

# London's Economy Today



Issue 61 | September 2007

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## Market volatility and banking difficulties are part of a wider issue of liquidity

by Simon Kyte, Economist and Richard Davies, Economist

**Considerable turbulence on money markets has been evident since the middle of July 2007 when defaults on loans in the US sub-prime residential mortgage market began to infect wider lending markets. Spreads on US sub-prime residential mortgage-backed securities started to increase markedly and some lending markets in complex structured products have effectively ceased to exist, markedly reducing liquidity. Since then banks have found it harder to raise wholesale funds on capital markets and to raise funds through mortgage-backed securities or asset-backed commercial paper. In turn, this resulted in them being less able to lend to other banks.**

Usually the Bank of England base rate and the Libor,<sup>1</sup> three month inter-bank lending rate track each other closely. From the early summer of 2007 however, they started to diverge and a large spread has been created between Libor and the base

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## Latest news...



## Working Hard or Hardly Working

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GLA Economics' third international conference,  
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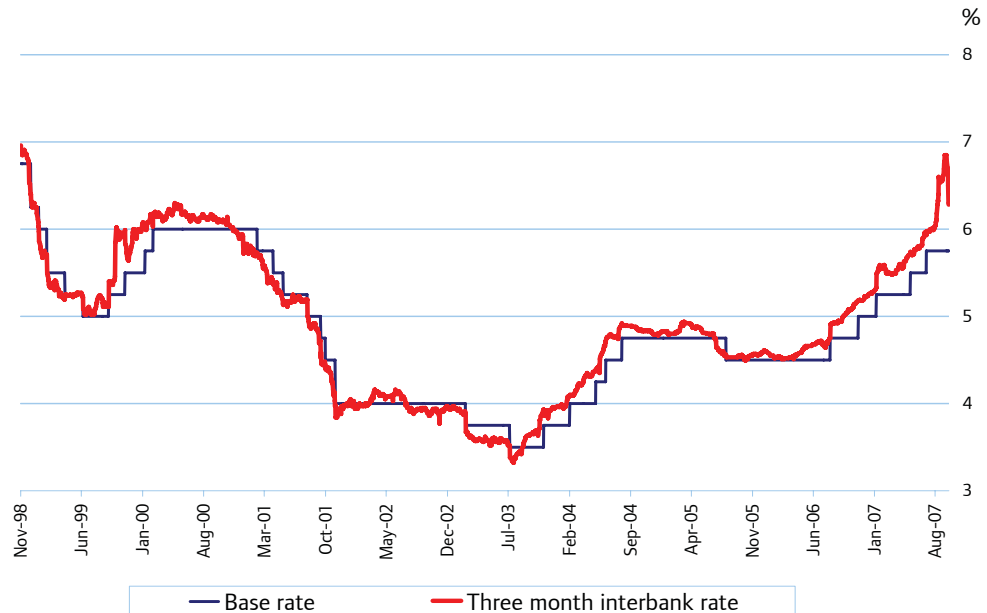
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rate. In spite of Libor falling back slightly over the last couple of weeks, the gap between Libor and the base rate is still far greater than it has been in recent years. Whilst the official policy lending rate is 5.75 per cent, the three month unsecured inter-bank rate in early September was 6.85 per cent. Even following the Bank of England's announcement that they were prepared to inject £10 billion into three month money markets, the rate only fell to around 6.3 per cent.

