Regional Economic Development
Business Intelligence Report 6: Summer 2016[1]

The Economy in Summary

On 23rd June, the UK electorate voted to 'leave' the EU (BREXIT). The immediate economic consequence was a collapse in Sterling, making exports cheaper and imports dearer. Over time, this might help growth and add to inflation. However, the referendum increased uncertainty about the economic outlook and, thereby, may reduce net new investment, output and jobs in the months ahead and beyond.

More firms and investors now seem less confident about the outlook for UK growth. The forecast consensus has shifted towards weaker but still positive growth, whilst acknowledging that there is an **increased risk of mild recession** with negative real GDP growth, higher inflation and lower employment. Some business surveys weakened in the second quarter when caution about the referendum reached its height. With retail sales volumes softening in June and July and other evidence indicating a slowdown in household expenditure after the vote, summer sentiment appears modest.

Further out, upheaval within the leading UK political parties, the lack of terms/a plan to smooth the UK approach to BREXIT, and concerns over the forthcoming presidential election in the United States all encourage a **'wait and see' attitude** amongst key local businesses.

Forward indicators are weakening and the economy is constrained **by fundamental weaknesses: low productivity growth and weak competitiveness** (as shown by persistently large trade deficits). For the foreseeable future, uncertainty over what BREXIT means will not make these factors any better.

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[1] This is the sixth 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

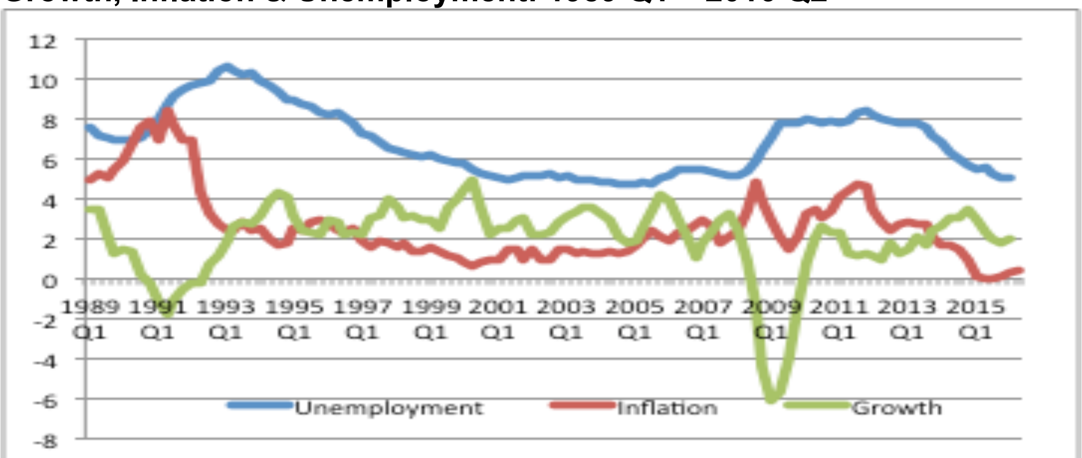
	Annual	Quarterly	Monthly
Real GDP (%ch, yoy)	+2.2 (2015)	+2.2 (Q2)	n.a.
CPI inflation (%ch, yoy)	0.0 (2015)	+0.4 (Q2)	+0.5 (Jun)
LFS unemployment (%)	5.4 (2015)	5.1 (Q1)	4.9 (Mar-May)
Trade deficit* (£bn)	-36.6 (2015)	-12.4 (Q1)	-2.3 (May)
Base rate (%)	0.5 (2015)	0.5 (Q2)	0.5 (Jul)

Source: ONS * goods and services

Growth in the UK economy was fairly flat through the first half of 2016. Despite global/national political and economic uncertainty, as the table above, and the chart below, indicate, real growth was maintained close to trend (just over 2% year-on-year), inflation remained well below the 2% per annum policy target (though it edged a little higher) and the drop in unemployment may have started to flatten out (at about 5%). The net trade deficit was still enormous and the loose money and austere fiscal policy stance was largely unchanged. Productivity growth remains too low for sustained and sustainable UK growth.

