



London Economic Panel 12 February 2008

Summary

There has been a marked shift in outlook and attitude towards the economy since the last Economic Panel in July 2007. On the one hand, London remains on track to make the most of the opportunities centred around the 2012 Olympics, but recent global turbulence in financial markets creates genuine cause for concern.

Overview

Since September 2007's credit crunch, the question that has been repeatedly asked is whether we are in the midst of a slowdown or a move towards recession. The focus for the year ahead is whether and how quickly the UK, and in particular London's financial sector, can bounce back from this inevitable downturn. Figures for the last quarter suggested growth of 3%. Forecasts by the Greater London Authority's economics unit put London's growth at 2% for 2008, although this is likely to be revised to around 1.7/1.8% in the lead up to the year end.

The UK has not historically seen an annual fall greater than 2% and, while the situation would have to decline significantly to reach these levels, some forecasts suggest a decline similar to those seen in the 1980s and early 90s. However, London is much more volatile than the rest of the UK due to its high levels of private sector as opposed to public sector activity. It is therefore likely to feel changes in the financial sector more keenly. The lack of availability of credit demonstrates how seriously confidence has been affected.

Eyes on US

All eyes are on the US and the ability of its economy to withstand a recession. Surveys coming out of the US for January look fairly negative. However, the US economy has a strong history of bouncing back quickly, which, while suggesting an uncomfortable year for 2008, could point to a more promising 2009.

London is more affected by events in the US than the rest of the UK, due to its reliance on the service sector. Other UK regions are more affected by manufacturing, which tends to be more Europe-driven. The consumer is essential to bolster the economy and yet a lack of disposable income is likely in 2008 due to increased mortgage rates, higher utilities and council tax bills, along with increases in food prices. Fortunately, employment remains high, whilst in the US, unemployment is growing.

Short term caution, long term confidence

The overall picture indicates short term caution but long term confidence in London's potential to bounce back from the economic instability of 2007 and 2008. In some respects it could be seen as a cautionary note which may result in the financial market correcting itself after a period of unsustainable, rapid growth. As the summaries below show, certain industries are thriving.

The London Economy – by sector

1. Financial sector

In the past six months there has been a swift unwinding of the very rapid growth experienced in the previous few years. While this correction had to happen, it may take a while for the markets to stabilise and the real value of financial assets to be ascertained. It is difficult to be positive for 2008 and the focus needs to be on the driving forces which can push the economy through to 2009.

Credit squeeze

The growing presence of non-bank institutions (such as hedge funds, private equity firms etc) has helped to compress risk spreads over recent years. The days of easy money are now well and truly over and the availability of debt has decreased. A massive under-pricing of risk has meant banks now have to re-balance.

The UK is particularly vulnerable to a credit squeeze due to its record high debt to household income ratio - the highest of all the G7 countries. Ratios have moved up to the same levels as the peaks in 1990 and, if previous economic cycles are an indicator, it could take a few years for the economy to normalise.

House price factors

There is a correlation between house prices and consumer demand more generally. The lack of availability of credit has meant a corresponding drop in housing demand. Furthermore, the connection between house prices and consumer spending is the highest in the world. Consumers have been tapping in to the equity from a growth in property values via available and cheap credit. There is a close correlation between housing demand and retail sales (i.e. consumer spending), albeit with a time lag. As the demand for housing has dropped, there are suggestions that consumer demand may follow suit.

Given the above scenario, interest rates do not appear to be reducing quickly enough. However, the Monetary Policy Committee is deeply concerned about runaway inflation. Since the UK tends to be inflation-prone, it may prove harder for the UK to bounce back from a downturn or recession than the US.

Hiring freeze

Confidence in the market has been greatly affected and the full cost of the credit squeeze is yet to come in. Many banks are reporting a hiring freeze with firms not replacing employees that leave. It is likely that the industry will shed labour and, correspondingly, organisations that service the sector will be affected.

2. Legal

The sector has seen a weakening in demand since December. There were some suggestions of a decline before December but overall the outlook was fairly positive. While the industry does not expect 2008 to be as positive as 2007, emerging markets are very busy and there has consequently been a shift in activity. The hiring freeze described by the financial sector is also affecting the legal profession and head count is being monitored. There are also cut backs in IT and other investment lines.

3. Retail

London outperformed the UK as a whole in 2007. December sales were good but that was following a disastrous November, and increased trade was the result of heavy discounts. Figures show a decreased footfall but a higher spend per head. It is hard to predict the prospects for 2008 but the rising consumer price index is due to energy and utility increases and the higher cost of food from suppliers rather than any ability for profit rebuilding. This will undoubtedly put pressure on the consumer, alongside the lowering of disposable income as a result of housing costs. It is expected to be a challenging year in retail.

4. Creative industries

4.1 Media and advertising

Advertising trade in London has seen flat to moderate growth and certainly not a reduction. There are more bookings than last year and growth is expected through 2008 – 2009. The current performance of the sector bears no comparison with the economic problems of 2001, which were seen faster and felt more deeply than any other since World War I.

The mood is cautious but optimistic and, with the prospect of the 2008 Olympics and the US election, there is much for the industry to be positive about.

4.2 Merchandising/Manufacturing

Orders have been coming through although enquiries are not as high. There is an expectation that the next five-six months will be strong but a significant drop off could follow.

Typically the sector has done well during an actual recession but lagged on the way out of it.

5. Energy

Energy consumption has been increasing year on year for more than a decade and, while London's energy consumption rose in 2007, consumption in the east of England fell. It is too early to tell whether this is a result of energy efficiency or evidence of an economic downturn affecting consumers.

