Scottish Economic Bulletin

Office of the Chief Economic Adviser

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Scottish Government
Riaghaltas na h-Alba

Contents

Data up to: 20 December 2023
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Cover page Image of peat sampling at Blawhorn Moss © Dougie Barnett NatureScot

Overview

This month's bulletin updates on the latest economic data which provide further emerging insights into the final quarter of the year. This follows the recent Scottish Government budget, and the updated official outlook for the Scottish economy published by the Scottish Fiscal Commission (SFC). The budget continues to support investment in public services, in part funded by tax increases on higher earners, which the Commission has judged not to be economy moving.

Latest data show Scotland's GDP grew 0.2% in the three months to October, down from 0.4% in the three months to September. This reflected a sharp fall in output of 0.5% during the month of October (-0.3% across the UK as a whole) with anecdotal evidence indicating that the winter storms and exceptionally wet weather during the month impacted on business activity across sectors.

Over the three months to October, growth was driven by the services sector (0.1%) and production sector (1.4%) offsetting a fall in construction sector output (-0.4%). Within the production sector, manufacturing output continued its downward trend, falling 1.4% in the three months to October and has now fallen 5.6% over the past year. In the services sector, consumer facing services grew 0.2%, with growth across hospitality and recreational activities, while retail output continued to contract.

Business conditions remain challenging, however falling inflationary pressures over 2023 (including input costs) is providing a welcome albeit gradual easing in cost pressures for businesses and households. Cost pressures related to wage and energy costs remain key concerns for business, alongside weakening new orders as interest rates continue to squeeze demand and spending in the economy. That said, business optimism for output growth over the year ahead has remained resilient, partly reflected in businesses continuing to add to their staffing levels, though economic uncertainty is continuing to impact on wider business investment intentions.

Latest consumer sentiment data for November shows a slight fall over the month and remains in negative territory. However, sentiment has improved significantly over the past year as inflationary pressures have gradually eased, unemployment has remained low and earnings growth has remained robust with average earnings in Scotland forecast to grow faster than the UK over 2023-24. Despite this, households continue to report challenges relating to mortgage and energy bills and more broadly are less relaxed about spending money in these circumstances.

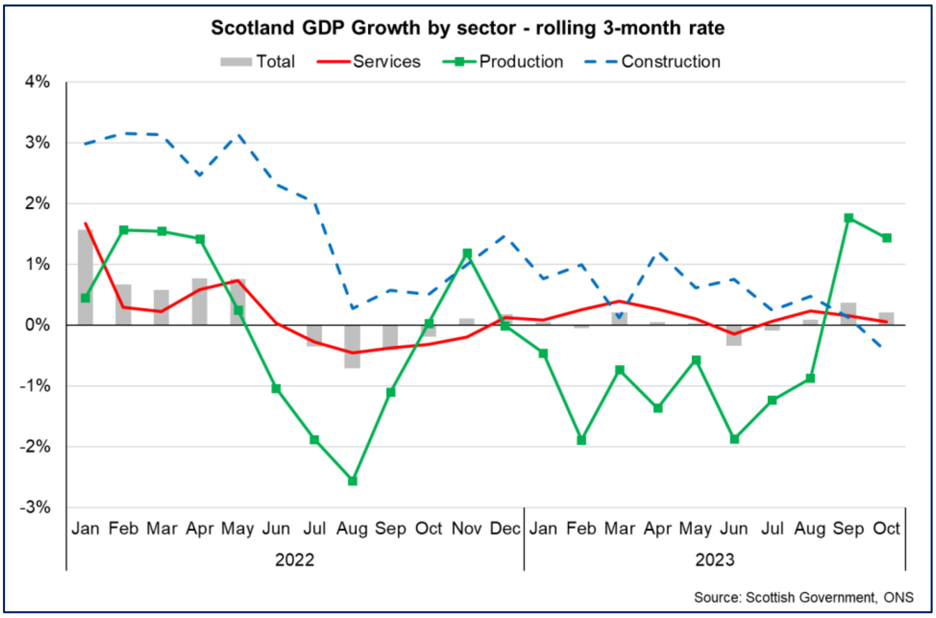
Looking ahead, the SFC forecast GDP growth to remain relatively subdued over 2024 and 2025 with growth of 0.7% and 1.1%. This reflects their view that both inflation and interest rates are expected to remain higher for longer than previously forecast. That said, the resilience of business optimism for the coming year, increased expectations that interest rates may have peaked, the tight labour market with increased earnings growth, improved consumer sentiment, alongside the opportunities for investment in Scotland, provide a strengthening basis for an improving growth outturn in 2024.

Output

Scotland's GDP growth remains subdued going into the fourth quarter of the year.

- Scotland's GDP grew 0.2% in the three months to October, down from 0.4% in the three months to September. This reflected a sharp fall in output of 0.5% during the month of October (-0.3% across the UK as a whole) with anecdotal evidence indicating that the storms and exceptionally wet weather during the month impacted on business activity across sectors.[1]
- More broadly, the level of GDP has remained broadly flat since the start of 2022, reflecting the ongoing weakness in economic growth.

- Growth in the 3-months to October was driven by the services (0.1%) and production (1.4%) sectors, offsetting the first 3-month fall in construction output in two years (-0.4%).



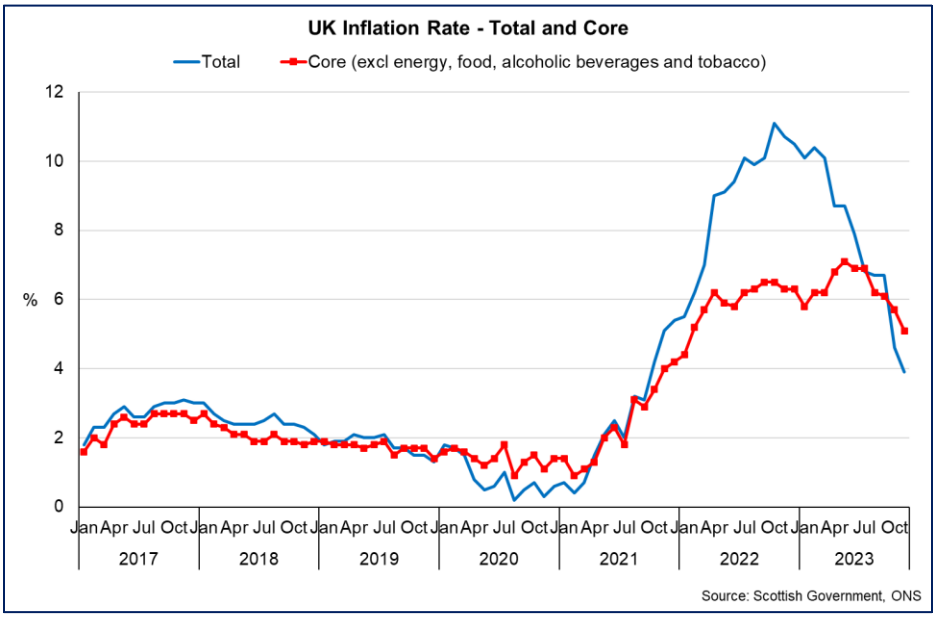
[1] Economy statistics - gov.scot (www.gov.scot) , GDP monthly estimate, UK - Office for National Statistics (ons.gov.uk)

- Within the production sector manufacturing output continued its downward trend, falling 1.4% in the 3-months to October and has now fallen 5.6% over the past year. In the services sector, there was further robust growth in professional, scientific and technical services (1.8%), while consumer facing services grew 0.2%. This was mainly driven by growth in accommodation and food services (0.5%) and arts, culture and recreation (1.1%) while retail output continued to fall (-0.3%).

Inflation

Inflation fell to 3.9% in November and is forecast to fall further over the coming year.

