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In this issue

GLAECONOMICS

Volatile markets and a UK inflation data surprise lead to a reassessment of rate rise prospects

by Simon Kyte, Economist, GLA Economics

Global financial markets have been increasingly volatile following the US subprime mortgage crisis and wider fears concerning a global ‘credit crunch’.

Over the past month equity market falls have spread to Europe and Asia but the size of the equity market falls has not been exceptional in historical terms and there are no signs that the global financial system is in danger of collapse. Volatility indices, such as VIX, have tended to be at or around historic lows since the summer of 2004, so the marked increases which have taken place since the beginning of July have only returned such indices to levels comparable with much of 2003. Credit spreads have not widened as much as many feared. Nevertheless, the European Central Bank (ECB) injected levels of funds into European money markets not seen since the attack on the World Trade Centre in September 2001. Investment bankers in the City may face a small cut in end-of-year bonuses which could have a marginal, but negative, impact on the London economy overall.

On 17 August the Federal Reserve cut the rate at which it makes loans to banks by 0.5 percentage points. The rate is only used by institutional investors who find themselves unable to borrow from other banks. In effect, the ‘penalty’ on the rate

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GLA Economics will be sending out invitations for the conference shortly. To make sure you’re on the invite list, please email glaeconomics@london.gov.uk has been reduced from one percentage point to 0.5 percentage points – an unexpected move. Stock markets surged in response to the Federal Reserve's actions.

Figure 1: Stock market performance since January 2006 (percentage change)

Source: EcoWin, FT

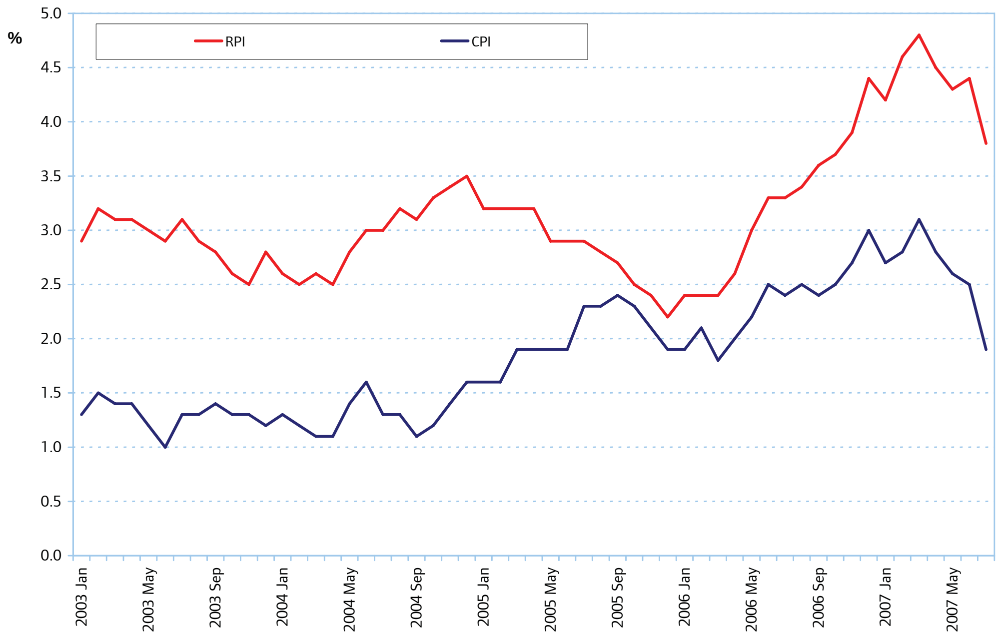
UK CPI inflation back beneath target amidst initial signs that the economy may be slowing

The release of the July inflation data has led many to reassess the prospects for future changes in interest rates. The rate of CPI inflation fell by 0.5 percentage points, the largest decline in more than five years, compared to the 0.1 percentage point that most analysts had been expecting. This brought CPI inflation to 1.9 per cent, just beneath the 2 per cent target – far earlier than had been anticipated by the Bank of England. RPI inflation, which includes mortgage repayments, fell back 0.6 percentage points from 4.4 per cent to 3.8 per cent in July.

The main contributor to the steep fall in inflation was falling food prices sparked by a supermarket price war. The food price data confounded expectations that recent global weather patterns would force food prices upwards. In the medium term this may still happen and it is certainly unwise to write too much into one month's inflation figures. Wage pressures are also milder than expected with average earnings including bonuses having risen by 3.3 per cent in the three months to June compared with the same quarter one year earlier. Most analysts had expected average earnings to be rising by around 3.5 per cent.

Figure 2: UK annual inflation rates

Source: ONS



Although the underlying health of the service sector remains robust, the five recent interest rate rises may have been responsible for having pushed service sector growth, as revealed by PMI, to its lowest level for ten months in July. The PMI service sector activity index fell from 57.7 to 57.0. Nevertheless, new orders rose and activity in the IT and financial services sectors was particularly robust. The latter has been boosted by the rise in insurance claims driven by the summer floods. Insurance companies are facing an estimated £2.5 billion bill for the recent flooding but are expected to pass on the costs to five million people living in flood-prone areas, although all customers are expected to face some increased insurance premiums.

An interest rate rise over the next couple of months now seems less likely. However, most City analysts still believe that there will be one further quarter point rate rise. Even this is now less clear than it was given the unanimity of the MPC vote in August to keep rates on hold and the recent exacerbation of stock market volatility.

However, retail sales grew in July at their fastest pace in five months. The volume of retail sales rose by 0.7 per cent between June and July, yielding an annual increase of 4.4 per cent. A closer look at the data demonstrates that heavy discounting was an important factor and that the value of retail sales grew by only 0.3 per cent in July.

London house prices rising twice as rapidly as in the remainder of the UK

RICS data show that in the national housing market, the number of new buyers fell at its fastest rate for nearly three years. However, London continued to outperform the remainder of the national market with strong price rises. There is some doubt as to whether this would be likely to continue if there were to be a significant slowdown in the financial services sector as a response to recent market turmoil. The Financial Times Index shows house prices have risen more than 15 per cent over the last 12 months in London compared with 7.3 per cent outside London, although neighbouring regions have benefited from a spillover of demand from London.

However, there is a potential risk of the current market contagion spreading to the commercial property market. According to De Montfort University, debt secured on commercial property by the end of last year reached £172.5 billion, nearly three-and-a-half times in nominal terms what it had been in 1999. Around 17 per cent of debt no longer sits on bank balance sheets but has been parcelled off to investment institutions. It is this portion which may now be subject to widening price guidance and credit spreads. New data from the Investment Property Databank shows that the commercial property market now has its lowest monthly return for 12 years.

US jobs growth slower than expected

The United States created fewer jobs in July than most analysts had expected (92,000 as opposed to a forecast 127,000) and the index from the Institute for Supply Management on service sector activity fell more sharply than expected. Such data may convince the Federal Reserve that inflationary pressures in the economy are weakening. Markets in the US are now pricing in a cut in base rates over the next few months. The US has also experienced substantial downward revisions to GDP estimates for the previous three years.

