London's Economy Today



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In this issue

GLAECONOMICS

Economic tough times with inflation rising while growth slows

by Richard Davies, Economist, Gordon Douglass, Economist and Christopher Lewis, Senior Economist

The UK economy faces rocky times with growth slowing at the same time as inflation is increasing. UK CPI inflation rose from 2.5 per cent in March to 3.0 per cent in April mainly due to increases in petrol, energy and food prices. The Bank of England's Governor Mervyn King has warned that the outlook for inflation has deteriorated markedly in recent months. CPI inflation is now expected to be above 3 per cent for much of the rest of the year (the government's target is 2 per cent). Factory gate inflation has also increased reaching an annual rate of 7.5 per cent in April from 6.5 per cent in March. Major inflationary pressures are coming from dramatically increasing oil prices with Brent crude oil trading at around $130 per barrel (see Figure 1).

Latest news...

- **GLA Economics' 'Credit crunch and the London economy' seminar - Thursday 26 June**

The credit crunch represents one of the most serious tests for the UK economy (and particularly the London economy) of the past decade or so. This seminar will look at the impacts of the credit crunch on financial services - a sector crucial to London's economy. It will also address specific impacts of the credit crunch on London's property markets. We will conclude with GLA Economics' latest forecast for London's growth in output, employment, household expenditure and household income in 2008, 2009 and 2010. If you would like further information about this event please email **glaeconomics@london.gov.uk**

Figure 1: Brent crude oil price

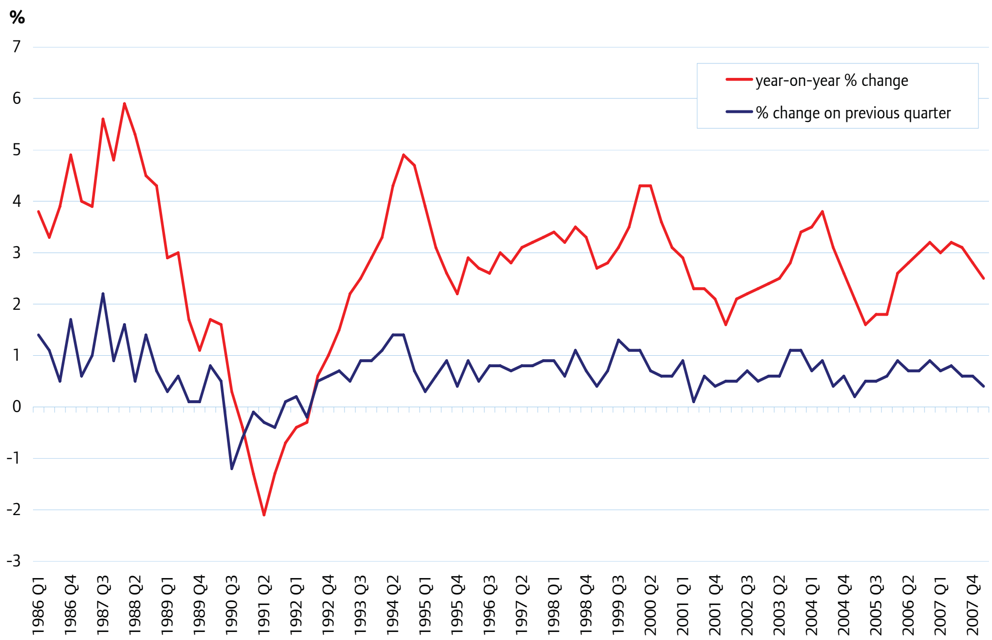
Source: FT

The UK economy is weakening

The UK economy is estimated to have grown by a below trend 0.4 per cent in Q1 2008, the lowest rate since Q1 2005 (see Figure 2). The annual growth rate in Q1 2008 fell to 2.5 per cent from 2.8 per cent in Q4 2007. Growth in the UK service sector has weakened and is likely to slow further. As the recent driver of the UK economy a faltering service sector will negatively impact on total economic growth during the next few years. 'Other business activities', 'wholesale', 'hotels and restaurants', and 'post and telecommunications' were all sub-sectors that were particularly weak in Q1 2008. Overall, the UK's business services and finance sector only grew by 0.4 per cent in Q1 2008, which was the lowest rate since Q2 2003. Business investment fell and investment in dwellings was subdued in Q1 2008. The business services and finance sector plays an important role in the London economy. Hence, the slowdown this sector has experienced since autumn 2007, which is expected to continue, will dampen the capital's economic growth over the next couple of years.

