Economic Commentary

February 2023

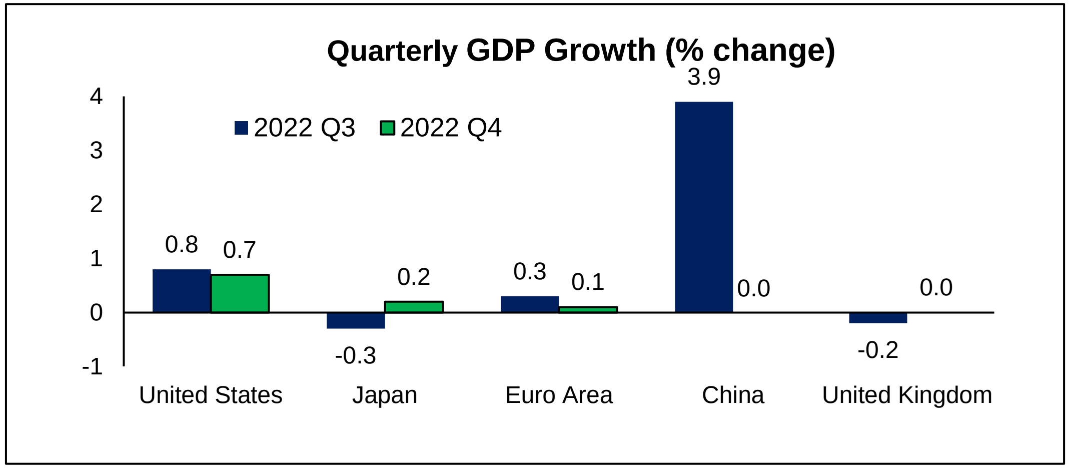
Insights & Economics

Scottish Enterprise

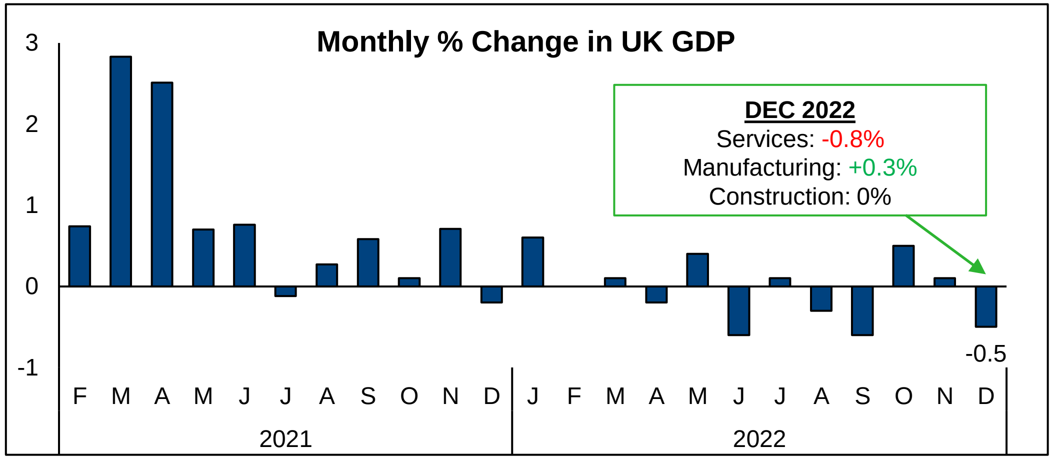
- Over the last quarter of 2022, **economic growth slowed** across the world's largest economies as high inflation, the war in Ukraine and Covid outbreaks in China dampened activity. More recent business surveys reported **output rising** in China, Japan and the eurozone in January, but **falling in the US and UK**.
- The IMF is forecasting global growth to ease to +2.9% in 2023, before picking up marginally to +3.1% in 2024. The **UK is expected to be the only major economy to shrink in 2023** (-0.6%) as higher interest rates and inflation reduce household real incomes.
- UK business activity **declined in all UK nations and regions except London** in January as high inflation and tightening financial conditions dampened demand for goods and services.
- The Bank of England increased **interest rates to 4%** in February to help combat high, although easing, inflation (+10.1% in January). The Bank expects inflation to fall sharply to around 4% towards the end of the year.
- **Scotland's onshore GDP is estimated to have fallen by -0.1% in November**, after growing +0.7% in October. Output in the services sector, which accounts for around three quarters of the economy, recorded **zero growth**.
- **Unemployment** in Scotland remains low (3.3% over the last quarter of 2022). **Rising wages** (+5.5% over the year to January) are, however, failing to keep pace with inflation.
- Scotland's **employment rate** was 76.6% in December**,** and is now 1.2 percentage above the immediate pre-pandemic rate. While high employment is a positive, it is creating worker shortages for some sectors.
- Businesses continue to report widespread **inflationary pressures and recruitment difficulties;** this is impacting the ability of some to meet demand as well as affecting profits and the ability to take forward growth plans.
- The **Scottish Fiscal Commission** is forecasting that the **Scottish economy will contract by 1.2% in 2023** and will not recover to its pre-recession peak until the **first quarter of 2025.** Similarly, the **Fraser of Allander Institute is** expecting a contraction of -1%. Both forecasters point to inflation reducing real disposable incomes and consumer spending as the main drag on the economy.

