November 2014

UK Economic Outlook

How robust is the UK consumer recovery?

Getting the balance right in the UK regions

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Contents

Highlights and key messages for business and public policy

- The UK economy has been recovering at a relatively strong rate (compared to other G7 economies) since early 2013, although there have been signs of a slight slowdown in growth since the summer.
- In our main scenario we expect GDP growth to average around 3% in 2014, before easing slightly to around 2.5% in 2015 as consumer spending growth moderates. Risks to growth are weighted somewhat more to the downside now than in July due to potential problems in the Eurozone and global geopolitical risks.
- The services sector will remain the main engine of UK growth for both output and employment, with manufacturing growth having slowed due to renewed stagnation in our key European export markets over the past six months.
- Consumer price inflation is likely to be somewhat below target in 2014-15. We expect the MPC to keep interest rates on hold in the short term, but then to increase them gradually from mid-2015 onwards, perhaps returning to around 4% by 2020. Businesses and households should start to prepare for this upward trend now.

Key projections

	2014	2015
Real GDP growth	3.0%	2.5%
Inflation (CPI)	1.6%	1.7%

Source: PwC main scenario projections

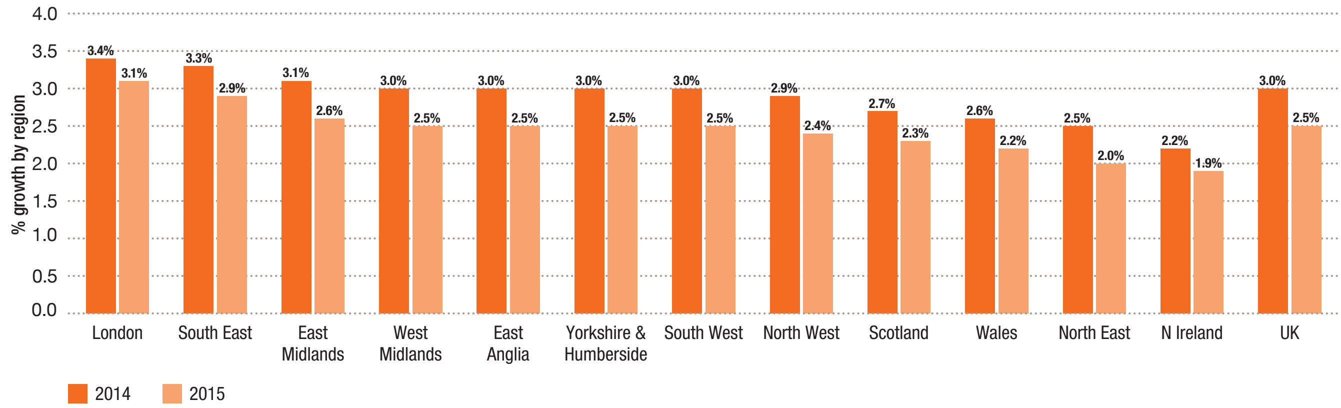
Consumer spending growth set to moderate in medium term

- Consumer spending growth has been boosted over the past two years by a falling savings ratio, but our analysis suggests there are limits to how low this can go.
- Our main scenario envisages consumer spending growth remaining relatively robust at around 2.3% in 2015, but then moderating to around 1.7% per annum on average in 2016-20. This will increase pressure on retailers already hit by fierce price competition and the ongoing shift to online sales.
- Households are likely to have to continue to spend an increasing proportion of their budgets on housing and utilities, rising to over 25% by 2020 in our main scenario projections.

Regional imbalances remain despite positive growth across the UK

- We expect London and the South East to continue to lead the recovery, but all regions should see relatively strong growth in 2014, moderating slightly in 2015 (see Figure 1.1).
- We think greater regional balance would be good for the long-term future of the UK economy. There should be a particular emphasis on building up successful manufacturing and service sectors clusters and improving transport links within regions outside London and the South East, alongside the interconnectivity of these regions to the rest of the world.
- This requires long-term investment in transport infrastructure, skills, knowledge hubs linked to universities and effective local leadership in regions outside London.

Figure 1.1: PwC main scenario for output growth by region



Source: PwC main scenario estimates and projections

1 – Summary

Recent developments

The UK economy grew by 0.7% in the third quarter of 2014 compared to the previous quarter, and was up by around 3% on a year earlier. The recovery has now been sustained at an above trend rate for nearly two years since early 2013 after a couple of sluggish years in 2011 and 2012.

Growth has been driven primarily by services over the past five years, but manufacturing and construction have also been on an upward trend since early 2013. This momentum seems to have waned recently in the case of manufacturing, however, as our key European export markets have lost momentum over the past six months.

The slowdown in the Eurozone has been partly offset by stronger growth in the US since the second quarter of 2014, but more generally international risks have increased over the past six months. Emerging market performance has faltered, with Chinese and Indian growth slowing (but remaining fast in absolute terms) and more marked downturns in economies such as Brazil, South Africa and Turkey. The situation with Russia and Ukraine also remains an important source of geopolitical uncertainty, as do ongoing conflicts in the Middle East and the risk of ebola spreading beyond West Africa. But lower global oil prices have been a positive side-effect of slower global growth from the perspective of UK energy consumers.

UK employment has continued to rise strongly, which has supported consumer spending growth despite persistent subdued rates of average real earnings growth. Rising house prices have also supported consumer confidence and spending, but may now be starting to moderate.

Table 1.1: Summary of UK economic prospects

Indicator (% change on previous year)	OBR forecasts (March 2014)		Independent forecasts (October 2014)		PwC Main scenario (November 2014)	
	2014	2015	2014	2015	2014	2015
GDP	2.7	2.3	3.1	2.6	3.0	2.5
Consumer spending	2.1	1.8	2.4	2.6	2.2	2.3
CPI	1.9	2.0	1.7	2.0	1.6	1.7

Source: Office for Budget Responsibility (March 2014), HM Treasury survey of independent forecasts (average values in October 2014 survey) and PwC main scenario.

Business investment has also shown signs of stronger recovery in the latest revised official data, accounting for around a third of total GDP growth over the past year, although this has not yet translated into stronger productivity growth. Public spending cuts have slowed down over the past year, but will remain a drag on growth for many years to come.

The rate of consumer price inflation (CPI) has drifted down over the past year as import price inflation has moderated and is now some way below its 2% target rate.

Future prospects

As shown in Table 1.1, our main scenario is for UK GDP growth to average around 3% in 2014 and around 2.5% in 2015. This is similar to the latest consensus forecasts and slightly more optimistic than the OBR was in March.

Consumer spending growth is projected to be broadly similar to GDP growth next year, but with some moderation after 2015 as discussed further below.

Investment growth has picked up strongly recently according to both latest official estimates and recent business surveys. We expect continued relatively strong investment growth in 2015, but perhaps at a slightly slower rate than in 2014 as business confidence could be affected by increased international risks.

Net exports have been erratic and we do not expect them to make a material positive contribution to growth in 2015 given ongoing problems in the Eurozone in particular.

As always there are many uncertainties surrounding our growth projections, as illustrated by the alternative scenarios in Figure 1.2. There are still considerable downside risks relating to trends in the Eurozone and emerging markets (including Ukraine and the Middle East as well as ebola in West Africa), and these do seem to have increased since our last report in July. But there are also upside possibilities if these problems can be avoided and a virtuous circle of rising confidence and spending can be established as in past economic recoveries.

Inflation has fallen below the 2% target since January 2014 for the first time in more than four years, and we expect it to remain below target in 2015 (see Table 1.1). There could still be upside risks to this inflation outlook in the longer term, however, if stronger global growth pushes commodity prices up again at some point, or if domestic wages start to recover without a corresponding rise in productivity.

We do not expect any immediate rise in official UK interest rates, but a gradual upward trend seems likely to begin during the course of 2015 although market expectations of the timing of the first rate rise have been pushed back to the middle of next year. In the long term, however, we would still expect official rates to return to a more normal level of perhaps around 4% by 2020.

Higher interest rates will help savers and reduce pension fund deficits, but borrowers (including businesses and the government) might gain from locking in funding now for long term investments such as infrastructure and housing. Households need to bear in mind likely future interest rate rises in any decisions on mortgages or other longer term loans.

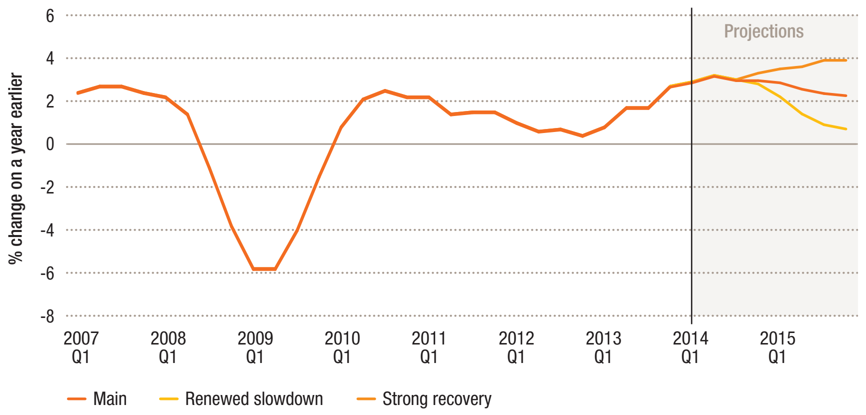
How robust is the UK consumer recovery?

As discussed in detail in Section 3 of this report, consumer spending growth has been relatively strong for the past two years despite weak wage growth. This has been due to strong employment growth, increased income tax personal allowances and low mortgage interest rates, all of which have boosted real incomes. In addition, increased confidence and borrowing since mid-2012 have been reflected in a falling savings ratio, giving an extra boost to spending over and above disposable income growth.

Looking ahead, our analysis suggests that the downward trajectory in the household savings ratio is projected to continue, but the pace and duration of this further decline is unclear.

In our main scenario, we project that real household spending growth will remain relatively strong at around 2.3% in 2015, but this could then slow in the medium term to an average of around 1.7% per annum in 2016-20 as the savings ratio bottoms out and spending growth has to rely on increases in real disposable incomes (see Table 1.2).

Figure 1.2: Alternative UK GDP growth scenarios



Source: ONS, PwC scenarios

Table 1.2: Main scenario projections of growth in real household expenditure

% per annum	2014	2015	2016-20
Real household disposable income	1.4%	1.5%	1.4%
Adjusted savings ratio level	0.5%	-0.3%	-1.0%
Real household expenditure	2.2%	2.3%	1.7%

Source: PwC analysis – adjusted savings ratio defined as difference between household disposable income and expenditure, expressed as a % of disposable income

Other scenarios show a range in medium-term real consumer spending growth of around 1.5-2% after 2015, but in general we would expect this to remain relatively subdued by historic standards. This will increase the pressure on retailers already affected by tough price competition and digital disruption to their established business models as the shift to online sales continues.

Finally, using our main scenario for total spending, we project that, by 2020, households will have to allocate more than 25% of their budgets to spending on housing and utilities, continuing the long-term upward trend in the importance of this spending category.

Getting the balance right in the UK regions

In Section 4 of the report our senior economic adviser, Andrew Sentance, looks in detail at the current evidence on regional differences within the UK economy, and discusses policy proposals which might contribute to a more balanced pattern of economic growth. He notes that the days when the north of England and the midlands were the industrial heartlands of the British economy, with manufacturing industry accounting for a third or more of employment and GDP, are long gone. The UK is now a post-industrial economy, in which manufacturing accounts for about 10% of GDP and around 8% of total employment. In all UK regions, the services sector is now the key driver of economic growth, accounting for around 70-75% or more of economic activity and employment, although manufacturing's share of GVA in 2011 does vary from a high of 17% in Wales to just 3% in London.

The UK still has some important clusters of manufacturing strength in areas like cars, aerospace, pharmaceuticals and high value consumer brands that should not be neglected. But it is the services industries which will make the biggest contribution to growth in all regions in the modern post-industrial British economy. Building on the UK's strong position as a services exporter will therefore be a key factor shaping regional success.

The strength of London and the south of England in services industries – particularly business and financial services – is a key factor underpinning the regional disparities which exist in the UK today. London is one of the top global cities in the world (albeit with challenges of its own in terms of housing affordability, transport congestion and pockets of severe deprivation) – and its pre-eminence has not been significantly dented by the financial crisis. The challenge for other UK cities and regions is to develop their own strengths and capabilities in a world where comparative advantage in services, which can be complementary to maintaining a competitive edge in manufacturing, is the main source of economic progress for the UK economy in the future.

The final section of the article discusses the policy agenda for supporting more balanced regional growth. Four key regional growth levers are identified:

- developing knowledge hubs and centres of expertise, enterprise and competitive advantage, particularly linked to universities;
- providing efficient transport and digital infrastructure to support local connectivity and links to the global economy;
- investing in a high level of skill and capability across the workforce to support local business and encourage inward investment; and
- encouraging the role of local and regional leadership – through a process of gradual devolution and decentralisation of control over issues relevant to economic development.

2 – UK Economic prospects

Key points

- The UK economy has continued to grow reasonably strongly with a preliminary estimate showing quarter-on-quarter growth of 0.7% in Q3 2014, although this did represent a slight slowdown from the previous quarter.

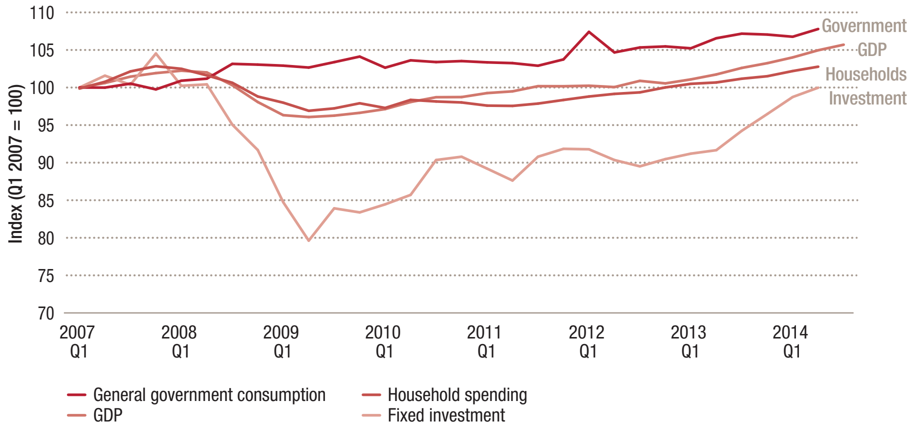
- In our main scenario, we expect the UK economy to grow by around 3% this year, moderating somewhat to around 2.5% in 2015 as consumer spending becomes more constrained by disposable income growth.

