

London's Economy Today



Issue 54 | February 2007

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Brisk expansion in London's financial services sector

by Christopher Lewis, Senior Economist, GLA Economics

London is one of a handful of world cities and competes on a global stage with the likes of New York, Tokyo and Paris. To maintain and enhance its position requires infrastructural investment, such as on the capital's transport network. Crossrail will play a key part in increasing accessibility to jobs and ensuring London's attractiveness as a business location is enhanced. This month's supplement, by GLA Economics' Consultant Chief Economist Bridget Rosewell and Kathryn Grant, Economist, will look at the important issues surrounding Crossrail.

London has come second in an annual international survey that measures the strength of a city's brand ahead of Paris, Rome and New York. However, the capital did fall from the top spot, which is now held by Sydney, in the latest Anholt City Brands Index. London was ranked as having the greatest future potential and was also placed highly in terms of public amenities, entertainment, finding work and doing business.

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● **Economics: from theory to reality – an event for A level students studying Economics**
GLA Economics will be holding an event for A level students on 26 March 2007 to discuss London's economy, the work of the unit and how our analysis influences policy. If you would like further information please email glaeconomics@london.gov.uk

London's financial services sector continues to perform strongly. The latest edition of International Financial Services London's (ISFL's) City Indicators Bulletin showed that on an annual trend 13 out of the 14 indicators rose between Q4 2005 and Q4 2006. Job vacancies were up by nearly a half over the year. Nine out of fourteen indicators were also higher in Q4 2006 compared with Q3 2006 with two unchanged. Growth in activity in the capital's financial markets is expected to continue well into 2007.

The capital's labour market remains healthy with the Bank of Scotland London Labour Market Report indicating that permanent job placements rose at their fastest pace for over two years in December. In January, the Purchasing Managers' Index (PMI) seasonally adjusted business activity and new orders indices for the capital picked up and were well above their UK levels. The rate of growth in London's new orders rose to its highest level since April 2006.

Retail sales weaken in the New Year after a buoyant Christmas

After robust Christmas retail sales there was a sharp fall in January when the seasonally adjusted volume of retail sales fell by 1.8 per cent, which was the largest monthly decline since January 2003. Despite a drop from an upwardly revised 4 per cent the annual growth rate was still a healthy 3.3 per cent. If December and January are taken together then the picture for retailers seems patchy rather than buoyant or desperately poor. The overall mixed picture hides two extremes with specialist internet retailers performing excellently whereas some High Street stores continue to struggle. With the likelihood of a further rise in interest rates this year, retail trading conditions could worsen.

There are now a few further signs that the housing market has started to slow slightly. Seasonally adjusted mortgage approvals eased in December to their lowest since April 2006. With interest rates on the rise, Council of Mortgage Lenders' (CML) figures on property repossessions reached their highest level last year since 2000 and are expected to increase further in 2007. In January, seasonally adjusted UK house prices, as measured by the Nationwide and Halifax rose by 0.3 per cent and 1.3 per cent respectively. The Nationwide recorded annual house price inflation of 9.3 per cent in January, a fall from 10.5 per cent in December, whereas the Halifax measure shows that house price inflation stabilised at below 10 per cent (in the three months to January house prices were 9.9 per cent higher than a year earlier). Housing demand seems to be weakening as stretched affordability and higher interest rates begin to bite. However, housing supply remains low, which is supporting prices along with an improving labour market. The labour market is tightening slightly with employment rising, unemployment falling and job vacancies increasing.

Eurozone growth strengthens

The eurozone economy grew strongly at the end of last year. For the whole of 2006, growth was 2.7 per cent compared to 1.4 per cent in 2005. The European Commission has now raised its forecast for growth in 2007 to 2.4 per cent from 2.1 per cent and has urged European governments to make use of this to pursue sound public finances and structural reform. With growth prospects firm, the European Central Bank is expected to increase interest rates to 3.75 per cent in March.

The US economy remains reasonably strong due to the service sector. The Dow Jones hit further all time highs in February and the University of Michigan consumer sentiment index reached its highest level since 2004 in January. However, manufacturing activity remains weak and fell slightly in January according to the Institute for Supply Management (ISM) index. The Federal Reserve expects the economy to expand at a moderate pace this year. So far the slow down in the US economy has been gentler than expected.

Firmer consumer spending helped Japan's economy to pick up pace at the end of 2006. Industrial production also increased by a better than expected 0.7 per cent in December and has now risen for three consecutive months. With Japan's economic recovery continuing, the Bank of Japan increased interest rates from 0.25 per cent to 0.5 per cent on the 21 February. However, with inflation still around zero, Japanese interest rates are only expected to rise gradually over the next couple of years. Meanwhile, India's economy continues to boom. India's Government expects the fastest growth rate in 18 years of 9.2 per cent for the current financial year ending in March and the stock market has hit another all time high during February.

