EY Scottish ITEM Club 2019 Forecast

Challenges ahead

December 2018

EY

Building a better working world

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This report is based on data and information available before 12 November 2018. The EY Scottish ITEM Club report is part of the EY Economics for Business programme which provides knowledge, analysis and insight to help business understand the economic environments in which they operate, both in the UK and globally. Find out more:
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Foreword

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Are we building an economy on unstable foundations?

On the surface, the latest economic figures for 2018 reflect a Scottish economy that has recorded robust rates of growth and outperformed the UK average. However, dig a little deeper and weak foundations begin to emerge, which put Scotland's future growth rate at risk.

Having outperformed the UK economy in 2018, this EY Scottish ITEM Club 2019 Forecast predicts Scotland's growth to slow in 2019, dropping from a recorded 1.6% growth in 2018 to an expected 1.0% growth for the year ahead. Furthermore, growth rates for Scotland are anticipated to remain below that of the UK during the next five years.

Growth rates can be difficult to maintain even in stable times, never mind the uncertain world we find ourselves operating in today. However, accepting pockets of growth are not enough in this climate, an enduring focus on how to grow Scotland's economy for the long term needs to be a priority, for both business and government.

There are growth builders ...

2018's growth was underpinned by exports, consumer spending, and investment in house building and by central government capital investment.

This report highlights that the service sectors will continue to drive growth across Scotland, expecting to contribute over 70% of GVA growth in 2019.

Professional, scientific and technical activities are the strongest performers in this group, with life sciences having experienced the largest increase in employment over recent years.

Currently the sixth largest economic sector, the life sciences sector is a real growth area for the Scottish economy, with an ambitious turnover target of £8 billion by 2025, as announced by the Life Sciences Scotland Industry Leadership Group. If it continues its upward growth curve toward this target, life sciences is set to become one of Scotland's future top three sectors.

... but the economy has weak foundations ...

However, despite a relatively good economic story for 2018, Scotland has suffered from falling employment levels, skills gaps and a contracting working-age population, resulting in both the near-term and longer-term expected future slowdown.

The report cites a number of factors that have previously propped up the economy, but are unstable going forward.

Importantly, the additional demand in the economy has not been met by capital investment or job creation, but by employees working longer hours, which is not a productive formula for growth.

Troublingly, with a population that spends more than it saves, fuelling consumer spending by pushing down the saving rate is unsustainable in the long-run.

There is an urgent need to push up the skills levels of the existing workforce, so that growing Scottish businesses can address their current hard-to-fill-vacancies.

We face challenges that are more prevalent to Scotland such as our decrease in the number of people of working age combined with a decline in migrants. Scotland's weak demographic structure hinders both population and economic growth.

Brexit-related uncertainty continues to encourage businesses to delay and postpone projects. It is vital that a smooth Brexit agreement unfolds and growth in business investment returns to underpin productivity improvements across all sectors.

... with people, skills and business investment a critical solution.

What this report highlights is that while there is economic growth news to share, challenges remain that need to move from a cautionary tale to a critical call for action.

When looking at building a strong economic future, all roads lead back to people, skills and business investment.

All three areas are interlinked in that the right people and skills will help drive productivity and stimulate business investment.

A coherent skills strategy that addresses both short-term and longer-term issues; a narrative from both UK and Scottish Government that tells a story of certainty and confidence; along with increased business investment are all vital building blocks.

2018 overview

- Scotland's onshore GDP grew by 0.5% in real terms in Q2 2018[1], and by 1.7% year-on-year – faster than the UK as a whole. Importantly, the Scottish economy gained momentum, growing 0.3% at the end of 2017 and 0.4% in Q1 2018.
- Services continue to drive this expansion, accounting for almost three-quarters of all Scotland's nominal GVA[2] growth year-on-year . In real terms, the service sector expanded by 0.5% in both Q1 and Q2, and by 1.4% over the year to Q2 2018 – its fastest annual rate of growth since the end of 2016.
- In addition, industrial production in Scotland has grown for four consecutive quarters, and six of the last seven, expanding by 4.3% in real terms in the year to Q2 2018. This is in large part due to the strength of manufacturing, which also grew at 4.3% over this period (second fastest among industrial sectors, after the much smaller electricity & gas supply sector), supported by strong export performance.
- In nominal terms, Scotland's onshore GDP grew by 4.1% over the year to Q2 2018, with external demand its largest driver. Exports grew in nominal terms by 7.3% over the period, as Scottish exporters continued to take advantage of sterling's weakness. However, growth in the value of imports (3.4%) offset this somewhat, meaning net trade accounted for 1.7 percentage points of Scotland's nominal GDP growth.
- Consumer spending provided the second-largest contribution to Scotland's nominal GDP growth, accounting for 1.5pps in the year to Q2 2018, as household spending outpaced growth in disposable income (2.3% compared to 1.2%). In doing so, households further drove down the savings rate to just 2.7% in Q2 2018, compared to 3.7% a year earlier and 6.4% in Q2 2016.
- Business investment was 5.3% down in nominal terms on the same quarter of 2017, as uncertainty delayed or cancelled projects. Strong growth in house building and government investment offset this to an extent, but overall, investment contributed only 0.2pps to overall growth in the year to Q2 2018.
- Business surveys suggest Scotland's robust growth continued into Q3, while even the weaker readings recorded in September and October represented solid growth going into Q4. Indeed, October's growth reading was the third strongest of all UK regions, and the rate of job creation was above the UK average.
- Nonetheless, these business surveys provide signs of caution, suggesting that private sector reluctance to invest continued throughout Q3, and that business optimism was at a low for the year as Brexit uncertainty damped sentiment.
- From a labour market perspective, overall employment was 16,000 lower from August 2017 to August 2018 (a drop of 0.6%), despite the UK averaging 1.1% growth for the same period. Scotland's employment levels are now similar to those recorded at the end of 2014 – yet there appears to be little spare capacity in the labour market, with evidence of hard-to-fill vacancies across a number of sectors of the Scottish economy.

1 Scotland's Quarterly National Accounts provide performance measures in both real and nominal terms. We use both in this document as the headline data is available in real terms, but often detailed sectoral data and information on the components of growth are only available in nominal terms.

2 GVA or Gross Value Added is total output less intermediate consumption (that is, goods and services used up in the process of producing the output).

2019 overview

- Having outperformed the UK economy in 2018, Scotland's growth is forecast to slow in 2019, dropping to 1.0% growth in real terms over the calendar year (0.6 pps slower than in 2018), despite a modest increase in growth for the UK as a whole. The slowdown in Scottish growth reflects our forecasts for the labour market resulting from a weak labour market, and an expected slowdown in manufacturing growth throughout the UK.
- For the period to 2023, Scotland's annual real growth rate is set to average 1.5%, below the UK average of 1.8%.
- We expect real growth in consumer expenditure (1%) to outpace that of personal disposable income (0.9%) in 2019, as households borrow to support spending. It is a similar picture across the UK, albeit at stronger rates of growth.
- It is predicted that private services will continue to drive growth across Scotland, contributing over 70% of GVA growth in 2019. Professional, scientific & technical activities are the most notable performers of this group, outperforming growth across the UK (along with finance & insurance). In each of the remaining private service sectors, Scotland's growth rates will underperform the UK.
- Public services are expected to grow in real terms by just 0.1% in 2019, and by an average of 0.5% up to 2023. This growth will be largely driven by human health & social work, which is in turn driven primarily by increases in NHS expenditure. Public administration & defence is forecast to contract the most of all Scotland's sectors, while construction is projected to be its fastest-growing sector in real terms in 2019 at 3%, outperforming the UK as a whole.
- We forecast a slowdown in Scottish manufacturing growth to 0.3% in real terms in 2019. We assume a transitional customs arrangement will be in place once the UK leaves the EU early next year, followed by a free trade agreement that ensures tariff-less trade. Any outcome that varies from this, in applying tariffs to Scottish manufacturers' exports to the EU, represents a downside risk to our forecast.
- After a contraction in 2018 due to a particularly weak Q2, employment is forecast to grow by a modest 0.3% in 2019 – and by an average of 0.3% per year to 2023, compared to 0.5% across the UK. Consequently, we expect only 36,300 net additional jobs by 2023 in Scotland, not enough to offset the 43,500 jobs estimated to have been lost in 2018[3].
- The sectoral profile of employment growth will also continue to favour private services. This is largely resulting from strong growth in administrative & support services, and professional, scientific & technical activities, averaging 1.5% and 1.4% respectively per year to 2023. Construction is likely to be Scotland's fastest-growing employer, supporting 15,000 additional jobs by 2023. Growth in these sectors will be partially offset by contractions elsewhere, notably in manufacturing (12,400 jobs) and public administration & defence (8,900 jobs).
- Scotland's demographic profile is a key consideration for the near-term and long-term outlook. We project its population to grow by just 0.1% per annum to 2023, equating to an additional 37,300 residents – well below the UK-wide average of 0.5% per year.
- Furthermore, we expect the working-age population of Scotland to contract. A falling net inflow of workers suggests that migrants, typically of working age, will become increasingly less able to offset the natural ageing of the Scottish population. The working-age population is forecast to contract by an average of 0.4% per year to 2023, or 66,500 residents in total, compared with modest annual growth of 0.1% across the UK.

3 It is worth noting that our forecast for employment is based on Workforce Jobs data. Our previous estimate of job loss to August 2018 was based on the Labour Force Survey that provides more timely monthly estimates.

Global and UK background

Global growth to slow slightly, but let's not panic

Recent data from the Global Composite Purchasing Managers Index (PMI), which measures the strength of economic activity, suggests the global economy has been slowing. The PMI recorded a two-year low for output of 52.8 in September 2018.[4] Although there was a slight rise in October to 53.0, this is still the second-lowest reading since September 2016. While this indicates weak growth relative to the last two years, it is still consistent with healthy annual real GDP growth in Q4 2018 of just below 3%.

The US remains the major driver of growth, given its fiscal policy. Our expectation for continued economic expansion in the US should benefit the rest of the world by increasing demand for exports. However, the trade conflict with China will partially offset this boost in demand.

China continues to record robust growth at around 6.5% in real terms, as policy loosening has offset the initial effects of the trade conflict. However, we expect the 'tarrif war' with the US to dampen China's exports in Q4. Combined with an anticipated easing in domestic demand due to slow credit growth and weaker real estate activity, we forecast the Chinese economy to grow in real terms slightly more slowly at 6.1% in 2019.

