SCOTTISH TRENDS

(Press Release - 12th October 2016)

Analysis of latest Quarterly Scottish GDP (2016 Q2) statistics, including detailed look at the Services sector

Key points

- Latest data reveals **growth in the Scottish economy in the Second Quarter (Q2) of 2016 of 0.4%, but only 0.7% growth over the last year** (Q2 on Q2). This compares poorly with UK growth over the same periods, of 0.7% and 2.2% respectively.
- The **underlying health of the Scottish economy is notably poorer than for the UK** as a whole, largely **due to the on-going underperformance of the Service sector**. This dominant sector has grown at just above half the rate seen in the UK over the last two years and **Transport & Communications** have seen next to no growth compared to the 10% growth at the UK level.
- During 2014 and early 2015 this weakness had been largely disguised by rapid, but temporary, growth in **Construction**.
- Scotland's immediate economic prospects remain poor, with **GDP growth likely to be around or under 1% in 2016**.
- The **Governor of the Bank of England believes Scotland has been making progress** on the last two years, including in Services, **but the data appears to contradict him**.
- If a similar situation were to emerge **at the UK level, it seems highly likely that greater policy intervention would be forthcoming**.
- Upcoming **policy and budgetary decisions** by the Bank of England and by both the Scottish and UK Governments **need to take into account the current precarious position**.
- Scotland's poor **GDP performance has been at odds with the labour market** position, which could mean that there are data mis-measurement issues to be resolved.
- Even countries like **Japan** are **experiencing GDP measurement problems** with alternative measures delivering very different outcomes. The accuracy of Scottish data may also benefit from introducing alternative growth measures.

(Note: As North Sea related activity is allocated to the UK as a whole, and not on a regional basis, the UK measure shown throughout this analysis excludes it in order to make overall GDP growth more comparable with the Scottish figure. Hence both effectively refer to 'onshore' GDP growth.)

The remainder of this analysis looks at the following:

- an overview and commentary on the latest data (page 2);
- a more detailed look at the Scottish Services sector (page 4 and Annex 1);
- prospects for the second half of 2016 (page 6);
- data reliability and interpretation issues relating to Scottish GDP statistics (page 7).

Overview - latest data (see also Table 1)

Latest quarter (change Q2 2016 on Q1 2016)

- Scottish GDP grew by 0.4% in the second quarter, mainly due to a spurt in Business Services. However, Q1 has now been revised to negative growth (-0.1%).

Latest year (change Q2 2016 on Q2 2015)

- Scottish GDP grew by 0.7% over a year ago, due to growth in Financial Services, Retail and Hospitality. However, the boom in Construction has ended and outputs now contracting.

Latest 2 years (change Q2 2016 on Q2 2014)

- Scottish GDP has grown by only 3% over the past 2 years, much slower than the comparable UK figure (4.8%). Most of this is down to slower growth in Services.

Main Revisions

- The latest figures include a number of revisions, due to the availability of more data. In particular, Construction output has been revised up for 2015.

Commentary

The closure of Longannet Power Station at the end of March is thought to have had a negative impact on GDP in Q2 equivalent to around -0.2% taken off overall growth. This compares with an earlier estimate of up to -0.4% by the Fraser of Allander Institute (FAI).

In comparison to the GDP performance in Q2, other Scottish economic indicators showed:

- **Employment** rose by over 50,000 in the quarter to June 2016, almost offsetting the fall seen in the quarter to March 2016;
- The ONS measure of Scottish **Construction** output rose by 3% in Q2, partly offsetting the fall of 7.5% seen in Q1;
- **Survey results** (e.g. the Bank of Scotland PMI, the RBS (Scottish) Business Monitor and the Scottish Chambers of Commerce Quarterly Business Survey**)** continue to be mixed , though generally poorer in Scotland than for the UK as a whole;
- **North Sea** output has been rising, due to past investment, but job cuts continue to be made.

