Summary Report – November 2019

UK Economic Outlook

Special features on:

The Productivity Puzzle revisited: why has UK productivity lagged behind other advanced economies?

What drives regional productivity gaps across the UK and how can these be closed?

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Highlights and key messages for business and public policy

Key projections

(%)	2019	2020
Real GDP growth	1.2	1.0
Consumer spending growth	1.2	1.4
Fixed investment growth	-0.3	-0.5
Inflation (CPI)	1.8	1.5

Source: PwC main scenario projections

Recent UK developments and prospects

- In our main scenario, we project UK economic growth to remain modest at 1.2% in 2019 and around 1% in 2020, somewhat below its long-term average rate of around 2%.
- These projections assume an orderly exit from the EU. Risks are weighted to the downside over this period due to the possibility of a more disorderly Brexit as well as global economic risks.
- Consumer spending has continued to drive the economy, helped by stronger real earnings growth over the past year. But the housing market has cooled and business investment has been on a declining trend as a result of Brexit-related uncertainty. Employment also fell back slightly in the third quarter from previous record highs.
- The Bank of England is expected to keep interest rates on hold until the situation on both Brexit and the global economy is clearer.

UK productivity level continues to lag behind other advanced economies

- Latest data suggest that UK output per worker lags around 10-15% behind Germany, France and Sweden and more than 30% behind the US.
- Our analysis shows that, with the partial exception of Germany, these productivity gaps are not due to the UK having too small a manufacturing base. Instead they reflect lower average UK productivity within certain industry sectors relative to other advanced economies.
- Comparative international evidence suggests that relatively low levels of UK investment and R&D spending and a longer tail of companies and workers with relatively low productivity and skills are the main reasons for this productivity shortfall in the UK relative to other advanced economies.

Levelling up productivity across the UK could boost GDP by over £80 billion

- There are wide regional variations in productivity per job across the UK. This is mostly due to productivity differences within particular sectors, rather than differences in industry structures across the UK.
- Our analysis suggests that variations in skills levels and transport connectivity are the most important factors in explaining differences in productivity across UK local areas and so should be a particular focus of investment for both government and business.
- If local areas with productivity below the UK average level could make up half of this gap, the boost to UK GDP could be as much as 4%, or around £83bn.

1. Summary

Recent developments

Economic growth has been volatile so far this year, with relatively solid growth in the first and third quarters interspersed with declining output in the second quarter. This largely reflects Brexit-related timing effects, however, and looking through this volatility the underlying trend has been for continued modest growth of around 1% over the past year.

Consumer spending has remained relatively resilient, despite some slowdown in retail sales growth in recent months, and government spending has picked up during 2019. But business investment shrank for four consecutive quarters in 2018 as anxiety about the uncertainties of Brexit became more acute. Investment rose slightly in the first quarter of 2019, and stockbuilding jumped due to contingency plans for a possible no deal Brexit at the end of March, but both dropped back in the second quarter. Business surveys suggest continued subdued confidence and investment in the third quarter.

The jobs market has generally remained strong, with the employment rate at near record levels and unemployment down to its lowest rate since the mid-1970s, but employment did fall back slightly in the third quarter. Over the past year the scarcity of workers has finally lent them some bargaining power, which has fed through into increased real wage growth. But this will be difficult to sustain in the medium term unless productivity growth also picks up from the subdued rates seen over the past decade.

Table 1.1: Summary of UK economic growth and inflation prospects

Indicator (% change on previous year)	Bank of England forecasts (November 2019)		Independent forecasts (October 2019)		PwC main scenario (November 2019)	
	2019	2020	2019	2020	2019	2020
GDP	1.25	1.25	1.2	1.0	1.2	1.0
Consumer spending	1.25	1.5	1.4	1.3	1.2	1.4
Inflation (CPI)	1.8	1.5	1.9	2.0	1.8	1.5

Source: Bank of England forecasts (November 2019), HM Treasury survey of independent forecasters (average value of new forecasts made in October 2019 survey) and latest PwC main scenario.

Future prospects

As shown in Table 1.1, our main scenario is for UK GDP growth to average around 1.2% in 2019, down slightly from 1.4% in 2018, before moderating slightly to around 1% in 2020. Our views on growth and inflation are broadly similar to the latest consensus and Bank of England forecasts (see Table 1.1).

