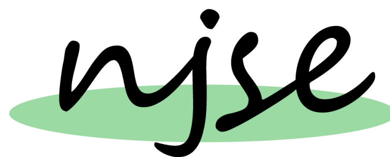

# Strategic Economics Report

**Issue 6: November 2013**

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## Report Index pages

**Executive Summary:**
**The Marathon Recovery** 2-3

**Economic Profile** 4-17

- **National Overview** 4
- **Recent data & trends** 5-10
- **Forward Guidance** 11-15
- **Local Overview** 16-17

**Economic Prospects** 18-19

**Afterword** 20

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## Executive Summary: The Marathon Recovery[2]

Finally, we all now assume that a recovery is underway. It is vulnerable to shocks and there are imbalances still to correct but, this time, it feels like the upturn has some underlying momentum. Nonetheless, we suspect it is going to be a slow marathon rather than a fast sprint. Indeed, if we are to avoid further aggravation, with structural imbalances leading to new 'bubbles' and 'busts', it would be better to maintain a moderate pace. Perhaps, it would be better to build endurance for a long race rather than to burn out the economic muscles in a short spurt.

We would prefer a sustained, modest recovery that can gradually correct all the inadequacies of UK economic structures and policies. To run this marathon, the economy will have to get three things right: its weight, its fitness and its stamina.

Analogous to **economic weight** is the key relationship between output growth and debt dependence. The UK policy argument between '*you need to get the debt down before you can grow*' and '*you need to get the growth in order to get the debt down*' has been intense. The recent US debt ceiling/default crisis is another example of the argument about economic 'weight'. There is no doubt that to run an economic marathon competitively, you have to get the economic weight ratio (debt/dependence to total output) to a sustainable level. With the UK public sector net debt to GDP ratio at 75.9% (2013 Q3), we are not there yet. Whatever the politics, the need for a long-term adjustment in debt dependence will be an important economic factor in many excessive debtor countries for, at least, the next decade. At present, the UK economy is carrying to much weight (debt) for the marathon ahead[3].

The question of **economic fitness** leads us to the problem of productivity. As we have discussed before, this long downturn has been characterised by, unusually – (almost uniquely), a failure of UK productivity to recover. Abnormally, over five years in to the crisis, productivity remains lower than it was at the last peak. Importantly, without an improvement in 'productivity fitness', the UK economy will struggle to keep up with its

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[3] Debt is not bad per se. As we all know, it is good to borrow young and repay old. It is good to borrow for capital that will earn a return rather than for current spending. As with body weight relative to personal activity, it's getting the 'just right' debt to output ratio that matters.

competitors. At present, the UK economy is not fit (productive) enough for the marathon ahead and, without an improvement on this measure, it will be difficult to start and sustain any employment and value added growth and, thereby, raise average living standards.

Real investment and incomes represent **economic stamina**. Investment allows supply to grow whilst incomes fuel demand. At the moment, investment is lower than desirable. Many businesses have the liquidity to invest but low official interest rates, undermining the whole spectrum of economic returns, are not supportive of a 'normal' funds flow system. Moreover, for many households, real incomes are falling and have been since 2009. Without a turnaround in these two trends, the recovery will not have the stamina to keep going to the end of the marathon recovery.

As we head for the 2015 General Election, a lot of debate will be about the economy: whether austerity has worked and must be maintained and how we can address cost of living pressures. Ideally, the debate will focus on making the recovery real and long. The recovery should be a marathon that allows a gradual approach to sustained development. For this, we need to get our aggregate weight (debt dependence) down, our fitness (productivity) up and our stamina (real investment and incomes) higher. These are the areas that business and government need to concentrate on - hopefully, in a non-partisan way …

**Running the marathon recovery** to a successful finishing line requires a lean and mean approach to economic development that builds international competitiveness through innovation and skills. We need a more normal monetary system, a more rational fiscal system and a development system that builds productivity and real growth by encouraging entrepreneurship and competitiveness. Getting our economic weight, fitness and stamina right will determine whether we compete and where we finish in the forthcoming economic race.

# Economic Profile

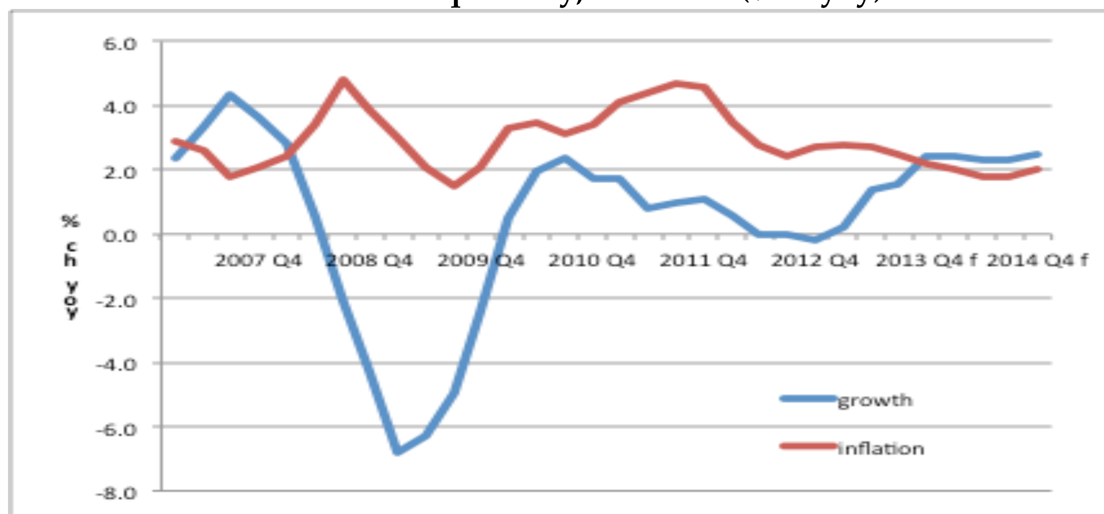
## National Overview

The first estimate of UK **real GDP** for the third quarter (July-September 2013) showed output up 0.8% on the quarter and 1.5% higher year-no-year. Whilst the latter rate is still well below our economic potential, suggesting a positive 'output gap', the former rate shows that **the recovery** that seemed to get underway in the April-June period **persisted through the summer**.

