Strategic Economics Report

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Headlines

The recovery has finally pushed the UK economy into an upturn, albeit by just 0.2% above the previous peak, in the second quarter of 2014. Forecasts suggest growth may slow down through the end of the year and into 2015, reflecting the weakness of external markets, particularly in the euro-zone, the inert policy mix, and adverse structural deficits.

Against this background, the SW economy has tended to perform close to average. As usual, the regional recovery is significantly dependent on domestic demand. Supply rebalancing remains limited and the 'holy grail' of higher productivity remains elusive. We need to see progress on both matters for a sustained and sustainable upturn to emerge.

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Executive Summary[2]

The **UK economy** is bigger than ever. In the second quarter of 2014, total real GDP was 0.2% above the peak reached in the first quarter of 2008. Looking back, the recovery seems robust. Looking forward, there are important domestic constraints on growth, reflecting weak real incomes, political uncertainties and structural imbalances.

Moreover, the **international environment** is full of risk. The Euro-zone economy is, at best, stagnant. The clouds of war shadow the Ukraine and the Middle East. Although still growing, America and China have both lost confidence and momentum. Finally, the financial markets are nervous, reflecting renewed default in Argentina, further western banking scandals and policy ineffectiveness.

Turning to **political and economic issues,** the imminent Scottish referendum, the UK General Election (in 2015) and the prospect of an EU membership referendum (in 2017) all add to market and business uncertainty. The risk is that this will delay or skew investment and dampen overall expenditure, damaging any recovery of lost capacity and hurting underlying growth potential.

Meanwhile, **competitive constraints** remain large, from the still growing UK public sector debt to GDP ratio, through the huge UK trade deficit, to weak productivity levels, modest growth and falling real average earnings. Without a larger contribution from **investment and exports** (the latter difficult given the soft external environment), the UK's continuing dependence on consumption-led growth leaves it vulnerable to a slowdown in 2015 and beyond.

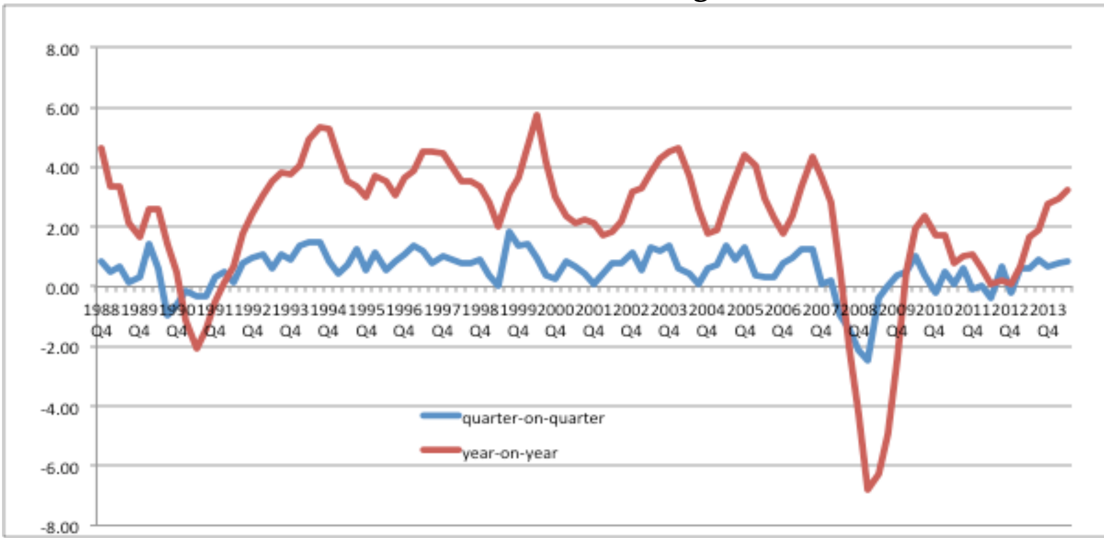
Any recovery driven largely by a **replacement cycle** will falter.
On the one hand, we now need a burst of investment that raises productivity, boosts real wages and feedbacks positively to demand. On the other hand, we need a recovery overseas that gives business the confidence to seek invest in new capacity, and develop new products and services, and pursue new markets.

Economic Profile

Recent Data & Trends:

In the first half of 2014**, real GDP** maintained its recovery. As the chart below shows, growth averaged 0.8% on the previous period and 3% year-on-year. These are positive results that, if maintained, would drive a strong upturn through 2015. The question is whether this momentum will peter out, as in 2011-12, or be sustained, as after 1992.

UK real GDP trends: 1997 Q1 - 2014 Q2 (% change)



