Scottish Economic Bulletin

Office of the Chief Economic Adviser

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Scottish Government
Riaghaltas na h-Alba

Contents

Data up to: 7 February 2024
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Overview

This month’s bulletin updates on the latest economic data during the final quarter of 2023 and into the start of the new year. Whilst economic conditions remain challenging with economic growth weakening during the final quarter of the year, forward-looking indicators continue to provide signs that wider economic conditions are improving with inflation now expected to fall faster than was thought at the end of last year.

Latest GDP data indicates that the pace of growth slowed at the end of 2023 with output falling 0.2% in the three months to November and contracting across the months of October and November. The fall in output in the three months to November was broad based across the services, production and construction sectors with services output falling for the first time since September 2022 and as such did not offset falls in output in production and construction as it had done in recent months.

Weaker growth in the final quarter of the year is consistent with business surveys for that period indicating declining business activity and a rising share of businesses reporting weakening demand as a key concern. Business conditions more broadly have remained challenging however falling inflationary pressures over 2023 have provided a gradual easing in cost pressures for businesses and households. This is set to continue with the latest Bank of England forecasts now showing that inflation could temporarily return to the 2% target in the second quarter of the year and although it may rise again later in the year, it is still expected to remain below 3%.

The easing in inflationary pressures, coupled with market sentiment that interest rates have peaked and are now expected to fall, has improved business and consumer sentiment. The Scottish Consumer Sentiment Indicator rose to -5.1 in the final quarter of the year, its highest level since the start of 2022 however falls in sentiment across the months of November and December 2023 continue to emphasise the underlying challenges and uncertainty facing households.

Improving sentiment has also been underpinned by the resilience in the labour market with unemployment remaining extremely low below 4% while we continue to see the return to real terms earnings growth.

Looking ahead economic conditions are forecast to improve in 2024 and 2025 with GDP growth forecast to pick up moderately to 0.7% and inflation to fall below 3%. Growth could surprise on the upside given falling inflation and interest rate expectations are supporting improved business and consumer sentiment.

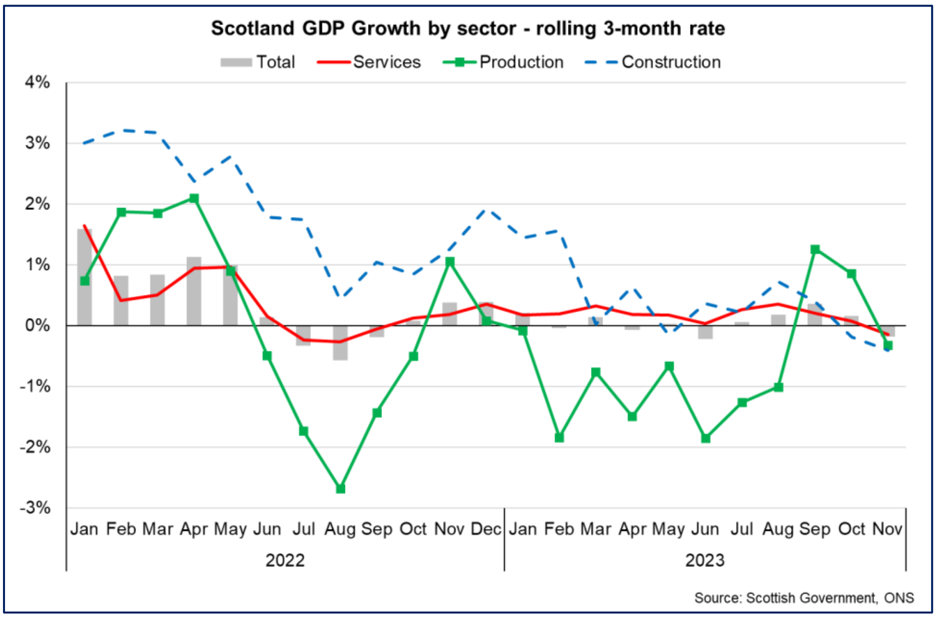
However the events in the Red Sea present a new risk to the outlook and has the potential to impact business conditions through supply chain disruption and increased costs over the coming year. They further emphasise the uncertainty that remains in the economic outlook and that external geo-political factors remain important and have the potential to influence economic conditions.

Output

Scotland's GDP fell in October and November indicating weaker growth in Q4 2023.

- Scotland's GDP fell 0.2% in the three months to November 2023, in part reflecting recent monthly falls in output across October (-0.6%) and November (-0.1%). UK GDP also fell by 0.2% over the same period.[1]
- This is the first three monthly fall in GDP since June however continues to reflect a period of weak economic growth in which Scotland's GDP fell 0.6% over the twelve months to November.

- The fall in output in the three months to November was relatively broad based across the services (-0.1%), production (-0.3%) and construction (-0.4%) sectors.



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

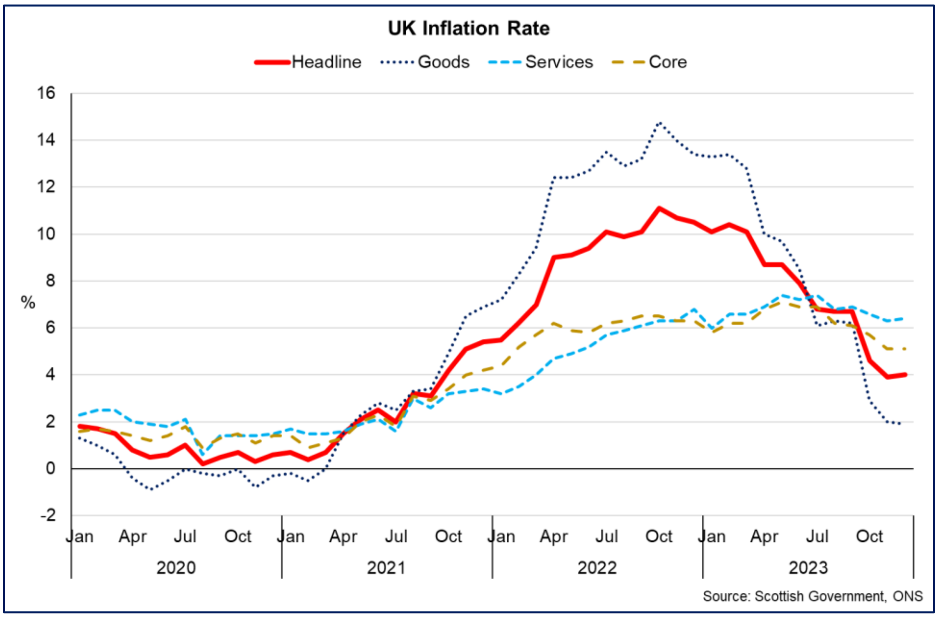
- Within the production sector, manufacturing output continued its downward trend, falling 3.4% in the three months to November and has now fallen 8.9% over the past year with notable falls in the manufacture of metals, metal products, machinery and equipment (-14.9%) and food products, beverages and tobacco (-13.3%).
- In the services sector, the fall in output was marginal overall (-0.1%) and the first three monthly fall in services output since September 2022 with output growing 0.7% over the past year. However the pace of growth in the sector has slowed in the second half of 2023 with the recent fall in output driven by a further contraction in wholesale, retail and motor trades (-2.3%) and flat growth across consumer facing services more broadly (0.0%), albeit partly supported by positive growth in accommodation and food services (0.5%).
- More broadly, the pace of growth slowed in other parts of the services sector such financial and insurances activities (0.1%) and professional, scientific and technical services (0.2%).

