Monthly Economy Brief

Office of the Chief Economic Adviser

March 2023

Scottish Government
Riaghaltas na h-Alba

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March 2023

Data up to 3 March 2023

Overview

Economic conditions continue to be extremely challenging in 2023 as the inflationary shock progresses through the economy. However, outturn data indicate that the Scottish economy has shown a greater degree of resilience than forecast during last year while latest UK and global projections set out a shallower downturn than was previously expected.

Latest GDP data estimates that the Scottish (and UK) economy avoided entering the recession during 2022 which had previously been forecast. That said, economic growth was largely confined to the first quarter of the year and effectively stalled over the following three quarters. The final quarter of 2022 saw Scotland's GDP grow 0.1% over the quarter and 0.6% annually, with flat quarterly growth in the services sector particularly weighing on overall output.

Scotland's labour market continued to perform very strongly at the headline level in the final quarter of 2022, outperforming the UK as a whole on the unemployment rate (3.3%), employment rate (76.6%) and inactivity rate (20.8%) indicators, although the number of economically inactive due to long term sickness remains high. Latest business surveys provide further evidence that recruitment activity has continued to moderate into the start of 2023 and there has been further rebalancing in the demand for and availability of staff, at least in the short term. However, the underlying tightness in the labour market and increased costs of living continue to place upward pressure on nominal pay growth. Average regular pay growth (GB) was 7.3% for the private sector in the final quarter of 2022 and 4.2% for the public sector and remains a key consideration for employers.

The inflation rate fell for a third consecutive month in January to 10.1%, providing further indication that inflation is now on a downward trend. Inflation is expected on average to fall to around 4% by the end of the year with the outlook for energy prices a key element of this. The fall in the Ofgem energy price cap for April and the forecast of a further fall in July presents an improving outlook for energy prices, however the scale and timing of benefit to households in the short term will be dependent on the level of government support (through the Energy Price Guarantee or otherwise) made available over the coming months.

However, for now, price rises continue to outpace earnings growth, resulting in a 4.1% fall in real terms pay over the year to January and emphasises that while the initial inflation shock may be starting to ease, the cost of living pressures facing households is a longer term concern, particularly as some cost of living support is expected to end in 2023-24.

Reflecting the underlying resilience in economic and labour market activity and the recent easing in the inflation rate, both consumer and business sentiment strengthened into the start of the new year. However, both remain notably weaker than their historical averages.

Looking ahead, the latest forecasts from the start of the year indicate that a recession (two consecutive quarters of declining output) remains likely in 2023 as consumers continue to face falling real household incomes and tighter financial conditions. Where savings or borrowing have supported spending to date, we may see consumption more exposed and at greater risk to these conditions in the year ahead.

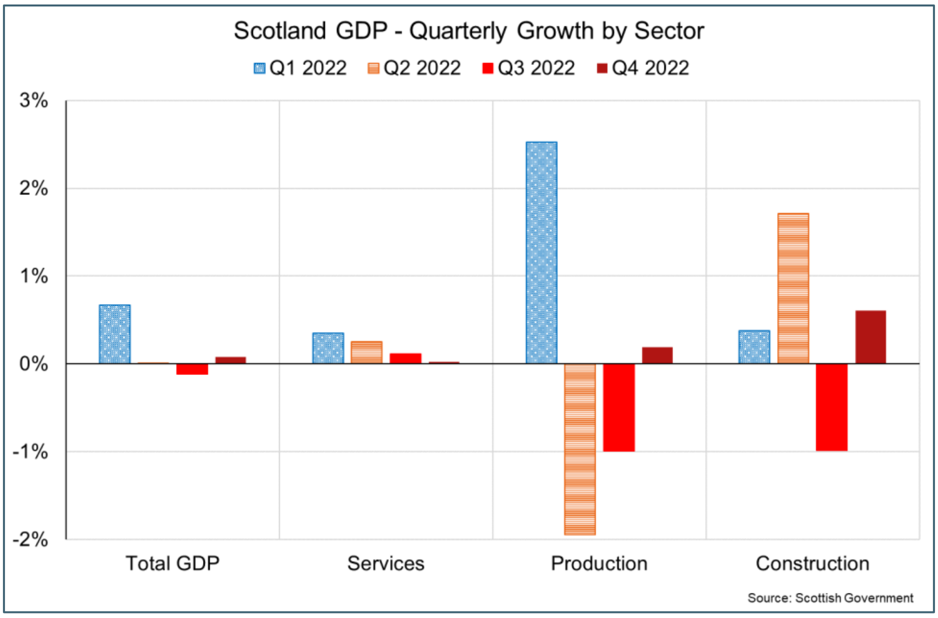
Output

Economic output grew slightly in the fourth quarter of 2022 avoiding a technical recession.

- The Scottish economy grew 0.1% in the fourth quarter of 2022 (UK: 0.0%), despite falling 0.6% in December, and grew by 0.6% on an annual basis (UK: 0.4%).[1]
- Growth in the fourth quarter followed a contraction of 0.1% in the third quarter meaning the economy avoided a technical recession during 2022, however growth during the year was largely confined to the first quarter of the year and was broadly flat thereafter.

- At a sector level, services output was flat (0.0%) in the fourth quarter and grew 0.7% on an annual basis, though with the pace of growth slowing over the year. Within that, consumer facing services output fell 0.1% over the quarter and more broadly contracted over the second half of the year. This partly reflects the demand side challenges facing the economy from the sharp rise in inflation and its impact on household disposable income.
- Production sector output grew 0.2% in the fourth quarter however fell 0.3% annually. This was predominantly driven by a third consecutive quarterly fall in manufacturing output and a 1.5% fall over the year as a whole. In contrast, construction output grew 0.6% over the quarter and 1.7% over the year.

