Research Briefing 2013-08
September 2013

Economic Outlook and Performance

1 Economic Outlook and Performance

Tower Hamlets has experienced exceptional economic growth over the last 20 years with new employment opportunities and new businesses settling in the borough. While the establishment of Canary Wharf and the financial industries is representing a wider shift in the national and global economy, changes in the national and global economy can have a substantial impact on businesses locally. This was dramatically highlighted with the collapse of Lehmann Brothers based in Canary Wharf. However, those occurrences are not just limited to big businesses. They are likely to filter down to local small businesses too, as many of them are part of wider supply chains.

It is clear, wider economic trends will have an impact on the economy in the borough. For that reason, this document is summarising the main economic indicators necessary to understand the economy and the labour market.

The document presents key economic indicators including GDP, Inflation and the Bank of England interest rate. The indicators support the overall understanding of the underlining economic condition in the UK, the relationship to the labour market and any local and regional consequences of those macro-economic trends.

This Economic outlook and performance document sets the scene for related research papers about the local business structure, the labour market and unemployment in the borough and should be read in conjunction.

1.1 Gross Domestic Product (GDP)

Change in GDP is the main economic indicator for growth. For the first time since 2011, the UK economy has produced economic growth for two quarters in a row. UK Gross domestic product (GDP) in volume terms grew by 0.7 per cent in the second quarter of 2013. This development follows an initial increase in Q1 2013 of 0.4 per cent.

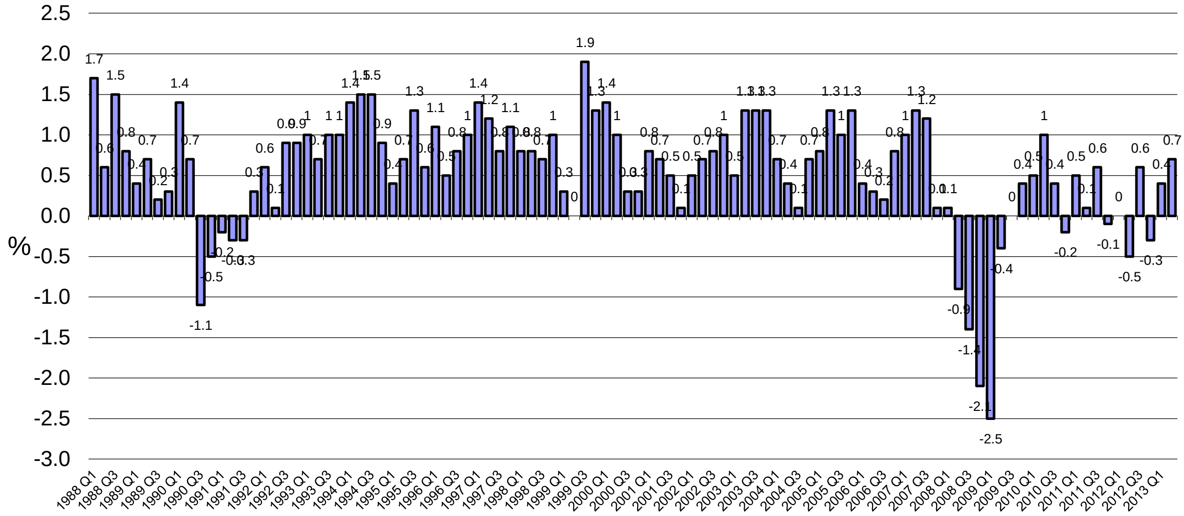
Although GDP growth since mid-2011 has been broadly flat, in the first half of 2013 the economy has expanded by 1.1 per cent. That is below the pace of growth needed to make material in-roads into the margin of slack in the economy, but is nonetheless important after over a year of almost no growth.[1]

The 0.7% increase in output between Q1 2013 and Q2 2013 was broad based, with all three major industry groups – services, production and construction – making positive contributions.

[1] Bank of England August 2013 Inflation report

As a consequence, a range of economic forecasters have recently upgraded their forecast for UK economic growth.[2] For example, the British Chambers of Commerce (BCC) has upgraded its forecast to 1.3 per cent growth this year compared to a previously forecast growth rate of 0.9 per cent.

