Monthly Economic Brief

Office of the Chief Economic Adviser

December 2022

Scottish Government
Riaghaltas na h-Alba

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December 2022

Data up to 8 December 2022

Overview

This month's economic brief provides an update on some of the latest economic data during the third and fourth quarters of the year with forecasts indicating that the UK economy has now entered recession as inflation has continued to rise and financial conditions worsen.

Scotland's GDP fell 0.2% in the third quarter of the year, in line with the UK as a whole, following flat growth in the second quarter. The extra bank holiday in September impacted output, however, flat growth in the services sector across the quarter, in part driven by a fall in consumer facing services, indicates that the increasing cost of living is negatively impacting spending in the economy.

The falls in output was relatively broad based over the quarter, with falling output in the production and construction sectors and indications that supply side challenges are also continuing to impact on activity, albeit to a slightly lesser degree than earlier in the year. Business surveys indicate further contractions in business activity in the fourth quarter as businesses continue to face weakening demand while responding to the challenges of rising costs.

Businesses are continuing to adopt a range of measures in response to higher cost pressures, with most reporting to absorb costs, followed by passing on higher prices to customers, and some taking other measures to reduce costs such as changing suppliers or decreasing staff work hours. Energy costs continue to be the main concern for businesses, however broader inflationary pressures, supply chain disruption and interest rates are also concerns.

Median real earnings fell by 5% in the year to October as inflation rose to 11.1%. Further increases in energy and food prices, which alongside rising interest rates, are significantly impacting household budgets. Consumer sentiment in Scotland has fallen to its lowest level since the start of the time series in 2013, reflecting the significant concerns that households currently have for the economy, household finances and spending.

Unemployment increased slightly over the third quarter to 3.5%, however remains low overall and labour market conditions remain tight with many businesses continuing to report shortages. However there are indications that the overall pace of recruitment activity has slowed, partly reflecting that demand for staff has become increasingly tentative given the level of uncertainty in the economic outlook.

Looking ahead, forecasts expect that the fall in output in the third quarter marked the start of a UK recession with output expected to continue falling in 2023 as persistent, though slowing, inflation and tightening financial conditions result in falling real household income and demand. However there remains a great deal of uncertainty over the depth and duration of this economic downturn due to the complexity of both current domestic and global factors. The Scottish Fiscal Commission will publish their latest forecasts for Scotland on 15 December alongside the Scottish budget.

Output

Economic output fell in September and over the third quarter as a whole.

- The Scottish economy contracted by 0.6% in September, and by 0.2% over the third quarter of 2022, weakening further from flat growth (0.0%) in the second quarter.[1]
- The contraction over the third quarter is in line with UK GDP (-0.2%) and reflects a stalling in growth as the economy has faced increasing and elevated inflationary pressures over the course of the year.

- Part of the fall in output in September (and therefore over the third quarter) was due to the additional bank holiday for Her Majesty The Queen's funeral, during which many businesses closed or operated differently. The Office for National Statistics estimate that at least half of the UK GDP fall in September was due to the bank holiday.[2]
- However, the fall in output also reflects the wider economic challenges from the increasing cost of living caused by energy and food price rises affecting household disposable income. Services growth was flat (0.0%) over the quarter in which consumer facing services fell 0.1%. There are also indications that supply side challenges continue to impact the production sector (-1.0%) in which manufacturing output fell 0.8% over the quarter, while construction output fell 0.3%.

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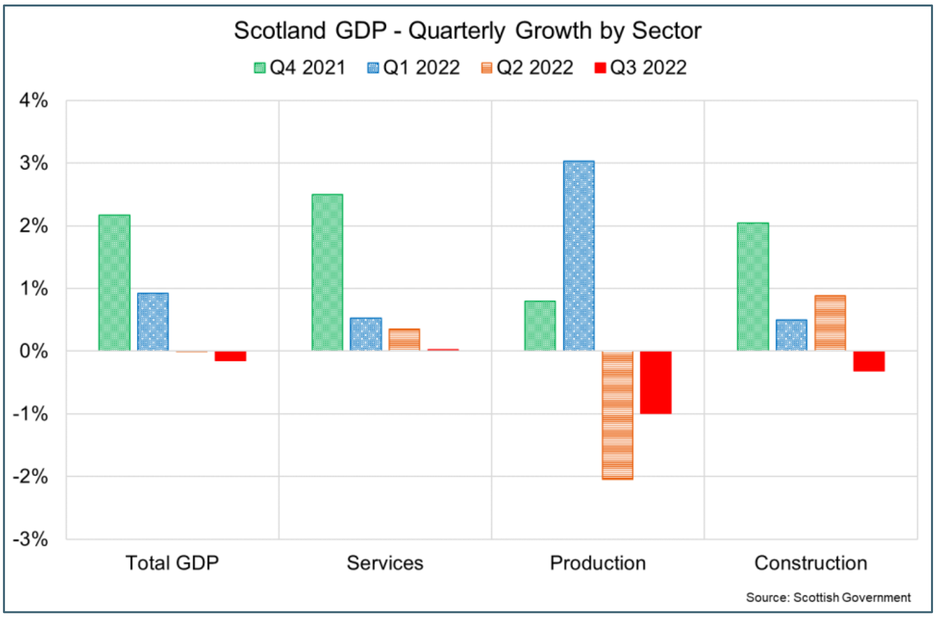
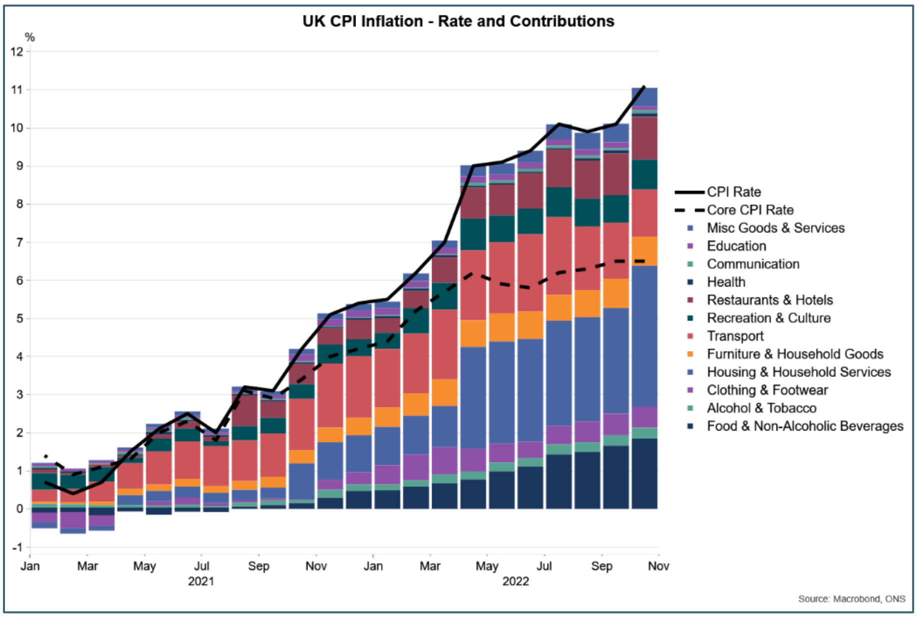
[1] [GDP first quarterly estimate: 2022 Quarter 3 (July to September) - gov.scot (www.gov.scot)]
[2] [GDP monthly estimate, UK - Office for National Statistics (ons.gov.uk)]



