State of the Economy

Office of the Chief Economic Adviser

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Data up to 18 May 2022

Overview

This edition of the State of the Economy presents new analysis on how the economy has been impacted by the three recent economic shocks: Covid, EU Exit and the war in Ukraine. As the economy continues to rebalance from the pandemic, it is facing new and unexpected challenges, with the nature and pace of rising inflation putting significant pressure on household finances with weak consumer sentiment and further raising costs for businesses already dealing with supply-side challenges. This is at the same time as fiscal and monetary policy has begun to tighten, with tax increases coming into effect in April alongside an increase in the energy price cap, and central banks in the UK and elsewhere starting to increase interest rates.

Scotland's GDP has continued to recover from the pandemic, growing 0.4% in February, and is now 1.3% above its pre-pandemic level in February 2020. The removal of remaining Covid restrictions in April marked an important stage in the domestic recovery. However, risks to the recovery are heightening, with latest data showing the UK economy shrank by 0.1% in March, as higher prices started to weigh on trade in the wholesale and retail sector.

Scotland's labour market has remained robust at the start of the year with the unemployment rate falling to 3.2%, (its joint lowest level in the series) and the number of payrolled employees rising to 29,000 above its pre-pandemic level. However, labour market conditions remain tight with low unemployment accompanied by persistently high vacancy rates and demand for staff. This continues to place upward pressure on nominal earnings, which rose by 6.8% over the year to March, however, didn't maintain pace with inflation, resulting in a fall in real earnings.

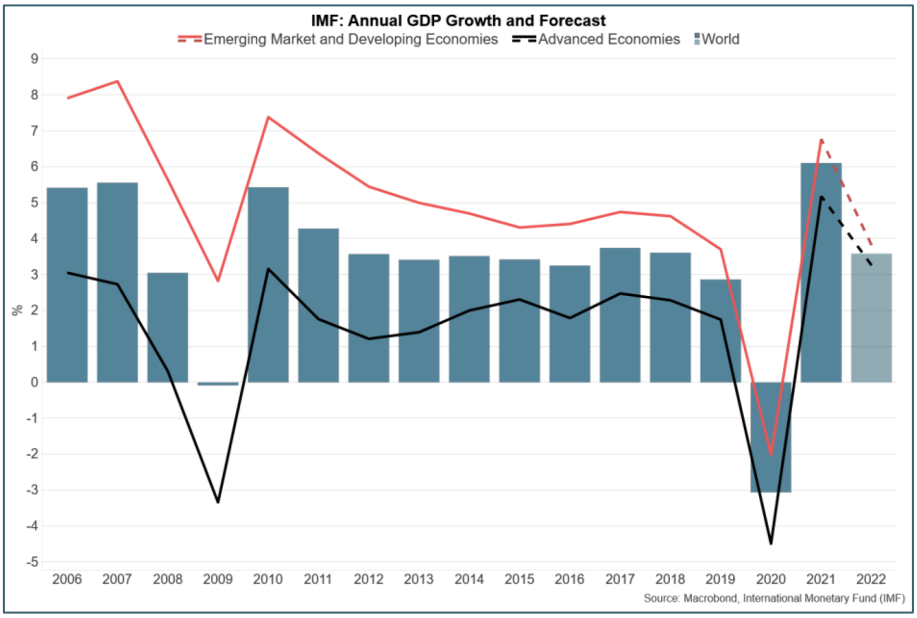
Trading conditions remain challenging for businesses. Bottlenecks in supply chains, in part due to Covid restrictions in China, are proving persistent while the war in Ukraine and the resulting sharp increases in global commodity and energy prices are also exacerbating cost pressures. Our analysis also suggests a drop in trade intensity and openness in the UK economy which may also be contributing to higher input costs post EU exit. In addition, business are also facing upward pressure on wage costs, with ongoing staff shortages particularly concentrated in specific sectors of the economy such as in Accommodation & Food services.

Looking ahead, the economic outlook has weakened rapidly since the turn of the year. Levels of consumer and business sentiment have declined as cost of living challenges have sharpened and expectations of continued higher inflation and lower growth have set in. This is reflected in the latest forecasts from the Bank of England and the International Monetary Fund (IMF), warning of a risk of recession. The Scottish Fiscal Commission (SFC) due to present its latest forecast of the Scottish economy on 31 May. Regardless of whether the economy formally enters a technical recession, it is clear we are entering a difficult period for economic growth, household incomes, and living standards.

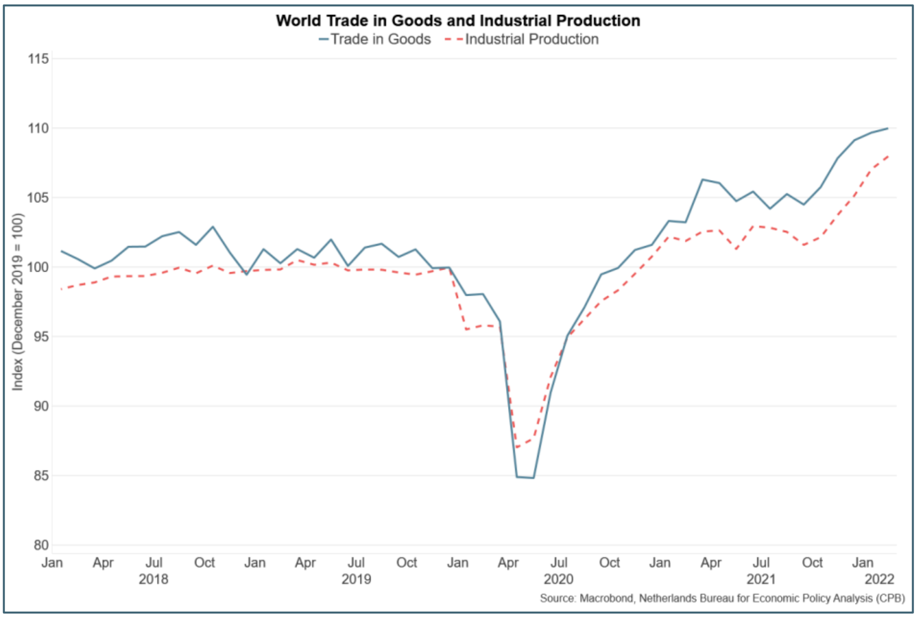
Global Economic Context

The situation in Ukraine has presented a new shock to the global economy following the economic shock from the pandemic, lowering GDP growth forecasts and leading to higher inflation.

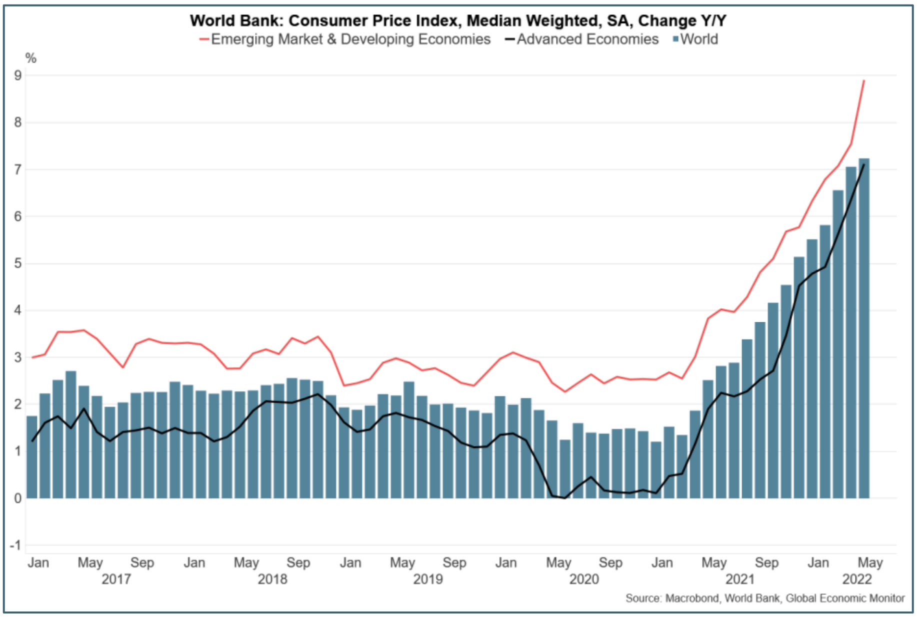
The global economy is continuing to recover from the economic shock of the pandemic. In 2021 global output grew 6.1%, rebounding robustly from the 3.1% fall in 2020, as economic activity strengthened with the easing of Covid restrictions.



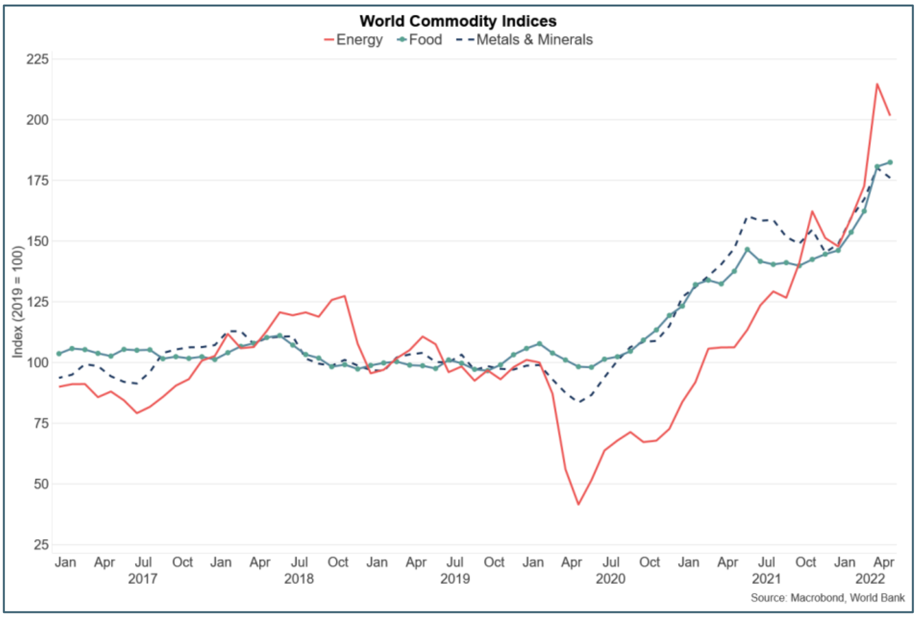
Global industrial production and trade in goods also continued to strengthen into February 2022, however the economic outlook has weakened significantly as a result of the situation in Ukraine and the significant sanctions imposed on the Russian economy.



Global inflation rose sharply during 2021, reflecting a combination of rising energy prices alongside disruption in global supply chains as the supply side of the economy continued to readjust to the rebound in global demand following international easing of COVID restrictions.



The war in Ukraine has exacerbated these inflationary pressures reflecting the importance of Ukraine and Russia in the production and supply of a range of commodities particularly in energy (oil and gas), various agricultural products (notably wheat) and an array of precious metals.



Furthermore, the use of Covid-related restrictions continues to impact on economic activity and trade flows. The recent lockdown restrictions in China to contain outbreaks of Covid is expected to further exacerbate existing supply disruptions and inflationary pressures.

The combination of the situation in Ukraine, alongside the ongoing disruption to supply chains, has resulted in a weaker economic outlook than had previously been expected, with higher rates of inflation and slower GDP growth impacting on the recovery from the pandemic. The IMF now forecast global GDP growth to slow from 6.1% in 2021 to 3.6% in 2022, 0.8 percentage points lower than forecast in January.[1]

How might sanctions on trade with Russia affect the economy?

The situation in Ukraine has caused a significant shock to the global economy. The March Monthly Economic Brief considered the channels through which it is impacting on the economy, from the direct impact on trade, through to impacts on commodity prices which impact on domestic inflation and create challenges for households through increases in the cost of living.

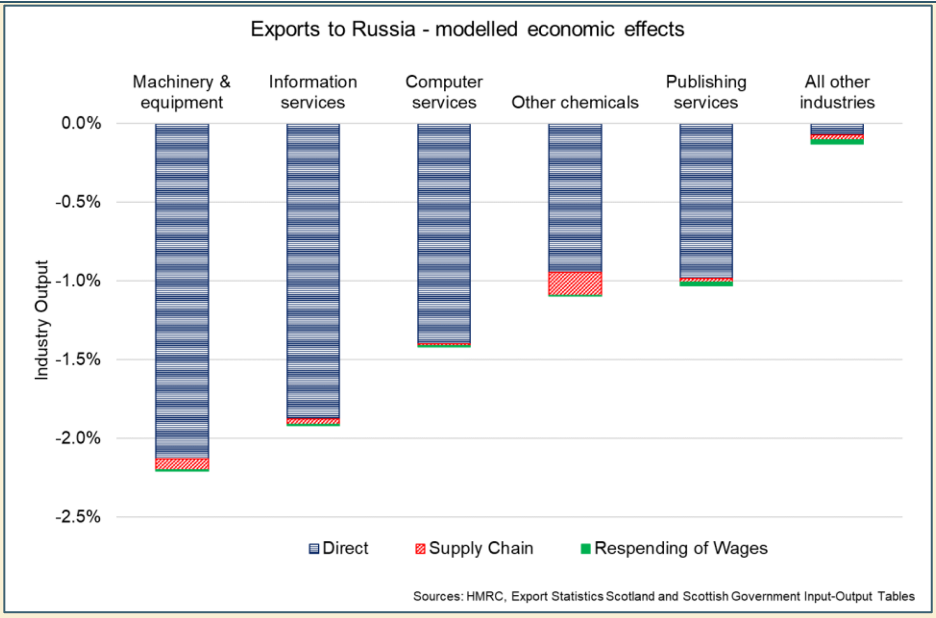
The analysis below considers in more detail the first of these issues, and in particular how different industries may be affected. The direct impacts on the Scottish economy will be seen through trade, both through reductions in exports to Russia due to sanctions, and a reduction in the availability of and an increase in the price of many global commodities that are exported by Russia and Ukraine, including energy, foodstuffs, and metals.

