

UK corporate profits and employment:

Resilient – but can it last?

30 April 2010

A surprising aspect of the recent UK downturn has been the resilience of the labour market and firms' trading profits, both compared to previous recessions and to the US' experience. This report reviews recent developments, considers potential explanations and what these trends might mean for the recovery.

These benign trends could simply represent the calm before the storm. Firms may have unrealistically high expectations for the recovery or are relying on the weaker exchange rate and low interest rates to support profits. If so, there is a danger of further substantial layoffs in the period ahead, as neither will provide long-term support to earnings. A significant new round of job cuts by firms would pose a threat to the sustainability of the wider recovery, given the fragility of household balance sheets. Moreover, layoffs in the private sector would likely come on top of job reductions in public sector, given the need to repair the public finances in the period ahead.

But there are upside risks too. Inventories are at very low levels suggesting that, in the event of a strong rebound in demand, firms would quickly need to ramp up production, which could lead to a quick turnaround in productivity and support profits and/or a quicker recovery in employment. This is not impossible, but would be at odds with historical experience.

Our central forecast envisages restrained profit growth and ongoing labour market weakness over the next two years. Our expectation of a sluggish recovery and a need to lift productivity imply further job losses over the next twelve months before a gradual rise thereafter. This would still mark a much quicker turnaround than during previous recessions, but nevertheless cautions that credit quality and credit demand are likely to remain under pressure for some time yet.

UK firms – holding on to workers

The UK economy shrank by 6.25% in this downturn, making it the longest and deepest recession in the post-war period. Yet the reduction in employment has so far been modest by historic standards. Total employment has fallen by 2.2% from its pre-recession peak, compared to 6% in the wake of the 1980s and 1990s recessions (chart 1). It may simply be that firms have yet to react to the deterioration in conditions and that the pace of layoffs will accelerate in the months ahead. This is not the view of most forecasters, who currently expect a modest decline in employment this year (c1%) before increasing in 2011 and beyond. Moreover, recent signs of a slowdown in the rate of layoffs and a rising number of vacancies do not support the notion that a further dramatic weakening is imminent.

Chart 1: UK employment trends during previous recessions

Source: ONS, RBS Group Economics

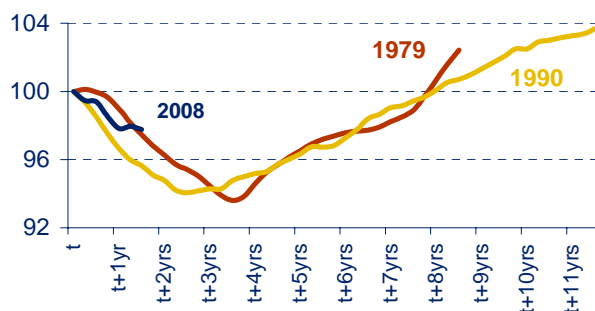
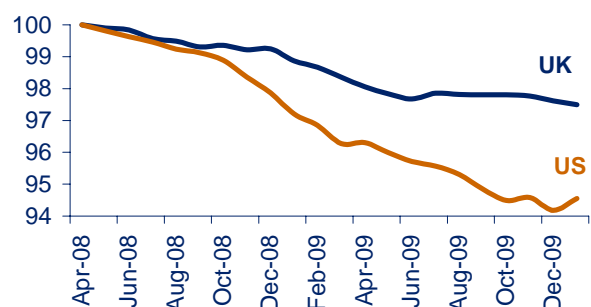


Chart 2: Employment levels (Index, April 2008 =100)

Source: ONS, BLS



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Some have attributed this resilience to the increased flexibility of the UK labour force. Workers have been more willing to accept lower wage settlements and shorter working hours, which has reduced the need for job cuts. Indeed, average hours worked each week have declined by c2% from 2007 levels. After accounting for inflation, wages declined by c2% in 2009, after being flat in 2008 (this compares with average annual growth of 2% over the previous ten years). Clearly flexibility has played a role, but the argument appears less persuasive when viewed against the recent experience of the US - a country known for its labour market flexibility. The US also experienced its worst post-war decline in economic output over the past two years, although at 3.8%, the contraction was significantly less wrenching than in the UK. Nevertheless, US firms slashed their workforces by 5.8% - more than twice as severe as the cutbacks experienced in the UK. These divergent trends are important as they may offer clues as to the sort of recovery we can expect.

