Economy Module

Business Review

South West business – pre- and post-recession

September 2010

SW SOUTH WEST OBSERVATORY

South West RDA

Contents

FOREWORD

SW businesses experienced a long period of growth from the early 1990s to 2008. Much of this growth was based on strong domestic demand, fuelled by increasing real incomes, high net job creation (especially in business services and the public sector) and strong asset values (particularly property). That era of long expansion over-reached itself, creating financial imbalances that resulted in the banking crises of 2008. The subsequent downturn has been severe and, while a recovery has started, few expect it to be robust.

Importantly, the sources of growth in the last upturn – public sector, property and related services – seem unlikely to come back strongly in the next one. Indeed, many would see this as undesirable. In addition, the policy environment will be different: fiscal policy will be tighter; monetary policy will stay accommodative for now but will need to "normalise" in due course; and development policy is being overhauled, at least in most of England.

In sum, SW businesses face a different economic environment than they got used to before the recession and, if they are to grow and prosper, they need to be able to engage proactively with the changes underway. In turn, this may help to re-balance our economy on to a better path and grow employment.

This Business review seeks to provide readers with an objective analysis of where SW business stands in terms of a range of crucial indicators. It describes the structure and dynamics of the SW business environment and assesses its readiness for the competitive market environment ahead. Its key messages are:

- With a weak recovery and previous dependency on public sector, some SW business is still vulnerable, especially in consumer services and products.

- The region has a low propensity to trade and invest, yet this is where economic rebalancing needs to occur. Business churn is relatively low and competitiveness needs to improve.

- SW business will remain highly dependent upon the national picture. Strong competitive advantage in some high end manufacturing, such as transport equipment and, perhaps, energy renewables, needs to be enhanced, but there is still a question over where the new jobs are going to come from.

- Some SW businesses are ready for the challenges ahead – at the forefront of technical and process innovation. Others are not. What help will SW entrepreneurs need in the brave new world?

As the Economy Module of the SW Observatory, the South West RDA's Economics Team provides this Review as a baseline assessment for whatever economic trends and structures emerge in England over the next few years. It is important for public and private actors alike to understand the strengths and weaknesses of the SW business demographic and the risks and opportunities likely to be faced. This Business Review, together with its sister publications on the SW labour markets (Labour Review early 2010 – next early 2011), SW spatial elements (Place Review planned for later this autumn, and building on our previous SW Economic Profiles), as well as our overarching Economics Review (next issue October 2010), gives those interested in the SW economy and its parts the vital foundation they need to plan for the future.

The principles of economic development do not change, even as private economic trends and public development structures do. Indeed, as cycles and incentives adjust, it is important to emphasise the necessary anchors for thought about future development. In simple terms, there are ten elements to our story on economic development:

- Our standards of living are driven by our competiveness and that depends, in turn, upon our comparative productivity.
- Businesses create wealth, in response to demand signals, through investment and innovation.
- Sustainable employment derives from the skills mix and the value added by its combination, through business, with other factors of production.
- Markets are effective but not always perfect – sometimes, public intervention can aid competitiveness, especially through access infrastructure.
- The tax and regulatory environments are crucial for incentivising entrepreneurship and investment.
- The inherited/inherent structure of the UK economy means there is a role for state engagement in infrastructure and human capital accumulation.
- Our competitors, elsewhere in Britain and overseas, will not stand still and our starting point, in terms of competitiveness and productivity, is not as good as it could or should be.
- UK economic development has not been well-balanced or consistent over the last half century or more.
- There are large challenges ahead, implying power shifts between different parts of the world, from political, economic, climate and demographic change.
- As our successful peers demonstrate, any recipe for successful economic development requires a consistency of approach over the long run between business and policy – competition through collaboration.

I commend this Business Review to readers and hope that it is found useful by those interested in economic development in SW England, now and in the future.

Nigel F Jump, Chief Economist
Economy Module of the SW Observatory, and South West RDA

INTRODUCTION

The United Kingdom economy has only just come out of the most severe recession in recent history and the legacy will be with us for some time to come. Coupled with a significant reduction in the size of the public sector, substantial challenges remain for UK business and the economy as a whole in the years ahead.

Different regions of the country and different sectors suffered in different ways – the recovery will be the same with differential effects across the economy. Some places and sectors are better placed to take advantage of the upturn in the economy. So, in this report, we address questions about how SW business coped with the economic downturn; its readiness to take advantage of the recovery and the new opportunities that might arise going forward.

This Business Review has been produced by the Economy Module of the South West Observatory. This publication, along with its counterparts the Labour Market Review and a forthcoming Place Review, replaces the South West Economic Profile in order to present a thorough analysis of the SW economy for these changing times.

The purpose of the Business Review is threefold: to provide an overview of business structure across the South West, to look at how businesses across the South West fared during the economic downturn and how they are faring now the economy is recovering, and finally an assessment of how fit SW businesses are looking to the future. Inevitably, the analysis touches on the geographical disparity and variation across the region – however, because of its emphasis on business, this Review does not cover "place" in detail. We have started work on a "Place Review", which will complement this Review by analysing local economies in more detail. Similarly, SW business is reliant on the regional labour market and significant changes in the labour market are underway. These aspects of the economy are covered in our Labour Market Review. The current issue was published earlier this year and the next will be published in the spring.

ECONOMIC CONTEXT

An economic recovery appears to be underway in the United Kingdom, though the risk of a "double dip" remains potentially significant. The recent recession was deep and long by historical standards, lasting six quarters from 2008 Q2 to 2009 Q3 – at its height the UK economy was shrinking at 2.3% per quarter and 5.9% per year (Figure EC1). The country has now experienced three quarters of positive quarterly growth. Indeed, 2010 Q2 (the latest figure) saw a 1.2% rise on the quarter (1.7% on the year), higher than many commentators expected and better than most other major economies, including the United States, but excluding Germany (2.2% quarter on quarter growth). The high Q2 figures for the United Kingdom are attributed to a catch-up in construction due to the poor weather in the previous three month period, as well as growth in business services and finance. Such growth may not be sustained and a return to something more modest is expected in Q3 and beyond, with the Treasury's consensus forecasts suggesting 1.5% annual growth in 2010, followed by a slightly better 1.9% in 2011[1].

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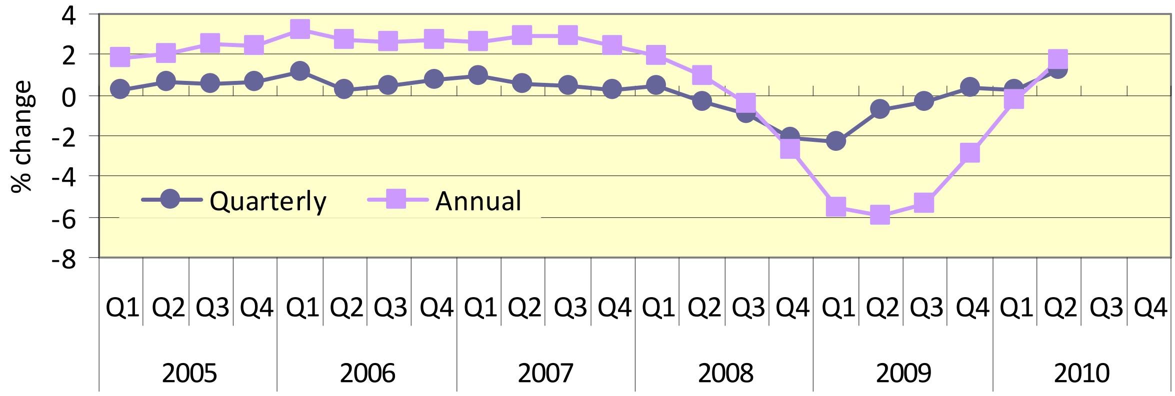
[1] Forecasts for the UK Economy 18/08/2010 – HM Treasury, August 2010

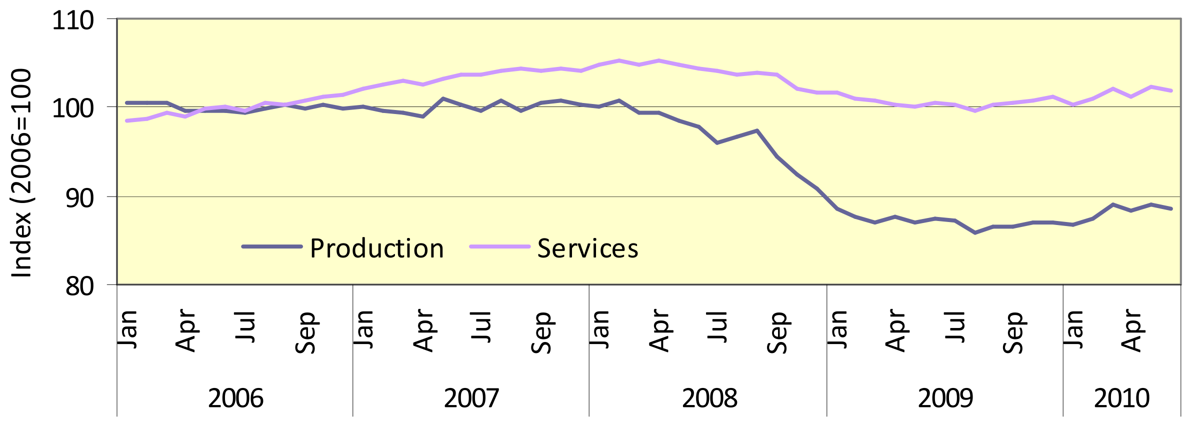
Figure 1 EC1 UK GDP - % qoq and yoy



Source: ONS

Production industries were hit hard during the recession, output falling by more than 10% (Figure EC2). However, the corner seems to have been turned with a gradual rise since late last year. In particular, manufacturing has climbed steadily since January, with much of the growth coming from machinery and equipment; and transport equipment sectors (12.9% and 9.0% growth from June 2009 to June 2010), which is good news for key parts of the SW economy. Meanwhile, the service industries were broadly more resistant to the effect of the downturn and have already recovered to pre-recession growth rates, although it will take a while for the ground that was lost, in terms of output foregone, to be recovered.

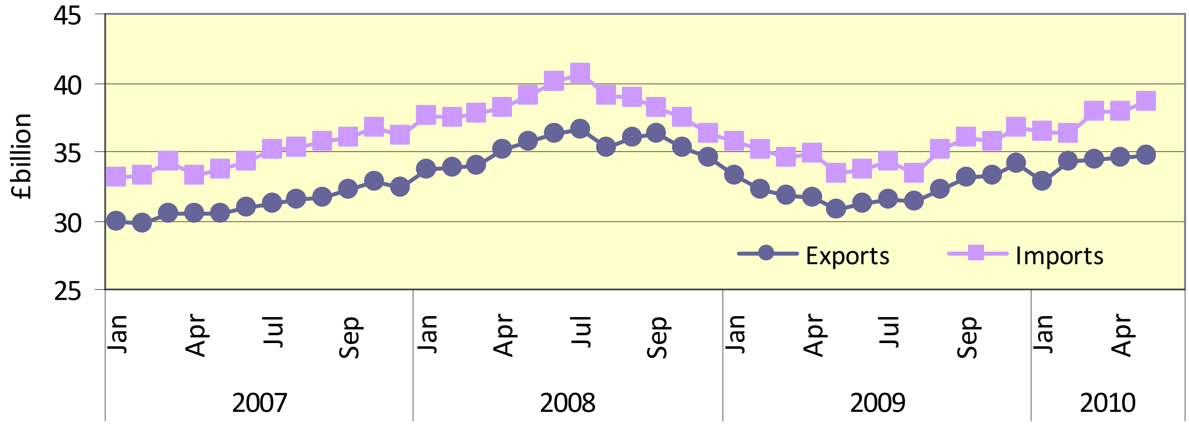
Figure EC2: Indices of Production and Services



Source: ONS

It is hoped that international trade, in particular exports, will help to deliver the private sector recovery expected by the new Coalition government. As Figure EC3 shows, UK trade fell off at the start of the recession, the trade gap (between importing and exporting) closing as exporters were able to take advantage of the pound weakening relative to the Euro and the US dollar. Trade has been picking up again since last summer and, with currency movements less volatile now, trade is approaching pre-recession levels in value terms.

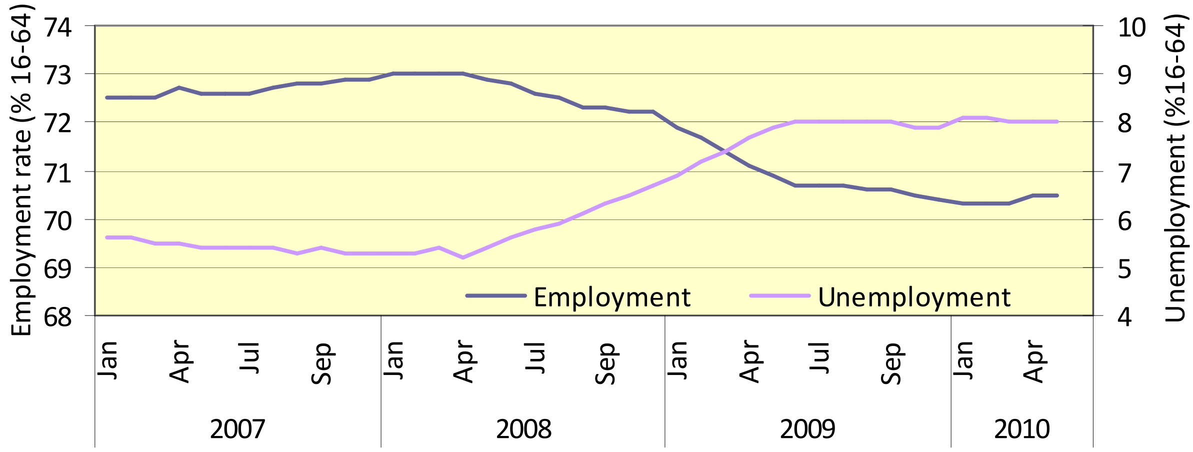
Figure EC3: Value of UK trade in goods and services



Source: ONS

Although the recession may be behind us, the effects of the downturn will linger, especially in the labour market, with employment and unemployment rates tending to lag other indicators of economic performance. Following a long period of relative stability, the labour market changed rapidly after the outset of the recession: the employment rate falling and the unemployment rate rising. The unemployment rate has remained fairly stable since summer 2009 – however, employment continued to fall for a further six months, with some signs of things picking up in the spring of 2010 (Figure EC4).

Figure EC4: UK employment and unemployment (%)

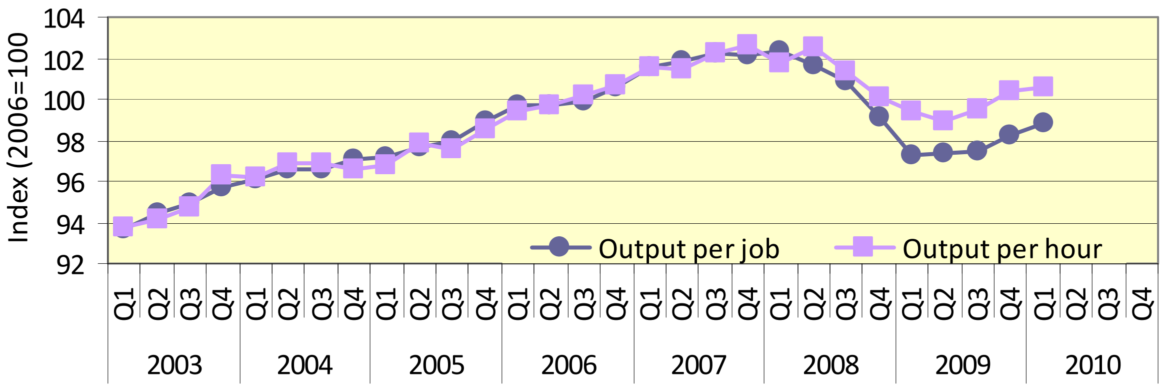


Source: ONS

This is not necessarily a sign that the labour cycle has turned upwards for good, as much of the rise to date represents increases in part-time or temporary employment, which are not necessarily a long-term solution to employment and productivity weaknesses.

Figure EC5 highlights the change to working patterns since the beginning of the recession. Productivity fell from 2008 Q2 to 2009 Q2 as output fell off ahead of lay offs but, interestingly, a gap between productivity per hour and per job has opened up. Compared with the last few recessions, many more companies appear to have held on to their staff during the 2008/2009 downturn. The hours-jobs gap, therefore, reflects a reduction in worker hours rather than workers as over-time working stopped, and many employees were put on reduced hours or extended leave. As the recovery gains momentum, this gap will start to close.

Figure EC5: UK productivity (2006=100)



Source: ONS

When this will happen is uncertain. The new Conservative Liberal coalition is committed to dealing with the United Kingdom's public debt head-on. The imminent public sector austerity drive, in part a consequence of the recession, may well dampen growth in private sector jobs over the next year or so, thus slowing down the closing of the output gap. Indeed, public sector cuts – in terms of both jobs and funding – will adversely impact directly on private sectors dependent upon public sector contracts and indirectly on sectors dependent upon consumers facing lower disposable incomes. In the longer run, the economy will start to rebalance, hopefully away from dependence upon the public and finance sectors. Assuming this is achieved, then the prospects for the United Kingdom and many parts of SW England within it, will improve.

Against this background, SW businesses have experienced mixed fortunes. Those directly affected by the drop in property, financial services and manufacturing were hit harder and earlier than others. Overall, however, many SW firms fared relatively well compared with those in other English regions. Ironically, this reflects a structural weakness in the area's economy: its relative lack of engagement in the global economy. This weakness will not favour SW business in recovery. Indeed, to date, generally, SW businesses have not bounced back as quickly as others. With a high proportion of small and medium sized business focussed on domestic demand, SW companies tend not to fall as far in the downturn and not to pick up as well in the early stages of the upturn. To address this characteristic, SW companies need to become proactive in capturing the higher productivity opportunities now likely to emerge as the economy rebalances.

STRUCTURE OF BUSINESS IN THE SOUTH WEST

The economies of many western countries have been undergoing a restructuring for many years now – a shift away from manufacturing and towards a more services-dominated industrial structure. The South West has not been immune to this trend. The geography, natural resources and industrial legacy of the South West of England – its coastline, its peripherality, its rural nature - also shape its economy and the sectors at which it excels (or not) and those in which it has been able to specialise.

A number of data sources exist that can be used to paint a picture of SW business, many of which are covered in the narrative below. These generally capture slightly different subsets of SW business or cover slightly different time points, and can have varying levels of robustness, as well as geographies. Some venture into the time period of the recession (few go beyond, however), others are more lagged in time.

VAT- AND PAYE-REGISTERED BUSINESSES

The following figures – based on VAT and PAYE[2] registration – were obtained from the Inter-Departmental Business Register (IDBR), the ONS' statistical business register for the United Kingdom[3]. The IDBR is believed to represent 99% of UK economic activity, though excludes many small businesses, which have turnover levels below the VAT threshold or have no employees. ONS publications based on the IDBR provide key statistics on business numbers, size (by employment and turnover), age, as well as "births and deaths" and survival rates[4], with selected figures provided down to Middle Super Output Area level[5].

In March 2009, there were 202,545 VAT- or PAYE-registered enterprises in the South West[6]. An enterprise can be made up of multiple local units, such as individual shops, factory sites, etc. – there were 243,935 local units in the region. Comparison to 2008 is discussed later in the context of the recession.

Figure BS1 shows the percentage of enterprises by turnover size band in 2009. In the South West, around 28% of enterprises have an annual turnover between £100k and £250k, the largest grouping. The pattern for the South West and United Kingdom are broadly similar but even without including the large number of sole traders and businesses below the VAT threshold, it is clear that the region has a smaller share of large companies and higher share of smaller companies. 72% of SW enterprises have

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[2] The Pay As You Earn (PAYE) system is a method of paying income tax and National Insurance contributions. An employer deducts tax and National Insurance contributions from employee wages or occupational pensions before paying wages or pension.

[3] Unfortunately, there are various discontinuities in the data series – while these have resulted from efforts to improve the overall accuracy of the data, in the short-term sensible analysis of regional or sub-regional business structure over time is not possible. The recent introduction of a new industrial classification system further thwarts analysis of performance over the period of the recession.

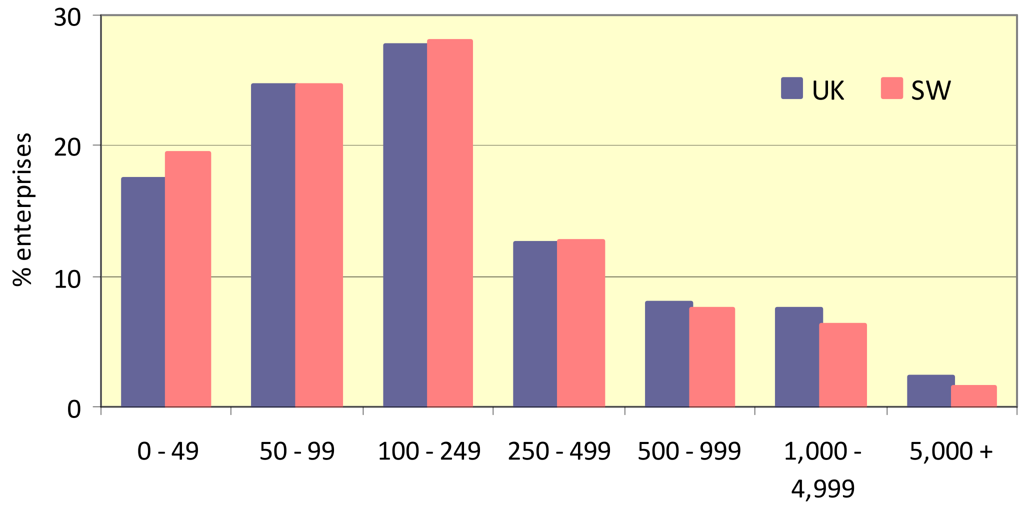
[4] Replaces DTI/BERR VAT-registration data – the last published dataset was for 2007.

[5] Middle Super Output Area level is an ONS small area geography – www.statistics.gov.uk/geography. IDBR data for MSOAs are available through Neighbourhood Statistics (neighbourhood.statistics.gov.uk).

[6] UK Business: Activity, Size and Location 2009, ONS

turnover of less than £250k (68% UK), the second highest proportion in the United Kingdom after Wales – conversely only 15% of firms have turnover above £500k (18% UK), the second lowest level. A similar though more skewed pattern is seen for employment – although the South West overall has a 9.4% share in all businesses, it has a 9.9% share of firms with 5 to 9 employees but only a 6.8% share of those with more than 250 employees.

Figure BS1: SW enterprises by turnover band, 2009



Source: UK Business: Activity, Size and Location 2009, ONS

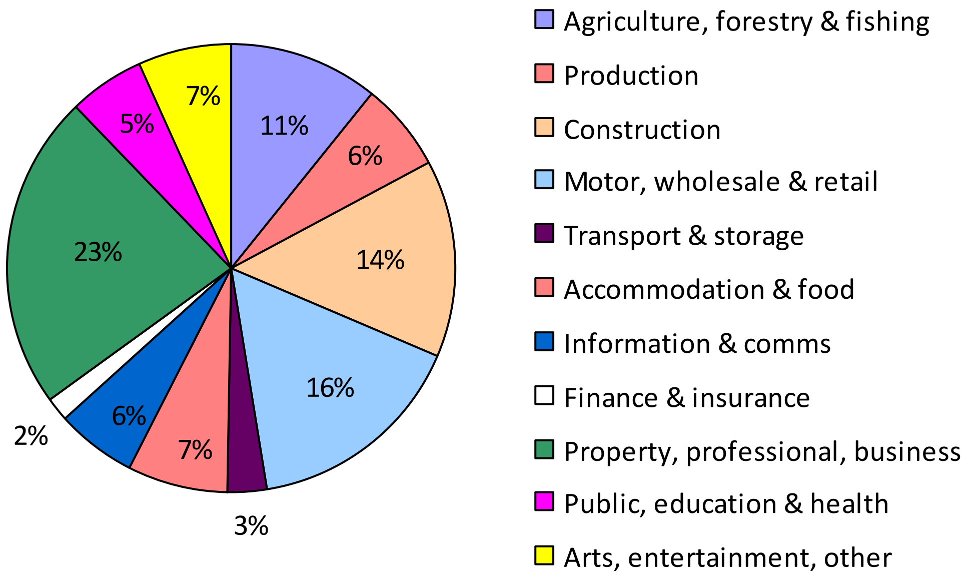
Figure BS2 shows the share of SW enterprises by broad industrial sector. Given its rural nature, it is not surprising that the region has a relatively large number of agriculture, forestry and fishing enterprises – 22,000 enterprises and a 16% share of the United Kingdom in 2009. According to 2009 figures, just around 6% of enterprises are in the production industries, only slightly below the UK average. Construction accounts for 14% of SW enterprises.

