SCOTTISH TRENDS

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Getting to grips with the recent slowdown in the Scottish economy

Since the start of 2015 the (onshore) Scottish economy has barely grown, while that of the UK has continued to expand. As well as being highlighted for some time by Scottish Trends, this situation has also been discussed by other Scottish economic commentators. The EY Scottish Item Club describe the Scottish economy as being "*stuck in the slow lane*", while the latest Fraser of Allander Economic Commentary predicted that the Scottish economy "*will remain weak with little hope of a sharp increase in growth*" .

The purpose of this note is to investigate how robust this finding of a weak economy is and to better understand what may be the underlying cause(s) of it.

Key findings

- Between the 1st quarter of 2015 and 4th quarter of 2016 the Scottish economy only grew by 0.4 of a percentage point, while the UK economy grew by 3.5%.
- Looking in more detail at the reasons behind this we find that:
    - in **output** terms, this is down to a poorer performance by manufacturing and private sector services;
    - in **income** terms, this is down to slower growth in total wages, via a poorer employment performance, and in profits ;
    - in **expenditure** terms, this is down to a poorer trade performance.
- There has been less of a discrepancy in the growth of **household consumption** between Scotland and the UK, due to a fall in the Scottish **savings ratio** to a record low.
- At some point this running down of **household savings** will need to be reversed and the impact of the Scottish slowdown on household budgets will be seen more clearly.
- The **underlying causes** behind Scotland's poorer performance remain difficult to ascertain. The decline in offshore (North Sea) activity, with its knock on impact on onshore activities, will have had some impact. However, in employment terms, the lack of Scottish growth in private sector areas, like Retail and Admin support, are not so obviously related to onshore oil related business.
- If the weaker Scottish employment outcome is caused by improved **productivity** levels then, ultimately, this may end up being a good thing. However, if this is not the case then worries remain over where and how Scotland's performance will start to improve.
- One further reason behind the slowdown may be a perceived increase in **uncertainty and risk** associated with Scotland. This could be connected to the series of referenda in Scotland as well as the stated preference of most Scottish political parties for a higher tax regime than in the UK.
- With Scottish construction output and costumer sentiment falling, prospects for 2017 are poor.

Economic growth 2015Q1 to 2016Q4

Over the period 2015 Q1 to 2016 Q4 the onshore Scottish economy barely grew, in real terms (i.e. after adjusting for inflation), while the UK economy grew by well over 3%. (A similar differential can be seen when looking at this in cash terms, 3% vs 6%. (See Table 1.)) Even after adjusting for population change, to get closer to a change in the standard of living measure, most of this differential remains.

Charts 1 and 2 show the recent pattern of (cash terms) GDP growth for Scotland including and excluding the North Sea and between Scotland (onshore only) and the UK in (real terms) GDP per capita terms.

Chart 1: Scottish GDP: onshore only and total (i.e. onshore + offshore)