China's stock market still booming and annual export growth accelerating

So far, China is bucking the trend in terms of equity markets. The Shanghai exchange has nearly a million new trading accounts opening every week and the Shanghai Composite Index, in spite of having stalled briefly in mid-August, has now passed the 5,000 point level and is around 20 per cent above where it was at the time of the last issue of *London's Economy Today*. However, there are mounting concerns that a significant correction could be due. There is potential for corrections in emerging markets to be very sharp given the increases that have been created by unswerving belief in robust growth over the past few years.

Some had expected China's export growth to tail off after June's rush to ship goods before rebates of sales taxes were cut or scrapped by the authorities. In fact, whilst the trade surplus in July was down from June's record high of $26.91 billion to $24.36 billion, this was still the second highest surplus on record. Annual export growth has accelerated from 27.1 per cent in June to 34.2 per cent in July. With the economy booming, China's inflation rate hit a 10-year high of 5.6 per cent in July.

Conclusion

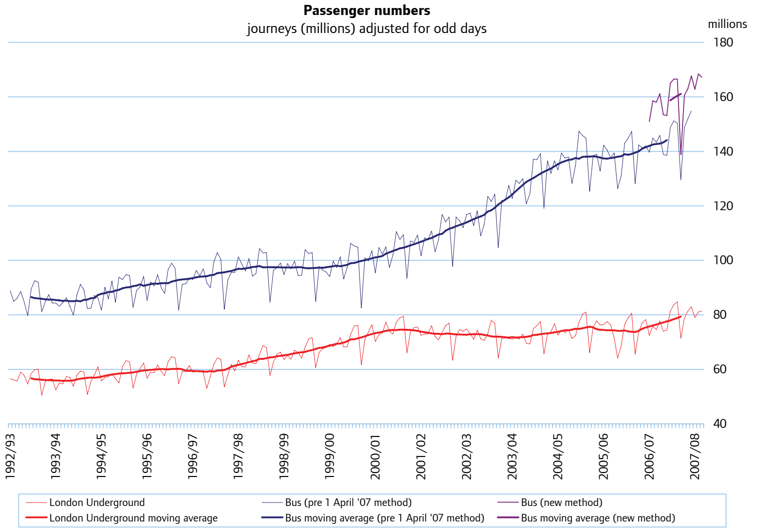
Although it is important not to draw too many conclusions from individual releases of data, there are signs of the beginning of a worldwide downturn in business optimism. Some businesses will be hit directly by the liquidity crunch. As liquidity dries up, debt investors become more selective in their lending, reducing opportunities for cheap credit or even access to credit, for firms well beyond the financial sector. Companies with low credit ratings may struggle to raise fresh finance. This will impact upon real economies – including London's. However, this should be seen as an adjustment rather than any immediate threat to the global financial system.

Economic indicators

Increase in moving average of passenger numbers

- The most recent 28-day period is from 27 May to 23 June 2007. London's Underground and buses had 248.7 million passenger journeys; 167.2 million by bus and 81.4 million by Underground.
- The moving average increased to 240.5 million from a revised 239.3 million passengers every period. The moving average for buses was 161.1 million. The moving average for the Underground was 79.4 million.
- The methodology used to calculate the number of bus passenger journeys was changed by TfL from 1 April 2007. For a detailed explanation please see LET edition 58 (June 2007).

Latest release: August 2007
Next release: September 2007



Source: Transport for London

Average annual growth rate of passengers continues to rise

- The moving average annual rate of growth in passenger journeys increased to 6.4% from 6.0% in the previous period.
- The moving average annual rate of growth in bus passenger journey numbers rose to 5.6% from 5.5% in the previous period.
- The moving average annual rate of growth in Underground passenger journey numbers increased to 7.9% from 7.0% in the previous period.

Latest release: August 2007
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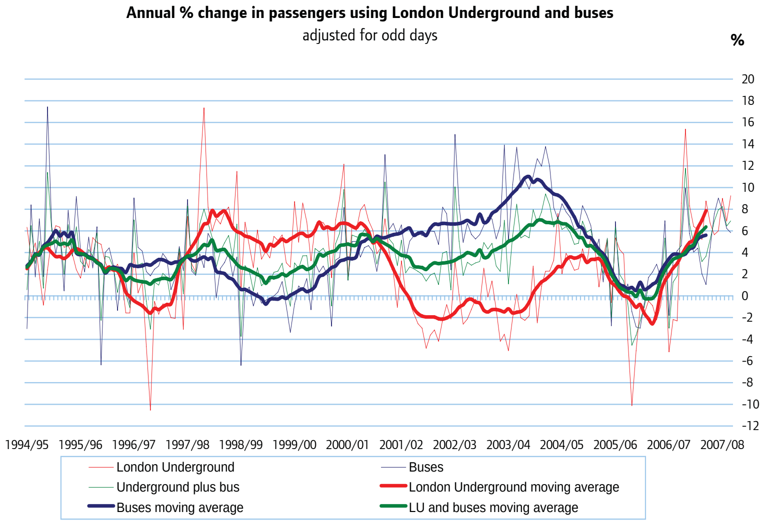

Source: Transport for London

Claimant count unemployment

- The rate of claimant count unemployment (the percentage of resident working age population who are unemployed and claiming Jobseekers' Allowance) in London was 2.9% in July 2007.
- There were 144,100 unemployment claimants in London in July 2007 compared with 169,300 in July 2006.
- The claimant count unemployment rate of the UK remains below that of London's.

Latest release: August 2007
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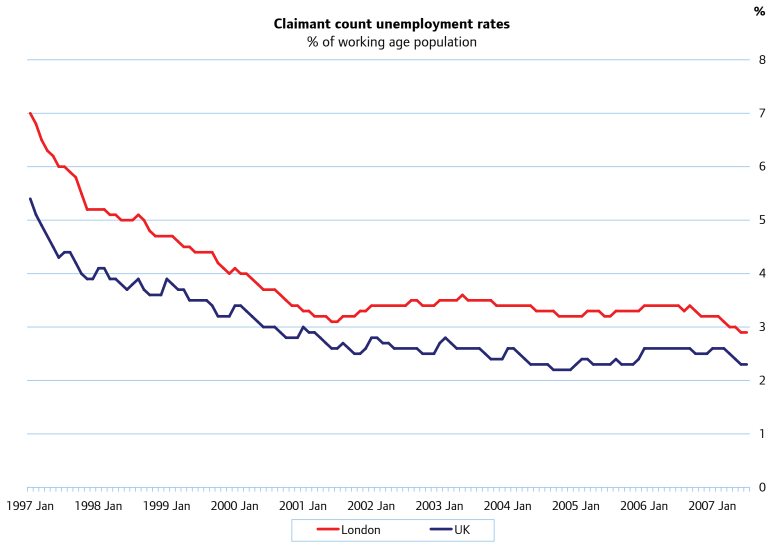

Source: Claimant Count, NOMIS

Annual growth in London still faster than the UK's

- London's annual growth in output increased to 4.0% in Q1 2007 from 3.8% in Q4 2006.
- The UK's annual growth in output decreased to 2.8% in Q1 2007 from 2.9% in Q4 2006. London has been growing at a faster annual rate than the UK since Q2 2004.
- There have been revisions to previous growth rates to reflect the availability of new data.

