Strategic Economics Report

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Headlines

The national and regional economies have performed well in 2014. This will be the 'best' year for the growth-inflation nexus for some time.

If official and private forecasters are to be believed, however, it may also be the 'best' one for some time to come.

Fundamental structural imbalances continue to dominate global and local business conditions. Moreover, there are plenty of risks and uncertainties that are tending to restrict business development – not least nervousness about commodity and other asset prices.

Some of these risk factors are political – to do with the imminent General Election, the complicated picture on devolution, and the possibility of an EU exit referendum.

Some of them are policy driven – the mix of loose money and austere fiscal budgets seems set to persist for years to come.

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The main economic constraints of public and trade deficits, the wide productivity gap and the lack of any meaningful rebalancing of wealth creation remain key.

In trend terms, 2015 may be a year of moderate growth, low unemployment and low inflation but this apparently good outlook cannot disguise some worrying, underlying structural weaknesses that still need to be addressed.

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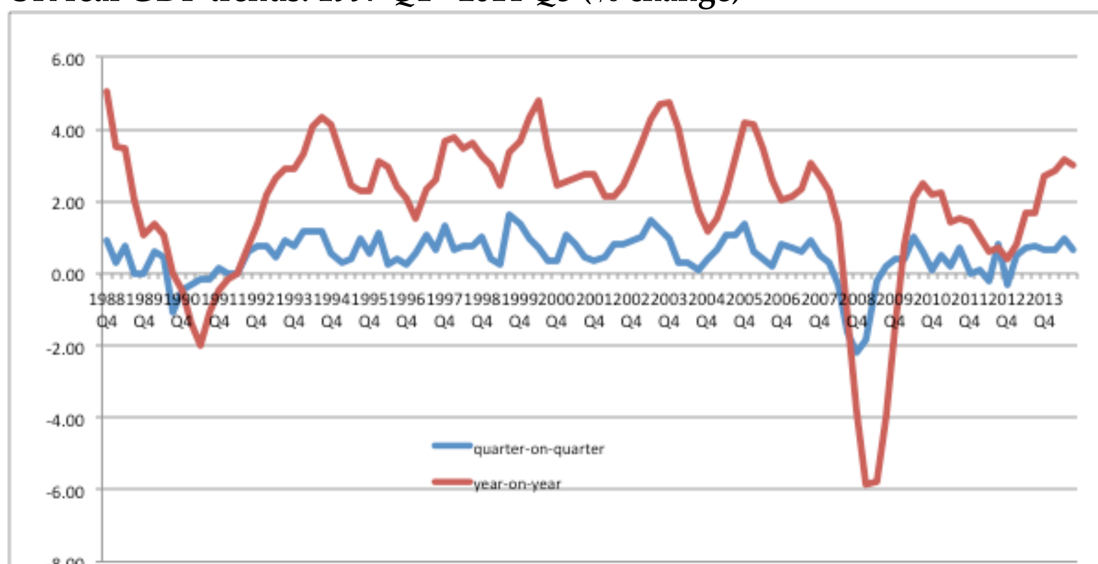
Economic Profile

Recent Data & Trends:

Data for the first nine months of 2014 suggests that the recovery was reasonably solid. As the chart below shows, **real GDP** growth averaged 0.8% on the previous period and 3% year-on-year. Forward momentum may have peaked about mid-year but, as a whole, 2014 is likely to have been the 'best' year for growth since 2006. The question is whether the acceleration can be maintained through 2015 or whether the pace of positive progress will now recede, making 2014 the 'best' year for the foreseeable future.

UK real GDP trends: 1997 Q1 - 2014 Q3 (% change)



Source: ONS data

Sustained growth requires a **positive loop** from investment and supply capacity through incomes and demand growth: the investment accelerator must reinforce the consumption multiplier and vice versa. With employment levels holding up better than expected over the last six years, the key ingredient for sustained growth going forward has got to be an improvement in productivity: something lacking from the recovery to date.

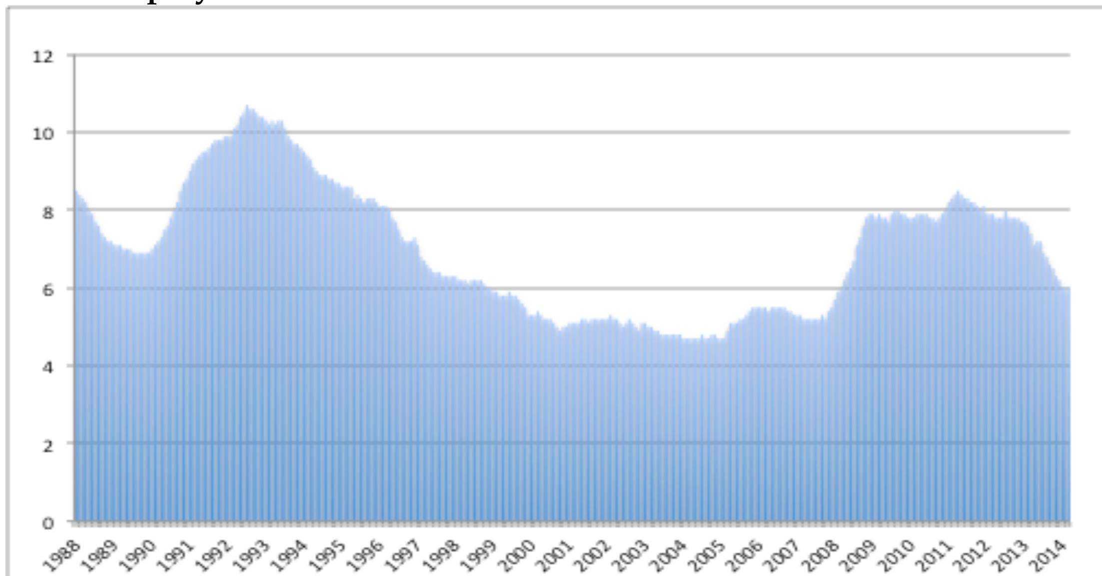
As the next chart shows, growth in output per hour (green line) has been almost non-existent in the year to date. We need to get this growth rate consistently back above 2.0-2.5% for a positive long-term outlook for overall growth to emerge and for better living standards to be sustained and sustainable.

