State of the Economy

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State of the Economy

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

Data correct up to and including the 20 August 2015

To view previous State of the Economy presentations please visit the following link: http://www.scotland.gov.uk/Topics/Economy/state-economy

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Economist-webgroup@scotland.gsi.gov.uk
Summary of Key Conclusions

The Scottish economy posted its eleventh quarter of expansion at the start of 2015, which was its longest period of uninterrupted growth since 2001. The most recent data for the first quarter of this year recorded growth across each of the main sectors of the economy, with a particularly strong performance in the construction sector underpinned by infrastructure investment.

The continuous growth over the last three years demonstrates the Scottish economy’s underlying resilience given the difficult external and domestic challenges that we have seen during this period. Over the same period of time we have seen very positive trends in the labour market, with both employment and unemployment moving towards their pre-recession averages and marked improvements showing more recently in youth employment (and unemployment) levels. Buoyant labour market conditions have combined with low price pressures to boost household incomes.

The continuing recovery in economic conditions is fostering a rise in confidence and investment – visible in developments such as house price rises and record levels of inward investment – and these factors are expected to drive growth in Scotland’s economy throughout 2015. As recovery continues, with employment now hovering around record levels we expect the pace of employment growth to ease somewhat and we should see a pick-up in productivity growth and rising real wages. Both of these are required to sustain competitiveness and consumption patterns.

With oil prices remaining well below last year’s levels in recent months, the impact of low oil prices will continue to have a material bearing on economic conditions in Scotland, with both positive and negative implications.

External risks are likely to remain present over the course of 2015, with global demand conditions influenced by slowing growth in emerging markets, the fallout from subdued growth, financial volatility and currency depreciation in China, and the expected rise in US interest rates as the Federal Reserve looks to begin normalising monetary policy. The outlook for the Euro Area economy is generally positive but the situation in Greece remains a significant challenge.

Nevertheless, underlying data and forecasts point to a positive outlook for the rest of this year. The most recent independent forecasts expect growth in the Scottish economy of around 2.4 per cent in 2015, which is broadly in line with the expected performance of the UK as a whole.
Recent Global Economic Developments

- Global growth softened slightly in Q1 2015 – driven largely by a muted first quarter performance in North America – but recent data points to a stronger second quarter.

- World economic growth patterns continue to diverge. Whilst it experienced a slow start to the year, economic conditions are fundamentally positive in the United States. In Europe, the UK is forecast to see solid growth this year and economic data points to a strengthening recovery in the Euro Area, albeit with continued risks from events in Greece. The pace of growth in China continues to ease and the country has been grappling with stock market volatility, which has both highlighted and exacerbated weaknesses in the finance sector. Weak demand in China has spilled over to the rest of the Asia-Pacific region, adding to the already-subdued picture across emerging markets. Lower demand from China is also contributing to the fall in commodity prices observed over the past year which is depressing growth in many commodity exporters, such as Brazil and Australia.

- Following the sharp fall in oil prices at the end of last year, prices have stabilised at around $50-$60 a barrel. Whilst this has presented challenges for oil producers, it has also helped to keep costs and prices – and therefore inflation – low, and boosted demand in many countries. However, the impact on inflation is expected to start unwinding towards the end of this year and, with economic conditions generally positive in advanced economies, central banks in the US and UK have resumed their signalling on policy interest rates rises.

- World growth is expected to be around 3.3% this year, a fraction down on last year and below its long term average reflecting the global economy adjusting to slower growth in emerging markets.

Recent Scottish Economic Developments

- The Scottish economy saw growth of 0.6% in Q1 2015, with expansion across services, production and construction.

- Outturn data shows that some sectors are experiencing the expected negative knock-on impacts from consolidation in the offshore sector as it adjusts to lower oil prices. However, these were more than offset by expansion elsewhere in the economy. For example the pattern of robust growth in construction output continued driven, to a large degree, by infrastructure investment. Meanwhile, consumption has been buoyed by factors such as high employment and low inflation.

- The broader positive economic picture is also reflected in the labour market and we are seeing unemployment stabilise at or around its historical average. As in the UK, employment growth has started to level off and encouragingly we are seeing full-time working increase its share of overall employment. Meanwhile, wages continue to grow driven by a gradual acceleration in nominal wage growth coupled with low inflation.
Business survey measures for the second quarter pointed to continued expansion in both output and exports. However, they also highlight some of the key headwinds facing the economy, such as the combination of the strong pound and muted demand in some export markets.

