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GLAECONOMICS

Turmoil on global financial markets

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Global financial markets experienced one of the most turbulent weeks in living memory starting on 14 September when Lehman Brothers, the fourth largest US investment bank which had employed 5,000 workers in the UK (mainly in London), filed for bankruptcy protection under chapter 11 of the US bankruptcy code.

The 158 year old bank, which had seen its share price plunge was hit by $6.6 billion of credit crunch-related losses so far this year and the failure to raise investment from Korea Development Bank, with which it had been in discussions. Emergency talks had taken place over the weekend of 13-14 September with a number of banks involved, including Barclays which has now agreed a deal to buy its US-based investment banking and capital markets business (and since then Japanese bank Nomura seems set to buy some of its UK/European/Asian operations). These talks however faltered as the US Treasury indicated that it was strongly opposed to using government money to support the deal. The US government's non intervention is believed to be due to a number of factors, including the moral hazard of supporting failing banks, a belief that the bank's failure would not completely undermine the wider financial system and that enough time had elapsed since the start of the credit crunch for market participants to deal with its outcomes. The collapse of Lehman Brothers intensified the credit crunch as the liquidation of its assets is likely to reduce the value of similar assets of other financial institutions thereby reducing

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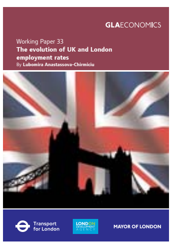

The structural shift from manufacturing to services combined with the early 1990s recession played a significant role in the decline of London's employment rate relative to that for the UK as a whole. Whilst this structural change accounts for London's employment rate falling below that for the UK as a whole in the early 1990s, this analysis shows that it is female employment rates that are responsible for the continuing divergence of the UK and London employment rate.

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their capital base. The belief that the government may no longer step into save some failing banks has increased the cost of banks borrowing with each other as confidence in the market has reduced.

American International Group (AIG), which had been heavily involved in investing in mortgage backed securities, also came under pressure with the news that its credit rating had been cut by Standard and Poor's from AA minus to A minus on the 15 September and that it required emergency capital. This led to the Federal Reserve (Fed) announcing an $85 billion bridge loan rescue package for the company in exchange for 79.9 per cent of the company and an interest rate of the 3 month Libor plus 850 basis points in order to encourage it to quickly repay the loan. The Fed announced that it had acted in order to avoid "a disorderly failure" of the company. Given its involvement in insuring bank loans around the world a collapse of AIG would have significantly damaged a number of financial institutions as they would have had to raise a large amount of new capital to cover the risk of these loans. Thus in this case, unlike in the case of Lehman Brothers, AIG was considered 'too big to fail', although significant restructuring or liquidation of the business is now likely to occur. As worries emerged that Lehman's problems could spread to the rest of the investment-banking sector Merrill Lynch agreed on the 14 September a $50 billion takeover by the Bank of America.

The financial market turbulence and collapse of confidence between banks, as shown by the jump in inter-bank lending rates (a sign that banks are unwilling to lend to each other), also led to the European Central Bank (ECB), Federal Reserve, the Bank of England and the central banks of Canada, Japan and Switzerland intervening in the money markets to improve liquidity conditions. Thus on the 18 September these central banks pumped $180 billion of Fed money into the money markets in a coordinated move to lift the amount of funds available and reduce the inter bank lending rates. This came on the back of other liquidity-providing actions earlier in the week. On the 17 September the Bank of England also extended its Special Liquidity Scheme until 30 January 2009 in light of the current market turmoil. Further, a group of 10 banks including JP Morgan and Goldman Sachs have created a $70 billion collaborative fund, which the member banks will be able to borrow against in order to support their liquidity under times of stress.

The recent financial turmoil caused significant falls in global stock markets on the 15-18 September (see Figure 1), as investors lost confidence in the banking and insurance sectors and sold these shares. Some of this selling was believed to have been caused by banking stock being short sold, the practice of selling a borrowed share in the anticipation that the share price will fall and that the share can then be bought back at a profit. This has led on the 19 September to the US Securities and Exchange Commission (SEC) banning the short selling of 799 companies until 2 October. The Financial Services Authority (FSA) has reacted similarly by banning, until 16th January 2009, the short selling of 29 financial companies shares. Sir Callum McCarthy the FSA's outgoing chair said, "This is a measure which reflects the present turbulence in markets. It is designed to have a calming effect – something which the equity markets for financial firms badly need".

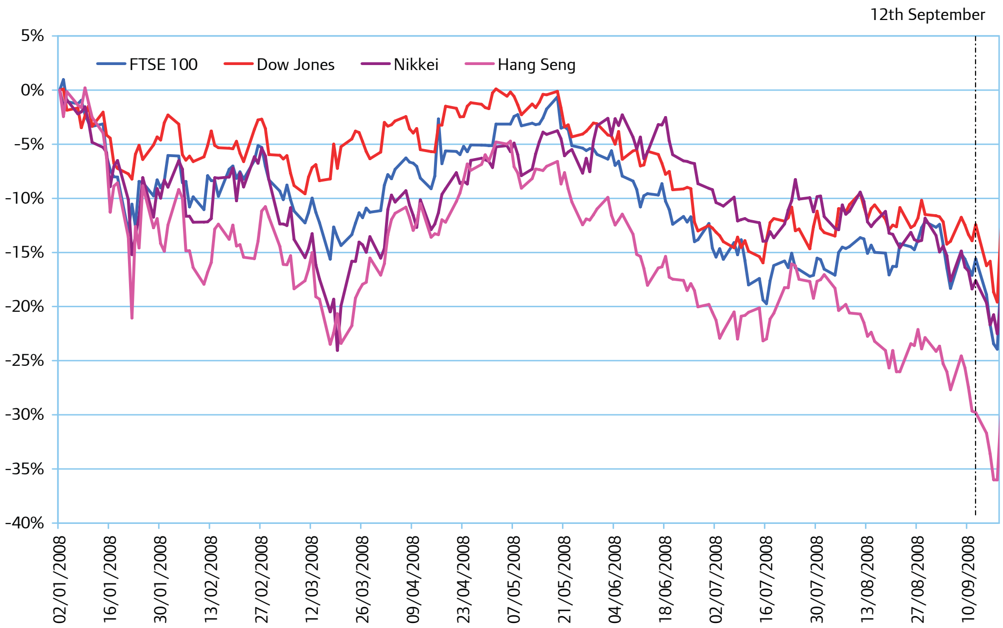
Even bigger news is that the US Treasury wants to create an around $700 billion rescue plan (although the cost could be as much as $2 trillion) to remove illiquid mortgage backed assets from the financial system. The US Treasury Secretary