Inflation

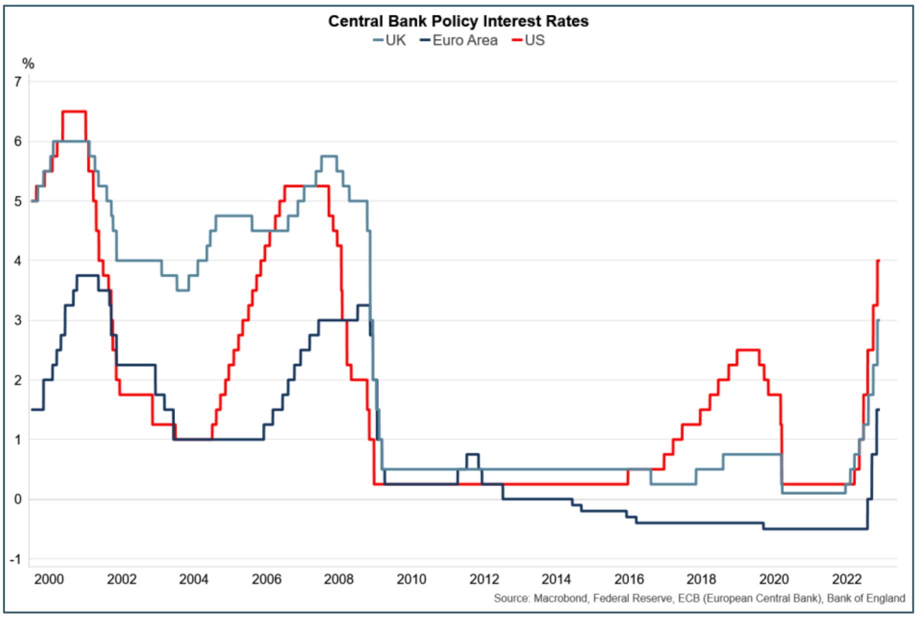
Energy and food price rises drive inflation higher in October.

- UK CPI inflation rose to 11.1% in October, up from 10.1% in September, and is at its highest rate since 1981.[3]
- The increase over the month was particularly driven by an increase in gas and electricity prices, despite the introduction of the Energy Price Guarantee, and food prices, while motor fuels and second-hand car prices made the largest, partially offsetting, downward contribution to the rate change.



[3] [Consumer price inflation, UK - Office for National Statistics](#)

- The introduction of the Energy Price Guarantee (EPG) meant that electricity, gas and other fuels prices rose by 24.3% over the month to October and 89.7% on an annual basis. The ONS estimate that without the EPG, electricity, gas and other fuels prices would have risen by 75% over the month to October.
- Food prices have also continued to rise and in October rose by 2% over the month and 16.5% over the year.
- Core inflation, which excludes food, energy, alcohol and tobacco, remained at 6.5% in October, unchanged from September, and further highlights that energy price rises have been the main driver of the rise in October and over the year. However, core inflation has risen from 1.4% at the start of 2021 and is at its highest rate since 1992, reflecting that inflation has been broad based and rising energy and food prices are having indirect effects across the basket of goods and services.
- In response to the further rise in underlying inflationary pressures, the Bank of England's Monetary Policy Committee (MPC) increased the Bank Rate by 0.75 percentage points to 3% in November; its eighth consecutive rate rise since December and up from 0.1% over this period.[4]



- The increase in interest rates over the past year follows a similar pattern to the US Federal Reserve and the European Central Bank (ECB) as monetary policy has tightened to reduce inflationary pressures. Market expectations are that the Bank of England could raise interest rates further over the coming year to around 4%, while the Federal Reserve and ECB have indicated that further tightening in the US and Euro Area is also likely.

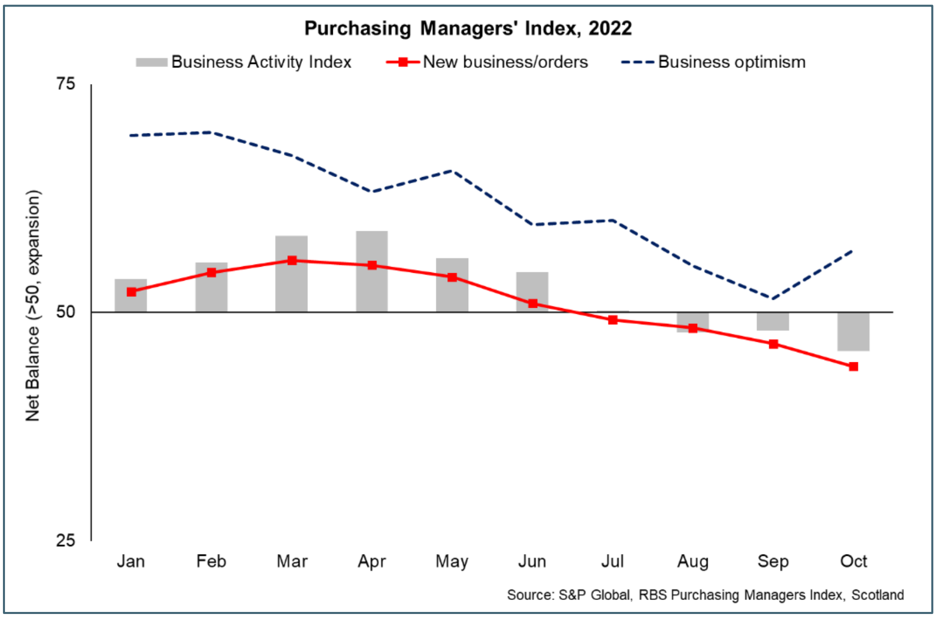
[4] Bank Rate increased to 3% - November 2022 | Bank of England

Businesses

Business activity weakens further in October as cost pressures remain elevated.