Overall Scottish economic growth continues to disappoint.

Post its recession related slump in 2009, **Manufacturing** output peaked in 2014 and has fallen since by a cumulative 5%.

The boom in the **Construction** sector has ended and is now having a dampening effect on growth as it reverts to more normal levels. This effect may well continue to contribute negative growth for some time to come.

Services are growing but only slowly and at well below the rate seen for the UK (see next section).

Table 1: Economic growth comparison: Scotland and the UK, % change

	% change on Q1 of 2016		% change on Q2 of 2015		% change on Q2 of 2014		
	Scotland	**UK**	**Scotland**	**UK**	**Scotland**	**UK**	**Diff**
GDP*	0.4	0.7	0.7	2.2	3.0	4.8	-1.8
Mining & Quarrying	0.3	2.8	*-0.2*	1.0	0.3	10.6	-10.3
Manufacturing	0.8	1.6	*-3.6*	1.0	-4.8	1.1	-5.9
Construction	*-1.9*	*-0.1*	*-4.5*	0.4	19.4	6.7	12.7
Services	0.5	0.6	2.0	2.7	2.9	5.4	-2.5
Of which:							
Private sector							
- Wholesale & Retail	0.3	1.0	3.1	5.0	4.6	9.9	-5.3
- Hotels & Restaurants	*-0.8*	1.7	3.6	5.1	5.5	9.2	-3.7
- Transport & Comm'ns	0.6	0.6	0.8	2.5	0.3	9.9	-9.6
- Financial Services	0.3	*-0.2*	11.5	2.1	8.4	3.8	4.6
- Business Services	3.6	1.9	0.3	4.6	3.1	9.5	-6.4
- Other Services	*-0.9*	0.8	*-1.3*	4.3	-0.5	5.1	-5.6
Public sector							
- Admin & Defence	*-0.4*	*-0.5*	*-0.1*	*-2.0*	-1.6	-4.3	2.7
- Education	*-0.5*	*-0.3*	0.0	0.6	0.4	1.5	-1.1
- Health & Social Work	0.5	0.6	1.0	3.3	2.3	4.8	-2.5
GDP* per capita	0.3	0.5	0.6	1.4	2.4	3.1	-0.7

Sources: Scottish Government GDP release (October 2016); ONS UK National Accounts
* Excluding extra regio (mainly North Sea related) activity.
Colour Code for end 3 columns: Red = negative; Green = over 5%; Blue = over 8%; Orange = UK very much (>5%) better than Scotland; Grey = Scotland very much better than the UK.

In terms of specific sub-sectors:

- **Mining & Quarrying** (which includes support activities for oil and gas extraction) has maintained its output level over the past 2 years, despite the slowdown in **North Sea** activity;
- **Transport & Communications** has seen next to no growth in Scotland over the past 2 years, continuing its long run (relative to the UK) underperformance;
- Scottish **Business services** has contributed relatively little in the past two years, in comparison to previous periods and to the UK;
- Scottish and UK **Public Services** show some contrasting fortunes, with the cuts to **Administration** over the past 2 years relatively smaller in Scotland but the growth in **Health** relatively bigger in the UK. It could be argued that the reverse would be more welcome.

Scottish Services Sector

The services sector accounts for around 75% of all economic activity in Scotland and so is crucial in terms of determining Scotland's growth rate. However, it is not an easy sector across which to measure output.

For example, on the private services side Financial Services are difficult to measure, in terms of value added and 'Real Estate' is a large sector because it is includes an imputed rental for all housing in Scotland, regardless of whether owned or rented. On the public services side there are obvious difficulties in accurately measuring the output in relation to most areas, including schools, hospitals, law and order and social work.

Nevertheless such problems apply across all countries so it is still an informative exercise to compare service sector growth between Scotland and the UK as a whole.

As **Table 1** and **Charts 1 to 5 (see Annex 1)** show that both private and public services output in Scotland have been under performing the UK. This finding applies - post devolution, post recession and in recent years.

