GLAECONOMICS

London's Economic Outlook: Autumn 2007

The GLA's medium-term planning projections

Transport for London

LONDON DEVELOPMENT AGENCY

MAYOR OF LONDON

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GLA Economics provides expert advice and analysis on London's economy and the economic issues facing the capital. Data and analysis from GLA Economics form a basis for the policy and investment decisions facing the Mayor of London and the GLA group. The unit is funded by the Greater London Authority, Transport for London and the London Development Agency.

Contents

1. Executive summary

The Greater London Authority's (GLA) current central forecast[i] for London, suggests that:

- London's Gross Value Added (GVA) should grow at 3.3 per cent in 2007, reducing to growth of 2.0 per cent in 2008, before increasing to 2.6 per cent in 2009.

- London is likely to see above trend growth in employment in 2007 of 1.2 per cent, followed by slightly slower employment growth in 2008 and 2009.

- London household spending will probably grow more slowly than GVA until 2009. Household spending is forecast to grow more slowly than household income throughout the forecast period.

- There is a risk of worse performance than the forecast resulting from the credit crunch, though equally it could be shaken off through global economic strength.

Table 1.1 summarises this report's forecasts and provides an average of independent forecasts.

Table 1.1: Summary of forecasts

Annual growth rates (per cent)	**2006**	**2007**	**2008**	**2009**
London GVA (constant 2003 £ billion)	3.8	3.3	2.0	2.6
Consensus (average of independent forecasts)		3.5	2.9	3.3
London civilian workforce jobs	2.0	1.2	0.9	1.0
Consensus (average of independent forecasts)		1.3	0.9	1.2
London household spending (constant 2003 £ billion)	2.7	2.3	1.7	3.0
Consensus (average of independent forecasts)		3.0	2.4	3.0
London household income (constant 2003 £ billion)	1.6	3.0	2.4	3.1
Memo: Projected UK RPIX[ii] (Inflation rate)	2.9	3.2	2.7	2.6
Projected UK CPI[iii] (Inflation rate)	2.3	2.4	2.0	2.0

Source: GLA Economics' Autumn 2007 forecast and consensus calculated by GLA Economics.

2. Introduction

The autumn 2007 edition of *London's Economic Outlook* (LEO) is GLA Economics' eleventh London forecast. The forecasts are issued every six months to assist those preparing planning projections for London in the medium term. The report contains the following:

- An overview of recent economic conditions in London, the UK and the world economies with analysis of important events, trends and risks to short and medium-term growth (Section 3).

- The 'consensus forecast' – a review of independent forecasts indicating the range of views about London's economy and the possible upside and downside risk (Section 4). In this document, 'consensus forecast' refers to the average of the four independent forecasters listed under Section 2.1.

- The GLA Economics forecast for output, employment, household expenditure and household income in London (Section 5).

- An in-depth assessment of a topic of particular importance (Section 6). This issue features a supplement on skills.

2.1 Note on the forecast

Any economic forecast is what the forecaster views as the economy's most likely future path and as such is inherently uncertain. Both model and data uncertainty as well as unpredictable events contribute to the potential for forecast error. GLA Economics' forecast is based on an in-house model built by Volterra Consulting Limited. GLA Economics' review of independent forecasts provides an overview of the range of alternative opinions. Independent forecasts are supplied to the GLA for the main macroeconomic variables by the following organisations:

- Cambridge Econometrics (CE)
- The Centre for Economic and Business Research (CEBR)
- Experian Business Strategies (EBS)
- Oxford Economics (OE)

Only the most likely outcomes, which the different forecasting organisations provide, are recorded. Each forecaster may also prepare scenarios they consider less likely but these are not shown here. The low and high forecasts combine the lowest and highest forecasts respectively taken from each year separately and which, may therefore, come from different forecasters. High and low estimates therefore may not represent the view of any one forecaster over the whole of the forecast period.

Economic forecasting is not a precise science. These projections provide an indication of what is most *likely* to happen, not what will *definitely* happen.

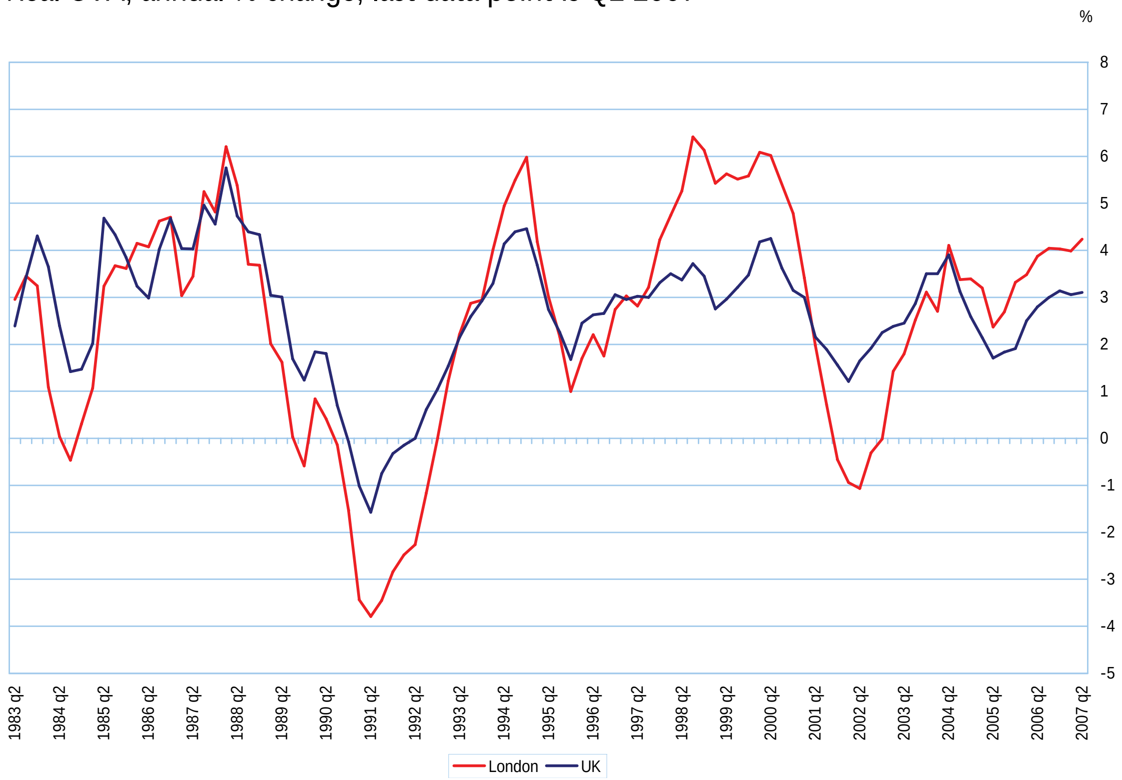
3. Economic background: World growth remains strong despite weakness in US

This section provides an overview of recent developments in the London, UK and world economies.

3.1 The London economy

London's economy continues to outperform the UK in terms of annual GVA growth. Annual output in London grew at 4.2 per cent in quarter two of 2007, slightly up on the previous quarter. Annual output in the UK as a whole grew at 3.1 per cent in quarter two. Annual economic growth has been positive in London since 2002 and stronger than the UK as a whole since the second quarter of 2004.

Figure 3.1: Output growth – London and UK
Real GVA, annual % change, last data point is Q2 2007

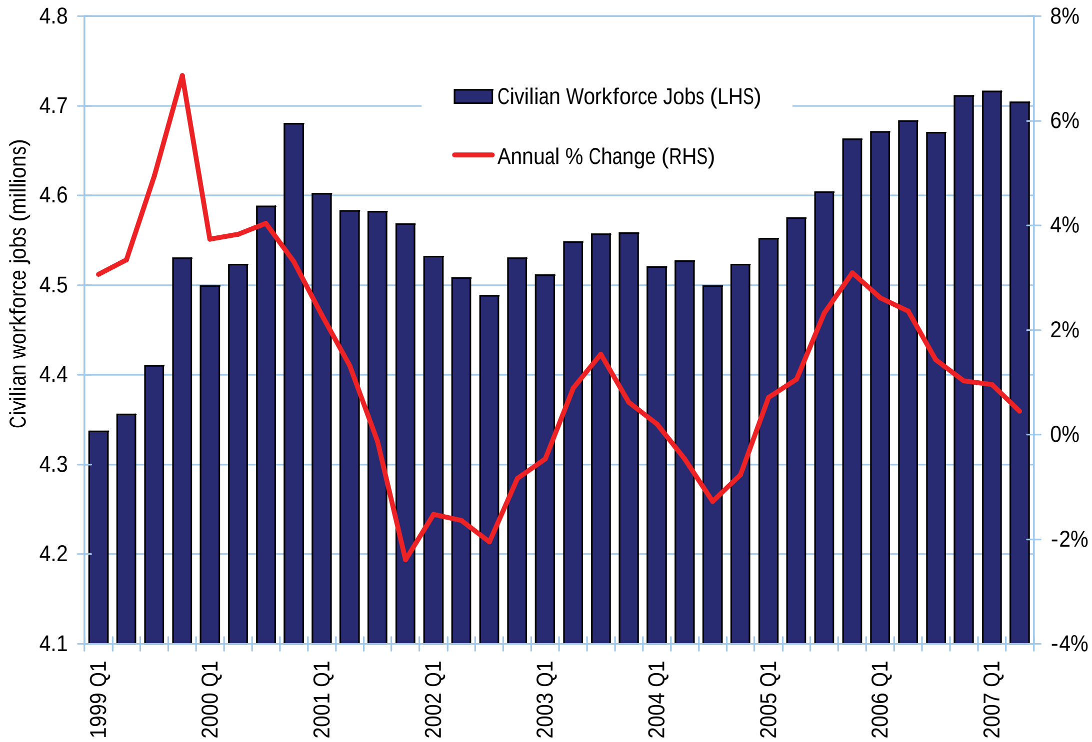


Source: Experian Business Strategies

Despite very high levels of recruitment in the City, annual employment growth in London is slowing. Nonetheless, there has been continued year-on-year employment growth since quarter one 2005. The total number of workforce jobs in London was over 4.7 million in quarter two 2007 (see Figure 3.2).

Figure 3.2: London civilian workforce jobs

Level and annual % change, last data point is Q2 2007

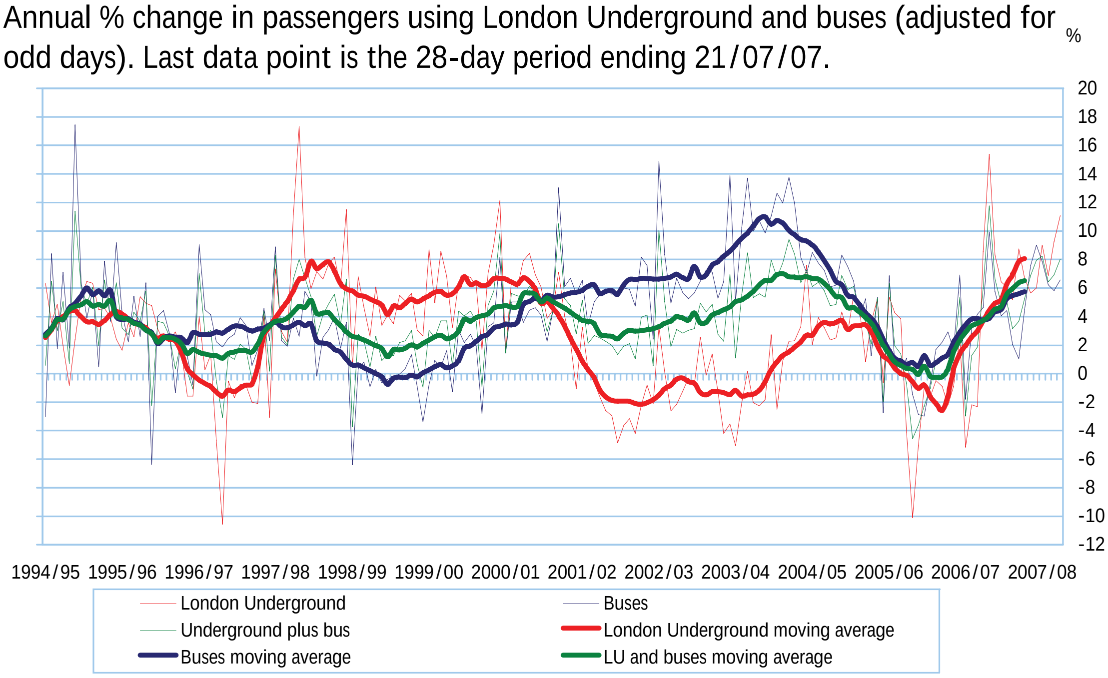


Source: Office for National Statistics

Public transport usage is a useful and timely indicator of economic activity in London. Figure 3.3 shows there has been particularly strong annual growth in underground usage this year.

Figure 3.3: London public transport usage

Annual % change in passengers using London Underground and buses (adjusted for odd days). Last data point is the 28-day period ending 21/07/07.

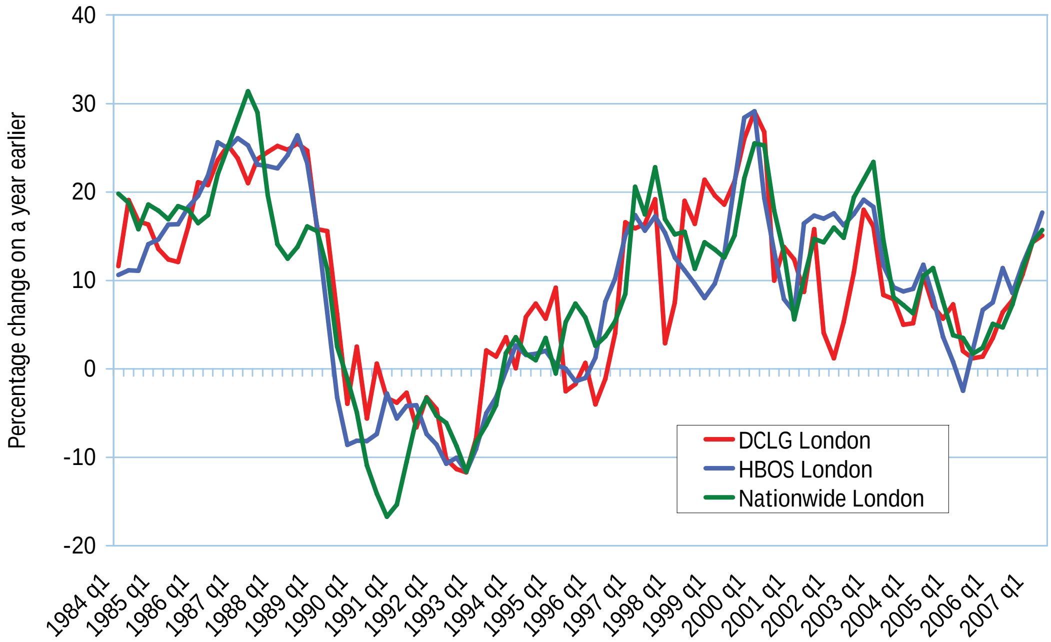


Source: Transport for London

House price inflation in London has continued on a strong upward path which began in the second half of 2005 following a slow down in 2004. City bonuses, which increased by 30 per cent to a record £14 billion this year,[iv] has been one factor helping to push up London house price inflation. Annual house price inflation in London stood at around 15 per cent in the second quarter of 2007 (see Figure 3.4) and remains above that in the rest of the UK. Indeed UK house price inflation is beginning to slow on most measures.

Figure 3.4: House price inflation in London

Last data point is Q2 2007

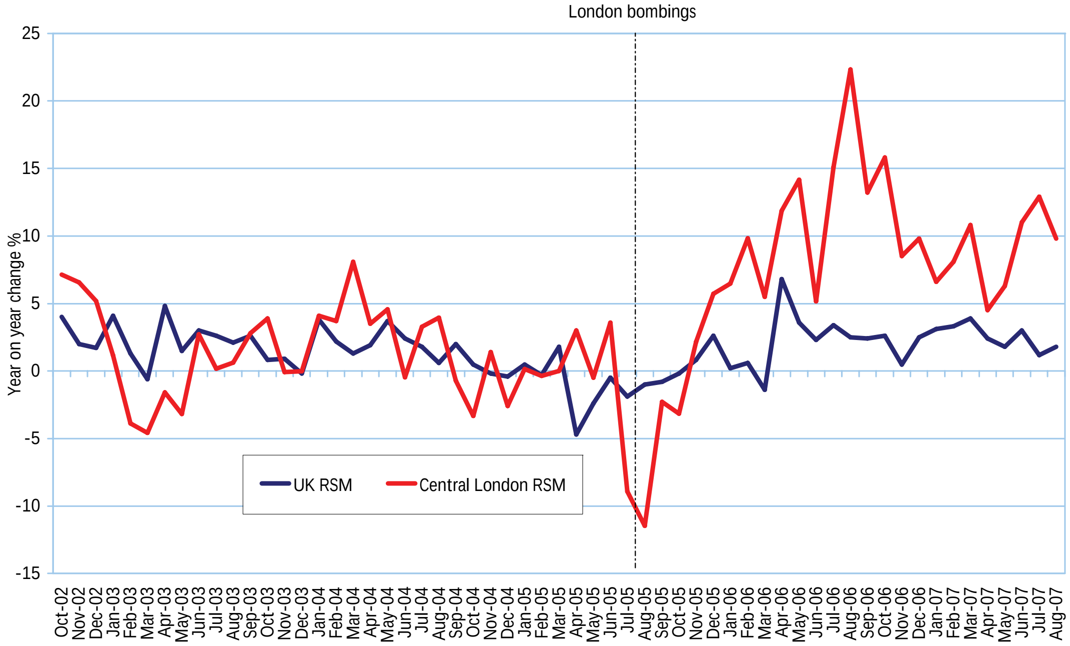


Source: DCLG, Halifax Bank of Scotland, Nationwide

Similarly London's commercial property market has performed well so far this year with commercial office rents in Central London rising at their fastest rate for seven years according to agents Knight Frank.[v] This was due in part to the strength of London's financial sector in the first half of 2007. Going forward there are some concerns that the recent turmoil in financial markets could derail this trend.

The retail sector in Central London has continued to perform well. Retail sales in Central London as monitored by the London Retail Consortium (Figure 3.5) show strong year-on-year growth since December 2005. Annual retail sales growth in the UK remains below that of Central London.

