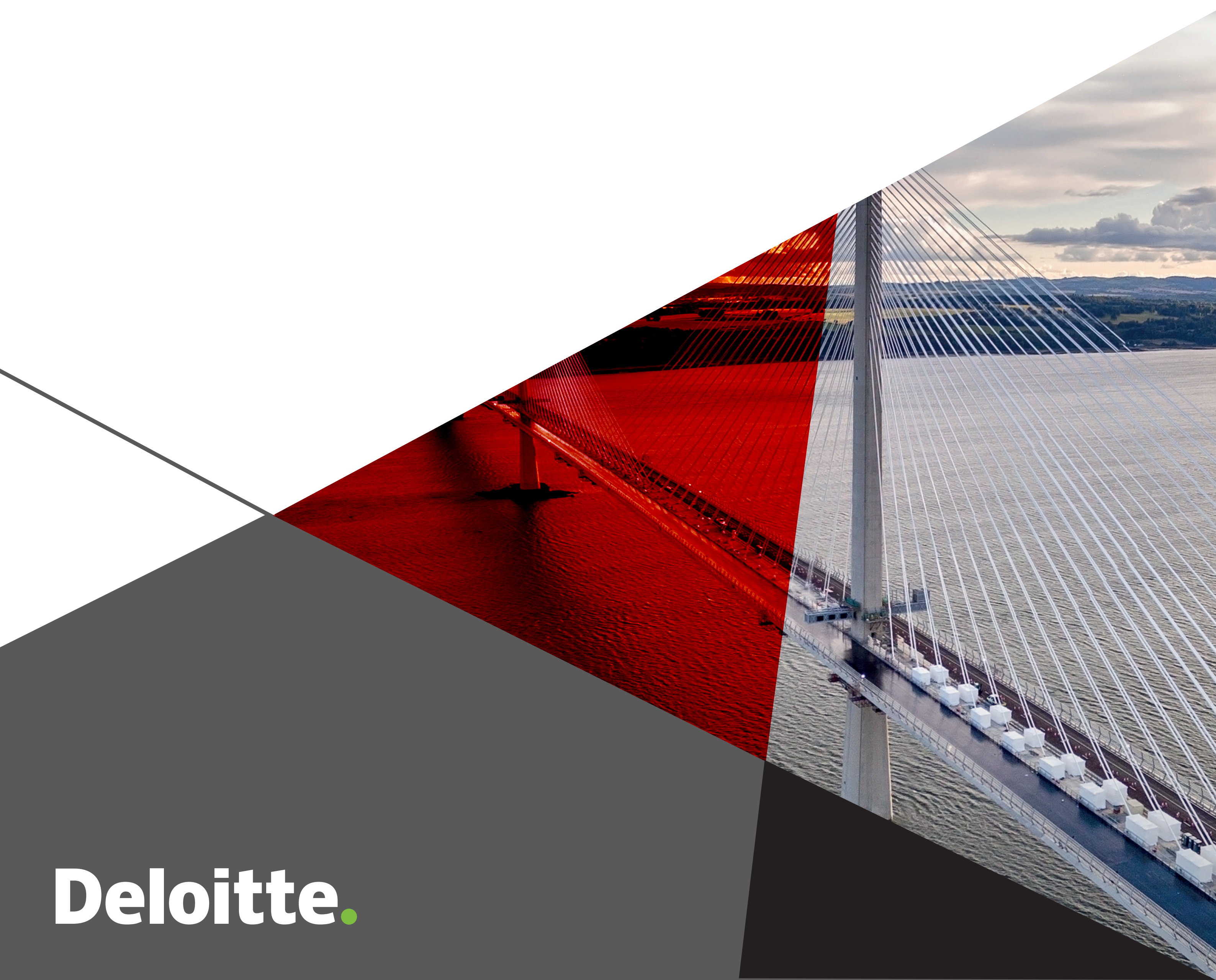
University of Strathclyde Glasgow

Fraser of Allander Institute

Economic Commentary

Vol 47 No 2



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Foreword

As we find ourselves halfway through 2023, it remains clear that mounting economic pressures from the last year in the shape of high levels of inflation and rising interest rates are continuing to challenge businesses and consumers alike.

This quarter's Commentary comes as Humza Yousaf marks his first few months as Scotland's First Minister with the first of his government's major fiscal statements - the Medium Term Financial Strategy. Outlining the financial plans and priorities for the next five years, it made clear that some very difficult decisions will need to be made imminently to ensure the sustainability of Scotland's public finances in the coming fiscal periods.

Despite the difficulties of the current climate, the latest data from the Fraser of Allander shows that the Scottish economy has performed better than was expected only a few months ago, when predictions indicated that a shallow recession was likely. Early estimates are that the Scottish economy has grown by 0.4% in the first quarter of 2023[1]. This has led the Fraser's economists to revise Scotland's 2023 forecast for growth up to 0.5% this quarter.

However, the outlooks for 2024 and 2025 have worsened in the face of ongoing high inflation. Both core and services inflation, watched closely by economists as indicators of how embedded price pressures are, have accelerated in the last month. With this underlying inflation hitting its highest level in 31 years, last week the Bank of England raised interest rates by 0.5 percentage points to 5%. Financial markets now expect the Bank to raise rates further, to a peak of 6% by the end of the year.

As interest rates continue to rise, recent house prices and higher mortgage rates, which are of significant concern for a large portion of the Scottish population, are a focus of this quarter's Commentary. The average two-year fixed residential mortgage rate rose to 6.15% last week, up from 6.07%[2], which comes as a considerable income shock for the roughly 25% of UK households with such deals.

Our Chief Economist at Deloitte, Ian Stewart, noted recently that consumer spending will come under greater pressure as mortgages reset and rates rise[3], with the Institute for Fiscal Studies reporting that 1.4m mortgage holders could lose 20% of their disposable income to rising borrowing costs[4].

Moreover, the team at the Fraser cite the Royal Institution of Chartered Surveyors who recently reported that the current economic climate has put a squeeze on housing availability. The supply of adequate housing promotes socio-economic benefits such as increased educational opportunities and labour market participation, and a lack of it can be detrimental to people's health and wellbeing.

In this context, the risks posed to the housing market are in plain sight, with rising inflation and interest rates hardening the mortgage crunch for millions of people. This was evident in Deloitte's recent Gen Z and Millennial Survey, which found that 61% of Gen Zs and 62% of millennials believe that buying a house will become harder or impossible if the current economic environment remains the same or gets worse[5], with financial precarity making it harder to plan ahead and invest in the future.

1 Fraser of Allander, Q2 Economic Commentary
2 Moneyfacts: mortgages
3 Soft landings, hard landings - The Monday Briefing (deloitte.co.uk)
4 Institute for Fiscal Studies: The impact of rising mortgages explained
5 Deloitte Global: Gen Z and Millennial Survey 2023

Global issues are continuing to affect the labour market and business operations. Market uncertainty is still a factor in business confidence, with businesses generally still cautious about investing.

While the unemployment rate in Scotland remains near record lows, this quarter's Commentary indicates that the labour market is slowing. The employment rate in Scotland fell 1.8 percentage points between February and April this year to 74.6%, while economic inactivity ticked up by 1.9 percentage points to 22.9%, the largest quarterly increase in these figures since the data series began in 1992[6].

Meanwhile, the review into the skills delivery landscape in Scotland (Withers Review)[7] was published this month, which sets out to ensure the public body landscape for skills remains fit to meet the challenges and opportunities of the future. Acting on the recommendations within the report will be crucial for delivering the right skills to support a growing Scottish economy, alongside vital support from each sector.

The challenges many businesses face in finding people with the right skills now, and longer term, was one of the areas focused on during an inclusive growth event held by Deloitte earlier this month. We reconvened almost 70 leaders from across Scotland's private, public, academic and third sectors in a follow up to our Shaping Scotland's Future Economic Landscape event, first held last November. I was once again very encouraged by the attendees' enthusiasm and commitment to make Scotland's businesses, industries, regions, communities, and public services more productive and innovative.

Key outputs from the skills session focused on how all sectors need to come together to make a difference, complementing each other's expertise, as well as a focus on the less technical skills or "softer" skills that are needed in order to grow our economy.

A focus on innovation is also a clear priority of the new Scottish Government, with the recently published National Innovation Strategy[8] outlining plans to make Scotland one of the most innovative small countries in Europe.

With this strategy comes an effort to reset the relationship between business and government, complemented by a New Deal for Businesses Group. Established to provide a forum for government and leaders to explore how best to support businesses and communities, this group will be welcomed by the many businesses that are actively working to innovate and narrow the productivity gap in Scotland.

These strategies should help to pave the way for businesses across Scotland to navigate the volatile economic climate and future-proof operations.

Douglas Farish

Office Senior Partner for Deloitte in Edinburgh

June 2023

6 Office for National Statistics: Labour market overview, UK: April 2023
7 Scottish Government – Independent Review of the Skills Delivery Landscape
8 Scottish Government – National Innovation Strategy

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Deloitte supports the production of the Fraser Economic Commentary. It has no control over its editorial content, including in particular the Institute's economic forecasts.

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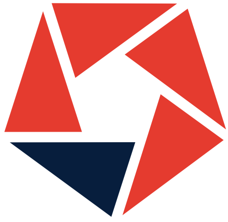

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Summary

In the last three months the news about the economy has been quite mixed. In March, we had predicted, along with many other forecasters, that it was likely that the UK and Scottish economies would be in a shallow recession as the impact of high inflation hit consumers and businesses.

However, the data in early 2023 has (mostly) confounded these expectations, with growth in the Scottish economy being recorded at 0.4% in Q1 of 2023. Surprisingly, we are also still seeing healthy growth in consumer-facing services in Scotland, which, in this early data, is showing some divergence in the experience in the UK as a whole.

This short-term optimism is countered somewhat by the stubbornly high inflation we are seeing in the UK economy. Inflation stood at 8.7% in May, unchanged from the April figure. Worryingly, core inflation (inflation excluding food, energy, alcohol and tobacco) rose in May, to 7.1%. These two pieces of news last week undoubtedly contributed to the Bank of England's decision last Thursday to raise rates for the 13th time in a row, taking the base rate up to 5%.