<u>Over the longer term</u>, the **Transport & Communications** and **Public Services sectors** have performed particularly poorly, growing at around half the pace of the rest of the UK.

<u>Since the recession</u>, both **Retail & Hospitality** and **Business & Financial Services** can be added to the list.

<u>More recently</u>, the **Retail & Hospitality** sector has been the weakest, relative to the UK. However, Table 1 shows that over the two years to Q2 2016, **Transport & Communications** have contributed next to nothing to growth, while at the UK level they have grown by almost 10%. **Business Services** have also underperformed in comparison to the UK.

Concentrating on just two of these areas:

- the long term underperformance in **Transport & Communications** is worrying as these activities can be associated with higher productivity growth. Furthermore, this has been the fastest growing sector of the UK economy since 1998, so it is a concern when a sector with fast growth potential under performs, as it has in Scotland.
- the recent slowdown of growth in **Business services** is another worry due to the importance of this sector. It is the largest services sector (excluding the contrived retail estate sector), accounting for 10% of the economy and has contributed the most to Scottish economic growth since 1998. More recently it appears to be faltering. In contrast to Scotland this sector continues to power ahead in the rest of the UK.

In the longer term some of this slower growth can be put down to relative changes in population, with the UK's population rising by just over 5% more than Scotland's, over the period 1998 to 2015. However, in most cases, this still leaves a large growth gap.

More recently some of this may be put down to a slowing North Sea sector. If so then, relative to the past, it would appear to be Manufacturing and Business services that are being hit hardest.

Furthermore, the constitutional upheaval since 2014, in terms of the referendums on both Scottish independence and on Brexit, may have had some longer term negative impact on the economy.

However, the problems that are affecting the Scottish Services sector have been largely ignored both north and south of the border.

The Scottish Government has repeatedly stated that *"the foundations of the Scottish economy are strong"* (see for example comments made in August at the time of the last GERS being published). Given the importance of the Services sector to the economy as a whole, this statement seems complacent, or just wrong.

Furthermore, the Governor of the Bank of England, Mark Carney, on a visit to Scotland earlier this month, highlighted his view that the Scottish economy had strengthened in the two years since he last visited. He stated, *"The Scottish economy has continued to progress…You see it in the jobs figures…You see it in the services sector of the economy"*. While in one sense this statement is true, the Scottish economy has grown (although the employment rate is unchanged on two years ago), it belies a distinct underperformance relative to the UK economy, particularly with respect to the Services sector.

Such perceptions are important as they imply a lack of awareness over the true state of the economy with possible policy implications. If similar figures to those seen in Scotland were replicated at the UK level, it seems highly likely that greater demands for action would be forthcoming.

What might the **policy prescriptions** for the Bank of England and the Scottish and UK Governments be?

From the Bank of England side extreme distress in specific regions may warrant an acceleration of a further interest rate cut and investigation as to what other forms of new or enhanced monetary policy might be of assistance. Alternatively, it could call for more fiscal policy support from the government.

From the Scottish Government side, with todays GDP figures being the final set that will be issued before the Scottish Budget for 2017-18 is published in December, it is important that their import is fully taken on board. Ideally much more analysis would be undertaken to understand the depth of the problems, but this will not be possible in the time available. In the meantime extra borrowing may be merited in order to boost activity and improve productivity, through greater funding of infrastructure and other investment projects.

The UK Government may be less minded to adjust its Budget to take Scottish conditions into account but it should be open to the Scottish Government putting in place exceptional measures and increased borrowing, if requested.

Prospects for the second half of 2016

Scotland is currently facing very high levels of uncertainty with downside risks dominating any upside ones.

As a result, prospects for the second half of 2016 are not good and growth for 2016 as a whole is likely to be under 1%.

The main growth projection for 2016 as a whole (0.9%), shown in **Table 2,** is the same as projected by Fraser of Allander, (FoA) for 2016.

