GLA ECONOMICS

London's Economic Outlook

The GLA's medium-term planning projections

December 2003

Transport for London

LONDON DEVELOPMENT AGENCY

MAYOR OF LONDON

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The Mayor of London established GLA Economics in May 2002 to provide a firm statistical, factual and forecasting basis for policy decision-making by the GLA group. GLA Economics is funded by Transport for London (TfL), the London Development Agency (LDA) and the Greater London Authority (GLA).

Contents

What this report is for
London's Economic Outlook presents the third London forecast commissioned by GLA Economics and prepared by EBS. The GLA produces the forecast to assist planning projections for London in the medium term. The forecast provides projections for the major variables required for planning purposes – output, consumer expenditure and employment in London.

If you require forecasts for other economic variables, GLA Economics may be able to assist or include additional variables in future issues.

Economic forecasting is not a precise science. These projections provide an indication of what is judged to be most likely to happen in the London economy, not what will happen.

What it contains
Chapter 1 reviews recent world and UK economic events. Chapter 2 contains the GLA's review of independent London forecasts (the 'consensus' forecast). The GLA's forecast is in Chapter 3. In addition, as the forthcoming HM Treasury Spending Review for London has critical implications for London, Chapter 4 analyses the possible consequences of this process.

Economic forecasts represent the forecaster's view as to the most likely future path of the economy, and are inherently uncertain. The review of independent forecasts provides some indication of the range of alternative opinions. GLA Economics has also commissioned a second scenario, based on higher UK growth rates, to give some indication of the upside risks associated with its baseline forecast which is included with the main forecast in Chapter 3.

What variables are forecast?
Both the consensus forecast and the main forecast report on three main indicators of London's economic performance: workforce employment, real output, and private consumption (household expenditure) in London. Both annual growth rates and 'standardised' absolute levels (see Chapter 2) are reported.

In each case, the main forecast variables are compared with previous history from 1982 to the present, and the main forecast is also compared with our previous two forecasts. The forecast horizon is 2003-2005.

Both forecasts also provide predictions of growth rates for employment and output in six broad sectors:

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

Summary

The GLA's third London forecast predicts[1] that:

- After a slowdown that has been minor compared with the last two decades, London's economy is on course for recovery.
- In 2003, jobs have grown faster than expected and are set to reach 4.56 million – their highest level since 1974 – by the end of the year.
- Consumer spending, which propelled the UK and London economies through the downturn, is expected to fall below trend in 2004, although capital spending is expected to take up some of the slack.
- This is expected to lead to slower but still positive growth, with London's total jobs reaching 4.59 million in 2005
- Real output is projected to pick up slowly and growth is only likely to exceed its trend rate when it reaches 3 per cent in 2005.
- Finance and Business are expected to lead output growth, with Transport and Communications a strong second.
- Public Services and Distribution are projected to be the main sources of job growth.

Table 1 Projected growth: GVA, jobs and household sending

	2003	2004	2005
London GVA	0.7	1.9	3.0
London civilian workforce jobs	1.5	0.1	0.6
London household spending	1.0	0.9	1.8
Memo: Projected UK inflation rate[2]	*2.8*	*2.5*	*1.9*

Source: Experian Business Strategies
Notes: All figures represent annual growth rates. Output is Gross Value Added (GVA) measured in prices of the year 2000 (see Appendix 1 and below).

The predictions are supported strongly by London's independent forecasters, whose consensus conclusions are published here with the GLA's own forecast.

The GLA forecast takes full account of new official data on regional output. The GLA's forecast supplier, EBS, has replaced its estimates of output with new data based on 2000 weights. As a result, London's recent growth rate and its share of UK output have increased.

Downside risks include residual uncertainties in the world economy. These uncertainties are receding as the recovery spreads to Europe, although the twin US deficits – budget and trade – and the stability of the dollar are considerable cause for concern. Current levels of retail spending may prove unsustainable if interest rates rise, and a reduced rate of growth in government spending appears likely.

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[1] For an explanation of the terms used, see Appendix 1.
[2] Retail Price Index inflation (without mortgage interest). While not part of the GLA Economics forecast for London, the forecaster's view of the inflation rate is reported for information.

On the upside, there is every possibility the UK will grow faster than the rather cautious consensus estimates on which the GLA forecast is based. If the UK grows for the next two years, even at the 3 per cent rate projected by the Bank of England, London's jobs are expected to reach 4.63 million and output growth would rise to 3.4 per cent by 2005. As the markets pick up, London's premier role as a global financial centre will ensure that it drives the UK economy.

The balance of risks is probably on the upside in the short term, but further out the threat of a sudden and ugly readjustment of the twin US deficits loom larger.

1. Background: The world and UK economic situation

The world economy

The world economy has turned the corner. Third quarter provisional estimates of gross domestic product (GDP) suggest that growth has spread to all major regions of the world. A definite recovery has begun, even if it is uneven so far. The United States (US) is leading with annualised third-quarter growth, compared to the previous quarter, of 7.2 per cent (Table 1.1). US employment is also on the rise, growing by 120,000 in both September and October. Europe, whose slow recovery has been cause for concern, has shown its first definite sign of growth since the third quarter of 2002, with positive growth in the core French, German and Italian economies.

Table 1.1 Output growth rates
Selected OECD countries

	2001		2002				2003		
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
US	-0.1	0.7	1.2	0.3	1.0	0.3	0.4	0.8	1.7
Japan	-0.8	-0.5	0.1	0.7	1.2	0.4	0.5	0.9	0.6
France	0.4	-0.3	0.7	0.7	0.2	-0.3	0.1	-0.3	0.4
Germany	-0.2	-0.1	0.2	0.2	0.1	0.0	-0.2	-0.2	0.2
Italy	0.0	-0.1	0.0	0.3	0.2	0.4	-0.2	-0.1	0.5
UK	0.3	0.4	0.3	0.5	0.7	0.6	0.2	0.6	0.7

Source: OECD, ONS (UK only)
Notes: Units: per cent growth from last quarter, national currency, constant price

China's dynamism has spread to neighbouring economies. After several years of negative or low growth, Japan has posted third-quarter growth of 0.6 per cent on the previous quarter, its seventh successive quarter of expansion.

Rising rates of investment are sending a cautious sign that the recovery is becoming more balanced, as capital spending takes up some of the demand previously generated by consumers.

Table 1.2 Fixed investment growth rates

	2001		2002				2003		
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
UK	3.9	-1.8	-1.8	1.9	2.3	4.8	5.0	1.5	0.0
US	-5.1	-6.7	-6.3	-3.7	-2.7	0.6	0.7	2.7	6.2
Japan	-1.7	-8.3	-8.4	-6.3	-4.4	0.6	1.8	5.2	5.9
Germany	-5.7	-6.0	-6.4	-7.9	-6.4	-5.1	-4.4	-1.1	
France	1.9	-0.8	-1.3	-0.7	-1.5	-2.2	-1.9	-1.8	
Italy	0.8	1.9	-2.2	-1.3	1.2	5.1	0.9	-0.8	
Canada	1.6	-1.6	0.6	-0.4	-2.2	1.3	2.3	2.7	
G7	-2.7	-5.3	-5.4	-3.7	-2.7	0.4	0.5	2.1	

Source: HM Treasury Pocket Databank
Notes: Units: per cent growth on same quarter last year, national currency, constant prices

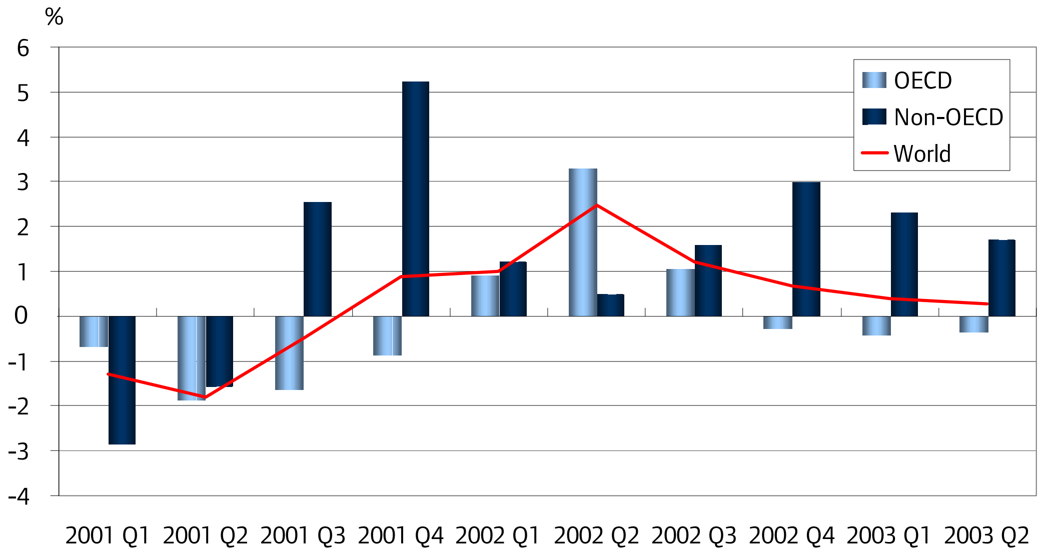
Trade growth has followed in the wake of expansion. World exports have now expanded every quarter since the fourth quarter of 2001 (Chart 1.1). However, recent developments contradict past trends. As the IMF notes in its September 2003 *World Economic Outlook*, world trade between 1995 and 2002 expanded at an annual rate of 6 per cent, between 2 and 3 per cent above the level of output growth.

This trend has not been maintained in the last year. The exports of OECD countries have receded and export growth has been dominated by non-OECD countries which account for a relatively small proportion (about a quarter) of world exports.

The upturn is sparking recovery in a growing number of emerging or newly-industrialising markets. China's seasonally adjusted GDP growth is rising at an annual rate of 18 per cent, Singapore and Taiwan by 17 per cent respectively, Russia by 8 per cent, Argentina by 12.5 per cent and Brazil by 4 per cent.[3] Until new data confirms the previous rate of trade expansion will be maintained, it is uncertain whether this can fuel the expansion of the G7 countries to the extent it has in the past.

[3] *The Economist* 22 November 2003 and J.P. Morgan Chase.

Chart 1.1 World exports
Annualised per cent growth on previous quarter



Source: OECD
Notes: Units: Current US dollars at current exchange rates

Downside risks centre on uncertainties in world financial markets provoked by the size of the US deficit. The recovery is uneven, with Europe lagging behind the US and now Asia. With US growth outstripping other G7 countries, it requires even more imports which may not be counterbalanced by a matching rise in exports to its more slowly-growing trade partners. Its expansion is financed by inward flows of capital which are placed at risk by the declining value of dollar assets. The US dollar fell from €1.1 to €0.83 in the last two years – an all-time low – leading to a seven-year high in gold prices at $400 an ounce as investors seek a hedge against foreign exchange risk. Net inward investment into US bonds and shares fell from $50 billion in August to $4 billion in September, its lowest since 1998.[4]

Uncertainties also surround world trade in the wake of the effective breakdown of the Cancun World Trade Organisation summit in March 2003.There are fears of protectionism by the US and Europe as exemplified by the dispute over US tariffs on European steel, and from the G21 group of emerging market economies who have blocked progress towards further multilateral trade liberalisation in order to secure reduced tariffs on their own exports from the US and Europe.

The UK economy

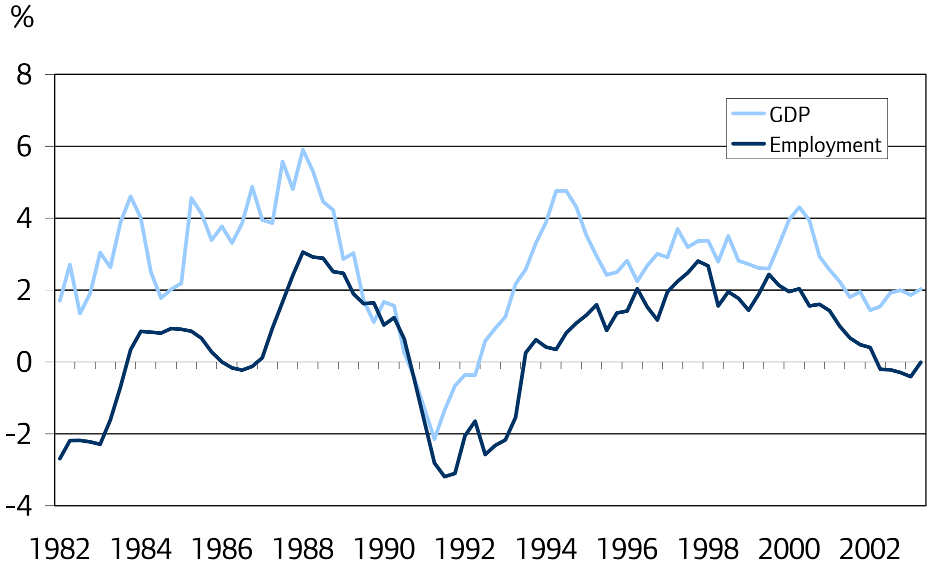
The UK is witnessing a slow recovery after passing through a benign downturn. It was among the countries least affected by the downturn after posting 46 consecutive quarters of output growth. However, this has now been below trend for ten out of 11 quarters.