Business activity

- The Purchasing Managers Index (PMI) business survey indicates that business activity in Scotland's private sector continued to contract in October (45.8), with sharpening falls in activity across the manufacturing and services sectors.[5]
- This has partly been driven by further falls in inflows of new business and orders (44.1) which contracted for a fourth consecutive month and at its fastest rate since February 2021. The fall in new business has been broad based across the sectors but has been most prominent in manufacturing which saw a sixth month of contraction.
- Business optimism overall remained positive and increased in October to 56.8. However, the level of optimism remains notably lower than earlier in the year.

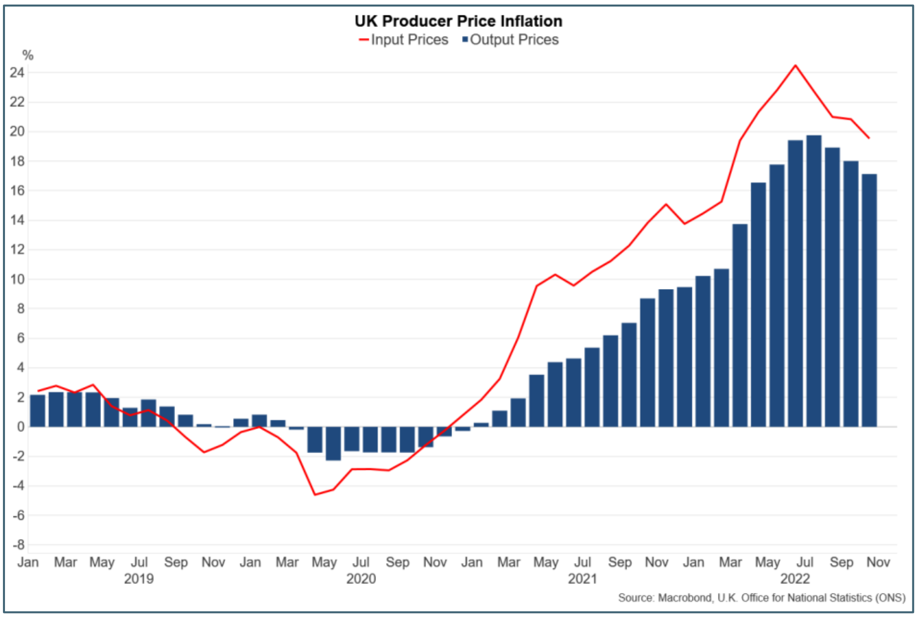


- UK PMI data indicates a further fall in business activity in November, and at the same rate as in October (48.2), with incoming new business volumes falling at their fastest rate since the start of 2021 and continues to emphasise weaker demand and the cost of living pressures facing business.[6]

[5] S&P Global, RBS Purchasing Managers Index: Royal Bank of Scotland PMI report for October 2022 | Royal Bank of Scotland (rbs.co.uk)
[6] S&P Global/CIPS UK PMI: c9088b35645b4075925dc0388e005e56 (spglobal.com)

Business costs

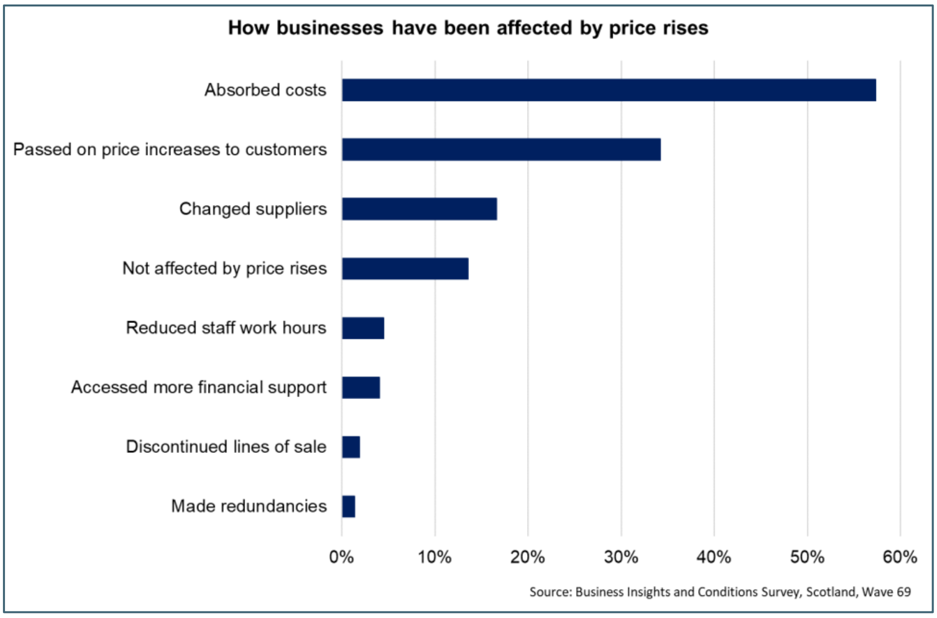
- Rising costs (energy, materials, staffing) present a significant challenge to business operations and resilience in the face of weakening demand.
- Producer price inflation (changes in the prices of goods bought and sold by UK manufacturers, including price indices of materials and fuels purchased and factory gate prices) has risen sharply over the past two years. In October, annual input price inflation was 19.2%, easing back from the recent peak of 24.2% in June, however remained elevated.[7]
- The rise in input prices has been broad based across product groups. Crude oil input prices rose by 2.5% over the month and 43.8% annually, while imported home food material prices increased 31% annually and home food materials and chemicals increased by 18.7%.
- Output price inflation has also eased back in recent months to 14.8% in October, down from the recent peak of 17.3% in July, but also remains elevated. Over the year, the increase in input prices have largely been reflected in increased output prices with petroleum products prices increasing 40.6% annually, chemical and pharmaceuticals +20.1%, and food products +16.1%.



