UK Regional Economic Forecast

Rebalancing the economy: a complex challenge

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EY
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EY's UK Regional Economic Forecast

This report provides the latest UK economic forecast and examines the current economic trends and outlook for the next three years in regions and cities across the UK. They represent a detailed and directly comparable analysis of UK economic performance at a regional and city level. This report is part of our Economics for Business programme, which provides knowledge, analysis and insight to help businesses understand the economic environments in which they operate.

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Foreword

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We are very pleased to share our fourth annual report, which analyses the recent economic performance of the English regions and cities and Wales and uses this to forecast likely economic activity levels to 2021.

The UK economy is growing significantly slower than its historic trend, and the outlook remains uncertain and volatile. Our analysis also identifies that Brexit, demographics and technological change are reshaping the labour market in what could be a significant break with the behaviour we have seen over the last decade.

In the three years since our first regional forecast, there has been no reduction in the imbalances between the South of England and the rest of the country. However, slowing services sector growth has limited further increases in the geographic differences between North and South. As this report demonstrates, of more concern is the continuing disparity in the growth in performance between Core Cities and Large Towns and the rest of the country, with smaller locations falling further behind the larger places. These smaller places have traditionally been more vulnerable to economic shocks and therefore policy needs to respond rapidly, given the challenges facing the UK economy.

While there are some positive and encouraging signs in regards to rebalancing the UK economy, we must acknowledge it is a more significant and complex challenge than considered to date. Radical thinking on economics and politics is required at a local level, to address imbalances within regions. We look forward to supporting that conversation and process.

Executive summary

Rebalancing — more of a priority than ever

Still work to do on geographic imbalances …

Slowing of growth in the services sectors at a time when manufacturing has been performing better than in the recent past has slowed down any increase in geographic imbalances between the South and the rest of the country. However, the imbalance in growth between different places within regions continues to increase, with cities and larger towns pulling away from their neighbours. Against this backdrop, a slowdown in growth creates challenges, especially for smaller, more economically exposed places in the UK.

We expect little change in the next three years between North and South but we do expect the imbalance within regions to increase. The significant degree of uncertainty in the UK and the associated risks of shocks and higher volatility are causes for concern and should focus minds on developing appropriate policy responses in the coming months.

… and some new challenges

What is striking in our latest analysis is the change in the outlook compared to recent trends. Some of the stronger-growing places in the last few years, such as the South East region and its cities and towns, have seen activity slow. Even more marked are the changes in the labour market, with employment falling in the South East over the last three years, and the UK as a whole expected to see total employment growth at only 40% of the rate achieved between 2015 and 2018.

Part of the reason for the changes in the labour market is employers responding to expected lower EU immigration and other demographic changes. The services sectors are forecast to improve their labour productivity as a result. However, we are also seeing the impact of the slowdown in the retail sector, especially on the high street, that has captured many headlines this year. This poses significant challenges for smaller towns and communities in particular as retail tends to be a major employer in these places.

We can see the same challenges when we consider manufacturing. The sector has grown over the last three years and employment has increased as a result. We expect the sector to grow, albeit more slowly, over the next three years but the numbers employed will fall as technology is used to drive higher productivity in a more challenging labour market.

Stepping back, it is clear to us that the priority area for policymakers should be investment in skills to enable people to respond to a more challenging and changing labour market. We need to work out how we can equip people for the new roles that are emerging, giving them the tools to move between sectors and roles as appropriate. When we view skills development in the context of the geographic imbalances mentioned earlier, the clear implication is that more of the activity on skills and education has to be shaped at the local level and not from the top down.

Our analysis of relative city performance provides an insight into how differences in industrial structures influence economic performance. This means that policy must ensure it addresses issues across sectors and geography in order to be impactful.

An agenda for change

As we have identified in this report, with economic growth slowing and the outlook becoming more uncertain, maximising the potential of all the UK's places is essential to allow us to generate solid economic growth. The priority areas for action in our opinion are:

- Investment in the **skills** required to build a successful modern economy that can compete on the world stage.
- **An economic policy approach for towns** which goes beyond the current focus on policy which tends to be based around the largest cities.
- **Further development of sector strategies,** recognising the opportunity provided by modern manufacturing but also the UK's strengths in services.

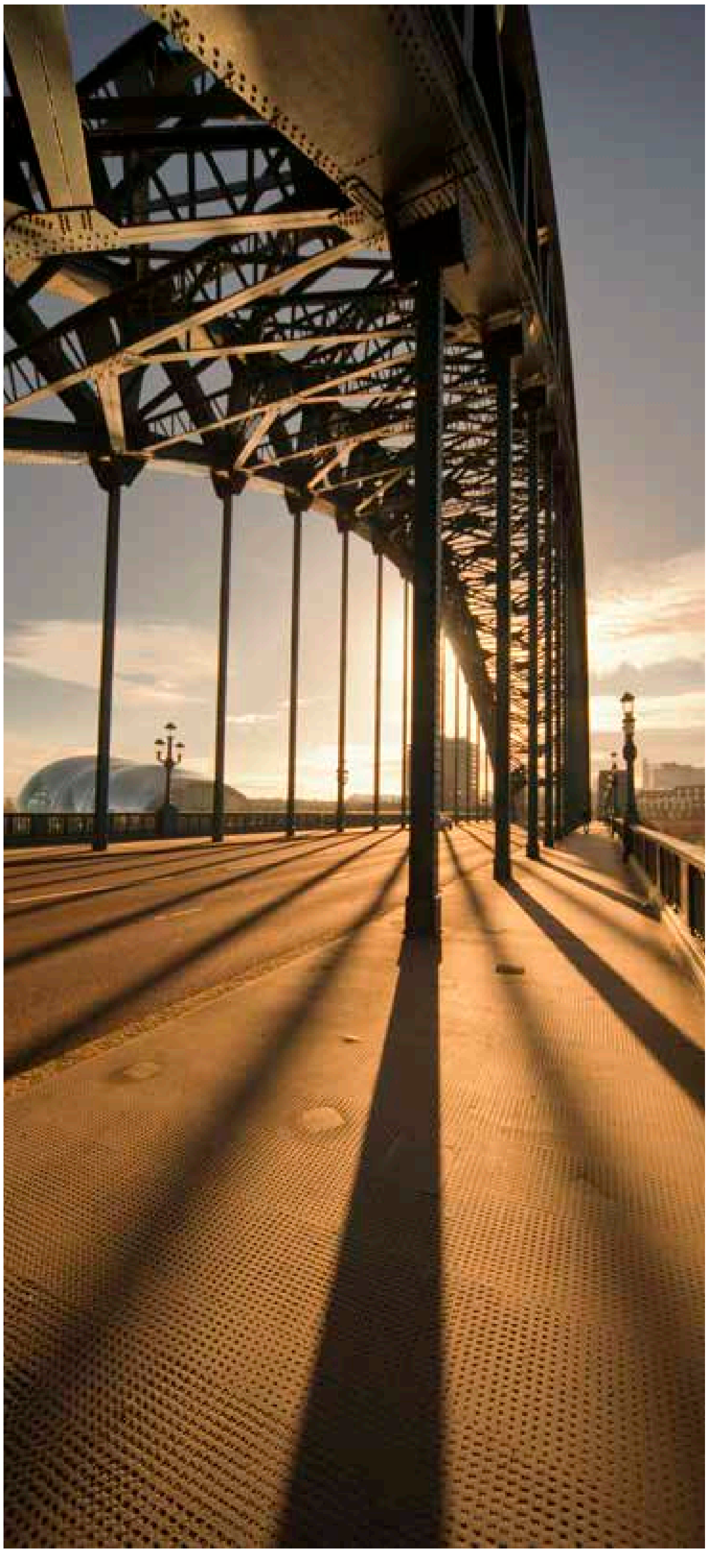
Start at the local level and change the conversation

