Midlands Perspectives

BCU-MEF Output Model - Quarterly Assumption

Change in %	2016				2017			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP (Preliminary)	0.4	0.6	0.5	0.4	0.3	0.4	0.4	0.5
GDP (Final)	0.4	0.7	0.5	0.4	0.3	0.4	0.4	0.5
GVA	0.4	0.5	0.6	0.7	0.7	0.8	0.9	1.0
Midlands GVA	0.5	0.8	0.7	0.8	0.9	0.9	1.0	1.1
GDP	1.9				1.7			
Midlands GVA	2.9				3.8			

Source: ONS, IMF & MEF

Preliminary figures from the ONS suggest that GDP rose 0.5% in Q3, which was driven mostly by an increase in the services sector of 0.8% - driven mostly by transport, storage and communications industry growth of 2.2%. Growth in the production sector fell by 0.4%, with manufacturing down by 1% within that, although production has still increased by 1.2% from Q3 2015 to Q3 2016. The construction sector was the biggest drag on growth, falling by 1.4%. Given the UK's performance was higher than expected, we have revised our yearly growth forecast up to 1.9%.

The full effect of the fall in Sterling has not yet been felt though the whole supply chain, and prospects for Manufacturing are good if future increased price competitiveness of exports are realised. This bodes well for the Midlands' Economy, given exports of machinery, cars and chemicals increased in July and August according to the ONS UK Trade statistics..

BCU-MEF Output Model - Yearly Assumption

	2015e	2016e	2017f	2018f	2019f
UK GDP (£bln)	1,789	1,829	1,864	1,896	1,930
UK GDP % change	2.2	1.9	1.7	1.8	1.9
UK GVA (£mln)	1,666,342	1,710,933	1,772,099	1,839,439	1,911,177
UK GVA % change	2.6	2.7	3.6	3.8	3.9
Midlands GVA (£mln)	215,903	222,228	230,740	240,097	250,072
Midlands GVA % change	2.8	2.9	3.8	4.1	4.2