- PMI business survey data for Scotland also indicate that businesses are continuing to pass on higher costs to customers. Latest data for October indicates that while input and output price rises continued to moderate in the manufacturing sector, they re-accelerated in the services sector over the month with businesses citing higher wages and utilities and general inflation as the driving factors.
- Business Insights and Conditions Survey (BICS) data provide further insight into the effects on businesses of price rises. At the start of November, 57% of businesses reported that they had to

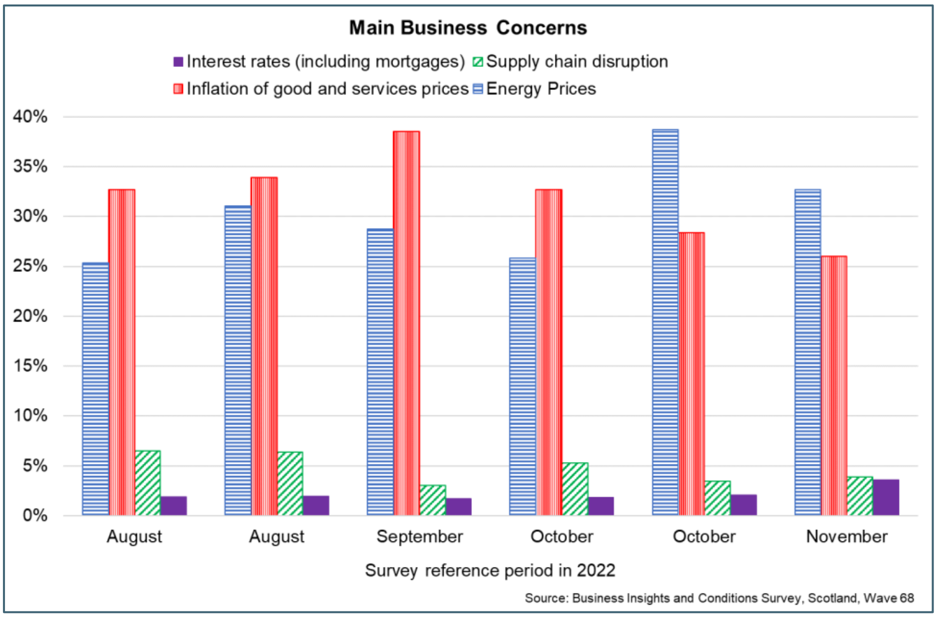
[7] [Producer price inflation, UK - Office for National Statistics (ons.gov.uk)]

absorb costs and 34% reported having to pass on price increases to customers. A much lower percentage of firms reported having to access more financial support (4%) and having to reduce staff work hours (4.5%), however both have increased from earlier in the year indicating that businesses are adopting a broad set of approaches to tackling the persistence of cost pressures.[8]



- There are also differences in effects across sectors with 16.5% of Accommodation and Food businesses reporting having to reduce staff work hours (compared to 4.5% for all businesses) and 47% of information and communication businesses reporting that the business had not been affected by price rises (compared to 13.5% for all businesses).
- This further reflects that costs rises are impacting sectors differently and business responses to price rises will reflect a range of factors such as the nature of the business and customer base within sectors and the options available to improve efficiency and reduce costs.

[8] BICS weighted Scotland estimates: data to wave 69 - gov.scot (www.gov.scot)



- Overall, the main concerns for business in November were energy prices (32.7%) which has been on an upward trend over the second half of the year, and inflation of good and services prices (26.0%). Much lower and declining percentages of businesses are concerned about supply chain disruption (3.9%) while concerns about interest rates (including mortgages) (3.6%), remains low but has risen in recent months and may reflect the tightening financial conditions that businesses are facing from rising interest rates.

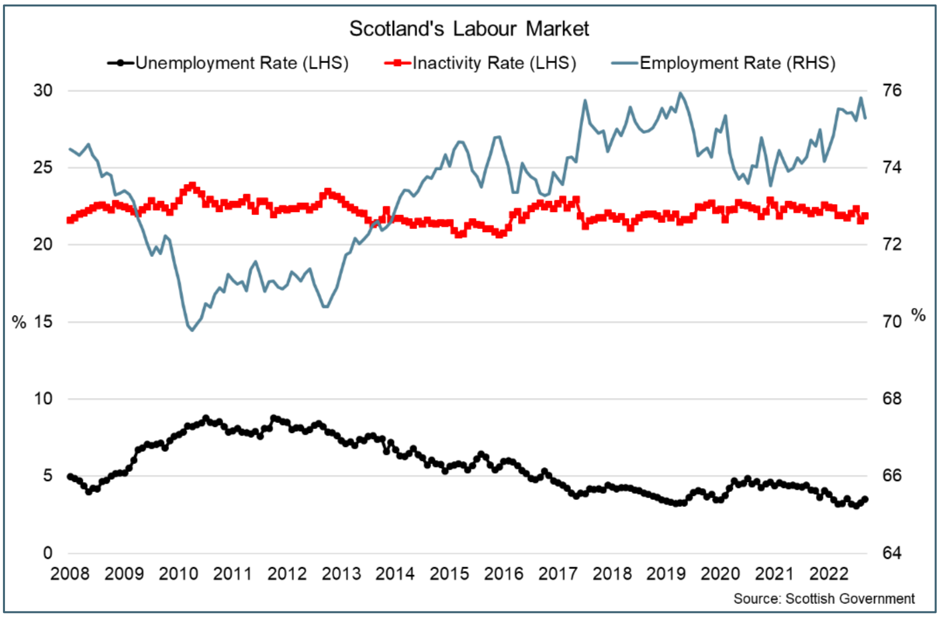
Labour Market

The labour market remains tight, however inflation continues to outpace earnings growth.

Official labour market statistics

- The latest labour market statistics for July to September 2022 in Scotland show there were 2.7 million people in employment (rate of 75.3%, up 0.6 percentage points on the year), 98,000 people unemployed (rate of 3.5%, down 0.6 percentage points) and 753,000 people economically inactive (rate of 21.9%, down 0.2 percentage points).[9]

[9] Labour Market Trends: November 2022 - gov.scot (www.gov.scot)

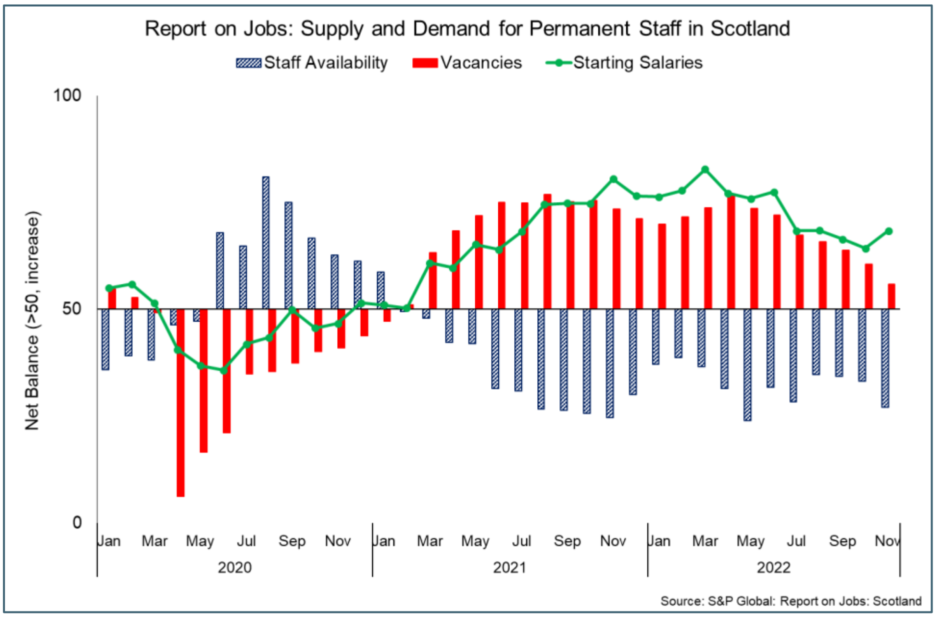


- Latest PAYE data signals further increase in employment in October with the number of PAYE employees rising 4,100 (0.2%) over the month and is 49,800 higher than in October last year.[10]