Figure 2: UK GDP Growth

Source: Office for National Statistics



London's success lies in its role as a strong player in global markets

London Chamber of Commerce and Industry's "The competitiveness of London – future challenges from emerging cities" (April 2008) report, written by Europe Economics, has compared London's future competitiveness to emerging competitor cities. The research provided an insight into the size and scope of future challenges faced by London from the rapidly developing cities of Dubai, Mumbai, Moscow and Shanghai. The report concluded that the key to London's success lies in its role as a strong player in competitive global markets and in attracting internationally mobile services and skilled personnel. London's economy is very strong in global services, especially financial, and it is important that efforts continue to retain and attract international firms in this area. It is therefore vital that firms are not subject to either excessive regulation or regulatory uncertainty.

Federal Reserve cuts interest rates again

On 30 April the US Federal Reserve cut the federal fund interest rate for the seventh time since September 2007 by 25 basis points to 2 per cent. The cut was made despite upside risks to the inflation outlook in a further attempt to bolster the weak US economy, which only grew by 0.1 per cent in Q1 2008. The Federal Reserve has now reduced its 2008 growth forecast to between 0.3-1.2% (from 1.3-2% in February). In April US unemployment rose again, though by less than in March. The effects of the credit crunch are still being felt with lending criteria to businesses and consumers continuing to tighten. However, more recently, the Fed has suggested that interest rates must now reflect the inflation risks from energy costs.

London's economy to slow as the UK stutters

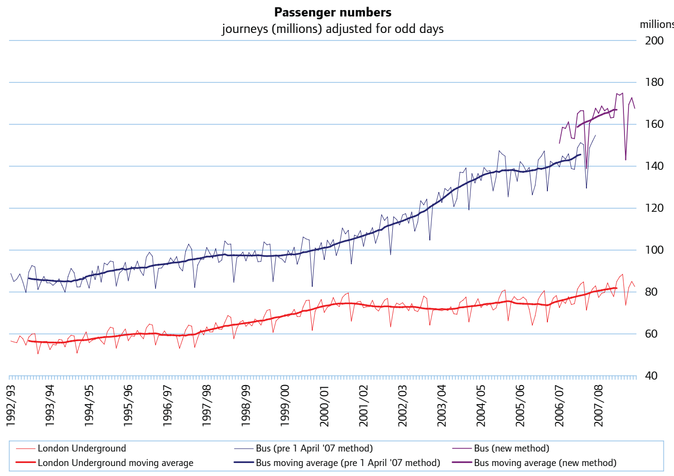
Over the last couple of years London's economy has grown robustly and has outperformed the rest of the UK. However, with the credit crunch still negatively impacting upon the financial services and commercial property sectors in particular, the London economy is expected to grow at a below trend rate during the next few years. Tougher lending criteria, falling consumer confidence and increasing inflationary pressures will all dampen real household expenditure. Demand uncertainty and tighter credit conditions are reducing business investment intentions, especially in the service sector, so overall domestic demand growth could fall dramatically. The recent depreciation in sterling should increase net exports, but exporters are facing slowing world demand led by the US. London's economy therefore faces the rockiest economic background since the early 1990s. Further falls in house prices and a changing labour market involving higher unemployment should all be expected.

Economic indicators

Moving average of passenger numbers unchanged

- The most recent 30-day period is from 2 March 2008 to 31 March 2008. Adjusted for odd days London's Underground and buses had 250.1 million passenger journeys; 167.6 million by bus and 82.5 million by Underground. Passenger journeys were depressed in the period by Easter, which usually reduces journeys by around 6%.
- The moving average of passengers every period remained at 248.8 million (there has been downward revisions to previous data). The moving average for buses was 167.0 million. The moving average for the Underground was 81.8 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: May 2008
Next release: June 2008

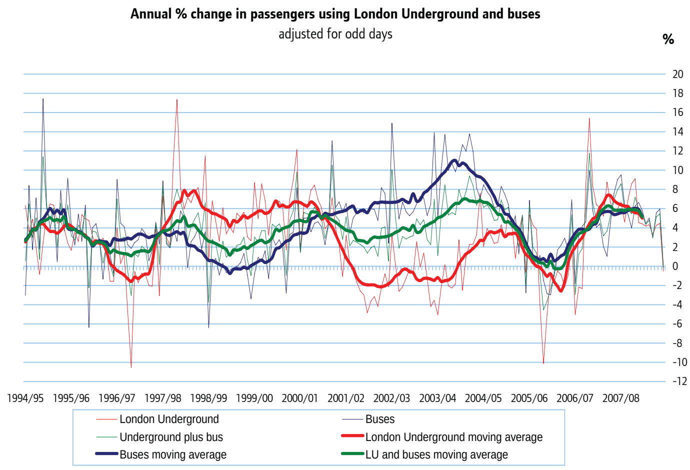


Source: Transport for London

Average annual growth rate of passengers decreases

- The moving average annual rate of growth in passenger journeys decreased to 5.1% from a downwardly revised 5.8% in the previous period.
- The moving average annual rate of growth in bus passenger journey numbers decreased to 5.2% from a downwardly revised 5.9% in the previous period.
- The moving average annual rate of growth in Underground passenger journey numbers decreased to 5.0% from a downwardly revised 5.5% in the previous period.

