London's Economy Today

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In this issue

GLAECONOMICS

Rising interest rates and oil prices just below record highs

by Simon Kyte,
Economist, GLA Economics

London's commercial property market continues to strengthen. With the financial sector performing well on the strength of a strong stock market and high levels of mergers and acquisitions activity, commercial office rents in Central London are now rising at their fastest rate for seven years according to agents, Knight Frank. Typical 'Grade A' City rents jumped last year by 25 per cent to £61.50 per square foot. A similar proportionate increase in the West End has driven the comparable typical commercial rent to £107.50 per square foot.

The PMI index of business activity for London (seasonally adjusted) rose again in June to 59.1. The index has now been above 50 (which indicates 'no change') for 37 consecutive months. Growth in new orders in London was also up to its highest level since April last year. The employment prospects index fell marginally but at 54.5 is well inside positive territory.

Latest news...

- **Economist job vacancies** Do you want to join our team? We are recruiting for two new economists. For further details please see this week's edition of *the Economist* or visit the GLA website www.london.gov.uk/jobs.jsp

- **Annual Report 2007** covers the work of GLA Economics from April 2006 to March 2007. Established in May 2002, GLA Economics has had a busy fifth year. We have produced an array of detailed reports on a broad range of issues that have an impact on London and presented our research at a number of events. For the complete picture please read the report. The report can be downloaded from our website at http://www.london.gov.uk/gla/publications/economy.jsp#glaecar07

Bank raises base rate to 5.75 per cent

The Bank of England's Monetary Policy Committee (MPC) raised interest rates for the fifth time over the last 11 months to 5.75 per cent. The minutes of the meeting reveal that six out of the nine members voted for the increase. The MPC noted that market interest rates had increased markedly since the May Inflation Report and monthly data had suggested that second quarter GDP growth would be "at least as strong" as the Committee's May projection. The Committee identified four key upside risks to UK inflation: the impact of stronger demand growth on companies' prices; the evolution of inflationary expectations; prospects for energy and import prices and possible limited spare capacity within the economy. The labour market had continued to surprise on the downside with weak employment growth and relatively subdued earnings growth.

Where base rates go from here is far from clear. The July minutes reveal an ongoing split amongst members of the Monetary Policy Committee. CPI inflation is still above target but seems to have come off its peak, although this has been driven primarily by cheaper energy utility bills. The markets are pricing in further increases to 6 per cent by the end of the year and to 6.25 per cent beyond that but they sometimes have a tendency to overshoot. Retail sales grew by 0.2 per cent between May and June – slightly less than the City was expecting. It was the fourth consecutive monthly decline in the annual growth rate, which may suggest that the combination of rising interest rates and low real wage growth may now be taking effect. It is possible that the Bank may wait for markets to consider the August Inflation Report before making any decisions on raising rates further although unexpectedly strong growth in the economy will raise pressure for a further increase. Annual GDP growth for the UK as a whole is at 3 per cent with second quarter growth recorded at 0.8 per cent – higher than expected.

CPI inflation down in June – but RPI up due to increased mortgage payments

In June, CPI inflation fell to 2.4 per cent from 2.5 per cent in the previous month. CPI inflation is now at its lowest level since October last year. Although CPI inflation, the Bank's target measure, was down the fall was less than the City had been expecting. Lower energy utility bills have driven CPI inflation lower over the last few months. However, once this factor has worked its way through, underlying inflationary elements may reappear in the index. RPI inflation, which tends to be the measure used during wage bargaining, edged up to 4.4 per cent from 4.3 per cent in May. The main upward pressure came from increased mortgage payments, which are excluded from the CPI.

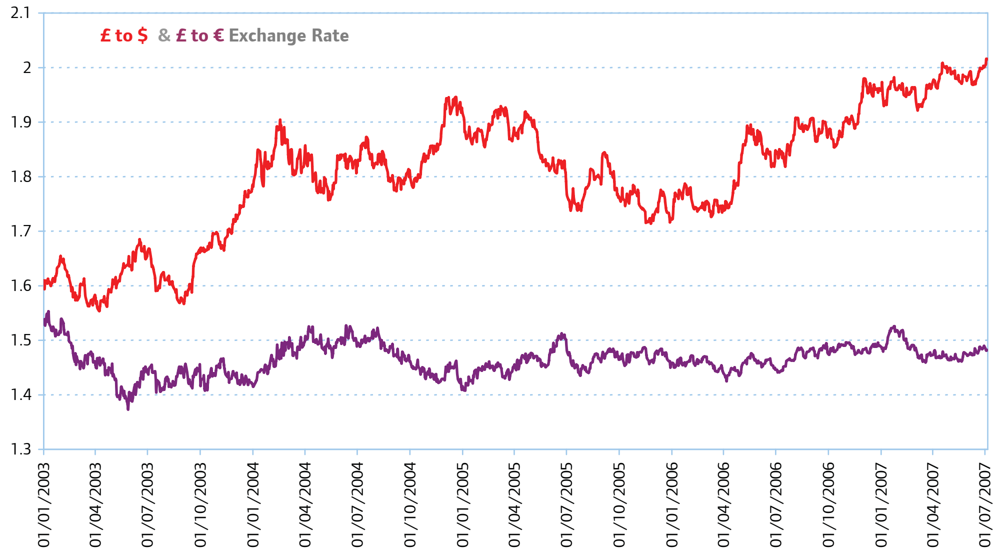
Pound at 26 year high against weak US dollar

In January 2007, Goldman Sachs estimated that sterling was overvalued by around 13 per cent on a trade-weighted basis. However, in spite of the UK balance of trade deficit, the pound has risen by more than a further 15 per cent against the US dollar since the beginning of 2007 with sterling seen increasingly as a reserve currency.