A resumption of capital spending offers the healthier prospect of more balanced growth after a prolonged period in which the UK economy was sustained by consumer demand and, more lately, by government spending.

[4] *The Economist* 22 November 2003

The downside risks in the UK arise from the very factors that have sustained its economy through the world downturn: government spending and private consumption.

Chart 1.2 UK output and employment
Year-on-year growth



Source: ONS and EBS
Notes: GDP: £billion at constant 2000 prices; Employment: number of workforce jobs.

Possible constraints on government spending are examined in Chapter 3 of this report.

Consumer spending has been sustained by borrowing. As borrowing is presently associated with low interest rates compared to the recent past, private debt has risen but the burden of debt service has not. Most forecasters predict a temporary fall in consumer spending because it is expected that as output rises, inflation will rise and the Bank of England will raise interest rates. However, as yet there are no reliable indications as to how far this process will go.

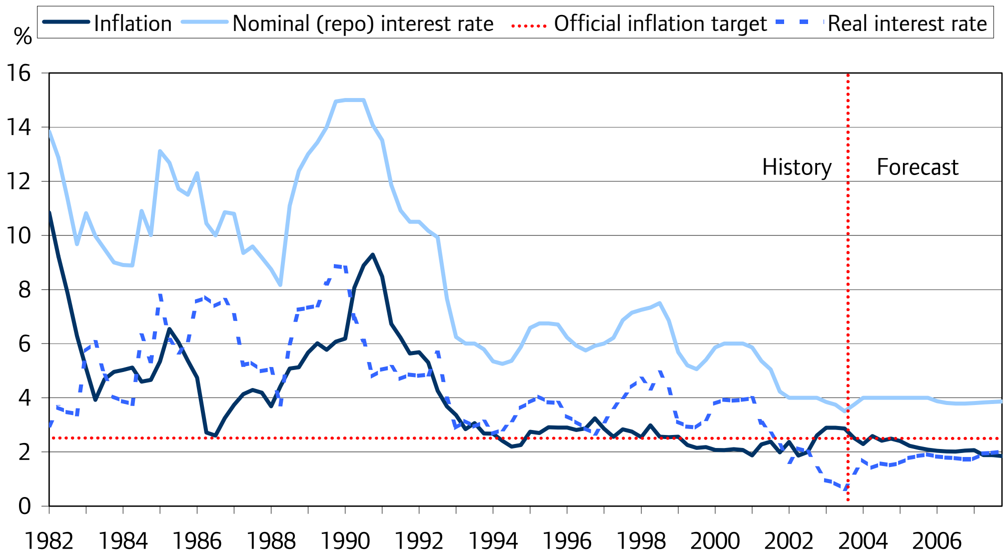
Interest rates were high throughout the 1980s for two reasons: first, because inflation was high and second, because the rate was set substantially above the rate of inflation (Chart 1.3). In other words, the real interest rate – the difference between the interest rate and inflation – was higher than it is now.

There is evidence of a long-term reduction in both the underlying inflation rate and the real interest rate, leading to a long-term reduction in the nominal interest rate. From 1982 to 1992 inflation averaged 5.7 per cent and the real interest rate 5.8 per cent, so that the nominal rate averaged 11.5 per cent. From 1992 to 2002 these figures were 2.8, 3.6 and 6.4 per cent respectively.[5] The GLA's forecasters have assumed that the low levels of inflation and interest experienced at the beginning of this century will be sustained, with a slight rise in interest rates up to about 4 per cent over the forecast horizon accompanied by inflation below the Bank of England target (Chart 1.3). This is somewhat lower than the consensus of 5 per cent, which currently matches market expectations as shown by the price of long gilts.

[5] Source: Bank of England

If the interest rate levels expected by EBS are sustained then, based on existing debts, the level of households debt payments would remain well below the levels seen in the late 1980s and early 1990s (Chart 1.4). Therefore, a collapse in consumer spending provoked by a sudden rise in debt burdens is avoidable. However, the ratio between debt and household income has already risen to around 1.4, a historic high compared even to what it was when the equity bubble burst at the end of the 1980s, when it peaked at 1.1. So a substantial rise in interest rates, above the EBS projections, would be likely to have a more significant effect on consumer spending.

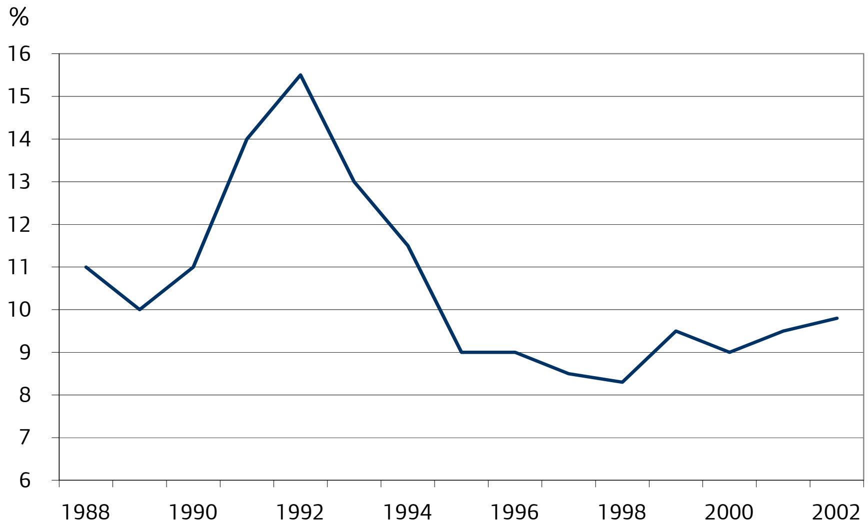
Chart 1.3 Interest rates and underlying inflation



Source: EBS and the Bank of England
Notes: Interest rate: the Bank of England Repo rate; Inflation: Retail Price Index inflation

Moreover, in a climate where consumers expect interest rates to rise, it is likely that borrowing decisions will be reviewed or curtailed. As a result, EBS and most forecasters predict the growth in consumer spending will tail off next year.

Chart 1.4 Interest plus mortgage payments
Per cent of disposable income

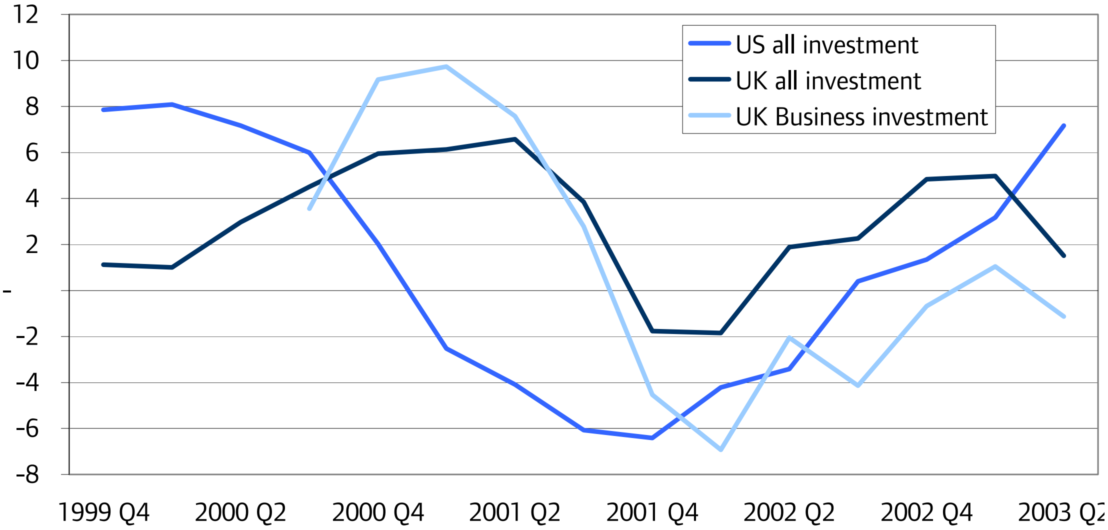


Source: EBS

The strongest downside risk to the UK economy is that consumer spending reduces faster the sources of demand which will need to replace it over the next period – the rate of increase of capital spending and exports. In turn, this threatens to reduce government tax revenue, and potentially government spending which has also risen rapidly over the immediate past.

Capital spending in the UK so far has been rising consistently with the world trend and with the trend in the US (Chart 1.5).

Chart 1.5 Growth in investment
Annual per cent



Sources: US data, Bureau of Economic Analysis; UK Business Investment Series NPEN; UK All Investment Series NPQT, both chained volumes at 2000 prices
Notes: All data in constant national currency
'All investment' = business investment + residential investment + purchases less sales of land and existing buildings

On the upside, London's great strength is that it is a world city. In terms of predominance in financial markets, London and New York are the world's two greatest cities, and arguably London is number one. The signs of growth in world economic activity and capital markets are now unmistakable and this creates opportunities for London's finance and business services sector to capitalise on its world dominance and resume a relatively rapid rate of expansion.

2. Consensus forecast

Summary
There is a clear consensus that London's economy has turned the corner and will grow steadily for three years. However, a return to the high rates of the late 1990s is not expected by any forecaster.

Output growth is expected to rise in 2003, 2004 and 2005, reaching above trend by the end of this period. Accompanying this change, employment growth in 2003 is now recognised by all forecasters to be higher than previously expected, with an average forecast growth of 0.9 per cent and a minimum of 0.2 per cent.

However, the consensus is that this rate of jobs growth will not be sustained in 2004 given predicted levels of output growth and higher than expected employment levels. Average employment growth in 2004 is predicted to be just above zero, and a low estimate of negative job growth (-1.1 per cent). Job growth is forecast not to rise above trend in the forecast period.

The estimates for 2003 are consistent with what has been observed in the two quarters for which provisional estimates are already available. Employment in London rose by 88,000 in June compared with the previous year, the highest annual growth of all UK regions.

The view that job growth will slacken in 2004 is consistent with the hypothesis of job hoarding put forward in the last GLA forecast, and with the pattern observed at the beginning of the last cycle in 1994. One explanation for London's exceptionally small job losses over the last three years is that employers are unwilling to shed skilled or otherwise scarce employees which they believe they will need when growth recommences. For similar reasons, London's employers could be recruiting in anticipation of a continued upturn. If growth is at the forecast level, this anticipated recruitment would be sufficient for employers to meet demand and they would not need to expand their workforce again in the next year.

Where do the forecasts come from?
The main macroeconomic aggregates are supplied to the GLA on the basis of forecasts from five organisations:

- Cambridge Econometrics (CE)
- Centre for Economic and Business Research (CEBR)
- Experian Business Strategies (EBS)
- London Economy Research Project forecast (LERP), produced by the National Institute for Economic and Social Research (NIESR), run by the London Chamber of Commerce and Industry
- Oxford Economic Forecasting (OEF).

Only the most likely outcomes predicted by the forecasting organisations are recorded here. Each forecaster may also prepare less likely scenarios but they are not shown here. However, presenting the range of the most likely outcomes from different forecasters provides some indication of the upside and downside risks to the GLA's forecast.

The low and high forecasts combine the worst or best growth forecasts taken from each year separately and come from different forecasters. The high and low estimates may not represent the view of any one forecaster over the whole of the forecast period.

What forecasts are provided?

To get a complete picture of what any forecast means for London, planners and the public must know the rate at which each variable is growing and its absolute level. It is important to know that London's workforce is expected to grow by 1.5 per cent in 2003; but it is just as important to know that in that same year it will reach 4.56 million, its highest level in 30 years.

The difficulty with providing a consensus for future levels is that forecasters do not agree on present levels. There is no official estimate of real output in London, and even definitions of employment – for which there is an official estimate – vary for a number of reasons.[6] As a result, forecasts differ not only because they predict different outcomes for the economy but also because their estimates of the basic data are not the same. For example, the lowest reported value of London's output for year 2002 at 1995 prices is £119 billion and the highest is £137 billion. At 2000 prices EBS now estimates London's output to be £156 billion.

