GLAECONOMICS

London's Economy Today

Issue 184 | December 2017

In this issue

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UK inflation hits six-year high adding further squeeze to cost of living

By **Emma Christie,** Economist, **Eduardo Orellana,** Economist and **Mark Wingham,** Economist

The UK's inflation rate rose to 3.1 per cent in November, its highest level since March 2012. The Governor of the Bank of England, Mark Carney, now needs to write to the Chancellor explaining why it is substantially above the inflation target of 2 per cent (see Figure 1). The Governor will write his letter in February 2018 alongside the next update to the Bank's forecasts.

The Office for National Statistics (ONS) attributed the rise in inflation to increases in the cost of airfares and recreational and cultural goods and services. That said, it is likely to still be affected by the depreciation of sterling following the EU referendum result. For instance, a fall in the value of the pound has led to higher import prices and, consequently, through to higher consumer prices.

Despite the latest increase, the inflation rate is generally thought to be nearing its height. For example, the Governor expects inflation to peak around the final months of 2017. Nevertheless, the rate of inflation remains faster than the rate of increase in average weekly earnings. Across the UK, average total pay grew 2.3 per cent year-

Latest news...

London borough by sector jobs series

GLA Economics has produced a London Jobs series from 1971-2015 for sectors and boroughs.

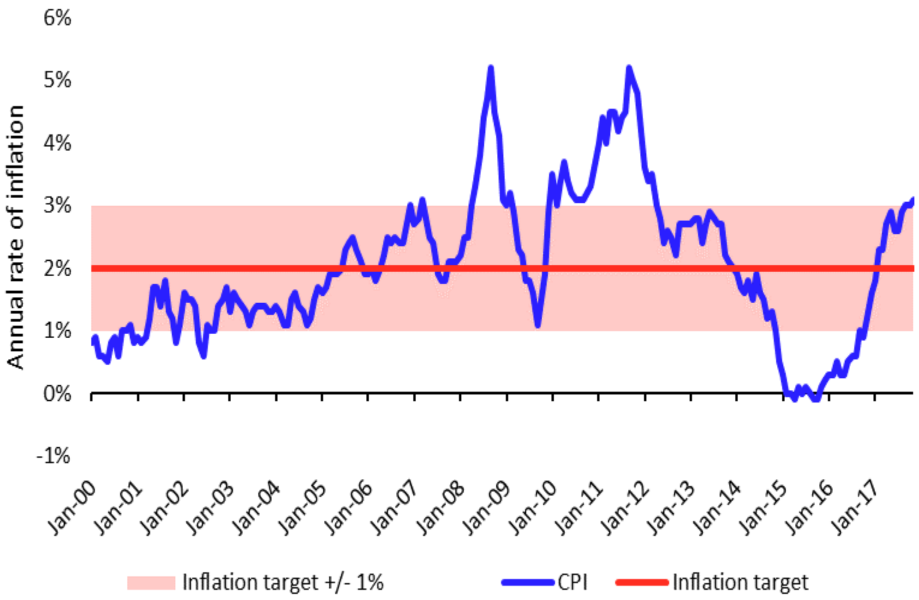
In 1971 the largest sector of the London economy was Manufacturing. By 2015 Professional and real estate services had become the dominant sector.

Strongest jobs growth over the entire period 1971-2015 has been in Tower Hamlets (where jobs have more than doubled). This has been followed, in descending order of growth, by Richmond upon Thames; Southwark; Barnet; and, Hounslow.

Download the full publication.

Figure 1: Annual rate of UK consumer price inflation

Source: ONS Consumer price index

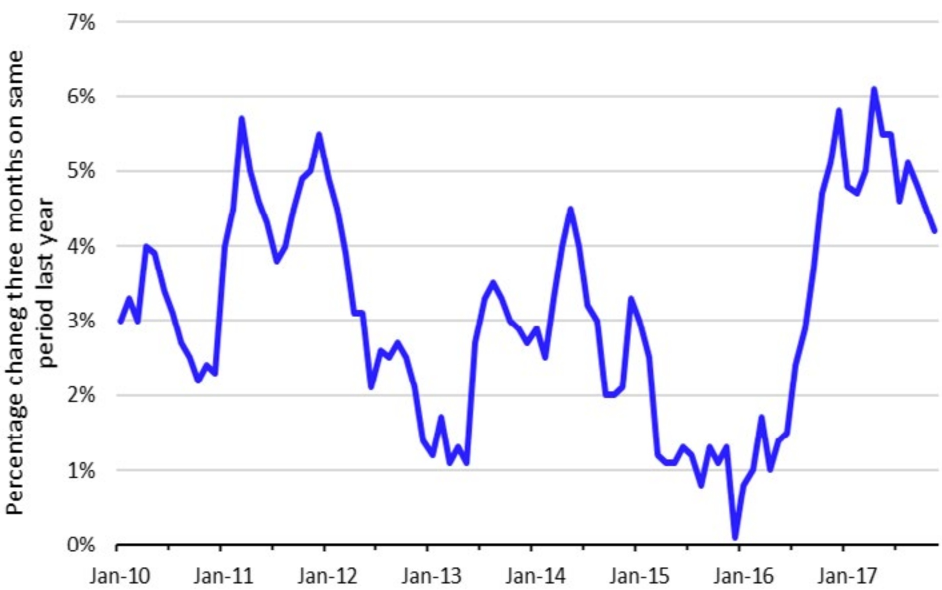


on-year in October in nominal terms. However, after accounting for inflation, it fell 0.4 per cent and continues the negative trend for seven months.