**Future Prospects – Scottish Economy**

- The impact of low oil prices will continue to have a material bearing on the Scottish economy this year.
- As discussed in the previous edition of State of the Economy, lower oil prices boost consumption as well as production in energy-intensive sectors, but squeeze investment and profitability in the oil and gas sector and the wider supply chain.
- Despite this challenge, the economy has displayed a high degree of resilience and the overall outlook remains upbeat. Employment and investment have continued to grow in the early part of 2015. Business and consumer surveys also paint a positive picture of firm and household economic behaviour for the second half of the year.
- There are still a number of prevailing headwinds in the outlook, for example from further fiscal tightening at the UK level, weak conditions in key export markets and sterling appreciation.
- However, underlying conditions – low interest rates and inflation, high employment, robust investment and healthy domestic demand, alongside improving conditions in some of Scotland’s most important export markets – point to continued expansion over the course of 2015.
- This is reflected in independent forecasts, which are predicting that the positive growth momentum from last year will continue this year with growth of around 2.4% expected.
Global Overview

Global conditions mixed in first half of 2015
- Global growth weakened slightly at the start of 2015, driven to a large extent by a dip in economic activity in North America, which added to an already subdued picture in emerging markets.
- Outturn data for Q2 was mixed but generally pointed to a more positive picture in the second quarter.

Central banks debate interest rate rises
- The very low inflation in advanced economies that has prevailed since oil prices fell at the end of last year is showing signs of bottoming out. Forecasters expect inflation to start rising again towards the end of this year as economic conditions continue to improve and last year’s oil price effect drops out of the annual inflation calculation.
- With this in mind, discussions among central banks have refocused on the appropriate time to begin normalising monetary policy and increase interest rates. Based on the economic outlook and signals emerging from central banks, markets are now expecting the first US rate rise before the end of this year and the UK to follow in the first half of 2016.

Outlook positive with both downside and upside risk
- The IMF has revised down its latest forecasts for world growth in 2015 marginally to reflect the slightly weaker conditions in Q1. It now expects global growth this year to be 3.3%, a fraction down on last year and still below its long term average of 3.8%.
- Downside risks to the outlook include still-subdued conditions in emerging markets, with further drag from China also possible if conditions worsen.
- Balancing these are several bright spots, including the continued boost from lower oil prices and a gradually improving picture in the Euro Area.
United States

Growth rebounds in the second quarter
- The US economy slowed in Q1 2015 due mainly to severe weather dampening household consumption and a sharp dollar appreciation weighing on exports. An additional factor was a softening in oil and gas sector investment on the back of low oil prices.
- Conditions improved in Q2 with quarterly growth of 1.0% as consumption rebounded sharply underpinned by a mix of low prices, strong employment growth, and buoyant conditions in the US housing market.

Labour market gains and modest wage growth
- The US labour market has posted healthy job gains and unemployment has remained on its downward trajectory, but this has yet to feed through to a sustained acceleration in nominal wage growth.
- Nevertheless, alongside low inflation and rising house prices, and with consumer confidence upbeat, we should see solid consumption growth in the second half of the year.

Forecasts expect solid growth but risks present
- The Federal Reserve is moving towards enacting its first interest rate rise in nine years. However, this remains subject to supportive economic conditions and there are still domestic and external factors causing uncertainty on the timing.
- Internally, these include softness in business investment, muted productivity and wage growth and stable inflation expectations. Externally, the strong dollar and weak global demand are keeping exports subdued, with potential for additional drag if conditions in China worsen.
- Overall, the IMF expects US growth of around 2.5% this year, a modest acceleration on last year to around its long term trend.
Euro Area

EA recovery continues to make inroads
- Euro Area growth in Q1 was 0.4%, slowing slightly to 0.3% in Q2 (preliminary estimate). The Q2 figure was a little below expectations and reflected stagnation in France and weaker than expected growth in Germany, offset by very strong growth in Spain.

Growth underpinned by growing confidence
- Consumer confidence has been recovering since early 2013 underpinned by improving employment prospects and, to a lesser extent, low prices, both of which have boosted household incomes.
- The ECB’s Quantitative Easing programme has significantly weakened the euro allowing for export growth, particularly among those economies which have boosted their competitiveness in recent years (e.g. Ireland and Spain).
- Finally, very low interest rates, improving health in the finance sector, and a lift in business confidence has seen business lending and investment recovering, both for SMEs and for larger firms.

Expansion to continue and accelerate over 2015
- Forecasters expect the Euro Area economy to continue strengthening in 2015 with annual growth expected to accelerate to 1.5%. However, the positive outlook depends on further progress on structural economic reforms aimed at boosting productivity and potential growth.
- Thus far events in Greece have failed to make a substantial impact on Euro Area growth prospects, although it still constitutes a key risk to the outlook if the situation escalates and leads to contagion to other Euro Area economies.
Japan, China and Emerging Markets

Mixed picture in Japan over year to date
- After strengthening in Q1 Japan’s economy contracted -1.6% (annualised) in Q2 2015. Domestic conditions were subdued and external demand was affected by a slowing Chinese economy.