Consumer spending growth held up relatively well in 2018 and the first three quarters of 2019 but is projected to moderate to around 1.2% in 2019 as a whole in our main scenario and remain below trend at around 1.4% in 2020. This reflects our expectation that stronger real wage growth will be offset by concerns about the implications of Brexit, slower projected jobs growth and subdued house price growth.

Brexit-related uncertainty will also continue to hold back business investment in the UK. Our main scenario assumes that an orderly Brexit will be achieved, but there are still important uncertainties surrounding this assumption.

The September 2019 spending round provided a significant boost to government spending in 2020/21, and other major parties are also indicating plans for significant fiscal expansion over the next few years. This will support growth, but at the cost of rising public borrowing.

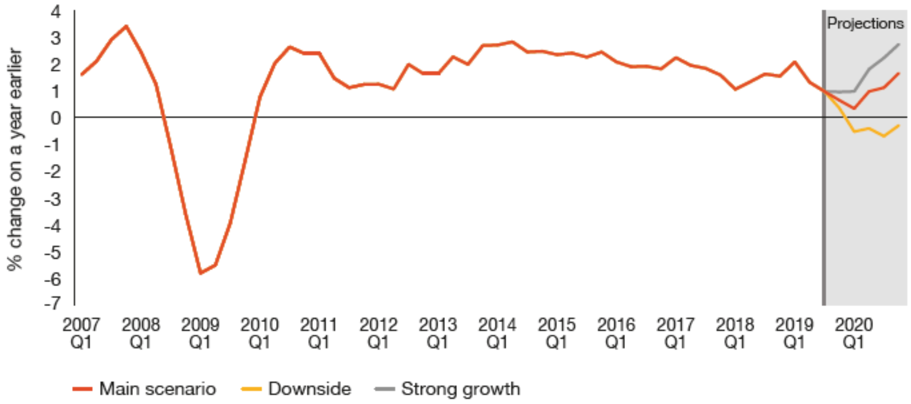
The global economy has cooled since mid-2018 as a result of slower growth in each of the US, China and the Eurozone. In the US, the impetus given by one-off personal and business tax cuts in early 2018 has faded, though recent Fed rate cuts will support domestic demand over the next year. The Chinese government is continuing to manage the gradual moderation of its economy as smoothly as possible. In the Eurozone, a progressive deceleration in growth from 2016 peak rates has already caused the ECB to start to undertake renewed monetary loosening.

The fact that the three largest economies in the world have slowed simultaneously has weakened business sentiment. There is also a risk that US trade policy towards China and others could cause a broader slowdown in global growth in 2020, although trade tensions continue to ebb and flow from month to month. If a full-scale trade war did break out, however, this would have adverse effects on both UK exports and, through confidence effects, business investment.

There are always uncertainties surrounding any growth projections, as illustrated by the alternative scenarios in Figure 1.1. There are still considerable downside risks relating in particular to the outcome of the Brexit process and the global outlook, but there are also some upside possibilities if these problems can be contained and global growth regains some momentum. In our main scenario, we expect the UK to continue to see moderate growth in 2020, but businesses need to monitor and make contingency plans for potential alternative scenarios related to Brexit and other factors such as global growth.

Consumer price inflation has fallen back below the Bank of England's 2% target rate recently, despite some acceleration in earnings growth, and may remain below 2% in 2020 due to planned cuts in regulated energy and water prices. However, there are many uncertainties around this, linked in particular to possible volatility in global commodity prices and exchange rates.

Figure 1.1 – Alternative UK GDP growth scenarios



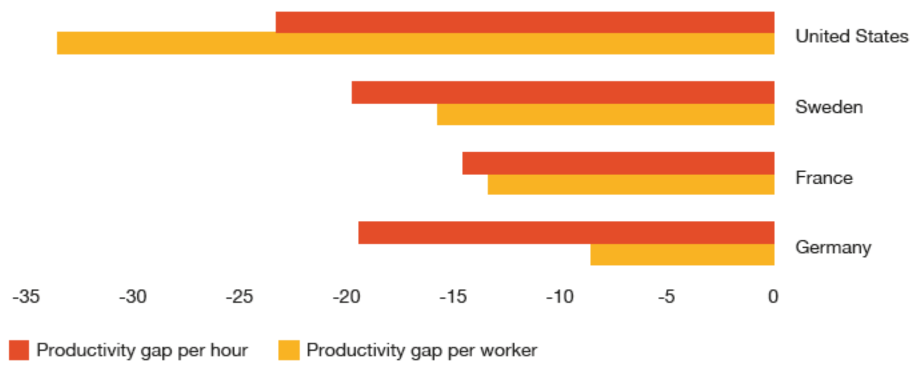
Sources: ONS, PwC

Given benign current levels of inflation and continued uncertainties around Brexit and the global economy, we expect the Monetary Policy Committee to remain cautious. In our main scenario we assume no interest rate changes in the short term. But UK rates could move in either direction over the next year depending on developments on Brexit as well as wider global economic trends.