While Emerging Markets (EMs) are largely resilient, the knock-on impacts from the trade conflict (through complex international supply chains), along with weaker domestic demand in China, will dampen their outlook. We expect EM real growth to slow from 4.4% in 2018 to 4.2% in 2019.

Recent GDP data for the Eurozone was disappointing, with real growth falling to 0.2% in Q3 2018 (the slowest rate in five years). This reflects short-term disruptions in German industry that should recover in Q4 – but also higher inflation that restricted household disposable income and weakened domestic demand in Q3. As such, the Eurozone economy enters Q4 with little momentum, and we expect its real growth to slow to 1.7% in 2019, from 2% in 2018.

As a consequence of all the above, we forecast global growth in real terms to drop from 3.1% in 2018 to 2.8% in 2019.

World GDP growth

	2017	2018	2019	2020	2021	2022
US	2.2	2.9	2.3	1.6	1.8	1.9
Japan	1.7	1.0	1.1	0.1	0.9	0.9
Eurozone	2.5	2.0	1.7	1.6	1.4	1.3
UK	1.7	1.3	1.5	1.7	1.8	2.0
China	6.9	6.5	6.1	5.7	5.4	5.2
India	6.2	7.6	7.2	7.0	6.8	6.5
World	3.0	3.1	2.8	2.7	2.8	2.8
World (PPP)	3.7	3.8	3.5	3.5	3.5	3.4

Source: EY ITEM Club/Oxford Economics

4 A value of 50 represents no change, while anything above it indicates growth, and anything below, contraction.

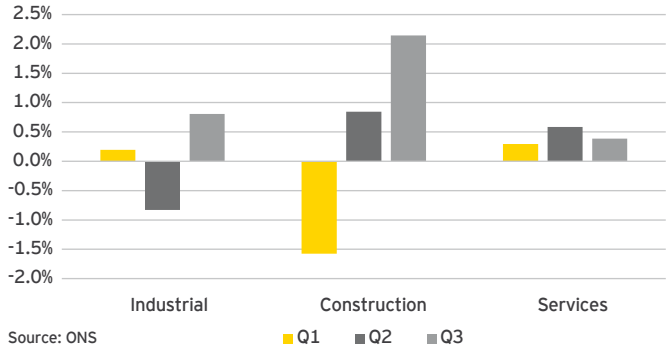
2018 UK performance is disappointing, but not unexpected

Our previous Scottish ITEM Club report (released in December 2017) forecast UK growth to weaken to 1.4% in real terms in 2018. In fact, the year to date appears to have been slightly more challenging, so we have revised down our forecast to 1.3%.

The winter weather, courtesy of the 'Beast from the East', limited UK GDP growth in Q1 to just 0.1% quarter on quarter (q/q), with activity in retail and construction worst affected. While growth recovered in Q2 to 0.4% q/q, it was still only in line with the last two quarters of 2017, signalling that the UK economy was unable to step up its pace of growth. Overall, growth in the first half of 2018 was the UK's weakest six-month performance since the second half of 2011.

The ONS's preliminary estimate for Q3 reported that GDP growth had sped up to 0.6% q/q, as the heatwave and football World Cup encouraged consumer spending and supported construction activity. This was the fastest rate of growth since Q4 2016, and the UK's three main output sectors all grew: construction by 2.1% q/q, services by 0.4%, and industrial production by 0.8% (after contracting by 0.8% q/q in Q2 2018).

UK: quarterly GDP growth by main output sectors, 2018



Source: ONS

On the expenditure side, the UK's consumer spending was up 0.5% q/q in Q3 2018. Growth could have been stronger but for weak new car sales in September, which were affected by new emission regulations. In addition, after making negative contributions to GDP growth in the first two quarters of 2018, net trade made a positive contribution of 0.8 percentage point in Q3, driven by a return to growth in exports.

Business investment did not experience a similar rebound, instead recording a third-consecutive quarter of contraction. Worryingly, these quarterly contractions have intensified throughout 2018 (-0.5% in Q1, -0.7% in Q2, -1.2% in Q3) as businesses delay or cancel their investment projects while Brexit uncertainty continues.

A loss of momentum going into Q4

In fact, the Q3 growth speed-up masks a gradual loss of momentum over the quarter. While the UK enjoyed a particularly strong July, with its economy expanding 0.4% month on month (m/m), August and September were flat. Indeed, the dominant services sector dipped by 0.1% m/m in September, while industrial production was flat.

More recently, both the CIPS manufacturing survey and CBI industrial trends survey for October suggest a slowdown in manufacturing (although there was some rebound in the CBI survey in November from the particularly poor October performance). The UK manufacturing PMI fell from 53.6 in September to 51.1 in October, a 27-month low. This reflects both global headwinds and the closer-to-home uncertainty of Brexit. Likewise, the October PMI indicated a slowdown in the UK services activity, from 53.9 in September to 52.2 in October. Except for March (and its bad weather), this is the weakest measure since the EU referendum.

As result, we expect real UK growth to be limited to 0.3% q/q in Q4 2018, resulting in overall GDP growth of 1.3% in 2018 – the weakest since 2009.

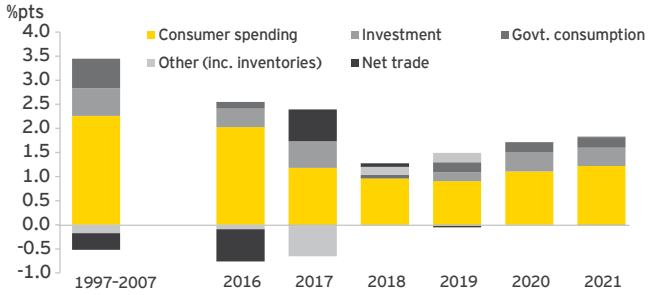
A soft 2019

The slowdown in the UK's economic growth is likely to carry over into 2019, as Brexit negotiations come to a head. We expect the UK and EU to come to an agreement ahead of March 2019, but the uncertainty in the run-up will fuel increased business and consumer caution. Consequently, while we expect growth to pick up from 2018, it will remain relatively subdued at 1.5% in 2019.

If the UK and EU cannot agree an exit deal, we predict short-term growth will be weaker again[5]. Business investment could be significantly impacted, while trade could be notably affected by trade barriers (both tariff and non-tariff). Although a sharp drop in the pound would provide help to UK exporters, it could also push up businesses' costs and consumer price inflation, thereby weighing down on UK households' purchasing power.

Over the longer term, however, our GDP growth forecasts remain at 1.7% in 2020, 1.8% in 2021, and 2.0% in 2022.

UK: Contributions to GDP growth



Source: EY ITEM Club

5 A 'no-deal' scenario would generate notable trade frictions and a major depreciation of sterling. We would expect both monetary and fiscal policy are loosened to help cushion the shock.

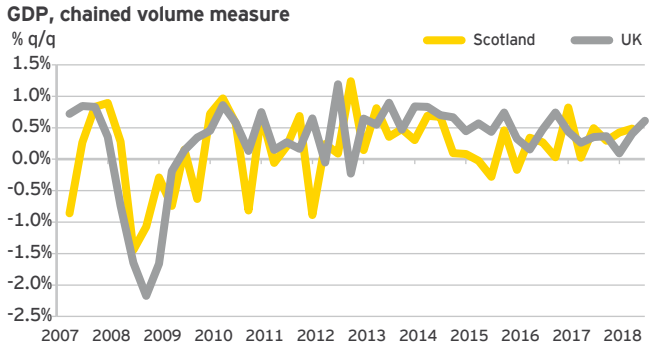
Scotland 2018

An analysis of the Scottish economy over the past 12–18 months reveals an economy recording robust rates of growth and outperforming the UK average. However, the foundations of this growth are arguably not sustainable, meaning it is more at risk than the UK average. Furthermore, despite its growth in GDP, the Scottish economy has been suffering from job losses, skills gaps, and a contracting working-age population.

Scottish economy gains momentum in first half of 2018

The latest data from the Scottish Government show the economy grew in Q2 2018.[6] Onshore GDP (which excludes North Sea oil & gas extraction) grew by 0.5% in real terms in Q2, slightly faster than the UK average (excluding oil) of 0.4%. Compared to the same quarter in 2017, Scotland's GDP has grown by 1.7% – notably higher than the equivalent figure for the UK (1.2%).

Not only has Scotland outpaced the UK, the data shows its economy has gained momentum, growing by 0.3% at the end of the 2017 and 0.4% in Q1 2018. Given that the UK economy recorded a strong Q3 (albeit skewed to a very strong July), there are reasons for optimism for the Scottish economy over the same period – not least, the importance of the rest of the UK for Scottish exports (as is discussed later in this report).

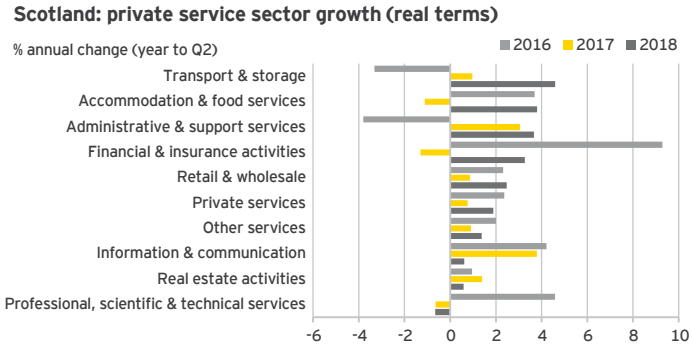


Source: ONS, Scottish Government

Services continue to drive growth in Scotland, but some individual service sectors have acted as a drag. Over the year to Q2 2018, services accounted for almost three-quarters of all nominal GVA growth in Scotland. In real terms, the sector expanded by 0.5% in both Q1 and Q2, and by 1.4% over the year to Q2 2018 – the fastest annual rate of growth since Q4 2016.

Financial & business services was the single biggest contributor, accounting for 24.8% of the national expansion over the last year. Government & other services accounted for a further 21%, with wholesale, retail & hospitality a close third at 18.2%.

Despite the overall growth in services, some sub-sectors contracted in Q2 2018 – including high value-added, export-orientated sectors such as information & communications, which contracted by 0.7% q/q in Q2, eroding some of its impressive 2.2% q/q growth in Q1. Professional, scientific & technical services also contracted in Q2, by -0.5%, and this sub-sector is now 0.7% smaller than in Q2 2017.



