

South East and London economic report

Executive summary

The London economy is forecast to outperform the UK average over the period 2006-2008, underpinned by growth in financial & business services and construction. From being the fastest growing region in 2006, growth in activity in the South East is forecast to moderate in 2007 and 2008 to around the UK average.

Key trends

- **The London and South East economies outperform UK average in 2006.** The Greater London and South East economies are forecast to expand by 3¼% and 3½% respectively in 2006. In 2007 and 2008, growth in London is forecast to remain unchanged at 3¼% while the South East economy will moderate to 2¾%.

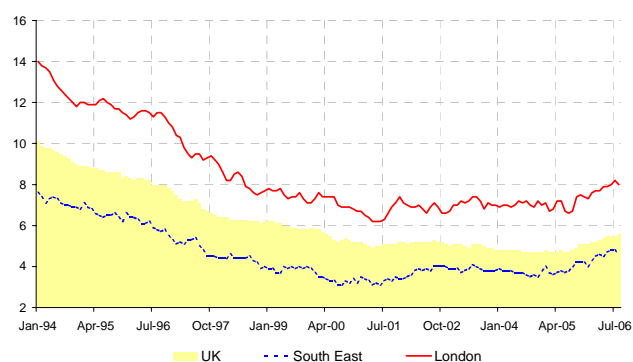
- **Services remains key driver of growth.** Robust growth in financial & business services has underpinned the pick-up in activity in the London economy. Strong growth in private sector services has also underpinned robust growth in the South East. The recent performance of manufacturing, on the other hand, has been mixed.

- **Employment increases in both London and South East but the unemployment rate edges up.** Increased jobs in services and construction have underpinned moderate growth in employment. An increase in the supply of labour has pushed up the unemployment rates.

- **Annual house price inflation strengthens in 2006.** The DCLG measure of house prices points to a modest growth in annual house price inflation in both London and the South East.

- **Competitiveness remains above UK average.** Despite a small fall during 2006, London and the South East remain the main sources of competitiveness in the UK.

London, South East & UK unemployment rate (percent)



Strong growth in regional economies

The pick-up in activity in the London economy, which began in 2004 and 2005, has been sustained into 2006. The regional economy was hit during the 2001-2004 by the technology slump and cuts in financial services jobs following 9/11. A recovery in private sector services, particularly Financial & Business Services and Transport & Communications, has underpinned the upturn.

Survey data suggests that growth in activity in the London economy has firmed in 2006. The RBS PMI London Report indicates that private sector activity in the region is amongst the strongest in the UK. The BCC survey also suggests that activity in both manufacturing and services has expanded strongly in 2006. Furthermore, the rate of growth has exceeded the UK average. The pick-up in financial & business services has underpinned moderate growth in employment. Robust growth in international financial & business services and construction work for office space, transport and preparation for the Olympic Games will see the Greater London economy expand by 3¼% in 2006 and 2007.

The South East continues to benefit from its proximity to London, with economic activity spreading from the capital into adjoining regions. Recent RBS PMI South East surveys indicate that the region's private sector has expanded at a robust pace in the year to date. While activity in the region is expected to remain strong, the rate of growth will moderate as the increase in interest rates by the Bank of England lead to an easing in consumer spending. Activity in

construction is expected to expand strongly, as is transport and communications. From 3½% in 2006, we are forecasting that growth in the South East economy will moderate to 2¾% in 2007, in line with the UK average.

Real Output Growth (percent)

	London	South East	UK
2002	-0.5	3.0	2.1
2003	1.4	3.5	2.7
2004	2.8	3.9	3.3
2005	3.0	1.9	1.9
2006	3¼	3½	2¾
2007	3¼	2¾	2¾
2008	3¼	2¾	2½

Source: Experian

London is not only larger than any other UK region in terms of total output, but its output per capita is also higher than in any other UK region. That said, growth in the South East region has picked up over the past decade such that its total output is now only marginally behind that of London. On a per capita basis, however, London's output was 28% higher than the UK average in 2004, reflecting London's importance as a center for business activity and the number of people who commute into the area. The next highest region was the South East, with total output 13% higher than the UK average in 2004.

