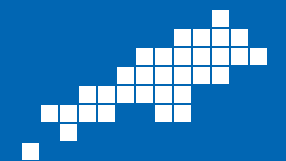


# Economics Review Issue 23

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South West RDA

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## Headlines

- The UK economy is experiencing mild stagflation. If it persists, and most forecasters suggest it will for at least another 18 months, it will hurt growth potential and price signalling.
- Given the high level of economic uncertainty in the world, a fiscal policy that hurts growth and a monetary policy that allows inflation should be avoided.
- The adverse risks to global growth appear high: EU sovereign debt defaults, East-West imbalances in trade and finance, political change in the Arab countries, and natural resource supply constraints. There are positive risks too, mainly from the prospects for higher demand beyond Europe.
- Parts of the SW economy may seem isolated from these external trends and events. This is an illusion. The current economic transformation is profound and may well expose the region's long term relative weaknesses. These include low productivity and engagement in international trade; under-investment in people and place; over-dependence on discretionary and public spending; and poor access to competitive markets.
- The SW economy performed sluggishly in the first half of 2011. With domestic real incomes dropping and unemployment rising, this pattern looks set to continue.
- But, difficult times can create the impetus to address old deficiencies, using the South West's labour market flexibility, broad sector and business spread, and diversity of place to "do things better and do better things".
- Against this background, reform of the regional policy landscape must bring a renewed drive to collaborate in order to compete. To paraphrase, "Invest, innovate and learn for tomorrow we... thrive."

## Economic Policy

### Economic problems are better addressed early... rushed responses can make things worse.

For optimum results, economic policy often needs a balance between these alternative extremes of when and how it is best to act. Here are some recent examples:

- The world's trade and financial imbalances could have been addressed earlier by the world's leading monetary authorities in the mid-2000s, reducing the ultimate cost and avoiding most of the current economic malaise.
- Swift action by key treasuries and central banks to pump in liquidity after the Lehman Brothers' collapse in 2009 probably saved us from an economic depression.
- The hasty decision to slash US interest rates immediately after the dot.com bust in 2001 kick-started the excessive credit expansion that we are still recovering from.

The current UK situation of tightening fiscal policy with a loose monetary stance puts the risks of being too late or too soon in stark relief.

- Is the Bank of England letting the inflation problem fester by keeping monetary policy too loose for too long?
- Is the Treasury too aggressive in addressing the deficit problem when the private economy is not yet ready to pick up the slack?

History will answer these questions in due course. In the short term, the issue is how this frames the current macro economic risks of stagflation that we all face.

As I have explained before, my own analytical preference would be to fix the monetary problem before the fiscal one, largely because demand is more of a present economic weakness than supply.

- Major fiscal readjustment is a prerequisite for higher long term growth but will damage short term growth if rushed or adopted too early.

- Monetary correction is a prerequisite for a quicker return of short term normality, getting us out of the liquidity trap and providing the oil of savings, credit and demand.
- Anyway, we are in the middle of an interesting experiment in which it is not clear whether fortune will favour the brave or the cautious.
- Are we letting the muscles of monetary discipline get flabby whilst persisting with a strict fiscal diet and crowding out household demand?
- Will we praise those who got rid of the debt-belly, kept up our liquid intake and crowded in business investment for the competitive race ahead?

Others will write the verdict on the current approach to stabilisation and development. My final thought, however, is that the consistent evolution of national stabilisation and sub-national development policies has stood some of our main competitors in comparatively good stead for decades. The benefits of revolution - throwing everything up in the air every decade or so to see where they fall just when we are starting to learn important lessons - are less evident.

## World Economy

### The world economy looks strong one day... but shaky the next.

The global economy is like a person recovering from severe illness, with signs of recovery often followed by signs of relapse, and vice versa. These symptoms have been observed in the securities markets (see Charts WD1 and especially WD2) where day-to-day volatility of long term interest rates and share prices has been high. The markets have absorbed:

- major events, such as natural disasters and their consequences around the Pacific Rim, political changes in North Africa and the Middle East, fiscal or debt uncertainties for sovereigns in the EU
- minor developments in particular businesses, sectors or places causing big commodity price and currency movements (see Chart WD3 for recent dollar weakness) on the slightest whiff of a potential supply constraint or demand shift.

The high degree of uncertainty in the current situation breeds a lack of consumer confidence to spend and a business tendency to wait and see on investment. For now, this probably means more sluggish growth (consumption and investment – public and private) and more unemployment for the UK economy, and the South West within it, than might otherwise have been possible.

Short term sluggishness may be most pronounced in figures coming out about the world economy for the March to June period. For example, because Japan's disasters badly affected its production sector and many industries across the world depend on Japanese components, this will have caused factory shortages and slowdowns across the globe through April and May. Japan's manufacturing output dropped a whopping 15 per cent in March.

Against this background, businesses might do well to **prepare for the downside whilst planning for the upside.**

### Structural issues

The global imbalances of trade and debt, created by the long expansion that led to the 'credit crunch', remain to be addressed. Some of the symptoms can be seen in:

- the increased likelihood of a sovereign default (or two) in the euro-zone
- the currency 'wars' resulting from prolonged, official monetary largesse and reflected in distortions of the commodity markets

- the fears about mercantilist approaches to securing resource supplies amongst the leading emerging economies

The international community, led by a new boss at the IMF, needs to be bolder in avoiding these potential disasters, focusing on the best long run outcomes and discounting demands for short term palliatives.

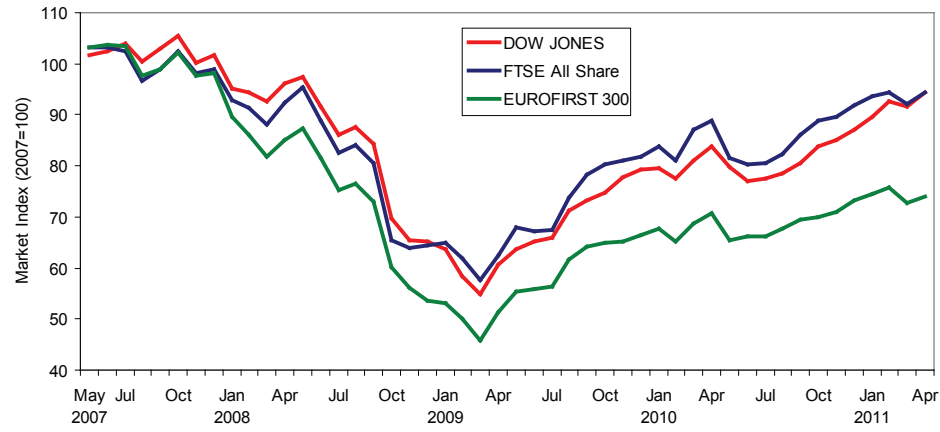
### Euro-zone

Let us consider the problems of the euro-zone, since this is most directly pertinent to the fortunes of several parts of SW England and acts as a good proxy for wider global travails.

Currency unions, such as the euro-zone, work best when and where:

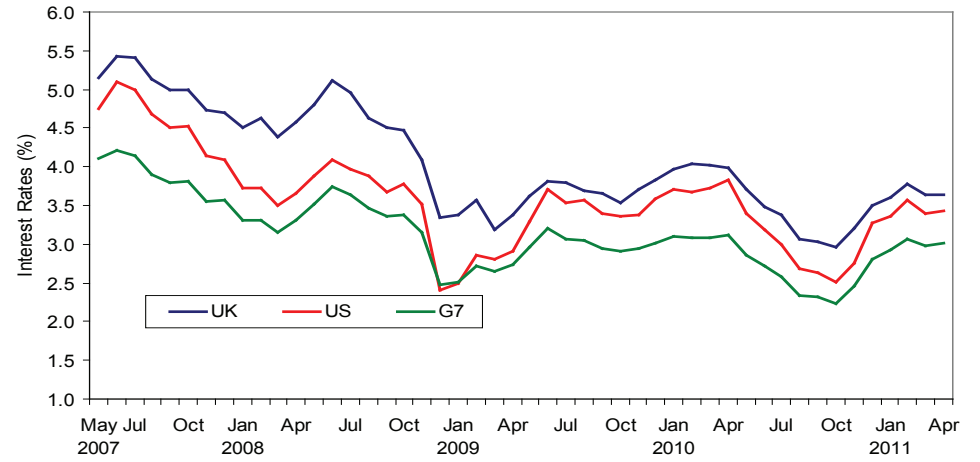
- they operate between fairly homogeneous economic areas
- members agree to remove any significant market and other economic differences over time through structural, fiscal and regulatory reform
- the 'stronger' members offer an explicit guarantee of support to the 'weaker' members in times when the union is stressed.

