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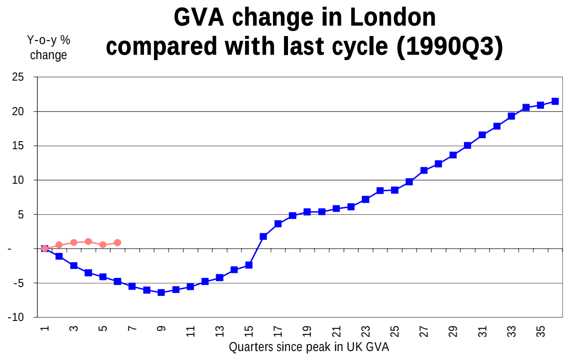
The London Economy
by Bridget Rosewell

- There is no evidence of a recession in London. The present slowdown has been very weak in comparison with previous ones.
- National data suggests that recovery is becoming well established.
- Evidence in London is not yet showing this, although there are positive signs in tube ridership numbers and hotel usage.
- There are still some downside risks, however, around the international situation, domestic consumer confidence and business investment.
- The London economy continues to be affected by stock market weakness and profit warnings, but we do not believe that there is a high risk of recession.

Official figures continue to show that there is a recovery taking place in the UK and that recession has been avoided. For many people in London this is not how it feels, and there are some significant down side risks. Moreover, even if a recovery is in place, it may well be slow and with interruptions.



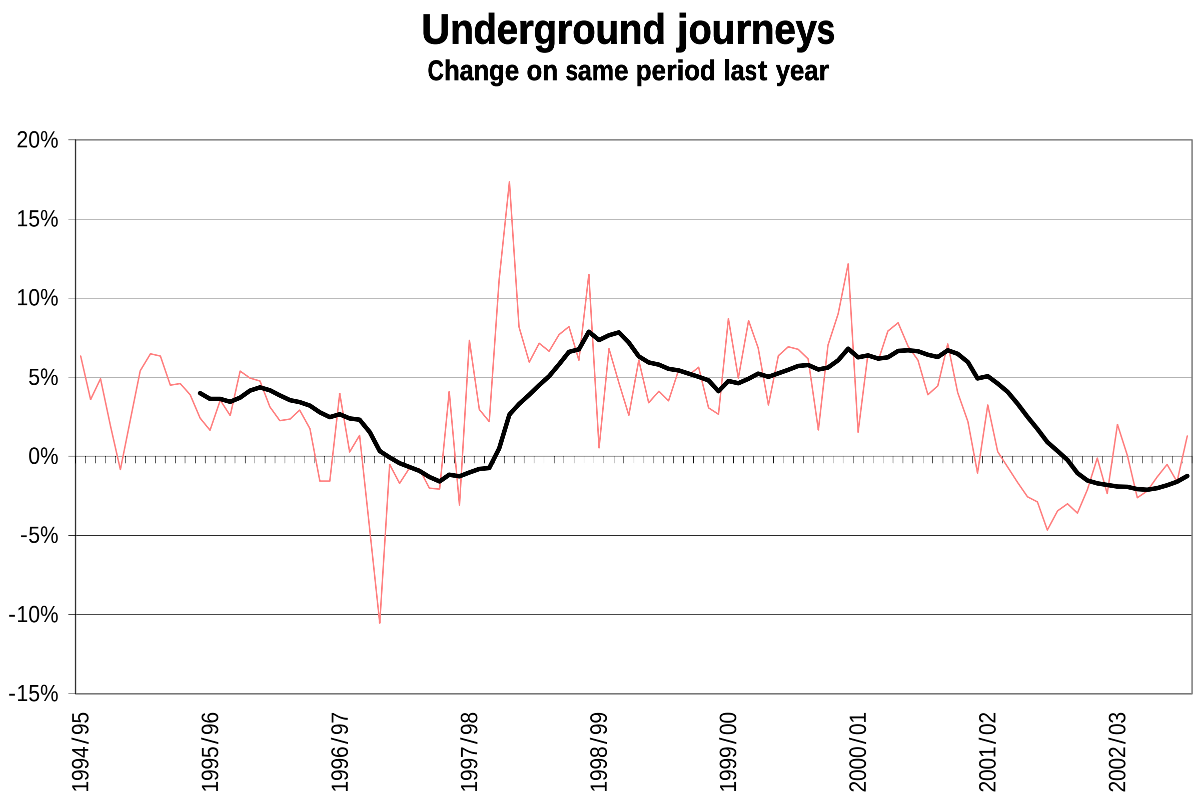
Source: Transport for London

However, we do not believe that there is a high risk of a recession.

Reasons to be optimistic

The best short term indicator that we have for London is the use of the underground system. This month's figures show ridership to be fairly flat.

However, if we examine the year-on-year change in use of the Underground system, we see that the trend has turned upwards in recent months. Moreover, estimates of output (GVA) in London show some recovery, albeit rather minor at present.