Robust world equity markets but global imbalances remain

Global equity markets have risen further at the beginning of this year. In mid-February the FTSE 100 hit its highest level since autumn 2000 reaching 6444.4 at the close of trading on 19 February (see Figure 1). The Nikkei has also risen to highs last seen in 2000 and the Dow Jones has hit all-time highs. Alongside robust stock markets the world economy remains solid but risks remain due to global imbalances. China's trade surplus continues to grow reaching nearly \$180bn in 2006 an increase of around 75 per cent from 2005. The Chinese trade surplus hit \$15.9bn in January and G7 finance ministers have renewed pressure on China to speed-up their efforts to make the yuan more flexible, and therefore stronger, on world currency markets. At the end of the G7 meeting on 11 February the communiqué highlighted the issue of global imbalances by saying 'In emerging economies with large and growing current account surpluses, especially China, it is desirable that their effective exchange rates move so that necessary adjustments occur.' The concern is that global imbalances continue to worsen and that rather than a gradual correction the required adjustment becomes further delayed and when it does occur is disorderly and threatens economic stability.

Figure 1: FTSE 100

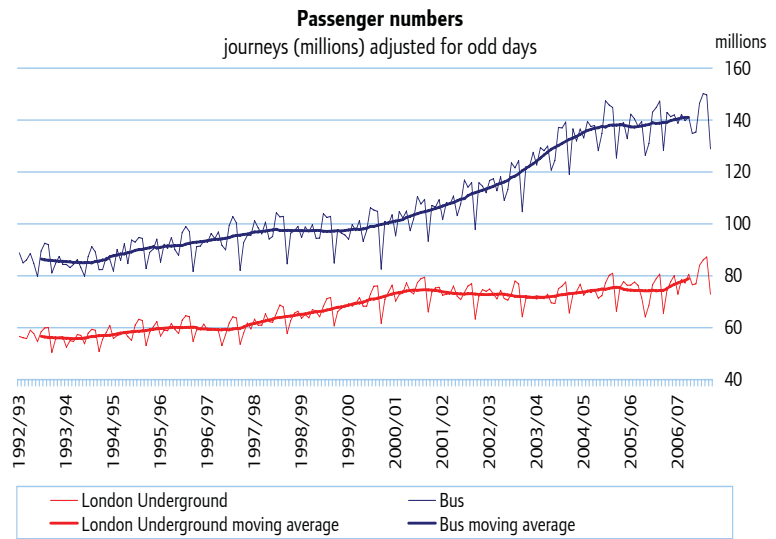
Source: FT.com



Moving average of passenger numbers steadily increases

- The most recent 28-day period is from 10 December 2006 to 6 January 2007. London's public transport had 201.8 million passenger journeys; 128.9 million by bus and 72.9 million by Underground.
- The moving average increased to 219.9 million from 219.3 million passengers every period.
- The moving average for buses was an unchanged 141.0 million. The moving average for the Underground was 78.9 million.

Latest release: February 2007
Next release: March 2007

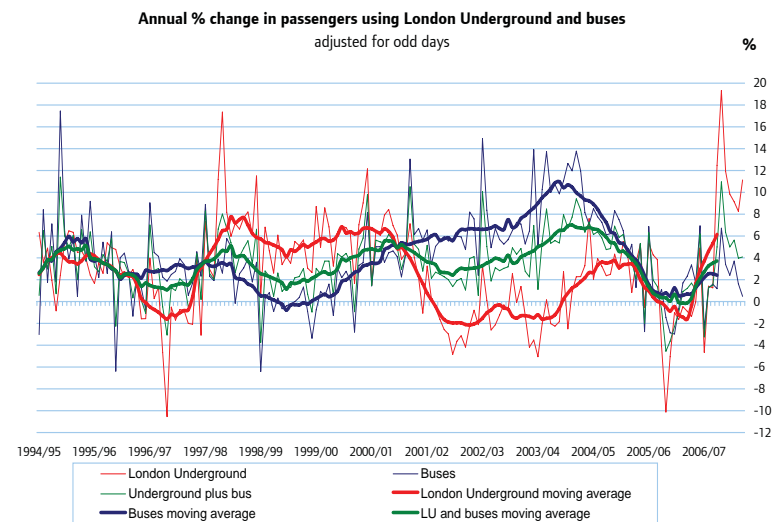


Source: Transport for London

Annual growth rate of passenger journeys continues to rise

- The moving average annual rate of growth in passenger journeys increased to 3.7% from 3.5% in the previous period.
- The moving average annual rate of growth in bus journey numbers decreased to 2.4% from 2.5% in the previous period.
- The moving average annual rate of growth in Underground passenger journey numbers increased to 6.1% from a downwardly revised 5.3% in the previous period.