Chart WD1: World Stock Markets (indices)



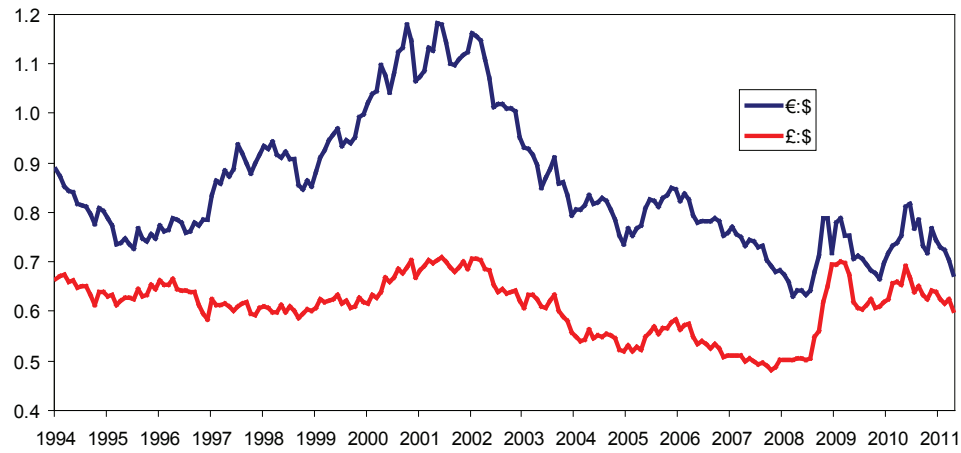
Source: HM Treasury

Chart WD2: World Bond Yields



Source: HM Treasury

Chart WD3: World Exchange Rates



Source: Bank of England

In other words, the game has clear rules which all agree to follow.

Thus, the United States works as a currency union because there is a political consensus that the richer states, to a degree, will support the weaker states and there are federal authorities to devise and operate overall structures, policies and flows. Common language and free movement of labour and capital is crucial, as is the existence of a fairly homogeneous legal and regulatory system for property ownership and exchange. A dynamic business culture helps too.

The EU lacks some of these prerequisites, notably interrelated fiscal and legal structures, free flows of funds and people, and the popular will to support 'losers'. The euro-zone experiment was based on the hope that closer integration would bring a growing overall economy and that this would allow room and time for the less productive to move towards the 'best practice' of the 'core' members. Over time, greater harmony of a range of policies, laws, attitudes and commitments would emerge.

Seemingly, this vision has run aground, on the shifting sands of debt washed up by historically low interest rates and high liquidity during the 1990s and 2000s.

The debt excesses established before the credit crunch can only persist as long as there are willing lenders. Lenders will be willing to roll over debts only as long as they believe future returns will more than compensate for the current returns foregone. The basic problem for Portugal, Ireland and Greece (PIGs) - acknowledging that there are important differences between each of these cases - is that, for a range of reasons, from global economic prospects to domestic market conditions, **'investors' no longer believe tomorrow's returns will be better than selling out today**. This is why bond yield spreads over German bunds have widened (at the time of writing) to more than 1400 basis points for Greece, over 800 for Ireland and 700 for Portugal. These differences are astonishing and imply a high risk of collapse. In effect, they mean a euro in a Greek bank is no longer worth the same as a euro in a Dutch bank.

As with bank runs, mortgage arrears or other debt repayment problems, there are four possible solutions (or combinations of them):

- sell off assets to raise the funds to get debt down to manageable levels – hence Greece's massive privatisation proposals
- find a new lender (usually a tax payer financed body such as the IMF) to refinance outstanding loans and provide time for new stabilisation policies to generate growth and debt recovery
- agree a "haircut" or debt restructuring that requires private investors to share the pain directly through partial write offs or indirectly through lengthening maturities

- announce a unilateral debt default, causing intense pain to creditors and debtors alike with a likelihood of collateral damage and contagion to others.

The first is planned but 'fire sales' tend not to yield the best value – the Financial Times thinks only €16 billion of the €50 billion Greek target will materialise. The second has occurred already, but it seems to have been not enough and the appetite for further bail-outs seems low. The third, effectively a predetermined, mutually agreed, debtor default with lenders allowing the debtor to 'start again', now seems more likely. The fourth is not unthinkable but, right now, hopefully unlikely.

**Default, even if partial, is often resisted for as long as possible because it is painful for both sides:**

- The debtors' credit reference is destroyed, its ability to finance future growth is lost, at least for a while, and, when it does start to borrow again, it will have to pay higher interest rates. There are real negative impacts on the lives of most citizens through higher unemployment, reduced public services and falling real incomes.
- The creditors face real capital losses that will reduce overall economic activity. It will lower their spending and lending propensities generally, even to other 'good prospects'.

Consequently, after a unilateral default, the aggregate level of economic activity tends to diminish and the adjustment process can be protracted. Sometimes, however, a quick, sharp, agreed and partial default is less messy than a prolonged “will they won’t they”.

What happens to euro-zone cohesion if one or more of the PIGs have to restructure their obligations? **Usually, a sovereign refinancing or default involves a major currency adjustment.** An immediate devaluation makes exports cheaper and imports more expensive for the country in trouble, starting to address the underlying payments problem and providing a push for the debtor to rebalance its economy more generally. Devaluation also tends to be inflationary, further eroding the real value of any remaining debt and hurting domestic incomes. Again, this is part of the adjustment to a new reality of lower domestic consumption – ‘living within our means’.

**Inside a currency union, however, currency devaluation is not possible** and an important mechanism of rebalancing is removed. Indeed, with Germany and its immediate satellites currently growing rather well (a situation which tends to strengthen the euro), a defaulting PIG staying within the euro-zone may actually have the worst of both worlds – no credit and a stronger currency. This may be exacerbated further if it faces higher short-term interest rates driven up by the strong ‘core’ desire (at the European Central Bank) to bear down on inflation expectations.

With the fiscal burden of further bail-out seemingly unpalatable to all sides, **a sovereign default in the euro-zone becomes more likely.** Without a ‘cleanish’ slate, the PIGs face years of fiscal restraint to turn their finances from large and growing primary deficits (over 12 per cent of gross domestic product (GDP) in the case of Ireland) to surpluses. With the rate of interest on the debt exceeding the rate of real GDP growth, the debt gets bigger as long as the underlying problem is not addressed. This is the unsustainable case for the PIGs right now.

In turn, there is a socio-political burden of the required adjustment, with or without default. This raises the risk of a euro-zone break up. (Get out those old drachmas and escudos and welcome Ireland back into the sterling area) With the clouds of default hanging over the euro-zone, the risk of contagion and renewed financial collapse is strong. As a result, any return to ‘normal’ economic conditions is postponed for everybody.

**Currency unions tend to end in two ways: political union or collapse.** The current crisis has pushed the odds more towards the latter but there is still a lot of European political will for the former. Whilst things continue to muddle through, place your bets - a new ‘core’ European federation or a euro-zone demise?

The problem now is that central banks are financing state deficits. This cannot continue but, to avoid a banking collapse, it may take many years to get back to private finance. Some suggest the euro-zone will need cross border banking systems and a dedicated European Monetary Fund.

## Cyclical outlook

Since February, most commentators’ views of the world economy have moved more towards stagflation: lower growth and higher inflation in 2011. Table WD1 shows the current consensus, which now sees slower growth in America and Japan and the euro-zone as a whole, though not in Germany, and higher inflation everywhere.

The outlook for 2012 has changed much less, showing some rebalancing of growth differentials, from Germany and to America, and some moderation of inflation generally (2.9 per cent for the world average). On this basis, global stagflation may not be too protracted.

Table WD1: Consensus Forecasts:

Real Growth & Inflation - % change, year-on-year

	2010 growth	2011 growth	2012 growth	2011 Inflation
Euro-zone	+1.7	+1.7	+1.7	+2.5
Germany	+3.6	+2.8	+1.9	+2.3
France	+1.5	+1.6	+1.7	+2.0
USA	+2.9	+2.7	+3.2	+3.0
Asia-Pacific	+6.8	+4.7	+5.7	+3.3
Japan	+3.9	0.0	+2.8	+0.4
World	+4.0	+3.2	+3.6	+3.6

Source: Consensus Economics Inc, May 2011

Around this consensus, however, there is a wide divergence of views. For example, the lower inflation outlook depends on no rise in inflation expectations and no more 'shocks' through commodities. Some business and consumer surveys suggest the former cannot be taken for granted, (especially against a background of fiscal withdrawal, modestly tightening monetary policy and falling real incomes) whilst further natural, political and financial 'events' cannot be ruled out (changes in the Arab countries, climatic and geological developments, and a euro-zone default).

