

South East Economy Review – October 2008

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Executive Summary

- Recent days and weeks have seen unprecedented developments within the global financial system, with central banks in the US, Europe, Japan and UK intervening to try and boost liquidity in flagging financial markets. Most notably, the US has effectively nationalised its two largest mortgage lenders and two remaining investment banks.
- At UK level, growth in GDP came to a halt in the second quarter of 2008. Total production output declined in both quarters one and two, while growth in the service sector slowed to just 0.2 percent in quarter two. The credit crunch continues to persist.
- With commodity prices rising and the credit crunch persisting, a number of major global economies, including the Euro area and Japan, have seen falling output growth in the second quarter of 2008. In the US, however, output growth expanded strongly in this period, largely driven by an increase in exports.
- Over the year to August 2008 a sharp rise in food, energy and transport costs helped to push UK inflation to 4.7 per cent – more than twice the Bank of England inflation target. Rising costs are putting pressure on business prospects in the South East, particularly in the manufacturing sector. Businesses are responding either by squeezing profit margins or passing higher costs on to customers.
- The latest survey evidence points to a sharp slowdown in business activity and new orders at both national and regional level in recent months. Business activity showed little if any growth in the South East in June and July, with a majority of firms in the service sector reporting contraction in their business activity. New orders declined at the fastest rate in almost seven years, although the rate of contraction in the region was less severe than elsewhere in the UK. A small increase in business activity was recorded in August.

- Employment growth slowed down in the three months to July at UK level, with a drop in the employment rate of 0.2 point. By contrast, the South East was one of only a few regions to see an *increase* in employment between the first and second quarters of 2008. However, the latest survey data points to a further weakening of the labour market, with a net fall in private sector employment in the South East in July 2008, for the first time since August 2005.
- Unemployment in the UK rose by 81,000 in the three months to July, taking the unemployment rate to 5.7 percent. In the South East, unemployment rose by 28,000 in the same period (the largest increase of any region), with the unemployment rate rising to 4.4 percent. This was almost entirely driven by an increase in unemployment amongst men. The number of people claiming Job Seekers' Allowance increased by 4,200 between July and August in the South East.
- Slower economic growth and concern amongst businesses that the economic downturn might in fact last longer and be more pronounced are likely to lead to a further weakening of the labour market, both regionally and nationally, over the next 12 months. The South East is particularly vulnerable to any effects of the credit crunch because of its heavy exposure to both the financial and business services sectors and any slowdown in consumer demand. The recent demise of Lehman Brothers and XL Airways, for example, has led to job losses in the region.
- A significant housing market correction is underway at both UK and regional levels. Average house prices in the UK have been falling for ten consecutive months, with an overall drop of 10.5 percent in the year to August 2008 according to Nationwide. Factors behind the drop in house prices include a slump in mortgage lending (a 70 percent drop in new mortgage approvals in the year to July 2008), a decline in disposable incomes due to high inflation and a downturn in the labour market.
- In the South East, house prices fell by 6.4 percent in the three months to June, according to Halifax – faster than the UK average of 4.7 percent in the same period. East and West Sussex bucked national and regional trends by recording small house price increases. A slowing economy, downturn in the labour market and the persistence of the credit crunch suggest that it is likely that house prices will continue to fall this year and possibly well into 2009.
- Business confidence in the South East is at extremely low levels. Only one in nine businesses in the region believe that the climate in which they operate will improve in the next twelve months. One third of businesses expect the volume of output and domestic orders to fall, while almost half expect profit margins to be lower in the next 12 months. Nevertheless, firms in the South East report slightly less gloomy expectations about the year ahead than the English average.
- Forecasts for the UK economy for 2008 and 2009 have been revised downwards in the light of the current economic situation. The consensus of independent forecasts compiled by the Treasury shows the UK economy expanding by 1.1 percent in 2008 and just 0.3 percent in 2009. Applying these forecasts to the South East suggests rates of growth in the regional economy of around 1.3 percent this year and 0.3 percent in 2009.

The UK Overview and Outlook

The credit crunch gets worse ... unprecedented developments within the global financial system

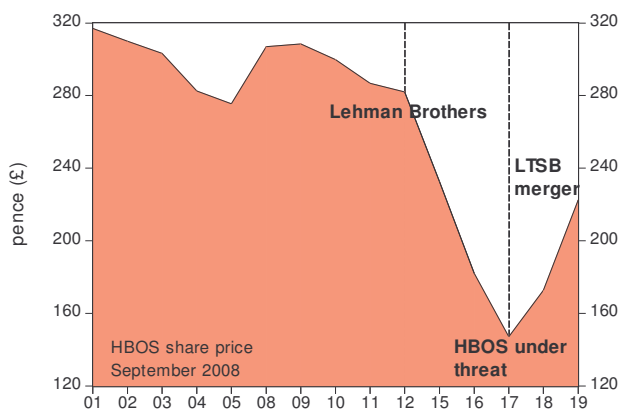
Large US investment bank Lehman Brothers collapses; Halifax Bank of Scotland (HBOS) under pressure. In order to revive the US housing market the US Treasury has effectively nationalised two of the largest mortgage lenders in the country that between them have several trillion dollars in assets. The move did little to bring back badly needed liquidity in the US financial system. By mid September the credit crunch worsened: Merrill Lynch, a large US investment bank was bailed out by Bank of America and Lehman Brothers, previously the fourth largest investment bank, became the largest bankruptcy in US history. The fall of Lehman brothers led to a further deterioration of confidence within the global financial system, resulting in large falls in equity prices across the globe (Figure 1). The instability quickly spread across the financial system, with AIG (until recently the largest insurer in the world) being effectively nationalised by the US Treasury.

Figure 1: 'Credit crunch' gets worse ... (FTSE100, May 2008 - 19 September 2008)



Source: London Stock Exchange 2008

Figure 2: ... HBOS under pressure ... HBOS merge with LTSB ... Central Banks intervene



Source: London Stock Exchange 2008

Within the UK, Halifax Bank of Scotland (HBOS), the largest mortgage lender in the country came under pressure with its shares plummeting (Figure 2). A significant drop in share prices led to a takeover of HBOS by Lloyds TSB (LTSB), creating the largest banking group in the country.

A coordinated intervention by central banks leads to a revival in equity markets. In order to prevent a global financial 'meltdown' a number of central banks (US, UK, Eurozone, Switzerland and Japan) have provided a \$180 billion injection to boost liquidity within the global financial system. The US Treasury announced the creation of a \$700 billion fund to buy 'bad debts' and revive the financial markets. The Bank of England has extended its Special Liquidity Scheme until early next year and the Financial Service Authority (FSA) has banned the short selling of financial stocks in the UK.

With the FTSE100 recording its biggest one day rise in history on Friday 19 September 2008, the policy makers' move has helped market recovery.

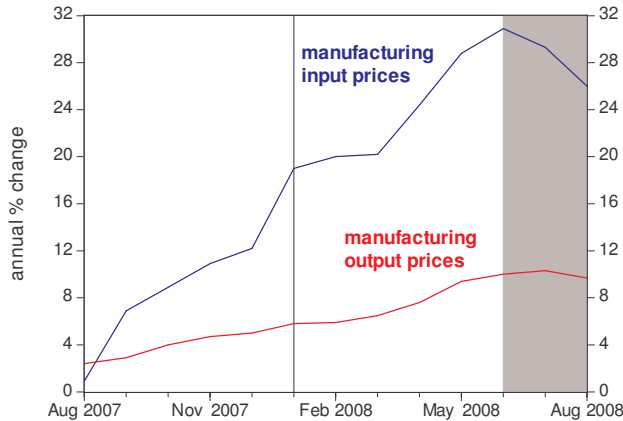
It might take much longer before full liquidity returns to the global financial markets. It is likely that a degree of instability will remain within the system for the foreseeable future before the markets return to 'normality'. The actions of the US government which effectively led to nationalisation of a significant chunk of its economy could have an impact on US inflation and destabilise the US dollar. This in turn could have an impact on oil prices (oil is largely traded in dollars) and rates of economic growth across the world. Given the importance of the financial sector to the overall economy, the global economic outlook has clearly deteriorated and this will have an impact on the UK and South East outlook for this year, in 2009 and beyond.

