State of the Economy | June 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 12 June 2017.

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Scottish Government

Overview

The State of the Economy report provides the latest assessment of Scotland's economic performance.

Since the March publication, GDP data for Scotland confirmed growth overall in Scotland during 2016 of 0.4 per cent, which was below trend and expectation. In contrast, the labour market has been more resilient with employment continuing to rise and unemployment falling to near record low rates, albeit with a slight rise in inactivity levels.

In considering the Scottish growth and labour market data for 2016, there are a number of important considerations. Firstly, the impact of the Oil and Gas sector downturn is evident in the GDP data and we provide further analysis of the importance of the sector's supply chain to recent growth in Scotland. However, there are emerging signs that confidence is returning to the sector which, coupled with the structural improvements made by the industry since 2015, will put it on a stronger footing to take advantage of the opportunities which will emerge as cyclical factors improve.

The labour market data has remained strong during this period of lower growth. This, in part, reflects the ability (and demand) within the wider economy to absorb skilled labour and the underlying strengths of the economy in continuing to attract investment and generate employment opportunities.

The EY Attractiveness Survey for 2016 confirmed that Scotland continued to attract more FDI projects than any part of the UK, outside of London. Interestingly the composition of investment continues to evolve, with Scotland attracting more R&D/skills intensive projects reflecting the knowledge and skills base within Scotland. This report provides further analysis of those trends and new analysis looking at the influence of London on UK growth figures.

Looking ahead, the outlook for growth in 2017 remains positive but at below trend growth. Evidence suggests that growth in exports sales are materialising given the sustained depreciation of Sterling over the last year, supporting key export sectors such as Food and Drink. It is also rebalancing the economy as rising import prices feed through to higher inflation, impacting real income growth and household consumption. This is reflected in the retail sales data in the first quarter of 2017 and the continued weakness in consumer sentiment in Scotland. This report contains updated Scottish consumer sentiment data for Q1 2017.

Brexit continues to present a significant risk to business and consumer sentiment in Scotland with investment sensitive to changing market signals. It also presents the greatest source of uncertainty for the outlook particularly beyond 2018. The range of independent forecasts for 2017 suggest growth of between 0.9% and 1.3% for Scotland. At this level of growth, it is not unexpected to have a negative quarter as was evident in 2015 and 2016. However, as cyclical factors improve, coupled with the underlying strengths of the economy, growth should remain resilient.

Global Summary

Global growth forecast to pick-up in 2017 and 2018.

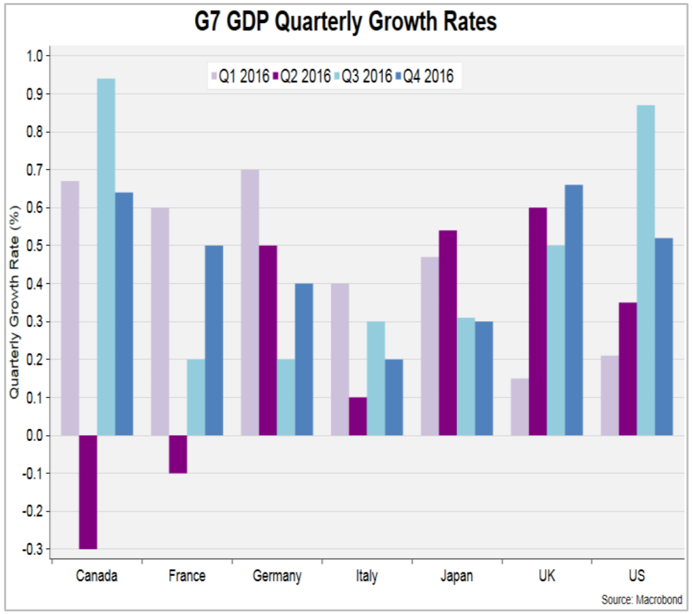
- The global economy gathered momentum at the end of 2016 with recoveries in trade, investment and manufacturing forecast to drive growth of 3.5% in 2017.
- The stronger outlook for advanced economies is supported by the pick-up in global manufacturing and trade, alongside an up-tick in business and consumer sentiment.
- Partial recovery in commodity prices is expected to support the stronger growth outlook in emerging market and developing economies.
- Global risks regarding financial tightening, trade protectionism and geopolitical tensions have the potential to reduce the growth outlook.

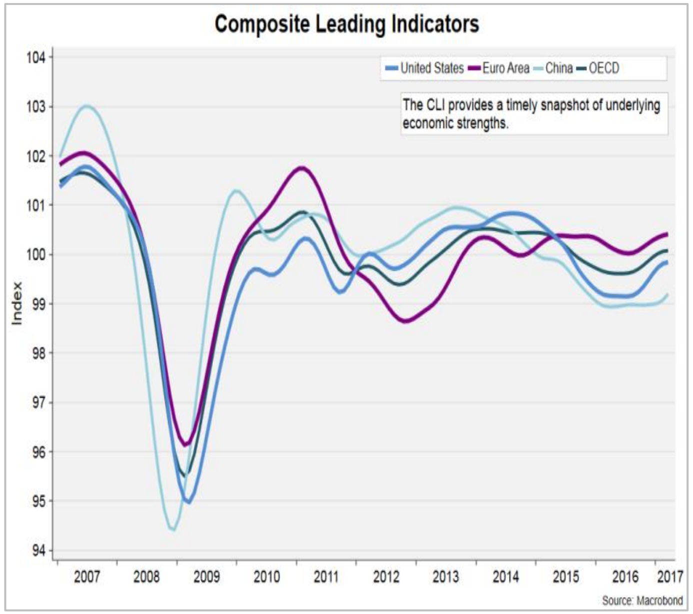
US economy forecast to build momentum in 2017.

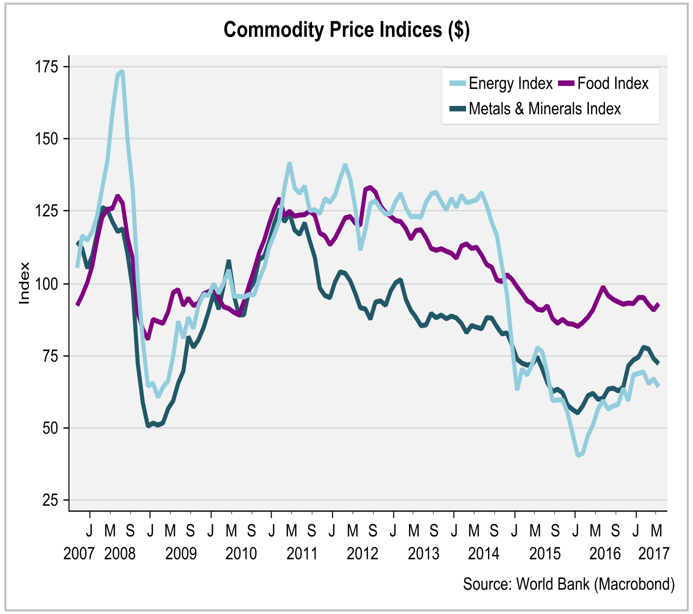
- In 2016, the US economy gathered momentum with solid growth in job creation and disposable income supporting strong consumer spending.
- Investment and business confidence have strengthened amidst expectations of looser fiscal policy.
- Consumer prices inflation has increased in the US, driven by the rebound in energy prices, however core inflation has remained subdued.
- US GDP growth is forecast to accelerate from 1.6% in 2016 to 2.3% in 2017 and 2.5% in 2018.

