State of the Economy

Office of the Chief Economic Adviser

November 2021

Scottish Government
Riaghaltas na h-Alba
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19 November 2021

Data up to 18 November 2021

Overview

This edition of the State of the Economy provides an overview of economic activity in Scotland during the third quarter of 2021, at a new point of the pandemic in which restrictions on economic activity have largely been lifted and intensifying global supply chain and inflationary headwinds have emerged as key features of this stage of the recovery. This is at the same time as fiscal support has begun to be withdrawn, with the end of the furlough scheme and the temporary changes to VAT and Universal Credit.

Scotland's GDP continued to edge back towards its pre-pandemic level in August and is now 1.3% below, having fallen over 20% at the start of the pandemic. The pace of growth has generally slowed over July and August reflecting that the boost in output from restrictions easing on consumer facing services over the second quarter has moderated and supply chain disruption has been impacting on activity in construction and manufacturing in particular.

Labour market conditions are also continuing to improve with the number of payrolled employees rising back above pre-pandemic levels for the first time, having fallen almost 4% during 2020. However, uncertainty has increased slightly in recent months as labour shortages in some sectors continue to emerge while the end of the furlough scheme presents a key step change in the support being provided to employment and incomes. 80,000 jobs in Scotland were still on the furlough scheme when it ended in September and while it is too early to see impacts in the official unemployment figures, emerging survey data suggests many furloughed workers have returned to work which should contribute to economic scarring being lower than initially feared.

Trading conditions remain challenging for businesses at this stage of the pandemic as supply chain disruption and inflationary pressures on input costs have intensified and present new cashflow challenges for many businesses. Part of this reflects bottlenecks in supply chains and material shortages, while the sharp rise in energy costs and some upward pressure on wage costs are also impacting.

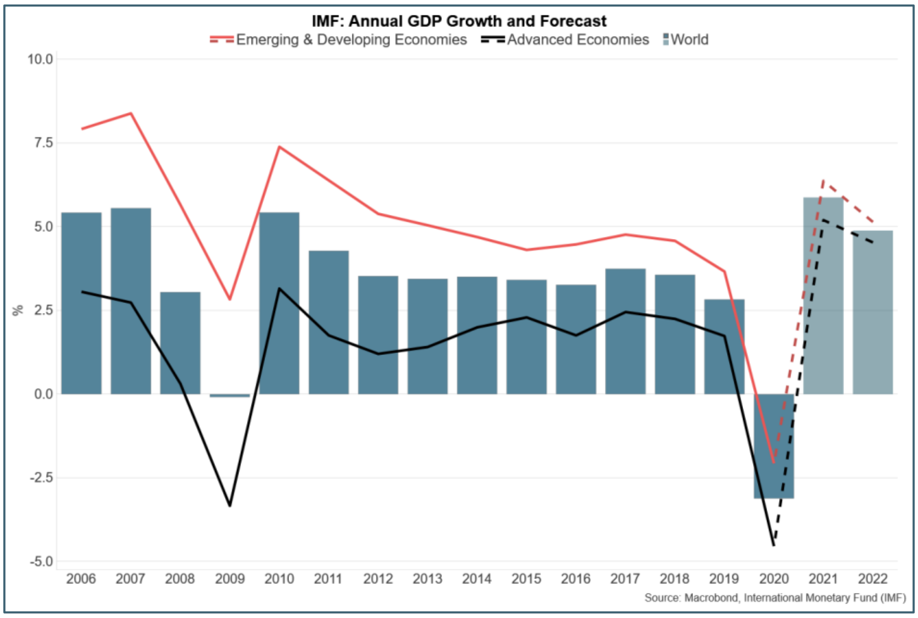
The latest data indicate that businesses are partly absorbing some of the higher costs, however costs are also passing through to consumers and could see inflation rise towards 5% in the coming months. This is largely expected to be temporary as the economy continues to rebalance, however will create new pressures on households budget and spending power.

Looking ahead, levels of business and consumer sentiment remain positive and have significantly improved on last year, however have softened slightly recently as new challenges have emerged. Current forecasts expect Scotland's GDP to return to pre-pandemic levels in the first half of 2022.

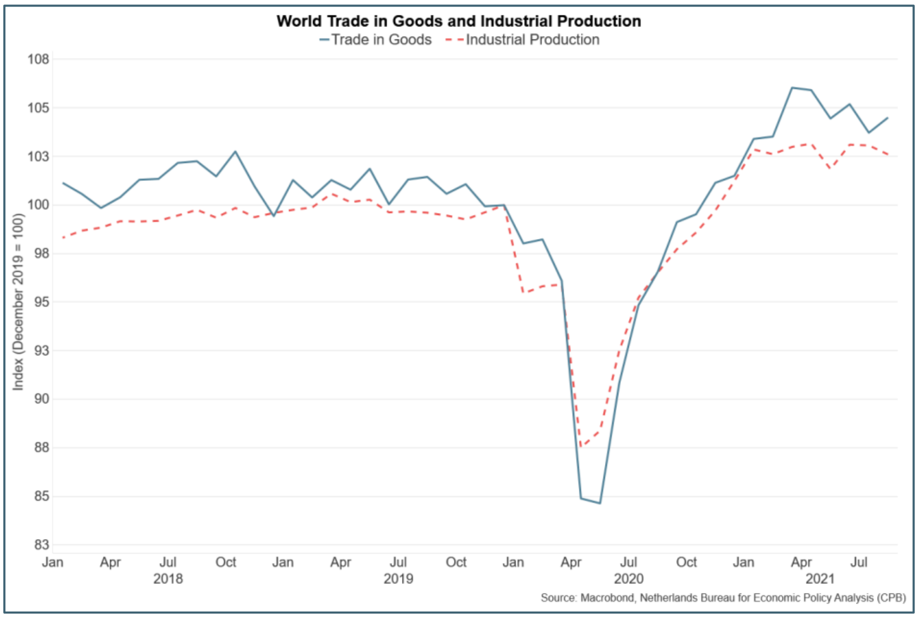
Global Economic Context

The global economy is recovering however supply chain disruption is impacting global trade and inflation.

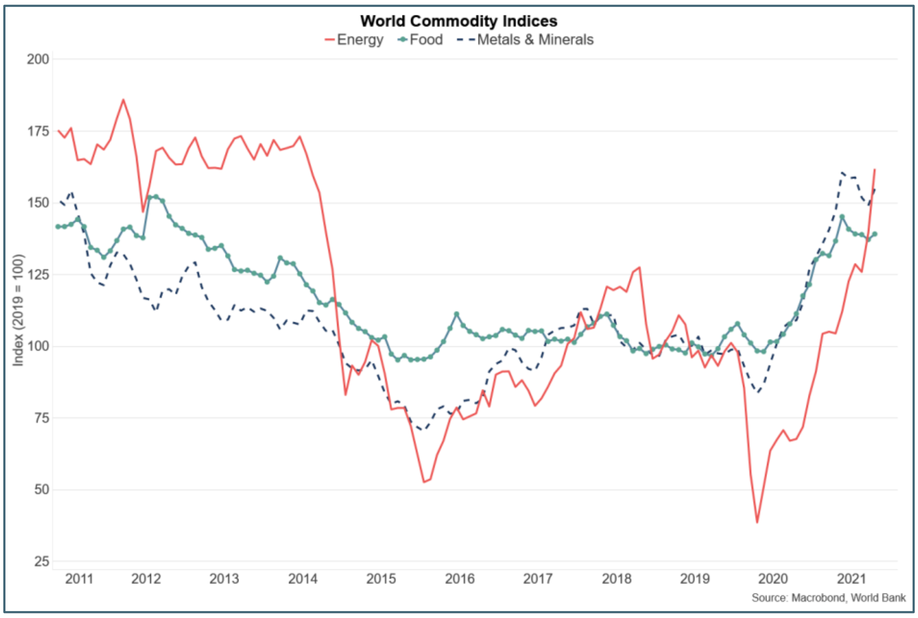
The pandemic has had an unprecedented impact on the global economy. 2020 saw global output fall 3.1%, with a synchronised fall in output across advanced and emerging and developing economies as restrictions were introduced to slow the spread of Covid-19.



The global economy is recovering from the initial impacts on output in 2020, with latest data indicating that industrial production and world trade in goods is back above pre-pandemic levels. However, the nature of the impact and pace of recovery has varied significantly across countries, partly reflecting differences in the timing and nature of restrictions, the relative success of vaccination programmes, the scale of fiscal support, alongside the ongoing spread of different variants of the coronavirus.

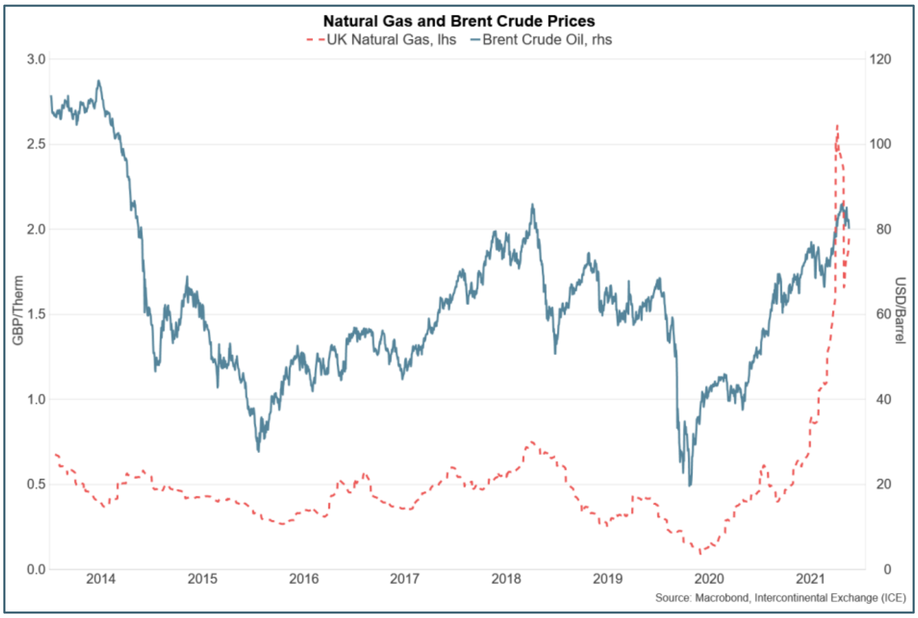


Global demand and output have recovered strongly as restrictions on activity have eased, however the supply side of the economy is re-adjusting more slowly, leading to significant bottlenecks and disruption in global supply chains and a rise in inflationary pressures.



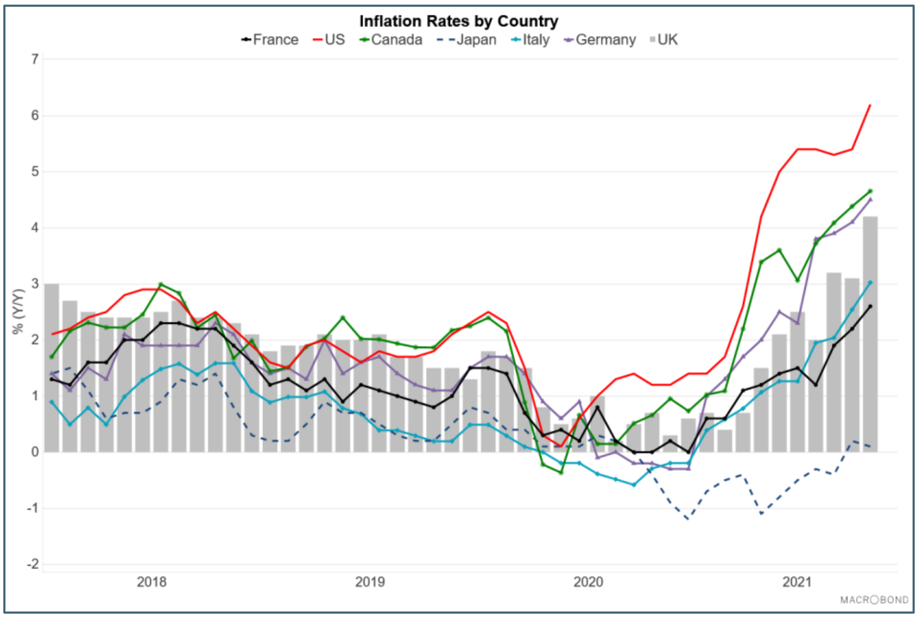
Commodity prices covering energy, food and metals have all risen over the past 12 months and have risen to their highest levels in almost a decade. Compared to pre-pandemic levels at the end of 2019, global food commodities are up 31%, metals 57%, while energy is up 60% having fallen sharply in 2020 at the start of the pandemic.

The rise in the energy index has been particularly driven by a rise in natural gas prices which had risen by over 500% on an annual basis, before partly falling back into November, while the Brent Crude oil price has broadly doubled over the past year to over $80 per barrel.



Strong global demand and supply chain disruption has also been reflected in a sharp rise in global freight costs as capacity across supply chains has continued to re-adjust to the strong rebound in demand (see Box B) while temporary restrictions and closures across countries continue to further impact the recovery.

Imbalances in global supply chains and the associated increase in costs, alongside domestic recovery in demand has fed into a rise in inflationary pressures across countries in 2021 with inflation in many countries rising to their highest rates since the financial crisis.



Much of the global supply chain and inflationary challenges are expected to be temporary as the economy rebalances from the sharp impacts on economic activity during the pandemic to date, however, central banks have revised up their medium-term outlook for inflation, and price pressures are expected to persist for most of 2022.

Although global output is back above pre-pandemic levels,[1] the pace of global recovery slowed over the third quarter, reflecting the impacts on activity of supply chain challenges and further indicating that the short run outlook for 2022 remains challenging. The IMF forecast global GDP to grow 5.9% in 2021, slowing to 4.9% in 2022.[2]

Scottish Output

Scotland's GDP is continuing to recover back towards its pre-pandemic level, however the pace of growth has slowed during the third quarter of 2021.