Source: Transport for London

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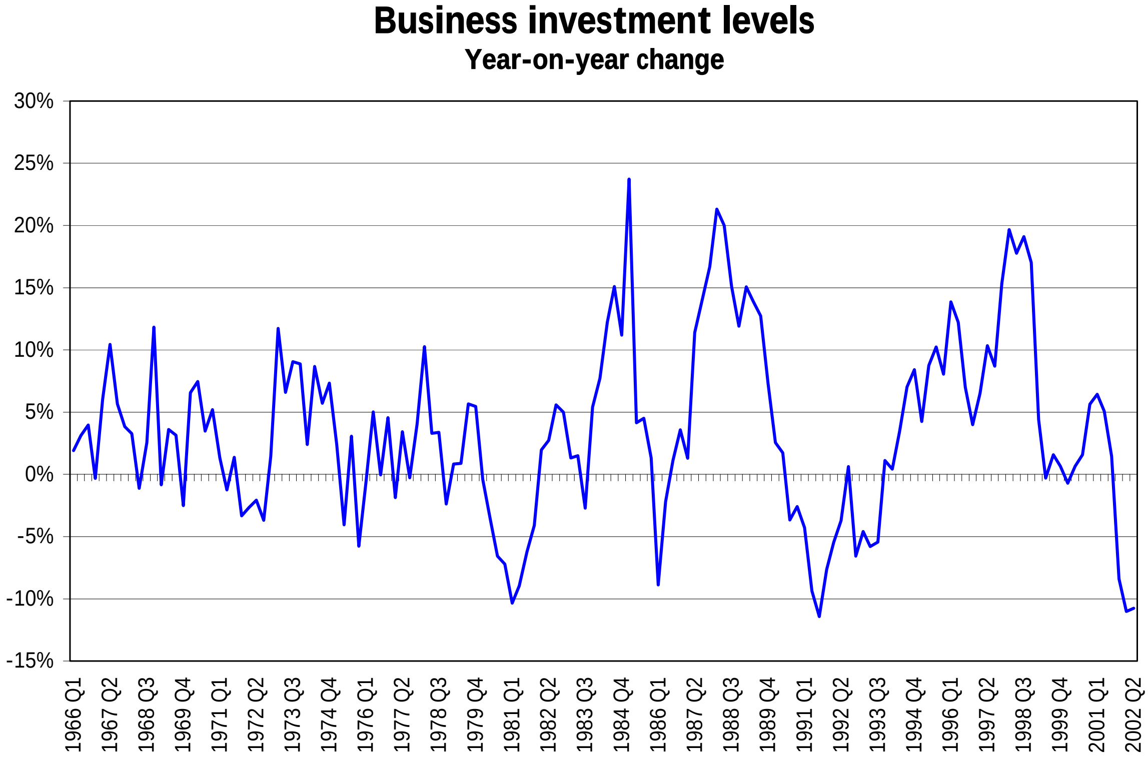

Source: ONS

Most importantly, consumers are still spending. Although the British Retail Corporation's Retail Sales Monitor showed the weakest figures for two years, they remain positive. As long as consumers do not lose their nerve, they will continue to provide the backbone to economic performance.

Unemployment remains low and incomes good. Taken together with faster growth in government spending than in the last 30 years, it is not surprising that recovery is taking place. However, some sectors are not sharing in this, including sectors in central London at present. In addition, the risks are undoubtedly on the down side, as our supplement this month describes.

Reasons to be more cautious

The central London property market is showing rising vacancy rates and weak investment. Profit warnings and balance sheet weaknesses are affecting all kinds of business outcomes, and business confidence, which seemed to be holding up earlier in the year (rather against the data) now seems to be turning down.

Office space availability, though still below the levels of the early 1990s, has increased sharply. Moreover as the chart shows, investment has fallen as strongly as in the last two recessions, slowing down recovery and affecting the financing institutions in particular.

A recovery at this point would start from a high base. The downturn which started in 2000 has been much slower and less deep than that of 1991, as the chart shows. In the 18 months since the peak of the current cycle (mid-2000 to Q3 2002), output in London had risen over 4 per cent, while in the period between the end of 1989 and mid 1991, it dropped 5.8 per cent.

As far as employment is concerned, the rise in claimant unemployment in the last six quarters is only two thirds that of the previous cycle.

Hence a recovery might quickly create capacity constraints, as we outlined in *London's Economy Today* issue 3.

Conclusion

Our view is that there are indeed signs of overall recovery in the London economy. Our supplement this month looks at the risks to this projection, which are certainly focused on the downside.

Recovery is in any case likely to be patchy and there will still be parts of the economy which it is unable to reach. Investment remains a concern, as does the international situation, both of which are particularly important to London.

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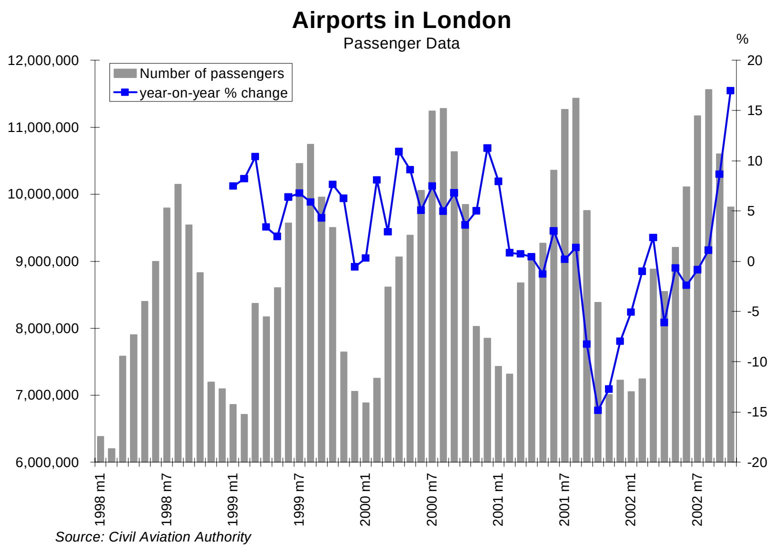
Economic indicators

Source: TfL
Latest release: 12/12/02
Next release: 17/1/03

- The decline in underground passenger numbers that began in December of last year has almost flattened out.
- Usage is hovering at 30 per cent higher than in 1993/1994.
- The latest index was 129.0.

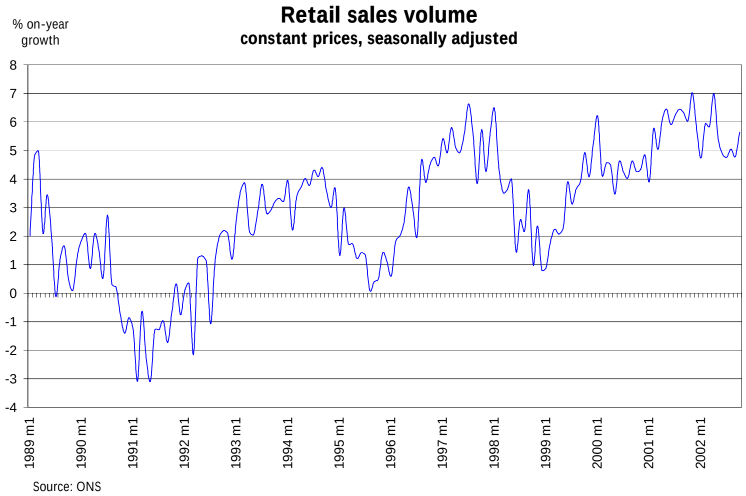
Source: Civil Aviation Authority
Latest release: 6/12/02
Next release: not known

- Airport traffic seems to have recovered entirely from 11 September 2001.
- The exceptionally high year-on-year growth rates of the last two months are a one-off bounce from the low levels of September and October 2001.
- Nevertheless, it can be seen from the absolute numbers of passengers that the upward trend of the decade continues.