Recovery in the euro area expected to continue in 2017.

- Domestic demand continued to drive growth in 2016 though strong export growth has been supported by the pick-up in global trade and euro depreciation.
- Unemployment has continued to fall in 2017 to 9.3%, however remains above pre-2008 levels.
- Rising headline inflation alongside disparities in unemployment across euro area countries continues to influence the outlook for 2017.
- Euro Area GDP growth is forecast to remain broadly stable with growth of 1.7% in 2017, weakening slightly to 1.6% in 2018.







GDP Growth (%)	Outturn	Projections		Revisions from January 2017 Forecast	
IMF WEO (April 2017)	2016	2017	2018	2017	2018
World Output	**3.1**	**3.5**	**3.6**	**0.1**	**0.0**
Advanced Economies	**1.7**	**2.0**	**2.0**	**0.1**	**0.0**
United States	1.6	2.3	2.5	0.0	0.0
Euro Area	1.7	1.7	1.6	0.1	0.1
United Kingdom	1.8	2.0	1.5	0.5	0.1
Japan	1.0	1.2	0.6	0.4	0.1
Emerging Market & Developing Economies	**4.1**	**4.5**	**4.8**	**0.0**	**0.0**
China	6.7	6.6	6.2	0.1	0.2
India	6.8	7.2	7.7	0.0	0.0
Brazil	-3.6	0.2	1.7	0.0	0.2
Russia	-0.2	1.4	1.4	0.3	0.2
South Africa	0.3	0.8	1.6	0.0	0.0

United Kingdom Summary

UK GDP growth slowed in 2016.

- UK GDP grew 1.8% in 2016, driven by robust service sector growth (2.8%), alongside growth of 2.4% and 1.2% in the construction and production sectors.
- Initial estimates signal quarterly growth slowed to 0.2% in Q1 2017 (from 0.7% in Q4 2016) with a particular slowing in consumer facing services such as retail and accommodation.
- In line with this, household spending growth slowed at the start of 2017, whilst net trade continued to make a negative contribution to GDP growth.

UK unemployment continues to fall in 2017.

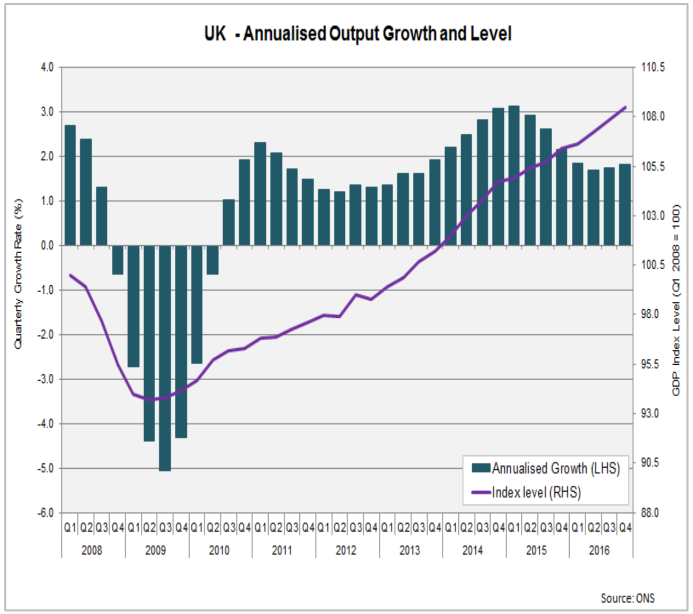
- The UK labour market remained buoyant throughout 2016 and into 2017 with the unemployment rate falling to 4.6%.
- Employment also continued to rise and the current rate of 74.8% is the highest since comparative records began in 1971.

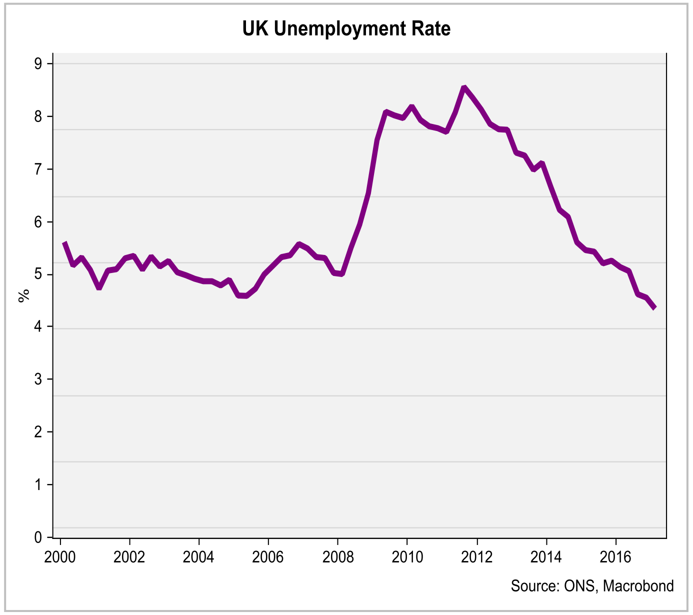
Inflation surpasses 2% target at the start of 2017.

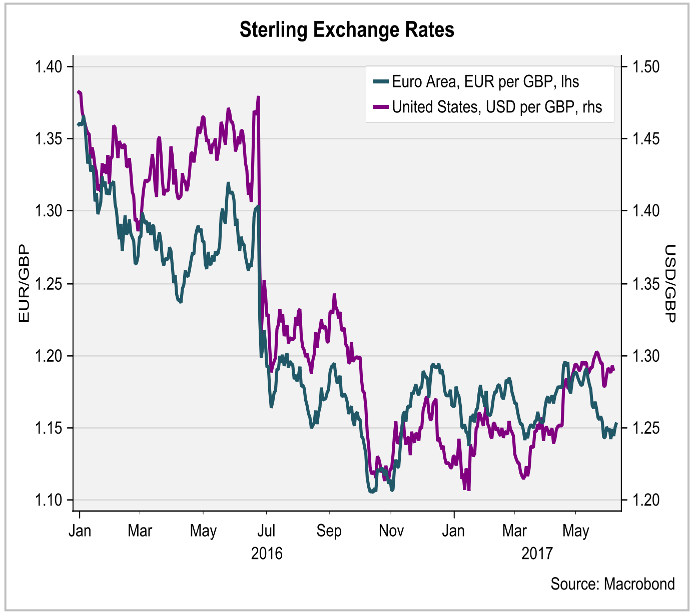
- Consumer price inflation rose to 2.7% in April 2017 and is forecast by the MPC to peak at 2.8% later this year.
- Consequently, real earnings declined over the year to January to March 2017 by 0.2%, the first real wage decline since 2014.

