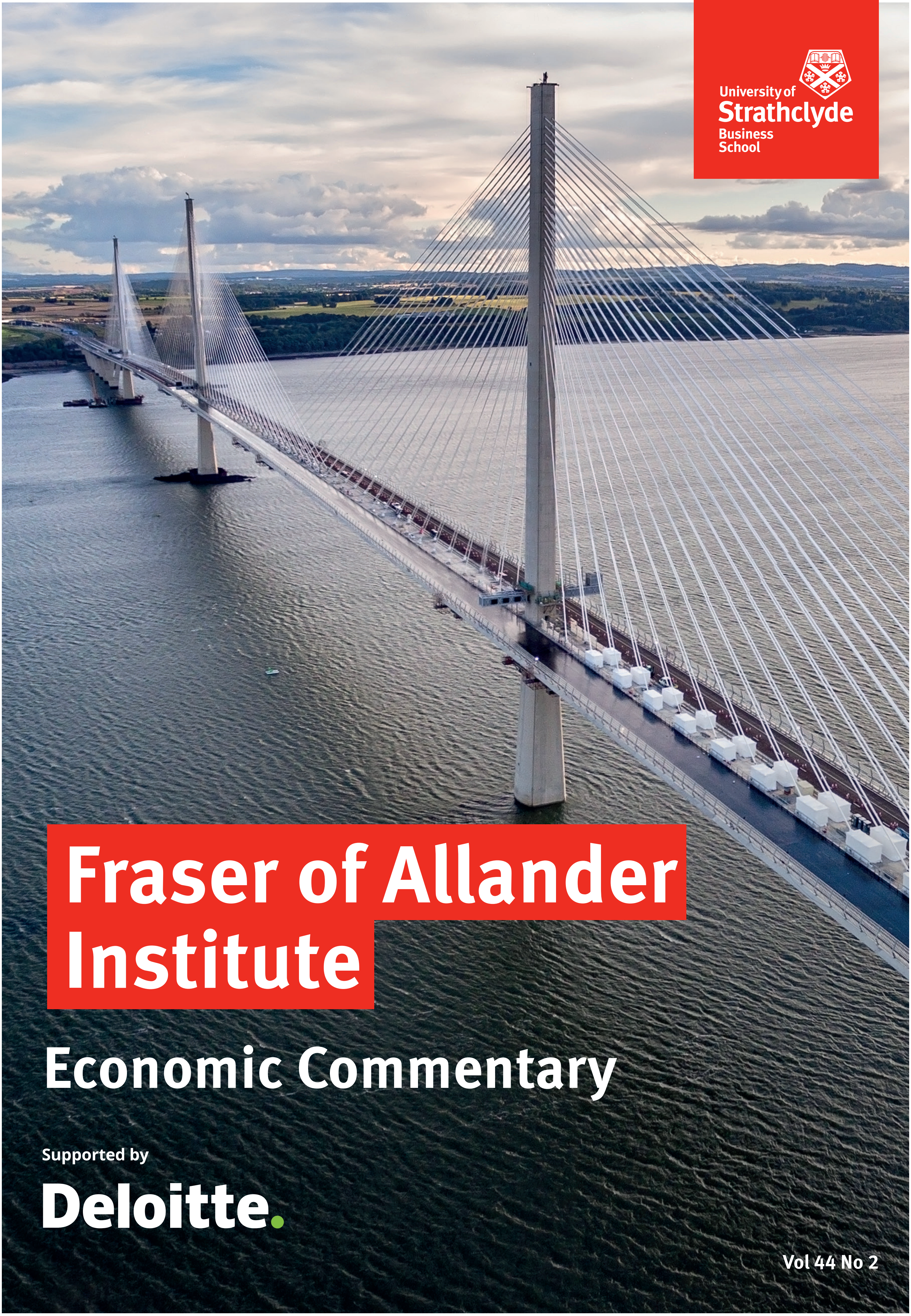

University of Strathclyde Business School

Fraser of Allander Institute

Economic Commentary

Supported by

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Vol 44 No 2

Foreword

Reimaging the future in a post COVID-19 era

Three months ago when we wrote the foreword for the last economic commentary, the world was just beginning to be gripped by a global health pandemic.

In Scotland, we entered lockdown alongside the rest of the UK on 23 March. The deliberate closure of non-essential parts of our economy, synchronised across the globe, makes this economic crisis different to those that we have experienced previously.

At the end of May, after over two months in lockdown, the country took its first tentative steps to restarting the economy. However, as we move into 'Phase two' of easing lockdown, there remains a great deal of uncertainty over how quickly businesses, and even industries, will be able to recover. There is also the very real threat of a second wave of the virus and the impact to the economy if restrictions were put in place once again.

It is safe to say that no one knows exactly what will happen, and it will take several years to understand the full impact COVID-19 has had on society and businesses. However, we are starting to understand how this virus has fundamentally altered the way we live our lives and can begin to draw out key themes that will shape the 'new normal'.

Faced with large government deficits and pressure to increase spending on the public sector, governments may well increase taxes and it is likely we will see new guidance and regulation covering corporate conduct, possibly leading to improved working conditions and increased protections for lower paid employees, particularly key workers.

Businesses will need to repair balance sheets and, in the medium-term, it is likely there will be a wave of merger and acquisition activity as companies look to address excessive debt and adapt to a lower growth world.

Social attitudes and consumer habits have been fundamentally altered by COVID-19, and there is a greater expectation on businesses to behave more ethically and sustainably as consumers become more aware of corporate practices. There will also be a greater focus on the health and wellbeing of employees and working from home will have increased significantly. When discussing the topic of flexible working a few months ago, we would have talked about the benefits a flexible workforce brings to an organisation and how the future of work will be disrupted by technology. But here we are today, fast-tracked into unchartered territory with many now indefinitely working from home.

We asked global businesses and HR leaders in our 2019 Human Capital Trends Report what they believe to be a requirement for a 21st-century leader, and only half said it is to manage on a remote basis. Given the changes that we've all had to make in recent weeks, one can imagine how these responses would change if we were to ask this question today. The future of work is here right now and leaders need to take a proactive stance in understanding how work will be done and how that shift impacts the workforce.

In terms of consumer habits, it is reasonable to expect more prudent spending behaviours in the short term, while the rise in online shopping and virtual services will persist.

COVID-19 has given businesses the opportunity to take stock, to rebuild and look closely at where they can truly deliver prosperity and productivity.

The next few months will be critical for the long-term prosperity of our economy. While restrictions are being eased, they are likely to remain in place for some time. The sooner businesses accept the new normal is here to stay and understand what this means to them, the faster we will be able to move towards a reimagined economy.

For analysis of the workplace recovery from COVID-19 see Deloitte's Reopening the workplace: A resilient leader's guide.

Steve Williams
Senior Partner for Scotland
Deloitte

June 2020

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Fraser of Allander Institute

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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

UNIVERSITY of STRATHCLYDE
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Summary

It is hard to believe that it is just three months since our last commentary.

Since then, we have seen the greatest scaling back of economic activity in memory, an unprecedented fiscal stimulus, and millions of workers furloughed or working from home.

Last week's figures confirmed that in April, GDP fell by almost 19% in Scotland and over 20% in the UK.

What matters now is the pace of recovery, and the scale of the damage left behind as a consequence of this – albeit temporary – hibernation in economic activity.

There remains huge uncertainty however, about the restart, not least because of the ongoing risks to public health and concerns around the timing of the removal of government support. Sadly, it will only be when government funding is lifted that the full economic costs of the crisis will be realised.

For this commentary, we spoke with over a dozen economists, business leaders and anti-poverty campaigners to get their take on the outlook. All agree that any hope of a 'v-shaped' recession has all but disappeared.

The immediate priority for many businesses is survival. But expect a spike in closures and job losses as firms look ahead to the rolling back of the furlough support later in the year.

In this latest update, we publish a range of scenarios ranging from an 'optimistic' scenario – or a 'lopsided v' as Andy Haldane described it – to a more 'pessimistic' scenario where the recovery takes much longer to gain momentum. All of them suggest it will take some time to make up the ground lost as a result of the lockdown.

Alongside our update on the Scottish economy, we are publishing a series of articles on the impact of COVID-19, including the implications for the Scottish Budget.

We are also delighted to have an excellent reflective piece by Caroline Gardner, the retiring Auditor General for Scotland, on the challenges and opportunities facing public sector leaders in Scotland.

As we have argued before, the Scottish economy has not had its challenges to seek in recent times. The COVID-19 crisis may have pushed them out of our view, but they have not gone away. If anything, recent events have only added to them.

The last few months have highlighted the link between a strong economy and, the in-vogue phrase, 'wellbeing'. Expect this to become ever clearer in the coming weeks as the full consequences of the economic crisis hit home.

Fraser of Allander Institute
June 2020

Outlook and Appraisal

The outlook for the Scottish economy – like the entire global economy – looks hugely challenging. We need to focus on four critical areas in the short-run: testing, schools, the balance between easing of restrictions and scaling back of government support, and restoring confidence.

Introduction

In this section of the commentary, we summarise some of the latest indicators covering the global, UK and Scottish economies.

There is a mountain of information that we could cover, so we do not try to replicate it all here. Our website – www.fraserofallander.org – provides a regular update and analysis of developments.

Instead we trace some of the key charts and commentary on economic activity, jobs, household incomes, and the latest thinking on the recovery.

The outlook for the next few months looks hugely challenging.

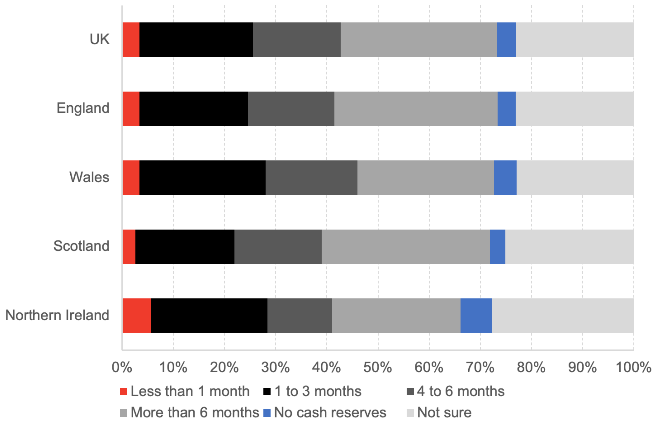
The unprecedented government support has provided an invaluable safety net –

- Around £10 billion of funding support for the Scottish economy through additional resources for the Scottish Government and various business support schemes. Equivalent to over 5% of GDP.
- Over 750,000 employees furloughed & self-employed workers supported via the Coronavirus Job Retention and Self-employment Income Support Schemes.