Fig. 1: UK GDP, Quarter on Quarter Growth UK Timeline 1988 to 2013



(Source: Office for National Statistics, National Accounts, Sept 2013)

Figure 1 above shows GDP trends from 1988 onwards and it becomes clear the recent recession in 2008/09 has been worse than the economic recession of 1990/91.

GDP in the UK grew steadily from 2000 until early 2008, when the financial market shock affected UK and global economic growth. Up until that point, services in the UK had continued to grow steadily, while production output had been broadly flat over the same period. Construction activity grew strongly in the early part of the decade and although there was a temporary decline in the mid-2000s, this was reversed by the end of 2007.

The deterioration in economic conditions during 2008 had a large effect on the construction and production industries, but the effect on the services industries was less pronounced. The recession in Q2 2008 to Q2 2009 was followed by a slow recovery, mainly because demand was subdued by inflation outstripping nominal wage growth, leading to a fall in the real income of households.

However, the services industries grew steadily, if slowly, during this period; activity in these industries is now approximately at the level previously seen in early 2008.

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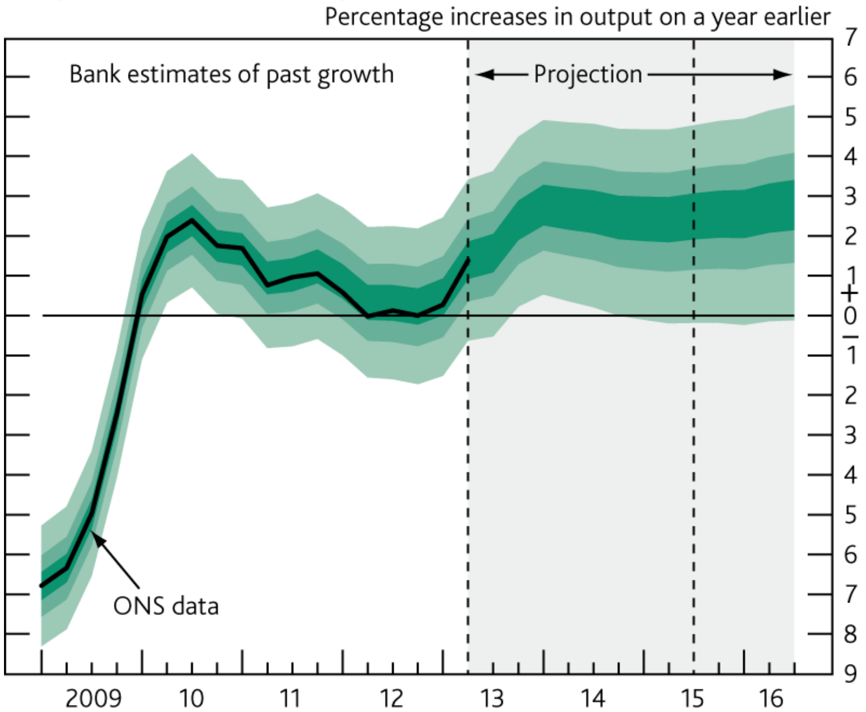
[2] GLA London's Economy Today Sept 2013

Activity in both the construction and production industries is now close to the trough recorded in 2009, meaning that GDP growth since then is entirely attributable to services.[3] Production and construction activity grew in 2010 but did not sustain this growth, with continued long-term economic uncertainty – exacerbated by the euro area sovereign debt crisis – particularly affecting construction in 2012.

While many commentators describe the current trends in 2013 as significant recovery, it remains to be seen if pre-recession growth will return any time soon. The Bank of England has published projections for national GDP with the expectation of growth around the 2 per cent rate over the next three years. The projection below in Figure 2 will be revised every quarter.

Fig. 2: Bank of England projection GDP growth (%)



(Source: Bank of England, August 2013)

[3] Gross Domestic Product (GDP) is an integral part of the UK national accounts and provides a measure of the total economic activity in a region. GDP is often referred to as one of the main 'summary indicators' of economic activity and references to 'growth in the economy' are quoting the growth in GDP during the latest quarter.

