

SCOTLAND Q4 2015

VOICE OF SMALL BUSINESS INDEX

The FSB Voice of Small Business report is now five years old. To mark this milestone, this special expanded edition of the quarterly report starts by looking at the economic environment over the past five years. This is followed by a more in-depth look at the latest results from small businesses, which show confidence levels hovering just in positive territory, businesses expecting slow but steady turnover and profit growth, and continuing to plan for investment ahead.

Five year economic review and update on current situation:

The Scottish economy held up better than the UK as a whole during the financial crisis, with a peak-to-trough decline in quarterly output of 4.9%, compared to 6.1% across the UK. In the past couple of years, Scotland has been growing at a very similar rate to the UK, as can be seen in Figure 1, opposite, with the economy expanding by 2.7% in 2014 and by an estimated 2.0% in 2015. This is notably faster than the average of 0.8% growth between 2010 and 2013, and puts Scotland near the top of the growth rankings in the G7, with countries such as France, Japan and Italy expanding much more slowly.

However, one factor that is likely to be constraining Scottish performance is the collapse of the price of Brent crude oil, as illustrated in Figure 2. The Mining & Quarrying sector in Scotland, which includes the extraction of oil and gas, saw output decline by 4.0% year on year in real terms in Q2 2015. Likewise, the manufacturing sector, which includes the refining of petroleum products, has seen growth slow markedly, actually contracting by 0.1% between Q2 2014 and Q2 2015.

Alongside this slowdown in the Scottish economy, net job creation has ground to a halt. Annual employment growth stood at just 0.3% in Q3 2015, following a sharp fall from average growth of around 2.0% during 2014, and highs of close to 3.0% in 2013. This slow growth rate still compares favourably to the falling employment seen during much of 2012 and 2010, but it's not enough to stop the unemployment rate from rising again. After reaching a post-crisis low of 5.3% in Q4 2014, the headline rate has climbed to 6.0% in Q3 2015 (as seen in Figure 3). Although employment growth is expected to pick up again in the near future, one factor that is likely to constrain hiring prospects to some extent is the ongoing planned government cutbacks. In Q2 2015, 21.0% of Scottish workers were employed by the state, compared to just 16.5% in England. So, the Autumn Statement's forecast that the public sector will shed 40,000 jobs between 2015/16 and 2020/21, may have a particular impact in Scotland.