Latest release: February 2007
Next release: March 2007

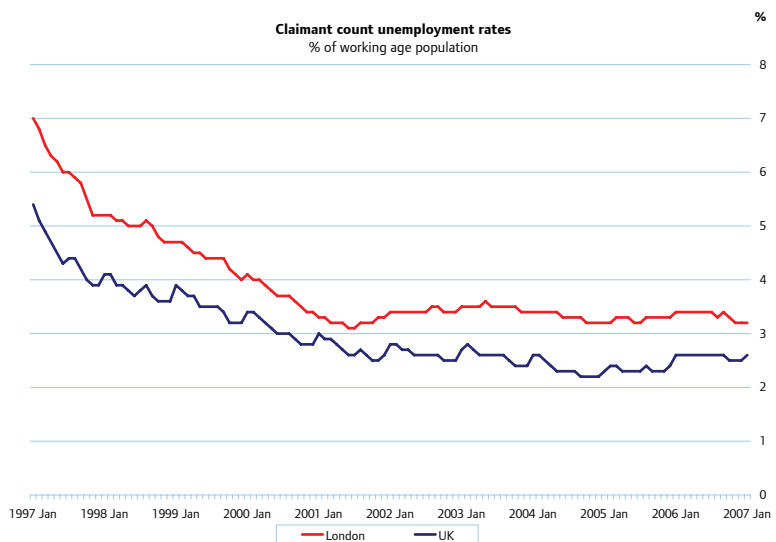


Source: Transport for London

Claimant count unemployment

- The rate of claimant count unemployment (the percentage of resident working age population who are unemployed and claiming Jobseeker's Allowance) in London was 3.2% in January 2007.
- There were 159,800 unemployment claimants in London in January 2007 compared with 169,000 in January 2006.
- The claimant count unemployment rate in the UK remains below that of London's.

Latest release: February 2007
Next release: March 2007



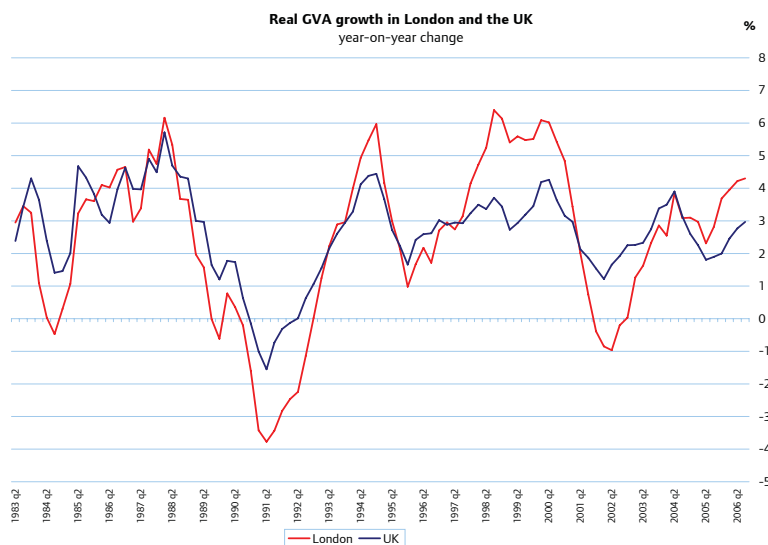
Source: Claimant Count, NOMIS

London's annual growth still quicker than the UK's

- London's annual growth in output increased to 4.3% in Q3 2006 from a revised 4.2% in Q2.
- The UK's annual growth in output was 3.0% in Q3 2006, up from a revised 2.8% in Q2. London has been growing at a faster annual rate than the UK since Q4 2004.
- There have been revisions to previous growth rates to reflect the availability of new data.

Latest release: February 2007

Next release: May 2007



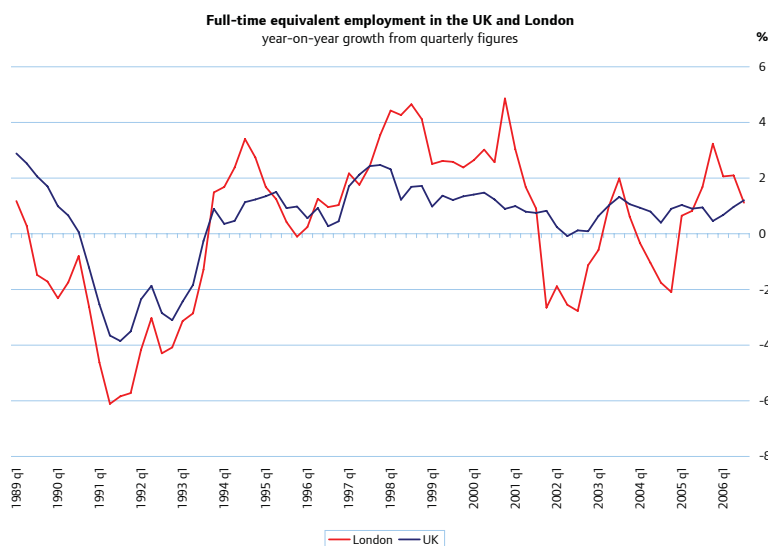
Source: Experian Business Strategies

Similar rates of annual employment growth in London and the UK

- London's annual employment growth was 1.1% in Q3 2006 a decrease from 2.1% in Q2.
- Annual employment growth in the UK increased to 1.2% in Q3 2006 from upwardly revised annual employment growth of 1.0% in Q2.
- There have been revisions to previous growth rates to reflect the availability of new data.

