Scottish Economic Bulletin

Office of the Chief Economic Adviser

Gary Gillespie
Chief Economist
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Scottish Government
Riaghaltas na h-Alba

Contents

Data up to: 29 September 2023
Contact: OCEABusiness@gov.scot

Cover page Image of peat sampling at Blawhorn Moss © Dougie Barnett NatureScot

Overview

This month's bulletin provides an update on economic indicators during the third quarter of 2023 in which inflationary pressures have continued to ease however the economy remains in a period of subdued growth, labour market conditions have softened and business and consumer sentiment have moderated.

Furthermore, in line with recommendations from the New Deal for Business Group on metrics, this refreshed publication provides further evidence on latest business conditions to improve understanding of the business climate.

The Scottish economy grew 0.1% in July, although more broadly it contracted 0.1% over the three months to July, continuing a period of subdued growth in which output has remained broadly flat since the start of 2022. PMI data for August indicate a further slowing in new business orders suggesting that this period of weak growth is set to continue through the quarter.

This period of weaker growth is in line with forecast, with above target inflation and higher interest rates weighing on economic activity. Although inflation is coming down and fell to 6.7% in August, it's forecast to remain above the 2% target through 2024. The decision to maintain the Bank Rate at 5.25% in September, after fourteen consecutive rate rises, highlights the Bank's judgement that rates are now restricting the economy with the effect of previous rises yet to be fully felt.

Despite challenging conditions, Scotland's labour market has remained particularly resilient, although latest data indicates the labour market has softened slightly with unemployment rising to 4.3%. This latest rise has been driven by a reduction in inactivity rather than a fall in employment. That said, recruitment activity has slowed as both the demand for and availability of staff has softened in the face weaker expectations for growth over the coming months.

Business conditions more broadly are challenging with cost pressures remaining the main concern. The recent fall in overall Producer Input Prices will provide a welcome easing in some inflationary pressures for some producers, however business surveys indicate that wage costs have become a key cost pressure for firms while businesses are also increasingly concerned about higher interest rates and weakening demand.

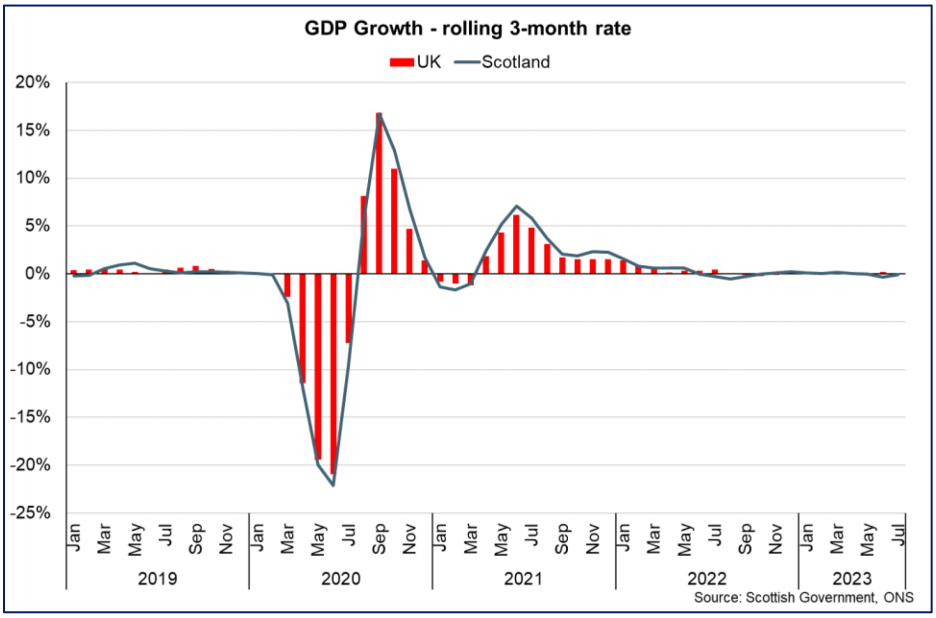
Consumers also continue to face challenging conditions with recent improvements in consumer sentiment over the past year moderating in recent months in the face of inflationary pressures and higher interest rates. Real median PAYE earnings have returned to positive growth recently however households continue to report challenges paying mortgage and energy bills and more broadly are not relaxed about spending money.

Looking ahead, the weakness in optimism across consumers and businesses emphasises the ongoing uncertainty in the economic outlook and the risks to growth over the remainder of the year.

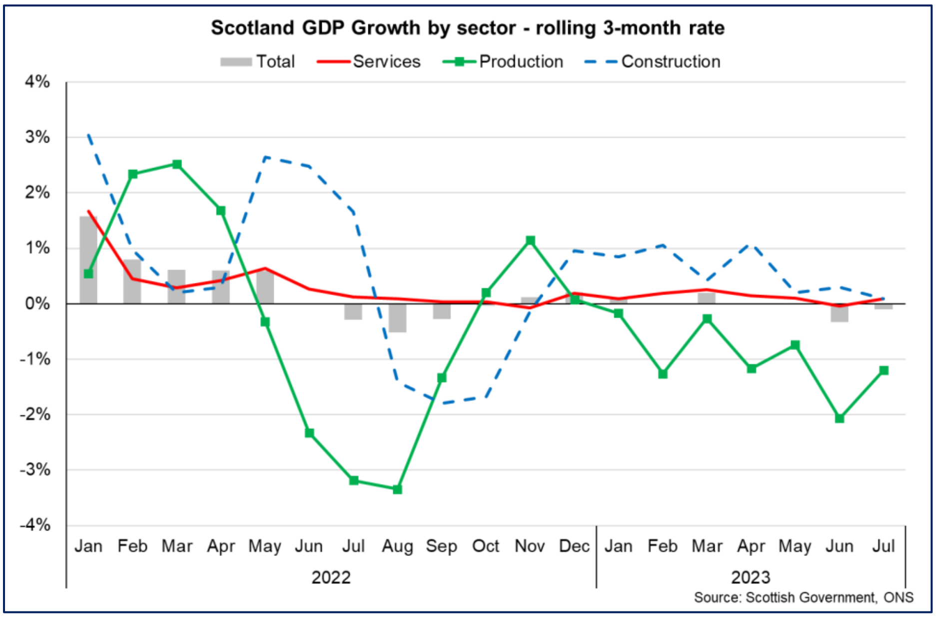
Output

Scotland's GDP growth remains subdued going into the second half of the year.

- Scotland's GDP grew 0.1% in July 2023 (UK: -0.5%), however more broadly fell 0.1% over the 3-months to July.[1] This followed a fall of 0.3% over the 3-months to June, reflecting that the growth at the beginning of the year has proved temporary so far.
- Overall, growth has been broadly flat since the start of 2022 as consumer and business activity have been progressively impacted by inflationary pressures and rising interest rates.



- At a sector level, the fall in output over the 3-months to July has been driven by the production sector (-1.2%) with a further fall in manufacturing output (-0.3%), offsetting 0.1% growth in both the services and construction sectors.



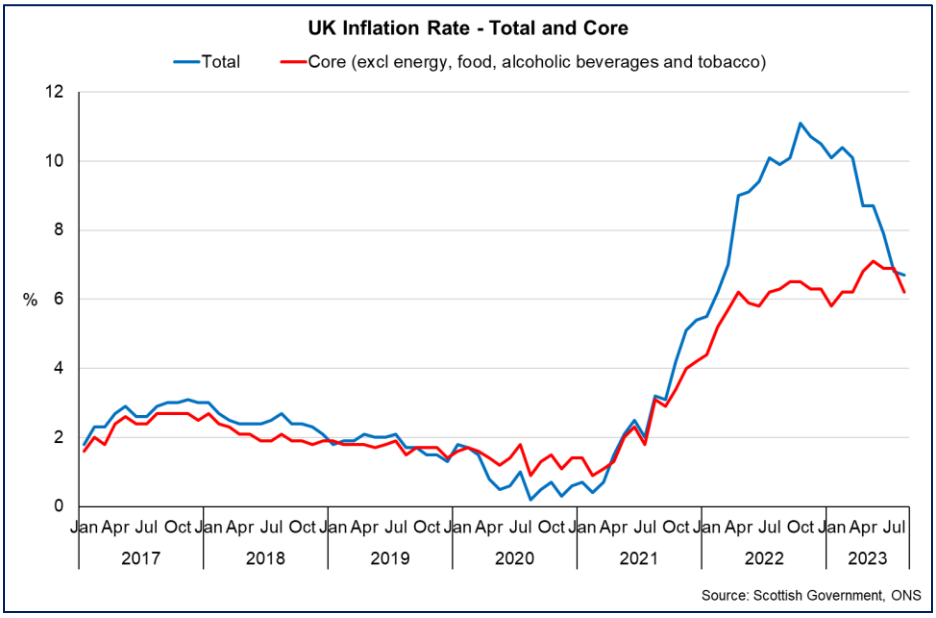
[1] Economy statistics - gov.scot (www.gov.scot)

- Within the services sector, growth picked up in the health, education and public services sectors (0.8%) however fell 0.1% in consumer facing services with retail output falling 1.9%, offsetting growth in sectors such as accommodation and food services (0.3%) and arts, culture and recreation (2.4%).

