Monthly Economic Brief

Office of the Chief Economic Adviser

February 2023

Scottish Government
Riaghaltas na h-Alba

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February 2023

Data up to 3 February 2023

Overview

This month's economic brief provides an update on the latest economic data in the final quarter of 2022 and the latest forecasts for the year ahead.

Globally, economic conditions in the final quarter of 2022 weakened significantly as pressures on household finances and falling business confidence impacted consumer spending and investment. The recent falls in energy prices from their peaks in 2022 offered some optimism that although economic conditions remain difficult, most advanced economies are likely to avoid recession in 2023 as inflationary pressures ease, though economic conditions remain tough.

Growth in the Scottish economy stalled during the second half of 2022 with latest data showing flat growth in the three months to November. Growth in the UK is similarly weak, with GDP falling 0.3% over the same period. PMI business survey data indicated that a further fall in business activity in December is expected, however this is not surprising given the cost challenges that are continuing to impact households and businesses. Relative to the independent forecasts for this period, output has not fallen by as much.

At a sector level in Scotland, the weakness in growth has been seen in the large Services sector, falling 0.1% over the latest three months, and Construction falling 0.2%. This has been offset by Production growth (0.6%), driven by growth in the electricity and gas supply industry.

The headline inflation rate fell to 10.5% in December, down slightly from its recent high of 11.1% in October and indicates that overall inflation may have peaked; however, underlying core inflation remained unchanged, suggesting that price pressures will remain for some time. Prices also continue to rise for some goods and services, such as food where inflation was 16.8%, emphasising the challenges that households continue to face for essential items. Scottish consumer sentiment reflected this, falling to a series low in the fourth quarter.

Businesses likewise continue to see input cost rises with annual producer price inflation of 16.5% in December, although the pace of inflation has slowed in recent months. Energy costs continue to be the main concern for businesses, however staffing costs are a rising cost consideration.

The increase in nominal wage settlements in part reflects the ongoing tightness in the labour market in which unemployment remains at historically low levels and upward pressure on salaries reflects ongoing shortages of staff and the need to retain staff. However, recruitment activity has slowed amid the uncertainty of the economic outlook.

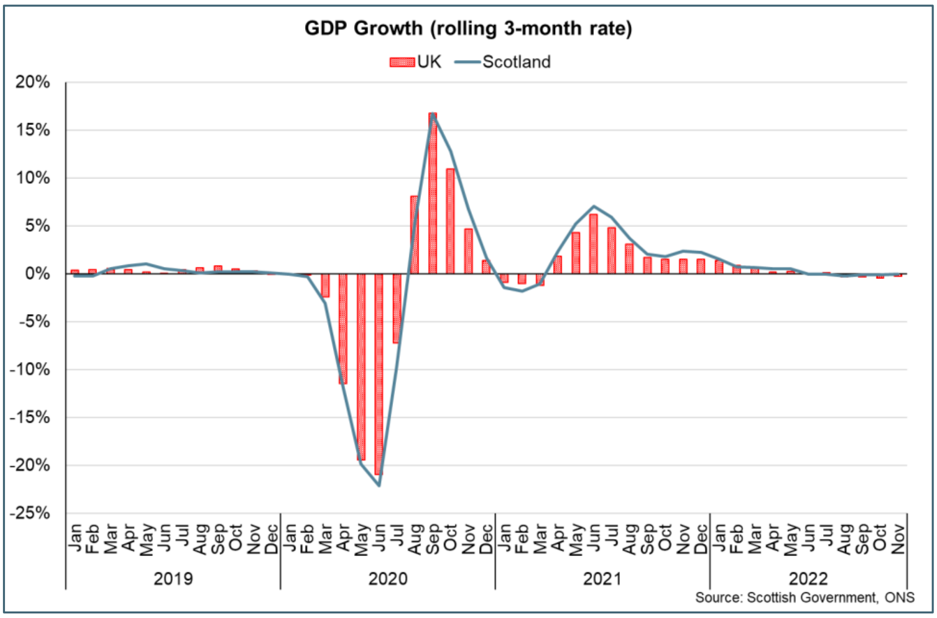
Looking ahead, the economy is now expected to enter recession during 2023 rather than the second half of 2022. The recent Bank of England forecast for the UK suggests a shallower fall in output in 2023 and inflation may fall faster reaching 4 per cent by the end of the year. Although this is more positive, with interest rates rising to 4 per cent in February, this will continue to be a difficult year for households and businesses – particularly those in consumer-facing sectors.

Finally, the trend growth estimates for the UK, which reflect the underlying capacity of the economy to grow without generating inflation, continue to be reduced, reflecting weak investment and productivity growth.

Output

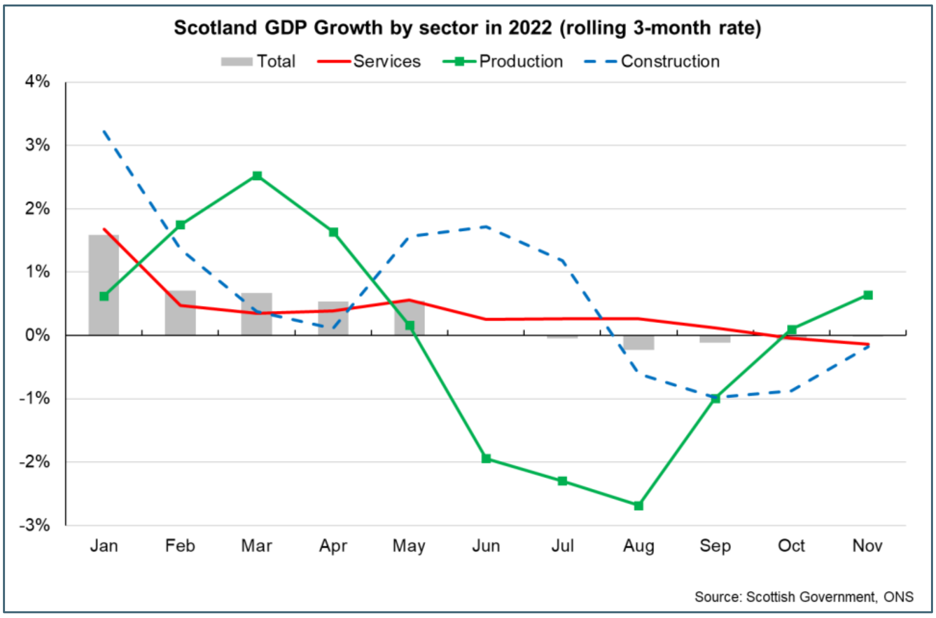
Economic output fell in November as the underlying pace of growth continued to stall.

- The Scottish economy contracted by 0.1% in November, and growth was flat over the three months to November having fallen by 0.1% in the third quarter and was flat in the second quarter (0.0%).[1]
- The weak performance over this period is broadly consistent with the pattern of growth in the UK as a whole (-0.3% in the three months to November) and reflects a stalling in growth as the economy faced increasing and elevated inflationary pressures over the course of the year.



