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Fraser of Allander Institute

25 years of the Scottish Business Monitor

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Table of contents

The Fraser of Allander Institute

ii Executive Summary

1 Introduction

2 Section 1: Key business volume indicators

4 Section 2: Inflationary pressures

6 Section 3: Expectations for growth

7 Section 4: Looking ahead with key productivity drivers

Disclaimer

The analysis in this report has been conducted by the Fraser of Allander Institute (FAI) at the University of Strathclyde. The FAI is a leading academic research centre focused on the Scottish economy.

The analysis and writing-up of the results was undertaken independently by the FAI. The FAI is committed to providing the highest quality analytical advice and analysis. We are therefore happy to respond to requests for technical advice and analysis. Any technical errors or omissions are those of the FAI.

Executive Summary

Launched in 1998, and now in its 25th year, the Scottish Business Monitor is one of Scotland's pre-eminent trackers of business sentiment and activity.

The quarterly monitor is published weeks in advance of national statistics, allowing the temperature of the economy to be taken closer to real time.

The Scottish business survey is compiled by the Fraser of Allander Institute and is currently produced in partnership with Addleshaw Goddard, an international law firm.

In celebration of 100 business monitors, this report looks over the past 25 years of business in Scotland, highlighting how Scottish firms have coped with significant changes in the economic landscape.

In this report, we find that –

- In Q2 2008, as the Great Recession loomed, business sentiment began to fall significantly to a record, at that time, low of -48%. While business sentiment had mostly recovered by Q3 2009, the net balance of firms reporting an increase in business volume remained negative until Q2 2011.
- Business sentiment then fell to a 25-year low during the height of the COVID-19 pandemic in Spring 2020, with the net balance of firms expecting an increase in business volume at -70%.
- While sentiment recovered by Q1 2021, the ongoing energy and cost-of-living crisis then pushed sentiment back into the red in Q3 2022, and as of Q4 2022, sentiment sits just above the positive line.
- Export activity levels also fell to their lowest rate recorded by the monitor in Q1 2020, and whilst this rate has since recovered, the net balance of firms reporting an increase in current and expected export activity remains, as of Q4 2022, well below zero.
- In the wake of the cost-of-doing business crisis, the share of firms reporting increased costs reached its highest level on record in Q3 2021 and has remained roughly at that level since.
- In Q4 2022, we found that 90% of firms surveyed had seen their costs increase on the year, with just under half reporting that they expected to reduce operations in 2023 due to higher energy bills. However, the latest quarterly results found that businesses are increasingly taking steps to tackle the current energy crisis, with more than 60% of firms reporting that the energy crisis has encouraged them to speed up making energy-efficient improvements.
- This is just one of many times the business monitor has captured resilience among Scottish firms. At the start of last year, the Institute found that 40% of businesses agreed that the pandemic had accelerated their plans to make a major part of their business model digital.
- But, while Scottish businesses have demonstrated their resilience time and time again over the past 25 years, it is crucial that investment is being made for future growth.
- Since 2014, new capital investment made by Scottish firms has been weak, and despite recovery being made from the record lows seen in 2020, business investment has fallen consecutively each quarter since Q4 2021 and has remained negative since Q3 2022. Expectations around future investment have also been negative since Q2 2022.

Introduction

In Q4 of 2022, the Scottish Business Monitor celebrated its 100th quarter. This milestone presents an opportunity to look back over the past 25 years and analyse how the economy, and businesses operating within it, have fared.

The quarterly Scottish Business Monitor survey provides regular indicators of business trends, market conditions, financial factors, and business conditions in the Scottish economy. The sample used is designed to be representative of the structure of the Scottish economy and takes the temperature of around 500 firms.

When the first ever Scottish Business Monitor was published in 1998, the Scottish economy was quite different to how it is today.

Scottish parliament was yet to exist, reconvening in 1999 to mark a new era for Scotland, the first time in 292 years that parliament had met north of the border. In just 25 years, as a nation, we have seen five First Ministers of Scotland, seven Prime Ministers of the UK and two Monarchs.

Among others, Google, Wi-Fi, electric vehicles, and cryptocurrency were yet to shake up our economy.

Scotland has experienced many ups and downs, with economic crises and periods of growth influenced by domestic and global economic conditions.

Today, Scotland finds itself in yet another difficult economic period, following years of turmoil for businesses, including the UK's exit from the European Union, COVID-19, and now the cost-of-doing business crisis.

