Monthly Economic Brief

Office of the Chief Economic Adviser

June 2023

Scottish Government
Riaghaltas na h-Alba

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June 2023

Data up to 30 June 2023

Overview

Scottish economic activity has recovered from the fall in the second half of 2022, with latest data indicating that economic output remains more resilient than initially forecast. Although the ongoing tightness in the labour market coupled with stronger services sector growth are contributing to a greater degree of persistence in underlying inflationary pressures.

The Scottish economy grew 0.2% over the three months to April, with growth slowing from the first quarter and output falling over March and April. Weaker growth in the production sector has been a key driver over this period while there has been stronger growth in construction and the service sector. Consumer facing services output grew 1.1% over the three months to April, continuing its recent pattern of growth in the face of ongoing inflationary pressures.

Inflation is on a downward trend from its recent peak, however the latest data indicates a greater breadth and persistence of inflationary pressures than expected in recent months. Inflation was unchanged over April and May at 8.7%, with the inflation rate for services strengthening and food price inflation remaining elevated at 18.3%. More broadly, core inflation rose to 7.1%, its highest rate since 1992.

The resilience in economic activity since the start of the year has been underpinned by ongoing low unemployment in Scotland at 3.1%, while the gap between nominal earnings and prices growth has narrowed. That said, there remains significant pressure on household finances with some of the impacts of interest rate rises still to be felt. Furthermore, recruitment activity in the labour market has softened notably in recent months, in part reflecting the uncertain economic outlook, however it’s too early to tell whether the recent rise in inactivity reflects a more persistent weakening in the labour market more broadly.

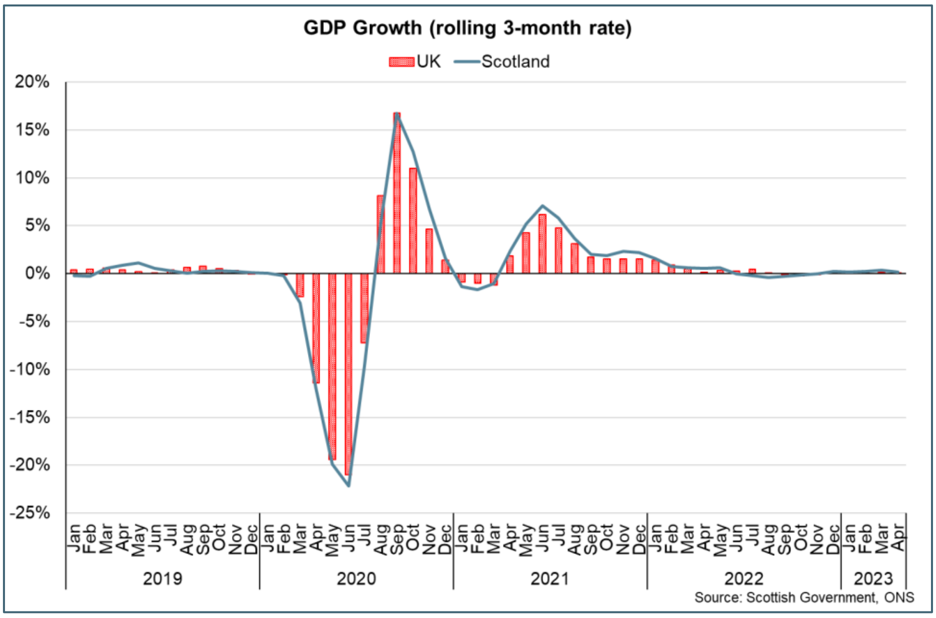
The rise in core inflation and strength of earnings growth were key factors in the Bank of England’s decision for an accelerated 0.5 percentage point increase in the Bank Rate to 5% in June. Strengthening consumer sentiment in May further points to the underlying resilience in consumer demand, however latest PMI business survey data indicates a slight easing in business activity growth, emphasising the ongoing complexity of reducing inflationary pressures amid subdued growth. The fall in producer input price inflation to 0.5% in May should further reduce pressure as it feeds through.

Looking ahead, the Scottish Fiscal Commission forecast the Scottish economy to grow 0.2% in 2023, revised up from their previous forecast, but remaining subdued overall. The recent easing in output growth is consistent with this forecast, which is at best a low growth environment. However, the risk of more persistent inflation and interest rate rises creates a more uncertain and fragile outlook for growth.

Output

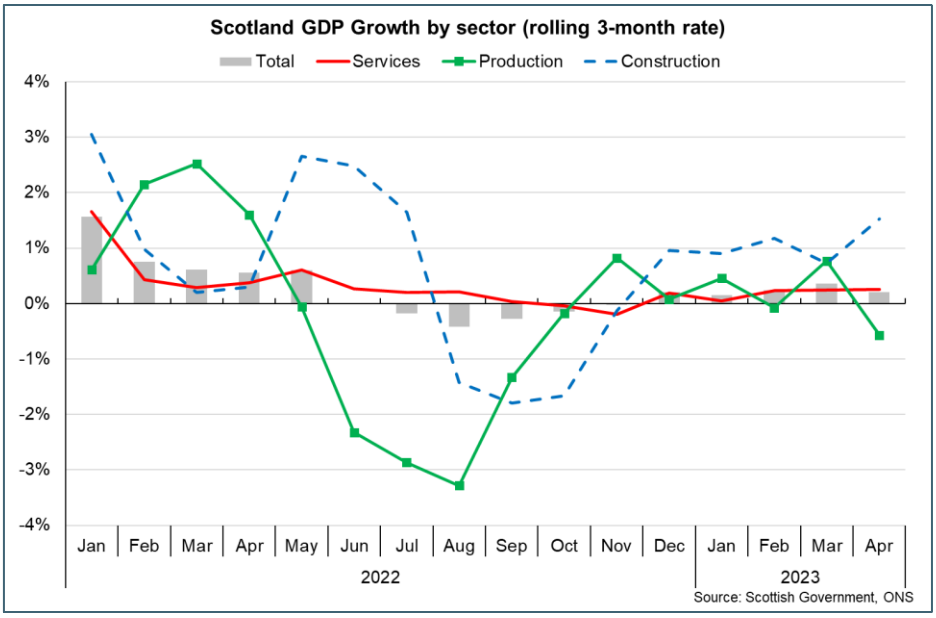
Scotland’s GDP grew 0.2% in the 3-months to April as the pace of growth eased.

- Scottish GDP grew 0.2% in the three months to April (UK: 0.1%), slightly slowing from 0.4% growth in Q1, with output falling over the months of March (-0.1%) and April (-0.5%).[1]
- Compared to April 2022, the economy has contracted 0.2% over the year and reflects the slowdown in growth and fall in output during the second and third quarters of 2022 before gradually recovering into the start of 2023.



- At a sector level, the recent softening in the 3-months to April has been driven by a fall in Production output (-0.6%), particularly across manufacturing (-0.9%) and mining and quarrying industries (-2.9%) which have also seen notable falls in output over the past year.
- Growth was stronger across other parts of the economy. Construction output grew 1.5% over the 3-months to April and has grown 0.9% over the past year while service sector growth strengthened to 0.3% over the quarter with growth across professional, scientific and technical services (1.1%), financial and insurance activities (0.4%), accommodation and food services (2.7%) and consumer facing services more broadly (1.1%).