Using the latest Scottish Government Input-Output model of the economy, it is possible to estimate the indirect Scottish supply chain impact on the Scottish economy of the lost exports. This is a partial measure of the overall impact, but allows a more detailed industrial analysis to be carried out.

Prior to 2022, Scotland exported around £300 million of goods a year to Russia. These exports were estimated to support Scottish GDP by around £250 million, or around 0.2%. Around £170 million of the impact is the direct impact on output from reduced exports, with the remaining £80 million a result of the indirect impacts on supply chains and from reduced wages in the wider economy.

Although the overall impact on the economy is small, it is more pronounced for certain sectors. In particular, manufacturing of machinery and equipment and information services are two of the most affected industries in Scotland, although both see their output only fall by around 2%. The chart shows the top five affected industries.

[1] World Economic Outlook, April 2022: War Sets Back The Global Recovery (imf.org)



This loss in output is likely to have an adverse impact on employment, although it will be difficult to identify this directly due to the wide pressures that the labour market is currently facing. Overall, the analysis suggests that around 3,500 jobs were being supported by exports to Russia.

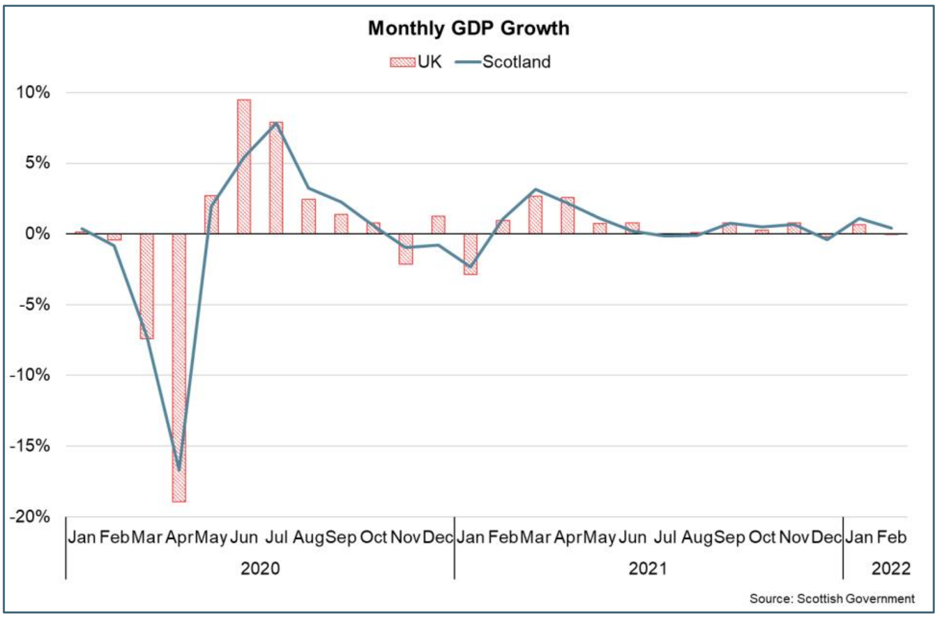
Scottish Output

Scotland's economy has continued to recover at the start of 2022 with output from consumer facing services growing as Covid restrictions have eased.

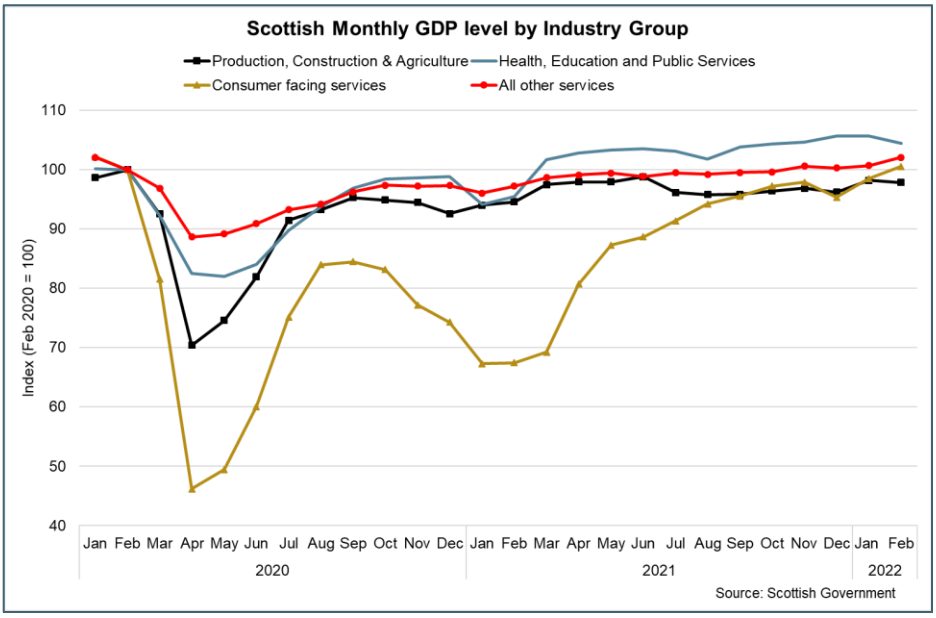
The start of 2022 has seen the removal of Covid restrictions which had been tightened during the Omicron wave, and the remaining Covid legal requirements for businesses and services providers, while international travel restrictions for people coming to Scotland has also ended.

In February, Scottish output grew by 0.4% (UK: 0.0%) and GDP is now 1.3% above its pre-pandemic level in February 2020.[2]

[2] Monthly GDP Estimate: February 2022: https://www.gov.scot/publications/monthly-gdp-february-2022/



Growth in February was driven by the services (+0.7%) and production sectors (+0.3%) while construction sector output fell (-0.1%).



Within the services sector, there continued to be a strong pick-up in growth from consumer facing services which increased by 2.1% over the month in February. This was driven by 8.1% growth in the Accommodation and Food sector, which has been supported by the gradual removal of restrictions since the start of the year. Elsewhere, in the service sector, output in Health, Education and Public services fell by 1.2% during February as activity around Test and Trace eased back (though the industry remains 4.4% above its pre-pandemic level) while output in all other services grew by 1.3%.

Output across the production sector grew by 0.3% in February and eased back to 3.4% below its pre-pandemic level of February 2020. Growth was driven by electricity and gas supply (+4.7%) which tends to be volatile on a monthly basis and offset smaller falls across the sector, with manufacturing output falling 0.6%. Output in the construction sector is estimated to have fallen by 0.1% and in the agriculture sector, output fell by 8.1%. Activity in this group of industries continues to be adversely impacted by ongoing global supply chain disruptions, impacting the cost and availability of materials.

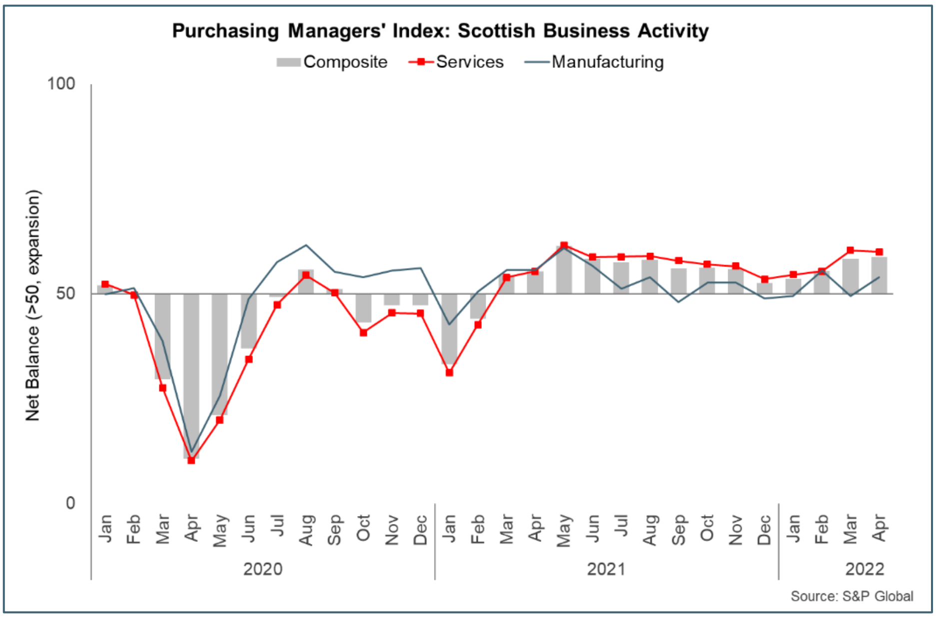
More recent UK GDP data indicates that the UK economy contracted by 0.1% in March driven primarily by a fall in services output where wholesale, retail and repair of vehicles fell by 15.1% and emphasises the ongoing challenges to growth at the end of the first quarter. Equivalent data for Scotland will be published on 1 June.[3]

Business Activity

The direct impacts of the pandemic on business activity have eased, however significant headwinds persist from ongoing supply challenges and intensifying inflationary pressures.

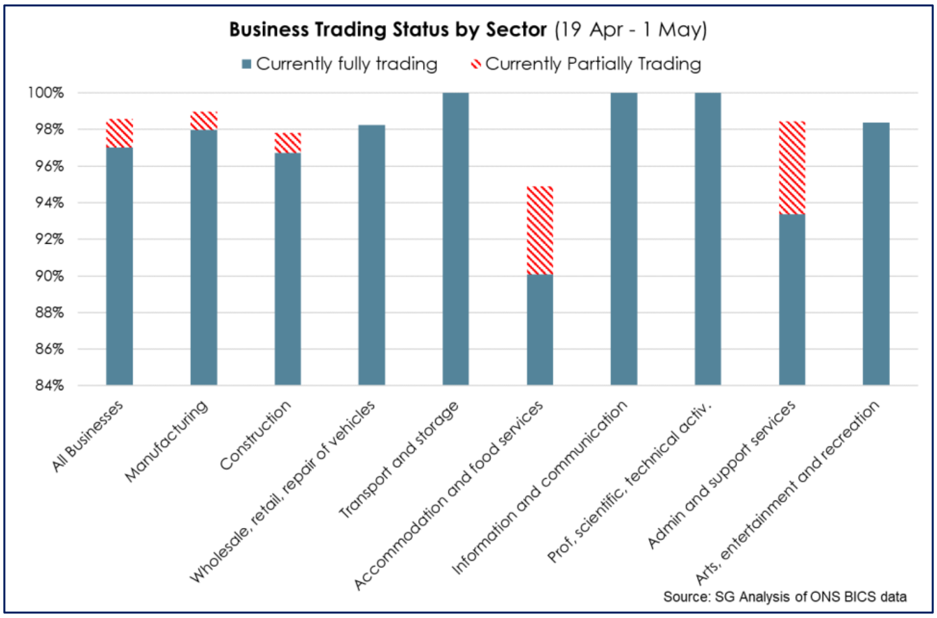
The Purchasing Managers Index (PMI) business survey signalled that Scottish business activity growth accelerated for a fourth consecutive month in April (58.9, its highest rate since May 2021), with the latest momentum supported by a renewed pick-up in manufacturing production, while services output remained strong.[4]

Although the rate of growth slowed marginally in the services sector, panellists cited that reduced pandemic restrictions continued to have a positive impact while producers in the manufacturing sector noted an upturn in orders. However, inflationary pressures and supply chain challenges intensified in April, resulting in prices charged rising to survey records and future activity expectations falling.



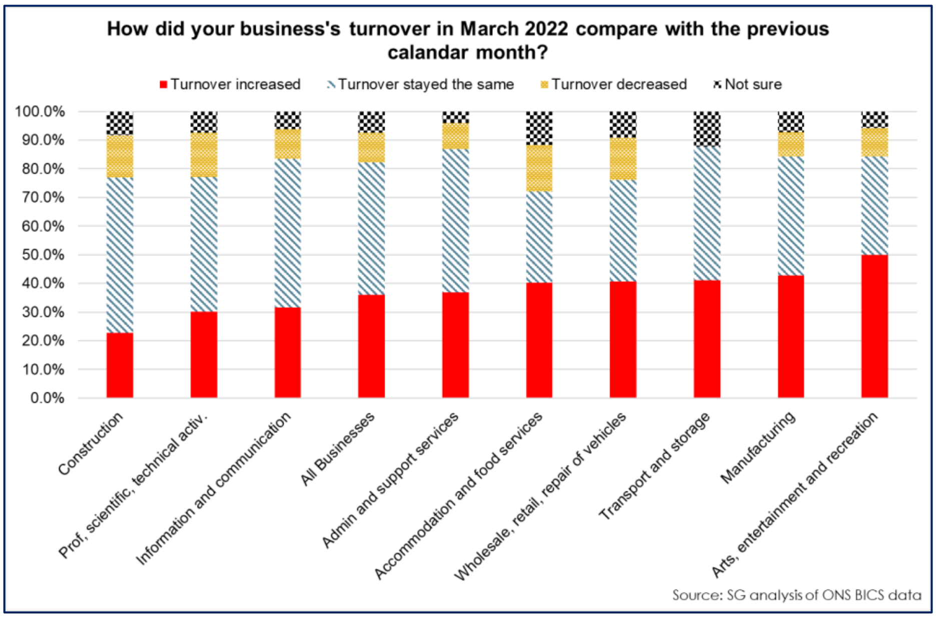
[3] GDP monthly estimate, UK - Office for National Statistics (ons.gov.uk)
[4] RBS Purchasing Managers Index: 3584a89617ad452f9e1370a1f294fa99 (markiteconomics.com)

Strengthening business activity has also been reflected in improvements in business trading capacity, though there continues to be variation across sectors. At the beginning of May, business survey evidence signalled that all businesses in the Information and Communication, Transport and Storage and Professional, Scientific and Technical Activities sectors were trading fully.[5] However, lower capacity continued in parts of consumer facing services with 90% reporting as fully trading in the Accommodation and Food Services sector.