Fig. 1: Annual growth in economy, real terms

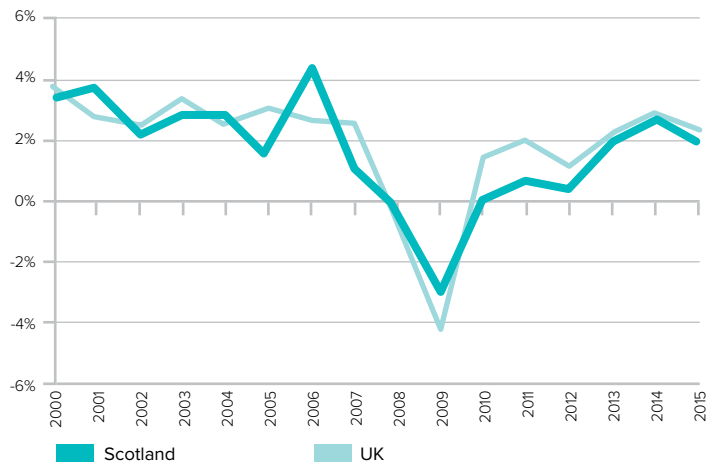


Fig. 2: Brent crude oil spot price, month averages, \$ per barrel

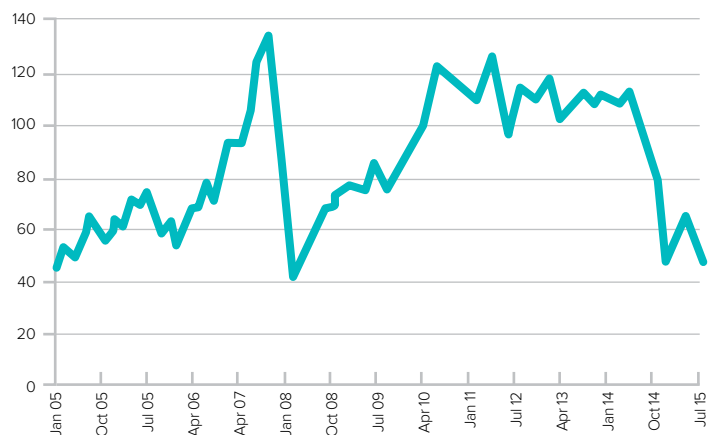
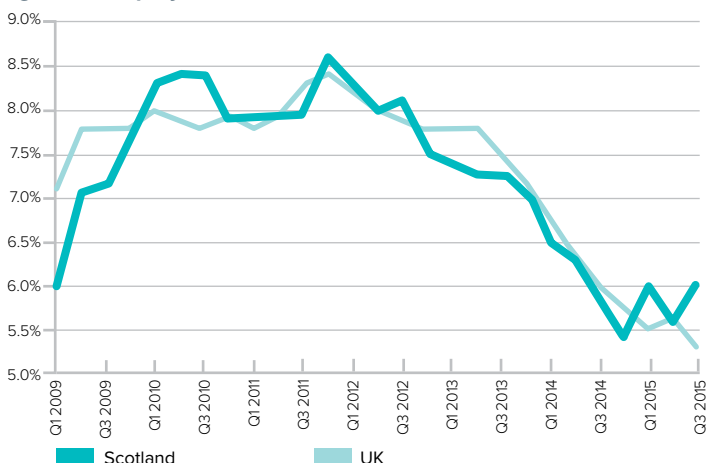


Fig. 3: Unemployment rate



Another key trend in the Scottish labour market is that there are a large number of people working part time only because they cannot find a full time contract. This accounted for 15.4% of part time workers in the year to June 2015, well up from an average of under 10.0% before the financial crisis (as illustrated in Figure 4). While the number has been falling since its 2013 peak, there is still some way to go before the slack in the labour market is used up. These results for Scotland are largely in line with those seen for the UK as a whole, however, and are significantly lower than in many other regions, such as Northern Ireland and London, suggesting Scotland's labour market is more robust than other parts of the country.

Although employment growth has slowed for now, household incomes and spending power are being supported by the environment of very low inflation that persisted across most of 2015. Total consumer spending rose year-on-year by over 4.0% in cash terms (i.e. without removing the effects of inflation) across 2015 at a time when job creation fell to zero. This is up from 3.8% in 2014, 3.5% in 2012-2013 and just 1.9% in 2010, as shown in Figure 5. The strength of the consumer market is a key factor in helping drive the Scottish economy forward at present, as growth in government spending has slowed to just 1.3% over the year to Q2 2015 in nominal terms. This is down from 6.1% across 2014 as a whole. Meanwhile, total exports fell back by 3.8% over the past year. Capital investment has also grown rapidly over the past year – at a sustained rate of over 10.0% – which is encouraging news. However, looking ahead, inflation is likely to rise again once the effect of last year's sharp decline in the oil price falls out of the annual comparison. This means pressure is likely to be placed once again on the spending power of Scottish households, thus applying a brake to spending growth. At that point, the Scottish economy will need business investment and exports to take up the slack.

One further way of looking at the strength of the economy is by looking at the housing market. House prices in Scotland are on average just past their pre financial crisis peak, and saw some buoyant growth in 2014 and early 2015, with prices up by highs of 8.0% compared to the previous year. However, later in 2015, house price growth collapsed, with the average value of a home dropping by 0.6% year-on-year in July and August, as shown in Figure 6. This compares to UK-wide increases of over 5.0% over the same time period, and highs of 12.1% growth in 2014. As such, it looks as though the Scottish housing market is much less robust than that of UK-wide market. This may bear down on consumer confidence in the coming months, and further constrain household spending over the year ahead.