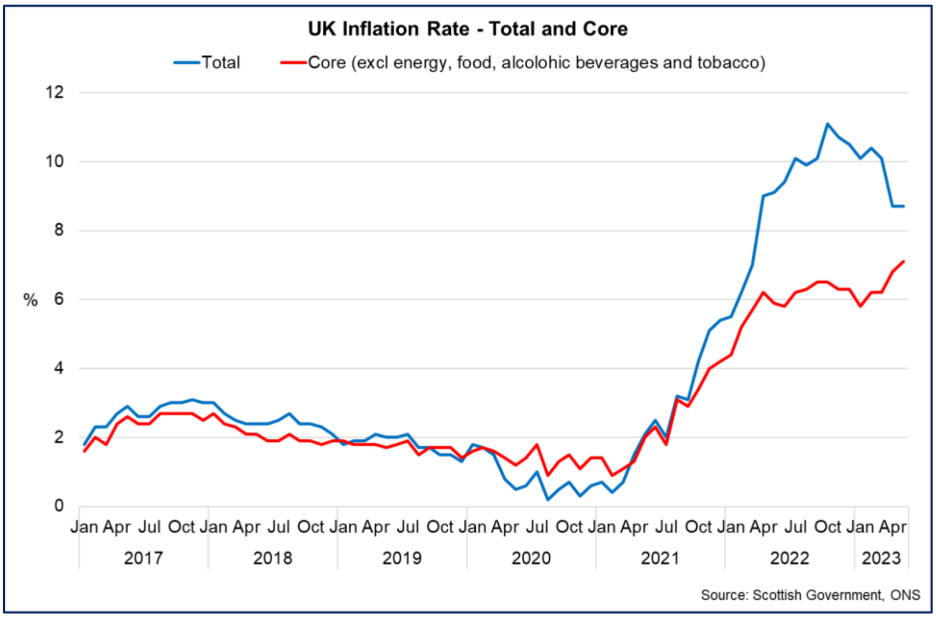
[1] Economy statistics - gov.scot (www.gov.scot)



Inflation

Headline inflation remained unchanged in May while core inflation continued to rise.

- Following the notable 1.4 percentage point drop in the inflation rate in April as the sharp rise in energy prices in 2022 started to fall out of the annual comparison, UK inflation remained unchanged at 8.7% May; slightly higher than forecast and market expectations. [2]

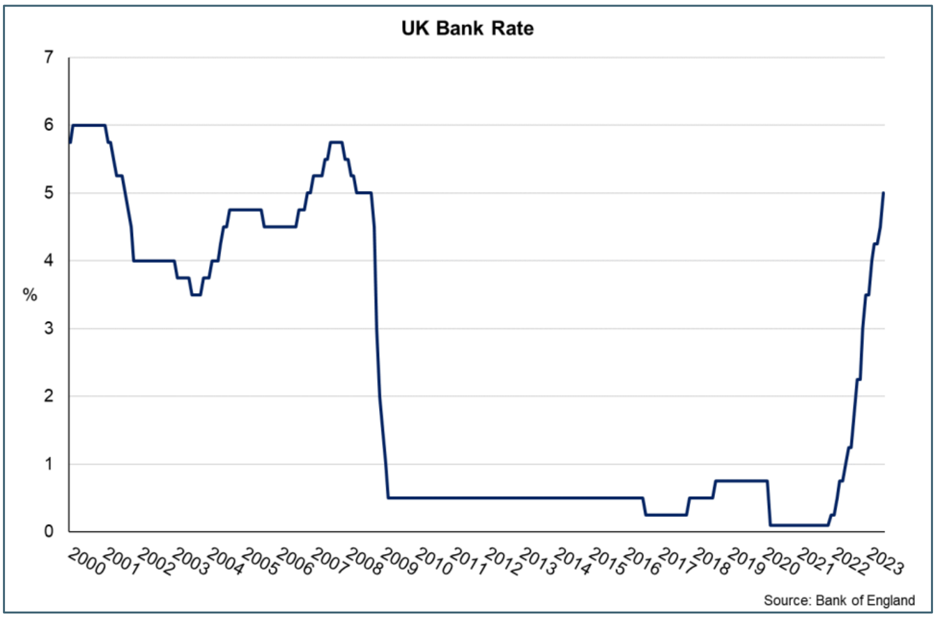


- Services prices in particular rose in May with the annual inflation rate rising 0.5 points to 7.4%, driven by increasing inflation rates for recreational and cultural services (4.5%) and restaurants and hotels (10.3%), while goods prices inflation eased for a third consecutive month to 9.7%.

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

Food and non-alcoholic drink price inflation eased slightly over the month from 19% to 18.3% however remained elevated overall.

- Core inflation, which excludes food, energy, alcohol and tobacco, rose 0.3 percentage points in May to 7.1%, its highest rate since March 1992. With much of the inflationary pressures to date reflecting the energy and commodity price shock due to the war in Ukraine, the further increase in the core inflation rate reflects the subsequent breadth and persistence of current inflationary pressures.



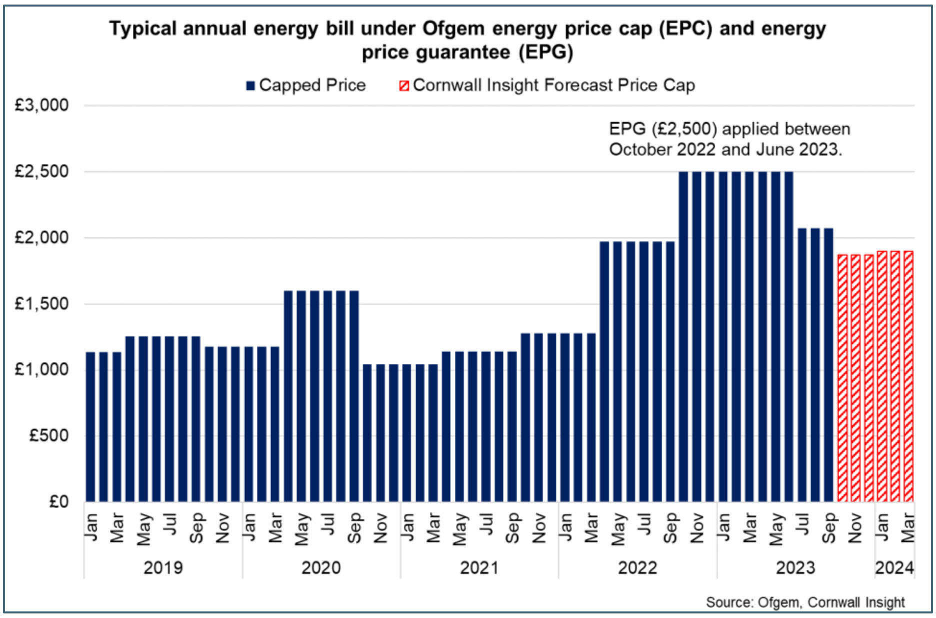
- In June, due to inflation falling more slowly than forecast and stronger than expected wage growth, the Bank of England's Monetary Policy Committee (MPC) raised the Bank Rate by 0.5 percentage points from 4.5% to 5% to further reduce inflationary pressures and expectations. It was the thirteenth successive rate rise since December 2021 when the Bank Rate was 0.1% and is at its highest rate since 2008. Markets currently expect interest rates to rise further and average 5.5% over the next 3-years. [3]

- The Bank of England's latest forecast from May is for inflation to fall to 5.1% by the end of 2023. The recent elevation of food price of inflation alongside the persistence of core inflationary pressures presents a risk that inflation will fall more slowly than this.[4]

- Household energy prices are expected to continue falling over the remainder of the year, placing downward pressure on the overall inflation rate. Due to the fall in wholesale energy prices over recent months, at the start July, the new energy price cap for the third quarter is applied meaning that the typical annual energy bill will be £2,074. This represents a 17% fall from the Energy

[3] Bank Rate increased to 5% - June 2023 | Bank of England
[4] Monetary Policy Report - May 2023 | Bank of England

Price Guarantee of £2,500 which has been in place since October 2022. However, the capped price remains 5.2% higher than a year ago and double the capped price in January 2021, reflecting the ongoing pressure that energy prices will continue to have on household finances.[5]



- Looking ahead, Cornwall Insight forecast that the Energy Price Cap will fall further in the fourth quarter to £1,871 (-9.8%) before picking up slightly at the start of the new year.[6]