Inflation

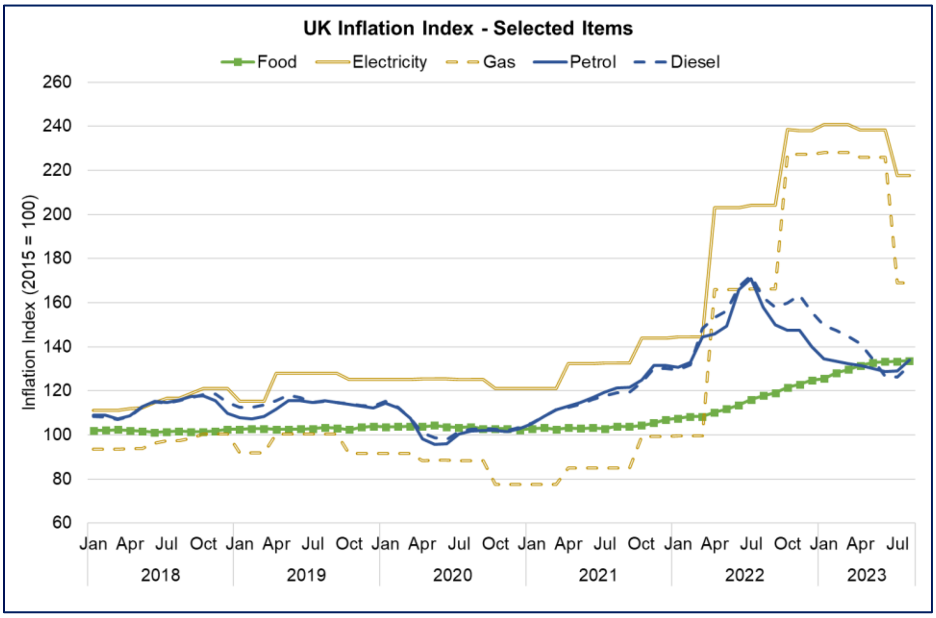
Inflation continues to fall however remains significantly above the 2% target.

- UK inflation fell for a third successive month in August to 6.7%, continuing its downward trend from its recent peak of 11.1% in October 2022 and is at its lowest rate since February 2022. [2]
- The fall in August was modest, down from 6.8% in July, with the largest downward contributions from food and non-alcoholic beverages and restaurants and hotels, offset by upward contributions from transport (particularly motor fuels) and clothing.
- Core inflation, which excludes food, energy, alcohol and tobacco, fell to 6.2% in August, down from 6.9% in July, and while it remains elevated, indicates a slight easing in inflation pressures from recent months.

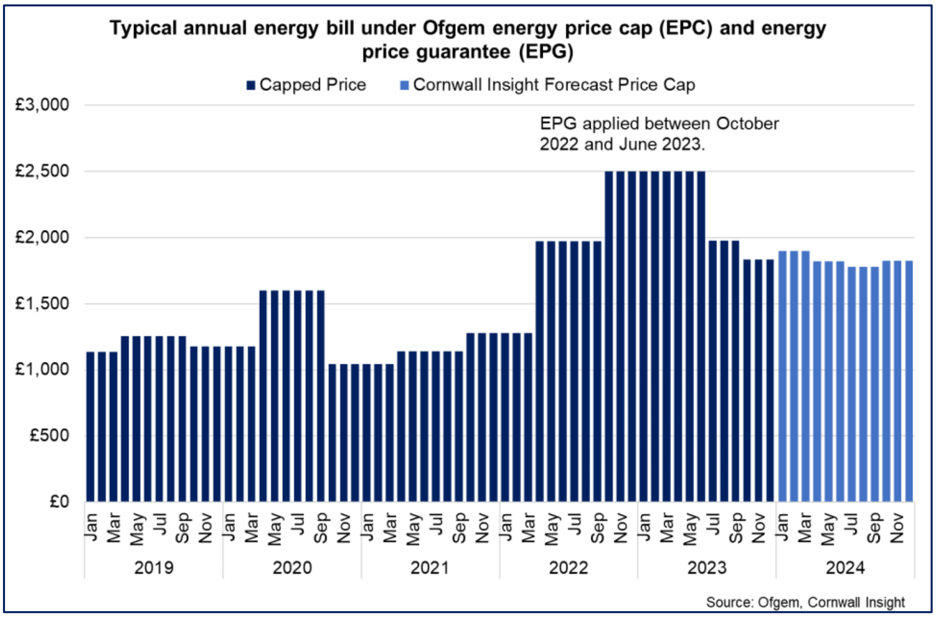


- In terms of the downward contribution from food and non-alcoholic beverages, the annual rate of inflation fell for a fifth consecutive month in August to 13.6% (down from 14.8% in July and from its recent peak of 19.1% in March), however remains notably elevated. In contrast, motor fuel prices (petrol and diesel) have been on a downward trend since the end of 2022, and are 15% and 19% lower respectively compared to last year. However, prices increased by c. 4% over the month between July and August, providing an upward contribution to the overall rate.

[2] Consumer price inflation, UK - Office for National Statistics



- Electricity and gas price annual inflation rates remained unchanged at 6.7% and 1.7% respectively, and partly reflects the shift in July from the Energy Price Guarantee to the Energy Price Cap (EPC) for July to September, which estimates the typical annual energy bill to fall c. 17% to £1,978. The EPC for October to December is expected to result in a further 7.3% fall in the typical annual energy bill to £1,834 from October.[3]

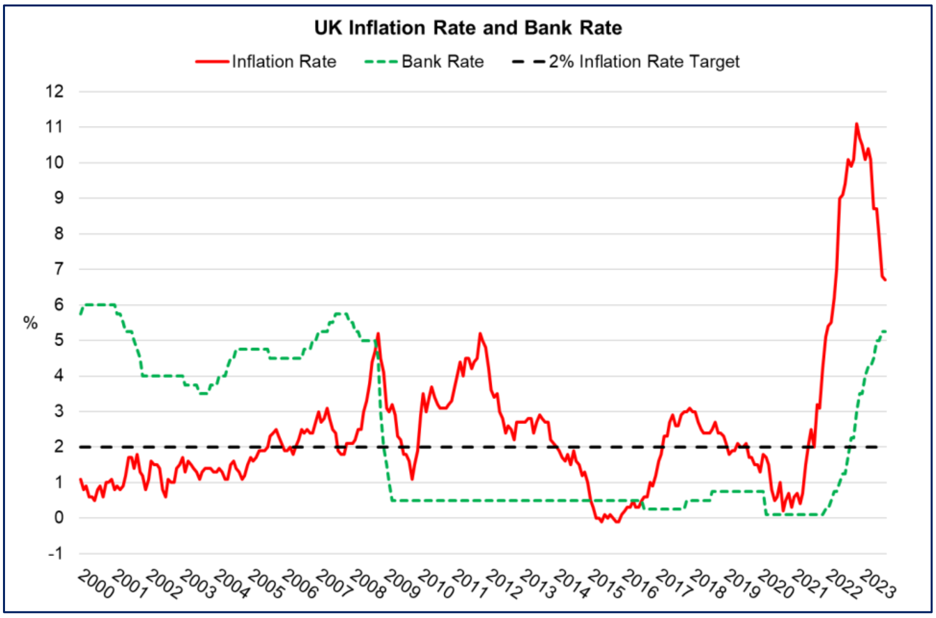


- Overall, annual consumer price inflation rates are on a downward trend, however the price index level remains 21% higher than at the start of 2021, illustrating the rapid increase in the overall price level facing consumers over this period.

- In response to latest inflation and wider economic data the Bank of England's Monetary Policy Committee (MPC) voted by 5 to 4 to maintain Bank Rate at 5.25% in September, unchanged

[3] Energy price cap | Ofgem. The values used from July 2023 are based on the new Typical Domestic Consumption Values approach by Ofgem.

from the previous meeting in August. This was the first pause in the current sequence of Bank Rate rises since December 2021 having risen at fourteen consecutive MPC meetings.[4]



- The Bank Rate remains at its highest rate since 2008 and is expected to remain at restrictive rates to support the fall in inflation back towards the 2% target in the medium term. Markets currently expect the Bank Rate to average slightly under 5% over the next 3-years, which is slightly lower than expectations in August and reflects the easing in inflationary pressures.

