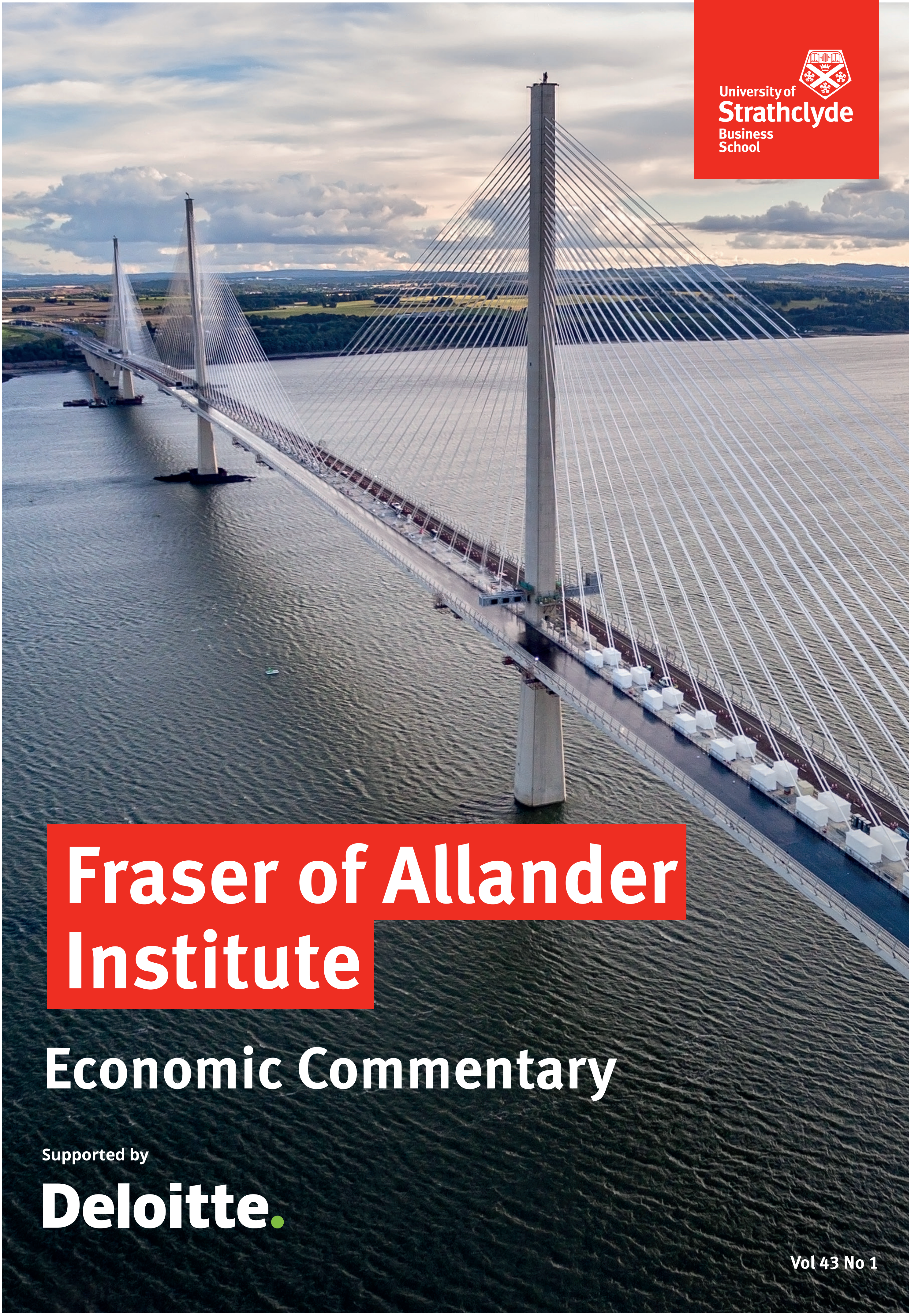

University of Strathclyde Business School

Fraser of Allander Institute

Economic Commentary

Supported by

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Vol 43 No 1

Foreword

Against a backdrop of heightened uncertainty, Scotland's economy has continued to grow, albeit below trend. This, combined with near all-time high employment, is to be welcomed and provides some positives in these extra-ordinarily testing times.

However, Scotland continues to face a productivity challenge with the consequent impact on real earnings growth. As the Commentary evidences, the economic growth we have seen has been matched by an increase in hours worked rather than an increase in productivity. If we want to see a rise in real earnings and living standards, we need to see productivity grow.

The fragile level of productivity and earnings growth means devolved tax revenues are forecast to grow more slowly, with a subsequent impact on Scottish Government budgets. This quarter's Commentary points to that budgetary pressure, explaining that while Scottish taxpayers are paying £500m more than they would if they were rUK taxpayers, the Scottish Government will only collect £180m more in 2019/20. The difference is accounted for by weaker earnings growth.

With uncertainty the new norm, particularly in light of another Brexit extension, the challenge for businesses is how to respond and prepare for the future.

Increased investment should help to improve productivity. However, this quarter's Commentary also shows business investment has fallen for four quarters in a row, while Deloitte's latest CFO survey[1] shows that businesses are continuing to build their cash balances and delay investment.

Like our Q4 2018 CFO Survey, the latest edition continues to demonstrate a definite 'hunkering down' mentality across the UK's CFO community. Key findings include a predicted decline in revenues, a focus on cost pressures and tighter credit conditions.

Approximately 80% of CFOs said they expected the long-term business environment to be worse as a result of leaving the EU which has led to firms tightening spending and planning to scale back on recruitment. There is also a diminished appetite for capital expenditure and M&A.

While this cautious business climate is understandable, as the Commentary shows, there remains a wide range of outcomes possible. It will be important for businesses to continue to consider that range of outcomes, to remain agile and be able to take advantage of the opportunities that do arise.

Scotland has many economic strengths on which it can build. However, in a world where uncertainty appears to be the new normal, it is unlikely that continuing with the same approaches as before will do. As our UK-wide Growth Power Up report identified late last year, there is a need for a bolder and more collegiate approach – one which ensures resilience but is also ambitious by applying greater innovative and tactical thinking to carve out medium-term strategies that deal with the future economic and fiscal challenges.

There is a pressing need to encourage investment and to improve productivity. There is no doubt this is a significant challenge. However, with the economic strengths we have, a determination to capitalise on the opportunities that will arise while supporting people to enhance their skills, encouraging innovative thinking and improving collaboration in key sectors, we should be confident we can rise to the challenge.

John Macintosh
Tax Partner
Deloitte
April 2019

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[1] Deloitte's Q1 2019 CFO survey gauges sentiment among the UK's largest businesses in the wake of Parliament's rejection of Mrs May's Brexit deal. The survey ran between 26th March and 7th April, opening just after the announcement of the first delay in Brexit and covering a period that saw the failure of the House of Commons to agree a new plan and the start of Brexit talks between the government and the Labour Party.

Fraser of Allander Institute

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Economic Commentary

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

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UNIVERSITY of STRATHCLYDE
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Summary

Growth in the Scottish economy remained steady over the course of 2018.

Employment is close to a record high, with unemployment at a record low.

But productivity and earnings growth remain weak, and there are signs that the recent divergence in economic performance between Scotland and the UK is feeding through into some devolved tax revenues.

Of course any growth in the current climate is welcome, particularly given the uncertainty that surrounds the UK's exit from the EU.

As a result, all economic forecasts need to be viewed with caution. We simply do not know how decisions in Westminster or Brussels will pan out. Nor do we have any precedent to fall back on to give guidance on what the economic impacts might be.

Moreover, the smoothness, or otherwise, of the UK's withdrawal from the EU is but one step in the process. Negotiations on the terms of our future relationship with the EU have yet to fully begin.

In the light of all this, we present a series of scenarios for how the Scottish economy may evolve over the next three years.

As with any such scenarios, the exact decimal point estimates are less important than the overall scale and direction of travel.

In our central forecast, we continue to assume that the UK makes an orderly departure from the EU at some point in 2019, although uncertainty continues to impact on investment and private sector spending decisions for the foreseeable future. In light of weaker recent data, and the decision to grant an extension to October 31st, we have lowered our forecast a little to 1.1% for 2019 and 1.4% and 1.5% for 2020 and 2021 respectively.

Whilst the immediate risk of a 'no-deal' outcome has been reduced, it remains a possibility at some point in 2019. To illustrate this, we have developed – like the Bank of England – a 'worst' case scenario of a disorderly Brexit. In this scenario, Scotland would enter a recession.

Of course, in such an instance policymakers would react and seek to offset some of this immediate shock to the economy.

It is also possible to envisage a more optimistic scenario, where uncertainty is reduced and confidence returns over the coming months. In such an instance, growth could surprise on the upside and be closer to trend in 2019 and 2020.

One consequence of Brexit is that it has left little room for discussions of the emerging structural challenges and opportunities our economy is facing. The delay to October is only likely to make this worse.

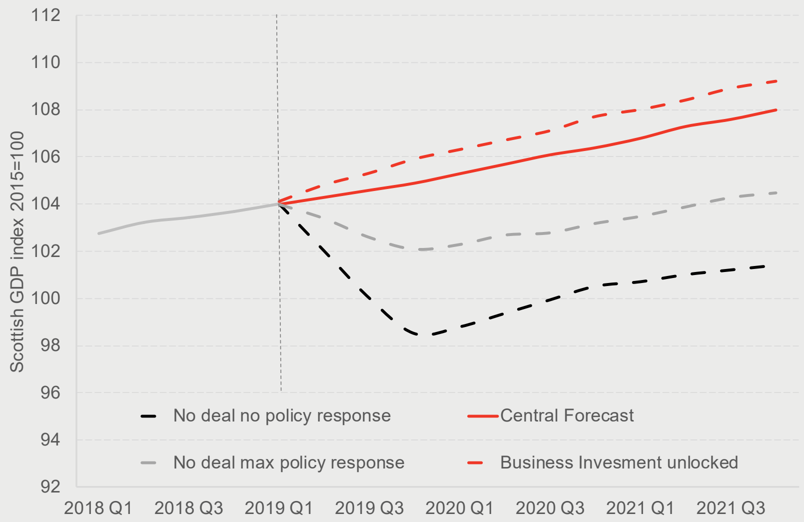
Next month will mark 20 years since the first elections to the devolved Scottish Parliament. Despite progress in some areas, the growth challenge is arguably still something that remains inadequately addressed in the political discourse in Scotland.

Those who established the Scottish Parliament had the hope that it would usher in a new era of collective effort and decision making.

With Brexit marking the most significant structural change – for good or bad – in our economy in over 40 years, the need for that approach is now more crucial than ever.

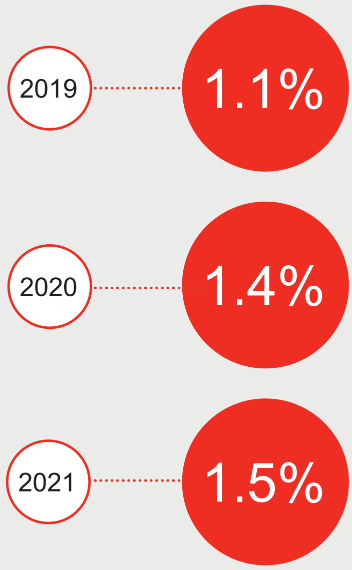
Fraser of Allander Institute
April 2019

Scottish growth scenarios



Due to uncertainty around possible Brexit outcomes, we have developed a range of different scenarios. More information can be found in the 'Our forecasts' section.

Central forecast



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At a glance

Chart: Scottish growth (since 2014) – year and quarter

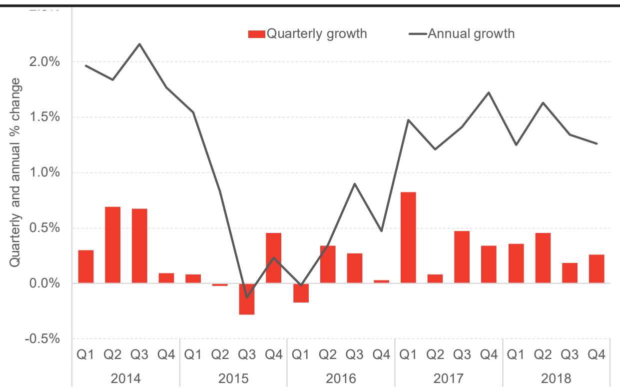

Table: Employment & unemployment rates, Dec - Feb 2019

	Employment (16-64)		Unemployment (16+)	
	Rate (%)	Year Change	Rate (%)	Year Change
Scotland	75.6	▲	3.3	▼
England	76.4	▲	4.0	▼
Wales	75.5	▲	4.5	▼
N. Ireland	71.2	▲	3.0	-
UK	76.1	▲	3.9	▼

Table: FAI forecast Scottish labour market indicators - central forecast based on orderly departure

	2019	2020	2021
Employment rate (%)	75.1%	75.0%	74.8%
Unemployment Rate (%)	3.8%	3.9%	4.1%

Table: FAI forecast Scottish economic growth (%), 2019 – 2021, central forecast based on orderly departure

	2019	2020	2021
GDP	**1.1%**	**1.4%**	**1.5%**
Production	1.2%	1.6%	1.7%
Construction	1.0%	1.1%	1.1%
Services	1.1%	1.4%	1.4%

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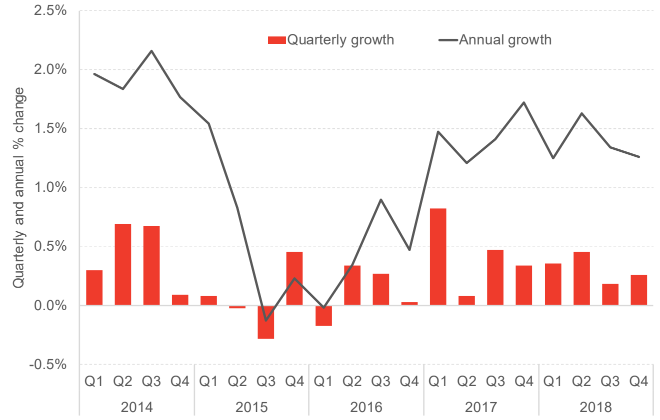
Outlook and Appraisal

The lack of Brexit clarity continues to cast a shadow over the outlook for the Scottish economy. Whilst the immediate risk of a 'no deal' outcome has been removed – for now – the remaining outcomes remain as far apart as ever. Despite this, the Scottish economy continues to grow, albeit at a relatively slow pace.

