State of the Economy | March 2017

Office of the Chief Economic Adviser

State of the Economy

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State of the Economy

This report outlines recent developments in the global, UK and Scottish economies. Updates are provided on a periodic basis.

Data correct up to and including the 24th February 2017.

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Scottish Government

Overview

The Scottish economy continued to grow during the second half of 2016, with GDP rising and unemployment falling over the year; reflecting in part the strong fundamentals of Scotland's economy.

As outlined in this report, Scottish productivity has grown strongly in recent years, with the historic gap in productivity performance between Scotland and the UK as a whole now closed. Our analysis shows this has contributed more to Scottish growth whilst UK growth has been driven more strongly by population growth.

The labour market has also remained resilient with employment and unemployment rates continuing to outperform their long run averages, despite the external challenges that have impacted the economy over this period.

Previous analysis has highlighted the impact of low oil prices on the production sector in Scotland, which impacted negatively on investment and employment. New sectoral analysis presented in this report highlights that the slowdown in Scotland's GDP performance since the end of 2014 can be attributed in part to a contraction in the sectors most closely associated with the oil and gas supply chain in Scotland.

Looking forward, whilst conditions remain challenging for North Sea producers, there are indications that companies believe they are approaching the bottom of the cycle, and that business confidence is starting to slowly increase. This may indicate that the sector will see an improved outlook in 2017, which should in turn benefit overall economic growth.

The UK vote to leave the EU and the prospect of commencing exit negotiations in 2017 has been a source of significant uncertainty to the UK and Scottish economy since June 2016. The fall in the value of Sterling has been the most visible impact on the economy to date, helping to boost export orders whilst contributing to the reintroduction of inflationary pressures towards the end of the year as import prices rise.

Business and consumer sentiment in Scotland has been particularly sensitive to information regarding plans to exit the EU. Business sentiment was broadly positive towards the end of 2016, particularly in the manufacturing sector, which is benefitting from an uptick in new orders, supported by the lower value of Sterling.

In contrast, consumer sentiment in Scotland weakened in the second half of 2016, with a net balance of respondents indicating that they believe the economic outlook will worsen over the next twelve months. This is likely to reflect wider concerns about the impact of Brexit on the Scottish economy going forward.

In general, the economic outlook remains weaker on the back of the EU referendum in anticipation that higher uncertainty will start to weigh on business investment, whilst rising inflation will restrict real income growth and consumption. This is reflected in the economic forecasts for both Scotland and the UK in 2017 with growth in both expected to be below their long term average. Scottish Government forecast growth of 1% for Scotland in 2016-17 and 1.3% in 2017-18.

Global Summary

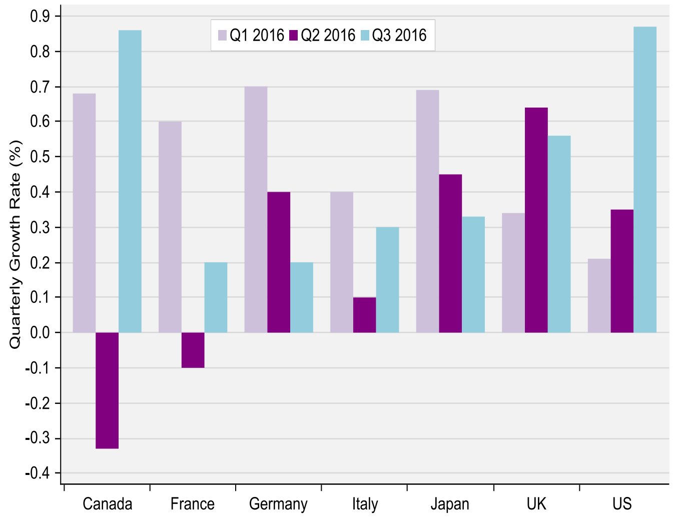
Global growth remains steady in the second half of 2016

- The IMF estimate global growth of 3.1% for 2016, slightly down from 3.2% in 2015 as weak global trade, investment and political uncertainty continue to weigh on growth.
- Growth in advanced economies picked up in the second half of 2016, re-introducing inflationary pressures, whilst growth was weaker than expected in some emerging market and developing economies.
- In the US, strong consumption expenditure supported quarterly growth of 0.5% in the final quarter of 2016. However, across 2016 as a whole the US economy grew 1.6%, down from 2.6% in 2015.
- Euro Area growth remained broadly stable in the second half of the year, with growth of 0.4% in Q4 2016, unchanged from the previous quarter. On an annual basis, growth slowed slightly from 1.8% in Q3 to 1.7% in Q4.
- China GDP growth held up in the second half of 2016 though is estimated to have slowed slightly over the year to 6.7%, down from 6.9% in 2015.
- Growth across other emerging market and developing economies was mixed at the end of 2016 though showed signs of stabilising supported by firmer commodity prices.

Global growth forecast to accelerate in 2017-18

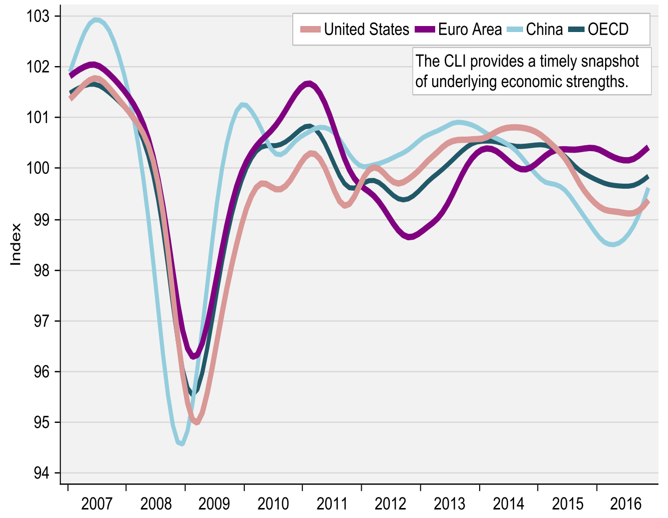
- The IMF forecast global growth to accelerate to 3.4% in 2017 and 3.6% in 2018.
- Global surveys signal that business and consumer sentiment have strengthened into 2017.
- Advanced economies are forecast to grow 1.9% in 2017 rising to 2.0% in 2018, though will be impacted by rising inflation and uncertainty surrounding the Brexit process and the economic policy of the new US administration.
- Growth in emerging market and developing economies is forecast to accelerate to 4.5% in 2017 rising to 4.8% in 2018. However, downside risks dominate as vulnerability to external shocks remains high and financial conditions have tightened.