Source: ONS data

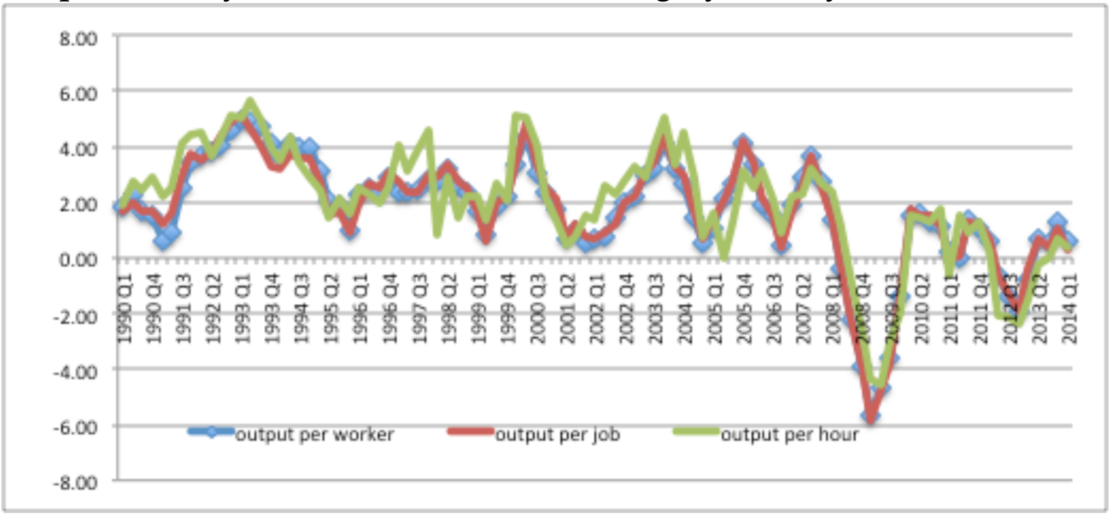
Sustained growth requires a **positive feedback cycle** from investment and supply capacity through employment to incomes and demand growth. In essence, this is dependent on the investment accelerator kick-starting the consumption multiplier and vice versa. With employment levels holding up better than expected over the last six years, the key ingredient for growth is an improved productivity performance – not least because, without that, employment growth cannot contribute strongly from here.

As the next chart shows, the UK economy remains afflicted by a disappointing **productivity** story. Arguably, growth in output per hour (green line) needs to get back consistently above 2.5% for a positive long-term outlook to be sustained and sustainable.

The second chart below shows how the **unemployment** rate peaked at just over 8% - below prior expectations - and has trended downwards –

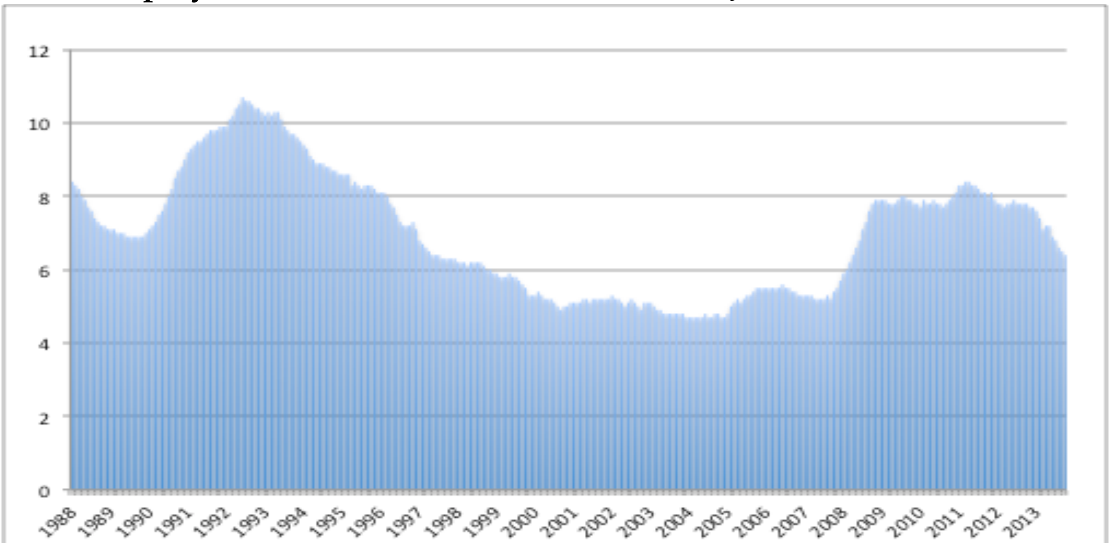
ahead of expectations - over the last two years. Productivity growth must now support employment growth if progress is to be maintained.

UK productivity: 1990 Q1 to 2014 Q1 (% change, year-on-year)



Source: ONS data

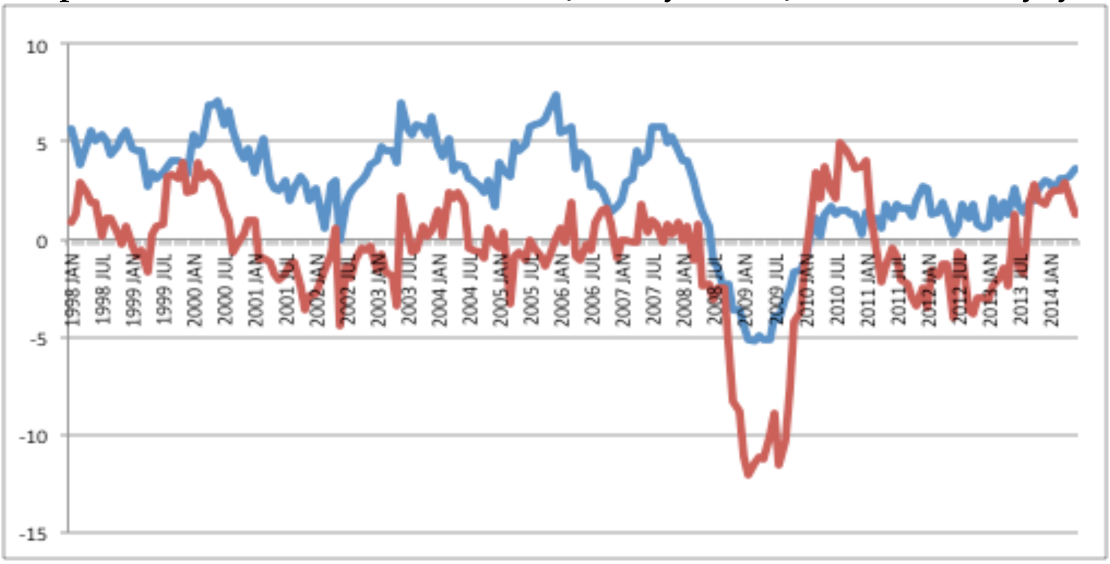
UK unemployment (% LFS rate) December 1988 – June 2014



Source: ONS data

In broad sector terms (see next chart), **services** (currently 77.8% of GDP – private and public) are growing consistently but have yet to match the kind of growth rates experienced before the downturn. Industrial **production** (15.2% of GDP, including manufacturing) has performed much better over the past year in growth terms. But, in levels, manufacturing remains 7.4% below the previous peak. The capacity lost during the downturn will not be fully made up for years, if ever. **Construction** (6.3% of GDP) and **agriculture** (0.7%) remain volatile but essentially flat, tending to follow rather than lead the recovery.

