Regional Economic Development

Business Intelligence Report 13: Spring 2018[1]

Summary 1-2

The UK Economy 2-5
Latest Evidence
Economic Stability

The Dorset Economy 5-8
Latest Data & Surveys
Structural Features

Summary

The UK economic engine spluttered in early 2018, faced with some cold east winds and persistent policy doubts. There should be some rebound from adverse weather effects, but other uncertainties will last a while longer.

It is always **a matter of concern when the inflation rate is higher than the growth rate**. It tends to mean a sluggish economy and constrained living standards. With inflation rates easing and some signs of earnings growth, we must hope that this imbalance (see chart below) does not last long.

Sadly, the **consensus is that a modest outlook will persist**. For example, the OBR's March forecast has real GDP growth at or below 1.5% per annum over the next five years with investment at 2.5% p.a. or less.

This implies the 'wrong' kind of growth. Rather than productivity-led, long-term sustainable, 'green' growth fuelled by investment, innovation, skills, entrepreneurship and competitiveness, we have growth held back by
1) subdued consumption - high debts, low real wages, an ageing population,
2) an unsupportive policy mix - too loose money and high fiscal debt, and
3) an uncertain global outlook - Brexit unknowns and President Trump's mercantilism.

[1] This is the latest of a regular overview series of Business Intelligence Reports that BU produces for the Dorset and neighbouring business community and its partners.

Against this background, **many Dorset businesses seem focused on the here and now** and micro rather than macro prospects. Local views are pointing in several different directions. Some firms/sectors strive hard to fill near-term order books and manage skills shortages, whilst others fear unfavourable EU supply chain shifts from March 2019 (Brexit) onwards.

Unfortunately, there are messages from local used car sales, garden centres, and other leisure and retail services that final (consumer) demand has softened in recent months. Household spending is not growing robustly, especially in real terms. This has affected retailers in the high street, tourism and other consumer services, and elements of discretionary construction. In contrast, high-end manufacturers and most business services remain relatively buoyant. Current trading and investment seem to be driven by capital replacement and capacity maintenance rather than building future growth potential.

Nigel F Jump, Professor in Regional Economic Development

The UK Economy

LATEST EVIDENCE

	Annual (2017)	Quarterly	Monthly
Real GDP (%ch, yoy)	+1.9	+1.2 (Q1)	n.a.
CPI inflation (%ch, yoy)	+2.7	+2.7 (Q1)	+2.5 (Mar)
LFS unemployment (%)	4.4	4.4 (Q4)	4.2 (Dec-Feb)
Current Account (£bn)	-82.9	-18.4(Q4)	n.a.
Base rate (%)	0.29	0.5 (Q1)	0.5 (Apr)

Source: ONS

The UK economy (see table above and chart below) **slowed through 2017 and has started 2018 sluggishly** – just 0.1% qoq growth in the first three months. There have been signals of weak consumption and investment growth, dampened by modest expectations about future earnings and profits. Surveys of consumer confidence have been softening.

The international environment has not helped, with a number of trade and diplomatic factors adding uncertainty – threatening a ‘cold war’ and a ‘trade war’. The US President is risking a return of mercantilism: the belief that it is the share of the cake, rather than the size of the cake, that matters. Such economic policies were abandoned a century and a half ago – their revival now would be a retrograde step.

Meanwhile, all this political controversy has been reflected in a stock market correction, commodity price swings and volatile exchange rates, adding