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

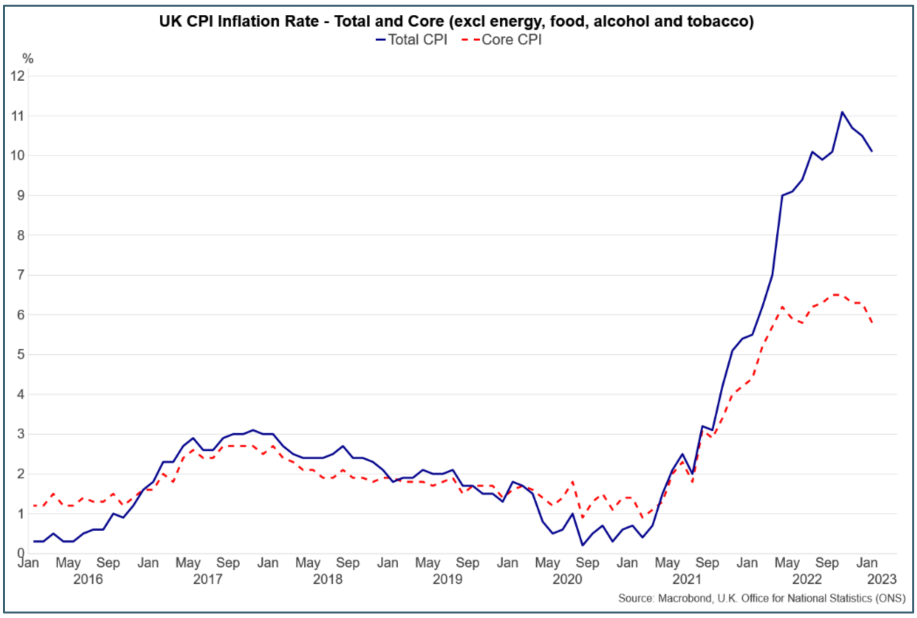


- At a UK wide level, ONS reported that there is anecdotal evidence to suggest that postal and rail strike activity during the fourth quarter had an impact on output across a range of industries, however it is not possible to isolate their impacts from other demand and supply factors currently impacting across the wider economy.[2]

Inflation

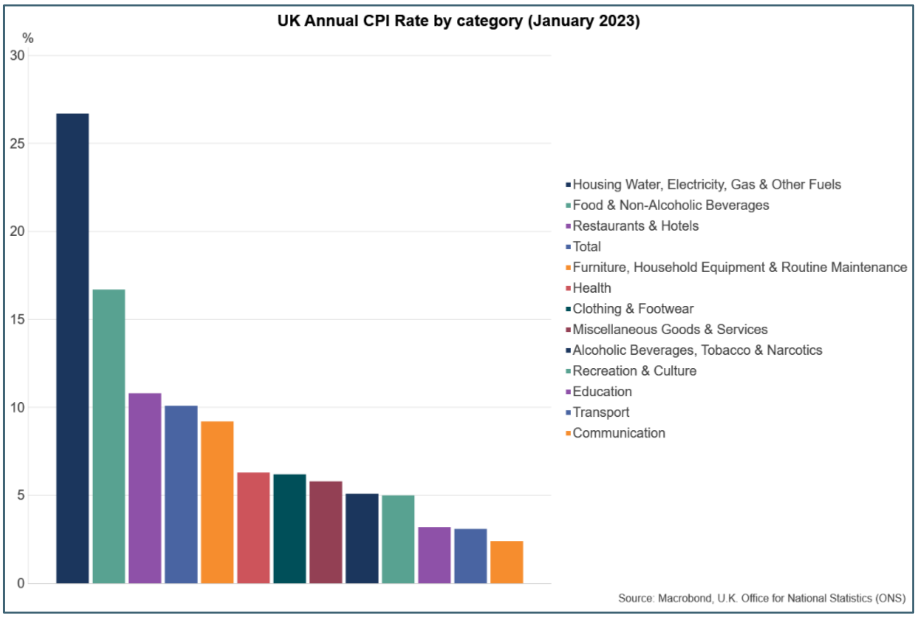
Total and core inflation rates fell in January.

- UK CPI inflation fell to 10.1% in January, the third successive fall from 11.1% in October, indicating that the inflation rate is now on a downward trend.[3]



[2] [GDP first quarterly estimate, UK - Office for National Statistics (ons.gov.uk)]
[3] [Consumer price inflation, UK - Office for National Statistics]

- Similar to recent months, the fall during the month of January was particularly driven by motor fuels, with petrol and diesel prices now around 21% and 13% respectively lower than their recent peaks in July 2022, though remain higher over the year as a whole. Further downward contributions to the rate came from restaurants and hotels, although the annual inflation rate remained elevated at 10.8%, down from 11.3% in December 2022 which was the highest rate since September 1991. The largest upward contribution to the rate in January was in alcoholic beverages and tobacco, with the price index rising 2.7% over the month.
- However, compared to last year (annual inflation rates), the price level of housing, water, electricity, gas and other fuels continued to have the largest increase (26.7% in January, up from 26.6% in December) followed by food and non-alcoholic beverages (16.7%, down from 16.8% in December).



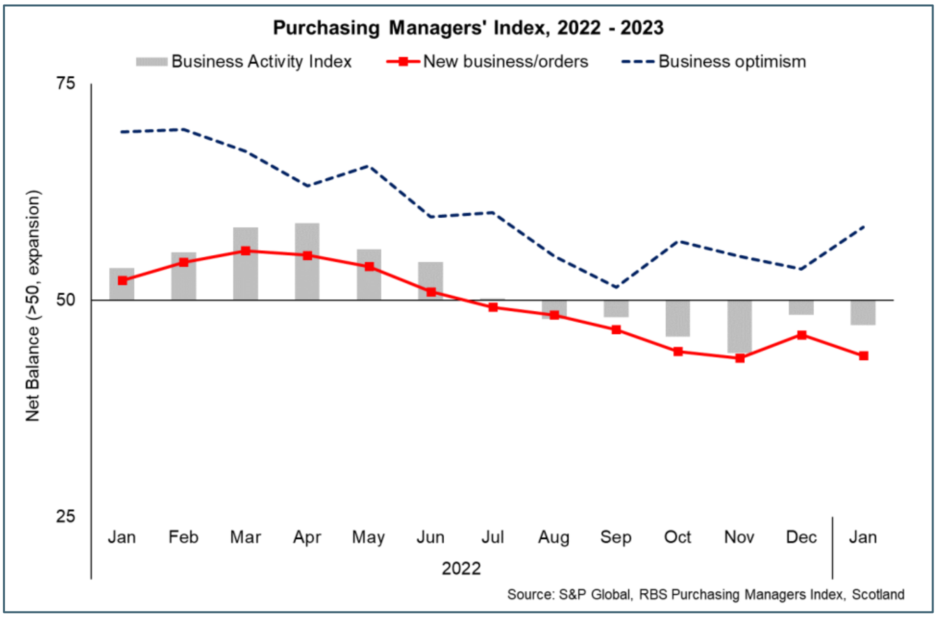
- Core inflation, which excludes food, energy, alcohol and tobacco, fell to 5.8% in January (down from 6.3%) and is at its lowest annual rate since June last year. Core inflation has been around 6% since April 2022, highlighting that energy price rises have been the main driver of overall inflation over this period. However, over the longer term, core inflation has risen from 1.4% at the start of 2021 and its persistence reflects that inflation has been broad based.

Businesses

Business activity contracted further in January, however optimism improved.