But shutting down large parts of the economy was the easy (albeit costly) part. A safe restart, with demand at a fraction of normal levels, supply chains disconnected, markets closed, logistics and transportation networks disjointed and the public health crisis far from over, is likely to be much more difficult.

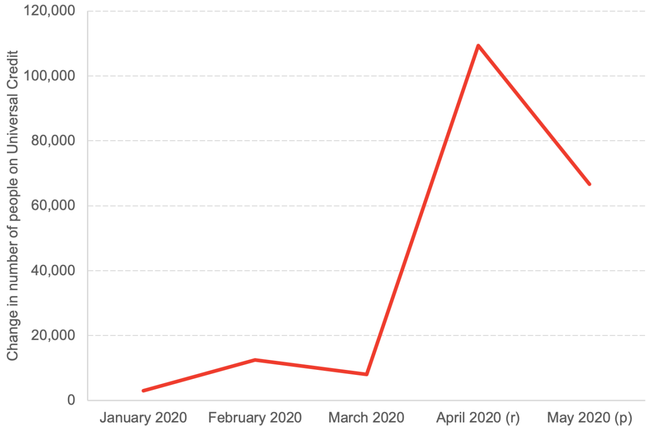
Lockdown measures have meant that businesses have had to rely on their cash reserves and government support schemes in order to meet their fixed costs. However, the stakes are high with many businesses having limited reserves. Chart 1.

Chart 1: Cash reserves of businesses across UK regions, 4th – 17th May (surveyed between 18th and 31st May)



Source: *ONS Business Impact of Coronavirus Survey*

Chart 2: Change in number of people on Universal Credit, Scotland, Jan–May 2020



Source: *Department for Work and Pensions*

Expect a spike in closures and job losses in the next few weeks and months as firms look ahead to the rolling back of government support later in the year.

Already, over 440,000 people have received support through Universal Credit in Scotland in May 2020 – this compares to around 185,000 in May 2019. Chart 2.

One caveat that is important to note though, is that because of the way in which Universal Credit operates, not everyone in receipt of support is necessarily unemployed, around 40% of new Universal Credit claimants in April were people who were in work but whose incomes dropped below the threshold for support.

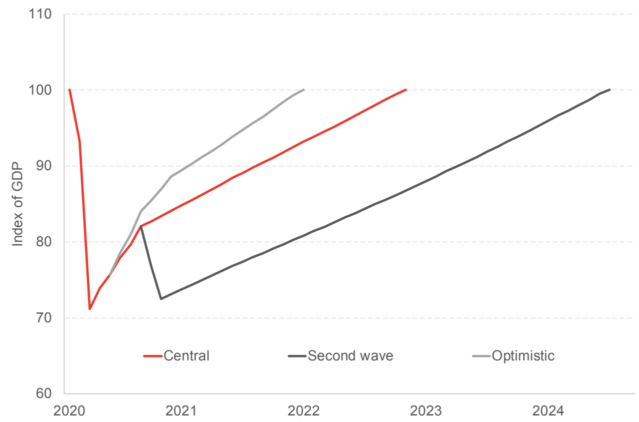
With over 750,000 people in Scotland currently either furloughed or supported through the self-employment scheme, expect a further sharp rise in unemployment in the months to come.

The lockdown and its aftermath will lead to financial hardship for many households. Sadly, as with 'typical' recessions, the most vulnerable – those at the lower end of the income distribution, in insecure work, with underlying health conditions and with caring responsibilities – are likely to be the most exposed to the fallout from this crisis.

There is also huge uncertainty about what might happen next.

Once again, given such uncertainties, we have avoided providing a specific point estimate or a central forecast for the next few years. Instead, we highlight different scenarios.

Chart 3: Scottish Economic Growth scenarios: 2020 to 2024 based upon return to 'pre-crisis level'



	Trough	Return to pre-crisis level	Recovery time
Optimistic	Apr/May-20	Jan-22	1 year, 9 months
Central	**Apr/May-20**	**Nov-22**	**2 years, 7 months**
Second wave	Apr/May-20	Jul-24	4 years, 3 months

Source: *FAI calculations*

What broadly do they tell us?

On the one hand, there is an optimistic view that if firms survive the immediate next few weeks and the re-start of key sectors goes smoothly, the recovery may build momentum relatively quickly. Yes, there will be winners and losers, but provided there is no 2nd spike in COVID-19 infections, economic activity could pick-up sharply as demand returns. Whilst a 'v-shaped' recession seems unlikely, and some scarring is a certainty, the hope is that towards the autumn the outlook might look more positive. Our scenario estimates in this case that the economy will get back to pre-crisis levels in late 2021 / early 2022.

On the other hand, should the virus continue to act as a drag on confidence, then the effects of the crisis could be more significant.

The longer the crisis lasts, for many small businesses, those on tight margins, or in sectors disproportionately impacted, the prospects for recovery look particularly challenging. In this scenario, there is likely to be much more gradual recovery. In this, our "central" scenario, output gets back to pre-crisis levels towards the end of 2022.

Of course, should there be a second-wave and re-introduction of more stringent restrictions, the hit to the economy will be all the greater. Here, the hit to livelihoods could be greater than we have seen in a generation. We estimate that this could mean the economy does not get back to pre-crisis levels until mid-2024.

On balance, we continue to take the view that – at this stage – the balance of evidence points to somewhere in between these extremes. Four factors will be crucial to helping shift the balance in favour of the more positive outcomes:

- Firstly, it is vitally important to avoid a second wave of infections. The need for an effective testing and tracking regime at scale is an urgent necessity. The fact that it is still not ready is a major concern.
- Secondly, government needs to develop a more effective plan for the safe return of schools to let parents return to work. Failure to do so risks extending the economic crisis and widening inequalities.
- Thirdly, it is absolutely critical that governments get the right balance between the easing of their support measures and the lifting of restrictions. All the key surveys points to a high proportion of businesses having only a few weeks of reserves to survive at reduced levels of demand. Lifting the government support too early and/or delay the easing of restrictions too long (even by a matter of weeks) and the knock-on impacts across the economy could be severe.
- Finally, much will depend upon how consumers and businesses react to the easing of restrictions. Will it lead to a spike in demand as delayed spending comes back on stream, or will spending remain subdued if expectations remain fragile?

Of ongoing importance, is making sure that we protect the most vulnerable in society – and in particular, those at greatest risk from economic harm because of poverty, health or wider inequalities.

In time, practical support measures for the recovery – including employability and skills, flexibility to change jobs, recapitalisation of balance sheets and the like – will also be important.

The fact that different aspects are controlled by UK, Scottish and local government makes delivery a real challenge.

But as is often the case in the midst of a crisis, much time appears devoted to much grander objectives around re-imagining a ‘better’ economy in the long-run. All sorts of ideas are coming to the fore. But we cannot lose sight of the seriousness or the urgency of the situation now.

This week’s publication of the Economic Recovery Group’s report aims to counter that. Of course, we have seen numerous reports and strategies in the past. This time we are told it is different. Time will tell.

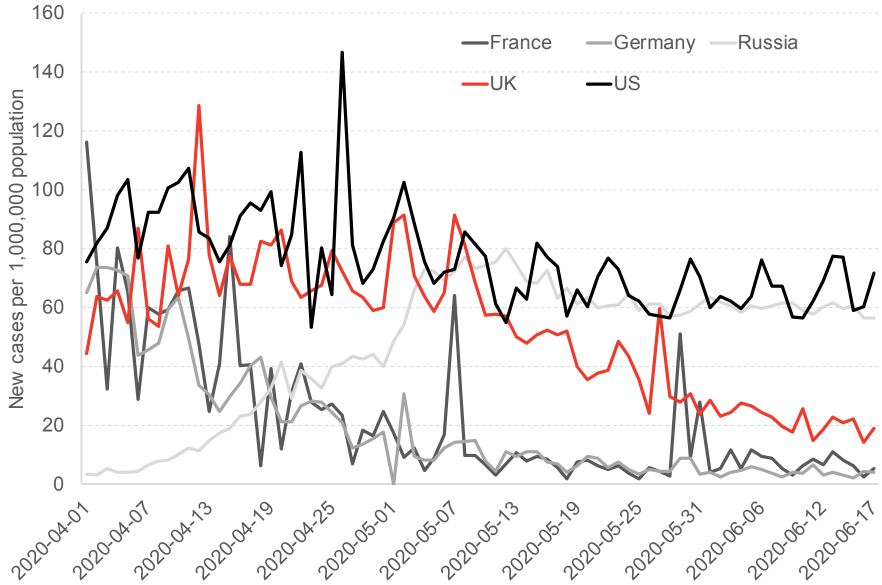
Global economy

The global health crisis brought about by the COVID-19 pandemic is without precedent in living memory.

It has triggered the most severe global recession in nearly a century and a surge in unemployment.

As at June, it would appear that some developed economies might be 'past the initial peak', with the lockdown measures having the desired impact in slowing the spread of the virus – although there remains huge uncertainty, and much still unknown, about the virus' behaviour.

Chart 4: COVID-19 infections across the population, select major economies, 1st April 2020 - 17th June 2020



Source: *World Health Organisation*

But by freezing business activity to 'flatten the curve', the reality of the economic crisis is only now starting to bite.