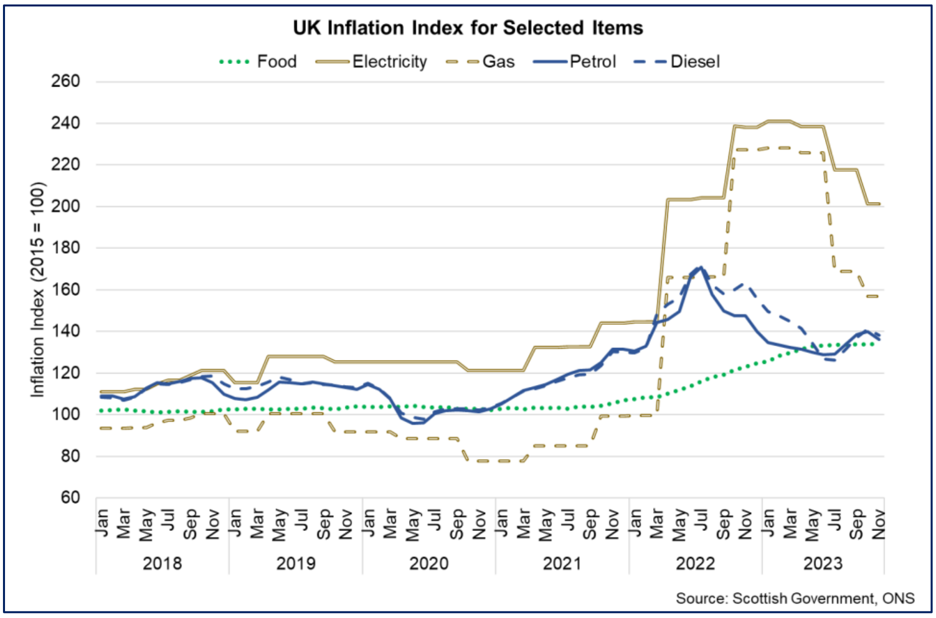
- UK inflation fell to 3.9% in November, down from 4.6% in October and from its recent peak of 11.1% in October 2022, and is at its lowest rate since September 2021.[2]
- The largest downward contributions to the annual rate in November came from transport, recreation and culture and food and non-alcoholic beverages.
- Core inflation, which excludes food, energy, alcohol and tobacco, fell to 5.1% in November, down from 5.7% in October, and while it remains elevated, indicates a further easing in inflation pressures from recent months.



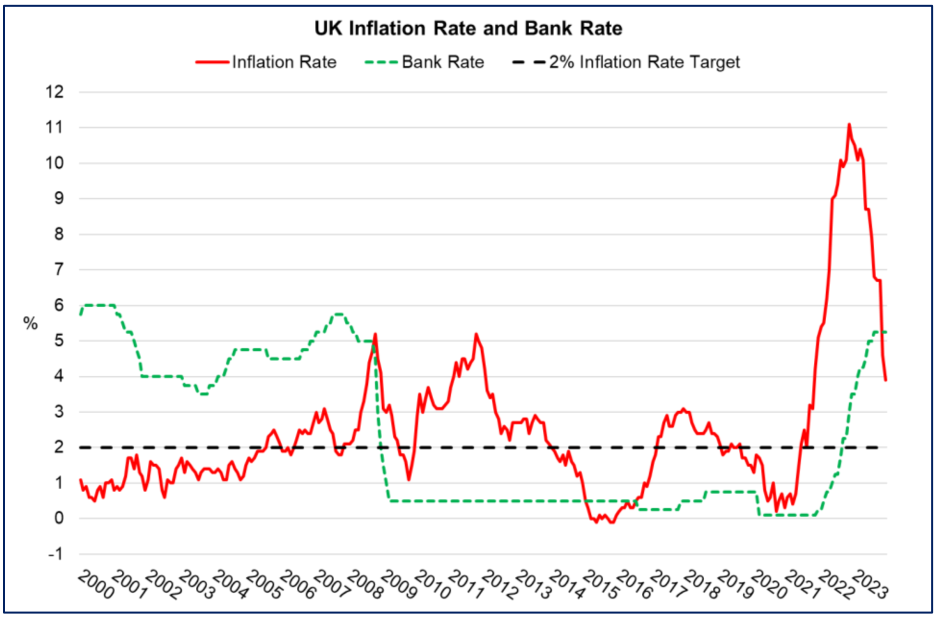
- Considering a selection on items, the food and non-alcoholic beverages inflation rate remains elevated, however its annual rate fell for an eighth consecutive month in November to 9.2% (down from 10.1% in July and from its recent peak of 19.1% in March). Motor fuel prices (petrol and diesel) have been on a downward trend since the end of 2022 and are 7.7% and 15.4% lower respectively compared to last year. However, prices have picked up in recent months with the price index for petrol rising 1.6% since August and by 5.4% for diesel. The electricity and gas

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

price index remains 15.4% and 31% lower compared to last year, partly reflecting the fall in the Energy Price Cap in October.



- 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 recent inflation and wider economic data the Bank of England's Monetary Policy Committee (MPC) voted by 6 to 3 to maintain Bank Rate at 5.25% in December, unchanged since August following fourteen consecutive rises since December 2021 when it was 0.1%.[3]



[3] [Bank rate maintained at 5.25% - December 2023 | Bank of England]

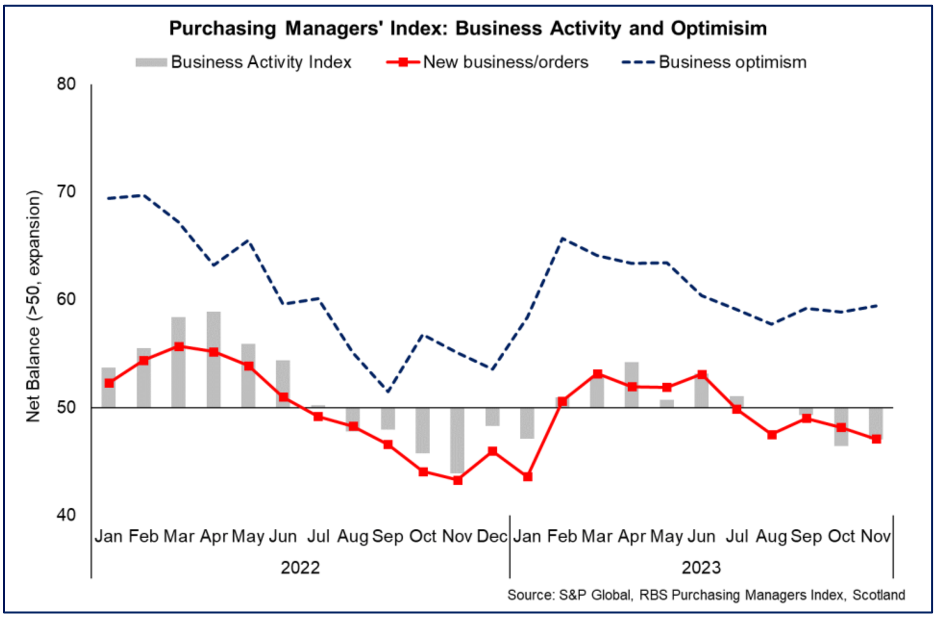
- The Bank Rate remains at its highest rate since 2008 and is expected to remain at restrictive rates to weigh on demand and support the fall in inflation back towards the 2% target in the medium term.
- The Bank's central forecast in November was underpinned by market expectations that the Bank Rate will average 5.25% until Q3 2024 before gradually declining to 4.25% by the end of 2026.[4]

Business Conditions

Business activity has weakened further in the third quarter of the year however business optimism for the year ahead has picked up slightly.

Business Activity

- The Purchasing Managers Index (PMI) business survey indicates that business activity in Scotland's private sector has fallen during the third quarter of the year.[5]
- The business activity indicator was 47.1 in November, slightly improved from October, however was the third consecutive month indicating falling activity with a sharp fall in manufacturing activity (43.2) and a more moderate fall in services activity (48.0).
- A key driver of weaker business activity has been a broad based fall in new business orders across the manufacturing and services sectors, with businesses indicating that weakening demand and economic uncertainty are impacting negatively on sales.

