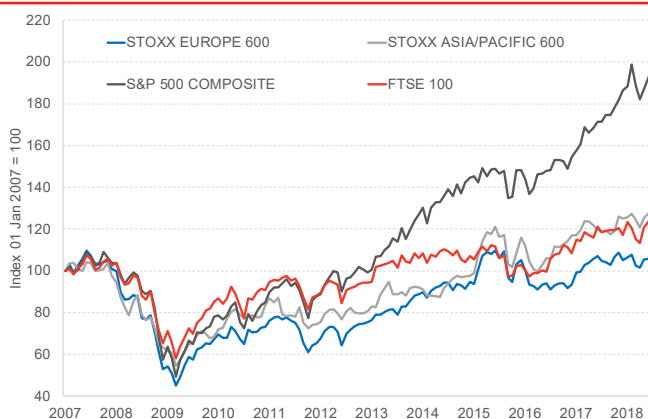
Whilst the agreement for a transition period up to 2020 has helped alleviate some immediate fears, the longer term damage to our economy from a ‘Hard Brexit’ would be significant. The need for effective economic leadership at the top of government has never been more urgent.

Table 2: OECD forecasts for G7 Growth: 2017 (outturn) to 2019

	2017	2018	2019
UK	1.8	1.4	1.3
US	2.3	2.9	2.8
Japan	1.7	1.2	1.2
Canada	3.0	2.1	2.2
Euro Area	2.6	2.2	2.1
Germany	2.5	2.1	2.1
France	2.3	1.9	1.9
Italy	1.6	1.4	1.1

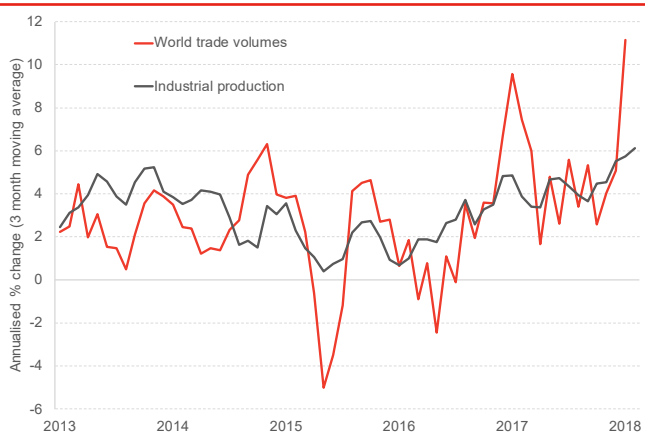
Source: OECD

Chart 3: Global stock market resilience since 2007



Source: Thomson-Reuters Datastream

Chart 4: Global trade and industrial production, 2013 – 2018



Source: IMF, World Economic Outlook

The global economy

As we documented in March’s Economic Commentary, the global economy has been performing strongly in recent times.

At 3.8 percent, global growth in 2017 was ½ percentage point higher than in 2016 and the strongest since 2011. (Table 2)

Most projections are for world growth to continue at around 4% for the next few years – with the outlook positive for both advanced and emerging market economies.

Europe is on course for its best performance in a decade.

Unemployment is projected to continue to fall, with the OECD average on track to hit its lowest rate since 1980. Stock markets have returned to growth following their correction in February. (Chart 3)

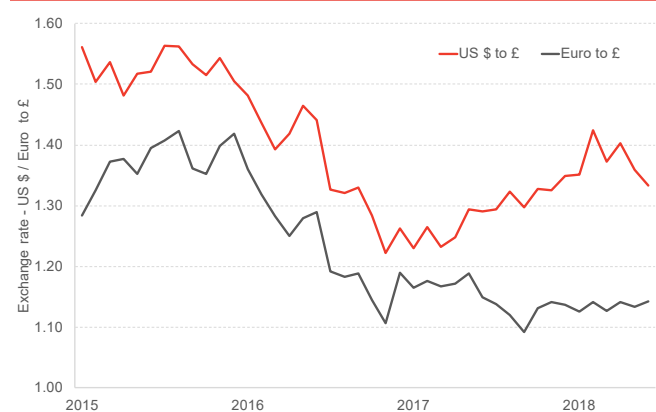
A feature of the recent pick-up in global activity has been the focus on investment and trade.

Global exports, for example, have risen sharply over the past 12 months helping to boost industrial production. (Chart 4) This should help ensure that the recent gains are sustained.

These developments should prove positive for Scotland’s economy.

With Sterling trading around at 15% below its November 2015 peak, and with inflationary pressures easing, there is an important window for Scottish firms to take advantage of the buoyancy in global growth by exporting into new markets and expanding sales. (Chart 5)

Chart 5: Depreciation of Sterling, 2015 – June 2018



Source: Thomson-Reuters Datastream

Chart 6: Growth in Scottish international exports and imports since 2010



Source: Scottish Government

In contrast to recent years, Scottish exporters had a better year in 2017.

Imports from outside the UK had been growing faster than exports since 2011, eroding Scotland’s international net trade balance. But last year marked a turnaround in fortunes, with Scottish international exports rising by 10%. (Chart 6)

This positive outlook for trade is, however, once again threatened by political uncertainty.

The US decision to impose tariffs on steel and aluminium might be politically appealing for some US voters, but it risks sparking a minor – or possibly major – trade war.

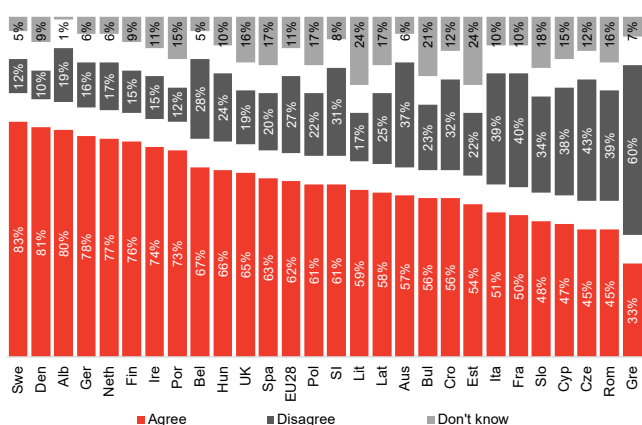
Given our industrial structure, the Scottish economy should be relatively immune from any immediate impact. The potential, however, for the dispute to escalate is a more serious concern. The US is Scotland’s largest single international destination for exports and a key market for major industries like whisky.

It is not just international trade where there are risks, but also those from rising political uncertainty in Europe, e.g. Italy. Whilst the EU economy is now more resilient than it was five years ago, there remains a hangover.

In particular, the lack of meaningful progress in economic prospects for a large proportion of Europe’s population means that trust in the global economic system remains weak. (Chart 7)

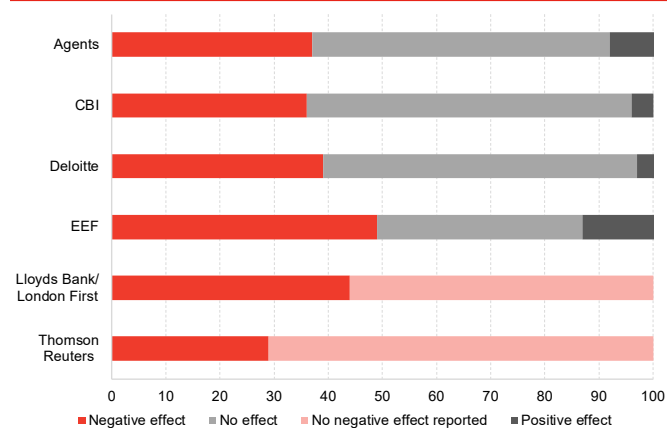
Of course, we do not have far to look for our own uncertainty to act as a drag on growth in the UK. (Chart 9)

Chart 7: To what extent do you agree or disagree – ‘Globalisation is an opportunity for economic growth’, December 2017



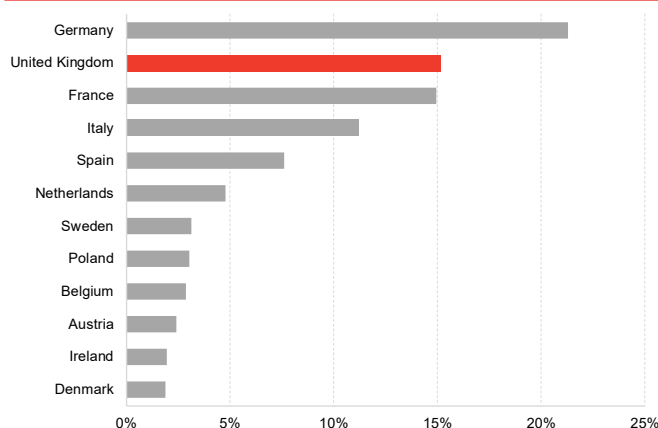
Source: European Commission

Chart 9: Surveys of the impact of Brexit on investment



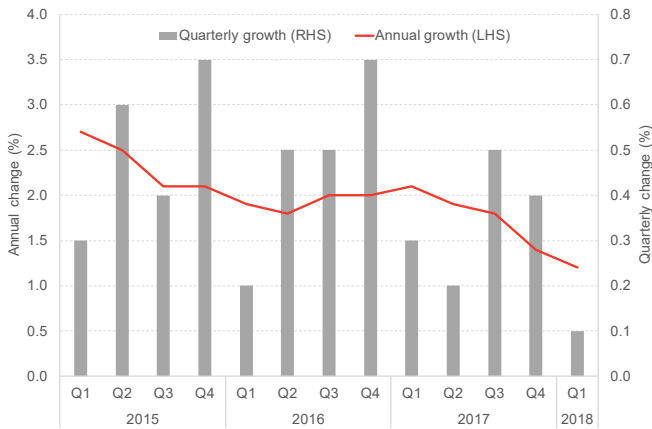
Source: Bank of England

Chart 8: Percentage of EU GDP by country



Source: Eurostat

Chart 10: Weakest UK quarterly growth since 2015



Source: ONS

The UK economy

UK economic growth was just 0.1% in Q1 2018 – the weakest since the end of 2012. (Chart 10)

Annual growth has slipped to 1.2%. To put this in context, the UK economy grew by 3.1% in 2014 and had been one of the stand out performers in the G7 as recently as 2016. (Chart 11)

The poor performance at the start of 2018 was driven by a sharp decline in construction (-2.7%) and sluggish growth in the manufacturing sector. Growth in services also slowed. (Chart 12)

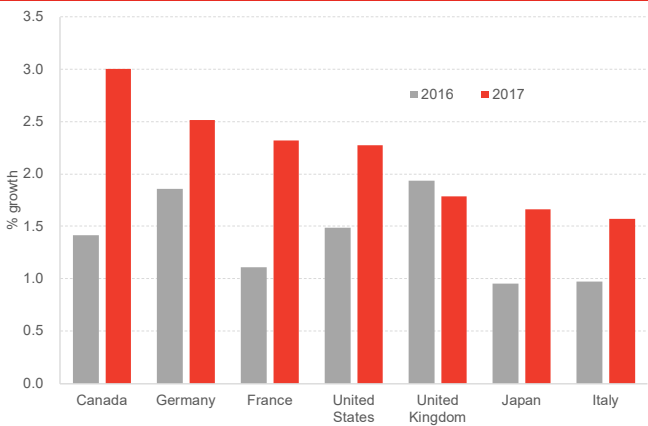
Some of this can be attributed to the ‘beast from the east’ shutting down the economy for a couple of days. But overall, ONS believe that wider factors also played a role.