Business activity

- The Purchasing Managers Index (PMI) business survey indicates that business activity in Scotland's private sector continued to contract in January (47.1) and at a faster pace than in December.[4]



- The fall in business activity at the start of the year reflected a further reduction in incoming new business/orders (43.6), predominantly in the services sector, with respondents attributing the fall to the squeeze on disposable incomes amongst other factors.
- Despite this, business optimism strengthened sharply in January to its highest level since July last year (58.4) with expectations of increased activity over the coming year. However, the level of business optimism remained below the survey average, reflecting ongoing concerns regarding the cost of living challenges and their impacts on prospects for growth.

Business costs

- Higher energy, materials and staffing costs continue to present significant challenges for businesses, however there are further indications at the start of the year that the pace of cost increases is easing.
- 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 14.1%

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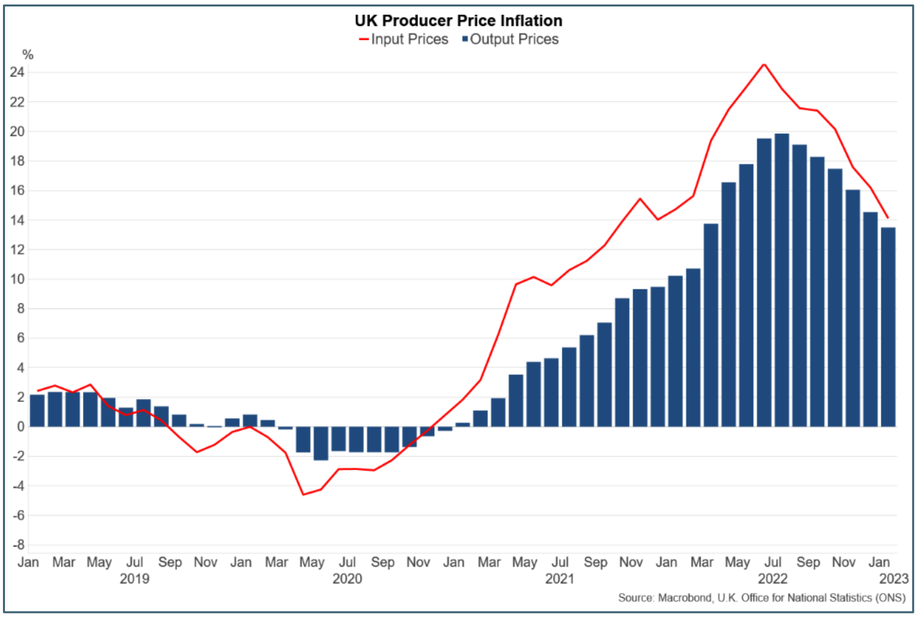
[4] S&P Global, RBS Purchasing Managers Index: [Purchasing Managers' Index Reports | Royal Bank of Scotland (rbs.co.uk)](rbs.co.uk); [46287263e1ff4ff5a3d7c5142b26fc2a (spglobal.com)](spglobal.com)

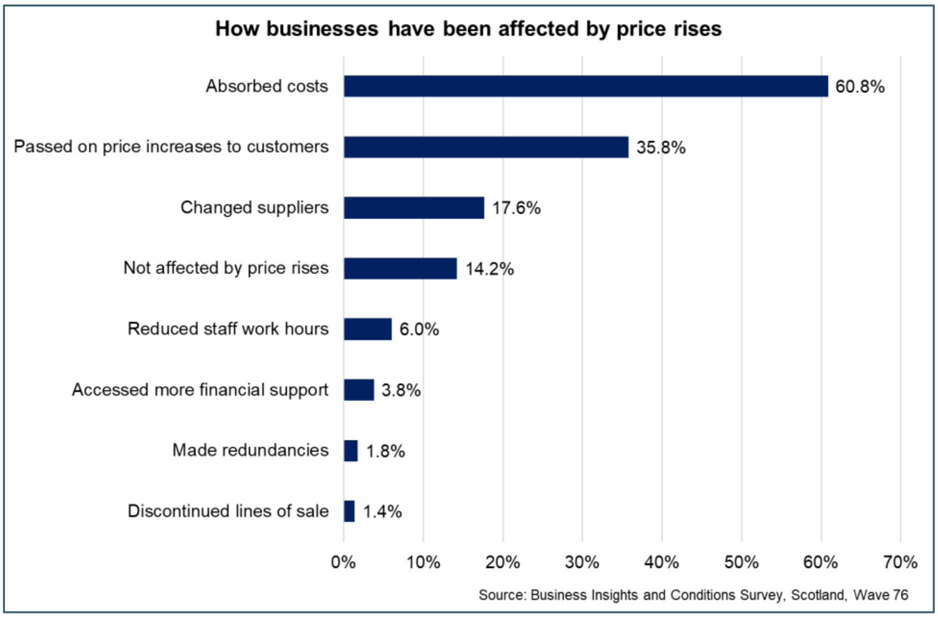
over the year to January, though the annual rate eased for the sixth consecutive month and prices fell by 0.1% over the month.[5]

- Input fuel costs have increased the most over the past year (61%) followed by imported food materials (26%) with crude oil input falling 0.1%. Over the month of January, most input cost categories fell; fuel prices (-2.5%), crude oil (-8.7%) and chemicals (-0.4%).
- Similarly output price inflation also continued to ease back in January to 13.5% in January, down from the recent peak of 19.9% in July, but also remains elevated. Over the month of January, output prices for petroleum products fell 2.7%, however food product prices continued to rise by 1.1%.