There is a risk, therefore, that the current consensus for 2012 proves too sanguine and stagflation is here for a while.

On the other hand, there is the possibility that we are surprised on the upside. The Asia-Pacific engine seems strong, a pre-election, fiscal adjustment bounce is distinctly possible in the United States and the meagre recoveries in most of Europe may just start to accelerate as Germany's positive demand multipliers and investment accelerators lift its neighbours. The OECD's latest economic outlook suggests private growth will start to outweigh public prospects over the next year.

This probably all sounds like the proverbial economist's two-handed approach to forecasting. For 2012, however, the need to offer two alternative outlooks beyond the middling consensus seems particularly appropriate:

- We are living through a downturn caused by financial reconstruction that has some way to run.
- There may be some positive growth to help the fiscal withdrawal along but the risk is that the adjustment itself continues to constrain real growth.

In several respects, therefore, the next 18 months could well make or break many economic agents and government policies.

## UK Economy

### The UK economy is experiencing stagflation... though not like the 1970s.

In the 1970s, growth averaged 2.4 per cent per annum (Real GDP) and inflation (RPI) 12.6 per cent per annum. The word “stagflation” came into the language at this time to describe a combination of:

- growth too low to generate ‘enough’ business investment and new jobs
- inflation high enough to distort normal income and price signals.

**Stagflation damages current economic performance, future economic potential, many real living standards and well-being.**

In 2011, the word has returned to prominence, albeit the absolute scale or range of the stagflation problem is not as bad as during the “lost decade” of the 1970s.

The consensus is that UK growth and inflation will average 1.7 per cent and 3.2 per cent per annum respectively for the “recovery” period 2010-12. This average rate of growth is not enough to create net new jobs and the average inflation rate is enough to mean falling real incomes for many households.<sup>1</sup>

<sup>1</sup> N.B. that this is the consumer prices measure of inflation - not the higher RPI measure: many will ‘feel’ inflation much more than the CPI suggests.

In effect, the rates for growth and inflation are the “wrong” way round. The United Kingdom needs to generate about 3 per cent growth and 2 per cent inflation to get a sustainable recovery in economic activity and living standards. Even the Coalition’s Office for Budget Responsibility (OBR) believes aggregates of this order are a long way off.

### Structural issues

Where could faster growth and lower inflation come from in the long run?

### Growth

Real GDP is measured as the sum of total activity in an economy in a particular period, usually a year. This is driven by the normal economic circle: output creates income which is spent creating more output and so on.

As traditionally discussed, the spending measure of GDP has five components: consumption by households, investment by business, spending by government (both current consumption and investment), net exports (exports minus imports) and changes in inventories or stocks. Real GDP uses an appropriate price deflator for each of these components to remove the illusory effects of monetary change.

Normally, in broad terms, private consumption accounts for about 63 per cent of total UK GDP, government spending 23 per cent and business investment about 15 per cent. The United Kingdom tends to have a net deficit on trade which takes 2-3 per cent off the total. Stocks can be very volatile and affect quarterly totals dramatically (positively and negatively), but normally they make up a net small percentage in a full year.

From these percentages, it is easy to see the combined importance of household consumption and government spending to total economic activity and its growth. At present, both of these ingredients of growth are being constrained: the latter by the will of government to restore the public sector finances and the former by a lack of confidence stemming from employment uncertainty, falling real incomes, debt rebalancing, and negative savings and wealth effects.

If a recovery in growth is ruled out from these two main factors, then it is no surprise that the policy and media spotlight has fallen on “rebalancing growth” towards investment and net exports.

There are lots of theoretical and practical reasons why this would be a “good thing” for the long term development of this country and personal living standards in the broadest sense: low investment and trade deficits have held back UK growth for years. There are, however, three notes of scepticism we need to sound:

- Investment and net exports, since they contribute proportionately much less to the overall total, would really have to go some to compensate even partially, for lower expenditure growth by consumers and government
- The different categories of growth are interrelated. It is hard, especially for the majority of domestic-oriented businesses, to justify investing a lot more if the final domestic markets they serve are expected to be weak. (90 per cent of investments are in services.) Moreover it is hard to grow net exports when external funding, through savings and finance, is sparse
- Overseas competitors are not standing still: why would they accommodate our desire to export more, unless we strongly improve our competitiveness? Building competitiveness is a long run process of micro economic development and not just a result of a fresh desire for macro re-stabilisation

In the short term then it is hard to see rebalancing having a significantly positive effect. Such structural adjustments take years.

It took years for the UK economy to be characterised by persistent low investment and trade deficits and it will probably take years to reverse that.

The aim of economic rebalancing is laudable but not immediately achievable. The upshot of this, as acknowledged by the OBR, is that **real growth may be quite a bit less than we were used to, or is desirable, for the foreseeable future.**

In this respect, there is a need to understand how the recession has changed future growth prospects structurally, possibly forever<sup>2</sup>. With the worst loss of output since the Great Depression, the recent “Great Recession” may leave unpalatable long term effects.

Compared with what might have been, permanently lower national incomes imply:

- Attempts to cut the public sector share of output will require a larger loss in public services and public investment, particularly for ‘unprotected’ spending departments
- Lower private investment, especially if the cost of capital and business risk aversion stay higher than before – rebalancing will be delayed
- Lower household permanent incomes, causing a need for the adjustment of savings to generate the same level of real pensions, particularly in an ageing population, which suggests prolonged lower consumption

<sup>2</sup> We considered alternative growth futures for the SW economy based on how the recession would affect underlying growth trends (in terms of return to trend and level, return to trend without level and new lower trend) in Economics Review 19, February 2010

- Higher unemployment and hysteresis (the loss of productive capacity in the workforce and physical capital), which push real wages down for many employment categories
- Higher interest rates and uncertain, a priori, trade and capital flows

**A permanent loss of national income would mean that all our tomorrows have shifted downwards economically.**

## Inflation

Inflation is a generalised increase in prices across the whole economy and not a particular rise in the price of some goods and services. In “normal” times there are always some prices going up and some coming down but aggregate inflation can still be relatively low and stable.

The problem is that, when inflation is high and unstable, it distorts income incentives and price signals and, thereby, changes detrimentally the time preference of buyers, savers, investors, builders, makers, and servers. This tends to mean sub-optimal economic outcomes.

There are several potential aspects to an unwelcome acceleration in inflation.

## Spare capacity and exogenous costs

**Demand pull:** Inflation can rise when demand exceeds supply for assets, goods and services in many parts of the economy all at the same time. When an economy is booming, excess demand may cause inflation to accelerate generally, as spare capacity is used up and market pressures build. This usually requires a response from the authorities, often through higher interest rates, to cool things down. If action is not taken in a timely fashion, there is a risk that the 'boom' becomes a 'bubble' and inflation becomes more embedded than it would have done.

The problem for economics is that it is difficult to measure spare capacity or the 'output gap' in both an absolute and relative sense. At the present time it is difficult to assess, for example, what damage the recession has done to future UK growth trends.<sup>3</sup>

Rather than analysing this econometric, macro view of aggregate capacity, we can use business survey questions about capacity utilisation and official unemployment rates to interrogate issues of spare capacity. None of these alternatives are conclusive, particularly about how quickly the output gap is likely to contract because of a mixture of factor depreciation and recovering growth.

**Cost push:** Inflation can rise when a range of important costs, especially those affecting many businesses or households all together and at the same time, have to be passed through the production chain to final prices.

There can be several aspects to this:

- An exogenous increase in certain commodity or energy prices (e.g. oil, essential materials and/or foodstuffs) can affect nearly all parts of a modern economy and push up prices of many goods and services almost simultaneously
- A drop in the domestic currency's trade-weighted value can cause all import costs to rise and, where substitution of home alternatives is slow or difficult, this can push up domestic price inflation
- Generalised wage demands, perhaps through collective bargaining by politically motivated or powerful unions, for increases in excess of underlying productivity growth can perpetuate (though seldom initiate) a cost push spiral
- Fiscal changes that add to all costs, such as an increase in VAT or other sales/excise duties, can increase short term inflation rates with uncertain knock on effects through aggregate prices generally

## Money and inflation

Milton Friedman is accredited with the statement "inflation is always and everywhere a monetary phenomenon." He was saying that, if it is to persist beyond the short term, inflation must be driven by an excess of the supply of money in an economy. As with any economic factor in any market, if there is too much money in the system (supply exceeds demand), its value drops relative to those of other goods and services.

In other words, the price of money, (interest rates), falls in absolute and relative terms and other things become comparatively more expensive.

Friedman was explaining that whatever the original stimulus of a set of generalised price increases, it can only turn into ongoing aggregate inflation if it is "accommodated" by an excess in the growth of the money supply.