Source: Scottish Government/EY ITEM Club

Another positive note is that industrial production in Scotland has now grown for four consecutive quarters, and six of out of the last seven – expanding by 4.3% over the year to Q2 2018. Within this, electricity & gas supply recorded the fastest rate of growth (7%), reflecting impressive growth in Q3 and Q4 of 2017, and despite subsequent contractions in Q1 and Q2 of 2018.

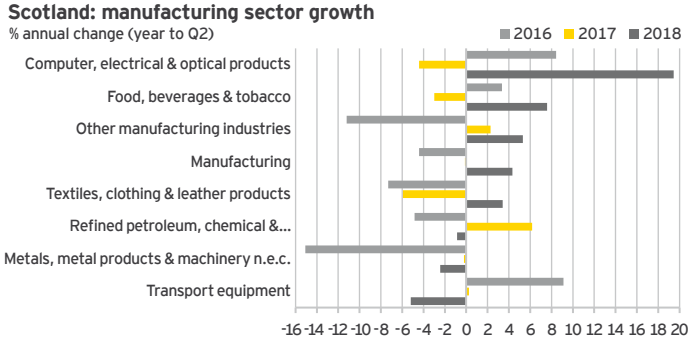
Manufacturing is still important: it experienced the industrial sector's second-fastest rate of annual growth to Q2 2018 at 4.3%, including expansion in each of the last three quarters. Consequently, it accounted for 14.2% of Scotland's total annual GVA growth, supported by strong export performance over the year.

The computer, electrical & optical products sub-sector enjoyed the fastest rate of growth within manufacturing in Q1 and Q2 of 2018. Over the year to Q2 2018, it has grown by an impressive 19.4%.

6 https://www2.gov.scot/Topics/Statistics/Browse/Economy/QNAS

As with Scotland's services, however, some of its manufacturing sub-sectors have contracted over the year. These include transport equipment (-5.2%); metals, metal products & machinery n.e.c. (by -2.4%); and refined petroleum, chemical & pharmaceutical products (-0.9%). Together, these three sub-sectors account for just over a third of Scotland's annual manufacturing GDP.

Scotland: manufacturing sector growth

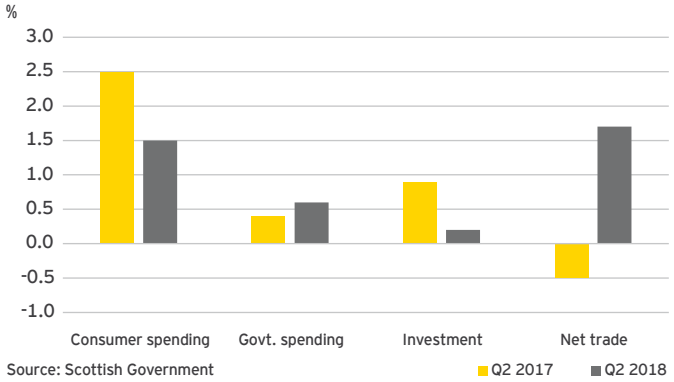


Source: Scottish Government/EY ITEM Club

External demand drives Scottish growth

Onshore GDP grew by 4.1% in nominal terms over the year to Q2 2018, with external demand the largest driver. Scottish exports increased in nominal terms by 7.3% over the period, and contributed 3.8 percentage points to overall nominal GDP growth, as exporters continued to take advantage of sterling's weakness. However, a parallel growth in the value of imports (3.4% over the period) offset some of the increased export windfall, meaning net trade accounted for 1.7 percentage points of Scotland's nominal GDP growth in this period.

Scotland: GDP contributions to growth

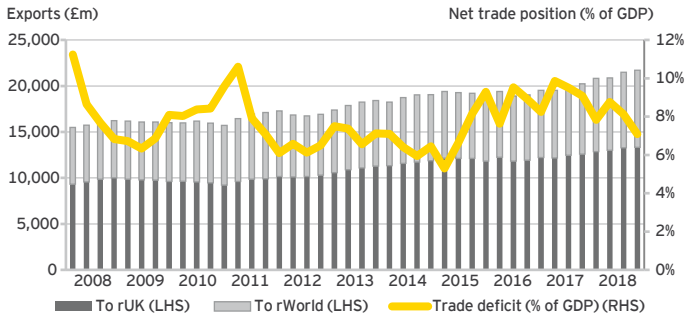


Source: Scottish Government

Importantly, though, growth in the value of imports (as compared to the same quarter a year earlier) has slowed (almost) consistently since 2017 Q2, while growth in exports has grown consistently except for a slight slowdown in the year to Q2 2018. This has helped to reduce Scotland's trade deficit.

Exports to the rest of the UK account for 61.4% of Scotland's total annual exports – just one reason why the health of the rest of the UK economy is so important to Scottish performance. But this share is down from 62.3%, recorded a year earlier in Q2 2017, as exports to the rest of the UK grew by 5.8% in nominal terms, while exports to the rest of the world grew by a much stronger 9.7%.

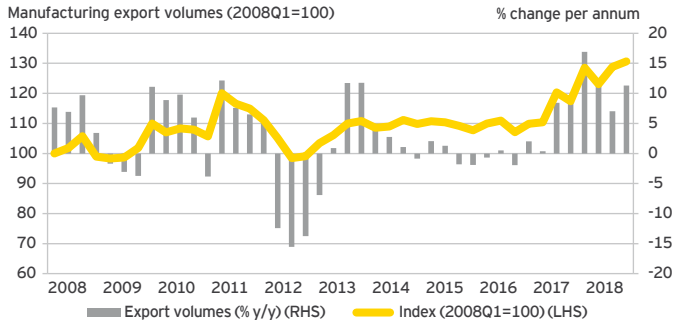
Exports by destination and net trade position



Source: Scottish Government/EY ITEM Club

Manufacturing exports accounted for nearly one-fifth of the total value of Scotland's exports in Q2 2018, having enjoyed strong growth since the start of 2017. Over the year to Q2 2018, they grew by 11.3% in nominal terms, supporting the general expansion in the sector.

Manufacturing exports continue to rise



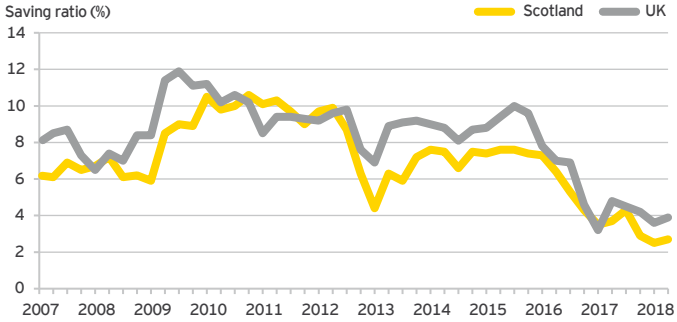
Source: Scottish Government/EY ITEM Club

Consumer spending still important, but savings ratio is already very low

Consumer spending provided the second-largest contribution to nominal Scottish GDP growth in the year to Q2 2018, accounting for 1.5 percentage points. An analysis of the Scottish Quarterly National Accounts shows that household spending continues to grow faster than disposable income in Scotland (2.3% compared to 1.2% in the year to Q2 2018).

However, as is discussed in more detail below, employment levels have fallen. Therefore, to support stronger growth in spending, Scottish households have again driven down the savings rate[7], which is estimated to be 2.7% in Q2 2018, compared to 3.7% a year earlier, and 6.4% in Q2 2016. Clearly, this trend is unsustainable in the long term.

Consumer savings have continued to fall

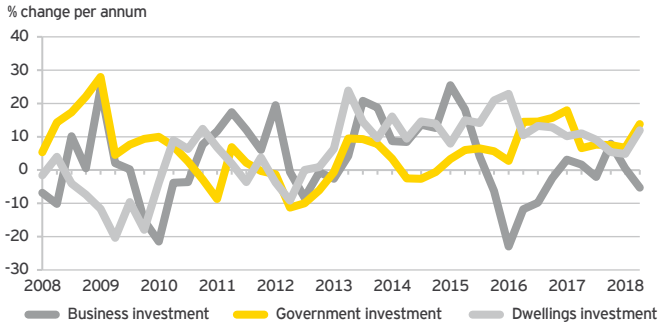


Source: Scottish Government/ONS

Business investment continues to be a drag

Brexit-related uncertainty continues to encourage businesses to delay or cancel projects altogether. As a result, business investment was 5.3% down on the same quarter (Q2) of 2017. Strong growth in house building and central government capital investment offset this drag, meaning business investment still contributed positively to Scotland's nominal GDP growth – but only by 0.2%, notably down on its 2017 performance.

Weak business investment offset by housebuilding and the public sector



Source: Scottish Government/EY ITEM Club

The private sector's reluctance to invest appears to have continued into Q3. The Scottish Chamber of Commerce Quarterly Economic Indicator for Q3 2018 reported falls in manufacturing confidence and overall investment, as well as rising material costs and uncertainty. It found that investment had declined in all sectors in Q3, relative to Q2, with the notable exception of retail. The expected bounce-back in investment post-Brexit (on the basis of a reduction in uncertainty and the private sector implementing investment projects that were previously postponed) will be a welcome boost to the economy going forward, and will be needed to ensure sustainable growth.

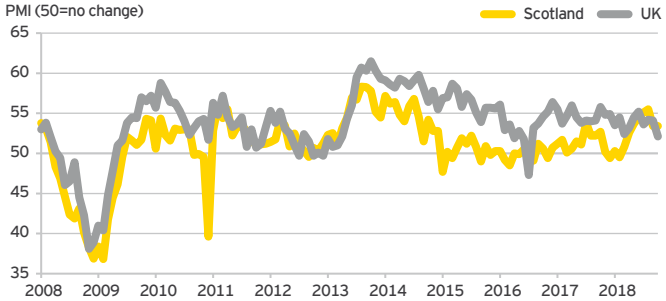
Businesses report growth throughout Q3, but signs of caution for the future

PMI provides more up-to-date data and suggests performance of the Scottish economy in Q3 might also have been strong (we would expect this, given the strength of the UK's Q3). Private sector sentiment in Scotland strengthened consistently from a low in February to a high in August 2018 – meaning Scotland's PMI was stronger than the UK average in June, July, and August. The Scottish Chamber of Commerce survey also reported a broadly positive picture for the Scottish economy in Q3 2018.

The latest PMI data show that September and October's readings weakened slightly to 53.4. Nonetheless, this still suggests solid growth going into Q4, with October's reading the third strongest of all UK regions, and the rate of job creation the fastest for four months (and above the UK average). While all sectors reported growth in the PMI survey, service companies again reported the strongest rise, while activity in manufacturing was up only marginally.