In a no deal scenario, which looks unlikely in the short term but could return as a possibility later in 2020, both monetary and fiscal policy would probably be loosened in the short term to soften the blow to the economy. But fiscal policy might need to be tightened again in the longer term to repair the potential damage to the public finances from a disorderly Brexit.

> Businesses need to make contingency plans for alternative scenarios for both Brexit and global growth.
>
> **John Hawksworth**
> Chief Economist, PwC

Figure 1.2 – The UK productivity shortfall (% difference)



Note: Productivity is measured here by GVA per hour and GVA per worker at PPP exchange rates, 2017 data. PPP exchange rates take account of differences in prices between countries and are generally acknowledged as the most appropriate measure when making international comparisons of output or productivity. Data excludes the real estate sector as differences in measurement of imputed rents can distort the figures.

Source: Eurostat

UK productivity lags behind many other advanced economies

A key economic challenge for the next UK government will be to address the long-standing shortfall in our productivity levels relative to other advanced economies.

Latest data suggest that UK output per worker lags around 10-15% behind Germany, France and Sweden and more than 30% behind the US (see Figure 1.2). The figures for output per hour also show significant shortfalls for the UK relative to these countries (although the gap drops to 23% for the US given the longer hours worked there on average).

Our analysis shows that, with the partial exception of Germany, these productivity gaps are not due to the UK having too small a manufacturing base. Instead they reflect lower average UK productivity within certain industry sectors (e.g. retail and wholesale) relative to other advanced economies.

Comparative international evidence suggests that relatively low UK levels of investment and R&D spending and a longer tail of companies and workers with relatively low productivity and skills are the main reasons for this productivity shortfall in the UK relative to other advanced economies. Future policy needs to be targeted on investing more in each of these areas, but business also has a key role to play in achieving these aims, notably through upskilling their employees.

Levelling up regional productivity across the UK could boost GDP by over £80 billion

In Section 4 of this report, we turn our attention to regional productivity gaps within the UK.

The region with the highest level of productivity is London (where productivity is around 40% above the UK average) while the region with the lowest productivity is Yorkshire and the Humber, where productivity is 16% below the national average (see Figure 1.3).

The gap between the best- and worst-performing local economic partnerships (LEPs) in England has widened over time, with productivity in the highest-ranking LEP being around 2.1 times more than the lowest-productivity LEP in 2017, as compared to 1.8 in 2002.

Our analysis shows a statistically significant correlation between skill levels and productivity in different local areas, as well as between physical and digital connectivity and productivity. There is also a positive, albeit weaker correlation between the share of large enterprises and productivity. This may reflect lower adoption of the latest technologies and processes in smaller businesses, resulting in lower productivity levels in those businesses.

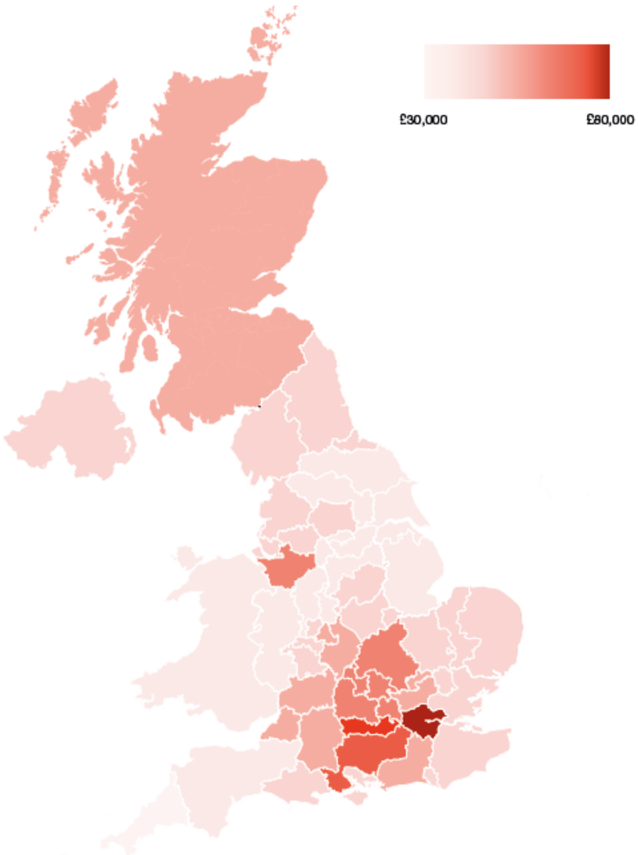
While differences in the composition of industrial activity can explain some regional and local productivity differences, variations in skills and connectivity appear more significant based on our cross-sectional regression analysis.

