GLAECONOMICS

London's Economy Today

Issue 3
November 2002

Transport for London

LONDON DEVELOPMENT AGENCY

MAYOR OF LONDON

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London's Economy Today: Edition 3

GLA Economics Publication

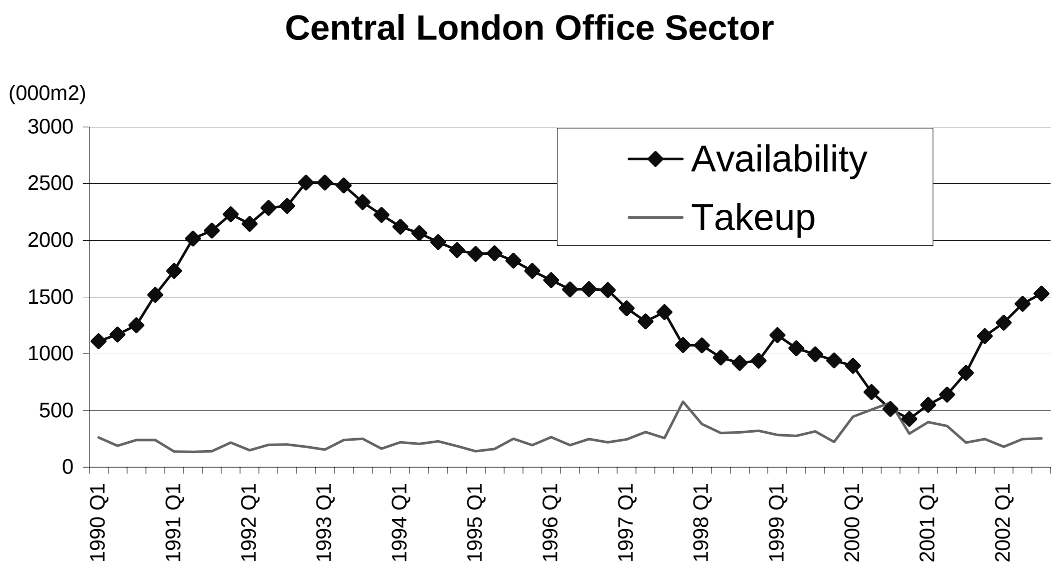
- The latest evidence confirms the picture that there has not been much of a slowdown in the London economy.
- Output growth is still positive, tube ridership is flat and unemployment is slightly up (although the rise is fairly small).
- Moreover, a recovery has started and the Bank of England thinks it will accelerate, leaving the possibility of capacity shortages going forward.
- Both the labour and property markets have some slack, however the transport system offers little spare potential and rapid reinvestment is necessary to allow growth to go forward.
- Of course there remains some near term risks. Risks to the international economy from the US consumer and war, as well as from the inflation that may be generated by rapid recovery combined with strong growth in investment spending.
- The London economy continues to be affected by stock market weakness and difficulties for financial institutions.
- Tourist numbers are up on a year ago but still below previous peaks. Although arrivals have recovered to pre-crisis levels, this is not true of visitor numbers as a whole.

The Bank of England is clearly convinced that the economic recovery has begun. It's latest Inflation Report for November 2002 has a central projection that growth in output will accelerate through the early part of 2003 and that we have already seen the worst of the slowdown, which bottomed out at a rate of growth of just 1 per cent. This means that the UK economy will not suffer recession in this cycle. Most recent estimates of the London economy also show a recovery starting in the second quarter.

This raises two key questions. Not only must we ask what the risks are should this not happen, but also what the implications are of economic recovery.

Capacity constraints

Resuming growth requires finding new space for activities to take place in, new people to work in such space and the transport mechanisms to deliver them to work. Alternatively we must all work at home or there will need to be a productivity revolution. Though new working practices and productivity solutions are all potentially desirable they are slow to take place and offer only small possible adjustment in any year. Moreover, recovery in the near term will more likely build on existing successes, even when new activities are also being started. So looking at constraints in existing markets for property and labour is important. The property constraint is the least likely to bite.



Source: CB Hillier Parker

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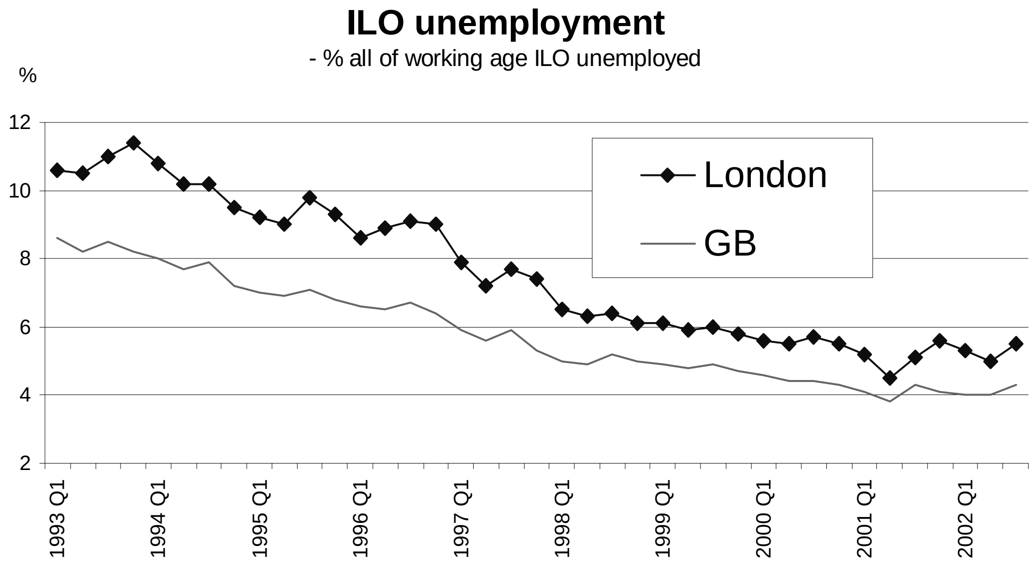
The chart shows how office availability has risen in the last year, while take-up has flattened from 2000. In Central London at any rate there should be capacity for expansion. While data for other areas is less readily available, anecdotal evidence suggests that space is also available outside central London.