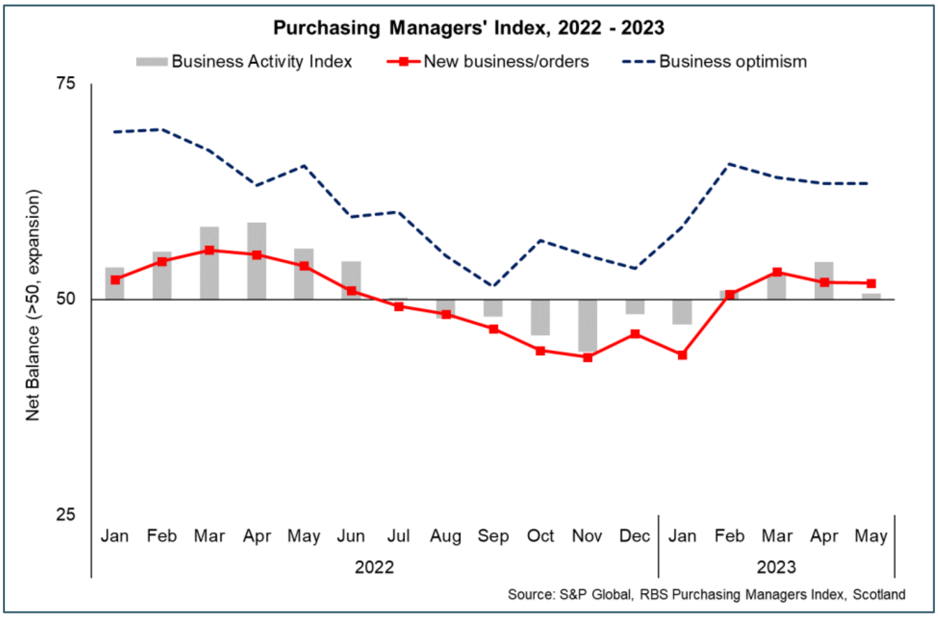
Business conditions

Business activity has improved during the first half of the year however uncertainty continues to temper optimism.

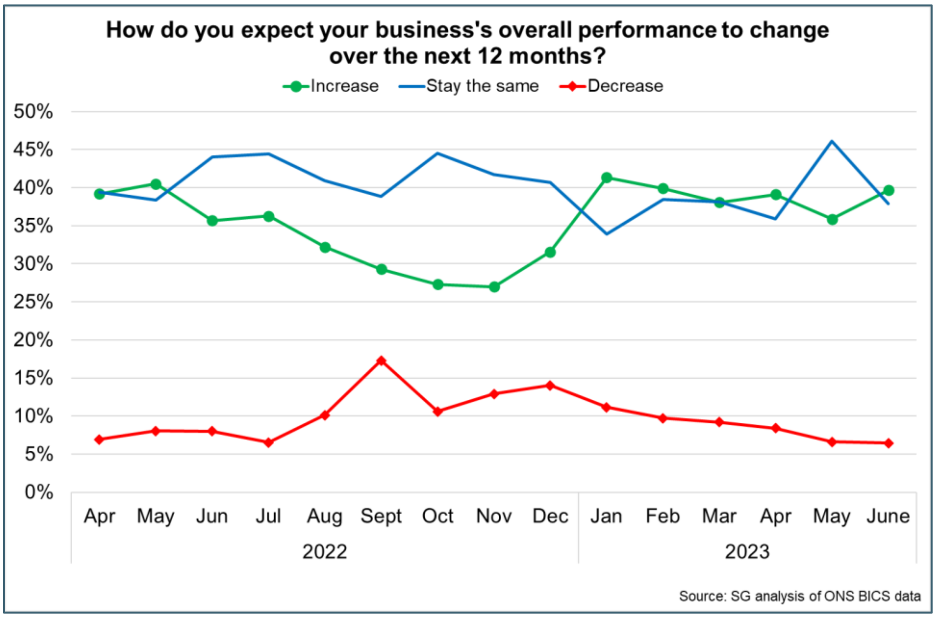
Business activity

- The Purchasing Managers Index (PMI) business survey indicates that business activity in Scotland's private sector has improved from the slowdown in the second half of 2022, however the momentum has stabilised during the second quarter of the year.[7]
- Business activity continued to grow in May, though at its slowest rate since January and was moderate overall (51.9). As has been evident in recent GDP data, this moderation has been particularly driven by the manufacturing sector which has seen a fall in new order book volumes while service sector activity has remained relatively more robust.

[5] Customers to pay less for energy bills from summer | Ofgem
[6] Predictions and Insights into the Default Tariff Cap - Cornwall Insight (cornwall-insight.com)
[7] Royal Bank of Scotland PMI report for May 2023 | Royal Bank of Scotland (rbs.co.uk)



- This has also been reflected in a slight easing in business optimism, which remains positive overall, however has softened in the manufacturing sector while remaining broadly stable in the services sector.

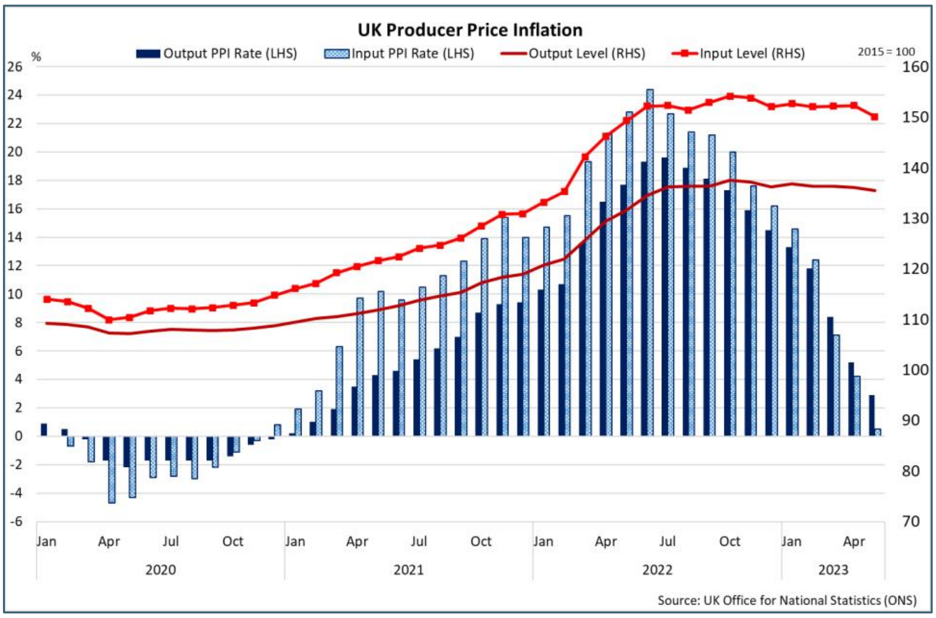


- Business Insights and Conditions Survey (BICS) data for Scotland also indicates that the level of business optimism for the coming year has stabilised. In June, 39.7% of respondents thought their business's performance would increase over the next 12 months, broadly in line with the average since the start of the year (39%), while 6.4% thought it would decrease (slightly lower than the year to date average of 8.6%).[8]

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

Business costs

- Businesses are continuing to adjust to higher energy, materials and staffing costs and remain key concerns reported by business. There are indications that the pace of some input cost increases facing producers has moderated.
- 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 0.5% over the year to May, its lowest annual rate since November 2020 and slowed for the eleventh consecutive month from its recent peak of 24.4% in June last year. Similarly, producer output price inflation also continued to fall to 2.9% in May, down from the recent peak of 19.9% last July and to its lowest rate since March 2021. [9]



- The moderation of energy and wider commodity price inflation has been a key driver of falling producer price inflation with crude oil inputs costs falling 34.7% over the year, while petroleum products output costs fell 30.6% over the year. However, food commodity prices have not fallen to the same extent and food materials continued to provide upward cost pressure with imported food materials costs rising 24% over the year while the output price of food products rose 11.5%.
- Wider business surveys also indicate the pace of input price rises are moderating. The PMI business survey input price indicator moderated further in May to a net balance of 67.3, remaining elevated but below last year's average.
- BICS data for Scotland provide latest insights into the effects on business of price rises. At the start of June, 61.5% of businesses reported that they had to absorb costs, 34% reported having