Latest release: May 2008
Next release: June 2008

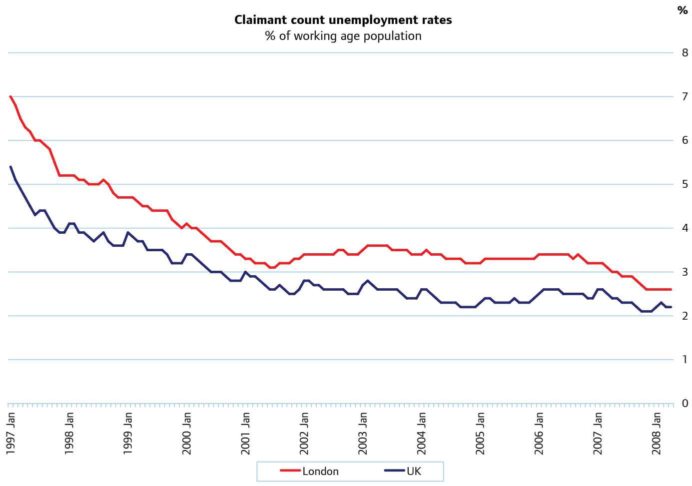


Source: Transport for London

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 2.6% in April 2008.
- There were 130,000 unemployment claimants in London in April 2008 compared with 153,500 in April 2007.
- The claimant count unemployment rate of the UK remains below that of London.

Latest release: May 2008
Next release: June 2008

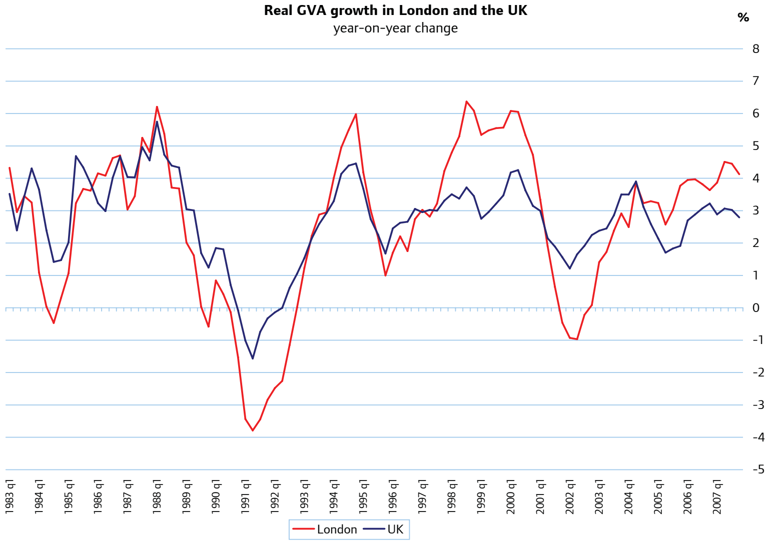


Source: Claimant Count, Nomis

Annual output growth in London still faster than in the UK

- London's annual growth in output decreased to 4.1% in Q4 2007 from a downwardly revised 4.4% in Q3 2007.
- The UK's annual growth in output decreased to 2.8% in Q4 2007, from a downwardly revised 3.0% in Q3 2007. London has been growing at a faster annual rate than the UK since Q3 2004.
- There have been revisions to previous growth rates to reflect the availability of new data.

Latest release: May 2008
Next release: August 2008

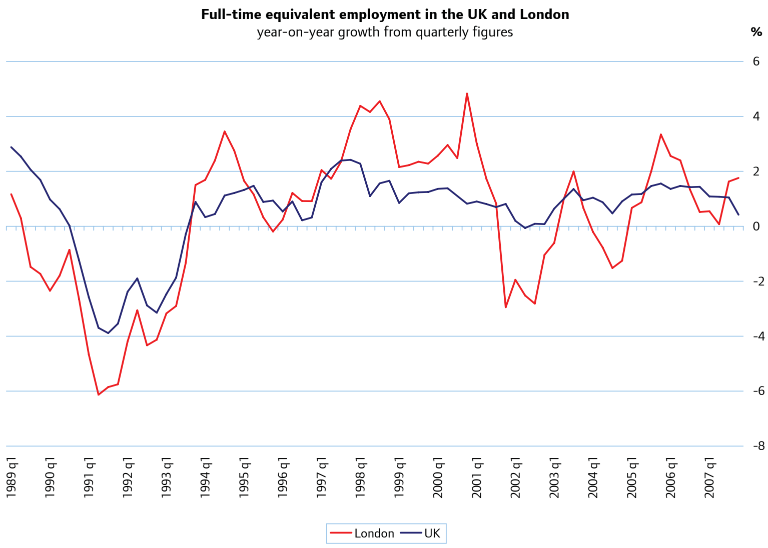


Source: Experian Business Strategies

London's annual employment growth faster than in the UK

- London's annual employment growth increased to 1.8% in Q4 2007 from 1.6% in Q3 2007.
- Annual employment growth in the UK decreased to 0.4% in Q4 2007 from an upwardly revised 1.1% in Q3 2007.
- There have been revisions to previous growth rates to reflect the availability of new data.