- The services sector has continued to drive the UK recovery. Manufacturing output has also been growing, but the outlook for this sector is less bright than it was earlier in the year due to the recent slowdown in the Eurozone.

- London is expected to remain the UK's fastest growing region in 2014 and 2015, but all regions are expected to see average growth of at least 1.9% per annum over these two years.

- The UK recovery is still vulnerable to downside risks including continued slow economic growth in the Eurozone and an escalation of geopolitical tensions in Russia/ Ukraine and/or the Middle East. However, there are also upside possibilities such as increased business investment as the recovery strengthens and faster than expected falls in unemployment acting as a driver for household spending. On balance, however, risks have tilted somewhat to the downside since our last report in July.

Figure 2.1: GDP and key components of domestic demand



Source: ONS

- Our main scenario is for annual consumer price inflation to remain below the Monetary Policy Committee's 2% target in 2014-15. We expect that the official interest rate will begin to rise gradually during 2015, but the timing of the first rate rise remains highly uncertain.

Introduction

In this section of the report we describe recent developments in the UK economy and review future prospects. The discussion covers:

2.1 Recent developments and the present situation

2.2 Economic growth prospects: national, sectoral and regional

2.3 Outlook for inflation

2.4 Monetary and fiscal policy options

2.5 Summary and conclusions

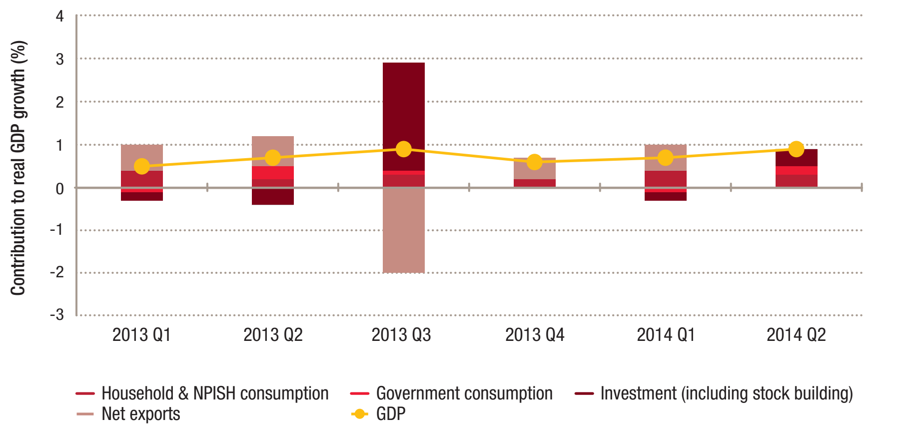
2.1 – Recent developments and the present situation

UK GDP grew by 0.7% in the third quarter of 2014 after growing by 0.9% during the second quarter. This is based on the preliminary estimate of third quarter GDP; however there is no data yet on the expenditure components of GDP in Q3 (which is why the components lines do not extend quite as far as the GDP line in Figure 2.1). It should be noted that the methodology used to compile the UK national accounts was updated during September 2014, which has changed the historical data. We discuss the consequences of this change in Box 2.1. GDP is now estimated to have moved above its pre-financial crisis peak in the third quarter of 2013, as can be seen in Figure 2.1. This chart also shows the strong recovery in fixed investment resulting from the methodological change. It is still below its pre-crisis peak, but is much closer to it now than was previously estimated.

Figure 2.2 shows the recent contributions to GDP growth of the expenditure components. Household spending has contributed positively to growth throughout the period covered by this chart (as discussed in more detail in Section 3 below). The large contribution from gross capital formation (investment) in the third quarter of 2013 can be explained by a large swing in the level of stock building, which can be quite erratic, but this was offset by the negative contribution of net exports in that quarter. Government consumption has had only a modest effect on growth over the period.

At a sector level, the services sector continues to outperform manufacturing and construction, and output in this sector is now some way above its pre-crisis peak, as shown in Figure 2.3. Despite output levels in the manufacturing and construction sectors being on an upward trend, both are still well below their pre-crisis peaks.

Figure 2.2: Contributions to real GDP growth

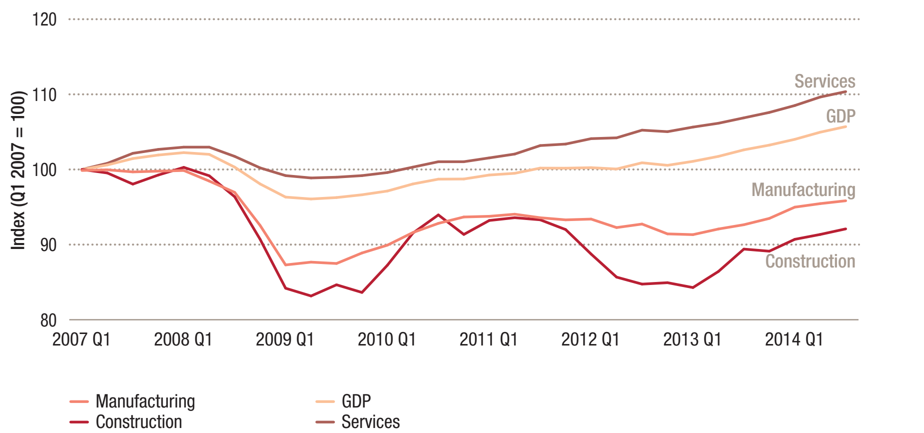


Source: ONS
Note: Components may not sum due to rounding

Manufacturing growth has been supported recently by falling producer prices; however, the disappointing economic performance of the Eurozone poses a threat to continued growth, as demand for UK manufacturing exports could fall as a result.

Despite the general upward trend in construction, recent official data has been less positive. Construction output fell by 0.3% in August 2014 compared with a year earlier, the first such decline since May 2013. Housebuilding remains relatively strong for now, but could slow down if, as expected, we see some cooling down of house price inflation over the next year.

Figure 2.3: Sectoral output and GDP trends



Source: ONS

The UK recovery is still blighted by slow productivity growth. Figure 2.4 shows that jobs growth has been particularly strong since early 2013. The latest estimate of the unemployment rate is just 6%, the lowest since September 2008. However, productivity has been broadly flat since the middle of 2012.

This is even more puzzling given the stronger revised investment data. One possible explanation for the productivity puzzle had been that low levels of investment were keeping productivity low. A rise in investment normally means that workers can increase the level of output they are able to produce in a given period of time. However, the latest data show that investment has been rising strongly since the end of 2012, but workers are not more productive.

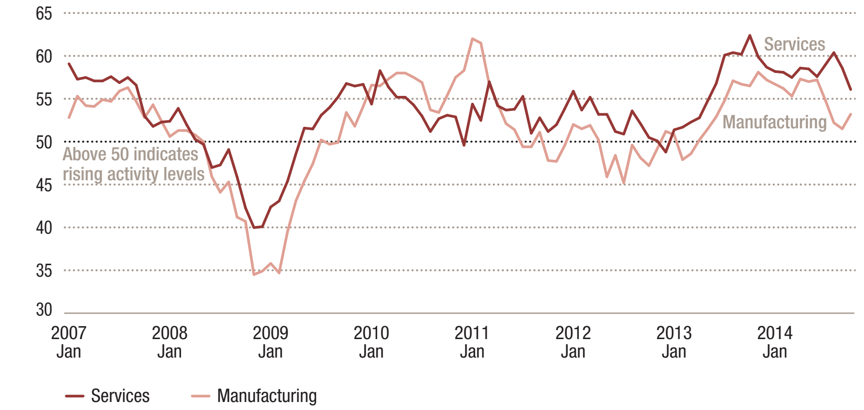
Real wages have also been falling steadily over time though recent falls in inflation are reducing the speed of this decline. The labour market seems to be in a state of adjustment, with increased labour supply from immigrants, older workers and others boosting employment but keeping average real wages and productivity relatively subdued in recent years. However, as unemployment falls further and existing spare capacity is reduced, productivity and real wages should start to rise at some point, though the timing of this remains highly uncertain.

Business surveys suggest that activity levels in the services and manufacturing industries have continued to grow in recent months. The latest Markit/CIPS Purchasing Managers' Indices (PMIs) were both above 50 (as shown in Figure 2.5). The services sector has fallen back recently but remains significantly above 50 suggesting it will continue to power the UK's recovery. However, the story is less positive for manufacturing, where growth has fallen back since June, due in part to weaknesses in the Eurozone that suggest a fall in demand for UK manufacturing exports.

Figure 2.4: Employment is rising strongly but productivity has been broadly flat

Source: ONS

Figure 2.5: Purchasing manager's indicies of business activity



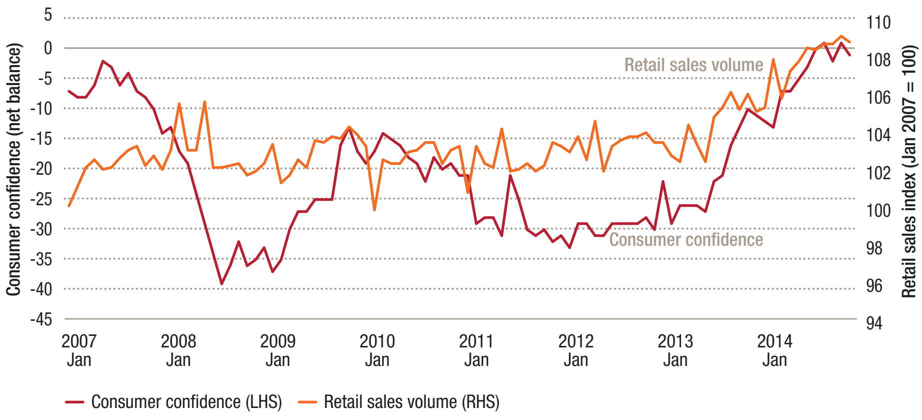
Source: Markit/CIPS

Figure 2.6 shows the evolution of consumer confidence and retail sales. During the financial crisis and subsequent downturn the two did not really move together but, since 2013, both have been on an upward trajectory as the recovery in the UK has strengthened.

House prices have continued to increase, driven by price rises in London where the latest figures state that prices rose by 19.6% in the year to August. However, there are signs that the London market may be cooling as prices actually fell by 0.1% when looking at the month-on-month change. Our house price growth projection for 2014 is 8%-10%, with an expected average UK house price of between £261,000 and £266,000, but we expect some moderation in growth in 2015.

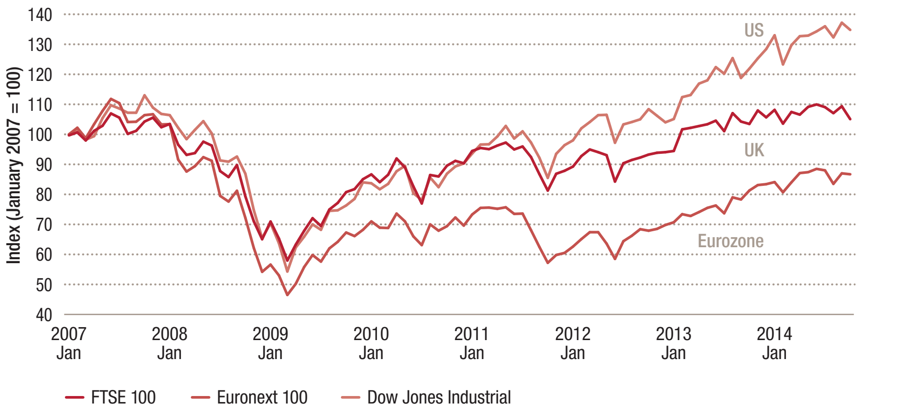
Equity market indices had been relatively strong in the UK, US and Eurozone until early September (see Figure 2.7). Since then, however, share prices have fallen back amid concerns about the outlook for global GDP growth, rising geopolitical risks and the upcoming normalisation of monetary policy in the US and UK. But it is worth pointing out that these falls are not large relative to earlier increases.

Figure 2.6: Consumer confidence and retail sales



Sources: GfK (on behalf of the European Commission), ONS, Thomson Reuters Datastream

Figure 2.7: Equity market indices



Source: Thomson Reuters Datastream

Box 2.1

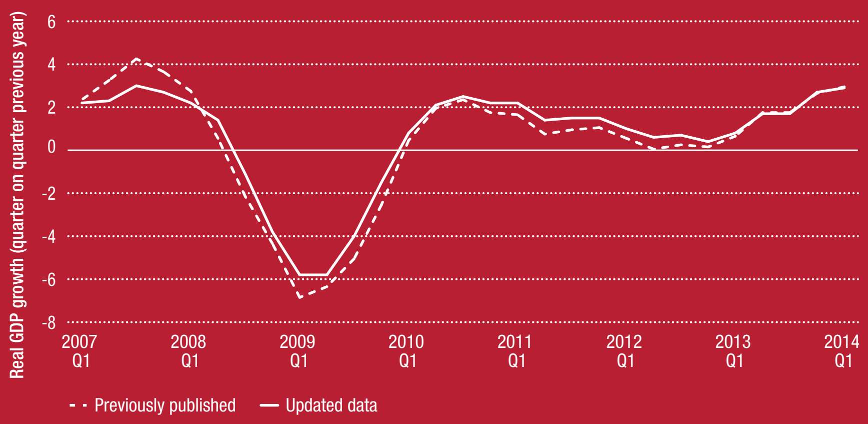
Effect of changes to UK national accounts in September 2014

On 30th September, the ONS released a revised set of UK national accounts, which were the first to reflect a series of significant methodological changes, including the switch to the new ESA 2010 accounting standards that are being rolled out across the EU this year.