Overall Scotland's economy has held up well during the past five years, and performed particularly strongly in 2014. However, more recently, the knock to the economy from the drop in the oil price, as well as a more general slowdown, looks to have hampered growth in 2015. Economic headwinds are emerging in the form of a slowing global economy, a likely rise in inflation and constrained government spending.

Fig. 4: Share of part time workers that want a full time contract

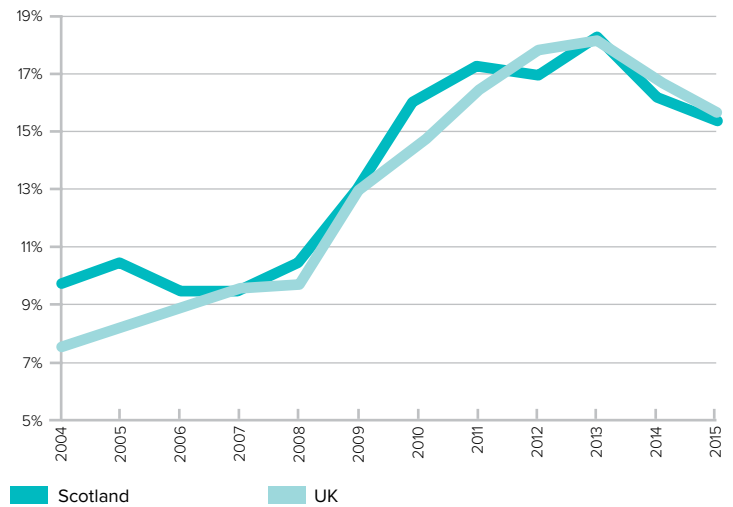


Fig. 5: Year-on-year growth in consumer spending in Scotland, nominal terms

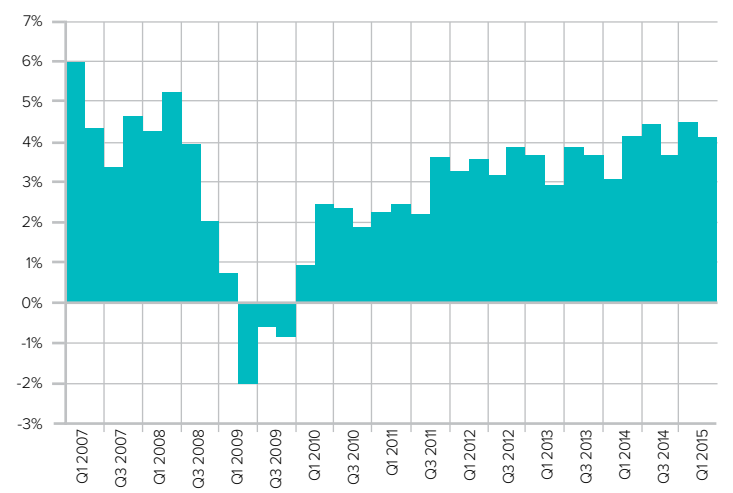
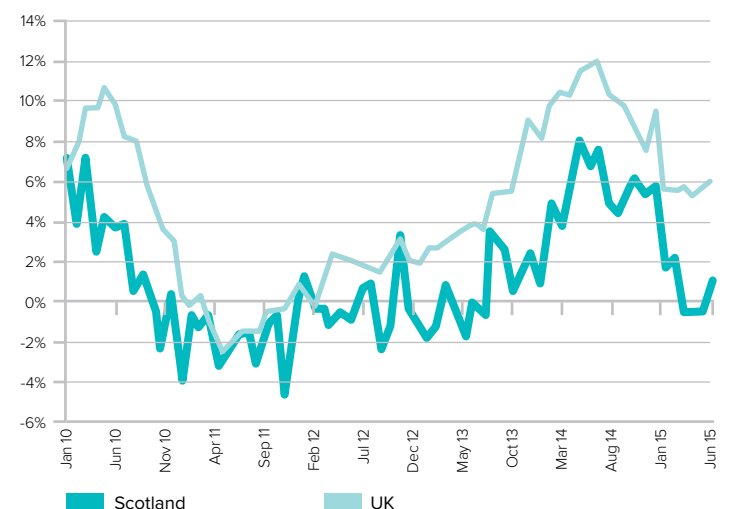