A further fall in real earnings could add further pressures to household finances, although so far the squeeze in real earning appears to have had little effect on retail spending. For instance, the ONS reported that retail sales across the UK were 0.8 per cent higher in the three months to November in comparison with the previous three months, or 4.2 per cent higher when compared with the same period a year earlier (see Figure 2). There was a particular uplift in sales of electrical household appliances. However, the results could have been skewed by Black Friday discounts, whereby people could have brought forward purchases that they would otherwise have made in December or January to take advantage of the sales.

Figure 2: Value of retail sales across the UK, seasonally adjusted, percentage change three months on same period last year

Source: ONS Retail Sales



Nevertheless, the IMF revised down their forecasts of GDP growth for the UK citing the fall in real earnings which could dampen consumer spending. The IMF now expects growth to be 1.6 per cent in 2017 (down from 1.7 per cent made in October), before slowing slightly to 1.5 per cent in 2018 (unchanged from October). Their forecasts are however based on further progress in the Brexit negotiations, "culminating in understandings on a broad free trade agreement and on the transition process".

Brexit negotiations move to look at the future relationship

On 8 December, and after months of negotiations, Britain reached a deal on the terms of its EU exit which paved the way for the second phase of talks focussing on the future UK/EU relationship. The European Commission said that "sufficient progress" has been made on the first phase to move onto discussing the framework of a future relationship - including issues such as security and trade. On 15 December, EU leaders subsequently voted to support this move.

Of the things that were agreed in the first phase, the size of the 'divorce bill' was perhaps the most contentious. The UK Prime Minister agreed to pay a final settlement to the EU that was "fair to the British taxpayer". No actual figure was mentioned, though it is expected to be between £35 billion and £39 billion to be paid over four years. Analysis by the influential Institute for Fiscal Studies (IFS) suggested that this will not make a significant difference to the public finances. IFS Director Paul Johnson said that most of the bill was money the UK would have paid into the EU anyway and that it is the longer-term impact on growth that should be of more concern.

While the conclusion of the first stage of talks may reduce some of the uncertainties over Brexit, there still remains substantial risks to the future, especially in terms of the future UK/EU trading relationship. This was highlighted by the European Commission President, Jean-Claude Juncker, who warned that the second round of negotiations will be "significantly harder" than an already difficult first phase of talks. For instance, while the Prime Minister had previously called for a two-year status quo transition period starting in March 2019, supplementary guidelines from the European Commission said that any transition will not continue past 31 December 2020 and reiterated that the UK cannot 'cherry pick' which parts of EU rules it abides with during this period.

One of the risks that remains around the future trading relationship is future passporting rights for financial services, which has led to some institutions opening subsidiaries elsewhere in the EU. For instance, Standard Chartered chief executive, Bill Winters, warned that his company was "preparing for the worst" as they start turning their Frankfurt office into a subsidiary – a process they are finding "inconvenient and expensive". The Confederation of British Industry (CBI) has warned that more clarity is still needed to stop other companies proceeding with their contingency plans.

A consequence of financial firms opening subsidiaries elsewhere in the EU could potentially include job losses in the UK, though research from the Financial Times suggest that the UK's biggest international banks are set to move fewer than 4,600 jobs from London. That is just 6 per cent of their workforce. However, this is highly uncertain with other research having higher estimates. For example, EY published their research this month that claimed that as much as 10,500 jobs could move on 'day one' of Brexit.

Nevertheless, the Bank of England in their latest stress test has said that the UK's financial sector is resilient against a wide range of risks, including a deep recession, large falls in asset prices and large banking fines for past misconduct. The Bank also said the financial system can support the UK economy through a wide range of Brexit outcomes, though there could be complications if it occurred at the same time as some of those risks mentioned earlier. Noticeably, this is the first time that all the UK's biggest lenders have passed the Bank's stress tests since the financial crisis. That said, the Bank is pushing ahead with raising the capital buffer rate and will evaluate whether this needs increasing further in the new year.

International risks to the UK's economy edge up

Looking at the global economy, the IMF recently published a report looking at China's resilience to economic shocks and contagion. This was its first report since 2011. It found that rising levels of Chinese debt posed "large risks" to China's economy.

The levels of Chinese debt and imbalances in the economy have long been of concern to the IMF as it can potentially have wider implications on the world economy, particularly its key trading partners. For example, London exported around £1.1 billion and imported £8.3 billion of goods to/from China in 2016. Of particular note, the IMF conducted a stress test on China's largest banks and found that 27 out of 33 were under-capitalised. Consequently, the IMF urged Chinese banks to strengthen their capital buffers and suggested that the government strengthens its financial supervision and regulation.

In the US, the Federal Reserve announced its third interest rate rise in 2017. It raised its benchmark interest rate range from 1.25 per cent to 1.5 per cent at its December meeting. The Fed said the move underscores the "solid" gain made in the US economy and comes alongside improved economic forecasts. For instance, the Fed now expects the US economy to grow by 2.5 per cent in both 2017 and 2018 (up from 2.4 per cent and 2.1 per cent respectively). Additionally, the Fed expects that there could be a further three interest rate rises in 2018 and potentially two hikes in 2019 meaning it could be around 2.7 per cent in just a couple of years.