One of the main effects of these changes was to alter the historical path of real GDP growth. Figure 2.1.1 shows that the UK experienced a less extreme contraction as a result of the global financial crisis. Growth rates during 2007 and the first quarter of 2008 have been revised downwards while the deepest contractions have been revised upwards. The effect of these changes is that the fall in GDP from Q1 2008 to Q2 2009 is now estimated to be 6.0%, as compared to the 7.2% fall in the previously published data. The recovery up to the end of 2012 is now stronger than had previously been thought, but after that it has remained broadly unchanged (though this could be revised too in later years). GDP is also now estimated to have passed its pre-crisis peak in the third quarter of 2013. The revisions to GDP have also led to real GDP per capita being higher than thought, although it remains around 1% below its pre-crisis peak due to increases in the size of the UK population.

Another significant result of this new methodology is that the fall in total fixed investment during the recession is now estimated to have been somewhat less extreme than had been thought and the recovery has been considerably stronger, although it has still not regained its pre-crisis peak. This pattern can also be seen in revisions to business investment – as shown in Figure 2.1.2 – and this is actually now estimated to be back above its pre-crisis level.

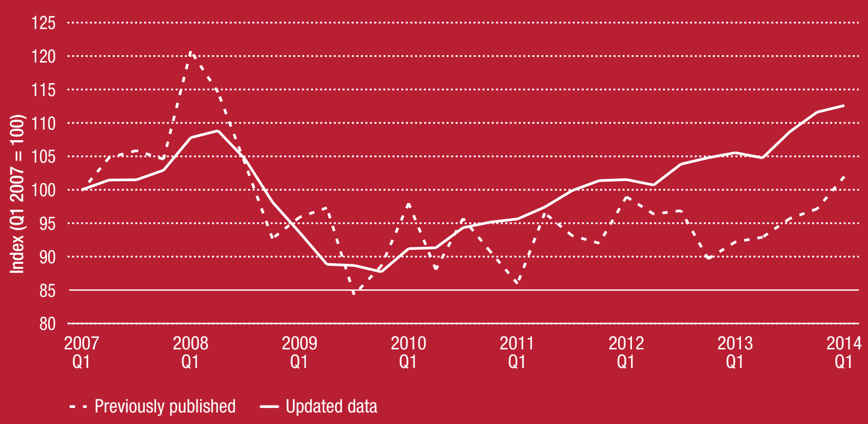
Figure 2.1.1: Change in real GDP growth rates resulting from the new national accounts methodology



Source: ONS

One of the main reasons behind the rise in fixed investment is that R&D spending is now classed as investment as opposed to intermediate consumption. The ONS estimates that this revision is responsible for around 75% of the change in nominal fixed investment.

Figure 2.1.2: Change in business investment resulting from the new national accounts methodology



Source: ONS

2.2 – Economic growth prospects: national, sectoral and regional

We are projecting GDP growth of around 3% in 2014, falling slightly to around 2.5% in 2015 as growth in domestic demand moderates.

Our overall GDP growth projections are largely unchanged from the July edition of this report, though we have revised our estimates for the expenditure components in line with new data releases and the change in methodology described in Box 2.1.

Our main scenario projection envisages faster growth in consumer spending in 2014 than last year as confidence amongst households about the recovery has risen and employment has increased sharply. Consumer spending growth is then expected to flatten off, however, as it becomes more dependent on disposable income growth rather than, as in 2013-14, a falling savings ratio (see Section 3 below for a more detailed discussion of this point).

We are projecting strong growth in fixed investment this year and next. One reason for this is that fixed investment still has to regain its pre-crisis level so is rising from a lower base than the other major components of domestic demand (see Figure 2.1). The second reason is that, with the recovery well underway and interest rates still at historically low levels, businesses are expected to take advantage of the favourable climate to increase their investment levels.

Government consumption is likely to increase at a slower rate than consumer spending and fixed investment, as the government continues in its attempts to reduce the budget deficit.

Table 2.1: PwC main scenario for UK growth and inflation

(% real annual growth unless stated otherwise)	2013	2014p	2015p
GDP	1.7%	3.0%	2.5%
Consumer spending	1.6%	2.2%	2.3%
Government consumption	0.7%	1.0%	0.7%
Fixed investment	3.2%	7.9%	5.4%
Domestic demand	1.9%	2.9%	2.6%
Net exports (% of GDP)	0.0%	0.1%	-0.1%
CPI inflation (%: annual average)	2.6%	1.6%	1.7%

Source: ONS for 2013, PwC main scenario projections for 2014-15.

Table 2.2: Official and independent forecasts

(% real YoY growth unless stated otherwise)	Latest estimates	OBR forecasts (March 2014)		Average independent forecast (October 2014)	
	2013	2014	2015	2014	2015
GDP	1.7%	2.7%	2.3%	3.1%	2.6%
Manufacturing output	-0.1%	N/A	N/A	3.2%	1.9%
Consumer spending	1.6%	2.1%	1.8%	2.4%	2.6%
Fixed investment	3.2%	8.6%	8.2%	8.3%	6.7%
Government consumption	0.7%	1.2%	-0.5%	0.8%	0.2%
Domestic demand	1.9%	2.9%	2.2%	2.9%	2.7%
Exports	0.5%	2.6%	4.7%	0.3%	3.9%
Imports	0.5%	3.0%	4.3%	0.0%	4.0%
Current account (£bn)	-72	-40	-34	-71	-65
Unemployment claimant count (Q4 m)	1.3	1.2	1.1	1.0	0.9

Source: ONS for 2013, OBR Economic and Fiscal Outlook (March 2014), HM Treasury Forecasts for the UK economy: a comparison of independent forecasts (October 2014)

We are expecting the contribution of net exports to growth to remain low, reflecting the slowdown in the Eurozone, the UK's largest export market, and continuing geopolitical risks in Russia/Ukraine and the Middle East, which could put downward pressure on global growth and business confidence more generally.

Comparing Tables 2.1 and 2.2 shows that our GDP projections are slightly higher than those of the OBR, though these forecasts are from their March 2014 Economic and Fiscal Outlook and so are rather out of date now. Our GDP growth projections are quite close to the average of the independent forecasts in the Treasury's October 2014 survey, which is a more timely report.

As usual, we have developed two additional scenarios to reflect the uncertainty around our main scenario projections, as shown in Figure 2.8:

- Our **'strong recovery' scenario** projects growth picking up to around 3.7% in 2015, rather than moderating to around 2.5%. This relatively optimistic scenario assumes a quicker recovery in the Eurozone economy than in our main scenario, boosting consumer and business confidence in the UK. This would result in businesses undertaking more investment activity and a rise in the purchase of consumer goods, as well as higher demand for UK goods abroad. This scenario also assumes that economic growth will be higher in the UK's other key trading partners such as the US.

- Our **'renewed slowdown' scenario**, by contrast, sees UK growth falling back more sharply to just 1.3% next year. This is assumed to be the result of a renewed recession in the Eurozone, a poor economic performance in some emerging markets, and further flare-ups in Russia/Ukraine and the Middle East. These events would likely reduce the appetite for businesses to invest in new capital and see them slow down their recruitment efforts. Consumer spending would also be expected to slow in this scenario as confidence fades.

Despite neither of these scenarios being as likely as our main scenario, they are certainly well within the bounds of plausibility. Businesses should ensure they have contingency plans in place to deal with these kinds of events if they do arise.

Figure 2.8: Alternative UK GDP growth scenarios

Source: ONS, PwC scenarios

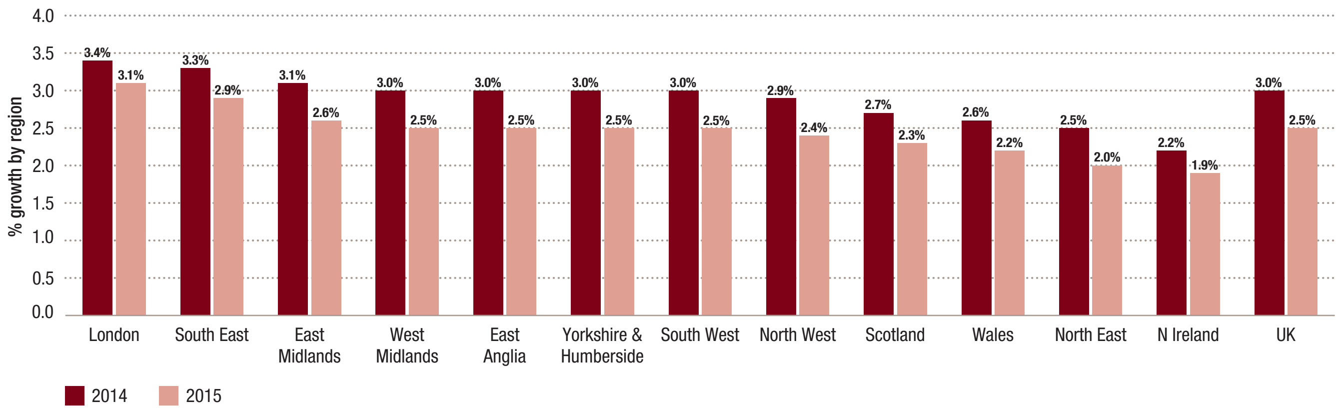
The UK is expected to grow faster than any of the other G7 economies this year but going forward, downside risks such as continued slow growth in the Eurozone and increased geopolitical risks seem now to somewhat outweigh the upside possibilities of increased business investment and faster than expected decreases in the unemployment rate. The balance of risks does seem to have tilted more to the downside since our last report in July, due primarily to adverse international developments in the Eurozone and beyond. But this has had less effect on our main scenario projections.

Table 2.3: UK sector dashboard

	Growth			
Sector and GVA share	**2013**	**2014p**	**2015p**	**Key issues/trends**
Manufacturing (10%)	-0.1%	3.6%	2.8%	The manufacturing PMI surveys have shown mainly falling, but still positive, growth in the last few months (as has official data for Q3). Weakness in the Eurozone economy could put downward pressure on exports of UK manufacturing goods.
Construction (6%)	1.5%	5.0%	2.2%	The construction PMI has been indicating strong growth in the sector. Private housing construction has been a source of strength. New private housing output was 13% higher in August than it was a year earlier. However, over the month it fell by 5.5% suggesting that new private house building might be starting to slow.
Distribution, hotels & restaurants (14%)	3.6%	4.2%	2.6%	Retail sales have been on a generally upward trend since 2013, but growth slowed in Q3. Falling unemployment should see further increases in retail spending, although subdued real wage growth is an offsetting factor.
Business services and finance (31%)	2.3%	4.0%	3.5%	The UK has a large and relatively strong business services and finance sector, and while it too is vulnerable to events in the Eurozone, it could become more important to the UK's growth prospects if manufacturing slows down further as a result of continued weakness in Europe.
Government and other services (23%)	0.4%	1.3%	1.2%	Government spending should continue rising but at a relatively modest pace given the continued austerity programme.
Total GDP	**1.7%**	**3.0%**	**2.5%**	

Sources: ONS for 2013, PwC for 2014 and 2015 main scenario projections and key issues. These are only five of the most important sectors of the economy, so their GVA shares only add up to around 84% rather than 100%.

Figure 2.9: PwC main scenario for output growth by region



Source: PwC analysis

Sectoral prospects

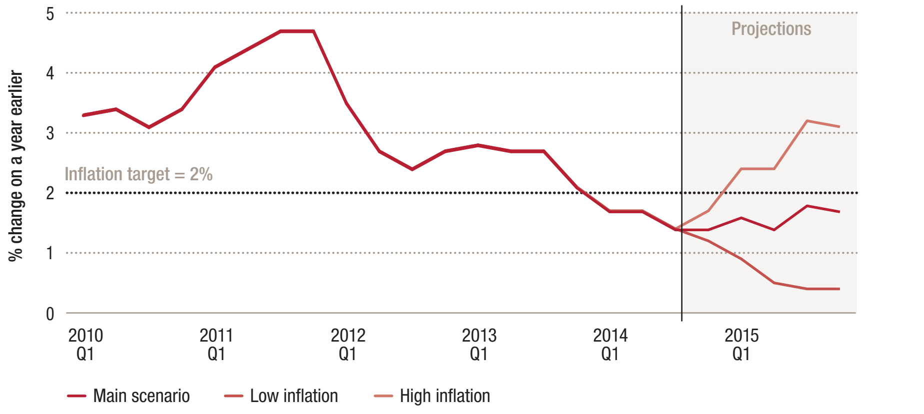
Table 2.3 shows the actual growth rates for 2013, alongside our projected growth rates for 2014 and 2015, for five of the main sectors within the UK economy. The table also includes a summary of the main factors affecting, or likely to affect, each particular sector.

Regional prospects

Figure 2.9 shows our projections for growth in the main UK regions this year and in 2015. London and the South East are expected to be the two fastest growing regions this year and next while Scotland, Wales and Northern Ireland are expected to grow more slowly than the UK average rate. For a detailed discussion of regional rebalancing see Section 4 below.

It should be noted that regional data is much less timely than national data – the latest available regional GVA data is for 2012. As a result, the margins of error around these regional projections are even larger than for the national growth projections and so they can only be taken as illustrative of broad directional trends. Small differences in projected growth between regions are not of any practical significance.

Figure 2.10: Alternative UK inflation (CPI) scenarios



Source: ONS, PwC scenarios

2.3 – Outlook for inflation

Inflation has been falling during the last few months and is currently well below the Monetary Policy Committee's target of 2%. Motor fuel prices and food prices, which have contributed significantly to slowing inflation, fell by 6% and 1.5% respectively in the year to September.

There are several possible explanations for why inflation has been coming down. The value of sterling has risen over the past 18 months making imports relatively cheaper while low inflation in the Eurozone is also likely to be reducing the amount of inflation being imported from the UK's largest trading partner. Oil prices have also fallen significantly recently, pushing down the price of motor fuels and other oil-related products.

In our main scenario, we expect the annual rate of inflation on the Consumer Prices Index (CPI) measure to average 1.6% this year. This is above the inflation rate of 1.2% recorded for September, which was driven down by falling transport costs, particularly in air and sea fares, which often fall in September after the summer holiday season ends. We expect inflation to rise slightly to an average of around 1.7% next year, but to remain below the Monetary Policy Committee's 2% target.