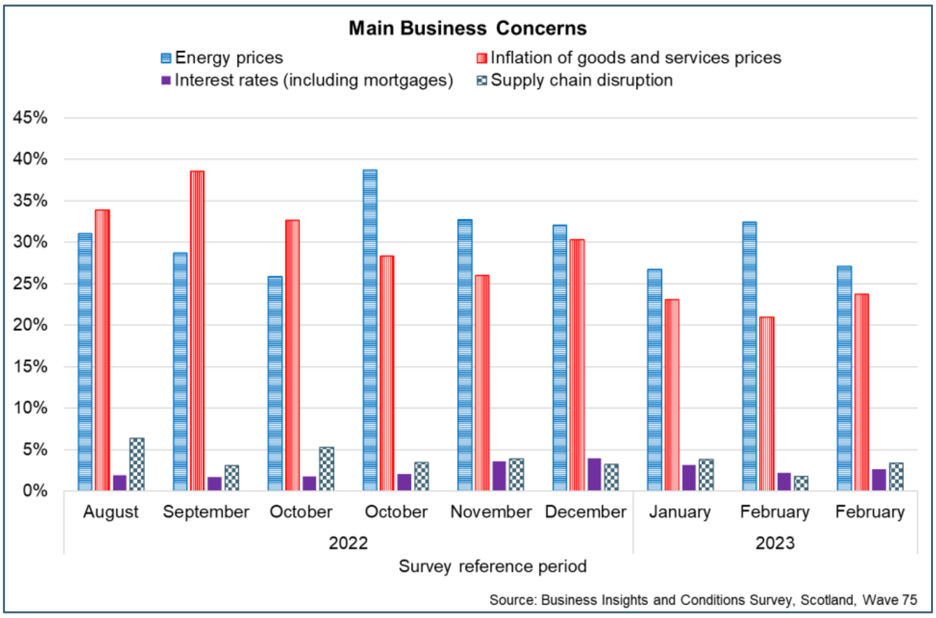


- PMI business survey data for Scotland also indicated that the pace of input price rises across the services and manufacturing sectors continued to moderate in January, while remaining elevated overall, with anecdotal evidence that higher wages, energy prices and raw material prices were continuing to drive up input costs.
- Business Insights and Conditions Survey (BICS) data provide latest insights into the effects on businesses of price rises. In February, 60.8% of businesses reported that they had to absorb costs, 35.8% reported having to pass on price increases to customers and 17.6% had to change suppliers. A much lower percentage of firms reported having to access more financial support (3.8%) and having to reduce staff work hours (6%).[6]

[5] Producer price inflation, UK - Office for National Statistics (ons.gov.uk)
[6] Business and innovation statistics - gov.scot (www.gov.scot)



- There continues to be notable differences across sectors. For example, 22.2% of Accommodation and Food sector businesses and 12.3% of Arts, Entertainment and Recreation businesses reported having to reduce staff work hours (compared to 6% for all businesses). Furthermore 33.4% of Professional, Scientific and Technical Activity businesses and 33.5% of Information and Communication businesses reported that they had not been affected by price rises (compared to 14.2% 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.



- Overall, the main concern for business in January and February continues to be energy prices (27.1%), which remains elevated, and inflation of good and services prices (23.7%), which has been decreasing through the turn of the year. Much lower and declining percentages of businesses are concerned about supply chain disruption (3.4%), which chimes with UK manufacturing PMI data for February indicating that suppliers' delivery times improved for the first time since 2019, particularly in areas where there was improved availability of materials or supplier capacity.[7] Concerns about interest rates (including mortgages) (2.6%), fell slightly at the start of the year and remains low overall despite tightening monetary conditions. In February, the Bank of England raised the Bank Rate to 4%, the tenth successive rate rise since the end of 2021.

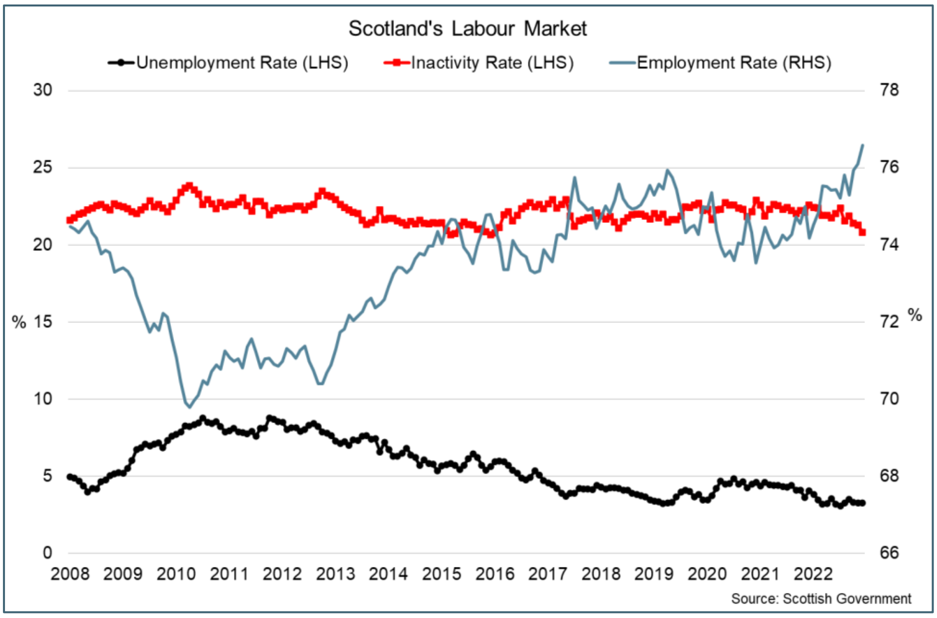
Labour Market

The employment rate rose further at the end of 2022 however the pace of recruitment activity has moderated.

Official labour market statistics

- The latest labour market statistics for October to December 2022 in Scotland show there were 2.7 million people in employment with the employment rate rising by 2.4 percentage points over the year to 76.6% (UK: 75.6%) and 93,000 people were unemployed with the unemployment rate falling 0.8 percentage points to 3.3% (UK: 3.7%).
- Scotland's inactivity rate fell 1.8 percentage points over the year to 20.8% with 717,000 people economically inactive in Scotland. The primary reason for economic inactivity is long term sickness. 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 0.1 percentage points over the year to 21.4% continuing an upward trend from the start of the pandemic.[8]

[7] S&P Global, CIPS UK Manufacturing PMI: b30e13dba3f94f0998a007801081c08a (spglobal.com)
[8] Labour market statistics - gov.scot (www.gov.scot)

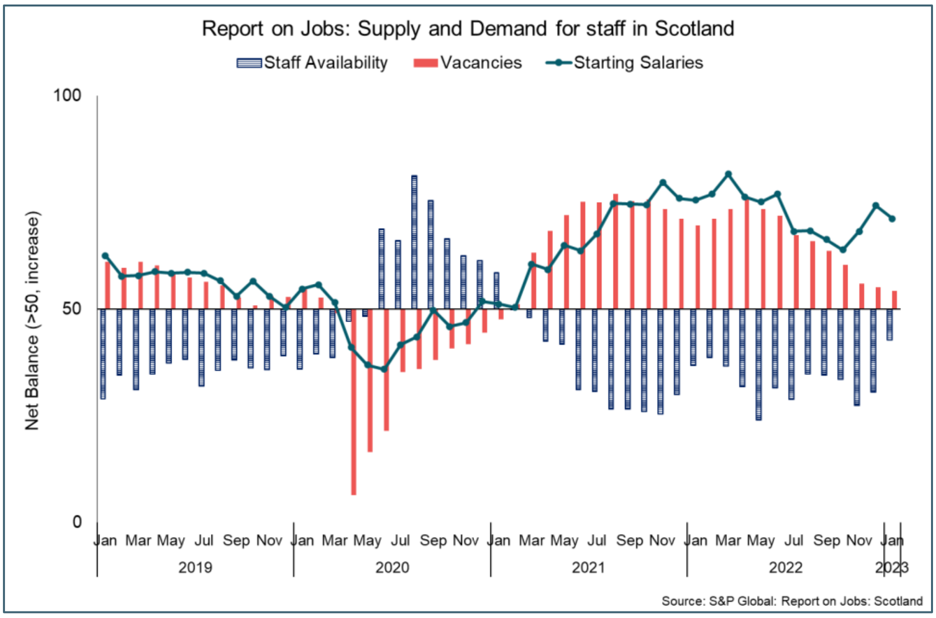


- Latest PAYE data signals a further increase in employment in January with the number of PAYE employees rising 2,742 (0.1%) over the month and is 48,302 higher than in January last year.[9]

