4 – Regional growth trends and prospects[1]

Key points

- London has consistently outperformed other UK regions for most of the past two decades in terms of economic growth, both before and after the global financial crisis.

- Outside London, there is less of a clear North-South divide in historical regional growth patterns. Some Northern regions and Northern Ireland did better than some Southern regions in the decade before the financial crisis, though they have performed less well since the crisis.

- The Midlands struggled before the crisis but has performed relatively better since 2010 when compared to other regions except London.

- More recently, there have been signs that London's relative performance has been less strong and we expect this to continue in 2018-19, with London growing at close to the UK average rate.

- As manufacturing has bounced back recently on the back of a stronger global economy and a more competitive value of the pound, this has helped parts of the UK with stronger industrial bases in the North and the Midlands.

Introduction

It is well-documented that the UK has been characterised in recent decades by an increasing economic growth divide between London and other regions of the country. But what exactly has driven the opening up of this growth divide and can we expect it to continue?

In this article we begin by reviewing new data on regional growth since 1997 published by the ONS in December 2017 (Section 4.1) and then consider what factors may have driven these historical growth differentials (Section 4.2). We then look at how regional growth rates might evolve in 2018 and 2019 (Section 4.3). Section 4.4 summarises and concludes.

4.1 – Historical trends in UK regional growth

When economists compare national growth rates they do so in real terms, after adjusting for price changes. The reason is that people are not, in aggregate, better off if national income increases just because prices are higher. Living standards only rise if average incomes increase in real terms after adjusting for price inflation.

Until recently data on UK regional incomes were only available in nominal (i.e. cash) terms. In December 2017, however, the ONS published new data giving an analysis of real regional gross value added (GVA[2]) levels from 1997 to 2016, broken down in detail by industry sector. These combine data from the income and output methods of calculating GVA for the first time.

1 This article was written by John Hawksworth and George Mason, with research assistance from Ravi Desor.
2 GVA is the regional equivalent of GDP, with some minor definitional differences of no great consequence for our analysis here.

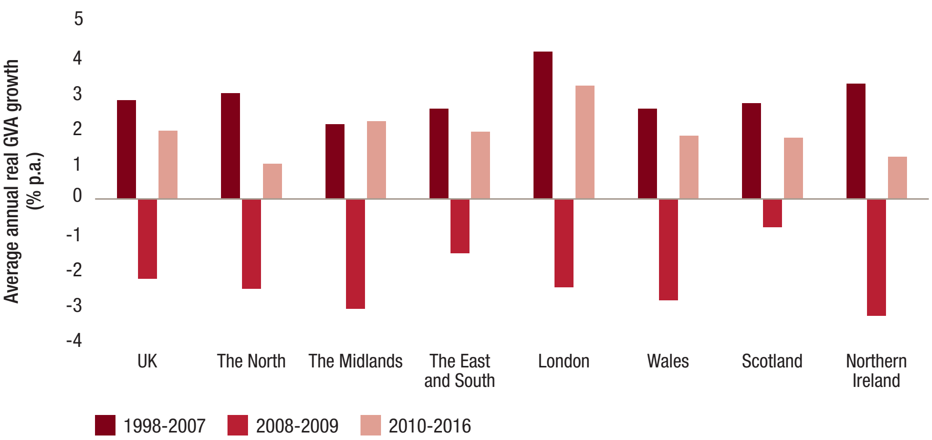
Figure 4.1 shows overall regional trends in average real GVA growth over three periods: before the global financial crisis (1998-2007), during the crisis (2008-9) and since the crisis (2010-16). For ease of presentation, we group together English regions in the North, Midlands and the East and South outside London.

The fact that London had the highest average real growth rate (4.2%) before the crisis is well known, but the fact that Northern Ireland (3.3%) and the North of England (3.0%) were the next fastest growing regions may be more surprising. Furthermore, the rest of East and South England outside London had a somewhat below average growth rate of 2.6%, with only the Midlands (2.1%) seeing lower average real growth over this period. All regions saw average growth of over 2% per annum over this period which was a relatively strong one for the UK economy.