- The pace of growth was on a downward trend across sectors during 2022 and services sector output fell 0.1% in the three months to November. This was in part driven by a 0.7% fall in consumer facing services, despite anecdotal evidence at a UK level that the World Cup had helped generate some business activity in food and beverage services activities in November.
- Construction output also fell in the three months to November (-0.2%), while Production output grew 0.6% over the period, with growth in the sector driven by electricity and gas output (3.5%). Manufacturing output however fell 0.1% over the three months and there are indications that supply side challenges continue to impact the production sector, though to a much lesser extent than earlier in the year.

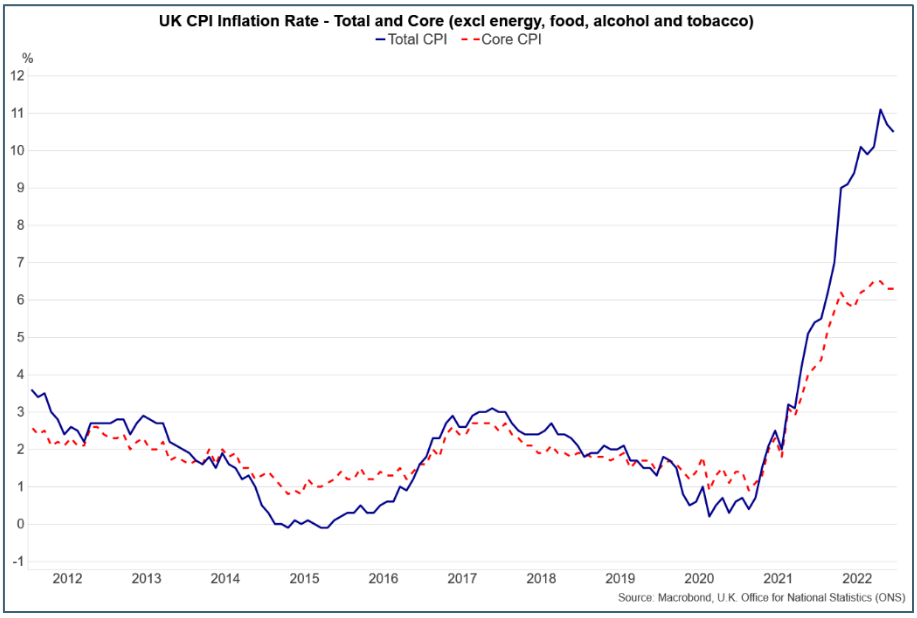
[1] GDP monthly estimate: November 2022 - gov.scot (www.gov.scot)



Inflation

Food prices continue to rise despite overall inflation falling in December.

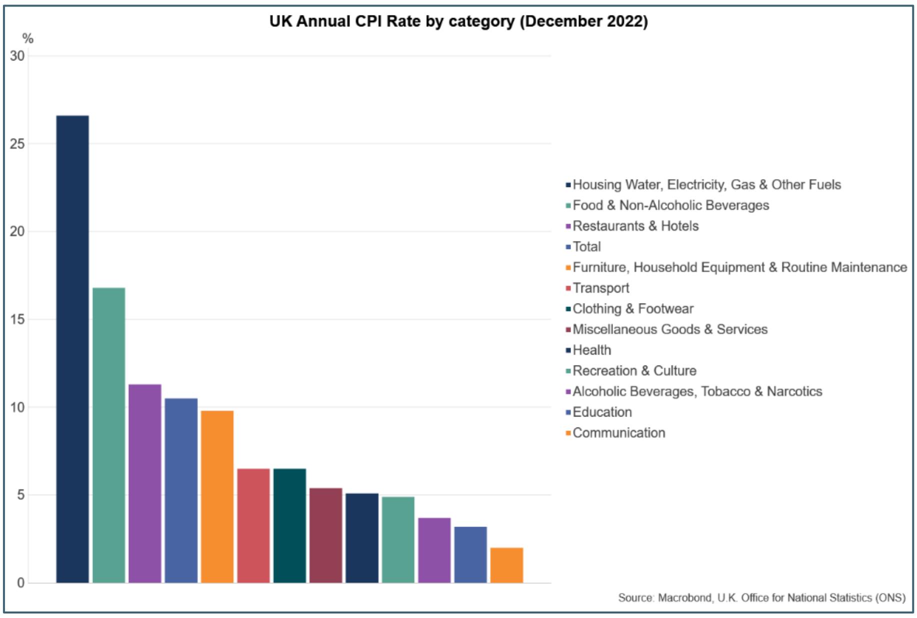
- UK CPI inflation fell to 10.5% in December, down from 10.7% in November, and its recent peak of 11.1% in October.[2]



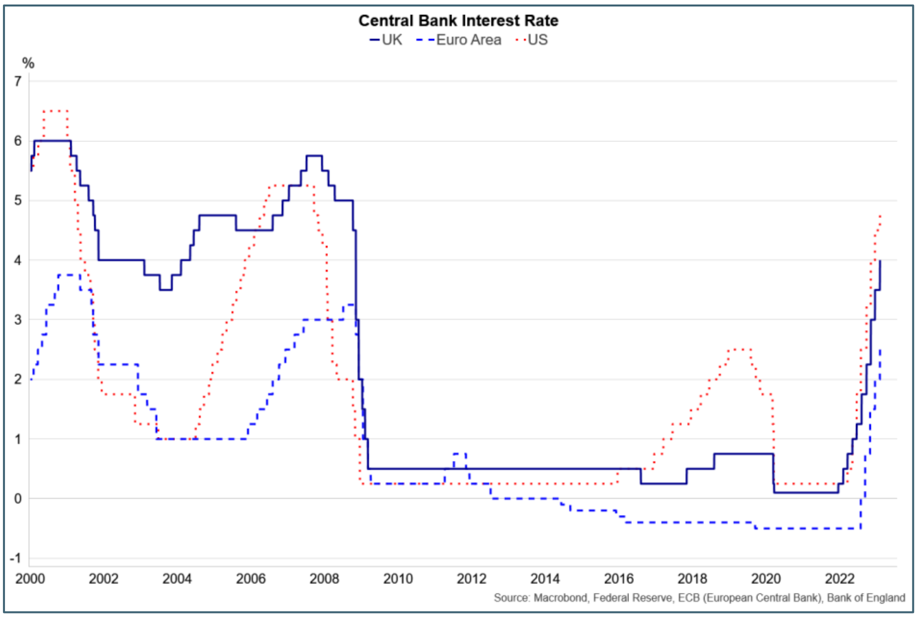
- The fall over the month was particularly driven by motor fuels, with petrol prices now around 20% lower than their peak in July.[3] Further downward contributions to the rate came from clothing and footwear and recreation and culture, although the annual inflation rate for these categories remained elevated (6.5% and 4.9% respectively).

[2] Consumer price inflation, UK - Office for National Statistics
[3] Monthly and annual prices of road fuels and petroleum products - GOV.UK (www.gov.uk)

- However, inflation continued to rise across a range of categories, including essentials such as food and non-alcoholic drinks (16.8%) and restaurants and hotels (11.3%).