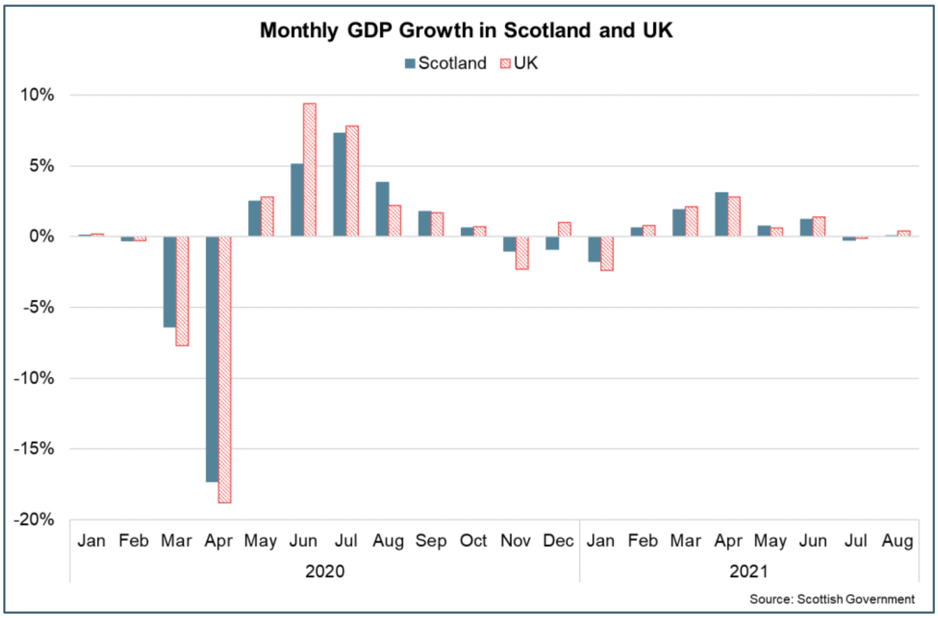
The Scottish economy is continuing to recover from the significant impact on output that necessary restrictions on activity have had since the start of the pandemic. The latest GDP data for August reflects a period in which Scotland moved beyond level zero enabling the

[1] OECD Economic Outlook
[2] World Economic Outlook, October 2021 (imf.org)

removal of most remaining restrictions on consumer facing sectors (with some protective measures remaining place).

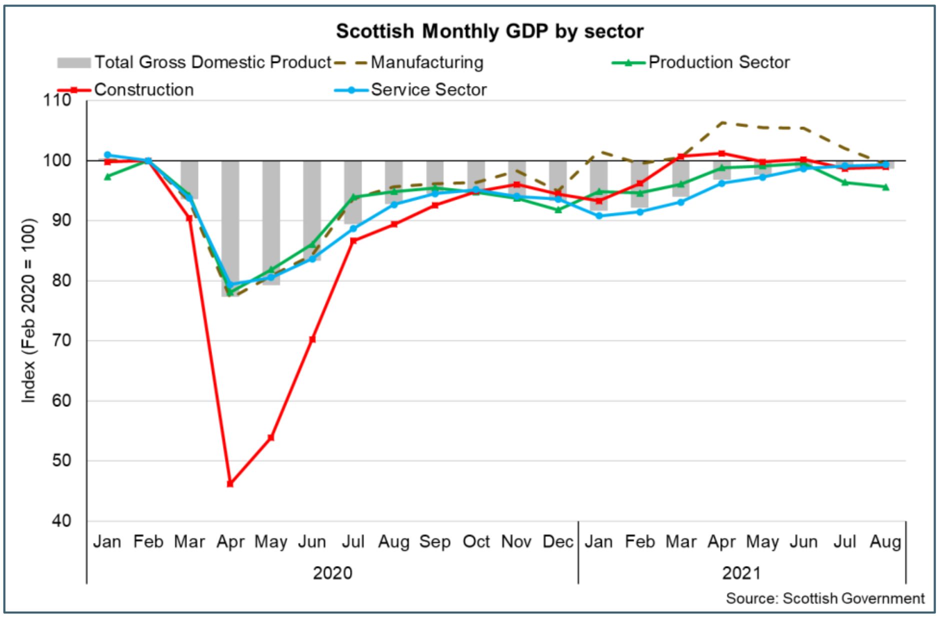
While the pandemic is not yet over, this stage of the recovery marks a period for the first time since the start of the pandemic that the economy is adjusting to an environment largely without restrictions in place, although it continues to be influenced by legacy effects of past restrictions and imbalances in demand and supply which have emerged. At the same time, UK Government fiscal support has gradually been withdrawn, with the end of the furlough scheme and the temporary changes to VAT and Universal Credit.

Scotland's GDP grew 0.1% in August and is now 1.3% below pre-pandemic levels having fallen to 22.6% below in April 2020 at the start of the pandemic.[3]



The recovery in output in recent months has partly been driven by the easing of restrictions on some consumer facing parts of the services sector, enabling a period of businesses reopening and rise in demand, while output in the manufacturing and construction sectors have faced intensifying challenges from supply chain disruption weighing on activity.

[3] GDP Monthly Estimate: August 2021 - gov.scot (www.gov.scot)



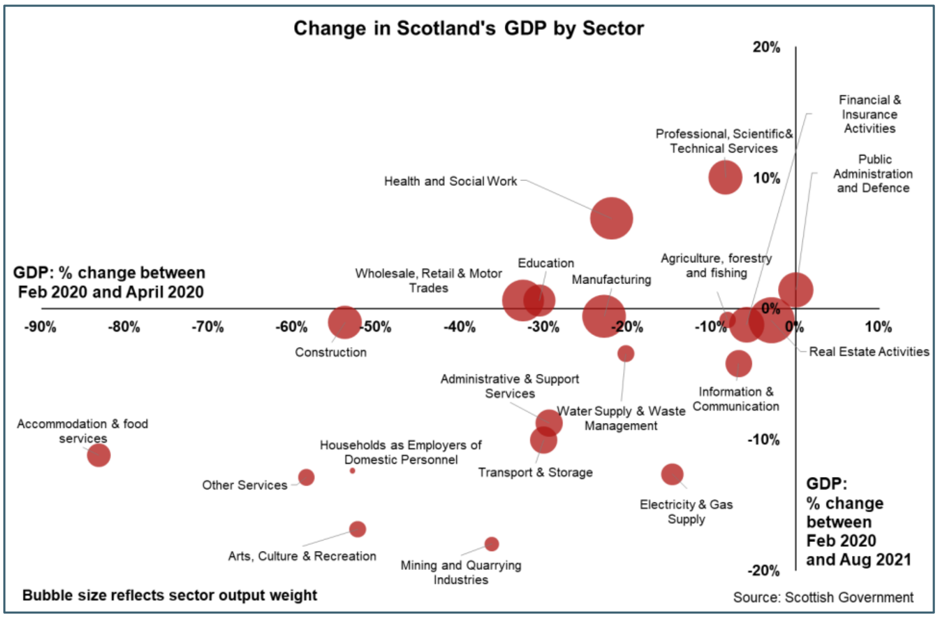
Services sector output grew 0.2% in August, its eighth consecutive month of growth and is 0.7% below its pre-pandemic level. There continued to be strong contributions to growth in August from accommodation and food services (8.7%) and arts, recreation and culture (6.7%) which continue to rebound from the easing of restrictions on their sectors over the spring and summer months.

Output across the production sector as a whole fell 0.8% in August, driven predominantly by a 2.6% fall in manufacturing output, its fourth consecutive month of falling output. Manufacturing output has now fallen back below it pre-pandemic level of output (-0.6%), having recovered to 6% above in April and in part reflects supply chain bottlenecks constraining economic activity in the sector.

There has been a similar pattern of activity in the construction sector in recent months which although it grew in August (0.2%), output has also fallen back below pre-pandemic levels (-1%) amid supply chain challenges in the sector.

Overall, in the three months to August, GDP grew 2.6%, down from 5.6% growth in the second quarter. This reflects that the most significant boost to consumer facing services from businesses reopening over the summer has eased and that supply chain disruptions have been affecting activity in the manufacturing and construction sectors.

Despite the robust levels of growth in recent months, consumer facing sectors such as accommodation and food (-11.2%) and arts culture and recreation (-16.8%) remain amongst sectors that are further below their pre-pandemic levels, reflecting the impacts of restrictions on the sectors over the course of the pandemic.

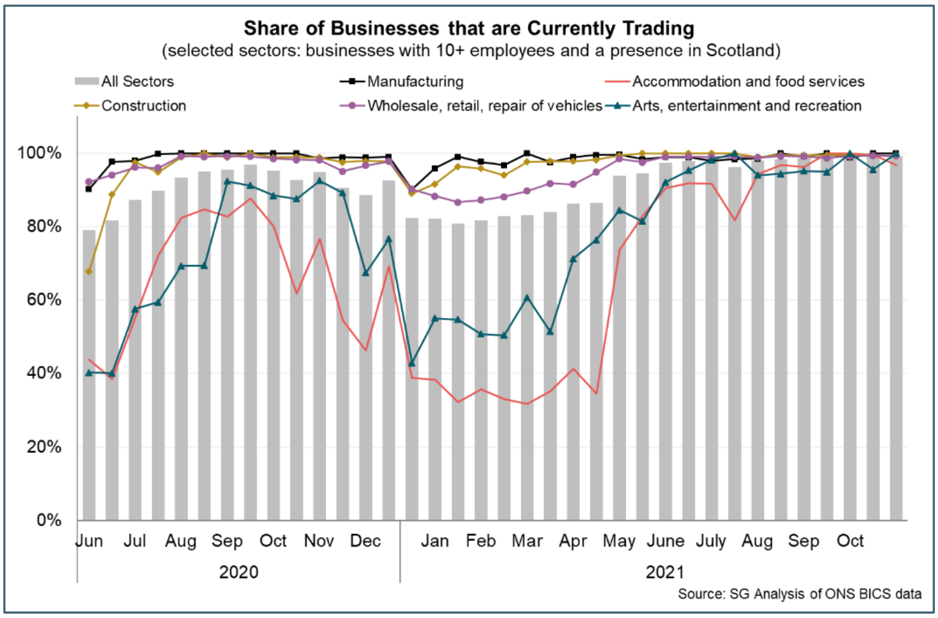


Output from some sectors across services and production are currently back above pre-pandemic levels. For example, professional, scientific and professional services (+10%) and wholesale, retail and motor trades (+0.6%).

Business Activity

Businesses activity has strengthened as most restrictions on activity have been removed, however rising input costs raises risks for cashflows.

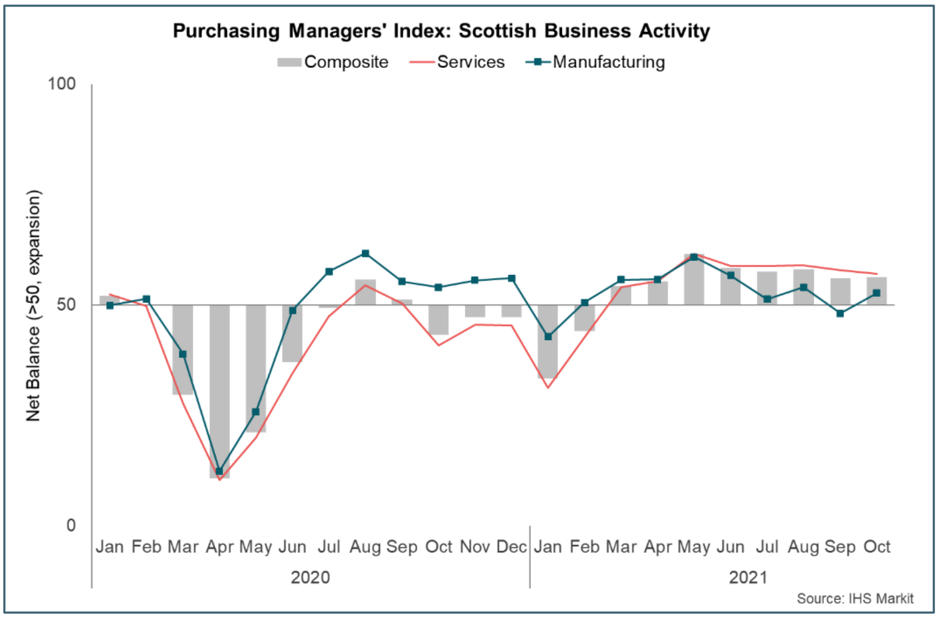
At this stage of the pandemic, businesses in Scotland are back to trading with very limited levels of restrictions on activity. The removal of most remaining restrictions on consumer facing sectors as Scotland moved beyond level 0 restrictions in August (with some protective measures remaining place) has meant that around 99% of business have been trading since August and the gap between sectors that had been most directly impacted by restrictions is effectively closed.



Business Activity and Cashflow

In terms of overall activity, the latest Purchasing Managers Index for October signalled that private sector activity continued to grow robustly over the month with the net balance at 56.3 and up marginally from September.[4] However, the pace of growth has moderated slightly from stronger growth in the second quarter.

The service sector continued to drive growth in October, though at a slightly slower pace than in recent months, and business activity in the sector continued to expand at pace following the easing of restrictions over the second quarter. Manufacturing activity picked up in October, however the pace of activity growth in the sector remained notably slower than earlier in the year.



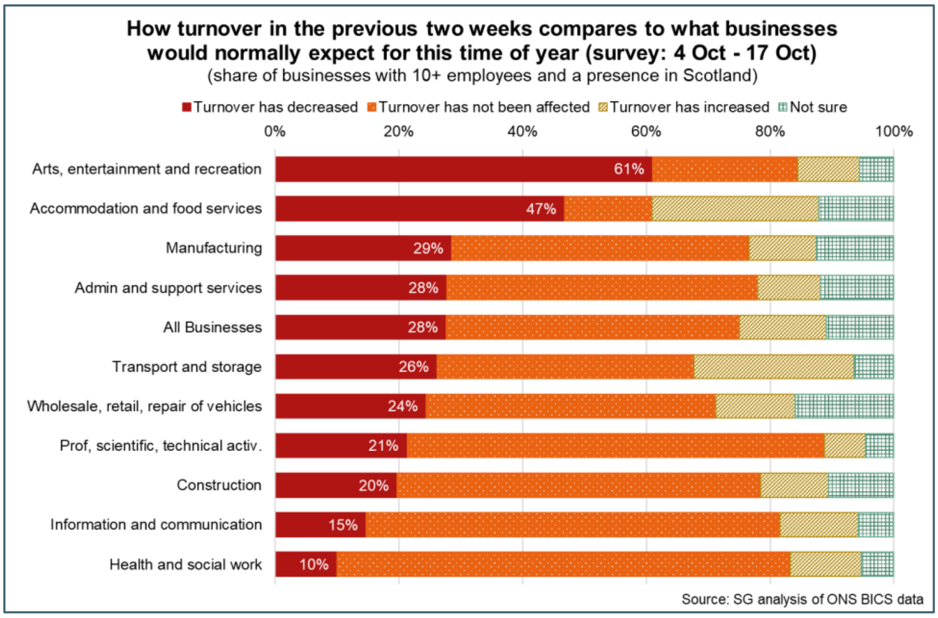
Sector differences remain a key characteristic of this stage of the recovery. The removal of most of the restrictions on the consumer facing parts of the services sector and subsequent reopening, means that the focus has partly shifted from whether businesses are trading, to the level of capacity they are trading at and the challenges they are facing as they continue to recover.