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



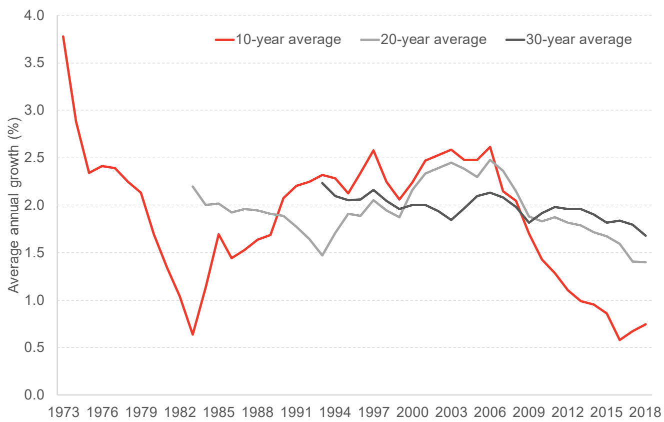
Source: *Scottish Government*

Table 1: FAI forecast growth scenarios, %, 2019 to 2021

	2019	2020	2021
Business Investment unlocked	1.7%	1.8%	1.6%
Central Forecast	**1.1%**	**1.4%**	**1.5%**
No deal max policy response	-0.2%	-0.3%	1.3%
No deal no policy response	-2.1%	-1.5%	1.4%

Source: *Fraser of Allander Institute*

Chart 2: 10, 20 and 30 year average Scottish growth rates, 1973 - 2018



Source: *Scottish Government*

Introduction

Growth in the Scottish economy was steady – if unspectacular – in 2018. This was in line with our own forecast, where our modelling in late 2017 suggested growth of 1.4% in 2018. Chart 1.

This weak growth was mirrored across the UK. Indeed, new FAI modelling estimates that Scotland was the fastest growing part of the UK outside of London in 2018.

But the outlook continues to be dominated by one issue: Brexit. The range of outcomes seems as wide as ever. To illustrate this, rather than just our forecast, we have produced a number of scenarios.

We provide a 'worst case' scenario through to a more optimistic one where there is a swift resolution to the UK's departure. We believe that it is important to provide the full range of scenarios, both positive and negative. Table 1.

In the worst case, there is a significant contraction in the Scottish economy in the second half of 2019 (with a peak to trough of 5.5%, leading to growth in 2019 of -2.1%). However, this assumes no policy response from the Government or the Bank of England, which is not very realistic.

Assuming that there is a response, output still contracts, but much less so than in the worst case scenario, and soon picks up after that (a peak to trough contraction of 1.9%, leading to growth in 2019 of -0.2%).

There is also a more positive scenario where uncertainty is reduced and confidence returns, perhaps if a deal is agreed. In this case, we think that growth could surprise on the upside, with growth of 1.7% in 2019.

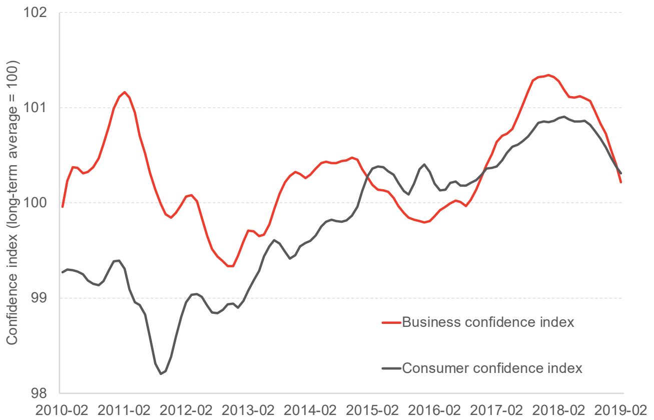
We said in our previous commentary that, whatever the outcome of Brexit, it was likely that critical elements may simply be fudged, or more openly deferred, leaving uncertainty for many more months, if not years. Unfortunately, nothing has happened in the interim to change that view.

Table 2: OECD growth rates: 2017 (outturn) to 2020

	2017	2018	2019	2020
UK	1.7	1.4	0.8	0.9
US	2.3	2.9	2.6	2.2
Japan	1.7	0.7	0.8	0.7
Canada	3.0	1.8	1.5	2
Germany	2.5	1.4	0.7	1.1
France	2.3	1.5	1.3	1.3
Italy	1.7	0.8	-0.2	0.5
Euro Area	2.4	1.8	1.0	1.2
World Growth	3.7	3.6	3.3	3.4

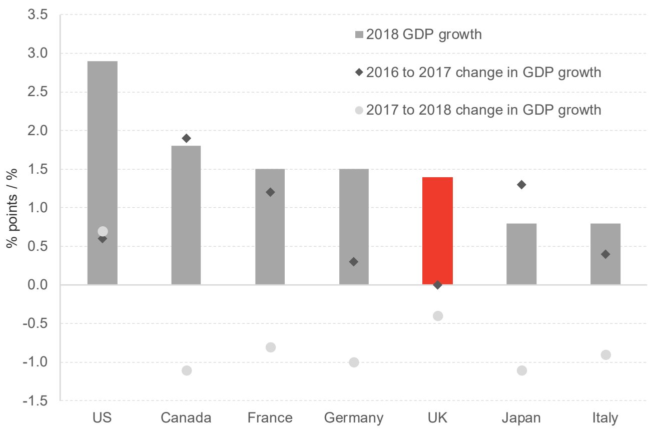
Source: *OECD*

Chart 3: OECD business and consumer confidence indices, Feb 2010 - Feb 2019



Source: *OECD*

Chart 4: Loss of momentum in global economic growth



Source: *ONS, OECD*

The global economy

The general slowdown in global growth that we discussed in the last commentary has intensified in recent months.

Most major economies are now expected to grow more slowly in the next couple of years than they did in either 2017 or 2018. Table 2.

In recent days, the IMF have cut their growth forecasts warning that "While the global economy continues to grow at a reasonable rate and a global recession is not in the baseline projections, there are many downside risks."

There are a number of reasons for this.

Firstly, overall sentiment indicators across advanced and emerging economies have weakened since the autumn, suggesting fading momentum in global growth. Chart 3.

There have been a series of disappointing economic indicators over the past 3 months that have shown a similar picture in the US, China and in Europe.

Italy has re-entered recession, whilst Germany narrowly avoided following suit. Chart 4.

To an extent, this was always going to happen following a period of above trend growth, and talk of a 'global recession' – at this stage – is overblown.

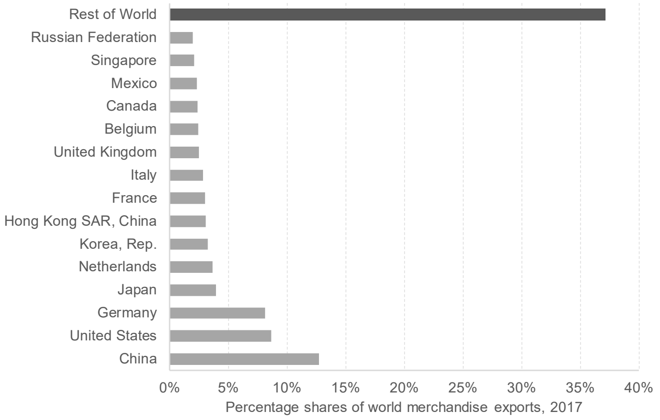
Secondly, the significant fiscal stimulus injected into the US economy by President Trump's tax cuts has started to wear off.

Thirdly, uncertainties over the longer-term health of emerging markets – most notably whether or not China's years of rapid growth are coming to an end – have injected a new wave of uncertainty into the outlook and financial markets.

Finally, the ongoing threat of trade skirmishes between the US and China has weakened forecasts.

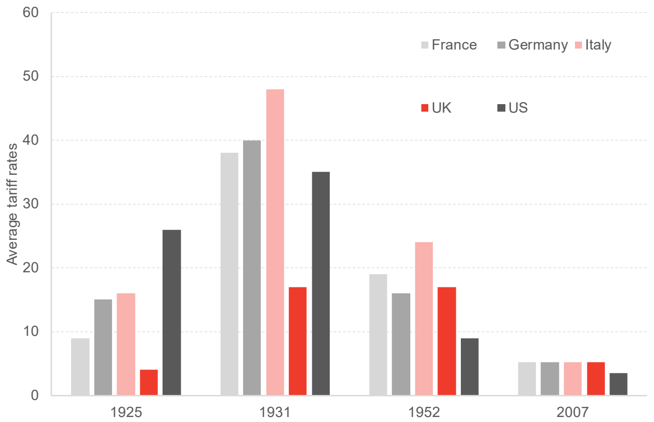
On top of this, a mix of weakening emerging market growth, coupled with trade uncertainties, has already had a negative impact on international trade flows.

Chart 5: Who Trades?



Source: *World Bank*

Chart 6: Average Tariff Rates



Source: *Irwin (2002), WTO (2008)*

Table 3: WTO Negotiation Rounds

Round	Period	Number of countries
Geneva	1947	23
Annecy	1948	13
Torquay	1950	38
Geneva	1956	26
Dillon	1960-61	26
Kennedy	1964-67	62
Tokyo	1973-79	102
Uruguay	1986-93	123
Doha	2001-?	164

Source: *WTO*

The threat to international trade prospects remains one of the greatest risks and uncertainties to global growth prospects over the longer-term.

For the best part of five decades, the global economy had experienced a steady and sustained rise in international trade. Much of this trade had been concentrated in a small number of countries, but in recent years new markets have started to exert greater influence. Chart 5.

This was supported by a gradual reduction in the barriers to trade, particularly between the world's major trading partners. Average tariff rates fell sharply, and remain low by historical standards. Chart 6.

However, in recent times, political and economic instability – both localised and global – has created a more uncertain outlook.

The term 'slowbalisation' has been coined to describe the recent flat-lining in global trade patterns, and rising protectionist sentiment. And it is not just trade that has been impacted. Cross-border investment has fallen sharply in recent times.

Part of the explanation for this is likely to be short-term domestic policy agendas, which are likely to be temporary in nature.

But it is also likely to reflect a more structural shift in attitudes to globalisation, particularly as the benefits of ever closer integration have not been shared equally.

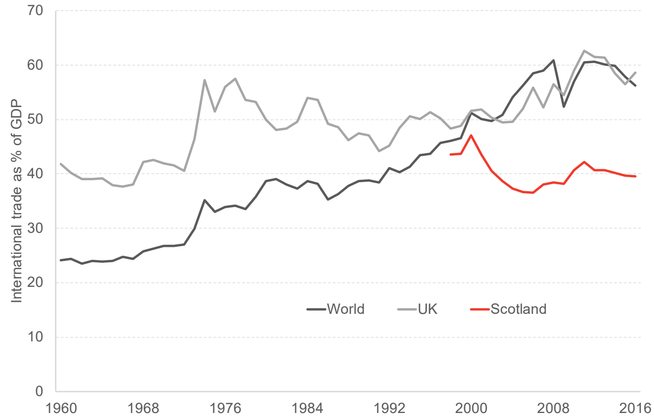
It is also the result of being unable to come to any form of agreement on the core remaining barriers to trade such as non-tariff barriers on technology, health care, intellectual property etc. The lack of any effective multi-lateral trade discussion since 1993 is a case in point. Table 3.

Boosting levels of international trade is crucial for a small open economy like Scotland. In January, new export statistics were published for Scotland.

These showed that international exports from Scotland rose by £1.9 billion – or 6.2% – between 2016 and 2017. Note that this is in nominal terms; in real terms the growth was just 0.5%.

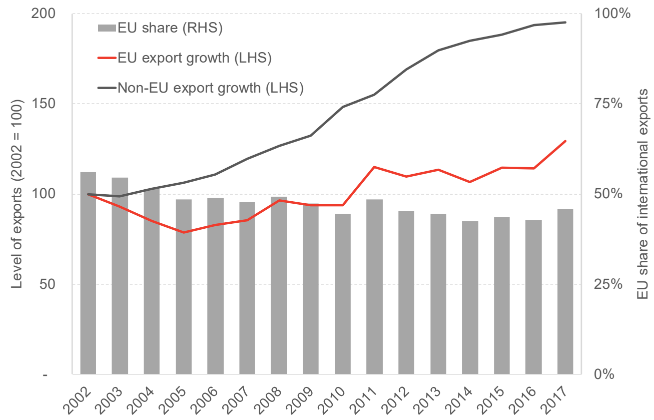
Boosted by the competitive value of the pound and strong growth in Europe during 2017, the improvement in Scottish exports was driven by a £1.7bn (13.3%) increase in exports to the EU.

Chart 7: International trade as a percentage of GDP, 1960 – 2016



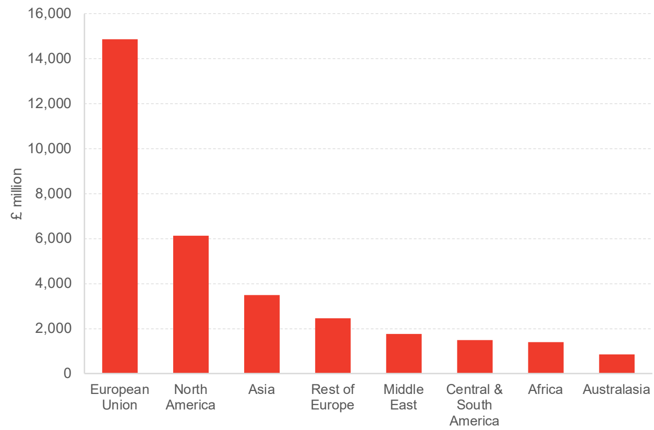
Source: *World Bank, Scottish Government, FAI*

Chart 8: Growing Markets - non-eu export growth becoming increasing large share of Scottish international exports



Source: *Export Statistics Scotland, Scottish Government*

Chart 9: International exports by market size, 2017



Source: *Export Statistics Scotland*

Whilst positive, the Scottish Government did miss its target to grow exports by 50% by 2017 (on a 2010 baseline), with growth of only around 35% instead.

And overall, trade as a share of our economy have slipped back in recent times – in contrast to the UK and global economies. Chart 7.

The uplift in EU exports somewhat reverses a trend we had been seeing in recent years where the growth in international exports had been driven by markets outside the EU. Chart 8.

Back in 2002/03, Scottish exports to the EU were around 56% of total international exports, today the figure is 46%.

The latest figures show that for 2017, over 45% of Scotland's international exports are to EU markets.

Indeed, EU exports of £14.9bn are – on their own – nearly as much as Scotland exports to North America, Central and South America, the Middle East, Asia, Africa and Australasia combined (£15.1bn). Chart 9.

And of Scotland's Top 10 export destination countries, 8 are in the EU and a further country – Norway – is part of the European Economic Area and therefore the Single Market.

Of course, the exact scale of risk to Scottish exports from Brexit remains uncertain. Exports will still continue but on what scale? Will the impact be minimal or significant?

And could Brexit – depending upon the final deal – provide opportunities to explore new trade deals with other countries?