The expectation of higher interest rates in the UK than in other major economies makes sterling more attractive to investors. In the US, the moderation of the core inflation data to its lowest level in 15 months has raised the prospect that the US Federal Reserve might cut the base rate later in the year, thereby weakening the exchange value of the dollar still further. The release of the UK CPI and RPI inflation data caused the pound to strengthen even further whilst the US dollar continued to decline on the back of the ongoing housing market decline. As a result, sterling crossed both the $2.04 and the $2.05 thresholds within 24 hours, putting it at its highest level since 1981 although the publication of the MPC minutes showing that three members had voted to hold rates took sterling off its absolute highs. Another reason for the increasingly weak performance of the US dollar has been raised concerns about the vulnerability of Wall Street to the continued weak performance of the US housing market. The Governor of the Federal Reserve now believes that the losses associated with the sub-prime mortgage crisis could be in the order of $50-100 billion. Falling house prices are also weakening consumer expenditure and this is being exacerbated by scarcer and more expensive credit. There is increasing pressure on the Federal Reserve to lower US base rates and that could increase sterling's relative strength further as money moves into sterling to profit from higher interest rates.

Figure 1: Exchange rates

Source: Ecowin/FT



Oil prices continue to climb

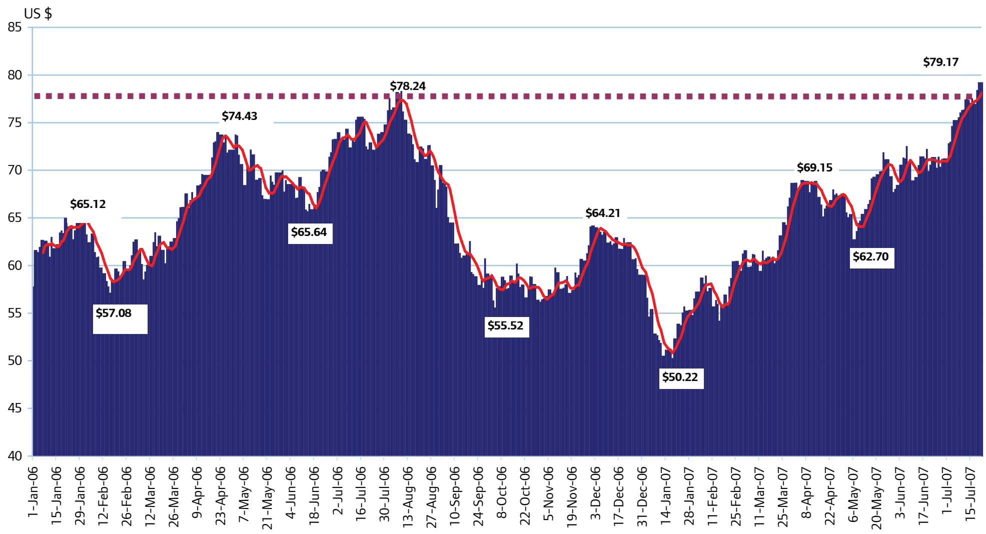
Over July the price of Brent Crude has risen steeply. On Friday 20 July it closed trading at $79.17, more than $9 up on the previous month and the highest ever closing price for Brent Crude[1]. Part of the concern has been about inventories with the International Energy Agency warning that the world faces a five year 'crunch' with production in mature producer countries declining more rapidly than expected and demand from rapidly developing economies rising more steeply than anticipated. The other concern is regarding insecurity of supply on account of political factors and the events which have been taking place in Nigeria.

The price movement to higher levels over the summer has been supported by money flowing into the energy market – long position speculation has reached all time highs. Prices could still be driven higher given the failure of any slowdown in the Chinese economy to materialise. The IEA now believes that demand from China for oil will grow by 6.1 per cent during 2008. Of the 51 oil-producing nations in BP's Statistical Review of World Energy, 27 reported declines in 2006[2].

Goldman Sachs has warned that without increased OPEC production, prices could surge to $95 a barrel by Christmas. Rising energy costs have prompted some analysts to warn about further inflationary impacts. However, others believe that the market is overdue a short term downward correction, especially if the forecasts for the hurricane season prove to be overstated. Gasoline futures generally move broadly in parallel with oil prices. Since January, generic gasoline futures traded on Nymex have risen 73 per cent - far faster than crude oil - thanks to restricted capacities in US refineries, showing that the cost of turning crude oil into gasoline is rising.

Figure 2: Brent crude oil US $/per barrel

Source: FT



Eurozone rate rise likely in September

Inflation is still not a problem in the Eurozone but the European Central Bank (ECB) seems likely to raise interest rates in September driven by strong economic growth in many of the major Eurozone economies, particularly Germany and France. In France, consumer confidence is at a record high whilst unemployment is at a 25 year low. The ECB's concern is price inflation in 2008 and beyond. In June, Merrill Lynch raised its forecast for Eurozone growth this year from 2.5 per cent to 2.7 per cent.

