Scottish Economic Bulletin

Office of the Chief Economic Adviser

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Scottish Government
Riaghaltas na h-Alba

Contents

Data up to: 3 April 2024

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Cover page Image of peat sampling at Blawhorn Moss © Dougie Barnett NatureScot

Overview

Economic sentiment and conditions improved at the start of 2024, with latest indicators providing a more encouraging start to the year, which is reflected in improved forecasts for economic growth and lower inflation in 2024 compared to 2023.

Monthly Scottish GDP grew 0.6% in January 2024 following 0.4% growth in December 2023 – albeit over the quarter remained negative at -0.1 per cent overall - indicating a modest strengthening in output growth over this period. The return to growth in services (0.4% over the quarter) is encouraging and particularly consumer facing services growth which had its highest quarterly growth rate since May 2022. However, the further falls in output in manufacturing and construction sectors over the quarter emphasise the headwinds that continue to impact across the economy.

Stronger growth in consumer facing services is reflective of improving consumer confidence. The Scottish Consumer Sentiment Indicator strengthened for a second consecutive month in February to -6.1, and although remains negative, has improved significantly over the past year as the inflation rate has fallen and the outlook for the economy and household finances have improved.

The inflation rate fell to 3.4% in February, its lowest rate since September 2021 and is forecast to fall further over the coming months, raising expectations of reductions to the Bank Rate during the year. This, alongside the continuation of low unemployment and real earnings growth should further support demand in the economy. Despite the uncertainties around the ONS's Labour Force Survey data, other indicators of labour market activity show the number of payrolled employees in Scotland edged down marginally in February but remains close to its series high, while the claimant count unemployment level remained at 3.5%.

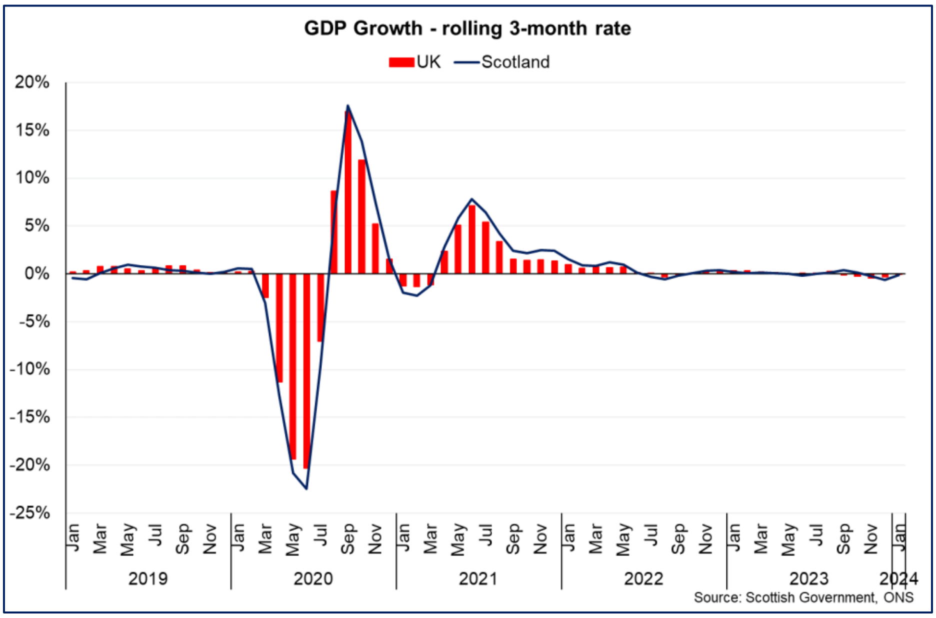
Latest business surveys show that business activity strengthened over January and February, albeit mainly in the services sector, supported by growth in new business orders. This has supported further improvements in business optimism for the year ahead. That said, indicators of business investment intentions remain subdued, however the outlook of strengthening demand, further stabilisation in cost pressures and the prospect of looser financial conditions could potentially unlock that to a greater degree over the year.

Looking ahead economic growth is forecast to strengthen moderately across 2024 and 2025 and latest indicators provide an encouraging start to the year with stronger business activity, consumer sentiment and ongoing resilience in the labour market. Although the drag on economic activity from higher interest rates should start to fade this year, the path for interest rates remains uncertain and will be an important determinant of the economic outlook. Downside risks to the economic outlook remain, notably from developments in the Middle East including disruption to shipping through the Red Sea.

Output

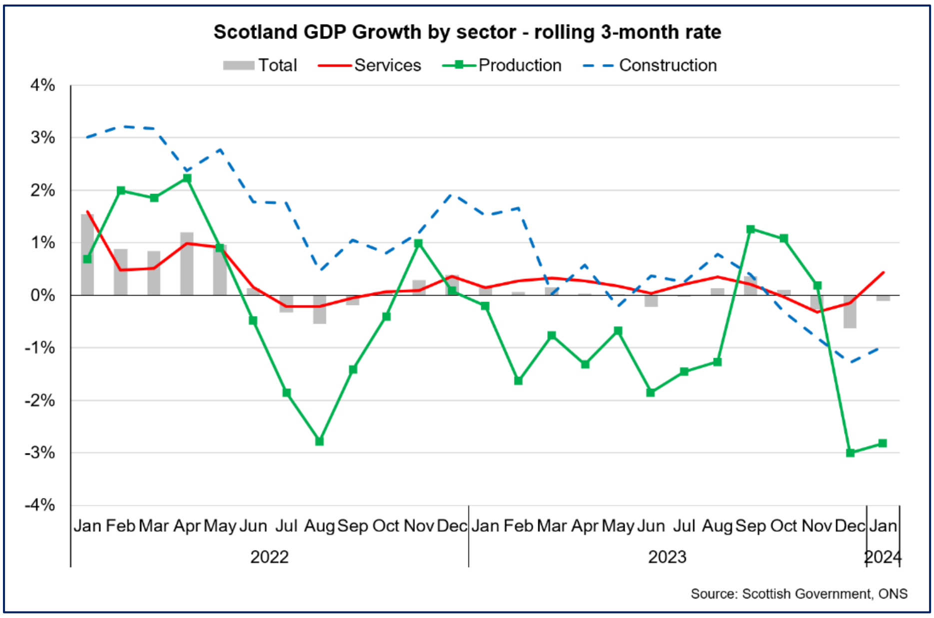
GDP growth strengthened in January following contraction in the final quarter of 2023.

- Scotland's economic output grew 0.6% over the month of January 2024 however more broadly fell 0.1% over the three months to January following an 0.6% fall in the final quarter of 2023. The overall pace of growth remains subdued, however monthly growth of 0.4% in December, and 0.6% in January indicates a modest strengthening and is reflective of a stronger growth outlook for the year ahead.[1]



- The 0.1% fall in output over the three months to January was driven by a fall in output in the Production (-2.8%) and Construction (-1.0%) sectors which offset growth in the Services sector (0.4%).
- In the Production sector, Manufacturing output continued its downward trend, falling 2.4% in the three months to January, within which the manufacture of food products, beverages and tobacco output fell 6%. More broadly, manufacturing output has fallen 5.6% over the past year.
- Services sector output growth was driven by steady growth in Professional, Scientific and Technical Services (1.6%) while Consumer Facing Services growth strengthened to 3.1%, its fastest three-monthly growth since May 2022. This was mainly driven by growth in Accommodation and Food Services (2.4%) and Arts, Culture and Recreation (3.9%), while Retail output fell on a three-monthly basis for its nineteenth consecutive month (-0.4%), reflecting that challenging conditions are continuing to impact on economic activity.