Global/UK

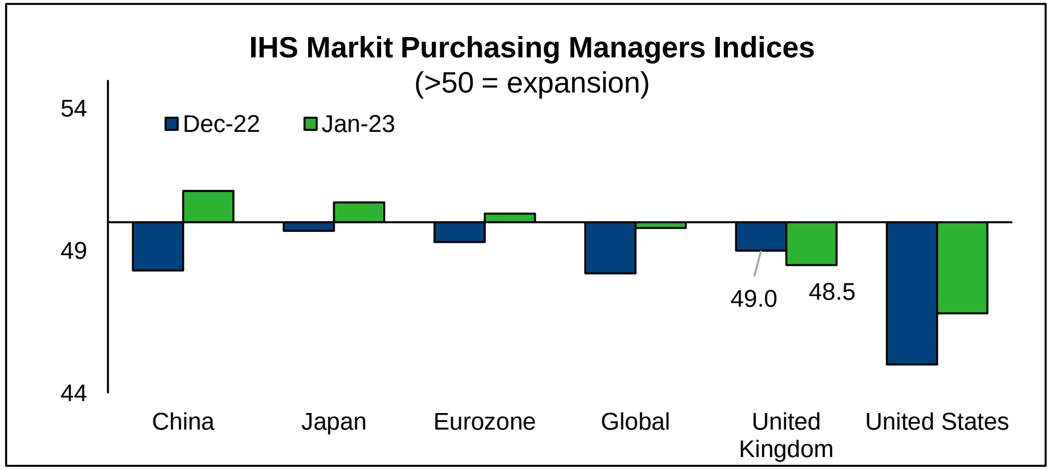
The euro area and Japan recorded relatively weak economic growth over the final quarter of 2022, and output in the UK and China flatlined (the latter due to Covid lockdowns). Only the US posted a respectable performance.



