

## **State of the Economy**

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### **State of the Economy**

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

Data correct up to and including the 26<sup>th</sup> October 2016.

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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### Overview

The last State of the Economy update was published in June, prior to the EU referendum vote. At that time, the outlook for both the UK and Scottish economies in 2016 and 2017, despite the challenges impacting the oil and gas sector, remained positive. Central to these projections was the assumption that the UK would vote to remain in the EU.

The EU referendum result had an immediate impact on economic and business sentiment in Scotland and the UK. This led to a review of existing economic forecasts as both Sterling and stock markets reacted to the vote. Four months on, there still remains a high degree of uncertainty, with most forecasters downgrading growth expectations for 2017 and beyond, reflecting the view that investment plans for the UK will be impacted negatively next year as a result of the uncertainty regarding future UK trading arrangements.

In considering the outlook for the economy, expectations and market sentiment continue to be highly sensitive to the political process relating to the EU referendum and signals of what negotiated outcomes are likely. This adds an additional layer of complexity to economic forecasts. Similarly, the market response, reflected in the depreciation of Sterling by around 17% and rising UK stock markets, alongside the monetary response of the Bank of England, is serving to bolster immediate economic activity. All of which clouds the outlook as the immediate data are stronger than expected, whilst the forecast outlook is much more downbeat. The latter reflects the fact that the key economic impacts will materialise more strongly as market access for goods, services, capital or labour are changed, which has not happened yet.

#### Scottish Economic Performance – Pre-EU Referendum.

Data for the first half of 2016 showed a continuation of previous trends with subdued output growth but stronger labour market conditions. In the three months leading up to the EU referendum, Scottish GDP grew 0.4% over the quarter and 0.7% over the year. This was an encouraging rebound from flat growth at the start of the year, supported by a pick-up in growth in the Production sector. However, it also reflected the continued impact of low oil prices on North Sea profitability.

The resilience observed in the labour market during 2015, with employment and unemployment rates close to their long run averages, has been evident in the first half of 2016 also. Most recently, in the three months to August, unemployment fell to 4.6%, its lowest rate since 2008.

#### Post-EU Referendum Outlook.

There is considerable uncertainty about the outlook for the UK and Scottish economies. Almost all forecasters have revised down their projections for 2016 and 2017. The outlook for the UK in 2017, based on the HMT average independent forecast, is for growth of 1.0%, down from an average forecast of 2.1% made prior to the referendum. There have been similar downward revisions in the forecasts for Scottish GDP growth

All forecasts are conditional on a number of assumptions relating to the political process and the response of consumers and businesses. Expectations are key in driving short run economic sentiment and can change quickly, making any forecasts uncertain. What we can say is that activity in Scotland has been impacted by the EU referendum with business survey evidence signalling weak activity in the immediate aftermath of the vote. However, whilst business optimism is weak, there are encouraging signs of a pick-up in activity towards the end of the third quarter.

We also know that the Scottish Consumer Sentiment Indicator for Q3, published within this report, recorded its lowest level since the survey began in 2013. If the fall in consumer sentiment translates into less household expenditure then this will impact negatively on economic activity in Scotland. However, longer term, the key impacts relate more to any future changes in trading arrangements with the EU and uncertainty will persist until these are clarified.

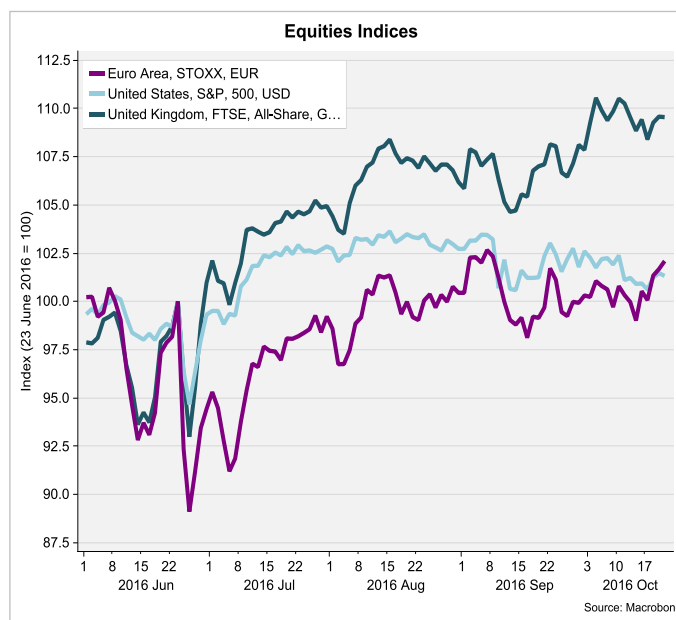
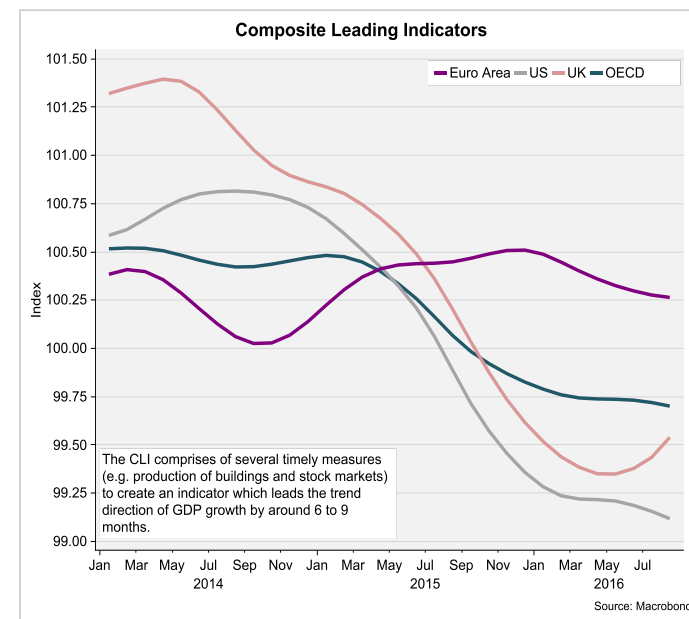
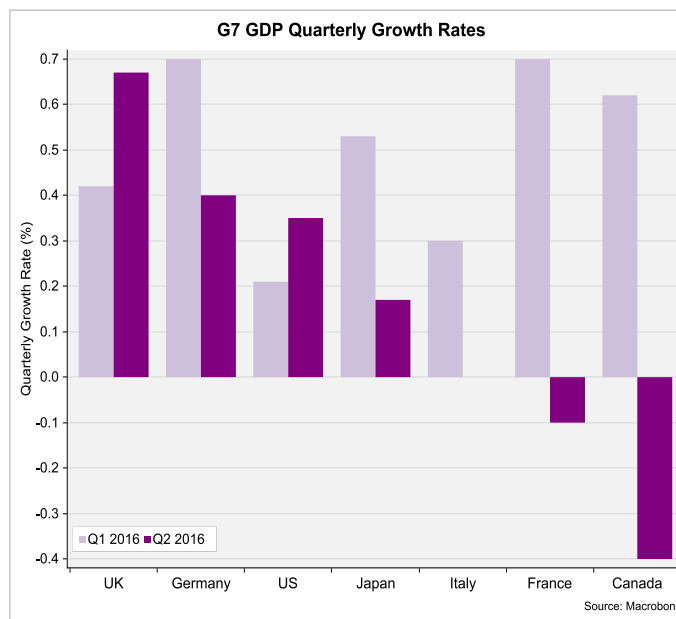
## Global Summary

### Growth remains fragile in the first half of 2016

- During the first half of 2016, growth remained below trend in most advanced economies.
- Activity in the US rebounded in the second quarter after a weak start to 2016, with rising incomes and house prices boosting household spending.
- Although growth picked up in the Euro Area at the start of 2016, fuelled by private consumption, the pace of expansion slowed slightly in the second quarter reflecting a weakening in investment.
- Growth in China has strengthened due to stronger infrastructure investment, and the slight rebound in oil prices has benefitted both Brazil and Russia.

