University of Strathclyde Business School

Fraser of Allander Institute

Economic Commentary

Vol 44 No 3

Supported by

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Foreword

The importance of re-imagining resilience in order to survive and thrive

COVID-19 has been one of the most disruptive events that society and businesses have experienced since World War II. The last six months have led to a dramatic contraction in economic activity across the world, in large part due to the shutdown of the global economy as countries managed the threat posed by the pandemic. In Scotland, this has resulted in the economy shrinking by nearly a fifth between April and June with unemployment on the rise and further redundancies expected across the country in the coming weeks.

The recent increase in COVID-19 cases has shown the virus is still at large and, regrettably, the country could now find itself taking a step backwards on the route to immediate economic recovery with new restrictions announced.

When the pandemic struck, it tested everyone on a global scale like never before. For many businesses it highlighted strengths and exposed vulnerabilities. However, while a number of businesses have unfortunately struggled to survive the past six months, many have demonstrated resilience - moving through crisis response and making tactical decisions to secure operations as much as possible.

As uncertainty prevails as we head into the winter months, relying on progress to date is not enough, businesses now have a crucial window to consider what further changes need to be made to continue to operate effectively. As organisations strive to do this they must become even more resilient.

Our latest thinking in this area, Resilience Reimagined, asks businesses to focus on what being resilient means to them and in doing so consider three key pillars - financial resilience, operational resilience, and reputational resilience. This is because when a shock or disruption happens, it will typically affect one of these pillars first, but their combined strength will ultimately help them thrive.

COVID-19 has been a test of leadership teams and while the coming months will bring a different dynamic of challenges, the agility to respond and adapt with measured assuredness will be among key factors to resilience.

Financially, for example, revenue and growth are critical priorities for business leaders and to effectively manage potential risk, teams must be flexible and willing to shift resources to the areas of biggest growth.

Operationally, it is worth businesses evaluating what unexpected benefits have emerged from the pandemic and consider how to adapt business models so that agility is embedded into supply chains, allowing for faster decision making and enhancing resilience across operations.

The legacy of home working is another example which has been a critical move for industries that have been able to make the change to remote working. However, now the focus must now turn to what type of arrangement will benefit business operations in the future.

All of these factors have reputational consequences, and the pandemic has shown how important it is for businesses to show their resolve to make meaningful contributions to the greater good. As the COVID-19 threat dissipates, organisations will need to consider how they can incorporate reputational resilience into their wider approach, focussing on the values and principles that have proven important to their employees, customers and wider society during the pandemic.

By specifically addressing these three pillars, organisations can increase their capacity to withstand future uncertainties and shocks – in the coming months businesses in the UK will be grappling with not only the ongoing pandemic, but the implications of our exit from the EU. Resilience offers the key to success during uncertain and extraordinary times. While the task of rebuilding the economy is a long-term one, by asking questions now and understanding areas within their control, businesses can lay the groundwork for recovery in the future, ensuring they will be in a stronger position when the pandemic passes.

This is, of course, not without its challenges, as there are still questions about what a recovery looks like within the context of rising unemployment, health and safety concerns, social distancing, and no end in sight until a vaccine is widely available. However, if organisations take the time to focus on their resilience, there is a valuable opportunity to reimagine the Scottish economy, regenerate future prosperity and re-charge an uplift in productivity and innovation.

Steve Williams
Senior Partner for Scotland
Deloitte

September 2020

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ISSN 2046-5378

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Summary

It is a little over six months since the World Health Organisation declared a global pandemic ushering in the largest upheaval to our day-to-day lives in over 70 years.

The ensuing economic crisis has been severe: the Scottish economy shrunk by nearly a fifth between April and June. Unemployment is on track to rise sharply with a significant number of redundancies in the pipeline.

But the recovery is underway. The high frequency business activity and mobility data that we track are all showing a pick-up in activity in all our major centres. Over 96% of businesses in Scotland are back working. The re-opening of schools has enabled more families to get back to work. In the last few days, university and college students have returned to campuses for the first time since March.

But we are far from being out of the woods. Unprecedented government financial support – including bounce-back loans and the furlough scheme – has enabled many businesses to hang on with little in the way of revenue. Once these schemes are wound down, the full cost of the economic crisis will hit home.

Activity was always going to bounce back to some extent when our economy opened back-up again. And for all the talk of growth returning, the reality is that our economy is still around 10% smaller than before COVID hit. The average forecast for the UK economy as a whole is for it to be well into 2022 before we fully make up the ground lost this year.

We have therefore reached a crucial inflection point in our recovery from the crisis.

What happens next will depend on the evolution of the pandemic, measures taken to protect public health, and how governments, households and businesses respond to these factors. All of these remain hugely unclear.

A major challenge facing businesses in the coming months is simply coping with a such an uncertain environment. Consumer and business behaviours will drive much of the recovery.

On the one hand, there are reasons to be optimistic. Our economy has shown that it can be remarkably resilient. Many businesses have also found ways to adapt to COVID restrictions, whether that be the switch to home working or an expansion into digital marketplaces. Many of these changes will lead to improvements in productivity that will endure.

But the recovery will be slow. And it will feel like we're in a recession for some time yet, even if the growth numbers are suggesting things are getting better.

It is not hard to take on a much more pessimistic outlook, and the events of the last week or so simply underline that. New restrictions will hamper the ability for certain businesses to get back on their feet.

We have written in the institute about a 'k-shaped' recovery. For some businesses fortunately to have been able to shift to home working or who work in an environment where physical distancing is not a concern, operations have been able to continue largely as normal. But for others, demand has fallen off a cliff and is unlikely to recover soon. A two-speed recovery – between businesses lucky enough to open up and those less fortunate – seems inevitable.

As government financial support evolves and is wound down, many businesses will no longer be able to postpone the hardest of decisions.

The ending of the UK Government's furlough scheme promises to be a pivotal moment in the recovery. History is likely to judge the Chancellor's decision to pay 80% of workers wages during the height of the lockdown as one of the most effective policy responses to any economic crisis in history. Over 9 million workers have benefited. But removing the furlough scheme too early, particularly in sectors like hospitality and tourism, has the potential to undermine the good work done to date.

The new Job Support Scheme announced last week is designed to keep that support going but in a new format. Whilst welcome, it is much less generous than the furlough scheme. People will have to be back working and businesses themselves will have to pick-up the majority of the tab. Sadly, not all of them will be able to afford to keep their existing workforce in jobs.

Another policy announcement that will have significant consequences for devolved policy making is the cancellation of the UK Budget. Whilst the Scottish Government is due to see 'indicative' grant allocations for next year, this is only part of the Scottish Budget story nowadays. The cancellation of the UK Budget throws-up all manner of implications for tax devolution and public spending. In short, the Scottish Government will have to set policies not knowing their final budget allocations or how devolved tax policies will interact with equivalent tax policies set by the UK Government.

Setting a Scottish Budget during such times was always going to be subject to great uncertainty. But the complex nature of Scotland's fiscal framework – and the interactions between UK and Scottish tax and spending decisions – is only adding to these risks. This is not what the system was designed to do. Good fiscal systems should seek to minimise risks, not add to them.

An effective budget process is all the more important this year given the proximity to May's Scottish election. Both governments have a responsibility. Yes the Scottish Government needs to be much more open about the financial scenarios it faces. But the UK Government needs to have a much greater appreciation of the knock-on impact of its decisions, such as the cancellation of the Autumn Budget, on devolved policymaking. Devolution shouldn't be seen as an afterthought.

Of course, amidst of all this and to only add to the uncertainty, Brexit continues to loom on the horizon. Many of the short-term impacts of 'no deal' will be masked somewhat by the COVID-19 pandemic. But failure to agree a comprehensive trade deal for the end of December still risks doing significant damage to the UK economy in the long-run and will hamper the recovery.

Over the last five decades, economists at the Fraser of Allander have done their best to forecast the future direction of the Scottish economy. Sometimes the outlook as been positive, other times more challenging. What is striking about the immediate outlook is just how uncertain it is - indeed, it is hard to think of a past occasion when the range of possible outcomes has been so wide. What we can agree on however, is that the task of rebuilding our economy will take years.

Fraser of Allander Institute
September 2020

Outlook and Appraisal

The outlook for the Scottish economy is extremely uncertain - driven by concerns over the ongoing containment of COVID-19 and Brexit. Not only is this having an impact upon the economy, but decisions such as cancelling the Autumn Budget risk undermining good poilcymaking.

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 and years looks incredibly uncertain.

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.

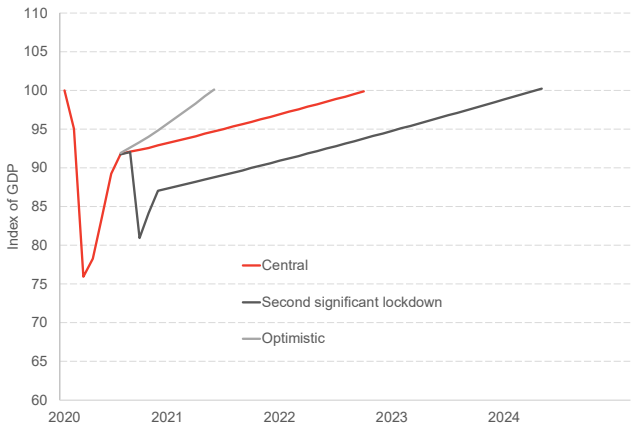
What do they tell us?

The optimistic scenario sees firms bouncing back relatively quickly over the coming months with a full recovery across all industries by summer 2021. But, given that there is no vaccine as of yet and last week's announcement of further restrictions, this is becoming increasingly unlikely.

Any hope for a 'v-shaped' recovery have all but gone. We are looking towards more of a 'k-shaped' recovery with certain industries recovering rather quickly whilst others struggle. The central scenario reflects this. In this scenario there are some scarring effects from the current recession and the economy as a whole does not recover until Autumn 2022, around two years from now.

In our last commentary we discussed a 'second wave' scenario in the anticipation that a second wave would result in a second lockdown. But we are already seeing a sharp rise in infections with further restrictions being imposed. Further restrictions, up to and including a further national lockdown, remain on the table. This commentary we have decided to focus on if there is a second significant lockdown, like that felt in March but slightly less restrictive. Under this scenario, it will take just over four years for the economy to recover.