Importantly, the latest increase in aggregate output seemed reasonably broadly based across the different sectors of production and services. Also, the statistical 'story' of recovery seems supported by the latest surveys of business confidence and aspiration. Modest rises in orders, output and employment are evident in more UK places and industries.

But, output is still 2.5% below its pre-recession peak and inflation is still above the 2% MPC target (see chart below). Also, unemployment remains above the Bank of England's 'new' 7% threshold. In other words, **the downturn persists**. At long last, after five and a half difficult years, we are moving forward but we are not fully adjusted for the recovery ahead.

**UK Real Growth & Inflation: quarterly, 2007-2014 (%ch yoy)**




Source: ONS & Strategic Economics

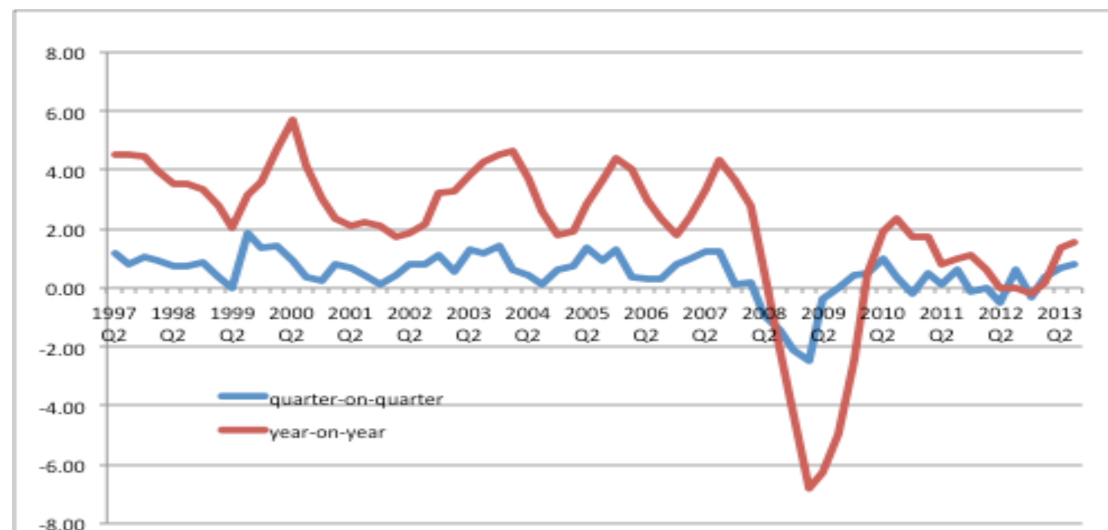
The growth and inflation chart above shows our view of the main macro aggregates for the year ahead, with growth likely to exceed 2% per annum (our forecast range 2.1-2.7%) and inflation hovering close to its 2% (1.8-2.0%) annual target. Barring negative shocks, **the balance of risk** is that we are underestimating the pace of recovery and overestimating the fall in inflation.

## Recent Data & Trends:

The economy fell into a deep hole in 2008-2009, bounced back a bit in 2009-2010, but was unable to maintain that recovery and lost momentum again through 2011 and 2012 (see chart below). It may be, however, that a real upturn has started in the last six-nine months. Unless this is a second false dawn, a turning point appears to have passed at the end of last winter.

This is most noticeable by looking at growth expectations for the current quarter compared with its equivalent a year ago. According to the comparatively conservative forecasters at the IMF (World Economic Outlook October 2013), **UK real GDP** growth was flat in year-on-year terms in the final three months of 2012. This year, the IMF WEO estimates the equivalent rate of growth for the October-December period will be 2.3%.

**UK real GDP trends: 1997 Q1 - 2013 Q3 (% change)**



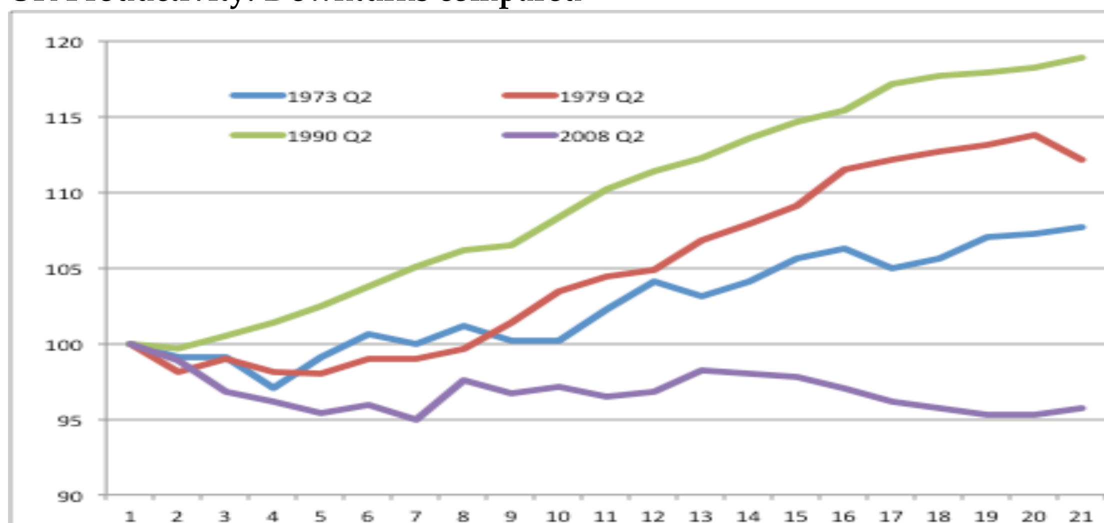

Source: ONS data

Nevertheless, whilst we do believe this recovery to be genuine, it is still going to be more constrained than previous ones. A significant reason for this is the **poor productivity performance** of the economy during this downturn.