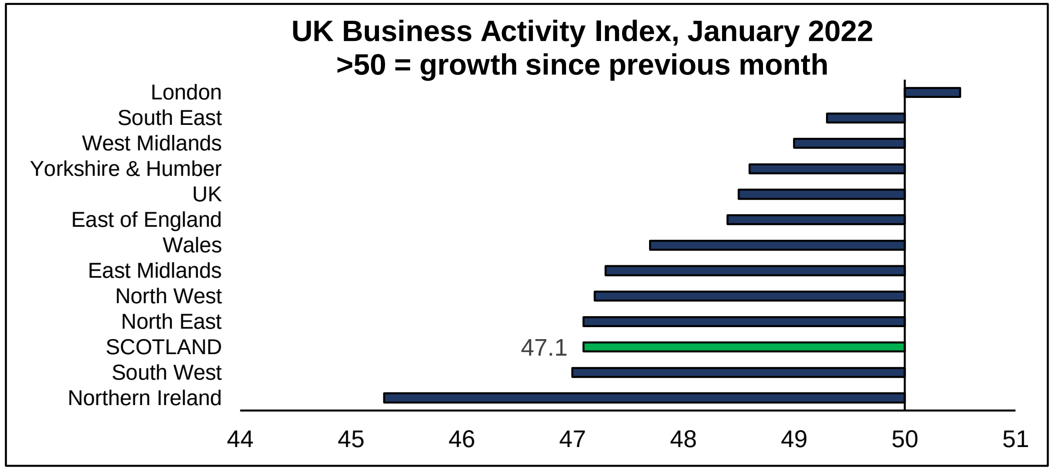
UK GDP is estimated to have fallen by 0.5% in December 2022. Although manufacturing output grew, the service sector contracted (particularly consumer-facing services) and construction flatlined.



More recent business surveys indicated private sector output returned to growth in China, Japan and the eurozone in January. However, activity continued to fall in the UK (for the sixth consecutive month - the longest period of continuous decline since the 2008/09 global financial crisis) and the in US.

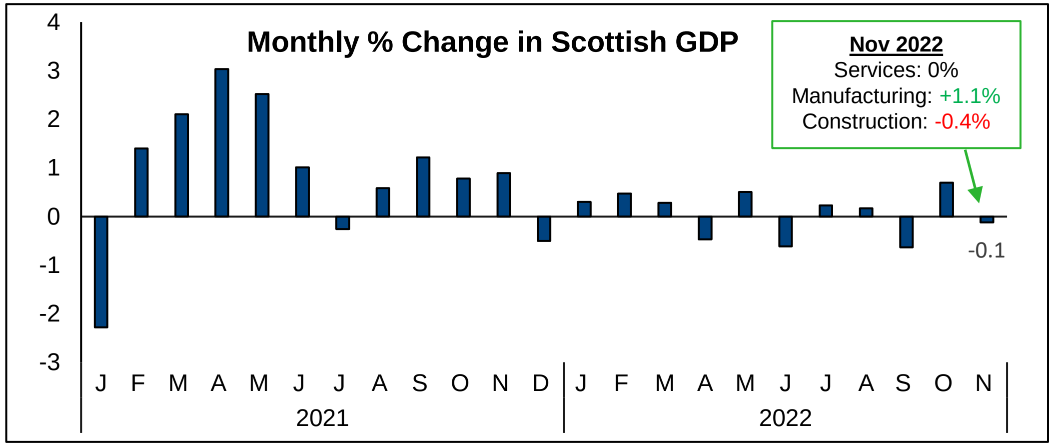


Nearly all UK regions and nations saw business activity contract over January as high inflation continued to weaken demand for goods and services. Only businesses in London posted growth.