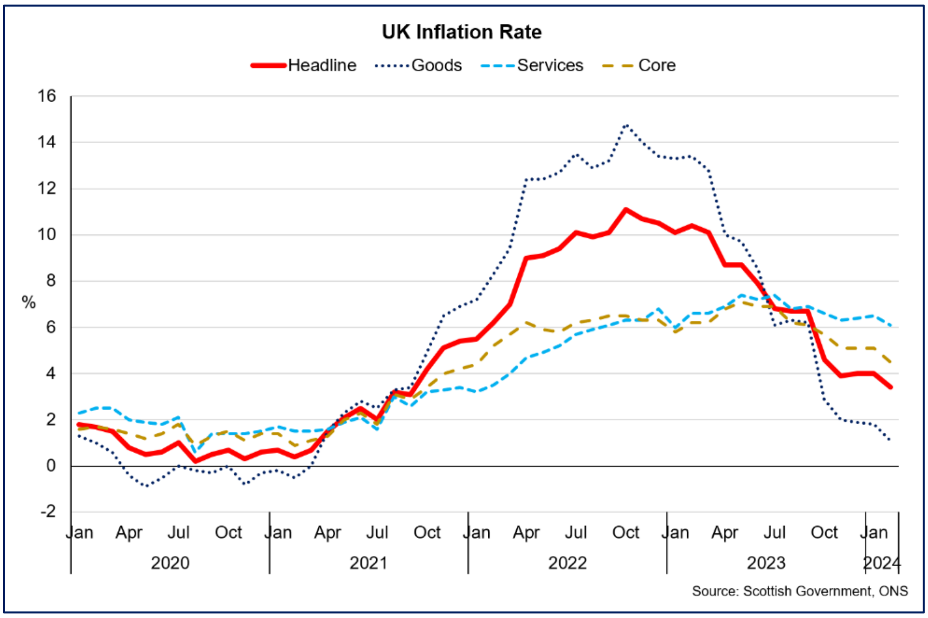
[1] Economy statistics - gov.scot (www.gov.scot) , GDP monthly estimate, UK Statistical bulletins - Office for National Statistics (ons.gov.uk)



Inflation

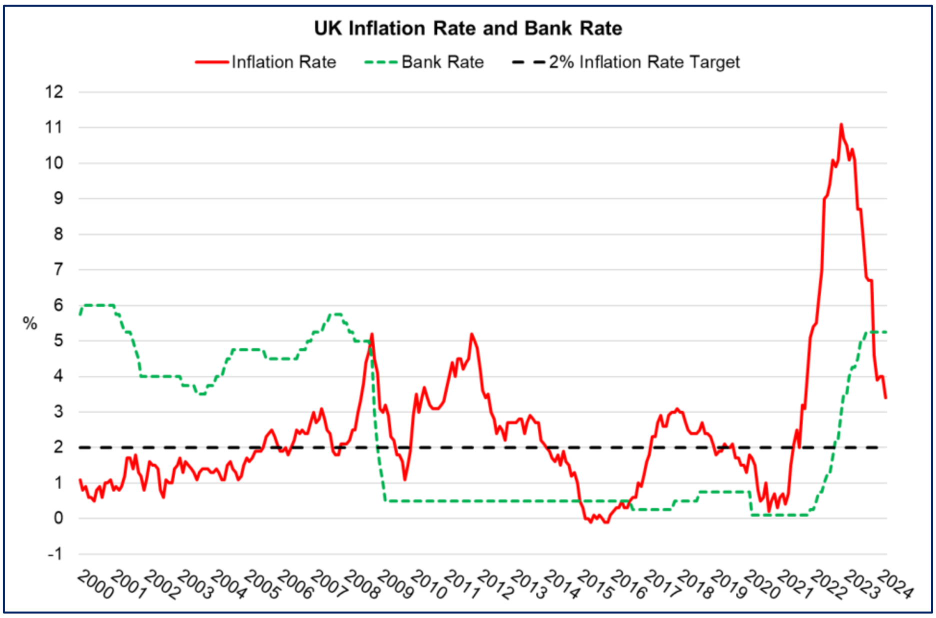
Inflation fell to 3.4% in February, its lowest rate since September 2021.

- The inflation rate fell to 3.4% in February, down from 4% in January, and is at its lowest rate since September 2021 as inflationary pressures continue to stabilise.[2]
- The largest downward contributions to the monthly change in the annual inflation rate came from food and restaurants and cafes. The inflation rate for food fell for its eleventh consecutive month in February to 5% (down from 7% in January) while the inflation rate in restaurants and cafes fell to 6.7% (down from 8.2% in January). The largest upward contribution came from housing and household services in which the annual inflation rate rose from -2.1% to -1.7% while motor fuels also provided an upward contribution with the annual rate rising from -9.2% to -6.5%.



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

- Core inflation, which excludes energy, food, alcohol, and tobacco, fell in February to 4.5% and continues to partly reflect the current persistence of services prices inflation which fell from 6.5% to 6.1% while goods prices inflation fell from 1.8% to 1.1%.
- In response to recent inflation and wider economic data, the Bank of England's Monetary Policy Committee (MPC) maintained the Bank Rate at 5.25% in March, unchanged since August 2023. The Bank set out that further evidence on areas of inflation persistence, such as in the services sector and the pace of wage growth, was required before changing the current monetary policy position.[3]



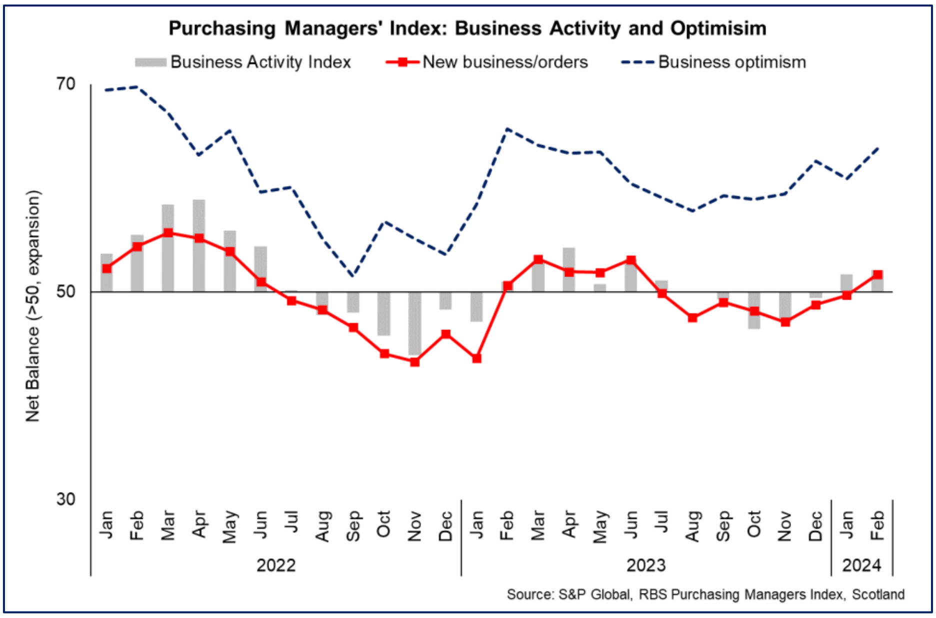
Business Conditions

Business activity has strengthened at the start of the year, however investment intentions remain subdued.

Business Activity

- The Purchasing Managers Index (PMI) business survey indicates that business activity in Scotland's private sector has strengthened at the start of the year and increased for the second consecutive month in February (52.1). There was partly underpinned by an increase in new orders for the first time in eight months (51.7), however this was driven by growth in the services sector while manufacturing activity continued to weaken, though to a lesser extent than in recent months.[4]

