Strategic Economics Report

Issue 10: April 2015

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Headlines

The UK recovery seems sound, with moderate growth accelerating slightly over the last two years.

Recent sub-national surveys point to mixed and volatile fortunes, by sector and geography, for sales, employment and investment.

The overall outlook is for more of the same through 2015 and into 2016, though the pace may slacken from the end 2014 pace.

Three structural factors concern us, however, for maintaining the upturn beyond the foreseeable future:

- The brake of poor productivity growth remains engaged.
- Huge external deficits threaten a strong financial and real economic adjustment at some point.
- The prospect of a period of deflation cannot be totally ruled out.

Meanwhile, given the monetary policy trap and austere fiscal stance, the policy environment seems almost irrelevant.

The global environment is unfavourable too, with the wars in Eastern Europe and the Middle East and financial imbalances in China and the Eurozone.

Against this background, for local southern business, the development emphasis has to be on the micro aspects of growth rather than the macro conditions.

This is a politics free report. We only hope the General Election and the threat of an EU-exit referendum do no harm.

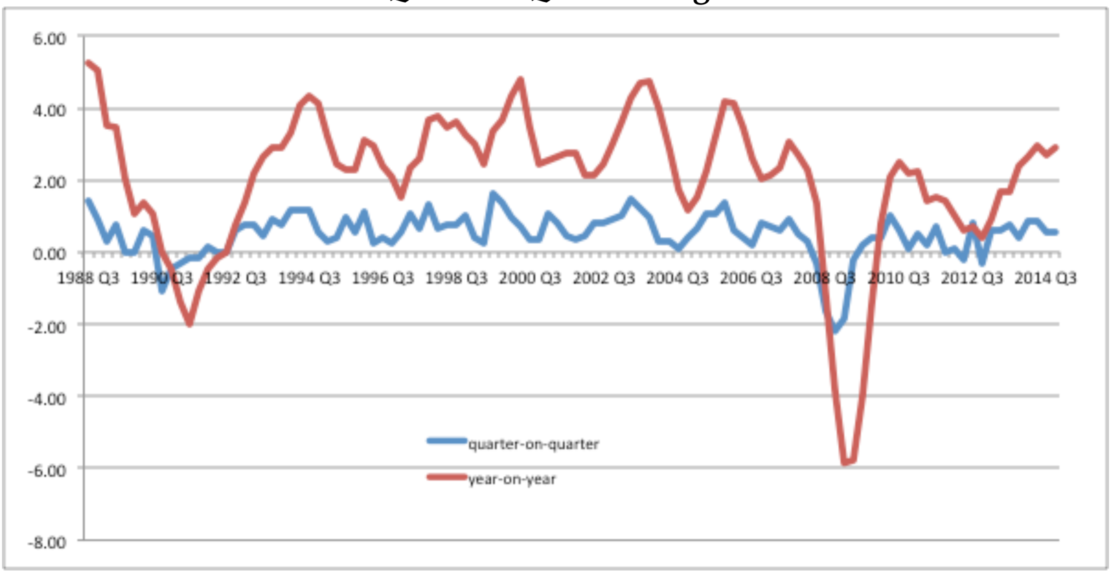
Economic Profile

Recent Data & Trends:

Having started at the beginning of 2013, the current UK economic recovery is now in its tenth quarter. The ***growth rate*** has moved above trend potential, averaging 2.8% in 2014, and the series has been less volatile than expected (see chart below).

After a long downturn and period of uncertainty, the UK economy appears to have found a more positive footing, despite the politicians. Still, GDP per head has yet to regain its previous highs and the question now is how sustainable the recovery might be.

UK real GDP trends: 1997 Q1 - 2014 Q4 (% change)



