



University of  
**Strathclyde**  
Business  
School

# Fraser of Allander Institute

## Economic Commentary

Vol 42 No 3



# Contents

## Economic Commentary

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**2**

Summary

---

**3**

At a glance

---

**4**

Outlook and  
appraisal

---

**5**

Global economy

---

**7**

UK economy

---

**9**

Scottish economy

---

**10**

Scottish economy  
dashboard

---

**13**

Scottish labour  
market

---

**17**

Focus: FAI Brexit  
survey

---

**18**

Our forecasts

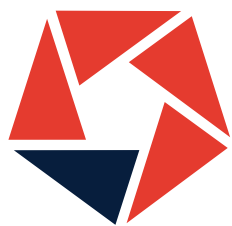
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Policy context

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

[www.fraserofallander.org](http://www.fraserofallander.org)



## Summary

After a sustained period of weak growth and despite ongoing political uncertainty, the Scottish economy has been showing some signs of strengthening.

This trend has continued over the summer.

As we discussed in our last commentary, in recent months we have seen evidence of a short-term pick-up in the rate of economic growth in Scotland.

Growth over the year to June 2018 – whilst still below average – was the fastest since late 2014/early 2015 and the Scottish economy has outpaced the UK for the last two quarters.

While we remain cautiously optimistic, growth is likely to remain below trend for the duration of our forecast horizon.

And overall, the immediate outlook for Scotland's economy remains highly uncertain.

On the one hand, wages across the UK have started to pick-up, whilst the global economy remains in strong health which should boost Scottish exports.

Tourism numbers continue to go from strength to strength. And the majority of measures of business confidence we track have been on the rise, albeit from very low levels.

On the other hand, despite being less than six months from the UK leaving the EU, the lack of clarity on the UK's future relationship with its largest external market continues to cast a shadow over the outlook.

As a result, whilst we are forecasting – in our base case – growth of 1.3% this year and 1.4% in 2019 and 2020, we would stress the heightened degree of uncertainty around such point estimates at the current time.

Our forecasts are based upon a broad-based agreement between the UK and the EU. Should this not happen, then our forecasts are likely to change significantly. With so many different factors – both economic and political – about what a 'no-deal' may look like, we have not forecast this scenario at this stage. An update will be provided in December when more details are known.

As we have argued before, in our view, a 'hard-Brexit' would act as a significant drag on Scotland's – and the UK's – economic potential.

Many of the impacts, such as weakened supply chains, reduced flow of skilled workers, trade barriers, and lower levels of international investment will set in gradually.

However, it is the risk of a 'no-deal' scenario that is of most concern in the immediate term. Whether you agree or disagree with the decision to leave the EU – or the final agreement the UK should negotiate with the EU – the need for an orderly transition is vital.

As both the Chancellor of the Exchequer and the Governor of the Bank of England have agreed, a 'no-deal' outcome would cause hardship for many firms, workers and families across the UK.

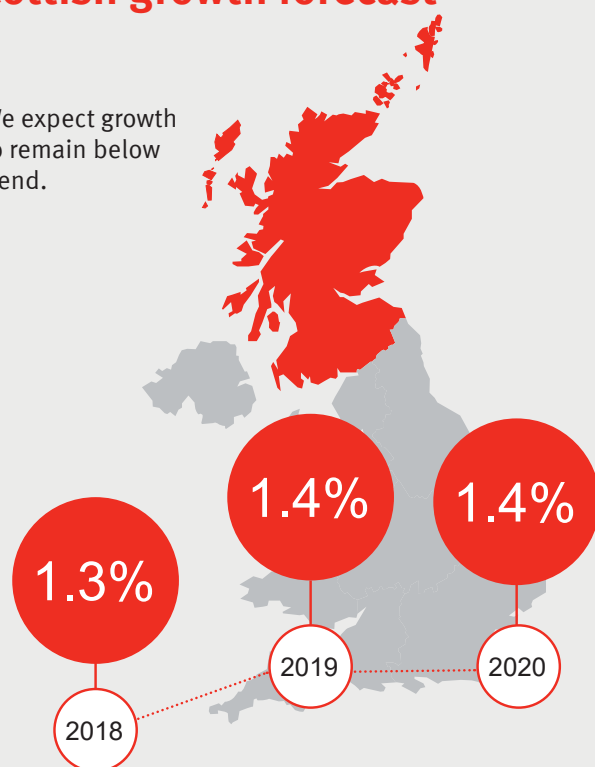
Sleepwalking into a 'no-deal' outcome cannot be viewed as an effective economic plan.

Now is the time for effective and strong leadership from all our political leaders.

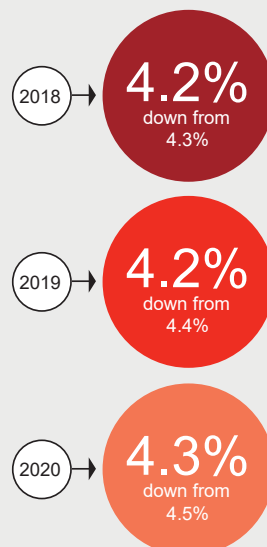
Fraser of Allander Institute  
September 2018

## Scottish growth forecast

We expect growth to remain below trend.



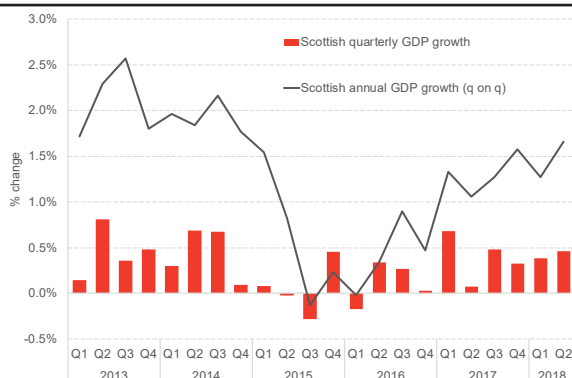
## Unemployment forecast



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# At a glance

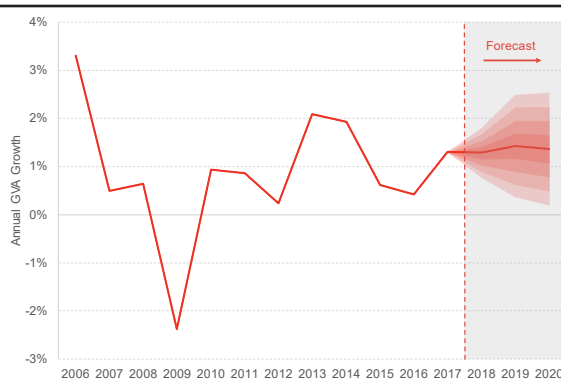
**Chart:** Scottish growth (since 2013) – year and quarter



**Chart:** Employment & unemployment rates, May - July 2018

	Employment (16-64)		Unemployment (16+)	
	Rate (%)	Year Change	Rate (%)	Year Change
Scotland	75.1%	▼	4.1%	▲
England	75.8%	▲	4.0%	▼
Wales	74.8%	▲	3.8%	▼
N. Ireland	69.3%	▲	4.0%	▼
UK	75.5%	▲	4.0%	▼

**Chart:** FAI forecast Scottish economic growth range



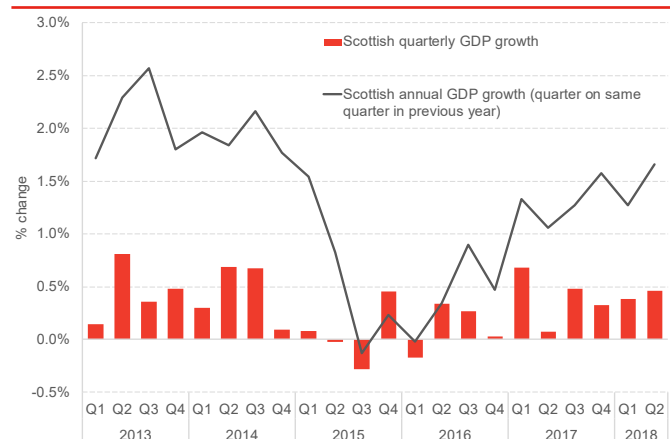
**Table:** FAI forecast Scottish economic growth (%), 2018 – 2020

	2018	2019	2020
<b>GDP</b>	<b>1.3%</b>	<b>1.4%</b>	<b>1.4%</b>
Production	1.5%	1.6%	1.5%
Construction	1.0%	1.1%	1.0%
Services	1.2%	1.4%	1.3%

# Outlook and Appraisal

As we argued back in June, there have been welcome signs of a gradual pick-up in activity in the Scottish economy after a sustained period of weak growth. Indeed, the most recent data point to Scotland's economy outpacing growth in the UK as a whole. These figures are clearly welcome, although below the surface businesses are becoming increasingly worried about the costs of a 'no-deal' Brexit.

**Chart 1:** Scottish growth since 2013, year and quarter



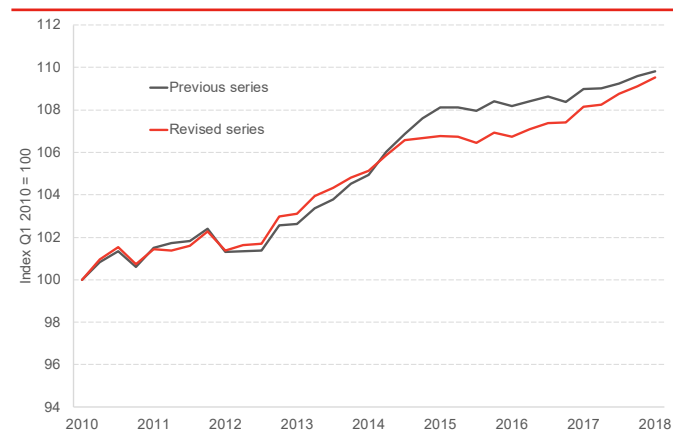
Source: Scottish Government & FAI calculations

**Table 1:** Employment & unemployment rates, May - July 2018

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UK	75.5%	▲	4.0%	▼

Source: ONS

**Chart 2:** Scottish economic growth revisions, 2010 – Q1 2018



Source: Scottish Government & FAI calculations

## Introduction

The Scottish economy grew by 0.5% in the 3-month period to June 2018 – ahead of the UK for the 2nd consecutive quarter. (Chart 1 and Chart 2)

Growth over the year was the fastest since late 2014/early 2015. Revisions for 2016 and 2017 lifted the official growth estimates much closer to our own forecasts. (Chart 3)

As outlined in June, we are slightly more optimistic about Scotland's near-term economic prospects than this time last year.

On balance, our central view is that the Scottish economy is showing greater signs of resilience.

Why?

First, whilst there is undoubtedly heightened uncertainty around Brexit, many businesses appear to be 'looking-through' such concerns and are getting on with day-to-day activities. But this is clearly fragile. And the apparent lack of contingency planning by many firms is a significant concern.

Second, the outlook for oil and gas – and its all-important supply chain – remains more positive than it has been in almost three years.

Third, there are signs that the recent upturn is relative broad-based with most sectors currently posting positive returns.

We forecast that growth will continue at around its current pace for the next 2 to 3 years.

