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Scotland's growth slows further as threat of Brexit looms

- *Forecast for Scottish GDP growth is 1.9% in 2015, 1.9% in 2016, and 2.2% in 2017; downward revisions to 2016 and 2017 from the Fraser of Allander Institute's November 2015 forecasts.*
- *The Institute urges the Chancellor not to adopt further austerity to meet his fiscal targets as slowing growth reduces tax revenues.*
- *The Institute warns that Brexit poses a real threat to Scotland's future growth with the consequent loss of trade, inward investment and finance worsening already weak productivity growth.*

Growth in Scotland is set to slow further with falling oil prices having a net negative impact on Scotland compared to the rest of the UK, according to the latest Economic Commentary from the University of Strathclyde's Fraser of Allander Institute, sponsored by PwC.

The Institute argues that the main positive influences on Scotland's economic growth are: domestic demand is still growing; domestic inflation is close to zero; nominal earnings/income growth is picking up slowly and so boosting real income; interest rates remain low and household demand is boosted by some pick up in wages and earnings; and external demand for goods and services is being boosted by the continued resilience of the US economy and a gradual pick-up in growth in the Eurozone as the risks of deflation appear to recede.

However, there are significant threats to Scotland's economic growth. The low price of oil is producing a drag on Scottish growth, with the negative supply effect outweighing a positive demand effect – and this is being sustained by the longer than expected delay in the recovery of oil prices which is dampening overall investment expenditure. Other factors include:

- unbalanced growth with household spending the key driver fuelled largely by rising household debt which appears unsustainable.
- net trade (exports minus imports) continues to be strongly negative, exacerbated by slowdown in China and a slowing of the growth of world trade.
- fiscal austerity continues in the UK, and may be strengthened further since the Chancellor has signalled that he may need to tighten the fiscal stance in his Budget as tax revenues remain weak with growth of GDP now projected to be lower. According to the Institute this would be a mistake serving to worsen the slowdown in growth and tax revenues.
- finally, the referendum on the UK's membership of the EU announced for June 23 2016 increases uncertainty significantly in the short term, which is likely to have a negative effect on investment, as plans are postponed until the outcome is clearer.

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

> "With growth slowing further across the UK and even more so in Scotland, now is not the time for the Chancellor to adopt more austerity measures which will slow growth further and only worsen the flow of tax revenues to the Exchequer."

The Institute's analysis of the implications of Brexit for the Scottish economy leads to the conclusion that it is difficult to imagine that it would help improve Scotland's competitive position with respect to our trade with the EU.

In recent years, the decline in electronics production and the erosion of Scotland's manufacturing base has meant that Scotland has struggled to maintain its penetration of EU markets even on the favourable trading terms obtained through membership.

It is difficult to see how any post BREXIT trading relationship with the EU would be better than current arrangements. So, not only would actual and potential Scottish exporters have to overcome their weaker competitive position due to lower labour and total factor productivity they would face the additional hurdle of less favourable trading arrangements. Moreover, Brexit might worsen Scottish productivity growth particularly via the negative effects on trade, inward investment and financial integration.

Brian Ashcroft, Emeritus Professor of Economics at the University of Strathclyde, said

> **"**Scottish voters in the referendum on June 23rd should not lightly dismiss this warning about the consequences of Brexit for productivity growth in view of the already weak performance of Scottish productivity."

Paul Brewer, Government and Public Sector partner, PwC in Scotland, said:

> "The Scottish economy faces a number of domestic and external challenges. Global markets remain difficult territory for Scottish exporters while domestic consumption in being fuelled by worrying levels of household debt. Nonetheless, projected growth is relatively close to overall UK forecasts and remains ahead of other UK regions, with Scottish exporters supported by US demand and a modest upswing in EU markets.
>
> "The potential for the forthcoming Budget to exert further fiscal tightening, oil price uncertainty and the uncertainty surrounding the potential outcome of the EU referendum together create a difficult environment for business and investor confidence.
>
> "With the effects of the lower for longer oil price backdrop now rippling through other sectors, another smart strategy the Chancellor could employ to sustain the flow of oil investments in this mature North Sea basin and protect long-term total tax revenues would be to reduce the tax rates on oil companies. Cutting the headline rate, currently ranging from 50% to 67.5%, and the infrastructure tax burden for example could provide a much needed cushion – and, crucially, provide a stimulus for investment and its tax paying employees."