UK inflation is running at more than twice the inflation target ...

There has been a significant increase in UK inflation over the past 12 months. The last year has been characterised by a significant increase in global inflation. Global food prices rose by around 60 per cent in sterling terms in the year to July. By July 2008 sterling oil prices had more than tripled since early 2003, with real prices higher than at any time since the 1970's. Over the past couple of years there has been a significant rise in other global commodity prices.

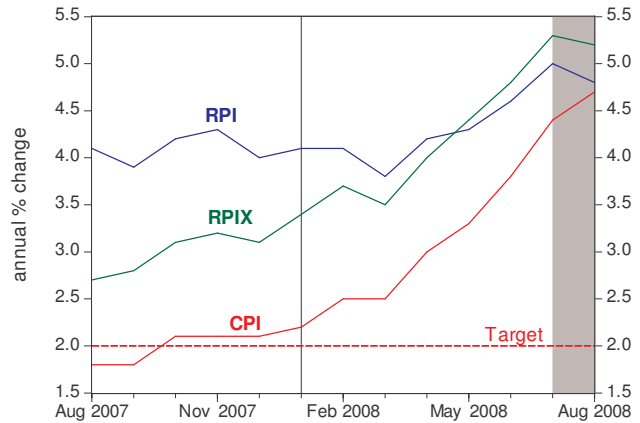
As a result of the high oil and commodity prices, UK manufacturing input and output prices have risen sharply over the past 12 months (Figure 3). In addition to a significant increase in manufacturing output prices, by August 2008 a sharp rise in food, energy and transport costs helped to push UK inflation to 4.7 per cent, more than twice the Bank of England inflation target (Figure 4).

Figure 3: A sharp increase in UK producer prices ...



Source: National Statistics 2008

Figure 4: ... UK inflation well above the target

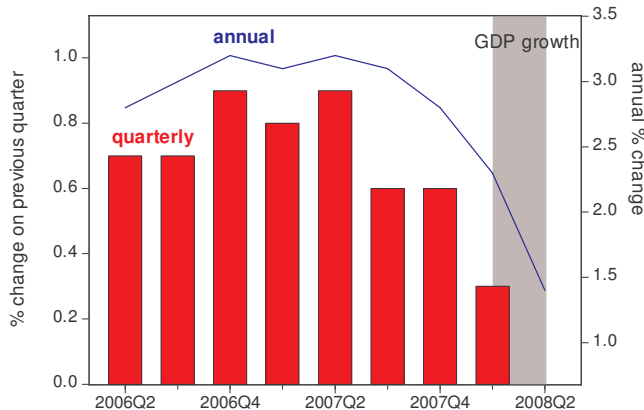


Source: National Statistics 2008

UK economic growth comes to a halt

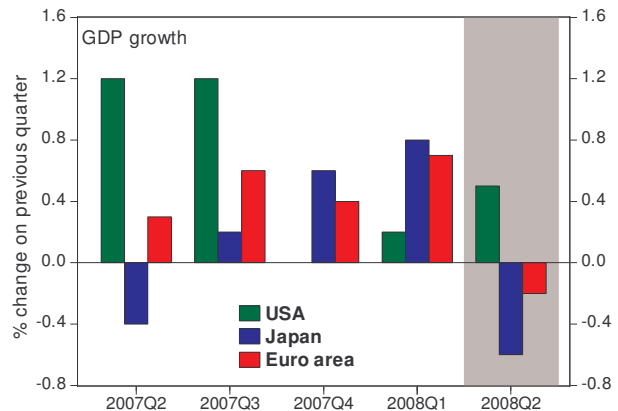
UK Gross Domestic Product (GDP) flat in the second quarter. In the second quarter of the year, UK output remained unchanged on the first quarter of 2008. This marks the end of a run of 63 consecutive quarters of growth in the UK and is the weakest output data since 1992. The rate of growth was 1.4 per cent on the same quarter a year ago, well below the 2.3 per cent growth seen in the first quarter (Figure 5).

Figure 5: UK economic growth comes to a halt in second quarter, ...



Source: National Statistics 2008

Figure 6: ... UK is not alone ... recession looming in Europe and Japan ... US growth uncertain?



Source: National Statistics 2008

Total production output decreased by 0.8 per cent in the first quarter of 2008, compared with a fall of 0.2 per cent in the first quarter. With industrial production having fallen in both Q1 and Q2, industry is (technically) already in recession. Growth in the service sector, which constitutes 74 per cent of GDP, slowed from 0.3 per cent in the first quarter to just 0.2 per cent in quarter two.

Manufacturing made the largest contribution to the slowdown, falling by 0.8 per cent in the second quarter, compared with a rise of 0.4 per cent in the previous quarter. There was a sharp slowdown in construction output, from a rise of 0.4 per cent in the first quarter to a fall of 1.1 per cent in quarter two. There was a fall in household final expenditure, imports, exports and a large fall in investment.

The UK economy is not alone: a global slowdown is under way and a global recession is still possible

Output growth declines across a number of developed economies. As the deflationary impact of globalisation (through a significant increase in trade, low global inflation, the impact of ICT etc.) that has kept price pressures low for over a decade has come to an end, a surge of oil and commodity prices and the impact of the 'credit crunch' have had a significant impact on global growth. Output growth in a number of advanced economies declined in the second quarter of the year. The Euro area and Japan contracted by 0.2 per cent and 0.6 per cent respectively in the second quarter. The latest economic data from the US show output growth expanding strongly, by 0.5 per cent (or 3.3 per cent quarter-on-quarter annualised), Figure 6.

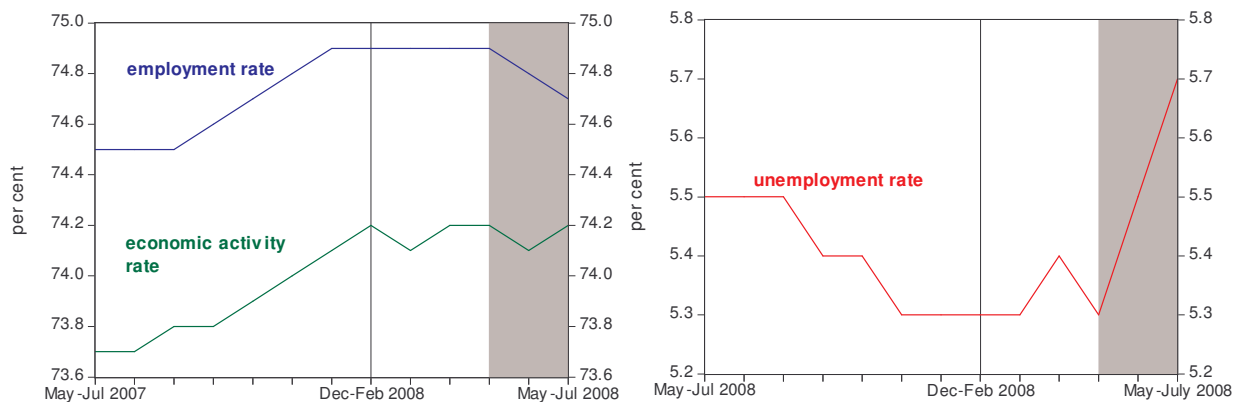
In the US, both consumption and business investment grew in the second quarter, and unlike in the UK, the US housing market started to show some signs of stability. However, as shown by the latest developments within the financial markets it is too early to argue that the US economy has indeed reached the trough of the current slowdown. During the second quarter much of the US growth came from exports, (boosted by a significant fall in the value of the US dollar). In the first half of September the US dollar strengthened, whilst global demand (in particular from Europe and Japan) weakened. It is more likely that stronger domestic demand will be needed to lift the US economy from the slowdown that started in the second half of last year. Furthermore, a return to liquidity within the financial markets is a pre-requisite for a return to 'normality' within the financial markets, which is needed to support the rest of the economy.