There were also indications of improved business turnover at the end of March, with 24% of businesses reporting to be trading with reduced turnover compared with normal expectations, the lowest rate in the time series and down from around 30% at the beginning of 2022. Similarly the proportion of all firms reporting that turnover had improved, increased to 14%, up from around 8%, while over 50% reported that turnover had not been affected.[6]

[5] BICS weighted Scotland estimates: data to wave 55 - gov.scot (www.gov.scot)
[6] BICS weighted Scotland estimates: data to wave 55 - gov.scot (www.gov.scot)

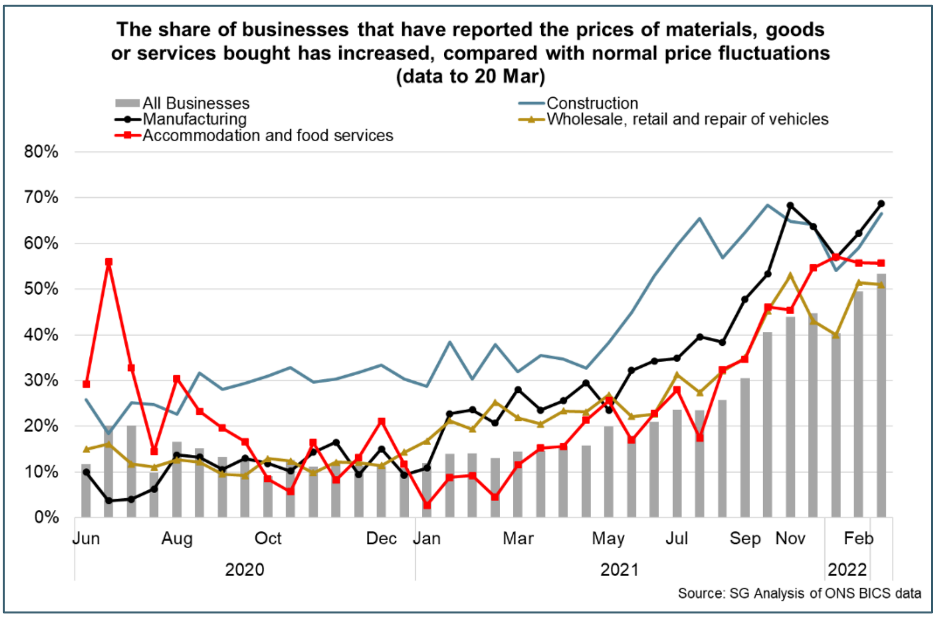


When considering turnover in March 2022, relative to February 2022, 36% of all businesses reported that turnover had increased, compared to 10% reporting turnover had decreased and 46% reporting that turnover had stayed the same. Challenges impacting business turnover at the beginning of May include cost and shortage of labour and cost of materials amongst others.

Looking to the month ahead, 18% of all businesses expected turnover to increase in April, while 58% expect it to stay the same, 15% expected turnover to decrease.[7]

However, inflationary pressures have continued to intensify for businesses through higher energy prices, costs of materials and supply chain disruptions. BICS data for March, showed that 53% of businesses reported that input prices increased more than normal, its highest rate in the time series and up from 49% in February. Furthermore 59% of businesses currently trading reported that input prices had increased compared to the previous month. Higher than normal input price increases remained most widespread in manufacturing (69%), construction (67%) and accommodation and food services (56%).[8]

[7] BICS weighted Scotland estimates: data to wave 55 - gov.scot (www.gov.scot)
[8] BICS weighted Scotland estimates: data to wave 55 - gov.scot (www.gov.scot)

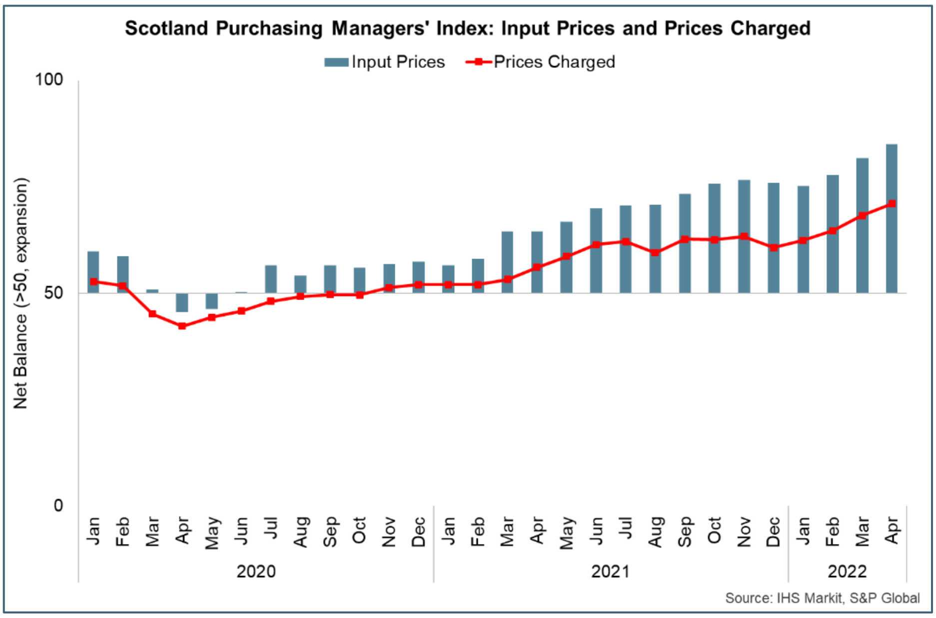


Scottish PMI data also showed the indicator for input cost inflation continued to rise into April, and peaked at a new record high for the third consecutive month (85.0).[9] Respondents noted a range of factors driving this including higher fuel, energy, material, food and labour costs with Brexit, the pandemic and the situation in Ukraine adding further pressures.

This was also the case for SMEs with Scotland's Small Business Index for Q1 2022 reporting that 88.2% of respondents reported increasing overheads, predominantly due to fuel, utilities and inputs, while only 1.6% reported they had fallen.

As a result, firms have continued to pass higher costs through to customers, with the PMI prices charged indicator also increasing to a record high for the fourth consecutive month (71.0). Further business survey data for Q1 2022 indicates that 70% of businesses expected to raise their prices over the next three months as cost pressures hit a five-year high for construction, manufacturing and tourism.[10]

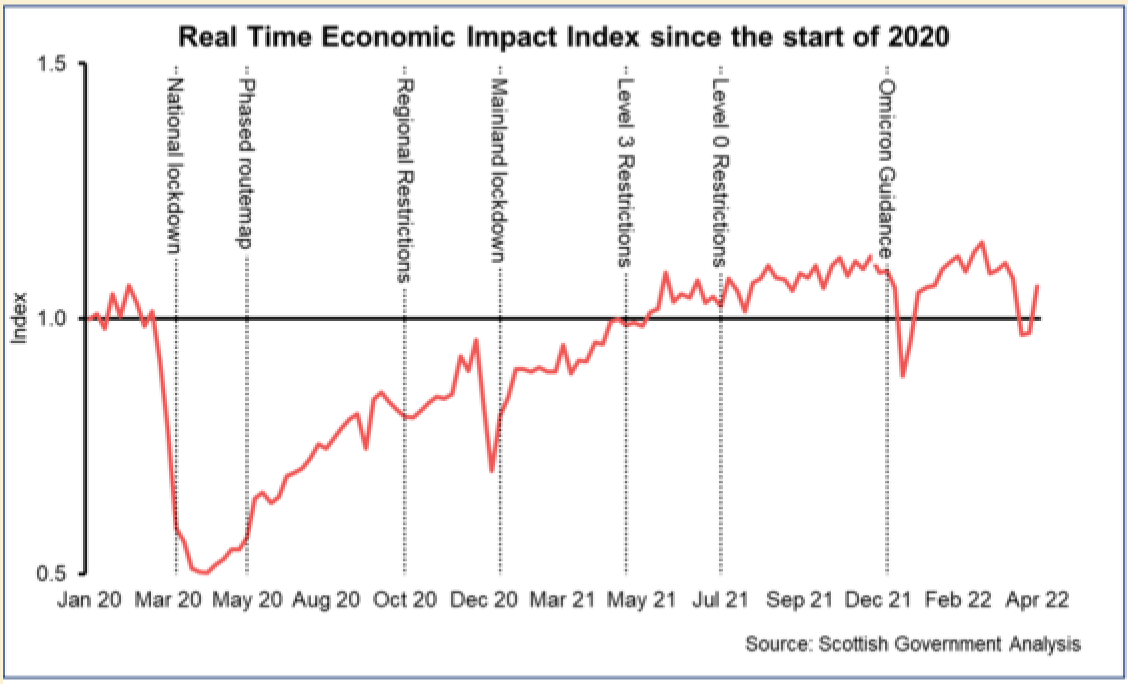
[9] RBS Purchasing Managers Index: [3584a89617ad452f9e1370a1f294fa99 (markiteconomics.com)]
[10] [Quarterly Economic Indicator - Scottish ChambersScottish Chambers]



Monitoring the economic impact of COVID-19 in real time

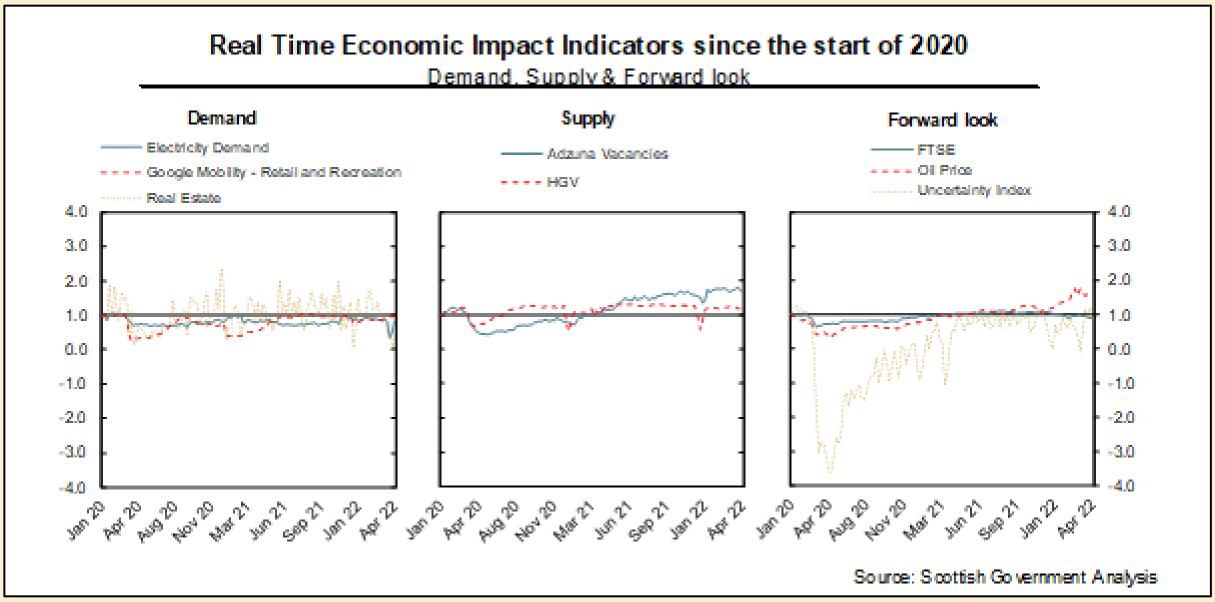
In the July 2020 Monthly Economic Brief we set out our Real Time Economic Impact Index, which we used to monitor the economic impact COVID-19 was having on the economy on a weekly basis. The quickly changing nature of the pandemic and the government response meant that traditional measures of the economy, which do not provide a real time assessment but instead look over longer periods such as a month or a quarter, were less timely.

The Real Time Economic Impact Index used a set of high-frequency indicators to report on economic impacts on a weekly basis, looking across three areas: demand, supply, and future expectations.



As can be seen in the chart, the Real Time Economic Impact Index performed well in tracking the impacts of the pandemic

It deteriorated *before* lockdown was introduced, highlighting the importance of changing behaviour and expectations, falling heavily (significantly below 1) as the lockdown was then in place. The Index then recovers but deteriorates each time there are new stages of restrictions, although to a lesser extent each time. The index recovered to pre-covid levels during 2021, and then dipped again following the tightening of restrictions in response to the Omicron variant.