Food price inflation does seem to be easing, now at 18.4% for the year, down from the highs of 19.1% in March. While this is good news, it is still significantly above the average rate of inflation and is a source of inflation that is impacting those on the lowest incomes.

Despite the latest data showing little movement, we still expect that inflation will come down as we move through 2023 as we compare to the higher price levels in 2022. The expectations are that inflation will get down to around 5% by the end of 2022 – meaning that while the Prime Minister may meet his commitment to halve inflation it is looking much closer than it did before.

However, as everyone is getting fond of saying, this does not mean that prices will start to come down – only that they will not be rising as quickly. It is now not likely to be until 2025 when inflation gets back to the Bank of England's target level of 2%.

The combination of the short-term improvement in data we are seeing and the worries for the medium-term have led us to revise our forecasts for the Scottish economy.

We are now forecasting growth of 0.5% in 2023, followed by growth of 0.7% in 2024 and 1.2% in 2025. This is a considerable improvement for 2023 based on the outturn data to date. However, our views on growth for 2024 and 2025 have become more pessimistic given the likelihood that inflation and interest rates will be more elevated for a longer period of time.

Fraser of Allander Institute
June 2023

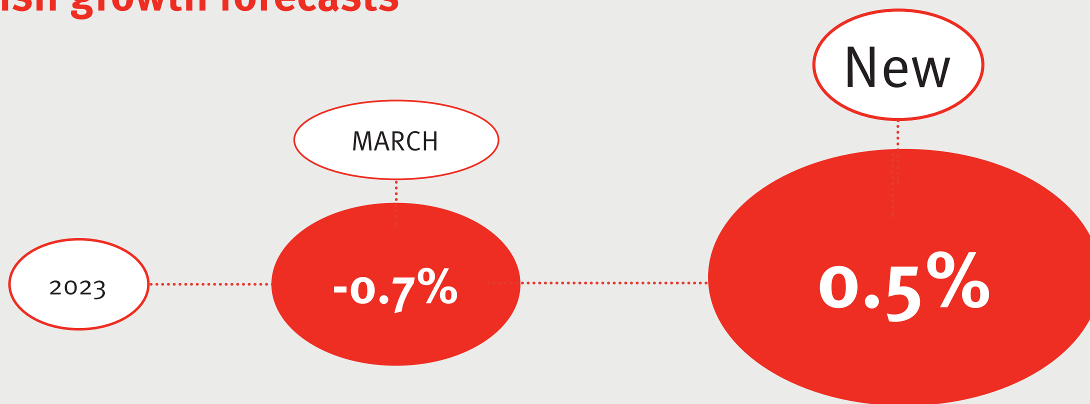
Fraser of Allander Institute

State of the economy

Indicator	% of 2019 Q4	Change on previous quarter	Performance	Latest data
Scottish GDP	101.2%	0.4%	▲	March 2023
Production	95.4%	0.8%	▲	
Construction	116.2%	0.7%	▲	
Services	101.4%	0.2%	▲	

Indicator	Level	Change on previous year, same month/ quarter	Trend	Latest data
Inflation (CPI)	--	10.4%		April 2023
Employment rate	75.3%	-0.4 pp	▼	Jan - Mar 2023
Unemp. rate	3.1%	-0.1 pp	▼	
Inactivity rate	22.2%	-0.2 pp	▼	

Scottish growth forecasts



	2023	2024	2025
FAI *June 2023*	0.5%	0.7%	1.2%
FAI *MARCH 2023*	-0.7%	0.9%	1.7%
FAI *FEBRUARY 2023*	-1.0%	0.6%	1.7%

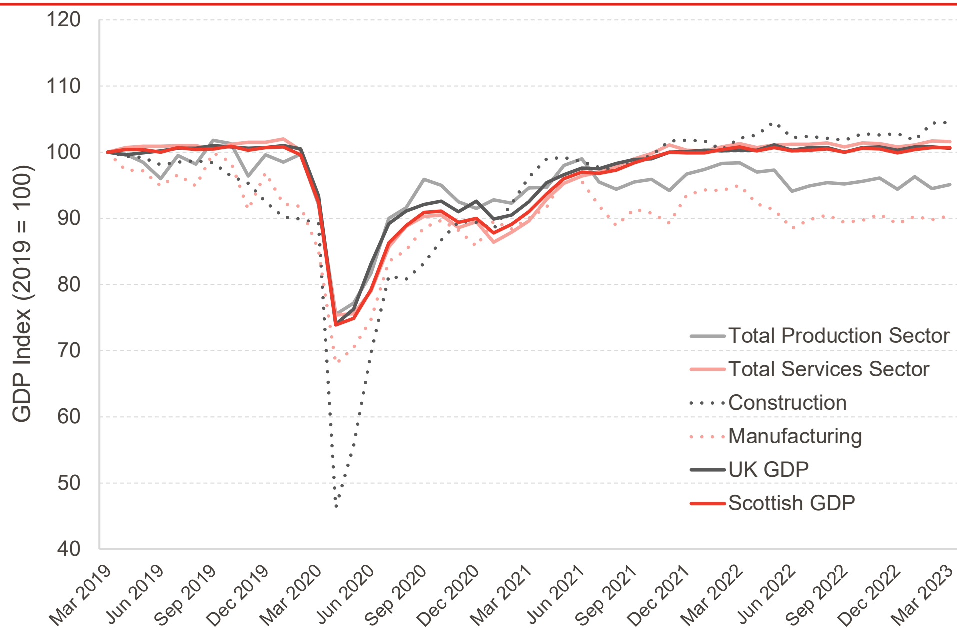
Outlook and Appraisal

Where are we now?

Growth in both Scotland and the UK continues to be slow and fragile, remaining broadly flat in the first few months of 2023. First estimates of quarterly growth show Scotland had grown by 0.4% in the three months to March, compared to 0.1% for the UK as a whole.

Output in the production sector grew by 0.7% in March, with the manufacturing and construction sectors expanding by 0.6% and 0.1%, respectively. Output in the services sector fell by 0.1%, following a 0.5% increase from January to February.

Chart 1: Scottish and UK GDP growth indices with selected Scottish sectors, March 2019 – March 2023



Source: *Scottish Government, ONS*

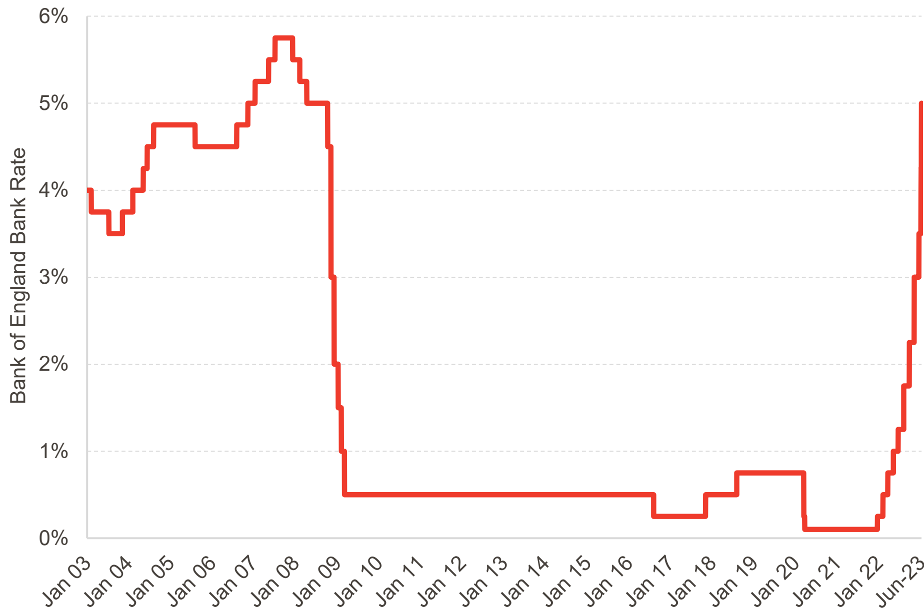
In the 12 months to May 2023, consumer price inflation (CPI) rose by 8.7%, unchanged from April, and down from 10.1% in March.

The Bank of England continues in its attempts to suppress inflation with the interest in the bank rate from 4.5% to 5%, see Chart 2.

Inflation is forecasted to slow slightly towards the end of this year, with the BofE estimating CPI of 8.2% in Q3 of 2023, falling to 3.4% by Q2 of 2024, and CPI back at 2% by 2025.

It is important to note however that consumer price inflation is measured on prices over the 12-month period to the latest month. With inflation as high as 9% in April 2022, falling CPI suggests that price growth is slower, however does not mean that prices are falling.

Chart 2: Bank of England Bank Rate, January 2003 – June 2023



Source: *Bank of England*

Nonetheless, growth expectations have improved greatly in recent months, with both the Bank of England and IMF revising expectations upwards. In April, the IMF forecast a contraction of 0.3% this year but now expects growth of 0.4% in the UK economy.

Although expectations remain closer to zero than normal growth, they surpass the worst recessionary forecasts following the mini-budget and series of global crises significantly.