Chart 1: Scottish Economic Growth scenarios: 2020 to 2025 based upon return to 'pre-crisis level'



	Trough	Return to pre-crisis level	Recovery time
Optimistic	Apr/May-20	Jun-21	1 year, 2 months
Central	**Apr/May-20**	**Oct-22**	**2 years, 6 months**
Second significant lockdown	Apr/May-20	May-24	4 years, 1 months

Source: *FAI calculations*

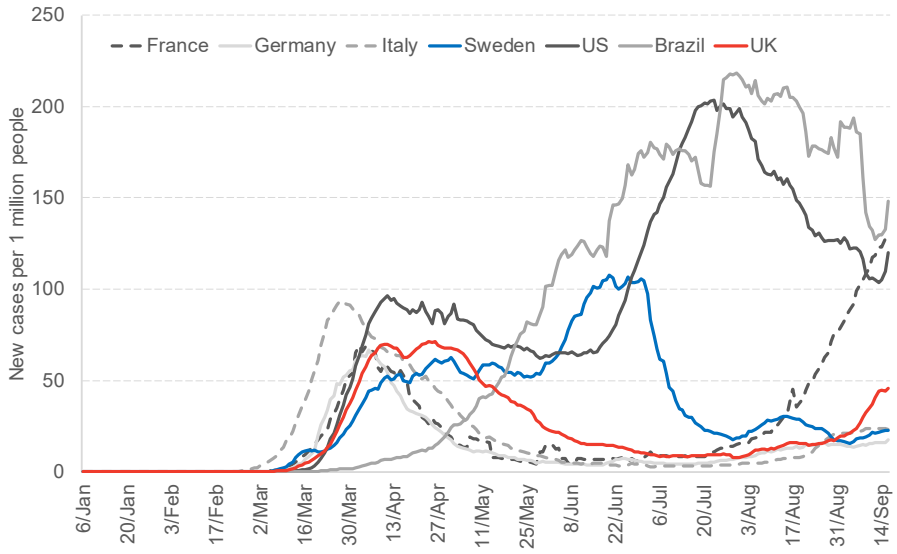
Where are we now?

It has been around six months since the World Health Organisation declared the Coronavirus outbreak as a global pandemic.

Since then, large parts of the global economy have been shut down on an unprecedented scale.

Daily confirmed Covid-19 cases have fallen as result of the lockdown restrictions but have climbed since these have been eased in many countries. In the UK, we have had local lockdowns and the 'Rule of Six' being brought in. New restrictions have been imposed in Spain, France and many other parts of Europe. As of 20th September, Israel has embarked on a three-week national lockdown. See Chart 2.

Chart 2: New daily Covid-19 cases per 1 million of the population, 6th Jan – 16th Sept



Source: *Our World in Data*

Despite managing to contain the virus after a strict spring and summer lockdown, Covid cases are accelerating across Scotland. See Chart 3.

The ensuing economic crisis has been severe: the Scottish economy shrank by just under a fifth between April and June. Scotland, like the UK, officially enter recession – defined as two consecutive quarters of negative growth in Q2 2020. See Chart 4.

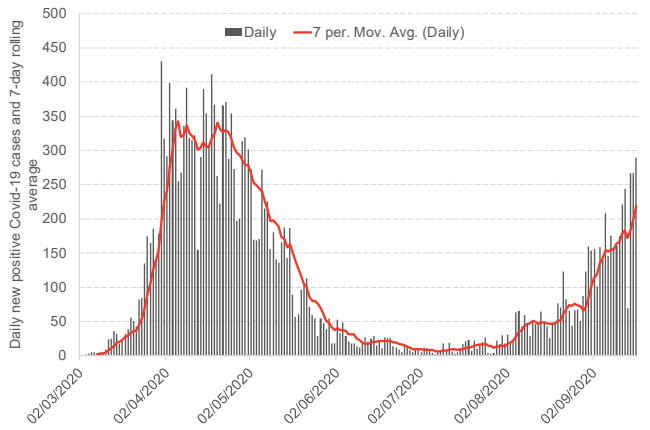
We will undoubtedly see a bounce back in growth over the next few months. What is important however, is not the rate of growth but comparisons between pre-COVID levels of activity and where we are now.

In response to this crisis, the government has provided unprecedented financial support - including bounce-back loans, grants and of course one of the most generous furlough schemes – which has enabled many businesses to hang on with little in the way of revenue.

The government's furlough scheme, as of mid-August, has supported 9.6m people across the UK.

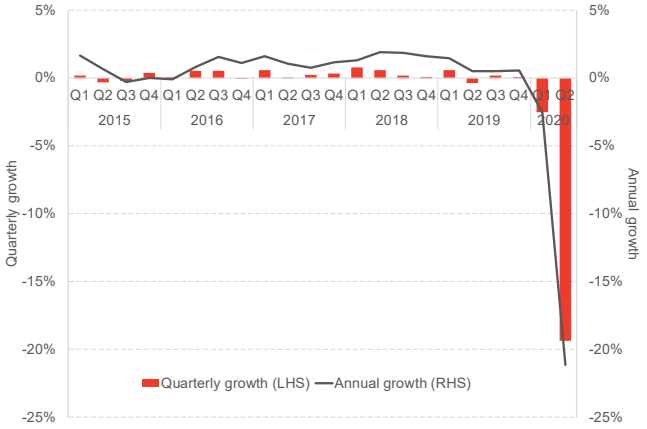
It has helped to prevent a sharp rise in unemployment for the time being. But with redundancies rising at their fastest rate since 2009 and many firms looking to work at a fraction of capacity over the months ahead, a sharp rise in unemployment is inevitable.

Chart 3: Daily new Covid-19 cases and 7-day rolling average, Scotland, 2nd March – 17th September 2020



Source: *Scottish Government*

Chart 4: Scottish GDP, Q1 2015 – Q2 2020



Source: *Scottish Government*

Indeed, we only expect to see the true effect of Covid on the economy crystallise when this support stops.

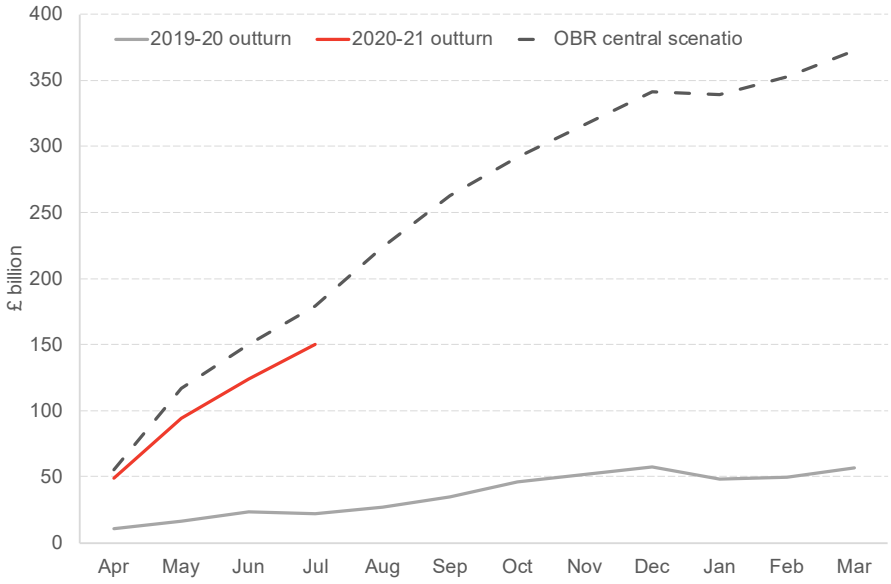
There is of course an important balance to be had between lifting the support too early and keeping it in place for too long.

In the longer term, there will be, as the chancellor has said, tough decisions ahead, particularly surrounding how we will pay for all of this.

Record spending by the government has had significant implications for public finances. So far, this year, public sector net borrowing has totalled over £150bn, almost £130bn higher than last year. The highest level in peacetime.

The UK's debt now totals a record £2 trillion.

Chart 5: Public Sector Net Borrowing (PSNB), UK



Note: Actual borrowing was slightly less than the OBR's central scenario as tax receipts fell less than originally assumed.

Source: *ONS; OBR*

Borrowing rates remain at low levels, in part through continued Quantitative Easing (QE) and a demand for secure assets such as gilts from financial markets. This is providing room for governments to continue to borrow without running into concerns of fiscal sustainability.

Of course, this is unlikely to continue for ever. Many of the long-term fiscal challenges that the UK faces – including from issues such as the transition to net zero and demographic ageing – have not gone away.

In terms of monetary policy, at the height of the crisis, the Bank of England responded swiftly with a series of measures designed to support demand, ease liquidity and provide financeable stability.

In March, interest rates were cut interest rates to 0.1% - the lowest it has ever been – alongside a new injection of QE.

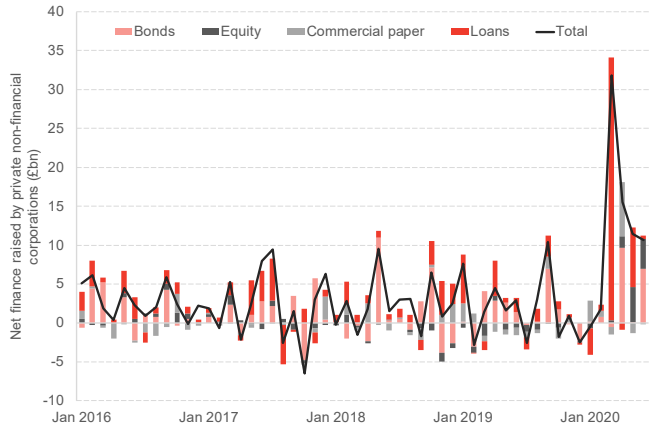
In mid-September the Monetary Policy Committee held interest rates at this level, and QE at £745bn. However, if the current economic crisis worsens and the Brexit transition goes awry, the Bank may – at least consider – introducing even more unconventional monetary policy by cutting interest rates below zero.

On top of low interest rates, the government-backed loan support schemes – i.e. the Coronavirus Bounce Back Loan - have allowed credit supply to meet the demand of UK firms.

More broadly, UK companies have managed to raise a large amount of finance since the pandemic started. Total finance raised between March and June was just under £70bn – most of which was through capital markets. See Chart 6.

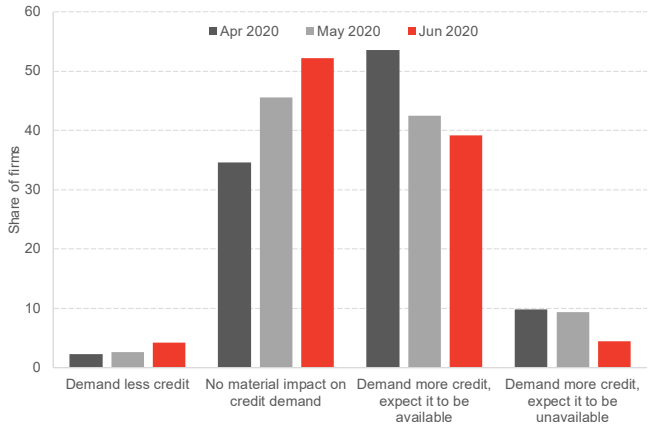
While many firms have not required to take out credit in response to the pandemic, the majority of those that need it expect it to be available to them. See Chart 7.