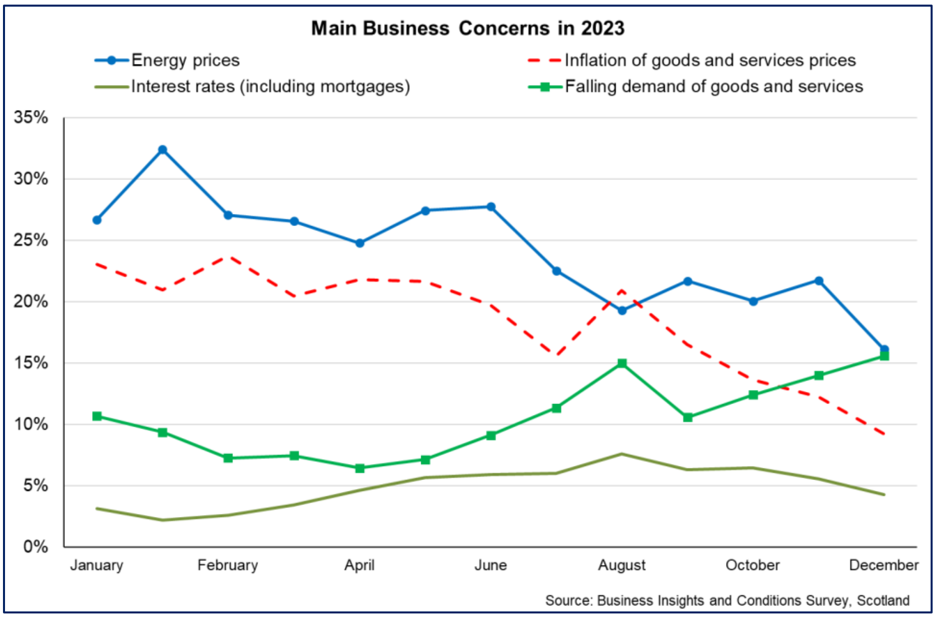


[4] Monetary Policy Report - November 2023 | Bank of England
[5] Purchasing Managers' Index Reports | Royal Bank of Scotland (rbs.co.uk)

- The findings in the PMI business survey are consistent with the Scottish Business Monitor business survey which also, on balance, indicated a fall in the volume of business activity (-1.2%) and volume of new business activity (-9.6%) in Q3 2023.[6]

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 December is energy prices (16.1%) and falling demand of goods and services (15.6%).[7]
- The former, alongside broader concerns about inflation, has been on a downward trend over the past year as inflationary pressures have eased and businesses have continued to adjust to the change in costs of energy, goods and services over this period.
- The Scottish Chambers of Commerce Quarterly Economic Indicator also showed that concern over inflation had eased in the third quarter, however concern remains high overall and across sectors, particularly in retail and tourism.[8]
- In contrast, there has been rising concern over falling demand for goods and services, reflecting the weakness in demand during the year and the uncertainty in the economic outlook for the year ahead.

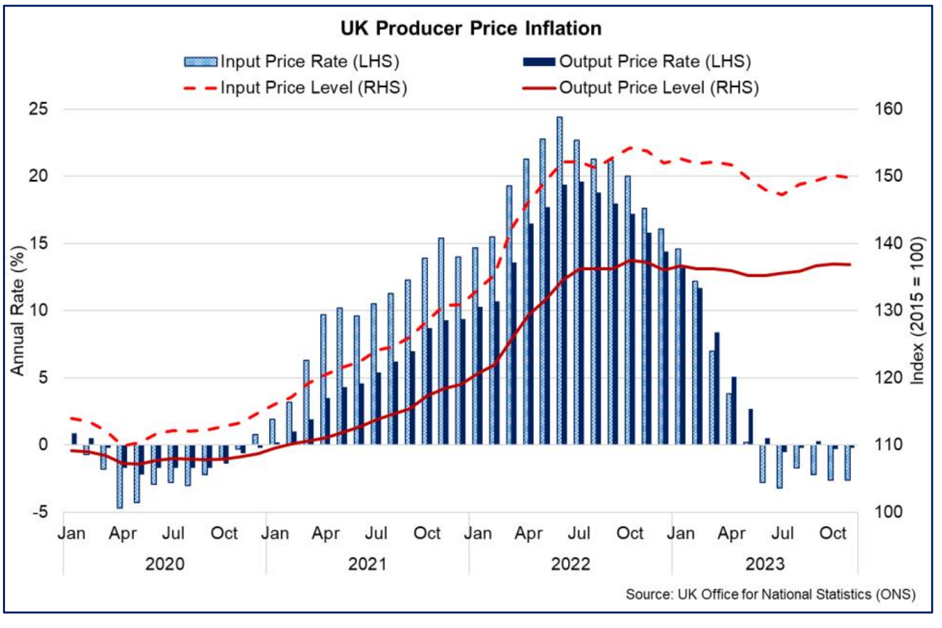


[6] Scottish Business Monitor Q3 2023: Investment a key issue for Scottish firms as business conditions deteriorate | FAI (fraserofallander.org)
[7] Business and innovation statistics - gov.scot (www.gov.scot)
[8] Quarterly Economic Indicator - Scottish ChambersScottish Chambers

- More broadly, the Scottish Business Monitor for Q3 2023 reported that 75% of firms are more concerned than normal about the availability of new staff and 71% about staff retention, while 68% of firms are more concerned than normal about the impact of interest rate rises (a similar proportion to the previous quarter).
- The Scottish Chambers of Commerce Quarterly Economic Indicator for Q3 2023 reported a sharp rise in business concern over interest rates (50%, up from 37%) reflecting the impacts this could have on demand/sales and the cost of borrowing.
- More recently, the BICS data during the fourth quarter of the year shows a declining share of businesses reporting interest rates as a main business concern and may reflect that interest rate expectations have stabilised in recent months with markets expecting that they are at, or near, their peak.

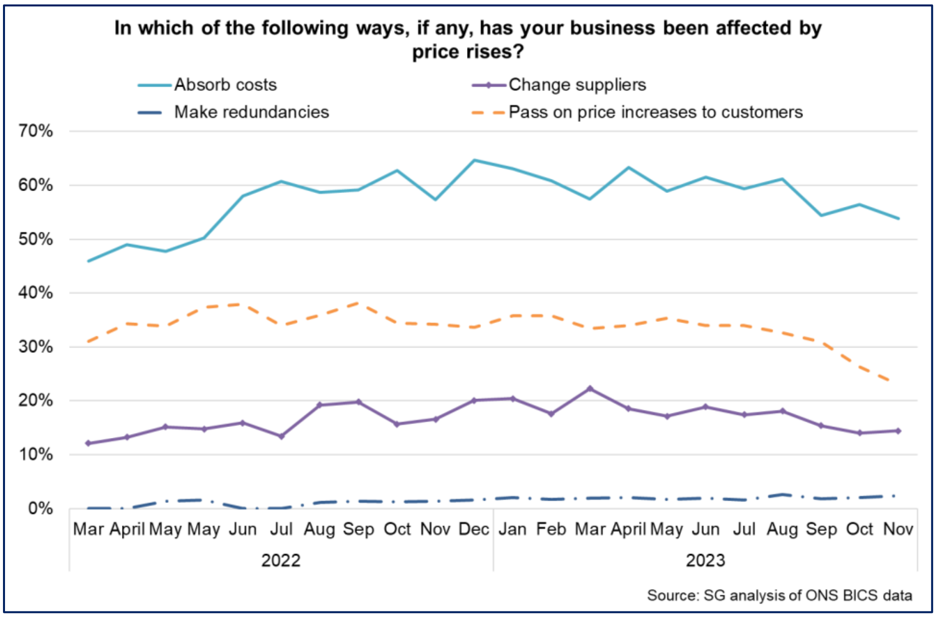
Business Costs

- Cost pressures remain a key concern for businesses following the rapid increase in costs faced by businesses since the start of 2022. In Q3 2023, the Scottish Business Monitor reported that 83% of firms were more concerned than normal about the costs facing business.
- 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 2.6% over the year to November, their sixth consecutive month of annual decline with input price inflation having recently peaked at 24.4% in June last year.[9]
- The change in input prices has also been reflected in producer output prices which fell by 0.2% in the year to November, down from the recent output price inflation peak of 19.6% last July.



[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 6.3%, however imported food material costs rose 8.1% over the year.
- 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 29% and 25% 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 business input costs continued to rise in November, though at one of its slowest rates since the start of 2021.
- The Scottish Chambers of Commerce Quarterly Economic Indicator and the Scottish Business Monitor report that labour costs remained the main cost pressure for businesses in Q3 2023, followed by energy, and are expected to remain so during the coming year.
- BICS data for Scotland provide latest insights into the changing effects on businesses of price rises. In November, 53.9% of businesses reported that they had to absorb costs, 23.1% reported having to pass on price increases to customers and 14.5% had to change suppliers. A much lower percentage of firms reported having to make redundancies (2.4%).