Latest release: February 2007

Next release: May 2007



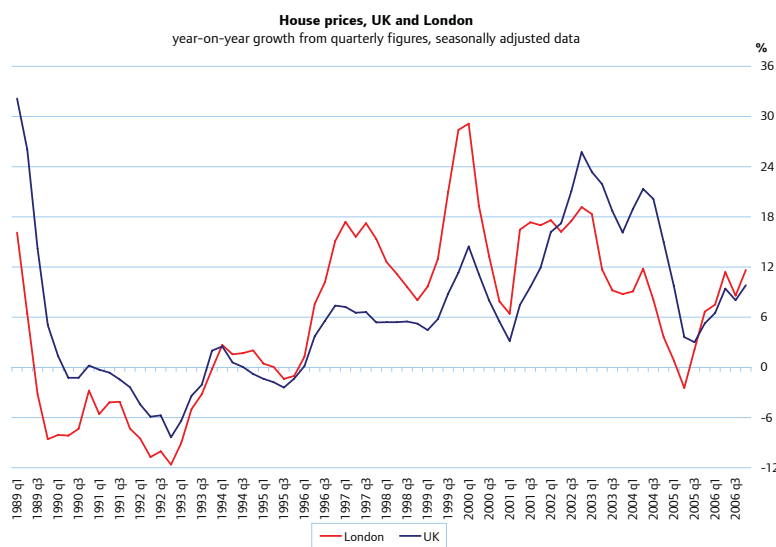
Source: Experian Business Strategies

Increase in annual house price inflation in London and the UK

- Annual house price inflation, as measured by the Halifax Bank of Scotland, increased in Q4 2006 in both London and the UK.
- Annual house price inflation in London increased to 11.7% in Q4 2006 from 8.6% in Q3. Annual house price inflation in the UK increased to 9.8% in Q4 2006 from 8.0% in Q3.
- Annual house price inflation was higher in London than in the UK for the fifth consecutive quarter.

Latest release: January 2007

Next release: April 2007



Source: HBoS

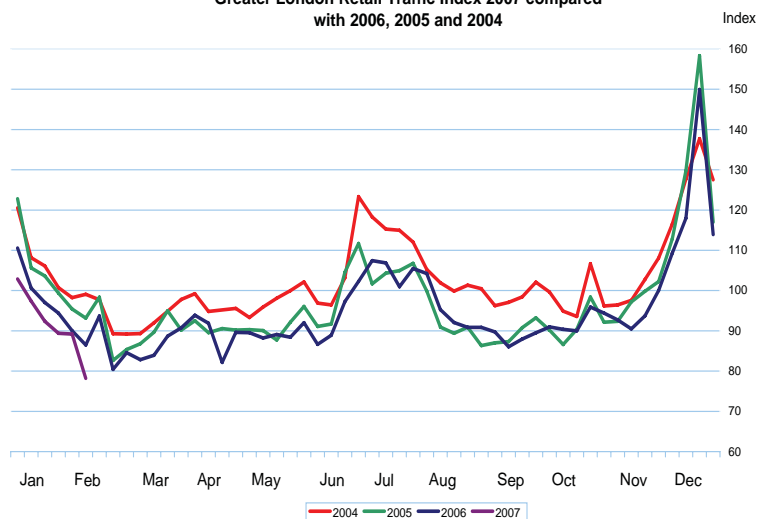
SPSL Retail Traffic Index below 2006 levels at the beginning of 2007

- The SPSL Retail Traffic Index of shoppers in London was 78.2 in the first week of February compared to 89.2 in the previous week.
- Since the beginning of 2007, the level of the index has been lower than the same period in 2006.
- SPSL's Retail Traffic Index measures the number of shoppers and does not necessarily reflect the level of spending.

Latest release: Mid-February

Next release: every week

Greater London Retail Traffic Index 2007 compared with 2006, 2005 and 2004



Source: SPSL

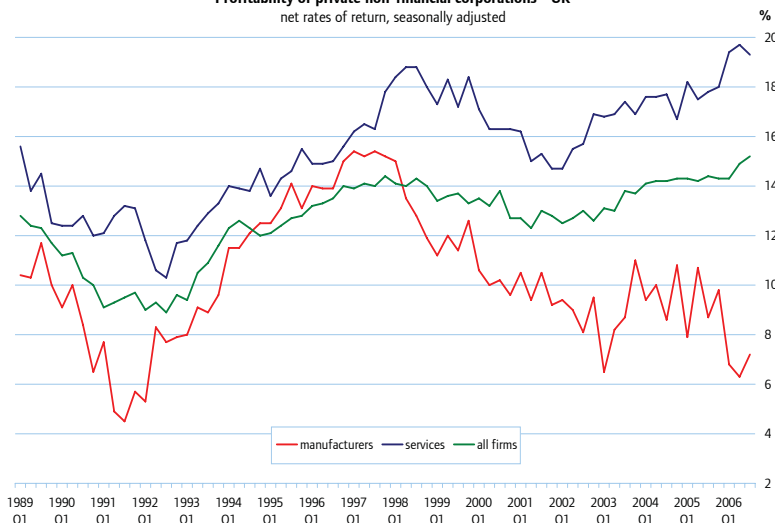
Overall UK corporate profitability increases

- The net rate of return for all private non-financial corporations increased to 15.2% in Q3 2006 from an upwardly revised 14.9% in Q2 2006.
- The manufacturing sector experienced increased profitability in Q3 2006. The net rate of return was 7.2%, up from an upwardly revised 6.3% in the previous quarter.
- The service sector's net rate of return decreased to 19.3% in Q3 2006, from a downwardly revised 19.7% in the previous quarter.