G7 GDP Quarterly Growth Rates



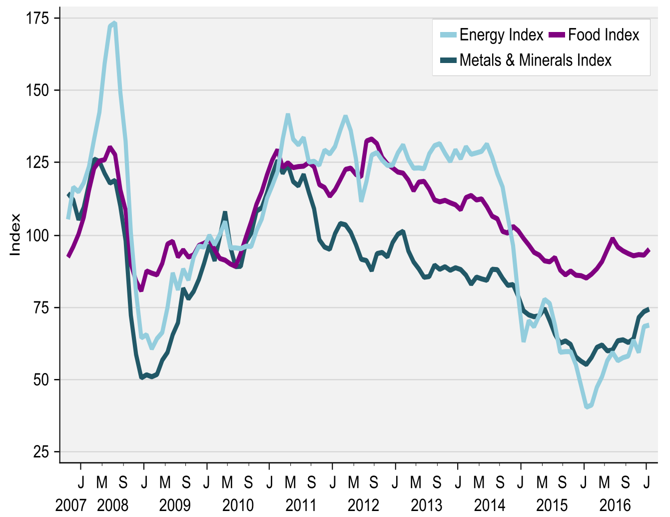
Source: Macrobond

Composite Leading Indicators



Source: Macrobond

Commodity Price Indices ($)



Source: World Bank (Macrobond)

GDP Growth (%) IMF WEO (Jan 2017)	2016 estimate	2017 projection	2018 projection	Revisions from October 2016 Forecast 2017	2018
World Output	3.1	3.4	3.6	0.0	0.0
Advanced Economies	1.6	1.9	2.0	0.1	0.2
United States	1.6	2.3	2.5	0.1	0.4
Euro Area	1.7	1.6	1.6	0.1	0.0
United Kingdom	2.0	1.5	1.4	0.4	-0.3
Japan	0.9	0.8	0.5	0.2	0.0
Emerging Market & Developing Economies	4.1	4.5	4.8	-0.1	0.0
China	6.7	6.5	6.0	0.3	0.0
India	6.6	7.2	7.7	-0.4	0.0
Brazil	-3.5	0.2	1.5	-0.3	0.0
Russia	-0.6	1.1	1.2	0.0	0.0
South Africa	0.3	0.8	1.6	0.0	0.0

United Kingdom Summary

UK GDP growth rose slightly in Q4 2016

- UK GDP (second estimate) grew by 0.7% in the fourth quarter of 2016, up from 0.6% in the previous two quarters. Across 2016 as a whole the UK economy grew by 1.8%.
- Robust growth in wholesale and retail trade, supported by strong consumer demand, drove growth of 0.8% in the Services sector. This offset more marginal growth in the Production and Construction sectors.

UK labour market remained strong in 2016

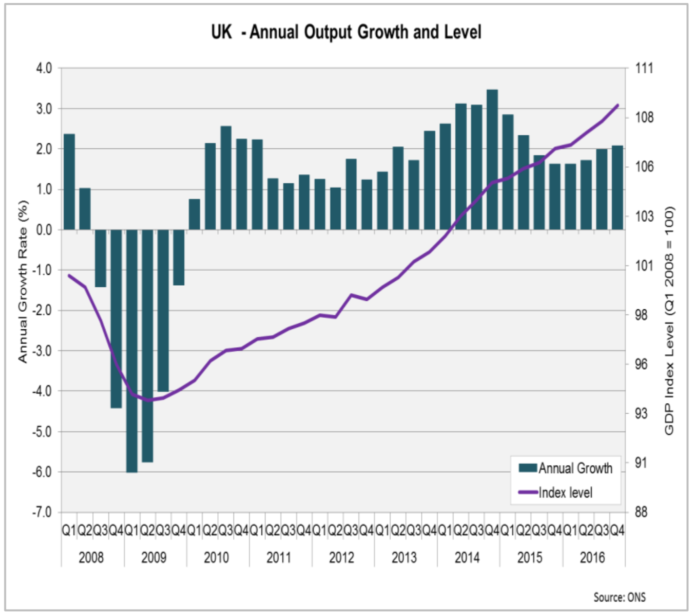
- Latest data for October to December 2016 show the UK employment rate rose marginally by 0.1 percentage points over the quarter to 74.6% whilst the unemployment rate remained at 4.8%.
- The inactivity rate fell marginally over the quarter and the year to 21.6%.

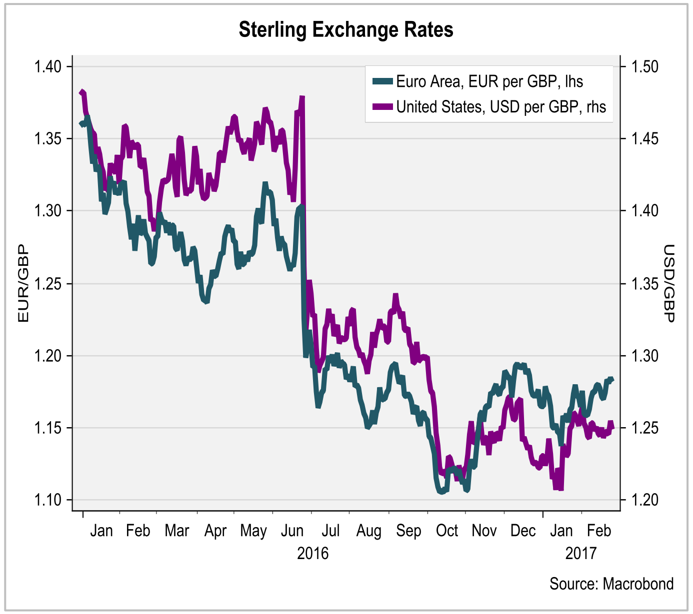
Inflation picked up as the value of Sterling remains low

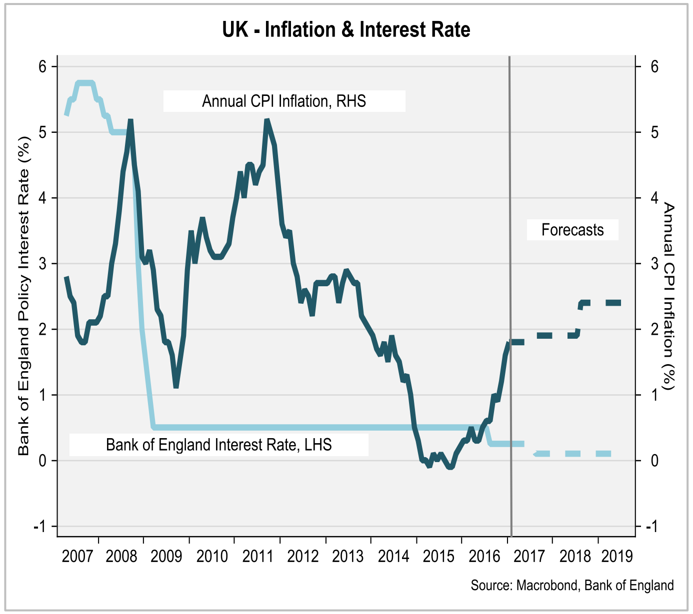
- Sterling has remained relatively weak following the EU Referendum and is around 17% and 11% lower against the dollar and the euro compared to pre-referendum levels.
- The lower value of Sterling started to feed through to higher prices during the year. Upward pressure on fuel and food prices contributed to annual CPI inflation rising to 1.8% in January 2017 from 0.3% in January 2016.
- The Bank of England projects the weaker value of Sterling to drive inflation above its 2% target during 2017.