Growth in the US is good news for the UK and London as it is the largest country we export to. For instance, London exported approximately £5.9 billion of goods to the US in 2016. However, businesses and some countries like China and India who are particularly reliant on exports have concerns about the possibility of an increase in US protectionism and the impact this will have on global trade. For example, earlier this month, the US trade agency ruled to maintain tariffs on certain Canadian lumber imports after its commission found that US industry was "materially [being] harmed".

London's economy starts 2018 on a solid footing

London has had its title as one of the world's largest financial centres re-confirmed recently (despite the risks around Brexit) with Chinese banks continuing to invest in the capital. In the past four years, four Chinese banks have opened branches in London, with a total investment value of around $17 billion. And in November, the Bank of China launched a new private banking service in London while the Bank of Communications announced that it is looking to increase its involvement in foreign exchange rate trading. This is largely due to London's emergence as the largest offshore renminbi hub outside of Asia. For instance, the Society for Worldwide Interbank Financial

Telecommunication reported that a third (36.3 per cent) of all global offshore renminbi exchange transactions were conducted through London in Q1 2017. Zhu Jianhai, head of corporate banking at Agricultural Bank of China, said that London's financial sector "has evolved through 100 years to build a robust financial infrastructure, which is the solid backbone of financial activities. This is one advantage that Brexit cannot take away".

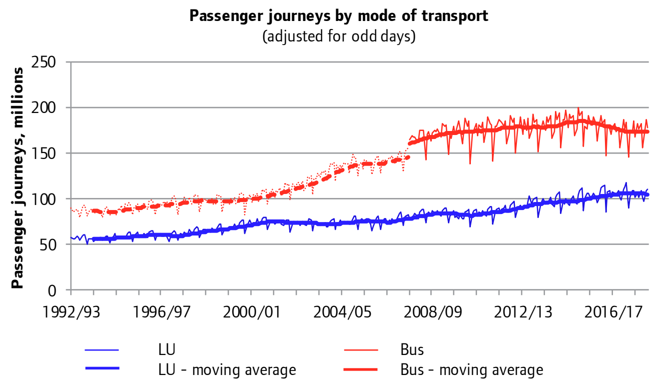
Elsewhere, research by Deloitte suggested that London office development is potentially starting to slow. The total volume of office space under construction in central London fell by 9 per cent in the last six months. That was the second consecutive fall, though the level remains relatively high in comparison with the long-run average. This will eventually feed through to completions, but currently the amount of new space being completed in 2017 so far is on track to reach a 13-year high.

More generally, London's economy continues to perform well. Recent forecasts made by EY showed that London's economy is expected to grow by 2.2 per cent on average up until 2020. This is ahead of the UK's average forecast rate of growth of 1.8 per cent. In fact, EY expected London and the surrounding area to continue growing at a faster rate than the rest of the UK. Linked to this, the Centre for Cities reported that productivity in London (as measured in terms of output per worker) was as much as 44 per cent higher than in other parts of the UK. In fact, it was also 7 per cent higher than in Germany. Consequently, the Centre for Cities argued that if the UK was as productive as London (and the South East more generally), the size of the UK economy would be more than £200 billion bigger. They attributed differences in regional productivity to the sector composition of regional economies where highly productive sectors make up a larger share of jobs in cities such as London. Thus, although uncertainties around the economy remain elevated heading into 2018, the fundamentals on which London's economy is based would appear to be sound.

Underlying trend in passenger journeys remains stable

- A total of 288.3 million of passenger journeys were registered between 15 October and 11 November, accounting for odd days. Of this, 110.6 million were Underground journeys and 177.7 million were bus journeys.
- The 12-months-moving average in the total number of passenger journeys remained constant at 277.9 million.
- The methodology used to calculate the number of bus passenger journeys was changed by TfL on 1 April 2007. For a detailed explanation, please see LET issue 58 (June 2007).

Latest release: December 2017
Next release: January 2018

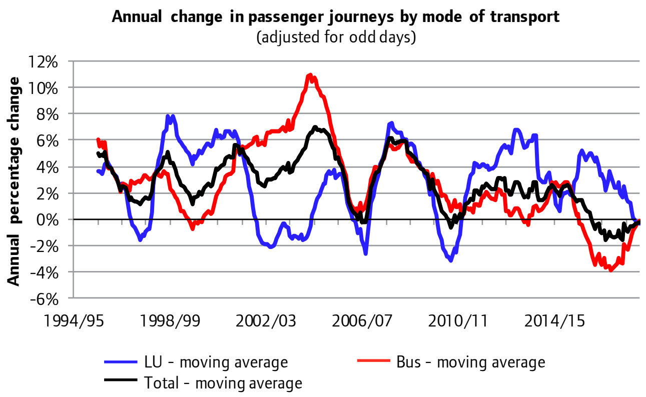


Source: Transport for London

Weakest underlying decline in total passenger journeys for two years

- The moving average annual change in the total number of passenger journeys was -0.2 per cent. That was one of the weakest rates of decline (i.e. least negative) in two years.
- The underlying trend in bus passenger journeys was broadly stagnant. The moving average annual change was -0.1 per cent, its highest reading for almost three years.
- In contrast, the moving average change in Tube passenger journeys was -0.3 per cent, its lowest reading since 2010-11.