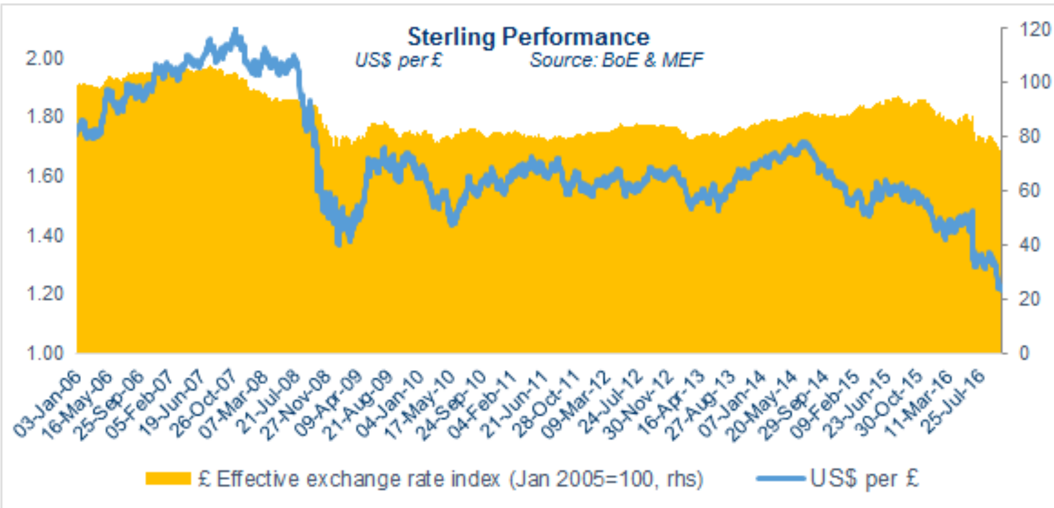
Source: ONS, IMF & MEF

Overview

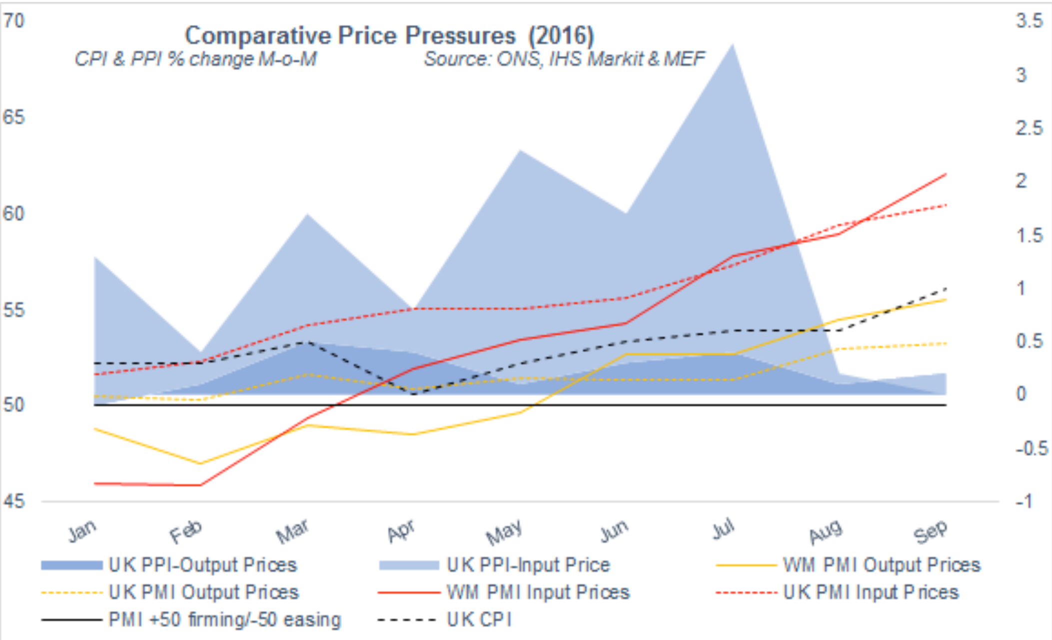
- Sterling remains under pressure over market Brexit concerns and the implications of next March's activation of Article 50 of the Lisbon Treaty.
- Immediate post-referendum performance has been much firmer than many commentators anticipated, but difficult headwinds remain.
- Manufacturers, particularly exporters, appear to be benefitting from recent terms of trade gains, although Sterling's volatility could jeopardise recent improvements in competitiveness.
- With re-exports an important component of gross exports, imported price pressures could weaken the Midlands relative position vis-à-vis global value-added supply chains.
- Employment levels, coupled with low levels of unemployment suggest a tightening of future labour market conditions

Recent Output Performance

The most notable feature of the past quarter has been the depreciation of Sterling since the outcome of the referendum was announced, and it is yet to stabilise into a new trading range. The immediate impact of Sterling's depreciation has been increased international competitiveness for UK exports, which may result in a near term increase in exports.