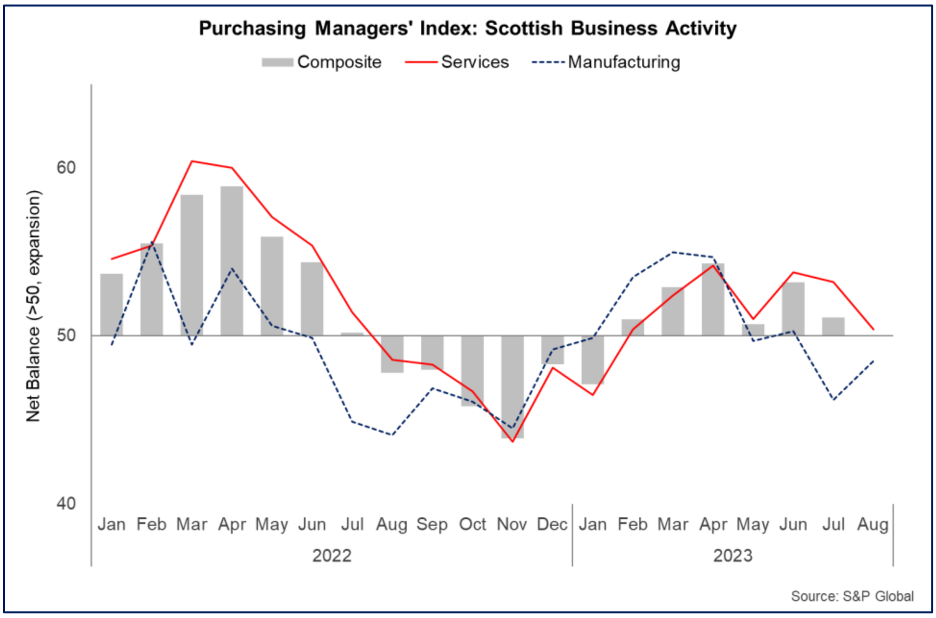
Business Conditions

Business conditions remain challenging with slowing business activity and persistent cost pressures further weighing on business optimism.

Business Activity

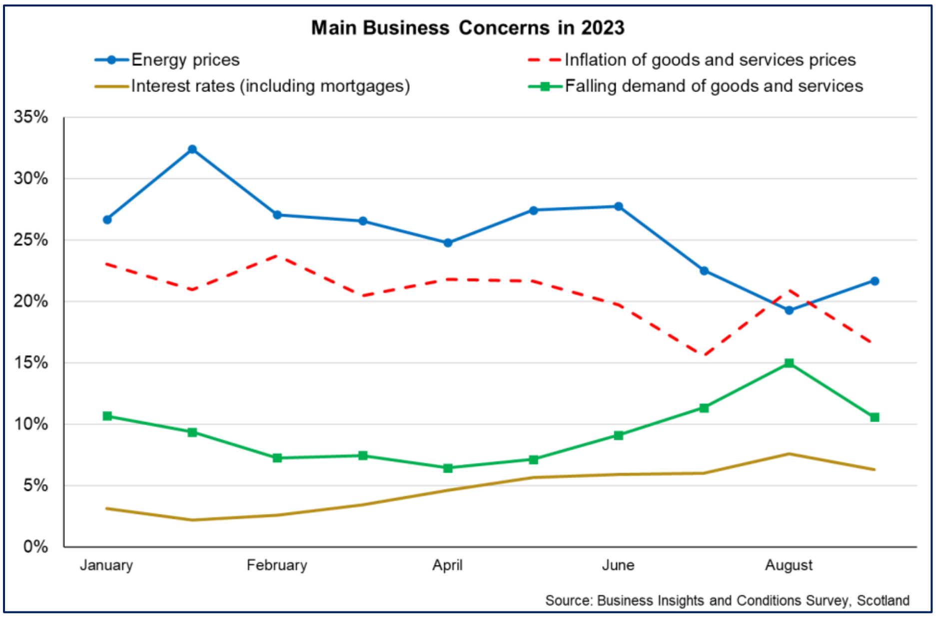
- The Purchasing Managers Index (PMI) business survey indicates that the pace of business activity in Scotland's private sector has slowed over the second quarter and through July and August.[5]
- The business activity indicator fell to the 50 no change mark in August, its lowest rate since January, driven by a further moderate fall in manufacturing activity (48.5) accompanied by a notable slowing in services activity growth (50.4).
- A key element of weaker business activity was a broad based fall in new business orders across the manufacturing and services sectors, with respondents citing that weakening demand reflected inflationary pressures, economic uncertainty and the cost of living.

[4] Bank rate maintained at 5.25% - September 2023 | Bank of England
[5] Royal Bank of Scotland PMI report for August 2023 | Royal Bank of Scotland (rbs.co.uk)



Business Concerns

- The factors weighing on demand reflect the broader concerns that business are currently reporting on business conditions.
- The main concerns reported by businesses in the Business Insights and Conditions survey (BICS) for September is inflation of goods and services prices (16.5%) and energy prices (21.7%). The share of businesses reporting these as their main concern have fallen from their 39% peaks in the second half of 2022, indicating that businesses have been adjusting to the inflationary pressures of energy and goods and services over this period.[6]



- The Scottish Chambers of Commerce Quarterly Economic Indicator also showed that concern over inflation had eased generally in the second quarter, however at a sector level remained

[6] [Business and innovation statistics - gov.scot (www.gov.scot)]

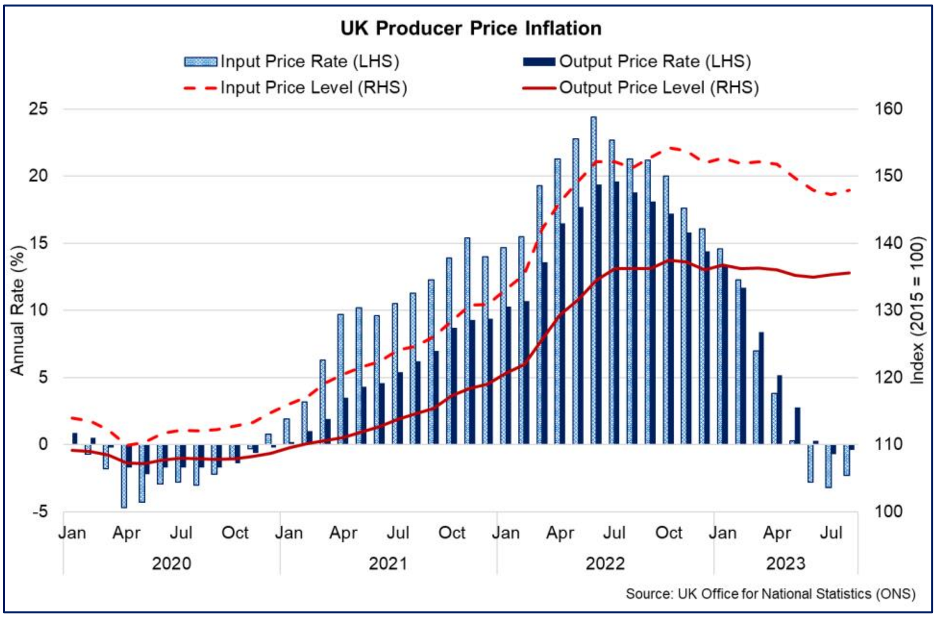
highest in construction, retail and tourism. In the retail sector in particular, the increased concern reflected the risks that sustained high inflation would have on consumer spending power. [7]

- Furthermore, the Scottish Chambers of Commerce Quarterly Economic Indicator and the Scottish Business Monitor report that labour costs have become the main cost pressure for businesses in the first half of 2023 and are expected to remain so over the next 6-months.[8]
- Rising interest rates and borrowing costs are also an increasing concern for businesses with 6.3% of respondents reporting interest rates as the main concern for their business which has been on an upward trend over the past year (up from 1.7% in September 2022). Furthermore, 10.6% of businesses are concerned about falling demand of goods and services, which has also been on an upward trend in recent months reflecting the ongoing concerns business have regarding the headwinds facing domestic and international demand from higher cost of living and borrowing costs.

Business Costs

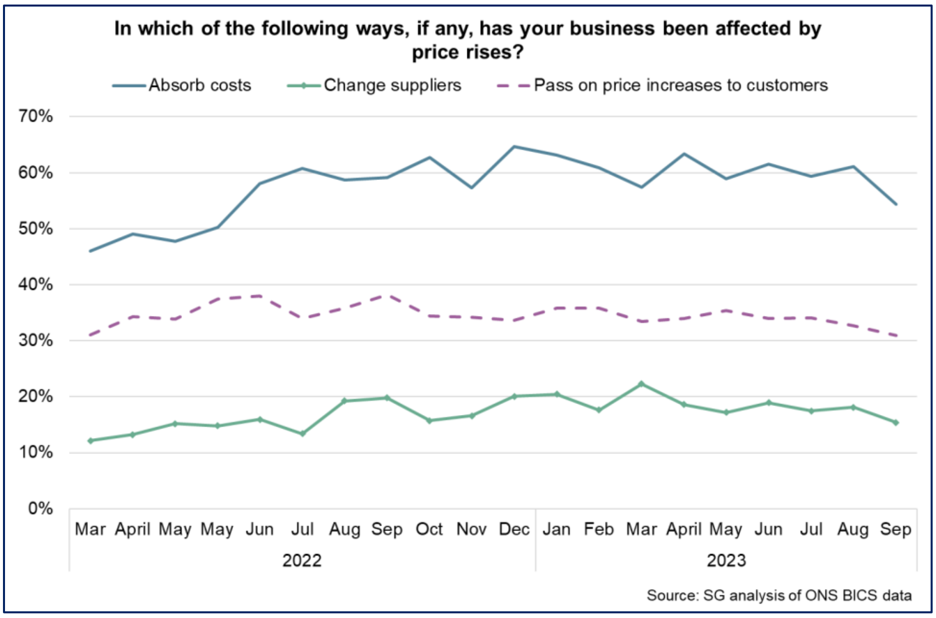
- As set out above, cost pressures remain a key concern for business having faced rapid increases over the past eighteen months, and their source and the response by businesses have continued to evolve into the second half of the year.
- Producer input price inflation (prices of goods bought and sold by UK manufacturers, including price indices of materials and fuels purchased and factory gate prices) fell by 2.3% over the year to August, their third consecutive month of annual decline with input price inflation having recently peaked at 24.4% in June last year.
- The change in input prices has also been reflected in producer output prices which fell by 0.4% in the year to August, their second consecutive month of decline, down from the recent output price inflation peak of 19.9% last July. [9]