Henry Paulson said, after meeting with congressional leaders and financial regulators on the 18 September, "We talked about a comprehensive approach that will require legislation to deal with illiquid assets on financial institutions' balance sheets". It is thought that the US may be looking into setting up an agency modelled on the Resolution Trust Corporation used after the 1980s Savings and Loan crisis. This agency would require Congress to pass legislation to implement it, which could take some months to set into action. However, the US Treasury wants the legislation to be passed by the weekend of 27-28th September to calm financial markets. Markets reacted extremely favorably to Henry Paulson's announcement on the 18 September leading to a strong rebound in share prices on the 19 September with the FTSE 100 rising by a record 431.3 points closing 8.8 per cent higher. Concerns, however, about the pace and details of the US bailout package drove shares lower in the last few days.

Figure 1: Stock market performance since January 2008 (percentage change)

Last data point is 23/09/08

Source: EcoWin, FT



In further signs of the ongoing restructuring in the banking sector the Fed announced on the 21 September that Goldman Sachs and Morgan Stanley would be allowed to change their status from investment banks into banking holding companies. This effectively ends the big stand-alone investment banking industry. The Fed will now regulate these banks, subjecting them to bank capital requirements, which will be phased in over a transition period. The banks themselves will now be able to greatly increase their ability to take deposits from savers, thereby reducing their dependence on the short-term money markets. In other signs of the restructuring, Morgan Stanley also announced on the 22 September that Mitsubishi UFJ Financial Group would acquire between 10 to 20 per cent of their shares. Mitsubishi UFJ Financial Group is the world's second largest banking holding company; the tie up will allow Morgan Stanley to shore up its capital base. Also on the 23 September it was announced that Warren Buffett's company (Berkshire Hathaway) would be investing $5 billion in Goldman Sachs, which should help to fortify its capital base.

The main casualty of the financial market turmoil in the UK has been HBOS which agreed on the 18 September to a £12.2 billion takeover by Lloyds TSB after its share price came under concerted pressure throughout the week. Prior to the credit crunch HBOS had a market valuation of £27.8 billion. The deal, which would normally contravene competition rules due to the fact that the combined bank will have about one third of the UK savings and mortgage market, will be allowed by the government on public interest grounds, given the high costs to the UK financial system and the economy associated with HBOS failing. The FSA said the deal was "likely to enhance stability within financial markets and improve confidence among customers and investors in the UK financial sector"; however a number of reports note that there are likely to be many job losses from the new bank as it restructures. Jobs in Halifax and Scotland look especially vulnerable. In yet further signs of the continuing restructuring in the financial sector the Nationwide building society announced that it would take control of the Cheshire and Derbyshire building societies that had been experiencing strains due to the ongoing credit squeeze.

Global financial turmoil this month started with the US government having to put mortgage lenders Fannie Mae and Freddie Mac into "conservatorship" on 8 September taking control of the companies and suspending the dividend, thus effectively nationalizing them. The companies, which had been shareholder owned but mandated by the US Congress, guarantee or own over $5trillion in mortgages issued by other institutions. They had been severely damaged by the continued dislocation in the US housing market. The "conservatorship" will insure that the companies can continue to provide financing to the US housing market.

Increasing signs of a UK slowdown with forecasts of a recession

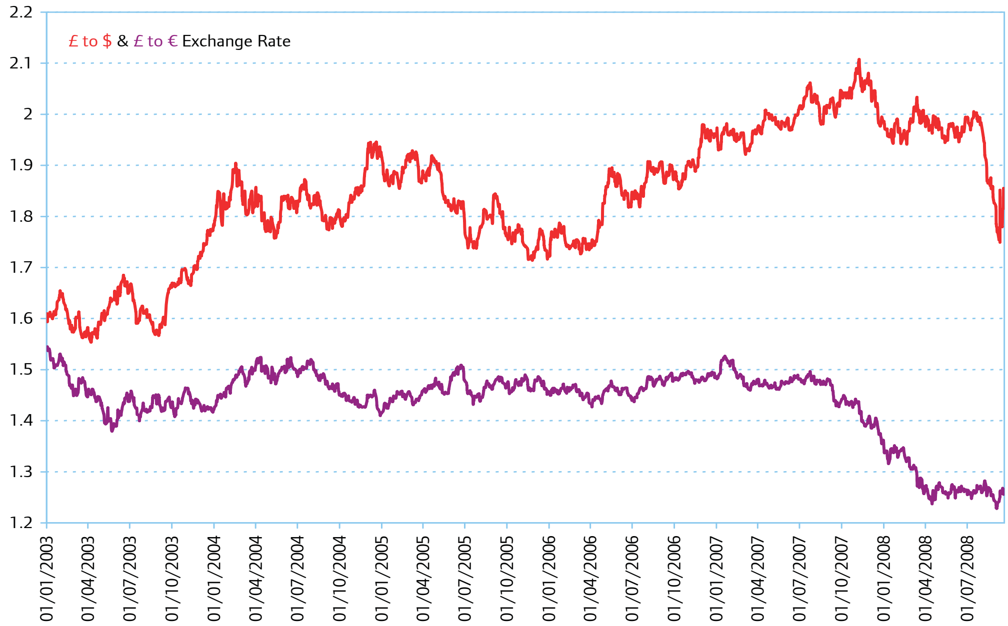
The OECD's latest report into the economic outlook for member countries forecast that the UK is likely to experience falls in GDP of 0.3 and 0.4 per cent in Q3 and Q4 2008; whilst the CBI forecasts that the economy will shrink by 0.2 per cent in Q3 and 0.1 per cent in Q4 2008. A technical recession is when GDP falls in two consecutive quarters. This follows on the back of continuing bad economic news with ILO unemployment now at 5.5 per cent the highest level since 1999. Elsewhere a survey by KPMG and the Recruitment and Employment Confederation showed that the number of permanent jobs available in the UK declined in August for the fifth consecutive month. UK industrial production is also falling and the service sector is suffering as well with the Purchasing Managers headline index (which is compiled by the Chartered Institute of Purchasing & Supply (CIPS) and Markit) showing the fourth consecutive month of decline (though the rate of decline eased in August.) Data from the Society of Motor Manufacturers and Traders showed that new car sales had hit their lowest level for any August since 1966. However, according to Office for National Statistics data, seasonaly adjusted volume of retail sales were up by an unexpected 1.2 per cent in August, whilst analysts had been expecting a fall.