Growth is expected to weaken in 2017

- Uncertainty is expected to subdue business activity as the UK Government triggers Article 50 whilst higher inflation is projected to weigh on real incomes and consumption.
- The OBR forecast that UK growth will slow to 1.4% in 2017, whilst among the independent forecasters monitored by HM Treasury, the average forecast is also 1.4%.
- The Bank of England forecast GDP growth of 2.0% in 2017 on the back of strong consumer spending however, the pickup in household debt presents a risk for the outlook as inflation and expectation of tighter monetary policy rises.







Scotland Summary

Marginal output growth continued in Q3 2016

- The Scottish economy grew 0.2% in Q3 (0.7% over the year), largely in line with growth in the previous quarter.
- Output growth was driven by a fifth consecutive quarter of growth in the Service sector (0.4%) offsetting further contractions in the Production sector (-0.1%) and Construction sector (-1.4%).

Scottish unemployment fell over the year

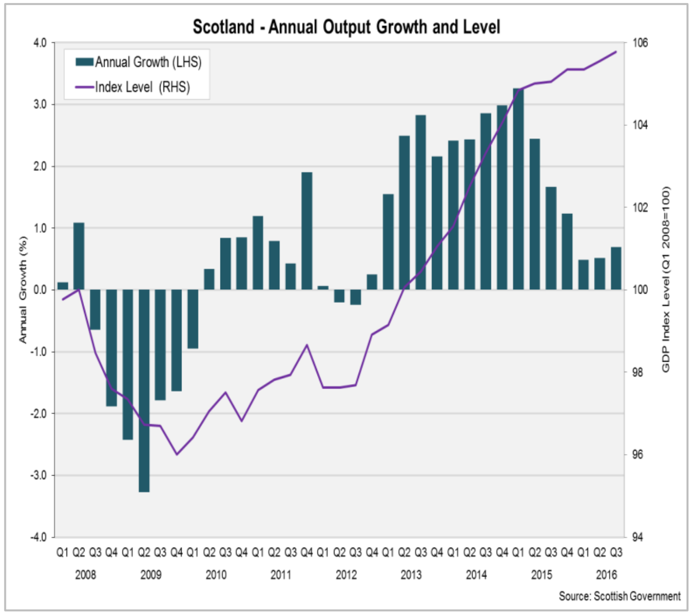
- Latest labour market data for October to December 2016 shows that the unemployment rate rose over the quarter to 4.9%, though fell over the year.
- The employment rate stands at 73.6%. The number of people in employment in Scotland is now 47,000 above its pre-recession peak (March-May 2008).
- Inactivity levels decreased by 8,000 over the quarter with the inactivity rate falling to 22.4%.

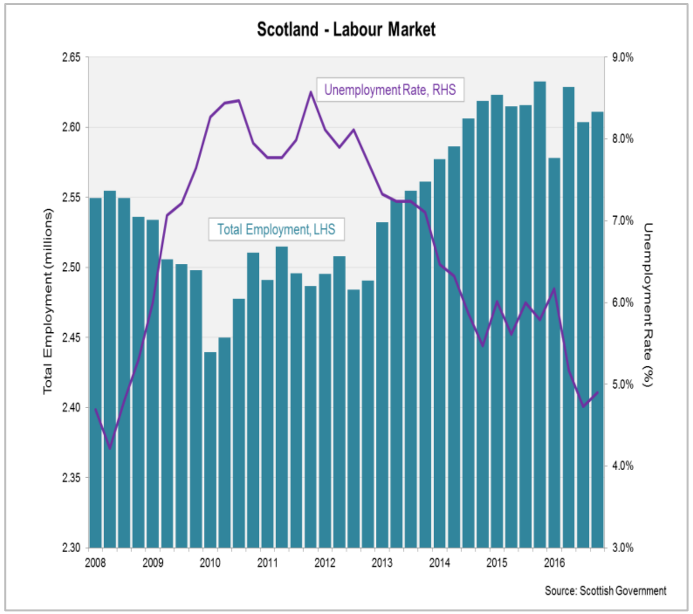
Scotland's international exports rose in 2015

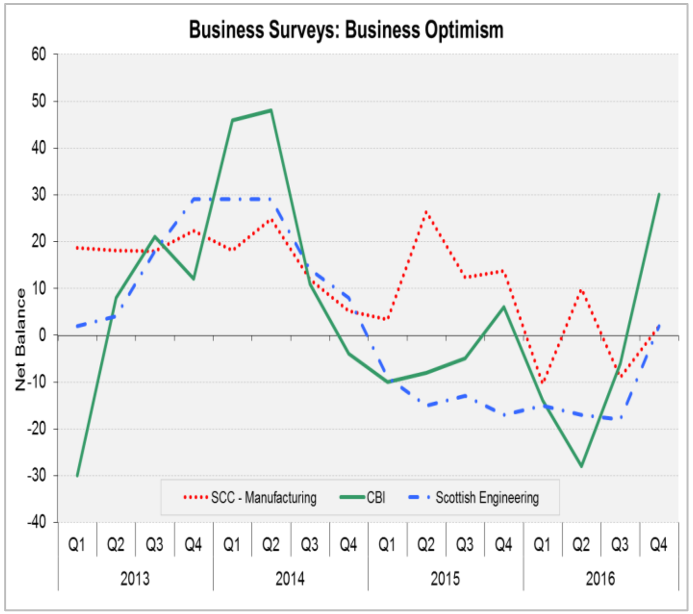
- Scotland's international exports (excluding oil and gas) increased in 2015 by £1 billion (3.6%) from £27.7 billion in 2014 to £28.7 billion in 2015.
- The EU continued to be Scotland's largest single market for international exports with exports to EU countries rising by 4.4% over the year to £12.3 billion, making up 43% of international exports.
- Exports to the rest of the UK stood at £49.8 billion in 2015, an increase of 4.4% on the previous year.