[7] Quarterly Economic Indicator - Scottish ChambersScottish Chambers
[8] Scottish Business Monitor, 2023 Q2 | FAI (fraserofallander.org)
[9] Producer price inflation, UK Statistical bulletins - Office for National Statistics (ons.gov.uk)



- The moderation of energy and wider commodity price inflation has been a key driver of falling producer price inflation with crude oil input costs falling 21.8%. However food commodity prices have not fallen to the same extent and food materials continued to provide upward cost pressure with imported food materials costs rising 15.1% over the year. Furthermore, while the pace of fuel input cost inflation has eased in recent months, it remained elevated in August at 22.9%.
- Overall, while annual producer price inflation rates have turned negative, with prices in some sectors falling, the index levels for input and output prices are 27.4% and 23.8% higher than at the start of 2021, illustrating the rapid rise in producer price levels over this period as a whole.
- Looking across a broader range of input costs (energy, materials and staffing) the PMI business survey indicates that cost burdens continued to rise in August, albeit at a significantly slower rate than over the past year and at one of its lowest rates since February 2021.[10]
- BICS data for Scotland provide latest insights into the effects on businesses of price rises. In September, 54% of businesses reported that they had to absorb costs, 31% reported having to pass on price increases to customers and 15% had to change suppliers. A much lower percentage of firms reported having to reduce staff work hours (3.4%), make redundancies (1.9%) or access more financial support (7.8%), however the latter has been on an upward trend.[11]

[10] Royal Bank of Scotland PMI report for August 2023 | Royal Bank of Scotland (rbs.co.uk)
[11] Business and innovation statistics - gov.scot (www.gov.scot)



- Both the scale and persistence of cost increases is an issue for firms. The Scottish Business Monitor highlights the risk to the ability of businesses to continue absorbing costs going forward. The survey for Q2 2023 found that 74% of those firms absorbed up to 50% of their increased costs. However, 35% of firms reporting that they cannot absorb costs anymore, 36% of firms expect to only be able to absorb costs for the next year, and 14% of firms are unsure how much longer they can absorb costs for.[12]

Business Investment

- The combination of business concerns around inflationary pressures, higher interest rates and weakening demand is impacting on business investment decision making.

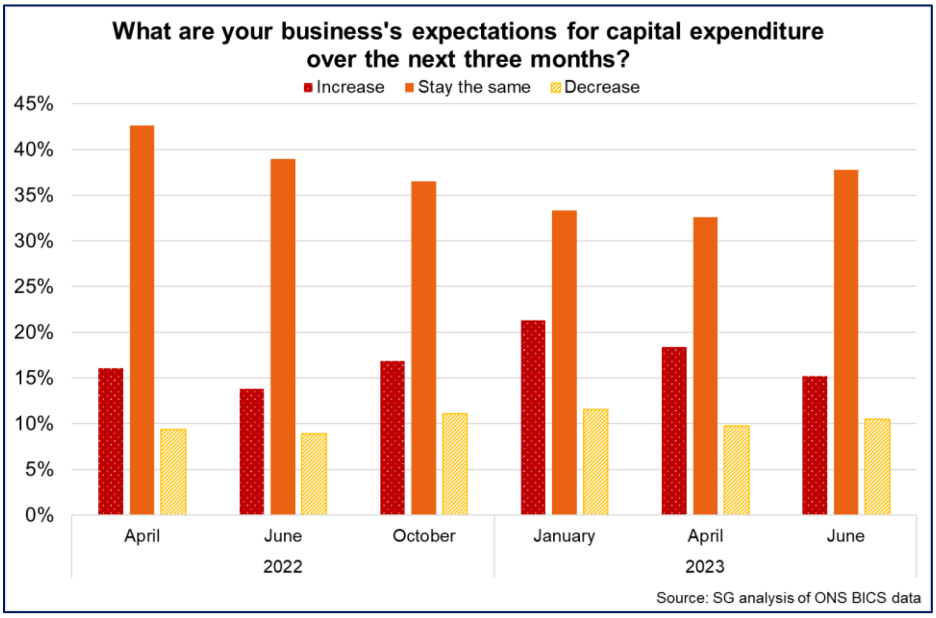
- The Scottish Business Monitor indicates business investment remained weakened in the second quarter of 2023, with 40% of businesses cancelling or delaying planned investment over the last 12 months. Reported reasons were economic uncertainty (75%), affordability (71%) and borrowing costs (38%).[13]

- The Scottish Chambers of Commerce Quarterly Economic Indicator reported a similar stalling in businesses investment (particularly in training investment) with over half of those in financial and business services reporting no change in investment, the retail sector observing a notable fall in capital investment and over half of firms in tourism reporting that they had pulled investment altogether. [14]

- At a UK level, the Bank of England Agents' Summary of Business Conditions for Q3 2023 indicated that business investment intentions, particularly construction, remained subdued due to

[12] Scottish Business Monitor, 2023 Q2 | FAI (fraserofallander.org)
[13] Scottish Business Monitor, 2023 Q2 | FAI (fraserofallander.org)
[14] Quarterly Economic Indicator - Scottish ChambersScottish Chambers

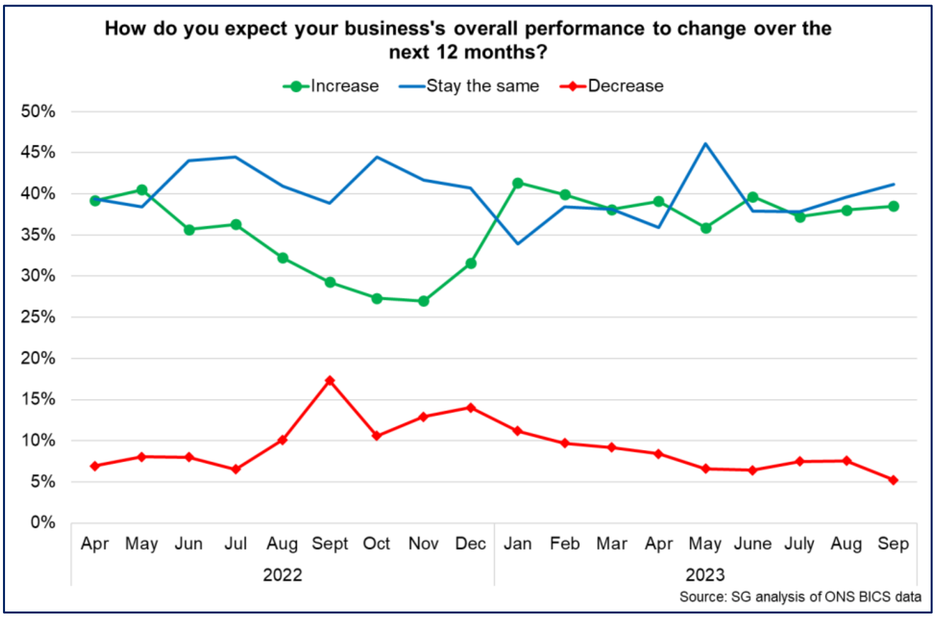
higher investment costs and pressure on cash flow and margins, while investment intentions in IT, digital and automation remained stronger.[15]



- BICS data for Scotland at the end of June and start of July show 15.2% of respondents thought their capital expenditure would increase over the next three months, showing a slight improvement from the middle of last year but lower than the start of this year, while around 10.5% of respondents continue to expect to decrease capital expenditure over the coming year.