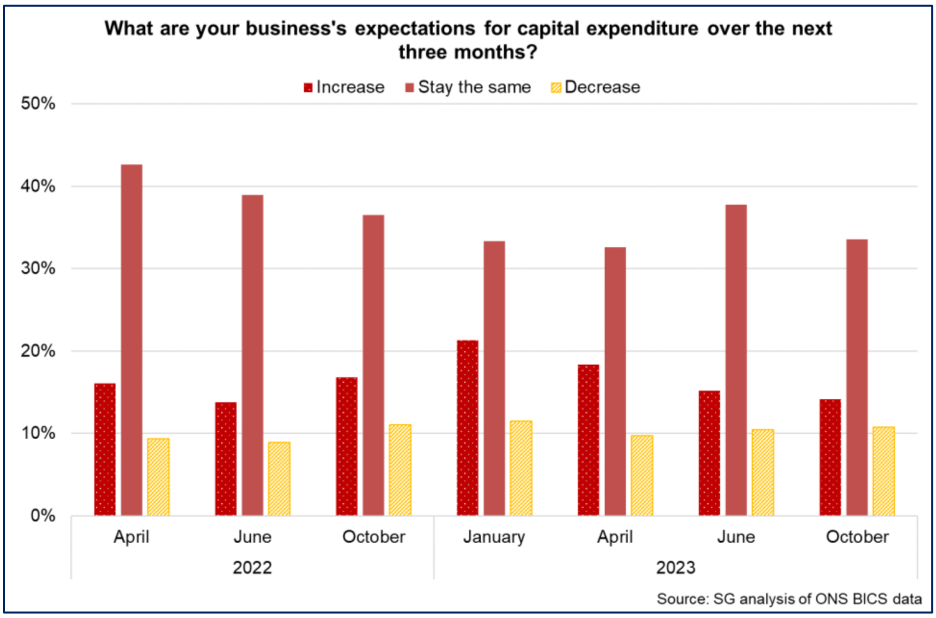


- The slight downward trend in the share of businesses reporting to be absorbing costs potentially reflects the slowing pace of input cost rises while the recent downward trend in businesses reporting to pass on price increases to customers could partly reflect weakening demand facing businesses in the third quarter of the year.

Business Investment

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

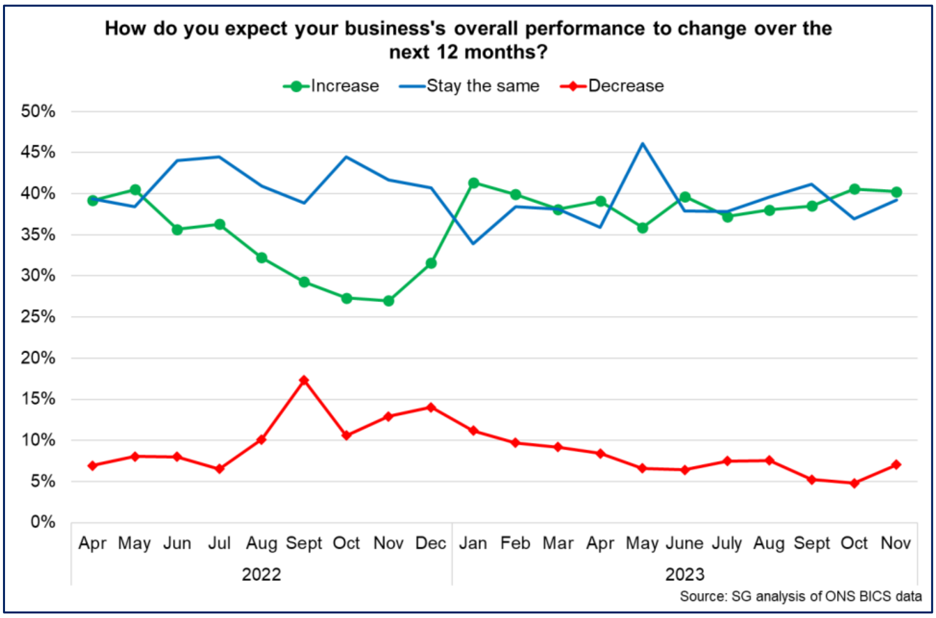
- The Scottish Business Monitor indicates business investment remained weak in Q3 2023, with 47% of businesses cancelling or delaying planned investment over the last 12 months, up from 40% in the previous quarter. Reported reasons were economic uncertainty (71%), affordability (66%) and borrowing costs (40%).
- The Scottish Chambers of Commerce Quarterly Economic Indicator for Q3 2023 reported a similar stalling in businesses investment (particularly in training investment) with over half of businesses reporting no change. Construction firms, on balance, reported a contraction across all investment trends for the first time in three years, while 70% of manufacturing firms reported no changes to total investment. In the services sector, investment remained positive on balance in the financial and business services sectors, albeit that at least half of firms indicated no changes to investment while half of firms in the retail and wholesale sector expect investment to fall in the next quarter.
- BICS data for Scotland in October show 14.2% 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 10.7% of respondents continue to expect to decrease capital expenditure over the coming year.



Business Optimism

- Looking ahead, PMI business survey data indicates that business optimism for growth over the coming year remains positive on balance, however the level remains below the series average despite rising to a 5-month high in November.
- This optimism for strengthening demand is partly reflected in the PMI data indicating that firms have continued to add to their staffing numbers and at the strongest pace in six months.

- BICS data for Scotland also indicates that during the second half of the year, there has been a slight increase in the share of firms expecting their business performance to increase over the coming year (40.3%) or stay the same (39.2) while 7% of businesses expect performance to decrease.



Labour Market

Unemployment remains low while earnings growth is robust but some sectors continue to face labour shortages.

Employment, Unemployment and Inactivity

- Labour market conditions have been very tight since the start of 2022 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.
- Adjusted experimental statistics for August to October show that Scotland's unemployment rate fell over the quarter to 3.8% (UK: 4.2%), while employment rose by 5,000 to an employment rate of 74.3%, and the inactivity rate remained unchanged at 22.6%.[10,11]
- Labour market conditions have softened slightly over the last year as a whole, with the employment rate falling 1.7 percentage points while the unemployment rate has increased 0.6 percentage points and the inactivity rate has risen 1.2% percentage points.

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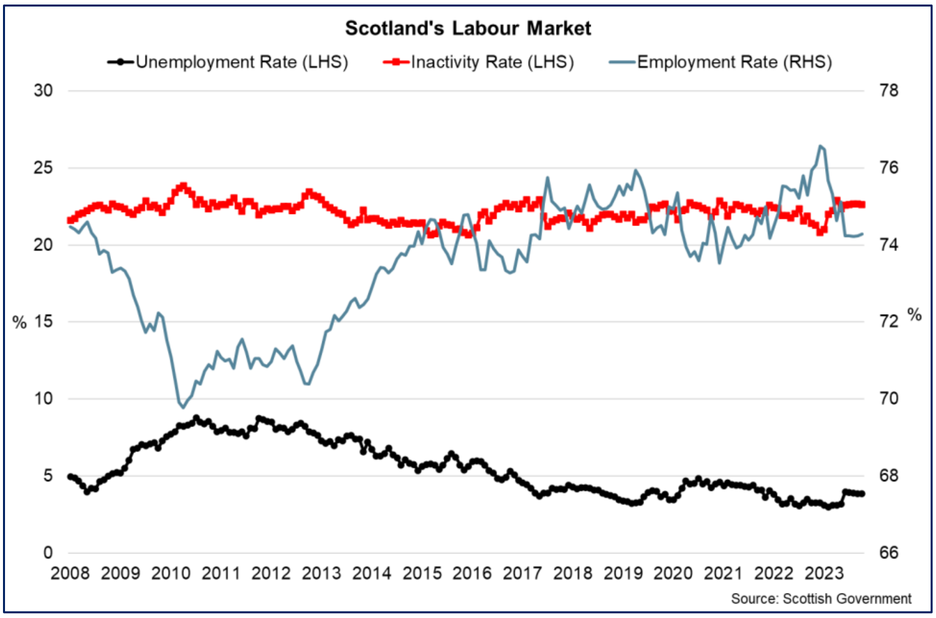
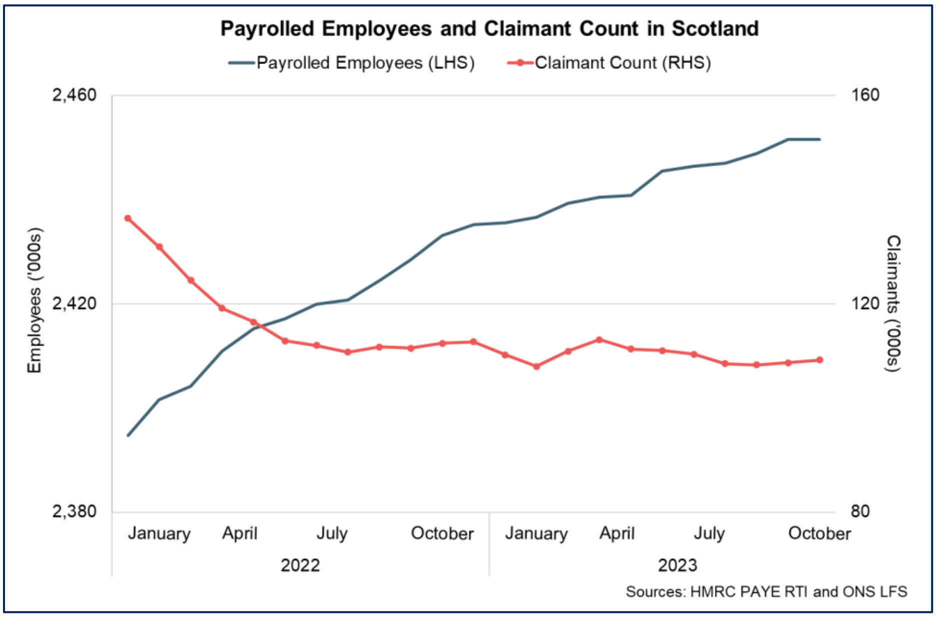
[10] Labour market statistics - gov.scot (www.gov.scot)
[11] Due to the increased uncertainty around the Labour Force Survey (LFS), these estimates are based on the ONS new experimental series for the UK and regions of the UK which use additional data sources to produce adjusted levels and rates for employment, unemployment and inactivity for May to July 2023 onwards.