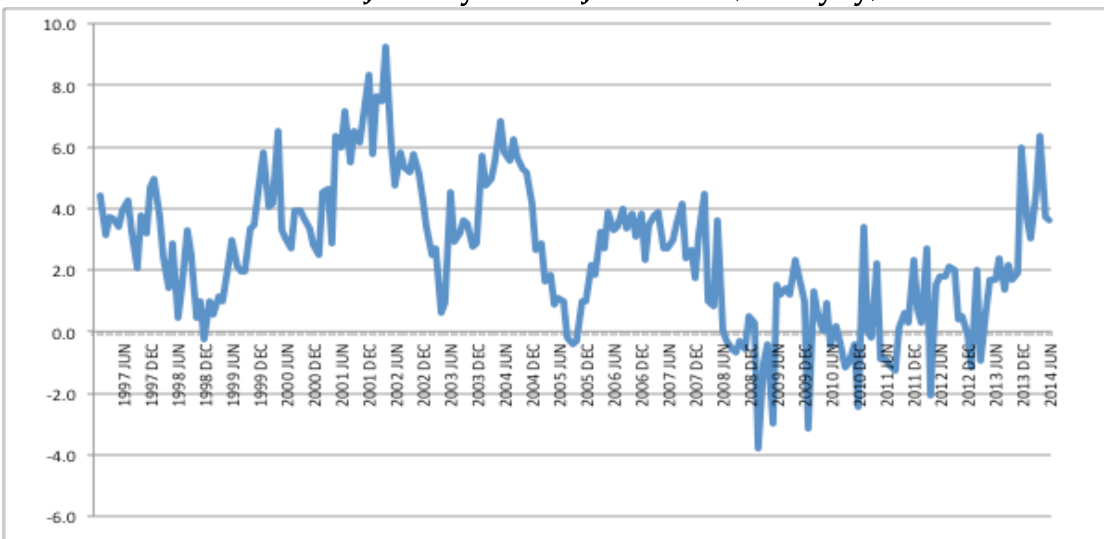
UK production (red) & services (blue): January 1998 – June 2014 (%ch, yoy)



Source: ONS data

UK **retail sales volumes** have increased well in 2014 to date. In the first half, structural change remained crucial, with internet sales continuing to outpace strongly the traditional high street. Non-food and durables areas were more robust than foods and other consumables. Households seem to have been following a replacement cycle. The risk is that, with average earnings still falling in real terms, this replacement cycle will peter out before more fundamental drivers of growth kick in.

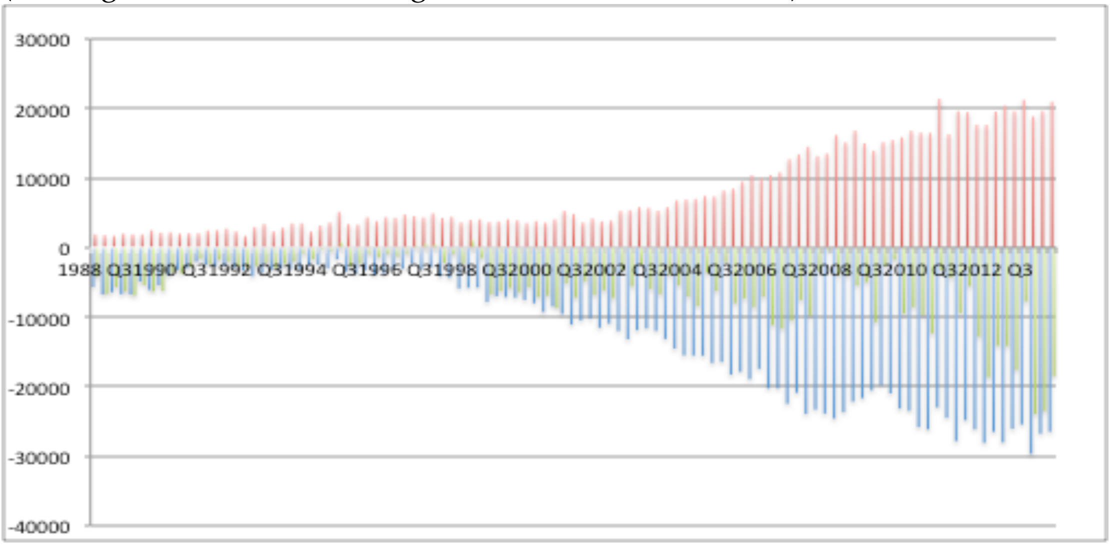
UK retail sales volumes: January 1997 – June 2014 (% ch yoy)