Latest release: August 2007
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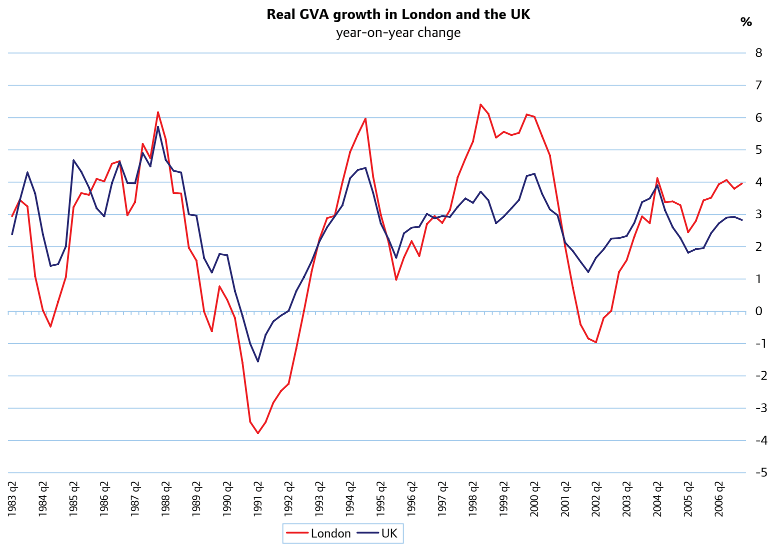
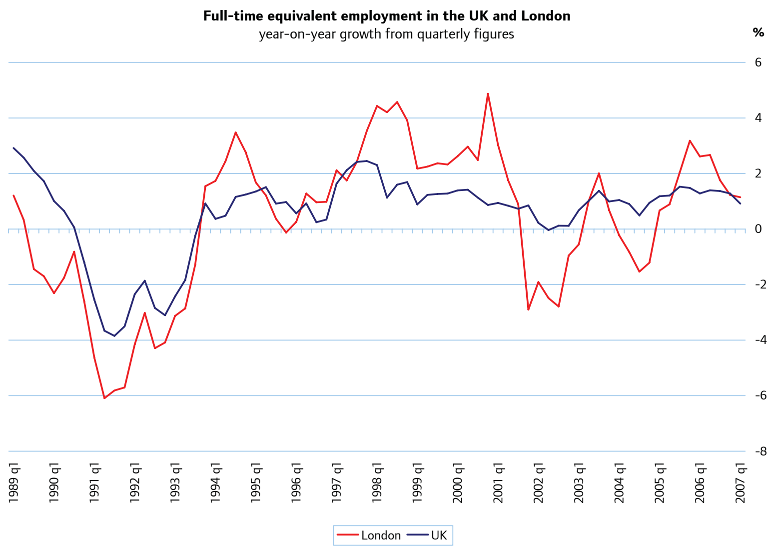


Source: Experian Business Strategies

Annual employment growth rate higher in London than the UK

- London's annual employment growth decreased to 1.1% in Q1 2007 from 1.2% in Q4 2006.
- Annual employment growth in the UK decreased to 0.9% in Q1 2007, from an upwardly revised 1.3% in Q4 2006.
- There have been revisions to previous growth rates to reflect the availability of new data.

Latest release: August 2007
Next release: November 2007

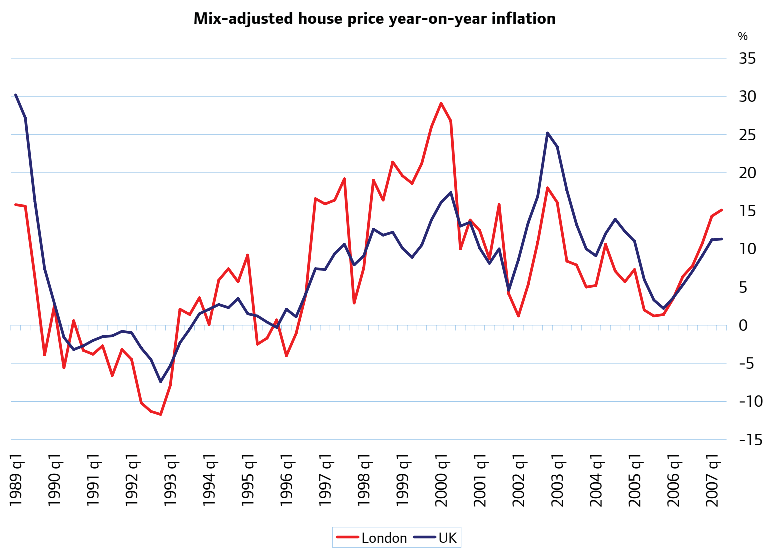


Source: Experian Business Strategies

Annual house price inflation higher in London than the UK

- The Department for Communities and Local Government (DCLG) house price index is an official measure of house prices. It is available up to Q2 2007.
- The DCLG reported an increase in annual house price inflation in London and the UK in Q2 2007.
- Annual house price inflation in London increased to 15.1% in Q2 2007 from 14.3% in Q1. Annual house price inflation in the UK increased slightly to 11.3% in Q2 from 11.2% in Q1.

Latest release: August 2007
Next release: November 2007

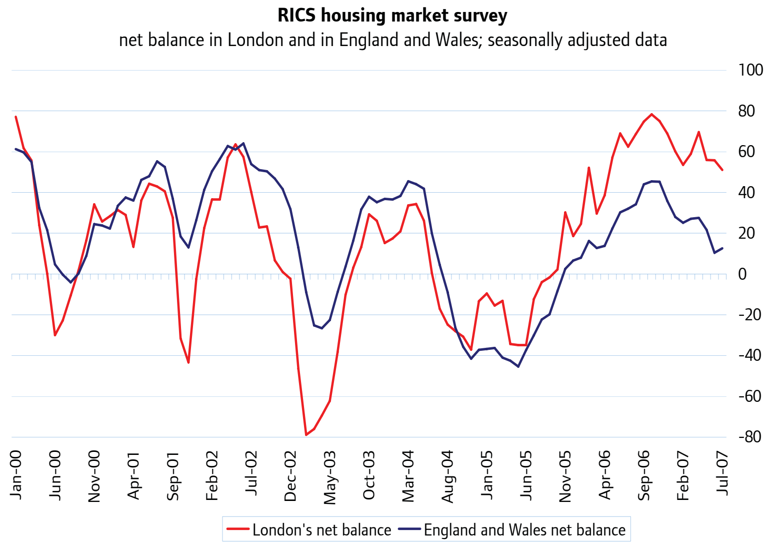


Source: Department for Communities and Local Government

Surveyors report that house prices continue to increase

- The RICS survey shows a positive net balance of 51 for London house prices over the past three months up to July 2007. This net balance is down from a revised 56 in June.
- Surveyors also reported a positive house price net balance for England and Wales of 13 in July, up from 10 in June.
- London's net balance remains above that of England and Wales.