Most importantly, we must acknowledge that rebalancing is a more significant challenge than considered to date. We need to devolve power much more widely than has been done so far. This means consulting more extensively in towns and smaller places and using this insight to develop ‘bottom-up’ plans that reflect local knowledge and strengths. These plans can then be aggregated up through sector strategies to regional and national levels as necessary. This will inevitably require that more control and resources for skills and education, housing, infrastructure, transport and health care will have to be devolved to the local level.

The three key policy initiatives to support the shift to more balanced growth are:

1. A commitment to **deliver infrastructure** that addresses needs at the local and regional level. A cross-country rail and road network fit for purpose in the North and Midlands are essential requirements. Broadband and mobile access also need to be upgraded to ensure that all parts of the country are connected so that people can participate fully in the economy.
2. Investment in the **skills** required to build a successful modern economy that is competing on the world stage. This should be based around the needs of the entire workforce with more focus on retraining and reskilling than is currently the case. Digital skills will be a key part of this but so will the communications and interpersonal skills that employers value so highly.
3. A comprehensive assessment of the **future of the retail sector** and the policy necessary to shape and support the transformation of the high street. This should go beyond business rates and consider planning approaches, environmental issues, the costs of the online supply chain and alternative models for high streets.

This will require radical thinking but this is the time to increase our ambition as we need to do more to position our economy for a different future. How can we stimulate activity in disconnected parts of the economy?



Into the unknown ...

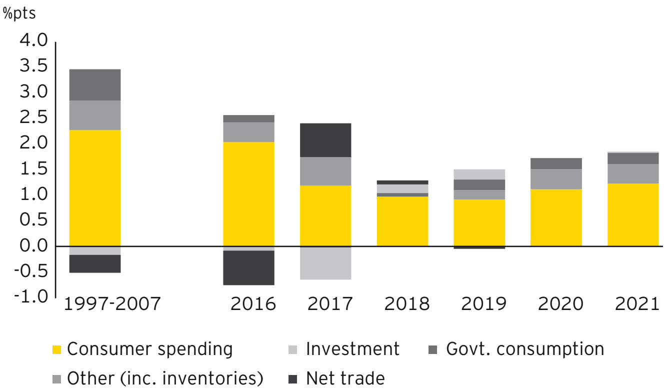
When the Office for Budget Responsibility suggests, as it recently did, looking at the Three-Day Week in the 1970s as one way to estimate the potential impact of a 'No Deal' Brexit, we can be in no doubt that these are unusual times for UK economics and politics. The situation regarding Brexit appears to change almost daily and as the recent EY ITEM Club Autumn Forecast (October 2018) set out, this uncertainty is affecting the economy.

This report sets out our view on the prospects for the English regions and Wales over the next three years under our base case assumption that the UK is able to agree a withdrawal agreement and outline political declaration on future trade with the EU by 29 March 2019. Recognising the uncertainty around this assumption, we also discuss the implications of alternative scenarios below.

... with a slowing economy ...

Our 2017 UK Regional Economic Forecast noted that the UK economy was slowing down, and this trend has continued throughout 2018. During the year, the squeeze on consumers has led to them spending less, business investment has fallen and the global economy has slowed, reducing the boost that trade was providing to UK activity. Even allowing for the fact that the Chancellor provided a stimulus to activity in his Autumn Budget, the EY ITEM Club Autumn Forecast suggests that UK GDP will expand by around 20% less between 2018 and 2021 than in the equivalent forecast made a year ago. This is a significant downgrade on what was an already weak performance by historic standards.

UK: Contributions to GDP growth



Source: EY ITEM Club

... amid a backdrop of uncertainty ...

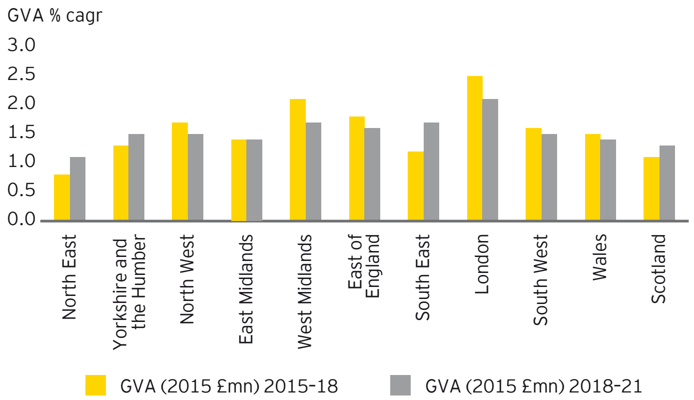
As mentioned above, the negotiations on the UK's exit from the EU are creating significant uncertainty for businesses regarding the future nature of regulation, trade and migration policy between the UK and the EU. While the forecasts presented in this report assume a smooth Brexit, this is far from certain. Forecasting the impact of No Deal is very difficult, partly because exactly what form it would take is unclear, and partly because we have no precedent on which to base forecasts of the potential impact. Our discussions with businesses and review of other forecasts leads us to believe No Deal would have a significant short-term negative impact but, potentially even more significantly, would also change investor perceptions of the UK and may well therefore have a negative longer-term impact as well. It is certainly important for businesses to plan on the basis of several quarters of very difficult trading conditions in a No Deal scenario.

... impacting all parts of the economy ...

Not only is the UK economy slowing but all parts of the economy are under pressure. Business investment has fallen for the last three quarters, consumer spending has slowed — with clear impacts on high streets — and the boost from trade has largely disappeared. The consequences of these changes are clearly visible when we analyse the performance of our regions and cities, with much more significant variations in sector performance across geographies than we have seen in previous years.

In our previous reports, we have tended to find that London and the South East have been the fastest-growing regions in the UK economy with the East of England, South West and the North West the other fastest-growing places. The situation has changed, and while London was still the fastest-growing region between 2015 and 2018, the South East, South West and East of England, together with the North West, have slowed relative to the rest of the country, meaning that growth rates outside of London are more balanced than has been the case in our three reports since 2015.