- Wider labour market data illustrates further the resilience in the labour market, indicating recent trends have remained broadly stable. The number of PAYE employees in Scotland continued its upward trend since the start of the year to 2.45 million, though was largely unchanged over the month of November, while Scotland's claimant count rate remained unchanged at 3.6% though the number of claimants rose slightly over the month to 109,218.[12,13]



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 unemployment has remained low and recruitment activity has stabilised.

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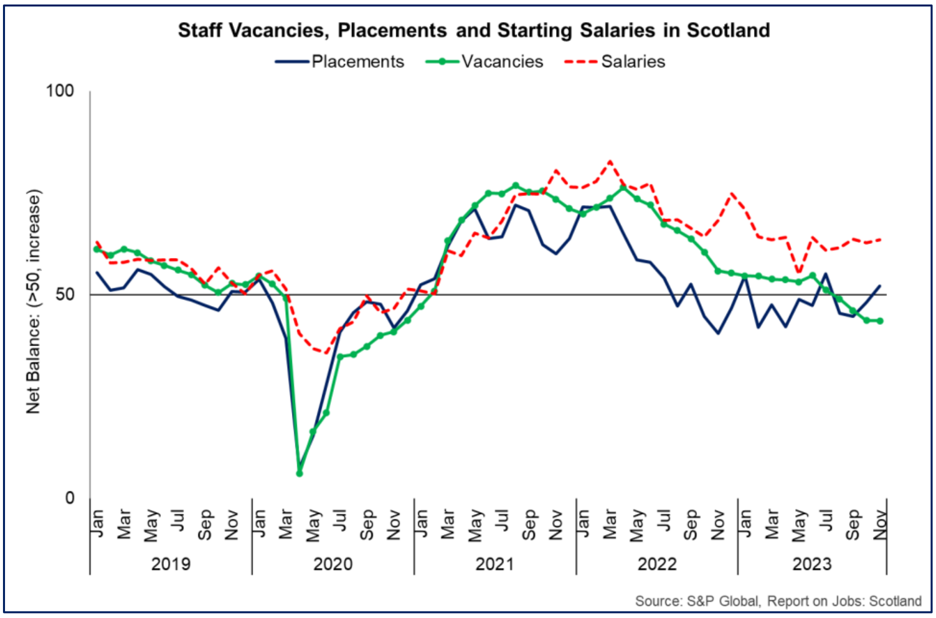
[12] Earnings and employment from Pay As You Earn Real Time Information, seasonally adjusted - Office for National Statistics (ons.gov.uk)
[13] Nomis - Official Census and Labour Market Statistics (nomisweb.co.uk)

- The RBS report on Jobs for November signalled positive growth in permanent staff placements for the first time in four months (52.3), however business demand for staff fell for a fourth consecutive month and to its lowest level in three years (43.7).[14]

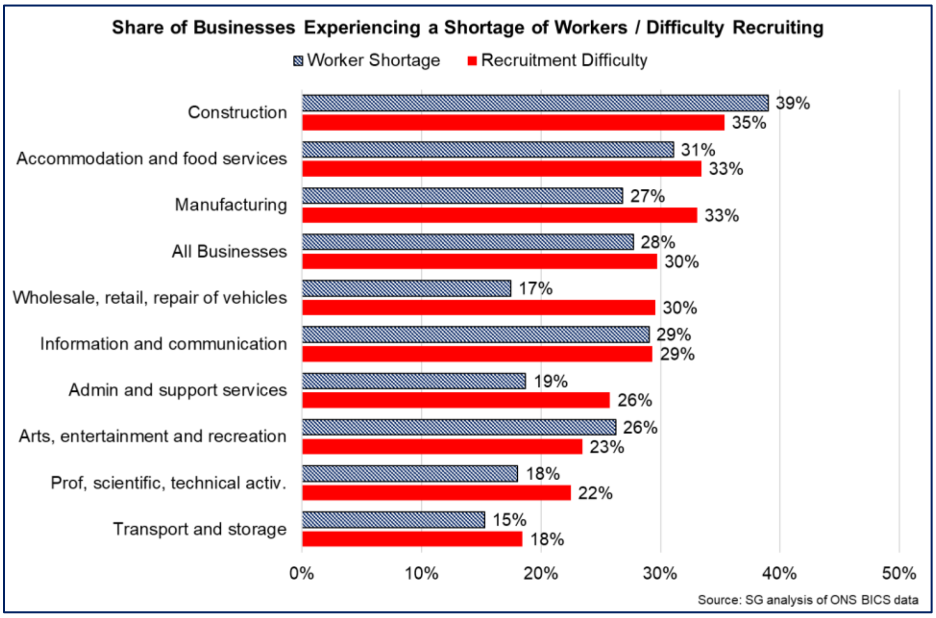


- BICS data provides further insights on labour shortages and recruitment challenges across sectors, which have been gradually easing over the past year. In November, 27.7% of businesses reported experiencing a shortage of workers (down from 43.4% in November 2022) and in October, 29.7% reported experiencing difficulties recruiting employees (down from 39% in October 2022).

- At a sector level, worker shortages remain most reported in Construction (39%) and Accommodation and Food Services (31%), with most businesses (53%) reporting that worker shortages led to employees working increased hours or the business was unable to meet demands (34%).

- Recruitment difficulties were also most reported in the Construction sector (35%) alongside Accommodation and Food Services (33%). Latest data from October shows most businesses responded that a low number of applications (50%) and a lack of qualified applicants (55%) were reasons for why they experienced difficulties in recruiting employees, while 28% reported not being able to afford an attractive pay package to applicants.