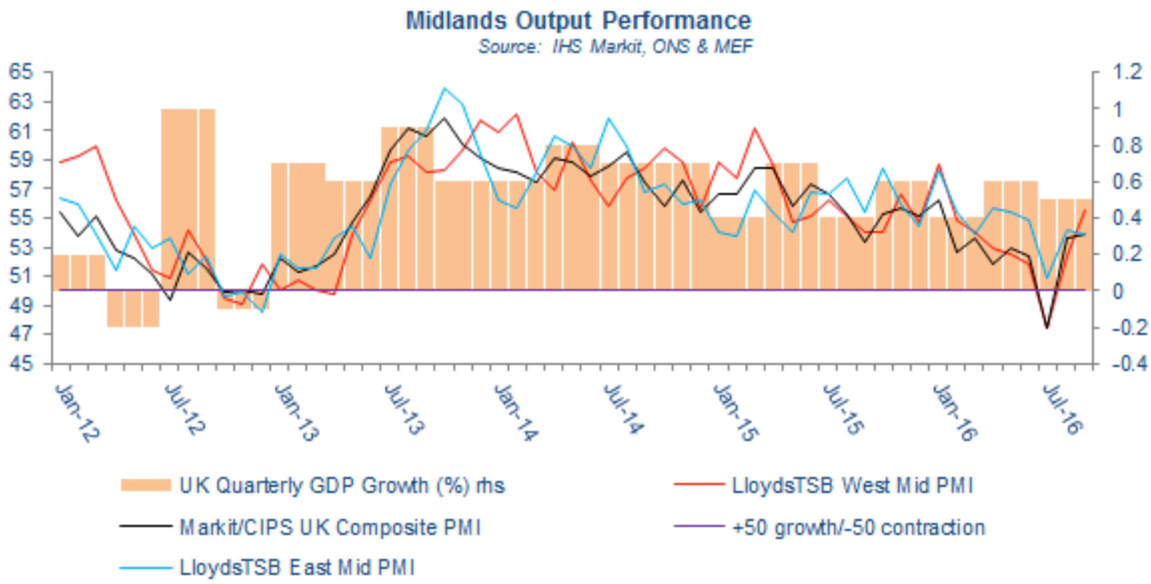
However, given the proportion of re-exports in UK exports, the fall in Sterling has also led to a substantial tightening of price pressures, most notably for inputs. With its higher dependency on imports, manufacturing sector prices appear to be increasing at a greater pace than those in the services sector. This has contributed to consumer prices accelerating in September to 1%. This build-up of price pressures was evident in mid-year PPI data as input prices reflected the gradual weakening of Sterling, over the past two years, offsetting the gains of low global commodity prices. Sterling's accelerated depreciation post-referendum appears to have led to a marked tightening, although August and September data suggest that some moderation of both output and input price pressures. PMI data for the quarter indicates future firming of inflationary pressures. Moreover, perhaps as a result of regional differences of industry sector concentrations, there appears to be a widening of price differentials between regions. In the case of the West Midlands, given the high concentration of manufacturing and related services, there were inflationary benefits to global commodity price weakness earlier in the year. However, this has been partially offset by recent currency depreciations, and West Midlands' input and output prices have risen faster than nationally since June. Given the region's significant role within global value-added supply chains, the impact is more rapid than in other, more domestically orientated sectors.



The sharp fall in PMI data in July, after the referendum result, was followed by a sharp recovery in August and September, although overall the data is mixed and a clear trend is yet evident. Manufacturing, services and construction have all recorded improving if subdued performance. Notably PMI data indicates there has been a strong increase in new orders, as negative Brexit sentiment dissipates and firms benefit from improved competitiveness and import substitution effects impact.

Nevertheless, despite the performance evident in PMIs, the volatility and sustained erosion of Sterling continues to cast doubt on medium term growth prospects. Whilst the existing trading regime with the EU remains in place at least until 2019, this increased competitiveness is likely to be beneficial. However, obviously, medium-term trading prospects will depend on the future structure of the relationship with the EU, in all its manifestations, after Article 50 has been triggered. Negotiations toward a new trade agreement could prove protracted, and may indeed not be completed until 2030. As a result the UK is likely to revert to WTO status, unless an interim arrangement can be agreed to take immediate effect, once the UK concludes the formal constitutional exit process in 2019.

The Chancellor's Autumn Statement on 23rd November is widely expected to announce a more accommodative fiscal policy, with revived focus on infrastructure investment and housing. With limited scope for further monetary policy easing, market sentiment will be heavily determined by the direction of the new government's strategy. There is some anticipation of a greater emphasis on regional economic policy, with a more comprehensive approach anticipated. Similarly, it is widely expected, in a major break from previous government approaches, that an effective industrial strategy will be fleshed out.