Turning to the labour market, there is also some scope for expansion, though perhaps on a more limited scale. Unemployment has risen very little in London from the low point at the beginning of 2001 but still stands above the rate for the whole of Great Britain, using the definition of unemployment which asks whether people are looking for work.



Source: Labour Force Survey

The difficulty comes when we look at the transport infrastructure and puts into sharp relief the need for renewed investment in transport systems. Tube ridership has barely fallen from the peak and bus use has risen strongly on the back of price restructuring. London can cope with expansion but it may be difficult and fairly quickly constrained by capacity constraints.

But will it happen?
There are a number of risks – and they are all on the downside. First there are international risks. One is the risk of war and the effect on tourism which we estimate could cost the London economy up to £1bn. War will also have an impact on commodity prices and business costs as well as further depressing the capacity to do deals in the investment banking industry. Partly associated with this risk is that of a renewed slowdown in the US economy, which is otherwise showing a pattern of recovery similar to that in the UK. However, consumer confidence has weakened significantly in recent weeks.

Second, there is the risk of inflation more generally. The Monetary Policy Committee (MPC) has for the first time in some years raised its forecast of inflation so that the rate is over target in the near term. This is driven largely by the recovery in output and by the pass through of higher taxes associated with both good consumer spending growth and rapid government spending increases. The MPC may well head off a capacity crunch by raising rates – but this will also reduce growth again.

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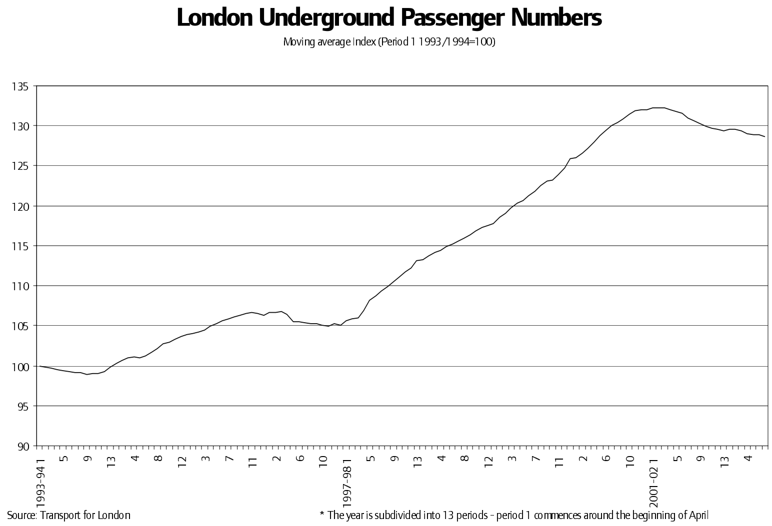
Tube Usage

Source: Transport for London
Latest Release: Tue 19 Nov 2002
Next Release: Tue 17 Dec 2002

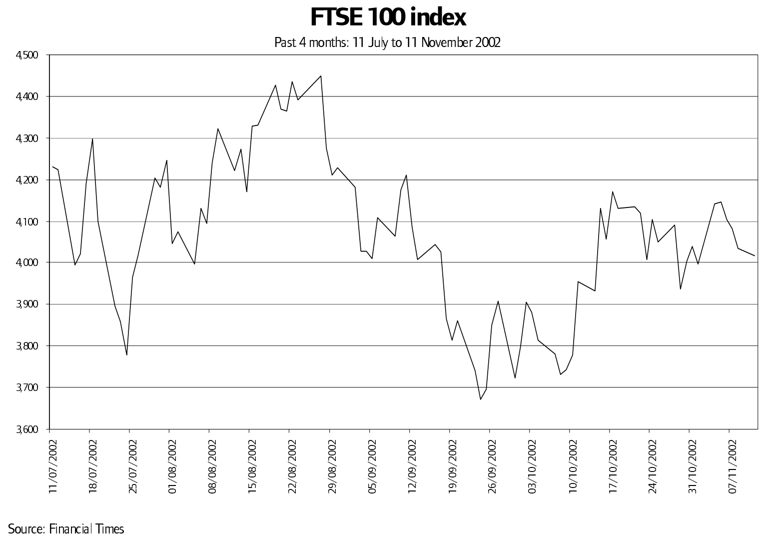
- Latest passenger numbers show virtually no change over the four weeks since 14 September.
- There has been little change since the Spring of 2002.
- The trend in tube usage has been in decline turned down in the spring of 2001.