As we have argued before, reading too much into one data release should be avoided. However, these latest figures are consistent with a more general trend pointing toward a slowing UK economy. In April, manufacturing output fell by its fastest rate since 2012.

Such a challenging trading environment will require businesses to be resilient and to focus upon the long-term drivers of productivity that they can control, such as investing in new plant and machinery, effective management and staff development.

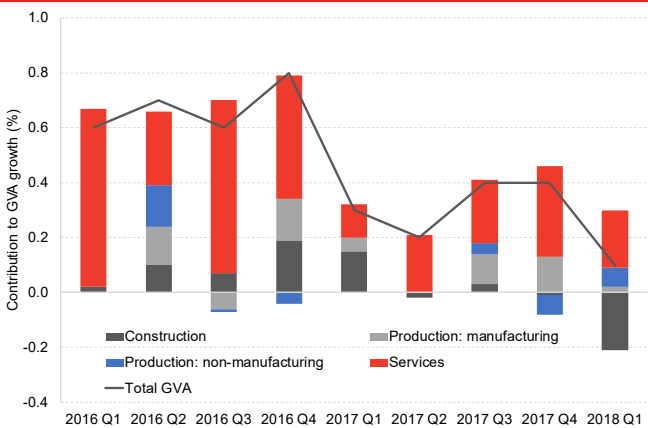
One positive has been rising real wages. For the first time since 2015, the mix of growing nominal earnings and falling inflation has boosted household budgets. (Chart 13)

Chart 11: G7 GDP growth in 2016 and 2017 – only UK slowing



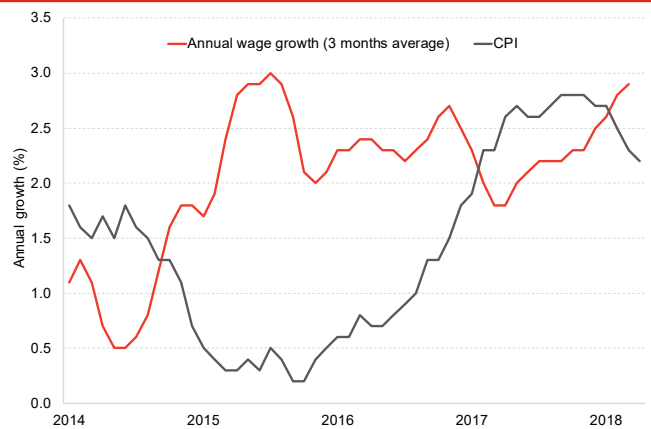
Source: ONS & OECD

Chart 12: Decline in output driven by sharp decline in construction alongside weak growth in most other areas of economy



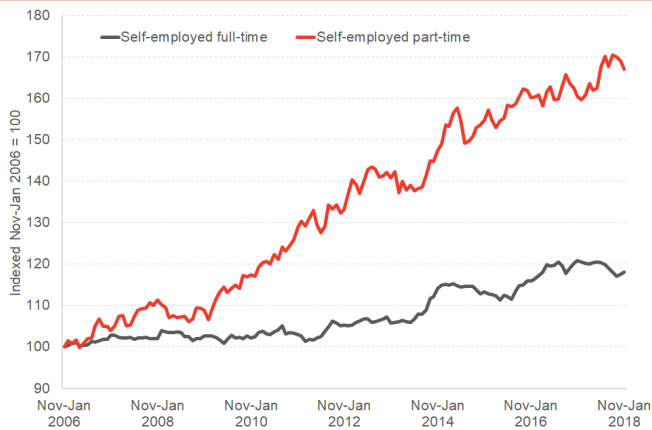
Source: ONS

Chart 13: Annual wage growth and CPI, 2014 – 2018



Source: ONS

Chart 14: Full-time and part-time self employment in the UK



Source: ONS

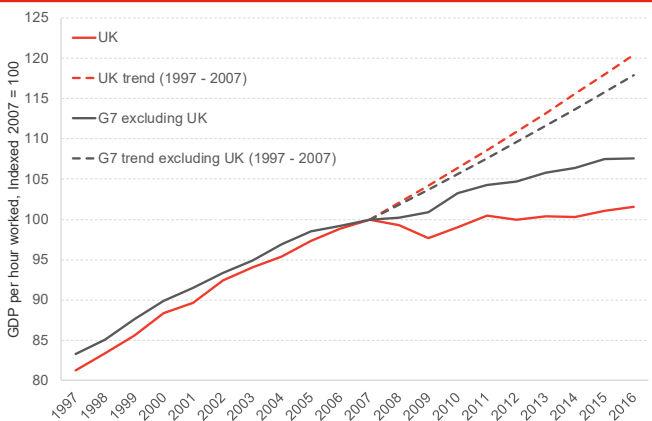
This improvement in wages is one aspect of a UK labour market that continues to hold up remarkably well, with high rates of employment and low unemployment.

However, as we have discussed before, underneath these headline figures there are signs of fragility.

For example, much of the recent growth in UK employment has been in the form of self-employment. And as Chart 14 reveals, part-time self-employment has been growing particularly quickly.

As we discuss in detail later, productivity growth in the UK (and Scotland) has been a constant source of concern.

Chart 15: UK and G7 productivity since the financial crisis



Source: ONS & OECD

Productivity continues to lag behind key competitors. (Chart 15)

There had been some optimism that UK productivity may have started to turnaround in 2017 with strong growth recorded in the 2nd half of the year. But output per hour fell once again at the start of 2018. (Chart 16)

This weakening in economic performance has spread through to the latest business surveys.

For example, whilst all three UK PMI indicators – for services, manufacturing and construction – point to growth continuing, they are all lower than their historical averages. (Chart 17)

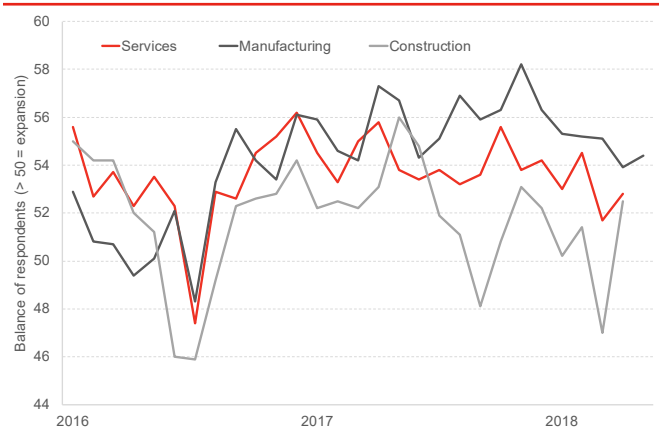
At the same time, the CBI's monthly tracker of industrial orders turned negative in May – and recorded its lowest value since 2016. The CBI's small business assessment of confidence was also negative.

Chart 16: UK productivity quarterly growth, Q1 2016 – Q1 2018



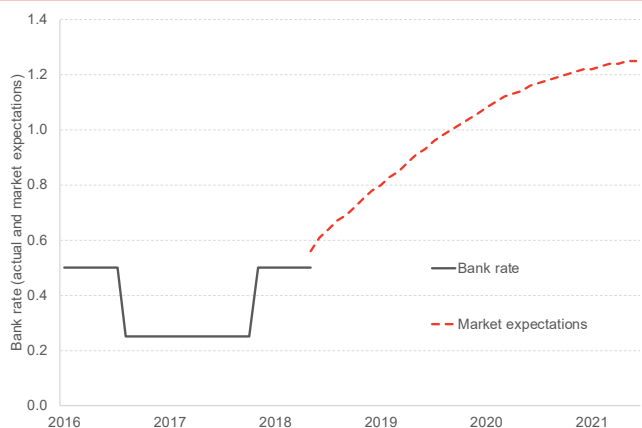
Source: ONS

Chart 17: UK Purchasing Managers Index (>50 indicates expansion)



Source: IHS Markit

Chart 18: Bank of England interest rate and market expectations



Source: Bank of England

The speed of the deterioration in performance caught many economists by surprise. It was undoubtedly a key reason why the Bank of England chose to delay the widely trailed rise in interest rates which many had pencilled in for May.

Expectations are still for interest rates to rise in the near future but there is uncertainty over *when* this will occur. (Chart 18) In a speech at the Fraser of Allander Institute in April, Michael Saunders of the Monetary Policy Committee outlined his view that interest rates should rise gradually and at a pace that ‘need not be glacial’.

The prospect of weak demand in the domestic economy now dominates the risk register of many UK firms. (Chart 19)

Most forecasters predict that the UK economy will grow by around 1.4% in 2018 and by 1.5% in 2019. Long-term growth in the UK is typically between 2 to 2.5%. (Chart 20)

Chart 19: Risk to business by factor, 100 = highest possible risk

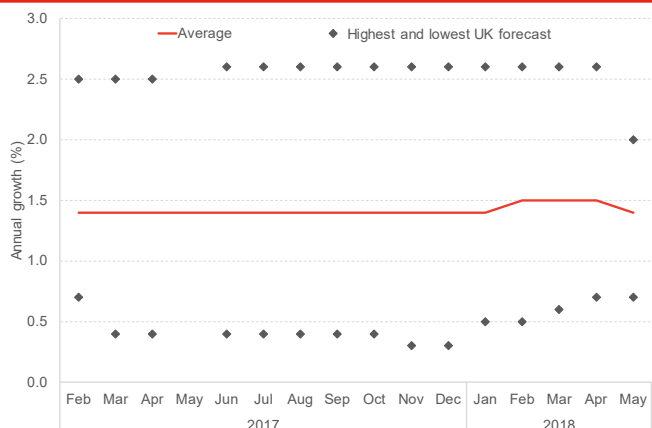


Source: Deloitte CFO Survey

Of course, Brexit looms on the horizon. To an extent, the planned transition period now agreed between the UK and the EU has improved optimism amongst businesses and has acted to help ward off any immediate uncertainties. (Chart 21)

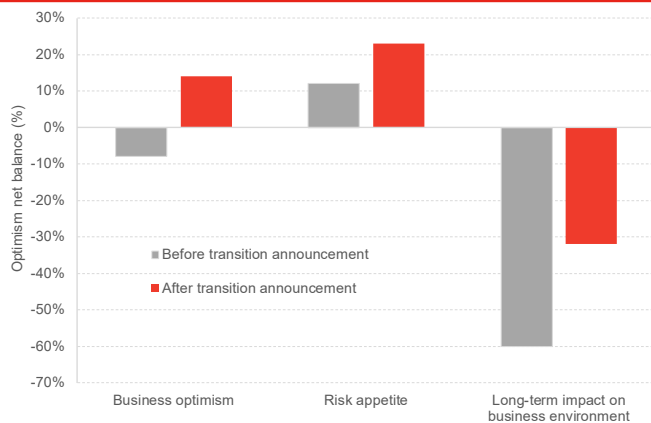
But the lack of clarity about the UK’s future relationship with the EU remains a major concern for many businesses.