In addition to the developments within the Western world, in its latest outlook the International Monetary Fund argues that emerging markets like China and India could also suffer more pain in the future from the credit crunch.

A slowing economy is taking its toll on the labour market

As economy slows UK unemployment is on the increase. In the three months to July the economic activity rate has marginally increased (Figure 7).

Figure 7: UK labour market weakens...



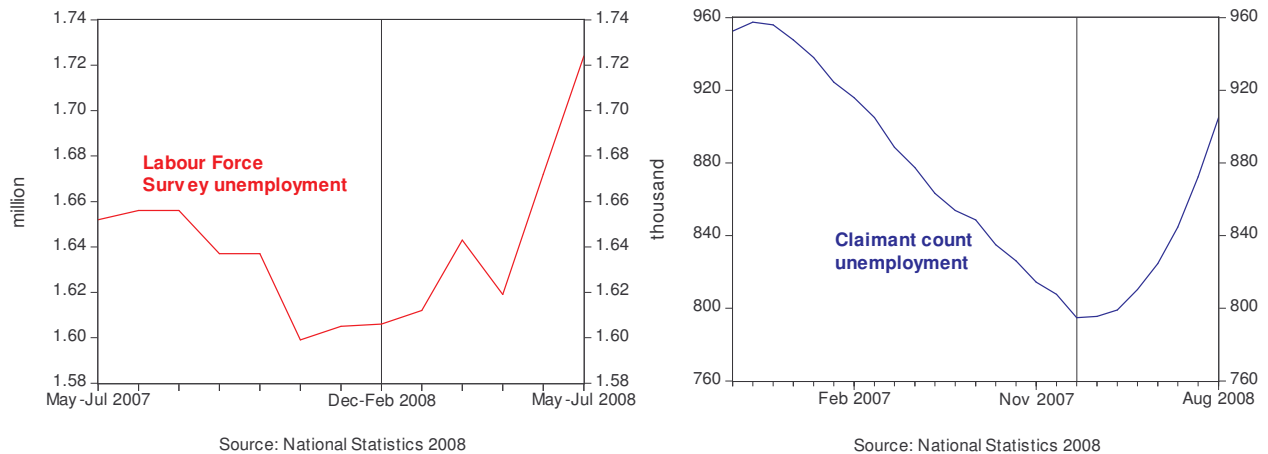
Source: National Statistics 2008

Source: National Statistics 2008

The working age employment rate for the three months to July was 74.7 per cent, down 0.2 per cent from the previous three months (Figure 7). Total employment fell by 16,000 over the previous three months but it remains some 333,000 higher than a year ago. However, over the same period the Labour Force Survey (LFS)¹ measure of unemployment increased by 0.3 per cent to 5.7 per cent.²

The LFS measure of unemployment in the three months to July stood at 1.72 million or 81,000 higher than in the previous three months. The number of people claiming Jobseeker's Allowance (JSA) has increased for the seventh month in a row. In August 2008 there were 904,900 people in the UK claiming JSA or 32,500 higher than in July (Figure 8).

Figure 8: ... A sharp increase in UK unemployment



Slower economic growth and concern amongst businesses that the downturn might actually last longer and be more pronounced could lead to a rapidly deteriorating labour market over the remainder of this year and in the first half of 2009.³ The latest survey evidence points to a further deterioration of the labour market in the UK with some analysts expecting the number of unemployed to increase by 200,000 over the next 18 months.⁴

A significant UK housing market correction is underway

House prices fall for tenth consecutive month. Since the start of the credit crunch UK banks have been hoarding cash in order to shore up their balance sheets. The liquidity crisis has forced UK financial institutions to ration their lending to only their most creditworthy borrowers. There has been a collapse in housing starts and a sharp slump in mortgage lending in the course of the past year. In July 2008 there were just 38,000 new mortgages approved – down by 70 per cent on a year ago (Figure 9). Bank lending to all mortgage borrowers shrank by £12.1 billion in July, which was by far the biggest monthly contraction on record.

Developments in the wider economy, such as a decline in disposable incomes resulting from high inflation and a downturn in the labour market, have also significantly curbed housing demand. The latest data from Nationwide and Halifax shows that a housing market correction is underway. According to Nationwide and Halifax the average house price in the UK fell by over 10 per cent in the year to August 2008 (Figure 10). August's fall marks the tenth consecutive month of falling house prices.

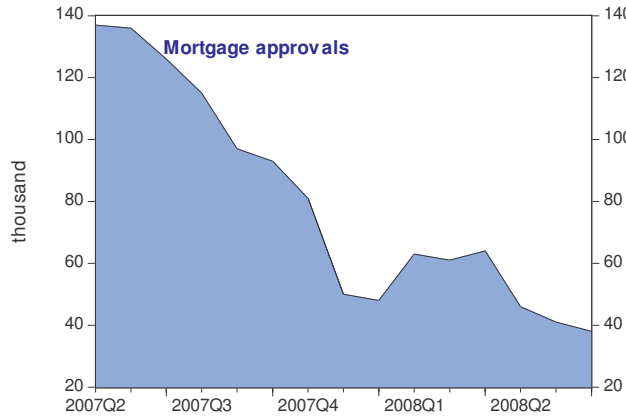
¹ The LFS is a broader (survey based) measure of unemployment than the claimant count unemployment, which only measures people in receipt of Job Seekers' Allowance.

² For working age population.

³ The Chancellor Alistair Darling recently told the Guardian that the downturn would be more 'profound and long-lasting' than most had feared.

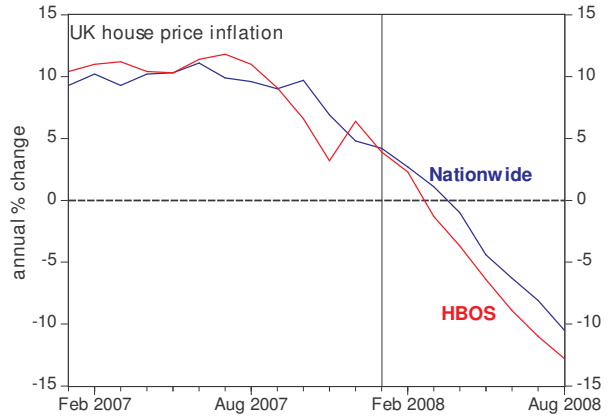
⁴ Oxford Economics (2008).

Figure 9: A sudden drop in mortgage availability ...



Source: Bank of England 2008

Figure 10: ... Housing market correction is under way



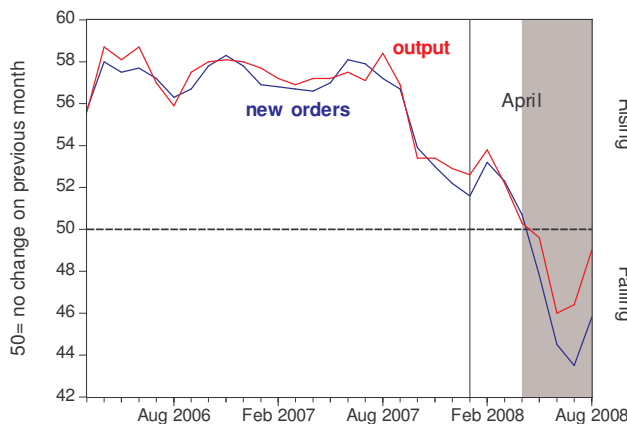
Source: Nationwide and HBOS 2008

A slowing economy, a downturn in the labour market and the persistence of the credit crunch imply that it is likely that house prices will continue to fall this year and possibly well into 2009. Some 24 months ago the Organisation for Economic Cooperation and Development (OECD) argued that house prices in the UK were overvalued by as much as 30 per cent. Thus a fall in house prices of around 22 per cent would be needed to bring the prices back to 'sustainable' levels. At the end of the summer, most forecasters expected house prices in 2008 to decline by over 10 per cent, with further decline in 2009. A number of leading forecasting houses now expect a cumulative fall in house prices this year and the next in the range of 20-30 per cent.