The worsening economic outlook and the rapidly weakening UK housing market has hit sterling (see Figure 2), which had depreciated by around 10 per cent against the US dollar since the beginning of August, before rebounding slightly in light of the financial turmoil in America in mid September. A cut in base rates by the Bank of England has become more likely, though the Monetary Policy

Committee (MPC) may well wait until the current inflationary pressures in the economy have eased, which have been exacerbated by the fall in sterling. However, a weaker pound will improve net exports supporting the UK economy and helping it to rebalance away from domestic consumption.

Figure 2: £ to $ and £ to € exchange rates
Last data point is 23/09/08

Source: EcoWin



Inflation rises again but should ease in 2009

The CPI rate of inflation hit 4.7 per cent in August (the government's symmetrical target is 2 per cent.) This was the fourth month in a row that CPI inflation was above 3 per cent and therefore necessitated that the Governor of the Bank of England, Mervyn King, write another letter to the Chancellor explaining the reasons for the divergence from the target and the actions that the Bank would be taking to remedy the situation. In his letter the Governor noted that 2.1 per cent of the 2.6 per cent rise in inflation since December 2007 was due to increases in food, petrol and retail gas and electricity prices. He also noted that "The fall in the value of sterling pushes up on import price inflation, which, in the latest data for the second quarter of 2008 was around 12 per cent - its fastest rate of growth in over twenty years". The Governor expects inflation to peak soon at around 5 per cent, and will remain markedly above the 2 per cent target well into 2009. However with the price of oil having recently fallen below $100 per barrel (though it did spike upwards again after the announcement of the US Treasury rescue plan), it looks like the inflationary pressures in the UK economy may start to ease in early 2009.

Gatwick Airport put up for sale

Gatwick Airport has been put up for sale by its owners BAA in response to pressure from the Competition Commission for the break up of the airports group. A number of companies are believed to be interested in bidding for the airport including: Global Infrastructure Partners, which already owns 50 per cent of City Airport; Manchester Airport Group; and Virgin Atlantic. It is believed that the break up of BAA, which currently controls Heathrow, Gatwick and Stansted airports around London will increase competition and hopefully benefit the airlines and passengers.

The global slowdown gathers pace

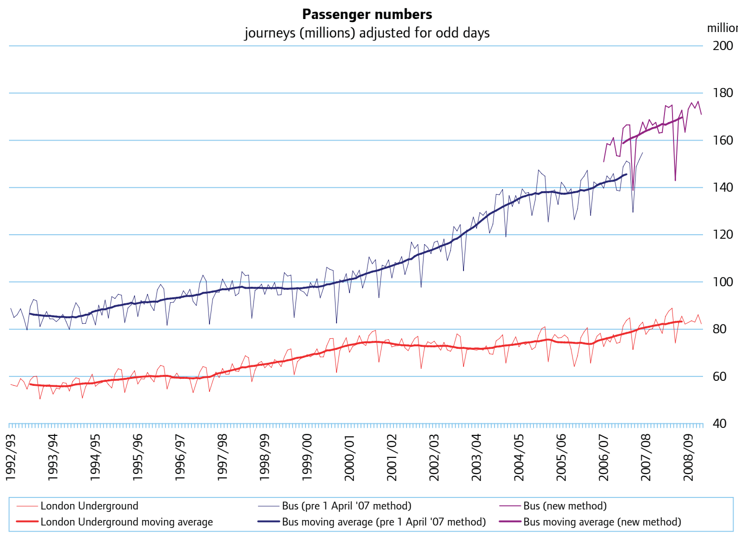
Although recent headlines have been dominated by stories of financial turmoil, developed countries are also about to enter the final quarter of the year with their economies weakening. Hence the European Commissions' latest economic forecast as well as predicting that the UK will enter a recession in the second half of 2008, also predicts one for Germany and Spain. The Eurozone is now forecast to grow at 1.2 per cent for 2008, down from a previous forecast of 1.7 per cent. The US economy also remains sluggish with unemployment hitting a near five-year high of 6.1 per cent in August. Survey evidence for the Federal Reserve also showed that economic activity across the country was "weak, soft or subdued". However, in general emerging market economies are still growing rapidly, though even their pace is being tempered to a slight degree. Given the overall picture the economic outlook for the UK and London looks increasingly less rosy for the end of 2008 and the beginning of 2009. London's economy is still expected to have low but positive annual economic growth over the whole years of 2008 and 2009. However, the turn of the year will be especially tough and a technical recession (i.e. two consecutive quarters of negative growth) could well be on the cards.