In the UK three different theoretical approaches are used in the estimation of one GDP estimate. This measure is taken from the third revision published 26th Sept 2013.
GDP from the output or production approach – GDP (O) measures the sum of the value added created through the production of goods and services within the economy (our production or output as an economy). This approach provides the first estimate of GDP and can be used to show how much different industries (for example, agriculture) contribute within the economy.

GDP from the income approach – GDP (I) measures the total income generated by the production of goods and services within the economy. The figures provided breakdown this income into, for example, income earned by companies (corporations), employees and the self-employed.

GDP from the expenditure approach – GDP (E) measures the total expenditures on all finished goods and services produced within the economy.

Recent GDP growth Trends by industry
As mentioned above, recent GDP growth has been broad based, with all three major industry groups – services, production and construction – making positive contributions. See Table 2 for the data.

Production Industries
In Q2 2013, production output increased by 0.8 per cent and followed a 0.5 per cent increase in Q1 2013.

Within the sector, *manufacturing* output increased by 0.9 per cent between Q1 2013 and Q2 2013, the highest quarter on quarter growth since Q3 2010 when output increased by 1.2 per cent. For the second quarter in a row, the manufacturing sector did not decease.

However, Electricity, gas, steam & air was the only production industry to contract, falling by 2.1 per cent in Q2 2013 compared with an increase of 1.4 per cent in Q1 2013.

Construction
In comparison, Construction output rose by 1.9 per cent in Q2 2013, a strong increase, following a decrease of 1.3 per cent in the previous quarter.

Service industries
The *service industries* have been responsible for mainly consistent growth in 2013, with the industry growing by 0.6 per cent in Q1 and Q2.

Distribution, hotels & restaurants
Output of the distribution, hotels & restaurants industries rose by 1.8 per cent in Q2 2013, largely due to increases in wholesale activities. This follows an increase of 1.3 per cent in Q1 2013.

Transport, storage & communication
Output of the transport, storage & communication industries rose by 0.2 per cent in Q2 2013, mainly due to increases in telecommunications and air transport. The 0.2 per cent increase in Q2 2013 follows another, more substantial increase of 1.7 per cent in Q1 2013.

Business services & finance industries
Business services & finance industries output rose by 0.7 per cent in Q2 2013. In Q1 2013 output rose by 0.1 per cent. The increase in Q2 2013 was mainly due to architectural & engineering activities, technical testing and employment activities.

Table 1: Quarter on quarter percentage GDP growth by sector in the UK (%)

	Q1 2012	Q2 2012	Q3 2012	Q4 2012	Q1 2013	Q2 2013
Agriculture, forestry & fishing	-1.8	-2.2	-0.4	0.4	-5.1	2.0
Total Production	**-0.5**	**-1.1**	**0.1**	**-2.0**	**0.5**	**0.8**
Mining & quarrying (Extraction)	-3.0	-2.8	0.3	-9.4	3.9	1.5
Manufacturing	0.0	-1.4	0.4	-1.6	0.0	0.9
Electricity, Gas & Air (Utilities)	-0.3	5.3	-3.1	3.3	1.4	-2.1
Water supply, sewerage etc.	-0.7	-1.5	0.5	0.1	-0.7	2.0
Construction	**-4.1**	**-3.8**	**-1.9**	**1.8**	**-1.3**	**1.9**
Total Services	**0.2**	**-0.1**	**0.9**	**-0.1**	**0.6**	**0.6**
Distribution, hotels & communication	0.3	-0.1	1.7	-0.6	1.3	1.8
Transport, storage & communication	0.8	-1.3	-0.4	0.4	1.7	0.2
Business services & finance	-0.1	0.1	0.8	0.4	0.1	0.7
Government & other services	0.4	0.1	1.3	-0.7	0.5	0.0

(Source: ONS, National Accounts, September 2013)

1.2 *Measuring Inflation*[4]

Everything that consumers buy has a price; the price may vary over time. Consumer price indices are designed to measure such changes.