Chart 20: Evolution of independent UK forecasts for 2018



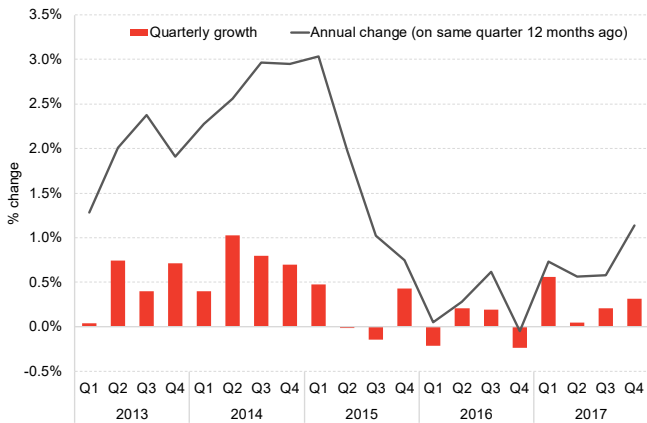
Source: HM Treasury

Chart 21: Impact of the Brexit transition announcement, net % of respondents



Source: Deloitte CFO Survey

Chart 22: Economic growth in Scotland since 2013



Source: Scottish Government

The Scottish economy

The Scottish economy grew by 0.3% in the final three months of 2017 – marking another quarter of below trend growth. (Chart 22)

Annual growth was just 1.1% (or 0.8% on a 4Q-on-4Q basis). This was slightly weaker than our forecast of around 1.2%.

The downturn in oil and gas has clearly been a driver of Scotland’s recent weak economic performance – with many of the manufacturing sectors tied to the North Sea experiencing a sharp recession.

As Chart 23 highlights, the decline in these production industries had a material impact on headline Scottish growth in both 2015 and 2016.

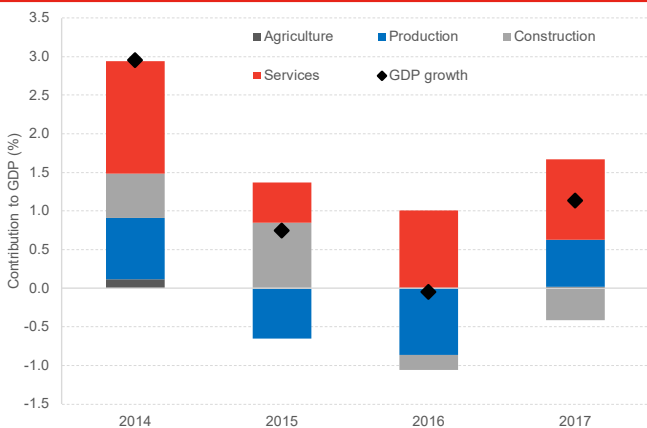
But in recent times, these sectors have stabilised. Instead, it has been a sharp fall in construction activity that has held back growth – see below for a further discussion.

At the same time, activity in services have been muted. In a number of industries – including professional, finance, retail and wholesale services – activity during 2017 was weaker than in 2016. (Chart 25)

One exception was health and social work. This is a peculiar sector from an economic statistics perspective and is largely made up of the NHS and related activities. It is also difficult to measure.

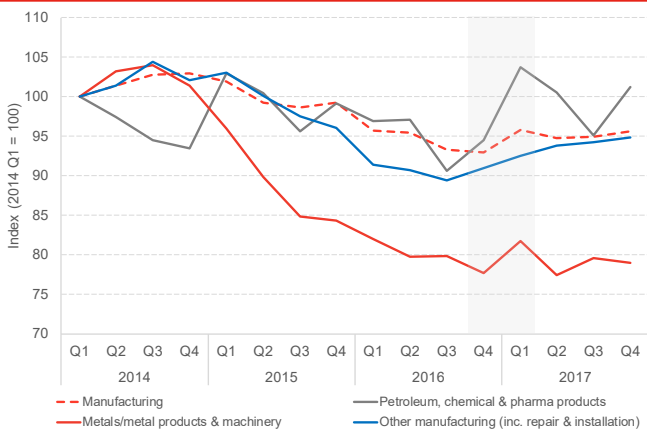
For a sector that makes up around 9% of the economy, it has apparently seen remarkable growth in recent times – not just on its own but relative to sectors like education and public admin. (Chart 26)

Chart 23: Drivers of growth in Scotland by sector, 2014 - 2017



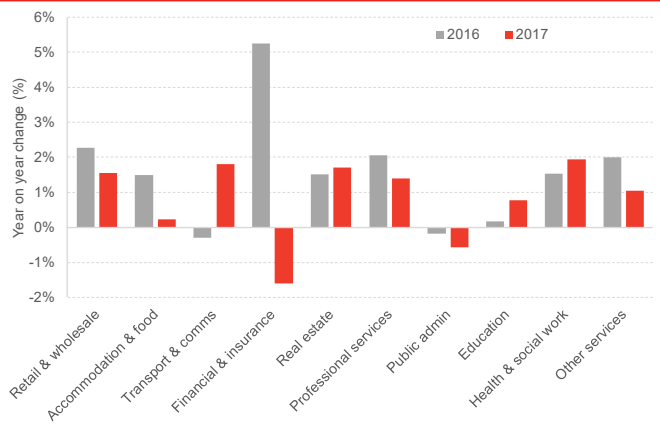
Source: Scottish Government & FAI

Chart 24: Performance of manufacturing sectors tied to North Sea Supply Chain since fall in oil price



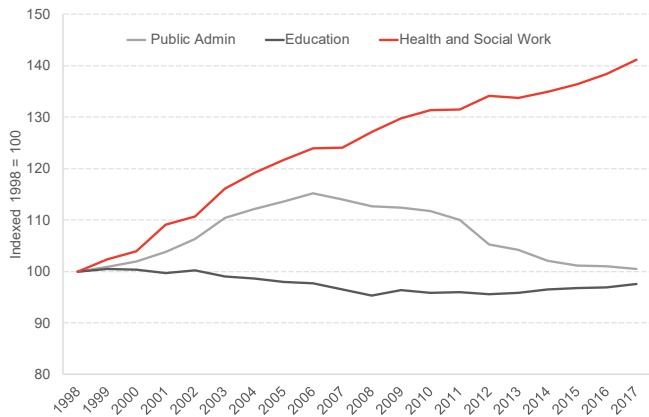
Source: Scottish Government & FAI

Chart 25: Services in Scotland: 2016 vs. 2017



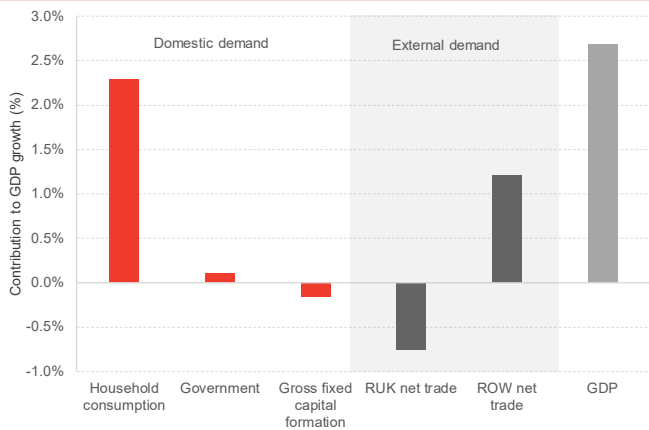
Source: Scottish Government & FAI

Chart 26: Growth in ‘public services’ GDP in Scotland since 1998



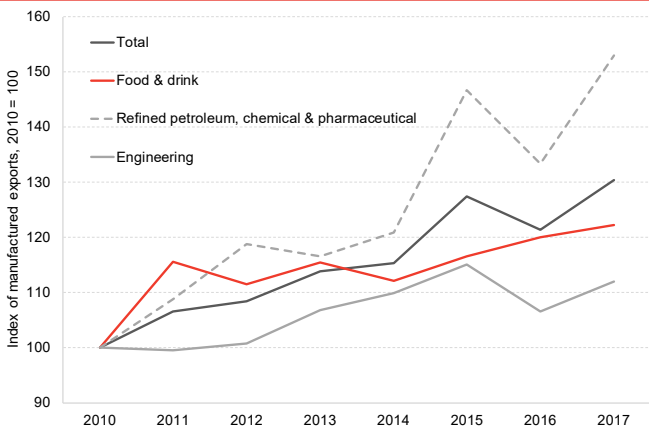
Source: Scottish Government & FAI

Chart 27: Domestic vs. external demand in Scotland for 2017 (nominal terms)



Source: Scottish Government & FAI

Chart 28: International manufactured exports since 2010



Source: Scottish Government & FAI

As highlighted above, international trading conditions have been positive in recent times and this has helped to boost Scottish exports.

As a result, with rest of world (ROW) exports growing faster than imports, Scotland’s economy has been supported by growing external demand – although net trade with the rest of the UK (RUK) has weakened further. (Chart 27)

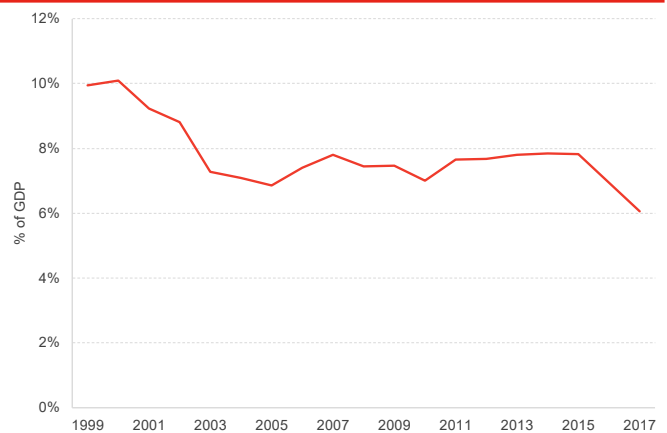
The source of Scotland’s strong export performance has been from traditional sectors.

International manufactured exports are up 30% on 2010 levels (in real terms). Key to this success has been strong growth in food & drink, petrochemicals and engineering. (Chart 28) These three sectors account for over 80% of Scottish manufactured exports.

In sharp contrast, one area of ongoing concern is the continued decline in business investment which fell by a further 10% in 2017. In real terms, annual business investment in Scotland is some 25% below 1998 levels. (Chart 29)

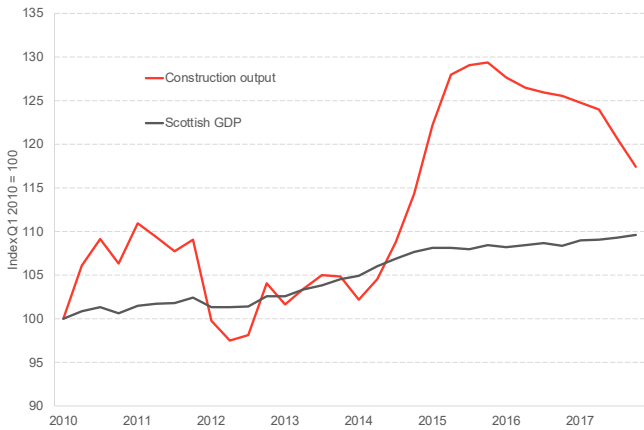
It is hard to argue that this is linked to Brexit and not instead a more structural problem within the Scottish economy. The new Scottish National Investment Bank may help at the margins, but its funds are small and it seems it is a lack of demand for finance – rather than supply – that is the greatest barrier to investment.