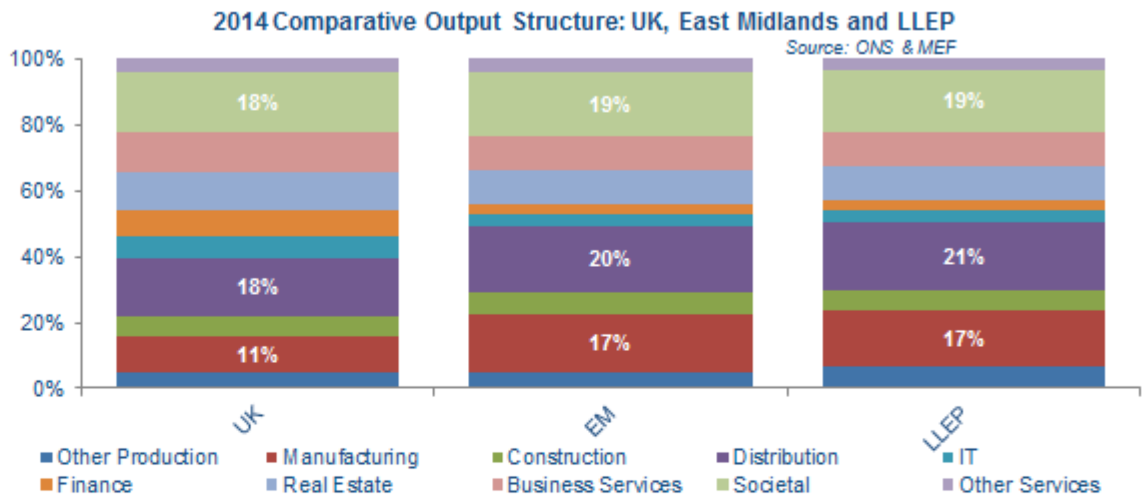


The latest available regional PMI data for the third quarter, for East and West Midlands recorded the fact that not only has the performance of the region matched that achieved nationally, but has most probably out-performed it. This appears to be the result of the preponderance of manufacturing and related services sector enterprises. As the strongest regional export performer, at least in terms of growth if not volume, the Midlands is well placed to benefit from current trading conditions. However, to sustain this performance key broadband, road, rail and aviation infrastructure investments are required to improve the region's global connectivity and provide a solid platform for growth.

Between the end of March and the end of August, the latest available labour market data (on an ILO basis) recorded a growth of the regionally economically active population (aged 16-64) from 76.3% to 77.4%, or some 2.9 million workers. Paradoxically, unemployment, on the same basis, eased up 3,000 although it remained static as an overall percentage, 5.9%. Similarly, total JSA claimants at 2.9% of the total available workforce, and 3.5% of the 18-24 year old age cohort, indicated that unemployment may be close to the natural rate of full employment. Accordingly, wage pressures can be expected to tighten over the forecast period, and coupled with anticipated Brexit curbs of free movement of labour, could incentivise firms to increase capital investment and automation over the medium-term. Whilst, the economically inactive population is slightly larger than other areas, of these 27% are registered students, some 238,500, reflecting the strength of the regions tertiary and further education sectors.

LEP Focus: Leicester & Leicestershire

The Leicester and Leicestershire Enterprise Partnership (LLEP) economy enjoys comparative advantage in a range of production, manufacturing and logistics sectors. Moreover, many firms operating in these sectors are at the final or finishing stages of the production process, where significantly more GVA per unit of production is generated.



Recent economic growth in the LLEP has been firm, averaging over 3.9% pa in nominal GVA up to 2015. Notwithstanding the clouded economic outlook as Brexit is being negotiated, the balanced sectoral composition of the LLEP economy indicated that growth prospects from 2016 to 2019 are more robust than nationally, with output growth forecast to average 4.4% pa.

Comparative Nominal GVA Performance

£ Billions	2010	2014	2015e	2016e	2017f	2018f	2019f
UK GVA	1397.7	1618.3	1666.3	1713.0	1784.9	1861.7	1941.8
UK GVA % change	2.3	4.7	2.6	2.8	4.2	4.3	4.3
East Midlands GVA	82.6	95.2	98.3	101.3	105.9	110.8	115.8
EM GVA % change	5.5	4.0	3.3	3.1	4.5	4.6	4.6
LLEP GVA	18.9	22.0	22.8	23.7	24.8	26.0	27.2
LLEP GVA % change	4.0	5.7	3.8	3.7	4.6	4.8	4.6
Memo item:							
UK Real GDP % change	1.5	2.9	2.2	1.5	1.9	2.2	2.1