The GLA has adopted a standard estimate of workforce employment and uses estimates of output and household expenditure produced by EBS. The forecasters' predictions are standardised using their growth estimates and the GLA's own estimates of the three main indicators. In effect, the GLA calculates what each forecaster would predict for the future if it used the EBS estimates for the past. This provides a common basis to compare the reports, removing the statistical differences that arise when forecasters adopt different definitions.[7]

Definitions, differences and revisions

As mentioned above, forecasting organisations use varying definitions of the regional indicators they supply. Therefore, it is not 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*. 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.

Consumption refers to private consumption, otherwise known as household expenditure. Sometimes the expenditure of non-profit organisations is included and sometimes it is not.

Output refers to gross value added (GVA), a term introduced by the 1995 revision of the European System of Accounts (ESA95). Some forecasters still estimate gross domestic product (GDP) which can differ slightly from GVA. Imputed rental income from the ownership of property is included in some cases and not others.

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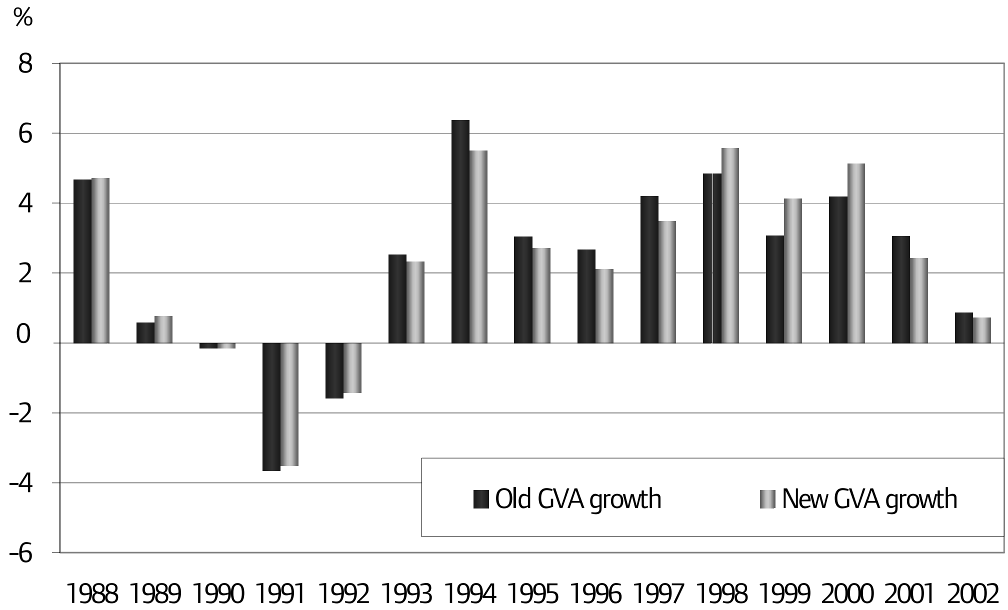
[6] For more detail see GLA 2003d

[7] A subtle point is that the level of each variable is calculated separately for each supplier before deriving the average, highest and lowest forecast. The resultant forecast may differ from that obtained by simply applying average, high and low growth rates to the GLA's standard estimates.

'Distribution' refers to Retail, Hotels and Catering. 'Public Services' refers to the Defence, Health, Education and Other Services, and all other sectors have their standard meaning.

Chart 2.1 Effect of revisions on growth rate of London GVA



Source: ONS and EBS

Two important revisions to official data have been published since our last forecast. The Office for National Statistics (ONS) has published revised estimates of London's past GVA at current prices (GLA Economics 2003e); and as a result of the chain-linking of estimates of national GDP, new weights are now available, for the year 2000, with which to transform current price estimates into constant price (real) estimates of output.

The GLA's own forecast fully incorporates these changes. Our data supplier, EBS, have taken the new regional GVA estimates supplied by the ONS as the point of departure, and in deriving year 2000 weights with which to calculate real output for London. These produce quite significant changes (Chart 2.1). The EBS figure for London's output is now measured in 2000 prices instead of 1995 prices and is different from those previously published. Growth rates are estimated to be up to 1 per cent higher than previously thought, particularly during 1998-2000, and lower than previously thought at most other times.

Not every forecaster has fully integrated the new data. These differences cause some variation between the forecasts and should be taken into account in interpreting them.

Output

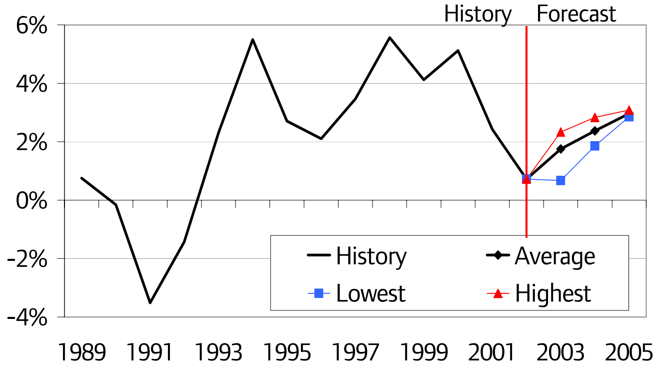
There is a consensus that the low point of London's output growth was reached in 2002, and is expected to rise in 2003 to 1.8 per cent, rising over the next two years to an above-trend rate of 3.0 per cent.

There is little divergence between forecasters, who predict that London's absolute GVA level will reach about £165 billion by 2005.

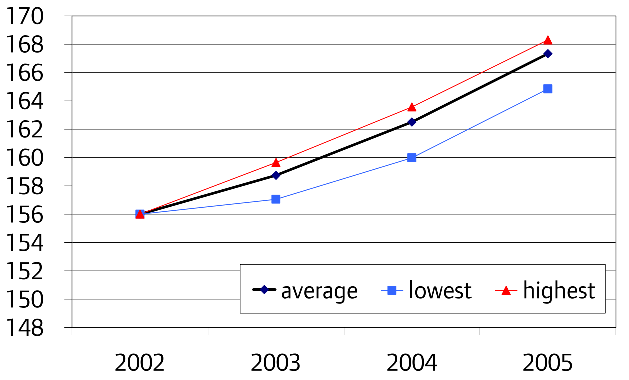
Forecasters no longer differ about whether growth will recover by 2005, differing marginally only on the timing of the process.

However, growth is not expected to reach the heights of 1994-2000, when it rose to a high of over 5.5 per cent.

Annual growth (constant year 2000 £billion)



Level (constant year 2000 £billion)



Annual growth (per cent)

	2003	2004	2005
Average	1.8	2.4	3.0
Lowest	0.7	1.9	2.9
Highest	2.3	2.8	3.1

Level (constant year 2000 £billion)

	2003	2004	2005
Average	158.7	162.5	167.3
Lowest	157.1	160.0	164.8
Highest	159.7	163.6	168.3

History: annual growth (per cent)

1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
0.8	-0.2	-3.5	-1.4	2.3	5.5	2.7	2.1	3.5	5.6	4.1	5.1	2.4	0.7

History: level (constant year 2000 £billion)

1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
117.6	117.5	113.3	111.7	114.3	120.6	123.9	126.5	130.9	138.1	143.8	151.2	154.9	156.0

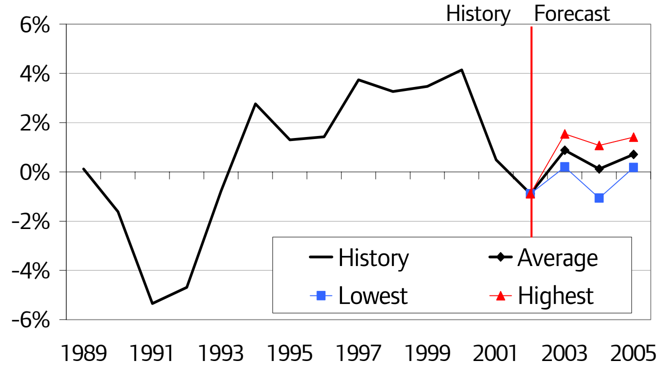
Employment: workforce jobs

The consensus is for significant job growth in 2003 (0.9 per cent), but with some job losses in 2004 (0.1 per cent) and rising in 2005 (0.7 per cent).

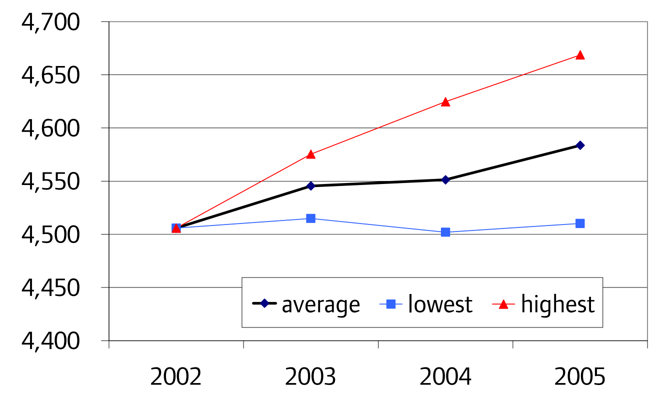
Forecasts diverge more than for output, particularly for 2004 with a low of –1.1 per cent, and a high of +1.1 per cent.

As a result, the average forecast is that London's workforce will reach 4.58 million by 2005. The low is 4.51 million and the highest is 4.67 million – a difference of 160,000 jobs.

Annual growth



Level (thousands)



Annual growth (per cent)

	2003	2004	2005
Average	0.9	0.1	0.7
Lowest	0.2	-1.1	0.2
Highest	1.5	1.1	1.4

Level (thousands)

	2003	2004	2005
Average	4,550	4,550	4,580
Lowest	4,520	4,500	4,510
Highest	4,580	4,630	4,670

History: Annual growth (per cent)

1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
0.4	-1.6	-5.4	-4.6	-0.7	2.7	1.2	1.4	2.8	3.3	3.5	4.2	0.5	-0.9

History: Level (thousands)

1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
4,240	4,170	3,950	3,770	3,740	3,840	3,890	3,940	4,050	4,180	4,330	4,510	4,530	4,490

Household expenditure

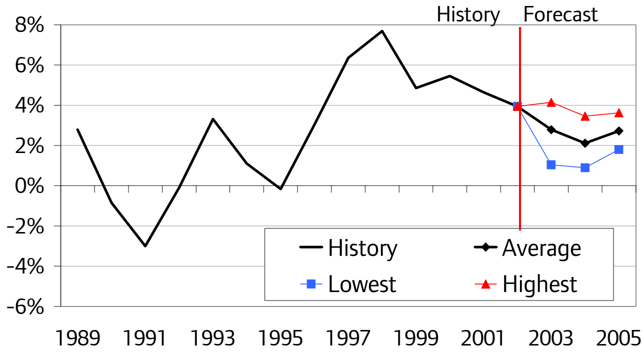
Consumer expenditure has maintained both the economy and London's economy during the last three years, growing above its trend rate of 2.65 per cent over the last cycle.

All forecasters expect growth to slacken off in 2004 as interest rates rise and consumers evaluate the levels of debt they can sustain.

The consensus is that it will fall to 2.1 per cent in 2004 and rise again above trend in 2005 when it is projected to attain 2.7 per cent.

The most pessimistic forecast predicts growth of 1.0, 0.9, and 1.8 per cent in 2003-2005 whilst the most optimistic predicts growth of 4.1, 3.5 and 3.6 per cent respectively.