Latest release: May 2008
Next release: August 2008

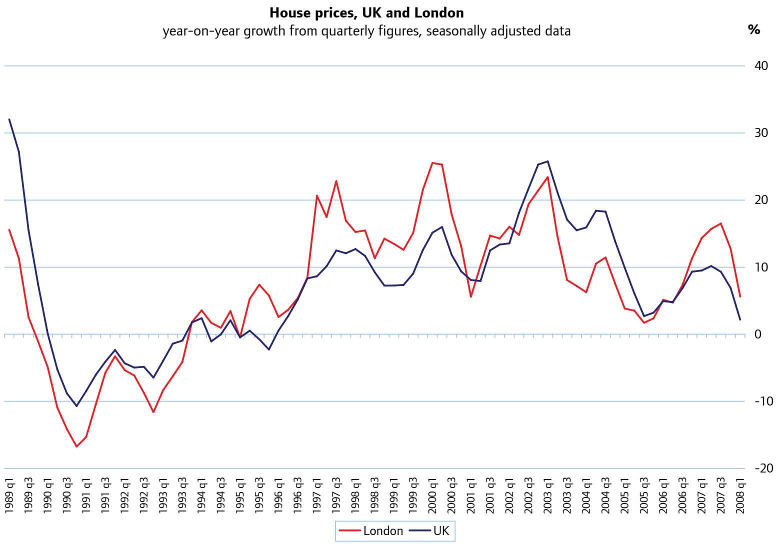


Source: Experian Business Strategies

Annual house price inflation slowing sharply

- Nationwide reported stronger annual house price inflation for London than the UK in Q1 2008.
- Annual house price inflation in London was 5.6% in Q1 2008, down from 12.8% in Q4 2007.
- Annual house price inflation in the UK was 2.2% in Q1 2008, down from 6.9% in Q4 2007.

Latest release: April 2008
Next release: July 2008

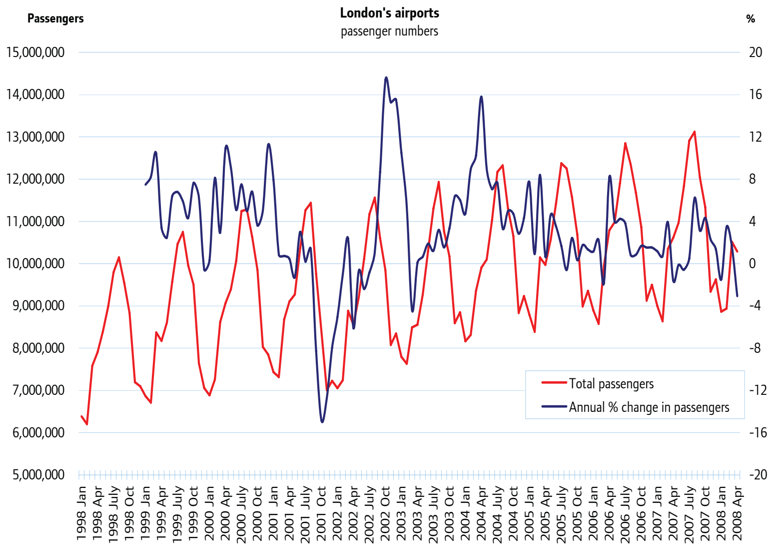


Source: Nationwide

Fewer airport passengers in April compared to previous year

- 10.3 million passengers travelled through London's airports in April 2008.
- The number of passengers using London's airports decreased by 3.1 per cent from April 2007 to April 2008.
- The number of passengers using London's airports has fallen year-on-year for the first time since January 2008.