Survey evidence points to worsening business conditions

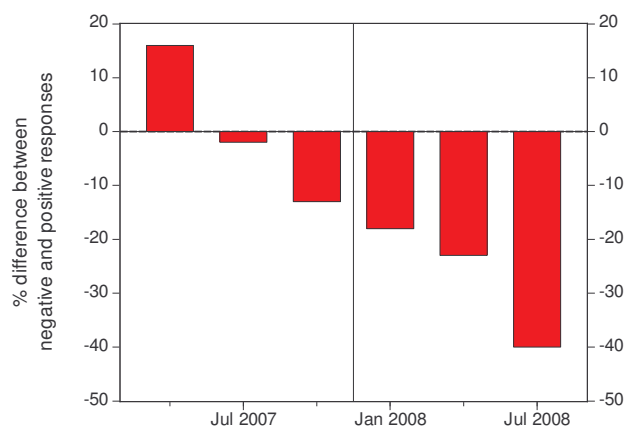
Economic growth could contract in the three months to September. The latest evidence from a number of surveys conducted over the summer months points to worsening economic conditions in the UK. The Purchasing Managers' Index (PMI) shows a steep decline in value since February. The deterioration was not only driven by a decline in current activity (output) but also by a sharp decline in new business (new orders) - a more forward-looking indicator of business growth (Figure 11). Since April 2008 business activity and incoming new business have shown negative growth, indicating falls in output and the volume of new orders.

Figure 11: Business activity (output) and level of incoming new business (new orders) plummet ...



Source: RBS 2008

Figure 12: ... a sharp drop in business optimism



Source: CBI 2008

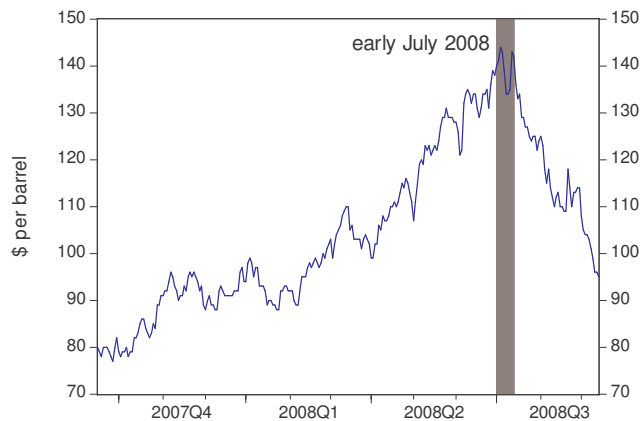
The persistence of the credit crunch and the turmoil in the financial markets, coupled with high inflation, falling business activity and a decline in the volume of new orders have impacted on business optimism. Business optimism in the UK has been falling over the past 12 months (Figure 12). UK output (GDP) in

the three months to June was flat and given the weak demand at home and weakening global demand, there is a possibility that UK GDP growth will contract over the three months to September.

A cut in interest rates is on the way. Given the current and projected slowdown in economic activity, the Bank has come under growing pressure to cut the base rate. However in its latest Inflation Report (August 2008) the Bank expects inflation to increase further during 2008, and peak at around 5 per cent later this year or in early 2009.

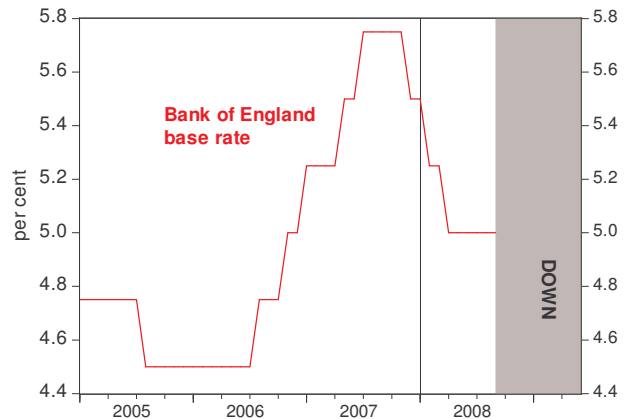
Growing inflation would normally make it difficult for a central bank to cut interest rates in the near future. However, global oil prices have fallen sharply since their peak in early July (Figure 13), a sharp slowdown in the economy is underway, average earnings growth has remained subdued and there is little evidence to suggest that longer-term inflationary expectations have risen substantially. All of the above factors would eventually curb inflationary pressures and allow the Bank to cut the rate (Figure 14).

Figure 13: Oil prices decline sharply... UK inflation expected to peak this year ...



Source: RBS 2008

Figure 14: ...UK base rate expected to start falling later this year or in early 2009 ...



Source: Bank of England 2008

We will probably see the first cut in the base rate once the Bank is satisfied that inflation has peaked, probably later this year. A fall in inflation and interest rates will help the economy to recover, although the recovery might take longer than in the past.⁵

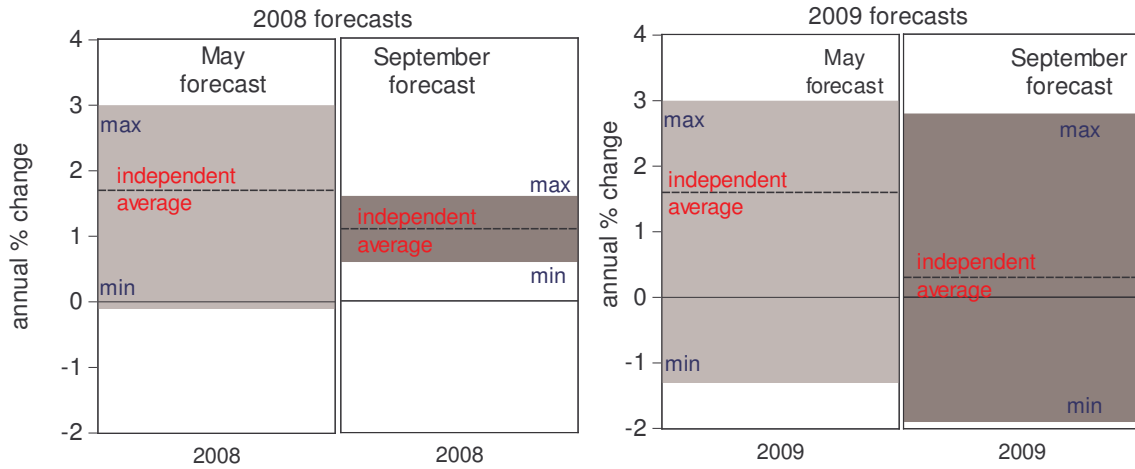
The consensus forecast is still for UK output to expand in 2008 and 2009.⁶ The latest official data from National Statistics, the turmoil in financial markets and high inflation, a gloomy outlook from business surveys and falling consumer and business confidence have lead major private and public sector organisations to revise their forecasts for the UK economy. The OECD and the European Commission are now expecting a number of major European economies to contract and in its latest Inflation Report the Bank of England expects UK GDP to remain broadly flat over the next 12 months.

The consensus of independent forecasts compiled by HM Treasury shows the UK economy expanding by 1.1 per cent in 2008 (down 0.6 points from the forecasts reported in our May 2008 Review), Figure 15. The revised outlook for 2009 shows even greater downward revisions, from 1.6 per cent to 0.3 per cent. As indicated in Figure 15, the forecast spread for 2009 has also widened downward.

