Regional Economic Development
Business Intelligence Report 12: Winter 2017/18[1]

The Economy in Summary

The UK economy experienced another year of modest economic performance in 2017. Despite the technological drive for change across a range of industries, political, public sector, business investment and consumer factors held back the pace of economic development.

The consensus is that there will be 'more of the same' in 2018, with the 'wrong kind of growth' persisting unless productivity accelerates. Inflation is expected to stay above target but ease back from its exchange rate highs. The risk of recession is higher than the risk of a boom but an improving world economic outlook suggests some upside to offset BREXIT uncertainties.

Even if the forecasters are correct, there should be considerable interest in major structural changes that will be negotiated or get underway this year, especially those related to future trade patterns and industrial strategy.

Against this background, local businesses are confident, operating at high capacity and continuing to face constraints from infrastructure and skills. The need for investment in competitive productivity has never been stronger.

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

The UK Economy

LATEST EVIDENCE Update 26/1/18

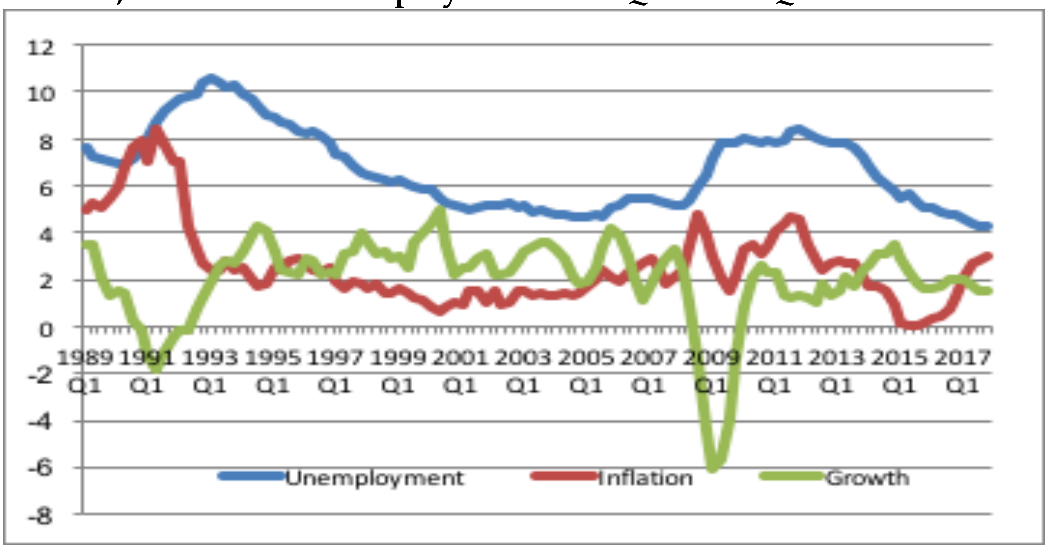
UK	Annual	Quarterly	Monthly
Real GDP (%ch, yoy)	+1.8 ('17)	+1.5 (Q4)	n.a.
CPI inflation (%ch, yoy)	2.7 ('17)	3.0 (Q4)	3.0 (Dec)
LFS unemployment (%)	4.9 ('16)	4.3 (Q3)	4.3 (Aug-Oct)
Trade deficit* (£bn)	-40.7 ('16)	-5.8 (Q3)	-2.8 (Nov)
Base rate (%)	0.29 ('17)	0.41 (Q4 17)	0.5 (Jan 18)

Source: ONS   *goods and services

The UK economy (see table above and chart below) ended 2017 with modest growth, high inflation and low unemployment. The trade deficit was probably shrinking a bit and interest rates were starting to edge higher, along the yield curve. There were signs of good activity in some manufacturing and export sectors but the overall mood in many industries was more sombre, with uncertainty about the future weighing on business decision making. At the same time, consumers were restrained by falling real incomes whilst net government and net trade's contributions were unhelpful, at best.

For 2018, the questions are whether unemployment has troughed, inflation has peaked and growth can be maintained. Most forecasters suggest a slight move away from the 'wrong kind of growth' towards more productivity-led activity but the extent of the improvement is expected to be modest. In particular, the consensus of current forecasts is for 1.4% growth and 2.4% inflation, both slower than in 2017.