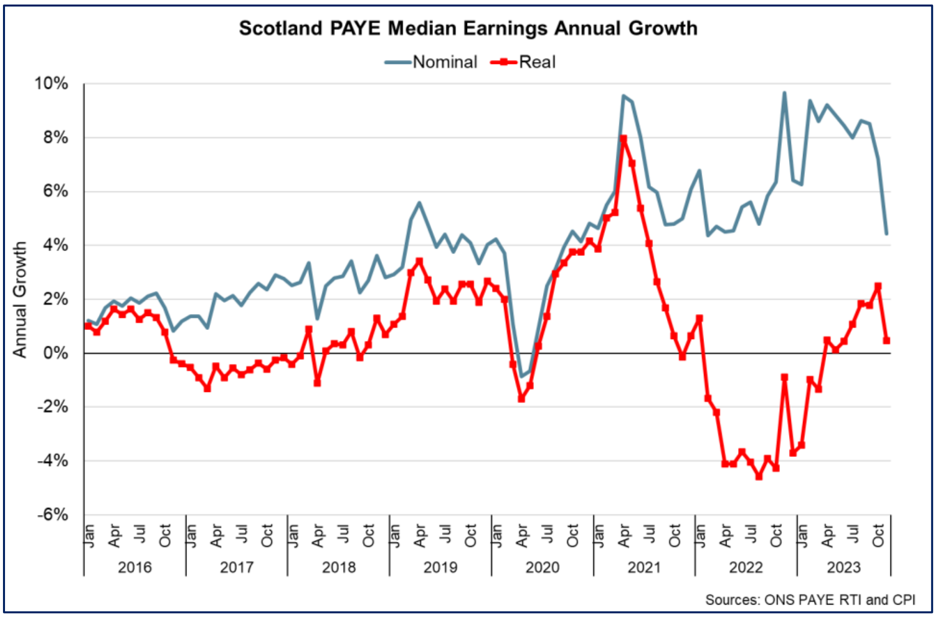
[14] S&P Global, RBS Report on Jobs: https://www.natwestgroup.com/news-and-insights/news-room/press-releases/economic-analysis/2023/dec/royal-bank-of-scotland-report-on-jobs-november-2023.html



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 November indicates that growth in starting salaries remains robust (net balance of 63.6), though the pace of growth has softened compared to the start of the year (71.0 in January 2023).
- More broadly, nominal median monthly PAYE pay in Scotland was £2,334 in November, up 4.4% over the year. This remains above the average annual growth rate over the past eight years (4.0%), however has slowed from higher rates of growth recently (7.2% in October) and to its slowest pace since November 2020.[15]
- Adjusting for inflation, which was 3.9% in November, real median earnings grew 0.5% on an annual basis. This was the eighth 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.

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



- Looking ahead to over 2023-24 as a whole, the Scottish Fiscal Commission Forecast average nominal earnings in Scotland to grow 6.6% over the year, faster than the OBR forecast of 6.2% for the UK as a whole.

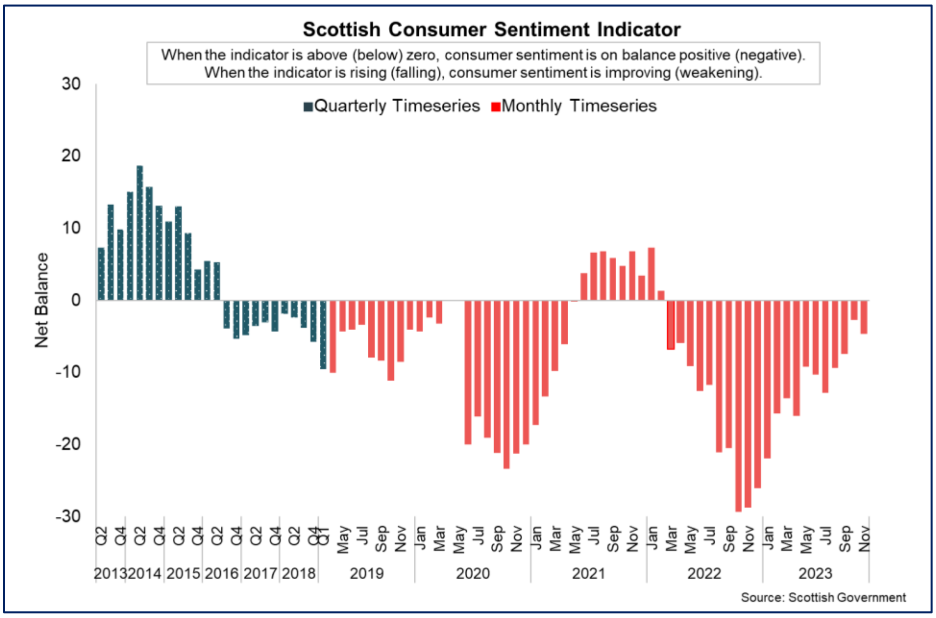
Consumer Activity

Consumer sentiment has strengthened over the year, however consumers continue to be impacted by inflation and higher interest rates.

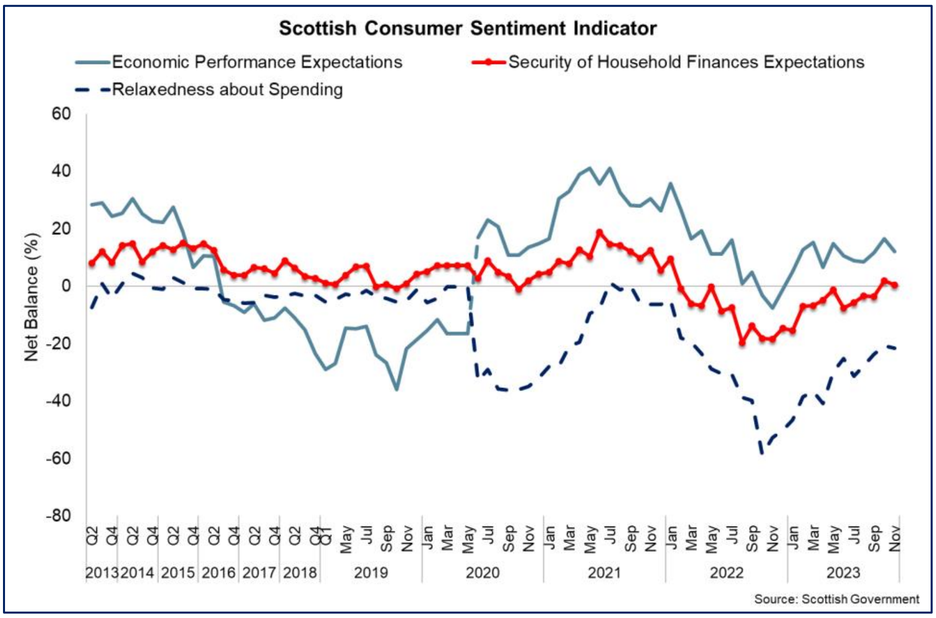
Consumer Sentiment

- Consumer sentiment indicators currently 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 to -29.4 in October 2022, consumer sentiment has strengthened significantly over the past year with latest data for November 2023 showing the consumer sentiment indicator at -4.6, having fallen by 1.9 points over the month.[16]

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



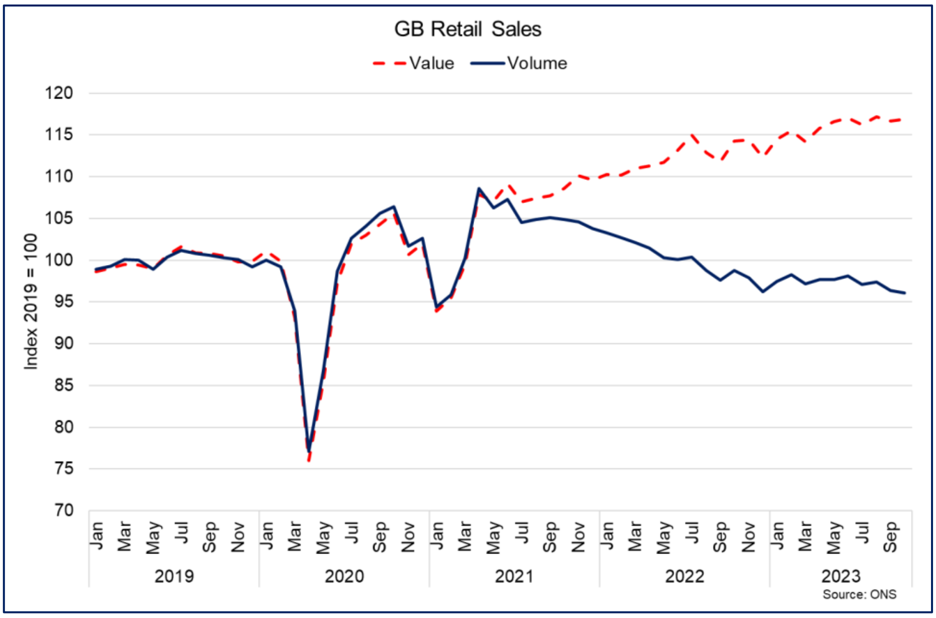
- Consumer sentiment has improved significantly from last year, however it remains negative overall and reflects the concerns that households have for the economy, their household finances and how relaxed they feel about spending money.
- Repondents continue to report on balance that circumstances regarding the economy and their household finances are weaker than a year ago. While these sentiment indicators are generally on an upward trend, their negative scores (-3.6 and -10.7 respectively) reflect the challenging cost of living circumstances that households currently face.
- This is reflected in the spend indicator (-21.5) which remains significantly negative and reflects that respondents are not currently relaxed about spending money.