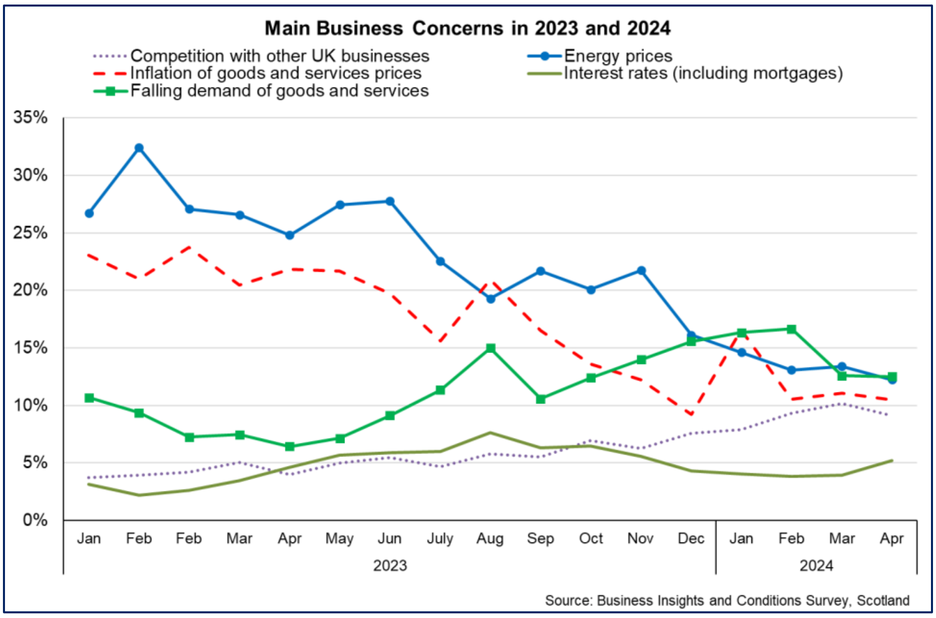
[3] Bank rate maintained at 5.25% - March 2024 | Bank of England
[4] Royal Bank of Scotland PMI report for February 2024 | Royal Bank of Scotland (rbs.co.uk)



- Reflecting the pick-up in activity, business optimism for the year ahead rose to an 11-month high, with reports indicating hopes of improved economic conditions underpinning expectations.

Business Concerns

- Reporting of key business concerns have continued to converge through the first quarter of the year as inflationary pressures have eased and increased expectations for improved trading conditions for the year ahead have emerged.
- The Business Insights and Conditions Survey (BICS) for April indicates that businesses concerns around energy prices (12.2%) and inflation of goods and services (10.5%) have stabilised in recent months following their downward trend over 2023 and have converged with wider concerns of falling demand (12.5%) and competition with other UK businesses (9.1%).[5]

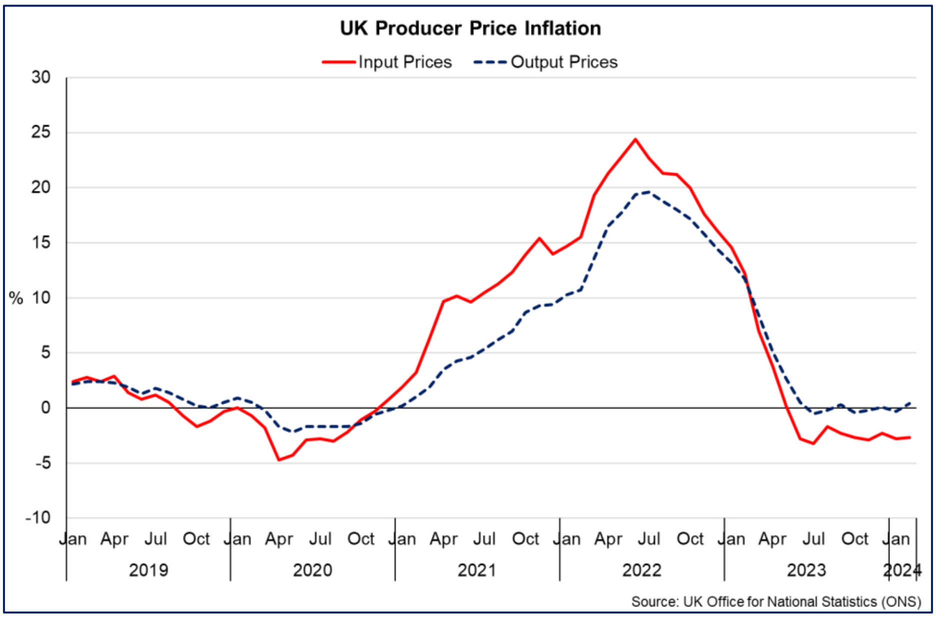


[5] [Business and innovation statistics - gov.scot (www.gov.scot)]

- The fall in the share of businesses reporting falling demand of goods and services in recent months potentially reflects the improvement in business activity at the start of the year. Concerns regarding interest rates eased over the second half of 2023 likely reflecting increased expectations that interest rates may fall during the coming year and have broadly stabilised at the start of 2024, increasing slightly over the recent month to 5.2%.

Business Costs

- At a headline level, producer input prices continued to decline in February on an annual basis for a ninth consecutive month, which is feeding through to significantly lower rates of output price inflation. The input price index fell 2.7% on an annual basis in February, while producer output prices rose 0.4%.[6]



- Overall, input and output price levels have been relatively more stable since June 2023, albeit they are significantly higher than at the start of 2021 (c. +25%) prior to the spike in inflation.

- The largest downward contributions to the annual input inflation rate for producers in February came from inputs of chemicals (-7.4%, up from -8.4%) and other parts and equipment (0.1%, down from 0.6%). Domestic food input prices have also continued to fall on an annual basis (-2.4%), however imported food input price inflation has remained positive (0.5%, down from 4.3%), alongside fuel inputs (6.1%, down from 10.5%).

- Looking at a broader range of input costs across the manufacturing and services sectors, PMI business survey data indicates that input prices continued to rise in February, however the pace of input cost inflation in recent months has returned to around its lowest rates since the start of 2021.

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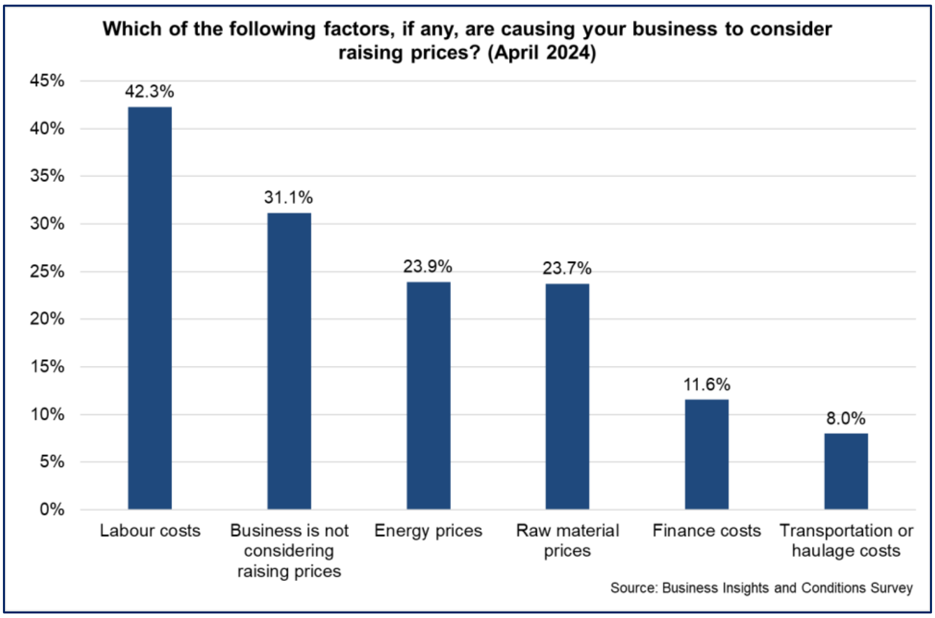
[6] Producer price inflation, UK Statistical bulletins - Office for National Statistics (ons.gov.uk). Prices of goods bought and sold by UK manufacturers, including price indices of materials and fuels purchased and factory gate prices.

- In terms of the feed through to output prices, BICS data show that many businesses are not considering raising prices in April (31.1%). However, it also provides insights on which costs remain the most challenging to absorb, with the main factor of considered price rises being labour costs (42.3%), followed by energy prices (23.9%) and raw material prices (23.7%).