The second chart below shows how, during the downturn, the **unemployment** rate peaked at just over 8% (lower than expected) and has fallen back to 6% now (quicker than expected). There has been a big debate as to whether the drop in unemployment and its obverse, positive job creation, masks qualitative issues about under-employment, hidden unemployment and low-wages. More vital is the fact that the recent, positive rate of jobs growth will not be maintained unless productivity growth now picks up. This means a boost to investment-led supply capacity, forcing real wages higher and supporting an advance in aggregate demand.

UK Productivity: 1990 Q1 to 2014 Q2 (% change, year-on-year)

Source: ONS data

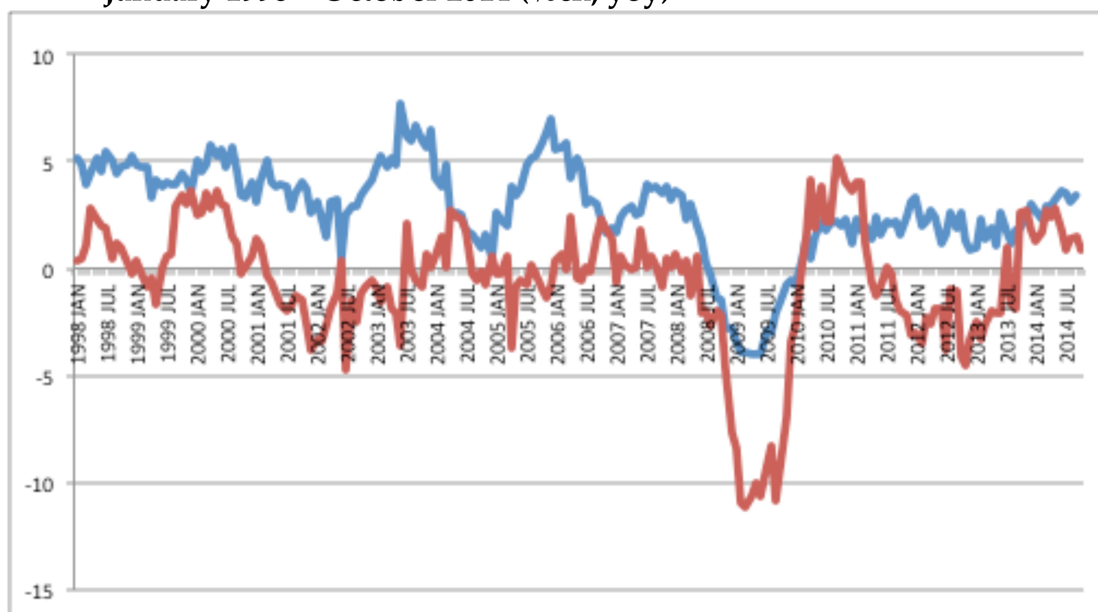
UK unemployment (% LFS rate) December 1988 – October 2014



Source: ONS data

In broad sector terms (see next chart), **services** (contributing over three quarters of GDP) are recovering well. Within this total, however, there remains a wide variation – even at a broad level (see the four services categories highlighted in the table below).

UK Production (red) & Services (blue): January 1998 – October 2014 (%ch, yoy)



Source: ONS data

Industrial **production** (about 15% of GDP, including manufacturing) has performed less robustly. Although the manufacturing growth series is now positive, it is volatile. Moreover, in terms of levels, in October, manufacturing output remained 6.4% below the previous peak. The capacity lost during the downturn may be lost forever unless there is a profound turnaround in competitive capacity. Within manufacturing, in the first three quarters of the year, output growth varied enormously (see table below).

Services & Manufacturing Sector Performance 2014 to date (Jan-Sep Average, % ch yoy)