The productivity chart below compares this downturn with the previous three. Fixing the output per hour level at 100 in the last quarter of growth before the downturn (the previous peak), it shows that productivity usually recovers to new highs within about two years (eight quarters) and expands thereafter. The line for the current period (2008 Q2+), however, shows that **over 5 years on (21 quarters), productivity is still below the previous peak**.

This 'productivity conundrum' is a considerable weakness for the recovery to come. Optimists say that an upturn in demand will see productivity bounce back quickly. Firms have the liquid funds to invest for growth and have kept the labour needed to boost output when they judge the upturn is real. Pessimists say there is little prospect of a demand surge, given falling real incomes, and any productivity increase must be hard-won through investment. But, investment will remain constrained by uncertainty about future sales. Whoever is right, until productivity starts to recover convincingly, boosting business and household confidence, the forces pushing up and sustain employment growth will stay weak.

**UK Productivity: Downturns compared**




Source: ONS data

Worryingly, the latest **international comparisons on productivity** show the UK's relative position weakening in 2012. Last year, UK output per hour and output per worker were 16 and 19 percentage points respectively below the G7 average. The ONS says the former was the largest gap since 1994. Unlike most of its peers, UK productivity was lower in 2012 than in 2011.

In current prices, last year, UK output per hour was 29 points behind the USA and 24 points behind Germany and France. In terms of GDP per worker, the equivalent gaps were 40 points and 10 and 11 points respectively. The large relative US differential between these measures (40-29) is explained by its longer working hours whereas the opposite is the case in Europe (10-24).

In constant prices, UK productivity remained below its 2007 peak in 2012 and slipped back relative to its rivals and, significantly, compared with its own previous long-term trend. **Here is the real cost of the UK downturn**. We are less competitive, buying a less negative employment impact at the price of poor productivity. In contrast, the USA and Canada in particular, have seen a

previously 'normal' pattern of productivity-led employment fall and rebound over the downturn.

**Why does this matter?** It matters because productivity growth is the 'holy grail' of economic performance and future living standards. If our relative productivity performance is slipping and our absolute productivity is not increasing, relative living standards will fall over time and absolute, post-inflation, living standards will, at best, stagnate, and probably drop. In turn, this means lower employment and real incomes, and higher unemployment down the line.

So, the UK recovery will not be sustained and secure until productivity starts to climb again, in absolute and relative terms. Moreover, in the short-term, employment growth will be restricted. Later, once we have got on to a productivity-led growth path, the increases in employment will come.

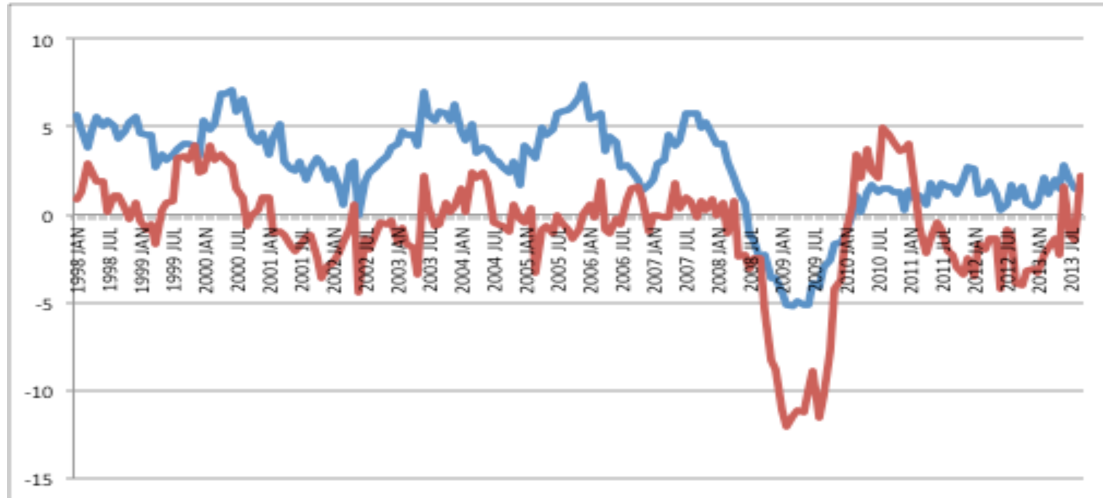
Politicians and commentators have been talking about rebalancing the UK economy to make it more internationally competitive for the long run. Our argument is that the crucial element is for this rebalancing to be investment-led in a way that boosts productivity. The latest UK productivity figures are awful and current policies are not really helping. **Right now, unlike our competitors, we are going in the wrong direction.** Until, we turn this around, the recovery can only be weak and will remain vulnerable to shocks.

Coming down from this international perspective, in October, ONS published analysis of its **microdata on the productivity of UK firms** since the downturn. Overall, it showed working hours back above and output below pre-downturn levels. Hence, productivity was still falling on average. But, the variation by firm and by sector is wide. The ONS confirms that exporters, foreign-owned and larger companies perform better, in relative terms, as do high broadband users - although, the downturn has had more negative effects on some of these 'better' categories in absolute terms. The ONS' central finding is that the lack of recovery in productivity is worse for services (excluding the financial and communications sectors) than manufacturing, and that labour productivity performance in 2010 was weaker among smaller firms than larger firms across all sectors.