63% of enterprises fall into sectors that mainly comprise private sector services – 68% for the United Kingdom. Within these groupings, the South West has more than its average share in both motor trade and in accommodation and food services (10% and 11% shares, respectively), the latter being linked to the region's relatively large tourism sector. There is also a higher dependence upon the public sector than average, with a 14.5% share of UK enterprises in this sector. On the other hand, the region has a relatively low share in many other parts of the private sector. A lower share in finance and insurance is not surprising given that much of this activity in the United Kingdom is focussed on London. A relatively lower proportion of wholesale enterprises is also not surprising, due to the peripheral nature of the region, which often prevents it being a central hub for linking into the distribution industry. However, there is also a lower share of enterprises in the professional, scientific and technical sector, which contains some high value added, knowledge-intensive activities and may indicate a lower propensity to innovate proactively within the region.

The industrial compositions of local and unitary authority areas across the South West vary considerably. For example, the largely rural, county areas (including the new unitary authorities of

Cornwall and Wiltshire) have relatively high proportions of agricultural businesses – over 30% of enterprises in parts of Devon, and 27% in West Somerset and North Cornwall. On the other hand, Bristol has a relative high proportion of ICT (10%), professional, scientific and technical (18%), and finance and insurance (11%) enterprises. Elsewhere, Torbay exhibits greater reliance on accommodation and food services – 14% of enterprises, linked to its dependence upon tourism.

Figure BS2: Industry make up of SW enterprises, 2009



Source: UK Business: Activity, Size and Location 2009, ONS

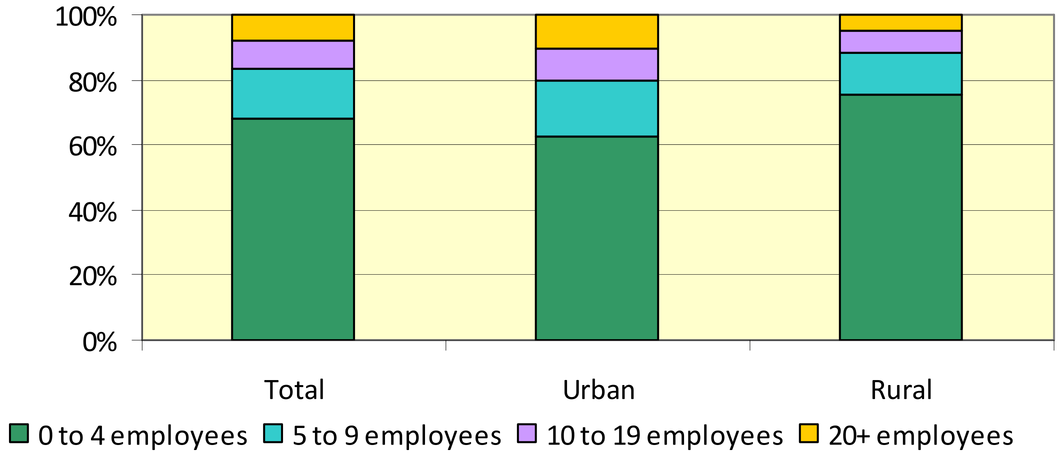
As well as being smaller, SW businesses also tend to be older than the UK average. 45% of SW businesses are 10 years old or more (UK = 42%). Conversely, 27% of businesses are under three years old, compared to 31% for the United Kingdom. This perhaps shows that the region has a core of well-established business with experience and good market presence enabling them to continue trading, but may also suggest that there is less competition and innovation in some parts of the region than elsewhere.

The South West is the largest rural region in England. About a third of the population live in rural areas (2001 Census), compared to 19% for England and it has been estimated that around a quarter of the region's economic output arises in rural areas[7]. The rural nature of the region influences many of the characteristics of SW businesses and much is spoken of the "rural economy" – however, rural businesses are inextricably linked through upstream and downstream supply chains and labour market movements, and consumers on businesses located in urban areas and so, in reality, it can be difficult to distinguish between rural and urban economies.

[7] South West rural economy – in Economics Review Issue 10 (November 2007), South West RDA. Available at economy.swo.org.uk/publications.

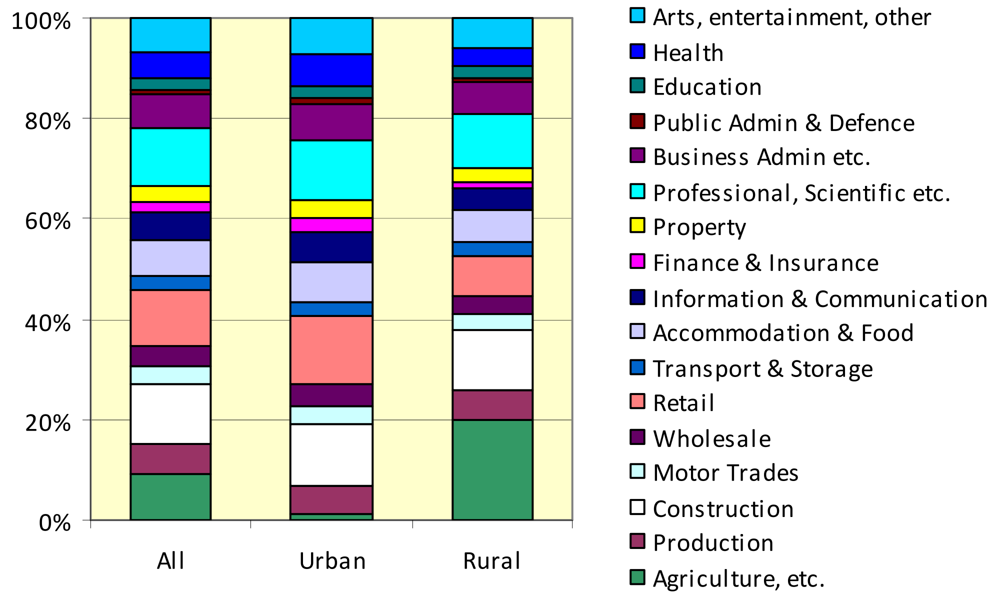
In 2009, 43% of SW businesses were located in rural areas, compared to only a quarter for England. Rural businesses tend to be smaller and older than average. As Figure BS3 shows, 76% of rural businesses in the South West had only 0 to 4 employees compared to 63% for urban areas. Around 40% of SW businesses in urban areas are aged over 10, while in village and hamlet areas this figure grows to 53%. The propensity of older businesses may be linked to lower business turnover rates, which are also observed in rural areas, in turn a sign of comparatively depressed competitiveness.

Figure BS3: Size of SW enterprises - rural/urban, 2009



Source: Neighbourhood Statistics, ONS

Figure BS4: Local units by industry - rural/urban 2009



Source: Neighbourhood Statistics, ONS

As might be expected, there is a greater proportion of both agriculture enterprises and food and drink manufacturers in rural areas (Figure BS4). Rural areas, however, have a smaller relative share of some service sectors, such as finance, retail and health, which tend to be located in urban centres, closer to the majority of their client base (either the population or other business). Otherwise, excluding agriculture, the patterns are actually fairly similar between rural and urban areas – indeed previous analysis suggested that the patterns vary more between different rural parts of the region than between neighbouring rural and urban areas[8].

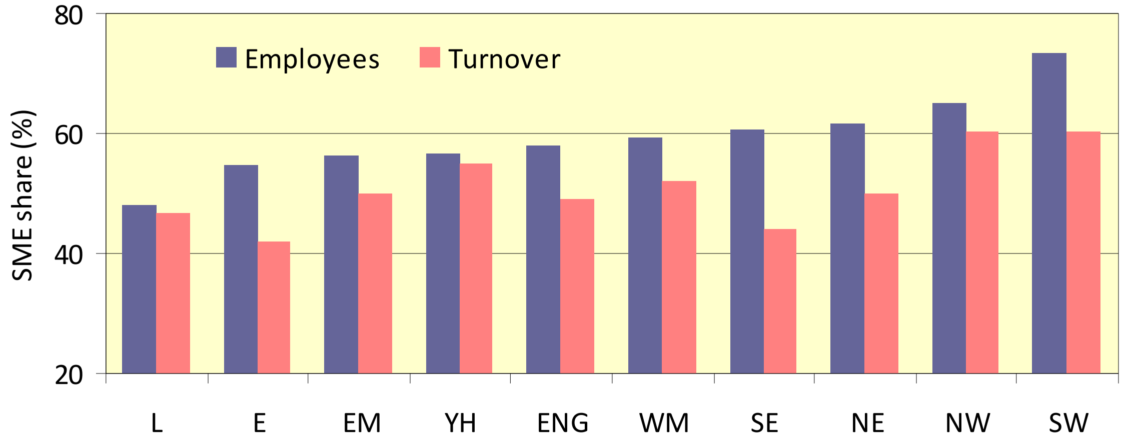
SMALL- AND MEDIUM-SIZED ENTERPRISES

As mentioned above, many small businesses are excluded from the official business counts. Modelled "SME statistics" are produced annually by the Department for Business, Innovation and Skills (or its predecessors) to provide a more complete business count - based on IDBR business counts, the dataset also brings in additional information, such as self-employment statistics from the Labour Force Survey.

There were an estimated 456,295 private sector enterprises in the South West at the start of 2008 – more than twice as much as the VAT/PAYE count of 203,000! In total, these enterprises employed an estimated 1.7 million people, with a combined annual turnover of £164 billion.

In 2008, small- and medium-sized enterprises (SMEs[9]) accounted for 99.9% of all SW enterprises, similar to the UK average. However, SMEs in the South West play a far more important role in the regional economy than nationally, responsible for 73% of private sector employment and 61% of turnover. These are the highest levels for the English regions and compared to only 58% and 49% for England, respectively (see Figure BS5).

Figure BS5: SME share of employment and turnover by region, 2008



Source: SME statistics, Department for Business, Innovation and Skills

[8] South West rural economy – in Economics Review Issue 10 (November 2007), South West RDA. Available at economy.swo.org.uk/publications.

[9] An SME has less than 250 employees.

In the ten year period 1998 to 2008, SMEs' share of employment and turnover increased overall by 6.1 and 2.5 percentage points, respectively, suggesting that their significance to the SW economy has been increasing and/or reflecting the relatively buoyant economic conditions and abundance of opportunities for small entrepreneurs up until the recession.

BIRTHS, DEATHS AND BUSINESS SURVIVAL

Although the region has seen a healthy net growth in business numbers over the last decade, it has experienced a relatively low level of churn in its business population due to low rates of business births/deaths relative to other regions and generally high survival rates.

Since 2008, information on business deaths and births (using VAT or PAYE registration/de-registration as a proxy) is obtained from the ONS' Business Demography publication (annual). The dataset represents a snapshot from the Inter-Departmental Business Register (IDBR) recording the position of active business units as at November (2008 latest).

Of the 207,115[10] active enterprises in the South West in 2008, 10.2% (or 21,025) were newly registered businesses (i.e. proxy for births or start-ups). As might be expected of newly active businesses, the vast majority (89.9%) belonged to the smallest size category in terms of number of employees (less than 4) – a higher share than seen in the business population as a whole – see Figure BS6. In the same year, 18,130 enterprises became inactive[11]. This counted for (8.8%) of all businesses (i.e. the proxy death rate). Births outnumbered deaths leading to more business creations than closures during 2008, and a subsequent growth of net business stock both in the South West (1.4%) and nationally (2.2%); this despite the onset of the recession during this period.

When compared to other UK regions and Devolved Administrations, the South West has a low rate of business churn - 18.9% of businesses were replaced in 2008, the lowest rate in England (21.3%) and second lowest in the United Kingdom. This in part reflects the industry make up of the region, as well as other characteristics of the South West, but also suggests that the region may lack sufficient competition, a main driver for productivity and innovation.

The dataset reveals a high degree of variation across the sub-regions of the South West. As we expect, churn and birth/death rates are generally higher in the more productive North and North East of the region and other large urban conurbations (for example, Bournemouth and Swindon 22%, Bristol and Plymouth 21%). On the other hand, more peripheral and rural areas tend to have a lower churn and net rates due to less exposure to domestic and international competition and distance from major markets (for example, Cornwall, Devon and Wiltshire counties 18%). Torbay is an exception – rather than being a healthy sign, the high churn rate of 21% reflects a relatively high death rate, the highest of the upper tier SW authority areas and well above the SW and UK averages (11% vs. SW 9%). The death rate exceeded the birth rate in 2008 resulting in shrinkage of Torbay's business population, a sign of acute stress in Torbay's economy.

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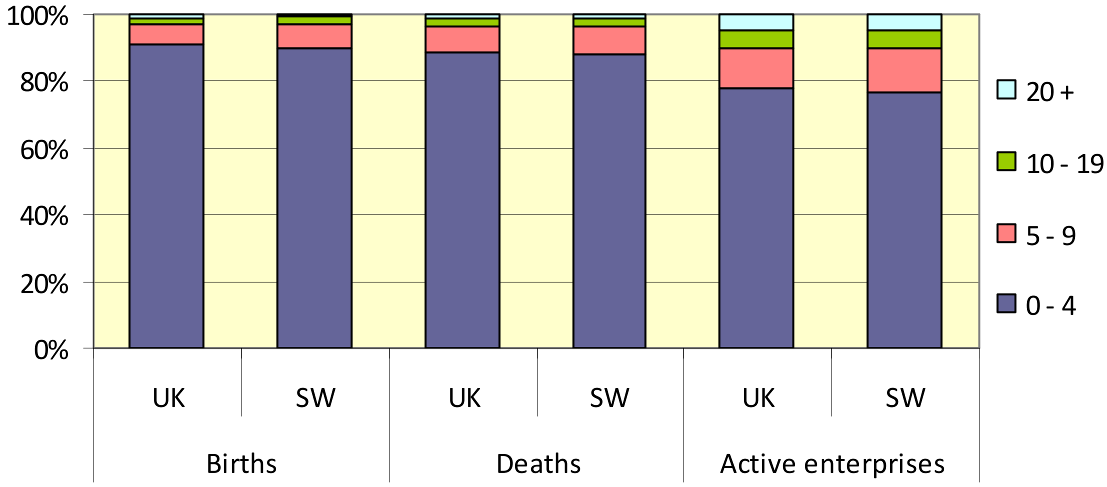
[10] A higher number of active businesses is reported in Business Demography than in UK Business: Activity, Size and Location (cited earlier). The Business Demography methodology takes into account businesses that were active at any time during the reference year.

[11] No longer registered for VAT or PAYE, or had no turnover

Figure BS6: Business birth, death and all active enterprises by employment size, 2008

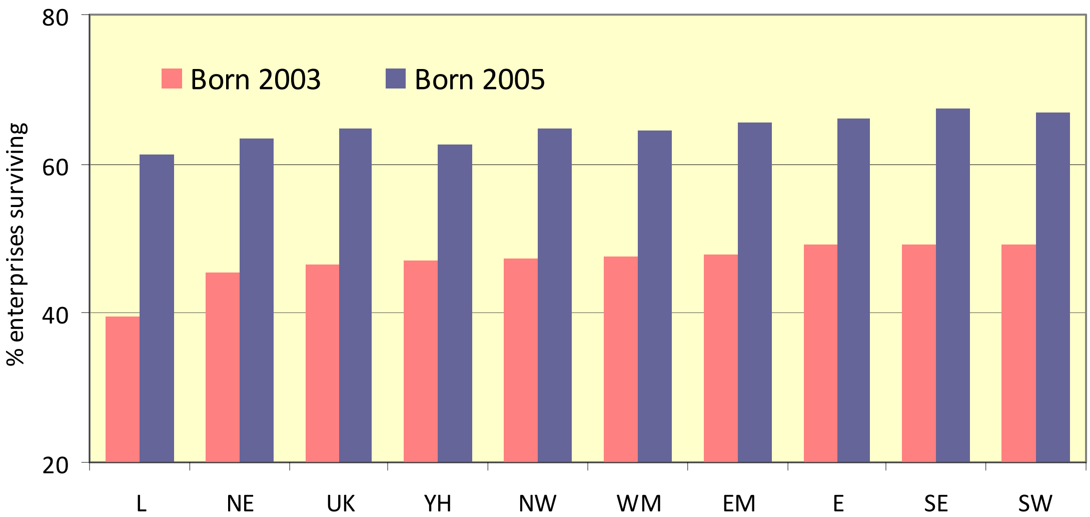


Source: Business Demography 2008, ONS

The South West performs well in terms of business survival, suggesting that the region provides a good environment for new businesses to thrive in. Again, it may reflect less competition relative to other regions, such as the highly productive London and South East where more intense competition elicits creative destruction.

Figure BS7 shows the proportion of businesses registered in 2003 and 2005 and still active in 2008 (i.e. the five-year and three-year survival rates, respectively). Less than half of businesses are not still active five years after starting up. For businesses "born" in 2003 only 46.6% survived nationally. In the South West however, a slightly higher percentage (49.3%) continued to trade in 2008 – this was the second highest in the United Kingdom after Northern Ireland.

Figure BS7: Regional enterprises registered in 2003 and 2005 and still active in 2008



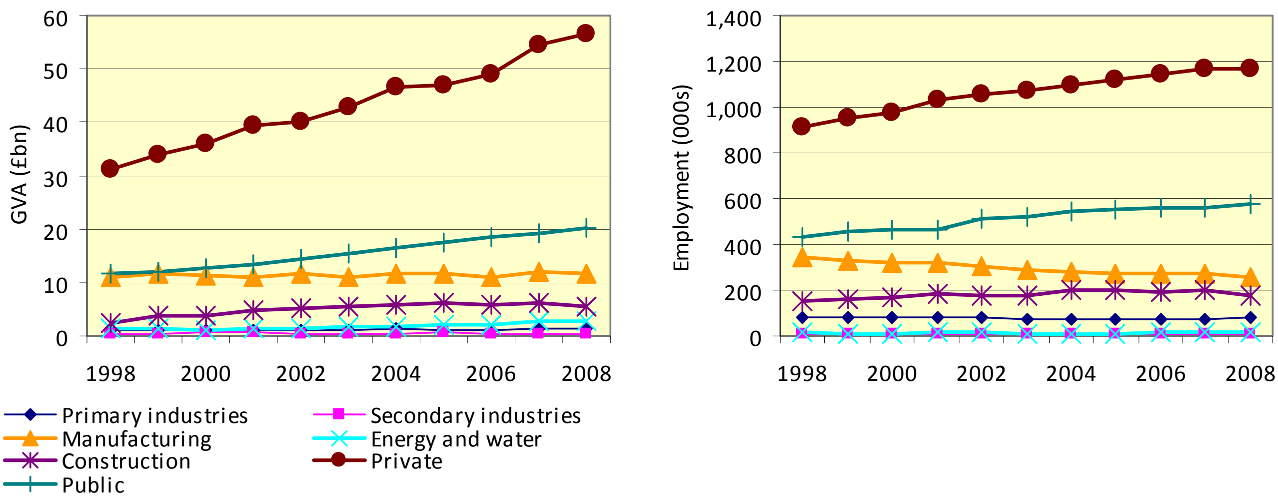
Source: Business Demography 2008, ONS

Survival rates have broadly increased since 2003, both regionally and nationally. 92.6% of SW businesses started in 2003 survived one year, compared to 95.5% of businesses started in 2007. This may reflect the buoyant economic conditions experienced in the years up to 2008 – the effect of the recession on business survival will be discussed later.

GROSS VALUE ADDED, EMPLOYMENT AND PRODUCTIVITY

It is well recognised that developed economies such as that of the United Kingdom have been undergoing a restructuring of output by industry. For example, much new investment in manufacturing is moving, often through off-shoring or out-sourcing, from companies based in these economies to countries with cheaper labour and production costs and, as a result, western economies are increasingly dependent upon growing service sectors for their generation of wealth. In relative terms, SW manufacturing has been losing output and employment shares and SW business services have been gaining since the late 1990s. Without radical change, this structural shift is expected to continue for the foreseeable future. There is a lot more detail at a sub-sector level, however, with relative "winners and losers" to be found across a range of manufacturing, services and other activity sectors[12].

Figure BS8: SW GVA (current prices) and FTE employment by broad sector



Source: South West Regional Accounts, South West RDA

Over the period 1998 to 2008, the SW economy grew from £59 billion to £98 billion in terms of total Gross Value Added (GVA) – growth of 5.2% per annum, compared to an average of 5.5% per annum for

[12] Analysis of the South West's changing industrial structure can be found in two Economics Review articles. Economic restructuring in South West England – Economics Review 8 (May 2007). South West England business & financial services – Economics Review 12 (May 2008). Available at economy.swo.org.uk/publications/economics-review.

Great Britain[13]. These totals are in nominal terms, i.e. including inflation. Full-time equivalent (FTE) employment grew from 1.94 million to 2.28 million over the same period (1.6% per annum, compared to 1.2% for GB). Figure BS8 shows how this change is distributed by broad sector group, with most of the growth clearly seen to be in private services.

The two charts show broadly similar patterns – the key trend being the rise in both public and private services. The main difference between the charts is the contraction of manufacturing employment whilst output remained stable, though this flat output line represents a decline in GVA in real terms. Manufacturing output in the South West grew slightly faster than GB (0.5% and 0.3% per annum), as did agriculture (1.8% vs. 0.3%). Similarly, the SW manufacturing labour force has contracted at a slower rate than nationally (2.5% decrease per annum, compared to 4.0% for GB), possibly due to less international exposure.

The SW construction sector doubled in output over this period, though employment increases were more modest. The sector started to slip back in 2008 with the onset of the recession – as discussed later.

The rise of services

The major change seen in the SW economy over this ten year period is the relatively rapid expansion of both public and private services. Private services output increased by 80% and public services by 75%, whilst employment increased by 28% and 34%, respectively. This is a pattern seen across Great Britain – SW employment in both of these groups grew somewhat faster than nationally (2.5% vs 2.0% per annum for private; 3.0% vs. 2.7% public), though output grew a slightly slower rate (6.2% vs. 6.4% for private; 5.7% vs. 6.0% public).

As the largest sector of these broad groupings, it is growth in private services that has contributed most to growth in the SW economy, responsible for 65% of the increase (67% GB) and three quarters of the increase in SW employment. Drilling beneath this relatively large grouping of diverse business types, it can be shown that all parts of private services increased in both employment and GVA terms. Financial services and business services output grew the fastest at 9% and 7% per annum, respectively, together responsible for two thirds of private services growth. Business services employment also rocketed at 4.7% growth per annum, accounting for 59% of private sector employment growth. Finance employment, on the other hand, remained largely unchanged over the same period.