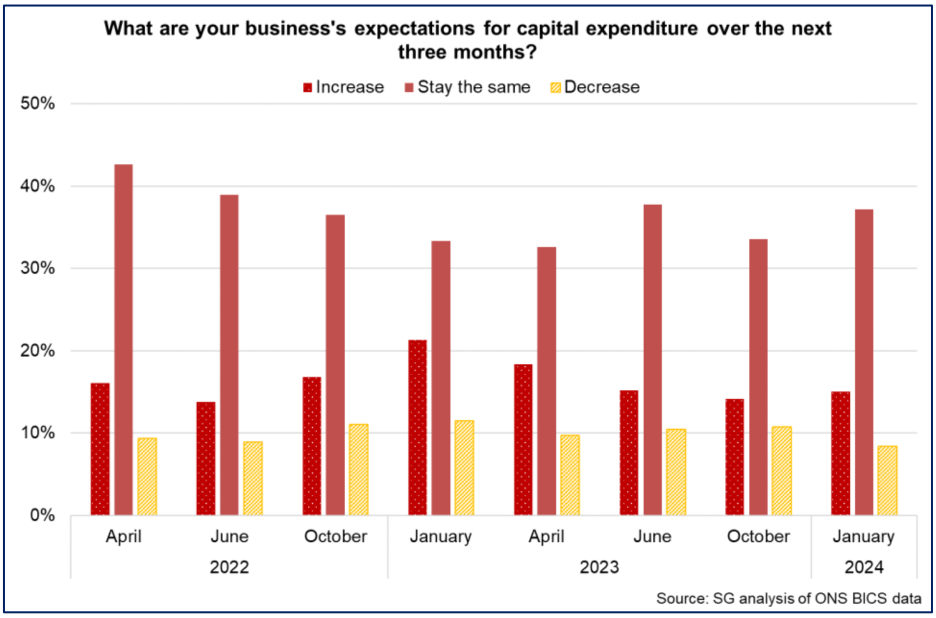
- Over March and April, around 8% of businesses reported that transportation or haulage costs are causing business to consider raising prices. This potentially partially reflects the increase in shipping and supply chain costs and delivery times that businesses are facing due to the attacks on commercial shipping in the Red Sea and the rerouting of shipping routes from Asia to Europe round the Cape of Good Hope rather than through the Suez Canal.

- There remains uncertainty over the persistence and impacts of the current supply chain disruption. BICS data show that only 5.1% of businesses in February experienced global supply chain disruption, remaining below the average for the past year (7.5%), however this is higher in the manufacturing sector (11.1%), which is particularly exposed to this disruption.

Business Investment

- The combination of business concerns around demand, cost pressures and higher interest rates continues to weigh on business investment decision making.

- BICS data for January show that capital expenditure expectations have moderated over the past year with 15% of respondents expecting their capital expenditure to increase over the next three months (down from 21.3% in January 2023) while an increasing share of businesses expect their capital expenditure to stay the same (37.2% up from 33.3%). Furthermore, of those expecting to authorise capital expenditure, 43% report that it will be for replacements, with lower shares reporting to authorise capital expenditure to increase efficiency (14%), expand capacity (13%) or to use new technology (11%).

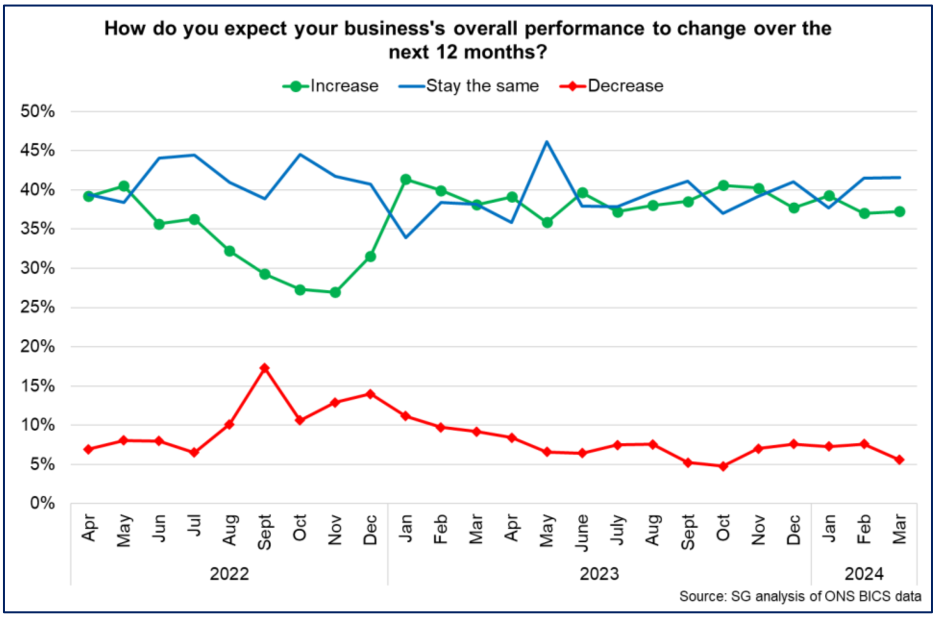


- The Scottish Chambers of Commerce Quarterly Economic Indicator for the first quarter of 2024 also indicates a level of caution reporting that business investment trends remaining largely frozen. Over half of businesses (53%) reported no change to total investment and 52% no change to training investment.[7]

Business Optimism

- Despite the challenging conditions continuing to face businesses, the recent pick-up in business activity and easing of some cost inflation pressures has been reflected in a further improvement in business optimism.
- The PMI business survey data indicates that business optimism for the year ahead rose to an 11-month high in February, continuing its upward trend since the middle of 2023 amid business hopes of improved economic conditions.
- BICS data for March indicates that most businesses expect their overall business performance to stay the same (41.6%) or increase (37.3%) over the coming year. On aggregate, this has remained broadly stable compared to the start of 2023, while the share of businesses expecting their performance to decrease has fallen to 5.6%.

[7] Quarterly Economic Indicator - Scottish ChambersScottish Chambers

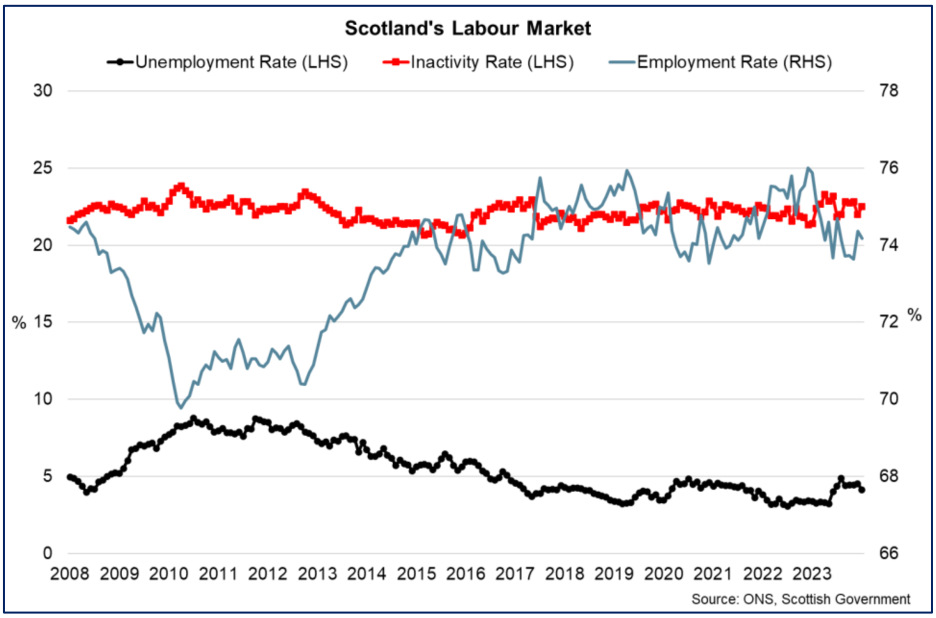


Labour Market

Payrolled employees remain at a near record high in February however recruitment activity continues to slow.