Despite the resilient growth in Q3, the PMI provides reasons for caution going forward. Businesses reported rising costs as the weak pound interacted with rising raw material prices and higher labour costs. In addition, business optimism was at a year low as Brexit uncertainty damped sentiment. These findings reinforce those of the Scottish Chamber of Commerce, noted above.

PMI composite shows a positive business outlook



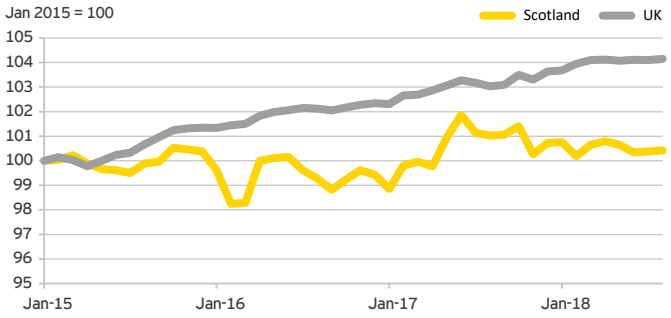
Source: Lloyds Bank Commercial Banking Regional PMI

7 Defined as the savings as a share of total resources.

Tight labour market may limit future growth

While Scotland's economy grew in Q1 and Q2 2018, its labour market showed signs of a slowdown – yet still there are signs of little spare capacity. Employment contracted in both quarters, leaving the labour market with 10,000 fewer jobs by June 2018. The latest data for July and August show the back-to-back contractions of May and June were arrested, with a net creation of 1,000 jobs in each month. However, this still means the employment level was 16,000, or 0.6%, lower than a year earlier, despite general growth of 1.1% across the UK over the same period. Indeed, Scotland's employment levels are now similar to those recorded at the end of 2014.

Employment in Scotland and UK



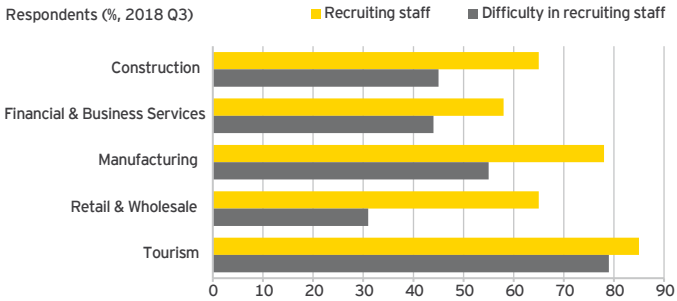
Source: LFS

Despite the general loss of employment so far in 2018, there has been little movement in the rate of unemployment or, indeed, the resident employment rate. The number of people economically active in Scotland in 2018 was below both 2014 and 2015 levels. This was primarily due to a significant fall in 2016. While the number economically active has increased over the past two years, it has grown by only 0.2% over the period.

These labour market trends reflect Scotland's ageing population: the share aged 16–64 peaked in 2011, and has since fallen back to rates last seen in the mid-1990s. Consequently, the number of Scottish residents aged 16–64 remains relatively unchanged since 2011; this slowdown in growth of the working-age population has clear implications for businesses attempting to grow.

A further indication of the tightness of the labour market is the evidence of hard-to-fill vacancies from the Scottish Chamber of Commerce survey, conducted in Q3 2018, which also finds that demand for labour has risen, compared to 2016, in every sector it covers. Recruitment difficulties were reportedly most acute in the tourism sector, with nearly four-fifths of businesses reporting issues in Q3 2018. Tourism was also the sector with the highest demand for labour, with 85% of respondents indicating they were recruiting staff. In addition, over half of manufacturing firms also reported labour difficulties in Q3 2018, while financial and business services saw a slight increase in the number of firms reporting issues.

Shortage of labour is causing recruitment difficulties



Source: Scottish Chambers of Commerce

Despite these recruitment difficulties, the Scottish Chamber of Commerce found that most firms (68%) did not increase wages in Q3. However, there is evidence of wage inflation earlier in the year: the Annual Survey of Hours and Earnings from the ONS found that, in Scotland, annual gross full-time wages grew by 3.3% in the year to April 2018, faster than the UK-wide growth of 2.8%[8]. Consequently, there are signs that the Scottish labour market has limited spare capacity, which will limit future growth.

8 It is worth noting that the definition of wages used here is taken from the Annual Survey of Hours and Earnings and relates to growth of employee earnings. The household disposable income discussed earlier is defined as income for spending/saving from everyone in the household sector, which takes into consideration self-employed, benefits income, and pensions. In addition, the measure of disposable income from the Quarterly National Accounts is income after taxes.

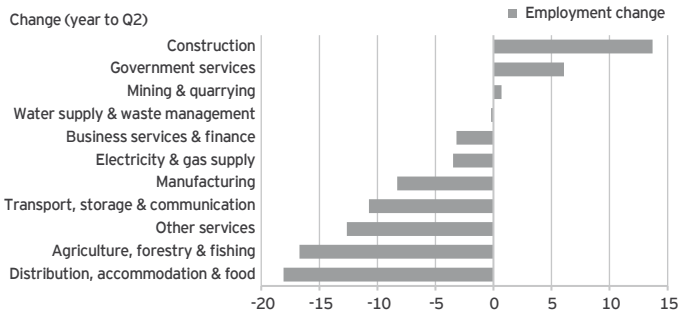
Productivity: the answer to Scotland's employment puzzle

While the Scottish Quarterly National Accounts show robust growth in the Scottish economy over the first half of 2018, the labour market data suggest a different picture. Overall, employment in Scotland fell by 1.9% in the year to Q2 2018, while the UK experienced a rise of 0.4%. So which sectors are the source of this decline in employment, and how does this relate to positive GDP growth?

Most sectors in Scotland experienced a fall in employment over the year to June 2018. The largest declines were in the distribution, accommodation & food, and agriculture, forestry & fishing sectors, with nearly 18,100 and over 16,700 jobs lost respectively. Other services, and transport, storage & communication were also major sources of jobs loss, shedding over 12,600 and 10,700 jobs respectively.

In contrast, three sectors experienced net new job creation. Construction expanded by 13,700 jobs over the period, while government services created nearly 6,100 jobs. The only other broad sector to grow was mining & quarrying, which created nearly 700 jobs.

Employment growth by broad sector in Scotland



Source: Scottish Government/EY ITEM Club

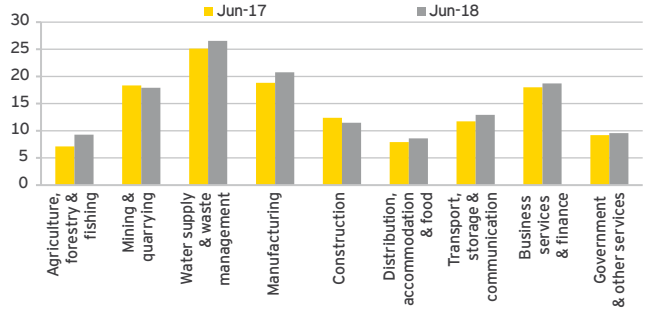
As noted, however, despite the overall contraction in employment, Scotland's GDP has outpaced the UK over the year to June 2018. This is because of improvements in productivity (as measured by GVA per job).

Overall productivity in the Scottish economy rose by 6.0% in the year to June 2018, with increases seen in the majority of sectors. For example, business services & finance experienced the largest rise in output over the year, despite contracting by almost 3,200 jobs. Growth in this sector was therefore driven by productivity gains, with output per employee up 4% compared to June 2017. Similarly, output increased by £240m in the distribution, accommodation & food sector (the third-largest rise of any sector) in the year to June 2018, despite it suffering the largest fall in employment, thanks to an 8% rise in employee productivity.

On the other hand, construction experienced a decline in output, with falling productivity levels offsetting its increase in employment. Declining productivity was also seen in the smaller mining & quarrying sector.

While 2018 data are not yet available for output per hour, the 2017 data showed a 2.4% increase in Scotland's overall productivity levels, but a much slower increase in output per hour (0.5%). Services in particular experienced a decline in output per hour alongside an overall rise in productivity, suggesting that gains have been made as a result of workers putting in longer hours.

Productivity rising in the majority of sectors



Source: Scottish Government/EY ITEM Club

In our 2018 EY Scottish ITEM Club forecast (released December 2017), we discussed the performance of Scotland's 'growth sectors', identified by the Scottish Government for their ability to build on their existing comparative advantage. The six sectors identified in Scotland's Economic Strategy 2015 were:

- Food & drink (including fisheries)
- Creative industries (including digital)
- Sustainable tourism
- Energy (including renewables)
- Financial & business services
- Life sciences

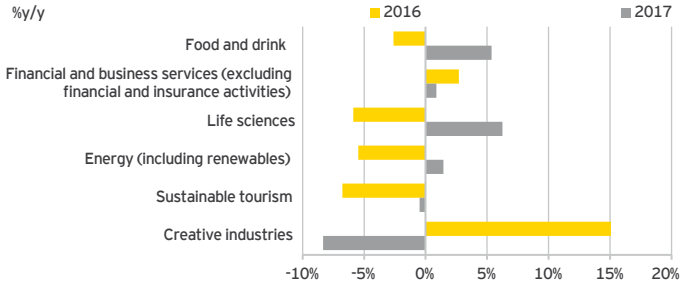
With an additional year of employment data (for 2017), it is useful to revisit this analysis and understand how these sectors are performing. We find there has been a general improvement, with the growth sectors expanding by an average of 0.3% in 2017, reversing their 0.8% decline in 2016. However, employment growth was mixed across the sectors.

The life sciences sector experienced the largest turnaround in employment, from -5.9% in 2016 to 6.3% in 2017. This growth has outpaced the UK-wide average, despite quarterly fluctuations.

The food & drink sector has enjoyed growth in both employment and GDP over the past year. The freeze on spirit duty from the latest budget will be of relatively higher importance to the Scottish economy, as spirits account for 11% of EU exports and 18% of non-EU exports.

In contrast, the largest employing sector, sustainable tourism, experienced a slight decline in employment in 2017, despite GDP growth and a 16.7% rise in spending. But there is evidence of hard-to-fill vacancies in this sector. The other growth sectors have also experienced a challenging year, with both energy and creative industries experiencing a decline in employment. And these challenges have continued into 2018, with more recent GDP data showing a yearly decline to Q2 2018 in both sectors[9].

Growth sectors saw improvement in 2017



Source: Scottish Government/ EY ITEM

Is 2018's growth sustainable?