**Figure 1: UK base rate and the 3 month inter-bank rate, 1998 to 2007**

Source: Bank of England and Ecwin



## City bonuses could fall from high levels amidst recruitment freezes and possible job losses

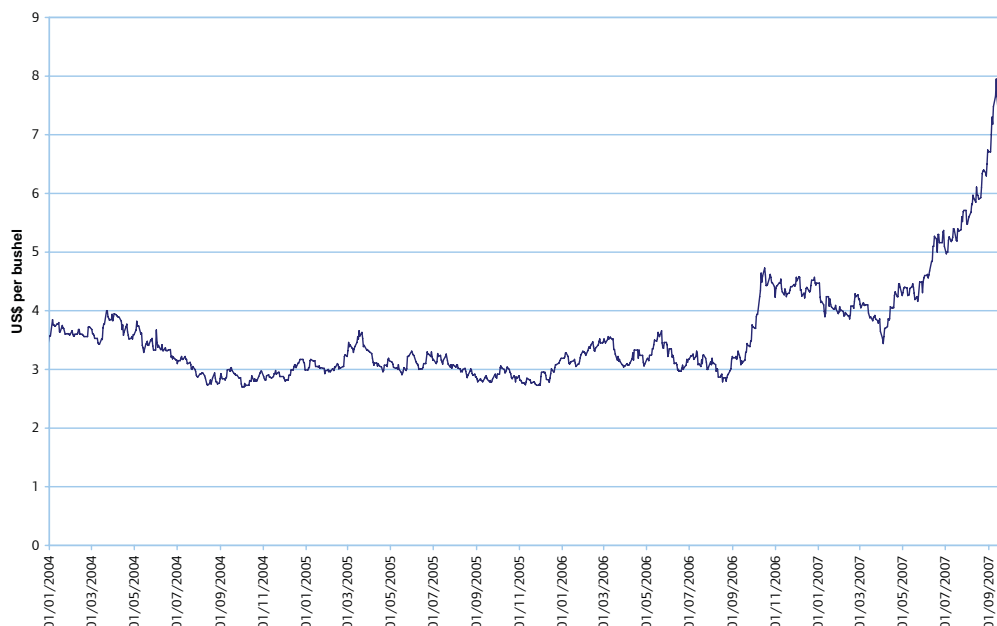
Preliminary data from the Office for National Statistics (ONS) show that the one million people working in the UK financial services sector earned over £14 billion in bonuses in 2007, more than half of the total in bonuses across the whole economy. Slower mergers and acquisitions activity and reduced confidence may lead to a 20 per cent reduction in City bonuses according to the London Stock Exchange. The CEBR<sup>2</sup> claims that cuts in bonuses could have a negative knock-on effect on the housing market in areas popular with City professionals, such as Mayfair, Kensington and Chelsea. However, any fall in bonuses will be from record highs, and foreign investment in the capital's real estate market is expected to remain strong. There will also be some impacts created by less easy access to loans and credit – both for businesses and individuals. These can be expected to impact negatively on consumer expenditure and business investment.

## High commodity prices continue to pose an inflationary risk

In spite of recent falls in UK CPI inflation to just below the 2 per cent target, food prices in particular still represent a volatile element within the index. On 18 September, the Australian Government reduced its forecast of wheat production by nearly one third, from 22.5 million tonnes to 15.5 million tonnes. Global stocks of wheat are at their lowest level for 18 years leading to a sharp rise in wheat prices (see Figure 2).

**Figure 2: Chicago daily spot wheat price at close, 2004 – 2007**

Source: Ecwin



Meanwhile, crude oil prices have now risen by approximately 60 per cent since January and are currently at around \$80 per barrel. US inventories have fallen by more than expected and OPEC's recent agreement to raise production by 500,000 barrels a day has been viewed by most analysts as 'too little and too late'.

### **Chinese inflation will raise prices of imported goods**

The Chinese economy continues to grow strongly and the World Bank has raised its forecast for Chinese growth in 2007 from 10.4 per cent to 11.3 per cent. However, in August, Chinese inflation hit a 10-year high at 6.5 per cent. Recent increases in inflation have been driven by higher food prices and consumer expenditure of an increasingly affluent middle class. Increasing Chinese prices could have significant inflationary impacts on western economies as China has become one of the main suppliers of cheap goods, particularly in sectors such as textiles. In response, the Chinese Government has raised interest rates five times over the last year – and twice in August.

### **The actions of central banks may stoke further inflationary pressures in the world economy**

Liquidity injections are a fairly normal activity by central banks but their recent scale has been large to try to calm financial markets and ease the current credit crunch. Injections of liquidity by central banks represent an increase in the money supply and are therefore potentially inflationary in their effects. A more significant impact could be generated by the Federal Reserve's recent action in cutting US base rates by 0.5 percentage points to 4.75 per cent which was more than the markets were anticipating. If the cut turns out to be more than what was needed, there could be inflationary impacts. Unlike the UK situation, the US monetary policy framework lacks an inflation target and this is a weakness which increases the likelihood of inflationary expectations rising in the US.

## How might London and the UK be affected by recent turmoil?

The UK economy has been healthy over the last few years with strong household spending and investment growth, and GDP growth in the first half of 2007 above trend. Growth in London over the past couple of years has been notably stronger than in the rest of the UK. However, historical patterns suggest that this may be because London is more volatile than the UK as a whole: when the UK economy is doing well, London tends to do very well; when the economy slows, London tends to slow more markedly – particularly when the slowdown is driven by international considerations on account of higher levels of exposure. Its concentration of high level financial services and related professional services make it more vulnerable than the UK as a whole on this front.

The Ernst and Young ITEM club<sup>3</sup> has suggested that the broad impact of the credit crunch for the UK could be in the order of reducing GDP growth by around 1 per cent for both 2008 and 2009. Oxford Economics<sup>4</sup> suggests a similar degree of growth loss for 2008 but something more akin to a 0.6 percentage point loss for 2009. This would seem to be a plausible scenario and puts the effects on the UK somewhere between the stronger impact on the US economy and the relatively small impact on Eurozone growth (although component countries may be hit differentially). However, any slowdown in growth is coming from a strong starting point and a recession seems extremely unlikely (see Table 1).