Latest release: January 2007

Next release: April 2007

Profitability of private non-financial corporations - UK
net rates of return, seasonally adjusted



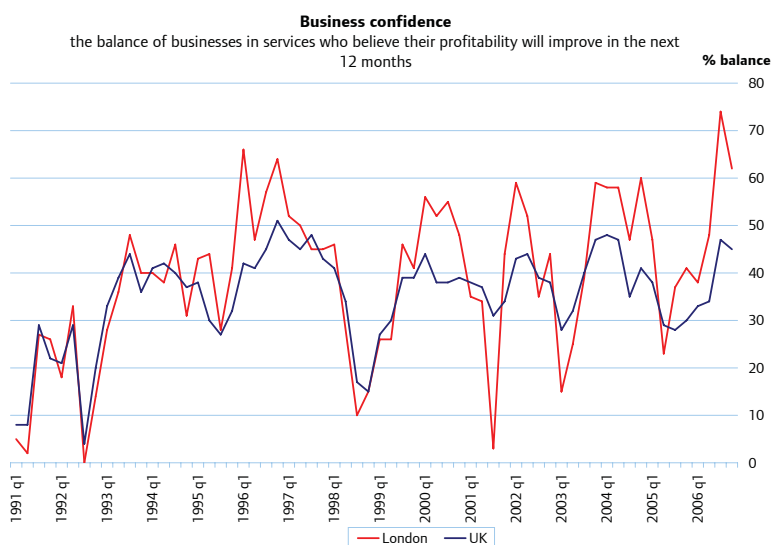
Source: Office for National Statistics

Expectations of profitability higher in London than for the UK

- The British Chamber of Commerce's January Quarterly Economic Survey (QES) shows that London's service sector firms expect their profitability to improve.
- The net balance of businesses in services in London expecting to increase profitability over the next 12 months was 62% in Q4 2006.
- The net balance of UK businesses in services expecting increased profitability over the next 12 months was 45% in Q4 2006.

Latest release: January 2007

Next release: April 2007

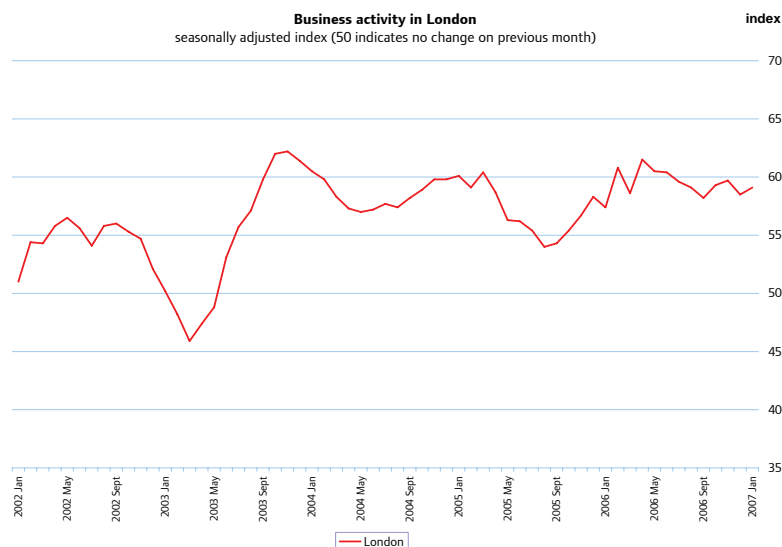


Source: British Chamber of Commerce, Quarterly Economic Survey

London's business activity remains strong

- London firms continued to expand their output of goods and services in January 2007.
- The Purchasing Managers' Index (PMI) of business activity recorded 59.1 in January compared to 58.5 in December.
- 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.

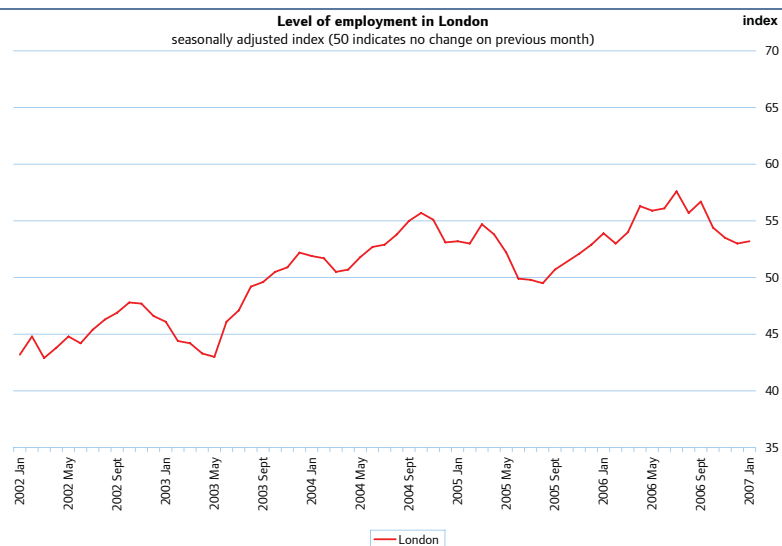
Latest release: February 2007
Next release: March 2007