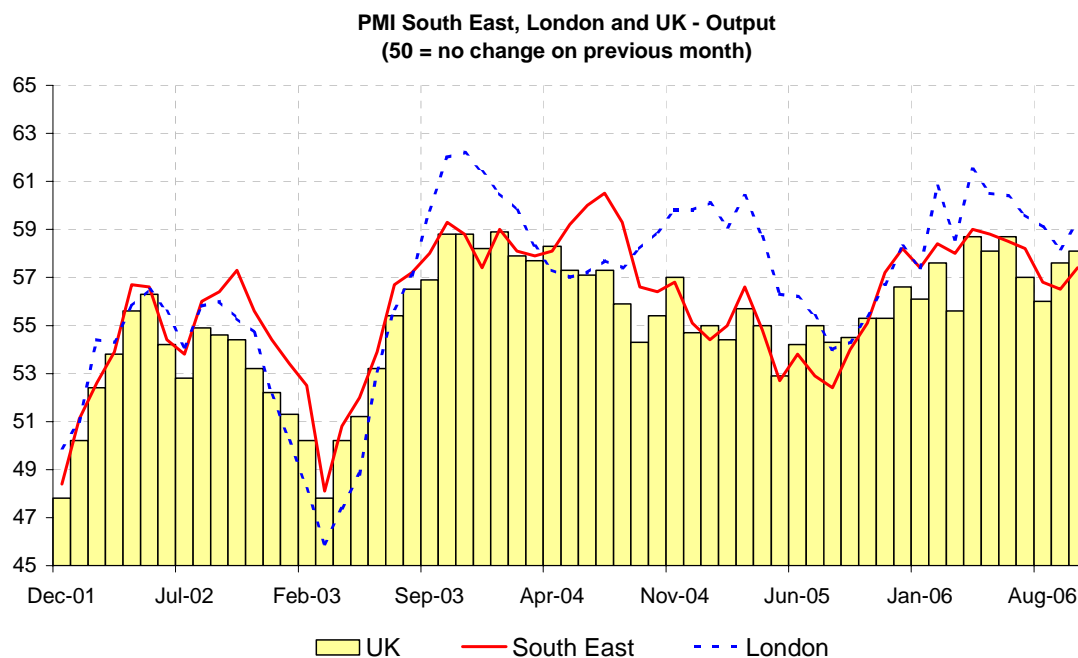
The London economy is heavily skewed towards private services, in particular Financial & Business Services. Manufacturing in London has the smallest share of total GVA output of all the UK regions, thus the London economy was not heavily affected by the poor performance in industry in recent years. London large public services sector also reduces the area’s dependence on manufacturing.

Results from the recent monthly PMI South East survey indicate that growth in the region’s private sector has expanded at a robust pace in the year to date. That said, the rate of expansion in output has dipped below the UK average in recent months. Service providers continue to report a more marked rate of growth in business activity than manufacturers, underpinned by robust growth in new orders. Manufacturers have reported significantly weaker growth in new business.

Business activity remains robust

Recent PMI London reports point to continued strong growth in activity in the private sector. Furthermore, the rate of growth remains above the national average. Growth has been broad-based across both manufacturing and services, underpinned by strong growth in new orders. While backlogs of work have recently declined, this has been largely due to a decline in manufacturing.

Levels of unfinished business in both London and the South East continue to decline as firms utilise excess capacity to reduce the levels of outstanding business. Firms in manufacturing have signaled a sharp decline in order backlogs while firms in services have reported an increase. Employment levels continue to increase in response to increased workloads. That said, the rate of employment growth has eased to its lowest level in a year.



Despite easing in recent months, the rate of increase in input price inflation in both London and the South East remains very strong. Manufacturers have reported higher levels of input price inflation than service firms. Output inflation has continued to rise markedly, rising above the UK average. That said, the rate of increase in output inflation has been well below that of input inflation, suggesting firms' margins remain under downward pressure.

The CBI/Experian Regional Trends Survey, however, pointed to relatively downbeat conditions in manufacturing for the South East and London economies in late 2006. Growth in output stabilized, after an upturn in the previous three months but new orders continued to decline. The outlook, however, is more promising, with new orders expected to increase over coming months. Employment fell sharply, with the rate of job losses faster than in any of the other English regions for the fourth consecutive quarter. Investment intentions for plant and machinery also remained negative. Marked declines in both domestic and export prices kept downward pressure on margins.

The BCC Quarterly Economic Survey pointed to strong growth in activity in both the London and South East economies during the September 2006 quarter. Survey respondents indicated that activity in services was robust, with conditions in the home market remaining stable while demand in export markets strengthened. In contrast to the CBI survey, respondents indicated that activity in manufacturing picked-up in both regions during the September 2006

quarter, reflecting stronger demand in both home and export markets. Employment increased in services and manufacturing in both regional economies.