FTSE 100

Source: Financial Times
Latest Release: Fri Nov 16 2002
Next Release: Daily

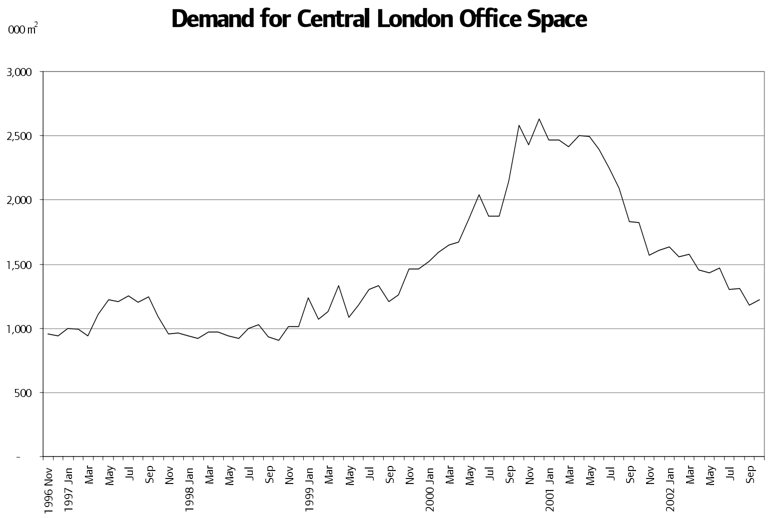
- The FTSE 100 Index remains well above its low point of 3700, but the market is showing no consistent trend.
- It closed down 46 points at the end of the week after reacting to the mixed signals coming out of the US.
- Trading volumes have held up well in London despite price weakness. Derivatives trading on Liffe is up 20 per cent on last year.



Office Space Demand

Source: CB Hillier Parker
Latest Release: 1 Nov 2002
Next Release: 2 Dec 2002

- Demand for central London office space stabilised in October and remains 60 per cent down from its peak in December 2000.
- Although monthly movements continue to be a little erratic the overall trend is emphatically negative.
- By contrast demand for retail warehousing remains exceptionally strong.



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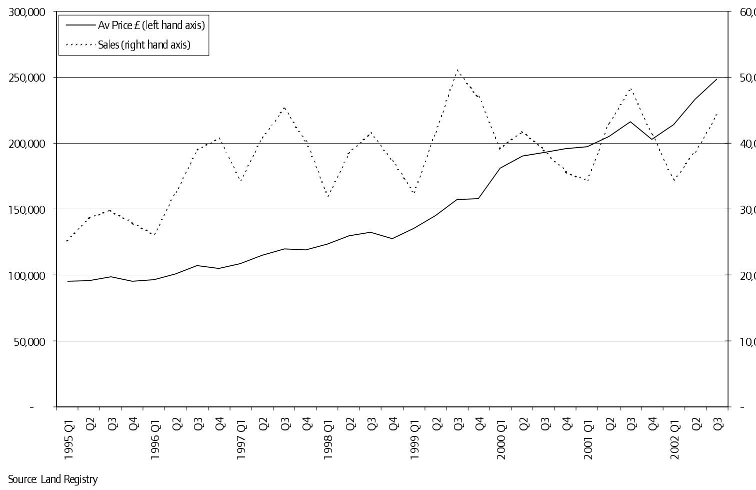
House Prices

Source: Land Registry
Latest Release: 8 Nov 2002
Next Release: Feb 2003

- The price of an average London home is now close to £250,000; having increased by around £30,000 in the year to September.
- House prices show little sign of slowing down. Figures released by the Nationwide for October showed average prices 1.4 per cent up on the month and 24 per cent above the previous year.
- Corresponding figures from the Halifax were 4.7 per cent and 30.6 per cent.

London House Prices and Sales



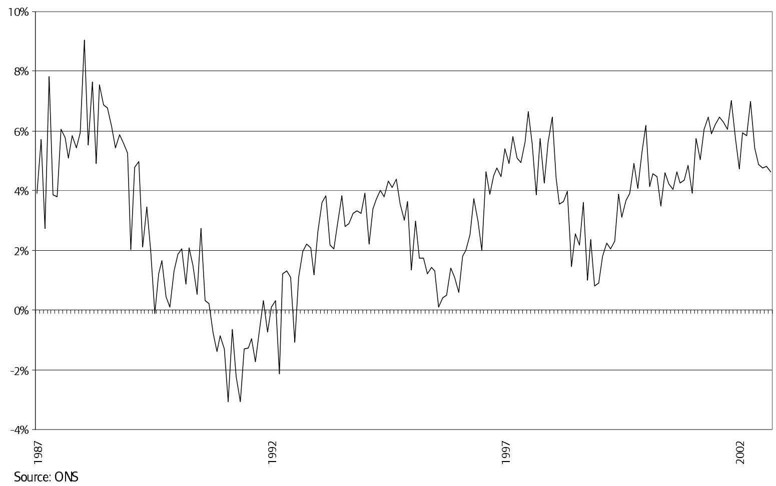
Retail Sales

Source: ONS
Latest Release: 24 Oct 2002
Next Release: 21 Nov 2002

- Retail sales were 0.4 per cent higher in September than in the previous month; and stood 4.1 per cent over the level of September 2001.
- Food stores showed the strongest growth in the sector with sales of household goods still robust.
- The High Street remains the principal engine of the UK's growth, but sales growth has certainly stabilised, if not started to fall.