A convenient way to understand the nature of these indices is to envisage a very large shopping basket comprising all the different kinds of goods and services bought by a typical household. As the prices of individual items in this basket vary, the total cost of the basket will also vary; consumer price indices measure the change from month to month in this total cost.

No two households spend their money in exactly the same way. Each household's or person's experience of inflation will be different. The CPI (Consumer Price Index) and RPI (Retail Price Index) are measures of average inflation, based on average household expenditure on the items in the shopping basket.

[4] ONS Consumer and Retail Price Index March 2012 and ONS Consumer Price Index Technical Note 2012

Consumer Price Index (CPI) August 2013

The CPI, which was launched in 1996, is an internationally comparable measure of inflation which employs methodologies and structures that follow international legislation and guidelines. The CPI is the government's inflation target, set at 2 per cent since December 2003, when the Chancellor of the Exchequer announced that all future monetary policy would be based on a 'new' measure of inflation - the CPI.[5]

CPI annual inflation stands at 2.7 per cent in August 2013, down from 2.8 per cent in July. The 2 per cent target hasn't actually been met since November 2009 when 1.9 per cent inflation was achieved.

Inflation was boosted by clothing and footwear prices, which exhibited a smaller seasonal decline in June 2013 compared to 2012. Some of the rise in CPI inflation during Q2 also reflected the effect of the reductions in energy bills and petrol prices, which occurred in Q2 2012, dropping out of the twelve month comparison.

CPI inflation is likely to remain close to 3% in the near future, reflecting the impact of past increases in import prices and the persistent contribution from administered and regulated prices. Inflation is likely to fall back to around the 2% target by 2016 as external price pressures fade. A gradual moderation in domestic cost pressures, aided by a revival in productivity growth, should help to offset the sustained contribution from administered and regulated prices.

The outlook for inflation remains highly uncertain, and will depend on the extent to which productivity picks up as demand accelerates, on the degree to which companies' profit margins are restored, and whether that is through higher prices rather than lower cost growth. As ever, inflation will also be sensitive to sharp movements in both the exchange rate and commodity prices.[6]

Retail Price Index (RPI) August 2013

The RPI began life as a compensation index, developed as an aid to protect ordinary workers from price increases associated with the First World War. It was only much later, after a number of significant developments that it came to be used as the main domestic measure of inflation.

RPI annual inflation stands at 2.6% in August 2013, the same rate as in July 2013. The last time the annual rate was lower than this was in December 2009.

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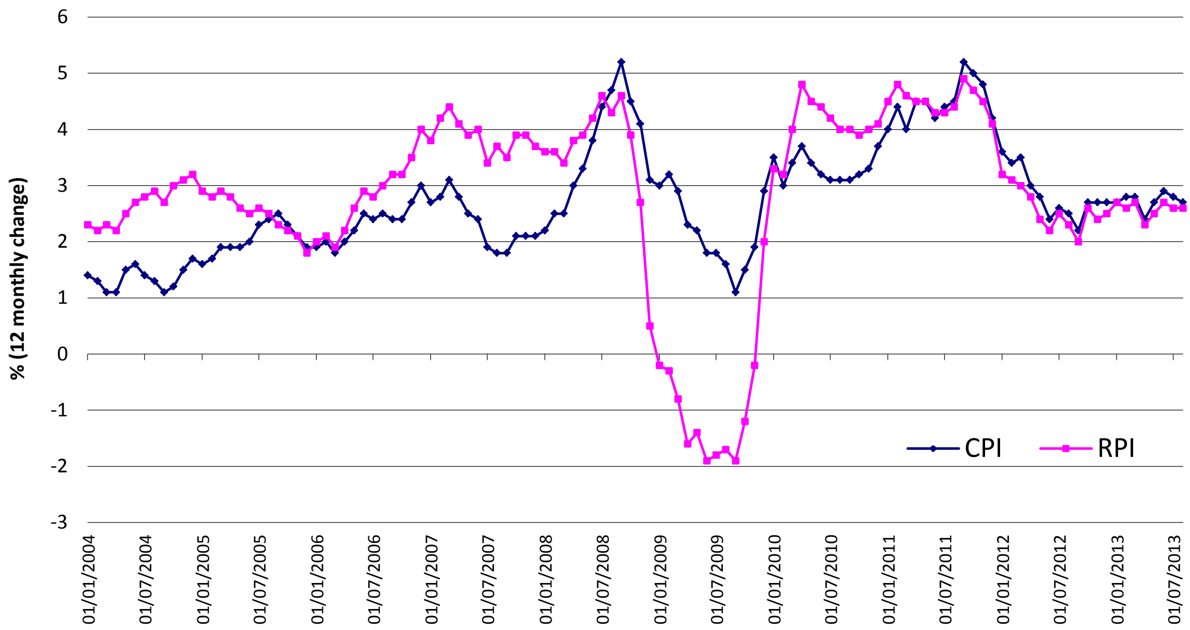
[5] ONS Differences between the RPI and CPI Measures of Inflation