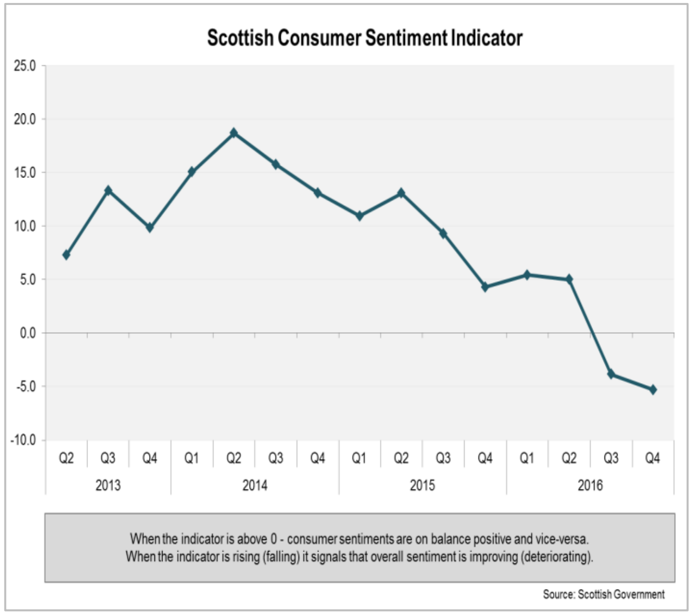
Outlook remains mixed for 2017

- The Scottish Consumer Sentiment Indicator weakened further in Q4 2016 with the net balance of respondents expecting the economic outlook to deteriorate in 2017.
- Whilst business optimism strengthened at the end of the year, the Scottish Retail Sales Index for Q4 2016 showed that the volume of retail sales in Scotland decreased by 0.5% over the quarter and grew 3.1% over the year.
- Economic forecasts published by the Scottish Government alongside the Draft Budget expect GDP growth of 1% in 2016-17, rising to 1.3% in 2017-18.



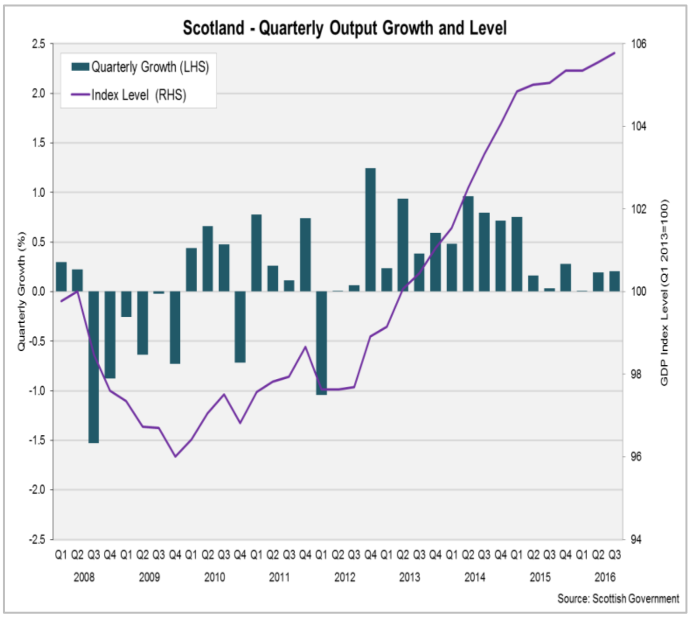






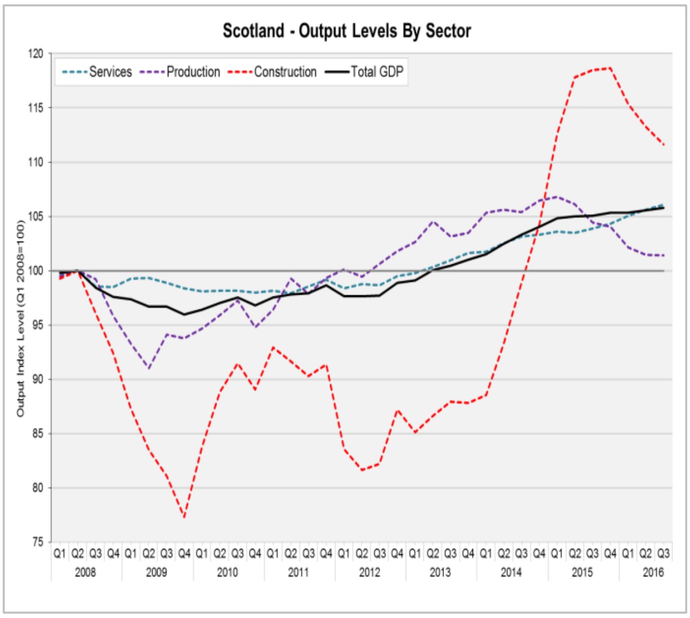
Scottish Economy Update

Gross Domestic Product



The latest GDP data for Scotland shows that the Scottish economy grew 0.2% in Q3 2016 (0.7% over the year); the pace of growth remaining stable from the previous quarter.

The Service sector continued to drive growth, expanding by 0.4% in Q3 (2.1% over the year). Growth was most prominent in the Business Services and Finance subsector (0.8%) with growth in Government and Other Services (0.2%) and Distribution, Hotels and Catering (0.1%) also contributing.



The growth in the Service sector offset contractions across the Production and Construction sectors, with the Production sector contracting 0.1% in Q3 (2.9% over the year). The main contraction was within the Manufacturing subsector (-1.9%) – its fourth consecutive quarter of contraction – which offset modest growth from Mining and Quarrying industries (2.1%) and Electricity and Gas supply activity (5.2%).

The Construction sector contracted 1.4% in Q3 – its third consecutive quarter of contraction. This partly reflects the completion of large public sector infrastructure projects which supported growth in the sector across 2014 and the start of 2015. However, despite recent declines, output in the sector remains 13% higher than it was in Q3 2014.

Retail Sales Index

The first output data for Q4 2016 - the Scottish Retail Sales Index – showed the volume of retail sales in Scotland decreased by 0.5% over the quarter though grew 3.1% over the year.

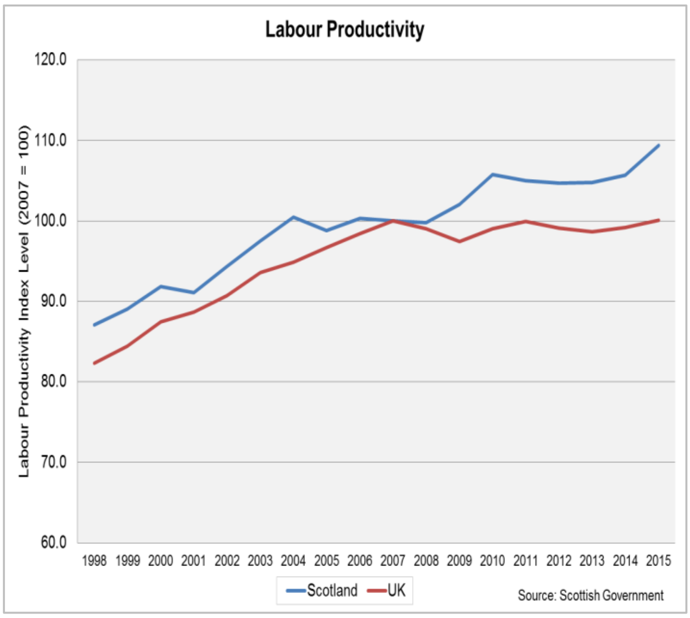
The contraction in sales volumes was evident in small & medium size stores whose sales decreased by 1.7% over the quarter whilst sales volume from large retail businesses grew by 0.7%.