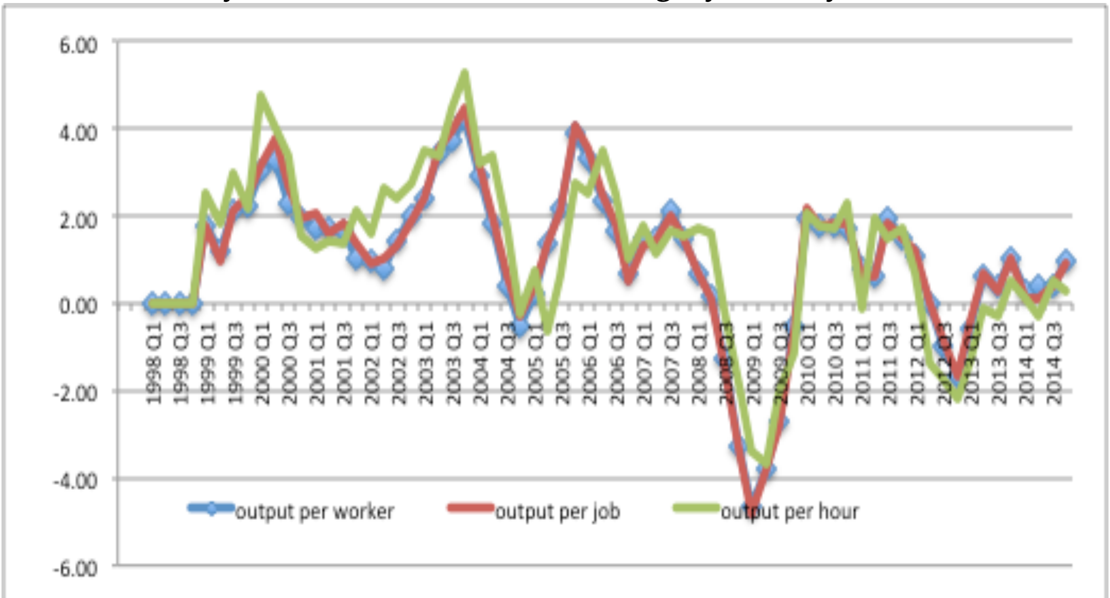
Source: ONS data

Most of the growth to date has been driven by employment and consumption. The contribution of household spending has increased consistently since late 2013 whereas the input from investment has been erratic – indeed, disappointingly tiny in the final three months of 2014. (By contrast, net trade was positive in this latest period, largely reflecting the differential impact of falling oil prices on imports and exports.)

It is important to say, however, that real household expenditure per head remains below its pre-recession levels. It does not usually take so long for this indicator to recover. Presumably, current performance reflects the long drag of the downturn on real household earnings. In turn, this helps to explain the modest upturn in investment. For many firms, there is still a lot of uncertainty about forward demand/market prospects, as well as other constraints such as doubts about local trading and political factors – especially the risk of a possible EU exit referendum within the next two years. There are still a number of reasons for companies to 'wait and see' when it comes to anything other than modest replacement and stepped investment rather than transformational new investment.

Fundamentally, these trends are captured by the profoundly disappointing ***productivity series*** (see next chart). The three main measures of productivity (output per worker, per job and per hour) turned modestly positive in late 2014 but all three have yet to regain previous highs in both level and rate terms. The crucial output per hour index was at 98.8 in the last three months of 2014 compared with 100.5 in the first three months of 2008. Without a stronger recovery in these key series, there will remain doubts about the sustainability of the current upturn. ***This is our first reason for worrying about whether the recovery can turn into a prolonged upturn.***

UK Productivity: 1990 Q1 to 2014 Q4 (% change, year-on-year)

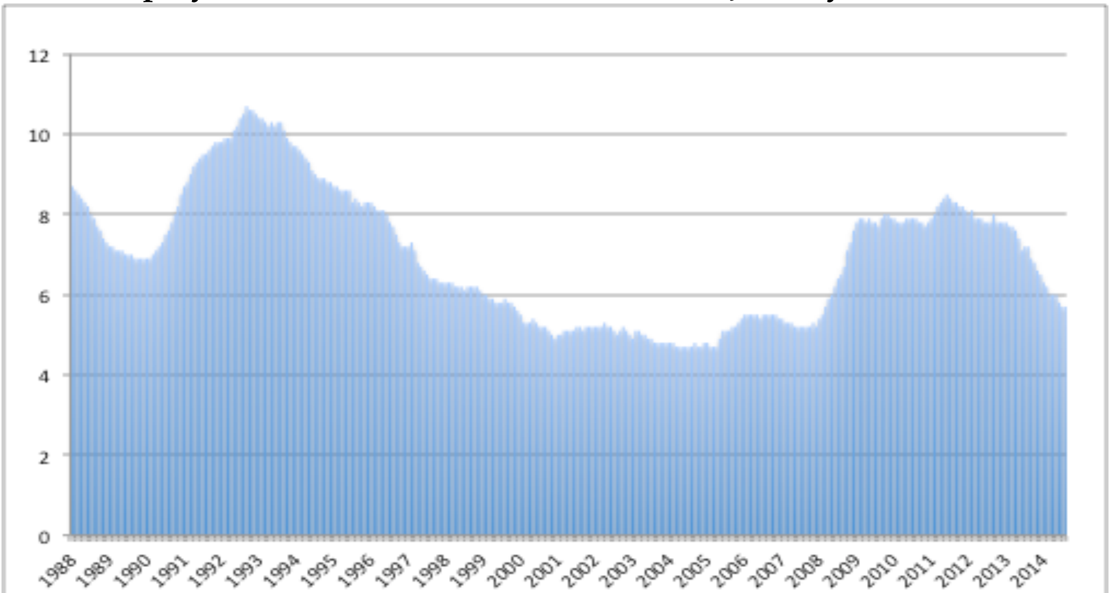


Source: ONS data

The converse of the disappointment about productivity is the pleasant surprise about the labour market. Employment growth has been quite buoyant. At the end of last year, a record 73.3% of the workforce age group (16-64) were employed and 617,000 more were in work than a year earlier (78% of the increase full-time and 22% part-time).