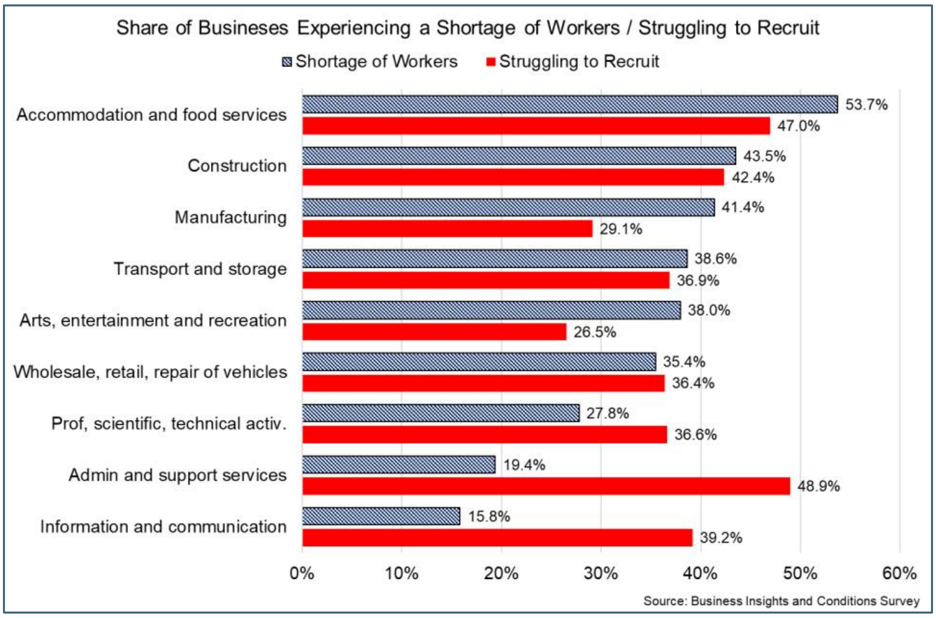
Demand and supply of staff

- Business surveys signal that labour market conditions have remained tight going into the final quarter of the year, however recruitment activity has slowed reflecting the uncertain economic outlook.
- The RBS Report on Jobs for November signalled that growth in demand for staff remained positive but continued to slow across both permanent (55.9) and temporary (57.1) vacancies to their lowest rates since the first quarter of 2021.[11]
- However, for businesses seeking to recruit, supply side challenges in the labour market have also continued with candidate availability (labour supply) falling and at an accelerated rate in November. Recruiters continue to cite underlying challenges of skill shortages and Brexit as factors constraining supply, alongside an increased hesitancy of labour market participants to seek out new roles due to rising economic uncertainty.

[10] Earnings and employment from Pay As You Earn Real Time Information, seasonally adjusted - Office for National Statistics (ons.gov.uk)
[11] Royal Bank of Scotland Report on Jobs | NatWest Group, 9962424e4e23435c8d2ad08766e17671 (spglobal.com)



- The underlying tightness in the labour market continued to provide upward pressure to starting salaries in November which rose at elevated rates across permanent (68.4) and temporary (65.0) positions. The pace of growth picked up in November, however remained slower relative to the first half of the year.
- Labour shortages continue to affect a range of sectors with BICS data indicating 41.6% of businesses experienced a shortage of workers in September to October. The overall share has fallen from the end of August when it was 44.5%, however remains higher compared to earlier in the year and remains most notable in accommodation and food services (53.7%), construction (43.5%), and manufacturing (41.4%) sectors.[12]

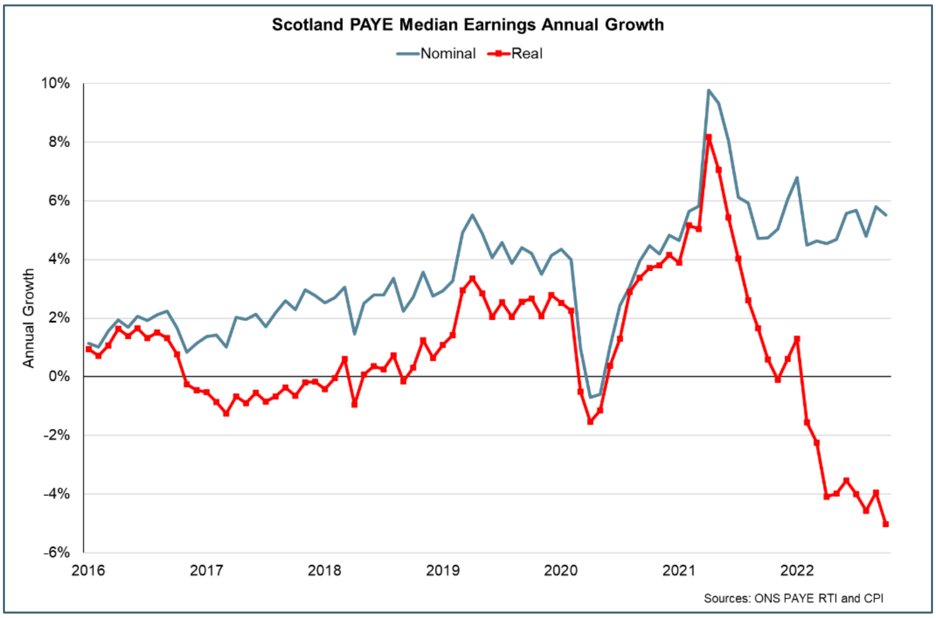


[12] BICS weighted Scotland estimates: data to wave 69 - gov.scot (www.gov.scot)

- Furthermore, when asked about recruiting in October, 39% of all business reported experiencing difficulties recruiting employees. This is highest within admin and support services (48.9%), accommodation and food services (47%) and construction (42.4%). Earlier in the month, most businesses responded that a lack of qualified applicants (67.5%) and a low number of applications (58.5%) were reasons for why the business experienced difficulties in recruiting employees.

