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Low oil price could boost recovery even as oil and gas sector suffers

Fraser Institute urges Chancellor to help the oil & gas sector

The substantial and sustained fall in the price of oil could boost the recovery in Scotland despite the harmful impact on the oil and gas sector both offshore and onshore, according to the latest Economic Commentary from the University of Strathclyde's Fraser of Allander Institute, sponsored by PwC.

The Scottish and UK economies are now recovering at a reasonable rate from the greatest economic shock since the 1930s. Recovery picked up in 2013 as the pace of austerity slowed after the UK posted the slowest recovery from the global recession of any advanced country, with the exception of Italy and Greece. The recovery has taken hold as consumers raise their spending and as investment picks up and there may be a further boost to growth from lower oil prices if they continue at the present low levels.

However, the Institute notes that there are many risks to a durable recovery: growth is unbalanced raising the risk that the recovery might falter; further planned austerity will, if implemented, act to slow growth unless the private sector grows more quickly to compensate, and the continuing problems in the Eurozone, with the risks of deflation and a Greek exit (Grexit), could potentially damage the Scottish economy.

Brian Ashcroft, Emeritus Professor of Economics, University of Strathclyde, said:

> "The falling oil price and recovering investment could provide a welcome boost to the recovery just as there are signs of some slowing in the rate of growth in most major economies except the US, and as the troubles in the Eurozone worsen with the increased risk of deflation and a distinct threat of Greece exiting the Euro.
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> "The absence of good data and uncertainty about future oil prices allow only a crude estimate of the impact on the Scottish economy of the fall in oil prices. Nevertheless, we estimate that the impact on employment this year could range from 9,700 net additional jobs to a net job loss of 600 on best and worst case scenarios."

He added:

> "While the boost from low oil prices to real disposable incomes and reduced production costs is to be welcomed, we must not forget the oil and gas industry, which is major asset to the Scottish economy."

In the latest Economic Commentary, the Fraser of Allander Institute forecast for GDP growth is 2.8% in 2014, 2.6% in 2015, and 2.4% in 2016; an upward revision to their November 2014 forecasts. These reflect the evidence of a strengthening of the recovery in investment in particular.

David Glen, head of tax, PwC in Scotland, said:

> "The Scottish economy continues to show healthy, sustained growth with sectors such as manufacturing and production, construction and business services helping drive this momentum.
> "While the latest forecast should boost business confidence in the short to medium term, the challenge will be keeping this recovery on track.

> "As a result of the volatile, low oil prices, we believe there is a real danger of an economic triple whammy across the oil and gas industry: reductions in income may result in incremental investment becoming uneconomic, potentially diminishing field life and accelerating decommissioning.
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> "With the 2015 UK budget on the horizon, there is real scope for the Chancellor to reform what is currently a highly complex tax regime: protecting existing production; incentivising future exploration; safeguarding skills in the North Sea and across the UK supply chain; and preventing what could be an irreversible decline in the oil and gas industry.
>
> "Other industries, such as automotive in the 80s and 90s, prove that there can be opportunities in adversity – but it needs more than innovation, collaboration and bold business strategies. Fiscal levers are also a vital part of the jigsaw and the oil and gas industry will be looking to the Government to deliver on 18 March."

To coincide with the Commentary's 40th anniversary, this edition will also include the first of a three-part series by **Alf Young**, Visiting Professor at the **International Public Policy Institute (IPPI)** at the University of Strathclyde on the transformation of the Scottish economy over the past 40 years; his first article covers the period 1975-1990.

Other articles include:

- **A complete catalogue of Commentary reviews, forecasts and articles (1975-1990)** that constitute the first part of the new Fraser Economic Commentary Digital Archive
- **A review of the economic impact and prospects of Scotland's financial services sector** by Jeremy Peat former RBS Chief Economist and Visiting Professor at the International Public Policy Institute (IPPI);
- **How behavioural economics can help inform new solutions to public policy challenges** – from pensions' policy to wage setting by Strathclyde economists Alex Dickson and Marco Fongoni.