Given the data available to us, it would appear the robust economic growth recorded in the past 12–18 months was underpinned by exports (helped by sterling's weakness), consumer spending (given the fall in the savings rate), and investment in house building and by central government capital investment. However, we have already noted that fuelling consumer spending by pushing down the saving rate is unsustainable in the long-run. It would also seem that the additional demand in the economy has been met not by capital investment or job creation, but by employees working longer hours. Again, this is not the most desirable formula for growth.

For Scotland, it is important that growth in business investment returns to underpin productivity improvements across all sectors. This is all-the-more important when we consider the future contraction in the country's working-age population. Another consideration is the need to push up skill levels of the existing workforce, so that growing Scottish businesses can address their current hard-to-fill vacancies.

9 https://www2.gov.scot/Topics/Statistics/Browse/Business/Publications/GrowthSectors/Briefings

Forecasts for 2019 and beyond

Scotland faces a weaker growth outlook for 2019

Despite outperforming the UK economy in 2018, Scotland's real growth is forecast to slow to 1.0% in 2019 – a year-on-year drop of 0.6 percentage points, against a modest projected increase in growth across the UK (from 1.3% to 1.5%). The slowdown in Scottish growth reflects a disappointing employment performance, coupled with a forecast slowdown in manufacturing growth across the UK as a whole.

For the period to 2023, the annual real growth rate is set to average 1.5%, compared with a UK average of 1.8% a year. This represents a slight downgrade on our summer forecast, which estimated real growth over the period to 2023 at 1.7% per year in Scotland, and 2.0% across the UK.

Scotland is forecast to see stronger performance of personal disposable income, growing by 0.9% in real terms in 2019 (a reversal of the 1.0% contraction in 2018). Consumer expenditure will grow slightly faster at 1.0% in real terms in 2019, highlighting the fact that there is limited capacity for Scottish households to borrow to support their additional spending. Across the UK, however, both disposable incomes and consumer spending are forecast to outperform the Scottish economy in 2019, growing by 1.2% and 1.4% respectively.

We forecast Scottish house prices to grow by 3.7% in real terms in 2019, outperforming the UK equivalent (2.5%) but a slowdown from their 4.8% growth in 2018. While UK house price growth is forecast to remain relatively static over the coming years, we forecast Scotland's rate to continue to slow, equivalent to 3.2% in 2020 and 1.7% in 2021. Annual real growth up to 2023 will average 2.3%, 1.0 percentage points below the UK equivalent.

Private services will continue to drive growth across Scotland, contributing over 70% of GVA growth in 2019. Professional, scientific & technical activities is the most notable performer of this group, outperforming growth across the UK (along with finance & insurance). For the remaining private services, Scotland's growth rates underperform the UK. In 2019, we forecast that only accommodation & food services – the smallest of the private services – will be overrepresented in Scotland, relative to the UK economy.

Public services have historically formed a larger share of Scotland's economy than the UK as a whole, accounting for over a fifth of GVA in 2018. However, public services will grow in real terms by just 0.1% in 2019, and by an average of 0.5% per year up to 2023. This growth will be largely driven by human health & social work, which is in turn driven primarily by increases in NHS expenditure. Public administration & defence is projected to contract the most of all sectors across Scotland, while construction is forecast to be Scotland's fastest-growing sector in 2019, outperforming the UK economy as it bounces back from a slight -0.1% contraction in 2018.

We forecast a slowdown in manufacturing growth. Having been projected to be Scotland's fastest-growing sector in 2018, accounting for a quarter of all growth, we expect a slowdown in manufacturing output in 2019, with growth set to fall to 0.3%, representing a drag on the country's overall growth.

Note: our manufacturing forecast relies on the assumption that a transitional customs arrangement will be in place once the UK leaves the EU early next year, followed by a free trade agreement which ensures tariff-less trade. Any outcome that varies from this, in applying tariffs to Scottish manufacturers' exports to the EU, represents a material downside risk to our forecast.

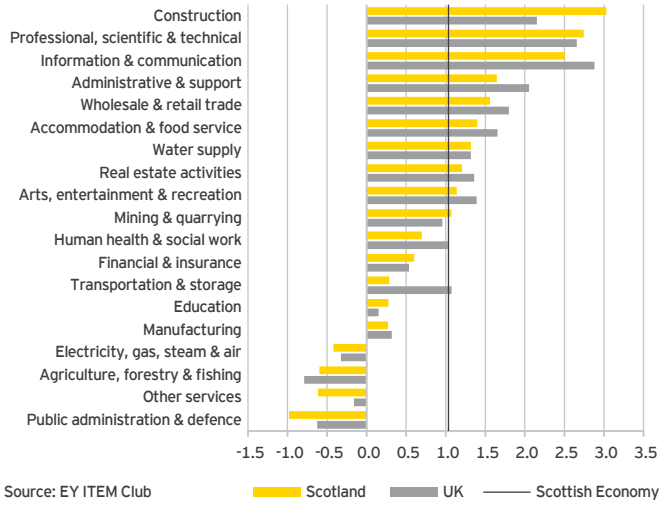
The ITEM Club forecast for the Scottish Economy, November 2018

percent changes on previous year unless otherwise stated

	GVA	Personal disposable income	Consumers' expenditure	Population 000s	Employment 000s	Unemployment rate % (Claimant Count)	Working-age migration 000s
2017	1.4	0.2	1.1	5,425	2,809	4.1	24
2018	1.6	-1.0	0.5	5,447	2,765	4.2	22
2019	1.0	0.9	1.0	5,457	2,773	4.0	10
2020	1.4	1.5	1.3	5,465	2,780	4.1	8
2021	1.5	1.7	1.4	5,472	2,787	4.2	7
2022	1.7	1.7	1.7	5,478	2,795	4.3	6
2023	1.8	1.7	1.7	5,484	2,802	4.4	7

Source: EY ITEM Club

Forecast GVA growth rates by sector: 2019 (%)

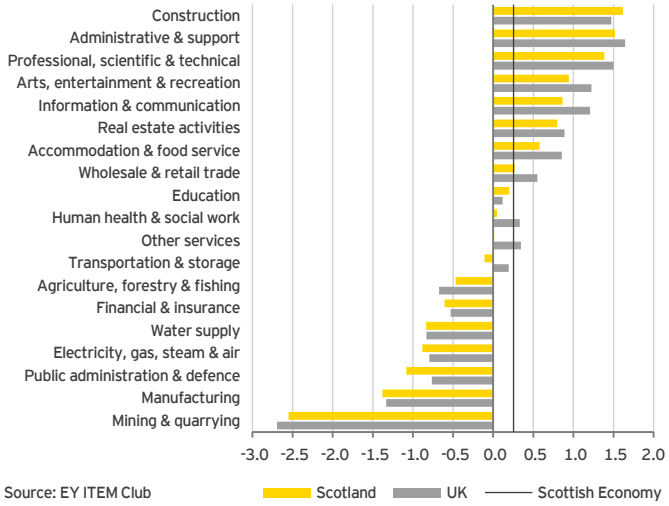


Source: EY ITEM Club

Modest employment growth not sufficient to offset recent contractions

We forecast a reversal of fortunes for employment. Despite our projected contraction in 2018 – due to particularly weak employment data in Q2 – employment is projected to grow by a modest 0.3% in 2019. In the longer term, it is forecast to remain relatively static, with growth averaging just 0.3% per year between 2018 and 2023, compared to 0.5% across the UK. Owing to this lacklustre rate, the Scottish economy is projected to generate only 36,300 net additional jobs by 2023, not enough to offset the 43,500 jobs estimated to have been lost in 2018.

Forecast employment growth by sector: 2018-2023 (% y/y)



Source: EY ITEM Club

The sectoral profile of employment growth will also continue to favour private services. This is largely resulting from strong growth in administrative & support services, and professional, scientific & technical activities, averaging 1.5% and 1.4% respectively up to 2023. These sectors collectively will support 30,100 of the 36,300 net additional jobs across Scotland.

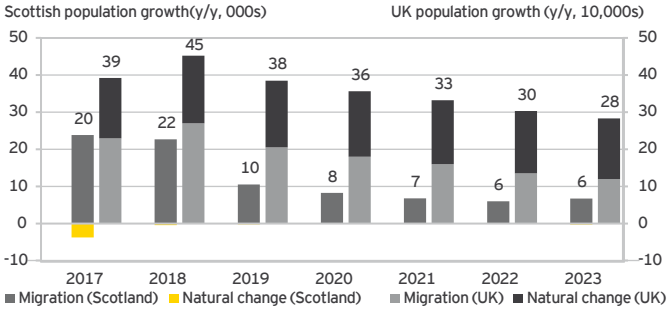
Construction will be Scotland's fastest-growing employer, supporting 15,000 additional jobs by 2023. Growth in these sectors will, however, be partially offset by contractions elsewhere, most notably in manufacturing (12,400 jobs) and public administration & defence (8,900 jobs.

Weak demographic structure hinders population growth

Scotland's demographic profile is also a key consideration for our forecast. From 2019 onwards, its population growth will be entirely reliant on net migration, despite migrants contributing less than half of population growth across the UK. However, the forecast for net migration into Scotland is weaker, equating to 6,800 additional residents in 2023, compared to 22,500 in 2018. Natural change, the number of annual births minus deaths, will be largely unchanged.

Overall, we forecast the population of Scotland to grow by 0.1% per annum to 2023, equivalent to 37,300 additional residents. This compares unfavourably to the UK, where the population is due to grow by an average of 0.5 percent per annum.

Components of population change



Source: EY ITEM Club

Although the overall population is projected to grow, the working-age population of Scotland is forecast to contract. A falling net inflow of workers suggests that migrants – typically of working age – will become increasingly less able to offset the natural ageing of the population. Scotland's working-age population is projected to contract by an average of 0.4% per year up to 2023, or 66,500 residents in total, compared with modest growth of 0.1% per year across the UK.

Although this will be coupled with growth in Scotland's overall employment over the same period, we forecast the unemployment to remain relatively stable at 4.4% in 2023. This implies there will be an increase in labour market participation by the (currently) economically inactive.

City focus

Glasgow

Employment in Glasgow increased by 1.1% in 2017, equivalent to 4,900 jobs. This represents a modest increase compared to the 3.1% rise recorded in 2016. Its GVA is estimated to have increased by 2.1%, outpacing both the rate for Scotland (1.4%) and the UK as a whole (2.0%).