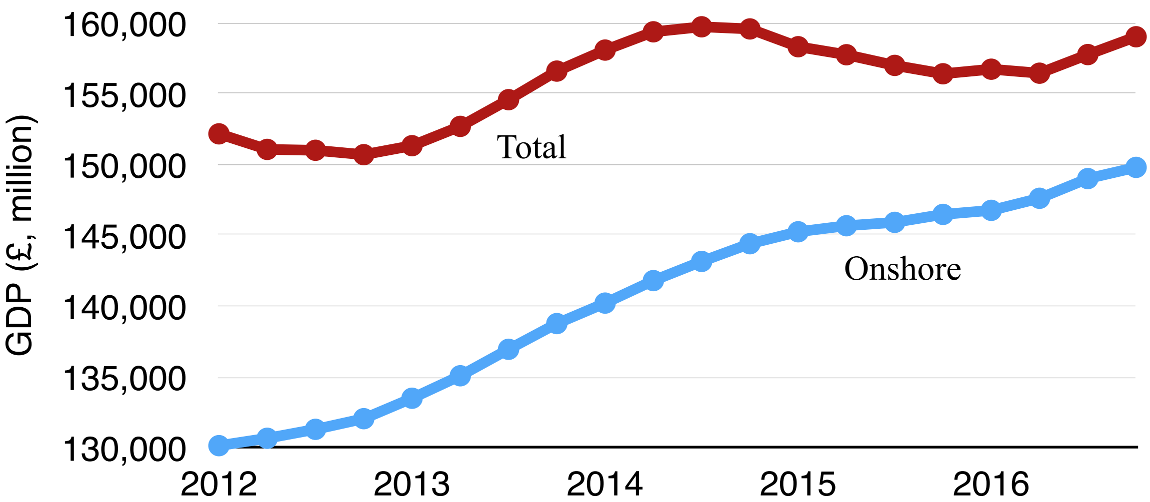
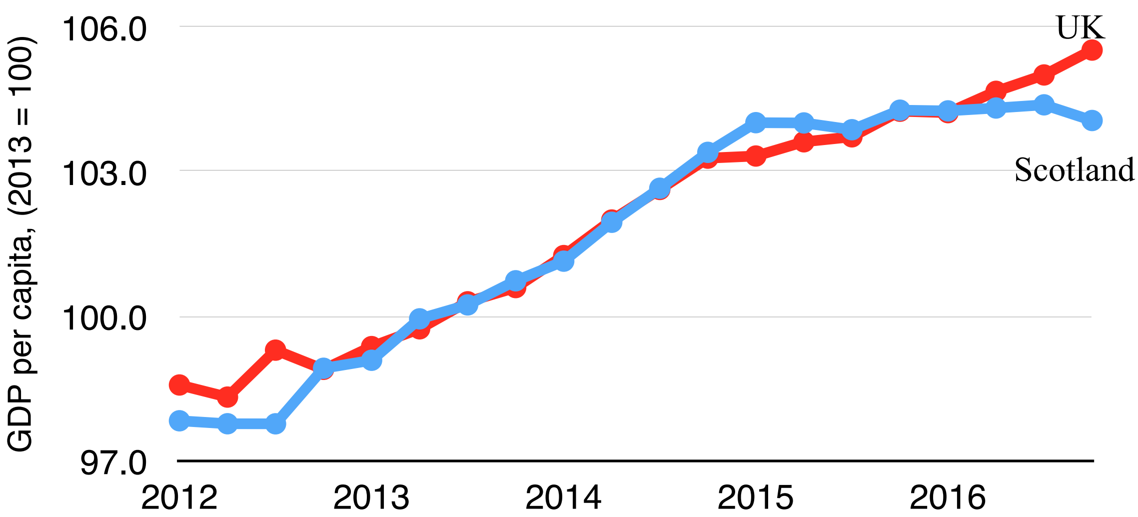


Chart 2: Scottish (onshore) and UK GDP per capita, 2012 Quarter 1 to 2016 Quarter 4



Sources: QNAS; Scottish GDP Quarterly Bulletin

Note that the comparative picture is far worse for total cash terms Scottish GDP than for onshore only, due to the impact of the big fall in the price of oil recently. Such a dramatic fall exaggerates the impact on the Scottish living standards (GDP per capita), as much of the North Sea operations are foreign owned (be it RoUK or RoW). Hence much of the loss in output and earnings from the North Sea is not felt directly in Scotland. However, even excluding the North Sea impact, living standards in Scotland have been at a standstill since 2015 Q1.

It has proved difficult to understand why and where this slowdown in growth has occurred. Recent analysis by Scottish government economists suggest about 60% of the slowdown between 2014 and 2016 was due to a fall in output in the oil and gas (onshore) supply chain, but this still leaves much to be explained.

In order to get a more detailed breakdown of where Scotland's under performance stems from, GDP can be disaggregated in 3 different ways. The Scottish Government publishes data on each of these in the Quarterly National Accounts for Scotland (QNAS), although only in cash terms and mainly for the onshore economy i.e. excluding the North Sea.

Table 1 disaggregates the overall GDP effect between the constituent components of the three different sources of GDP: by Output (e.g. manufacturing); by Income (e.g. wages); and by Expenditure (e.g. consumption), as well as looking at shifts in employment.

OUTPUT

While the slowdown is most prominent in the case of the Manufacturing sector, given the weights attached to each sector, then the impact of the slow growth in the services sector (which makes up 70% of output) is actually more important.

As past analysis has shown (see http://scottishtrends.co.uk/wp-content/uploads/2017/04/Scottish-GDP-April-17.pdf) this slowdown can be seen across a range of private sector services (with the exclusion of Financial services).

EXPENDITURE

A worsening Trade Balance has been the main driver of the relatively poor Scottish performance, principally through static Exports, while Imports have continued to rise. In contrast, the increase in UK Exports exceeded that seen in Imports. Within the worsening of the Scottish Trade balance it is trade with the RoUK that has been the problem, with Exports down 2% and Imports up nearly 7%.

Better news comes from growth in Gross Capital Formation (investment spending), which grew by 10% over the period (vs a fall at the UK level), although this sector is relatively small.

Household Consumers Expenditure under performed, but much less so than for GDP as a whole, i.e. the slowdown had less of an impact on household spending. This was made possible by the running down of savings, with the Scottish Savings Ratio now being at a record low.