Latest release: May 2008
Next release: June 2008

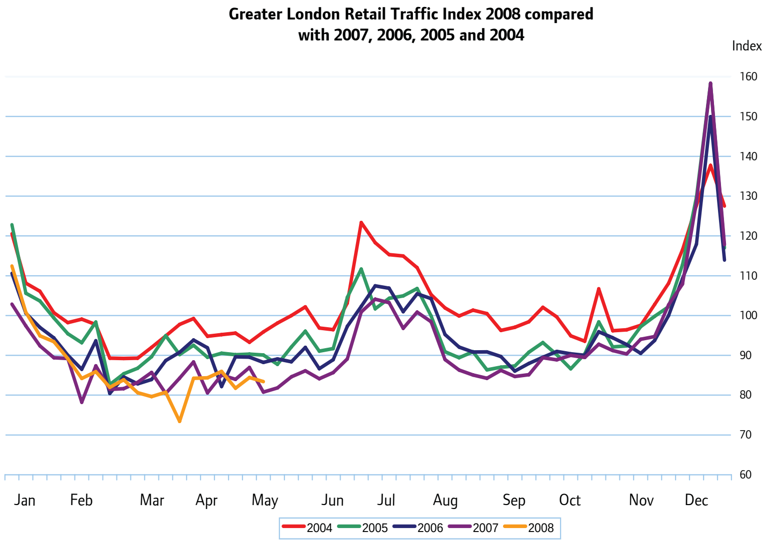


Source: Civil Aviation Authority

SPSL Retail Traffic similar to 2007 levels

- The SPSL Retail Traffic Index of shoppers in London was 83.4 in the first full week of May compared to 84.4 in the previous week.
- The index has been quite similar to 2007 levels this year.
- SPSL's Retail Traffic Index measures the number of shoppers and does not necessarily reflect the level of spending.

Latest release: Mid-May
Next release: Weekly

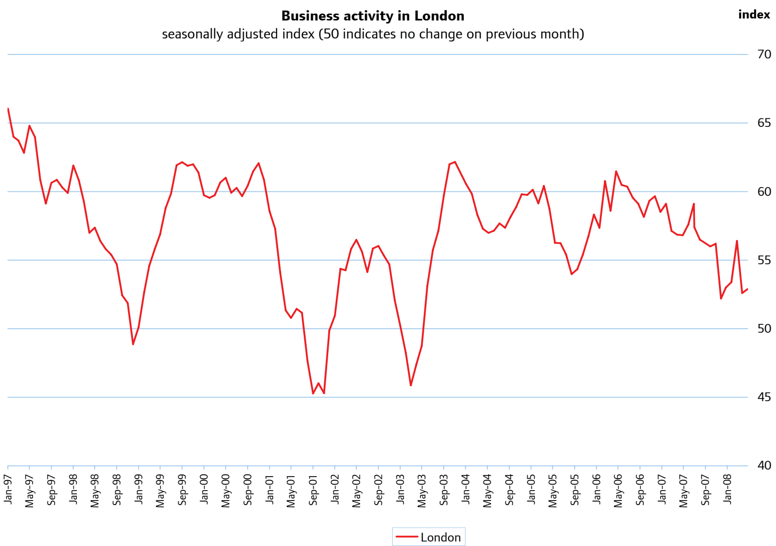


Source: SPSL

London's business activity expanding slowly

- London firms continued to expand their output of goods and services in April 2008.
- The Purchasing Managers' Index (PMI) of business activity recorded 52.9 in April compared to 52.6 in March.
- 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: May 2008
Next release: June 2008



Source: The Royal Bank of Scotland/NTC Economics

Employment still increasing in London

- London firms continued to increase their level of employment in April 2008.
- The PMI for the level of employment was 52.3 in April compared to 51.0 in March.
- A rate of above 50 on the index indicates an increase in the level of employment from the previous month.

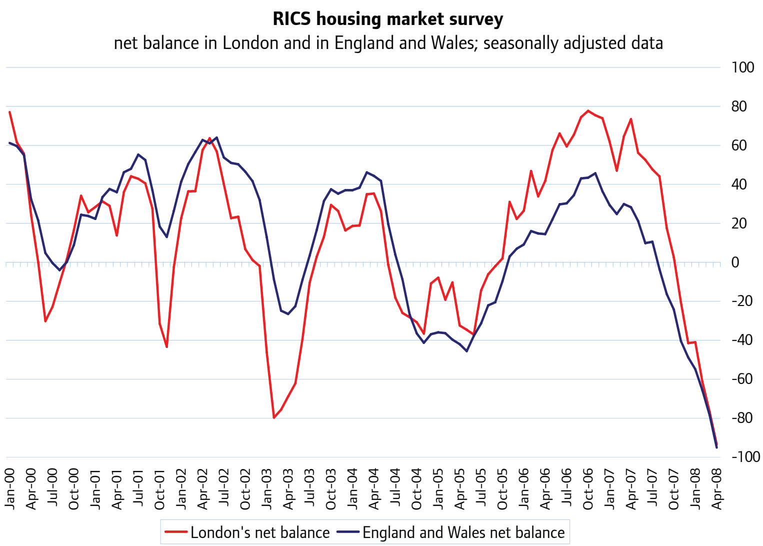
Latest release: May 2008
Next release: June 2008

Source: The Royal Bank of Scotland/NTC Economics

Surveyors report that house prices are falling in London and in England and Wales

- The RICS survey shows a negative net balance of -94 for London house prices over the past three months up to April 2008. This net balance is down from –77 in March.
- Surveyors reported a negative net house price balance for England and Wales of –95 in April 2008, down from -78 in March.
- London's net balance remains just above that of England and Wales.