⁵ It normally takes between 12 and 18 months for a cut in interest rates to feed through the economy.

⁶ This does not imply that UK output could not contract for a quarter or two. A technical definition of recession is two consecutive quarters of negative growth.

Figure 15: ... Revised outlook for UK GDP growth in 2008 and 2009



Source: HMT 2008

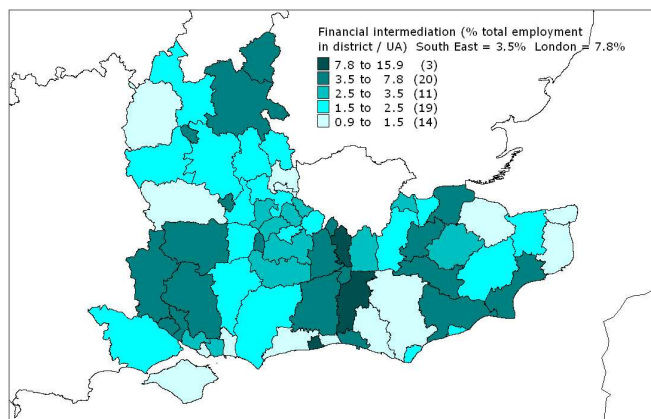
The South East Overview and Outlook

The fallout from the credit crunch impacts on employment within the South East

The financial sector is a significant component of the South East economy. The financial services sector accounts for 7.5 per cent of South East output and 3.3 per cent of total workplace based employment in the region. Although this is slightly lower than the figures for the UK as a whole (9.7 per cent of GVA and 3.9 per cent of employment), the average figure is skewed by the large concentration of financial services in London.

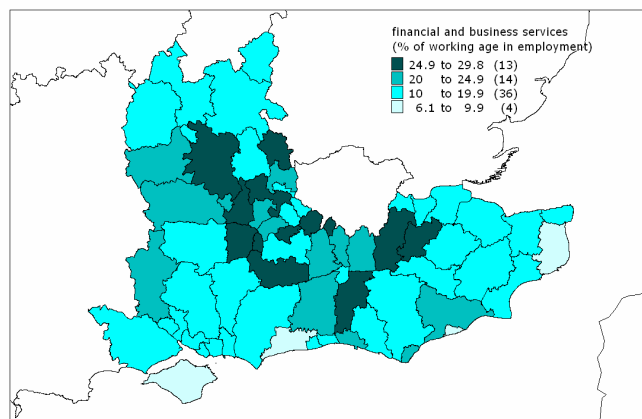
Several areas in the South East are more exposed to any fallout affecting the financial sector. This is simply due to the fact that they have a greater proportion of employment in the financial sector than elsewhere in the region. This is particularly the case in Reigate and Banstead, where almost 16 per cent of total employment within the district is in the financial sector, and Worthing and Mid Sussex (which have a greater concentration of financial sector employment than in London), Figure 16. The negative effects of the credit crunch on employment within financial services in the South East could also be felt in several other districts located in the north of the region (Aylesbury Vale, Milton Keynes, in the west (Test Valley, Basingstone and Deane, Winchester, Southampton, Eastleigh), in the central area (Epsom and Ewell, Mole Valley, Horsham, Brighton and Hove) as well as in the east (Medway Towns, Shepway, Tonbridge and Malling and Tunbridge Wells). The extent of the slowdown within these areas will depend on the composition of the financial sector locally, since some sub-sectors are more exposed to the credit crunch than others.

**Figure 16: Financial Services
% of total employment in the area (workplace)**



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**Figure 17: Residents of working age employed
in Financial Services, % (residence),**



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Given the inter-linkages between the South East economy and London, any analysis which is just based on a workplace based measure (as above) gives us an incomplete picture for the South East.

The residence based estimates reveal that there are more than 730,000 South East residents employed in financial services. A large number of districts in the Inner South East have a significant proportion of people of working age who work in financial services (Figure 17).⁷ There are 13 districts in the South East where more than one in four people of working age in employment work in financial services (such as Elmbridge 29.8 per cent, Woking 29.4 per cent or Waverley 28.7 per cent) and a further 14 districts where between 20 and 25 per cent of residents are employed in financial services. Clearly those districts with proximity to London and better transport infrastructure have a significant proportion of their resident population employed in financial services (either in the South East or outside the region) and as such are exposed to a much greater extent to any job losses affecting this sector (either within the region or outside and in particular in London). In the early 1990s the areas around London suffered a sharp increase in unemployment, associated with a downturn in financial services. According to Oxford Economics people on average spend around 80 per cent of their income in areas where they live, thus any

⁷ The residence-based estimate includes people who commute to work outside the region.

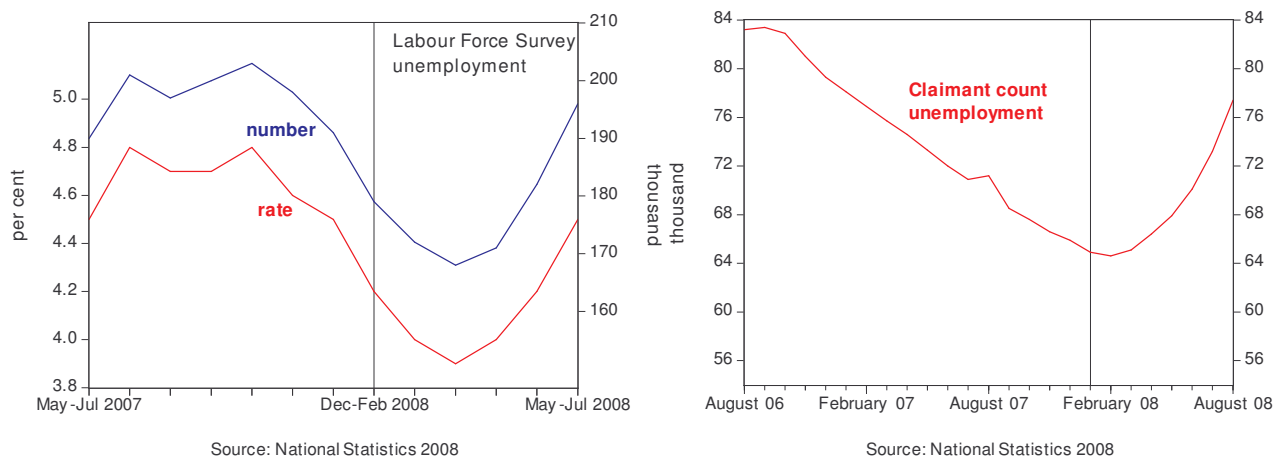
downturn in commuter income is also likely to have an impact on demand within a number of sub-regions within the South East.

The demise of Lehman Brothers and XL Airways leads to job losses within the South East. The South East is particularly vulnerable to any effects of the credit crunch because of its heavy exposure to both the financial and business sectors and any slowdown in consumer demand. The South East is closely tied into the global economy, which means that financial crises elsewhere in the world will inevitably have some impact on the region. The demise of the fourth largest US investment bank, Lehman Brothers, has led to 50 job losses in High Wycombe and around 4,000 in London. XL Airways, which had its base at Gatwick, could not raise capital to pay its next fuel bill and went into administration with the loss of several hundred jobs. The turmoil within the global financial markets could have an impact on employment within several large financial institutions present in the South East. The large US bank Merrill Lynch has a presence in Camberley (Surrey Heath) and Morgan Stanley, another large US bank, is present in Milton Keynes. Furthermore, any significant job losses in London will inevitably have an impact on employment and consumption patterns within the South East.

Unemployment is on the increase ... economic activity and employment are also rising?