Latest release: December 2017
Next release: January 2018

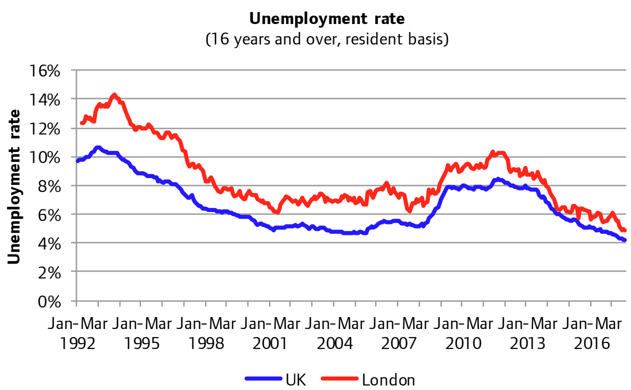


Source: Transport for London

London's unemployment rate falls to new series low

- For the period August to October 2017, there were 240,400 London residents over 16 years old who were unemployed, down 13,000 from the three months to July.
- The unemployment rate in London fell from 5.2 per cent to 4.9 per cent and was the lowest since data collection began in 1992.
- The UK's unemployment rate similarly stood at the historically low level of 4.3 per cent.

Latest release: December 2017
Next release: January 2018

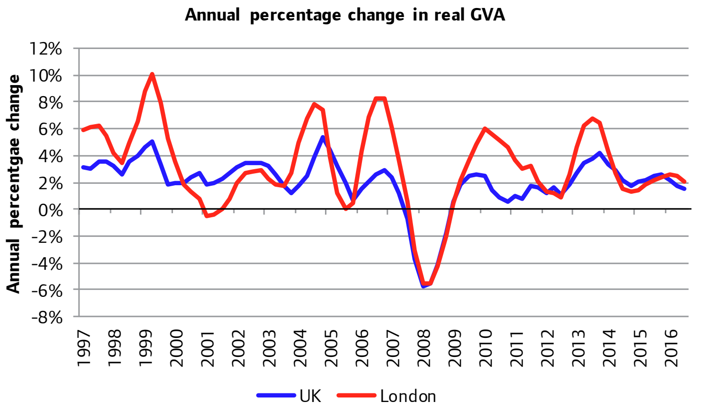


Source: ONS Labour Force Survey

London's annual output growth slows to 2.1 per cent

- London's annual growth in output slowed to 2.1 per cent in Q3 2017, down from 2.4 per cent in Q2 2017.
- Annual output growth in the UK similarly slowed to 1.6 per cent in Q3 2017, which was the weakest expansion in four years.
- From LET Issue 165 (May 2016), GLA Economics now reports our own GVA estimates for London and ONS data for the UK.

Latest release: October 2017
Next release: January 2018

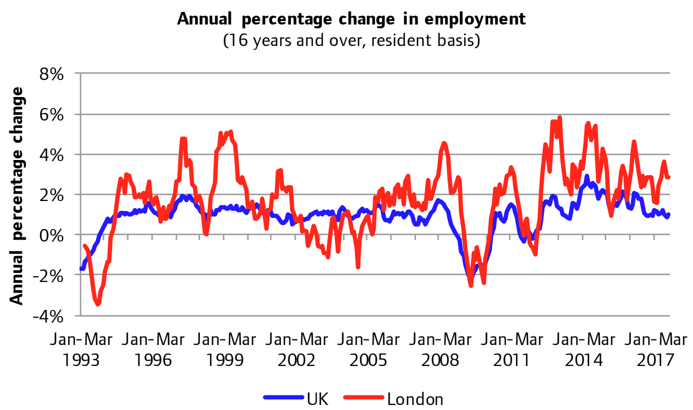


Source: ONS and GLA Economics calculations

Employment in London continues to grow

- Around 4.67 million London residents aged 16 years and over were employed between August and October 2017. That was up 128,000 from a year earlier.
- The annual rate of growth in employment was 2.8 per cent, down from a 3.4 per cent expansion during the May to July period.
- Employment across the UK grew at a slower rate year-on-year (1 per cent) than London (2.8 per cent).

Latest release: December 2017
Next release: January 2018

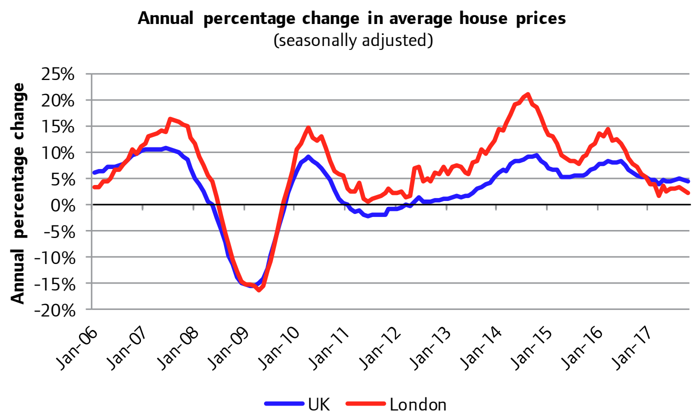


Source: ONS Labour Force Survey

House price inflation in London at seven-month low

- In October, the average house price in London was £480,353.
- The annual increase in house prices was 2.1 per cent. That was down from 2.9 per cent growth in September and, in fact, the slowest rate of increase for seven months.
- For the UK, house prices grew 4.5 per cent year-on-year in October. Although down from 4.8 per cent in September, it was more than double the rate recorded for London.