As the next chart shows, ***unemployment*** peaked early at a lower rate (8.5%) than expected in this part of the economic cycle and has dropped away steadily over the last eighteen months (to 5.7%). There has been lots of debate about the quality of the jobs being created but the quantity remains remarkable compared with other recent examples of UK recovery. From the poor productivity numbers, we suspect that some trade-off of value is evident, whether this reflects wage compression, flexible working and hidden or under-employment. The macro issue remains that overall employment growth can not persist without an improvement in value-driven productivity.

UK unemployment (% LFS rate) December 1988 – January 2015

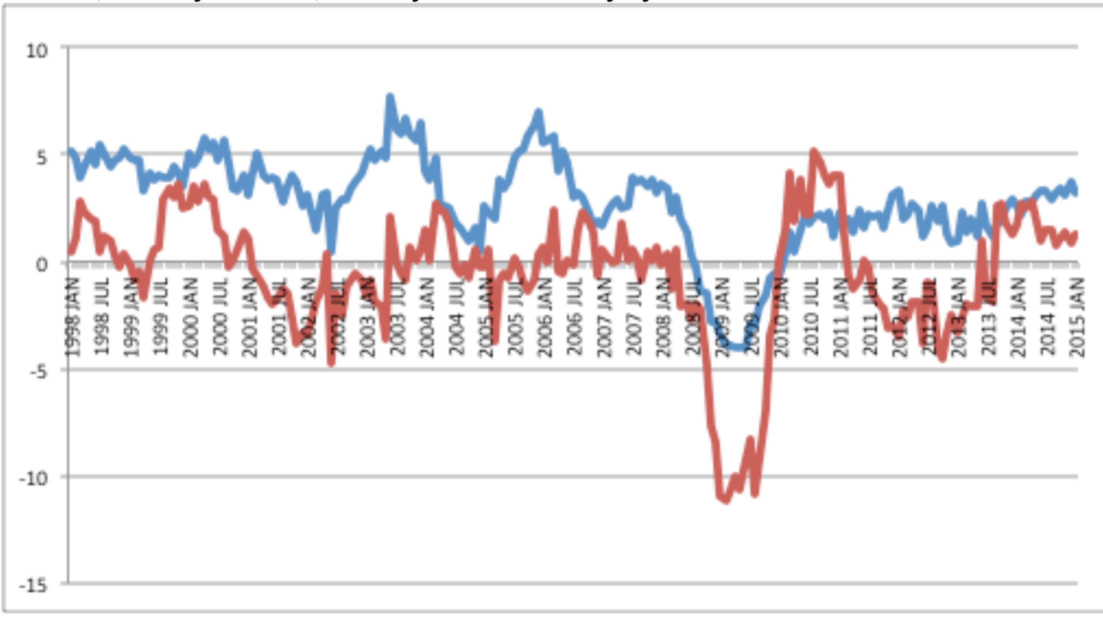


Source: ONS data

Meanwhile, on its output side, the UK economy has made positive progress in recent months. The next chart (below) indicates a steady climb in the services growth rate and a more subdued performance for production. The former is now almost 8% above its pre-recession peak whereas manufacturing remains 5.7% below its equivalent high.

The contrast between ***services and manufacturing*** is evident in the table below, which shows respective growth rates in 2014. Perhaps equally significant, however, is the contrast within manufacturing, from the strong growth of motors to the large declines in pharmaceuticals and textiles. The experience of different firms in different sectors continues to vary enormously – *again emphasising that the recovery is real but moderate and not uniform.*

UK Production (red) & Services (blue):
January 1998 – January 2015 (% ch, yoy)