Earnings

- Nominal median monthly PAYE earnings grew 0.4% in October 2022 to £2,143. Over the past year to October, earnings have grown 5.5%, following the end of the furlough scheme in Septmber 2021.[13,14]
- However, adjusting for inflation, which rose to 11.1% in October, real median earnings fell 5.0% on an annual basis, the ninth consecutive month of negative annual growth and the sharpest annual fall in the monthly timeseries during the current period of rising inflationary pressures.



- The sharp fall in real median earnings over the past year emphasises the cost of living challenges facing individuals and households.

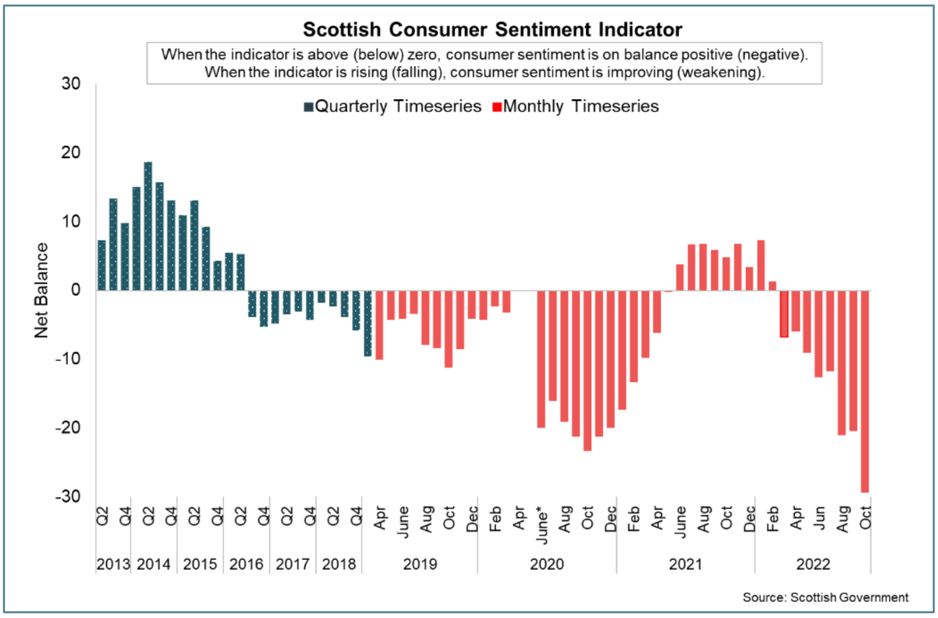
[13] The rates of earnings growth during the pandemic need to be interpreted with caution as base effects, compositional factors and the furlough scheme have all influenced the data.
[14] Earnings and employment from Pay As You Earn Real Time Information, seasonally adjusted - Office for National Statistics (ons.gov.uk)

Consumption

Consumer sentiment fell sharply in October to its lowest level in the time series.

Consumer sentiment

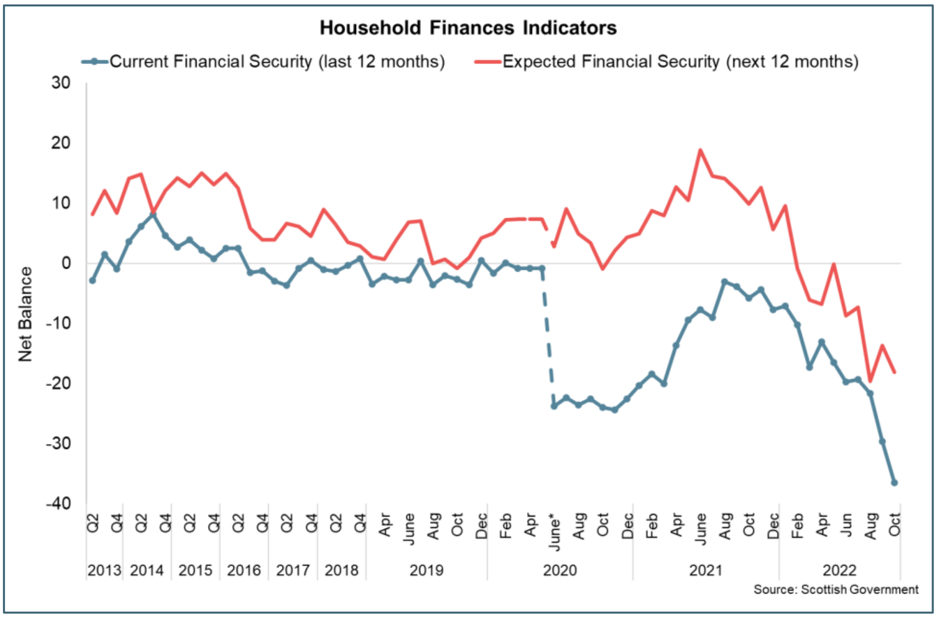
- Consumer sentiment indicators continue to be highly sensitive to the rapidly changing economic environment as households and consumers face significant challenges from the sharp rise in inflation and cost of living.
- These challenges have instensified since the start of the year, which has been reflected in a sharp drop off in the Scottish Consumer Sentiment Indicator.
- Latest data show consumer sentiment declined considerably in October (-29.4 down from -20.5 in September). Overall, consumer sentiment has fallen 36.7 points since the start of the year and is at its lowest level in the time series.[15,16]



- The latest fall in sentiment in October has been broad based regarding the economy, security of household finances and relaxedness about spending money.
- On the economy, respondents on balance consider current economic circumstances to be worse than last year (-30.7, down from -24.5 in September) and expect the economy to deteriorate over the coming year relative to the current situation (-3.2). The level of optimism has been on a downward trend since July 2021, and has entered negative territory for the first time since March 2020.