The decline of manufacturing

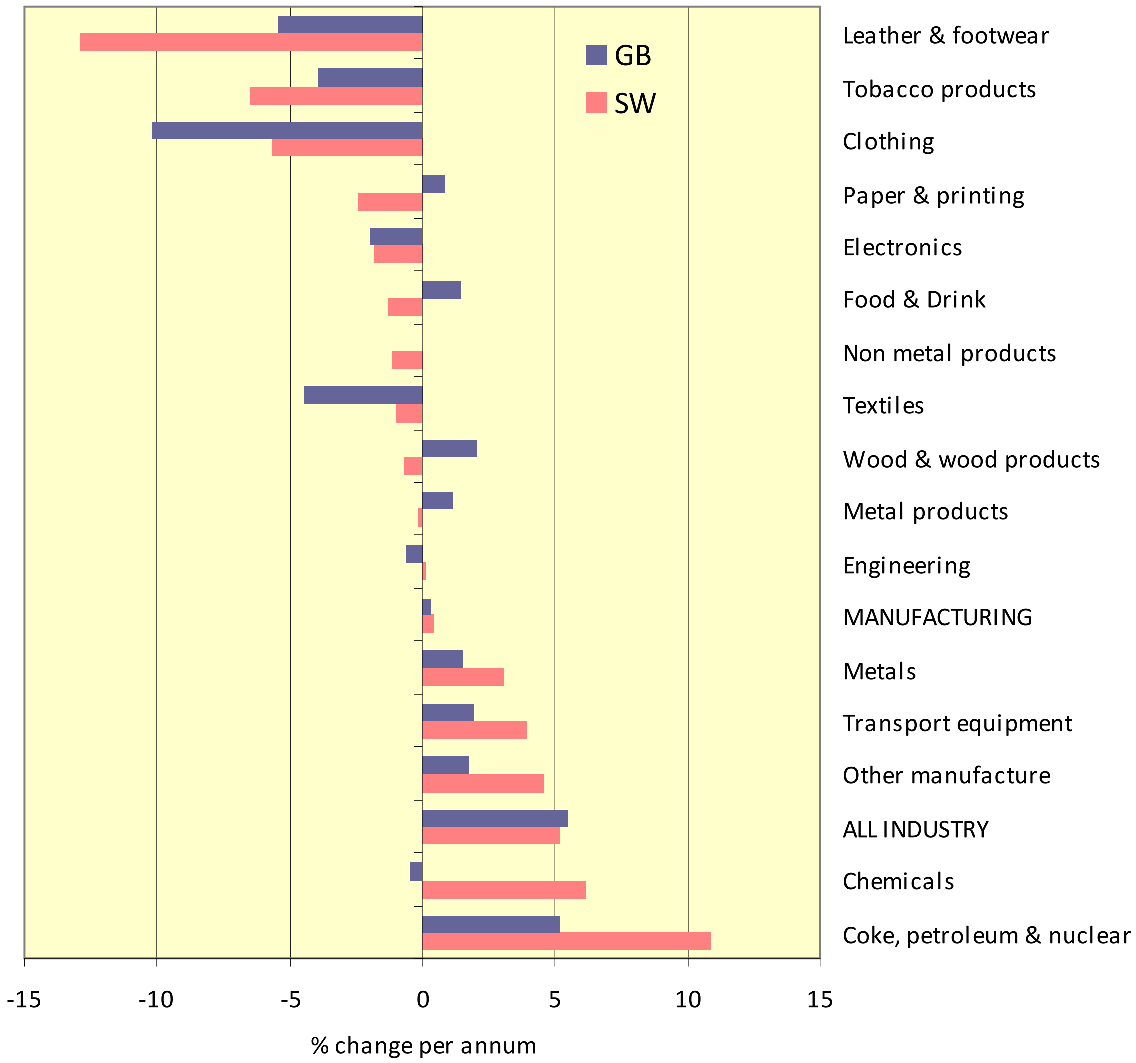
Although manufacturing employment is in decline, national data show that in volume terms UK manufacturing remained fairly stable from the late 1990s up to the middle of 2008 – however, the contribution to and the share of GVA declined over this period – from about 19% to 11% of GVA. SW

[13] The official ONS Regional Accounts GVA figures show GB growth to be 5.0%, UK growth to be 5.2% and SW growth to be 5.2% (per annum 1998 to 2008). The ONS figures exclude certain production activities, such as oil extraction – these are accounted for in the South West Regional Accounts, resulting in higher relative GVA growth nationally. There are also methodological differences in construction of the SW Regional Accounts figures and the ONS figures.

manufacturing GVA declined at a slightly slower rate than nationally, but like the national picture the sector has seen substantial losses in employment. But, who are the losers and are there any winners?

In 2008, the South West had an 8% share of GB manufacturing, broadly in line with its share of all GB industry. The top four SW manufacturing sectors by size are transport equipment, electronics, food and drink, and engineering – which accounted for 58% of manufacturing and 7% of the SW economy. This suggests that the South West has a clear competitive advantage in these sectors as a whole, which account for only 45% of GB manufacturing and 5% of the GB total. Indeed, all four are relatively important to the region and include parts of three of the regional priority sectors – advanced engineering, food and drink, and ICT.

Figure BS9: Annual change in manufacturing GVA by sub-sector, 1998 to 2008



Source: South West Regional Accounts, South West RDA

Figure BS9 shows the change in SW manufacturing GVA between 1998 and 2008 by manufacturing sub-sector. Performance has been very mixed with about half of the SW sub-sectors increasing and the other half decreasing – thus restructuring is occurring within the manufacturing sector as well as across the economy as a whole. This may be explained by increased specialisation, driven by globalisation and the region's revealed comparative advantage.

Five sub-sectors showed growth above the average for SW manufacturing (0.5% per annum), though only two above the all industry average (5.2% per annum). The greatest growth was in coke ovens, refined petroleum and nuclear fuel, though this not that interesting in terms of the overall SW economy as it is a very small sector (1.6% of SW manufacturing in 2008). The chemical sector accounts for just under 7% of SW manufacturing in 2008 and grew at 6% per annum. Transport equipment accounted for 23.5% of manufacturing in 2008 and grew by 3.9% per annum.

At the other end of the spectrum, paper and printing (about 8% of SW manufacturing) declined – much of the slip was in 2008 as the recession started, though this is part of a longer term decline. Significantly, electronics, one of the largest manufacturing sub-sectors, also declined over the period. As a sector comprising many high tech manufacturing industries, this is of concern both regionally and nationally. Engineering and food and drink, also important sectors for the South West saw only a small change over the same period, though a decline in real terms.

There are differences in the patterns shown by the South West and Great Britain. While transport equipment provided the largest positive contribution to manufacturing change in the South West, the GB sector did not increase as much – the chemicals sector, though relatively small in SW England provided the second largest contribution to growth, while the GB sector declined. A number of manufacturing sectors declined in both the South West and GB.

In terms of employment, there is decline in manufacturing both in the South West and nationally – a 24% and 33% fall, respectively, between 1998 and 2008. All SW sub-sectors saw a decline, with the exception of transport equipment which has maintained its workforce at around 43,000 FTE workers compared to a 23% decline nationally.

Productivity

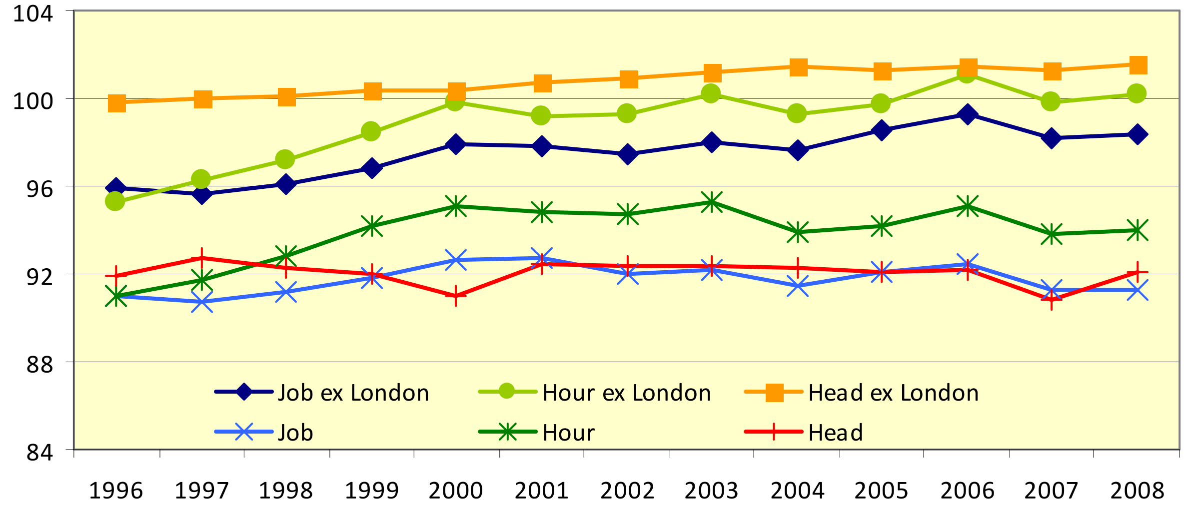
Productivity is the relative efficiency with which inputs are converted to outputs and is a key indicator for comparing the success and health of economies. There are a number of ways in which regional and sub-regional productivity can be measured – the most used being output per hour, output per job, or output per head.

In terms of UK regional productivity, all of these relative measures are generally skewed due to the effect of London's high GVA and productivity driven upwards by the capital's globally facing financial sector (and other business services). It is not necessarily "fair" to compare the productivity of regions distant from and with very different economic makeup with that of London. An analysis of relative productivity, with and without London, was carried out to see how SW productivity compares with the other parts of the United Kingdom – see Figure BS10.

The chart shows that excluding London from the analysis pushes up productivity for the South West on all three measures – the order of the three measures changes slightly, however. On a per head basis, the South West performs at or slightly above the UK average (excluding London) – this measure jumps the most as the impact of London's extremely high level of commuting is excluded, and is the highest measure, possibly due to the higher proportion of economically active people in the region. Higher productivity values per hour (with and without London) than per job illustrate the effect of higher than average levels of part-time working in the South West. There has been some progress on all measures, particularly in the late 1990s, after which the region was able to consistently match the average UK performance (with and without London).

According to the South West Regional Accounts, SW productivity as measured by GVA per full-time equivalent (FTE) employee was £43,052 in 2008, 12% lower than that in Great Britain, again pushed higher by London and the greater South East – the gap reduces to only 3% lower if London is excluded.

Figure BS10: Relative SW productivity (UK and UK ex London=100)



Source: Regional productivity, ONS

As shown in Table BS1, there is considerable variation by sector - from £216,865 per FTE in the energy and water sector to a low of £16,366 in primary industries. Importantly, transport equipment and business services, key components of growth over the last decade, are 54% and 47% above the SW average, respectively and both slightly higher than the equivalent GB figure. On the other hand, other key sectors for the South West have relatively low productivity relative to either the SW average or the average for the GB sector – for example, hotels and catering is 40% less productive than the SW average, while food and drink manufacture is 7% less productive than the SW average and 17% less productive than the GB food and drink sector.

Productivity varies across the region. GVA per head in 2007 (where UK=100) ranged from 151 in Swindon and 134 in Bristol, to 64 in Cornwall and 63 in Torbay. These figures are skewed because they do not account for commuting, pushing urban productivity measures up – nonetheless they demonstrate greater variation than in any other region and significant disparity in economic prosperity across the South West.

Productivity in urban centres is also higher due to the effect of agglomeration. Agglomeration refers to the benefits (and also costs) that firms face by locating relatively close to one another. Typically, this relates to the ability of firms to benefit from economies of scale (which are internal to the firm) and network effects (which exist between firms).

Table BS1: SW productivity by industrial sector, 2008

	% of SW economy	£ per FTE worker	as % of GB	As % SW average
All industries	**100.0**	**43,052**	**88**	**100**
Primary industries	**1.3**	**16,366**	**103**	**38**
Secondary industries	**0.3**	**80,647**	**20**	**187**
Manufacturing	**11.8**	**45,061**	**88**	**105**
Food and Drink	1.4	40,175	83	93
Tobacco products	0.0	146,047	78	339
Textiles	0.1	42,861	113	100
Clothing	0.1	42,538	99	99
Leather and footwear	0.0	38,022	86	88
Wood and wood products	0.2	25,374	70	59
Paper and printing	0.9	37,006	69	86
Coke ovens refined petroleum and nuclear fuel	0.2	146,174	85	340
Chemicals	0.8	76,103	97	177
Non metal products	0.9	37,862	87	88
Metals	0.1	59,473	72	138
Metal products	0.9	30,585	75	71
Engineering	1.2	39,962	91	93
Electronics	1.5	49,470	98	115
Transport equipment	2.8	63,338	102	147
Other manufacture	0.7	36,985	95	86
Energy and water	**2.9**	**216,865**	**96**	**504**
Construction	**5.7**	**31,530**	**74**	**73**
Services	**77.9**	**43,766**	**91**	**102**
Distribution and retail	12.3	33,339	84	77
Hotels and catering	3.4	25,964	98	60
Transport and communication	5.9	45,900	87	107
Finance	7.2	93,551	90	217
Business services	25.0	66,256	103	154
Public administration and defence	6.4	41,909	109	97
Education	6.2	38,998	94	91
Health and social services	8.0	28,630	94	67
Other services	3.7	33,027	79	77

Source: South West Regional Accounts, South West RDA

Research was recently commissioned by the South West RDA to consider the relationship between productivity and agglomeration and to identify empirically whether spillover effects (positive or negative) exist from the South West's primary urban areas to their surrounding hinterland[14]. Compared with the rest of England, the South West has more low productivity districts than any other region. At a national level, UK agglomeration and spillover positives are concentrated in London and the Greater South East, including a bit of the South West at the edge (largely Swindon). Spillover effects tend to dissipate between 40 to 50 miles from a centre of agglomeration - it is not surprising that agglomeration centres are weaker in the South West than nationally given the lower density of economic and demographic concentration, and even at a 30km level, the relationship between spillover and productivity is weak.

As with previous research into the causes of the productivity differential in the region[15], the results suggest a strong role to play for greater levels of capital stock and full-time working. Furthermore, there is strong evidence using analysis at 10km to 20km distances from urban centres that spatial spillovers enhance agglomeration and benefit major conurbations, suggesting that strengthening the urban core areas will further enhance their labour productivity.

The findings of this research have implications for how economic development should or could be targeted to enhance agglomeration or spillover effects to and from the region's priority places.

[14] What does firm level data tell us about the agglomeration and spillover effect? Dr Don J Webber, 2010 (available at economy.swo.org.uk/research/corporate-research-programme/). Summarised in Economics Review 20 (May 2010).

[15] 'Meeting the Productivity Challenge', Boddy et al. Universities of West of England and Bath. For South West RDA, 2005

THE RECESSION AND RECOVERY

The United Kingdom recently emerged from recession and recovery is hopefully underway. Despite a pressing need to understand how local businesses have performed during the recession and whether they are yet benefiting from the recovery, assessing sub-national economic performance is problematic due to the lack of or lag in production of robust statistics.

Regional statistics tend to lag UK figures – sub-regional datasets are even further behind. For example, at the time of writing UK GDP figures are available for 2010 Q2, so only a couple of months behind – 2009 GVA for the regions is expected in December (but with no industrial detail), along with 2008 GVA for the sub-regions, including industrial breakdown.

This section looks at how the SW economy and businesses across the region have weathered the recession and what the prospects are for the short- to medium-term. National level statistics provide some clues as to what we might see in the regional figures when they eventually appear. The analysis also draws on regional statistics where available, as well as a range of survey information on business sentiment regarding the coming months.

ECONOMIC INDICATORS

Output

Overall, UK real GDP contracted by 4.9% in 2009; this followed a 0.1% decline in 2008. Although the country officially emerged from recession in the final quarter of 2009, growth was weak in the first half of 2010. The unexpectedly sharp growth in Quarter 2 2010 of 1.2% is encouraging but many commentators consider this to be a blip which will not be sustained, particularly given the anticipated reduction in government spending. Figure RR1 shows how most industries began to experience a fall in output (albeit to varying degrees) in the second half of 2008 before beginning to stabilise or even start to pick up a year later.

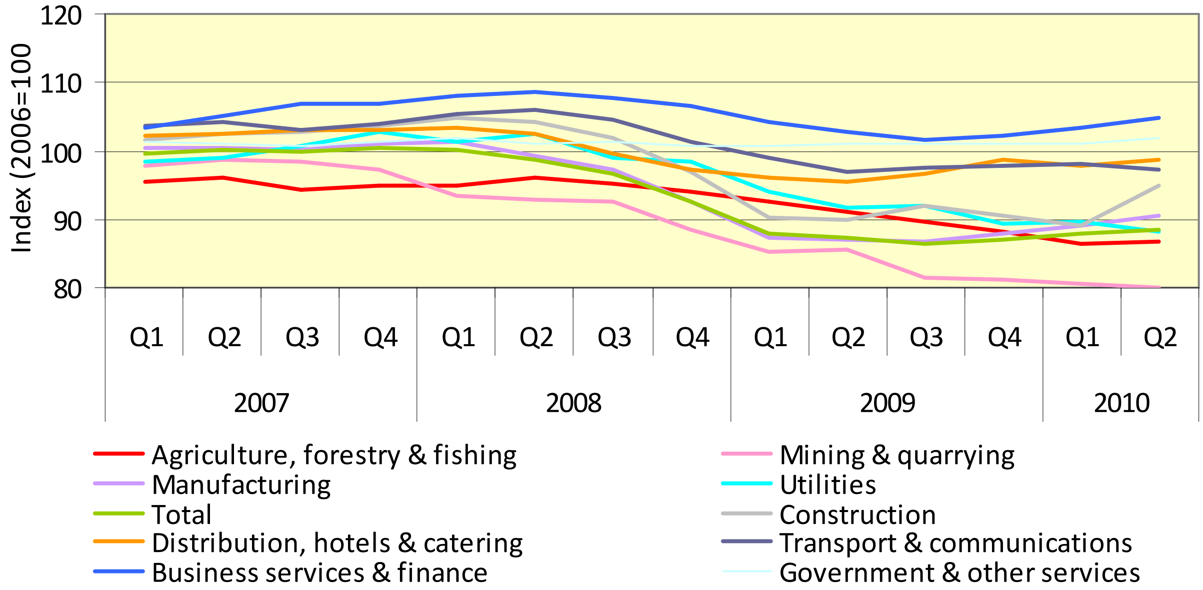
In relative terms, the production industries (manufacturing, utilities and mining & quarrying) appear to have been hit the hardest, with the largest declines in output over the period of the recession (Q2 2008 – Q3 2009), though the extractive industries have been in long-term decline. Manufacturing saw the largest fall in output (-14.5% peak to trough) overall; however, it appears to have picked up faster than other sectors with three consecutive quarters of growth.

The seasonally adjusted index of manufacturing in June 2010 rose by 4.1% compared with June 2009, with output increasing in nine of the 13 manufacturing sub-sectors. The largest contributors to the 4.1% year on year rise were approximately 1.0 percentage points from the machinery and equipment industries (12.9% increase) and approximately 0.9 percentage points from the transport equipment industries (9.0%). The South West has relatively large shares in the main components that make up this growth – mechanical power machinery, motor vehicles and ship building. The relatively speedy recovery of these sectors could be good news for SW business.

For services, the transport and communications sector recorded the largest decline in output over the recession period (-8.4% peak to trough) and saw a further dip in 2010 Q2 as a result of the Icelandic volcanic ash cloud and industrial action. Government and other services recorded the smallest (-1.2%

peak to trough) decline and output stayed relatively flat throughout. However, government services is expected to come under increasing pressure in the months ahead as the impacts of the government's fiscal tightening start to feed through into output figures.

Chart RR1: UK GVA Index by industry. Chained Volume Measures (2006=100)



Source: National Accounts, ONS

An ONS pilot project looked at the possibility of producing more timely and detailed data on regional output. The data produced by this project is classed as experimental with the large majority not meeting the quality standards required for ONS methodologies. The data covers 80% of the economy, excluding agriculture, forestry & fishing; public administration & defence; education; health and social work[16.] Table RR1 shows the change in regional output by broad industry groupings (production, construction and market services) during the first half of the recession, with relative shares of regional GVA.

In the South West, the production industries appeared to perform fairly well through the period covered by these indicators, with the lowest estimated decline in output of the English regions. Similarly, the decline in construction output was lower than the UK average (-10.0% versus 13.7%) and about half the decline of that seen in the northern and midland regions, where construction accounts for a greater share of GVA. Market services (i.e. business & financial services, transport & communications and retail…etc) accounted for around 55% of SW GVA in 2005; slightly lower than the United Kingdom as a whole but significantly lower than London and the South East. Between 2008 Q1 and 2009 Q2, market services output declined by 4.8% which was at the less severe end of the range of regional performance, but not the best. These relatively positive results do not necessarily show that the South West was affected less badly than elsewhere – it may just have been affected later.

[16] More details can be found in Economics Review 19 (February 2010) - 'Regional short term indicators – an ONS pilot project'. Available at economy.swo.org.uk/publications/economics-review.

Table RR1: Change in broad industry output – 2008 Q1 to 2009 Q2, and share of regional GVA

	Production		Construction		Market Services	
	% change	% share of GVA, 2005	% change	% share of GVA, 2005	% change	% share of GVA, 2005
SW	**-9.8**	**16.7**	**-10.0**	**6.3**	**-4.8**	**54.7**
NW	-10.2	19.3	-20.4	6.8	-4.2	54.2
E	-10.8	15.5	-13.9	7.9	-7.3	59.2
YH	-12.4	19.9	-21.9	7.2	-8.1	51.5
UK	**-12.9**	**17.2**	**-13.7**	**6.3**	**-5.7**	**57.4**
EM	-12.9	21.9	-23.4	7.0	-3.6	51.8
L	-16.1	6.5	-6.6	3.9	-3.2	74.8
NE	-16.5	21.3	-23.4	7.6	-4.7	46.5
SE	-17.8	13.7	-13.9	6.2	-6.7	63.8
WM	-23.4	19.7	-24.8	6.5	-8.2	53.5

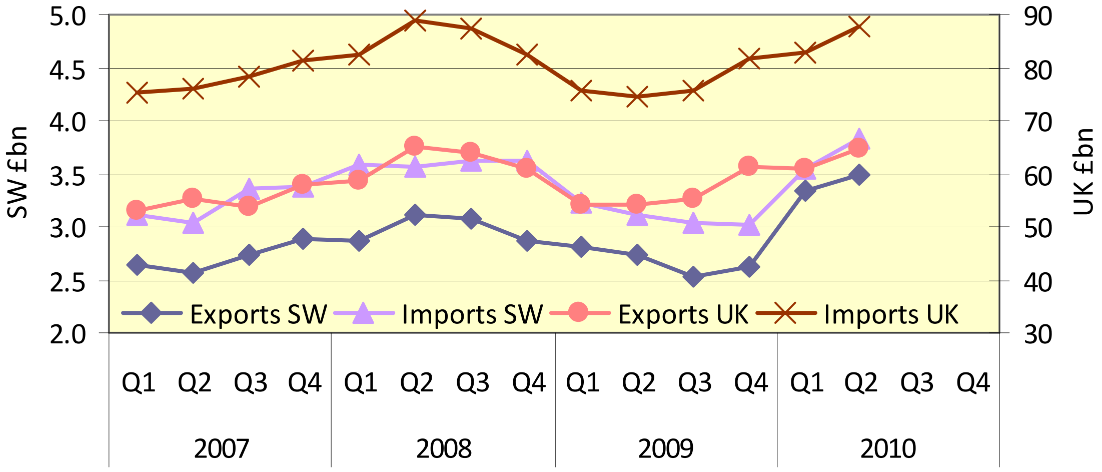
Source: Short term regional indicators, ONS

South West international trade

The links between trade and competitiveness are well established. Engagement with international trade can lead to a boost to productivity by increasing competitive pressures and enabling firms to gain economies of scale, thereby specialising in line with their comparative advantage. International trade is hoped to be the key to economic recovery in the coming months and years. The question is: how well is SW business, with its relatively low propensity to engage in the global economy, positioned?