Despite these unprecedented challenges, much of the Scottish business base continues to show significant resilience.

What the next 25 years will hold is far from certain. However, with the scarring effects of both Brexit and the pandemic, and an uncertain political environment, business reliance will no doubt continue to be put to the test.

This report looks back at the past 25 years of the business monitor, analysing trends in our key business indicators. It also looks at the development of key productivity indicators that will be crucial for business and economic growth in the next 25 years.

This report is structured as follows –

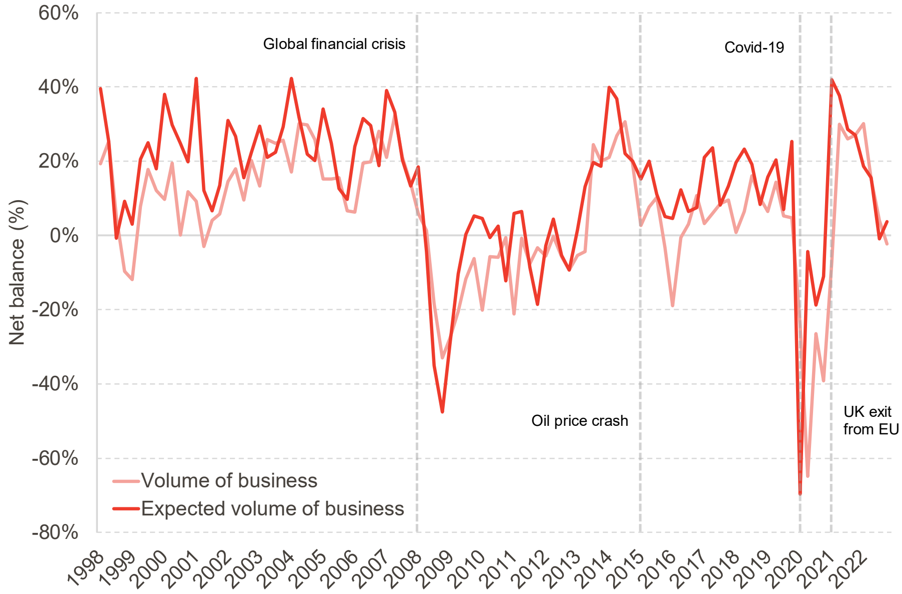
- Section 1 analyses the business monitor's key volume of business indicators since 1998, highlighting key trends in business sentiment over the past 25 years.
- Section 2 looks at business costs and how they have developed since the turn of the century.
- Section 3 evaluates how business expectations of economic growth in Scotland have changed in recent years.
- Section 4 examines how current export activity and expectations around export activity have changed since 2000, and follows capital investment, both current and expected, over the past 25 years. Both indicators are key drivers of productivity and will be crucial to Scotland's medium to longer-term economic growth.

Section 1: Key business volume indicators

- This section analyses the business monitor's key volume of business indicators since 1998, highlighting key trends in business sentiment over the past 25 years.
- The Great Recession technically[1] began in Scotland in the third quarter of 2008 however, the financial crisis which began in the year prior had already started to impact business sentiment.
- As this recession loomed, business sentiment began declining. The net balance[2] of firms expecting an increase in their business volume fell from 19% in Q1 2008 to -4% in Q2 2008. **See Chart 1.**
- In Q4 2008, businesses sentiment plummeted to its lowest level on record at that time (-48%). Our headline indicator remained negative until Q3 2009.
- Just as confidence was returning, Scottish businesses were hit by the oil price shock in 2015, closely followed by the EU referendum which ushered in a new period of uncertainty.
- Volume of business slumped for firms at the start of 2016 before regaining some positive ground until the onset of the COVID-19 pandemic.
- In the first quarter of 2020, Business sentiment fell to the lowest level in the business monitor's 25-year record, with the net balance of firms expecting an increase in business volume at -70%.
- One year on and things began to pick up in Spring 2021 as Scotland emerged from another lockdown and the economy reopened.
- However, in the wake of the cost-of-living crisis, businesses sentiment has become increasingly pessimistic. Net balances fell throughout 2022, dropped below zero in Q3 2022 for the first time since Q1 2021, and, as of Q4 2022, sits just above zero.
- The decline marks a significant slowdown from the recovery from COVID-19.
- According to our business monitor, the hardest sit sector during the height of the pandemic was construction, and despite it experiencing a quick recovery in 2020 and 2021, the ongoing cost-of-doing business crisis has significantly impacted the sector, along with the manufacturing and hospitality sectors. **See Chart 2.**

