University of Strathclyde Business School

Fraser of Allander Institute

Economic Commentary

Vol 46 No 2

Deloitte.

Foreword

As was hoped would happen this year, recent months have seen restrictions eased across the country, signalling a welcome return to a more normal way of life for many of us. While case numbers are rising amid warnings of a new wave of infections in Scotland, the aspiration must continue to be that COVID-19 remains a more manageable part of life.

In line with this positive news, this quarter's Commentary highlights that Scotland's economic recovery was well underway in the first quarter of 2022. However, the historic increases in inflation we are now all witnessing and the accelerating cost-of-living pressures are creating increasingly challenging economic conditions, impacting consumers and businesses alike. Lower-income households are being impacted the most with rapidly rising energy and food prices. The Bank of England has increased interest rates as part of a major tightening of monetary policy across the industrial world, with UK inflation expected to peak at around 11%[1]. In the UK it is likely that interest rates, which have risen sharply since the start of this year, will see further significant increases before 2023.

This quarter's Commentary also points out that Scotland's public sector is facing pressures too. While prioritising spending on health, social care and social security, the Scottish Government's recent Spending Review has laid out real term declines in budgets across local government, policing, prisons, universities and colleges amongst others.

The risks posed to future economic growth are in plain sight. Weaker demand, higher interest rates, corporate cost-cutting, and uncertainty inhibit the likelihood of growth. Price hikes and supply chain disruptions have resulted in rapidly rising prices for electricity, gas, and fuel, which now cost almost double what they did this time last year.

The outlook for households looks set to worsen before it improves, a trend reflected in Deloitte's latest Consumer Tracker[2]. For younger generations, recent research by Deloitte found that the cost-of-living is now the leading concern among Gen Zs and millennials in the UK, overtaking climate change which was the top concern in last year's findings. The report found that half of UK Gen Zs and millennials use all their monthly income on living costs, while two in five have taken on additional work to simply make ends meet[3]. The increasing rental and property prices cited in this quarter's Commentary, alongside other rising living costs, undoubtedly play a part in such a stark finding.

However, for businesses, growth potential is not solely dependent on the ups and downs of the economic cycle, but can be driven by other factors, including the organisation of production and work.

1 How high will inflation go? | The Bank of England
2 The Deloitte Consumer Tracker Q1 2022 | Deloitte UK
3 Cost of living now leading concern among Gen Zs and millennials | Deloitte UK

When coupled with the mass application of new technologies, reorganisation of work is one of the surest ways to faster productivity growth and to increase staff retention[4]. Hybrid working is an obvious driver of change, with the pandemic compressing years of digital and cultural innovation in remote working into months. Indeed, Deloitte's Gen Z and Millennial survey also found that an increase in hybrid working, combined with a positive work-life balance are now the top attractions for younger generations to join a business.3Leaders and employers must strive to empower these future workers to have the choice and flexibility they need to do their best work.

Businesses must also pay close attention to the transition to a green economy, with the definition of what it means to be green set to inevitably evolve in the years ahead. Deloitte's new report, A blueprint for green workforce transformation, developed in collaboration with the Institute of Environmental Management and Assessment (IEMA), found that the transition to a sustainable workforce is already underway, with job searches for green skills seeing double digit growth[5]. 80% of the people who will make up the workforce of 2030 are already in employment today, and if businesses are to build on their capabilities and productivity for the future, now is the time to act. A one-size-fits-all approach to workforce transformation is not sufficient.

Clearly, these changes are easier said than done. The expected peak in inflation will signify a critical moment for businesses, and leaders must find effective ways to respond. This makes improving productivity particularly vital, though it is unlikely to avoid scenarios that involve raising prices or accepting a reduction in margins.

Organisations must now navigate the challenges that come with rising costs, and a tougher economic environment. While there is no simple solution for this, leaders should tap into their experiences and resilience developed during the pandemic, innovating their operations to thrive.

Angela Mitchell
Senior Partner for Deloitte in Scotland
June 2022

4 Roaring twenties, spluttering twenties | Deloitte UK
5 Transforming your organisation for the green economy | Deloitte UK

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ECONOMIC COMMENTARY

For regular analysis on the Scottish economy and public finances please see
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ISSN 2046-5378

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Summary

The consequences of rising inflation are being felt across the economy, with clear signs that consumer confidence is being dented and that people are cutting back on both essential and non-essential spending.

Alongside this, there is an increasing fear that high inflation will be more persistent than was first thought, with expectations now that it may be 2024 before we get back to more normal levels of inflation.

This has led the Bank of England to act to successively raise interest rates, as the central bank uses the only tool it really has to manage inflation back down over the medium term. In the short term, however, this is likely to add to the pain for many households as it increases to cost pressures on mortgage and rent payments.

The Scottish economy recovered strongly in the first quarter of the year, with output now well above pre-pandemic levels. However, the data published just yesterday for April shows the impact of current conditions across all sectors of the economy.

These conditions have led us to cut our forecasts for 2023 and 2024: we are now forecasting growth of just 0.5% in 2023, and 1.0% in 2024.

In this edition of the Commentary, we have extensive analysis of the inflation data and associated sources, including surveys of consumers, to understand the impact of rising prices on different types of individuals.

We also include an analysis of the recent spending review published by the Scottish Government, which sets out the likely challenging fiscal environment over the next few years.

More than two years on from the start of the pandemic, we also include three sections reflecting on some of the big economic issues caused by the pandemic and associated global shutdown, analysing the impacts on detailed sectors of the economy, on the way we work, and on global trade.

Alongside the Commentary, we are delighted to publish the thoughts of a number of contributors in Scotland about where we are in the recovery – comparing these thoughts with what the contributors were expecting in June 2020, when we last did such an exercise.

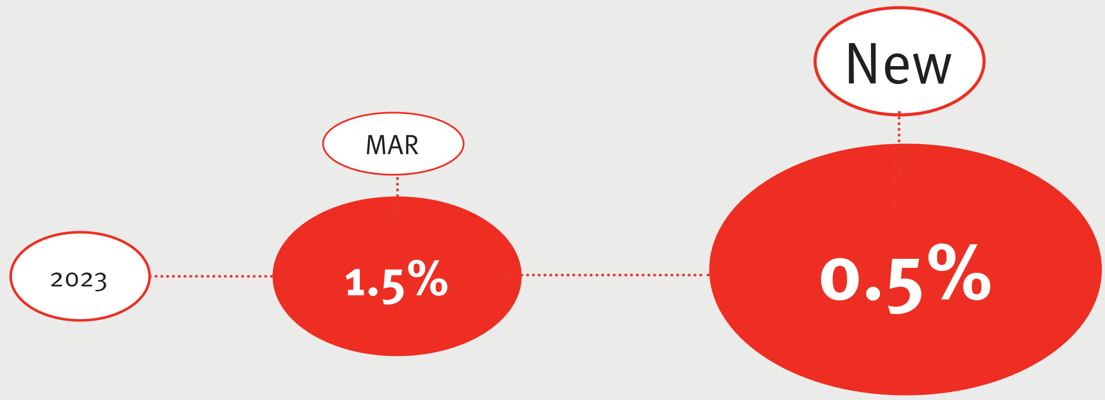
Fraser of Allander Institute

June 2022

State of the economy

Indicator	% of Feb 2020 levels	Rate	Change on previous month / quarter	Performance	Latest data
GDP					
Total	101.0%		+ 0.3%	▲	March 2022
Production	95.7%		- 1.1%	▼	March 2022
Construction	103.5%		+ 1.6%	▲	March 2022
Services	102.0%		+ 0.5%	▲	March 2022
Labour Market					
Employment rate		75.5%	+1 p.p.	▲	Feb 2022 - Apr 2022
Unemployment rate		3.2%	-0.6 p.p.	▼	Feb 2022 - Apr 2022

Scottish growth forecasts



	2022	2023	2024
FAI *SCOTTISH FORECAST*	3.8%	0.5%	1.0%
OBR *UK FORECAST*	3.8%	1.8%	2.1%

**OBR Forecasts are from March 2022 and so may not be a fair reflection of the current economic conditions*

Outlook and Appraisal

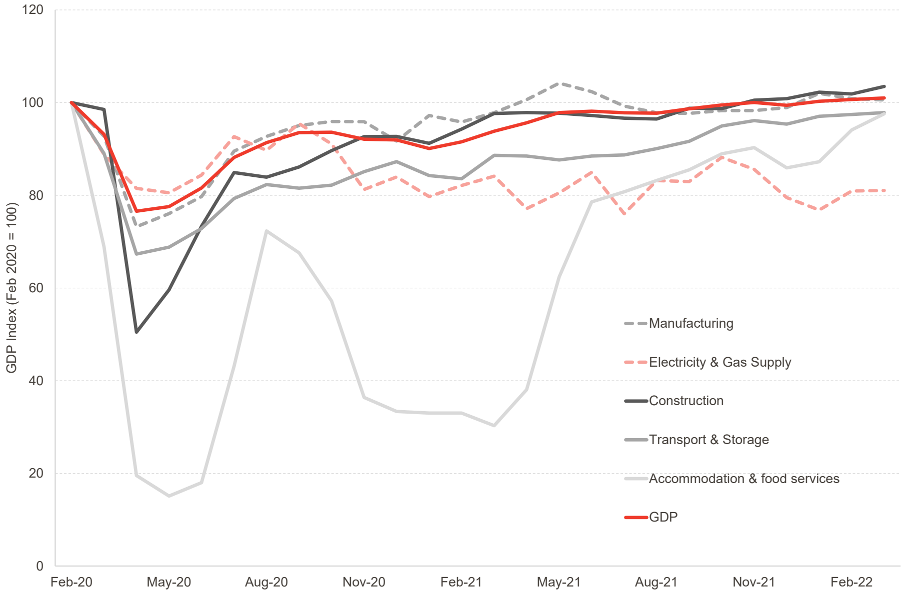
Where are we now?

In recent months, the phasing out of in-person test sites and closing of temporary vaccination centres show that COVID-19 is now, we all hope, a manageable part of everyday life for many people.

Despite slower growth towards the end of 2021, Scotland's economic recovery was well underway into the first quarter of 2022.

In Scotland, onshore GDP grew by 0.4% in February and 0.3% in March meaning the Scottish economy was maintained above pre pandemic levels for the 3rd consecutive month, Chart 1.

Chart 1: GDP Index, Scotland, February 2020 - March 2022



Source: *Scottish Government*

Whilst we continue to live with COVID-19, which was expected to bring more optimism within the economy, the emerging cost of living crisis poses uncertain times for many households across Scotland and the UK.

Despite wholesale gas prices falling on the significant highs witnessed in March, they remain almost double the cost that they were this time last year, Chart 2.

As well as high gas prices, oil prices have also remained high given the ongoing Ukraine-Russian conflict and subsequent global sanctions on Russia.

In early March, Brent Crude Oil prices spiked to $127 per barrel, 21% higher than previous spikes in 2012. In early June, this had fallen slightly, but was still trading at $121 per barrel[1].

1 See UK Parliament Oil Prices

In 2021, it was estimated that 43% of energy was generated from primary oils such as crude, with a further 30% generated from natural gases in the UK[2], meaning the persistent high prices of both oil and gas have caused energy prices across the UK to surge.

As wholesale oil and gas prices continue to increase, producers can no longer absorb the associated high costs and will look to pass these on to both businesses and consumers.

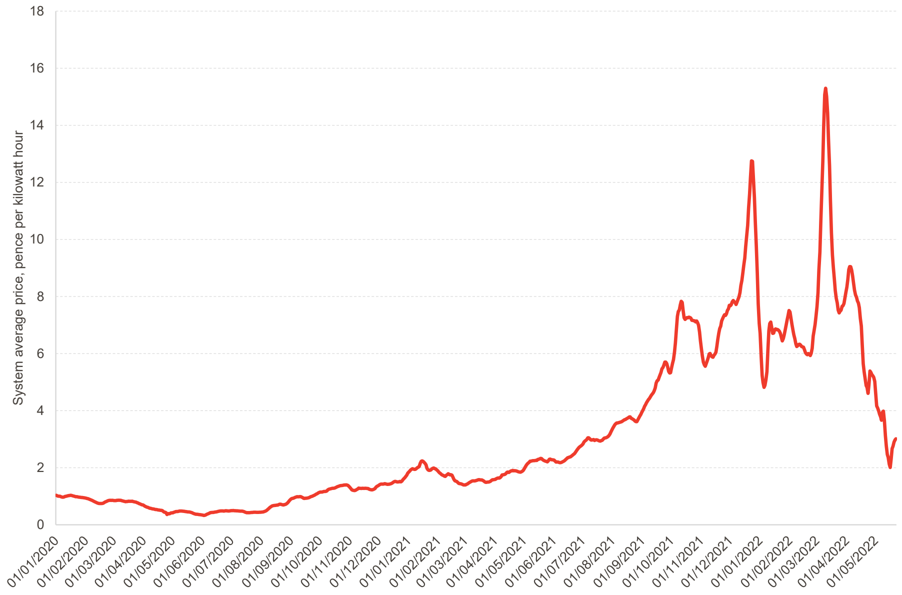
For consumers, the energy price cap, a measure introduced by the energy regulator Ofgem to limit the rates that suppliers can charge for their standard tariffs, protects them.