However, the Annual Population Survey shows the unemployment rate in Glasgow rose by 0.7 percentage points between the year to June 2017 and the year to June 2018, with this rate now the highest among the Scottish cities we cover. But the narrower claimant count measure of unemployment suggests the rate has fallen marginally in the third quarter of 2018.

Employment growth in Glasgow is forecast to fall by 0.3% in 2018, with administrative & support services and manufacturing heading up the sectoral contractions. Over the period to 2021, we forecast employment growth to average 0.8% per year, equivalent to an additional 11,100 jobs in the city.

Glasgow's GVA growth should remain healthy at 2.6% in 2018, then average 2.0% per year over the period to 2021.

Employment change by sector

Sector	Total employment		
	2018 (000s)	2021 (000s)	Annual % growth 2018-2021
Utilities, extraction & agriculture	5.6	5.4	-0.8
Manufacturing	17.6	16.9	-1.3
Construction	21.1	23.0	2.8
Wholesale & retail trade	52.4	53.2	0.5
Transportation & storage	14.9	14.8	-0.2
Accommodation & food service	29.1	29.9	0.9
Information & communication	20.5	21.1	1.0
Financial & insurance activities	24.2	25.7	1.9
Real estate activities	9.2	9.6	1.5
Professional, scientific & technical	35.7	38.0	2.2
Administrative & support service	54.1	57.7	2.2
Public administration	23.3	22.9	-0.6
Education	34.0	34.4	0.4
Human health & social work	79.6	79.6	0.0
Arts, entertainment & recreation	10.0	10.3	1.0
Other service activities	11.0	11.0	0.0
Total	**442.3**	**453.4**	**0.8**

Source: EY ITEM Club

Edinburgh

Employment in Edinburgh increased by 1.8% in 2017, equivalent to 6,200 additional jobs, with nearly half of these coming in the accommodation & food services sector. We estimate its GVA increased by 0.7%, half the rate for Scotland (1.4%), and well behind the UK as a whole (2.0%).

The Annual Population Survey shows the unemployment rate in Edinburgh has fallen by 0.7 percentage points between the year to June 2017 and the year to June 2018, and is now among the lowest rates among the cities in our analysis. However, the claimant count rate shows a small increase in unemployment through Q3 2018.

We forecast that total employment in Edinburgh will fall by 0.3% in 2018, but will then recover over the period 2018-2021, averaging 0.8% growth per year. While Edinburgh will likely see job losses in financial & insurance activities, growth in its business services and consumer sectors should compensate.

GVA in Edinburgh is forecast to increase by 2.1% in 2018, contributing to growth of 1.6% per year over the period to 2021. This is marginally below the UK (1.7%) but ahead of the Scottish average (1.3%).

Employment change by sector

Sector	Total employment		
	2018 (000s)	2021 (000s)	Annual % growth 2018-2021
Utilities, extraction & agriculture	3.9	3.8	-0.9
Manufacturing	8.0	7.6	-1.5
Construction	11.1	12.0	2.8
Wholesale & retail trade	39.1	40.3	1.0
Transportation & storage	14.0	14.2	0.6
Accommodation & food service	32.7	34.2	1.5
Information & communication	20.4	21.2	1.2
Financial & insurance activities	33.5	31.5	-2.0
Real estate activities	5.3	5.6	1.5
Professional, scientific & technical	34.4	36.7	2.2
Administrative & support service	25.8	27.4	2.1
Public administration	22.3	21.8	-0.7
Education	33.8	34.8	1.0
Human health & social work	52.4	53.3	0.6
Arts, entertainment & recreation	11.8	12.3	1.6
Other service activities	10.7	10.9	0.6
Total	**359.0**	**367.7**	**0.8**

Source: EY ITEM Club

Aberdeen

Employment rose by 0.8% in Aberdeen in 2017, equivalent to 1,500 additional jobs, arresting a trend of falling employment in the two years prior. Its GVA is estimated to have stayed broadly flat, again exhibiting some respite after the sharp contractions of 2015 and 2016.

Yet Annual Population Survey data show that unemployment in Aberdeen rose by 1.1 percentage points between the year to June 2017 and the year to June 2018; the biggest rise among the cities covered in this analysis. More recent, but narrower, claimant count data does, however, suggest a modest reduction in the city's unemployment rate in late 2018.

Employment is forecast to fall again in 2018, with the city shedding 3,000 jobs. Over the 2018–2021 period, Aberdeen's labour market will continue to shrink, contracting by an average of 0.1% annually. Extraction will be the hardest-hit sector, with around 1,400 job losses expected.

Aberdeen's GVA is estimated to remain flat in 2018. Recovery is likely from 2019 onwards, however, with the city forecast to experience average GVA growth of 1.1% per year over the period 2018–2021, falling just short of the average for Scotland as a whole (1.3% per year).

Employment change by sector

Sector	Total employment		
	2018 (000s)	2021 (000s)	Annual % growth 2018-2021
Utilities, extraction & agriculture	24.6	23.2	-2.0
Manufacturing	10.3	10.0	-1.1
Construction	6.3	6.6	1.8
Wholesale & retail trade	19.2	19.1	-0.1
Transportation & storage	9.5	9.3	-0.7
Accommodation & food service	12.9	13.0	0.2
Information & communication	3.1	3.2	1.0
Financial & insurance activities	1.5	1.4	-2.3
Real estate activities	2.3	2.3	0.6
Professional, scientific & technical	29.4	30.7	1.4
Administrative & support service	12.7	13.1	1.0
Public administration	7.4	7.0	-1.6
Education	10.4	10.3	-0.2
Human health & social work	27.7	27.4	-0.3
Arts, entertainment & recreation	3.3	3.4	0.4
Other service activities	3.2	3.2	-0.6
Total	**183.8**	**183.2**	**-0.1**

Source: EY ITEM Club

Dundee

Employment in Dundee grew by 1.0% in 2017, equivalent to an additional 800 jobs. Its GVA is estimated to have increased by 1.5% in 2018, surpassing Scotland (1.4%) but lagging the UK outturn (2.0%).

The Annual Population Survey reports the unemployment rate in Dundee rose by 0.8 percentage points between the year to June 2017 and the year to June 2018. However, more recent claimant count data suggest the city's unemployment fell slightly in Q3 2018.

Employment is forecast to decline by 0.6% in 2018, resulting in 500 fewer jobs in the city next year. Over the period to 2021, job growth is projected at 0.3% per year, on average, with limited employment change among sectors. Job losses in the human health & social work, and manufacturing sectors will be offset by rising private services employment.

Dundee's GVA is forecast to grow by 1.6% in 2018, and by an average of 1.3% per year over the period to 2021, aligning with our expectations for the Scottish economy as a whole.

Employment change by sector

Sector	Total employment		
	2018 (000s)	2021 (000s)	Annual % growth 2018-2021
Utilities, extraction & agriculture	0.8	0.8	-0.8
Manufacturing	4.9	4.7	-1.3
Construction	3.9	4.2	2.4
Wholesale & retail trade	12.0	12.0	0.1
Transportation & storage	2.1	2.0	-0.3
Accommodation & food service	7.2	7.3	0.5
Information & communication	3.8	3.9	1.0
Financial & insurance activities	1.0	0.9	-2.2
Real estate activities	1.3	1.4	1.2
Professional, scientific & technical	4.1	4.3	1.7
Administrative & support service	3.6	3.8	1.8
Public administration	5.7	5.8	0.5
Education	9.0	9.0	0.1
Human health & social work	17.9	17.7	-0.4
Arts, entertainment & recreation	1.9	1.9	0.7
Other service activities	2.5	2.5	-0.3
Total	**81.6**	**82.3**	**0.3**

Source: EY ITEM Club

Perth and Kinross

Perth and Kinross experienced minimal employment growth of 0.1% in 2017, arresting a trend of declines in the previous two years. Gains in agriculture and manufacturing were largely offset by losses in a collection of consumer sectors. Its GVA is estimated to have increased by 1.3%, slightly trailing Scotland (1.4%) and falling well below the UK as a whole (2.0%).

The Annual Population Survey shows the unemployment rate in Perth and Kinross fell by 0.7 percentage points between the year to June 2017 and the year to June 2018. The claimant count measure indicates unemployment rose again in Q3 2018, knocking off some of the gains made in the year prior.

The city's employment level will see a large contraction this year, with 2,600 fewer jobs in 2018. Contractions will continue over the next three years, with sustained losses in a number of sectors resulting in 500 fewer jobs in the city by 2021; equivalent to an annual average fall of 0.2%.

GVA is expected to remain flat in 2018 and 2019, with a pick-up thereafter resulting in average GVA growth of 0.7% per year to 2021, trailing behind our forecast for the UK as a whole. Perth and Kinross will suffer from a contraction in its public administration & defence sector.

Employment change by sector

Sector	Total employment		
	2018 (000s)	2021 (000s)	Annual % growth 2018-2021
Utilities, extraction & agriculture	7.6	7.5	-0.6
Manufacturing	4.1	3.9	-1.5
Construction	5.8	5.9	0.6
Wholesale & retail trade	10.2	10.2	-0.1
Transportation & storage	2.6	2.5	-0.2
Accommodation & food service	7.4	7.4	0.2
Information & communication	0.7	0.7	1.0
Financial & insurance activities	1.6	1.5	-2.3
Real estate activities	1.2	1.2	-0.3
Professional, scientific & technical	4.1	4.1	0.2
Administrative & support service	4.6	4.6	-0.1
Public administration	3.7	3.6	-1.6
Education	5.2	5.2	0.1
Human health & social work	8.7	8.6	-0.3
Arts, entertainment & recreation	2.4	2.4	0.7
Other service activities	2.1	2.1	-0.5
Total	**72.0**	**71.5**	**-0.2**

Source: EY ITEM Club

Stirling

Total employment in Stirling grew by an impressive 3.4% in 2017, making it the fastest-growing Scottish city in our focus. This is equivalent to an additional 1,800 jobs, with the construction and financial & insurance activities sectors responsible for almost two-thirds of these extra jobs. GVA increased by an estimated 2.7% in 2017, significantly outpacing both Scotland and the UK as a whole.

The Annual Population Survey shows unemployment fell by 1.7 percentage points to 2.5% between the year to June 2017 and the year to June 2018, bringing Stirling in line with Edinburgh as the cities with the lowest unemployment rate in our focus. However, the more up-to-date claimant count measure suggests Stirling's unemployment rose slightly in Q3 2018.

Over the period to 2021, we forecast the city's rate of job creation will slow, averaging 0.4% per year.