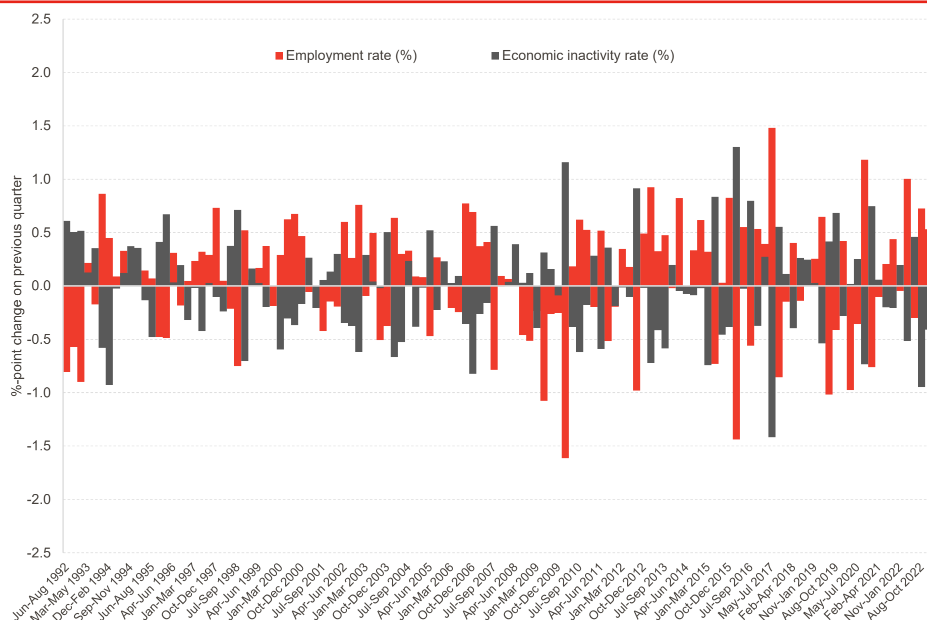
The Scottish labour market appears to be slowing, with employment falling by 1.8-p.p in between February 2023 and April 2023 to 74.6%, and the economic inactivity rate up by 1.9-p.p to 22.9%, see Chart 3.

This was the largest quarterly increase in these figures since the data series began in 1992 and highlights the persistent challenges with labour market inactivity in Scotland.

The unemployment rate was unchanged on the previous quarter with a rate of 3.2%.

Vacancies have continued to fall across the UK, with the number of vacancies down by 3% on the previous 3 months, the 11th consecutive fall since April to June 2022.

Chart 3: Change in employment and economic inactivity rate, quarter-on-quarter, Scotland, June 1992 – April 2023



Source: *ONS*

Have conditions improved for consumers?

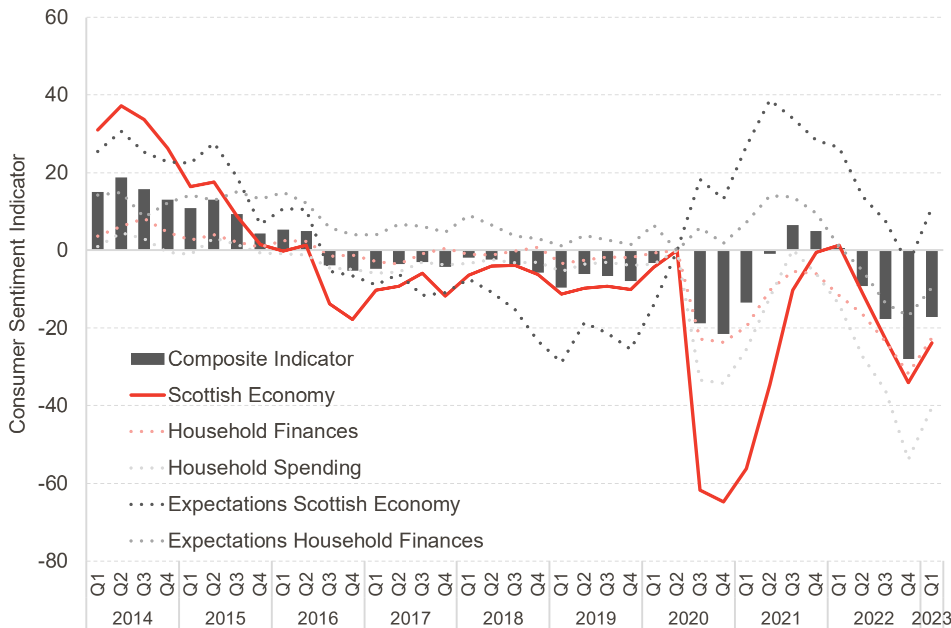
Given the slight up-tick in optimism, there have also been improvements in consumer sentiment across the Scottish economy.

After falling sharply through 2022, future expectations for the Scottish economy among consumers picked up over the first quarter of 2023, increasing by 14.9 percentage points.

Consumers' sentiment on household finances and spending had also improved, with increases of 9.3-p.p. and 13.4-p.p, respectively, however both of these indicators were still negative for the latest quarter.

The slower than expected fall in inflation also continued to impact expectations for household finances, with the indicator negative for the 4th consecutive quarter, however had improved 7.3-p.p on the previous quarter, suggesting some cause for optimism.

Chart 4: Consumer sentiment indicator, Scotland, Q1 2014 – Q1 2023



Source: *Scottish Government*

The largest upward contributions to the UK annual CPIH inflation rate continued to come from housing and household services (primarily from electricity, gas and other fuels), and food and non-alcoholic beverages, similar to recent months. See Chart 5.

The contributions of housing and household services fell again by 0.01-p.p. in May 2023, having fallen by 1.3-p.p. in April, a reflection of recent falls in energy prices.

With recent announcements from Ofgem that July's price cap will drop to £2,074 for households, down from £3,280 in April of this year, there are signs of optimism that when the energy price guarantee ends this month, that consumer bills will not be high as expected.

However with persistently high food prices, the consensus is that the once cost of energy crisis is now very much a cost of food crisis, with many households unlikely to feel much benefit from the upcoming drop in the energy price cap.

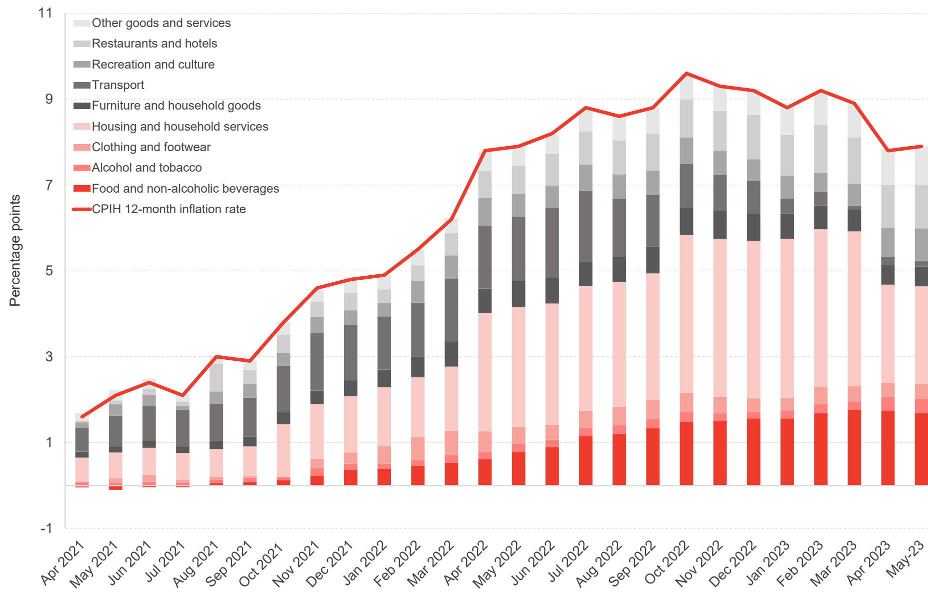
The rate at which grocery prices grew did slow in the year to May, but at 18.4% remains close to record highs as consumers continue to grapple with high prices.

Wholesale food prices have, in part, soared as a result of extreme weather conditions hitting crops, as well as the war in Ukraine which continues to disrupt global supply chains.

However Brexit, and the implications of higher non-tariff barriers, are also inflating food prices, with a recent report from the London School of Economics estimating that UK households had paid an extra £7bn since Brexit to cover the extra cost of trade barriers on food imports from the EU.

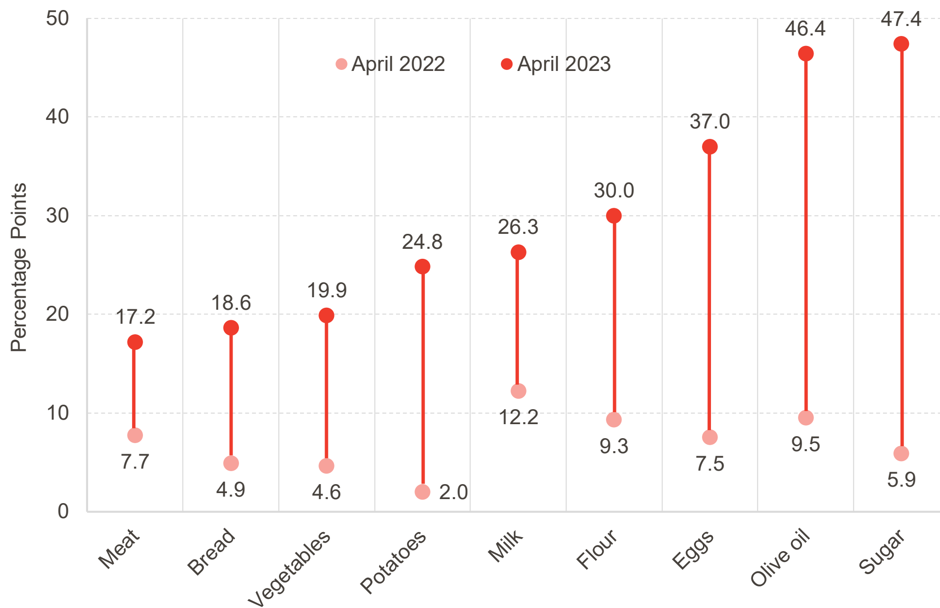
Foods such as sugar and olive oil have seen the sharpest price hikes over the past 2 years, with the price of sugar 41.5-p.p. higher in April 2023 than its price in April 2021, Chart 6.