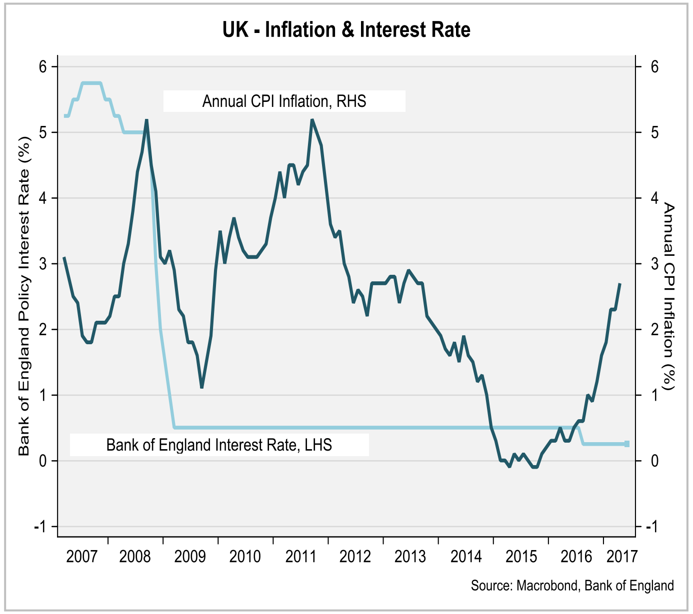
Weaker household spending weighs on growth forecasts.

- UK growth forecasts for 2017 have been buoyed by the resilient end to 2016, however the outlook for 2018 is weaker.
- Higher inflation is projected to weigh on real income growth and household consumption in 2017-18, whilst Brexit remains the principal challenge for the medium term outlook.
- The IMF and OECD forecasts for UK growth in 2017 range from 1.6% to 2.0%, falling to between 1.0% and 1.5% in 2018.









Scotland Summary

Scottish GDP grew 0.4% in 2016.

- GDP grew 0.4% in 2016, however contracted by 0.2% in the final quarter of the year.
- The service sector grew 1.8% in 2016, though growth was flat in Q4 with quarterly contractions in both consumer-focused subsectors and Business Services and Finance.
- Construction sector output fell 3.3% in 2016, after strong growth in 2015, whilst production sector output fell 4.4% partly due to weak demand from the oil and gas industry.

Scottish unemployment rate has continued to fall.

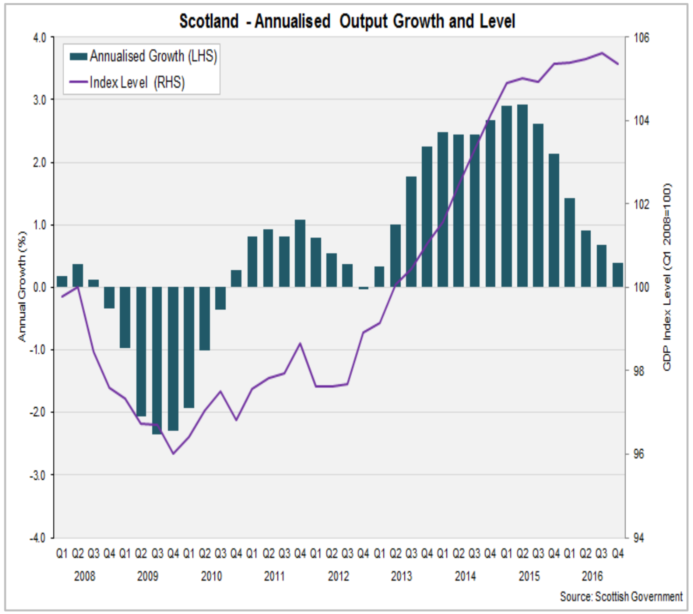
- Scotland's unemployment rate fell to 4.4% in January – March 2017, below the UK average of 4.6%.
- Alongside this, employment levels in Scotland have remained high, with 2.62 million people in employment, 53,000 above its pre-recession peak.
- However, Scotland's inactivity rate picked up over the year and now stands at 22.5%.

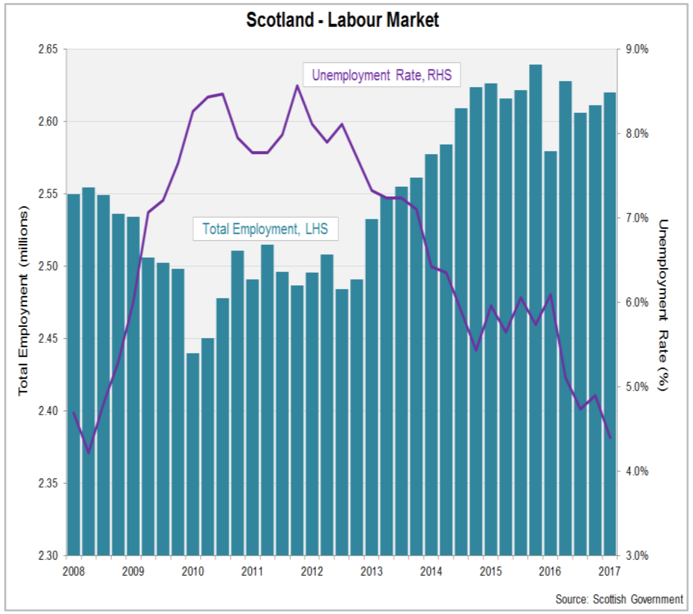
Productivity has increased by 7.6% since 2007.

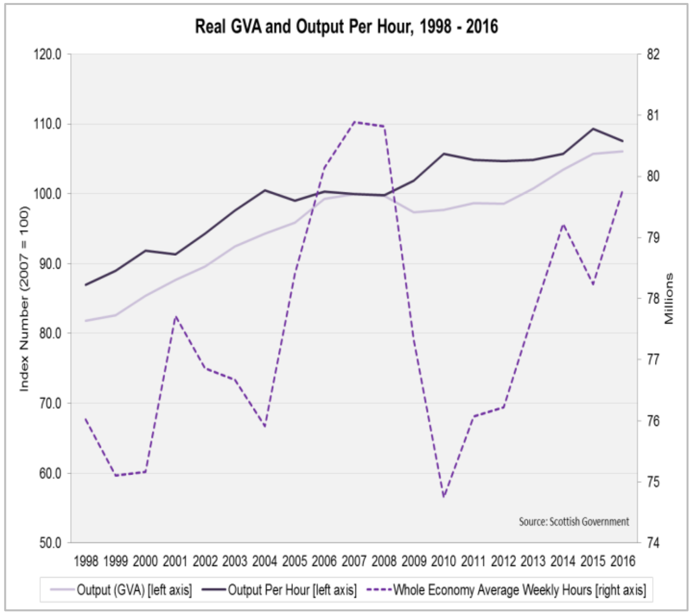
- Output per hour worked fell by 1.5% in 2016 following strong growth of 3.5% in 2015.
- The contraction in productivity reflected strong growth in the average number of hours worked that outstripped GDP growth over the year.

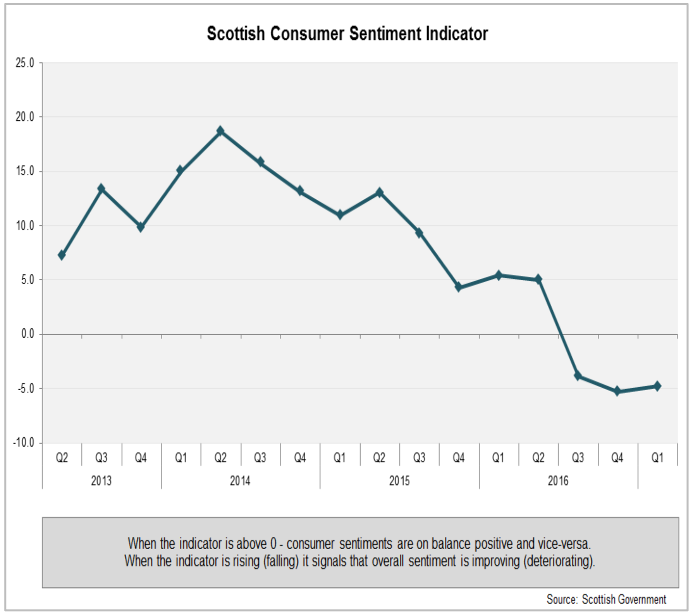
GDP growth of around 1% forecast for 2017 and 2018.