### UK's EU referendum adding to global uncertainty

- The short term outlook for the global economy has weakened slightly, partly as a result of the uncertainty following the EU referendum outcome alongside weaker than expected growth in the US and subdued global trade.
- The rise in uncertainty was immediately reflected in increased volatility of financial markets. Markets have largely recovered to their pre-referendum levels. However, they remain sensitive to new information on the impacts and responses to the referendum result.
- In response to the EU referendum uncertainty adding to ongoing weaknesses in advanced economies, the IMF and OECD both revised down their global growth forecasts for 2016. The IMF's latest outlook projects world output growth of 3.1% in 2016 and 3.4% in 2017 (down from 3.2% and 3.5% previously).



GDP Growth Forecasts	2016		Revisions from April	
	2016	2017	2016	2017
<b>IMF WEO (October 2016)</b>				
<b>World Output</b>	3.1%	3.4%	-0.1	-0.1
<b>Advanced Economies</b>	1.6%	1.8%	-0.3	-0.2
<b>United Kingdom</b>	1.8%	1.1%	-0.1	-1.1
<b>Euro Area</b>	1.7%	1.5%	0.2	-0.1
Germany	1.7%	1.4%	0.2	-0.2
France	1.3%	1.3%	0.2	0.0
Italy	0.8%	0.9%	-0.2	-0.2
Spain	3.1%	2.2%	0.5	-0.1
<b>United States</b>	1.6%	2.2%	-0.8	-0.3
<b>Emerging Markets</b>	4.2%	4.6%	0.1	0.0

## United Kingdom Summary

### Conditions improve in lead up to EU referendum

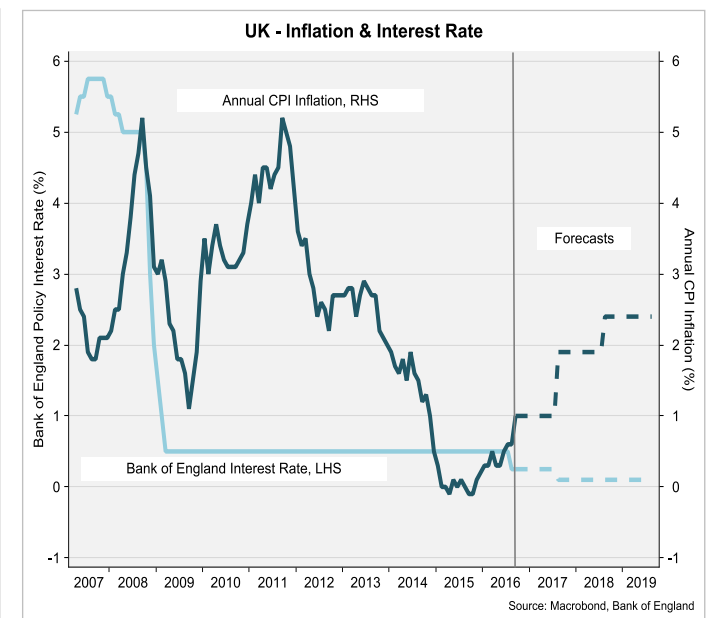
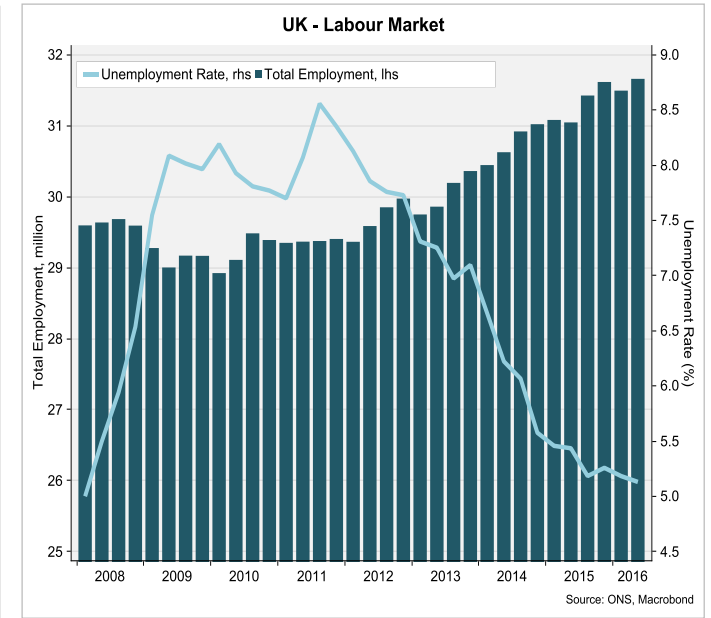
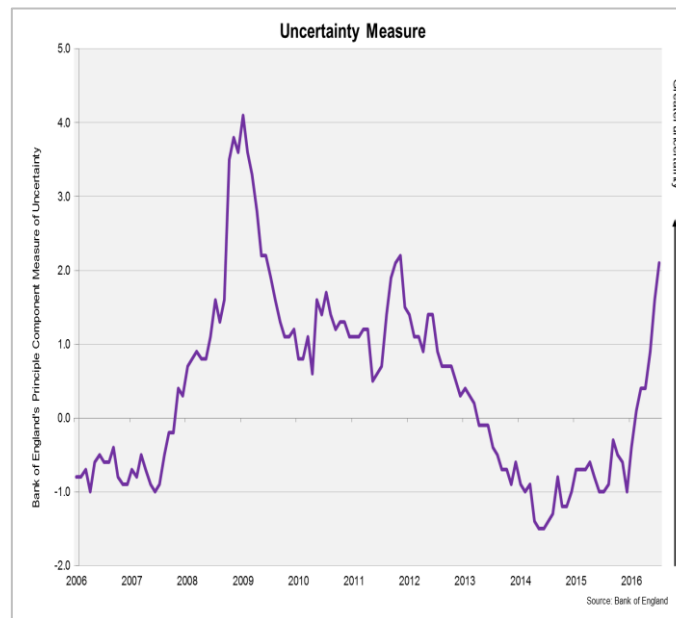
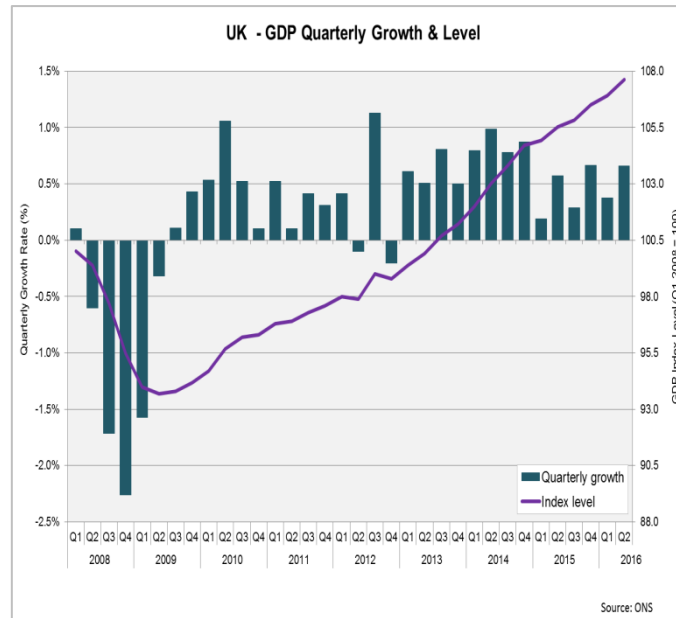
- UK GDP grew by 0.7% in the second quarter of 2016 (up from 0.4% in Q1) with growth in both the Production and Services sectors
- The UK employment rate increased by 0.1 p.p in the latest quarter (Jun-Aug 2016) to 74.5% - the highest rate since comparable records began in 1971 and a 0.9 percentage point rise on the year.