Chart 5: Contributions to the annual CPIH inflation rate, UK, April 2021 – May 2023



Source: *ONS*

Chart 6: Consumer Price Inflation detailed changes, staple foods, UK, April 2022 and April 2023

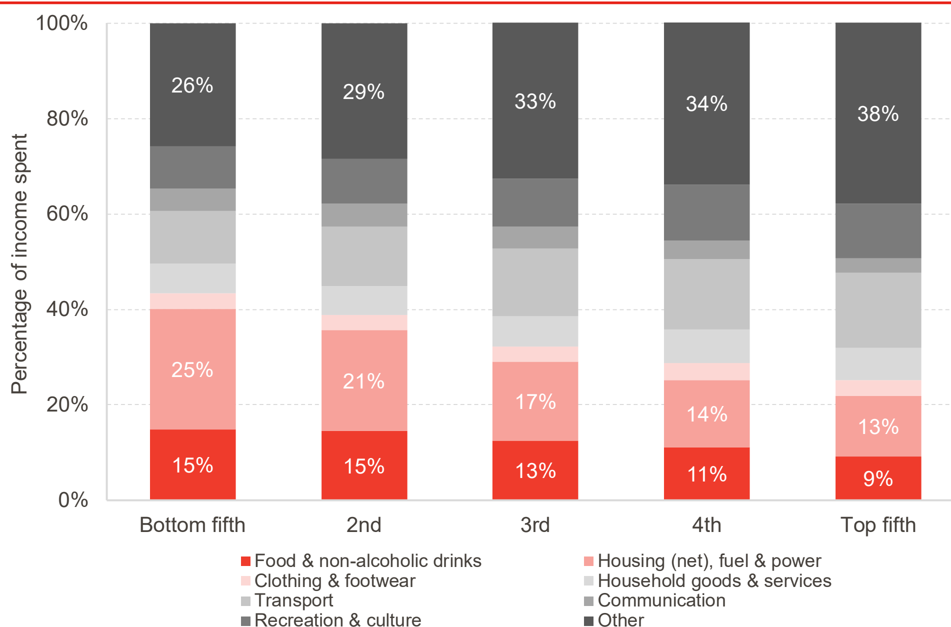


Source: *ONS*

The nature of the current inflationary pressures means that the poorest households continue to be the most impacted given that they tend to spend a larger proportion of their budget on food and other essentials.

These households are estimated to spend around 40% of their total expenditure on essentials – namely food and housing, fuel and power – compared to just over 20% of the richest fifth, Chart 7.

Chart 7: Average weekly household expenditure as a percentage of total weekly expenditure, by quintile group, UK, FYE 2022



Source: *ONS*

Staple foods are those defined as those eaten regularly and tend to form the basis of most meals, and so as prices continue to rise or remain high, the affordability of these products worsens.

In attempts to combat this, many households have turned to own-label lines or 'value' products.

Research by Kantar, a UK based consultancy, found that the cheapest value own-label lines saw sales increases of 46% in the 12 months to May 2023, with the annual shopping bill per household estimated to rise by £837 for those households choosing not to adjust spending habits.

However, with many shoppers already swapping expensive branded products for own-label goods at the supermarket, there are few to no cheaper alternatives to trade down to going forward, meaning many poorer households are being forced to cut down as opposed to adjust their consumption.

Results from the latest ONS Opinions and Lifestyle survey estimates that 62% of the most deprived fifth of UK households were spending less on food and essentials to combat increases in the cost of living.

The latest Consumer Insights Tracker also found that 27% of respondents had skipped or cut down the size of their meals as they could not afford to buy food.

Whilst many retailers have invested in protecting consumers from the full force of inflation, revenues have suffered and it is uncertain for how much longer this can continue.

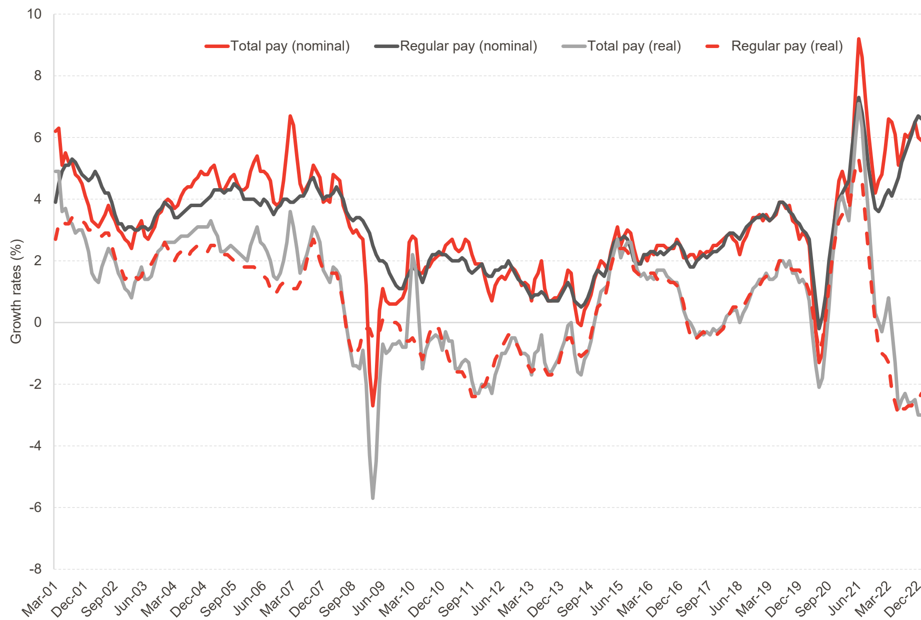
The significant cost increase for households are also not being met by equivalent increases in earnings for the majority of households across the UK.

Growth in employees' average total pay (including bonuses) was 6.5% in the three months to April 2023, and 7.2% in regular pay (excluding bonuses). This remains among the highest seen outside of the pandemic period for regular pay.

However, the longer than expected slowing of inflation continues to suppress real pay growth.

Total real pay i.e. pay adjusted for inflation, fell by 2% on the year, whilst real regular pay fell by 1.3% over the three months to April 2023. See Chart 8.

Chart 8: Real average weekly earnings single-month annual growth rates in Great Britain, seasonally adjusted, and CPIH annual rate, March 2001 – March 2023

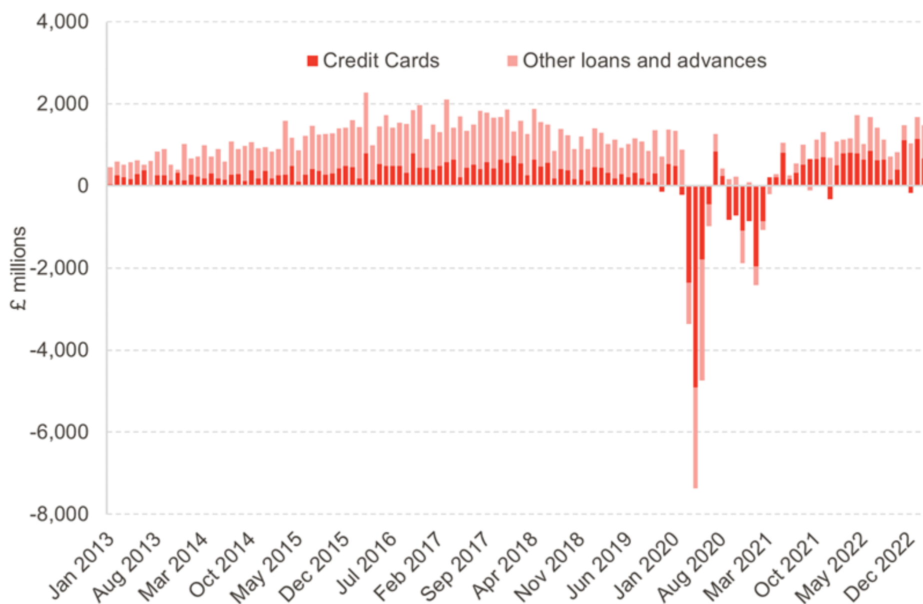


Source: *ONS*

Given this wage suppression caused by higher inflation, many individuals have turned to credit as a way to top up households' incomes.

Individual borrowing rose by £0.1bn to £1.6bn in March 2023, of which around £0.7 was attributed to credit card borrowing and £0.9 billion to borrowing through other forms of credit, such as car dealership finance or personal loans, see Chart 9.

Chart 9: Consumer credit flows, UK, January 2013 – March 2023



Source: *Bank of England*

How are businesses fairing?

Firms also continue to face significant increases in the price of their inputs leading to much higher prices at the factory gate.

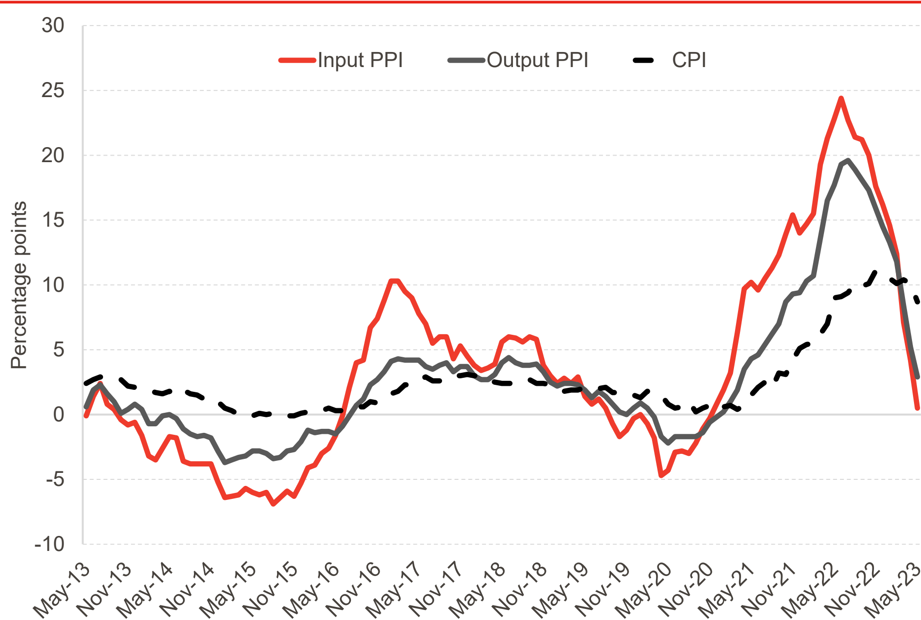
Input and output producer price inflation (PPI) measures the price of goods bought by UK manufacturers and the price of goods at the 'factory gate'.

Both input and output PPI have slowed dramatically since the highs of June 2022 of 24.4% and 19.4%, respectively.

Input PPI rose by 3.9% in the 12 months to April 2023, with output PPI rising by 5.4% over the same period, with both input and output PPI now positive for 29 and 28 consecutive months, Chart 10.