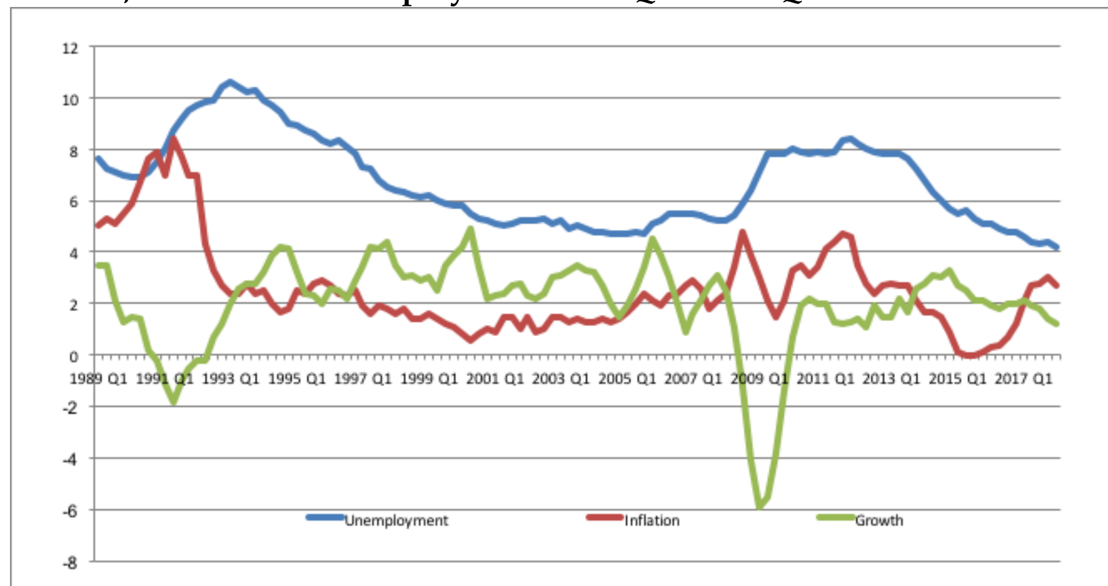
market uncertainty to political and policy uncertainty. No wonder more people are back to a 'wait and see' mode of thinking, planning and commitment.

The essence of the problem, with or without Brexit, is that the UK economy has experienced the **'wrong' kind of growth** for a number of years, almost to the point of establishing a 'new normal'. The monetary and fiscal policy mix adopted to deal with the risks of debt and depression at the start of this decade seem intractable. At the same time, household and business prospects are constrained, and constraining, in an economy not built on productivity but on debt and cheap labour.

Crucially, the UK growth/inflation mix (discussed earlier and below) and the debt/deficits mix are unfavourable. The current account deficit remains large (3.6% of GDP in Q4 2017) and the public debt ratio huge at 86% (fiscal 2017/18). An ageing population, falling household living standards, weak investment incentives also contribute to the 'wrong' kind of growth, with **low creative destruction and poor competitive aspiration**.

Although some improvement was experienced in the second half of 2017, the "productivity puzzle" persists, with output per hour still about 20% below trend and the 'gap' with our competitors not shrinking. In essence, we have **too many low value jobs in a weak investment cycle** and not enough robust supply chains based on 'collaborative yet competitive' business relationships.

Growth, Inflation & Unemployment: 1989 Q1 – 2018 Q1



Source: ONS: Growth = real gross domestic product (GDP) % change year-on-year (yoy), Inflation = Consumer Price Iindex (CPI) % ch yoy, and Unemployment = Labour Force Survey (LFS) % rate.

OBR FORECASTS

The Spring release by the OBR in March barely changed its forecasts from November. The key messages were:

- *The cyclical economy is weak*: growth is not expected to exceed 1.5% per annum between now and 2022.
- *The structural economy is weak*: growth potential remains modest by historical standards because productivity is still poor.
- *The fiscal economy is weak*: the public finances remain precarious - the deficit is shrinking but the debt burden is not.

Essentially, the OBR is **predicting more of the same** over the forecast period: growth not fuelled enough by investment, productivity and real earnings. The economy is operating near to potential and there is little spare capacity. In the near term, Brexit uncertainty may dampen domestic and foreign direct investment, whilst reducing net positive immigration, compared with what otherwise might have occurred.

The wider consensus is the same. The latest HM Treasury compilation has growth of 1.5% in 2018 and 1.4% in 2019. The UK economy is precariously balanced with low growth and higher inflation (2.3% and 2.1% respectively). Historically, if it persists, the latter being at a higher rate than the former has proved uncomfortable for growth and jobs.

ECONOMIC STABILITY

Interest rates remain very low and are only expected to increase slowly over the next few years. At some point, base rates probably need to get back to about 3.0-3.5% (roughly equivalent to underlying nominal GDP growth), if pre-Great Recession ‘normality’ is to be restored.

As long as this is done in small, slow steps, such an adjustment need not hurt overall economic growth. There may be some pain for over-extended household and corporate debtors who may not have planned properly for higher rates, but a gradual process of change to more ‘normal’ interest levels will improve resource allocation for and by most economic actors in time – **a likely condition for getting the economy working sustainably towards the ‘right’ kind of growth**.