- Core inflation, which excludes food, energy, alcohol and tobacco, remained at 6.3% in December, unchanged from November. Core inflation has been around 6% since April 2022, and highlights that energy price rises have been the main driver of changes in inflation over this period. However, core inflation has risen from 1.4% at the start of 2021 and its persistence reflects that inflation has been broad based.
- Due to the further rise in underlying inflationary pressures, the Bank of England's Monetary Policy Committee (MPC) increased the Bank Rate by 0.5 percentage points to 4% in February; its tenth consecutive rate rise since December 2021 and up from 0.1% over this period.[4]



[4] [Bank Rate increased to 4% - February 2023 | Bank of England]

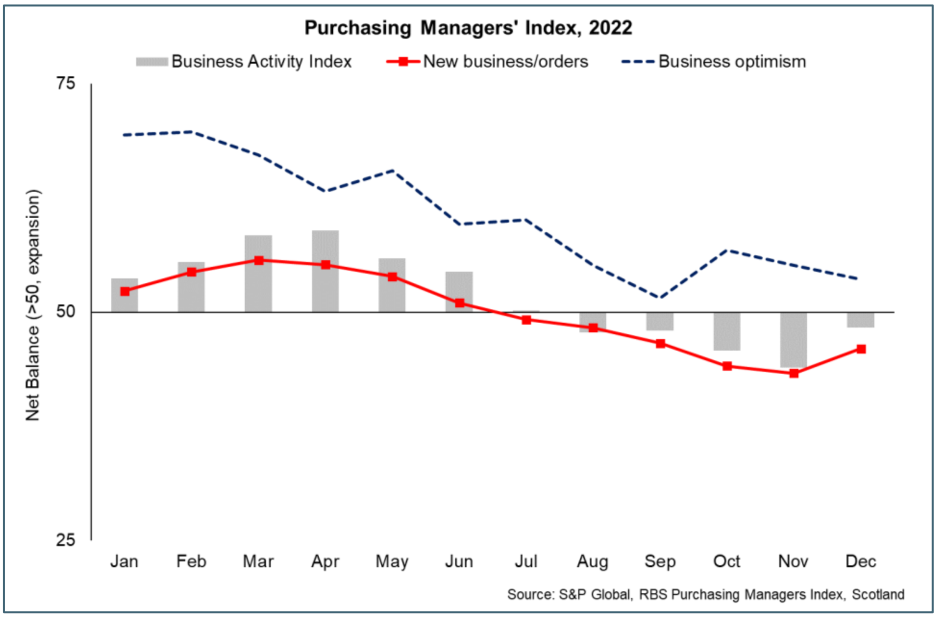
- The increase in interest rates over the past year follows a similar pattern to the US Federal Reserve (currently 4.75%) and the European Central Bank (ECB) (currently 2.5%) as monetary policy has tightened to reduce inflationary pressures. Market expectations are that the Bank of England could raise interest rates further over the coming year to around 4.5%, while the Federal Reserve and ECB have indicated that there is potential for further tightening in the US and Euro Area.

Businesses

Business activity fell at a slower rate in December though cost pressures broadened.

Business activity

- The Purchasing Managers Index (PMI) business survey indicates that business activity in Scotland's private sector continued to contract in December (48.3), though to a lesser extent than in recent months across the manufacturing and services sectors.[5]



- This was partly driven by less widespread falls in inflows of new business and orders (46.0) during the month, though the indicator did signal a sixth consecutive month of contraction in December. The persistence of this period of falling business activity alongside elevated inflationary pressures, are reflected in a further reduction in business optimism (53.6), which remained positive overall but had weakened notably over the second half of the year.

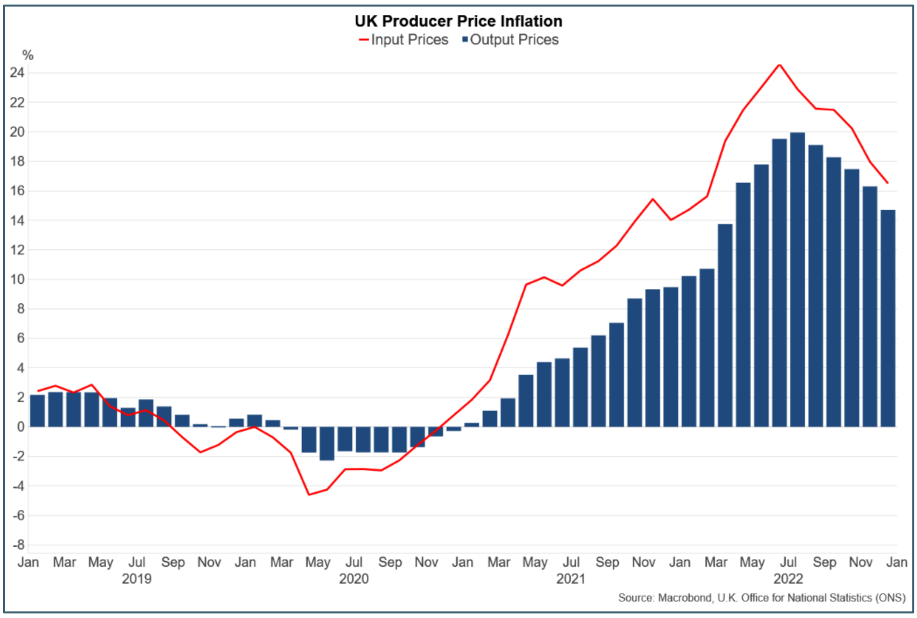
Business costs

- Rising costs (energy, materials, staffing) continued to present a significant challenge to business operations and resilience in the face of weakening demand in the final quarter of 2022. There

[5] S&P Global, RBS Purchasing Managers Index: [Purchasing Managers' Index Reports | Royal Bank of Scotland (rbs.co.uk)]

are signs that the pace of cost increases is easing, however annual rates remain significantly higher than they were prior to the pandemic.

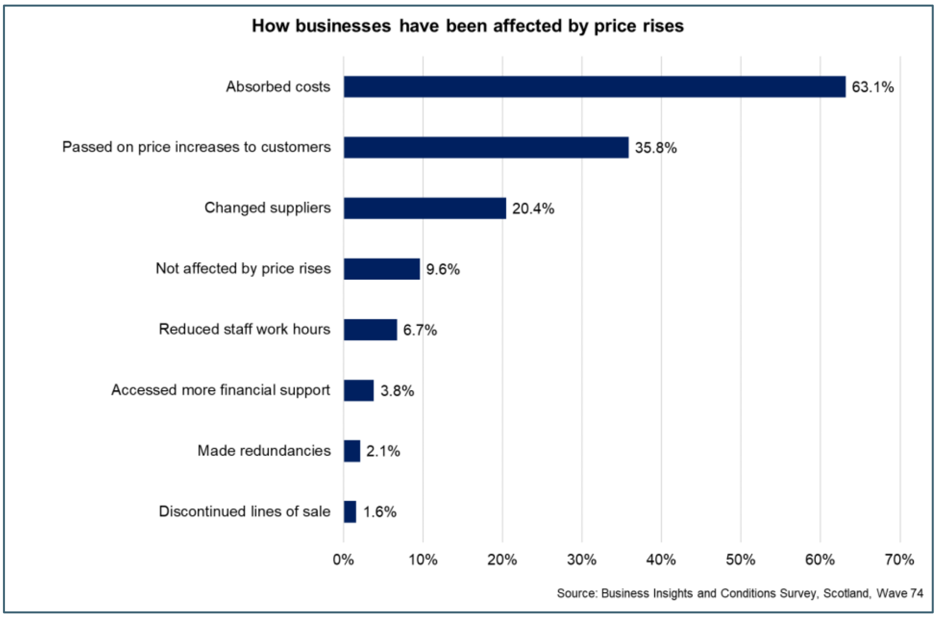
- Producer price inflation (changes in the prices of goods bought and sold by UK manufacturers, including price indices of materials and fuels purchased and factory gate prices) rose by 16.5% over the year to December, though the annual rate eased for the fifth consecutive month and prices fell by 1.1% over the month.[6]
- Input fuel costs have increased the most over the past year (70%) followed by crude oil (28%) and imported food materials (26.2%), however over the month of December, most input cost categories fell; crude oil (-10%), parts and equipment (-0.8%), chemicals (-0.4%)
- Similarly output price inflation also continued to ease back at the end of the year to 14.7% in December, down from the recent peak of 19.9% in July, but also remains elevated. Over the month of December, output prices for petroleum products fell 11.9% while food products continued to rise by 0.8%.