Structural weaknesses and financial vulnerabilities weigh on Chinese economy
- The slowdown in China’s economy has continued, with the 7.4% economic growth recorded in 2014 its slowest for 24 years.
- China has also been grappling with stock market volatility, prompting the government to intervene with measures to stem a rout in equities prices. The situation has served to highlight additional vulnerability in an already fragile, heavily debt-financed, Chinese finance sector.
- Whilst the Chinese government has also introduced other short term measures to stimulate the economy (monetary policy loosening, renminbi devaluation) and has set a timetable for structural reforms (e.g. through reform of state-owned enterprises), most indicators point to growth slowing further this year.

Muted conditions across emerging markets
- In other emerging markets the picture is generally downbeat. Conditions in China are spilling over to Asia. Alongside this, whilst low commodity prices have benefited India they have spelt problems for commodity exporters like Russia and Brazil. These countries have seen their currencies slide and inflation rise, forcing them to raise interest rates which in turn damps growth.
- Set against underlying structural problems, the outlook for emerging markets is therefore for growth to remain below-par this year.
UK

Solid pace of growth in the second quarter
- After strong annual growth in 2014 economic conditions softened slightly in Q1 (growth was 0.4%), primarily due to a drag from net trade which was not fully offset by accelerating consumption growth.
- However, preliminary estimates point to a pickup in growth in Q2 to 0.7%, helped to a large degree by strong activity in the North Sea (see pg. 16).

Mixed progress on economic rebalancing
- The last two years have seen some progress on rebalancing in the UK economy. In particular, investment is generally making a stronger contribution to growth compared to pre-crisis trends, whilst the average contribution from consumption has reduced.
- Whilst encouraging, consumption still outstrips income growth resulting in the savings ratio recently falling back to pre-crisis levels. Household debt also remains high in comparison to countries such as the US and Germany. This leaves UK households vulnerable to an income shock, with attendant risks for aggregate demand.
- The picture on net trade is less positive. Little or no productivity growth in recent years has undermined UK competitiveness and, combined with weak global demand, UK exports have suffered. More recently, exports have been further dampened by the pound’s strength, especially relative to the euro.
- Government’s contribution to aggregate demand has remained largely unchanged through the recovery, although the OBR does expect the increased rate of fiscal tightening at the end of 2015 to reduce economic growth slightly at the start of next year.
Employment gains and signs of continued pay growth

- Recent months have seen further employment gains, pushing unemployment down to 5.6%.
- The gradual tightening in the labour market has resulted in further growth in nominal wages which, combined with low inflation, has pushed up real earnings growth.
- There are signs that employment levels may be peaking. This may point to a new phase in the recovery that sees employers focus less on hiring and more on increasing output with existing workers. If this is the case it should improve productivity and set the scene for wage growth to increase in a way that is less inflationary and therefore more sustainable.

CPI forecast to rebound paving the way for a rate rise

- The fall in oil and other commodity prices at the end of 2014 have kept recent UK CPI inflation readings at record lows (0.1% July).
- Nonetheless, the Bank of England is expecting inflation to start rising again towards the end of 2015 as last year’s fall in oil price drops out of the annual calculations and spare capacity in the economy diminishes.
- It has therefore been renewing its signalling to households and markets to prepare for an interest rate rise.

Forecasts see sustained growth in 2015

- The average forecast for UK economic growth in 2015 is now 2.5%, a little down on last year but still healthy by historical standards.
- A pickup in productivity growth remains a key assumption, and also a key domestic uncertainty, in most forecasts.
Recent Developments in the Scottish Economy
Summary

Economy sees eleventh consecutive quarter of growth
- Last year’s growth momentum was maintained into 2015 with 0.6% growth in Q1 (UK 0.4%).
- This was the eleventh consecutive quarter of growth in the Scottish economy, the longest uninterrupted period of economic expansion since 2001.
- Whilst there was expansion across all the main sectors, construction stood out with very strong growth, underpinned by infrastructure investment.
- We have also seen encouraging trends in house prices, which have recorded growth over the last seven quarters.
- Business surveys and consumer confidence readings point to continued growth in Q2 2015.

Positive labour market conditions and wage gains
- The labour market has continued to show positive trends, with both employment and unemployment displaying signs of stabilising at or around their pre-recession averages, consistent with the picture in the UK as a whole.
- In the latest figures there were particularly encouraging trends in youth employment, which is now above pre-recession levels.