These findings suggest that both policymakers and businesses need to focus on upskilling workers, particularly in areas where there are skills gaps, such as self-management and leadership skills as well as digital capabilities.

Investing to improve the quality and capacity of local infrastructure could help boost the connectivity of a place (and consequently its productivity). LEPs could work in collaboration to strengthen intra-region connectivity and access to economic hubs, for instance drawing on the experience of the Oxford-Cambridge arc, which is supported by four LEPs in the region.

The economic prize for getting this right is potentially significant. We estimate that, if areas that are currently performing below the UK average can close 50% of this productivity gap, this could boost total UK GDP by nearly 4%, equivalent to around £83 billion per annum at today's values.

Figure 1.3 – Heatmap of UK productivity based on output per job for LEPs in England as well as Scotland, Wales and Northern Ireland (2017)[1]



Sources: ONS. PwC analysis

1 There are 38 local enterprise partnerships (LEPs) in England. We present these alongside the data for the other three nations of the UK (Wales, Northern Ireland and Scotland).

Appendix A
Outlook for the global economy

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

In 2019, the world economy is expected to grow by around 2.8% (based on GDP at market exchange rates), slowing down significantly from last year. In our main scenario for next year, we expect global growth to grow at a similar rate to this year assuming no further intensification of global trade tensions. Should these worsen, however, then global growth could be even slower as this would hit business confidence further, with a knock-on impact on global investment. The manufacturing sector in the UK and elsewhere would be particularly exposed to any such global economic events given its high dependence on trade.

Focusing on the US, we expect growth of around 2.5% in 2019, down from 2.9% last year. US economic activity continues to be propped up by recent interest rate cuts and loose fiscal policy, with the federal budget deficit expected to exceed the $1 trillion mark by the end of next year. Nonetheless, we expect some further slowdown to growth of around 1.8% in 2020, which is more in line with its potential growth rate. Meanwhile, the Chinese economy is expected to grow by just under 6% in 2020.

Economic activity in the Eurozone has been sluggish in 2019 on the back of a slowing German economy. However, we project a modest recovery in 2020 given the boost from monetary and fiscal loosening that is expected to support economic activity.

We project mixed levels of economic performance across emerging economies. However, there are some bright spots especially in India and Indonesia, which are expected to expand by an average rate of around 7% and 5% respectively in 2019-20.

Table A.1: Global economic growth and inflation prospects

	Share of world GDP (%)	Real GDP growth (%)		Inflation (%)	
	2018 at MERs	**2019p**	**2020p**	**2019p**	**2020p**
United States	24.2	2.5	1.8	2.0	1.9
China	15.8	6.2	5.8	2.4	2.5
Japan	5.9	0.9	0.3	0.9	1.3
United Kingdom	3.3	1.2	1.0	1.8	1.5
Eurozone	14.2	1.1	1.4	1.2	1.5
France	3.3	1.3	1.4	1.2	1.4
Germany	4.7	0.6	1.3	1.6	1.8
Greece	0.3	2.1	2.2	0.4	0.8
Ireland	0.4	4.2	3.5	1.0	1.5
Italy	2.4	0.1	0.6	0.8	1.2
Netherlands	1.1	1.7	1.6	2.3	1.8
Spain	1.7	2.3	2.0	0.7	1.0
Poland	0.7	4.3	3.0	2.2	3.5
Russia	1.9	1.2	1.8	4.6	3.5
Turkey	0.9	0.3	3.0	14.6	12.8
Australia	1.7	2.2	2.3	1.7	2.0
India	3.2	7.3	7.5	4.2	4.8
Indonesia	1.2	5.0	5.1	3.2	3.5
South Korea	1.9	2.5	2.8	1.4	1.6
Brazil	2.2	1.2	2.2	4.3	3.9
Canada	2.0	1.6	1.8	1.7	1.9
Mexico	1.4	0.4	1.3	3.7	3.0
South Africa	0.4	0.6	1.1	4.3	5.1
Nigeria	0.5	2.3	2.5	11.3	11.4
Saudi Arabia	0.9	0.1	1.9	2.7	2.8
Global (Market Exchange Rate (“MER”)	100	2.8	2.7	2.2	2.3
Global (Purchasing Power Parity (“PPP”) rate)	-	3.3	3.3	2.7	2.8
G7	45.9	1.8	1.4	1.7	1.7
E7	26.7	4.8	5.0	3.4	3.3