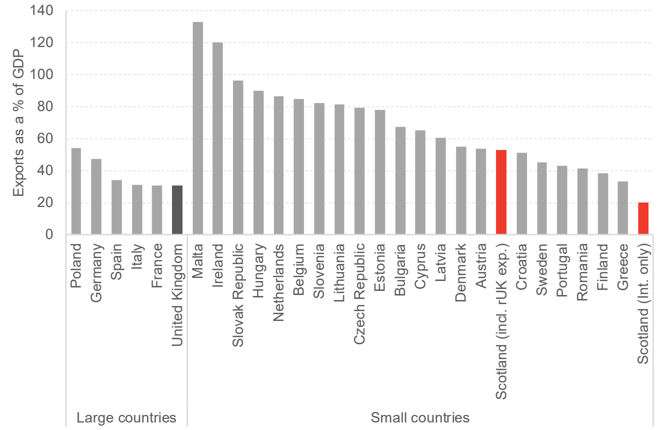
But we must be realistic. It is simply not possible to unwind integrated trading patterns overnight.

For many countries, the imposition of tariffs or non-tariff barriers will mean the difference between being able to sell and compete in EU markets and not.

Trade deals with other countries are possible, but little can match the scale or accessibility of the EU Single Market.

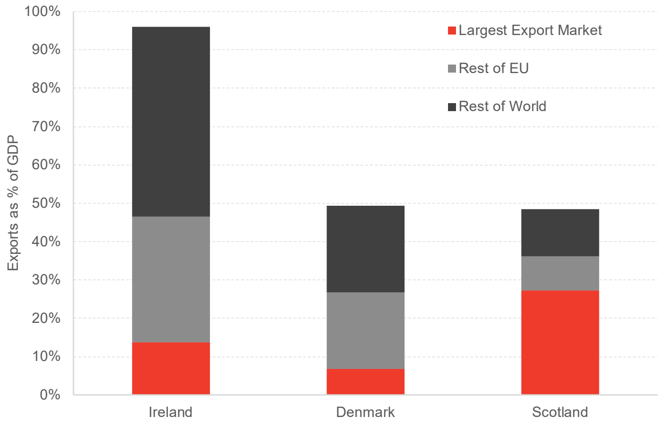
It is against this backdrop that the Scottish Government will publish its new Export Action Plan.

Chart 10: EU exports as a percentage of GDP, 2017



Source: *World Bank, Scottish Government & FAI*

Chart 11: Exports by market for Ireland, Denmark and Scotland as a percentage of GDP, 2017



Source: *Scottish Government, CSO, Statistics Denmark*

Table 4: Scotland's five largest exports, 2017

Sector	International exports (£ million)	Percentage of all exports
Food and drink	5,855	18.0
Professional, scientific and technical activities	3,670	11.3
Refined petroleum and chemical products	3,485	10.7
Mining and quarrying	1,940	6.0
Retail and wholesale	1,890	5.8
Total	**16,840**	**51.9**

Source: *Scottish Government*

Scotland has significant export strengths in a number of markets, most notably food and drink, energy related sectors and professional and financial services.

But there is scope for improvement.

As a share of our economy, Scotland exports less than many comparable countries within the EU

Including UK exports, Scotland has a ratio of exports to GDP of around 53%. But this falls to 20% when looking only at international exports. This compares to EU and OECD averages of 45% and 28% respectively. Chart 10.

Overall, Scotland's export base remains relatively narrow. This is not unusual in a country of Scotland's size, but it does seem to be an issue that is more pronounced here.

For example, according to data from HMRC Scottish registered firms account for just under 6% of UK registered exporters – below a per capita share.

At the same time, Scotland depends much more upon one market (i.e. the rest of the UK) as a destination for its exports than many other small countries. Chart 11.

Whilst just five sectors account for over half of all Scottish international exports, with whisky accounting for a significant proportion of that. Table 4.

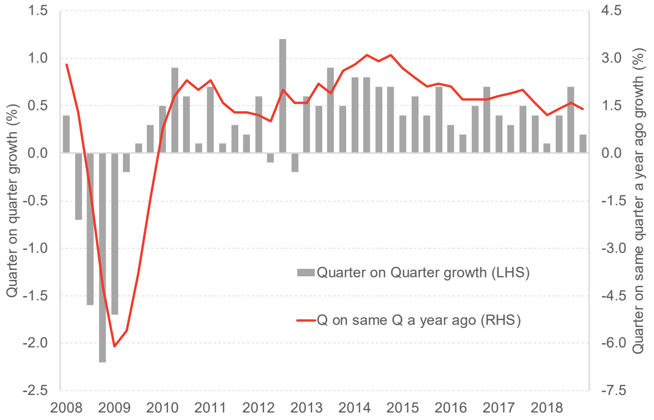
With limited resources, and levers at its disposal, in its export strategy the Scottish Government will need to develop a robust evidence based approach that moves beyond high level targets and ambitions of 'internationalisation'.

Tough decisions will be required on what businesses to offer support to – e.g. is the focus upon a small number of firms already exporting but could do more, decent sized domestic firms that could export but currently do not, or the large volume of smaller firms who do not export but if they were would do so on a small scale?

What sectors should policy help support? And what markets should be targeted?

What practical steps should be taken, and how should different initiatives be evaluated?

Chart 12: UK GDP Growth, 2008-2018



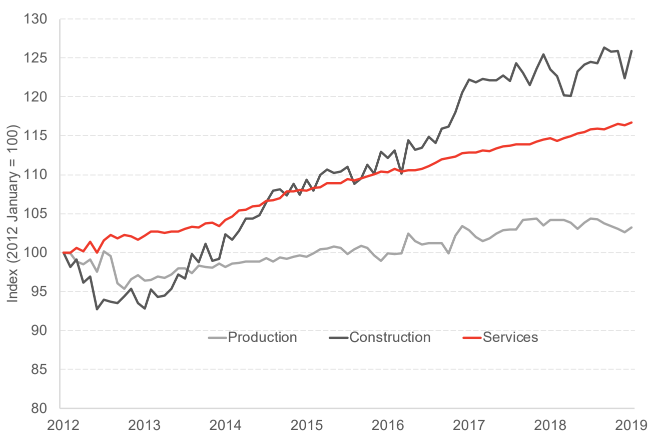
Source: *ONS*

Table 5: Breakdown of UK GDP growth rates by month

	November 2018	December 2018	January 2019
GDP	0.2%	-0.4%	0.5%
Index of services	0.3%	-0.2%	0.3%
Index of production	-0.3%	-0.5%	0.6%
Manufacturing	-0.1%	-0.7%	0.8%
Construction	0.1%	-2.8%	2.8%
Agriculture	0.5%	0.4%	-1.3%

Source: *ONS*

Chart 13: Economic performance of broad sectors of UK economy since 2012



Source: *ONS*

The UK economy

The UK economy slowed in the final three months of 2018, with growth of just 0.2%. Growth was always expected to be subdued in light of the ongoing Brexit uncertainty, but also following on from the strong growth witnessed over the summer as one-off effects from the warm weather and the World Cup unwound.

The weakening global outlook discussed above has also not helped. As a result, growth in the UK continues to remain below trend, with the economy up just 1.4% over the year – compared to a longer term growth rate of closer to 2.5%. Chart 12

The ONS' new monthly GDP series provides a useful insight into the current performance of the UK economy. Table 5. Whilst the series can be volatile, it does suggest that the reason for the weak growth was a contraction of output in December, with growth bouncing back in January. Table 5.

It is highly likely that the outlook over the coming year will change on a monthly or even weekly basis, as and when uncertainty impacts bite, withheld investment comes on stream and/or stockpiling takes place.

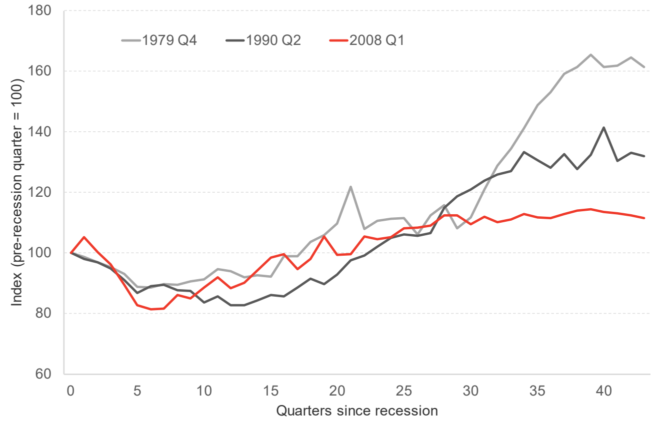
Recent growth was once again driven by services, with output up 0.5% over the quarter. However, annual growth for 2018 was 1.6% – the weakest it has been since 2010.

Production output declined by 0.8% in the final three months of the year, with manufacturing contracting in 3 of the 4 quarters in 2019 and by 0.9% over the year. Chart 13.

Transport equipment – most notably car production – has been particularly badly hit. A recent survey by the Society of Motor Manufacturers and Traders reported that UK car production fell 18.2% in the year to January 2019, reflecting a decline in domestic and foreign demand.

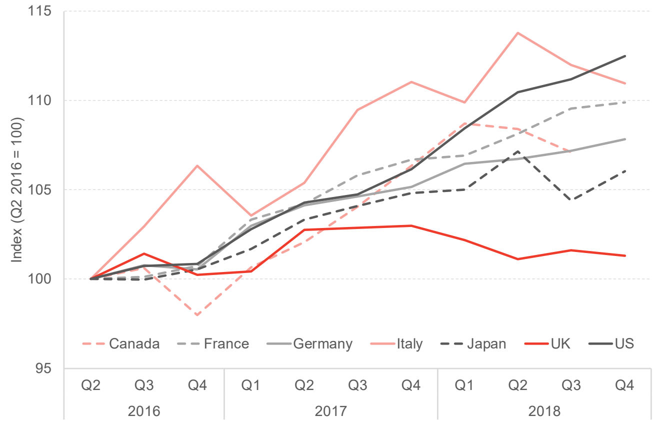
As we have discussed in previous commentaries, a feature of the UK economy – and one that appears to have been exacerbated since the EU Referendum – has been the weak performance of business investment. Business investment has now fallen for 4 consecutive quarters, the first such instance since 2009. This is despite the economy growing and employment rising.

Chart 14: Business investment in previous UK recessions and recoveries



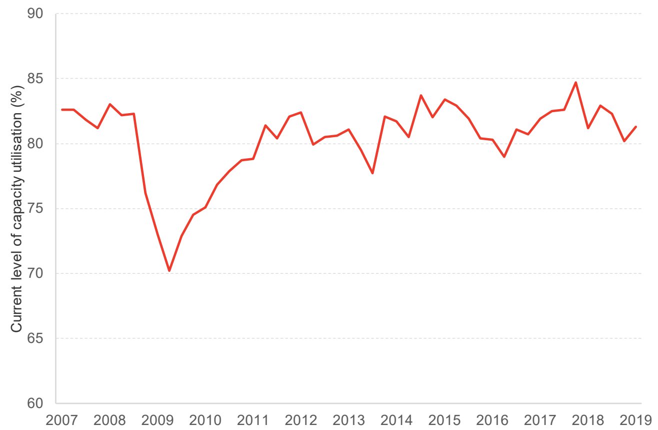
Source: *Office for Budget Responsibility*

Chart 15: Non-dwellings investment in the G7, Q2 2016 - Q4 2018



Source: *OECD*

Chart 16: Capacity utilisation (%) in UK manufacturing



Source: *Eurostat*

Most commentators believe that this reflects an increasing number of firms delaying investment in response to Brexit uncertainty. The Bank of England's intelligence gathering points to firms holding back on capital spending (with the scale of the investment being postponed increasing). Further evidence of a Brexit impact can be seen by comparing the path of investment since the financial crisis with previous UK recessions. Chart 14.

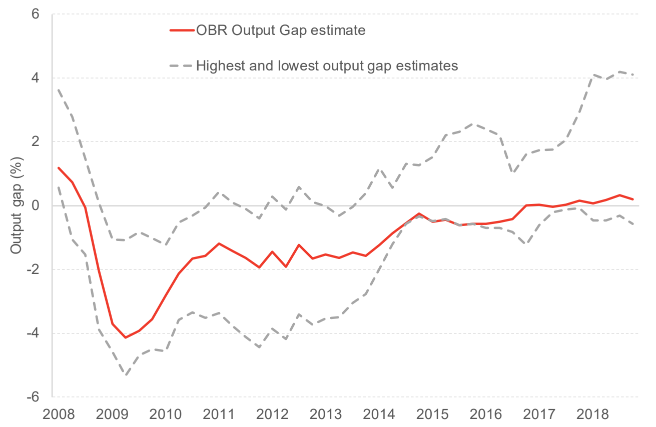
It appears that businesses have held back on capital spending at a point in the cycle where previous historical episodes would point to a pick-up. This coincided with the EU Referendum. Cumulative growth since the referendum has also been 18 percentage points lower than the Bank of England were forecasting in Spring 2016.

Although weaker global growth may be a factor, it is unlikely to explain all of this marked weakness. UK business investment growth has lagged its peers for a period of time. Chart 15. Whilst business investment makes up a small component of aggregate demand, it is crucial for productivity and boosting long-term growth capacity.

All this comes at a time when most indicators point to firms operating with limited spare capacity (and who normally should be investing). Chart 16.

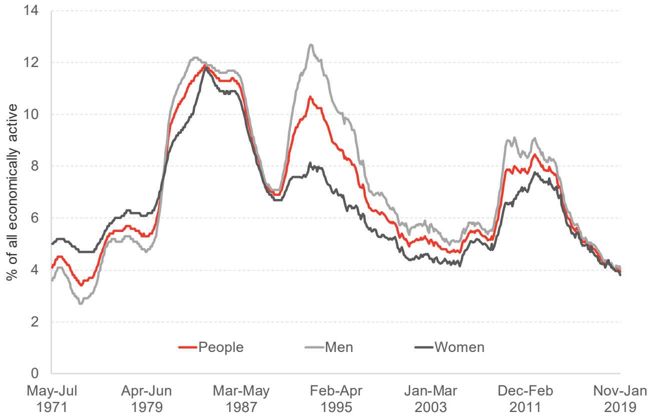
As a result, the output gap – i.e. how close the UK is to operating at its 'potential' level – remains small. This suggests that even with growth being weak in recent times, there may not be as much scope for UK growth to pick-up materially in the medium term. Chart 17.