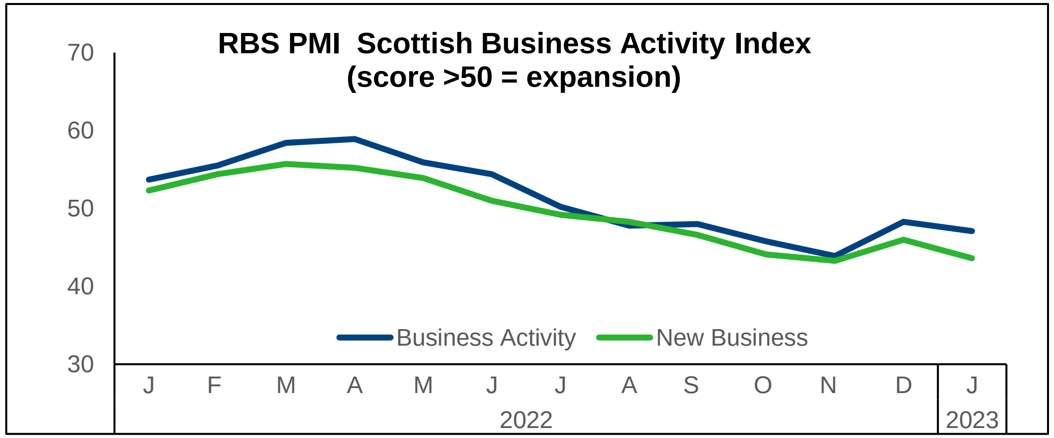


Scotland

Scotland's onshore GDP is estimated to have fallen by 0.1% in November, after growing 0.7% in October. Of the main sectors, only manufacturing output grew.



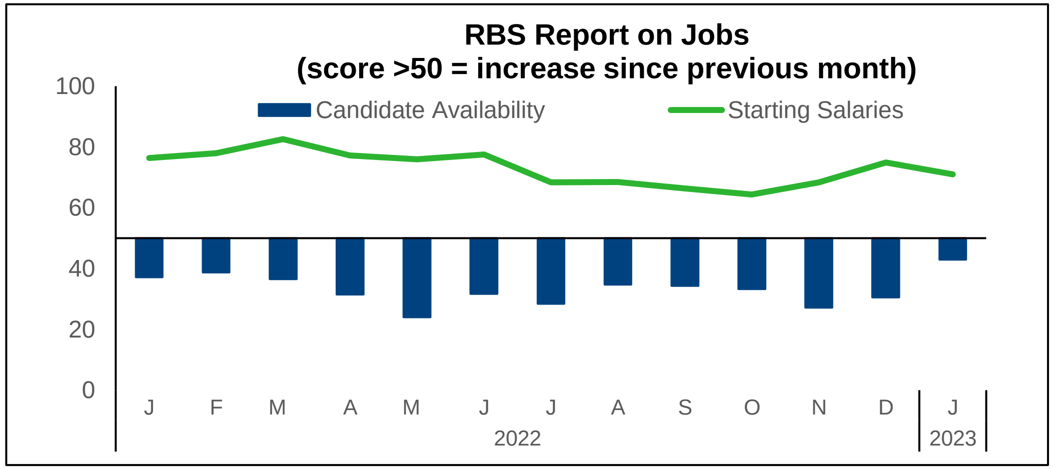
Business activity in January declined for the sixth consecutive month, and at a quickened pace. High inflation, supply chain disruptions and a slowdown in the housing market were all highlighted as factors. For the second month running, workforce numbers contracted.



In the labour market, unemployment among 16–64 year-olds remains low. The employment rate has increased by 1.3pp over the quarter (+37,000 people), and by 1.2pp since the immediate pre-pandemic levels. Economic inactivity declined.

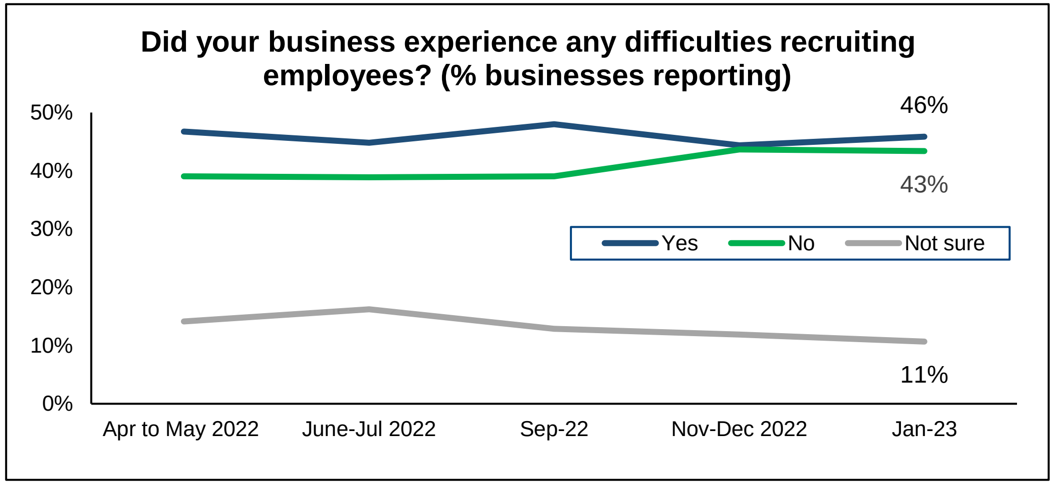
	RATE (Oct – Dec 2022)	ANNUAL CHANGE
EMPLOYMENT	76.6%	+2.4%pts
UNEMPLOYMENT	3.3%	-0.8%pts
ECONOMIC INACTIVITY	20.8%	-1.8%pts