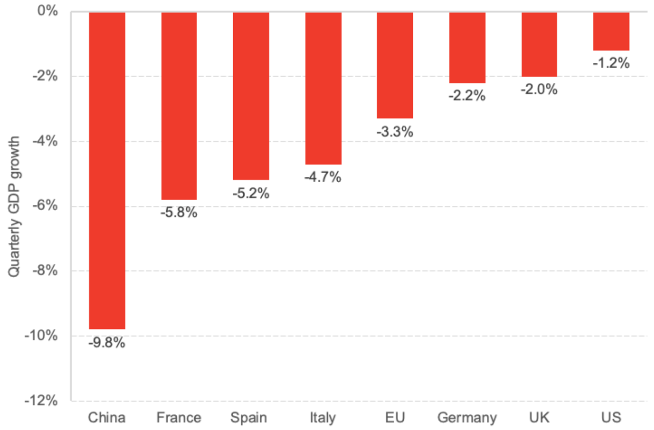
The impact of the shutdown is clearly evident in the latest global growth figures.

Chart 5 shows estimated GDP falls for the first quarter of 2020. Chart 6 the high-frequency PMI indicators.

Both are interesting. The GDP figures show the sharp - unprecedented - falls in economic activity as the global economy went into lockdown.

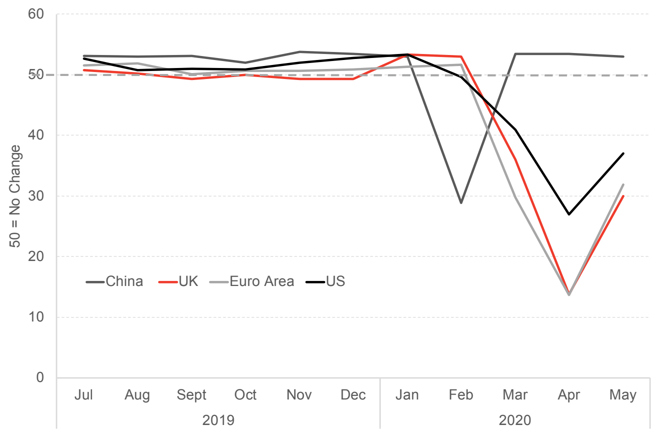
These were matched by the PMI measures, but in recent months there has been a bounce from the bottom.

Chart 5: Global economic growth, Q1 2020



Source: *China National Statistics Bureau; Eurostat; ONS; US Bureau of Economic Analysis*

Chart 6: PMI, July 2019 - May 2020



Source: *IHS Markit*

The scale of such changes is without precedent.

Box 1: Interpreting changes in GDP during the pandemic

We need however, to be cautious about what these GDP or PMI indicators – such as in Chart 5 – are telling us.

Sharp falls in GDP figures are exactly what we should be seeing at this time. If the very objective of the heath response was to scale back normal day-to-day activities, then it follows that there should be a major contraction in GDP. Of course, when key parts of the economy are 'switched back-on', we should see upward spikes in the very same measures. Indeed, figures for Q3 and Q4 this year are likely to be the fastest ever quarterly growth rates recorded!

What matters therefore, is not the size of any one quarterly or six-month shift per se, but the scale of the hit to the economy when it finally emerges from the crisis. A key question is therefore, by the end of the year, or early next year, how much smaller is the global economy compared to where it was pre-COVID-19?

What matters too are the lasting implications from such an unprecedented – albeit temporary – shock to the economy, and in particular the scarring effects it could leave behind. In other words, how long will it take the economy to recover?

The answers to both the questions posed in Box 1 are highly uncertain.

What we can say with some degree of certainty that any recovery is likely to be gradual. Restrictions – whilst being eased – are likely to remain in place for some time yet. Some, such as barriers on international travel, are likely to remain for the foreseeable future.

The recovery may also be hesitant, and could be interrupted by further outbreaks or ongoing delays in the role out of testing and tracking programmes.

So where might things go next?

The chart below shows the latest forecasts from the OECD. They are based upon what they see as ‘two equally likely scenarios’ - one scenario in which a second outbreak of COVID-19 occurs in all economies towards the end of 2020; and an alternative scenario where a second outbreak is avoided.

As the chart highlights, the UK is forecast to be particularly badly hit given the scale of our infection rate (and also unrelated challenges, such as Brexit).

In our final commentary of 2019, we discussed the latest projections for world growth in 2020. At the time, we commented that they were slightly less optimistic than before. Table 1 compares these same forecasts to now.

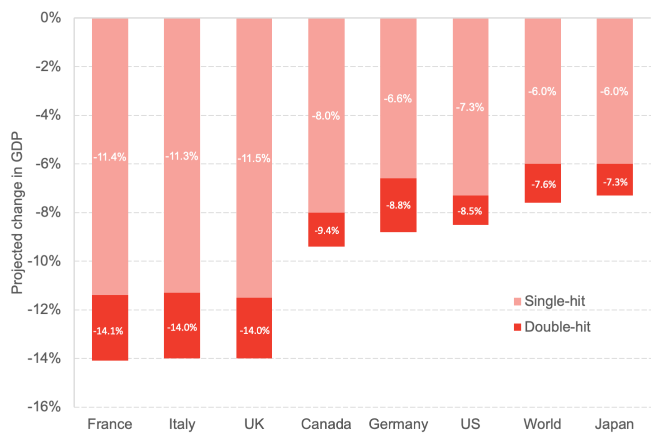
Back in 2019, the IMF forecast that the world economy was on track to grow by over 3%, now it is forecasted to contract by around the same amount.

Table 1: IMF economic outlook, last FAI commentary of 2019 and now

	Outlook (pre-Coronavirus)		Outlook (April 2020)	
	2020	**2021**	**2020**	**2021**
UK	1.5	1.5	-6.5	4.0
US	1.7	1.6	-5.9	4.7
Japan	0.5	0.5	-5.2	3.0
Canada	1.8	1.7	-6.2	4.2
Germany	1.4	1.3	-7.0	5.2
France	1.3	1.4	-7.2	4.5
Italy	0.8	0.7	-9.1	4.8
Euro Area	1.4	1.4	-7.5	4.7
World	3.6	3.6	-3.0	5.8

Source: *IMF Economic Outlook*

Chart 7: Projected change in GDP, World & G7 Economies, 2020



Source: *OECD*

Additionally, there has been a range of scenarios produced for the OECD economies.

In the OECD's “double-hit” scenario, global output is projected to decline by over 7% in 2020 (6% in the single hit scenario). Even in the more optimistic scenario, this would still be equivalent to around 5 years of per capita real income growth lost by 2021.

Away from headline measures of economic activity, the scale of the stress on the global economy is clearly evident:

- World trade has contracted sharply, with volumes down nearly 4% in the first 3 months of 2020 alone and export orders falling to their lowest level on record.
- Oil prices have fallen to track between $30-$40.
- International air passenger traffic in April was over 98% lower than a year earlier, whilst international freight traffic was close to 30% down.

- Equity prices collapsed at the fastest daily pace since 1987 at the onset of the crisis and although the policy response has boosted markets, most indices remain 10-20% below end-2019 levels.
- Long-term government bond yields have fallen substantially reflecting a flight to safety, with large capital outflows from developing countries.
- Unemployment in the OECD, which had declined to a fifty-year low, is projected to more than double to over 10% (and well above the level seen after the financial crisis).

All this being said, there are some tenative postiive signs.

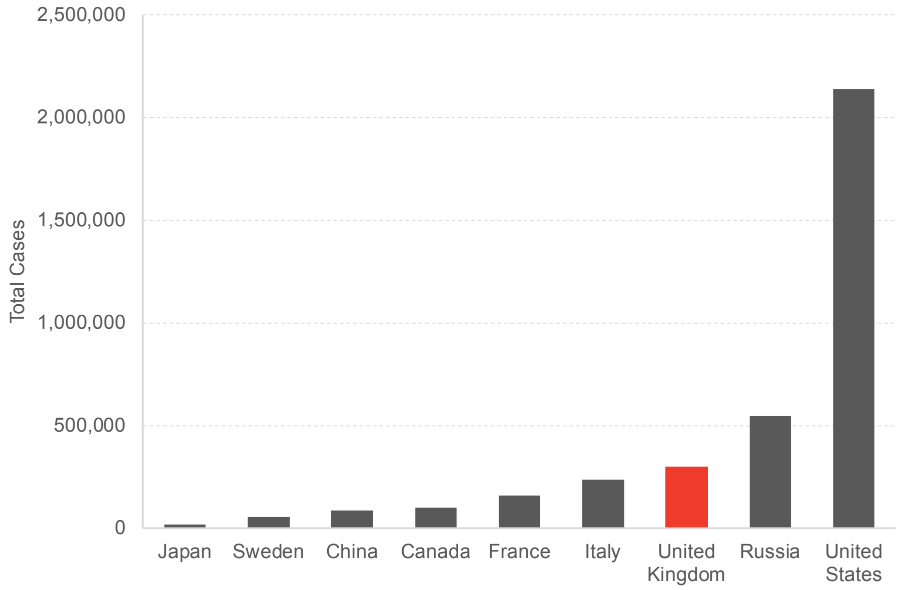
There are some early indications of a recovery in domestic spending in China, and this is likely to be echoed in other countries that have started to relax Covid related restrictions.

Attention is now turning to the more medium term implications of the crisis.

For an excellent summary, see the new Economics Observatory website.

From a global perspective, one aspect to keep an eye on will be the differences in the speed in which certain countries open up their economies (and the impact that this has). Chart 8. Many countries are ahead of the UK. Whilst it would appear that little was learned from how different countries responded at the onset of the crisis, perhaps this will be better during the recovery.

Chart 8: Total CoVid-19 cases (up until 17th June 2020)



Source: *World Health Organisation*

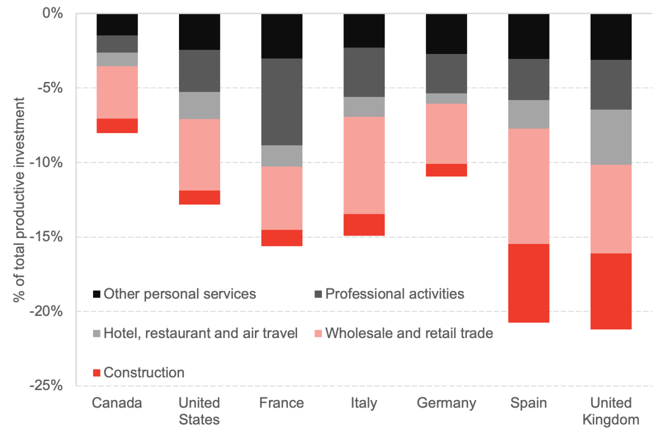
Of course, of particular concern are the more structural implications of the crisis and how they might impact global growth in the longer-term.