- Scottish consumer sentiment strengthened slightly in Q1 2017 though remained negative.
- Signals suggest that the oil and gas sector may weigh less on production sector growth in 2017.
- The lower value of Sterling is expected to support export growth, however inflationary pressures are forecast to weigh on domestic consumer spending.
- Independent forecasts for GDP growth in 2017 range between 0.9% and 1.3% and for 2018 between 0.7% and 1.3%.









Scottish Economy Update

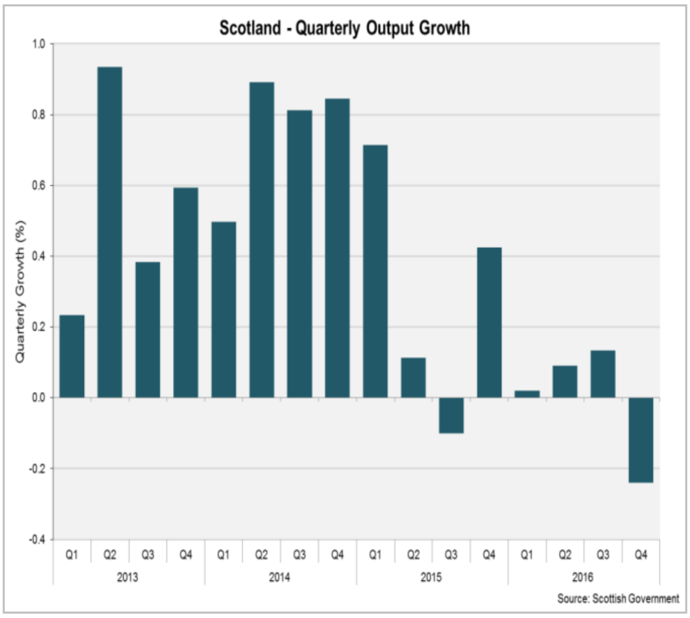
Gross Domestic Product

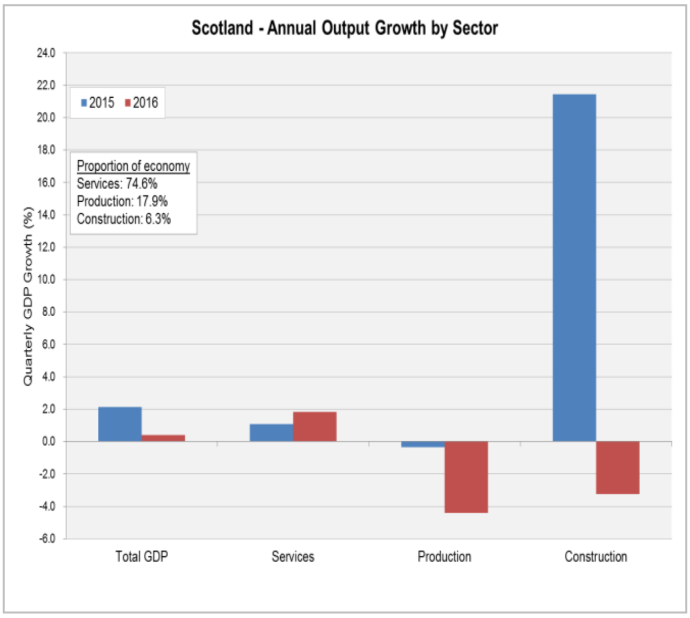
In 2016, the Scottish economy grew 0.4%, with 1.8% growth in the Service sector offsetting contractions of 3.3% in the Construction sector and 4.4% in the Production sector.

Quarterly growth remained subdued across 2016, with output contracting 0.2% in the final quarter.

Service sector growth in 2016 was driven by Business Services and Finance and Distribution, Hotels and Catering. However, growth was flat in the fourth quarter, driven by contractions in Business Services and Finance and in household-facing services such as retail and accommodation and food services. This is likely to have been impacted by weakening consumer sentiment in Scotland in the second half of 2016, alongside continued job losses and lower wages in the oil and gas sector.

The Production sector contracted throughout 2016. This partly reflects the continued impact of the slowdown in the oil and gas sector on its supply chain. However, in the second half of the year the contraction was more widely spread throughout the Production subsectors.



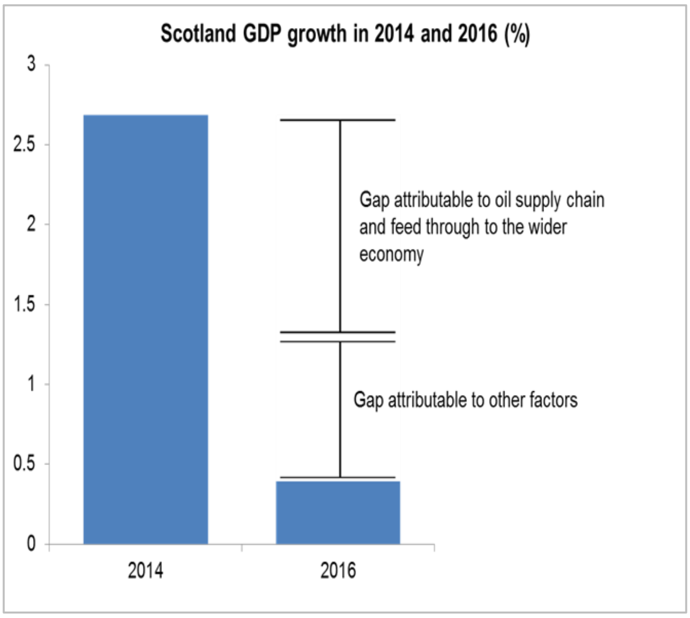


Whilst output levels in the Construction sector remained significantly higher in 2016 than they were in 2014, the sector contracted throughout 2016, ending the year contracting 0.8% in Q4. This moderation in output follows exceptionally rapid growth in the sector in 2015 as a number of major infrastructure projects neared completion and signals an adjustment in the sector back towards more sustainable levels of output.

Oil and Gas related activity

The Scottish GDP statistics do not include offshore oil and gas production. However, much of the onshore supply chain servicing the industry is based in Scotland, and is reflected in the GDP statistics.

Prior to the oil price falling in 2014, the supply chain to the oil and gas sector grew by 1.2% a quarter – four times faster than the wider economy. Since the oil price fall, the sector has contracted by 0.6% a quarter and in turn has fed through to the wider economy. As a rule of thumb, a £10 million reduction in output in the oil and gas supply chain will result in an additional £5-7 million reduction in output from the wider economy.