Inflation

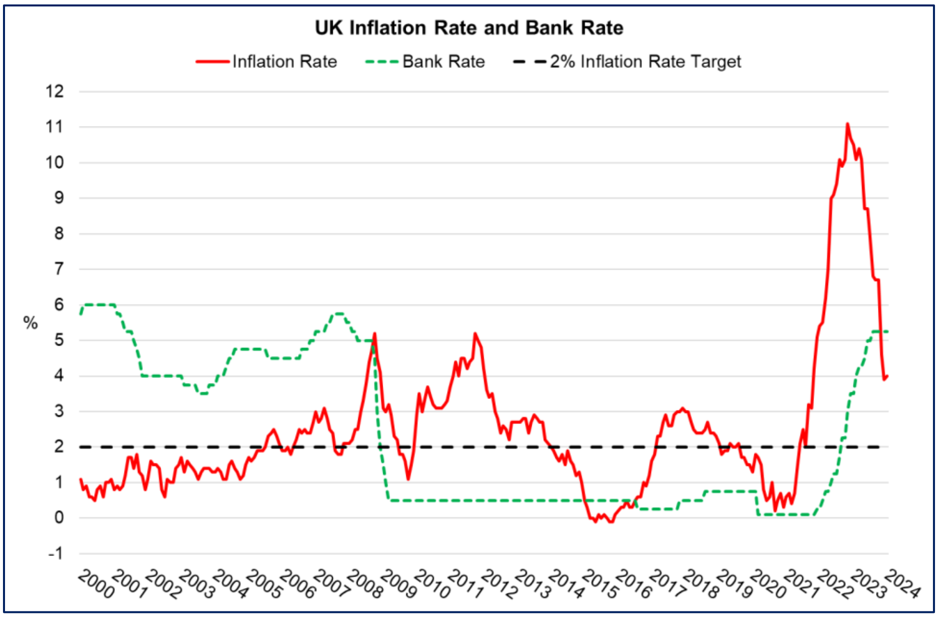
Inflation rose slightly in December to 4% as core inflation remained unchanged.

- UK inflation rose to 4% in December 2023, up slightly from 3.9% in November, and is the first increase in inflation since earlier in the year in February.[2]
- The increase in December was mainly driven by a rise in alcohol and tobacco inflation (from 10.2% to 12.9%), largely reflecting the increase in tobacco duty announced in the UK Autumn Statement. There was also upward pressure from categories such as recreation and culture (from 5.3% to 5.7%) and clothing and footwear (from 5.7% to 6.4%) offsetting downward contributions in categories such food and non-alcoholic drinks (from 9.2% to 8%), and restaurants and hotels (from 7.5% to 7%).
- Core inflation, which excludes energy, food, alcohol and tobacco, was unchanged in December at 5.1%. This partly reflects the current persistence of services prices inflation which rose from 6.3% to 6.4% while goods prices inflation continued its downward trend from 2% to 1.9%.

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



- 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 and forecasts, the Bank of England's Monetary Policy Committee (MPC) maintained the Bank Rate at 5.25% in February, unchanged since August following fourteen consecutive rate rises from December 2021 when it was 0.1%.[3]



- The Bank of England judge that risks from domestic inflation pressures are now more balanced than they have been, however risks to its inflation projection are skewed to the upside in the near term due to recent geopolitical factors and are keeping under review for how long Bank Rate should be maintained at its current level.[4]

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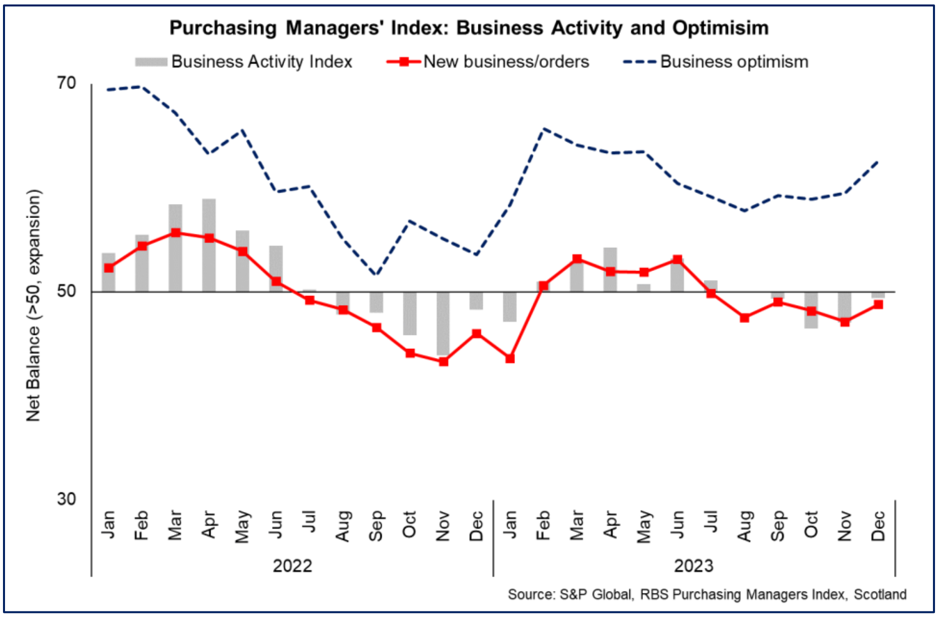
[3] [Bank rate maintained at 5.25% - February 2024 | Bank of England]()
[4] [Monetary Policy Report - February 2024 | Bank of England]()

Business Conditions

Business activity further weakened in December however optimism remains resilient.

Business Activity

- The Purchasing Managers Index (PMI) business survey indicates that business activity in Scotland's private sector fell in December and across the fourth quarter of the year.[5]
- The business activity indicator was 49.4 in December, slightly improved from November however was the fourth consecutive month indicating falling activity with a sharp fall in the manufacturing sector (45.2), partly offset by marginal growth in services (50.4).
- A key driver of weaker business activity has been subdued new business orders, which have fallen continuously since July and most notably in the manufacturing sector in recent months.



- Despite the current weakness in business activity and demand, business optimism for the year ahead improved over the second half of 2023 and in December was at its highest level since earlier in the year in May. Business optimism stemmed from a combination of expected improvements in trading conditions alongside an increase in marketing and sales activity.

Business Concerns

- The factors weighing on demand continue to reflect the broader concerns that businesses are currently reporting on business conditions. The main business concern reported in the Business Insights and Conditions survey (BICS) for February is falling demand of goods and services (16.6%). This has been a rising concern reported by businesses since the middle of 2023.[6]

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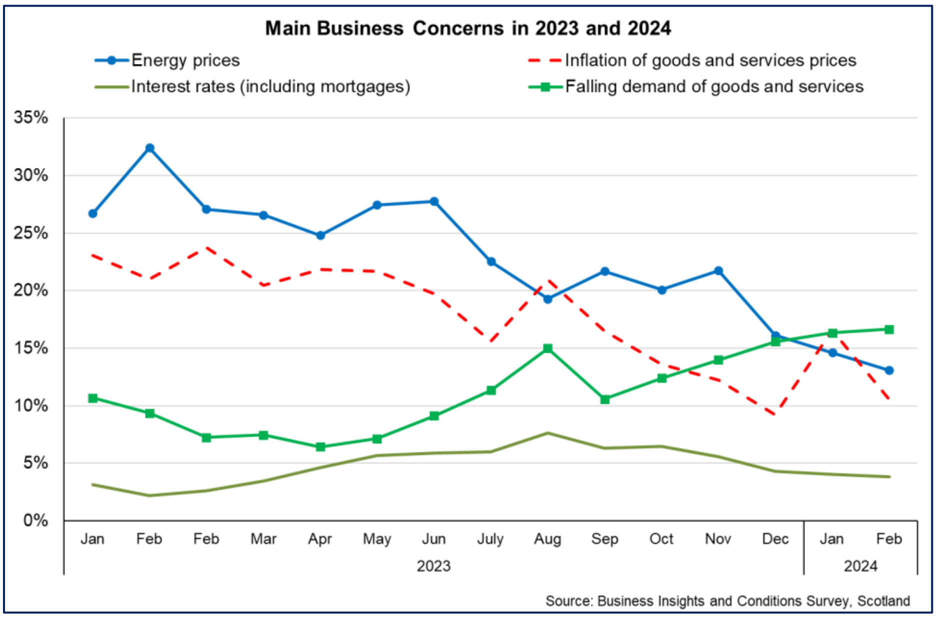
5 Purchasing Managers' Index Reports | Royal Bank of Scotland (rbs.co.uk) ; 83c380b9efc94959add0e817874891c8 (spglobal.com)
6 Business and innovation statistics - gov.scot (www.gov.scot)

- Businesses continue to have concerns about energy prices (13.1%) and wider inflation of goods and services (10.5%) however these has been on a downward trend over the past year and likely reflect adjustments businesses have made in response to the changes in costs, the general easing of inflationary pressures and expectations of further reductions over the coming year.
- Concerns regarding interest rates have also eased over the second half of 2023 and start of 2024 and also likely reflect increased expectations that interest rates have peaked and may start to fall over the coming year.