Of course, some of this upturn is cyclical and follows a sustained period of weak growth. The greatest risk to this forecast is from a no-deal Brexit. Whilst not sharing some of the concerns of the most pessimistic commentators regarding the potential negative hit to the economy should this happen, we do think that a cliff-edge scenario would have serious short-term – and long-term – negative consequences for the Scottish economy.

**Table 2:** IMF forecasts for growth (%), 2017 (outturn) to 2019

	2017*	2018	2019
UK	1.7	1.4	1.5
US	2.3	2.9	2.7
Japan	1.7	1.0	0.9
Canada	3.0	2.1	2.0
Euro Area	2.4	2.2	1.9
Germany	2.5	2.2	2.1
France	2.3	1.8	1.7
Italy	1.5	1.2	1.0

\*Outturn.

Source: IMF

## The global economy

Whilst the pace of growth in the world economy has slowed slightly, particularly in emerging economies, the outlook remains robust.

Most predictions are for world growth to continue to be close to, or slightly above, average over the next couple of years. (Table 2)

The slight easing in world growth seems to reflect a movement toward a more balanced type of growth, rather than a more significant slowdown.

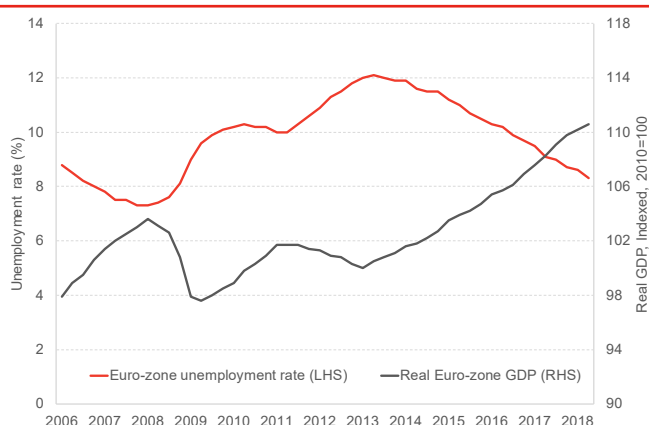
There has been a gradual shift toward more sustainable drivers of growth such as trade, investment and wages across most major economies.

At the same time, some structural problems – such as unemployment in Europe – whilst still significant, continue to be slowly addressed. (Chart 3)

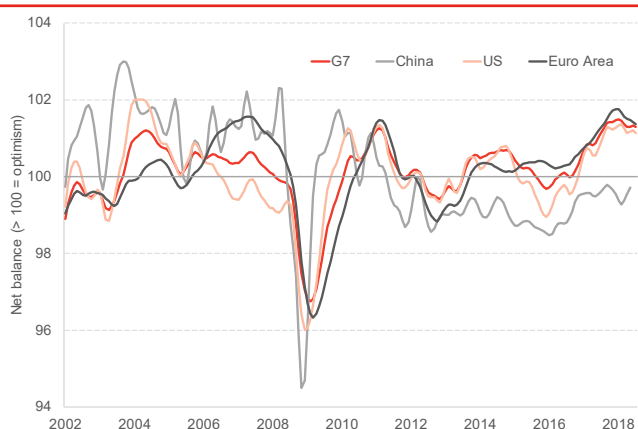
Overall sentiment and demand in Europe remains high and well ahead of the UK. (Chart 4)

Across the Atlantic, the US continues to power ahead driven by more confident households and increasing investment. President Trump's tax cuts have helped to provide a significant fiscal stimulus. (Chart 5). US unemployment is on track to fall to its lowest rate in around 50 years.

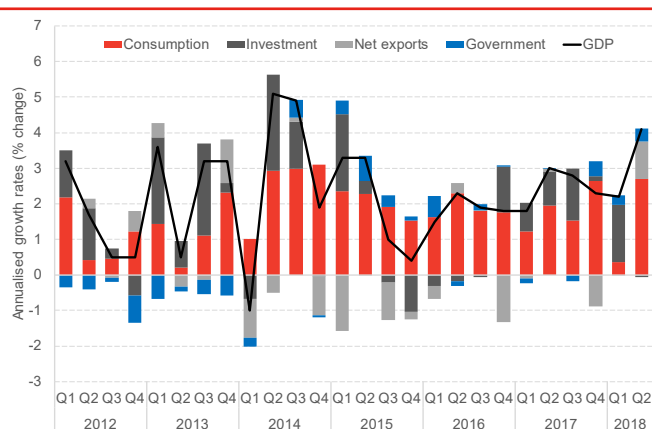
Without Brexit, such factors would be pointing toward a highly positive outlook for Scottish exporting firms over the next few months.

**Chart 3:** Euro-zone unemployment rate and real GDP since 2006

Source: Eurostat

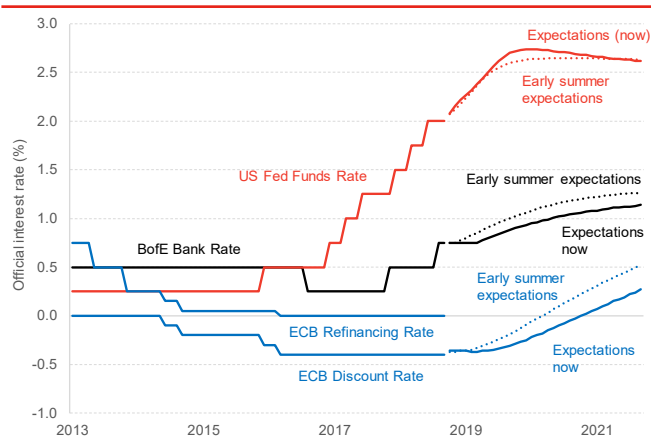
**Chart 4:** Business confidence in the UK's major markets

Source: OECD

**Chart 5:** Contributions to US growth, Q1 2012 – Q2 2018

Source: U.S. Bureau of Economic Analysis

**Chart 6:** Policy rates in UK, US and Europe, 2013 – 2021



**Source:** Thomson Reuters Datastream & FAI calculations

Of course, there are risks to this outlook.

The Trump administration's decision to increase tariffs on some European and Chinese imports, has escalated trade tensions.

The short-run impact of a trade war may be more modest than one might expect (relative to the geopolitical consequences). But the potential damage to long-run prospects for growth is a concern.

The strength of global growth has led to increased speculation about a gradual return to normality in interest rates. (Chart 6)

The US Fed increased rates by 25 basis points in June, with two further hikes pencilled in for 2018. The ECB plans to taper its QE programme, marking the first step in the unwinding of its emergency support efforts.

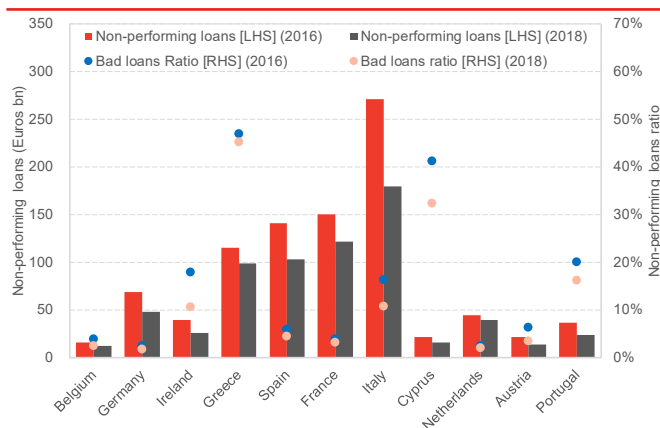
But a combination of fiscal consolidation, weak productivity, bad loans – Chart 7 – and demographics is likely to mean that the 'neutral interest rate' in most economies will remain lower than pre-crisis averages for at least a decade.

Equity prices have bounced back following their correction in February. Volatility has subsided and risk appetite has been strong. (Chart 8)

Consequently, overall financial conditions have remained highly supportive.

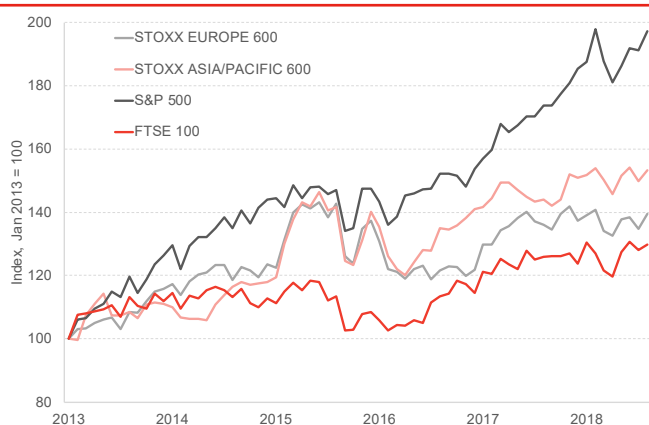
Our colleague Gary Koop has co-developed a financial accounting index which draws on data such as equity, corporate bonds and interbank spreads. It shows general financial conditions remain highly supportive. (Chart 9)

**Chart 7:** Bad loans in Europe, 2016 and 2018



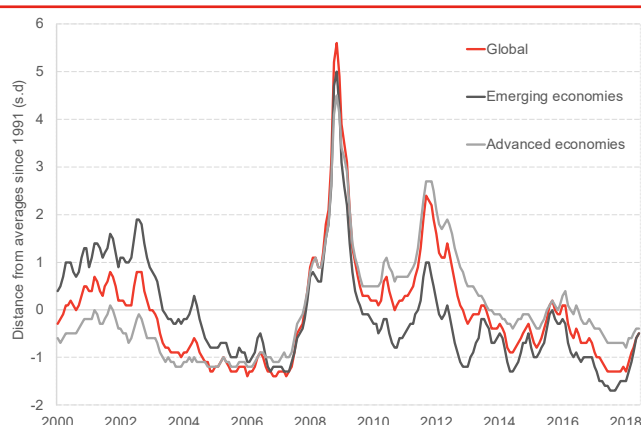
**Source:** European Central Bank

**Chart 8:** Stock market indices, Jan 2013 – Aug 2018



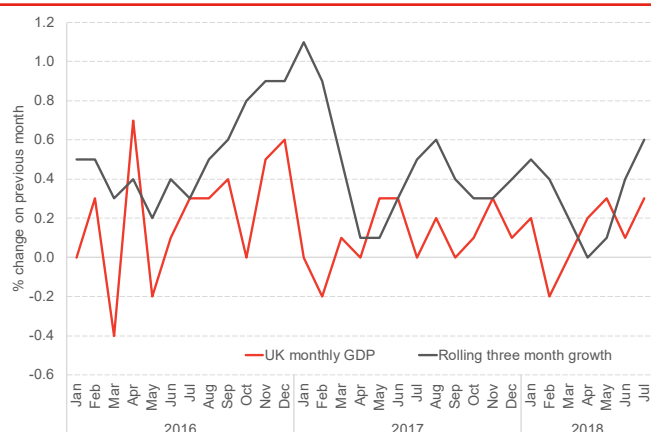
**Source:** Thomson Reuters Datastream

**Chart 9:** Koop and Koroblis Financial Conditions Index, 2000 – 2018 (values < 0 = supportive, values > 0 = restrictive)



**Source:** Bank of England

**Chart 10:** Monthly UK economic growth to July 2018



Source: ONS

## The UK economy

For the first time, in July the ONS published UK GDP on a monthly and rolling 3-monthly basis.