A devaluation related boost to Tourism and Exports are the main hope for a pick up in growth in the second half of the year.

Table 2: Quarter by quarter growth in the Scottish economy since 2014 Q1

Time period	GDP Level	Change on previous quarter or year		
Out-turns				
2014 Q1	101.4	0.5		
2014 Q2	102.3	0.9		
2014 Q3	103.0	0.7		
2014 Q4	103.8	0.8		
2014	102.6	**2.6**		
2015 Q1	104.6	0.8		
2015 Q2	104.6	0.0		
2015 Q3	104.7	0.1		
2015 Q4	105.1	0.4		
2015	104.8	**2.1**		
2016 Q1	105.0	-0.1		
2016 Q2	105.4	0.4		
Forecasts*		**average**	**low**	**high**
2016 Q3	*105.8*	*0.4*	*0*	*0.6*
2016 Q4	*106.2*	*0.4*	*0*	*0.6*
2016	*105.6*	***0.9***	***0.6***	***1.1***

Source: Scottish Government GDP release (October 2016) to 2016Q2.

* ‘Average’ equates to the average quarterly growth rate over the past 5 years. High and low growth rates are asymmetrical around the average due to downside risks dominating upside ones at present.

Issues over the reliability and interpretation of Scottish GDP data

Reliability of economic indicators

While the latest Scottish GDP figures look poor, its labour market performance seems more reassuring. Employment is up, although the employment rate is steady. This suggests that there may be some degree of mis-measurement in the Scottish data, with the GDP figures being the more likely culprit.

Such problems are not unusual when measuring GDP and not just in countries with particular measurement issues like China and Ireland. In response to accuracy worries revolving around declining response rates to official surveys, **Japan** recently calculated growth using an **alternative methodology based on tax returns**. As a result, instead of a worrying decline of 0.9% in the Japanese economy in 2014, the alternative methodology found there to be a respectable 2.4% of growth.

In the UK a VAT turnover methodology is being developed by the ONS to complement existing sources (mainly the Monthly Business Survey), with an eye to introducing it by the end of 2017. Were this to come about it should improve the reliability of Scottish estimates which would be based on a more comprehensive Scottish dataset.

Impact of North Sea activity

The North Sea saw a substantial rise in output in 2015, for the first time since 1999 and this has continued in the first half of 2016. How does this affect the data covering Scottish economy? The answer is not straightforward.

The **real terms** Scottish GDP data published today does not distribute North Sea output between regions, so there is a positive impact at the UK level but none registered at the Scottish level.

The **cash terms** national accounts data for Scottish GDP <u>does</u> include a geographic share of North Sea output, but, as the price of oil fell by more than its level of production rose in 2015, the North Sea made a negative contribution to Scottish growth last year.

There is no rationale why one published measure includes and the other excludes North Sea Oil in the Scottish data and the inconsistency in approach seems increasingly odd.

The above examples highlight the need to approach measuring and interpreting the performance of the Scottish economy with great care. Where possible crosschecks should be made and alternative measures, which best identify different aspects of the economy, used.

Quotes:

"*The Second Quarter of 2016 has turned out to be better than expected, given the extenuating circumstance of the negative impact of the closure of Longannet power station.*

Longer term, slow growth in Services, partly hidden in recent times by exceptional Construction sector growth, has been holding back the rate of Scottish economic growth for some time now.

If similar poor growth figures, especially in the Services sector, were being seen at the UK level it seems highly likely that the Bank of England and the UK Government would be more pro-active in terms of amending monetary and fiscal policy.

However, our understanding of the causes of this slow growth is limited, which restricts our ability to identify, and put in place, appropriate budgetary and regulatory measures to help."