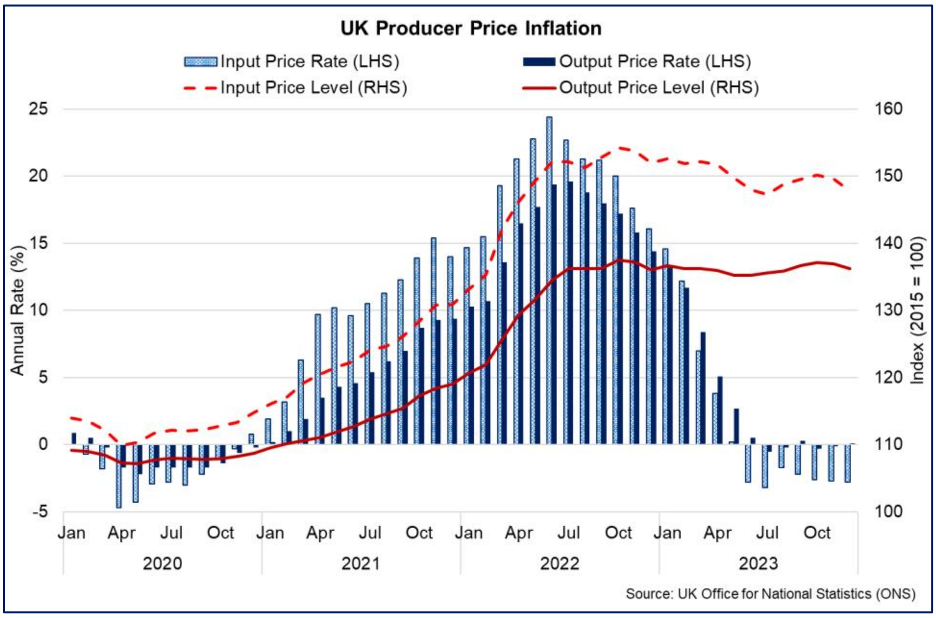


- The Scottish Chambers of Commerce (SCC) Quarterly Economic Indicator shows a similar pattern with concerns about inflation (52%) and interest rates (40%) easing in the final quarter of 2023 albeit remaining higher than prior to the inflation shock.[7]

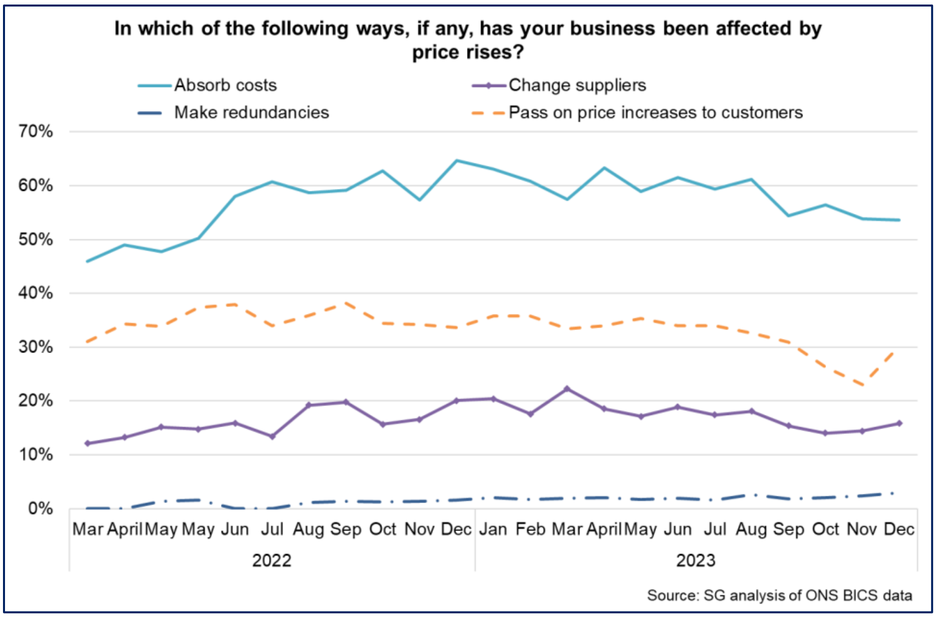
Business Costs

- At a headline level, producer input price inflation continued to decline with input prices falling on an annual basis for a seventh consecutive month and by 2.8% in December.[8] The change in input prices has also been reflected in producer output prices which grew by 0.1% annually.

[7] Quarterly Economic Indicator - Scottish ChambersScottish Chambers
[8] Producer price inflation, UK Statistical bulletins - Office for National Statistics (ons.gov.uk). Prices of goods bought and sold by UK manufacturers, including price indices of materials and fuels purchased and factory gate prices.



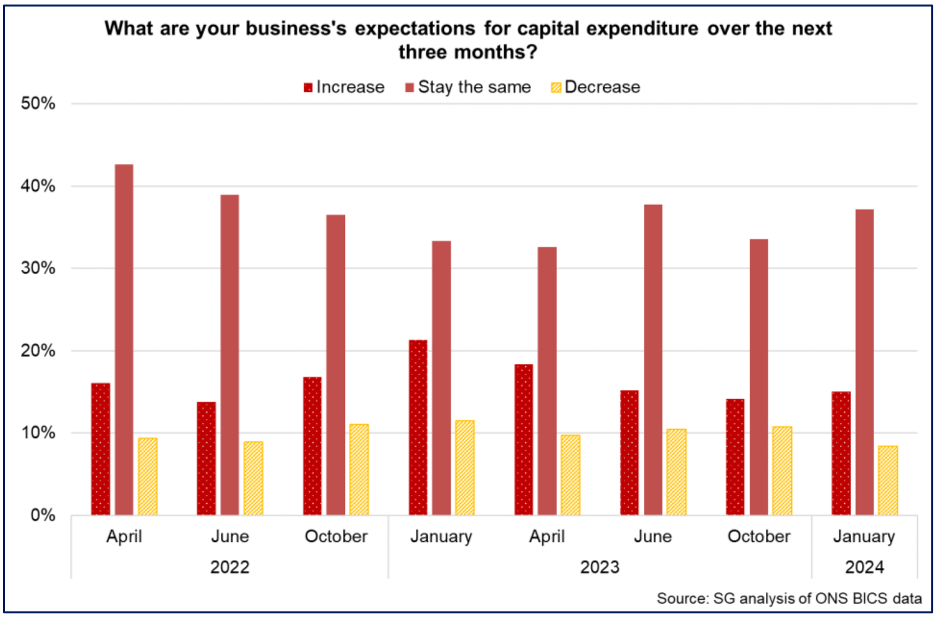
- Overall, input and output price levels have been relatively stable since June 2023, and remain substantially higher than their 2021 levels. The moderation of energy price inflation has been a key driver of falling producer price inflation with crude oil input costs falling 10.2% over the past year, however imported food material costs rose 10.4% over the year.
- Looking across a broader range of input costs the PMI business survey indicates that business input costs continued to rise in December, with businesses indicating that labour, shipping and fuel costs were creating upward pressure though at one of the slowest rates since the start of 2021.
- The SCC Quarterly Economic Indicator also shows that while cost pressures are easing, the source of these for businesses remains broad based with 60% reporting increased cost pressures from labour costs, 57% from energy costs, 45% from raw materials and 37% from fuel costs.
- BICS data for Scotland provide latest insights into the changing effects on businesses of price rises. At the start of December, 53.7% of businesses reported that they had to absorb costs, 30.2% reported having to pass on price increases to customers and 15.8% had to change suppliers. A much lower percentage of firms reported having to make redundancies (3%).