Input and Output PPI were also lower than consumer price inflation for the second consecutive month suggesting that given inflationary pressures are easing for firms, consumers may be subject to higher pass through rates as firms try to recoup lost revenues.

Chart 10: Input and Output Producer Price Index (PPI) annual inflation rate, UK, April 2013 – April 2023



Source: *ONS*

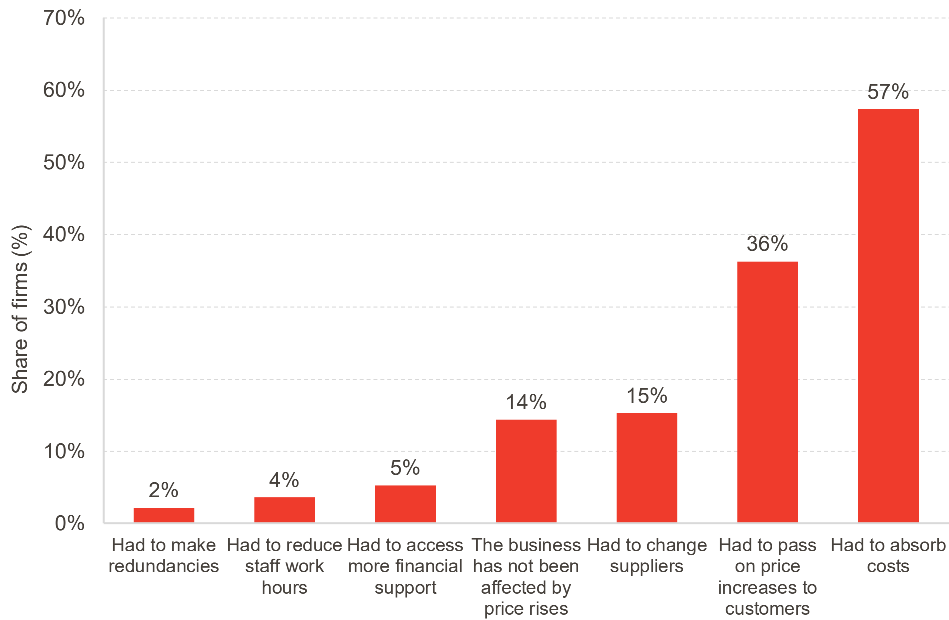
This has been particular criticism for some firms in recent months, primarily those in the retail sector such as supermarkets and grocery stores, with many suggesting that firms are profiteering from the current economic climate.

These firms have been accused of using high inflation as an excuse to hike prices further, compounding the already difficult economic situation for households.

Chart 11, however, shows that just over 1 in 3 firms had passed price increases onto consumers, compared to 57% of firms who reported absorbing higher costs, suggesting that most firms are still choosing not to pass price increases onto consumers.

However, given that the share of firms expecting to pass price increases onto consumers had grown 1.7-p.p since the last survey wave suggests that as inflationary pressures ease, more firms may now look to recoup foregone or lost revenues by increasing prices for consumers towards the end of the year.

Chart 11: In which of the following ways has your business been affected by price rises? Scotland, 2nd May 2023 – 14th May 2023



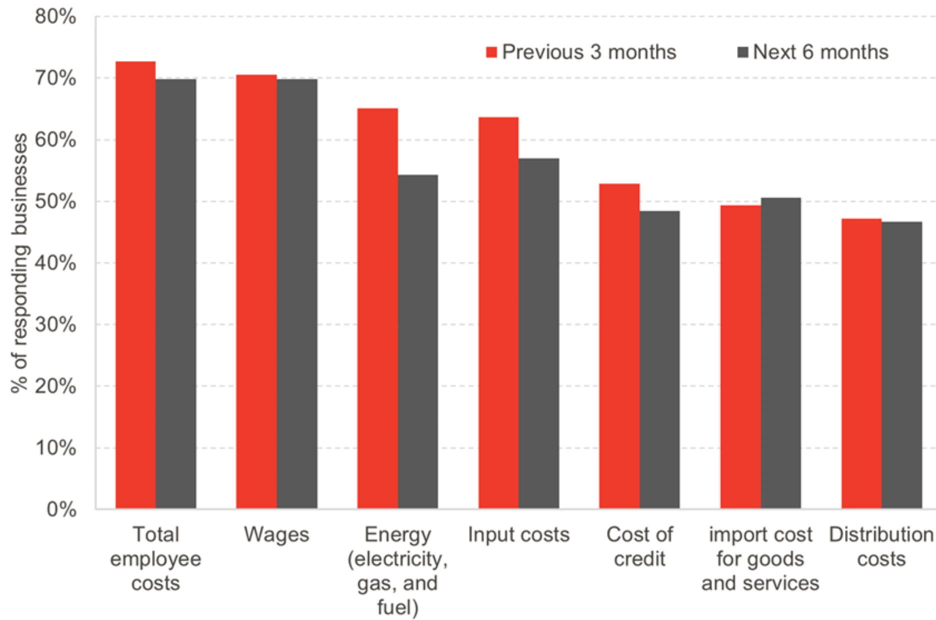
Source: *ONS*

Over the past year, the main concern cost pressure for firms over the past year has been higher energy prices, particularly given that businesses are not protected by an energy price cap.

In our latest Scottish Business Monitor for quarter 2 of 2023 we asked firm how their operations were continuing to be impacted by higher energy prices, with 39% of firms reporting that they expected to reduce operations this year due to higher energy bills, down from 50% in the first quarter of the year.

In fact, given the higher inflationary pressures across the economy and the upward pressures this has placed on wage expectations of employees, more firms now reported employee costs as their key cost driver, see Chart 12.

Chart 12: Thinking about the key cost drivers for businesses, what is your business' assessment of the following cost pressures over the past 3 months and the next 6 months?



Source: *FAI Scottish Business Monitor*

Global economy

Similar to the UK, global economic growth has bettered expectations.

The IMF now forecast that global GDP will grow by 2.8% in 2023, with further growth of 3% in 2024.

In the Euro area, the IMF forecast that both Germany and the United Kingdom will see a contraction in 2023, with a return to slight but positive growth in 2024.

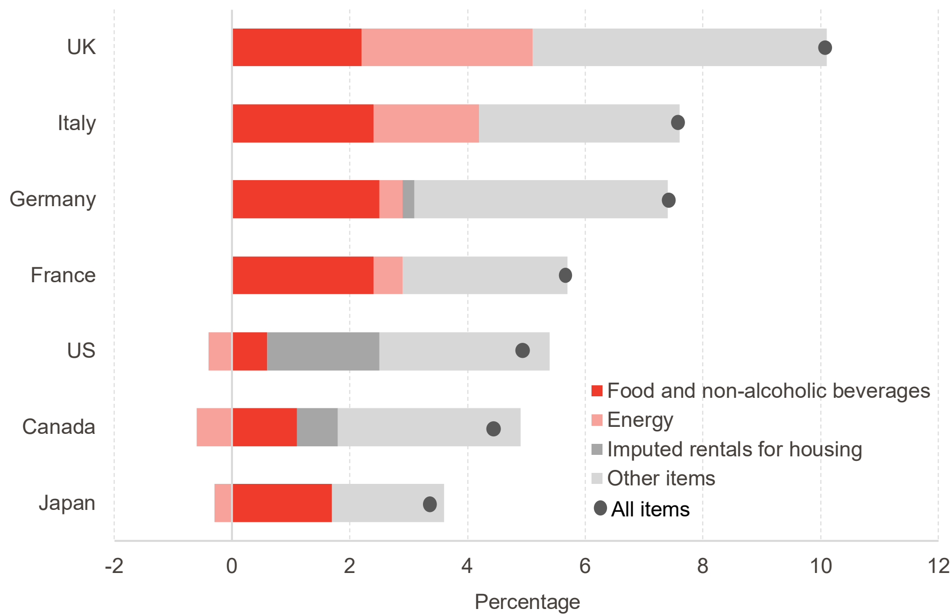
The UK also has the highest core inflation of all G7 countries, see Chart 13.

Recent figures show clear signs of disinflation in the eurozone however, with inflation in Germany falling from 7.6% in April to 6.3% in May, and 6.9% to 6% in France, reflecting a sharp slowdown in energy prices as well as lower inflation for food, other goods, and services across Europe.

This is in part due to the responses in these countries such as in France, where strict limits were placed on increases in household energy bills.

Meanwhile, in the US, Canada and Japan, soaring energy prices have had less of an impact given their own domestic gas product and higher reliance on alternate electricity generation for power.

Chart 13: Contributions to the 12-month rate of CPI inflation, G7, March 2023



Source: *ONS*

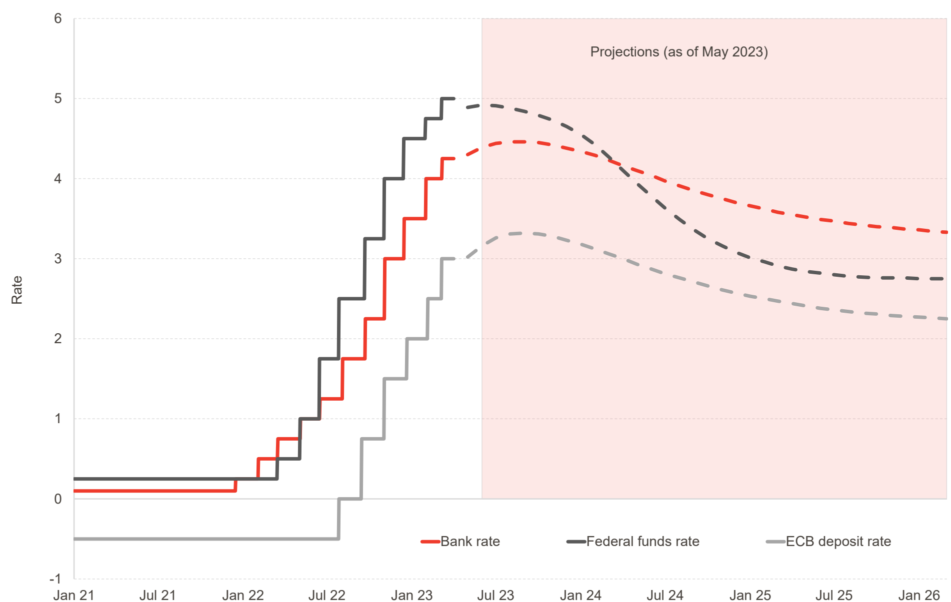
Despite this, inflation is still high across the majority of Europe and in the US.