The fall in retail sales volumes in Q4 2016 - the first time since the start of 2015 - is consistent with the relatively weak economic picture that GDP and labour market data has presented in recent months.

Low inflation has supported retail sales growth in recent quarters, however the fall in Sterling following the EU Referendum has contributed to the re-introduction of inflationary pressures in the retail sector, which, along with weaker consumer sentiment, may have started to weigh on consumer spending power and sales at the end of 2016.

Labour Productivity

Labour productivity measures the amount of economic output that is produced, on average, per hour worked and is an important indicator of economic performance. Latest labour productivity statistics showed that Scottish labour productivity increased by 3.5% in 2015 whilst UK productivity grew by 0.9%.



Growth in Scottish productivity in 2015 was underpinned by a 2.1% growth in GDP, supported by strong growth in the construction sector, while labour input as measured by the number of hours worked decreased by 1.3% over the year - the first time since 2010.

Labour productivity in Scotland has grown by 9.4% since 2007. UK productivity has grown by 0.1% over the same period. Whilst there are year to year fluctuations in the data, the historical gap between labour productivity levels in Scotland and the UK average has narrowed significantly during the last decade and are now broadly aligned. Scottish productivity has gone from being 5.5% below the UK average in 2007, to broadly matching the UK average in 2015.

Drivers of Scottish Economic Growth

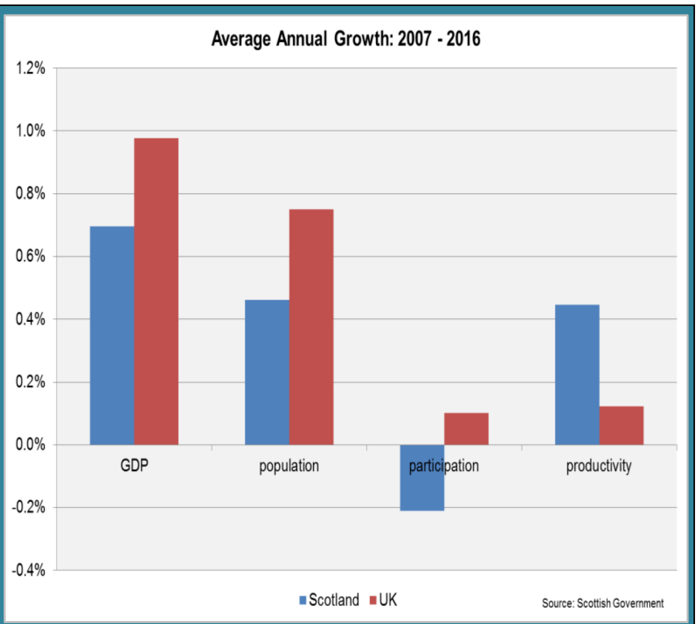
Over the longer term, changes in a country's productivity, population and labour market participation are the key drivers of its economic growth. Understanding the contribution that each element makes to a country's economic growth can help better understand the drivers of a country's economic performance.

- Productivity is defined as output per unit of input. Increases in productivity reflect improved skills, innovation, investment etc. and are key to underpinning long run growth. The data reported above show the change in labour productivity for Scotland since 1998.

- A country's population, and in particular the population aged 15+, represents the maximum size of a country's labour force. It is driven by birth rates, net migration and mortality rates. Changes in the overall size and composition of the population and workforce can drive aggregate growth through both increased demand and on the input side – labour supply.

- Labour market participation reflects the proportion of the adult population who are employed or actively seeking a job. It is driven by both the demand and supply of labour and is linked to the drivers above.

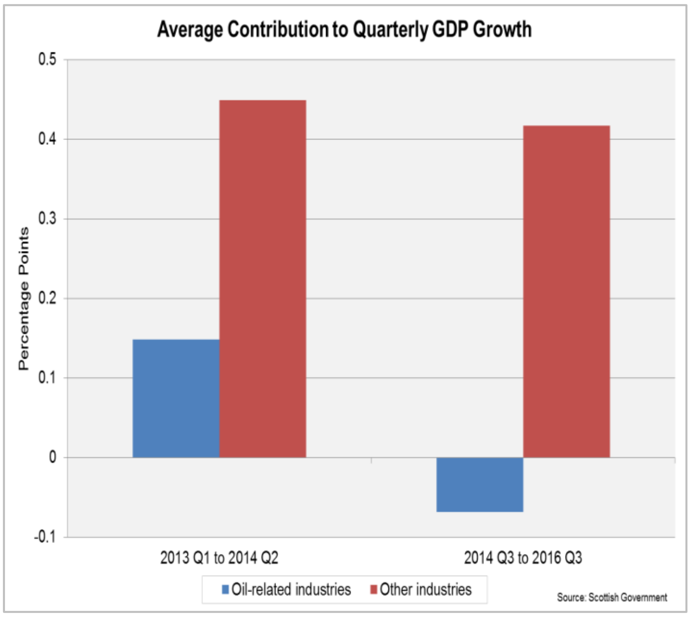
The adjacent chart shows the average annual GDP growth in Scotland and the UK as a whole since 2007. It therefore captures both the impact of the global financial crises and the subsequent recovery. The results show that average annual GDP growth over this period, has been less in Scotland than in the UK as a whole (0.7% vs. 1.0%).



Decomposing this growth highlights the sources of this difference. In particular, since 2007 population growth has made a much larger contribution to GDP growth in the UK as a whole, reflecting the higher levels of net migration into the rest of the UK. Labour market participation has also made a greater contribution to growth in the UK as a whole. This reflects the fact that Scotland entered recession in 2007 with a much higher level of labour market participation than the UK. However, productivity growth has made a larger contribution to growth in Scotland's economy since 2007 than it has for the UK as a whole. This difference in productivity growth between Scotland and the UK has helped to offset the slower population growth which has occurred in Scotland. This is important for underpinning longer term growth and rising living standards.

Oil Price Fall and Scottish GDP

The low oil price has been a feature of the global economy since the second half of 2014. As set out in previous State of the Economy publications, this has impacted the Scottish economy directly through a reduction in investment and operational activity in the North Sea oil and gas sector. This has also weighed on economic activity in the North East of Scotland more broadly and the entire supply chain to the oil and gas industry.



The sectors of the Scottish economy which are most exposed to developments in the North Sea oil and gas industry include: Mining support; Fabricated metals; Machinery and equipment; Ships and boats, 'rest of repair and maintenance'; and Architectural and engineering services.

Collectively, these sectors account for approximately 9% of the Scottish economy. In the 18 months prior to the fall in the oil prices, they made an important contribution to Scottish GDP growth. However, since oil prices have fallen, these sectors have contracted and acted as a drag on overall growth.

Between Q1 2013 and Q2 2014, the Scottish economy grew on average by 0.6% per quarter. The above sectors contributed 0.1 percentage points of this growth, whilst the wider Scottish economy accounted for the remaining 0.5 percentage points of growth.