- The slight downward trend in the share of businesses reporting to be absorbing costs potentially reflects the slowing pace of input cost rises and similarly, while the share of businesses passing on price increases to customers rose in December, it remains slightly down compared to December 2022. The SCC Quarterly Economic Indicator also reported a declining share of businesses planning to raise prices (40% in Q4 2023, down from 48% in Q3 2023).

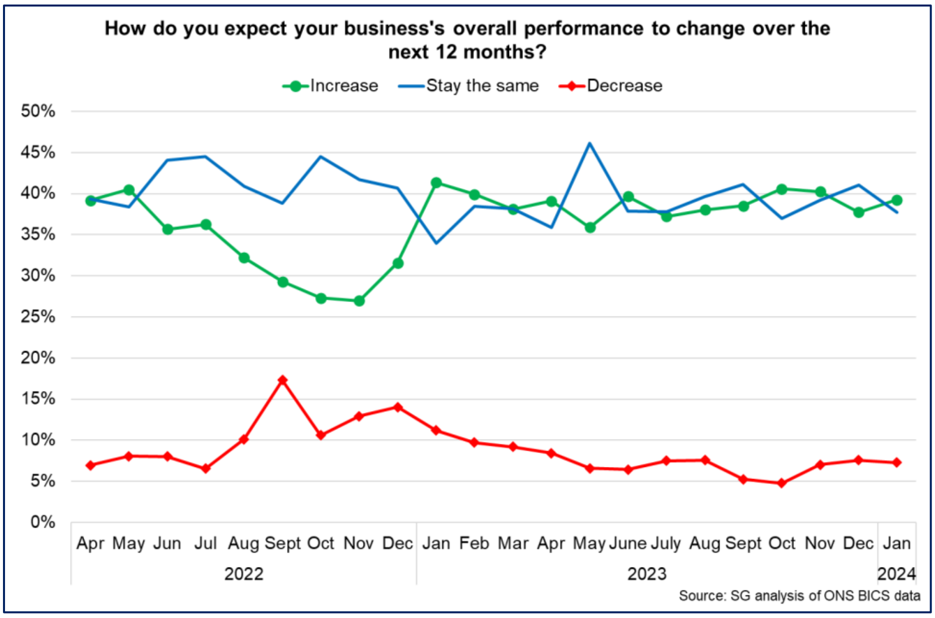
Business Investment

- The combination of business concerns around weakening demand, inflationary pressures and higher interest rates continues to weigh on business investment decision making.
- The SCC Quarterly Economic Indicator for Q4 2023 reported that while on balance firms continue to increase rather than reduce investment, over half of firms continued to report no changes to both total (55%) and training (54%) investment. At a sector level the balance of firms reported a return to investment growth in the construction sector, further positive growth in the manufacturing sector and a return to investment growth in retail and wholesale for the first time since the start of 2020. Elsewhere in the services sector the majority of investment remained positive on balance in the financial and business services sectors, however capital investment contracted for the first time in a year.
- BICS data for Scotland in January show 15% of respondents thought their capital expenditure would increase over the next three months, lower than at the start of 2023, while 8.4% of respondents continue to expect to decrease capital expenditure over the coming year. Overall compared to the start of 2023, there has been an increasing share of businesses reporting that capital expenditure will stay the same.



Business Optimism

- PMI business survey data indicates that business optimism improved over the second half of 2023, rising to a seven-month high in December however remains lower than at the start of last year. This optimism for improving demand is partly reflected in the PMI data indicating that firms have continued to add to their staffing numbers by filling vacant positions and replacing leavers.
- BICS data for Scotland indicates that at the start of 2024, most businesses expect their overall business performance to increase (39.3%) or stay the same (37.7%) over the coming year. On aggregate, this has slightly improved compared to the start of 2023, while the share of businesses expecting their performance to decrease has fallen slightly to 7.3%.

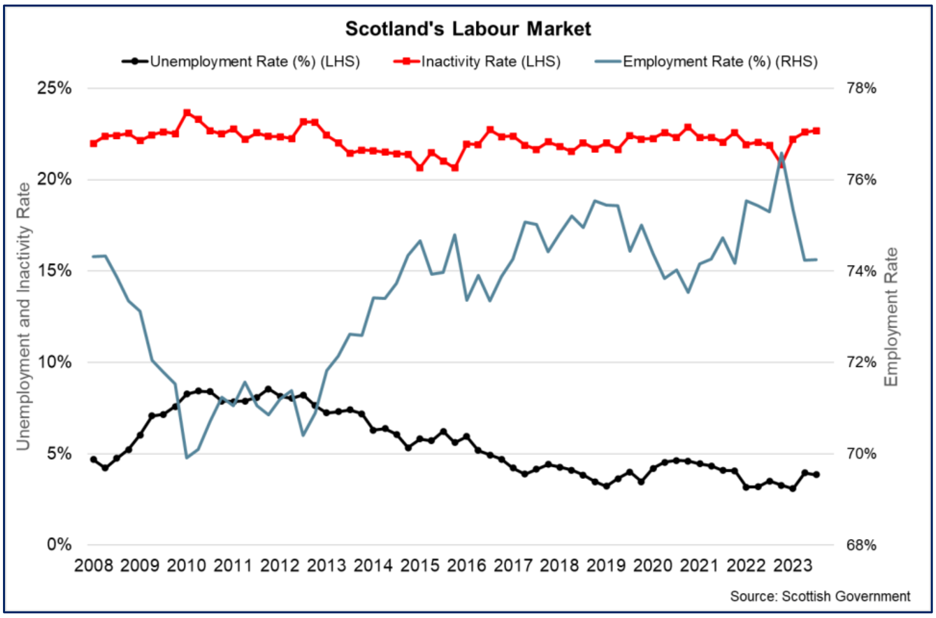


Labour Market

Unemployment remains low however recruitment activity continues to slow.

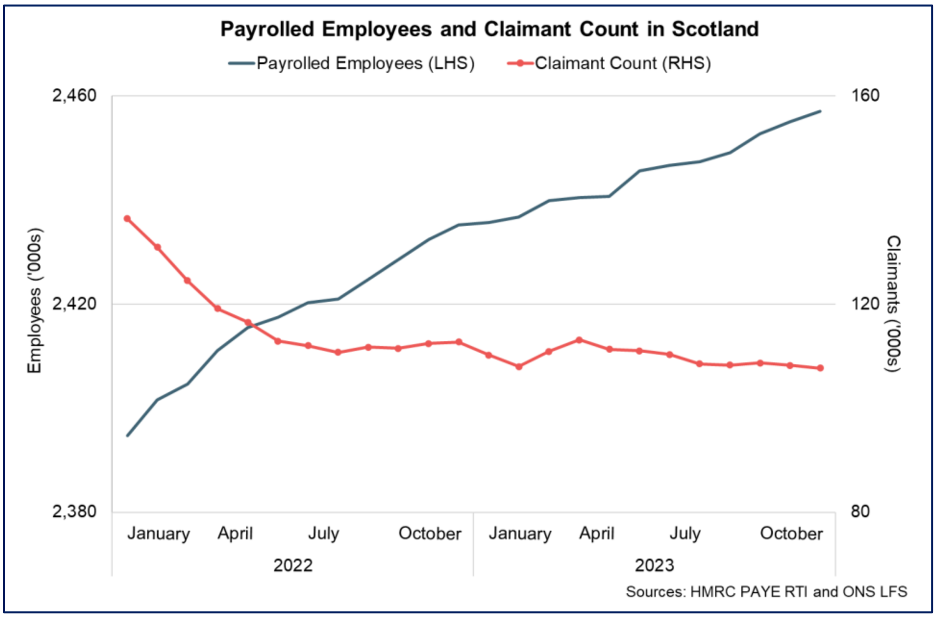
Employment, Unemployment and Inactivity

- 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.
- Latest data for September to November show that Scotland's unemployment rate fell over the quarter to 3.8% (UK: 4.2%), while employment rose by 6,000 to a rate of 74.4%, and inactivity fell by 3,000 to a rate of 22.6%.[9,10]
- Labour market conditions have softened slightly over the last year 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 1.3 percentage points.