Looking across the different indicators it can be seen that many of the individual indicators have returned to pre-pandemic levels, whilst supply indicators have stabilised above these levels. Greater HGV traffic likely reflects the increased use of online retail, whilst the elevated vacancy data likely reflects labour market shortages discussed in more detail in the Labour Market section.

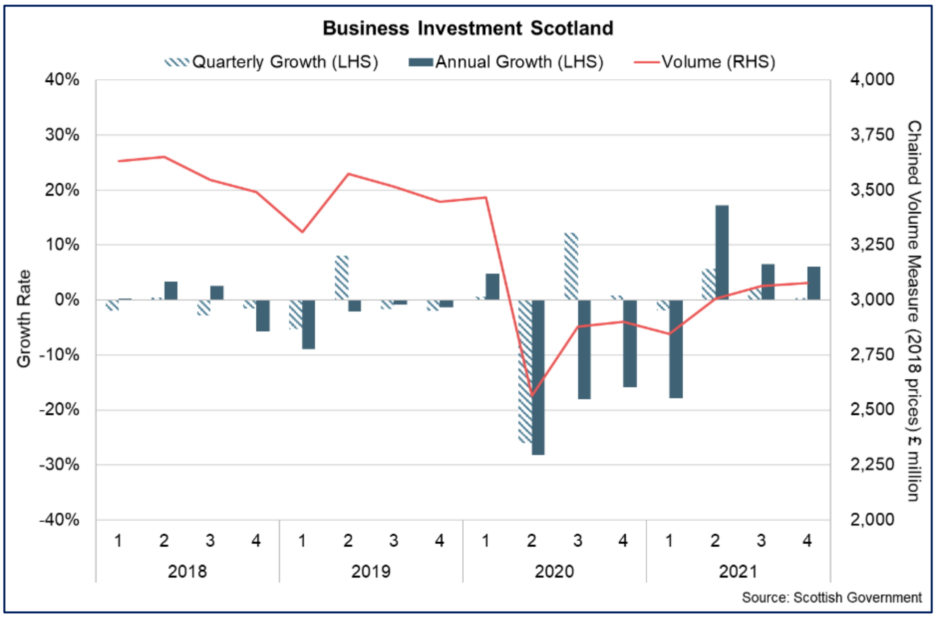
Whilst indices like this have been useful in monitoring the real time impacts of COVID-19, as time passes there is considerable uncertainty around both the best choice of variables and the strength of the link between the performance of the index and that of the economy. As we move into a new phase of the pandemic, it becomes difficult to disentangle possible structural changes from ongoing economic harm being caused by COVID-19.

With the reduced need for real time monitoring of the economy, the focus is shifting back to measuring economic impacts by traditional measures.

Business Investment

The uncertainty during the pandemic, supply chain disruption and inflationary pressures have resulted in challenging conditions for business investment.

Although business investment continued to strengthen over 2021 it remains subdued. Latest data for Q4 2021 showing growth of 0.4% over the quarter and 6.1% over the year. In comparison to the pre-pandemic level in the fourth quarter of 2021, the volume of business investment remains £369 million, or 10.7% below and has been slower than other indicators in recovery to pre-pandemic levels.[11]



Latest business survey data continues to present a mixed picture for business investment, likely reflecting the ongoing uncertainty in the outlook for businesses and wider cost pressures which have emerged and the different challenges which sectors are facing.

In the first quarter of 2022, there have been signs of strengthening growth in business investment across construction, manufacturing, and financial and business services, while investment in retail and wholesale remained negative and tourism firms expect to cut back on investment.[12] In March, BICS data shows that over half of businesses (51%) report that capital expenditure has not been affected compared to normal expectations for the time of year. However, 9% of businesses reported that capital expenditure was lower than normal and 10% reported capital expenditure is higher than normal (both at their strongest points in the time series).[13]

At the beginning of May, 16% of all businesses expect capital expenditure will increase in the next three months while 43% expect it to remain the same, 9% forecast a decrease and an additional 20% are not sure. When asked what would limit business capital expenditure in April

[11] GDP Quarterly National Accounts: 2021 Quarter 4 (October to December) - gov.scot (www.gov.scot)
[12] scc qei template (scottishchambers.org.uk)
[13] BICS weighted Scotland estimates: data to wave 55 - gov.scot (www.gov.scot)

2022, 51% of all businesses were not expecting any limits to capital expenditure while 16% responded that uncertainty about demand or business prospects would be a limiting factor.[14]

Trade

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. Trade has, however, shown signs of strengthening over 2021 as the impacts of the pandemic eased.

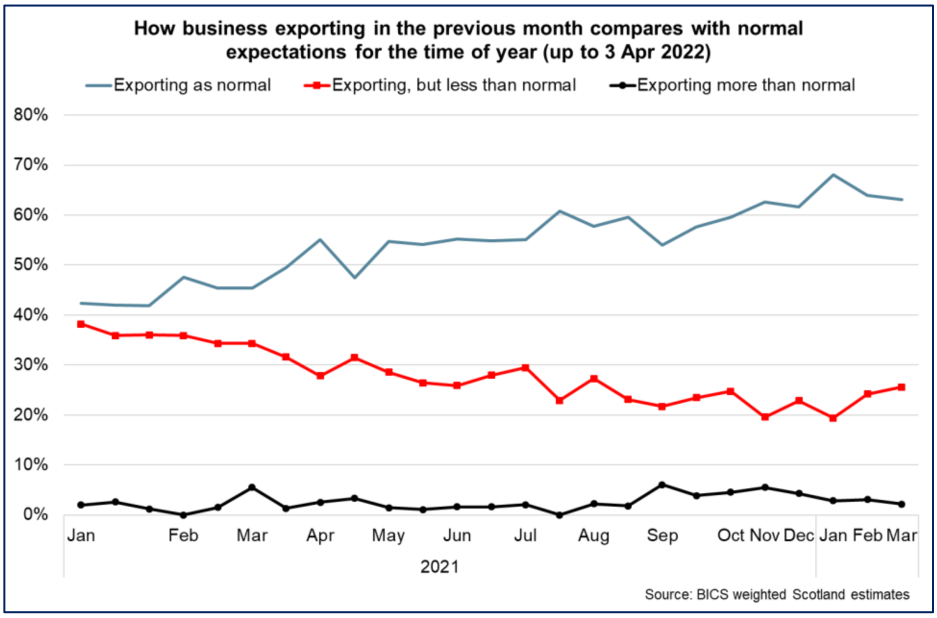
Compared to 2020, Scotland's goods exports (including oil and gas) increased by 1.6% to £27.0 billion in 2021, although they remained 20% lower compared to 2019 prior to the pandemic. The fall compared to 2019 was driven by a fall in exports of oil and gas which decreased by 46.9% (down £6.5 billion). When this is excluded, Scotland's goods exports fell 1.3% over the period.[15]

Over 2021, exports of chemicals (+22.4%) and manufactured goods (+11.4%) increased notably compared to 2019, however there were decreases in exports of food (-4.8%), beverages (-6.6%) and machinery and transport (-9.8%).

Compared to 2020, Scotland's goods imports in 2021 (including oil and gas) increased by 24.1% to £24.8 billion and increased by 4.8% compared to 2019 prior to the pandemic. The increased value of imports was driven by oil and gas (+119.2% compared to 2019) and when excluded, international goods imports rose by 1% over the year and fell 10.8% compared to 2019.

[14] BICS weighted Scotland estimates: data to wave 55 - gov.scot (www.gov.scot)
[15] UK regional trade in goods statistics: fourth quarter 2021 - UK Trade Info

More recent business survey data for April indicates trading conditions remain challenging for businesses. 63% of Scottish businesses report to be exporting as normal for the time of year while the share reporting they are exporting less than normal has risen to 26%, up from around 20% at the start of the year. [16]



This is likely to reflect ongoing supply chain disruptions which are expected to be exacerbated by the situation in Ukraine and the recent Covid lockdown restrictions in China. In April, 41% of exporters and 50% of importers reported facing changes in transportation costs (down from 48% and 57% respectively in March) while 26% of exporters and 39% of importers reported facing challenges with custom duties and levies (down from 33 and 40% respectively in March).[17]

How has Scotland's trade in goods with the EU been affected by the new UK-EU trading arrangement?

On 1st of January 2021, trade between the UK and EU became governed by the new trading agreement, the Trade and Cooperation Agreement (TCA). While not introducing tariffs on trade with the EU, this was still expected to increase the cost of trading with the EU for Scottish businesses due to additional checks and reporting requirements.

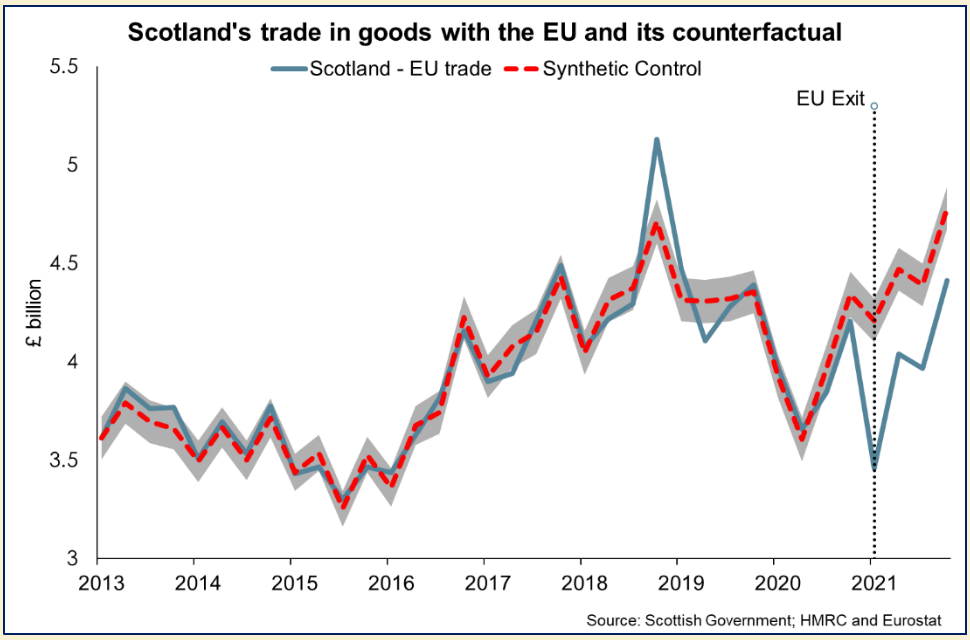
To quantify the impact of the new relationship on Scotland's trade with the EU, a counterfactual (the synthetic control) is estimated to provide an indication of what would have happened to trade if there had been no change in the trading relationship with the EU. The synthetic control is a weighted average of similar countries which closely track Scotland's trade with the EU before the implementation of the TCA. The divergence between the

[16] BICS weighted Scotland estimates: data to wave 55 - gov.scot (www.gov.scot)
[17] BICS weighted Scotland estimates: data to wave 55 - gov.scot (www.gov.scot)

synthetic control and real Scotland allows an empirical estimate of the TCA impact. The analysis assumes that the impact of the pandemic or other common shocks on trade with the EU is already reflected in the counterfactual. The analysis only covers trade in goods as data on Scotland's trade in services in 2021 is not available. It also excludes trade in oil & gas which are more influenced by overall changes in demand for fuels rather than TCA-related changes. No trade with the rest of the UK or Non-EU partners is included in this analysis.

The estimates show that Scotland's trade in goods with the EU was lower in 2021 than it otherwise would have been under continued EU membership. When the impact on imports and exports are estimated separately, the TCA is found to have a statistically significant effect on imports from the EU, an effect which has persisted in each quarter of 2021. The estimates suggest that imports from the EU in 2021 were 18% to 25% lower than they otherwise would be, equivalent to between £1.7 and £2.5 billion in cash terms. The central estimate suggests that imports have been 22% lower (or £2.1 billion lower in cash terms). Meanwhile the model finds a significant impact of EU Exit on exports to the EU in the first quarter of 2021, when EU exports were 9% to 14% lower than the counterfactual, equivalent to between £200 to £300 million in cash terms. The model finds no significant impact of EU Exit on exports to the EU beyond the first quarter.

The chart below shows that Scotland's trade in goods with the EU has diverged from its counterfactual. This takes into account the shortfall in imports between Q1 and Q4 2021, and the shortfall in exports in Q1 2021. Overall, the central estimate shows that during 2021 trade in goods with the EU was 12% lower (or £2.3 billion in cash terms). The estimated shortfall in trade with the EU ranges from 10% to 14%, or £1.9 billion to £2.7 billion in cash terms. The effect is driven primarily by lower imports from the EU.



These findings are consistent with the research by LSE CEP[18] and UK Trade Policy Observatory[19] that found a small and temporary effect of the TCA on UK exports to the EU and a persistent decline in EU imports. The CEP study also found a sharp drop in the number of varieties/products exported to the EU while exports of high-value products have increased, supporting recovery in aggregate EU exports in 2021.