Chart 6: Net finance raised by private non-financial corporations, Jan 2016 – Jun 2020, UK



Source: *BoE*

Chart 7: Impact of Covid-19 on firms' demand for credit, April – June 2020, UK



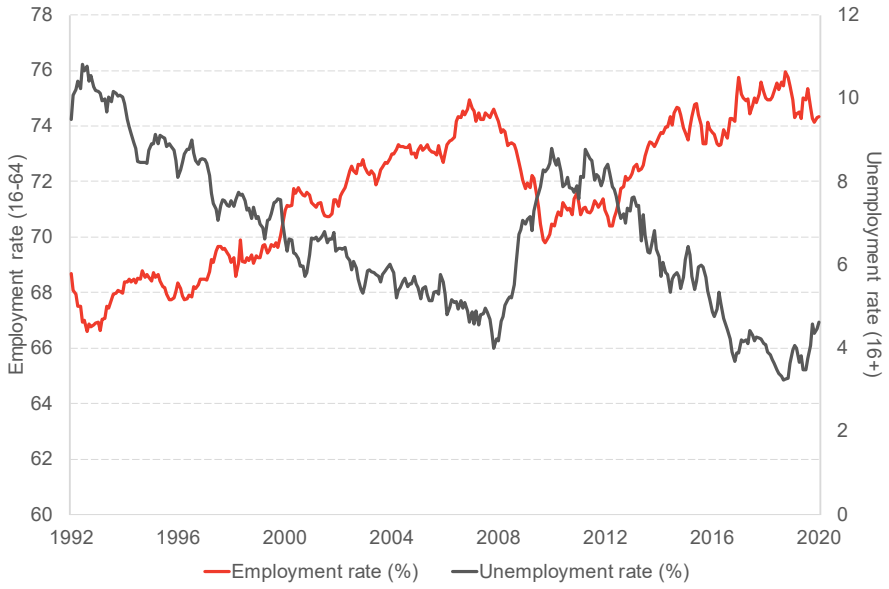
Source: *BoE*

Labour market

The latest Labour Force Survey data for Scotland cover the period to the end of July 2020, so well into the period when the economy was most acutely affected by pandemic restrictions.

These data suggest that the unemployment rate remained around historically low levels (4.6%) while the employment rate remained relatively high (74.3%). See Chart 8. On both of these measures, the Scottish labour market was slightly weaker than that of the UK as a whole (which registered 4.1% and 76.5% respectively).

Chart 8: Unemployment and employment rate, Scotland



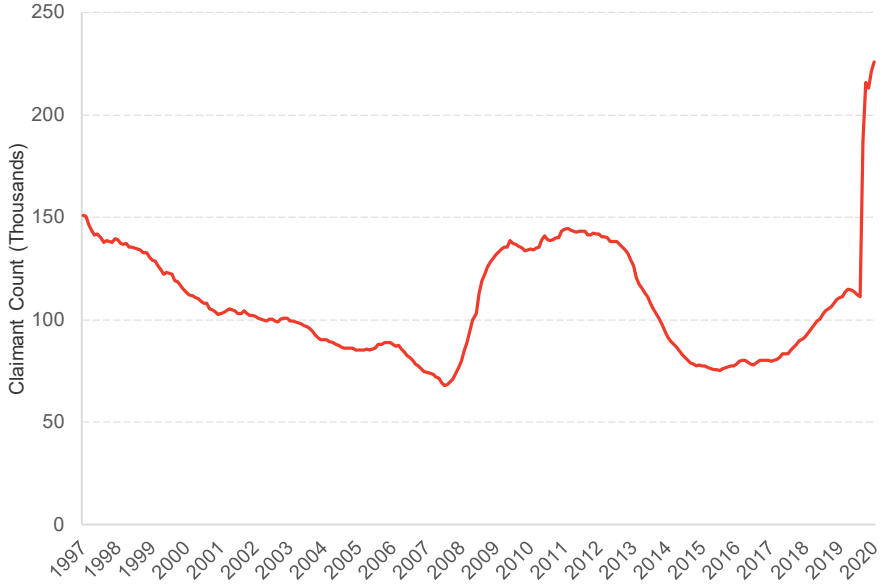
Source: *ONS*

Now, an optimist might take these numbers as evidence that the switch to home working by many professionals as well as the resilience of public sector employment in Scotland has cushioned the blow of the pandemic. But do not be fooled for the reasons that we will highlight later. A sharp rise in unemployment is on the horizon.

The latest claimant count data (Chart 9) shows a sharp increase in recent months. The experimental claimant count in Scotland increased between August 2019 and August 2020 by 115,000 or over 100%.

A recent article by colleagues at the Resolution Foundation provides more detail on how changes in the welfare system suggest that the claimant count is currently overstating unemployment rates. Just in the same way that the headline LFS unemployment rate is undoubtedly understating unemployment.

Chart 9: Experimental claimant count Scotland



Source: *ONS*

No doubt some people reading this far are screaming 'but the furlough scheme' at their screens at this point. And you'd be right.

The UK Government furlough and self–employment support schemes have indeed played a role in freezing employment relationships across the UK through much of this period. Undoubtedly these play a key role in ensuring that the number of people who are unemployed is lower than it otherwise would have been.

The latest data (covering the period to the end of August 2020) show that almost 370,000 jobs in Scotland were furloughed under this scheme. This represents a take-up rate of around 15%, slightly lower than the UK as a whole.

Over this same period, 157,000 claims from Scotland were made to the Self-Employment Income Support Scheme (SEISS).

On the face of it, this is good news. As firms have been able to return to trading and activity has picked up again, many workers have been brought back by their employers.

That said, a significant number of workers appear still to be on furlough. That these workers still have not been brought back, despite large parts of the economy now back up and running, raises concerns about whether they ever will be.

This gets us to what else is happening in the labour market and here we only have data for the UK as a whole, and it paints a worrying picture.

The obvious place to start here is looking at working hours. This gets us beyond simple employment measures to think about how much people are working, and in that way gives us an insight into the extent of demand being faced by businesses.

It is important to note too that with the introduction of more flexibility in the furlough scheme, firms are able to bring workers back part of the time and be furloughed for part of the time. This might also explain some falls in average hours worked as people return from full furlough. Use of the flexible furlough scheme by firms does raise the prospect that the winding down of the furlough scheme may not result in workers returning to their previous hours.

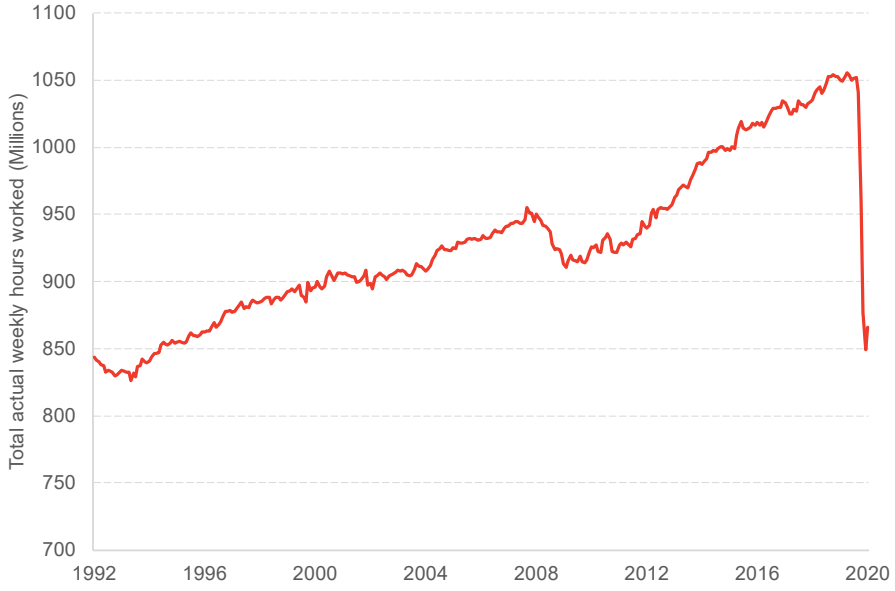
The latest data that we have for Scotland only run to March 2020 (although these will be updated to June 2020 in the ONS release next month). So let us look at what the UK data show. See Chart 10.

In the three months to the end of July, total actual weekly hours worked in the UK decreased by 93.9 million to 866 million. This translates to a drop in average hours worked of 2.8 hours over this period.

Compared to a year ago, there are 183.8 million hours less being worked in the UK economy.

This is huge – and suggests that even while headline employment rates remain relatively stable, there are notably fewer hours being worked by those in employment.

Chart 10: Total actual weekly hours worked in the UK

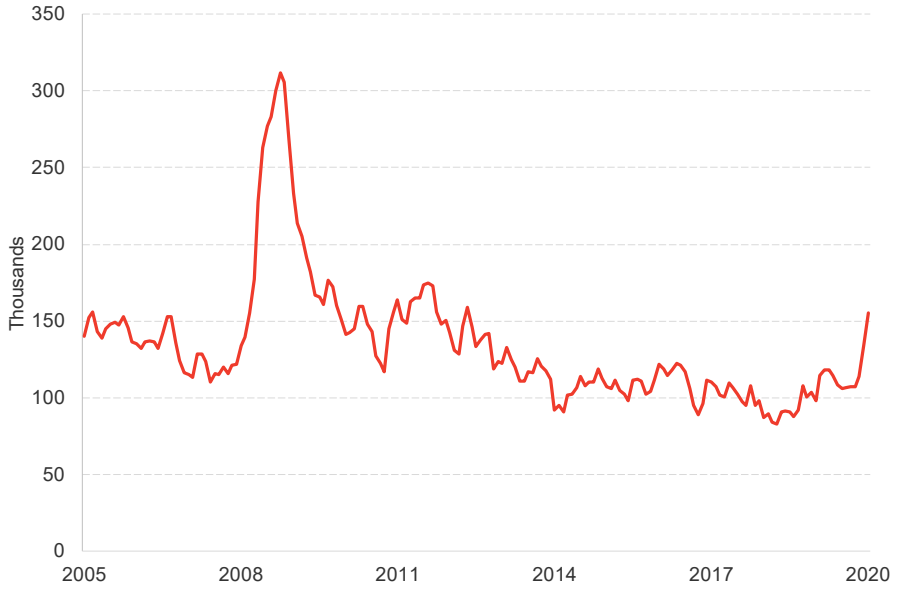


Source: *ONS*

Just as for those in work, hours are being squeezed, the winding down of the furlough scheme sadly means that we are seeing a rise in the number of people being made redundant. Chart 11.