Latest release: August 2007
Next release: September 2007

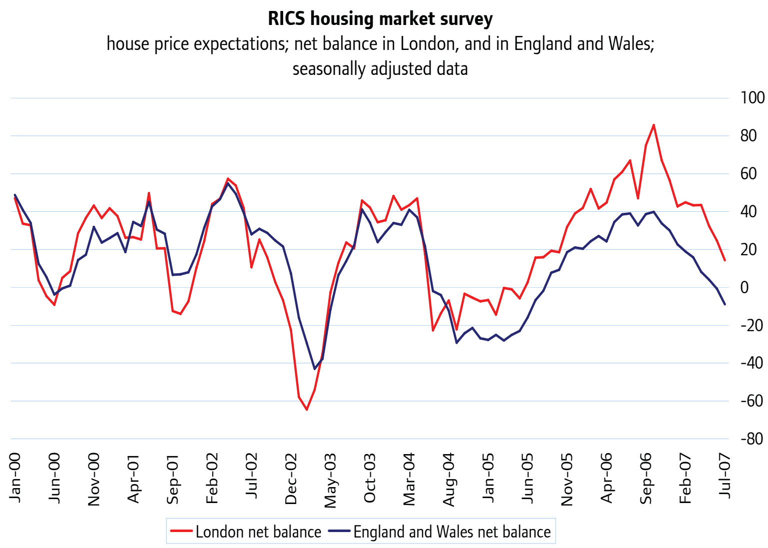


Source: Royal Institute of Chartered Surveyors

Surveyors expect London house prices to rise

- The RICS survey shows that surveyors expect house prices to increase over the next three months in London but to decrease in England and Wales.
- The net house price expectations balance in London was 14 in July, down from 25 in June.
- For England and Wales, the net house price expectations balance was –9 in July, down from –1 in June.

Latest release: August 2007
Next release: September 2007

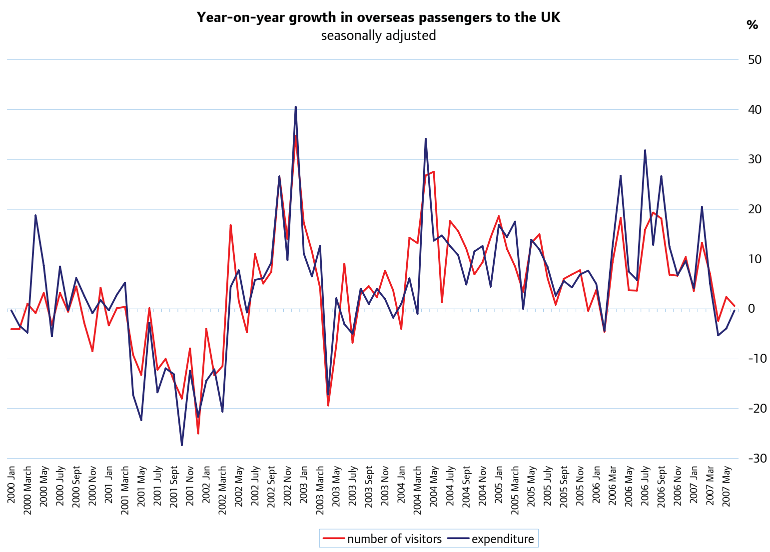


Source: Royal Institute of Chartered Surveyors

Low annual growth in overseas visitor numbers

- Annual growth was positive in overseas visitor numbers to the UK in June 2007 although annual growth in their expenditure was negative. Up to half of overseas visitors to the UK spend time in London.
- The annual growth rate of overseas visitors to the UK was 0.6% in June.
- The annual growth in expenditure by overseas visitors in the UK was –0.3% in June.

Latest release: August 2007
Next release: September 2007

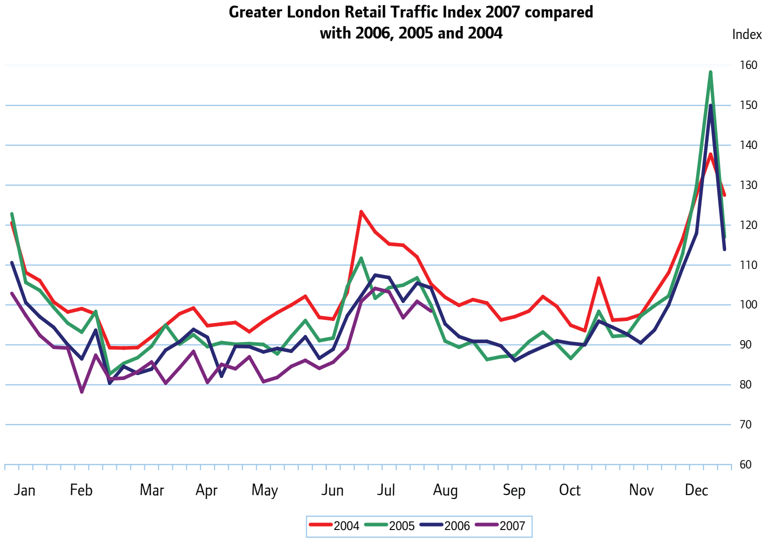


Source: Office for National Statistics

SPSL Retail Traffic still below 2006 levels

- The SPSL Retail Traffic Index of shoppers in London was 98.4 in the final week of July compared to 100.9 in the previous week.
- The index has generally been lower than 2006 levels throughout 2007 so far.
- SPSL's Retail Traffic Index measures the number of shoppers and does not necessarily reflect the level of spending.

Latest release: Mid-August
Next release: Weekly

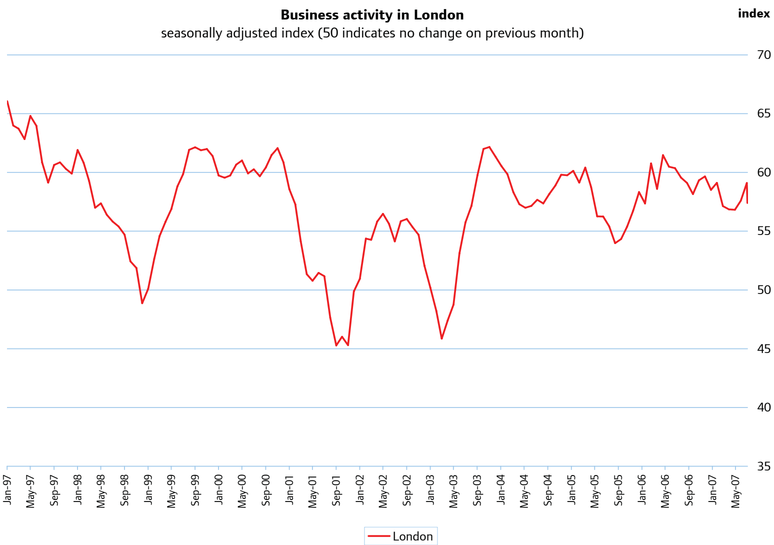


Source: SPSL

London's business activity still expanding

- London firms continued to expand their output of goods and services in July 2007.
- The Purchasing Managers' Index (PMI) of business activity recorded 57.4 in July 2007 compared to 59.1 in June.
- A rate of above 50 on the index indicates an increase in business activity from the previous month. The PMI for business activity has been above 50 since June 2003.

Latest release: August 2007
Next release: September 2007



Source: PMI/The Royal Bank of Scotland

Firm employment growth in London

- London firms continued to increase their level of employment in July 2007.
- The PMI for the level of employment was 54.6 in July compared to 54.5 in June.
- A rate of above 50 on the index indicates an increase in the level of employment from the previous month.

Latest release: August 2007
Next release: September 2007

Source: PMI/The Royal Bank of Scotland

Alan Freeman,
Economist

GLA Economics' latest publication, *Working Paper 22 - London's Creative Sector: 2007 Update,* reveals who actually works in the creative industries sector, where the jobs are and what they are doing.