Meanwhile, whilst **services output** has now increased enough to pass the previous peak, its growth remains subdued (see next chart). Moreover, **production** is still below previous levels: in the case of **manufacturing**, still 9% down (in September 2013). There is considerable debate as to whether and when this bridge from downturn to upturn can be crossed. Even though there are some remarkable, current, success stories in terms of export growth

and output gains, (particularly in the transport goods industries such as aerospace and motors), there are questions about whether manufacturing output, in aggregate, has permanently lost UK capacity. In industrial terms, rebalancing remains a dream rather than a reality.

**UK production (red) & services (blue): Jan 1998 – Sep 2013 (%ch, yoy)**



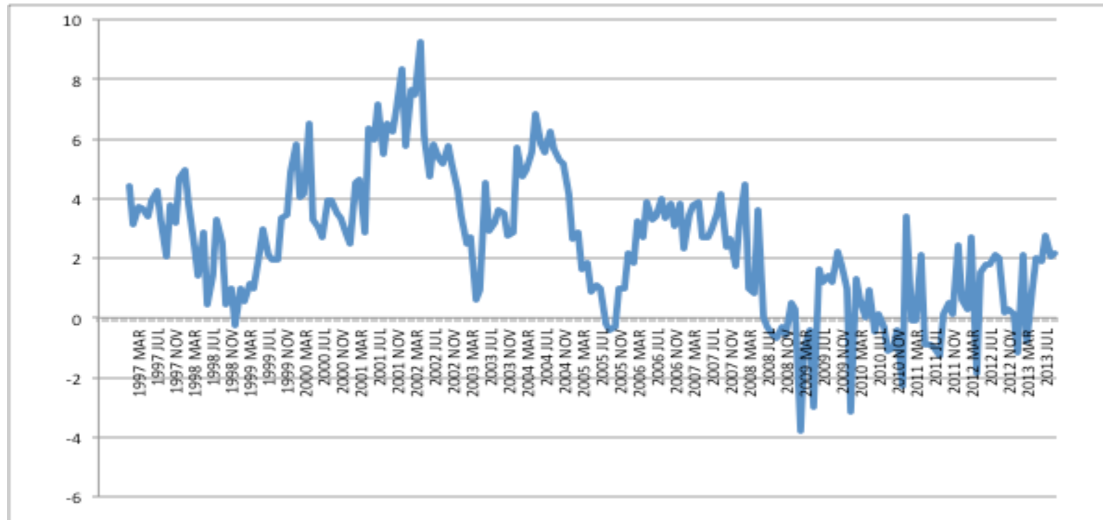

Source: ONS data

Some of the growth in evidence is being driven by overseas demand but most UK businesses are engaged domestically and here demand remains constrained. As the **retail sales** chart below shows, the recovery in demand has been erratic and difficult to sustain. For the first time since the 1930s, aggregate real household incomes have fallen since 2009. And, whilst employment has held up better than expected, the fundamentals driving demand are weak.

Through the summer of 2013, the improvement in sales volumes looks better founded (see chart). Perhaps, this reflects the activation of liquid funds that have been held, earning little return, by some economic actors. It could also reflect the inevitable, eventual turn in the replacement cycle for durable and other products. (Some commentators ascribe 2013's higher car sales to this factor, although special offers abound and there is a risk that the manufacturers and dealers are merely bringing forward future sales.)

**Overall, it will be interesting to see how the balance of pressures between falling real wages and pent up demand goes in driving final sales in the months ahead.**

**UK retail sales volumes: Jan 1997 – September 2013 (% ch yoy)**

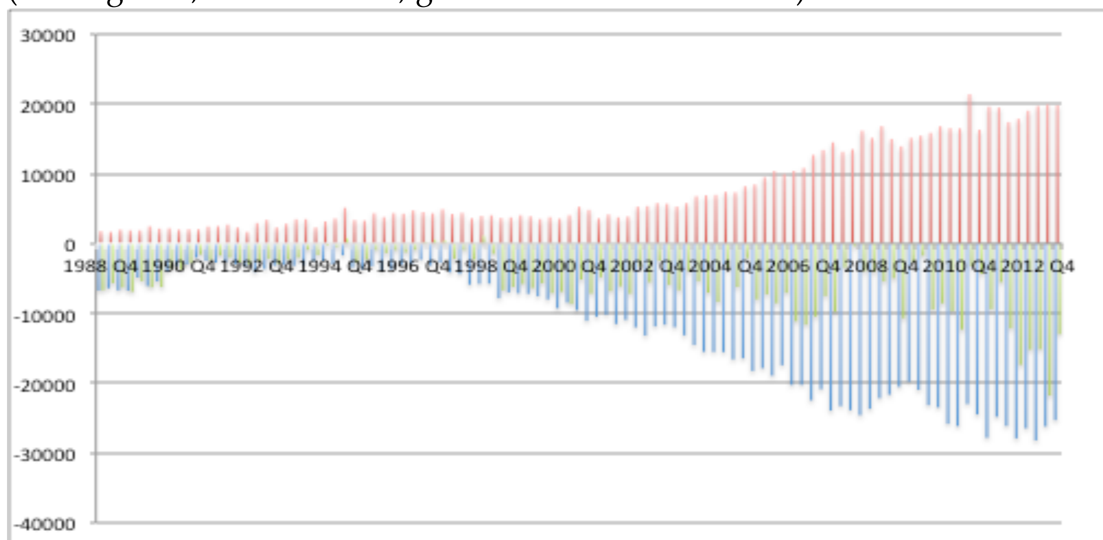



Source: ONS data

The UK **external accounts** also show a lack of evidence about the rebalancing in the economy. The negative balance on goods remains at very high levels (about £25bn per quarter – see chart below). Whilst the positive services balance has reached £20bn per quarter, the failure of the aggregate current account measure and ratio to show any real improvement during the downturn points to the same issues of lack of competitiveness because of falling productivity identified above. External rebalancing remains as illusive as industrial rebalancing.