In these latest data we have seen the number of redundancies increased by 48,000 in the three months to July 2020. This is an indicator to watch in the time ahead, as it will track the extent to which as the furlough scheme winds down, those on furlough are seeing their employment coming to an end.

Chart 11: UK redundancies



Source: *ONS*

It is against this backdrop that the debate over how and when to unwind the furlough scheme has intensified.

Keeping such schemes in place for too long risks hampering the recovery by putting off the return to work. The furlough scheme has been expensive – over £35 billion has been spent on it so far.

There are also concerns of fairness, with many people who have already been made redundant earning a fraction of those still on furlough.

But lifting these vital support mechanisms too early will tip many businesses over the edge and undo the good work that the scheme has done to date. It may also undermine public health efforts to limit the spread of the virus if people are forced back to work, or to look for work. At a time when cases are on the rise this is a real risk.

But doing too little in a crisis is worse than doing too much.

The new Job Support Scheme announced last week is designed to keep that support going but in a new format. Whilst welcome, it is much less generous than the furlough scheme. People will have to be back working and businesses themselves will have to pick-up the majority of the tab. Sadly, not all of them will be able to afford to keep their existing workforce in jobs.

Of course, it is easy to criticise the scheme as not being generous enough. And there is strong case for a targeted approach for those sectors that are particularly impacted by the recent extension of restrictions.

But at some point, we also need to start discussing how all of this is going to be paid for. Taxes will have to rise, but growing a vibrant tax base will be important too. It's easy to call for an extension of the furlough scheme. But just like unwinding it, it is much harder to come up with a plan for paying for it.

A hesitant recovery is now underway

As lockdown restrictions have been eased, economic activity has started to pick-up.

The Scottish government has started producing monthly GDP estimates which has allowed more timely analysis of the economy – something that is crucial during an economic downturn. That being said, GDP data at this time should be viewed with significant caution. For example, over the next few months it is likely to show rapid growth in our economy, but it needs to be remembered that this is off a low base. It will feel as though we are in a recession for many months to come. Moreover, GDP does not tell us much about what will happen next, and crucially the resilience (working capital or indebtedness) of businesses.

For this better information there are even timelier data, real time indicators, that provide a snapshot of the economy every week or fortnight - the ONS' BICS survey being one of them.

Recent analysis from the Scottish government weighted the sample of survey responses from Scotland in the ONS's BICS data to understand how the trading status of businesses with a presence in Scotland and the percentage of the workforce in Scotland on furlough has changed since June.

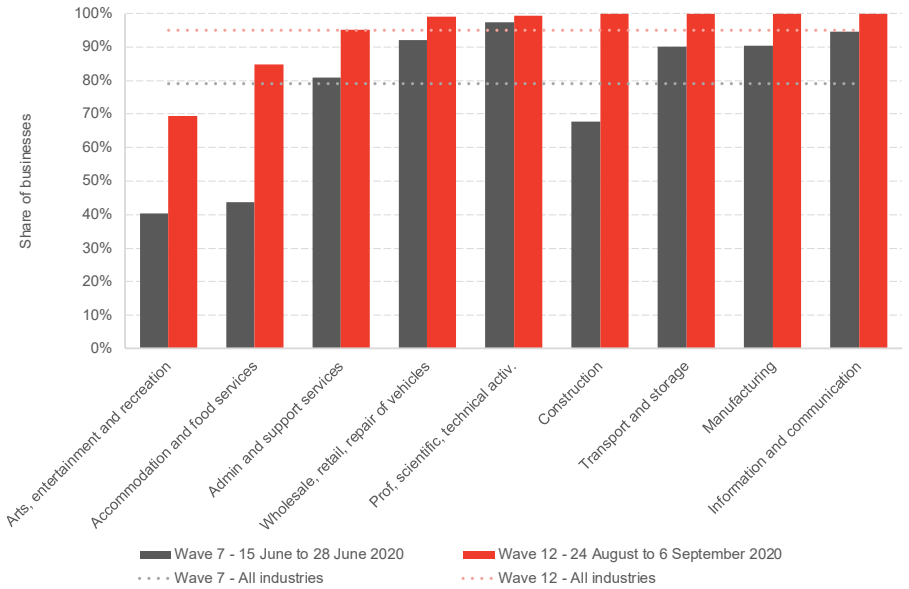
Since June the share of businesses – with 10+ employees and a presence in Scotland - trading has increased from 79% to 95% however, the recovery from this crisis has been different among industries.

Almost 95% of small and medium enterprises (SMEs) in Scotland were trading in September, up from 78% in June. This compares to 99% of large (250+ employees), 95% of whom were trading in June.

Industries reliant upon 'social spend' have been hit hardest. Although the economy has come out of the 'strict' lockdown, capacity constraints coupled with household and group socialising limits has meant these industries have struggled to recover as fast as other industries.

As we discuss later, the prospects of a 'k-shaped' recovery seem to be strong.

Chart 12: Estimated share of businesses that are currently trading, by industry, Scotland, 15th June – 6th September



Note: Businesses with 10+ employees and a presence in Scotland **Source:** *Scottish Government; ONS (BICS)*

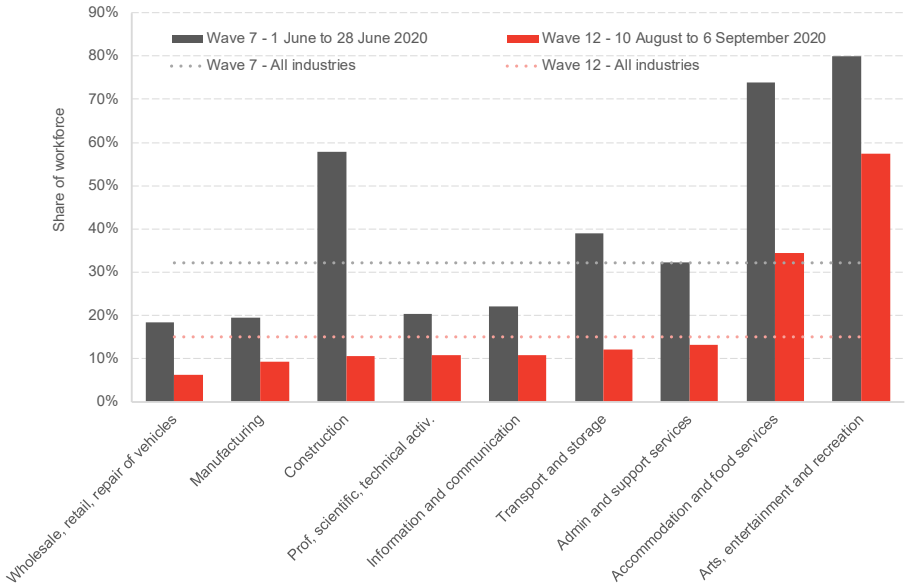
In terms of furloughed workers, the latest data suggests that there has been a substantial reduction over this period in the share of workers still on furlough since June. See Chart 13.

On one hand, this is positive. As demand has picked up and businesses return to trading, many workers have been brought back to work.

That said, around half of workers on furlough in June appear still to be on furlough. The fact that these workers still have not been brought back, despite large parts of the economy now back up and running, raises concerns about whether they ever will be.

Unsurprisingly, industries most reliant on 'social spending' continue to have much larger shares of workers on furlough and are most exposed to job losses once the furlough scheme comes to an end after October.

Chart 13: Estimated share of workforce on furlough leave, industry, Scotland, 1st June – 6th September



Note: Businesses not permanently stopped trading (i.e. 'Currently Trading' or 'Paused Trading') with 10+ employees and a presence in Scotland

Source: *Source: Scottish Government; ONS*

Global context

Of course, Scotland is not unique in any of this.

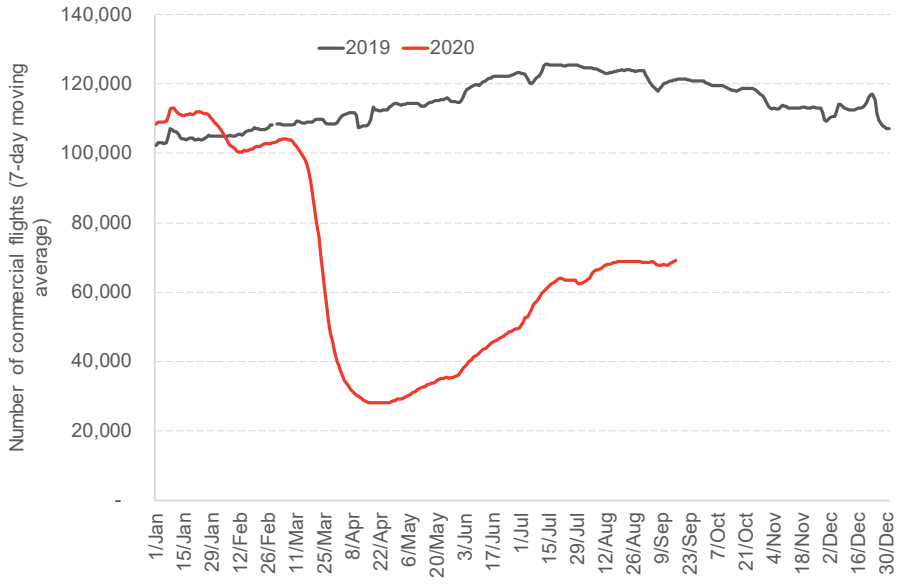
The COVID-19 shutdown has impacted all corners of the global economy from international trade through to travel and investment. Large parts of the global economy ground to a halt in the first half of 2020. See Chart 14.

Interestingly, countries across the world have responded to the crisis in different ways. Some have implemented furlough schemes to mitigate the rise in unemployment, others have instead been less proactive in keeping people in their existing jobs and instead relied upon the market to support a transition to new opportunities.

For example, in contrast to the UK, the U.S. unemployment rate peaked at 14.7% in April - a direct result of US labour laws and support mechanism which provided very limited in-work government support – but which has subsequently fallen to 8.4% in August as coronavirus restrictions were eased.

We saw similar patterns, albeit not on this scale or speed, during the financial crisis where the US job market shake-out was much greater than in Europe. But in time, the US economy returned to pre-recession levels of unemployment much more quickly.