Source: PwC main scenario projections for 2019 and 2020; IMF for GDP shares in 2018 at market exchange rates (MERs).

These projections are updated regularly in our Global Economy Watch publication, which can be found at www.pwc.com/gew

Appendix B
UK economic trends: 1979-2018

Annual averages	GDP growth	Household expenditure	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	-4.2
1980	-2.0	0.1			16.6	0.5	-3.9
1981	-0.8	0.3			13.9	1.5	-3.0
1982	2.0	1.2			12.2	0.6	-2.3
1983	4.2	4.4			10.1	0.2	-3.0
1984	2.3	2.5			10.0	-0.5	-3.3
1985	4.1	5.1			12.2	-0.3	-2.5
1986	3.2	6.0			10.9	-1.0	-2.0
1987	5.4	5.1			9.7	-1.6	-1.3
1988	5.7	7.3			10.4	-3.5	0.6
1989	2.6	3.9		5.2	13.9	-4.1	0.6
1990	0.7	1.0		7.0	14.8	-3.1	-0.6
1991	-1.1	-0.6	-5.0	7.5	11.5	-1.3	-2.6
1992	0.4	1.0	-0.1	4.2	9.6	-1.5	-5.6
1993	2.5	2.9	1.5	2.5	5.9	-1.3	-6.7
1994	3.8	3.2	4.7	2.0	5.5	-0.5	-5.7
1995	2.5	2.2	1.5	2.6	6.7	-0.7	-4.6
1996	2.5	3.8	0.9	2.4	6.0	-0.6	-3.3
1997	3.9	4.8	1.6	1.8	6.8	0	-1.9
1998	3.6	4.3	0.3	1.6	7.3	-0.5	-0.3
1999	3.4	4.6	0.3	1.3	5.4	-2.5	0.8
2000	3.4	4.7	1.8	0.8	6.1	-2.3	1.5
2001	3.0	3.5	-1.3	1.2	5.0	-2.1	0.1
2002	2.3	3.2	-2.4	1.3	4.0	-2.1	-2.2
2003	3.3	3.4	-0.5	1.4	3.7	-1.8	-3.6
2004	2.4	3.2	1.9	1.3	4.6	-2.3	-3.5
2005	3.2	2.5	0.1	2.1	4.7	-1.9	-3.4
2006	2.8	1.8	2.4	2.3	4.8	-2.8	-2.9
2007	2.4	2.6	0.6	2.3	6.0	-3.3	-2.7
2008	-0.3	-0.5	-2.9	3.6	5.5	-3.9	-5.6
2009	-4.2	-3.1	-8.6	2.2	1.2	-3.3	-10.4
2010	1.9	1.1	4.5	3.3	0.7	-3.2	-12.2
2011	1.5	-0.1	2.4	4.5	0.9	-1.8	-7.4
2012	1.5	1.6	-1.1	2.8	0.8	-3.4	-7.7
2013	2.1	3.0	-1.1	2.6	0.5	-4.8	-6.0
2014	2.6	2.5	2.9	1.5	0.5	-4.7	-5.6
2015	2.4	2.9	-0.1	0.0	0.6	-4.9	-4.5
2016	1.9	3.8	0.2	0.7	0.5	-5.2	-3.3
2017	1.9	2.3	2.2	2.7	0.3	-3.5	-2.5
2018	1.4	1.6	0.4	2.5	0.6	-4.3	-2.3
Average over economic cycles****							
1979 - 1989	2.8	3.7			12.2	-0.8	-2.2
1989 - 2000	2.4	3.0		3.2	8.3	-1.5	-2.4
2000 - 2014	1.9	2.0	-0.1	2.2	3.3	-2.9	-4.8

* Pre-1991 figures for manufacturing output growth are not currently available on a consistent basis ** 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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