Chart 29: Business investment in Scotland as a share of GDP



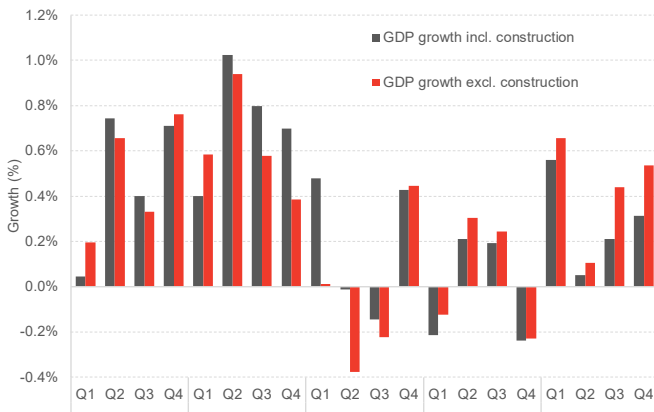
Source: Scottish Government & FAI

Chart 30: Growth in Scottish GDP and construction sector GDP since 2010



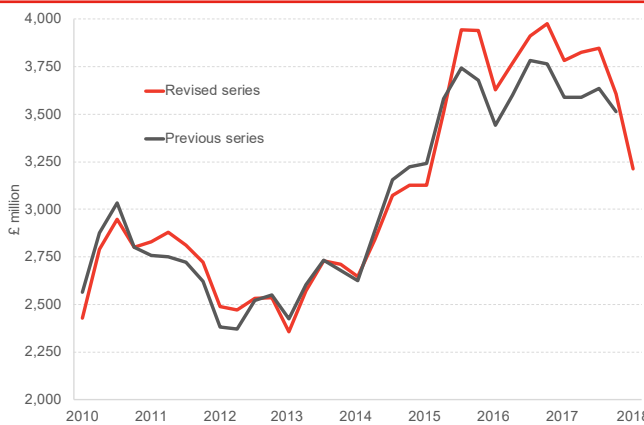
Source: Scottish Government & FAI

Chart 31: Scottish GDP performance since 2013, with and without construction



Source: Scottish Government & FAI

Chart 32: Revisions to Scottish construction series



Source: ONS

Construction

As highlighted above – and raised in our previous Economic Commentary – one of the key drivers of the weak performance of the Scottish economy in 2017 has been the sharp fall in construction activity. (Chart 30)

According to the most recent data, over the past 12 months construction output fell by 6.5% – and is nearly 10% below its 2015 peak.

As the chart highlights however, all of this is on the back of a sharp spike in activity during 2014 and 2015 (where output rose 27%).

The scale of these changes have had a material impact on Scottish growth rates.

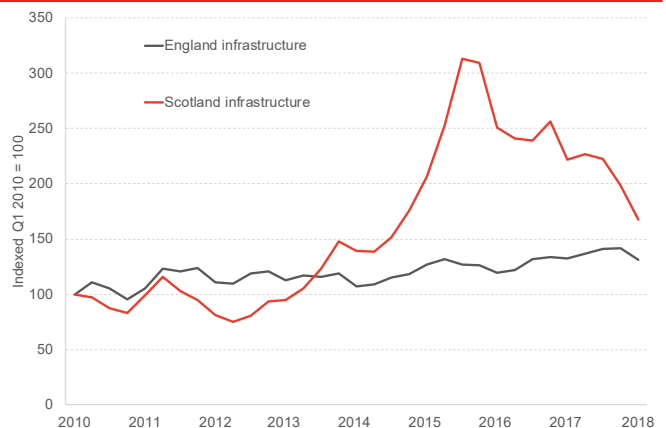
Indeed, if we remove construction then overall growth would have been 1.7% for 2017 as opposed to the 1.1% reported. To put this in context, UK growth in 2017 was 1.4%. (Chart 31)

New data published in early June from the ONS suggests that such trends are likely to continue in the new data to be released next week.

As Chart 32 highlights, even with a revised methodology to track construction activity across the UK, the sharp rise and subsequent fall in Scottish construction remains.

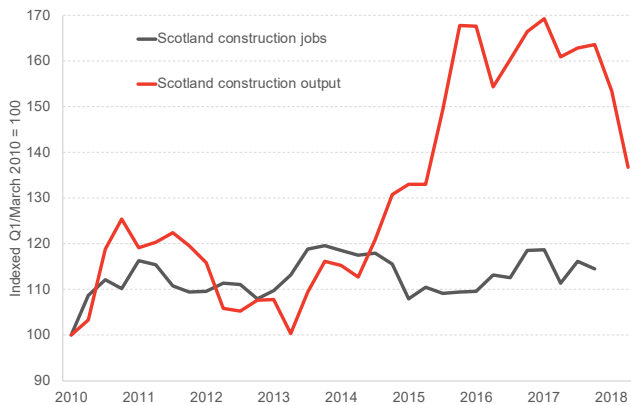
The key driver of this volatility has been the profile of infrastructure spending. Chart 33 shows the ONS series for infrastructure in Scotland vis-à-vis England. The difference is striking.

Chart 33: Infrastructure new work in Scotland and England, Q1 2010 = 100



Source: ONS

Chart 34: Output growth in the construction sector vs. job growth in the construction sector since 2010



Source: ONS

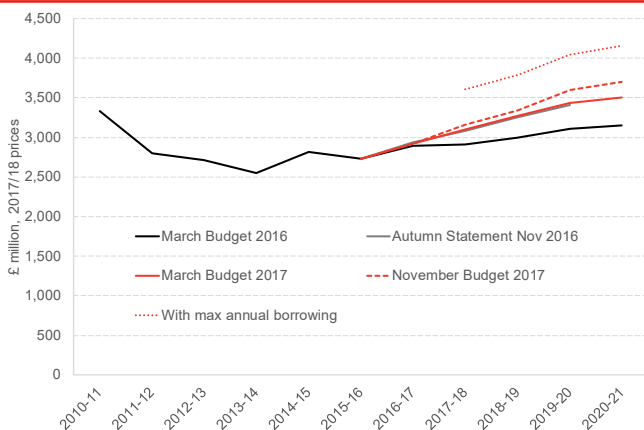
At the same time, we see nothing like this pattern for Scotland in the construction employment figures. (Chart 34)

So what explains this?

We know of a small number of private infrastructure projects which will have boosted activity – e.g. £800m gas plant in Shetland (2016) and £300 million Beaulieu-Denny grid upgrade (a couple of years earlier). But these cannot explain the scale of movement in the official statistics.

The government has suggested that the completion of large and iconic public projects – e.g. the Queensferry Crossing and M8 corridor – could also be a factor.

Chart 35: Outlook for Scottish Government capital budget



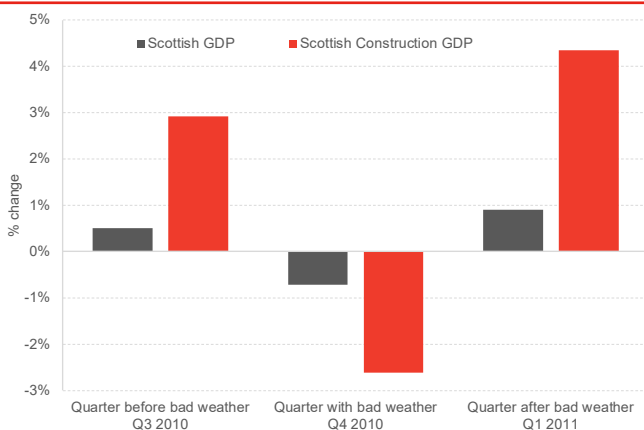
Source: FAI

Whilst a possibility, it can only tell part of the story. Whilst these projects have been delivered, the amount of money the government is actually spending on public infrastructure is rising. (Chart 35)

One more plausible explanation might be the impact of the re-classification of NPD projects by the ONS. The subsequent re-profiling of spend and loss of additionality in public investment may be behind part of the slowdown.

But all things considered, we still find the recent statistics on construction very puzzling. We have yet to see a convincing explanation from either the ONS or the Scottish Government. We cannot help but think that there is something with the methodology being used to measure activity in Scotland that is skewing the figures.

Chart 36: Construction activity during bad weather (Q4 2010)



Source: Scottish Government

Irrespective of this, one thing that we can conclude with certainty is that based upon past methodology, next week's construction GDP figures will show a further sharp fall.

According to the ONS, the value of construction sector output in Q1 for Scotland is down 15% in a year.

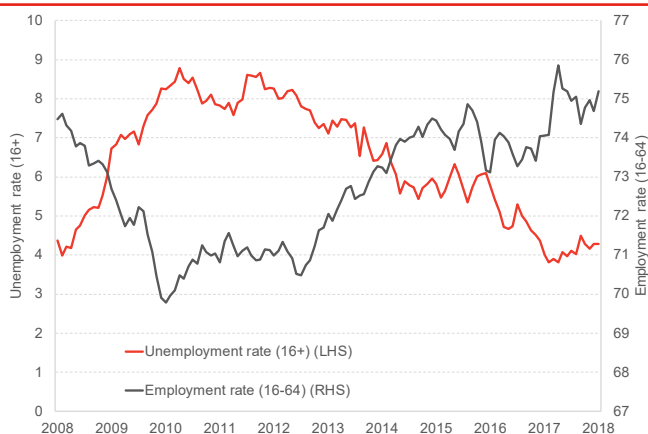
The collapse of Carillion in January may be a factor. But like the bad weather in March, any impact is likely to be temporary – as was the case back in 2010. (Chart 36)

Table 3: Scotland and UK labour market, Feb-Apr 2018

	Employment rate (16-64)	Unemployment rate (16+)	Inactivity rate (16-64)
Scotland	75.2%	4.3%	21.4%
Quarterly change (pp)	0.4	0.0	-0.5
Annual change (pp)	1.1	0.3	-1.3
UK	75.6%	4.2%	21.0%
Quarterly change (pp)	0.3	-0.1	-0.2
Annual change (pp)	0.8	-0.4	-0.5

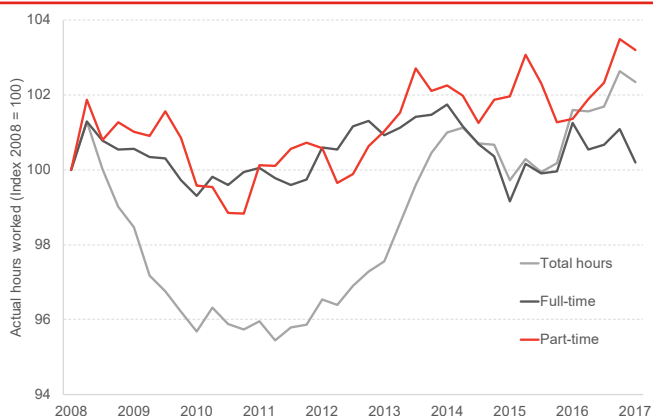
Source: ONS

Chart 37: Scottish employment & unemployment rate since 2008



Source: ONS

Chart 38: Growth in average weekly hours worked by employment status since 2008



Source: ONS

Labour market

The latest data illustrate that the Scottish labour market continues to remain relatively robust with high employment and low unemployment. (Table 3)

There are 18,000 more people in work than a year ago but 9,000 more people in unemployment than a year ago. (Chart 37)

The quarterly unemployment rate was maintained at 4.3% over the period Feb-Apr, with the employment rate rising by 0.4% points over the same 3 months.