Latest release: December 2017
Next release: January 2018

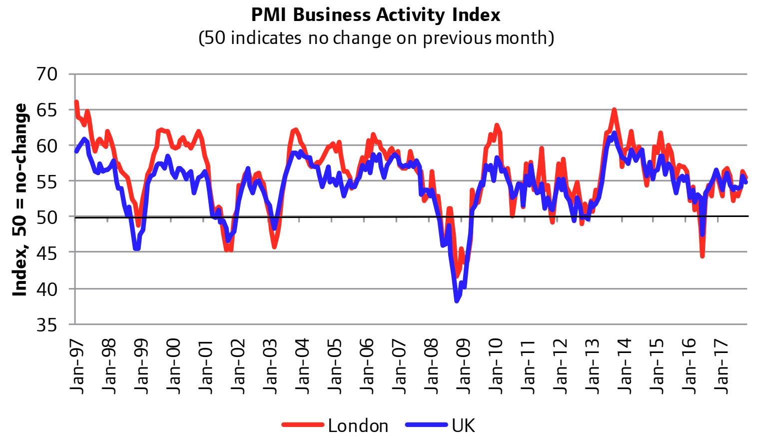


Source: Land Registry and ONS

Business activity growth remains strong in London

- The Purchasing Managers' Index (PMI) survey shows the monthly business trends at private sector firms. Index readings above 50.0 suggest a month-on-month increase in that variable, while readings below indicate a decrease.
- Business activity levels at private sector firms based in London increased solidly in November (55.6). Firms have reported an increase in each month since August 2016.
- The UK also saw a solid increase in output during November (54.9).

Latest release: December 2017
Next release: January 2018

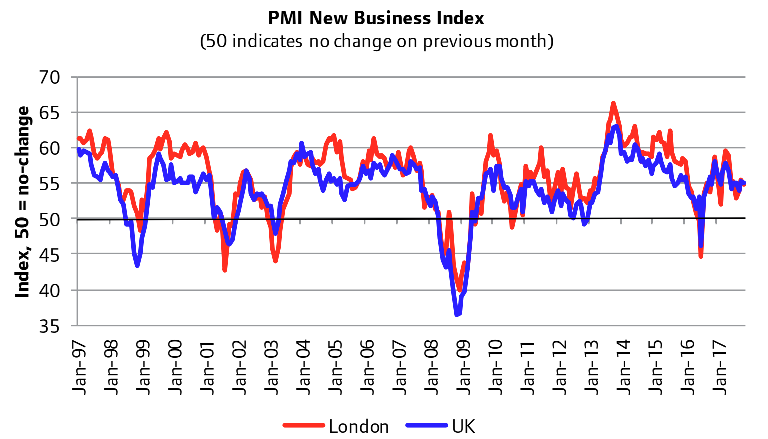


Source: IHS Markit

Private firms report a further increase in new business

- The PMI New Business Index was 54.8 in November, down from 55.5 in October, and signalled a solid increase in new orders in London.
- There was also a strong increase in new business across the UK with the index posting 55.0 in November.
- An index reading above 50.0 indicates an increase in new orders from the previous month.

Latest release: December 2017
Next release: January 2018

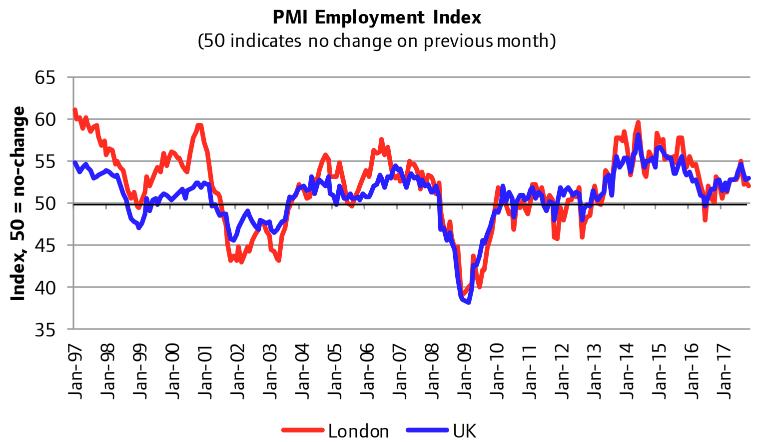


Source: IHS Markit

Slowest growth in employment since March

- The PMI Employment Index shows the monthly change in employment at private sector firms. Readings above 50.0 suggests and increase, whereas a reading below indicates a decrease in employment from the previous month.
- The Employment Index for London was at 52.0 in November and signalled a further increase in jobs. However, down from 52.6 in October, the rate of employment growth was the weakest in eight months.
- Employment levels increased at a faster rate across the UK (52.9) as a whole than in London.

Latest release: December 2017
Next release: January 2018

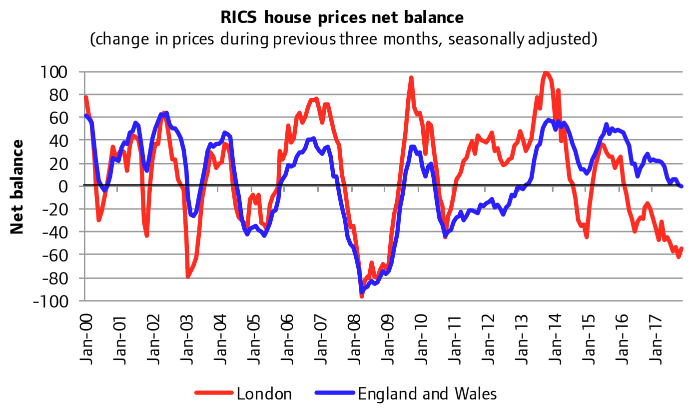


Source: IHS Markit

Surveyors report a fall in London's house prices

- Property surveyors reported a decline in house prices during the three months to November. The net balance remained negative at -54, though was slightly higher than October's near eight-year low of -62.
- In contrast, there was no change in house prices across England and Wales, with the net balance at 0.
- House prices also declined in the South East, East Anglia and the North.