Latest release: May 2008
Next release: June 2008

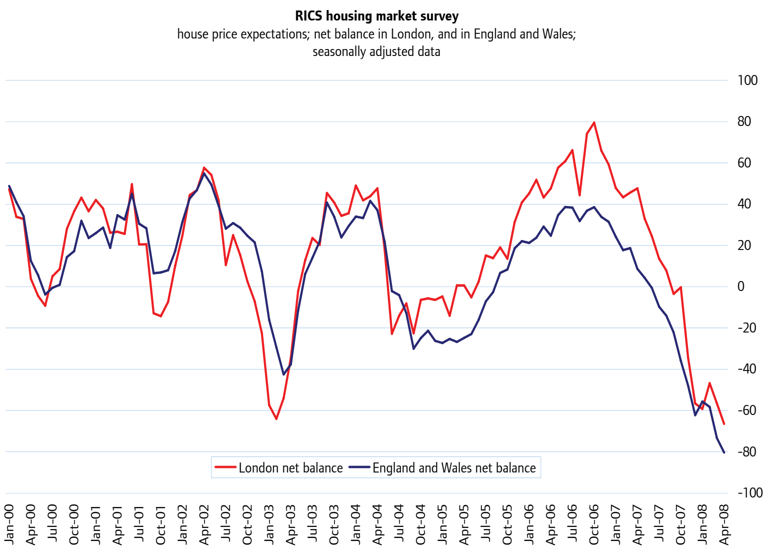


Source: Royal Institute of Chartered Surveyors

Surveyors expect house prices to fall further in London and in England and Wales

- The RICS survey shows that surveyors expect house prices to decrease over the next three months in London and in England and Wales.
- The net house price expectations balance in London was -66 in April 2008, down from -57 in March.
- For England and Wales, the net house price expectations balance was –80 in April 2008, down from –73 in March.

Latest release: May 2008
Next release: June 2008



Source: Royal Institute of Chartered Surveyors

Credit crunch and the property market

by CB Richard Ellis, summarised by Margarethe Theseira

Earlier this year, GLA Economics commissioned CB Richard Ellis to provide a report on the impacts of the credit crunch on the property market. For this feature article we summarise the key findings from that report. The full report is available online at www.london.gov.uk/gla/publications/economy.jsp#crunch and the findings will form part of a wider GLA Economics seminar on the credit crunch and the London economy. The seminar will take place at City Hall on the morning of 26 June. Places are strictly limited so you must register in advance if you wish to attend – for further details please contact glaeconomics@london.gov.uk or phone us on 020 7983 4922.

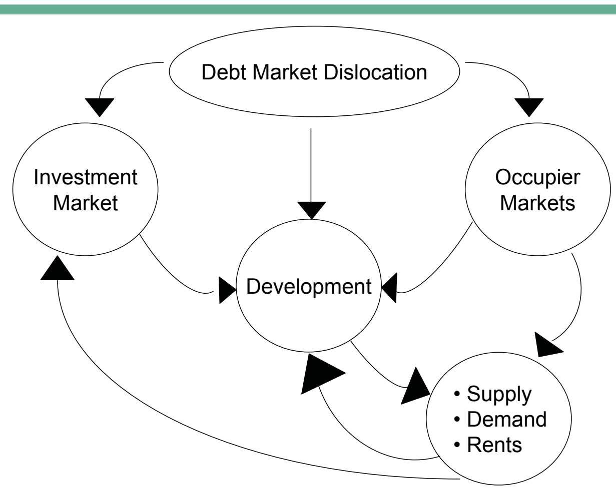
Property investment in the UK was extremely strong between 2004 and the early part of 2007 driven by growth in cheap debt and a strong flow of money from private investors diversifying from other asset classes.

The collapse of the US sub-prime mortgage market in mid-2007 caused widespread contamination in world financial markets. In the UK, the aftershocks of the sub-prime mortgage crisis have hit financial sector activity but as of yet, there have been limited job cuts. The full impact of the credit crunch on the property sector will be felt through the inter-related effects that it is having on investment, development and occupational demand. There have already been sharp changes in investment activity and pricing.

The impact on development will become more apparent going forward in the amount of new construction activity. Impacts on occupational demand will be a consequence of the effect that the credit crunch, alongside other economic influences, has on business investment, employment, consumer spending and retail sales amongst other economic variables. Changes in these variables in turn feed through to occupational demand for commercial property, interacting with property supply to determine rental levels. The demand/supply balance in the market and resulting rental trends will in turn feed back to pricing and decisions in both the development and investment markets.