Chart RR2 shows the trend in quarterly values of SW and UK exports and imports in goods between 2007 and the first half of 2010. Both exports and imports fell as a result of the recession, as demand diminished across all markets. Throughout 2008, the impact on trade appeared to be relatively muted with exports only dropping slightly in the second half and imports remaining fairly stable. The intensification of the downturn and associated decline in consumption in 2009, however, triggered a sharp fall in trade values. Although exports started to decline earlier, the value of SW imports fell more steeply, particularly in the first quarter of 2009. This reflects the relative depth of the UK downturn as well as suggesting that the weakness of Sterling against key currencies (i.e. US dollar and Euro) may have mitigated a more substantial fall in exports. Overall, total exports decreased by 10% in value between 2008 and 2009 (though 19% peak to trough – 2008 Q2 to 2009 Q3) while imports decreased by 15% (16% peak to trough 2008 Q4 to 2009 Q4). This had the positive effect of reducing the region's annual trade deficit (which had been growing yearly since 2006) from £2.5 billion in 2008 to £1.7 billion in 2009.

Chart RR2: SW international trade in goods (Q1 2007 – Q1 2010)



Source: uktradeinfo (HMRC)

A small upturn in SW exports in the final quarter of 2009 and more steeply in both imports and exports in the first two quarters of 2010 could signal the start of a more prolonged recovery as the global economy starts to progress and as exchange rates remain favourable for the region's largest trading partners.

Overall, the value of exports decreased across most broad sectors (to varying extents) over the period of the recession. The exception was the food, drink & tobacco sector, which experienced export growth (see Table RR2).

Table RR2: SW exports by broad sector (2009)

	£m	% total exports	% share of UK	% change 2008-2009	
				£m	%
Food, drink & tobacco	531	5.0	3.7	62	13.1
Crude materials & mineral fuels	182	1.7	0.6	-27	-13.1
Chemicals & oils	745	7.0	1.6	-317	-29.9
Manufactured goods	979	9.1	4.0	-153	-13.6
Machinery & transport	6,786	63.3	8.6	-600	-8.4
Other*	1,494	13.9	5.0	-1639	-10.2
Total	10,718	100.0	4.7	-1,200	-10.3

* Includes miscellaneous manufactured goods and commodities not classified elsewhere.
Source: uktradeinfo (HMRC)

In absolute terms, the machinery and transport equipment sector saw the largest decline between 2008 and 2009, though the smallest in relative terms. The particularly sharp rise in SW trade in Q1 of this year is attributed to strong growth in trade in this product group (39% and 45% increase in exports and imports, respectively, compared to previous quarter), more specifically "power generating machinery and equipment" (491% and 671% increase in exports and imports, respectively!). Similar levels were achieved in the second quarter too. Interestingly, Scotland seems to have lost levels in "power generating machinery and equipment" trade similar to those gained by the South West, so the transfer may be something to do with the renewable energy sector.

Chemicals & oils experienced the largest decline in percentage terms and, as a result, the South West's share of UK exports in the chemicals & oils sector declined from 2.4% in 2008 to 1.6% in 2009, suggesting that the region performed much worse than average. Although it experienced a decline of 13.5% in export value between 2008 and 2009, SW manufactured goods saw its share of UK exports rise from 3.5% to 4.0% suggesting other regions may have been more adversely affected in this sector over this time period.

For a more detailed analysis of SW trade, see Economics Review Issue 20 May 2010 article 'South West International Trade – recession and recovery'[17].

Construction output

The value of construction output in the South West in 2009 was £981 million (9%) lower than in 2008, the result of a large fall in the value of new private work[18]. The values of new private housing construction and new private non-housing or infrastructure work in the region were, respectively, £555 million (30%) and £837 million (26%) lower in 2009 than in 2008. These decreases were only partially offset by increases in the value of public work (£103 million or 14%) and repair and maintenance (£44 million or 1%).

In the second quarter of 2010, the latest date for which regional data are available, the value of construction output in the South West was about 8.2% of the total for Great Britain as a whole.

In most regions, the value of construction output reached a peak in late 2007 or early 2008 and decreased over the remainder of the period, with things really only beginning to pick up in the last quarter, where the increase in output from construction was the main driver for the high increase in total GDP nationally.

Using an index based on the value of construction output in each region in the first quarter of 2006 allows comparisons of how output varied in the quarters after this date. Figure RR3 shows that, during the next four years, and even during the recession, the performance of the SW construction industry was consistently above-average (where average is defined as the median of the 11 British regions).

Values for new orders (excluding repairs and maintenance) tend to be more volatile and lower than values for output. As Figure RR4 shows, smoothed data[19] provide early indications of changes in trends. Following a downward trend that started in late 2007, there was a sharp upturn in the value of new orders in the South West in the first quarter of 2010 followed by a dip in Q2 – the fall appears to be an

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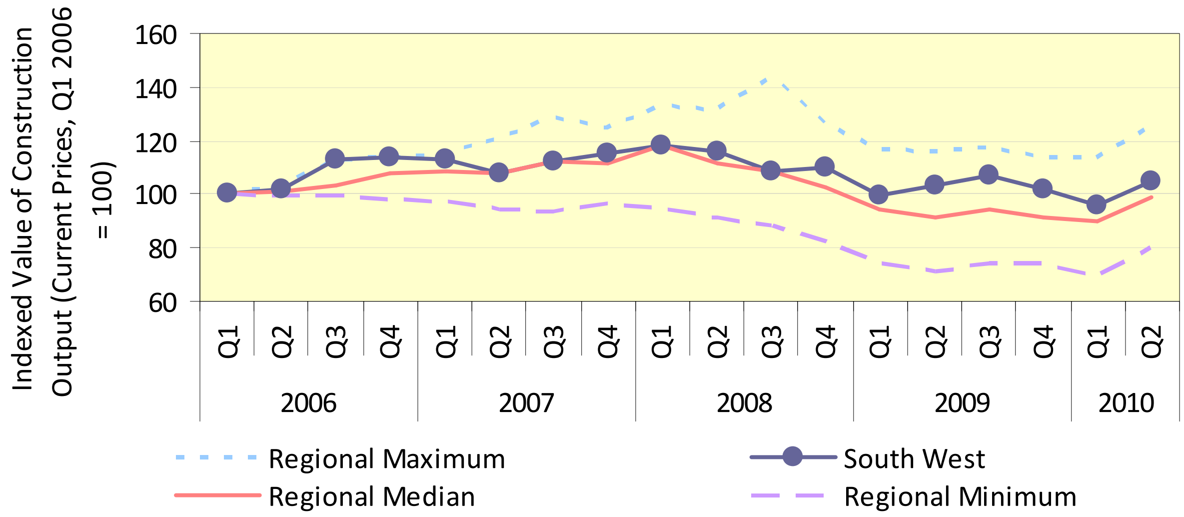
[17] Available at economy.swo.org.uk/publications/economics-review

[18] Based on analysis by Eddie Smith, Regional Analyst for the South West

[19] This smoothing process uses data from the most recent five quarters in the proportions 0.5, 0.2, 0.15, 0.1 and 0.05 (most recent quarter first)

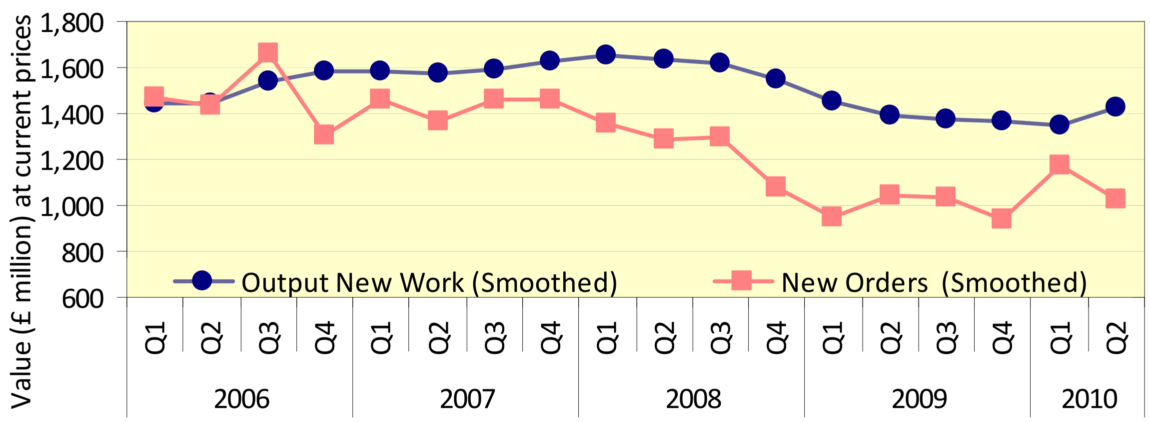
adjustment following a good Q1, particularly for "other public non infrastructure" construction. It's not necessarily an indication of a renewed downturn but public sector funding of construction in future is likely to be at a lower level than in the recent past.

Figure RR3: Index of Construction Output, Q1 2006 to Q1 2010



Source: Based on analysis of ONS construction statistics by ONS regional analyst

Figure RR4: South West Construction (New Work) Output & New Orders Q1 2006 to Q2 2010



Source: Based on analysis of ONS construction statistics by ONS regional analyst

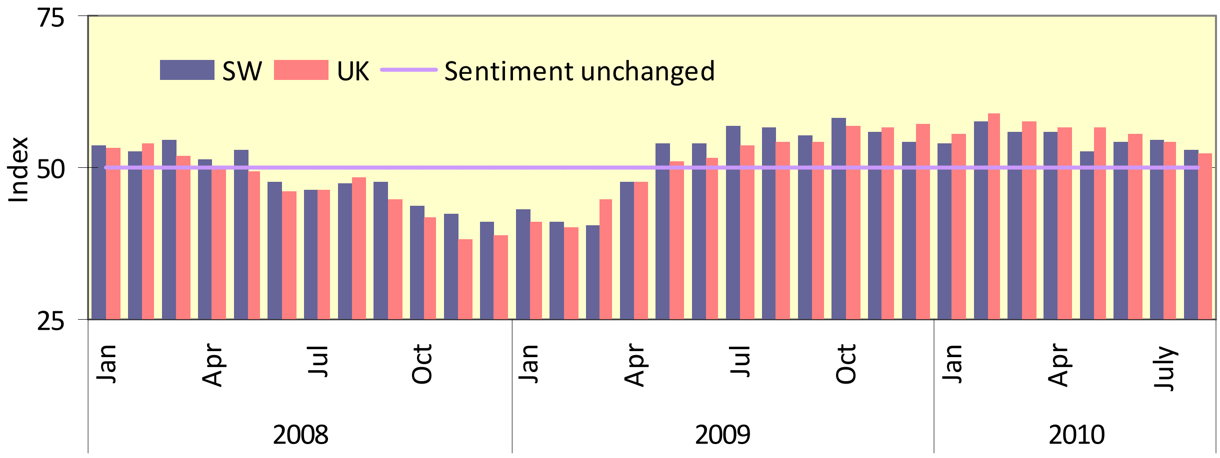
BUSINESS CLIMATE

Business surveys and confidence indicators can also be used to gauge how businesses are now performing post-recession, as well as the current "mood" of business and confidence regarding future prospects – they also tend to be more up-to-date than the official statistics.

Purchasing Managers Index

The latest Purchasing Managers Index (PMI) confirmed a sixteenth month of consecutive growth in business activity. Chart RR4 shows the monthly change in the index of output since the start of 2008: a score of 50 means 'no change' on the previous month, anything above means an increase in output and anything below signals a decline.

Chart RR4: Purchasing Manager's Index of Output



Source: Purchasing Managers Index

Based on this index, the South West effectively lagged the United Kingdom into recession – possibly explaining relatively good ONS output indicators and relatively poor financials more recently. The PMI turned negative in June 2008 and, overall, remained below the line for eleven months in total. Between November 2009 and June 2010, whilst remaining positive, the SW index stayed below the UK average – May 2010 was of particular concern when the index fell sharply to 52.8 and was 3.6 points shy of the corresponding UK value. Encouragingly, data for July and August see the SW index back above the UK average, though August's figures have slipped back for both, perhaps due to the mounting concern about the impact of public sector cuts. This continued overall rise in output can be attributed to gains in activity in manufacturing industries; the service sector, in contrast, continued to contract.

Following a five month expansion in staffing levels in the region, August's release saw levels remaining the same as the previous month; for the United Kingdom as a whole, the survey revealed a moderate level of staff shedding. These results again reinforce the fragility of the economic recovery which is not evident in national labour market statistics. Those businesses reducing the size of their labour force cited natural wastage and lighter workloads as the driving factors. Sectorally, the picture has been mixed, with manufacturers reporting a marked rise in employment in recent months, while service sector businesses have reduced their intakes.

Input prices for regional firms rose for the twentieth consecutive month; this was predominantly due to a higher price for raw materials and higher wages. Mirroring this upward trend, companies (predominantly manufacturing) raised their charges in August to protect profit margins. Output prices have been rising since February but still remain lower than pre-recession levels.

England's rural PMI, though not broken down into regions, gives some indication of economic conditions for the private sector in rural areas more generally. As the largest, rural region, the findings are relevant to the South West. The latest report (July 2010) states that business activity in rural England rose in June but at the slowest rate for 11 months. This reflected a fall in overall business levels in contrast to the economy as a whole. As with the main PMI index, this was largely due to weaker performance in the service sector which recorded a dip in business activity and new orders; while in contrast manufacturing firms continue to go from strength to strength. In terms of rural private sector employment, levels in June 2010 were at the lowest level recorded so far in 2010; conversely, modest employment growth was signalled across the English economy as a whole.

CBI Industrial Trends Survey

The CBI Industrial Trends survey, which focuses solely on UK manufacturing businesses, captures expert qualitative opinion from senior executives on past and expected trends across a number of economic indicators. The latest survey results (May-July 2010) confirm the trend, evident in other business surveys, of a positive national manufacturing sector performance with a strong rise in orders and a surge in output growth (the strongest since April 1995). Although orders increased for both domestic and export markets in the quarter, firms anticipate slower growth in the next; for domestic orders this is a result of a weaker outlook among small businesses (1-199 employees), while concerns over future economic conditions abroad was cited as an important factor in dampening the outlook for export orders. On a positive note, there are signs that capacity utilisation is normalising with a greater number of businesses planning to expand capacity in the year ahead.

The survey also confirmed an easing in credit access with fewer businesses reporting it as a restraint to output growth, though this was more pronounced in larger firms. Overall, business optimism was highest among medium and larger firms with smaller firms reporting a marginal decline in the quarter. This is of some concern to the South West given the aforementioned importance of its SME stock to the regional economy.

Business confidence

The Business Confidence Index provided by the ICAEW[20] is calculated from the responses to the following:

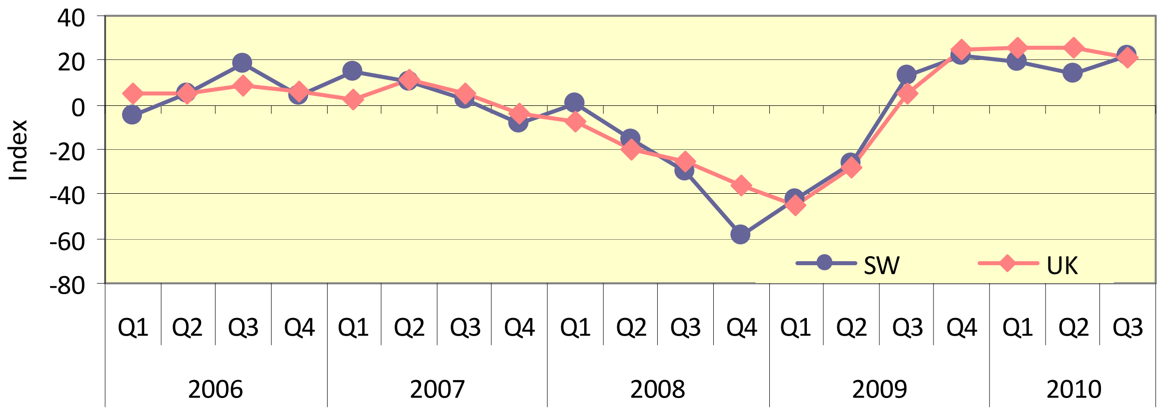
'Overall, how would you describe your confidence in the economic prospects facing your business over the next 12 months, compared to the previous 12 months?'

A score of 0 means the business is 'as confident', +100 'much more confident' and -100 'much less confident'. For the South West, 80 business professionals were interviewed– this is a fairly limited sample and so only tentative conclusions should be drawn from the results.

Business confidence in the South West and United Kingdom followed a similar downward trajectory into negative territory in the second half of 2007 as the credit crunch and expectation of the recession to come shook business confidence (see Figure RR5)[21]. At its lowest point (-58.1 in Q4 2008), the South West was ranked bottom of the English regions; the UK dipped to its lowest point (-45.3) a quarter later. In 2009, business confidence improved consistently and by the second half of the year, confidence was back into positive territory (i.e. slightly more confident over future prospects) both regionally and nationally. The chart shows that, although SW business confidence fell further (bear in mind the small sample size), it recovered at a slightly faster rate than the UK average.

Confidence in the first half of 2010 lagged the UK average: the UK index stabilised at around 25 while the SW index dipped slightly, falling by 4.9 points between Q1 and Q2. The latest index for Q3 shows that confidence has picked up to 22.0, now in line with the UK figure of 21.5.

Figure RR5: Confidence Index, Q1 2006 – Q3 2010



Source: Business Confidence Monitor, ICAEW/Grant Thornton

Although confidence picked up in Q3, the ICAEW also report that growth in key performance indicators for the South West softened in 2010 Q3, with expectations for the year ahead somewhat bleak. Growth rate for turnover, gross profits and sales volume for the last 12 months are all lower than the

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[20] Institute of Chartered Accountants in England and Wales – www.icaew.com
[21] ICAEW/Grant Thornton UK Business Confidence Monitor

UK average and the expected figures for next year are the lowest of all of the regions, suggesting that customer demand is weakening in the South West. 48% of firms report customer demand to be a greater challenge than a year earlier (37% nationally), with tourism bookings reported to be lower this year. On a more positive note, the ICAEW suggest that there is evidence of strengthening in labour market conditions in the region - demand for skilled labour is increasing and staff turnover becoming a greater challenge. However, late payments continue to be a problem for SW firms: in the second quarter of 2010, 38% of firms reported late payments from customers as a greater challenge than a year ago; the corresponding figure for the United Kingdom was 30%.

Credit

According to the Bank of England[22], the amount of money made available at a national level to the corporate sector overall in the three months to early June 2010 increased by less than had been expected in the previous survey (Qtr 1 2010). Over the longer term, the availability of credit hit its lowest point in the final quarter of 2007 - the so-called 'credit crunch' - remained negative (i.e. a decline in credit availability) throughout 2008, turning positive in 2009. The balance in the second quarter of 2010, although still positive, was back down to what it was in the first quarter of 2009. Lenders feel that continued macroeconomic uncertainties will continue to constrain availability.

On the upside, lenders reported that the amount of credit made available to small businesses had increased in the past three months. Demand for new credit facilities from small businesses was reported to have strengthened in the second quarter of 2010, while demand from medium and large private non-financial corporates recorded an unanticipated fall. Lenders expect demand from small businesses to strengthen further in the next three months.

The ICAEW survey mentioned earlier also suggests that the challenge of access to capital continues to ease and is now more in line with the levels seen before the credit crunch. About one in six businesses in the South West reported that access to capital was a greater challenge than 12 months ago, down from nearer to 1 in 3 a year ago. However, the ICAEW report also suggests that demand for new debt is limited as firms are managing their costs by other means.

British Chamber of Commerce (BCC) survey

This Quarterly Economic Survey from the British Chamber of Commerce (BCC) covers over 5,000 businesses belonging to the Chambers of Commerce in the United Kingdom and asks questions on a wide range of issues including exports, sales and orders, investment, confidence and price pressures. The latest survey findings (2010 Q2) show an increase in both domestic sales and exports for the UK manufacturing sector: both above pre-recession levels – the former at their highest level since the final quarter of 2007 and the latter at their highest since the third quarter of 2006. This is in line with the SW trade figures discussed above which show a substantial uplift in exports in the first quarter of 2010. Elsewhere, domestic and export sales for the UK service sector have improved at a rather subdued pace and are still low compared to historical levels.

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[22] Credit Conditions Survey, Bank of England

Deviation between manufacturing and service sector performance is also evident in business confidence balances: manufacturing turnover and profitability confidence rose to its highest level since Q1 2008 while balances for the service sector weakened.

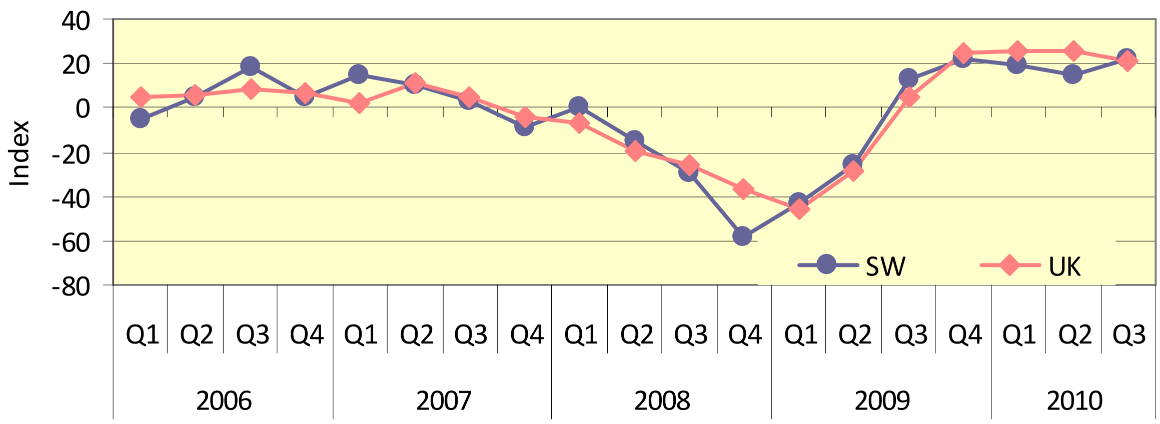
Of some concern from the latest quarterly survey, however, is the pressure manufacturing firms are facing due to increased prices of raw materials. Furthermore, although both manufacturing and service sector cash flow balances have improved in the second quarter they remain low by historical standards. So, while there are encouraging signs of recovery (mirroring the national trends in output), the recovery remains fragile. It is vital that the right conditions to foster further growth are maintained.

GfK Consumer Confidence Barometer

On the demand side, the UK Consumer Confidence Survey from GfK gives us an up to date picture of the financial position of consumers and their perception of current and future economic conditions. The results must be considered alongside business survey evidence in order to gain a fuller understanding of how the economy is likely to perform in the short-term. The survey is based on a sample of 2,000 individuals aged 16 or over and is carried out on behalf of the European Commission.

The latest survey results show a weakening in consumer confidence nationally with a fifth successive month of decline in the overall index up to July 2010 (see Chart RR5). This decline effectively cancels out the recovery recorded in the index between December 2009 and February 2010, and is most likely fuelled by consumer concern over future spending cuts, job losses and tax rises. Compared to a year ago, however, the overall index score points to a small improvement. This is partly due to a less negative evaluation of the general economic situation over the last 12 months i.e. consumers were less negative about the year up to July 2010 than the year up to July 2009. Also, on a more positive note, the climate for major purchases is less negative than 12 months ago. Expectations for the general economic situation over the next twelve months, however, are considerably lower than a year ago. In addition, the forecast for personal finances over the next 12 months is negative compared to a year ago (July 2009) when it was zero. Overall, consumers seem to have been more positive over the last 12 months but are anticipating tough times ahead.