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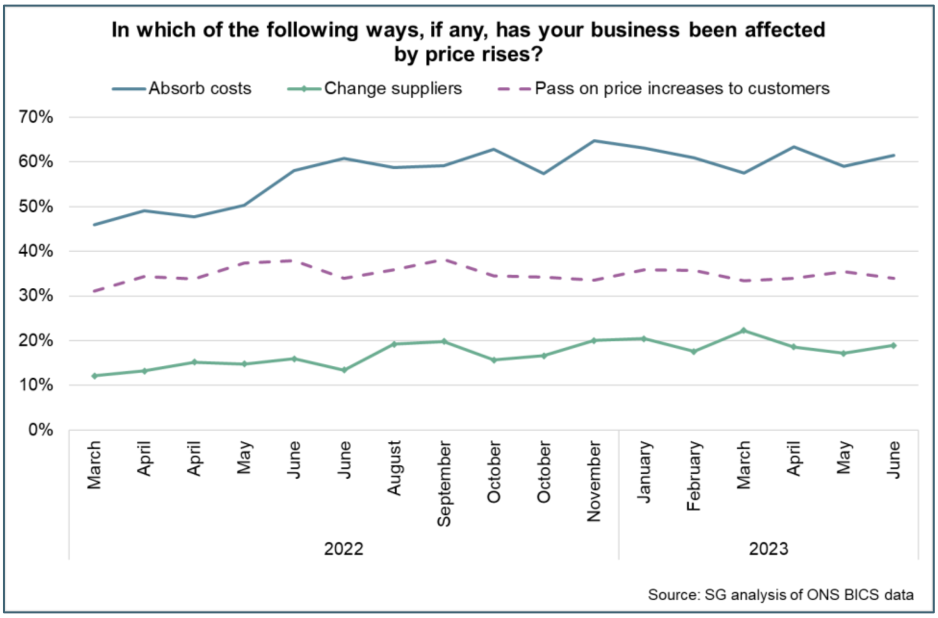
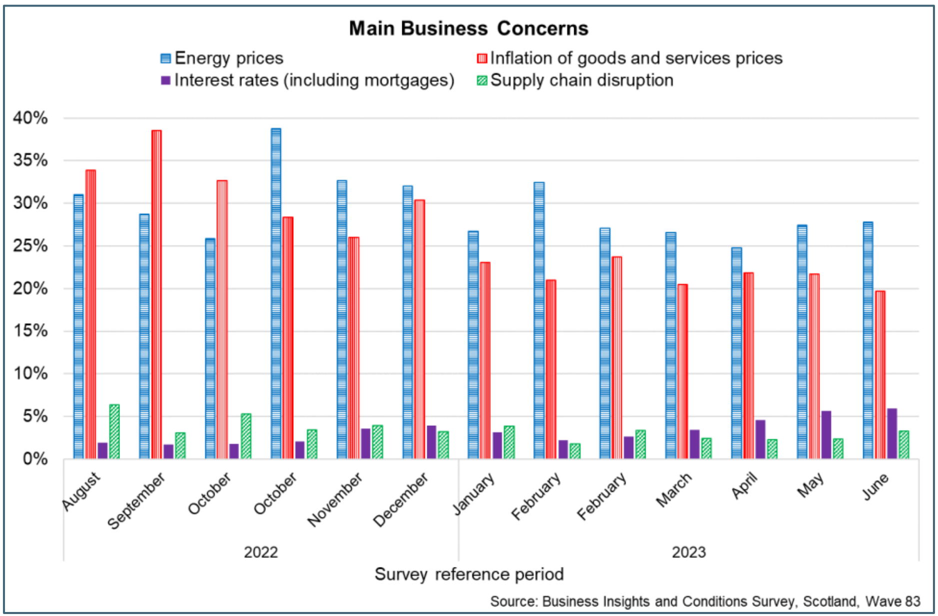
[9] [Producer price inflation, UK Statistical bulletins - Office for National Statistics (ons.gov.uk)](https://www.ons.gov.uk)

to pass on price increases to customers and 18.9% had to change suppliers. A much lower percentage of firms reported having to access more financial support (4.9%) and having to reduce staff work hours (6.7%). [10]



- While each of these effects have remained broadly stable over the past year, there continues to be notable differences across sectors. For example, 22% of accommodation and food sector businesses reported having to reduce staff work hours (compared to 6.7% for all businesses). Furthermore, 48.3% of firms in the accommodation and food sector, 44.1% of manufacturing businesses and 47.1% of wholesale, retail and repair of vehicles businesses reported passing prices onto customers (compared to 34% for all businesses).



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

- Overall, the main concerns for businesses in June continues to be energy prices (27.8%), which has reduced from 38.7% in October last year, and inflation of good and services prices (19.7%), which is on a gradual downward trend. Much lower and declining percentages of businesses are concerned about supply chain disruption (3.3%), which reflects wider business survey evidence showing improvements in suppliers' delivery times.[11] 5.9% of respondents noted interest rates as the main concern for their business which has been on a slight upward trend over the past year (up from 1.7% in September) and likely reflects the increase in Bank Rate over this period. Furthermore, 9.1% of businesses are concerned about falling demand of goods and services, reflecting the subdued economic outlook.
- This chimes with the Scottish Business Monitor for Q1 2023 which indicates the main business concerns over the coming year remain around the costs of energy, price of inputs and availability of staff.[12] This is likely to reflect a combination of concerns for further inflationary pressures and ongoing adjustment to recent price rises.
- While the pace of producer cost inflation has moderated sharply, the index level has remained broadly flat since June 2022 reflecting that some of the fall in the inflation rate over the past year is a base effect as the sharp price rises last year fall out of the annual comparison. As such, producer input costs remain 23% higher than in May 2021.

Business Investment

- The combination of these business concerns is impacting on decision making including on business investment. The Scottish Business Monitor indicates business investment remained weak in the first quarter of 2023, although improved from the second half of last year.
- More recently at a UK level, the Bank of England Agents' Summary of Business Conditions for Q2 2023 indicated that business investment intentions, particularly in buildings and construction, remained subdued due to higher investment costs and the uncertain economic outlook, while investment intentions in IT, digital and automation remained relatively stronger.[13]

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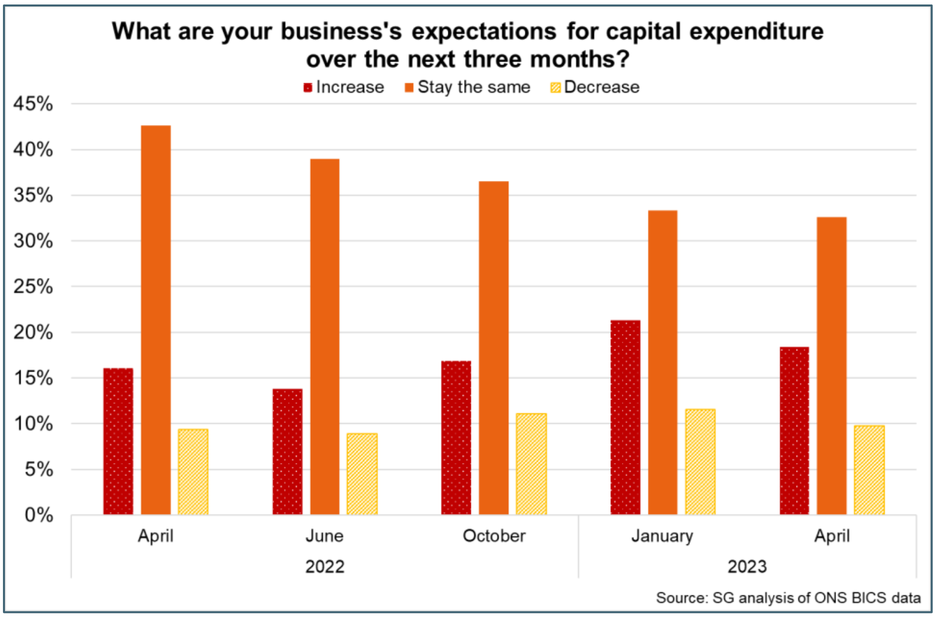
[11] S&P Global, CIPS UK Manufacturing PMI: 45d54ac2ea9b4d74bdc4adc2c6c22ee6 (spglobal.com)
[12] Scottish Business Monitor, 2023 Q1 | FAI (fraserofallander.org)
[13] https://www.bankofengland.co.uk/agents-summary/2023/2023-q2



- BICS data for Scotland in April show 18.4% of respondents thought their capital expenditure would increase over the next three months, showing a slight improvement from the middle of last year, while around 10% of respondents continue to expect to decrease capital expenditure over the coming year.