[6] Bank of England Inflation report August 2013

Fig. 3: CPI and RPI over time 2004 to August 2013



(Source: Office for National Statistics)

Differences between RPI and CPI Inflation
RPI includes the costs of housing (mortgage interest costs and council tax etc) while CPI does not. There are also some additional crucial differences in how the rates are calculated.

The RPI is arithmetic mean – i.e., the prices of everything to be included in it are simply added up and divided by the number of items.

The CPI is a *geometric mean*. It is calculated by multiplying the prices of all the items together and then taking the nth root of them, where 'n' is the number of items involved.

Trends in CPI and RPI are currently very similar, with the RPI just below the CPI. Historically, the RPI tends to be above the CPI, but RPI dropped far below CPI during the 2008/09 recession. While this trend was reversed in 2010, from 2011 onwards the RPI stood just below CPI.

After the Coalition government came into power, it linked a number of key benefit increases to the *consumer price index*, which tends to be lower than the RPI. However, it also introduced a 1 per cent up-rating (instead of using CPI) for three years from 2013-14 for the main working-age benefits, and for two years from 2014-15 for Child Benefit and for Local Housing Allowance within Housing Benefit.

1.3 *Bank of England Interest rate*

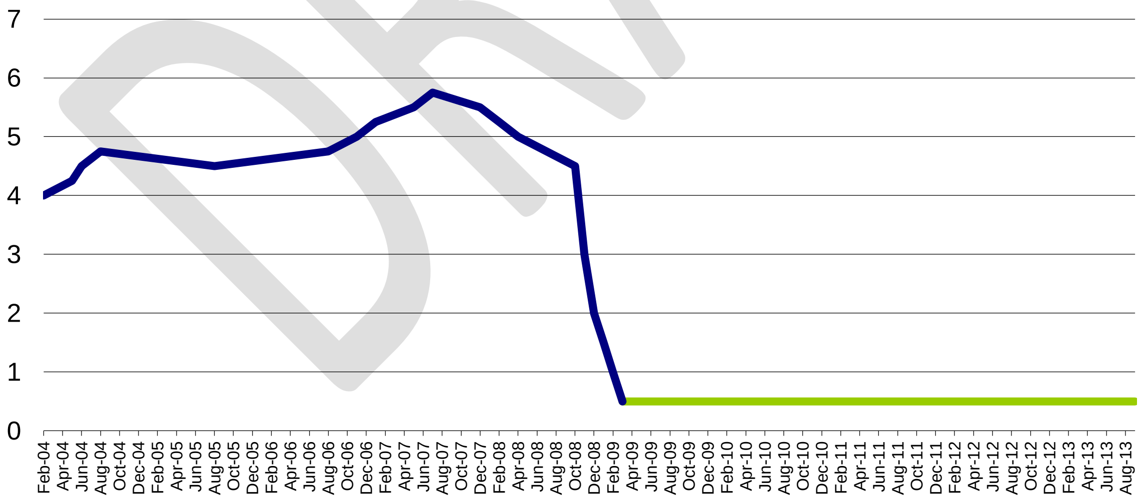
In the UK, the Monetary Policy Committee (MPC) sets an interest rate for the Bank of England's own market transactions with financial institutions - the rate at which the Bank will make short-term loans to banks and other financial institutions. This rate is known as the official Bank Rate.[7]

Since the 5th March 2009 the Bank of England interest rate has been kept at a historic low of 0.5 per cent. The low interest rate is kept low to stimulate demand in the economy. The low interest rate makes saving less attractive and borrowing more attractive. Borrowers tend to spend more of any extra money they have than lenders, so the net effect of lower interest rates through this cash-flow channel is to encourage higher spending in aggregate.