In October, the consumer facing parts of the service sector continue to report more challenges in their trading and revenue status than other sectors, likely reflecting a combination of legacy effects of having stricter restrictions on activity for the first half of 2021 and some changes in the capacity at which they are trading.

[4] IHS Markit, RBS Purchasing Managers Index. [RBS | Scottish private sector growth remained sharp in October (rbsbusinesshub.com)]

For example, in October 95% of all businesses reported being fully trading (4.3% partially), however this was lowest in accommodation and food services (83% fully trading and 14% partially) and in arts, entertainment and recreation (84% fully trading and 17% partially).[5]

Furthermore the financial performance of businesses continues to vary across sectors. In terms of business turnover in October, 28% of all business reported having lower turnover than normal for the time of year, while 47% reported that turnover was not affected and 14% reported that it had increased. Lower than normal turnover continues to be most widespread in the arts, entertainment and recreation services sector (61%) followed by the accommodation and food services sector (47%). However in the case of the latter, accommodation and food also had the highest share of firms reporting that turnover had increased (27%) alongside the transport and storage sector (26%), emphasising the level of variability within sectors of customer demand.



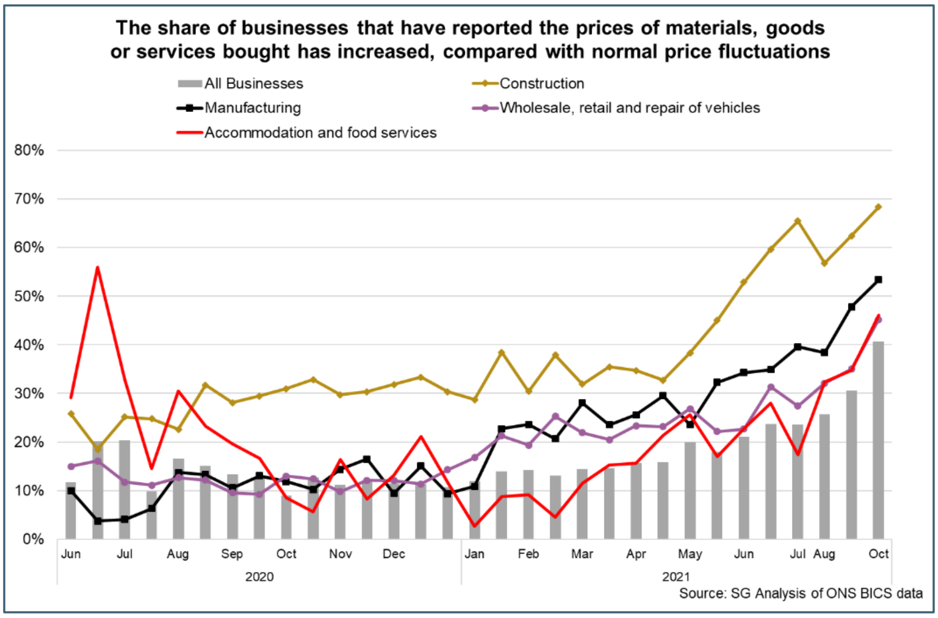
Overall, turnover performance has improved since March with a rise in the proportion of firms reporting an increase in turnover (from 6% to 14%) and a fall in the share reporting lower turnover (from around 45% to 28%). However, on the cost side, supply chain disruption, rising input costs inflation and employee shortages have emerged as key challenges and risks for many businesses reflecting imbalances following the sharp rebound in demand at this stage of the recovery.

As set out above, this has emerged as both a global and domestic challenge. In Scotland, PMI data for October show the indicator for input cost inflation, particularly for manufacturers, has been on an upward trend since the start of the year and has risen to its highest level on record.

[5] BICS weighted Scotland estimates: data to wave 42 - gov.scot (www.gov.scot)

Respondents cited that this is due to issues around the pandemic and EU-Exit and greater costs for materials, wages and fuel.[6]

Increased input costs have been evident across sectors. In October, the Business Insights and Conditions Survey (BICS) showed that 41% of businesses had seen prices increase more than normal, however this was most prominent in construction (68%), manufacturing (53%) and wholesale and retail (45%).[7]



Recent business survey data for Q3 2021, showed that firms across sectors were on balance providing positive net-balances for revenue and profit, some for the first time in a number of months.[8] This points to an improvement in demand and business activity, though on the back of an extremely difficult period and as such remains fragile. Alongside this, 86% of respondents in the construction sector and 90% in the manufacturing sector reported concerns around cost pressures for raw materials, with less but similarly elevated levels for overhead costs, indicating that while business conditions have improved, risks to the cashflow of some businesses in the short term remain.

Business Investment and Trade

Cashflow challenges present a key risk to business investment as businesses recover from the recent shocks to economic activity and look to adapt or build capacity.

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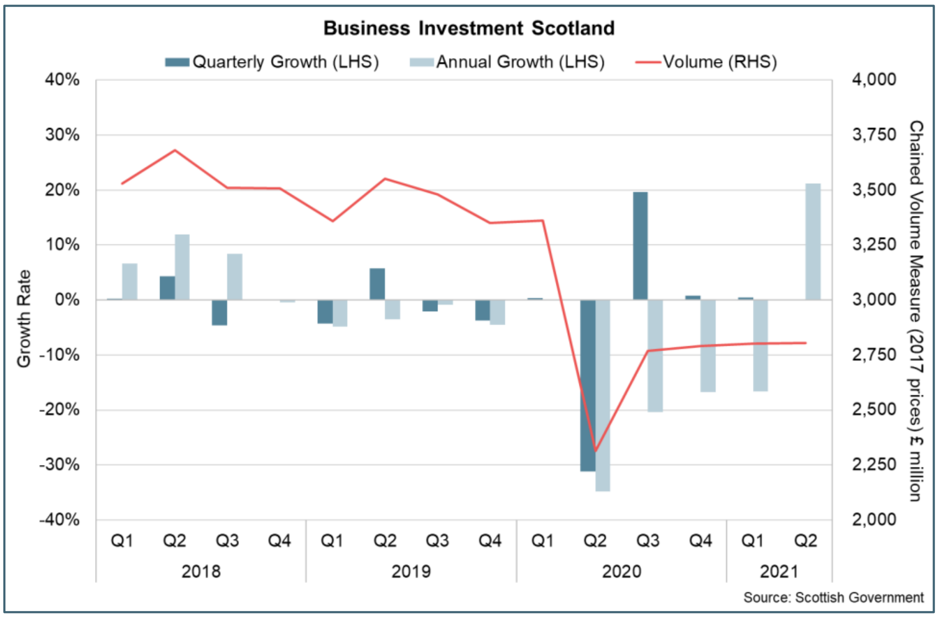
[6] IHS Markit, RBS Purchasing Managers Index, October 2021. [RBS | Scottish private sector growth remained sharp in October (rbsbusinesshub.com)]
[7] [BICS weighted Scotland estimates: data to wave 42 - gov.scot (www.gov.scot)]
[8] [Quarterly Economic Indicator (scottishchambers.org.uk)]

Business investment has fallen sharply during the pandemic and while it has recovered some of the initial fall (up 21% between Q2 2020 and Q2 2021), growth remained relatively flat over the first half of 2021 and remains 16% below its pre-pandemic level in Q4 2019.[9]



Latest business survey data presents a mixed picture for business investment, likely reflecting the ongoing uncertainty in the outlook for businesses and wider cost pressures which have emerged and may present cashflow risks.

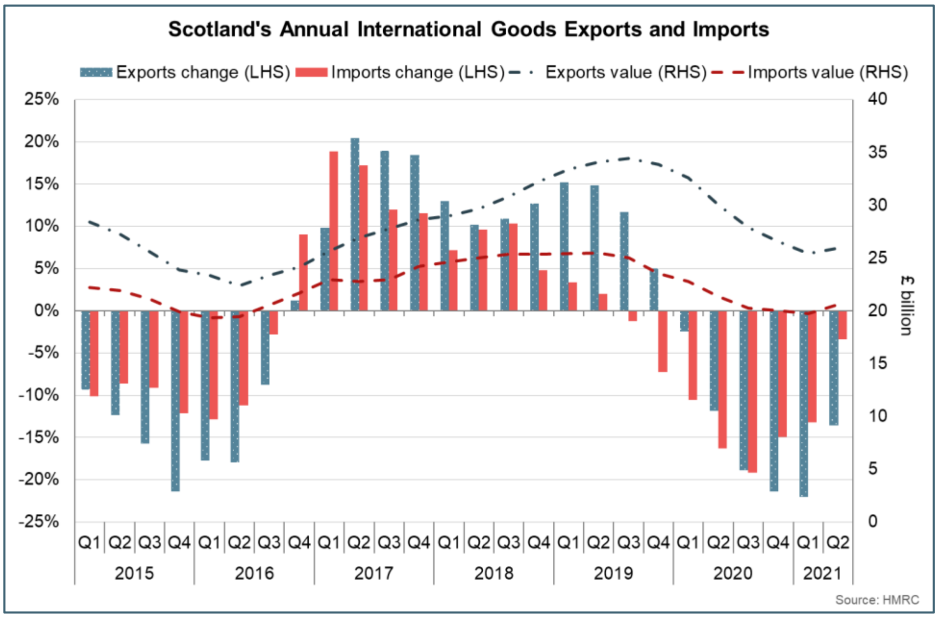
In the third quarter of the year, there has been signs of strengthening growth in business investment across construction, manufacturing and financial and business services, while investment in retail and wholesale and tourism fell.[10] Furthermore, in September, BICS data shows that 10.4% of businesses reported that capital expenditure remained lower than normal, however this has improved and fallen from over 19% at the start of the year.[11]

Scotland's international trade in goods has also experienced significant challenges arising from the impacts of the pandemic and the transition to the new trade agreement between the UK and EU.

In June 2021, the value of Scotland's annual goods exports was £26 billion, down 14% compared to annual exports to June 2020.[12] This was driven by a 41% fall in the exports of oil and gas and as such, when excluded, Scotland's goods exports increased by 3%. Similarly, machinery and transport, which is a key exporting commodity for Scotland, also decreased over the year (-6%), however there were increases in exports of chemicals (+19%) and manufactured goods (+16%). In terms of destination, Scotland's annual goods exports to the EU

[9] GDP Quarterly National Accounts: 2021 Quarter 2 (April to June) - gov.scot (www.gov.scot)
[10] Quarterly Economic Indicator (scottishchambers.org.uk)
[11] BICS weighted Scotland estimates: data to wave 42 - gov.scot (www.gov.scot)
[12] UK regional trade in goods statistics: second quarter 2021 - GOV.UK (www.gov.uk)

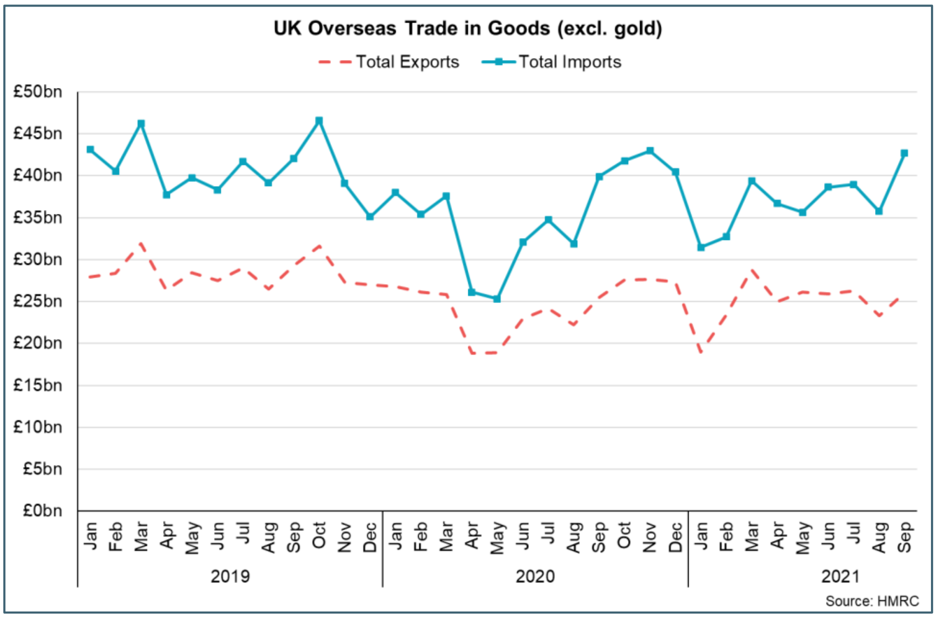
fell 14% to £13.2 billion while exports to non-EU countries fell by 13% to £12.8 billion. Over the same period, goods imports decreased by 4% to £20.6 billion.



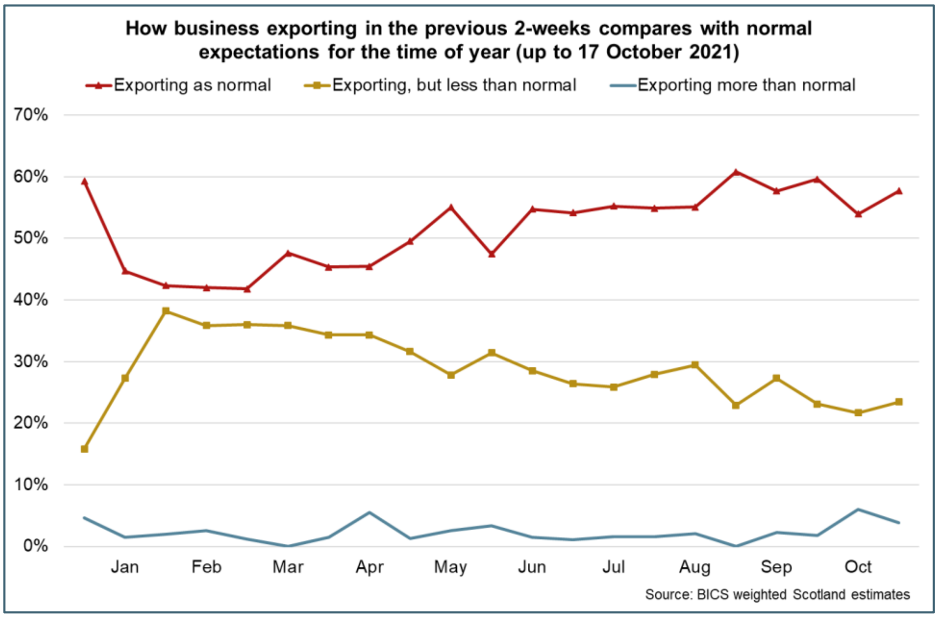
The latest quarterly data indicates that the value of trade (exports and imports) has strengthened from the sharp fall in the second quarter of 2020, however has eased slightly in the first half of 2021.