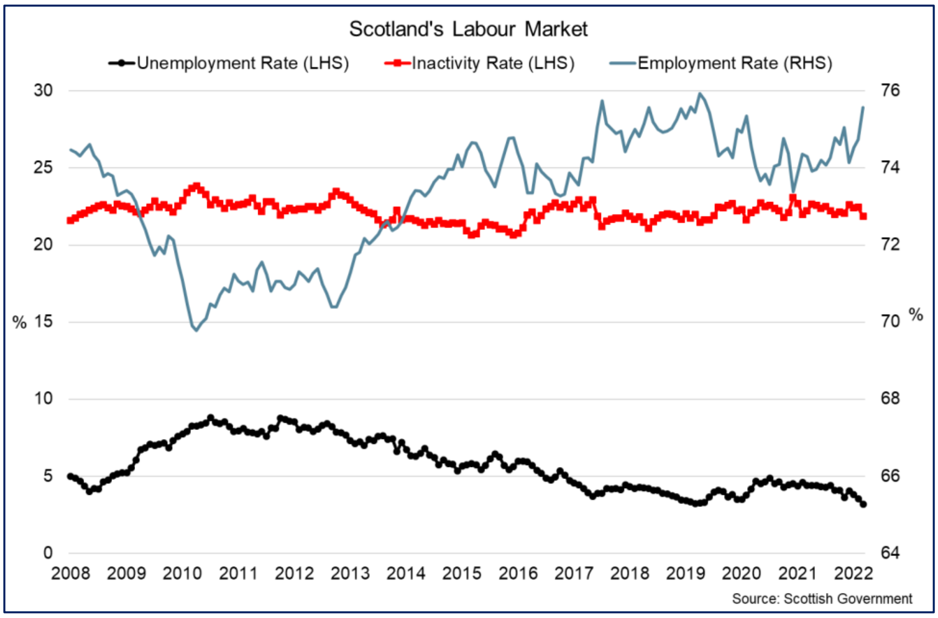
Robustness checks for imports (the main driver of the overall impact) suggest that the estimated gap is not affected by any specific country included in the comparator. Some differences in estimates are obtained when the policy date is backdated but all estimates follow the same pattern in 2021. Finally, the gap in imports becomes insignificant when some sectors are excluded from the total which may be expected if the TCA has affected some sectors more than others.

Labour Market

The labour market is tight: high levels of vacancies, low unemployment and shortages of workers affecting many sectors.

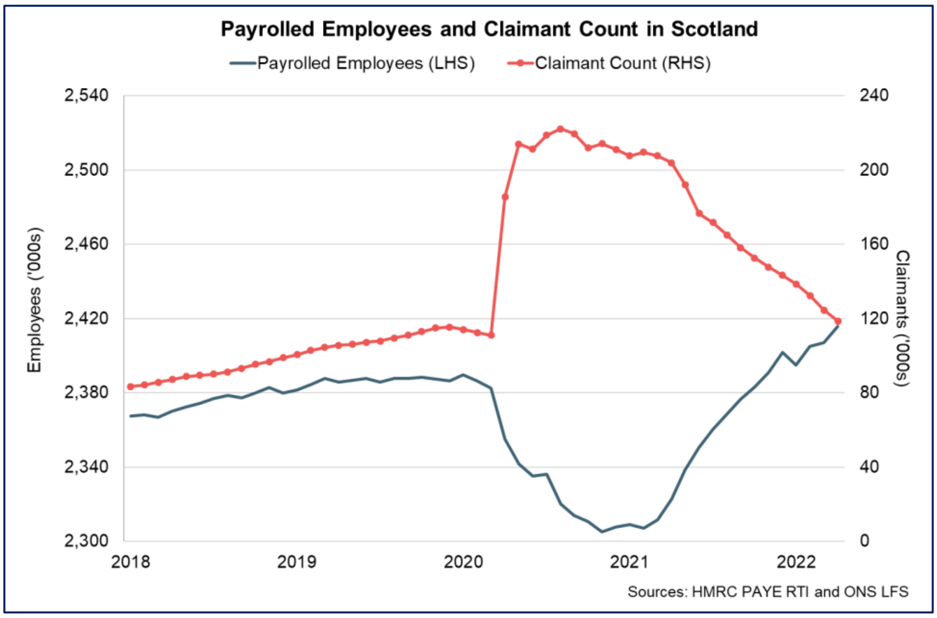
Employment and Unemployment

The latest labour market statistics for January to March 2022 in Scotland show there was 2.682 million people in employment (rate of 75.6%, up 1.3 percentage points over the year), 88,000 people unemployed (rate of 3.2%, down 1.2 percentage points over the year) and 749,000 people economically inactive (rate of 21.9%, down 0.3 percentage points). [20]



[18] UK trade in the wake of Brexit - UK in a changing Europe (ukandeu.ac.uk)
[19] Post-Brexit: UK Trade in Goods « UK Trade Policy Observatory (sussex.ac.uk)
[20] Labour market statistics - gov.scot (www.gov.scot)

Wider labour market indicators showed signs of further strengthening in April. Pay As You Earn (PAYE) Real Time Information flash estimates indicate the number of payrolled employees in Scotland increased by 9,000 in April to 2.42 million.[21] Compared with the same month the year before, the number of employees had risen 4.0% and compares with a rise of 4.2% in the UK over the same period.



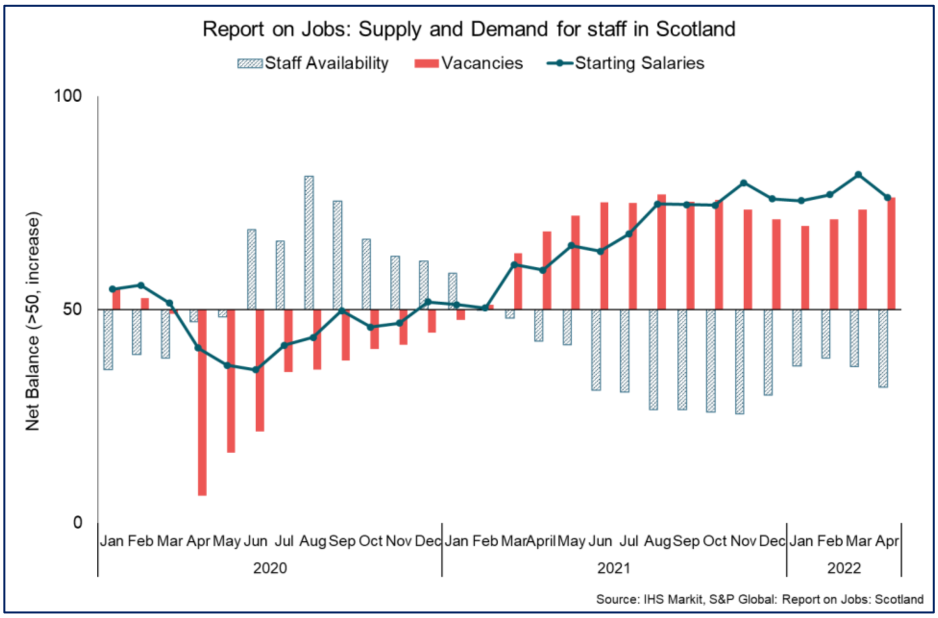
Scotland's Claimant Count (the number of claimants of Job Seekers Allowance and claimants of Universal Credit claiming principally for the reason of being unemployed) also continued its downward trend in April, down 4.8% (6,000) over the month to a claimant count rate of 3.9%. Overall, the claimant count has fallen 47% from its peak in August 2020 and 25% since September when the furlough scheme ended. However, it remains 5.5% higher than its pre-pandemic level in February 2020.[22]

Demand for staff

Business surveys have also signalled that labour market tightness has persisted into the start of the second quarter of 2022 with strong demand and declining availability placing upward pressures on pay. The latest Report on Jobs signalled that overall demand for staff (vacancies) continued to grow in April (76.3, up from 73.4 in March) with demand for both permanent and temporary staff increasing over the month.[23]

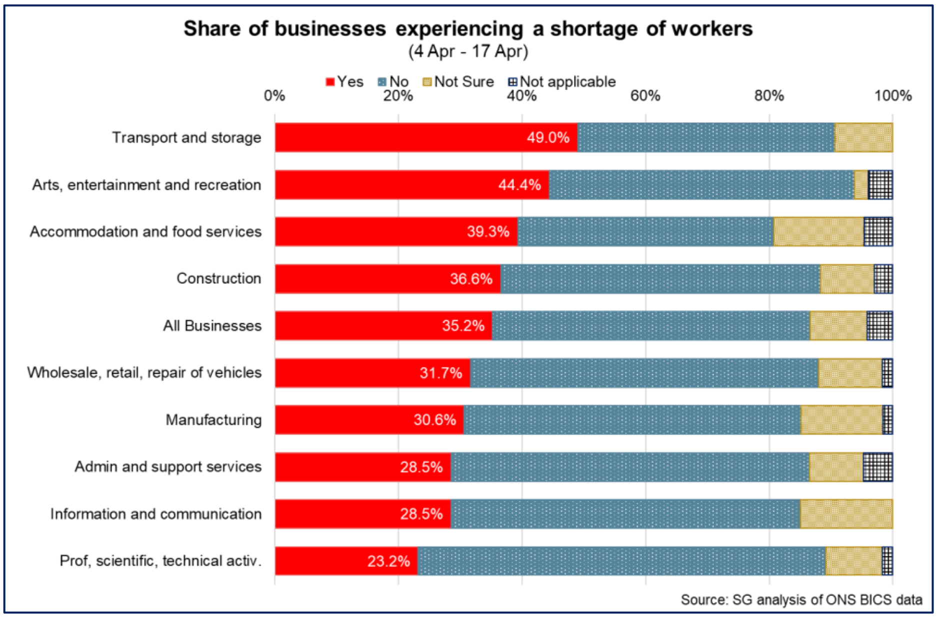
Supply side challenges in the labour market have also continued with candidate availability (labour supply) continuing to fall and the rate of decline the sharpest of 2022.

21 Earnings and employment from Pay As You Earn Real Time Information, UK - Office for National Statistics (ons.gov.uk)
22 Scotland data (not seasonally adjusted) JM22 - Office for National Statistics (ons.gov.uk)
23 Royal Bank of Scotland Report on Jobs – April 2022 | NatWest Group



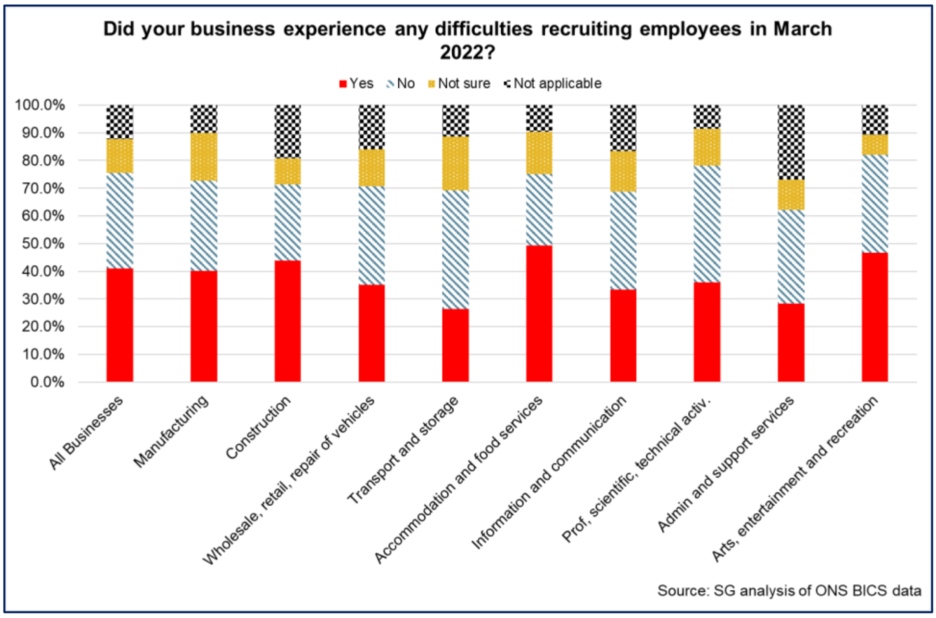
Adzuna online vacancies data also signal that strong demand for staff continued at the beginning of May, with online job vacancies 44.1% higher than in February 2020.[24] The strength in demand for staff, coupled with low unemployment, falls in candidate availability and anecdotal evidence of challenges in recruiting the necessary staff, meant upward pressure on rates of pay elevated in April, with both starting salaries and wages increasing rapidly.