Source: ONS
Latest release: 21/11/02
Next release: 19/12/02

- Retail sales were 8.1 per cent higher in October than the previous month and 5.6 per cent higher than last October.
- This extends the upward trend noted last month. September sales were 4.6 per cent up on the previous year.



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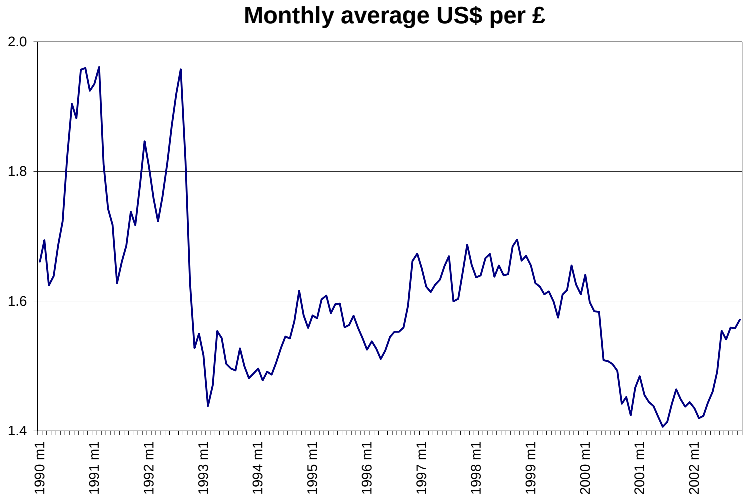
Source: Experian Business Strategies
Latest release: 1/12/02
Next release: 1/1/03

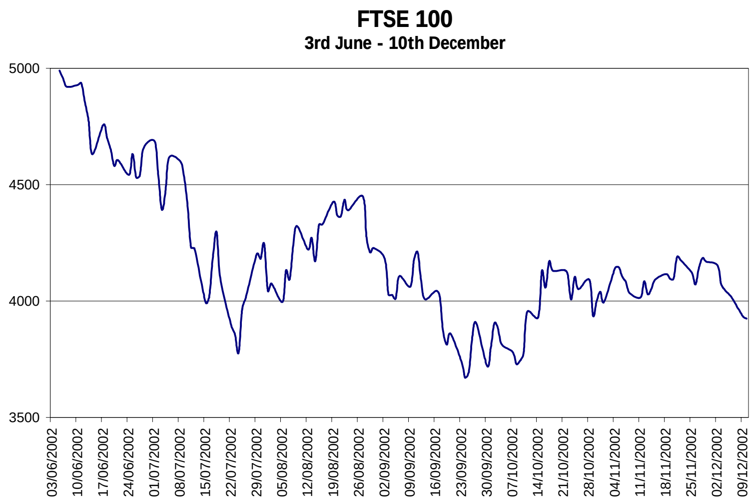
- After falling against the dollar from mid-1998 to early 2002, the pound has been rising since February.
- This reflects both a fall in the dollar and a rise in the pound against major currencies. The pound has been rising against the Euro since September.
- At the lowest point in February the average exchange rate was $1.42 per £, and has now reached $1.57.



Source: Daily Press

Source: Experian Business Strategies

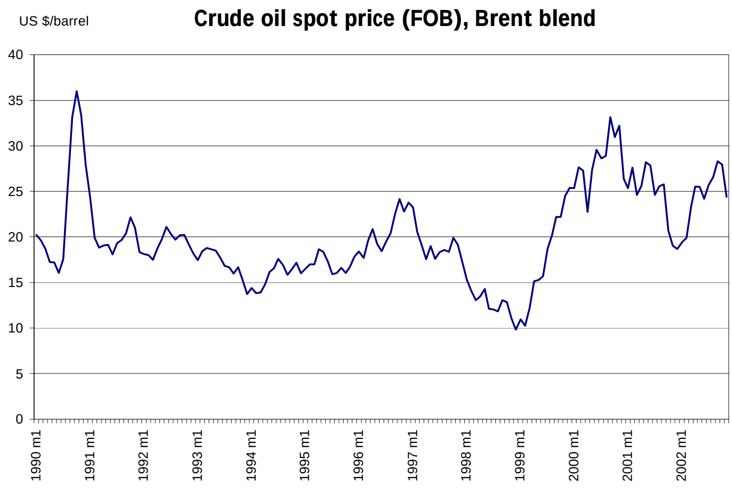
- The FTSE 100 Index remains above its 3700 low. Having risen above the 4000-mark on 15 October, it failed to break through 4200 and fell back below 4000.
- Trading volumes continue to hold up despite price weakness. The Corporation of London estimates that trade in UK equities from January to October 2002 was £1,826 billion compared with the 2001 high of £2,030 billion.
- International Equities traded £2,425billion over this period compared with £3,676 billion in 2001.



Source: Daily Press

Source: Daily Press
Released daily

- Oil prices have been rising since last December but have not reached their 2000 peak.
- December low was $18.7 per barrel, compared to the September 2000 high of $33.2.