Regional GVA growth 2015–18 and 2018–21



Source: EY ITEM Club

These findings reflect, to a large extent, the sector mix within individual regions and the performance of those sectors over the last three years. Manufacturing has grown at a faster rate than it has for some time, helped by a weaker pound and higher global growth, and this has generated benefits for the manufacturing-oriented regions such as Yorkshire and the Humber, and the North East. The East Midlands also gained but to a lesser extent as the region had already seen manufacturing improve earlier. By contrast, slower overall services sector growth has pulled back growth rates in the southern regions.

With the second-fastest regional growth rate, the standout performer over the last three years has been the West Midlands. The boost from the Midlands Engine getting up to speed has helped to improve activity levels across a range of sectors with manufacturing growing at 2.8% per year on average and Construction at 4%. The region also achieved faster growth in Professional Services and ICT than the national average, demonstrating broad-based improvement across the local economy.

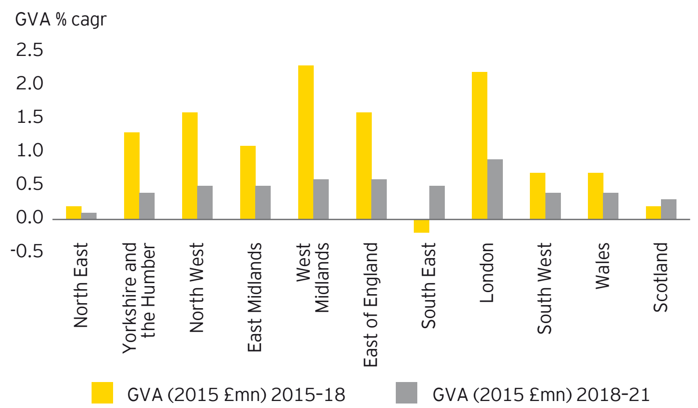
… and will continue to do so

Looking forward, we expect that growth overall will be lower and more balanced across the country. London will continue to outperform all other UK regions through to 2021, but the overall outlook reflects the results of a slowdown in growth by manufacturing, and reasonable but slower growth across Services.

However, the real story is the forecast slowdown in employment creation over the next three years. The South East is the only region expected to see employment growth accelerate in the next three years, and this largely reflects a catch up after a weak performance between 2015 and 2018 as retail employment fell and other sectors improved productivity faster than previously. A slowing economy, expected reduction in immigration and technological change are all contributing to this expected significant shift in the labour market over the next few years. We expect the rate of employment growth to be around 0.5% per annum on average over the next five years compared to over 1.4% in the five years to 2018, a major change in pace.

The UK's economy is slowing and transforming, with the labour market changing dramatically. Businesses will have to pay detailed attention to the economic landscape and especially labour market developments as they unfold. To understand the drivers of relative geographic performance to 2020 in more detail, we now turn to our analysis of cities in England and Wales.

Regional employment growth 2015–18 and 2018–21



Source: EY ITEM Club

A changing narrative ...

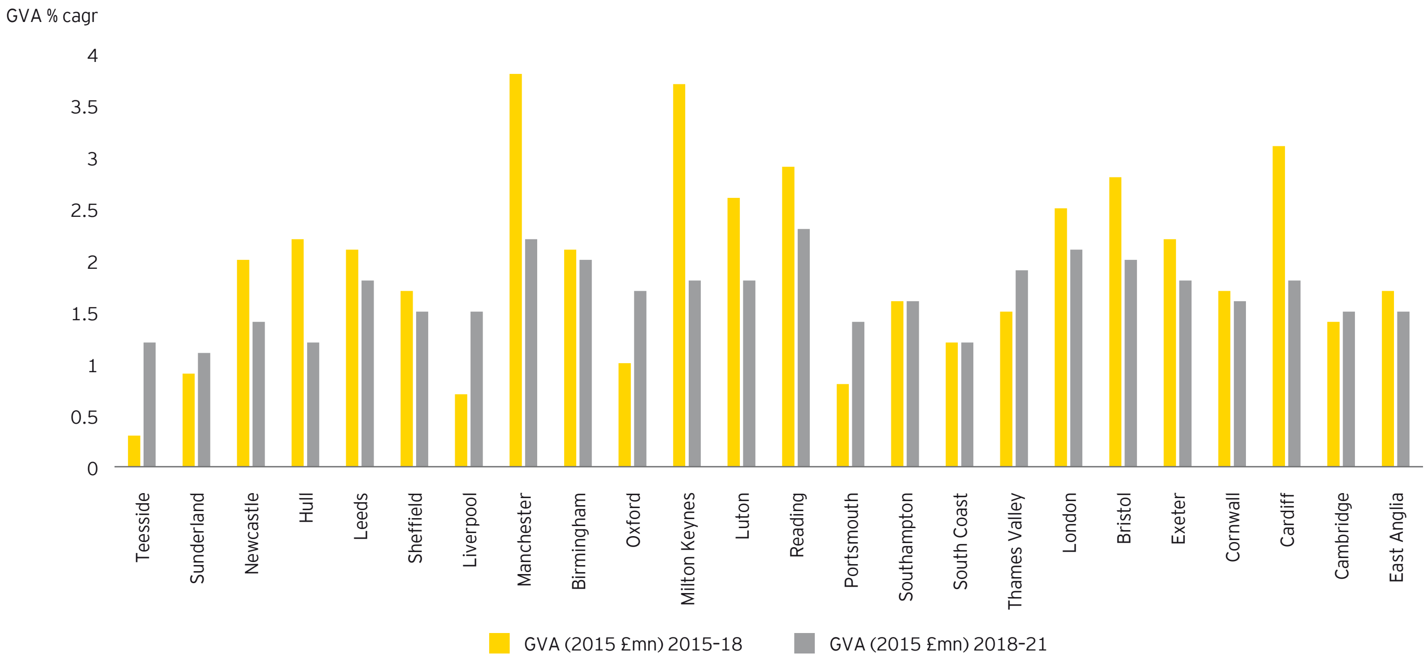
As the UK economy has slowed and sector growth rates have adjusted, so the balance of growth rates between cities has changed. There are a number of standout performers such as Manchester, Milton Keynes and a few others with above average growth rates, but compared to our previous analyses, the city growth rates across the UK are much more closely bunched. The closing of the gap in growth rates between manufacturing and services has been a key factor in shaping the relative levels of change in activity across the UK.

The South West has a number of cities that have grown strongly over the last few years and services sector growth has been a major contributor to this, especially in university towns, consistent with the findings of our recent work with the Centre For Towns on foreign direct investment (FDI). The improvement in manufacturing has underpinned this in several northern centres such as Hull, Newcastle and Sheffield, with growth in logistics also contributing. In Leeds and Manchester, services have driven growth.

The surprise has been the slowdown in growth in the South East with even Reading seeing its activity levels increase much more slowly than in previous reports. The most significant factor influencing the relative slowdown has been the weaker growth of services sectors such as Professional Services, Administrative Services and even ICT compared to their rapid historic rates of growth. In several places this has also fed through into a property slowdown.