However for businesses, there is no cap, meaning as wholesale prices rise, so too does the costs they incur.

The energy price cap increases, both in October of last year, and April of this year have already increased many household energy bills. However, the proposed increase to an estimated £2,800, from £1,971, in October 2022, means producers will be able to pass on more of these costs to consumers in the form of higher tariffs.

Therefore until wholesale gas and oil prices settle, households energy bills will likely increase again in October, before we see any improvements, worsening the economic conditions many households are already facing.

Chart 2: Growth in UK wholesale gas prices, January 2020 - May 2022



Source: *National Grid*

Some optimism

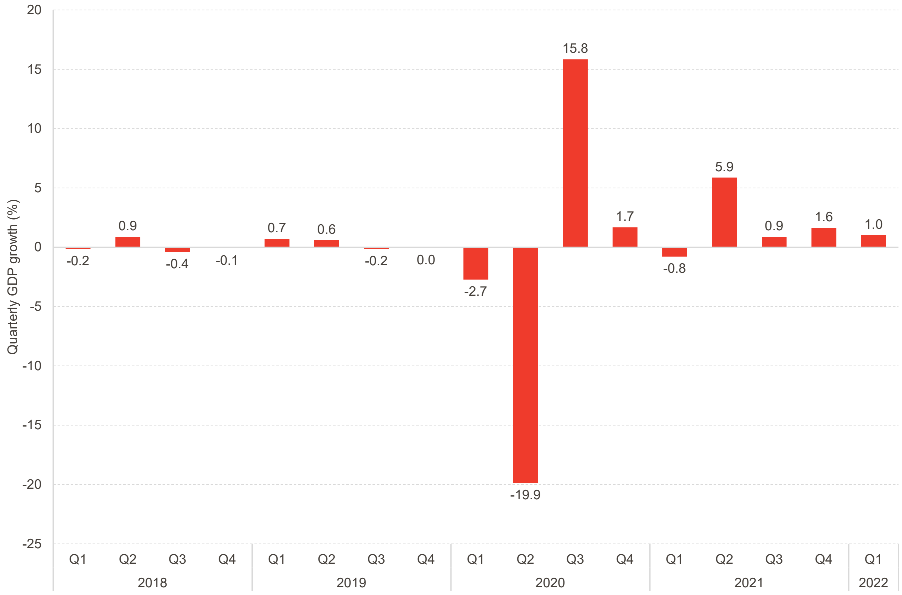
GDP expanded by 1% in the first quarter of 2022, around 0.2 percentage points (p.p.) higher than the UK's growth for the same quarter (0.8%), Chart 3. Over the year, the economy has expanded by 11.8%.

There was growth across the production, manufacturing and services sectors in quarter 1 of 2022. Manufacturing contributed the most of these industries in Q1, expanding by 2.7% across the first three months of the year.

2 See UK Energy Brief

Accommodation and food services expanded the most in quarter 1, with welcome growth of 5.2% for a sector significantly impacted by COVID-19 restrictions.

Chart 3: Quarterly GDP growth, Scotland, 2017 Q1 - 2022 Q2

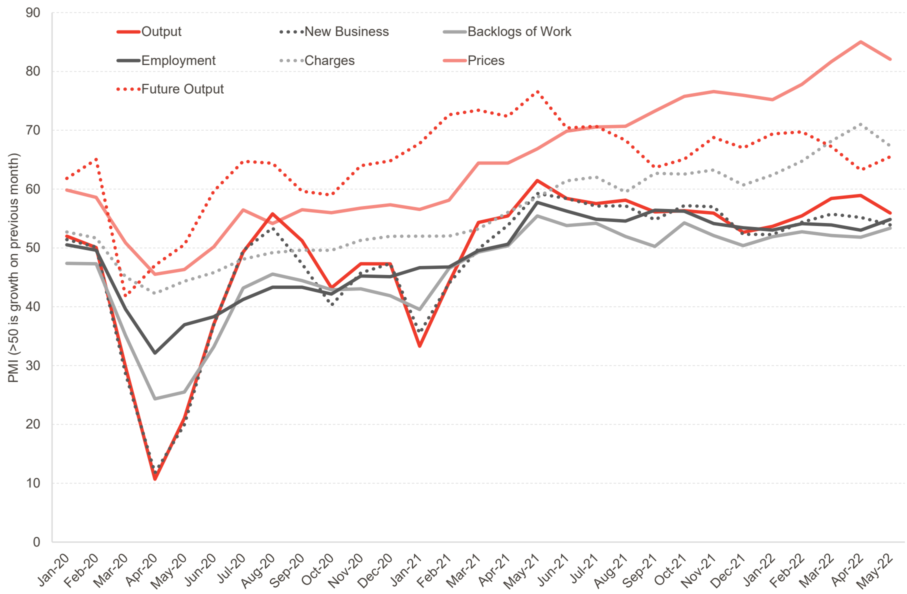


Source: *Scottish Government*

All indicators in the Purchasing Managers Index (PMI)[3] have also remained positive since April 2021, see Chart 4.

The prices indicator[4] has risen sharply in the past three months, with prices in May 2022 9% higher than January 2022, in line with inflation.

Chart 4: Purchasing Managers Index, Scotland, January 2020 – May 2022



**A PMI reading over 50 indicates growth, whilst a reading under 50 suggests contraction.*

Source: *IHS Markit*

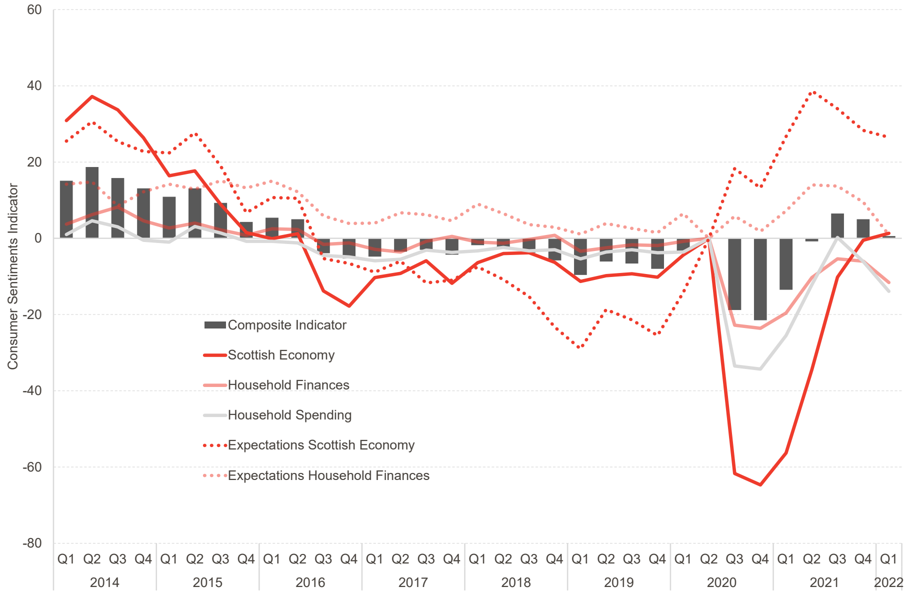
3 The Purchasing Managers Index (PMI) is a series of economic indicators derived from monthly surveys of private sectors firms and measures the rate of expansion or contraction of specific sectors.
4 The prices indicator reports the rate of input price inflation reported by responding private sector firms.

Consumer sentiment remained positive in Q1, with sentiment positive on the composite indicator[5] for the third consecutive quarter since Q2 of 2016.

Consumer sentiment about current household finances and spending were the worst performing indicators in 2022 Q1, and had worsened since the last quarter of 2021. Expectations for consumer household finances had also fallen on the end of last year, however remained positive for Q1 of 2022.

Household expectations for the Scottish economy also remained positive, despite a significant reduction in the net balance for household finances since 2021 Q4, see Chart 5.

Chart 5: Consumer Sentiments Indicator, Scotland, Q2 2013 – Q1 2022



Source: *Scottish Government*

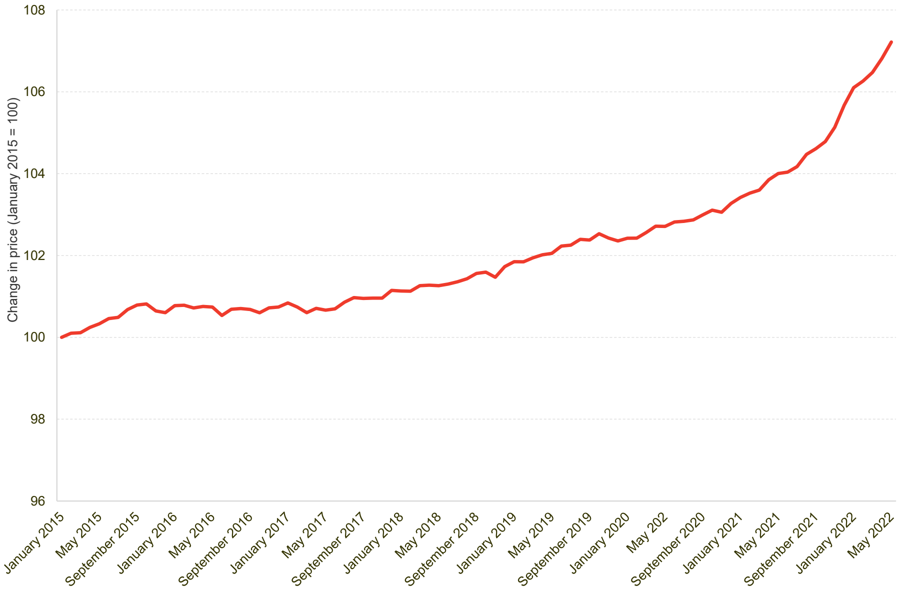
Whilst much of the cost of living discussion is centred on rising energy and fuel prices, there are also significant increases in prices in the property and rental markets.

In April, rental prices in Scotland increased to their highest levels ever, see Chart 6. Rental prices have risen by 4.3% since February 2020, the second highest increase in the UK behind Northern Ireland.

This was a similar story for those looking to get on the property ladder, with house prices at similar levels to the start of the year, however still 12.6% higher than at the start of 2020, see Chart 7.

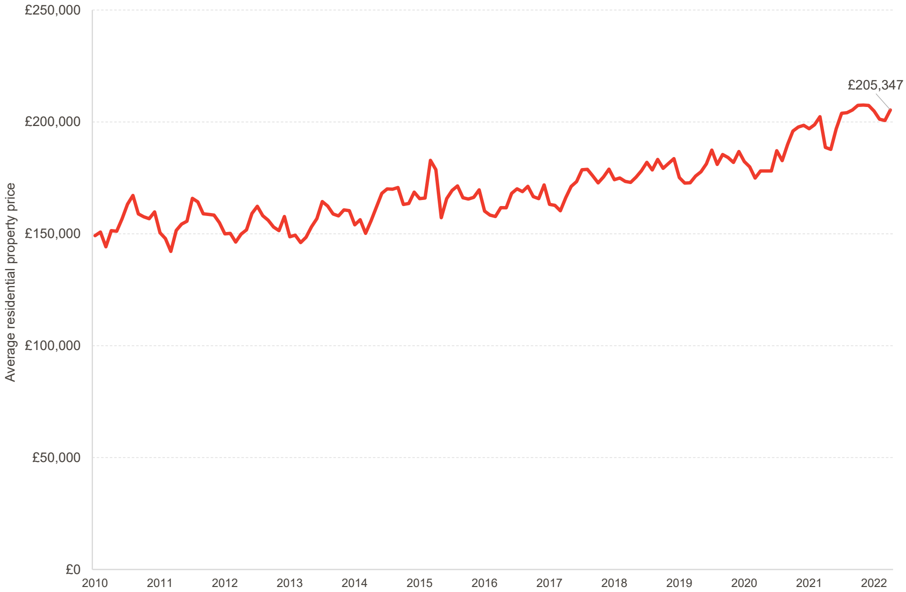
5 The composite indicator measures consumer sentiment based on current sentiment and future expectations of Scottish economic performance, security of households' financial position and attitudes to spending.