Latest release: December 2017
Next release: January 2018

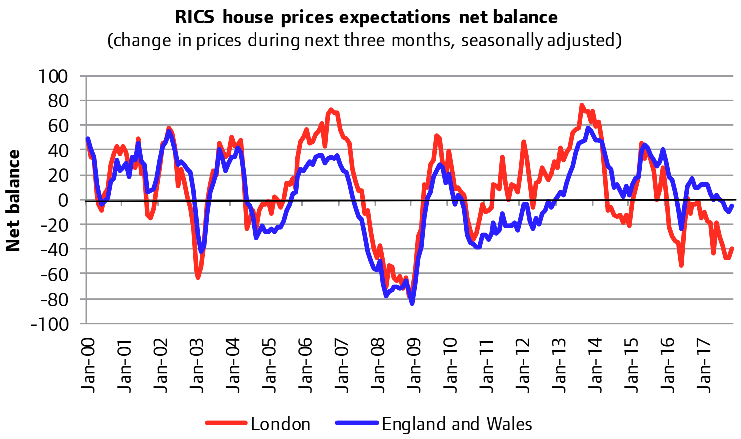


Source: Royal Institution of Chartered Surveyors

House prices expectations in London remain negative

- In November, surveyors had negative expectations for London's house prices over the next three months (-39).
- Sentiment across England and Wales was also negative in November. However, the net balance improved from -10 to -5.
- Property surveyors were also pessimistic in the South East, East Anglia, the South West and the North.

Latest release: December 2017
Next release: January 2018

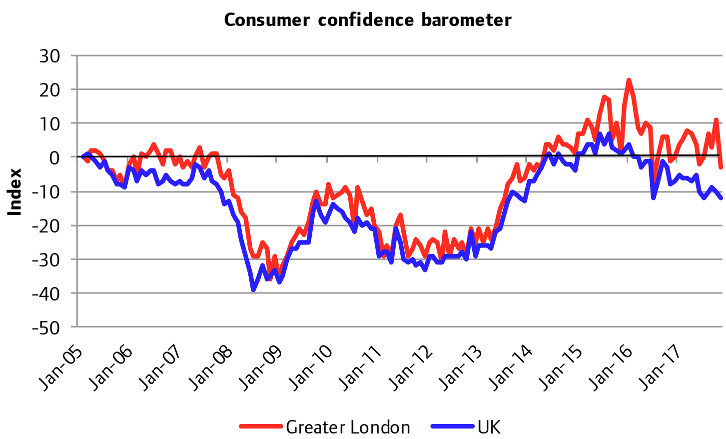


Source: Royal Institution of Chartered Surveyors

Consumer confidence turns negative in London

- The GfK index of consumer confidence reflects people's views on their financial position and the general economy over the past year and in the next 12 months. A score above zero suggests positive opinions; a score below zero indicates negative sentiment.
- Consumer confidence in London turned negative for the first time in five months during November. The index fell sharply to -3 from +11 in October.
- Sentiment was also negative for the UK, though the index was much lower than for London (-12).

Latest release: November 2017
Next release: December 2017



Source: GfK NOP on behalf of the European Commission

By **Mark Wingham,**
Economist

The year has again been dominated by Brexit, but other big economic events included the first increase in interest rates since 2007, the General Election, two UK Budgets and the strength of the labour market. This supplement looks at some of these economic events and discusses what the future may hold for London's economy.

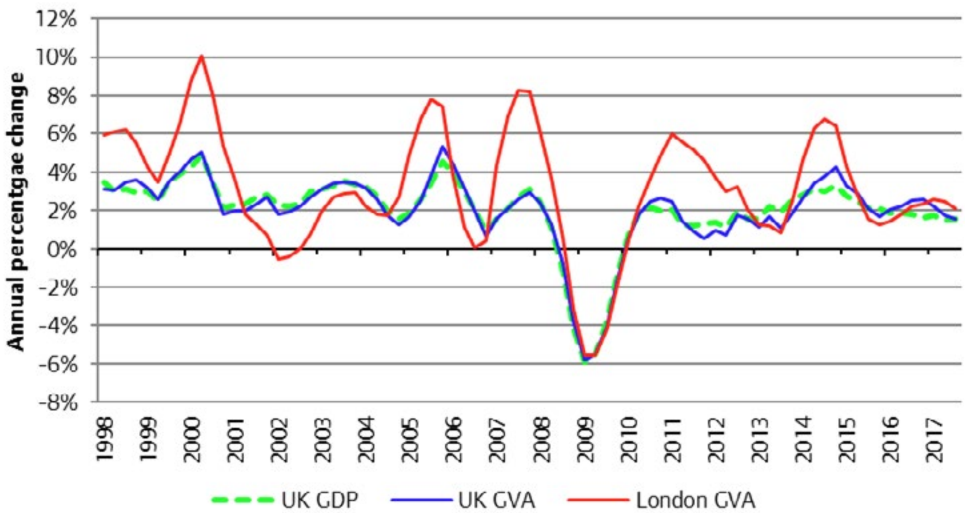
Article 50 was triggered in March with the Brexit negotiations starting in June and being split into two parts. The first is focussed on the UK's exit from the EU, and the second will then look at the future relationship. After months of very slow progress there was an eventual breakthrough in the first phase of the talks as discussed within the main editorial of this issue. This paves the way for the start of the second phase of talks beginning in 2018, with the focus on a two-year status-quo transition period and a long-term trade deal.