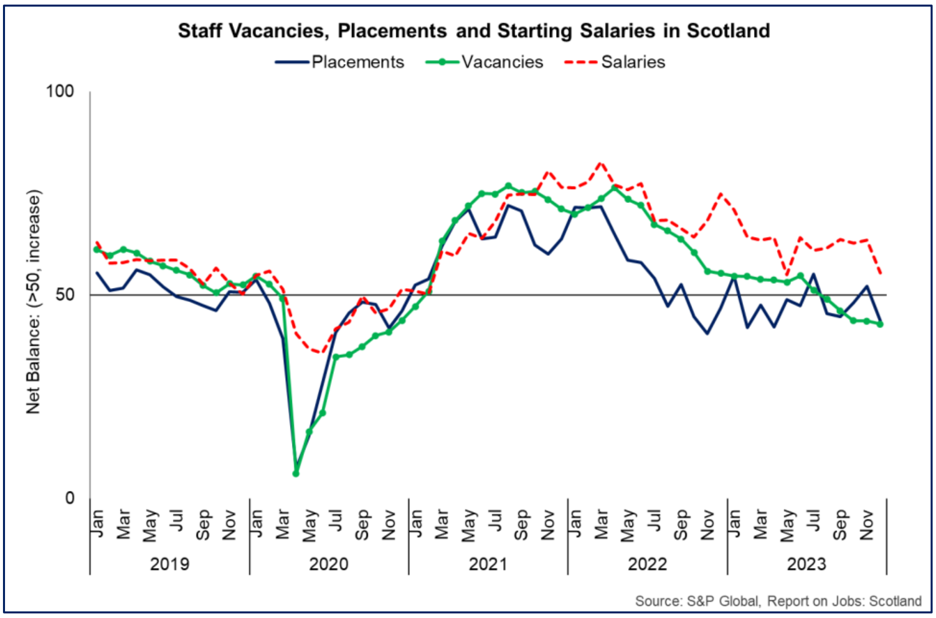
- Wider labour market data illustrates further the resilience in the labour market. The number of PAYE employees in Scotland continued its upward trend since the start of the 2023 to 2.46 million, though was largely unchanged over the month of December, while Scotland's claimant count rate was 3.5% with the number of claimants down slightly over the month to 107,700.[11,12]

[9] Labour market statistics - gov.scot (www.gov.scot)
[10] 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.
[11] Earnings and employment from Pay As You Earn Real Time Information, seasonally adjusted - Office for National Statistics (ons.gov.uk)
[12] Nomis - Official Census and Labour Market Statistics (nomisweb.co.uk)



Recruitment Activity

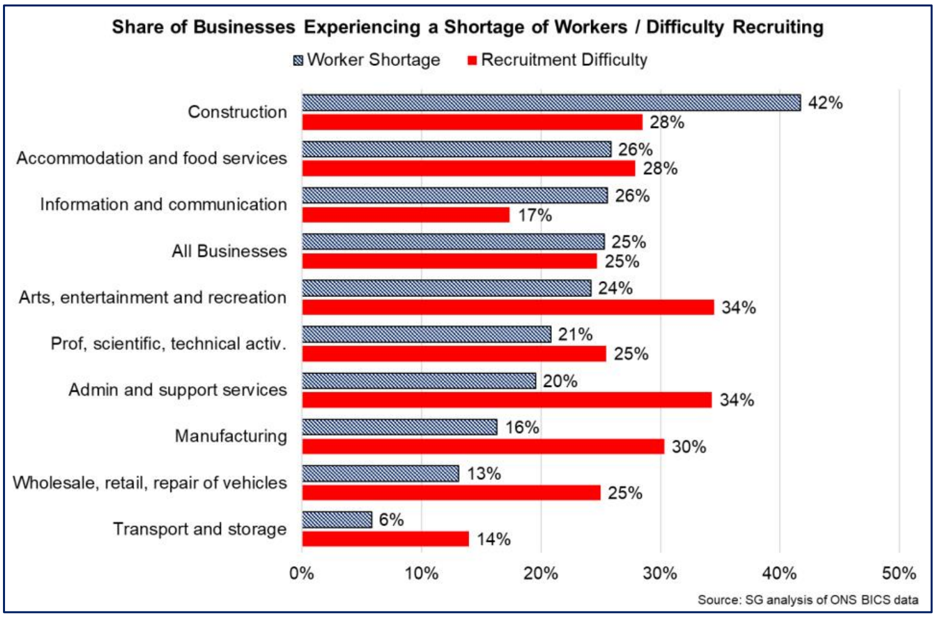
- Business survey data also signal that the extent of tightness in the labour market has cooled slightly over the past year as unemployment has remained low and recruitment activity has stabilised.
- The RBS Report on Jobs indicated a fall in permanent staff placements in December (43.7) with falls in four out of the last five months of the year. Furthermore, business demand for staff fell for a fifth consecutive month in December and to its lowest level in three years (42.9).[13]



- BICS data provides further insights on labour shortages and recruitment challenges across sectors, which have been gradually easing over the past year. At the start of January 2024, 25.3% of businesses reported experiencing a shortage of workers, down from the average rate

[13] S&P Global, RBS Report on Jobs: Royal Bank of Scotland Report on Jobs – December 2023 | NatWest Group

of 33.4% in 2023 and 37.4% in 2022. In December, 24.7% reported experiencing difficulties, down from the average rate of 34.9% in 2023 and 40.3% in 2022.



- At a sector level, worker shortages remain most reported in construction (41.7%) and accommodation and food services (25.8%). Nearly half of businesses (48.1%) reported that worker shortages led to employees working increased hours, while 38.6% reported being unable to meet demands and 34.2% reported having to recruit temporary workers.

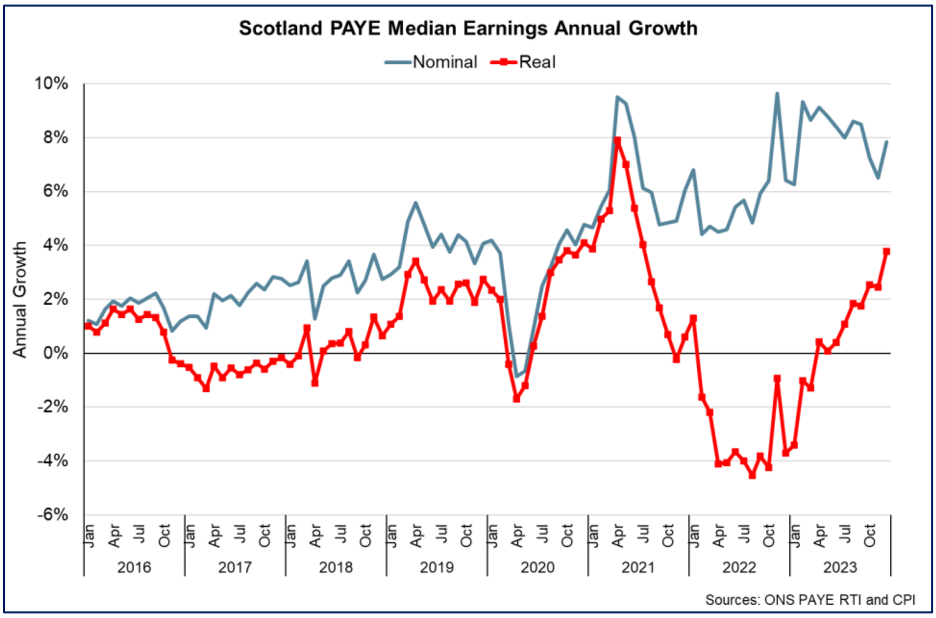
- Recruitment difficulties were also most reported in arts, entertainment and recreation (34.5%), admin and support services (34.3%), manufacturing (30.3%) and construction (28.5%). Latest data from January show most businesses responded that a lack of qualified applicants (63.1%) alongside a low number of applications (49.1%) were reasons why they experienced difficulties in recruiting employees while 20.1% 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 Report on Jobs for December 2023 indicates that growth in starting salaries remained positive (net balance of 55.4), though the pace of growth has significantly softened compared to the start of the year (71.0 in January 2023).