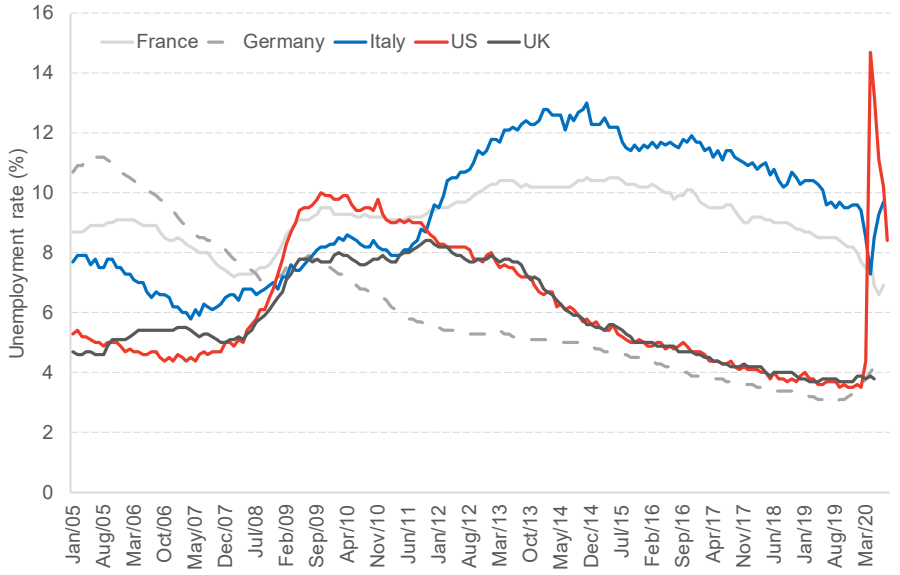
Chart 14: Number of commercial flights (7-day moving average), Global, 1 January – 31st December



Source: *Flightradar24*

Just like Scotland and the UK, the greatest risk to the global recovery is the ongoing containment of the virus. If the number of cases gets out of hand again and stricter measures are imposed to contain the virus, then we may see longer term scarring effects on employment and longer recovery times for economic activity.

Chart 15: Unemployment rate, January 2005 – August 2020



Source: *OECD*

The situation in developing countries is a particular concern. As Roger Mullin wrote in an article on our website, developing countries do not have the same public sector support mechanisms that many European or North American economies can turn to in times of a crisis. At the same time, the nature of society in many developing countries, and the rapid rise in urbanisation, means that implementing social distancing rules are that much more difficult.

What next for economic growth?

As we have highlighted, it is difficult to think of a time when the immediate outlook for growth has been more uncertain.

We are at a crucial inflection point in the recovery. On the one hand, there are reasons to be optimistic.

Our economy has shown that it can be remarkably resilient. If confidence returns, spending and investment decisions that have been delayed should start to come back on stream. If demand picks-up this will create multiplier effects that will ripple across the economy.

But even under this positive scenario, the recovery will be slow.

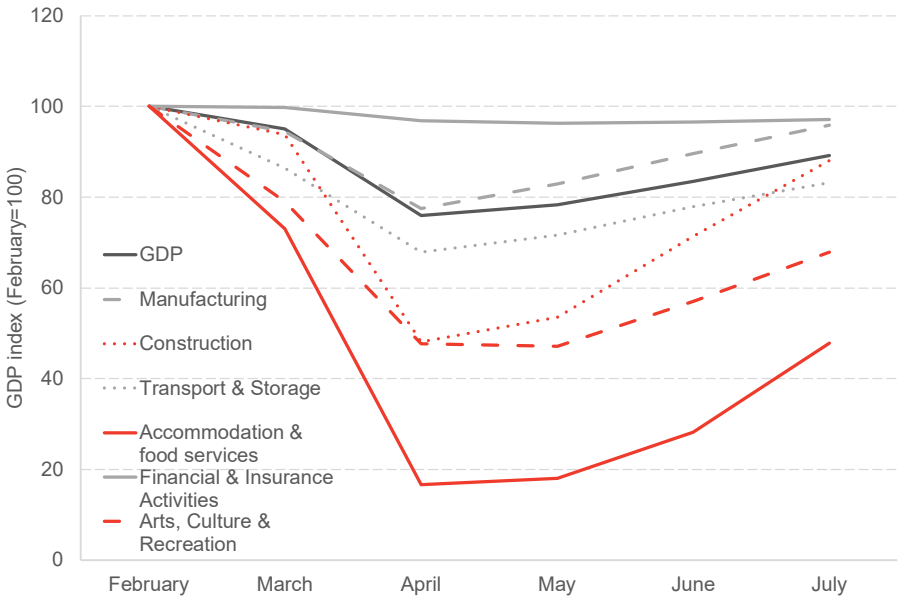
It is not difficult however, to take on a more pessimistic outlook. The virus remains far from contained. Social distancing is likely to remain in place for the foreseeable future. Ultimately a vaccine is the only guaranteed route out of this crisis.

Until then, business models that rely on social spending, significant passing footfall, or high turnover of customers, will struggle.

At the same time, for many businesses their supply chains remain hugely disrupted and access to international markets remains closed for many exporters.

The latest GDP figures for Scotland highlighted some bounce back in growth at the start of the third quarter in July of 6.8% however, this is expected as we are recovering from a very low base. The economy is still over 10% smaller than in February. See Chart 16.

Chart 16: Sector performance in the Scottish economy since lockdown



Source: *Scottish Government*

It is important to focus on the levels of output in each industry and not the growth rates.

For example, output in the accommodation and food services industry grew by 70% in July but is producing under half of what it was in February.

Tourism-facing industries like these, which rely on face-to-face interactions, were mostly incapable of operating during lockdown and have struggled to recover as restrictions were eased due to capacity constraints and household and group socialising limits.

On the other hand, the financial industry experienced output growth of 0.5% in July however, it is producing around 97% of what is was in February.

Industries like financial services, have found it much easier to continue operating with employees working from home. The transition to greater levels of home working seems to be a legacy of this crisis that will not go away, with ongoing implications not just for individual businesses and workers but the future of city centres, corporate property markets and the many businesses that depend on the passing trade of office workers.

We will arguably have much greater understanding of the pace and resilience of the recovery in the next few months, particularly as the government support packages introduced at the height of the lockdown are eased or reformed.

Around £2 billion worth of loans has been provided to businesses in Scotland to help them get through the economic crisis. But the longer this economic crisis runs, the more thinly these funds must be spread. Many businesses will no longer be able to postpone the hardest of decisions.

The government's Eat Out to Help Out scheme provided around £38m in support to Scottish businesses and although this scheme closed at the end of August many businesses are running similar discounts in September to boost demand. But with capacity constraints and no sign of a vaccine in the near future, businesses will struggle to attract the demand needed to stay afloat.

Like the initial economic shock, we are likely to see continued variation in the recovery of different parts of the economy.

Any hope of a v-shaped recovery has disappeared as increasing evidence points towards a k-shaped recovery.

K-shaped recovery

As we discussed earlier, Scotland entered into a recession in the first half of the year – with an eye-watering fall of 21.4% between Q4 2019 and the end of Q2 2020.

But what next?

Hope of a sharp bounce back – a 'v-shaped' recovery – have all but disappeared. The fear is that the recovery will be long leading to a 'U' or 'bathtub' shaped recovery.

But there is increasing evidence to suggest that an alternative 'shaped' recovery is on the horizon – a 'k' shaped recovery. The idea being that some parts of the economy will recover quickly, i.e. financial services, while other parts struggle to return to normal, i.e. tourism-facing industries.

How likely is this? And in what parts of our economy might it play out in the months to come?

The first way in which such a recovery pattern may emerge is through the performance of different sectors.

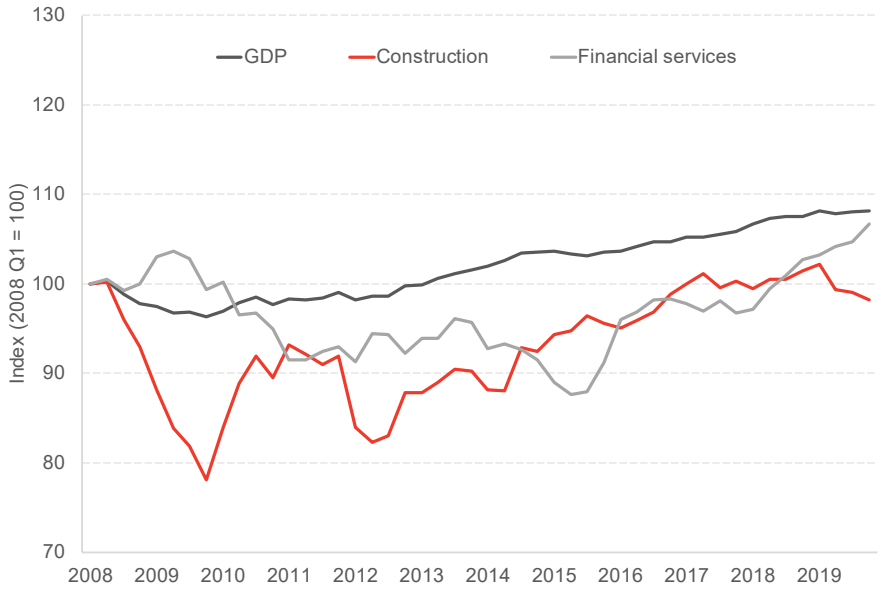
In a modern economy, all sectors are closely integrated, so in a recession very few sectors, and the businesses that work within them, are immune.

But the scale of the 'economic shock' is never shared equally. [NB: Of course, there will be some firms, e.g. PPE manufactures and online retailers, who will have benefited during the crisis, but they are very much in the minority of businesses].

Let's take the 2008/2009 financial crisis and recession as an illustration.

As the chart highlights, whilst the Scottish economy as a whole had recovered to its pre-recession peak by 2013, it took almost a decade for the two sectors at the epicentre of the crisis – construction & financial services – to make-up the ground that they lost during the crisis.

Chart 17: Scotland's economy during the 2008/09 Financial Crisis – recession and recovery



Source: *Scottish Government*

What about this time?

There are reasons to believe that the sector splits in 2020 will be even greater. Already we are seeing a divergence in outcomes among industries.

Large parts of our economy – from restaurants, bars, tour operators through to gyms, traditional retail, airports and other services relying upon social spending – effectively ceased trading for months. Even now as restrictions are lifted, many of them operate under significant restrictions. Recovery for businesses in these sectors will be long. Sadly, many jobs will be lost, particularly when the furlough scheme ends in the autumn.

In contrast, in some other parts of the economy, from financial services through to legal and accountancy firms, activity has been able to continue pretty much as normal (albeit with work taking place remotely).

How long this will last is, of course, uncertain.