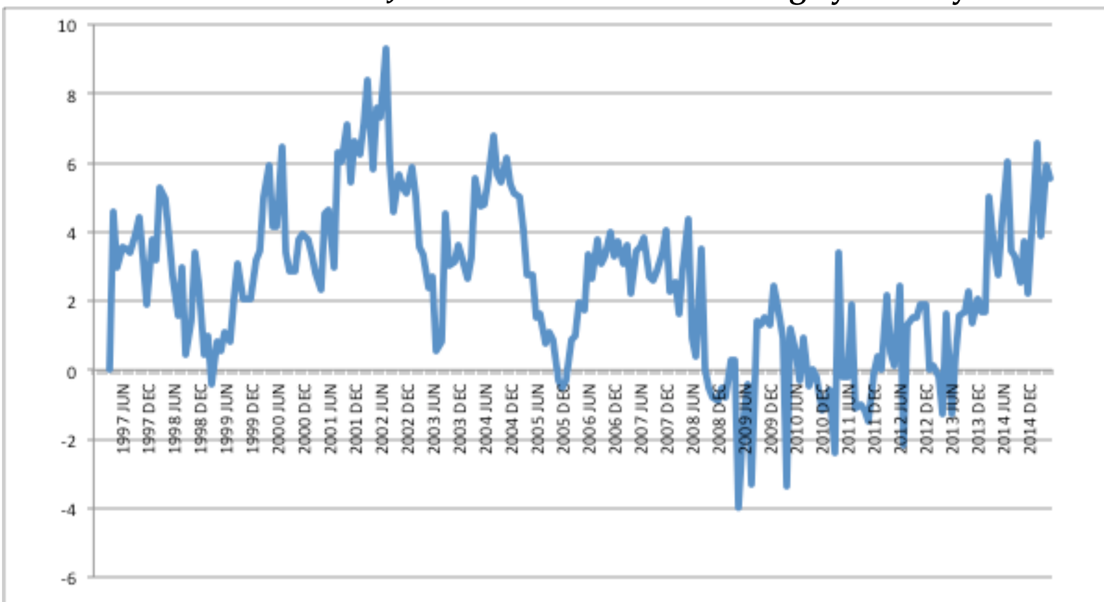
Source: ONS data

Services & Manufacturing Sector Performance: 2014 (% ch yoy)

Foods	+5.3	Pharma	-4.8	Other trspt eqpt	-0.7
Beverages	+6.2	Metals	-3.4	Distribution	+4.7
Textiles	-4.5	Elec eqpt	-2.1	Busin, prof & finance	+3.9
Clothing	-0.1	Machinery	+4.2	Public	+1.1
Chemicals	+3.7	Motors	+9.3	Trspt & Comms	+2.5

Source: ONS

UK Retail Sales Volumes: Jan 1997 – Feb 2015 (% change year-on-year)



Source: ONS data

On the demand side, ***retail sales volumes*** displayed quite a strong trend last year (see chart above) with real growth heading into a 4-6% range. Partly satisfying replacement demand and partly using excess liquidity, consumers are spending again. In 2014 as a whole, strongest growth was achieved in non-foods (see next table below). In the months ahead, it will be interesting to see whether the halving of oil prices over the last year feeds fully through to fuel costs, releasing spending power for other markets and demands. Until real incomes regain some of the ground lost since the late 2000s, however, the demand side of the economy will be subject to continuing restraint.

Retail Sale Volumes: 2014 (% ch yoy)

Mostly foods	+0.5	Non-foods	+6.1
Textiles & Clothing	+2.7	Household goods	+6.9
Other non-food stores	+8.4	Non-specialised stores	+7.0

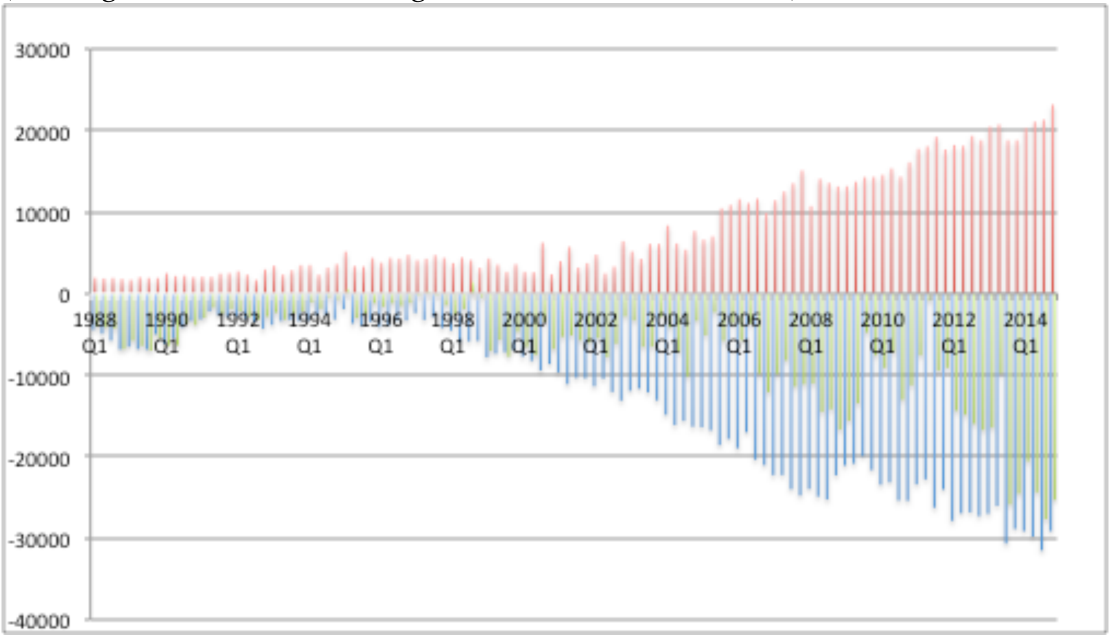
Source: ONS

Meanwhile, the UK's ***international balances*** remain very negative. The goods deficit reached almost £120 billion last year with the goods and services deficit at £33.7 billion. The current account deficit reached over £25 billion, some 5.5% of GDP (see green bars in chart below).

