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Economic Bulletin

SCOTLAND: COULD IT BECOME GREECE WITHOUT THE SUN?

- Scottish independence would entail significant economic risk. Scotland's budget deficit is currently over three times higher than the UK average as a % of GDP.
- North Sea oil and gas revenue expectations have plunged. Expected revenues of £6.8 to 7.9bn this year have fallen to just £0.5 to 2.8bn.
- Two thirds of Scotland's exports go to the rest of the UK but just 15% go to other EU countries, further questioning the economic rationale behind Scottish independence.
- Euro membership would expose Scotland to the risk of more asymmetric economic shocks, and the European Central Bank would be less capable of responding to shocks compared to the Bank of England.

1. INTRODUCTION

The EU referendum has exposed wide divisions across nations of the UK. While England voted by a margin of 6 percentage points to leave the EU, Scotland overwhelming supported remaining. In response, Scotland's first minister Nicola Sturgeon said that a second referendum on Scottish independence is "on the table" and "highly likely". This economic bulletin seeks to examine the economic backdrop to the prospect of a second referendum, and whether this backdrop would influence the result of a referendum if it were held over the next few years.

2. SCOTLAND'S FISCAL POSITION

Table 1: Net Fiscal Balance Projections (UK and Scotland)

	2016-17	2017-18	2018-19	2019-20	2020-21
Scotland	-9.4%	-8.5%	-7.6%	-6.2%	-6.2%
UK-wide	-2.9%	-1.9%	-1%	+0.5%	+0.5%

Source: Institute for Fiscal Studies (IFS) link

In comparison to the UK, Scotland's fiscal position is precarious. It is estimated that Scotland's budget deficit as a proportion of GDP is over three times higher than the UK-wide level in 2016/17. Furthermore, the IFS has previously predicted that the UK as a whole is projected to achieve a budget surplus by the financial year 2019/20, while Scotland's deficit is set to be stubbornly high at 6.2%. Of course, George Osborne has subsequently dropped his goal of achieving a budget surplus by 2020, meaning that the fiscal outlook for the UK and Scotland may have declined. However, we expect that the ratio of the difference between the UK and Scotland's budget deficits will be maintained.

Despite this discrepancy, Scotland's place in the UK makes it largely insulated from the consequences of the substantial gap between government revenues and government expenditure.

Earlier in the decade, the UK and Scotland had a similar budget deficit as a proportion of national income. In 2010-11, for example, Scotland's fiscal balance was -8.4% while the UK's fiscal balance was -8.5%, according to IFS analysis.

3. WHY HAS SCOTLAND'S COMPARATIVE FISCAL POSITION DECLINED?

As highlighted in the Centre for Policy Studies' economic bulletin *'*99p petrol will not last forever*'*, the global price of oil crashed by around 75% from 2014 to the beginning of 2016. Oil prices have since recovered somewhat to around $50 a barrel, but are still well over 50% below their 2014 peak. Forecasts from the International Energy Agency suggest that production of oil is exceeding demand by over 1 per cent, which is leading to a huge oversupply on global markets.

The North Sea oil and gas industry, which has historically been of critical importance to the Scottish economy, has been badly affected by these trends. According to Oil and Gas UK's Activity Survey 2016, nearly half of the UK Continental Shelf's oil fields are likely to be operating at a loss in 2016 and exploration and appraisal activity was at its lowest in 45 years in 2015. Moreover, Sir Ian Wood has claimed that oil and gas companies in the UK's North Sea region may shed a further 45,000 employees in 2016.

This downward forecast has had a dramatic impact on the Scottish economy. The North Sea comprised over 15% of its economy in 2010, whereas in 2015 this had plummeted to just 6.5%.[1]

Table 2: North Sea Oil Government Revenue Projections for 2016-17

	Low	High
2013	£6.8bn	£7.9bn
2015	£0.5bn	£2.8bn

Source: Scottish Government

It has also led to a marked fall in revenue from the sector. When the Scottish Government published *"Scotland's future: your guide to an independent Scotland"* in 2013, it was assumed that oil prices would remain above $100 a barrel and that receipts from Scottish North Sea oil and gas would be between £6.8bn to £7.9bn in the year 2016-17. However, the subsequent problems faced by the industry means that North Sea oil and gas receipts are only expected to achieve between £0.5bn to £2.8bn, according to the Scottish Government's latest Oil and Gas Bulletin.

Figure 1: Global oil price since 2012

Source: Bloomberg link

[1] In 2015, onshore Scottish GDP was £142bn. Including offshore activity it was £152bn.

This plunge in expected revenue has left a 9.4% budget deficit in Scotland for 2016-17. This dwarfs the 2.5% to 3.3% deficit, which was projected by the Scottish Government in 2013.