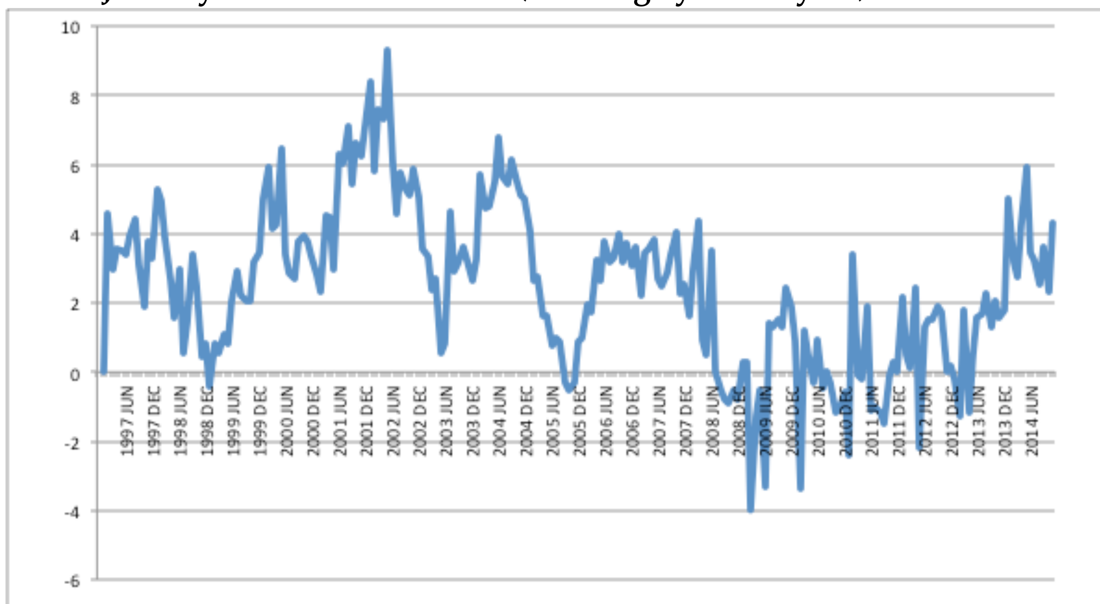
Foods	+4.9	Pharma	-1.7	Other trspt eqpt	-4.0
Beverages	+6.0	Metals	+3.0	Distribution	+4.4
Textiles	-2.9	Elec eqpt	-3.9	Busin, prof & finance	+4.0
Clothing	+7.5	Machinery	+6.7	Public	+1.3
Chemicals	+4.4	Motors	+9.6	Trspt & Comms	+2.4

Source: ONS

Construction (almost 6.5% of GDP) experienced its 17th consecutive month of growth in October but only at a meagre pace of 0.7% year-on-year. In the third quarter, new construction orders were merely 3% higher than a year earlier.

UK **retail sales volumes** have increased well in 2014 to date, averaging growth of 3.6% per annum (see chart below). Structural change has remained a key ingredient, with inter-net sales outpacing the high street. Indeed, this Christmas, there are reports that the transport and postal companies have found it difficult to meet demand for home deliveries. More generally, the durables replacement cycle has tended to dominate demand patterns, with average earnings still falling in real terms. The danger is that this peters out after the festive season; something we have already seen with some consumable products.

UK Retail Sales Volumes:
January 1997 – October 2014 (% change year-on-year)

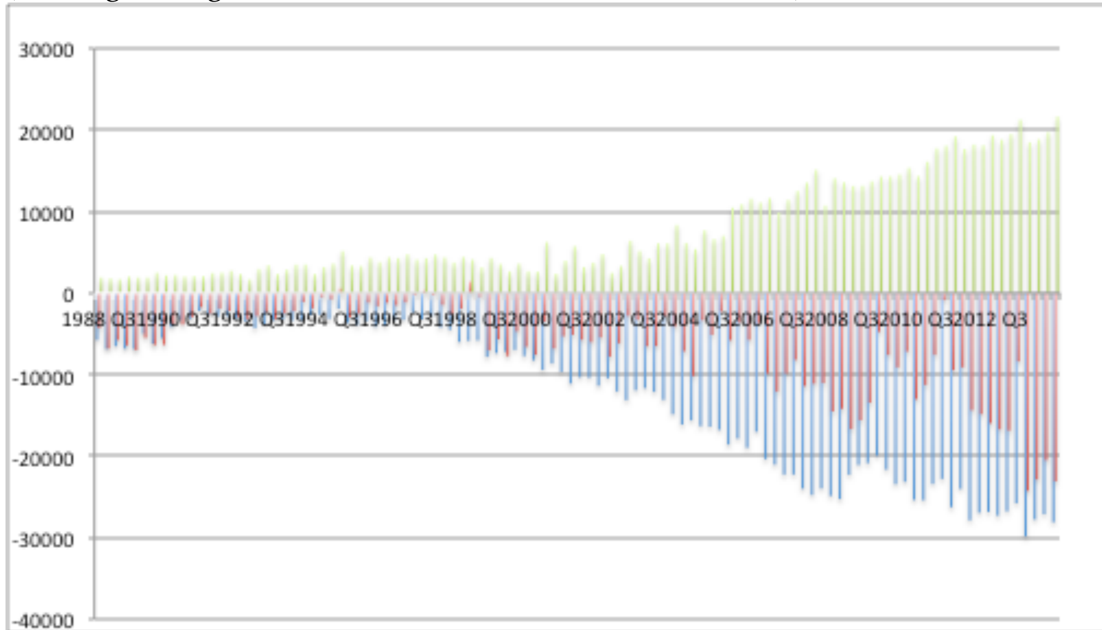


Source: ONS data

The external position of the economy remains dire. The **current account** deficit is running at over £20 billion per quarter (see chart below). At some 5% of GDP, this is well in excess of a sustainable level. The goods and services trade deficit averaged £3bn per month in the first ten months of 2014. In recent months, it may have been flattening out somewhat, but only at a still unsustainable deficit level. Whilst the recent fall in oil prices helps the economy by potentially boosting non-oil demand, its effects on our trade balance are ambiguous.