The most recent monthly UK trade data for September[13] signals that trade has strengthened from the falls at the start of the year and goods exports were 2% higher than in September 2020. However, for the period January to September in 2021, goods exports remain 11% below the equivalent period in 2018 prior to the pandemic and trade volatility in 2019 surrounding EU Exit. In terms of key exporting sectors for Scotland, in September, total exports of Scotch whisky remained unchanged over the month however in the first nine months of 2021 were down 1% compared to the same period in 2018. Exports of fish fell 9% in September and in the first nine months of 2021 were 12% down on same period in 2018.

[13] UK overseas trade in goods statistics: July 2021 - UK Trade Info



More recent business survey data for October indicates further improvement in trade activity from the start of the year with 58% of Scottish businesses reporting to be exporting as normal for the time of year (up from 42% at the start of February) while 24% were exporting less than normal (down from 38% at the start of February).



However, supply chain bottlenecks have emerged as the global economy adjusts and rebalances from the impacts of restrictions during the pandemic, while for some sectors, the new trading relationship with the EU provide further challenges. In October, 37% of exporters and 43% of importers reported facing changes in transportation costs while 15% of exporters and 23% of importers reported a lack of hauliers to transport goods or lack of logistics equipment.[14]

[14] BICS weighted Scotland estimates: data to wave 41 - gov.scot (www.gov.scot)

Box A: Estimates of economic scarring from the pandemic.

The economic policy response to the pandemic sought to protect the productive capacity in the economy through measures such as the furlough scheme and business support. The aim was to minimise the extent of economic scarring and so it is useful to consider the extent to which this has taken place.

Output in the Scottish and UK economy is forecast to return to pre-pandemic levels over the coming months, however the impacts of the pandemic on labour supply, investment and productivity are expected to have some longer term/permanent impacts (scarring) on the potential output from the economy.

Due to the longer term nature of scarring on potential output, estimates of the scale of scarring are uncertain and subject to revision as new data on the pace of recovery as well as on the extent of economic challenges associated with the reopening of the global economy become available.

In October, the Office for Budget Responsibility, revised down their estimates of medium term scarring on potential output in the UK economy to 2% (down from 3% in March), reflecting that the pace of the recovery back to pre-pandemic levels of output, the labour market, capital investment and total factor productivity have performed more strongly than previously forecast.[15]

Similarly in November, the Bank of England estimated the level of potential supply in the UK economy in 2024 will be around 2% lower than would have been implied by the MPC's pre-pandemic projections.[16]

In terms of the Scottish economy, the latest forecast from the Scottish Fiscal Commission in August revised up the rate at which GDP is expected to return to pre-pandemic levels of output, reflecting the stronger than expected period of growth since their previous forecast in January. As a result of the subsequent upward revision to trend productivity, trend GDP in 2025 is forecast to be 2% lower than pre-pandemic forecasts (down from 3% lower forecast in January 2021).[17]

Overall, stronger than expected economic activity in 2021 and the upward revisions to forecasts compared to the start of the year has meant that some estimates of scarring impacts on the economy from the pandemic have slightly fallen and are currently converging around 2%.

[15] Economic and fiscal outlook - October 2021 - Office for Budget Responsibility (obr.uk)
[16] Monetary Policy Report - November 2021 | Bank of England
[17] Scotland's Economic and Fiscal Forecasts – August 2021 | Scottish Fiscal Commission

There remains significant uncertainty in the medium to long term outlook for the labour market, skills and capital investment and the extent to which falls in these areas will recover, however latest data continues to signal that the aggregate impacts on the labour market have been less than expected following the end of the furlough scheme.

Furthermore, impacts of the pandemic on the economy continue to be complicated by the effects of EU Exit and the move to the new economic relationship which is expected to weigh on potential supply. The OBR estimate that the reduction in trade post EU Exit will result in a 4% reduction in long-run potential productivity, which is bigger than the expected long run effect of the pandemic.

Overall, the degree of economic scarring appears to be low, particularly when compared to what had initially been feared and this, to a large extent, reflects the policy response, which the OBR has described as “remarkably successful”.

Labour Market

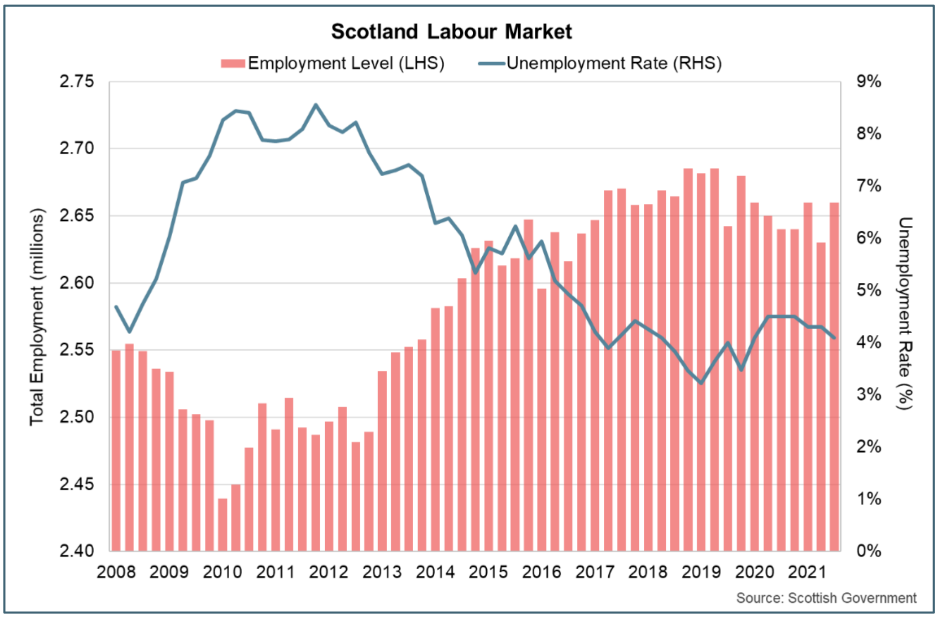
In October, the number of payrolled employees in Scotland rose back above its pre-pandemic level for the first time since the start of the pandemic, however the claimant count continues to fall more slowly.

Employment, Unemployment and Furlough

The unemployment rate has remained broadly stable since the start of the year, however the latest labour market statistics for July – September 2021 show Scotland’s unemployment rate was 4.1%, down 0.2 percentage points over the quarter, and the lowest rate since the start of 2020 (3.7%, Dec-Feb 2020).

Scotland’s employment rate in the 3-months to September was 74.8%, up 0.6 percentage points over the quarter, while the inactivity rate fell 0.4 percentage points to 22.0%, signalling some strengthening in the labour market as restrictions have eased[18].

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

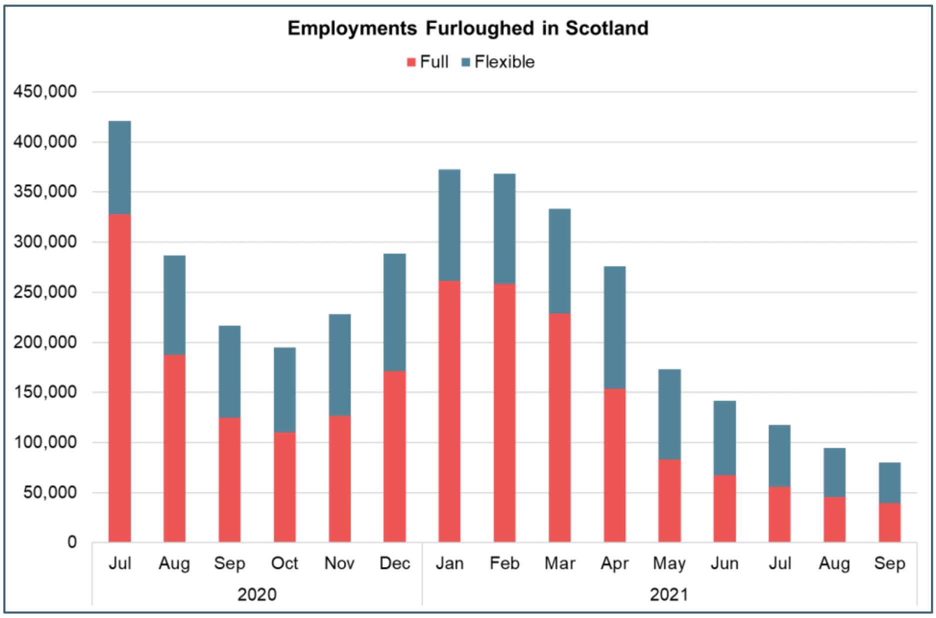


Up to the end of September, the Furlough Scheme was providing significant support to the labour market and the retention of jobs and earnings. Since its inception, the furlough scheme has supported 911,700 unique jobs in Scotland (11.7 million across the UK) and since its most recent peak of supporting 393,400 during lockdown restrictions in January this year, the number of jobs on furlough has naturally steadily fallen as restrictions eased and businesses resumed trading.

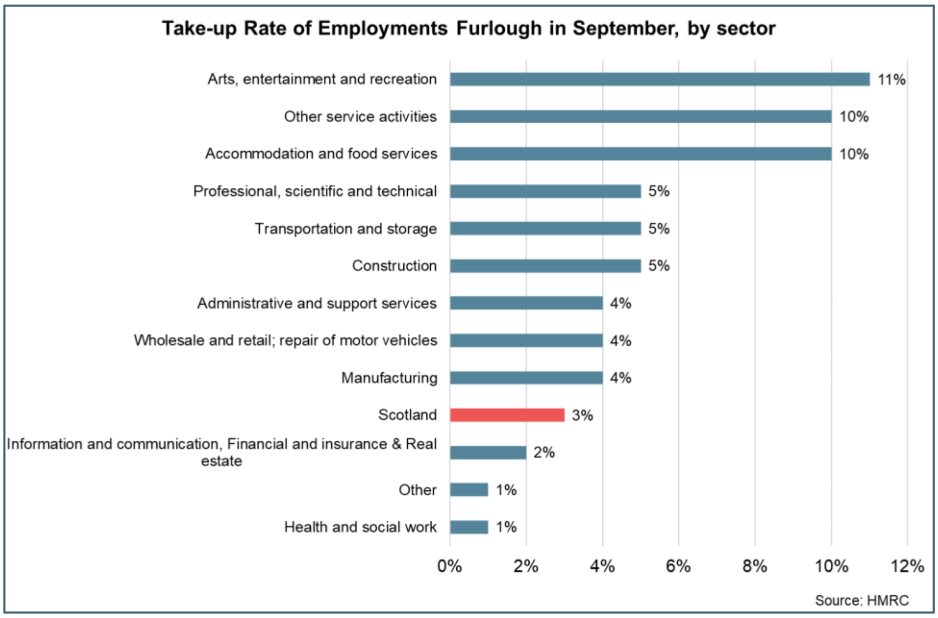
However, the ending of the support scheme at the end of September, provides a degree of uncertainty regarding the impact that this will have on businesses ability to retain staff that have remained most recently furloughed and the near term outlook for redundancies and unemployment.

At the end of September, 80,300 jobs in Scotland were furloughed (3% of eligible jobs), with 51% of those flexibly furloughed and 49% fully furloughed.[19]

[19] Official statistics overview: Coronavirus Job Retention Scheme statistics: 4 November 2021 - GOV.UK (www.gov.uk)



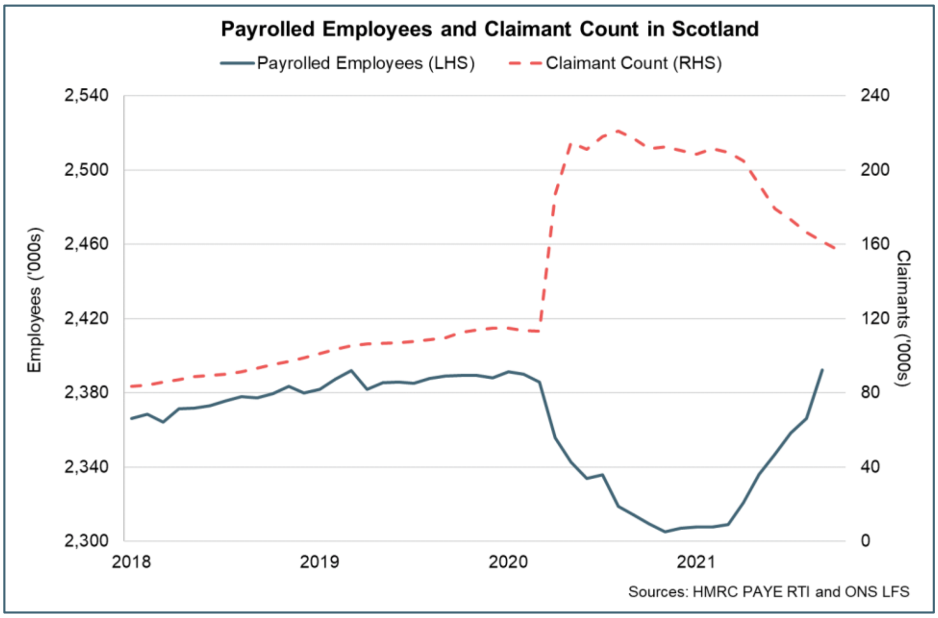
Furthermore, in September there remained widespread use of the furlough scheme across sectors, however the highest take up rates remained in consumer facing services such as arts, entertainment and recreation (11%) and accommodation and food services (10%), reflecting the uncertainty that these sectors are continuing to face at this stage of recovery around the capcity at which they are trading and their staffing requirements.