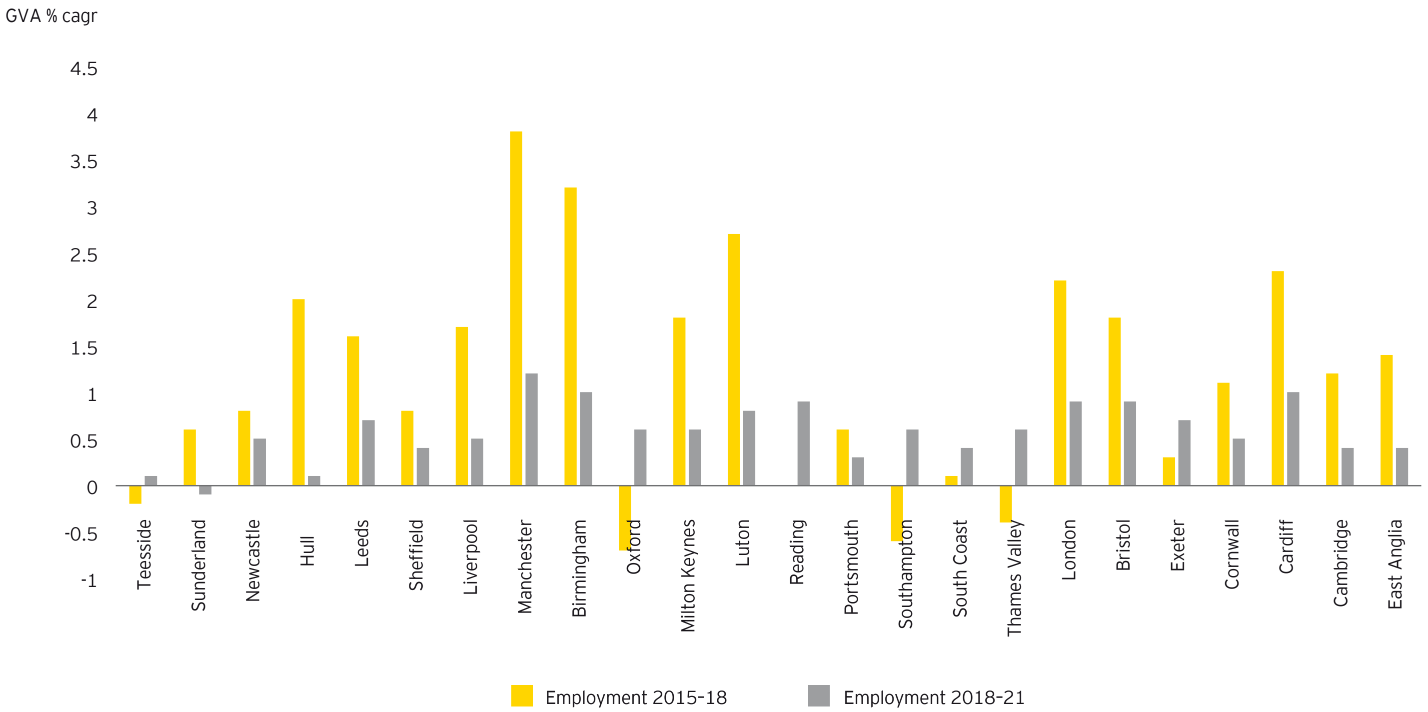
The story on employment growth is broadly similar to that for gross value added (GVA), with the faster-growing cities achieving higher rates of employment growth. However, the performance of the South East is striking, with generally much lower levels of employment growth and even some falls. It appears that labour shortages in some of the faster-growing sectors are causing employers to look to grow with smaller labour increases than previously would have been the case. But several cities are also seeing a loss of retail jobs, suggesting that the South East may be a leading indicator of what will be a more widespread change throughout the next three years.

City GVA Growth 2015–18 and 2018–21



Source: EY ITEM Club

City employment growth 2015-18 and 2018-21



Source: EY ITEM Club

… in cities and towns …

Our forecast is for a reduction in the rate of economic growth for cities across the UK over the next three years, as the rates of growth of individual sectors converge as they slow down. The recently strongly performing cities such as Manchester, London, Birmingham, Bristol and Reading will continue to grow faster than average. However, the gap compared to the slower-growing areas will be less than in the recent past, with little more than a 1% difference in average annual growth rates between the fastest- and slowest-growing locations.

The South East and East of England are expected to recapture some ground with their growth rates increasing from their weak performance in the last three years. Their improvement will be driven by the Professional Services and ICT sectors which are expected to be the two fastest-growing sectors nationally.

The disparity between regions is forecast to be more significant for employment creation in the next three years. Once again, the forecast performance for the South East stands out. We expect that employment growth will turn positive but nevertheless the cities in the region will grow much more slowly than previously. We expect that businesses in the region will respond to slowing growth in labour supply, as immigration falls, by driving productivity, and our forecasts suggest Professional Services and ICT will be leading the way, helping to explain the outlook for cities in the South East.

With all sectors expected to have slower employment growth over the next three years, with manufacturing and public sector employment numbers turning negative, it is no surprise that employment growth will be muted across the country. The North East is more dependent on both manufacturing and public sector employment so its cities fare relatively badly. The northern manufacturing cities of Hull and Sheffield will also see employment growth slow, but so will Cambridge and Oxford as lower immigration impacts sector growth in their areas too.