Strong recent German economic performance has encouraged higher than expected wage deals and the ECB views these as a significant inflationary risk to the Eurozone economy as a whole. German growth accelerated to 2.8 per cent last year, its fastest for six years and unemployment has been falling strongly and, recently, faster than analysts forecast. The number of jobseekers fell by a seasonally adjusted 37,000 in June. At an unadjusted 3.69 million, the number of unemployed is now one and a half million less than it was at its peak in early 2005.

China's growth shows no signs of slowing but inflation is rising

China's annual growth rate accelerated to 11.9 per cent in the second quarter of 2007, up from 11.1 per cent in the first quarter in spite of a series of attempts by the Chinese Government to restrain growth. Meanwhile, consumer price inflation hit 4.4 per cent. Inflation is expected to continue rising sharply over the coming months, driven by increasing food prices which account for about a third of the country's CPI basket. This has prompted the People's Bank of China to increase interest rates again.

Conclusion

London continues to perform well and to grow more rapidly than the rest of the UK. However, previous interest rate rises and possible future ones are likely to dampen UK consumption and economic growth and this will impact on the London economy as it heads into 2008.

Footnotes

1 Brent Crude's price has subsequently fallen from its recent peak but remains both high and volatile.

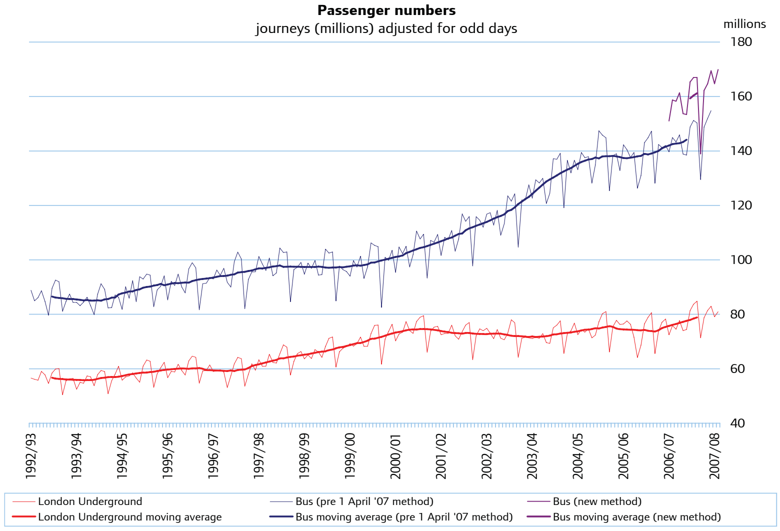
2 Peter Warburton

Economic indicators

Increase in moving average of passenger numbers

- The most recent 28-day period is from 29 April to 26 May 2007. London's public transport had 250.9 million passenger journeys; 169.9 million by bus and 81.0 million by Underground.
- The moving average increased to 240.1 million from an upwardly revised 238.8 million passengers every period. The moving average for buses was 161.2 million. The moving average for the Underground was 78.9 million.
- The methodology used to calculate the number of bus passenger journeys was changed by TfL from 1 April 2007. For a detailed explanation please see LET edition 58 (June 2007).

Latest release: July 2007
Next release: August 2007

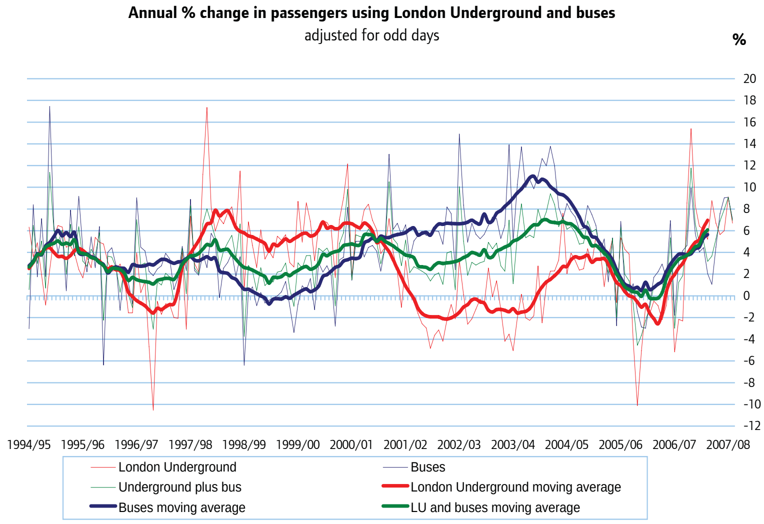


Source: Transport for London

Average annual growth rate of passengers continues to rise

- The moving average annual rate of growth in passenger journeys increased to 6.1% from 5.6% in the previous period.
- The moving average annual rate of growth in bus passenger journey numbers rose to 5.6% from 5.3% in the previous period.
- The moving average annual rate of growth in Underground passenger journey numbers increased to 7.0% from 6.3% in the previous period.