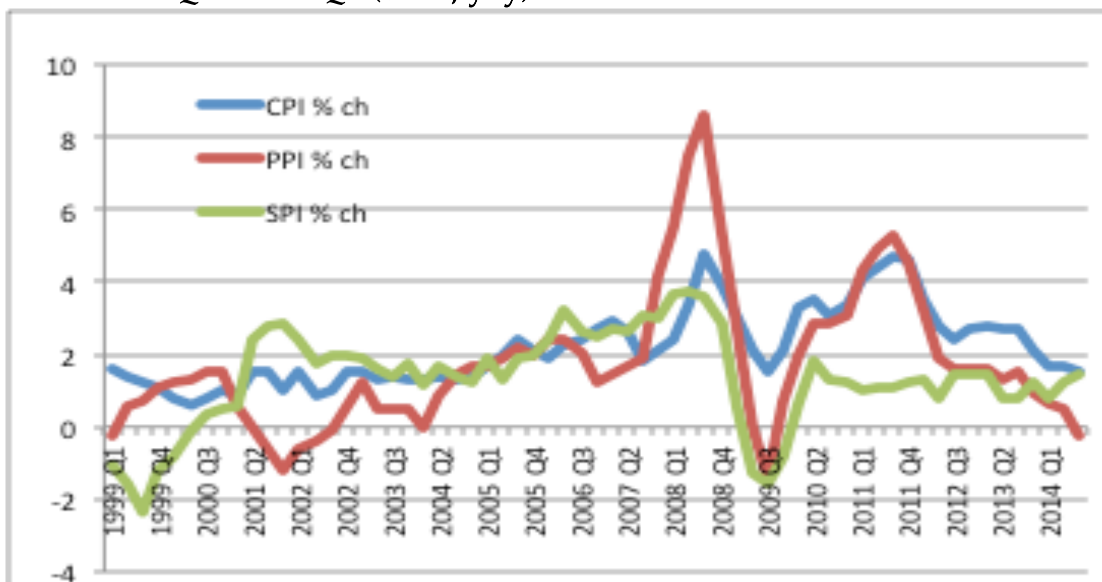
Moreover, with the historically positive net inward financial investment flows now disappearing, the United Kingdom is finding it even harder to pay its way in the world. If sustained, this 'balance of payments' deficiency will restrict future UK growth potential by leaking resources out of the country that might otherwise be available for investment-led productivity growth.

UK Balance of Payments: 1988 Q4 – 2014 Q2 (£mn):
(blue - goods, green – services, red - net current account)



Source: ONS data

UK Services (green), Producer (red) & Consumer prices (blue): 1997 Q1 – 2014 Q3 (% ch, yoy)



Source: ONS data

Meanwhile, the **inflation** series, with the exception of some services (see chart above) appear to be flirting with deflation. Input prices fell 8.8% in the year to November. Producer prices were down 0.1%, and consumer prices, rising just +1%, have moved well under the 2% target.

House prices, however, continue to defy gravity – up 10.4% in the year to October, ranging from 3.9% in the North East to 17.2% in London: 7.2% in SW England is about average for the United Kingdom outside the Greater South East. All this suggests the real estate distortion in the UK economy remains firmly in place.

Normally, a macro picture of good growth (around 3%) and low inflation (below 2%) might be a sign of economic strength. It is the trend that is important, however, and with many price series dropping, the spectre of prolonged Japanese-style deflation has to be considered a possibility. The current concern is that the growth and inflation rates will both decline over the next twelve months. Such a combination of output stagnation and price deflation would undermine the recent progress of the recovery.

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. They have downplayed the spectre of deflation whilst delaying any move to less accommodative monetary policy.

On the other side of the risk outlook, however, a sustained recovery could activate excess liquidity, risking much higher inflation in the medium term and implying further damage to UK personal finances.

Meanwhile, the European Central Bank (ECB) and the US Federal Reserve (Fed) have kept **base interest rates** at very low levels. For the ECB, monetary policy levers are effectively stuck. With the Euro-zone economy struggling to maintain positive growth, it is moving towards some variant of quantitative easing (QE). In contrast, the Fed has ended its QE programme this autumn and is likely to start raising base

interest rates in 2015. Note, however, this means US policy is only getting a little "less loose". Despite recent stock market jitters, we are a long, long way from a tight US policy stance.

At home, the Bank of England's "MPC" is also indicating a reduction in its monetary stimulus. Unless, with falling oil prices, the deflation dragon raises its head in real anger – delaying expenditure decision making, we may see the 0.5% base rate raised in the year ahead.

In simple terms, base interest rates would normally be about 0.5% less than the growth rate of nominal GDP – roughly the sum of real GDP growth and its inflation denominator. With trend growth of 2.5-3.0% and inflation of 2.0%, this implies a 'normal' UK base rate of up to 4.5%. We are a long way from that level of base rate and will be for the foreseeable future. Even if the MPC were to add a full percentage point to the base rate next year - an outcome currently considered unlikely by many forecasters, the UK would still have an incredibly loose monetary stance.

Nevertheless, businesses and consumers, in America and Britain, should be planning for gradually higher interest rates in the next few years. This should mean little risk of significant economic disruption, except for those heavily indebted. In macroeconomic terms, however, there is an argument that interest rates more in line with normal levels will provide a positive stimulus. The prospect of some real returns for savings and investment and some bulwark against the risk of future inflation would support underlying growth potential and may help to resolve the investment/productivity gap.

Fiscal Policy

The fiscal outlook remains one of current (though not perfect) austerity mixed with very slow progress in addressing the public debt ratios. The General Election (next May), the uncertainty of devolution within the Kingdom, and the spectre of an EU Exit Referendum (in 2017) each imply profound 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, major disruption to funding and tax flows.

The recent Autumn Statement by the Chancellor put all this in perspective. At a micro level, the Statement had a scattering of measures that might benefit businesses and workers. The Chancellor proposed small

incentives for each of the drivers of productivity - skills, innovation, investment, entrepreneurship and competitiveness. If they come to fruition, these may benefit growth - at least in the long run. Many of these micro actions can be welcomed in their own right, although, yet again, the whole package does not really reduce the complicated regulatory environment facing most business and financial planners.