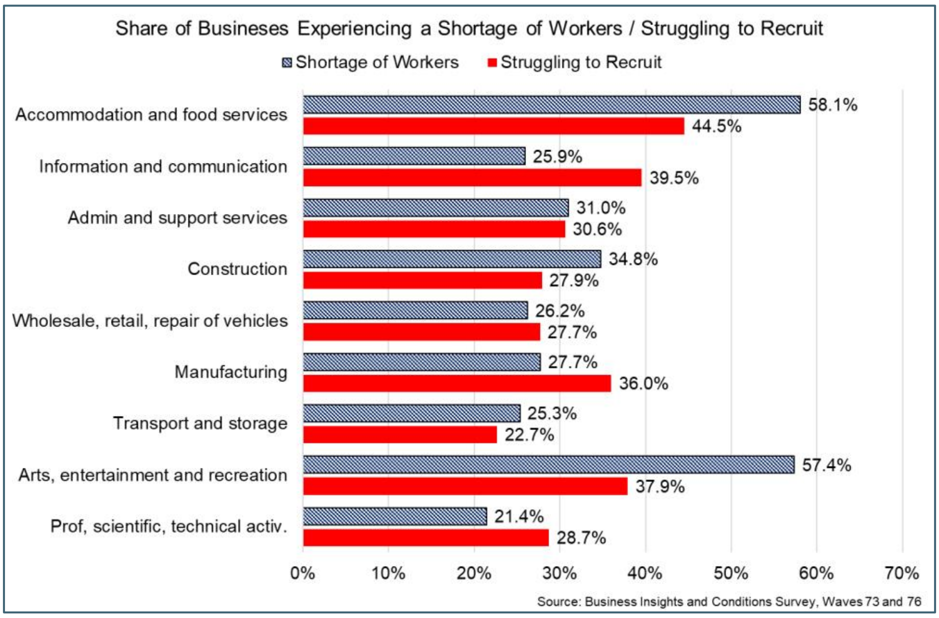
Demand and supply of staff

- Business surveys signal that labour market conditions have remained tight in January, however recruitment activity shows further signs that it has moderated compared to the first half of 2022.
- The RBS Report on Jobs for January signalled that growth in demand for staff remained positive (54.7) but had slowed to its softest rate since the start of 2021.[10] For businesses seeking to recruit, supply side challenges in the labour market have also continued with candidate availability (labour supply) falling in January (42.9), however at the softest rate since April 2021. Alongside underlying challenges of skills shortages and Brexit, recruiters in recent surveys cite the uncertain outlook and cost of living crisis as key factors weighing on the movement of labour.

[9] Earnings and employment from Pay As You Earn Real Time Information, seasonally adjusted - Office for National Statistics (ons.gov.uk)
[10] 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 January with the overall pace of growth remaining significant, however eased over the month (71.2) and remained slightly slower relative to the first half of 2022.
- 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.[11] 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.



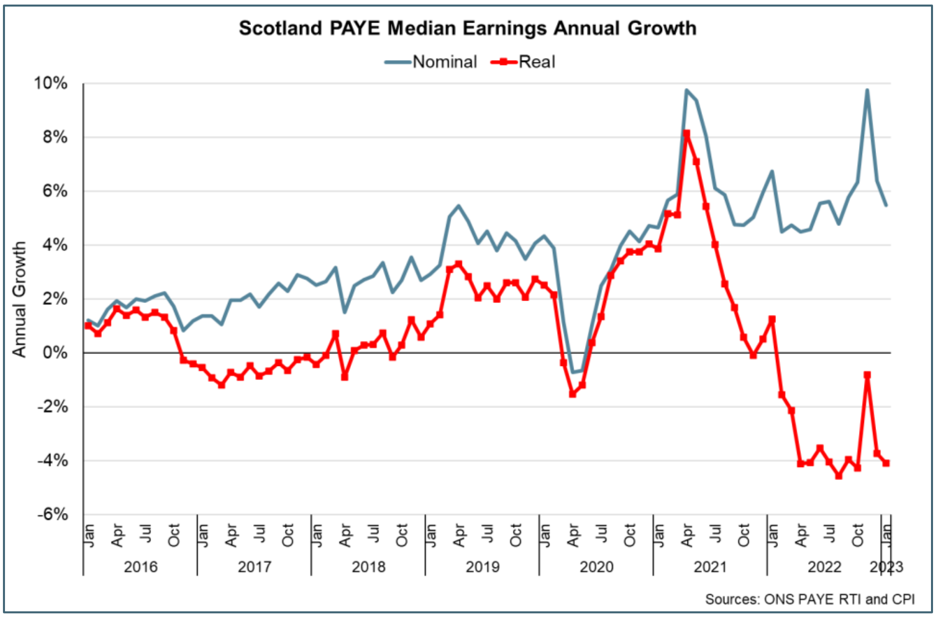
- Furthermore, when asked about recruiting in January, 38.7% of all business reported experiencing difficulties recruiting employees. This is highest within accommodation and food services (44.5%) and information and communication (39.5%). Most businesses responded that a lack of qualified applicants (63.9%) and a low number of applications (55.6%) were reasons for

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

why the business experienced difficulties in recruiting employees, while 20.8% reported not being able to afford an attractive pay package to applicants.

Earnings

- Nominal median monthly PAYE earnings grew 0.4% in January to £2,206. The monthly figure can be volatile, and over the past year earnings have grown 5.5%.[12]
- However, adjusting for inflation, which was 10.1% in January, real median earnings fell 4.1% on an annual basis, the twelfth consecutive month of negative annual growth.



- 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 strengthened in January but remains significantly negative.