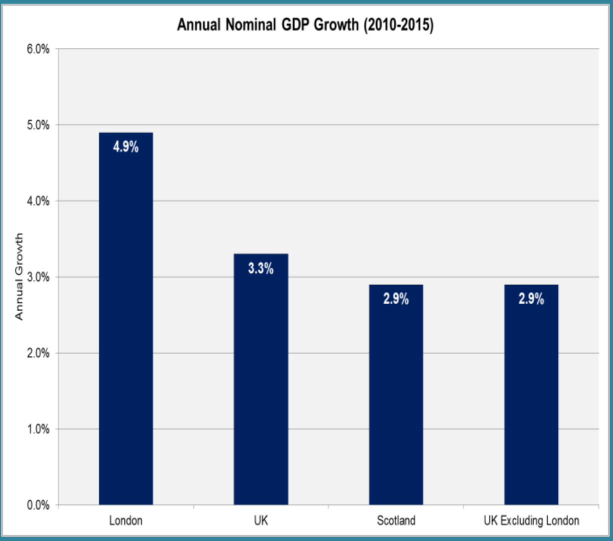


These effects explain much, but not all, of the slowdown in the Scottish economy in 2016. The chart above compares Scottish GDP growth in 2014 (the point when the oil and gas industry started to slow) and 2016. It shows that the slowdown in the oil and gas supply chain, and the feed through to the wider economy, accounts for around two thirds of the slowdown in growth between 2014 and 2016.

Economic Performance – Scotland, UK and London

On many economic indicators, Scotland's performance is compared to the UK as a whole. This reflects the fact that the data are generally produced on a comparable basis and to a similar timetable.

On some economic indicators, levels of economic performance vary significantly across the countries and regions of the UK. In particular, some UK economic statistics are skewed by the impact that London has on aggregate UK indicators. For example, productivity in every part of the UK outside of London and the South East is below the UK average owing to the fact that London's productivity is nearly 40% above the UK average.



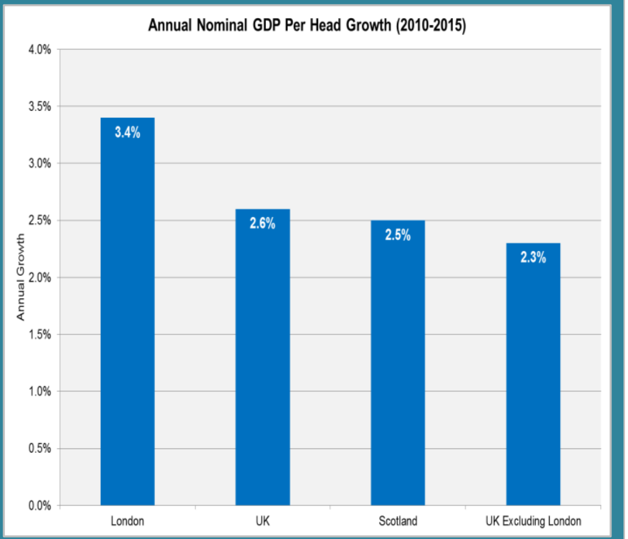
This reflects the fact that London's economy, as a global financial, economic and political hub, and the subsequent scale and pace at which it can attract drivers of productivity, make it distinct from the rest of the UK.

This box summarises new analysis by the Scottish Government, drawing on a range of recently published statistics, to quantify the impact that London has on various UK economic statistics and compares Scotland's performance to both the UK total and the UK excluding London.

GDP Growth[1]

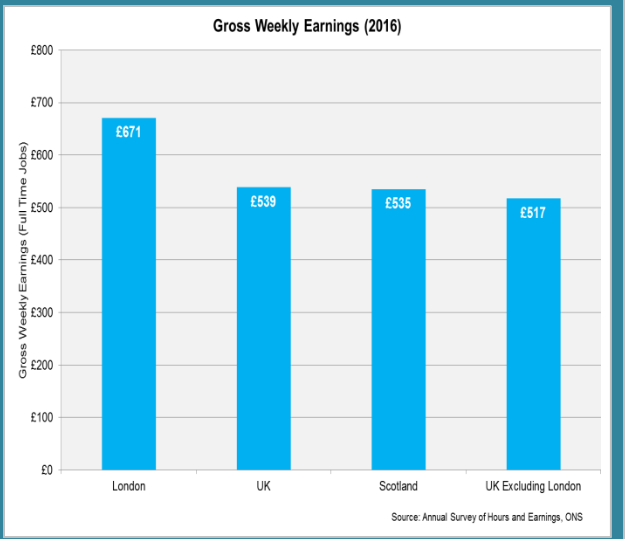
Gross Domestic Product (GDP) growth is among the most frequently cited metrics for economic performance. Regional Accounts statistics published by the ONS enable comparisons of GDP growth in nominal terms between different parts of the UK. The figures are not as timely as the Scottish GDP statistics published by the Scottish Government. However, calculations based on them do allow the effect of London on the UK aggregates to be assessed. The chart above shows that annual GDP growth in Scotland between 2010 and 2015 has been slightly slower than the UK average, but has been in line with the UK average when London is excluded. The chart shows that growth in London has been significantly higher than the UK average.

GDP Per Head Growth



Some of the difference in GDP growth across the UK is attributable to variations in growth in the working age population. One way in which this effect can be accounted for is by looking at growth in GDP per head. The chart on the right shows average nominal growth in GDP per head between 2010 and 2015. The results show that London's performance is significantly higher than the UK average, although the gap is smaller than for growth in overall GDP. Scotland's performance is broadly in line with the UK as a whole and higher than the average for the UK when London is excluded.

Earnings and Tax Receipts

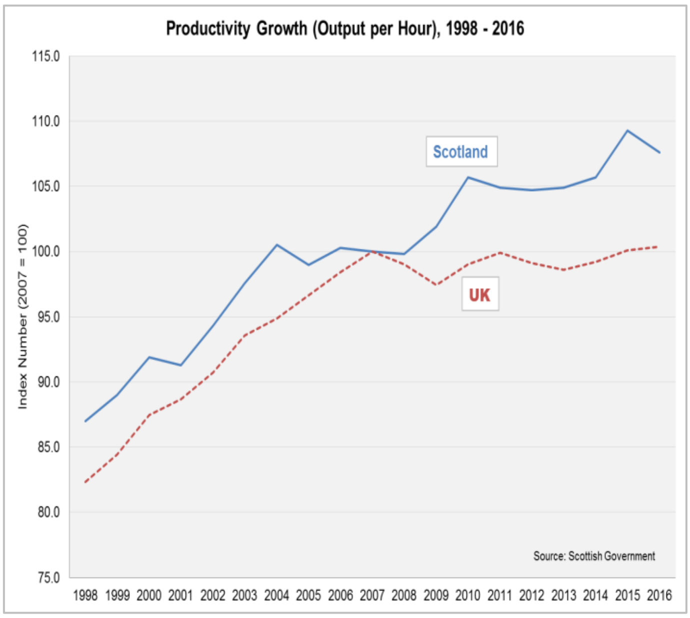


The variations in earnings between London and the rest of the UK reflect the above GDP trends. Average earnings in London are 25% higher than the UK average. This will partly reflect higher financial costs of living in London, and in particular the cost of housing. In contrast, earnings in Scotland are in line with the UK as a whole, and approximately 3% higher than the UK average when London is excluded.

A similar gap is observed in income tax receipts. Income tax receipts per person in Scotland (£2,600) and the rest of the UK outside of London (£2,300) are around half the level observed in London (£4,600).