The results require careful interpretation.

Firstly, the latest UK figures might not always follow the ‘traditional’ calendar quarters of Q1, Q2 etc. So growth comparisons – including with Scotland – need to ensure a like-for-like basis. Secondly, month-to-month results will be volatile. (Chart 10). One-off events – e.g. weather – could have significant impacts on the headline results.

Up to July, rolling 3-month growth of 0.6% was the highest since last summer.

This pick-up follows a challenging start to 2018, and weak growth through 2017, when the UK lagged behind other G7 economies. (Chart 11).

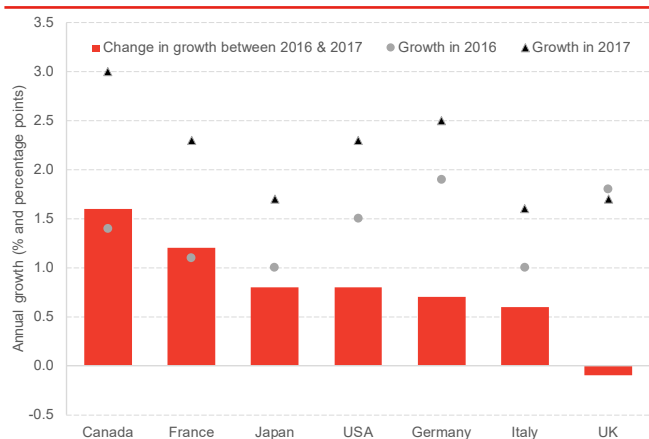
Within sectors, performance has been mixed. Manufacturing output fell over both the quarter and the year.

With manufacturing activity still lower than a decade ago, any hope of boosting exports substantially – and to the government’s target of 35% of GDP – is hugely optimistic. (Chart 12)

A strong performance from consumer facing activities, driven by factors such as the good weather, boosted the summer growth numbers.

The growth in consumer activity has also been boosted by an upturn in real earnings. But conditions remain challenging for many in the sector. Over the year to July, real terms regular earnings increased by 0.5%. (Chart 13)

**Chart 11:** Annual GDP growth in G7 countries, 2016 – 2017



Source: ONS & OECD

**Chart 12:** UK manufacturing output, Jan 2008 – Jul 2018



Source: ONS

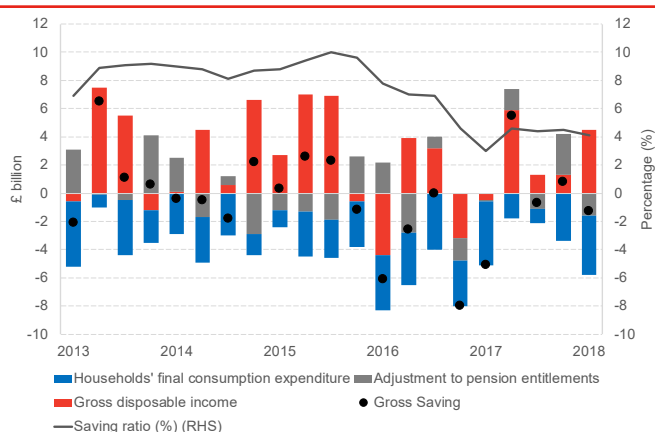
**Chart 13:** Real and nominal earnings growth, Jan 2007 - Jul 2018



Source: ONS

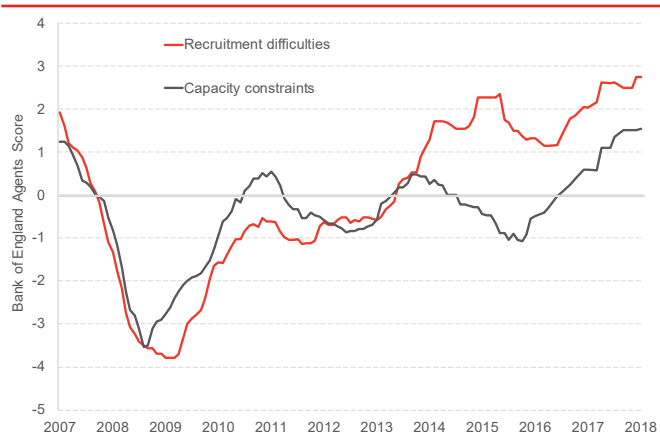


**Chart 14:** Contributions to the UK savings ratio, 2013 – 2018



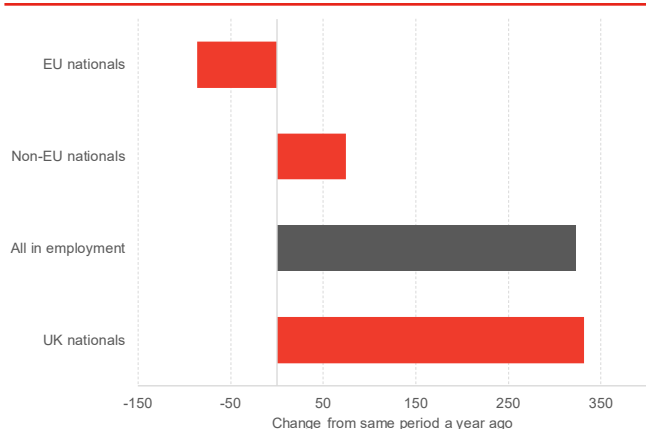
Source: ONS

**Chart 15:** Bank of England Agent Scores: capacity constraints & recruitment difficulties since August 2007



Source: Bank of England

**Chart 16:** Change over year in employment by nationality, Apr-Jun 2017 – Apr-Jun 2018



Source: ONS

That being said, average regular pay remains around £11 per week lower than prior to the financial crisis – and over £30 less when bonuses are included.

As a result of this squeeze, the UK savings ratio (the proportion of income not spent each quarter) is at its lowest level in over 50 years. (Chart 14)

Some of the rise in wages is undoubtedly driven by the tight UK labour market.

Unemployment of 4 per cent is the lowest since the winter of 1974-75.

Whilst welcome, there is increasing evidence that this is posing recruitment challenges and wider capacity constraints. (Chart 15)

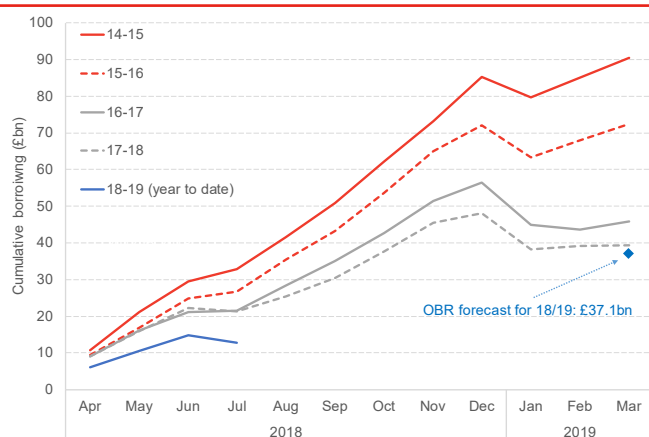
The number of people in work continues to grow, but there is also evidence of a fall back in the number of EU nationals in employment in the UK. (Chart 16)

Whether or not this is part of a 'Brexit effect' remains unclear. Reports from the Bank of England's network of agents suggests that companies are becoming more uncertain about the outlook, with a fall-back in investment intentions. Contingency planning, whilst modest, is intensifying.

This backdrop of fragility – albeit counterbalanced by positive indicators of current activity – will set the context for the upcoming 2018 UK Budget.

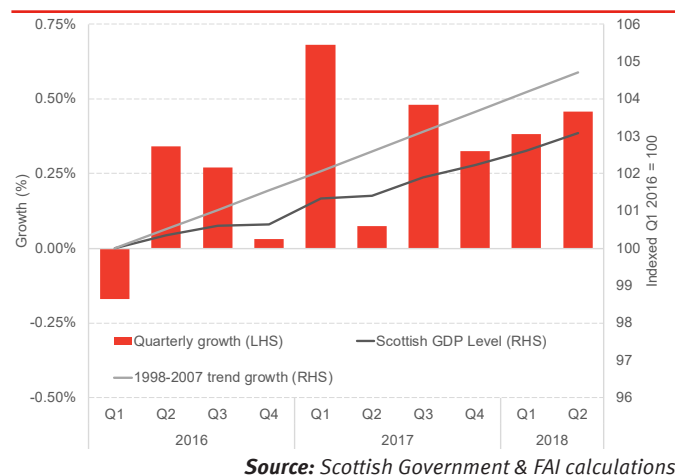
Whilst borrowing continues to fall (Chart 17), with debt still above 80% of GDP, and rising pressures on health and social care costs, the Chancellor does not have his challenges to seek.

**Chart 17:** UK public sector net borrowing by financial year, 2014/15 to 2018/19



Source: OBR

**Chart 18:** Scottish GDP since 2016



## The Scottish economy

The latest Scottish GDP growth figures were published last week (19th September). (Chart 18)

They showed a further pick-up in growth, with the Scottish economy expanding 0.5% over the 3-months to June. This followed revised growth of 0.4% in the first 3-months of the year.

These figures (consistent with the latest survey indicators) show further evidence of the first sustained period of expansion since the downturn in early 2015. Indeed, growth over the year to June 2018 was the fastest since late 2014/early 2015.

That being said, annual growth of 1.7% (quarter-to-quarter) and 1.4% (4Q-on-4Q), still lags Scotland's long-term historical growth rates.

The Scottish economy has outpaced the UK for the last two quarters and over the year as a whole.

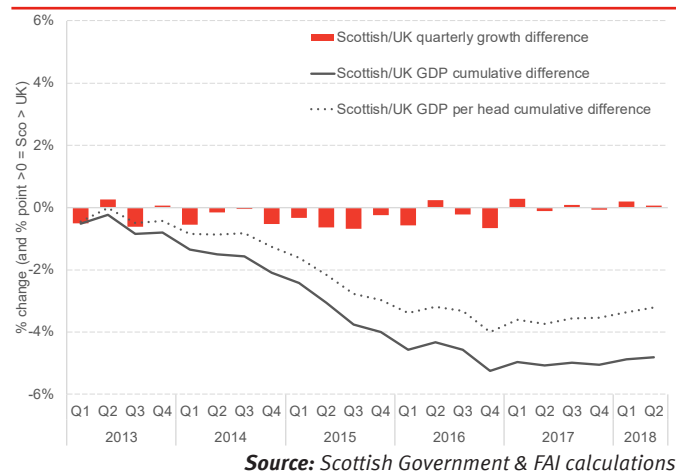
Some of this, reflects a degree of cyclical catch-up, with the UK having grown more strongly over the four years to late 2016, shown in Chart 19.

But the upturn has been broad-based. Over Q2, there was growth of 0.6% in production activities, 1.8% in construction and 0.4% in services.