If real GDP growth now slips below 2% per annum, employment growth will ease or reverse and little or no improvement in productivity can be envisaged. Meanwhile, the recent (roughly 9%) drop in Sterling will boost future inflation. The economic outlook, especially in the face of having to unwind or replace trade, regulation and other business-facing agreements within the EU and other partners, has deteriorated. Over the next 18 months, we might experience **a dose of relative 'stagflation'.**

Growth, Inflation & Unemployment: 1989 Q1 – 2016 Q2



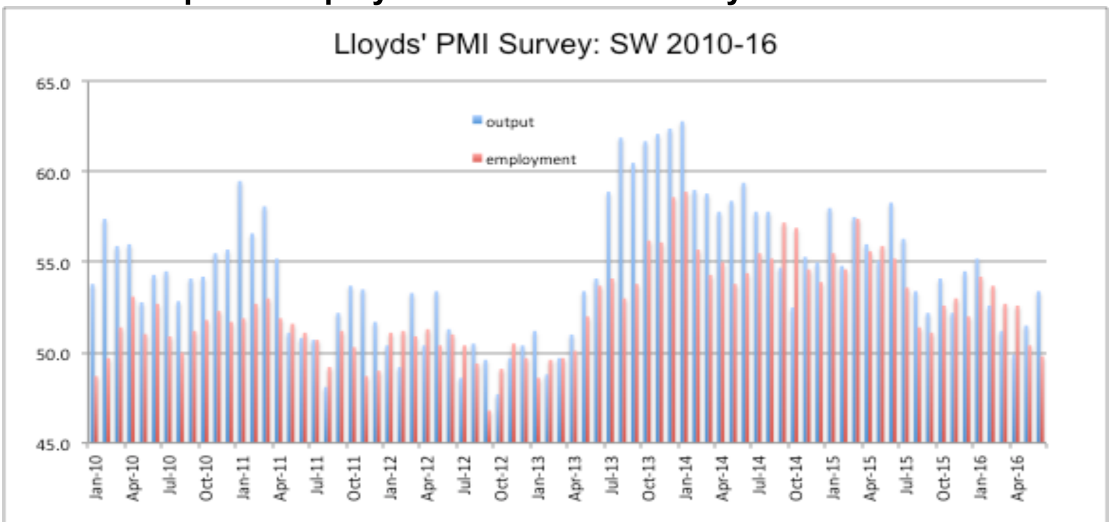
Source: ONS: growth = real GDP % change year-on-year (yoy), Inflation = CPI % ch yoy, Unemployment = LFS % rate

The Dorset Economy & Local Development

The latest purchasing managers' index (PMI) for SW England shows SW output fairly good but employment slipping back in June. These figures were recorded "pre-BREXIT". Worryingly, the "post-BREXIT" UK average for PMI in July showed a sharp drop into negative territory. Moreover, as the chart below indicates, **the SW regional economy tended to soften through the first half of 2016.**

For the PMI series, apart from momentum over time, the crucial benchmark is whether the indices are above or below 50. The former indicates growth and the latter stagnation. It will be interesting to see, in response to BREXIT, whether the next reading for SW PMI output, (to be issued mid-August), will edge below the 50-benchmark, as the UK average did in July and the SW employment index already had done in June. Thereafter, the question is w**hether "BREXIT effects" persist through the second half of 2016.**

SW PMI Output & Employment balances January 2010-June 2016



Other surveys have shown similar recent trends. For example, the **British Chamber of Commerce** Survey for the latest quarter pointed to "sub-par UK economic growth even prior to the EU-referendum". With regard to the future outlook, recent anecdotal signals from Dorset firms have been mixed. The mood has been generally more cautious than it was, with many sectors from manufacturing, through retailing and car sales, to property and other services declaring **a sudden loss of business momentum after the referendum.** What little evidence we have suggests there was an immediate drop in household spending, affecting retailing, tourism and leisure locally; a decline in property movements – affecting commercial and housing sales; and a continuation of the caution with respect to business investment that was evident in the second quarter.

In response to these developments, and the aggravated risks and eventual opportunities that lie ahead, **the development question for Dorset is how businesses and the various public agents mitigate any negative impacts**. The significant drop in sterling will help some (exporters) but not all (importers and exporters dependent on imports of components and materials). In time, the likely increase in a range of input, factory and final prices will affect some supply chains and household budgets. Moreover, there is a fear that the continuing banking malaise (with share values down sharply from already low levels) may dampen the flow of credit – a key ingredient for maintaining growth.

The Bank of England stands ready to support the financial system (e.g. by relaxing banking capital requirements, lowering base rates, and issuing more quantitative easing). It believes the banking and insurance sectors are much more resilient to shocks than they were in 2008. Also, the new "May-Hammond" Treasury has indicated that it may be more willing to borrow and spend than its predecessor. Its 'new' industrial/EU-funding policies, however, are far from clear, (especially as the Business Department is to be reformed).

It has to be hoped that development strategy, policy and delivery supports the economic transition Dorset firms will have to make in the next few years.

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The Overall Economic Outlook

According to **the latest consensus** compiled by HM Treasury from a full and wide range of forecasters of the UK economy (see table below), growth will be very sluggish in the next 18 months. The average forecast is for growth rates well below trend in 2016 and 2017 whilst CPI inflation is now expected to exceed the target (2% per annum) during 2017 and unemployment to rise back above 5.5%.