**Table 1: Credit crunch scenario, annual % growth**

*Source: Oxford Economics*

Baseline scenario	2007	2008	2009
US	1.9	2.8	3.1
Eurozone	2.7	2.4	2.1
Japan	2.4	2.2	2.2
UK	2.9	2.4	2.8
Crunch scenario	2007	2008	2009
US	1.9	1.3-1.7	1.3-1.7
Eurozone	2.7	1.4-1.8	1.4-1.8
Japan	2.3	0.8-1.2	1.3-1.7
UK	2.8	1.2-1.6	2.0-2.4

### Footnotes

1 London Interbank Offered Rate

2 Centre for Economic & Business Research

3 ITEM (Independent Treasury Economic Model) Club Special report, Sept 2007

4 Oxford Economics – How much of a threat does the subprime crisis pose? (20 Aug 2007)

# Economic indicators

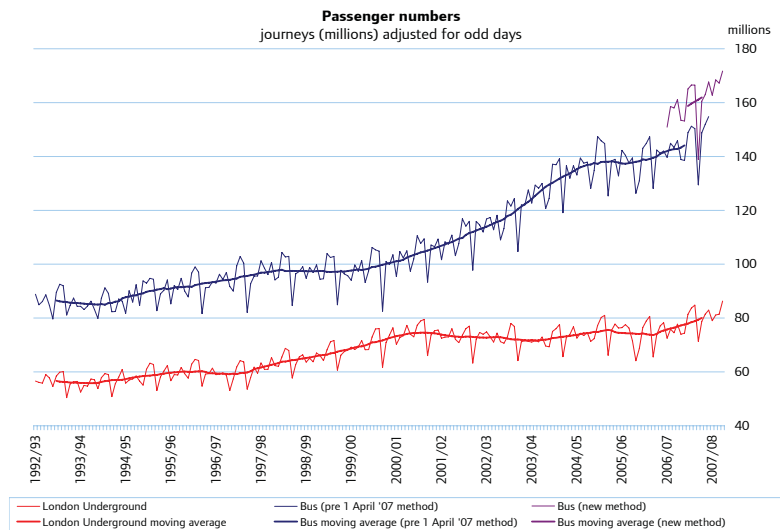
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## Increase in moving average of passenger numbers

- The most recent 28-day period is from 24 June to 21 July 2007. London's Underground and buses had 258.0 million passenger journeys; 171.7 million by bus and 86.3 million by Underground.
- The moving average increased to 242.0 million passengers every period from 240.5 million. The moving average for buses was 161.9 million. The moving average for the Underground was 80.1 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: September 2007

Next release: October 2007



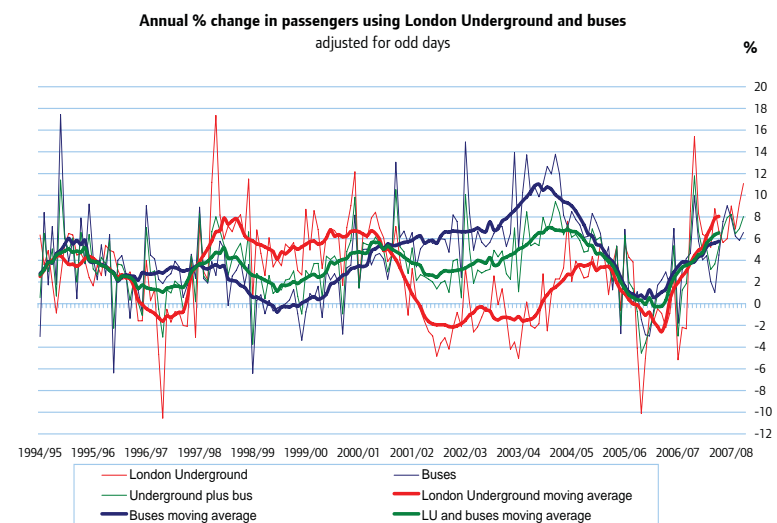
Source: Transport for London

## Average annual growth rate of passengers continues to rise

- The moving average annual rate of growth in passenger journeys increased to 6.5% from 6.4% in the previous period.
- The moving average annual rate of growth in bus passenger journey numbers rose to 5.8% from 5.6% in the previous period.
- The moving average annual rate of growth in Underground passenger journey numbers increased to 8.1% from 7.9% in the previous period.

