Regional Economic Development: Local Economy Briefing 22

The Development Environment
OBR Forecasts, the Budget & the Industrial Strategy

Introduction

The Autumn 2017 Budget period was interesting for five broad reasons.

- It was the first full Budget produced in the Autumn rather than the Spring, allowing the government to consider changes for fiscal 2018/19 and wider prospects for 2018 and beyond.
- It was hampered by a lot of uncertainty - domestic and foreign politics and policy, including BREXIT.
- It was set against a very modestly growing economy: expectations remain fragile with inflation outpacing growth.
- It was accompanied by a significant revision to the OBR forecasts and a comprehensive re-consideration of current productivity 'gaps'.
- It was followed by the Industrial Strategy White Paper: the framework for sub-national development in the years ahead.

This note covers the main points of these releases for the Dorset economy: its businesses, workers and others engaged in local development.

OBR Forecasts

There were three important messages from the OBR (see table):

- *The cyclical economy is weaker* than previously thought – real GDP growth projections have been lowered and are not forecast to reach even a modest 2% per annum over the next five years.
- *The structural economy is weaker* than previously thought – growth potential has been lowered to about 1.4% per annum because the UK's historical and predicted performance on productivity has deteriorated.
- *The fiscal economy is weaker* than previously thought – as a result of the economic malaise (above), and the new Budget measures, the public finances will remain in deficit until 2019/20. The debt burden may peak soon but will stay worryingly high for the foreseeable future (close to 80% of GDP).

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The table below shows UK economic growth to be set on on a new lower trend into the 2020s, with business investment remaining extremely modest. Other patterns in the forecasts (not shown) include weak household consumption and no net trade contribution. Inflation is assumed to come back to target and real earnings to start to increase, (though still restrained), from 2019 onwards. Unemployment is likely to rise but not by much.

Essentially, the OBR is predicting more of the same over the forecast period for the UK macro economy. This can be summed up as “the wrong kind of growth” – growth not fuelled enough by investment, productivity and earnings.

OBR Economic Forecasts November 2017

Macro (% ch)	*2016*	*2017*	*2018*	*2019*	*2020*	*2021*	*2022*
Real GDP	1.8	1.5	1.4	1.3	1.3	1.5	1.6
Business Investment	-0.4	2.5	2.3	2.3	2.4	2.4	2.4
CPI Inflation	0.7	2.7	2.4	1.9	2.0	2.0	2.0
Unemploy (%)	4.9	4.4	4.3	4.4	4.6	4.6	4.6
Public Sector (% GDP)	*16-17*	*17-18*	*18-19*	*19-20*	*20-21*	*21-22*	*22-23*
Net borrowing	2.3	2.4	1.9	1.6	1.5	1.3	1.1
Net debt	85.8	86.5	86.4	86.2	83.1	79.3	79.1

The key pages in the OBR’s Economic and Fiscal Outlook are in the section on “the output gap and potential output”. The conclusion here is that the economy is operating near to potential and the output gap is small – there is little spare capacity available for growth. The prediction is that, in the near term, BREXIT uncertainty will dampen domestic investment and foreign direct investment and trade, whilst reducing net immigration, compared with what otherwise might have occurred.

Together with downward revisions to previous productivity growth rates, this all implies a lower path for potential output growth – hence real growth is expected to persist at half the rates that were achieved in the decade before the ‘Great Recession’. For the period 2017-22, potential output is said to average 1.4% per annum, consisting of about 1% per annum of productivity growth (output per hour) and the rest due to net employment growth (driven by population and participation factors). This is an unfavourable prospect.

Considering how inaccurate central forecasts have tended to be, there are two main risks to the OBR's central outlook:

- On the upside, fears about BREXIT may be over-blown or short-lived and new technological innovation, skills and investment may start to add value quicker than currently assumed. Also, a more buoyant world economy may provide a positive boost, if the pound remains competitive and UK trading patterns can adjust smoothly to post-BREXIT relativities. On this basis, it may be feasible to see output and productivity growth back at, or even over, 2% per annum at some point in the 2020s.

- On the downside, the OBR economic forecasts are now so low and narrowly painted that there must be a chance of a shock to confidence or something worse causing bigger problems. Given the margins for error, a further slowdown, even recession, cannot be ruled out during the forecast period, especially if investment and consumption stagnate under the weight of i) constrained living standards and high debt burdens, ii) new trade barriers and corporate realignment of capacity and operations, and iii) higher interest rates.

Indeed, there is a chance that the macro economy follows a much more cyclical path, with a sharper downturn in the near future, weeding out some 'zombie' companies and jobs, followed by a better recovery thereafter once the BREXIT dust begins to settle. On this basis, it is possible to be both a short-term pessimist and a long-term optimist about Dorset's business prospects.

The Budget

Despite the gloomy OBR prognosis, the Chancellor of the Exchequer tried to emphasise some positive aspects, supporting BREXIT preparations, higher housebuilding, new technologies and skills, the National Productivity Investment Fund (NPIF), and some welfare and tax changes. The result was a net fiscal stimulus over the medium term, with most of the extrat spending happening in 2018/19 and 2019/20.

A verdict on the Budget details is beyond the scope or interest of this paper. There are plenty of examples of that kind of analysis elsewhere, especially from the accountants. Here, we are more concerned with the economic strategy behind the fiscal thinking.