Flash estimates of PAYE employment data for October signalled an increase in employment levels with the number of payroll employees in Scotland rising by 12,000 over the month and is now 0.1% above its pre-pandemic level.[20] Similarly, Claimant Count data also signalled further improvement in October with the number of claimants of Job Seekers Allowance and Universal Credit (claiming principally for the reason of being unemployed) falling 1.3% to 157,100. The number of claimants is at its lowest level since the start of the pandemic, though remains 43,300

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

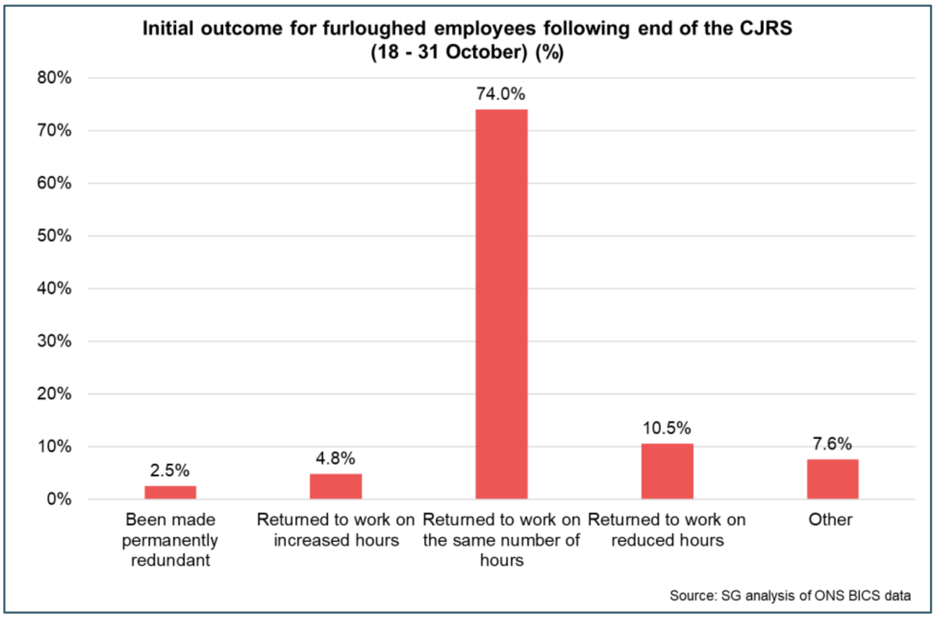
(38.1%) higher than its pre-pandemic level in February 2020 suggesting that there remains pressure in this element of the labour market.[21]



Demand for Staff and Labour Shortages

The end of the furlough scheme continues to present an element of uncertainty for the labour market in the near term and the impact this could have on unemployment over the final quarter of the year. BICS data for October estimates that since the end of the furlough scheme, 74% of furloughed workers returned to work on the same number of hours, 10.5% on reduced hours with 2.5% of furloughed workers being permanently made redundant.[22] At a UK level, analysis by the Resolution Foundation found that 88% of employees who were furloughed in September were working in October.[23]

[21] Labour Market Statistics, Scottish Government. https://www.gov.scot/collections/labour-market-statistics/
[22] BICS weighted Scotland estimates: data to wave 41 - gov.scot (www.gov.scot)
[23] Post-furlough blues • Resolution Foundation

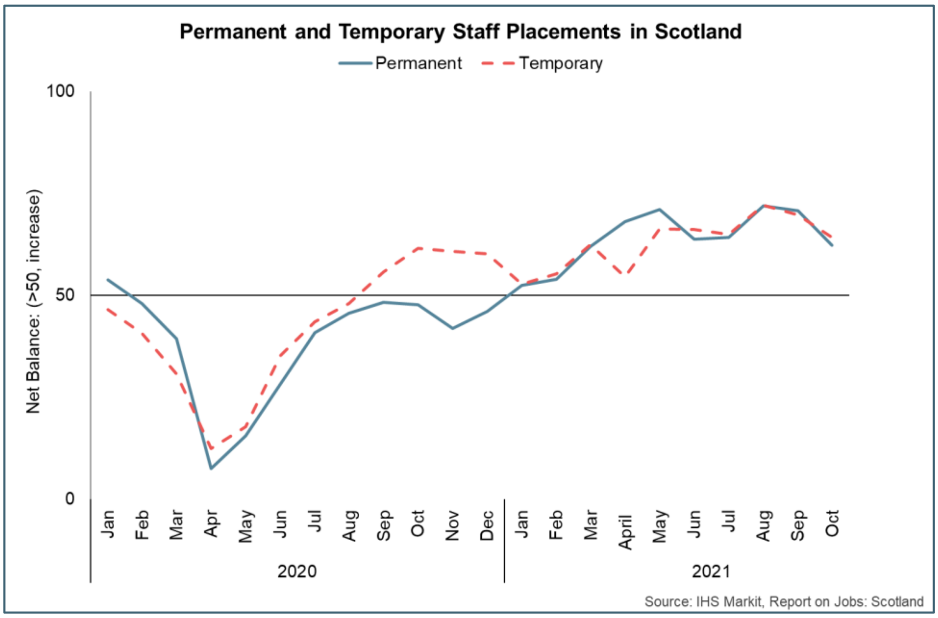


The Scottish Fiscal Commission forecast that unemployment will rise slightly at the end of the year to 5.4% reflecting that some people on furlough in September may be made redundant, while there may also be an increase in labour market participation with restrictions largely removed.[24]

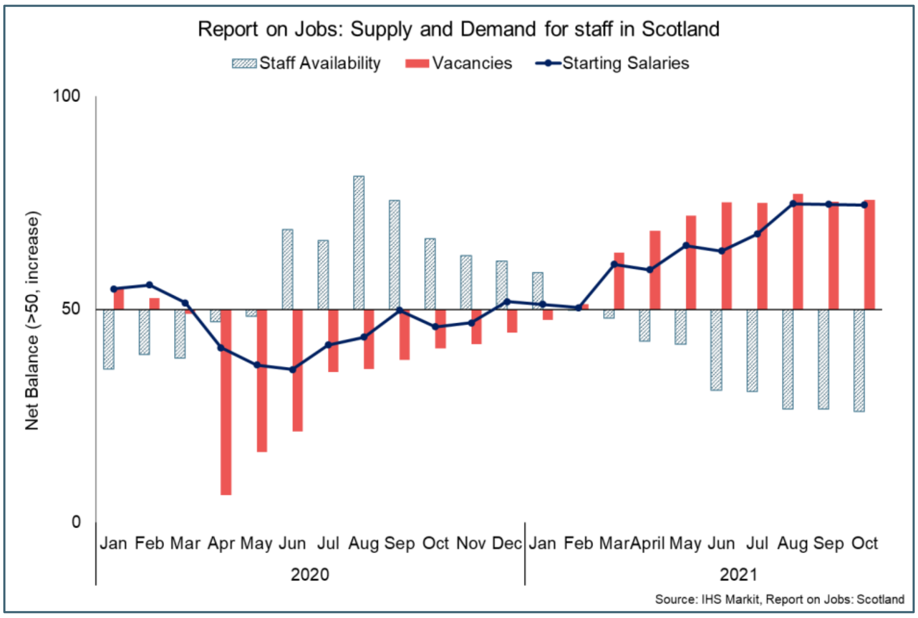
To date, the return to work of furloughed staff over the course of the year and the rebound in the number of payrolled employees reflects the strong increase in demand for staff and recruitment activity as restrictions have eased and economic activity has strengthened.

The November RBS Report on Jobs for Scotland signalled that permanent and temporary staff placements continued to grow robustly with net balances of 62.4 and 64.2 respectively, though the pace of growth had slowed slightly from the more rapid rates of growth over the second and third quarters.[25]

[24] Scotland's Economic and Fiscal Forecasts – August 2021 | Scottish Fiscal Commission
[25] IHS Markit: RBS Report on Jobs: Royal Bank of Scotland Report on Jobs - October (natwestgroup.com)



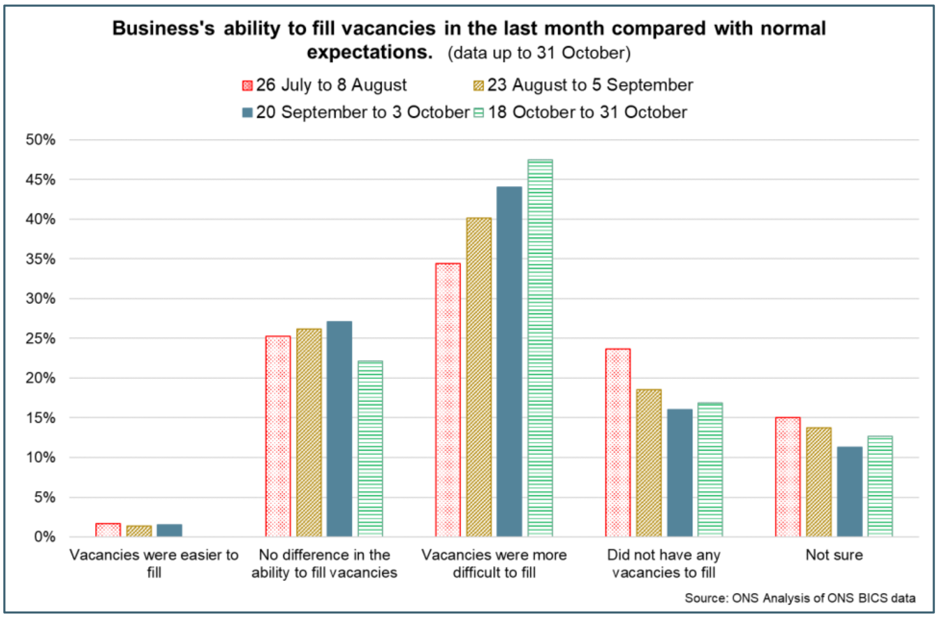
Despite the slight slowing of placements in October, demand for permanent and temporary staff remained heightened with vacancy rate net balances remaining close to their record high in August. Furthermore, ONS Adzuna data shows that during the third quarter of the year, online job vacancies in Scotland have been on average 27% higher than pre-pandemic levels, rising to an average of 37% higher in October and into November.[26] However, staff/candidate availability continued to fall in October, which businesses attributed to the effects of the pandemic, EU Exit and the overall strong demand for staff, and has resulted in recruitment challenges intensifying in recent months.



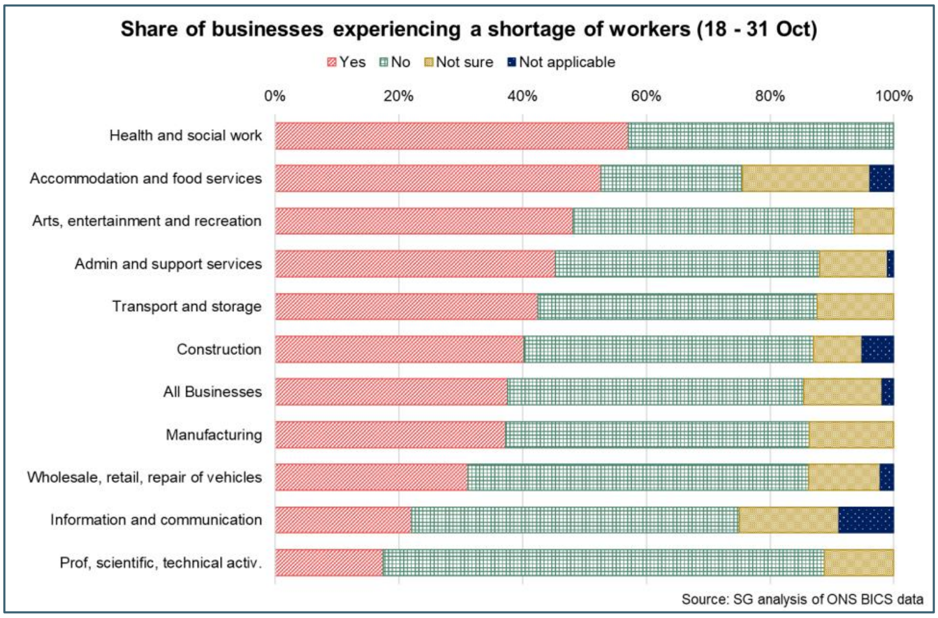
Furthermore, latest BICS data show that at the end of October, the proportion of businesses that did not have any vacancies to fill had fallen from 24% at the start of the third quarter to 17%

[26] [Online job advert estimates - Office for National Statistics (ons.gov.uk)]

in October, while the proportion of businesses finding vacancies more difficult to fill had increased from 34% to 47% over the same period.[27]



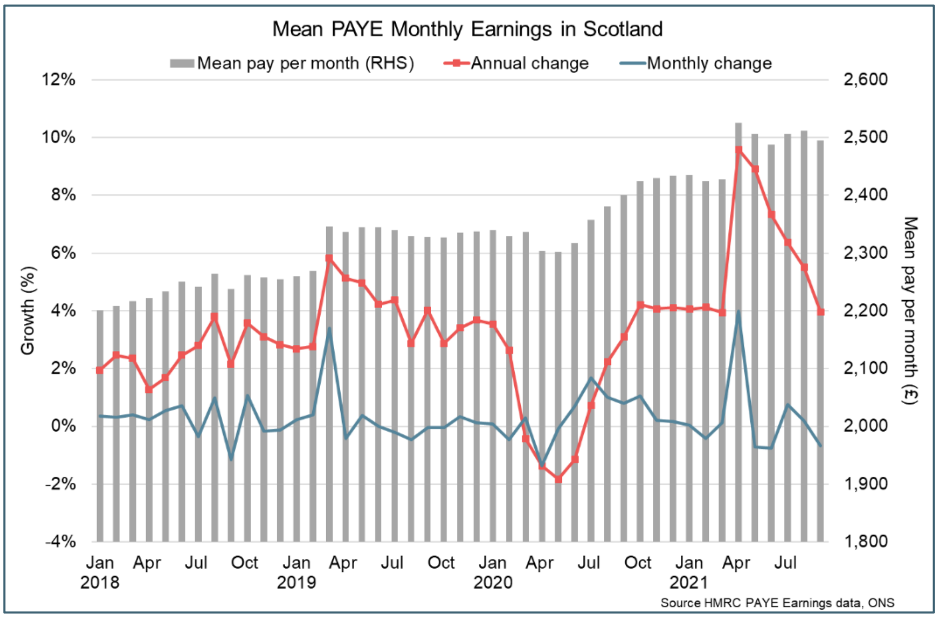
Overall, the imbalance between demand and supply of staff has resulted in labour shortages affecting sectors including haulage, construction, tourism, hospitality and food & drink.