- PMI business survey data for Scotland also indicated that the pace of input price rises across the services and manufacturing sectors continued to moderate in December, while remaining elevated overall, with businesses citing higher wages, inflation, energy prices and Brexit as key factors generating upward pressure on prices.
- Business Insights and Conditions Survey (BICS) data provide latest insights into the effects on businesses of price rises. In January, 63% of businesses reported that they had to absorb costs, 35% reported having to pass on price increases to customers and 20% had to change suppliers. A much lower percentage of firms reported having to access more financial support (4%) and

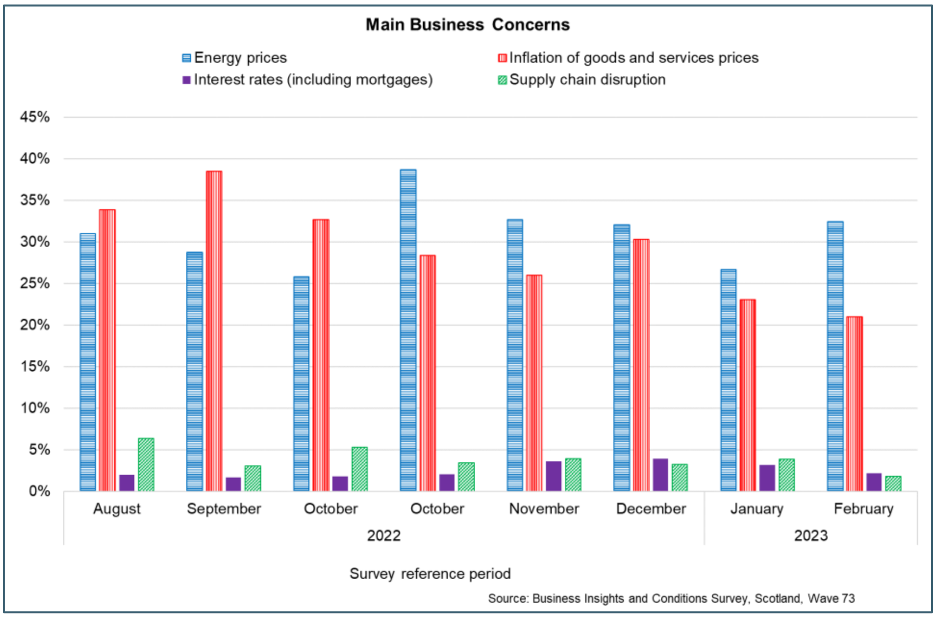
[6] Producer price inflation, UK - Office for National Statistics (ons.gov.uk)

having to reduce staff work hours (7%), however the latter continued to increase from previous months, as has the proportion having to change supplier, indicating that businesses are adopting a broader set of approaches to tackling the persistence of cost pressures.[7]



- There continues to be notable differences across sectors. For example, 20.4% of Accommodation and Food sector businesses and 15% of Arts, entertainment and recreation businesses reported having to reduce staff work hours (compared to 6.7% for all businesses). Furthermore 34.3% of Professional, Scientific and Technical Activity businesses and 32.6% of Information and Communication businesses reported that they had not been affected by price rises (compared to 9.6% 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.

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



- Overall, the main concern for business at the start of 2023 continues to be energy prices (32.4%), which remains elevated, and inflation of good and services prices (21%), which has been decreasing through the turn of the year. Much lower and declining percentages of businesses are concerned about supply chain disruption (1.8%), which may reflect that disruption has eased or businesses have been changing suppliers where required, while concerns about interest rates (including mortgages) (2.2%), fell slightly at the start of the year.
- Similarly, the latest Scottish Business Monitor report for Q4 2022 indicated that energy prices were the most common cost issue for businesses (73%), followed by input costs (69%). However, looking ahead, a higher share of respondents reported employee costs (75%) than energy costs (71%) as a key cost driver they are expecting in the next 6 months.[8]

Labour Market

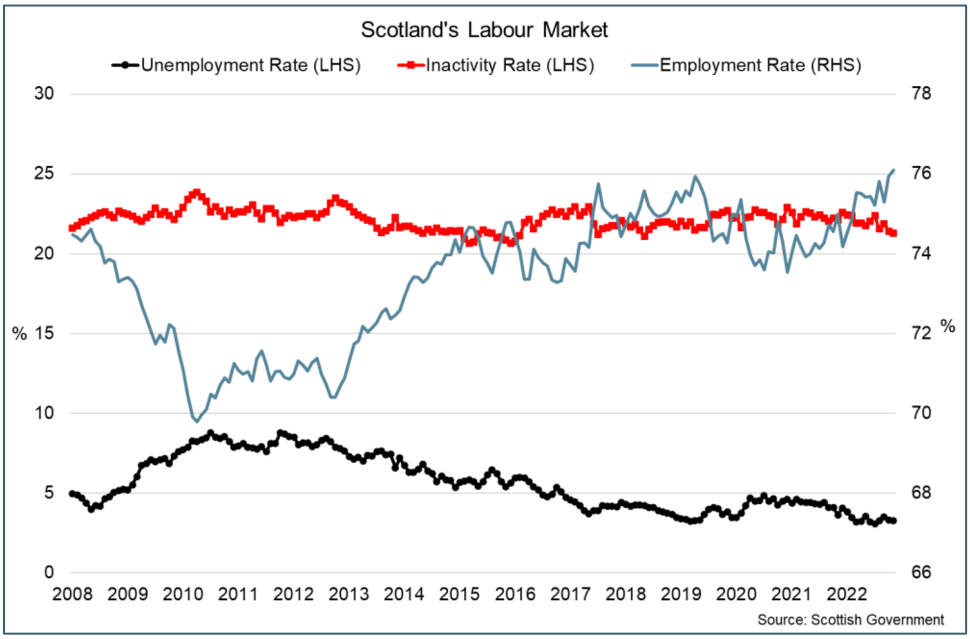
The labour market remains tight, however recruitment activity has slowed.

Official labour market statistics

- The latest labour market statistics for September to November 2022 in Scotland show there were 2.7 million people in employment with the employment rate rising by 1.1 percentage points over the year to 76.1% and 92,000 people were unemployed with the unemployment rate falling 0.4 percentage points to 3.3%. This is a similar pattern to the UK labour market as a whole with the employment rate rising 0.2 percentage points over the year and unemployment falling 0.4 percentage points.