Paul added:

> "Despite those headline concerns, the report projects continued modest growth in output and employment and a steady decline in unemployment. And we're continuing to see the economic fruits of the Scottish Government's strong focus on major infrastructure projects and construction output figures continuing to outperform the UK trend. But lead times are long and generating a sustainable pipeline of new projects over the next few years will be vital if we are to maintain this momentum."

Economic forecasts and the wider Commentary

The Fraser of Allander Institute forecast for GDP growth is 1.9% in 2015; 1.9% in 2016, and 2.2% in 2017. The downward adjustment to the 2016 and 2017 projections reflects the evidence of slowing income growth, both home and abroad, a weakening of previously strong domestic investment growth, and an extension of the expected period in which a low price of oil is likely to be sustained.

ENDS

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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.
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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.

Annex: Fraser of Allander Institute Forecast Tables

(All tables are © Fraser of Allander Institute, March 2016)

Table 1: Forecast Scottish GVA Growth, 2015-2017

GVA Growth (% per annum)	2015	2016	2017
Central forecast	**1.9**	**1.9**	**2.2**
November forecast	1.9	2.2	2.5
UK mean independent new forecasts (February)	2.2	2.1	2.2
Mean Absolute Error % points	+/- 0.16	+/- 0.64	+/- 1.37

Table 2: Forecast Scottish Net Jobs Growth in Three Scenarios, 2015-2017

	2015	2016	2017
Upper	35,650	50,700	79,400
November forecast	*54,950*	*65,500*	*88,800*
Central	**31,200**	**36,800**	**46,850**
November forecast	*49,400*	*45,000*	*54,650*
Lower	26,850	24,250	31,200
November forecast	*43,800*	*24,450*	*20,500*

Table 3: Forecasts ILO unemployment 2015-2017

ILO unemployment	2015	2016	2017
Rate (ILO un/TEA 16+)	**5.8%**	**5.7%**	**4.8%**
November forecast	6.2%	5.7%	4.6%
Numbers	**162,000**	**153,350**	**159,850**

I Overview

In its latest Economic Commentary, sponsored by PricewaterhouseCoopers, the University of Strathclyde's Fraser of Allander Institute notes that Growth in both the Scottish and UK economies is set to slow further with falling oil prices having a net negative impact on Scotland compared to the rest of the UK. The chained volume measure of GDP rose by 0.1% in Scotland in the quarter, while UK GDP rose by 0.4%. UK GDP (ex oil & gas) now stands 7.1% above the pre-recession peak compared to only 3.1% in Scotland. UK GDP - ex oil & gas - has had an even stronger recovery from recession than Scottish GDP and UK GDP as a whole. Scottish GDP has recovered by 8.6% since the trough of recession while UK GDP - ex oil & gas – has recovered by 14.0% from its trough by 2015q3, compared to 13.0% when oil and gas output is included. In the latest quarter, UK GDP ex oil and gas rose by 0.5% - more than the 0.4% reported when oil & gas is included - and by 2.3% over the year, four quarters on four quarters.