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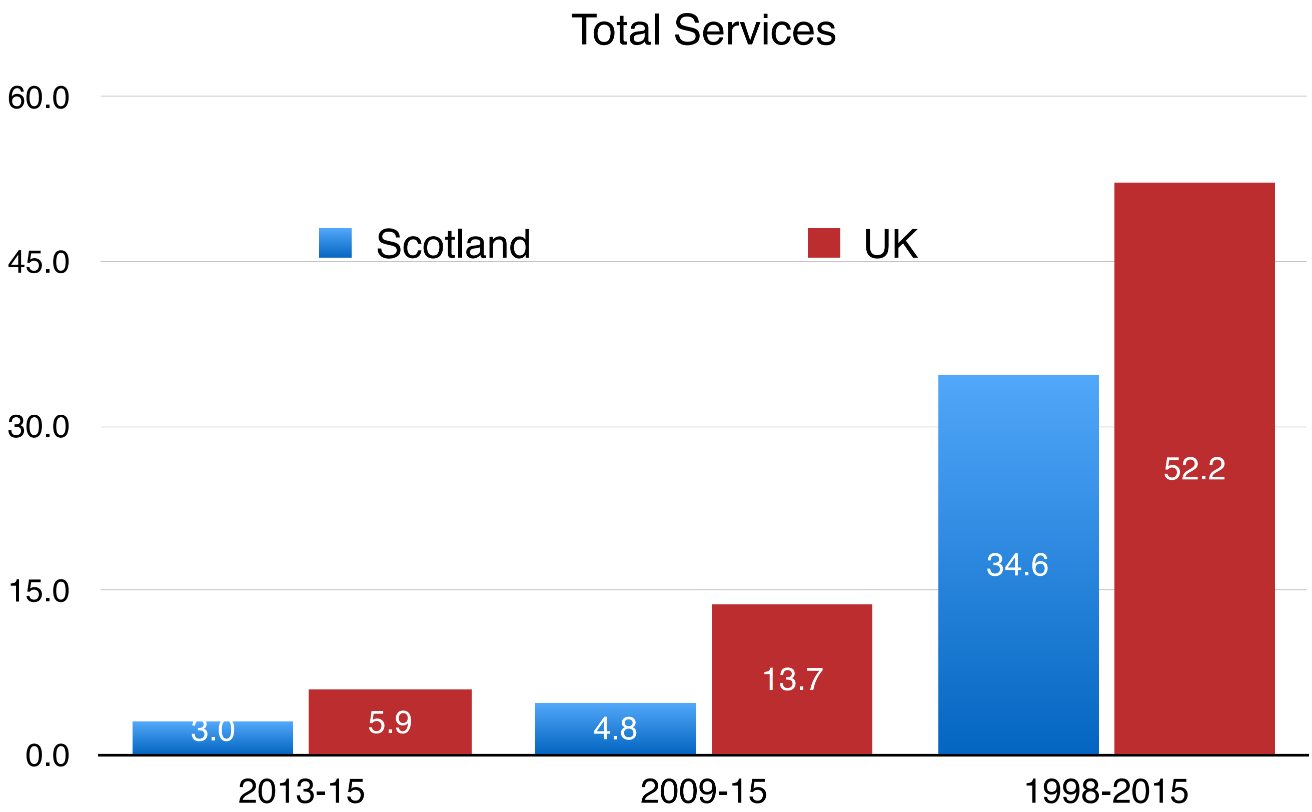