Chart 6: Index of Private Housing Rental Prices, Scotland, January 2015 – May 2022



***Source:** ONS, Index of Private Housing Rental Prices*

Chart 7: Average residential property price, Scotland, January 2010 - April 2022



***Source:** Registers of Scotland*

On the 16th June, the Bank of England announced an increase in the interest rate to 1.25%, up from 1% at the beginning of May. This meant the bank rate had increased 1 percentage point since the end of 2021.

With the bank rate now much higher than hikes witnessed at the beginning of the pandemic in March 2020, mortgage rates and general borrowing also continue to increase, contributing to further costs for owner-occupied households across Scotland and the UK.

UK economy

The recovery in the UK has stalled since the beginning of year, as the UK economy shrank by 0.3% in April, Chart 8.

April was the third consecutive month of no or negative growth within the UK economy.

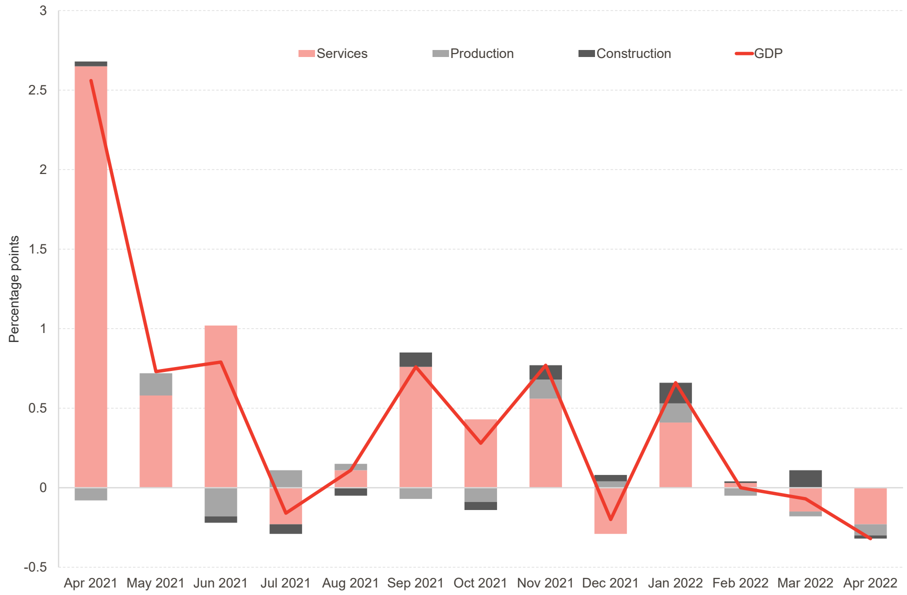
Activity fell in the manufacturing, production and services sector, with the end of the NHS track and trace system contributing heavily to the fall in the services sector, as the health sector shrank 5.6% in April.

This lack of growth has led to many institutions to revise down their economic forecasts for the UK economy for 2022, with the OECD reducing their May 2022 forecast of 4.7% to 3.6% in June.

The OECD also forecast ***zero*** growth in the UK economy next year, with expectations that inflation would remain high, around 7.4%, leading to a stagnant economy in 2023.

Further to this, the Confederation of British Industry (CBI) have also revised their April forecast of 5.1% down to 3.7% in June, in the wake of rising prices and hampered growth.

Chart 8: Contributions to monthly GDP growth, UK, April 2021 – April 2022



Source: *ONS*

Across the UK, prices continue to rise, with growth of 9.1% in the 12 months to May 2022, the highest inflation rate in 40 years, see Chart 9.

Given these price hikes for both goods and services, the Bank of England suggest that inflation will likely reach around 11% before beginning to slowly decline in 2023, with their estimates that inflation will likely be back at target of 2% in two years time.

Box 1: Note on inflation

The leading measure of UK inflation – the Consumer Price Index (CPI) – carefully constructs a 'virtual shopping basket' of over 700 items to track changes in the prices of goods and services that consumers typically purchase.

This enables statistical bodies like the Office of National Statistics (ONS) to produce headline measures of inflation that estimate the average change in the price of all goods and services in the UK over a given period.

Although useful, these inflation measures do have some shortcomings.

Notably, inflationary pressures can vary significantly across different types of goods, meaning the average rate of inflation can hide some important things.

Furthermore, as inflation measures capture the average level of inflation, there will be consumers who experience higher rates of inflation than others.

Notably, as cheaper food alternatives have risen generally at a faster pace than headline CPI inflation in recent months, low-income groups, who spend a greater proportion of their income on these goods, could have experienced higher inflationary pressures in comparison to other groups in society.

Chart 9: Consumer Prices Index, UK, January 1989 – May 2022

Source: *ONS*

However it is not just consumers incurring high costs, producers are also experiencing significant price hikes both at the beginning of production and the end.

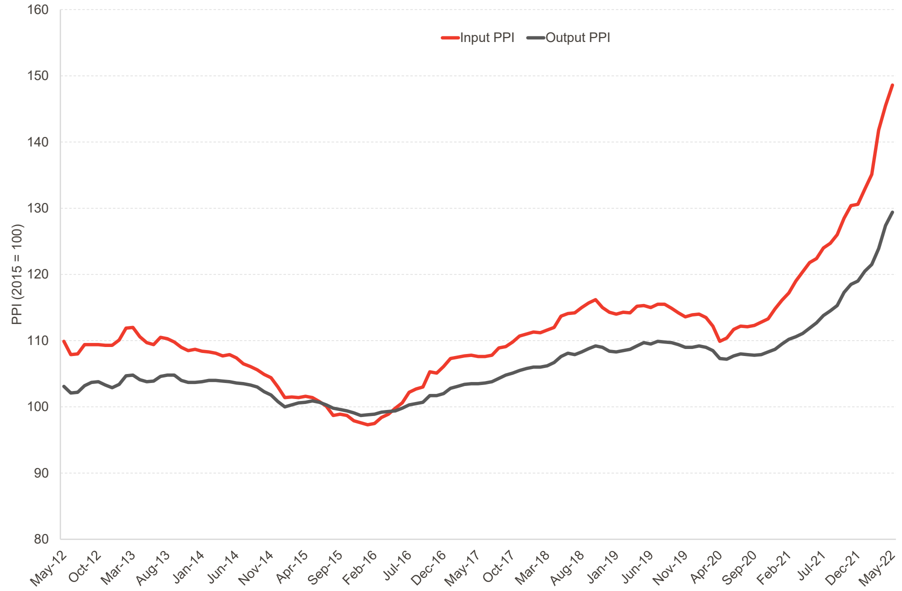
The input producer price inflation (PPI) rate rose 22.1% in the year to May 2022, a 1.2 percentage point increase on the previous month. This was significantly higher than the output PPI rate of 15.7% in May, the 17th consecutive positive output PPI rate, see Chart 10[6].

6 Input producer price inflation measures the price of goods bought by UK manufacturers whilst Output producer price inflation measures output or 'factory gate' prices.

Producers can only absorb these high costs for so long before beginning to pass these costs on.

This suggests that for consumers, who are already experiencing sharp price increases across the economy, prices may yet still increase as producers begin to pass through the high costs that they are incurring.

Chart 10: Producer price inflation, input and output, UK, May 2012 – May 2022



Source: *ONS*

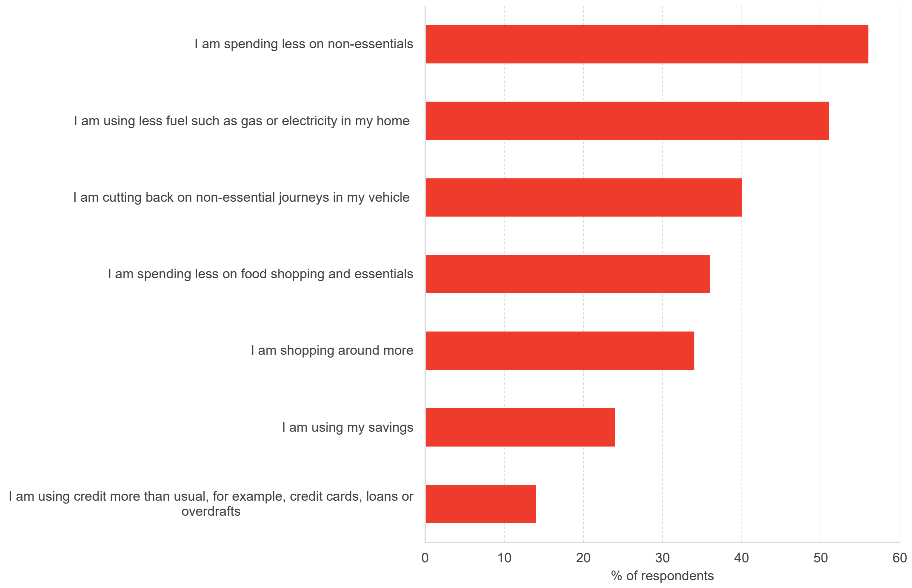
Cost of living crisis

The ongoing cost of living crisis continues to worsen across the UK currently, as a result of the high prices of food, energy and fuel.

At the end of March, most individuals had cut back on spending on non-essential items.

Households also reported using less gas and electricity in the home, and chose to make less non-essential journeys in their vehicles to avoid using fuel, Chart 11.

Chart 11: Which of the following are you doing because your cost of living has increased? UK, 27th April - 22nd May 2022



Source: *Opinions and Lifestyle Survey*

In the 12 months to May 2022, the price of most goods and services had risen, with growth in the CPIH 12-month inflation rate[7] of 7.9%, Chart 12.

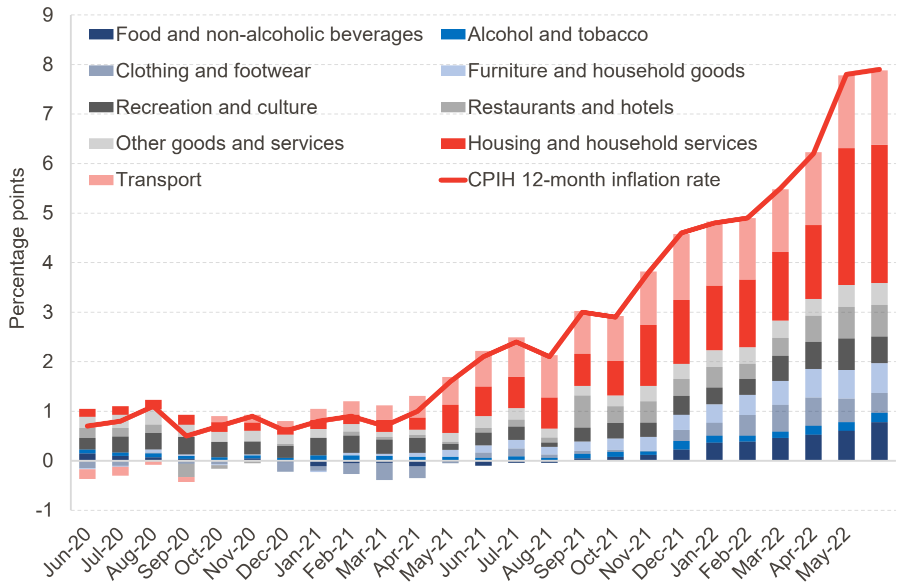
Housing and household services contributed the largest share of this at 2.79 percentage points, a 2.19-p.p. increase on the previous month.

Transport also contributed 1.5 percentage points, given the continued price hikes for fuel over the past few months.

The average pump price of unleaded petrol was 165.09p per litre in May, up 14% on the start of the year, whilst the average diesel price was 179.67p per litre, Chart 13.