Source: Daily Press

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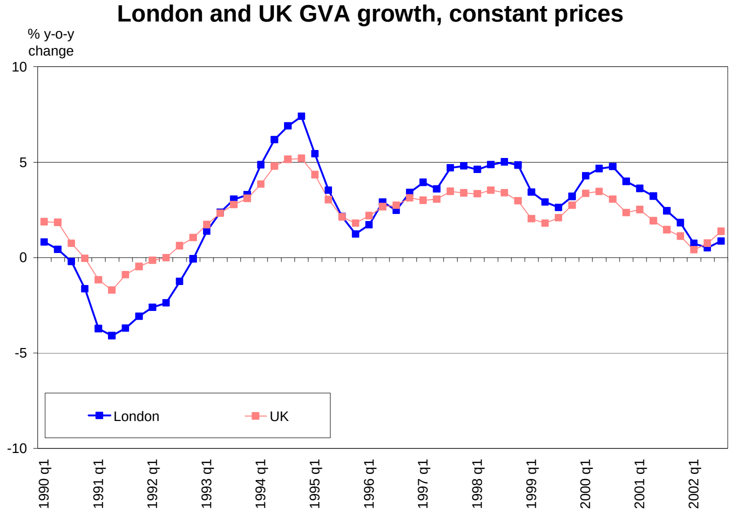
Source: Experian Business Strategies
Latest release: 5/12/02
Next release: spring 2003

- There is increasing evidence that the persistent fall in GVA growth, which began in the mid-2000, has turned.
- The growth rate of UK GVA, at 1.4 per cent, rose for the second quarter running, from its low of 0.4 per cent in Q1.
- London's GVA growth rate, having fallen continuously from Q2 of 2000, rose slightly in Q3 to 0.9 per cent.

London and UK GVA growth, constant prices

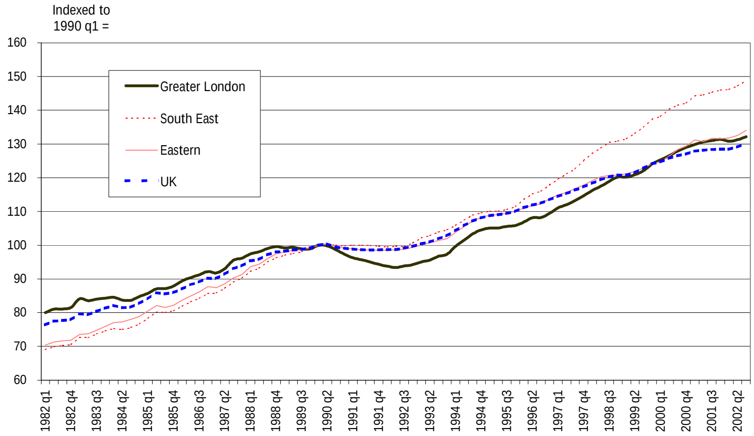


Source: Experian Business Strategies

Source: Experian Business Strategies
Latest release: 5/12/02
Next release: spring 2003

- London's relation to the surrounding regions has transformed.
- In 1993, after a deeper initial recession, it began outpacing UK growth.
- The southeast suffered less of a fall in the last recession and also outpaced the UK in the 1990s.
- The eastern region, which outpaced the UK in the 80s, slowed in the 1990s and grew at the average UK rate.

Real GVA for London and surrounding regions

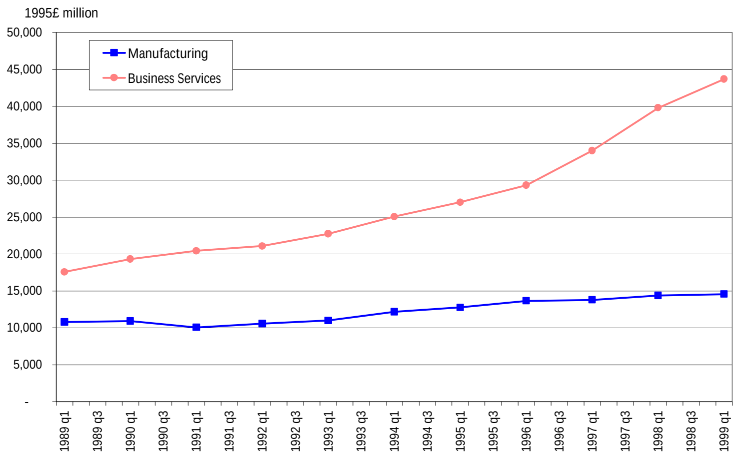


Source: Experian Business Strategies

Source: Experian Business Strategies
Latest release: 5/10/02
Next release: spring 2003

- Business services now contribute three times as much to London's output as manufacturing, compared with 50 per cent more at the start of the decade.
- The contribution of business services has increased almost threefold in 1999, compared to the early 1990s.
- The share of manufacturing output in London GVA fell to an all-time low in 1991. Since that time manufacturing output has expanded slightly.

Real GVA at 1995 prices in London



Source: Experian Business Strategies

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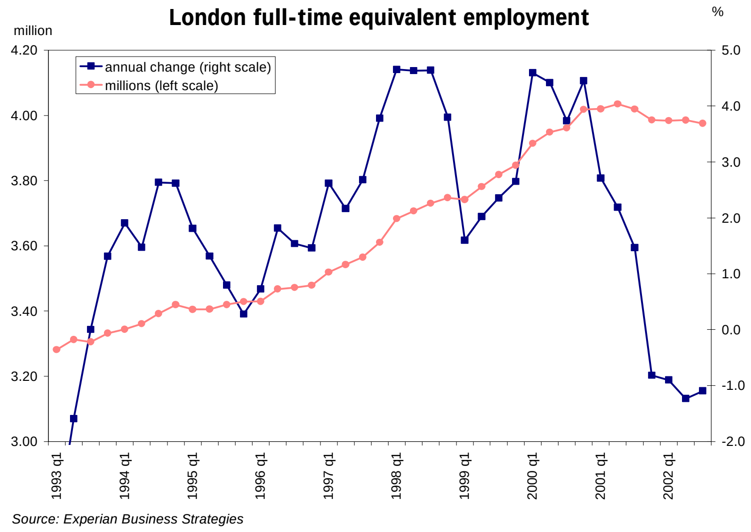
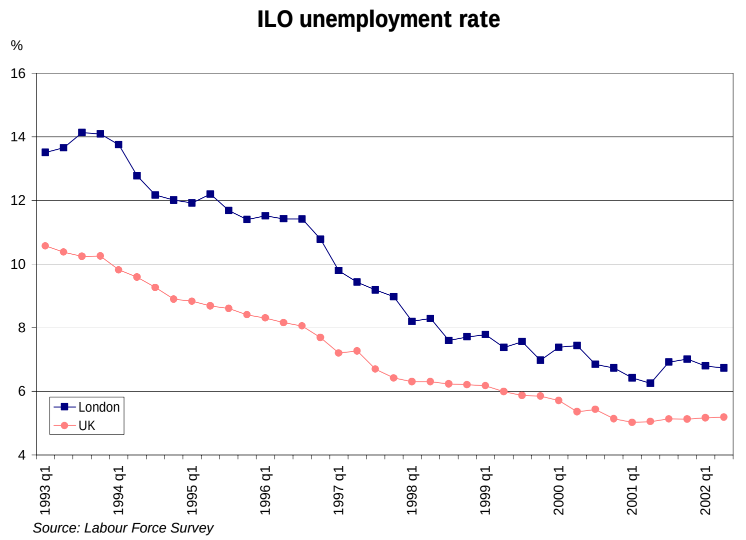
Source: Experian Business Strategies
Latest release: 5/12/02
Next release: early spring