INCOME

A smaller increase in the Compensation of Employees (wage related income) is the main source of weakness in terms of GDP (I), although the growth in Profits was also lower than for the UK.

Table 1: Disaggregated growth - Onshore Scotland & the UK, % change 2015 Q1 to 2016 Q4

GDP	Scotland	UK	Diff
GDP (Output) Real terms	0.4	3.5	-3.1
GDP (Output) Cash terms	3.0	6.0	-3.0
Population change (1)	0.9	1.3	-0.4
GDP (Output)	**Scotland**	**UK**	**Diff**
Manufacturing	-4.4	5.3	-9.7
Construction	4.7	7.5	-2.8
Services	3.9	7.1	-3.2
GDP (Income)	**Scotland**	**UK**	**Diff**
Compensation of Employees	2.7	6.4	-3.7
- Savings	*-57*	*-43*	*-14*
Gross Operating Profits	2.8	5.5	-2.7
GDP (Expenditure)	**Scotland**	**UK**	**Diff**
Household consumers expenditure	5.7	7.1	-1.4
- Savings Ratio	*-3.6*	*-2.8*	*-0.8*
Gross Capital Formation	10.0	-3.2	13.2
- Exports	*-0.2*	*12.2*	*-12.4*
- Imports	*5.4*	*8.2*	*-2.8*
Trade Balance (£,bn)	1.1	-4.5	5.6
Labour Market	**Scotland**	**UK**	**Diff**
Employment level	-0.4	2.1	-2.5
Workforce Jobs level	0.4	2.3	-1.9

Sources: QNAS, May 2017, ONS National Accounts and Economic Accounts.

LABOUR MARKET

The smaller increase in the Compensation of Employees could be due to lower wage rises at the UK level or to a poorer employment performance. Table 1 suggests it is the latter. While the number of people employed in Scotland over this period fell a little, at the UK level the number rose.

The best breakdown available for disaggregating this employment differential comes from the ONS 'workforce jobs by industry' statistics. The overall numbers are similar, but do not correspond exactly, between the two sources shown in Table 1, with the workforce data suggesting that the main areas of underperformance in the Scottish jobs market were: Manufacturing; Retail: Admin support services (i.e. non professional business related jobs); and Public Services. (2)

One interpretation of the above disaggregated analysis suggests that:

- there has been slower growth in jobs related to exports of manufactured goods and private sector services in Scotland vs the rest of the UK;
- this has had less of an impact on household spending than on GDP due to the running down of savings in Scotland in order to allow for higher consumer's expenditure;
- if slower growth persists it is unlikely that savings will be able to keep on falling to allow for rising consumption levels.

While some of this lower onshore growth may due to oil related manufacturing and private sector services exports, equally it may be that, as the 'workforce jobs by industry' data suggests, other forces are at work. There is no clear connection between a North Sea slowdown and onshore activities like Retail, Admin and Public Services. This means that other factors are likely to be at work in slowing the Scottish economy, beyond the oil related slump.

THE POTENTIAL ECONOMIC IMPACT OF POLITICS AND UNCERTAINTY

While the analysis above attempts to discover which sectors have proved weak in the recent downturn, the North Sea apart, it remains difficult to identify specific causes.

This may be in part due to the fact that employers and employees expectations and levels of confidence, 'animal spirits' in the words of the the economist J.M. Keynes, have been negatively affected of late. If so, why might this be?

There are two areas of potential concern here:

- The first relates to **uncertainty**. This could have been negatively impacted upon in a Scottish context due to the uncertainty surrounding the independence referendum of 2014 and the potential for a second referendum to come (with the UK wide Brexit referendum compounding this impact). Such uncertainty, for example over future currency and trading arrangements, can spill over into delayed or reduced investment and employment.

  While the timing of the slowdown (early 2015) with regards to the first independence referendum (late 2014) may appear awry, this could be down to two reasons. First, the outcome of the first referendum seemed highly likely to be a NO vote until late on in the campaign. Second, over a third of Scottish growth in the year to 2015 Q1 was related to the Construction sector and in turn to exceptional public sector related infrastructure projects (e.g. the new Forth Road Bridge). Adjusting for this suggests that the relative slowdown started earlier, in 2014.

- The second relates to **policy divergence**. Here the evidence so far shows a move to a higher tax policy in Scotland vs the UK. The SNP led Scottish government has put in place a slightly higher income tax system along with support for, although not unilateral implementation of: a higher top rate of income tax; higher than planned corporation tax; a higher national minimum wage; and higher public sector wages. Furthermore other parties in the Scottish Parliament would go even further than the current Scottish Government in some of these areas and would do so on a unilateral basis.