Profitability hasn't taken the hammering you might have expected...

Clearly, a resilient labour market is good for households, consumer-facing businesses (by helping to support spending) and the financial sector (by containing the rise in bad debts). But it may not be sustainable if it starts to take a heavy toll on firms' bottom lines. Indeed, the flip side of firms' reluctance to lay off workers has been that productivity (output per hour worked) has slumped, in stark contrast to developments in the US where it has been rising strongly (chart 3). So far the impact on UK corporate earnings has been modest. UK trading profits have fallen through the recession, but the decline has been much less marked than the severity of the downturn would have implied. Trading profits at UK non-oil, non-financial firms' declined c10% in real terms from their peak compared with a 20% fall during the early 1990s (which was a much shallower recession) and a 30% drop in the early 1980s.

Part of the explanation could relate to financial conditions. The recessions of the 1980s and 1990s were triggered by a sharp rise in interest rates, which quickly forced many firms out of business. Higher rates also hit spending across the economy, although this took longer to have its full effect on businesses. This time around interest rates have not dealt the initial hammer blow to firms. Indeed, the cost of financing for many borrowers actually declined relative to the pre-crisis period (chart 4). Lower interest costs may be providing support for corporate earnings. Similarly, firms may be taking advantage of the weaker level of sterling to boost margins, rather than to increase market share – this would also help to account for the lack of robust growth in UK export volumes, despite the sharp decline in the pound.

Chart 3: UK Productivity has stagnated (output per hour worked, Index 2007 = 100)

Source:

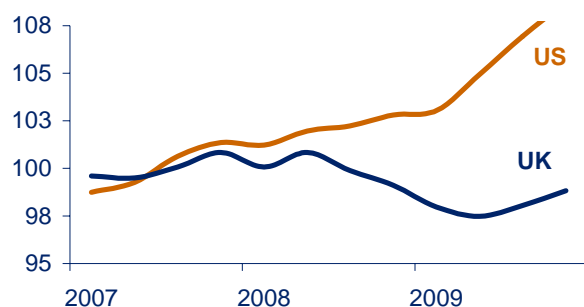
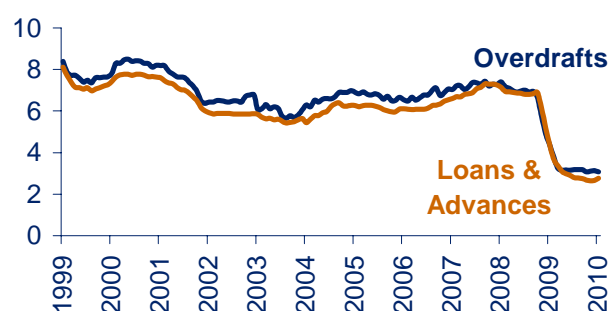


Chart 4: Effective interest rates on loans to UK Private Non-Financial Corporates (%)

Source:



But once again, evidence from the US cautions that this is unlikely to be the full story. Even though the dollar has also seen a significant depreciation in trade weighted terms and lending rates in the US have seen similar reductions to the UK, profits at non-financial US firms have slipped by c40% in real terms, much more than the 26% fall in the 1990s and similar to the declines of 39% seen in the 1980s, and 50% after the dot-com bust. It may be that UK banks have shown greater forbearance, with two of the largest UK lenders (including RBS) committed to increase lending through the downturn. Indeed, company insolvencies have risen more rapidly in the US, doubling from pre-crisis levels, compared to a 50% rise in the UK. Fewer UK corporate insolvencies could also be part of the explanation for the weaker productivity performance - as less productive firms would be expected to have been lost - and the more benign labour market conditions.

Where next?

The reason for the pattern we're seeing remains unclear. But weak productivity growth and resilient profits are unlikely to co-exist for long. The situation could unwind in a number of ways, depending on why firms have kept on workers and how business conditions evolve.