**UK balance of payments: 1988 Q4 – 2013 Q2 (£mn):**

(blue - goods, red – services, green - net current account)



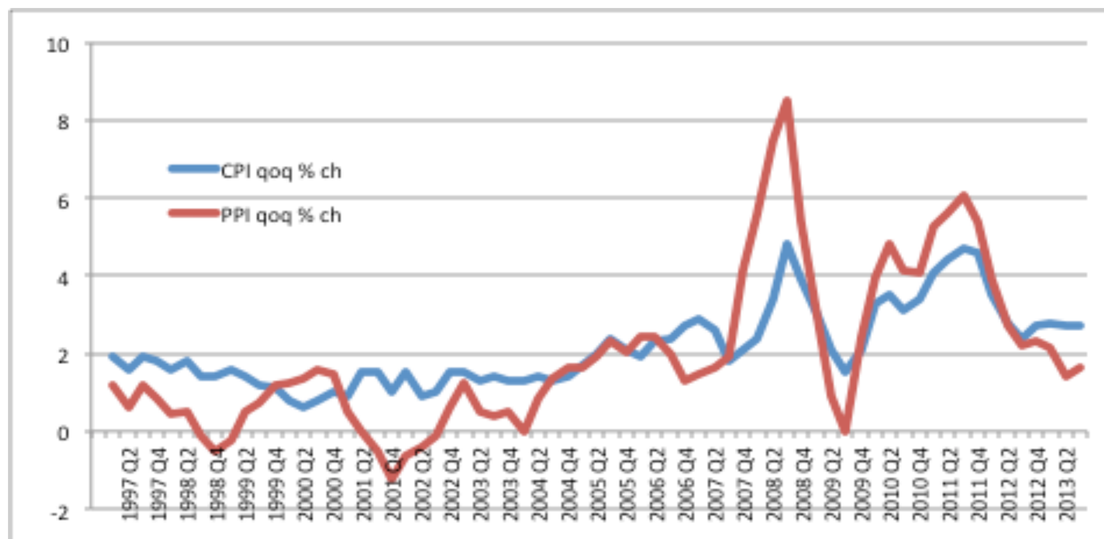

Source: ONS data

Turning to **inflation**, despite a fall in the indices of input and producer price inflation, the consumer measure remains stubbornly stuck above 2.5%. The Bank of England, as always, is predicting that it will drop back to target within its forecast horizon. But, they have been consistently wrong in that prediction for several years now. Because the Bank does not focus on the institutional drivers of high relative UK inflation, monetary policy is probably being held too loose, for too long.

Moreover, as the current vibrant debate about the cost of living illustrates, the pressures from administered and other unavoidable price increases for non-discretionary items in most household budgets, mean that many consumers experience inflation significantly above that recorded in the official index. The difference between discretionary and non-discretionary spending is crucial, given that overall declines in real wages and living standards are evident for many. **The UK's tendency to experience higher inflation than its rivals remains an inhibition to long-term growth.**

The Bank of England is probably right that underlying inflation pressures are falling. But, underlying pressures is not what is being reflected in most households' decisions and expectations. The preponderance of structurally high UK inflation compared with our competitors overseas is another area where rebalancing is needed but largely ignored by the policy makers.

**UK producer (red) & consumer prices (blue): 1997 Q1 – 2013 Q3 (% ch, yoy)**




Source: ONS data

## Forward Guidance:

The new Governor of the Bank of England, Mark Carney, has persuaded the Chancellor of the Exchequer and the Monetary Policy Committee (MPC) to adopt a new (actually retro) approach to monetary policy. Based on North American models, it introduces a **more direct link between monetary policy and the real economy as well as the inflation target**. It aims to achieve three things:

1) to calm fears that interest rates are likely to rise soon;
2) to support the short-term recovery; and,
3) to provide a longer term framework that can influence market and inflation expectations.

In its recent **Inflation Reports**, the Bank has seen the prospects for UK growth as higher than it did before. But, for inflation, its outlook is essentially unchanged. Importantly, the path of its growth forecasts is not sufficient to remove the slack in the economy. Because of this persistent degree of spare capacity (and negative/low real wage increases), the Bank believes that underlying UK inflation is likely to remain subdued. The MPC does acknowledge, however, that administrative and import price rises are still holding the rate of increase in the consumer price index (CPI) above target. Indeed, even the Bank says the inflation target is not likely to be hit until well into 2015.

Meanwhile, by May 2013, forward market interest rates had started to rise in response to better economic prospects. The Bank, particularly Mr Carney himself, feared that expectations of (short-term) interest rate increases were premature and that they might cut off a real economic recovery before it had really got going. (Mr Carney worked in Japan when interest rates went up "too soon". Some believe this killed off an incipient recovery and kept the economy weak throughout the 1990s.) Adding in his successful Canadian experience with forward guidance in the 2000s, the MPC (endorsed by the Treasury) has adopted "Forward Guidance" as its new policy framework.