Fig. 6: Annual house price growth by area



Results from the latest Small Business Index survey:

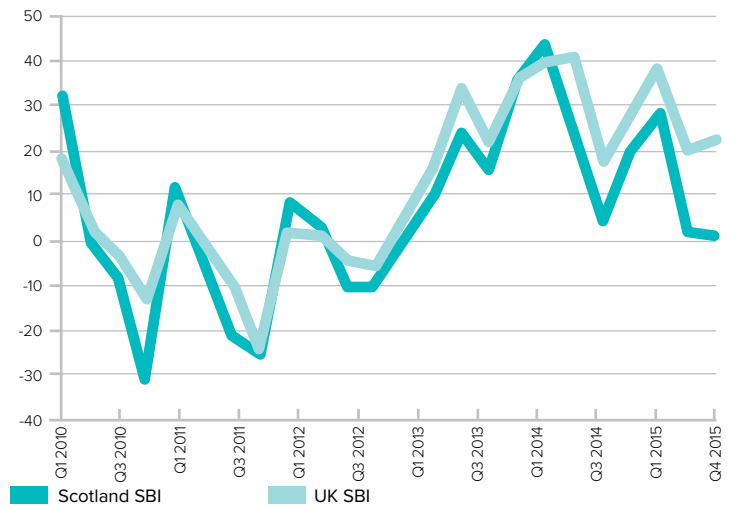
Confidence among small businesses in Scotland fell back again this quarter, and remains only just in positive territory. In Q4 2015, the Small Business Index (SBI) for Scotland fell to +0.3, down from +1.7 the previous quarter and from +4.6 at the same point a year before. This is the weakest reading since Q1 2013, and suggests that, overall, small businesses expect the trading environment to remain about the same, rather than improving or worsening. As such, it's not necessarily a discouraging result, despite being lower than in recent years, as it still remains well above the negative SBI results that were posted during most of 2010-2012.

Movements in the Scottish SBI have fairly closely followed those in the overall UK since the series began at the start of 2010, as illustrated in Figure 7. This quarter is no significant exception, although across the UK the index ticked up slightly, while in Scotland it edged down. However, a series of small cumulative differences in recent quarters has opened up quite a wedge between optimism on average between the UK average and in Scotland. The latest Scottish reading of +0.3 compares to +21.7 nationwide, suggesting that in England, business conditions are more benign.

Growth in profit and turnover has picked up this quarter among small firms in Scotland, but expectations are lower. In Q4 2015, a net balance of 15.4% of small firms report that revenues rose over the previous three months, with a slightly lower figure for profitability. This is still a strong result for profit growth, perhaps indicating that businesses are seeing their bottom lines supported by falling or static input costs. However, reflecting the fact that businesses expected conditions to remain broadly unchanged over the coming quarter rather than improving, fewer expect their turnover and profit to rise during the next three months. A balance of just 3.3% of firms in Scotland expects to see their profits rise in the short term.

Fewer Scottish businesses are increasing their headcount, the data shows. In line with other figures, employment growth in Scotland has fallen back markedly in recent months. This overall trend is also reported by small businesses: this quarter, a net balance of 3.5% report that they increased their staff headcounts over the past three months. This figure is down from 5.0% in Q3 2015, and well below the spike of 18.1% reported in Q2. In addition, in the first three months of 2016, a net balance of just 1.1% predicts that they will raise their employment levels. This is not good news, as to avoid unemployment continuing to rise, the Scottish labour market will need the private sector to continue creating jobs as the public sector reduces headcount. It is also below the UK results as a whole, which show a net balance of 7.3% expecting to raise staffing levels.