Unemployment is on the increase. In the three months to July there were some 196,000 unemployed people in the region or 28 thousand more than in the previous quarter. The number of unemployed people in the UK increased by 81 thousand over the same period. Hence the increase in unemployment in the South East accounted for over one third of the increase in UK unemployment. The unemployment rate increased by 0.6 per cent to 4.4 per cent, - above the South West, Scotland and Northern Ireland. The increase in unemployment in the South East was almost entirely driven by an increase in male unemployment (+27 thousand). The male unemployment rate increased by 1.1% to 4.6%. Female unemployment increased by one thousand, while the rate remained unchanged at 4.1%.

Figure 18: A sharp rise in unemployment ...



There were 77,000 people in the South East claiming Job Seekers' Allowance (JSA) in August – some 4,200 more than in July. The number of males claiming JSA increased by around 3,200 between July and August and the number of female claimants by around 1,000.

At sub-regional level, the claimant count (number of people claiming JSA) is the only timely measure of unemployment. Between December 2007 and August 2008 the claimant count rate in the South East has increased from 1.3% to 1.5%. Within the region Milton Keynes (which has a significant concentration of employment in financial services) has seen the greatest increase in claimant count unemployment within the region, from 1.8% to 2.7% (+0.8 points). The claimant count unemployment in Southampton increased by 0.5% to 2.4%, and in Hampshire and West Sussex by 0.4 points to 1.3% and 1.5% respectively.

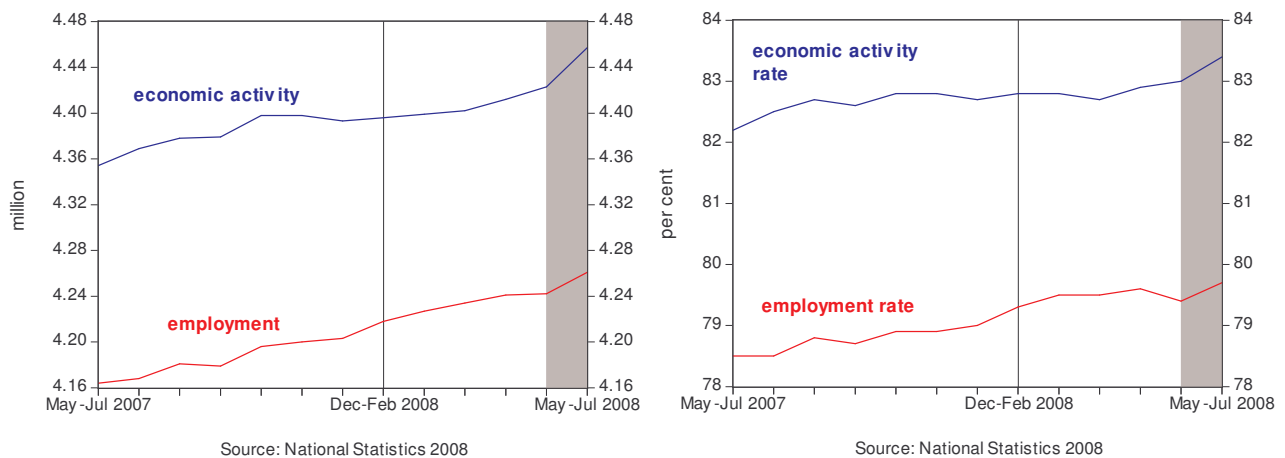
A survey by South East Business covering Kent, Surrey and Sussex has found firms closing factories and making staff redundant for a host of reasons linked to a slowing economy.⁸

Slower economic growth and a concern by businesses that the downturn might actually last longer and be more pronounced are likely to lead to a further increase in unemployment in the South East over the next 12 months.

Employment and economic activity are higher than three months ago. In the three months to July there were 4.26 million people in employment in the South East or 27 thousand more than in the previous quarter. An increase in employment in the South East is in sharp contrast to the UK where employment fell by 16 thousand on the previous quarter. The change in employment in the South East was by far the greatest increase in employment in the country. Some regions have seen a large drop in employment – in the West Midlands employment fell by 30,000.

In the three months to July the South East employment rate stood at 79.7 per cent - 0.1 per cent higher than in the previous quarter. The South East, South West and North West were the only UK regions/countries with higher employment rates in the last quarter.

Figure 19: ... employment and activity are holding well?



The employment rate for men in the South East declined by 0.7 points in the three months to July, to 83.5 per cent. This is still the highest in the country, but the rate of change in the South East was faster than the national average. Male employment declined in every UK region/country except the North West and Scotland. The employment rate for women in the South East increased by 1.1 points to 75.5 per cent, the highest in the country. The rate of change in the South East was almost twice as fast as in London, which was the next best performing region. The UK female employment rate remained flat at 70.3 per cent.

The latest survey evidence points to a further weakening of the labour market. The Royal Bank of Scotland (RBS) PMI survey⁹ covering July and August indicates a net fall in private sector employment for the first time since August 2005. Spare capacity at both manufacturers and service sector firms and deterioration in new orders were the factors behind a net fall in private sector employment. However, the level of employment growth in the South East was above the UK average.

Slowdown in business activity over the past year ...

The latest survey data points to a sharp slowdown in business activity in the region. The official (National Statistics) preliminary data set of South East Gross Value Added (GVA) covering last year will be

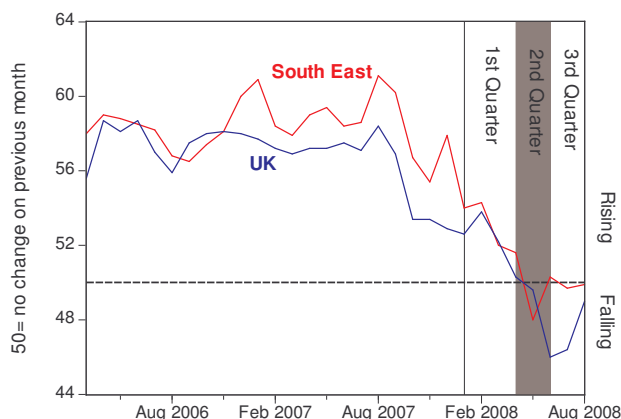
⁸ South East Business, September 2008.

⁹ The Royal Bank of Scotland PMI Survey is a summary monthly report compiled by the Royal Bank of Scotland and NTC Economics. It provides information on the state of business conditions from private sector activities in the South East during July 2008. This survey is widely used by private and public sector organisations, including Bank of England.

published in December this year. The preliminary estimate of GVA growth for 2008 will become available in December 2009.

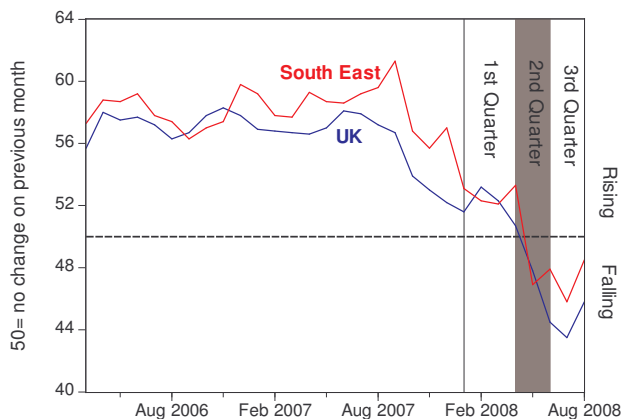
The latest data from the Royal Bank of Scotland (RBS) PMI Survey shows that although there was a marginal increase in business activity in August 2008, the rate of growth remains very low (Figure 20). Data for the South East showed that the main laggard was the service sector. The latest data reflected a greater proportion of firms reporting contraction in business activity (output) at their units compared to the proportion of firms signalling expansion. The difference was marginal and August marked the third consecutive month in which the survey showed little change in overall business activity. However, the level of business activity in the South East was above the UK average and the second highest in the country after the North West.