In this month's supplement we provide an overview of what has proven to be a revealing and popular working paper.

London is known around the globe for its world-class cultural offer. The Tate Modern Gallery is the most visited contemporary art gallery in the world with more than four million visitors every year. West End revenues for commercial theatre broke the £400 million mark in 2006. London's film industry, with an annual turnover of around £13 billion, is the largest post production centre outside of Hollywood and of the last decade's top 15 grossing films, five were made in and around London.

GLA Economics' third study of the creative industries suggests that this sector remains at the forefront of London's global status. By 2005, 12 per cent of all London workers – 554,000 people – were creatively employed (see Box 1: How is creative employment calculated?). London and the South East remain the hub of Britain's creative industries, accounting between them for 57 per cent of all British creative workforce jobs.

Charts 1a and 1b

Source: ABI, LFS, GLA Economics, TBR Economics

Chart 1a: Where creative jobs are located

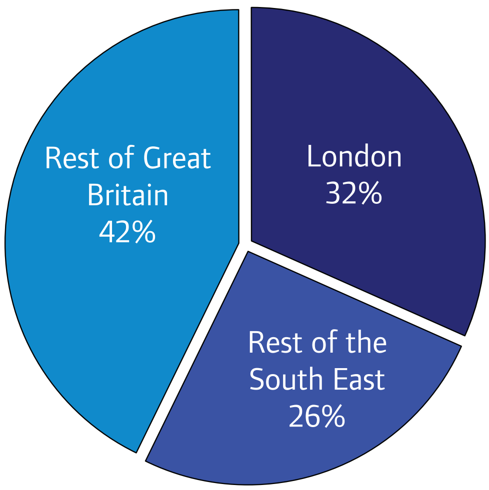
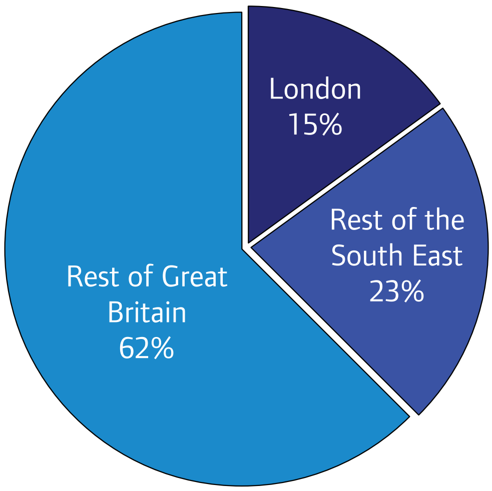


Chart 1b: Where all jobs are located



However *Working Paper 22* shows that the creative industries were affected by the downturn experienced by London in the first half of this decade. Creative industry workforce employment fell by ten per cent between 2001 and 2004; compared with five per cent for finance and business services. In 2005 the creative industries recovered sharply, growing by five per cent to create 18,000 jobs in the capital. All but one creative sector added jobs over this period.

Box 1: How is creative employment calculated?

We measure creative employment using national standards, developed by the Department for Culture, Media and Sport (DCMS). These standards are also broadly in line with international standards developed by UNESCO and by European co-ordinating bodies.

Creative employment in total is made up of three components:

1) employees in creative industries
2) self-employed persons in creative industries
3) persons who have creative occupations, but do not work in creative industries.

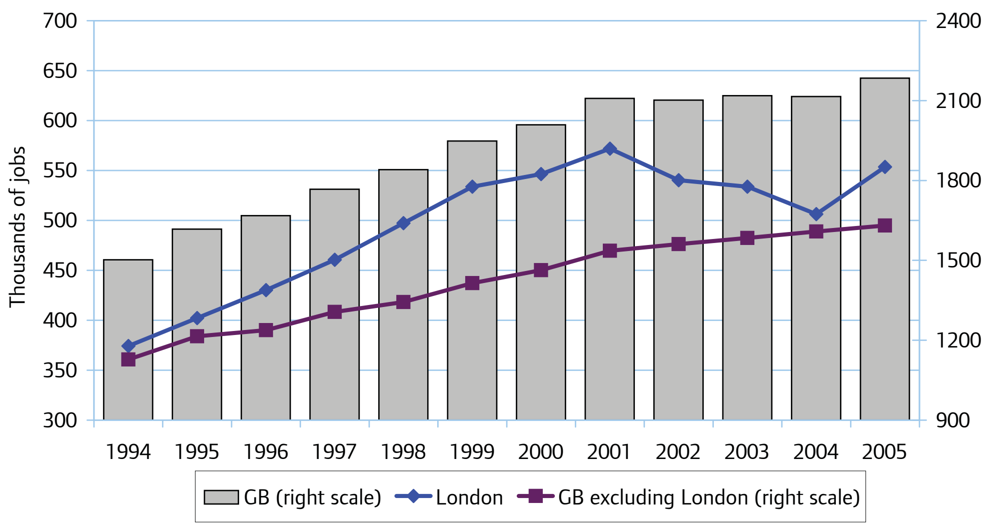
An example of the last category would be a musician who works in a school as a teacher. The school is not counted as part of a creative industry, but music is a creative occupation. So the job is counted, using the DCMS method, as creative.

Double counting is avoided. A musician who works in a music company is only counted once.

Creative industries are identified using the SIC (Standard Industrial Classification) codes. In many cases, official statistics are not precise enough to identify creative industries uniquely. We have used estimates provided by TBR Economics, using data which underlies the official statistics but is not in the public domain, to calculate the proportion of each SIC code that is actually made up of creative industries.

Chart 2: Total creative employment in London and Great Britain

Source: ABI, LFS, GLA Economics, TBR Economics

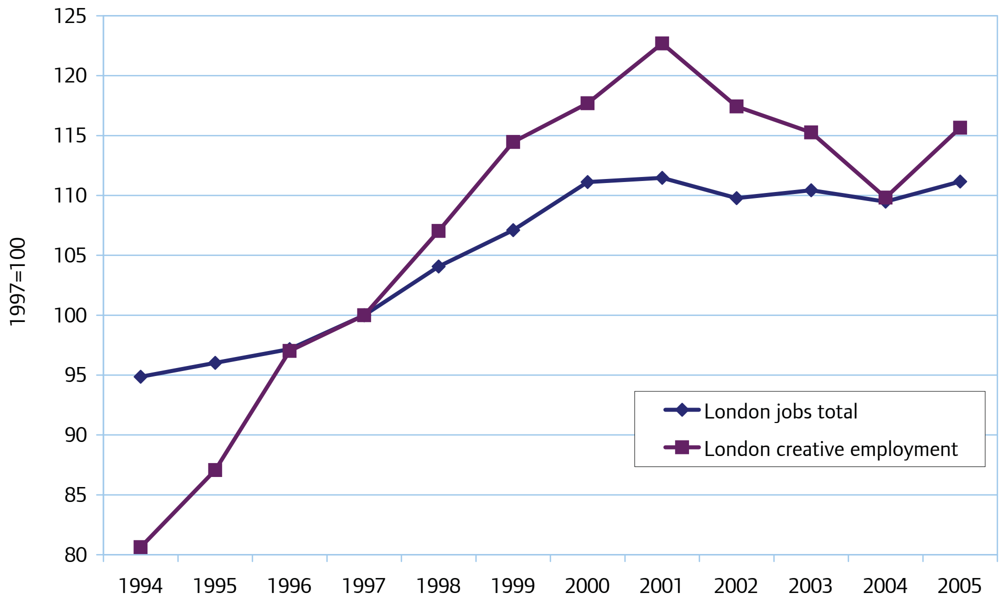


Notes: Total Creative Employment = workforce employment in the creative industries + creative occupations outside the creative industries

As Chart 3 shows, employment in the creative industries was more volatile than for London as a whole. Between 1997 and 2001, it grew by 23 per cent, compared to 11 per cent for London's economy as a whole. But in the next three years the creative industries contracted, such that between 1997 and 2004 both the creative industries and London's economy as a whole had grown by around ten per cent. Creative employment took off again in 2005.