Growth, Inflation & Unemployment: 1989 Q1 – 2017 Q4



Source: ONS: growth = real GDP % change year-on-year (yoy), Inflation = CPI % ch yoy, Unemployment = LFS % rate

OBR FORECASTS

There were three key messages from the OBR in November:

- *The cyclical economy is weaker* than previously thought: growth projections fell (not forecast to reach 2%p.a. over next 5 years).

- *The structural economy is weaker* than previously thought: growth potential dropped to c1.4% per annum (because productivity worse).

- *The fiscal economy is weaker* than previously thought: public finances in deficit until 2019/20. (Debt burden stays close to 80% of GDP.)

Essentially, the OBR is predicting more of the same over the forecast period. This can be summed up as "the wrong kind of growth" – growth not fuelled by enough investment, productivity and real earnings. The economy is operating near to potential and there is little spare capacity. In the near term, BREXIT uncertainty dampens domestic and foreign direct investment, whilst reducing net immigration, compared with what otherwise might have occurred.

There are two broad risks to this OBR central outlook:

- Fears about BREXIT disruption may be over-stated. New technological innovation, skills and investment may add value more quickly than anticipated. Also, a buoyant world economy could provide more of a local boost, as long as the pound remains competitive and UK trading patterns can be adjusted smoothly. Output and productivity growth may get back to 2% p.a. or more sooner than we think.

- The forecasts are now so low, however, that the chance of a shock to confidence causing a further slowdown, even recession, cannot be ruled out. Investment and consumption may stagnate because of constrained living standards/high debt burdens, new trade barriers/corporate realignment of capacity and operations, and higher interest rates.

The future is always uncertain but the current UK outlook is particularly so.

ECONOMIC STABILITY

Interest rates remain very low and are only expected to increase slowly over the next few years. Base rates probably need to get back to about 3.5% at some point (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 have not planned properly for higher rates, but a gradual process of change to more 'normal' interest levels will improve resource allocation in time – a necessary condition for getting the economy working well, sustainably.

The fiscal side of stabilisation policy remains constrained by historical and projected levels and ratios of debt. Political imperatives may allow some easing of the immediate fiscal stance but the room for manoeuvre is limited in a low productivity, low growth economy that is losing clarity about access to important international markets.

Structural reform of the public finances is warranted but may be difficult in the current febrile environment of BREXIT and minority government.

The Dorset Economy

LATEST DATA & SURVEYS

The evidence is that the local economy lost a little momentum in the second half of 2017, reflecting the uncertainty about how BREXIT will evolve. It is unclear as to whether this is a real effect or a convenient scapegoat and some local firms are still quite sanguine. Whatever the truth, the impact is the same – more modest growth in 2018.

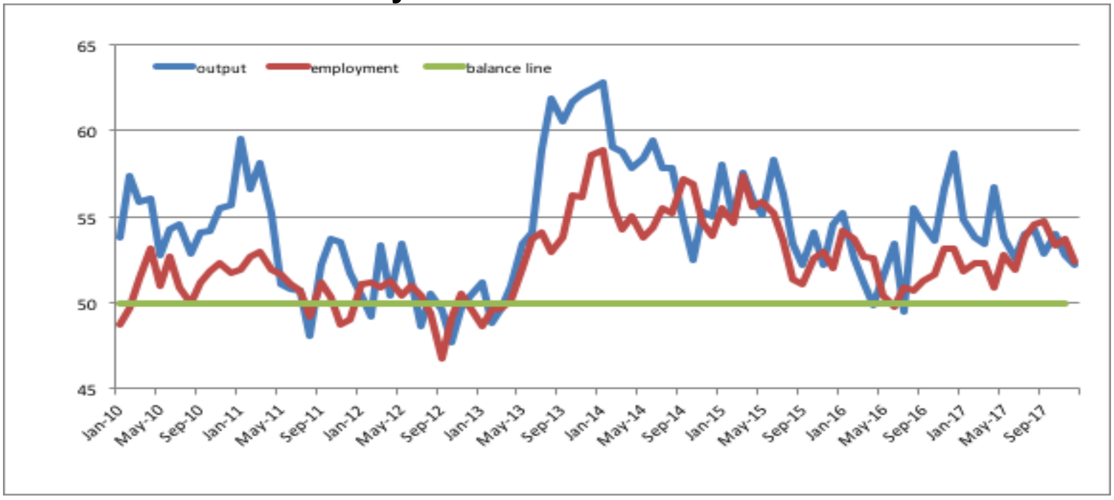
For example, the collapse of Carillion (15/1/18) suggests construction and public services may lose output in the near term whilst worrying statements from Airbus (FT 16/1/18) about the prospects for aerospace cast something of a cloud over local supply chains. Similarly, there have been a number of reports, notably from the **CBI** (FT 26/1/18), that contingency plans for "no deal" are being implemented by externally orientated businesses and this will involve a loss of UK jobs.