Latest release: September 2007

Next release: October 2007



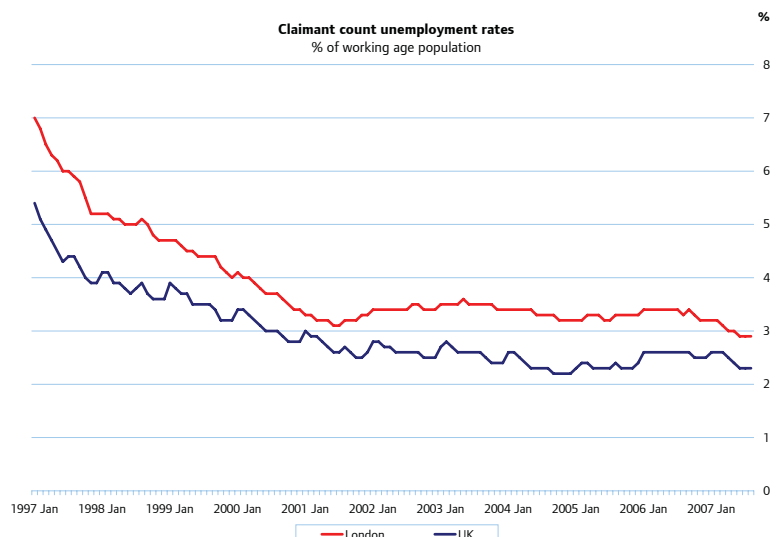
Source: Transport for London

## 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 August 2007.
- There were 143,900 unemployment claimants in London in August 2007 compared with 166,200 in August 2006.
- The claimant count unemployment rate of the UK remains below that of London.

Latest release: September 2007

Next release: October 2007



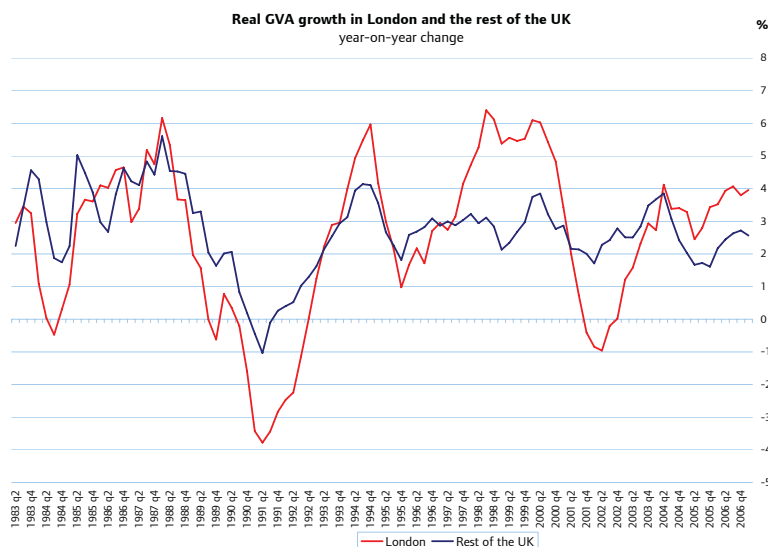
Source: Claimant Count, NOMIS

## Annual growth in London quicker than the rest of the UK

- London's annual growth in output increased to 4.0% in Q1 2007 from 3.8% in Q4 2006.
- The rest of the UK's annual growth in output fell to 2.6% in Q1 2007 from 2.7% in Q4 2006. London has been growing at a faster annual rate than the rest of the UK since Q2 2004.
- There have been revisions to previous growth rates to reflect the availability of new data.

Latest release: August 2007

Next release: November 2007



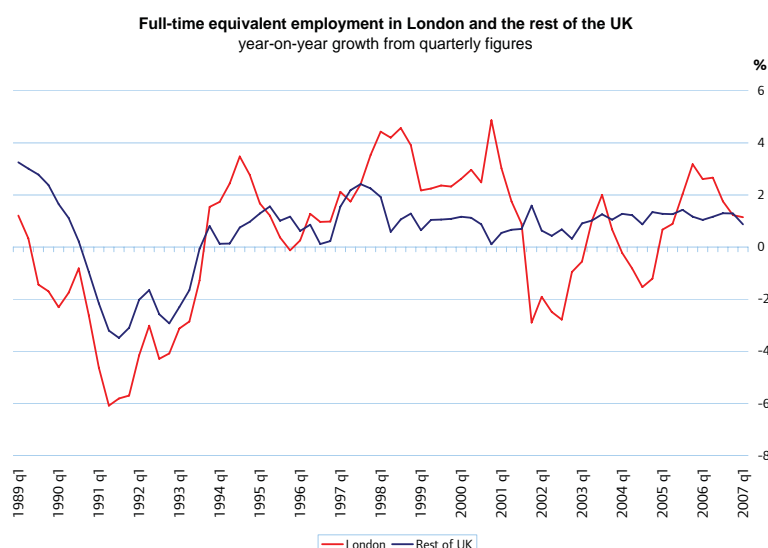
Source: Experian Business Strategies

## Higher annual employment growth in London than the rest of the UK

- London's annual employment growth fell to 1.1% in Q1 2007 from 1.2% in Q4 2006.
- Annual employment growth in the rest of the UK fell to 0.9% in Q1 2007 from 1.3% in Q4 2006.
- There have been revisions to previous growth rates to reflect the availability of new data.