In retrospect, however, these pre-crisis growth rates look unsustainably high, as shown both by the sharp falls in output during the crisis and the relatively modest recoveries thereafter. London was certainly not immune from the crisis, with an average annual real GVA decline of 2.5% per annum putting it in the middle of the regional pack. Scotland suffered the smallest decline in output during 2008-9, while Northern Ireland was the worst hit, followed by the Midlands.

After the crisis, London bounced back more quickly than other regions, helped by a resurgent business services sector and despite relatively sluggish growth in financial services after 2009. London's growth rate did not match its own rapid pre-crisis rates but still exceeded 3% per annum on average. But other regional rankings differed from those before the crisis, with Northern Ireland and the

Figure 4.1 – London led the way on real GVA growth both before and after crisis



Sources: PwC analysis of ONS data

Figure 4.2 – London is the only region which increased its share of total UK GVA

Sources: PwC analysis of ONS data

North of England lagging behind, but the Midlands performing relatively better. Indeed the Midlands was the only region to see a marginally higher average real growth rate in 2010-16 (2.2%) than in 1998-2007 (2.1%).

The big picture over the last two decades, however, is that London has steadily increased its share of UK GVA from just over 19% in 1997 to 23.4% in 2016, while all other regions have seen their share of GVA decline or at best remain flat (see Figure 4.2). We next need to consider why this has happened.

4.2 – Explaining regional growth variations over time

In simple mathematical terms, relative regional growth rates will reflect a combination of two factors:

- **industry mix**: variations in the sectoral composition of output across regions; and
- **industry-by-industry performance**: variations in the relative growth rates across regions of output in particular industry sectors.

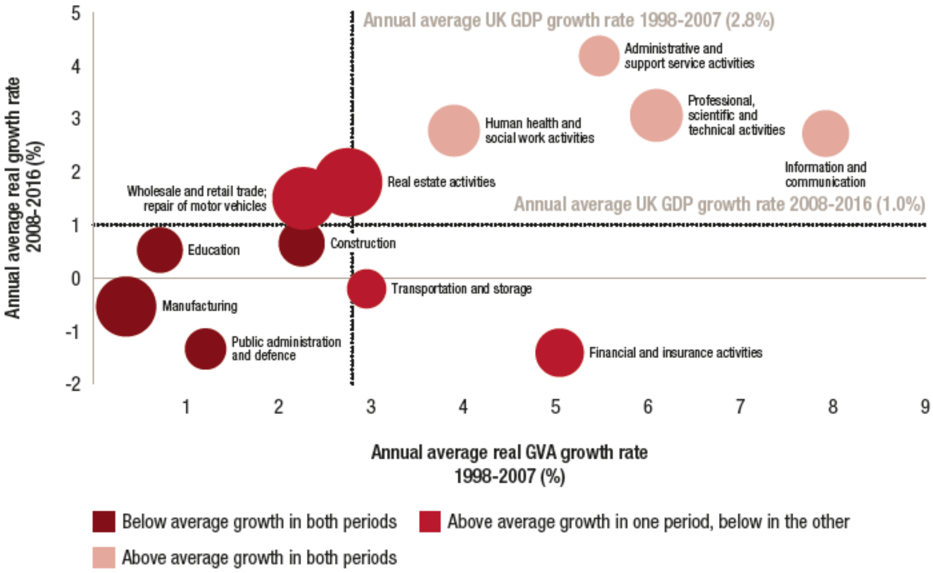
Variations in industry mix

The industries that matter most for regional performance are those that are both relatively large and have seen average national growth rates significantly higher or lower than the economy-wide UK average.

As Figure 4.3 shows, manufacturing is a relatively large sector that has tended to grow more slowly than the UK average, while professional, scientific and technical activities has been a relatively large and fast-growing sector throughout the last two decades. It is therefore useful to look in more detail at regional performance in relation to these two sectors.

Looking first at manufacturing, we can see that the average share of this sector in GVA correlates negatively with average regional GVA growth. This is most dramatically the case for London but also holds, with some minor variations, for other UK regions.