In any normal country risk analysis, such a ratio would be considered unsustainable and it would raise doubts about external financing capacity and persistence for the medium term. ***This is the second factor that seems to raise fundamental questions about the sustainability of the UK recovery***, especially as sterling happens to be strengthening right now against the euro, potentially making the external deficit problem worse. With net finance flows weakening as the ownership balance across borders shifts to Britain's detriment, the UK is struggling to pay its way in the world.

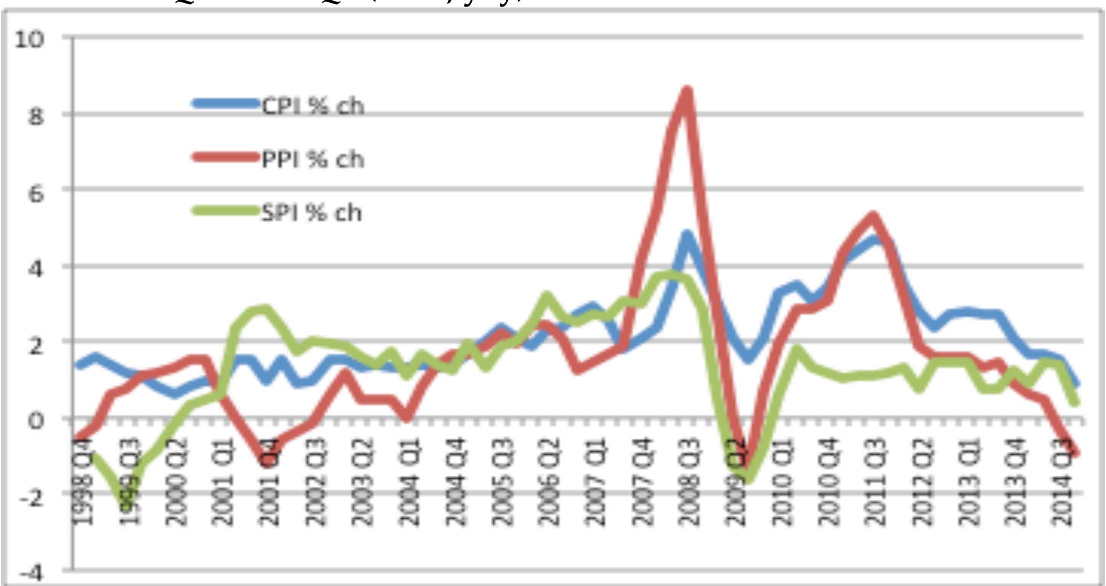
Reflecting the drop in commodity (especially oil) prices, the strong currency and the lack of wage pressures, despite an excess money supply, ***inflation*** is falling. Indeed, we may be entering a period of deflation. In Ferruary 2015, input and producer prices were negative (13.5% and 1.8% respectively) and consumer prices were flat. Even services price inflation has eased recently (see second chart below).

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



Source: ONS data

UK Services (green), Producer (red) & Consumer prices (blue):
1997 Q1 – 2014 Q4 (% ch, yoy)



Source: ONS data

Concern about such low inflation is tempered, according to the Bank of England and other commentators, by a belief that it is temporary and supply driven. In simple terms, this implies that falling prices allow consumers and firms to divert funds into buying more goods and services. Thereby, they can boost overall demand and growth. In addition, statistically at least, it starts to get some real earnings growth.

The worry would be if deflation persists and buyers start to defer expenditure in anticipation of lower prices later: deflation becomes a demand side phenomenon. Such a demand-led deflationary spiral would risk a period of malaise in which growth potential fades over the long run, as exemplified by Japan's experience since the 1990s. ***This is the third underlying risk to the present recovery.***

Policy Issues:

Monetary Policy

In its latest inflation report, the **Bank of England** argued that the UK economy will grow by 2-3% over the next couple of years with inflation returning to the 2% target rate by late 2016. It has kept its base rate at 0.5% for over six years and, in various speeches, members of the Monetary Policy Committee have identified a balance of risks which makes it difficult to predict when, or even if, interest rates might start to return to 'normal' soon.