The latest **Federation of Small Businesses Survey** (FT 5/1/18) found a high number (1 in 7) of respondents planning to downsize, close or sell the business in 2018. The overall confidence index was negative for only the second time in five years – the other time was just after the BREXIT referendum day 2016. Falling profits were highlighted, as costs increased and demand, especially consumer demand, weakened.

Similarly, the most recent **Chamber of Commerce Survey** casts a subdued shadow over the business atmosphere. It shows waning confidence in manufacturing and services at a national level. In Dorset, the mood was steadier about current activity and prospects. Locally, in the latest quarter, sales and orders remained positive and employment and exports grew. In the year ahead, more Dorset respondents expect turnover and profitability to rise than to decline. The prospects were steady compared with the previous quarter – an outlook a bit more confident than seen in the country as a whole.

The various **Purchasing Managers'** surveys continue to send mixed signals but, as the chart indicates, there was a softening of activity through 2017 in the SW region, including Dorset. The December report showed business confidence about the near future resilient yet the output and employment measures, whilst still positive, were lower (see chart below). Compared with a year ago, last month's output reading was down 11% (from 58.7 to 52.2).

SW PMI balances: January 2012 - December 2017



Source: Markit for Lloyds

Meanwhile, in the year to September 2017, Dorset enjoyed virtually full employment, with most local places' ratios below national and many below SW regional averages (see next table – SW averages 78% and 3.5% respectively).

Local Labour Indicators (Oct 2016 - Sep 2017)

	Emp %	Unemp %		Emp %	Unemp %
Bournemouth	76.4	3.8	Dorset	78.5	2.7
Poole	75.3	3.2	Somerset	74.8	4.0
Christchurch	80.7	2.3	Devon	78.3	3.0
East Dorset	80.6	2.4	Wiltshire	81.0	3.1
North Dorset	83.7	2.5	Southampton	73.3	4.9
Purbeck	85.2	2.3	Portsmouth	74.0	4.3
West Dorset	79.4	2.7	Hampshire	81.1	3.0
Weymouth & Portland	62.8	4.0	Isle of Wight	71.8	4.3

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

The local labour market is tight and living costs high, making it hard to find and attract new and replacement skills as long as companies are unwilling or unable to pay higher wages. Skills acquisition and retention is a key area in need of improvement if Dorset is to move towards more sustainable, productivity-led growth.

There is also an issue about a shrinking of the 'middle' market, with new entrants (16-25 year olds) finding it hard to enter and progress along a desired career path (see Prince's Trust Survey released 24/1/18 – said to reveal "a staggering deterioration of young people's confidence in themselves and in their future").

STRUCTURAL FEATURES

Our Local Economy Briefing 23 (December 2017) analysed the **GVA breakdown for 2016 for Dorset**. Here, we summarise the main points.

Dorset's total GVA was £16.1bn in 2016 (current prices), placing it 32nd out of the 38 LEP areas - roughly as expected given its relative size. In terms of GVA per head, taking population into account, Dorset achieved £20,900. This broad measure of productive performance showed Dorset to be below regional and national averages, ranking 24th out of the 38 LEPs.