As with our GDP scenarios, we have also considered two additional scenarios for UK inflation in the rest of 2014 and 2015 (see Figure 2.10):

- In our **'high inflation' scenario**, we assume that stronger global growth will push commodity prices back up in 2015 and there will be higher domestic demand for both goods and services. These events could lead to the average annual inflation rate moving back up to around 2.8% next year.

- In our **'low inflation' scenario**, by contrast, we assume that UK domestic demand growth will be slower, global GDP growth rates decline and commodity prices fall. As a result the average annual inflation rate under this scenario would decline to only 0.5% in 2015, pushing the UK close to the kind of deflation that is a concern at present in the Eurozone.

As for growth, neither of these scenarios is as likely as our main scenario, but businesses should plan for such contingencies.

2.4 – Monetary and fiscal policy options

The Monetary Policy Committee kept the Bank Rate at 0.5% and the level of Quantitative Easing at £375bn at its October meeting.

The majority of Committee members felt that key indicators, such as unit labour cost growth, were not indicative of strong upcoming inflationary pressures and felt that it was appropriate to keep the interest rate unchanged in the light of recent adverse trends in the Eurozone and elsewhere.

However, two MPC members disagreed as they have done consistently since August, instead wishing to raise the Bank Rate by 0.25 percentage points to head off the future inflationary effects of possible rises in wage growth as spare capacity in the labour market is eroded.

It now appears unlikely that the Bank Rate will rise during this calendar year, but we do expect the interest rate to start rising gradually during 2015. However, any rises are expected to be very gradual: broadly speaking, we might expect interest rates to increase to about 2-2.5% by the end of 2017 and around 4% by 2020. Business and individuals should factor such rises in the cost of borrowing into their forward plans, as well as stress testing against larger and quicker rate rises where these would have important adverse effects on their finances.

The latest public sector finances data showed public sector net borrowing (excluding public sector banks) was around £5.4 billion higher from April to September 2014 as compared with the same six month period in 2013. This was partly due to timing effects, but relatively weak wage growth does seem to be holding back income tax receipts in particular relative to the March OBR fiscal forecasts.

The data suggest that the government still has a lot of work to do to bring the budget deficit down. However, we do not expect there to be any large changes in the government's fiscal stance as part of the Autumn Statement, with any net 'giveaways' on tax and spending being broadly matched by net 'takebacks'.

2.5 – Summary and conclusions

The recovery is now well underway and the UK is expected to be the fastest growing of the G7 advanced economies in 2014. Consumption has been a key driver of this growth and recent data changes have also shown that business investment has been stronger than had previously been thought in recent years.

In our main scenario, we expect the UK economy to grow by around 3% in 2014 before slowing slightly to around 2.5% in 2015 as domestic demand growth moderates. We expect London and the South East to continue to be the fastest growing regions both this year and next, but all regions should see reasonable positive growth over this period.

Our main scenario projection is for inflation to remain below the Monetary Policy Committee's (MPC) inflation target of 2% in 2015, but despite this we expect the Bank Rate to begin to rise gradually during the course of the next year as the recovery continues. We do not expect any major fiscal policy changes in the upcoming Autumn Statement despite the latest public sector finances data showing an increase in net borrowing in the year-to-date.

Downside risks to the UK recovery have picked up somewhat since our last report in July, in particular due to continued very sluggish growth in the Eurozone and a heightening of geopolitical tension in Russia/Ukraine and the Middle East. There are also some upside possibilities, however, such as a stronger than expected rise in business investment and faster than expected falls in unemployment. At present, however, the balance of risks to growth appears to be weighted slightly to the downside relative to our main scenario.

In summary, the UK recovery remains relatively strong, but it may not be all plain sailing ahead.

The UK recovery remains relatively strong, but it may not be all plain sailing ahead.

3 – How robust is the UK consumer recovery?

Key points

- Consumer spending has grown around 2% per annum faster than inflation over the past two years, despite continued declines in real wages.

- This reflects rising employment levels, declining real income tax payments and a decline in the adjusted household savings ratio as consumers have grown more confident in light of improving general economic conditions in the UK and rising house prices.

- Looking ahead in our main scenario we expect the savings ratio to continue its downward trajectory in 2015 before stabilising in the medium term. This means that consumer spending growth will become more dependent on real income growth after 2015.

- As a result, we expect real consumer spending growth to slow from around 2-2.5% per annum in 2014-15 to around 1.5-2% per annum in the rest of this decade, depending on the assumptions made on house prices and household borrowing and saving rates.

- Our main scenario is for real consumer spending growth to average just 1.7% per annum in 2016-20, which will increase the pressure on retailers already suffering from intense price competition and the structural disruption of digital.

- In this main scenario, we project that households will spend more than a quarter of their total budgets on housing and utilities by 2020. We also expect that spending on financial services will tend to increase again later in the decade as interest rates gradually rise.

Introduction

Consumer spending has played a leading role in the UK recovery to date, but how robust is this? What might throw the recovery off track over the next few years? And which areas of consumer spending might grow the fastest over the rest of this decade?

To answer these questions, we need to look in detail at what the latest revised national accounts data tells us about the drivers of consumer spending in recent years. This will then provide us with a foundation to look at the prospects and risks relating to future consumer spending. To do this it is convenient to consider separately the two key determinants of consumer spending growth:

- **real disposable household income growth**, which in turn splits down into trends in real income from employment, state benefits and pensions and other private income; and

- **movements in the household savings ratio**, which are influenced in particular by wealth effects (notably house price trends) and household debt to income ratios.

The discussion in the rest of the article is organised as follows:

- Section 3.1 looks at past trends and future prospects for each of the key determinants of real household disposable income growth;

- Section 3.2 looks at past trends and future prospects for the household savings ratio;

- Section 3.3 brings this analysis together to set out three alternative scenarios for consumer spending growth over the period to 2020;

- Section 3.4 estimates how spending growth to 2020 may break down by category in our main scenario; and

- Section 3.5 summarises and draws conclusions from the analysis.

3.1 – Trends and prospects for real household disposable income

Historic trends in household disposable income

The ONS defines household disposable income as the sum of earnings, state transfers (e.g. social security benefits or other social assistance) less taxes (mainly income tax and national insurance).

Table 3.1: Key drivers of household expenditure

	£ billion		Average growth rates per annum		
	2014	2015	2014	2015	2014
Wages and salaries	173	184	3.0%	1.8%	1.3%
Household share of gross operating profits	56	61	4.3%	1.8%	2.5%
Pre-tax earnings	**229**	**245**	**3.3%**	**1.8%**	**1.6%**
Income tax paid	- 46	-48	1.9%	1.8%	0.1%
National insurance contribution by workers	- 31	-33	3.2%	1.8%	1.5%
Post-tax earnings	**152**	**164**	**3.8%**	**1.8%**	**2.0%**
Social security benefits	81	82	0.6%	1.8%	-1.2%
Post-tax earnings and benefits	**234**	**246**	**2.7%**	**1.8%**	**0.9%**
Net property income received (interest, dividends, rent etc)	38	37	-1.0%	1.8%	-2.9%
Net current transfers (other than social security)	8	7	-2.8%	1.8%	-4.7%
Gross household disposable income	**279**	**291**	**2.1%**	**1.8%**	**0.3%**
Change in net equity of households in pension funds	14	17	10.1%	1.8%	8.5%
Available household resources	**293**	**308**	**2.5%**	**1.8%**	**0.7%**
Household expenditure	**267**	**287**	**3.6%**	**1.8%**	**1.9%**

Source: PwC Analysis of ONS data

Table 3.1 shows how the key drivers of household expenditure have changed over the two years to Q2 2014, which is the period over which we have seen the UK economy start to recover on a more sustained basis. Real growth rates in the final column of the table have been calculated by deflating the nominal growth rates using the household expenditure deflator (which over this period averaged 1.8% per annum). The most notable feature from this analysis is that household disposable income grew by just 0.3% per annum in real terms which is significantly below household expenditure growth of almost 2% per annum over this period.

Table 3.1 shows that real pre-tax earnings increased by around 1.6%[1] per annum over the period, supported by a 1.3% real increase in wages and salaries. This trend reflects strong employment growth, with more than 1.3 million net new jobs being created since Q2 2012, offset in part by a decline in average real earnings per employee over this period. As noted by many commentators, this has been a 'jobs rich, pay and productivity poor' recovery to date. This has, however, meant that the pain of this recession has been spread more widely across the employed as well as the unemployed, in contrast to the early 1980s and early 1990s recession where it was more heavily focused on those who lost their jobs. In this sense, the sharing of pain has been more 'democratic' in this downturn. Profits earned by the self-employed and owners of small businesses also grew by strongly by around 2.5% per annum in real terms. This reflects the growing importance of self-employment, which has risen to record highs (at least in recent decades for which comparable data are available) of around 15% of total UK employment.

As Table 3.1 shows, post-tax earnings have grown somewhat more strongly than pre-tax earnings, reflecting relative weakness of income tax payments (national insurance payments have held up better). This reflects significant rises in the income tax personal allowance in recent years, as well as low real earnings growth leading to negative fiscal drag. This is also a key reason why the budget deficit has not been falling as had been expected over the past year.

However, there are two areas that have significantly dampened the real growth of household disposable income over the past two years. These are decreased social security benefits (down by 1.2% per annum in real terms) and other household income (property income down by 3% and other transfers down by almost 5%).

1 It's worth highlighting the fact that this figure measures the aggregate change in earnings of UK households rather than that of individuals. Average real wage rates per employee (or per hour) have continued to decline over this period according to ONS data, but this has been offset in the aggregate data by strong employment growth.

We can explain these movements as follows:

- Social security benefits: As the UK economy has recovered and government has cut back on welfare benefits, so this category of income has started to decline in real terms, despite protection being given to state pensions.

- Other income and transfers: Net property income is made up of net interest expenses and investment income receipts (including dividends). As expected these were affected negatively by the low Bank of England base rates (which is then translated into lower market interest rates). Dividend yields remained broadly constant over the period (at least for the FTSE 100) but some overseas income could have been negatively affected by re-allocation of household assets into safer but lower yielding assets.

Overall, as noted above, this has restricted total real disposable household income growth to just 0.3% per annum over the past two years.

As the final row in Table 3.1 shows, total household resources have grown somewhat faster (0.7% per annum) due to a relatively strong rise in net equity of households in pension funds by around 8.5% per annum in real terms. However, it is not clear that most households regard this as income given it cannot be accessed until pensions are paid out, so we prefer to focus on the household disposable income line here when considering the drivers of household spending growth.

Future trends in household disposable income

So how will household disposable incomes fare in the future? Clearly there are many uncertainties, but Table 3.2 sets out what we consider to be a reasonable main scenario for real growth in each of the key elements in household disposable income. In particular, we assume that:

Table 3.2: Main scenario projections of real gross household disposable income growth

Key indicators	2014	2015	2016-20 (% pa)
Wages and salaries	1.5%	1.8%	2.0%
Household share of gross operating profits	2.4%	2.8%	2.5%
Pre-tax earnings	2.9%	2.1%	2.1%
Income tax paid	0.5%	0.5%	0.5%
National insurance contribution by workers	1.8%	2.2%	2.2%
Post-tax earnings	6.0%	2.7%	2.6%
Social security benefits	-1.5%	-1.0%	-1.0%
Post-tax earnings and benefits	3.3%	1.5%	1.5%
Net property income received (interest, dividends, rent etc)	0.0%	0.5%	1.5%
Net current transfers (other than social security)	1.0%	1.0%	1.0%
Gross household disposable income	1.4%	1.5%	1.5%

Source: PwC Analysis

- Total income from wages and salaries grow at a rate of around 1.5% in real terms in 2014 gradually increasing to around 2% in the medium-term. This reflects continued employment growth and a gradual recovery in real wages over the next few years.

- The income of households from gross operating profits is projected to grow at around 2.5% per annum in real terms reflecting stronger receipts from small businesses, particularly those that have been established during the past few years.

- Income tax receipts grow at a more modest 0.5% per annum in real terms on the back of higher wages and salaries, but also a continued rise in personal tax allowances. We have assumed that national insurance contributions grow faster at around 2.2% per annum in real terms reflecting the recent trends as shown in Table 3.1.

- Social security benefits continue to be cut back in real terms (on average by 1% per annum).

- Net property income (which includes dividends and interest income receipts) starts growing by 0.5% in real terms in 2015 and then picks up to around 1.5% in real terms per annum in the medium term as interest rates pick up gradually.

Based on these assumptions, we find that real household disposable income growth could remain around 1.5% per annum on average over the rest of this decade, reflecting offsetting trends in different elements of disposable income. This is relatively subdued compared to historic average real growth rates of around 2-2.5%, but seems a prudent basis for planning based on our analysis.

To see how this translates into consumer spending growth, however, we also need to consider how the household savings rate will evolve over this period.

3.2. – Household savings ratio

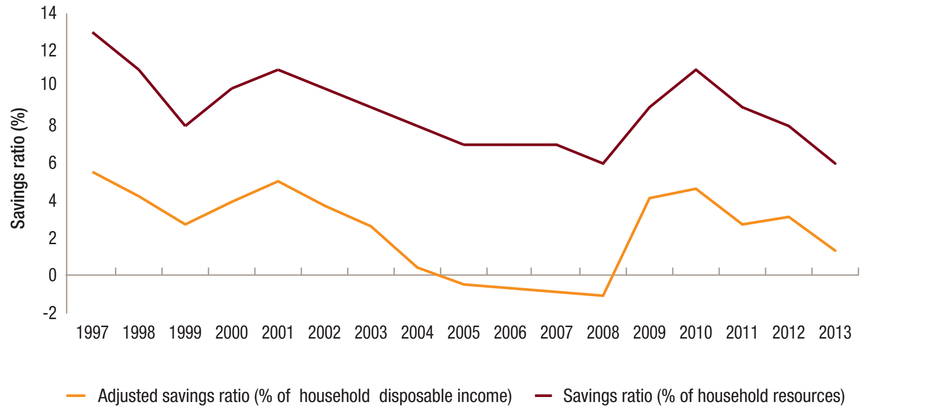
The savings ratio is calculated by the ONS as the difference between available household 'resources' (household disposable income plus an adjustment for the change in net equity of households in pension funds) and household expenditure, expressed as a proportion of household resources.