Chart RR5: UK Consumer Confidence Barometer – July 2010



Source: GfK

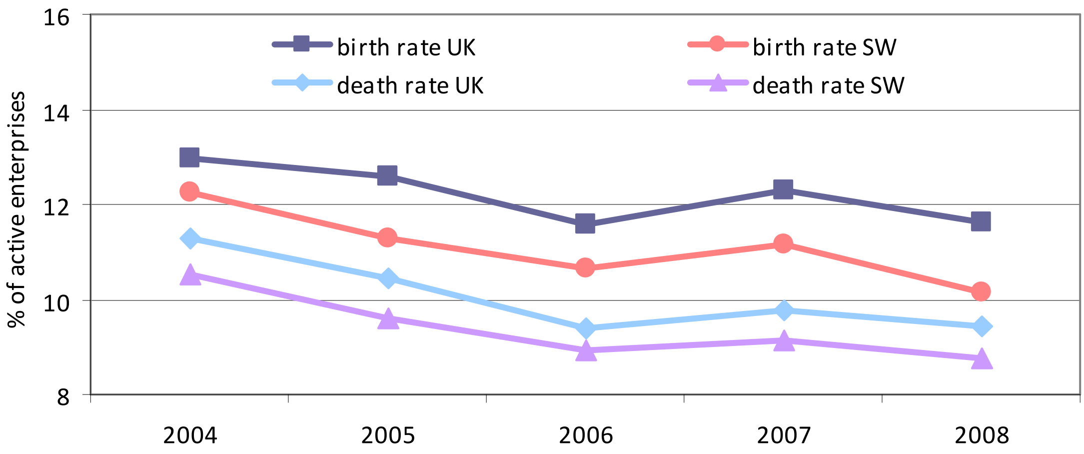
BUSINESS STRUCTURE

The UK economy has been undergoing a restructuring away from manufacturing and towards services. In addition, the economy is just emerging from a deep and hard recession. This section assesses early evidence for signs of further restructuring of SW business as the region moves into economic recovery.

Births, deaths and numbers

Figure RR6 shows the birth and death rates for SW and UK business for the time series currently available. All rates fell from 2004 to 2008, though births were higher than deaths throughout, meaning net growth in the size of the business population. The SW rates are lower than those for the United Kingdom.

Figure RR6: Business birth and death rates (% of active enterprises)



Source: Business Demography 2008, ONS

Despite the onset of the recession, all regions saw net growth in 2008. All Counties and Unitary Authorities in the region had a positive net birth rates other than Torbay where deaths exceeded births by 1.7% and Devon just breaking even (-0.02%). Numbers of births and deaths were down, however, suggesting a less dynamic business population. The last time point shows a dip, though still high, suggesting that the recession may have just been beginning to affect new firms. A further decline in these rates is expected in the 2009 figures when released due to the harsh trading conditions and difficulties in obtaining credit which can help business with their cash flow management - a crucial element for their survival.

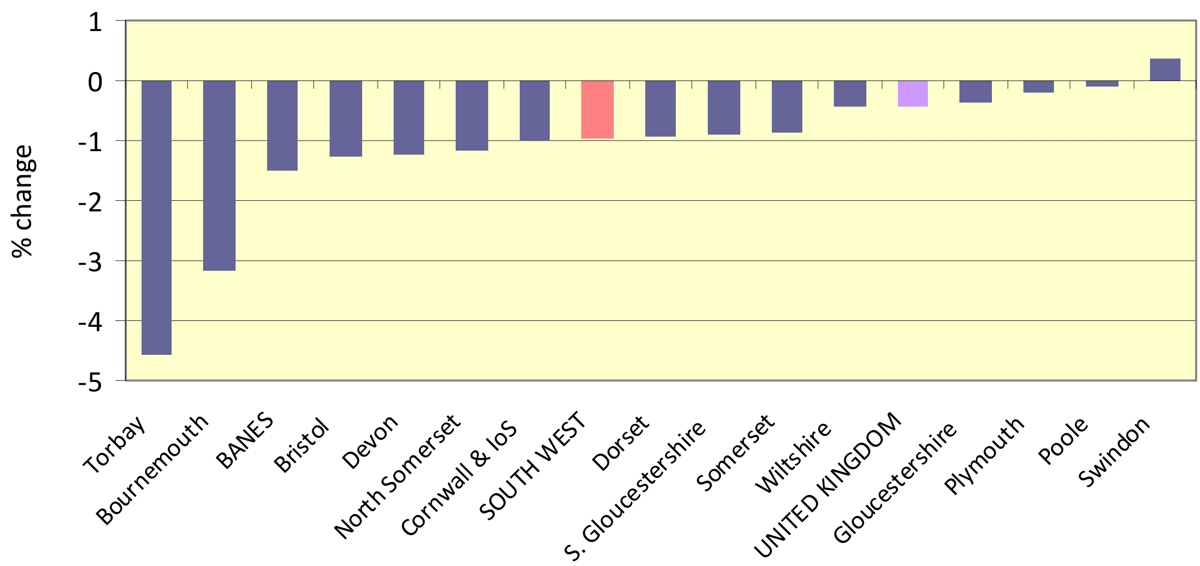
Between 2008 and 2009, the total number of VAT and/or PAYE based enterprises declined in the South West by 1.0%, a higher drop than the national average (-0.4%). Although the South West was hit worse than any other region, accounting for a 20% share of the UK fall in enterprises and a 27% share of local units, this is not a major fall. It may be related to the region's higher dependence upon small firms, who may have been disproportionately affected by the credit crunch, alternatively it could suggest different timing of impacts.

Indeed, the highest drop was indeed in enterprises that have four or less employees (-2.2% in SW, -1.5% UK) as these businesses tend to suffer the most from deteriorating trading conditions and restraints on the attainment of credit. In the South West, apart from enterprises with 100-249 employees, which saw a decline of 0.5% between 2008 and 2009, all other groups had an increase. Similarly, it is those firms with relatively low turnover levels that seemed to suffer from the credit crunch and onset of the recession. The number of firms with turnover below £250k fell, though not as fast as nationally. Conversely, there has been an increase in the number of SW enterprises with a turnover of £250k and over.

Figure RR7 shows the sub-regional distribution of this change – interestingly the urban unitary authorities fared both best and worst in 2008, reflecting a mixture of locational and sectoral differences. For example, Plymouth may have been relatively protected in the early stages of the recession because of its more peripheral location and dependence upon the public sector. Swindon actually increased whereas most places performed worse than the UK average. Torbay was relatively small and fragile and faced worse knock-on effects. Bristol, Bath, etc., with better access to the national picture, may have felt the effects of recession earlier on. At this data point, the effects of increasing unemployment had yet to feed through to the more consumption reliant parts of the economy, such as Devon and Cornwall.

It is not possible to compare numbers by sector between 2008 and 2009 due to a fundamental change in the industrial classification system.

Figure RR7: Change in enterprise numbers – 2008 vs. 2009 (%)



Source: UK Business: Activity, Size and Location 2009, ONS

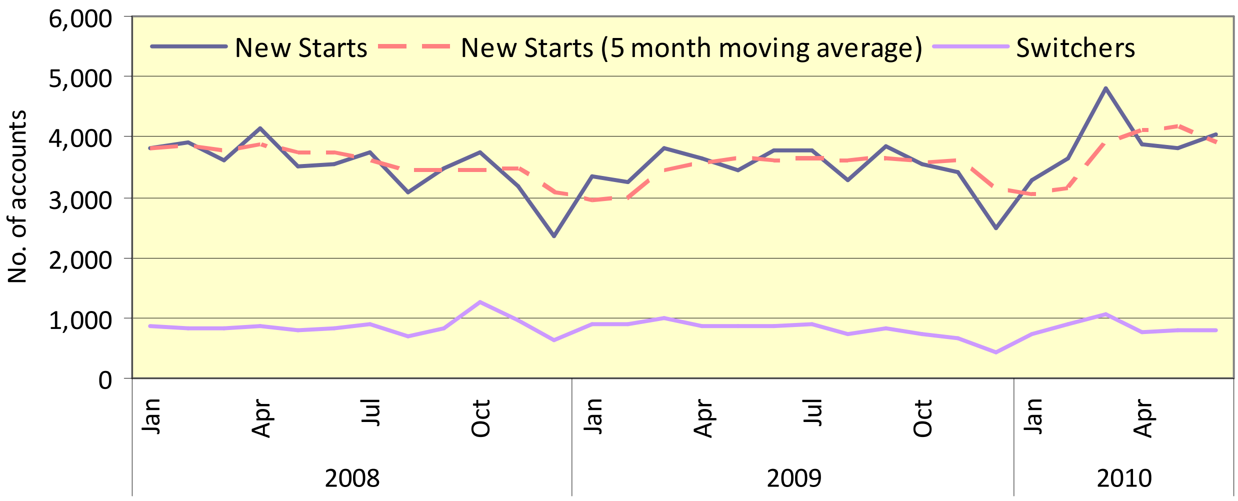
Bank accounts

As seen above, there is a delay in release of official statistics on business numbers. It is possible to use other proxy estimates of business start-ups to get a more up-to-date impression of the business environment for start-ups. For example, figures for business bank account openings are available with only a two to three month lag[23].

In June 2010, there were 4,032 small business start-ups in the South West based on bank account openings. This compares to 3,772 in June 2009. Chart RR8 shows the monthly change in the number of SW business start-ups and switchers[24] since January 2008. Seasonal factors are evidently at play, with dips in December each year. March 2010 was a notable peak for start-up activity, with the number of new starters rising to 4,804 – the highest figure based on available data. Start-up numbers fell back somewhat in April and May, but this was due to seasonal factors (bank holidays in May) and the uncertainty that stemmed from the general election and change in government. The recent emergency budget included measures that may help support future business start-ups in the region, including the VAT increase (giving a potential competitive advantage to non-VAT registered businesses) and the proposed reduction in corporation tax.

Overall, start-up activity in the first half of 2010 has improved markedly from a year ago – 23,453 start-ups in total compared to 21,239 in the first half of 2009. This suggests that more stable economic conditions and the aforementioned easing in bank lending to small businesses are helping to foster improved start-up activity.

Figure RR8: Monthly business start-ups and switchers Jan 2008 – Jun 2010



Source: BankSearch Information Consultancy

[23] For an introduction to the business start-up data provided by BankSearch, please see article available from the South West Economy Module at economy.swo.org.uk/publications/special-economy-module-publications/.

[24] 'Switchers' describes the number of accounts which have switched to another bank – these are not necessarily new businesses.

Given that the service sector accounts for around 70% of the economy, it is not surprising that new start-ups also occur in this sector. In 2009, the highest percentage shares were in ‘real estate, renting, computer and business’ (30%), ‘recreational, personal and community service’ (20%) and ‘construction’ (12%). Within ‘real estate, renting, computer and business’, it is legal, accountancy and consultancy businesses which consistently record the highest number of start-ups. The ‘manufacturing’ sector contributed just 4% of business start-ups. These proportions were broadly the same in 2008. Looking more closely at data for 2010, the more positive trend in overall start-up activity is reflected across sectors. In the first half of 2010, there were 1,165 start-ups in the ‘manufacturing’ sector – a 30% increase on the first half of 2009. Similarly, the largest sector ‘real estate, renting, computer and business’ saw a 10% increase in start-ups compared to the previous year: this equated to an additional 620 business start-ups.

Employment by sector

As we have seen, the recession has had a disproportionate effect on some industries in terms of economic output: this is also true for employment.

According to the Annual Population Survey, the number of employed people in the region (workplace based) fell by around 57,000 between 2008 and 2009 (both covering the period January to December). This decline was focussed around the distribution, hotels & restaurants (-41,000) manufacturing (-15,000) and construction (-19,000) sectors. Employment in the banking, finance & insurance sector dropped to a lesser extent over the same time period (-5,000) but suffered a more severe decline in employment between 2007 and 2008 when it saw a 6% decline (-22,000) – this is what we would expect given that the recession had its origins in this sector. For England as a whole, the turn around in fortunes for this sector has been more pronounced – after recording a 16,000 decline in employment in 2008, the sector saw an increase of 162,000 in 2009. Elsewhere, employment in the public administration, education & health sector grew strongly both nationally and regionally: in the South West sector employment increased by around 24,000 employees between 2008 and 2009.

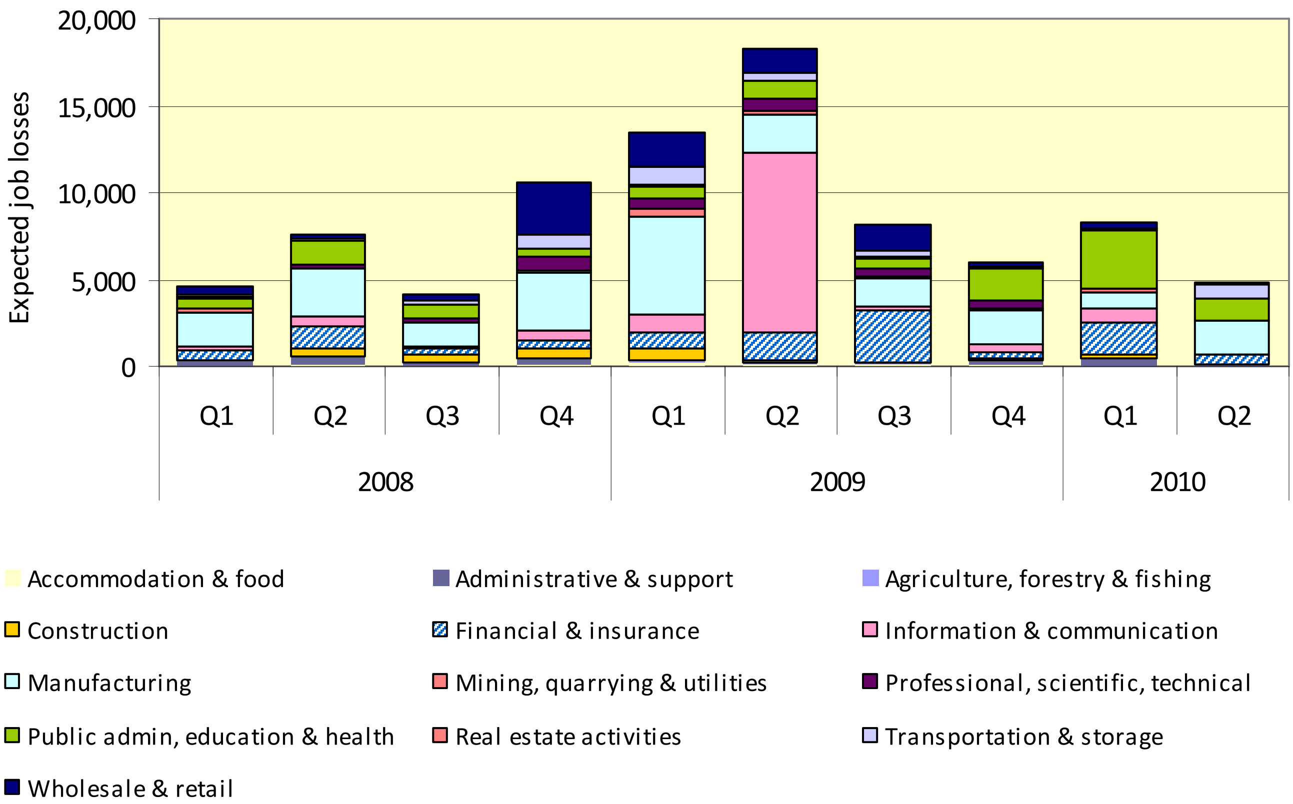
Redundancies and Insolvencies

Figure RR9 shows job losses announcements by sector up to the second quarter of 2010[25]. The second quarter of 2009 represented a significant peak in job losses, due to an uncharacteristic peak in the information and communications sector – this figure constituting two large scale redundancy announcements from a large (probably head office) telecommunications firm. Up to this point, the majority of announcements had been from manufacturing firms which is in line with the sharp downturn in sector output evident in national statistics. The manufacturing sector has been a

[25] This analysis is based on job losses announcements from the Redundancy Payment Services (RPS), media and other sources. It should be noted that these are ‘expected’ losses and may not translate into actual job losses. Job losses experienced by smaller firms may not be sufficiently noteworthy to appear in the news or be officially recorded – cumulatively these numbers may be significant. In addition, there may be a head office effect for some announcements in which the job losses may have, in reality, occurred outside the region.

significant contributor to overall job losses since the first quarter of 2008; however, data for the first half of 2010 shows a slight easing, consistent with the more positive outlook reported in business surveys – announcements in the first half of this year (around 3,000) were considerably less than a year ago (7,700). Following a relatively small contribution in 2008, financial and insurance announcements crept up in 2009, reaching a peak in the third quarter of 2009 when they made up over a third of announcements. Losses from public administration education & health have been creeping upwards since the national economy emerged from recession in the final quarter of 2009. The peak in 2010, where the sector contributed 40% of job losses announcements, was due to a number of announcements from local authorities which stipulated 'budget cuts' as the prime reason.

Figure RR9: Job losses announced between 2008 Q1 and 2010 Q2 (media and RPS)

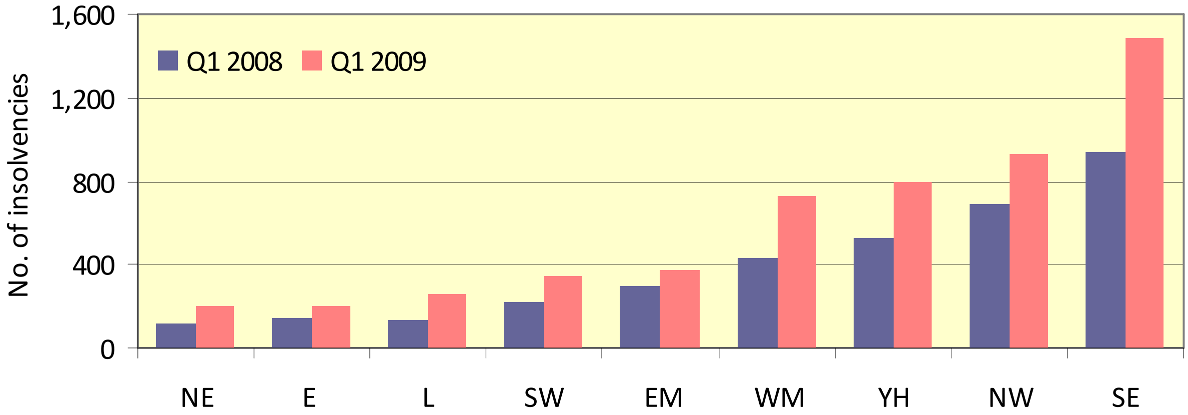


Source: Redundancy Payment Service; media

In terms of distribution of these announcements across the South West region, there has been a concentration of losses in the more productive north east of the region, particularly in the wider Bristol conurbation and Swindon. This can be largely attributed to the sharp downturn in the manufacturing sector and the subsequent large scale redundancy announcements, though in part reflects the higher concentration of employment in the north. Numbers eased off in the first half of 2010, reflecting the overall decrease in redundancy announcements. With an expected increase in public sector losses (already beginning to feed through into the data) we are likely to see a different spatial distribution across the region over the coming months.

According to statistics from Ministry of Justice, in the first quarter of 2010, a total of 133 companies were winding up in the South West, this was 8% less than a year previously. This compared to a 20% decrease for England and Wales over the same time period. Figures from Experian, suggest that business insolvencies increased across all of the English regions between the first quarter of 2008 and the first quarter of 2009. The South East, which already had the largest number of insolvencies nationally in Q2 2008, saw the largest percentage increase across the year (58.6%). Insolvencies in the South West are reasonably low - the rankings depicted in Figure RR10 are the same even when accounting for the relative size of the working age population.

Figure RR10: Regional Business Insolvencies 2008 Q1 to 2009 Q1



Source: Experian

SHORT- TO MEDIUM-TERM PROSPECTS

The South West's economy is more dependent on tourism and consumer sectors than other regions. Given the continued weakness of the pound, the South West is well placed to capitalise by attracting domestic as well as international visitors. This will have a positive affect on the distribution, hotels and catering sector; however, it should be borne in mind that a prolonged relative decline in the value of the euro could reduce sterling's competitiveness. A weakened pound and reduced demand in the EuroZone (the South West's largest trading partner) may dampen the potential for an export-led recovery.

For the construction sector, steep falls in house prices have made housing more affordable but the lack of credit availability is holding buyers back. The sector may be particularly vulnerable to the government's fiscal tightening policies with publically funded construction projects under threat.

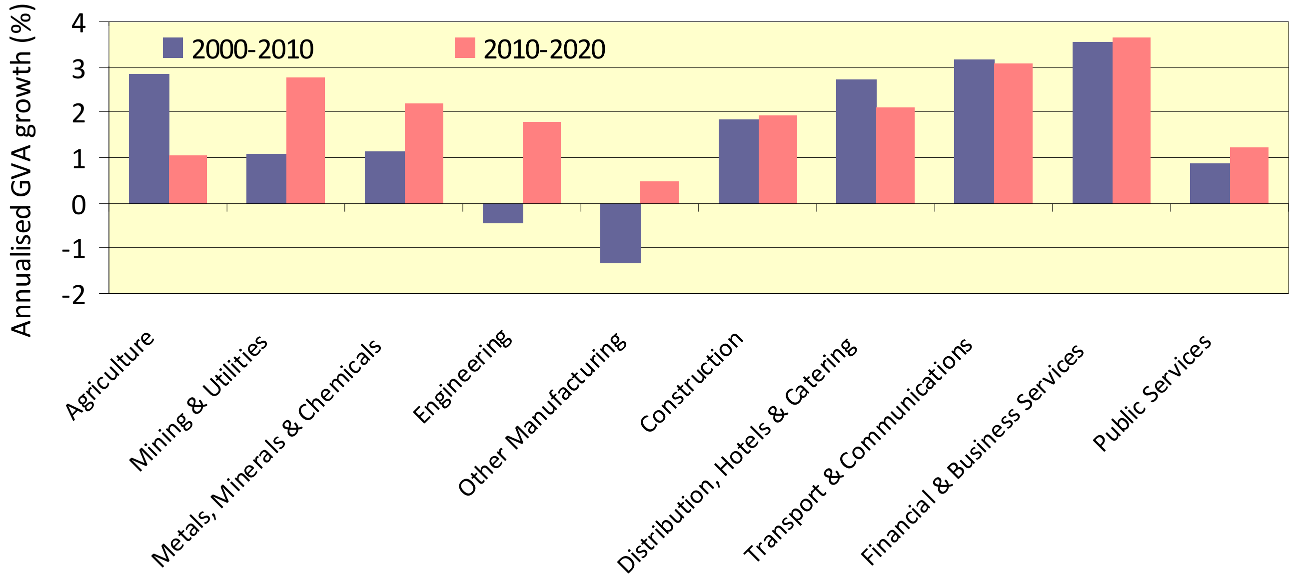
As mentioned above, the financial and business service sector has faired well through the recession and is exhibiting healthy levels of growth. However, there is a risk that the strong recovery in this sector will be focussed around the Greater South East, which will have the effect of pulling down growth in the region relative to the national average.

In the longer term, the constraints on regional competitiveness remain: the relatively high concentration of employment in low value added sectors and the difficulties in attracting and retaining highly skilled individuals. In addition, demographic change will exert pressure on productivity in the long run.

Experian projections

The latest projections provided by Experian (Spring 2010) show which sectors and places are likely to be the drivers of regional economic growth over the next decade. These projections are 'policy neutral' and should therefore be considered as a benchmark for debate rather than an accurate picture of how the economy is going to develop. Chart RR11 shows annualised growth in real GVA (2005 prices) across broad industry groups in the SW region both for the last decade and the coming decade. As with the United Kingdom as a whole, the highest growth rates were experienced in financial and business services in the last decade (3.6% pa between 2000 and 2010). Even in light of the downturn in this sector, growth is expected to be strong (indeed slightly higher) in the next ten years; however, any future policies aimed at reducing the economy's reliance on this sector may lower the projected growth rate. Elsewhere, public services output is expected to grow at a slightly higher rate over the next decade; however, this may turn out to be too optimistic given the prospect of heavy public sector cuts in the coming few years. Following a decade of negative growth, the production based industries - engineering and other manufacturing - are expected to see positive levels of growth between 2010 and 2020.