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<u>The Industrial Strategy</u>

After the Budget, the UK government released its long-anticipated white paper on a modern "Industrial Strategy: Building a Britain fit for the Future". As with the Green Paper launched for consultation early this year, this long document is very worthy in intention and direction, proposing to tackle the UK's long-established and widening productivity 'gap' with its closest competitors.

The document and the spending policies it promotes are trying to raise living standards over the long-term by rebuilding the underlying capacity and export competitiveness of UK sectors, places and workers.

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

- Ideas (innovation):
  targets to i) raise R&D to 2.4% (from 1.7%) of GDP by 2027(still below current USA and Germany rates – 2.9%), ii) turn more inventions into markets and iii) preserve and extend collaboration between economic actors.

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

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

- Business Environment (entrepreneurship and competitiveness):
  targets to i) generate government-industry sector deals (see below),
  ii) make UK the place to start and grow businesses (through such as better access to finance and dissemination of best practice), and
  iii) develop a fiscal system that supports scale-ups and exports.

- Places (local capacity and competitiveness):
  target to produce local industrial and transforming cities strategies that narrow regional productivity and other disparities through local leadership and co-operation between places – (such as Northern powerhouse, Midlands Engine, and the Cambridge-Bedford-Milton Keynes-Oxford development arc).

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 for supporting future (emerging and disruptive) sectors.

The Strategy presents four Grand Challenges for the industries of the future – a fourth industrial revolution of technological fusion:

- Artificial Intelligence & Big Data:
  general purpose approaches, using world class research, to transform product processing and services delivery in six priority business sectors – cybersecurity, life sciences, construction, manufacturing, energy, and agricultural technology.

- Future Mobility:
  innovative technology (new vehicles and modes) and business models (sharing and connection) for a revolution in movement.

- Clean Growth:
  the environment–centred economy is expected to grow faster than 'regular' GDP as resource efficiency advances through 'smart' power generation, transport, construction and agriculture.

- Ageing Society:
  new products and services, working and living practices, and business models to meet changing demand patterns.

The government states that the SW economy will benefit from additional spending on R&D (including universities), transport, connectivity, technology and skills improvements, although most of the emphasis was on developments in the West of England (Greater Bristol) and the Gloucester-Exeter-Plymouth corridor.

Moreover, there was a lot more emphasis on other English regions and the devolved administrations. Yet again, we have a government document that, generally, is oblivious to where Dorset sits in the regional economic structure and what it can offer to the productivity cause[1].

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[1] It will be interesting to see how the proposed review of LEP roles and responsibilities affects the local area, especially in light of the promise to work with ONS and others to provide a better local economic evidence base and to appoint an independent Industrial Strategy Council for assessment and evaluation.

The Strategy talks about the composition of the economy, with its world class heights but its long tail of mediocrity, as being a major cause of relatively low productivity. To an extent, this reflects the response to the Great Recession (2008-9) which, by preserving most of the financial structure, by encouraging labour flexibility at the lower end, and by allowing weak businesses and jobs to survive, favoured employment-led growth over productivity-led growth in the subsequent decade. This encouraged weak growth driven more by domestic consumer debt than overseas exports.

What was a valid policy response to a particular crisis in 2009/10 is long overdue for switching towards an emphasis on how sustained growth is generated: globally competitive productivity growth on the supply side and greater trading engagement on the demand side.

Conclusions

The Industrial Strategy addresses many of the ‘right’ issues and proposes to act on many of the ‘right’ levers. The timescales, resourcing and processes are less clear but it is a good framework for future development, based, as it is, on improving national and local productivity performance. It brings together most of the strands that have underpinned successful development policies around the world over recent decades and approaches a sensible range of likely technological and demographic futures.

Moreover, it sits well with BU’s own, soon to emerge, BU2025 plans for further development of the “fusion” approach to the University’s learning, research and professionalism.

As with all UK governments, the questions that are outstanding are about:
i) long term political commitment and consistency, especially in an era of changing international economic relationships, and
ii) securing private sector and local buy-in across industries and place.

For Dorset, the important thing is to consider existing economic linkages – markets, supply chains and wider connectivity – and to develop new ones.

The danger is that we remain peripheral to both the South East and the South West of England. Is Dorset sufficiently engaged and integrated – through its public authorities, academic institutions and private companies - with the ‘right’ neighbouring or global partners/clusters?

It is likely that access to, and involvement with, wider agglomerative bodies and forums will need to be promoted and exploited. For example, Dorset is part, but on the edge, of Innovation South – the SE Science and Innovation audit programme. Dorset is also part, but on the edge, of the SW Rural Productivity Commission. What other relationships (including international ones) exist, or could exist, that offer value and need to be resourced?

Dorset has its own internal interests too: learning how to “co-operate to compete” across communities and sectors under the umbrella of the Dorset LEP and other stakeholders. The latter include the possibility of new local authority structures, evolving business groups and expanding Universities.

To that end, without (yet?) specifying exactly when and how, the new Industrial Strategy requires Dorset to produce its own Local Industrial Strategy under the LEP’s leadership. It is probably important for all those interested in local development to engage with this process soon, efficiently and effectively.