Many forecasters previously expected Brexit to have a negative and sudden impact on the economy, but the UK has been relatively resilient. For example, UK gross domestic product (GDP) has continued to grow, albeit at an unspectacular average quarterly rate of 0.3 per cent (or 1.6 per cent on an annual basis) in 2017 so far[1]. That was broadly in line with the 2016 average of 0.4 per cent, yet weaker than the 0.6 per cent average growth seen since the financial crisis and before the EU referendum[2]. This trend of relatively weak growth can also be seen for gross value added (GVA) – another indicator of economic growth. The average rate of annual GVA growth across the UK was 1.8 per cent in 2017 so far, down from the average rate of 2.3 per cent in 2016.

The same can be said for London. The annual rate of GVA growth for London in 2017 so far has averaged 2.4 per cent, which is around a third faster than the UK. In fact, London has seen a faster rate of growth than the UK average in every quarter since Q2 2016. Nonetheless GVA growth has been slower than the London average since the financial crisis (3.4 per cent).

Figure A1: Annual rates of GVA and GDP growth for London and the UK

Source: ONS GDP, ONS Regional GVA



1 At the time of writing, GDP data was only available up to Q3 2017.
2 Q1 2010 to Q2 2016

That said, in light of expected barriers to trade post-Brexit, several businesses have announced plans to open subsidiaries in other EU countries. This especially includes London-based financial institutions that may potentially lose their passporting rights, though the impact of this is not yet fully known. For instance, estimates of the potential number of jobs that could be moved because of Brexit includes 10,000 finance jobs based on a Reuters survey of businesses and up to 75,000 jobs across financial and associated professional services used by the Bank of England as one of their many scenarios.

Still given the relative resilience of the UK (and London) economy, since last year, many (but not all) forecasters have revised up their growth expectations for 2017. However, they also revised down their forecasts for 2018 and 2019. Of particular note are the latest forecasts from the Office for Budget Responsibility (OBR) who revised down their forecasts largely because of the "remarkable" period of weak productivity growth seen since the financial crisis (see LET Issue 183 for a larger discussion on this). In all cases, the rates of growth forecast are all relatively slower in the context of historical data.

Table A1: Forecasts of UK GDP growth

Source: Bank of England Inflation Report, HM Treasury Summary of Independent Forecasts, OBR Economic and Fiscal Outlook, IMF World Economic Outlook

Forecast	2017	2018	2019	2020	2021
Bank of England Inflation Report					
Nov-16	1.4%	1.5%	1.6%	..	..
Nov-17	1.5%	1.7%	1.7%	1.7%	..
HM Treasury Summary of Independent Forecasts					
Nov-16	1.3%	1.5%	1.8%	2.1%	..
Nov-17	1.5%	1.4%	1.5%	1.8%	1.9%
OBR Economic and Fiscal Outlook					
Nov-16	1.4%	1.7%	2.1%	2.1%	2.0%
Nov-17	1.5%	1.4%	1.3%	1.3%	1.5%
IMF World Economic Outlook					
Oct-16	1.1%	1.7%	1.8%	1.9%	1.9%
Oct-17	1.7%	1.5%	1.6%	1.7%	1.7%

A similar trend of upward revisions in 2017 and downward revisions for subsequent years in comparison to the forecasts made in 2016 can be seen for London. In our London's Economic Outlook publications, we now expect London's GVA growth to be 2.1 per cent in 2017 (up from 2 per cent), 1.8 per cent in 2018 (down from 2.3 per cent) and 2.6 per cent in 2019.

Table A2: Forecasts of London GVA growth

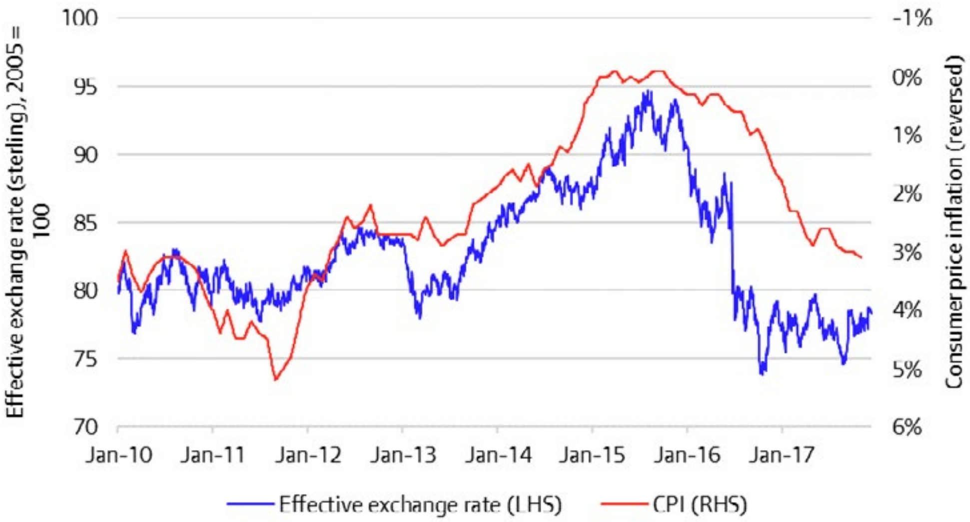
Source: GLA Economics London's Economic Outlook