Annual growth (constant year 2000 £billion)



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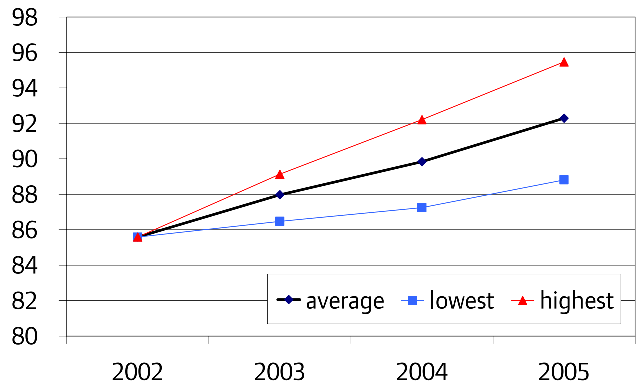


Annual growth (per cent)

	2003	2004	2005
Average	2.8	2.1	2.7
Lowest	1.0	0.9	1.8
Highest	4.1	3.5	3.6

Level (constant year 2000 £billion)

	2003	2004	2005
Average	88	90	92
Lowest	86	87	89
Highest	89	92	95

History: Annual growth (per cent)

1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
2.8	-0.8	-3.0	-0.1	3.3	1.1	-0.2	3.0	6.4	7.7	4.9	5.5	4.6	3.9

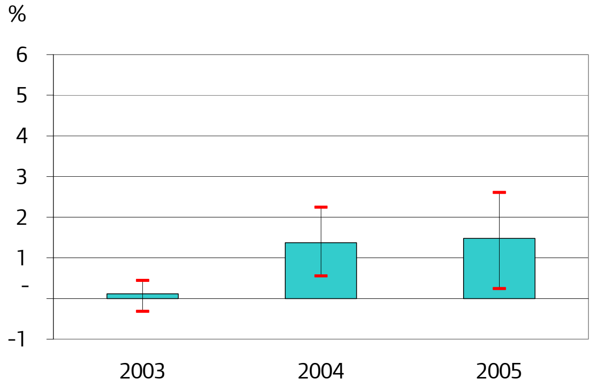
History: Level (constant year 2000 £billion)

1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
60.2	59.7	57.9	57.8	59.7	60.4	60.3	62.1	66.1	71.2	74.6	78.7	82.3	85.6

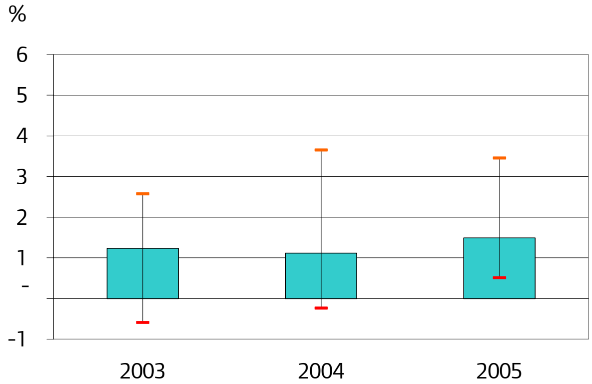
Output growth by sector

Finance and Business Services are expected to lead London's output recovery with growth rates rising to 4.2 per cent in 2005. Strong growth from Transport and Communications is also expected, rising to 4.0 per cent in 2005, and Public Services, the third largest sector, is also predicted to be a steady source of growth.

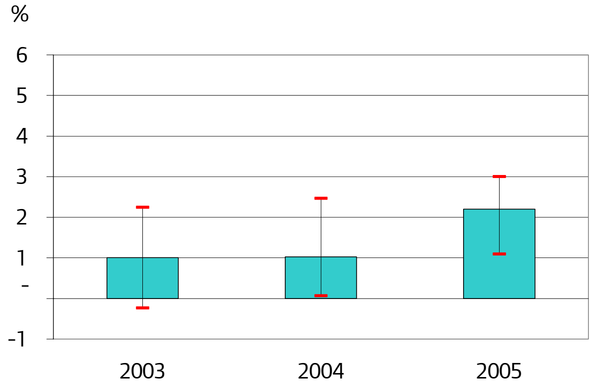
Manufacturing



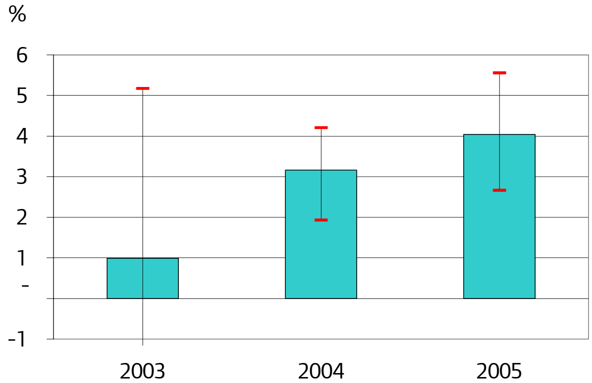
Construction



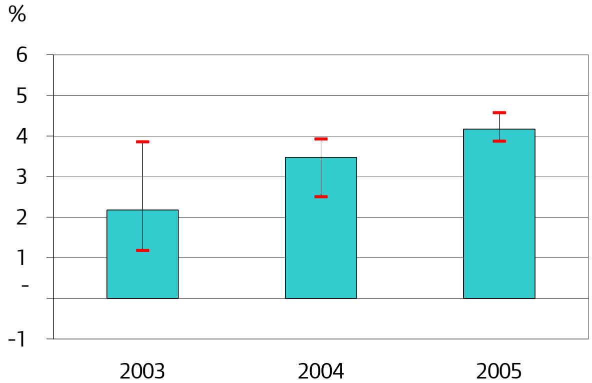
Distribution



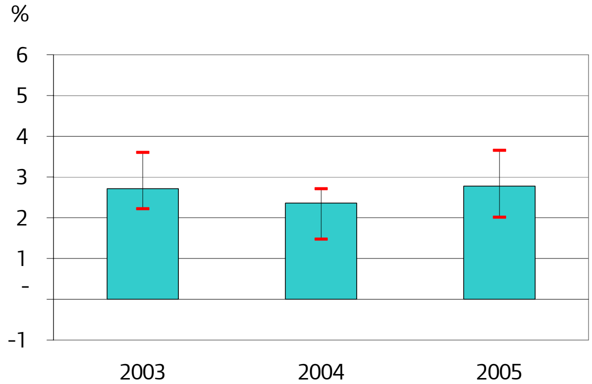
Transport



Finance and Business



Public Services



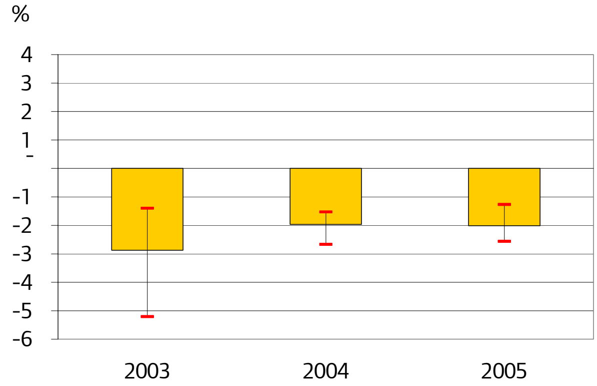
Note: In each chart, the bars represent the consensus forecast, while the top of the lines represent the highest forecasts surveyed and the bottom of the lines represent the lowest.

		2003	2004	2005			2003	2004	2005
Manufacturing	*Average*	0.1	1.4	1.5	**Construction**	*Average*	1.2	1.1	1.5
	Lowest	-0.3	0.6	0.2		*Lowest*	-0.6	-0.2	0.5
	Highest	0.4	2.2	2.6		*Highest*	2.6	3.7	3.5
Distribution	*Average*	1.0	1.0	2.2	**Transport and Communications**	*Average*	1.0	3.2	4.0
	Lowest	-0.2	0.1	1.1		*Lowest*	-4.6	1.9	2.7
	Highest	2.2	2.5	3.0		*Highest*	5.2	4.2	5.6
Finance and Business	*Average*	2.2	3.5	4.2	**Public Services**	*Average*	2.7	2.4	2.8
	Lowest	1.2	2.5	3.9		*lowest*	2.2	1.5	2.0
	Highest	3.9	3.9	4.6		*highest*	3.6	2.7	3.7

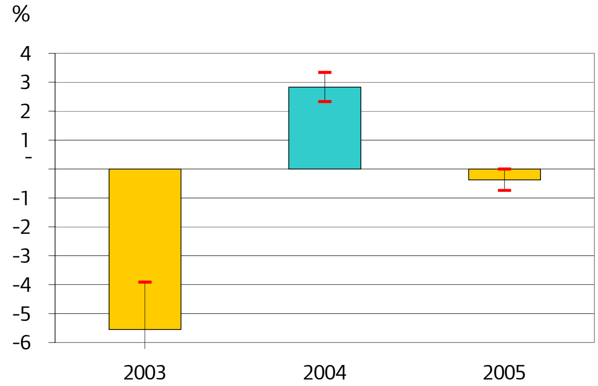
Employment growth by sector

The job picture is more mixed, with implicitly higher rates of productivity growth leading to a moderate expansion in Finance and Business Services, which is expected to shed jobs for two years before attaining growth of 1.5 per cent in 2005. No other sector dominates job creation, but Public Services are again seen as an important stabilising factor.

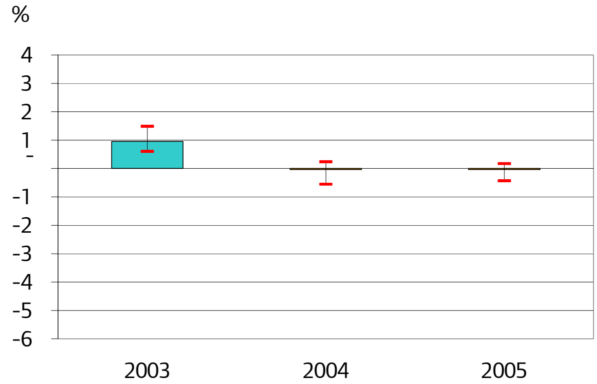
Manufacturing



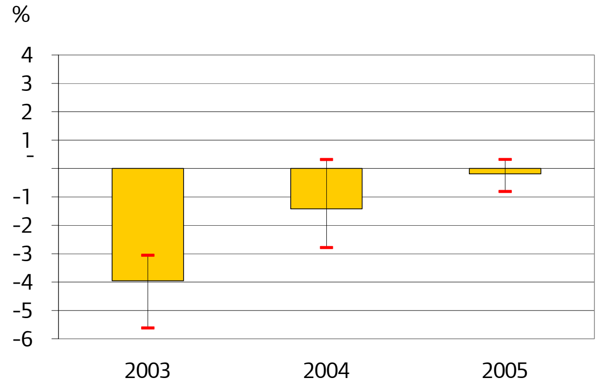
Construction



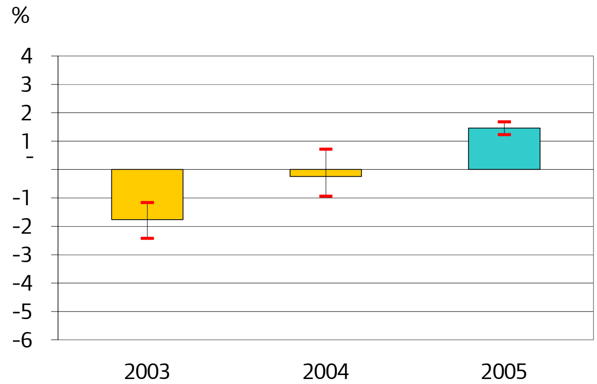
Transport



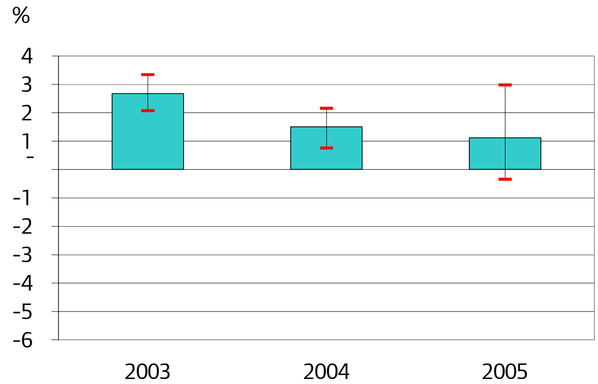
Distribution



Finance and Business



Public Services



Note: In each chart, the bars represent the consensus forecast, while the top of the lines represent the highest forecasts surveyed and the bottom of the lines represent the lowest.

		2003	2004	2005			2003	2004	2005
Manufacturing	*Average*	-2.9	-2.0	-2.0	**Construction**	*Average*	-5.6	2.8	-0.4
	Lowest	-5.2	-2.7	-2.6		*Lowest*	-7.2	2.3	-0.7
	Highest	-1.4	-1.5	-1.3		*Highest*	-3.9	3.3	0.0
Distribution	*Average*	1.0	-0.0	-0.0	**Transport and Communications**	*Average*	-4.0	-1.4	-0.2
	Lowest	0.6	-0.6	-0.4		*Lowest*	-5.6	-2.8	-0.8
	Highest	1.5	0.2	0.2		*Highest*	-3.1	0.3	0.3
Finance and Business	*Average*	-1.8	-0.2	1.5	**Public Services**	*Average*	2.7	1.5	1.1
	Lowest	-2.4	-0.9	1.2		*lowest*	2.1	0.8	-0.3
	Highest	-1.2	0.7	1.7		*highest*	3.3	2.2	3.0

3. The GLA's forecast

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 the Treasury's August and October reviews of independent forecasts of the UK economy (HM Treasury 2003b, 2003c).