Economic indicators

Increase in moving average of passenger numbers

- The most recent 28-day period is from 20 July 2008 to 16 August 2008. London's Underground and buses had 253.2 million passenger journeys; 171.0 million by bus and 82.2 million by Underground.
- The moving average of passengers every period increased to 252.9 million from 252.2 million. The moving average for buses was 169.7 million. The moving average for the Underground was 83.2 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 issue 58 (June 2007).

Latest release: September 2008
Next release: October 2008

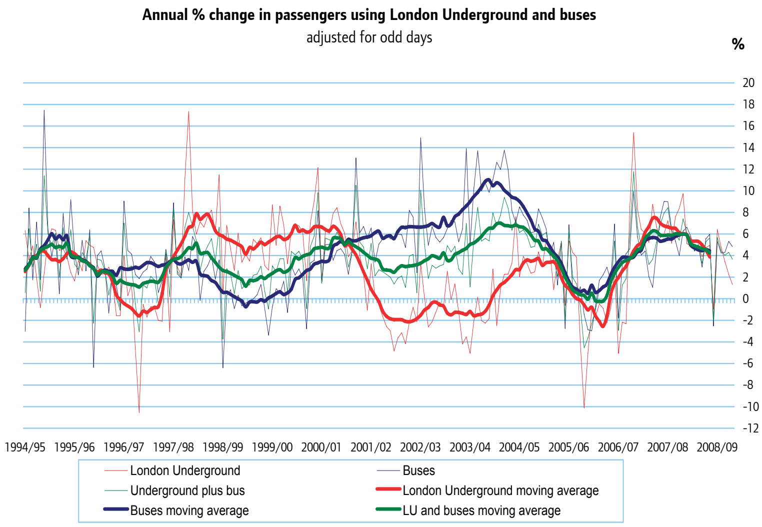


Source: Transport for London

Average annual growth rate of passengers decreases slightly

- The moving average annual rate of growth in passenger journeys decreased to 4.3% from 4.5% in the previous period.
- The moving average annual rate of growth in bus passenger journey numbers decreased to 4.5% from 4.6% in the previous period.
- The moving average annual rate of growth in Underground passenger journey numbers decreased to 3.9% from 4.5% in the previous period.

Latest release: September 2008
Next release: October 2008

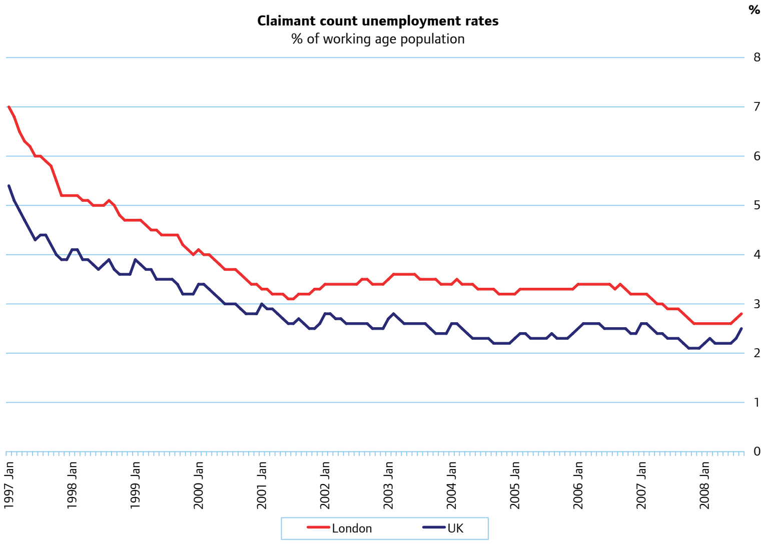


Source: Transport for London

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 2.8% in August 2008.
- There were 138,700 unemployment claimants in London in August 2008 compared with 143,900 in August 2007.
- The claimant count unemployment rate of the UK remains below that of London.

Latest release: September 2008
Next release: October 2008

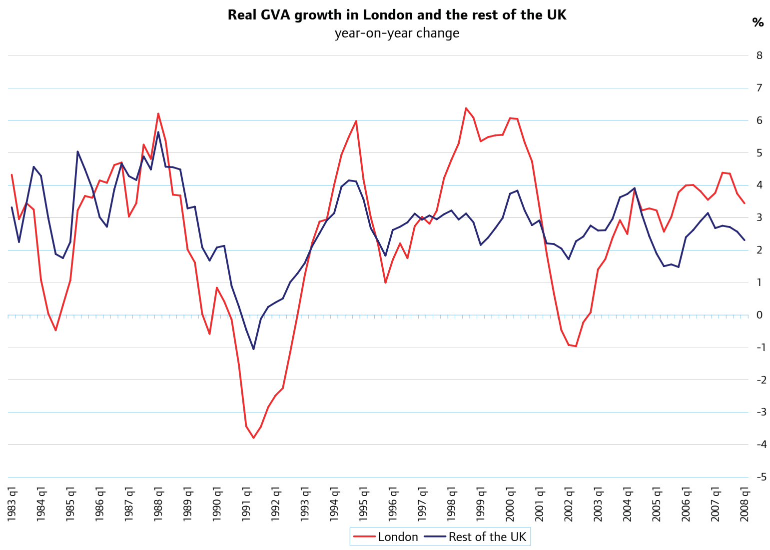


Source: Claimant Count, Nomis

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

- London's annual growth in output decreased to 3.4% in Q1 2008 from a downwardly revised 3.7% in Q4 2007.
- The rest of the UK's annual growth in output decreased to 2.3% in Q1 2008 from an upwardly revised 2.6% in Q4 2007. London has been growing at a faster annual rate than the rest of the UK since Q3 2004.
- There have been revisions to previous growth rates to reflect the availability of new data.