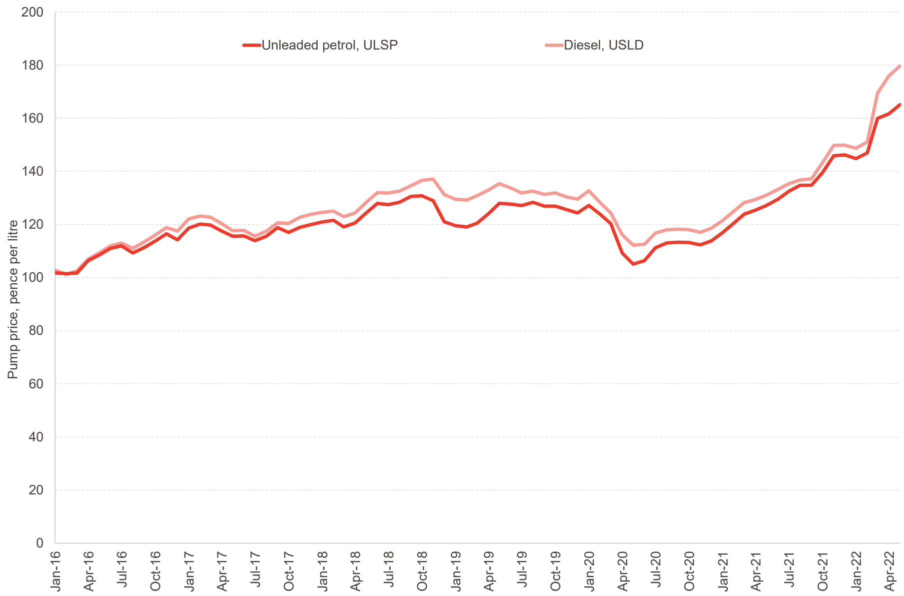
At the beginning of June, the [RAC motoring group](#) reported that the cost of filling the average 55-litre car had hit £100 for the very first time.

Chart 12: Contributions to the CPIH 12-month inflation rate, UK, May 2020 - May 2022



Source: *ONS*

Chart 13: Road fuel pump prices, UK, January 2012 – May 2022



Source: *UK Government, Department for Business, Energy and Industrial Strategy*

7 The Consumer Prices Index including owner occupiers' housing costs.

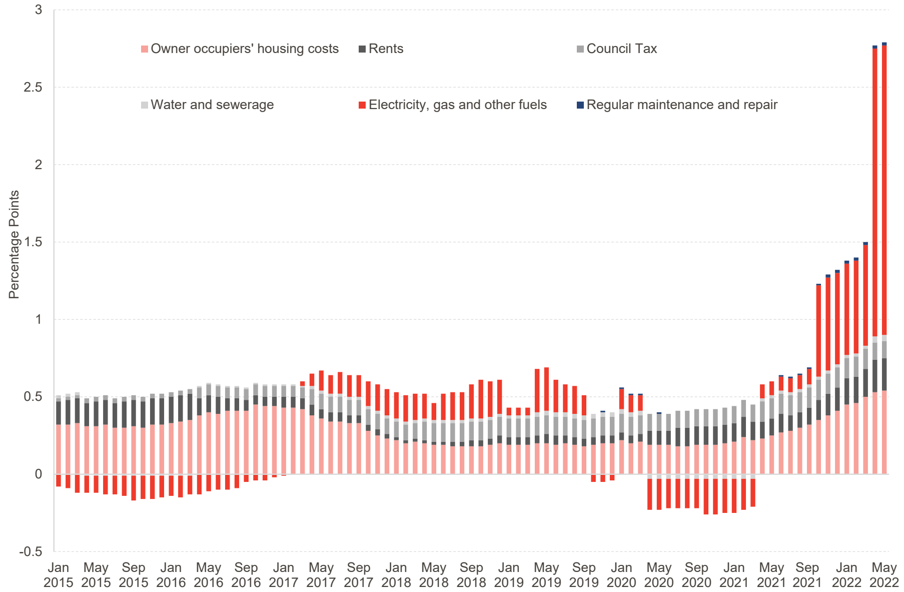
Housing costs for both owners and renters of properties also continued to rise significantly in April, Chart 14.

In particular, the cost of electricity, gas and other fuels contributed 1.87 percentage points to the CPIH 12-month inflation rate.

The price cap introduced by Ofgem aims to offer protection for households against high energy bills, however the increase in the cap as of 1st April 2022 to £1,971 has put a strain on household finances.

Further to this, the ongoing Ukraine-Russian conflict and its effect on global oil and gas prices, as well as the expected price cap increase in October 2022, means energy prices for households will likely rise further before the situation may improve.

Chart 14: Contributions of housing components to the CPIH 12-month inflation rate, UK, January 2015 - May 2022



***Source:** ONS*

UK earnings are also not keeping up pace with the current inflationary pressures in the economy, meaning some households are likely to see reductions in their disposable incomes.

UK regular earnings (pay excluding bonuses) grew by 4.2% between February and April of 2022 compared to the year before.

Higher bonus payments and the increase in regular pay meant that not only did total earnings increase by 6.8% between February and April, but overall pay growth was strong.

However, in the current economic climate, the consistent price rises experienced are hampering this strong wage growth.

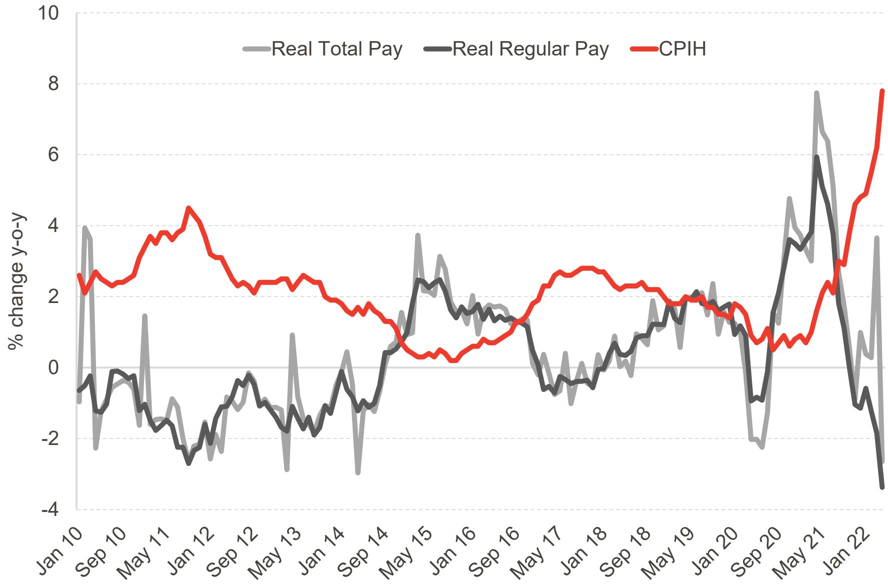
Given the CPIH inflation rate of 7.8% in April, when adjusted, growth in total pay falls to 0.4%, with the increase in regular pay falling to a cut of 2.2%, see Chart 15.

Wage growth has also varied across sectors and industries.

Average total pay growth was far higher for those in the private sector, with an 8% increase in total pay between February and April 2022, compared to only 1.5% in the public sector.

This disparity was primarily driven by higher bonus payments in the private sector, with sectors such as the finance and business services sector experiencing a 10.6% increase in total pay, and the wholesale, retail, and accommodation sector experiencing an 8.4% total pay increase.

Chart 15: Real wages and the CPIH, UK, January 2010 – April 2022



Source: *ONS*

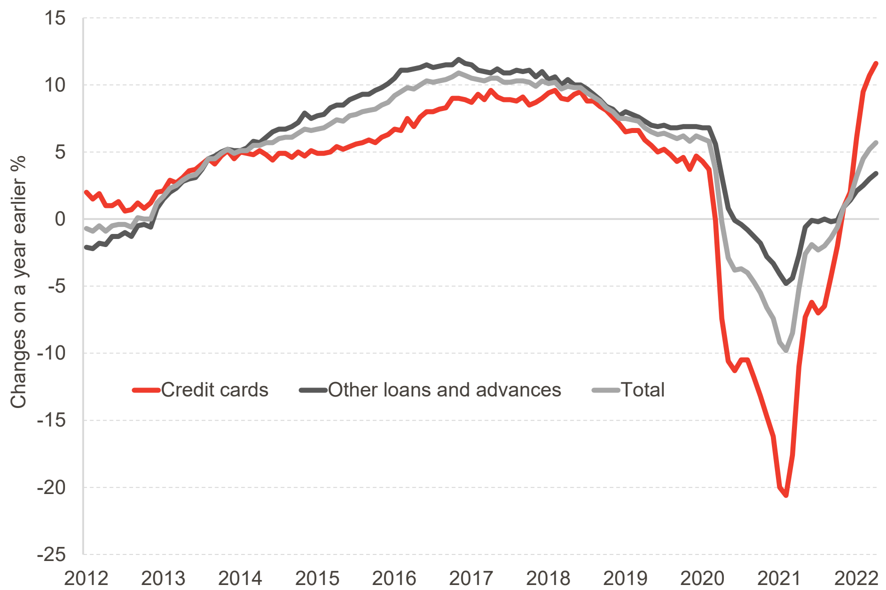
The Bank of England estimate that individuals borrowed an additional £1.4 billion in consumer credit in April 2022, following £1.3 billion borrowed in the month before.

The annual growth rate for consumer credit was 5.7% in April, up 0.5 percentage points from March. This was driven primarily by increases in growth rates of credit card borrowing (11.6%) but also increases in other loans and advances (3.4%), see Chart 16.

Given the variation in earnings growth and rising prices, inflation is chipping away at many households disposable income.

This means we could see higher credit growth in the coming months as some households take on more credit in order to top up depleted incomes, but also a reduction in social spending, which could have negative implications for industries such as hospitality, who are only just recovering from the effects of the COVID-19 pandemic.

Chart 16: Consumer Credit Growth Rate, UK, January 2012 – April 2022



Source: *ONS*

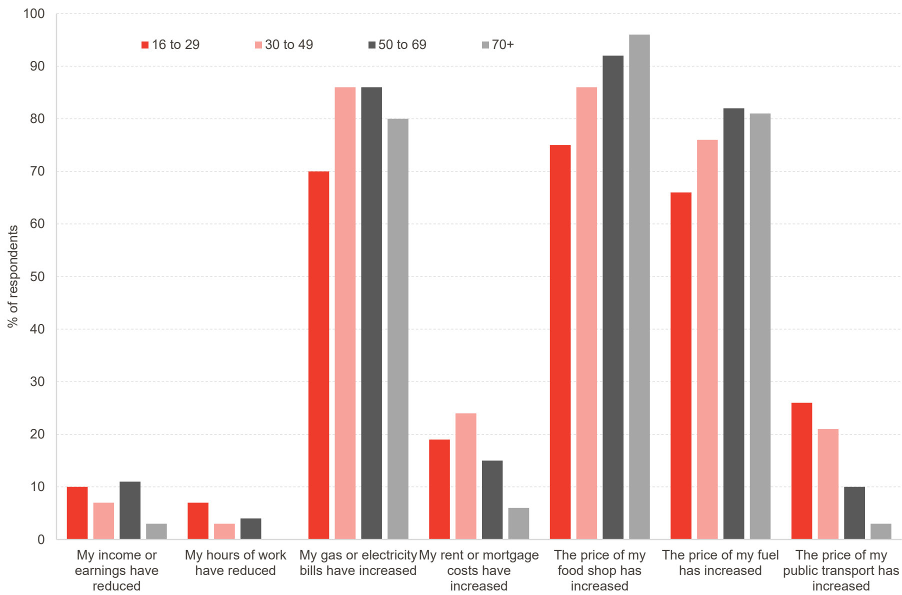
Are the effects of inflation equal?

The high costs also appear to be impacting individuals of all ages. The majority of young people, working age adults and over 70's reported increases in the cost of electricity and gas, food and fuel prices, see Chart 17.

However, in 2021, it was estimated that individuals under the age of 30 spend around 26% of their income on housing, fuel and power, compared to 12.5%, on average, for those over the age of 30[8].

This suggests that whilst individuals of all ages are affected by the ongoing price rises, it is young adults that may be feeling the pinch more given that they spend a higher share of their income on housing, fuel and power.

Chart 17: Cost of Living Crisis by age band, 16th March 2022 – 27th March 2022



***Source:** Opinions and Lifestyle Survey*

Global Economy

Since our last commentary, global economic growth has stalled.

The continued supply chain disruptions, inflationary pressures and rising energy costs continue to hamper global economic growth.

As well as this, the ongoing conflict in Ukraine has also had significant impacts, with estimates from the National Institute of Economic and Social Research (NIESR) indicating a 1% fall in global GDP as a result.

All of this uncertainty has led to a far more pessimistic outlook of the global economy when compared to the beginning of the year.