The GLA's long-term projections for London are those underlying the draft London Plan as set out in *Planning for London's Growth* (GLA 2002). The model is constrained to London-based employment projections for the year 2010 derived from the long-term growth rate of London's population and the workforce.

The UK assumptions comprise the medium-term growth rates of UK total and manufacturing output (GVA), and the medium-term growth rate of household spending.

Detailed assumptions for the UK

Table 2.1 shows the assumptions adopted by the GLA for its baseline forecast and its higher-growth scenario and, for comparison, the Treasury and consensus estimates.

Table 3.1 UK economic assumptions

		2003	2004	2005	2006	2007	2008-10
Baseline forecast	GVA	1.9	2.5	2.7	2.5	2.4	2.5
	Consumption	2.5	2.2	2.2	2.5	2.6	
High growth scenario	GVA	2.0	3.0	3.0	2.8	2.5	2.5
	Consumption	2.5	2.7	2.5	2.7	2.7	
Treasury	GVA	2.0-2.5	3.0-3.5	3.0-3.5			
	Consumption	2.8-3.0	2.5-2.8	2.5-3.0			
Consensus[8]	GVA	2.3	3.3	2.7			
	Consumption	2.9	2.7				

Source: GLA Economics and HM Treasury

The GLA takes a more cautious view of the UK economy than the Treasury, adopting consensus growth estimates[9] throughout. Given sub-trend growth in 2002 and 2003, it is not unreasonable to forecast that the economy is able to grow at an above trend growth rate of 2.7 per cent in 2005 without generating inflationary pressures, followed by a return to trend in 2006. Indeed there may well be scope for further above trend growth than that embodied in the consensus.

These estimates, when applied to EBS's UK model, generate UK growth rates for manufacturing and non-manufacturing which impact on the London forecast, since it has a much higher share of non-manufacturing production than the UK average (Table 3.2).

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[8] For 2003 and 2004, the average of new forecasts from the Treasury's October *Review of Independent Forecasts (HM Treasury 2003c)*; for 2005 onwards the mean taken from the August *Review of Independent Forecasts (HM Treasury 2003b)*.
[9] For 2003 only, a growth rate of 1.9 per cent was adopted as opposed to the consensus of 2.0 per cent. This was a modelling constraint arising because GVA estimates already exist for three of the four quarters of 2003.

Table 3.2 Implicit UK growth rates

	2002	2003	2004	2005
Manufacturing output	-3.6	0.0	2.0	1.0
Non-manufacturing output	2.4	2.3	2.6	3.0

Source: EBS UK forecast using GLA Economics assumptions on UK GDP growth

Government borrowing

As discussed in Chapter 4, the Central Government's current balance and public sector net borrowing are critical determinants of future government spending, which is a key element of London's future development. GLA Economics asked EBS to forecast these as part of the output from its UK model (Table 3.3).

Table 3.3 Government borrowing forecast

	2003/04	2004/05	2005/06
General Government current surplus			
Forecast	-19.1	-21.0	-27.0
High scenario	-18.9	-18.3	-21.8
Public Sector Net Borrowing			
Forecast	37.2	37.6	43.1
High scenario	37.1	35.0	37.8

Source: EBS UK forecast using GLA Economics assumptions on UK GDP growth

Projection and forecast

It is necessary to distinguish carefully between the GLA's trend projections, which underlie the draft London Plan and 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 and 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 whether underlying trends are continuing or whether new trends are setting in. While the forecast is calibrated to the GLA's employment projections for 2010, it provides early warnings of significant deviations from these projections because it takes into account the most recent data and incorporates the latest estimates of UK growth rates.

Results
London's economy, having passed through a relatively benign downturn, is now set for a gradual but steady recovery. In line with the consensus, the GLA's forecast predicts three years of steady growth without a return to the high rates of the late 1990s.

Output growth is expected to rise in 2003, 2004 and 2005, reaching above trend by the end of this period. Accompanying this change, employment growth for 2003 is forecast to be higher than previously expected at 1.5 per cent, towards the high end of the consensus range.

Table 3.4 Forecast growth rates
Per cent

	2000	2001	2002	2003	2004	2005
GVA	5.1	2.4	0.7	0.7	1.9	3.0
High scenario				*0.7*	*2.5*	*3.4*
Civilian workforce jobs	4.2	0.5	-0.9	1.5	0.1	0.6
High scenario				*1.5*	*0.5*	*1.2*
Household Spending	4.6	3.9	4.2	1.0	0.9	1.8
High scenario				*1.0*	*1.4*	*2.2*

Source: GLA Economics and EBS

Table 3.5 Forecast levels
Constant year 2000 £billion except jobs

	2000	2001	2002	2003	2004	2005
GVA	151.2	154.9	156.0	157.1	160.0	164.8
High scenario				*157.1*	*161.0*	*166.5*
Workforce jobs (millions)	4.51	4.53	4.49	4.56	4.56	4.59
High scenario				*4.56*	*4.58*	*4.63*
Household spending	87.0	90.3	94.2	95.1	96.0	97.7
High scenario				*95.1*	*96.5*	*98.6*

Source: GLA Economics and EBS

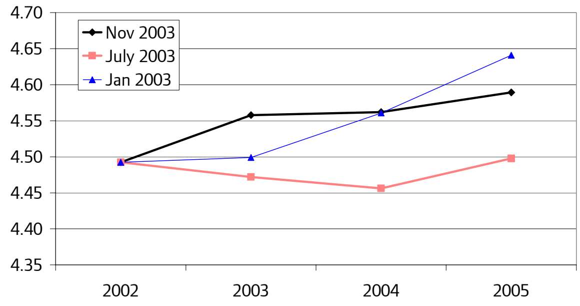
This rate of growth is not expected to be sustained in 2004 on the basis of predicted levels of output growth, and the job growth forecast for this year is towards the lower end of the consensus range at 0.1 per cent. Employment is forecast to rise slowly to 4.59 million, with growth of 0.1 per cent in 2004 followed by 0.6 per cent in 2005. On the higher growth scenario, growth of 0.5 per cent and 1.2 per cent in 2004 and 2005 respectively bring the job total up to 4.63 million.

As noted in Chapter 2.1, this general view is consistent with the consensus and, for the same reasons, compatible with the hypothesis of job hoarding put forward in the last GLA forecast.

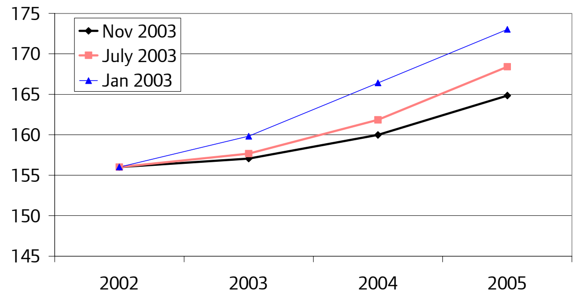
An alternative to the explanation of labour hoarding is that employment has fallen by less because the slowdown in output has been modest – certainly compared to the experience of the early 1990s. If true, this would suggest that employment might rise by more than the GLA forecast. This possibility continues to provide a significant upside risk to the GLA employment forecast for 2004.

Chart 3.1 Comparison with previous forecasts

Jobs



Output



Source: GLA Economics

The forecast is less cautious for 2003 than the GLA's January and June forecasts. Job growth of 1.5 per cent is predicted, compared with the July forecast for a 0.5 per cent decline. In part, this is informed by the encouraging growth observed in the first two quarters of this year. As noted, employment rose by 88,000 in June compared with the previous year, the highest annual growth of all UK regions.

However, as yet there are insufficient grounds to revise upwards the underlying assumptions for the growth of UK GDP, which were 1.9 per cent for 2003 and 2.6 per cent for 2004 back in June. The present forecast predicts slower output growth than in the past, remaining below trend until it reaches 3 per cent in 2005. On the higher growth scenario, London's growth remains mild but rises to trend in 2004 at 2.5 per cent.

Strong output growth is expected to return to financial and business services, with 4.1 per cent output growth in 2005. The output growth rate in Transport and Communications is forecast to increase to 5.6 per cent in 2005. Output growth in Distribution, Hotels and Catering is anticipated to stay weak in both 2003 and 2004, being more or less flat in 2003/04 and reaching only 2.1 per cent in 2005. However, consistent growth of public services is forecast to reach 2.0 per cent by 2005.

On the high scenario, Finance and Business is predicted to grow more slowly, reaching a rate of only 2.9 per cent in 2005. The expansion will be taken up by other industries, most noticeably Distribution.

This pattern of output growth is not predicted to be the same for jobs because of differences in productivity growth rates. The fastest rate of job growth is predicted for Public Services, with a low scenario job growth rate of 1.8 per cent and a high scenario job growth rate of 2.2 per cent.

This forecast is also more optimistic for 2003 than the London consensus forecasts, which predicts job growth of 0.9 for that year. For 2004, the forecast coincides with the consensus and is marginally lower in 2005 at 0.6 per cent compared with the consensus 0.7 per cent.

GVA and household expenditure comparisons with the consensus are not particularly informative. As discussed above, the GLA applies year 2000 chain-linked prices whereas not all other forecasts incorporate this recent revision.

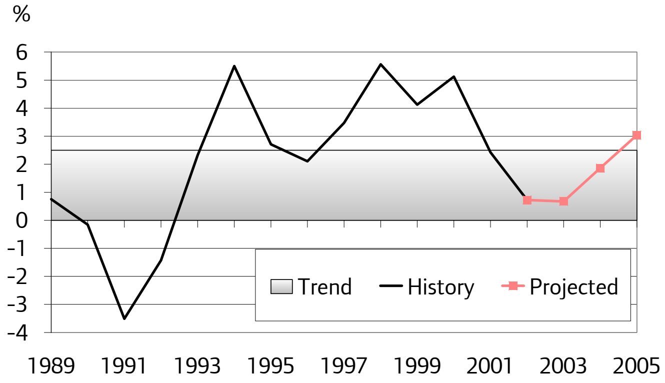
It is now clear from observation, and not just from forecasts, that the recent economic slowdown is not nearly as severe as the early 1990s. At that time there were four years of negative job growth with a low point of –5.4 per cent in 1991 and three years of negative output growth. In contrast, GVA growth has remained positive throughout the recent slowdown and in 2002 there was only a 1.1 per cent decline in employment.

Output

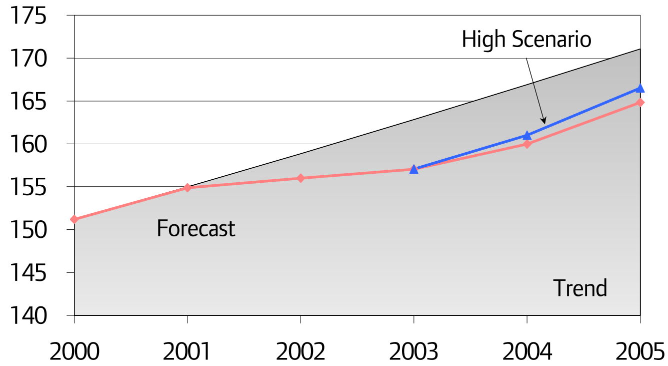
The low point of London's output growth was reached in 2002. It is projected to rise to 0.7 per cent in 2003, and to an above-trend rate of 3 per cent over the next two years.

The high growth scenario predicts a return to trend by 2004, with a growth rate of 2.5 per cent.

Annual growth



Level (constant year 2000 £billion)



Growth (annual per cent)

	2003	2004	2005
Baseline	0.7	1.9	3.0
High scenario	0.7	2.5	3.4

Level (constant year 2000 £billion)

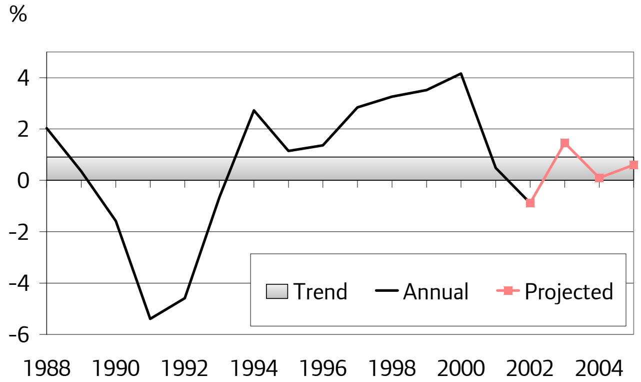
	2003	2004	2005
Baseline	157.1	160.0	164.8
High scenario	157.1	161.0	166.5

Employment

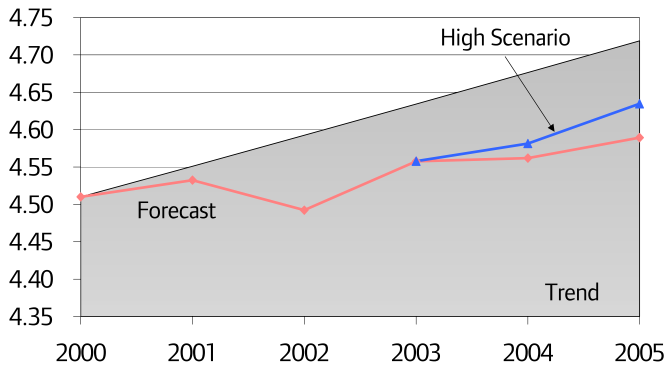
Significant job growth is projected for 2003 (1.5 per cent), but growth will slow in 2004 (0.1 per cent) before rebounding to 0.6 per cent in 2005. Workforce jobs are projected to reach 4.59 million in 2005.