Retail Sales Index

Year on Year change in monthly RSI volume of sales (%) constant price and seasonally adjusted



GDP/GVA Growth

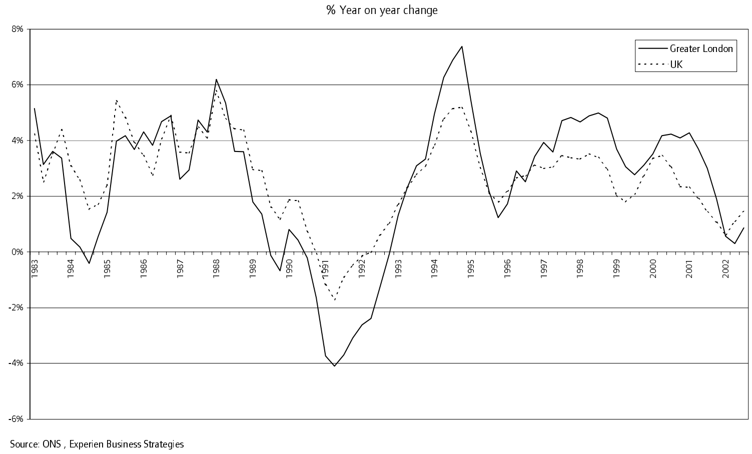
Source: Experian Business Strategies

Latest Release: 19 Oct 2002

- Experian have slightly increased the estimates of London's GVA in 2002, however London's growth over the first three quarters still lags the rest of the UK.
- The latest estimates show growth in London picking up in the second quarter, from a low point of 0.3 per cent year on year in the second quarter to 0.9 per cent in the third.
- The pick up is slightly later than in the UK as a whole, where two quarters of recovery are apparent.

Real GVA (GDP)- London & UK

% Year on year change



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Index of Production

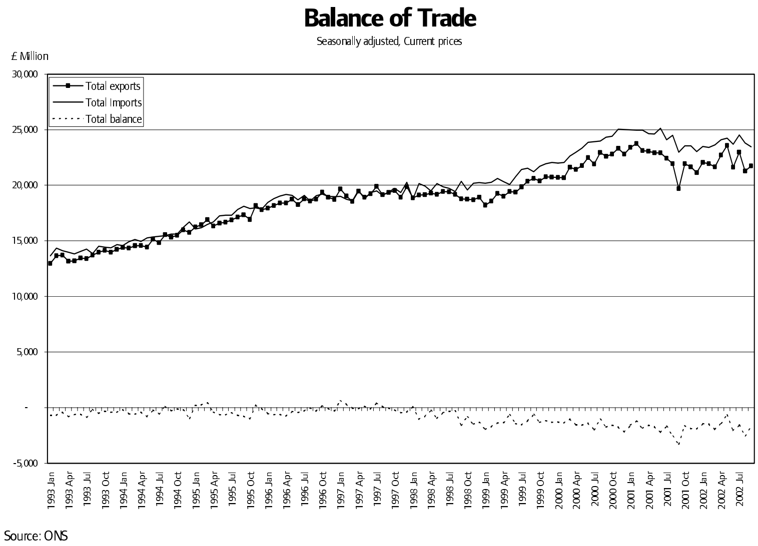
Source: ONS
Latest Release: 5 Nov 2002
Next Release: 6 Dec 2002

- September saw a slight decline in the index of production, because falls in manufacturing and electricity, gas and water supply outweighed rises in the mining and quarrying sector.
- Manufacturing staged a stronger comeback in the third quarter but nevertheless remains 3.0 per cent below last year's level.

Balance of Trade

Source: ONS
Latest Release: Fri 8 Nov 2002
Next Release: Tue 10 Dec 2002

- The UK balance of trade deficit shrunk in September from £2.5 billion to £1.7 billion, on the performance of exports and reduced goods imports.
- However, the underlying trend of a widening UK deficit is unaffected.



Unemployment in London

Source: ONS
Latest Release: 13 Nov 02
Next Release: 18 Dec 02

- In the period June 2001 to October 2002, there have been increases of 31,000 and 16,500 in London ILO unemployment and the claimant count respectively.
- This illustrates the larger increase in the number of London residents who are unemployed and are actively seeking work rather than the number of people who are claiming benefit.
- The gap between unemployment in London and the UK has continued to widen.

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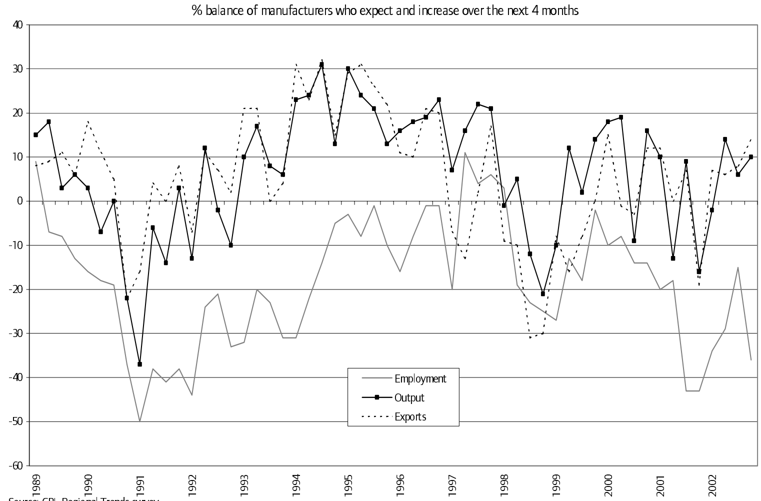
Manufacturing Expectations

Source: CBI Regional Trade survey
Latest Release: 12 Nov 2002
Next Release: Feb 2002

- London manufacturers expect both output and export sales to pick up over the next 4 months.
- The outlook for employment has fallen back markedly almost reversing the gains of the previous quarter.
- The national picture is very mixed, with sharp falls in confidence in the South West and East and the North East and East Midlands benefiting from a sharp rise in orders.