Source: ONS data

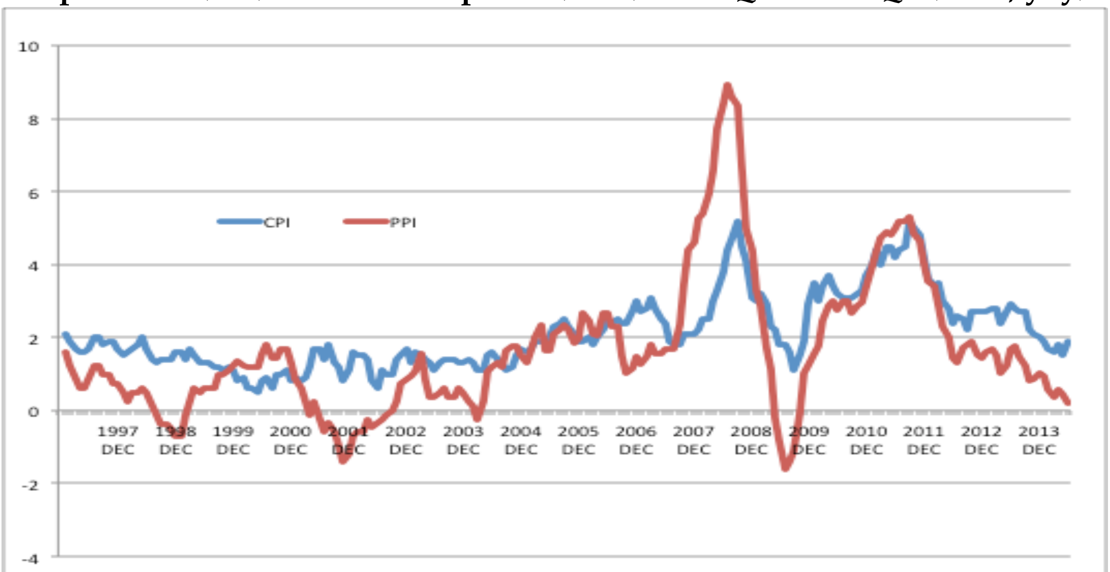
The external position of the economy remains poor. The **current account** deficit is running at about £20 billion per quarter (see chart below): at 5% of GDP this is well in excess of a sustainable level. The goods and services trade deficit averaged £8bn per month in the first half of 2014. Worryingly, goods export and imports both declined and the former by more than the latter. We are far from paying our way in the world – a severe dampener on future growth potential.

UK balance of payments: 1988 Q4 – 2014 Q1 (£mn):
(blue - goods, red – services, green - net current account)



Source: ONS data

UK producer (red) & consumer prices (blue): 1997 Q1 – 2014 Q2 (% ch, yoy)



Source: ONS data

Meanwhile, the **inflation** series appear to be heading for deflation. Input prices fell 4.4% in the year to June. Producer prices (see chart above) are close to flat and consumer prices have moved under the 2% target. Normally, a picture of good growth (around 3%) and low inflation (below 2%) would be seen as a sign of economic strength.

If this balance of respective rates were to be maintained, the outlook would be quite promising. The current concern, however, is that both rates will drop over the next twelve months: a combination of output stagnation and price deflation that undermines recent progress.

Policy Issues:

Monetary Policy

The **Bank of England** seems fairly sanguine about the inflation picture, proposing higher interest rates and an end to quantitative easing as the economic recovery gains ground. It will be interesting to see, however, how they react if the spectre of deflation looms larger in the short term, delaying any move to less accommodative monetary policy. Later, however, any sustained recovery will activate the excess funds floating about, as we have already seen in the Greater SE housing market, risking much higher inflation in the medium term and implying a double-hit on already damaged personal finances across SW England.

Meanwhile, the ECB (0.15%), Bank of England (0.5%) and Federal Reserve (0.00-0.25%) are all keeping **base interest rates** at very low levels. For the ECB, monetary policy levers are effectively stuck. With the Euro-zone economy finding it hard to maintain positive growth, the ECB may be forced to engage in a bout of quantitative easing (QE) before long. In contrast, the "Fed" and the "MPC" are reducing the monetary stimulus. The Fed should end QE this autumn and is expected to start raising interest rates over the winter. The MPC may do likewise, but the expectation, reinforced by recent statements by the Fed Chairman and the Bank of England Governors, is that any increase in interest rates, on either side of the Atlantic, will be small and gradual in the foreseeable future.

All businesses and consumers, in America and Britain, should be planning for gradually higher interest rates in the next few years. But, with UK rates, in particular, unlikely to increase by more than 1% in the next year and 2.5% over the medium term, there should be little risk of significant economic disruption. There is some concern about high household debts, particularly in housing. But, in macroeconomic terms, the impact should not be strong. Indeed, there is an argument that interest rates more in line with normal levels will be a positive stimulus. The prospect of real returns for savings and investment and some bulwark against future inflation would support future growth.

Fiscal Policy

The fiscal outlook has not changed since the spring: an overall tone of current austerity mixed with very slow progress in addressing the debt ratios. At the present time, the fiscal effect is broadly neutral for current growth. Some major changes may be coming, however. The Scottish Referendum (next month), the General Election (next May) and the EU Exit Referendum (in 2017) each imply changes in fiscal expenditure and taxation over the medium term.

Right now, these impacts remain highly uncertain but they do suggest, at best, a significant redistribution of spending and, at worst, a major disruption of funding and tax flows. We will need to analyse these events and the politicians' plans closely in the future to judge their potential effects for the UK economy in general and parts of the SW economy in particular.