Latest release: August 2007

Next release: November 2007



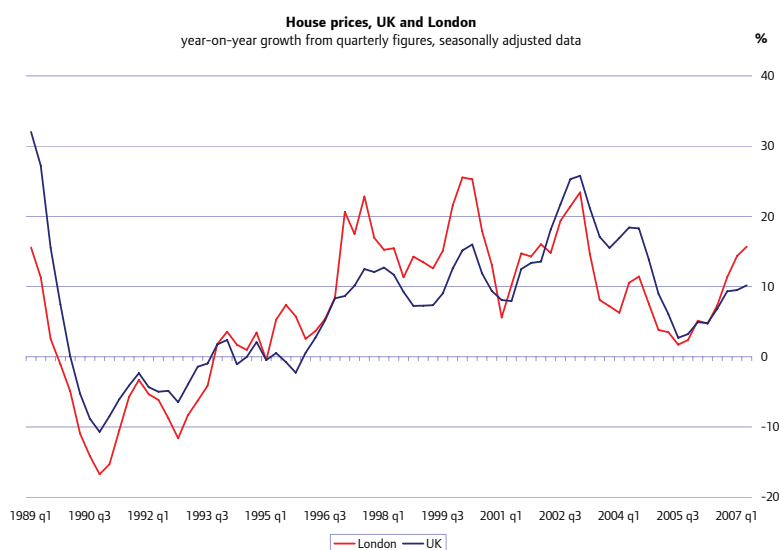
Source: Experian Business Strategies

## House price inflation continues to be higher in London than the UK

- Nationwide reported stronger annual house price inflation for London than the UK in Q2 2007.
- Annual house price inflation in London was 15.7% in Q2 2007, up from 14.3% in Q1 2007.
- Annual house price inflation in the UK was 10.2% in Q2 2007, up from 9.5% in the previous quarter.

Latest release: July 2007

Next release: October 2007



Source: Nationwide

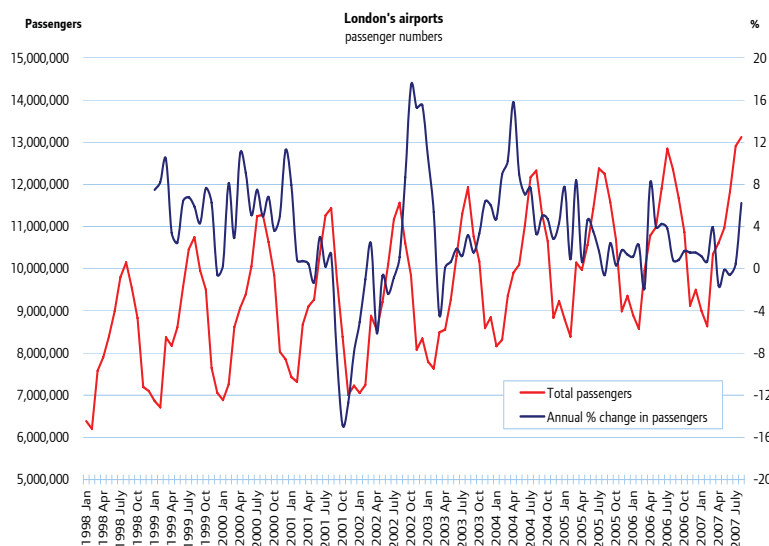


## Increase in year-on-year airport passenger numbers

- 13.1 million passengers travelled through London's airports in August 2007.
- The number of passengers using London's airports increased by 6.2 per cent from August 2006 to August 2007.
- The number of passengers using London's airports has risen year-on-year for the past two months.