The imbalance also presents upward pressure on earnings. At an aggregate level, mean PAYE monthly pay fell sharply at the start of the pandemic, however strengthened over the course of 2020 and rebounded back above its pre-pandemic level in July 2020. Relatively robust earnings growth over this period in part reflects the lower inflows of new employees, for which mean pay tends to be around 40% lower than for those continuously employed meaning inflows into payrolled employment tend to bring down average pay and average pay growth. Latest data

[27] [BICS weighted Scotland estimates: data to wave 41 - gov.scot (www.gov.scot)](https://www.gov.scot)

shows mean pay per month in Scotland fell 0.7% in September to £2,495, with annual growth slowing to 4.0%.[28]



In general, the rate of earnings growth over this period needs to be interpreted with caution over this period as base effects, compositional factors which reflect a fall in the number and proportion of lower-paid employee jobs, and the furlough scheme have all influenced the data.

Looking ahead, the recruitment challenges that have emerged, has created upward pressure on starting salaries in the near term for both permanent and temporary staff positions. The latest RBS Report on Jobs reported that the permanent starting salaries index remained close to its series high in October (74.8) while temporary wages (70.7) had eased back slightly from August and September.[29]

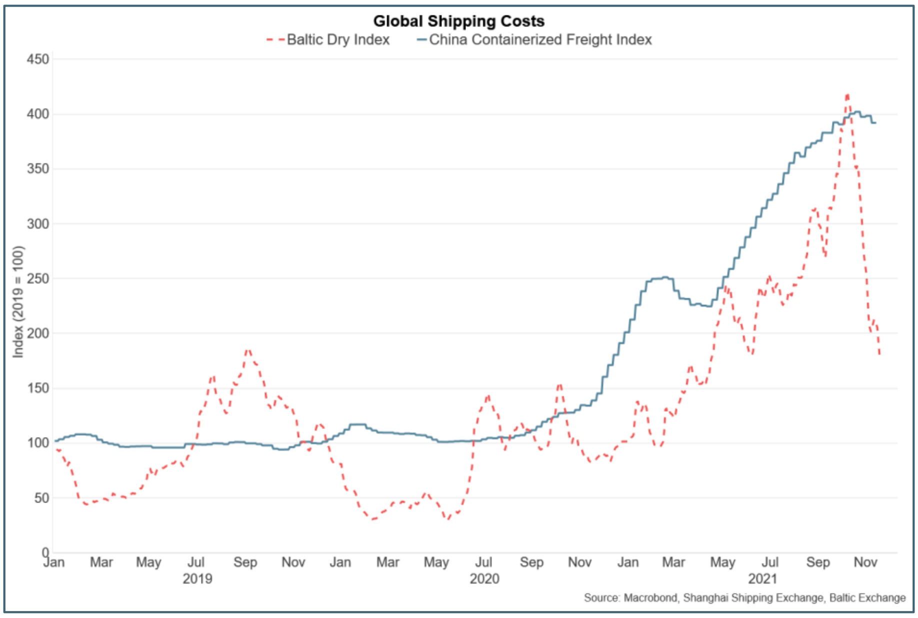
Box B: Bottlenecks in Supply Chains and the Labour Market

Demand across the global economy has rebounded sharply as restrictions on activity have been removed over the course of 2021. However, the impacts of the pandemic on the supply side of the economy has meant that resource availability and international supply chains have not readjusted and rebounded as quickly, leading to significant bottlenecks in supply chains.

As a result, costs of many materials and goods have increased, as has the cost of transporting them across supply chains. Global shipping costs have increased sharply over the past year in response to the strong demand for goods, ongoing disruption from the pandemic impacting supply chain capacity and temporary disruptions such as the blockage of the Suez Canal. Shipping price indices have more than doubled over the past year and

[28] Earnings and employment from Pay As You Earn Real Time Information, UK - Office for National Statistics (ons.gov.uk)
[29] IHS Markit: RBS Report on Jobs: Royal Bank of Scotland Report on Jobs - October (natwestgroup.com)

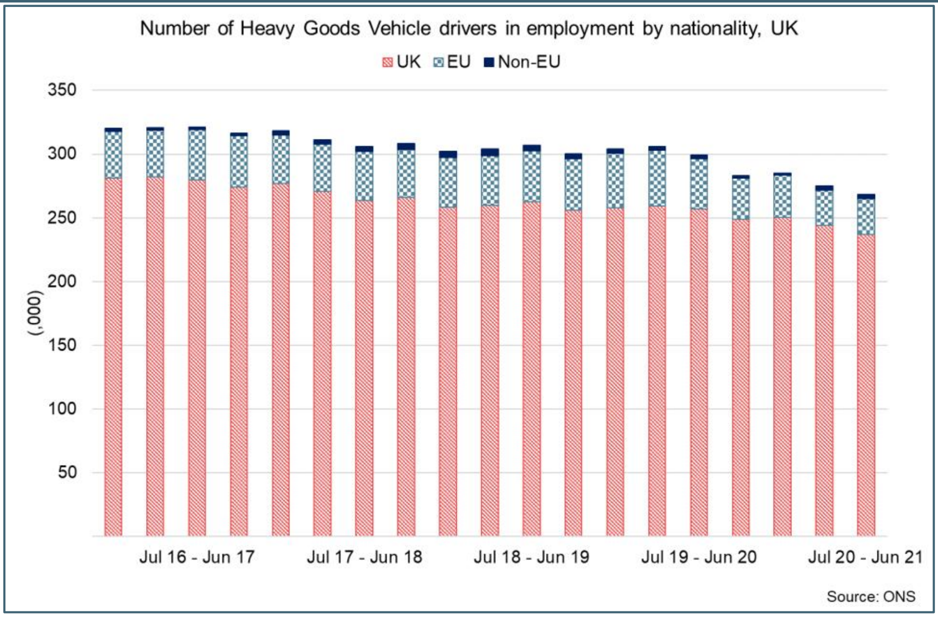
remain elevated in November, however recent data suggest that the pace of growth has moderated over the past month.



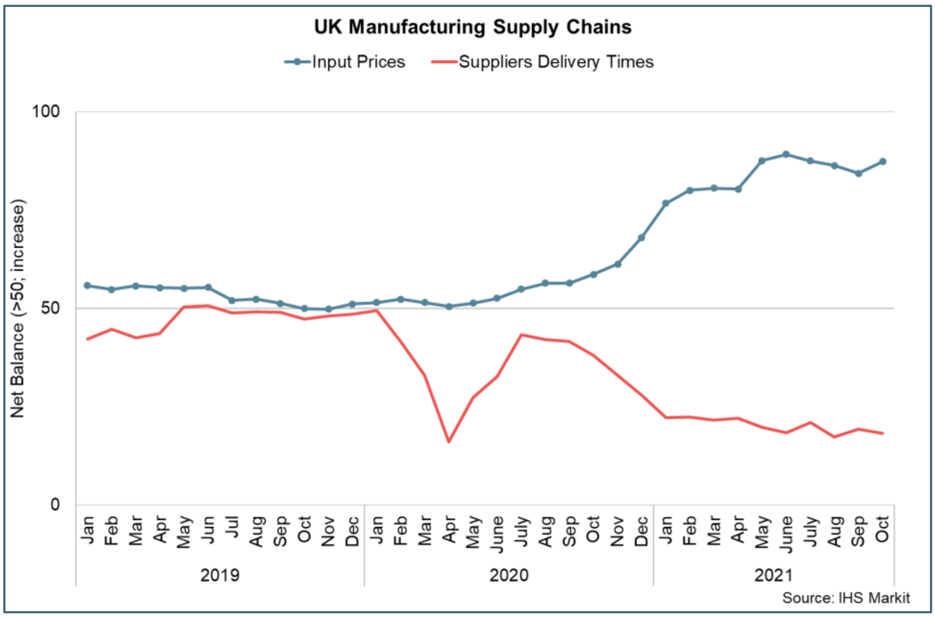
Supply disruption in the UK partly reflects the global issues, however domestic factors are also impacting. For example, a shortage of HGV drivers has emerged across a range of countries including the UK. This in part reflects longstanding recruitment challenges in the haulage sector. At the UK level, there has been a general downward trend in the total number of HGV drivers in employment with 15% (42,000) fewer UK nationals working as HGV drivers than there were four years earlier.[30]

However, the largest decrease was during the pandemic with 26,000 (-10%) fewer UK nationals employed as HGV drivers in the year ending June 2021 than in June 2019. This has been exacerbated by a fall in EU nationals working as HGV drivers over the same period and delays due to COVID regulations which have stalled the number of newly qualified drivers gaining certification.

[30] Fall in HGV drivers largest among middle-aged workers - Office for National Statistics (ons.gov.uk)



Combined, the impacts of global and domestic supply chain disruption remains elevated in the UK with many industries reporting both a deterioration in the availability of materials and supplier delivery times coupled with a corresponding rise in input prices. UK PMI data for the manufacturing sector shows that suppliers delivery times have weakened to their lowest levels in the time series, while input price inflation remains close to its highest level.[31]



Bottlenecks across supply chains and shortages in certain parts of the labour market are expected to be temporary as the demand and supply side of the economy rebalance following the significant shocks to activity during the pandemic to date. However, they are currently weighing on activity and output in a range of sectors including manufacturing, construction and parts of the services sector during the third quarter of the year and continue to contribute significantly to the current rise in inflationary pressures.

[31] IHS Markit / CIPS UK Manufacturing PMI: 031456d3e67f43b086a30e2003539cb3 (markiteconomics.com)

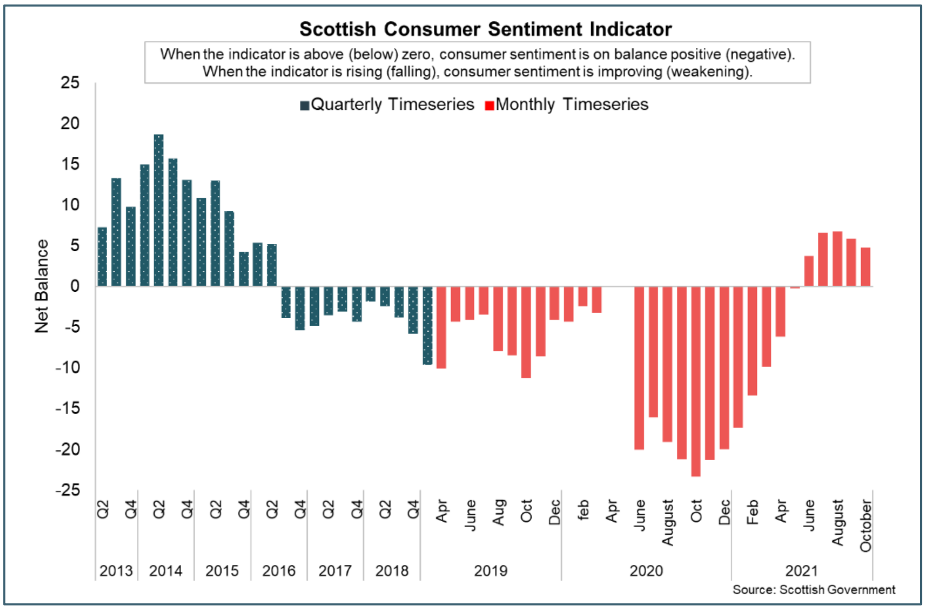
Consumption

Consumer sentiment has strengthened significantly over the past year however patterns of household spending and saving continue to adjust to the removal of restrictions.

The pandemic has had a significant impact on consumer sentiment, reflecting amongst many other factors, the scale of the shock to the economy and the uncertainty it has created for household incomes.

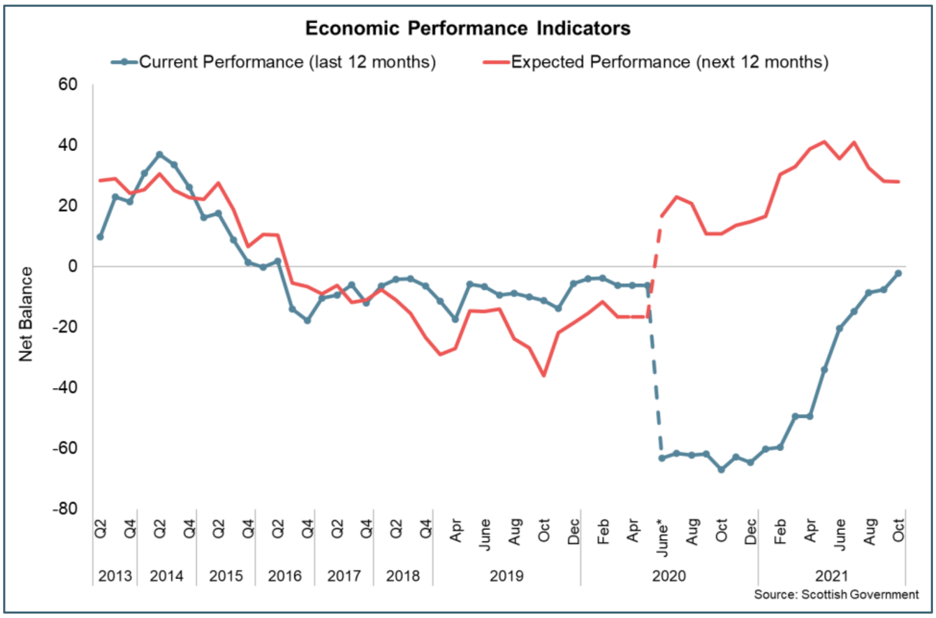
Having fallen sharply during 2020, consumer sentiment has recovered steadily over the past year to back above pre-pandemic levels, likely reflecting improved confidence from the gradual removal of restrictions, delivery of the vaccination programme and the economic recovery that has been underway.