Steady employment growth in London

- London firms continued to increase their level of employment in January 2007.
- The PMI for the level of employment was 53.2 in January compared to 53.0 in December.
- A rate of above 50 on the index indicates an increase in the level of employment from the previous month.

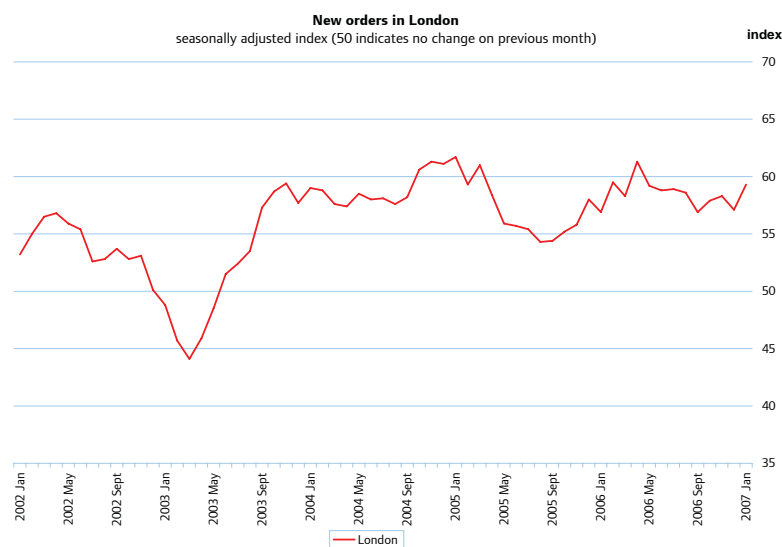
Latest release: February 2007
Next release: March 2007



New orders in London increasing strongly

- January 2007 saw continued growth in new orders for London firms.
- The PMI for new orders recorded 59.3 in January compared to 57.1 in December.
- A rate above 50 on the index indicates an increase in new orders from the previous month.

Latest release: February 2007
Next release: March 2007

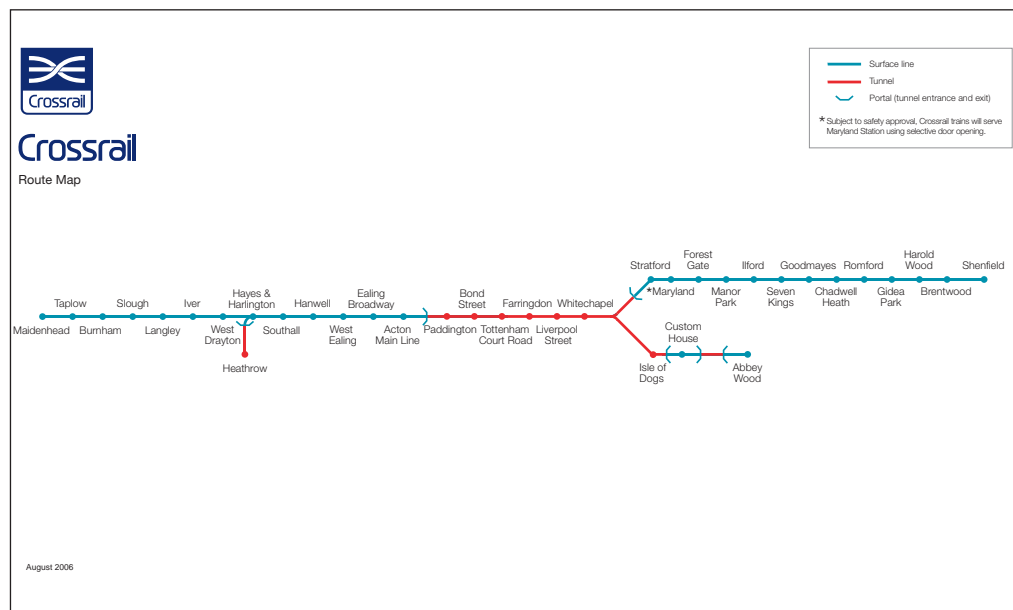


Crossrail: Where is it going?

Bridget Rosewell,
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Kathryn Grant,
Economist

Crossrail is an East-West rail link which will transform public transport in, around and through the UK's capital. It has been variously mooted over many decades, but the current project has now reached the Hybrid Bill stage in Parliament. 2007 should see the Bill become an Act and is a key date for deciding on funding for the scheme. Figure 2 shows the proposed Crossrail route.