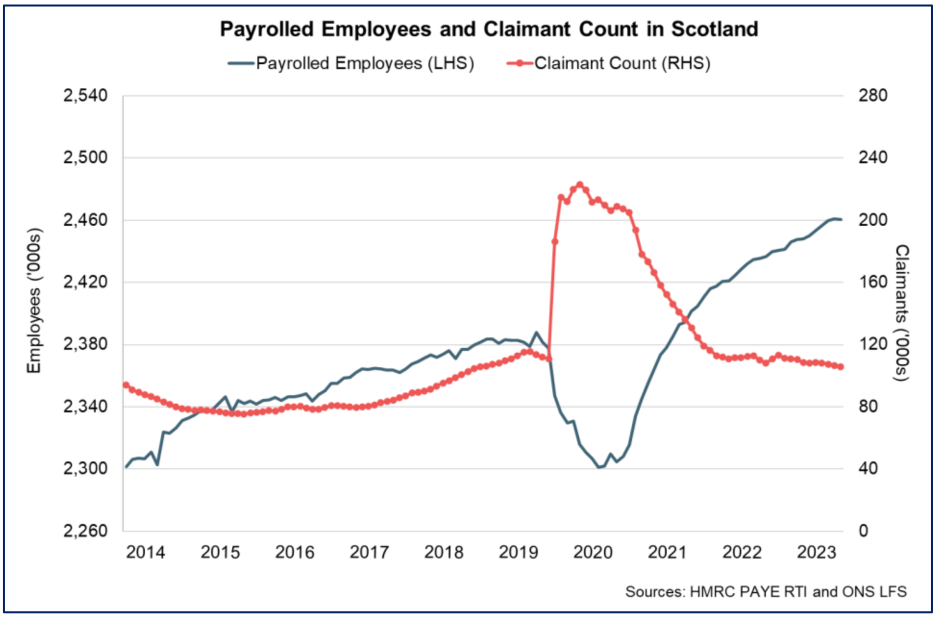
Employment, Unemployment, and Inactivity

- Scotland's labour market has remained resilient at the turn of the year in the face of subdued GDP growth and inflationary pressures. Latest data for November to January show that Scotland's unemployment rate fell 0.3 percentage points over the quarter to 4.1%, while the employment rate rose by 0.4 percentage points to 74.2%, and inactivity rate fell by 0.2 percentage points to 22.5%.[8]



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

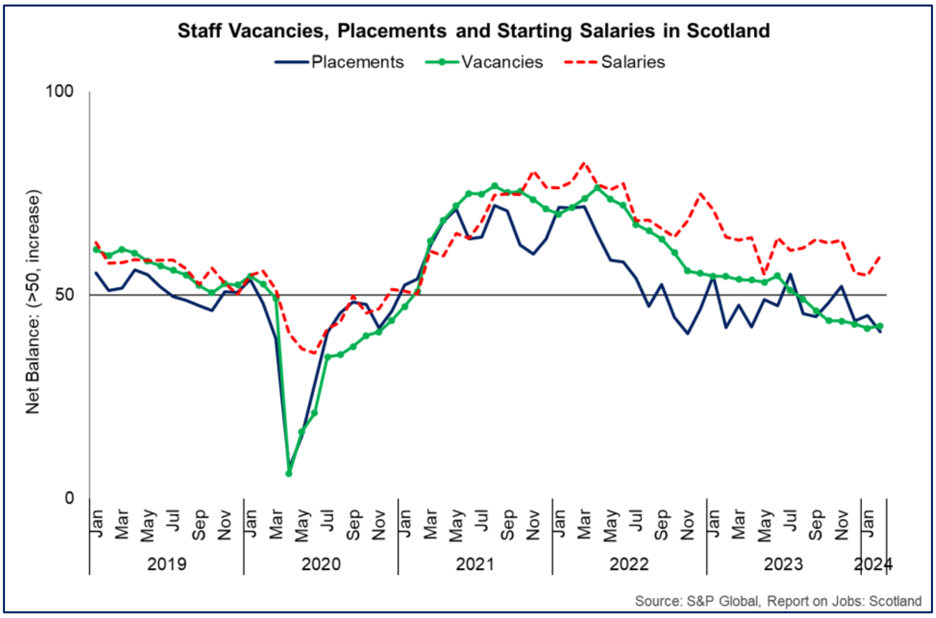
- The labour market has softened slightly over the last year with the employment rate falling 1.7 percentage points while the unemployment has increased 0.8 percentage points, and the inactivity rate has risen 1.1 percentage points. Despite the uncertainties around the ONS's Labour Force Survey data, wider labour market data continues to illustrate the underlying resilience. In February the number of payrolled employees in Scotland edged down slightly over the month to 2.46 million but remains close to its series high. Alongside this, Scotland's claimant count rate remained stable in February at 3.5% with the number of claimants falling 0.6% over the month to 105,800, its lowest level since April 2019.[9,10]



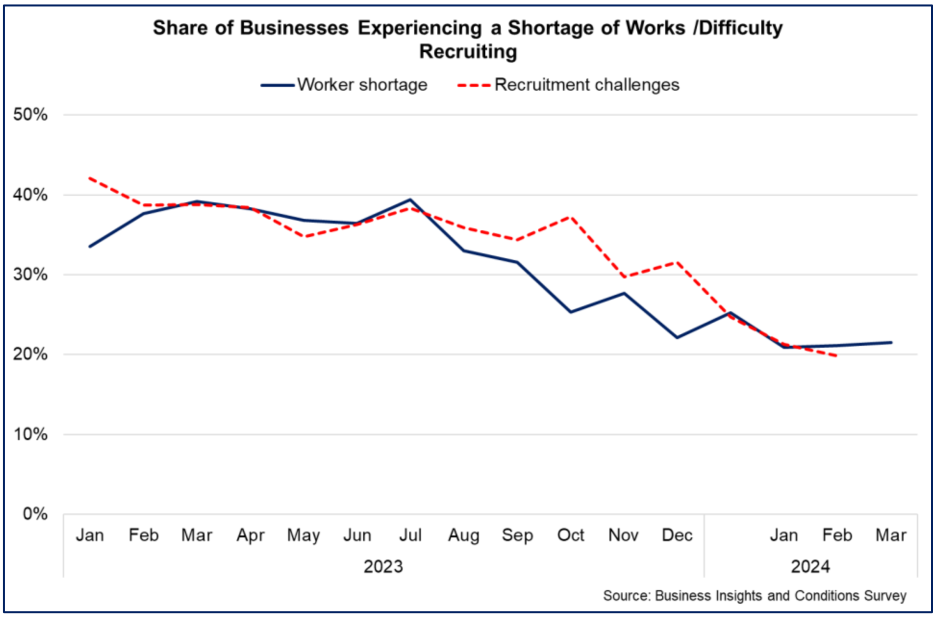
Recruitment Activity

- The softening in labour market conditions over the past year has been accompanied by a slight cooling in the extent of labour market tightness in recent months. The RBS Report on Jobs indicated a sharpening fall in permanent staff placements in February (41.1) as business demand for permanent staff fell for a seventh consecutive month (42.5).[11]

[9] Earnings and employment from Pay As You Earn Real Time Information, seasonally adjusted - Office for National Statistics (ons.gov.uk)
[10] Nomis - Official Census and Labour Market Statistics (nomisweb.co.uk)
[11] Royal Bank of Scotland Report on Jobs – February 2024 | NatWest Group