## Expectations

Inflation also feeds off what business and households think will happen next. Why do house prices and share values continue to rise beyond the point at which sensible analysis suggests they should, creating "bubbles" that inevitably burst with damaging consequences? Often, this is because expectations that prices will rise further become self-reinforcing.

Despite all logic and experience that "what goes up too much must come down hard", it is difficult to ignore the chance of short term monetary gains when a market is still spiralling higher. Hence, we hear comments like:

- "if I do not get on the housing ladder now, it will be even more difficult and expensive later"
- "share values seem toppish but there are still gains to be made so I'll ride the roller coaster a bit longer"
- "everybody else is getting a cost of living increase, so I deserve one too in order to maintain my relative standard of living"

<sup>3</sup> See footnote 2

These three examples of behaviour suggest a degree of economic “illusion” can emerge from time to time. In the first and second cases, even though jumping on the bandwagon perpetuates the “it can only go one way” myth, it is hard for people to follow the logic of pulling back, letting the market adjust downwards, and then going back in again at a lower price. In the third case, people concentrate on relative income rather than recognising that not all businesses can afford pay rises every year, especially when their particular employer (including government) may not be doing so well.

Inflation is then, also a behavioural phenomenon based on people’s subjective and objective expectations about tomorrow and what is ‘normal’. The illusion is often the belief that what is best for me now, getting my share of a diminishing ‘cake’, is also what is best for everybody, (including me), later.

### Summary

This summary of the various processes shows that **inflation has market/capacity, monetary and expectations components.**

The question as to which of these is most important at any particular moment is at the heart of the debates about whether current UK inflation is a real problem or not. This debate is critical and has become more open with the media’s regular discussion of the Bank of England’s Monetary Policy Committee (MPC) voting patterns for and against an increase in interest rates.

The problem is that the evidence is two-handed.

- On the one hand, we know we have had some strong exogenous cost push pressures on inflation through commodities, currencies and taxes (but not, importantly, through labour costs)
- On the other hand, at present, there is little or no sign of demand pull inflation in the United Kingdom – spare capacity exists for many<sup>4</sup>
- On the one hand, the growth in the broad money supply is at unusually and surprisingly low rates, suggesting no underlying inflationary stimulus
- On the other hand, the price of money (low interest rates) means money is very cheap, suggesting a potential for monetary inflation down the line
- On the one hand, wage settlements do not seem to be creeping up – held down by the fear of unemployment in a weak real economy and indicating expectations of future inflation are still benign
- On the other hand, there is a widespread concern about food and fuel prices and their negative impacts on household real incomes: expectations of future inflation, as revealed by popular surveys and inflation forecasts, are edging higher.

<sup>4</sup> Although it is not long since there was demand pull: viz. the housing boom of the late 2000s and its stimulus to the prices of related goods and services.

On the MPC, we have a majority faction which believes our current high inflation is down to temporary cost push factors that will drop out of the numbers in due course. UK inflation will return to target within the MPC’s acceptable time frame and there is no need to change monetary policy... yet.

There is also a minority who suggest that the longer the Bank fails to act the more likely it is that inflation expectations will rise, affecting wage bargaining and consumption patterns.<sup>5</sup> (The OECD raised this concern about UK inflation in its latest Economic Outlook.) This could undermine the currency, adding to imported inflation, resuming growth in monetary demand and releasing pent up money supply.

- For those with the latter view, it is better to start nudging up our very low interest rates sooner rather than have to jack them up more strongly later
- For proponents of the former view, it is not worth the risk of jeopardising the recovery to increase rates just yet.

Meanwhile, in the short term, UK inflation will remain higher than is desirable. Whether or not you believe the Bank’s majority view that it will come back down to target in due course, there is a risk of further growth or supply ‘shocks’ that cause expectations about future inflation to shift higher.

<sup>5</sup> There is some concern that inflation is becoming less sensitive to spare capacity/output gap measurements and monetary policy adjustments as doubts rise about the MPC’s time consistency on policy decisions.

If this bout of stagflation is to remain short-lived and not become embedded (as it did in the 1970s and early 1980s), it is better to dampen inflation expectations with a nudge towards higher interest rates sooner rather than later. I find it difficult to believe that, over the next year, gradually increasing rates from a very low 0.5 per cent to a still low 1.5 per cent, say, would damage current activity levels. It might do some good, by helping the savings market and, thereby, helping the rebalancing process towards better investment-led growth potential for the long run.<sup>6</sup>

## Cyclical outlook

### Recent UK Statistics: monthly numbers

The accompanying series of Charts from UK1 to UK3 reveals a UK economy that is struggling to get going through 2011.

**Retail sales (UK1) are proving to be erratic around a low growth average.** Although they bounced by 6.2 per cent (value) and 2.8 per cent (volume) in April compared with a year earlier, this followed two very slow months in February and March. The April jump partly reflected the fall of Easter and the Royal Wedding long weekends. For the latest three months (February-April) compared with the previous three months (November-January), volume growth was only 0.2 per cent and, excluding automotive fuel, there was no increase at all.

**Industrial production and services (UK2) are also mixed,** with the former still being helped by exports but yet to regain pre-recession levels of activity and the latter still very much in the doldrums.

- In the year to March, production rose by 0.7 per cent and, within that, manufacturing by 2.7 per cent. Capital goods grew by 6.7 per cent whereas consumer durables fell by 2.7 per cent. Amongst the fog of all these increases and decreases, it is important to remember the key fact: none of the production sectors have regained the peak levels of output they enjoyed before the recession. The recovery of export-led manufacturing is welcome but the downturn has yet to run its course.
- In the year to March, services output increased by about 1 per cent. As Chart UK2 shows, forward momentum is apparent but modest. Over the first quarter of 2011, distribution, government and business services were less erratic than transport and communications, and hotels and restaurants. But, worryingly, all lost some momentum through this period.

**Inflation (UK3) is high and volatile** – as discussed earlier, there is a clear ‘cost push’ drive to inflation and the danger is that this will be ‘internalised’ by monetary policy and expectations. In the year to April, the CPI measure of inflation reached a new high of 4.5 per cent.

- For consumers, accelerating inflation and little growth in wages and employment means a squeeze on living standards and discretionary spending.
- For producers, the wide gap between input and output price inflation is unprecedented and probably only maintained by low investment and low wage increases.

- The Bank of England now describes an even chance that inflation peaks above 5 per cent before falling back into the target range by spring 2012. Unfortunately, according to Citigroup economists, the Bank’s record at forecasting inflation is worse than its peers across Europe.

### Recent UK Statistics: quarterly numbers

The next series of Charts from UK4 to UK6 updates our quarterly picture for the UK economy to the end of 2010

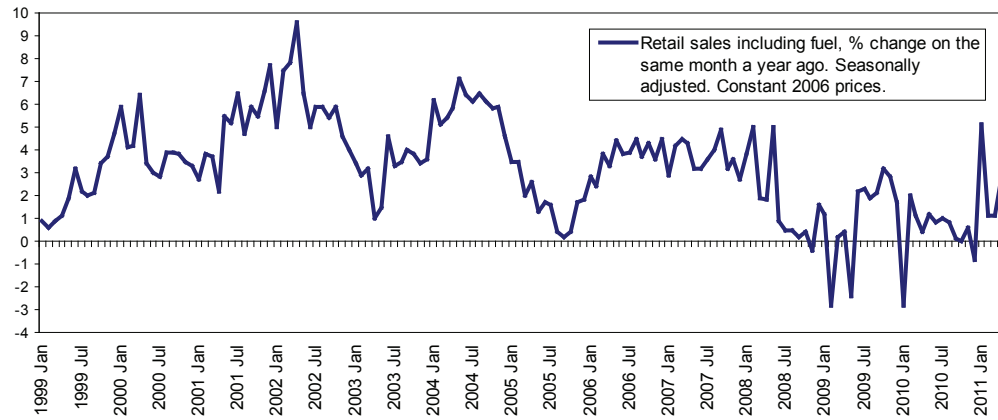
**The trade picture (UK4) improved only briefly in recession and, for goods, was worse than ever at the end of last year.** Although exporters seem to have done well in the first half of 2011, they are recovering from a low level and do not appear to be offsetting the growth of imports. There is no sign of significant trade rebalancing.

**Profitability rates (UK5) remain historically low for many UK businesses.** Although there were some signs of tentative recovery through 2010, rates of return remained short of where they need to be to encourage investment rebalancing.

**Productivity (UK6) suffered a renewed fall at the end of last year.** This was partially weather-related. We can probably expect that a recovery occurred in the first half of 2011, but, not to an extent that suggests we have yet achieved a sustainable economic “take off”. UK productivity growth remains lower than desirable for optimal long term development in absolute and relative terms.