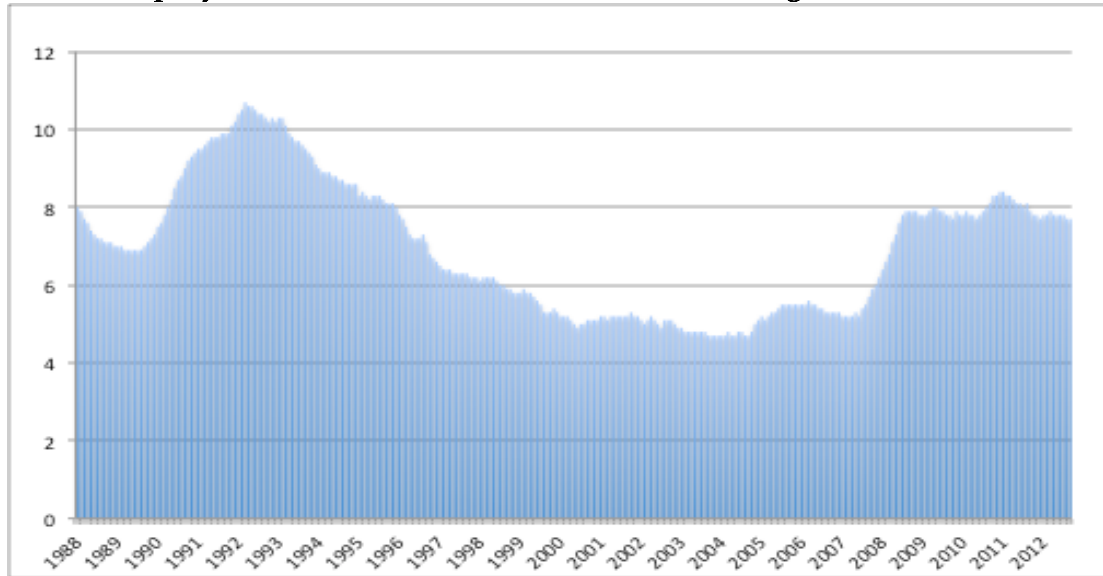
**Forward Guidance** can be summarised as follows:

1. The Bank expects to maintain its loose money policy as long as the economy has considerable spare capacity, provided this does not risk price or financial stability (see 3 below).

2. Subject to 'knockout' conditions (3 below), the bank will not raise the 0.5% base interest rate and will maintain the asset purchase stock

(quantitative easing) until, at least, the headline Labour Force Survey measure of the unemployment rate has fallen to/below a 7% 'threshold'. (The current position is shown in the chart below. The national unemployment rate has peaked at a lower rate than in the previous downturn but has stayed stubbornly high - just under 8%).

**UK Unemployment (% LFS rate) December 1988 – August 2013**




Source: ONS data

3. The conditions for this approach, termed '**knockouts**', are threefold. The MPC will, at least, consider an adjustment to policy if:

    a. The MPC forecasts the CPI measure of inflation 18-24 months ahead as likely to be 0.5 percentage points above the 2% target (i.e. greater than 2.5%).
    b. Medium term inflationary expectations amongst business, households and financial markets are no longer sufficiently "anchored" i.e. they are tending to increase.
    c. The Financial Policy Committee (FPC) judges that the monetary policy stance poses a significant threat to financial stability in a way that cannot be contained by other mitigating policies.

It is important to stress that the **2% inflation target still has primacy** and any significant risks to this should mean the MPC amends or sets aside the new unemployment 'test'. Moreover, the 'knockouts' are not mandatory. They are signals for the MPC to consider rather than triggers to necessarily raise interest rates or decrease asset purchases.

What does this mean in practical terms?

1. Unless the economy accelerates much more than anyone now expects, **base interest rates** will stay low for the foreseeable future – perhaps, on current forecasts of growth and unemployment, staying at 0.5% until well into 2016/17. This suggests firms and households can borrow now without worrying that loan costs will rise suddenly. This should help to sustain the recent improvement in current demand. (However, we think this is a risky approach. Borrowers should always prepare for loan rates to return to 'normal' at some point and policy makers should always be ready to move interest rates higher earlier in the face of 'events' that threaten higher inflation expectations.)

2. **Inflation above target** will continue to be tolerated as long as the forecast trend is for a move back towards that target within the normal time horizon (3 years). (As above, this carries some inherent concern that there will be too much monetary stimulation and inflation over the medium term.)

The Bank's desire to prevent current growth petering out is understandable but raises the inflation risks.

1. **Markets will still speculate**. Every word that the Bank and the MPC use will now be poured over for signals of a change in forward guidance – even if only in nuance. Market interest rates will still fluctuate in response to news, rumours and shocks. Indeed, the long end of the yield curve is already starting to anticipate the higher short rates to come.

2. The **unemployment rate is a lagging indicator**. The recovery will be well underway when it drops below 7%. This risks that inflation pressures will be building up and interest rates will then have to go even higher than might otherwise have been necessary to get inflation back under control. This might shorten significantly the next economic cycle overall, adding volatility and uncertainty to prices and output.

3. Continued **asset purchasing** is building up a money stock that needs to be considered in terms of its future inflation potential and what it might mean for the real economy when/if/how its withdrawal occurs. As in America, the issue of when and how to 'taper' the monetary stimulus will become increasingly important.

4. **Savers and investors** will suffer lower living standards and be less economically active, constraining real economic activity. Real growth

and low inflation are sustained by productivity gains incentivised by strong real returns over time. Arguably, persistently low interest rates resulting from policy are distorting such signals.

5. Moreover, persistent low interest rates mean that **debt rebalancing** will be less than desired. Arguably, the housing market and other debt-driven activities need to be more realistic about what 'normal' interest rates imply for borrowing costs and loan sustainability over the economic cycle. The risk is that renewed demand 'bubbles' blow up and are only heard when they pop. For housing, this is likely to be reinforced by the government's misguided policy to subsidise mortgage-to-incomes loan ratios, especially in the Greater South East.