Chart RR11: Long term SW GVA growth by industry, 2000-2020



Source: Experian

In terms of employment, between 2000 and 2010, public services saw by far the biggest increase in its share of regional employment, rising from 27.6% to 31%. Over the next 10 years, its share is expected to increase by just 0.3% in total. As with the GVA projections mentioned previously, this may still prove to be too optimistic if public sector cuts are more severe than anticipated. Following a small reduction at the start of the decade, employment in the financial and business services sector is expected to recover and grow strongly between 2010 and 2020 and subsequently its share of employment will rise from 18.7% to 20.6%. The rate of decline in manufacturing and engineering employment is expected be at a slower rate in the next 10 years compared to the previous decade: the number of full-time jobs fell at an average rate of 2.1% and 2.6% respectively between 2000 and 2010, between 2010 and 2020 these rates of decline will moderate to 0.8% and 1.7%.

Public sector retrenchment

It is clear that the current coalition Government is under some pressure to make substantial public sector savings in order to address the national deficit. Furthermore there is a need to strengthen the private sector as the nation recovers from recession and to rebalance the economy away from its reliance on the public sector and financial services. Details of the planned public sector cuts will not be clear until publication of the Comprehensive Spending Review in October. Cuts of 25% (and more) across the majority of Government departments are expected. Inevitably this will mean job losses and it is forecasted that around 600,000 public sector jobs could go across the United Kingdom by 2016[26].

The UK economy has just suffered from a relatively deep recession and, depending upon the timing and nature of public sector cuts, there is a risk of seriously impacting upon the wider economy. Clearly, the magnitude of public sector savings to be made (and the relatively short timing) poses a risk to the private sector recovery. In addition to direct job losses from the public sector, there will be a reduction in contracts for private sector business that has the public sector as a client, potentially leading to private sector redundancies in some sectors; reduced wages (through job losses but also through a public sector pay freeze) and benefits will dampen consumption, potentially leading to further private sector job losses; and as citizens we will see a reduction to public service provision. At the same time, there is likely to be a range of offsetting factors – opportunities will arise for the private sector, which is hoped will supply the shortfall in jobs as a result of public sector cuts.

Recent analysis looks at the available evidence on the impact of public sector cuts across the South West of England in terms of loss to public sector jobs, reduced capital spending and lower levels of private sector procurement[27]. The analysis suggests that the South West is vulnerable to cuts due to relatively high dependence upon the public sector for employment, with potential loss of over 100,000 jobs over the next five years. Impacts are likely to be widespread across the region. Although large urban centres will see greatest numerical public sector job losses, small centres and peripheral areas, where private sector activity is weaker, may feel the effects most. The South West has high levels of defence-related employment and any cuts in defence spending could have significant impact on many

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[26] OBR forecast: employment, Office for Budget Responsibility – 30 June 2010

[27] Impact of public sector spending cuts: emerging evidence base for the South West – September 2010, Economy Module of the South West Observatory

local places across the region. Any cuts are expected to be compounded by the effects on the defence supply chain as many key companies are also located in the South West.

SW growth scenarios

It is important to understand the possible and probable directions that the regional economy can take in the years ahead and beyond this period of recession and recovery in order to allow planning and delivery at the local level.

A suite of South West Growth Scenarios has been developed which provide a consistent and objective set of forward-based projections of the South West regional economy, consistent with UK and regional economic fundamentals and potential[28]. There are three economic scenarios, giving a central view of trend growth and upper and lower scenarios that will offer sensible boundaries for discussion of regional and sub-regional economic futures.

The research aims are to explore the impact of the following three potential alternative outcomes of economic growth as the economy moves out of recession.

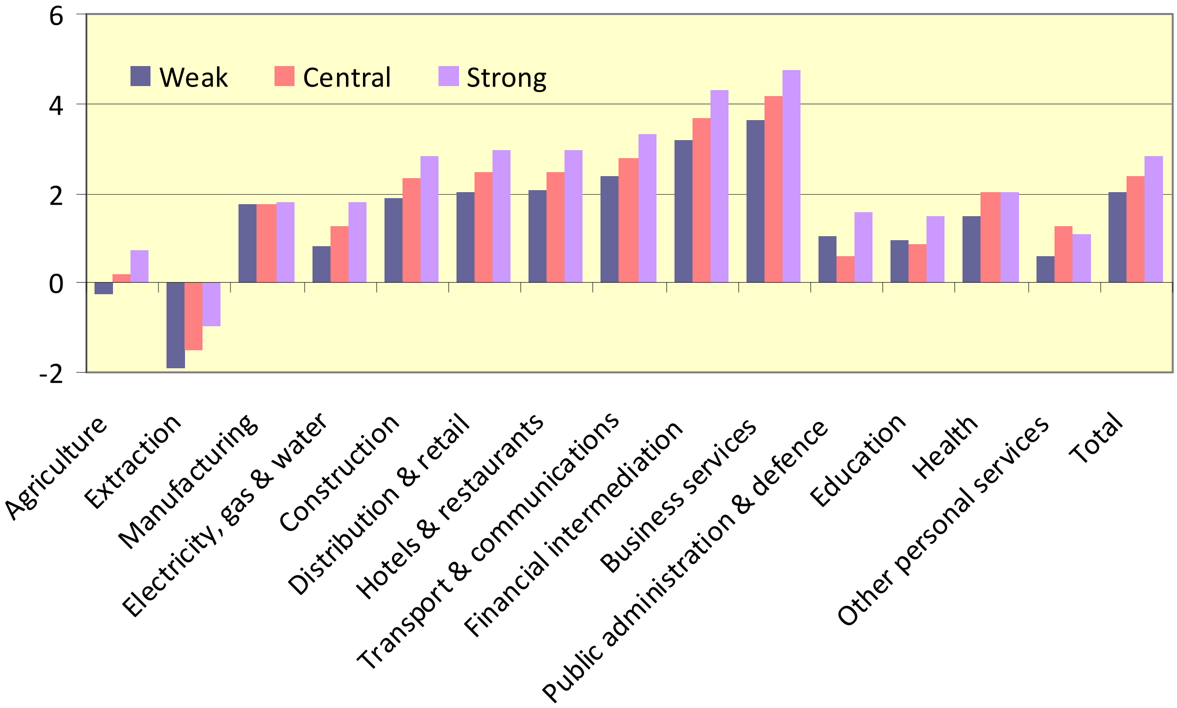
- Partial recovery – economic growth recovers to a sustainable rate but does not make up all the potential activity lost in the downturn
- Full-recovery – growth recovers to the pre-recession rate and does make up the potential activity lost in recession
- Lower potential – the economy suffers a permanent loss to both the level of activity and its growth potential.

These three headline scenarios are alternative outcomes driven by strong, objective policy neutral assumptions about demographic and technological change. Results presented over a twenty year horizon to 2030 and explore regional and sub-regional level. Figure RR12 shows the SW growth rates by sector between 2010 and 2030.

The three growth scenarios suggest growth rates in the SW economy over the next twenty years of 2.0%, 2.4% and 2.8% per annum for the weaker, central and stronger scenarios, respectively. The central scenario is broadly in line with the most recent projections from the Office for Budget Responsiblity – these are considerably more pessimistic than projections released prior to the General Election (including the Experian projections discussed earlier), predicting lower trend growth in the future than seen in the run up to the recession. This has important implications for business and personal prosperity in the future.

[28] South West Growth Scenarios 2010-2030 – June 2010, South West RDA and South West Councils. Available at economy.swo.org.uk/publications.

Figure RR12: SW growth scenarios – average annual growth in GVA by sector, 2010 to 2030



Source: SW Growth Scenarios, Oxford Econometrics for South West RDA and South West Councils, June 2010

The scenarios have broadly similar trajectories by sector – higher growth in services, particularly private services, lower growth or contraction in production sectors. As with the last twenty years, the next twenty years will see continued expansion of business services, expected to double under the weakest scenario. It is this growth in private services that differentiates between the scenarios, with manufacturing expected to behave similarly for all three. Far weaker public sector growth is likely in future, especially under the central scenario.

LOOKING TO THE FUTURE – FITNESS OF SOUTH WEST BUSINESS

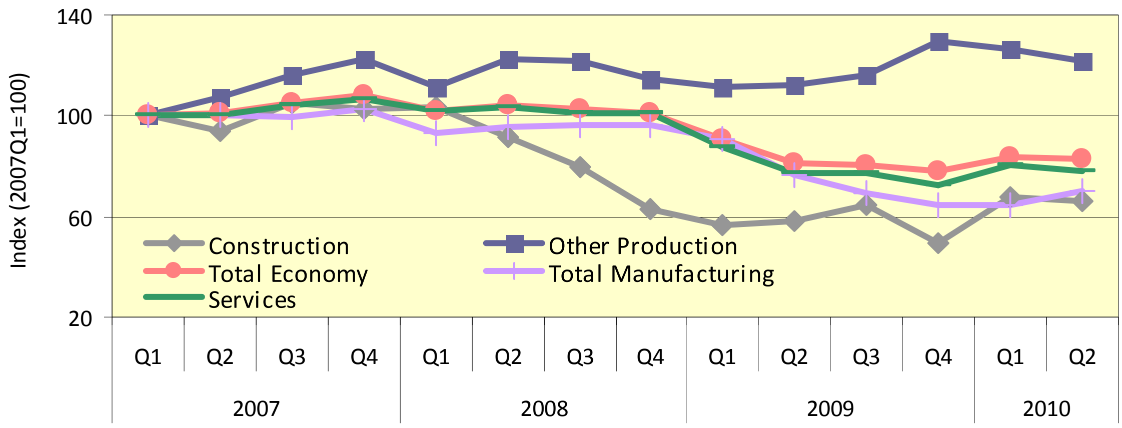
A number of challenges lie ahead for the UK economy and its businesses in the coming years, with the recovery from the private sector recession, an imminent public sector downturn and a new Government intent on changing policy and delivery structures – these include demographic aging, globalisation, energy and food supply and, last but not least, climate change. How these are dealt with lies in skills, new technologies, and readiness to see and seize the opportunities before it's too late. But in every challenge lies an opportunity. How fit and ready is SW business to cope with these issues and turn these challenges into opportunities? Does SW business have the entrepreneurship, investment capacity/readiness/infrastructure, skills, innovativeness and competitiveness – the drivers of productivity - that will be needed in the future? Is SW business ready for climate change – the regulatory environment and the risks of being directly affected?

INVESTMENT

Empirical studies show that levels of physical capital stock are closely correlated with productivity performance. However, the United Kingdom has long suffered from relative under-investment and is today significantly less capital intensive than its main competitors. The unexpected severity of the world economic slowdown severely affected investment levels in the short term. Indeed, although many companies have already built up the financial health to invest in future capacity, at the time of writing, they seem extremely reluctant to make such commitments. Eventually, if the global economic recovery becomes self sustaining, these strong economic and financial fundamentals should give rise to acceleration in investment expenditure. In a time when business is only just gearing up to increase its investment, the public sector will be cutting its expenditure – although essential for closing the UK deficit, fiscal tightening, including proposed tax increases and spending cuts, will feed through to household consumption and may well dampen the recovery.

With the challenges facing the South West in the future, is SW business investing enough? ONS figures for early 2010 show that nationally business investment levels overall may now be starting to recover, albeit weakly – see Figure F1, which shows investment relative to the start of 2007.

Figure F1: UK business investment (2007 Q1 = 100)

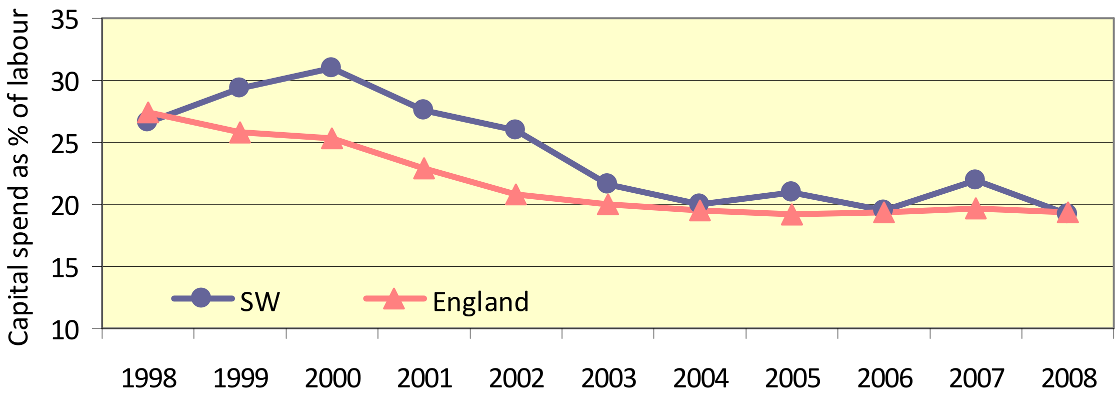


Source: Business investment, ONS

Total business investment peaked at £37.6 billion in the final quarter of 2007, falling to 72% of this level by the end of 2009. Figures for 2010 Q1 show the first quarter on quarter increase in investment since the start of the recession (2008 Q2) - Quarter 2 figures showed a slight fall back. Utilities (other production) investment remained fairly high throughout. Construction felt the effects of the impending recession first but is hopefully now starting to recover, with a 38% increase in the first quarter of 2010, though flat in Q2. Manufacturing investment has been falling since the start of the recession, but is possibly starting to now pick up with a 9.6% quarterly rise in 2010 Q2. Overall, services investment also picked up in Q1, led by increases in transport and communications and real estate (as the housing market started to pick up), though the figures for these two sectors fell back in Q2. Overall, the figures do not yet show clear signs of business-led recovery, suggesting lack of confidence may be still be delaying investment.

Regional figures on capital expenditure are available through the Annual Business Inquiry[29] (ONS), though with a substantial time lag. SW business invested an average of £6.2 billion per year from 1998 to 2008. Figure F2 shows the ratio of investment to labour costs for England and the South West. The region's businesses saw a relatively strong period of investment in the early part of the decade. This tailed off in recent years reaching levels more in line with the England average (about £5 spent on labour for every £1 invested). As with England, the SW capital:labour ratio declined in the early part of the decade, as the nation and region became more dependent upon cheap labour rather than investment in plant, machinery and technology for productivity improvements. It is the region's share of capital expenditure that has fallen over this period, as share of employment costs has been fairly stable throughout. Further analysis suggests that the South West's overall share of private sector business has been declining, as its dependence upon the public sector has grown[30]. This will have important implications for both investment and wider economic performance in the South West over the next few years as the public sector retrenches.

Figure F2: Capital expenditure to labour costs ratio (%)



Source: Annual Business Inquiry, ONS

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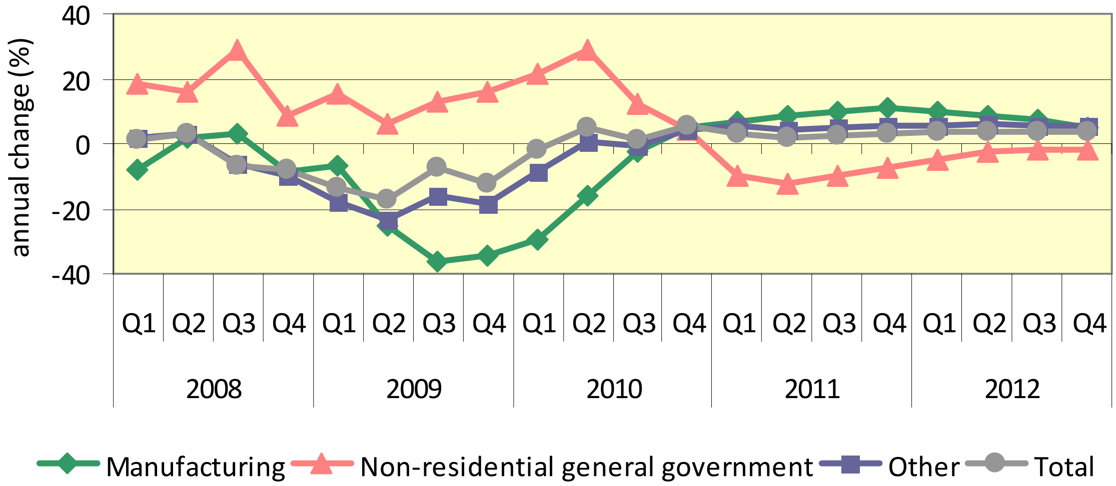
[29] Not produced as part of the data release but available upon request.
[30] SW business in 2008 – latest ONS Annual Business Inquiry release, Economy Module of South West Observatory, August 2010. Available at economy.swo.org.uk/publications/special-economy-module-publications/.

Experian estimates for the region suggest that total SW investment fell from around £5 billion in 2007 Q4 and 2008 Q1 to just over £4 billion in 2009 Q4, a 20% fall overall[31]. As with the UK trend (discussed earlier), Experian forecast that recovery began in Q1 2010. Figure F3 shows annual projected growth rates for investment over the next few years. Government investment, which grew by 25% over the period of the recession, is projected to begin to fall off later this year, along with government consumption. In the short term this is expected to be more than compensated for by private sector investment as economic recovery continues. Investment will not, however, return to pre-recession levels any time soon.

Figure F3: Investment projections for the South West - annual change (%)



Source: Regional Planning Service Spring 2010, Experian

During the recession, access to finance problems combined with a more general downturn in business conditions, dampened investment activity in the South West significantly. The last RDA National Business Survey[32] (autumn 2009) suggested that even towards the end of the recession investment intentions remained very low, with the majority of businesses not intending to invest at a greater rate in the next year than in the previous 12 months. Other survey findings over the past year suggest that businesses have concentrated on paying down debt and improving their balance sheets rather than investing, particularly in tangible assets. Only 12% of SW businesses surveyed intended to invest more in plant and machinery, of some concern as this may affect their ability to expand quickly enough once the recovery is underway. Businesses currently have a reasonable amount of space capacity – and therefore can expand output without necessarily expanding capacity – but could well hit capacity constraints in the long run.

Public sector investment is also important to SW business – business is both a client and service provider to the public sector, and public sector investment is key to delivering the infrastructure (from

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[31] Regional Planning Service Spring 2010, Experian. Produced before General Election and Emergency Budget so considered optimistic relative to subsequent projections and forecasts.
[32] RDA National Business Survey – see economy.swo.org.uk/publications/business-surveys/

transport and communications to education and skills) that is fundamental to developing a successful business environment. The South West already received 9% per head less than average public spending in 2008-09[33]. While above average on things like agriculture, environment protection and education, public spending in the region has been below average on important economic drivers such as science and technology, transport, enterprise and economic development. The fiscal tightening announced by the new Government will serve to undermine public spending across the board – but in terms of its effect on overall investment will it affect the South West relatively more or less than elsewhere? It is too early to say but reduction or delay to investment in major transport and ICT and other economic development and regional spatial planning could be a barrier to SW economic development in the short term[34].

ENTREPRENEURSHIP

An environment that encourages enterprise and supports people who take opportunities and risks is a crucial ingredient of productivity improvement. A strong entrepreneurial base is an essential driver of growth and prosperity in a modern economy. New and more dynamic businesses increase competitive pressures in markets and facilitate the introduction of new ideas, technologies and more efficient working practices.

Enterprise can also play a vital role in helping to renew our poorest and most marginal communities. It helps to create jobs and stimulate activity in communities where crime and unemployment are high. It helps meet the basic needs of local people, by providing vital services like shops.

Self-employment

Self-employment is sometimes used as a (less than perfect) proxy for entrepreneurship. In January 2009 to December 2009 (latest), the South West had the second highest level of self-employment in the United Kingdom after London – 14.3% of working age population in employment (12.7% UK)[35]. The South West figure has risen by about one percentage point over the last five years, slightly faster than average.

The South West has the third highest female and male self-employment rates – 9.7% (7.9% UK) and 18.4% (16.9% UK), respectively. Furthermore, 47% of the self-employed population in the South West is female, above the average of 41%, and second after the South East.

So do these high self-employment rates mean that people in the South West are more entrepreneurial? It is hard to be sure. The figures will largely reflect the rural nature of the region and the dependence in some parts on sectors that are themselves characterised by high levels of self-employment, such as agriculture, tourism and lifestyle businesses. Following from this, self-employment is highest in far

[33] Public Expenditure in SW England, Economy Module of the South West Observatory, May 2010. Available at economy.swo.org.uk/publications/special-economy-module-publications/.
[34] See Transport in the South West – does it matter for the South West economy, July 2010; and Impact of public sector spending cuts – an emerging evidence base for the South West, September 2010. Economy Module of the South West Observatory. Available at economy.swo.org.uk/publications/special-economy-module-publications/.
[35] Annual Population Survey, ONS (via www.nomisweb.co.uk)

south west of region – Devon, Cornwall, Dorset and Torbay all show high rates of self-employment, again most likely linked to leisure and tourism.

The South West has attracted high levels of inward migration in recent years and that may in part be linked to the opportunities presented by the region and its parts for entrepreneurship. Migrants come mainly from South East and London, possibly seeking change of lifestyle and pace and bringing a wealth of skills as well as aspirations to be entrepreneurs.

However, self employment isn't always about opportunity, sometimes it is about need or distress and this can be reflected in high figures in areas with lagging economies or rises in response to recession. There is no sign of that yet in the regional data for the South West – the latest for January to December 09 showed no significant change in rates compared to the previous year. Indeed, the number of self-employed people fell across most parts of the region and nationally. More up to date national figures show that the number of UK self-employed fell in the first three quarters of 2008 but has broadly been climbing ever since - at a rate similar to that seen in the years leading up to the recession and at the same time as the number of employees has been falling.

Global Entrepreneurship Monitor

The Global Entrepreneurship Monitor (GEM) is an international survey designed to capture entrepreneurial activity from the stage of people seeing themselves as potential entrepreneurs through to becoming established business owners[36]. This makes GEM invaluable as a source of information for understanding the characteristics of entrepreneurship and may be of particular interest in trying to understand the difference in nature of entrepreneurship during a recession compared to that observed during more economically buoyant times.

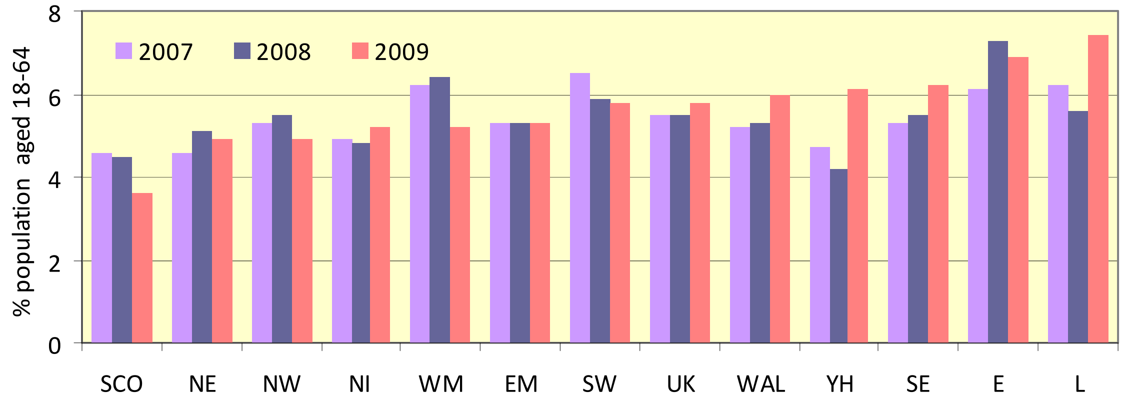
Total early-stage entrepreneurial activity (or TEA) captures the behaviour of individuals actively involved in setting up a business or those who are the owner-manager of a business no older than 3.5 years. Figure F4 shows regional performance on this measure over the last three years as a proportion of the population aged 18 to 64.

Since recording the highest regional TEA rate in 2007 (6.5% vs. UK average 5.5%), the region's relative position has weakened – in 2008 it was in line with the UK average, but ranked fifth of the English regions. This may, on the surface, suggest that the recession has had a more negative impact on entrepreneurial aspirations in the South West than elsewhere; however, the distinction between necessity (lack of other employment opportunities) and opportunity (where entrepreneurs may be exploiting the potential for new markets) may also be a contributing factor here. The significant peaks in 2009 for London and Yorkshire & Humberside might be influenced by a rise in necessity entrepreneurship as a consequence of the downturn in the economy.