Latest release: August 2008
Next release: November 2008

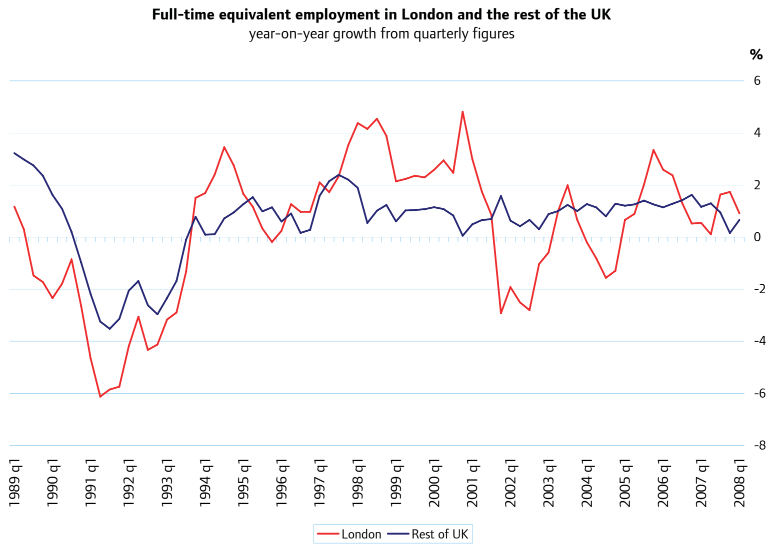


Source: Experian Business Strategies

Annual employment growth in London eases

- London's annual employment growth decreased to 0.9% in Q1 2008 from a downwardly revised 1.7% in Q4 2007.
- Annual employment growth in the rest of the UK increased to 0.7% in Q1 2008 from an upwardly revised 0.4% in Q4 2007.
- There have been revisions to previous growth rates to reflect the availability of new data.

Latest release: August 2008
Next release: November 2008

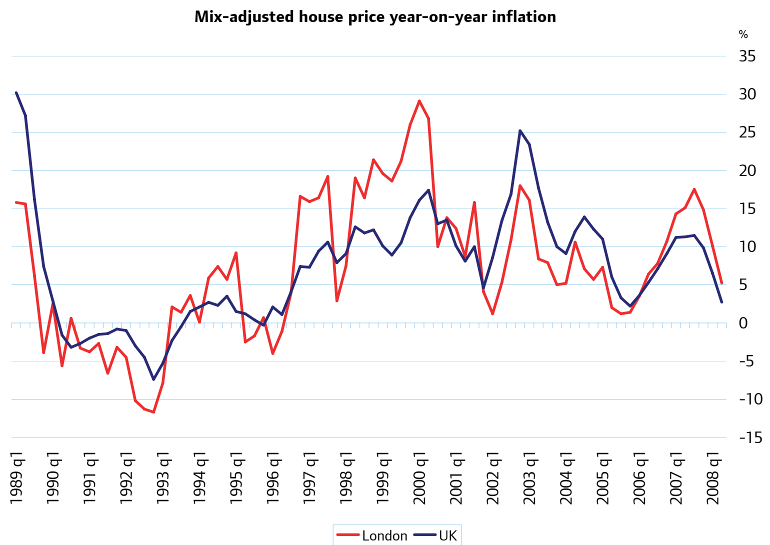


Source: Experian Business Strategies

Annual house price inflation slowing sharply

- The Department for Communities and Local Government (DCLG) house price index is an official measure of house prices. It is available up to Q2 2008.
- The DCLG reported a decrease in annual house price inflation in London and the UK in Q2 2008.
- Annual house price inflation has been slowing down since Q3 2007.

Latest release: August 2008
Next release: November 2008

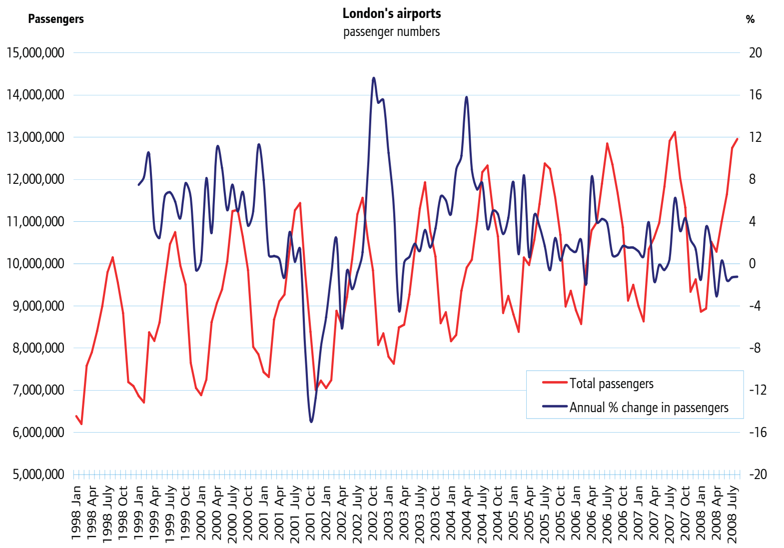


Source: Department for Communities and Local Government

Weak airport passenger numbers

- 13.0 million passengers travelled through London's airports in August 2008.
- The number of passengers using London's airports decreased by 1.2 per cent from August 2007 to August 2008.
- The number of passengers using London's airports has fallen year-on-year for the last three months.