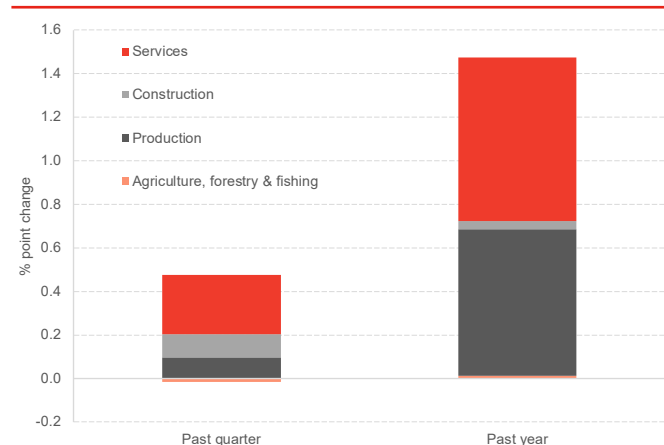
With services making up over 75% of activity – it is no surprise that Scotland's overall rate of growth has been shaped by services. (Chart 20)

Some of the improvement in the Scottish numbers undoubtedly reflects a more positive outlook for oil and gas than last year – albeit cutbacks continue to be made. (Chart 21)

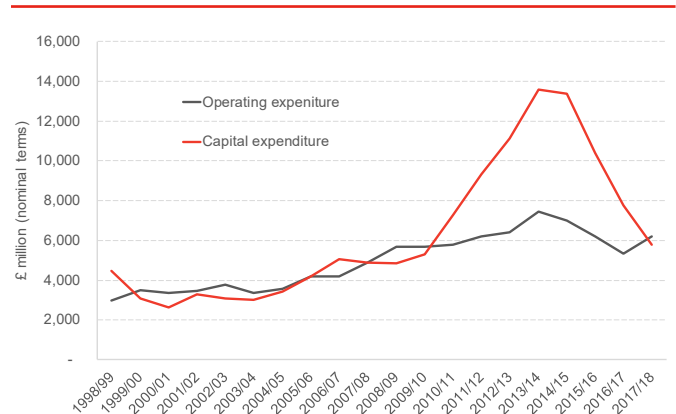
**Chart 19:** Scotland vs. UK economic growth since 2013







**Chart 20:** Composition of growth over year and latest quarter



**Chart 21:** Capital and operating expenditure in the North Sea, 1998-99 to 2017-18

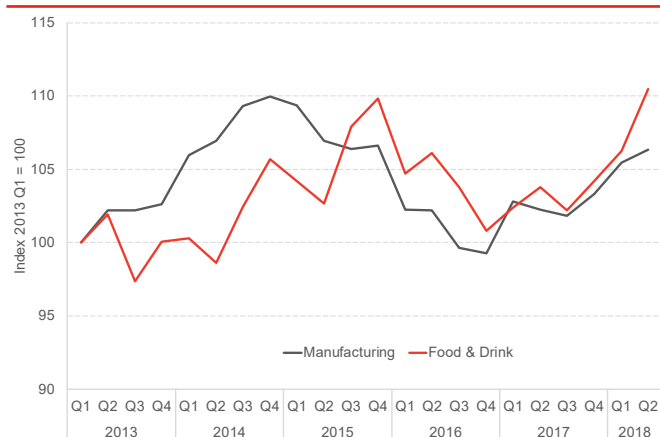


# Scottish Economy Dashboard

		% of Economy	Growth		Key issues/trends
			2017	Q2 2018	
	<b>Production</b>	<b>17%</b>	<b>1.9%</b>	<b>0.6%</b>	
	Manufacturing	11%	1.7%	0.9%	<ul style="list-style-type: none"> <li>Confidence and growth has returned recently – boosted by a more positive outlook for the oil and gas supply chain</li> <li>Exporters likely to continue to benefit from weak pound and strong global economy. But also most likely to be at risk from dislocation of UK-EU trade</li> </ul>
	Food and drink	3%	-0.7%	4.0%	<ul style="list-style-type: none"> <li>Sector continues to grow strongly – and is now at its highest ever level</li> <li>Growth potential is high, although boosting productivity in sector will be key for sustainability</li> <li>Future post-Brexit challenges could include ‘just-in-time’ deliveries and access to migrant workers</li> </ul>
	<b>Services</b>	<b>76%</b>	<b>0.9%</b>	<b>0.4%</b>	
	Retail and wholesale	10%	1.4%	1.1%	<ul style="list-style-type: none"> <li>Aggregate data suggests a recent upturn in sector activity</li> <li>Micro data suggests tough trading conditions, with many high-profile names on the high street struggling</li> <li>Rising wages could give some respite to a sector going through significant structural change</li> </ul>
	Accommodation & food services	3%	0.3%	-0.2%	<ul style="list-style-type: none"> <li>Mixed performance with growth over the year, but some fall-back in the most recent quarter</li> <li>Like retail, many casual eating and drinking establishments have been struggling. Changes in how households consume entertainment is impacting many business models</li> <li>Tourist faring elements of the sector continue to improve</li> </ul>
	Financial & insurance	6%	-1.3%	1.1%	<ul style="list-style-type: none"> <li>Relative modest output in this key sector of the Scottish economy</li> <li>Unlike other sectors directly exposed to the financial crisis – such as professional services and real estate – financial services has taken much longer to get back on its feet</li> <li>Uncertain future for financial services in relation to trading with Europe, even under the ‘Chequers’ plan</li> </ul>
	<b>Construction</b>	<b>6%</b>	<b>4.3%</b>	<b>1.8%</b>	<ul style="list-style-type: none"> <li>Significant revisions to official data paint a more positive picture for sector than before</li> <li>Uplift in public sector capital investment should help support infrastructure, but wider measures of activity – including commercial property and house-building – remain relatively subdued</li> </ul>
	<b>Agriculture</b>	<b>1%</b>	<b>4.5%</b>	<b>-1.2%</b>	<ul style="list-style-type: none"> <li>Sector grew in 2017 but is arguably most exposed to any hit to migration post-Brexit</li> <li>Sector will need clarity on support, opportunities and regulation post-Brexit to ensure growth can continue</li> </ul>



**Chart 22: Manufacturing and Food & Drink in Scotland, Q1 2013 – Q2 2018**



Source: Scottish Government & FAI calculations

But there is also increasing evidence of a wider recovery. For example, manufacturing grew by 0.9% over the quarter and by 3.2% over the year on 4Q-on-4Q basis.

A key driver of this has been the strong growth in Scotland's food and drink sector. The sector has grown 3.0% over the year on a 4Q-on-4Q basis to reach its highest ever level. (Chart 22)

Whilst electricity and gas supply activity has slipped back a little in the most recent quarter, growth was strong over the year buoyed by renewables output.

Within services, growth has been more modest but – for the most part – broadly positive. (Chart 23)

Retail and accommodation and food sectors have picked-up. Whilst positive, it is clear from wider indicators that such sectors continue to find trading conditions challenging.

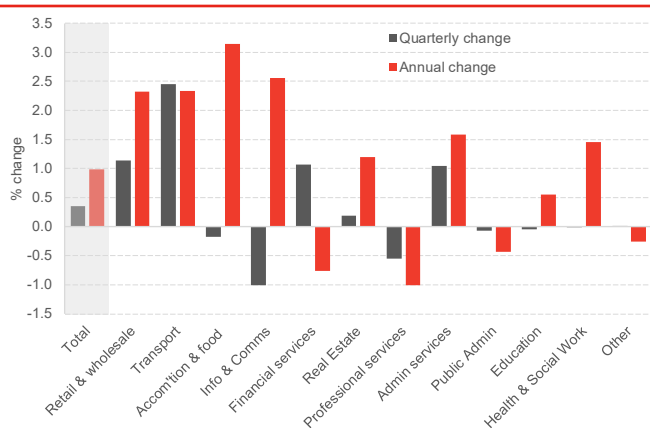
If the rise in earnings continues to build momentum, then this should provide some respite. However, many of the challenges that they face are more structural and relate to the way in which people now choose to consume such services (e.g. online retailing).

One sector which returned to growth was financial services, which grew by 1.1% in Q2.

But as Chart 24 highlights, the sector continues to lag behind its counterparts, such as real estate and professional services. (Chart 24)

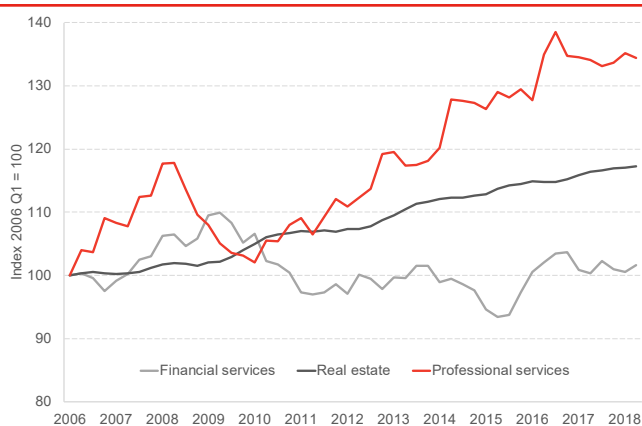
That said, Scotland's financial services industry appears to be no different in operating on a slightly smaller scale – post financial crisis – than the UK sector. (Chart 25)

**Chart 23: Growth in services over quarter and year**



Source: Scottish Government & FAI calculations

**Chart 24: Financial services in Scotland since the crisis**



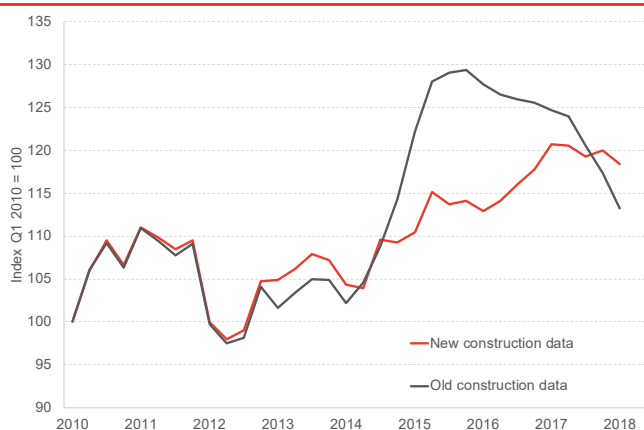
Source: Scottish Government & FAI calculations

**Chart 25: Financial services in Scotland since the crisis**



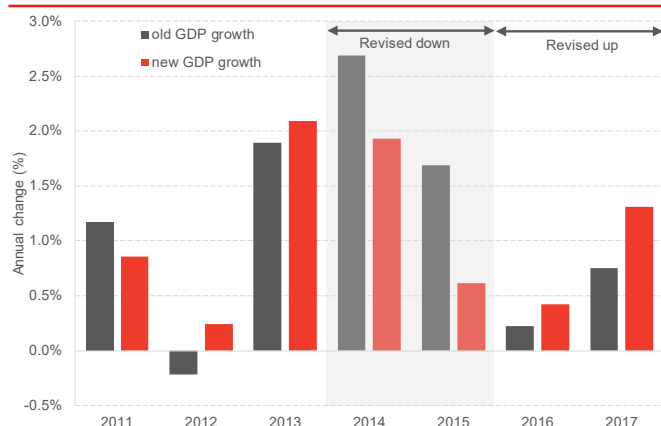
Source: Scottish Government, ONS & FAI calculations