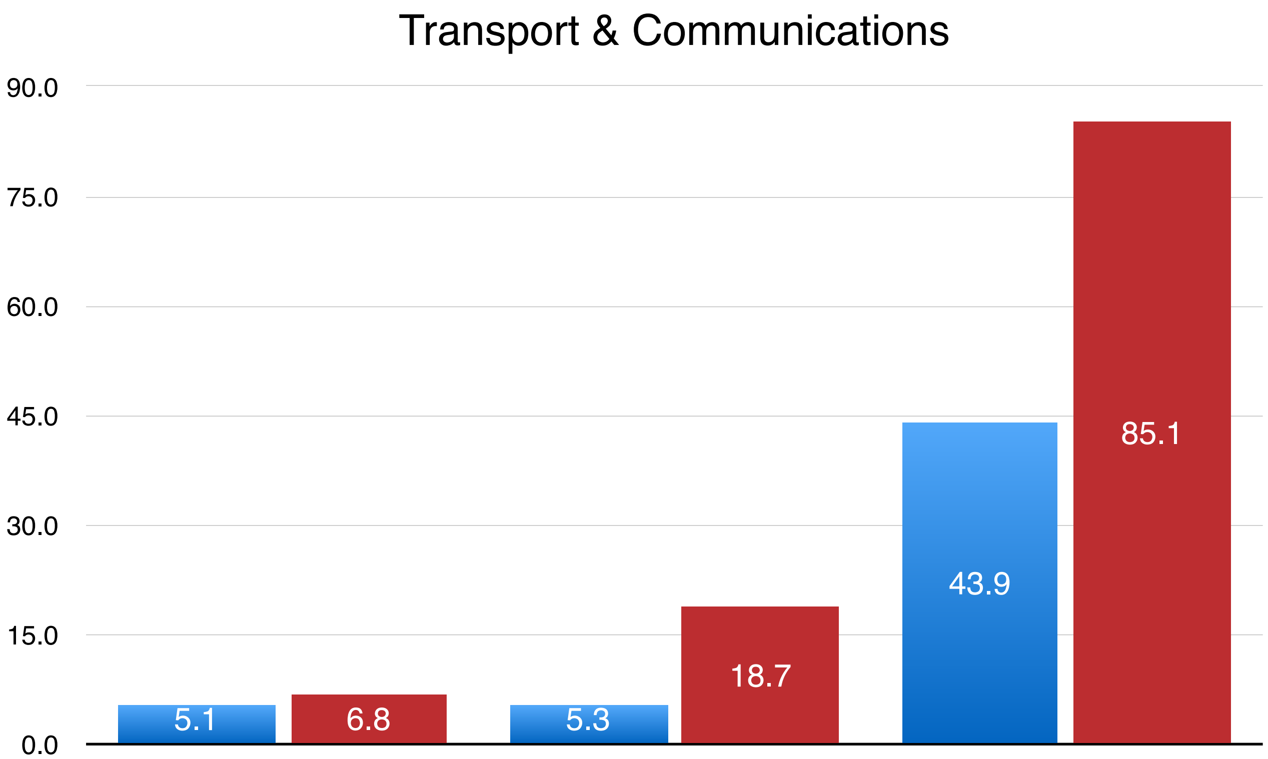