[8] Scottish Business Monitor Q4 2022 | FAI (fraserofallander.org)

- Scotland's inactivity rate fell 0.8 percentage points over the year to 21.3% with 733,000 people economically inactive in Scotland. The fall in the inactivity rate continues a recent downward trend in Scotland with overall inactivity rates broadly similar to pre-pandemic levels. This is a different recent pattern to the UK as a whole, in which the inactivity rate increased by 0.2 percentage points over the year to 21.5% continuing an upward trend from the start of the pandemic.[9]



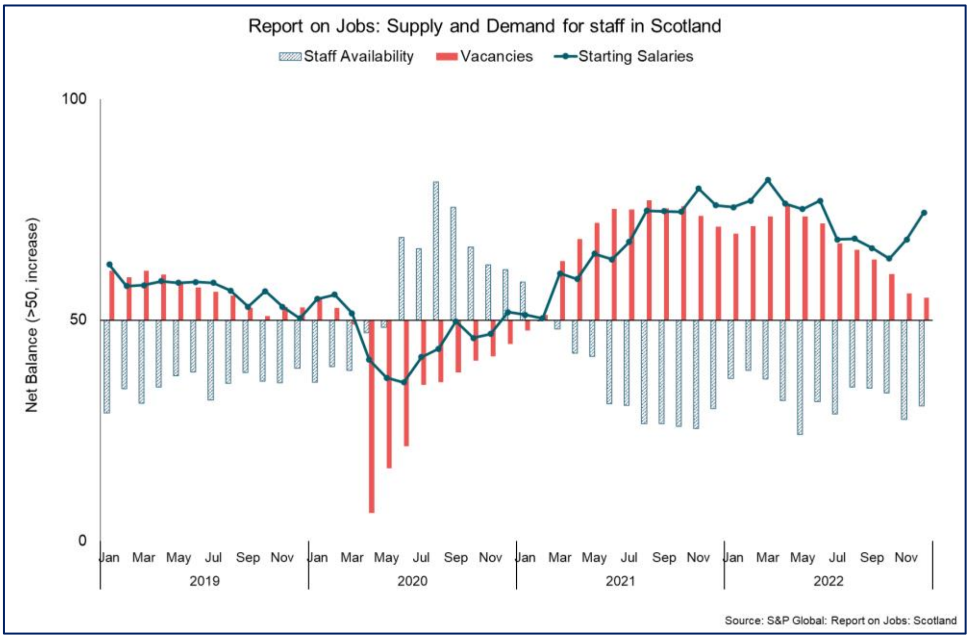
- Latest PAYE data signals a further increase in employment in December with the number of PAYE employees rising 5,000 (0.2%) over the month and is 47,470 higher than in December last year.[10]

Demand and supply of staff

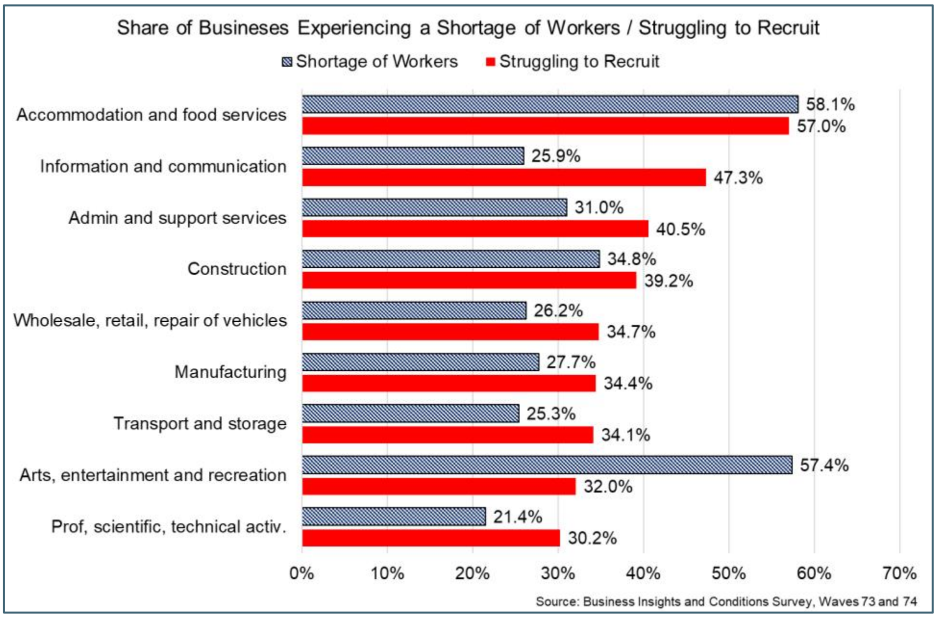
- Business surveys signal that labour market conditions have remained tight going into the final quarter of the year, however recruitment activity has slowed.

- The RBS Report on Jobs for December signalled that growth in demand for staff remained positive (55.4) but had slowed to its softest rate since the start of 2021.[11] 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 December (30.5). Alongside underlying challenges of skills shortages and Brexit, recruiters cite the uncertain outlook, cost of living crisis and fear of recession as key factors weighing on the movement of labour.

[9] Labour Market Trends: January 2023 - gov.scot (www.gov.scot)
[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



- The underlying tightness in the labour market continued to provide upward pressure to starting salaries in December with the overall pace of growth picking up over the month (74.3), however remaining slightly slower relative to the first half of the year.
- Labour shortages are affecting a range of sectors with BICS data indicating 33.6% of businesses experienced a shortage of workers at the start of January. The overall share has fallen from the end of November when it was 43.4%, however remains highest in accommodation and food services (58.1%), arts, entertainment and recreation (57.4%), and construction (34.8%) sectors.[12]



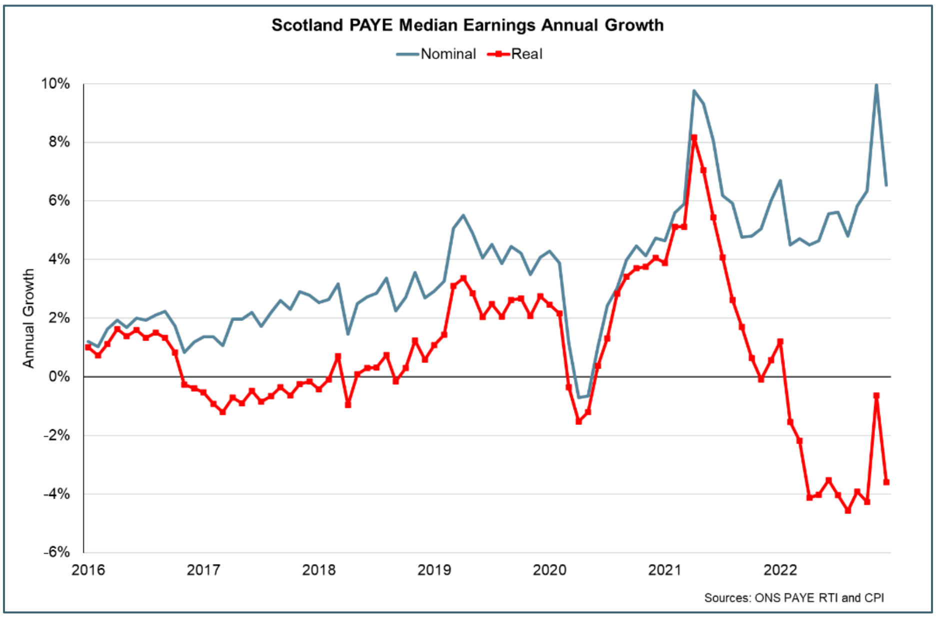
- Furthermore, when asked about recruiting in December, 42.1% of all business reported experiencing difficulties recruiting employees. This is highest within accommodation and food

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

services (57%) and information and communication (47.3%). Most businesses responded that a lack of qualified applicants (63.9%) and a low number of applications (55.6%) were reasons for why the business experienced difficulties in recruiting employees.