As highlighted above, and despite unprecedented government support initiatives, it is likely that there will be scarring – both amongst businesses and the labour market (particularly for non-standard workers[1]) – even when the crisis eases.

1 Non-standard workers include those in part-time work, temporary work and the gig economy.

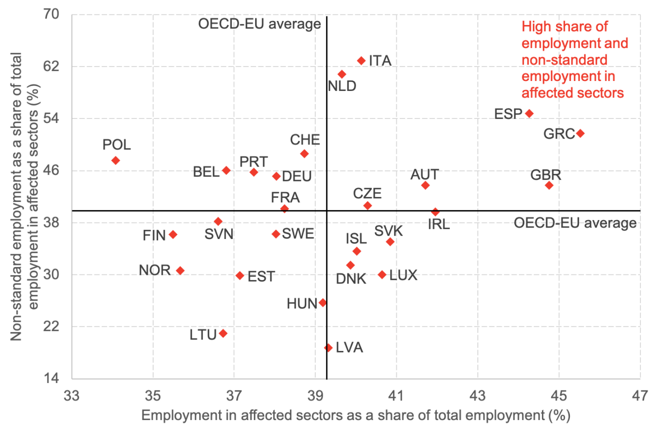
At the same time, the sharp drop in business revenues not only increases the likelihood of insolvencies and defaults, but will curtail the profit-investment cycle for years to come. The IMF's Global Financial Stability Report estimates levels of questionable corporate debt at risk in the US for example, are now even greater than on the eve of the GFC. See Chart 9.

Chart 9: Potential impact of shutdowns on productive investment



Source: *OECD*

Chart 10: Total employment and non-standard employment in activities most affected by containment measures



Source: *OECD*

Different economies across the world have different levels of resilience to the impacts of the crisis, given their sectoral make up and the characteristics of their labour market. Economies with high levels of employment in affected sectors, and with high levels of non-standard employment, are likely - all else remaining equal - to be impacted more severely. Chart 10.

More broadly, the crisis has opened up fundamental questions about the resilience of the global economy to key global risks.

This week, we publish in the Commentary an article from Professor Andrew Goudie "Re-thinking our Global Economic Future?" which looks at some of the key challenges around public health, the environment and inequalities.

Of course, from the perspective of the outlook for the Scottish economy, it will be the recovery in key European and North American markets that will be most important.

But as Roger Mullen argued in a guest article last month, we should not lose sight of the major challenges facing developing countries. Many of these countries are particularly exposed to a collapse in global demand and have weaker social safety nets. At the same time, the public health consequences are much more severe, not least because of the challenges in implementing strict social distancing in communities and workplaces.

The UK economy

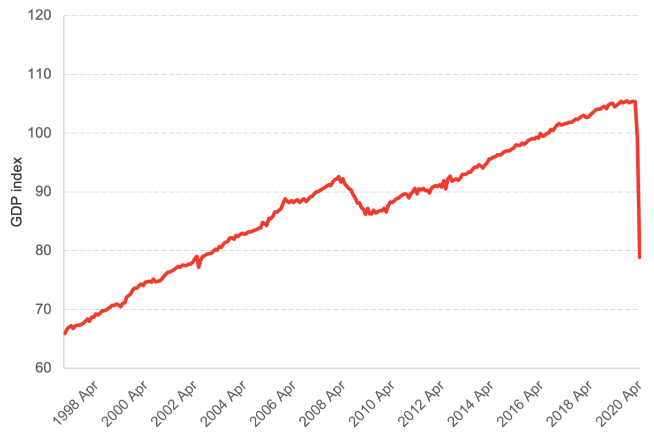
The first cases of COVID-19 were reported in the UK in late January. Two months later, much of the economy was in lockdown. And now in June, we are witnessing one of the greatest demand, supply and financial shocks to ever hit the UK economy.

Indeed, what is particularly unique about this crisis is the range of channels through which the crisis is impacting the economy.

- We are seeing demand shocks from the closure of non-essential businesses – including retail and tourism where social distancing is not possible. And we are seeing major disruption in international markets and reduced consumer spending as households tighten their belts.
- We are seeing supply shocks from lower productivity and hours worked by people having to work from home and balance care and work responsibilities. And we are seeing supply chains and routes to market disrupted.
- We are seeing financial shocks as investors pull out from riskier assets, raising the cost of capital for many firms.

The latest ONS figures show that economic activity – as measured by GDP – contracted 20.4% in April, following a fall of 5.8% in March 2020. Chart 11.

Chart 11: Monthly GDP Index, UK, Jan 1997 - April 2020



Source: *ONS*

Table 2: GDP Growth in 2020 by industry, UK

	Feb	Mar	Apr	Change Feb - Apr	Rolling 3 month average
Index of services	0.0	-6.2	-19	-24	-9.9
Index of production	-0.1	-4.2	-20.3	-23.7	-9.5
Manufacturing	0.3	-4.6	-24.3	-27.8	-10.5
Construction	-2.1	-5.9	-40.1	-43.6	-18.2
Agriculture	-0.1	-0.2	-5.5	-5.6	-2.1

Source: *ONS*

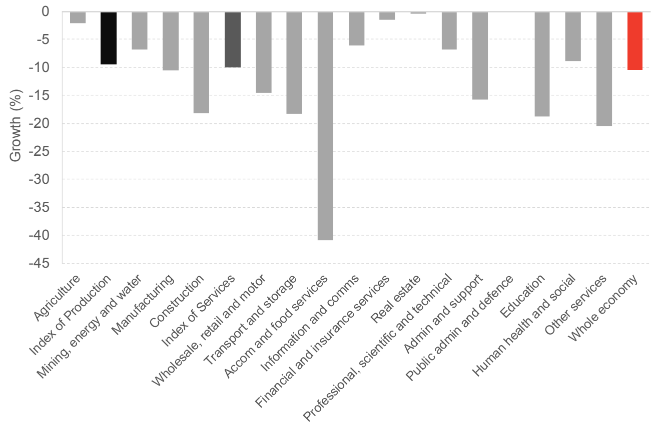
The contraction is widespread across all sectors with the lockdown causing businesses to close, factories to shut down and retail outlets to shut up shop. Table 2.

Of course, underlying these headline statistics are significant variations both by individual business and sector.

Unsurprisingly, those parts of the economy tied closely to 'social spending' – such as travel, retail and hospitality – have been hardest hit. Chart 12.

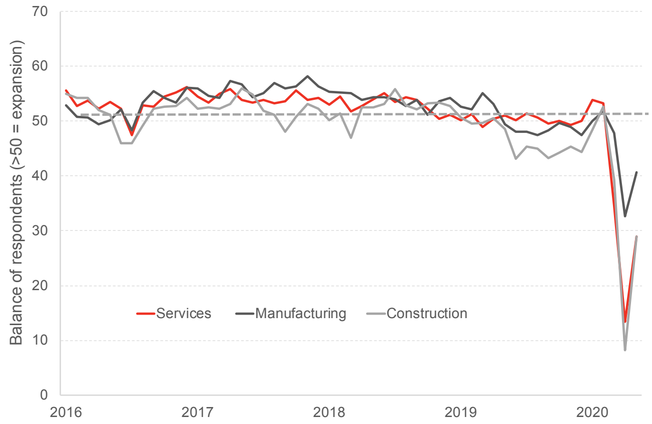
The PMI indicators for many sectors are amongst their lowest ever level, although there is some evidence of a modest bounce-back as the lockdown (at least at the UK level) is eased. Chart 13.

Chart 12: Breakdown of GDP growth by sub-sector, UK, Feb 2020 – Apr 2020



***Source:** ONS*

Chart 13: PMI by sector, UK, January 2016 - May 2020



***Source:** IHS Markit*

As highlighted above, traditional trackers of economic activity are not well suited to telling the full story about the economy at this time, or the scale of the challenge.

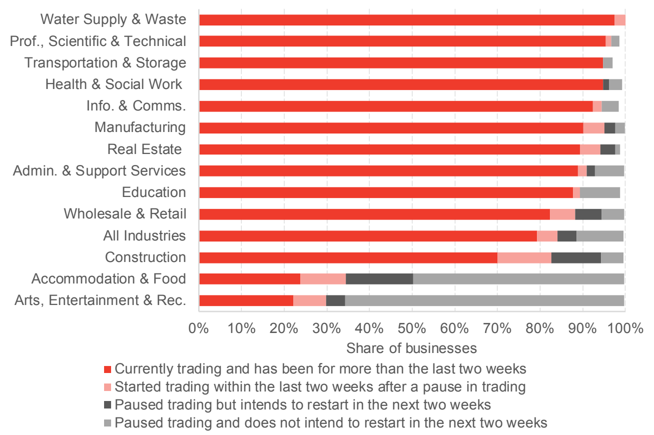
Instead, we have to rely upon other more novel indicators.

To their credit, ONS responded quickly with a new survey of UK businesses. Not only does this help identify changes in activity, but it also picks-up underlying stress within businesses and possible turning points far ahead of indicators such as GDP.

The latest data confirms that at the start of June, 5% of businesses, across all industries, responded they had restarted trading in the last fortnight after a halt in trading.