Scotland now has an unemployment rate slightly above that of the UK and an employment rate nearly half a percentage point lower. Although as we have discussed before, such small variations are not statistically significant.

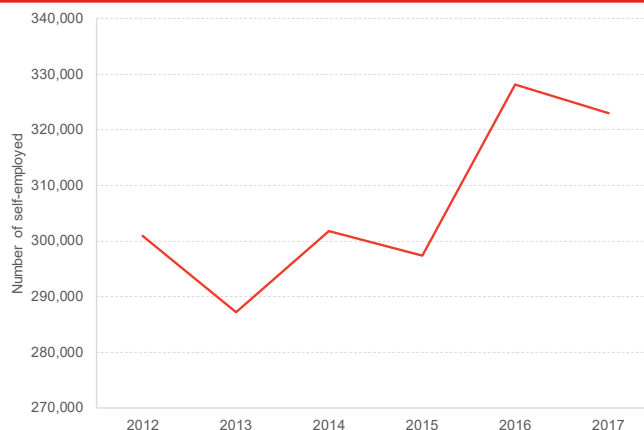
With increased flexibility in the labour market, we continue to see changes in working hours and the type of employment being undertaken.

Chart 38 shows that part-time workers have seen their hours grow, on average, by around 3% over the past decade. In contrast, the hours worked by full time workers are now back to 2008 levels. So the rise in hours worked in the Scottish economy is coming from increases via part-time rather than full-time workers.

While self-employment remains a relatively small proportion of those in employment in the Scottish labour market, it is growing.

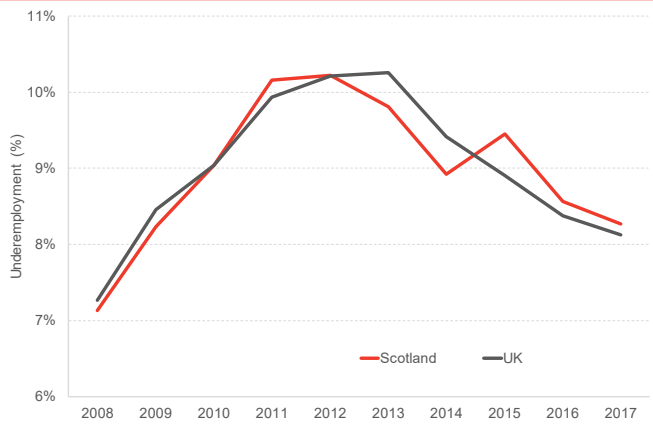
Indeed, 70% of the growth in employment over the past two years has stemmed from self-employment. (Chart 39)

Chart 39: Number of self-employed in Scotland, 2012 – 2017



Source: ONS

Chart 40: Underemployment (in terms of hours worked) in Scotland and the UK since 2008



Source: ONS

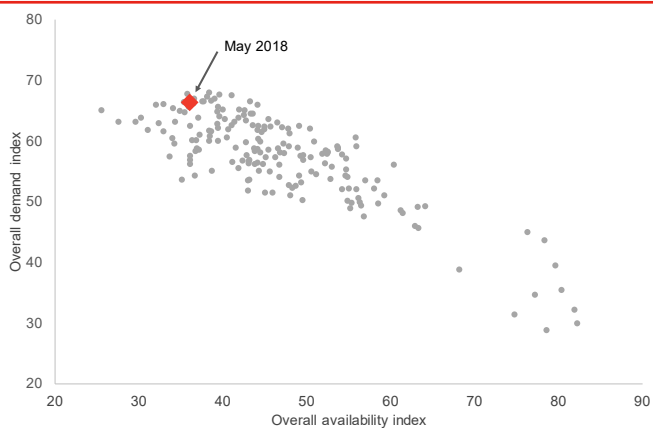
This changing pattern of labour market activity is one reason why we believe that there is perhaps more capacity to be utilised than others.

Underemployment continues to fall, but remains above pre-financial crisis levels. (Chart 40)

Similarly, despite an apparently tight labour market we continue to see little in the way of substantial wage pressure building up in the Scottish economy. (Chart 41)

Taken together – and even though data such as Chart 41 appear to show high demand and low availability of workers – we still believe that there is scope to achieve better outcomes (particularly for those in work).

Chart 41: Demand and availability index for Scotland since 2003



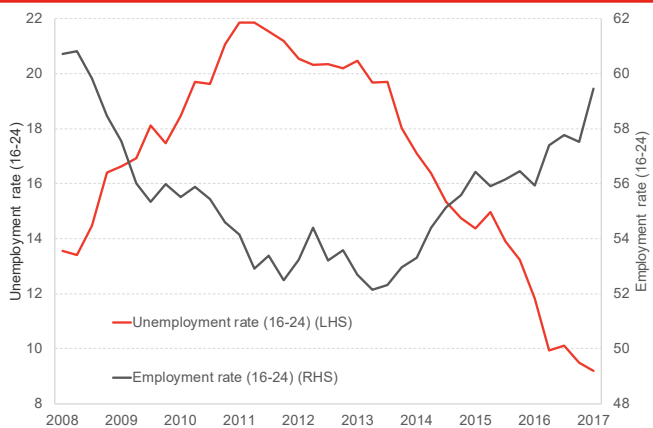
Source: Bank of Scotland & IHS Markit

One of the most notable trends over the past two years has been the substantial falls in youth (16-24 year old) unemployment.

Over 2017, youth unemployment hit a record low of 9.2%. This is less than half what it was five years ago. In 2012, youth unemployment was 20.5%. (Chart 42)

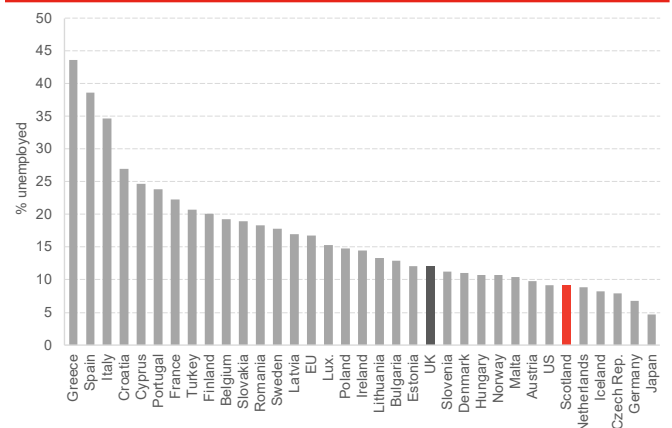
Scotland's record low rate of youth unemployment is impressive in its own right, but particularly so when compared to other parts of Europe and beyond, only a handful of which have youth unemployment rates lower than Scotland's. (Chart 43)

Chart 42: Youth (16-24) employment and unemployment since 2008



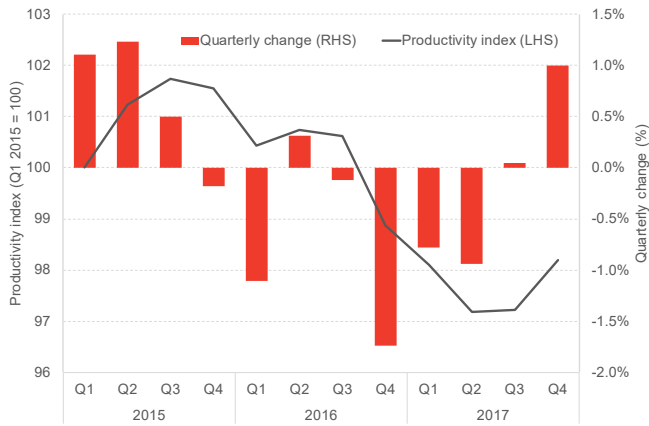
Source: ONS

Chart 43: 16-24 year old unemployment rate by country, 2017



Source: ONS & Eurostat

Chart 44: Scottish productivity performance since 2015



Source: Scottish Government

Productivity

The latest data shows that productivity in Scotland fell again in 2017 – and is now over 3% lower than in 2015. (Chart 44)

The reason for this – with the exception of the final quarter of 2018 – has been that the number of hours worked in the economy has been increasing at a faster rate than overall economic growth. (Chart 45).

In other words, it is requiring ever more effort simply to keep production at the same level.

Much has been made of the fact that Scotland’s productivity has ‘caught-up’ with the UK – and this is indeed the case.

But as Chart 46 highlights, the reason for this can be effectively traced back to the performance of the Scottish labour market during the financial crisis when Scotland lost more jobs than the UK as a whole. As a result, our productivity ‘improved’.

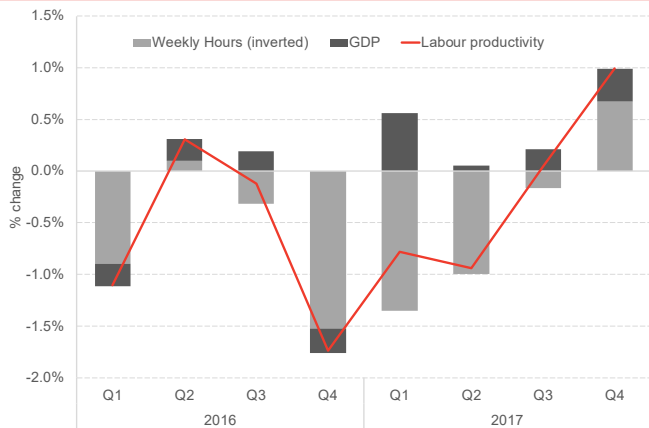
Whether or not this can be viewed as ‘catching-up’ with the UK is open to question.

Even then, catching up with the UK is not something to write home about. The UK – and its constituent parts outside of London – lags behind many of our key competitors in Europe. (Chart 47)

Boosting productivity is a key goal of policymakers.

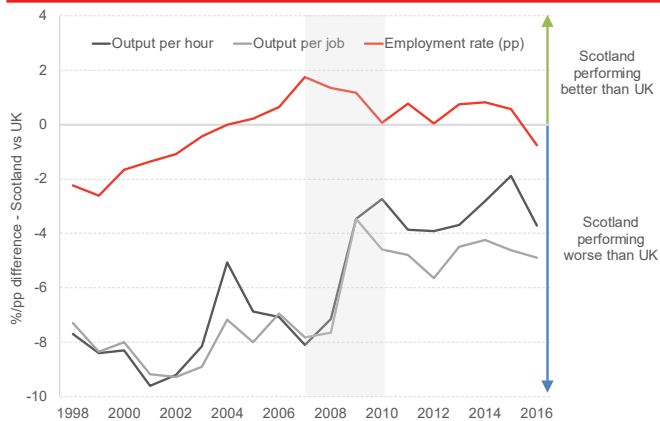
Much of the policy focus tends to be on high-end productivity improvements – e.g. so-called frontier firms or initiatives to boost innovation, R&D and university activities.