Notably, in May 2022, the Bank of England forecast global economic growth of 2.5% in 2022, 1.8 percentage points lower than their January 2022 forecasts.

8 See ONS

Table 1: World GDP growth projections, 2022 - 2024

	2022	2023	2024
BofE	2.5	2.0	2.0
OBR	3.9	3.8	3.8
World Bank	2.9	3.0	3.0
OECD	3.0	2.8	-
IMF	3.6	3.6	-
Fitch Ratings	2.9	2.7	-

Source: *BoE, OBR, World Bank, OECD, IMF, Fitch Ratings*

In the Bank of England's May forecasts, GDP growth between emerging market countries and countries in the Euro area and the US had diverged. See Chart 18.

GDP growth is forecasted to fall to 2.25% in 2022, before dropping to 1.25% in 2023 and 1% in 2024.

Meanwhile, GDP growth in emerging markets and developing economies is expected to grow from 4% in 2022, to 4.5% in 2023, and to 5% in 2024.

Chart 18: Bank of England Economic Growth Forecasts, 1998-2024

Source: *Bank of England*

The ongoing conflict in Ukraine also continues to have a significant impact globally.

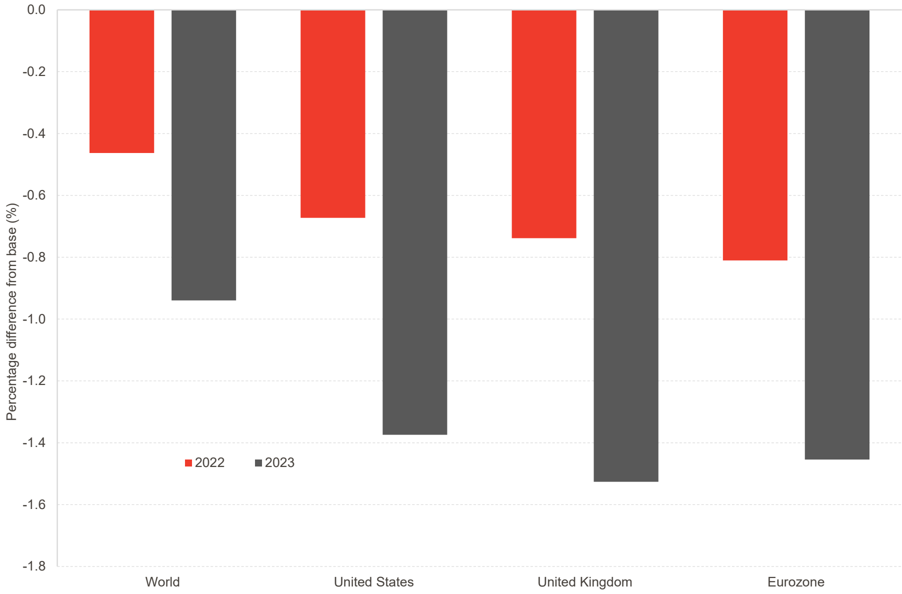
Not only has the conflict left millions of Ukrainian nationals displaced, with the UN and Global Protection Cluster Coordinator estimating that 17.5% of the Ukraine population (12.8 million individuals) have now fled the country.

But projections from the World Bank estimate the Ukrainian economy could contract by 45.1% this year if the war continues at its current intensity.

The spill-over effects into the global economy have also had significant implications.

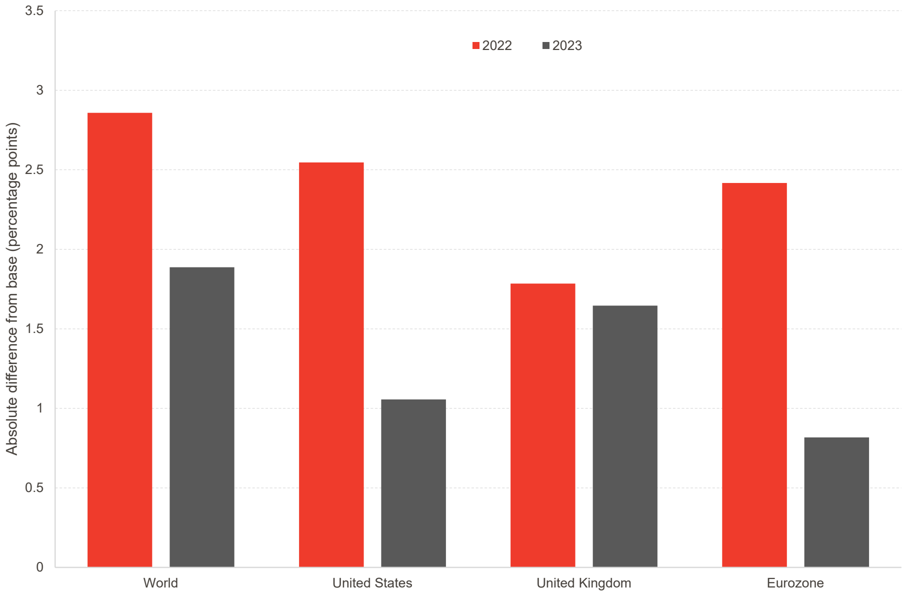
Globally, the war in Ukraine is estimated to reduce global GDP by 1% by 2023 and increase global inflation by 3% in 2022 and 2% in 2023. See Charts 19 and 20.

Chart 19: GDP cost due to Ukrainian conflict, 2022-2023



Source: *NIESR, NiGEM Simulations*

Chart 20: Inflation impact due to Ukrainian conflict, 2022-2023



Source: NIESR, NiGEM Simulations

The situation in Ukraine and subsequent sanctions imposed on Russia mean that, similar to the UK, inflationary pressures are causing a significant cost of living crisis for many countries.

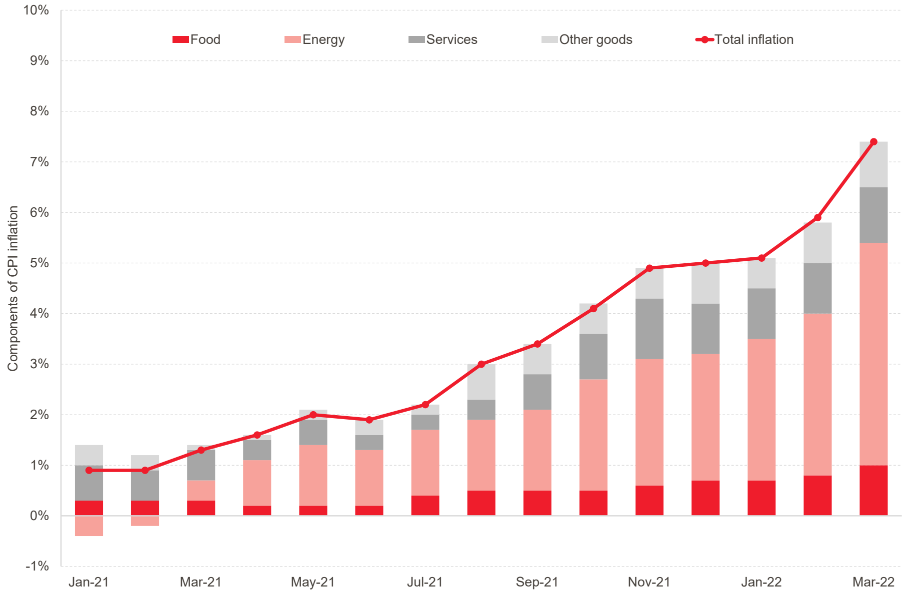
In March 2022, the price of most goods continued to rise across the Eurozone, with growth of 7.4% in the CPI inflation rate, see Chart 21.

Energy contributed the largest share of this at 4.4-p.p., a 1.2 percentage point increase on the previous month.

The story was similar in the US where the CPI inflation rate was 8.5% in March 2022, a 0.6 percentage point increase on February's rate, see Chart 22.

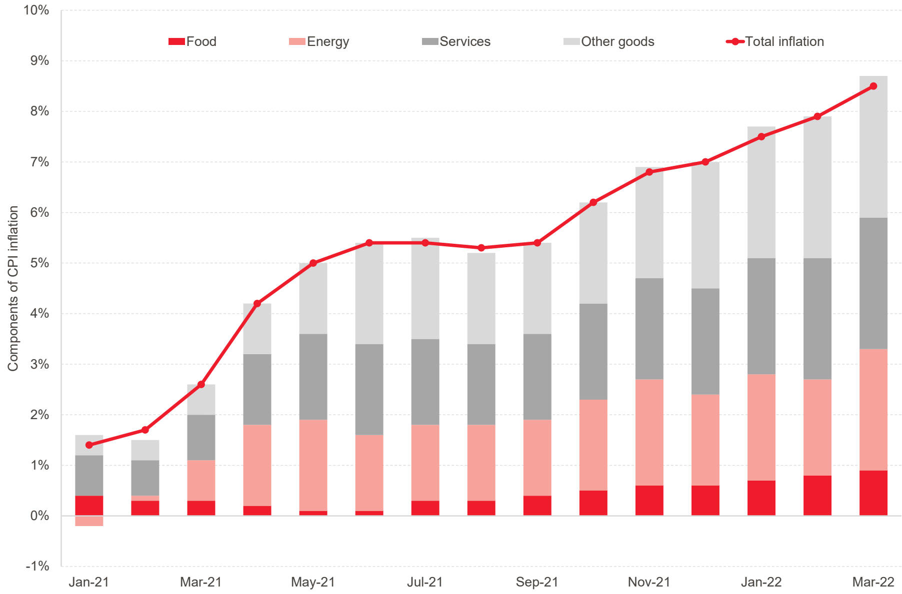
The increase in prices was far more spread across a number of sectors in the US. The price of other goods contributed the largest share of 2.8 percentage points. However, this was followed by the price of both services (2.6 p.p) and energy (2.4 p.p).

Chart 21: Euro Area Components of CPI Inflation, January 2021 – March 2022



Source: *Bank of England*

Chart 22: US Components of CPI Inflation. January 2021 – March 2022



Source: *Bank of England*

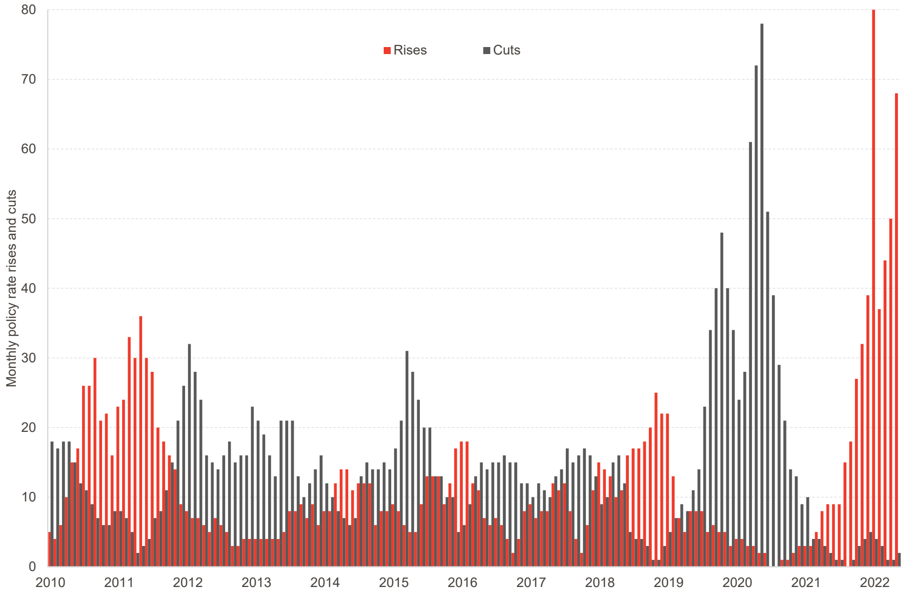
In an attempt to combat the ongoing price hikes, central banks have extensively increased interest rates to drive down inflation, see Chart 23.

In June, the US Federal Reserve increased its interest rate target to 1.5% - 1.75%, an increase of 0.75 percentage points, the largest interest rate increase by the Fed in almost 30 years.

Recent reports by the Economist Intelligence Unit suggest the FED could raise interest rates further, with early estimates suggesting rates of 2.9% by 2023.

The story is similar for European Central Bank, with early predictions that the ECB will introduce positive interest rates for the first time since 2014.

Chart 23: Central Bank interest rate rises/falls over the month, 3-monthly rolling sum



In their analysis, the Financial Times identified 55 countries and measured policy rate increases/decreases against their latest target rate.