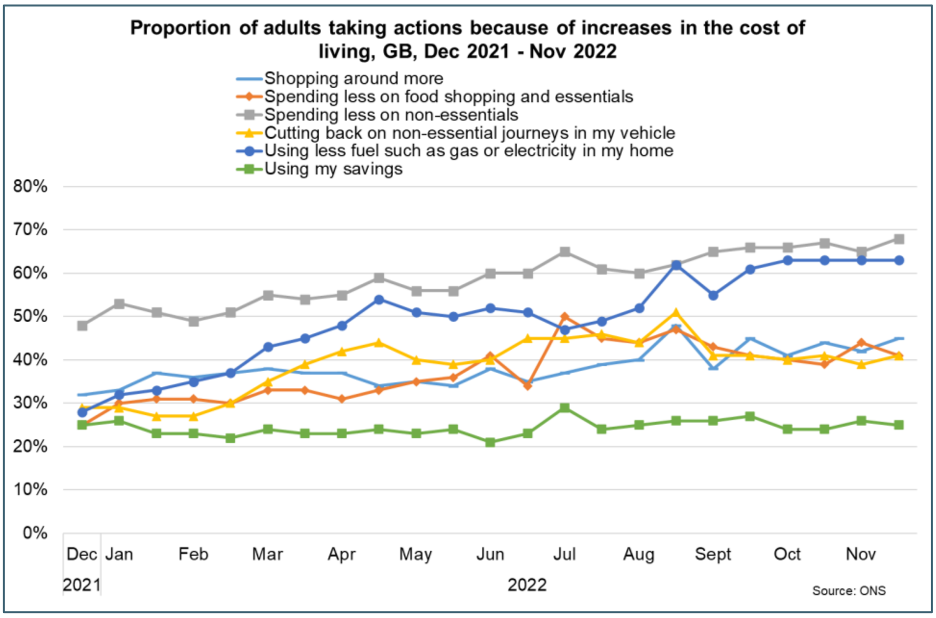
[15] The latest consumer sentiment survey was undertaken between 7 – 31 October 2022.
[16] Scottish Consumer Sentiment Indicator : Monthly Data - gov.scot (www.gov.scot)

- In terms of households personal finances, respondents on balance continued to report that their household finances are less secure than 12 months ago (-36.5, down from -29.6 in September). Furthermore, looking ahead, respondents increasingly expect their financial security to fall over the coming year (-18.1, down from -13.7 in September), with both indicators falling to their lowest levels in the time series.
- Furthermore, since the beginning of the year, households have been increasingly uneasy about spending money as inflationary and cost of living pressures have increased. In October, the spending indicator fell 18.8 points to -58.5, its lowest level in the time series, indicating a signficant weakening in sentiment about spending.



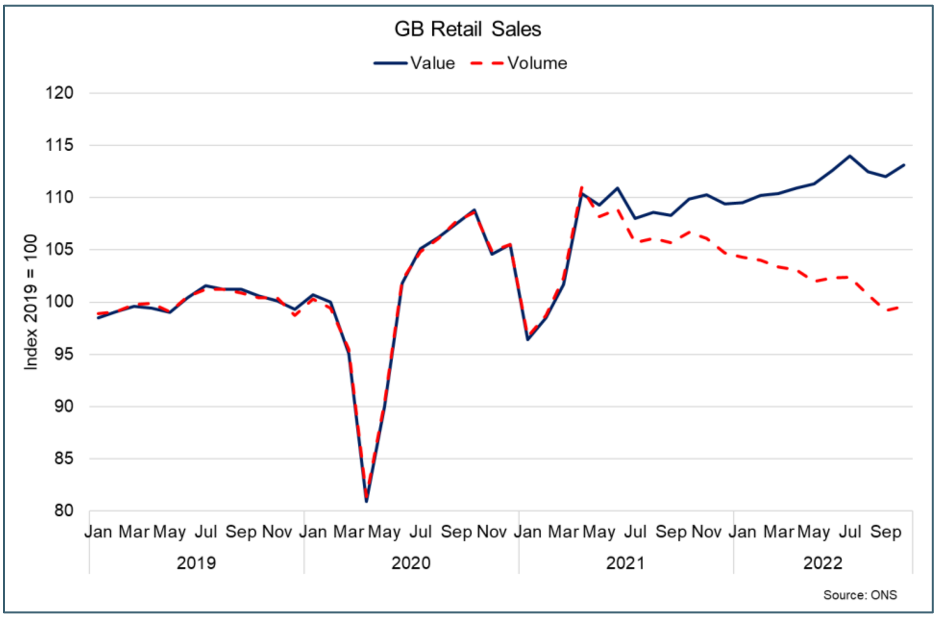
- Overall, the fall in sentiment since the start of the year has been driven by a combination of falling sentiment regarding the economy as a whole, and falling sentiment regarding personal household financial circumstances and personal relaxedness to spending money.
- This reflects the challenging economic and financial environment households are facing and the risks to consumption growth over the months ahead. This is seen in other household surveys. At a GB level, the ONS Public Opinions and Social Trends survey for November showed that 77% reported being worried about rising costs of living, 45% reported finding it difficult to afford energy bills and 34% reported finding it difficult to afford rent or mortgage payments.[17]
- The proportion of adults taking actions because of increased cost of living has risen over the year, with 68% spending less on non-essentials, and 63% using less fuel in their homes.

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



Retail Sales

- GB retail sales volumes increased by 0.6% in October 2022, however fell by 2.4% in the 3-months to October, compared to the three previous months, continuing the downward trend since summer 2021. It is also the lowest three-month growth rate since restrictions were in place in March 2021.[18]
- Compared to the same period a year earlier, sales volumes decreased 6.1% in the three months to October 2022, while sales values increased 4.7%. As illustrated in the chart below, the gap between GB retail sales value and volume sold has widened, reflecting the rise in inflation.



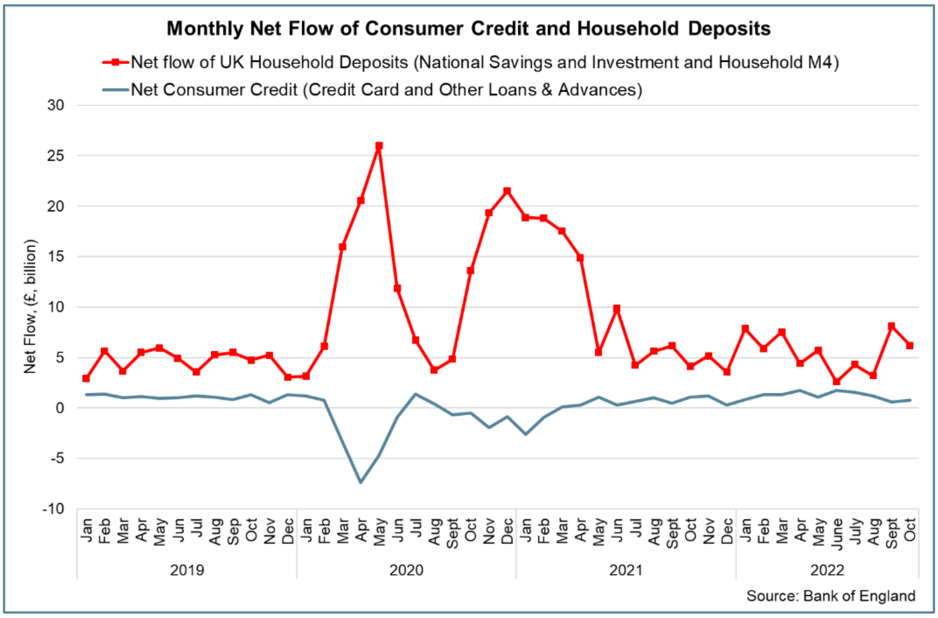
- Over the month to October, there was an increase in sales volumes in all main sectors (non-food stores, non-store retailing and fuel), which offset a fall in food stores sales, which fell 1.0%. The

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

ONS bulletin highlights that in recent months, supermarkets have highlighted that they are seeing a decline in volumes sold because of increased cost of living and food prices.