The question, however, is whether pre-2010 ‘normality’ is a viable target or only of academic/historical interest. The west’s policy response to the debt crisis, including zero interest rates and ballooning central bank balance sheets (quantitative easing - QE), avoided a Great Depression. But, the resulting, persistent debt pile (worldwide over $230trn and over 300% of GDP), was merely shifted from private to public balance sheets. This implies a risk of a

renewed funding default if creditors lose confidence in the ability of debtors to repay, particularly as the costs of borrowing (bond yields) edge higher.

As the central banks start to unwind the ‘2010-model’, it is not clear that a return to the ‘old normal’ is possible. **The risk is that another crisis hits when the authorities have less room for manoeuvre**: a drop of interest rates of the scale seen at the start of the decade to support activity levels is not now feasible. With growth at no more than 1.5% per annum, a fairly small negative ‘shock’ could push the UK towards recession and the Bank of England has less room to do anything about it. In this respect, current evidence of a softening of final demand is worrying. Moreover, it makes a shift towards more sustainable investment and productivity-led growth even more urgent.

The Dorset Economy

LATEST DATA & SURVEYS

The anecdotal evidence is that **the local economy lost a little momentum in early 2018** but experience was highly variable.

Retailers, manufacturers, consumer services and construction companies report very mixed performances across a range:

> ‘struggling to fulfil current contracts and order books amidst skills shortages’ or
> ‘struggling to maintain demand without discounting and offers that undermine profitability’.

There are wide differences between businesses orientated to domestic markets (sluggish household expenditure) and exporters (tail-end of the 2016 sterling boost) and also between those who have long or short lead times in their supply chains. There are rumours that orders for a year ahead (post Brexit) are not matching previous ‘normal’ experience in some supply chains.

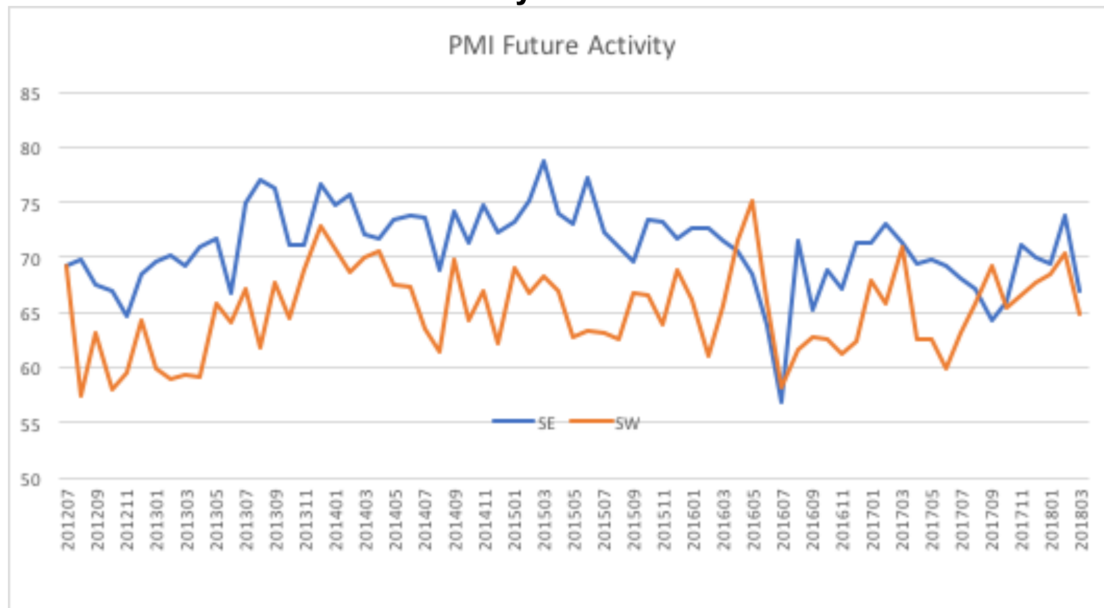
Despite some doubts about the ‘medium-term’ future, current business surveys remain quite good.

- The latest **Federation of Small Businesses Survey** (March 2018) was more optimistic, on average, than the late 2017 version. Nevertheless, there was significant variation between the negativity in retail accommodation and food services and positivity in manufacturing, and professional and scientific services.