Chart 17: Output gap – actual vs. potential output – is estimated to have closed with UK economy near capacity



Source: *Office for Budget Responsibility*

Chart 18: UK unemployment rates, 1971 onwards

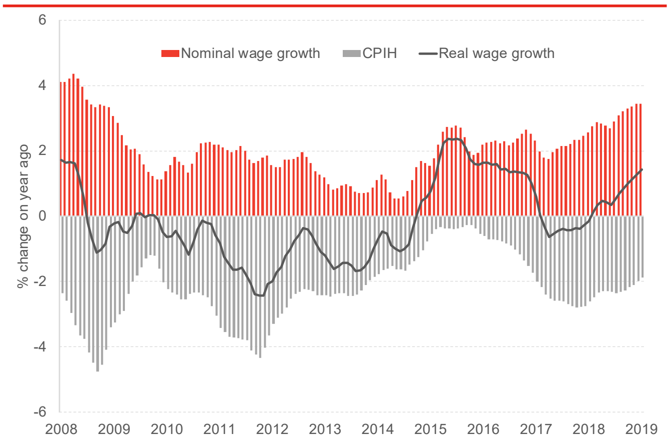


Source: *ONS*

Chart 19: Number of vacancies in the UK, 2001 to 2018

Source: *ONS*

Chart 20: UK regular average weekly earnings growth: 3-month on a year ago



Source: *ONS*

One flipside of firms holding back on investment is that the demand for labour continues to remain high.

In the three month period to January 2019, UK unemployment was estimated to be just 3.9%. Chart 18. It has not been lower since November 1974 to January 1975. It remains well below the EU average unemployment rate of closer to 6.5%.

At the same time, the UK employment rate is at a record high (of 76.1%), whilst economic inactivity is at a record low (20.7%).

Whilst high employment rates are welcome, there are concerns that the UK labour market has become less 'dynamic' than in the past with less progression and movement between employers. At the same time, vacancies continue to rise. Chart 19.

In normal times, this would provide an ideal climate for investment. But as highlighted above, this is not happening.

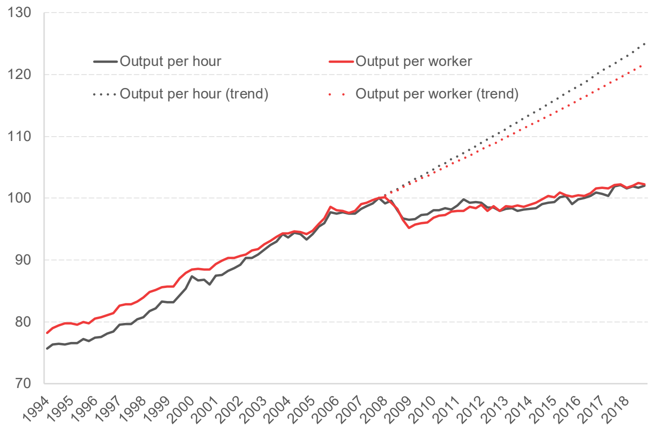
The high employment rate, coupled with high vacancy rate, is putting some (weak) upward pressure on earnings. Chart 20.

At the start of 2019, average weekly employee earnings – excluding bonuses – were estimated to be rising by 1.4% in real terms.

But the combination of weak economic growth and continued increases in employment meant that productivity continues to lag behind. Chart 21.

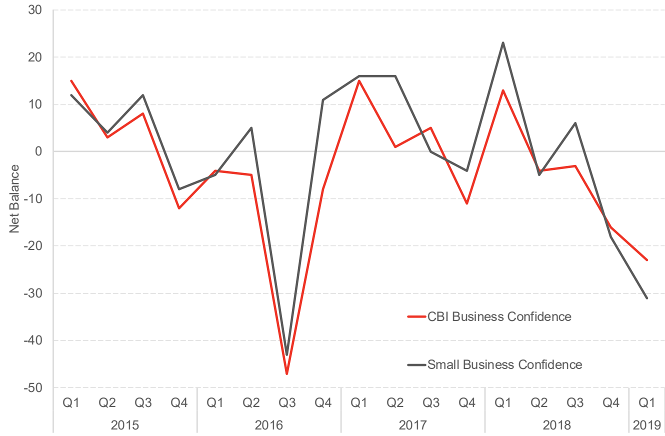
Productivity in Q4 2018 – output per hour – remains 18.3% below its pre-downturn trend. Or, equivalently, productivity would have been 22.5% higher had it followed this pre-downturn trend.

Chart 21: Productivity per hour trend, Q1 1994 - Q4 2018



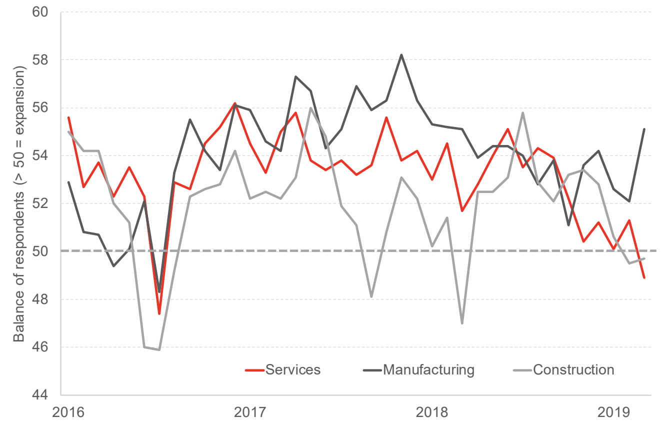
Source: *ONS*

Chart 22: CBI measures of confidence, Q1 2015 - Q1 2019



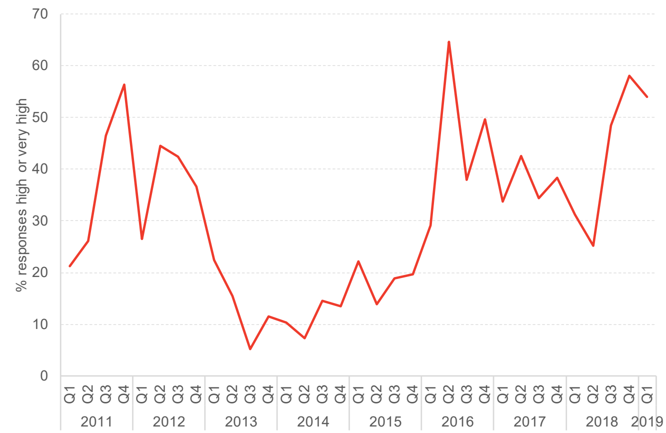
Source: *CBI*

Chart 23: Purchasing Manager's Index for the UK, Jan 2016 - Mar 2019



Source: *IHS Markit*

Chart 24: Deloitte CFO survey - % of CFOs who rate external uncertainty facing their business as higher or very high



Source: *Deloitte*

UK economic outlook

The mix of a weakening global economic outlook, coupled with Brexit uncertainty, has led to a significant shift in most indicators of confidence and activity in the UK economy.

The CBI's index of business confidence fell again – for the 2nd quarter in row – to -23 (from -16 in Q4 2018). This is its lowest reading since the 2016 EU referendum. In particular, there was a marked fall in sentiment around export prospects with firms nervous that the ongoing turmoil may inhibit opportunities to secure future orders. Chart 22

The UK PMI for services fell to 48.9 in March – recall a value above 50 marks expanding activity; a value below 50 marks contracting activity. This was the first contraction since 2016. Chart 23

Against expectations however, the same PMI for manufacturing jumped up from 52.1 in February to 55.1 in March. Rather than a rise in confidence, it would seem that this followed an increase in stock-piling (see below).

It should be noted however, that surveys do not always provide a full-proof picture of current trends in the economy. For example, in the immediate aftermath of the EU referendum, virtually all business surveys pointed to a marked immediate slowdown in the economy. This turned out not to be the case.

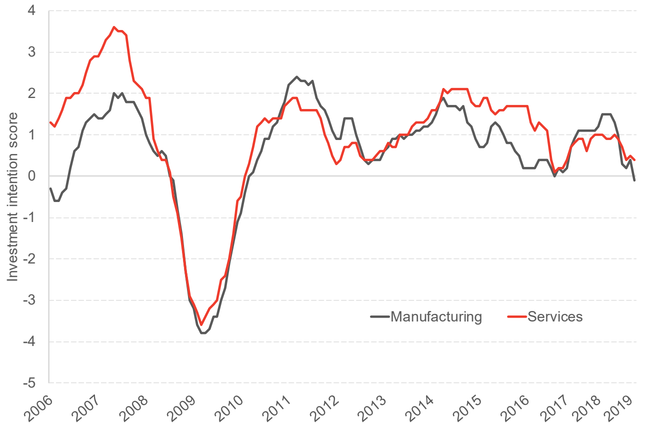
It is possible that in times of uncertainty, the link between surveys – particularly around measure of 'confidence' – and actual day-to-day activity is not perfect.

Uncertainty has intensified recently, so it is important to exercise caution when interpreting survey responses.

The latest Deloitte CFO Survey uncertainty index shows that more than half of CFOs continue to rate current levels of uncertainty as high or very high. In addition, the survey shows that risk appetite remains close to a nine year low and that revenue expectations remain depressed. Chart 24.

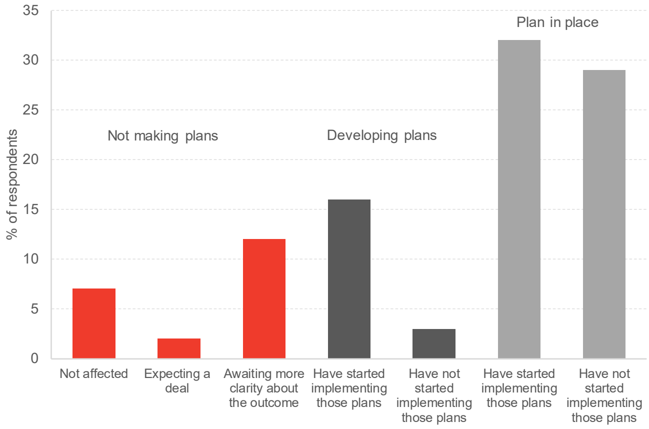
A common theme throughout all surveys is that investments remain notably below their long-term averages, with spending on buildings, plant & machinery, training and innovation all expected to be lower in the year ahead.

Chart 25: Investment intentions, BoE agents 2006 - 2019



***Source:** Bank of England*

Chart 26: Contingency Planning for 'no-deal' Brexit



***Source:** Bank of England*

A recent survey by the Bank of England found that investment intentions for the next 12 months fell sharply in manufacturing. This was the lowest rate in nine years. Chart 25.

Contacts mostly cited Brexit uncertainty as the main reason, with some choosing to build cash reserves. Some, particularly those with overseas owners, said that investment was being diverted outside the UK.

In the main however, most surveys also report that there could be a rebound in investment if a Brexit deal was agreed.

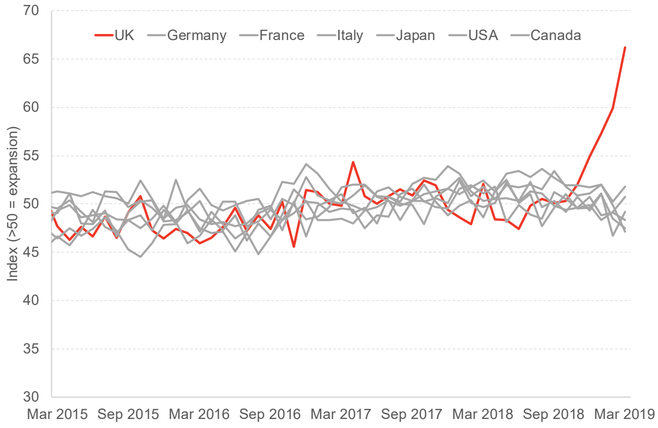
In previous commentaries, we have cited the apparent lack of planning for Brexit amongst firms. However, it is clear that there has been a significant increase recently. Chart 26.

For many companies, preparing for Brexit will involve holding higher than normal levels of stocks of supplies or finished goods. In recent surveys there has been a sharp increase in stock-piling. Chart 27 shows the outcome for inventories of raw materials, contrasting the UK with other G7 countries. Prior to 2019, the highest this index had reached was 55.

It is within this environment that the OBR published their latest outlook for the UK economy in March.

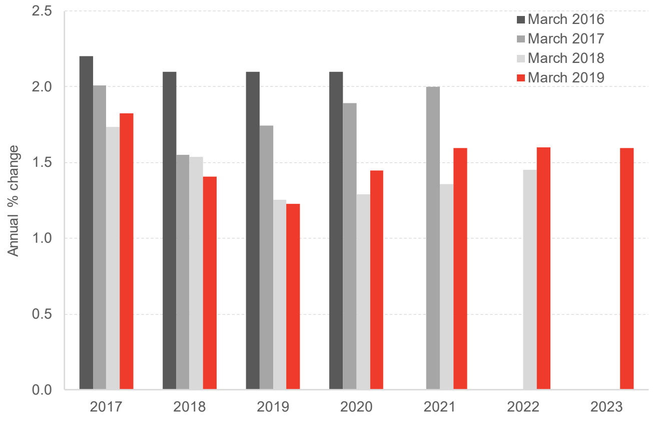
Like the Bank of England, the OBR are now forecasting that the UK economy will grow more slowly this year than they thought back in the Autumn. Along with the Bank, they are forecasting growth of 1.2% in 2019 before growing by 1.4% in 2020 and 1.6% in 2021.

Chart 27: Purchasing managers index of materials purchased for inventory at factories, Index, March 2015 - March 2019



***Source:** IHS Markit*

Chart 28: Evolution of OBR Spring forecasts

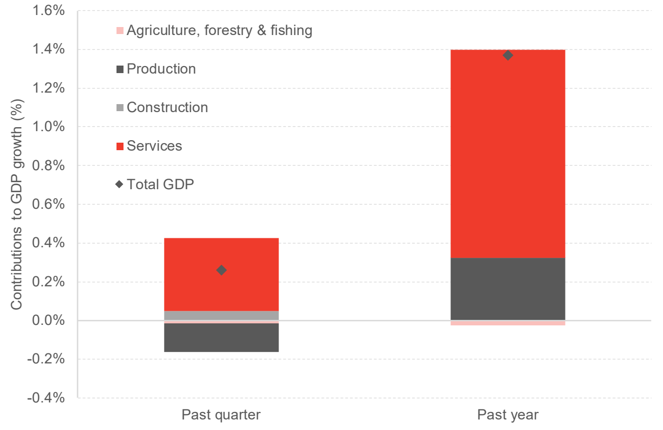


***Source:** Office for Budget Responsibility*

Scottish Economy Dashboard

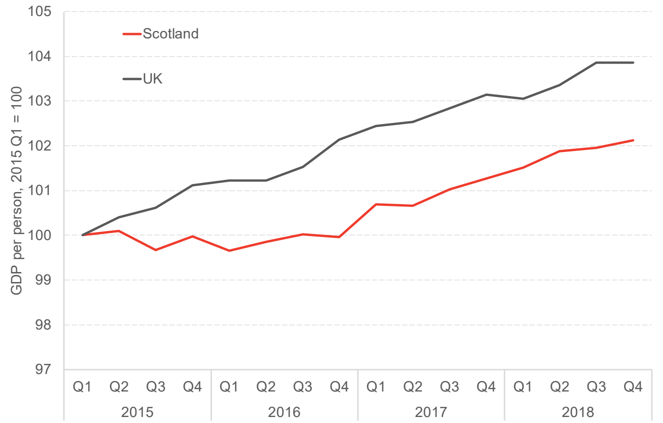
	% of Economy	Growth 2018	Growth Q4 2018	Key issues/trends
Production	**17%**	**2.0%**	**-0.9%**	
Manufacturing	11%	2.8%	0.1%	■ Confidence and growth has returned recently, with a strong performance in 2018. In particular, growth in computer products, food and drink, and petroleum products has boosted growth ■ Exporters continue to benefit from weak pound. But remains most at risk from dislocation of UK-EU trade
Food and drink	3%	3.5%	1.8%	■ Sector continues to grow strongly – and is now at its highest ever level ■ Growth potential is high, although boosting productivity in sector will be key for sustainability ■ Future post-Brexit challenges could include 'just-in-time' deliveries and access to migrant workers
Services	**76%**	**1.4%**	**0.5%**	
Retail and wholesale	10%	1.6%	0.8%	■ The retail and wholesale sector held up well in 2018. But significant troubles remain for traditional retailers. ■ Rising wages across the economy could give respite to a sector going through significant structural changes
Accommodation & food services	3%	4.4%	1.7%	■ A strong year for accommodation and food services, which was one of the best performing sectors in services ■ Tourist facing elements of the sector continue to do well ■ Future post-Brexit challenges will include recruitment
Financial & insurance	6%	2.7%	1.0%	■ There was steady growth in this sector throughout the quarter and the year ■ The sector is now finally back above pre-crisis highs
Construction	**6%**	**0.0%**	**0.8%**	■ Output was flat for construction for 2018 as a whole, which was the poorest year of growth since 2012
Agriculture	**1%**	**-1.9%**	**-1.1%**	■ Agriculture, forestry and fishing has had a weak 2018 following a strong 2017, contracting throughout the second half of the year, (in part due to weather conditions).