Manufacturing Expectations - London

% balance of manufacturers who expect and increase over the next 4 months



Source: CBI Regional Trends survey

Profitability Prospects

Source: London Chamber of Commerce and Industry
Latest Release: 21 Oct 2002

- After a sharp increase in profit expectations in the first and second quarters, these gains began to be reversed in the third quarter.
- The severe fall in the service sector was both disappointing and unexpected.
- The survey findings confirm the British Chamber of Commerce's view that "recovery remains limited".

London Profitability Expectations

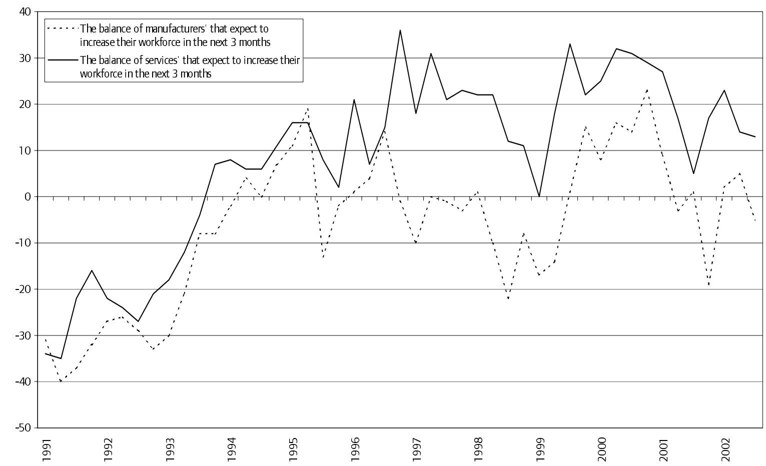
Source: London Chamber of Commerce and Industry

Employment Prospects

Source: London Chamber of Commerce and Industry
Latest Release: 21 Oct 2002

- With prospects for profitable expansion limited, the outlook for employment in London appears poor.
- As services remain by far the most important source of London's new jobs, increased pessimism in this sector is particularly worrying.

London Employment expectations

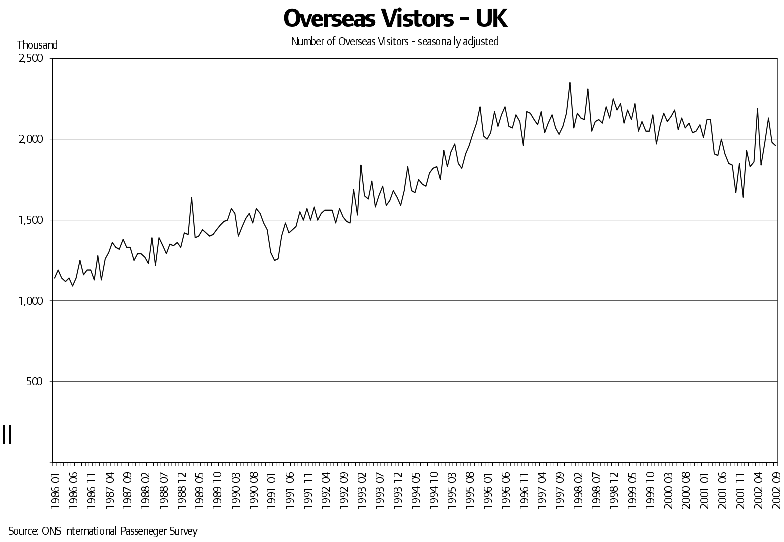


Source: London Chamber of Commerce and Industry

Tourism – Overseas Visitors

Source: ONS International Passenger Survey
Latest Release: 6 Nov 2002
Next Release: 6 Dec 2002

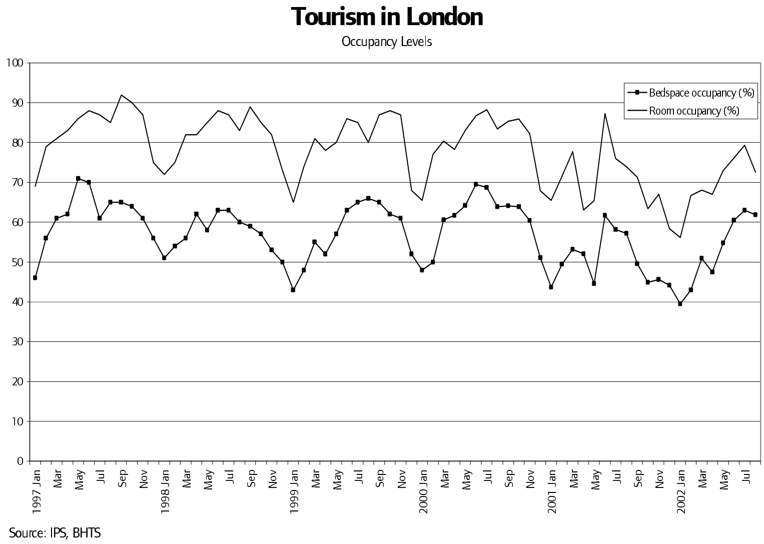
- Overseas visitors to the UK in September fell back slightly on last month, but remains 7 per cent higher than a year ago. Numbers from all the main regions were up, including North America.
- Spending was up by 5 per cent to a total of £1.16 billion.
- While this is clearly good news, visitor numbers remain down on their previous peak. January to September numbers are still 6 per cent below the same period in 2000.