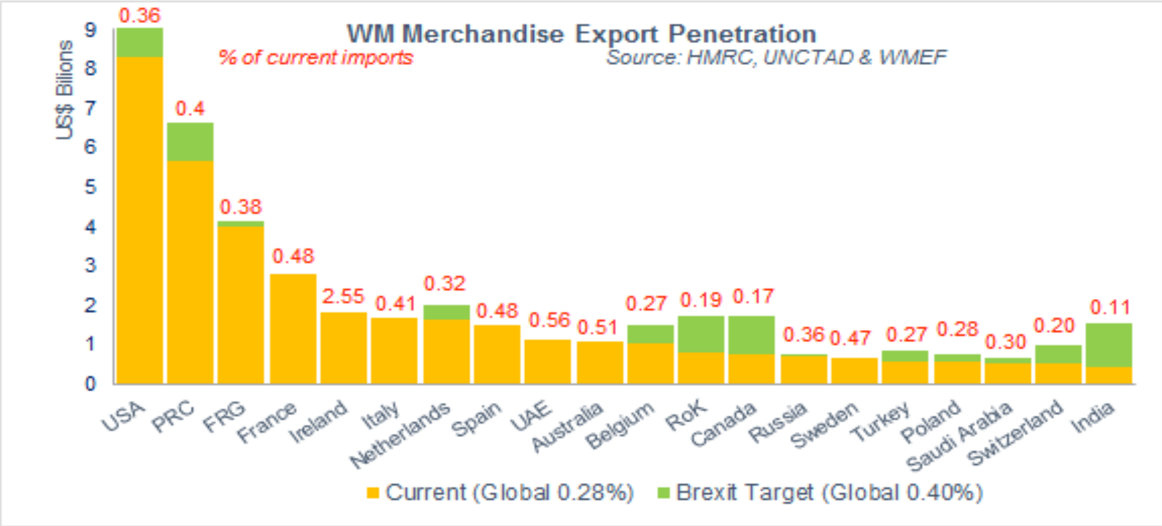
Source: ONS, IMF & MEF

The prevalence of SMEs in the local economy means it possesses a keen capacity for innovation. Since the creation of a single product can involve the competitive collaboration of a number of enterprises, these firms have experience of working across a wide range of technology fields which allows them to enhance product innovation and refinement. This is particularly the case given the size of the engineering and advanced manufacturing clusters present.

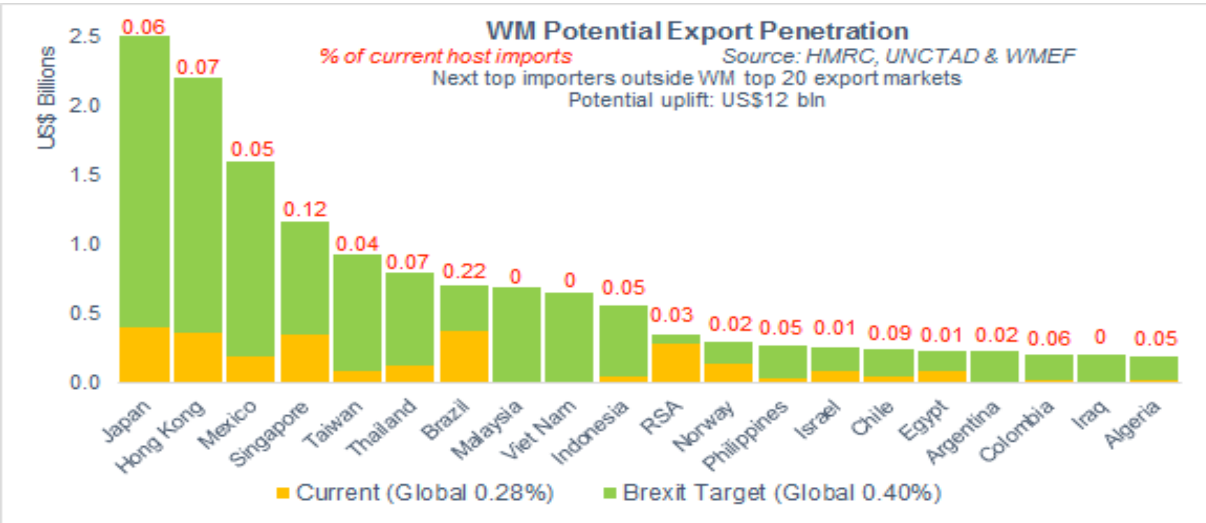
The LLEP acts as a logistics hub for the East Midlands, as well as hosting transport infrastructure assets of national importance. Consequently it is well integrated within global value-added supply chains and outperforms the national economy in several key sectors, for example textiles manufacturing, which has a location quotient of 3.42 and food and drink manufacturing.