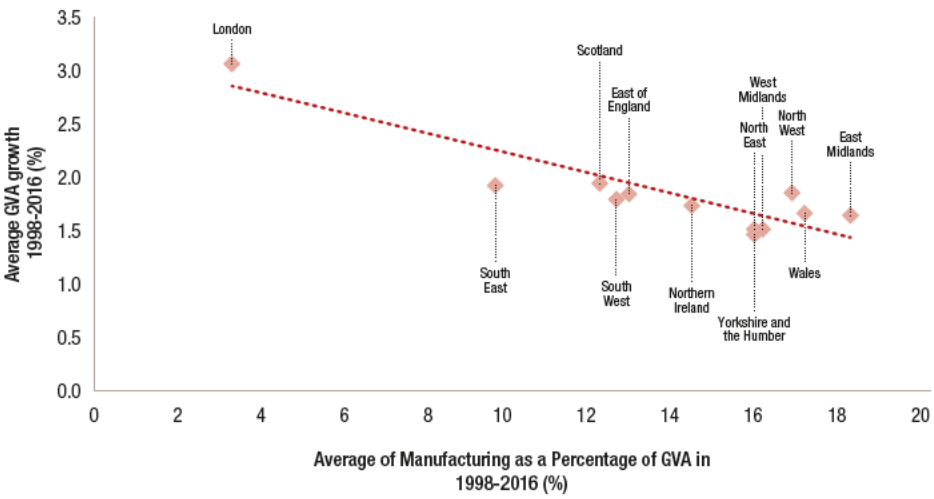
Figure 4.3 – Real GVA growth rate by sector (1998 – 2016)



Sources: PwC analysis of ONS data

Note: Size of bubbles indicates relative sectoral GVA in 2016. Mid-point of the bubbles indicates average real GVA growth rates in the two periods shown on the axes.

Figure 4.4 – Share of manufacturing output negatively correlated with regional GVA growth



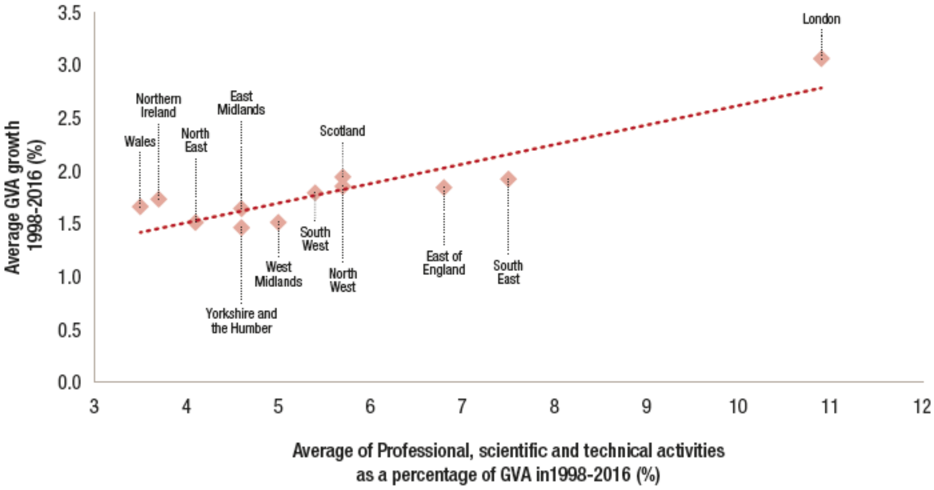
Sources: PwC analysis of ONS data

By contrast, the share of GVA in professional, scientific and technical services is positively related to relative regional GVA growth, as shown in Figure 4.5.

In other cases, industry mix has had varied impacts over time. In particular, the public sector grew relatively fast between the early 2000s and 2009, but then slowed markedly as austerity set in from 2010. This is illustrated in Figure 4.6 by the negative correlation between the share of public sector employment in total employment by region and relative regional GVA growth in 2010-16.