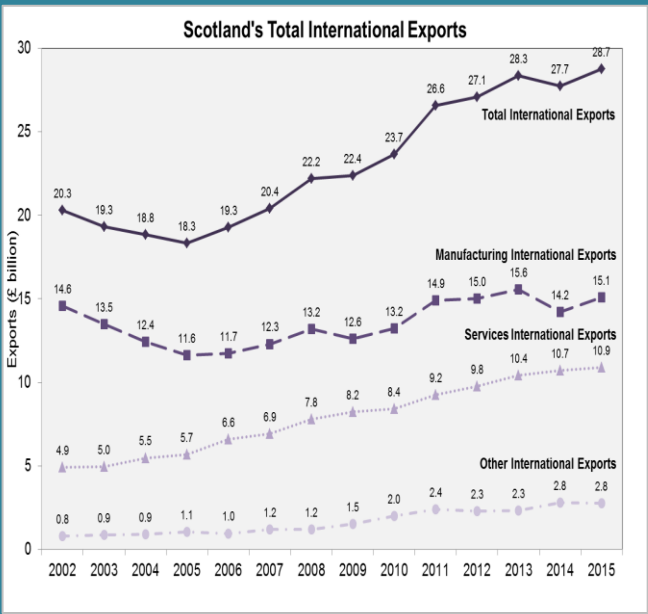
In the period following the fall in the oil price, the situation has changed. Between Q3 2014 and Q3 2016 the wider Scottish economy continued to contribute approximately 0.4 percentage points to quarterly growth in Scotland, broadly unchanged from the previous 18 months. However, the sectors linked to the oil and gas industry have contracted since Q3 2014, and acted to reduce overall Scottish growth by 0.1 percentage points a quarter. As a result of the contraction in these sectors, overall Scottish growth has slowed to 0.3% a quarter over this period.

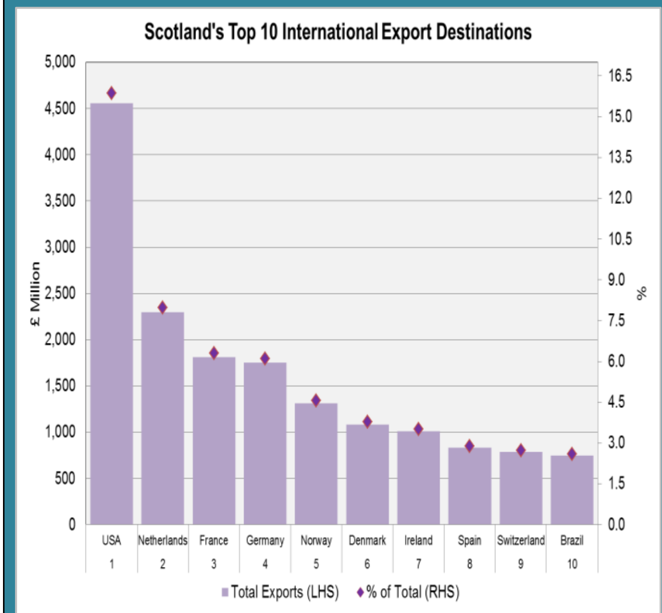
Export Statistics Scotland[1]

The latest Export Statistics Scotland publication measures total Scottish exports to the rest of the UK and the rest of the world in 2015 (excluding oil and gas).

In 2015, the value of total exports from Scotland (to the rest of the UK and internationally) was £78.6 billion, a 4.1% increase from 2014.

The rest of the UK continues to be the destination for the majority of Scottish exports, accounting for 63% of the value and totalling £49.8 billion in 2015, an increase of 4.4% over the year. This was driven by an increase in the export of utilities such as electricity, gas and water.





International markets account for the remaining 37% of Scottish exports and in 2015 the value of Scottish exports to international destinations was £28.7 billion, an increase of 3.6% over the year. The EU continues to be Scotland's largest single market for international exports accounting for 43% (£12.3 billion) of Scotland's international exports. Exports to the EU increased by 4.4% in 2015, driven by an increase in the export of petroleum and chemical products.

Exports to non-EU countries were £16.4 billion in 2015, increasing 3% on the previous year.

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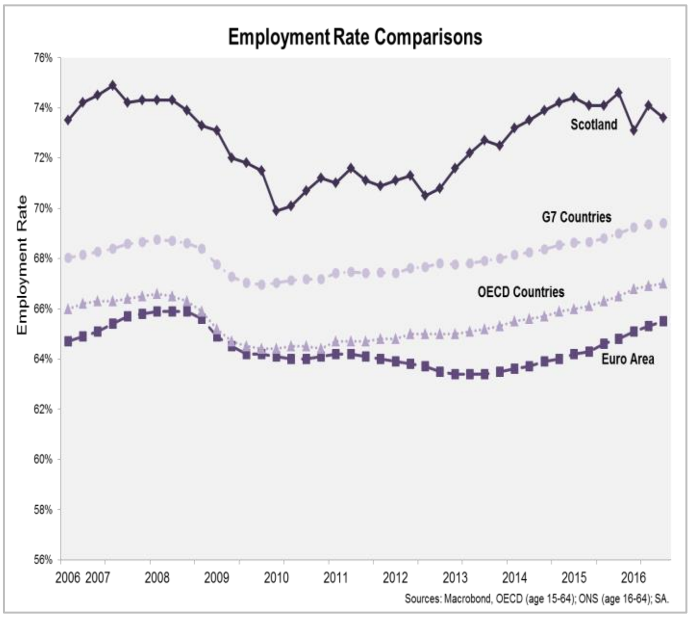
[1] http://www.gov.scot/Topics/Statistics/Browse/Economy/Exports/ESSPublication

Labour Market

The Scottish employment rate has remained at historically high levels over the past two years, despite the challenges faced by the Manufacturing and Oil and Gas sectors. The table below summarises the latest labour market data for Scotland.

HEADLINE LABOUR MARKET STATISTICS							
RATES	**Latest Data**	**Quarterly Change (% p.t.)**	**Annual Change (% p.t.)**	**LEVELS**	**Latest Data**	**Quarterly Change**	**Annual Change**
Scotland				**Scotland**			
Employment*	73.6%	0.1	-1.0	Total Employment^	2,611,000	8,000	-20,000
ILO Unemployment**	4.9%	0.2	-0.9	ILO Unemployment^	135,000	6,000	-27,000
Economic Inactivity*	22.4%	-0.2	1.7	Economic Inactivity^^	765,000	-8,000	59,000
UK				**UK**			
Employment*	74.6%	0.1	0.5	Total Employment^	31,837,000	37,000	302,000
ILO Unemployment**	4.8%	0.0	-0.3	ILO Unemployment^	1,597,000	-7,000	-97,000
Economic Inactivity*	21.6%	-0.1	-0.2	Economic Inactivity^^	8,862,000	-31,000	-61,000
*Denominator = Working age population (16-64) **Denominator = Total economically active				^All persons ages 16+ ^^All persons aged 16-64			
Source: Labour Force Survey (October – December 2016)							