[1] Analysis refers to GDP in basic prices based on: ONS Regional gross value added (income approach), UK: 1997 to 2015 https://www.ons.gov.uk/economy/grossvalueaddedgva/bulletins/regionalgrossvalueaddedincomeapproach/december2016 and Quarterly National Accounts Scotland http://www.gov.scot/Topics/Statistics/Browse/Economy/QNA2016Q4

Labour Productivity



Labour productivity measures the level of output produced per hour worked and is an important indicator of economic performance.

Year on year changes in labour productivity can be relatively volatile. In 2016, Scottish labour productivity fell by 1.5%, reflecting average hours worked growing more rapidly than GDP. The growth in hours worked reflects, in part, an increase in the proportion of the workforce working full time.

Over the longer term, labour productivity has continued to grow strongly in Scotland. Since 2007, labour productivity in Scotland has grown by 7.6% whereas UK productivity has grown by 0.4% over the same period. As a result, the historical gap in productivity between Scotland and the UK has closed, with Scotland's productivity now essentially matching the UK as a whole.

Labour Market

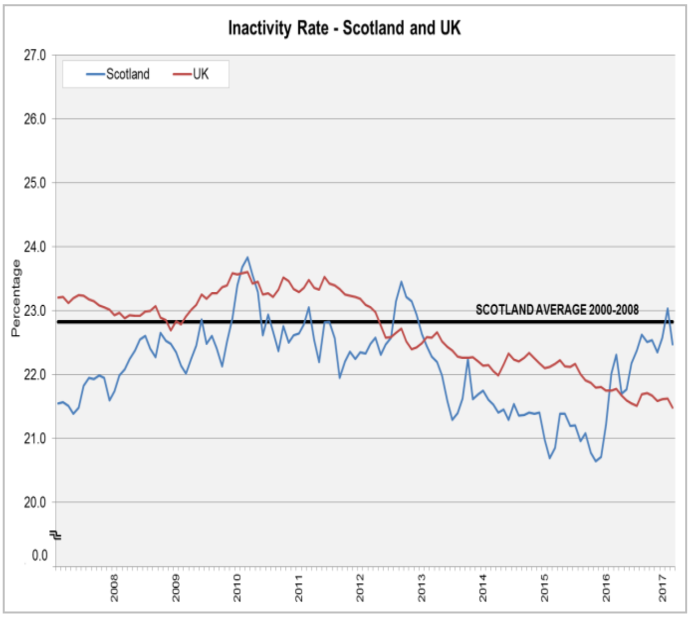
In contrast to weaker output growth in 2016, Scotland's labour market has proved more resilient with unemployment falling over the year and employment increasing.

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*	74.0%	0.3	0.9	Total Employment^	2,620,000	5,000	41,000
ILO Unemployment**	4.4%	-0.5	-1.7	ILO Unemployment^	120,000	-14,000	-48,000
Economic Inactivity*	22.5%	0.1	0.5	Economic Inactivity^^	767,000	4,000	15,000
UK				UK			
Employment*	74.8%	0.2	0.6	Total Employment^	31,947,000	122,000	381,000
ILO Unemployment**	4.6%	-0.2	-0.5	ILO Unemployment^	1,541,000	-53,000	-152,000
Economic Inactivity*	21.5%	-0.1	-0.3	Economic Inactivity^^	8,829,000	-40,000	-82,000
*Denominator = Working age population (16-64) **Denominator = Total economically active				^All persons ages 16+ ^^All persons aged 16-64			
Source: Labour Force Survey (January – March 2017)							

Latest data for January to March 2017 show that the number of people in employment rose over the past year, with the employment level now 56,000 above its pre-recession peak. The employment rate now stands at 74.0%, above the average employment rate since 1999 (72.3%).

Scotland's unemployment rate has fallen over the year from over 6.1% at the start of 2016 to 4.4% at the start of 2017. This is below the rate in the UK as a whole and in the majority of OECD countries.



Whilst the unemployment rate has fallen, there has been a rise in economic inactivity over 2016, reflecting an increase in the number of individuals who are not in employment and are not actively seeking a job. This can be for a wide range of reasons including; retirement, higher education, looking after family/home and long term sickness.

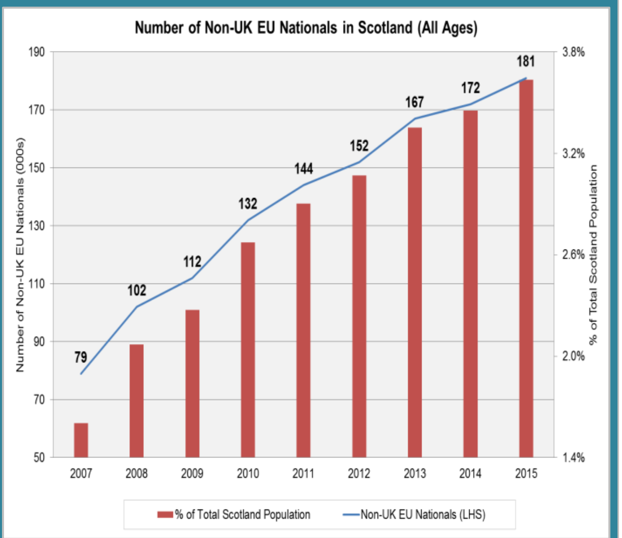
Over the year to January to March 2017, the number of people economically inactive in Scotland increased by 15,000 with the inactivity rate rising to 22.5%. Using the latest available data on reasons for inactivity, for January to December 2016, the reasons cited for the increase in the level of economic inactivity were looking after family followed by long term sickness.

Immigration and Scotland's Economy

The Scottish Government recently published new analysis of EU nationals living and working in Scotland[2].

The analysis shows that in 2015 there were 181,000 non-UK EU nationals living in Scotland, representing 3.4% of the population. The number of EU nationals living in Scotland has increased significantly over recent years, more than doubling since 2007.

There are a number of differences in the make-up of the EU nationals in Scotland compared to the population as a whole.

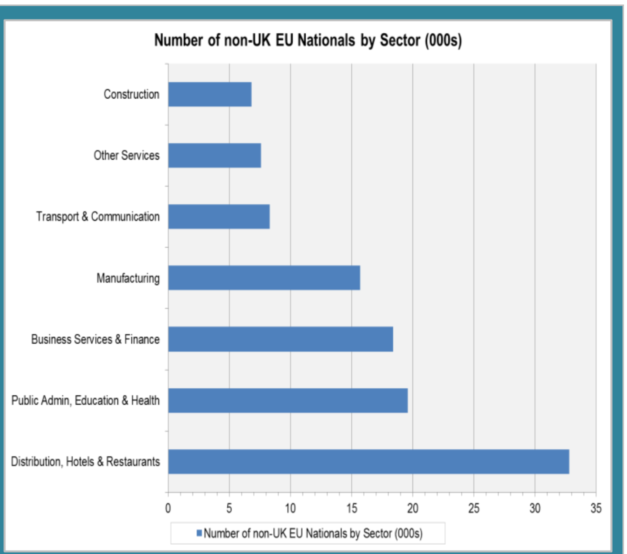


Firstly, EU nationals are generally younger. Nearly half of EU nationals in Scotland are aged 16-34 whilst around a quarter of the overall Scottish population is in this age group.

With Scotland's population aging, being able to attract and retain younger workers is important to ensuring that companies have access to the staff they need to operate and expand their businesses and mitigating the effect of this demographic change.