Similar to the Bank of England, both the US Federal Reserve (FED) and European Central Bank (ECB) have utilised their interest rate powers to dampen inflation.

In their last monetary policy report in May, the Bank of England estimated that the UK Bank Rate, US FED rate and ECB deposit rate would peak around the autumn of 2023, and then fall throughout 2024, returning close to target by the middle of 2025.

Since then, the UK bank rate has increased to 5%, with the ECB also increasing the deposit rate to 3.5%, and the US FED keeping their rate the same, therefore these forecasts will likely change in the coming months.

Chart 14: UK Bank rate vs other countries, past and projections, January 2021 – March 2026



Source: *Bank of England, ECB, FED*

The UK and Scottish Housing Market

Few could have predicted the positive impact the pandemic has had on the housing market over the past few years.

In March 2020, when government lockdown restrictions were first announced, the average house price in the UK was £232,000; by March 2021, this was £253,000.

Many speculated at the time that with individuals confined to their homes, and social contact restricted, the ability to buy and sell properties would falter, and the housing market weaken.

However, when faced with this confinement, and more importantly the shift to remote working, those that could, looked to move, in the pursuit of bigger homes and more greenspace.

What has caused house prices to rise?

For many individuals, the lockdown periods also reduced non-essential spending significantly and hence increased household savings.

Research by the ONS last year estimated that household savings as a proportion of resources peaked at around 24% in quarter 2 of 2020, with the savings ratio (the ratio of personal savings to disposable income) 6% higher than the pre-pandemic ratio over the same period.

As well as this, the announcement of the stamp duty holiday in July 2020 by the UK Government, and the implementation of the furlough employment support scheme, helping to keep income levels stable and interest rates low, meant the affordability of housing was much improved.

In the rental market, the 3% cap on rental price increases and the restrictions on forced evictions introduced by the Scottish Government also helped to keep rent prices stable.

When the stamp duty 'holiday' was rolled back across 2021 depending on what region of the UK you lived in, many thought the rush to buy and sell in the housing market might ease, which it did for a short while.

However despite slower growth, the housing market remained stable, whilst other prices such as fuel and energy began to put upward inflationary pressure on the economy, inevitably leading to the high inflation still present in the economy today.

This has led to most of the attention being put on costs within households in recent months, as households tackle some of the worst economic conditions in decades.

However, outside the home, costs of housing have still risen over the past year, with higher interest rates placing pressure on lenders to increase mortgage costs, and high inflation forcing private landlords to increase prices in the face of higher costs.

In this section we provide an overview of the current UK and Scottish housing market, with discussion of the current state of mortgage lending and what further interest rate hikes might mean for house and rental prices over the coming year.

What is happening in the UK housing and rental market?

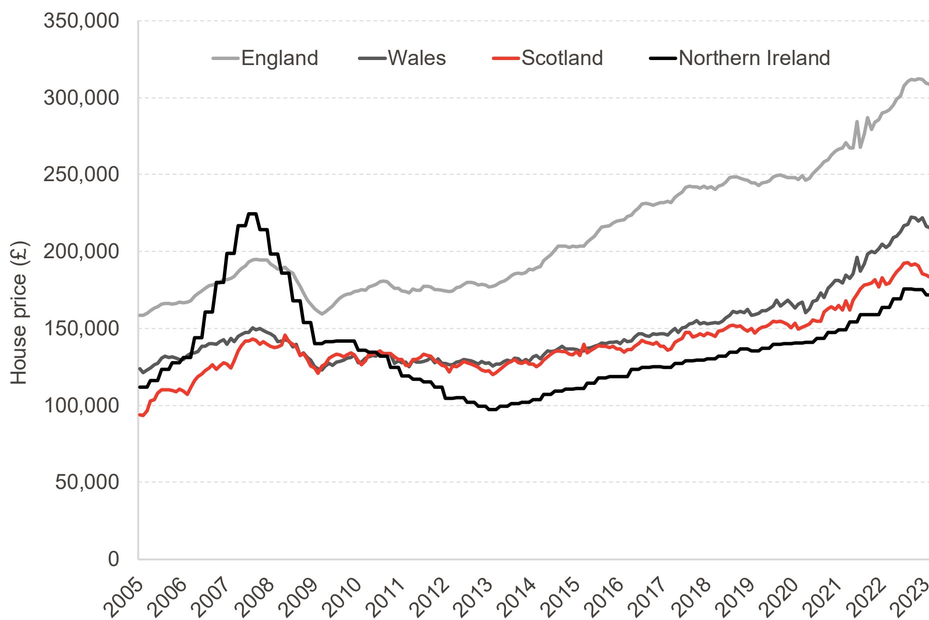
The average UK house price rose by 4.1% in the 12 months to March 2023, down significantly on the highs seen last year but still rising along with most other prices in the economy.

The sharpest growth in house prices came towards the middle of 2022, with price growth as high as 14% in July 2022.

However, house prices have been on the rise since the end of 2020 as the strict lockdown restrictions during the pandemic began to ease.

When looking across the UK, house prices are significantly higher in England than in the other regions of the UK. The average house price in England was around £304,000, compared to £214,000 in Wales and £184,877 in Scotland, see Chart 15.

Chart 15: Average house prices by UK region, January 2005 – March 2023



Source: *ONS*

For those renting, private rental prices rose the fastest in Scotland (5.2%) compared to England (4.7%) and Wales (4.8%).

With the current economic climate increasing cost pressures for all households and individuals, private landlords will likely look to increase rent prices further to cover this.

In an attempt to combat this, the Scottish Government implemented stricter rental controls in March of this year, capping annual rental price increases at 3% and prolonging the pause on forced evictions from properties for the next six months.

However, with both the cap and enforcement restrictions set to end in September, and inflation still forecast to be around 8% then, the cost pressures in the rental market may worsen.

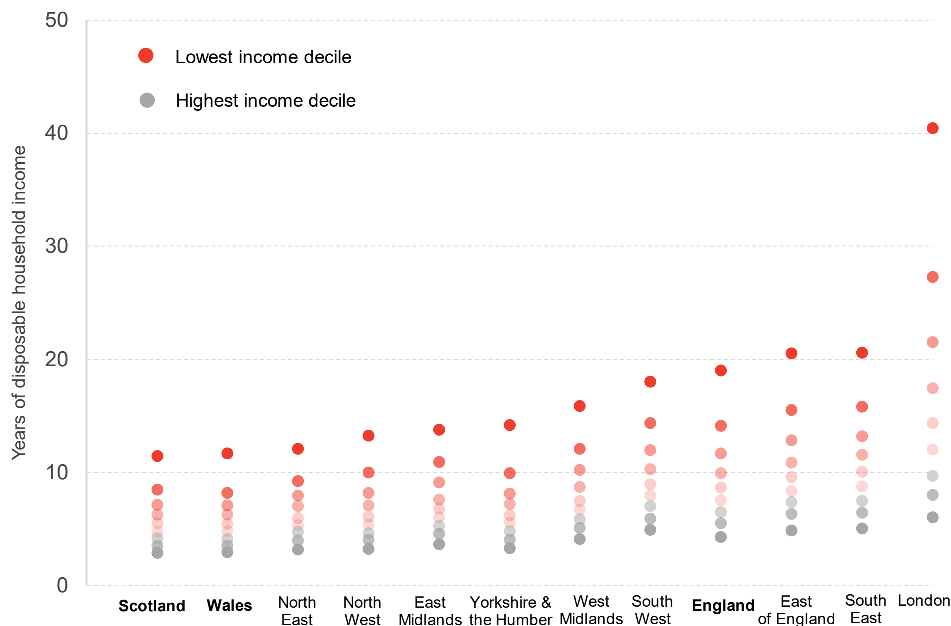
Furthermore, provided price growth continues to fall slower than expectations, interest rates will likely remain high, putting further upward pressure on mortgage rates, hence raising costs further, leading many individuals, particularly those with buy-to-let mortgages, to increase prices further.

The Royal Institution of Chartered Surveyors recently reported that the current economic climate has put a squeeze on housing availability, and that with laws such as the renters reform bill upcoming in England, many landlords are likely to increase rental prices to recoup losses, making renting even more unaffordable.

When looking across the income distribution, Chart 16 highlights that in 2021, those households in the lowest income decile required an estimated 12 years of income in order to purchase an average-priced home in Scotland.

This meant that for those earning the lowest salaries, Scotland was the most affordable or quickest place to purchase an average-priced home.

Chart 16: Years of disposable income required to afford a median house price, by income decile,



Source: *ONS*

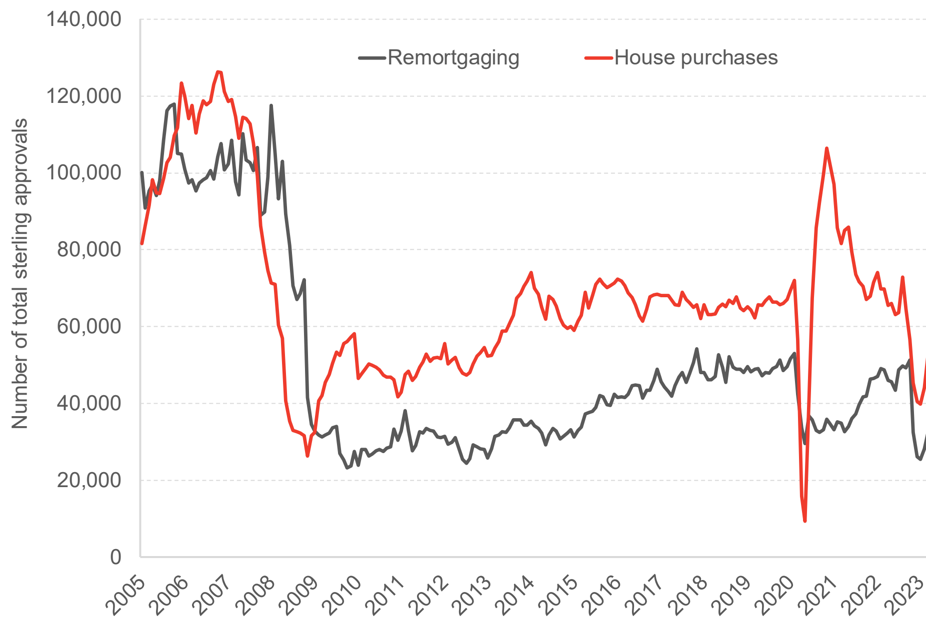
The impact on mortgages

Given the spike in residential property demand over the past few years, there has inevitably been an increase in both mortgage availability and approvals in recent years.