Lower interest rates can boost the prices of assets such as shares and houses. Higher house prices enable existing home owners to extend their mortgages in order to finance higher consumption. Higher share prices raise households' wealth and can increase their willingness to spend.

Recently in August 2013, the new Governor of the Bank of England Marc Carney linked any future increases of the interest rate to improvements on the labour market. The Bank of England indicates that the unemployment rate will not fall below 7 per cent in the next three years. However, the Bank will provide forecasts updated each time the Bank publishes its quarterly Inflation report, so more regularly updated forecasts than the six-monthly Office for Budget Responsibility forecasts will be available.

Fig. 4: Bank of England rate Feb 2004 to August 2013



(Source: Bank of England Sept 2013)

[7] Monetary policy aims to influence the overall level of monetary demand by influencing the price at which money is lent in the economy so that it grows broadly in line with the economy's ability to produce goods and services. This stops output rising too quickly or slowly. Interest rates are increased to moderate demand and inflation and are typically reduced to stimulate demand. The majority of financial transactions will be affected in some way by any change to interest rates, though there is typically a time lag between a rate change and the impact on consumer behavior and then subsequent wider impacts on the economy as a whole. There is a more immediate impact on for example financial assets such as shares and bonds.

Why the Bank of England interest rate is linked to the unemployment rate[8]

There are some good reasons to use the unemployment rate as a guide for interest rates. The main aim of the Bank of England is to control inflation. In economic theory, unemployment is a key driver of pressure on wages: if unemployment is very low, it's harder to fill vacancies and to retain staff, so wages have to go up. If it is high, the opposite is true.

Because real earnings have been falling, economists will understand the current high unemployment rate as deflationary – reducing any inflationary pressures anywhere in the economy. Economists tend to see this as a good thing even if unemployment is excessive at the moment. The Bank of England policies would aim for a trade-off between the unemployment rate and the inflation rate. The Bank thinks the 'equilibrium' rate for unemployment is around 5 per cent, way below the current 7.8 per cent levels.

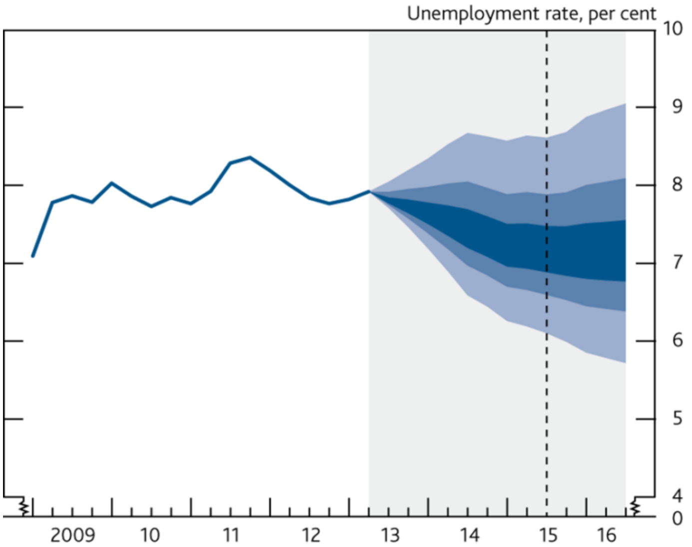
While the unemployment rate helps to understand the likely pressure that the unemployed put on wages and thus inflation it has the advantage of being available regularly (monthly) with fewer revisions (unlike some alternatives).

Of course the unemployment rate is no indicator of the overall state of the labour market or the position of those out of work, as it ignores the economically inactive, who are not looking for work.