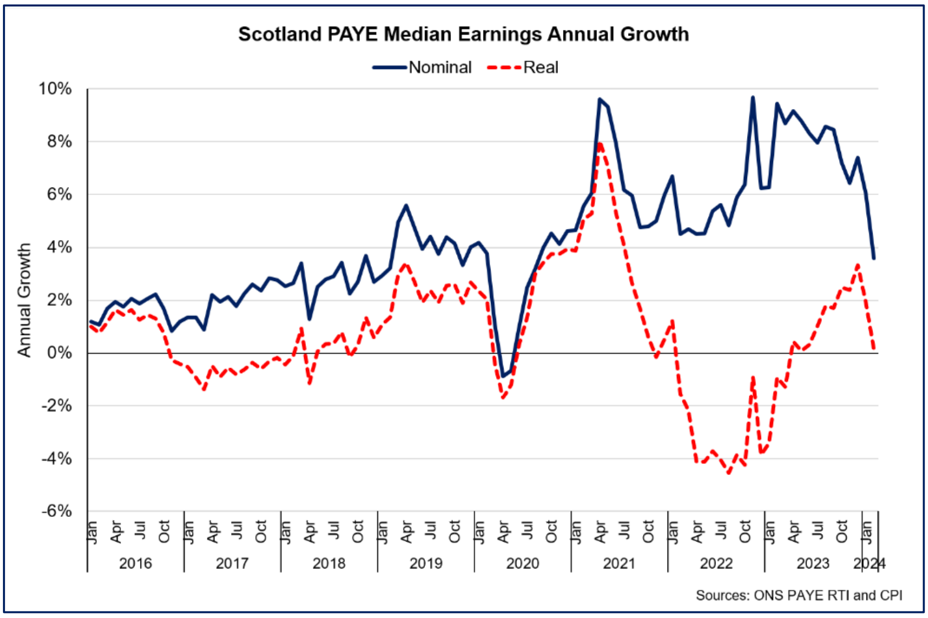
- The survey also indicates that while there has been a slight easing in labour market tightness over the past year, there have been slightly sharper falls at the start of the year in permanent staff availability (supply) indicating that recruitment conditions remain challenging. Furthermore, the Scottish Chambers of Commerce Quarterly Economic Indicator for Q1 2024 indicated that labour market concerns have increased over the quarter with 47% of businesses reporting recruitment challenges (up from 40% in Q4 2023), with challenges particularly in the construction and manufacturing sectors.
- BICS data provides further insights on labour shortages and recruitment challenges. In March, 21.5% of businesses reported experiencing a shortage of workers, down from the average rate of 34% at the start of 2023, while 19.8% of businesses reported experiencing difficulties recruiting in February, down from 42.1% in January 2023.



- At a sector level, worker shortages in March were most reported in construction (35.1%), health and social work (26.7%) and professional, scientific, and technical activities (25.8%). Most recently at the start of February, 60% of businesses reported that worker shortages led to employees working increased hours, while 40% reported being unable to meet demands and 33% reported having to recruit temporary workers.
- Recruitment difficulties in February were most reported in construction (34.1%) and manufacturing (27%). Latest data from January show most businesses responded that a lack of qualified applicants (63.1%) alongside a low number of applications (49.1%) were reasons why they experienced difficulties in recruiting employees while 20.1% reported not being able to afford an attractive pay package for applicants.

Earnings

- Recruitment challenges, staff shortages and inflationary pressures generated upward pressure on earnings growth over the past 18-months, however the pace of growth has recently eased.
- The RBS Report on Jobs for February indicated that growth in starting salaries picked-up over the month (59.7), with respondents attributing this to a shortage of candidates with the necessary skills, however the overall pace of growth has significantly slowed compared to the start of 2023 and during 2022.
- More broadly, nominal median monthly PAYE pay in Scotland was £2,341 in February, down 0.6% over the month and up 3.6% over the year. This is below the average annual growth rate over the past eight years (4.2%), having slowed from higher rates of growth of around 9% in 2023 and is its lowest annual rate of growth since August 2020.[12]



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

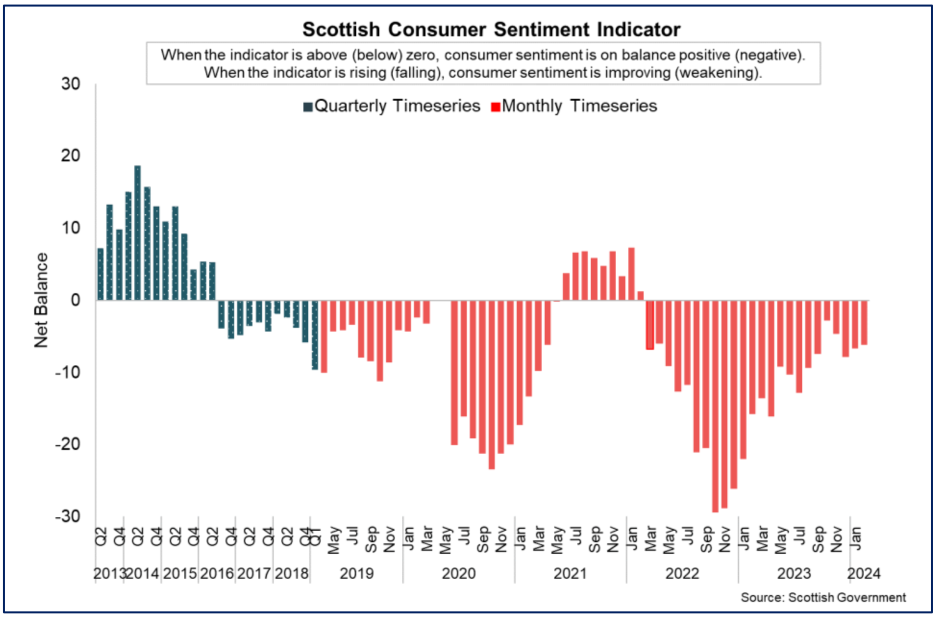
- Adjusting for inflation, which was 3.4% in February, real median earnings grew 0.1% on an annual basis. Whilst marginal, this was the eleventh consecutive month of positive annual growth following the period of falling real pay during 2022 and the start of 2023.

Consumer Activity

Consumer sentiment improved in January and February but remains negative overall.

Consumer Sentiment

- The Scottish Consumer Sentiment Indicator reflects how households think the economy is performing, how secure they feel about their household finances and how relaxed they feel about spending money.
- Consumer sentiment fell sharply during 2022 to -29.4 as inflationary pressures increased and the economic outlook weakened. However, sentiment strengthened significantly over 2023 as inflationary pressures reduced and latest data for February show sentiment increased by 0.5 points over the month and by 9.6 points over the year to -6.1.[13]



- While all the sentiment sub-indicators have strengthened over the past year, households continue to report on balance that the economy is performing less well than last year (-3.9) and their personal financial secuity is weaker (-14.3). Looking ahead to the coming year, households expect the economy to improve (9.6) however continue to expect their personal financial security to weaken (-0.6).
- This is reflected in the spend indicator which remains significantly negative (-21.5) and reflects that households remain cautious about spending money.

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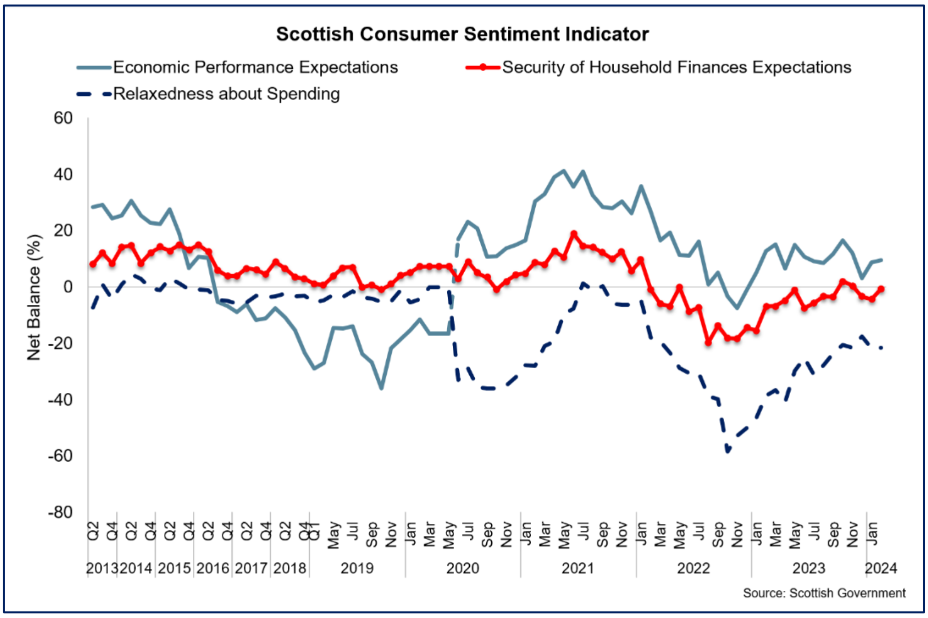
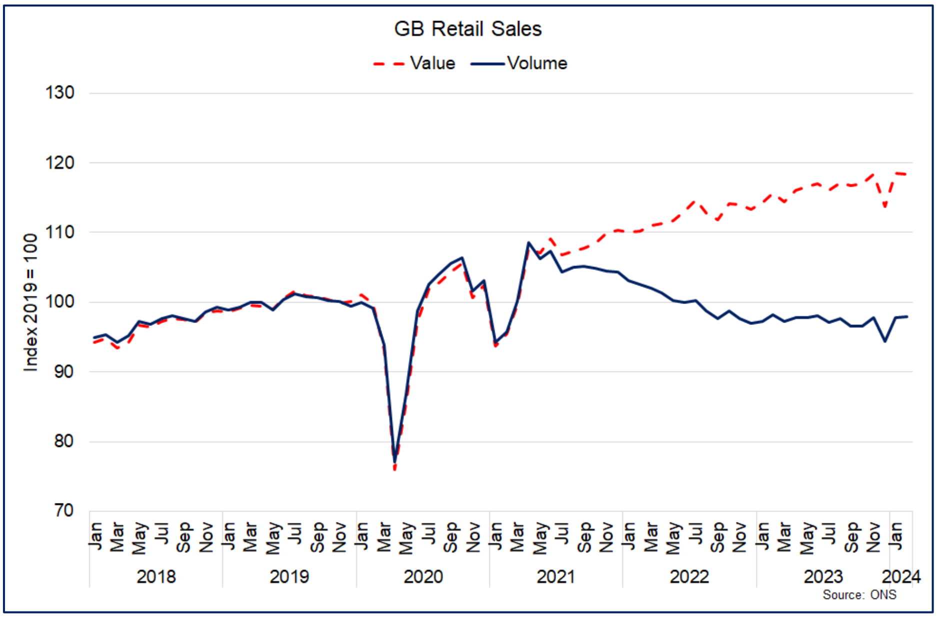
13 Economy statistics - gov.scot (www.gov.scot)