If we believe the Treasury itself and the new forecasts from the Office of Budget Responsibility (OBR), however, there is very little effective rebalancing of macroeconomic growth coming in the foreseeable future. In particular, the key UK weakness - the deficiency of productivity - is not expected to reverse enough soon.

The OBR's growth, inflation and unemployment profiles are fair enough in headline terms but subdued and modest compared with history and aspiration (see table below). Repair of the public finances is again forecast but has been further delayed – it always seems a couple of years away. Moreover, this prediction is built on considerable risks and uncertainties, not least assumptions of a revival of real incomes and of the continued willingness of financial markets to accumulate UK bonds.

OBR Forecasts (December 2014)

Annual years	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Growth (%ch yoy)	3.0	2.4	2.2	2.4	2.3	2.3
Inflation (&ch yoy)	1.5	1.2	1.7	2.0	2.0	2.0
Employment (%ch yoy)	2.3	1.6	0.6	0.3	0.3	0.3
Productivity (%ch yoy)	0.7	0.8	1.6	2.1	2.0	2.0
Unemployment (% rate)	6.2	5.4	5.2	5.3	5.3	5.3
Fiscal years	**2013/14**	**2014/15**	**2015/16**	**2016/17**	**2017/18**	**2018/19**
Debt ratio (% GDP)	78.8	80.4	81.1	80.7	78.8	76.2
Public net borrowing (£bn)	97.5	91.3	75.9	40.9	14.5	-4.0

Source: OBR

Essentially, the OBR is saying that:

- A better than expected growth rate this year does not persist into the medium term;
- The lower than expected inflation rate this year persists into 2016;
- Recent bigger than expected falls in unemployment level out after 2015 as employment growth slows;
- The derived recovery in productivity over the medium term remains weak by international and historical standards; and

- The short-term 'worse than hoped for' aspect of the fiscal numbers is turned into a 'better future' - a bigger turnaround after 2015/16.

The OBR seems to base its forecasts on permanent, adverse structural shifts in the UK economy and its public finances – some linked to demographic trends. This suggests little scope for underlying improvement in potential growth because the productivity performance has not and will not bounce upwards as expected before and once an upturn is underway.

There are high risks and severe uncertainties in current economic conditions. The OBR's forecasting is cautious. Essentially, though, the OBR, the Treasury and, indeed, all the leading political parties are offering most of us no break from austerity and little prospect of better living standards over the foreseeable future.

Local Overview

The **SW economy** exhibits many of the characteristics of the UK economy as a whole. A regional, consumer-led recovery has been underway and employment growth has been good, although there are doubts about the quality of some of its components. In particular, there has been more low-wage jobs growth this year, which may augur well for the long term but, right now, is not helping the gaps in productivity and the weaknesses in real earnings.

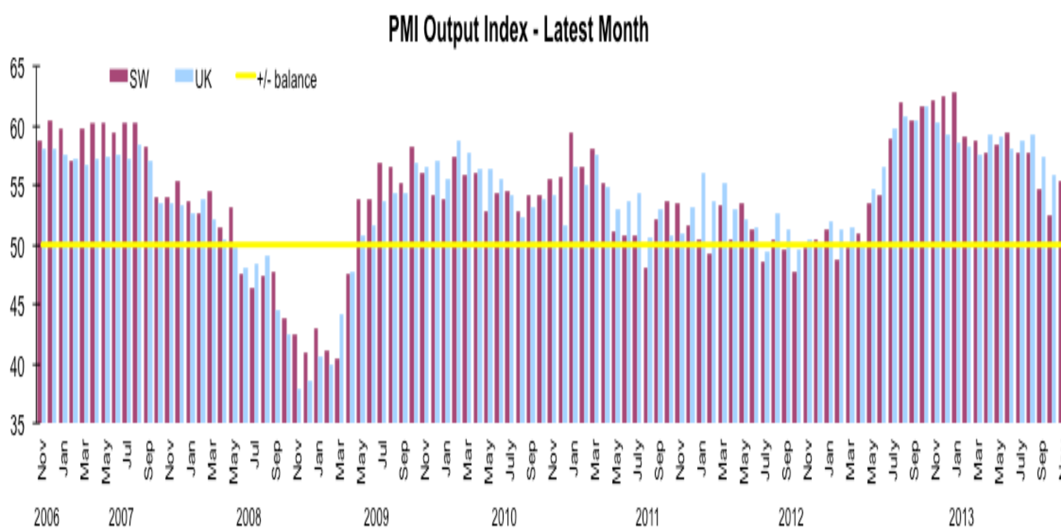
Recent surveys suggest a mixed outlook amongst SW businesses, with some improved investment intentions; some concerns about exports; and an uncertain profile for future orders. The trend of forward momentum is not totally robust and structural weaknesses have still to be addressed.

The latest ***purchasing managers'*** (PMI) survey, a good indicator of recent and current regional performance, shows some loss of momentum this year, with the SW output balance slipping below the UK average (see chart below). The employment balance has held up, confirming that the SW economy is experiencing employment-driven growth rather than productivity-driven growth. Over time, the former will be difficult to maintain without some reinforcement from the latter.

Other surveys have also been mixed. For example, the British Chamber of Commerce, the CBI, the ICAEW, the Manufacturing Advisory Service

and other local indicators recorded an ebbing of confidence and activity in September-October whilst suggesting that November was better. Once the distortions of the festive season are over, given moderate winter weather in the new year, we will be able to assess how this volatility may resolve itself.