> While few of these higher tax intentions have come about, they do give an indication of the intended direction of travel, should conditions allow. As such they may be interpreted by businesses and wealthy individuals as a risk to future income levels and impact on behaviour now in order to reduce future losses.

It is impossible to quantify the impact of these political influences on the Scottish economy but it is at least a potential, partial, explanation for the relative slowdown in performance.

It should be noted that the above discussion should not be interpreted as meaning that higher tax and spend policies are 'wrong', or will lead to a worse economic result. The final outcome would depend on the impact of higher public investment and better resourced public services. What it does point to is the potential negative economic effects, in terms of demand and investment for example, associated with higher uncertainty and with manipulable cross border tax discrepancies.

LOOKING FORWARD

Current prospects for the performance of the Scottish economy in 2017 are not good.

Recent ONS data has indicated a 5% fall in Scottish construction output in the 1st quarter of 2017, with the likelihood of a further drop to come in 2017, as the sector adjusts from the elevated level of output seen in 2015 and 2016.

Furthermore the 'Scottish Consumer Sentiment Indicator for the next 12 months' remains negative and at its lowest level since its inception in 2013.

On a more positive note, the recent Chambers of Commerce Oil & Gas Survey points to any negative impact on GDP from the oil and gas supply chain being much reduced in 2017.

Overall, this suggests that forecasts by EY ITEM, PWC and FAI of Scottish (real terms, onshore) GDP growth of around 1% in 2017 are not unreasonable. While this is over twice the rate of growth seen in 2016 it is still historically low and well below what is forecast for the UK. As such it will also have implications for the Scottish Budget via a low rate of growth of income tax receipts.

SUMMARY

An analysis of disaggregated Scottish economic data suggests that there may have been slower growth in jobs related to exports of manufactured goods and private sector services in Scotland vs the rest of the UK. The milder impact on household spending is due to the running down of savings in Scotland, although if slower growth persists household consumption is likely to suffer.

Some of this lower growth is due to the slowdown in oil activity but other forces are also at work and may include the heightening of uncertainty and risk associated with recent political events.

In terms of furthering our understanding of what is happening within the Scottish economy, more analysis of the data and surveys used to compile QNAS, alongside other survey information, may offer some deeper insights.

Quotes:

"The principal cause of the Scottish slowdown seen over the past two years may have been related to the slump in North sea related activity but other factors are also contributing to it.

The GDP slowdown is consistent with the relatively, vs the UK, poor employment performance and appears to be associated with a worsening trade position.

This slowdown has been much less prominent in terms of household consumption, but this has only been possible due to a decline in the Scottish savings ratio to a record low, and well below that of the UK.

Increased uncertainty and higher risks, relating to future political scenarios, may have also played a part in holding back Scottish economic activity.

Further analysis needs to be undertaken in order to reach firmer conclusions and to enable the best policy options to be identified.

The oft repeated view of the Scottish Government that "the foundations of Scotland's economy remain strong" ***would appear to be disconnected from reality in light of the wealth of evidence to the contrary."***

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END-NOTES

1) At present the population data used in QNAS is out-of-date (for example, the latest mid 2016 estimate is much higher then the Registrar General (2014 based) projection for 2016 and is even higher than the its projection for 2017). Once adjusted for it is likely that the differential in population growth will around 0.4 of a percentage point.

2) Note that the workforce jobs data is not the most robust statistical source and shifts in the overall numbers sometimes conflict with shifts in the recorded employment levels. However, as a guide to understanding changes in employment by industry across the economy, it is the best data available.

Note on National Accounts Statistics for Scotland

National Accounts (cash terms) statistics are important for any country but they are particularly so for a country like Scotland which potentially has a large component of its economy that is dependent on a natural commodity (in Scotland's case oil).

While real terms (i.e. adjusted for inflation) changes to GDP give an accurate picture of the underlying growth of the economy in normal circumstances, this is less true when dealing with natural commodities. These are often largely exported and their price is determined externally, i.e. in international terms, rather than internally. Because of this difference, adjusting for inflation is less relevant, as a high price is good for the exporting country (i.e. Scotland) though bad for importing countries.

However, cash terms GDP does not adjust for another crucial factor affecting our reading of the Scottish economy, the high degree of foreign ownership, particularly in relation to North Sea activity. To adjust for this, and get to Gross National Income (GNI), income flows relating to Scottish owned assets overseas and to overseas owned assets in Scotland are needed but are currently unavailable.