Figure 2: Proposed Crossrail route



Building such a large new piece of infrastructure in the centre of London requires clear justification and analysis. As time has gone on, the case for Crossrail has only strengthened. The shortcomings of London's transport system are now so evident that support for Crossrail has been building from all corners – business owners, local and national politicians, the general public, academics, trade unions, business organisations and transport workers.

Furthermore, delaying the start of construction is not costless. Each year Crossrail is delayed will cost the London and UK economies dearly.

In this supplement, we restate the economic case for Crossrail (acknowledging that there is also a very strong regeneration case for increasing accessibility into the outer regions of London) and outline ways of thinking about the potential costs of delaying the project further.

Crossrail will relieve many transport and economic bottlenecks in London. It will provide a first-class transport service to thousands of business, commuting and leisure users. It will also create potential for increasing growth in high productivity areas, and relieves congestion and cost in accessing these areas. It provides new access routes to the East where housing development is possible. It supports the UK's world class position in business and financial services and ensures that international businesses continue to want to come here to work, trade and invest.

The economic case for Crossrail

Up until recently, transport project appraisals were conducted on the basis that any direct user benefits (through reduced travel times, increased reliability and so on) would eventually feed through into economic benefits for the country as a whole. However, this vastly underestimates the economic benefits of a project like Crossrail. Here, the user benefits are huge – time savings alone (such as the 50% reduction in travel time from Heathrow to Canary Wharf) create massive benefits. But Crossrail’s business case also hinges on agglomeration and productivity benefits.

The economy of Central London occupies a unique position not just in the economy of the UK, but throughout the entire European Union. The average value of output per worker in Inner London¹ is estimated at £54,200 compared to £39,500 across the UK. No other area of comparable size in the EU has an output per head as high. Moreover, this itself underestimates productivity in the core central business area: estimates of output per worker in the three core boroughs of Westminster, the City of London and Tower Hamlets are even higher. Enabling more people to work in this high productivity area generates benefits labelled ‘move to more productive jobs’ in Table 1. Table 1 shows a range of estimates of the benefits of Crossrail based on the guidance provided by the Department for Transport and earlier Crossrail estimates. These are currently being updated and will be published soon.

Table 1: Output benefits of Crossrail

Benefit	Value (£ billion present value)
Business trips time savings	5
Increase in labour force participation	1
Move to more productive jobs	11
‘Pure’ agglomeration benefits	3-11
Imperfect competition	1
Total	20-30

There are several important features of the Central London economy which contributes to this high productivity: these include its areas of specialisation as well as its scale, scope and density.

Specialisation

Over the last three or four decades, the decline of London’s traditional manufacturing and port employment (most notably along the East-Thames corridor) has in turn been replaced by an intensification of central area activity – predominantly office based.

The special nature of financial and business services (FBS) sector jobs (and perhaps creative industries jobs) and the importance of this agglomeration to the wheels of the UK economy means that more and more people now rely on commuting into the centre of London to work.

Supporting London's FBS sector is crucial to the future success of the UK economy: the FBS sector enjoys a historical position of advantage in Central London, which cannot now be replicated elsewhere (increasing returns to scale and clustering means that companies would have to make a collective decision to relocate elsewhere in the UK: individual firms are as or more likely to relocate to Paris, Frankfurt or New York than to Leeds, Manchester or Edinburgh).

Scale, scope and density

The concentration of high-value-added activities such as FBS and the creative industries helps to explain London's high productivity levels. But there is a second reason why output per head in Central London is so high, which is quite distinct from the particular mix of economic activity. It arises from the very high concentration of employment which exists in Central London.

This idea that concentration matters to economic activity was identified by early economists and geographers but has only relatively recently re-emerged into modern analysis, where it has been labelled the 'agglomeration effect'. Output per worker across all industries is observed to be greater, the higher is the density of employment². The effect of this can be estimated on the basis of a number of different models and the range is estimated as the agglomeration effect in Table 1.

The potential sources of the agglomeration effect have been described as early as the 1890s. In London, these could include:

- Access to a large, specialised labour force
- More competing and complementary businesses and institutions
- Availability of intermediate goods (specialised inputs and services)
- Access to a large, specialised client base
- Potential for informal contacts and knowledge sharing (technology spillover).

Agglomeration benefits thus provide businesses with incentives to co-locate. However, the benefits extend far beyond the individual firms themselves: externalities exist in the sense that when one more firm joins the cluster, the existing firms also experience productivity gains – and the output of the whole increases by more than just the output of the marginal firm.

The estimates of the benefits to output of Crossrail are based on the difference between productivity in Central London and in Outer London. They do not assume that the capacity of Crossrail is entirely associated with additional activity, but only a proportion of its passengers would otherwise work elsewhere. These are all conservative assumptions. History has generally shown that the entire transport system refills over a fairly short period, and it is likely that output in Central London is underestimated. Moreover, no allowance is made for the risk (in the event of Crossrail not going ahead) that activity may be relocated out of London altogether. This would give rise to an even greater loss to the UK economy – especially as with many London activities any relocation is more likely to be to Frankfurt or New York than it is to Leeds or Edinburgh.