### Referendum result impacts on economic outlook

- There have been significant downward revisions to UK GDP growth forecasts. Key drivers cited are:
  - (1) *Decreased investment* – increased economic uncertainty and financial market volatility posing a risk to business investment;
  - (2) *Impact on recruitment* – businesses may delay recruitment decisions until the long term outlook is clearer;
  - (3) *Lower household spending* – greater uncertainty, combined with a potential squeeze in real incomes, due to the depreciation of Sterling expected to feed through to higher inflation, impacting on consumption.

### Bank of England responds to weaker outlook

- At its August meeting, the Bank of England's Monetary Policy Committee voted to introduce a monetary stimulus package to support the economy, including: a cut in the Bank Rate to 0.25% (from 0.5%); introducing a 'Term Funding Scheme' to reinforce the pass-through of the cut in Bank Rate to the real economy; and an expansion of the Quantitative Easing programme (including buying both government and corporate bonds).



## Scotland Summary

### Output growth picks up in the second quarter

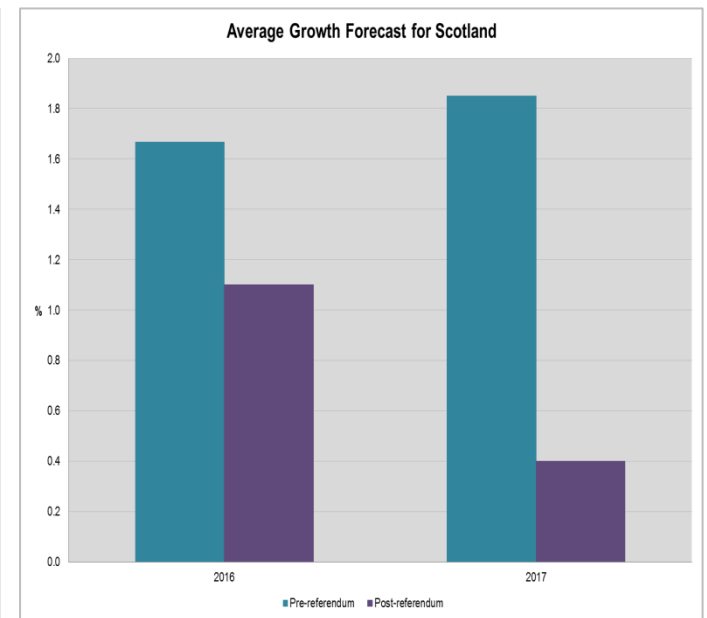
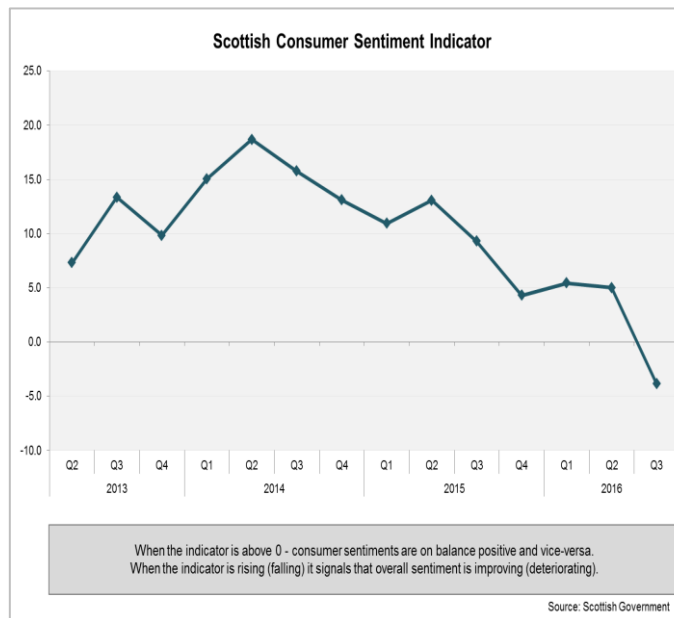
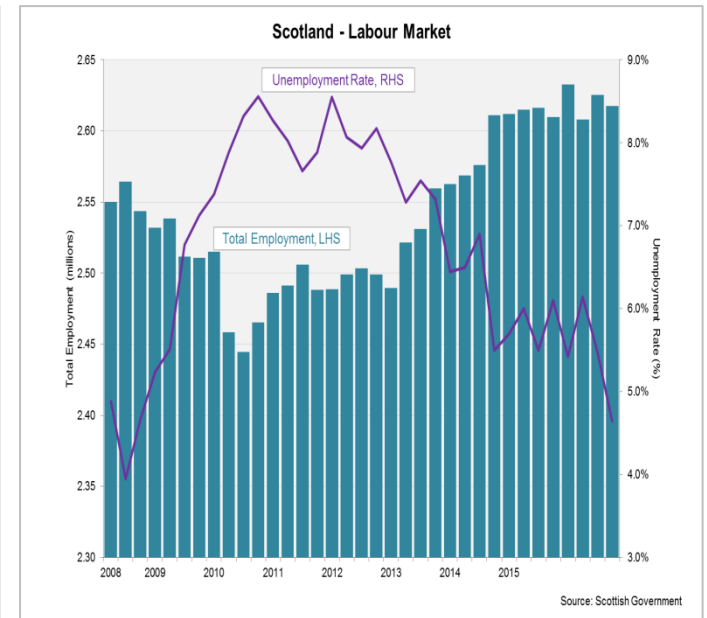
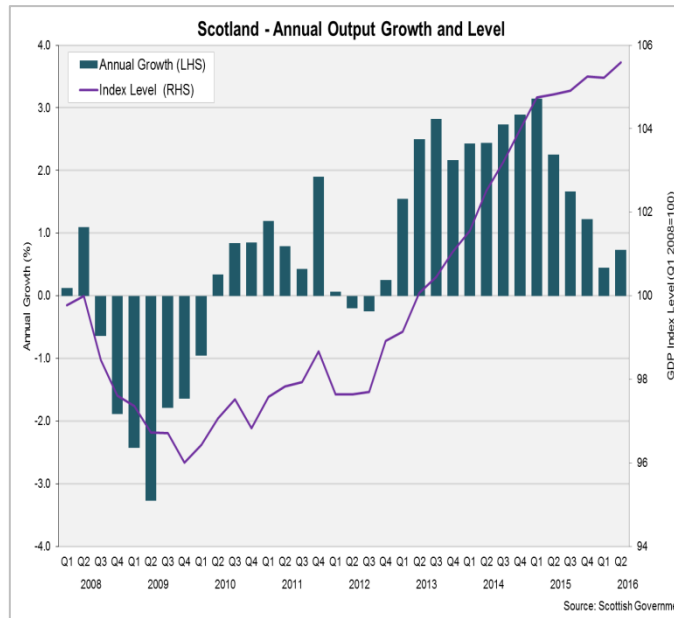
- The Scottish economy grew 0.4% in Q2 (0.7% over the year), following flat growth in the first quarter.
- Output growth was driven by continuing growth in the Service sector (0.5%) and a return to growth in the Production sector (0.3%) offsetting a second consecutive quarter of contraction in the Construction sector (-1.9%).