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Notes to Editors:

1. The University of Strathclyde's Fraser of Allander Institute (FAI) issues its Economic Commentary with the support of PricewaterhouseCoopers LLP.
2. PwC supports the production of this report but it has had no control of its editorial content, including in particular the economic forecasts. FAI's comments on the future performance of the UK economy have been drawn from consensus forecasts.
3. PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details.
4. The University of Strathclyde is a leading international technological university which is recognised for its strong research links with business and industry, commitment to enterprise and skills development, and knowledge sharing with the private and public sectors. The University was named UK University of the Year in the 2012 Times Higher Education (THE) Awards. In the 2013 THE Awards, the University was named Entrepreneurial University of the Year.
5. The Fraser of Allander Institute (FAI) is the leading centre of research on the Scottish economy as is a research institute within the Department of Economics in Strathclyde Business School. The FAI has an international reputation, developed over 40 years, for rigorous, independent and applied economic research, forecasting and commentary, with strengths in economic and energy modelling.

Annex: Forecast Tables

Table 1: Fraser of Allander Forecast of Scottish GVA Growth, 2014-2016

GVA Growth (% per annum)	2014	2015	2016
Central forecast	**2.8**	**2.6**	**2.4**
November forecast	*2.7*	*2.2*	*2.1*
UK mean independent new forecasts (February)	2.6	2.6	2.3
Mean Absolute Error % points	+/- 0.18	+/- 0.52	+/- 1.12

Table 2: Fraser of Allander Forecast of Scottish Net Jobs Growth in Three Scenarios, 2014-2016

	2014	2015	2016
Upper	57,000	64,215	85,790
November forecast	*53,000*	*53,450*	*76,750*
Central	**53,850**	**51,350**	**57,600**
November forecast	*46,560*	*41,600*	*48,900*
Lower	50,600	38,500	30,750
November forecast	*33,400*	*19,900*	*29,900.*

Table 3: Fraser of Allander Forecasts ILO unemployment 2014-2016

	2014	2015	2016
ILO unemployment			
Rate (ILO un/TEA 16+)	**5.5%**	**5.0%**	**4.6%**
November forecast	6.0%	5.8%	5.6%.
Numbers	**149,000**	**136,600**	**125,250**

Overview

In its latest Economic Commentary, sponsored by PricewaterhouseCoopers, the University of Strathclyde's Fraser of Allander Institute notes that the Scottish and UK economies are now recovering at a reasonable rate from the greatest economic shock since the 1930s. This recovery has taken longer than from the 1930s Depression or any of the three other recessions experienced since the 1970s. The UK Coalition Government's austerity programme slowed the recovery considerably until the pace of fiscal consolidation was paused in 2012 and then slowed thereafter. Recovery picked up in 2013 as the pace of austerity slowed after the UK posted the slowest recovery from the global recession of any advanced country, with the exception of Italy and Greece. The recovery has taken hold as consumers raised their spending and investment picked up.

The jobs market and unemployment recovered more strongly than output, resulting in falling labour productivity and hence little improvement in real wages and real household incomes. The recovery in the labour market has been biased in favour of part-time employment, self-employment and temporary employment. Full-time employment still remains more than -4% below its pre-recession peak and the total numbers of hours worked is still lower in Scotland than before the recession, although that is not the case in the UK. With a growing working population the growth in jobs has not managed to absorb the increasing labour supply and so the employment to working population ratio is more than -2% below pre-recession levels, whereas in the UK it is slightly above the pre-recession peak. The implication is that despite better headline unemployment figures in Scotland, there is still more 'slack' in the Scottish labour market than in the UK and so despite jobs growth there is little upward pressure on wages.

We ask: will the recovery continue? We identify several positive and negative influences that will impact on the pace of the recovery. We examine them under four headings: growth in markets; oil prices, inflation and deflation; UK fiscal and monetary policy; and Greece and the Eurozone.

Growth in markets
The key points here are that despite the steady growth in world trade the latest IMF and OECD forecasts suggest a slowing in key countries and Scotland's key export markets. The composition of Scottish and UK growth also continues to be unbalanced with household spending driving growth, and fixed investment making a variable contribution. As we have stressed in recent Commentaries, household spending is being fuelled by rising debt, which is almost certainly unsustainable. If the economy is to rely on continued growth in household spending it requires a sustained rise in the real wages and incomes of households. However, this is unlikely to occur unless labour productivity improves, which has been badly hit as a consequence of the Great recession.