In summary,

- Crossrail is the best solution to three substantial and interlocking issues: significant congestion in London, support for the high value sectors of London's economy, and support for future development in East London and the Thames Gateway
- Crossrail delivers substantial net present value of between £20-30 billion
- The exchequer contribution from enhanced GDP is £8-12 billion, releasing revenue benefits that will more than repay any debt incurred in the up-front investment
- No other option has yet been found that matches these benefits.

The costs of delay

As we have explored, one of Crossrail's main purposes is to enable growth within the key employment clusters of Central London. The economic gain to the UK from enabling that growth has been quantified and valued within the appraisal of agglomeration benefits.

The costs of delay can be broadly grouped into four categories:

- Loss of agglomeration benefits
- Loss of user benefits
- Impact on scheme costs
- Planning and transport blight.

The loss of benefits in each of these categories can be quantified and will be released soon. Here we examine the main elements in each case and their likely scale.

Loss of agglomeration benefits

The agglomeration benefits are clearly very important to the case for Crossrail, but there is also a potentially significant difference between them and the transport user benefits. That difference concerns whether these benefits are simply delayed or whether they are permanently lost.

If there is a one-off opportunity to capture that employment growth then the loss would not be a temporary loss over one or five years but a permanent one. That would significantly increase the cost of delay. Moreover, if the loss of confidence in London as the result of delay deters investment it could dent London's prospects in a fundamental way.

Loss of user benefits

Each year that Crossrail is delayed results in a further year of slower and more congested journeys for public transport users in London than would otherwise be the case. Congestion relief is provided to most underground lines; reductions in interchange movements relieve station congestion; extra capacity provided at new stations serves to relieve some of the worst crowded stations on the system; and additional platform capacity is provided at Liverpool Street and Paddington.

The value of the lost benefits is available directly from the transport economic appraisal and is very significant (although it is of course offset by not having to

pay for the capital, operating and maintenance costs of Crossrail). It should be noted that in general, transport appraisals show benefits increasing over time as congestion becomes more significant and the cost of time rises. The Crossrail appraisal is no exception to this rule.

Impact on scheme costs

Every one year delay to scheme implementation increases the scheme costs in real terms due to expected price inflation within the construction sector at a faster rate than in the economy as a whole. In addition, changes over time in the relevant design standards and legislation further raise the cost.

Additionally, the current cost to the Government of borrowing via long dated government bonds is at low levels by historic standards. Research by Morgan Stanley has suggested that the level of real interest rates on long dated UK government bonds is now close to 300 year lows. Thus now is the time to undertake worthwhile long-term public investments such as Crossrail when the Government can take advantage of the very low cost of borrowing that is unlikely to persist. Delaying Crossrail risks backfiring on the Government as the costs it ends up paying to finance such a major project may increase substantially with higher real interest rates in the future.

Planning blight

The safeguarding of the Crossrail route, essential if the scheme is to be implemented, is not cost-free. It imposes constraints on developments along the route as a whole which have to make adjustments to their design to accommodate the future implementation of Crossrail, but in general those adjustments are relatively cheap to make and do not unduly delay developments.

In the case of the sites which will be used as Crossrail worksites, the situation is different. Here developments cannot take place until after Crossrail has been implemented (or after the government has said that Crossrail will definitely not happen). There are a number of sites affected, including Bond Street and Tottenham Court Road worksites.

Transport blight

It is not just development schemes that are affected by delays to the implementation of Crossrail. There are also a number of transport projects that would benefit from a rapid decision.

Conclusions

Delay is not a cost-free option, and this supplement has summarised a number of different analyses to this effect.

Delay means:

- Project costs increase;
- User and wider economic benefits are lost;
- Potential developments or improvements are delayed; and
- Planning and transport decisions are not optimal.

Some of these costs are unambiguous losses which cannot be recouped. This is clearly the case with construction costs, planning blight and transport blight. Losses of user benefits can potentially be recouped in the future – the value of these depends on the treatment of future notional benefits against nearer term ones. Losses of agglomeration benefits have features of each of these. It is not at all clear that losses can simply be moved into the future. Not only may losses not be recouped but there could be potential negative feedback as well.

All the reports which have investigated London's global competitiveness have concluded that an ailing public transport system is likely to be a brake on London's future growth. Historical evidence from the rise and decline of cities, and recent employment changes from increased US regulation, reminds us that change does occur, and that current dominance is no guarantee of future success. Missed employment opportunities may be lost forever, and not simply delayed until the opening of Crossrail.

Footnotes

1 At Nomenclature of Units for Territorial Statistics 2 (NUTS2) Inner London level, 2004: based on regional Gross Value Added (workplace based) and workplace based employee analysis from the ABI.

2 See GLA Economics (2006), 'Why distance doesn't die: agglomeration and its benefits', Working Paper 17, June 2006.

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

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About GLA Economics

GLA Economics provides expert advice and analysis on London's economy and the economic issues facing the capital. Data and analysis from GLA Economics provide a sound basis for the policy and investment decisions facing the Mayor of London and the GLA group. The unit was set up in May 2002.

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