4. SCOTLAND'S MAIN TRADING PARTNER: THE UK

Figure 1: Scotland's international export partners (2014)

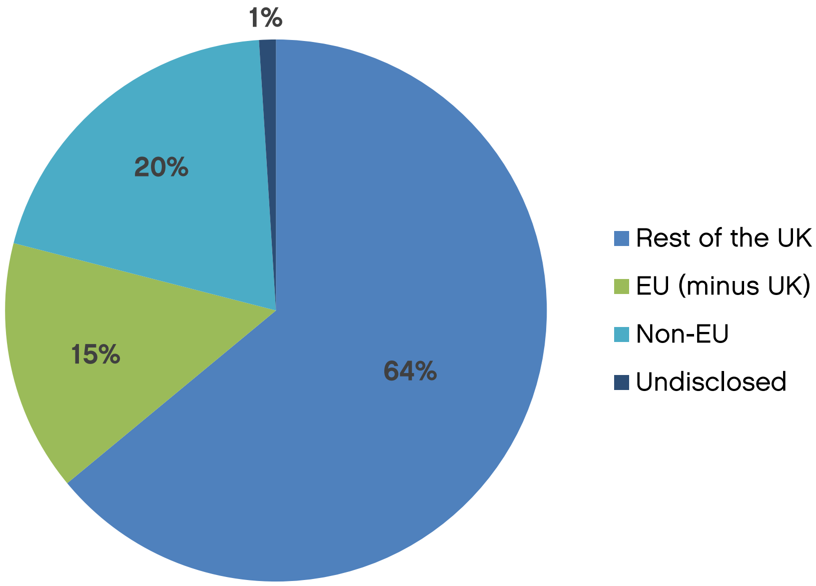

Table 3: Scotland's international export partners (2014)

	Exports (£m)	Export Share
Rest of the UK	48,525	64%
EU (minus UK)	11,560	15%
Non-EU	15,255	20%
Undisclosed	765	1%

Source: Scottish Government link

The majority of Scotland's trade is conducted with the rest of the UK, making other parts of the UK Scotland's primary trading partner. Nearly two thirds of Scotland's exports in goods and services go to other countries in the UK, accounting for £48.5bn of value. This is equivalent to 31.7% of the value of Scottish GDP (Scottish GDP is around £153 billion). For the purposes of context, the UK's exports to the EU have the equivalent value of just 12% of UK GDP.

Scotland trades over four times more with the rest of the UK compared to other EU countries. The economic logic of breaking ties with the UK for the purpose of restoring ties with the rest of the EU via European Union membership is therefore questionable.

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5. RISKS OF POTENTIAL EURO MEMBERSHIP

The disproportionate amount of trade conducted with the rest of the UK explains why the Scottish Government has previously advocated an independent Scotland to have a formal currency union with the rest of the UK. However, there are clear reasons to believe that such a currency union would not be achievable in the event of independence.

Firstly, the UK Government has previously ruled out any such arrangement. Secondly, whatever route Scotland might take to rejoin the EU, the EU stipulates that all new members are expected to adopt the euro, if they meet the necessary criteria. The same rules would apply to Scotland, unless it was able to negotiate a new opt-out – although, of course, Scotland's currently high budget deficit would preclude it from joining the Euro.

If an independent Scotland were to eventually adopt the Euro, transaction costs with the Euro area would indeed fall, but the economic benefit would not offset the costs of introducing exchange rate risk with the UK – given Scotland does four times more trade with the rest of the UK.

The nature of the single currency area would also pose great risks for Scotland. Analysis from HM Treasury highlighted that differences in the structure of the Scottish economy relative to the euro area average suggested that adopting the euro may be less well suited to Scottish economic conditions. In particular, it was noted that manufacturing is a much larger share of employment in the euro area than in Scotland. This could mean that the Scottish economy would be more likely to be exposed to asymmetric shocks with the euro area – shocks that would affect the Scottish economy but not the euro area – than with the rest of the UK.

In addition, there are huge differences between members of the Euro, which create tensions in the Single Currency. Unemployment ranges from 24% and 20% in Greece and Spain respectively, but stands at just 4.3% in Germany, according to data from Statista. These imbalances in the Eurozone mean that Scotland as part of the Euro currency zone would be more likely to be exposed to shocks that the European Central Bank would not accommodate compared to the status quo under the Bank of England's monetary policy.

6. CONCLUSION

Nicola Sturgeon's push for independence does have some logic from a democratic standpoint. Scotland is being taken out of the European Union despite voting to remain within the institution. However, the economic backdrop to Sturgeon's push for independence is not encouraging for her.

Revenues from North Sea oil have collapsed, leaving Scotland with a budget deficit that is three times higher than the UK average. Indeed, Scotland's budget deficit today is nearly equivalent to the UK's budget deficit in the immediate aftermath of the financial crisis. There are also other major economic issues associated with Scottish independence at this time. Scotland trades over four times more with the rest of the UK compared to other EU countries. Why therefore would you break ties with the UK for the purpose of restoring ties with the rest of the EU via European Union membership? Furthermore, if Scotland were proposing to adopt the euro as its currency, this would present huge risks for a newly independent Scotland.

There is a precedent for a small, romantic country, surrounded by hundreds of islands, perched on the extremity of Europe, seeking membership of the Euro: Greece. Of course, it would be impertinent to suggest that Scotland's circumstances are directly equivalent to those of Greece, but it does undoubtedly serve as a useful reminder that countries with challenging public finances can end up suffering inside the Euro. This will undoubtedly be on the minds of the Scottish electorate should there be a second independence referendum

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