Cost of Living and Spending

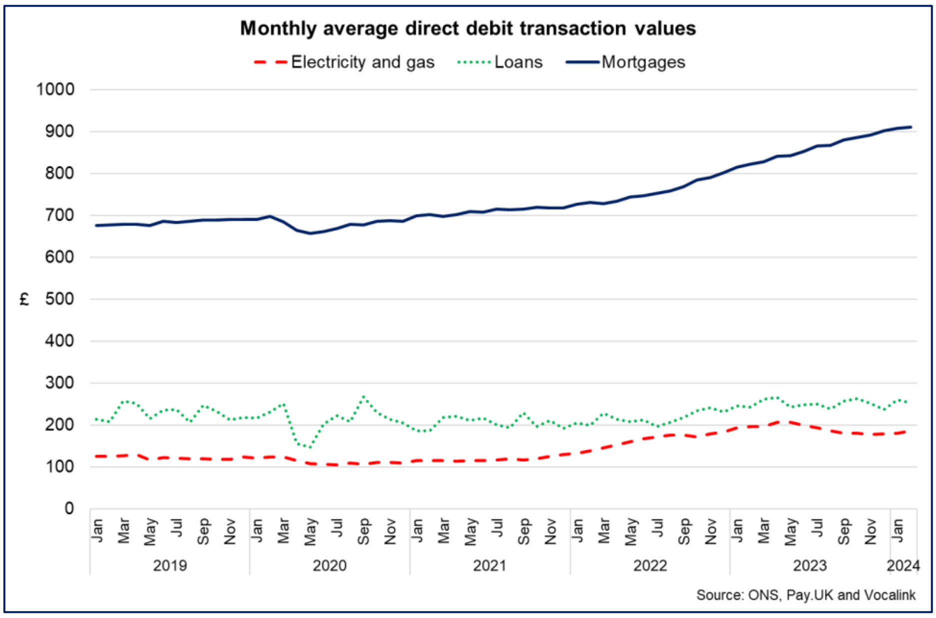
- The rate of inflation has reduced significantly over the past year, however the sharp rise in cost of living and higher interest rates continues to impact household decisions on spending (essential and non-essential), saving, and borrowing (including financing outstanding borrowing).
- For example, retail sales volumes in Great Britain have remained settled below their 2019 level over the past year and fell 0.3% over the year to February while sales value grew 2.3%; the divergence reflecting the pace of rising prices.[14]



- Similarly the change in prices and interest rates have had a significant impact on the amount UK conumers are paying for their energy costs, mortgages and other loans. In February the

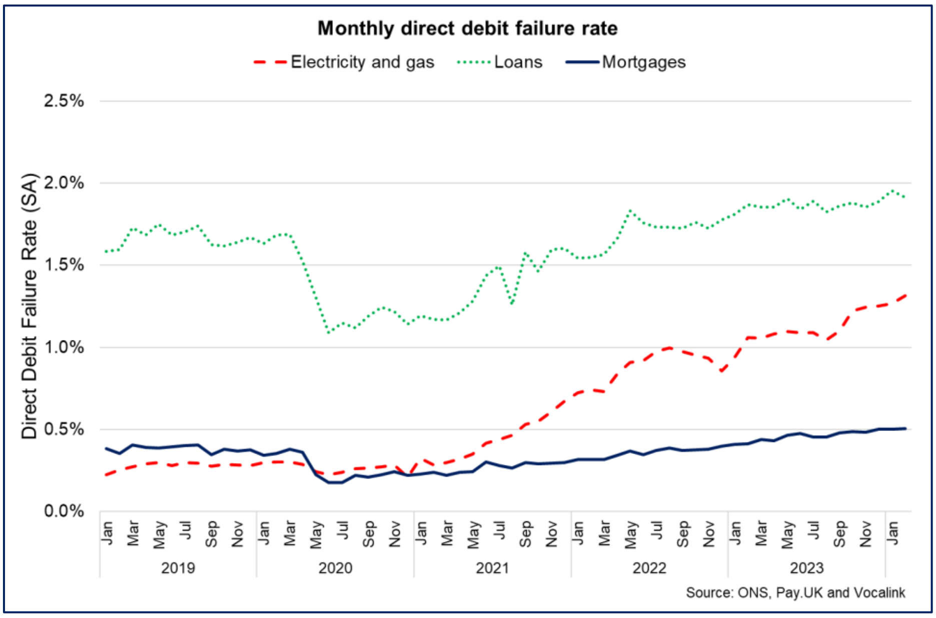
[14] Retail sales, Great Britain - Office for National Statistics (ons.gov.uk)

average monthly direct debit payment for electricity and gas was £186.48, down 5.1% compared to February 2023 however was up 35% compared to February 2022. This in part reflects that the Energy Price Cap has fallen over the past year, however remains significantly higher compared to two years ago.[15]



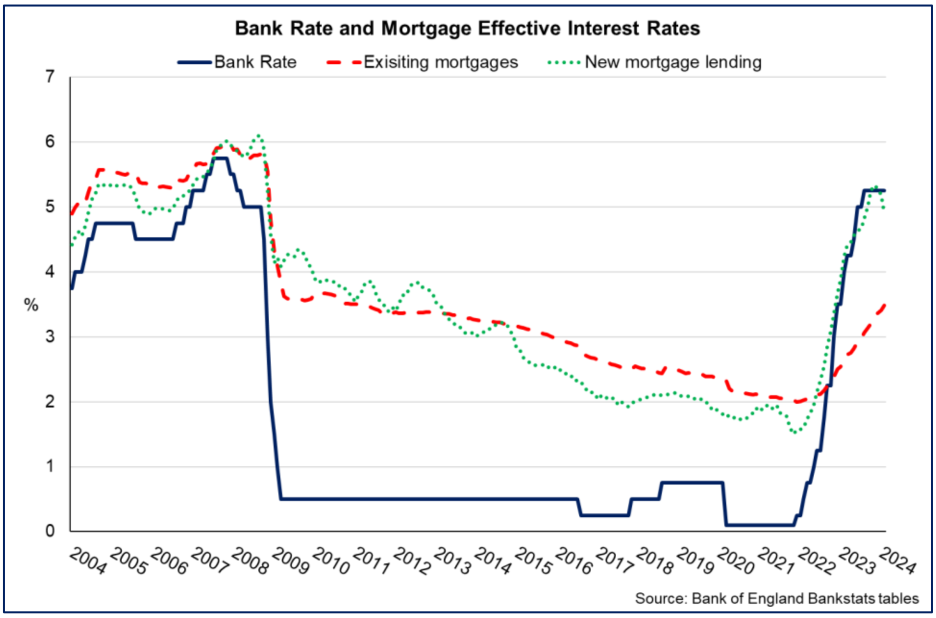
- However, the average monthly direct debit payment for mortgages was £910.76 in February (up 10.8% over the year and 24.5% since the start of 2022) and £253.51 for loans (up 4.3% over the year and 26.7% since 2022). This in part reflects that higher interest rates are continuing to progressively feed through to higher borrowing costs.
- The sharp increase in prices has been accompanied by an increase in the direct debit failure rate (the percentage of transactions that fail due to insufficient funds), reflecting the challenges facing some household budgets. For electricity and gas payments, the payment failure rate has risen to 1.31% (up from 1.06% in February 2023), while for mortgages it has risen to 0.51% (up from 0.41% in February 2023).