Forecasts point to continued strong growth this year
- With oil prices remaining well below last year’s levels in recent months, the impact of low oil prices will continue to have a material bearing on economic conditions, with both positive and negative impacts.
- Nevertheless, the economy has displayed a high degree of resilience and the overall outlook remains upbeat.
- The most recent forecasts expect growth in the Scottish economy to continue over 2015 with an average growth expectation of 2.4% growth this year.
Recent Scottish Performance

Output

The Scottish economy saw solid expansion in the first quarter of 2015 with growth of 0.6%, the same rate as the previous quarter and a little above the UK figure of 0.4%. Annual growth (quarter-on-quarter) in Q1 was 2.8%.

Quarterly National Accounts Scotland\(^1\) (QNAS) data provides an estimate of the expenditure drivers of nominal GDP growth over the year to Q1 2015, which was 2.9%. Household consumption was the largest contributor with robust growth over the year supported by high employment, rising wages, low inflation, and low mortgage rates, all of which have served to boost real household disposable income. Other factors that have contributed to the strong growth in consumption include rising Scottish house prices\(^2\) which tend to stimulate consumption both indirectly via their impact on household wealth, and directly from housing-related spending. Further improvements in lending conditions (e.g. lower retail interest rates\(^3\)) have also fed through to consumption of durable goods in particular – for example new car registrations in Scotland have seen very strong growth.

Rising consumption growth is welcome to the extent that it reflects rising consumer confidence and household income. However, as in the UK as a whole growth in household income has not kept pace with consumption resulting in the savings ratio in

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1. Note, QNAS figures are expressed in nominal terms and, unlike headline GDP growth, are not adjusted for price changes.
2. The ONS House Price Index for Scotland has registered positive annual growth in each of the seven quarters to Q2 2015. More details here.
Scotland falling, therefore a pickup in productivity and real wages is needed to support consumption patterns.

Investment continued to make a significant contribution to nominal GDP growth over the year to Q1 2015, driven to a large extent by the strength of construction output, which is discussed in more detail in the box on page 17.

Net trade acted as a drag on nominal growth over the year. This was driven mainly by a pickup in import growth in the context of a strong pound and solid consumption patterns. Meanwhile, market conditions and the appreciating pound meant that the average prices received for Scottish manufactured exports fell even as overall export volumes grew – although at the firm level this effect will have been offset by falling input costs.

### The Summer 2015 Budget

The UK Chancellor of the Exchequer delivered his Summer 2015 Budget on 8 July accompanied by a revised set of economic forecasts from the Office for Budget Responsibility (OBR).

#### Economic Projections

The OBR’s outlook for the UK economy was little changed from the previous forecasts (March 2015). Economic growth in 2015 was revised down marginally from 2.5% to 2.4%, reflecting a weaker than expected start to the year. However, the outlook is for solid growth through to 2020.

The OBR highlighted that whilst UK productivity growth has been disappointing it should gradually pick up over the forecast period as cyclical factors diminish, although this assumption remained a key uncertainty with attendant uncertainty for wage and growth forecasts.

<table>
<thead>
<tr>
<th>GDP Growth</th>
<th>July 2015 Forecast</th>
<th>March 2015 Forecast</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>1.7 (outturn)</td>
<td>1.7 (outturn)</td>
<td>-</td>
</tr>
<tr>
<td>2014</td>
<td>3.0 (outturn)</td>
<td>2.6</td>
<td>-</td>
</tr>
<tr>
<td>2015</td>
<td>2.4</td>
<td>2.5</td>
<td>-0.1</td>
</tr>
<tr>
<td>2016</td>
<td>2.3</td>
<td>2.3</td>
<td>0</td>
</tr>
<tr>
<td>2017</td>
<td>2.4</td>
<td>2.3</td>
<td>0.1</td>
</tr>
<tr>
<td>2018</td>
<td>2.4</td>
<td>2.3</td>
<td>0.1</td>
</tr>
<tr>
<td>2019</td>
<td>2.4</td>
<td>2.4</td>
<td>0</td>
</tr>
<tr>
<td>2020</td>
<td>2.4</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

#### Fiscal Measures

In the Budget the UK Government changed the composition and pace of planned fiscal consolidation. Planned cuts to public services were scaled back whilst further cuts to welfare budgets and tax increases were announced. Fiscal consolidation will now last a year longer than originally projected with a budget surplus now expected in 2019-20. The pace of fiscal tightening is expected to be at its greatest in 2016, with growth therefore forecast to be at its slowest in that year.

Alongside the Budget the Chancellor announced a new Fiscal Mandate requiring the UK Government to run a surplus on the total budget (incl. investment) from 2019-20 unless there is a significant economic shock. From a fiscal policy perspective, this will impact any future government’s ability to increase capital spending when the economy is growing. However, to put this in context the UK has only run an overall budget surplus on seven occasions since 1965.