Chart 17 shows that the number of approved house purchases increased significantly since the end of 2020 but have settled over the past few years.

The boom in house sales post-pandemic is made more evident, given the slight fall in the number of approved remortgages, suggesting individuals looked to purchase new properties as opposed to refinancing existing ones.

Chart 17: Total number of mortgage approvals and housing transactions, UK, January 2005 – March 2023



Source: *Bank of England*

For those getting approved for mortgages, either for a new property or refinancing, the majority opt into a fixed rate, given the relatively low interest rates in the economy over the past two decades, Chart 18.

Over 90% of mortgages were on a fixed rate since the end of 2017, with this as high as 95% at the end of last year.

Those households currently tied into fixed mortgages over 2-5 years, will likely be shielded from the current interest rate rises as the Bank of England tries to dampen inflationary pressures in the economy.

However, those coming to the end of their fixed term mortgage agreements and looking to remortgage are likely to pay significantly more in monthly mortgage payments.

Recent research by the IFS estimates that if mortgage rates are to remain at current levels, the average mortgage holder will see monthly mortgage payments rise by £280, equivalent to 8% of their disposable income.

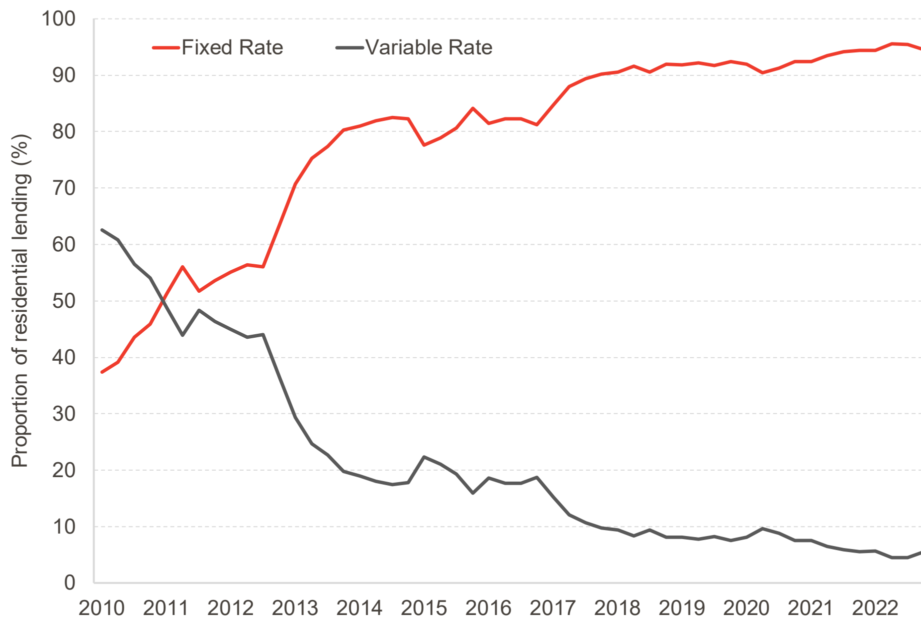
Table 1 shows that the average two-year fixed mortgage rate has risen from 2.6% in May 2021 to over 5% in recent months, with a five-year fixed rising by a similar margin.

Variable rates have also seen similar increases, however, were significantly higher than fixed rates in May 2021.

Despite variable rates being 2.4-p.p higher than a 5-year fixed in May 2023, households face the trade-off between tying into long-term higher fixed rate mortgages, knowing eventually rates will come down, or face significantly higher costs by opting for a variable rate mortgage.

With stickier inflation reinforcing expectations that the Bank of England will increase interest rates further in the medium term, mortgage rates are likely to continue to rise before we see any easing of cost pressures in the housing market.

Chart 18: Proportion of residential lending to individuals by rate type, UK, 2010 – 2023



Source: *Financial Conduct Authority*

Table 1: Average interest rate by mortgage rate type, UK, May 2021 – May 2023

	May-21	May-22	Oct-22	Apr-23	May-23
2-year fixed	2.6%	3.0%	5.4%	5.4%	5.3%
5-year fixed	2.8%	3.2%	5.2%	5.1%	5.0%
Variable rate	4.4%	4.8%	5.6%	7.3%	7.4%

Source: *Moneyfacts*

The impact of current economic challenges on third-sector organisations

Last month, we published our latest Scottish Business Monitor, our quarterly survey of around 500 businesses in Scotland. The survey has run since 1998, taking the temperature of the Scottish business community ahead of the publication of national statistics.

In our latest survey for Q1 2023, we asked firms if they identify as being in the third or voluntary sector in order to understand better how these types of organisations are coping with current economic challenges relative to the rest of the business base.

In this section, we explore our analysis of our business monitor results through the lens of firms that identify as TSOs, such as charities and social enterprises, setting out what their main pressures and concerns are and their outlook for the next year.

Of our Scottish business sample, 5.5% of businesses identified as TSOs[1]. This limited sample size means that we can draw broad conclusions from our analysis but err with caution on what this means for the third sector as a whole.

Pressures facing TSOs

Third-sector organisations are facing significant financial strain due to the combination of stubbornly high inflation and squeezed household incomes. Recent analysis of the latest Understanding Society data by the Diffley Partnership estimated that the share of individuals reducing their charitable donations had risen to 45% in May 2023, up from 40% in November 2022.

Alongside donation challenges, charities, like most firms, are also facing significant cost and operations pressures. In our latest survey, 95% of responding TSOs reported that they were concerned about energy bills, compared to 83% of businesses across all sectors. See Chart 19.

Third-sector firms, like the rest of the business community, were protected by rising energy bills under the UK Government's Energy Relief Scheme, which ended in March 2023. However, on the 1st of April of this year, this scheme was replaced by the less generous Energy Bills Discount Scheme.

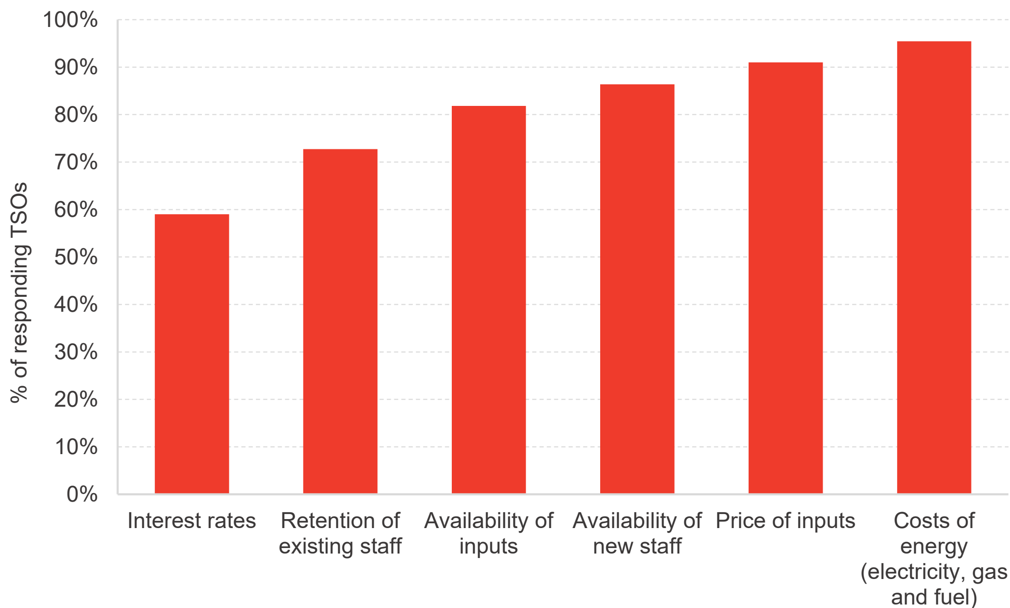
Despite receiving the same government support, our latest survey highlights that TSOs are more impacted by higher energy prices than businesses in other sectors. 45% of third-sector firms reported that they expected to reduce operations in the next 12 months due to rising energy prices, compared to 39% of businesses across all sectors.

36% of TSOs also reported that they felt the Energy Bills Relief Scheme would not adequately support them over the next 12 months.

As well as this, TSOs have been acutely impacted by persistently high inflation, with 91% of responding TSO's reporting that the price of inputs was of concern to their business. This compares to 78% of firms across all sectors.

1 83% were not TSO's, with the remaining 12% responding N/A.

Chart 19: Compared to normal, how concerned is your third sector organisation about the following factors?



Source: *FAI Scottish Business Monitor*

Like the rest of the business community, TSOs are least concerned with interest rates. However, it is worth noting that just under 60% of third-sector businesses are concerned, which is still high.

Given that this survey was carried out in April of this year when expectations were more optimistic regarding the pathway of inflation – i.e., we were expecting inflation to come down quicker than it has –, it will be interesting to see how concerned firms and charities are about rates in our Q2 survey.

The rising cost of borrowing will have a direct impact on TSOs borrowing costs, but it will also have an indirect impact on donations as household budgets continue to be squeezed further by rising interest rates. Analysis of these business concern indicators and the differences between businesses in the charitable sector and other sectors will therefore be one to watch out for in our next Scottish Business Monitor (Q2 2023), due to be published early August.

Recruitment and pay

Unlike non-TSOs, third sector organisations rely on the generosity of individuals in terms of volunteering, and with an increase in the number of people in the UK having a second job to cope with squeezed income, this sector faces complex recruitment challenges as it tries to attract people to engage in unpaid work when they could be spending their extra time earning money through a second job.