Figure 3.5: Retail sales growth – Central London and the UK
Annual % change, last data point is August 2007



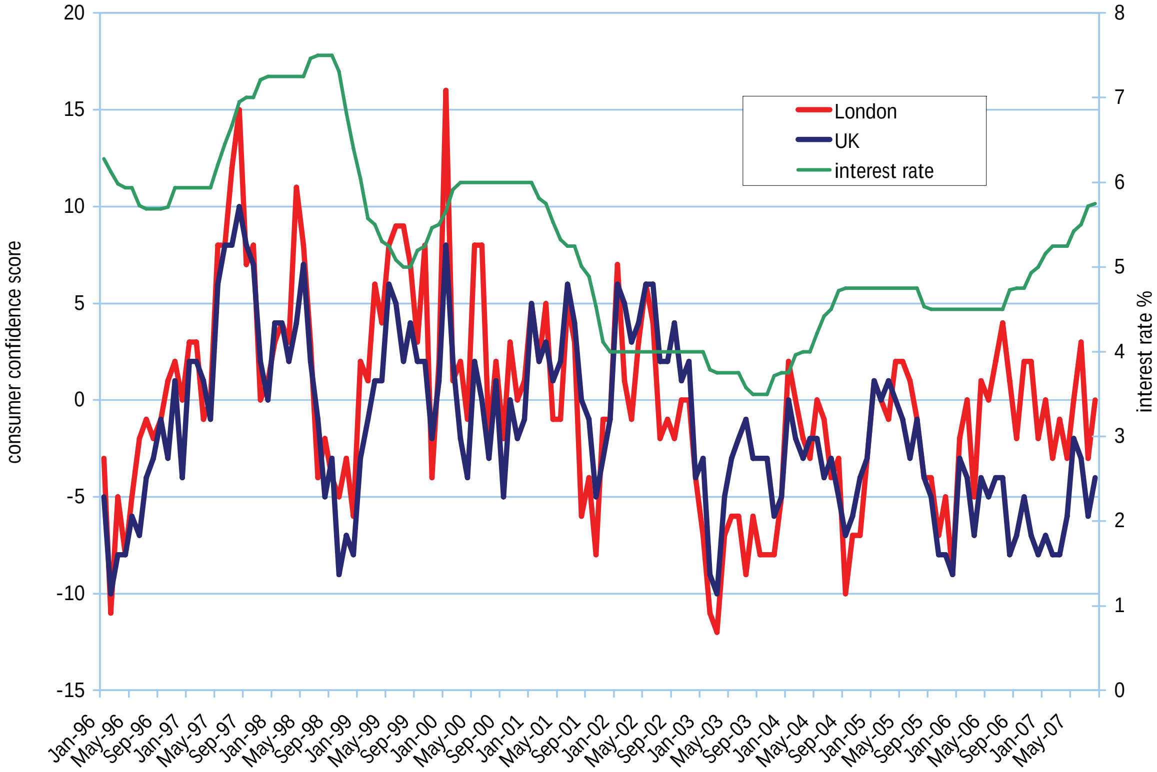
Source: UK Retail Sales Monitor – BRC/KPMG, Central London Retail Sales Monitor – London Retail Consortium

Visitors to London, as measured by Visit London's London Visitor Index, fell in July following a slow down in the rate of growth in June. Indeed the rate of growth has been on a downward trend since August 2006. The recent fall is partly due to a decline in North American visitors (possibly put off by the weak dollar).

GfK NOP's regional consumer confidence index (see Figure 3.6) shows that consumer confidence remains higher in London than the UK as a whole. So far higher UK interest rates have not caused a dramatic fall in London consumer confidence, though confidence is below its recent peak in summer 2006. The index reflects people's views on their financial position and the general economic situation over the past year and their expectations for the next 12 months.

Figure 3.6: GfK NOP's regional consumer confidence index with UK interest rate

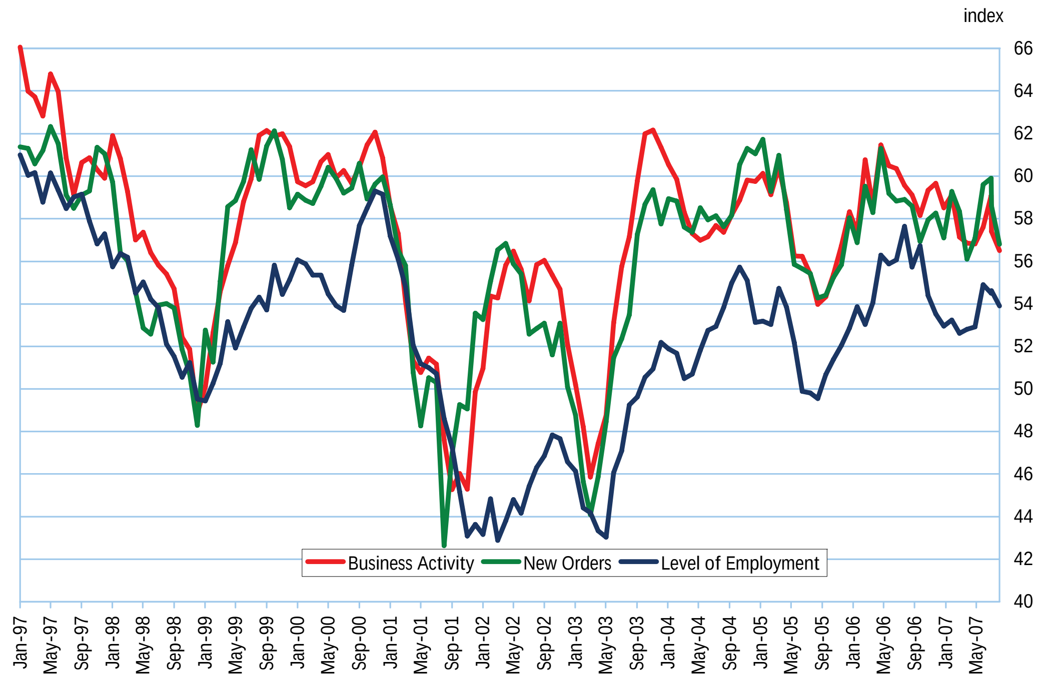
Last data point is August 2007



Source: GfK NOP on behalf of the European Commission, EcoWin

Business survey results indicate that the rate of London's expansion remains strong. Figure 3.7 shows that PMI's surveys of seasonally adjusted business activity, new orders and the level of employment all remain well above 50, which indicates growth.

Figure 3.7: Recent survey evidence on London's economic climate
Purchasing Manager's Index (PMI) survey, last data point is August 2007
Seasonally adjusted index (above 50 indicates increase, below 50 indicates decrease)



Source: The Royal Bank of Scotland/NTC Economics

3.2 The UK economy

UK Gross Domestic Product (GDP) rose by an estimated 0.8 per cent in the second quarter of 2007. The annual growth rate in the second quarter of 2007 remained constant at an above trend 3.1 per cent. This growth has been driven by the service sector, which in the second quarter grew at an annual rate of 3.7 per cent.

Table 3.1: HM Treasury and consensus forecasts for the UK economy
Annual % change, unless otherwise indicated

	Average of Independent Forecasters		Pre-Budget Report October 2007	
	2007	2008	2007	2008
GDP growth (per cent)	2.8	2.2	2¾-3¼	2-2½
Inflation rate (Q4: per cent)				
CPI	2.0	2.1	2	2
RPI	3.6	2.7	-	-
Claimant unemployment (Q4: mn)	0.91	0.93	-	-
Current account (£bn)	-46.0	-47.7	-41	-41
PSNB (2007-08, 2008-09: £bn)	33.4	32.1	38.0	36.0

Note: CPI = Consumer Price Index, RPI = Retail Price Index, mn = million, bn = billion

Source: HM Treasury Comparison of Independent Forecasts, September 2007

HM Treasury 2007, Pre-Budget Report and Comprehensive Spending Review, October 2007

Most forecasters tend to be predicting weaker growth in 2008 than 2007 as the effects of higher interest rates and the slowdown in the US begin to feed through. The Bank of England expects growth in the economy to moderate over the medium term, moving closer to its long term average, reflecting a slowing in both consumer spending and business investment.[vi]

As can be seen in Table 3.2 annual growth in business services and finance was buoyant in the first half of 2007.

Table 3.2: Recent growth in broad industrial sectors of UK economy
Annual % change

	2006				2007	
Industrial sectors	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**
Agriculture, forestry, and fishing	4.2%	3.0%	2.7%	1.3%	2.1%	1.8%
Mining & quarrying inc oil & gas extraction	-6.9%	-10.9%	-7.2%	-7.8%	-6.7%	-1.3%
Manufacturing	-0.2%	1.2%	1.8%	2.7%	1.0%	1.1%
Electricity gas and water supply	0.8%	-3.5%	-3.1%	-4.2%	-3.3%	-1.1%
Construction	0.0%	-0.3%	1.9%	3.1%	2.7%	3.5%
Distribution hotels and catering	2.7%	3.9%	3.6%	3.8%	3.9%	3.4%
Transport, storage and communication	2.8%	4.4%	4.3%	4.2%	6.2%	5.4%
Business services and finance	5.2%	5.4%	5.5%	5.1%	4.9%	5.1%
Government and other services	2.2%	1.8%	1.5%	1.8%	1.9%	1.6%

Source: Office for National Statistics

Table 3.3 shows that there was a pick-up in annual household spending growth in the first half of 2007 compared with 2006. Investment spending grew very strongly in 2006, although the annual growth rate fell back somewhat in quarter 2, 2007.

Table 3.3: UK domestic expenditure growth
Annual % change

	2006				2007	
Expenditure	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**
Households	0.9%	2.3%	2.0%	2.6%	3.2%	2.7%
Non-profit institutions	5.0%	6.4%	6.7%	6.1%	3.7%	3.5%
General Government	3.3%	1.6%	1.7%	1.9%	1.2%	2.0%
Gross fixed capital formation	6.2%	8.0%	8.1%	10.3%	9.0%	6.2%

Source: Office for National Statistics

Annual consumer price index (CPI) inflation has fallen back from its peak of 3.1 per cent in March 2007, to 1.8 per cent in August. In July 2007 CPI annual inflation fell below the Government's 2 per cent target for the first time since March 2006. Benign average earnings growth, and a strong pound against the dollar have both contributed to the fall in inflation.

The Bank of England acknowledges that there is 'greater-than usual ' uncertainty about the outlook for inflation, with the balance of risks on the upside over the next few years. Stronger than expected activity in Asia and the Eurozone pose an upside risk to inflation while a slowing of consumption and domestic demand particularly against a background of tightening credit conditions, pose downside risks.

Box 3.1 Sterling strong against a weak dollar

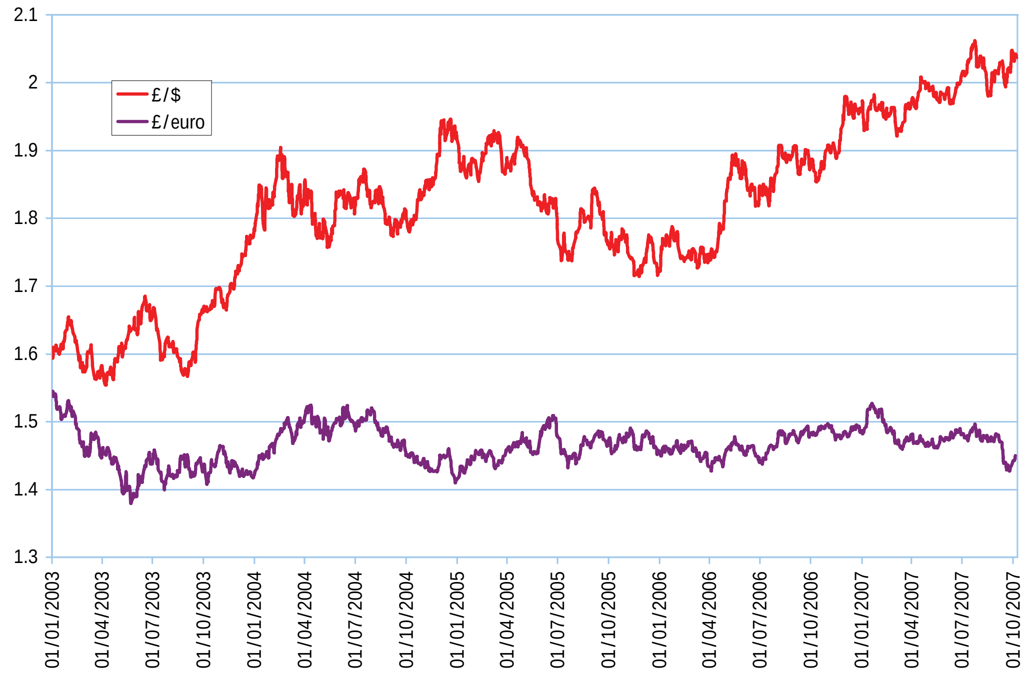
Figure 3.8 shows that the pound has strengthened against the dollar since 2001 and during 2007 has once again broken through the $2 mark.

Figure 3.8: US $ per £ exchange rate

Source: EcoWin

The strength of the pound against the dollar is more due to dollar weakness than an exceptionally strong pound (the dollar has also fallen to record lows against the euro). Monetary tightening in the UK and an expected slowing in the US economy are among the reasons for the pound to rise above the $2 mark. However, the pound has remained relatively stable against the euro (see Figure 3.9). While the recent rise against the dollar is clear, the pound has shown little change against the euro over the past few years. In fact in mid-September 2007 the pound slightly weakened against the euro to one and a half year lows.

Figure 3.9: Euro per £ and $ per £ exchange rates



Source: EcoWin

Figure 3.10 shows the Sterling Effective Exchange Rate Index (EERI)[vii] since January 2000. Overall sterling has strengthened since Spring 2006, but by a relatively modest 5 per cent. In fact sterling's EERI was above current levels during 2004. The story of the pound breaking through the $2 mark is more one of dollar weakness than of excessive strength of the pound.

(Jan 2005 = 100)

Figure 3.10: Sterling EERI

Source: Bank of England

Overall, the weakening dollar has had a beneficial impact on UK inflation. Oil, and many other commodities, are priced in dollars so rising oil dollar prices have less of an inflationary impact on the UK when the pound is strengthening against the dollar. However, an area of concern for the UK, and in particular London, is the export of financial and business services. One of London's main competitors in this sector is New York and a weak dollar allows US firms to gain a competitive edge over those based in the UK. Fewer US tourists may also visit London or those that do may well spend less due to the weak dollar.

UK official base interest rates have risen twice since the Spring edition of LEO from 5.25 to 5.75 per cent. Monetary tightening since summer 2006 is expected to start impacting on consumption and there are some indications that this is beginning to happen. Figures from the CBI based on a survey carried out between the last week in July and first week in August, show that over the past three months sales across the leisure, personal care and travel sectors fell.[viii]

It is helpful to look back to the recent past to see how quickly higher base rates have affected consumer spending. November 2003 to August 2004 and September 1999 to February 2000 were both periods of rising base rates. On both these occasions growth in consumption clearly slowed in the third quarter following the first rate rise. However, past experience is not always a good guide to what will happen in the present or the future and one reason why consumption may have been slower to react to the current period of rising base rates is the lower pass-through to the retail interest rates that households face. For example, many more people in recent years have opted for fixed-rate mortgages.

Box 3.2: Interest rates faced by debtors and savers compared to the base rate

Interest rates are a perennial source of economic punditry and media speculation. In the current inflation-targeting environment much stock is placed on MPC members' 'dovish' versus 'hawkish' tendencies. In Box 3.2 we examine how UK households may react to interest rate movements.

Household indebtedness and household wealth have both risen dramatically over the last 15 years, but aggregate household data cannot tell us how this is spread across the population. Recent NMG Research (an annual survey commissioned by the Bank of England) shows that around 15 per cent of households report having only secured (mortgage) debt. Around 20 per cent report having only unsecured debt (for example, credit cards, overdrafts or personal loans) and around 20 per cent report having both secured and unsecured debt (see Table 3.4).

Table 3.4: Percentage of households with secured and unsecured debt

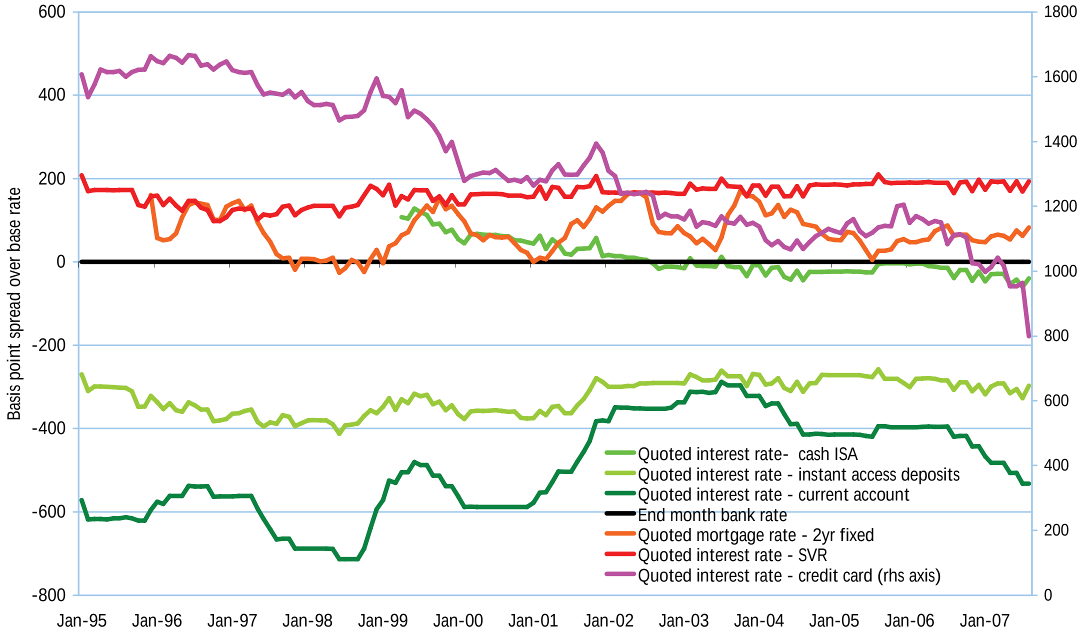
	BHPS 1995	BHPS 2000	NMG 2004	NMG 2005	NMG 2006
None	46	45	42	43	43
Unsecured only	15	15	23	20	22
Secured only	19	18	13	16	14
Both	21	21	22	21	21

Source: British Household Panel Survey (BHPS), NMG Research and Bank of England

Savers and debtors face different interest rates, and are affected by monetary policy actions in different ways. Figure 3.11 shows *quoted* household interest rates, in relation to the Bank of England's base rate.[ix] The following general observations can be made:

- Quoted rates on credit cards have, on average, become more attractive relative to the base rate – most likely due to increasing competition.
- The quoted Standard Variable Rate (SVR) for mortgages (the rate paid on existing mortgages not enjoying a fixed or discounted period) has been set at a relatively constant spread over the base rate.
- Quoted interest rates paid to current account holders are low compared to the base rate. They tend to be fairly unresponsive to changes in the base rate.

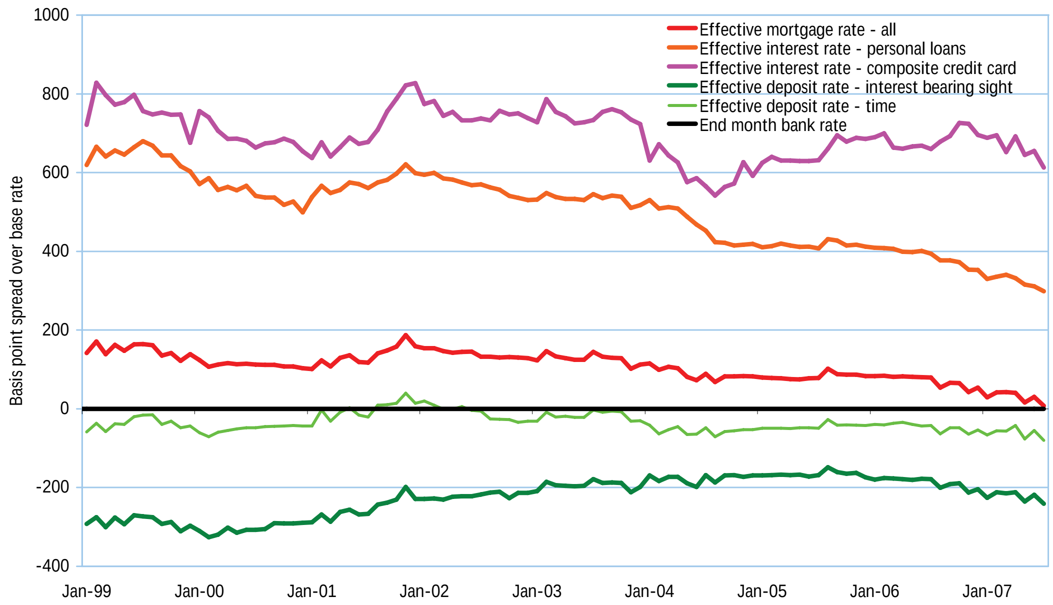
Figure 3.11: Quoted household interest rates: spread over base rate



Source: Bank of England

Quoted interest rates tell only a partial story. They do not tell us what interest rates are paid (earned) across the entire stock of borrowing (deposits). The Bank of England also collects information on banks' aggregate balance sheets – which it uses to construct 'effective' interest rates (the average rate paid, for example, on the entire stock of fixed rate mortgage balances).

