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Oil drags us down – we need an energy boost

North Sea output has halved. Could we look to shale gas to drive new growth?

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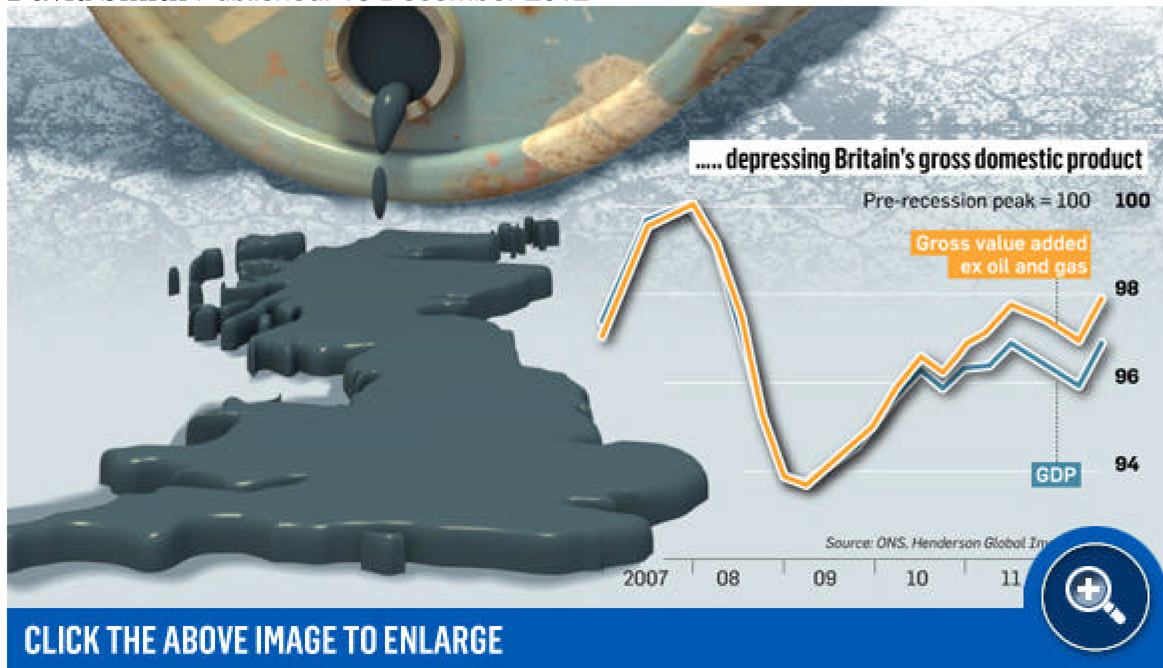

Long ago, in the mists of time, it was common to think about Britain's economy in two distinct ways.

There was the onshore, or non-oil, economy, and often — I am talking about three decades ago — its performance was underwhelming.

Then there was the oil economy, booming as a result of the opening up of the North Sea as one of the world's most important sources of oil and gas from the 1970s.

Combine the two and you got a healthy growth picture. Exclude oil and things were not nearly as strong.

Today, the picture is reversed. Oil is desperately weak. The non-oil economy — while subdued by normal standards — is rather stronger.

A few days ago we had another instalment of the economic puzzle. There was a big fall of 82,000 in unemployment over the latest three months and, official figures showed, a net rise in employment of 499,000 over the past 12 months.

At a time when the economy did not grow at all, according to gross domestic product (GDP) figures, employment rose by nearly half a million — to its highest ever number of 29.6m — and hours worked and vacancies both rose sharply.

Some of this puzzle will be resolved in the fullness of time by data revisions. Some of it reflects the fact that pay has been, and continues to be, very subdued: it is rising by just 1.8% annually.

Part of it, however, is to do with oil. Britain's onshore economy is doing better than its offshore economy. The decline in North Sea oil and gas output is striking.

Britain's recovery got under way in the middle of 2009. For the North Sea, however, that was the start of an accelerated decline in output. In October, North Sea production stood at 51% of its June 2009 level. The overall economy has grown, though not as much as anybody would have hoped, but North Sea output has halved.

In the old days, such a development would have been devastating because North Sea oil had a bigger weight in the economy. These days the effects are smaller but still significant. So, instead of shrinking by 0.1% over the past year, as the overall GDP figures suggest, the non-oil economy has grown by 0.2%.