Latest data for October 2021, show the Scottish Consumer Sentiment Indicator stood at 4.8. This was the fifth consecutive month of positive consumer sentiment, however has weakened slightly by 1.1 points from September.[32]

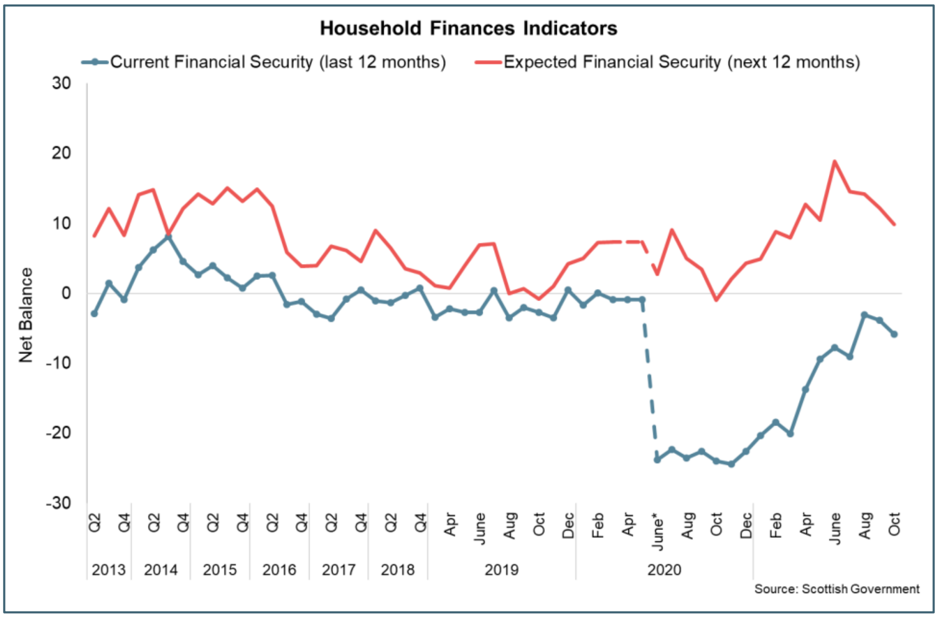


On the economy, respondent's on balance consider current economic circumstances to be slightly worse than last year (-2.2), however sentiment continued to improve. Looking ahead, respondents expect the economy to impove over the coming year relative to the current situation (+28), though the level of optimism has gradually weakened since July.

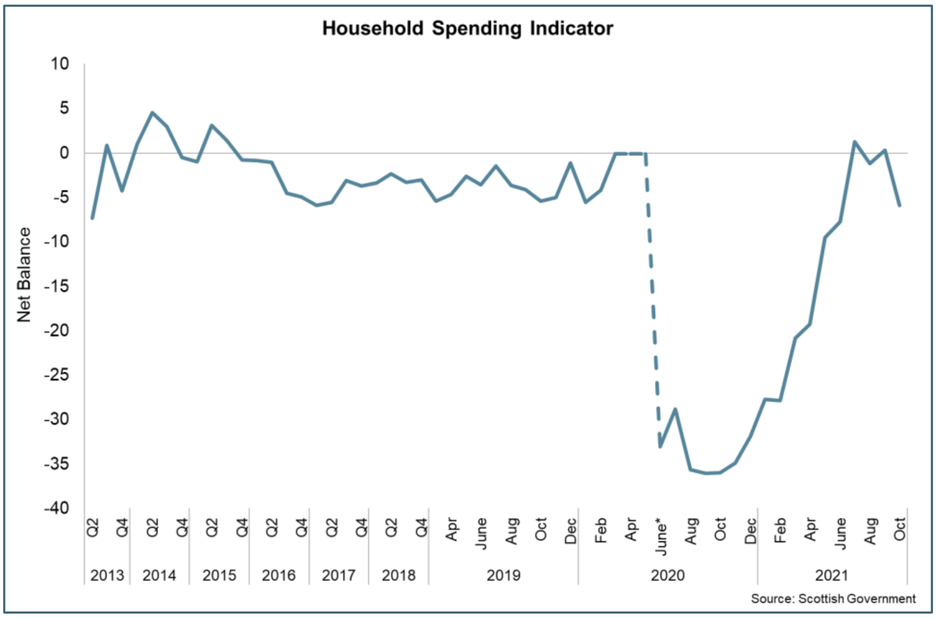
[32] Economy statistics - gov.scot (www.gov.scot)



On the issue of sentiment around household finances, households responded that their household finances were less secure than 12 months ago (-5.8), though looking ahead, expect them to strengthen over the coming year (+9.9). However, both indicators have weakened in recent months signalling that uncertainty in this regard remains heightened.

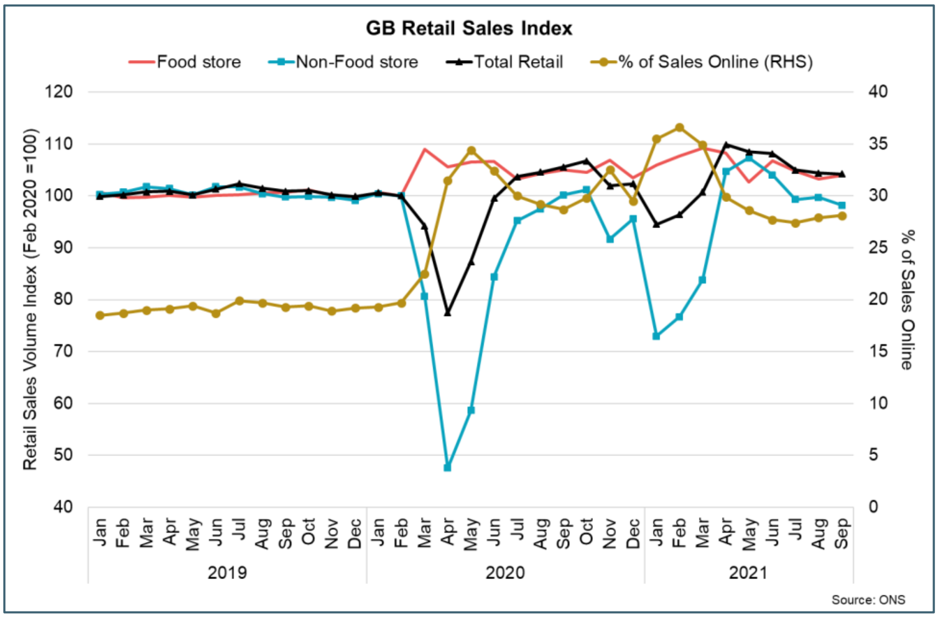


Both the outlook for the economy and household finances influence how relaxed households are about spending money. Households have been increasingly relaxed about spending money over the past year (rising from a low base), however sentiment stabilised over the third quarter before falling in October to a net balance of -5.9. This is in keeping with the recent falls seen in some of the other indicators in October, signalling that respondents confidence about spending money has weakened recently.



Sentiment indicators continue to be highly sensitive to the rapidly moving developments on the pandemic and the unprecedented economic impacts that we have seen. As such, they will continue to be a key indicator in understanding the level to which a recovery in consumer sentiment feeds through to changes in consumption.

The strengthening in consumer sentiment over the past year has been broadly reflected in strengthening retail sales, which have recovered to 4.2% higher than their pre-pandemic level, having fallen sharply during lockdown restriction periods in 2020 and 2021.[33] However, GB retail sales in September fell 0.2% over the month, following a 0.6% fall in August. Food store sales rose 0.6% and were 3.9% above pre-pandemic levels, while non-food sales fell 1.4%.



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

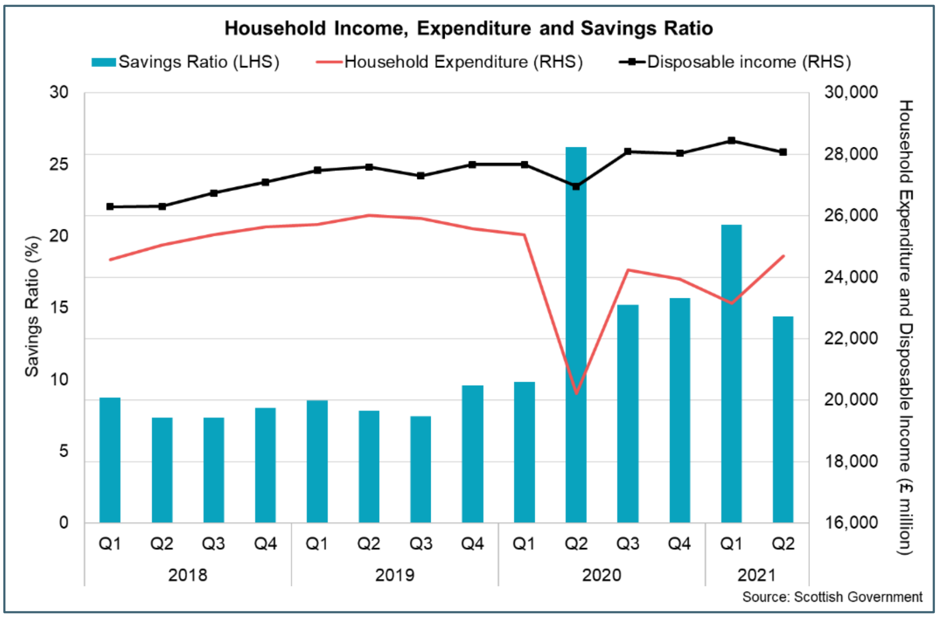
The easing back of retail sales in recent months, particularly non-food sales, may reflect a level of displacement in consumer spending as restrictions on consumer facing services further eased enabling increased consumption of consumer services rather than consumer goods.

Furthermore, the split between online retail sales and in-store retail sales has continued to adjust following the removal of restrictions. The proportion of retail sales online increased to 28.1% in September, having been over 35% at the start of the year during lockdown restrictions. While the share of retail sales online has fallen back, it remains substantially higher than in February 2020 prior to the pandemic (19.7%).

Household Savings and Consumer Credit

At an aggregate level, households have increased their levels of savings during the pandemic due to a reduction in expenditure coupled with a rise in disposable income through the retention of earnings. This has been particularly evident during periods of lockdown in Q2 2020 and Q1 2021 when consumer facing services were largely closed.

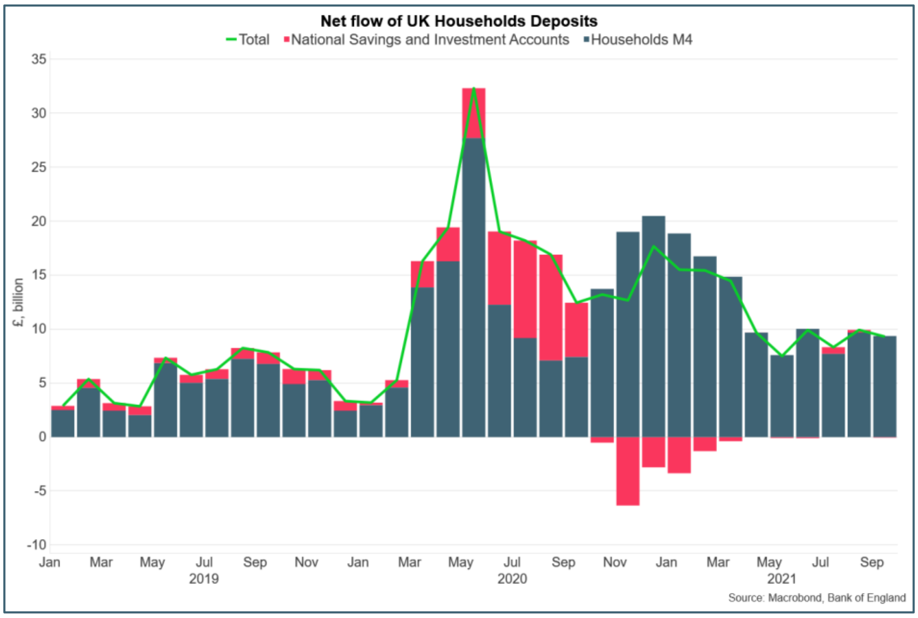
Following these peaks (26% and 21% respectively), the savings ratio fell in Q2 2021 to 14% reflecting that disposable income has remained broadly stable while household expenditure picked up as restrictions eased from the start of the year. This is the lowest rate the savings ratio has been since the start of the pandemic, though remains notably higher than pre-pandemic levels (9.6% in Q4 2019).[34]



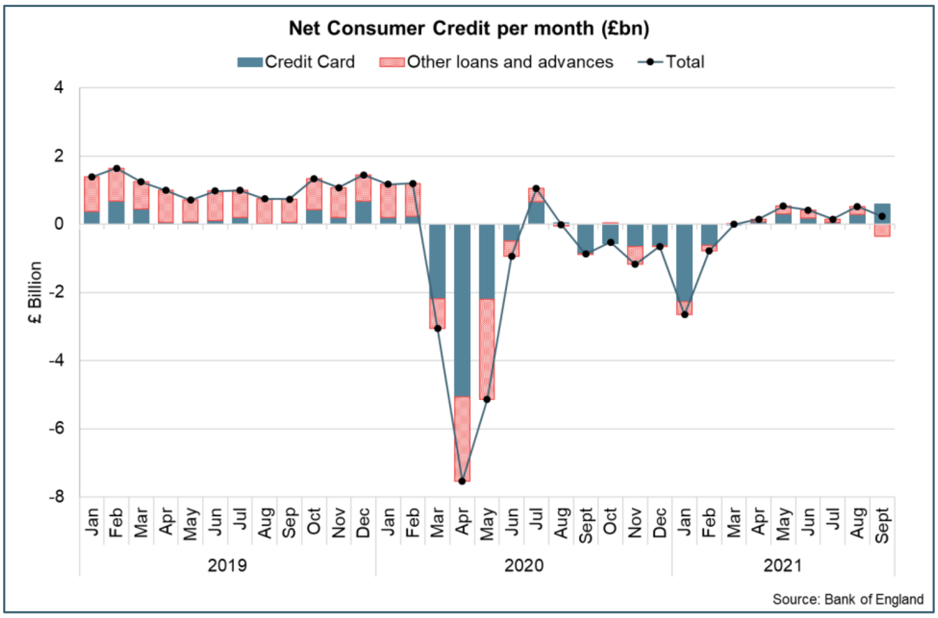
Bank of England data for September provide further insight at a UK level of how household savings have changed over the third quarter of the year.[35] At an aggregate level, net flows from UK households into deposit-like accounts was £9.4 billion in September. Despite monthly

[34] GDP Quarterly National Accounts: 2021 Quarter 2 (April to June) - gov.scot (www.gov.scot)
[35] Money and Credit - September 2021 | Bank of England

variations, net inflows have remained relatively stable over the second and thirds quarters, notably lower than deposits made earlier in the pandemic, however remain around twice as high as pre-pandemic levels when the average net inflow in the year to February 2020 was £4.7 billion.