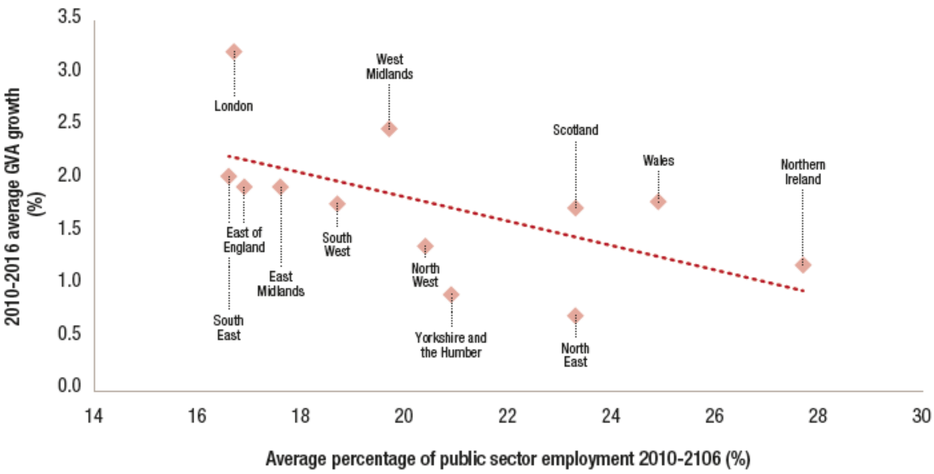
The squeeze on public spending since 2010 has been a particular drag on growth in Northern Ireland and the North East of England, together with other factors such as a relative lack of new business start-ups compared to other regions.

Figure 4.5 – Share of professional, technical and scientific services shows a positive correlation with relative regional GVA growth



Sources: PwC analysis of ONS data

Figure 4.6 – Regions with relatively high public sector employment have seen slower growth since 2010



Sources: PwC analysis of ONS data

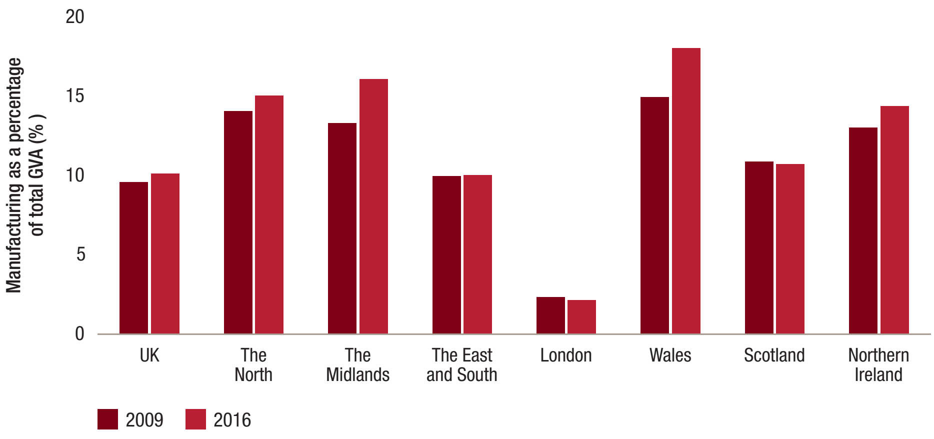
Variations in industry-by-industry performance

At least as important as industry mix, however, has been the relative performance of different regions within large industry sectors.

Manufacturing, for example, has increased its share of total GVA within regions that have a strong industrial base (see figure 4.7 below). This has helped to drive recovery in areas that, before the financial crisis, were growing below the national rate. For example, between 1998 and 2007, the West Midlands had an annual average real GVA growth rate of around 1.8% (compared to a national average of 2.8%). However, an increasingly strong global economy (and a more competitive value of the pound) has encouraged the growth of its export-focused manufacturing sector, which in turn has seen its annual average GVA growth rate rise to 2.5% since 2010, compared to the UK average of just 1.9% per annum over this period.