Business Optimism

- Looking ahead PMI business survey data indicates that business confidence remains positive on balance however has fallen to its weakest rate since the start of the year, reflecting the ongoing challenging economic environment, inflationary pressures and recruitment challenges.[16]



15 Agents' summary of business conditions - 2023 Q3 | Bank of England
16 Royal Bank of Scotland PMI report for August 2023 | Royal Bank of Scotland (rbs.co.uk)

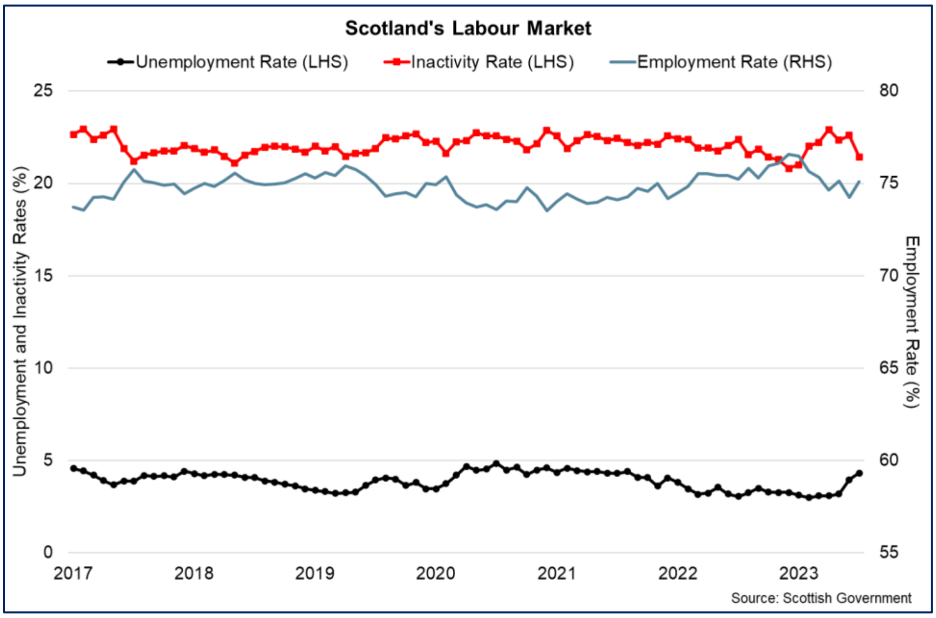
- BICS data for Scotland also indicates that the level of business optimism has eased from the start of the year and has been stabilising between July and September with 39% of firms expecting their performance to increase, 5% expecting it to decrease and 41% expecting it to stay the same.[17]

Labour Market

The labour market has softened slightly with a pick-up in unemployment accompanying further slowing in recruitment activity.

Employment, Unemployment and Inactivity

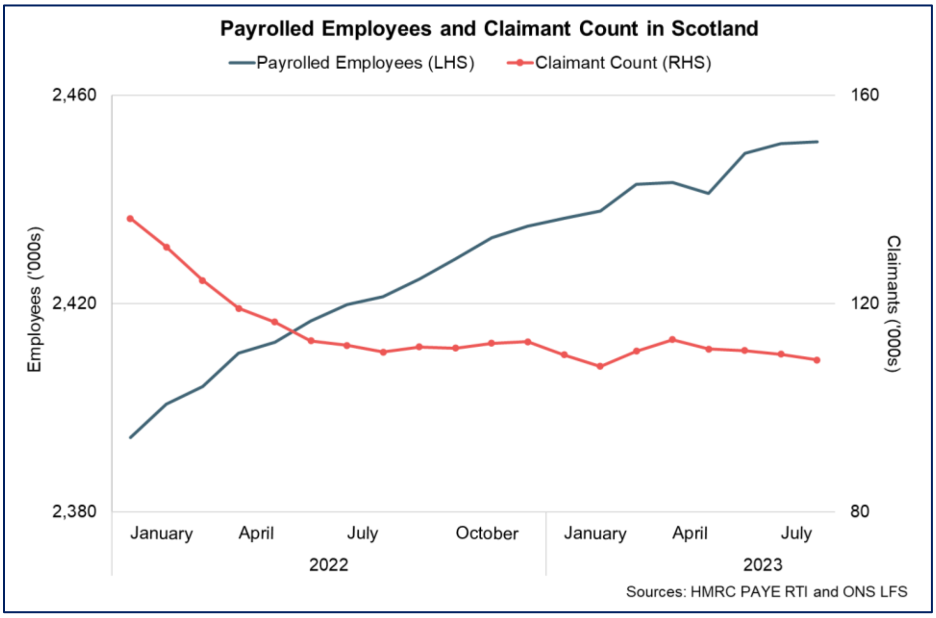
- Labour market conditions in Scotland and the UK as a whole have been very tight over the past eighteen months and have been resilient in the face of subdued GDP growth and inflationary pressures. This has been characterised by low unemployment, strong demand for labour with elevated vacancy rates and some companies reporting staffing shortages.
- Latest LFS data for May to July indicates that Scotland's labour market may have slightly softened. Unemployment rose by 37,000 over the quarter, with the unemployment rate rising to 4.3% (same as UK). However, this coincided with a rise in the employment rate (to 75.1%) and a fall in economic inactivity (to 21.4%), indicating that the recent shift was driven by inactive people moving into economic activity and either securing work or actively seeking employment.[18]



- Wider labour market data indicates recent trends have stabilised with no clear decrease in staffing levels. The number of PAYE employees in Scotland continued its upward trend since the

[17] Business and innovation statistics - gov.scot (www.gov.scot)
[18] Labour market statistics - gov.scot (www.gov.scot)

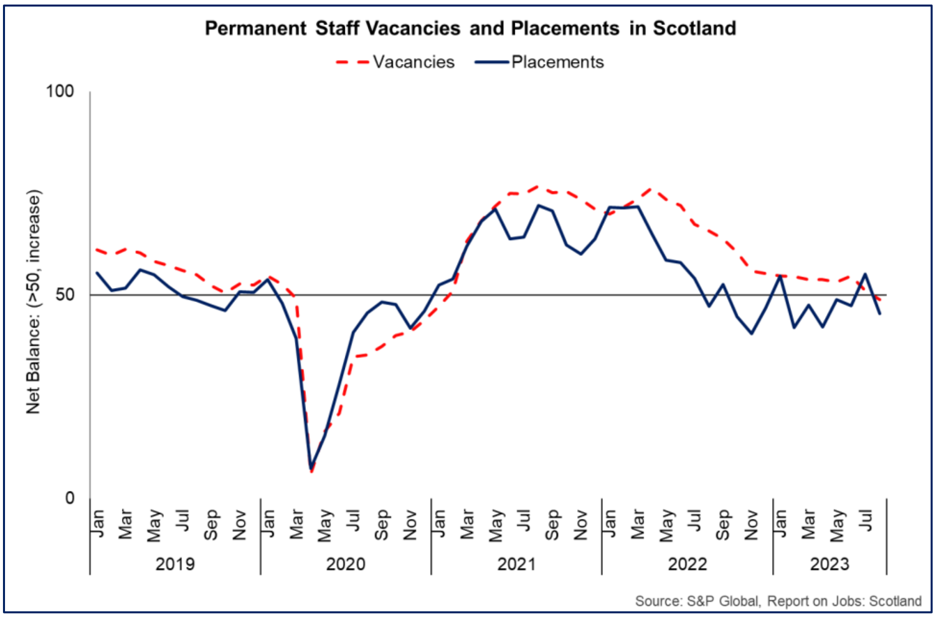
start of the year to 2.5 million, though was largely unchanged over the month of August, while Scotland's claimant count rate remained unchanged at 3.6%.



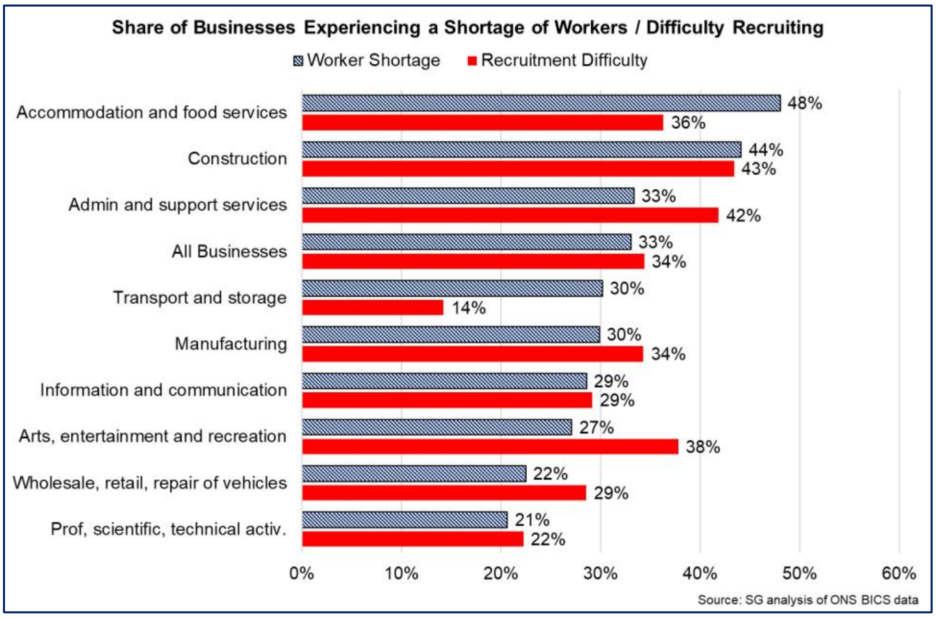
Recruitment Activity

- Business survey data also signal that the extent of tightness in the labour market following the pandemic has cooled slightly over the course of the year as recruitment activity has slowed.
- The RBS report on Jobs for August signalled that growth in permanent staff placements fell over the month and has been largely negative since the start of the year following a period of robust growth over 2021 and 2022. This reflects a general slowing in the growth in vacancies, which contracted in August for the first time since the start of 2021. [19]
- Respondents reported the contraction in staff placements was due to weaker economic conditions and skilled labour shortages.