Source: *Bank of England*

The outlook for Scotland's public finances

What was published?

At the end of May the Scottish Government set out its first resource spending review since 2011 alongside the Medium Financial Term Strategy.

The review covers the government's spending plans for the remainder of this term of parliament – from 2023/24 to 2026/27.

Spending plans are expressed at 'level 2' for the four years of the review period. The focus on Level 2 means that there are no specific allocations for organisations whose funding is at 'level 3' or 'level 4' – these include for example SEPA, Health Boards, Zero Waste Scotland, and many others.

However, even at this relatively aggregated level, we can still learn a lot about the government's priorities over the coming years.

What did we learn?

There was much discussion in the lead-up to the Spending Review of a funding 'black hole', with the government's own analysis in December 2021 showing a £3.5bn gap between its total spending aspirations and its likely budget in 2026/27.

This analysis was undertaken by the government to provide context on the scale of the challenge and manage expectations.

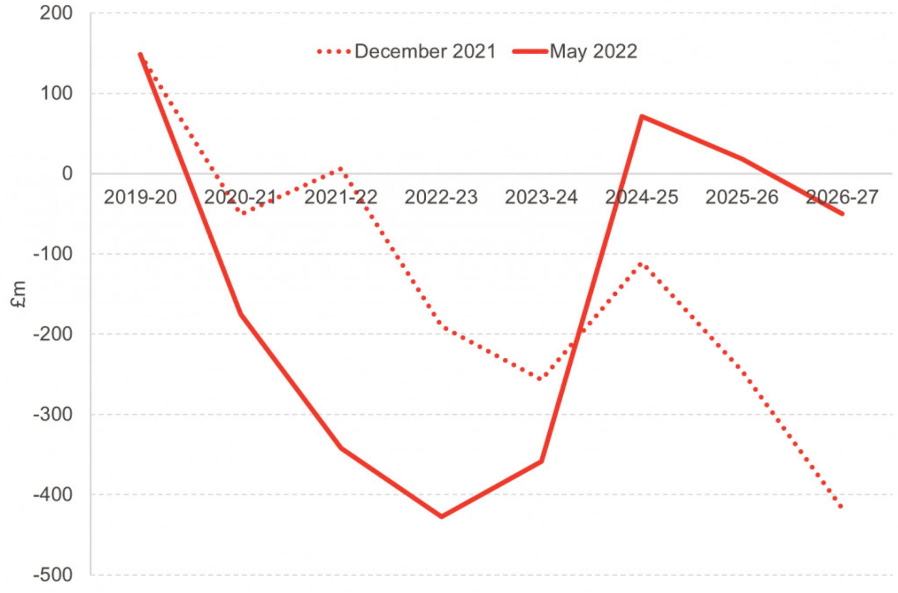
In reality, there cannot be a funding gap given the Scottish government has to run a balanced budget. What we don't know explicitly is which elements of spending aspirations the government has had to do without in order to bring its aspirations into line with budget reality.

The government warned that the outlook was challenging given the key factor determining the size of the Scottish budget - the block grant from the UK government - is projected to barely increase at all in real terms between 2022/23 and 2025/26, with only a slight increase in the final year of the forecast.

In addition, the outlook for the contribution of income tax revenues to the budget has deteriorated in 2022/23 and 2023/24 compared to the position in December 2021, see Chart 24. This further constrains the envelope available for the Scottish Government.

However, the outlook for the income tax net position improves considerably in later years, partly because of changes to assumptions about Scottish and UK government income tax policy. In particular, the decision of the UK Government to cut the Basic Rate to 19% from 2024-25 is improving the net position, given that it lowers tax receipts in the rest of the UK.

Chart 24: The implied income tax net position



Source: *Scottish Fiscal Commission*

All of these constraints led to some tough settlements for certain portfolios in the budget.

The local government budget will decline by 7% in real terms between 2022/23 and 2026/27.

Universities and colleges (including student grant support), the police authority, prisons, fire and rescue services and the legal aid budget, amongst other areas, also see real terms fall in their allocations of 8% over the period.

The government said it would prioritise spending on health, social care, and social security.

However, the health budget is projected to increase by only 3% over the parliament and whether this is sufficient to meet the government's aspirations, addressing pandemic pressures and dealing with other budgetary pressures, remains to be seen.

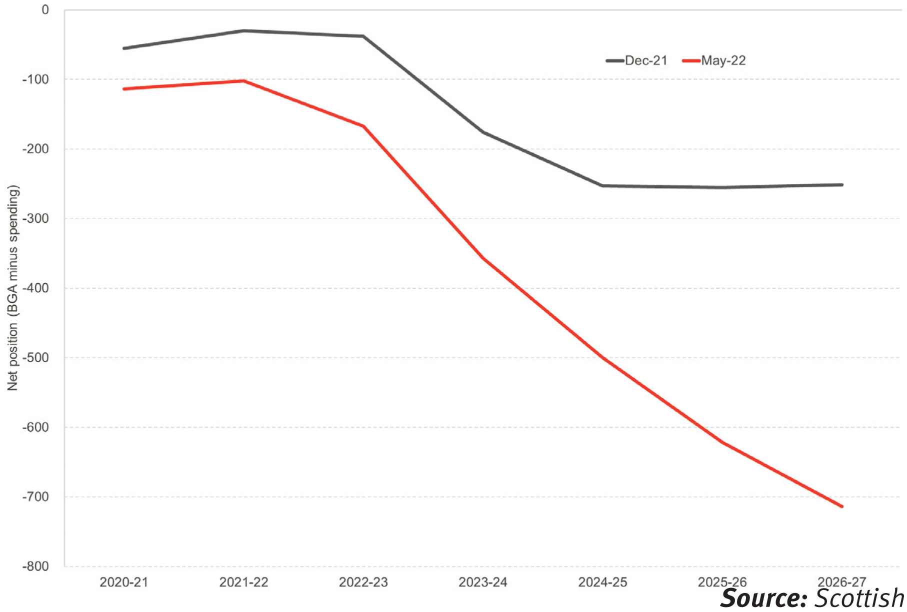
Whilst spending on health and social care is set to increase by almost £2bn over the course of the parliament, spending on social security is set to increase by a similar amount in cash terms, reaching over £6bn by the final year of the parliament.

Spending on social security is now forecast to exceed the additions to the Scottish block grant by over £700m in the final year of the Spending Review period, worsening the net position, see Chart 25.

This difference largely reflects policy decisions by the Scottish government around the newly devolved disability and carer benefits.

However it is important to note that this does not include the costs of 'new' Scottish social security payments, notably including the Scottish Child Payment, which add a further £500m to social security spending each year.

Chart 25: Social security spend net position (BGA less spending), May 2022 forecasts



Source: *Scottish Fiscal Commission*

What's next?

The next big event in the fiscal calendar is the Scottish Draft Budget which is usually published early in December.

However, before that, we can expect a period of pre-budget scrutiny in parliament over the course of the Autumn, as subject committees consider the implications of the Spending Review for their portfolios.

In some cases, more detail is likely to be needed in order for scrutiny to be fully informed; for example, the spending implications of the introduction of the National Care Service, and how this interacts with local government funding.

Despite this, after waiting more than a decade for a multi-year spending review, the subject committees will no doubt welcome having this detail to guide their deliberations in the run up to the budget.

The detailed sectors of the UK Economy

In each edition of the Commentary since the start of the pandemic, we have discussed that the impact of the pandemic and associated lockdowns has not impacted equally across sectors.

As we move further into 2022, despite the economy as a whole moving past pre-pandemic levels, there are concerns that those sectors which have been most affected may well be those who will also suffer due to the cost of living crisis.

We use detailed sectoral data in this section (only available for the UK) to analyse where detailed sectors are in comparison to pre-pandemic levels (at the end of 2019). The figures in Q1 2022 are compared with Q4 2019 (100 would be a sector which is back to Q4 2019 levels).

Table 1: Level of detailed sectors, UK, 2019 Q4=100, poorest performers

	Level in Q1 2022, (2019 Q4=100)	Types of companies/services	Weight in the economy (parts per thousand 2019)
Water transport	57.1	Passenger and freight related water transport	3.6
Rail transport	58.9	Passenger and freight related rail transport (interurban, not including subways)	2.6
Travel agency, tour operator and other reservation services	59.6	Travel agents, tour operators & tourist guides	5.5
Air transport	77.7	Passenger and freight related air transport activities	2.8
Activities of membership organisations	81.8	Business and employer membership organisations, trade unions and political organisations	4.3
Mining and quarrying	83.5	Oil and gas extraction activities (e.g. in the North Sea) & onshore mining support services	10.7
Buying and selling, renting and operating of own or leased real estate	86.3	Those who buy, sell and rent their own or leased property, like property companies, housing associations, and conferencing and events (not estate agents)	35.6
Other personal service activities	88.1	Dry cleaners, hairdressers and beauticians, spas	11.4
Crop and animal production	88.7	Growing of crops & plants, raising of cattle, sheep & poultry	6.1

Source: *ONS low-level aggregates*

As may be expected, transport related services (as at Q1 2022), are those furthest behind their pre-pandemic levels. As working from home and travel restrictions have continued to ease over the course of quarter 2, it will be interesting to see how these sectors further recover.

Sectors related to the North Sea continue to operate below pre-pandemic levels, which has some of the fiscal consequences (in terms of the outlook for income tax, given the relatively high wages in the sector) discussed in the previous section. Conferencing and Events related activities are still not back to pre-pandemic levels, but again this is likely to have improved during Q2.

Of concern related to discretionary spending by consumers is "Other personal services", which includes businesses like hairdressers and beauticians, which could be cut back on by consumers if they need to divert their spending to essentials.

We also analysed those sectors who are best performing compared to pre-pandemic levels.

Table 2: Level of detailed sectors, UK, 2019 Q4=100, top performers

	Level in Q1 2022, 2019 Q4=100	Types of companies/services	Weight in the economy (parts per thousand 2019)
Advertising and market research	111.1	Advertising agencies, media representatives, market research and public opinion polling	9.2
Veterinary activities	111.5	Activities of qualified vets, in vet hospitals and when visiting farms, vet assistants and diagnostic testing related to animals	2.0
Programming and broadcasting activities	112.4	Radio and television broadcasting	4.1
Employment activities	112.6	Employment agencies, including temporary employment agencies and HR services	14.7
Warehousing and support activities for transportation	113.1	Warehousing and storage, operation of freight terminals, cargo handling	12.1
Security and investigation activities	116.6	Private security services (like security guards), security alarm services, investigation and detective services	1.8
Human health activities	121.3	Hospital and GP activities, Dental Services etc. Mostly public sector delivered through the NHS, but also includes private providers. This sector also includes activity associated with the vaccination programme and test and trace which will unwind somewhat over subsequent quarters	52.2
Accounting, bookkeeping and auditing activities; Tax consultancy	124.3	Accounting and auditing services, plus tax consultancy	11.9
Postal and courier activities	127.2	Post and courier services, both Royal Mail and private carriers	6.1

Source: *ONS low-level aggregates*

Postal and courier services continue to do very well compared to pre-pandemic levels, related to the ways we have changed how we work and shop. Related to this is the strong performance of the warehousing sector.

Professional services related to accountancy, tax and auditing are one of the best performers. In a tight labour market, it is perhaps not surprising that employment agencies are doing well compared to pre-pandemic levels.

We will continue to produce this analysis as we move through 2022 to understand what is happening to the detailed sectors of the economy.

The changing nature of work

Many parts of our normal life have resumed, with most of the measures that were introduced to slow down the spread of COVID now gone.

However, in March 2020, as offices were upheaved, computers taken home, and desk chairs loaded into the back of cars, most individuals would have expected to only be working at home for a short period of time.

But two years on and this temporary way of working has become the new way to work for some.