It is a matter of some concern that monetary policy has been so distorted for so long. It is surprising that many businesses still baulk at the idea that base interest rates might have to go back towards 4% for the economy to be seen as properly mended. If this sentiment represents a 'new normal', it is unclear what it might mean for monetary policy transmission mechanisms and other financial incentives over the long term. The monetary 'fog' looks set to continue for some time yet.

Fiscal Policy

The fiscal outlook has also not changed. Large public deficits persist and public sector debts are high. Despite lots of promises and potentially important micro tweaks, the recent (March 2015) Budget Statement by the Chancellor did not really change the macro fiscal outlook.

In particular, although, it predicted a gradual turnaround from deficit to surplus during the next political cycle (2015-20), the OBR's latest fiscal projections also confirmed the persistence of the high debt ratios we have been assuming for some time (see table below).

Moreover, the plans of both the major parties in the current General Election do not alter the basic fiscal arithmetic: both promise more 'austerity measures' for the years ahead. Whatever you think about their relative speed of adjustment or about their precise policies towards spending and taxation, the economic reality is clear: in net terms, government will not be contributing much towards growth any day soon.

It will be interesting to see whether this net fiscal position has a positive or negative impact on overall growth through the medium term.

OBR Forecasts (March 2015)

	2015/16	2016/17	2017/18	2018/19	2019/20
Debt ratio (% GDP)	80.2	79.8	77.8	74.8	71.6
Budget deficit (% GDP)	2.4	0.5	-0.8	-1.7	-1.7

Source: Office of Budget Responsibility

In summary, whilst, according to historical expectations and standard theory, monetary policy remains stimulatory and fiscal policy contractionary for economic growth, the reality is less obvious.

Indeed, we are living through an interesting policy experiment. In a period of prolonged weak growth (subdued by poor productivity, huge trade deficits and deflation risks), the usual transmission mechanisms from low interest rates, inactive but large money supply overhangs, and austerity government policies may be distorted.

It is possible, indeed reasonable, to forecast either weak growth and high inflation or strong growth and disinflation from here! Such wide uncertainty does not support underlying potential in terms of UK growth prospects.

Local Overview

The **SW and SE economies** have tended largely to follow the overall UK trends over the last year or so. Looking ahead, there is a reasonable degree of local optimism about market prospects, the development of new products and technologies, and investment and employment intentions. In many ways, the economic problems for businesses across our regions are ones of success rather than failure.

But, given the macro constraints outlined above, these positive messages are patchy and volatile, quarter-by-quarter and sector-by-sector. For example, the latest ***purchasing managers'*** (PMI) survey, a good indicator of recent and current regional performance, shows some loss of momentum in February compared with January in SW England, though not in SE England. Overall, however, the SW and SE balances for output (54.8 and 57.3 respectively) and employment (54.6 and 57.6 respectively) are good by historical terms and still suggest the local 'southern' recovery is sound.

Other surveys have been more mixed. For example, the British ***Chamber of Commerce survey*** for the first quarter of 2015 shows SE manufacturing weakening in terms of orders and sales. For SE services, the former balance moved up whilst the latter moved down. Indeed, SE services recorded the best balances of all regions. Export balances, however, remained very low and investment and employment intentions retrenched compared with the final three months of 2014. In contrast, SW manufacturers were more buoyant and SW services less strong on the activity measures in the latest period whilst investment and employment intentions were fairly stable. Overall, despite a moderating recovery, southern confidence is high and activity good compared with many other parts of the UK economy.

The first quarter 2015 ***ICAEW survey*** saw southern business confidence positive but recorded a fall in the level for a third consecutive quarter. Political and financial uncertainties at home and in Europe are blamed for some of the recent caution. As a result, slightly slower growth is expected through 2015.