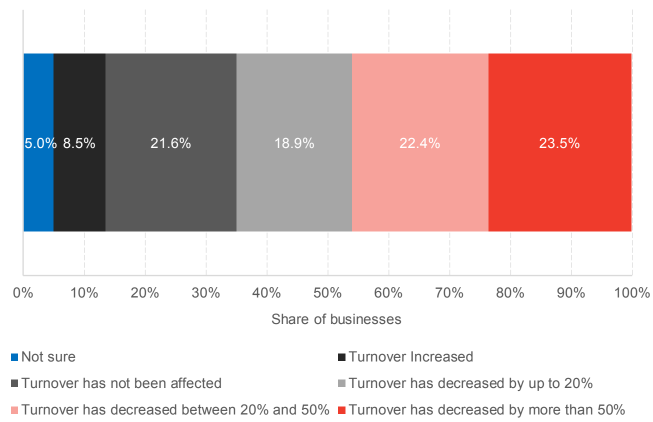
Of those thinking of starting back-up again, whilst some are hopeful of starting up soon, for many the lockdown is likely to last for some time yet.

Chart 14: Percentage of businesses in each industry current trading, UK, 1 June to 14 June 2020



***Source:** ONS BICS*

Chart 15: Effect on turnover, businesses continuing to trade, UK, 18 May - 31 May 2020



***Source:** ONS BICS*

Of those still operating, conditions have been hugely challenging. Over 20% report that their turnover has declined by more than 50%. In total, nearly 1 in 2 businesses still operating have seen their turnover decline by more than 20%.

According to the Bank of England's Decision Maker Panel, companies' sales are expected to be around 45% lower than normal in 2020 Q2 and business investment 50% lower.

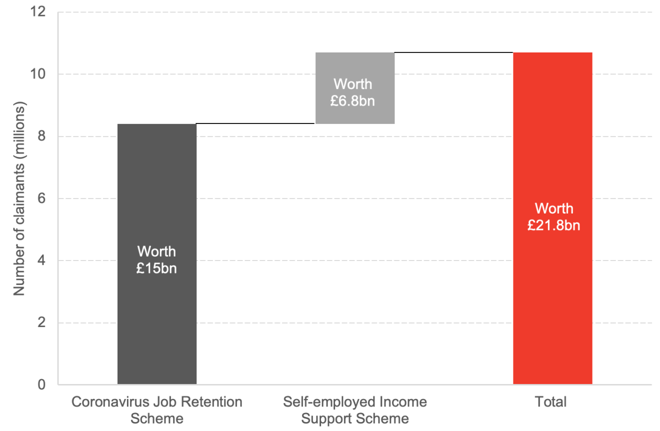
As a result, it is no surprise that 1/3 of companies still trading have been laying off staff or reducing working hours. A great many more have been furloughed.

The response to the public health emergence – to effectively lockdown key parts of the economy – was entirely the right approach. So too was the response by the Chancellor to step-in and provide a bridge for businesses and employees over the crisis period.

The UK Government is spending billions of pounds supporting over 10 million jobs across the country. Chart 16.

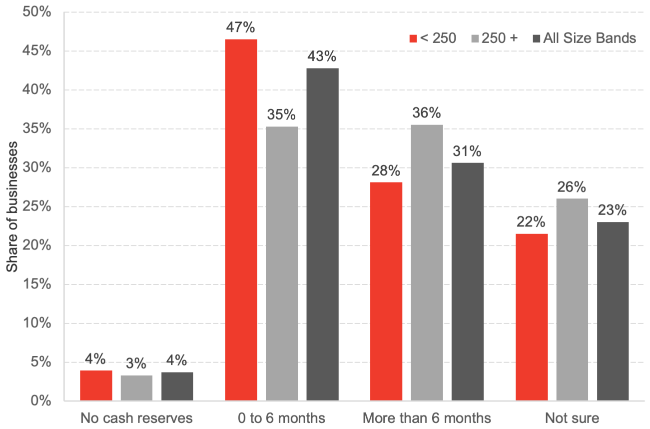
Almost half of businesses who have not permanently closed have either no cash reserves or cash reserves that will last them less than 6 months. Chart 17.

Chart 16: Claimants and cost of furlough and self-employment support scheme, as of 27 May 2020



Source: *BBC News*

Chart 17: Cash reserves, businesses who have not permanently stopped trading, by size band, UK, 18 May to 31 May 2020



Source: *ONS BICS*

But this is not all –

- The UK Government's Coronavirus Job Retention Scheme has been extended.
  - As of August, the government will continue to pay 80% of wages up to £2,500 per month however, employers will now have to pay national insurance and pension contributions from this date onwards.
  - In September, the government will only cover 70% of wages up to £2,187.50 with employers topping up wages to ensure staff receive 80% of their wages up to £2,500.
  - In October, the government will pay 60% of wages up to £1,875 for furloughed hours and employers will top up wages to ensure staff receive 80% of their wages up to £2,500.

- The Self-employment Income Support Scheme has been extended.
    - Currently this scheme offers grants worth 80% of average monthly trading profits, covering 3 months' worth of profits up to £7,500.
    - A second and final grant will be available in August 2020 which will cover 70% of average monthly trading profits, covering 3 months' worth of profits up to £6,570.
- Billions of pounds have been spent through loans, tax relief and cash grants for businesses and sole-traders.

On top of all this, the Bank of England reduced interest rates to 0.1%, supported by a further round of quantitative easing (alongside other measures to support liquidity in financial and corporate markets).

In time, government will have to tread a fine line between ongoing support where needed, but also helping businesses to get back trading again.

Plans to phase the rundown of the CJRS – with a gradual withdrawal of support and greater flexibilities – are designed to do just that. Other measures, such as supporting furloughed workers to look for new jobs in growth businesses, will be needed too.

Not all businesses will require the same level or type of support. Some are likely to require longer-term financial help. For others, the best form of support will be less about cash and more about practical measures to help plug breaks in supply chains, close gaps in logistics, or invest in new technologies and skills.

Government cannot do all the heavy lifting. Innovative private financing approaches will be required to address the £100bn of unsustainable debt estimated to have built up in the corporate sector since the crisis began.

No matter how generous, government cannot expect to support each and every business in all circumstances. It will only be once our economy emerges from its hibernation that many risks will crystallise.

And here there are concerns, with large numbers of businesses reporting limited reserves. Chart 17.

Businesses most at risk are those operating with tight margins, long-supply chains, limited capacity to pivot to new ways or working, or sectors where the lockdown has been particularly severe.

So, what next?

There is a wide range of forecasts and scenarios about how the UK economy might fare in the months to come.

Table 3 provides a range of the latest of these – with the range extending from -6.5% to -14%. The latest average forecast for 2020 is for a contraction of 9.1%, worse than the -7.9% which was the average from forecasters in May. In the main, most predict some form of bounce-back in 2021, although the average of independent forecasters has become slightly more pessimistic in recent months about how fast the return to 'normal' will be.

Table 3: UK GDP projections, 2020 - 2021

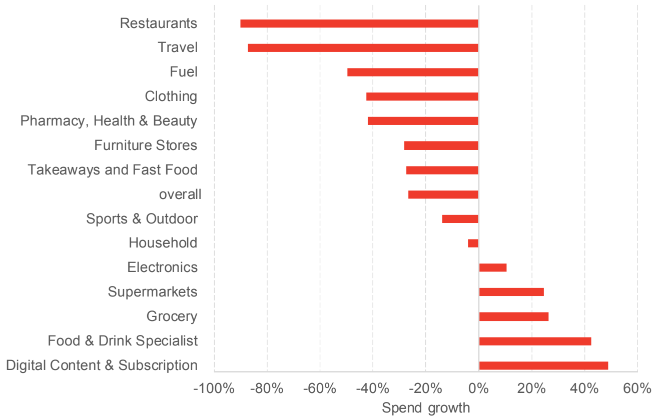
	2020	2021
IMF	-6.5%	4.0%
OECD 'single hit'	-11.5	9.0%
OECD 'double hit'	-14.0%	5.0%
BoE	-14.0%	15%
OBR	-12.8%	
HMT average of forecasts (June 2020)	-9.1%	6.2%

***Source:** OBR; IMF; BoE; OECD; HMT*

A crucial determinant of how the economy will recover will be how consumer spending and business confidence responds post-lockdown.

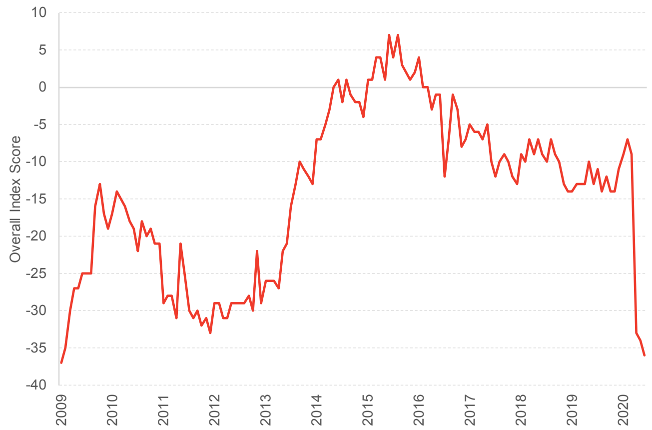
With many businesses shut down, combined with many consumers finding themselves earning less through supported income schemes, demand for a large proportion of goods and services has fallen – Chart 18 shows year-on-year growth in spending by category.

Chart 18: Consumer spending by category, % change year-on-year, April 2020



***Source:** Barclays – Consumer Spending May 2020*

Chart 19: GfK Index Score, Jan 2009 - Jun 2020



***Source:** GfK*

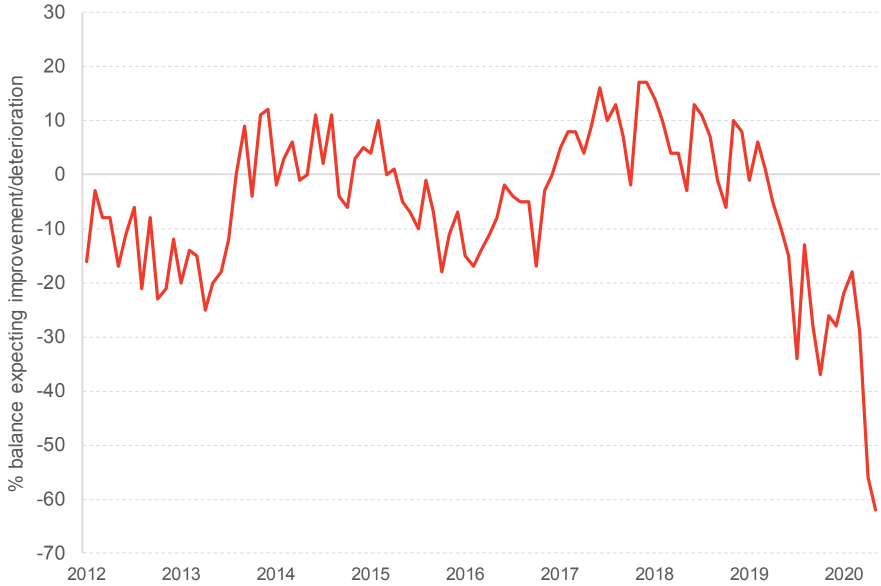
As Chart 19 highlights, consumer sentiment has fallen sharply – to a near record low.