Figure 3: Credit squeeze: property market impacts

Source: CB Richard Ellis



The impact of the credit crunch has already been felt in the London property market with a discernible decline in leasing levels from the fourth quarter of 2007. The fall in leasing activity was most apparent in the City with its high concentration of banking and financial companies. This trend continued into the beginning of 2008 with the decrease in occupational demand spreading to the West End.

Investment volumes, which had set consecutive records in the second and third quarter of 2007, fell back sharply in the final quarter of the year, only to recover slightly in the first quarter of 2008 and there has been a marked impact on yields. Although yields have stabilised in recent months, yields are likely to remain below the long-term average. In Outer London where yields have not moved out as far, there is scope for outward movement to maintain the relative pricing to prime.

Figure 4: Historic Central London Prime Office Yields

Source: CB Richard Ellis Monthly Prime Yields

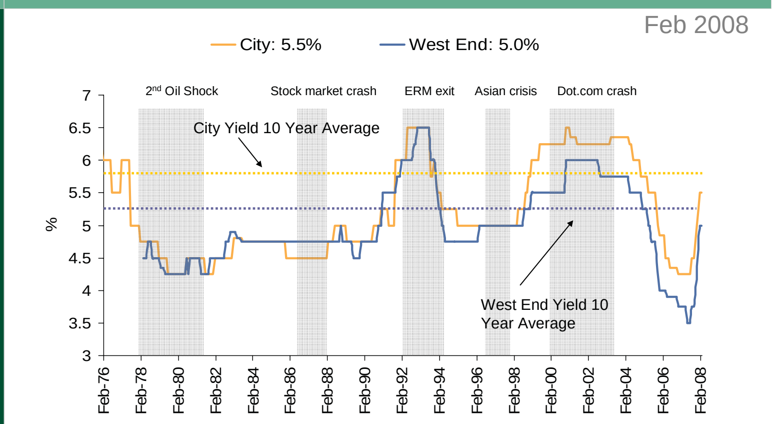
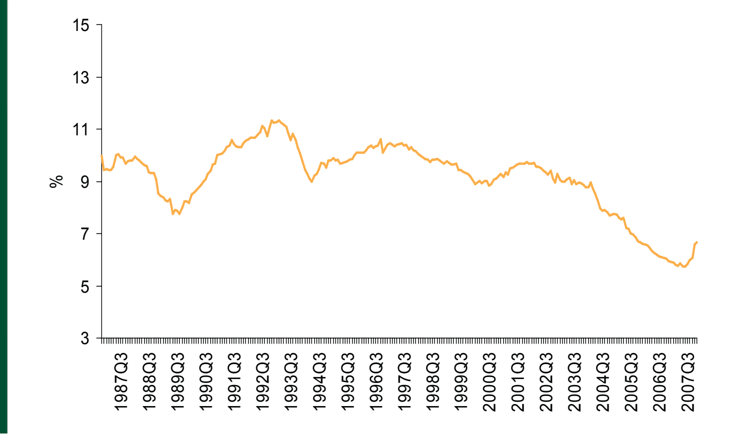


Figure 5: Rest of London Office Yields

Source: IPD, February 2008



Comparison with other downturns

There are reasons to suggest that the current downturn will not be of the same scale as that of the 1990s. There is a wider range of investors, particularly from overseas, active in the London investment market in sharp contrast to the domestic investors that dominated in the period leading up to the 1990s. Developers have been quick to react to the changing market conditions and although the development pipeline will peak this year, the potential for a sharp rise in development and therefore supply has been removed. This contrasts with the uninterrupted build up of development in the 1990s before demand collapsed. The recent fall in the cost of borrowing aligned with the outward movement in yields have made debt-financed investment easier than in the recent past, although tighter lending conditions have offset this to some extent. The UK economy is forecast to grow this year, albeit significantly below trend, so the macroeconomic environment is on a better footing than in the 1990s. However, the London economy with its high concentration of banking and financial companies remains highly susceptible to the fall out from the credit crunch.

For the retail market there is likely to be a weakening but compared to previous cycles the sector is relatively better placed. Retail rents have not experienced the same volatility as they have in the past and the lack of strong retail rental growth limits the potential for any sharp downward correction in retail rents. Activity levels in the retail investment market have been quite stable over the last three years without the large increases that the office market experienced.

The residential property market is now experiencing a widely anticipated slowdown. However, compared with previous downturns there are a number of factors that are different – one of the key factors that led to a surge in house price growth in the late 1980s was the removal of mortgage tax relief in 1988 so householders brought forward transactions to avoid the loss of tax relief. There are also historically low interest rates (5 per cent) compared with the 14.75 per cent rate of 1990, remaining above 10 per cent until 1992. Unemployment is currently low and the economy is forecast to grow, albeit modestly for the next few years.