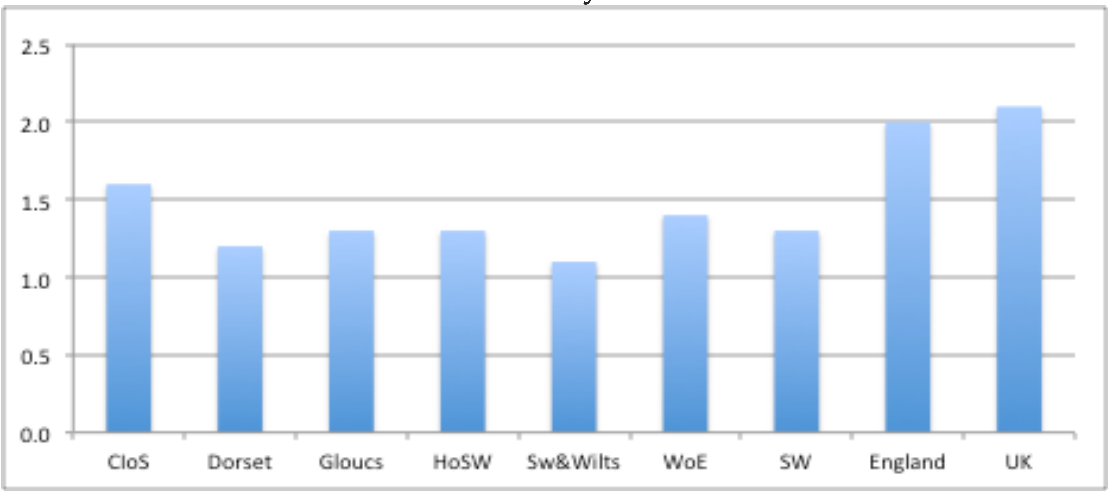
The latest ***Manufacturing Advisory Service (MAS) Barometer*** also found positive activity balances. In the last three months of 2014, these were slightly better than in the previous quarter but not quite as strong as a year ago. Overall, these balances suggest a UK and regional manufacturing sector that is experiencing moderately positive trends though it varies widely by industry/supply chain. In common with many other business surveys, MAS manufacturers find factors such as skills, finance, and especially regulation tend to be the ones hindering current growth prospects.

Meanwhile, as at a national level, ***unemployment*** provides a positive regional picture. In both the SW and the SE of England, unemployment rates are better than average and almost back to where they were before the downturn. For example, in February 2015, the ***claimant count rates*** were low across the patch.

As the two charts below show, all the SW and SE Local Enterprise Partnership (LEP) areas are performing better than the national averages. In many parts of southern Britain, (although the provenance of these statistics is now somewhat biased downwards by the regulatory changes made in recent years), these count rates imply virtually full employment.

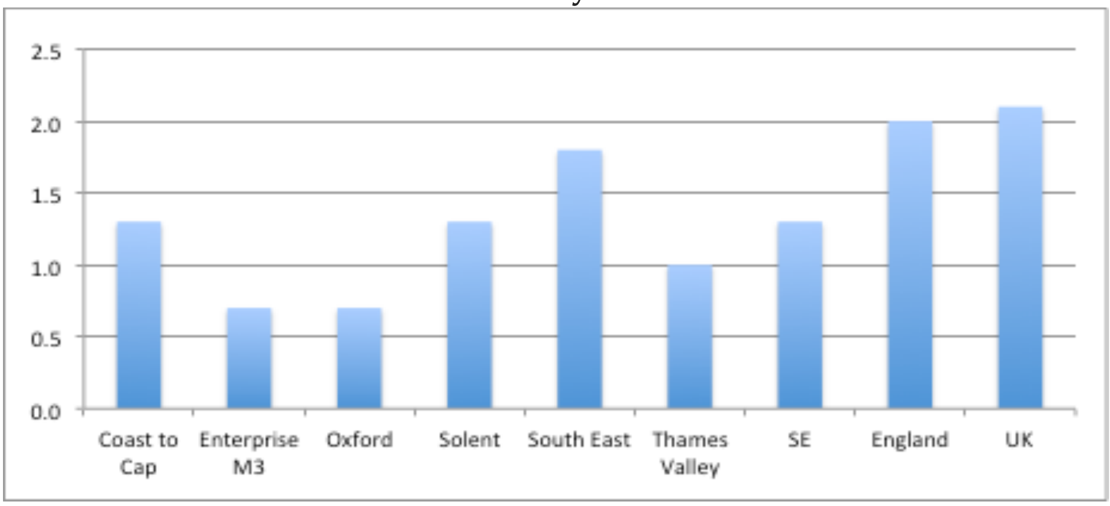
Again, the issue is whether the economy can sustain such a favourable employment story with low productivity, huge trade deficits and a risk of deflation.

SW LEPs Claimant Count rates: February 2015



Source: ONS

SE LEPs Claimant Count rates: February 2015



Source ONS

Economic Prospects

The **current consensus** (see table below) is that real GDP growth will average about 2.5% this year. Meanwhile, inflation will remain well below the official target (and range) and unemployment will fall a little further.

UK Consensus & Strategic Economics Forecasts:

	Growth 2015	CPI 2015	Unemployment 2015
HMT Consensus	2.7	0.8	5.3
OBR	2.5	0.2	5.3
Strategic Economics	2.5	-0.1	5.4

Source: HM Treasury compilation of private sector forecasts (March 2015), OBR (March 2015) & Strategic Economics Ltd (April 2015).

Given our emphasis on the three main factors (low productivity, large deficits and deflation) that could limit the recovery from turning into a sustainable upturn, we can use the OBR forecasts (see table below) as a broad benchmark to assess the longer outlook. We note that:

- The OBR shows growth stabilising at a historically low trend potential (about 2.3%) over the medium term.
- Productivity growth does improve, but slowly, and it remains too weak by historical and international standards (mostly under 2%).
- Unemployment stabilises and inflation slowly returns to target.