However, as mentioned above, most households have little awareness of the changes in their net equity in pension funds when making spending decisions. We therefore think it makes more sense to focus on an 'adjusted saving ratio' that simply looks at the difference between disposable income and spending as a proportion of disposable income. We plot this ratio in Figure 3.1 alongside the official headline savings ratio[2].

Both savings ratio measures show broadly similar trends over time, but with much lower levels for the adjusted savings ratio. We can see that the latter dropped from around 5% in 2001 to around -1% just before the recession began. After that households boosted their savings in response to increased uncertainty and a fall in housing wealth in particular, with the adjusted ratio rising by around 5 percentage points in two years. However, since 2010, the savings ratio has begun to drop again as confidence has gradually recovered. This downward trend in the adjusted savings ratio helps to explain the sustained growth in household consumption over the past two years despite the modest growth in real household disposable incomes described in Section 3.1 above.

So how will the household savings ratio move in the future? To answer this question we first need to understand the key factors driving movements in the adjusted savings ratio

Figure 3.1: Trends in headline and adjusted savings ratio for UK households (1997-2013)



Source: PwC analysis of ONS data

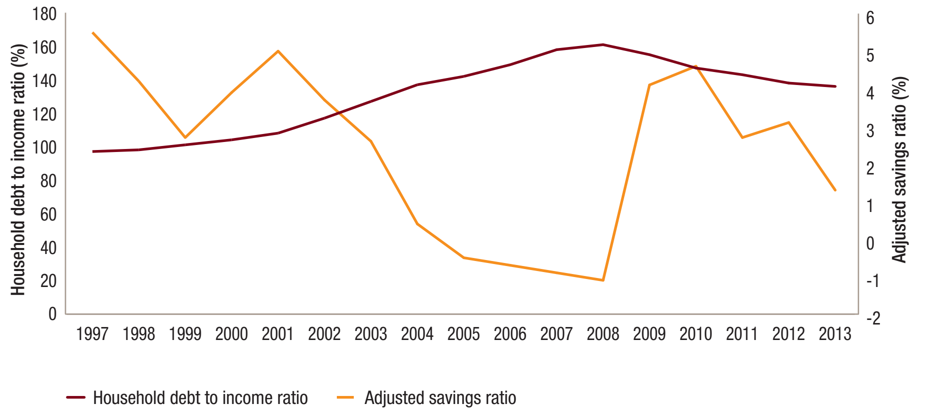
Key factors underlying trends in the household savings ratio

We have focused our analysis on what we think have been the two most important and readily quantifiable drivers of trends in the adjusted savings ratio over the period since the late 1990s:

- **Household debt to income ratio:** Households that have accumulated high levels of debt are more likely to encounter payment difficulties, particularly following shocks to the economy (e.g. a sharp fall in actual or expected household income or an interest rate hike). Therefore, in broad terms, we would expect household indebtedness levels to vary inversely with the savings ratio, particularly at times of crisis.

Figure 3.2 shows this relationship over time and indeed we can see that the savings ratio bottomed out in 2008, which was also when household indebtedness ratio peaked at around

Figure 3.2: Relationship between the adjusted savings ratio and the household debt to income ratio



Source: PwC analysis of ONS data

2 The ONS published revised data on the elements that make up the adjusted savings ratio on 30th September. These go far as back as 1997, which explains the timescale of Figure 3.1.

162% of disposable income. Subsequent to this the financial crisis led to an increase in the adjusted savings ratio as households reduced their debt ratios.

- **House prices:** higher house prices are typically associated with a drop in the savings ratio as many people see their houses as 'doing their saving for them'. This inverse relationship can be seen from Figure 3.3, with the peak in house prices[3] in mid-2007 closely followed by the low point in household savings.

Link between household debt, savings and consumption

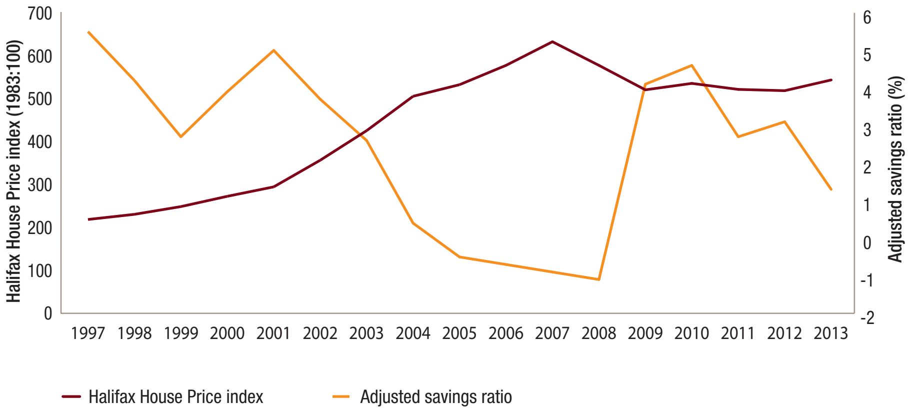
The wider relationship between excessive levels of household debt and how this interacts with household consumption (and hence the household savings ratio) has been an area of focus in recent economic research[4].

Cross-country macroeconomic analysis from the Bank of England[5], for example, shows that recessions that have been preceded by large increases in household debt tend to be more severe and protracted (see Figure 3.4). This is driven by the fact that households tend to reduce their spending and pay down debt during and after the crisis. Note that it is the change in the household debt ratio that matters most here, rather than the absolute level of the ratio.

The Bank of England study cites three main reasons for this relationship backed up by analysis of UK household level data:

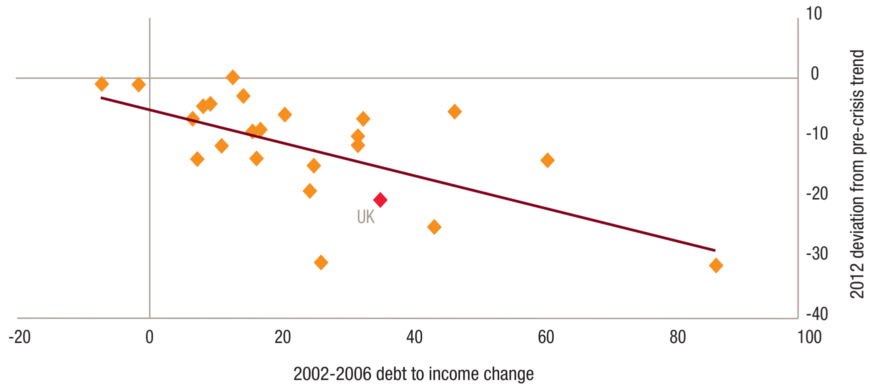
- At times of crisis highly indebted households are disproportionately affected by tighter credit conditions. A survey[6] carried out by the Bank showed that mortgagors who had cut spending due to concerns about credit availability had significantly higher than average debt to income ratios.

Figure 3.3 Relationship between the adjusted savings ratio and house prices



Source: PwC analysis of ONS data, Thomson Datastream

Figure 3.4 Cross country falls in consumption and pre-crisis household debt growth



Source: Bank of England

- After a severe economic downturn, highly indebted households also become more concerned about their ability to make future debt payments.

- Data from the same Bank of England survey showed that, in 2013, around one third of households with a relatively high mortgage to income ratio thought that a sharp fall in their income was quite likely over the next year, compared to only around 19% for households with a lower median debt to income ratio.

So, there is clear empirical evidence to support the view that highly indebted household disproportionately cut spending and increase their savings ratios at times of crisis. This is also backed up by our own modelling work, as summarised in the technical annex at the end of this article. So what does this mean for the UK household savings ratio looking forward?

3 The Halifax house price index is used here, but other house price indices give similar pictures.
4 This concept was popularised in the recent book House of Debt by Atif Mian and Amir Sufi. Using national, regional and local US data these authors argue that the banking crisis was caused by a large run-up of household debt which eventually led to a large drop in consumer spending in the US.
5 Philip Bunn and May Rostrom, 'Household debt and spending', Quarterly Bulletin 2014 Q3, Bank of England: http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2014/qb14q304.pdf
6 NMG Consulting and Bank of England survey.

Projecting the household savings ratio

Projecting forward the (adjusted) household savings ratio is subject to considerable uncertainties, reflecting the fact that it is the difference between two much larger numbers: disposable income and consumer spending.

To address this issue, we first estimated a model for how the adjusted savings ratio had moved in the past relative to house prices and household debt to income ratios. As described in the technical annex, this produced a reasonably strong statistical relationship. We then projected this forward based on our latest main scenario for UK house prices and the latest OBR projection for the household debt to income ratio.

However, we also allowed for plausible variations in these assumptions to derive three possible scenarios for how the adjusted savings ratio might evolve, as summarised in Table 3.3 below. All three scenarios envisage some further decline in this ratio, but the medium-term average level of the ratio could potentially range from around zero in 2016-20 to around -2.8% (bringing it back below the lowest levels seen in 2007-8 as shown in Figure 3.1).

In summary, the adjusted savings ratio has been on a downward path since 2010, which helps to explain why consumer spending growth has remained relatively strong during the recovery despite weak average wage growth. We expect some further falls in the savings ratio based on our modelling work, but the extent of such declines remains subject to significant uncertainty.

Table 3.3: Projections of the adjusted savings ratio in alternative scenarios

Level of savings ratio	2014	2015	2016-20
Greater fall in savings ratio	0.5%	-0.3%	-2.8%
Main scenario	0.5%	-0.3%	-1.0%
Smaller fall in savings ratio	0.8%	0.3%	0.0%

Source: PwC scenarios for the level of the adjusted savings ratio as % of household disposable income

3.3 – Alternative scenarios for consumer spending growth to 2020

We can now combine our household disposable income projections from Section 3.1 with our alternative savings ratio scenarios from Section 3.2 to derive alternative scenarios for real consumer spending growth to 2020. Specifically, as set out in Tables 3.3 to 3.5:

- Our main scenario projects that real household expenditure growth will peak at around 2.3% in 2015 followed by a more subdued medium-term growth rate of around 1.7% per annum (so that the average growth rate would be around 1.8% for the whole 2015-20 period).
- Our optimistic scenario is similar in the short term but shows stronger medium term real spending growth of around 2.3% per annum driven by a larger fall in the adjusted savings ratio. But, as noted above, this would involve this ratio falling back below very low pre-crisis levels, which does not seem likely to be sustainable.
- Our downside scenario assumes that the adjusted savings ratio bottoms out at around zero, with implied real spending growth of only around 1.5% per annum in the medium term.

Table 3.4: Main scenario projections of growth in real household expenditure

% per annum	2014	2015	2016-20
Real household disposable income	1.4%	1.5%	1.4%
Adjusted savings ratio	0.5%	-0.3%	-1.0%
Real household expenditure	2.2%	2.3%	1.7%

Source: PwC analysis

Table 3.5: Optimistic scenario projections for growth in real household expenditure

% per annum	2014	2015	2016-20
Real household disposable income	1.4%	1.5%	1.5%
Adjusted savings ratio	0.5%	-0.3%	-2.8%
Real household expenditure	2.2%	2.4%	2.3%

Source: PwC analysis

Particularly on the supply side, this is unlikely to change anytime soon. The Chancellor's recent announcement of measures to limit planning restrictions was welcome, but it remains to be seen how effective this will be in practice.

Whichever scenario we adopt, however, this still implies a relatively cautious outlook for consumer spending growth in the medium term, most likely in the range of around 1.5-2% per annum in 2016-20 after growth of around 2-2.5% in 2014-15. When added to other pressures from increased price competition and digital disruption to their business models, this will be a challenging environment for retailers and consumer goods manufacturers.

Table 3.6: Downside scenario projections for growth in real household expenditure

% per annum	2014	2015	2016-20
Real household disposable income	1.4%	1.5%	1.5%
Adjusted savings ratio	0.8%	0.3%	0.0%
Real household expenditure	1.9%	2.1%	1.5%

Source: PwC analysis

3.4 – Projected consumer spending growth by category

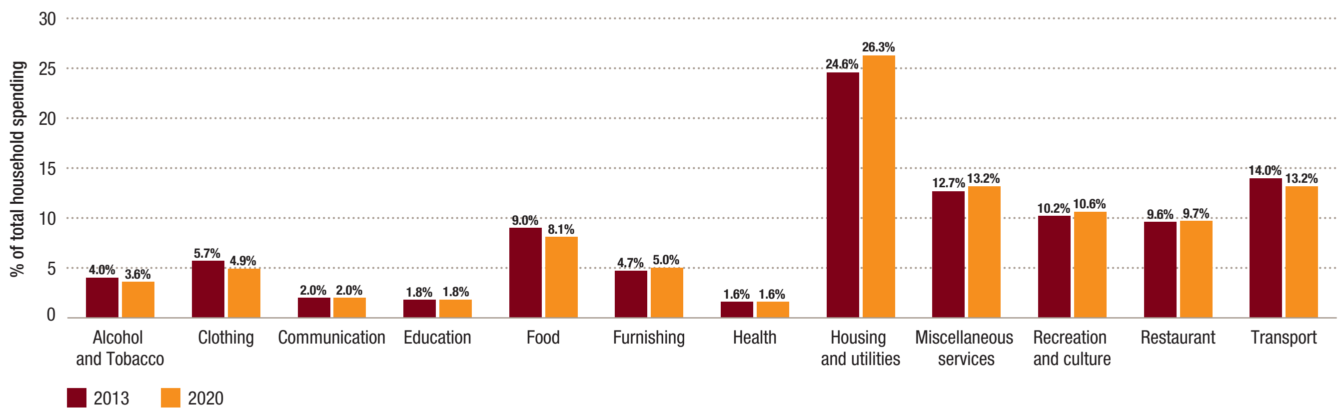
From a business perspective, it is not just total consumer spending growth that matters but also how this is divided up by category of spending. To address this question we have updated our long-term UK consumer spending model, the results of which we last published in November 2013[7]. This model uses factors like real income levels, relative price levels, income distribution and the age structure of the population to project how consumer spending growth will vary across the main categories of spending. We focus here on the period to 2020 to match the analysis above.

In these projections, as summarised in Figure 3.5 and Table 3.6, we have assumed that:

- Total UK household expenditure grows as in the main scenario described in Table 3.3.
- Income inequality remains at latest estimated levels.
- The relative size of different age groups evolves as in the latest ONS projections, implying a steady rise in the proportion of people above the age of 65.