The fall in consumer spending and drop in confidence has had a number of impacts. Personal borrowing has fallen sharply, which has been matched by an increase in household savings.

Much will depend upon how consumers react to the easing of the restrictions in the weeks to come. Should optimism return, this might help bring-back some demand postponed during the lockdown. If consumers remain nervous, then the likelihood of a much slower recovery in spending will rise.

Of course, one thing that will have an impact on all of this is our old friend Brexit. In the midst of the pandemic crisis, it has largely been lost that the deadline for the UK securing a deal with the EU to avoid a 'no deal' trade arrangement is approaching fast. Should a no deal occur, it will only add to the economic headache facing the UK, and could not come at a worse time.

Chart 20: Balance of businesses expecting an improvement/deterioration in conditions, January 2012 - May 2020



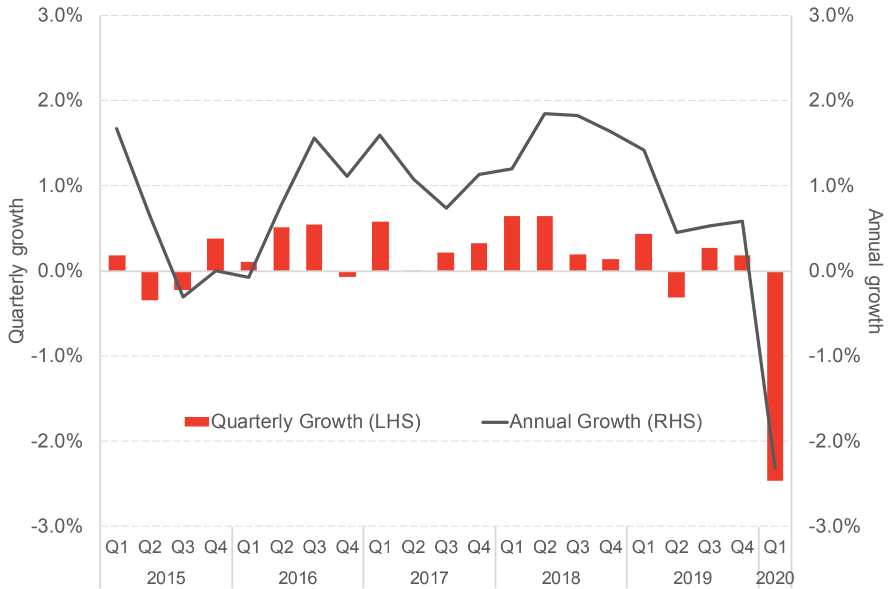
Source: *CBI*

Scottish economy

The latest GDP data for Scotland highlights that the Scottish economy contracted by 2.5% over the 3 months to March, and by 2.3% compared to the same quarter last year. Chart 21.

This is slightly worse than the UK overall where GDP fell by 2% over the quarter and 1.6% over the year.

Chart 21: GDP growth, Scotland, Q1 2015 – Q1 2020



Source: *Scottish Government*

However, this data only covers the first week of lockdown.

To help provide a more timely indicator of activity in the economy, the Scottish Government has started publishing an experimental monthly release of GDP. This data – whilst likely to be much more volatile than the headline quarterly rate – will provide a useful approximation of key turning points in the data.

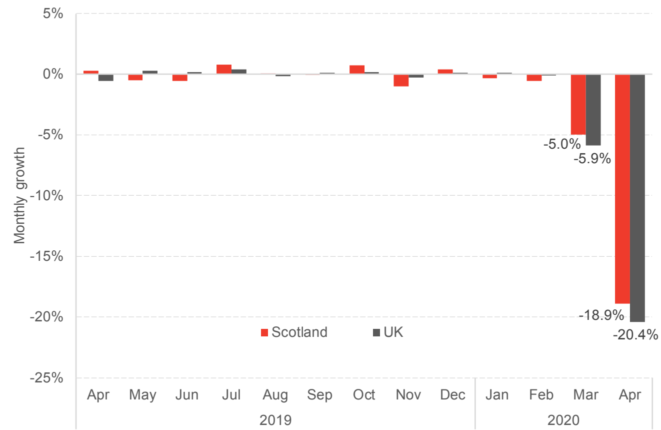
This new GDP estimate for April 2020 shows the full extent of lockdown measures on day-to-day economic activity. Chart 22.

Scotland's GDP contracted by just under 19% in April, slightly less than the UK overall, but still far beyond anything we have ever seen. This follows a fall in March of 5%. Despite the unprecedented nature of these falls, this is broadly what was expected given the scale of the mothballing of large sectors of the economy.

In terms of the sectoral impact on GDP contraction, once again the effects of lockdown have been fairly similar across Scotland and the rest of the UK.

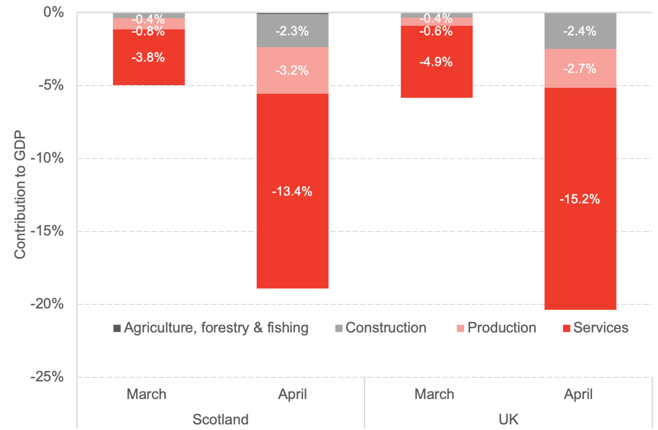
As would be expected, the sectors which are related to the hospitality industry have seen the most extreme impacts, e.g. Accommodation and Food Services contracted by 85% since February.

Chart 22: GDP growth, UK & Scotland, April 2019 – April 2020



***Source:** Scottish Government; ONS*

Chart 23: Contributions to GDP growth, UK & Scotland, March – April 2020



***Source:** Scottish Government; ONS*

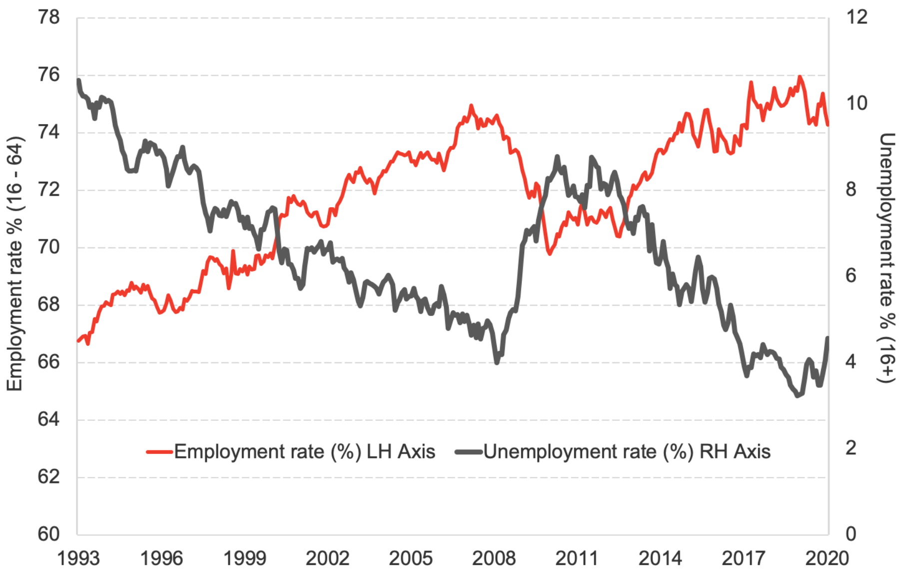
Labour Market

Many are surprised that the headline unemployment rate in Scotland, and indeed the UK as a whole, has not changed by more given the falls in GDP outlined above.

The latest data put the unemployment rate at 4.6% in Scotland, and 3.9% in the UK as a whole.

Looking at the headline numbers over time in Scotland (Chart 24) you'd be forgiven for wondering what is going on!

Chart 24: Employment and unemployment rate, Scotland, 1993 - 2020

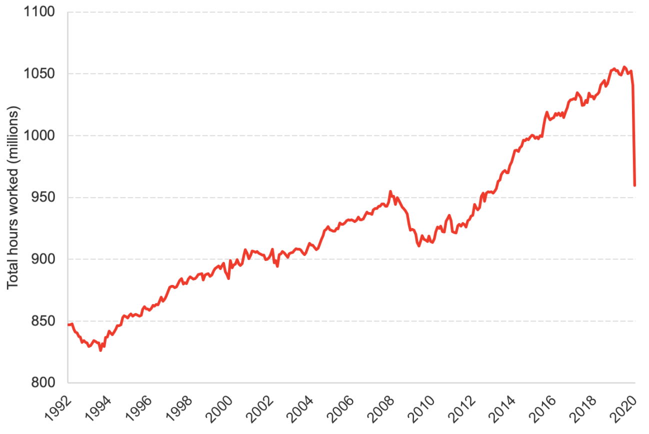


***Source:** ONS (LFS)*

Even though these data cover the period to the end of April, the furlough schemes are continuing to 'freeze' many employment relationships through this crisis. The latest count puts the number of jobs furloughed in Scotland at just under 630,000 with a further 145,000 self-employed workers benefiting from the support for self-employed workers.