Latest release: September 2007

Next release: October 2007



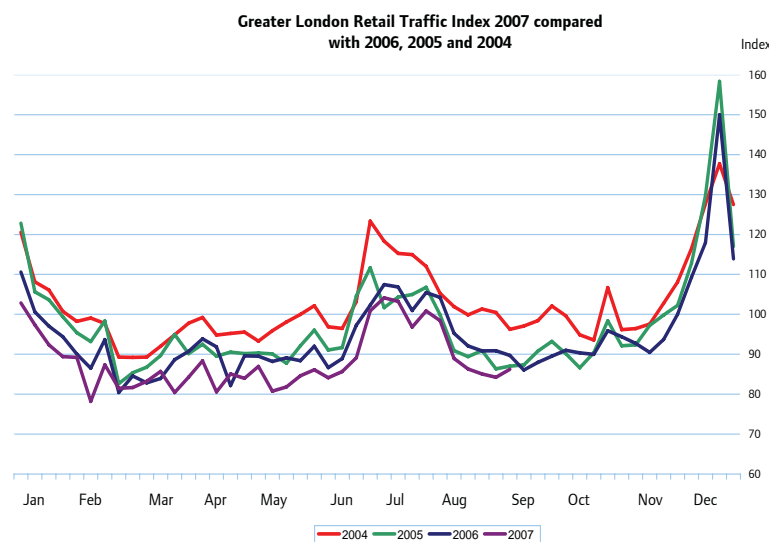
Source: Civil Aviation Authority

## SPSL Retail Traffic still below 2006 levels

- The SPSL Retail Traffic Index of shoppers in London was 86.2 in the first week of September compared to 84.2 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-September

Next release: Weekly



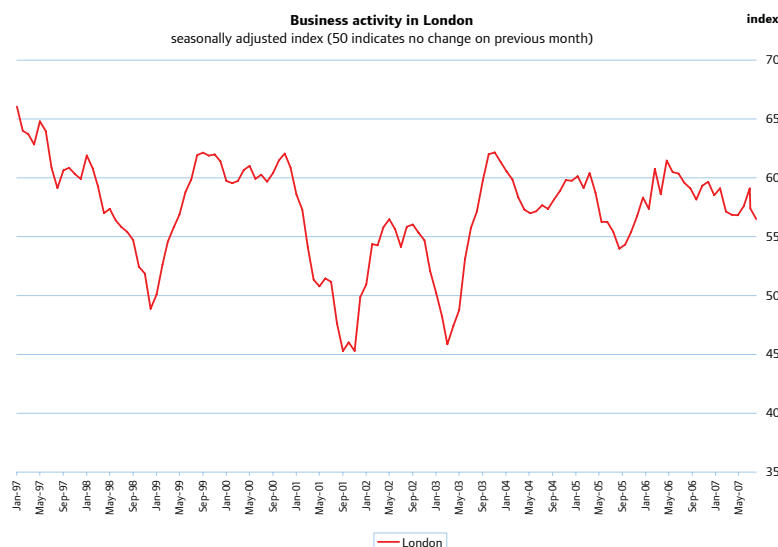
Source: SPSL

## London's business activity still expanding

- London firms continued to expand their output of goods and services in August 2007.
- The Purchasing Managers' Index (PMI) of business activity recorded 56.5 in August 2007 compared to 57.4 in July.
- 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: September 2007

Next release: October 2007



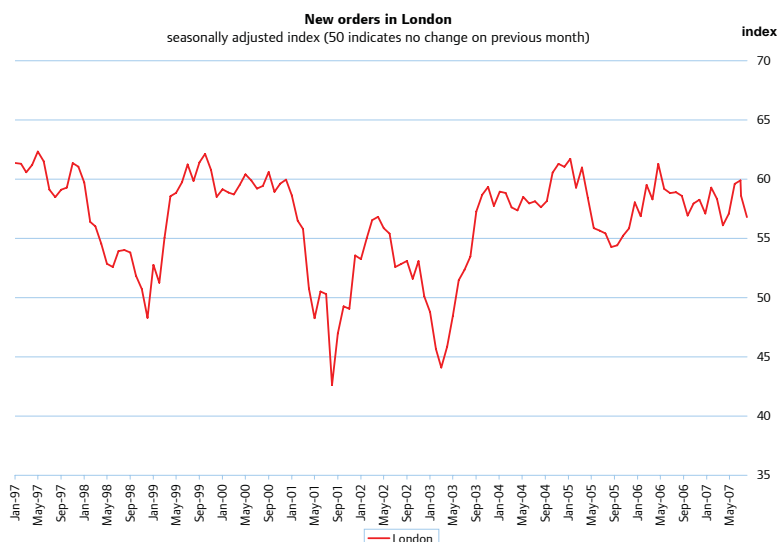
Source: The Royal Bank of Scotland/NTC Economics

## New orders in London still increasing

- August 2007 saw continued growth in new orders for London firms.
- The PMI for new orders recorded 56.8 in August compared to 58.6 in July.
- A rate of above 50 on the index indicates an increase in new orders from the previous month.