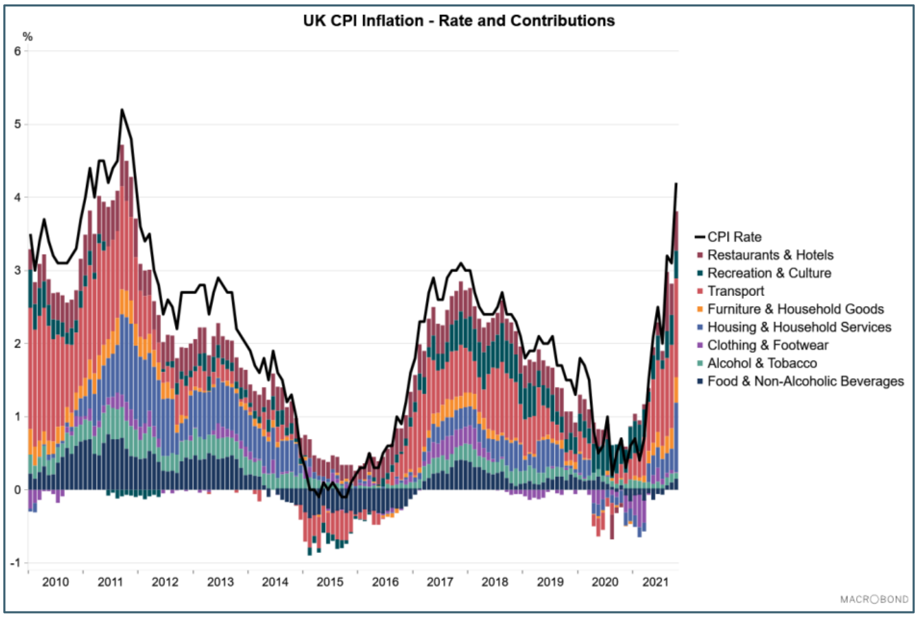


In keeping with higher rates of net deposit flows, net consumer credit has fallen significantly during the pandemic. Consumer credit started to grow again over the second quarter and in September, consumers borrowed £0.2 billion in credit on net. Within this, they borrowed £0.6 billion in credit card debt (the strongest level since July 2020) and repaid £0.4 billion in 'other' forms of consumer credit (such as card dealership finance and personal loans). However, net borrowing remains significantly lower than the pre-pandemic monthly average of £1.1 billion in the year to February 2020.



Looking ahead, the extent and pace at which households retain or spend accumulated savings and further increase borrowing remains uncertain, particularly in the context of the recent rise in consumer prices inflation.

Inflationary pressures have picked up sharply since the start of the year with the CPI inflation rate rising from 0.7% in January to its current rate of 4.2% in September; its highest rate since 2011.[36]

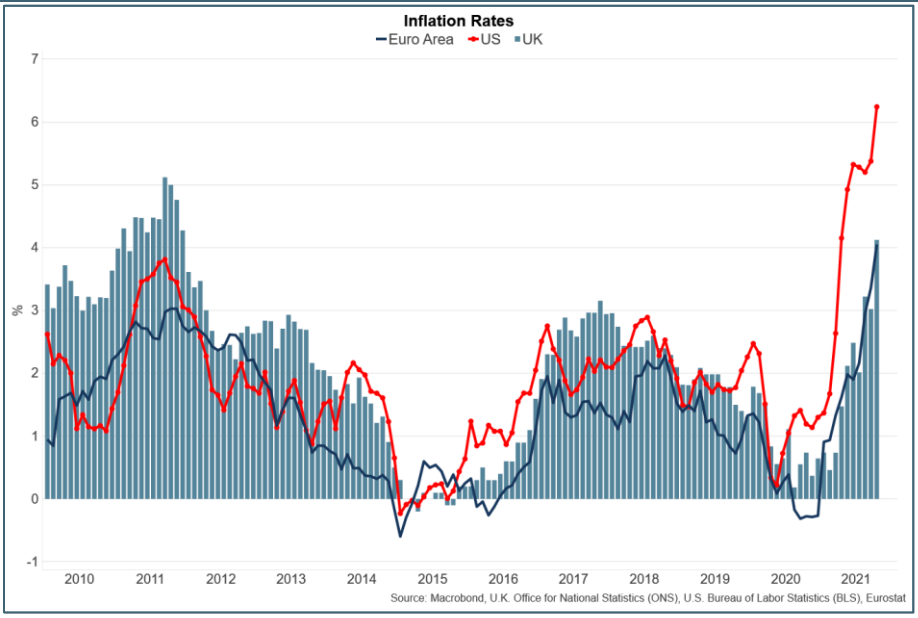


The rate rose from 3.1% in September, with the change driven by broad based positive contributions across all areas and the largest upward contributions from housing and household services, transport and restaurants and hotels.

Box C: Recent Drivers of Inflation

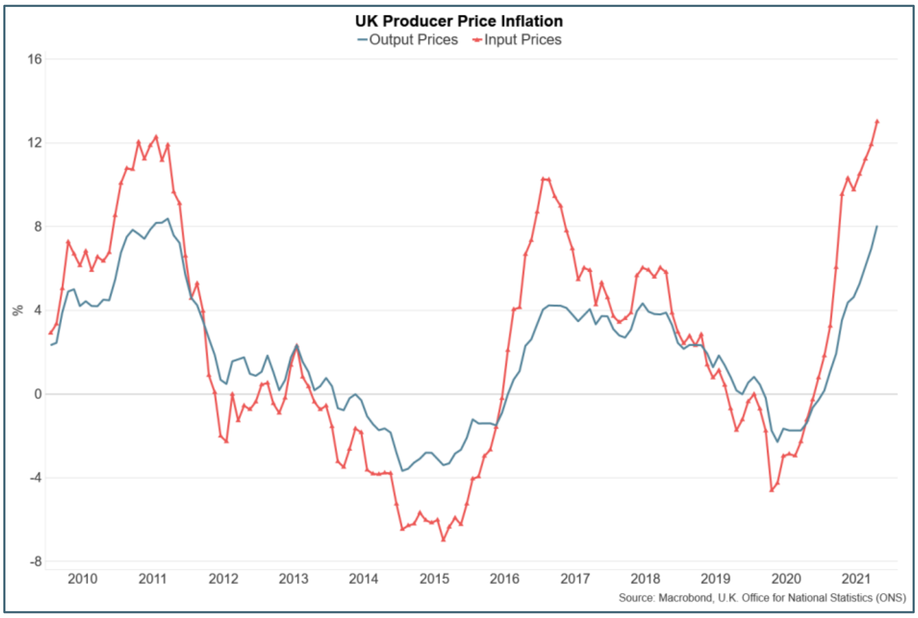
Inflation has risen sharply in the UK and internationally during 2021 to some of its highest levels in a decade as the global economy recovers and rebalances from the shocks to demand and supply during the pandemic to date. UK inflation has risen to 4.2% in October while the rate in the US is 6.2% and is 4.1% in the Eurozone.

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



The rise in inflationary pressures during 2021 reflect a combination of domestic and global factors. At a domestic level, demand for goods and services has strengthened during the year, however base effects in the data have contributed significantly to the pick-up in inflation in recent months as prices this year are compared to lower prices last year which had fallen significantly in the initial stages of the pandemic. Some of the increase will also be driven by policy effects, with temporary cuts to VAT for the hospitality industry now coming to an end.

At a global level, the disruption in supply chains and the feed through of rising input costs into consumer prices has been a key driver. UK input price growth rose to 13% in October, while output price growth rose to 8% suggesting that, while businesses are partly absorbing higher costs, higher costs are passing through to consumers.[37]



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

These drivers of inflation are largely expected to be temporary as base effects in the data moderate and the global economy continues to recover and rebalance enabling current bottlenecks in supply chains to ease. However, most recently the recent sharp rise in energy prices and the feed through to retail gas and electricity prices is expected to generate further upward price pressures in the near term.

The Bank of England forecast inflation to rise above 4% going into 2022 and peak at around 5% in April before gradually easing back toward the Bank's 2% target over 2023. This profile reflects that domestic cost pressures are expected to rise in the near term alongside retail energy prices. However, the level of uncertainty that remains in the economic outlook means there are risks that global supply chain pressures remain persistent while the outlook for domestic price drivers is partly dependent on the pace at which demand in the economy continues to recover.[38]

The rise in inflation has notable implications for household's cost of living and spending power in the short term with real earnings growth expected to remain relatively subdued. Furthermore, current forecasts assume some tightening in monetary policy to ensure inflation is brought back to the 2% target sustainably which would potentially see a rise in interest rates over the coming months which will impact on the costs of certain aspects of debt across households and businesses. At their November meeting, the Monetary Policy Committee (MPC) made no change to monetary policy, maintaining the Bank Rate at 0.1% and the current programme of Quantitative Easing, with their next decision scheduled for mid-December.[39]

GDP Growth Outlook

Scotland's GDP is forecast to return to pre-pandemic levels in the first half of 2022, however supply chain disruption and inflationary pressures risk slowing the pace of recovery over the coming months.

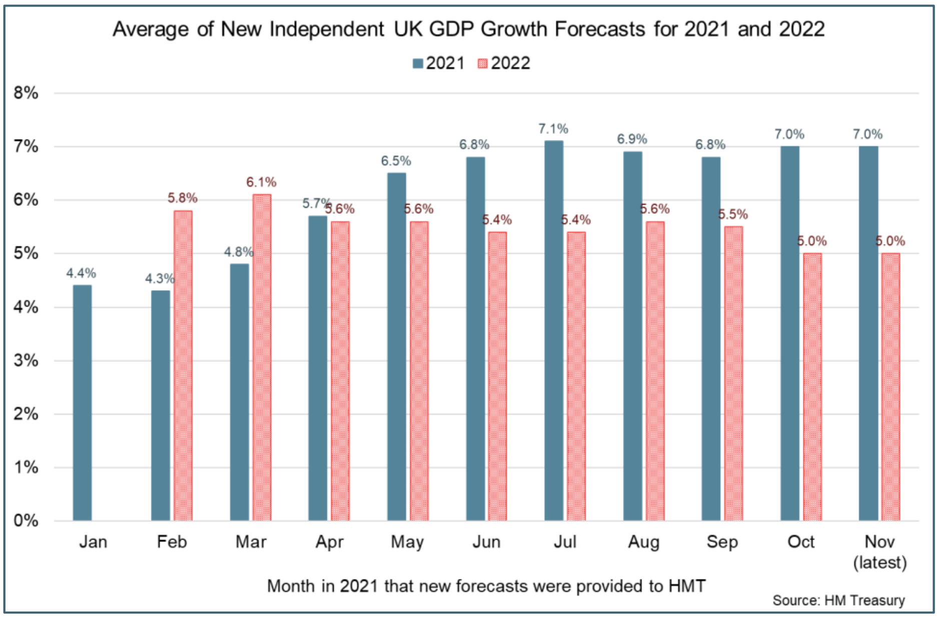
Over the past year, the global economic outlook has strengthened following the introduction of vaccination programmes and the easing of restrictions on domestic and international activity.

In October, the IMF forecast global GDP to grow 5.9% in 2021, easing to 4.9% in 2022.[40] This is similar to latest OECD forecasts of 5.7% in 2021 and 4.5% in 2022.[41] However, the pace and stage of recovery varies significantly across countries. Furthermore, the emergence of

[38] Monetary Policy Report - November 2021 | Bank of England
[39] Bank Rate maintained at 0.1% - November 2021 | Bank of England
[40] World Economic Outlook, October 2021 (imf.org)
[41] OECD Economic Outlook

bottlenecks in global supply chains and a sharp rise in inflationary pressures has softened the pace of recovery in recent months and provides downside risks and increasing uncertainty for the outlook.

These global factors are reflected in latest forecasts for Scotland and the UK. At a UK level, the Bank of England revised down their GDP growth forecasts in November to 7% in 2021 and 5% 2022 (down from 7.25% and 6% respectively in August) reflecting the headwinds which have emerged and the indicators of slower growth in the third quarter of the year.[42] This is in line with the average of new independent forecasts (published monthly by HMT) in November which forecast UK GDP growth of 7% in 2021 and 5% in 2022 and which have also moderated slightly in recent months.[43]



Scotland's GDP in August had recovered to 1.3% below its pre-pandemic level, having fallen over 20% below at the start of the pandemic, showing that there has been strong progress in the recovery to date. In the short term, latest data suggests the pace of growth during the third quarter of this year has slowed compared to earlier in the year when the economy was rebounding from the easing of restrictions and partly reflects the impacts of supply chain disruption weighing on growth. Furthermore, while businesses and households remain optimistic for further recovery over the coming year, the level of optimism has also eased in recent months.

In August, the Scottish Fiscal Commission (SFC) forecast Scotland's GDP to grow 6.7% in 2021 before moderating to 4% in 2022, with GDP returning to pre-pandemic levels in the second quarter of the year.[44] This is broadly in line with forecasts from the Fraser of Allander Institute in

[42] Monetary Policy Report - November 2021 | Bank of England
[43] Official statistics overview: Forecasts for the UK economy: November 2021 - GOV.UK (www.gov.uk)
[44] Scotland's Economic and Fiscal Forecasts – August 2021 | Scottish Fiscal Commission

September which expect growth of 6.5% in 2021 and 4.8% in 2022, and for GDP to return to pre-pandemic levels in April 2022.[45]

Uncertainty in the labour market outlook has increased slightly in recent months as labour shortages in some sectors have emerged while the end of the furlough scheme presents a key step change in the support being provided to employment and incomes. In August, the SFC forecast unemployment could peak at 5.4% in Q4 2021 before gradually falling back to 4.4% at the start of 2023. When the furlough scheme ended at the end of September, there were around 80,000 jobs in Scotland under the scheme. It is too early to say how far this will lead to job losses, however initial survey data for October suggests many furloughed workers have returned to work.

Overall, current supply chain and inflationary pressures are largely expected to be temporary, however longer term the SFC forecast that trend GDP at the start of 2025 will remain 2% lower than in their pre-pandemic February 2020 forecast, illustrating the legacy effects that the economic shock to date is expected to have on the economy. The SFC will publish their next set of forecasts alongside the Scottish Budget on 9 December.

[45] Fraser of Allander Institute Economic Commentary 2021 Q3 | FAI

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Any enquiries regarding this publication should be sent to us at

The Scottish Government
St Andrew's House
Edinburgh
EH1 3DG

ISBN: 978-1-80201-678-9 (web only)

Published by The Scottish Government, November 2021

Produced for The Scottish Government by APS Group Scotland, 21 Tennant Street, Edinburgh EH6 5NA
PPDAS980446 (11/21)