Oil prices, inflation and deflation
Inflation is falling right across the global economy. There is a clearly a risk of deflation – a sustained falling price level, leading to expectations of further price falls, postponed spending and reduced spending as the real value of household and corporate debt rises. However, while the risk is there for the UK and the US, at this stage it is more apparent than real. We are not witnessing a general deflation but a focused fall in oil prices and commodity prices, especially food. When energy and food costs are stripped out core inflation is around 1.6% in the US and close to 2% in the UK. The fall in oil prices has been large, around 50% at the time of writing, and the potential for a sizable boost to spending is significant with some respected analysts forecasting a 0.5% boost to UK GDP in 2015. The impact on Scottish GDP should be similar on that account. However, Scotland is also an oil producer and activity in the sector has already been hit by the significant fall in the price of oil. Overall, we cannot draw a definitive conclusion on the impact on the wider Scottish economy of the fall in the oil price: there are both benefits and costs and the costs particularly are difficult to isolate given present state of data on links between the UKCS and onshore. Nevertheless, we provide a 'crude' estimate of the likely net impact on employment in the Scottish economy in 2015 on best and worse case scenarios; this ranges from an additional net 9,700 jobs to a net loss of 600 jobs.

UK fiscal and monetary policy
The base rate set by the Bank of England's Monetary Policy Committee (MPC) is likely to remain at 0.5% for the remainder of this year at least despite the strong growth and falling unemployment. It will not be changed because inflation is close to zero and may turn negative, however briefly. So monetary policy should remain accommodating to growth for the foreseeable future. The same cannot be said for fiscal policy in the UK. A comparison by the Institute of Fiscal Studies of IMF forecasts for structural borrowing in 32 advanced economies shows that the UK has the largest planned fiscal consolidation between 2015 and 2019 and the 18th largest (or 15th smallest) planned structural deficit in 2019. A further £92 billion of fiscal tightening is planned. We estimate, that if the economy is to grow at around 2.5% per annum then the underlying growth rate in the face of such anticipated fiscal consolidation – which might change after the UK General Election in May - would need to be about 4% per annum: a big challenge for the private sector.

Greece and the Eurozone
The new Greek Government led by the Syriza party came to power with a mandate to renegotiate the terms of the 2012 bailout, which most analysts agree is imposing a severe burden on the Greek economy and society. GDP has fallen by 25% since 2007 and unemployment is currently over 25%, with youth unemployment 50%! No other democratic country has endured austerity of such size and pace. If by June 2015 there is not agreement on a reduction in the pace of austerity, then there is a real risk of 'Grexit', that is a Greek exit from the Eurozone. This would have significant economic and political consequences for the Eurozone itself and for the global economy, including the Scottish economy. When the threat of Grexit was last posed in 2012, the Fraser of Allander Institute undertook a modelling exercise which estimated that a Greek exit would lower Scottish GDP by -1.2% and reduce employment by 49,000 and this is before estimating the potentially greater impact of a wider contagion of bank runs and possible further withdrawals of other peripheral countries from the Eurozone.

Notwithstanding the developments above, we are forecasting growth of 2.8% in 2014, 2.6% in 2015, and 2.4% in 2016, an upward revision to our November 2014 forecasts. These reflect our view of a strengthening of the recovery. We have also raised our forecasts for employee job creation compared to our November forecasts. On the central forecast, we are now forecasting that net jobs will increase by 53,850 in 2014, 51,350 in 2015 and 57,600 in 2016. Our unemployment forecasts have been revised down further again from November, reflecting higher economic activity. Our projection for unemployment on the ILO measure at the end of 2015 is 136,600 (5.0%), falling further to 125,250 (4.6%) by the end of 2016.

Key Points

GDP Performance

- The latest Scottish GDP data for Q3 2014 show that Scottish GDP rose by 0.6% in the quarter, slower than the rate of 0.8% in the UK.
- Over the year to the fourth quarter - four quarters on the previous four quarters - Scottish GDP grew at 2.5%, a growth rate that is above trend.
- In the third quarter, GDP in Scotland was +2.0% above its pre-recession peak. Because of changes to accounting practices in the UK, which have yet to be introduced in Scotland, we do not have comparable UK data to Scotland in the second quarter. But we estimate on the old system UK GDP would have been +1.0% above its pre-recession peak in the third quarter.
- When oil and gas production is removed, we find that on the old data series both UK and Scottish GDP was about 2.0% above the pre-recession peak by 2014q3. The long period of weak oil and gas production has resulted in the UK GDP - ex oil & gas - having a much stronger recovery from recession than Scottish GDP. Scottish GDP has recovered by 8% since the trough of recession while UK GDP - ex oil & gas - recovered by 10% from its trough by 2014q3.