Compared with 2009, overall GDP has risen by 3.3%, its non-oil equivalent by 4.1%. Simon Ward, economist with Henderson Global Investors, notes that this recovery is less of an outlier if adjusted in this way: the profile of non-oil GDP becomes more like that of the late 1970s and early 1980s.

This does not, I emphasise, solve all the puzzle. If you take the non-oil figures at face value, this is still a much weaker recovery than we would like. They point to an economy that has averaged only 1% to 1.5% growth in the recovery phase, and that growth has slowed the longer the recovery has gone on.

But it is part of the explanation and it has a couple of other interesting aspects. The first concerns Scotland. The debate about Scotland's fiscal future under independence rests mainly on the proportion of North Sea revenues it would be allocated.

Fast-falling North Sea output suggests this is a shaky foundation on which to build an independent country. The Institute for Fiscal Studies (IFS) recently concluded that if Scotland were assigned North Sea revenues on a so-called geographical basis — something that would have to be debated — its budget deficit would be proportionately smaller than that of the rest of Britain, though it warned about the volatility of such revenues.

For every swing, however, there is a roundabout. If Scotland were to get most of the oil revenues, its economy would also be more oil-dependent in general. The oil/non-oil distinction, important for Britain as a whole, would be hugely significant.

The IFS's calculations suggest that North Sea oil and gas would account for 18% of the Scottish economy. What this means, by my calculations, is that Scotland would have had no recovery at all over the past three years but still be stuck in the recession that began in 2008.

Assuming Scotland had the same 4.1% non-oil GDP rise as the rest of the country, this would be more than outweighed by the near-halving of output from a sector that makes up nearly a fifth of its economy. Scotland's GDP would be 4% to 5% below its mid-2009 levels and even further below pre-crisis levels.

The other interesting question is whether we can look to a future in which energy once more drives the economy rather than acts as a drag on it.

On Thursday the government gave its approval to Cuadrilla, an energy firm, for the resumption of "fracking" — hydraulic fracturing — for the exploitation of shale gas reserves. Shale gas is environmentally problematical and most of the evidence suggests that our recoverable reserves do not approach those of the North Sea.

However, the British Geological Survey, which is the most reliable independent source, says "UK potential is as yet untested" and that there are "abundant shales at depth". It has identified significant accumulations, including the Widmerpool Gulf stratum near Nottingham and the Elswick gasfield near Blackpool.

Caution is justified. Shale gas may never have the effect on Britain it is having in America, where prices have tumbled. But even an echo of those early North Sea days, when oil and gas helped to mend damaged public finances and the balance of payments, would be very welcome. On both counts, we need all the help we can get.

¦ I discovered two interesting things about the Bank of England last week, neither to do with changing the inflation target, which I will tackle another time.
The first was that, unbeknown to us, Sir Howard Davies was on the shortlist to succeed Sir Mervyn King as governor. Davies, former CBI director-general, deputy Bank governor and chairman of the Financial Services Authority, could have been governor if Mark Carney, the Canadian central bank governor, had said no.

My understanding is that so keen was the Treasury for a new broom that neither Paul Tucker nor Lord (Adair) Turner, the hot favourites, made it to the final three, which comprised Carney, Davies and Lord (Terry) Burns, the veteran former Treasury permanent secretary.

I don't know whether this makes things better or worse for Tucker and Turner. But it seems clear that when it came to the job, it was a significant handicap to be working for the Bank or the Financial Services Authority.

The other interesting thing is that the Bank may never need to sell off most of the gilts (government bonds) it has acquired under quantitative easing (QE). The point here is that the banks have greatly increased the reserves they hold at the Bank to about £280bn at present from a tiny amount before the crisis.

Under regulatory and other pressures, large holdings of reserves at the Bank are likely to be permanent, and the Bank needs corresponding assets on the other side of its balance sheet. The obvious assets are the gilts it has acquired under QE, currently worth £389bn on the Bank's balance sheet.

That means, though these gilts would have to be moved between different accounts at the Bank, most of them — perhaps £300bn — might never have to be sold back into the markets. The Bank would simply keep them on its books, and might even need to buy more over time to top up its holdings as the existing ones mature. The prospect of large losses to the Treasury and taxpayer on the eventual unwinding of QE is thus greatly reduced.

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