Figure 3.12: Effective household interest rates: spread over base rate



Source: Bank of England

Figure 3.12 shows how these effective interest rates have been moving in relation to the Bank's base rate. The following observations can be made:

- The effective rate on all credit card balances has been broadly stable, and is somewhat lower than the quoted rate (due, in part, to introductory discounts such as time-limited offers on balance transfers).
- The effective rate on personal loans and mortgages has, however, been falling steadily relative to the base rate. For mortgages, this is because mortgage 'churn' is growing – more and more of the stock of mortgage balances is enjoying a period of fixed or discounted mortgage rates.
- Effective time deposit rates have been very stable relative to the base rate. Sight deposit rates have slightly improved their interest rates in relation to the base rate over the last seven years.

Figures 3.11 and 3.12 confirm that interest rates faced by households, whether as borrowers or savers, do not necessarily respond exactly to policy rate changes. This could 'muddy the waters' of monetary policy transmission and could perhaps lead to larger and more frequent increases in policy rates than would otherwise have been necessary.

The Bank of England base rate has increased by one and a quarter percentage points since summer 2006. Assuming that the stock and composition of debt does not change, the effect on consumption itself will depend on the relative numbers of savers and borrowers in the economy. Extrapolating the data in Table 3.4 to the UK population, we can assume that households are fairly well balanced, with 45 per cent net savers and 55 per cent net borrowers. And of the net borrowers, around 60-70 per cent also have housing assets. The Bank of England has been keen to un-pick the complex relationships at work here. In Benito et al (2007) the effect of a 1 percentage point rise in real interest rates, in both a relatively low-debt (1995) and high-debt (2005) environment, is explored. An over-lapping generations (OLG) model is used, calibrated to both BHPS and NMG data. They find that, in both cases, consumption falls in the first instance (reflecting income and substitution channels, and possible indirect channels, such as house prices). The decline varies according to the levels of debt in the economy. In a high debt economy, consumption declines (relative to base case) by around 2 per cent; in a lower-debt economy, consumption declines by around 1.6 per cent.

Conclusions

Since inflation targeting began in the UK, and especially since the creation of the independent Monetary Policy Committee, monetary conditions have been relatively benign and stable. The policy rate has varied in a range of around four percentage points. Together with a buoyant economy and booming housing market, this has created a sense of real economic prosperity. But, as MPC member Tim Besley emphasised in a recent speech, credit conditions are a constraining influence on a significant number of households.[x] In addition, as interest rates reach their highest level for six years, those households reaching the end of their discounted or fixed rate mortgage periods will face higher housing costs. Together with the growing stock of debt in the UK economy, these conditions may squeeze household expenditure. In addition the recent credit crunch (see Box 3.3) could cause a significant increase in the spread for quoted and effective household interest rates over the Bank of England's base rate. This will further dampen consumption growth at the current Bank of England base rate. Any large negative shock to household income or to the housing market could lead to an even bigger (and more worrying) fall in consumption growth.

3.3 The world economy

The world economy is in its fifth year of robust growth and in July the IMF revised up its April forecast for global growth in 2007 and 2008. The IMF forecasts growth of 5.2 per cent for 2007 and 2008, an upward revision of 0.3 per cent for both years.

The IMF's forecast allows for the slowing of growth in the US (revised down by 0.2 per cent to 2.0 per cent), but includes major upward revisions for emerging markets and developing countries such as India, China and Russia. In the IMF's next set of forecasts to be published shortly, overall global growth is expected to be revised slightly downwards from its current robust pace.

In the global context, a slowing of growth in the US has so far been moderated by above trend growth in the eurozone, as well as by continued rapid expansion in China, India and Russia. However, the risks to world inflation have risen. Inflationary pressures are increasing in a number of emerging economies, not helped by rising energy and food prices.

As shown in Figure 3.13, oil prices have remained high in 2007 and are around record nominal highs. Moreover, there is increasing uncertainty about their future path.

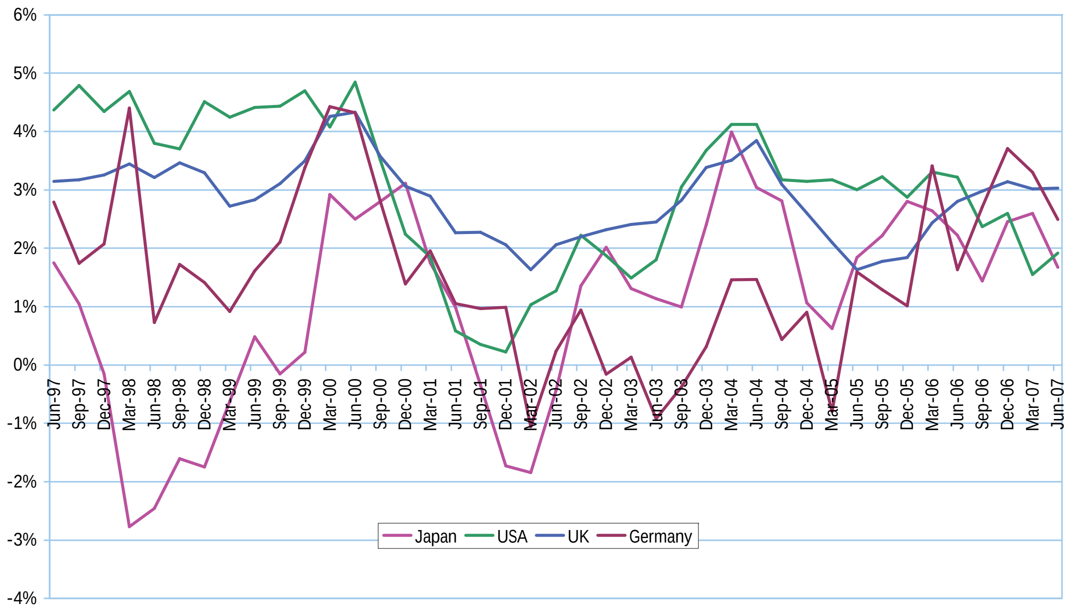
Figure 3.13: Brent crude oil price ($ per barrel)

Source: FT.com

The **US** economy performed better in quarter two 2007 than in the first quarter, although consumer spending slowed and the housing market remained weak. However, business investment, government spending and rising exports all boosted economic activity. The Federal Reserve has revised down its forecast for annual growth in 2007. Interest rates were cut by 0.5 per cent to 4.75 per cent on 18 September. In the near future with regard to further interest rate cuts the Fed faces a difficult balancing act between stubbornly high oil prices and a weaker dollar, creating inflationary pressure, and a struggling housing market and weaker growth. In August the Federal Reserve had already cut its primary discount rate (the rate at which it lends money to banks) in an effort to ease liquidity problems facing many banks following the slump in the sub-prime mortgage market.

Growth in the **eurozone** remains above trend and inflation has stayed below 2 per cent. Nonetheless, after a pause, interest rates are likely to remain on an upward trend, given the above trend growth, rising capacity utilisation, and continuing high oil price.

Figure 3.14: GDP growth in selected industrialised countries
Real GDP, annual % change



Source: Ecowin

Japan's economic growth fell by 0.3 per cent in the second quarter of 2007 following a strong first quarter. Nonetheless the IMF has forecast Japan's growth to be 2.6 per cent in 2007 before moderating to 2.2 per cent in 2008. With fears over recent global stock market turbulence further increases in interest rates look likely to be delayed.

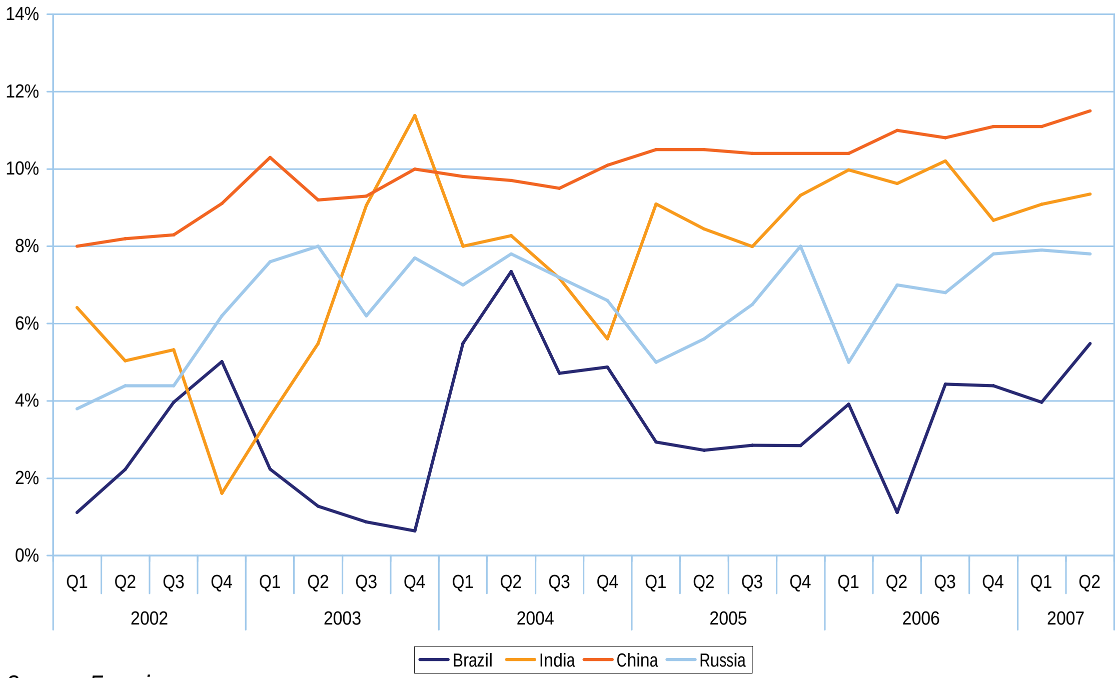
3.4 Emerging market economies

China's economic expansion continues to outstrip expectations, having grown by 11.9 per cent on a year-on-year basis in the second quarter of 2007. This rapid growth continues despite government efforts to put the brakes on the economy. One consequence of such rapid growth is rising inflation. Annual consumer price inflation hit 6.5 per cent in August , the fastest pace in over a decade.[xi] The Chinese stock market has been one of the best performing in the world in the last 12 months. China's trade surplus was $24 billion in September close to its record high in June.[xii]

India's economy shows no signs of moderating having grown by 9.3 per cent year-on-year in the second quarter of 2007[xiii], up from annual growth of 9.1 per cent in quarter one. The Indian central bank expects growth of 8.5 per cent for the whole of 2007. The IMF forecast for growth in India was also revised up in July to 9.0 per cent in 2007 and 8.4 per cent in 2008. India is the world's second fastest growing major economy after China.

India is experiencing particularly strong growth in the manufacturing and services sectors as the middle classes grow and gain spending power. However, as in China, inflation is a problem and further monetary tightening is anticipated.

Figure 3.15: GDP growth in selected emerging market economies
Annual % change



Source: Ecowin

Rapid expansion in the emerging economies is impacting on global money supply. **Russia**'s money supply has grown by over 50 per cent in the last year, while in India and China money supply has grown by around 20 per cent.[xiv] The build up of potentially excessive inflationary pressures in these emerging economies is a risk to the world economy.

3.5 Risks to the world economy

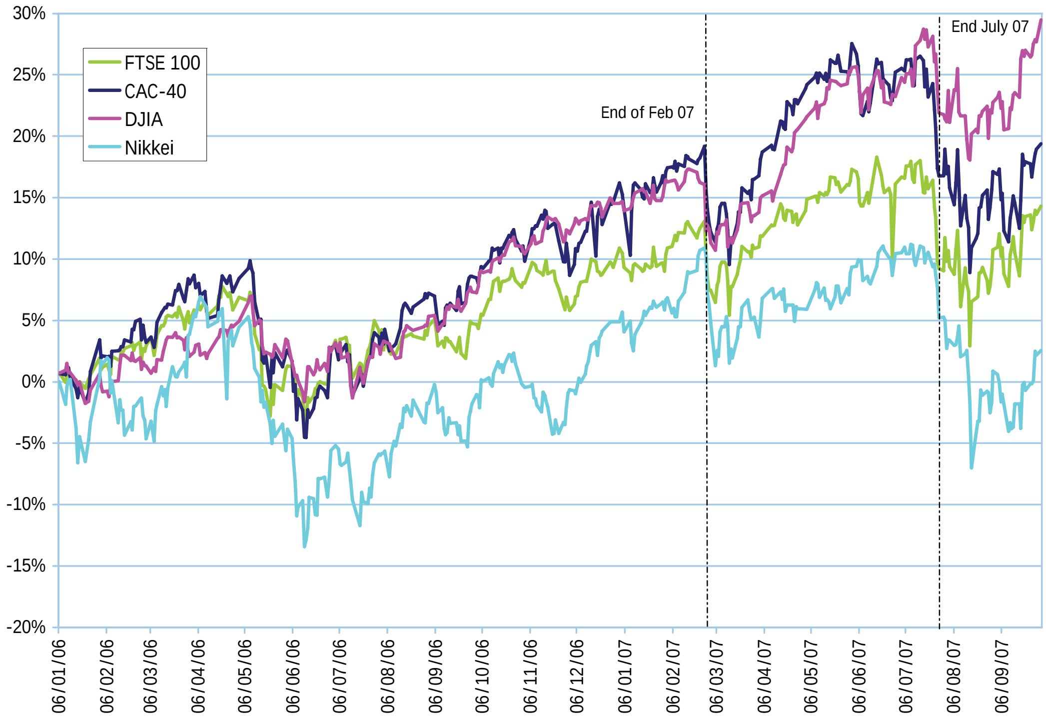
There are both upside and downside risks to the outlook for the global economy. Overall the downside risks are currently far greater but the background to these risks is still one of robust world growth. In the Spring 2007 LEO, US sub-prime mortgage lending and the potential knock-on effect to US growth was highlighted as a downside risk. This has begun to unfold over recent months and the full extent of its impact on the US, and indeed the global economy, is still difficult to predict.

Ongoing turbulence in financial markets with some financial institutions facing severe liquidity problems could cause a significant slowing of growth in the US and potentially across the world. However, for now China and India are still growing extremely rapidly.

Box 3.3: The recent credit crunch

Recent turbulence in global stock markets (see Figure 3.16), has led to speculation as to whether the credit cycle is finally turning. The 'credit crunch' is having a disturbing impact upon financial markets and institutions with potential negative impacts upon the real economy.

Figure 3.16: Global stock markets (% change since January 2006)



Source: Financial Times

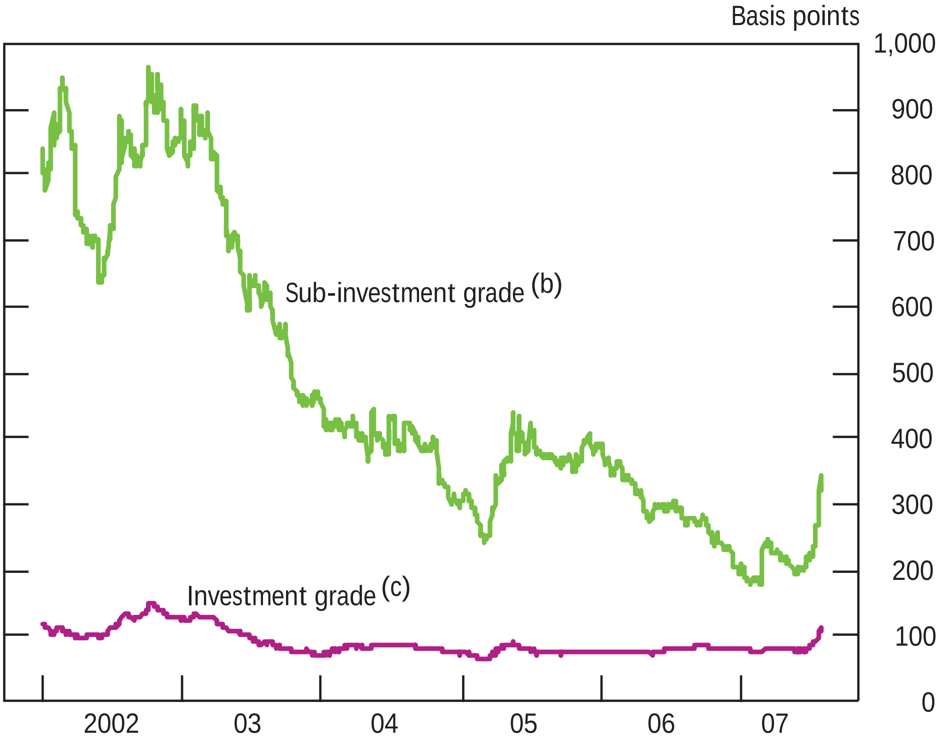
The term 'credit crunch' appears to have first been coined in 1966 when the US Federal Reserve tightened monetary policy. It refers to a sudden reduction in the availability of loan and other types of credit from banks and capital markets at given interest rates. Put another way, it is when the supply of credit is restricted below the range usually identified with prevailing market interest rates and the profitability of projects. In practice this means some borrowers cannot get loans at all. A reduced availability of credit can result from many factors, including an increased perception of risk on the part of lenders, an imposition of credit controls, or a sharp restriction of the money supply.

What has been happening?

Investors (including banks), having been bruised by their losses in the US sub-prime mortgage market, are less keen to purchase risky (or even non-risky) loans from other banks. Some initial estimates of the credit losses associated with the US sub-prime mortgage market are between \$50bn - \$100bn.[xv] Financing packages for some takeovers have been postponed and this in turn prompted share prices to fall.

In the UK the first signs of a tightening of credit conditions began in June through a surge in credit spreads, that is the premium that riskier borrowers must pay over government debts as shown in Figure 3.17 below.

Figure 3.17: Sterling-denominated corporate bond spreads[a]



(a) option-adjusted spreads over government bonds.
(b) Aggregate index of bonds with a composite rating lower than BBB3.
(c) Aggregate index of bonds with a composite rating of BBB3 or higher.

Source: Bank of England

The background over recent years has been of benign financial markets linked to strong world growth and high corporate profitability around the globe. Combined with this the world economy has seen a prolonged period of historically low interest rates. Plentiful sources of liquidity have helped to create an enthusiasm for high yield high risk products and this may have led to a mis-pricing of risky assets. The market share of corporate debt in the lowest rated entities has risen significantly.

Rises in share prices over the last couple of years has to some extent been driven by a boom in mergers and acquisitions. Private equity groups have pushed up the value of the firms they are targeting. Often these deals are financed with borrowed money and the banks that have loaned this cash have been laying off a large proportion of the loans by selling them on to other investors.