Latest release: July 2007
Next release: August 2007

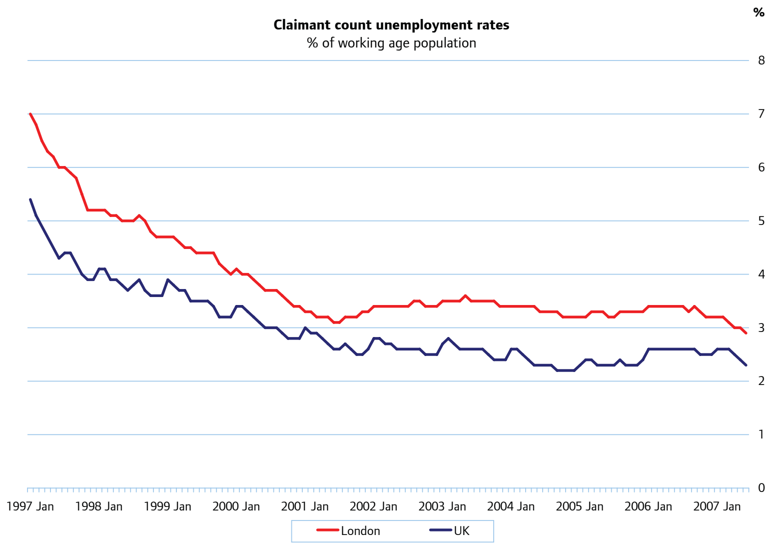


Source: Transport for London

Claimant count unemployment

- The rate of claimant count unemployment (the percentage of resident working age population who are unemployed and claiming Jobseekers' Allowance) in London was 2.9% in June 2007.
- There were 145,100 unemployment claimants in London in June 2007 compared with 168,800 in June 2006.
- The claimant count unemployment rate of the UK remains below that of London's.

Latest release: July 2007
Next release: August 2007

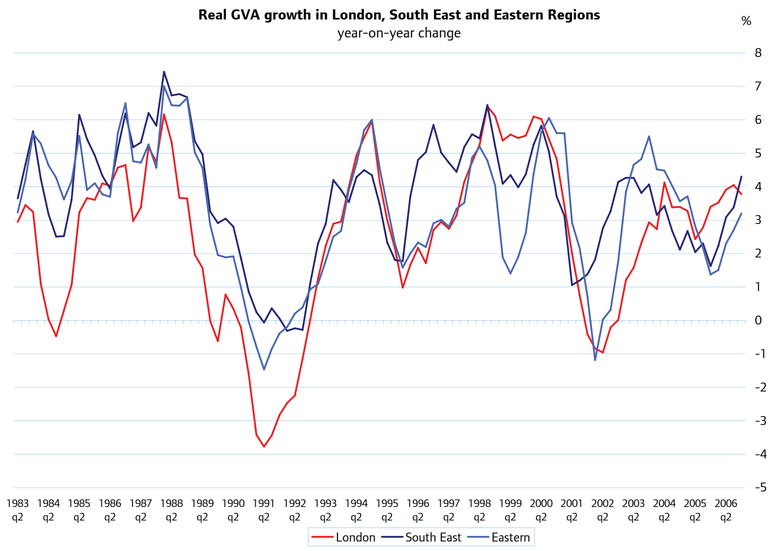


Source: Claimant Count, NOMIS

Robust annual output growth in the South East and London

- London's annual growth in output decreased to 3.8% in Q4 2006 from 4.0% in Q3.
- Annual output growth in the South East increased to 4.3% in Q4 2006 from 3.4% in the previous quarter.
- Annual output growth in the Eastern region was 3.2% in Q4 2006, up from 2.7% in Q3.

Latest release: May 2007
Next release: August 2007

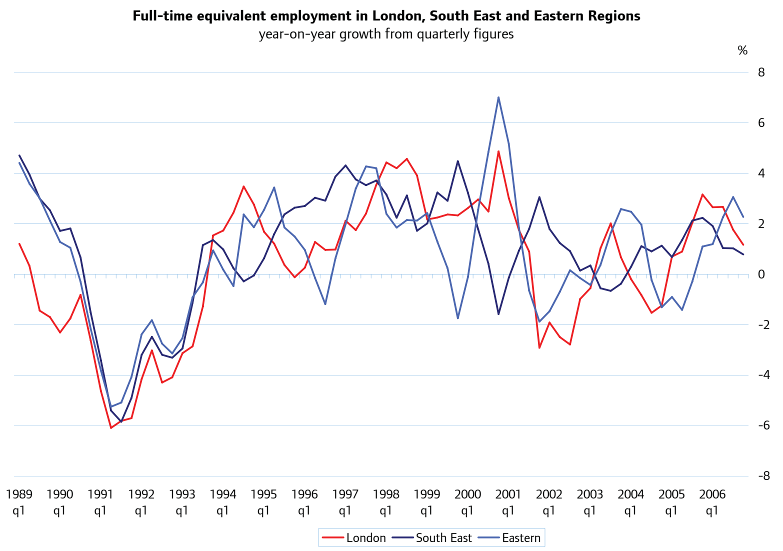


Source: Experian Business Strategies

Slowing annual employment growth in London and its neighbouring regions

- London's annual employment growth was 1.2% in Q4 2006, a decrease from 1.8% in Q3.
- Annual employment growth in the South East decreased slightly to 0.8% in Q4 2006 from 1.0% in Q3.
- Annual employment growth in the Eastern region was 2.3% in Q4 2006, down from 3.1% in the previous quarter.