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

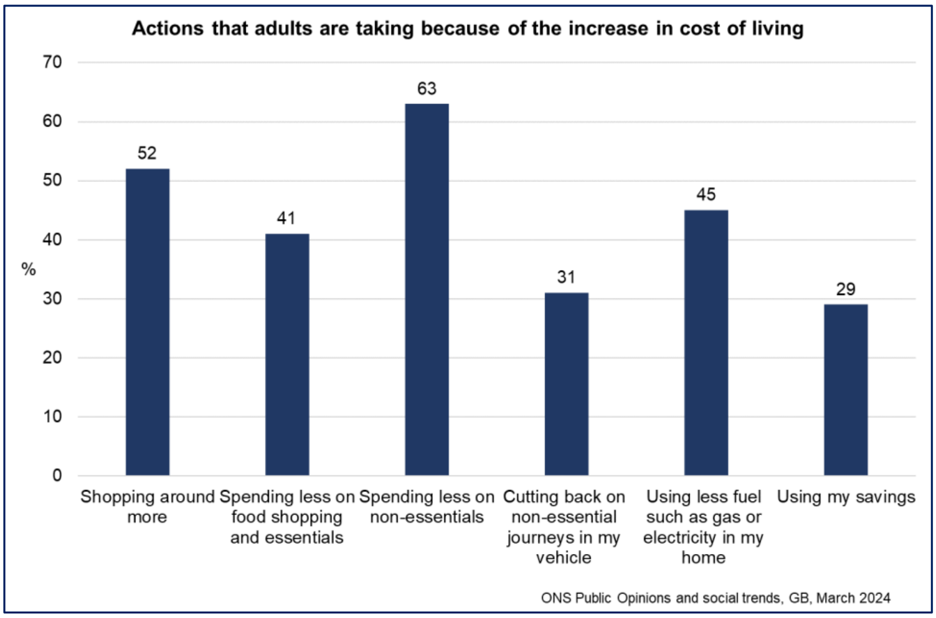


- More broadly in March, the ONS Public Opinions and Social Trends survey showed that 36% of respondents were finding it very or somewhat difficult affording energy bill payments and 35% for mortgage and rent payments. For energy bills, this was slightly lower than at the same point in 2023 (49%), however is broadly the same for mortgage and rent payments.[16]
- The more gradual and persistent impacts of higher interest rates on mortgage payment challenges compared to energy payments reflects the sharp rise in the Bank Rate between the end of 2021 and middle of 2023 and the time it takes for the full impact of the increases to be felt at an aggregate level due to the high share of mortgages that are on a fixed rate.
- Reflecting this, the 'effective' interest rate – the actual interest paid – on newly drawn mortgages remains elevated but fell for a third consecutive month in February to 4.9%, in part reflecting increased market expectations that interest rates may reduce in 2024. Rates on the outstanding stock of mortgages however continued to rise to 3.48%.[17]

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



- In response to the change in cost pressures facing households, ONS Public Opinions and Social Trends survey data from March show that the most common actions people are taking in response to the increased cost of living were spending less on non-essentials (63%) and shopping around more (52%). 45% reported using less fuel such as gas or electricity in their home and 41% reported spending less on food shopping and essentials.



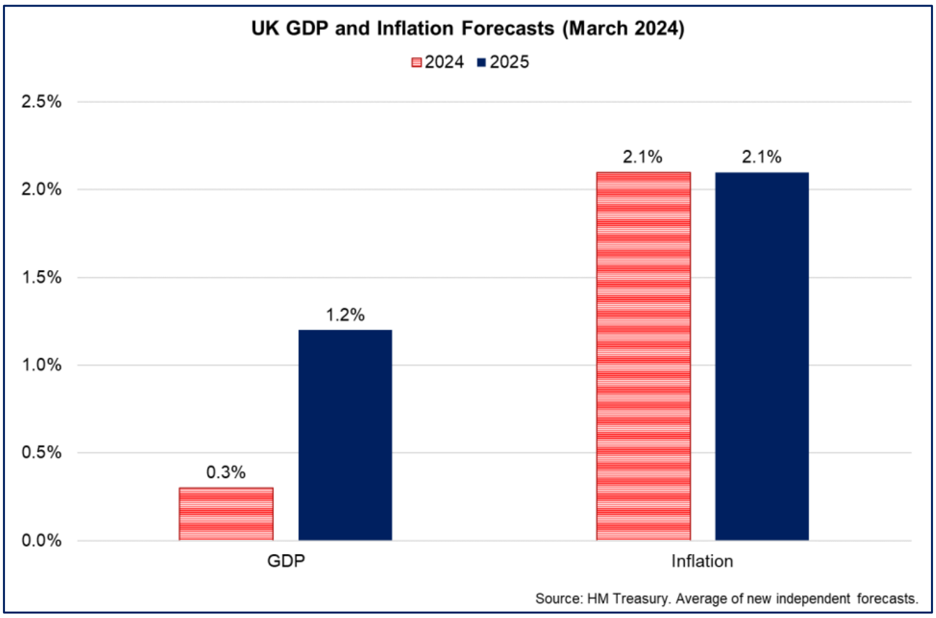
Economic Outlook

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

- The outlook for economic growth in 2024 remains relatively subdued however is expected to strengthen while inflationary pressures are forecast to moderate further.
- In December, the Scottish Fiscal Commission forecast Scotland's economic growth to strengthen from 0.1% in 2023 to 0.7% in 2024, rising to 1.1% in 2025. Most recently in March, the Fraser of

Allander Institute forecast a similar pattern of strengthening growth of 0.6% in 2024, rising to 1.1% in 2025. At a UK level, in March the Office for Budget Responsibility forecast UK growth to strengthen to 0.8% in 2024 rising to 1.9% in 2025.[18,19,20]

- The HMT March average of new independent UK forecasts further illustrates the expectation of stronger growth and falling inflation with UK GDP growth forecast on average to rise to 0.3% in 2024 and 1.2% in 2025, while inflation is forecast to fall on average to 2.1% in Q4 2024 and remain at 2.1% at the end of 2025.[21]



- In March, the Bank of England projected inflation to fall temporarily below the 2% target in the second quarter of 2024 before rising slightly back above target during the second half of the year.[22] This reflects a combination of factors including base effects which continue to work through the annual data while the 12.3% decrease in the Energy Price Cap (-32.4% annually) will also impact.

- The Bank of England maintained the Bank Rate at 5.25% in March, however the projected fall in inflation this year has raised expectations that the Bank Rate will be reduced during the year. This, alongside the recent improvements in growth, business activity and consumer sentiment and resilience in the labour market underpin the stronger growth outlook for the year ahead. Downside risks to the economic outlook remain, notably from developments in the Middle East including disruption to shipping through the Red Sea.

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18 Scotland's Economic and Fiscal Forecasts – December 2023 – Scottish Fiscal Commission
19 FAI Economic Commentary | FAI (fraserofallander.org)
20 EFOs - Office for Budget Responsibility (obr.uk)
21 Forecasts for the UK economy - GOV.UK (www.gov.uk)
22 Bank rate maintained at 5.25% - March 2024 | Bank of England

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