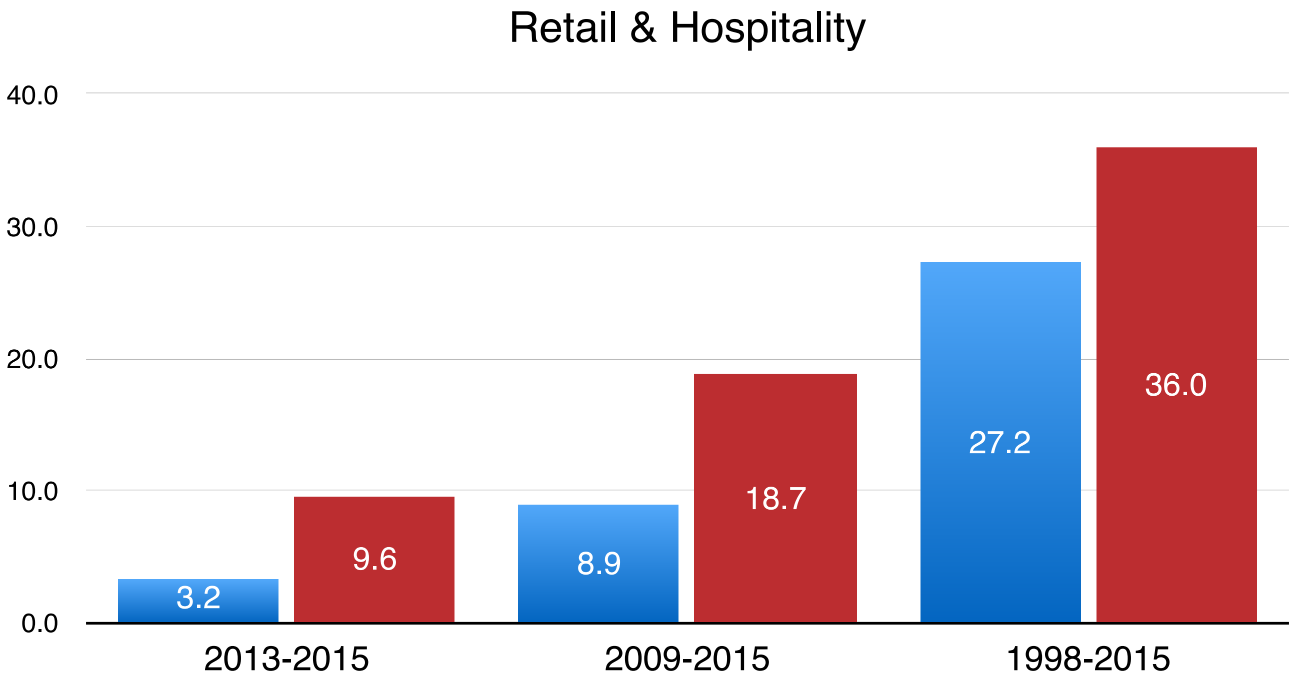
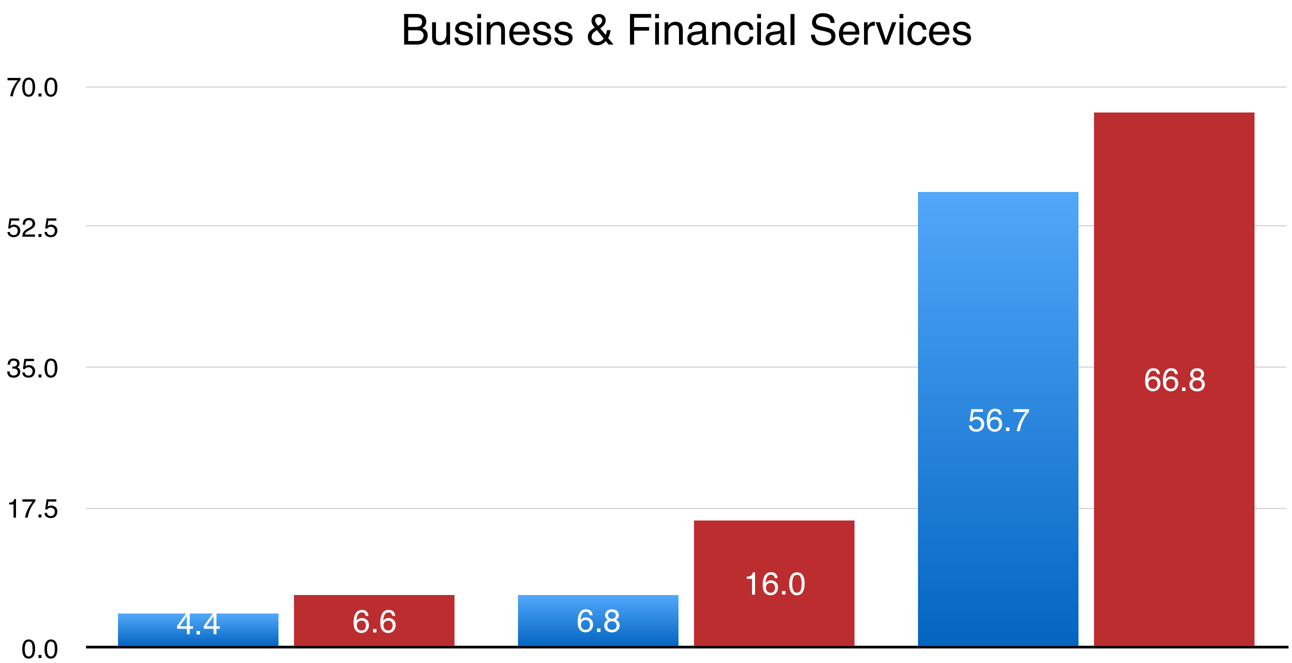
ANNEX 1