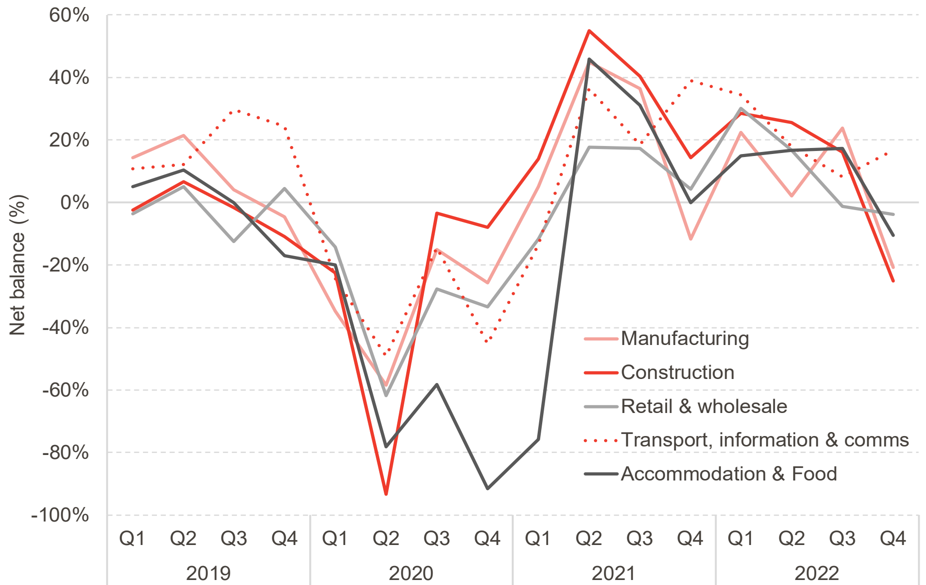
1 i.e., two consecutive quarters of negative growth.
2 Net balance of firms is defined as the share of firms reporting higher minus the share of firms reporting lower.

Chart 1: Net balance (%) of businesses reporting and expecting an increase in volume of business over the past three months and next six months, respectively, Q1 1998 – Q4 2022



Source: *Scottish Business Monitor*

Chart 2: Net balance (%) of businesses reporting an increase in the volume of business over the past 3 months, by sector, Q1 2019 – Q4 2022