- Full-time equivalent employment is an estimate that combines full-time employment, self-employment and part time employment.
- Employment growth has been negative since Q3 of last year.
- In Q3 it ticked up to –1 per cent, year- on- year.



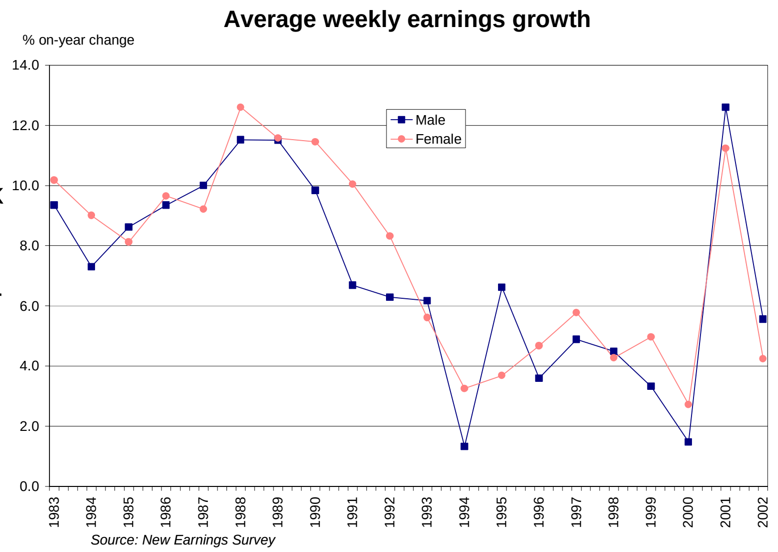
Source: Labour Force Survey
Latest release: 13/11/02
Next release: 18/12/02

- The ILO unemployment rate for Great Britain is flat, and for London fell slightly, in Q2 of 2002.
- Both remain very low compared to the early 1990s.
- At 6.7 per cent, London's unemployment has not even risen above its 1999 level and is less than one-half its 1994 peak.
- London's unemployment remains significantly higher than the UK's current 5.5 per cent.



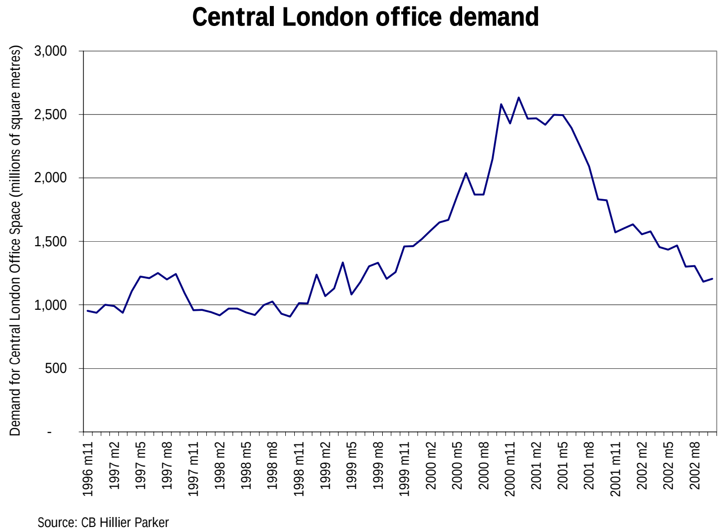
Source: New Earnings Survey
Latest release: 30/10/02
Next release: not known

- Earnings are holding up despite the slowdown.
- The latest release shows that the peak of 12 per cent in 2001 was not sustained in 2002.
- Growth remains above the average for the 1990s.



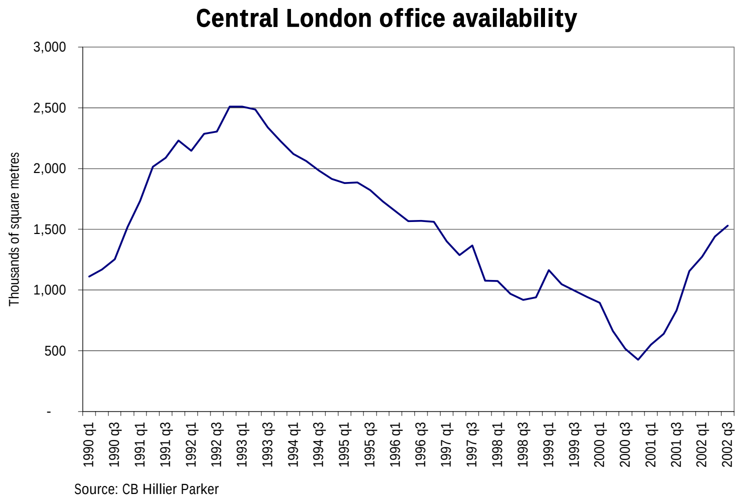
Source: CB Hillier-Parker
Latest release: 13/11/02
Next release: not known

- Central London office demand has declined steadily since its peak in 2000.
- There are signs of an uptick in October.