Chart 45: Sources of change in productivity in Scotland since 2016



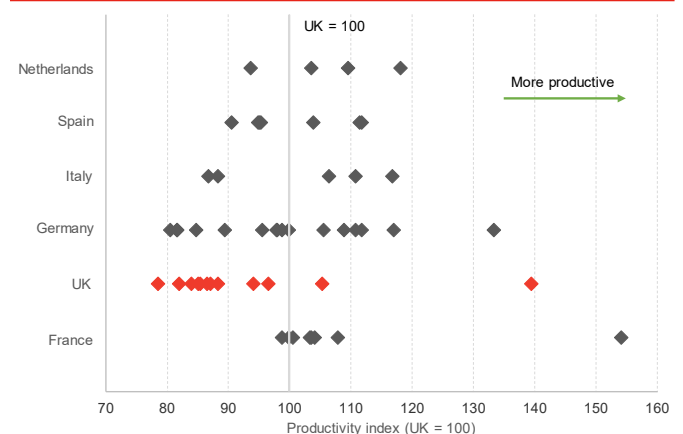
Source: Scottish Government

Chart 46: Scotland and UK % / pp difference in employment rate and productivity since 1999



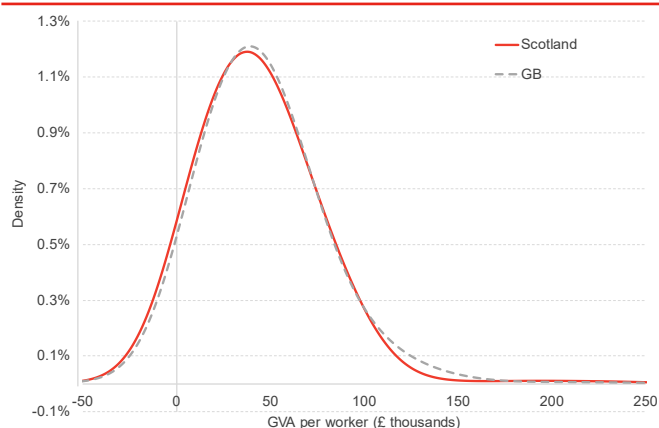
Source: FAI, Scottish Government & ONS

Chart 47: Labour productivity in 2014 by region, UK average = 100



Source: ONS & Eurostat

Chart 48: Distribution of labour productivity by firm, Scotland 2015



Source: ONS

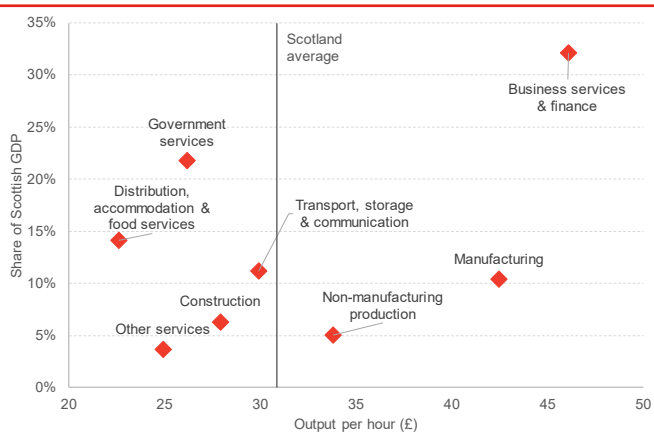
Whilst valuable, it is important to remember that the vast majority of firms in Scotland share broadly the same level of (low) productivity.

Modest improvements amongst this group, e.g. through better connectivity, improved skills, process innovation and better management arguably have greater potential to boost overall productivity in Scotland. (Chart 48)

Similarly, the make-up of the Scottish economy itself drives productivity.

As Chart 49 highlights, manufacturers tend to have amongst the highest levels of productivity in Scotland.

Chart 49: Relative productivity and size of sector in Scotland



Source: FAI & Scottish Government

But services make up a much greater share of our economy. So alongside boosting levels of manufacturing, improving productivity in labour intensive service sectors is just as crucial.

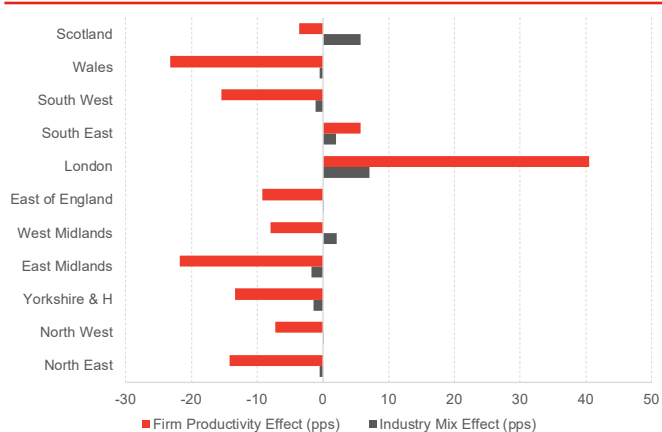
The scope for many of these local services' productivity improvements will be limited, but that is not to say that more cannot be done.

New data from the ONS aims to split up UK productivity data according to differences by –

- differences in the productivity of firms in each industry and,
- the mix of different industries in the economy.

A higher value of 'Firm Productivity' than the UK average suggests that individual firms in a given industry tend to be more productive than elsewhere. A higher value of the 'Industry Mix' implies that the UK's more productive industries tend to be located in a given locality.

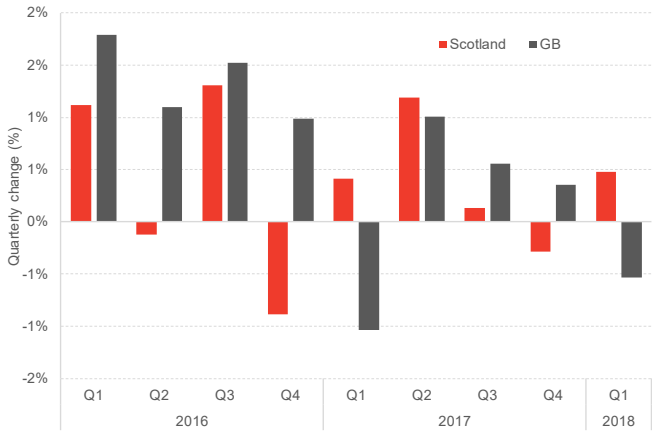
Chart 50: Firm productivity and industry-mix effects on average productivity, 2015



Source: ONS

For Scotland we see that compared to the UK average, like most parts of the UK at a firm level, our businesses tend to be slightly less productive than average, but we do tend to have a disproportionate number of highly productive sectors in Scotland. (Chart 50)

Chart 51: Retail sales in Scotland and UK, quarterly real terms change since 2016



Source: Scottish Government

Latest economic data for Scotland

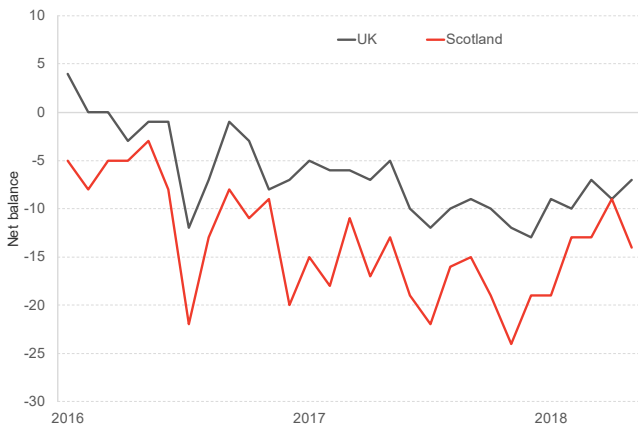
Recent data on Scotland’s economy offers some signs for cautious optimism.

Whilst significant risks remain, most indicators are pointing to a better outlook for 2018 compared to 2017.

The agreement for a transition period to 2020 for the UK’s exit from the EU has helped provide some, albeit short-term, clarity for businesses.

Retail sales for Q1 2018 were positive in Scotland, with growth of 0.5% over the quarter. This was despite the ‘beast from the east’, with growth outperforming Great Britain for only the third time in two years. (Chart 51)

Chart 52: Consumer confidence, Scotland and UK



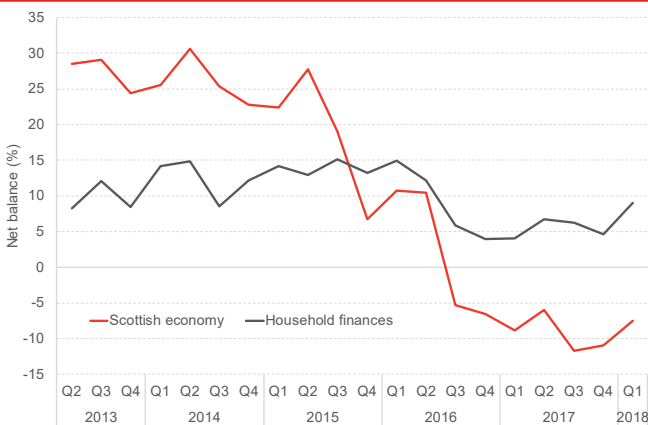
Source: GfK

Consumer confidence levels, whilst remaining weak by historical standards, have also picked up in recent times. The GfK index of consumer confidence recorded its best performance in April since the end of 2016 (although it slipped back a little in May). (Chart 52)

The Scottish Government’s own indicator of consumer sentiment has also improved slightly. (Chart 53)

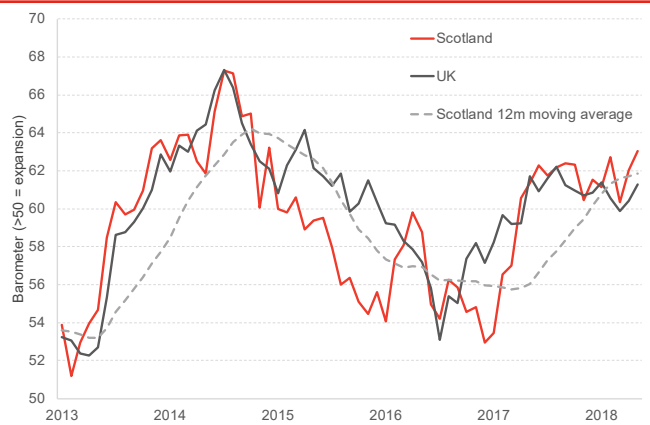
Indicators of labour market demand continue to post relatively healthy returns. The Bank of Scotland Jobs Barometer was 63 in May, and continues to be above its long-term moving average. (Chart 54)

Chart 53: Scottish Consumer Sentiment Indicator: expectations for economy and household finances



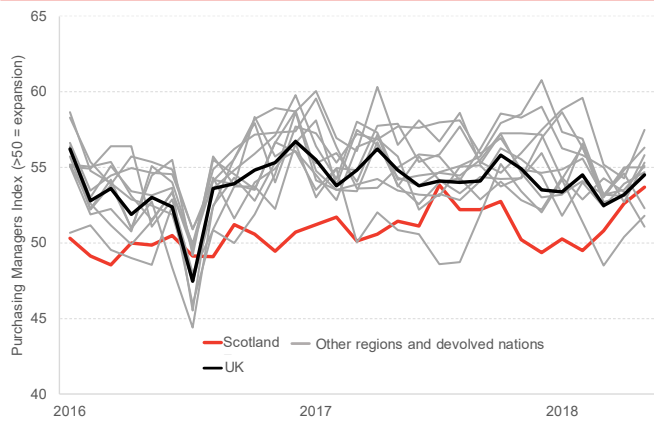
Source: Scottish Government

Chart 54: Scottish Jobs market survey showing ongoing resilience



Source: Bank of Scotland

Chart 55: Royal Bank of Scotland PMI for Scotland – up-tick in activity



Source: Royal Bank of Scotland / IHS Markit

Indicators of business sentiment – again, whilst not showing strong growth – have also been slightly more positive in recent times.