Occupancy Levels

Source: IPS, BHTS
Latest Release: 28 Oct 2002
Next Release: Nov 2002

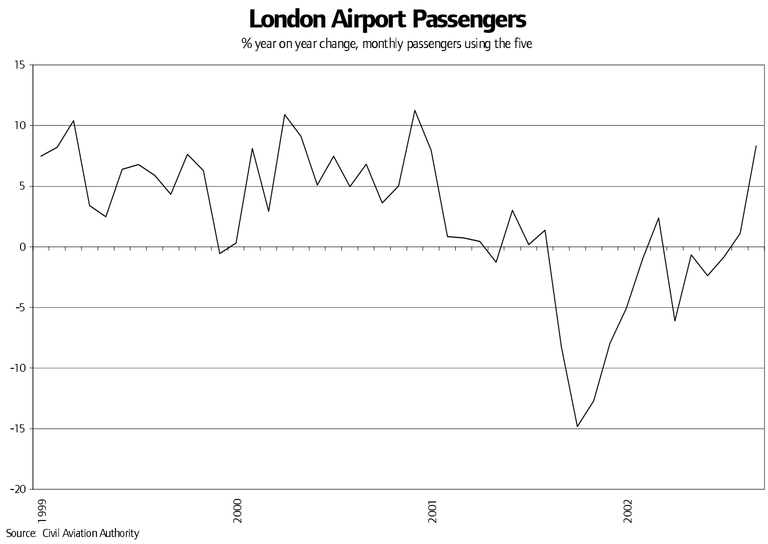
- London hotel occupancy rose by 9.3 per cent in the year to September, but was still 8 per cent lower than in September 2000.
- Room rates reflected the weakness of demand and were 6 per cent lower than last year.
- The underlying trend in occupancy rates remains strongly positive.



London Airports:

Source: CAA
Latest Release: 28 Oct 2002
Next Release: Nov 2002

- The numbers of flights and passengers at all of London's main airports continued to rise in October, having staged a major increase in September.
- Passenger numbers are now back to pre-crisis levels. Stansted and Heathrow have made a major recovery, being 22 per cent and 24 per cent above last October's levels.



Data Sources

Tube Usage:	Further information contact Transport for London on 020 7941 4500
FTSE 100 Index:	Further information see www.ft.com or the daily Financial Times
Office Space Demand:	Further information see www.cbhillierparker.com
House Prices:	Nationwide house price data available from www.nationwide.co.uk/hpi/
Retail Sales:	Data available from www.statistics.gov.uk
GDP/GVA Growth:	Data available from Experian Business Strategies on 020 7630 5959
Index of Production:	Data available from www.statistics.gov.uk
Balance of Trade:	Data available from www.statistics.gov.uk
Unemployment:	Data available from www.statistics.gov.uk and www.nomisweb.co.uk
Manufacturing Expectations:	Further information see www.cbi.org.uk
Profitability Prospects:	Further information see www.chamberonline co.uk
Employment Prospects:	Further information see www.chamberonline co.uk
Tourism – Overseas Visitors:	Data available from www.statistics.gov.uk
Occupancy Levels:	Further information available from London Tourist Board
London Airports:	Further information available from www.caa.co.uk

Abbreviations

CBI	Confederation of British Industry
FTSE 100	Financial Times Stock Exchange 100 index of stocks traded on the London Stock Exchange
GDP	Gross Domestic Product
GVA	Gross Value Added
ILO	International Labour Organisation
ONS	Office of National Statistics
CAA	Civil Aviation Authority

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London's Economy Today: Supplement

Public Sector Finance And Recession

The Chancellor will make his next Pre-Budget Report to the House of Commons a week on Wednesday – the 27th of November. The Treasury accepted some while ago that the economic projections on which the Budget arithmetic was based were too optimistic and would need to be re-worked.

The forecast for GDP growth this year according to the Treasury's latest sampling of independent forecasters is 1.6 per cent, unchanged from the previous month. The economy is generally expected to rebound in 2003 with average growth put at 2.5 per cent - marginally down on September.

These projections have changed surprisingly little from the Treasury's pre-Budget sampling in April, when growth for this year was expected to be 1.9 per cent and 2.7 per cent for 2003. We share the general view of prospects and do *not expect recession* in the near term. However uncertainty has increased substantially and this is reflected widely in the forecasts, especially for 2003, which range from –0.6 per cent to 3.1 per cent. Our projections are conditional upon US confidence holding up, a sustained pick-up in world trade and a stable UK housing market.