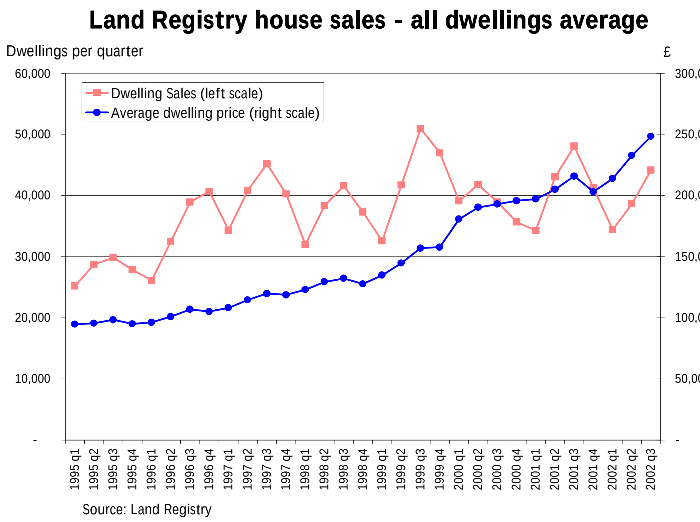
Source: CB Hillier-Parker
Latest release: mid-November
Next release: not known

- Office availability in London continued its recent upward trend in Q2 of 2002.
- It is still below its 1996 level and just over half what it was at the peak of the last cycle in mid-1993.



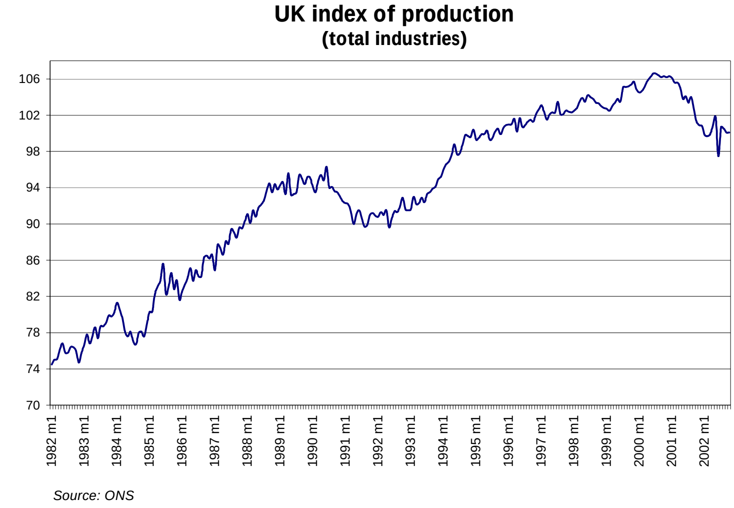
Source: Land Registry
Latest release: 4/11/02
Next release: not known

- House prices continued to rise rapidly throughout the UK.
- Sales volume in Q3 grew as fast as in the previous quarter.
- The average price of a UK dwelling is now £250,000.



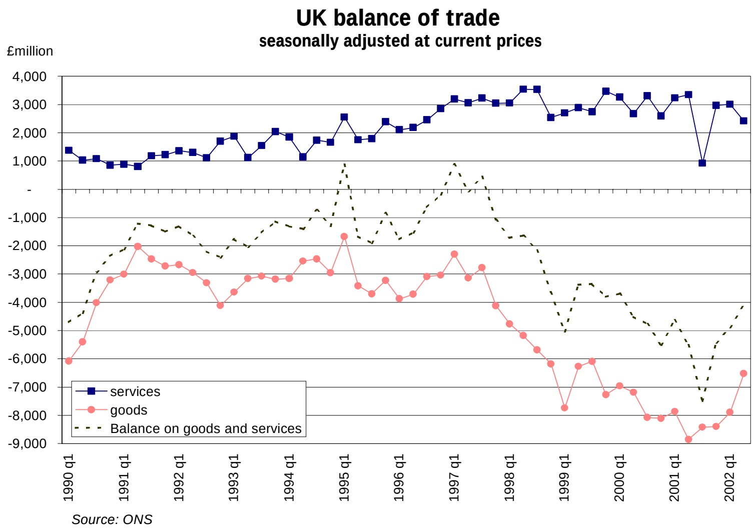
Source: ONS
Latest release: 06/12/02
Next release: 19/12/02

- Setting aside the effect of the Jubilee – the spike up in May and down in June – the index remains flat, having fallen from its June 2000 high of 106.6 to exactly 100.
- The dip is now of the same length and proportional size as in the last cycle, just before the start of the upturn.



Source: ONS
Latest release: 27/9/02
Next release: not known

- The UK deficit in the current account narrowed further in Q2 2002.
- The deficit in goods has a structural element. It worsened from 1997. From 2000 it fell by only two-thirds as much as in the previous two years.
- In the last four quarters the deficit on goods has improved.
- The surplus in services remains unaffected by the downturn and has recovered from 11 September 2001.



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Supplement

The risk of recession in London

- The UK economy is showing signs of recovery. However there are downside risks.
- The uncertainty in world equity markets, weak UK business investment and a rise in office space availability in London present risks to the sustainability or a recovery.
- Consumer spending is the main uncertainty. However, the risk of a recession in London remains relatively low.

The Chancellor and the Bank of England believe that the economic recovery has started and that the UK economy will not suffer recession in this cycle. However, significant risks to the outlook for growth and inflation remain.

State of the London economy

There is strong evidence that a UK economic recovery has begun. Year-on-year output growth increased by 1.8 per cent in 2002 Q3, higher than in the past three quarters, as manufacturing production strengthened in Q3.