We forecast GVA growth of 2.6% for Stirling in 2018, boosted by its resilient consumer sectors. Over the next three years, we expect the city's GVA to increase on average by 1.4% per year. This rate of growth will marginally surpass our forecast for Scotland, but fall short of the UK average.

Employment change by sector

Sector	Total employment		
	2018 (000s)	2021 (000s)	Annual % growth 2018-2021
Utilities, extraction & agriculture	1.6	1.6	-0.6
Manufacturing	2.8	2.7	-1.0
Construction	4.2	4.4	2.2
Wholesale & retail trade	8.3	8.4	0.4
Transportation & storage	1.5	1.4	-0.2
Accommodation & food service	5.1	5.3	0.8
Information & communication	1.9	2.0	1.1
Financial & insurance activities	3.7	3.5	-2.2
Real estate activities	0.9	0.9	1.0
Professional, scientific & technical	3.2	3.4	1.8
Administrative & support service	4.4	4.6	1.6
Public administration	2.3	2.2	-1.5
Education	4.9	5.0	0.3
Human health & social work	5.1	5.1	-0.3
Arts, entertainment & recreation	2.0	2.0	1.0
Other service activities	1.4	1.4	-0.2
Total	**53.4**	**54.0**	**0.4**

Source: EY ITEM Club

Inverness

Employment in Inverness fell by 2.0% in 2017, equivalent to 1,000 fewer jobs. This contributed to negative GVA growth of an estimated -1.9%, the largest economic contraction among the cities covered in this analysis. Substantial losses in the business services sector are likely to have impacted most heavily on the city's GVA growth last year.

While claimant count data unsurprisingly show Inverness's unemployment rose over the year to July 2018, it has fallen slightly throughout the third quarter of 2018.

We forecast that the city's employment will continue to fall in 2018 and 2019, by 1.7% and 0.2% respectively, shedding 900 further jobs in the process. Over the period to 2021, employment is forecast to fall by an average of 0.1% per year, with additions in the construction and business services sectors failing to offset job losses across the utilities, extraction & agriculture, manufacturing and public sectors.

While the labour market will contract, we expect to see GVA growth rising to 0.9% in 2018, with the consumer sectors driving this growth. Annual average growth is then forecast to pick up slightly over the period 2018–2021, averaging 1.0% per year, but still below the overall Scottish rate.

Employment change by sector

Sector	Total employment		
	2018 (000s)	2021 (000s)	Annual % growth 2018-2021
Utilities, extraction & agriculture	1.4	1.4	-0.8
Manufacturing	1.7	1.6	-1.2
Construction	3.1	3.3	1.7
Wholesale & retail trade	8.0	8.0	0.0
Transportation & storage	3.1	3.0	-0.4
Accommodation & food service	3.5	3.5	0.3
Information & communication	1.3	1.4	1.0
Financial & insurance activities	0.6	0.6	-2.2
Real estate activities	0.5	0.5	0.2
Professional, scientific & technical	2.9	3.0	0.7
Administrative & support service	2.0	2.1	0.8
Public administration	2.7	2.6	-1.5
Education	1.8	1.8	0.0
Human health & social work	13.5	13.3	-0.4
Arts, entertainment & recreation	1.1	1.1	0.5
Other service activities	1.0	1.0	-0.5
Total	**48.3**	**48.2**	**-0.1**

Source: EY ITEM Club

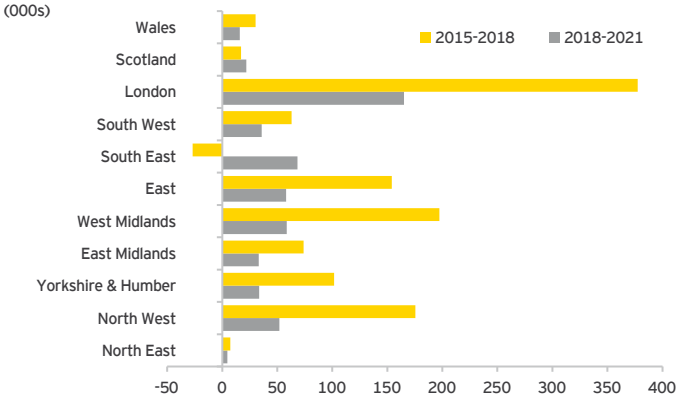
GVA forecasts (%)

City	2018	2019	2018-2021
Inverness	0.9	0.6	1.0
Aberdeen	0.0	1.1	1.1
Glasgow	2.6	2.0	2.0
Edinburgh	2.1	1.3	1.6
Belfast	1.1	1.4	1.7
Newcastle	1.9	1.0	1.4
Leeds	2.2	1.8	1.8
Hull	2.0	1.2	1.2
Liverpool	1.1	1.3	1.5
Manchester	2.1	2.0	2.2
Birmingham	1.5	2.0	2.0
Stoke on Trent	1.3	1.5	1.4
Cambridge	1.2	1.1	1.5
Luton	1.3	1.3	1.8
Exeter	0.7	1.3	1.8
Bristol	2.4	2.0	2.0
Reading	1.9	2.0	2.3
Southampton	1.7	1.3	1.6
Dundee	1.6	1.1	1.3
Stirling	2.6	1.2	1.4
Perth & Kinross	0.0	0.0	0.7
South Coast	1.1	1.3	1.6
Thames Valley	1.0	1.6	1.9
Scotland	**1.6**	**1.0**	**1.3**

Source: EY ITEM Club

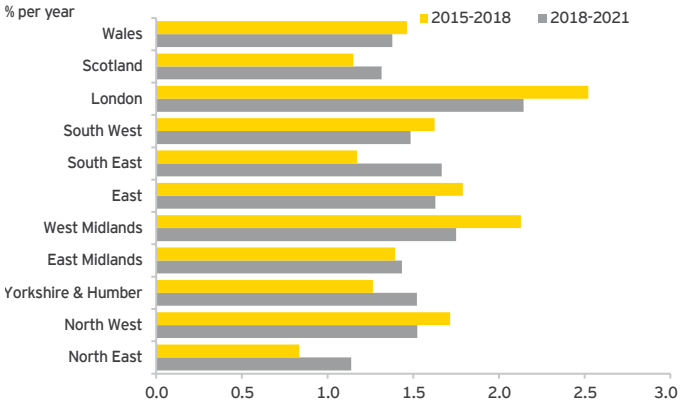
Cities and regions: Scotland compared to the rest of the UK

Employment change, 2015-2018 and 2018-2021



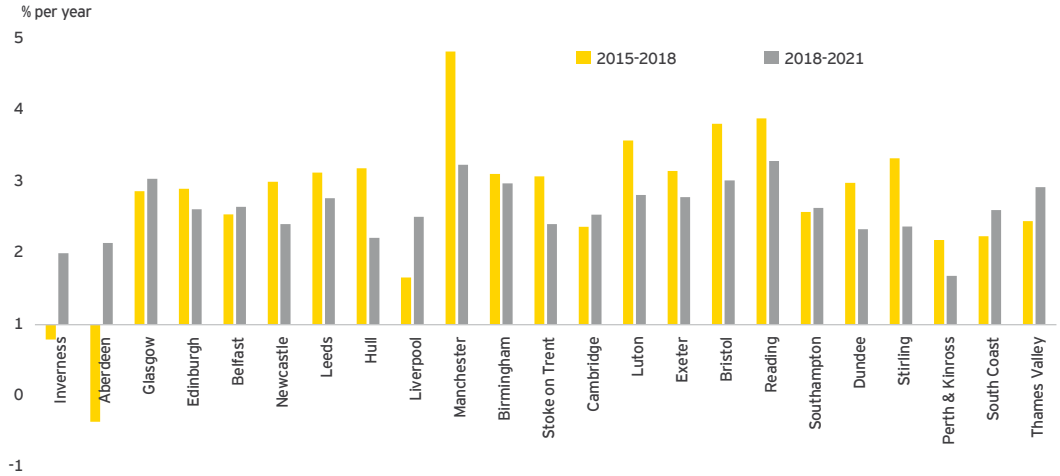
Source : EY ITEM Club

Annual average GVA growth, 2015-18 and 2018-2021



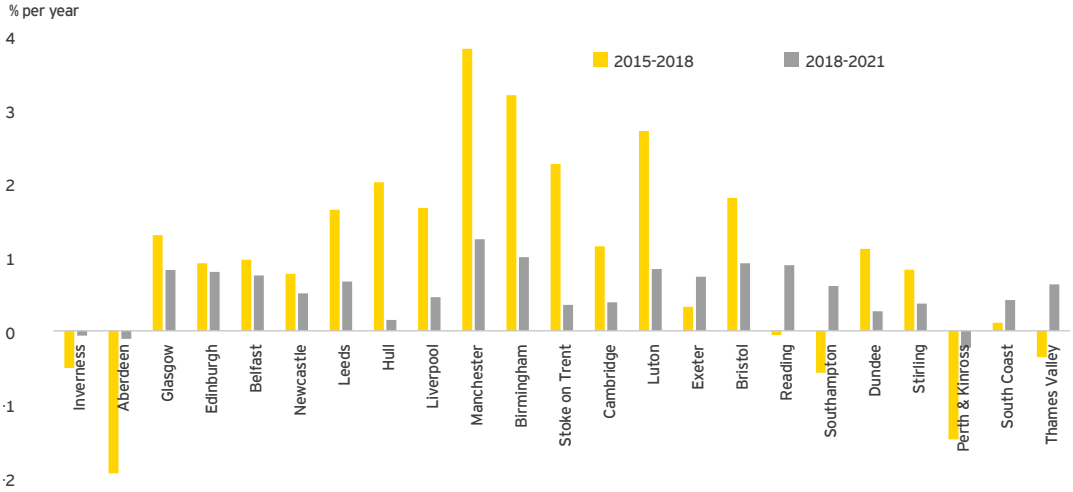
Source : EY ITEM Club

City GVA growth, 2015-2018 and 2018-2021



Source : EY ITEM Club

City employment growth, 2015-2018 and 2018-2021



Source : EY ITEM Club

Risks and uncertainties

The outlook for Scotland and the global economy is more uncertain than it has been for some time, with the balance of risks weighed slightly on the downside.

Brexit continues to be the main source of uncertainty affecting the Scottish economy. At the time of writing, the UK government and the EU have agreed a draft Brexit deal – but the Prime Minister must still secure parliamentary approval. Given the political upheaval in the hours and days following the announcement of a draft deal, the risk of a disorderly Brexit cannot be ruled out.