Dorset's index of GVA per head was 79.3 (UK average = 100, see table below) - down on the previous year. For the first time, Dorset was more than 20 percentage points (pps) below the national average, continuing a long-term downward trend.

This slippage in comparable standing is disappointing. Although it reflects a widening gap across the country (Greater London versus the rest), it also indicates a poor relative local productivity record: Dorset GVA per head dropped from just 8.7pps below the UK average in 2000 to 20.7pps below average in 2016.

This fall in the relative GVA per head index is similar to the experience of other south coast areas. Amongst the 12 "southern" LEPs listed in the next table, Dorset ranked 10th on GVA per head. Only four of twelve have seen a positive change over the last two decades.

GVA per head by LEP area, UK = 100 2016 & pps change since 1998

	index	change		index	change
Cornwall & IoS	64.8	-0.5	Solent	91.7	-8.9
Heart of the SW	75.2	-4.7	Oxfordshire	126.6	+6.9
Dorset	79.3	-9.4	Coast to Capital	95.6	-10.5
Gloucestershire	99.1	+3.0	Bucks Thames Valley	114.3	-12.7
Swindon & Wilts	96.9	-12.2	Enterprise M3	122.3	+2.1
West of England	111.5	+4.5	Thames Valley Berks	158.4	-6.1

Source ONS.

Recent growth in Dorset GVA has been in services, with most growth in business and financial services and least in manufacturing and resources. Production has gone from 23.5% of the economy in 1998 to 18.5% in 2016. This 5% loss has shifted largely to private services (not including real estate).

Within Dorset, about two-thirds of the GVA was generated in the east Dorset conurbation – Bournemouth, Poole, Christchurch and East Dorset (next table shows details).

GVA & GVA per head within Dorset: All industries

	£mn	£/head	GVA % share
Bournemouth	4,145	20,971	25.7
Poole	3,964	26,167	24.6
Christchurch	1,019	20,596	6.3
East Dorset	1,693	18,999	10.5
North Dorset	1,233	17,354	7.6
Purbeck	879	18,962	5.5
West Dorset	2,322	22,905	14.4
Weymouth & Portland	875	13,386	5.4

Source: ONS

The Government's recently announced Industrial Strategy (see below) aims to correct some of the imbalances and inadequacies displayed by the latest GVA statistics.

The annual GVA regional performance publication will always be one of the areas where future analysts will observe whether the Industrial Strategy is having the desired effect.

The Development Outlook

BREXIT & TRADE

More open trade deals between customs unions/countries are intended to increase economic welfare for all partners to the agreement by reducing barriers to exchange in the markets and sectors covered by the agreement, by increasing economic efficiency, productivity and wealth.

Economic analysis shows decisively, in theory and in practice, that movement towards open (freer and fairer) trade is a net 'good' for all concerned. It is one of the things on which virtually all economists agree: more open trade increases competition, raises productivity and boosts living standards for trading partners as resources are re-allocated to reflect absolute and comparative advantage. Although there may be internal distribution issues, all macro parties are better off.

Historically, most trade deal activity has been based on trade in products rather than services but, increasingly, more agreements are likely to be made about the latter. It is important, however, to remember that trade deals are political as well as economic animals. Sadly, the spirit of mercantilism - the view that trade is a zero-sum game with winners (surplus generators) and losses (deficit generators) - is far from dead. In a world of "America First" and "Deutsche vorherrshaft"), Ricardian views of trade - that efficient and mutual specialisation means it is not a zero-sum game) - need to be defended.

This is what is worrying about BREXIT. For example, one of the UK's comparative advantages is in financial services. Shifting capacity from London to Paris, because of reduced EU access freedoms/passports for the former, merely diminishes both countries' ability to create total wealth most effectively. It is a potentially negative reallocation of resources.

The problem is that BREXIT does the opposite to 'normal' trade negotiations. For any likely eventual UK-EU terms, it slead to a constraint on trade rather than a liberalisation. Even if, in the long run, 'freer' trade deals are agreed with other trading blocs, it will be many years for the near-term losses to be compensated for. **There are costs of losing 'single access' for both sides.**

Also, under BREXIT, **failure to set a trade deal with the EU does not mean, as it usually does, a return to the status quo**. It results in a less open move to WTO rules. Countries that have a 'better than WTO' trade deal with the EU – e.g. Norway, Switzerland, Canada, South Korea - and those further along in the trade negotiations - over 50 in total others) would have better access to EU markets than the United Kingdom after a 'hard' BREXIT.