The high scenario predicts a significantly faster rate of jobs growth at 0.5 per cent in 2004 and 1.2 per cent in 2005, leading to 40,000 more jobs by 2005.

Annual growth



Level (thousands of workforce jobs)



Growth (annual per cent)

	2003	2004	2005
Baseline	1.5	0.1	0.6
High scenario	1.5	0.5	1.2

Level (thousands of workforce jobs)

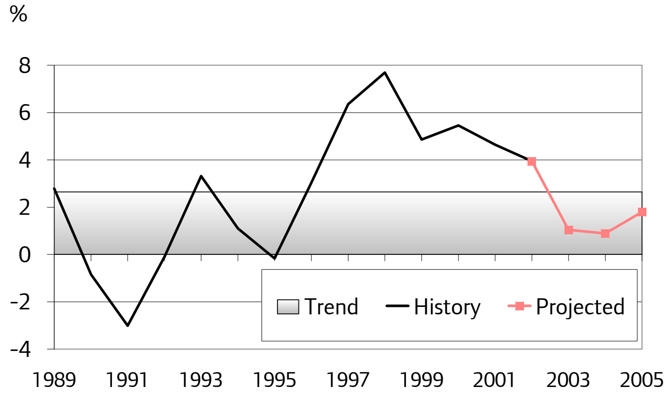
	2003	2004	2005
Baseline	4,560	4,560	4,590
High scenario	4,560	4,580	4,630

Household expenditure

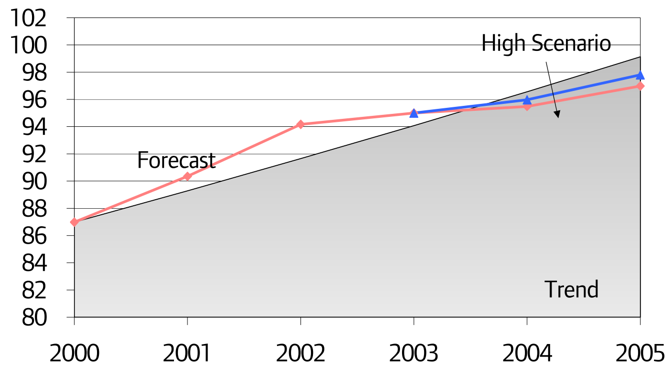
Growth in household expenditure, which has remained above its annualised trend growth rate of 2.7 per cent throughout the downturn, is forecast to slow over the next three years. It will bottom out in 2004 at 0.9 per cent and rise in 2005 to 1.8 per cent.

The high scenario predicts growth rates of 1.4 per cent in 2004 and 2.2 per cent in 2005, above the baseline but still below trend.

Annual growth



Level (constant year 2000 £billion)



Growth (annual per cent)

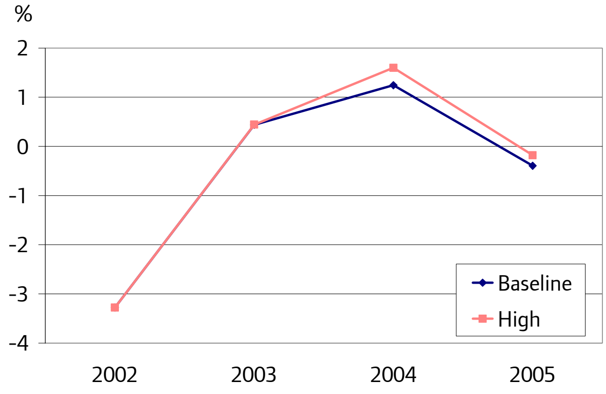
	2003	2004	2005
Baseline	1.0	0.9	1.8
High scenario	1.0	1.4	2.2

Level (constant year 2000 £billion)

	2003	2004	2005
Baseline	95.1	96.0	97.7
High scenario	95.1	96.5	98.6

Output growth by sector

Manufacturing



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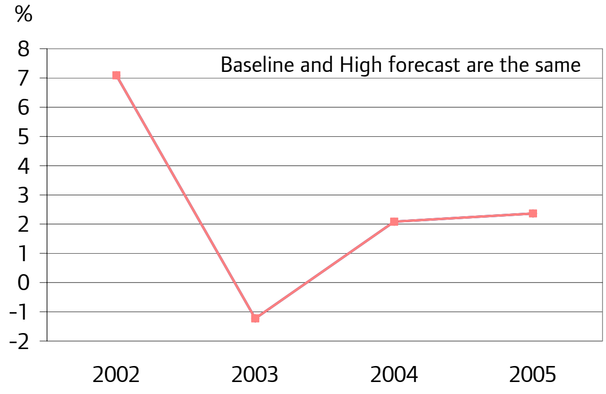
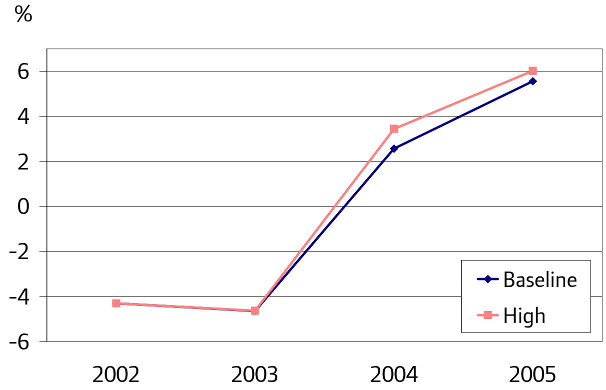
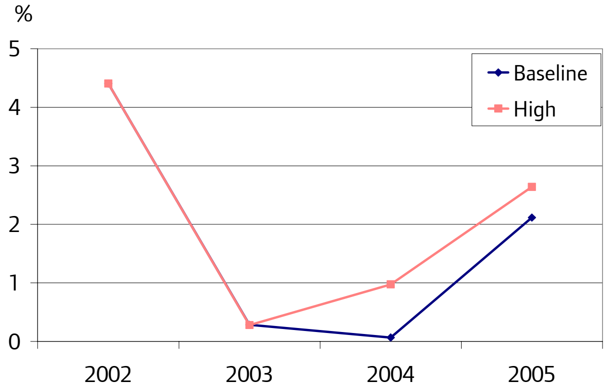


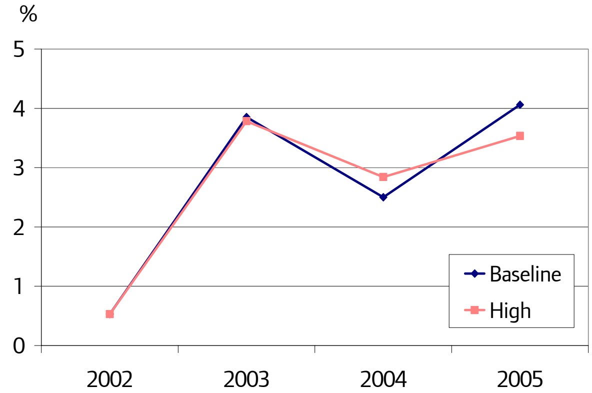
Transport



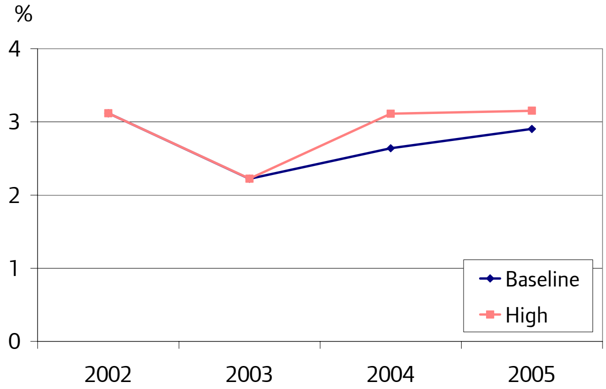
Distribution



Finance and Business



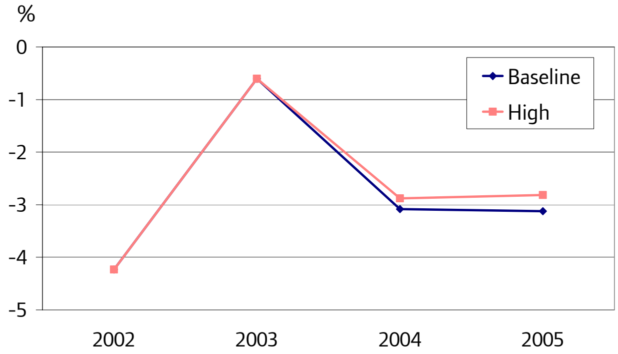
Public Services



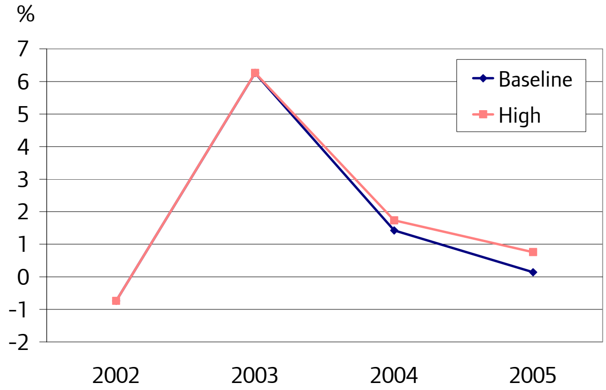
		2003	2004	2005		2003	2004	2005
Baseline	**Financial and Business Services**	3.9	2.5	4.1	**Other (Mainly Public) Services**	2.2	2.6	2.9
High		*3.9*	*2.8*	*3.5*		*2.2*	*3.1*	*3.2*
Baseline	**Distribution, Hotels, Catering**	0.3	0.1	2.1	**Manufacturing**	0.4	1.2	-0.4
High		*0.3*	*1.0*	*2.6*		*0.4*	*1.6*	*-0.2*
Baseline	**Transport and Communications**	-4.6	2.6	5.6	**Construction**	-1.2	2.1	2.4
High		*-4.6*	*3.4*	*6.0*		*1.2*	*2.1*	*2.4*
Baseline	**Memo: Non-Manufacturing**	0.7	1.9	3.3				
High		*0.7*	*1.9*	*3.3*				