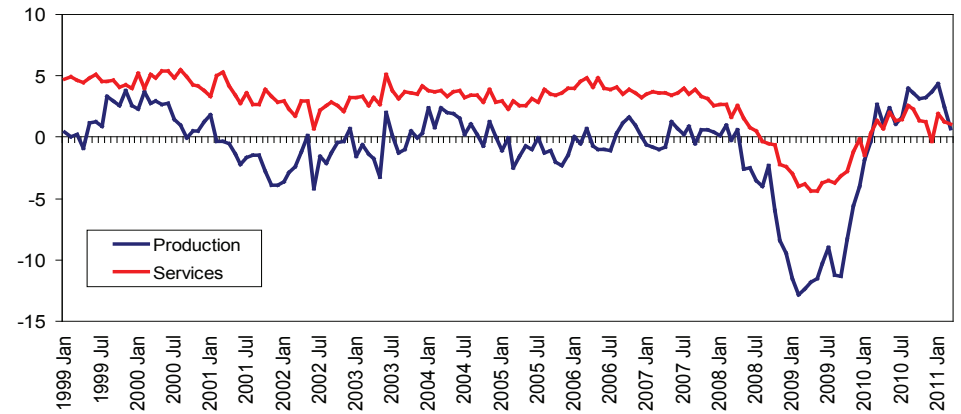
<sup>6</sup> The alternative view is that any increase in savings or interest rates will cut short-term demand even more.

Chart UK1: Retail Sales Volumes (% change year on year)



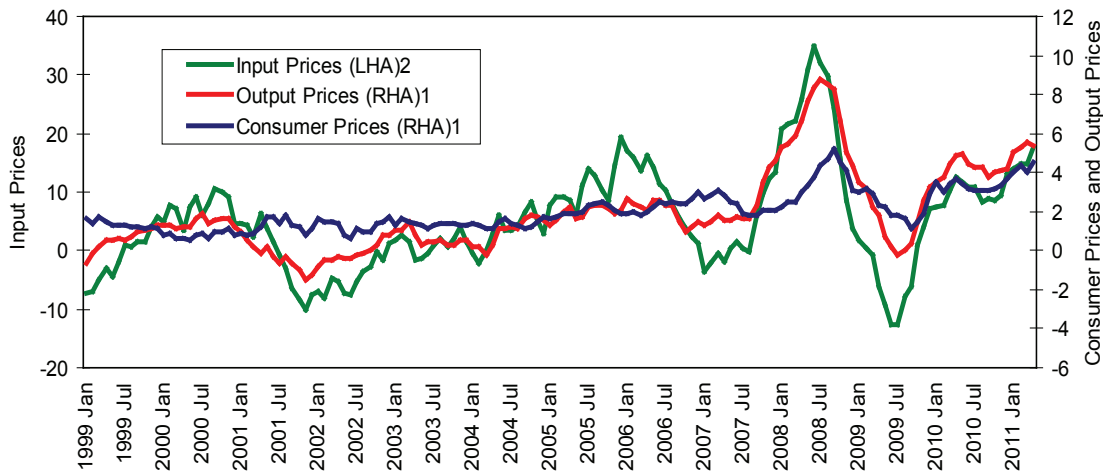
Source: ONS

Chart UK2: Industrial Production & Services (% change year on year)



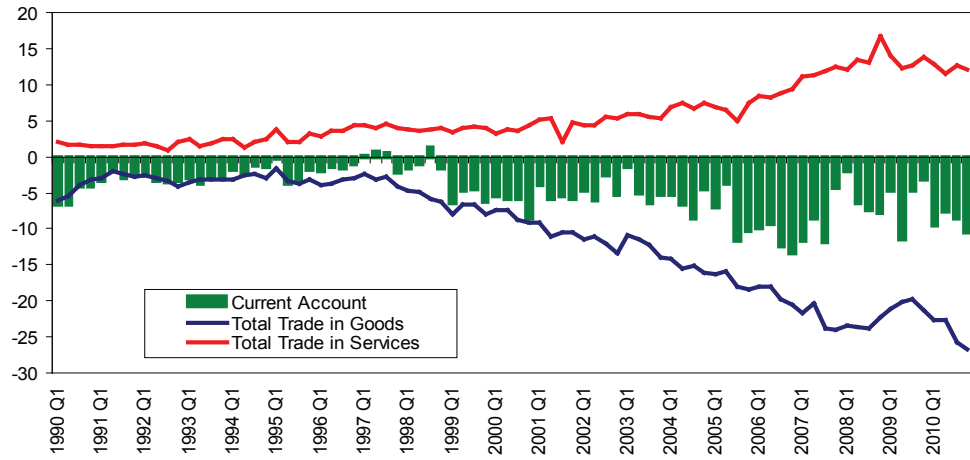
Source: ONS

Chart UK3: Inflation (% change year on year)



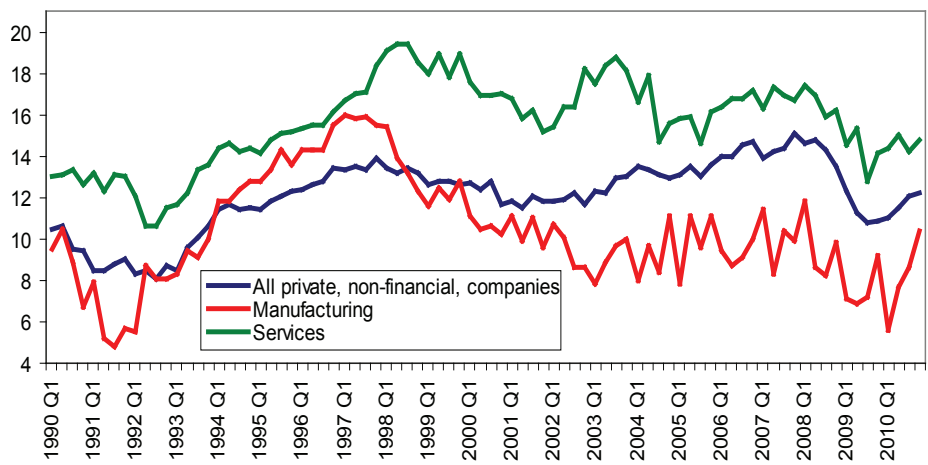
Source: ONS

Chart UK4: UK Current Account Balance (£ billion)



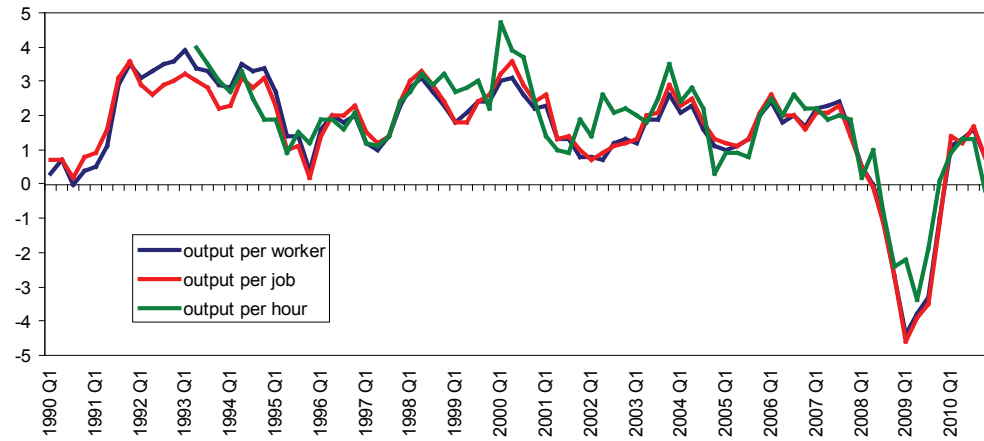
Source: ONS

Chart UK 5 UK Rates of Return (%)



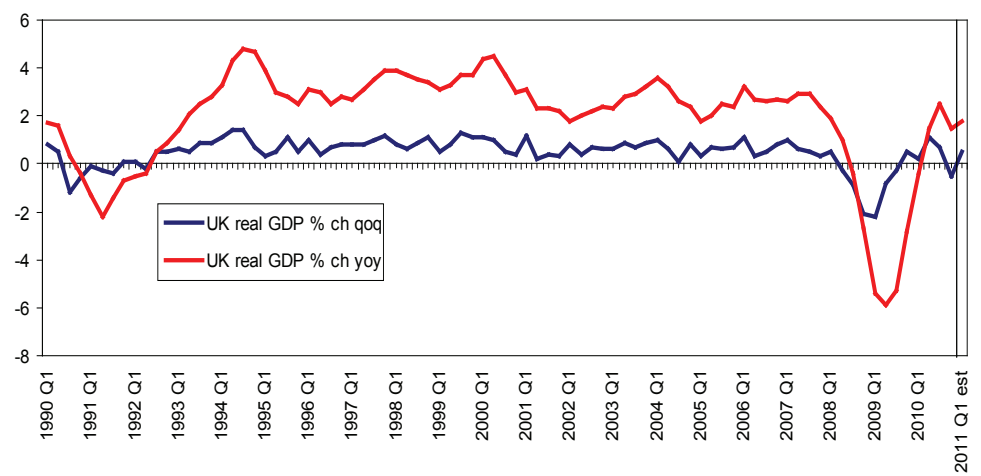
Source: ONS

Chart UK6: UK Productivity (% change year on year)