### Labour market remains resilient

- The latest Scottish labour market data (Jun-Aug 2016) shows that unemployment fell to 4.6%, below the rate in the UK (4.9%).
- Employment levels fell by 8,000 over the quarter but still remain close to their record high at 2.6 million. Labour inactivity levels increased by 26,000 over the quarter resulting in an inactivity rate of 22.3%.

### Outlook weakens post-EU referendum

- Retail sales data and business surveys provide relatively positive signals for output in the three months following the referendum, though business optimism remains weak.
- The Scottish Consumer Sentiment Indicator has presented a weaker outlook from households in Q3, falling into negative territory for the first time since the survey started in 2013.
- Following the EU referendum the Fraser of Allander downgraded their projections for growth in 2016 to 0.9% (from 1.4% previously) and for 2017 to 0.5% (from 2.1% previously), whilst PWC forecast growth of 1.3% in 2016 and 0.3% in 2017.



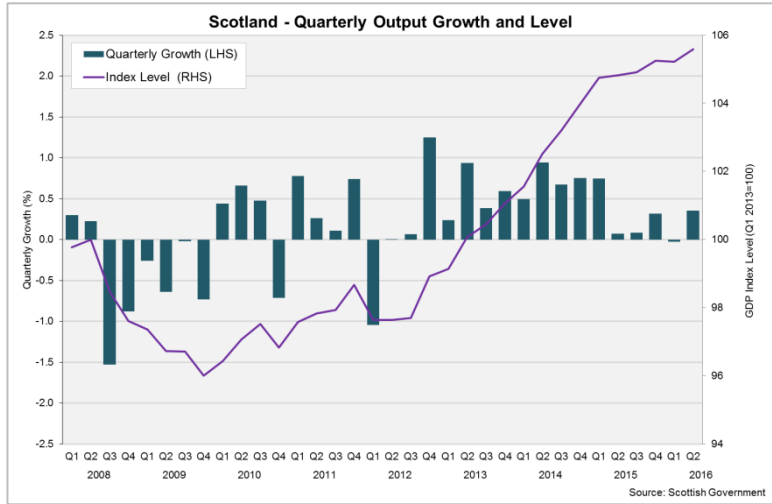
# Scottish Economy Pre-EU Referendum

## The First Half of 2016

### Sectoral Output Growth

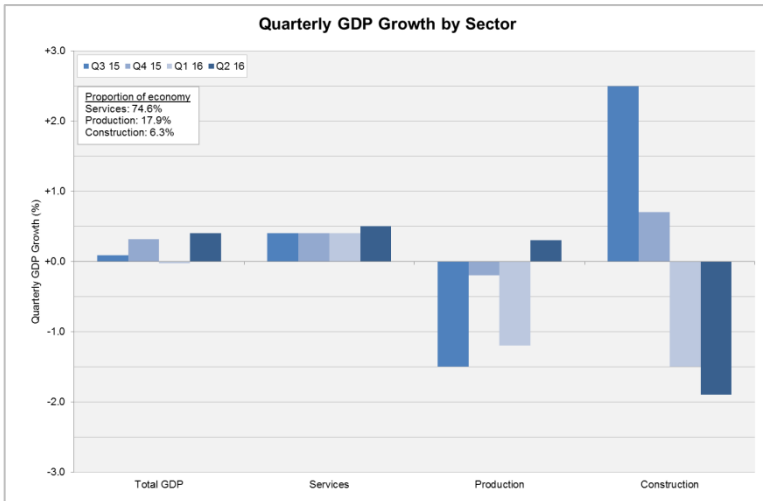
Following flat growth at the start of 2016, the Scottish economy picked up in the second quarter, growing 0.4% over the quarter and 0.7% over the year.<sup>1</sup>

At a sector level, Services grew 0.5% in Q2, in line with the growth observed over recent quarters. This was particularly supported by robust growth in the Business Services and Finance sub-sector which grew 1.3% over the quarter.



There was a pick-up in output growth from the Production sector in Q2 to 0.3% – the first quarterly expansion in the sector since the start of 2015. This was underpinned by a return to growth in the manufacturing sub-sector, particularly in the food and drink industry. However, weak growth across the industries associated with the oil and gas sector signal that the low oil price continued to weigh on the sector over the quarter.

The Production sector also grew despite the closure of Longannet (Scotland’s last coal-fired power station) in March 2016. The closure of Longannet is estimated to have resulted in a reduction of Scottish GDP of around 0.2 percentage points in Q2 2016. However, as a one-off closure, it will not have an ongoing impact on the growth of the Scottish economy.

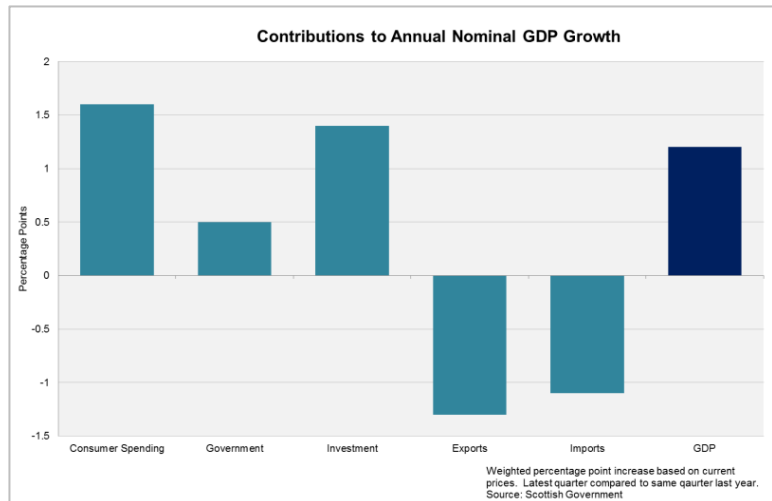


Together, growth in the Services and Production sectors offset a 1.9% contraction in the Construction sector – its second consecutive quarter of contraction. Large public sector infrastructure projects had been supporting very strong growth in this sector across 2014 and the start of 2015, and whilst output levels from the sector remain high, the growth rate has naturally slowed into 2016.

<sup>1</sup> Scottish Government Quarterly GDP: <http://www.gov.scot/Topics/Statistics/Browse/Economy/PubGDP/GDP2016Q2>

## Expenditure Drivers of Output Growth

The Quarterly National Accounts Scotland<sup>2</sup> (QNAS) report provides an estimate of expenditure underpinning nominal GDP up to Q1 2016<sup>3</sup>. Comparing Q1 2016 to the same quarter the previous year, the largest contribution to annual growth was from consumer spending. This was supported across the year by resilient conditions in the labour market as employment levels reached record levels during 2015 and increasing real wages continued to boost disposable incomes.



Capital investment also continued to make a strong positive contribution to growth as high levels of public infrastructure investment supported growth in the Scottish economy throughout 2015, though investment did slow across the year and into the start of 2016.