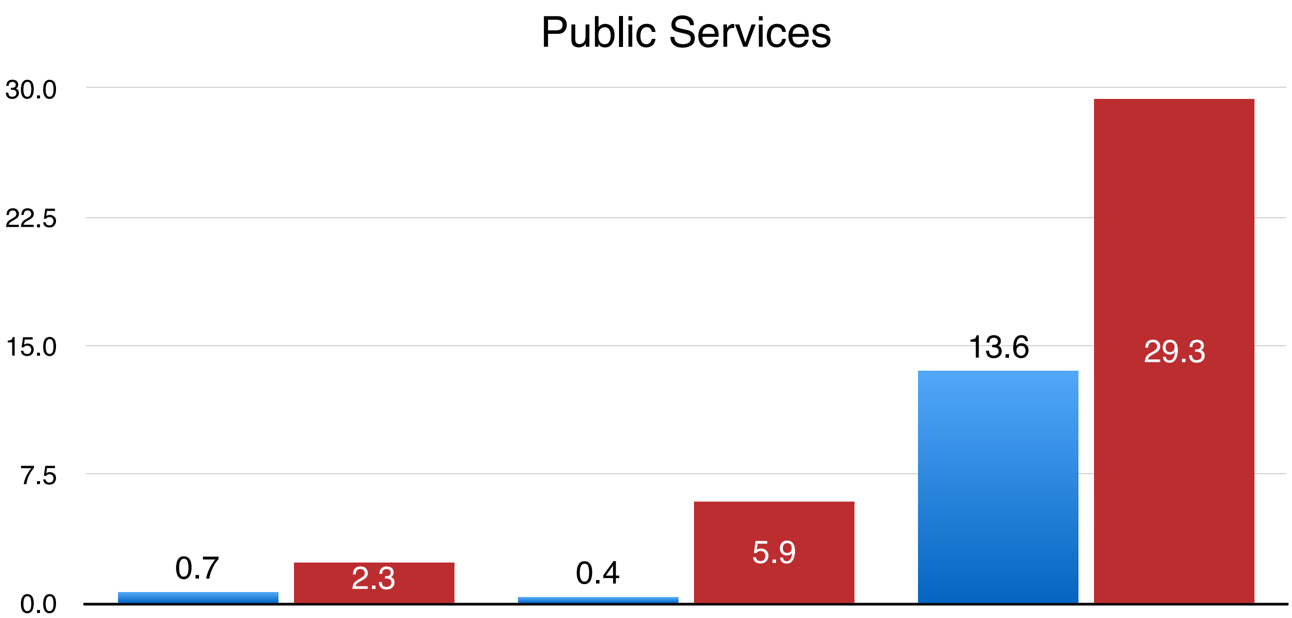
Charts 1 to 5: Scottish and UK Service sector growth, across sub-sectors and time
(Source: Scottish Government GDP release October 2016)






Retail & Hospitality
40.0
30.0
20.0
10.0
0.0
3.2
9.6
8.9
18.7
27.2
36.0
2013-2015
2009-2015
1998-2015


Business & Financial Services
70.0
52.5
35.0
17.5
0.0
4.4
6.6
6.8
16.0
56.7
66.8


Public Services
30.0
22.5
15.0
7.5
0.0
0.7
2.3
0.4
5.9
13.6
29.3