Latest release: May 2007
Next release: August 2007

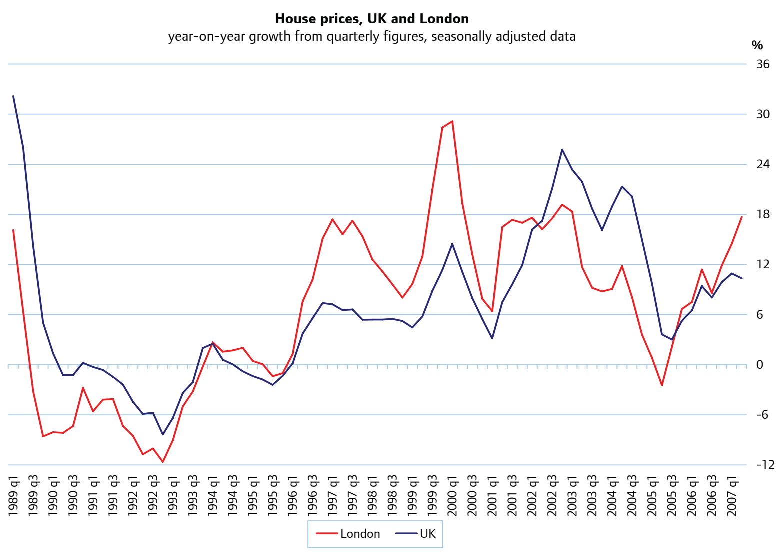


Source: Experian Business Strategies

Annual house price inflation in London and the UK remains strong

- Annual house price inflation, as measured by the Halifax Bank of Scotland, increased in Q2 2007 in London and remained above 10% in the UK.
- Annual house price inflation in London increased to 17.7% in Q2 2007 from 14.5% in Q1. Annual house price inflation in the UK decreased slightly to 10.3% in Q2 from 10.9% in Q1.
- Annual house price inflation was higher in London than in the UK for the seventh consecutive quarter.

Latest release: July 2007
Next release: October 2007

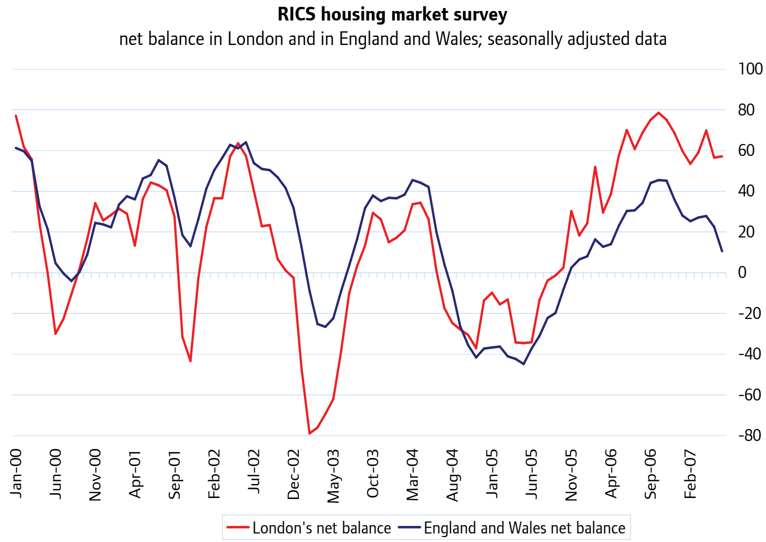


Source: HBoS

Surveyors report that house prices are still rising

- The RICS survey shows a positive net balance of 57 for London house prices over the past three months up to June 2007. This net balance is unchanged from May.
- Surveyors also reported a positive house price net balance for England and Wales of 11 in June, down from 22 in May.
- London's net balance remains above that of England and Wales.

Latest release: July 2007
Next release: August 2007

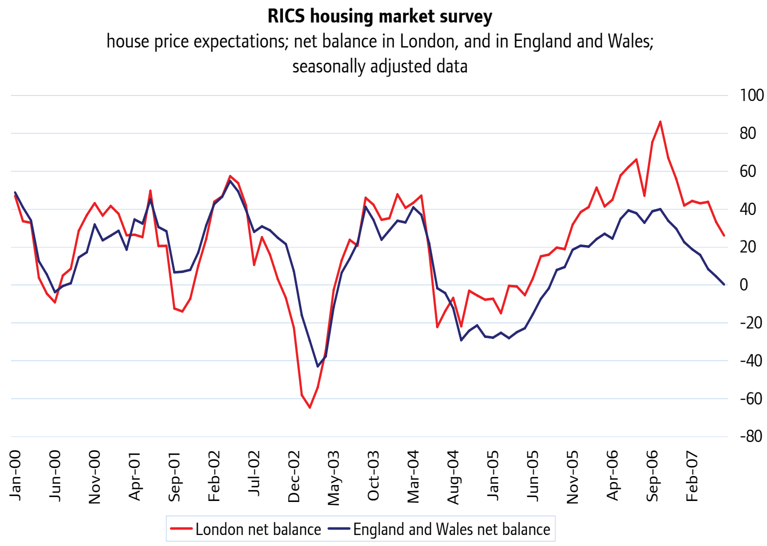


Source: Royal Institute of Chartered Surveyors

Surveyors expect London house prices to increase

- The RICS survey shows that surveyors expect house prices to increase over the next three months in London but remain unchanged in England and Wales.
- The net house price expectations balance in London was 26 in June, down from 33 in May.
- For England and Wales, the net house price expectations balance was 0 in June, down from 5 in May.