- The Scottish service sector, which accounts for 72% of GDP in Scotland and 78% in the UK, grew by 0.6% in Scotland in the third quarter and by 0.8% in the UK. Over the year, the service sector in Scotland grew by 2.7% compared to 2.8% in the UK.
- Scottish services output in the third quarter stood at 2.9% above its pre-recession peak, while UK services was 3.8% above.
- The production sector continues to boost Scottish growth, growing by nearly 11% over the recovery, while the sector remains a significant drag on the recovery in the UK growing only 1.3% during recovery to the third quarter.
- By the third quarter Scottish manufacturing GVA was still -4.6% below its pre-recession peak compared to -6.8% for UK manufacturing.
- Scottish construction GVA picked up considerably again in the third quarter growing by 3.2%. UK construction GVA in contrast rose by 1.6% in the third quarter. Over the year – four quarters on four quarters - Scottish construction grew by 6.3%, almost identical to the 6.4% growth in UK construction output.
- Despite the recent recovery construction remains considerably depressed in both the UK and Scotland. By the third quarter Scottish construction was still -4.9% below its pre-recession peak while UK construction was -7.3% below its peak.
- Within services, the principal sub-sectors all displayed positive growth in the third quarter. Business and financial services grew by 0.7%. Over the year, the sector grew at 4.6%. By the third quarter of this year output in the sector in Scotland stood at +7.9% above the previous peak compared to +5.2% in the UK.
- In financial services, the recovery is continuing but erratically. After contracting in the third quarter GVA in the sector was -7.8% below the pre-recession peak compared to the trough of -16.0% in 2012q4.
- The other principal sub-sector in private services displaying positive growth in the third quarter was distribution, hotels and catering (accounting for 18% of services sector output in Scotland), which grew by 0.9%. Over the year, the sector grew by 2.1% to stand +0.6% above its pre-recession peak compared to +1% in the UK.
- Output in the transport, storage & communication sector in Scotland in the third quarter fell by -1.1% while rising in the UK. Over the year, the sector grew by 2.4% in Scotland and by 1.9% in the UK. By the end of the third quarter GVA in the Scottish sector was -4.2% below pre-recession peak compared to +0.3% in the UK.

Labour Market

- The latest labour market data (see Scottish Labour Market section below) show that the recovery continues strongly. In the quarter October – December 2014, employment rose by 0.8% in Scotland and by 0.3% in the UK. In terms of numbers, jobs in Scotland rose by 20,160 in the quarter, compared to an increase of 103,440 in the UK as a whole. Over the year, Scottish jobs rose by 63,000, a rise of 2.5%, while UK jobs rose 608,000, or 2.0%.
- As employment continued to rise during the quarter, unemployment in Scotland fell, by -15,000, or -9.3%, to 149,000, or a rate of 5.4%, while in the UK, unemployment fell less rapidly by -97,000, or -5.0%, to a rate of 5.7%. Over the year, unemployment in Scotland fell strongly by -48,000, or -24.4%, while in the UK unemployment also fell strongly but a little more slowly by -486,000, or -20.7%.
- By the end of the third quarter, Scottish jobs as reported in the LFS household surveys were 2.0% above the pre-recession peak, while UK jobs were 3.6% higher than the peak.
- There appears to be more 'slack' in the labour market in Scotland compared with the UK.
- An indication that there is still a deficiency of demand in the Scottish labour market in relation to the situation before the recession is provided by data on the number of weekly hours worked. By the period October 2013 – September 2014, the number of total weekly hours worked in Scotland was still -1.0% below the pre-recession peak, while in the UK the figure was +3.6%.

- The recovery in the labour market continues to be driven by a shift - since the recession - away from full-time, permanent, employees towards part-time, temporary, and self-employment, although it is also clear that full-time employment is now recovering.
- The employment to population (aged 16 and over) ratio relative to pre-recession peak for Scotland stood at -2.1% below the pre-recession peak, compared to -6.7% at the trough of the recession. In the UK as a whole, in contrast the ratio is 0.7% above its pre-recession peak.

Forecasts

- We are forecasting GDP growth in Scotland of 2.8% in 2014, 2.6% in 2015, and 2.4% in 2016, an upward revision to our November 2014 forecasts. These reflect our view of a strengthening of the recovery.
- Production and manufacturing continue to be the major sectors exhibiting the fastest growth in 2014, 2015 and 2016.
- We have also raised our forecasts for employee job creation compared to our November forecasts. On the central forecast, we are now forecasting that net jobs will increase by 53,850 in 2014, 51,350 in 2015 and 57,600 in 2016.
- Our unemployment forecasts have been revised down further again from November, reflecting higher economic activity. Our projection for unemployment on the ILO measure at the end of 2015 is 136,600 (5.0%), falling further to 125,250 (4.6%) by the end of 2016.

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