**Chart 26:** Revisions to construction GDP, Q1 2010 = 100, Q1 2010 – Q2 2018



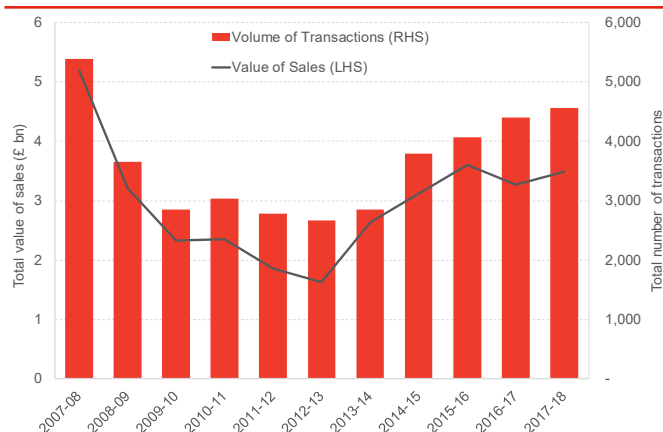
*Source: Scottish Government & FAI calculations*

**Chart 27:** Revisions to GDP growth, %, 2011 – 2017



*Source: Scottish Government & FAI calculations*

**Chart 28:** Commercial property transactions in Scotland, 2007-08 to 2017-18



*Source: National Registers of Scotland*

## Revisions to Scottish construction data

Back in June, we discussed the puzzling patterns in the Scottish construction series.

The official Scottish Government data had been showing a sharp rise in construction activity during 2014 and 2015 – by around 30% - before falling back in 2017 and 2018.

The scale of such changes was unprecedented.

The government had hypothesised that the figures were driven – in part – by a number of major infrastructure projects coming to an end (such as the Queensferry Crossing and M8 upgrade).

But even with expanded borrowing powers, and growing capital budgets, this was always difficult to reconcile with activity on the ground and what other data was telling us.

In August, the statistics were revised substantially (Chart 26). The official data now show construction growing since 2014, with only a modest decline in recent times.

As a result, even though construction accounts for just 6% of our economy, the revisions were of such a large scale that they changed the entire profile of growth in the Scottish economy. (Chart 27)

In June, the Scottish Government published growth estimates for 2017 of just 0.8%. Now that figure is 1.3%.

That being said, the changes do not alter Scotland's long-term growth profile (with GDP per head still rising by just under 2% over the decade).

Revisions are an important and necessary part of producing robust economic statistics. And there are advantages in making major changes to methodology at set points in time.

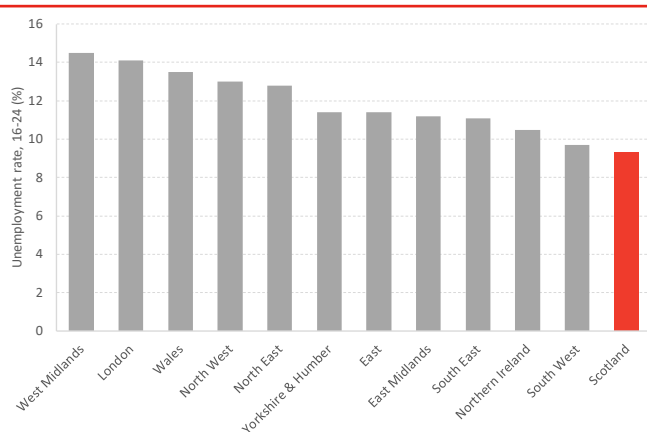
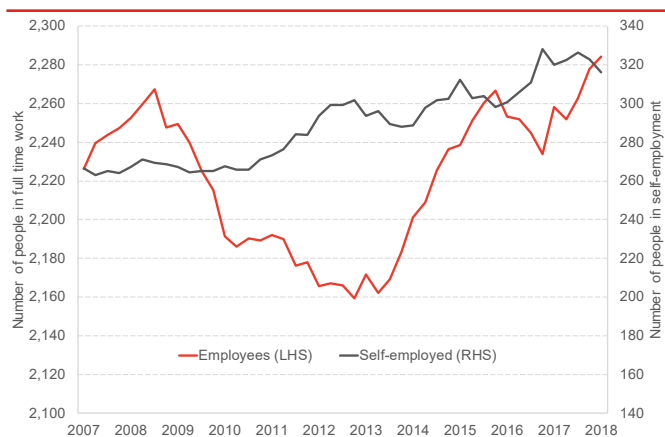
These data have wider implications with sustained weak economic performance unlocking emergency borrowing, depending on the performance of the economy.

So one lesson is perhaps the need to revise more quickly if the official methodology is clearly and *significantly* inconsistent with wider evidence.

Double checking a suite of data, e.g. commercial transactions, actual Scottish Government data on infrastructure spending, housing completions etc, should provide a more accurate picture. (Chart 28)

**Table 3:** Scotland and UK labour market, May - Jul 2018

	Employment rate (16-64)	Unemployment rate (16+)	Inactivity rate (16-64)
Scotland	75.1%	4.1%	21.7%
Quarterly change (pp)	-0.1	-0.2	0.3
Annual change (pp)	-0.8	0.3	0.5
UK	75.5%	4.0%	21.2%
Quarterly change (pp)	-0.1	-0.2	0.3
Annual change (pp)	0.2	-0.3	0.0

*Source: ONS, LFS***Chart 29:** 16-24 unemployment rate, Apr 2017 - Mar 2018*Source: ONS, APS***Chart 30:** Number of employees and self-employed in Scotland since 2007*Source: ONS, LFS*

## Scottish labour market

Unemployment in Scotland remains low and, taking the confidence intervals around headline estimates into account, effectively no different from the UK.

But over the last year, there has been a degree of weakening in labour market outcomes. Employment has fallen by around 40,000, whilst there has been a rise 7,000 in unemployment. (Table 3)

One big success story for the labour market in Scotland in recent years has been substantial drops in youth (16-24) unemployment. Scotland currently has the lowest 16-24 unemployment rate of anywhere in the UK. (Chart 29)

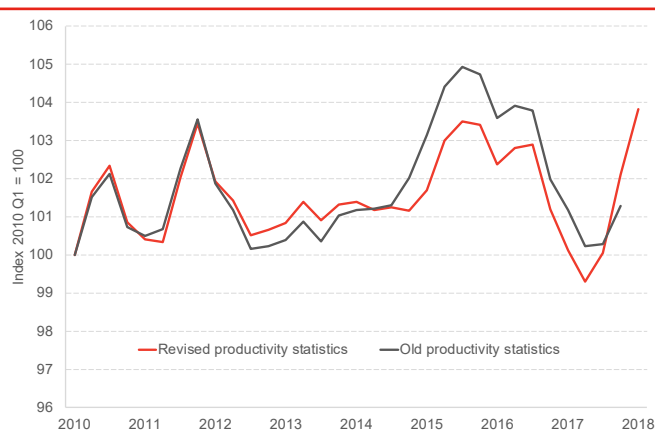
One feature we have discussed in past commentaries, has been the rise in part-time work and self-employment, with a corresponding relative squeeze on the number of full-time employees.

Interestingly, over the last year to 18 months this trend has eased. Instead, the number of employees has been on the rise, as has the number of full-time workers. (Chart 30)

The fall in employment, alongside the revisions to GDP growth by the Scottish Government, has led to a bounce back in Scotland's productivity numbers. Labour productivity in Scotland is nearly 4% higher than this time last year.

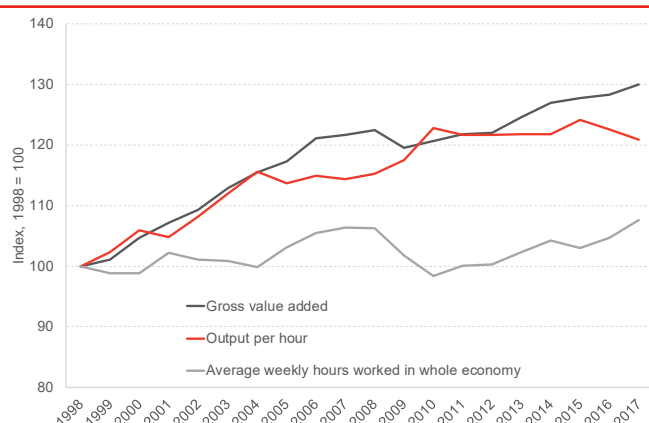
However, these revisions do little to alter Scotland's relatively weak track record in productivity – with last year's boost counterbalanced by weaker than before estimates for productivity in earlier years. (Chart 31)

As a result, productivity in Scotland is largely back at 2011 levels.

**Chart 31:** Revised productivity estimates, Q1 2010 – Q1 2018*Source: Scottish Government*



**Chart 32:** Components of Scottish Productivity, 1998 – 2017



Source: Scottish Government

Over a longer time horizon, productivity has lagged behind wider growth in the economy. The slack has been picked up by rising employment. (Chart 32)

But with an ageing population, employment at near record levels, and uncertainty over the future of migration post-Brexit, it is not difficult to see why turning around Scotland's productivity performance is so crucial to future prosperity.

Greater efficiency, not just in high value added sectors, but across our economy will be key. (Chart 33)

### Latest Scottish indicators

Over the summer, indicators of day-to-day activity in the Scottish economy have held up relatively well.

This backs up the assessment we made in June that, despite Brexit uncertainty, underlying economic conditions have strengthened a little. We retain that cautious optimism.

Some of this is undoubtedly tied to a more positive outlook for oil and gas. But there are also signs that activity has been stabilising or picking-up across the wider economy.

For example, at 55.5, the RBS Purchasing Managers Index (where >50 marks expansion; <50 marks contraction) is the strongest it has been in four years. Indeed last month's figure was the first time since July 2016 that Scotland outpaced the UK average. (Chart 34)

A similar rise in activity was found in the latest Quarterly Economic Indicator from the Scottish Chamber of Commerce.

All sectors were showing positive trading conditions and optimism in Q2 2018, with tourism once again leading the way. (Chart 35)

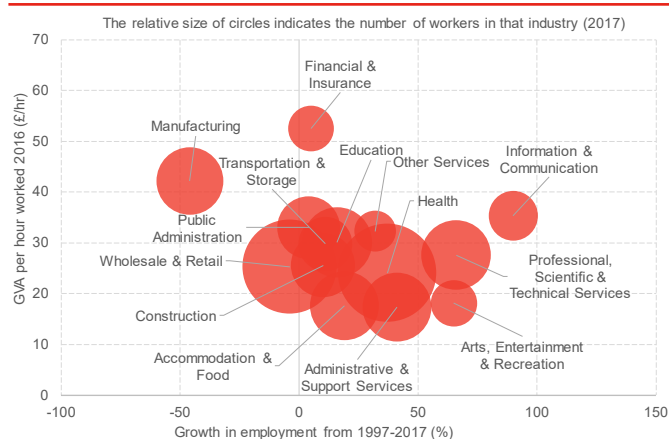
Our own Scottish Business Monitor – produced in association with RBS – highlights a similar picture.