#### Other Key Economic Measures

The Chancellor also announced a reduction in UK corporation tax (from its current 20% to 19% in 2017 and 18% in 2020) aimed at attracting overseas investment as well as incentivising domestic business expansion. The Chancellor also increased the National Minimum Wage for over-25s to £7.20/ hour (currently £6.50) from April 2016 with a stated aim for it to rise to 60% of the median income level by 2020, implying a figure of over £9/ hour. The measure is intended to raise the incomes of low earners via wage growth, albeit with offsetting effects from other measures such as reductions in tax credits.
Sectoral Trends

Most sectors and subsectors posted healthy expansion in the first quarter of 2015 and over the year to Q1.

### Quarterly Growth (i.e. Q1 2015 compared to Q4 2014)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Scot</th>
<th>UK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service Sector</td>
<td>0.5</td>
<td>0.4</td>
</tr>
<tr>
<td>Distribution, Hotels &amp; Catering</td>
<td>0.6</td>
<td>1.1</td>
</tr>
<tr>
<td>Transport, Storage &amp; Comms</td>
<td>-0.3</td>
<td>0.7</td>
</tr>
<tr>
<td>Business Services &amp; Finance</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Government &amp; Other Services</td>
<td>1.1</td>
<td>0.1</td>
</tr>
<tr>
<td>Production Sector</td>
<td>0.7</td>
<td>0.2</td>
</tr>
<tr>
<td>Mining &amp; Quarrying</td>
<td>-0.4</td>
<td>-0.5</td>
</tr>
<tr>
<td>Electricity &amp; Gas</td>
<td>4.6</td>
<td>2.8</td>
</tr>
<tr>
<td>Water Supply &amp; Waste Mgmt</td>
<td>0.8</td>
<td>0.2</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>0.2</td>
<td>0.1</td>
</tr>
<tr>
<td>Construction</td>
<td>2.1</td>
<td>-0.2</td>
</tr>
<tr>
<td>Agric., Forestry &amp; Fishing</td>
<td>-4.0</td>
<td>-2.3</td>
</tr>
</tbody>
</table>

### Annual Growth (i.e. Q1 2015 compared to Q1 2014)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Scot</th>
<th>UK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service Sector</td>
<td>1.6</td>
<td>3.1</td>
</tr>
<tr>
<td>Distribution, Hotels &amp; Catering</td>
<td>1.8</td>
<td>4.6</td>
</tr>
<tr>
<td>Transport, Storage &amp; Comms</td>
<td>2.9</td>
<td>4.6</td>
</tr>
<tr>
<td>Business Services &amp; Finance</td>
<td>1.2</td>
<td>3.6</td>
</tr>
<tr>
<td>Government &amp; Other Services</td>
<td>1.5</td>
<td>0.8</td>
</tr>
<tr>
<td>Production Sector</td>
<td>2.0</td>
<td>1.0</td>
</tr>
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<td>4.9</td>
<td>-0.7</td>
</tr>
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<tr>
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<td>0.9</td>
<td>-2.0</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>1.8</td>
<td>1.4</td>
</tr>
<tr>
<td>Construction</td>
<td>21.1</td>
<td>4.5</td>
</tr>
<tr>
<td>Agric., Forestry &amp; Fishing</td>
<td>-5.3</td>
<td>2.5</td>
</tr>
</tbody>
</table>

Construction had another solid quarter in Q1 2015 with growth of 2.1%. As with previous quarters the Q1 growth was driven to a large extent by infrastructure investment, although construction activity related to repair and maintenance also expanded. Notably, the expansion in Q1 contrasted with UK construction output, which fell -0.2% in the same quarter. Recent editions of the Bank of England’s Agents’ Summary of Business Conditions provide a possible insight into the divergence, reporting pre-election uncertainty causing delays in public infrastructure projects at the UK level. However, business survey intelligence for the second quarter suggests that this effect proved only a temporary setback, so we may see less divergence in future quarters.

After stalling at the end of 2014, Service sector activity rebounded in Q1 2015 with growth of 0.5%. Each of the Service subsectors expanded with the exception of Financial and Insurance activities, where output contracted -2.2% on the quarter. Evidence from the business surveys suggested that the contraction may have been partly due to weaker demand from the oil and gas sector.

Meanwhile, Production output continued to expand in Q1 with growth of 0.7%. Expansion was seen across all subsectors with the exception of mining & quarrying output which contracted slightly (-0.4%). This again partly reflected the impact of the fall in oil prices at the end of last year. As highlighted in the last edition of State of the Economy, lower oil prices impact on oil and gas sector firms’ profitability and, as such,
have resulted in a reduction in investment which has fed through to the onshore Scottish mining & quarrying subsector given its supply chain linkages to the North Sea.