Latest release: September 2008
Next release: October 2008

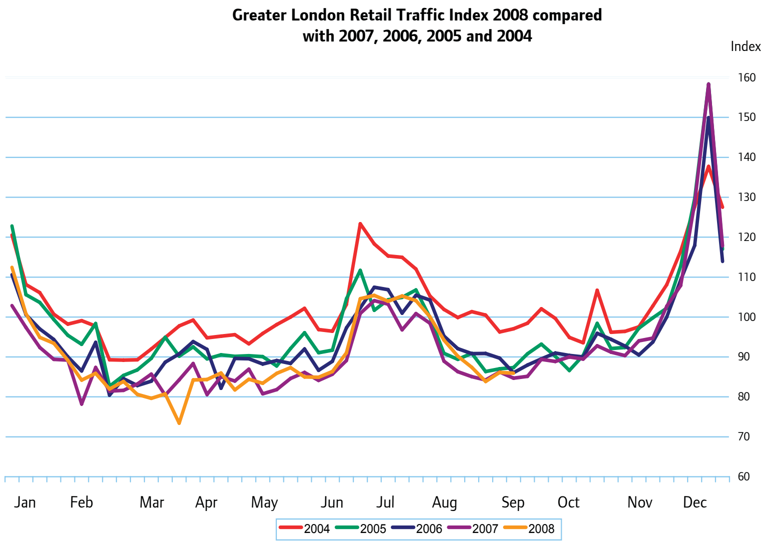


Source: Civil Aviation Authority

SPSL Retail Traffic similar to 2007 levels

- The SPSL Retail Traffic Index of shoppers in London was 85.9 in the first full week of September compared to 86.1 in the previous week.
- The index has been quite similar to 2007 levels since mid-August.
- 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

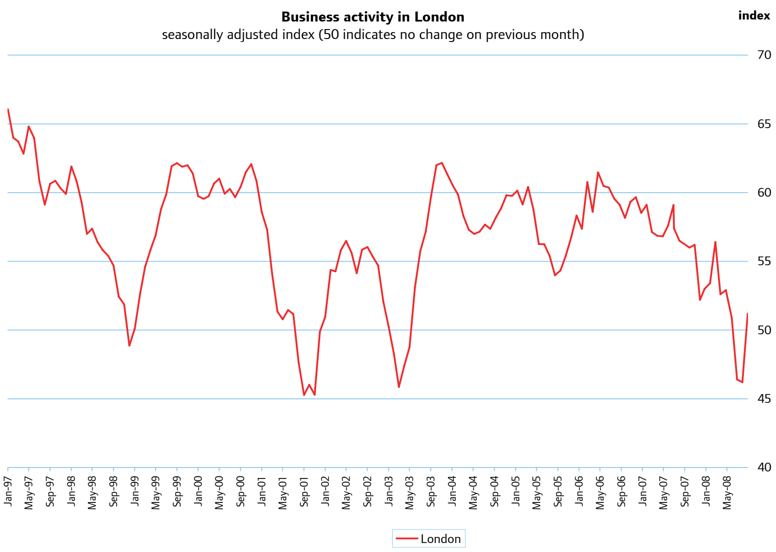


Source: SPSL

London's business activity rises slightly

- London firms increased their output of goods and services in August 2008.
- The Purchasing Managers' Index (PMI) of business activity recorded 51.2 in August compared to 46.2 in July.
- A rate of above 50 on the index indicates an increase in business activity from the previous month.

Latest release: September 2008
Next release: October 2008

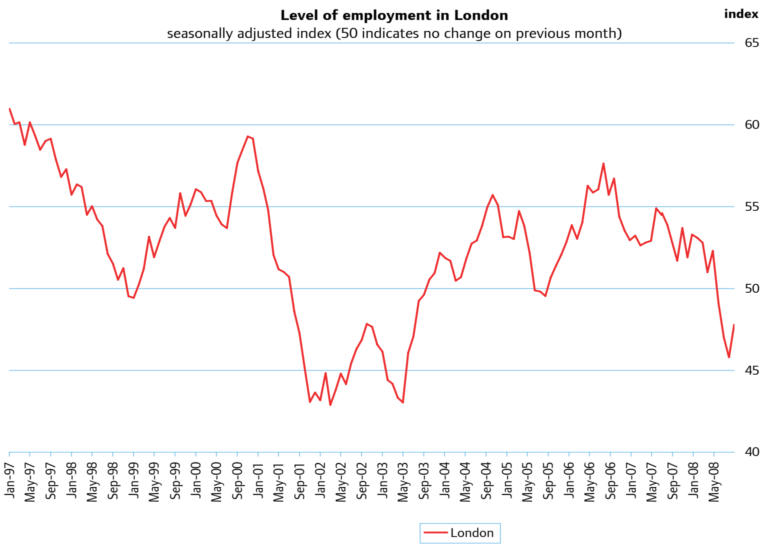


Source: RBS/Markit Economics

London employment is still weakening

- The PMI shows that the level of employment in London firms decreased in August 2008.
- The PMI for the level of employment was 47.8 in August compared to 45.8 in July.
- A rate of below 50 on the index indicates a decrease in the level of employment from the previous month.