A 'no deal' scenario would have significant implications for the Scottish economy. We would expect sterling to fall considerably, pushing up prices for businesses and consumers alike. Tariffs and non-tariff barriers would adversely affect Scottish businesses exporting to the EU. While Government expenditure would likely rise in response to the slowdown, it would not be enough to offset the contraction in business investment and net trade, along with a marked slowdown in consumer spending growth.

There is also a downside risk of market turmoil stemming from an acceleration in the pace of US monetary tightening. Under this scenario, the sell-off of equity and bonds would hit global growth and restrict demand for Scottish exports.

On the positive side, a reversal in the trade conflict between the US and China would boost Scottish growth. In such a scenario, financial market sentiment could improve and the dollar could weaken. Consequently, the global economy could strengthen and boost world trade, with Scottish exporters likely benefiting from the additional demand created.

Annex: Scotland's fiscal position

The latest UK Budget centred on the announcement of fiscal loosening, including the sizeable increase in health spending mentioned earlier in the year. In net terms, these revisions amounted to £15bn in 2019–20, rising to £30.6bn by 2023–24. Further 'giveaways' were hinted at, based on the successful negotiation of a Brexit deal. The budget also included specific investments for Scotland, including an extra £950mn for the Scottish Government over the next three years, and £150mn towards the Tay Cities Deal.

Last year's budget included progressive changes to income tax rates; however, with the recent upward revision to the UK tax thresholds coming one year earlier than expected, the difference between tax paid in Scotland and the UK at certain wages will likely increase as workers in the rest of the UK pay less than before. The overall net effect of the respective income tax changes should be set out in the Draft Budget for Scotland on December 12, 2018.

In estimating Scotland's fiscal position, we continue to assume that the £450m annual borrowing allowance from the UK Government is fully utilised, with the full amount directed into infrastructure spending.

The first two tables, below, show our ITEM forecasts for the net fiscal balance, and its components, for both Scotland and the UK, while the third table splits out Scotland's total public revenue. Net fiscal balance (also known as public sector net borrowing) is the difference between total public revenues and total public spending. The 2015–16 to 2017–18 data is consistent with the Government Expenditure and Revenue Scotland data.

Net fiscal balance, Scotland, 2015-16 – 2021-22 £bn

Scotland	Published			ITEM forecasts			
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
Public sector current receipts (£bn)	54.0	56.9	59.0	60.1	62.0	63.6	65.6
Public sector current receipts (%y/y)	-0.6	5.3	3.7	1.8	3.2	2.6	3.1
Total managed expenditure (£bn)	69.5	71.4	73.4	75.4	77.4	79.3	81.1
Total managed expenditure (%y/y)	1.2	2.7	2.9	2.8	2.7	2.4	2.3
Public sector net borrowing (£bn)	-15.5	-14.5	-14.4	-15.4	-15.4	-15.7	-15.5
Public sector net borrowing (% of GDP)	-10.2	-9.2	-8.8	-9.1	-8.8	-8.7	-8.3

Net fiscal balance, UK, 2015-16 – 2021-22, £bn

UK	Published			ITEM forecasts			
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
Public sector current receipts (£bn)	684.3	726.4	754.0	775.4	790.8	818.1	841.4
Public sector current receipts (%y/y)	3.7	6.2	3.8	2.8	2.0	3.4	2.9
Total managed expenditure (£bn)	756.8	772.0	793.8	815.7	837.4	857.5	877.1
Total managed expenditure (%y/y)	0.8	2.0	2.8	2.8	2.7	2.4	2.3
Public sector net borrowing (£bn)	-77.0	-50.8	-50.2	-43.0	-48.0	-41.2	-37.3
Public sector net borrowing (% of GDP)	-4.1	-2.6	-2.5	-2.0	-2.2	-1.8	-1.6

Public sector current receipts, Scotland, 2015-16 – 2021-22, £bn

Scotland's Public sector current receipts (£bn)	Published			ITEM forecasts			
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
Income tax	12.0	12.3	12.5	12.8	13.4	13.8	14.4
National insurance contributions	9.1	10.0	10.6	10.7	11.1	11.5	12.0
Value added tax	9.7	9.9	10.1	10.4	10.7	10.9	11.2
Onshore Corporation tax	3.1	3.7	3.9	3.9	3.9	3.9	4.0
Fuel duties	2.3	2.4	2.4	2.4	2.5	2.5	2.6
Non-domestic rates	2.6	2.7	2.8	2.9	2.9	2.9	3.0
Council tax	2.0	2.1	2.3	2.4	2.4	2.5	2.6
Capital gains tax	0.4	0.4	0.3	0.4	0.4	0.4	0.4
Inheritance tax	0.3	0.3	0.3	0.3	0.3	0.3	0.4
Reserved stamp duties	0.3	0.3	0.3	0.3	0.3	0.3	0.4
Tobacco duties	1.0	1.0	1.0	1.0	1.0	0.9	0.9
Alcohol duties	1.0	1.1	1.1	1.1	1.2	1.2	1.2
Vehicle excise duties	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Other taxes	9.7	10.2	10.8	11.0	11.4	11.7	12.0
Public sector current receipts	54.0	56.9	59.0	60.1	62.0	63.6	65.6
Growth		5.3%	3.7%	1.8%	3.2%	2.6%	3.1%

Forecast tables

Economic & demographic indicators

	2017	2018	2019	2020	2021	2022
Population (000s)	5425	5447	5457	5465	5472	5478
(% pa)	0.4	0.4	0.2	0.1	0.1	0.1
Migration[10]	4.4	4.2	1.9	1.5	1.2	1.1
Employment rate[11] %)	59	59	59	59	59	59
Unemployment rate[12]	2.3	2.6	2.6	2.6	2.7	2.7
Personal disposable income (% pa)	0.2	-1.0	0.9	1.5	1.7	1.7
Per capita (UK=100)	94	93	93	93	93	93
Consumers' expenditure (% pa)	1.1	0.5	1.0	1.3	1.4	1.7
Per capita (UK=100)	97	96	95	95	95	95
Self-employed (000s)	300	269	271	271	272	273
(% pa)	9	-11	1	0	0	0
Employment						
Total employment[13] (000s)	2809	2765	2773	2780	2787	2795
(% pa)	2	-2	0	0	0	0
Manufacturing (000s)	194	184	183	180	177	175
Location quotient[14]	90	87	87	87	88	88
Private serv. (000s)	1333	1311	1319	1329	1337	1345
Location quotient	90	90	90	90	90	90
Government serv. (000s)	795	803	799	798	797	798
Location quotient	113	116	116	116	116	116

10 Per 1,000 of the population of working age.
11 Labour force as a percentage of the 16+ population.
12 Claimant count basis.
13 Employees plus the self-employed, Government Supported Trainees and HMF Forces
14 Sector's share of total regional employment divided by the sector's share in total UK.

Sectoral outlook: total employment

	2017	2018	2019	2020	2021	2022
Agriculture, forestry & fishing	71	62	62	61	61	60
Mining & quarrying	35	35	35	34	33	32
Manufacturing	194	184	183	180	177	175
Food, beverages & tobacco	44	42	42	42	41	41
Textiles, clothing & leather products	10	10	9	9	9	9
Refined petroleum, chemical & pharmaceutical products	11	10	10	10	10	10
Metals, metal products & machinery n.e.c.	37	37	36	36	35	34
Other manufacturing industries including repair	63	60	59	58	57	56
Electrical and instrument engineering	14	13	13	13	13	13
Transport equipment	14	13	13	13	12	12
Electricity & gas supply	18	17	17	17	17	17
Water supply & waste management	19	19	19	19	19	18
Construction	183	180	185	188	190	192
Retail & wholesale	380	373	375	376	376	377
Transportation and storage	135	130	129	129	129	129
Accommodation & food services	205	198	199	200	202	203
Information and communication	80	82	83	84	85	86
Financial & insurance	88	86	85	84	83	83
Real estate	36	38	38	38	39	39
Professional, scientific and technical activities	203	203	207	210	213	215
Administrative and support service activities	206	201	204	207	210	213
Public administration & defence	167	168	166	164	162	160
Education	206	209	209	210	211	212
Human health & social work	422	426	424	424	424	426
Other service activities	162	154	155	155	156	157
Total employment	**2809**	**2765**	**2773**	**2780**	**2787**	**2795**

Sectoral outlook: GVA

	2017	2018	2019	2020	2021	2022
Agriculture, forestry & fishing	4.6	-1.7	-0.6	-0.3	-0.1	0.3
Mining & quarrying	6.2	0.6	1.1	-0.9	-1.0	-0.8
Manufacturing	1.6	4.0	0.3	0.6	0.8	1.0
Food, beverages & tobacco	-0.8	7.6	0.8	1.1	1.3	1.5
Textiles, clothing & leather products	-3.5	0.8	0.2	0.5	0.7	0.9
Refined petroleum, chemical & pharmaceutical products	7.1	0.0	0.2	0.5	0.6	0.9
Metals, metal products & machinery n.e.c.	1.7	5.9	-0.1	0.2	0.4	0.6
Other manufacturing industries including repair	3.2	2.7	0.1	0.4	0.6	0.8
Electrical and instrument engineering	-2.4	1.4	-0.2	0.1	0.3	0.5
Transport equipment	3.5	1.9	0.3	0.5	0.9	1.2
Electricity & gas supply	2.5	2.3	-0.4	1.2	1.2	1.5
Water supply & waste management	-1.6	2.4	1.3	1.0	1.2	1.5
Construction	4.4	-0.1	3.0	1.6	1.1	1.3
Retail & wholesale	1.6	2.3	1.6	1.1	1.0	1.3
Transportation and storage	1.4	3.6	0.3	0.7	0.9	1.1
Accommodation & food services	0.2	3.9	1.4	1.4	1.6	1.6
Information and communication	3.1	2.0	2.5	2.8	3.0	2.7
Financial & insurance	-0.9	2.0	0.6	0.5	0.8	1.8
Real estate	1.3	0.7	1.2	1.8	1.9	2.0
Professional, scientific and technical activities	-0.2	0.4	2.7	2.9	2.9	2.9
Administrative and support service activities	1.5	4.0	1.6	2.6	2.4	2.7
Public administration & defence	-0.2	-0.3	-1.0	-0.8	-0.7	-0.6
Education	1.2	-0.2	0.3	0.7	0.6	0.6
Human health & social work	1.7	1.0	0.7	1.1	1.4	1.6
Other service activities	1.1	1.2	0.1	0.2	0.6	0.9
Total GVA	**1.4**	**1.6**	**1.0**	**1.4**	**1.5**	**1.7**

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