Chart 3: Creative and total employment in London

Source: ABI, LFS, GLA Economics, TBR Economics

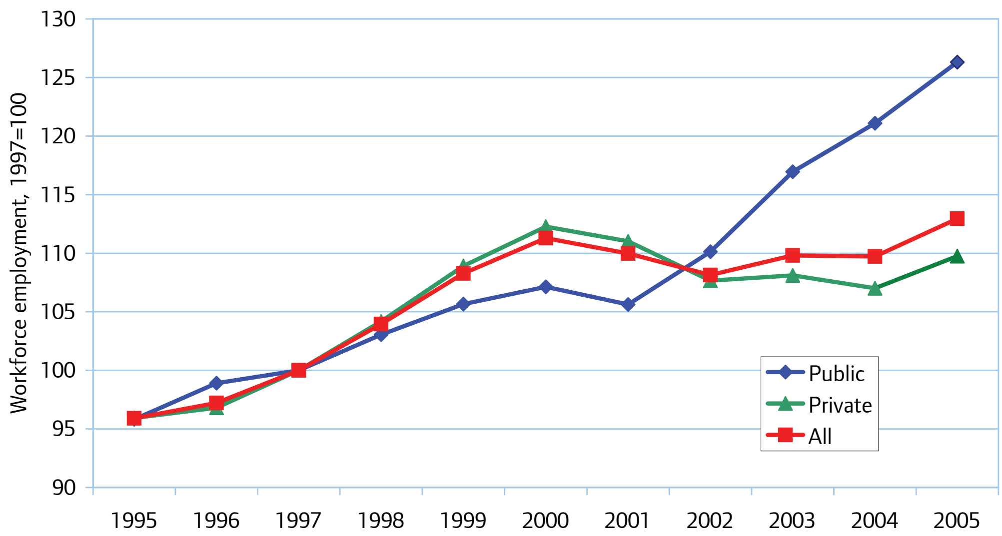


The working paper looks at the source of this volatility, and shows that it is affected by the creative industries' tight linkages to London's financial and business services sector.

The 2001-2004 decline was in part due to the hit taken by London's private sector as a whole, in which the creative industries are entirely located. The private sector fared worse in London than in the rest of Great Britain, and also when compared with the public sector. As Chart 4 shows, unlike total employment, by 2005 private sector employment had failed to regain its 2000 level. Indeed between 2000 and 2004, it rose in only one year, 2003.

Chart 4: Public and private sector employment in London

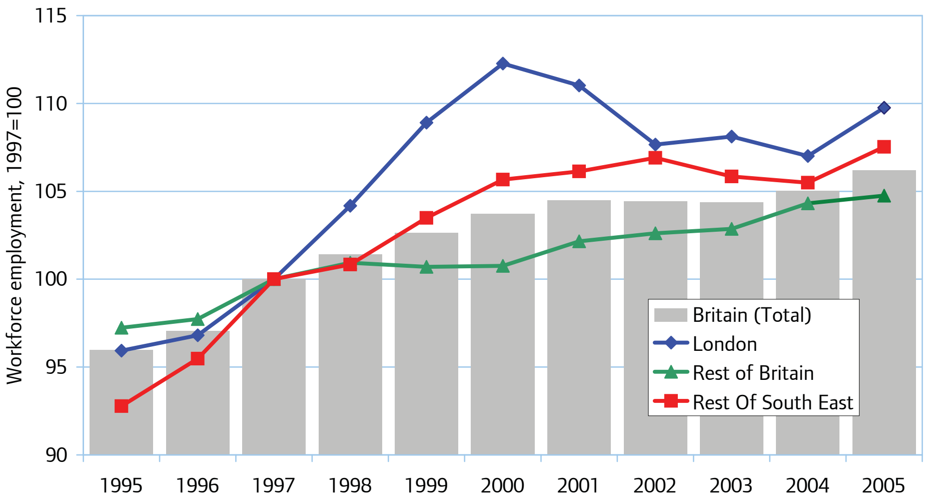
Source: ABI, LFS, GLA Economics, TBR Economics



But as Chart 5 shows, this pattern was not the same throughout Britain. Outside the South East, the private sector continued to grow throughout London's downturn. In the 'Rest of the South East' it grew until 2002 and then suffered a relatively light decline, reaching its highest ever point in 2005.

Chart 5: Private sector employment in Britain

Source: ABI, LFS, Labour Market Trends.



'Rest of the South East' = South East and East of England Government Office Regions.
'Rest of Great Britain' = all British regions except London and the Rest of the South East.

Creative linkages

What might explain the volatility of the creative industries in London? One argument is that creative industries are affected by cyclical upturns and downturns because their products are, in economic terms, luxury goods. Demand for them is more income elastic, meaning that when income falls or rises, spending on creative products falls or rises even further. It is therefore affected by ups and downs in the economy.

It is therefore likely to be more affected by rises and falls in two areas:

- High income earners, who spend more on leisure and luxury items that are typically products of the creative industries, as noted in *Creativity: London's Core Business*
- Business purchases of creative products, which tend to be on items such as software or advertising, that are cut back in downturns.

Consumer demand was considered in GLA Economics' 2002 report, *Creativity: London's Core Business*. The new report takes a closer look at business demand. The strong economic link between London's creative industries and London's finance and business services sector is evidenced by input-output tables produced by the Office for National Statistics (ONS). As Table 1 shows, business is a major purchaser of creative products, particularly advertising, architecture, and software – termed 'business-led' in the report. These account for 40 per cent of creative products, which they sell almost entirely to other businesses or abroad. The remaining 'consumer-led' industries sell 61 per cent of their products to households. Even so, 66 per cent of the total demand for creative industry products comes from sources other than households.