Real estate activities[3] have also seen an improvement in their share of total GVA across the majority of regions since the financial crisis, though London is the only region to exceed its 1998 peak (see figure 4.8 below). In contrast, Wales and Ireland have seen a decline over the period, experiencing a fall of 6.7 and 5.0 percentage points since their height in 1998.

Figure 4.7 – Wales and the Midlands have seen the highest increase in manufacturing since 2009



Sources: PwC analysis of ONS data

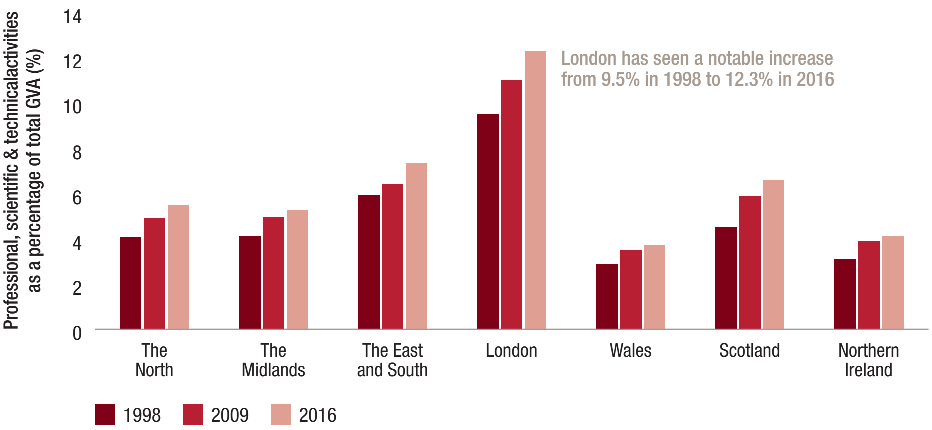
Figure 4.8 – Real estate has become increasingly important to the majority of regions since 2009

Sources: PwC analysis of ONS data

3 However, it should be noted that ONS data include imputed rent on owner-occupied property in real estate GVA statistics, which is not actual income.

In the case of professional, technical and scientific services, London both had a relatively high initial share of activity and grew relatively fast in that sector. While all regions have seen this sector rise as a share of their GVA since 1998, this has been particularly marked in London (see Figure 4.9), helping to drive its overall relatively strong performance.

Figure 4.9 – Professional, scientific and technical activities have been increasingly important to all regions, but particularly so in London



Sources: PwC analysis of ONS data

Underlying factors driving relative regional success

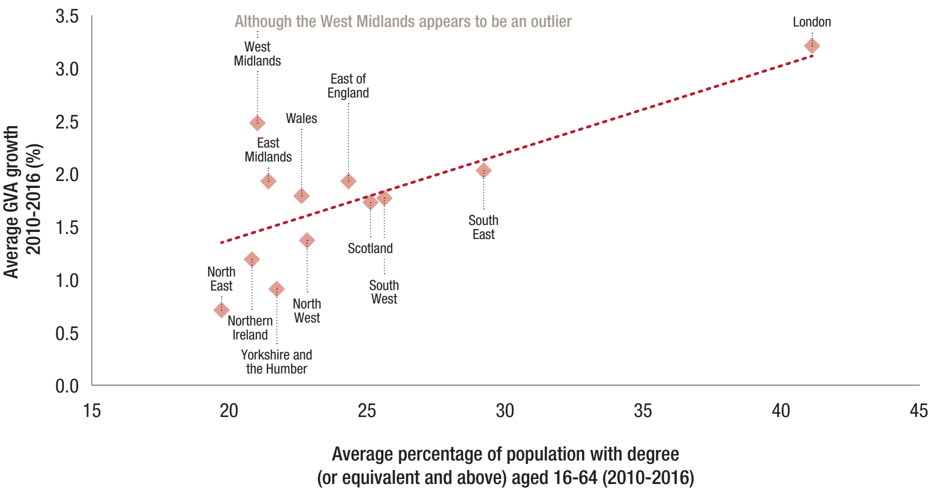
A complex mix of factors drive relative regional growth, but some are more easily quantified than others. In particular, attracting and retaining skilled people is critical as the correlation of relative regional growth since 2007 with average education levels over this period makes clear (Figure 4.10).