Latest release: July 2007
Next release: August 2007

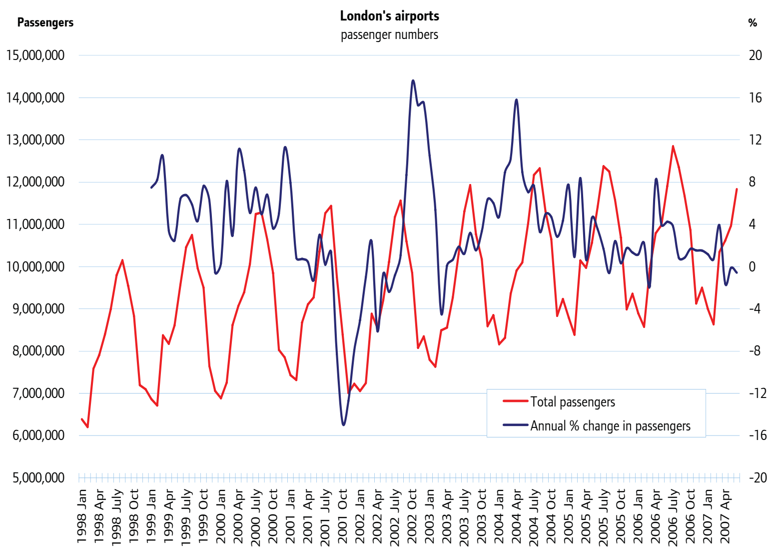


Source: Royal Institute of Chartered Surveyors

Slight decrease in year-on-year airport passenger numbers

- 11.8 million passengers travelled through London's airports in June 2007.
- The number of passengers using London's airports fell by 0.6 per cent from June 2006 to June 2007.
- The number of passengers using London's airports has fallen slightly year-on-year for three successive months.

Latest release: July 2007
Next release: August 2007

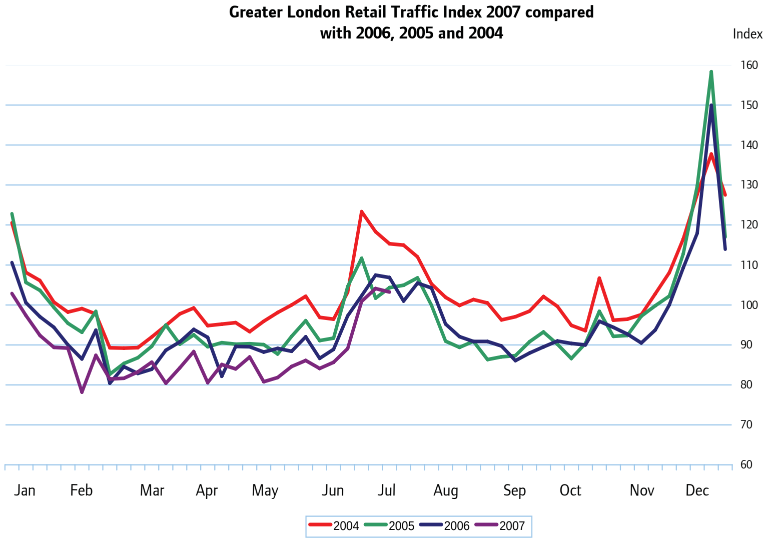


Source: Civil Aviation Authority

SPSL Retail Traffic remains below 2006 levels

- The SPSL Retail Traffic Index of shoppers in London was 103.2 in the second week of July compared to 104.1 in the previous week.
- The index has generally been lower than 2006 levels throughout 2007 so far.
- SPSL's Retail Traffic Index measures the number of shoppers and does not necessarily reflect the level of spending.

Latest release: Mid-July
Next release: Weekly

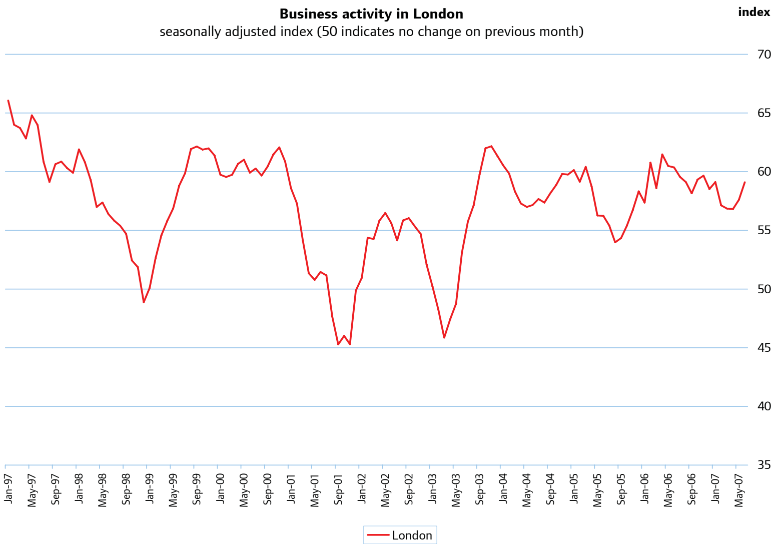


Source: SPSL

London's business activity expanding quickly

- London firms continued to expand their output of goods and services in June 2007.
- The Purchasing Managers' Index (PMI) of business activity recorded 59.1 in June 2007 compared to 57.6 in May.
- A rate of above 50 on the index indicates an increase in business activity from the previous month. The PMI for business activity has been above 50 since June 2003.