Labour shortages continue to affect a range of sectors with 35% off all businesses experiencing a shortage of workers in April. The overall share has remained broadly stable since the start of the year and remains most notable in transport and storage (49%), arts, entertainment and recreation (44%), and accommodation and food services (39%).[25]

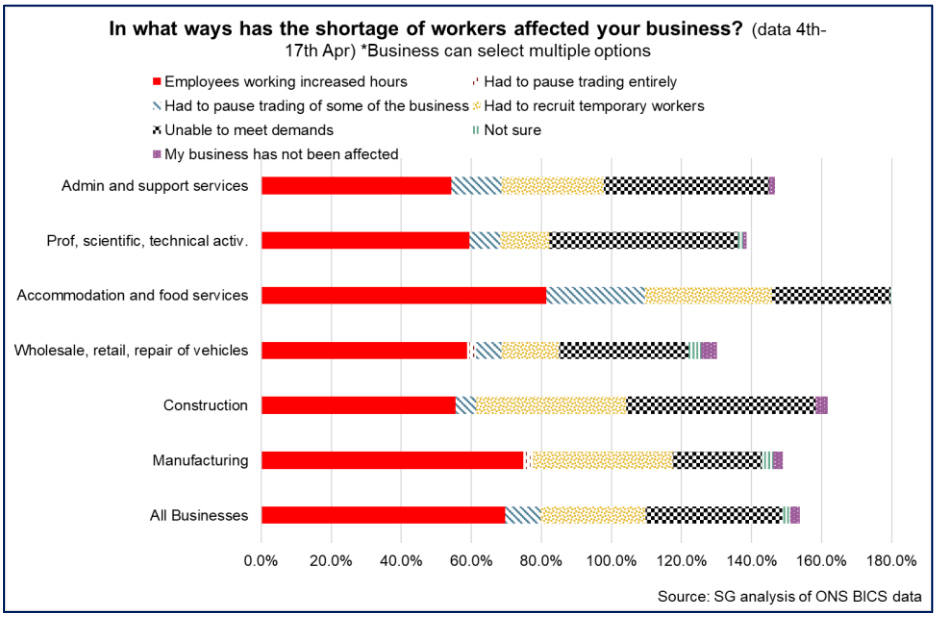


24 Online job advert estimates - Office for National Statistics (ons.gov.uk)
25 BICS weighted Scotland estimates: data to wave 55 - gov.scot (www.gov.scot)

Similarly, 41% of all businesses in March, reported difficulties in their ability to recruit employees. The share has remained broadly stable since the beginning of the year, however, is down from 47% in October, while the share of businesses reporting that they did not have difficulties in recruiting employees was 34%, (up from with 22% in October).[26]



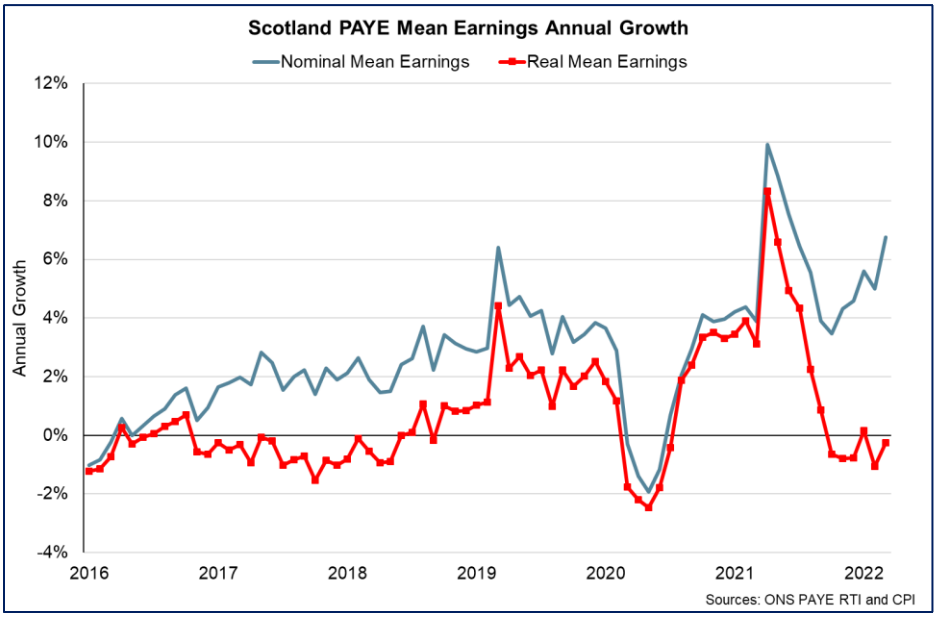
Furthermore, there is some evidence that worker shortages is impacting business trading ability. Of those experiencing staffing shortages, 10% reported having to pause trading some of the business, 39% were unable to meet business demands and 70% reported that existing employees had to work increased hours. Additionally there is sectoral variation with 28% of those in the Accommodation and Food services sector that have a shortage of workers reporting that they have had to pause trading some of the business, compared to 6% in the construction sector.



[26] BICS weighted Scotland estimates: data to wave 55 - gov.scot (www.gov.scot)

Earnings

Mean PAYE monthly pay growth has continued to stabilise at the start of 2022 following significant volatility during the pandemic when mean pay initially fell sharply, strengthened over the course of 2020 and rebounded back above its pre-pandemic level in August 2020.[27,28]



Latest data show mean monthly pay grew 1.0% over the month in March, 6.8% annually to £2,606 (UK: £2,890). Despite, the relatively high rate of pay growth, the CPI annual inflation rate was 7.0% in March and is weighing notably on real earnings growth.

Consumption

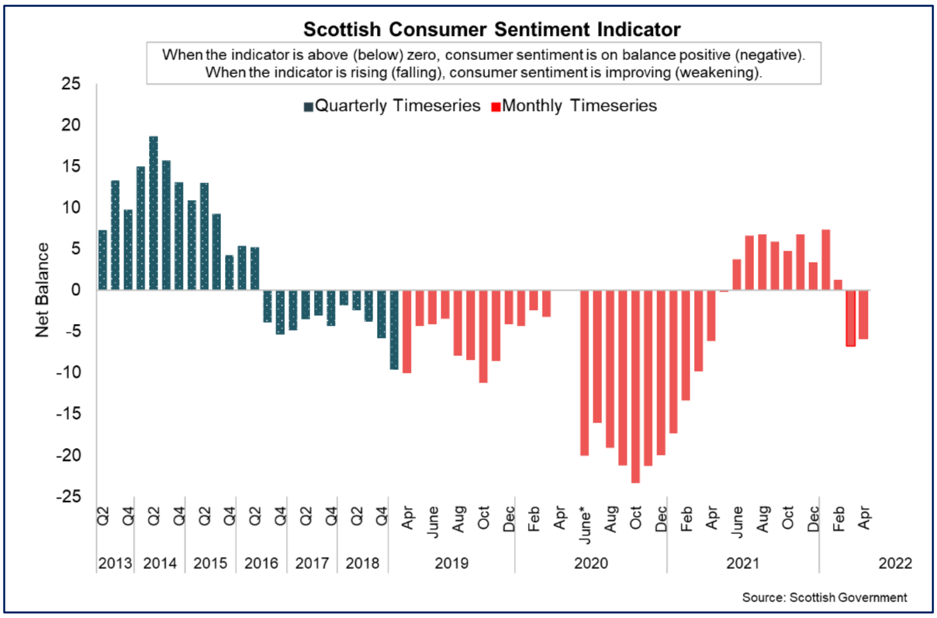
Consumer sentiment declined significantly in March and April driven by weakening across the current and expectations indicators.

Consumer sentiment indicators continue to be highly sensitive to the rapidly changing economic environment during the pandemic and the rise in inflationary pressures.

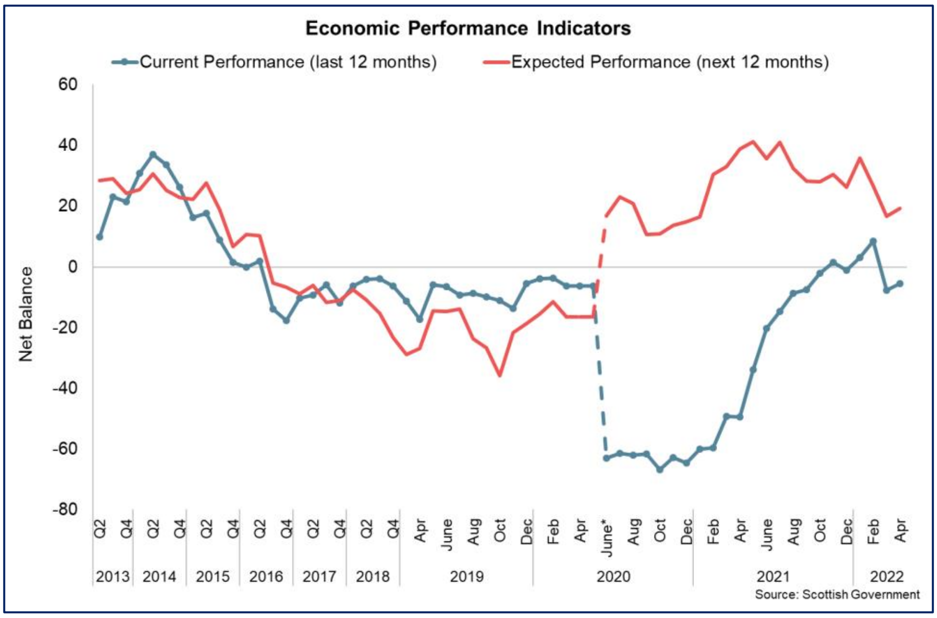
The ongoing economic and financial challenges that are being faced by households have instensified over the first quarter of 2022 and the composite index has fallen, likely as a result of the rapidly increasing cost of living, which presents as a new consumer shock.

Latest data for April showed consumer sentiment strengthened slightly in April having fallen sharply in March, however remained negative on balance (-5.9, up from -6.8 in March).[29,30]

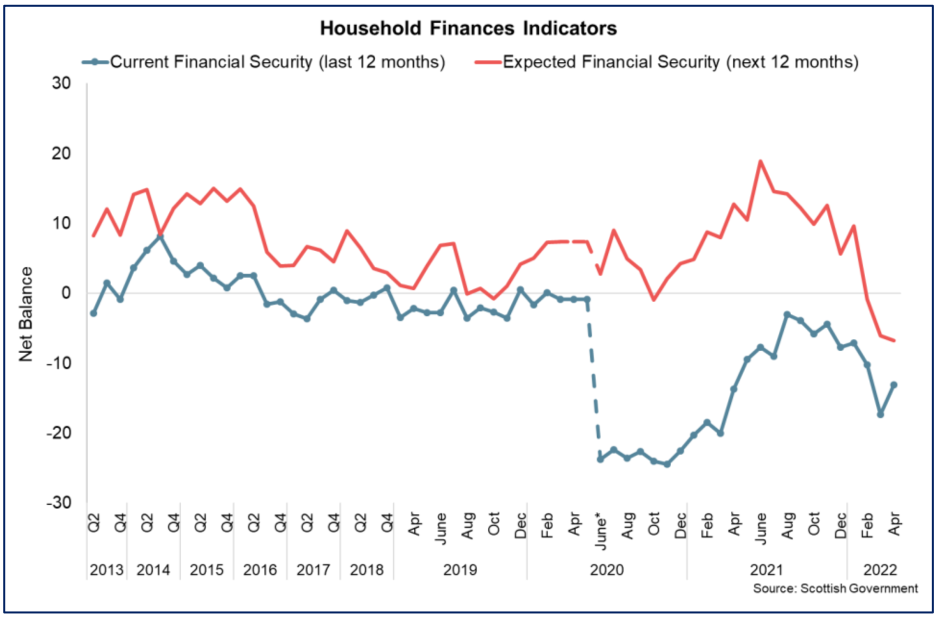
[27] Earnings and employment from Pay As You Earn Real Time Information, seasonally adjusted - Office for National Statistics (ons.gov.uk)
[28] The rates of earnings growth during the pandemic need to be interpreted with caution as base effects, compositional factors and the furlough scheme have all influenced the data.
[29] The latest consumer sentiment survey was undertaken between 30 March – 24 April 2022.
[30] Scottish Consumer Sentiment Indicator : Monthly Data - gov.scot (www.gov.scot)



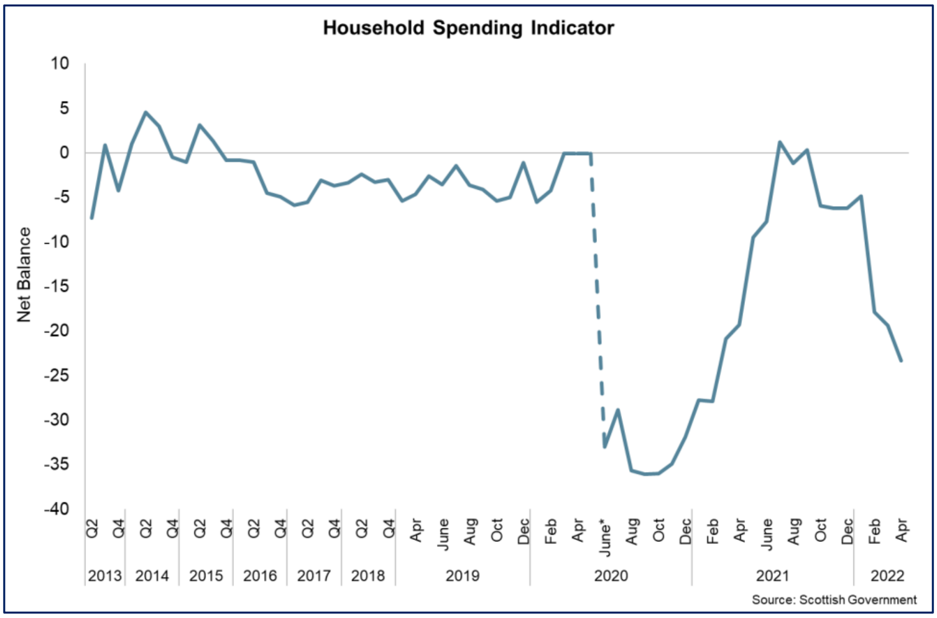
On the economy, respondent's on balance consider current economic circumstances to be worse than last year (-5.6), however sentiment was marginally more positive than in March (up from -7.8). Looking ahead, respondents expect the economy to impove over the coming year relative to the current situation (+19.4), although the level of optimism has been on a downward trend since July 2021 as the economy has continued to rebalance.