The latest results for new and repeat business continue to grow. (Chart 36)

Optimism is also on the rise.

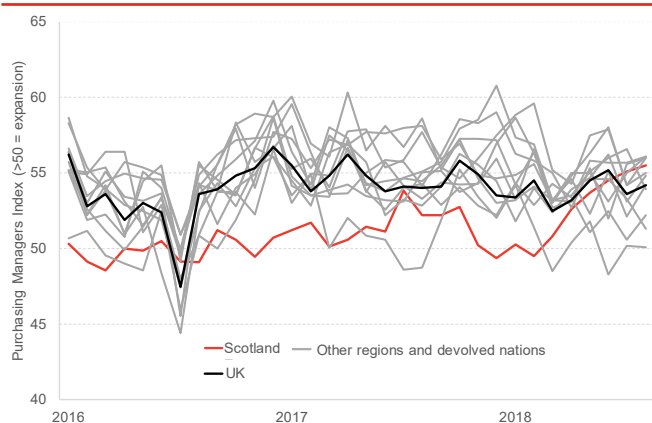
One exception to this was the latest Federation of Small Businesses Scotland confidence index which fell from plus 5.1 points to minus 13.2 points with Scottish businesses amongst the most concerned in the UK about a no-deal Brexit.

**Chart 33:** Growth in employment from 1997-2017 and GVA per hour worked in 2016, size of circle indicates the number of workers in that sector



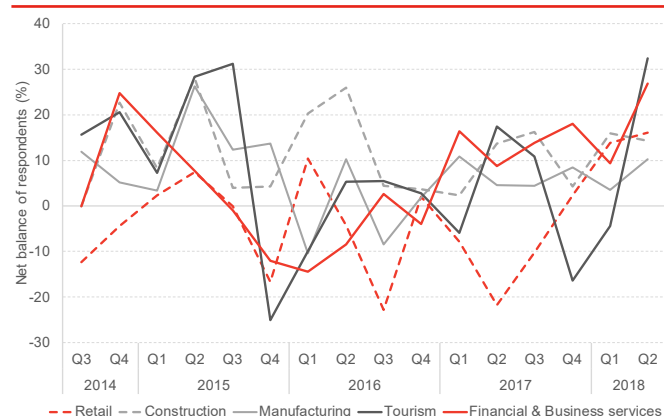
Source: ONS & FAI analysis

**Chart 34:** Royal Bank of Scotland PMI, Jan 2016 – Aug 2018



Source: Royal Bank of Scotland & IHS Markit

**Chart 35:** Quarterly Economic Indicator: business optimism, Q3 2014 – Q2 2018



Source: FAI & Scottish Chambers of Commerce

One advantage of our Business Monitor is the ability to track trends in activity over time. The survey has been running on a consistent basis since 1998. It therefore provides a valuable record of conditions in the Scottish economy.

Over time, we find that – on balance – most firms tend to report costs rising ahead of turnover. Clearly this cannot happen forever, and shows an inherent nervousness built into most firms' interpretation of current conditions (i.e. they tend to be more worried about costs rather than opportunities). (Chart 37)

What is revealing however, is where the gap widens and narrows and how closely this tracks Scotland's growth record. When the gap grows - e.g. 2008/09 and 2015/16 – growth slows. When the gap narrows, growth tends to pick-up.

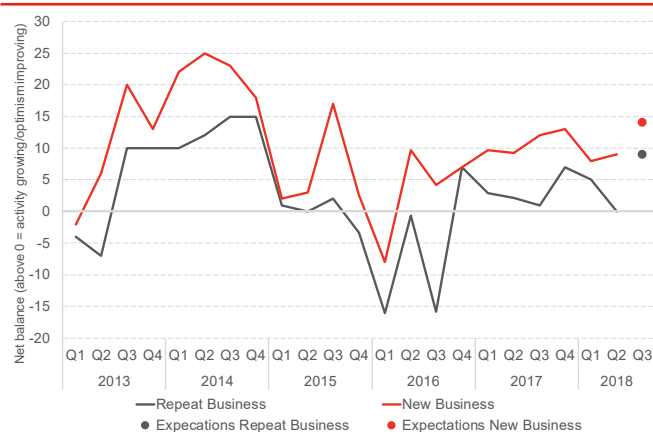
Another advantage of our Business Monitor, is the ability to track 'hot topics' over time.

Access to finance and access to workers is just one element. We find a sustained fall in the number of firms citing credit availability as an important issue for them (but rise in concerns over staff availability). (Chart 38)

One interpretation of these data is that the current period of heightened uncertainty is leading businesses to meet any increase in demand by taking on more workers, rather than investing in new plant and machinery.

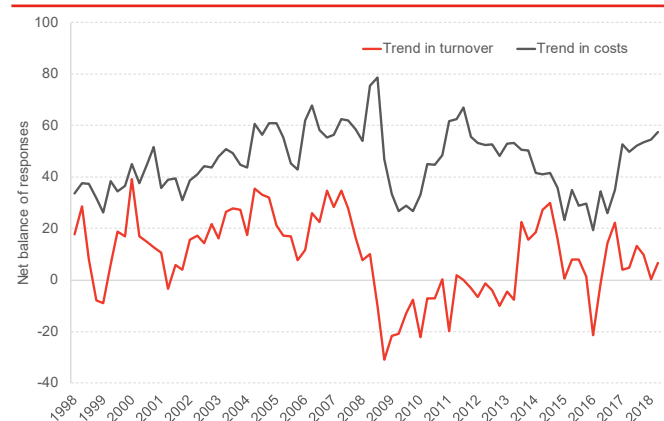
These data pose questions for recent efforts – such as the new Scottish National Investment Bank and British Business Bank – to boost the supply of finance. Our survey suggests that demand for credit is likely to be just as important.

**Chart 36:** Scottish Business Monitor: repeat and new business, Q1 2013 – Expected Q3 2018



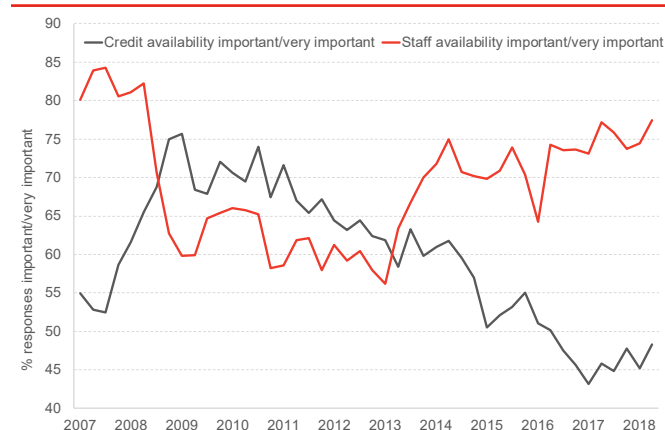
Source: FAI-RBS Scottish Business Monitor

**Chart 37:** Scottish Business Monitor: turnover and costs, Q1 1998 – Q2 2018



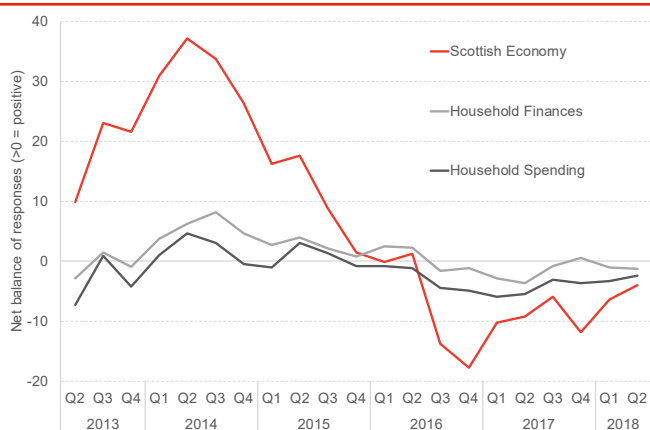
Source: FAI-RBS Scottish Business Monitor

**Chart 38:** Scottish Business Monitor: credit and staff availability important/very important, Q1 1998 – Q2 2018



Source: FAI-RBS Scottish Business Monitor

**Chart 39:** Consumer Sentiment Index current conditions: the economy, household finances and spending, Q2 2013 – Q2 2018



Source: Scottish Government

One area of ongoing fragility is around consumer and household confidence.

Scottish households' assessment of current conditions remains weak – although they have at least stabilised in recent times. (Chart 39 and 40).

For comparisons the GfK indicator for August 2018 was -13.

It would appear that the key driver of the slightly more pessimistic outlook is households' expectations for the economy.

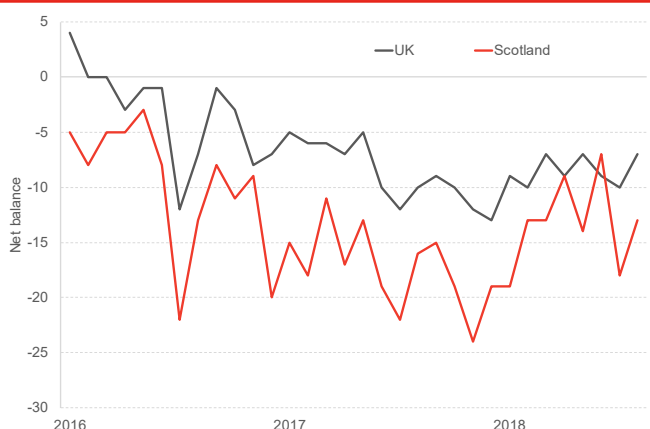
In contrast to their expectations for their own finances (which remain positive), an increasing number believe that the outlook for the economy is negative. (Chart 41)

The outlook for the labour market however, remains positive. (Chart 42)

The latest Royal Bank of Scotland Report on Jobs shows its headline indicator for labour market activity remains above its 12 month rolling average.

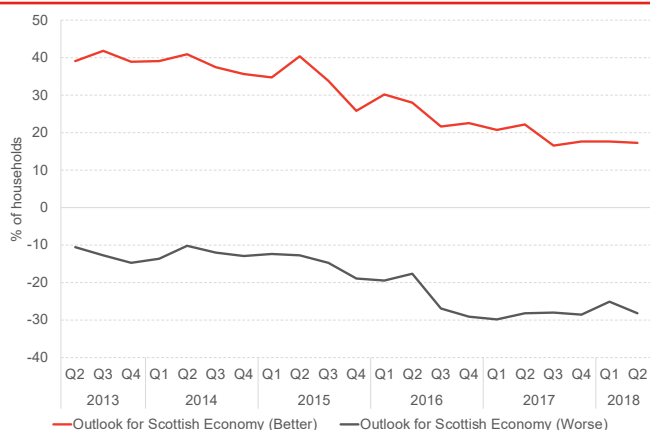
This should help – in time – put upward pressure on real wages, bolstering household incomes.