Latest release: September 2008
Next release: October 2008

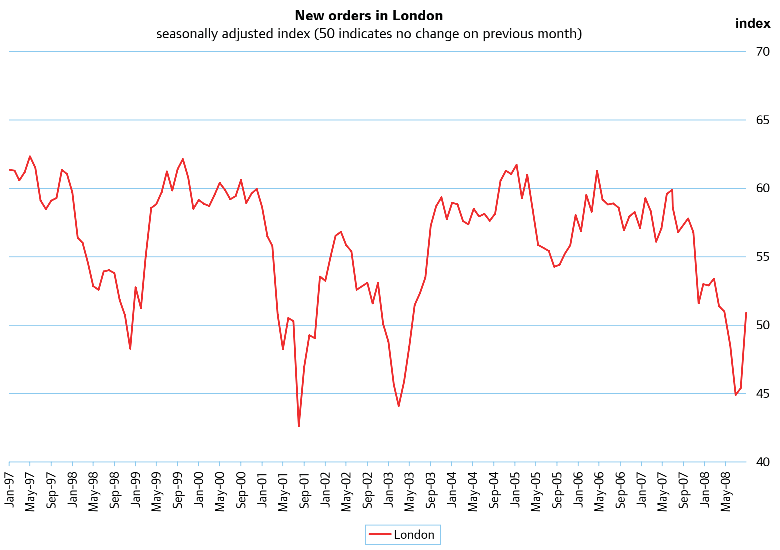


Source: RBS/Markit Economics

New orders in London increasing

- August 2008 saw a rise in new orders for London firms.
- The PMI for new orders recorded 50.9 in August 2008 compared to 45.4 in July 2008.
- A rate of above 50 on the index indicates an increase in new orders from the previous month.

Latest release: August 2008
Next release: September 2008

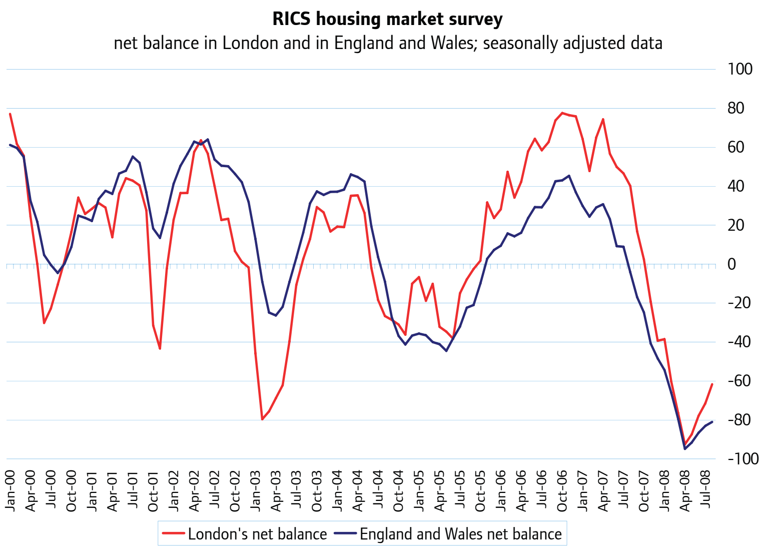


Source: RBS/NTC Economics

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

- The RICS survey shows a negative net balance of -62 for London house prices over the past three months up to August 2008. This net balance is up from –72 in July.
- Surveyors reported a negative net house price balance for England and Wales of -81 in August 2008, up from -83 in July.
- London's net balance remains above that of England and Wales.

Latest release: September 2008
Next release: October 2008



Source: Royal Institute of Chartered Surveyors

Filling the coffers: London's tax export

Duncan Melville,
Deputy Chief Economist

GLA Economics will soon be publishing research on London's tax export, the difference between estimated tax revenues raised in London and the amount of public spending in London. This article summarises this research.

GLA Economics has in the past produced estimates of London's tax export. Using our past methodology we estimate that London's tax export in 2006-07 was between £6.6 billion and £14.4 billion. However we have reviewed our previous approach and developed a new methodology incorporating improvements in the way we allocate part of particular UK taxes and other revenues to London. These improvements have principally affected our estimates of the amount of income tax, corporation tax, and vehicle excise, fuel, tobacco and alcohol duties which are generated in London.

We previously estimated London's income tax revenues by using London's share of total UK compensation of employees (wages and salaries) to allocate a share of UK income tax revenues to London. This was justified on the basis that employment income constitutes the majority of taxable income. An alternative is to use Her Majesty's Revenue and Customs (HMRC)'s Survey of Personal Incomes. This survey includes regional estimates of income from employment, self-employment, pensions and investment incomes as well as total tax. We judge that the use of income tax estimates from the Survey of Personal Incomes is superior to the method the GLA has used in the past, for two main reasons. Firstly, it includes non-employment income which, proportionately, is significantly higher in London and, secondly it provides actual estimates of total income tax by region, and the UK totals are very similar to published budget figures for the UK. Accordingly our estimates of London's income tax revenues are now based on using this information.

Beforehand, we used London's share of UK gross value added (GVA), or output, to estimate London's share of corporation tax. The problem with using GVA as a proxy for shares of revenues from a tax on company profits is that GVA is quite simply not a measure of profits. Instead regional profit shares can be inferred from the Annual Business Inquiry (ABI) by subtracting labour costs from GVA giving an estimate of operating surplus, which is a good approximation of profits. Our revised methodology now uses this information from the ABI to estimate London's receipts from corporation tax.