Figure 3.5 shows that the shares of consumer spending on food, alcohol and tobacco are projected to continue to

Figure 3.5: Main scenario projections for household budget shares in 2020



Source: ONS for 2013, PwC main scenario projections for 2020

7 For further details please see 'Consumer spending trends to 2030', UK Economic Outlook, November 2013: http://pwc.blogs.com/files/consumer-spending-trends-to-2030.pdf

decline steadily, as was experienced in the past. Transport is also on a declining trend which may seem surprising, but is in fact a continuation of an underlying trend that started in the 1980s. But these downward trends are offset by rising shares in the housing and utilities, miscellaneous services (which notably includes financial services spending), recreation and culture, and home furnishings.

By 2020, households are projected to allocate more than a quarter (26%) of their spending to housing and utilities. Also, the miscellaneous category which includes credit card and interest payments is projected to increase to around 13% of total household budgets as lending increases and interest rates go up. Finally, we can see that the recreation and culture category will see some modest increase in its budget share by 2020 as the economic recovery continues. The same is projected to be true of the home furnishings category on the back of an assumed continuation of the housing market upturn, albeit at a more moderate pace in the medium term than in the past couple of years.

Table 3.6: Household budget share projections for 2020 and average annual real growth rate by household spending category in main scenario (% pa: 2014-30)

% per nnum	2013 spending share	2020 main scenario projection	Implied average annual real growth rate
Alcohol and Tobacco	4.0%	3.6%	0.5%
Clothing	5.7%	4.9%	-0.2%
Communications	2.0%	2.0%	1.6%
Education	1.8%	1.8%	1.8%
Food	9.0%	8.1%	0.4%
Furnishings	4.7%	5.0%	2.7%
Health	1.6%	1.6%	2.0%
Housing and utilities	24.6%	26.3%	2.8%
Miscellaneous services	12.7%	13.2%	2.5%
Recreation and culture	10.2%	10.6%	2.4%
Restaurant	9.6%	9.7%	1.9%
Transport	14.0%	13.2%	1.0%
Total Spending	100.0%	100.0%	1.9%

Source: ONS for 2013, PwC main scenario projection for 2020

3.5 – Summary and conclusions

Consumer spending growth has been relatively strong for the past two years despite weak wage growth due to strong employment growth, increased income tax personal allowances and low mortgage interest rates, all of which have boosted real incomes. In addition, increased confidence and borrowing since mid-2012 have been reflected in a falling savings ratio, giving an extra boost to spending over and above disposable income growth.

Looking ahead, our analysis suggests that the downward trajectory in the adjusted savings ratio is projected to continue, but the pace at which this will happen is unclear.

In our main scenario, we project that real household spending growth will remain relatively strong at around 2.3% in 2015, but this could then slow in the medium term to an average of around 1.7% per annum in 2016-20 as the savings ratio bottoms out and spending growth has to rely on increases in real disposable incomes.

Other scenarios show a range in medium-term real consumer spending growth of around 1.5-2% after 2015, but in general we would expect this to remain relatively subdued by historic standards. This will increase the pressure on retailers already affected by tough price competition and digital disruption to their established business models.

Finally, using our main scenario for total spending, we project that, by 2020, households will have to allocate more than a quarter of their budgets to spending on housing and utilities, continuing the long-term upward trend in the importance of this spending category.

Technical appendix
Detail of savings ratio modelling methodology and results

In line with our analysis in Section 3.2, our model of the adjusted household savings ratio consists of two main explanatory variables[8]: house prices, and the household debt to income ratio. For the former, we used the Halifax House Price Index (though other leading indices would give similar results). The debt to income ratio was calculated using data from the ONS.

We investigated using the above variables with different lags as our preliminary graphical analysis (see Figures 3.2 and 3.3) and economic thinking suggested a delayed reaction of the savings ratio to the explanatory variables. To investigate this further we ran univariate regressions of the savings ratio with zero, one, two and three years lags. We subsequently filtered those parameters which were statistically significant at a 10% level and included them in our final model, which is summarised in Table 3A.1.

Note that the parameters of the model were estimated using the standard ordinary least squares (OLS) econometric technique based on annual data from 1997-2013. Also, our analysis focused on first order differences i.e. the relationship between the change in the adjusted savings ratio and the change in household debt to income ratio (DEBT) and the change in house price growth rates (HP) to reduce the risk of spurious correlations between levels of these variables (a common problem in time series analysis of this kind).

The model has an R^2 of around 0.59 (i.e. it explains just under 60% of the variance in the changes in the savings ratio over time) and as such we would expect it to broadly track the actual savings ratio. Figure 3A.1 plots the actual adjusted household savings ratio versus those implied by our model. We can see a generally good performance in the 1988 to 2008 period (including accurately detecting the turning point in 2008). The model tends to over-estimate the savings ratio somewhat after 2010, though it is too early to say if this is a systematic divergence.

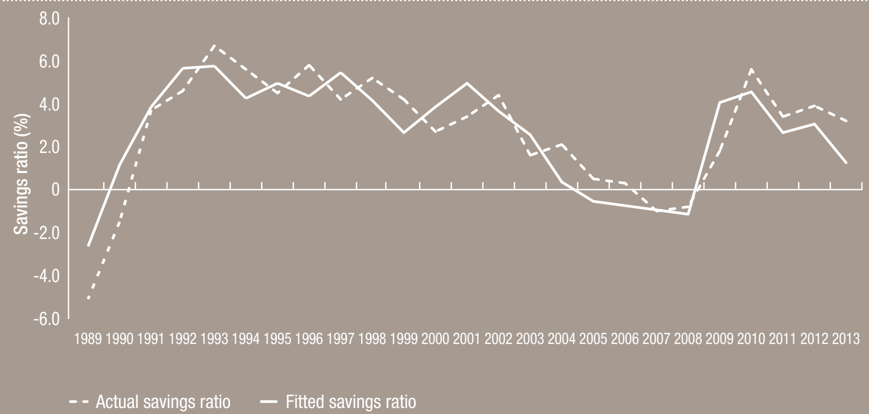
Table 3A1: Specification of PwC savings model

Dependent variable: change in adjusted savings ratio	No. of observations: 23	
R-squared: 0.59	Coefficient	t-statistic
HP	-0.11	-2.80
L1. DEBT	-0.11	-1.89
Constant	0.003	1.01

Source: PwC analysis

Note: 'L' refers to the lagged variable in the previous year. A t-statistic above around 1.6 in absolute levels shows the explanatory variable is statistically significant at the 10% level, or above around 2 shows significance at the 5% level.

Figure 3A.1: Actual adjusted savings ratio versus predictions by the PwC savings model



Source: PwC analysis and ONS data

8 We also considered including interest rates, but finding a robust econometric relationship here with savings is difficult as it will affect households in varying ways with potentially offsetting income and substitution effects on savings rates.

4 – Getting the balance right in the UK regions[1]

Key points

- The UK economy has become a post-industrial economy with manufacturing accounting for just 8% of employment and 10% of output. While important high-tech and high value-added manufacturing activities continue to support growth and exports, the UK regions now rely much more heavily on services industries.

- Across all regions of the UK economy, three broad industry clusters account for around 70% or more of economic activity and 75% or more of employment: business and financial services; public administration, health and education; and transport and distribution.

- It is too simplistic to characterise UK regional differences in terms of a North-South divide. There is also a North-North divide and a South-South divide as secondary locations with poor connectivity or other disadvantages struggle to attract high value-added manufacturing and services activities in an increasingly competitive global economic environment.

- A key source of regional imbalance in the UK economy is the strength of London as one of the leading global cities, which spills out into neighbouring regions in the south of England. But there is no merit in suppressing London's economy to achieve a regional rebalancing – this would damage the UK economy as a whole. The priority should instead be to increase investment in other regions of the country

- Differentials between regions and within regions in the UK can be limited or reduced by policies focussed in four main areas: building stronger clusters of knowledge-based industries – particularly in the services sector; developing transport infrastructure; building a stronger local skills base; and devolving responsibility for key elements of the economic development agenda.

Introduction

Rebalancing the economy has become a major theme for UK economic policy since the 2008/9 financial crisis. There are a number of aspects to the idea of economic rebalancing – including redressing imbalances between consumption and investment, exports and domestic demand, financial services and the rest of the economy and between the public and private sectors. But one of the most obvious ways in which the balance of growth has an impact on the UK economy is its regional dimension. Since the 1980s, there has been renewed concern that London and the South East have benefited to a much greater extent than other regions from the growth of the UK economy. Redressing regional imbalances has therefore become a key agenda item in the current economic debate and an important issue in the coalition government's policy agenda.

This article surveys the current evidence on the regional differences within the UK economy, and discusses policy proposals which might contribute to a more balanced pattern of economic growth. The article is divided into three main sections. The first section discusses the 'new economic geography' of the UK. Long gone are the days when the north of England and the midlands were industrial heartlands of the British economy, with manufacturing industry accounting for a third or more of employment and GDP. The UK still has important strengths in some manufacturing sectors, but overall it is now a post-industrial economy, in which manufacturing accounts for about 10% of GDP and around 8% of total employment. In all UK regions, services activities are now the key driver of economic growth, accounting for around 70-75% or more of economic activity and employment. Services are also becoming increasingly important to the UK's success in export markets.

The second section of the article looks at disparities in economic performance between the regions of the UK economy and how they have evolved in recent years. The strength of London and the south of England in services industries – particularly business and financial services – is a key factor underpinning these differences. London is one of the top global cities in the world – and its pre-eminence has not been significantly dented by the financial crisis. The challenge for other UK cities and regions is to develop their own strengths and capabilities in a world where comparative advantage in services is becoming the main driver of economic progress for the UK economy.

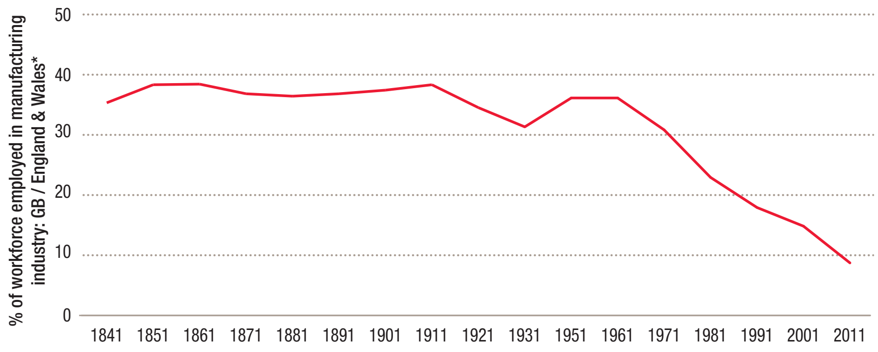
The third section of the article discusses the policy agenda for supporting more balanced regional growth. Four key regional growth levers are identified as the focus for policy action: developing knowledge hubs and centres of expertise, enterprise and competitive advantage, particularly linked to universities; providing efficient transport and digital infrastructure to support local connectivity and links to the global economy; investing in a high level of skill and capability across the workforce to support local business and encourage inward investment; and encouraging the role of local and regional leadership – by devolving and decentralising control over key issues which affect economic development.

1 This article was written by Andrew Sentance, PwC's Senior Economic Adviser. Conor Lambe provided valuable research assistance.

4.1 - The 'new economic geography' of the UK

The traditional view of the UK economy is of a divide between the midlands and the north – the 'industrial heartlands' – and a commercial and financial south which facilitates trade and investment with the rest of the world. According to this view, cities like Birmingham, Manchester, Leeds, Sheffield, Swansea, Belfast and Glasgow are regarded as major industrial centres while London is seen as the centre of the commercial and financial world in the south of England. This perspective on the UK economy is rooted in the way the UK economy developed from the industrial revolution until the 1960s. Over this period manufacturing industry was a major driver of UK economic growth. As Figure 4.1 shows, the share of manufacturing jobs in the UK economy remained at around 35% until the 1970s – when a rapid de-industrialisation began, continuing for four decades now.

Figure 4.1: Manufacturing employment share since 1841

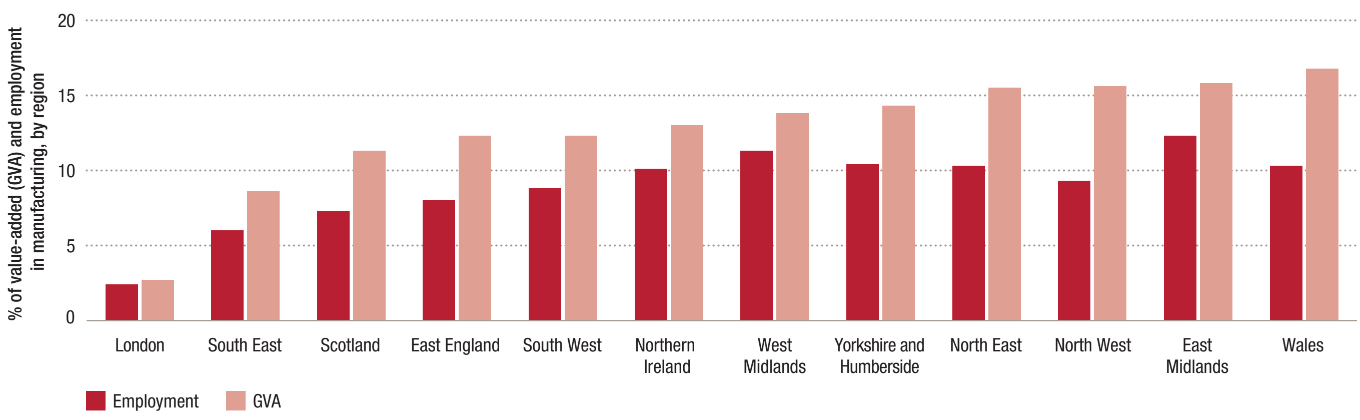


Source: ONS - based on 1841 to 2011 censuses
*Data is Great Britain to 1911 and England and Wales from 1921
Note: No census was carried out in 1941; 1971 is author's estimate as Census data is inconsistent

Though there is still an industrial bias to economic activity towards the north, midlands and west of the UK, this traditional view no longer reflects the current economic geography of the United Kingdom. Manufacturing industry no longer dominates economic activity in any region or country within the UK. As Figure 4.2 shows, it has the highest share of economic output in Wales (16.7%) and the highest share of employment in the East Midlands (12.3%). The lowest concentration of manufacturing activity is in London and the South East, which have recently been the fastest growing regions. Important clusters of manufacturing strength remain – particularly focussed on high value-added sectors like aerospace, cars and high-tech engineering. These high-tech and high value-added manufacturing activities are important for exports and help to boost productivity growth. But on average, manufacturing industry now contributes around 10% to UK GDP and accounts for about 8% of total employment.