But arguably, the predicted variation in economic outcomes for different sectors that we first discussed in our March Commentary has been even greater than we imagined. The longer the restrictions last, the longer it will take the economy to recover at an aggregate level, and it will increase the possibility of a much wider split emerging in relative performance by industry.

The months ahead

The virus remains far from contained. Social distancing is likely to remain in place for the foreseeable future. Cases are increasing at their fastest rate since the start of the lockdown and restrictions have been reintroduced across large parts of the country.

The 'Rule of Six' limits gatherings to a maximum of six people from two different households in Scotland, and the UK, and is likely going to be around for the foreseeable.

The chances of this restriction being lifted before Christmas seem unlikely given the current growth path of daily cases.

Local lockdowns, like that in Aberdeen, pose a significant threat to the economy's recovery in the coming months and there is a real chance that these localised restrictions become the norm until a vaccine is distributed.

Absent a vaccine, business models that rely on social spending, significant passing footfall, or high turnover of customers, will struggle.

At the same time, for many businesses their supply chains remain hugely disrupted and access to international markets remains closed for many of our exporters.

Summary

We are at an inflection point in the economy with great uncertainty about what is around the corner.

There is a possibility that the current economic recovery builds momentum, and whilst long, we recover strongly towards the end of the year and into 2021.

Recent data shows that the recovery has begun however, we are starting from a very low base, so the level of economic activity is crucial, not the growth rate of the economy.

But, the frequency of local lockdowns coupled with consumer insecurity could mean that the recovery is flat.

Policy in all of this is crucial. While people may currently have pent up demand this is unlikely to last.

The furlough scheme has kept unemployment low so far during this crisis but this should not be taken as a clear signal of what is about to come.

The timing of the lifting of the furlough scheme will be crucial. If this and other support schemes are unwound too quickly then there is a real risk of hindering the economic recovery process.

Of course, amidst of all this and to only add to the uncertainty, Brexit continues to loom on the horizon. Many of the short-term impacts of 'no deal' will be masked somewhat by the COVID-19 pandemic. But failure to agree a comprehensive trade deal for the end of December still risks doing significant damage to the UK economy in the long-run and will hamper the recovery.

In the coming months and years, action from the Scottish government will also be of critical importance. Economic strategies must acknowledge the asymmetric impact that localised lockdowns and restrictions have on different sectors and the variation in recovery among businesses in different industries.

The Scottish Government is limited in what it can do to inject additional stimulus to the economy, but it can certainly to more to shift spending around within its £30+ billion budget. It cannot be the case that priorities prior to the greatest global pandemic in 100 years are the same as today.

Of course the decision to cancel the Autumn Budget has major implications for Scottish policymaking, not just during the pandemic but in setting an agenda for post-May 2022.

Regional impacts of Covid-19

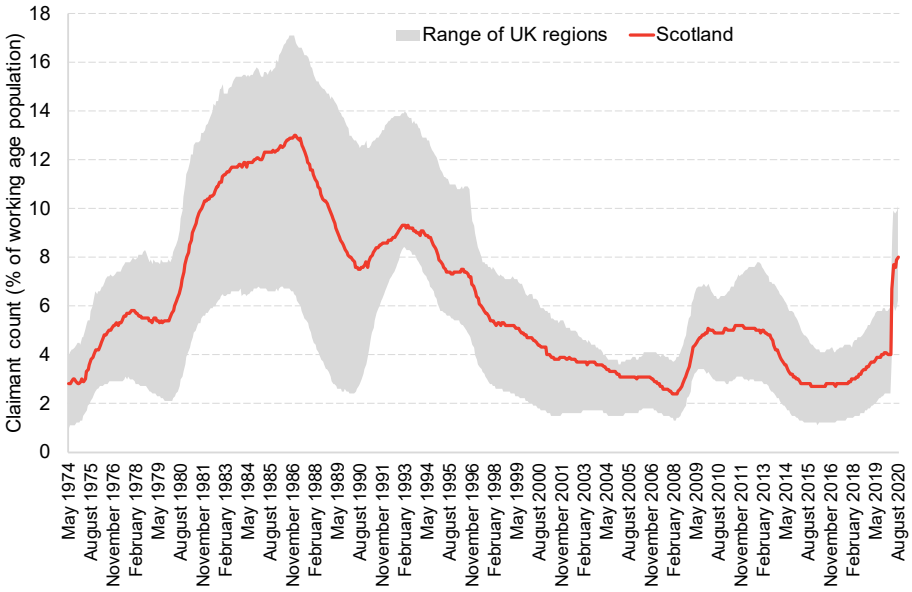
The pandemic has caused a negative economic shock in all regions of the UK. However, some regions have been affected more than others.

Impact on regions of the UK

The Claimant Count (number of people on Universal Credit and Job Seekers Allowance) is a timelier indicator for the number of people out of work than the unemployment rate. Although not directly comparable, the two series tend to move together over time.

Historically, Scotland has been somewhere in the middle of the pack compared to other regions of the UK. In the face of the pandemic some firms have had to readjust their labour costs as a result of lower consumer demand, which in turn has led to a sharp increase in the Claimant Count. See Chart 18.

Chart 18: Claimant Count as a share of working age population, Scotland and UK regions, May 1974 – August 2020

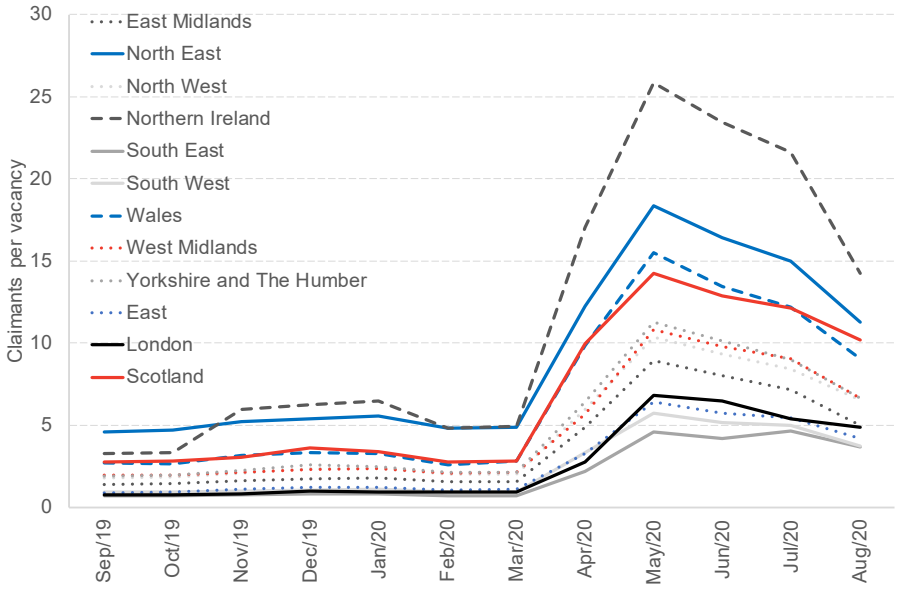


Source: *ONS NOMIS*

In August 2020, the share of claimants in Scotland has risen by 4.1 percentage points from the previous year. This is slightly more than in Northern Ireland and the South West, but less than in London, which saw the sharpest rise out of all UK regions. Despite the sharp increase, Scotland remains 'in the middle of the pack' compared to other UK regions in terms of the share of claimants.

Covid-19 has also forced firms to reduce the number of vacancies offered. The ratio of claimants per vacancy is an important indicator of how fast those who have lost jobs are able to find new employment. Similarly to the Claimant Count, the number of vacancies has fallen and recovered to differing degrees across regions of the UK.

Chart 19: Ratio of claimants per vacancy, UK regions, September 2019 – August 2020



Source: *ONS NOMIS, Adzuna Labour Market Stats, FAI calculations*

Between September 2019 and March 2020 Scotland had around 3 claimants for each vacancy. This was slightly higher than most English regions (except the North East), similar to Wales, but lower than Northern Ireland. At the start of the lockdown the number of vacancies fell the most in Northern Ireland and the North East, resulting in a sharper increase in the ratio of claimants per vacancy.

In April there were over 14 claimants per each vacancy in Scotland, but in August the number of vacancies recovered slightly and thus the ratio fell to around 10 claimants per vacancy.

Impact on Scottish regions

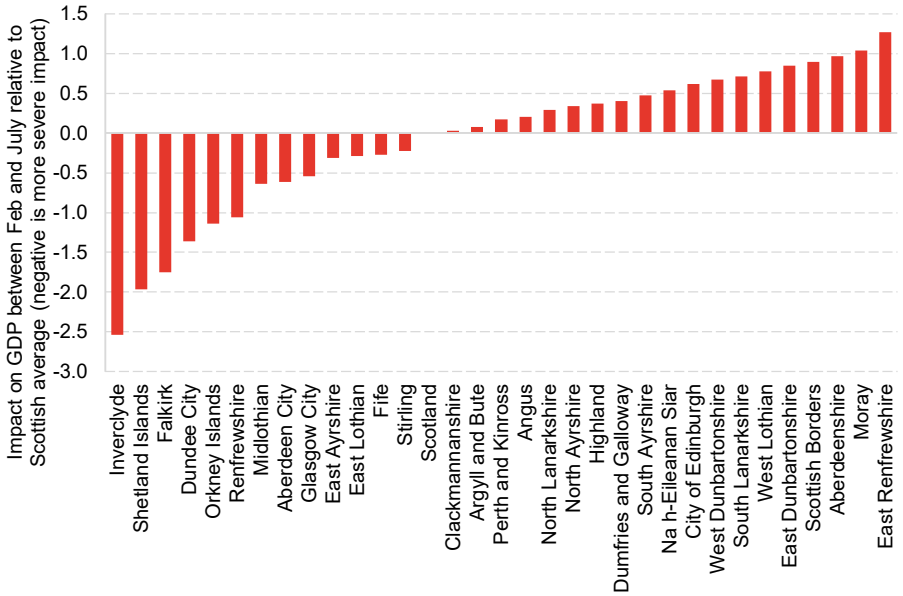
Certain sectors of the Scottish economy have been more likely to be affected than others by the lockdown. Since some local authorities in Scotland are more dependent on these sectors, the shock to their output has been more pronounced. Chart 20 models some illustrative changes to regional economic performance across Scotland, apportioning the national split of activity by each region's share of GVA in each sector.

Shetland Islands, Inverclyde, and Falkirk were most likely to be among the hardest hit Scottish local authorities due to their heavy reliance on sectors most exposed to lockdown - i.e. the transportation and storage sector (circa 20% of GVA in Shetland Islands and Inverclyde).

On the other hand, East Renfrewshire, Moray and Aberdeenshire are more reliant on sectors where the shock to output has been less significant.