Latest release: July 2007
Next release: August 2007

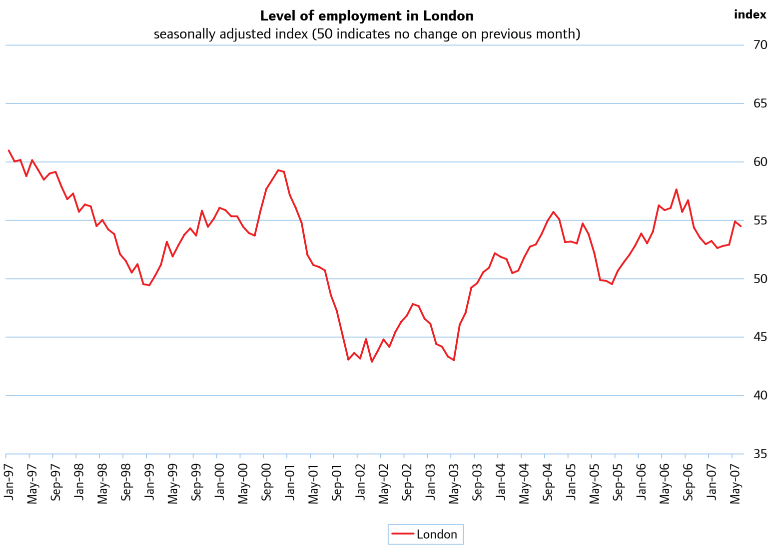


Source: PMI/The Royal Bank of Scotland

Firm employment growth in London

- London firms continued to increase their level of employment in June 2007.
- The PMI for the level of employment was 54.5 in June compared to 54.9 in May.
- A rate of above 50 on the index indicates an increase in the level of employment from the previous month.

Latest release: July 2007
Next release: August 2007



Source: PMI/The Royal Bank of Scotland

London Economic Development Snapshot

Matthew Waite,
Senior Economist

The latest Snapshot report, which every six months sets out the performance of London's economy against the objectives of the Mayor's Economic Development Strategy (EDS), was published this month.

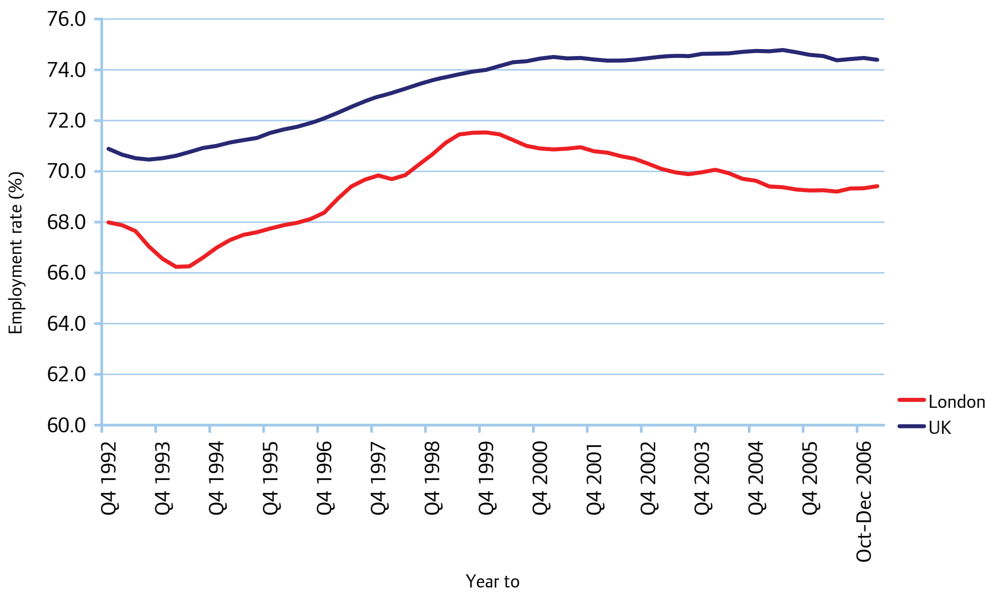
The Snapshot aims to:

- **identify and review London's progress against the strategic priorities of the EDS;**
- **provide a basis on which to review the priorities for London's economic development; and,**
- **act as a catalyst for directing economic development activities in London.**

The Snapshot shows that stakeholders in London's economy need to maintain their focus on London's relatively low employment rate, which particularly impacts on some disadvantaged groups and some deprived areas.

Figure 3: Working age employment rates (rolling annual average)

Source: LFS



London's employment rate was 69.4 per cent when averaged over the year to March 2007 compared to 74.4 per cent for the UK as a whole; London's employment rate has remained more than 5 percentage points below that for the UK for the past two years. This is the largest gap between the two employment rates since at least the early 1980s when London's employment rate was higher than that for the UK.

GLA Economics' most recent forecast (London's Economic Outlook: Spring 2007) sees London's economy growing above trend, and faster than the UK as a whole, between 2007 and 2009. As a result, GLA Economics forecasts strong employment growth over this period. Such growth should provide favorable conditions for Londoners to move into work. The extent to which this will close the gap between the employment rate for London and the UK as a whole will depend on the growth in London's working age population relative to the

UK and the ability of London's workless population – both the unemployed and economically inactive – to compete effectively for jobs in London's labour market.