Consumer sentiment

- Consumer sentiment indicators continue to highlight the pressures that households and consumers face from high inflation and the rapid increase in the cost of living.
- These challenges intensified over 2022 which was reflected in a sharp drop off in the Scottish Consumer Sentiment Indicator, however lastest data indicates that consumer sentiment has improved slightly through the turn of the year, albeit remaining significantly negative overall.[13]

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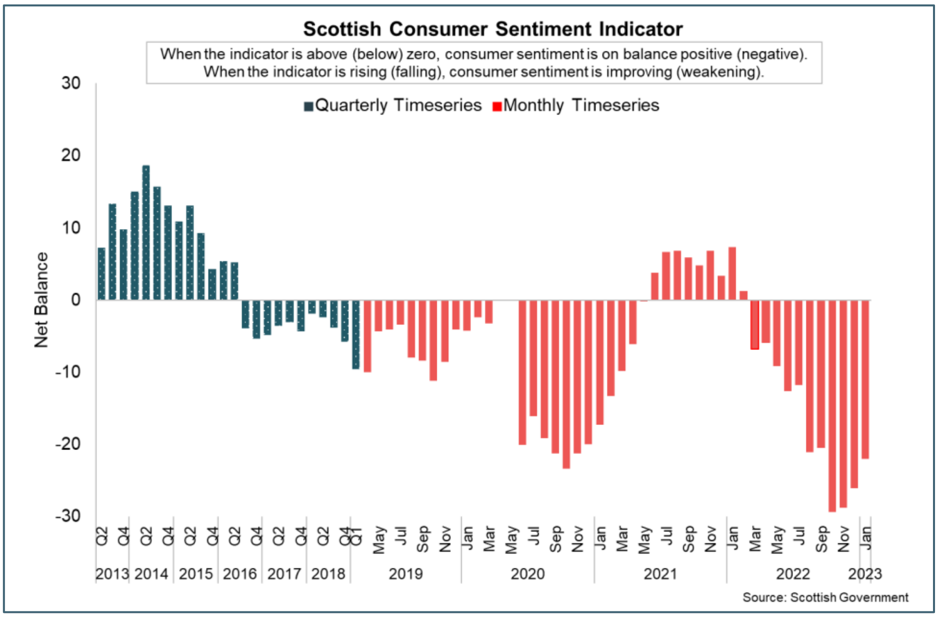
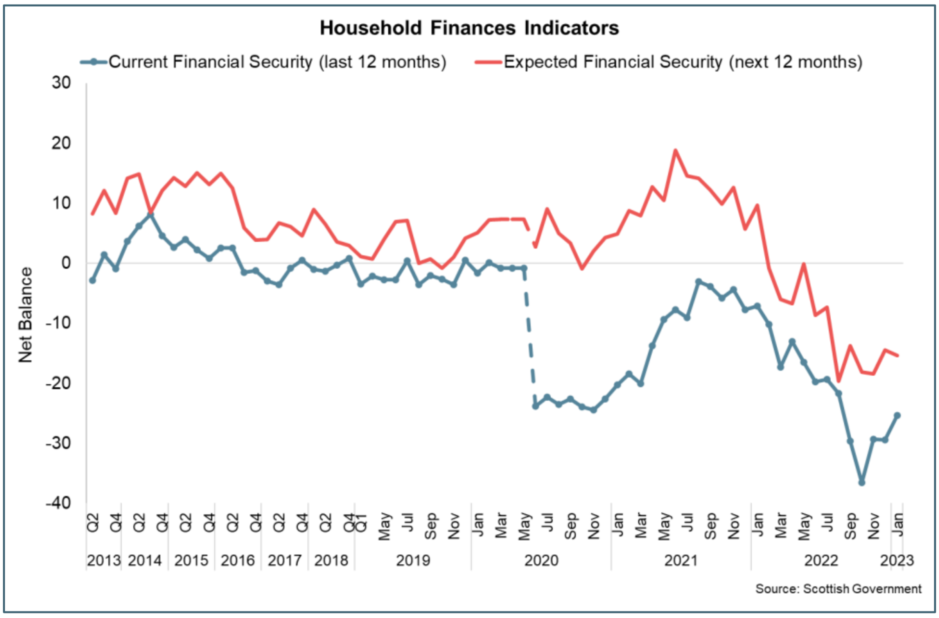
[12] Earnings and employment from Pay As You Earn Real Time Information, seasonally adjusted - Office for National Statistics (ons.gov.uk)
[13] Economy statistics - gov.scot (www.gov.scot)

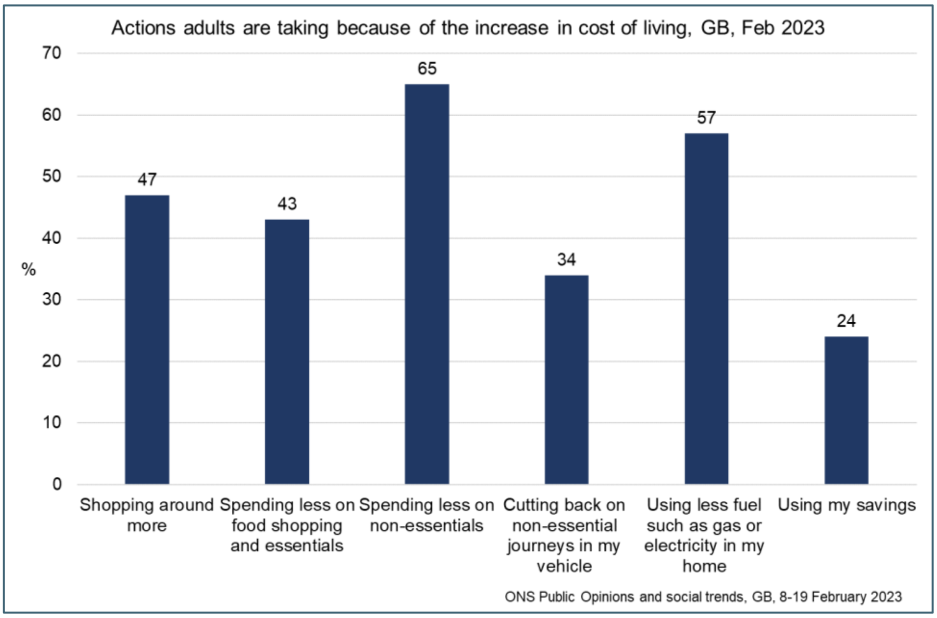
- In January, the Scottish Consumer Sentiment Indicator stood at –22. This was a rise of 4.1 points from December, implying a further slight strengthening in sentiment for a third consecutive month, having fallen to its recent trough (and time series low) in October (-29.4 points).



- On the economy, respondents on balance consider current economic circumstances to be worse than last year (-27.9, up from -35.5 in December) however expect the economy to improve over the coming year relative to the current situation (5.2, up from -1.0 in December). This is the first time the economy expectations indicator has been positive since September 2022.
- In terms of households personal finances, respondents on balance continued to report that their household finances are less secure than 12 months ago (-25.4, up from -29.4 in December). Furthermore, looking ahead, respondents continue to expect their financial security to fall over the coming year (-15.4, down from -14.4 in December). While both indicators remain in negaive territory, they have strengthened slightly from their recent low level in the fourth quarter of 2022.