... and imbalances still growing within regions

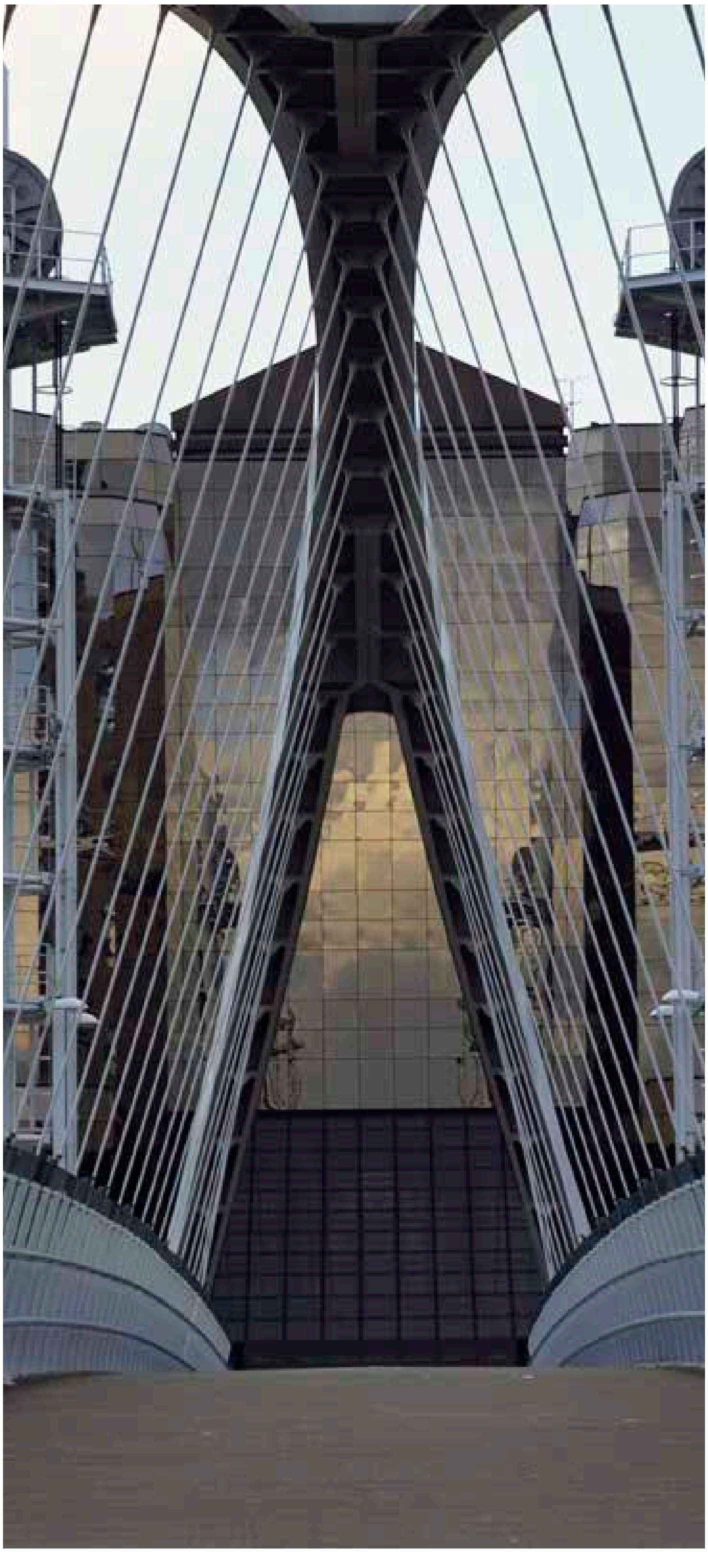
The analysis of relative city performance provides real insight into how policy and different industrial structures influence economic performance. As shown below, the strength of a city in Professional Services and ICT is an important explanatory factor for differences in growth rates. We have previously identified how the power of cities, especially the larger ones, can lead to unbalanced economic growth.

When we compare our region and city forecasts it is clear that the strong are getting stronger. City growth typically outpaces regional growth which means that the towns and other areas within regions are growing more slowly. We recently reported on UK historic performance in a piece of research undertaken in collaboration with the Centre For Towns. We have used their classification that distinguishes between the Core Cities group and Large Towns (places with a population over 75,000 that are either towns or smaller cities but which have similar economic characteristics).

Our analysis suggests that the Core Cities in our analysis (London, Leeds, Manchester, Liverpool, Newcastle upon Tyne, Birmingham, Cardiff and Bristol) grew at 2.2% annually on average between 2015 and 2018 whereas Large Towns grew at 1.8%. This analysis suggests that, with the exception of the East of England region, medium and smaller towns and other places grew more slowly than the regional average growth rate and hence geographic imbalances within regions increased.

We expect this distinction to continue with growth rates of 1.8% for Core Cities and 1.6% for Large Towns over the next three years. Once again this suggests that on average, smaller places will grow more slowly than both the national and their regional average up to 2021 and hence be more exposed to potential adverse economic shocks.

Geographic rebalancing is as important within regions as between them. This is an opportunity for geographic rebalancing to an extent but it is also a potential issue as it risks a concentration of activity in a small number of stronger cities. The national approach to geographic rebalancing must identify how to ensure that smaller cities and towns, and the more remote parts of regions, can benefit from the success of the faster-growing cities. Improved connectivity, both physical and digital, will be critical in ensuring the economy is one in which everyone has a chance to participate fully, regardless of location.



Shaping policy for an uncertain outlook

As the most recent UK forecasts by both the EY ITEM Club and the Office for Budget Responsibility (OBR) make clear, the UK economy is entering a challenging period as we prepare to leave the EU. There has been little progress in addressing geographic imbalances but a slowing of growth in the southernmost regions of the UK has stopped the imbalances increasing. However, the imbalance between Core Cities and the rest of their regions and then between Large Towns and smaller towns continues to increase.

We are also seeing signs of the change in the labour market as slowing EU immigration, an ageing population and technological change are starting to impact employment growth. We expect to see employment creation slow significantly over the next three years across all regions and all sectors. As the labour market changes, action will be required to ensure that people have opportunities to retrain and reskill themselves.

We have seen the challenges facing the retail sector come to the fore over the last 12 months and we expect this to continue. This sector is a major employer especially in medium- and small-sized towns and the loss of jobs will have a significant impact on local economic activity, and policy must be developed to support transition.

This means that the case for driving deeper geographic rebalancing to maximise the potential of all the UK's regions and cities, moving the country to a higher sustainable rate of economic growth, is stronger than ever. Brexit makes this policy even more important both to maximise growth but also to support the UK's transformation to be in a position to prosper after Brexit.

Policy proposals

This report has demonstrated how geographic imbalances not only remain within the UK economy but are actually widening at a local level within regions. With smaller places more vulnerable to economic downturns, it is critical that we start to develop policy now to drive greater balance and security in economic activity across the whole of the UK.

Most importantly, we must acknowledge that rebalancing is a more significant challenge than considered to date. We need to devolve power much more widely than we have done so far. This means consulting more extensively in towns and smaller places and using this insight to develop 'bottom-up' plans that reflect local knowledge and strengths. These plans can then be aggregated up through sector strategies to regional and national levels as necessary. This will inevitably require that more control and resources for skills and education, housing, infrastructure, transport and health care will have to be devolved to the local level.

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3. A comprehensive assessment of the **future of the retail sector** and the policy necessary to shape and support the transformation of the high street. This should go beyond business rates and consider planning approaches, environmental issues, the costs of the online supply chain and alternative models for high streets.

Spotlight on housing

London is the only UK region to post a house price contraction in the 12 months to August 2018.

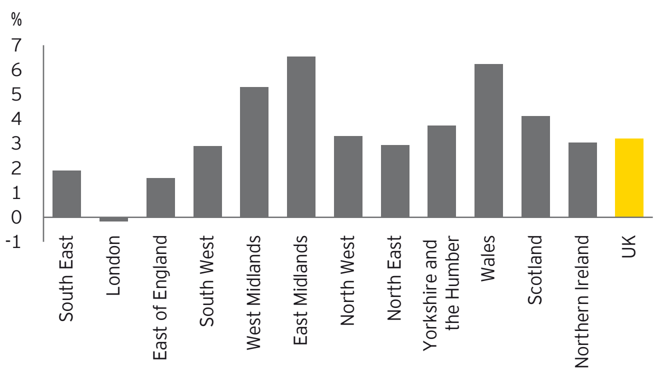
Prices fell by 0.2% over the year, compared to 3.2% growth for the UK as a whole.