**Chart 40:** Consumer confidence in Scotland and the UK, Jan 2016 – Aug 2018



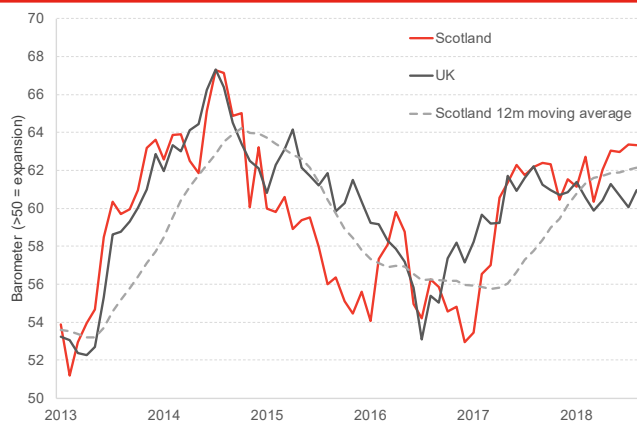
Source: GfK

**Chart 41:** Consumer Sentiment Index expectations: Scottish economy, Q2 2013 – Q2 2018



Source: Scottish Government

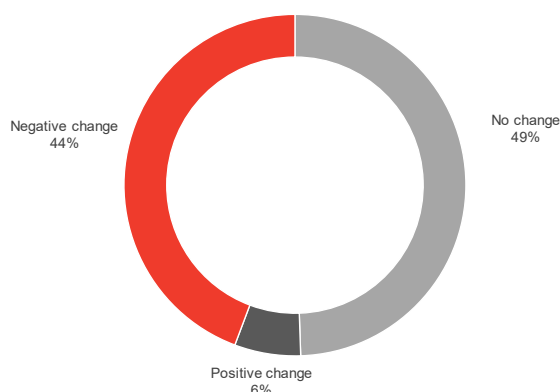
**Chart 42:** Jobs market indicator, Jan 2013 – Aug 2018



Source: RBS & IHS Markit

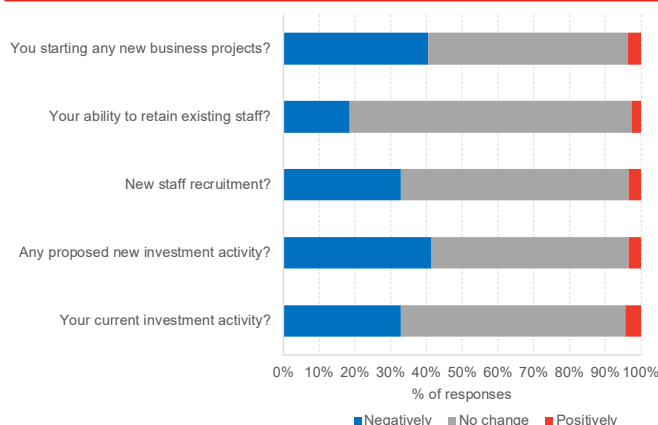


**Chart 43:** What has been the impact of the Brexit decision, to date, on your business?



*Source: Fraser of Allander Institute*

**Chart 44:** How has the Brexit decision affected...



*Source: Fraser of Allander Institute*

**Chart 45:** Do you feel that your business is prepared for Brexit?



*Source: Fraser of Allander Institute*

## Focus: FAI Brexit survey

In July, we undertook a survey of Scottish firms to assess their preparedness for Brexit. Over the course of the month we spoke to around 350 businesses from across the country and from a variety of different sectors.

The focus of the survey was not on whether or not businesses believe Brexit to be good or bad, but instead, how their preparatory plans were taking shape.

Around half of the businesses we spoke to said that the decision so far had no impact on their business activity. Only 6% said it had been positive, with 44% saying the impact had been negative. (Chart 43)

33% of firms said that it has had a negative impact on current investment activity (4% positive), with 41% saying that it has had a negative impact on new investment (3% positive).

33% indicated that it has had a negative impact on staff recruitment (3% positive). (Chart 44)

Brexit is happening, like-it-or-not. So it is vital that businesses prepare for such an eventuality. We asked firms about their preparedness for Brexit.

Only 38% said that they believed that they were prepared for Brexit. (Chart 45)

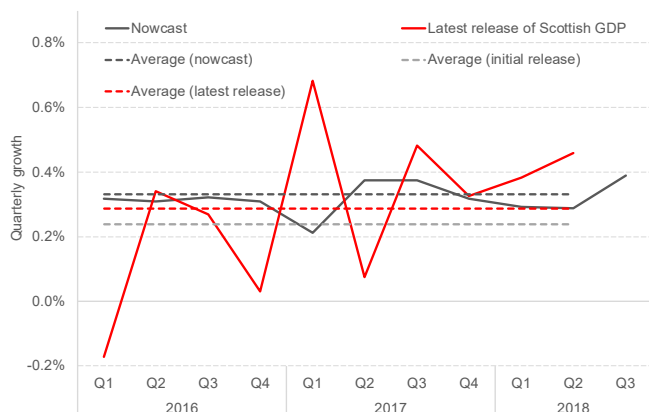
We also asked about the level of information that is available to them to make such preparations.

The overwhelming response was that there is not enough information currently available to enable them to plan for potential Brexit outcomes.

‘Uncertainty over the UK Government’s objectives in the negotiations’ was the most popular response amongst businesses (with over 59% citing this as a factor).

Finally, in terms of possible opportunities. Whilst 51% of business surveyed indicated that they did not see any immediate benefits, 28% of those surveyed believed that there might be benefits from moving away from EU regulations with 26% pointing to possible increased funding from the Scottish and/or UK Government in the future. Only 18% thought of opportunities in new markets outside the EU.

**Chart 46:** FAI nowcast and the latest release of Scottish GDP estimates, Q1 2016 – Q3 2018



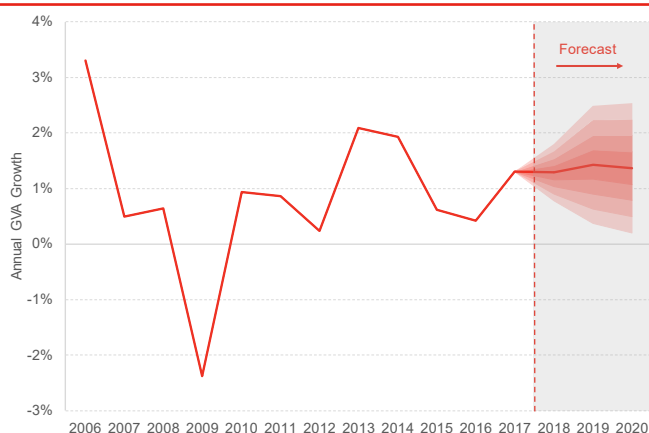
Source: Fraser of Allander Institute

**Table 4:** Nowcasts for Scotland's GDP in Q2 and Q3 2018

	Q2	Q3
Quarterly Growth	0.33%	0.39%
Annualised Growth	1.34%	1.57%

Source: Fraser of Allander Institute

**Chart 47:** FAI forecast Scottish economic growth range



Source: Fraser of Allander Institute

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

## Our forecasts

Chart 46 shows our latest nowcasts and also how they have tracked against the official data both before and after the recent revisions to the GDP series.

Our nowcasts do a much better job of tracking the revised estimates of GDP compared to the first estimates.

Last week's data, confirmed that growth continued into the 2nd quarter of 2018 picking up over the first three months.

As we have discussed before, quarterly results for Scotland can be relatively volatile given the size of the economy.

The latest results are therefore broadly consistent with our expectations for growth in 2018 that we first made back in 2017.

On balance, we believe that – setting aside any risks from the Brexit negotiations going awry – Scotland should be on track to grow at a broadly similar rate to last year (if not slightly faster). (Table 4)

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

It is important to note that such bands are based upon historical variations in our 'normal' forecasting performance. Looking ahead, the potential for a 'no-deal' Brexit outcome is clearly not a 'normal' event. Should this occur, an entirely new set of forecasts will be required. But with so much uncertainty over what this could mean – politically and economically – we have not published such an estimate at this stage. An update will be provided in December.

Overall, our base forecasts are very similar to June. (Table 4 and Chart 47)

**Table 5:** FAI forecast Scottish GDP growth (%) 2018 to 2020

	2018	2019	2020
<b>GDP</b>	<b>1.3%</b>	<b>1.4%</b>	<b>1.4%</b>
Production	1.5%	1.6%	1.5%
Construction	1.0%	1.1%	1.0%
Services	1.2%	1.4%	1.3%

Source: Fraser of Allander Institute

**Table 6:** Latest growth forecasts for the UK economy

	2018	2019	2020
Bank of England	1.5	1.8	1.7
OBR	1.5	1.3	1.3
NIESR	1.4	1.7	1.7
European Commission	1.5	1.2	-
IMF	1.4	1.5	-
Oxford Economics	1.3	1.4	2.0
ITEM Club	1.3	1.5	1.7
CBI	1.5	1.3	-

*Source: HM Treasury, Bank of England, OBR*

**Chart 48:** FAI GDP forecasts by sector, 2018 – 2020

*Source: Fraser of Allander Institute*

**Table 7:** FAI Labour Market forecasts to 2020

	2018	2019	2020
<b>Employee jobs</b>	<b>2,495,250</b>	<b>2,521,950</b>	<b>2,547,550</b>
% employee job growth over year	1.0%	1.0%	1.0%
ILO unemployment	111,400	114,150	118,900
Rate (%) <sup>1</sup>	4.2%	4.2%	4.3%

*Source: Fraser of Allander Institute*

Absolute numbers are rounded to the nearest 50.

<sup>1</sup> Rate calculated as total ILO unemployment divided by total of economically active population aged 16 and over.

Our central forecast is for growth of 1.3% in 2018 followed by growth of 1.4% in 2019 and 2020.

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

Our latest forecasts for Scotland put us slightly behind the Bank of England's forecast for the UK economy but ahead of the OBR's UK forecast. (Table 5). Whilst we do not forecast the UK economy directly, on balance, we believe that Scotland will do well to match UK growth over the next few years.

A no-deal outcome would significantly lower our forecasts as businesses adjust to this new normal.

With nominal earnings growth expected to continue to pick-up, and provided that this outpaces inflation, household spending should see some modest gains.

Investment activity is likely to remain under pressure as Brexit-uncertainty continues to cast a shadow over growth ambitions. This element of our forecast carries the greatest risk and has the greatest potential to be negatively hit should a 'no-deal' outcome become a reality.

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

As in recent years, services should make the greatest contribution to overall growth. However, we also expect the outlook for manufacturing to continue to be more positive, particularly as optimism in the North Sea supply chain continues to improve.

Building on recent growth, professional and business services are placed to do better. And with major new public investment in the pipeline, the construction sector should continue to see a more sustained outlook.