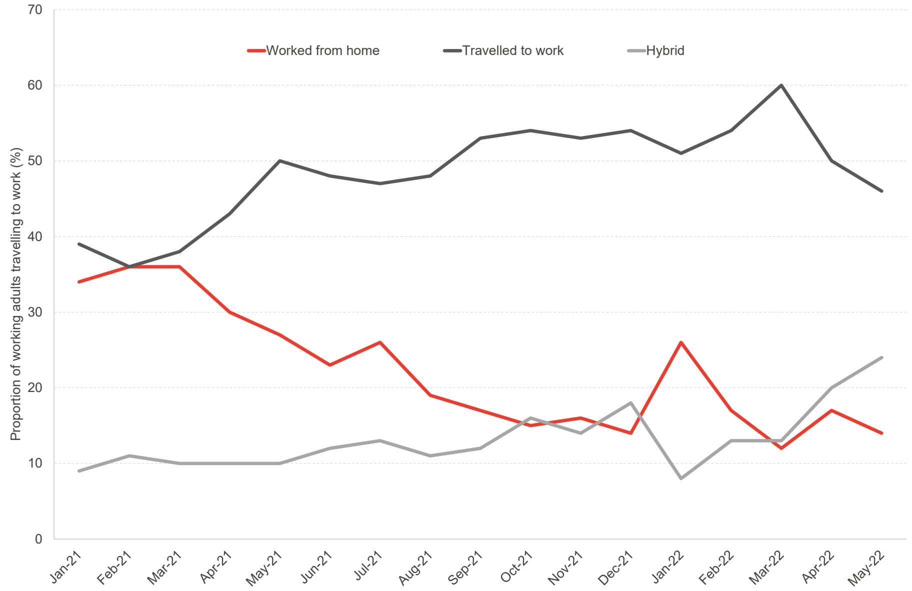
At the start of the pandemic, when government guidance mandated working from home, the ONS estimated that more than half of all working age individuals were working from home. In January 2021, around 1 in 3 individuals reported they had worked at home in the last 7 days.

Between 27th April and 8th May 2022, when the guidance to work at home was no longer in place, 14% of working individuals still reported working from home for at least 1 day that week[9].

The largest share of individuals - roughly 46% - had however returned to work in May, although the emergence of a new 'hybrid' mode of work created a new way of working.

At the beginning of May, 1 in 7 individuals were working both at home and at their place of work, a near 200% increase on the beginning of the year, see Chart 26.

Chart 26: Proportion of working adults travelling to work, GB, January 2021 – May 2022



Source: *ONS Opinions and Lifestyle Survey*

Part of the explanation of why many individuals are still choosing to work at home, even for only part of their week, is the change in attitudes of workers and their ability to work at home.

However, a lot of the myths surrounding lower productivity have been dispelled by businesses, with many firms now choosing to permanently introduce some form of homeworking into their business model.

9 See ONS

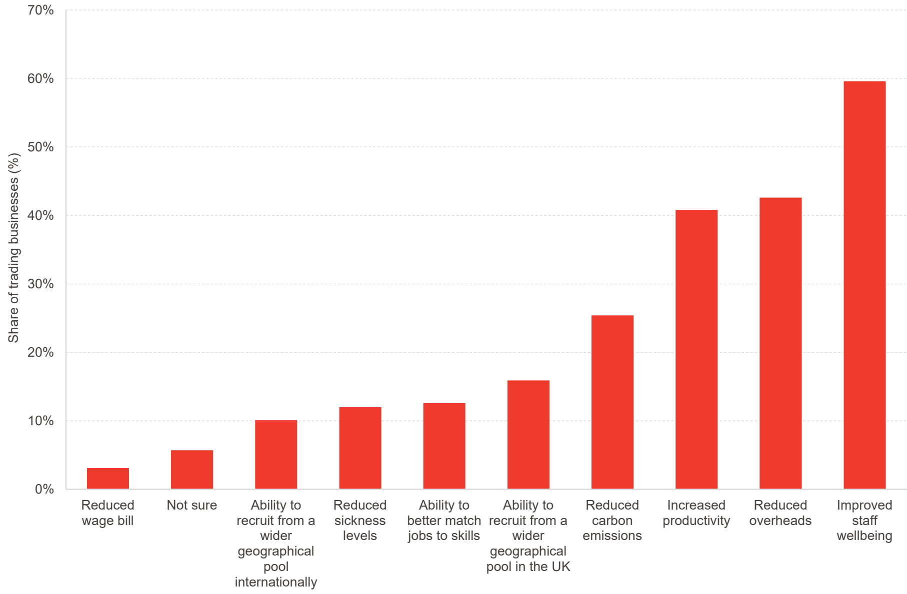
In the autumn of 2020, as the first lockdown had eased slightly, only 16% of firms expected to permanently include homeworking in their business model, however by April 2022 this had risen to 23%, or just under 1 in 4 firms.

Unsurprisingly this was particularly evident in sectors where the nature of work is far more adaptable to homeworking such as the Information and Communication industry (54%) and Professional, Scientific and Technical sectors (43%) – compared to only 3% of firms in the Accommodation and Food services sector.

On the employer side, the most common reasons given by firms for permanently introducing homeworking at the beginning of April was to improve staff wellbeing (60%), reduce overheads (43%) and increased productivity (41%), see Chart 27.

With employees reporting that improved work life balance (78%), having fewer distractions (53%) and the ability to complete tasks more quickly (52%) as the most common benefits for them to work from home.

Chart 27: Reasons for adopting homeworking as a permanent business model, 4th – 17th April 2022



Source: *ONS BICS*

What does this mean for the future of work?

The shift to a more hybrid style of work has not only adjusted attitudes of existing workers in firms and the firms themselves, but has also changed the attitudes of any prospective workers.

What this means is that individuals may begin to put a preference on jobs in firms that offer hybrid or at-home work over purely office-based work, placing pressure on firms to permanently adopt hybrid practises and offer these on vacancies.

Darby, McIntyre and Roy (2022) found when looking at over 47 million jobs vacancies advertised in the UK between January 2018 and January 2022 on the Adzuna job market website that the number of job adverts mentioning working from home opportunities was 5 times higher in January 2022 than it was in February 2020.

Their analysis finds that before the pandemic, the share of online job adverts did not exceed 3.3% in any month between January 2018 and February 2020, however by January 2021, this was as high as 11%, or roughly 1 in 10 online adverts.

What is therefore clear is that the nature of work has changed for good, and for many individuals, working 5 days a week in an office is a thing of the past.

Policy Section: Global trade

In our June commentary last year, we discussed the negative impact that the Coronavirus pandemic and Brexit had on trade activity.

Since then, despite the easing of coronavirus restrictions and major world economies returning to pre-pandemic levels, global trade continues to struggle with significant disruption for supply chains across the world.

18 months on from the UK's exit from the European Union and global shortages of materials, given the shutdown of production during several waves of lockdown in the wake of COVID-19, has put serious pressure on global supply chains.

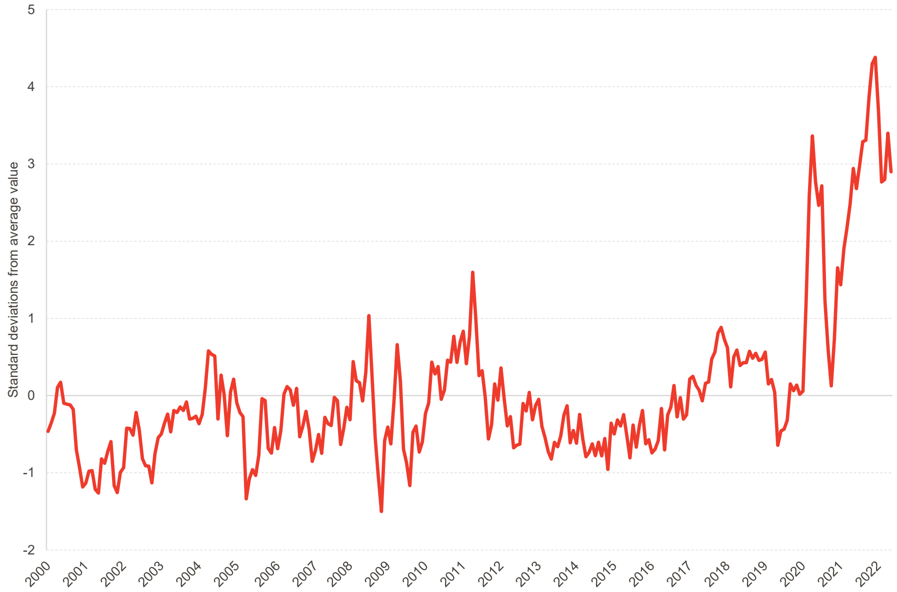
Global supply chains

Despite a continued easing of the significant pressures experienced at the end of 2021, the Global Supply Chain Pressure Index (GSCPI) remained at near record high levels in May, see Chart 28.

The continued pressures experienced in the global index were primarily driven by outbound trade from Asia and also UK backlogs, despite improvements across the majority of other indicators.

The ongoing Ukraine-Russian conflict also continues to hamper trade across Europe, with delivery times in the euro area placing greater strain on supply chains.

Chart 28: Global Supply Chain Pressure Index, January 2000 – May 2022

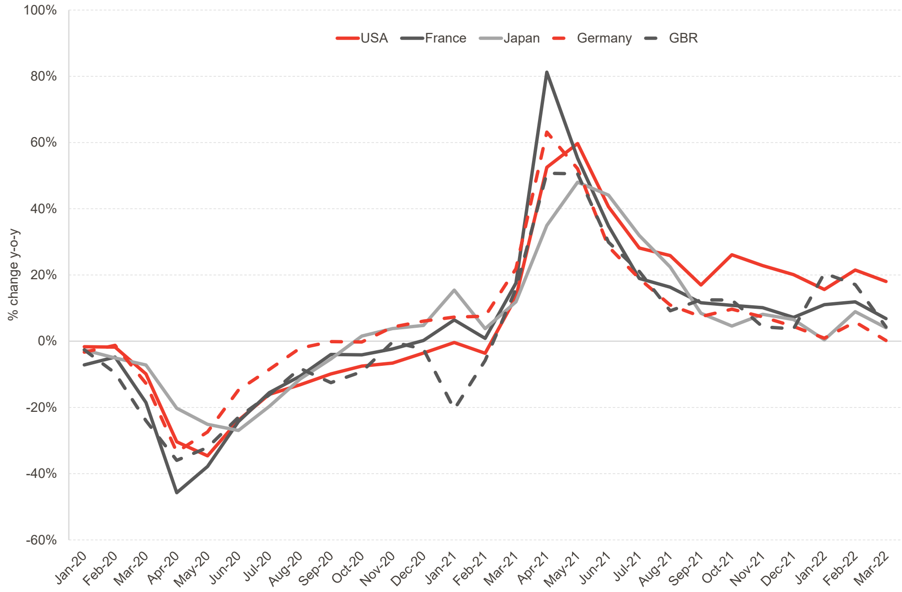


Source: *Federal Reserve Bank of New York*

However, despite the pressure on global supply chains, export of goods continues to grow across the majority of major economies.

Exports of goods from the US continued to grow at higher levels than other major economies, up 18% in March 2022. Average growth across other major economies was roughly 4%, far slower growth than experienced in April of last year.

Chart 29: Exports, major global economies, January 2020 – March 2022



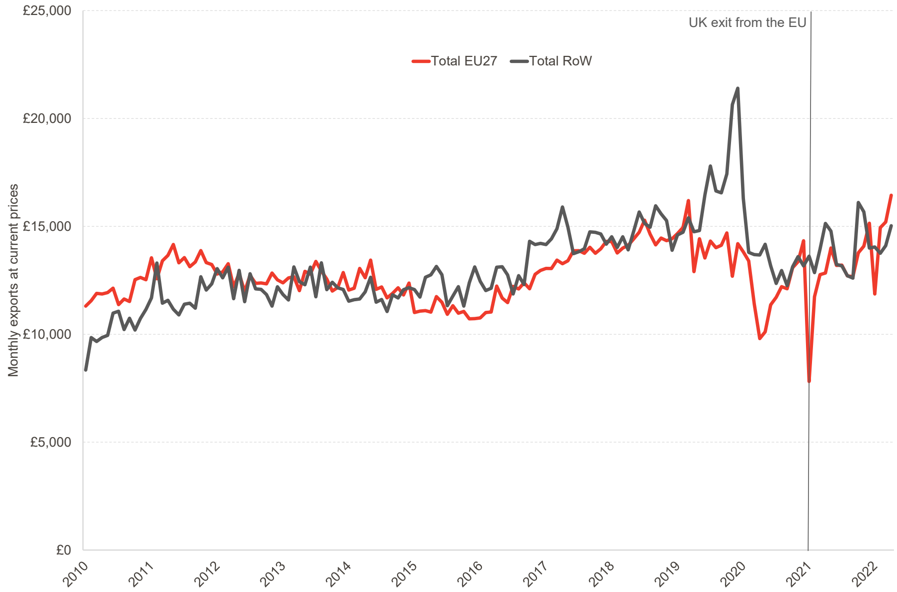
***Source:** OECD*

How has the UK been affected?