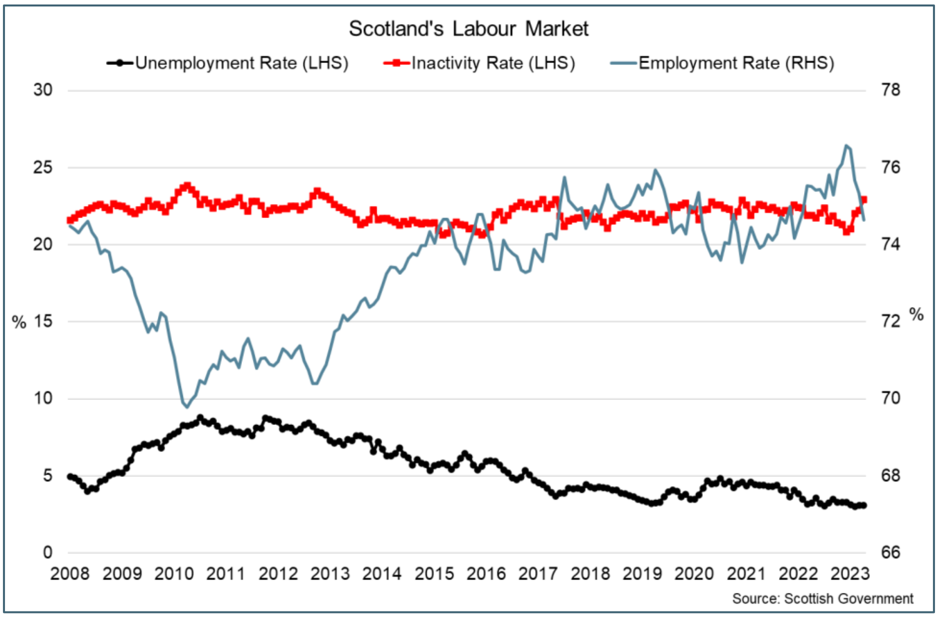
Labour Market

Unemployment remains at a near record low amid tight labour market conditions, however recruitment activity continues to ease.

Official labour market statistics

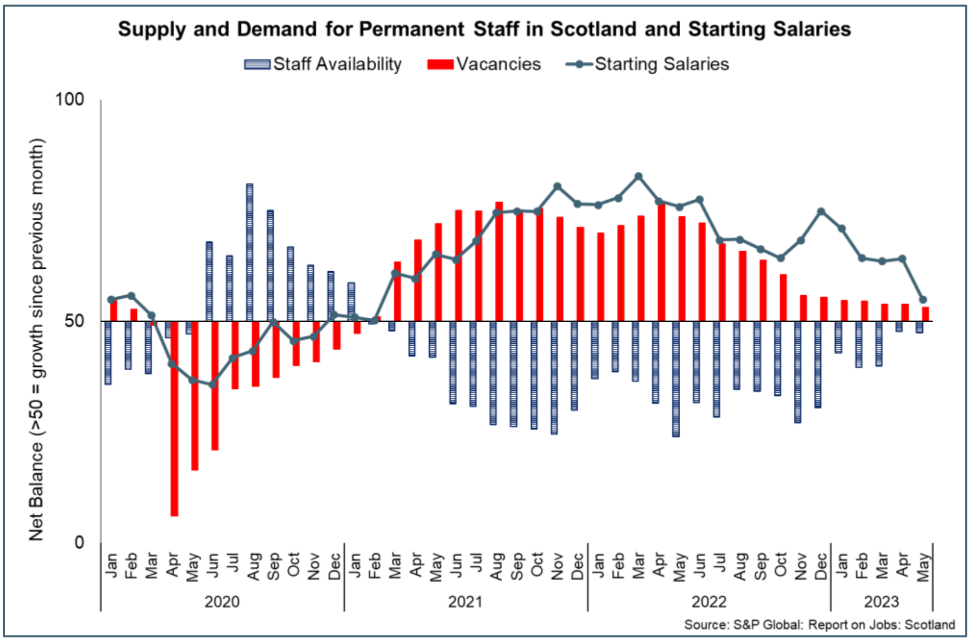
- The latest labour market statistics for February to April 2023 show Scotland's labour market performing well with the unemployment rate unchanged over the quarter at a near record low of 3.1% (UK: 3.8%) and is 0.1 percentage points lower over the year. [14]
- Recent movement in employment and inactivity rates indicates that there has been some cooling in the labour market with the employment rate falling 0.9 percentage points over the year to 74.6% and the inactivity rate increasing by 1 percentage point to 22.9%. This indicates that people have moved from employment into inactivity with the latest changes being particularly driven by women, however it is too early to conclude whether this represents a more persistent weakening.

[14] Labour market statistics - gov.scot (www.gov.scot)



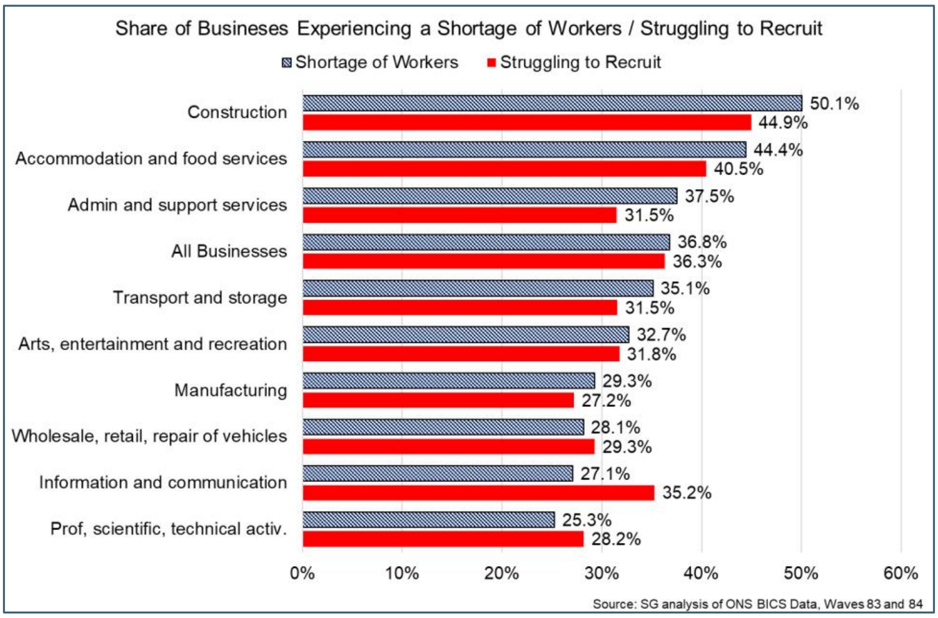
Demand and supply of staff

- Business surveys signal that labour market conditions have remained tight in May however there are further signs that recruitment activity has moderated. The RBS report on Jobs for May signalled that growth in permanent staff placements fell for a fourth consecutive month (net balance of 49) however, the rate of decrease was only marginal.[15]
- The fall in staff placements partly reflects uncertainty in the economic outlook for the coming year weighing on both the demand and availability of labour. Growth in demand for staff remained positive (53.2) but slowed to its softest rate in over two years, while businesses seeking to recruit continued to face supply side challenges with candidate availability continuing to fall (47.4) albeit at notably more moderate rates than over the past 2 years.



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

- The underlying tightness in the labour market continued to provide upward pressure to starting salaries in May, however the pace of growth did continue its downward trend to the softest rate since the start of 2021. Labour shortages are continuing to affect a range of sectors with BICS data indicating 36.8% of businesses experienced a shortage of workers in May.[16] The overall share has fallen from the start of September when it was 44.5%, however, along with recruitment struggles, remains most prominent in the construction (50.1%) and accommodation and food services (44.4%) sectors.