[2] http://www.gov.scot/Topics/Statistics/Browse/Labour-Market/Publications/EUnat

Secondly, EU nationals are more likely to be in employment. In 2015, the employment rate for EU nationals was 78.9%; this was higher than the overall employment rate for Scotland (73.1%). EU nationals also had a lower inactivity rate (16.2% vs. 22.3%) than Scotland as a whole.

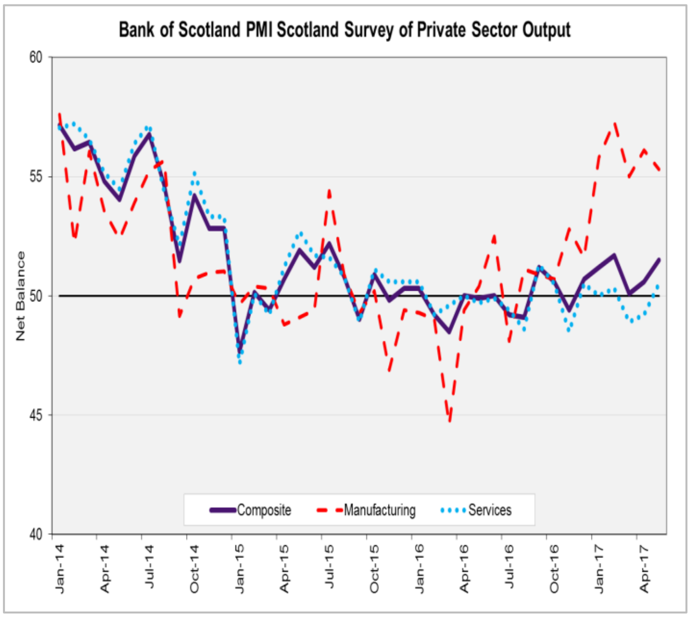


EU nationals are also more likely to hold degree level qualifications. Over a third of EU nationals hold degrees, compared to just over a quarter of the wider population in Scotland.

EU nationals work right across the Scottish economy. However, they are generally concentrated in three main sectors: Distribution, Hotels & Restaurants (28.6% of all non-UK EU nationals in employment), Public Admin, Education and Health (17.1%) and Banking Finance and Insurance (16.0%). However, when looking at sectors most dependent on the work of non-UK EU nationals, Manufacturing comes out on top with 7.1% of all employment in the sector being accounted for by non-UK EU nationals.

Business Sentiment

Over the last three months (March to May), the Bank of Scotland Purchasing Manager's Index composite output measure has averaged 50.7 signalling marginal expansion in Scotland's private sector.

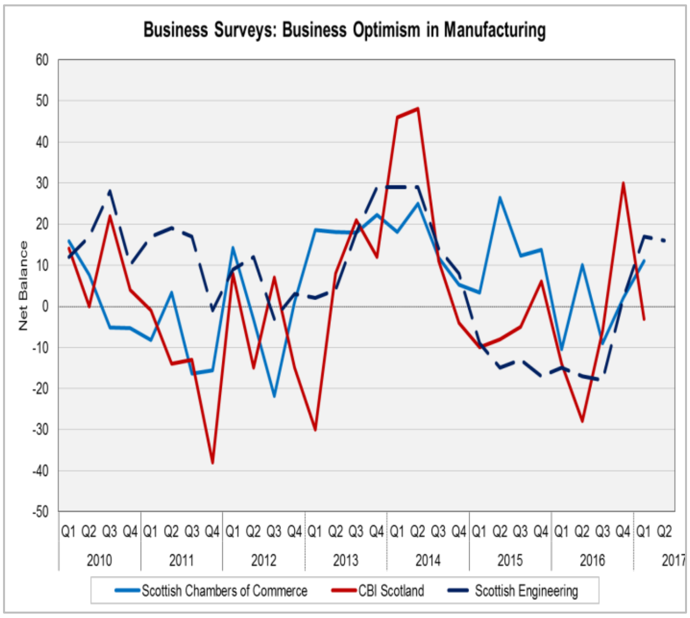


This expansion has been driven by growth in the manufacturing sector which has offset more subdued signals from the services sector.

Scottish buisness surveys more broadly have signalled a rebound in business sentiment in the second half of 2016 and into 2017, particularly in the manufacturing sector.

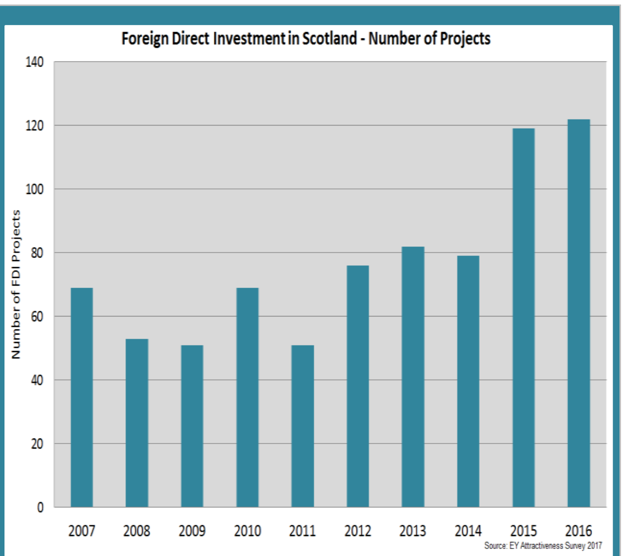
This has been assisted by the lower value of Sterling supporting an uptick in new orders from export markets alongiside more positive signals emerging from the oil and gas sector.

Whilst firms have signalled an increase in staffing levels to accommodate this higher demand, the lower value of Sterling has also generated inflationary input cost pressures, which firms are in part passing on to customers in higher output prices.



Overall, survey responses are signalling that despite challenging business conditions and with inflationary pressures impacting profits and cash flow, Scotland's private sector remains broadly optimistic about the economic outlook. This is reflected in indicators on investment expectations which have picked up for the second half of 2017 as firms expect to invest more in staff training and increase capital investment. However, sectoral differences remain, with Scotland's manufacturing sectors appearing more optimistic about future prospects in comparison to their service sector counterparts.

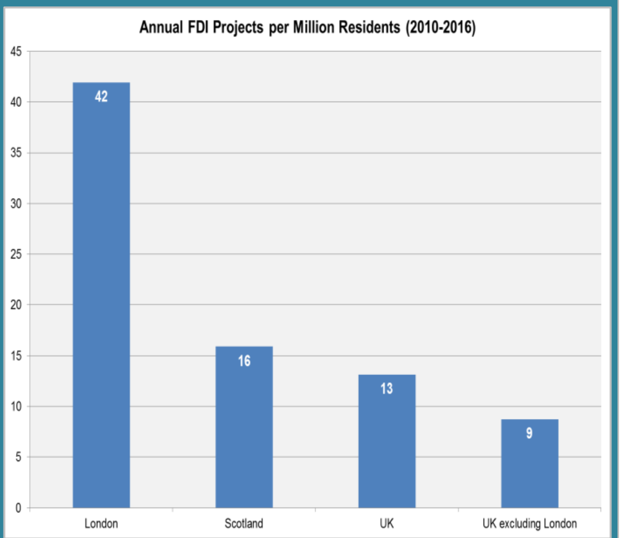
EY Scotland Attractiveness Survey 2017



The latest EY Scotland Attractiveness Survey showed that in 2016, Scotland secured 122 Foreign Direct Investment projects, the most projects Scotland has secured in the past decade.