Figure 20: Falling level of output (business activity) ...



Source: RBS 2008

... and new orders (incoming new business)



Source: RBS 2008

Contraction in new order books continued throughout the South East over the past four months. New orders (a useful indicator of future growth) declined at the fastest rate in almost seven years in July, although the rate of contraction in the region was less severe than elsewhere in the UK (Figure 20). The most recent data for August shows a small recovery, but the growth in the volume of new orders is still slow. The latest data shows that new clients have been harder to come by in recent months and that, when negotiating contracts, it has been tougher to bring deals to a close. Within the service sector, some firms suggested that economic weakness was causing clients to reconsider their spending on support contracts and non business-critical services.

... A significant housing market correction across much of the South East helps to further undermine consumer confidence

House prices in the South East decline faster than the national average.¹⁰ The latest data from Halifax for the three months to June show that in the South East house prices fell by 6.4 per cent, faster than the UK average of 4.7 per cent (Figure 21). Annually, house prices in the region fell by 7.2 per cent, above the UK average decrease of 6.1 per cent. The average house price in the South East is still some 30 per cent above the national average.

Prices have fallen across much of the South East, with the western parts of the region experiencing the greatest drop in prices. East and West Sussex bucked regional and national trends by recording small house price increases (Figure 22).

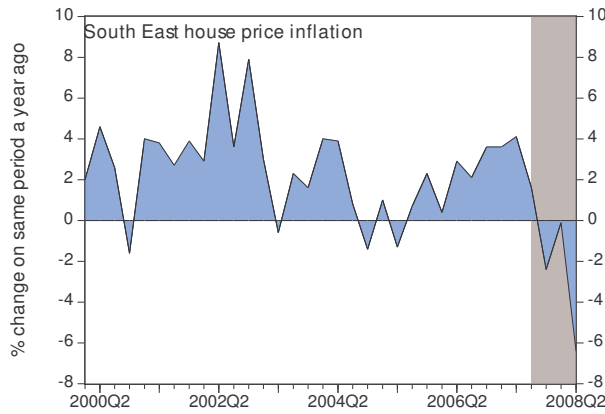
In its latest report CBRE Richard Ellis (SEEDA Monthly Housebuilders Snapshot Report) shows that there are limited numbers of buyers in the region because of a low confidence.¹¹ The report shows that '30 per cent purchases fell out and a 25 per cent fall in price achieved in the region over the past 6 months'. Land

¹⁰ Halifax data is based on the 'Standard Statistical Region' geography and not on more commonly used 'Government Office Region' (GOR) geography and as such includes parts of the East of England.

¹¹ CBRE Richard Ellis (2008) SEEDA Monthly Housebuilders Snapshot Report, August 2008.

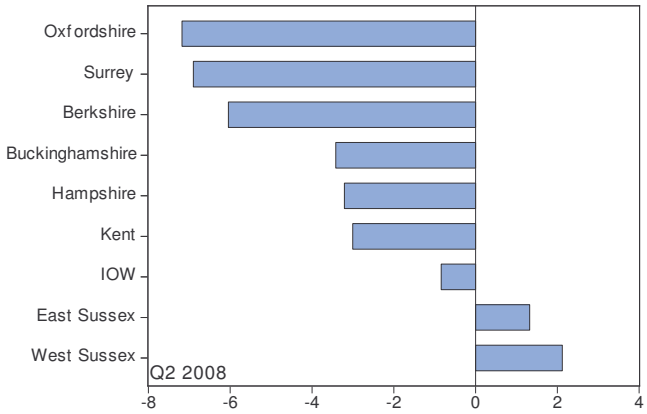
values have declined by more than the 25 per cent recently mentioned in a Savills report. Because of low sentiment, construction activities have been largely suspended, which is having a significant impact on employment within the sector. Thus, 'in 2-3 years time if the market turns around, there will no longer be a workforce to provide new housing as this will have dissipated'.

Figure 21: Housing market correction is under way ...



Source: HBOS 2008

Figure 22: ... across much of the South East

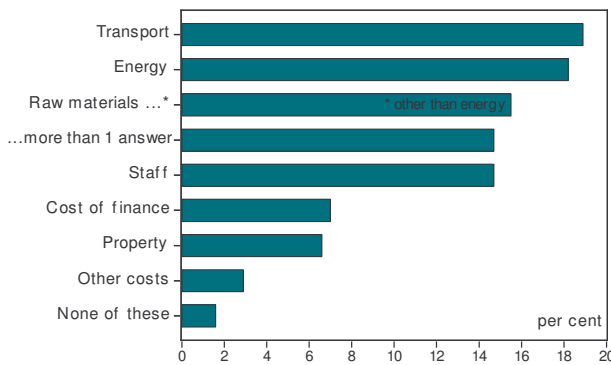


Source: HBOS 2008

High costs have a bearing on business prospects in the South East

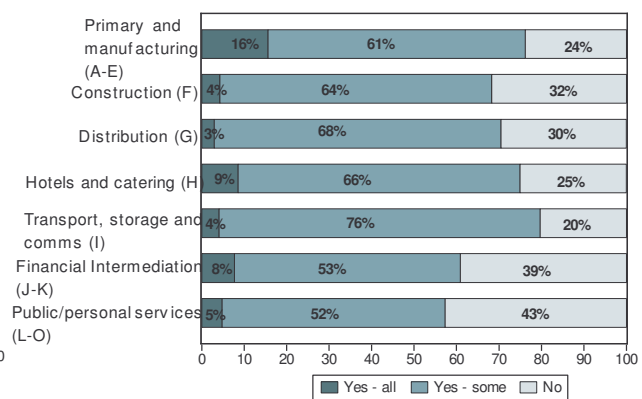
Transport, energy and raw material costs are having a significant impact on South East businesses. Global commodity and oil prices clearly have a direct bearing on business prospects. When asked about cost increases in the Regional Development Agencies' National Business Survey (RDA NBS), businesses in South East England reflect the national picture, with energy and transport costs seen as the costs which have increased most over the past year and are most likely to increase over the next 12 months (Figure 23).

Figure 23: Main upward cost pressure on the South East business ...



Source: RDA National Business Survey (RDA NBS) 2008

Figure 24: ... higher costs are increasingly passed on 'Costs passed on to customers in the past 12 months?'



Source: RDA NBS 2008

Two thirds of businesses in the South East have passed some or all of their increased costs on to their customers in the past year. The latest RBS PMI survey shows that input prices in the South East rose to the highest level in the survey's eleven-and-a-half year history and firms generally cited the burden of high oil prices as the main factor pushing input and running costs higher. Inflationary pressures troubled both manufacturing and service sector firms, but the effects were more marked in the manufacturing sector.

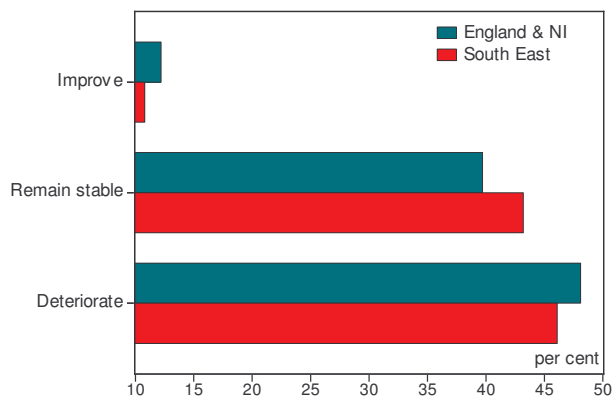
Faced with higher input costs, businesses in the South East have generally responded by allowing their profit margins to be squeezed or by passing on higher costs to their customers. However, the RDA NBS survey shows that there is a notable difference between sectors, with the transport, storage and communications, primary and manufacturing, and hotels and catering sectors more likely than other sectors to say that they have passed on costs (Figure 24). Generally, the public and personal services and finance and business services sector are less likely to pass on increased costs to their customers. This suggests that these services are currently less exposed to global price pressures. Over the past 12 months almost four in ten businesses experienced increases in prices charged, whilst over four in ten say profit margins are lower. The trends for volume of output, domestic orders and numbers employed are fairly balanced for the last 12 months.