Export Opportunities Post Brexit

Forecast global trade growth prospects remain muted, and effective regional infrastructure capacity, in its widest sense, will be critical to ensuring penetration of existing and new export markets. Thus within this context, Brexit, and the new relationship Britain ultimately establishes with Continental Europe and within it the EU, offers significant opportunities both in terms of domestic rebalancing of the British economy and in forging a more dynamic trading relationship with our nearest neighbours. There are obviously potential pitfalls, but these are not insurmountable.



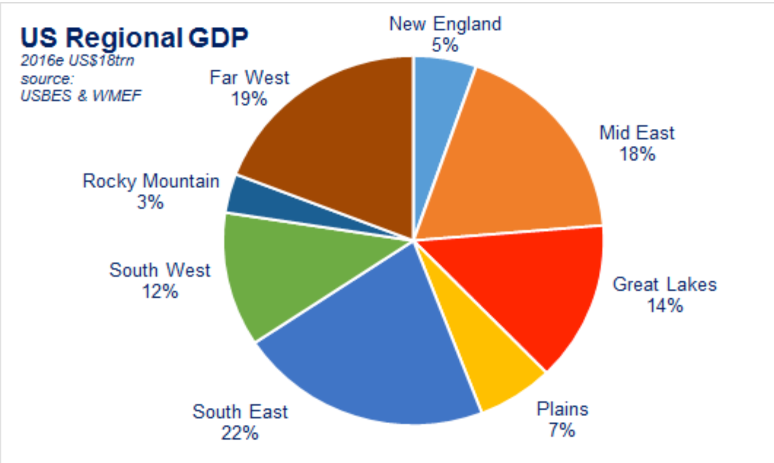
In terms of the region's penetration of global markets, the WM provides in the region of 0.28% of global merchandise export flows, a not considerable impact considering the relative size of the economy. In the case of the EU overall, however, the WM has manged to achieve a merchandise import penetration of 0.40%, significantly above its current global performance. Applying this as a target measure across the current top 20 exports markets for the WM, there is potential scope for increases in the USA, PRC and Germany. Elsewhere in Europe, there seems to be further opportunities in the Netherlands, Belgium and Poland, with limited potential in other EU states. Although there are a number of potential trade barriers, such as tariffs, regulatory regimes and iconoclastic procurement frameworks, Korea, Canada and India offer further potential.



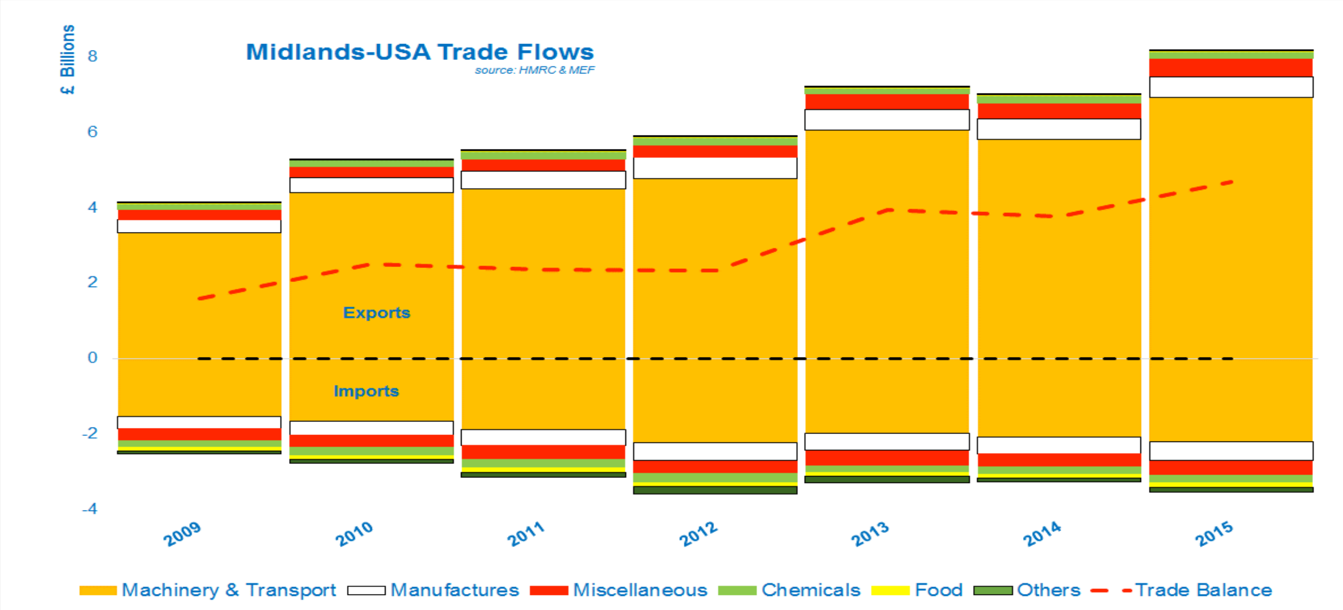
Whilst there are major data issues with regard to regional trade data, notably the fact that despite the fact that 90% of services sector exports are non-financial, there is no regional services export data, on a merchandise basis the top 20 export markets are responsible for over 80% of demand. The next 20 internationally-ranked trading economies do provide opportunities; nevertheless some are extremely difficult markets to enter, due to domestic political instability or economic autarky, whilst others are limited by the constrained connectivity that the region enjoys with them.