The Impact on Public Sector Finances

The government's pre-Budget projections of GDP growth were already at the optimistic end of the range of independent forecasts and the Treasury now admit that their numbers will need to be re-worked. Our guess is that they will reduce projected GDP growth by around 1 to 1 ¼ percentage points this year and by a maximum of ½ a point for 2003.

Forecasts for 2002

	Treasury budget 02	Independents		September Range	
		April	September	Lowest	Highest
GDP growth per cent	2.75	1.9	1.6	0.6	2.1
PSNB £bn 2002/3	10	NA	12.7	6.8	20.1

Forecasts for 2003

	Treasury budget 02	Independents		September Range	
		April	September	Lowest	Highest
GDP growth per cent	2.4	2.7	2.6	-0.1	3.2
PSNB £bn 2003/4	13	NA	16.6	6.0	24.3

Public sector finances are extremely sensitive to the level of economic activity in the private sector. A recent estimate by the Institute for Fiscal Studies (IFS) suggested that for every 1per cent fall in the level of GDP, Net Public Sector Borrowing could increase by around £6 - 8 billion as government tax revenues fall and spending rises in line with increasing unemployment and hardship.

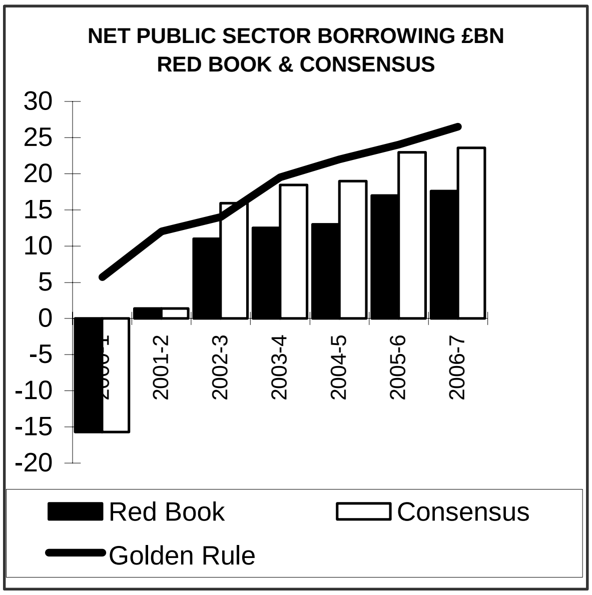
The table below shows the Treasury's Red Book projections for the medium term:

Red Book Projections

Fiscal Year	GDP growth per cent	PSNB £bn
2000-1	2.4	-17.2
2001-2	1.6	0.1
2002-3	2.75	10
2003-4	2.4	13
2004-5	2.5	13
2005-6	2.5	17

In order to track the possible effect of any growth shortfall on public sector borrowing and its possible knock-on effects on GLA funding, GLA Economics have constructed a simple simulation model based on Table C4 of the Budget 2000 Report. This model broadly confirms the IFS rule of thumb and calculates the impact of changes on the Chancellor's key fiscal 'rules', allowing us to speculate about how and when the government might be forced to adopt a change in its fiscal policy.

The Chancellor's first fiscal rule – the Golden Rule – is to ensure that the government only borrow to finance capital spending and not consumption. The level of planned capex therefore sets a ceiling on borrowing. The Budget projections unsurprisingly show this target to be comfortably met.



Reworking the arithmetic using the current consensus forecast for GDP shows that there could be a very small problem in the current fiscal year, should capex fall short of target or borrowing exceed it.

It is already clear that the government's capital spending is falling well short of plan and this may require some adjustment to its current spending. A weaker economy is not the only problem on the horizon. The prospect of war in the Gulf and a rash of public sector pay claims could further damage the public finances.

Nevertheless, assuming any slow-down is mild and short-lived, these problems are at worst modest and temporary.

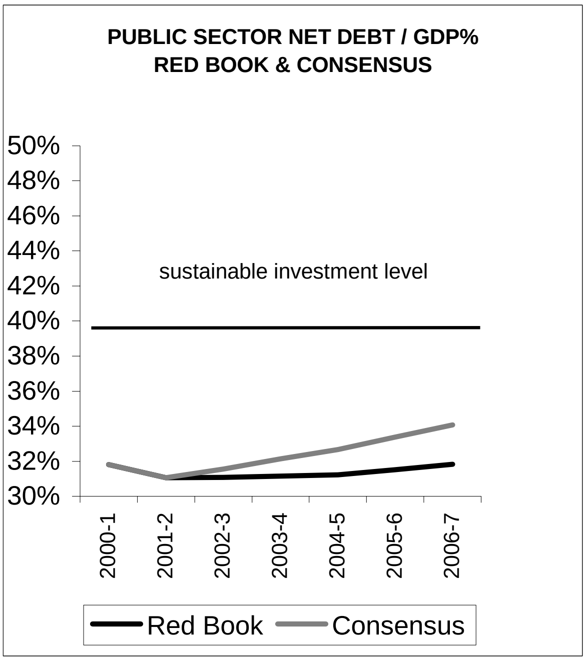
The Chancellor's second rule on 'sustainable investment' is designed to ensure that each generation pays for its own consumption rather than burdening future taxpayers. This is framed in terms of the ratio of Public Sector Debt to GDP. The prudent ceiling for this is put at 40 per cent.