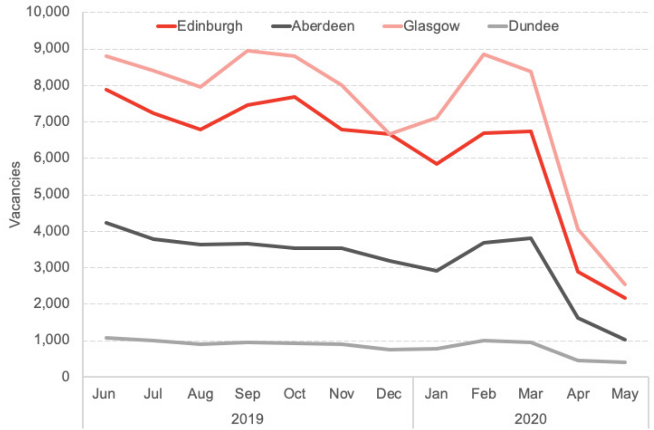
It is only as these schemes start to unwind during the period up to October that we will begin to see more movement in headline indicators, as it becomes clear what proportion of furloughed workers may ultimately end up losing their jobs.

Chart 25: Weekly hours worked, UK, 1992 – 2020



Source: *ONS (LFS)*

Chart 26: Number of vacancies, Scottish cities, Jun 2019 - May 2020



Source: *Adzuna*

As would be expected given the level of furlough, data for the UK as a whole show that there has been an unprecedented drop off in hours worked in the UK economy. Chart 25.

At the same time, and important as we think ahead to the winding down of the furlough schemes, and some jobs coming to an end as firms reassess their workforce needs, the number of vacancies in the labour markets of Scotland has deteriorated sharply. Chart 26.

This does not bode well for those who find themselves out of work later in the year.

We know that even relatively brief periods of unemployment, particularly for younger workers, can have long lasting negative effects on their labour market experience.

While data on overall unemployment has moved little in the data available to date, information from the welfare system has shed some light on the scale of the difficulties that some people are facing.

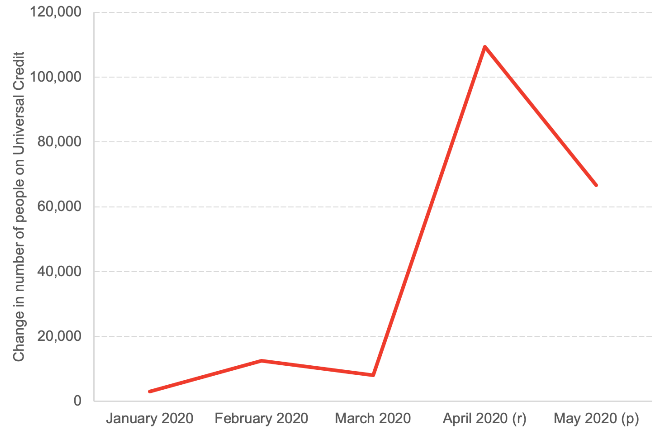
We have seen substantial increases in the number of new people claiming Universal Credit across Scotland. Chart 27.

Over 440,000 people received support through Universal Credit in Scotland in May 2020 – this compares to around 185,000 in May 2019. This underlines the scale of the economic and financial shock that many are experiencing.

It is important to note that because of the way in which Universal Credit operates, not everyone in receipt of support through Universal Credit is necessarily unemployed.

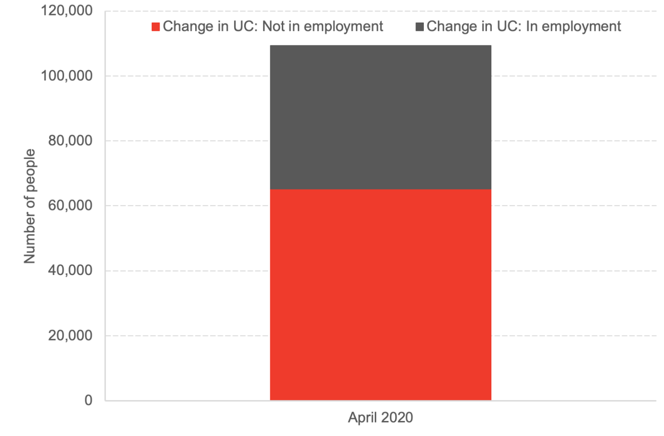
People who have seen their incomes drop below the threshold for support may now be registering for Universal Credit. Indeed the latest data (for April 2020), suggest that around 40% of the new Universal Credit claimants that month were people who were in work. Chart 28

Chart 27: Change in number of people on Universal Credit, Scotland, Jan–May 2020



Source: *DWP*

Chart 28: Change in Universal Credit claims, Scotland, March 2020 – April 2020



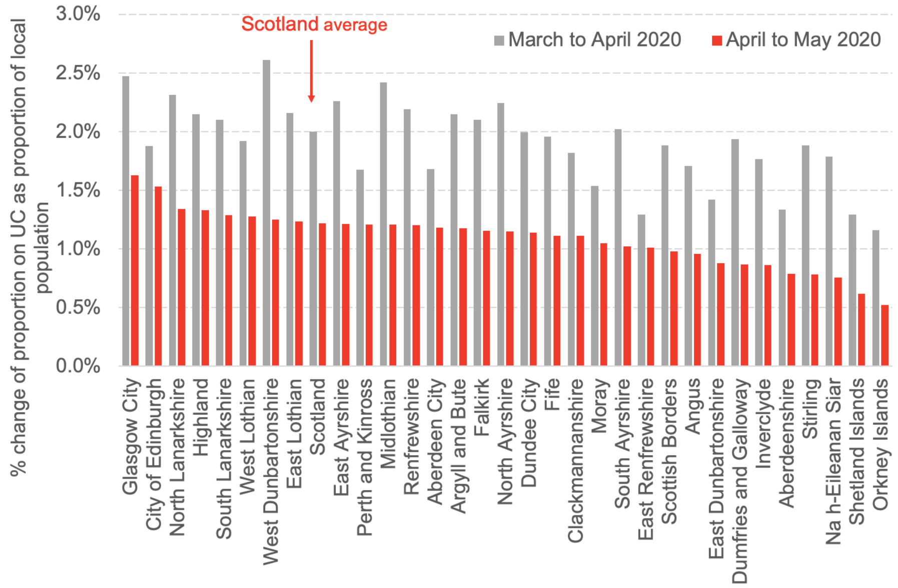
Source: *DWP*

Looking at the picture across Scotland, Glasgow and Edinburgh have seen the highest proportional increases in the number of people on UC this month. Chart 29. But nowhere is immune to the economic crisis.

It is clear that the impact of the lockdown on the labour market is going to be substantial.

This will pose a challenge for Government, and will necessitate an adjustment to the way training and skills provision takes place, as well as in how individuals, particularly those with caring responsibilities, are supported.

Chart 29: % change in share of population on Universal Credit, Scotland, March – May 2020



Source: *DWP;NRS*

Box 2: Key workers in Scotland

A new category of workers has emerged from the coronavirus pandemic – those termed 'key workers'. These were the workers who were encouraged to keep working as the rest of the economy shut down around them, with childcare and schooling provision made available for their children so they could do so. These were the workers that a functioning society would have struggled without.

They of course include health and social care staff, and teachers and childcare staff who looked after other key workers' children and also provided learning resources to children at home.

Other key workers include those work in food production, utilities and communication and logistics, transport and public services such as police and fire, as well as a number of national and local government staff and public safety and security officials.

In Scotland, the definition of a key worker could be flexed by local authorities depending on local circumstances but most are likely to fall into the categories above. In this analysis we've used the definition developed by ONS in order to give a statistical summary of the number of key workers in Scotland.

Table 4: Key workers in Scotland by category

	Number	Proportion of all key workers
Health & social care	320,000	35%
Education & childcare	160,000	17%
Food & necessary goods	140,000	15%
Utilities and communication	140,000	15%
Public safety & national security	60,000	6%
Transport	60,000	6%
Public services	40,000	4%
National & Local Government	20,000	2%
Total	**940,000**	

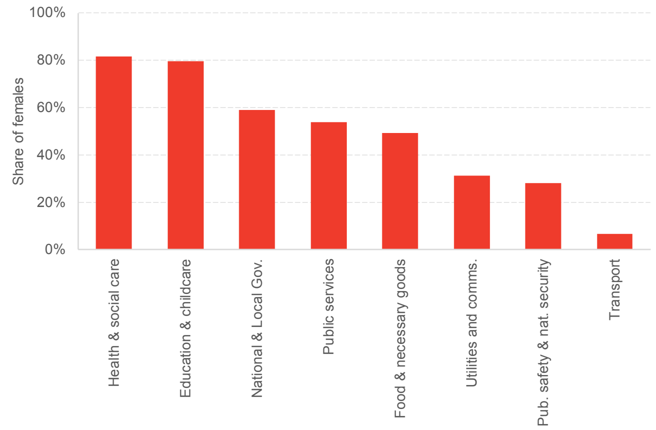
Source: *Q4 2019 Labour Force Survey*

Over a third of workers in Scotland are a key worker according to this definition, equating to 940,000 workers, and 60% are women. Women make up around 80% of key workers in health and social care and education and childcare but make up only 7% of workers in transport.

Many people have highlighted the relatively low pay of many key workers. In reality, there is wide variation of pay in each key worker category. For example, some healthcare workers, for example doctors, are very well paid, but others, for example social care staff, are poorly paid.