Market Focus: USA

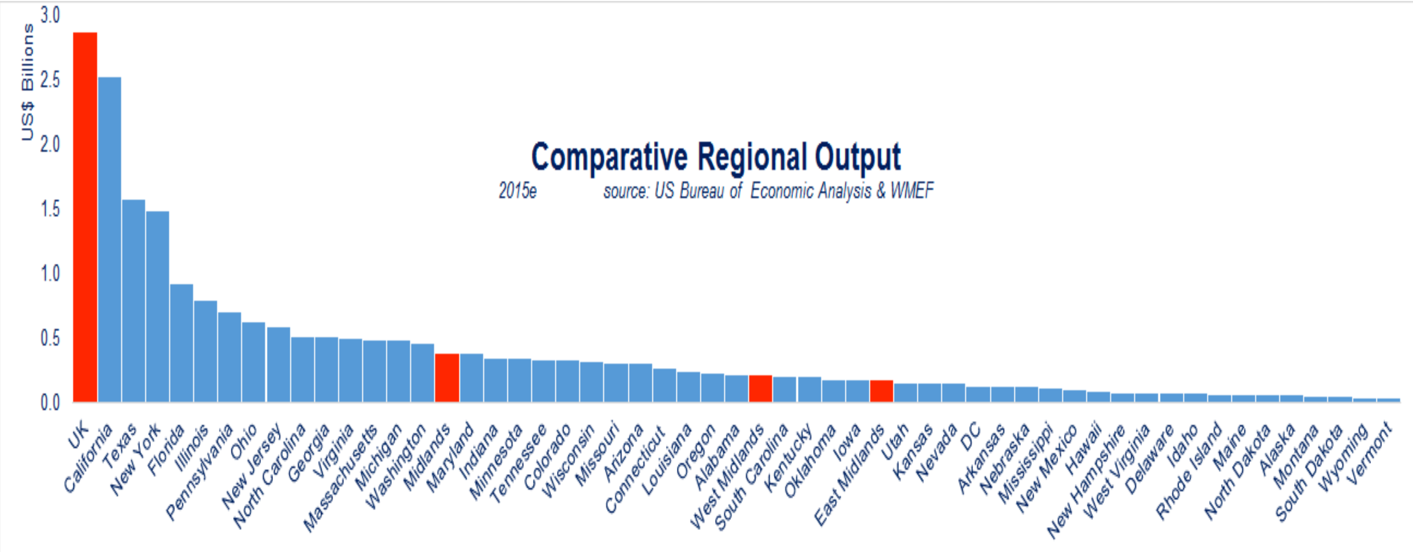
Notwithstanding the fact that the United States is one of the largest Midlands export markets, there remains significant potential uplift in terms of further penetration. Whilst this will be ultimately determined by the capacity of export infrastructure, public and private, to facilitate growth, the firmness of the US economy is indicative of future potential. Real GDP growth is forecast to exceed 2% in 2017, after achieving moderate growth of 1.6% this year, and remain at that level until 2021.