Forecast	2017	2018	2019
Autumn 2016	2.0%	2.3%	..
Spring 2017	2.3%	2.4%	2.9%
Autumn 2017	2.1%	1.8%	2.6%

Brexit has had a more noticeable effect on the exchange rate and the stock market. Immediately following the EU referendum result in 2016, the value of sterling and the FTSE 100 fell sharply. While the FTSE has recovered and in fact reached record-highs in 2017, the price of sterling remains low. This depreciation has made it more expensive to import goods and services and was one of the factors behind a strong increase in inflation (Figure A2). The rate of inflation has almost doubled from 1.6 per cent in December 2016 to 3.1 per cent in November 2017 – a near six-year high. It has also been rising faster than wages which means that real earnings (i.e. after accounting for inflation) have started falling for the first time in two-and-a-half years.

Figure A2: Effective exchange rate of sterling and inflation for the UK

Source: Bank of England, ONS Consumer prices index



Expectations are for inflation to start to slow in 2018. For instance, the Governor of the Bank of England said that he expected inflation to peak around October and November 2017. However, there is a risk that inflation will remain above the Bank's target of 2 per cent in the medium-term and was one of the factors behind the first increase in interest rates since the financial crisis. Interest rates rose to 0.5 per cent in November with this seen by some commentators as the first step to 'normalising' monetary policy so that interest rates return to historic levels. As such, the Governor warned that there could be a need for at least two further interest rate rises over the next two years. It also follows other central banks elsewhere. For example, the US Federal Reserve raised interest rates three times in 2017 (having raised interest rates once each in 2015 and 2016 already) and the European Central Bank announced that it would start reducing its quantitative easing programme in 2018.

Another factor behind the increase in interest rates has been the strong labour market. The UK's employment rate has been at its highest level and the unemployment rate at its lowest level since the 1970s during 2017. Similarly, London's labour market has been performing at its best levels since data collection began in 1992. Labour market forecasts for London looks at the number of jobs rather than the un/employment rates. On this basis, the latest London forecast suggests that the number of jobs will keep growing in the medium-term, though at a slower rate.

The economic news of 2017 has not just been dominated by Brexit. There was a UK General Election which resulted in no party having an all-out majority, and new devolved Mayoral elections across the UK outside of London. There have also been two UK Budgets where important London-specific announcements included a Memorandum of Understanding of more devolution to the capital and various housing policies such as additional funds for construction and stamp duty discounts for first time buyers. At the end of November, the Government published an Industrial Strategy setting out plans to improve the UK's productivity; while earlier in the year, the final report of the Taylor Review argued for more worker rights for those in the sharing economy.

More specifically for London, the Government provisionally agreed to Crossrail 2 and is continuing its plans to expand Heathrow Airport. Phase One of HS2 (linking London to the West Midlands) received Royal Assent while the process for appointing construction partners for the new HS2 stations at Euston and

Old Oak Common is underway. There has been a large increase in the number of international visitors to London. And the rate of house price inflation in the capital has more than halved, from an average annual increase of 10.1 per cent in 2016 to just 3 per cent in 2017 so far[3].

Looking forwards, the prospects for London remain positive, albeit slightly weaker than for 2017. There will be ongoing uncertainty caused by Brexit and the period of higher inflation caused by the depreciation of sterling is likely to continue but at a more moderate pace. It is not yet clear as to how this will impact real earnings and, consequently, household spending. Other noticeable events to look forward to in 2018 include the retention of 100 per cent of business rates in London from April and there will be local elections in May.

GLA Economics will continue to report on events of importance to London in future editions of London's Economy Today and upcoming Working Papers and Current Issues Notes. These can all be found on our publications webpage.

3 January to October 2017.

Additional information

Data sources

Tube and bus ridership	Transport for London on 020 7222 5600 or email: enquire@tfl.gov.uk
GVA growth	Experian Economics on 020 7746 8260
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.

ILO unemployment
The International Labour Organization (ILO) measure of unemployment assesses the number of jobless people who want to work, are available to work and are actively seeking employment.

Residence-based employment
Employment measures the number of people in work rather than the total number of jobs (as people may have more than one job). It consists of employees, self-employed as well as unpaid family workers and those on government supported training and employment programmes. The measure included here is residence-based.

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.

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. In 2017/18 there are twelve 28-day periods and one 29-day period. Period 1 started on 1 April 2017.

Bus ridership
Transport for London's measure of the number of passengers using buses in London in a given period. There are 13 periods in a year. In 2017/18 there are twelve 28-day periods, and one 29-day period. Period 1 started on 1 April 2017.

Acronyms

BCC	British Chamber of Commerce
BRES	Business Register and Employment Survey
CAA	Civil Aviation Authority
CBI	Confederation of British Industry
CLG	Communities and Local Government
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 Institution of Chartered Surveyors

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