We expect unemployment to rise slightly toward a level consistent with more medium-term trends. So any reported rise in unemployment in the coming months should pose little concern. (Table 6)





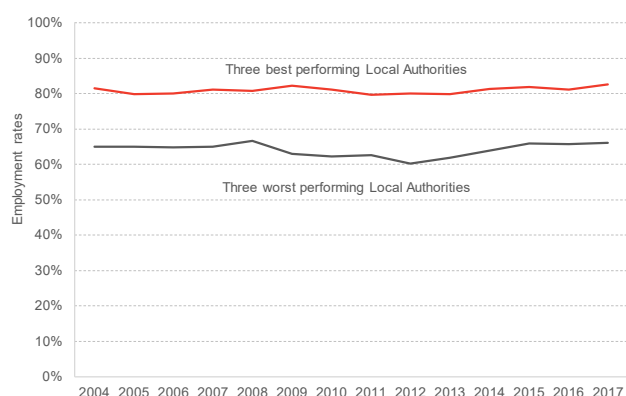
GVA per head in Edinburgh is nearly 2.5 times higher than in East and North Ayrshire. And over time, the gap has widened. GVA per head in the capital has nearly doubled since devolution, with growth in East and North Ayrshire around half that rate.

This translates into widening economic and social outcomes across Scotland. In North Ayrshire for example, around a third of children are in households classified as being in relative poverty.

And back in 2007, the Scottish Government established a target to narrow the gap in employment between the three ‘best’ performing and the three ‘worst’ performing local authorities in Scotland.

As the chart below highlights, a decade later, the gap remains largely the same. (Chart 52)

**Chart 52:** Difference in employment rate for the three best and worst performing Local Authorities (2004 – 2017)



Source: Scottish Government

## The Centre for Regional Inclusive Growth

This summer the Scottish Government launched its Centre for Regional Inclusive Growth.

So far this is a website. It pulls together local information and statistics. But the Centre does not (yet) offer any fresh insights into how to tackle the questions that have underpinned this policy area for decades.

Indeed, on policy solutions, evaluation of current programmes or plans for new investment, it is silent.

The website points to Regional Partnerships which are to come forward with new ideas but there is little detail on what resource will be made available and how ‘asks’ to central government will be acted upon.

Perhaps we will see more in the upcoming Budget.

## Policy opportunities and challenges with Regional Inclusive Growth

So one cannot help follow recent UK and Scottish Government initiatives and ask the question – “so what happens next?” It is hard not to be sceptical over any hope that current initiatives will tackle the wide and deep-rooted variations in economic performance across Scotland.

Narrowing regional inequalities is not easy. The challenges are complex and – often – deep-rooted.

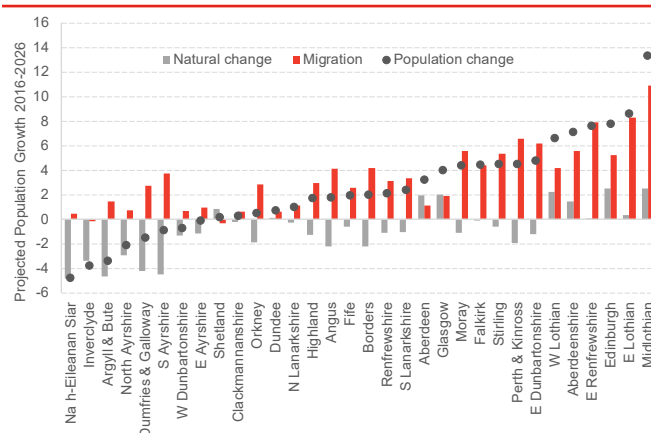
Firstly, there are a great many structural factors why some parts of the country lag behind.

For example, the industrial mix of regions varies significantly. Many of the challenges that parts of west central Scotland face can be traced to the rapid de-industrialisation of the 1970s and 1980s and a reliance on relatively low value service industries.

Social deprivation and health barriers often act as self-reinforcing barriers to economic prosperity. Geography also plays a part, with much of Scotland subject to the challenges of rurality and remoteness. Parts of our cities struggle with poor housing stock and wider basic infrastructure.

The make-up of a region’s population can also act as a significant drag on long-term growth. Some of the most fragile parts of the country are on track to lose population over the next few years. (Chart 53)

**Chart 53:** Projected population growth in Local Authorities in Scotland, 2016-2026



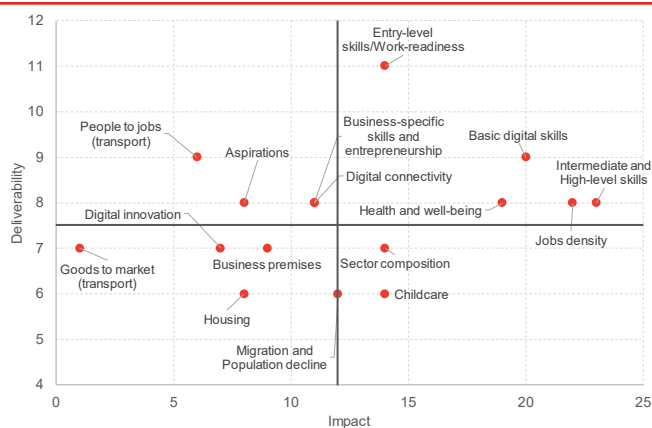
Source: National Records Scotland

Secondly, local areas often lack the tools to turnaround their economic performance (beyond limited interventions at the margins). Many of the levers that will make a difference – jobs, health and well-being, population, digital and transport connectivity – are national responsibilities.

Indeed, a quick glance at the diagnostic results from the Centre’s pilot study for North Ayrshire poses the question, “what realistic levers do local policymakers have to effect change in these areas?” (Chart 54)

At the same time, local government budgets have been squeezed putting pressure on local government jobs and wages. As local authorities prioritise statutory responsibilities, it is no surprise that many have scaled back support for economic development.

**Chart 54:** Prioritisation matrix for North Ayrshire



*Source: Scotland’s Centre for Regional Inclusive Growth*

Interestingly, the mechanism for funding local authorities has not changed much over time, and certainly not since regional inclusive growth has risen up the policy agenda. Perhaps that needs to change?

Thirdly, there is often a basic tension at the heart of national economic policy over where resources are targeted, particularly in a world of tight public spending.

On the one hand, prioritising policy efforts at areas of economic strength – like the strong parts of our cities – can create spill-overs, promote international competitiveness and lead to national benefits. But on the other hand, it is arguably only by shifting resources to areas in economic need that can one realistically expect gaps to be narrowed.

We have seen this played out in recent months, most visibly in the case of North Ayrshire.

The decision to locate the new Medicines Manufacturing Innovation Centre (MMIC) close to Glasgow Airport might make sense from an agglomeration and connectivity perspective. From an inclusive growth perspective, it passed up an opportunity to support private sector activity and the creation of skilled jobs - as part of an Ayrshire Growth Deal – in an area of the country where such investment is rarely undertaken and much needed.

The decision to locate the new Social Security Agency in Dundee was another such example. On this occasion, despite North Ayrshire being clearly identified as scoring best for ‘inclusive growth’ it was passed over by national policy makers because it was felt that the local authority might struggle to attract people to work there (despite transport links improving).

Anyone can agree or disagree with such a decision, and few would argue with the importance of ensuring that the new Social Security Agency performs effectively from day one. But it arguably highlights that even the Scottish Government itself – the key advocate of regional inclusive growth – often finds it difficult to back-up its vision with investment and funding support.

Finally, and an issue we have raised in previous commentaries, is that in attempting to be ‘all-things-to-all-people’, the policy landscape can become complex and cluttered.

Currently, we have a patchwork of 32 local authorities, various City-Region Deals, a new suite of Regional Partnerships, not to mention the large number of strategies and programmes many of which have their own regional dimension (including 32 Single Outcome Agreements).

Coordinating such activity across boundaries, different tiers of government (and governance) – often of different political hues – inevitably makes for a complex delivery landscape.

## Summary

Delivering regional inclusive growth is not easy.

Regional disparities reflect decades of social and economic change, as well as the basic geography of Scotland.

The Scottish Government should be commended for pushing it up the policy agenda.

Ultimately, however, tackling regional inequalities will only be achieved by investing significantly in Scotland's more fragile economic communities, finding out what works (and what does not) and prioritising some areas of the country over others whatever the impact on wider economic and political objectives.

Otherwise, we run the risk of continuing to talk about these issues while regional inequalities continue to widen.



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**8th  
Nov**

## Briefing event for Scotland's Budget: 2018 report

'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.

**Sign up**

**13th  
Nov**

## Understanding the Scottish Economy 1 day course

Identifying and interpreting changes in economic conditions can give businesses and public sector organisations an edge.

But for many, accessing clear and impartial information on how the economy is tracking can be anything but straightforward. This 1 day CPD event aims to help.

Upon completion of the programme, you will be better able to follow economic developments and be able to relate them to your organisation's day-to-day work.

For more information please email [fraser@strath.ac.uk](mailto:fraser@strath.ac.uk).

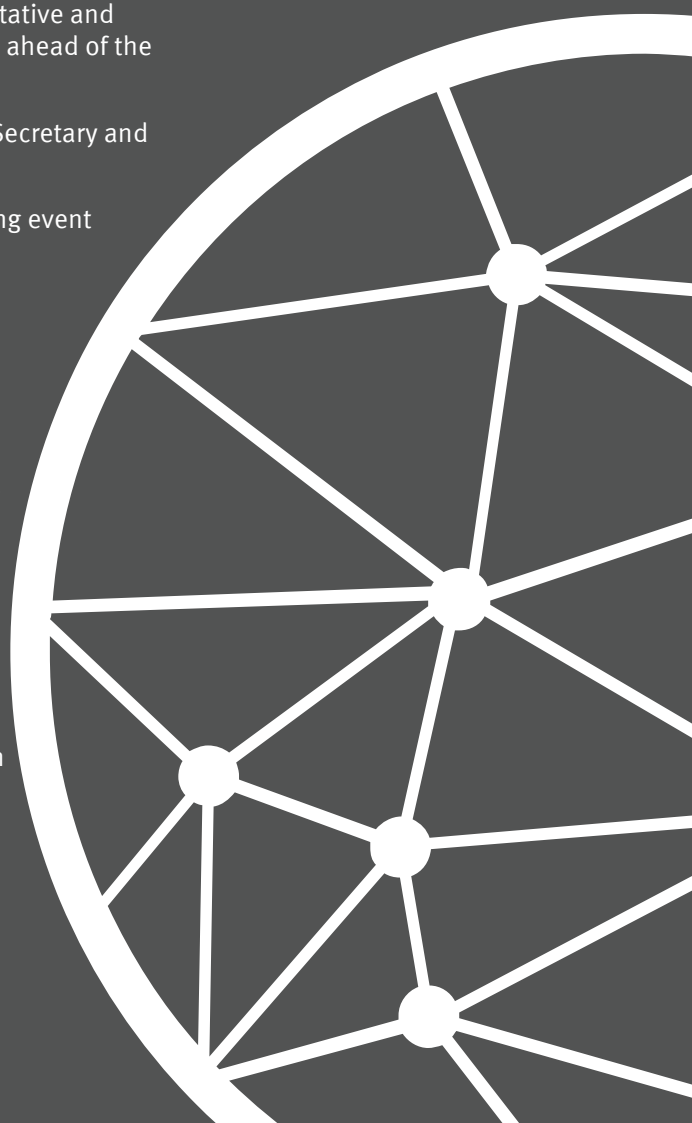
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