Table 1. Expenditure components of demand (Percentage changes on a year earlier) (a)

	2001				2002		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Consumption							
Household	4.2	3.9	3.9	4.2	3.5	4.1	3.8
Government	3.1	1.0	2.9	5.3	6.3	4.6	3.2
Investment							
Business investment	4.5	3.0	1.0	-6.9	-6.1	-5.6	-6.7
Change in inventories	-0.2	0.2	-0.5	0.3	0.1	-0.6	0.5
Trade							
Exports	8.8	3.4	-1.8	-5.0	-6.8	-1.6	0.0
Imports	11.3	4.1	-0.8	-2.5	-2.2	-0.1	1.5
GDP at market prices (a)	2.5	2.0	1.8	1.6	1.0	1.3	1.8

Source: ONS

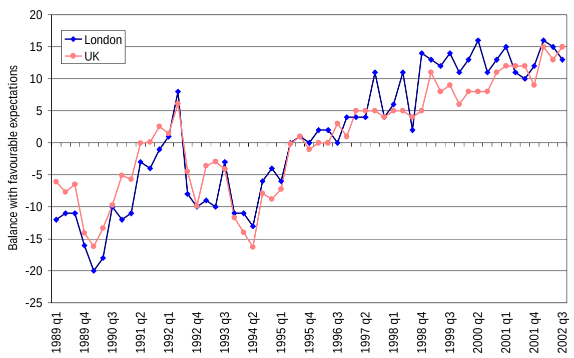
(a) GDP at constant 1995 market prices

Recent buoyancy in consumer spending has reflected strong consumer confidence, valuation in housing wealth and a surge in credit to households in the past months. Although annual consumption growth slowed in Q3 as retail sales growth decelerated, it remains around its average of the past two years.

Government spending has also provided a boost to output, with 3.2 per cent Q3 growth.

World equity prices fell sharply during late summer, but regained most of the lost ground in October. Equity markets remain volatile. A combination of low company profitability and sharp falls in UK equity prices have strained British corporate balance sheets, leading to further cuts in investment plans. Business investment has been falling since 2001 Q2. This downward trend has continued further in 2002 Q3.

Chart 1: Consumer confidence in UK and London (future financial position)



Source: Martin Hamblin GfK

Households remain optimistic about their future financial position. The September GfK consumer confidence survey was the highest on record. There are no signs that equity prices or other factors have affected the sentiment for consumer spending.

The GfK November measure supports this, since consumer sentiment with regard to future financial position of households remains strong. More reassuring is that other measurements of consumer sentiment have improved in particular perceptions of the economy's future. Furthermore, although consumer financial sentiment in London has declined for two successive quarters, the balance remains high at 15 per cent.

Both the Nationwide and Halifax indices of the UK house prices registered 25 per cent-30 per cent growth, rising more quickly than expected in recent months. Although the pace of house price annual growth in London has been slowing down, the market is still buoyant.

Unemployment has been stable in the past months in the UK and London. In October, the claimant count unemployment rate was 3.0 per cent and for London 3.6 per cent. Employment as recorded by the Labour Force Survey has ticked up recently but remains low.

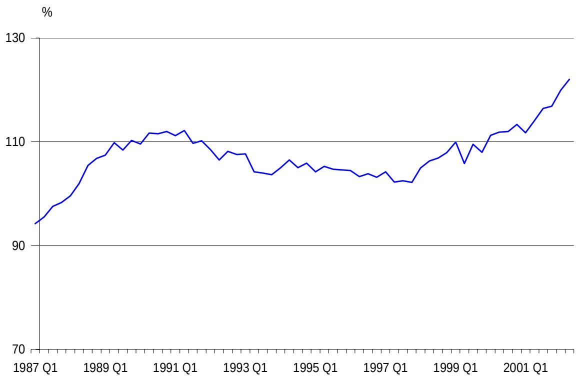
Most recent estimates of the London economy show a recovery starting in the second quarter. Although there are potential risks for a sustained recovery in the London economy, we believe that the likelihood of a recession remains relatively low.

Potential risks for London's economy

The main current risks are the state of the global economy and the sustainability of UK consumer spending.

Risks from external factors have not increased further. Recent data suggest that the US economy is stabilising although recovery remains mixed. The annual output growth in the US was 4 per cent, being higher than expected in the third quarter.

Chart 2: Household debt-to-income ratio



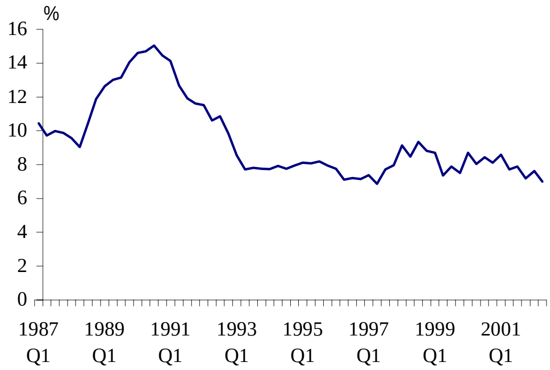
Source: ONS

A key domestic risk is the sustainability of consumer spending growth in the next months. Household borrowing has helped the upsurge in consumption. Currently, household debt, at 122 per cent in Q3, is historically high relative to income. However, household assets, which can cushion liabilities in a downturn, are uncertain due to the behaviour of equity and house prices.

Low interest rates have clearly facilitated the ability to service its total liabilities. The income gearing measure remains relatively low at 7 per cent, broadly unchanged from the past quarters.

It is possible that Londoners are more pessimistic about their financial position next year than the rest of the UK, suggesting a higher risk of a cut in consumer spending in London than the rest of the country.

Chart 3: Household total interest payments-to-income ratio



Source National Statistics

A more significant risk is whether a sharp correction could happen in the housing market. The Bank of England has increased the risk of a housing market correction in its Inflation Report. We believe that a sharp correction in the housing market, as seen in the last recession, is not likely provided that consumer confidence remains strong and unemployment remains low.

Regional information from Bank of England's Agents reported that the gradual and patchy recovery in manufacturing production has continued. However, low profitability, uncertainty in world equity markets and weaker business confidence resulting from the threat of a war in Iraq had led to cautious plans for investment among manufacturing and business services in different regions of the country. There is also anecdotal evidence that some jobs have been lost in legal and financial services in the City. This can also accentuate the risk of cuts in consumer spending in London, as City workers with higher incomes would tend to spend more than others.