[19] S&P Global, RBS Report on Jobs: Royal Bank of Scotland PMI® - August 2023 | NatWest Group



- BICS data provides further insights on labour shortages and recruitment challenges across sectors. At the start of September, 33% of businesses reported experiencing a shortage of workers and 34.4% reported experiencing difficulties recruiting employees; both down from their peaks of 44.5% and 42.8% in September 2022.[11]
- At a sector level, worker shortages remain most reported in Accommodation and Food Services (48%) and Construction (44%), with most businesses (63.5%) reporting that worker shortages led to employees working increased hours or the business was unable to meet demands (41.6%).
- Recruitment difficulties were also most reported in the Construction sector (43.4%) alongside admin and support services (41.8%). Latest data from the start of July shows most businesses responded that a low number of applications (66.4%) and a lack of qualified applicants (53.4%) were reasons for why they experienced difficulties in recruiting employees, while 27.1% reported not being able to afford an attractive pay package to applicants.



Earnings

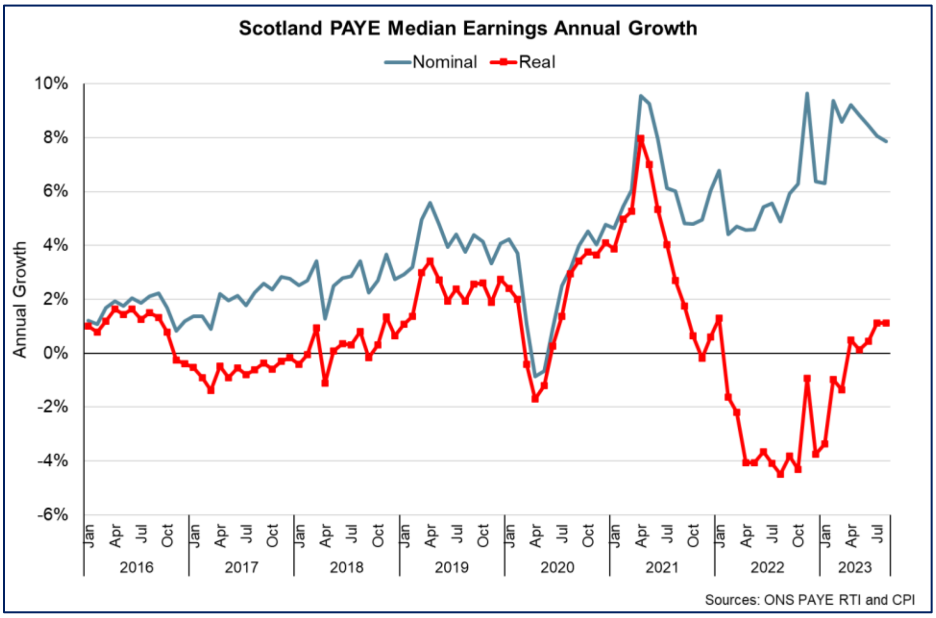
- Recruitment challenges, staffing shortages and inflationary pressures have generated upward pressure on earnings over the past year, however there are indications that this has started to ease.

- The RBS Jobs Report for August indicates that growth in starting salaries remains robust (net balance of 61.7), though the pace of growth has softened compared to last year from its peak of 82.8 in March 2022.

- More broadly, nominal median monthly PAYE pay in Scotland was £2,292 in August, up 7.9% over the year. This remains above the average annual growth rate over the past eight years (3.8%), however has slowed from higher rates of growth over the past year, peaking at 9.4% in February.[20]

- Adjusting for inflation, which was 6.7% in August, real median earnings grew 1.1% on an annual basis. This was the fourth consecutive month of positive growth following the period of falling real pay during 2022 and the start of 2023, reflecting the easing in inflationary pressures in recent months.

[20] Earnings and employment from Pay as You Earn Real Time Information, seasonally adjusted - Office for National Statistics (ons.gov.uk)

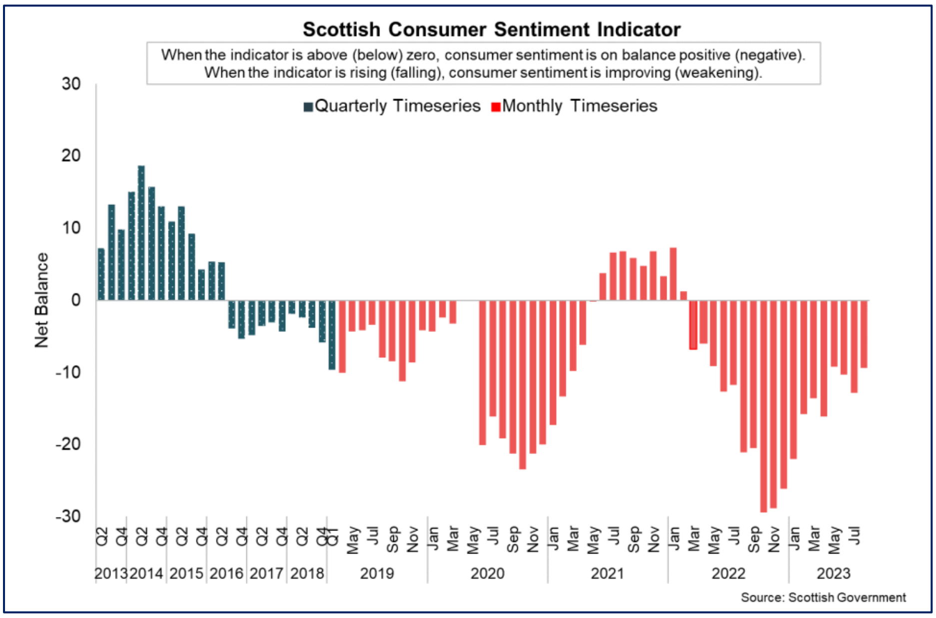


Consumer Activity

Inflation and higher interest rates are weighing on consumer sentiment and activity.

Consumer Sentiment

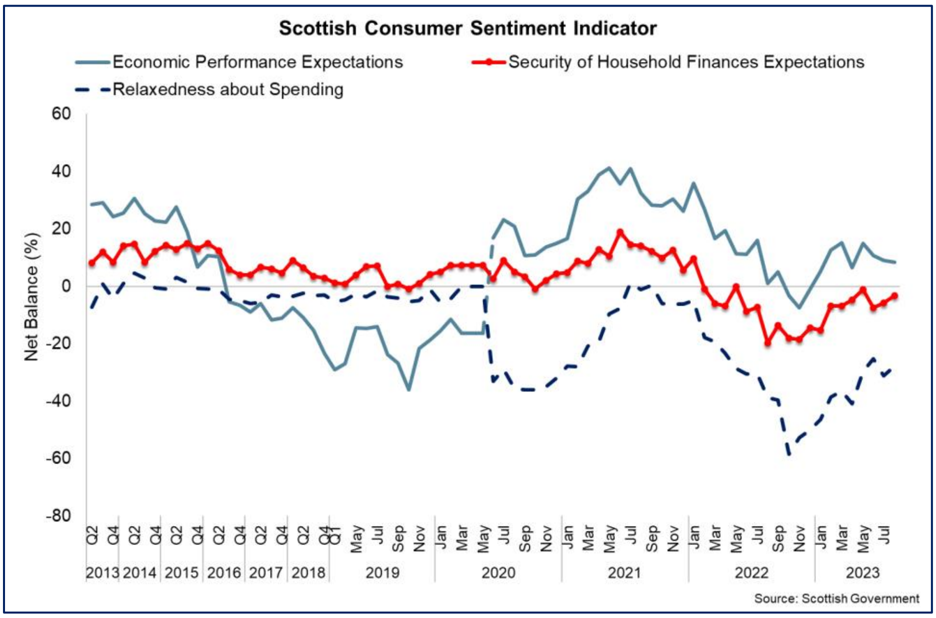
- Consumer sentiment indicators reflect the pressures that households face from higher inflation and interest rates and highlight the risks of weak consumer confidence to the economic outlook.
- Following a sharp drop in sentiment in 2022 to a low of -29.4 in October, latest data show that the gradual recovery in sentiment since then has paused in recent months. In August, the consumer sentiment Indicator increased by 3.5 points to -9.4, however fell over June and July and is now back broadly in line with its level in May (-9.2). [21]



[21] Economy statistics - gov.scot (www.gov.scot)

- While sentiment has improved from last year, it remains negative overall and reflects the concerns that households have for the economy, their household finances and how relaxed they feel about spending money.

- Repondents continue to report that the economy and their household financial security are worse than last year, however on balance expect the economy to grow over the coming year (8.5). In contrast respondents still expect their houdehold financial security to worsen over the coming year (-3.2). Consistent with the concerns for housholds financial security, respondents on balance do not feel relaxed about spending money currently (-27.7).