For example, after a lull at the start of the year, the PMI for Scotland hit a ten month high in May. (Chart 55).

The latest FAI-RBS Scottish Business Monitor did dip during the first quarter of 2018, but expectations for the next 3 to 6 months are more positive. (Chart 56)

Within sectors, our latest survey with the Scottish Chambers of Commerce suggests positive sentiment across the board, with the exception of tourism (which admittedly is coming off the back of a very strong 2017). (Chart 57)

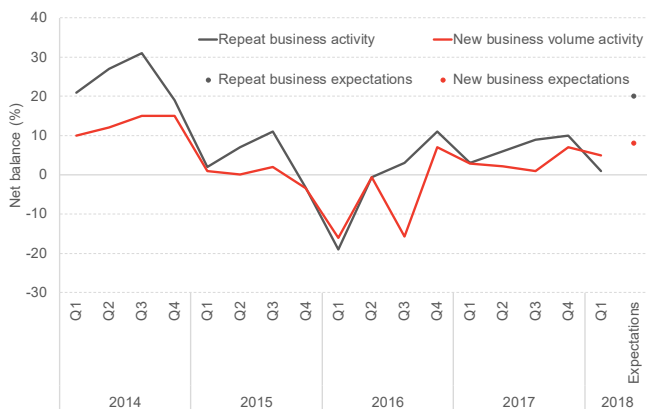
The same survey reports a pick-up in investment levels across most sectors.

Perhaps the most significant turnaround in sentiment has been in oil and gas. (Chart 58)

Boosted by oil prices returning to between \$75 and \$80 and significant cost-cutting in the sector and associated supply chain, confidence has returned to its highest level since spring 2013.

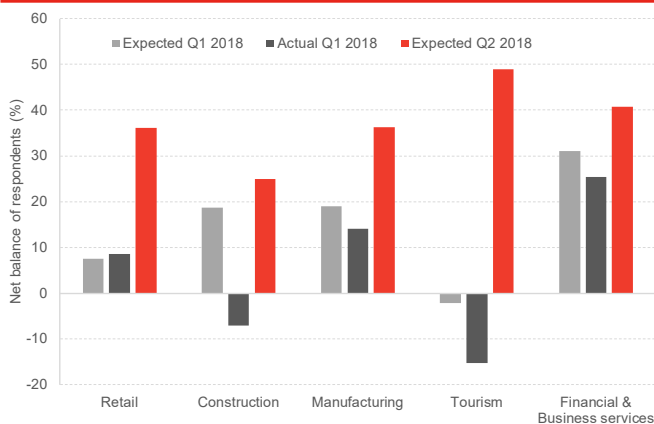
Our latest survey found that 41% of businesses are working at or above optimum levels, 75% are forecasting a rise in profits this year and around 70% see a further rise in business optimism this coming year.

Chart 56: FAI/RBS Scottish Business Monitor shows optimism improving



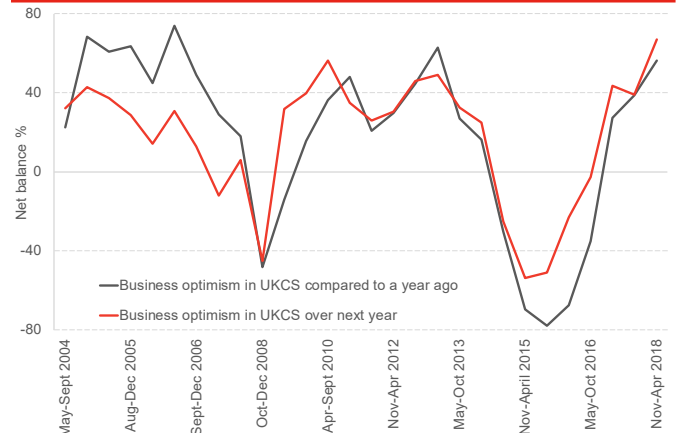
Source: FAI & RBS

Chart 57: Scottish Chambers of Commerce Quarterly Index for early 2018 suggests a rise in confidence



Source: FAI & Scottish Chambers of Commerce

Chart 58: FAI/AGCC optimism in oil and gas on the rise



Source: FAI & Aberdeen and Grampian Chambers of Commerce

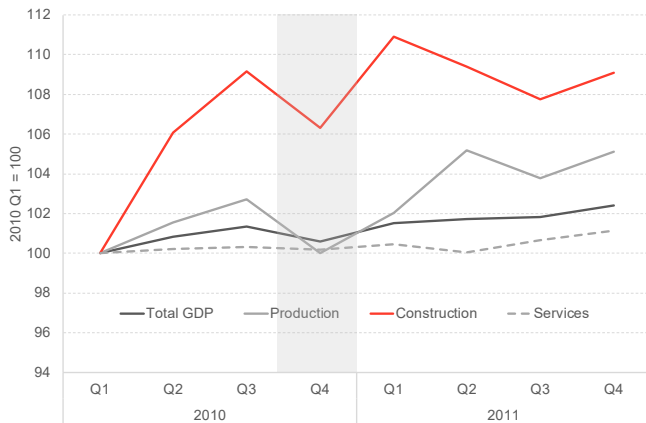
Our forecasts

Table 4: Nowcasts for Q1 2018 and Q2 2018 for Scotland's GDP

	Q1	Q2
Quarterly Growth	0.29%	0.29%
Annualised Growth	1.18%	1.16%

Source: Fraser of Allander Institute

Chart 59: Impact of bad weather on Q4 2010 Scottish GDP statistics



Source: Fraser of Allander Institute

Table 5: Latest growth forecasts for the UK economy

	2018	2019	2020
Bank of England	1.4	1.7	1.7
OBR	1.5	1.3	1.3
NIESR	1.4	1.7	1.8
European Commission	1.5	1.2	n/a
IMF	1.6	1.5	1.5
Oxford Economics	1.5	1.7	1.9
ITEM Club	1.4	1.7	n/a
CBI	1.5	1.3	n/a

Source: HM Treasury

Before turning to our forecasts, it is helpful to review what our latest 'nowcasts' are saying about the outlook for the Scottish economy.

These use the latest official and unofficial data (e.g. business and employment surveys) to provide a statistical prediction of current growth.

Our latest figures, including data up to early June 2018, predict growth of around 0.3% in Q1 and Q2 2018 and 1.2% for the year. This points to growth below trend, but ahead of 2017. (Table 4)

One word of caution. Our nowcasts are based upon trends from a variety of data points at an economy wide and/or sectoral level. Individual factors – e.g. the impact of bad weather on a retailer or the collapse of a construction firm – will not be immediately picked up.

In each individual quarter, the actual GDP series will therefore differ for a variety of reasons.

It is highly likely that the GDP data for Q1 will be below expectations – or close to zero – because of the bad weather in March (the so-called 'beast from the east').

However, we expect such disruption to be temporary. It therefore has not had a material impact on our forecasts for the year as a whole.

The last time we had such poor weather was back in winter 2010. As Chart 59 highlights, the weather did have an impact on Scottish GDP in Q4 2010, but the blip was temporary.

It will be important therefore, not to read too much into any weak GDP figure next week. A complete picture will be possible only once the first 6 months of data are available this autumn.

For comparison, the latest forecasts for the UK as a whole are highlighted in Table 5.

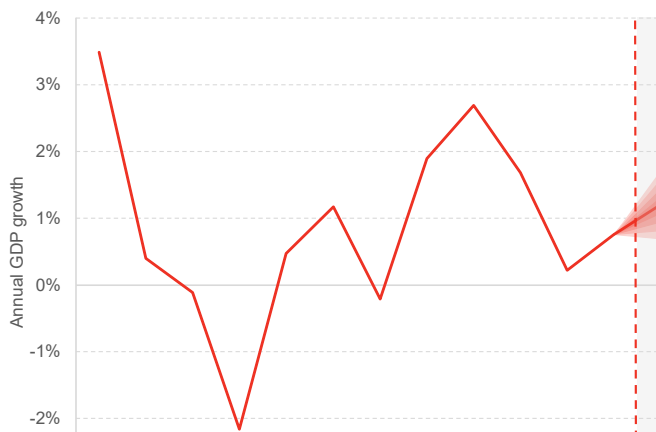
Overall, most organisations are predicting that growth will remain below trend for the foreseeable future. The OBR are amongst the most pessimistic, forecasting growth of just 1.3% in 2019 and 2020.

Table 6: FAI forecast Scottish GDP growth (%) 2018 to 2020

	2018	2019	2020
GDP	1.2%	1.3%	1.3%
Production	1.4%	1.5%	1.5%
Construction	0.8%	0.9%	0.9%
Services	1.2%	1.3%	1.2%

Source: Fraser of Allander Institute

Chart 60: Growth to remain below trend through forecast

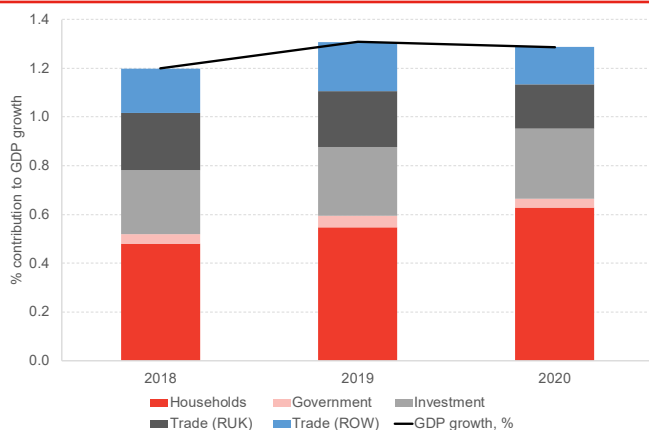


Source: Fraser of Allander Institute

* Actual data to Q4 2017, central forecast with forecast uncertainty for 2018 – 2020.

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

Chart 61: Contribution to FAI forecast 2018 to 2020



Source: Fraser of Allander Institute

Turning to 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 growth will lie.

Our forecasts are little changed on March.

The assessment is still the same – we believe that the economy will remain below trend, but that growth will pick-up this year. (Table 6)

Our forecast is for growth of 1.2% in 2018.

We share the SFC’s view that the Scottish economy faces long-term challenges – e.g. an ageing population and weak productivity. But in the short-term, we think that there is the potential for demand to pick-up as the economy makes up recent lost ground.

At a sectoral level, services should continue to make the greatest overall contribution to growth. Tourist facing businesses – such as hotels – whilst off to a slower start in 2018 should continue to do well. (Chart 60)

Weak earnings growth will mean that household spending – and the industries that they support (e.g. in retail) – will remain fragile.