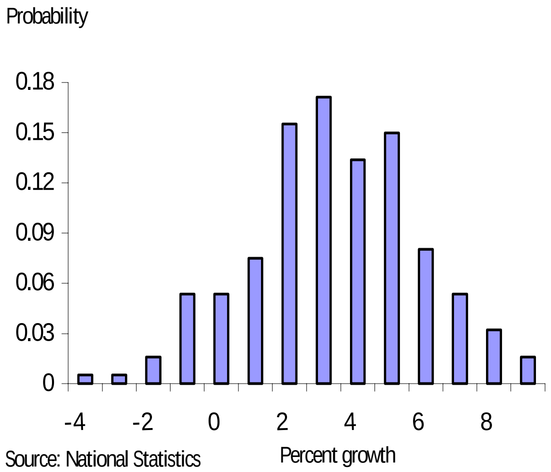
There is still a risk surrounding the uncertainty in the equity markets for prospects for business investment. But given that business investment is a small proportion of output, we would expect a smaller impact on output growth.

The availability of office capacity to let in London has been rising steadily since 2001 Q2, from 8 million sq to 20 million sq ft. This compares with the past recession when it rose sharply from 10 million sq ft to 35 million sq ft. If this upward trend continues, it could herald significant overcapacity in London.

How likely is a recession in London?

UK consumer spending has supported output growth in the UK economy in the past quarters. But how likely is an abrupt drop in consumption growth in the short term, leading to a recession in London?

Chart 4: Histogram of annual growth in UK consumption, 1956 Q1-2002 Q3



Looking at the distribution of consumption growth over time, we can determine the likelihood of a recession in London caused by a sharp fall in consumer spending growth.

Chart 4 shows the relative frequency (probability) of observing any particular year-on-year growth in UK consumption, using data from 1956 Q1-2002 Q3. Over this period, the average annual consumption growth rate has been 2.8 per cent.

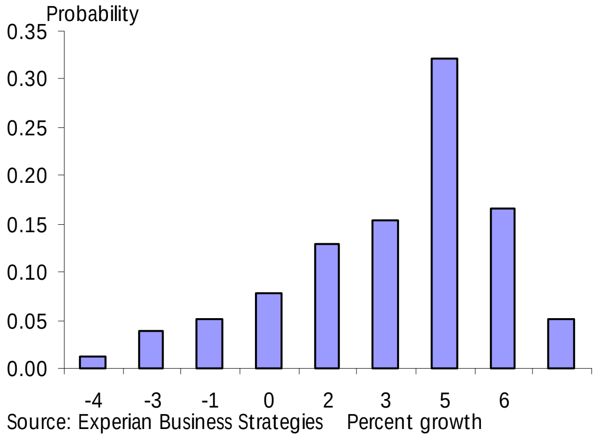
The maximum annual growth rate observed in any quarter was 8.8 per cent and the minimum was a fall of 4.0 per cent in 1980 Q2. Currently, the annual growth rate stands at 3.8 per cent in Q3.

The bar furthest to the left in this histogram indicates that growth was between minus 3 and minus 4 per cent over 0.6 per cent of the time.

This is equivalent to saying that in only one case did year-on-year growth in consumption drop by 4.0per cent over the whole period.

In terms of the worst case scenario – being conservative – this event is associated with the probability that annual consumption growth is less than zero, and is falling in the lower tail of the distribution. This event has a 13 per cent likelihood of happening in any quarter.

Chart 5: Histogram of annual output growth in London, 1983 Q1-2002 Q2



Similarly, we can determine the likelihood of a sharp fall in London's output growth. Chart 5 displays the distribution of annual output growth in London for the period 1983 Q1-2002 Q2. The average output growth for London is 2.5per cent and a median of 3.2 per cent. Output growth in the range 4 per cent-5 per cent was the most frequent observed in the whole period.

The distribution is negatively skewed. Currently there is a probability of 16 per cent of observing an annual output growth less than zero in a given quarter.

In summary, although there is significant uncertainty in the consumer sector and in housing markets, the risk for a recession in London at present remains relatively low.

Data Sources

Tube Usage	Further information contact Transport for London on 020 7941 4500
FTSE 100 Index	Further information see www.ft.com or the daily Financial Times
Office Space Demand	Further information see www.cbhillierparker.com
House Prices	Nationwide house price data from www.nationwide.co.uk/hpi/
	Land Registry data from http://www.landreg.gov.uk
Average Earnings & RPI	Data available from www.statistics.gov.uk
MEW	Data available from www.bankofengland.co.uk/mew.htm
Consumer Confidence	Further information see www.martinhamblin.co.uk
Retail Sales	Data available from www.statistics.gov.uk/rsi
GDP/GVA Growth	Data available from Experian Business Strategies on 020 7630 5959
Balance of Trade	Data available from www.statistics.gov.uk
Index of Production	Data available from www.statistics.gov.uk
Manufacturing Expectations	Further information see www.cbi.org.uk
Profitability	Data available from www.statistics.gov.uk
Tourism - Overseas Visitors	Data available from www.statistics.gov.uk
London Airports	Data available from www.caa.co.uk

Abbreviations

CBI	Confederation of British Industry
FTSE 100	Financial Times Stock Exchange 100 index of stocks traded on the London Stock Exchange
GDP	Gross Domestic Product
GVA	Gross Value Added
ILO	International Labour Organisation
MEW	Mortgage Equity Withdrawals
ONS	Office of National Statistics
RPI	Retail Price Index

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GLA Economics

This publication is produced by GLA Economics, which was established in May 2002 by the Mayor of London to provide a firm statistical, factual and forecasting basis for policy decision-making by the GLA and its functional bodies.

London's Economy Today is published on the GLA website on the third Tuesday in every month. It seeks to provide an overview of the current state of the London economy, publishing a changing selection of the most relevant and up-to-date data available. It will track cyclical economic conditions to ensure that they are not moving outside the parameters of the underlying assumptions of the GLA and central government.

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