Fig. 7: Small Business Index



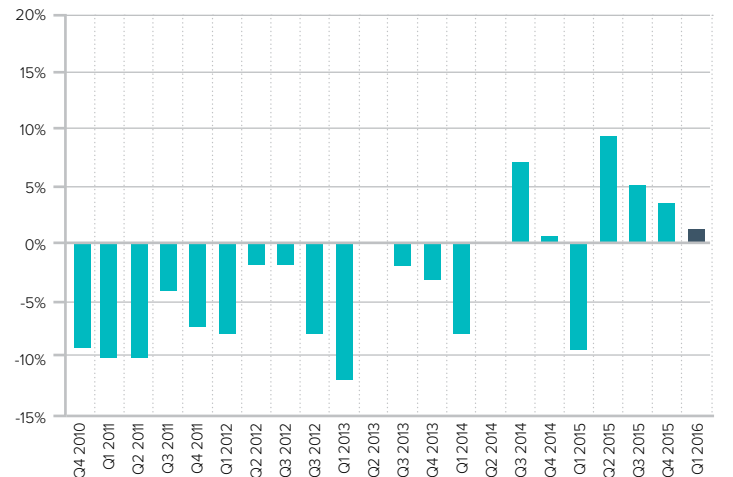
Source: FSB Small Business Index survey. Sample size: 361 small businesses in Scotland.

Fig. 8: Net balance of small firms in Scotland reporting revenue/profit growth



Source: FSB Small Business Index survey

Fig. 9: Net balance of firms in Scotland increasing employment in the past three months



Source: FSB Small Business Index survey

Despite weaker confidence levels, small business expectations for capital investment over the next year remain firm.

This quarter, a net balance of 18.9% of firms plan to increase investment over the year ahead, broadly unchanged from the 18.2% reported in Q3 2015. Although this is down from the 25.3% reporting investment plans at the same point a year ago and the 22.5% across the UK as a whole, investment intentions remain relatively robust. This is particularly important for Scotland's economy as the sharp decline in oil prices has led to significant cutbacks in investment among large multinational companies in petrochemical-related sectors. As a result, small businesses are needed to fill in the gaps in investment growth, helping to boost productivity across the economy.

The credit climate is improving for businesses wishing to access finance to fund investment.

This quarter, 16.6% of small firms in Scotland report that they find credit availability to be 'good', well up from 11.5% at the same point a year ago, and from just 6.0% when these data were first compiled at the start of 2012. Similarly, a quarter of small firms in Scotland report that credit is affordable now, compared to 19.4% in Q4 2014 and 9.2% at the beginning of 2012. The fact that credit is easier to access now than in previous years is also good news for the day-to-day financing of small businesses. Across the UK as a whole, 60.0% of those applying for credit report that they did so in order to manage cash flow, rather than to expand the business, so cheaper finance will help to support the everyday operations of many firms. However, the Bank of England is expected to start raising rates at some point in 2016 and firms will therefore need to be mindful of the fact that borrowing costs are likely to increase in the near future.

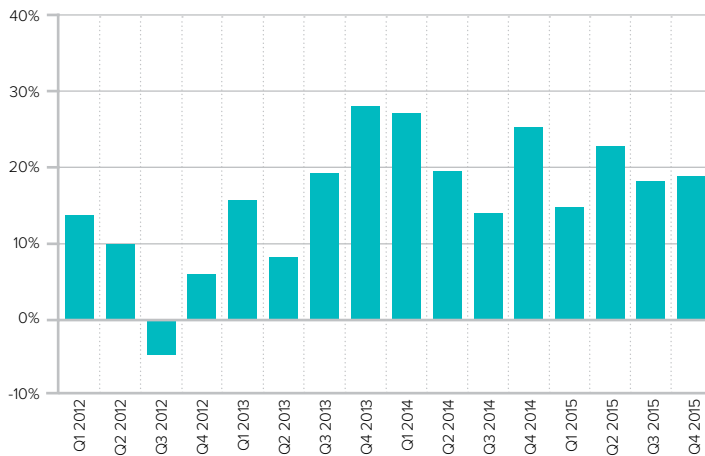
Another factor currently helping to support business finances is the very low level of inflation in the general economy.