Of the individuals demonstrating TEA in the South West, the gender split was roughly 50:50 in 2009 (a ratio that has held fairly constant over time). This differed from the average for the United Kingdom as a whole, where 46.4% of TEA individuals were females.

[36] Global Entrepreneurship Monitor – 2009 UK monitoring report. Aston Business School.

Figure F4: Total early-stage entrepreneurial activity in UK regions 2007, 2008 and 2009



Source: Global Entrepreneurship Monitor – UK Monitoring Report 2009

Table F1 shows the self-reporting attitudes to entrepreneurship in the South West compared to the United Kingdom in 2009. Just over 5.3% of working age adults in the South West region expected to start a business in the next three years compared to 6.2% nationally. The SW percentage has fallen by 3 percentage points since the 2007 survey: then the region was above the national average. In addition, only 23.4% of SW individuals know someone who has started a business in the last two years, a 3.6 percentage point decline on 2007. Over the same time period, the UK percentage has increased. Both nationally and regionally, however, there has been a substantial drop in individual's perceptions of future start-up opportunities.

Table F1: Attitudes to Entrepreneurship, SW and UK, 2009

	SW		UK	
	Agree	% point change from 2007	Agree	% point change from 2007
I expect to start a business in the next 3 years	5.3	-3.0	6.2	-1.2
I personally know someone who has started a business in the last 2 years	23.4	-3.6	26.5	0.8
There will be good start-up opportunities where I live in the next 6 months	26.9	-12.8	27.0	-12.0
I have the skills, knowledge and experience to start a business	53.6	4.4	52.4	3.9
Fear of failure would prevent me from starting a business	33.0	-2.7	35.1	-0.7

Source: Global Entrepreneurship Monitor – UK Monitoring Report 2009

It is important to place these results in context – the 2009 survey covers the period when the United Kingdom was in deep recession, only emerging in the final quarter of the year. In 2007, prior to the recession, the South West was above the UK average in the majority of attitudes listed in Table F1.

These results do suggest that attitudes seem to have deteriorated to a greater extent in this region. However, the region scored above the UK average in terms of individuals considering themselves to have the skills, knowledge and experience to start a business. This adds further weight to the notion that it is the economic climate that has lowered entrepreneurial activity, rather than there being any longer term weaknesses.

INNOVATION

Innovation is a key catalyst for productivity growth and plays a central role in supporting economic growth and increasing economic prosperity. New ideas drive enterprise, create new products and markets, and improve efficiency, delivering benefits to firms, customers and society. Most business leaders agree that in an increasingly competitive global economy, companies that fail to innovate will not survive. There are, however, various levels of innovation – from incremental changes to products, services or processes to moving into new markets, adopting new technologies or changing business models.

Innovation, and how an area can benefit from it, differs from place to place. As the production of new knowledge and technology becomes more global, different regions and places within the United Kingdom will innovate in different ways. As the nation continues to emerge from recession, those firms that are best able to innovate and react quickly to new market opportunities as they emerge will benefit most. On the other hand, budgets that might be spent on research and development are often the first to go when times are hard.

Innovation takes place through a wide variety of business practices and a range of indicators can be used to measure its level within the enterprise or in the economy as a whole. These include the levels of effort employed (measured through resources allocated to innovation), as well as of achievement (the introduction of new or improved products and processes).

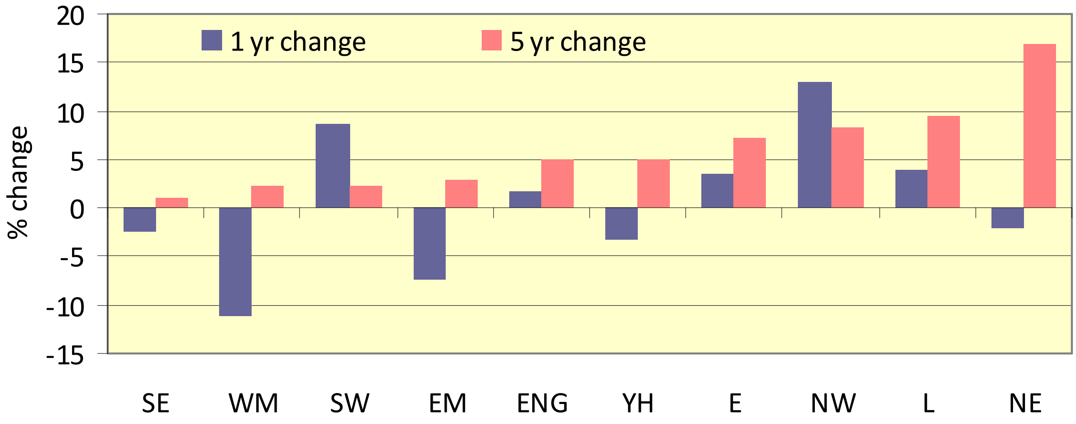
Research and development

ONS figures on research and development expenditure suggest that, despite the climate of uncertainty as the nation descended into global recession, expenditure on research and development by SW business was fairly buoyant. SW business invested £1,374 million in research and development in 2008, employing 15,000 FTE jobs, an 8.6% and 9.9% share of the UK equivalent figures, respectively.

Figure F5 shows the one and five year change in business expenditure on research and development. Spend by SW business went up by 8.7% in 2008 compared to 2007 (UK=1.7%), second highest of the English regions - employment also rose relative to 2007. Growth in R&D spend varies substantially across the English Regions, with the Midland regions were hit particularly hard in 2008.

There has been a fall in R&D expenditure relative to GVA over time, from 2.5% in 1999 to 1.9% in 2008 in line with a similar UK trend (1.4% to 1.3% in same period), related to the overall restructuring in the economy towards services. However, the region still ranks second highest equal (with Yorkshire and after London on this measure).

Figure F5: Annual change in business expenditure on R&D – 2007-2008 and 2003-2008 (%)



Source: Business Research and Development, ONS

According to R&D statistics for 2006, around a third of UK aerospace R&D spend takes place in the South West - £619 million and 47% of the region's £1.3 billion total. This illustrates the region's strong competitive advantage in this sector. However, it potentially puts the region at risk as much of its innovative capacity is focussed around one sector. The South West accounts for only 10% of overall manufacturing R&D, illustrating that other regions exploit their own competitive advantages.

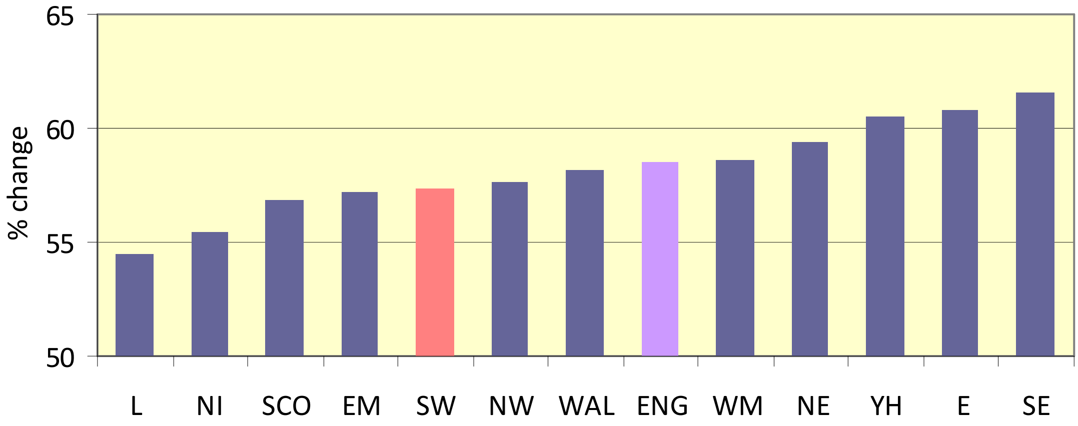
Wider Innovation Activity

The Community innovation Survey tries to measure wider innovation activity of firms. Innovation activity is defined as where enterprises were engaged in any of the following:

- introduction of a new or significantly improved product (good or service) or process
- engagement in innovation projects not yet complete or abandoned
- expenditure (activities) in areas such as internal research and development, training, acquisition of external knowledge or machinery and equipment linked to innovation activities.

Preliminary analysis by ONS of the 2009 Innovation Survey looks at innovation activity in UK firms, including barriers to innovation. Figure F6 shows the shares of innovation active businesses across the countries and regions of the United Kingdom. In 2009, 57% of SW businesses surveyed were innovation active, ranking the region eighth in the United Kingdom. This is down from 66% and fourth in 2007 (UK 64%). However, regional innovation rankings vary considerably from survey to survey and are generally a reflection of industrial location and variations in sectoral business cycles and product life cycles.

Figure F6: Shares of innovation-active businesses by region



Source: First findings from the UK Innovation Survey 2009, Economic & Labour Market Review, March 2010, ONS

As shown above, the South West is one of the top performing UK regions in terms of R&D expenditures by business. However, broader evidence on innovation from the UK Innovation Survey suggests that the region's firms are less likely to be engaged in most types of innovation activity, less likely to introduce actual innovations, derive a smaller share of revenues from innovative products, and are less likely to report various benefits of innovation than are their counterparts in the South East or in the United Kingdom as a whole. To a large extent, however, these differences in innovation performance can be explained by regional variation in the characteristics of firms that determine their innovation performance.

Many aspects of innovation activity are significantly related to improved business performance – higher productivity and faster growth of employment, productivity and output. More innovative firms tend to perform better than otherwise similar, but less innovative, firms in terms of these basic performance measures. Three economic simulations were carried out to look at the impact of improvements to innovation performance in those areas where SW firms significantly underperform relative to similar firms in the South East of England (turnover from innovative products). The results suggest that closing this innovation gap would have a small, but nevertheless noticeable, impact on employment, productivity and output in the South West over the longer term[37].

Start-ups are an important source of growth and variety in the economy. Despite this, very little is known about their innovative activities. Research based on the Community Innovation Survey was commissioned by the Department for Innovation, Universities and Skills (now Business, Innovation and Skills - BIS) to explore differences between start-ups and established firms in terms of innovative activity[38.] The findings demonstrate that start-ups do differ significantly from established firms in terms of innovation. Being a new firm increases the likelihood of being innovation active in the service sector, while it decreases this likelihood in the manufacturing sector. The results of this study contrast with the

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[37] Innovation and Productivity 1, Economy Module, 2008 – available at economy.swo.org.uk/publications/simulations-projections-and-forecasts/simulations

[38] The Elixir or Burden of Youth? Exploring Differences among Start-ups and Established Firms in Innovation Behaviour in the UK, Department for Innovation, Universities & Skills, 2009

assumption that new businesses are more innovative - start-ups' innovative performance differs by sector. The results imply that strategies to support innovation in the United Kingdom may need to account for the structural differences between new and established firms. With its much higher reliance on small firms, support for innovation in the South West possibly needs to be differently targeted than nationally.

SKILLS

A skilled workforce is essential for a successful economy. Developing and growing skills appropriate to the economy will help with the other drivers – skills for innovation, for enterprise, for competitiveness and skills as an investment. Skills are a fundamental component of the labour market and the qualifications and skills of SW workers and residents and surrounding issues have been covered previously in the Labour Market Review[39] and elsewhere. This section of the Business Review will concentrate on skills needs and issues for the future from a business perspective.

Skills and the recession/recovery

Skills are part of the commodity that an employee sells on the labour market in return for wages. Compared to only a few years ago, when the SW labour market was regularly described as "healthy", the region's labour market is currently in flux as a result of the fallout from the recent recession - it is those employees and firms with the right balance of skills that will be in the best position to exploit new opportunities as they arise from the economic recovery. There are a number of forces at play. On the one hand, increased unemployment potentially increases the pool of skilled labour, reducing wage costs for companies now in a position to recruit – older, more experienced workers may now be available to businesses, perhaps creating problems for younger people seeking work and the long-term unemployed. On the other hand, companies may not be replacing skilled labour, reducing their overall productivity. Furthermore, training budgets will have been put at risk, meaning that some firms may not be best placed to react to the recovery.

There is anecdotal evidence from the current recession that skills have been more highly valued than in previous recessions and that firms were keen to consolidate their workforces rather than lay off workers. High value added firms, such as Honda, have cut staff hours or given staff extended unpaid leave rather than laying off – taking the long view waiting for upturn in economic conditions.

A key source of information on business's view of skills is the National Employers Skills Survey (NESS). The 2009 iteration of the survey provides some insight into how skills needs and investment in skills changed during the recession.

As Figure F7 shows, the proportion of employers with skills gaps[40] increased in every region from 2007 to 2009, probably as a result of recruitment freezes, reduced training budgets and employees being

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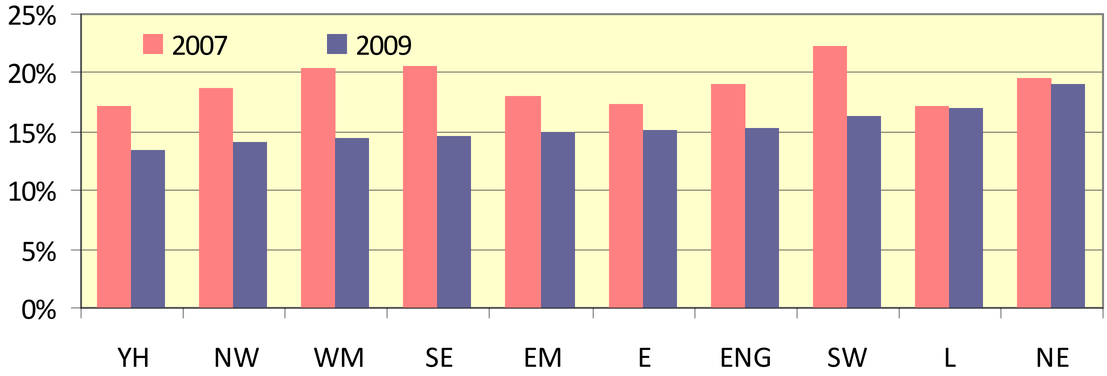
[39] Labour Market Review – Economy Module of the South West Observatory, February 2010. Available at economy.swo.org.uk/publications/labour-market-review/

[40] A skill gap is measured where at least one employee is not considered fully proficient.

expected to perform multiple jobs (within a job). The South West had the largest proportion of employers reporting skills gaps - 22% of employers (up from 16% in 2007), compared to 19% for England. Skills gaps were most common in hotels and catering, a third of SW employers in this sector reporting an issue (compared to 26% for England) – mainly put down to lack of experience or lack of motivation. The education sector also saw relatively high levels of skills gaps - 26% of SW employers versus 25% England. SW businesses had higher levels of skills gaps than the England average for all sectors except finance.

Figure F7: Percentage of employers reporting skills gaps – 2007 vs. 2009



Source: National Employers Skills Survey 2007 and 2009, UK Commission for Employment and skills

The NESS survey suggests that in 2009 the region didn't have any particular issues with skills shortage vacancies relative to other regions – the proportion of overall vacancies, hard to fill and skill shortage vacancies[41] were all in line with the regional share of employment. Swindon, Cornwall and Devon may have slightly more skills shortage vacancies than their 'fair shares'. Plymouth, South Gloucestershire and Bristol may have slightly fewer skills shortage vacancies than their 'fair shares'

The distribution of vacancies, hard-to-fill vacancies and particularly skills shortage vacancies are strongly skewed towards smaller employers – for example, in 2009 firms with less than 25 employees accounted for 37% of employment but 55% of vacancies and around 70% of hard to fill and skill shortage vacancies. However, there has been a relatively fast reduction in the number of skills shortage vacancies in all size bands as recruitment dried up. Small employers' share of the diminishing total of skills shortage vacancies has increased from around 60% in 2007, whereas that of larger employers who are better placed to cover skills shortages from within their workforce (in the short-term) has decreased.

In terms of sectors, hotels and catering, and education, again were the sectors most likely to report hard to fill (6.8% and 6.2% of employers, compared to an average of 3.5%) and skills shortage vacancies (4.4% and 4.9%, compared to an average of 2.4%)[42].

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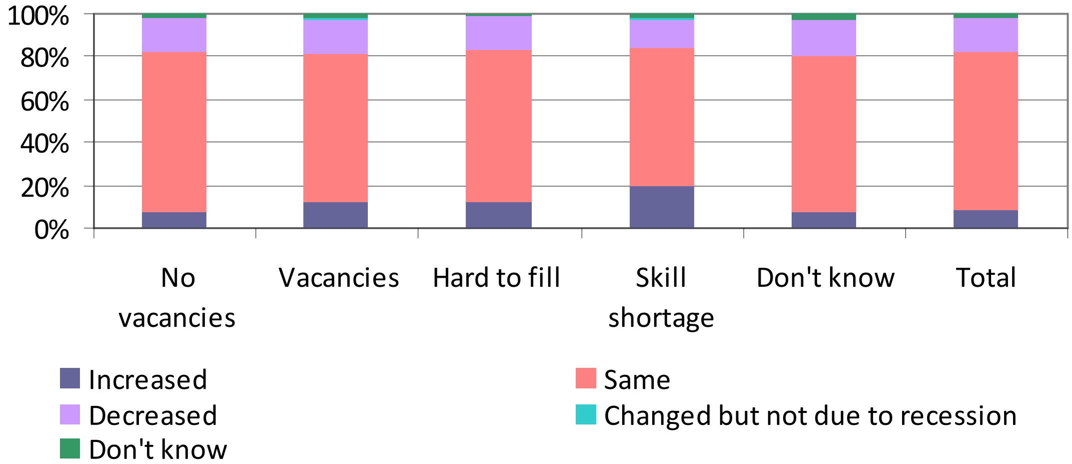
[41] Hard to fill vacancies are a subset of all vacancies. Skills shortage vacancies are a subset of hard to fill vacancies.
[42] Industrial data supplied by the Skills, Learning and Intelligence Module of the South West Observatory

Figure F8 shows the response of employers to training during the recession, depending on whether and what types of vacancies existed[43]. Those employers with skills shortage vacancies were far more likely to have increased training of staff, compared to all of the other categories, suggesting a consolidation of the workforce - 19% of companies surveyed, compared to 8.1% for those with no vacancies. Those with vacancies including hard to fill vacancies also saw an increase in take up of apprenticeships, whilst those employers with skills shortage vacancies were more likely to have increased the number of young people employed, presumably a longer term strategy.

Figure F8: Change in expenditure on training because of the recession, 2009



Source: National Employers Skills Survey 2009, UK Commission for Employment and skills

The RDA National Business Survey also asked business about skills needs[44]. In the two 2008 surveys, it was felt that management (36%) and IT skills (42%) and communication skills (29%) needed to be improved to meet business needs. About a third of companies also felt that improvement of technical, specialist or job-specific skills needed to be improved but only 14% for science, technology, engineering and maths (STEM) skills and 7% for foreign languages. These are in line with the England averages. Around 70% of firms think that workforce and management skills are important for their competitiveness so it is not surprising then that just under half have used external training and well over half some kind of internal training.

Skills for the future

It is difficult to predict what skills the region will need in the future with certainty. The future is never entirely set in stone. A large number of factors will influence the development of industry and employment in the South West. Industrial structure will depend on factors such as the development of global economic relationships, the pace and nature of technology and other changes across the

[43] Vacancies = employers with vacancies but none hard to fill; Hard to fill = employers with vacancies but none due to skill shortages

[44] RDA National Business Survey – see economy.swo.org.uk/publications/business-surveys/

economy, changing consumer preference, as well as the development of resources, including skills, that will determine the ability of SW businesses to compete locally nationally and internationally.

So what skills does the region need for the future? What should young SW people be training in for tomorrow? A suite of economic simulations was analysed to assess how the employment structure of the region will look post-recession. The analysis considers long-term prospects in terms of the industries and occupations that may be the basis for regional employment in the period 2010 to 2020, with a key focus on patterns of specialisation within the SW economy relative to other benchmark economies.

The 'global markets' scenario (Scenario 1) gives greater emphasis to growth in global trade, and the changes in patterns of specialization related to this. One effect of this is to concentrate economic activity in the South West in sectors with high export content (and in sectors which supply export industries) at the expense of those that principally serve national and local markets. On the other hand, a 'local communities' scenario (Scenario 2) assumes weaker growth in trade, with a greater emphasis on local sourcing by households, businesses and government alike. The result is a less specialised and less concentrated industry structure than under both the baseline and (particularly) Scenario 1, and this is also reflected in the occupational structure of employment.

The changes to industry structure (relative to baseline projections) under Scenario 1 are relatively minor, with more substantial changes under Scenario 2 where there is much stronger growth in activities which serve local (UK and SW) markets and those with relatively low carbon intensity. In terms of occupations, differences between the two scenarios and the baseline case are quite small. Under Scenario 1, the occupational employment structure of the South West becomes marginally more specialised in professional and associate professional occupations and in some areas of management relative to the baseline. Under Scenario 2, there is a marginally increased prevalence of design and media occupations within the South West (as these activities become more localised), while some professional and associate professional occupations become slightly less prevalent.

The real world will not adhere to any of these scenarios exactly but they give us useful benchmarks. Indeed, the eventual outcome is likely to incorporate elements of all three. The main finding is that specialisation of labour creates employment growth, opportunity and wealth, and generalisation destroys jobs and prospects. As the public sector and some other services retrench in the wake of the recession, the regions' businesses need to embrace opportunities in high value areas that the region already specialises in – aerospace and creative industries – as well as other parts of high end manufacturing, energy and business services. The region's workforce will need the right balance of skills to enable this.

COMPETITIVENESS

Competition is an important driver of productivity performance. Vigorous competition strengthens incentives to innovate and ensures that resources are allocated to the most efficient firms. By encouraging firms to reduce prices and improve the quality and choice of goods and services, it is also the most effective way of ensuring that consumers receive a fair deal. Competitiveness is achieved through a combination of the other drivers of productivity – investment in infrastructure and skills, entrepreneurship and innovation.

There has been a trend towards increased globalisation of the world's economies over the last few decades– businesses now need to be able to compete in the increasingly global market. Globalisation is both an opportunity and a challenge. In the SW, business is generally not as internationally engaged as in other parts of the United Kingdom and so benefits less from the productivity gains to be made from trade with other parts of the world. Indeed, the South West has a low propensity to trade, which in turn influences SW business productivity[45]. While it may be argued that the region may have been sheltered from much of the impact of the recession because of its reliance on the domestic rather than global market, it is this sheltering that may hold back its economic recovery.

The value of trade in goods by SW business was discussed in the Recession and Recovery section. The South West has a low propensity for trade, accounting for only 4.8% of UK exports in 2009. The region does, however, have a competitive advantage in some sectors – for example, "other transport equipment" accounts for 31% of SW exports (a 38% share of UK exports of this product group), reflecting its specialisation in manufacture of advanced engineering, especially aerospace but also marine ship building.

South West traders

As shown earlier, the SW economy is more dependent upon small businesses than other regions. Small businesses are likely to find it more difficult to trade internationally because of economies of scale and ability to price competitively, as well as lack of skills and information on markets and process. So why do SW businesses not compete globally – does the region have fewer companies trading or more (smaller) companies trading at a lower level – i.e. the region's share of exports is low, but what about its share of exporters?