The UK housing market has slowed over the last 12 months and the top end of the market has been most severely affected, with City of London (−10.1%) and Westminster (−7.6%) seeing the largest contractions. Growth in these boroughs has traditionally been bolstered by overseas buyers, and uncertainty surrounding Brexit would appear to have discouraged these investors over the past 12 months, with an increase in stamp duty on second homes also dampening demand.

Population growth is another key determinant of house prices. While the latest data shows slowed population growth across all regions in the wake of Brexit, London has been disproportionately affected. Population growth in the capital fell from 1.2% in 2016 to 0.6% in 2017, with negative net migration recorded for the first time since 2004.

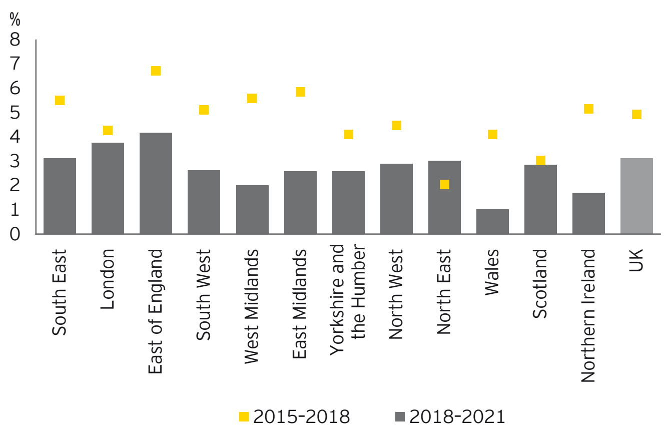
The East Midlands recorded the fastest house price growth over the past year, at 6.5%, closely followed by Wales (6.2%) and West Midlands (5.3%).

House price growth, August 2017 – August 2018



Source: ONS

Annual average house price growth, 2015-18 and 2018-21



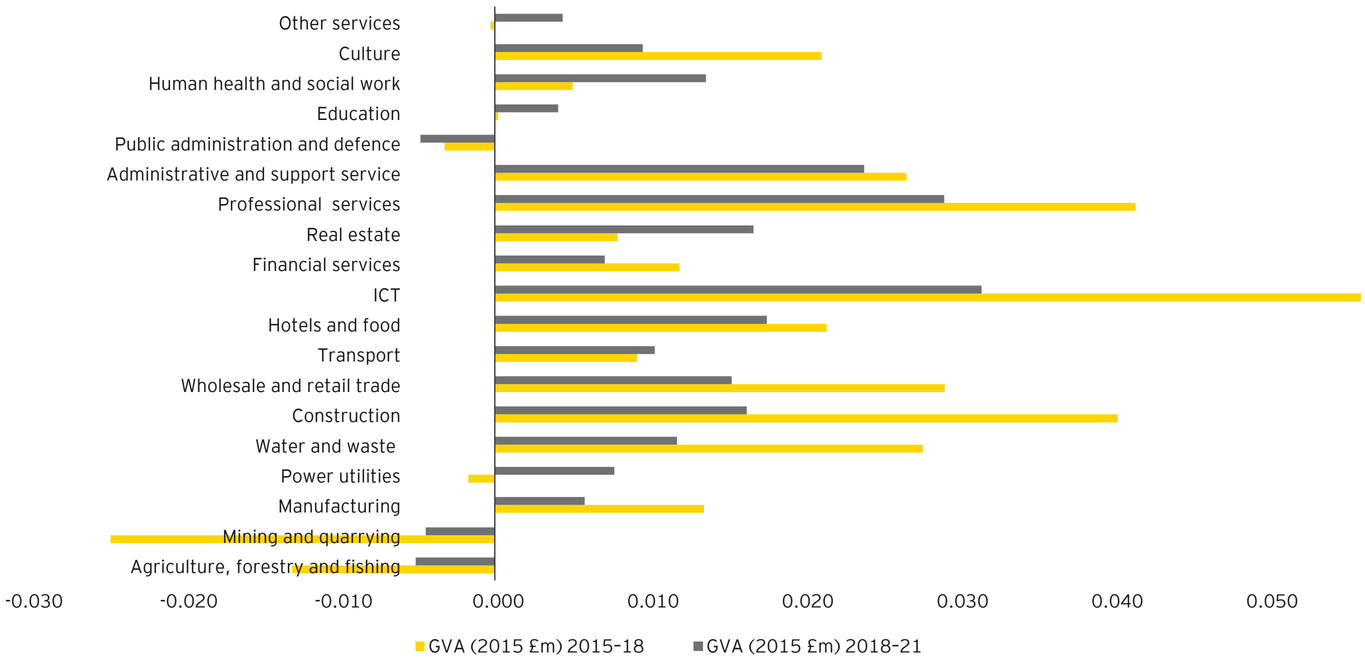
Source: EY ITEM Club

Spotlight on productivity

The sector structure of cities and towns is a significant influence on their short-term economic potential — it takes time to transform an economy so the immediate outlook tends to be driven by the starting point. Our analysis in this report identifies how changing sector growth rates in the UK have shifted the relative performance of places across the UK. A stronger relative performance from manufacturing and some slowing in the traditionally very fast-growing services sectors contributed to more balanced growth across the UK's regions. City and town performance is more volatile as typically a smaller number of sectors shape the level of activity.

Over the next three years we expect growth rates across sectors to slow compared to 2015–2018, and for there to be less difference between the growth of the best-performing sectors and the weaker ones. This will mean growth remains balanced at the regional level although differences in regions will continue to grow between larger and smaller places. With a small number of exceptions, most sectors will grow more slowly over the next three years than the last three, and only the ICT sector will achieve a growth rate of over 3%. This is a significant shift in outlook.