Looking ahead the ONS Index of Production reports that UK oil and gas production in Q2 2015 was up by 9% on the same period last year. Several factors were behind this including production in some fields coming back online after closure for maintenance, and the high levels of North Sea investment in recent years resulting in new fields coming on-stream or ramping up production. Whilst these factors generally spell positive news for the Scottish onshore supply chain, at this stage any specific impacts are difficult to quantify and will depend on this trend being maintained over future quarters and how trends in sector profitability play out.

Construction Output in Scotland

Scottish Construction sector output saw very strong growth throughout 2014, visible in the latest annual GVA growth figure of just over 21%. Whilst sectoral trends display volatility year-on-year, the recent growth was still unusually high compared to historical trends. This section looks at some of the drivers.

ONS Construction output data breaks down into ‘New Work’ and ‘Repair and Maintenance’, with the former historically comprising the lion’s share of output, although Repair and Maintenance is currently below its long-term share. Whilst both categories of output expanded over the year, New Work was the driver of overall construction growth.

Within New Work, there was strong expansion across the public sector categories, which include infrastructure and public housing. The figures for Infrastructure reflect a large programme of investment taking place across Scotland, some of which peaked or was completed in 2014/15. Projects included the Forth Replacement Crossing, two hospitals in Glasgow (Queen Elizabeth University Hospital and the Royal Hospital for Children), the Borders Railway construction and the Schools for the Future building programme.

Private sector led New Construction Work showed a more muted picture over the year with contractions in the private industrial and commercial categories (which include new retail premises, warehouses etc.) offset to an extent by growth in private housing construction. This is in line with wider conditions – rising housing market activity and house prices; the normalisation of credit and lending conditions in the economy – all of which increase the viability of housing developments.

Whilst the outlook for the Construction sector for the rest of this year is positive, we are unlikely to see growth continue indefinitely at the rates recorded recently as a number of major public sector projects reach completion. As the economic recovery embeds and private sector confidence grows we would expect to see a pickup in private sector led activity and a degree of rebalancing in Construction towards more Repair and Maintenance work.
Index of Manufactured Exports

Scottish Manufactured Exports – a subset of total international exports – increased 2.1% in Q1 2015. Below the aggregate figures the picture was mixed with growth in three of the largest exporting subsectors offsetting contractions in others.

Food & Drink exports rose 5.5% in Q1, driven by a 6.1% growth in Drinks export volumes (chiefly Scotch Whisky). The growth in Drinks exports was encouraging as it follows on from more subdued figures last year, visible in the annual figures. Separate data from HMRC suggests it may reflect improving conditions in key markets – particularly Europe and the US – as well as producers making inroads into new markets, such as Africa. Looking ahead industry indications⁴ are that producers are optimistic about prospects for sales growth.

The contraction in Engineering & Allied Industries exports, and in some of the smaller exporting sectors (Metal Products, Textiles, and Wood, Paper & Printing) are in line with industry intelligence⁵, which cited factors such as unfavourable exchange rate conditions and a more subdued demand picture faced by those firms which sub-contract to the oil and gas sector.

After a weak end to 2014, exports from the Refined Petroleum, Chemical & Pharmaceutical Products sector increased slightly in Q1 2015, driven by expansion within the Pharmaceutical subsector. This offset contractions in both Refined Petroleum and in Chemicals which were due partly to the low oil price.

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⁵ Business survey findings from Scottish Engineering Quarterly Review and the Bank of Scotland’s PMI.
Business Surveys

Scottish business surveys\(^6\) give an indication of activity across the economy in Q2 in advance of the publication of GDP figures for the second quarter on the 7\(^{th}\) October.

Q2 saw a mixed picture across the survey readings but most pointed to continued growth, particularly in Service sector activity. Coverage of construction firms is limited, but where they are sampled their reported sentiment in Q2 was upbeat. Meanwhile, Manufacturing firms generally continued to report relatively challenging conditions, highlighting issues like: the strength of the pound, weak global demand; muted demand from the oil and gas sector as it adjusts to lower oil prices; and pre-election uncertainty. However, with some of these issues expected to diminish in the second half of the year, manufacturers remained fairly optimistic in their outlook.

<table>
<thead>
<tr>
<th>Business Surveys - New Orders</th>
<th>Average pre-recession value (i.e. quarters up to Q4 07)</th>
<th>Q1 14</th>
<th>Q2 14</th>
<th>Q3 14</th>
<th>Q4 14</th>
<th>Q1 15</th>
<th>Q2 15</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scottish Chambers: Manufacturing</td>
<td>14.8 30.5 37.7 30.6 12.9 9.4 39.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Construction</td>
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\(^{6}\) The Bank of Scotland Markit Purchasing Managers Index, CBI Industrial Trends Survey (CBI), Scottish Engineering Quarterly Review, Bank of Scotland Business Monitor and Scottish Chambers of Commerce Quarterly Business Survey (SCC).
Conclusion

The Scottish economy posted its eleventh quarter of growth at the start of 2015, which was the longest period of uninterrupted expansion since 2001.