- Similarly, the most recent British **Chamber of Commerce Survey** talked of the economy "treading water despite the export boost". Consumer-orientated businesses are faring worse than business-to-business. With members' cash flow tightening, the BCC called for "fixing the fundamentals" of infrastructure, skills and over-regulation/taxation".

- The various **Purchasing Managers'** surveys show an economy that is growing modestly. The regional measures for SW and SE England recorded positive activity balances of 54.3 and 53.2 respectively in March – both above the UK average. There is an interesting contrast between good new orders and not so good business outstanding in SE England. In SW England, however, business outstanding is strong. As a result, many local respondents remain reasonably positive about the future (see chart below).

PMI Future Outlook balances: July 2012 - March 2018



Source: Markit for Lloyds

Meanwhile, in 2017, Dorset's labour market remained tight. The UK average employment rate was 74.7% and the unemployment rate was 4.4%. On the latter, Dorset as a whole and the various parts of Dorset were 'better' than average (see table below). As usual, the more urban areas were looser than more rural.

Overall, **Dorset has little problem employing residents who want and are able to work**. It is the productivity of the labour force that needs more attention.

Local Labour Indicators (Jan - Dec 2017)

	Emp %	Unemp %		Emp %	Unemp %
Bournemouth	75.8	4.0	Dorset	79.4	2.5
Poole	76.8	2.9	Somerset	75.9	3.9
Christchurch	80.9	2.3	Devon	80.9	2.6
East Dorset	83.1	2.2	Wiltshire	82.0	2.9
North Dorset	81.8	2.4	Southampton	74.0	4.4
Purbeck	83.4	2.4	Portsmouth	73.7	4.1
West Dorset	78.3	2.6	Hampshire	82.0	2.8
Weymouth & Portland	70.3	3.2	Isle of Wight	72.7	4.2

Source: ONS
employment 16-64 age groups, APS. unemployment 16+ economically active

STRUCTURAL FEATURES

With the government's recent agreement that Dorset will have just two unitary authorities from April 2019: - Bournemouth, Christchurch and Poole (City Dorset) and East Dorset, North Dorset, West Dorset, Purbeck, and Weymouth and Portland (County Dorset), the statistical landscape will be changing for our £16-17bn a year economy. We do not yet know how ONS will deal with the change in political geography For now, we can estimate that 'City Dorset' will have GVA per head of about £22,000 a year whilst 'County Dorset' will be just under £18,000 a year (2016 prices).

On average, Dorset is now more than 20% below the UK average on the GVA per head measure. Its **relative position has been slipping** for about a decade and a half. In 2000, it was not quite 10% below average. By 2016, it had lost a further 10 points of comparative ground.

This pattern is alarming but, sadly, not unusual. The divergence between above and below average has widened generally across the country, with the Greater London 'black-hole' pulling away from most other regions. It is disappointing for Dorset, nevertheless: local productive potential and performance is not keeping pace in relative terms.

This is further evidence of the 'wrong' kind of growth not producing optimal local well-being and prosperity. Productivity-led, long-term sustainable, 'green' growth remains mere aspiration. Growth is being *pulled along* by sluggish demand factors more than it is being *pushed along* by supply factors. This is inadequate to offset (consistently) some of the negative externalities, such as environmental degradation and congestion. Moreover, the 'demand pull' seems to be itself wavering with no sign of a countervailing 'supply push'.

The two new unitary authorities, the Dorset LEP and all others engaged in local economic development will have to address these structural and cyclical conundrums in their future economic strategies.

There is **scope for long-term economic optimism**, however. At some point, Brexit uncertainty will be removed. Mitigation and substitution can evolve, productivity will recover, and a 'new' psychology of supply chains and markets should emerge. With better 'agglomeration' and connectivity, more access and aspiration, and new demographic and technological change, there is no reason why the inherent entrepreneurial/innovatory spirit of today's (and tomorrow's) young economic entrants cannot emerge without sound invention and skill.

What might be termed the "**digi-yoof**" generation, now moving through our secondary and tertiary education systems, **will be the product and business creators and the market drivers** of a decade ahead. They will be "doing things better" and "doing better things". With this hopeful prospect, all of us engaged in local economic development need to "collaborate to compete", sharing 'best practice', offering 'fresh opportunity' and eliminating 'peripheral Dorset' from the local lexicon. Creating the infrastructure and other conditions for business growth, in real and psychological terms, is vital.