The faster pace of reopening after the lockdown of some sectors relative to others has also contributed to a divergence in developments amongst Scottish local authorities.

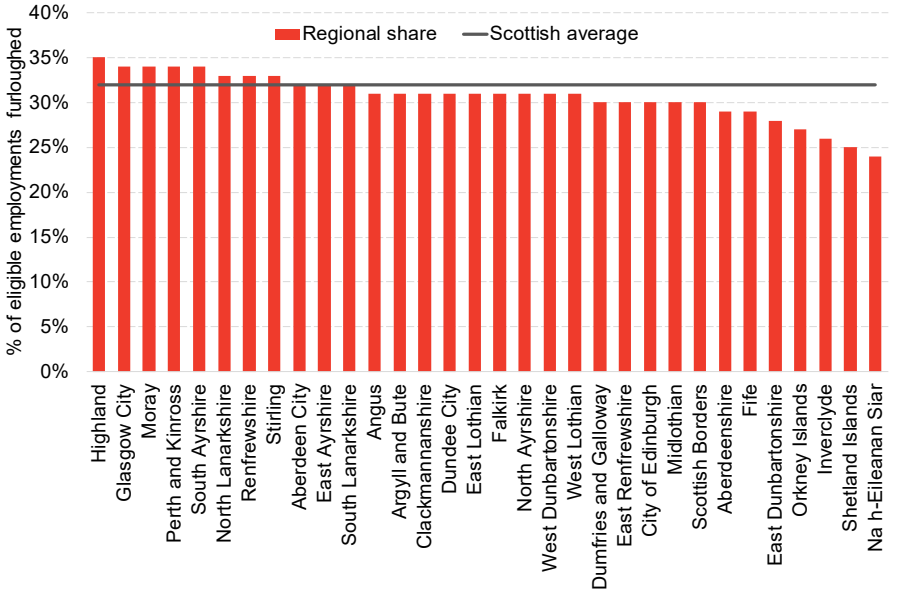
Chart 20: Modelled variations in regional economic activity in Scotland based on sectoral employment shares, February to July 2020



Source: *Scottish Government, FAI calculations*

Lower output and decreased demand have forced employers to put workers on the UK Government's Coronavirus Job Retention (furlough) scheme. However, the differing sectoral make-up of local economies has also led to a different degree of take-up of the scheme across Scotland.

Chart 21: Share of eligible employments furloughed, Scottish local authorities, July 2020



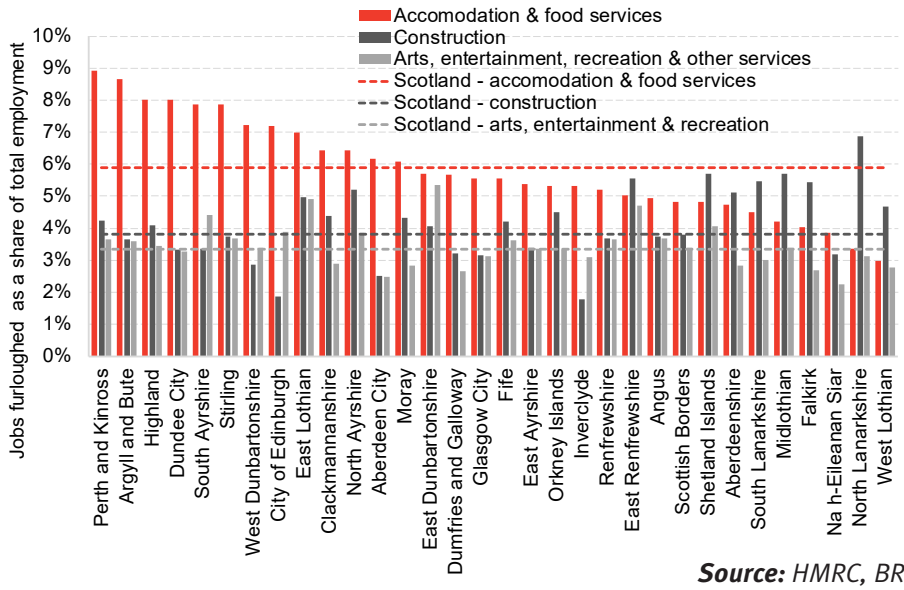
Source: *HMRC*

Highland, Glasgow, and Moray were amongst the areas with the highest share of employees on furlough (over 34%). On the other hand, Inverclyde, Shetlands, and Nah-Eileanan Siar were amongst the areas with the lowest share of furloughed workers (less than 26%).

In Scotland, accommodation & food services, construction, arts, entertainment & recreation were sectors with the highest share of furloughed workers. Around two thirds of all workers in these sectors have been put on furlough.

Chart 22 shows the total number of jobs furloughed as a share of total employment in a given local authority, calculated by applying the national sectoral furlough shares to regional employment data.

Chart 22: Jobs furloughed across different sectors as a share of total employment, Scottish local authorities, August 2020



Source: *HMRC, BRES, FAI calculations*

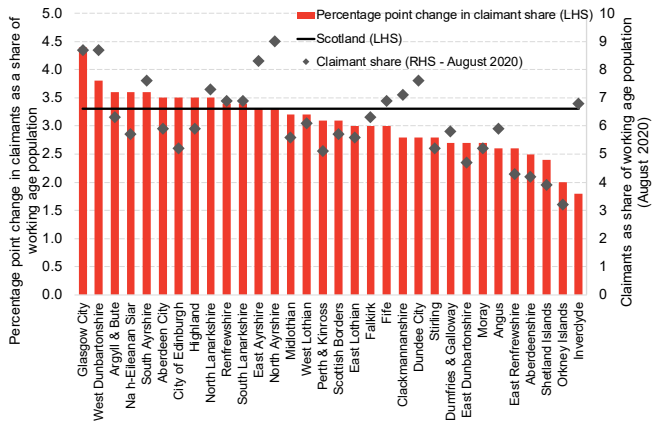
Perth & Kinross and Argyll and Bute had over 8% of all workers furloughed just in the accommodation & food services sector. On the other hand, more industrially focussed local authorities, such as North Lanarkshire, had the highest share of workers furloughed in the construction sector.

Firms for which the furlough scheme has not provided enough support have had to resort to job cuts. Similarly, to the UK level, this has led to a sharp increase in the Claimant Count, but with a differing magnitude of impact amongst Scottish local authorities

The impact in terms of job losses was most notable in Glasgow and West Dunbartonshire. On the other hand, rural local authorities such as Inverclyde, Orkney, and Shetland Islands were the least affected.

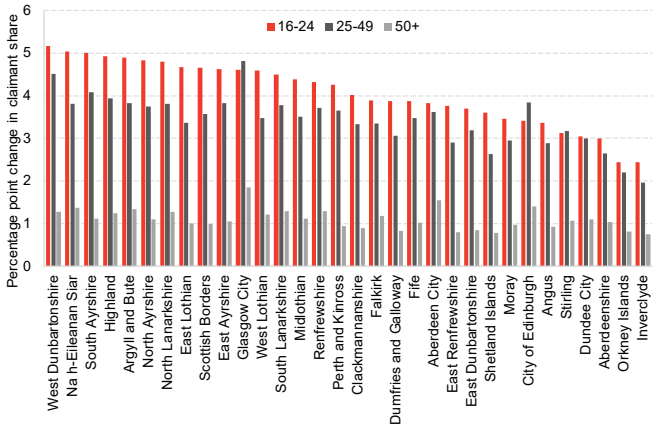
The crisis in the labour market has been more pronounced for young people amongst most Scottish local authorities. However, in cities such as Edinburgh, Glasgow, and Stirling the increase in the share of claimants was higher amongst those aged 25 – 49 than for those aged 16 – 24. Young people in cities may have been less affected relative to those in rural areas because a larger share of the age group continues into higher education straight after school. On the other hand, young people in rural areas are more likely to go into work straight away.

Chart 23: Percentage point increase in the Claimant Count as a share of working age population (August 2019 – August 2020) and Claimant Count as a share of working age population (August 2020), Scottish local authorities



Source: *ONS*

Chart 24: Percentage point increase in Claimant Count as a share of population in given age group, August 2019 – August 2020, Scottish local authorities

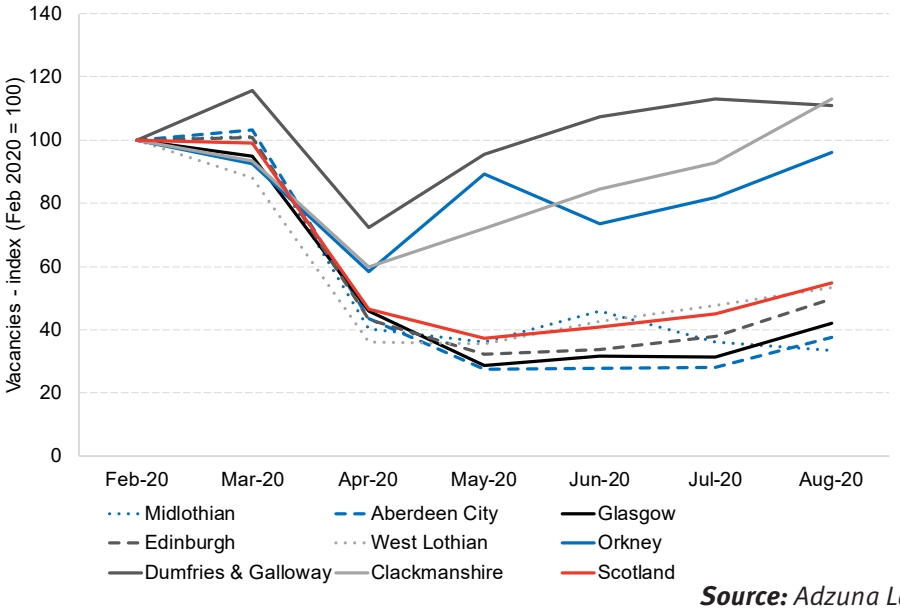


Source: *ONS NOMIS*

The magnitude of decline in vacancies has also varied amongst Scottish local authorities. Similarly to some of the previous indicators there is a divergence between city local authorities and rural areas. The number of vacancies in Dumfries & Galloway, Orkney, and Clackmannanshire fell less during the height of the lockdown and has recovered to pre-crisis levels by August.

On the other hand, vacancies in cities fell by around 60–70 % at the height of the lockdown and has been recovering much slower since then.

Chart 25: Number of vacancies, February 2020 – August 2020, best and worst performing Scottish local authorities



Source: *Adzuna Labour Market Stats*

Scottish budget outlook

The next Scottish budget, for 2021/22, will be the final one set in this parliament. It will be finalised in February and pass into legislation in March, setting the context for the debates leading up to the elections on 6 May.