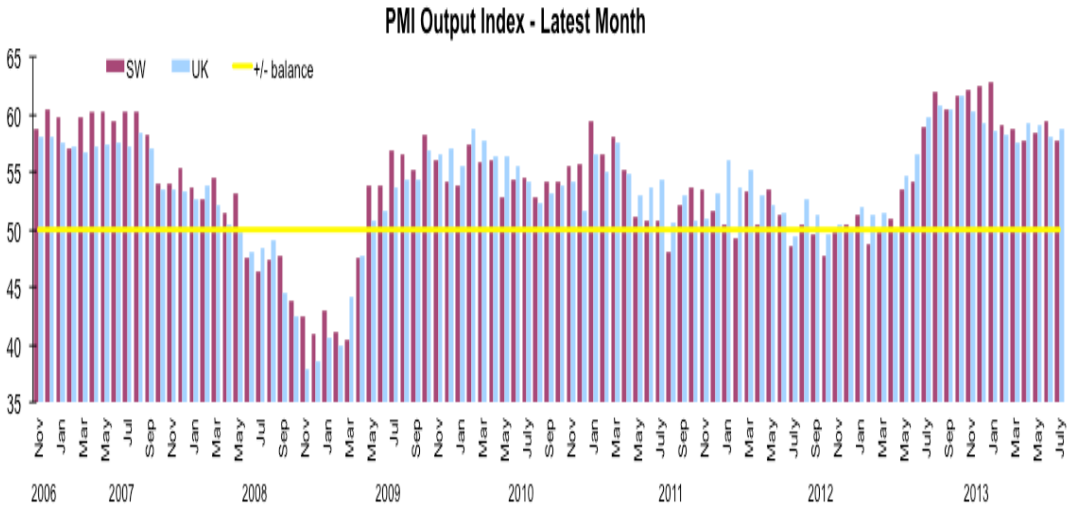
Local Overview

The **SW economy** exhibits many of the characteristics of the UK economy as a whole. A regional recovery is underway and it is largely consumption-led. Employment growth is good, though some of its components are more mixed, and unemployment is low. Recent surveys suggest a positive outlook amongst SW businesses, with improved investment intentions. Nevertheless, trend momentum is not totally robust and structural weaknesses have still to be addressed.

The latest ***purchasing managers'*** (PMI) survey, a good indicator of recent regional performance, shows some loss of momentum since the start of the year, with the South West slipping below the UK average.

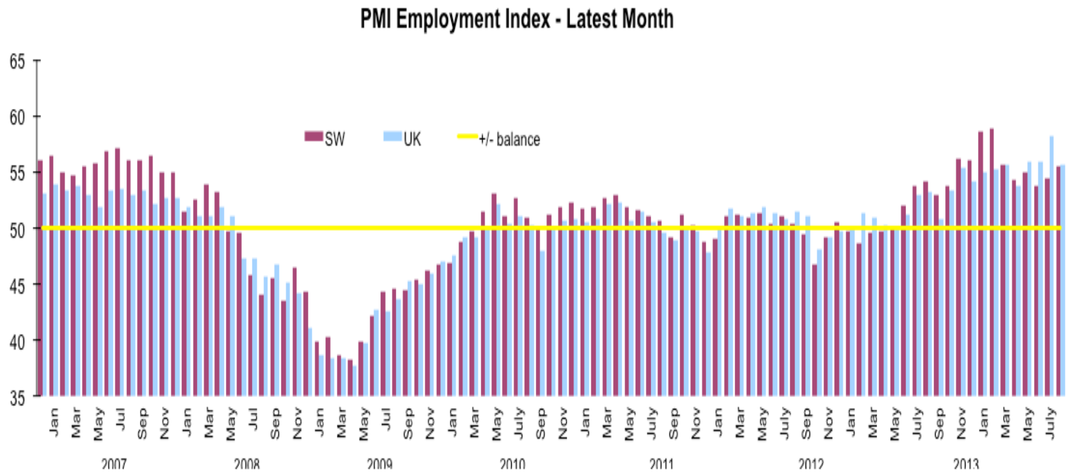
Nonetheless, with the output balance (first chart below) still well above 50, the SW series remains strong and suggests we can expect good growth through the rest of 2014. The employment balance (second chart below) shows the same broad pattern, confirming that we are experiencing employment-driven growth rather than productivity-driven growth. The problem is the former is difficult to maintain without some eventual reinforcement from the latter.

SW Purchasing Managers: Output July 2014



Source: Lloyds/Markit

SW Purchasing Managers: Employment July 2014

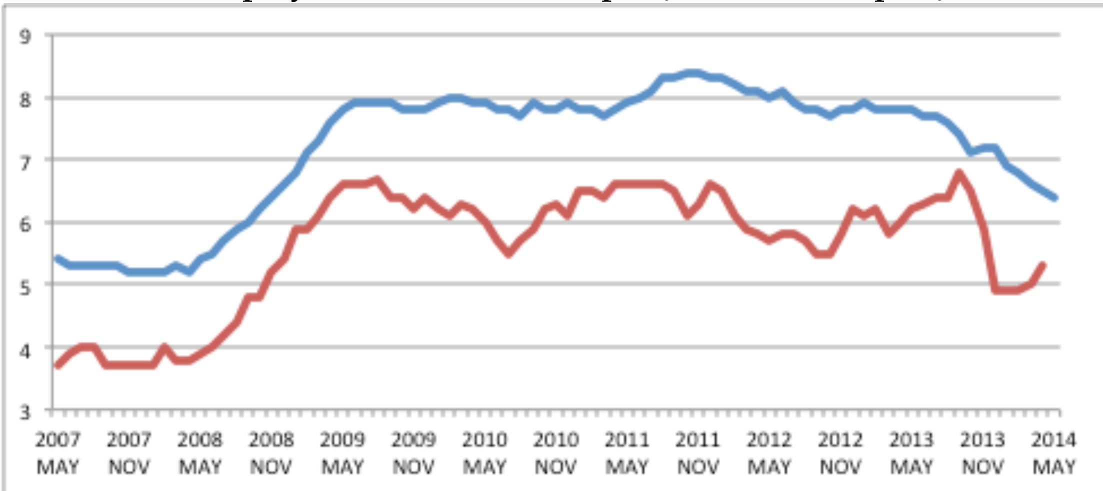


Source: Lloyds/Markit

Other surveys have also been positive recently. For example, the British Chamber of Commerce, the Manufacturing Advisory Service and other local indicators have all supported the prospect of continued recovery and some upturn through 2014 as a whole.