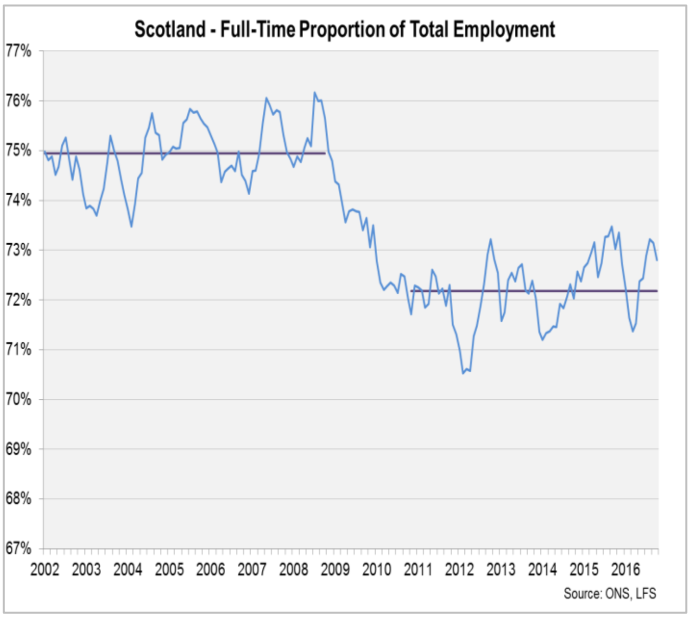
Latest data for October to December 2016 show that the employment rate rose slightly over the quarter to 73.6%. Whilst this represents a fall from the rate a year earlier it remains above the average employment rate since 1999 (72.3%). Comparing employment rates internationally, Scotland's employment rate also remains above the average rates for both the G7 economies and the OECD as a whole.



Between mid-2012 and the start of 2016, the unemployment rate in Scotland fell rapidly as the economy recovered from recession. As the economy and labour market have continued to improve, the rate of decline in the unemployment rate has slowed. The unemployment rate in Scotland currently stands at 4.9%. This is lower than it was twelve months earlier, but slightly higher than in recent months.

Although the unemployment rate is still slightly above the low point it reached immediately prior to the financial crises, it is currently below its long term average and the level in many other advanced economies. For example, the average rate across the G7 economies is currently 5.5%.

Whilst the number of people in employment in Scotland is comparatively high by historic standards, the proportion of people working full time is lower than it was prior to the financial crises. The increase in the number of part-time positions in Scotland following the recession reflects some workers having to accept fewer hours, even though they would prefer to work more. However, it may also in part reflect rising flexibility in the labour market, which is allowing more people to enter the market who may not want or be able to work full-time.

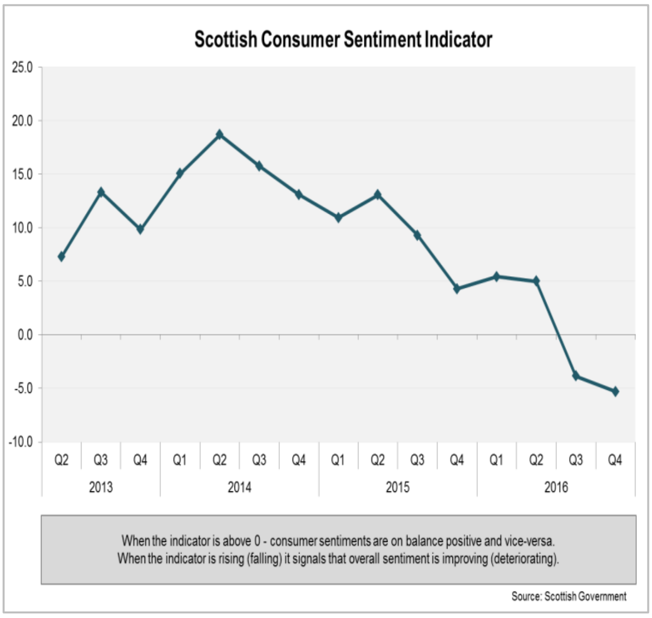


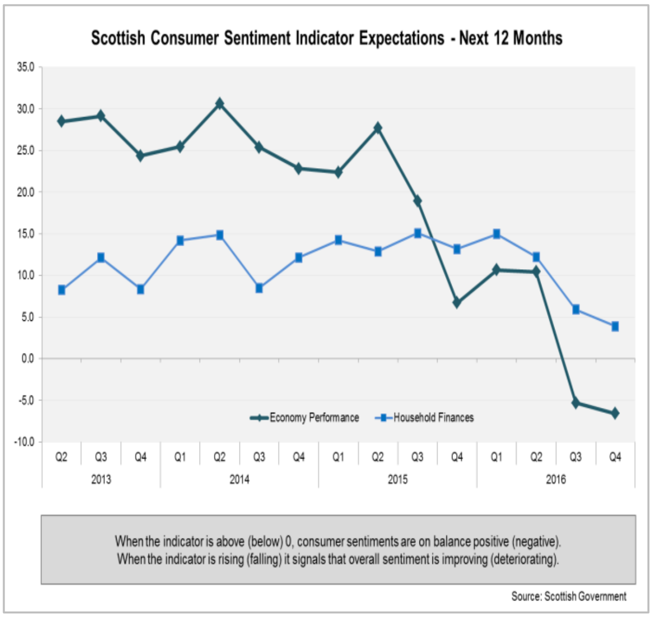
Consumer Sentiment

The Scottish Consumer Sentiment Indicator weakened in the second half of 2016 following the EU referendum, turning negative for the first time in Q3 and deteriorating further in Q4. This signals that respondents on balance believe that the economy will worsen over the next 12 months.

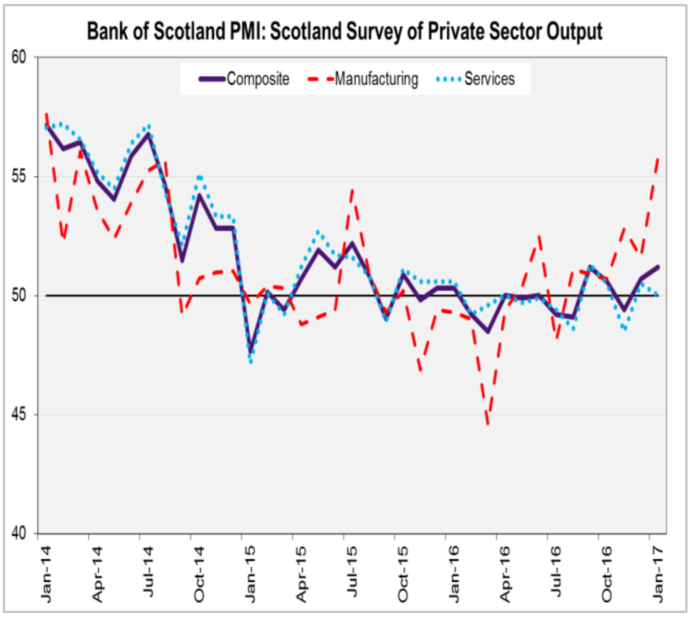
Underneath the headline indicator, there is a divergence between households perception of their personal financial position and their outlook for the economy as a whole. Whilst both measures reported a further weakening in Q4 2016, the net balance of respondents still believe that their household finances will improve next year, whilst the net balance believe that the outlook for the wider economy will worsen.