Property market outlook

The report prepared three scenarios to determine the impact on rents and capital values across the Central London office and retail markets. The scenarios include

- Base – a modest slowdown in economic growth
- Downturn – comparable with the dot.com downturn in 2000/01
- Recession – comparable with the 1990s recession

The impact on rents and capital values across the Central London office and retail markets are considerable.

	Central London Office			Central London Retail		
	Base	Downturn	Recession	Base	Downturn	Recession
Annual Rental Value Growth						
2008	3.9	-8.1	-10.9	2.5	0.6	0.2
2009	-1.5	-13.9	-18.3	1.1	-2.4	-7.9
2010	-2.8	-4.8	-17.7	3.4	-0.3	-4.6
Average 08-10	-0.1	-8.9	-15.6	2.3	-0.7	-4.1
Annual Capital Growth						
2008	-11.6	-21.8	-25.2	-10.2	-13.3	-16.6
2009	-0.8	-14.5	-19.4	2.0	-7.3	-13.7
2010	1.5	-0.6	-14.1	3.4	1.4	-3.1
Average 08-10	-3.6	-12.3	-19.6	-1.6	-6.4	-11.1

Source: CB Richard Ellis

Policy implications

Although it is quite early to predict the potential policy implications, consideration will need to be given to the following potential impacts:

Commercial offices in regeneration areas: A culmination of factors, including tighter credit conditions, weakening occupation markets and falling capital values, have meant that development has become increasingly unviable. The development pipeline for 2009 and 2010 has already been curtailed significantly since the summer; additionally developments currently at the start of the development process are less likely to proceed. In the present climate, developments in regeneration areas, such as Opportunity Areas, are at risk.

Transport related schemes: Transport is an important factor determining the viability of a location. Whilst the credit crunch will make development more costly and difficult, with returns lower, it is unlikely to have any significant implications on developments related to transport due to the long timeframes associated with these schemes. Where the credit crunch has an impact it will be on timing rather than the long-term viability of such developments.

Residential market: There are a number of constraints on the housing market, which the credit crunch will exacerbate, including:

- Lengthy, complex and potentially onerous Section 106 agreements: The research shows that there is wide variation in the time it takes to negotiate a Section 106 agreement. This creates uncertainty for developers in relation to planning and financing their development programmes. In a more onerous credit environment, this uncertainty affects a developer's ability to secure finance.
- Affordable housing provisions: The market weakening is likely to cause a fall in the number of affordable homes being built, although the proportion of affordable units being built in London might increase. The credit crunch will have differing effects across London. Sites close to transport hubs, for example, King's Cross and Elephant and Castle, will outperform those that are not. Well established locations will be less affected, so Waterloo and London Bridge will benefit relatively. Additionally, sites in Stratford and the Lower Lea Valley will be less exposed to the credit crunch as they will benefit from the Olympic effect.
- Land costs: A weaker residential market might mean that developers are unable to cover the total development cost (including land), reducing the prospects of achieving housing targets. A problem exacerbated by the difficultly developers now have securing finance.

Additional information

Data sources

Tube and bus ridership	Transport for London on 020 7222 5600 or email: enquire@tfl.gov.uk
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. In 2008/09 there will be eleven 28-day periods, one 26-day period and one 31-day period. Period 1 starts on 1 April.

Bus ridership

Transport for London's measure of the number of passengers using buses in London in a given period. There are 13 periods in a year. In 2008/09 there will be eleven 28-day periods, one 26-day period and one 31-day period. Period 1 starts on 1 April.

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

Past features

Issue	
45	The London living wage in 2006
46	Barker Review of Land Use Planning
47	London Economic Development Snapshot
48	A new Local Area Tourism Impact model for London
49	What works with tackling worklessness?
50	Retail in London
51	Who are London's low paid?
52	London's opportunities in emerging markets
53	London Economic Development Snapshot
	London's employee jobs - the latest trends
54	Crossrail: Where is it going?
55	How large is wage inequality in London?
	Budget 2007: The implications for London
56	The McKinsey Report and its relevance to London's financial services sector
57	Focus on key London employment sectors
58	Increasing London's housing supply
59	London Economic Development Snapshot
60	Creative London - London's Creative Sector: 2007 Update
61	The value of London's key exports
62	Globalisation, skills and employment: The London story
63	Working hard or hardly working? How cities could work better. GLA Economics' international conference reviewed
64	London's Central Business District: Its global importance
65	London Economic Development Snapshot
66	Women, employment and the gender pay gap
67	Budget 2008: A summary
68	Employment in London by firm size

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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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