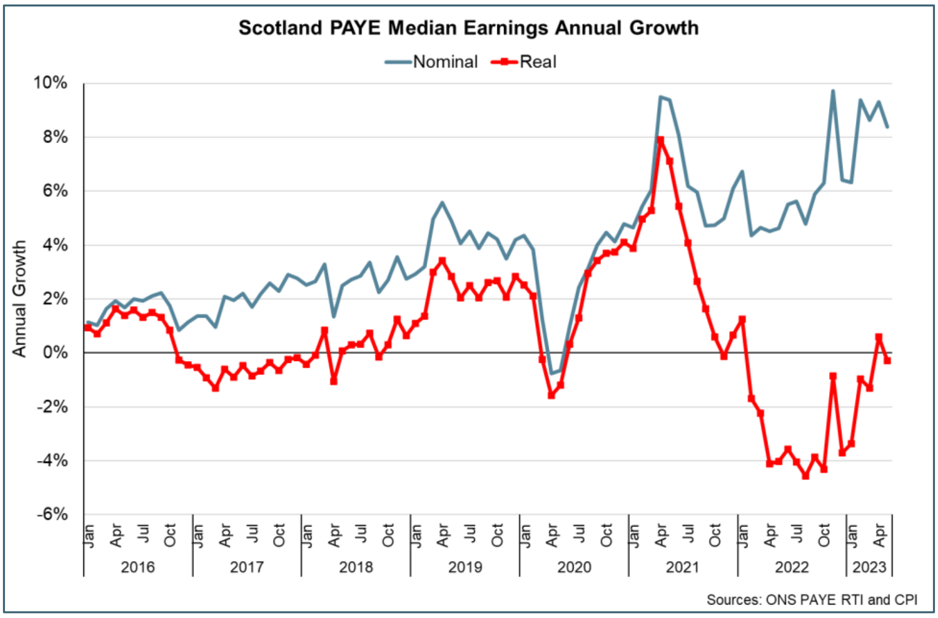
- Latest data for April show most businesses responded that a low number of applications (62.9%) and a lack of qualified applicants (60.7%) were reasons for why they experienced difficulties in recruiting employees, while 26.5% reported not being able to afford an attractive pay package to applicants.

Earnings

- As set out above, business survey evidence indicates that growth in starting salary pressures have eased over recent months. Considering earnings more broadly, nominal median monthly PAYE earnings in Scotland were £2,275, down 0.2% over the month but grew 8.4% over the past year. [17]

- However, adjusting for inflation, which was 8.7% in May, real median earnings fell 0.3% on an annual basis.

[16] Business and innovation statistics - gov.scot (www.gov.scot)
[17] Earnings and employment from Pay as You Earn Real Time Information, seasonally adjusted - Office for National Statistics (ons.gov.uk)



- The rate of annual real terms falls in earnings has moderated in recent months as annual growth in nominal earnings has continued its rising trend while the inflation rate has fallen from its recent peak of 11.1% in October to 8.7% in May. However, it continues to reflect the challenges that high inflation is having on incomes.

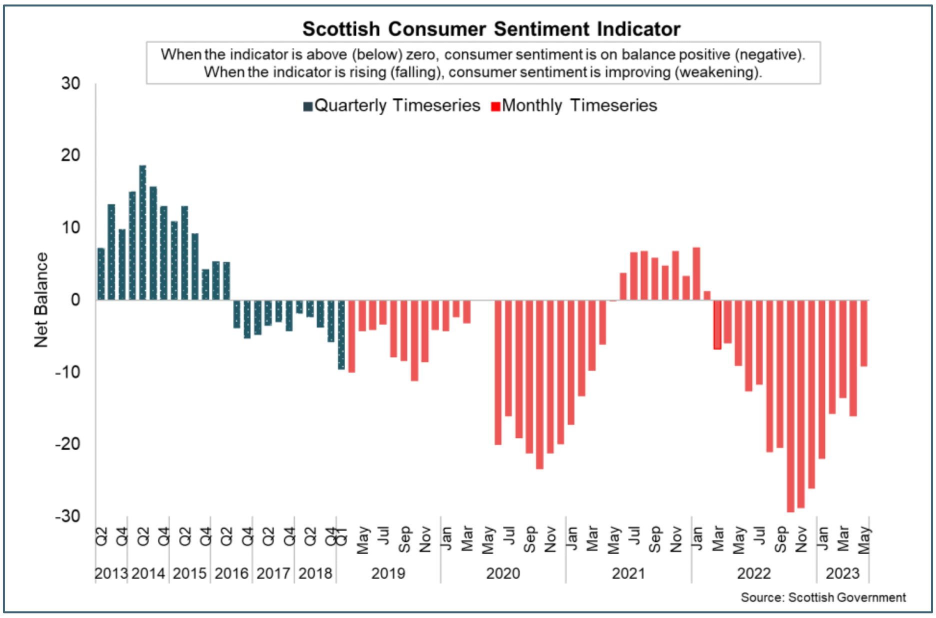
Consumption

Consumer sentiment continues to strengthen however remains negative overall.

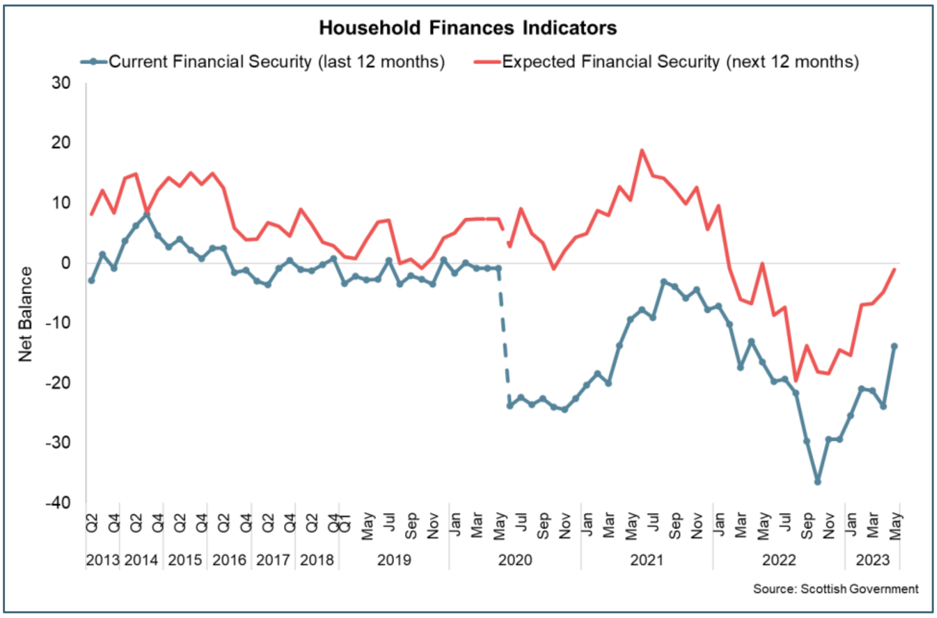
Consumer sentiment

- 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 sentiment has strengthened significantly in recent months albeit remaining negative overall. [18]
- In May, the Scottish Consumer Sentiment Indicator stood at -9.2; an increase of 6.8 points from April. This is a strong increase over the month, with the composite indicator now 20.2 points above the series low of -29.4 in October and at its highest rate since May 2020.