The continuous growth over the last three years demonstrates the underlying resilience of the economy, particularly during a period of some turbulence in which we have seen muted demand and volatility in key export markets and, more recently, the fall in the oil price.

The trends in the economy are kindling a rise in confidence and investment, both of which are expected to drive growth in Scotland’s economy throughout 2015.
Recent Labour Market Developments

Employment

Latest statistics (Apr-Jun 2015) show Scottish employment levels up 28,000 over the year to reach 2,611,000. Alongside this, the employment rate also rose 0.4 percentage points to 74.1%. The recent jobs growth means that the number of people in employment is now 173,000 above its recession low (Feb-Apr 2010).

The growth in employment in recent months has been accompanied by an increase in the share of full-time working in overall employment in both Scotland and the UK, albeit both remain below pre-recession figures.
Unemployment and Participation

Unemployment has been falling since its peak of 8.8% in May-July 2010 and now stands at 5.6% (April-June 2015), with the rate sitting at or around its pre-recession average for most of this year.

Meanwhile, at 78.6% in the latest quarter the labour market participation rate remains above pre-recession levels. As discussed in previous editions, higher participation has been driven to a large extent by more women working or seeking work due to a mix of structural and cyclical factors.

Youth Labour Market

Recent months have seen a number of encouraging developments in the youth labour market in Scotland. The number of people aged 16-24 in work increased by 20,000 over the year to April-June 2015, reaching its highest level for the April-June quarter since 2005. Also in the latest quarter the Scottish 16-24 unemployment level and rate both fell to their lowest point since Apr-Jun 2008. The latest figures from the Annual Population Survey also show that the level of 16-19 year olds who were not in employment, education of training was at its lowest level in 2014 since comparable records began in 2004.

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8 Note all youth labour market data is based on non-seasonally adjusted data
Interpreting Headline Monthly Labour Market Indicators

Official estimates of employment and unemployment in Scotland and the UK come from the Labour Force Survey (LFS), a survey of the employment circumstances of the population. Each quarter a representative sample of approximately 40,000 UK households – 6-7,000 in Scotland – are interviewed and their responses are weighted to provide estimates for the wider Scottish and UK population.

The LFS is undertaken by the Office for National Statistics and is the largest household survey across the UK. The survey has received National Statistics classification, meaning it is subject to rigorous quality assurance and is produced independently of Scottish or UK Ministers.

LFS data provides a detailed and timely picture of trends in the labour market but, as is inherent with sample surveys, both the headline estimates and month-on-month changes are always subject to a margin of error. These error margins do not fundamentally change our understanding of developments in the labour market. For example as the chart shows, even taking into consideration the margin of error, we know that the Scottish unemployment rate rose considerably in the 2008/09 crisis, peaked in 2010 then again in 2012, and has since fallen steadily to its current position.

However, it is important to bear in mind that small movements in the reported labour market position can lie within the margin of error of the survey and, as such, monthly volatility is not always indicative of an underlying change in labour market conditions. This is why estimates are reported on a rolling quarterly rather than a monthly basis.
Conclusions

The latest labour market statistics show employment up and unemployment down over the year to the second quarter of 2015. Alongside this, we have seen increases in full-time working and continued progress in labour market conditions for younger workers.

Consistent with the picture in the UK as a whole, there are indications of employment levels in Scotland peaking and the unemployment rate has been at or around its pre-recession average throughout the last year.
Future Prospects

### Annual GDP Forecasts

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### Overview

The impact of the fall in oil prices at the end of last year continues to work through the Scottish economy. On the one hand this has led to cutbacks in investment and employment in the oil sector which has had a negative impact on the onshore supply chain. However, this needs to be set against the positive impact that lower oil prices have had on the wider Scottish economy and the boost that it has provided to household incomes. With oil prices remaining around $50-$60 a barrel in recent months, these effects are likely to continue to play a role in the outlook as we proceed through this year.

Leaving these impacts aside, the wider outlook for the economy remains upbeat. Employment and investment continued to grow in the early part of 2015 and business and consumer surveys paint a positive picture of firm and household economic behaviour for the second half of the year.