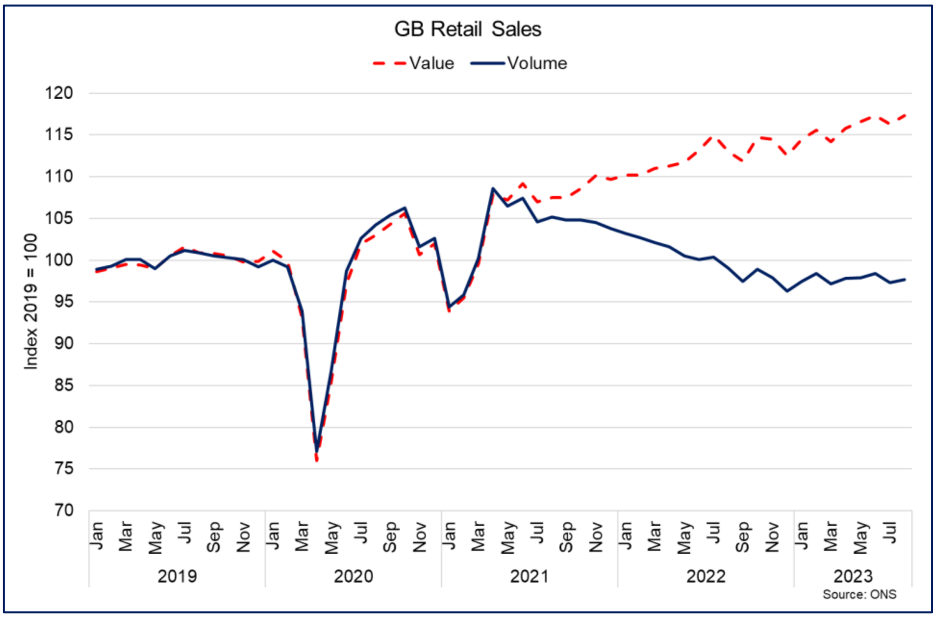
- The indicators have strengthened over the year, reflecting improving sentiment, however have stabilised in recent months and likley reflects the persistant impacts that inflationary pressures are having on household finances and the increasing impacts of rising interest rates on the cost of existing and new borrowing.

Cost of Living and Spending

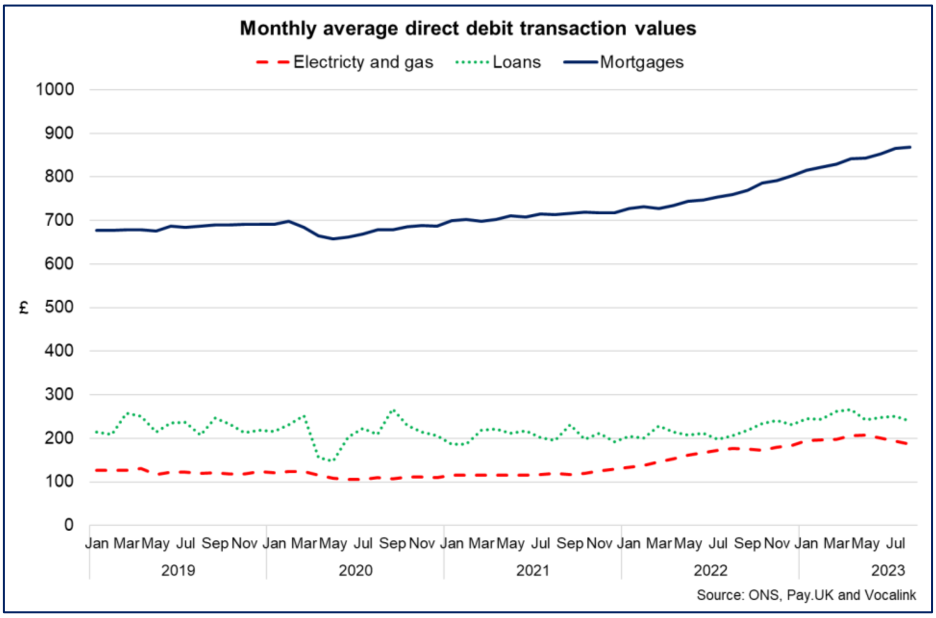
- The rise in cost of living and higher interest rates have progressively fed through to household decisions on spending (essential and non-essential) saving, and borrowing (including financing outstanding borrowing).

- For example, retail sales volumes in Great Britain have broadly stabilised over 2023 having adjusted back towards pre-pandemic levels over 2022. Latest data show sales volumes fell 1.4% over the year to August, however sales value grew 3.8%, with the divergence continuing to reflect the pace of rising prices over the past 18-months.[22]

[22] Retail sales, Great Britain - Office for National Statistics (ons.gov.uk)

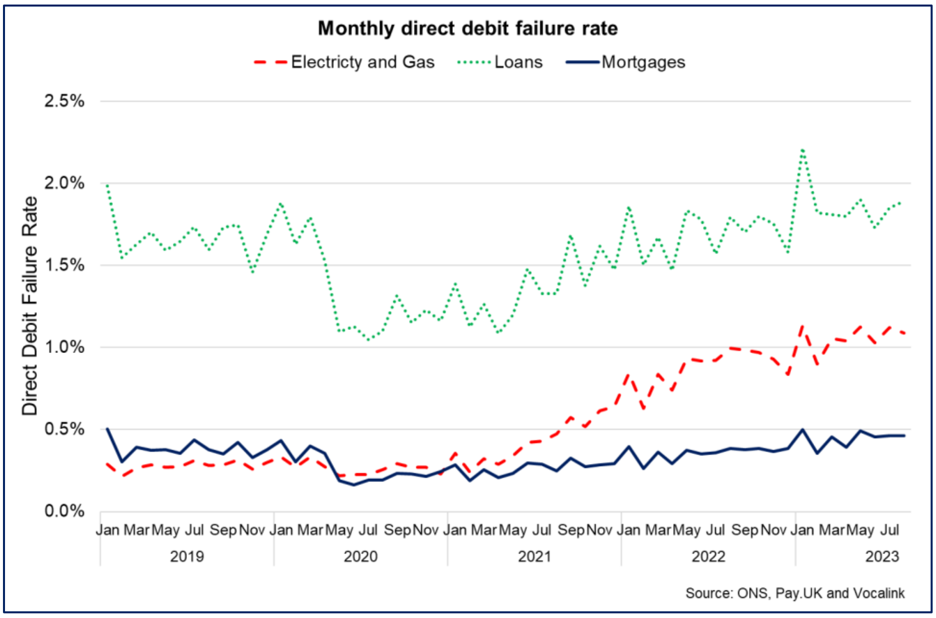


- Similarly the rise in prices and interest rates have had a significant impact on the amount UK conumers are paying for their energy costs, mortgages and other loans. In August the average monthly direct debit payment for electricity and gas was £186.46 (up 56% compared to August 2021), £868 for mortgages (up 22%) and £239 for loans (up 23%).[23]

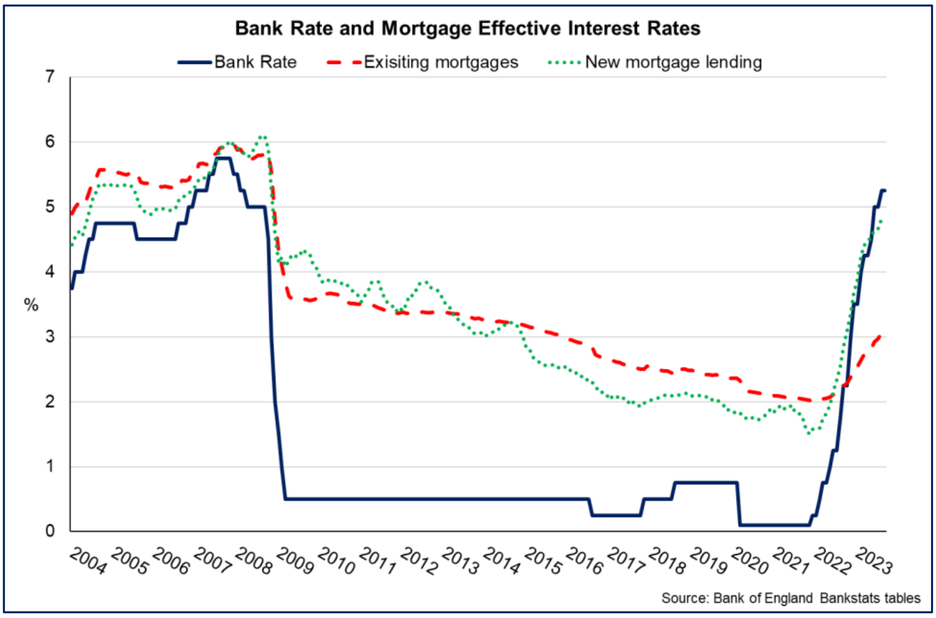


- The sharp increase in prices has been accompanied by an increase in the direct debit failure rate (the percentage of transactions that fail due to insufficient funds), reflecting the challenges facing some household budgets. For electricity and gas payments, the payment failure rate has risen to 1.09% in August, up from 0.47% in August 2021, while for mortgages it has risen to 0.46% (up from 0.25%).