Source: ONS

Chart UK7: UK Real GDP Growth (% change)



Source: ONS

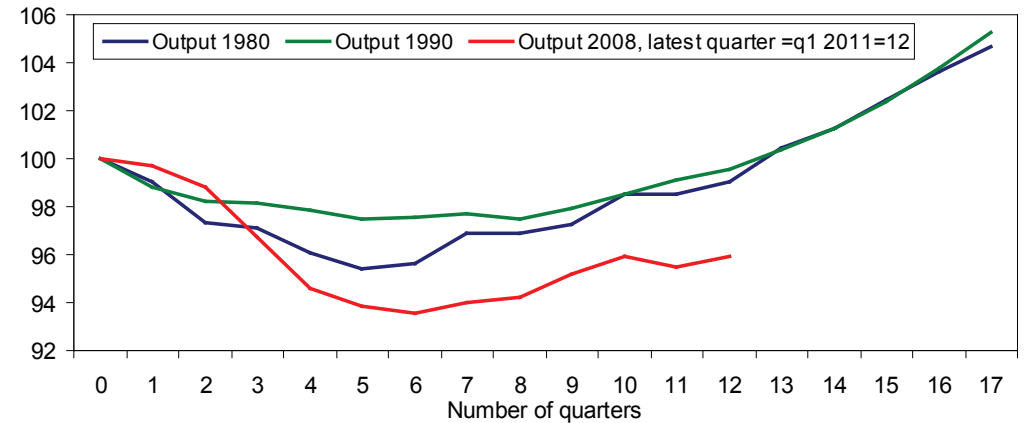
We now have a better estimate of real GDP growth in the first three months of 2011 (Chart UK7). This suggests, averaged over two quarters, **growth was essentially flat from October to March**. In aggregate, consumption and investment both declined in the first quarter, compared with the previous quarter and the same quarter a year earlier. The return to positive growth was caused by a smaller net trade deficit and higher government spending. In terms of output, the positives were from most services, especially a transport rebound from snow in late 2010, and manufacturing. Overall, the Office for National Statistics states that UK GDP has regained only about one third of the level of output lost during the recession. The negative phase of the economic cycle has yet to unwind.

If we compare this downturn cycle with its predecessors, we still have a picture of more output impact and less employment impact (Charts UK8 and UK9) than before. In this sense maintenance of high employment may be stifling the recovery.

Unfortunately, the latest quarters suggest the recovery in output may be stalling at a level well below those achieved in previous recoveries. In contrast, overall employment is holding up better, partly because we are not experiencing the major industrial restructurings and labour shedding associated with the early 1980s and 1990. Overall, this part of the economic cycle looks like being a prolonged period of subdued economic performance for UK businesses and workers alike.

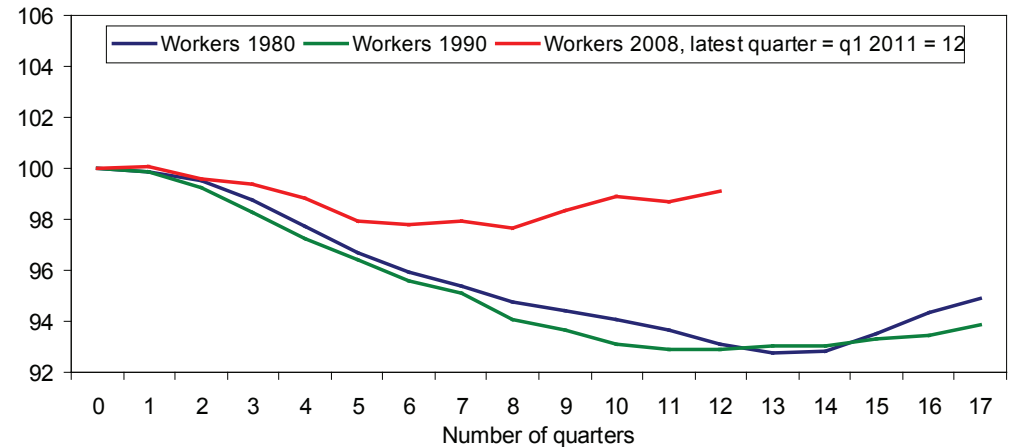
Nothing we know about the second quarter of 2011, at the time of writing, indicates much improvement in these UK macro statistics. We are still seeing a high degree of month-by-month volatility in activity trends that do not augur well for job creation and output rebalancing through the second half of 2011; a period when government austerity measures will increasingly take effect.

Chart UK8: UK Recessions Compared - Output (indices)



Source: ONS

Chart UK9: UK Recessions Compared - Workers (indices)



Source: ONS

## UK Outlook

The previous paragraph summarises our view for the rest of 2011: 'more of the same with not much gain'. Our expectations for 2012 are also muted. Although we expect a modest improvement in growth rates and an easing in inflation, it seems likely that the current period of mild stagflation will persist.

Recent earnings data from official sources, as analysed by some of the private consultancies, indicate the recession was not bad for living standards at the time. Indeed, the recovery has been much worse. These lags in the adjustment process have yet to run their course, with the Chancellor of the Exchequer and the Governor of the Bank of England joining many other high profile commentators in expecting the recovery to remain subdued (below trend).

As Table UK1 indicates, the overwhelming private consensus is that growth stays too low to generate many net new jobs and inflation remains above target. The unemployment rate is fixed at a high absolute level and investment is not strong enough to offset weak consumption. Importantly, the consensus picture shown here (from May) is worse on almost every measure than it was in February (as featured in our last Review). Expectations about the UK outlook from the "experts" have deteriorated.

The OECD is even less positive for 2011 and 2012, with overall growth at 1.4 per cent and 1.8 per cent respectively, and lower consumption and investment rates.

Table UK1: Consensus Forecasts of UK economy  
% ch pa (except unemployment)

	2010	2011	2012
Real GDP	+1.3	+1.6	+2.2
Consumer spending	+0.8	+0.5	+1.5
Investment	+3.0	+3.7	+6.0
CPI	+3.3	+4.1	+2.3
Unemployment (CC rate)	4.6	4.6	4.6

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In conclusion, **this period of stagflation is not as bad as the last one, but it is still no fun.** The apathy needs to end if the agony is not to be prolonged.

## South West Economy

### SW England has many attributes... and also many faults.

Closely studying the SW economy, in all its manifestations of sector and place, over recent years, has brought many rewards – not least the sense of an economy and a community with some real potential to develop positively in a sustainable fashion by raising productivity and, thereby, the returns to capital and labour alike.

There have been frustrations as well - the main one being a periodic sense of drift: a feeling that parts of the region have a tendency to be content to underperform.

At times, we have been confronted with the following questions: ones that remain pertinent for the new, emerging sub-regional infrastructure.

- Do the varied parts of SW England add up to viable economic entities?
- Do they have the business and political leaders that will drive forward growth and job creation?
- Are they willing to invest in infrastructure and skills, including all aspects of enterprise, to raise rates of productivity growth?
- Are they able to engage with new markets, new processes and technologies to realise competitive potential?

### The Economics Story

Fairly soon, we will be releasing “**The Economics Story**”, our synopsis of the knowledge about development economics and the economy of SW England that we have accumulated and promulgated over the past eight years. The key message from this work is that the South West and its parts have many economic attributes but also some significant faults.

We can summarise these strengths and weaknesses as:

- Strengths – flexible and high employment with some strong sector concentrations
- Weaknesses – low investment in productivity and low engagement with trade and growth.

These strengths and weaknesses suggest certain overall opportunities and threats at this juncture:

- Threats - that, in the new policy landscape, the degree of aspiration and access needed to correct deficiencies in enterprise will soon dissipate.
- Opportunities - that we can collaborate to compete better, amongst ourselves and beyond our boundaries: doing things better and doing better things.