The trade balance had an overall negative contribution to nominal GDP growth over the year to Q1 2016 due to a fall in exports combined with a rise in imports<sup>4</sup>. On the export side, this reflects the challenging conditions that Scottish exporters have faced over the past year with weak global growth impacting overseas demand. Furthermore, the relative strength of Sterling prior to the referendum also impacted the competitiveness of exports, as well as increasing imports into Scotland last year.

## Scottish Manufactured Exports

Further detail on Scottish manufactured exports can be derived from the Index of Manufactured Exports<sup>5</sup>. In Q1 2016, the volume of Scottish manufactured exports to overseas markets decreased by 0.5% over the quarter and by 4.8% over the year.

The decrease in export volumes was the fourth consecutive quarter of decline in manufactured exports and was driven by falls in export volumes from Refined Petroleum,

Chemical and Pharmaceutical Products (-8.0%), Metals and Metal Products (-13.6%), and Engineering and Allied Industries (-0.9%).

Manufactured Export Volumes, Q1 2016 (sector by weighting, largest first)	Quarterly Growth (%)	Annual Growth Q1-on-Q1 Growth (%)
<b>Total Manufactured Exports</b>	<b>-0.5</b>	<b>-4.8</b>
Engineering & Allied Industries	-0.9	-3.5
Food, Beverages & Tobacco	3.3	0.0
Refined Petroleum, Chemical & Pharmaceutical Products	-8.0	2.1
Non-metallic Products, Other Manufacturing & Repair	1.8	-11.5
Metals & Metal Products	-13.6	-38.2
Wood, Paper & Printing	2.1	-23.3
Textiles, Clothing & Leather	-0.3	5.9

Source: Index of Manufactured Exports, Scottish Government

<sup>2</sup> Quarterly National Accounts Scotland (QNAS): <http://www.gov.scot/Topics/Statistics/Browse/Economy/QNA2016Q1>

<sup>3</sup> QNAS figures are expressed in nominal terms and, unlike GDP growth, are not adjusted for price changes.

<sup>4</sup> The chart above illustrates that a rise in imports has a negative contribution to nominal GDP growth.

<sup>5</sup> Index of Manufactured Exports: <http://www.gov.scot/Topics/Statistics/Browse/Economy/IME2016Q1>

Encouragingly, Food and Drink, which accounts for 35% of Scotland’s overseas manufactured exports, grew 3.3%, whilst exports from Textiles, Clothing and Leather grew 2.1% and Non-Metallic Products, Other Manufacturing and Repair increased by 1.8%.

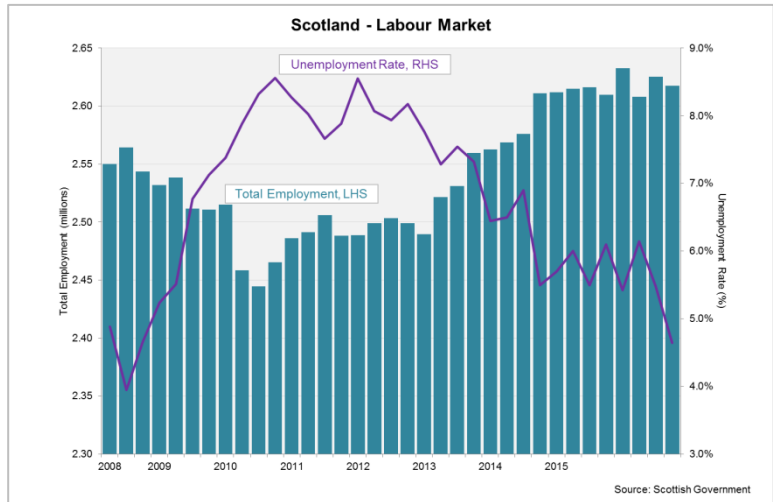
The decrease in manufactured export volumes over the quarter, on the back of negative export growth in recent quarters, is consistent with the subdued GDP figures for the sector and the evidence collected from business surveys conducted over the period.

**Scottish Labour Market**

The Labour Force Survey statistics for Jun-Aug 2016 straddle the EU referendum period. They show that Scottish unemployment decreased by 25,000 over the quarter, resulting in the unemployment rate falling to 4.6%, its lowest level since 2008.

Employment fell marginally over the quarter though the number of people in employment remains close to a record high at 2.6 million.

There has also been an increase in economic inactivity over both the past quarter and the past year. The inactivity rate in Scotland now stands at 22.3%, slightly higher than in the UK as a whole.



HEADLINE LABOUR MARKET STATISTICS							
RATES	Latest Data	Quarterly Change (% p.t.)	Annual Change (% p.t.)	LEVELS	Latest Data	Quarterly Change	Annual Change
<b>Scotland</b>				<b>Scotland</b>			
Employment*	74.0%	-0.1	0.2	Total Employment^	2,618,000	-8,000	7,000
ILO Unemployment**	4.6%	-0.8	-1.5	ILO Unemployment^	127,000	-25,000	-44,000
Economic Inactivity*	22.3%	0.8	1.0	Economic Inactivity^^	763,000	26,000	35,000
<b>UK</b>				<b>UK</b>			
Employment*	74.5%	0.1	0.9	Total Employment^	31,811,000	106,000	560,000
ILO Unemployment**	4.9%	0.0	-0.4	ILO Unemployment^	1,656,000	10,000	-118,000
Economic Inactivity*	21.5%	-0.2	-0.6	Economic Inactivity^^	8,809,000	-65,000	-231,000
*Denominator = Working age population (16-64)				^All persons ages 16+			
**Denominator = Total economically active				^^All persons aged 16-64			
Source: Labour Force Survey (June - August 2016)							

**Summary**

In the first half of 2016, the lead up to the EU referendum, the Scottish economy continued to demonstrate resilience in the face of on-going external headwinds.

Whilst output growth was flat in the first quarter of 2016, it picked-up in the three months prior to the EU referendum. The labour market has also continued to strengthen in the first half of the year, with the unemployment rate now at its lowest level since 2008 and the number of people in employment at near record levels.



This strong performance in the labour market helped support domestic demand, with rising real wages boosting household disposable incomes that fed through to consumption in the domestic economy; demonstrated by an increase in retail sales over the second quarter. Non-domestic demand however remained weak in the first half of 2016 reflected in the fall in manufactured exports.

# Scottish Economy Post-EU Referendum

The outcome of the EU referendum has a number of implications for the Scottish economy. This section sets out the current economic linkages between Scotland and the EU, economic performance emerging since the referendum and the potential outlook.

## Scotland and the EU

Scotland’s economy is closely integrated into the markets and institutions of the EU. It acts as a key destination for Scottish exports and a major source of investment into Scotland:

- In 2014, Scottish exports to the EU were worth £11.6 billion, equivalent to over 40% of Scotland’s international exports.<sup>6</sup>
- In 2015, there were nearly 1,000 EU-owned companies operating in Scotland, employing 116,000 people and generating turnover of £34 billion.<sup>7</sup>
- Around 160,000 people of working age living in Scotland were born in the EU.<sup>8</sup>
- Scotland secured more Foreign Direct Investment projects last year than any part of the UK outside London.<sup>9</sup> This investment created over 5,000 jobs, of which nearly 1,800 were associated with investments by EU based companies.
- Furthermore, 79% of investors cited access to the European Single Market (ESM) as a key feature of the UK’s attractiveness.<sup>10</sup>

### Scotland and the European Single Market

The European Single Market is underpinned by four freedoms – the free movement of goods, labour, capital and services. The Single Market removes tariffs and quotas on goods traded within the EU, creates a customs union within the EU (removing customs controls within the EU and applying a common external tariff for goods imported from outside the EU) and it reduces non-tariff barriers to trade within the EU.