According to these 'experts', the outlook has changed dramatically. Indeed, average forecasts for growth in 2017 slumped from 2.1% (June survey) to only 0.8% (July survey) after the BREXIT vote. Moreover, the current account and public debt positions are worse for 2016 and only expected to improve marginally in 2017. The Bank of England perspective (in its forthcoming August Inflation Report) is expected to show a similar warning about a deterioration in economic prospects.

BREXIT has induced a change in mood, with the consensus about economic prospects shifting markedly downwards in recent weeks. Indeed, the drop in forecasters' expectations has gained real expression with the downgrading of UK debt by the major credit rating agencies, the drop in the value of UK banking and other stocks, and the Bank of England's FPC recent highlighting of risks to the financial system.

UK Consensus Forecasts: July 2016

	2016	*2017*
Growth	+1.6	+0.8
Inflation	+1.3	+2.4
Unemployment	5.3	5.6
	2016/17	*2017/18*
Current Account (£bn)	-103.1	-82.1
PSNB (£bn)	67.4	58.3

Source: HM Treasury

Some of the new negative sentiment may fade after the initial shock but the danger is that the process of extracting the UK from the EU will generate a series of economic and political 'aftershocks' to the markets and the real economy and this could deplete confidence at a fundamental level.

The economics of BREXIT are straightforward. **The creation of economic barriers, borders or boundaries, whether real or psychological, always leads to an increase in costs.** That increase in costs, exacerbated by broader uncertainty, stalls investment, reduces output and cuts employment compared with what otherwise might have occurred. Thereby, the outlook for productivity and trade deteriorates.

The resulting fall in business profits and household incomes means less revenue for the government, which requires further fiscal austerity unless the government is willing to borrow more and grow the public deficit. In turn, these factors reduce realised and potential economic activity and confidence. At the same time, as higher costs are pushed through the supply chain, more inflation is generated, which, if accompanied by higher state borrowing, means, at some point, higher interest rates – a further dampener on future domestic demand**.**

It is important to note that in all these economic linkages and trends, we refer to outcomes in net, macro terms. There will be companies and workers in particular sectors that will benefit from the countervailing forces that always occur within any process of economic adjustment. There will be individual 'winners' and 'losers'. The key observation, however, is that **the net effect,** for the economy as a whole and for the foreseeable future, **is one of worsening growth prospects**.

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BREXIT will affect many Dorset businesses and households. Some of these effects will be immediate and obvious; some will be postponed and insidious and some will not have noticeable impacts for several years. But, **on average, in due course, less investment means less growth and lower**

living standards. In this respect, we should not be distracted by one-off (good or bad) data releases or items of business news over the weeks and months ahead. The important thing is the change to performance potential, and realisation, over the long run.

In the long run (after 2020), the economy may start to recover (assuming no major global 'shocks') from BREXIT. In the very long term (perhaps, eight years plus), it may be back, or even beyond, where it might have been without BREXIT. The economy is a dynamic creature made up of millions of individual and group actors with diverse characteristics and behaviours. Uncertainty creates opportunity as well as fear. Human beings are inventive, innovative and entrepreneurial, especially as new generations emerge without the baggage of recent history. **It is quite reasonable, therefore, to remain a long-term optimist about the economy.**

For the near future, however, the prognosis is for a period/process of negative adjustment.

- In the short run, this is likely to harm sectors dependent on current household and business spending first, though these effects may be temporary if incomes and employment hold up over the rest of 2016.

- In the medium term, it will be the new trading adjustments that matter: 1) sterling depreciation helping exporters unless they are vulnerable to supply chain shifts caused by political uncertainty and higher import prices and 2) trade agreements and new tariff regimes for UK businesses active across the world. Both positive and negative effects are likely to ensue here, the balance of which, is not really foreseeable.

- In the long run, changes to corporate investment strategies will drive impact. It is unlikely that global companies will see UK locations and facilities as favoured areas for investment to gain access to the wider European market. Importantly, it is changes at the margin that matter, specifically the potential for erosion of commitment to existing UK operations over time. Behavioural changes will gradually impact replacement and new investment demand. In a decade, the fear is that the next family of aerospace, motors and other engineering and electronics products and services go, at least partially, elsewhere. Such outputs may be supplied to EU markets more from continental plants than they have been in the last twenty years as trading costs and regulatory frameworks adjust to a new political reality

Analysis of current economic prospects makes regional development activity to boost the drivers of productivity even more vital. The development policy and delivery question is whether the negatives can be mitigated in terms of repairing or building local competitiveness over time. Even as the BREXIT storm rolls over us, we can prepare for better days.