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

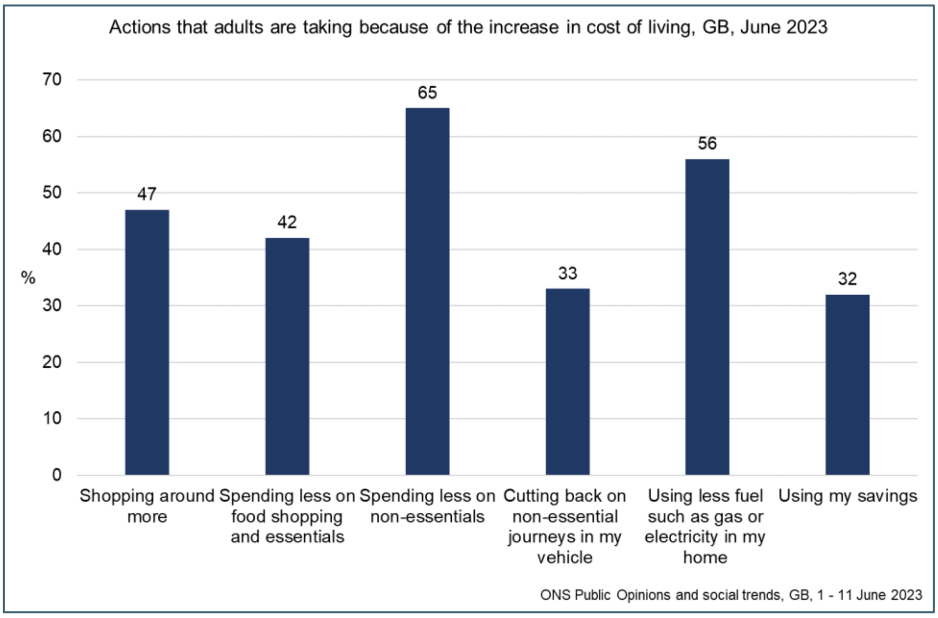


- The recent increase has been driven by strengtheing sentiment regarding the economy, personal household finances and attitute to spending, however households remain more optmistic about the outlook for the coming year than their current circumstances.
- On the economy, respondents on balance consider current economic circumstances to be worse than last year (-16.3, up from -17.4 in April) however expect the economy to improve over the coming year relative to the current situation (14.9, up from 6.6 in April).
- In terms of households' personal finances, respondents on balance continued to report that they are less secure than 12 months ago (-13.9, up from -23.8 in April) and looking ahead, respondents also continue to expect their household financial security to weaken, though to a much lesser extent (-1.1, up from -4.8 in April).



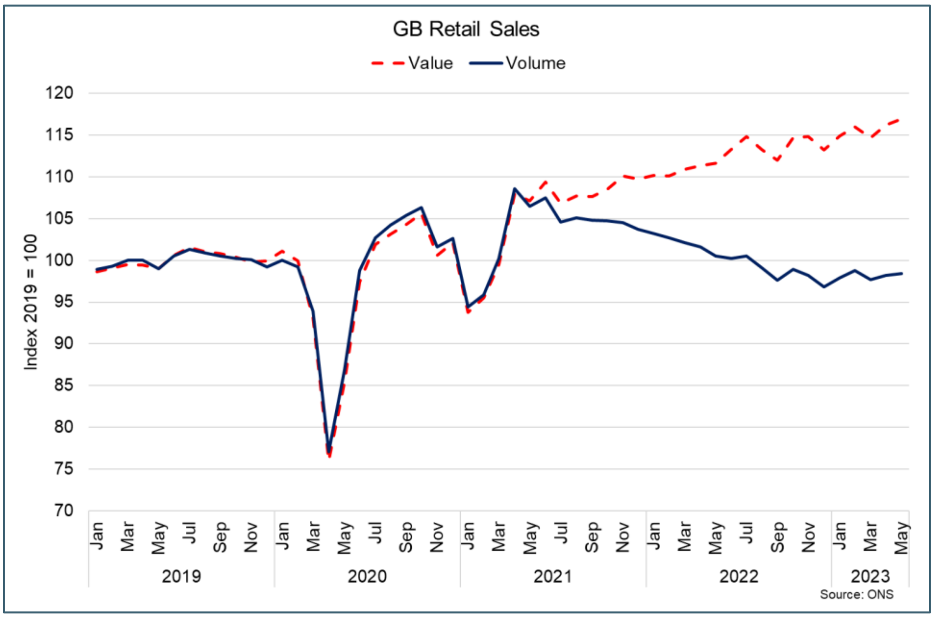
- Overall, households remain notably less optimistic about the outlook for their household financial security than they do for broader performance of the economy and is reflected in ongoing concerns about spending money.
- In May, the spending indicator increased 11.1 points to -29.7, up from -40.8 in April indicating that households continue to be uneasy about spending money, but to a slightly lesser degree than in recent months.
- The general strengthening in consumer sentiment in Scotland is consistent with findings from the GfK Consumer Confidence Index at a UK level which fell to its lowest point in September 2022 before picking up in recent months.[19]
- Despite recent strengthening, similar to the Scottish indicator, the GfK index remains in negative territory and reflects the ongoing challenges facing households from high inflation and higher interest rates. Furthermore, at a GB level, the ONS Public Opinions and Social Trends survey for June showed that 62% of respondents reported an increase in the cost of living compared to the previous month, though this had decreased from April when it was 76%.[20]
- The reasons given for the increase in the cost of living over the past month included (i) price of food shopping (96%); (ii) gas or electric bills (62%); (iii) price of fuel (34%), and rent or mortgage costs (26%).
- Data from the start of June show that the most common actions people were taking in response to the increased cost of living were spending less on non-essentials (65%) and using less fuel such as gas or electricity in their home (56%), while 47% reported shopping around more and 42% reported spending less on food shopping and essentials.

[19] https://www.gfk.com/press/uk-consumer-confidence-improves-on-personal-finances
[20] Public opinions and social trends, Great Britain - Office for National Statistics



Retail Sales

- GB level retail sales continued to show a slight improvement from the start of the year with sales volumes growing by 0.3% in May and 0.3% in the three months to May. Sales volumes remained 2.1% down over the year while sales values rose 4.8%, reflecting the impact of inflation.[21]



- Food stores sales volumes fell 0.5% in May and 1.1% over the year. Some retailers indicated that higher food prices may explain part of the fall with the food sales values rising 12.7% due to the impact of inflation.

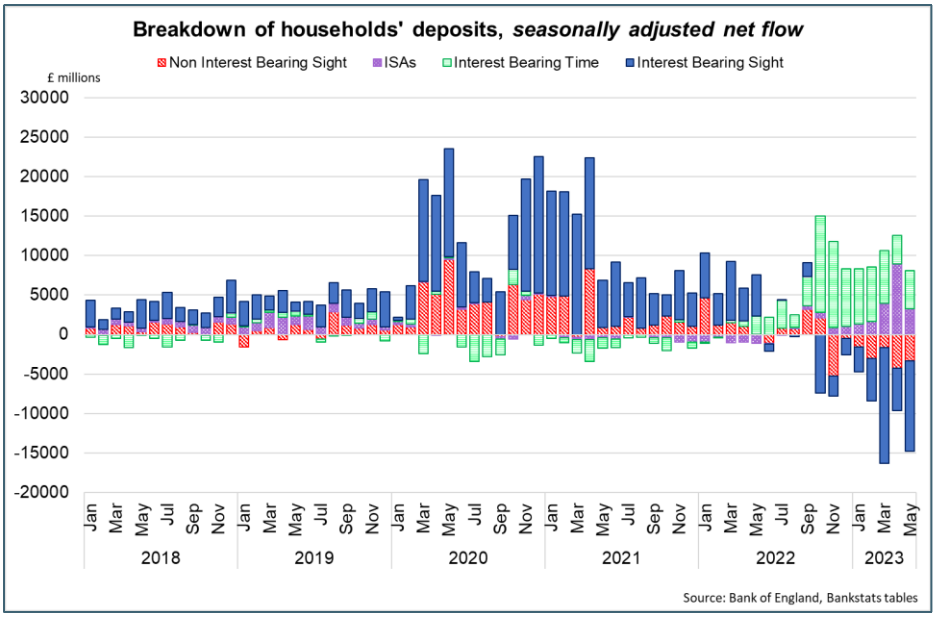
- Non-food store sales volumes fell by 0.2% in May and 2.1% over the year, however increased 4.2% in value terms. This increase in value terms was not to the same extent as in food stores reflecting the particularly high rates of food price inflation. Household goods stores provided the

[21] https://www.ons.gov.uk/businessindustryandtrade/retailindustry/bulletins/retailsales/may2023

largest upward contribution to non-food store sales volumes, increasing 1.5% with strong sales in DIY stores reportedly due to good weather.

Household savings and lending

- The rise in cost of living and higher interest rates are progressively feeding through to household decisions on spending, saving and borrowing.
- At an aggregate level, Bank of England Money and Credit data shows households on net withdrew £4.6 billion from banks and building societies in May, the highest level of household withdrawals since records began in 1997.[22] Within this, there were further net withdrawals from interest and non-interest-bearing sight deposits of £14.7 billion, partly offset by net flows of £8.2 billion into interest-bearing time deposits and ISAs.[23]
- This indicates households are needing to use their financial resources (net outflows from banks) while are also choosing to deposit and hold money in longer term savings accounts which will tend to offer higher interest rates. The effective interest rate paid on individuals' new time deposits with banks and building societies rose by 12 basis points, to 3.95% in May, while the effective rate on stock sight deposits dropped by 8 basis points to 1.33%.

