



- *Although UK growth was, once again, stronger than expected, it remains to be seen whether this can be sustained in the face of the programme of fiscal consolidation that is being implemented from this year until 2014/15.*
- *London will be hit hard by the raft of welfare cuts and public sector job losses that have been announced. Nonetheless, growth in its key sectors, a stronger housing market and tourism spending will offset much of the weakness.*
- *The northern regions will see only muted overall growth as their high rates of unemployment and weaker private sectors hold back their economies.*
- *Financial & business services will underpin the recovery despite underlying risks.*



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**The £1.4bn Regional Growth Fund and various transport initiatives outside the Greater South East aim to partially offset the large negative impact of the fiscal squeeze on the consumer and government sectors**

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Even though the UK has technically been out of recession for a year and all its sectors are now growing, overall expansion in the regions remains more muted than one would have expected in 'recovery mode' when growth rates typically tend to be faster. This is because, despite the exit from recession, the economy faces severe risks and the improvement in consumer and business confidence is still tentative.

Despite increased regulation in its key financial sector and the fact that welfare cuts will take a disproportionately higher toll on its economy, the Greater South East has several advantages that ensure that it remains the leader in regional growth rankings. London's housing market remained resilient even as the UK housing market entered a 'double dip' in 2010q3 and its consumer sector will be further supported by the return of financial sector bonuses and tourism. The outlook for regions outside the

Greater South East is weak. To allay fears that the Spending Review will perpetuate existing inequalities, the government first announced the setting up of a Regional Growth Fund and then increased its funding from £1bn to £1.4bn. Although a move in the right direction, the impact of this Fund is likely to be overshadowed by that of the looming government cuts.

The latest data show that UK **manufacturing** show that it has continued to expand with output in September 2010 was 4.8% higher than a year ago. UK manufacturing will be supported by the external sector as a revival in investment drives demand for capital goods. Demand for consumer durables, in contrast, will stay weak as households face higher taxes and weak wage growth. Thus, how successful the global economy is in maintaining its recovery (thereby generating demand for intermediate investment goods) will determine the prospects of manufacturing in the next few years.

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**Welfare cuts of £18bn by 2014/15 will only dampen consumer spending further in regions where unemployment rates remain high, wage growth is muted and house prices are failing to gain momentum**

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The big surprise of 2010 has been the strength of UK **construction**. ONS data show that the sector recorded growth of about 7% and 5% in 2010q2 and 2010q3 respectively. Seemingly surprising, this growth was driven by a backlog of work due to extreme weather conditions in 2010q1, the Kickstart Housing Delivery programme, a final rush of education projects and work on infrastructure projects. As the public sector cuts begin to bite and the private sector recovery remains weak, it is unlikely that construction will see such high rates of expansion in the next few quarters.

ONS data show that the **consumer** sector expanded by 0.6% in 2010q3. However, we expect this growth to now moderate as households face headwinds going into 2011. Although the unemployment rate fell to 7.7% in August, this was driven by part-time employment and self-employment, with the number of full-time employees continuing to fall. Public sector job cuts are being offset by employment gains in the private sector but as the pace of these cuts quickens, it is doubtful that the private sector can offset these to the extent it is now. In addition, the pace of annual earnings growth remains weak and, at about 2% in the three months to August, it is outpaced by

sticky inflation. Although the GfK consumer survey shows that confidence has stabilised in terms of personal finances, households remain wary of general economic conditions in the next 12 months. The 'major purchases index' is lower than a year ago suggesting that consumers continue to exert caution when it comes to major spending decisions.

**Financial & business services** has resumed its position as the driver of UK growth. However, overall activity in the banking sector stands to be affected by the new Basel III regulatory framework that was finalised in September 2010. Whatever the ultimate impact of Basel III on the financial sector, it is reassuring that the UK has not been forced into taking unilateral action to curb excessive risk taking. There had been fears that a unilateral move would discourage financial activity in London and that funds would find their way into alternative markets in Europe and Asia. This is now not the case and, although national governments have the jurisdiction to impose additional capital requirements in addition to those stipulated under Basel III, it is unlikely that the UK government will choose to exercise this particularly given its recent statements on the importance of London's financial sector in the overall economy.

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**London is expected to suffer the brunt of administrative job losses. Wales, North East and Wales are also vulnerable**

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Business services saw renewed growth in 2010 but its outlook has been revised downwards after the Spending Review as a weaker consumer sector and a smaller public sector reduce demand for supporting services.

**Public services** are entering a period of severe belt tightening. The Chancellor, in the Comprehensive Spending Review, reiterated his commitment to significant spending reductions, while ring-fencing health, education and spending on overseas aid. The biggest losers were Communities and Local Government, Business Innovation and Skills, the Home Office and the Ministry of Justice. In contrast, only a few will see some growth – the NHS, Work and Pensions, and the Department for International Development. Public admin. & defence will be one of the worst-hit sectors in the next few years.

London is expected to suffer the brunt of administrative job losses. The cuts in public sector jobs and the wage freeze for those earning over £21,000 will also affect Wales, and the North East disproportionately – Northern Ireland is also vulnerable – given that the public sector is a relatively large employer in these regions. 17,000 job cuts are also expected in

defence. However the fiscal consolidation works out, there is little doubt that the size of the public sector is set to diminish substantially by 2014/15.

It is thus clear that the economy must look to the business and external sectors to offset weakness in the public and household sectors. The reduction in corporation tax and other business-friendly measures are a step in the right direction. The danger is that these steps are a fraction of the scale required to pull the UK out of the gloom and that the welfare and spending cuts will overshadow any benefits that emerge.

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*Note: For the full 11-page report and a more detailed discussion of the risks to our outlook, please contact Michelle Cha about our UK regional service.*

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