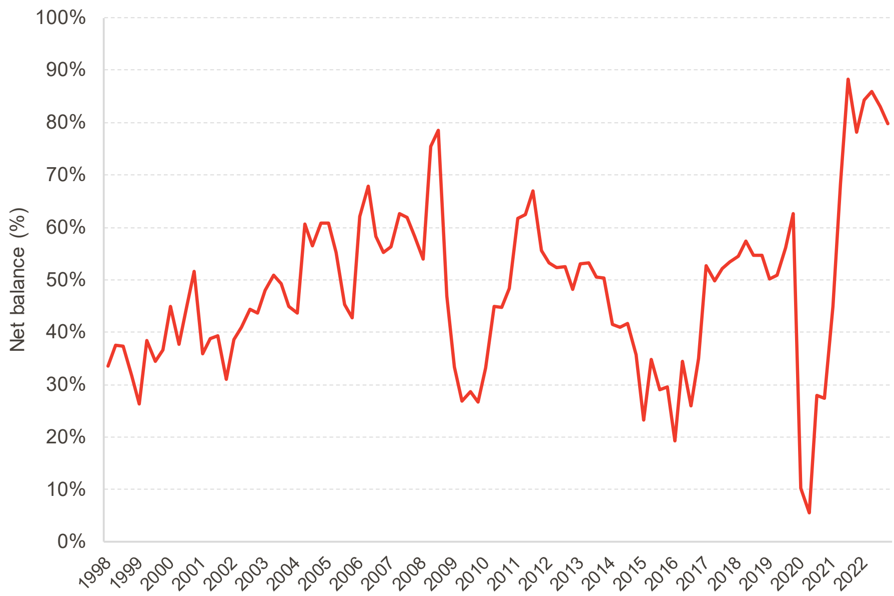


Source: *Scottish Business Monitor*

Section 2: Inflationary pressures

- The net balance of firms reporting an increase in business costs typically followed an upward trend for the first decade of the survey.
- During the 2008-2009 recession, the share of firms reporting increased costs fell considerably, increasing again slightly before the collapse in oil prices mid-2014.
- Costs then dropped dramatically at the onset of COVID-19, falling to all-time lows at the start of 2020.
- During the post-pandemic recovery, however, the net balance of firms reporting higher costs increased significantly. **See Chart 3.**
- In the most recent quarter, 90% of firms saw their costs increase with the majority (77%) experiencing increased costs of up to 50%.
- Scottish businesses have faced a number of headwinds over the past year, grappling with supply chain pressures, hiked up energy bills, and the highest inflation the economy has seen in 40 years.
- In addition to the direct costs of higher energy prices, businesses also face the risk of secondary impacts from those on households which may take the form of reduced demand.
- Households have felt the effects of poor economic performance on top of falling real pay acutely with many cutting back on consumption as a result.

Chart 3: Net balance (%) of businesses reporting an increase in total business costs over the past 3 months, Q1 1998 – Q4 2022

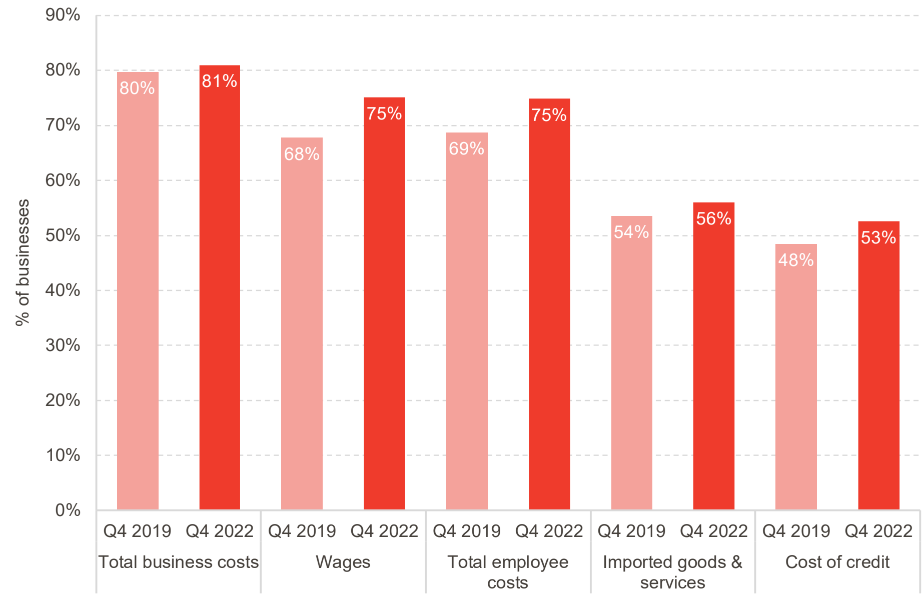


Source: *Scottish Business Monitor*

- Unsurpisingly, in the latest quarter (Q4 2022), the most common concerns among responding businesses were the costs of energy and the price of inputs.
- However, in terms of key cost drivers over the first half of 2023, 3 in 4 businesses are most concerned about increasing total employee costs, followed closely by energy costs (71%).

- Given the increases in borrowing costs driven by hikes in the Bank of England's base rate over the past year, and the demand from workers for higher pay amidst 40-year high inflation levels, we have seen a significant increase in firms expecting the cost of credit and employee costs to be key cost drivers for their business. **See Chart 4.**

Chart 4: Business expectations of key cost drivers over the next 6 months, Q4 2019 & Q4 2022