II Industries and sectors

When we examine the performance across different industries and sectors, we see that the pattern of growth between Scotland and the UK again differed in the third quarter, but the divergence was probably less than in some earlier quarters. In the UK, the service sector was again by far the main driver of the overall growth rate of 0.4% by contributing growth of +0.5% points. In Scotland the service sector was also the main driver of growth contributing +0.2% points. The construction sector, which was the main driver of Scottish growth in the second quarter still continued to contribute positively but by only +0.1% in the third quarter, while the sector's contribution to UK growth was again negative at -0.1% points. The production sector continued the pattern begun in the second quarter of contributing negatively to growth in Scotland - by -0.2% in the third quarter - while making neither a positive or negative contribution to growth in the UK. Within production, manufacturing in the UK made no contribution to growth, while making a negative contribution -0.1% points in Scotland, a continuation of the performance in the second quarter but a reversal of the earlier pattern. In Scotland electricity & gas also made a negative contribution to growth of -0.1% points, with the other production sub-sectors neither providing a positive or negative contribution to Scottish growth. The production sub-sectors in the UK all made a zero contribution to growth**.** Despite the stronger performance of the service sector in Scotland, financial services activity continued to weaken with the prospect of recovery to pre-recession levels of activity now looking less and less likely. The weakness of financial services and the negative impact of the low price of oil on business services were not, however, sufficient to halt the growth of business and financial services overall, which still grew by 0.3% in the 3rd quarter and by 1.4% over the year.

III The labour market

The weakness in Scotland's GDP growth has not yet impacted overmuch on the labour market. In the quarter to December 2015 employment rose by 22,000 (0.8%) to 2,636,000 while unemployment fell by 5,000 (-2.8%) to 162,000 with the rate falling to 5.8%. Yet, the jobs recovery remains weaker than in the UK as a whole. By the end of the third quarter, Scottish jobs as reported in the LFS household surveys were 3.2% above the pre-recession peak, while UK jobs were 5.7% above peak.

IV Factors influencing the recovery and growth

(i) Positive Influences

- Domestic demand is still growing helped by the income effect of a low price of oil but may be beginning to slow as investment especially public infrastructure investment growth tails off.
- Domestic inflation is close to zero, below nominal earnings/income growth, which is picking up slowly and so boosting real income;
- Interest rates remain low and household demand boosted by some pick up in wages and earnings.
- External demand for goods and services is being boosted by: the continued resilience of the US economy – despite the slowdown in US growth in the 4th quarter (and US growth was greater than UK growth in 2015 overall); and a gradual pick up in growth in the Eurozone as the risks of deflation appear to recede.

(ii) Threats

- The low price of oil appears to be having a negative effect on Scottish growth, with negative supply effect outweighing positive demand effect. This negative effect is being sustained as the longer than expected delay in the recovery of oil prices is dampening overall investment expenditure.
- Growth remains unbalanced with household spending the key driver fuelled largely by rising household debt. Household net assets are also high so there is a debate about the significance to demand of rising debt.
- Net trade continues to be strongly negative with export demand threatened by the high level of sterling – although note the recent fall – slowdown in China and 'policy normalisation' in United States.
- Fiscal austerity continues in the UK, although the tightness of fiscal policy was loosened after November's Autumn Statement. The risk is that the Government fails to meet its fiscal targets as tax revenues fail to meet expectations and the government re-intensifies austerity in order to attain its targets. This appears to be about to happen in the forthcoming Budget as signalled by the Chancellor's comments in China. If so, this would, in our view, be a major mistake. A fiscal tightening when growth is slowing is likely to slow growth further and reduce the tax revenues that the Chancellor desires to meet his fiscal targets.
- The referendum on the UK's membership of the EU announced for 23 June 2016 increases uncertainty significantly in the short term, which is likely to have a negative effect on investment as plans are postponed until the outcome is clear. Moreover, if UK voters do vote to leave the EU, this short-term negative impact on investment and growth is likely to carry over into the long term

(iii) Growth

Further analysis using new data on the long-term growth performance of the Scotland's economy leads to the following conclusions:

On long-term growth performance*, the main conclusions are:*

- Scottish 'trend' GDP growth of 2.1% p.a. over the last 50 years is lower than UK growth of 2.4% p.a. (under the former ESA 1995, Scotland's 'trend' GDP growth rate over last 50 years was identical to UK growth at 2.3% p.a.)
- Scottish 'trend' GDP per head growth over last 50 years is 2.0% p.a., the same as in the UK as a whole (under the former ESA 1995, Scotland's 'trend' GDP per head growth rate was 2.2% p.a., faster than UK's 2% p.a. – due to falling or slower population growth in Scotland).