Meanwhile, ***unemployment*** remains relatively good in this region. SW unemployment rates (see chart below) are consistently, if erratically, below the UK average. Moreover, SW employment growth was a healthy 3.2% over the last year, albeit that a significant element of this was self-employment and part-time. It is not yet clear whether this structural change has been driven by desire or distress. Some surveys suggest many of those displaced during the downturn are being re-employed on less favourable terms of pay, hours and productivity. Still, this does mean that the SW activity and employment rates are relatively high (80.4% and 76.3% respectively).

UK & SW Unemployment (% LFS rate) April-June 2007 to April-June 2014



Source: ONS data

SW England still seems able to employ most of its working age population. The question is whether a pattern of relatively low productivity growth and high employment growth leads to an imbalance in overall development that merely maintains the low wage, high cost nature of the local SW economy.

Special Note: Gross Disposable Household Incomes in SW England

The recent annual data on **gross disposable household income (GDHI)** at a regional and sub-regional level reinforced this point about low SW wages. The latest figures are for 2012. They reveal interesting facts about the structure of the SW economy.

In SW England as a whole, GDHI was £90.3 billion in 2012, broken down 45% in Gloucestershire, Wiltshire and Bristol/Bath, 25% in Dorset and Somerset, and 30% in Devon and Cornwall and the Isles of Scilly.

It is more interesting, however, to look at the GDHI figures in terms of a ratio to the size of the population: it would be silly, for example, to compare the rural Dorset total to that of urban Bristol without considering the number of people that the income totals are spread over.

At a regional level, in 2012, the **SE average GDHI per head was £19,126 whereas the SW total was £16,914**. **These compared with an England average of £17,066** i.e. above and below average respectively. Across South West England, the range was from a GDHI per head figure of £18,237 in Dorset (not including Bournemouth and Poole) to £14,564 in Plymouth.

In index terms (UK average = 100), SW England's GDHI per head ranked fourth out of twelve in the United Kingdom and was very close to the average (100.7). However, again, the internal range was wide from 8.6 points above average in Dorset to 13.3 points below average in Plymouth. The indices for the twelve SW areas are shown in the table below.

SW GDHI per head index (UK = 100)

SW places 2012		SW places 2012	
Dorset	108.6	Devon	99.3
Wiltshire	107.0	Swindon	97.6
Gloucestershire	107.0	Bristol city	93.5
Bath&NESom, NSom, & SGloucs	106.1	Cornwall & Isles of Scilly	93.2
Somerset	101.6	Torbay	91.7
Bournemouth & Poole	99.9	Plymouth	86.7

Source: ONS

There are two main stories behind this raw data.

1. **More rural areas tend to outperform their neighbouring conurbations on these income measures.** From this GDHI per head data, populations in more rural areas can appear 'richer' than those in neighbouring towns and cities. This is at odds with the equivalent output data (gross value added or GVA per head) for which urban areas usually outperform more rural areas. It can also seem odd intuitively – surely, most of the high paying jobs are in the cities? We resolve this by considering commuting and employment status.

a) In many places, there is quite a lot of commuting in and out of local conurbations. In simple terms, **high earners often work in town but live in the country**. Hence, GDHI per head, which is measured at the place of residence, can bias the numbers one way (towards rural) whereas GVA per head, which is measured at the place of work, can bias the other way (towards urban).

b) The employment structure is often very different in urban and rural areas. There are high and low paid jobs in both but the mix may vary significantly, if only because there are more land-based/linked opportunities in rural areas. Moreover, from the unemployment statistics, we know there are **proportionately more jobless people living in towns and cities and there can be more low earners at the two ends of the age range** – proportionately more low-income young and old people in the towns.

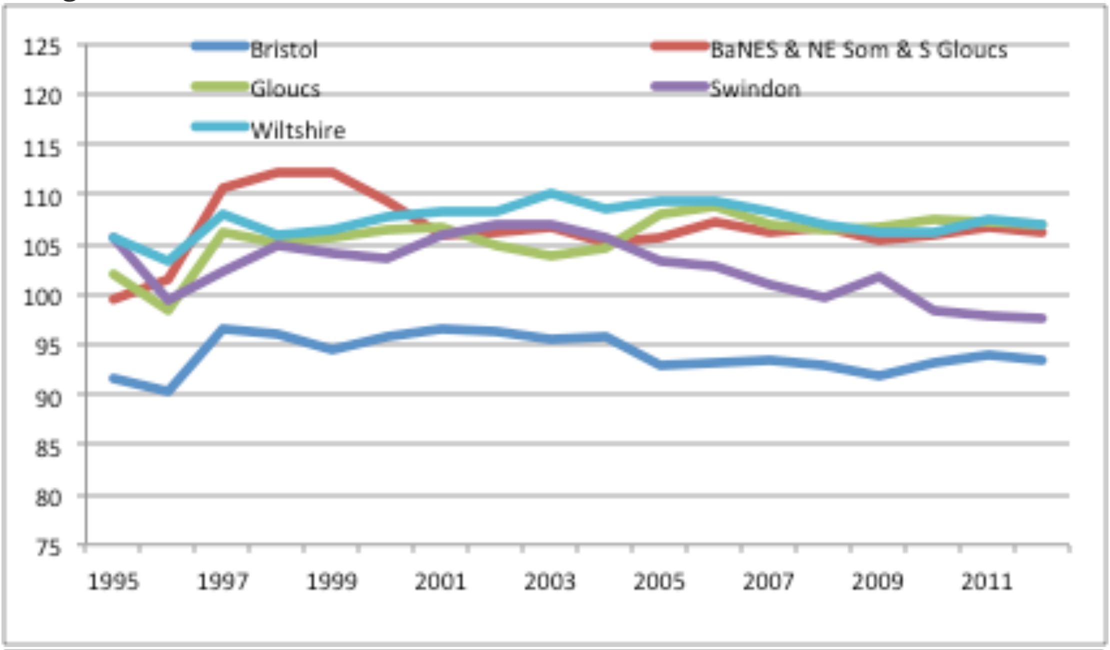
Both of these factors (commuting and employment status) tend to bring GDHI per head down in the conurbations relative to their rural hinterlands. To see how common this is, just look at the comparisons in the table above for
a) Torbay and Plymouth versus Devon County,
b) Bristol versus Gloucestershire and Somerset,
c) Swindon versus Wiltshire and
d) Bournemouth and Poole versus the rest of Dorset.
Across SW England, rural hinterlands have higher average GDHI per head than their urban centres.