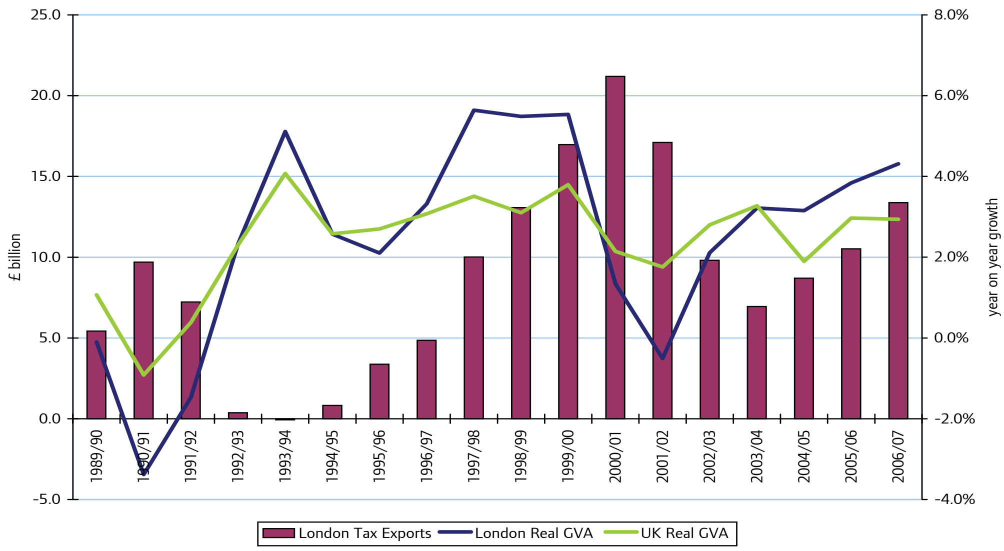
We have previously used household income figures as a proxy for household consumption to form our estimates of the proportion of most duties on goods such as vehicles fuel, tobacco and alcohol to London. This has probably led to an over estimate of the amount of such duties that should be attributed to London. This is because car ownership and use are much lower in London than the rest of the country, due to the much higher reliance on public transport characteristic of large cities. Similarly, London has below average rates of smoking and alcohol consumption. Our new method uses information on rates of car ownership, fuel consumption, percentage of smokers, and average consumption of alcohol to generate lower estimates of revenue from such duties in London.

Overall our revised methodology increases our estimate of London's tax revenues, and so our estimate of its tax export in 2006-07 is between £8.4 billion and £18.4 billion. This represents between 9.5 and 19.1 per cent of all tax revenues generated in London. This compares with a recent estimate of London's tax export in 2006-07 produced by Oxford Economics of £12.3 billion to £19.7 billion[1].

We have applied our revised methodology to estimate London's tax export over time back to 1989-90. We find that London has produced a surplus of tax revenues over public expenditure in London for all years since 1989-90 with the sole exception of 1993-94. Figure 3 shows London's tax export against economic growth in London and the UK.

Figure 3: London's tax export and economic growth in London and the UK (2006-07 prices)

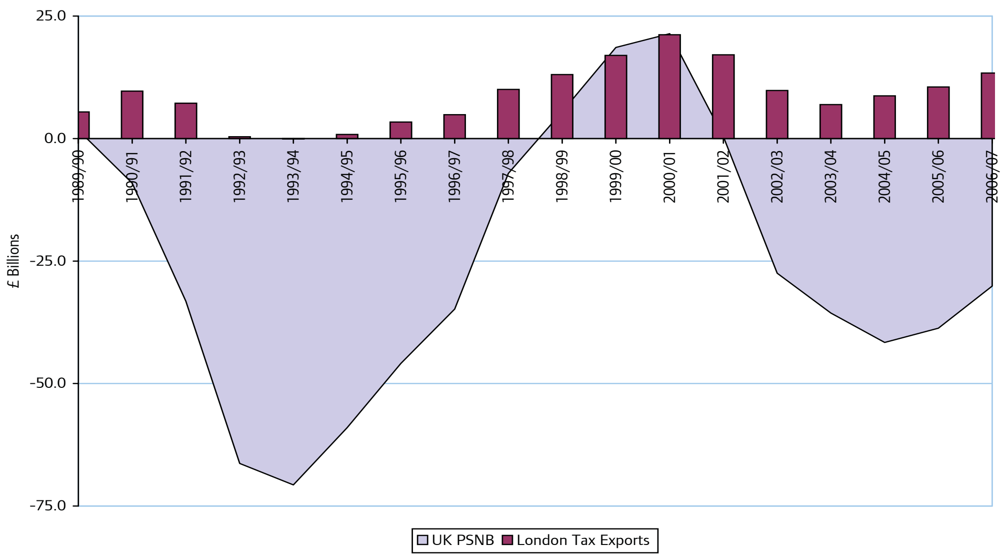
Source: GLA Economics calculations, Experian Business Strategies



The magnitude of this tax export has varied over time. In all but two years, 1999-00 and 2000-01, London's tax export exceeded the overall UK public sector fiscal surplus and then only marginally. Hence with the exception of these two years the rest of the UK outside London has consistently run a public sector deficit. Figure 3 indicates that there appears to be a generally positive relationship between economic growth in London and the size of London's tax export. However the period 1992-93 and 1994-95 appears out of step with this general relationship. This can be explained by considering how London's tax export varies with levels of overall public borrowing in the UK as measured by Public Sector Net Borrowing (PSNB). Figure 4 shows London's tax export compared to PSNB since 1989-90.

Figure 4: London's tax export and PSNB (2006-07 prices)

Source: GLA Economics calculations, HM Treasury



Overall, Figure 4 indicates a correlation between London's tax export and overall UK public borrowing. With a few minor exceptions, London's tax export increases in years where UK PSNB falls and vice-versa. The large public sector deficits in the early to mid-1990s explain the failure of London's tax export to increase significantly despite the increasing rates of economic growth in London experienced during this period.

In line with our previous research in this area[2], we find that there are two primary drivers of the size of London's tax export – national fiscal policy and the strength of economic growth in London. Larger UK public sector deficits tend to reduce the size of London's tax export. Stronger economic growth in London tends to increase the magnitude of London's tax export. **This positive relationship with London's economic growth indicates that there is a positive return to the national exchequer from investing in the infrastructure and other public services that underpin London's economic growth. Investing in London generates a tax export which can be used to fund public services throughout the UK. There is a clear national interest in ensuring that London receives sufficient public investment to underpin its continued economic dynamism.**

Footnotes

1 Oxford Economics, "Regional Winners and Losers in UK public finances", July 2008.

2 See Chapter 5 of 'Growing Together: London and the UK Economy', January 2005.

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
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 are eleven 28-day periods, one 26-day period and one 31-day period. Period 1 started 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 are eleven 28-day periods, one 26-day period and one 31-day period. Period 1 started 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

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