All economic policy is about balance. The MPC has now fixed monetary policy towards the easy end of the monetary 'seesaw' for some time to come. Our concern is that this attempt to bolster short-term demand may postpone fundamental rebalancing in the UK economy and risks worse supply adjustments to come. **Unemployment is like a broken leg**. It hurts and debilitates for some considerable time. But, when it sets and repairs, a full recovery is possible. **Inflation is like a cancer**. It can grow inside the economy for some time before it is recognised. Its treatment can be awful and ineffective (remember the 1970s/80s). They are two very different manifestations of sickness in the economy but few of us would want to swap the former for the latter.

**The MPC's job is to be pre-emptive:** to stop inflation getting a grip on economic decision-making. **The danger of Forward Guidance is that it is reactive.** Waiting for unemployment to fall probably means higher inflation and higher interest rates in the long run than otherwise might have occurred. It also dissuades some of the move to economic rebalancing. Is this a price worth paying for more certainty about short-term growth?

**The Bank has allowed inflation to stay above target for four years**. On balance, especially early on, this was necessary to prevent something worse – depression and deflation. We do wonder, however, now that confidence is rebuilding, whether the Bank has tied itself to a false premise. Our judgement is that the positive signal of a small increase in interest rates now (perhaps base rates up in four stages to 1.5% by mid-2014) would actually help the recovery, giving savers and investors hope of an earlier 'return to normal' and encouraging more current real activity. This might actually bring unemployment rates below 7% sooner, boosting entrepreneurship towards productive supply without hurting debtors and dampening demand very much. Indeed, it is surely a necessary part of a rebalanced recovery.

The bottom line is that the United Kingdom is not Japan, culturally or economically. Forward guidance, as currently set out, may be paid for by more of us and for longer through higher inflation. Indeed, it may delay the time that we can say the economy is 'back to normal'.

Hopefully, we are wrong. Governor Carney has left himself enough leeway to back away from or amend the unemployment trigger if necessary and he insists that the inflation target remains the MPC's prime policy driver. We suspect, however, that forward guidance will need to be adjusted from its summer 2013 position over the next few years.

## Local Overview

Within the context of a constrained macro recovery, southern England is generally performing better than average. As the table below shows, claimant count rates have dropped significantly over the last year, partly because of the government's change in the rules of qualification. In the SW of England, levels have come down by more than 15,000 over the last year. In the SE of England (excluding London), the equivalent figure is over 25,000.

Across the south, the average claimant rates in the Local Enterprise Partnership (LEP) areas are all below the England average (see table). Generally, the highest rates are in the urban areas – 3.4% in Torbay and Bristol, 3.1% in Slough, and 2.9% in Portsmouth, Plymouth and Swindon. The lowest rates are in non-peripheral less urban/rural areas - 1.2% in Surrey, and 1.3% in West Berkshire, Oxfordshire and Dorset.

Broadly speaking, unemployment would not appear to be an issue constraining the economy across southern England. The flexible labour market appears to be real. There are, however, concerns about part-time, low productivity employment and hidden and dissuaded unemployment, especially given the change to assessment for job-seeking allowance. The claimant count measure tends to under-record the under-utilisation or misallocation of resources in the labour market.

**Southern LEPs: unemployment rates (claimant count: September 2013)**

| | level | rate | pt ch on year |
|---|---|---|---|
| Cornwall & Isles of Scilly | 6674 | 2.0 | -0.6 |
| Dorset | 7772 | 1.7 | -0.6 |
| Gloucestershire | 8556 | 2.3 | -0.4 |
| Heart of the South West | 19970 | 2.0 | -0.5 |
| Swindon & Wiltshire | 8793 | 2.0 | -0.3 |
| West of England | 17388 | 2.5 | -0.6 |
| **South West region** | **69153** | **2.1** | **-0.4** |
| Bucks Thames Valley | 4960 | 1.6 | -0.3 |
| Coast to Capital | 25722 | 2.1 | -0.6 |
| Enterprise M3 | 13202 | 1.3 | -0.3 |
| Oxfordshire | 5496 | 1.3 | -0.3 |
| Solent | 20211 | 2.1 | -0.4 |
| South East | 66820 | 2.7 | -0.5 |
| **South East region** | **108277** | **2.0** | **-0.4** |
| **England** | **1078299** | **3.1** | **-0.6** |

Source: Nomis

The apparently good labour market reflects the wider signs of recovery revealed by recent local business surveys. For example, in both SE and SW England, the *purchasing managers' indices* (PMI) for output in August were the highest ever and the employment readings were strong. In September, the former were still both above 60 and the latter above 53. The PMI series started to move significantly into expansion territory (above 50) in May.

Similarly, the third quarter survey from the *British Chamber of Commerce* shows an improvement in most measures, with all time highs for manufacturing and forward progress for services. Domestic and export sales and orders, investment and capacity utilisation, employment and confidence all seem to be rising.

The chartered accountants (*ICAEW*'s) third quarter surveys are equally positive, with business confidence higher than it has been since 2010. All industries and regions are improving. The turnaround in construction is starkly positive and there are good improvements in manufacturing, business services, and distribution. The SW and SE confidence balances have both increased to over +20 from both being lower than -5 a year earlier. As a result, the ICAEW forecasts a return to "pre-downturn" trends in growth: +2.3% real GDP growth in 2014.

The micro evidence confirms what we see in the macro data: a recovery has started and looks to be widely based. In that sense, our outlook for 2014 is more positive that it has been for some time. But, we know structural issues and policy challenges remain.

The expected recovery will be a marathon rather than a sprint. If local economies and sectors are going to thrive during the prolonged race ahead, they need to be carrying less weight (debt), fitter (more productive) and have higher stamina (real investment and incomes growth). Fiscal, monetary and development policies need to reflect this underlying need for rebalancing of output, trade, workforces and inflation. Let us develop a motif of being able to "co-operate to compete" in the years ahead.