- Looking ahead, respondents expect the economy and their household finances to improve over the coming year with both indicators reporting a positive net balance (12.1 and 0.5 respectively).

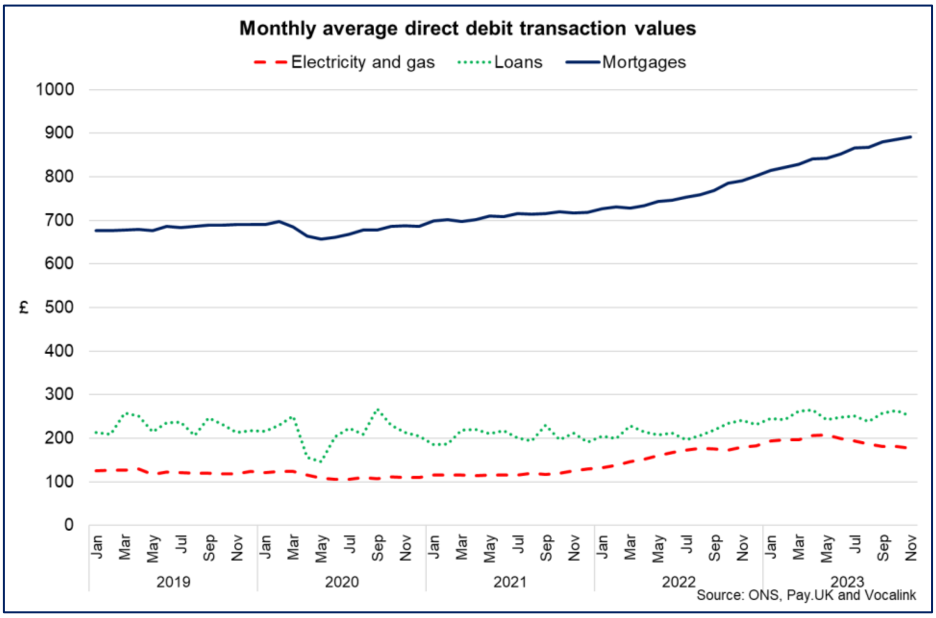
Cost of Living and Spending

- 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 2.7% over the year to October, however sales value grew 2.2%, with the divergence continuing to reflect the pace of rising prices.[17]

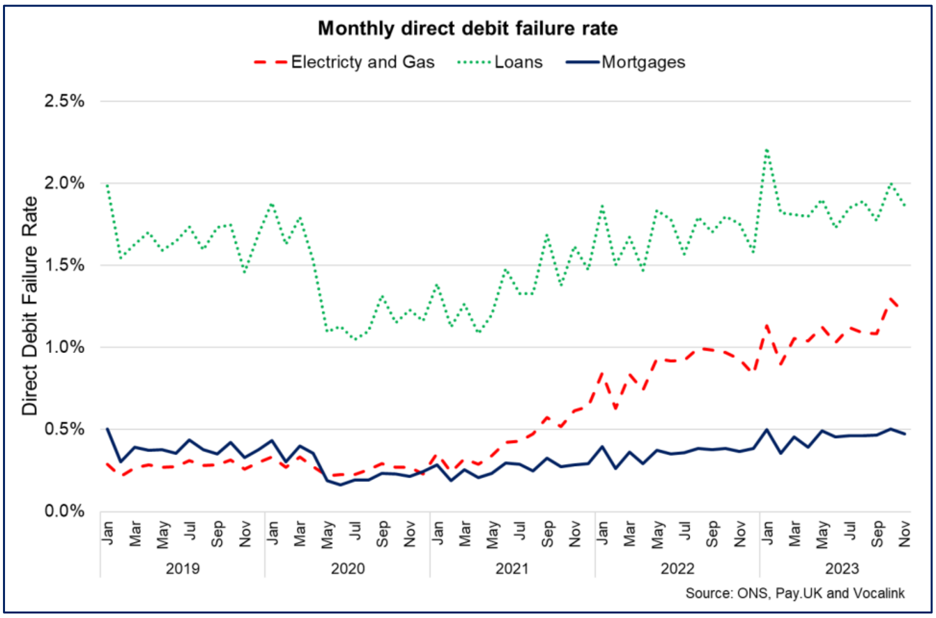


- Similarly the rise in prices and interest rates have had a significant impact on the amount UK conumers are paying for their energy costs, mortgages and other loans. In November the average monthly direct debit payment for electricity and gas was £177.49 (up 42% compared to November 2021), however has fallen 1% compared to November 2022.[18]
- More broadly, the average monthly direct debit payment for mortgages was £891 in November (up 13% over the year and 24% since 2021) and £252 for loans (up 4% over the year and 19% since 2021).

[17] Retail sales, Great Britain - Office for National Statistics (ons.gov.uk)
[18] Monthly Direct Debit failure rate and average transaction amount - Office for National Statistics (ons.gov.uk)



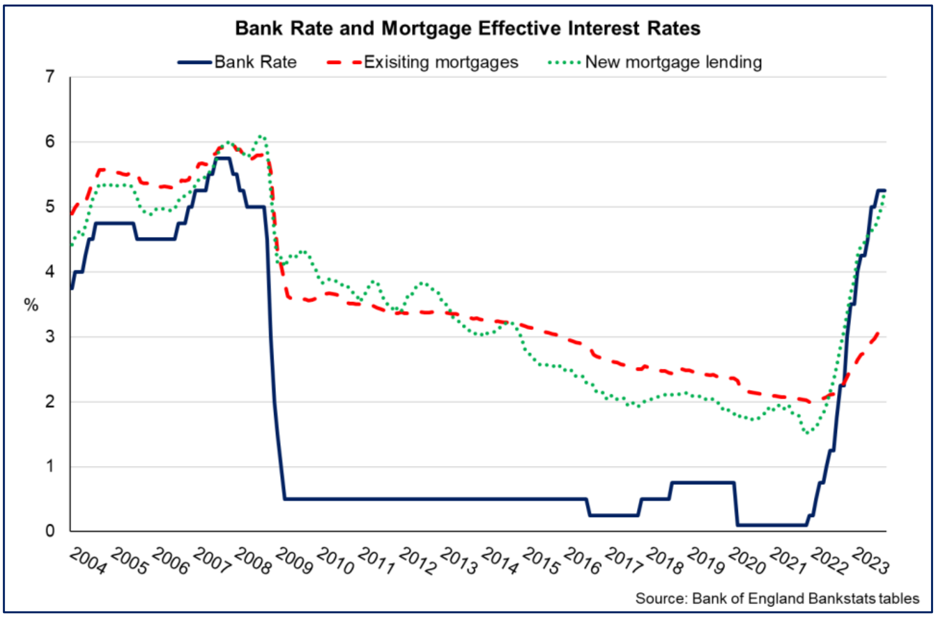
- The sharp increase in prices has been accompanied by an increase in the direct debit failure rate (the percentage of transactions that fail due to insufficient funds), reflecting the challenges facing some household budgets. For electricity and gas payments, the payment failure rate has risen to 1.21% (up from 0.93% in November 2022), while for mortgages it has risen to 0.47% (up from 0.37% in November 2022), though has remained broadly stable since May.