Scotland is one of the top performers in the UK when it comes to FDI. In each year since 2012, Scotland has secured more FDI projects than any other part of the UK except for London.

As the number of projects secured has grown over the past decade, so too has the diversity of projects into Scotland. In 2016, 14% of projects secured were in Business Services, followed by 11% in Construction. 11% of projects secured were in the Software sector with Scotland attracting the most Software projects of any region outside of London. Across all the sectors, in 2016 Scotland secured the highest number of research and development projects of all the regions of the UK.



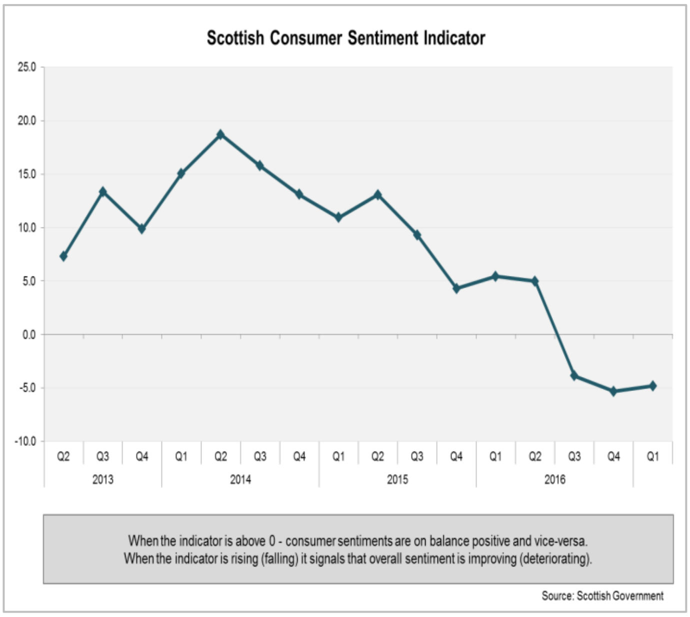
While the number of projects secured in 2016 was higher than in 2015, the number of jobs created from the projects fell, reflecting the smaller and more specialised nature of the projects attracted to Scotland last year.

As with indicators set out above, London's role as a global financial, economic and political hub means that it attracts the largest share of FDI projects. The chart above demonstrates that between 2010 and 2016, London secured on average 42 projects a year per million residents - three times the UK average. Scotland by contrast secured 16 projects per million residents on average, the second highest in the UK, albeit with a significant gap behind London. However, it is considerably higher than in the rest of the UK, with Scotland securing around 80% more projects per million residents than the UK as a whole excluding London.

Consumer Sentiment

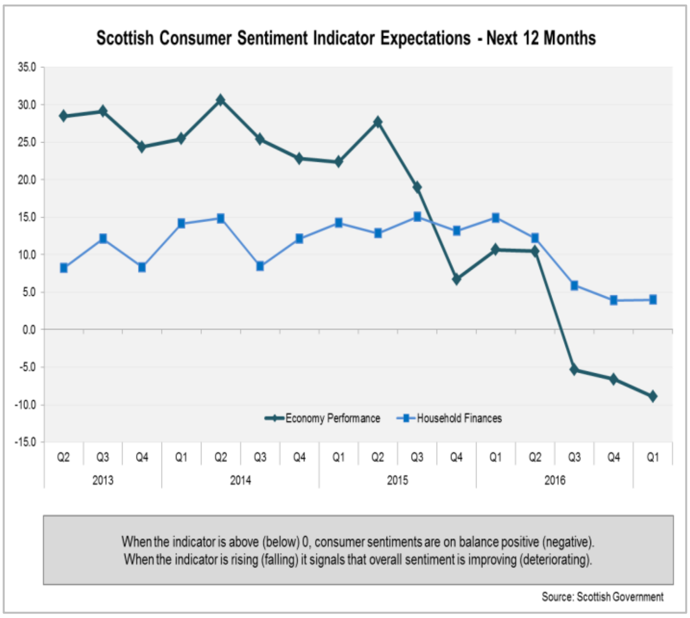
The Scottish Consumer Sentiment Indicator remained in negative territory in Q1 2017 for the third consecutive quarter.

As in recent quarters, underneath the headline indicator there is a significant difference between households perception of their personal financial position and their outlook for the economy as a whole.



The latest data for Q1 2017 shows that the economic outlook indicator has weakened to its lowest point since the series began in Q2 2013. In effect, a larger net balance of respondents than in previous quarters expect the economy to deteriorate over the next 12 months.

In contrast, the household finances outlook indicator has strengthened over the last quarter with a larger net balance of respondents expecting their household financial position to strengthen over the next 12 months.



This divergence between respondents views on their personal finances and the wider economy may reflect that they perceive issues such as Brexit and ongoing challenges in the oil and gas sector to continue having a negative impact on the Scottish economy over the next 12 months. However, the relatively resilient performance in the labour market may be supporting a more optimistic expectation for household finances.

With growth of around 1% expected in 2017 and the pick-up in inflation expected to squeeze on real income growth and household spending power, this may potentially start to re-align the indicators over the course of the year.

Retail Sales Index

The Scottish Retail Sales Index is a measure of the goods sold by retailers in Scotland. Data for Q1 2017 showed the volume of retail sales in Scotland decreased by 0.4% over the quarter (UK fell 1.4%) though grew 0.2% over the year (UK grew 2.1%).

The contraction in sales volumes at the start of the year was evident across all sizes of retail businesses in Scotland, with sales volumes from large retailers decreasing by 0.7% over the quarter and by 0.1% from small & medium size stores.

Low inflation had supported demand for retail sales growth through 2015 and most of 2016. However, rising inflationary pressures in the retail sector, coupled with weak consumer sentiment has potentially weighed on consumer's propensity to spend in recent quarters.

Scottish Economic Outlook

Looking ahead, the outlook for growth in 2017 remains positive but at below trend growth.

There are emerging signs that confidence is returning to the oil and gas sector which, coupled with the structural improvements made by the industry since 2015, will put it on a stronger footing to take advantage of the opportunities which will emerge as cyclical factors improve.

The low value of Sterling is expected to support export led growth for the manufacturing sector, whilst continuing to rebalance the economy as rising import prices feed through to higher inflation, impacting real income growth and household consumption.

Brexit continues to present a significant risk to business and consumer sentiment in Scotland with investment sensitive to changing market signals. The range of independent forecasts for Scotland suggest growth of between 0.9% and 1.3% in 2017.

Annual Output Growth Forecast (%)[3]	2016 (outturn)	2017	2018
Fraser of Allander Institute (Mar 2017)	0.4	1.2	1.3
EY ITEM Club (June 2017)	0.4	0.9	0.7
PWC (Mar 2017)	0.4	1.3	1.1

[3] The forecasts for the Scottish economy presented in this report are widely available in the public domain. 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.
Fraser of Allander Institute:
http://www.strath.ac.uk/business/economics/fraserofallanderinstitute/economic_commentary/latestcommentary/ ,
EY Scottish ITEM Club:
http://www.ey.com/uk/en/issues/business-environment/financial-markets-and-economy/ey-scottish-item-club-summer-update-2017
PWC:http://www.pwc.co.uk/services/economics-policy/insights/uk-economic-outlook.html.