- More broadly, nominal median monthly PAYE pay in Scotland was £2,377 in December, up 7.8% over the year. This remains above the average annual growth rate over the past eight years (4.1%), however has slowed from higher rates of growth of over 8% and 9% earlier in 2023.[14]
- Adjusting for inflation, which was 4% in December, real median earnings grew 3.8% on an annual basis. This was the nineth consecutive month of positive annual growth following the period of falling real pay during 2022 and the start of 2023, reflecting the increase in nominal pay growth and easing in inflationary pressures.



- 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 as inflation has reduced.

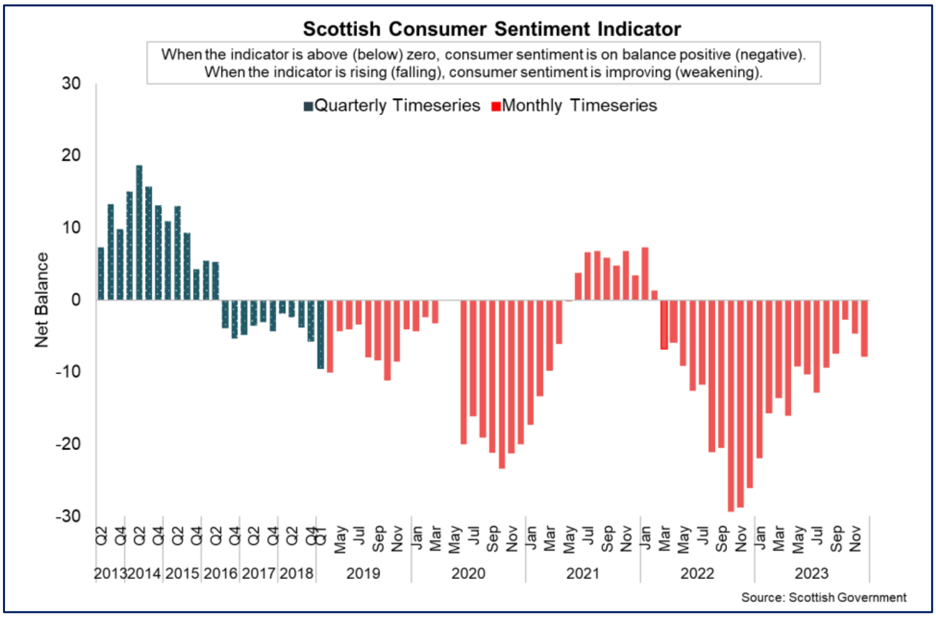
Consumer Sentiment

- The Scottish Consumer Sentiment Indicator reflects how households think the economy is performing, how secure they feel about their household finances and how relaxed they feel about spending money.
- Consumer sentiment fell sharply during 2022 to -29.4 as inflationary pressures increased and the economic outlook weakened. However sentiment strengthened significantly over 2023 as

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

inflationary pressures reduced with latest data for December showing the consumer sentiment indicator at -7.8 (-5.1 for the fourth quarter as a whole).[15]

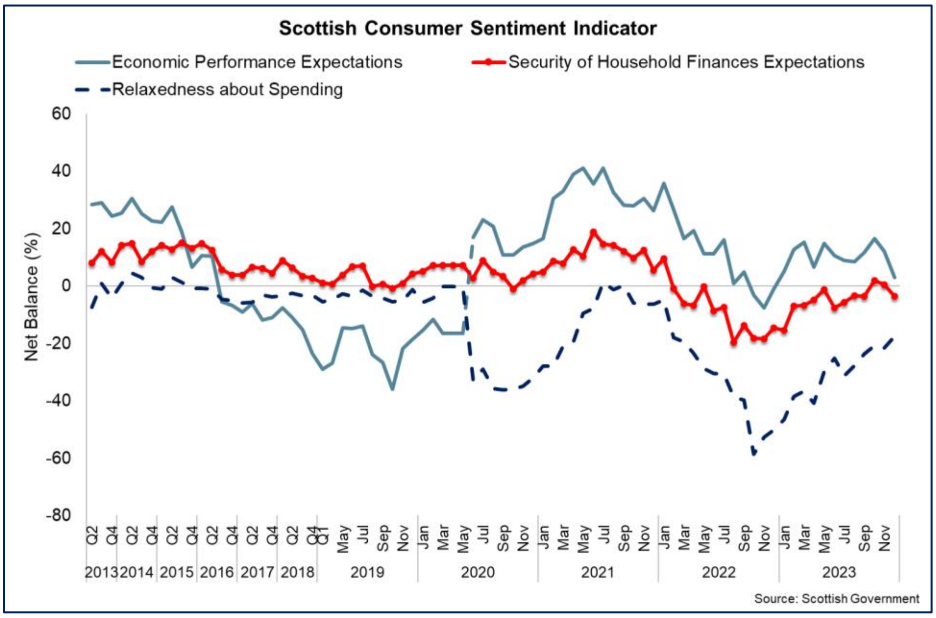
- The indicator has increased 18.3 points over the year, however fell 3.2 points over the month of December and remains negative overall reflecting the concerns that households continue to have for the economy, their household finances and spending money.



- 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 (-9.5 and -11.7 respectively) reflect the challenging cost of living circumstances that households currently face.

- This is reflected in the spend indicator (-17.5) which remains significantly negative and reflects that respondents are not currently relaxed about spending money.

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

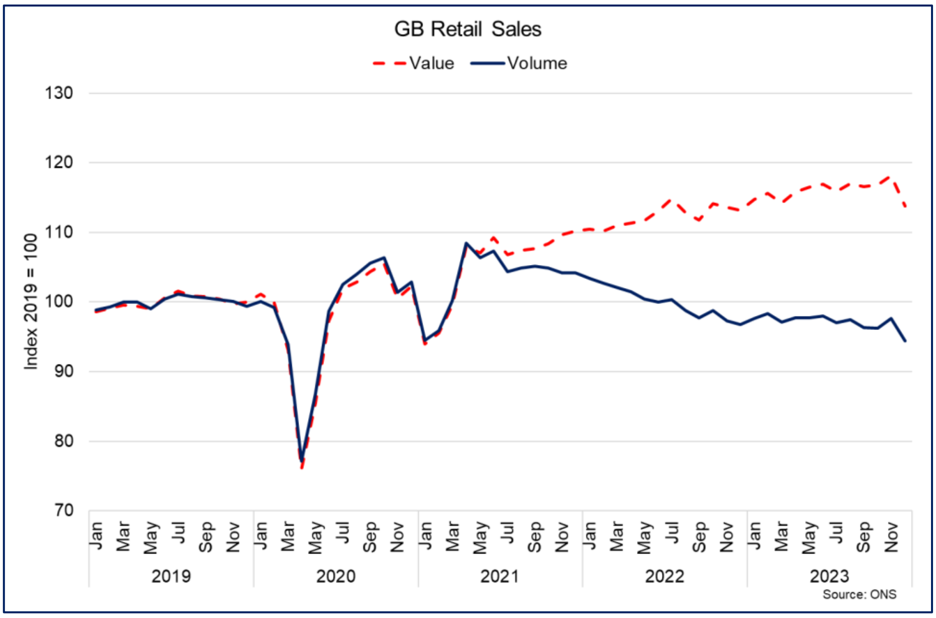


- The level of optimisim for the year ahead has improved over the year, however respondents remain less optimisic about the outlook for their household financial security than they do for the broader performance of the economy.
- Expectations for the economy are positive on balance at 3.1 points, while household finance expectations are negative on balance at -3.4 points, indicating that on balance, they are still expetced to weaken, though to a lesser extent than expectations over the past year.