Chart 29: Year and quarter contributions to Scottish GDP, Q4 2018



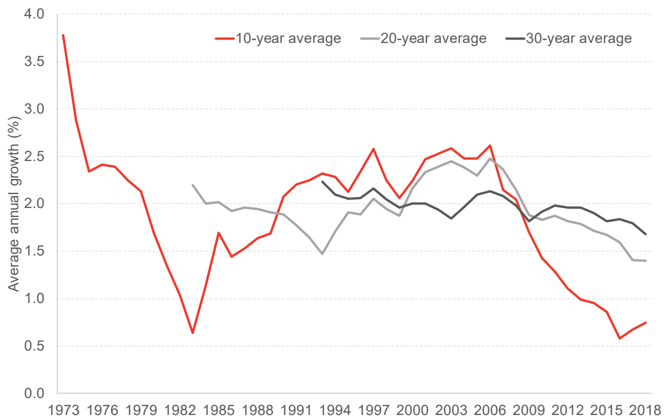
***Source:** Scottish Government*

Chart 30: Scottish GDP per head vs UK from 2015



***Source:** Scottish Government*

Chart 31: 10, 20 and 30 year average Scottish growth rates, 1973 - 2018



***Source:** Scottish Government*

The Scottish economy

The Scottish economy grew by 0.3% in the final quarter of 2018, slightly faster than the UK as a whole (which grew by 0.2%).

Over the course of 2018 as a whole, the Scottish economy grew by 1.4%.

Growth was driven by relatively strong growth in production activities (up 2.0% over the year) – including in manufacturing (which grew by 2.8%) – and steady growth in services (up 1.4% over the same time period). Construction activities were flat. Chart 29.

Growth was relatively strong over the quarter in both services (up 0.5%) and construction (up 0.8%).

In contrast, production output fell by 0.9%, driven largely by a fall back in electricity and gas supply. This reflected, in part, the part-closure of Hunterston power station following safety concerns.

Two things are apparent from the most recent data.

Firstly, with growth continuing at broadly the same pace as throughout 2017 and 2018, there does not yet appear to be too much of a direct feed through to the official data from any Brexit uncertainty (at least at an aggregate level) just yet.

Secondly, the data continues to show that growth continues to lag behind over the longer-term.

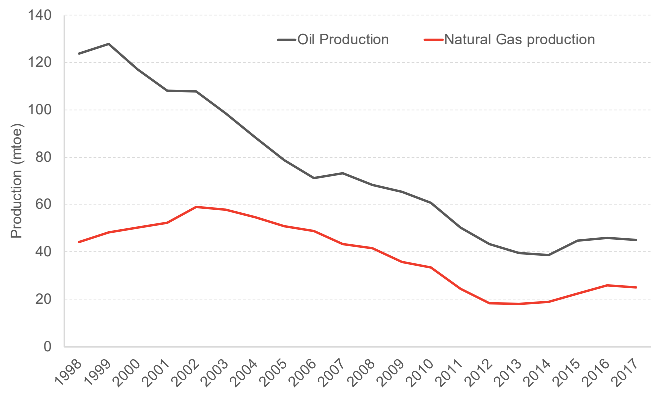
The gap that opened up with the UK in 2015 – during the height of the downturn in the oil and gas sector – has not closed to any great extent. Chart 30.

Of greater concern however, is the downward trend in core growth rates for Scotland. Chart 31.

The rolling 10, 20 and 30 year average growth rates for Scotland are now at their lowest level since the early 1970s.

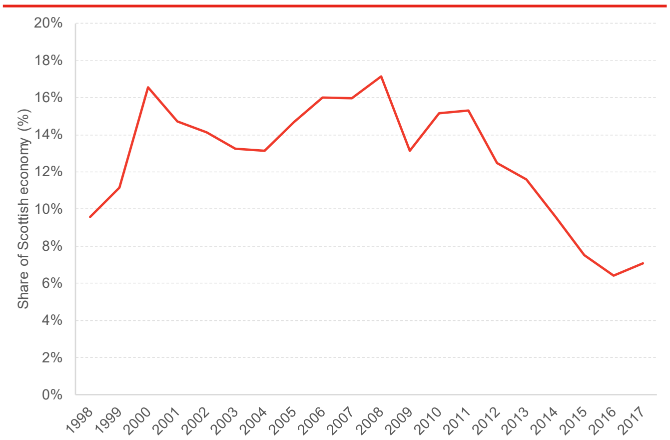
Long-term data shows that Scottish growth averaged around 2.3% in the 40 years prior to the financial crisis. In the 10 years since the financial crisis, Scottish growth has yet to reach that level in *any* year.

Chart 32: Oil and gas production volumes, million tonnes of oil equivalent, 1998 - 2017



Source: *Scottish Government*

Chart 33: Extra-regio (oil and gas) activity as a share of the Scottish economy, %, 1998 - 2017



Source: *Scottish Government*

One particular challenge that the Scottish economy has had to face in recent times was the downturn in the oil & gas sector in 2015 and 2016.

Oil production from Scottish waters peaked in 1999, with natural gas production topping out in 2002. Since then, production levels for both fossil fuels have been on a sustained decline – although in recent years production has increased ever so slightly. Chart 32.

As the North Sea enters its mature phase of operation, with production more and more concentrated in smaller and harder to reach fields, the contribution of the industry to Scotland's overall economic footprint has fallen. Chart 33.

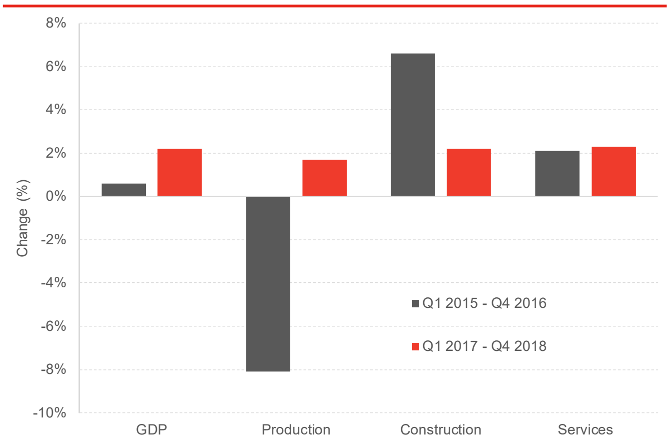
Oil and gas output produced on the UK Continental Shelf does not directly enter most Scottish economic statistics (including the official GDP estimate). But the firms that support such activity do enter the Scottish series. This includes those servicing oil and gas production outlets, those in the supply chain and businesses that benefit from the spending of people employed in the industry.

Chart 34 shows the percentage change in output across the main sectors of the Scottish economy over 2015-2016 compared with 2017-2018.

Production activities fell sharply – by nearly 8% during the height of the downturn. Metal industries fell 20%. There has been little bounce back.

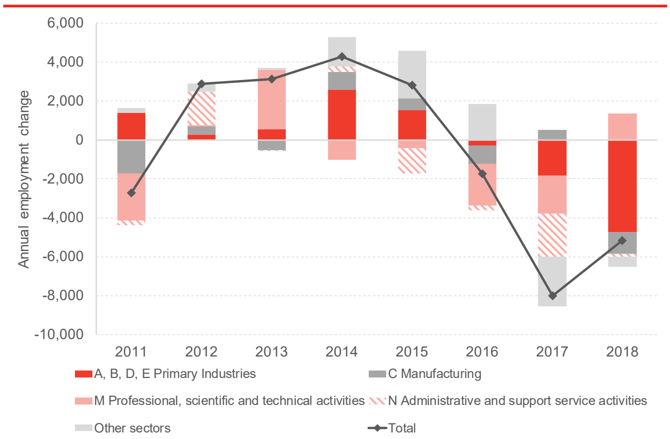
Aberdeen was at the centre of this with economic activity and employment taking a hit in the city. Chart 35. Indeed, looking at the other parts of the country, employment continued to rise across major cities, but fell in Aberdeen.

Chart 34: Change in output of Scottish sectors, %



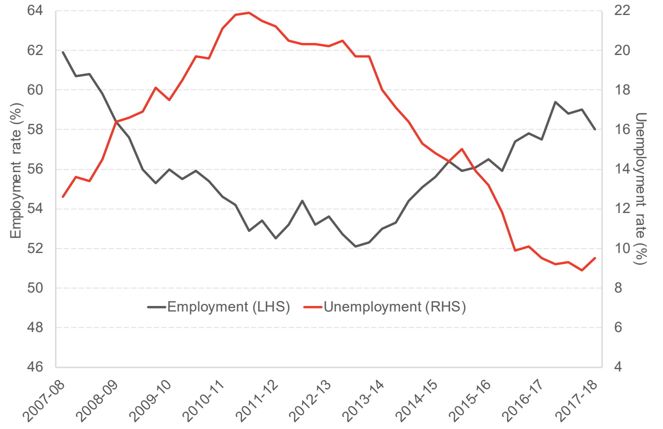
Source: *Scottish Government, FAI*

Chart 35: Annual sectoral employment change in Aberdeen City



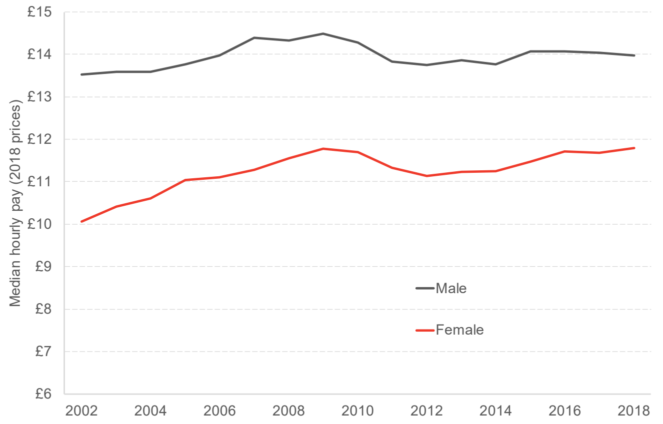
Source: *Scottish Government, FAI*

Chart 36: Employment and unemployment, Scotland



Source: *ONS, LFS*

Chart 37: Median pay by gender



Source: *ONS, ASHE*

Scottish labour market

The Scottish labour market continues to post impressive headline numbers. The employment rate is near its historic high and unemployment is at its record low. Chart 36.

Whilst positive, the experience of those in work is not foremost in most policymaker's minds when reciting thee positive statistics verbatim.

60% of working-age adults in Scotland in relative poverty (after housing costs) were living in working households, up 12%-points on two decades ago.

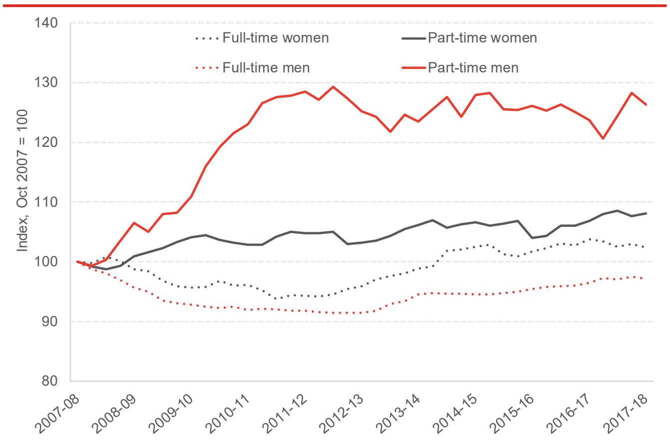
One reason for this is that despite expanding employment opportunities, wage growth has been extraordinarily weak. For example, median pay fell immediately following the financial crisis and has stagnated since. Chart 37.

Another reason is that work for many has become less secure. Underemployment, zero hour contracts, temporary working, and self-employment have at different times all been features of the post-crisis labour market. Chart 38 & 39.

We can see the fragile economic environment reflected to some degree in the trends for increased part—time working, particularly among men and in the increase in the employment rate of those over the state—retirement age. Economic necessity appears to be pulling more people into the labour market.

This in turn appears to explain the lack of dynamism in the labour market, with those in work choosing to stay put in their roles.