Given the scale of the US economy, equivalent to an estimated US$18 trillion in 2016, it is important to consider the US as a range of discrete regional markets, each with distinct characteristics – some with a preponderance of financial services, others who have retained core strengths in manufacturing – which demand different marketing and distribution strategies.

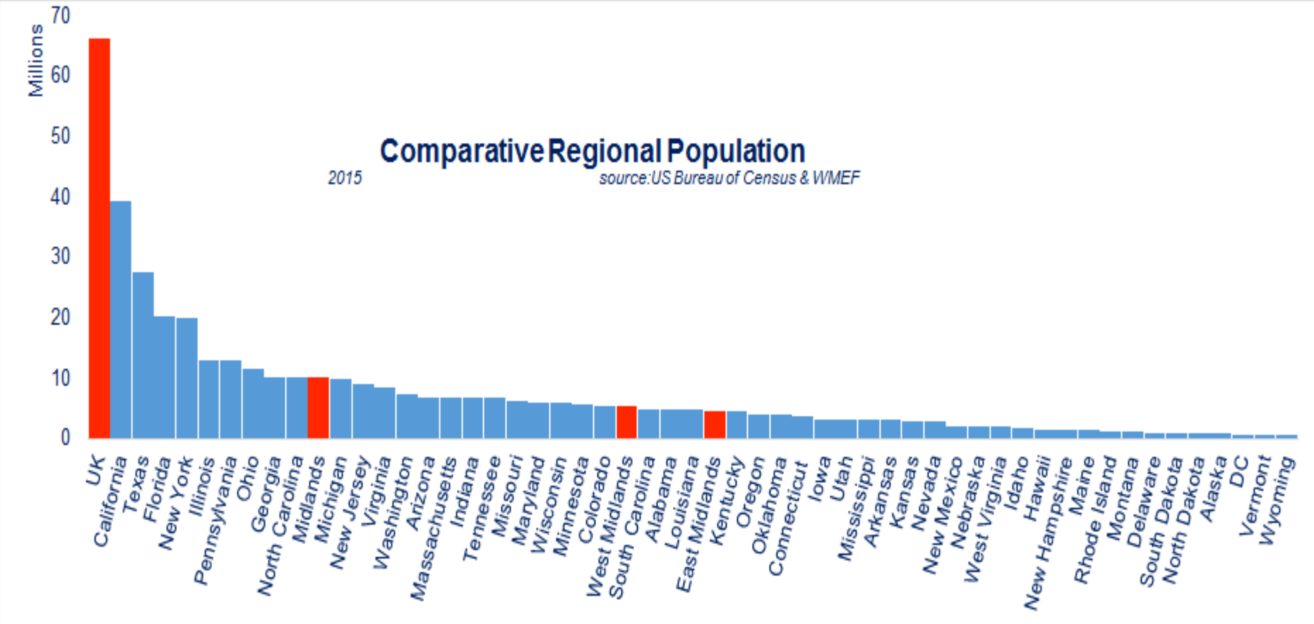


Export performance by the Midlands into the US, between the previous peak in 2008 and 2015, has been extremely robust, now £8.2 billion some 85% greater. Moreover, the region enjoys a substantial trade surplus of over £4 billion with the US, the largest component being Machinery and Transport Equipment. Indeed with the notable exception of the large Food sector deficit and the slight deficit in Chemicals, the Midlands enjoys positive balances, although a more diversified portfolio could further improve prospects.



In terms of economic output, the Midlands is comparable to a mid-sized US state, and in terms of structure to the more technologically advanced, with Intelligent Manufacturing becoming increasingly significant on both sides of the Atlantic.

Similarly, the region in demographic terms is comparable to a medium-sized state.



The *Midlands Perspectives* examines the comparative performance, international competitiveness and future prospects of the Midlands. Comments on how we could develop new perspectives on the regional economy are welcomed – we aim to create a dialogue rather than a monologue.

For further information:

info@midlandseconomicforum.co.uk

Report Authors: Rebecca Jones, Economist

e: rebecca.jones@midlandseconomicforum.co.uk

Paul Forrest, Head of Research

e: paul.forret@westmidlandseconomciforum.co.uk

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West Midlands Economic Forum

8 Beaufort Way, Aldridge, WS9 0HJ

info@midlandseconomicforum.co.uk

www.midlandseconomicforum.co.uk

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