With high profits and buoyant economic conditions default rates had been low. However default rates have picked up in the US sub-prime mortgage market and although these account for a relatively small proportion of overall mortgage lending outstanding, there has been a fear of this spreading, which has had an effect on the perception of risk worldwide.

A further factor is that a number of hedge funds have been wiped out by the problems in the US sub-prime mortgage market and some banks are admitting that bad debt problems are now spreading to conventional loans. The losses are dispersed widely throughout the global economy to the extent that it is not yet clear where exactly all the losses lie. This has sparked a nervousness among investors.

The question is whether the current tightening of liquidity will lead to a deeper financial crisis or whether the peak of problems in the UK was the Bank of England acting as lender of last resort (LOLR) to Northern Rock and the run on that bank that followed.

Northern Rock's business model relies, to a far greater extent than many other banks, on borrowing from the wholesale money market to fund its mortgage business (rather than funding through deposits), effectively using short term lending to lend long. Hence the reduction in the availability of credit in the wholesale market that began earlier in the summer created problems for Northern Rock. Takeover offers of Northern Rock emerged but fell through which then meant that Northern Rock was forced to go to the Bank of England to use the Bank's facility as LOLR. Judging that Northern Rock was solvent, the Bank of England agreed to lend to Northern Rock. However, the announcement that Northern Rock had used the Bank of England's LOLR facility led to a loss of confidence and panic among depositors. A 'run' on the bank ensued, signified by the vast queues outside branches shown widely in the media. Northern Rock's online banking facilities were also overwhelmed. Calm was only restored four days later when the Chancellor authorised a guarantee to depositors that all their savings would be 100 per cent guaranteed. Importantly, there have been no signs of bank runs spreading to other UK financial institutions. Hence the overall UK financial system has not been undermined by recent events.

Conclusion

It should be noted that the size of the falls in equity prices over the summer were not exceptional compared to those seen in 2001 with the end of the 'dot com' bubble. The recent falls were relatively small in magnitude and at the beginning of October the Dow Jones had recovered fully to reach new all time highs. Credit spreads, although widening would need to double to reach their early 1990s levels, and indeed the spreads are not yet close to those seen in 2002-2003 in the wake of the collapse of the Enron and Worldcom corporations. Moreover the background is that of a strong global economy. Despite some slowing in the US economy, positive annual growth in the US should continue in 2007 and given that US consumer inflation is now falling, the Federal Reserve has the opportunity to cut interest rates further. However, due to recent financial market turbulence there are indications that the boom in world M&A (Mergers and Acquisitions) activity may now have peaked. A recent report by KPMG suggests that the number of firms worldwide involved in M&A activity is set to peak in 2007 before falling away.

The Bank of England's recently published "Credit Conditions Survey" covering Q2 2007 and Q3 2007 has highlighted the potential negative impact the credit crunch will have on the UK's corporate sector and its investment intentions. Lenders now expect recent market developments will reduce significantly their capacity to extend corporate credit over the next three months. Lenders have tightened price terms on loans to the corporate sector over the past three months and a further tightening of price and non-price terms on loans is expected over the next three months. Lenders expected defaults by medium-sized corporates to rise, although defaults by large corporates were expected to remain broadly unchanged over the next three months. Overall, this survey suggested that the impact on lending to households would be far less severe than to corporates.

Some commentators have already underlined the potential impact to the US and UK economies of the current credit crunch and financial market turbulence given the large weight of their financial sectors. In the UK the financial intermediation sector accounts for around 8 per cent of overall GDP, but has recently been growing by around 10 per cent year-on-year. A halving of growth in this sector could reduce UK GDP growth by 0.4 per cent. On top of this, multiplier effects of reduced employment and lower bonuses in the financial sector could send ripples through to the residential housing market. The final result could be a period of below-trend GDP growth. Due to the importance of the financial services sector to the London economy, the impact will be greater in the capital than in other UK regions.

Increasing inflationary pressures remain a downside risk to the global outlook. Inflationary risks include both oil prices and food prices, in particular wheat. Poor weather conditions have reduced the supply of wheat and coupled with a rise in demand from emerging economies such as India, wheat prices have been pushed higher. This not only affects the price of bread but since wheat is used in livestock feed, it could also lead to rises in the prices of meat and dairy products. Regarding oil prices, there remains geopolitical tension in the Middle East and other key producer countries such as Nigeria which continues to make the outlook for oil prices more difficult than usual to predict.

Upside risks to the global outlook include stronger than expected growth in Asia and the eurozone. There is now much greater uncertainty about the future path of interest rates around the globe. If the Federal Reserve continues to reduce interest rates aggressively, then downward revisions to forecasts for US growth may turn out to be overly pessimistic. Chinese and Indian growth may also remain more buoyant than expected.

3.6 Summary

The London economy continues to perform strongly having seen annual growth of over 4 per cent in quarter two of 2007. London continues to outperform the rest of the UK. The outlook over the medium term is for the rate of growth to moderate by 2008, reverting to around trend by 2009. London's performance is more sensitive to a deepening of the recent turbulence in financial markets than the rest of the UK.

The UK economy is also expected to slow in 2008. Both consumption and investment are expected to moderate due to previous interest rate rises. Inflation has fallen from its high in March but pressures remain and the Bank of England believes there is greater than usual uncertainty surrounding the outlook for inflation.

The global economy has remained strong despite some slowing in the US. There has been stronger than expected growth in the emerging economies as well as in the eurozone. Despite recent volatility in financial markets, and the re-pricing of risk that is taking place, the underlying global economy remains firm. A main upside risk to the outlook is continued stronger than expected growth in the emerging economies. However, it remains to be seen the final extent of losses from the US sub-prime mortgage market and how they will fully spread to Europe and the rest of the world.

The main downside risk to the outlook is a deepening of the turbulence in financial markets, significantly tighter credit conditions and lending to businesses, both large and small, drying up. The tightening of lending criteria by banks in the UK has become far more likely since Northern Rock had to ask for lender of last resort support from the Bank of England. Stricter lending criteria, reducing the quantity of loans and increasing their price, will put further downward pressure on household consumption. It will also impact negatively on business investment intentions. Hence, the risks of a sharp slowdown for the UK and London economies in 2008 have risen substantially since Spring 2007 LEO.

4. Review of independent forecasts

What the forecasts provide

In section 5, GLA Economics' forecast of four economic indicators is provided: workforce employment, real output, private consumption (household expenditure) and household income in London. In this section the consensus view on the first three of these indicators is summarised, drawing on forecasts from outside (independent) organisations.[xvi] Both annual growth rates and 'standardised' absolute levels are reported. All the data is in real terms (constant prices).

Additionally, both the consensus and GLA Economics' own forecasts provide predictions of employment and output growth in six broad sectors:

- manufacturing
- construction
- transport and communications
- distribution, hotels and catering
- finance and business services
- other (mainly public) services.

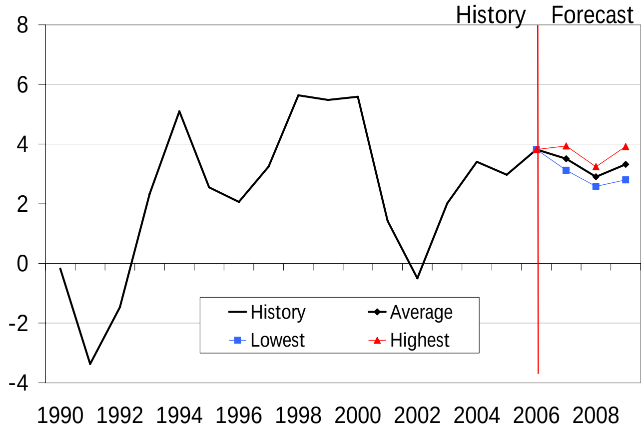
Output

(London GVA, constant prices (2003 base year), £ billion)

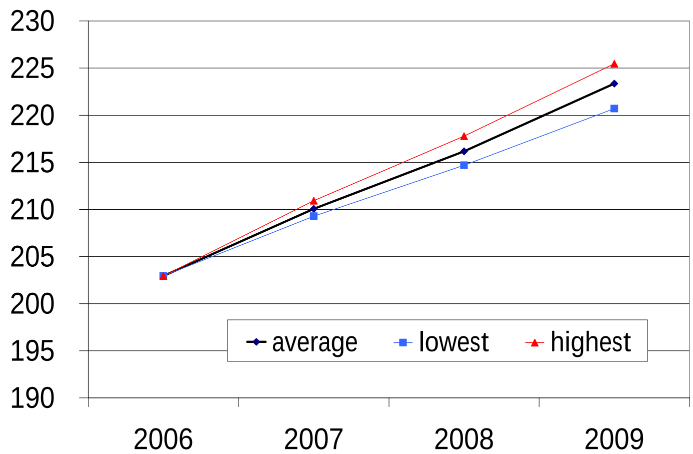
The consensus (mean average view) is for real output to grow above trend over the medium term: 3.5 per cent in 2007, 2.9 per cent in 2008 and 3.3 per cent in 2009.

The spread of predicted growth rates (over the medium term) is not as wide as in previous years with an average range of 0.8 per cent.

Annual growth (per cent)



Level (constant year 2003, £ billion)



Annual growth (per cent)			
	2007	2008	2009
Average	3.5	2.9	3.3
Lowest	3.1	2.6	2.8
Highest	3.9	3.2	3.9

Level (constant year 2003, £ billion)			
	2007	2008	2009
Average	210	216	223
Lowest	209	215	221
Highest	211	218	225

History: Annual growth (per cent)

1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
-0.2	-3.4	-1.5	2.3	5.1	2.6	2.1	3.2	5.6	5.5	5.6	1.4	-0.5	2.0	3.4	3.0	3.8

History: Level (constant year 2003, £ billion)

1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
137.0	132.4	130.4	133.5	140.3	143.8	146.8	151.6	160.1	168.9	178.3	180.9	180.0	183.6	189.8	195.5	203.0

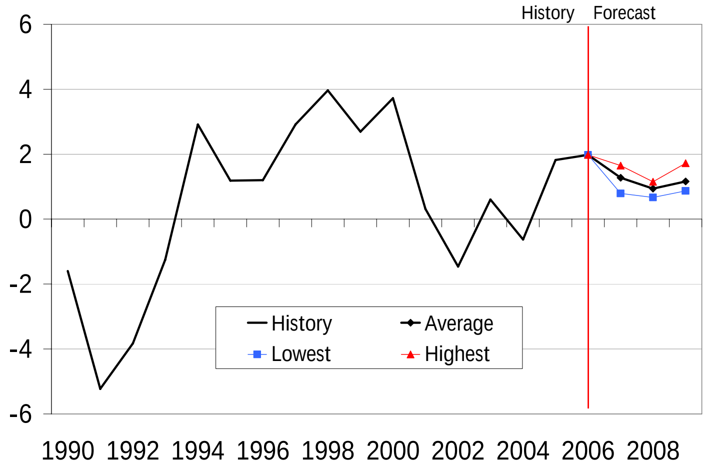
Employment
(London workforce jobs)

London's labour market showed strong growth in 2006 with workforce jobs growth at 2.0 per cent.

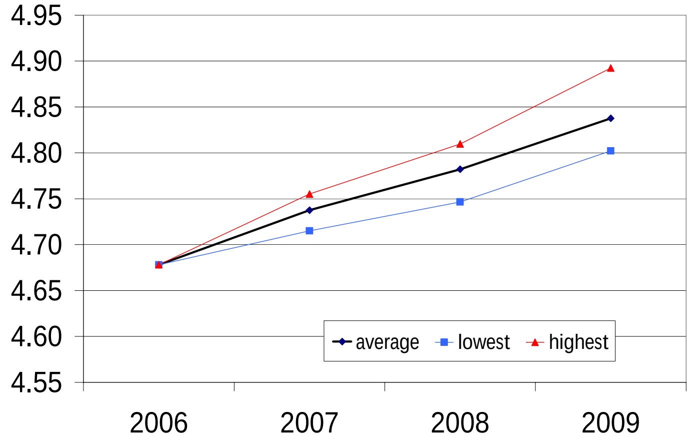
The consensus view is for workforce jobs to continue to grow at around or above trend in the medium term, albeit at a slightly lower rate: 1.3 per cent in 2007, 0.9 per cent in 2008 and 1.2 per cent in 2009.

The independent forecasters are in broad agreement on the path of workforce jobs in London: the spread of workforce jobs in 2009 ranges from 4.80 million to 4.89 million.

Annual growth (per cent)



Level (millions)



Annual growth (per cent)			
	2007	2008	2009
Average	1.3	0.9	1.2
Lowest	0.8	0.7	0.9
Highest	1.6	1.1	1.7

Level (millions)			
	2007	2008	2009
Average	4.74	4.78	4.84
Lowest	4.72	4.75	4.80
Highest	4.76	4.81	4.89

History: Annual growth (per cent)

1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
-1.6	-5.2	-3.8	-1.3	2.9	1.2	1.2	2.9	4.0	2.7	3.7	0.3	-1.5	0.6	-0.6	1.8	2.0

History: Level (thousands)

1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
4.22	4.00	3.84	3.80	3.91	3.95	4.00	4.12	4.28	4.40	4.56	4.57	4.51	4.53	4.51	4.59	4.68

Household expenditure

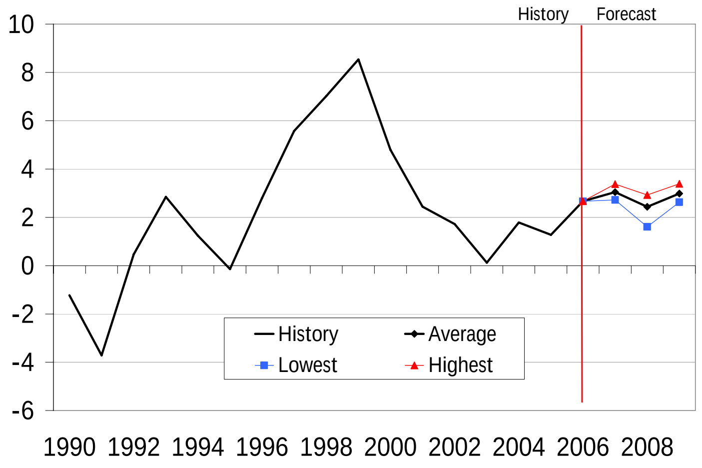
(London household spending, constant year 2003, £ billion)

Growth in household expenditure was a healthy 2.7 per cent in 2006.

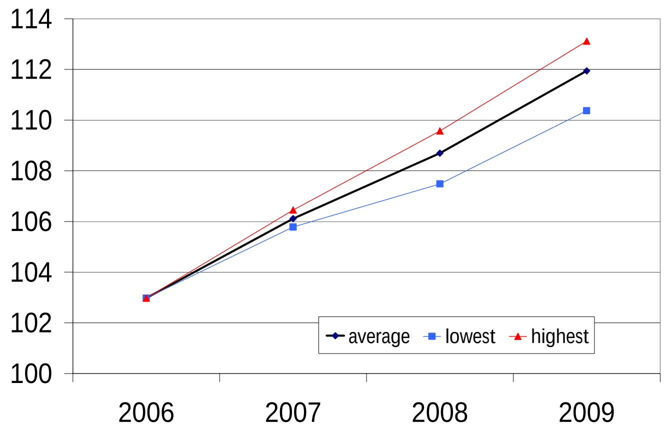
The average of independent forecasters is for household expenditure growth to remain similar over the medium term: 3.0 per cent in 2007, 2.4 per cent in 2008 and 3.0 per cent in 2009.

Even the most pessimistic forecasts expect household expenditure to increase to just over £110 billion by 2009.

Annual growth (per cent)



Level (constant year 2003 £ billion)



Annual growth (per cent)			
	2007	2008	2009
Average	3.0	2.4	3.0
Lowest	2.7	1.6	2.6
Highest	3.4	2.9	3.4

Level (constant year 2003, £ billion)			
	2007	2008	2009
Average	106	109	112
Lowest	106	107	110
Highest	106	110	113

History: Annual growth (per cent)

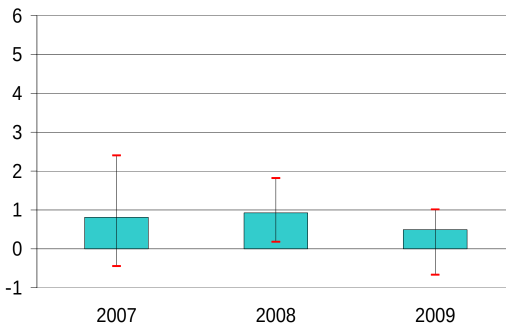
1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
-1.2	-3.7	0.5	2.8	1.2	-0.1	2.8	5.6	7.0	8.5	4.8	2.4	1.7	0.1	1.8	1.3	2.7

History: Level (constant year 2003, £ billion)

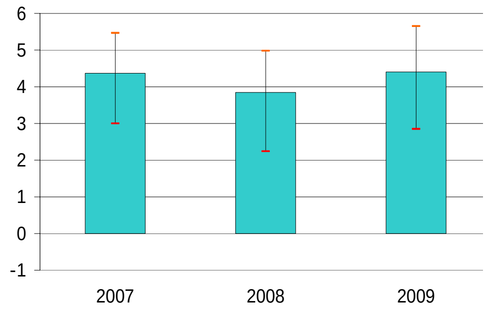
1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
70.2	67.6	67.9	69.8	70.7	70.6	72.6	76.6	82.0	89.0	93.3	95.6	97.2	97.3	99.0	100.3	103.0

Output growth by sector (per cent annual change)
Growth is expected across all sectors over the medium term. The highest growth is expected in the financial and business services sector, the construction sector, and the transport and communications sector.