This quarter, a net balance of just 49.3% of firms in Scotland report that their operational costs during the past three months were higher than the same point a year before. This compares to 62.1% reporting overhead rises in Q4 2014, and 79.5% when the series began in 2011. The latest figures from the Office for National Statistics for manufacturers' input prices show deflation of 13.1% in the year to November, while the prices that service firms charged to other businesses rose by just 0.5% in the year to Q3. This quarter's SBI results suggest that these trends are likely to have continued into the final quarter of the year, helping to boost businesses' bottom lines.

Overall, these results suggest that Scotland's short-term economic prospects are middling.

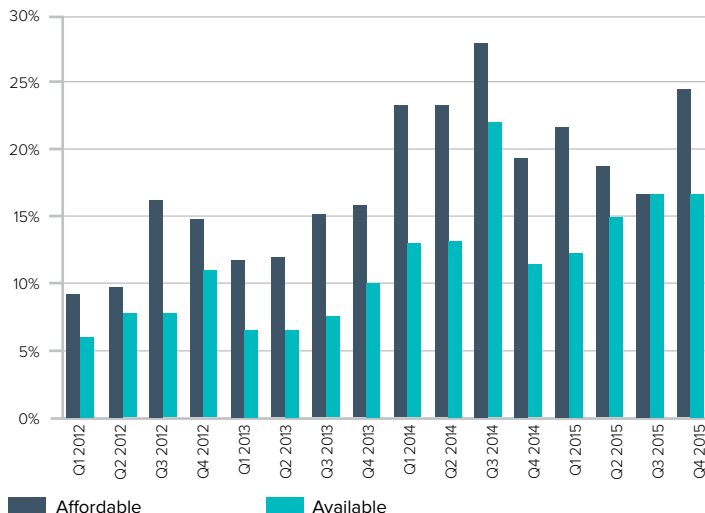
A small majority of businesses expect turnover and profits to increase over the next quarter and plan to take on a small number of new staff. However, over the coming year, small firms appear more optimistic, as many are still planning on making capital investments, helped by a lower cost of borrowing than seen previously.

Fig. 10: Net balance of firms expecting to increase capital investment over the next 12 months



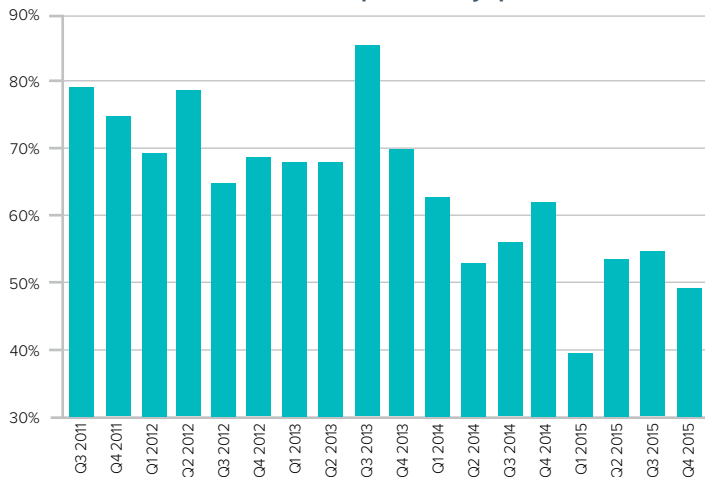
Source: FSB Small Business Index survey

Fig. 11: Proportion of firms in Scotland reporting that credit is affordable or available



Source: FSB Small Business Index survey

Fig. 12: Net balance of firms in Scotland reporting a year-on-year increase in the costs of operation by quarter



Source: FSB Small Business Index survey

FSB Scotland

74 Berkeley St
Glasgow
G3 7DS

Tel: 0141 221 0775
scotland.policy@fsb.org.uk
www.fsb.org.uk/scotland

federationofsmallbusinesses
 @FSB_Scotland