The price of wholesale energy has doubled in the past year which has put pressure on and forced price hikes. The challenge for the sector is to protect its margins while keeping customers satisfied; whilst at the same time working to keep inflation in check.

The 2012 effect

London is particularly active and in the lead up to 2012 is expected to see a huge increase in energy demand. Construction projects have also increased and the order books for future projects still look extremely positive. The only question is whether these commitments will waver if the economy is negatively affected in 2008.

The energy sector is looking to recruit more than it has ever done in history and there are plans to invest in major capital assets with long life terms.

Sustainable solutions

Vulnerable gas supplies and an ageing infrastructure, along with the issue of climate change rising up the agenda, means that there is a vital need to invest in the next 10 -15 years to protect energy supply. In addition to an investment programme, there is a need to promote a willingness to move into nuclear power, and find other sustainable solutions.

6. Health

Demand on the medical industry in London continues to increase, due to a growing population in certain 'hot-spots', an ageing population and the burden of disease rising. Conversely, NHS investment has been

migrating out of London to other UK regions and London has not benefited from the PFI schemes that other regions have seen. The result is that London is in desperate need of investment.

While the short term is particularly challenging, the long term prospects are more positive, as there are plans for major restructuring in the health sector. There is also a huge appetite for London to become a centre for biotechnical and medical excellence to rival the US, Singapore, Beijing, Shanghai and Toronto.

Despite London NHS trusts meeting their budgets, with possibly even a surplus, the big concern for the sector is where the large-scale investment will come from to match the huge restructuring needed.

7. Education and skills

There is an enormous amount of investment and commitment from the government to address employment and employability, particularly for disadvantaged groups. One area of tension for London is the emphasis of this funding. The recently formed London Skills and Employment Board's (LSEB) focus is on employability skills – getting the unemployed into work - whereas DIUS (Department of Innovation, Universities and Skills) is pushing for the emphasis of spending to be on workforce development.

There is concern that an economic downturn could negatively affect investment in training and the availability of jobs. The success of these relies on the willingness of business to invest in training and remain involved.

There is genuine capital investment in London Higher Education initiatives and business regularly cites a lack of skills as a key issue. A key aim of the LSEB is to provide training and jobs to the indigenous population; however, there is concern that, in an economic downturn, employers will avoid spending on staff training and available jobs will be filled by migrants, particularly from Eastern Europe.

8. Hospitality

In the last six months hotel occupancy levels have been mid-to-high, with peaks, particularly around Christmas. At the end of summer 2007, a drop was feared, but September was a good month. Room rates are holding up very well, especially corporate rates, and the spend per client is going up, which mirrors a trend in the retail sector. There has been a slow down in the leisure markets and as a result there is more weekend availability than at this time last year.

There is an expectation that corporate contracts due for renewal in the coming year will be negotiated downwards. There are already indications that corporate business is cutting back on non-essential bookings. Nonetheless a good year is expected for 2008, fuelled by the buoyant tourist market.

9. Commercial property

Following a year in which capital values fell for the first time in five years, UK commercial property continued to record capital declines in the first month of 2008. Although the rate of decline in returns has eased, it is probably still too early to assume that yields are stabilising, as limited evidence and uncertain investor sentiment still surround the sector.

Annual take-up for the 2007 was strong despite a weak final quarter and slowing rental growth. Take-up weakened considerably in the final quarter with only 2.6m sq ft leased. Take up was well above its ten-year average but nearly 2.0m sq ft lower than the previous year's total.

Vacancy rates have fallen further and supply tightened well below the long-term average. The supply of ready-to-occupy space fell again and is at its lowest since 2001. The West End is most affected.

Rental growth slowed in the final quarter. The index rose by only 1.8% compared with 2.6% and 6.9% in the previous quarters.

Development activity is expected to peak in 2008. A total of 12.8m sq ft of construction activity is currently underway across Central London, which is the highest since 2003. The bulk of the activity is in the City.

Investment in the markets also slowed in the final quarter as effects of the credit squeeze and the wider concerns about the market took their toll.

10. Construction

Office construction has been one of the fastest expanding areas of construction activity over the last three years and a key driver of industry growth. By the third quarter of 2007 the office occupier take-up was at nearly record levels, with 3.5m sq.ft. let across Central London – the most active quarter 3 since 2000. The Banking and Finance sector was responsible for 46% of all take-up by floor space. As a result, the demand for accommodation in 2008 is likely to be vulnerable as a result of retrenchment in the financial services sector.

The crisis in global financial markets is now however casting a shadow over the sector's prospects and commercial development activity has plunged by almost a quarter in the UK in January (Property Week 12.02.08). There were already signs that the investment market had started to peak before the US sub-prime market crisis broke last autumn, but the continuing crisis is exacerbating the down-turn.

The flow of new commercial development activity has seen a sharp fall, particularly in the private sector, and public sector office activity has reportedly hit a five year low. The flow of new projects is likely to fall back during 2008 as developers defer planned schemes and others struggle to secure the necessary funding from risk adverse financial markets. Developers are most pessimistic about retail and leisure and office development, and about 23% of commercial developers have reported a fall in total activity in January.

The Construction Products Association (CPA) has suggested that the construction industry may be forced into recession this year if the problems in the financial markets continue. The CPA warns that these issues will constrain private sector construction activity and, in particular, worsen the slowdown in the housing sector. Private and social housing will be affected and targets for social housing will not be met.

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