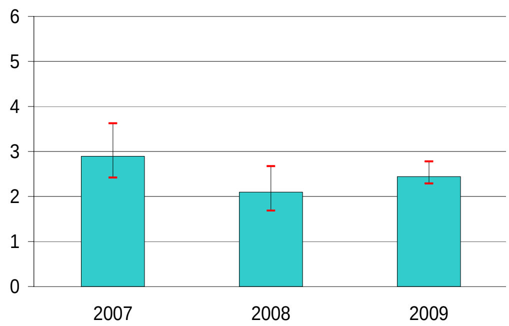
Manufacturing



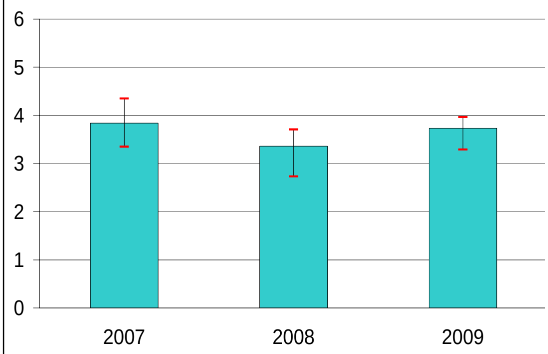
Construction



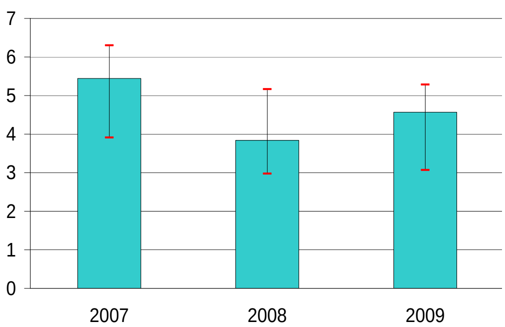
Distribution, hotels and catering



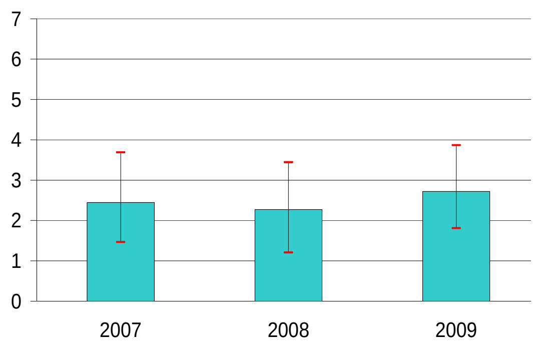
Transport and communications



Finance and business

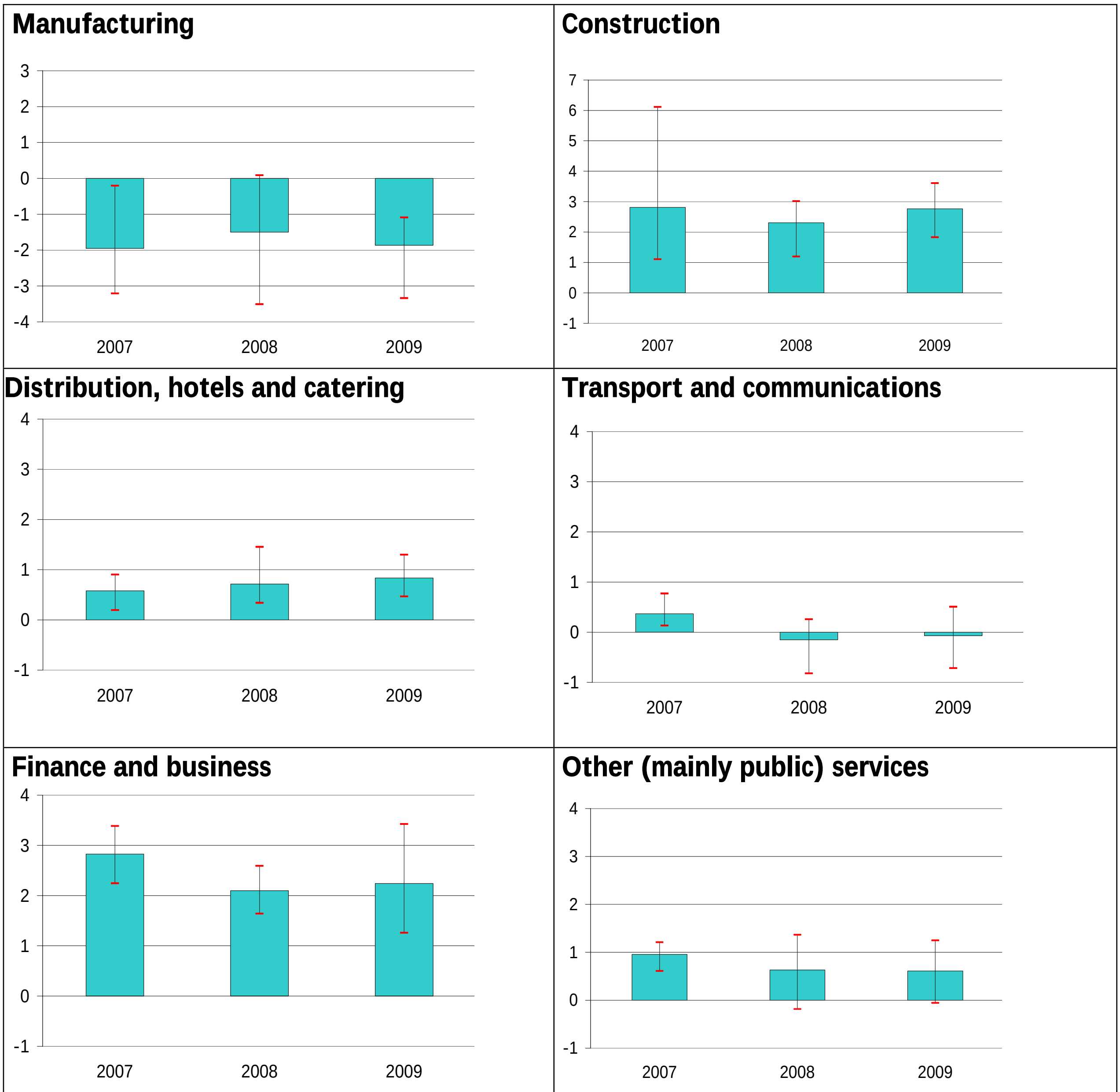


Other (mainly public) services



		2007	2008	2009			2007	2008	2009
Manufacturing	*Average*	0.8	0.9	0.5	**Construction**	*Average*	4.4	3.8	4.4
	Lowest	-0.4	0.2	-0.7		*Lowest*	3.0	2.2	2.9
	Highest	2.4	1.8	1.0		*Highest*	5.5	5.0	5.7
Distribution, hotels and catering	*Average*	2.9	2.1	2.4	**Transport and communications**	*Average*	3.8	3.4	3.7
	Lowest	2.4	1.7	2.3		*Lowest*	3.3	2.7	3.3
	Highest	3.6	2.7	2.8		*Highest*	4.4	3.7	4.0
Finance and business	*Average*	5.4	3.8	4.6	**Other (mainly public) services**	*Average*	2.4	2.3	2.7
	Lowest	3.9	3.0	3.1		*Lowest*	1.5	1.2	1.8
	Highest	6.3	5.2	5.3		*Highest*	3.7	3.4	3.9

Employment growth by sector (per cent annual change)
Forecast employment growth shows a mixed pattern across the sectors. Strong employment growth is expected in financial and business services and construction. Negative employment growth is expected in manufacturing in every year.



		2007	2008	2009
Manufacturing	*Average*	-2.0	-1.5	-1.9
	Lowest	-3.2	-3.5	-3.3
	Highest	-0.2	0.1	-1.1
Distribution, hotels and catering	*Average*	0.6	0.7	0.8
	Lowest	0.2	0.3	0.5
	Highest	0.9	1.5	1.3
Finance and business	*Average*	2.8	2.1	2.2
	Lowest	2.2	1.6	1.3
	Highest	3.4	2.6	3.4
Construction	*Average*	2.8	2.3	2.8
	Lowest	1.1	1.2	1.8
	Highest	6.1	3.0	3.6
Transport and communications	*Average*	0.4	-0.2	-0.1
	Lowest	0.1	-0.8	-0.7
	Highest	0.8	0.3	0.5
Other (mainly public) services	*Average*	1.0	0.6	0.6
	Lowest	0.6	-0.2	-0.1
	Highest	1.2	1.4	1.2

5. The GLA Economics forecast

5.1 Assumptions and methods

This forecast combines the GLA's long-term trend projections for employment and population with medium-term assumptions about the growth of the UK economy derived from HM Treasury's comparison of independent forecasts.

The model is constrained for the year 2020 to London-based employment projections derived from the long-term growth rate of London's workforce. The UK assumptions comprise the medium-term growth rates of UK total output. The GLA's long-term employment projections for London have been updated from those underlying the London Plan and updated projections were published in February 2007.[xvii]

5.2 Detailed assumptions for the UK

Table 5.1 shows the assumptions adopted by the GLA for its forecast and compares them to HM Treasury's Budget 2007 forecast. Note that the GLA forecast is based on assumptions up to 2020, though the forecast itself only goes up to 2009.

Table 5.1: UK economic assumptions
(annual percentage growth rates)

		2007	2008	2009
GLA forecast[xviii]	GVA	2.9	2.4	2.4
	Consumption	2.9	2.5	2.4
Budget 2007	GVA	2¾-3¼	2½-3	2½-3
	Consumption	2¼-2¾	2¼-2¾	2¼-2¾

5.3 Projections and forecasts

It is necessary to distinguish carefully between the GLA's long-term employment projections and this forecast which contains the GLA's medium-term planning projections. Trend projections, by definition, do not incorporate cyclical variations and constitute estimates of jobs and output at comparable points in the cycle. The actual course of output and employment will vary around this trend. Trend projections are essential for planning to provide capacity (such as office space, housing and transport) to accommodate the needs of the economy throughout and at the peak of the cycle, not just at its low points. For business planning (for example, in deciding the timing of investments and the likely course of revenue) estimates of actual numbers of jobs and actual output at any point in time are required. The medium-term planning projections provide these estimates.

As time progresses and more data become available, it becomes possible to identify turning points in the data: whether underlying trends are continuing or new trends are being established. While the forecast is calibrated to the GLA's employment projections for 2020, it provides early warnings of significant deviations from these projections because it accounts for the most recent data and incorporates the latest estimates of UK growth rates.

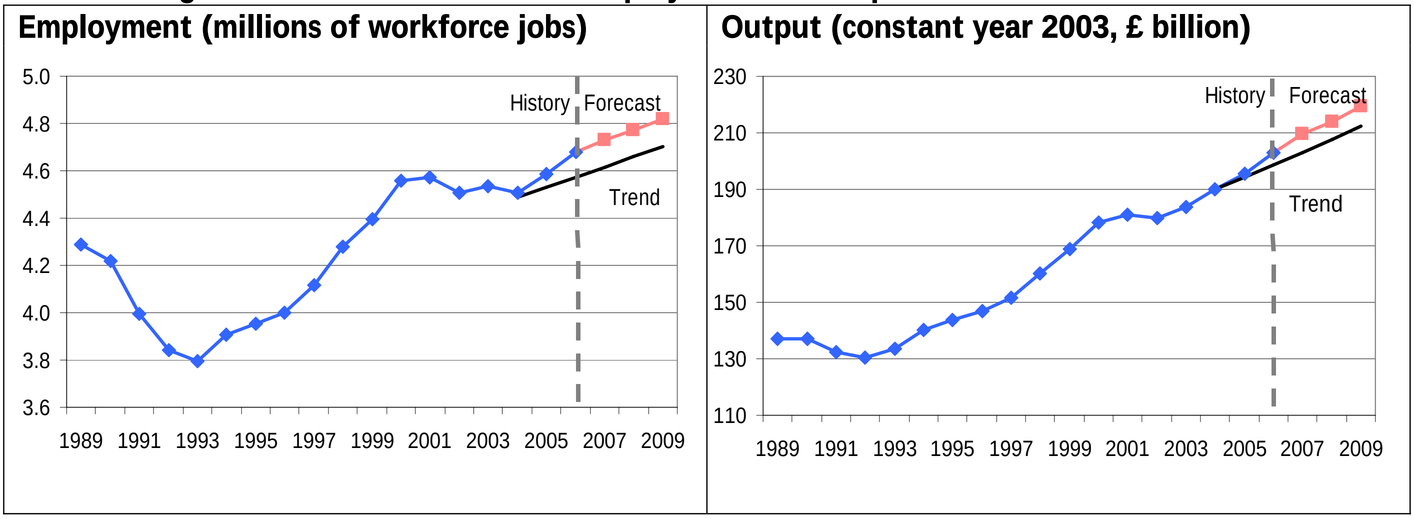
In 2007 the GLA commissioned new employment projections from Volterra Consulting which now form the trend projection on which the medium-term forecast is based. The start point for the trend projection is 2004. For this reason 2004 is taken as the start point for all trend (long-term) projections. For comparison purposes, absolute (level) trend projections are derived by applying the trend growth rates to the latest-available historical data for 2004. These levels may differ from the absolute levels for GVA, employment and household expenditure published elsewhere as a result of revisions to historical data as better information becomes available.

5.4 Results

Output is expected to grow at over 3 per cent in 2007 before falling back to 2 per cent in 2008. Employment is forecast to grow slightly above the trend rate over 2007-2009.

Following strong growth in 2006, household spending growth is expected to moderate in 2007 and 2008. Household income growth is forecast to slow in 2008 compared with 2007.

Figure 5.1: Trend and forecast employment and output



Source: GLA Economics' calculations

Table 5.2: Forecast and historical growth rates

Annual % change

	2001	2002	2003	2004	2005	2006	2007	2008	2009
GVA	1.4	-0.5	2.0	3.4	3.0	3.8	3.3	2.0	2.6
Workforce jobs	0.3	-1.5	0.6	-0.6	1.8	2.0	1.2	0.9	1.0
Household spending	2.4	1.7	0.1	1.8	1.3	2.7	2.3	1.7	3.0
Household income	4.6	1.3	2.8	0.6	3.1	1.6	3.0	2.4	3.1

Table 5.3: Forecast and historical levels

(constant year 2003, £ billion except jobs)

	2001	2002	2003	2004	2005	2006	2007	2008	2009
GVA	180.9	180.0	183.6	189.8	195.5	203.0	210	214	219
Workforce jobs (millions)	4.57	4.51	4.53	4.51	4.59	4.68	4.7	4.8	4.8
Household spending	95.6	97.2	97.3	99.0	100.3	103.0	105	107	110
Household income	106.8	108.2	111.3	111.9	115.3	117.1	121	124	127

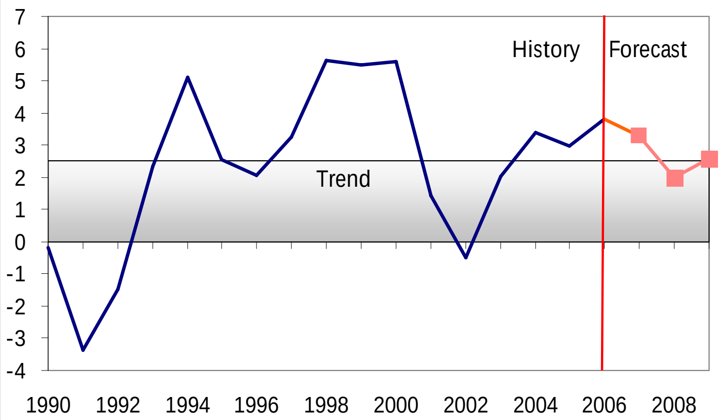
Output

(London GVA, constant year 2003, £ billion)

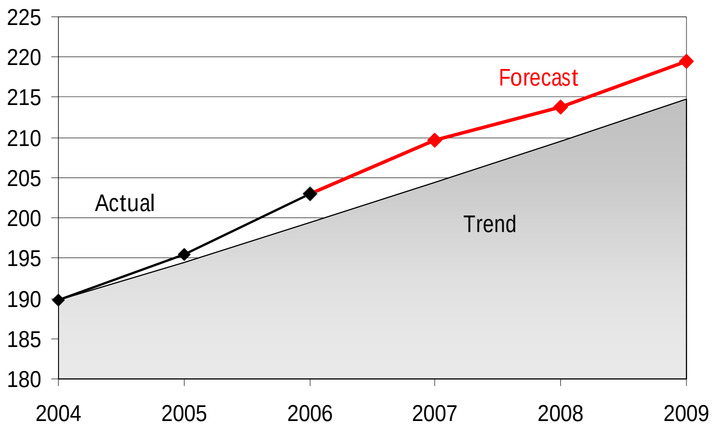
London real GVA growth is forecast to grow at 3.3 per cent in 2007, falling to 2.0 per cent in 2008 before recovering to 2.6 per cent in 2009.

The GLA forecast is below the consensus average growth forecast throughout 2007-2009.

Annual growth (per cent)



Level (constant year 2003, £ billion)



Growth (annual per cent)				
	2006	**2007**	**2008**	**2009**
GLA	3.8	3.3	2.0	2.6
Consensus		3.5	2.9	3.3

Level (constant year 2003, £ billion)				
	2006	**2007**	**2008**	**2009**
GLA	203	210	214	219
Consensus		210	216	223

History: Annual growth (per cent)

1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
-0.2	-3.4	-1.5	2.3	5.1	2.6	2.1	3.2	5.6	5.5	5.6	1.4	-0.5	2.0	3.4	3.0	3.8

History: Level (constant year 2003, £ billion)

1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
137.0	132.4	130.4	133.5	140.3	143.8	146.8	151.6	160.1	168.9	178.3	180.9	180.0	183.6	189.8	195.5	203.0

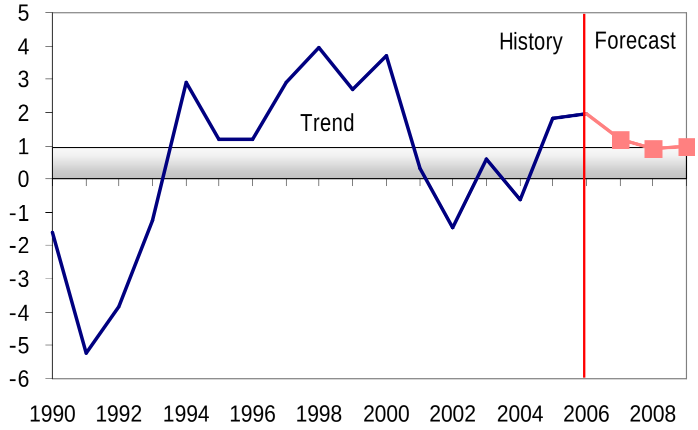
Employment
(London workforce jobs)

London's employment is forecast to grow at just above the trend over the medium term, albeit at a slower annual rate than in 2006.

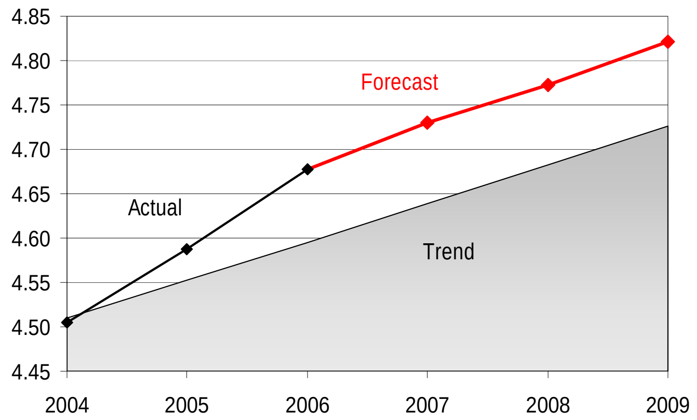
The GLA forecast for employment growth is slightly lower than the consensus average in 2007 and 2009.

By 2009, London is expected to have 4.82 million workforce jobs.