Chart 6: Employment in the creative industries and the private sector industrial groups containing them in London

Source: ABI, LFS, GLA Economics, TBR Economics

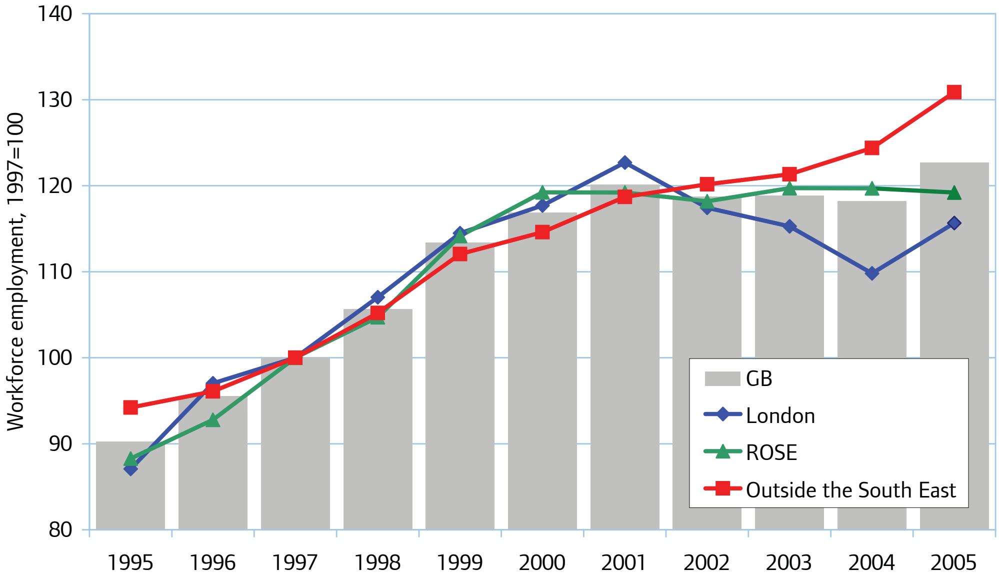


Table 1: Demand for creative products

Source: Office for National Statistics input-output tables 2004

Percent of total demand for creative products	**Investment**	**Business purchases**	**Government and non-profit**	**Households**	**Exports**	**Total Demand**
Business-led (Advertising, Software and Architecture)	15%	73%	1%	0%	11%	100%
Consumer-led (All other creative)	3%	26%	0%	61%	10%	100%
All Creative Industries	8%	47%	0%	34%	11%	100%

Table 2: Origin of products

Source: ABI, LFS, GLA Economics, TBR Economics

	Per cent of creative products
Total Business-led	42.1%
Consumer-led	57.9%
All Creative Industries	100.0%

As the report notes, more than 40 per cent of London's creative industries are located in boroughs adjoining the city, suggesting that London's core financial and business service sector is a powerful driver of demand for their products.

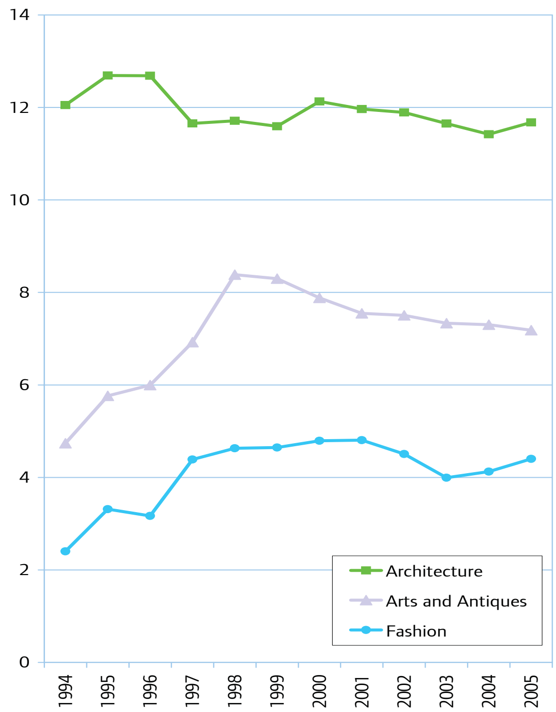
Thus, the report finds strong evidence that at least part of the explanation for the volatility of creative employment in London lies in its strong links to its financial and business service sector.

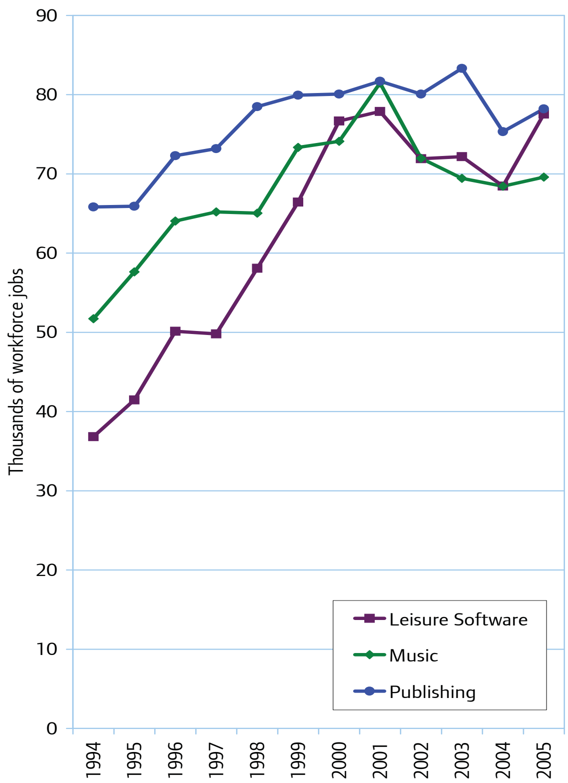
How have individual creative industries fared?
Charts 7a-c show the pattern of growth among the nine key creative industries. These can conveniently be separated into three groups:

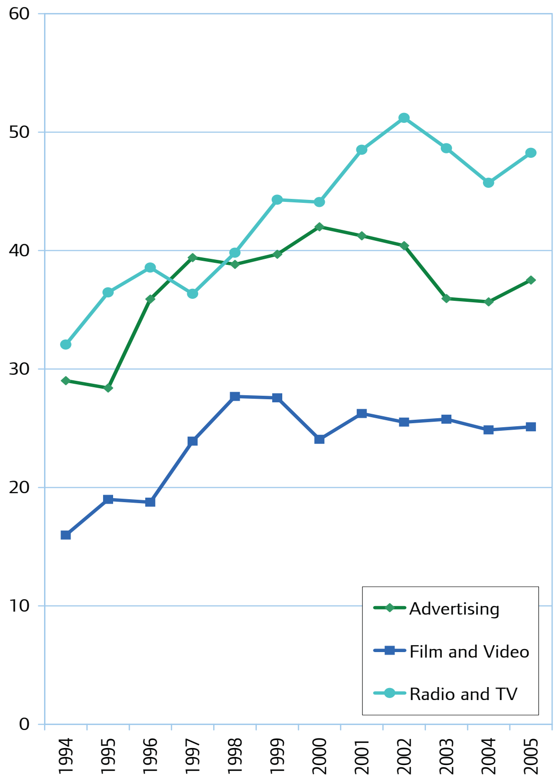
- Leisure Software, Music, and 'Publishing and Printing', each providing 70,000-80,000 workforce jobs
- Advertising, 'Film and Video', and 'Radio and TV', each providing 25,000-50,000 jobs
- Architecture, 'Arts and Antiques', and Fashion, all providing less than 15,000 jobs.