SW Purchasing Managers: Output November 2014

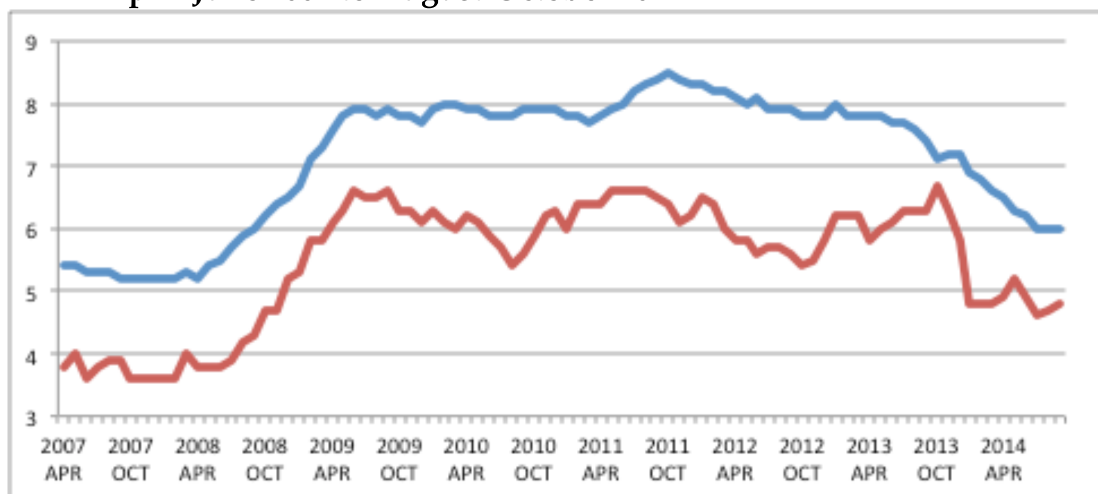


Source: Lloyds/Markit

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 positive, at 3.3% over the last year (to October). It is not yet clear whether this trend has been driven by desire or distress. Still, SW activity and employment rates remain relatively high (80.4% and 76.4% respectively).

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

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



Source: ONS data

Meanwhile, in November 2014, the ***claimant count rates*** for the region's six Local Enterprise Partnership areas were all very low: Dorset and Swindon and Wiltshire 1.1%, Gloucestershire and Heart of the SW (Devon and Somerset) 1.2%, Cornwall and the Isles of Scilly 1.4%, and West of England (Bristol and its neighbours) 1.5%. This produced a SW average of 1.3% and compared with the English average of 2.1%.

At a lower spatial level, the range is from 0.8% in BaNES to 2.3% in Torbay. Over time, the recent trend is mostly to lower claimant rates, reflecting structural changes in the regulations as well as changes in underlying economic behaviour. As a result, this indicator is becoming less useful than it was for reading current trends.

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

Special Note: Gross Value Added in SW England: the latest story

Annual data on **gross value added (GVA) – a measure of total output based on incomes** at a regional and sub-regional level – has just been released. The latest figures are for 2013. They reveal interesting facts about the structure of the SW economy and whether it is changing.

In SW England as a whole, GVA was £113.8 billion in 2013[2]. This was 3.2% above the 2012 level – barely positive once inflation is subtracted from this rate. Broken down in **spatial terms**, we find 52% of SW output was produced in Gloucestershire, Wiltshire and Bristol/Bath, 22% in Dorset and Somerset, and 25% in Devon and Cornwall and the Isles of Scilly.

In **sector terms**, the breakdown was 33% for finance, IT and business services, 22% for the largely publically-provided services (including education and health), 19% for distribution and transport services, 12% for manufacturing, 7% for construction, 4% for other personal services (including leisure), 3% for utilities and 2% for land based sectors (including agriculture). The long-term shift from manufacturing to services shows no sign of abating.

It is more interesting, however, to look at the GVA figures in terms of their ratio to the size of the population: it would be silly, for example, to compare the rural totals with those of urban areas without considering the number of people that the output totals cover.

At a regional level, in 2013, the **SW GVA per head total was £21,163**. This was 12.5% lower than the England average. Across SW England, the range was from a GVA per head figure of £14,226 in Torbay to £30,945 in Swindon, maintaining the massive gap in economic performance across the patch.

In index terms (set against UK average = 100), SW England's GVA per head figure was an index 90.5. SW England ranked fourth out of twelve in the United Kingdom. This high rank partly reflects the statistical changes introduced by the ONS this year.

Importantly, UK differentials, if anything, have been widened by this year's methodological changes: SW England is now 9.5% below the UK average versus only 6.8% after the recession in 2012. The economic 'black hole' that is

[2] N.B. the recent major revisions to ONS statistical methods for calculating GDP and GVA makes comparison of this year's release impossible with previous years' releases. E.G. SW GVA has been revised up by 8.6% for 2012!

Central London seems to have strengthened its gravitational dominance in the last three years as an unbalanced UK recovery has got underway.

The GVA per head indices for the twelve SW areas are shown in the table below; again showing the wide variation across this region.

SW GVA per head index (UK = 100, 2013)

Dorset	78.2	Devon	76.7
Wiltshire	84.5	Swindon	132.3
Gloucestershire	99.5	Bristol city	123.4
Bath & NE Somerset, N Somerset, & S Gloucs	108.8	Cornwall & the Isles of Scilly	65.8
Somerset	78.6	Torbay	60.8
Bournemouth & Poole	98.2	Plymouth	85.2

Source: ONS

There are two main stories behind this data.