#### (1) The free movement of goods

In 2015, the EU accounted for 22% of world GDP (US 24%, China 15%), with the Single Market providing EU Member States with access to over 500 million customers and over 22 million firms to trade with.

The EU is a key export market for Scottish firms, accounting for £11.6 billion (42%) of Scotland’s international exports in 2014. Scotland’s manufacturing sector accounts for 58% of Scottish exports



<sup>6</sup> Export Statistics Scotland; 2016

<sup>7</sup> Businesses in Scotland; 2015

<sup>8</sup> Annual Population Survey; 2016

<sup>9</sup> Ernst & Young Attractiveness Survey 2016

<sup>10</sup> Ernst & Young Attractiveness Survey 2016

to the EU, with food and drink, and coke, refined petroleum and chemical products making up more than half of those.

The key destinations within the EU for Scotland's exports are the Netherlands, France and Germany. The Netherlands (and Belgium) are consistently reported among Scotland's top trading partners, however as these countries contain key ports, many of these exports are likely to be for onward supply to other countries.

Over the decade to 2014, Scottish exports to the EU have increased by 23% whilst Scottish exports to non-EU countries have increased by 78%, facilitated in part by the common trade links that the EU has established with other countries. The EU currently has trade agreements with over 50 countries (including Switzerland, Norway, South Korea and Mexico) with a further 11 agreed and expected to be implemented soon (e.g. Canada, Singapore).

### **(2) The free movement of labour**

Freedom of movement for people guarantees every EU citizen the right to move freely, to stay and to work in another member state. This allows all countries within the Single Market to benefit from attracting labour to their economy, both temporarily and permanently.

EU Nationals make an important contribution to the Scottish economy, both in terms of bringing skills and expertise to the labour market, but also to supporting the demographic characteristics required to grow the economy in the longer term.

In 2015, 159,000 people of working age living in Scotland were born in the EU – 4.7% of all working age adults in Scotland. The employment rate for people born in the EU working in Scotland is 79%, higher than the overall Scottish employment rate of 74%.

For people born in the EU working in Scotland, the main industry of employment is Distribution, hotels and restaurants employing 37,000 followed by Public administration, education and health employing 24,000.

Nearly half of people born in the EU, residing in Scotland, are in the 16-34 years age band (48%), approximately double the share of the whole Scottish population in this age range. Just under half of those aged 16 and over live in three local authority areas: Edinburgh (20%), Glasgow (17%) and Aberdeen (11%).

### **(3) The free movement of capital**

Capital movements include foreign direct investment (FDI), real estate investments or purchases, securities investment, granting of loans and credits and other operations with financial institutions.

In 2015, Scotland attracted 119 FDI projects, more than anywhere else in the UK outside London, helping to create over 5,300 jobs. FDI to Scotland by EU companies in particular created 1,783 jobs in 2015.

Access to the EU single market is also an important factor in attracting FDI investment. At a UK level, 79% of investors list access to the EU single market as an important element of the UK's attractiveness for investment, whilst over 50% of investors reported that a significant or substantial decline in the terms of access to the Single Market would negatively impact the UK's attractiveness.

## **(4) The free movement of services**

The core principles governing the Single Market for services are (1) the freedom to establish a company in another EU country, and (2) the freedom to provide or receive services in an EU country other than the one where the company or consumer is established.

Services account for a third of Scottish exports to the EU with almost half of those made up of wholesale and retail and legal, accounting, management and architecture.<sup>11</sup>

There are 970 EU-owned enterprises operating in Scotland. These businesses operate 3,695 units employing 115,890 people and generate turnover of £34 billion (13% of all turnover from registered businesses in Scotland).

The sectors where EU ownership has the most influence in terms of employment are Utilities (23% of employment in this sector is in EU owned enterprises) and Mining and Quarrying (21% of employment in sector).

## **The Short Run Implications of the EU Referendum Result**

The EU referendum outcome represents a political shock to the Scottish, UK and EU economies. It had an immediate impact in the financial markets and is projected to have implications for Scotland's future economic performance.

The key factor influencing economic events in the short term is a heightened level of uncertainty for households and businesses about what the result will mean for their economic and financial outlook.

For households, such uncertainty can reduce consumer confidence and lead to consumers deferring spending. For businesses, uncertainty about the future economic and regulatory outlook may delay investment and recruitment decisions.

Taken together, these elements can slow economic growth until greater certainty and confidence about the economic outlook is restored.

The nature of this shock is different to that observed during the financial crisis of 2008. In the short run the EU referendum represents a demand side shock induced by a political process. In contrast, the financial crisis in 2008 stemmed from developments in the US subprime mortgage market which triggered a credit shock that intensified into a global financial crisis and pushed many advanced economies into recession.

In addition, the current economic shock is largely confined to the UK, whilst the financial crisis impacted on economic growth globally.

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<sup>11</sup> Of total international exports to the EU, other Production and Construction exports accounted for 7% and Agriculture, Forestry and Fishing 1%.

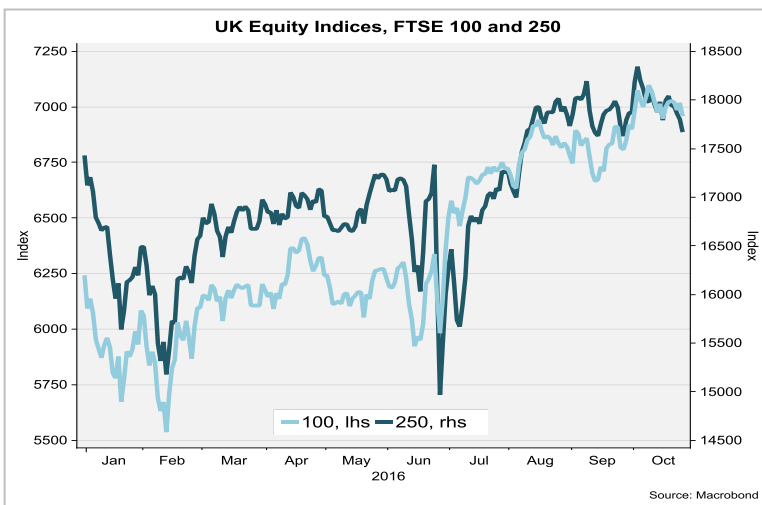
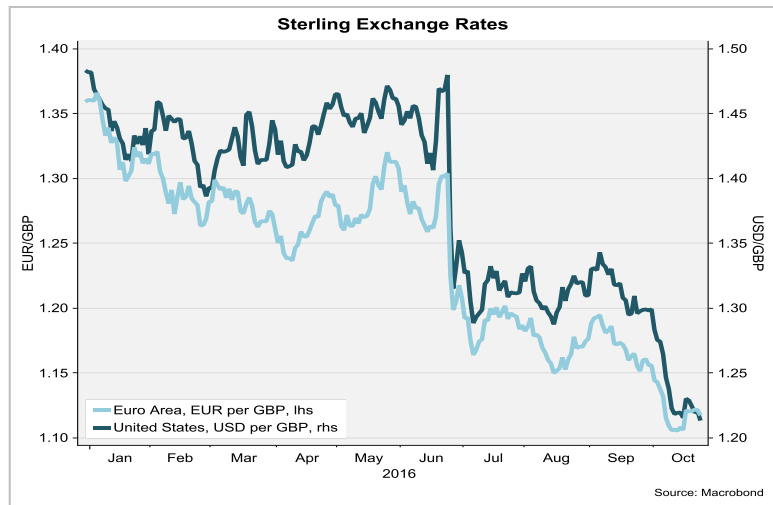
**Impact in Financial Markets**

The first impacts of heightened uncertainty and perceptions of risk were observed in the financial markets, which saw sharp falls in the value of Sterling and UK stocks.