Chart 38: Full time and part-time employment growth, Index 2007-08=100

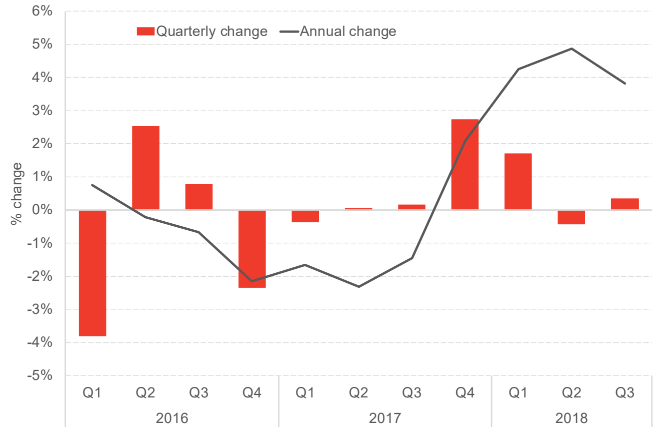


Source: *ONS, LFS*

Chart 39: Employment and self-employment growth, Index 2006-07=100

Source: *ONS, ASHE*

Chart 40: Scottish labour productivity growth, Q1 2016 - Q3 2018

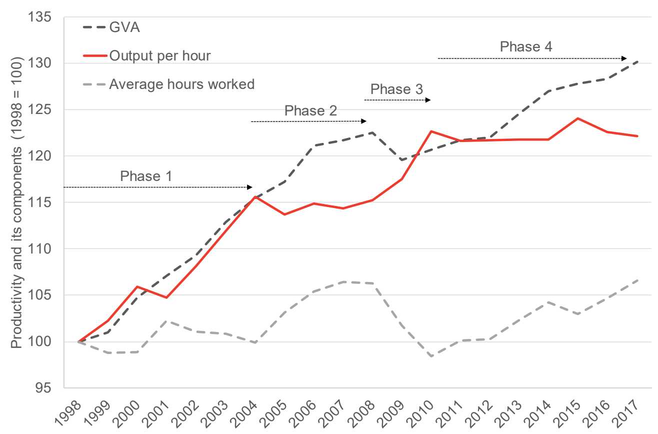


Source: *Scottish Government*

Chart 41: Drivers of Scottish labour productivity - GVA vs. hours worked (inverted)

Source: *Scottish Government*

Chart 42: Changes in Scottish productivity since 1998



Source: *Scottish Government*

Productivity

A common theme in previous commentaries has been Scotland's (and the UK's) weak productivity performance.

The latest 'trend' data shows productivity growth was effectively flat over Q2 and Q3 of 2018. Chart 40.

Looking at the underlying data reveals what has been driving the swings in productivity in recent times.

Remember, labour productivity measures how well output is fairing relative to changes in how much labour is being used to produce that output. If we are able to produce more for the same amount of hours worked then we are more productive. On the other hand, if we are working harder but not producing much more, then our productivity will fall.

As Chart 41 highlights, it is changes in the hours that we are working that has been the main source of much of any positive movements in Scotland's productivity performance. That is, rather than producing much more output, we are instead working less.

Chart 42 highlights changes in Scottish productivity since 1998. Some interesting patterns emerge.

Over the period 1998 to 2004 Scotland experienced strong growth in productivity driven by healthy growth in output and little change in hours worked. [Phase 1]

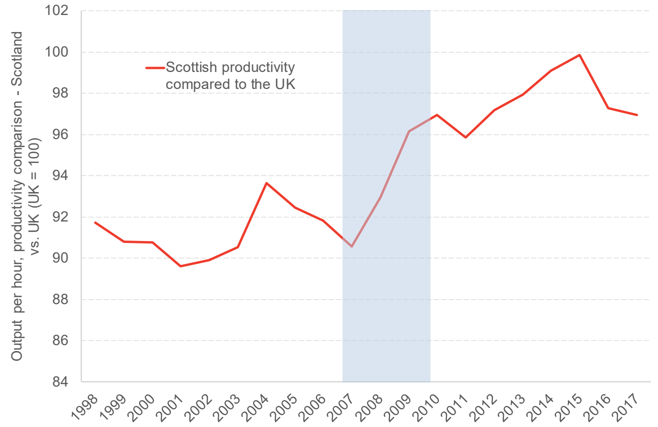
This was then followed by a period of growth in both output and hours worked, so that productivity as a whole remained relatively flat. [Phase 2]

During the financial crisis and subsequent recession, output slipped back, but this was more than matched by a fall in hours worked. As a result, productivity increased. [Phase 3]

But since 2010, productivity in Scotland has barely moved. [Phase 4]

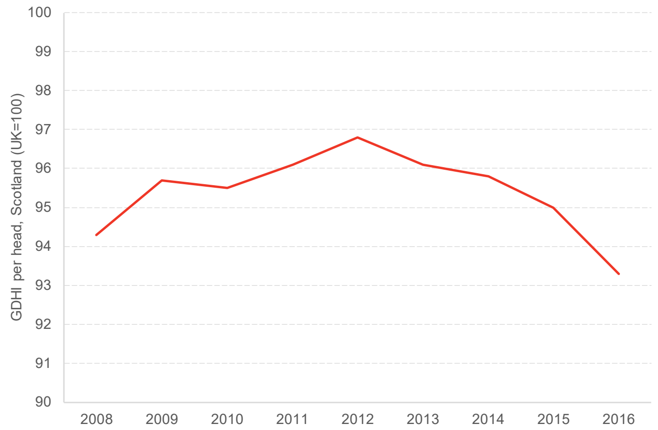
The weak growth we have seen in output has been matched by growing hours worked. In effect, the growth in output witnessed over the last seven or eight years or so has come from there being more people in work – or working longer hours – rather than any improvement in efficiency.

Chart 43: Scottish productivity compared to the UK, 1998 - 2017



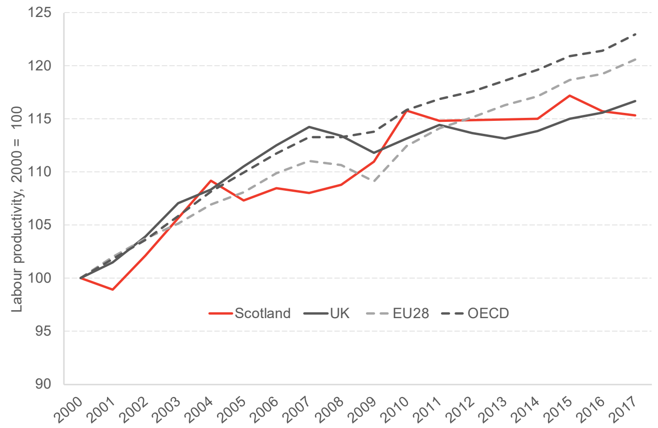
Source: *Scottish Government*

Chart 44: Scottish Gross Disposable Household Income per head, Index UK=100



Source: *ONS*

Chart 45: Scottish, UK, EU and OECD productivity since 2000



Source: *Scottish Government*

How has Scotland been comparing to the UK and internationally?

Chart 43 compares Scotland's labour productivity level with that of the UK (with for ease the UK = 100).

A quick glance shows that productivity in Scotland has risen from 92% of the UK rate in 1998, to 97% in 2017.

But on closer inspection, note that a substantial element of this 'closing of the gap' stems from what happened during the financial crisis.

Between 2007 and 2010, the gap between Scotland and the UK closed by 6.3 percentage points.

This closing of the gap matches to Phase 3 in Chart 42 – that is, the fall in output was more than matched by a fall in hours worked.

In effect, Scotland lost more jobs during the financial crisis per unit of output than the UK did, hence our 'productivity' improved.

As a result, whilst it might be possible to claim that we 'have caught up' a little with the UK, in terms of better economic outcomes this is highly debatable.

Chart 44 shows that in terms of household income per head, there has been no substantial change in relative performance between Scotland and the UK as a whole. Indeed if anything it has got worse.

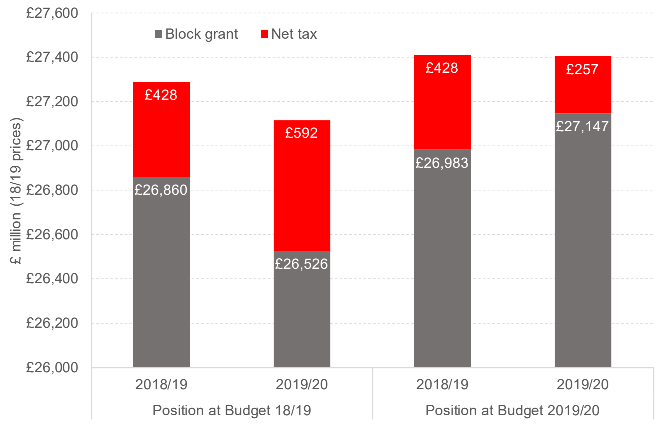
People in Scotland might be relatively 'more productive' but this has been eroded by other means, including weaker growth in working hours.

On an international basis, productivity in Scotland remains around 20% lower than the top quartile of OECD countries (remember the Scottish Government has a target to be in the top quartile).

Scottish productivity has effectively flat-lined since 2010. In contrast, productivity across the OECD and EU has been on the rise.

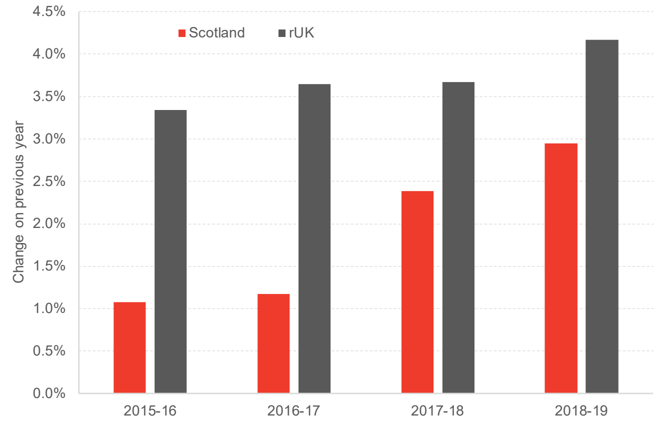
Turning around this productivity performance is crucial for boosting wages in the long-run. For all the debate about 'economic wellbeing', ultimately solving the productivity puzzle will go a long way to help improve outcomes.

Chart 46: Changes in the Fiscal Resource budget (£m, 2018/19 prices)



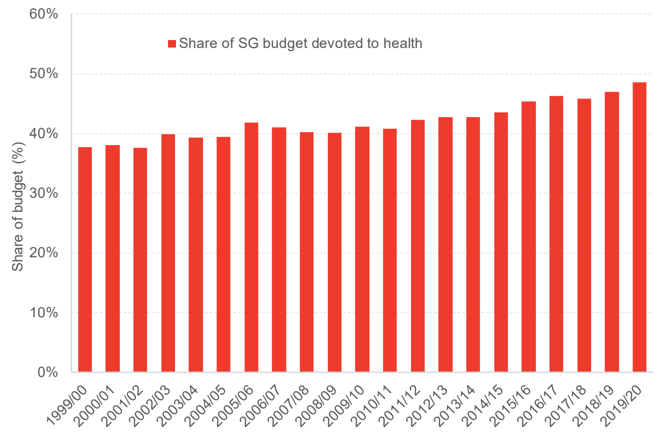
Source: *Scottish Government / FAI*

Chart 47: Growth in PAYE employment earnings per capita



Source: *HMRC*

Chart 48: Share of SG Budget devoted to health



Source: *Scottish Government / FAI*

Scottish Budget 2019-20: what next?

In February, the Scottish Budget for 2019-20 secured safe passage through Parliament. Once again, much of the debate focussed upon income tax rates and local government budgets. But longer-term trends are emerging which are starting to exert a greater influence on the Scottish budget.

In the end, as a result of additional consequentials from spending on the NHS in England, the fiscal envelope Mr Mackay had at his disposal for 2019-20 was better than first thought. Chart 46.

But the story on devolved revenues was less positive. In particular, Scotland's income tax revenues are now forecast to grow much more slowly. The net budget position for 2019-20 was therefore flat.

The focus once again on a 1-year budget allowed some emerging risks to be glossed over. Of particular concern from a Scottish perspective is this emerging outlook for devolved income taxes, with earnings growth lagging the rest of the UK. Chart 47.

So, although Scottish taxpayers are paying £500m more in income tax relative to what they would be paying if the government set the same policy as in rUK, the Scottish Government is only on track to collect around £180m more in 2019-20. The rest has been eaten up by weaker growth in the tax base.

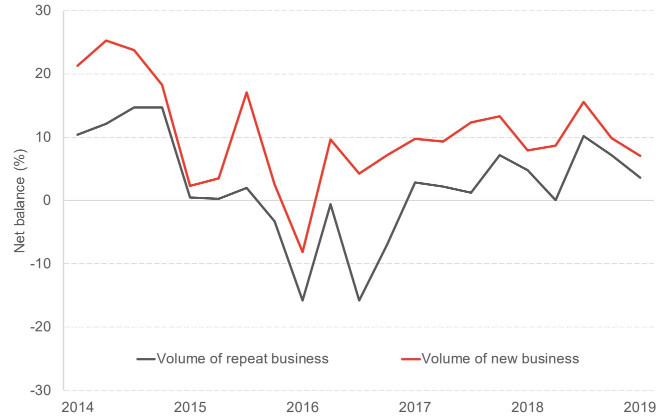
On top of this, it is increasingly likely that the tax forecasts for the first two years of its devolution - 2017/18 and 2018/19 – were too optimistic. Based upon current data, the Scottish Government could be forced to repay around £600m.

On the spending side, the NHS was once again the big 'winner'. But with health soon to absorb around half of day-to-day spending, the pressure on 'non-protected' areas continues to build. Chart 48.

One reflection is that whilst politicians are happy to set out their spending aspirations, not enough is said about their plans for non-prioritised areas. After a decade of austerity, a strategy is needed for managing reductions in certain areas just as much as one for where new money should be spent.

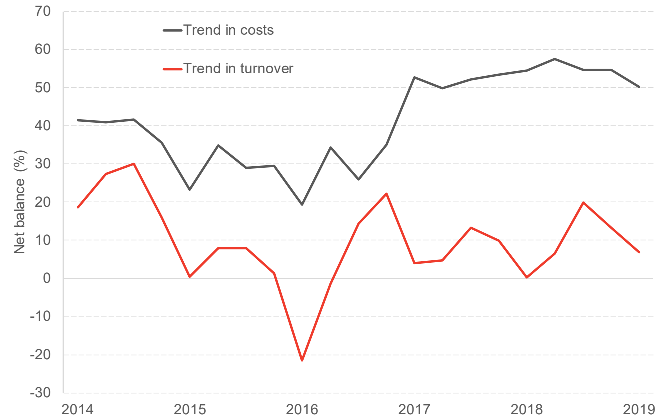
In May, the government will publish its latest medium term budget forecasts. This will offer an insight into the current administration's thinking on such issues. With an election 2 years away it will be incumbent on all political parties to set out their own approaches.

Chart 49: FAI Business Monitor - volume of repeat and new business, 2014 - 2019



***Source:** Fraser of Allander Institute*

Chart 50: FAI Business Monitor - business costs and turnover, 2014 - 2019



***Source:** Fraser of Allander Institute*

Latest economic indicators

Similar to at the UK level, most current indicators of business and consumer sentiment show high levels of uncertainty.

Whether or not this turns into a fall back in activity remains unclear.

Our latest Scottish Business Monitor for Q1 2019 showed that whilst activity remained net positive across the economy, it was less positive than 3-months ago. Chart 49.

New business activity has fallen back and now sits at its lowest point since the end of 2016.