1. **Rural areas tend to underperform their neighbouring conurbations on the GVA per head measure.** This largely reflects the natural skew for economic activity to be located more in towns and cities, especially for the larger, high value operations. This tendency partly reflects commuting and employment patterns.

a) In many places, there is quite a lot of commuting in and out of local conurbations. In simple terms, '**high value-adders' may work in town but live in the country**. Hence, GVA per head, which is measured at the place of work, boosts the urban economic contribution in the opposite direction to residential measures of income.

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 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.

Such factors can mean a net increase in GVA per head 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) Plymouth versus Devon County,
b) Bristol versus Gloucestershire and Somerset,
c) Swindon versus Wiltshire, and
d) Bournemouth and Poole versus the rest of Dorset.

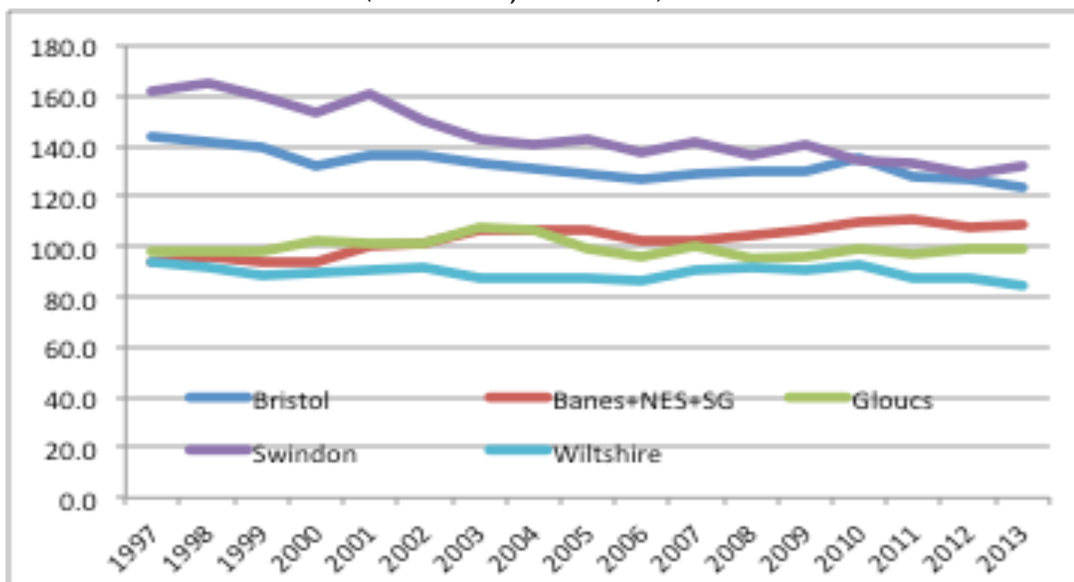
2. The other story is that there are **interesting contrasts in the way the series move across SW England over time.**

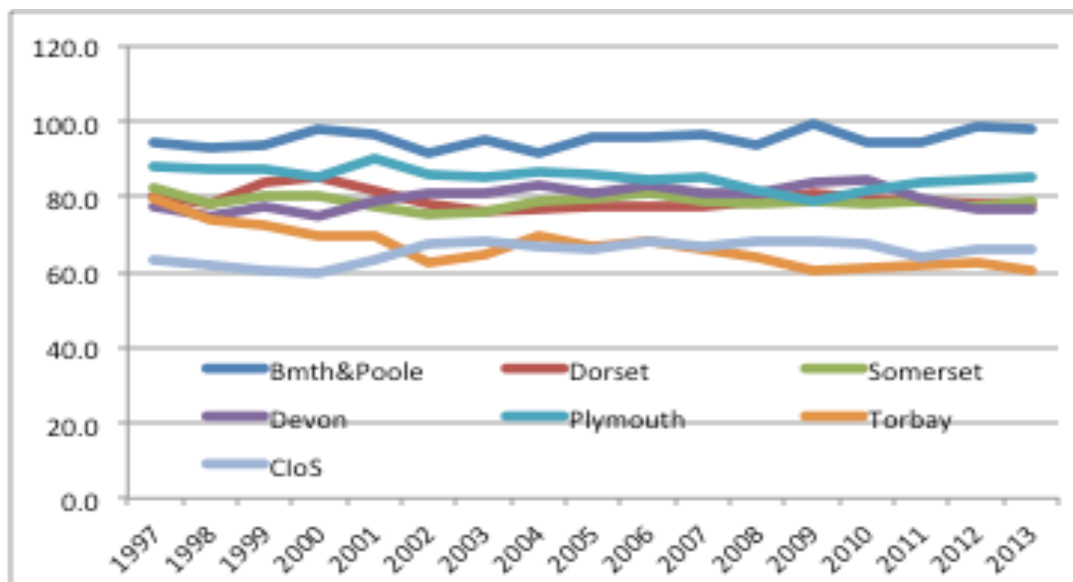
Many of the localities have, essentially, gone sideways over the last 16 years. The long downturn after 2008 saw some narrowing of differentials. But, as the two charts below show, the overall pattern is one of relatively insignificant changes over time. Broadly, the 'north-side' divide within SW England persists.

One key finding, however is that, 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. Bristol and Swindon still dominate the indices but they have both lost some of their relative strength over the years whereas Banes+ and Bournemouth-Poole have gained slightly in comparative terms.

Another point to note is that Cornwall has passed Torbay at the bottom of the ladder (around 65). Also, there has been some concentration of similar outcomes in the 'soft' middle of largely rural areas at an index of about 80.