Annual growth (per cent)



Level (millions of workforce jobs)



Growth (annual per cent)				
	2006	**2007**	**2008**	**2009**
GLA	2.0	1.2	0.9	1.0
Consensus		1.3	0.9	1.2

Level (millions of workforce jobs)				
	2006	**2007**	**2008**	**2009**
GLA	4.68	4.73	4.77	4.82
Consensus		4.74	4.78	4.84

History: Annual growth (per cent)

1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
-1.6	-5.2	-3.8	-1.3	2.9	1.2	1.2	2.9	4.0	2.7	3.7	0.3	-1.5	0.6	-0.6	1.8	2.0

History: Level (millions)

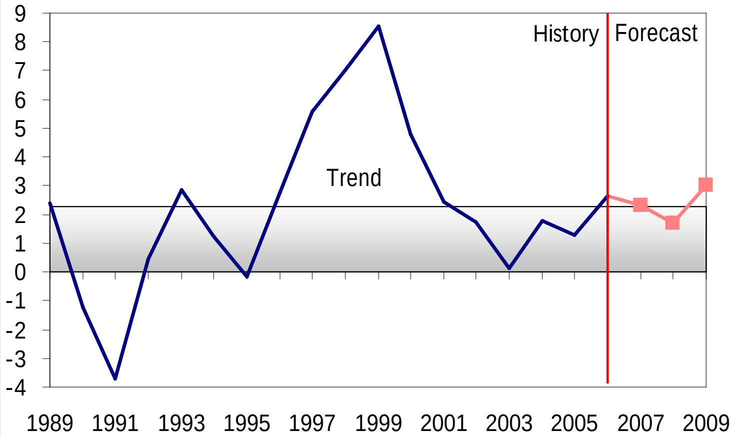
1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
4.22	4.00	3.84	3.80	3.91	3.95	4.00	4.12	4.28	4.40	4.56	4.57	4.51	4.53	4.51	4.59	4.68

Household expenditure
(London household spending, constant year 2003, £ billion)

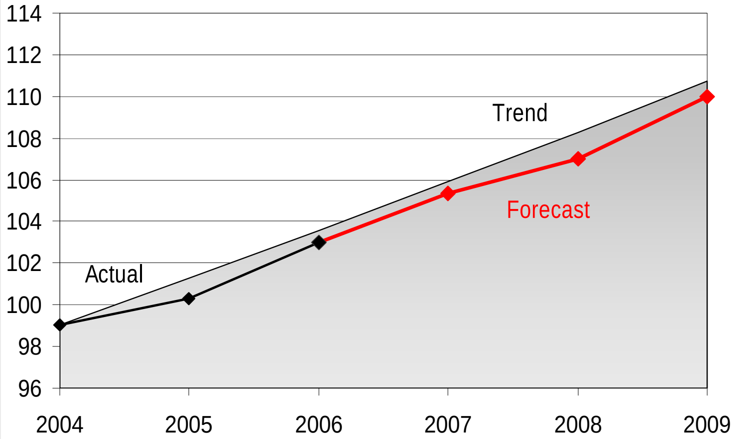
Growth in London household spending is forecast to fall to 2.3 per cent in 2007 and then 1.7 per cent in 2008 before recovering to 3.0 per cent in 2009.

This places the GLA forecast below the consensus average until 2009.

Annual growth (per cent)



Level (constant year 2003, £ billion)



Growth (annual per cent)				
	2006	2007	2008	2009
GLA	2.7	2.3	1.7	3.0
Consensus		3.0	2.4	3.0

Level (constant year 2003, £ billion)				
	2006	2007	2008	2009
GLA	103	105	107	110
Consensus		106	109	112

History: Annual growth (per cent)

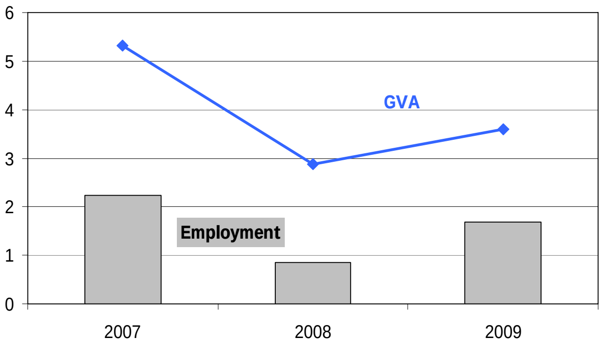
1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
-1.2	-3.7	0.5	2.8	1.2	-0.1	2.8	5.6	7.0	8.5	4.8	2.4	1.7	0.1	1.8	1.3	2.7

History: Level (constant year 2003, £ billion)

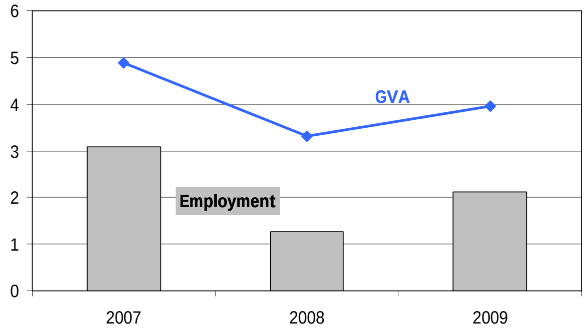
1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
70.2	67.6	67.9	69.8	70.7	70.6	72.6	76.6	82.0	89.0	93.3	95.5	97.2	97.3	99.0	100.3	103.0

Output and employment growth by sector (per cent annual change)

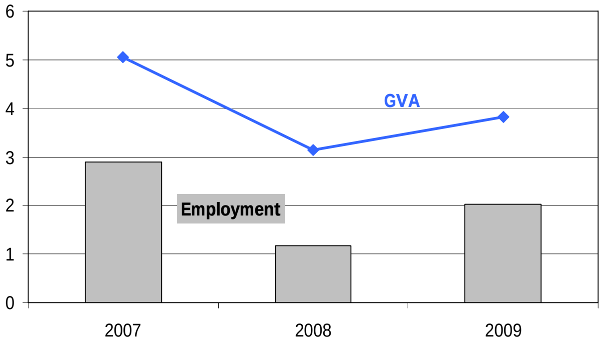
Financial services



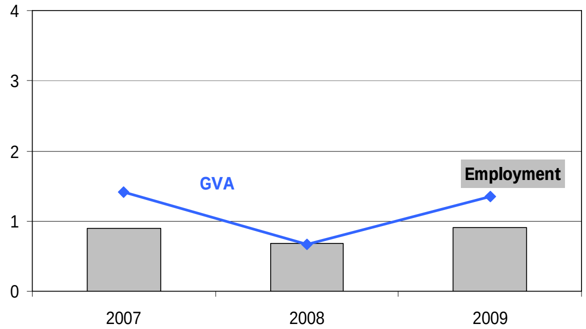
Business services



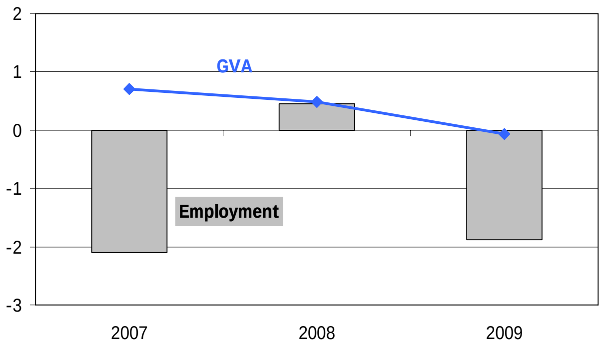
Finance and business (combined)



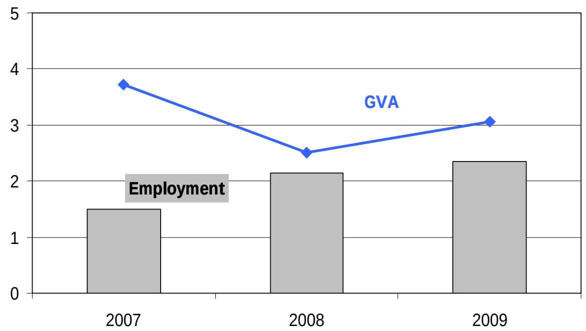
Distribution, hotels and catering



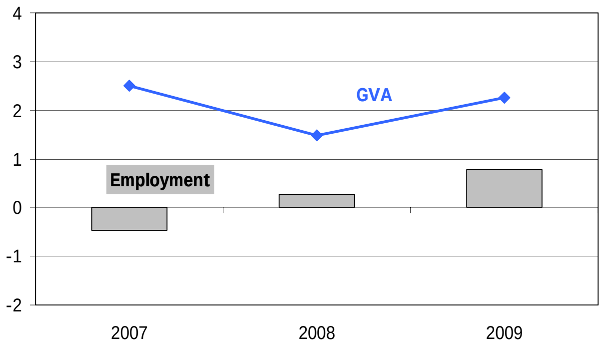
Manufacturing



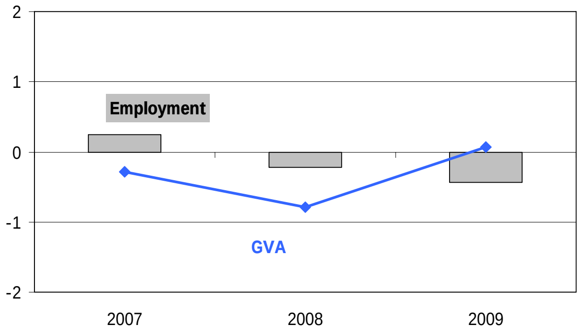
Construction



Transport and communications



Other (mainly public) services



Output and employment growth by sector (per cent annual change)

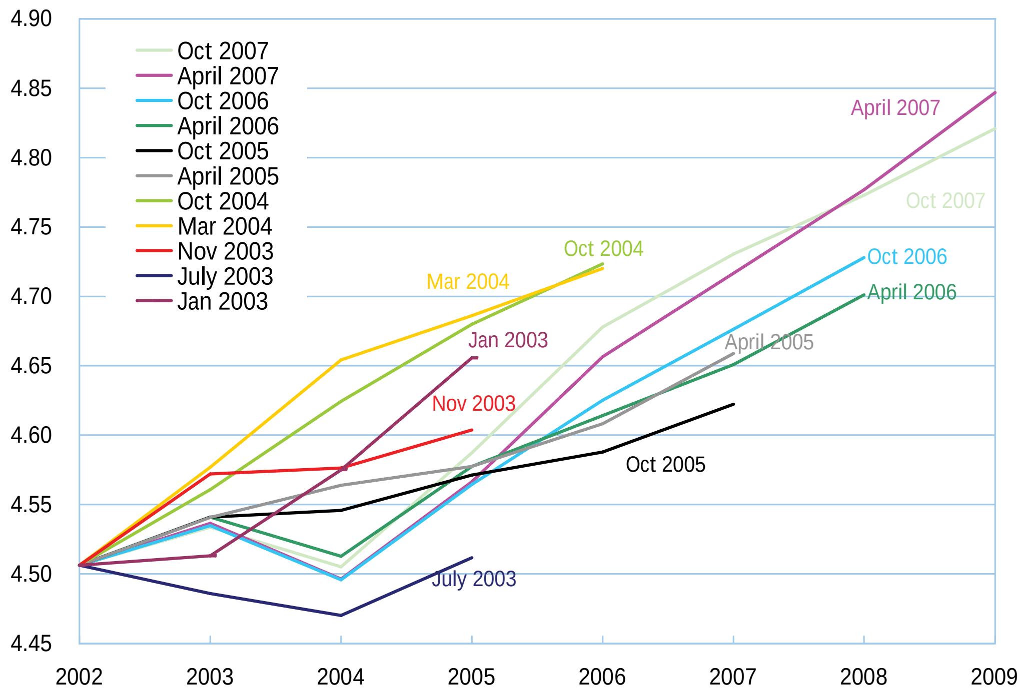
	2007	2008	2009
Financial services			
Output	5.3	2.9	3.6
Employment	2.2	0.9	1.7
Business services			
Output	4.9	3.3	4.0
Employment	3.1	1.3	2.1
Financial and business services combined			
Output	5.0	3.2	3.8
Employment	2.9	1.2	2.0
Distribution, hotels and catering			
Output	1.4	0.7	1.3
Employment	0.9	0.7	0.9
Transport and communications			
Output	2.5	1.5	2.3
Employment	-0.5	0.3	0.8
Other (mainly public) services			
Output	-0.3	-0.8	0.1
Employment	0.2	-0.2	-0.4
Manufacturing			
Output	0.7	0.5	-0.1
Employment	-2.1	0.5	-1.9
Construction			
Output	3.7	2.5	3.1
Employment	1.5	2.1	2.4
(Memo: non-manufacturing)			
Output	3.5	2.0	2.8
Employment	1.4	0.9	1.2

5.5 Comparison with previous forecasts

This section compares the current forecast with previous forecasts in this series. Since the base years for the forecasts change and the base data is continuously revised, the forecasts have been rebased into a common base year for the comparison in Figures 5.2 and 5.3.

The most recent forecast for London's workforce jobs growth is lower in 2008 and 2009 than in previous forecasts. For real output growth the current forecast is higher than previous forecasts for 2007 but lower for both 2008 and 2009.

Figure 5.2: Employment – latest forecast compared with previous forecasts
(millions of workforce jobs)

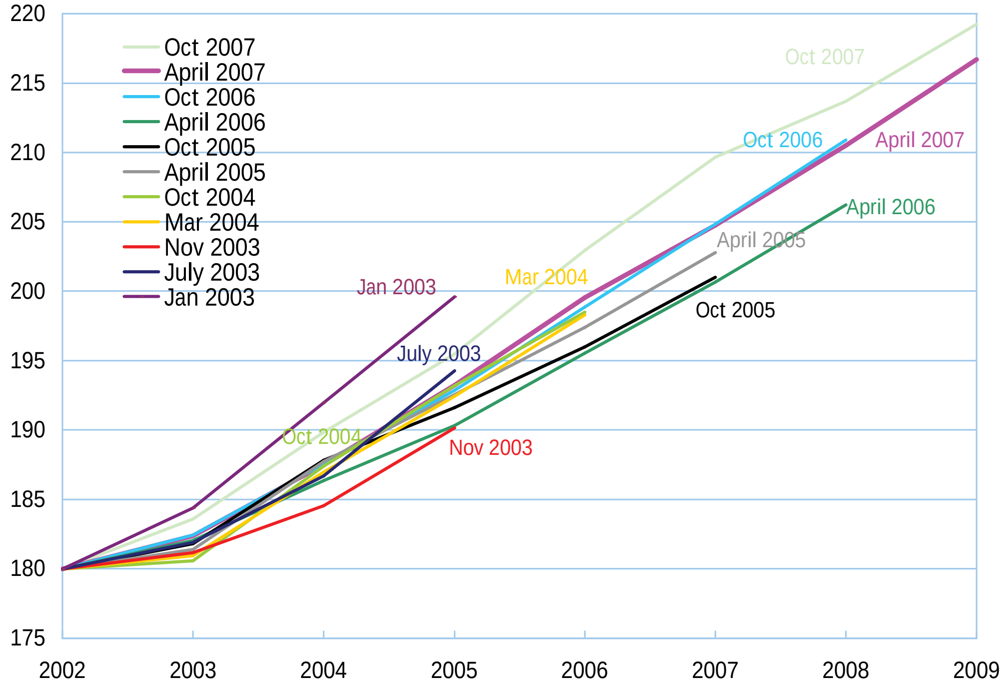


Source: Various London's Economic Outlooks

Table 5.4 Comparisons with previous published forecasts
(London workforce jobs, per cent annual growth)

Forecast	2003	2004	2005	2006	2007	2008	2009
Oct 2007	**0.6%**	**-0.6%**	**1.8%**	**2.0%**	1.2%	0.9%	1.0%
April 2007					1.2%	1.4%	1.5%
Oct 2006				1.3%	1.1%	1.1%	
April 2006				0.8%	0.8%	1.1%	
Oct 2005			0.6%	0.4%	0.8%		
April 2005			0.3%	0.7%	1.1%		
Oct 2004		1.4%	1.2%	0.9%			
Mar 2004		1.7%	0.7%	0.7%			
Nov 2003	1.5%	0.1%	0.6%				
July 2003	-0.5%	-0.4%	0.9%				
Jan 2003	0.2%	1.4%	1.8%				

Figure 5.3: Output – latest forecast compared with previous forecasts
(constant year 2003, £ billion)



Source: Various London's Economic Outlooks

Table 5.5 Comparisons with previous published forecasts
(London GVA, per cent annual growth)

Forecast	2003	2004	2005	2006	2007	2008	2009
Oct 2007	**2.0%**	**3.4%**	**3.0%**	**3.8%**	3.3%	2.0%	2.6%
April 2007					2.6%	2.8%	3.0%
Oct 2006				3.1%	3.0%	3.0%	
April 2006				2.7%	2.6%	2.8%	
Oct 2005			2.0%	2.3%	2.6%		
April 2005			2.6%	2.5%	2.7%		
Oct 2004		3.8%	3.1%	2.7%			
Mar 2004		3.3%	2.9%	3.0%			
Nov 2003	0.7%	1.9%	3.0%				
July 2003	1.1%	2.6%	4.1%				
Jan 2003	2.4%	4.1%	4.0%				

6. Globalisation, Skills and Employment: The London Story

6.1 Introduction

This supplement highlights the main findings from the recently published London Skills and Employment Board (LSEB) evidence base. The LSEB has been established to provide leadership in improving adult skills and employment in London. The Board is tasked with developing a strategy for adult training in London and ensuring its implementation. The Board determined that the strategy should be based on, and follow the development, of a robust evidence base.

This supplement starts by pointing out that London is a highly successful and competitive city region economy and one of the world's leading centres for international business and financial services. An overview of the demand for labour which takes account of sector and occupational changes follows. The supplement then looks at the supply of labour to London's economy, considering issues such as international and domestic migration and the educational achievement of young Londoners. The supplement ends with a consideration of the proportion of people in London that are out of work and the barriers to employment they face.

6.2 London's global economy

London is one of the world's most important centres for international business services and ranks as the world's leading centre in a number of areas of international financial intermediation. More FTSE500 companies have their headquarters in London than New York, Paris or Hong Kong, and London is the most common destination for foreign direct investment in Europe.[xix] London's success is based on its competitive strengths across a range of factors including qualified staff and access to markets amongst other things. These attributes are highlighted in Table 6.1 which illustrates the results from a survey of around 500 of Europe's largest companies.

Table 6.1 London's city ranking on various location factors

Location factor (in order of importance)	2005	2006	Leader
Easy access to markets	1	1	London
Qualified staff	1	1	London
External transport links	1	1	London
Quality of telecoms	1	1	London
Cost of staff	22	16	Warsaw
Climate created by government	6	5	Dublin
Office space value for money	24	29	Warsaw
Availability of office space	3	1	London
Language spoken	1	1	London
Internal transport	2	1	London
Quality of life	13	7	Barcelona
Freedom from pollution	27	26	Stockholm

Source: European Cities Monitor, Cushman & Wakefield (2006)

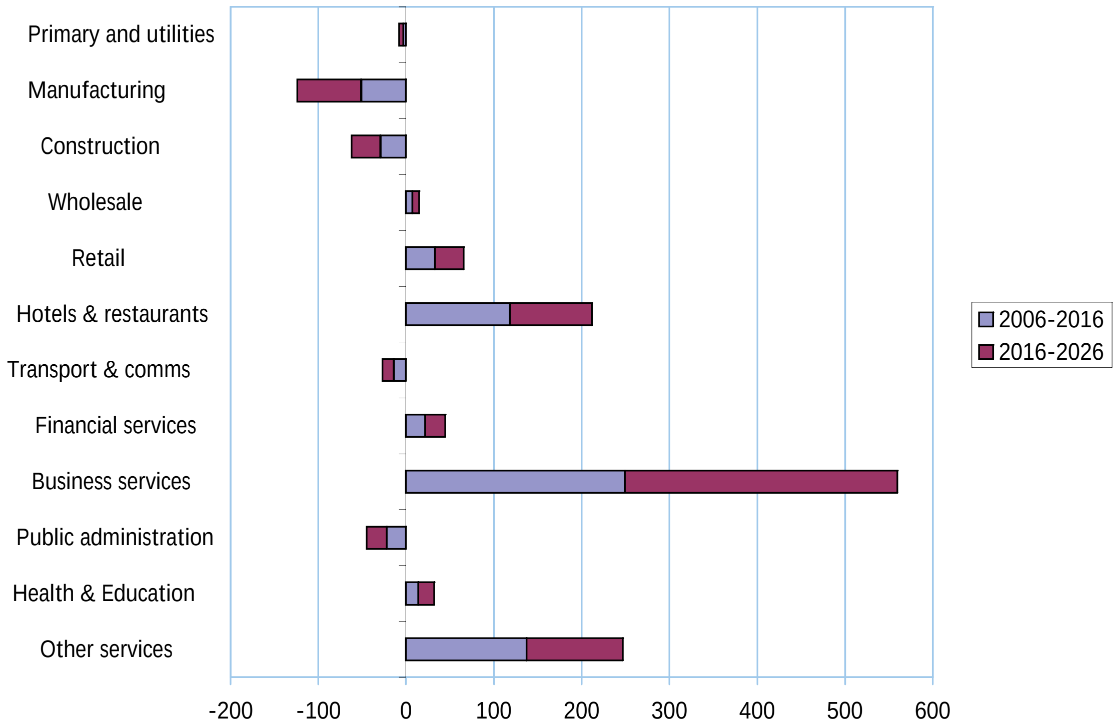
6.3 Demand for Labour

Global trends have driven a structural shift in London's economy away from manufacturing towards services, especially business services. As a result of such changes, London's employers now employ a more highly qualified workforce than in the past.[xx] Whilst there are always uncertainties in making forecasts, both occupational and sectoral analyses suggest that the demand for high skills is expected to grow in the future. Already 43 per cent of jobs require level 4 (degree level) or higher qualifications; by 2020, this is expected to increase to around 50 per cent, higher than the expected 42 per cent average across the UK.