Immediately following the referendum, Sterling fell approximately 10% against the dollar and the euro. It stabilised around this level until the start of October when it fell further following the announcement that Article 50 would be triggered in the first quarter of 2017 and market concerns of a "hard Brexit".

Sterling has now fallen almost 20% against the Dollar and 15% against the Euro since the referendum.

This reflects investor uncertainty and the response to the political and economic shock following the referendum. It increases the price of imports in the UK whilst increasing the competitiveness of UK exports in overseas markets.



UK share prices also fell in the days following the referendum result, with the FTSE 100 falling around 6% and the FTSE 250 falling around 13%.

As share prices fell, investors moved funds into relatively safer assets, such as government bonds. As a result, UK 10-year bond yields more than halved following the referendum due to increased demand.

The FTSE 100 and FTSE 250 have subsequently recovered to above their pre-referendum levels. However, markets remain sensitive to new information, data and policy announcements as they become available.

**Business Surveys**

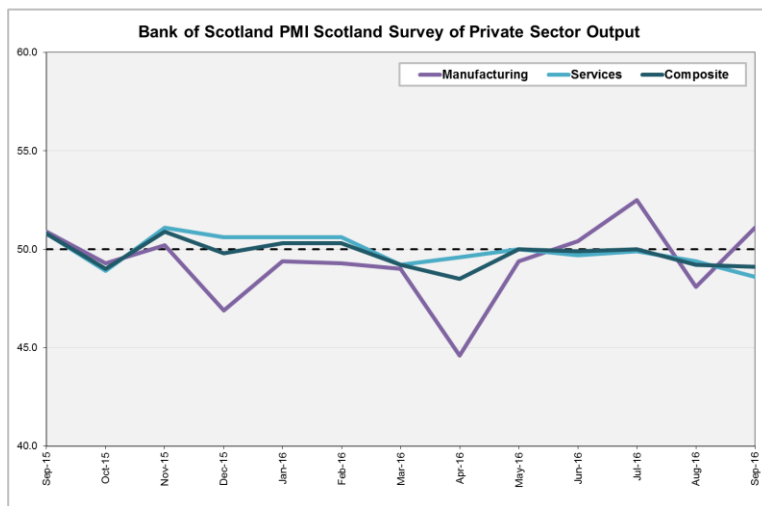
Most economic indicators don't yet reflect the impact of the referendum outcome. However, several Scottish business surveys have been undertaken, providing an indication of how business activity and sentiment are responding to the outcome in Q3 2016.

**Post EU Referendum Scottish Data**  
 Official GDP data is released quarterly. Scottish GDP data for Q3 2016 (July – September) will be available in January 2017. Official Labour market data is released monthly with this edition featuring data for June - August 2016. The first labour market release covering solely the post referendum period (July-September 2016) will be available in mid-November.

The latest CBI Industrial Trends Survey of Scottish manufacturing firms signalled that manufacturing output increased over the three months to October 2016, however new orders and employment numbers contracted. The survey results signalled that the lower value of Sterling is expected to have a strong influence going forward, boosting expectations for export orders whilst pushing up input costs.

The latest Scottish Chambers of Commerce Business Survey for Q3 2016 indicated steady performance in the period immediately following the EU referendum with sales revenue and employment level indicators signalling expansion across most sectors, apart from the Retail and Wholesale sector. However, business optimism remained weak across the board.

The monthly Bank of Scotland Purchasing Managers Index has fluctuated between marginal expansion and marginal contraction on a regular basis since the start of 2016. Following the referendum, private sector output contracted slightly in both July and August in Scotland, stemming from falls in new business intakes. However, private sector output picked up again in September, to a 14-month high, with both manufacturers and service providers reporting an increase in business activity, driven by a sharp increase in new business and exports, supported by the lower value of Sterling.



However, private sector output picked up again in September, to a 14-month high, with both manufacturers and service providers reporting an increase in business activity, driven by a sharp increase in new business and exports, supported by the lower value of Sterling. The survey signalled that employment numbers have remained positive over the quarter also.

The latest Royal Bank of Scotland Business Monitor also indicated that conditions in the Scottish economy improved slightly over the three months to August 2016, with firms citing increases in business volumes and turnover.

In contrast, the Scottish Engineering Quarterly Review for Q3 signalled a weakening in the Manufactured Engineering over the quarter. Responses on order intakes, output volumes, exports and staffing all signalled significant contractions over the quarter, indicating that increased uncertainty following the EU referendum may be compounding existing challenges for the sector.

Taken together, the findings from business surveys undertaken in Q3 have tended to become more positive as time has passed from the initial shock of the result, with indicators on business activity and employment across the private sector showing signs of strengthening over the quarter.

The depreciation in the value of Sterling is also starting to feature in responses with firms signalling that their input costs are increasing whilst also showing signs of exports starting to pick up towards the end of the quarter.

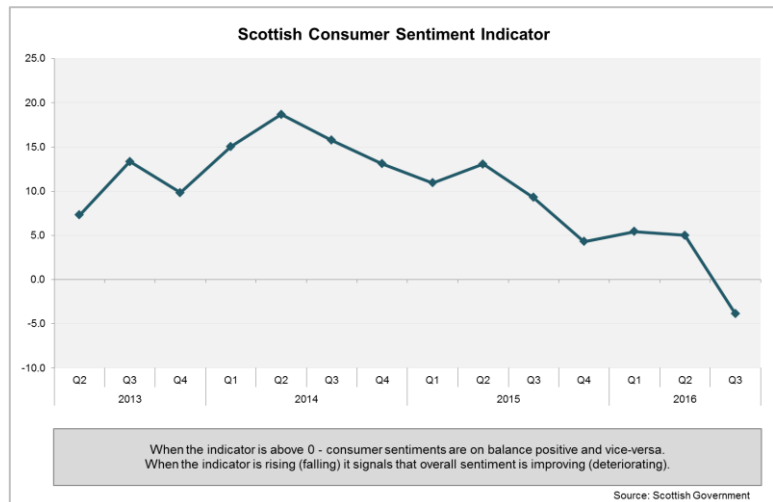
However, whilst the signals for Q3 are broadly positive, with EU referendum uncertainty compounding existing headwinds facing the Scottish economy, there is evidence that business optimism remains weak across the board and it is too early to draw any clear conclusions about how the referendum will impact on economic activity in Q4 of 2016 and into 2017.

### Consumer Sentiment

The Scottish Consumer Sentiment Indicator provides a measure of consumer confidence. It is undertaken quarterly, based on a sample of around 2,000 individuals across Scotland. The latest survey was conducted between 20th July and 5th September and showed that household sentiment in Scotland fell substantially in the third quarter of 2016. The overall indicator moved into negative territory for the first time since the survey began in Q2 2013 implying that a net balance of respondents believe economic conditions are worsening.

Underneath the headline indicator, each score on both current and future consumer sentiments surrounding the Scottish economy, household finances and expenditure fell over the quarter, with virtually all becoming negative.

Care should be taking when interpreting the headline and individual indicators as they are not seasonally adjusted and may be revised at a later date. With the indicator commencing in Q2 2013, at this stage we do not have a sufficiently long time series to allow for seasonal-adjustment or to examine the indicator’s power as a leading indicator. Despite this, the broad trend across all questions signal that households have become less optimistic about the outlook for both the economy as a whole, and their personal financial position since the EU referendum result.