Earnings

- Nominal median monthly PAYE earnings fell 0.4% in December 2022 to £2,201. The monthly figure can be volatile, and over the past year earnings have grown 6.5%.[13]
- However, adjusting for inflation, which was 10.5% in December, real median earnings fell 3.6% on an annual basis. This is the eleventh consecutive month of negative annual growth, although the gap between nominal earnings and inflation has narrowed slightly as the inflation rate has fallen.



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

Consumption

Consumer sentiment fell to a time series low in the final quarter of 2022.

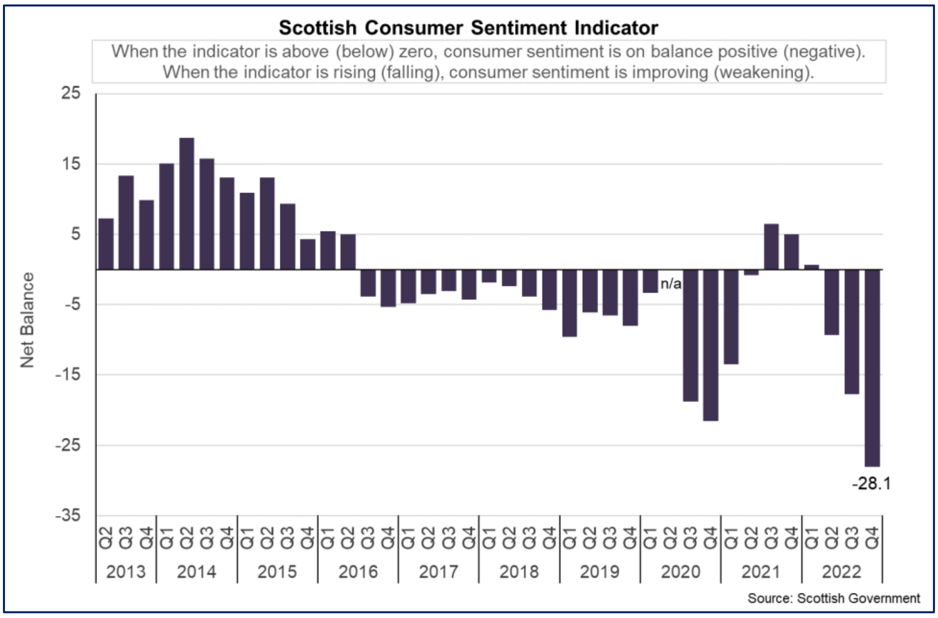
Consumer sentiment

- Consumer sentiment indicators continue to highlight the pressures that households and consumers face from the sharp rise in inflation and cost of living.
- These challenges intensified over 2022 which has been reflected in a sharp drop off in the Scottish Consumer Sentiment Indicator. In the final quarter of 2022, the composite indicator fell

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

to its lowest level in the time series, with all 5 sub-indicators falling across the quarter and the indicators for household financial security and attitudes to spending in particular falling to their lowest levels since the series began.[14]

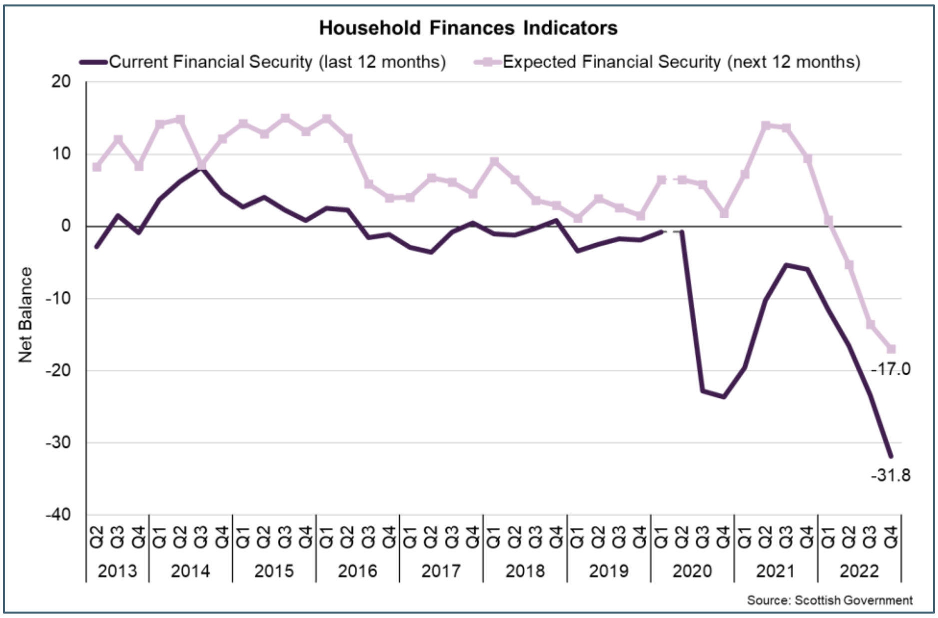
- In Q4 2022, the Scottish Consumer Sentiment Indicator stood at -28.1, decreasing by 10.4 points since Q3, implying a significant weakening in sentiment over the period.
- On a monthly basis during the fourth quarter, data show consumer sentiment was lowest in October (-29.4 points), before improving marginally in November (-28.8) and December (-26.1). However, sentiment remains significantly negative overall, having fallen 33.4 points since the start of the year.



- The weakness in sentiment 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 (-34.0, down from -22.8 in Q3) and expect the economy to deteriorate over the coming year relative to the current situation (-3.8, down from 7.5 in Q3).
- Following a positive score in Q1 2022 (1.3), the current economy indicator has decreased sharply since then (by 35.3 points) to its lowest level since Q2 2021 while the expected economy indicator has entered negative territory for the first time since Q2 2020.
- In terms of households personal finances, respondents on balance continued to report that their household finances are less secure than 12 months ago (-31.8, down from -23.5 in Q3). Furthermore, looking ahead, respondents continue to expect their financial security to fall over