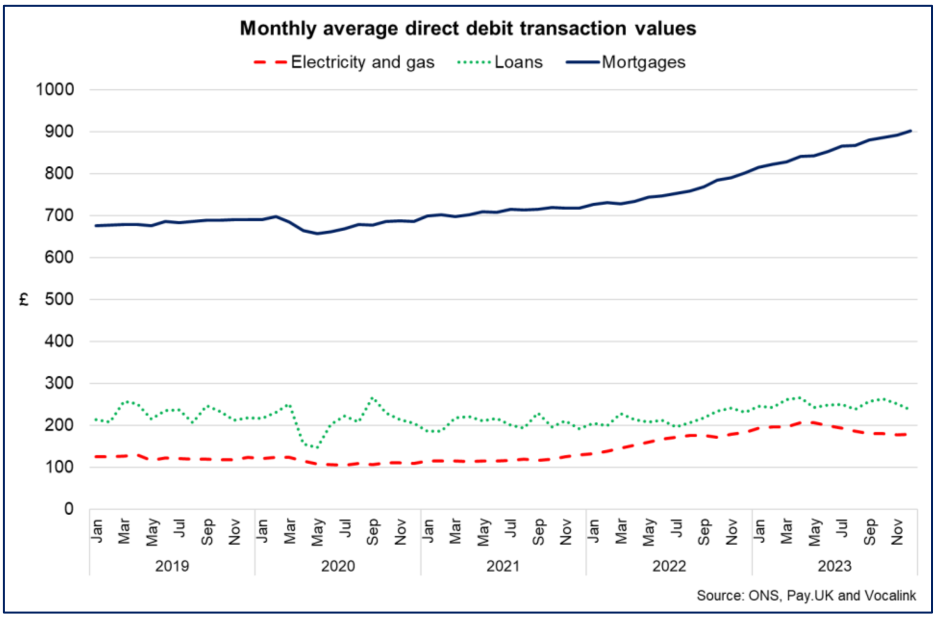
Cost of Living and Spending

- 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 fell 2.4% over the year to December, while sales value grew 0.6% with the divergence reflecting the pace of rising prices.[16]

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



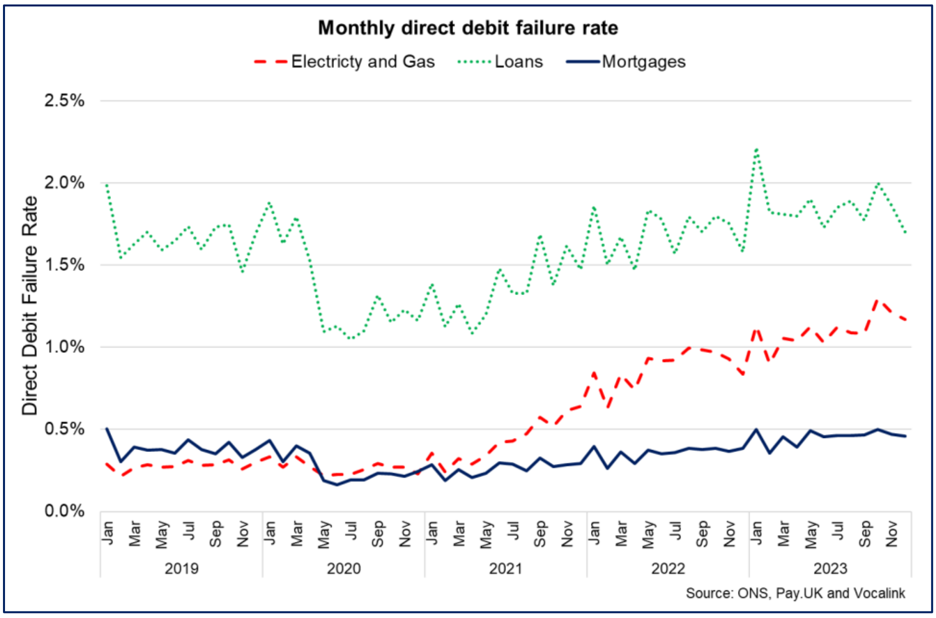
- Similarly the rise in prices and interest rates have had a significant impact on the amount UK conumers are paying for their energy costs, mortgages and other loans. In December 2023 the average monthly direct debit payment for electricity and gas was £178.79 (up 37.5% compared to December 2021), however fell 2.4% compared to December 2022.[17]
- More broadly, the average monthly direct debit payment for mortgages was £902.77 in December (up 12% over the year and 25.7% since 2021) and £236.47 for loans (up 2% over the year and 23% since 2021).



- 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

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

risen to 1.17% (up from 0.84% in December 2022), while for mortgages it has risen to 0.46% (up from 0.38% in December 2022), though has remained broadly stable since May.

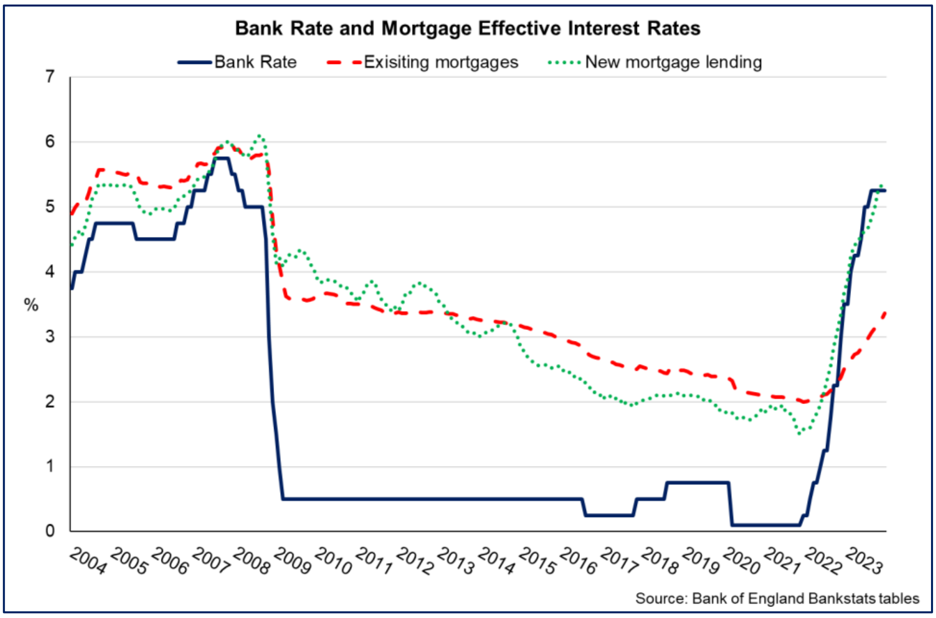


- More broadly in January, the ONS Public Opinions and Social Trends survey showed that 41% of respondents were finding it very or somewhat difficult affording energy bill payments and 35% for mortgage and rent payments. For energy bills, this was slightly lower than at the same point in 2023 (c. 47%), however has risen for mortgages payments from c.30% and potentially reflects the changing composition of inflationary pressures.[18]