London again stands out here in terms of its share of graduates, though the West Midlands is something of an outlier in terms of regional growth rates since 2010 that were higher than might have been expected just based on the proportion of graduates in the region. This seems to be explained in part by a relative recovery in manufacturing in the Midlands since the crisis, as well as diversification into business services. There may also be some positive spill-over effects from growth of London and the South East.

Entrepreneurship is also important in regional growth, as indicated by the data on business birth rates in Figure 4.11, with London again standing out. In practice, however, it is not just the birth of new businesses that matter but whether they can scale up to be larger companies driving long term growth of output and employment.

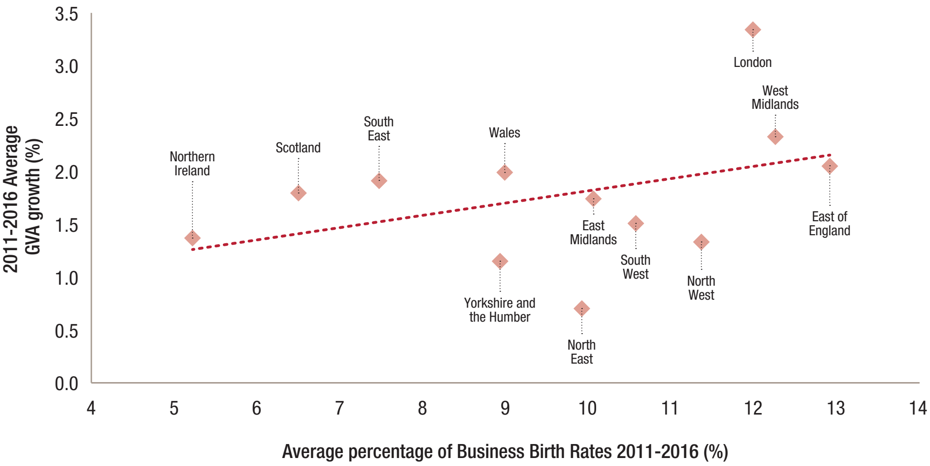
Many other factors will also be relevant here, including some that may be less favourable to London such as the affordability of housing and transport congestion[4], and others that may reinforce its lead such as the number of world-class universities in the region and the ability to attract world class talent to London due to its position as both a global financial centre and a leading cultural centre[5].

Figure 4.10 – Regional growth is positively correlated with average regional education levels



Sources: PwC analysis of ONS data

Figure 4.11 – There has been a positive relationship between business birth rates and regional growth (2011-2016)



Sources: PwC analysis of ONS data

4 These factors help to explain why London is not the most successful city in our Good Growth for Cities index, which looks at a broader set of measures of well-being than just GVA. In fact, cities in the Midlands and the North have seen the greatest improvements in index scores in recent years. Our latest report can be downloaded here: https://www.pwc.co.uk/industries/government-public-sector/good-growth.html

5 As reflected in London's consistently high ranking in our global Cities of Opportunity study, the latest edition of which is available here: https://www.pwc.com/us/en/library/cities-of-opportunity.html