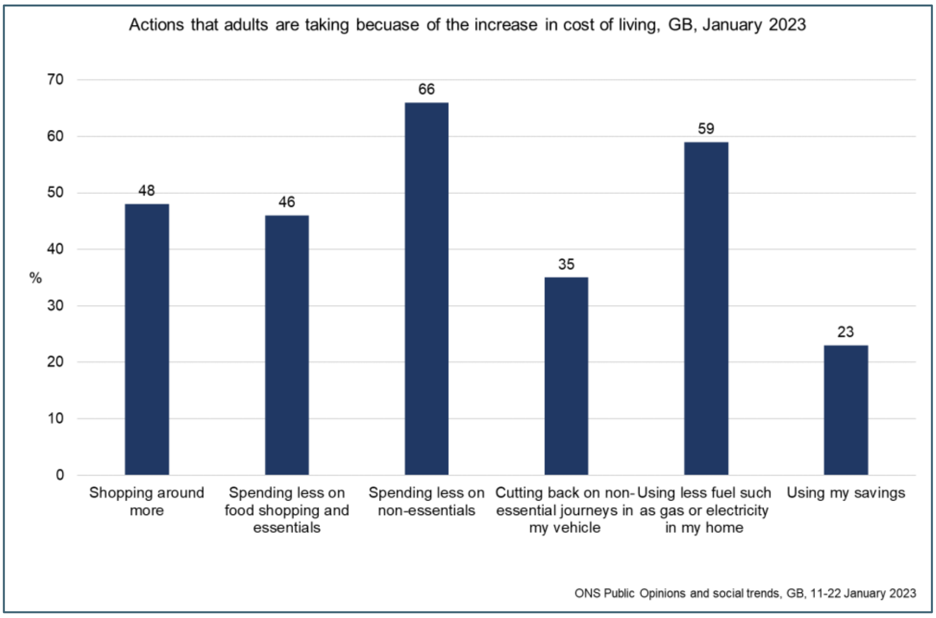
[14] Scottish Consumer Sentiment Indicator: 2022 Quarter 4 - gov.scot (www.gov.scot)

the coming year (-17.0, down from -13.6 in Q3), with both indicators falling to their lowest levels in the time series.



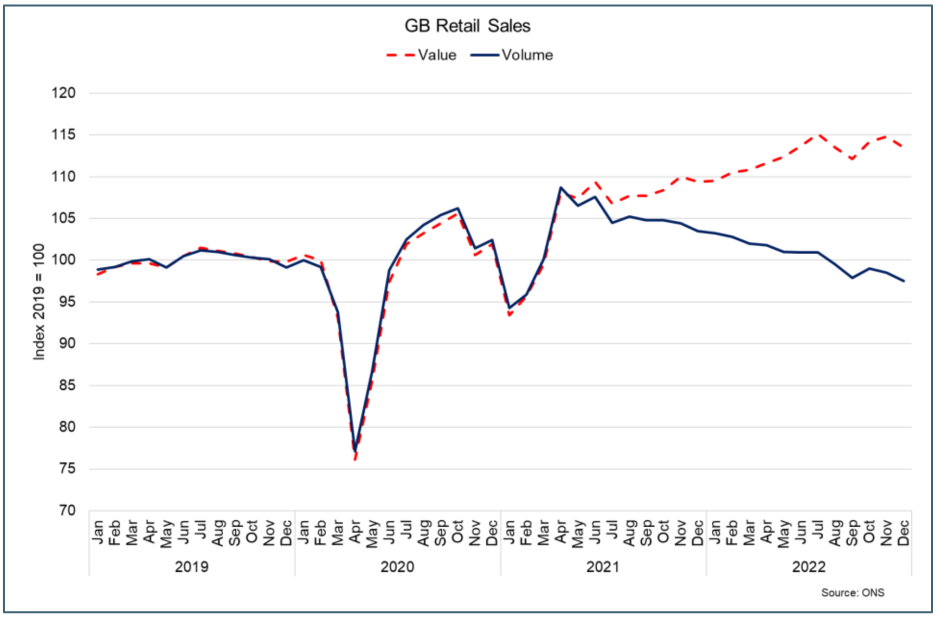
- Furthermore, since the beginning of the year, households have been increasingly uneasy about spending money as inflationary and cost of living pressures have increased. In Q4, the spending indicator reached its lowest level in the time series (-53.8, down from -36.1 in Q3).
- The weakening in sentiment towards spending is consistent with the fall in sentiment regarding the economy and security of household finances and 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 January showed that 92% of adults reported an increase in the cost of living compared with a year ago and 67% reported an increase compared to the previous month.[15] The reasons for the increase in the cost of living remain unchanged compared to the end of 2022: (i) price of food shopping (94%); (ii) gas or electric bills (74%); (iii) price of fuel (41%).
- The most common actions reported were spending less on non-essentials (66%) and using less fuel such as gas or electricity in their home (59%). This is a similar response to the previous period (65% and 59%, respectively)). In January, more adults reported shopping around more (48%) and spending less on food shopping and essentials (46%) than in the previous period (44% and 41% respectively).

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



Retail Sales

- GB retail sales volumes fell 1% in December 2022, with a 2.1% fall in non-food store sales and 0.3% in food store sales. This continues the downward trend in retail sales volumes since summer 2021.[16]
- Overall compared to December 2021, sales volumes decreased 5.7% as the lifting of restrictions on hospitality enabled a return to eating out, and more recently rising prices and the cost of living affected sales volumes.
- The value of retail sales increased by 4.5% over this period, reflecting the increase in prices and fall in purchasing power that consumers are facing illustrated in the chart below by the widening gap between GB retail sales value and volume sold.



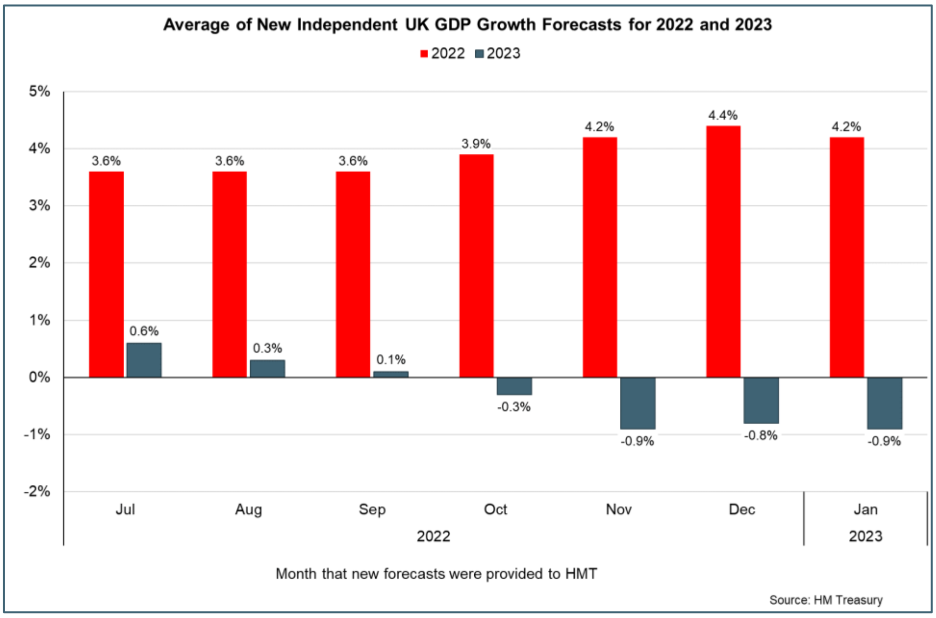
[16] Retail sales, Great Britain - Office for National Statistics (ons.gov.uk)