[23] Monthly Direct Debit failure rate and average transaction amount - Office for National Statistics (ons.gov.uk)

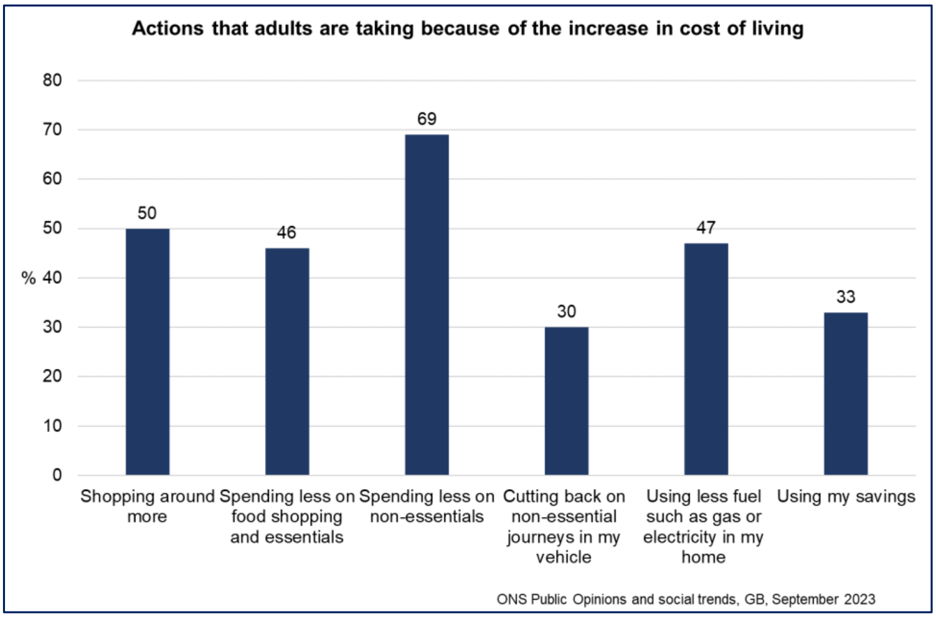


- More broadly in September, the ONS Public Opinions and Social Trends survey showed that 42% of respondents were finding it very or somewhat difficult affording both energy bill payments and mortgage and rent payments. For energy bills, this was slightly lower than at the same point in 2022 (c. 46%), however has risen for mortgages payments from c.31%.[24]
- The more gradual but recent impacts of rising interest rates on mortgage payment challenges compared to energy payments, reflects the rise in interest rates over the past year but also the time it takes for the full impact of the increase in Bank Rate to be felt at an aggregate level due to the high share of mortgages that are on a fixed rate.



[24] Public opinions and social trends, Great Britain - Office for National Statistics

- Reflecting this, the 'effective' interest rate – the actual interest paid – on newly drawn mortgages rose by 16 basis points to 4.82% in August while the rate on the outstanding stock of mortgages saw a 9 basis point increase to 3.06%.[25]
- In response to the change in cost pressures facing households, ONS Public Opinions and Social Trends survey data from September show that the most common actions people were taking in response to the increased cost of living were spending less on non-essentials (69%) and shopping around more (50%). 47% reported using less fuel such as gas or electricity in their home and 46% reported spending less on food shopping and essentials.



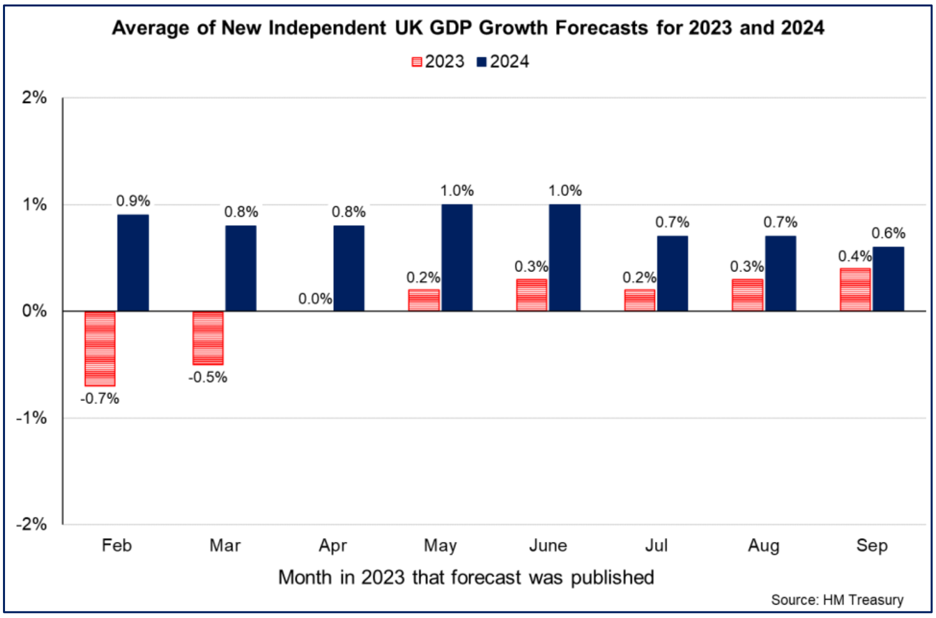
Economic Outlook

Forecasts continue to indicate positive GDP growth however recent weakening in consumer and business sentiment highlights the uncertainty that persists.

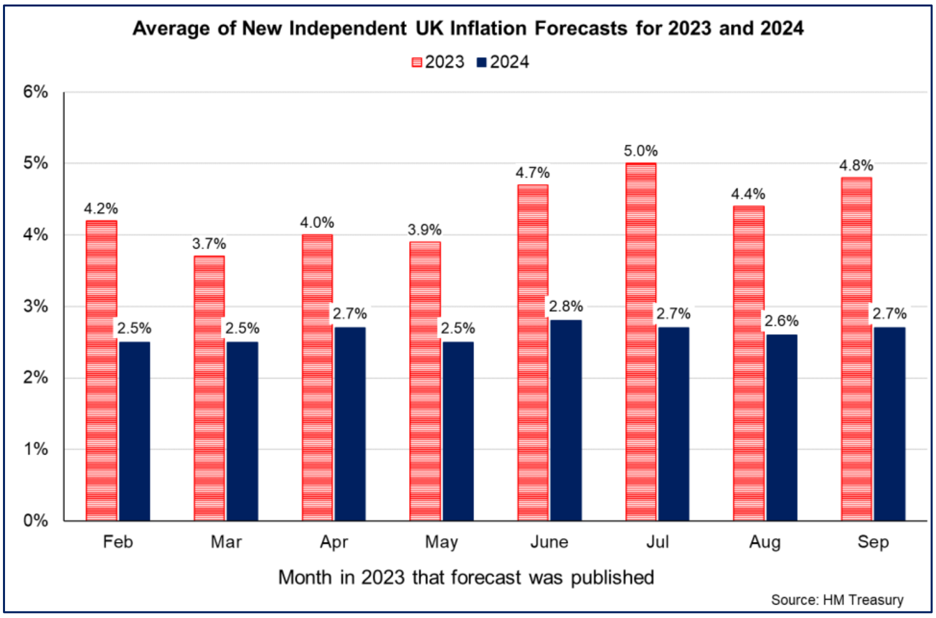
- In May the Scottish Fiscal Commission forecast Scotland's GDP to remain positive but subdued in 2023, growing 0.2% over the year before picking up to 0.9% in 2024 and 1.3% in 2025.[26]
- Economic data since then shows that GDP growth has remained broadly flat and there has been a slight softening in the labour market, while the gradual cooling of inflationary pressures has led to a pause in the current sequence of monetary tightening. Conditions for households and businesses remain challenging however with inflation still a way to go before getting back to the 2% target and the full impacts of previous interest rate rises still to be felt.
- The average of more recent UK forecasts (published in September) indicates a similar outlook pattern to the SFC forecast with UK GDP forecast to grow 0.4% in 2023 rising to 0.6% in 2024.

[25] Effective interest rates - A visual summary of our data | Bank of England
[26] Scotland's Economic and Fiscal Forecasts – May 2023 | Scottish Fiscal Commission

Furthermore, it continues to present a more resilient outlook than was forecast at the very start of the year, despite expectations for 2024 moderating slightly.[27]



- The average new forecast for inflation is that it will fall to 4.8% in the final quarter of 2023 before falling further to 2.7% by the end of 2024. This is a slightly slower than was forecast earlier in the year, reflecting the underlying persistence of current inflationary pressures.



- Overall, the resilience in economic output and the labour market, coupled with easing inflation pressures over the year has been positive. However the recent weakening in business activity alongside the weakening in business and consumer optimism highlights the risks and uncertainty in the economic outlook and the challenges in navigating the current economic environment.

[27] Forecasts for the UK economy - GOV.UK (www.gov.uk)

This publication is available at **www.gov.scot**

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The Scottish Government
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Edinburgh
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