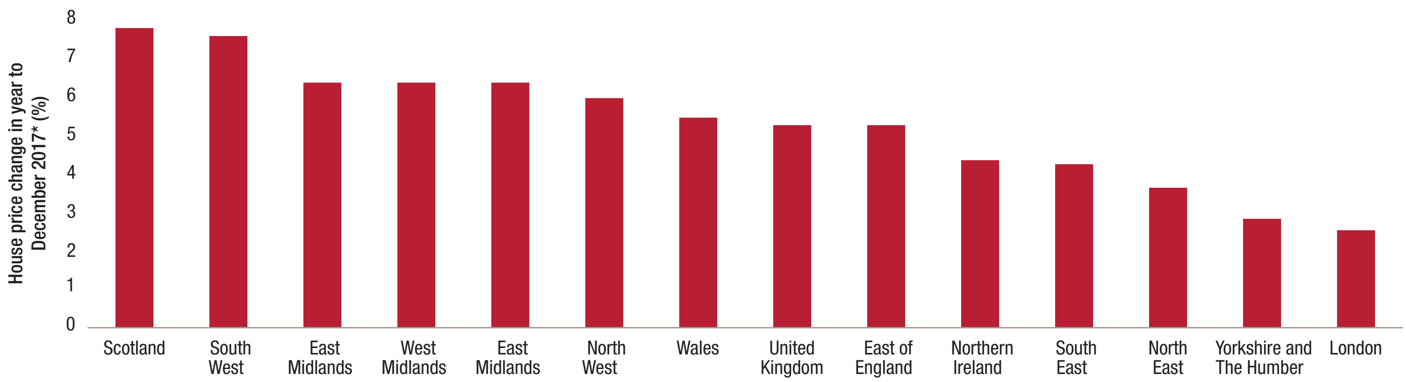
4.3 – Regional growth prospects for 2018-19

While London has grown relatively strongly for most of the past two decades, there have been some recent signs that other regions are starting to catch up.

In the housing market, for example, London house prices have seen the weakest growth of any UK region in the year to December 2017 (see Figure 4.12), reversing the relatively strong growth in London house prices seen in previous periods.

The labour market has also seen some other regions showing faster employment growth than London over the past year (see Figure 4.13).

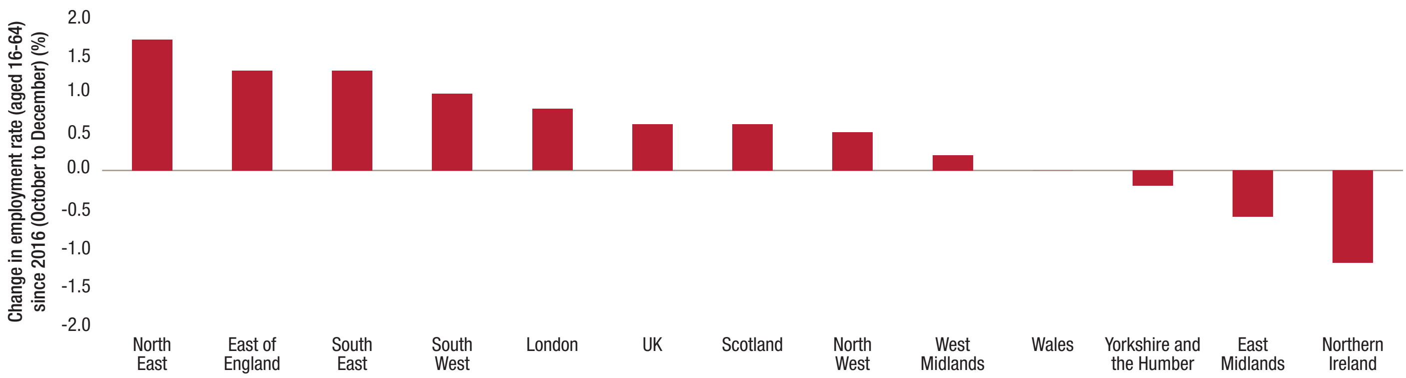
Figure 4.12 – London has seen the weakest house price growth over the past year