Staff availability fell in January (for the 24th month in a row), reflecting the tight labour market. Candidate shortages continue to drive rises in starting salaries.

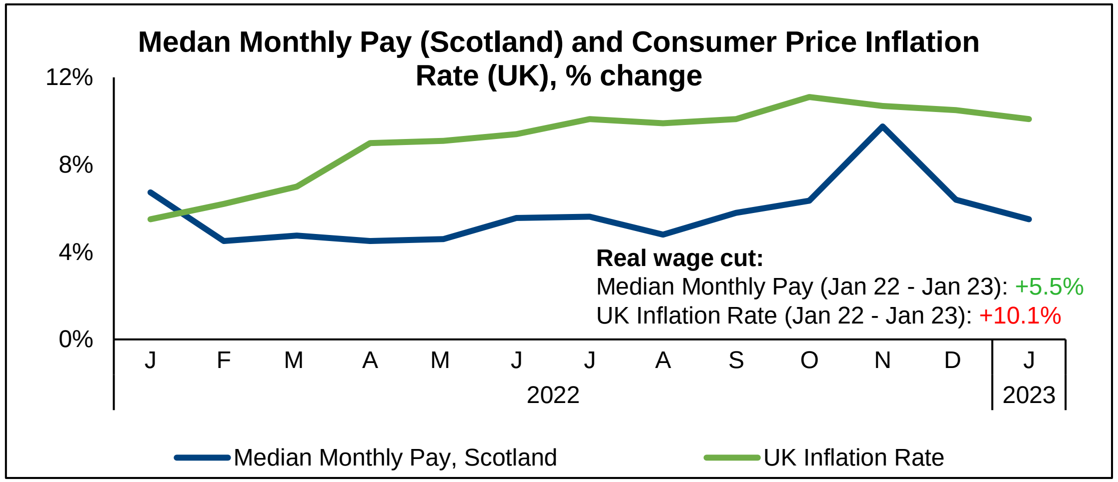


Scotland

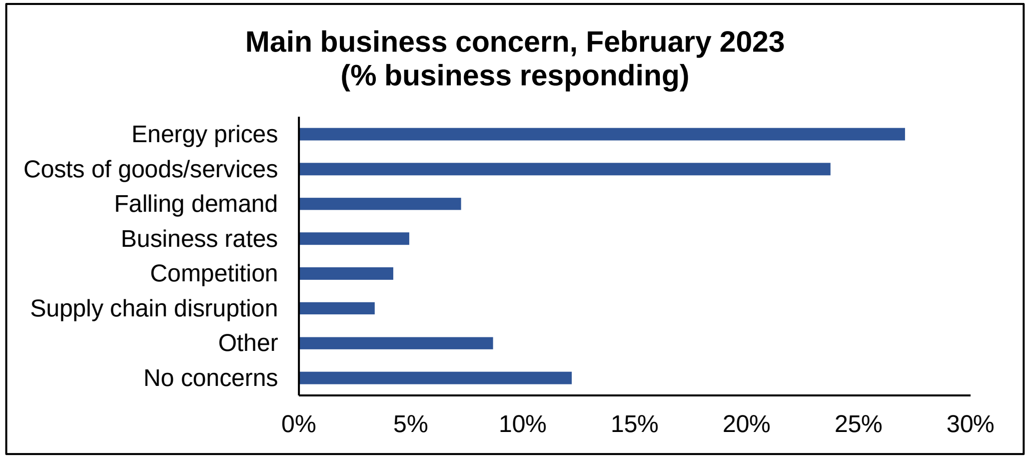
Due to the lack of candidates, in terms of both numbers and people with suitable qualifications, almost half of Scottish businesses are reporting recruitment problems, especially for skilled or semi-skilled employees.