In terms of households personal finances, respondents on balance continued to report that their household finances are less secure than 12 months ago (-13.0). The indicator strengthened over the month, however remained notably weaker than in the second half of 2021. Looking ahead, sentiment towards expected finances have wekeaned significantly (-6.7), down from -6.0 in March and +9.7 in January signalling that the uncertainty asscoiated with the rising cost of living is weighing on sentiment.

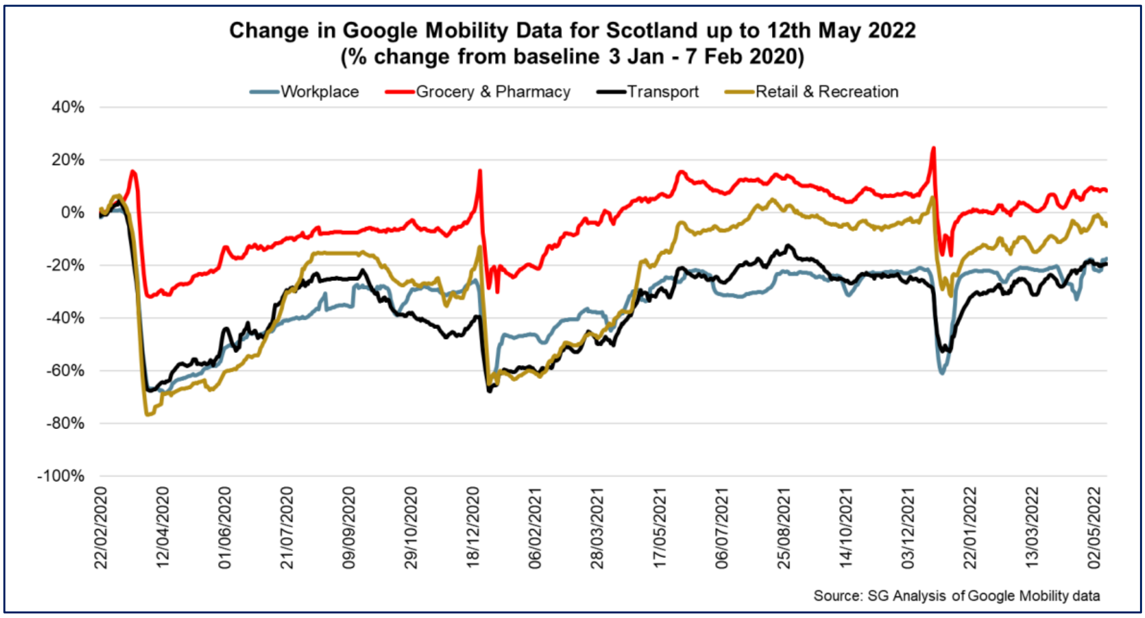


Both the outlook for the economy and household finances influence how relaxed households are about spending money. Since the beginning of the year, households have been increasingly uneasy about spending money as inflationary and cost of living pressures have increased, with the indicator falling to -23.3 in April, down from -19.4 in March.

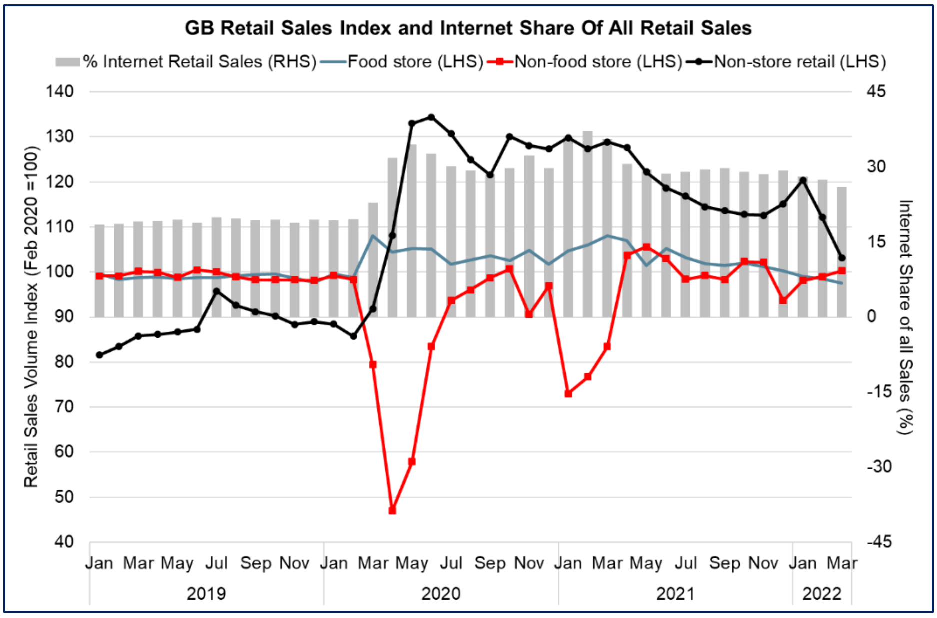


Google Mobility data indicates that movement around retail and recreation hubs is continuing to recover from the sharp fall in January during the Omicron wave and holiday period. Having fallen 30% below pre-pandemic levels in January, movement around retail and recreation hubs has recovered in May to around 2.5% below pre-pandemic levels. Looking across the economy, visits to workplaces remain 20% below, transport 20% below and grocery and pharmacy 9% above pre-pandemic levels. [31]

[31] The figures are taken from Covid-19 Community Mobility Reports published by Google and represent 7-day moving averages to control for daily volatility.



Retail sales volumes in Great Britain fell 1.4% in March, following a fall of 0.5% in February though sales volumes remain 2.2% above their pre-pandemic level. The largest contribution to the fall came from non-store retailing which fell 7.9% over the month.[32] Food stores sales fell 1.1% in March likely due to the relaxed restrictions on the hospitality sector, as well as the impact of rising food prices on the cost of living. Non-food stores sales rose by 1.3% over the month driven by an increase in other non-food stores (2.9%) and household goods stores (2.6%) such as DIY stores.



Automotive fuel sales fell by 3.8% in March with some evidence that consumers reduced non-essential travel amidst record high petrol and diesel prices. Online retail as a proportion of all retail sales, fell to 26.0% (down from 27.5% in February). This continues the wider downward

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

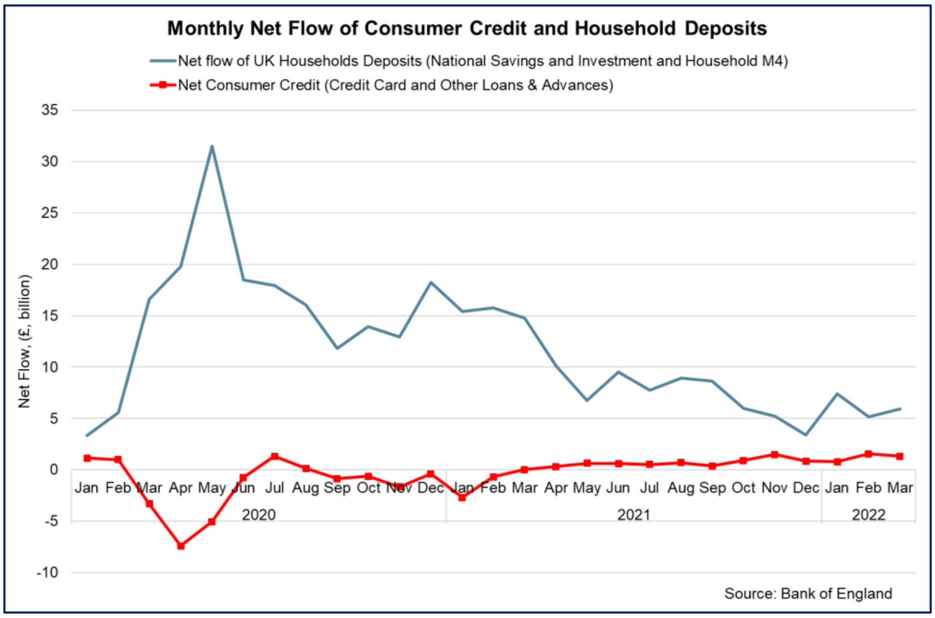
trend since its peak in February 2021 (37.1%) though remains higher than in February 2020 prior to the pandemic (20%).

Household Savings and Consumer Credit

At an aggregate level, households increased their levels of savings during the pandemic and reduced net credit levels, due to a reduction in expenditure coupled with a rise in disposable income through the retention of earnings. More recently, saving patterns have returned to levels similar to prior to the pandemic while credit consumption has increased, particularly in the latter half of 2021 and early 2022.

Bank of England data provides insights at an aggregate level of how savings and consumer credit flows have evolved as restrictions have been removed and economic activity has recovered alongside a rise in inflationary pressures.

In recent months, at an aggregate level, net flows from UK households into deposit-like accounts have returned to a broadly similar position as they were prior to the pandemic. In March, net inflows increased slightly to £6.0 billion, up from £5.1 billion in February and is slightly higher than pre-pandemic flows which averaged £5.5 billion in the year to February 2020. [33]

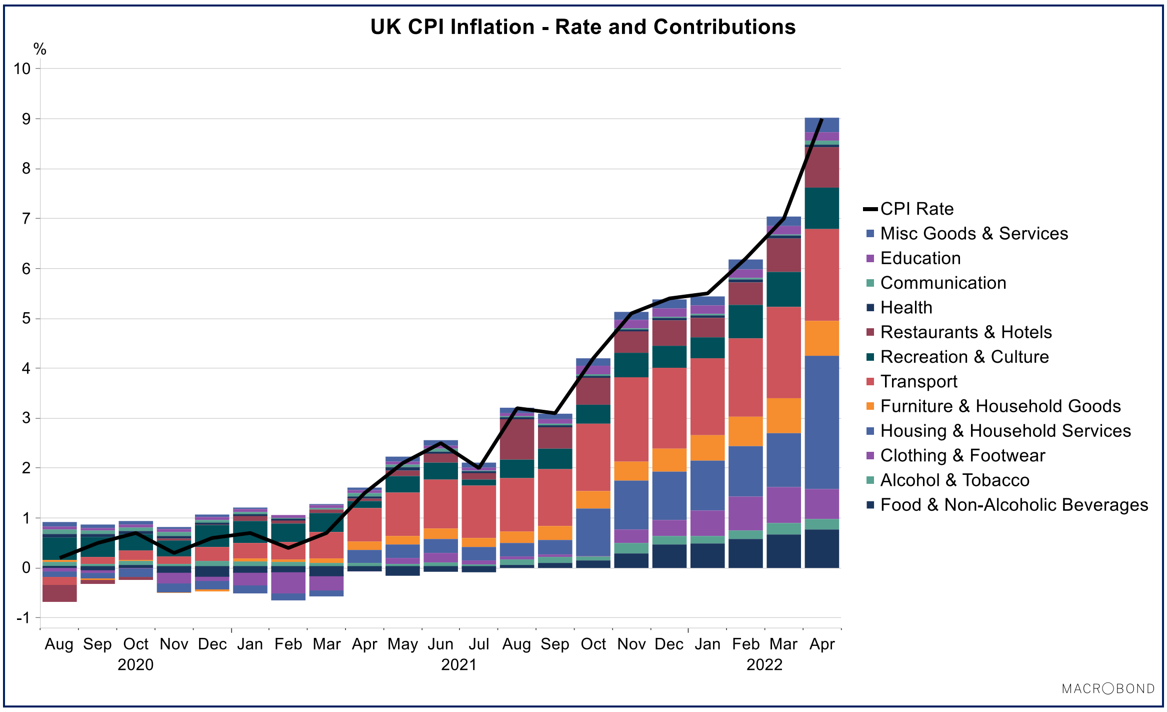


Alongside this, net consumer credit fell significantly during the pandemic, however started to grow again over the course of 2021. In March, consumers' net borrowing picked up to £1.3 billion, down from £1.6 billion in February. The additional borrowing in March was split between £0.8 billion on credit cards, and £0.5 billion through other forms of consumer credit (such as car dealership finance and personal loans).

[33] Money and Credit - March 2022 | Bank of England

Inflation

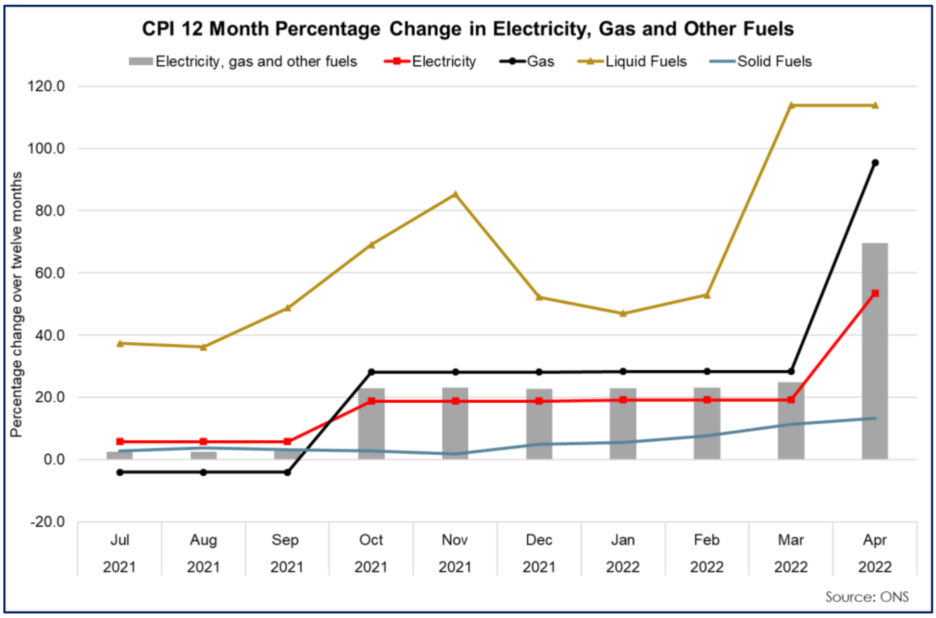
UK CPI inflation rose to 9.0% in April 2022, up from 7.0% in February and has risen to its highest rate in the historical constructed series which began in January 1989, presenting increased cost of living challenges.[34] Inflation rates have also continued to rise in the US (8.3%) and in the Eurozone (7.5%), in part reflecting rising global food and energy prices over the past year.