Our “Economics Story” concludes

- The average performance of SW economy often hides a wide spread of performance across its different geographies and industries
- Overall, the SW economy performs as well, or better than most but lags behind the ‘leaders’. Crucially, **SW England shares the rest of the United Kingdom’s comparatively modest record on investment**
- Parts of the SW economy are good at creating jobs, within the context of a flexible but only moderately productive workforce. **There are skills gaps and mismatches still to address in the South West**
- Many parts of the SW economy have a high population of small businesses with low rates of business growth and churn. **Entrepreneurship is more a quantitative than a qualitative success**
- Despite some world class activity, most of the SW economy’s sectors and businesses are not engaged in international trade. **External Competitiveness will need to be raised** if we are to re-balance activity in a way that underpins future living standards

- SW productivity growth has been constrained by a high reliance on current spending. **Private innovation tends to be relatively concentrated in a few sectors and places.** Spreading positive agglomeration effects (dynamic linkages between social, environmental and economic places) and improving access to market would help the relative economic performance of many SW places.

## Recent evidence

Overall, the SW economy has followed a modest path of recovery in the year to date. It is difficult to see this changing soon.

### Purchasing Managers

The latest PMI regional survey shows a mildly positive, erratic economy in 2011 in terms of both output (Chart SW1) and employment (Chart SW2). With regard to the former, a 'good' month often seems to be followed by a 'bad' month whilst, on the latter, a sense of waning momentum prevails.

What is becoming clear is that **this recovery is very patchy**. There are winners who have orders, are working hard, investing for the future, and employing staff and paying them well. There are many losers, however, who are being left behind on all these counts.

Interestingly, this dichotomy of experience applies across and within most industries and sectors. The suppressed SW recovery seems to be differentiating very clearly between the investors, the innovative, the skilled, the entrepreneurial, the competitive and the rest whether they are;

- in the public or private sectors;
- offering services or goods for consumers or businesses; and
- predominately operating in home or overseas market.

### Other Surveys

The first quarter survey from the **British Chamber of Commerce** described its results as "disappointing", particularly an adverse shift in manufacturing sentiment. Within the South West, there were deteriorating balances across the board. These were particularly noticeable with respect to manufacturing domestic output, services exports, and overall employment, investment and confidence.

The equivalent survey by the **Institute of Chartered Accountants in England and Wales** was equally gloomy. Indeed, the South West was an area where business confidence turned decidedly negative in the first three months of the year. (Only Wales was also negative, and worse)

The **Confederation of British Industry's** latest small and medium sized enterprise (SME) survey for the whole UK economy in the three months to April was much more positive, talking of solid orders and output growth and good investment intentions. We have yet to see whether the "April" effect was temporary.

The **Institute of Directors**, in its current 'Big Picture' publication, identifies six factors that are acting as "dragging anchors" on the UK economy this year. These

are said to be falling household real incomes, a flat savings ratio, upward interest rate expectations, anaemic broad money supply growth, higher oil prices and the fiscal squeeze.

### Labour Data

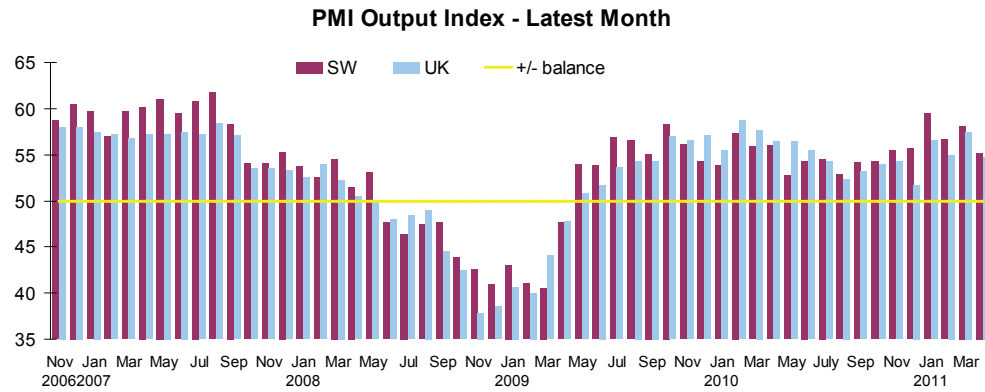
In the first quarter of 2011, SW England had an economically active workforce of 2.675 million, 78.7 per cent of its potential (16-64 age group). Of the total, 73.4 per cent (2.5 million) were employed and 21.3 per cent (almost 700,000) were inactive. In these three months, employment plummeted by 26,000 in the region, reflecting public sector losses and **representing by far the worst performance across the United Kingdom.**

The SW unemployment rate, based on a slightly different denominator, was 6.6 per cent. This ratio compared with an England average of 7.8 per cent and was the third lowest behind the South East and the East of England. The SW unemployment rate was 0.4 per cent higher than in the previous quarter and the same amount higher than a year earlier. Labour is still being shed.

The latest claimant count data is for April. It shows a very mixed picture across the region (see Chart SW3 and SW4).

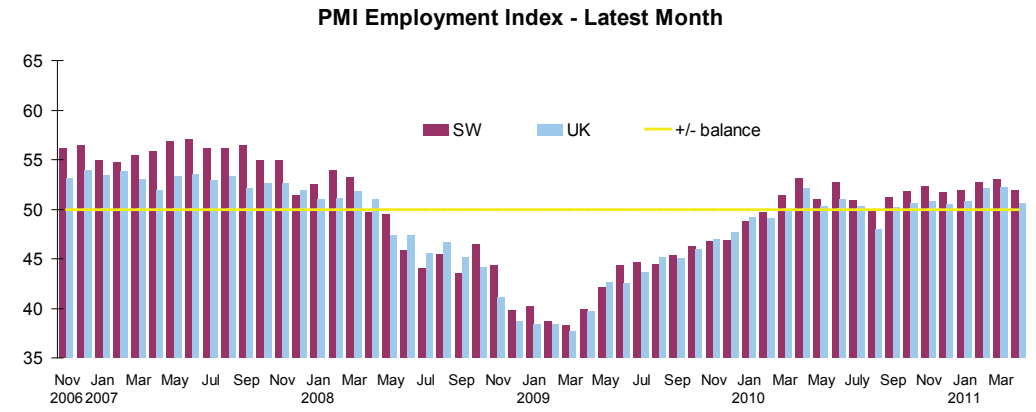
- As far as the rates are concerned (SW3), there is some contrast between the majority where rates are lower than last month and lower than a year ago, and places where rates are still higher than a year ago. The latter category constitutes Cornwall, Plymouth and Torbay, and Bristol, suggesting peripheral loss and urban effects.

Chart SW1: Output Expectations



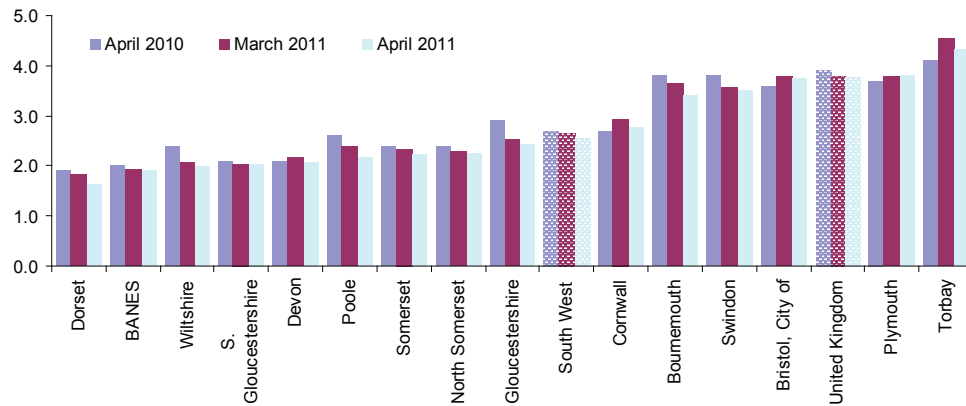
Source: Markit Economics, May 2011

Chart SW2: Employment Expectations



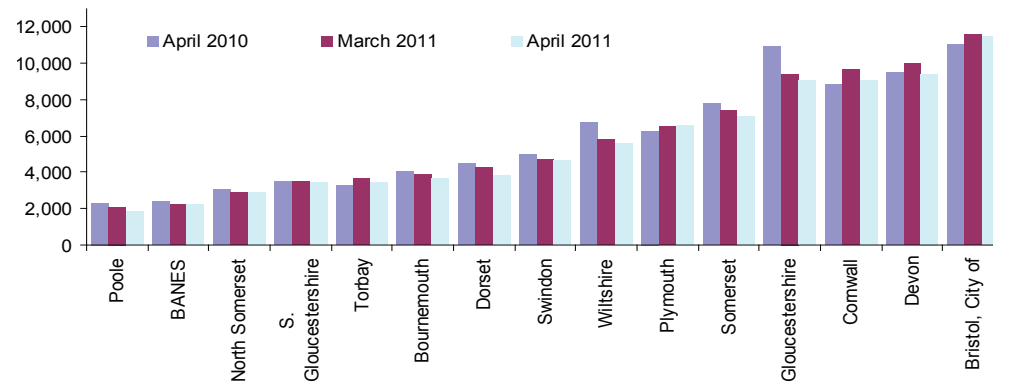
Source: Markit Economics, May 2011

Chart SW3: Claimant Count Rates (not seasonally adjusted)



Source: ONS, May 2011

Chart SW4: Claimant Count Levels (not seasonally adjusted)



Source: ONS, May 2011

- In terms of levels (SW4) the distribution of places is as you would expect, somewhat different – more in line with workforce scale. Overall however, the message is that the SW labour market made a small recovery in the period up to Easter. The question is whether this is temporary or can be sustained.