The dominant sectors for employment and output in all parts of the UK are now service-oriented. In all regions of the UK economy, three broad clusters of service sector activity account for the bulk of economic activity and employment:

Figure 4.2 –Share of manufacturing in UK regions



Source: ONS (2011 data for GVA and 2014 Q1 data for employment)

- financial and business services;
- public administration, health and education; and
- transport, retail and wholesale distribution, and hotels and restaurants.

The first key cluster is financial and business services – including banking and insurance, property-related activities, professional and other business services and the IT/communications sector. In the London economy, this group of activities accounts for nearly 60% of total economic activity (as measured by GVA – gross value-added). But in no major region of the UK does this cluster of financial and business services account for less than a quarter of total value-added, and in two of the traditional industrial regions – the West Midlands and the North West – the share of business and financial services is over 30%. These are relatively high value-added jobs so business and financial services contribute a lower share of employment than output. The share of total jobs in these sectors ranges from just over 15% in Wales and Northern Ireland to around 25% in the North West, East of England and the South East. London is the major exception where business and financial services account for over 40% of total employment.

As well as generating economic activity and jobs, business and financial services are also important because of their contribution to UK exports. The UK economy is a very successful exporter of services. In 2013, total UK services exports totalled £204.5bn, 12.3% of GDP – not far short of the total of manufacturing exports (£228bn and 13.7% of GDP). This services export share of GDP is significantly higher than in other G7 countries – 8% in Germany and France, 5% in Italy, 4% in the US and Canada, and 3% in Japan[2]. And over two-thirds of UK exports of services are in business and financial services (including information/communications and intellectual property). Moreover, these headline figures underplay the value of services to the export activity of the UK economy. Studies by the OECD and World Trade Organisation which measure the value-added contribution of services industries to UK trade suggest that they are responsible for 58% of the UK export contribution to value-added in the UK economy[3]. So while services trade appears less significant than goods trade in headline terms, its higher value-added component means it is a bigger contributor to jobs and rising living standards.

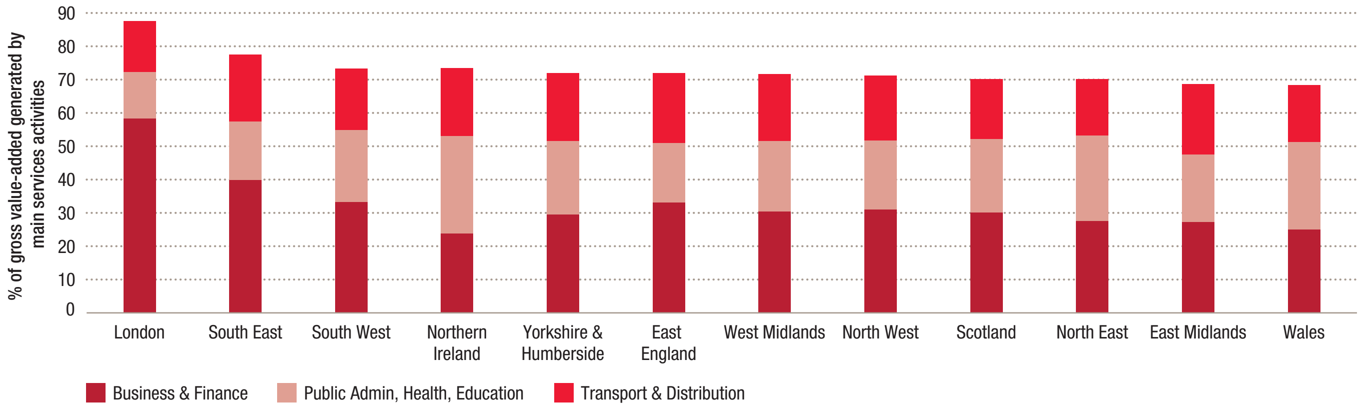
A second major services cluster is a group of services where the government is the driving force – public administration, health and education. These public services account for a bigger share of employment than they do in terms of GDP/value-added, due to relatively low measured productivity and a high proportion of part-time workers. Outside of London, these government-related services account for around 30% of total employment with the share ranging from 26% in the South East of England to 34% in the North East. Public administration, health and education also account for around a third of total employment in Wales and Northern Ireland. In London, the share of employment is lower – at 22%. But London continues to be the focus of the better paid jobs in these government-led sectors. So the value-added contribution (GVA) per head of population in these predominantly public services is still higher in London than in the rest of the UK, as Figure 4.3 shows.

Figure 4.3: Gross value added per head in public administration, health and education

Source: ONS (2011 data)

2 See "How the services sector is rebalancing the British economy", PwC UK Economic Outlook, November 2013
3 See "OECD Trade and Value-Added Indicators for the UK" - http://www.oecd.org/sti/ind/TiVA_UNITEDKINGDOM_MAY_2013.pdf

Figure 4.4: Key UK services clusters by region



Source: ONS (2011 data)

The third main cluster of services includes transport, retail and wholesale distribution and hotels/restaurants. The characteristics of this cluster is that these services predominantly serve the local economy and consumers – shopping, travelling to work, going out for a meal, etc. As a result, we should expect this cluster to be a more constant share of the economy – which is what the data shows. As a share of employment this cluster accounts for around 25-30% of employment across different regions and around 15-20% of economic activity. This cluster of services is also closely linked to manufacturing output and trade, as efficient transport and distribution networks are necessary to get goods to markets in the UK and overseas and to bring in supplies of raw materials and components to support manufacturing production.

As Figure 4.4 shows, these three major services clusters account for around 70% or more of total value added and 75% or more of employment in all the major regions of the United Kingdom. Perhaps the most striking feature of this chart, however, is how similar is the overall share of economic activity accounted for by these three clusters in all UK regions outside London and the South East. Elsewhere, the total share of economic activity in the three services clusters is quite similar – ranging from just over 68% in the East Midlands and Wales to around 73% in the South West and Northern Ireland. The mix between the three clusters does, however, vary more significantly. Business and financial services are particularly important in the South West and North West, while the public sector cluster is more important in Wales, the North East and Northern Ireland. The easterly regions – Yorkshire and Humberside, East Midlands and East of England have a stronger bias to transport and distribution – reflecting the importance of the UK's trade links with Europe for activities in those sectors and the location of major ports and inland distribution centres.

The approach to rebalancing the UK's economy needs to take into account this major shift in economic geography and structure. Very important clusters of industrial activity in the UK economy remain – but these are focussed on a limited range of sectors, mainly deploying highly skilled employees and exploiting an advantage sustained by technology and innovation – high value-added engineering, aerospace, pharmaceuticals and car production. While the UK economy will benefit from the expansion of these high value-added manufacturing industries, industrial activities do not play the same role in the UK economy as they did from the 18th century through to the 1960s. All the regions of the UK need to look to how they can develop their economic potential in a world where services industries have become much more important. The final section of this article discusses in more depth how policies might be developed to achieve this.

4.2 – UK regional disparities and recent trends

The strength of London as a leading global city and its strong presence in the financial and business services industries inevitably creates a strong pull of economic activity towards the South East of England. That magnetic attraction has not been seriously dented by the global financial crisis. London continues to rank highly in surveys of global cities – normally in the top two alongside New York. In the most recent (2014) PwC Cities of Opportunity survey[4], London ranked as the top global city. The financial crisis had a major adverse impact on banking, but other sectors which contribute to London's financial services industry – such as fund management, venture capital, insurance and trading in financial markets – were much less affected. In addition, London has diverse strengths as an international business centre outside financial services, as well as remaining a historical and cultural centre and a major focus for national and international government activity.

London's significance to the UK economy creates a large halo effect on the surrounding regions. As Figure 4.5 shows, household income per head is significantly higher in London than the national average and the proximity to London provides a boost to living standards in the adjacent regions – the South East and the East of England. With London also acting as the major financial and commercial hub for the UK, parts of the midlands and the South West also benefit from their transport connectivity to its economy. Towns and cities like Grantham (East Midlands), Coventry (West Midlands) and Swindon (South West) are just one hours journey time from London by rail. The location of Heathrow Airport and the 'M4 corridor' also have the effect of extending the reach of the London economy into the South West region.

Unlike the 1980s, when regional divergences in the UK economy started to open up following the big shake-out of jobs in manufacturing industry, these differences in income are not associated with large variations in unemployment rates. In 1986 – the peak year for unemployment after the 1980s recession – the official unemployment rate hit over 17% in Northern Ireland, just under 16% in the North East, 13% in Scotland and Wales and 12-13% in the north of England and the West Midlands. Differences in unemployment are now much less significant across the main regions of the UK economy[5]. Only two regions – the West Midlands (7.5%) and the North East (9.3%) currently have unemployment rates more than one percentage point above the national average rate (6%) and the lowest regional unemployment rates – in the South West (4.6%) and the South East (4.7%) are not much more than one percentage point below the national rate. In some parts of the UK, there may be a problem of 'hidden unemployment' associated with high economic inactivity - people of working age who are not either employed or looking for work. Inactivity rates are particularly high in Northern Ireland and Wales[6].

Where differences in employment prospects appear to be more noticeable is within regions where substantial pockets of unemployment remain in

Figure 4.5: Household disposable income per head, by region

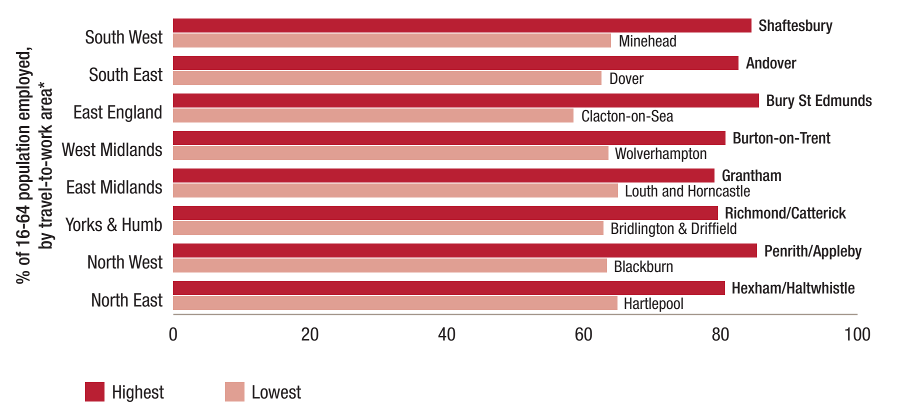
Source: ONS (2012 data)

4 http://www.pwc.com/us/en/cities-of-opportunity/
5 The official unemployment rate in the 1980s was the claimant count for unemployment benefits.
6 Latest figures from the Labour Force Survey for Jun-Aug 2014 show 26.3% of 16-64 year olds economically inactive in Wales and 27.2% in Northern Ireland, compared to a national average of 22.2%.

some smaller towns and cities. The agglomeration and clustering effects which have supported the growth of London are also beneficial to other large UK cities where they are well connected into national and international transport networks. But secondary locations can easily struggle when they do not benefit from good transport connections or other historical or locational advantages. This is creating a North-North divide and a South-South divide which is evident in substantial differences in the level of employment within the major regions of the UK. Figure 4.6 shows that the employment rate in English regions can vary from around 60% or below in some travel-to-work areas to 80-85% in the towns and cities with better employment prospects. This pattern is fairly consistent across the country – indeed, these sub-regional differentials are perhaps even more noticeable in the south of England than in the north.

Though it is not included in Figure 4.6, the London economy also encompasses very significant variations in employment rates. London's unemployment rate is above the national average but this is partly because unemployment rates tend to be higher in major cities than across other parts of the country. London's unemployment rate is the lowest of the UK major cities apart from Bristol. But there are still significant variations between boroughs, with Barking and Dagenham, Newham and Tower Hamlets showing the highest unemployment rates and Bromley, Richmond and Kensington/Chelsea the lowest[7]. Also, while London scores very positively on conventional measures of economic performance like GVA per head, it ranks much lower on a broader economic and social comparison with other cities in the UK, such as the PwC Good Growth for Cities index[8]. This reflects the impact of high housing costs, long travel to work times and congestion – which have a dampening impact on the quality of life in the UK's capital city.

Figure 4.6: Wide variation in employment in English regions



Source: ONS (2013/14 data)
*very small areas omitted

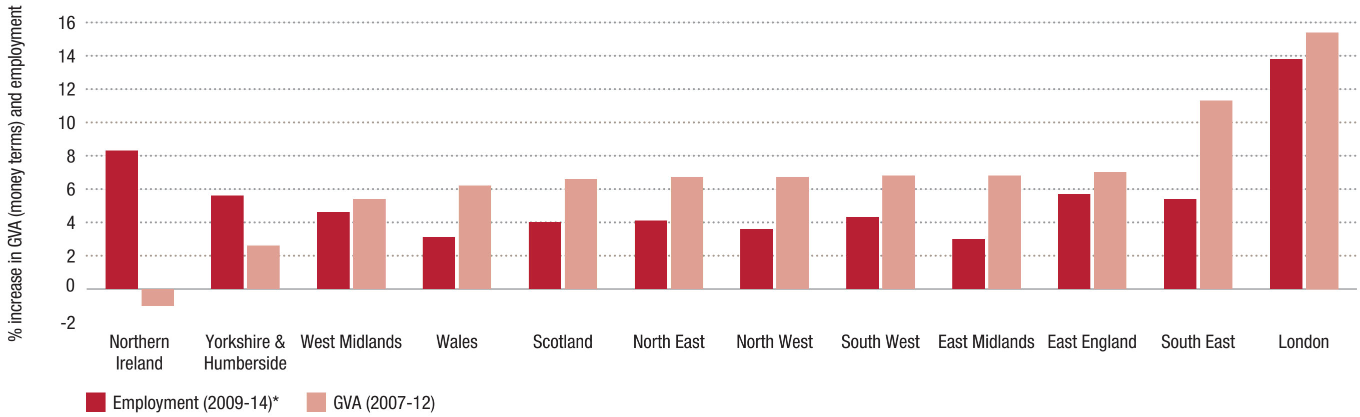
What do recent trends show in terms of the regional impact of the UK economic recovery from the 2008/9 financial crisis? We have already observed that the position of the London economy has not been seriously dented by the recent upheaval in the global financial system. As Figure 4.7 shows, value-added in money terms in the London economy grew by more than 15% between 2007 and 2012 and by more than 11% in the South East, compared to 5-7% growth in most other regions. Employment growth over the first five years of recovery has been 14% in London compared to 3-6% in most other UK regions. There is not too much evidence of a regional economic rebalancing in these numbers. If anything, the North-South divide is widening rather than narrowing. That raises the question of how more regionally balanced growth can be promoted by policy-makers – which is the subject of the next section.