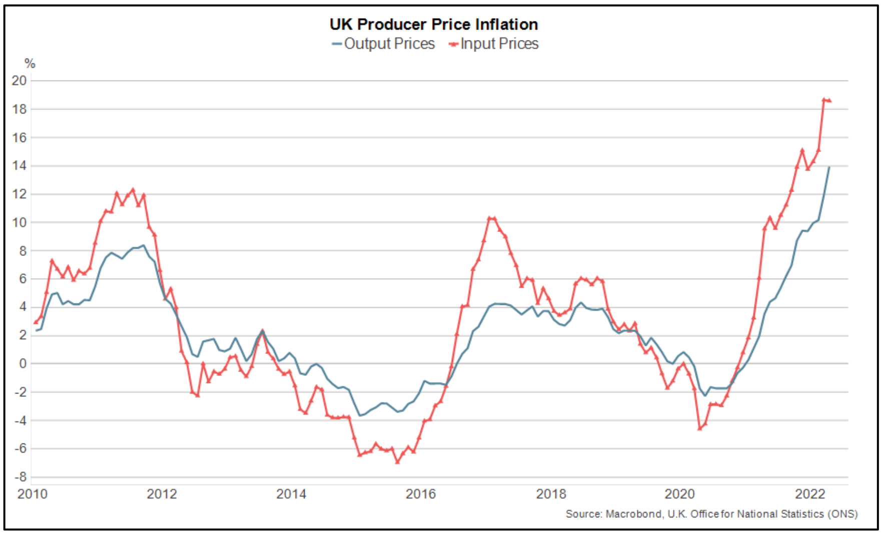
In April, UK consumer prices rose over the year across almost all goods and services monitored. Most notably there was large increases in electricity and fuel prices (+69.6%), in transport (+13.5%, partially driven by second-hand car price increases +27%, but also in motor fuels +31.4%), furniture (10.5%) and in clothing and footwear (+8.3%).

The CPI figure in April accounts for the Ofgem energy price cap uplift which resulted in 12-month inflation rates of 53.5% for electricity and 95.5% for gas, compared with rates of 19.2% and 28.3% respectively in the previous month.

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



Further inflationary pressures are expected, exacerbated by the situation in Ukraine and the impact on global commodity prices, with the Bank of England forecasting inflation to rise to over 10% in the second half of 2022, intensifying cost of living challenges.[35] This is expected to impact through a rise in energy prices and the pass through of higher producer costs to consumers. Producer price inflation (changes in the prices of goods bought and sold by UK manufacturers, including price indices of materials and fuels purchased and factory gate prices) has risen over the past year and remained elevated in April with input price inflation at 18.6% in (unchanged from March and at the highest rate since records began) while output price inflation was 14.0% (up from 11.9% in March).[36]



In response to the further rise in underlying inflationary pressures for the year ahead, the Bank of England's Monetary Policy Committee (MPC) increased the Bank Rate by 0.25 percentage

[35] Monetary Policy Report - May 2022 | Bank of England
[36] Producer price inflation, UK - Office for National Statistics (ons.gov.uk)

points to 1.0% in May, the fourth successive rate rise since December, and have signalled that further rate rises may be appropriate over 2022[37]

Cost of living challenges

Whilst the economy has recovered to be above pre-pandemic levels, the outlook has weakened notably since the end of 2021. The sharp rise in inflation, coupled with tightening fiscal and monetary policy, and exacerbated by the situation in Ukraine, is expected to weigh on household incomes and consumption, with official forecasters highlighting the largest fall in living standards on record.

UK inflation rose to 9.0% in April, its highest rate for 40 years, and has risen sharply over the past year from 1.5% in April 2021. Whilst the rise in inflation has been driven by an increase in fuel and energy costs, it has increasingly become broad based across goods and services.

Furthermore, inflation is forecast to rise further over the course of the year with the Bank of England forecasting inflation to rise to around 10% in the final quarter of 2022. This is expected to be largely driven by further rises in energy and fuel costs and to a lesser extent rises in the prices of food and tradeable goods.

The sharp rise in inflation has meant that inflation has generally been outpacing nominal earnings in Scotland since October 2021 (with the exception of January 2022). This means that living standards have already begun to fall, and they will be further squeezed by reductions in disposable income caused by net tax increases starting in April. In their forecasts alongside the Chancellor's Spring Statement in March, the Office for Budget Responsibility forecast real household disposable income per person to fall by 2.2% in 2022-23, its largest single year fall since records began in 1956-57.

[37] Monetary Policy Report - May 2022 | Bank of England

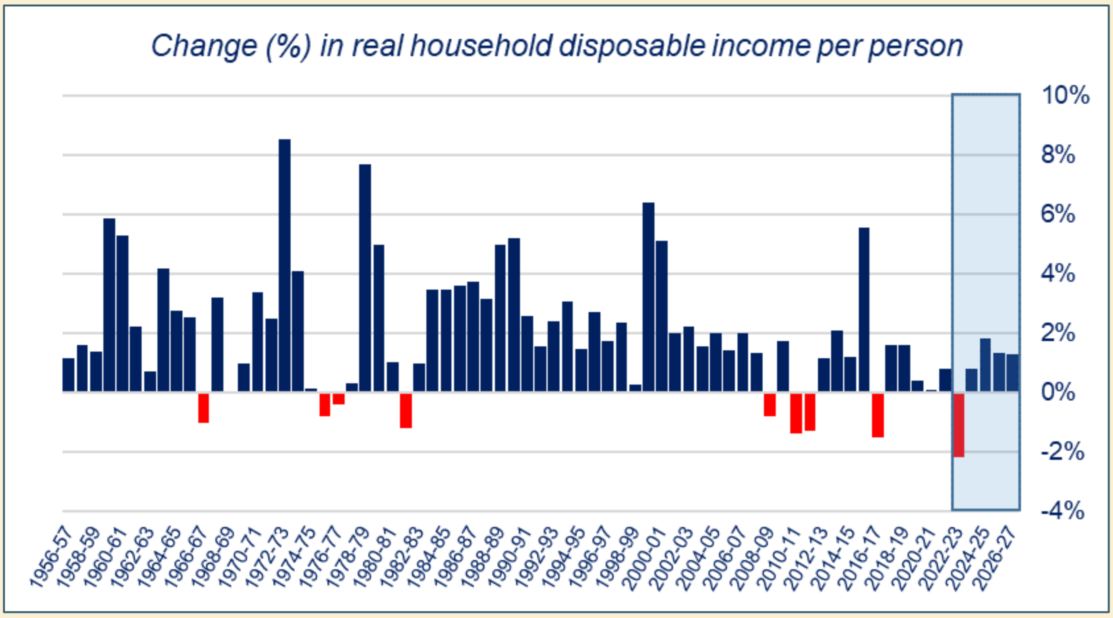


Chart source: OBR

More recently, the National Institute of Economic and Social Research (NIESR) has analysed the impact of rising prices and taxes on household incomes across the UK. Households across the UK are likely to face food and energy bills greater than their disposable income in 2022-23.

Scottish households are particularly at risk, in part due to the colder climate in Scotland which means they are more likely to spend more on heating than other parts of the UK. As gross disposable income in Scotland is below the UK average, NIESR estimate that households in Scotland could be disproportionately impacted by the rise in energy and food prices. They estimate that 150,000 Scottish households (6.1%) could face food and energy bills higher than their disposable incomes in 2022-23, compared to 5.1% for the UK as a whole.

GDP growth outlook

The economic outlook is forecast to slow as the situation in Ukraine and global supply chain issues heighten inflationary pressures, reducing real incomes.

At a global level, economic damage from the situation in Ukraine is subject to significant uncertainty. In April the IMF projected that global growth would slow from an estimated 6.1% in 2021 to 3.6% in 2022 and 2023 (down 0.8 and 0.2 points respectively on the January forecast).[38]

[38] World Economic Outlook, April 2022: War Sets Back The Global Recovery (imf.org)

In December, prior to the situation in Ukraine, the OECD forecast further recovery from the pandemic with global GDP growth of 4.5% in 2022 and 3.2% in 2023, while inflation was forecast to rise to 4.2% in 2022 and ease to 3% in 2023. Subsequent OECD illustrative model simulations in March suggest that global growth could be reduced by over 1 percentage point, and global inflation raised by close to 2.5 percentage points in the first full year after the start of the conflict.[39]

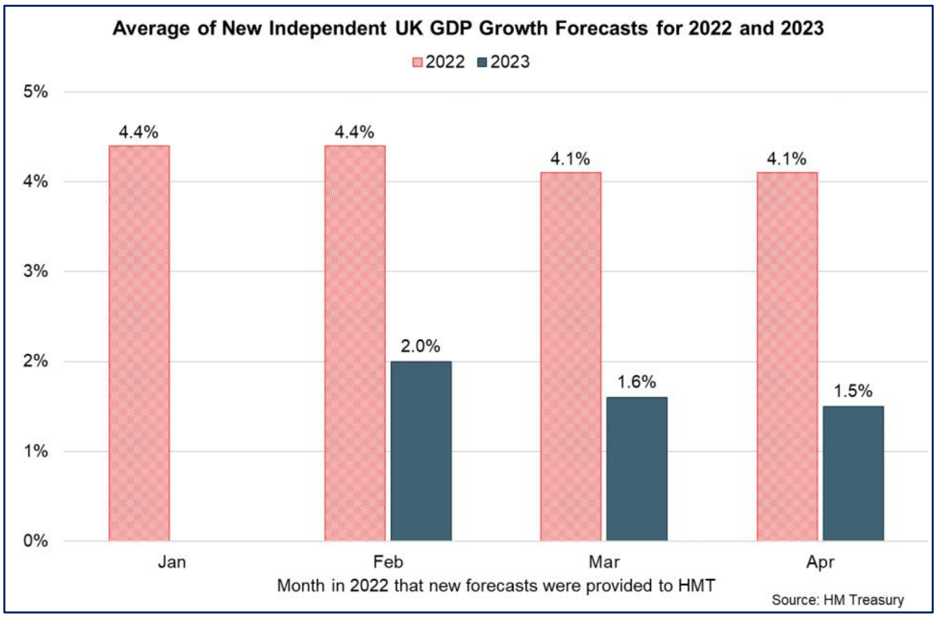
At a UK level the Office for Budget Responsibility (OBR) March forecasts, revised down the UK GDP growth forecast to 3.8% in 2022 (revised down 2.2 percentage points from October) and 1.8% in 2023 with the downward revision in the near term reflecting higher inflation weighing on real incomes and consumption.

The OBR forecast inflation to rise to close to 9% in Q4 2022, mainly reflecting higher global energy prices, with higher inflation outpacing nominal earnings growth. Combined with net tax increases starting April, they estimate that this could result in real UK household disposable income per person falling by 2.2% in 2022-23.[40]

More recently, the Bank of England forecast UK GDP to slow sharply this year as inflation weighs on real incomes and demand. The Bank forecast growth of 3.75% in 2022 (unchanged from February forecast), a fall of 0.25% in 2023 (down from +1.25% in February) and growth of 0.25% in 2024 (down from 1.0% in February). Inflation is forecast to rise above 10% in Q4 2022 and to remain high in 2023, before gradually falling towards the 2% target in 2024. [41]

The average of new independent forecasts in April (published monthly by HMT) forecast UK GDP growth of 4.1% in 2022 (unchanged from March forecast) and 1.5% in 2023 (down 0.1 percentage point on March).[42]

[39] OECD Economic Outlook
[40] Economic and fiscal outlook - March 2022 - Office for Budget Responsibility (obr.uk)
[41] Monetary Policy Report - May 2022 | Bank of England
[42] Forecasts for the UK economy: April 2022 - GOV.UK (www.gov.uk)



At a Scotland level, in March, the Fraser of Allander Institute downgraded their forecast for Scottish GDP growth in 2022 to 3.5% (down from 4.7% in the December forecast), reflecting the impact on households and businesses of higher inflation, with growth forecast to moderate further at 1.5% in 2023 and 1.4% in 2024.[43]

The Scottish Fiscal Commission will publish their latest economic and fiscal forecasts for Scotland on the 31st May alongside the Scottish Government's Medium Term Financial Strategy and Resource Spending Review.

[43] Outlook for growth in 2022 worsens as cost increases begin to bite | FAI (fraserofallander.org)

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