Scottish Consumer Sentiment Indicator	Latest Score (Q3 2016)	Score - Previous Quarter	Score - Same Quarter of Previous Year	Score - Series Average
<b>Overall Indicator Score</b>	<b>-3.9</b>	<b>5.0</b>	<b>9.3</b>	<b>9.8</b>
(a) Economy performance - last 12 months	-13.8	1.2	8.9	15.3
(b) Economy performance - next 12 months	-5.3	10.4	19.0	19.8
(c) Household financial position - last 12 months	-1.6	2.3	2.2	2.4
(d) Household financial position - next 12 months	5.9	12.2	15.1	11.9
(e) Attitude to household spending - current	-4.5	-1.2	1.4	-0.5

Note: The overall indicator score is the mean of the net balances for each question from a-e. The net balance is the difference between the percentage of respondents reporting an improvement and those reporting a deterioration. When the indicator is above 0, consumer sentiment is on balance positive and vice versa. When the indicator score is rising (falling) compared to previous quarters, it signals that sentiment is improving (worsening).

### Scottish Retail Sales Index

The Retail Sales Index for Scotland is a measure of the goods sold by retailers in Scotland and provides an early indication of the performance of the retail sector in Scotland and the strength of consumer spending. In the third quarter of 2016 (the three months following the EU referendum), the volume of retail sales in Scotland increased 2.1 per cent over the quarter and 4.9 per cent over the past 12 months. This was a pick-up in pace from the 0.3 per cent quarterly growth in the previous quarter.

The pick-up in growth was broad based across the retail sector with sales by large retail businesses increasing by 1.5% per cent over the quarter and by 2.8% from small and medium sized retailers (having contracted 2.4% in Q2).

The data indicates resilience in the retail sector and consumer spending in the immediate aftermath of the EU referendum. This, coupled with the evidence from the business and consumer surveys signal that uncertainty impacts are still unfolding in 2016.

## Revisions to Economic Forecasts<sup>12</sup>

Since the EU referendum there have been significant downwards revisions to UK GDP growth forecasts, particularly for 2017.

The Bank of England has kept its UK GDP forecast for 2016 unchanged at 2%, but has revised down its 2017 forecast from 2.3% to 0.8%. This represents the largest downward revision the Bank has made to its GDP forecasts since the Monetary Policy Committee (MPC) was formed.

Of the 38 forecasters tracked by HM Treasury, the average forecast for UK GDP growth in 2017 is now 1.0%, down from 2.1% forecast prior to the referendum<sup>13</sup>. Similar downward revisions have been made to the forecasts for Scotland. For example, the Fraser of Allander Institute now forecast Scottish GDP growth in 2017 of 0.5%, down from their earlier forecast of 1.9%, whilst PWC have forecast growth of 0.3% in 2017.

Forecasters have sighted several factors behind these downward revisions:

- **Decreased investment:** The referendum outcome has increased economic uncertainty and financial market volatility, which poses a risk to business investment and household consumption.
- **Decreased trade:** Whilst it will take a number of years for the UK to formally leave the EU, some forecasters expect the outcome to have a negative impact on trade before then as businesses adjust their expectations to life outside the EU.

The depreciation of Sterling and the subsequent boost to the competitiveness of UK goods in export markets has the potential to offset any reduction in the sentiment to trade over this period.

- **Decreased household consumption:** Forecasters expect that household spending and savings will be impacted by greater uncertainty, possible lower house prices, as well as squeezed real incomes following the fall in sterling, impacting on inflation, and any weakening in employment growth.

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<sup>12</sup> The forecasts for the Scottish economy presented in this report reflect those that are widely available in the public domain. They can be found at: Fraser of Allander Institute <https://www.sbs.strath.ac.uk/feeds/news.aspx?id=997> Ernst and Young ITEM Club <http://www.ey.com/UK/en/Issues/Business-environment/Financial-markets-and-economy/EY-scottish-ITEM-club-summer-update-2016> and PWC Scotland <http://pwc.blogs.com/scotland/2016/07/new-pwc-scotland-report-talks-chances-of-recession-and-house-prices-until-2020.html>. The choice reflects published forecasters which are known to us and are subject to review. No significance should be attached to the inclusion or exclusion of any particular forecasting organisation. The Scottish Government accepts no responsibility for the accuracy of material published in this comparison.

<sup>13</sup> This compares the average independent forecast for September to June.



Annual GDP Growth Forecast (%)	Country	2015	2016	2017
Fraser of Allander Institute [July 2016]	Scotland	2.1%	0.9%	0.5%
PWC [July 2016]	Scotland	2.1%	1.3%	0.3%
Bank of England [August 2016]	UK	2.3%	2.0%	0.8%
HM Treasury Average UK Independent Forecast [October 2016]	UK	2.3%	1.9%	1.0%
IMF [October 2016]	UK	2.3%	1.8%	1.1%
OECD (September 2016)	UK	2.2%	1.8%	1.0%

## Policy Responses

The extent to which uncertainty feeds through to economic activity and over what timescale is, in part, contingent upon the policy responses of the different UK regulatory authorities and tiers of government.

In response to the weaker economic outlook, the Bank of England introduced a monetary stimulus package including: a cut in the Bank Rate to 0.25% (from 0.5%); a Term Funding Scheme to reinforce the pass-through of the cut in Bank Rate to the real economy; a £60 billion expansion of the UK Government bonds purchasing programme (increasing the stock of purchased assets to £435 billion); and a further purchase of up to £10 billion of UK corporate bonds.

The reduction in the Bank Rate will encourage expenditure and investment over saving amongst consumers and businesses. It will also put further downward pressure on Sterling in the short term which will assist in boosting demand for exports whilst creating additional input costs for businesses that rely on imports. In their August Inflation Report, the Bank of England project inflation to increase back to their 2% target in 2017 and feasibly overshoot it in 2018. In September, CPI inflation increased to 1%, up from 0.6% in August, driven partly by an increase in the price in clothing and motor fuels. Whilst this rise in inflation can't be linked explicitly to the depreciation in Sterling, it demonstrates the challenges going forward if inflation starts to squeeze real incomes and household consumption.

The Scottish Government has also taken action to support the Scottish economy following the EU referendum result to offset the heightened risks of a weaker economic outlook. This included a £100 million Capital Acceleration Programme to provide immediate support to the Scottish economy and the setting up a new dedicated service to provide information and support to businesses affected by the referendum to reduce uncertainty where possible.

## Summary

The outcome of the EU referendum has increased economic uncertainty. To date this uncertainty has been most visible in financial and currency markets, however, latest data on retail sales in Scotland shows resilience in the sector and consumer spending in the immediate aftermath of the referendum. However, with signs of weaknesses in consumer sentiment and business optimism, it is expected to feed through to household and business behaviour over the remainder of this year and next, potentially leading to a slowdown in economic growth.

This weaker economic outlook is observed across most independent forecasts, with a general consensus that the UK and Scottish economies will slow over 2016 and 2017 in particular as a result of a slow-down in consumption and investment.

The scale of any slowdown will depend on how long the current economic uncertainty persists, the nature of the impacts as they unfold and the extent to which public policy can restore confidence. The fall in the value of Sterling will potentially act as an adjustment mechanism over this period, helping boost demand for exports, but will also generate pressure on business costs and household incomes as the increased cost of imports starts to feed through to inflation.