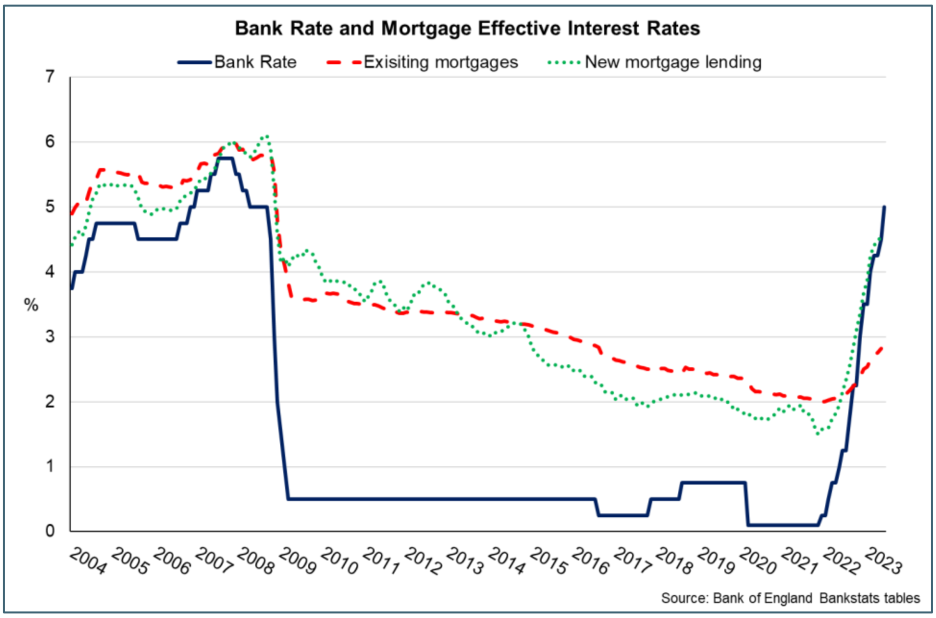


- A key channel through which higher interest rates impacts households is through mortgage interest payments. Around a third of households in the UK have a mortgage, with around 85% on fixed rate mortgages. While mortgage rates have been increasing as the Bank Rate has risen, the greater share of fixed-rate mortgages means that it will take time for the full impact of the

[22] https://www.bankofengland.co.uk/statistics/money-and-credit/2023/may-2023
[23] Interest-bearing sight deposits are accounts where the entire balance is accessible without penalty. Interest-bearing time deposits are accounts where the balance is not accessible without penalty.

increase in Bank Rate to be felt at an aggregate level. The Resolution Foundation estimate that 44% of households with a mortgage are yet to be impacted as they are yet to see their fixed-rate deals expire.[24]

- This is reflected in the effective interest rate on the stock of outstanding mortgages which rose to 2.8% in May while the rate on new mortgages rose to 4.6%.



- With around 85% of all mortgages on a fixed rate, as these fixed rate mortgages renew over the next 3 years, these households will face significantly higher mortgage costs. Furthermore, interest rates could rise further with markets currently expecting the Bank Rate to average 5.5% over the next 3-years.

- The Resolution Foundation estimate that, based on the latest market expectations for Bank Rate, the average rate on a two-year fixed-rate mortgage is likely to reach 6.25% this year based on current market pricing and won't fall back below 4.5% until the end of 2027.

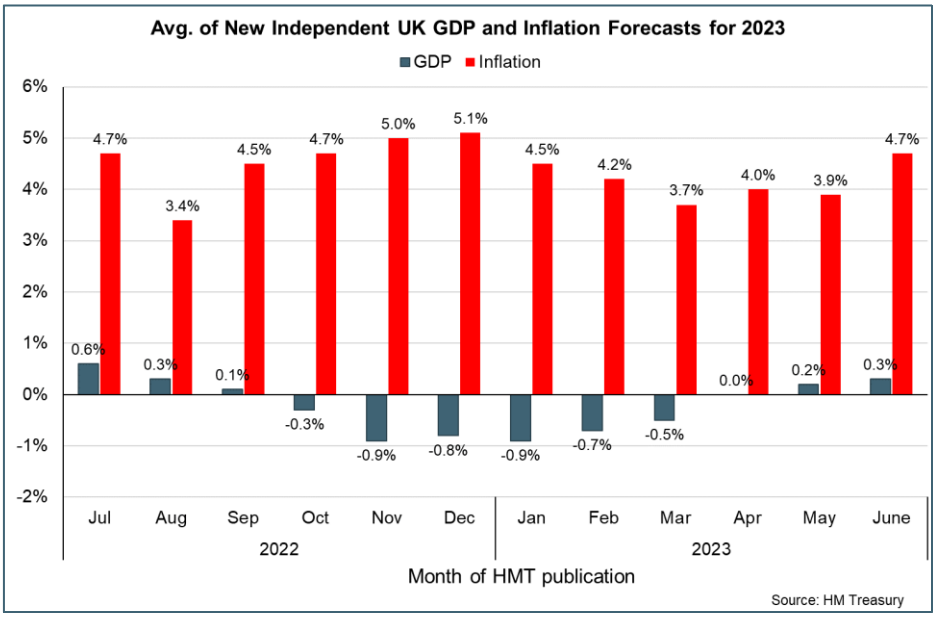
- At a UK level, the Resolution Foundation estimate that by the end of 2026, almost all British households with a mortgage will have moved on to a higher rate and are set to have annual mortgage bills that are £2,000 higher on average compared to December 2021.

Economic outlook

Output data continues to underpin a resilient economic outlook, however inflation has been stickier than expected and may require increased monetary tightening.

[24] The Mortgage Crunch • Resolution Foundation

- At a global level, some economic headwinds continue to ease with notable improvements in global supply chains and falls in global commodity price inflation. However, core inflationary pressures and tighter monetary policy continue to temper growth prospects.
- In June, the OECD forecast global growth to weaken from 3.3% in 2022 to 2.7% in 2023 (the lowest annual rate since the global financial crisis except during the pandemic in 2020) and remain subdued at 2.9% in 2024. OECD inflation is forecast to fall from 9.4% to 6.6% in 2023 and 4.3% in 2024, reflecting lower energy prices in the short terms and a subsequent easing of wider persistent core inflationary pressures.[25]
- At a UK level, growth forecasts for the year ahead have been revised up from forecasts made in the second half of 2022, however the growth outlook remains subdued and fragile amid higher interest rates. In May, the Bank of England forecast UK GDP to grow 0.25% in 2023, rising to 0.75% in 2024 while inflation is forecast to fall to 5.1% by the end of the year. [26]
- More broadly, the average of new independent forecasts published by HMT in June indicates UK GDP growth will be 0.3% in 2023, which is the highest average forecast since August 2022, while inflation is forecast to fall to 4.7% by the end of the year. This is higher than the average inflation forecast in recent months and likely reflects the persistence in elevated food price inflation and the recent rise in core inflationary pressures. [27]



[25] OECD Economic Outlook
[26] Monetary Policy Report - May 2023 | Bank of England
[27] Forecasts for the UK economy - GOV.UK (www.gov.uk)

- At a Scotland level, latest forecasts in May from the Scottish Fiscal Commission forecast output to grow 0.2% in 2023 (revised up from -1.2% in December), before growing 0.9% in 2024 and 1.3% in 2025. [28]
- Overall, economic activity strengthened at the start of 2023 having remained broadly flat over the second half of 2022, resulting in the outlook for 2023 being revised up from previous estimates.
- Most recent data indicates that growth slightly slowed in April, which is consistent with growth forecasts for the year. Inflation is forecast to fall sharply this year, however latest data indicates that this may be more slowly than recently forecast due to the persistence of core inflationary pressures. This has raised expectations of further increases in interest rates which emphasises the uncertainty and fragility facing the outlook for growth.

[28] Scotland's Economic and Fiscal Forecasts – May 2023 | Scottish Fiscal Commission

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