Economic outlook

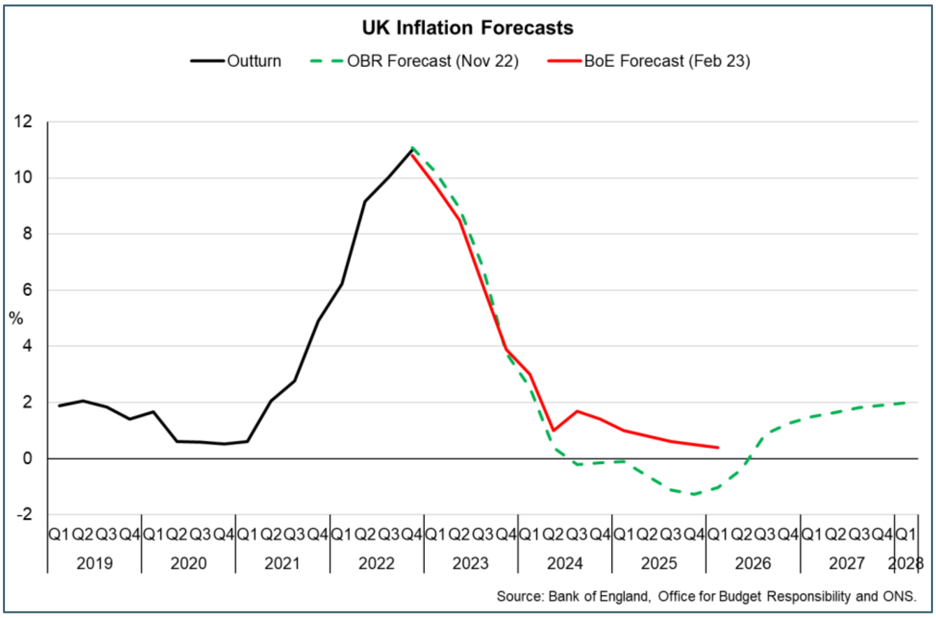
The economy is forecast to contract in 2023 as the inflation rate starts to fall sharply.

- The economic outlook remains challenging, with the economy broadly at the same level as February 2022. Although energy prices have fallen back slightly from their peak, prices will remain elevated over the coming year, despite inflation falling back from its current rates, and tightening monetary conditions will add further pressures to household finances.
- At a global level, in January the IMF forecast global economic growth to slow to 2.9% in 2023, with Europe in particular seeing slower growth. Euro Area growth is forecast to slow to 0.7% over the year whilst in the USA it slows to 1.4%.[17] However, the overall forecast for growth in 2023 has been revised up by 0.2 p.p since October, in part reflecting the potential for stronger growth following the recent reopening of China's economy.
- Global inflation is estimated to be 8.8% in 2022 and is expected to fall back but remain elevated in 2023 at 6.6%, with rising interest rates, weaker demand and falling energy prices to moderate inflation further into 2024 to 4.3%. For advanced economies the IMF forecast inflation to fall to 2.6% in 2024.
- Reflecting weakening global conditions, in December, the Scottish Fiscal Commission forecast that Scotland would enter a recession during 2022, and recover only slowly from the shocks of the pandemic and the war in Ukraine, with GDP not returning to pre-pandemic levels until 2025 Q3.[18] Real household incomes will be particularly affected by inflation, falling by a record amount, and are not forecast to recover to 2021-22 levels until 2027-28.
- At UK level, the Bank of England and the Office for Budget Responsibility forecast the UK will enter recession, with inflation and tightening financial conditions expected to cause a significant fall in real household disposable incomes and demand over 2023-24.[19]
- More broadly, the average of new independent forecasts in January (published monthly by HMT) highlights the downgrades over the past year to UK 2023 growth forecasts as economic conditions have weakened.[20] Latest forecasts from December project, on average, that UK GDP will fall 0.9% in 2023, broadly unchanged for the last three months, and in stark contrast to the average expectation of 2% growth from forecasts released at the start of the year in February.

[17] Inflation Peaking amid Low Growth (imf.org)
[18] Scotland's Economic and Fiscal Forecasts – December 2022 | Scottish Fiscal Commission
[19] Monetary Policy Report - February 2023 | Bank of England; Economic and Fiscal Outlook - November 2022 (obr.uk)
[20] Forecasts for the UK economy: January 2023 - GOV.UK (www.gov.uk)

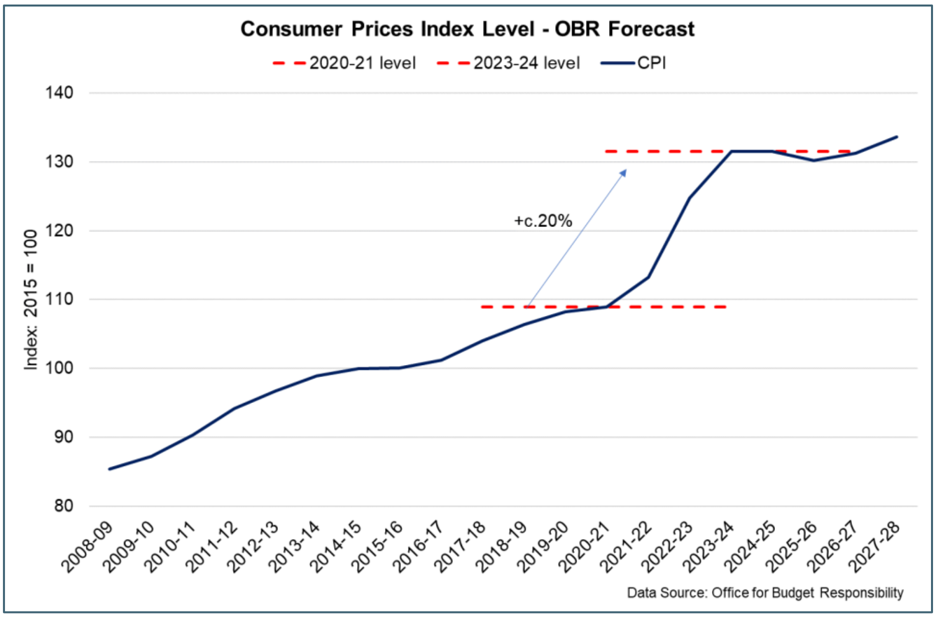


- There is significant uncertainty over the depth and duration of the expected recession, the pace at which inflation will fall back towards the 2% target, and the pace at which output will return to pre-recession peaks. This will reflect domestic and global economic developments, the impacts of fiscal and monetary policy and the persistence of the current energy supply and price shock.
- In February, the Bank of England forecast the UK economy to remain in recession from Q1 2023 through to Q1 2024 with UK GDP forecast to fall 0.5% in 2023 (revised up from a 1.5% fall in November forecast) and 0.25% in 2024 (revised up from a 1% fall). This is much shallower than their November forecast, reflecting a reassessment due to strength in the labour market, and the rapid decline in the contribution of energy to inflationary pressures.



- In November, 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 a notably shallower recession than those in 1980, 1990 and 2008. Furthermore, the inflation rate is forecast to fall back sharply over 2023 to around 4% by the end of the year and below 2% in 2024.

- However, even when the inflation rate does fall back towards target in 2024, the price level will remain notably higher than it was in 2021. The OBR forecast price levels in 2023-24 to be around 20% higher than in 2020-21. Previously it had taken around 9 years from 2008-09 for the price level to rise 20%.



- As such, the outlook for households and businesses remains extremely challenging as the economy continues to adjust to the significant increase in price levels over such a short period of time, while trend growth estimates for the UK, which reflect the underlying capacity of the economy to grow without generating inflation, continue to be reduced, reflecting weak investment and productivity growth.

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