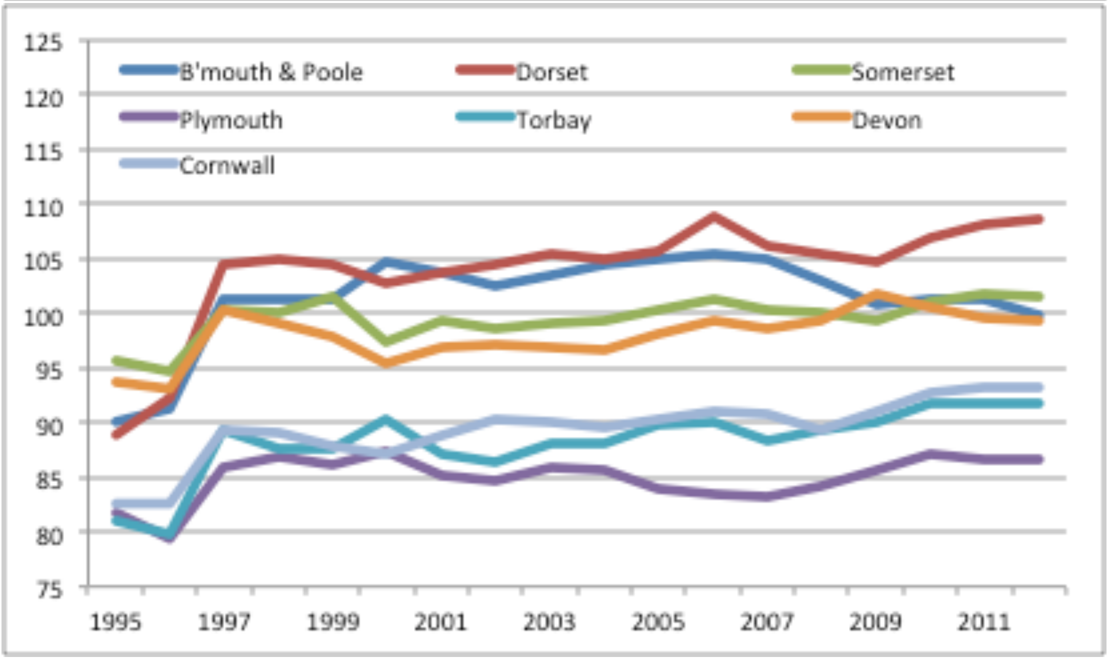
2. The other story is that there are **interesting contrasts in the way the series move across SW England over time.** In Dorset county (DCC), for example, the latest 108.6 index was the highest since 2006 and four points above the 2009 low. In contrast, the 99.9 index for Bournemouth and Poole (B&P) was the lowest since 1996 and 5.6 points below the peak reached in 2006.

These contrasting trends are stark, suggesting the Dorset conurbation is slipping down the relative incomes league whereas county Dorset is rising. Please note, this does not mean B&P's GDHI per head is falling (although, in real terms, incomes have not increased much in recent years). It means incomes in B&P are not rising as fast as elsewhere – i.e. B&P residents are relatively 'poorer' whereas DCC's are relatively 'richer'. The long downturn from 2008 to 2014, when some wage and non-wage earners have been under severe disposable incomes pressures, is bound to be part of the explanation for this divergence.

A range of such patterns has occurred across the region (see charts below). Although **relative rankings change slowly, if at all, over the years**, some urban areas have struggled to hold their relative positions against their hinterlands – e.g. a narrowing gap between Swindon and the rest of Wiltshire. One exception to that is Torbay, where the index has increased a little over time, although the town remains second lowest overall. Cornwall's relative index has also gone up, but its ranking is unchanged.

SW gross domestic household income (1995-2012, UK = 100)





To conclude, if a sustained upturn is now underway, **it will be interesting to see whether the SW's conurbations regain recent lost ground**. Normally, this would be my expectation… but not much has been 'normal' of late. Given the structural and rebalancing changes still needed, it may well take some time for such effects to feed through.

Moreover, we are not going to know for some time: 2013 data will not be released until spring 2015 and any bounce from the incipient upturn may not be 'known' until 2015 data is revealed in 2017! Yet again, we are driving the economy by looking in the rear view mirror.

Meanwhile, in July 2014, the ***claimant count rates*** for the region's six Local Enterprise Partnership areas were all very low: Dorset 1.2%, Swindon & Wiltshire, Heart of the SW (Devon and Somerset) and Cornwall and the Isles of Scilly 1.4%, Gloucestershire 1.5%, and West of England (Bristol and its neighbours) 1.7%. This produces a SW average of 1.5% and compares with the English average of 2.3%. At a lower level, the range is from 0.9% in Dorset County to 2.6% in Torbay. Over time, the trend is to lower claimant rates, reflecting structural changes in the regulations as well as changes in underlying economic behaviour. Perhaps, this indicator is becoming less useful than it was for reading future trends.