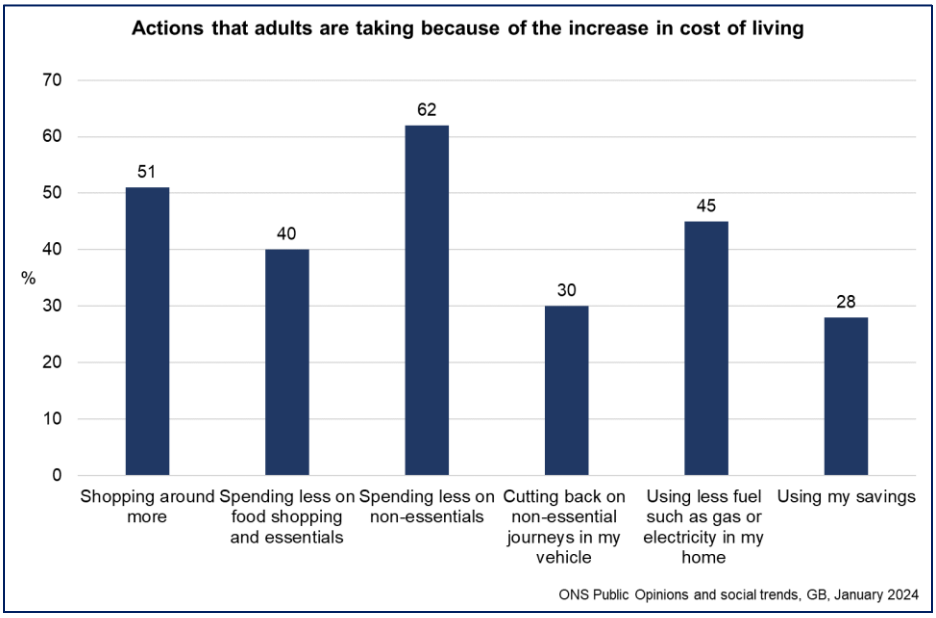
- The more gradual but recent impacts of rising interest rates on mortgage payment challenges compared to energy payments, reflects the rise in interest rates over the past year but also the time it takes for the full impact of the increase in Bank Rate to be felt at an aggregate level due to the high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

- Reflecting this, the 'effective' interest rate – the actual interest paid – on newly drawn mortgages remains elevated but fell slightly from 5.34% in November to 5.28% in December while the rate on the outstanding stock of mortgages rose from 3.27% to 3.36%. This is the first fall in newly drawn mortgage rates since November 2021, in part reflecting increased market expectations that interest rates may have peaked.[19]

[18] Public opinions and social trends, Great Britain - Office for National Statistics
[19] Effective interest rates - A visual summary of our data | Bank of England



- In response to the change in cost pressures facing households, ONS Public Opinions and Social Trends survey data from January 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%). 45% reported using less fuel such as gas or electricity in their home and 40% reported spending less on food shopping and essentials.

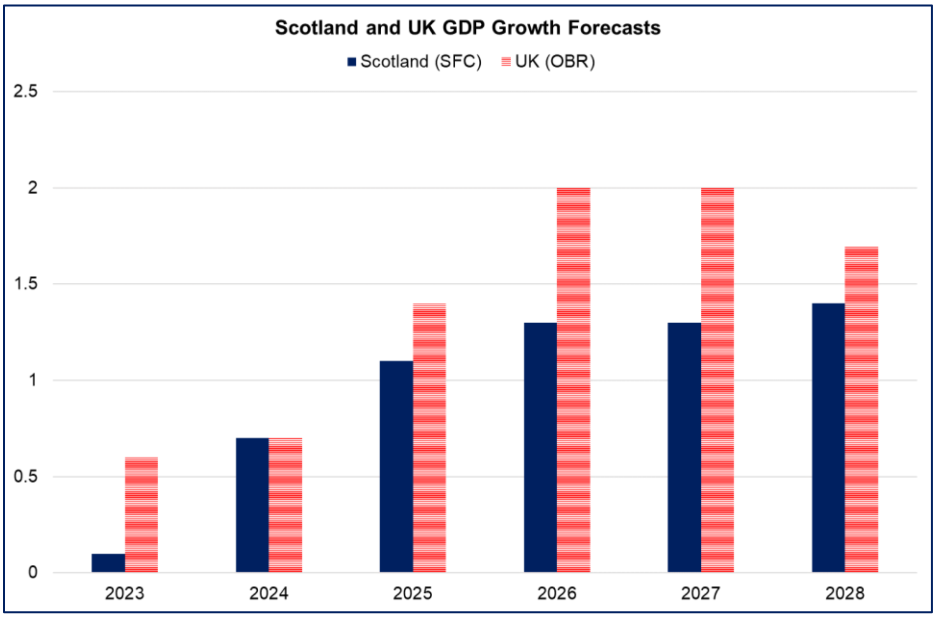


Economic Outlook

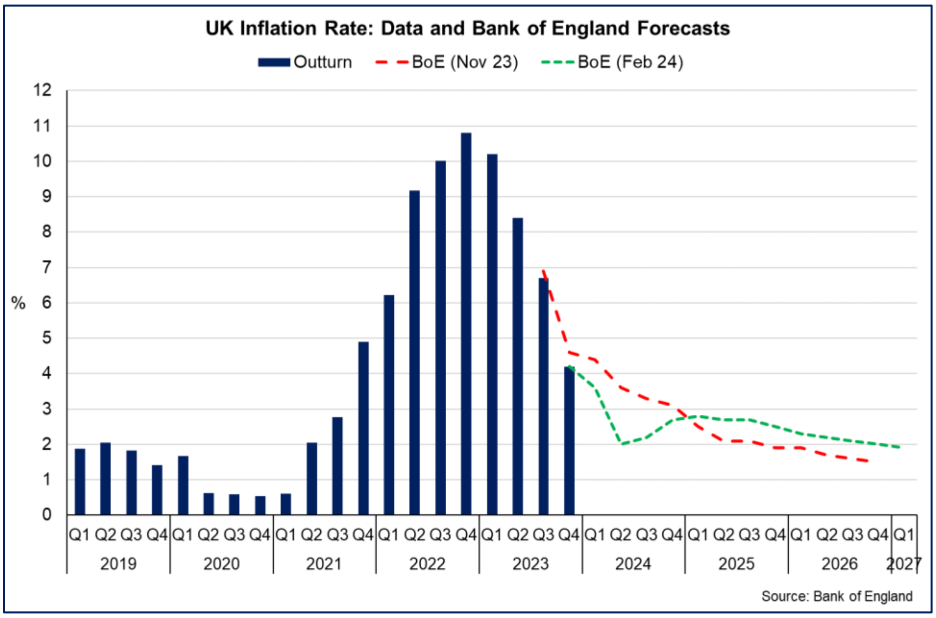
Economic conditions are forecast to improve with stronger growth and lower inflation.

- The outlook for economic growth in 2024 remains subdued however is expected to strengthen, while broader economic conditions are also improving. Inflation is forecast to fall below 3% over the year and low unemployment coupled with the recent improvements in sentiment and real earnings growth provide a stronger foundation for the improved growth outlook.

- In December, the Scottish Fiscal Commission forecast Scottish economic growth to strengthen from 0.1% in 2023 to 0.7% in 2024, rising to 1.1% in 2025. 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.[20,21]



- Most recently in February, the Bank of England forecast UK GDP to grow 0.25% in 2024 rising to 0.75% in 2025. The Bank also forecast inflation to fall from its current rate of 4% to temporarily meet the 2% target in Q2 2024, before rising to 2.7% in Q4 2024 and to 2.5% by the end of 2025 reflecting the persistence of domestic inflationary pressures.[22]



- The Bank of England, alongside the US Federal Reserve and the European Central Bank, have continued to retain a restrictive monetary policy position with Bank Rate held at 5.25% since

20 Scottish Fiscal Commission – Scotland's official, independent economic and fiscal forecaster
21 Home - Office for Budget Responsibility (obr.uk)
22 Monetary Policy Report - February 2024 | Bank of England

August. However, markets expect the Bank Rate to fall more quickly than previously anticipated, falling from 5.25% to around 3.25% by the start of 2027.

- Overall, the resilience in economic output and the labour market, coupled with declining inflation pressures over the year has been positive. Business activity has weakened further in the final quarter of the year, however the resilience of business and consumer sentiment, low unemployment, real earnings growth and falling inflationary pressures provide an improved basis for the stronger growth forecast for 2024.

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