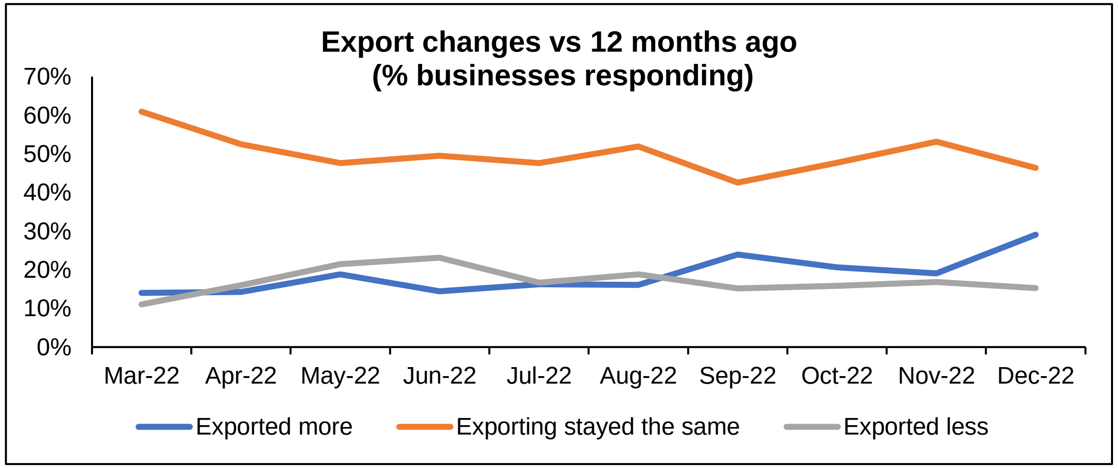
Although nominal wages are rising, high inflation (10.1% in January) means most Scottish workers continue to experience falling real wages. The Bank of England increased interest rates to 4% in February to help combat rising prices, and expects inflation to fall sharply to around 4% towards the end of the year.



Beyond staff shortages, energy prices and inflation continue to be the other main business challenges. Producer input prices rose by 14.1% in the year to January and he majority of businesses have had to absorb some or all cost increases, which will impact on profitability.



Around 20% of Scottish businesses (with 10+ employees) are exporting, and generally an increasing proportion are reporting that overseas sales have grown over the year. This is despite 60% reporting exporting challenges and costs have risen.



Feedback from Scottish Enterprise Customers

Key themes

- Challenges of **attracting and retaining staff** continue, mainly due to a lack of suitable applicants and staff leaving for higher wages elsewhere.
- Businesses are still considering **growth,** but plans are being **pushed back** primarily due to lack of staff.
- **Higher prices** (energy and raw materials) are impacting profitability.