- During 2022 households became less relaxed about spending money as inflationary and cost of living pressures increased. In January 2023, the spending indicator strengthened slightly (-46.4, up from -50.0 in December), indicating that households continue to be uneasy about spending money, but to a slightly lesser degree than towards the end of 2022.
- The recent strengthening in consumer sentiment is encouraging, albeit that it is strengthening from a low base. Furthermore, the fall in the household finances expectations indictor further emphasies the concerns that househlds have for their household finances over the coming year and remains a risk 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 February 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.[14] The reasons for the increase in the cost of living remain largely unchanged in recent months: (i) price of food shopping (95%); (ii) gas or electric bills (79%); (iii) price of fuel (45%).
- The most common actions reported were spending less on non-essentials (65%) and using less fuel such as gas or electricity in their home (57%), while 47% reported shopping around more and 43% reported spending less on food shopping and essentials.



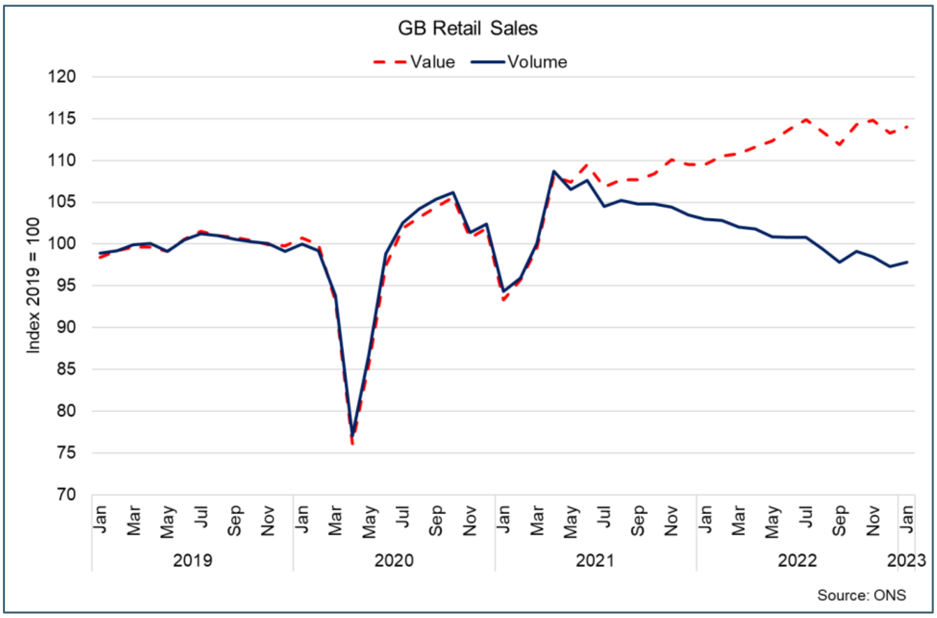
Retail Sales

- GB level retail sales volumes grew slightly by 0.5% in January, with a 0.6% increase in non-food store sales and 0.5% fall in food store sales. However, in the three months to January, sales

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

volumes fell 0.9%, continuing the general downward trend in retail sales volumes since the middle of 2021.[15]

- Overall compared to January 2022, sales volumes have 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 3.9% 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.



Household Savings and Consumer Credit

- The impacts of the rise in cost of living and higher interest rates on households are continuing to develop as disposable income, spending, savings and credit flows have been re-balancing over the past year following notable shifts during the pandemic.
- National accounts data show that after accounting for other income, interest payments, taxes and social contributions, total gross disposable income increased by 4.4% on an annual basis in Q3 2022. Over the same period, total consumer expenditure is estimated to have increased by 8.1%, driven by higher inflation. These movements have seen the household savings ratio (8.8% in Q3 2022) fall back over the last year from the high levels estimated during the pandemic, and indicates a tightening in household finances.[16]

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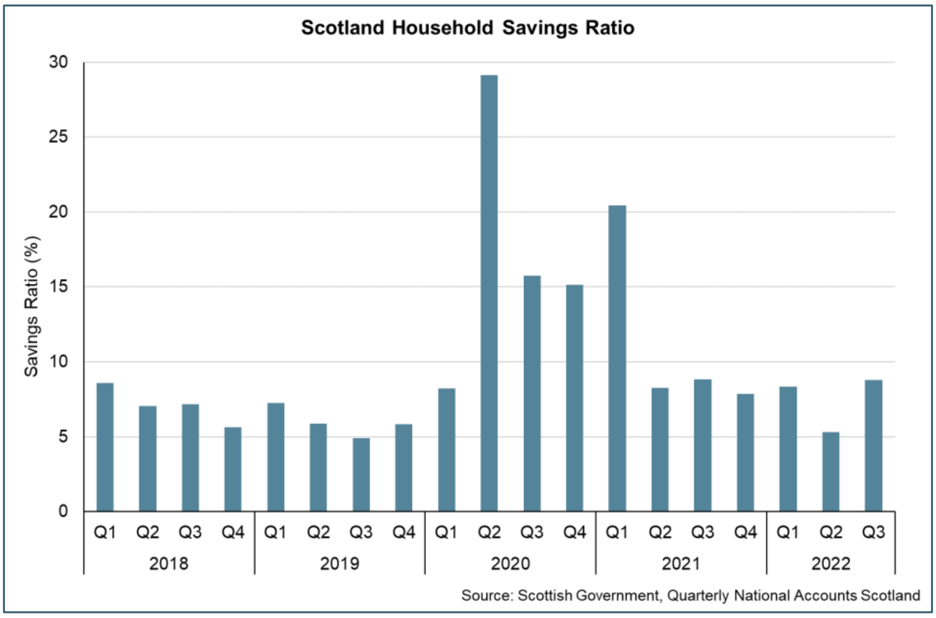
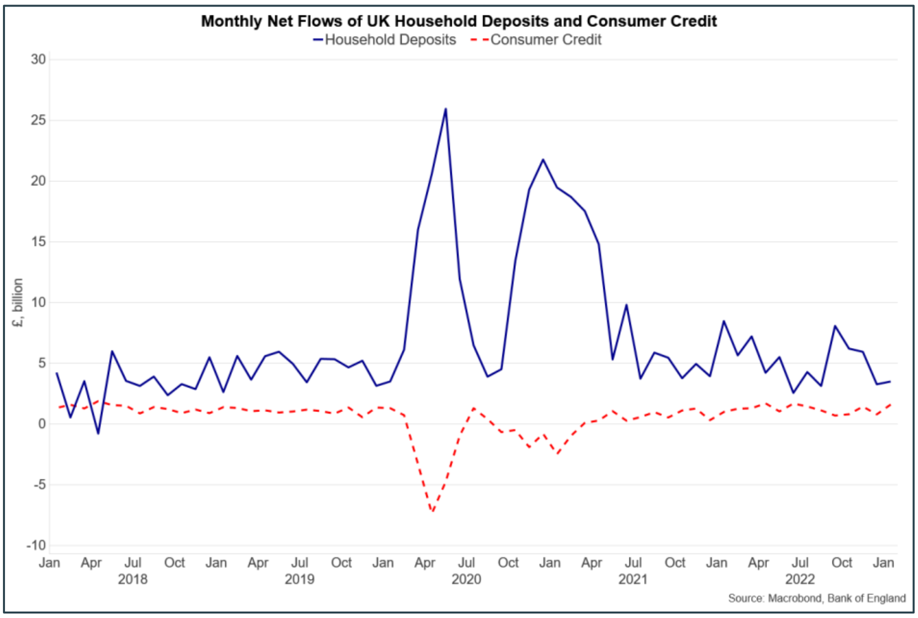
[15] Retail sales, Great Britain - Office for National Statistics (ons.gov.uk)
[16] Economy statistics - gov.scot (www.gov.scot)