- More broadly in November/December, the ONS Public Opinions and Social Trends survey showed that 41% of respondents were finding it very or somewhat difficult affording energy bill payments and 37% for mortgage and rent payments. For energy bills, this was slightly lower than at the same point in 2022 (c. 47%), however has risen for mortgages payments from c.33% and potentially reflects the changing composition of inflationary pressures.[19]

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

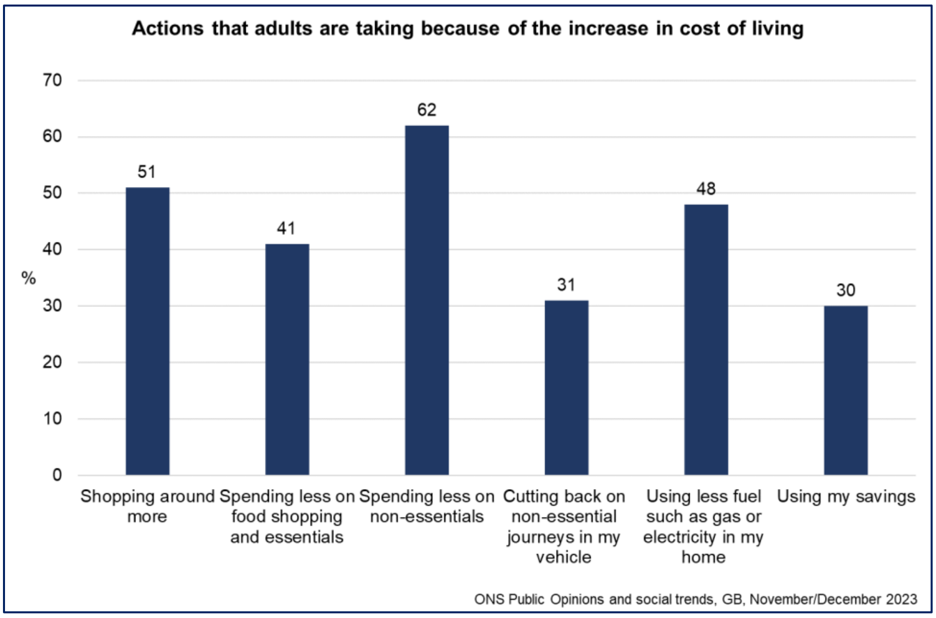
- The more gradual but recent impacts of rising interest rates on mortgage payment challenges compared to energy payments, reflects the rise in interest rates over the past year but also the time it takes for the full impact of the increase in Bank Rate to be felt at an aggregate level due to the high share of mortgages that are on a fixed rate.



- Reflecting this, the ‘effective’ interest rate – the actual interest paid – on newly drawn mortgages rose from 5.01% in September to 5.25% in October while the rate on the outstanding stock of mortgages rose from 3.14% to 3.2%.[20]

- In response to the change in cost pressures facing households, ONS Public Opinions and Social Trends survey data from November/December show that the most common actions people were taking in response to the increased cost of living were spending less on non-essentials (62%) and shopping around more (51%). 48% reported using less fuel such as gas or electricity in their home and 41% reported spending less on food shopping and essentials.

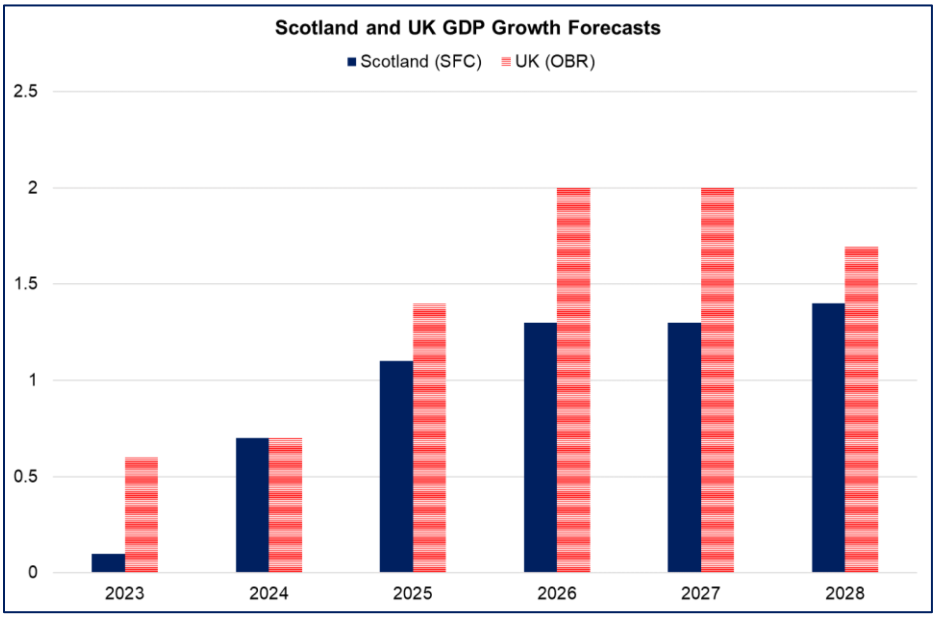
[20] Effective interest rates - A visual summary of our data | Bank of England



Economic Outlook

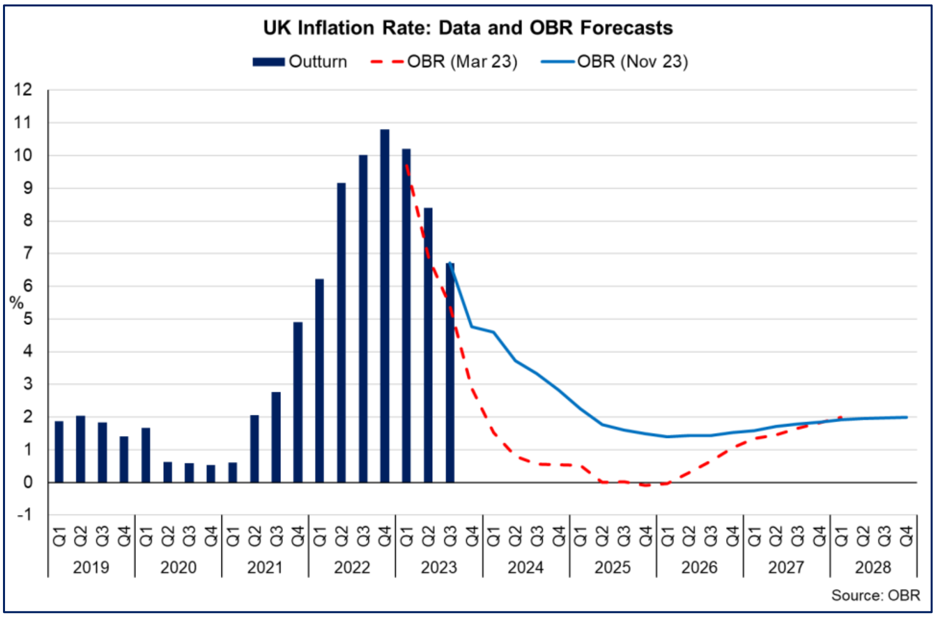
Forecasts continue to indicate positive but subdued GDP growth for the year ahead.

- Economic growth has remained more resilient in 2023 than was previously forecast, having been forecast in December 2022 to enter a shallow recession. However, the outlook for growth for 2024 remains subdued, with inflation expected to fall back to the 2% target more slowly than previously forecast and interest rates expected to remain higher for longer.
- The Scottish Fiscal Commission forecast the Scottish economy to grow 0.7% (previously 0.9%) in 2024, rising to 1.1% in 2025 (previously 1.3%). This is broadly in line with the OBR forecasts for the UK economy for growth of 0.7% in 2023 rising to 1.4% in 2024.[21,22]



[21] [Scottish Fiscal Commission – Scotland's official, independent economic and fiscal forecaster]
[22] [Home - Office for Budget Responsibility (obr.uk)]

- The lower profile of growth in Scotland compared to the UK over the forecast period is mainly due to slower total population growth in Scotland.
- The SFC forecast assumes inflation will fall from its October rate of 4.6% to 3% over the coming year and return gradually to the Bank of England's 2% target rate by mid-2025. This decline is slower than previously forecast and reflects the greater than expected persistence in domestic inflationary pressures.



- Reflecting this persistence, the Bank of England, alongside the US Federal Reserve and the European Central Bank, has continued to retain a restrictive monetary policy position with Bank Rate held at 5.25% since August. In their latest forecasts from November, markets expect the Bank Rate to remain around 5% until the end of 2024 before settling to around 4% by the end of 2026.
- Overall, the resilience in economic output and the labour market, coupled with easing inflation pressures over the year has been positive. In the short term business survey data point to business activity weakening in the latter part of 2024, and the persistence of above target inflation and higher interest rates continue to present a challenging outlook. However the resilience of business optimism for the coming year, the resilience in the labour market and earnings growth and the improvements in consumer sentiment over the past year provide a strengthening basis for the growth forecast in 2024.

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