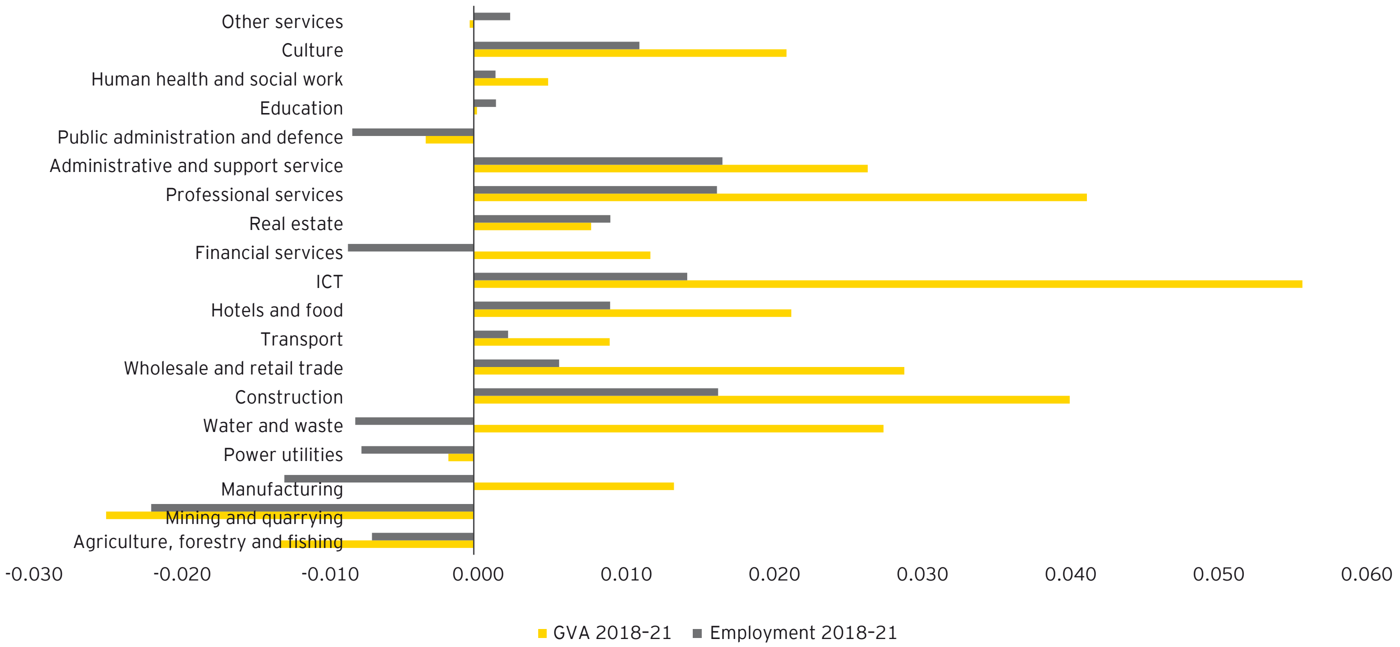
Sector GVA growth 2015–18 and 2018–21



Source: EY ITEM Club

What is even more striking over the next three years is the slowdown in employment creation compared to recent trends. Our forecast shows a slowing in the growth of employment from around 1.4% a year in 2013-2018 to 0.5% a year in 2019-2023. ICT, manufacturing, retail and Financial Services are all signalling that they expect to grow output much faster than employment, leading to higher productivity.

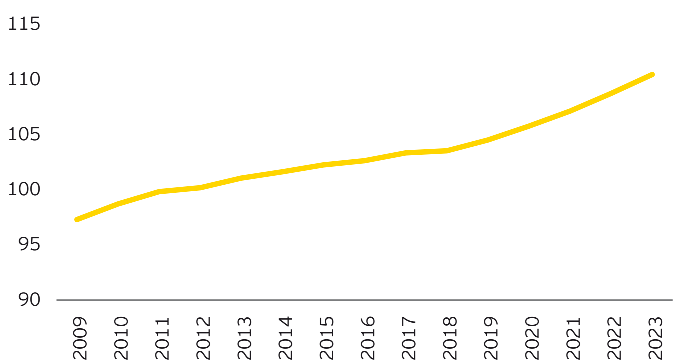
Sector GVA and employment growth 2015-18 and 2018-21



Source: EY ITEM Club

The result of these changes in business models will be an increase in output per worker over the next three years and a welcome rise in the rate of increase in UK productivity. Faced with an expected slowing of EU immigration, an ageing workforce and the scope for technological change, UK businesses do appear to be on the verge of changing their business models and reducing their reliance on hiring to drive growth.

Change in UK GVA/employee 2009-23 (2008 = 100)



Source: EY ITEM Club

Notes on data and forecast assumptions

The forecasts presented in this report are produced using the Oxford Economics Local Authority District Forecasting Model, but are fully consistent with the **UK ITEM Club Autumn 2018 forecast**.

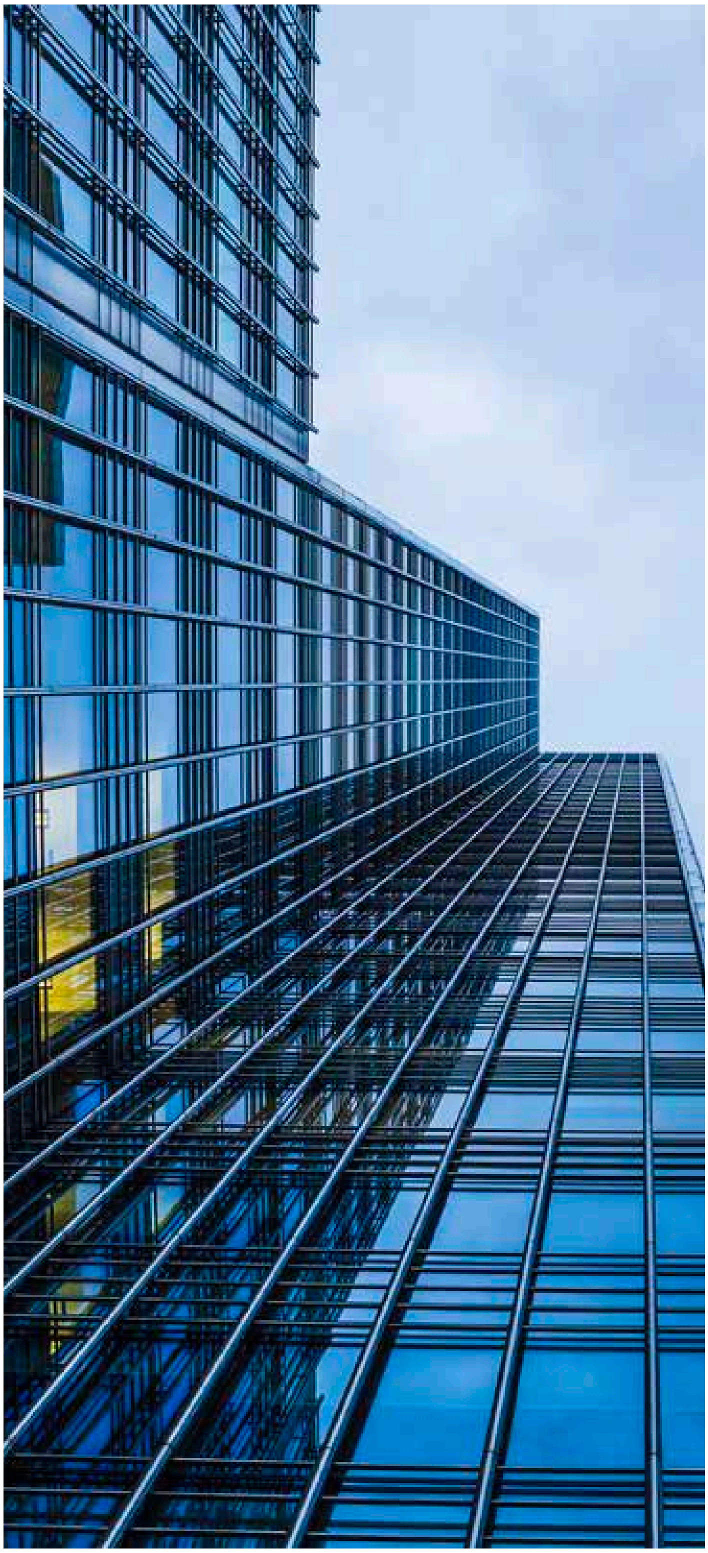
The forecasts depend essentially upon three factors:

- National outlooks.
- Historical trends in an area augmented by local knowledge and understanding of patterns of economic development, built up over decades of expertise.
- Fundamental economic relationships which interlink the various elements of the outlook.