6.3.1 Forecast changes in London's economy – by sector

As shown in Figure 6.1, employment growth in business services and other services is forecast to continue over the next two decades.

Figure 6.1: Forecast Change in London's Employment 2006-2026
('000s workplace jobs)



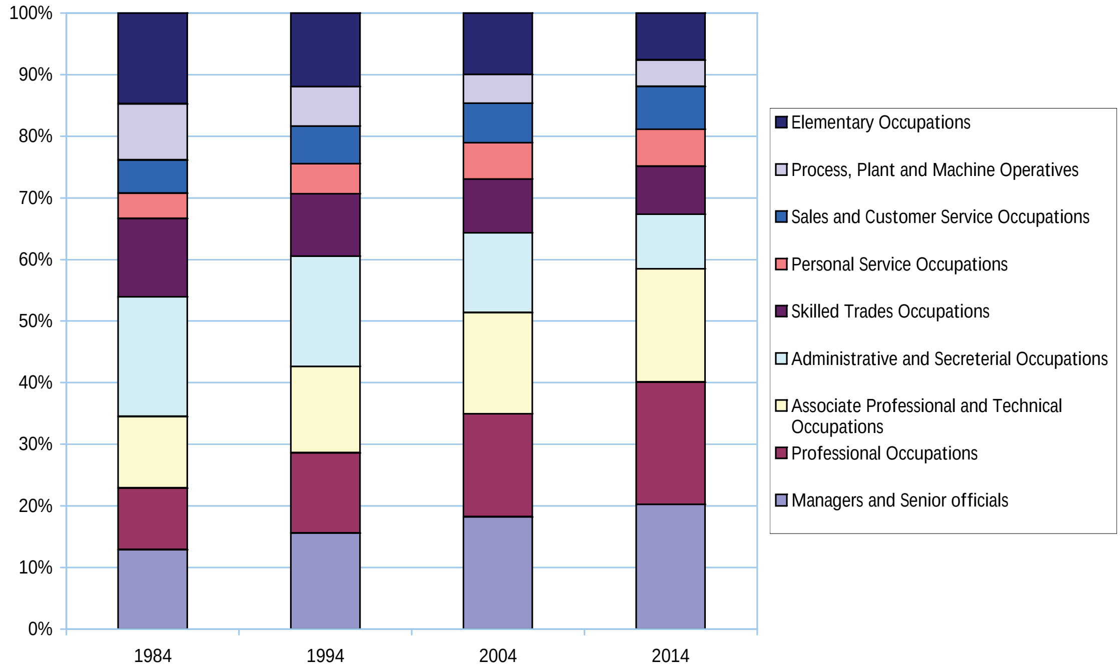
Source: GLA Economics based on data in Working Paper 20: Employment projections for London by Sector and Borough.

The 'business services' and 'other services' sectors that are forecast to provide the vast majority of London's future employment growth employ relatively high-skilled workers. Over 50 per cent of employees in 'finance and business services' and 40 per cent of employees in 'other services' are qualified to level 4 or above. In that respect, sector analysis suggests an increased demand for high skills in the future.

6.3.2 Forecast changes in London's economy – by occupation

Occupational analysis suggests that the growth in London's employment over the past two decades has been in managers, professionals and associate professional occupations.[xxi] These occupations generally employ high skilled individuals. For example 83 per cent of those employed in professional occupations (security broking, fund management, advertising, legal, management consultancy jobs, etc.) are educated to at least level 4 (degree level). Moreover, Cambridge Econometrics forecasts suggest that growth in these occupations will continue in the future (see Figure 6.2).

Figure 6.2: Occupation Change in London 1984-2014



Source: Cambridge Econometrics for Working Futures

Whilst, both sectoral and occupational analysis suggest that the demand for high skills is expected to grow, at the lower end of the skills distribution the picture is more complicated. The demand for low skill jobs is expected to remain stable as the demand for basic service jobs tends to increase with the growth of high skilled office-based jobs.

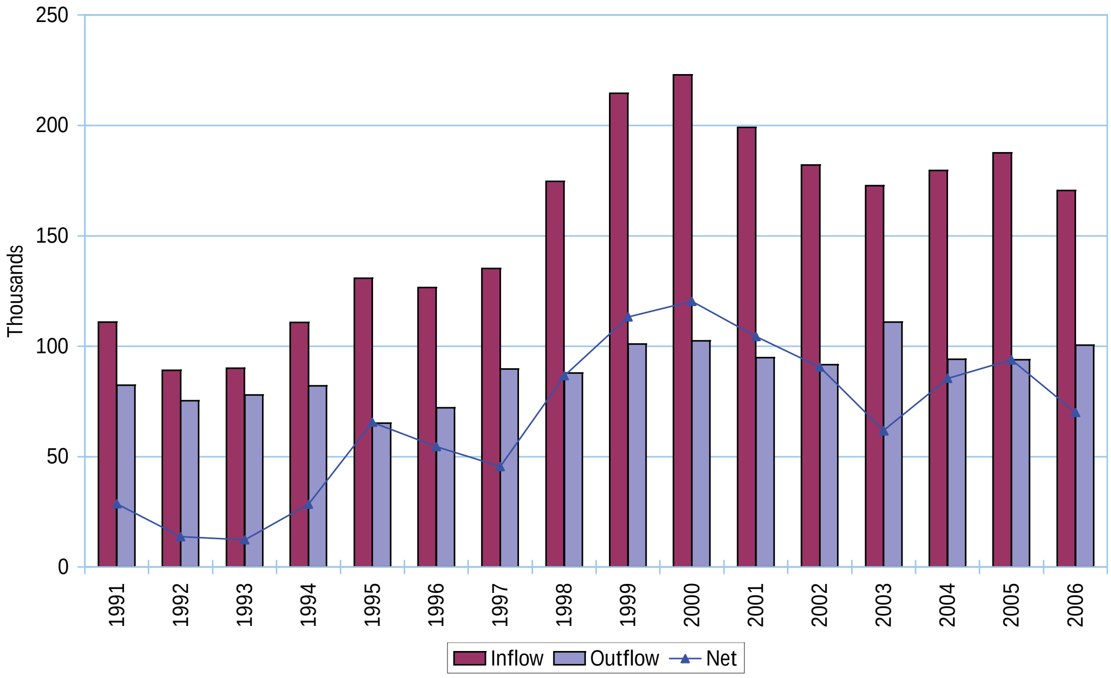
6.4 Labour Supply in London

London's population is continually changing and is more highly skilled than the rest of the UK because it attracts well-qualified inward migrants from the UK and abroad to supplement its own young people entering the labour market (as well as its existing resident population). GLA Economics estimates that each year approximately 8 per cent of London's working-age population is replaced due to domestic migration, international migration and young Londoners entering the labour market. International migrants or domestic migrants from the rest of the UK represent 75 per cent of working-age people entering the London labour market each year.

6.4.1 International Migration

As shown in Figure 6.3, inflows of international migrants to London have consistently exceeded outflows with an average annual gross inflow of around 156,000 since 1991. From 1998 onwards inflows of international migrants to London started to outstrip the outflows from London of both international and domestic migrants and began driving the net increase of London's population from that time. International migration to London has represented a large share of the UK's inward international migration overall, although that share has decreased in recent years mainly due to the more diversified geographical distribution of the A8 new migrants (all new member EU states that joined in 2004 except Cyprus and Malta).

Figure 6.3: International migration into and out of London

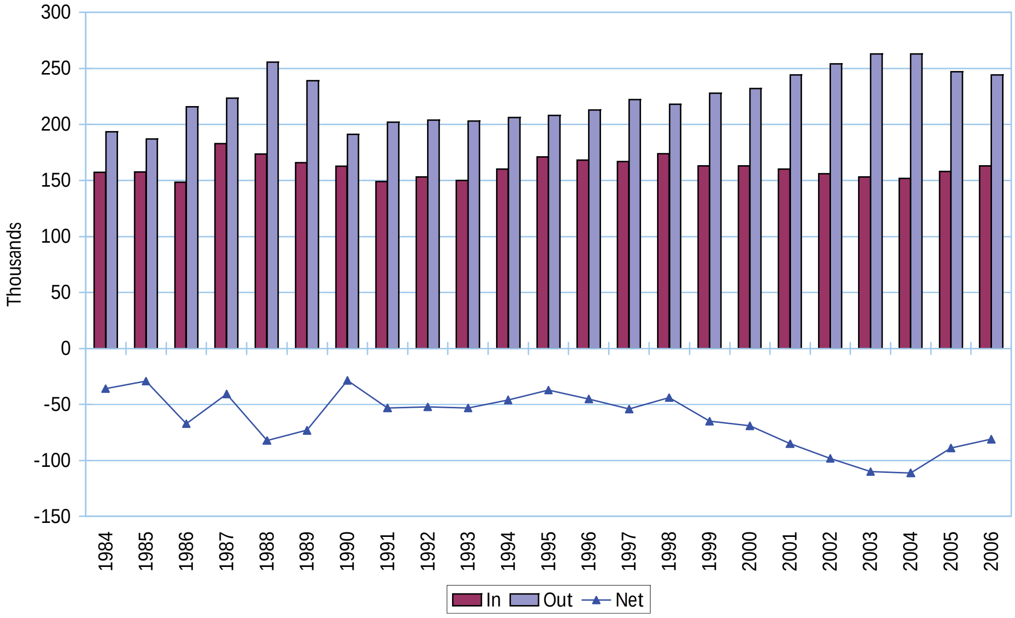


Source: ONS Regional Trends 39 using data from the National Health Service Central Register and International Passenger Survey

6.4.2 Domestic Migration

As shown in Figure 6.4, over time the outflow of people from London to the UK has continually exceeded the inflow. Some of those who migrate out of London, however, move to the surrounding regions and continue to work in London and commute.

Figure 6.4: Domestic Migration into and out of London

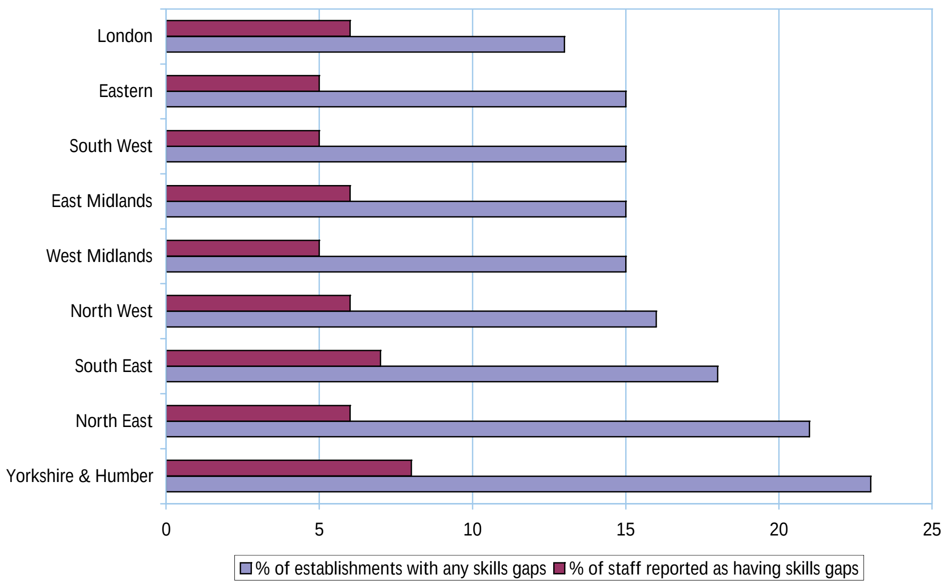


Source: Office for National Statistics

Much of the domestic migration into and out of London is by highly skilled workers. In many respects London acts as a 'gateway' for highly skilled people who come to London early in their careers and having developed their skills later migrate out to other areas.

London also draws on large numbers of daily commuters living in surrounding regions. Commuting helps to supply London's businesses with the labour it requires. Consequently, London's businesses do not face major skills gaps. As shown by Figure 6.5, London has the lowest percentage of establishments with skills gaps of any UK region.[xxii]

Figure 6.5: Incidence of Skill Gaps by Region, 2005



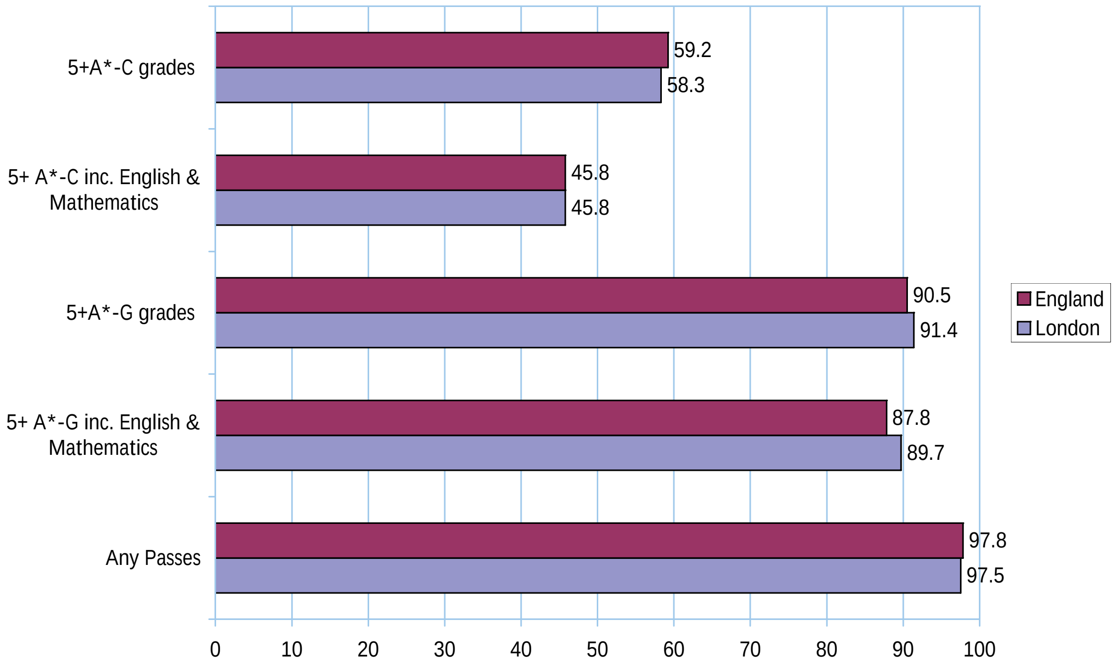
Source: National Employers Skills Survey, 2005

6.4.3 Young Londoners

Another inflow to London's labour market comes from school or university leavers. Young Londoners entering the workforce in London are faced with demand that is skewed towards high skilled jobs relative to the rest of the country as well as strong competition from regular migration to the capital.

The qualifications achieved by London's young people need to improve to match the requirements of London's economy. As shown in Figure 6.6, under 50 per cent of London children taking GCSEs achieve five with grades A* to C (including English and Maths) which are prerequisites for many higher education courses. As a result, even if all London's 15 year olds with five GCSEs at grades A* to C including Maths and English were to progress through A levels and into higher education it would still not meet London's future skills needs.

Figure 6.6: GCSE attainment levels in London and England for secondary school pupils aged 15, (2005/06), (%)

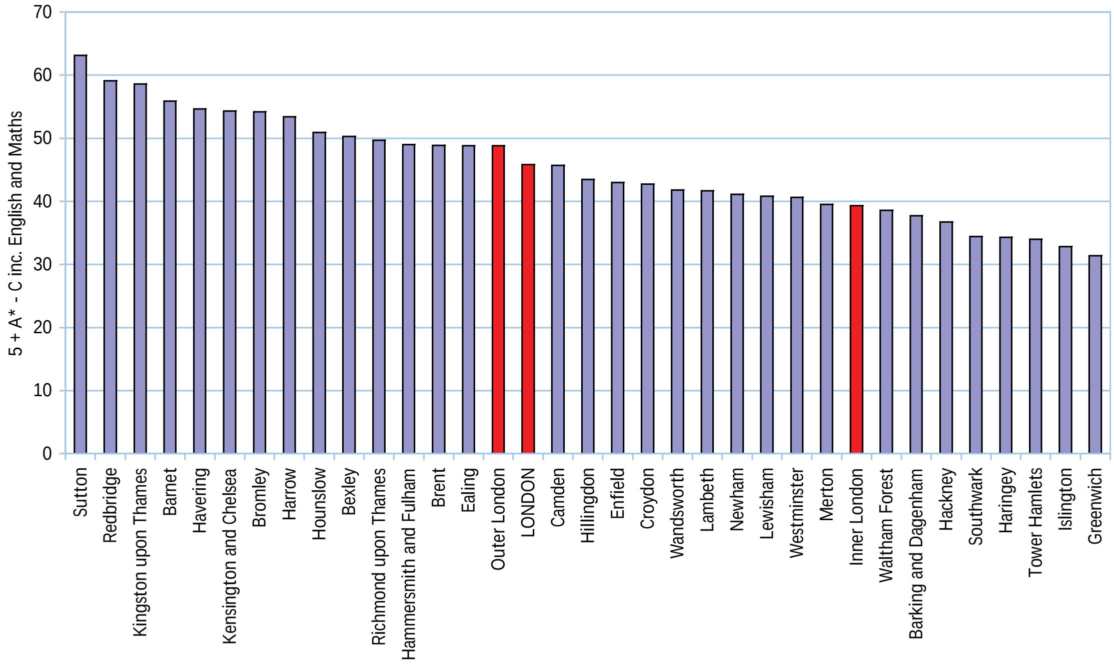


Source: DfES, 2005/2006

Research carried out for the Department for Education and Skills suggests that the educational attainment of students depends on individual characteristics (eg, prior attainment, gender, ethnicity, special educational needs and children in care), social factors (eg, parental education, involvement, expectations, peer effects) and educational factors (eg, curriculum, teacher expectations, resources, school type).[xxiii]

Moreover, Figure 6.7 suggests that there are significant variations in educational attainment across London boroughs, with the share of London's school children achieving five or more GCSEs with grades A*-C including English and Maths ranging from approximately 30 per cent to 60 per cent.