Production sectors – particularly manufacturing – should continue to benefit from the weak pound and the pick-up in activity in the North Sea. Scotland’s food & drink industry continues to perform strongly and shows no sign of easing off.

In looking forward, we have lowered our central forecast for growth in 2019 and 2020 to 1.3% in both years. (Chart 61)

This reflects a slightly weaker outlook for the UK as a whole. We expect the growth gap between Scotland and the UK to remain over the next couple of years, but to continue to narrow.

There are significant risks to such forecasts however. We clearly do not live in ‘normal’ times, with Brexit uncertainty having a cooling impact on investor sentiment. The possibility of tit-for-tat tariffs with the US is also another significant risk. As a result, the potential for a major change in confidence impacting on the outlook cannot be ruled out.

However, should greater clarity be provided over the UK’s future relationship with the EU post-Brexit, we should see some pick-up in activity.

Table 7: FAI Labour Market forecasts to 2020

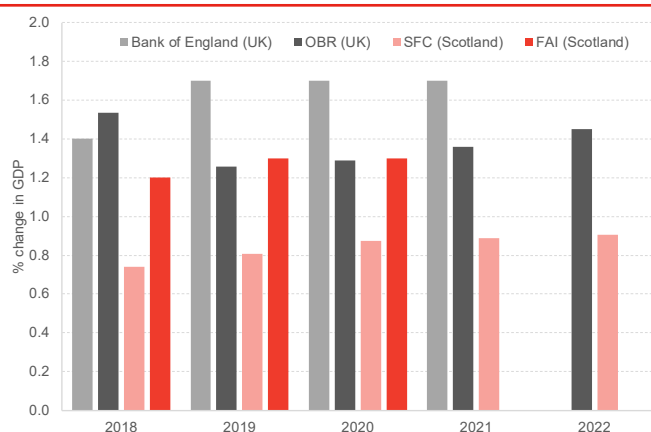
	2018	2019	2020
Employee jobs	2,493,150	2,516,750	2,540,350
% employee job growth over year	+0.9%	+0.9%	+0.9%
ILO unemployment	115,150	118,000	124,800
Rate (%) ¹	4.3	4.4	4.5

Source: Fraser of Allander Institute

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.

Chart 62: Scotland and UK GDP growth forecasts, 2018 – 2022



Source: Fraser of Allander Institute

We expect unemployment to rise slightly toward a level consistent with more medium-term trends of around 5%. So any reported rise in unemployment in the coming months should pose little concern. (Table 7)

On balance, our forecasts put us slightly behind those made by the Bank of England for the UK as a whole, but broadly in line with the OBR.

We remain more positive than the Scottish Fiscal Commission. (Chart 62)

Policy context

The medium-term fiscal outlook for the Scottish Government

The Scottish Government's 2018/19 Budget is the 2nd of 5 budgets to be set this parliamentary term.

It contained allocations for 2018/19 only (the last time a Scottish Budget provided anything beyond single year allocations was 2014/15).

However, the government's new Five Year Financial Strategy, published last month, provides a steer on how the pattern and distribution of Scottish resource spending (day-to-day public services) is likely to evolve over the next few years.

The Strategy contains forecasts of the Scottish budget for five years, based on forecasts for devolved tax revenues and the outlook for the block

grant. It also sets out broad spending commitments.

Government spending priorities

The most obvious spending change during this parliament results from the devolution of ten social security benefits. The first of these, an enhanced Carer's Allowance, will come on stream in summer 2018.

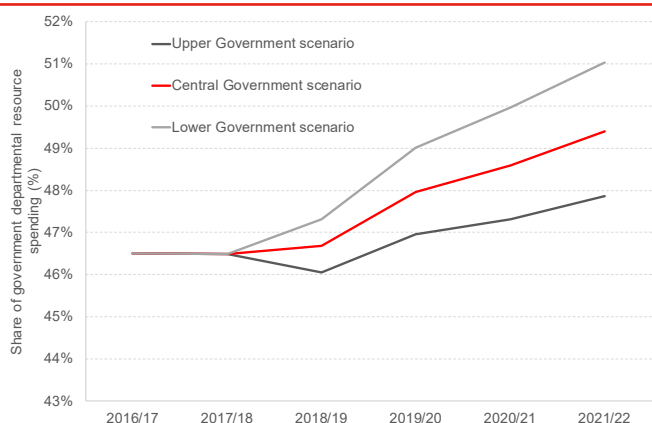
At face value the resource budget will be over £3bn higher, at £30.5bn, than it was in 2016/17. However, if we strip out the resources being transferred to pay for these new benefits and consider the Scottish budget on a like-for-like basis, the resource budget – based on the Scottish

Government's latest scenarios – is expected to be around half a percent lower in real terms by the end of this parliament compared to the end of the preceding parliament.

How will the government prioritise its declining resource budget? The Five Year Strategy identifies six key commitments 'that support the Government's social contract and require significant investment'. These are:

- Health: to increase NHS resource spending by £2bn over the parliament.
- Police: to protect the resource budget of the Scottish Police Authority in real terms over the parliament.
- Early learning and childcare: to increase resource funding to local authorities to £567m annually by the end of the parliament to support 1,140 hours per year of childcare.
- Attainment: to allocate £750m to the Attainment Scotland Fund over the parliamentary term.
- Higher Education: to continue to allocate £1bn each year to the sector.
- Social Security: to deliver a more generous Carer's Allowance Supplement from 2018 and a new Best Start Grant (replacing Sure Start Maternity Grant) from 2019. These policies imply costs of £35m in 2018/19, rising to £56m in 2019/20 and more thereafter.

Chart 63: Resource spending on health as a share of departmental resource budget, 2016/17 to 2021/22



Source: Fraser of Allander Institute

Implications for non-priority spending

But if the government's overall resource budget is falling in real terms, what is the impact on the government's 'other' areas of spend (those that are not mentioned as a specific priority)?

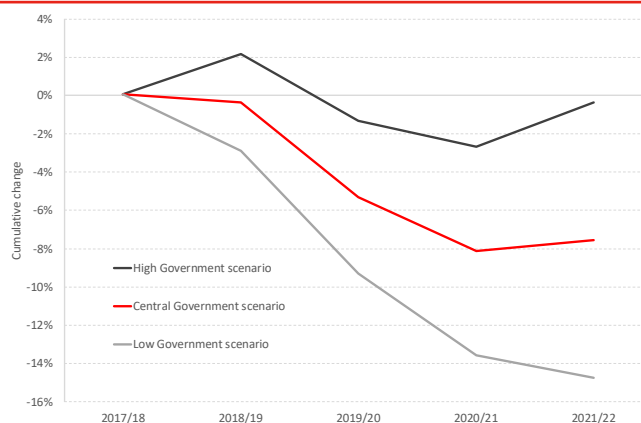
The Five Year Strategy identifies a 'central scenario' – based on the latest forecasts for the block grant and Scottish tax revenues – as well as an 'upper range' and a 'lower range' scenario around that. The upper and lower range scenarios are developed by considering historic variation in tax revenues that have been transferred to Scotland.

Under the government's 'central scenario', the resource budget available for these other areas will fall by around 10% in real terms between 2016/17 and 2021/22.

The areas included in this catch-all 'other' category include local government (including schools outwith the ring-fenced Attainment Fund), enterprise, the environment, tourism and culture.

However, the outlook for local government is unlikely to be as bleak as this. The analysis up until this point does not include Non-Domestic Rate Income (NDRI). **Including forecasts for NDRI, the resources available for 'other' spending areas will fall by around 8% over the course of the parliament in real terms, under the central scenario.** (Chart 64)

Chart 64: Cumulative real terms change in spend on 'other' policy areas



Source: Fraser of Allander Institute

Of course, within these aggregates lie other commitments. Some of these are legally binding – for example £1bn of repayments per year to fund historical PFI and NPD capital programmes. Others are policy related – for example, the government has pledged to introduce some form of ‘Income Supplement’ for low income families. And there will be ongoing costs from the implementation of the new fiscal powers, particularly in establishing the Social Security Agency.

Uncertainty and alternative scenarios

As noted in the Five Year Strategy, there is significant uncertainty around the Scottish budget outlook. The Five Year Strategy considers upside and downside risks around the central scenario, and the implications for spending on ‘other areas’ if these upside or downside risks materialise.

If there was additional departmental spending for Whitehall, and if devolved revenues perform better than forecast, then the Scottish Government’s more positive budget outlook could be realised. Under this scenario, spending on ‘other’ areas would fall by slightly less than 3% over the period 2016/17 – 2021/22.

On the other hand, there are also downside risks. Under the government’s ‘lower scenario’, spending on ‘other’ areas of the budget will fall by 17%, even if buoyant NDR income is taken into account.

Arguably, the downside risks in the Strategy are less likely to be realised than the upside risks. This is partly because it has been clear for some time that the UK Government likely to announce additional NHS spending at the UK level, which will generate consequential for Scotland. But it is also partly because the central scenario is based on the latest forecasts for tax revenues and the block grant adjustment, which envisage an unprecedented divergence in relative wage growth (and hence tax revenue performance) between Scotland and rUK over the next two years.

Indeed, in the end the UK Government announce substantial additional funding for the NHS in England on 18 June. It will be up to the Scottish Government to determine how it might distribute any consequential across its portfolio responsibilities. In its Five Year Strategy however, it indicates that it will pass on any consequential arising specifically from health spending in England to the Scottish health budget. This would suggest that ‘other’ areas

of the Scottish budget will face no less of a squeeze as a result of the consequential arising from the increase in UK Government health spending.

Another question is whether or not the government is or might consider making further changes to tax policy over the remainder of the parliament – something that Cabinet Secretary for Finance Derek MacKay refused to rule out when giving evidence to the parliament’s Finance and Constitution Committee.

Of course, if the expected increase in health spending by the UK Government is funded at least in part by an increase in rUK income tax – which would not apply in Scotland – this would pose some interesting tax setting dilemmas for the Scottish Government in its December budget.

Conclusions: Scotland’s fiscal outlook

The publication of ‘Scotland’s Fiscal Outlook: the Scottish Government’s five year financial strategy’ establishes the government’s policy priorities over the remainder of this parliament (and beyond), and the financial implications of those commitments.

The Five Year Strategy is not a budget document however, and it says little about the plans for portfolios or policies that are not explicitly mentioned in the strategy itself.

Over the course of this parliament, spending on ‘other’ areas could fall slightly or much more substantially, depending on how the government’s budget evolves. Either way, the clear conclusion is that the funding settlement is likely to be tight.

The Five Year Strategy says little about how the government’s plans might change if (and when) the financial outlook evolves. If the budget outlook improves will ‘other’ policy priorities be allocated additional resources, or might existing priorities be allocated more?

The publication of the Government’s Five Year Strategy means we are a little clearer about the fiscal priorities of the government, but there remains significant uncertainty around the budget outlook. The three remaining Scottish budgets of this parliament will be keenly watched.

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'Scotland's Budget: 2018' will once again provide an authoritative and independent analysis of Scotland's devolved public finances ahead of the Scottish Government's Draft Budget for 2019-20.

It will set out the choices and challenges facing the Finance Secretary and discuss some of the key policy issues of the day.

The publication of the report will be accompanied by a briefing event in Edinburgh in early October.

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