BCC survey respondents reported steady growth in job creation. That said, the rate of employment growth has eased in recent months as staffing levels in manufacturing have fallen. Strong competition continues to hamper the ability of firms to pass higher costs onto their customers. Overheads in services have been driven up by higher wages while higher fuel and commodity prices have been the main source of inflationary pressures in manufacturing.

Modest employment growth

The strong performance of the London economy, relative to both the South East and the UK average, has been reflected in the labour market. Since late 2005, annual growth in employment in London has picked up to average growth of 2% yoy. Job growth in London has been largely confined to services, particularly financial and business services, and construction. Manufacturing, on the other hand, has shed jobs. In contrast, annual growth in employment in the South East and the UK has trended down, dipping below 1% yoy in the September 2006 quarter. As in London, jobs growth in the South East has been largely confined to services and construction.

Despite the recent stronger performance in London's labour market, unemployment remains relatively high compared to other UK regions. The average unemployment rate across the UK has also trended up from its recent record lows as growth in the labour

force has exceeded growth in employment. In August 2006, the London region's ILO unemployment rate was 8.0%, compared with 4.5% for the South East and 5.6% for the UK.

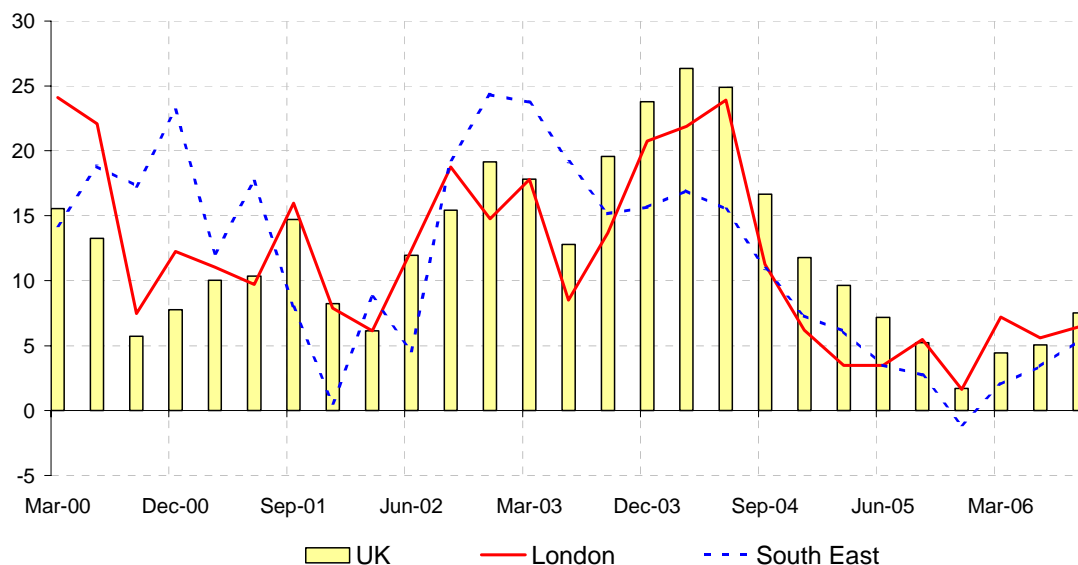
House price inflation strengthens

Data compiled by the Department for Communities and Local Government (DCLG) points to stronger house price inflation in London and the South East in 2006. The boost to London house prices from this year's high City bonuses looks to have been sustained into the third quarter, with annual growth in London house prices up by 6.5% yoy in September 2006. That said, the rate of growth is down slightly from March 2006, when annual growth stood at 7.2%, suggesting that demand may be starting to slow slightly. The annual rate of growth in house prices in the South East has accelerated to be up by 5.4% yoy in September, compared with 2.0% yoy in March 2006. While annual house price growth in the South East has remained below the UK average during 2006 (up by 7.5% yoy in September), it is in line with the average recorded for England (up by 6% yoy in September).

Recent reports suggest that the rate of house price inflation has continued to strengthen in late 2006. Rightmove reported further increases in the average asking prices for houses in November 2006, particularly in the South. Sellers in London were reported to be asking prices 18.2% higher than a year ago, reflecting underlying demand and a shortage of supply. The RICS Housing Market Survey also reported that the strongest rises in prices in October were in London and the South of England, reflecting a booming City economy.

In London, the office market is performing well. The Colliers CRE data indicates that take-up of office space in Central London in September 2006 reached its highest quarterly level since 2001. The Central Vacancy rate has fallen and construction levels have risen very strongly. Rents have also risen rapidly in 2006 after four years of virtual stagnation.

DCLG house prices, percentage change year on year



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