Indeed, care should be taken in the interpretation of unemployment data, since a reduction in the unemployment rate may simply mean that more people have become economically inactive and as a result are no longer looking for work. Once again, this may make it harder for employers to recruit, leading to inflationary pressures on the economy, without more people actually benefiting from being in employment. Therefore, even if the unemployment rate should fall in Tower Hamlets, the council should not necessarily reduce its efforts to support people into work – there may still be many economically inactive people who are far from the labour market, who may benefit from finding work.

[8] Bank of England Inflation report August 2013 / CESI http://www.cesi.org.uk/blog/2013/aug/bank-england%E2%80%99s-%E2%80%98forward-guidance%E2%80%99-and-unemployment

Fig.5: Bank of England Unemployment projection based on constant nominal interest rates at 0.5% and £375 billion asset purchases[9]



(Source: Bank of England August 2013)

[9] The fan chart depicts the probability of various outcomes for LFS unemployment. It has been conditioned on the assumption that the stock of purchased assets financed by the issuance of central bank reserves remains at £375 billion throughout the forecast period. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that the mature estimate of unemployment would lie within the darkest central band on only 30 of those occasions. The fan chart is constructed so that outturns are also expected to lie within each pair of the lighter blue areas on 30 occasions. In any particular quarter of the forecast period, unemployment is therefore expected to lie somewhere within the fan on 90 out of 100 occasions. And on the remaining 10 out of 100 occasions unemployment can fall anywhere outside the blue area of the fan chart. Over the forecast period, this has been depicted by the light grey background. In any quarter of the forecast period, the probability mass in each pair of identically coloured bands sums to 30%. The calibration of this fan chart takes account of the likely path dependency of the economy, where, for example, it is judged that shocks to unemployment in one quarter will continue to have some effect on unemployment in successive quarters. Q2 is a staff projection for the unemployment rate, based in part on data for April and May. The unemployment rate was 7.8% in the three months to May and is projected to be 7.9% in Q2. (Source: Bank of England August 2013)

1.4 London – Economic outlook[10]

Business confidence in London

The UK Business Confidence Monitor Q3 2013 by ICAEW/Grant Thornton reported an improving economic situation in London, finding that "confidence in the capital has been rising steadily since Q3 2012 and has now reached its highest level since Q2 2010". The report also found that "turnover is expected to rise by 5.1 per cent over the next 12 months, bolstered by accelerating domestic sales and export growth. Improved revenues are expected to lead to 4.4 per cent profit growth over the coming 12 months".[11]

Business confidence in London is above the national average. For the UK as a whole the report noted that "business confidence continued to improve in the third quarter of 2013", commenting that, "this quarter's reading suggests that the economy will expand by 1.0 per cent in Q3 2013". Export growth is expected to pick up over the next 12 months, despite a challenging global economic backdrop.

London Labour Market trends

London's labour market continues to be stronger than expected. London's total workforce (the number of jobs located in London, whether or not they are taken by residents of London) increased by 70,000 (1.4 per cent) in Q2 2013, to stand at 5.221 million. This is the highest level since the series began in 1996. Although household budgets remain tight it appears that the UK economic situation heading into the winter provides hope for a more prosperous new year with London leading the way.[12]

Oxford Economics - Economic outlook for London[13]

Oxford Economics suggests that London is expected to remain at the forefront of the UK recovery given its concentration of high valued added exporting service sectors. The region is also expected to account for an increasing share of UK output. In labour market terms, the forecasts suggest that 374,000 of jobs created in the UK between 2013 and 2018 will be within London, which equates to approximately 1 in every 4 jobs.

Oxford Economics report London's Growth Value added (GVA) growth of 1.4 per cent in 2010 and 0.8 per cent in 2011. The estimate for London's GVA growth in 2012 is now higher at 1 per cent with business services providing most of the growth, and with the accommodation & food and wholesale & retail trades being held up by the Olympics.

Oxford Economics forecast for London a GVA growth of 2.8 per cent in 2014, while during 2015-20 London's economy is to return to its long-run growth path of around 3.6 per cent.

Labour market activity is likely to pick up again in 2014 and Oxford Economics predict London's employment rate as averaging a growth of 1.3% over 2015-20 (67,000 net jobs per annum). The key sectors driving London's employment are expected to be professional services and administrative & support services.