External tail risks are still present, for example the drag on demand from fiscal policy tightening at the UK level and from weak demand in key export markets. Nonetheless, forecasters are predicting the positive growth momentum from last year to continue this year, with growth of around 2.4% expected.
Business Surveys

The July Purchasing Managers’ Index (PMI) – the earliest Scottish data available for the third quarter of 2015 – indicated that there was continued growth in the private sector in Scotland moving into the second half of the year. The manufacturing sector was the primary driver of this expansion, with the output indicator seeing a strong rebound after a relatively muted year. Alongside this the indicator for services also signalled a continued increase in business activity in July.

Overall, whilst results were generally positive for the first half of 2015, the impact of the fall in oil prices on demand from the offshore sector was a commonly-cited business concern amongst firms involved in the North Sea supply chain. However, this must be viewed against reports from business surveys that low oil prices have had a positive benefit by reducing cost pressures across most sectors.

Looking ahead to the rest of 2015, expectations were generally positive, with measures for business activity and turnover forecasting increases over the next six months.
Consumer Sentiments

To give a feel for consumers’ outlook on the economy we report on the latest Scottish consumer sentiment survey results.\(^\text{10}\)

The survey asks households whether conditions in the economy in 12 months’ time will be better, worse or the same. In Q2 2015, the balance of responses remained positive meaning that more households expected conditions to improve over the next year than worsen.

Looking at expectations for household finances, the survey asks whether these would be more/less secure – or as secure – in 12 months’ time. Again, the results generally pointed to the bulk of households feeling their finances will be more secure in a year’s time.

Finally, households were asked – in light of their previous answers – whether they were more/less relaxed about spending or the same compared to 12 months earlier. Encouragingly, in the latest quarter the balance moved into positive territory after two quarters of being negative. This was due to a slight increase in ‘more relaxed’ responses and a decrease in ‘less relaxed’ ones. This result may to some extent reflect recent trends in consumer prices and household incomes. Households may have initially saved the windfall from low prices and, as prices have remained low, are increasing their willingness to spend.

Generally, the consumer sentiment survey results for Q2 2015 point to a positive outlook amongst Scottish consumers.

\(^{10}\) More details of the development of the Scottish consumer sentiment indicator can be found here.
Potential Impacts of Events in Greece on the Scottish Economy

Economic volatility in Greece has receded as negotiations have progressed on financing arrangements. Nevertheless, until a sustainable long-term solution is reached, there remains a risk of a Greek exit from the Euro.

The Greek economy itself is small, relative to the wider Euro Area, and neither the UK nor Scotland have substantial direct trade or financial links with it. Therefore, if Greece were to leave the Euro then as long as there was little contagion to the rest of the Euro Area, the direct impact upon Scotland is unlikely to be significant.

However, a Greek exit could still feed through to the Scottish economy via several channels:

- Although Greece accounts for less than 1% of Scotland’s exports, if a Greek exit lowered confidence and economic activity within the rest of the Euro Area, it would pose a greater risk as the Euro Area is the destination of one third of our exports. However, it would also likely result in a weakening of the Euro, which would partly offset the reduced exports through lowering the price of Scottish imports from the Euro Area.
- A Greek exit could lead to a loss of confidence amongst Euro Area investors, resulting in higher risk pricing in bond and capital markets. This could impact upon public finances and investment within the UK and Scotland through increased borrowing costs.
- If a Greek exit led to widespread Greek debt default then, although the UK’s Bank’s exposure to Greece is minimal their exposure to other Euro Area economies is substantial. This could then pass through to the UK and Scotland via bank losses and reduced availability of loans to the real economy.
- However, some of these negative impacts could be offset by the UK attracting in capital flows as the UK becomes more of a ‘safe haven’ for investors.

Overall, the impact on Scotland of a Greek exit from the Euro would likely be relatively limited however, this would crucially depend on the degree of contagion across the Euro Area.

Independent Forecasts

In June the Scottish ITEM Club and the Fraser of Allander Institute (FAI) published their latest independent forecasts for the Scottish economy. Both reports expect growth to continue at a healthy pace in 2015 and on into 2016.

The ITEM Club revised up its forecast for Scottish growth in 2015 to 2.2% (previously 2.0%). Overall the forecasts projected expansion in the majority of sectors. One exception was a forecast softening in Mining & Quarrying sector output, which the report attributed to the effects of the fall in the oil price. It also forecasts slight contractions in Public Administration & Defence and Education, which it indicates is largely due to the impact of further fiscal tightening at the UK level.

The FAI also expected the strong growth of 2014 to continue into 2015, forecasting growth of 2.5% in 2015. Looking at risks to the outlook, the FAI highlighted potential challenges from further tightening in UK fiscal policy and from the uncertainties within the Euro Area, whose ongoing recovery continues to face risks such as the Greek debt crisis.

The average independent forecast for Scottish growth in 2015 is 2.4%.