Employment growth by sector

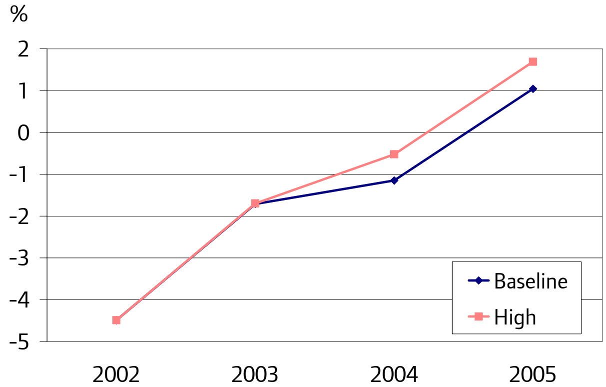
Manufacturing



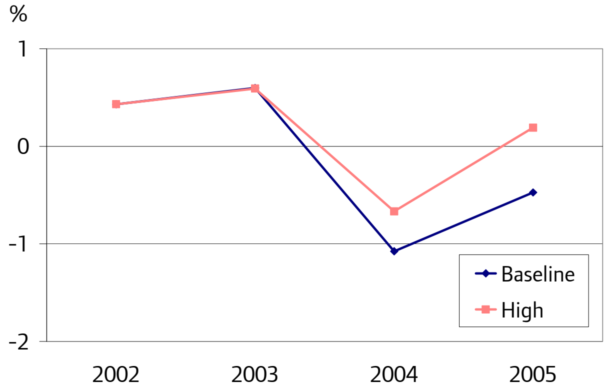
Construction



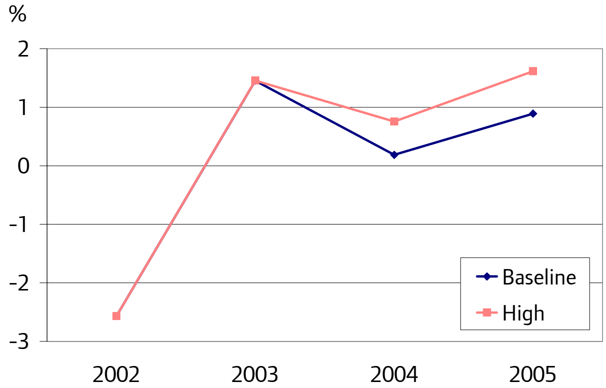
Transport



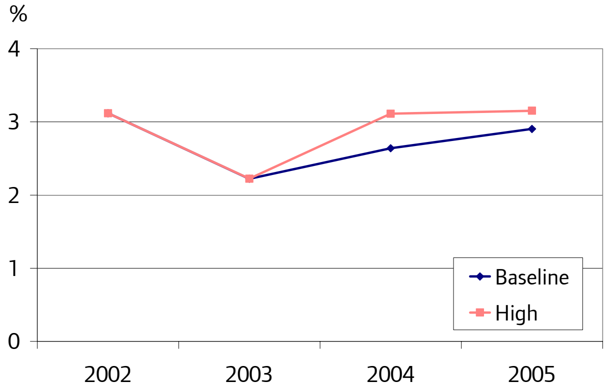
Distribution



Finance and Business



Public Services



		2003	2004	2005		2003	2004	2005
Baseline	**Financial and Business Services**	1.5	0.2	0.9	**Other (Mainly Public) Services**	2.6	1.8	1.8
High		*1.5*	*0.8*	*1.6*		*2.6*	*2.1*	*2.2*
Baseline	**Distribution, Hotels, Catering**	0.6	-1.1	-0.5	**Manufacturing**	-0.6	-3.1	-3.1
High		*0.6*	*-0.7*	*0.2*		*-0.6*	*-2.9*	*-2.8*
Baseline	**Transport and Communications**	-1.7	-1.1	1.0	**Construction**	6.3	1.4	0.1
High		*-1.7*	*-0.5*	*1.7*		*6.3*	*1.7*	*0.8*
Baseline	**Memo: Non-Manufacturing**	1.5	0.3	0.8				
High		*1.5*	*0.7*	*1.4*				

4. Some unpleasant fiscal arithmetic: the likely outcome of SR2004

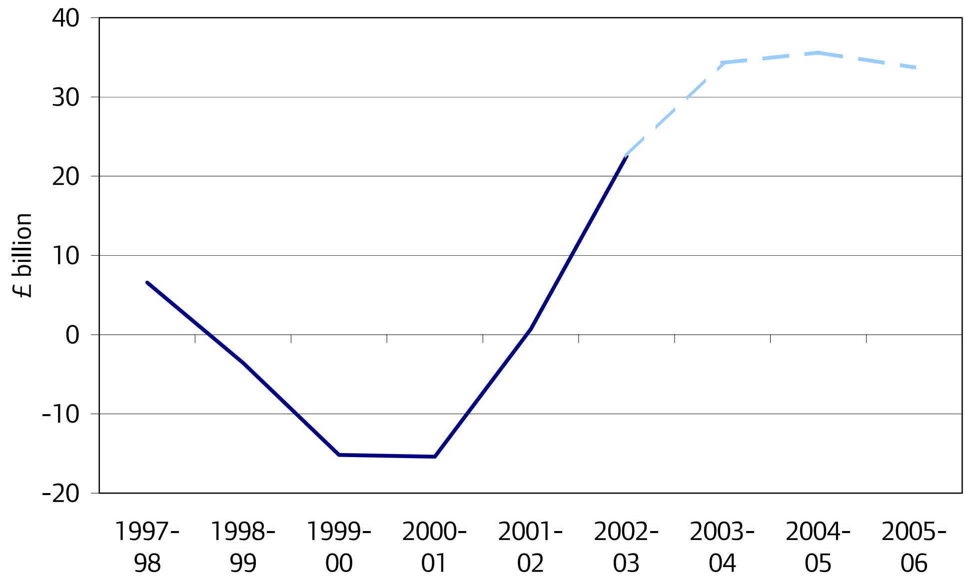
One of the major topics of economic discussion in recent months has been the outlook for the next year's Spending Review by the Central Government, or SR2004.

Spending reviews determine the allocation of public spending over a three-year period. For example, SR2004 will set allocations for the financial years 2005/06, 2006/07 and 2007/08. Total Public Spending is made up of both Departmental Expenditure Limits and Annually Managed Expenditure. Departmental Expenditure Limits are set for three years in the Government's spending reviews while Annually Managed Expenditure is, as its name suggests, set annually and includes essentially demand driven expenditure such as spending on welfare benefits. While Departmental Expenditure Limits are allocated to departments and not resources, this process indirectly influences the amount of public spending in London.

Much concern has been expressed about the amount the Government can afford to spend in the years 2005/06 to 2007/08, which will be determined by SR2004, given the large amounts that the Government is expected to borrow in the next few years. Chart 4.1 shows the actual amounts of government borrowing in the years to 2002/03 as a solid line and the consensus projections[10] up to 2005/06 as a dotted line.

Spending reviews are an innovation of the current Central Government. Since it took office in 1997, the Government has held three spending reviews in 1998, 2000 and 2002.

Chart 4.1 Public sector net borrowing



Source: ONS, HM Treasury 2003b,c

On average, economic forecasters expect Government borrowing, measured by Public Sector Net Borrowing, to expand from £22.5 billion in 2002/03 over the next few years and peak at

[10] The average of the forecasts for Public Sector Net Borrowing made by independent economic forecasters taken from HM Treasury 2003b,c.

£35.6 billion in 2004/05. Given this, it is not surprising that the general expectation is for growth in public spending will be slower in coming years than experienced recently.

In an attempt to quantify this, some fiscal arithmetic is set out below on the basis of the following assumptions:

- The consensus forecasts for Public Sector Net Borrowing (shown in Chart 4.1).[11]
- Forecasts for total public spending, based on the Treasury's Budget 2003 projections and adjusted to allow for lower economic growth as given by the consensus forecasts (Table 4.1).
- The Government's published plans for public spending from SR2002 which cover the period 2003/04 to 2005/06.
- Projections of public spending for 2006/07 and 2007/08 based on those published by the Treasury in Budget 2003.

Table 4.1 Consensus GDP growth forecasts

	2003	**2004**	**2005**	**2006**	**2007**
Latest consensus	2.0	2.6	2.7	2.4	2.4

Source: HM Treasury 2003b,c

It should be emphasised that projections set out below are speculative. For example, much may be changed by the new ONS GDP data released in September, but this will not become clear until the Treasury releases its Pre-Budget Report on 10 December 2003. In the Pre-Budget Report the Treasury will set out its current view of the state of the economy and the outlook for fiscal policy and public spending.

The projections for tax receipts and total public spending are summarised in Table 4.2. Projections covering the SR2004 period are in bold.

Table 4.2 Fiscal projections
£billion, current prices

	2003/04	2004/05	**2005/06**	**2006/07**	**2007/08**
Receipts	423	452	**485**	**510**	**536**
Total public spending	457	488	**519**	**545**	**571**
Public Sector Net Borrowing	34	36	**34**	**35**	**35**

Source: GLA Economics calculations

Total Public Spending is made up of Departmental Expenditure Limits and Annually Managed Expenditure as described above. Table 4.3 breaks down total public spending (which the Treasury calls Total Managed Expenditure) into Departmental Expenditure Limits and Annually Managed Expenditure. The projections for Departmental Expenditure Limits for the SR2004 period are in bold.

[11] Note that these differ from EBS's own central forecast as set out in Table 3.3.

Table 4.3 Public expenditure projections
£billion, current prices

	2003/04	2004/05	**2005/06**	**2006/07**	**2007/08**
Total Managed Expenditure	457	488	519	545	571
Departmental Expenditure Limits	264	280	**301**	**317**	**334**
Annually Managed Expenditure	193.0	209	218	228	237

Source: GLA Economics calculations

In SR2002 the Government committed to spending on the NHS through to the end of the SR2004 period – 2007/08. This commitment must be subtracted from total Departmental Expenditure Limits in order to see how much is left to meet other public spending needs such as transport (Table 4.4). The projections for non-NHS Departmental Expenditure Limits are in bold.

Table 4.4 Impact of existing NHS spending commitments
£billion, current prices

	2003/04	2004/05	**2005/06**	**2006/07**	**2007/08**
Departmental Expenditure Limits	264	280	301	317	334
NHS Departmental Expenditure Limits	75	82	91	99	109
Non-NHS Departmental Expenditure Limits	189	197	**210**	**217**	**224**

Source: Budget 2002, GLA Economics calculations

The impact of the commitments on the NHS is considerable. Total Departmental Expenditure Limits are projected to increase by on average 6.1 per cent per year over the SR2004 period, but with NHS Departmental Expenditure Limits increasing by on average 10.0 per cent per year, non-NHS Departmental Expenditure Limits increase by on average just 4.4 per cent per year. Once the impact of inflation is removed this suggests that non-NHS Departmental Expenditure Limits may increase by just 1.8 per cent in real terms on average per year over the SR2004 period. By comparison the SR2002 plans were for non-NHS Departmental Expenditure Limits to increase in real terms by on average 4.5 per cent a year.

The Government's Fiscal Rules
The Government has set out two key fiscal rules that it has promised to abide by:

- **Golden Rule**: over the economic cycle, the Government will borrow only to invest and not to fund current spending.
- **Sustainable investment rule**: public sector net debt will be held over the economic cycle at a stable and prudent level which the Chancellor has defined as below 40 per cent of GDP.

The projections above have been checked to see if they are affordable and meet the Government's fiscal rules.

Table 4.5 sets out projections for current receipts and current spending to 2007/08. The Treasury's view at the time of the 2003 Budget was that the current economic cycle began in 1999/2000 and is expected to end in 2005/06. This judgement may be changed as a result of the ONS releasing new GDP data back to 1948, but it is impossible to know this in anticipation of the 2003 Pre-Budget Report. Hence, this assessment of whether the Golden Rule is met assumes the Budget 2003 view on the timing of the economic cycle continues to hold. For the financial years 1999/2000 to 2002/03, the Government achieved a cumulative surplus on the current balance (current receipts minus current expenditure) of £36.8 billion. Table 4.5 shows deficits on the current balance for the years 2003/04 to 2005/06, which total £35.7 billion.

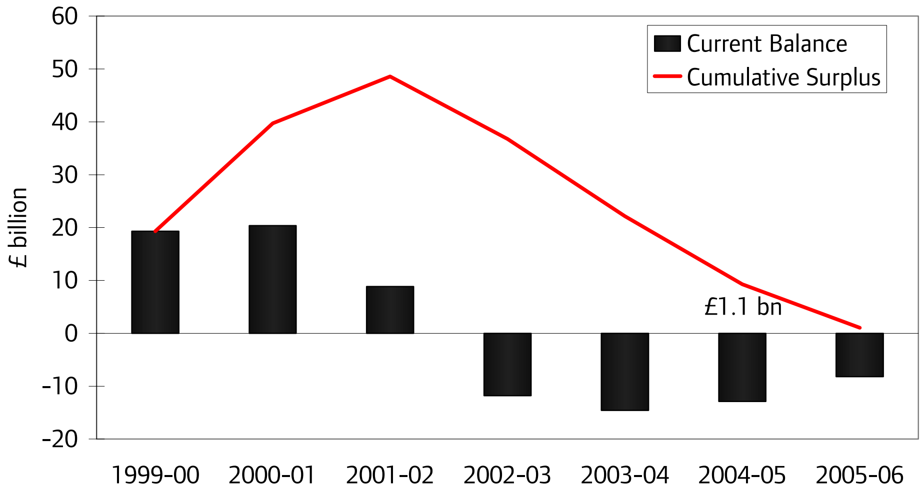
Table 4.5 The Golden Rule: Current receipts and expenditure
£billion, current prices

	2003/04	2004/05	2005/06	2006/07	2007/08
Current receipts	423	452	485	510	536
Current expenditure	437	465	493	518	541
Current balance	-15	-13	-8	-8	-5

Source: ONS, GLA Economics calculations

Over the whole economic cycle the cumulative current surplus is just £1.1 billion, and these projections just meet the Golden Rule. This is perhaps most clearly illustrated by Chart 4.2 which shows the build up and decline in the cumulative current surplus between 1999/2000 and 2005/06.