- Overall Scottish growth has been consistently weaker than UK growth since the 1970s, but up until the recent recovery the gap seems to have been narrowing.
- After weakness in the 1970s and '80s, GDP per head growth was stronger in Scotland relative to UK, until the recent recovery.

***On productivity**, the main conclusions are:*

- Labour productivity has risen absolutely in Scotland by 22% between 1998 and 2014
- Despite this growth it fell behind the UK, which had faster growth to 2007, before the Great Recession.
- Scotland's relativity improved during and after the Great Recession, with the UK experiencing a greater deterioration in productivity - hence the post-recession 'productivity puzzle' is much more of a UK than Scottish phenomenon. However, by 2014 it was still about 2.4% below the UK.
- However, academic research suggests that overall – i.e. 'Total Factor' – productivity in Scotland is much lower than rest of UK. In the absence of faster population growth, Scotland can only sustain an improved growth rate by raising its competitiveness through improved productivity.

V Brexit

The Institute's analysis of the implications of Brexit for the Scottish economy leads to the conclusion that it is difficult to imagine that it would help improve Scotland's competitive position with respect to our trade with the EU. In recent years, the decline in electronics production and the erosion of Scotland's manufacturing base has meant that Scotland has struggled to maintain its penetration of EU markets even on the favourable trading terms obtained through membership. It is difficult to see how any post BREXIT trading relationship with the EU would be better than current arrangements. So, not only would actual and potential Scottish exporters have to overcome their weaker competitive position due to lower labour and total factor productivity they would face the additional hurdle of less favourable trading arrangements. Moreover, Brexit might worsen Scottish productivity growth particularly via the negative effects on trade, inward investment and financial integration. There are several academic studies that seek to identify the impact of Brexit on the UK economy. One key study in 2014, by the Centre of Economic Policy (CEP) at the London School of Economics, estimated that UK GDP would be reduced by up to 9.5% of GDP in a world where the UK cannot negotiate favourable trade terms with the EU. However, under a more optimistic scenario, in which the UK secures a free trade agreement with the EU, CEP estimates the losses to be around 2.2% of GDP. The static trade welfare effects of Brexit – i.e. the loss of trade creation benefits - are estimated by CEP to range from 1.1% to 3.1% of GDP. However, once the estimated dynamic losses of Brexit on productivity growth through reduced competition and reduced technological innovation linked to lower FDI inflows and reduced financial integration, CEP's estimates of loss rise to 2.2% to 9.5%.

VI Forecasts

(i) Output

On GDP, our forecast for 2015 – for which we do not have official 4th quarter data until April 2106 - is 1.9%, which is a slight revision down from our forecast of 2.0% in November 2015. For 2016, we have also revised down our forecast from 2.2% in November to 1.9%. This is mainly driven by apparently slowing income growth, a weakening of previously strong domestic investment growth, and an extension of the expected period in which a low price of oil is likely to be sustained. On our central forecast, we are forecasting a pick up in the rate of growth in 2017 as the economy rides out the challenges of 2016 and the price of oil in particular begins to rise to more favourable levels. But at 2.2% our forecast of 2017 remains below our November forecast of 2.5%.

(ii) Jobs

The number of employee jobs is forecast to increase in each year, and the number of jobs added in 2015, 2016 and 2017 has been revised down slightly since our November 2015 forecast. The number of jobs at the end of 2015 is now forecast to be 2,415,200, an increase of 1.3% during 2015. Our new central forecast is that the Scottish economy will add 36,800 jobs in 2016, down by around 9,000 from our November forecast, with a net of 46,850 jobs added in 2017, down by almost 8,000 from our November forecast.

(iii) Unemployment

On unemployment, our latest forecasts for the unemployment rate in Scotland for the end of 2016 and 2017 are 5.7% and 4.8% and for numbers 153,350 and 159,850, respectively.

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