Source: ONS house price index based on Land Registry data

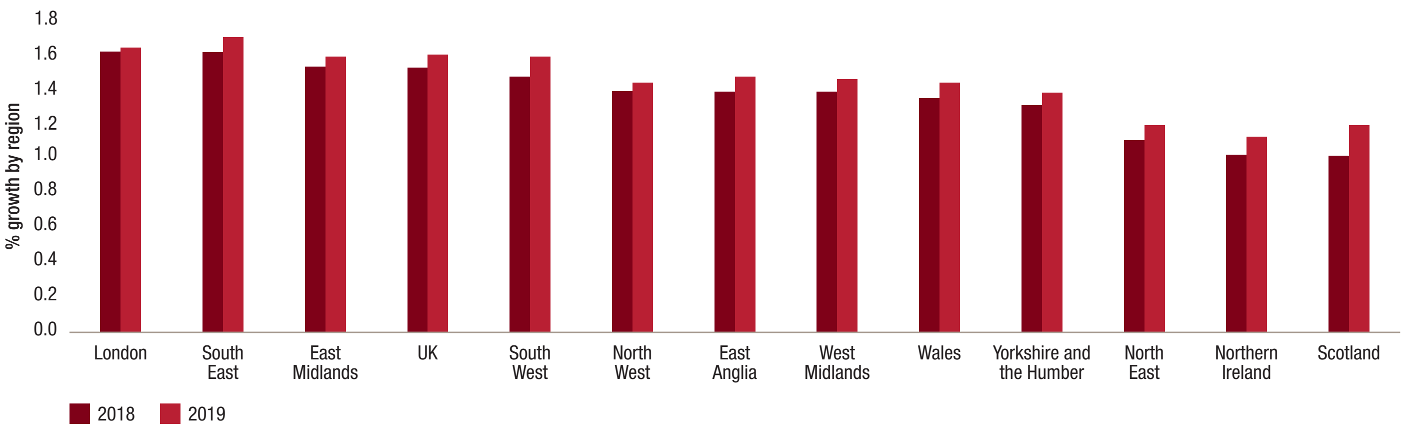
*Except for Northern Ireland where data are for year to Q4 2017 as monthly data are not available

Figure 4.13 – The North East has witnessed the largest rise in its employment rate over the past year, with London close to the UK average



Source: ONS

Figure 4.14 – PwC main scenario for output growth by region in 2018 and 2019



Source: PwC analysis

This is also reflected in our latest regional growth projections for 2018-19, which show London only marginally ahead of the UK average as shown in Figure 4.14.

To some extent this may just be a normal cyclical phenomenon. Because the economic recovery since 2010 has been significantly stronger in London than other regions (as Figure 4.1 above shows), this has left it with less spare capacity now. It has also led to constraints on growth from factors like transport congestion and lack of affordable housing that are more severe in London than elsewhere in the country (with the exception perhaps of a few other 'hot spots' like Oxford and Cambridge). These constraints can only be addressed through a major programme of new investment that will take time to have its effect, though Crossrail will come into operation soon.

Depending on the nature of the future UK-EU relationship on financial services, Brexit could also have an adverse effect on London given its particularly heavy reliance on this sector[6]. However, other regions will clearly also be affected by Brexit to varying degrees depending on the nature of the future UK-EU relationship, not least as regards Northern Ireland given the importance of retaining frictionless trade with the Republic of Ireland with no hard border. At present, therefore, Brexit remains an important source of uncertainty for all UK regions.

6 For a detailed vision of how the UK financial and professional services sector could continue to prosper in the longer term beyond Brexit, see our joint report with TheCityUK here: https://www.thecityuk.com/research/a-vision-for-a-transformed-world-leading-industry/

4.4 – Summary and conclusions

London has consistently outperformed other UK regions for most of the past two decades in terms of economic growth, both before and after the global financial crisis. This reflects both the fact that London has a higher share of activity in relatively fast-growing sectors such as business services, and that it has grown faster than most other regions in these fast-growing sectors.

Outside London, there is less of a clear North-South divide in regional growth patterns. Some Northern regions and Northern Ireland did better than some Southern regions in the decade before the financial crisis, though they have performed less well since the crisis. The Midlands struggled before the crisis, but has performed relatively better since 2010 when compared to other regions except London.

More recently, there are signs that London's relative performance has been less strong and we expect this to continue in 2018-19, with London growing at a rate close to the UK average. As manufacturing has bounced back recently on the back of a stronger global economy and a more competitive value for the pound, this has helped parts of the UK with stronger industrial bases in the North and the Midlands. All regions, however, continue to be affected by uncertainties relating to the future UK-EU relationship after Brexit.

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