SW Gross Value Added (1997-2013, UK = 100)





Source: ONS

If a sustained upturn is now underway, **it will be interesting to see whether the SW's conurbations regain some relative ground**. Normally, this would be the expectation but, given the structural and rebalancing changes still needed, it may well take some time for any such effects to feed through in the statistics.

Moreover, we are not going to know about any such effects for some time: 2014 data will not be released until a year from now and any real 'bounce back' from the upturn may not be 'known' until 2015 data is revealed in late 2016! Yet again, we are studying the economy with data that is like driving by looking in the rear view mirror.

Nevertheless, the overall message is that the relative performance and ranking of economic performance within and across the region is persistent. Efforts to change these trends, through development spending and investment have been too small to effect much change, with the possible exception of EU funding keeping Cornwall's relative index above 60 since 2002.

This does not imply that regional development is ineffective. Indeed, at a micro project or programme level, the net economic impact can be shown to be highly positive. What it might mean, for these data series, is that such investment in infrastructure, skills and business support may serve to resist the economy's underlying tendency to widen GVA per head differentials.

Economic Prospects

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

We believe the current risks to this forecast are more on the downside than the upside, at least in the immediate future. We cannot rule out a more positive story, but that will be a welcome relief 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	1.4	1.9
OBR	3.0	2.4	1.5	1.2
Strategic Economics	3.0	2.3	1.5	1.4

Source: HM Treasury (November 2014), OBR (December 2014) & Strategic Economics Ltd (December 2014).

Negative factors for future growth and development include:

a) The weak prospects in our major markets in Europe and slower growth in China and Russia,
b) The weakness of domestic real household incomes and persistent business uncertainty and investment indecision,
c) Ineffective monetary and fiscal policies, and
d) Continuing structural imbalances and the productivity gap.

Positive factors would have to come from higher business and household confidence at home feeding through investment and productivity to real wages and final demand. The 40% drop in world oil prices since June, to about $60 a barrel, can also have a beneficial effect, stimulating growth by redistributing spending power to non-oil parts of the economy, but this may be temporary.

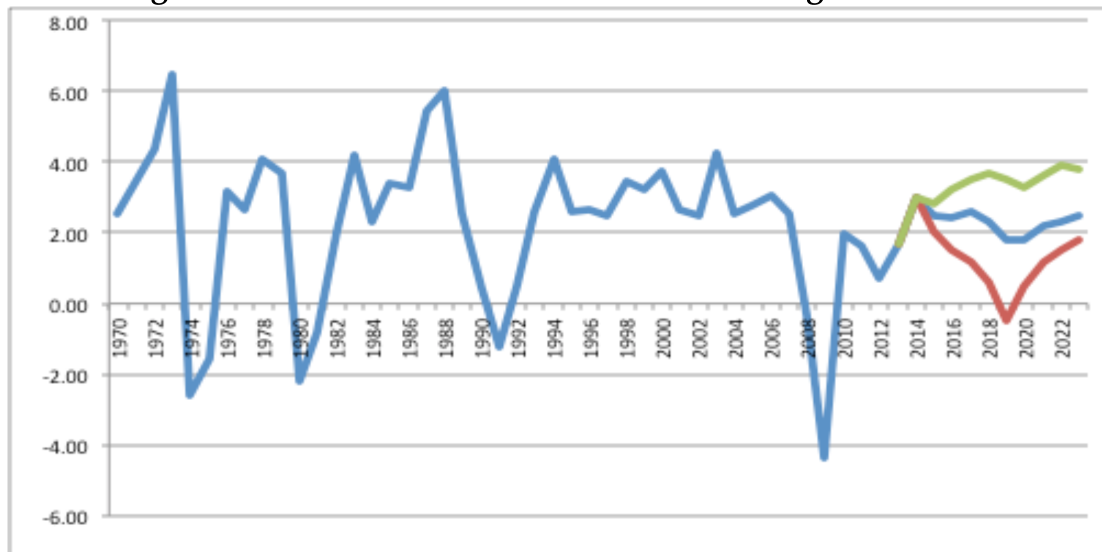
Further out, the **central view** (blue line in chart below) is that growth will moderate to a trend rate of about 2-2.5% per annum. On the upside, growth could be boosted towards 3.5% per annum if the productivity 'gap' is closed and some structural rebalancing of demand and supply can be achieved (green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

The higher risk, at least right now, 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 debts and deficits, weaken growth prospects (red line).

With the banking sector still vulnerable to shocks (as shown by the Bank of England's latest stress tests), the international environment uncertain and domestic fundamentals (incomes, finances and policies) in need of structural reform, there is a chance that we experience another recession within the next five years.

UK Strategic Economics Stories: Forecasts of real GDP growth



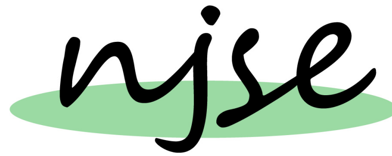
Source: Strategic Economics Ltd

Conclusion

Having considered current conditions and prospects, this **Strategic Economic Report** concludes:

Finally, recovery has pushed the UK economy into an upturn but that upturn is not expected to be robust. Reflecting the weakness of external markets, particularly in the euro-zone, the inert policy mix, weak household finances and adverse structural deficits, the risks of deflationary low growth have increased.

Against this background, the SW economy has lost some relative ground in trend and structural terms, partly because, as usual, the regional recovery is driven mostly by domestic demand. Supply rebalancing has been limited and the 'holy grail' of higher productivity has remained elusive. A sustained and sustainable upturn requires the search for the 'holy grail' to be successful.



Afterword

This is the ninth 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 spring 2015.

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.

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