UK firms could be "hoarding labour" as they expect the upturn to be robust. Firms may be willing to tolerate a temporary decline in productivity, since it will bounce back quickly if demand returns quickly and strongly (firms will be able

to boost output, and hence revenues faster than costs rise and without having to worry about finding additional workers to meet new orders). Inventories are at very low levels, so any rebound in new orders may require firms to ramp up production very quickly. While this interpretation is possible, it seems at odds with most surveys which suggest that firms are still relatively pessimistic about the economic outlook. If the recovery turns out to be sluggish (as we and most other analysts expect), then firms may eventually be forced to make further substantial layoffs, or at the very least, it will take even longer than usual for them to hire additional workers.

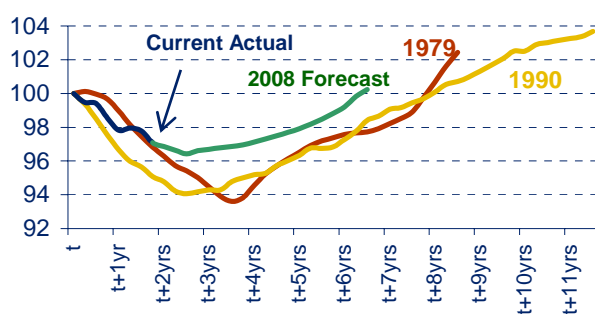
Low interest rates and the competitive level of sterling may be supporting profits, reducing the pressure to boost productivity. If so, the situation could change rapidly if and when interest rates start to rise. Firms remain relatively highly leveraged by historic standards, with a significant proportion of debt contracted at floating rates or on short-term fixes. Higher rates could pressure firms into making further layoffs to cut costs and support margins. Similarly, the boost to competitiveness from the 25% decline in the trade weighted exchange rate since 2007 will quickly be eroded if the gap between UK and foreign productivity widens, as it has between UK and US firms. Indeed, a further sterling depreciation is not guaranteed (we actually expect modest appreciation against the euro and stability against the dollar).

Conclusion – muddling through

Our central forecast is that the UK will achieve only a gradual economic recovery with growth of c1% in 2010 and c2% in 2011 (compared to c3% per annum pre-crisis) and that interest rates will rise gradually (to 2% by end 2011 and 4% by end 2012). Although it is expected to make up some ground against the dollar and the euro, sterling is expected to remain at fairly competitive levels. Against this backdrop, businesses will have some financial breathing space that will continue to provide some support for profits.

Chart 5: Labour market to remain tough for some time, but still turning quicker than in previous recoveries

Source: ONS/Group Economics



But firms will need to take some action to boost productivity to secure longer-term earnings growth and to help them to further strengthen their balance sheets, especially as interest rates rise. We therefore expect employment to see further modest falls in 2010 and into 2011, before rising gradually thereafter (chart 5).

This forecast embodies our view that improved labour market flexibility will allow a more rapid turnaround than during previous recessions. In the early 1980s and early 1990s it took eight years from the start of the recession until employment reached its pre-crisis levels – this will be achieved almost two years earlier. Nevertheless, this forecast also cautions that credit quality will be slow to improve and that credit demand is likely to remain lacklustre.

Is the resilience of the labour market all about the public sector?

Public sector employment has held up well through the recession. Between Q1 2008 and Q3 2009 private sector employment fell by c.3.3% while public sector employment *increased* by 2.4% (excluding the impact of financial sector interventions). But this is what you would expect, as governments usually increase public spending during a downturn to try and limit the depth of the recession. Although a public/private sector split of employment is not available before 1992, the high level of public sector employment in the early 1990s reinforces the notion that private sector employment layoffs were much more severe than public employment cuts during the 1990s recession too.

From an historical perspective, public sector employment is not at unusually high levels. The public sector currently accounts for c20.5% of total employment (excluding the financial sector), above the lows of c19% recorded in the late 1990s but below the highs of c23% recorded in the early 1990s. Indeed, the current share of public sector employment is close to the average of 20% recorded since 1992.

In the medium and long-term the private sector will have to offset weakness in public sector hiring. A reduction in public employment is likely to be a key part of reducing the UK's fiscal deficit. With a sluggish recovery expected, it will be hard for the private sector to generate enough jobs to absorb the unemployed and the natural growth of the labour force, let alone an exodus of workers from the public sector. This underlines our view that total employment levels are likely to remain under pressure for some time to come.