# Economic Prospects

All UK macroeconomic forecasts of growth have been revised upwards since the spring (see table below – compare HMT consensus with OBR). Indeed, the HMT consensus view on real GDP growth is a full 0.5% higher for 2013 and 0.6% higher for 2014. The Office of Budget Responsibility (OBR) will have to revise its forecasts higher when the Chancellor of the Exchequer provides his "Autumn Statement" (planned for 4th December). So far, the OBR has been forced to revise its forecasts down each time it has published them. This will be the first upward correction, underlining the turning point that appears to be happening in the economy.

**UK Consensus and Strategic Economics Forecasts: Real Growth**

| Real GDP growth | **2013** | **2014** |
|---|---|---|
| HMT Consensus | 1.4 | 2.2 |
| OBR | 0.6 | 1.8 |
| Strategic Economics | 1.4 | 2.4 |

Source: HM Treasury (October 2013), OBR (March 2013) and Strategic Economics Ltd (October 2013).

Our own forecasts reflect the recent, positive shift in business confidence. This year is almost a 'done deal' and the main risk is that we have underestimated the momentum that will be taken into 2014. Without further external or policy shocks, we may have to raise our 2.4% forecast when it is formally reviewed in January.

The key external influences remain:

a) The gradual correction of the Euro-zone – in aggregate, it is no longer in recession, driven by Germany, but the debt restructuring of the 'fringe' has a long way to go and could still tip us back into credit crunch;

b) The strength of the US recovery in the face of the default/budget debate and the Federal Reserve's vital decision as to when and how to 'taper' its monetary policy;

c) The turnaround in Chinese growth and the need for it to rebalance, raising consumption as a percentage of aggregate demand and letting its currency appreciate.

In such a changing environment, there is a high level of uncertainty about the outlook. All we can say is that, as the global economy gradually improves, the prospects for positive restructuring should increase.

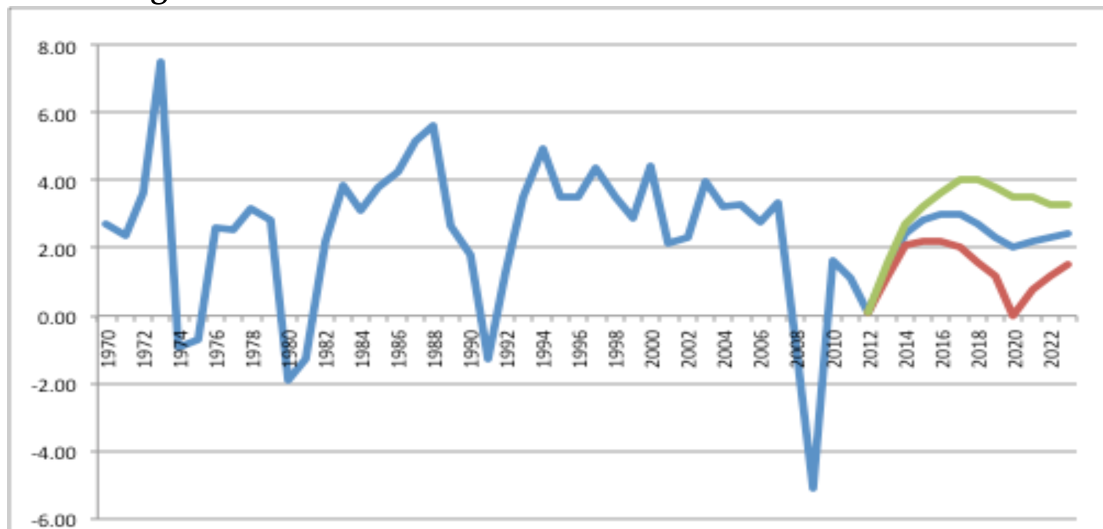
The key domestic policy questions are:

a) Has the austerity-based fiscal policy been real and effective and how much further (in content and over time) should it go?

b) How and when can the Bank of England adjust its monetary policy to support a rebalancing from borrowers to savers?

c) Is the government's emerging UK Industrial Strategy, with its multitude of funds and agencies, likely to have real, net additional, impact?

**UK Strategic Economics Forecasts: Real GDP Growth**




Source: Strategic Economics Ltd

Reflecting these issues, the chart above shows our current growth outlook. As always, we would focus on the 'economic story' rather than any particular point-forecast for a specific year.

a) Beyond 2013, *the 'blue' line* broadly follows the current consensus, which suggests that the recovery will bring the economy back to its long-term trend. The UK trend rate of growth has been declining over time. The downturn may well have exaggerated this effect, which is also reinforced by demographic aging. Hence, for example, the OBR sets the sustainable rate of growth at an average of 2.3% per annum, lower than we experienced before the downturn.

b) *The 'red' line* depicts a return to recession at some point. The long upturn of 1991-2008 was an aberration and a more normal, shorter cycle will now return, especially if economic imbalances persist or 'shocks' occur.

c) *The 'green' line* is more optimistic, founded on a belief that debt rebalancing is underway, productivity will recover and an investment-led increase in real incomes can be sustained.

Hope for the best but plan for the worst and get ready for a long, hard race.

## Afterword

This is the sixth of our **Strategic Economics Report** (SER) series, summarising the state of the economy and its prospects. We update the series three times a year. The next will be released in March 2014.

The **SER** covers current trends and structural changes that are likely to interest and influence sector and spatial development in the foreseeable future. When appropriate, it also considers the broad policy environment and its likely impacts on the economic future for businesses and workers.

The **SER** aims to be brief but authoritative, using economics in a form that readers will find easy to understand and can relate to their own situation. It is offered free to all interested partners.

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