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[10] Oxford Economics: Economic Outlook April 2012
[11] UK Business Confidence Monitor Q3 2013
[12] GLA London's Economy Today Sept 2013
[13] Oxford Economics: Economic Outlook for London April 2013.

Fig.6: Oxford Economics GVA and employment growth forecast for London

(Source: Oxford Economics April 2013)

1.5 Tower Hamlets – Economic outlook[14]

The economy of Tower Hamlets is quite heavily concentrated in financial services, mainly located in Canary Wharf, which account for a 29% share of total employment – second only to the City. While we will discuss the business structure and economic strength of the borough later in the Borough Profile, it is clear that Tower Hamlets is home to various growth sectors, not just financial services.

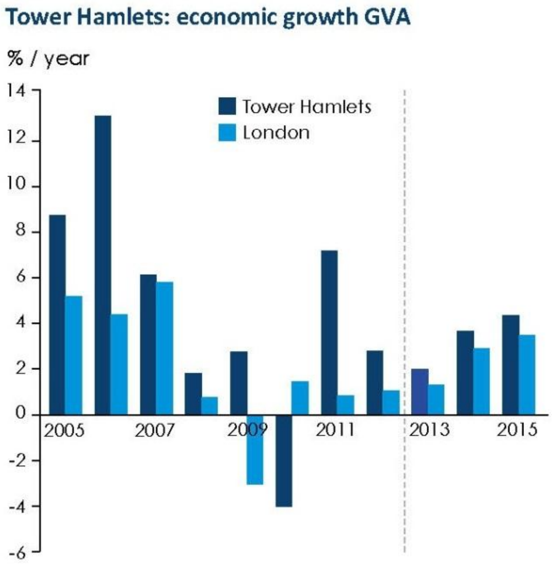
For this reason, Oxford Economics believe that recent employment growth in Tower Hamlets seems to have carried over into 2012 with total employment estimated to have grown by 5.8%, driven largely by professional and administrative & support services and, to a lesser degree, construction.

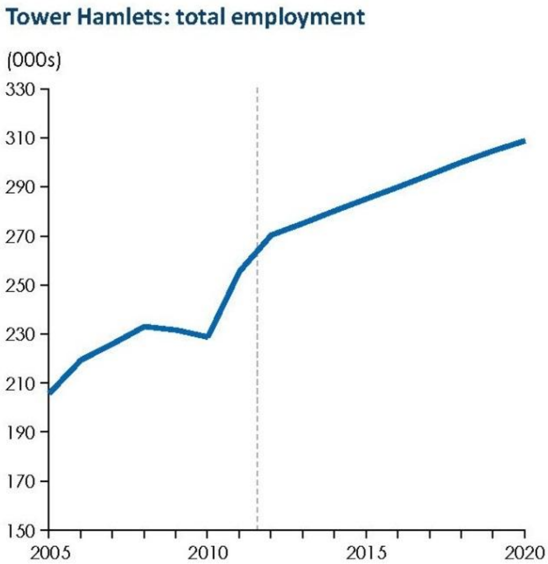
Oxford Economics regard the pace of job gains in 2011-12 as largely a result of recruitment bouncing back from the cuts made during the financial crisis. They forecast therefore that employment growth in Tower Hamlets will slow down considerably over 2013-20, averaging a rate of 1.7% per year.

However, this rate will be above Westminster and the City of London, reflecting the high potential of the area as a rival to the City. GVA growth will also outperform the City, Westminster, and London on the whole. See Figure 7 below.

[14] Oxford Economics: Economic Outlook City of London, Westminster & Tower Hamlets April 2013.

Fig.7: Oxford Economics GVA and employment growth forecast for Tower Hamlets





(Source: Oxford Economics April 2013)

Further information

This Briefing was produced by the Council's Corporate Research Unit, which is based in the Chief Executive's directorate. Research briefings provide timely and in depth analysis of data about Tower Hamlets.

Briefings can be downloaded on the LBTH Borough profile web pages.

Readers can contact the research team via email: CRU@towerhamlets.gov.uk