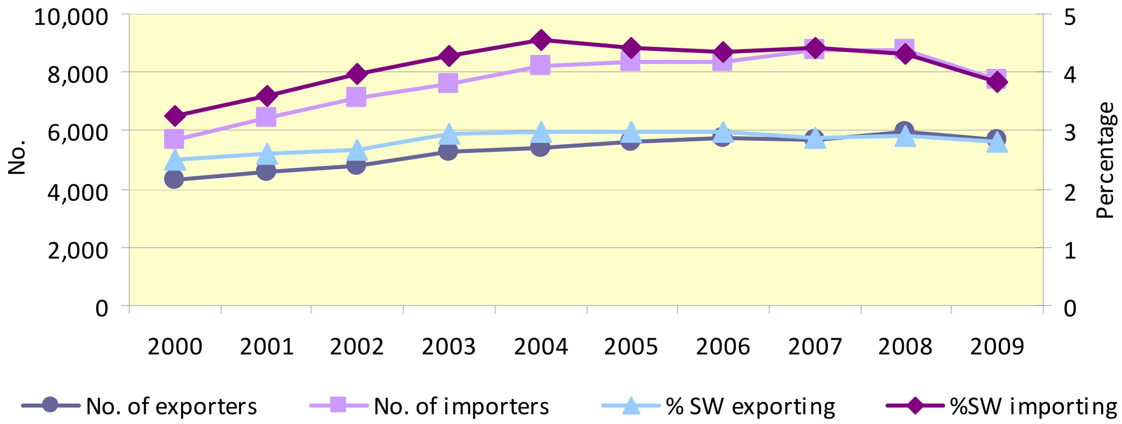
In 2009, 5,700 SW companies were involved in exporting of goods – 7,800 companies were involved in importing. These figures represent a 7.4% and 7.6% share of UK exporting and importing firms, respectively – see Figure F9. From 2000 to 2008, there was an increase of 1,600 exporters and 3,200 importers – the number of SW traders has grown faster than nationally, with the region's share of England's exporters and importers rising from 7.3% in 2000 for both to 8.4% exporters and 8.2% importers.

Although the South West has a similar share of firms exporting to/importing from non-EU countries, it has a lower share of businesses involved in trade with EU countries, which accounted for 58% of UK trade in 2009. So, in answer to the question above, it seems that perhaps the expected number of companies is involved in trade, just at a low level and perhaps not to the biggest markets.

Of course, business numbers have been on the rise at the same time that the number of traders has been rising. Figure F1 looks at relative participation of SW business in trade.

[45] Meeting the trade challenge, Boddy et al., University of West of England for South West RDA, 2007 – available at economy.swo.org.uk/research/corporate-research-programme/.

Figure F9: Number and percentage of SW firms involved in trade



Source: uktradeinfo.com

This shows that there was real expansion of importing (i.e. increase in the proportion of SW businesses involved in importing) from 2000 to 2004, with the proportion of companies involved in import rising from around 3.0% to a peak of 4.5% in 2008. Similarly, there was an expansion in exporting from 2000 to 2003, with an increase from 2.5% of companies involved in the export business to around 3.0% - this figure has fallen off slightly in recent years.

In 2009, in the middle of the recession both the proportion and numbers of importing firms fell reflecting demand and currency issues. Exporting has been fairly robust – indeed SW exporters weathered slightly better than England (4.3% decline vs. 5.3%, second best in England). But 12% decline in importers, 11% England. This is due to performance in non-EU importing – EU importing to South West though down is second best of regions. Despite a weak performance in 2009, the South West remains in a better position than in 2000.

Businesses dependent upon imports were more exposed to the recession than on average. Exporting businesses were perhaps sheltered because of the favourable currency position. Regardless of performance during the recession, if the private sector led recovery is to depend on exports then those companies most exposed and, therefore, hit hardest may be in a better position to respond to emerging opportunities as the economic recovery takes hold than those businesses more sheltered from the recession. It seems that the region has its fair share of traders but they are performing at a lower level – it will be important for SW traders to "raise their game" if they are to get their fair share of the benefits likely to emerge from the economic recovery.

Knowledge economy

Much has been said of the "knowledge economy" and how high value added, knowledge-intensive services (and parts of manufacturing) are the future basis for western economies as they de-industrialise and move more into services. Unfortunately, trade in services is not well measured, especially at regional level (and not at all at a local level).

In 2008, knowledge businesses comprised 20% of SW businesses and employees, i.e. [46]45,000 business units and 450,000 employees. The definition covers high and medium tech manufacturing as well as knowledge intensive services sectors. Knowledge intensive business numbers grew by 15% (15% nationally) and employees by 2% (4% nationally) between 2003 and 2008.

Broadly speaking, there has been growth or stability in knowledge intensive business numbers across the South West, though there is substantial sub-regional variation. Employment has fallen substantially, by about a third, in Plymouth and Bournemouth; less so in South Gloucestershire (9%) and Cornwall (4%). This has been mainly due to losses in education and health (Bournemouth, Plymouth, Cornwall), pensions and insurance (Bournemouth, Cornwall), high end manufacturing (Cornwall) and aerospace (South Gloucestershire).

The share of knowledge based business numbers and employment varies across the region, with a clear north-south difference. Bristol, Bath and Swindon have high shares of knowledge based businesses – 28%, 26% and 24%, respectively. Furthermore, almost a third of Bristol's employees work in a knowledge intensive sector. Plymouth and Devon have only a 15% share, and Torbay and Cornwall 13%.

There have been a number of high profile developments in the South West in recent years and months (all with RDA support), which will hopefully help the region and its parts further develop and exploit its knowledge economy. For example, the development of the Combined University of Cornwall, including the new Academy for Innovation and Research (AIR), a research and development laboratory for the creative industries and the Environment and Sustainability Institute. Wave Hub also puts Cornwall on the map in terms of renewable energy technology. Elsewhere in the region the National Composites Centre based at the University of Bristol helps put leading SW and UK businesses at the forefront of technology, with composites have a leading role to play in reducing the carbon impact of many industries. There is also the Centre for Fluid Mechanic Simulation at Bristol Business Park, which is already delivering a substantial shift in the capability power of fluid mechanics simulation systems, revolutionising the design simulation process and transforming the user interface. Together these centres could attract hundreds of highly skilled, high value jobs to Bristol and the South West.

ICT

In order to maintain competitiveness, it is important for businesses to remain at the forefront of technology – over the last couple of decades, this has largely meant keeping up to date with developments in ICT which have been a significant enabler of globalisation. Use of ICT has become a fundamental part of business today across all sectors – e-business, marketing through the web, improving efficiencies, etc. Reported business benefits of ICT include faster more reliable management systems leading to increased competitiveness.

Recent research has shown that the foundations for e-business are in place among SW SMEs, with comparable rates to the United Kingdom. Improved productivity and competitiveness were the main

[46] The knowledge-driven economy, Regional Economic Strategy And Regional Spatial Strategy in the South West of England, Martin Boddy, University of the West of England, for South West RDA, 2005

benefits reported by SMEs who were using ICT to enable flexible working. Good progress is being made against a range of ICT indicators both over time and compared with other regions, though the survey showed relatively low levels of system integration, low awareness and usage of support and limited knowledge about future technology developments[47].

The universal service commitment on broadband provision has been deferred to 2015. This could have a disproportionate effect on rural businesses in the South West, particularly as the region is already the worst off of all of the English Regions in terms of broadband speed provision. 19.9% of premises do not yet have 2 megabits per second (the universal service commitment speed). It is also worth noting that, as Government seeks to reduce costs through increased e-delivery (for example Business Support provided through a website only), there may well be issues with access for the rural South West.

A recent FSB survey showed that small businesses, especially rural businesses, did not seem to trade as much online as they could because of a lack of reliable and "fast enough for the purpose" broadband speed with appropriate IP throughput[48]. With small businesses dominating our rural economies – 27% of England's enterprises are rural – this is a significant barrier to growth and breaking this barrier must be the priority for any incoming Government. 24% of respondents are dissatisfied with their broadband service. Of those small firms that are dissatisfied, 63% said that they are unhappy with the speed and reliability of their internet connection supplied by their service provider. 30% said the area they live in has an unreliable broadband connection and 13% said they would consider moving business premises to an area with faster broadband. The survey also showed that a lack of broadband speed and acceptable IP throughput reduces productivity for a third of small businesses.

Looking ahead, Next Generation Broadband is one of the next major developments in ICT. Cornwall will be one of the first parts of the country to benefit from this new superfast broadband. This will be hugely important in boosting Cornwall's lagging economy and in attracting and retaining high value businesses, helping the county overcome existing problems of remoteness and giving Cornish business a real head start in competing in the global economy.

ENVIRONMENT

The natural environment provides a wealth of social and economic and health benefits. As a peripheral, coastal and largely rural region, the SW population benefits enormously from its natural environment – extensive coastline, areas of outstanding natural beauty and national parks. The diverse nature of the SW environment is a key driver of the economy in terms underpinning the region's agriculture, food and drink, and tourism sectors, providing employment for many. More recently, it has enabled the region to develop capacity and strength in renewable energy.

Environmental issues have risen up the political agenda due to global warming and climate change, conservation issues and food security, and an increased social awareness of the impact of mankind on the environment – there is increasing pressure to move towards economic growth within environmental limits. In the years ahead, policy and legislation will be introduced to mediate the move

[47] Exploiting the business opportunities of IT in the South West – ICT benchmarking research 2008. Step Ahead Research for South West RDA, 2008

[48] Broadband – steps for an incoming government. Federation of Small Businesses, July 2010

to a low carbon economy and to both manage and mitigate against the risks that climate change might bring. This presents particular challenges to the SW economy, which is dependent largely upon SMEs, many of whom may struggle to adapt or to exploit new opportunities.

REEIO Baseline analysis

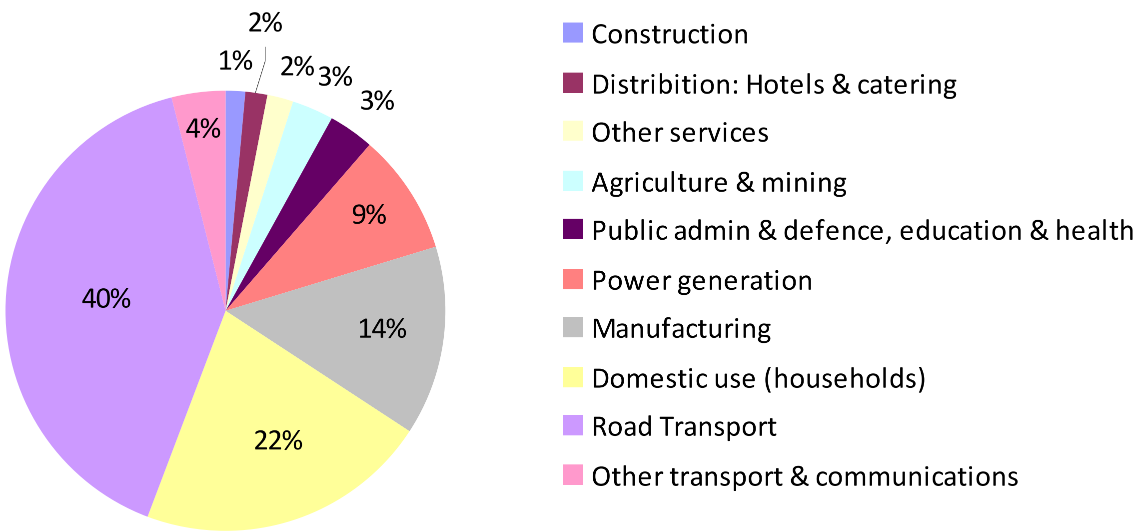
Pursuing growth within environmental limits acknowledges that economic growth cannot sustainably rely on ever increasing natural resource consumption. One of these environmental limits is the global atmospheric concentration of carbon dioxide (CO_2).

The following analysis considers the level of emissions generated by SW industries both now and into the future using the latest version of the Regional Economy Environment Input-Output (REEIO) model[49].

The baseline data for the model show that economic activity within the South West generated 27.4 million tonnes of CO_2 in 2007 – an increase on the 25.6 million tonnes generated in 2005[50]. This can be attributed to an increase in emissions associated with power generation and households, which cancelled out reductions made by the manufacturing and transport & communications sectors. UK emissions fell by 1% over the same period.

Road transport is by far the largest contributor to regional emissions (40%), followed by households (22%) and manufacturing sectors (14%) – see Figure F10. The service sector makes a relatively small contribution to emissions but this is in part because electricity consumption is largely discounted by the model.

Figure F10: SW emissions CO_2 emission by sector 2007



Source: Regional Economy Environment Input Output Model 2007, Cambridge Econometrics

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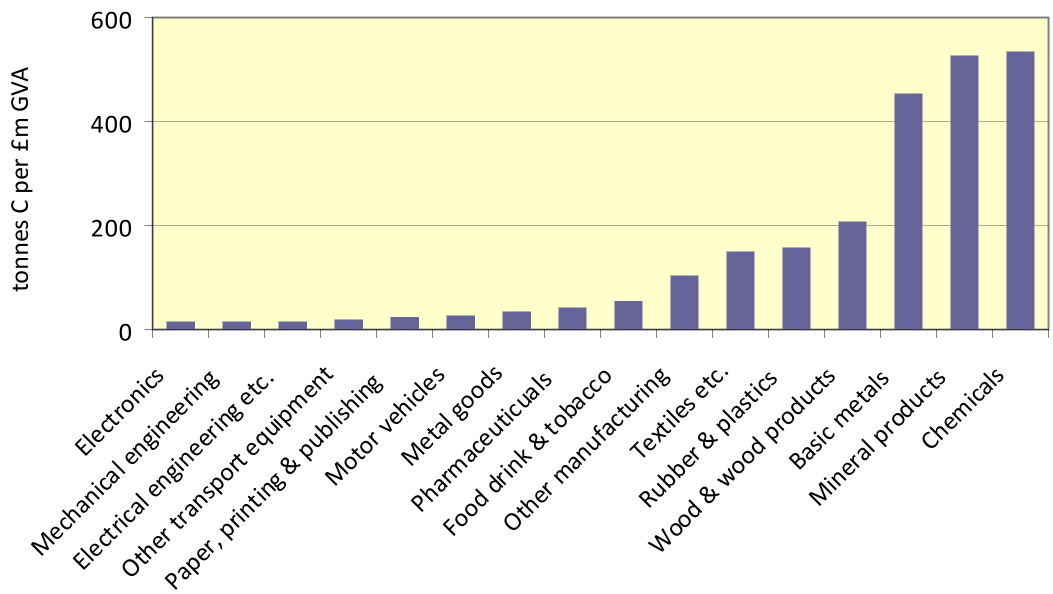
[49] Cambridge Econometrics. More info at www.scpnet.org.uk.
[50] These figures are lower than the official figures from the Department for Climate Change, which include emissions from electricity consumed within the region but generated outside of the region.

A more detailed analysis of the manufacturing sector reveals a notable variation in carbon intensity across sub-sectors (see Figure F11). Although reducing its emissions by around 40% since 2005, the 'chemicals' sector still contributed a fifth of all manufacturing emissions in 2007; this compares with a 3.2% share of manufacturing GVA, suggesting that this sub-sector is relatively carbon intensive. In contrast, the mechanical and electrical engineering sub-sectors are relatively carbon-light: the former emitting around 2% of manufacturing CO_2 emissions and contributing 12% of its GVA, the latter 2% and 9% respectively.

Figure F11: Contribution to CO_2 emissions and GVA by manufacturing sub-sectors 2007



Source: Regional Economy Environment Input Output Model 2007, Cambridge Econometrics

The REEIO model contains a built in forecast of the values of economic and environmental variables up to 2030 based on Cambridge Econometrics' regional economic forecasts (from a Local Economy Forecasting Model (LEFM)). Based on these assumptions, overall emissions (measured in million tonnes of carbon) in the SW region are projected to fall from 7,300kt to 6,400kt – a 12% reduction. In absolute terms, manufacturing will contribute the most to this reduction with emissions falling by around 500kt. This is due to model assumptions of improved energy efficiency as well as the shift towards higher electricity consumption and less from gas and other fuel oils. Emissions from road transport, however, are expected to increase by around 5% with the sector's share of total industry emissions rising from 40% to 48%. This is largely due to an anticipated increase in car and road freight vehicle kilometres travelled which will outweigh assumed gains in fuel efficiency.

SMEs

The SW economy is highly dependent upon SMEs and these businesses face a number of environmental challenges in the coming years as the region moves towards a low carbon economy[51]. These include the Government's climate change mitigation policies and the costs of understanding and responding to these, the increasing cost of energy (and potentially of other raw materials and inputs), changes in patterns of market demand for goods and services as a result of changing consumer preferences, the impacts on SMEs of climate change itself, given that the effects are occurring more rapidly than expected and that adaptation as well as mitigation will be needed.

There are also opportunities for SMEs in a low carbon economy, particularly for businesses whose operations are already on a more sustainable basis and those that are able to respond more innovatively and opportunistically. The opportunities include an increasing demand for low carbon or more sustainable goods and services – the South West is in a favourable position here due to its strength in renewable energy technologies and strengths in lifestyle goods and services, including regional food and its tourism offer. There are also opportunities for many existing SMEs to modify their processes and products/services to be more sustainable, resulting in lower costs and better profit margins and access to growing pro-environmental consumer markets. There are other opportunities in sectors particularly associated with the development of a low carbon infrastructure and productive capacity.

The literature on environmental management and green innovation shows that most SMEs have been slow to adopt environment-related improvements. Studies attribute this limited responsiveness on the part of most SMEs to a number of internal and external barriers, but particularly to a lack of market, regulatory and fiscal signals and doubt amongst owner-managers relating to the business case for sustainability.

In recent years, parts of the region have experienced severe climate-related events – heavy rainfall and flooding, severe snow and ice. It is expected that such events are likely to become more likely in coming years. A small survey was carried out to evaluate business vulnerability to weather-related risks from across key business sectors in the South West of England – advanced engineering; transport and distribution; food and drink manufacturing; and construction[52]. Both direct and indirect impacts flooding/heavy rain; water shortage; and high temperatures were assessed to create a high level cross-sectoral regional picture of vulnerability and resilience to climate change and weather-related impacts.

Whilst this research project was limited in its scope due to restrictions on time, number of businesses interviewed, and subjectivity inherent in interviewee responses, the key findings are generally reflective of those identified in other business surveys and research projects – as detailed in the full report's literature review. The key findings are as follows:

- Geographical location is a key factor in business vulnerability and is a key regional vulnerability due to the positioning of many businesses in the South West on low-lying or coastal land.

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[51] SMEs in a low carbon economy – Middlesex University for BERR, 2009.
[52] Business vulnerability to extreme weather in the South West: understanding the baseline. Tim Morris, University of Exeter for Climate South West, May 2010. Available at www.oursouthwest.com/climate/tools.htm#bu

- Indirect impacts of extreme weather can have a large impact on businesses, especially where there is road disruption, power and telecommunication loss are the most disruptive.
- Levels of vulnerability to utility/service disruption from extreme weather notably depends on preparation and business planning.
- Small and Medium Enterprises (SMEs) are disproportionately vulnerable due to their short time-planning horizons, lack of time and resources, and lack of influence over their supply chains.
- Most incidents are viewed as low probability and therefore adaptation is considered a low priority. This is also linked to the uncertainty involved in climate change, as businesses do not consider the costs of adapting worthwhile.
- There is a significant lack of awareness prevalent amongst SW businesses relating to; their vulnerability to direct and indirect impacts or the adaptation measures available to increase resilience.

A similar survey of tourism businesses showed that 56% of respondents had been affected by extreme weather in the past[53]. 63% think that they will be affected in future (mainly heavy rainfall). 50% see business planning for climate change a medium to high priority. 46% already implemented some measures, including assessment of flood risk, improvement of drainage and flood defence measures. 29% intend to do nothing. The overall research finding was that respondents are either confused by, or sidetracked by the debate surrounding the causes of climate change.

[53] Climate Change – Tourism Business Survey. South West Tourism, 2010. Available at www.swtourism.co.uk.

CONCLUSION

Structural messages:

Over the last couple of decades, the South West economy has been undergoing a restructuring of its sector or employment shares, away from manufacturing and towards services, primarily business services. Nonetheless, the region has maintained a strong, competitive advantage in advanced engineering, including aerospace, which is principally responsible for the South West's relatively high ranking on business expenditure on research and development and is its major exporting sector.

Despite such "pockets of competitiveness", the South West is not as globally engaged as other regions, reflected in its relatively low trade share figures. Businesses that engage in trade tend to be more productive, grow jobs and pay better, and so lack of trade involvement may mean missed opportunities for SW business to make productivity gains. Importantly, the UK economic recovery is hoped to come more from growth in exports than in the past – the South West has seen some recent gains, but its low starting point puts it at a disadvantage.

The region also has relatively low turnover of business stock, again suggesting lack of exposure to competition and some stagnation of economic vigour, at least in some parts or sectors of the region.

The SW economy is relatively dependent upon SMEs for employment and turnover, reflecting the industrial make up of the region and the peripheral nature of some of its geography. Distance from major markets of much of the far south west has been a constraint on relative SW development through time. Conversely, the business demography represented by our SMEs also reflects the entrepreneurial spirit of the SW population.

The region is also a highly rural one. Compared with many other regions, it is dependent upon rural areas for a significant share of its economic output and community. Rural businesses tend to be smaller and older.

Small businesses, especially in rural localities, are problematic to monitor and to support, as they are not always captured in the data. Because of their size, they may be more vulnerable to economic shocks, as seen in the recent credit crunch and consequent recession. They are also, generally, less productive due to lack of economies of scale, flexibility of resource allocation, and benefit less from spill over effects from agglomeration.

Cyclical messages:

The South West followed the United Kingdom into recession. There are signs of weak economic recovery regionally and nationally, with manufacturing so far doing better than (unrelated) services.

Public sector contraction now poses a threat to the recovery - if the timing, impact and extent of cuts are not introduced optimally. The South West has been relatively dependent upon the public sector for new employment, which is expected to be hit hard over the next few years. In addition, thousands of SW firms are part of the public sector supply chain and uncertainty about the future is already affecting a range of sectors, including, for example, construction and some creative industries. High value added defence companies may also be at risk should key projects be shelved or abandoned, whilst some communities could be affected badly by any base closures because of the strategic defence review.

The public sector contraction, in tandem with the private sector led recovery, however, potentially presents a raft of opportunities to those SW firms ready and able to respond. The region has relatively high proportions of knowledge based businesses and several centres that are at the forefront of technology and innovation in some areas and some sectors. SW business can capitalise on this in the coming years. Improvements to ICT, including faster broadband, will be needed to negate the negative effect that distance from major markets has had, historically, on some SW businesses. The South West was made the first UK low carbon economic area by the previous government. This still suggests exciting opportunities for SW business associated with the renewables sector and other low carbon technologies.

Strategic messages:

We have found that some parts of the region and some sectors are ready to take advantage of new opportunities as they arise. However, some remain relatively uncompetitive, with parts of the region dependent upon a number of relatively unproductive sectors. The reliance of many parts of the region on tourism, for example, is both a strength and a weakness, depending on how unemployment and falling real incomes filter through to this and other consumer dependent sectors. Low productivity sectors tend to dominate in areas of low wages and high public sector dependence.

As the economy recovers, albeit slowly over the next year or so, the strengths, weaknesses, opportunities and threats to SW businesses are not distributed evenly across the region. The higher productivity north and east of the region is more exposed globally, has higher proportion of high value added, knowledge based businesses, is more likely to be able to absorb public sector cuts, and will be better able to take advantage of new opportunities. The far south west is more dependent upon consumer spending, is less competitively exposed - less competitive on average - and more vulnerable to public sector contraction in the short-term.

- SW strengths have usually been concentrated in key, world class sectors and, more generally in our high employment and resilient business demographics.

- With notable exceptions, SW weaknesses have reflected a relative lack of access and competitiveness in new markets or technologies.

- There are profound opportunities in the new knowledge economy to build skills and businesses for a rebalanced economy with greater investment in innovative techniques and processes and new industries.

- The threats, however, are that parts of the region, spatially and entrepreneurially, start from a disadvantaged position in terms of historical appetite and aspiration to invest and trade on a bigger stage.

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Economy Module of the South West Observatory

The Economy Module of the South West Observatory is provided by the South West RDA Economics and Evidence Team. It provides a comprehensive data and analysis to support regional development and evidence based decision making. To improve the availability of regional data the Economy Module has developed a set of Regional Accounts which are freely available to all. For further information please visit the Economy Module website (**www.swo.org.uk/economy**).

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