Household Savings and Consumer Credit

- The impacts of the rise in cost of living and the increase in Bank Rate on household savings and consumer credit are continuing to develop. This is on the back of savings and credit flows continuing to normalise over the past year following notable shifts during the pandemic.
- At an aggregate level, latest Bank of England Money and Credit data shows net flows from UK households into deposit-like accounts fell in October. Net inflows sat at £6.4 billion over the month, down from £8.9 billion in September, however was above the average monthly net flow of £5.3 billion over the previous 6-months during which inflows trended downward before starting to pick up in the second half of the year.[19]



- Alongside this, consumers borrowed an additional £0.8 billion in October, following £0.6 billion of borrowing in September. This is below the previous 6-month average of £1.3 billion during which net consumer credit has trended downwards.
- Recent movements may reflect that at an aggregate level, higher inflationary pressures and tightening monetary policy/higher interest rates may have started to lower credit demand and attracting savings.

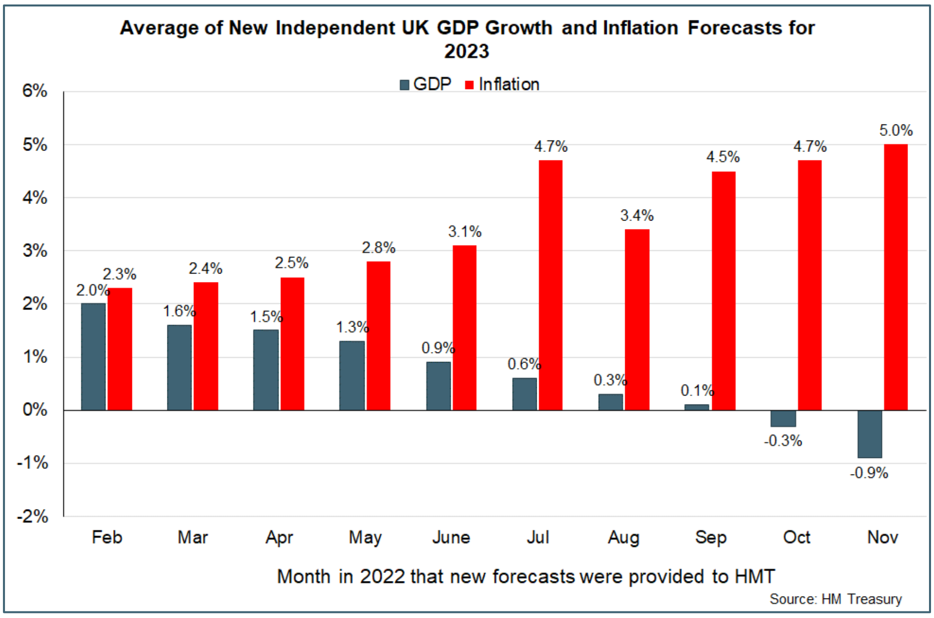
[19] Money and Credit - October 2022 | Bank of England

Economic outlook

The economy is forecast to contract in 2023 as inflation gradually falls over the year.

- The economic outlook is extremely challenging with output growth starting to contract in the second half of 2022, inflationary pressures remaining elevated, tightening monetary conditions and the downside risks from ongoing uncertainty in global energy supply chains.
- At a global level, in November, the OECD forecast global economic growth to slow to 2.2% in 2023, with US and Euro Area growth slowing to 0.5% over the year and output projected to decline in several European countries over this winter period.[20]
- Inflation in OECD countries is projected to be 9.4% in 2022 and is expected to fall back but remain elevated in 2023 at 6.6%, with rising interest rates, weaker demand and the easing of supply chain bottlenecks projected to moderate inflation further into 2024 to 5.1%.
- At UK level, the Bank of England and the Office for Budget Responsibility forecast that the fall in output in the third quarter of this year has marked the start of a UK recession, with high rates of inflation and tightening financial conditions expected to cause a significant fall in real household disposable incomes and demand over 2023-24.[21]
- There is significant uncertainty over the depth and duration of the expected recession, the pace at which inflation will fall back towards the 2% target, and the pace at which output will return to pre-recession peaks. This will reflect domestic and global economic developments, the impacts of fiscal and monetary policy and the persistence of the current energy supply and price shock.
- The Bank of England forecast (central) the UK economy to remain in recession from Q3 2022 through to the first half of 2024 with UK GDP forecast to fall 1.5% in 2023 and 1% in 2024. More recently, and taking account of the UK Government Autumn Statement, the Office for Budget Responsibility forecast the UK recession to last just over a year from Q3 2022 with UK GDP forecast to fall 1.4% in 2023 and grow 1.3% in 2024. Both forecasts expect inflation to fall back over 2023 and 2024 and a notably shallower recession than those in 1980, 1990 and 2008.
- The average of new independent forecasts in November (published monthly by HMT) highlights the downgrades during 2022 to UK 2023 growth forecasts as economic conditions deteriorated.[22] Latest forecasts from November project, on average, that UK GDP will fall 0.9% in 2023, further weakening from the forecasts in October and in stark contrast to the average expectation of 2% growth from forecasts released at the start of the year in February.

[20] OECD Economic Outlook
[21] Monetary Policy Report - November 2022 | Bank of England; Economic and Fiscal Outlook - November 2022 (obr.uk)
[22] Forecasts for the UK economy: November 2022 - GOV.UK (www.gov.uk)



- Forecasts for Scotland's economy have followed a similar pattern. Most recently in October, the Fraser of Allander Institute forecast Scottish GDP growth in 2022 of 3.6%, however set out that the economy is likely to contract in the second half of the year before contracting by -0.6% in 2023 before returning to growth of 0.8% in 2024.[23]
- The Scottish Fiscal Commission (SFC) will provide updated economy forecasts for Scotland on 15 December alongside the Scottish Budget.[24]

[23] FAI Economic Commentary 2022 Q3 | FAI (fraserofallander.org)

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