It is less than four years since Derek Mackay presented the first budget of the parliament, but already it feels a lifetime ago. The context for that 2017/18 budget was ongoing austerity and Brexit. The Scottish resource block grant was anticipated to fall by over three per cent to 2019/20 from the £27.6 bn (in today's prices) that Mr.Mackay had at his disposal. And there was a sense that the budget was exposed to unprecedented uncertainty given the uncertainty about the UK's future relationship with the EU.

Fast forward four years and it is striking to consider what has changed and what has stayed the same. Philip Hammond's austerity plans had already been relaxed as a result of stronger than anticipated tax revenues before being comprehensively consigned to the past at the September 2019 Spending Review. By this point the Scottish resource block grant for 2019/20 was 4% higher in real terms (£28.8bn in today's prices) than at the start of 2017/18.

Brexit uncertainty on the other hand has been ever present, and whilst we know much more about the terms of the UK's EU-exit, the terms of the future trade agreement with the EU continue to be haggled over.

But Brexit uncertainty now seems relatively benign compared to the uncertainty wreaked by Covid-19. The immediate fiscal response has involved the UK Government borrowing at unprecedented levels in the post war era. And whilst the majority of this borrowing covers UK-wide spending (on social security and the furlough scheme) and the decline of UK tax revenues, there have been substantial uplifts for the Scottish budget.

An additional £5.8 billion in resource consequentials, stemming from UK Government spending in England, has flowed to the Scottish budget since it was published in February. In fact the UK Government has guaranteed a minimum uplift in 2020/21 of £6.5 billion of funding related to COVID-19 to the Scottish Government. The Scottish Government's capital funding position has increased by £174 million since February.

The Autumn Budget Revisions published last week[1] show how these additional funds have been allocated. £3.2bn has been allocated to support public services, including:

- £2.2bn for health and social care
- £380m to local authorities to offset reduced income and increased costs, and
- £450m allocated to support rail services, and smaller amounts to schools and other public services.

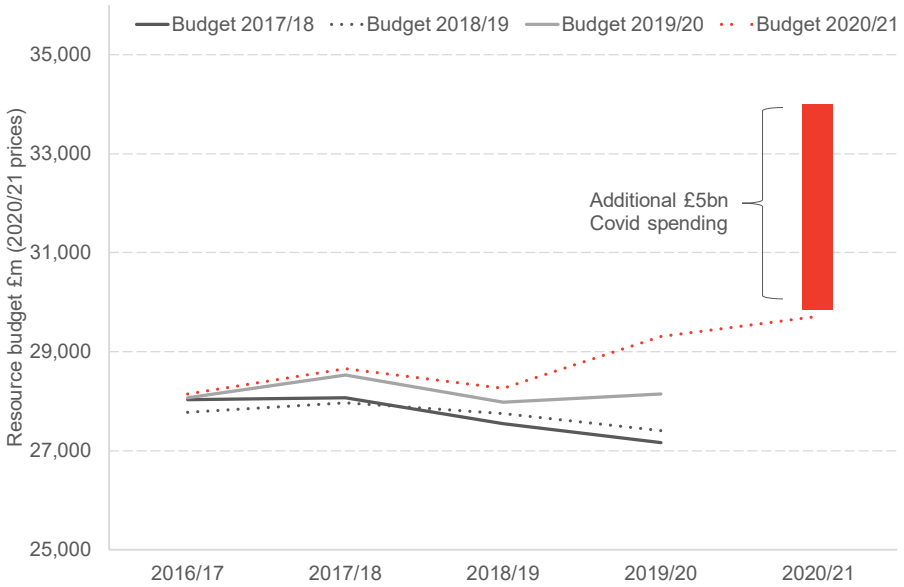
£2.4bn has been allocated to support business. This consists primarily of business grants (totalling £1.2bn) and business rates reliefs costing £1bn, plus specific support to cultural businesses and charities.

1 See Scottish Budget Autumn Revisions

£49m has been allocated to support vulnerable families and individuals. A further £800m remains to be allocated.

In short, Scottish Government resource spending is now estimated to be £5bn higher in 2020/21 than anticipated in March this year, whilst revenues from Non-Domestic Reliefs are anticipated to be £1bn lower.

Chart 26: Evolution of Scottish resource budget at successive budget events



Source: *Scottish Budgets, various years; Autumn Budget Revisions 2020; FAI analysis*

What about the outlook for the budget in 2021/22?

There is still significant uncertainty around the outlook for the block grant. There are likely to be further consequentials arising from additional spending on further and higher education, and on skills and employability initiatives in England. But some of this might be offset by a rolling back of business rates reliefs (revenues from business rates in England count as a negative consequential in the operation of the Barnett formula).

More fundamentally there is significant uncertainty about the timing of the UK budget. UK Chancellor Rishi Sunak announced last week that the UK budget will not go ahead in autumn, although there will be some form of Spending Review setting out departmental spending limits. That suggests that the Scottish Government will again need to prepare its budget before the UK; knowing roughly what its block grant will be but with significant uncertainty surrounding tax policy and tax forecasts for rUK income tax and stamp duty, which do impact on the size of the Scottish budget.

What is clear is that, whenever the Scottish budget is published, it will look very different from the budget published in early 2020, both in terms of the size of the budget envelope and how that envelop is distributed.

Whilst health and social care spending will remain elevated, the impact of the crisis on the labour market, and particularly the opportunities facing young people, will necessitate a robust increase in spending on further and higher education, and skills and employability initiatives. There will be difficult questions over how much to subsidise public transport in the face of reduced demand; and how to support the locations most affected by Covid, whether those are town centres or the places most reliant on tourism. Increased costs and reduced revenues facing schools and local authorities will need to be addressed. And further support for the most vulnerable groups is likely to be required.

So whilst the budget envelope is likely to remain at an unprecedentedly high level, the pressures on that budget will be acute. Some reprioritisation seems inevitable, and there is no guarantee that all portfolios will see spending increases.

If the Scottish Government feels the need to increase the size of its budget envelope over and above whatever resources flow through the block grant, its options are limited. While an economic case for income tax increases on the higher earners who have been sheltered from the impacts of the crisis can be made, politically the case may be harder given the existing gap in tax policy with rUK. The Scottish Government has argued that it should be able to borrow to fund additional spending, but so far the UK Government has been unwilling to countenance this idea.

Whilst the Scottish Government's ability to increase the size of its budget is limited, it does face some revenue risks. It is inevitable that tax revenues (from income tax, LBTT and business rates) will come in much lower in 2020/21 than was forecast, and will likely remain depressed in 2021/22. The fiscal framework does largely protect the Scottish budget from these effects. But the Scottish budget will bear the risk that devolved revenues decline proportionately more than the equivalent revenues in rUK.

This risk creates a further layer of uncertainty for 2021/22. So far this year there are no indications that the Scottish economy has been disproportionately affected by Covid-19 than rUK[2]. But relatively small differences in labour market impacts or consumer confidence could translate into revenue impacts running into the hundreds of millions of pounds.

One thing we do know with certainty is that the Scottish budget in 2021/22 will face a downwards adjustment (reconciliation) of £309m. This reflects income tax forecast error in the 2018/19 budget. The 2018/19 budget was based on a set of income tax forecasts which implied that the budget would have more resources available to it than has turned out to be the case – as shown by the outturn data published last week[3].

The forecast error was in not foreseeing that the Scottish tax base (and specifically earnings) would grow slightly more slowly than in rUK. Whilst the original forecasts anticipated that the Scottish budget would be £428m better off as a result of the Scottish Government's five-band tax policy and strong growth in the underlying tax base, the reality is that the outturn data reveal the 2018/19 budget to be 'only' £119m better off. The difference between the anticipated £428m and the actual £119m gives rise to the £309m reconciliation[4].

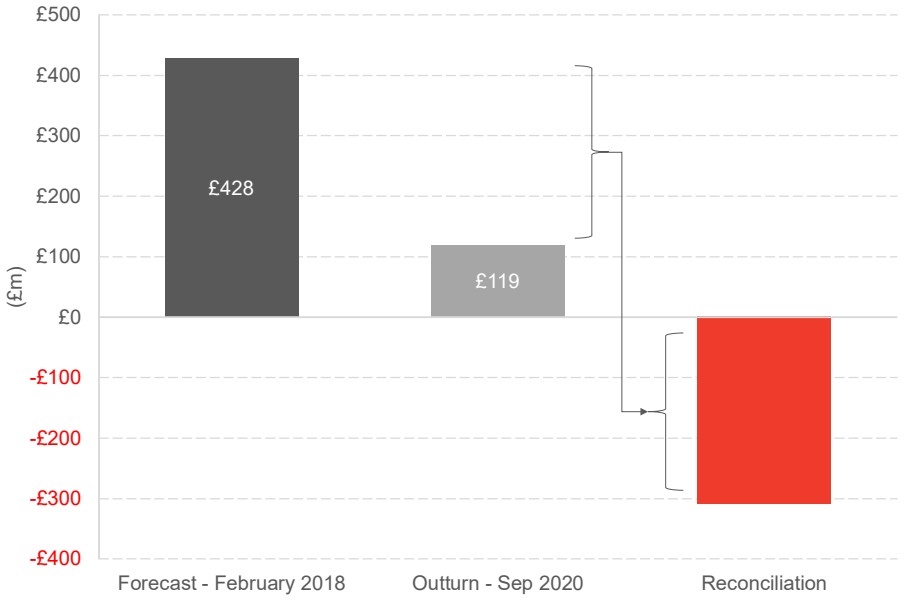
2 See the SFC's September fiscal update.
3 See outturn data.
4 For further details see FAI article.

The Scottish Government will be able to offset up to £300m of the £309m reconciliation through borrowing, in effect spreading the cost over several future budgets. The remainder of the reconciliation will imply (slightly) lower spending in 2021/22 than would otherwise have been the case[5].

The more worrying question for the Scottish Government is the extent to which slightly weaker growth in the Scottish income tax base relative to rUK might persist in future years. Weaker growth in the tax base has slightly offset the anticipated revenue impacts of Scottish tax policy in both 2017/18 and 2018/19, and is forecast to do so again in 2019/20.

Uncertainty and fiscal constraint have been the themes of Scottish budgets in this parliament, and will continue to be the theme of the 2021/22 budget, despite the ending of austerity.

Chart 27: Budget boost from income tax: forecast, outturn and reconciliation



Source: *Scottish Government; HMT*

5 The government could use reserves in the Scotland Reserve to fund the reconciliation, but this would mean the reserve cannot be used to fund other public services spending.

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