Recruitment challenges are evident by the fact that around 77% of third-sector firms that had vacancies in the first quarter of this year were finding them difficult to fill.

However, businesses in the third sector also have paid staff. In fact, a report by the Office of Scottish Charity Regulator (OSCR) estimated that 30% of charities had between 1 and 10 paid members of staff, and in our latest business monitor, we found that 80% of TSOs in our survey reported employing between 1 and 99 staff.

Therefore, these firms are not only faced with the challenges of recruiting volunteers and paid workers against the backdrop of a cost-of-living crisis and a tight labour market, but, like the rest of the business community, they are faced with significant wage pressures. In our latest survey, 86% of TSOs in our sample reported wages as their greatest cost pressure over the next 6 months, an estimate more than 15-percentage points higher than the sector average of the sample.

Overall, 86% of TSOs reported attracting new staff as their main recruitment concern, compared to 73% of businesses across all sectors, and 73% of TSOs cited staff retention as a key concern, compared to 66% of businesses across all sectors.

The economic outlook

Overall, results from our latest Scottish Business Monitor, indicate that businesses in the third sector have greater cost pressures and concerns around these pressures than the rest of the business community. They are also operating in a more challenging recruitment environment.

In the Bank of England's slightly more recent business conditions report for Q2 of this year, it was noted that charities expressed concern about the sustainability of the sector, with issues such as competition, demand, staffing – related to recruitment, retention, and pay –, income, and donations highlighted as key pressures for the sector.

Given the Bank's findings, our business monitor's findings, and the findings of other analysis discussed throughout this section, it is unsurprising that in our latest survey, firms from the voluntary sector reported a more pessimistic outlook for the Scottish economy this year, with 73% of firms expecting weak or very weak growth of the economy, compared to the sector average of 62%.

Scotland's Medium Term Financial Strategy 2023-24

What did we learn from the Scottish Government's Medium Term Financial Strategy?

On 25th May, the Deputy First Minister and Cabinet Secretary for Finance Shona Robinson presented her first major fiscal statement to parliament. The Scottish Government's Medium Term Financial Strategy (MTFS) is a document that outlines its financial plans and priorities over the next five years.

The strategy aims to provide a framework for fiscal decisions, resource allocation, and economic management in Scotland. It takes into account various factors such as economic forecasts, revenue projections, spending priorities, and the government's policy objectives. Importantly, then, it is presented with the new set of forecasts from the Scottish Fiscal Commission which provides 5 year forecasts for the economy, tax receipts and social security spending.

The MTFS was introduced following the Budget Process Review Group's final report, which recommended a number of changes to the budgetary process at Holyrood so the parliament could move to year-round budgeting. The idea is that this sets out the context at this time of year, to allow Committees to plan their pre-budget scrutiny in the Autumn, feeding into the Budget which comes towards the end of the year.

Funding Commitments are outstripping the funds available

The big headline from the MTFS is that public spending in Scotland is currently projected to outstrip the funds available by significant amounts of money from the next fiscal year (2024-25). The document says:

Our modelling indicates that our resource spending requirements could exceed our central funding projections by 2% (£1 billion) in 2024-25 rising to 4% (£1.9 billion) in 2027-28.

Of course, this gap cannot be allowed to manifest itself in reality. For context, this £1 billion gap is bigger than the whole of the Rural Affairs and Islands budget; or about the same as we spend on prisons and courts combined.

Given the Scottish Government has to present a balanced budget, and if the funding coming from both Westminster and devolved taxes is as expected, what this means in practice is that difficult decisions are going to have to be made about spending.

Opposition politicians were quick to criticise the Government for saying that they were prepared to take tough decisions to deal with this challenge – but not setting out what these tough decisions were, i.e. where the axe might fall if it needs to.

To be fair, this is not the first one of these documents to highlight a potential funding gap if things continue as they have been. The difference was that DFM was very upfront about the fact that this was going to mean tough decisions were necessary. The financial statement was not a budget, and we should not have expected detailed allocation announcements. However, some indication of how the Government may cut its cloth in this difficult environment would have been welcomed.

To add to these difficulties, there are a number of commitments the Government has already made that are not included in this – such as the expansion of childcare provision, or further investment in the National Care Service. Therefore Ministers will have to be clear over the Summer and in the Programme for Government that they are acknowledging the tough decision environment when policy announcements are being made.

The DFM is fond of saying to opposition parties that they need to set out where cuts should happen if they are asking for more to be spent on particular areas – therefore the Government must hold themselves to the same in the run up to the Budget in December.

A large income tax reconciliation still looks likely – but won't be confirmed until July

One of the issues that is contributing to the difficult outlook for the next financial year is a large income tax reconciliation. The Scottish Fiscal Commission has a good explanation (our boldening):

*When the Scottish Budget is set, funding from Scottish income tax for the financial year is based on forecasts and does not change during the year. Only when outturn information on income tax revenues becomes available is funding brought in line with outturn and a reconciliation applied to the following Scottish Budget. We can derive **indicative** estimates of future income tax reconciliations by comparing our latest forecasts and the latest forecast Block Grant Adjustments (BGAs) to those used in the Budget setting forecasts.*

*As we have highlighted in recent publications, we continue to expect a large and negative income tax reconciliation for the Budget year 2021-22. Comparing our and the OBR's latest forecasts indicates a large negative reconciliation for 2021-22 of -£712 million. **Final outturn data should be available in July 2023, with the resulting reconciliation being applied to the Scottish Budget for 2024-25.***

So, we will know in July to what extent this reconciliation emerges in practice. This feature of the fiscal framework highlights the complexity of the arrangements that now determine the Scottish Budget. So why has this reconciliation emerged?

The two sets of forecasts for which the 2021-22 Budget was unusually far apart – the Block Grant Adjustment was determined by the OBR forecast in November 2020, with the SFC producing their forecast in January 2021. By January, the vaccine rollout had begun and things were looking much more optimistic, compared to November when the alpha variant had emerged leading to fresh lockdowns.

So the SFC forecast for Scotland was much more optimistic than the OBR's outlook, leading to more money flowing to the Scottish Government for the 2021-22 financial year. The SFC flagged at the time that this was simply due to the time gap between the forecasts.

So, the current view of Scottish Income Tax is that it will be 9% higher than was forecast in January, but the current view of the Block Grant Adjustment is that it will be 15% higher than was forecast at the time of the 2021-22 budget, hence the negative reconciliation. Essentially, a +£400m net situation should have been a -£300m net situation, hence the possible £700m reconciliation.

What next for the public sector workforce?

When the Resource Spending Review was presented in May 2022, one of the main things that stood out was the analysis of the public sector workforce. In aggregate, the public sector workforce has increased significantly over the period of the pandemic; therefore one of the ways that the tight fiscal environment would be dealt with was to manage down the public sector to its pre-pandemic size.

What was not set out last year, or indeed anytime since, was how this would be achieved and in which areas the workforce would be managed down.

The MTFS does present different scenarios for the evolution of public sector pay settlements and the size of workforce. However, none of these assume that the public sector is to reduce overall. The scenarios the government examines in the document are:

- Low Scenario – 2% pay award in 2023-24, and 1% pay award from 2024-25 onwards, 0.3% workforce growth
- Central scenario – 3.5% pay award in 2023-24, and 2% pay award from 2024-25 onwards, 1.1% workforce growth
- High Scenario – 5% pay award in 2023-24, and 3% pay award from 2024-25 onwards, 2.2% workforce growth

The document still indicates that reductions may be required in some areas of the public service, but it seems clear that this will be driven by the budget allocations that will be dished out:

Where a reduction in workforce is required for a public body to remain sustainable, we would expect this to be through natural turnover wherever possible and we restated our commitment to no compulsory redundancies in this year's Public Sector Pay Strategy.

Consultation on tax over the Summer

As part of the statement that accompanied the MTFS, the Deputy First Minister has announced that an external tax stakeholder group will be established this Summer.

This group will build on the Government's inclusive approach to tax policymaking and will consider how best to engage with the public and other stakeholders on the future direction of tax policy, including whether a "national conversation" on tax is required.

The idea is that this engagement will shape a refreshed tax strategy from the Scottish Government. The Government will need to ensure that the membership encompasses a broad range of views, and also show that they are willing to take suggestions on board through this process.

Reflecting on some of the statements made by this new-look administration to date, here are some things to think about:

- Discussions about wealth taxes look very difficult in a devolved context. However, completely within the gift of the Scottish Government is the reform Council Tax, something the SNP have said they have wanted to do since coming to power in 2007. Given the number of commissions and groups that have discussed this over the years, another one is not required to set out the issues with CT, or indeed to set out options for replacement. Meaningful discussions about replacements and the political bravery to recognise there will be losers, as well as winners, will be required.
- Further additions to the higher and top rates of income tax are unlikely to be able to yield large amounts of revenue. For example, there is the suggestion from the new FM (which had been put forward by the STUC) to introduce a new band at 75,000 and up the rate by 2p. The new ready reckoners published by the Scottish Government recently show that even if the **whole** of the Higher Rate Tax band is upped by 2p, this will raise £176m – not an insignificant amount of money, but not enough to deal with the funding gap outlined in the MTFS.

- Tax rises are not cost-free. If engagement is to be meaningful, it is important that the SG engage with those who can see some of the costs as well as the benefits to either (i) more complexity in the tax system (ii) more divergence from the rest of the UK and (iii) higher tax burden overall.

Multi-year Funding envelopes will be set out with the 2024-25 budget in December

The Government have committed to publish refreshed multi-year spending envelopes alongside the Budget for 2024-25. Given everything that has changed since the Resource Spending Review was published in May 2022, this is to be welcomed – although given the difficulties overall it is unlikely to be good news for many areas.

University of Strathclyde Business School

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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www.strath.ac.uk/fraser

Fraser of Allander Institute
University of Strathclyde
199 Cathedral Street
Glasgow G4 0QU
Scotland, UK

Telephone: 0141 548 3958
Email: fraser@strath.ac.uk
Website: fraserofallander.org
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