Both the EU and the UK lose trade opportunities from a failure to agree favourable terms. Currently, the EU takes c40% of UK exports. The UK takes c10% of EU exports. At the margin, it is not easy for either to substitute these patterns with new markets quickly**.**

Finally, there are the psychological effects on supply chains – club members tend to deal more with themselves than outsiders – even at an economic cost. There are already reports that UK companies are finding it hard to get onto the list of potential suppliers in the EU after March 2019 and attracting EU ‘talent’ is getting harder.

There are always winners and losers when trading structures change but BREXIT, by meaning less open trade, means **the average UK citizen will be poorer than would otherwise have been the case – unless there is speedy substitution elsewhere.** Future politics will be judged on whether this price is material or not and on whether it turns out to be a price worth paying. It is to be hoped we do not have a populist, more closed economy by the early 2020s.

INDUSTRIAL STRATEGY

In our LEB 22 report on the Development Environment, we considered the Budget and the **Industrial Strategy** released in November. The key point about the latter is that it presents a worthy intention to tackle the UK’s long-established and widening productivity ‘gap’ (with its closest competitors) by rebuilding the underlying capacity and export competitiveness of UK sectors, places and workers. The issue is whether it yet amounts to more than throwing everything into the kitchen sink and seeing if anything floats!

The Industrial Strategy is a long-term plan to boost productivity and earnings, based on five foundations - re-packaging the inherent drivers of productivity as follows:

- **Ideas** (innovation): raise R&D as a percentage of GDP, turn more inventions into markets, and preserve and extend collaboration between economic actors.

- **People** (skills): advance technical education, STEM and retraining – raising quality, filling gaps, and spreading spatial capacity and opportunity.

- **Infrastructure** (investment): expand transport, housing and digital infrastructure and use public procurement to build resource efficiency.

- **Business Environment** (entrepreneurship and competitiveness): generate government-industry sector deals, make UK the place to start and grow businesses, and develop a fiscal system that supports scale-ups and exports.

- **Places** (local capacity and competitiveness): produce local industrial and transforming cities strategies that narrow regional productivity differentials and other disparities through local leadership and co-operation between places.

The Strategy announces sector deals for the life sciences, construction, artificial intelligence, and automotive industries and proposes ones for creative industries, industrial digitalisation, and nuclear. It also intends to form a team that will support future (emerging and disruptive) sectors.

The Strategy presents four Grand Challenges for the industries of the future – aspiring to a fourth industrial revolution of technological fusion. The four are: artificial Intelligence & big data, future mobility, clean growth, and ageing society. If engaged, Dorset can feature positively in each of these areas.

The Strategy also promises a review of LEP roles. The Industrial Strategy requires Dorset to produce its own Local Industrial Strategy under the LEP's guidance, although when, what and how this will be done is not yet clear.

The Strategy talks about the composition of the UK economy, with its world class heights but much mediocrity, as being a major cause of relatively low productivity. Any new policies to address this need to emphasise how sustained growth is generated: **globally competitive productivity growth on the supply side and greater trading engagement on the demand side**.

The Industrial Strategy discusses many of the 'right' issues and proposes to act on many of the 'right' levers. The timescales, resourcing and processes are unresolved, but it is a reasonable framework for future development, based, as it is, on improving national and local productivity performance.

As with all UK government' approaches to sub-national development, however, the uncertainties are about **long term political commitment and consistency**, especially in an era of changing international economic relationships, and about **private sector and local buy-in across industries and place**.

For Dorset, the important thing is to improve existing economic linkages – markets, supply chains and wider connectivity – and to develop new ones. We need more connective agglomeration, higher aspirations and a positive attitude towards personal, business and community development.

The danger, with most of the effort currently focused on the Northern Powerhouse, the Midlands Engine, and the Oxbridge Arc, is that, in development terms, Dorset experiences heightened peripherality.