Workforce

- Businesses continue to report **skills and staff shortages**, including:
  - engineers and optics (lasers)
  - software, including artificial intelligence
  - commercial skills - not just sales skills, also marketing, networking with customers, and getting products to market.
- **Staff retention** also remains an issue in many sectors as workers are being offered better conditions, wages and flexibility by other employers.
- As a result, many businesses are **raising salaries** and offering **enhanced benefit packages** to attract and retain staff.
- Some businesses, especially start-ups, say it is difficult to get new **board members with the right skills and experience** to help their growth aspirations.
- Due to shortages of **experienced staff**, a number of businesses are trying to attract **retired ex-employees** to return – often on a part-time basis or as a mentor to new/younger staff.
- Some businesses do not have the necessary skills to produce net zero/ESG action plans and are **employing consultants** to do this. Often, having an action plan in place is **a condition of getting funding** from both public sector and private sources..
- Some businesses are asking staff that can work from home to come into the office around two days a week as they feel that **productivity has declined**, and **staff interaction is suffering**.
- Businesses are increasingly **investing in automation** to address labour shortages and to reduce costs. However, there is a lack of qualified staff to operate automated systems.
- Some **oil & gas** workers have retrained and developed skills for the **renewables sector**. However, in some cases there are not enough renewable sector jobs and they have returned to oil & gas which is currently booming.

Workplace

- There is a **shortage** of **energy efficient industrial warehouses and units**. Large units are generally poorly insulated, and in many cases, energy efficiency measures are not possible (e.g. heat pumps require a minimum temperature to function).
- Some businesses in **leased buildings** report they cannot easily make **energy efficiency investments** as they need landlord approval.

Energy prices

- Business are still reporting that the gas and electricity energy supply market is **complex**.
- Those coming out of **fixed contracts** continue to experience very high renewal terms.
- However, as energy prices continue to fall **large users** in some cases are able to benefit from lower than expected costs as they are more likely to be buying through various mechanisms (e.g. hedging or using brokers).

Supply chain

- Due to issues with international supply chains (e.g. longer lead times and higher supply costs caused by Brexit, Covid, etc) some businesses are looking at **UK-based suppliers**, particularly the manufacturing sector.

Exporting

- Many exporters businesses are still selling to the EU but remain frustrated by **increased costs**, **complexity**, **additional administration** and **increased time** to get goods to market following Brexit. As a result, some are looking at other markets e.g. North America and Asia.
- Businesses are reporting European customers are becoming more **reluctant to buy** from any UK-based suppliers.

Deposit Return Scheme

- Businesses **continue to raise concerns** about the proposed **Deposit Return Scheme,** in particular the implementation costs and the operational challenges caused by this being implemented within the UK only in Scotland.
- Businesses are saying that as the details of the scheme are **not yet finalised,** they are **not able to be ready for implementation** in August 2023.

Economic Outlook

Global Forecasts

The IMF is forecasting **global growth to fall** from 3.4% in 2022 to 2.9% in 2023, then rise to 3.1% in 2024. Lower growth **reflects the rise in central banks interest rates to fight inflation, as well as the war in Ukraine.**

The **UK is expected to be the only major economy to shrink in 2023** (-0.6%) reflecting tighter fiscal and monetary policies and financial conditions and still-high energy retail prices weighing on household budgets. The US has notably low growth with growth projected to fall from 2.0 percent in 2022 to 1.4 percent in 2023 and 1.0 percent in 2024 due to the steeper path of Federal Reserve rate hikes

Average global inflation is expected to fall from 8.8% in 2022 to 6.6% in 2023 and 4.3% in 2024. However, this would still be above pre-pandemic (2017–19) levels of about 3.5%.

Scottish Forecasts

The Scottish Fiscal Commission expects the **Scottish economy to contract** by 1.2% in 2023, before returning to growth in 2024 and its pre-recession peak by the first quarter of 2025, one quarter behind the UK. **Employment is forecast to fall** by around 20,000 over 2023 and 2024.

The SFC highlights **significant uncertainty** around the economic outlook, due to the path of energy prices and inflation, and how **high inflation affects wages**: Although so far, pay awards have remained below inflation, resulting in falling real earnings, the SFC notes that with unemployment relatively low, it is possible that workers can bargain for better pay awards, affecting both the real terms earnings outlook and potentially inflation.

The Fraser of Allander Institute **forecast an economic contraction of -1.0% in 2023**, before returning to growth in 2024 of 0.6%. They expect **output to decline for three consecutive quarters in 2023** with growth returning in in Q4.