The chart shows that this target will be comfortably met in both scenarios. Having laid solid foundations during his first five Budgets, the Chancellor appears to have created sufficient fiscal margin to withstand at least a modest downturn in the economy. Under this scenario there is very little chance of a major change in policy direction.

What would it take to force a major change of policy?

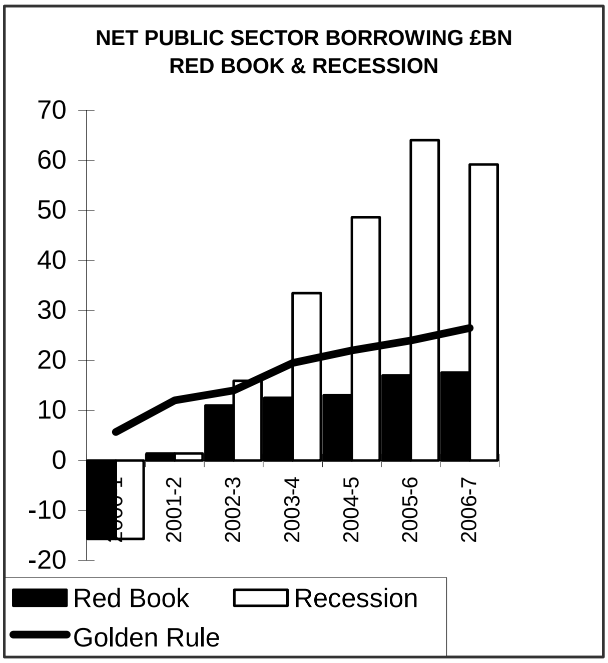
Looking at the problem from the other direction, it is clear that if conditions were to worsen sufficiently the Chancellor would be forced to take action. How bad would things have to get?

Though economic conditions are now quite different from those prevailing when the UK last slid into serious recession in 1990 – not least because of the state of public finances – it could be instructive to see what might happen were the UK again to experience an equivalent downturn. During the previous cycle, GDP growth was negative in two successive fiscal years and then grew by less than 1per cent in the following year.



Were this to happen again (and in the absence of corrective action) the Golden Rule would be breached from 2003/4 and well into the medium term. Cuts starting at around £15 billion and rising rapidly would be required from next year onward. Even the robust test of 'sustainable investment' would look threatened towards the end of the period.

The Chancellor would face a very uncomfortable dilemma – since either cuts or additional tax raising would have to be on an enormous scale to claw back the fiscal balance. The most likely policy response would be a substantial pre-emptive rise in taxation targeted to do the least damage to the government's core constituencies – together with a substantial but highly selective cut in spending programmes – again designed to protect the strategic heartland of health and education policy.



Such a scenario could be very damaging to those in lower priority areas – for example local and regional government, longer-term development and infrastructure spending. Central Government grants to local authorities to cover current expenditure are projected to be £76.5 billion in the current fiscal year – this represents some 20 per cent of total government spending and 90 per cent of Local Authorities planned spend.

Thus even a small change in spending priorities could have a disproportionate impact on local and regional government. This could be particularly serious for London, whose economy would be hit harder than the rest of the UK by general recession and for the GLA, which receives over 40 per cent of its funding in the form of central government grants.

Impact on London Taxation and Public Expenditure

London has long been a major net contributor of tax revenue to the rest of the UK, a reflection on the strength of the local economy and its highly productive and highly paid workforce. The figures shown in the table below were compiled by the LSE from a variety of official sources, and indicate a net 'contribution' by London of between £10 and £20 billion.

London's Contribution - £Billion	
Public Expenditure	**46 - 51**
Taxation	**62 – 67**
London's contribution	**10 – 21**

The authors accept that there is no definitive way of accurately measuring the allocation of taxation or public spending between any two regions. For example, the allocation of resources to a region does not necessarily mean the benefits will be enjoyed by its inhabitants. There are particular problems in the allocation of corporate taxation. Both taxation and spending numbers are therefore presented as a range. These estimates are seen by the authors as conservative and the GLA certainly believe that the actual figure is in excess of £20 billion.

The impact of a serious recession would be to reduce the imbalance somewhat as London's economy is likely to experience a more severe downturn than the rest of the UK. If London's GDP were to fall by a cumulative 5.5 per cent, as it did between 1990 and 1992, and the relationship between taxation and economic activity was similar to that of the UK as a whole, the London tax take would decline by around £3 billion. Increased public spending, mainly on additional social security payments, would rise by £4 to £5 billion. This would reduce London's net contribution by £7 to £8 billion, though other regions would also be affected at the same time.

Other current publications on offer by GLA Economics:

- **Planning for London's Growth:** The statistical basis for the London Plan.
- **Creativity: London's Core Business:** Key figures on the sector where 525,000 Londoners work.

*Future publications will provide in-depth coverage of tourism, housing and retail.

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GLA Economics

This publication is produced by GLA Economics, which was established in May 2002 by the Mayor of London to provide a firm statistical, factual and forecasting basis for policy decision-making by the GLA and its functional bodies. London's Economy Today is published on the GLA website on the third Tuesday in every month. It seeks to provide an overview of the current state of the London economy, publishing a changing selection of the most relevant and up-to-date data available. It will track cyclical economic conditions to ensure that they are not moving outside the parameters of the underlying assumptions of the GLA and central government.

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