- More recently, at an aggregate level, Bank of England Money and Credit data shows additional net flows from UK households into deposit-like accounts rose slightly in January 2023 to £3.5 billion (compared to £3.3 billion in December) however is below the monthly average for 2022 (5.4%).[17]
- Alongside this, consumers borrowed an additional £1.6 billion in January, following £0.8 billion of borrowing in December, driven by borrowing on credit cards (£1.1 billion). This was the highest net borrowing by consumers since June 2022 and above the monthly average for 2022 (£1.2 billion).



- Additional savings built up during the pandemic and credit have provided the potential to support consumption as household finances have been squeezed in real terms through higher inflation

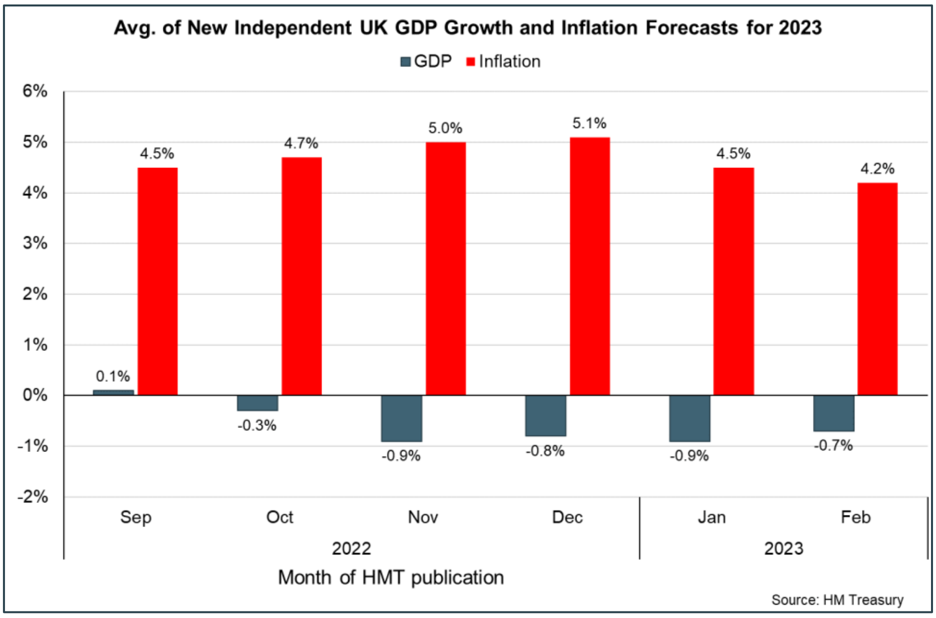
[17] Money and Credit - January 2023 | Bank of England

over the past year. Where savings or borrowing have supported spending to date, we may see consumption more at risk and exposed to lower levels of savings and higher interest rates/borrowing costs in the year ahead.

Economic outlook

Forecasts expect a shallow recession in 2023 as the inflation rate falls sharply.

- Economic growth stalled through the majority of 2022, and although latest outturn data estimates that output has been more resilient than previously forecast, the growth outlook for 2023 remains extremely challenging as households and business continue to face significant cost of living pressures, despite expectations that the inflation rate will fall sharply over the year.
- Forecasts from the start of this year point to a shallow recession in 2023. 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 and 0.25% in 2024.[18] This reflects a notably shallower fall in output than their November forecast, reflecting resilience in the labour market, and the rapid decline in the contribution of energy to inflationary pressures.
- More broadly, the average of new independent forecasts published by HMT in February indicates a contraction of 0.7% in UK GDP in 2023, which is also shallower than in recent months.[19] Alongside the fall in output, the Bank of England forecast inflation to fall to around 4% by the end of 2023. This is broadly in line with the average of independent forecasts (4.2%) which includes estimates of notably slower and more rapid falls in inflation over the year, reflecting the uncertainty and inflationary risks that persist in the outlook.



[18] Monetary Policy Report - February 2023 | Bank of England
[19] Forecasts for the UK economy - GOV.UK (www.gov.uk)

- At a Scotland level, latest forecasts in February from the Fraser of Allander Institute forecast three quarters of falling output in 2023 with output contracting 1% over the year as a whole, while EY forecast Scotland's GVA to fall 0.6% in 2023, in line with the UK as a whole.[20,21]
- There is significant uncertainty over the depth and duration of the forecast 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.
- Cost of living pressures will remain significant however as the economy continues to adjust to the sharp increase in price levels over such a short period of time. The outlook for energy prices has improved in recent months as wholesale energy prices have fallen, reflected in a reduction in the Ofgem energy price cap for April to an average of £3,280 per year and latest price cap forecasts from Cornwall Insight projecting a further fall to £2,112.42 in July.[22,23] The fall in wholesale energy prices will feed through the economy, however the scale and timing of benefit to households in the short term will be dependent on the level of government support (through the Energy Price Guarantee or otherwise) made available over the coming months.

[20] FAI Economic Commentary 2022 Q4 | FAI (fraserofallander.org)
[21] Cost of living pressures set to intensify the UK's regional economic divide | EY UK
[22] Ofgem announces latest quarterly price cap update | Ofgem
[23] Cornwall Insight responds to the announcement of the April price cap - Cornwall Insight (cornwall-insight.com)

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