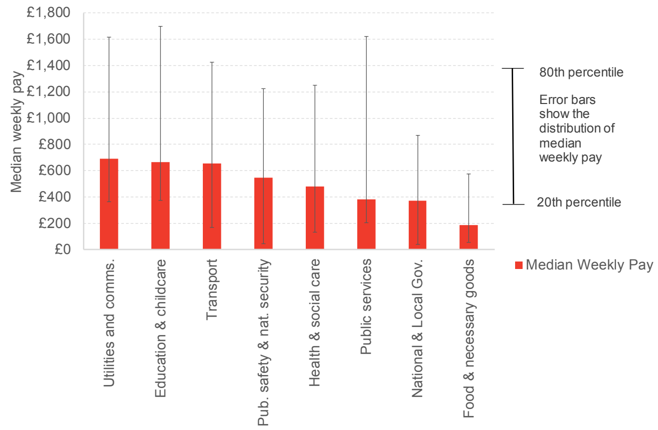
Those in the food and necessary goods category (broadly covering food processing, delivery and sale) received the lowest hourly pay and work the fewest hours giving them the lowest estimate of median weekly pay. The narrow variance in pay between the 20th and 80th percentile reflects that this is a predominantly low pay sector.

Chart 30: % of key workers who are women



Source: *Q4 2019 Labour Force Survey*

Chart 31: Key workers in Scotland by category: median weekly pay



Source: *Q4 2019 Labour Force Survey*

The hospitality sector

One of the sectors most affected by the shutdown has been the hospitality sector. Economic activity in this sector is going to be severely impacted for as long as physical distancing and travel restrictions remain in force and the sector is unlikely to rebound in the same form.

Analysis of the Labour Force Survey and the Family Resources Survey pre-crisis allows us to look at the characteristics of people who were working in firms in the accommodation and food services sector before the crisis started.

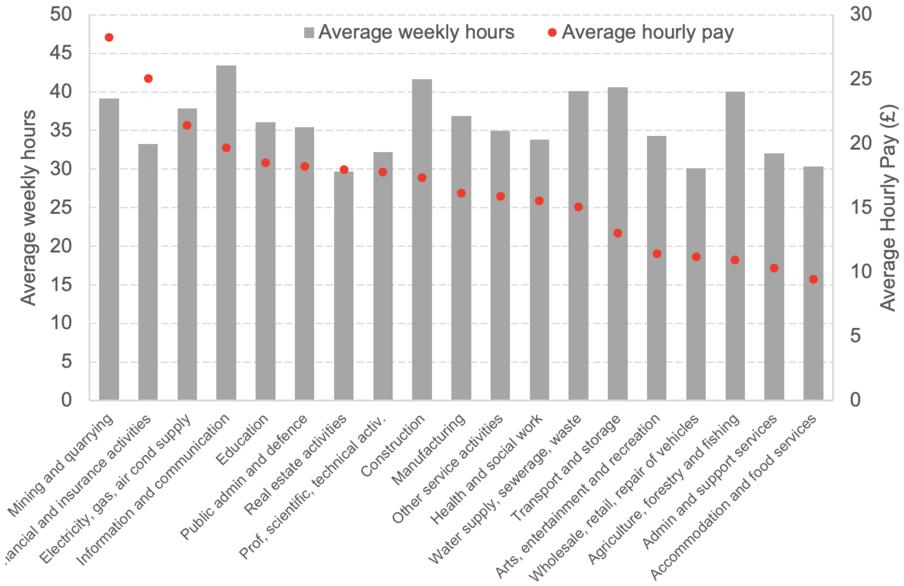
Pre crisis, the sector itself accounted for around 3% of total Scottish GDP and data from the LFS for Q4 2019 estimated that it employed just over 155,000 people (around 6% of the total workforce).

The sector had, on average a fairly young workforce with an average age of 34. It was also a sector with a high proportion of women in the workforce, but on the whole, it was a poorly paid sector. The accommodation and food services sector has amongst the lowest level of hourly pay of all industry sectors, and had the lowest number of weekly hours. Chart 32.

These factors resulted in a group of people who were already at a higher risk of poverty before Coronavirus. Weekly average household income for households with an AFS worker (the combination of net earnings, social security payments minus housing costs) was around 15% lower than the Scottish average in 2017/18. The poverty rate was higher than the Scottish average for households with a worker in this sector: 28% of all people who are in a household with a worker in this sector were in poverty (Scottish average was 19%) in 2017/18. The figure for children was 41% (Scottish average was 24%).

Tourism is of course much broader than just accommodation and food services, with many industries in our economy reliant on the spending of domestic and international tourists. Modelling carried out by the Institute suggests that as many as 260,000 jobs, or around 10% of employment, is supported by the wider tourism industry. It can be a key employer particularly in rural areas.

Chart 32: Earnings by industry, Scotland, Q4 2019



Source: *LFS*

Real time indicators of the Scottish economy

Traditional economic statistics are often published with a delay and thus they reflect the situation in the economy several weeks or months ago. It is also quite often the case that these measures may not actually capture what policy makers are particularly interested in, such as levels of cash flow or the risk of overloaded balance sheets.

The latest ONS BICS survey highlights that, In Scotland, 65% of businesses have reported a fall in turnover between the 4th and 17th May compared to 62% in the UK.

The decline in turnover has resulted in a lower cash-flow for most businesses and many have had to rely on their cash reserves and government support schemes in order to meet their fixed costs. However, many businesses have limited reserves. Chart 33.

The data does appear to show Scottish businesses in a slightly more favourable position in terms of cash-flow compared to other UK regions. Between 4thand 17th May –

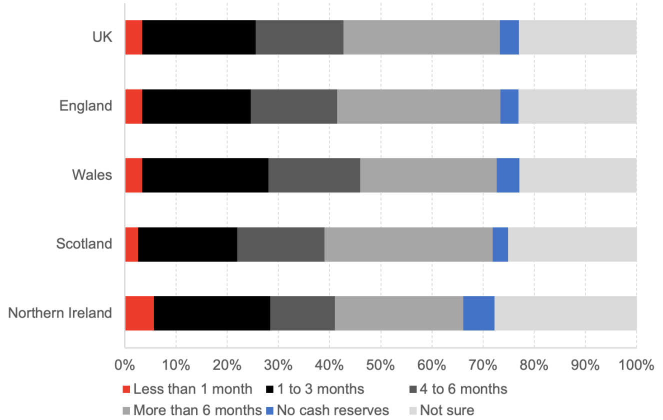
- 36% of Scottish businesses had cash-flow reserves for more than 6 months compared to 31% in England.
- 21% of Scottish businesses have cash-flow reserves which can last only for less than 3 months (25% in England).

It should be noted that there are some important caveats to this survey, which means that the results for Scotland need to be taken with a degree of caution. One of our recent articles outlines three important limitations concerning this data.

These are, briefly, that it does not cover agriculture or financial services, that small business form quite a small part of the sample, and that scores for UK wide companies are used if they have a Scottish presence. All of these mean that we have to be careful to remember that the actual effect on Scottish businesses may be hard to capture.

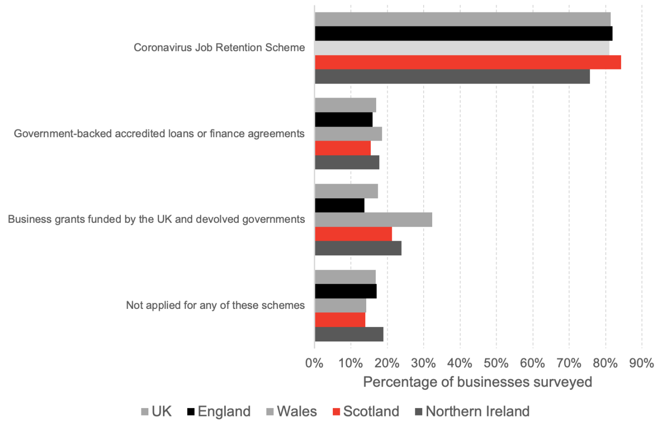
It will be important to keep an eye on how the differences in lockdown are being handled. Back in mid-May, before any major divergence had kicked off, there were some signs that more businesses were temporararily closed in Scotland.

Chart 33: Cash reserves of businesses across UK regions, 4th – 17th May (surveyed between 18th and 31st May)



Source: *ONS BICS*

Chart 34: Government schemes applied for, businesses who have not permanently stopped trading, UK regions, 4th – 17th May (surveyed between 18th and 31st May)



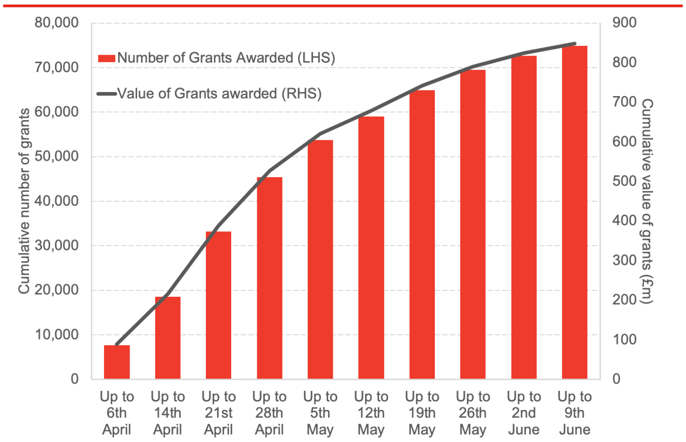
Source: *ONS BICS*

The ONS BICS survey shows that over 80% of surveyed Scottish businesses – who have not permanently stopped trading – have applied for the job retention scheme.

Unfortunately, it will only be when we start to open the economy back up that we will see many of the risks and jobs losses materialise. Already, firms are responding as they look ahead to future demand and the gradual unwinding of various government support schemes. From August, the rules of the furlough scheme are changing, and firms will be required to start paying a portion of wages. As highlighted above over 750,000 workers in Scotland have been furloughed or are being supported through the self-employment scheme.

We are starting to see a number of businesses announcing potentially large redundancies and we should expect a number of furloughed jobs to translate into Universal Credit Claims over the next few months. How many is uncertain.

Chart 35: Cumulative number and value of grants awarded under the Scottish Government's Business Support Fund, weeks up to 6th April – 9th June.



Source: *Scottish Government*

In addition to the government's furlough scheme, business grants provided by the UK and devolved governments have been popular. Around 19% of Scottish businesses have applied for grants from the Scottish Government's Business Support Fund.

The highest number of grants was awarded in April, but support has been flowing steadily to Scottish businesses in May too. As of the 9th June, almost 75,000 grants were awarded worth a total of £850 million across Scotland.

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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