This is not a picture that suggests a strong macro upturn.

OBR Forecasts March 2015

Annual years	**2015**	**2016**	**2017**	**2018**	**2019**
Growth (% ch yoy)	2.5	2.3	2.3	2.3	2.4
Inflation (% ch yoy)	0.2	1.2	1.7	1.9	2.0
Employment (% ch yoy)	1.3	1.0	0.3	0.6	0.6
Productivity (% ch yoy)	1.2	1.3	2.0	1.7	1.8
Unemployment (% rate)	5.3	5.2	5.3	5.3	5.3

Source: OBR

There are positive risks that the OBR and others are underestimating the ability of households and firms to maintain an acceleration of growth despite the policy environment and especially if global uncertainties ease. If you believe the "get the government out of the way and the economy has a natural tendency to thrive" school of thought, you may be more sanguine than the consensus about the outlook. The fact that rates of return to UK manufacturers and services companies improved to 12% and 16.9% respectively by the end of 2014 might point to further good news for growth from the corporate sector.

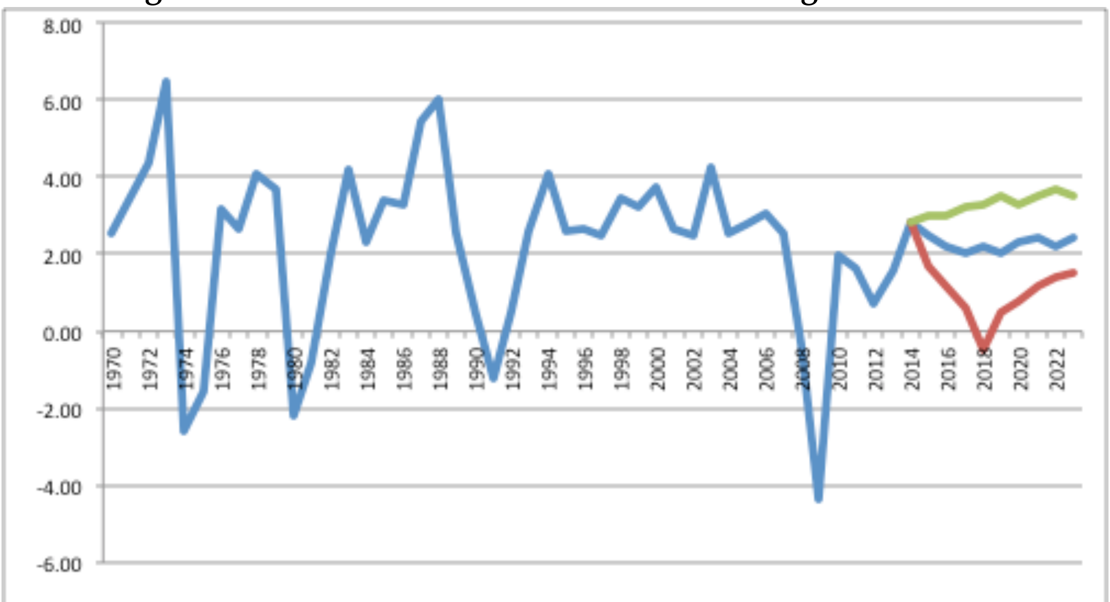
However, there are negative risks too.

- The international environment – (Eurozone default/collapse, slowing growth/excess investment in China, fighting in Ukraine, Yemen and Syria) - does not look like improving soon.

- The domestic policy environment – a mix of excessively loose money and tight fiscal - will not help, especially if there is to be an EU-exit referendum by 2017, casting further uncertainty for investors.

- Essentially, however, the key risk is the unbalanced nature of the recovery as discussed throughout this report. Until an investment-led, productivity enhancing, period of growth is secured, we will remain concerned about the longevity of the upturn.

UK Strategic Economics Stories: Forecasts of real GDP growth



Source: Strategic Economics Ltd

Indeed, as the chart above indicates, whilst our central view is that growth will fluctuate between 2.0% and 2.5% per annum (blue line) in the foreseeable future, there is a risk of another (hopefully short-lived and shallow) recession during the next parliamentary term (red line). We hope this is wrong and that we are surprised on the upside (green line). Perhaps, the animal spirits of consumers and investors are more robust than most currently think. But, we would not plan only on that basis.

The reality is always likely to be more volatile than the stories pictured here can show. Nevertheless, these scenarios represent a forward planning background for investment and development that encompass a range of likely outcomes, barring unforeseen shocks. Meanwhile, we await the General Election and its aftermath with some economic trepidation.

Afterword

This is the tenth 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 summer 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.

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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