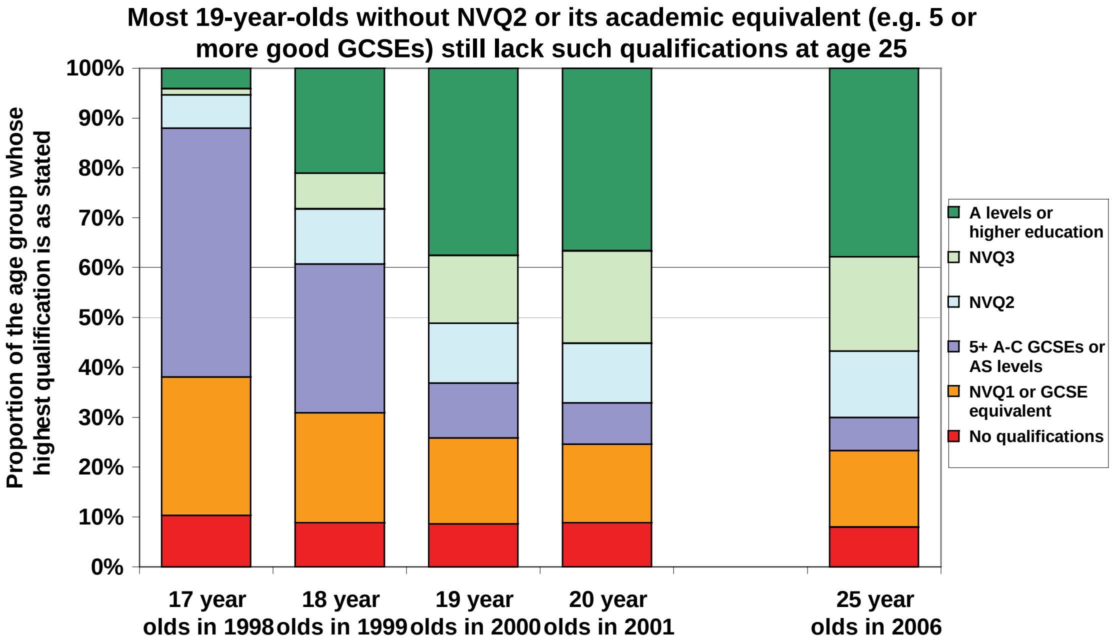
Figure 6.7: GCSE (5+ A*-C) attainment including English and Maths by London borough, (2005/06), (%)



Source: DfES, 2006

Achieving a good education first time around is important because there is little evidence that many adults with low qualifications progress through formal levels of learning beyond the age of 19 to any significant extent (as shown in Figure 6.8).

Figure 6.8: Progression of Young Adults with Low Skills



Source: Labour Force Survey, ONS; UK; updated April 2007

6.5 Employment, Unemployment and Economic Inactivity in London

6.5.1 Who is not in employment?

Around 30 per cent of London's working-age population is not in work, more than any other region of the UK. A lack of work impacts on individuals as well as the economy as a whole. As of February 2007, 1.5 million working-age adults in London from a total of 5.1 million were without work. They comprised 313,000 people who were unemployed (ie actively seeking employment and available to begin work within two weeks) and 1,233,000 economically inactive (ie without work, not seeking it or not available to start work in the next few weeks).[xxiv] The latter include students, people who are sick or disabled and people looking after their family or home. Although the economically inactive are by definition not seeking work, some 370,000 state that they would like to work.[xxv]

Until the early 1990s London's employment rate was higher than that for the UK. In the early 1990s London's relative position declined and a persistent gap has emerged between the capital and the UK as a whole. Recent analysis by GLA Economics and HM Treasury argues that London's low employment rate is a result of a number of factors including amongst others: the relatively greater concentration of those groups who experience lower employment rates wherever they are located (lone parents, people from Black, Asian and Minority Ethnic (BAME) communities; people with no qualifications; the long-term disabled, etc.);[xxvi] the relatively greater degree of competition for jobs especially at low skills levels; and an independent London effect. Table 6.2 compares rates of worklessness for different groups in London and the rest of the UK.

Table 6.2: Worklessness by Selected Characteristics

Characteristic	Rate of Worklessness	
	London	Rest of UK
Working age	31	25
Men	24	21
Women	37	29
Parents (incl. lone parents)	39	27
Fathers	26	18
Mothers	49	34
Lone parents	55	41
White	25	24
Black and minority ethnic	41	38
Born in the UK	28	25
Born abroad	36	30
16-17	85	63
18-24	48	34
50+	31	29
High skill (NVQ4+)	13	13
Mid skill (NVQ3)	31	22
Low skill (NVQ2 or less)	44	33
Owner occupiers	21	19
Rent	43	44
Social rent	38	30

Source: HM Treasury from Labour Force Survey, Spring 2006

Being out of work has a number of significant economic consequences including a loss of economic output and an increased fiscal burden on the Government. A key consequence of worklessness is its impact on children, not least because of the effect this has on educational and future work prospects of these young people.

6.5.2 Barriers to employment

Worklessness has multiple causes and research shows that these are best addressed in a holistic manner where all institutions involved work in a co-ordinated way.

Research suggests that the key barriers to work fall into four main groups, notably poor access to job opportunities, employability of individuals, employers' attitudes and practices, and other specific barriers to work. Such barriers include:

Accessing job opportunities
- Lack of information on work and training opportunities
- Lack of motivation
- Poor application, presentation, interview skills

Employability
- Lack of basic skills: language, literacy, numeracy, IT
- Lack of job-specific skills relevant to the available work
- Lack of recent work experience
- Personal and behavioural problems
- Record of offending

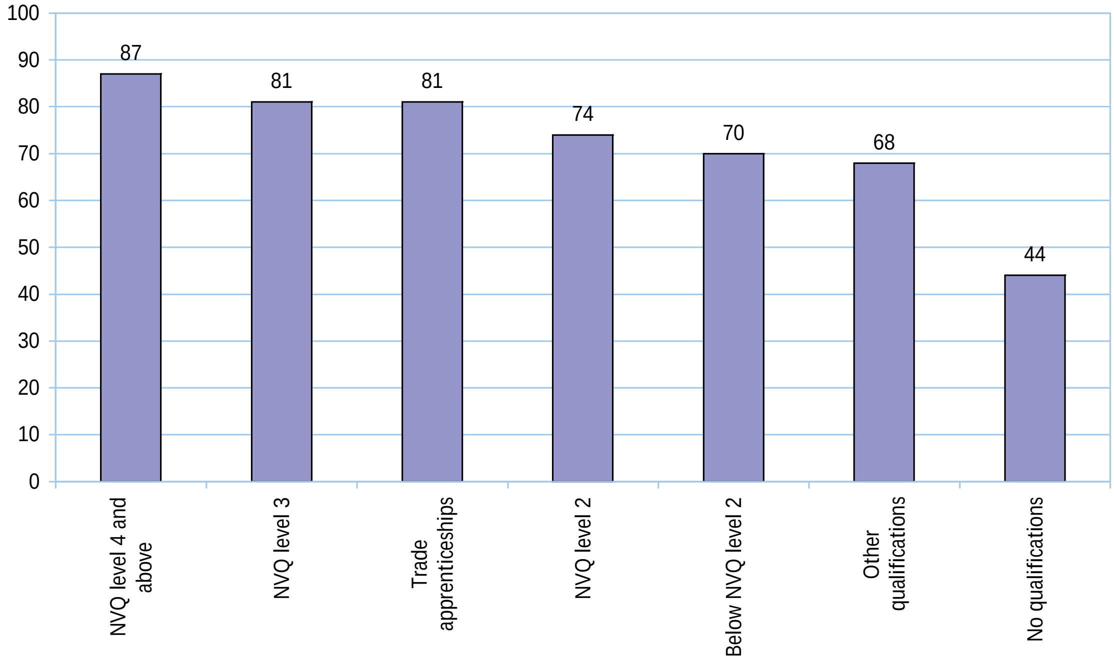
Employer attitudes and practices
- Reluctance to recruit unemployed, especially long-term unemployed people
- Discrimination on the basis of race, age, disability
- Requirement for formal qualifications
- Use of informal recruitment channels

Other specific barriers to work
- Childcare responsibilities
- Distance to work opportunities and cost of getting there
- Cost of work-related training and education
- Cost of work-related equipment
- Problems of health or disability
- Concern over financial benefits or insecurity of work

6.5.3 Skills and being out of work

Lack of skills and qualifications can be a barrier that prevents some people from working, although it is unlikely that a lack of skills on its own is the main cause of worklessness for many people.

Figure 6.9: Employment rates in London by qualification level, 2005 (%)



Source: Annual Population Survey, 2005

In London the lack of basic skills – or basic qualifications – appears to be a major factor for some individuals' employment prospects. As shown in Figure 6.9 the employment rate for individuals with any qualification is 68 per cent or higher, compared to only 44 per cent for those with no qualifications. Furthermore, according to cost-benefit analysis conducted for the Leitch Review, basic skills have high benefit-to-cost ratios when compared to other training initiatives. Additionally, the Leitch Review concluded that market failures in skills 'are more likely to impact at the lower end of the labour market, meaning that government intervention is most justified in low skills'.[xxvii]

6.6 Conclusion

London offers a plentiful supply of highly skilled workers to meet the needs of its businesses. A significant factor here is London's ability to attract highly skilled migrants from both the rest of the UK and internationally. There are challenges at the lower end of the London labour market and a need to improve London school students' educational achievements. London has a high rate of worklessness that needs to be addressed; notably, individuals with no formal qualifications have a much lower propensity to be in work.

This supplement provides a short overview of some of the points covered in the LSEB's evidence base. The main strategy is now being drafted to try and address some of the issues highlighted here.

Appendix A: Explanation of terms and some sources

Definitions, differences, and revisions

Forecasting organisations use varying definitions of the regional indicators they supply. It is not therefore always possible to assign a completely consistent meaning to the terms used.

Throughout this report, as far as is compatible with the individual definitions applied by the forecasters, 'employment' refers to 'workforce employment' as defined in, *Labour Market Trends. London's Economic Outlook: December 2003* and The GLA's *Workforce Employment Series* provide a more detailed explanation of this term.

Forecasters' definitions are broadly compatible with this but in some cases differences arise from the treatment of small items such as participants in government training schemes or the armed forces. The GLA uses civilian workforce employment throughout.

Output refers to GVA, a term introduced by the 1995 revision of the European System of Accounts (ESA95). Some forecasters still estimate GDP which can differ slightly from GVA. Imputed rental income from the ownership of property is included in some cases but not in others. GLA Economics' *London's Economic Outlook: December 2003* provides a more detailed explanation of this term.

Estimates of nominal regional GVA are available up to 2005 from the ONS. No official estimates of real regional GVA are available because of the difficulties in producing authoritative regional price deflators, although the ONS has now produced regional price indexes for the year 2004[xxviii]. Most regional forecasters supply their own estimates of London's real GVA. The real London GVA figures used in the GLA Economics' forecast are supplied by EBS.

GVA estimates are less reliable than employment estimates because there is no independent source of information from which to judge the size of total sales by London-based agents. ONS estimates are calculated by the factor incomes method, beginning from wages paid to people with workforce jobs located in London. Profits are imputed on the basis of these earnings estimates from knowledge of national sectors of employment. Most regional forecasters adopt a variant of this technique.

Consumption refers to private consumption, otherwise known as household expenditure; in some cases the expenditure of non-profit organisations is included and in other cases it is not.

Appendix B: Glossary of acronyms

bn	Billion
BRC	British Retail Consortium
CE	Cambridge Econometrics
CEBR	The Centre for Economic and Business Research
CIPS	The Chartered Institute of Purchasing and Supply
CPI	Consumer Price Index
EBS	Experian Business Strategies
ECB	European Central Bank
EU	European Union
FDI	Foreign Direct Investment
FT	Financial Times
GDP	Gross Domestic Product
GLA	Greater London Authority
GVA	Gross Value Added
HBOS	Halifax Bank of Scotland
HM Treasury	Her Majesty's Treasury
ILO	International Labour Organisation
IMF	International Monetary Fund
IPO	Initial Public Offering
LEO	London's Economic Outlook
LFS	Labour Force Survey
LHS	Left Hand Scale
mn	Million
MPC	Monetary Policy Committee
OE	Oxford Economics
OECD	Organisation for Economic Co-operation and Development
ONS	Office for National Statistics
OPEC	Organisation of Petroleum Exporting Countries
PMI	Purchasing Managers' Index
PSNB	Public Sector Net Borrowing
Q2	Second Quarter
R&D	Research and Development
RHS	Right Hand Scale
RPIX	Retail Price Index (excluding mortgage interest payments)
RPI	Retail Price Index
TfL	Transport for London
US	United States of America

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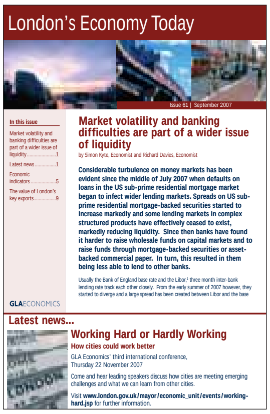
Footnotes

[i] The forecast is based on an in-house model built by Volterra Consulting Limited.
[ii] RPIX = Retail price index excluding mortgage interest payments. Although not part of the GLA Economics forecast for London, for reader information HM Treasury Consensus Forecast, August 2007 of the RPIX UK inflation rate are reported. Up to December 2003, the Bank of England's symmetrical inflation target was annual RPIX inflation at 2.5 per cent.
[iii] CPI = Consumer Price Index. Although not part of the GLA Economics forecast for London, for reader information HM Treasury Consensus Forecast, August 2007 of the UK CPI inflation rate are reported. Since December 2003 the Bank of England's symmetrical inflation target has been annual CPI inflation at 2 per cent.
[iv] Corporation of London, City News Monitor, 22 August-28 August 2007.
[v] Knight Frank, Central London Quarterly, Quarter 2 2007.
[vi] Bank of England Inflation Report, August 2007.
[vii] The Sterling Effective Exchange Rate Index measures the overall change in the trade-weighted exchange value of sterling. It is designed to measure changes in the price competitiveness of traded goods and services and so the weights reflect trade flows in goods and services.
[viii] BBC, 'Rate rises crimp consumer sales', 2 September 2007.
[ix] These quoted interest rates are simply the average of the Bank's sampled institutions' announced interest rates for new and existing customers, as posted on *Moneyfacts*.
[x] Besley, T, (2007), 'Consumption and Interest Rates', a speech given to the Centre for Economic Policy Research, 19 July 2007.
[xi] BBC, 'Chinese inflation at decade high', 11 September 2007.
[xii] BBC,'China trade surplus still strong', 12 October 2007.
[xiii] BBC, 'Indian growth tops expectations', 31 August 2007.
[xiv] The Economist, 'Economics focus, The Madarins of money', 11 August 2007.
[xv] BBC, 'Fed warns of $100bn credit losses', 20 July 2007.
[xvi] Most forecasters do not yet provide forecasts of household income.
[xvii]GLA Economics, February 2007, Working Paper 20: Employment projections for London by sector and borough.
[xviii] For 2007: the median of new forecasts from HM Treasury, August 2007, Comparison of Independent Forecasts. For 2008 onwards: the average of medium-term forecasts from the same publication.
[xix] Corporation of London (2004) 'The City's Importance to the EU Economy'.
[xx] The definition of qualifications has its limitations since it does not necessarily reflect the skills/competence level of workers in full. However, qualifications are easily measured and so for statistical purposes qualifications are usually used as an approximation for skills. However, it is acknowledged that many skills that are of value to businesses will be acquired through work experience, or other means, and not necessarily through qualifications.
[xxi] Cambridge Econometrics/Institute for Employment Research (2006) Working Futures 2004-2014: Spatial Report. Sector Skills Development Agency/Institute for Employment Research: Coventry, by A. Green, K. Homenidou, R. White and R. Wilson.
[xxii] National Employer Skills Survey 2005: Main Report, June 2006, Learning and Skills Council.
[xxiii] Social Mobility: Narrowing Social Class Educational Attainment Gaps, Supporting Materials to a speech by the Rt. Hon Ruth Kelly MP Secretary of State for Education and Skills to the Institute for Public Policy Research, 26 April 2006 available on
http://www.dfes.gov.uk/rsgateway/DB/STA/t000657/SocialMobility26Apr06.pdf.
[xxiv] The term unemployed refers to the International Labour Organization (ILO) definition (ie, jobless people who want to work, are available to work, and are actively seeking employment). A separate definition - the claimant count - measures how many unemployed people are claiming unemployment-related benefits.
[xxv] Labour Market Statistics, June 2007: London, National Statistics, First Release.
[xxvi] Meadows, P. (2006) Worklessness in London, GLA Economics Working Paper 15, Report to: Greater London Authority and HM Treasury (2006), 'Employment opportunity for all: Analysing labour market trends in London'.
[xxvii] HM Treasury, Leitch Review of Skills (2006), p.59.
[xxviii] Fenwick D and Wingfield D, 2005, Relative Regional Consumer Price Levels in 2004, Economic Trends No. 615, ONS, February 2005.

other publications



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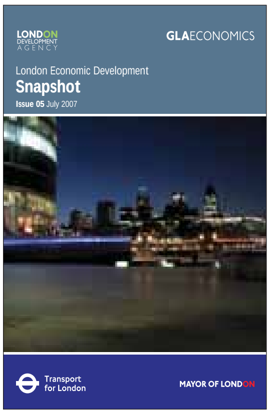

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Greek

Αν θέλετε να αποκτήσετε αντίγραφο του παρόντος εγγράφου στη δική σας γλώσσα, παρακαλείστε να επικοινωνήσετε τηλεφωνικά στον αριθμό αυτό ή ταχυδρομικά στην παρακάτω διεύθυνση.

Turkish

Bu belgenin kendi dilinizde hazırlanmış bir nüshasını edinmek için, lütfen aşağıdaki telefon numarasını arayınız veya adrese başvurunuz.

Punjabi

ਜੇ ਤੁਹਾਨੂੰ ਇਸ ਦਸਤਾਵੇਜ਼ ਦੀ ਕਾਪੀ ਤੁਹਾਡੀ ਆਪਣੀ ਭਾਸ਼ਾ ਵਿਚ ਚਾਹੀਦੀ ਹੈ, ਤਾਂ ਹੇਠ ਲਿਖੇ ਨੰਬਰ 'ਤੇ ਫ਼ੋਨ ਕਰੋ ਜਾਂ ਹੇਠ ਲਿਖੇ ਪਤੇ 'ਤੇ ਰਾਬਤਾ ਕਰੋ:

Hindi

यदि आप इस दस्तावेज की प्रति अपनी भाषा में चाहते हैं, तो कृपया निम्नलिखित नंबर पर फोन करें अथवा नीचे दिये गये पते पर संपर्क करें

Bengali

আপনি যদি আপনার ভাষায় এই দলিলের প্রতিলিপি (কপি) চান, তা হলে নীচের ফোন্ নম্বরে বা ঠিকানায় অনুগ্রহ করে যোগাযোগ করুন।

Urdu

اگر آپ اِس دستاویز کی نقل اپنی زبان میں چاھتے ھیں، تو براہ کرم نیچے دئے گئے نمبر پر فون کریں یا دیئے گئے پتے پر رابطہ کریں

Arabic

إذا أردت نسخة من هذه الوثيقة بلغتك، يرجى الاتصال برقم الهاتف أو مراسلة العنوان أدناه

Gujarati

જો તમને આ દસ્તાવેજની નકલ તમારી ભાષામાં જોઈતી હોય તો, કૃપા કરી આપેલ નંબર ઉપર ફોન કરો અથવા નીચેના સરનામે સંપર્ક સાધો.