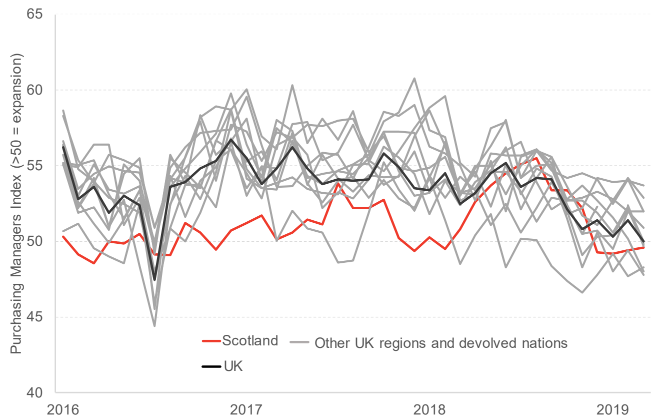
Alongside this, firms are reporting that costs are rising faster than turnover, with the gap widening; something which has in the past been a useful early indicator of a slowdown in economic activity. Chart 50.

The latest PMI for Scotland showed a similar picture. For March, the figure was 49.6 – just below the cut-off point between expansion and contraction. This was the 4th month in a row that activity reports have been marginally negative. Chart 51.

Sentiment amongst small businesses appears particularly negative at the current time. Chart 52.

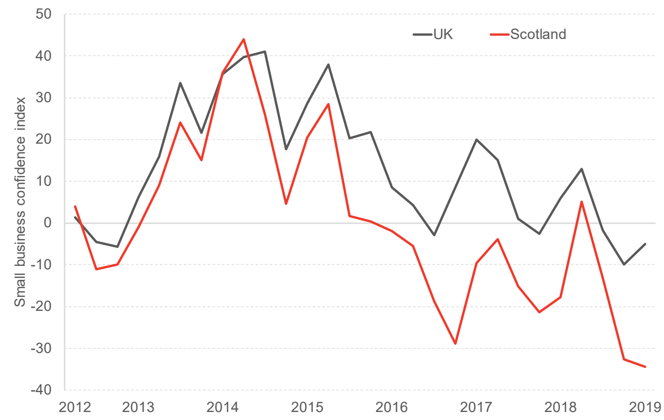
One common theme that we have identified is that whilst activity levels may be in the balance, there is clear and sustained negative sentiment toward investment. The Scottish Business Monitor reported a negative balance of -7 on capital investment.

Chart 51: Natwest regional Purchasing Managers Index, Jan 2016 - March 2019



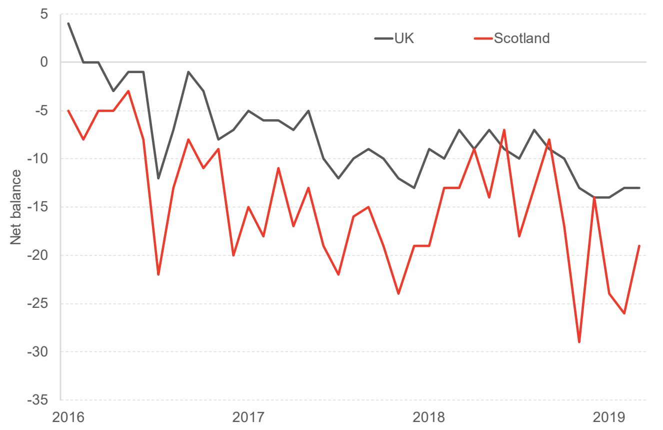
***Source:** IHS Markit / Natwest*

Chart 52: FSB Small Business Confidence Index, Q2 2012 - Q1 2019



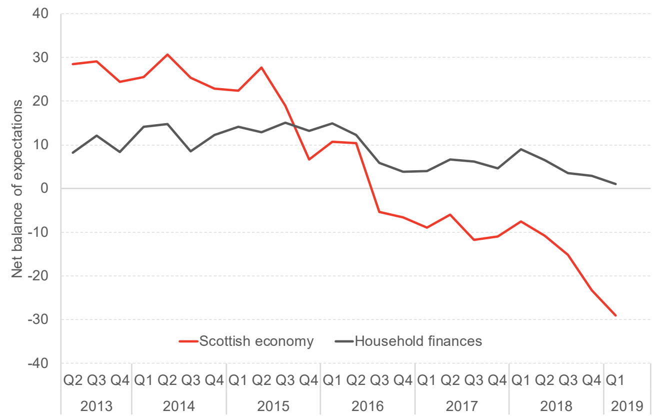
***Source:** Federation of Small Businesses*

Chart 53: GfK consumer confidence index, Jan 2016 - March 2019



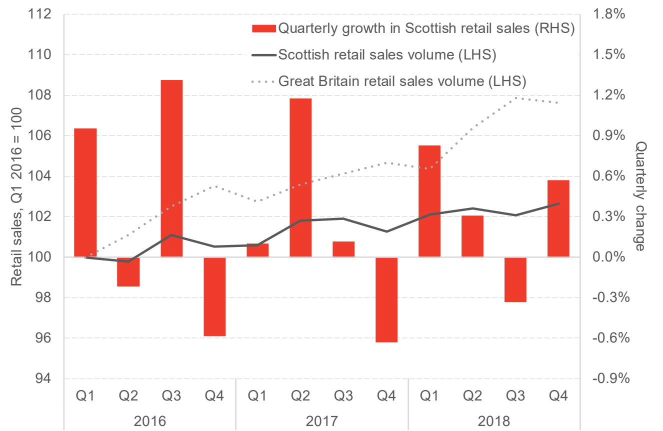
Source: *GfK*

Chart 54: Scottish household expectations of economy and household finances, Q2 2013 - Q1 2019



Source: *Scottish Government*

Chart 55: Scottish and UK retail sales growth, Q1 2016 - Q4 2018



Source: *Scottish Government*

Similar trends appear in the latest household surveys.

The latest consumer confidence indicator provided by GfK was -19. Chart 53

Optimism appears to be particularly negative amongst those at the lower end of the household income distribution.

The Scottish Government's own Scottish Consumer Sentiment Indicator – a composite measure based on a survey of households' current sentiment and future expectations of economic performance, household finances, and attitudes to spending money – fell to its lowest value since the survey was first conducted in 2013. Chart 54.

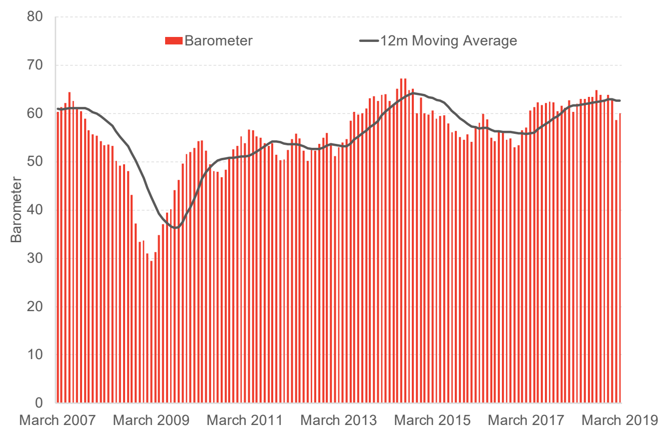
In Q1 2019, the Indicator stood at -9.6. Compared to Q4 2018, the indicator decreased by a further 3.8 points, implying that sentiment notably weakened. The fall was driven by a weakening across all major indicators of confidence, with the economic outlook weighing particularly heavily on the results.

Scotland's retail sector had a slightly better end to the year, with growth of 0.8% in the quarter. Despite troubles for a number of high street retailers, 2018 marks the 10th year of consecutive growth since the recession.

Overall however, the sector has been lagging behind the pace of growth in the rest of GB. This is likely to be explained, in part, by the ongoing challenges in household earnings. Chart 55.

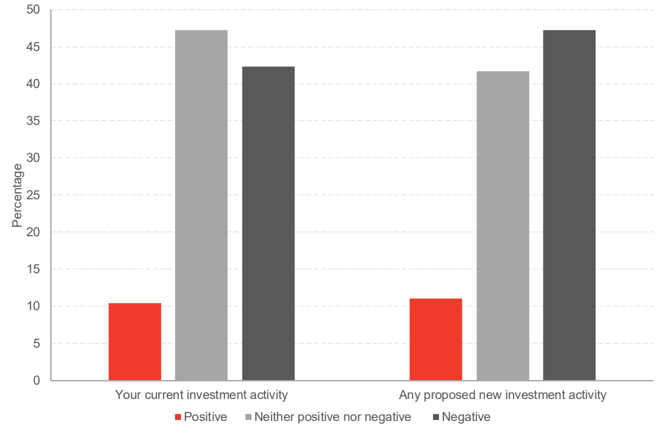
One positive note remains once again the outlook for the labour market. The RBS Jobs Indicator was 60.1 (where >50 marks improvement). Chart 56.

Chart 56: Royal Bank of Scotland employment barometer, March 2007 - March 2019



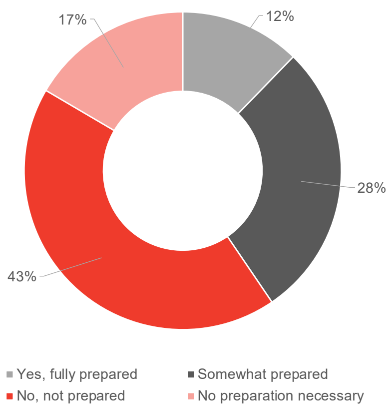
Source: *IHS Markit / RBS*

Chart 57: How has the UK's decision to leave the European Union affected……



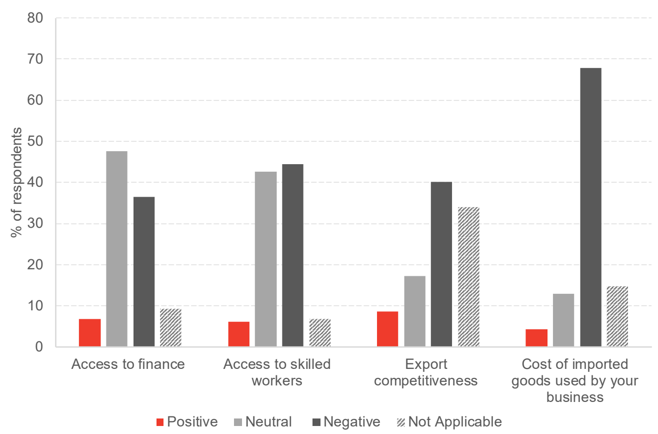
***Source:** Fraser of Allander Institute*

Chart 58: In the event that the UK leaves the EU without a deal, do you believe that your company is prepared for this 'no deal' Brexit?



***Source:** Fraser of Allander Institute*

Chart 59: What do you expect the impact of a 'no deal' Brexit to be for your business in the following areas?



***Source:** Fraser of Allander Institute*

Brexit readiness

As part of our ongoing work to monitor developments in the Scottish economy, earlier this Spring we asked a number of firms – from across Scotland and from different sectors – about their preparations for Brexit (and their experience so far).

The focus was not on whether businesses believe Brexit to be good or bad, but instead, how Brexit is affecting different areas of their day-to-day activities such as investment and recruitment.

Firstly, we wanted to see if any Brexit related uncertainty has been having an impact on investment, recruitment and firms undertaking new projects at the current time. Chart 57.

Four in ten reported that Brexit has had a negative impact on their current investment activity while only one in ten say it has been positive. Furthermore almost half of companies say that it has had a negative impact on new investment.

Secondly, we were also interested in whether firms had made plans for a possible 'no deal' Brexit. Chart 58.

The overwhelming response was that firms still do not feel fully prepared for a potential 'no deal' Brexit outcome. Whilst this is not that surprising given the uncertainties that currently exist, the scale of the response is clearly a concern.

Thirdly, we asked businesses about their expectations of the impact of 'no deal' Brexit. Chart 59.

45% fear it would have a negative impact on their access to skilled labour and more than 35% expect a negative impact with respect to their access to finance. Only around 7% said they forecast a positive impact.

Finally, in relation to any potential impacts on export competitiveness and imports, again negative expectations outweigh positive ones.

The mood of Scottish Businesses around a no-deal Brexit right now is fairly negative, which appears to be hampering investment in new business, new staff and new equipment.

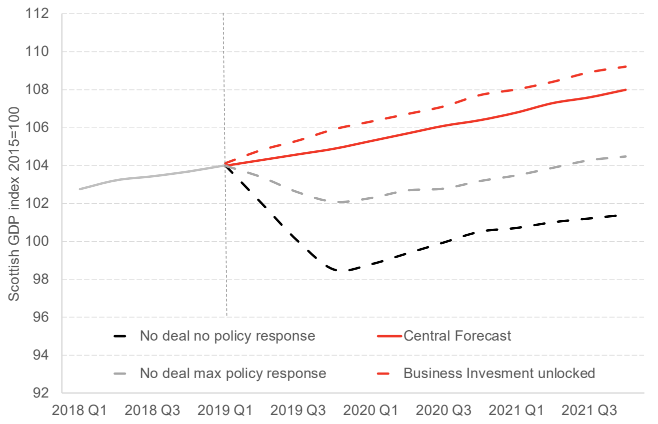
Whilst there are increasing signs of preparations ramping up, there are still a number of companies who have not done this.

Table 6: Latest growth forecasts for the UK economy

	2019	2020	2021
Bank of England	1.2%	1.5%	1.9%
OBR	1.2%	1.4%	1.6%
NIESR	1.5%	1.7%	1.7%
European Commission	1.3%	1.3%	-
IMF	1.5%	1.6%	1.6%
Oxford Economics	1.4%	1.9%	-
ITEM Club	1.3%	1.6%	-
CBI	1.4%	-	-

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

Chart 60: FAI forecast scenarios



Source: *Fraser of Allander Institute*

Table 7: FAI forecast growth scenarios, %, 2019 to 2021

	2019	2020	2021
Business Investment unlocked	1.7%	1.8%	1.6%
Central Forecast	**1.1%**	**1.4%**	**1.5%**
No deal max policy response	-0.2%	-0.3%	1.3%
No deal no policy response	-2.1%	-1.5%	1.4%

Source: *Fraser of Allander Institute*

Our forecasts

Economic forecasting in the midst of this current uncertainty continues to be fraught with issues.

As a result, all economic forecasts need to be viewed with caution. We simply do not know how decisions in Westminster or Brussels will pan out. Nor do we have any precedent to fall back on to give guidance on what the economic impacts might be.

Moreover, the smoothness, or otherwise, of the UK's withdrawal from the EU is but one step in the process. Negotiations on the terms of the UK's future relationship with the EU have yet to begin in earnest.

In the light of all this, we present a series of scenarios for how the Scottish economy may evolve over the next three years.

As with any such scenarios, the exact point estimates are less important than the overall scale and direction of travel.

In our central forecast, we continue to assume that the UK makes an orderly departure from the EU, although uncertainty continues to impact on investment and private sector spending decisions for some time yet.