Latest release: September 2007

Next release: October 2007



Source: The Royal Bank of Scotland/NTC Economics

## Firm employment growth in London

- London firms continued to increase their level of employment in August 2007.
- The PMI for the level of employment was 53.9 in August compared to 54.6 in July.
- A rate of above 50 on the index indicates an increase in the level of employment from the previous month.

Latest release: September 2007

Next release: October 2007



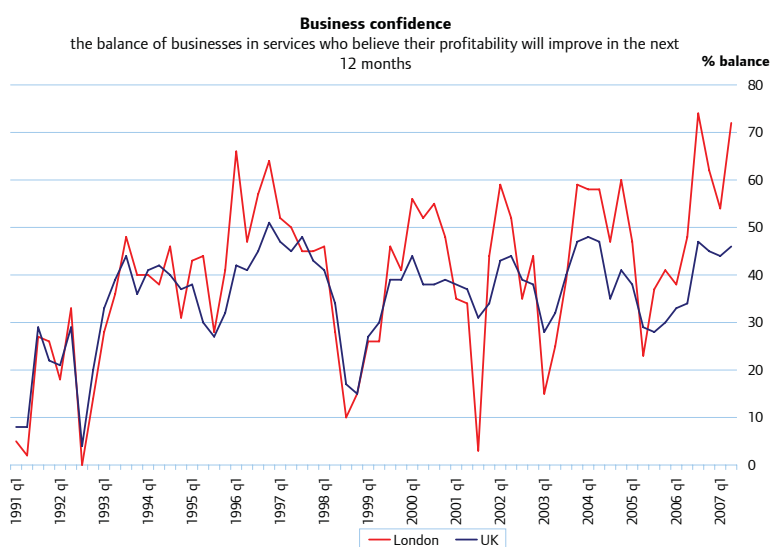
Source: The Royal Bank of Scotland/NTC Economics

## Expectations of profitability remain higher in London than for the UK

- The British Chamber of Commerce's July Quarterly Economic Survey (QES) shows that London's service sector expects its profitability to improve.
- The net balance of businesses in services in London expecting to increase profitability over the next 12 months was 72% in Q2 2007.
- The net balance of UK businesses in services expecting increased profitability over the next 12 months was 46% in Q2 2007.

Latest release: July 2007

Next release: October 2007



Source: British Chamber of Commerce, Quarterly Economic Survey



# The value of London's key exports<sup>1</sup>

Katerina Angelopoulou,  
Trainee Economist

**This article describes the approach taken by GLA Economics to estimate London's exports of goods and services, and provides the latest results for 2005.**

The Office for National Statistics (ONS) provides some estimates of trade statistics for regions in the UK from information collected via Customs and Excise and Intrastat surveys. These statistics are in their infancy and apply to visible goods only. Close inspection of the estimates raises doubts about using these statistics for London at this stage. For example, the total visible exports attributed to London's manufacturing, agriculture, mining and energy sectors is greater than the measured total output of these sectors in London. The source of this problem is that London's role as a centre of administration and distribution means survey responses are sourced to London when goods are actually produced and exported from elsewhere in the UK.

In addition to the problems with regional goods exports information, there is no official report on UK regional services exports. Given that London's economy is concentrated in business and financial services, this is a significant weakness in the understanding of regional trade.

GLA Economics has endeavoured to develop a consistent approach for estimating London's exports in goods and services. The method distributes UK exports to London by sector, based on London's share of UK employment for the relevant sector. No adjustment is made for the different productivity of London's employees, which tends to be higher than the average for the UK (and as such could raise London's level of exports). Neither is any adjustment made for a potentially higher rate of export intensity in London – that is, production in London may be more geared towards overseas markets than other UK regions. As a result, our estimates for London's exports are likely to understate the true position.

## Exports of goods

In 2005, the latest year for which data is available, London had 205,000 jobs in sectors producing export goods; this represents 6.0 per cent of total UK employment in sectors producing export goods. London's share of employment in many of these export goods sectors is small. However, in publishing and printing, London's share of UK employment is 27 per cent and in clothing, London's share of UK employment is 20 per cent.

It is estimated that London's exports of goods was £9.2 billion in 2005, or 5 per cent of the value of total UK goods exports. The oil and gas sector is the largest contributor to the value of London's goods exports under this methodology, but this reflects the importance of London as a headquarters for many large firms in this sector rather than visible trade.