Chart 4.2 The Golden Rule – cumulative surplus over the economic cycle

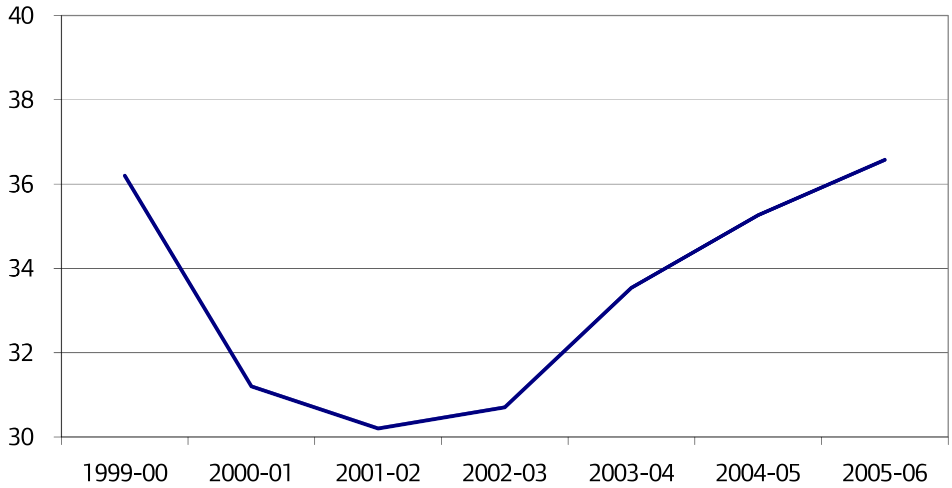


Source: ONS, GLA Economics calculations

The finding that the cumulative current surplus over the current economic cycle is likely to be only just positive is consistent with the projections recently made by the National Institute for Economic and Social Research (NIESR), one of Britain's leading economic forecasters and research institutes. It concluded that there is 'a roughly even chance that the Chancellor will break his golden rule of balancing current spending with current revenues over the present cycle' (NIESR, 2003).

Chart 4.3 shows projections of public sector net debt in order to assess whether the sustainable investment rule is met. By the end of the economic cycle in 2005/06, public sector net debt remains below the 40 per cent limit, which means these projections also meet the sustainable investment rule.

Chart 4.3 Public sector net debt/GDP



Source: GLA Economics calculations

Alternative projections
It is possible to envisage both more and less optimistic outlooks for public spending in SR2004. The less optimistic scenario is based on the Chancellor deciding to reduce the growth in public spending in order to better meet his fiscal policy rules. The more optimistic scenario is based on growth in the economy being higher than expected on average by economic forecasters.

Low growth in public spending: The Iron Chancellor returns
While the projections outlined above meet the Government's key fiscal rules, they could still be problematic. Firstly, in the past the Treasury has been able to claim that its fiscal projections not only meet the Golden Rule, but also do so on the cautious case in which the *level* of trend output is assumed to be 1 percentage point lower than the Government's central view. This increases the proportion of any deficit on the public finances current balance that can be ascribed to structural factors rather than temporary cyclical weakness in the economy. Given the small margin by which the Golden Rule is met – a cumulative surplus on the current balance of just £3.7 billion over the period 1999/2000 to 2005/06 it is highly unlikely that these fiscal projections will meet the cautious case of the Golden Rule.

Secondly, the projections imply that the current balance will enter the next economic cycle in deficit by £13 billion over 2006/07 and 2007/08. In contrast, the Budget 2003 projections show a surplus on the current balance in these two years. The Treasury might argue that the Golden Rule should be assessed over the whole of an economic cycle and that the deficits in 2006/07 and 2007/08 will be offset later in the economic cycle. However, such a stance might well not be perceived as credible by outside economic commentators and financial markets. The Chancellor might adjust fiscal policy accordingly to remove the deficits on the current balance in these two years.

Thirdly, while public sector net debt remains below the 40 per cent threshold through to 2007/08, it is on an upward trend and projected to reach 39.0 per cent by 2007/08. Once again fiscal action may well be required to stop the 40 per cent threshold being breached later on.

If the Chancellor does decide to act then he can decide to raise taxes or cut spending in order to eliminate the deficit on the public current balance in 2006/07 and 2007/08. To generate a downside scenario for public spending, an assumption has been made that the Chancellor decides to cut spending by £4 billion in 2006/07 and by £9 billion in 2007/08 from the projections set out above. This gives a deficit on the current balance of £4 billion in 2006/07 matched by a surplus of £4 billion in 2007/08. Since the whole of these potential deficits are removed by lower public expenditure rather than higher taxes, this gives a low case scenario for the future growth in public spending. Table 4.6 projects total Departmental Expenditure Limits, NHS Departmental Expenditure Limits and non-NHS Departmental Expenditure Limits under this scenario. Given the pre-existing commitments on NHS spending, reduced levels of public spending are assumed to fall completely on non-NHS Departmental Expenditure Limits. These projections are shown in bold.

Table 4.6 Alternative projection for public spending
£billion, current prices

	2003/04	2004/05	**2005/06**	**2006/07**	**2007/08**
Departmental Expenditure Limits	264	280	301	313	325
NHS Departmental Expenditure Limits	75	82	91	99	109
Non-NHS Departmental Expenditure Limits	189	197	**210**	**213**	**216**

Source: GLA Economics calculations

The lower levels of spending in 2006/07 and 2007/08 have a significant effect on the resources available for public services in areas other than the NHS. In this projection, non-NHS Departmental Expenditure Limits expand by just 0.5 per cent in real terms on average per year over the SR2004 period. The Iron Chancellor who presided over the tight control of public spending in the first couple of years after 1997 is back.

Higher growth scenario

The outcome from SR2004 is likely to be better if the UK economy manages to grow faster than the consensus view over the next few years. EBS has run a high growth scenario for the GLA through its model of the UK economy. The assumed rates of growth are shown in Table 4.7. EBS's central projection for government borrowing, as measured by Public Sector Net Borrowing, is somewhat higher than the latest consensus among economic forecasters which has been used so far as the base for these fiscal projections. Hence, the projections below add the difference between the projections for Public Sector Net Borrowing in EBS's higher growth and central projections onto the consensus estimate to generate a higher growth projection for public borrowing.

The impact of this higher growth, on the Government's fiscal position, relative to the central consensus view, is also shown in Table 4.7. The deficits on the Government's current balance over the next few years are reduced so that the margin by which the Golden Rule is met in the current economic cycle increases to £9.0 billion. Similarly, the Sustainable Investment Rule is also met by a wider margin as public sector net debt remains below 36 per cent of GDP by 2005/06. Further out there is no longer an overall deficit on the current balance in 2006/07 and 2007/08, and no need for tax increases or spending reductions. Instead there is an overall surplus of around £ 5 billion in these two years. Finally, in this scenario the average growth of non-NHS Departmental Expenditure Limits over the SR2004 period can increase to 2.5 per cent each year in real terms. However, it should be noted that this growth is still well down on the 4.5 per cent planned for the SR2002 period.

Table 4.7 Higher growth scenario

	2003/04	2004/05	2005/06	2006/07	2007/08
GDP growth (%)	2.0	3.0	3.0	2.7	2.5
Current fiscal balance (£b)	-15	-10	-3	-1	6
Non-NHS Departmental Expenditure Limits (£b)	189	197	210	219	229

Source: EBS scenarios, GLA Economics calculations

Conclusion

All the projections contained in this chapter support the view that SR2004 is likely to be much tighter than SR2002. On the basis of consensus among forecasters about economic growth and government borrowing, real non-NHS public spending covered by the spending reviews (ie Departmental Expenditure Limits, not Annually Managed Expenditure) is projected to grow by between 0.5 and 1.8 per cent on average per year over the three-year SR2004 period compared to average growth in the SR2002 period of 4.5 per cent. Even with somewhat higher economic growth, real non-NHS public spending is only projected to increase by on average 2.5 per cent per year.

Appendix 1: Explanation of forecast terms

Employment

In this report, unless otherwise stated, 'employment' means civilian workforce jobs as defined below.

There are two ways of looking at employment: the number of people with jobs, or the number of jobs. The two concepts represent different things as a person can have more than one job.

There are also two ways of looking at the location of a given job: *workplace* employment estimates the number of people working at a given location and who travel to that location; *residential* employment estimates the number of people who have a job and live in a given location.

The number of workplace jobs, usually employee jobs, is measured by the Annual Business Enquiry and the Short-term Employment Survey.

Workforce jobs represent the sum of: employee jobs, self-employment jobs from the Labour Force Survey (LFS), people in HM Forces and government-supported trainees. Vacant jobs are not included. *Civilian* workforce jobs, the most common measure of workforce jobs, excludes people in HM forces (who number around 14,000 in London).

The number of people with jobs is measured by the LFS and includes people aged 16 or over who did paid work (as an employee or self-employed), people who had a job they were temporarily away from, people on government-supported training and employment programmes, and people doing unpaid family work. Although the Labour Force Survey does provide information about workplace employment, it is chiefly used as a source of information on residential employment. The exception is self-employment for which the place of work and place of residence are assumed to be the same.

As part of the forecast, EBS also supplies the GLA with estimates of Employment as defined by the International Labour Organisation (ILO). This is the denominator in the figures normally quoted for unemployment, otherwise known as ILO unemployment. It is the same as residential employment, as found in the Labour Force Survey (LFS). EBS also supplies full-time equivalent (FTE) employment, defined as the sum of full-time jobs, 40 per cent of part-time jobs, and self-employment. Finally, employment forecasts are available broken down by gender, part-time/full-time and age group.

Output

Regional output is reported as gross value added (GVA) in line with the European standard ESA95. This has replaced gross domestic product (GDP) at factor cost in the European Accounts system. It is the total net product, measured at market prices, less taxes on output levied at the point of production and plus subsidies levied at the point of production. It is identical to GDP at basic prices. However because GDP at factor cost is still used as the basis for Treasury forecasts and reviews, minor differences between GVA and GDP growth rates can occur.

For forecast purposes the most important variable is real output, corrected for inflation. It is estimated at constant 2000 prices throughout this report. Until October 2003 the ONS measured real output in prices of the year 1995; most of its released figures have now been updated to 2000 prices. However the ONS does not produce regional estimates of real output. Private data suppliers therefore produce their own estimates, most of which are still in year 1995 prices. The GLA's forecast and data have been updated, by EBS, to year 2000 prices.

All growth rates refer to real GVA growth rates.

Estimates of nominal regional GVA are available up to 2001 from the ONS (Cope, Marais and Lucas, 2003). 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 2003 (Fenwick and O'Donaghue, 2003). Most regional forecasters supply their own estimates of London's GDP. The London GVA figures used to estimate the forecast, and the forecasts themselves, use estimates supplied by EBS which coincide with those of the ONS for 2000. In this year the nominal and real figures are the same apart from a minor adjustment to reflect ONS's revisions to estimated UK GVA in 2000

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.

Appendix 2: Glossary

Baseline forecast	The most likely outcome in the forecasters' judgement.
Cancun Summit	The Fifth World Trade Organisation Ministerial Conference was held in Cancún, Mexico from 10 to 14 September 2003. The conference ended without consensus.
Consumer expenditure	Household expenditure, including expenditure on durable goods but excluding house purchases and major house improvements, which are classed as capital expenditure.
Downside risk	The chance that the economy will perform worse than anticipated and the consequences of such an event occurring.
G21 group	A group of emerging market economies including Brazil, China and India.
G7 group	The world's largest seven industrial economies: the US, Japan, Germany, France, Italy, the UK and Canada.
Gross domestic product (GDP)	A measure of the total number of goods and services produced by an economy over a set period of time. It is obtained by valuing goods and services at aggregate market prices.
Gross value added (GVA)	Used in the estimation of GDP. GVA plus taxes on products minus subsidises on products is equal to GDP.
Hedge	The action a buyer or seller takes to ensure their business or assets are protected by a change in prices.
Imputed rental income	The rental income an owner would pay not to put an asset to an alternative use.
Long gilts	British government securities traded on the stock exchanges that are longer-term investments with fixed interest rates.
Output	The level of activity in the economy.
Public sector net borrowing	The excess of public sector spending over income financed by borrowing.
Residential employment	Estimates the number of people who have a job and live in a given location.
Trend rate	The rate at which growth is forecast based on past performance.
Upside risk	The chance that the economy will perform better than anticipated and the consequences of such an event occurring.
Workplace employment	Estimates the number of people working at a given location and who travel to that location.

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