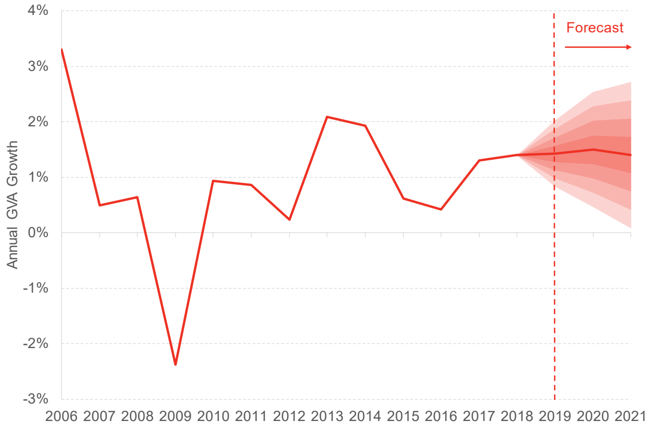
As a result, and in light of the weakening outlook for investment, we have lowered our forecast a little to 1.1% for 2019 and 1.4% and 1.5% for 2020 and 2021.

For our other scenarios, we take the impact point as Q2 2019. In reality, the impacts will occur at some as yet to be determined point in 2019. Starting at Q2 is simply for illustrative purposes to show the range of outcomes.

Whilst the immediate risk of a 'no-deal' outcome has been pushed back, it remains a possibility at some point in 2019. There is huge uncertainty over how this might look, the timing of when this might happen, and how the economy might respond.

We have therefore developed an illustrative 'worst' case scenario where the UK leaves in a disorderly fashion. If this was to occur, output could fall by around 5.5% from peak to trough (with a fall of 2.1% in 2019 as a whole compared to 2018). These are similar to the range of numbers produced by the Bank of England.

Chart 61: FAI forecast Scottish economic growth range



Source: *Fraser of Allander Institute*

* Actual data to 2018. Central forecast with forecast uncertainty for 2019 – 2021. Uncertainty bands sourced from accuracy of past forecasts at different forecast horizons.

Table 8: FAI central forecast Scottish GDP growth 2019 to 2021

	2019	2020	2021
GDP	**1.1%**	**1.4%**	**1.5%**
Production	1.2%	1.6%	1.7%
Construction	1.0%	1.1%	1.1%
Services	1.1%	1.4%	1.4%

Source: *Fraser of Allander Institute*

Table 9: FAI Labour Market forecasts to 2021

	2019	2020	2021
Employment rate (%)[1]	75.1%	75.0%	74.8%
Unemployment Rate (%)[2]	3.8%	3.9%	4.1%

Source: *Fraser of Allander Institute*

[1] Rate calculated as total employment divided by total of economically active population aged 16-64. [2] Rate calculated as total unemployment divided by total of economically active population aged 16 and over.

However, this assumes no policy response from government or the Bank of England. This is clearly unrealistic.

What a policy response to a 'no deal' Brexit might look like is uncertain. It is likely to involve a significant monetary stimulus through a cut in interest rates and possibly further Quantitative Easing.

A fiscal stimulus is also likely, with an uplift in spending – possibly on infrastructure – and, as in 2008, a temporary reduction in certain tax rates to support domestic spending.

Even then, and assuming a policy stimulus relatively comparable to that in 2008/2009, the economy is still likely to take a negative hit, but on a much smaller scale.

In that scenario, the Scottish economy would face a peak to trough decline of just over 1.9% before picking back up.

Of course, should the policy stimulus be bigger or smaller, then the exact number would change. On any reasonable assumption however, the scale of the 'hit' to the economy is likely to be much less than some of the 'worst' case scenarios have suggested.

Of course, there is a 'best' case scenario, where the recent uncertainty is reduced and confidence returns to the economy. In such a situation, we are likely to see a significant spike in new investment and in wider spending in the economy.

This could reflect for example, clarity on the UK's future relationship with the EU, including a commitment to close economic ties in some form or another.

In such an instance, we think that growth could surprise on the upside and be much closer to trend in 2019 and 2020.

Based on our central scenario, our latest nowcasts suggest that growth will be 0.31% in Q1 2019. Further information on some of the nowcasting work in the FAI is given in the box overleaf.

The central secnario is driven by solid growth in production and services, and a forecast pick up in construction activity after zero growth in 2018.

Box 1. Regional Nowcasting

Nowcasting involves the use of statistical models to estimate the current value of a variable of interest, most commonly economic growth, but these methods are also used by central banks and others to estimate current rates of inflation and other macroeconomic features. The basic idea is to use timely indicators of economic activity to produce more timely (and in some cases higher frequency) estimates of macroeconomic variables.

Researchers in the FAI are involved in two nowcasting projects.

The first, running since 2014, uses a Scotland only model and makes use of a range of 'hard' and 'soft' indicators of activity in the Scottish economy to understand what the current rate of economic growth in the Scottish economy is.

These results are reported on the FAI blog, as well as the project blog (http://www.nowcastingscotland.com).

The latest estimates are for Q1 2019, and these put economic growth in Scotland at 0.31%, or at an annualised rate 1.26%.

This is still significantly below trend growth in Scotland, but in line with the average official estimate of quarter to quarter growth in 2018.

The second project is funded by the Office for National Statistics (ONS) through the Economic Statistics Centre of Excellence, and produces quarterly estimates of growth for the UK regions and nations to the same approximate timescale as estimates produced by the ONS for the UK as a whole. Official estimates of growth in 2018 for the UK regions and nations will be released in December 2019. For more on this nowcasting work see: https://www.escoe.ac.uk/regionalnowcasting/.

UK growth is currently available to 2018 Q4, as are these nowcast estimates, which are summarised in the table below (the UK figure in bold is the official estimate from the ONS).

Table 10: Growth rate (%) in the year to 2018 Q4

Area	Growth rate
London	2.90%
Scotland	1.70%
North West	1.50%
South West	1.50%
East Midlands	1.40%
UK	**1.40%**
South East	1.30%
Yorkshire and The Humber	1.20%
West Midlands	1.10%
North East	1.00%
East of England	0.90%
Northern Ireland	0.90%
Wales	0.80%

Source: *Fraser of Allander Institute*

We can see that London continued to far outperform the rest of the UK in 2018, realising growth more than twice as fast as the UK as a whole. Meanwhile Scotland, the North West, South West and East Midlands saw growth in 2018 slightly faster than the UK as a whole. Lagging substantially behind the UK as a whole were Wales, Northern Ireland and the East of England.

Nowcasting provides a toolkit to estimate economic growth (and other features of the macroeconomy) in a more timely, and in some cases higher frequency, manner. There are (of course!) confidence intervals around any such estimates, as there are around all official economic statistics(!), and for this reason these estimates should be treated as (hopefully useful!) early estimates measured with some uncertainty.

Note: The figures for Scotland were produced after the first release of the UK figure for 2018 Q4, and will be different to the official Scottish Government estimates.

Policy context

Policy priorities in light of Brexit

Next month will mark the 20th anniversary of the first elections to the devolved Scottish Parliament.

There will no doubt be some reflection on the successes and failures of the parliament since then. But whatever your view, it is hard now to imagine Scotland and Scotland's economy without Holyrood playing a central role.

The significance of this role is only likely to increase in the years ahead. With Brexit, major structural shifts in our economy, the continuing recovery from a decade of austerity and the possibility of a 2nd independence referendum, further upheaval is inevitable.

The immediate policy challenges

Brexit is the most important inflection point in UK economic policy making since 1979.

Whilst we still(!) do not know the final outcome, if (and when) the UK does eventually leave the EU, it will also be the biggest single test of the capacity and capability of the Scottish Parliament since 1999.

We see three major challenges on the immediate horizon.

Firstly, even if there is progress toward some form of Withdrawal Agreement between now and the end of October, the ultimate end state in terms of a final deal with the EU remains uncertain.

Many critical elements of the negotiations over a future UK-EU relationship are likely to be fudged or deferred, leaving uncertainty hanging over the economy for many more months, if not years.

Businesses and policymakers will have to adapt to a world where uncertainty is a constant feature of the landscape.

Of course, much of the onus for providing greater clarity to the economic policy context rests with the UK Government.

But it is also a challenge for Scottish policymakers.

If uncertainty is the new normal, then a clarity of purpose on devolved policy, whether that be in setting out a clear direction of travel on devolved taxation, infrastructure, planning and wider economic development, becomes all the more important.

The second challenge relates to how the Scottish Parliament will respond to the new powers that will come its way as a result of the UK leaving the EU.

But what might these powers be?

The lack of progress in determining the split between devolved and reserved responsibilities of (ex-)EU powers is frustrating and only adds to the uncertainty. This is one area where the UK Government could make (and should have made) much quicker progress.

There is also a major question about how future Scottish governments might use these new powers?

Whilst it is understandable that the Scottish Government will make the political case for the maximum transfer of powers, it needs to consider carefully how such powers will be administered, funded and used for what purpose.

In recent weeks, we have seen the delivery of some new devolved social security powers pushed back into the next decade given the complexities of administration and delivery.

Finally, there is simply no escaping the fact that the decision to leave the EU marks the greatest shake-up to the UK's economy and policy landscape in over 40 years.

Much of what was taken as 'given' in economic policy circles – e.g. freedom of movement, Single Market access, EU structural funding, State Aid rules, Horizon 2020 – looks like it will be turned on its head.

With so much of recent debates still stuck either on the arguments for and against Brexit, the 'type of Brexit' or indeed the process, the lack of any detailed thinking as to what UK and Scottish economic policy might look like post-Brexit is a concern.

Scotland's domestic policy agenda

One consequence of the Brexit debate is that it has left little room for discussions of the emerging structural challenges and opportunities our economy is facing.

So what are these big policy questions?

First and foremost, the sustainable growth challenge is arguably still something that remains inadequately addressed in the political discourse in Scotland.

For all our economy's documented successes, the backdrop is an economy that has grown slowly for the best part of a decade.

We have clear strengths in sectors and firms across Scotland, from food & drink, financial services, energy and tourism. Our workforce is highly skilled with our university sector world class.

But we also know that our export base is too narrow and that our levels of R&D activity and entrepreneurship lag behind the UK as a whole (which in turn lag behind key OECD economies).

For all the talk about 'inclusive growth', nearly 1 in 4 children in Scotland continue to live in poverty. Indeed, the policy response in support of this asserted vision remains opaque at best.

And despite record levels of employment, for many being in work is no longer providing the security and prosperity it once did. In-work poverty is on the rise, with over 50% of those in poverty now living in a household where there is at least one working adult.

In some areas, such as renewables and climate change, the government has overachieved on the ambitious targets that they set themselves. But on the major 'macro' targets – such as the 2007 'Purpose Targets' – most have been missed.

Last year we highlighted the 'cluttered landscape' here in Scotland, with numerous strategies, advisory boards, action plans, agencies and small-scale initiatives. It would appear that little has changed.

But this is not just a challenge for the Scottish Government. In November 2017, and as part of their Industrial Strategy, the UK Government announced a review of how UK and Scottish Government agencies could better collaborate to support businesses. Nearly 18 months on, this review has yet to offer any insights, recommendations, or even any evidence of having got off the ground.

The lack of evaluation and scrutiny of the effectiveness and value of policy initiatives remains – in our view - the weakest aspect of the devolution policy landscape.

The second 'big' question relates to how the Parliament will respond to the major structural changes that we know are coming to our economy in the years ahead.

Some have a particular resonance in Scotland, such as sharp rise in the average age of our population, the challenges of managing the long-term scaling back in oil and gas or the advantages our natural environment can give us in a world where sustainability is rarely just an outcome of growth rates but a key driver.

Others are more universal, such as understanding both the benefits and risks to jobs, household incomes and inequalities from the 4th industrial revolution and the growth of new and emerging markets.

Scotland's economic strengths provide a solid foundation upon which to build. But in a world of such significant change and shifts, 'more of the same' policy ideas will not succeed. The scale of these changes will require a boldness in economic thinking that, arguably, we have not seen over the 20 years of the Scottish Parliament.

Finally, one thing that we can be certain of is that public sector budgets will remain under pressure for the foreseeable future.

Whilst borrowing has fallen in recent years, the UK's stock of debt still stands at nearly 90% of GDP. Should Brexit weaken the economy, this will hit tax revenues and lower the long-term rate of growth in public spending.

As highlighted above, the near-term outlook for some devolved taxes is a further concern, with a gap emerging between forecasts and revenues raised.

All this comes at a time when demand pressures continue to rise. Health is likely to absorb around half of day-to-day government spending by the end of the parliament. And even then, this is just sufficient to keep pace with rising take-up and costs of delivery.

As a result, future Scottish governments will have little room for manoeuvre, unless they are prepared to make radical changes to the way services are delivered, what services are delivered, and/or there is a step change in the level of revenues raised.

One reflection is that whilst politicians are happy to set out their spending aspirations, not enough is said about their vision for non-prioritised areas.

Is Scottish society content for the changes in spending distribution we are seeing to continue? Can we make more transparent, strategic and consensual decisions about which areas to prioritise (and which are less of a priority)? And at what point do we need to become more realistic about the scope to raise additional public revenues to meet ambitions for public service delivery?

So what next?

The age of economic and fiscal uncertainty and upheaval is clearly here to stay. This is the new normal to which we need to adapt.

Resilience, and an ambition to seek out new opportunities, are likely to be the two most in-demand qualities for businesses and policymakers over the coming months and years.

On a more long-term level, the Scottish Government – and opposition politicians – will need to understand and respond to the big structural economic and fiscal challenges and changes that are underway.

So where might they focus?

Firstly, there is clearly a much greater role for robust evaluation of policy than we have seen in recent years. What has worked? What has not? Why have some targets been met? And why have some been missed?

Some institutions, like Scottish Enterprise, are aware of the need to do this and engage in a wide variety of appraisals and evaluations. But more broadly, challenges remain around the extent and quality of economic data, the public sector's capacity to undertake such analysis, and – perhaps most concerning – the lack of recognition of the importance to good policymaking and accountability of evidence.

Secondly, a renewed emphasis on medium term challenges is needed. This will require more strategic thinking about the likely economic and fiscal challenges of the future, than appears to be the case just now. The new Scottish Government 5-year financial strategy is a good step forward, but is undone by the fixation to one year budgets.

Thirdly, and most politically challenging, is that there needs to be more recognition that if Scotland is to respond to the structural shifts that will impact on our economy in the years ahead, it will need a more collegiate approach that seeks consensus on the big issues and what should be done to understand their implications. The last few weeks in Westminster have shown the consequences that can arise when consensus policymaking breaks down.

20 years ago those who established the Scottish Parliament had the hope that politics here in Scotland would take a different approach and usher in a new era of collective effort and decision making.

The need for that approach is now more urgent than ever.

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