Of the remaining goods sectors, London's most important sources of exports are:

- publishing and printing – exports of £755 million
- radio, TV, telephony – exports £747 million
- motor vehicles – exports of £732 million

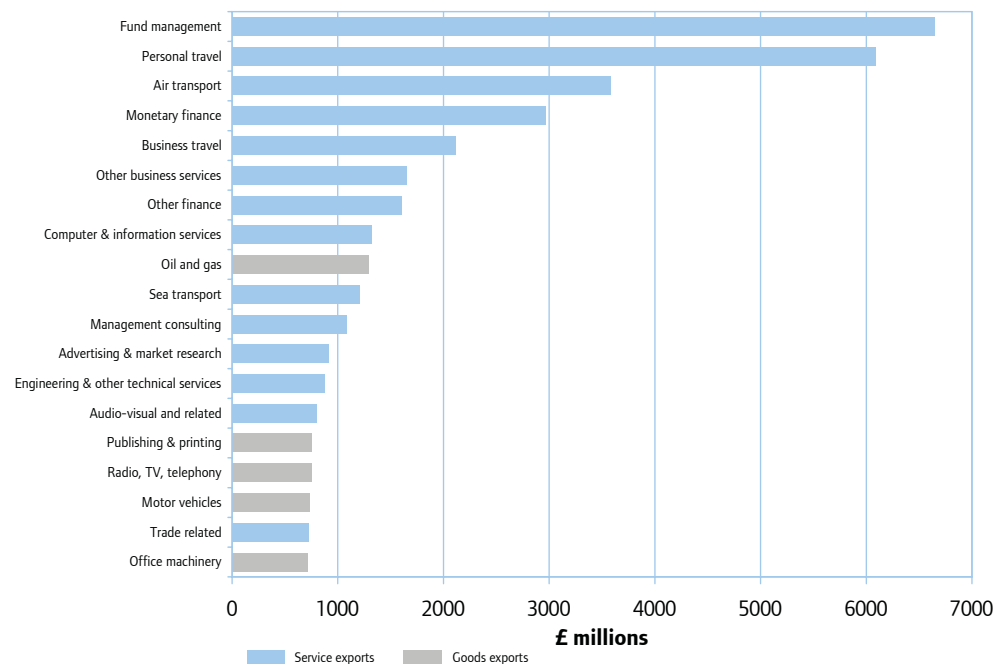
## Exports of services

London has 1.5 million jobs in service export sectors, 24 per cent of the national total. For many of these key exports, London's share of jobs is even higher with 72 per cent of jobs in fund management, 51 per cent of jobs in audio-visual services, 50 per cent of jobs in air transport, 38 per cent of jobs in advertising and 30 per cent of jobs in legal activities.

It is estimated that in 2005 London's total exports of services was £35 billion, 33 per cent of the value of all UK service exports, inclusive of travel. One of London's greatest service exports is the city itself – as a destination for holiday and business tourism. As a result of spending by overseas visitors, London's personal travel exports were an estimated £6.1 billion in 2005.<sup>2</sup> Travel exports are the second highest exports after fund management (£6.6 billion), followed by air transport (£3.6 billion), finance (£3 billion), and a range of business services. These sectors account for half of London's exports of services, equivalent to 17 per cent of all the UK's exports of services.

**Figure 3: Estimated values of London exports of goods and services in 2005**

Source: GLA Economics



## London's concentration in exports

Exports of services from London's economy represent 33 per cent of the UK total; exports of services represent 17 per cent of London's GVA. London is much less dependent on goods exports; London accounts for 5 per cent of the UK's total of export goods and the export of goods represents 5 per cent of London's GVA. Total exports from London, combining goods with services, equalled £44 billion in 2005, 22 per cent of London's GVA and equivalent to 15 per cent of all UK exports of goods and services.

## London: Source of UK services trade

The ONS Pink Book publication looks at total UK trade in services by type of service and geography. The most recent UK data is for 2005. The UK trade surpluses in business services and in financial services with both the EU and US emphasise the competitive advantage the UK has in these sectors. The UK's only deficits in services are in travel. The travel services deficit with the EU can be entirely attributed to the level of UK tourists visiting Spain and France.

London is the UK centre of services in business and finance. At least a third of UK exports in these sectors are from London. Therefore, the trade surpluses the UK records in services (which supports the UK's balance of payments) depend upon the performance of these sectors in London.

International trade in both business services and in finance, although largely focused on the EU, is also much more exposed to international markets and the US in particular than most export sectors of the UK. This further emphasises London's role as a world city with global linkages in its trade of business and financial services.

### Footnotes

- 1 Estimates based on UK trade and ABI employment figures.
- 2 London's exports of personal travel and business travel are estimated separately from other calculations using data from the ONS Pink Book and London and UK level expenditure from the International Passenger Survey (IPS).

## Data sources

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

## 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

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

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GLA Economics provides expert advice and analysis on London's economy and the economic issues facing the capital. Data and analysis from GLA Economics 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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