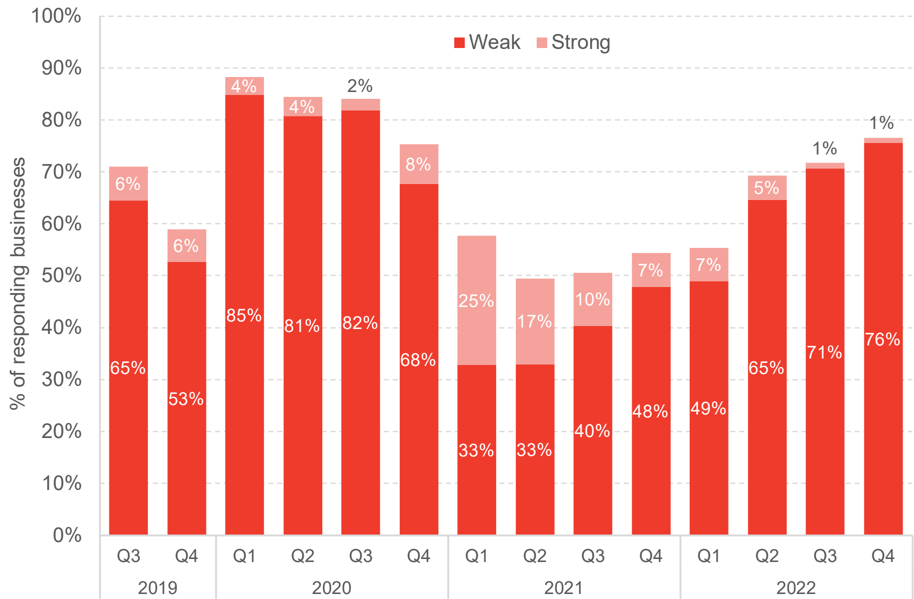
Note: in 2019, we did not ask firms about energy costs therefore, no comparison can be made.

Source: *Scottish Business Monitor*

Section 3: Expectations for growth

- Pessimism took a hold of the Scottish economy in 2020 as COVID-19 and the following uncertainties around the openness of the economy began to unfold.
- At the onset of the pandemic, the number of businesses expecting weak growth leaped to more than 4 in 5 with expectations remaining bleak until Q4 2020. **See Chart 5.**
- The outlook of firms did however pick up at the beginning of 2021 however, firms were comparing to a pretty poor baseline given how poor the outlook was in 2020 and given the fact we had just come out of a winter lockdown when firms were surveyed.
- But, despite a particularly challenging year for businesses in dealing with the fallout from Brexit and the pandemic, 1 in 4 businesses felt optimistic, expecting strong growth for the Scottish economy in Q1 2021 – the highest share since we first asked firms in Q3 2019.
- In sharp contrast, at the end of 2022 in the most recent survey, just 1% of firms expected strong growth while more than 3 in 4 firms expected weak growth over the coming year.
- While the outlook for the economy is not as bad as it was during the height of the pandemic, ongoing inflationary pressures and geopolitical developments continue to add to the uncertainties facing businesses.

Chart 5: Growth expectations of responding businesses for the Scottish economy, Q3 2019 – Q4 2022



Note: firms can respond N/A, therefore, shares may not sum to 100%.