### House building Data

New house building has a strong influence on regional economic activity. It plummeted in the first quarter of 2008 and now appears to have reached a new, lower equilibrium (at about 70 per cent of pre-recession levels). The latest data from the Department for Communities and Local Government (DCLG) shows 3,620 dwellings were started during the first three months of 2011 in the South West and 3,290 completed. These totals are about 15 per cent better than in the same period in 2010 but around 40 per cent below where they were in 2007. A relatively strong performance early in 2010, compared with England as a whole, was not sustained.

Over the longer run, the story is that a huge gap developed in 2008, with completions way above collapsing starts, and this persisted through to the end of 2009. As long as this gap exists, it is a sign of contracting activity in house building. Conversely, when the level of starts exceeds completions this would be the longed-for sign of expansion. Since the start of 2010, balance has been restored but at a lower level.

Within the house building totals, there have been marked movements between private enterprise, registered social landlord (RSL) and local authority activity.

RSL completions have been running at around double the pre-recession level in the last two quarters, accounting for over a quarter of the total. By contrast, RSL starts fell to only 70 per cent of the long run level in the second half of 2010 although they did pick up again in early 2011.

Most of the recovery from the trough in 2008 was due to RSL house building. There must be some concern that this will not be sustained as we enter the first year of substantive spending cuts and publicly-financed investments dry up.

### SW Outlook

SW England is experiencing a very modest recovery in 2011 and we expect this to continue through the rest of the year and well into 2012. This unspectacular trend represents the fairly equal balance of risks on either side of the central forecast.

- On the upside, monetary policy remains loose, the banks are supposed to be making more credit available, export markets are strong, and the main SW tourism season has started well.
- On the downside, fiscal withdrawal is set to build up, inflation is high, SW real incomes are dropping, and external factors could turn nastier. SW dependence on consumer-led demand is relatively high and recent business surveys and data have been, on balance, rather weak.

Against this background, the key word in the term Local Enterprise Partnerships (LEP) is enterprise. May our LEPs help the SW economy to encourage enterprise, in its widest sense (not just entrepreneurship).

**Nigel F Jump**  
Chief Economist, end of May 2011

## Economic Indicators United Kingdom and South West England

United Kingdom		2005	2006	2007	2008	2009	2010	2008	2009					2010				2011
								Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	
Real Gross Domestic Product - growth (% ch.) <sup>1</sup>		2.2	2.8	2.7	-0.1	-4.9	1.3	-2.1	-2.2	-0.8	-0.3	0.5	0.2	1.1	0.7	-0.5	0.5	
Inflation - Consumer Price Index (CPI) (%)		2.1	2.3	2.3	3.6	2.2	3.3	3.9	3.0	2.1	1.5	2.1	3.3	3.5	3.1	3.4	4.1	
Trade balance (£bn)		-42.8	-41.5	-43.0	-37.8	-29.7	-48.5	-5.6	-7.3	-7.9	-7.1	-7.4	-9.7	-11.1	-13.0	-14.7	-9.3	
Official Bank of England Interest rate (%) <sup>2</sup>		4.50	5.00	5.50	2.00	0.50	0.50	2.00	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	
Exchange rates <sup>3</sup>		€: £	1.463	1.467	1.462	1.259	1.123	1.166	1.196	1.101	1.139	1.148	1.106	1.127	1.175	1.200	1.164	1.171
		\$US: £	1.819	1.843	2.002	1.853	1.567	1.546	1.574	1.434	1.553	1.641	1.634	1.558	1.491	1.551	1.581	1.603
Employment rate (%) <sup>4</sup>		72.9	72.8	72.7	72.6	70.9	70.5	72.1	71.7	70.9	70.6	70.6	70.2	70.5	70.8	70.5	70.7	
Unemployment rate (%) <sup>5</sup>		4.8	5.4	5.3	5.7	7.7	7.7	6.4	7.1	7.8	7.9	7.8	8.0	7.8	7.7	7.9	7.7	
South West		2005	2006	2007	2008	2009	2010	2008	2009					2010				2011
								Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	
Gross Value Added (GVA)	Total nominal GVA (£bn)	84.8	89.6	94.7	97.3	95.3	...	...	...	...	...	...	...	...	...	...	...	
	Annual growth (% ch.)	3.8	5.6	5.7	2.8	-2.1	...	...	...	...	...	...	...	...	...	...	...	
	GVA per head (UK=100) <sup>6</sup>	92.1	91.8	91.2	90.9	91.2	...	...	...	...	...	...	...	...	...	...	...	
	GVA per filled job (UK=100)	92.1	92.5	91.3	91.3	90.7	...	...	...	...	...	...	...	...	...	...	...	
	GVA per hour (UK=100)	93.6	94.4	93.0	92.8	92.4	...	...	...	...	...	...	...	...	...	...	...	
Gross Disposable Household Income (GDHI)	Total GDHI (£bn)	68.7	71.7	73.7	76.8	79.2	...	...	...	...	...	...	...	...	...	...	...	
	Annual growth (%)	4.8	4.4	2.8	4.2	3.2	...	...	...	...	...	...	...	...	...	...	...	
	GDHI per head (UK=100) <sup>6</sup>	99.6	99.5	98.6	98.5	98.7	...	...	...	...	...	...	...	...	...	...	...	
Trade	Total goods exports (£bn)	10.3	11.0	10.8	11.9	10.7	14.0	2.9	2.8	2.7	2.5	2.6	3.3	3.5	3.6	3.6	...	
	Annual change (%)	6.3	5.9	-1.3	10.2	-10.1	31.0	-0.6	-1.7	-12.0	-17.7	-8.3	18.6	27.9	41.2	37.9	...	
	Share of UK exports (%)	4.9	4.5	4.9	4.8	4.8	5.4	4.7	5.2	5.1	4.6	4.3	5.5	5.3	5.5	5.2	...	
Labour Market	Employment rate (%) <sup>4</sup>	76.3	76.1	76.2	76.4	74.2	73.8	75.9	75.7	74.4	73.4	73.3	73.1	73.8	74.5	74.0	73.4	
	Unemployment rate (%) <sup>5</sup>	3.6	3.8	4.0	4.1	6.3	6.0	4.8	5.9	6.4	6.6	6.4	6.2	6.2	5.5	6.2	6.6	
House prices	Average house price (£k)	204.7	213.6	230.9	230.1	220.4	240.2	220.3	213.9	212.8	228.4	226.5	239.3	239.5	247.1	235.1	232.1	
	Annual change (%)	3.4	4.3	8.1	-0.3	-4.2	9.0	-4.5	-7.4	-7.5	-4.4	2.8	11.9	12.5	8.2	3.8	-3.0	
	Index (England=100)	101.1	99.8	99.5	97.0	94.4	91.8	95.5	95.1	95.3	93.6	93.6	91.1	92.3	92.0	92.0	90.0	
	Affordability ratio <sup>7</sup>	9.4	9.6	10.1	9.6	9.0	9.8	9.2	8.7	8.7	9.3	9.2	9.8	9.8	10.1	9.6	9.5	

<sup>1</sup> The quarterly GDP figures represent quarter on quarter change, elsewhere percentages represent annual changes unless otherwise stated. <sup>2</sup> Rate at end of period.

<sup>3</sup> Annual and quarterly average rates. <sup>4</sup> As percentage of working age (16-65) population. <sup>5</sup> As percentage of economically active population aged 16+

<sup>6</sup> (UK less Extra-Region=100), UK GVA per head for 2009 is £19,977. <sup>7</sup> Ratio of average price to average total gross annual earnings of workers.

Sources: Exchange, interest rates – Bank of England; Trade – UK TradeInfo; House prices – DCLG; All other – ONS. (...)Data unavailable.



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