Charts 7a-c: Workforce employment in nine DCMS creative sectors in London

Source: ABI, LFS, GLA Economics, TBR Economics





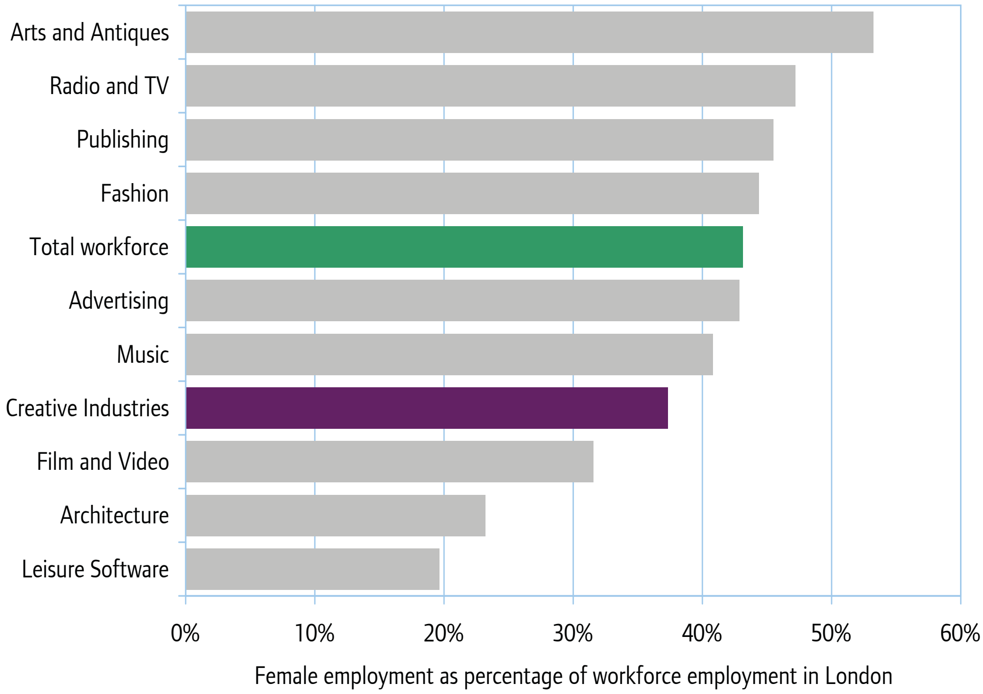


As can be seen, both the decline and the subsequent upturn affected all creative industries across the board, with the possible exception of 'Film and Video' and 'Arts and Antiques'.

Gender, ethnicity and creative employment

Chart 8: Female employment in the creative industries in London, average of 2003-04

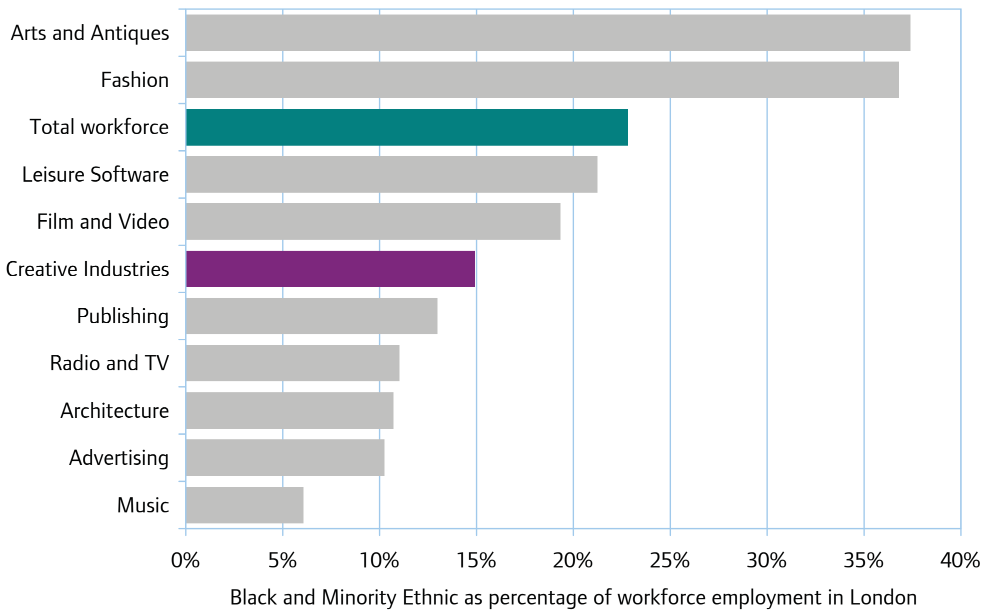
Source: ABI, LFS, GLA Economics, TBR Economics



The report confirms earlier findings that the creative industries in London perform below average in the employment of women and from ethnic minorities. In 2003-04[1] only four industries employed a higher proportion of women than the London average – 'Arts and Antiques', 'Radio and TV', Publishing, and Fashion. And only Fashion as well as 'Arts and Antiques' employed a higher proportion of Black, Asian and Minority Ethnic staff.

Chart 9: Black, Asian and Minority Ethnic employment in the creative industries in London, average of 2003-04

Source: ABI, LFS, GLA Economics, TBR Economics



[1] To improve the statistical reliability of figures on ethnicity and gender, GLA Economics calculated the proportions reported in this section of the paper by taking an average of the data for 2003 and 2004.

To read the complete *Working Paper 22 - London's Creative Sector: 2007 Update* or any of GLA Economics' other publications, please visit www.london.gov.uk/mayor/economic_unit.

Acronyms

ABI	Annual Business Inquiry
GLA	Greater London Authority
LFS	Labour Force Survey

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Additional information

Data sources

Tube and bus ridership	Transport for London on 020 7941 4500
GDP/GVA growth	Experian Business Strategies on 020 7630 5959
Tourism – overseas visitors	www.statistics.gov.uk
Tourism – domestic visitors	www.visitlondon.com
London airports	www.caa.co.uk
Business activity	www.rbs.co.uk/pmireports
Employment	www.rbs.co.uk/pmireports
House prices	www.nationwide.co.uk/hpi/
Unemployment rates	www.statistics.gov.uk

Glossary

Civilian workforce jobs

Measures jobs at the workplace rather than where workers live. This indicator captures total employment in the London economy, including commuters.

Claimant count rate

Unemployment rate based on the number of people claiming unemployment benefits.

Employee jobs

Civilian jobs, including employees paid by employers running a PAYE scheme. Government employees and people on training schemes are included if they have a contract of employment. Armed forces are excluded.

Gross domestic product (GDP)

A measure of the total economic activity in the economy.

Gross value added (GVA)

Used in the estimation of GDP. The link between GVA and GDP is that GVA plus taxes on products minus subsidies on products is equal to GDP.

ILO unemployment rate

The International Labour Organisation's calculation of the number of people out of work.

Tube ridership

Transport for London's measure of the number of passengers using London Underground in a given period. There are 13 periods in a year – twelve 28-day periods and one 29-day period. Period 1 starts at the beginning of the financial year rather than the calendar year.

Acronyms

ABI	Annual Business Inquiry
BAA	British Airports Authority
BCC	British Chamber of Commerce
BITOA	British Incoming Tour Operators Association
CAA	Civil Aviation Authority
CBI	Confederation of British Industry
DCLG	Department for Communities and Local Government
EBS	Experian Business Strategies
GDP	Gross domestic product
GVA	Gross value added
ILO	International Labour Organisation
IMF	International Monetary Fund
LCCI	London Chamber of Commerce and Industry
LET	London's Economy Today
MPC	Monetary Policy Committee
ONS	Office for National Statistics
PMI	Purchasing Managers' Index
PWC	PricewaterhouseCoopers
RICS	Royal Institute of Chartered Surveyors

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