4.3 – The way ahead for regional economic policy

The UK economy clearly benefits greatly from the commercial and financial strength of London which spills out to benefit the rest of the country – particularly other parts of southern and eastern England. Because of its commercial and financial links to the rest of the world – including Europe, North America, Asia and other emerging markets – London acts as a vital economic and financial hub for the UK, drawing in high value-added economic activities dependent on the dynamism of the global economy. With world GDP set to increase to over $100trn in money terms by the end of this decade – more

7 See http://www.londonspovertyprofile.org.uk/indicators/topics/work-and-worklessness/unemployment-by-borough/
8 See http://www.pwc.co.uk/government-public-sector/good-growth/index.jhtml for 2013 results. 2014 results will be published on 27 November.

Figure 4.7: Growth of value-added and jobs since the crisis



Source: ONS
*Labour Force Survey measure

than three times its value in 2000 – the UK's ability to tap into world growth by providing a wide range of business and financial services as well as producing manufactured goods is a major source of economic strength.

But there will inevitably be limits on how far from London this halo can spread – even with improved communications such as the High Speed 2 rail line. In addition, the economic disadvantages suffered by secondary towns and cities in the UK regions – which show up in the form of poor employment prospects in towns like Clacton, Louth and Hartlepool (see Figure 4.6) will not be addressed simply by strengthening transport links between London and other UK regions. Cities and regions need to build their own economic strengths and capabilities. That is the major challenge for achieving more balanced economic growth in the UK.

But how can this be realised in practice? There are a few misleading ideas which surface in the policy debate. One is that we need to hold back the growth of London to benefit other cities and regions. But policies which aim in this direction are more likely to benefit large financial and commercial centres elsewhere in the world – such as New York, Paris, Frankfurt, Shanghai, Singapore and Hong Kong – and could easily harm the prospects of other cities in the UK regions through their negative impact on the UK economy as a whole. Similarly, it does not make sense for other major UK cities to consider themselves as rivals for London in terms of its global position. The concentration of financial, business, political, historical and cultural assets which exists in London cannot be replicated elsewhere in the UK – however keen the desire to do so.

At the same time, London – and the impact that it has on the broader south of England economy – offers some useful lessons for the development of other cities and regions in the UK. London benefits from a well-developed transport infrastructure which supports easy communication with nearby towns and cities, but most importantly with other major centres in the global economy – particularly through aviation links. There are broader clusters of economic activity in and around London which support innovation and the development of knowledge industries – such as the London-Oxford-Cambridge 'Golden Triangle' of research centres and universities and the high-tech cluster which has developed along the M4 Corridor to the west. London and its surrounding commuter area houses and attracts a highly skilled workforce – and the cultural diversity of its arts and entertainments reinforce the attraction of working in London. And key decisions about the future of London have been devolved to local politicians – with the Mayor and the Greater London Authority now having a greater say in the strategic development of the London economy and its transport system.

The challenge to support economic development elsewhere in the UK is not to try and rival London and the South East, but to replicate these characteristics which have made it successful in their own distinctive way. Four key ingredients are particularly important to this model of encouraging regional economic growth and development: knowledge industries and innovation; transport infrastructure; skills; and local leadership. These are discussed below in more detail.

Knowledge industries and innovation

Knowledge industries and innovation are the key to attracting and generating high value-added jobs which drive economic growth – particularly in business and financial services industries, creative industries and manufacturing industry. Universities have a key role to play in this process. They not only boost our knowledge base, but they also act as magnets for inward investment and incubators for new business start-ups. Universities are also direct generators of export earnings through the fees and other expenditures made by foreign students. Oxford, Cambridge and the leading London colleges have been particularly successful in developing internationally recognised research, and acting as innovation and enterprise hubs. But there are also examples of international success outside London and the South East. Manchester and Edinburgh are in the top 50 medical schools worldwide and Nottingham, Birmingham, Sheffield, Leeds, Glasgow, Dundee and Liverpool are also in the top 100. Manchester, Nottingham, Bristol, Leeds and Birmingham feature in the top 100 universities for engineering and technology. There are also centres of excellence in the creative industries outside of London, including the Birmingham Conservatoire, the School of Music at Leeds University, computer games in Dundee, and the Cardiff School of Journalism, Media and Cultural Studies.

Transport infrastructure

An efficient transport infrastructure is a crucial ingredient of a successful regional economy in two respects: first, allowing passengers and freight traffic to move around easily within the local area, linking up nearby centres of economic activity to generate synergies and new clusters of economic activity; and second, providing easy access to markets and locations outside of the region. In an increasingly globalised economy, it will be links to markets and locations overseas which will be the most important drivers of growth for the UK regions. So investing in efficient links to ports and airports should be given high priority – such as improvements to the A14 linking the midlands to the East Coast ports and better rail links from other northern cities to Manchester Airport, which is the leading aviation hub for the north of England. One of the beneficial aspects of the new HS3 rail proposal to link up the northern cities is that it would provide greatly improved communications with Manchester Airport.

Strengthening the skills base

Strengthening the broader skills base is a key issue underpinning the economic success of a regional economy. The effectiveness of local schools, colleges and universities, and their willingness to provide education which meets the needs of local employers, is a key factor in ensuring a well-functioning local labour market. The establishment of Local Enterprise Partnerships – which give local policy-makers and local business executives more control over the way in which public funds are used to fund vocational education and training – should be a positive step in this direction.

Local leadership

Local leadership is needed to support economic development and regeneration. But local leadership requires devolution of power and responsibility to local politicians and business executives who understand the drivers of economic growth in their city and region. This is not necessarily a question of achieving a widespread devolution of spending and tax-raising powers – which was the issue in the recent Scottish referendum. Rather, it is a matter of ensuring that the levers of regional economic development – transport plans, skills and education policies and housing/spatial development – can be managed strategically at the regional level. The UK government has already stimulated this process by establishing the Regional Growth Fund which offers cities and regions the opportunity to bid for funds to support local development projects. However, there is significant scope for extending this devolution of responsibility to City-based regional areas like Manchester and the cluster of Yorkshire cities around Leeds. Recent reports by Lord Heseltine and the Cities Growth Commission have argued strongly in this direction[9].

9 The Heseltine Review - "No Stone Unturned": https://www.gov.uk/government/publications/no-stone-unturned-in-pursuit-of-growth and the Cities Growth Commission – "Unleashing Metro Growth": http://www.citygrowthcommission.com/

Conclusion – the future for the UK regional economy

Despite the substantial differentials across the UK regions we have noted in this article, the policy debate is now moving in a positive direction. In the dynamic global economy we now inhabit, London will always have advantages reflecting its position as one of the leading global cities of the world. The objective of policy should not be to limit London's potential, but to share it as widely as possible across the UK. At the same time, there are useful lessons from London's development that can be applied to other cities and regions. That should involve building stronger clusters of knowledge-based industries – particularly in the services sector, developing transport infrastructure, building a stronger local skills base and devolving responsibility so local leaders – not national politicians and civil servants – can productively shape the future direction of the UK regional economy.

The objective of policy should not be to limit London's potential, but to share it as widely as possible across the UK.

Appendix A
Outlook for the global economy

Table A.1 presents our latest main scenario projections for a selection of economies across the world.

We expect the UK and the US to post relatively strong growth in 2014 and 2015, but the outlook for the Eurozone economy is weak compared to its advanced economy peers. In the emerging markets, the Chinese economy is slowing (although remaining high in absolute terms) while only modest growth is expected in countries such as Brazil and Russia. Downside risks, including geopolitical tensions in Russia/Ukraine and the Middle East and the threat of deflation in the Eurozone, mean that the global recovery now appears less robust than it seemed earlier in the year.

These projections (including those for the UK) are updated monthly in our Global Economy Watch publication, which can be found at www.pwc.com/gew

Table A.1: Global economic prospects

	Share of world GDP	Real GDP growth (%)		Inflation (%)	
	2013 at MERs	2014p	2015p	2014p	2015p
United States	22.4%	2.3	3.2	1.8	2.1
China	12.7%	7.4	7.3	2.3	3.0
Japan	6.6%	1.3	1.2	2.5	1.7
UK	3.4%	3.0	2.5	1.6	1.7
France	3.8%	0.4	0.9	0.7	1.0
Germany	4.9%	1.2	1.2	0.9	1.5
Greece	0.3%	0.2	1.8	-1.2	-0.3
Ireland	0.3%	3.9	2.5	0.4	1.4
Italy	2.8%	-0.3	0.6	0.3	0.5
Netherlands	1.1%	0.8	1.5	0.9	1.2
Portugal	0.3%	0.9	1.4	0.0	0.6
Spain	1.8%	1.2	1.7	0.1	0.8
Poland	0.7%	3.2	3.3	0.4	1.8
Russia	2.8%	0.1	0.3	7.2	6.3
Turkey	1.1%	2.8	3.4	8.8	7.0
Australia	2.0%	3.2	2.8	2.6	2.6
India	2.5%	5.2	6.5	5.6	5.9
Indonesia	1.2%	5.2	5.8	6.2	5.9
South Korea	1.7%	3.5	3.6	1.7	2.2
Argentina	0.8%	-0.6	0.8	25.0	25.0
Brazil	3.0%	0.5	1.0	6.3	5.5
Canada	2.4%	2.2	2.5	2.0	1.8
Mexico	1.7%	2.6	3.7	3.9	3.7
South Africa	0.5%	1.4	2.3	6.2	5.6
Nigeria	0.7%	6.2	6.2	8.4	8.6
Saudi Arabia	1.0%	4.3	4.4	2.9	3.2
World (PPP)		3.4	3.8		
World (Market Exchange Rates)	100%	2.8	3.2	2.7	2.8
Eurozone	17.1%	0.7	1.1	0.5	1.0

Source: PwC main scenario for 2014 and 2015; IMF for GDP shares in 2013 at market exchange rates (MERs).

Appendix B
UK economic trends: 1979 – 2013

Annual averages	GDP growth	Household expenditure growth	Manufacturing output growth*	Inflation (CPI**)	3 month interest rate (% annual average)	Current account balance (% of GDP)	PSNB*** (% of GDP)
1979	3.7	4.8			13.7	-0.6	4.5
1980	-2.2	0.1			16.6	0.7	4.1
1981	-0.8	0.3			13.9	1.8	3.3
1982	2.1	1.2			12.2	0.7	2.5
1983	4.2	4.4			10.1	0.3	3.3
1984	2.3	2.5			10.0	-0.5	3.6
1985	3.5	4.1			12.2	-0.3	2.8
1986	3.2	6.5			10.9	-1.0	2.2
1987	5.5	5.3			9.7	-1.7	1.4
1988	5.9	7.8			10.4	-4.0	-0.7
1989	2.5	4.0		5.2	13.9	-4.7	-0.7
1990	0.5	0.7		7.0	14.8	-3.6	0.7
1991	-1.2	-0.7		7.5	11.5	-1.5	2.8
1992	0.4	1.2		4.3	9.6	-1.8	6.0
1993	2.6	3.1		2.5	5.9	-1.6	7.3
1994	4.0	3.3		2.0	5.5	-0.6	6.2
1995	2.5	2.1		2.6	6.7	-0.8	5.0
1996	2.7	4.2		2.5	6.0	-0.7	3.6
1997	2.6	4.6		1.8	6.8	-0.1	1.7
1998	3.5	4.4	0.4	1.6	7.3	-0.4	-0.1
1999	3.2	5.0	0.6	1.3	5.4	-2.6	-1.2
2000	3.8	5.3	2.2	0.8	6.1	-2.4	-1.5
2001	2.7	3.7	-1.5	1.2	5.0	-2.1	-0.7
2002	2.5	4.0	-2.6	1.3	4.0	-2.0	1.8
2003	4.3	4.0	-0.6	1.4	3.7	-1.6	2.8
2004	2.5	3.6	1.9	1.3	4.6	-2.0	3.1
2005	2.8	3.0	-0.1	2.1	4.7	-1.3	3.5
2006	3.0	2.2	2.2	2.3	4.8	-2.2	2.5
2007	2.6	2.8	0.8	2.3	6.0	-2.7	2.7
2008	-0.3	-0.5	-2.9	3.6	5.5	-3.7	4.8
2009	-4.3	-3.3	-9.4	2.2	1.2	-2.8	10.2
2010	1.9	0.5	4.7	3.3	0.7	-2.6	9.1
2011	1.6	-0.1	1.8	4.5	0.9	-1.7	7.0
2012	0.7	1.5	-1.3	2.8	0.8	-3.7	7.5
2013	1.7	1.6	-0.1	2.6	0.5	-4.2	5.9
Average over economic cycles****							
1979 - 1989	2.7	3.7		7.9	12.2	-0.8	2.4
1989 - 2000	2.3	3.1		3.3	8.3	-1.7	2.5
2000 - 2007	3.0	3.6	0.3	1.6	4.8	-2.0	1.8

* After the revisions to the national accounts data, pre-1998 data is not currently available ** Pre-1997 data estimated *** Public Sector Net Borrowing (calendar years excluding public sector banks)
**** Peak-to-peak for GDP relative to trend
Sources: ONS, Bank of England

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