More positively, over the past two years the combined employment rate for the seven most disadvantaged boroughs of London (Camden, Hackney, Haringey, Islington, Newham, Southwark and Tower Hamlets) has increased by more than London as a whole. This has closed the gap between the two employment rates to 6 percentage points - the smallest gap for 15 years. Whilst this is encouraging, the variability of this data is such that the reduction in the gap between the employment rate for London and that for the seven most disadvantaged boroughs in London will need to be monitored to see whether it is sustained over time.

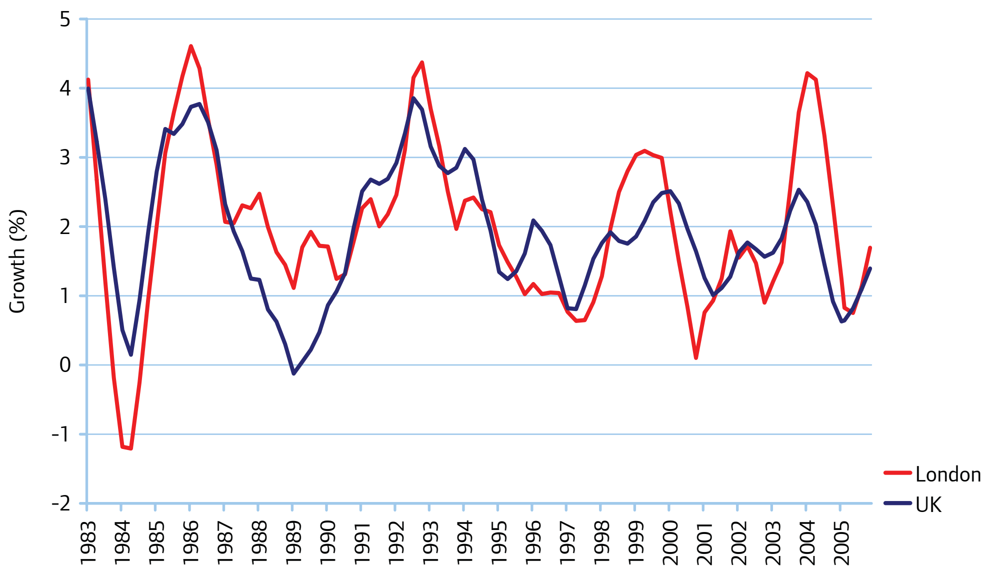
Another area that the Snapshot highlights as requiring some attention is resolving the funding of Crossrail. Whilst there are many significant infrastructure projects underway across London, Crossrail is required to increase accessibility and reduce congestion on London's public transport system to ensure London's attractiveness as a business and residential location is not diminished. The longer the funding package for Crossrail remains unresolved the more London's position as a competitive world city is put at risk.

The Snapshot also highlights that in 2006 the proportion of businesses considering the availability of appropriately skilled employees a significant or a very significant problem fell from 34 per cent in 2005 to 29 per cent in 2006. Moreover, when businesses are asked to rate the availability of appropriately skilled employees on a scale from 1-5, with 1 being a minor problem and 5 being a very significant problem, London scored an average of 2.65 in 2006, which ranks between a minor and an average problem. This is an improvement on the 2005 result (2.79) but is still higher than the results for the first two years of the survey (2.14 and 2.22 respectively).

Figure 4 shows the rate of productivity growth (i.e. the rate of growth in the output of each worker) in London and the UK over time. When averaged over the current economic cycle (1997 to date) annual productivity growth has been higher for London than for the UK as a whole.

Figure 4: Growth rates in GVA per worker (FTE) over time

Source: EBS



Whilst this is encouraging and whilst it may be due to the stage of the economic cycle, average productivity growth to date has been lower than in the previous economic cycle (1986-1997). Productivity growth is important as it affects the economy's ability to grow without running into constraints. If London's economy grows more quickly then income per head should increase so increasing London's prosperity.

For more information on the Snapshot see the LDA website:

http://www.lda.gov.uk/server/show/ConWebDoc.1203

Additional information

Data sources

Tube and bus ridership	Transport for London on 020 7941 4500
GDP/GVA growth	Experian Business Strategies on 020 7630 5959
Tourism – overseas visitors	www.statistics.gov.uk
Tourism – domestic visitors	www.visitlondon.com
London airports	www.caa.co.uk
Business activity	www.rbs.co.uk/pmireports
Employment	www.rbs.co.uk/pmireports
House prices	www.nationwide.co.uk/hpi/
Unemployment rates	www.statistics.gov.uk

Glossary

Civilian workforce jobs

Measures jobs at the workplace rather than where workers live. This indicator captures total employment in the London economy, including commuters.

Claimant count rate

Unemployment rate based on the number of people claiming unemployment benefits.

Employee jobs

Civilian jobs, including employees paid by employers running a PAYE scheme. Government employees and people on training schemes are included if they have a contract of employment. Armed forces are excluded.

Gross domestic product (GDP)

A measure of the total economic activity in the economy.

Gross value added (GVA)

Used in the estimation of GDP. The link between GVA and GDP is that GVA plus taxes on products minus subsidies on products is equal to GDP.

ILO unemployment rate

The International Labour Organisation's calculation of the number of people out of work.

Tube ridership

Transport for London's measure of the number of passengers using London Underground in a given period. There are 13 periods in a year – twelve 28-day periods and one 29-day period. Period 1 starts at the beginning of the financial year rather than the calendar year.

Acronyms

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

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

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