The forecasts are demand-based, and assume no supply-side constants. They also assume the continuation of existing government policies, and those currently announced. While the UK government does not have a specific regional policy, some enterprise support is allocated locally, and infrastructure decisions clearly have regional implications. The devolved administrations have their own responsibilities in these areas, which cause some differences in policies and priorities.

Key data definitions used in this report:

- **Total employment** is jobs-based, and includes employees in employment, the self-employed, Her Majesty's Forces and government supported trainees.
- **GVA data** is presented in 2016 prices and excludes output from the 'extra region'; i.e., the contribution from North Sea oil and gas extraction, UK embassies abroad, and UK forces stationed overseas. The latter are included in the GDP definition used in the EY macroeconomic forecasts.
- **Labour force unemployment** is the official unemployment measure, and refers to the number of jobless people who want to work, are available to work, and are actively seeking employment.
- Any reference to **workforce jobs** relates to employee jobs rather than total workforce jobs, given the volatility of the regional self-employment data.
- The analysis in this report is based on published data available on or before 12 November 2018.



Definitions

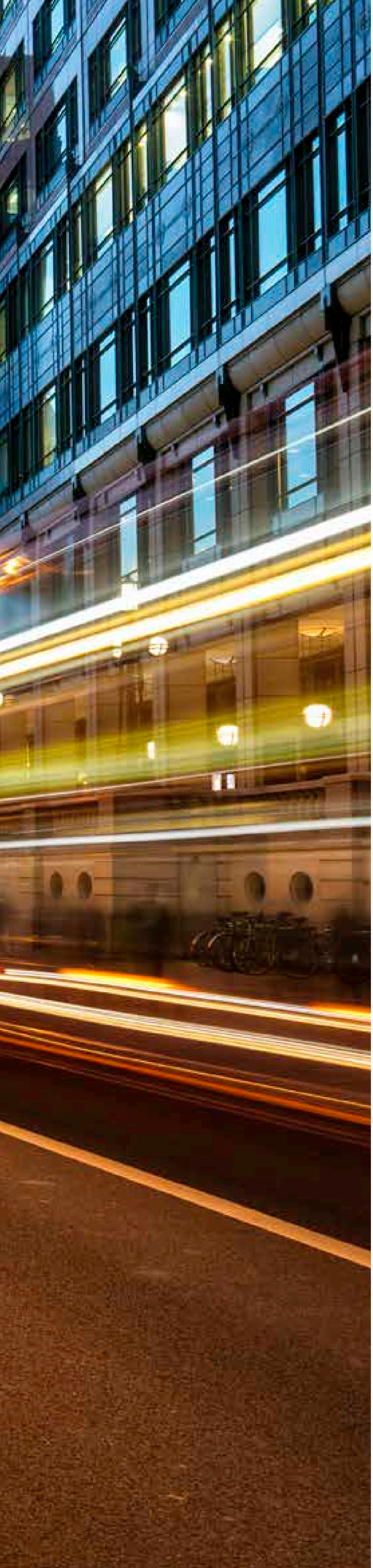
Newcastle	Newcastle upon Tyne LA
Liverpool	Liverpool LA
Manchester	Manchester LA
Kingston upon Hull	Kingston upon Hull UA
Leeds	Leeds LA
Birmingham	Birmingham LA
Cambridge	Cambridge LA
Luton	Luton LA
Reading	Reading UA
Southampton	Southampton UA
South Coast	Bournemouth UA, Poole UA, Test Valley LA, Southampton UA, New Forest LA, Eastleigh LA, Winchester LA, Fareham LA, Gosport LA, East Hampshire LA, Havant LA, Portsmouth UA, Isle of Wight UA
Thames Valley	West Berkshire UA, Reading UA, Windsor and Maidenhead UA, Wokingham UA, Slough UA, Bracknell Forest UA, Basingstoke and Deane LA, Hart LA, Rushmoor LA, Cherwell LA, West Oxfordshire LA, Oxford LA, Vale of White Horse LA, South Oxfordshire LA
Bristol	Bristol LA
Exeter	Exeter LA
Belfast	Belfast LGD
Aberdeen	City of Aberdeen CA
Dundee	City of Dundee CA
Edinburgh	City of Edinburgh CA
Glasgow	City of Glasgow CA
Inverness	Highland CA*
Perth and Kinross	Perth and Kinross CA
Stirling	Stirling CA
Sheffield City Region	
Combined Authority	Barnsley LA, Bassetlaw LA, Bolsover LA, Chesterfield LA, Derbyshire Dales LA, Doncaster LA, North East Derbyshire LA, Rotherham LA, Sheffield LA
Portsmouth	Portsmouth UA
Oxford	Oxford LA
East Anglia	
Combined Authority	Babergh LA, Breckland LA, Broadland LA, East Cambridgeshire LA, Fenland LA, Forest Heath LA, Great Yarmouth LA, Huntingdonshire LA, Ipswich LA, King's Lynn and West Norfolk LA, Mid Suffolk LA, North Norfolk LA, Norwich LA, Peterborough LA, St Edmundsbury LA, South Cambridgeshire LA, South Norfolk LA, Suffolk Coastal, Waveney LA
Tees Valley	
Combined Authority	Middlesbrough UA, Hartlepool UA, Redcar and Cleveland UA, Stockton-on-Tees UA, Darlington UA
Liverpool City Region	
Combined Authority	Halton LA, Knowsley LA, Liverpool LA, Sefton LA, St Helens LA, Wirral LA
Cardiff	Cardiff LA
Milton Keynes	Milton Keynes UA
Swansea	Swansea LA
Sunderland	Sunderland LA
Cornwall	Cornwall UA
West Midlands	
Combined Authority	Birmingham LA, Coventry LA, Dudley LA, Sandwell LA, Solihull LA, Walsall LA, Wolverhampton LA
Greater Manchester	Manchester LA, Stockport LA, Tameside LA, Oldham LA, Rochdale LA, Bury LA, Bolton LA, Wigan LA, Salford LA, Trafford LA

UA = Unitary Authority

LA = Local Authority District

CA = Council Area

LGD = Local Government District



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ED None

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