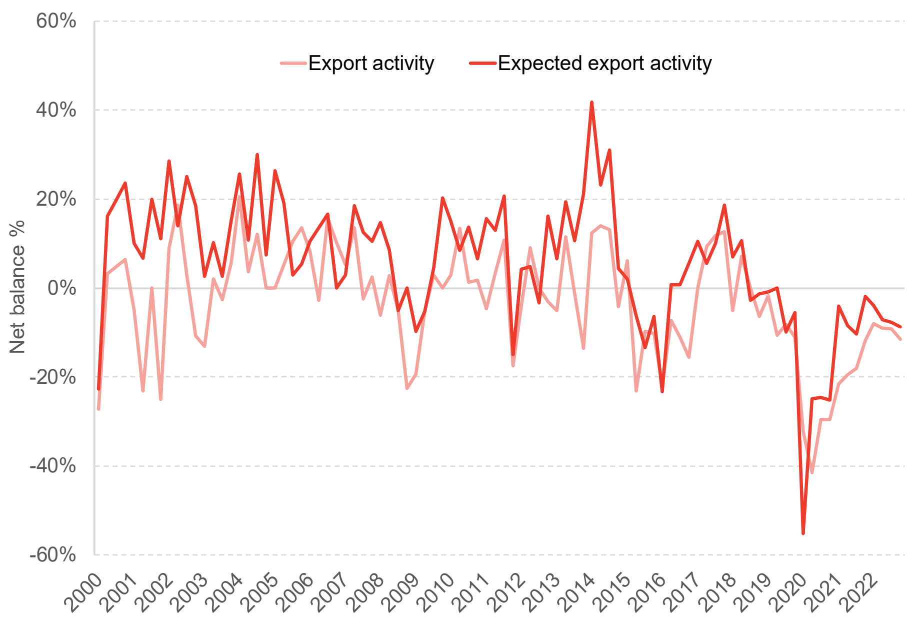
Source: *Scottish Business Monitor*

Section 4: Looking ahead with key productivity drivers

Export activity

- Since Q4 2018, and for seventeen consecutive quarters, the net balance of firms reporting an increase in export activity has been negative. Expectations around export activity have also been negative since the start of 2019. **See Chart 6.**
- At the start of 2020 as COVID-19 began to spread, restrictions were enforced, and international supply chains broke down, current and expected export activity fell to their lowest levels on record.
- As the economy began its recovery from the pandemic peak in 2020, Scotland, with the rest of the UK, officially left the European Union.
- In our survey in Q1 2021, after the transition period of the UK's withdrawal from the EU ended, we asked Scottish businesses about their experience trading with the EU. Of the firms that traded with the EU, almost two thirds reported negative or very negative impacts on their trade while just 3% reported positive impacts.
- In Q1 2021 the Scottish and UK economy also went into another lockdown.
- It is hard to decipher how business exports have been impacted by Brexit given the timing of the pandemic. However, businesses have had to cope with Scotland leaving the largest single market in the world, a global pandemic which shut down global supply chains, and now the cost-of-doing business crisis.

Chart 6: Net balance (%) of businesses reporting and expecting an increase in export activity over the past 3 months and the next 6 months, respectively, Q1 2000– Q4 2022

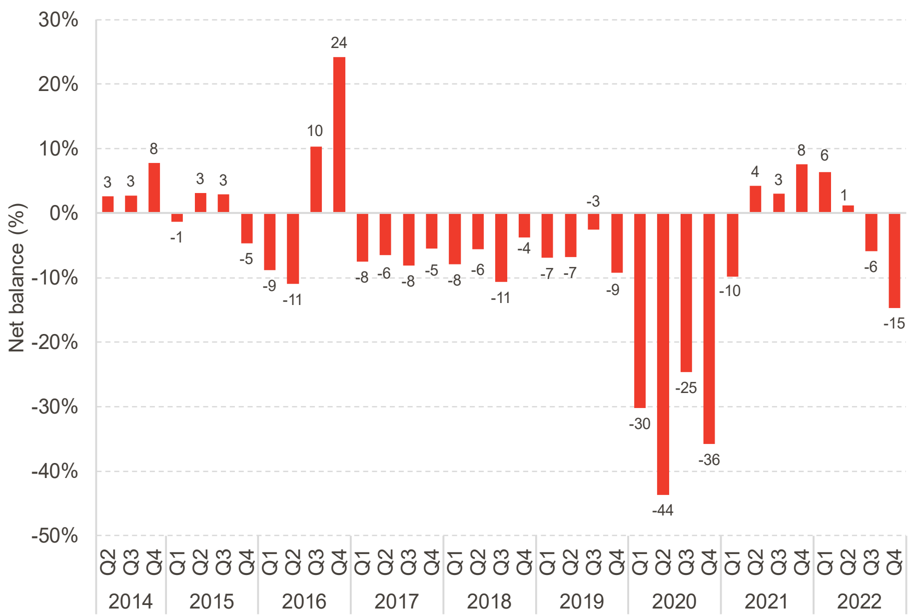


Source: *Scottish Business Monitor*

Business investment

- Low levels of investment have been a longstanding feature of the Scottish economy for many years.
- Amid heightened levels of uncertainty, it is unsurprising that the investment intentions of firms remain low.
- For seventeen consecutive quarters, between 2017 and 2021, the net balance of firms reporting an increase in capital investment was negative. **See Chart 7.**
- After falling to severe lows during the pandemic, investment intentions improved considerably in Q3 2021, regaining some positive ground for the first time since 2016.
- Business resilience is tested in times of crisis and often firms become more innovative in order to adapt. As noted in Addleshaw Goddard's 2022 Tech Report, we found that 40% of businesses agreed that the pandemic had accelerated their plans to make a major part of their business model digital.
- However, in recent quarters, new capital investment has fallen into negative territory once again.
- The performance of capital investment is concerning given that when we look across national statistics business investment rates in Scotland are already lower than the UK overall's and significantly lower than many developed economies.
- Business investment and export activity are key drivers of productivity and economic growth therefore, years of poor performance across both indicators is concerning for the longer-term outlook of the economy.

Chart 7: Net balance (%) of businesses reporting an increase capital investment over the past 3 months, Q2 2014 – Q4 2022



Source: *Scottish Business Monitor*

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