The latest UK trade data suggests that total monthly exports grew by 7% between March and April, up 12% on the previous year.

In the past year, both exports to the EU and RoW have remained at very similar levels. In recent months however, EU exports have remained slightly higher, with the value of exports higher than the RoW figure for the third consecutive month, see Chart 30.

Chart 30: UK monthly exports at current prices, January 2010 – April 2022

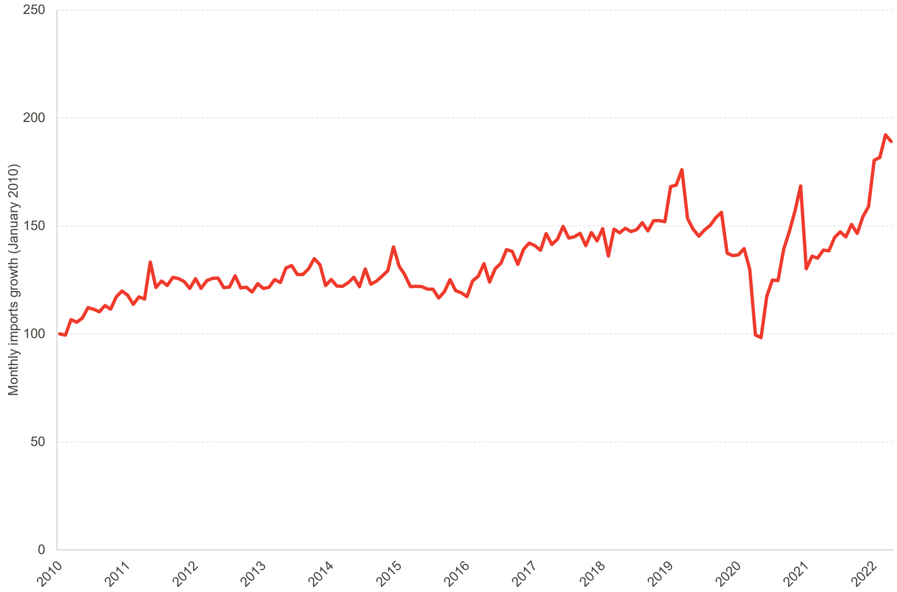


***Source:** ONS*

As well as recovery in exports in the past few months, imports to the UK have also continued to grow and recover.

Growth in imports remained at some of its highest levels since the beginning of 2010, with growth in imports of 35% since February 2020, see Chart 31.

Chart 31: UK monthly imports index, January 2010 – April 2022



Source: *ONS*

The implications of disrupted trade flows

As mentioned in our outlook and appraisal section, the input producer price inflation (PPI) rate rose 22.1% in the year to May 2022, a 1.2 percentage point increase on the previous month.

This rise was significantly higher than the output PPI rate of 15.7% in May, the 17th consecutive positive output PPI rate.

Growth in the input PPI rate was primarily driven by the surge in price of metals and non-metallic minerals, with annual price growth of 24.1% in May 2022, contributing 4.89 percentage points to the overall input PPI.

As well as this, crude oil also contributed significantly - 4.4 percentage points - highlighting that similar to consumers, producers are incurring huge costs for fuel and energy, see Chart 32.

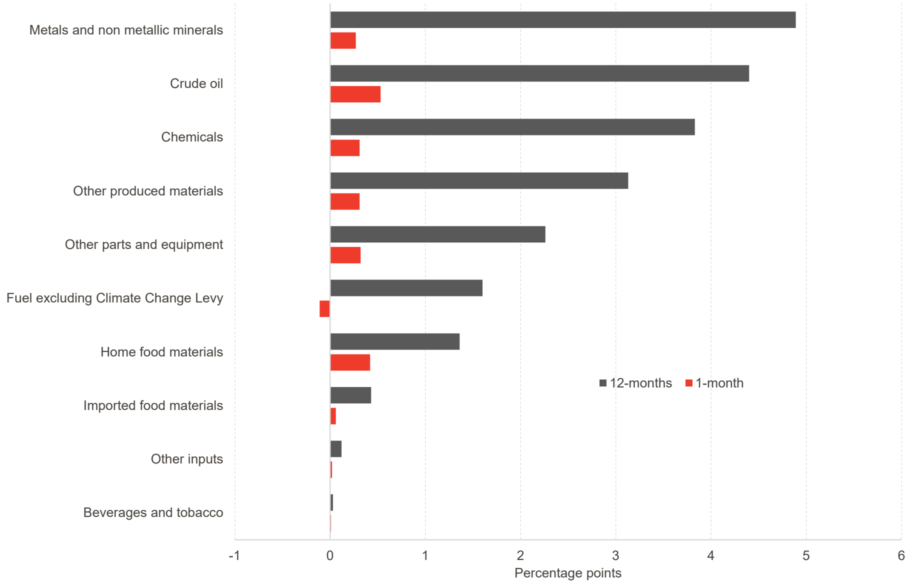
However despite oil, and subsequently fuel and energy driving price hikes for inputs, the cost of food provided the highest contribution to the annual output PPI rate, 3.47 percentage points, see Chart 33.

Food products experienced annual growth of 10.4% in May 2022, the highest annual rate since September 2008, given the sharp price rises in the preserved meat and meat products market.

The UN's global food price index[10] also indicated high prices in food markets globally, with the indicator averaging 157.4 points in May 2022, a fall in prices on April of 0.9 percentage points, but still a 29.2 percentage point increase on May 2021.

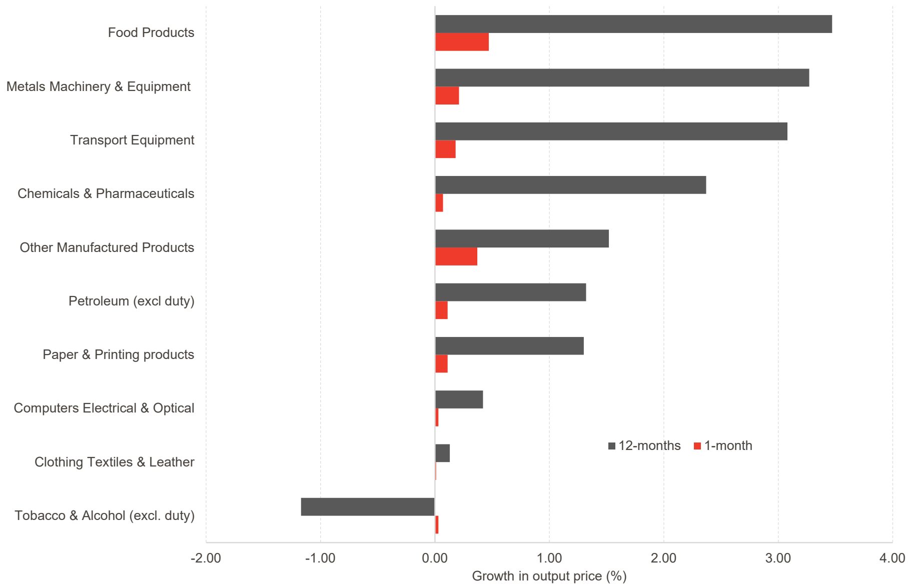
10 The UN Global Food Price Index is a measure of monthly change in international prices of a basket of food commodities including cereal, vegetable oils, dairy, meat and sugar.

Chart 32: Growth in input producer price inflation rate by component, 1 month and 12 month rate



Source: *ONS*

Chart 33: Growth in output producer price inflation rate by component, 1 month and 12 month rate



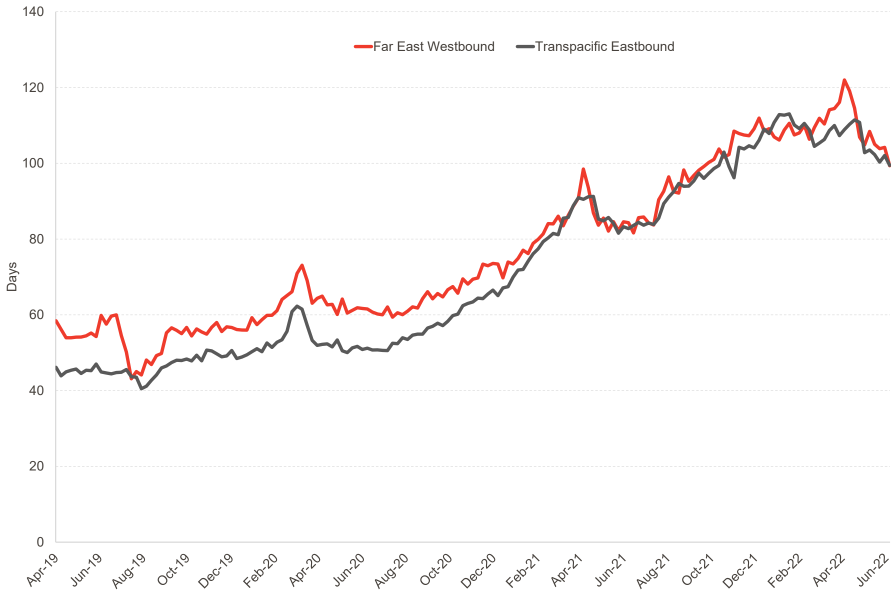
Source: *ONS*

Whilst the expectation is that the increases in producer prices at the 'factory gate' could further increase consumer prices, the growth in the input PPI rate shows that at the opposite end of the supply chain, availability of materials and goods is what is pushing costs up, particularly as demand increases.

Flexport's Ocean Timeliness Indicator shows this disruption in international shipping times with a shipping container on the Trans-Pacific route to US from Asia taking 99 days, a trip that took only 50 days at the beginning of 2020, see Chart 35.

This suggests that until international shipping returns to its pre-pandemic levels, if it does at all, and demand only continues to rise, it may be a while before we see any cooling in input prices for producers.

Chart 34: Flexport's Ocean Timeliness Indicator, Days taken from 'cargo ready' to the destination port, 1st January 2020 – 12th June 2022



Source: *ONS*

In order to overcome the ongoing supply chain disruption, many UK manufacturers have moved to reshore their production.

The current state of international trade flows means many business have looked closer to home, particularly those operating under just-in-time processes, who are now mitigating any risks by moving away from some of their offshore supply and sourcing domestic materials.

Many of these firms have also looked to move away from reliance on Asian suppliers given extensive lead times, and instead use UK based suppliers.

A recent survey by Make UK, an independent trade body for engineering and manufacturing in the UK, suggested that 75% of firms had increased their use of British suppliers in the past two years, with just under half planning to increase UK supply in the coming two years[11].

Their results suggested that around 40% of reshoring had come from China, and over 30% from Eastern Europe.

What can be done?

What the ongoing disruptions have taught us however is that there is an opportunity to rethink trade policy, particularly as manufacturers and suppliers slowly reverse the decades long move to offshore supply.

The recent launch of The Centre for Inclusive Trade Policy aims to aid this process. The centre is the first solely dedicated to trade policy and is funded by the Economic and Social Research Council (ESRC).

The centre is built on the idea that trade policy should be inclusive in both policy formulation and outcome and focuses on four dimensions of inclusiveness: geography, political domains, society and generations.

In addition, the Centre itself is inclusive with researchers in all four UK nations, in five disciplines and at all stages of their careers, with a commitment to hear the voices of all parts of UK society.

11 See Financial Times

Fraser of Allander Institute

University of Strathclyde

The Fraser of Allander Institute (FAI) at the University of Strathclyde entered Scottish public life in 1975. Since then, it has become established as a leading independent economic research institute working with a wide range of clients on a variety of different topics.

What we do

For 45 years, the Fraser of Allander (FAI) has been monitoring and commentating on the Scottish economy. Our regular publications include:

- FAI Economic Commentary – Quarterly – First published in 1975, our quarterly Economic Commentary provides the authoritative independent assessment of economic conditions in Scotland, along with a wide range of economic and policy issues.
- Scottish Business Monitor – Quarterly – Since 1998, the FAI Scottish Business Monitor has been a key leading indicator of the Scottish economy. This survey of Scottish business sentiment provides vital insights into the Scottish economy well in advance of official statistics.
- Scotland's Budget Report – Annual – The Fraser of Allander Institute's analysis of the Scottish Budget and the choices, risks and opportunities facing the Finance Secretary.
- Our blog – Launched in 2016, and viewed over 200,000 times, our FAI blog is a keenly watched discussion platform on the Scottish economy. The blog publishes short reflections on economic developments as well as the policy debate.

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