Overall, the SW economy is performing well but it still exhibits persistent structural weaknesses. The risk remains that the upturn peters out before the imbalances are addressed. Without that, a period of sustainable growth may prove elusive.

Economic Prospects

The **current consensus** (see table below) is that real GDP growth will average about 3% this year and ease to about 2.5% in 2015. Meanwhile, inflation will remain low, close to the official target.

We believe the current risks to this forecast are more on the downside than the upside. In this review, we have tended to stress the risks on the downside because we think these appear more immediate and are of more concern if they do emerge. We do not rule out a more positive story, but that can largely look after itself in the short term and needs less strategic or analytical consideration right now.

UK Consensus & Strategic Economics Forecasts:

	Growth 2014	Growth 2015	CPI 2014	CPI 2015
HMT Consensus	3.0	2.6	1.7	2.0
OBR	2.7	2.3	1.9	2.0
Strategic Economics	3.1	2.4	1.8	2.0

Source: HM Treasury (July 2014), OBR (March 2014) & Strategic Economics Ltd (July 2014).

Negative factors for growth and development include:

a) the weak prospects for our major markets in Europe, America and the Far East,

b) the weakness of domestic real household incomes and persistent business uncertainty/indecision,

c) ineffective monetary and fiscal policies, and

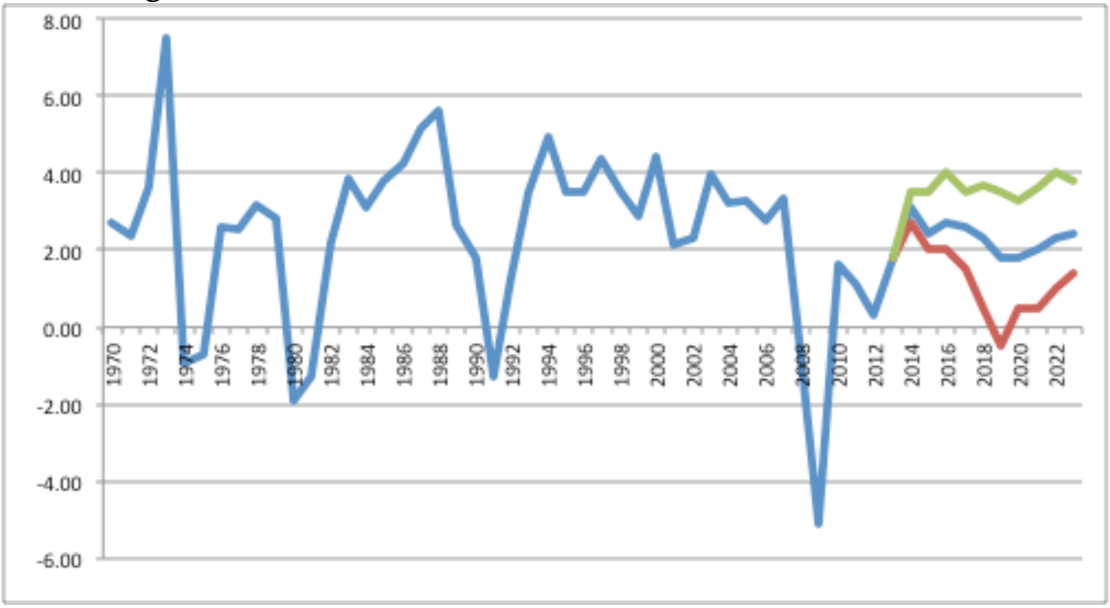
d) continuing structural imbalances.

Positive factors would have to come from more business and household confidence at home feeding through investment and higher productivity to real wages and final demand. There is hope that these positives can have a larger effect in the medium term.

Further out, the **central view** (blue line in chart below) is that growth will moderate to a trend rate of about 2-2.5% per annum. More optimistic forecasters are suggesting growth can be boosted towards 3.5% per annum if the productivity 'gap' can be closed and some structural rebalancing of demand and supply can be achieved (green line below).

The risk is that a lack of sustained external and domestic demand, coupled with inadequate supply-side investment in technological, skills and infrastructure development, and continuing excess debt and deficits weakens prospects (red line). There is some risk that we experience another recession within the next five years as unfavourable real household debt/income ratios weaken demand and policy/inflation and international uncertainty afflict investment/supply.

UK Strategic Economics Forecasts: Real GDP Growth



Source: Strategic Economics Ltd

Conclusion

This **Strategic Economic Report** has considered the current conditions and prospects for the UK and SW economies. It concludes:

The recovery has finally pushed the UK economy into an upturn, albeit by just 0.2% above the previous peak, in the second quarter of 2014. Forecasts suggest growth may slow down through the end of the year and into 2015, reflecting the weakness of external markets, particularly in the euro-zone, the inert policy mix, and adverse structural deficits.

Against this background, the SW economy has tended to perform close to average. As usual, the regional recovery is significantly dependent on domestic demand. Supply rebalancing remains limited and the 'holy grail' of higher productivity remains elusive. We need to see progress on both matters for a sustained and sustainable upturn to emerge.

Afterword

This is the eighth 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 is planned for November/December 2014.

The **SER** covers current trends and structural changes that are likely to interest and influence sector and spatial development in the foreseeable future. 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.

Those seeking more detail or extension of its themes should contact us directly to take advantage of our bespoke services for clients. Please see www.strategiceconomics.co.uk .