This divergence between respondents views on their personal finances and the wider economy may reflect that they perceive the process of leaving the EU to have negatively impacted on the outlook for the economy as a whole, but are not yet able to assess the impact that it will have for their personal finances.





Business Sentiment



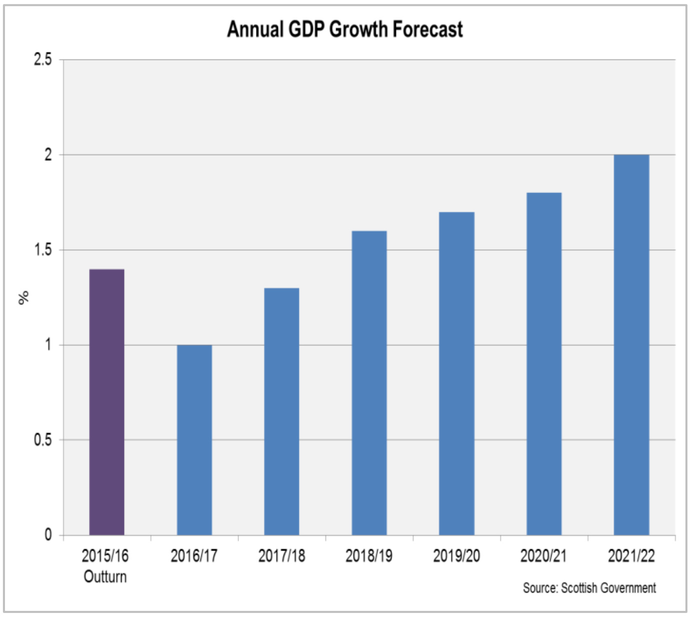
The latest Scottish business surveys present a relatively positive outlook for the end of 2016 and into 2017 as sales revenues and new orders have held up in the face of uncertainty following the EU referendum vote.

The Bank of Scotland Purchasing Manager's Index for January 2017 signalled a particular up-tick in manufacturing sector new orders and output resulting from stronger underlying demand.

The low value of Sterling has been a key issue for businesses. It is reported to have generated a boost to export orders, but is also starting to increase input costs and place pressure on cash flow and profit margins. Survey responses have suggested that businesses have started to pass through the increase in input costs to output prices and ultimately consumer prices which is consistent with the uptick in CPI inflation.

Survey evidence signals that the outlook remains finely balanced as business optimism picked up at the end of the year alongside investment intentions. However, this is balanced by ongoing uncertainty regarding the UK's exit from the EU and the impact on cash flow from rising input costs.

Scottish Economic Outlook



There is considerable uncertainty about the outlook for the UK and Scottish economies following the EU referendum. Current forecasts tend to project that output growth will remain below trend in 2017.

The Scottish Government published GDP forecasts for the first time alongside the Draft Budget 2017-18[2] to underpin the forecasts for the newly devolved income tax powers. The forecasts were for GDP growth of 1.0% in the 2016-17 financial year rising to 1.3% in 2017-18 and then gradually accelerating in subsequent years towards its long term historic trend – as summarised in the chart.

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[2] http://www.gov.scot/Publications/2016/12/6669

The forecasts for this year and next are based on two key judgements. Firstly, whilst the slowdown in the oil and gas sector is expected to continue in the short term, there are indications that the sector may be approaching its nadir. It is therefore expected to act as less of a drag on Scottish GDP growth from 2017-18 onwards.

Secondly, the EU referendum result is expected to feed through to the Scottish economy through the following channels:

- The depreciation of sterling is assumed to push up inflation and in turn depress real wages. Coupled with an increase in economic uncertainty, this is expected to reduce consumption.
- Increased economic uncertainty is expected to result in business investment being delayed and reduced.
- Lower economic growth in the rest of the UK, Scotland's largest trading partner, reduces intra-UK trade.
- This is expected to be partly offset by the depreciation in sterling providing a boost to Scotland's international exports.

The longer term forecasts for 2018-19 are considerably more uncertain, and will be heavily influenced by the future relationship secured for Scotland and the rest of the UK with the EU, and the nature and duration of any transition period. As a result, the outcome of the negotiations could result in economic growth being either higher, or lower, than assumed in the forecasts.

A number of other organisations have also recently published GDP growth forecasts for Scotland, including the Fraser of Allander Institute, EY Scottish ITEM Club and PWC. These forecasts are for growth of between 0.7% and 1.8% in 2016, falling to between 0.4% and 1.1% in 2017. This comparatively wide range illustrates the current level of uncertainty surrounding the economic outlook.

Annual Output Growth Forecast (%)[3]	2015 (outturn)	2016	2017
Fraser of Allander Institute (Dec 2016)	2.1	1.0	1.1
EY ITEM Club (Dec 2016)	2.1	0.7	0.4
PWC (Nov 2016)	2.1	1.8	0.9

Summary

The latest GDP and labour market data have followed similar patterns in the second half of 2016 as they did over the previous 18 months, suggesting that any immediate impacts from the EU referendum are still to fully take effect on economic activity.

However, the existing challenges facing the oil and gas industry and its supply chain from the low oil price, alongside further slowing in the construction sector, and weakness in global growth, have continued to weigh on growth in the Scottish economy.

Survey evidence does signal that business and consumers have been adjusting to the changing economic and political climate following the EU referendum. Whilst business optimism has rebounded at the end of 2016, consumer sentiment has weakened, with a fall in

[3] The forecasts for the Scottish economy presented in this report are widely available in the public domain:
Fraser of Allander Institute http://www.strath.ac.uk/business/economics/fraserofallanderinstitute/economic_commentary/latestcommentary/ ,
EY ITEM Club http://www.ey.com/uk/en/issues/business-environment/financial-markets-and-economy/ey-scottish-item-club-forecast
PWC http://www.pwc.co.uk/services/economics-policy/insights/uk-economic-outlook.html.
The choice reflects published forecasters which are known to us and are subject to review. No significance should be attached to the inclusion or exclusion of any particular forecasting organisation. The Scottish Government accepts no responsibility for the accuracy of material published in this comparison.

retail sales data for Q4 2016 signalling that this shift in sentiment may have fed through to economic activity.

Longer term, the outlook remains weaker on the back of the EU referendum result reflecting the underlying risks of a heightened level of uncertainty leading to a reduction in business investment and rising inflation weighing on real income growth and consumption.