Business confidence has deteriorated sharply

Business confidence in the South East is at extremely low levels. The RDA NBS has found that business confidence in the South East is at very low levels. Concerns about the economy appear to be shared by businesses in South East England with only around one in nine believing that the climate in which they operate will improve in the next 12 months (Figure 25). Although over four in ten South East England businesses say that the climate will remain stable, the most popular view is that this will deteriorate. This rises to over half of businesses in the hotels & catering, distribution and primary/manufacturing sector.

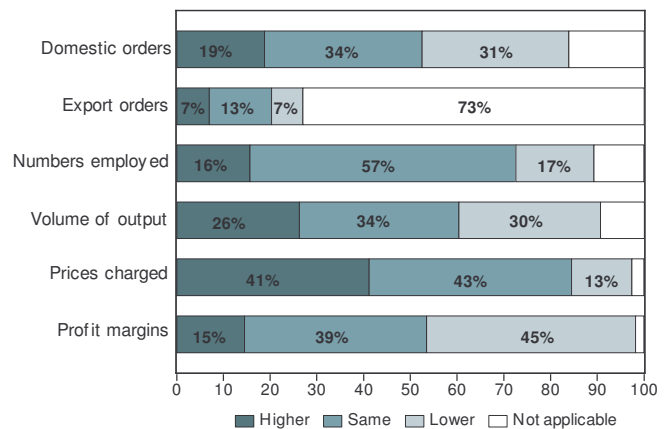
The expected trends for the next 12 months are more pessimistic than those for the past 12 months. Three out of ten businesses expect the volume of output to fall and only a quarter expect it to be higher (Figure 26). A third of businesses also expect domestic orders to fall, and only one in five expect them to increase. The views on profit margins are similar to those for the past 12 months, with close to a half of businesses expecting margins to be lower in the next 12 months. Amongst different sectors, hotels and catering and construction are those reporting the lowest expectations with regard to future trends in the volume of output.

Figure 25: Over the next 12 months do you expect the business climate in which your business operates to ...?



Source: RDA NBS 2008

Figure 26: What are the expected trends for the next 12 months with regard to...?



Source: RDA NBS 2008

Despite the general lack of confidence amongst South East businesses, regional companies report slightly less gloomy expectations regarding the next 12 months than the English average.¹²

¹² For further information on the more recent performance of the South East Economy and the South East and government response see:

HM Treasury, BERR and SEEDA (2008) *South East Economy: A joint response to changing economic circumstances*, August 2008.

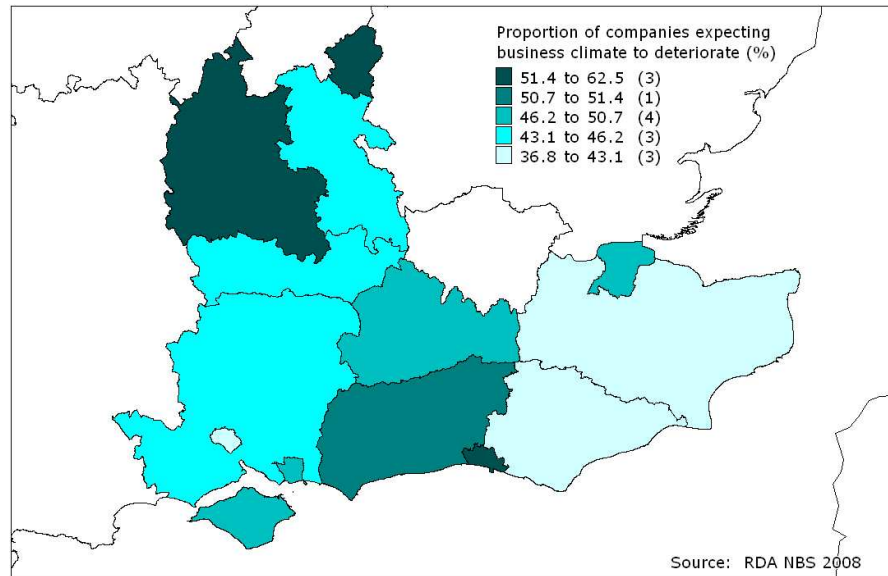
SEEDA (2008) *South East Economy Review – May 2008*.

Ipsos MORI (2008) *Regional Report for the South East England Region: The National Business Survey*, August 2008.

The reports are available on the SEEDA website: www.seeda.co.uk

At sub-regional level, businesses located in Brighton and Hove, Milton Keynes, Oxfordshire and West Sussex are more pessimistic regarding the business climate in the next 12 months, with more than half of companies expecting it to deteriorate (Figure 27). One of the main reasons why companies in these areas have more gloomy expectations than businesses in other locations is that they are more exposed to the credit crunch, as is illustrated later on.

Figure 27: Companies expecting business climate to deteriorate in the next 12 months



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Revised output growth for 2008 and 2009

Forecasts reported in May's Review likely to be too optimistic; further slowdown in economic growth is more likely. In May's *Economic Review* we reported the latest independent estimates of output (GVA) growth in the South East. Experian's forecast was for 2 per cent growth this year and 1.6 per cent growth in 2009. If we were to apply the average forecast revision to the UK figures (see the UK section), to the South East data, then the South East is forecast to expand by around 1.3 per cent this year and by about the national average of 0.3 per cent in 2009. The survey evidence shows that the South East is generally doing better than the UK average, which would imply that output growth should be higher than 1.7 per cent and 0.3 per cent, however there is a good possibility that the above figures could also prove to be overly optimistic.¹³

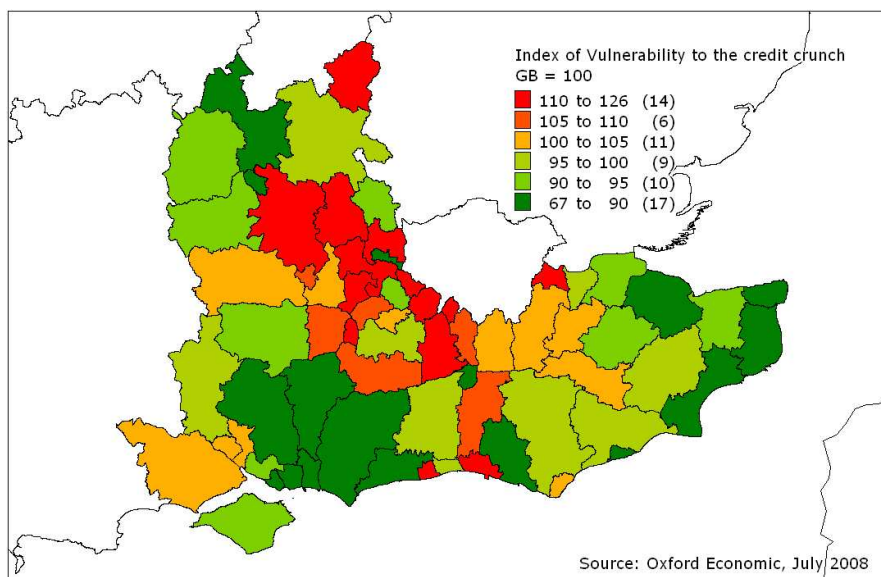
¹³ The next set of regional forecasts from Experian will become available in the autumn.

Geography of the credit crunch within the South East

Vulnerability index shows that 31 districts in the South East have above average exposure to the credit crunch. Oxford Economics has recently produced a vulnerability index to the credit crunch at local authority level, to assess which areas in Great Britain are more vulnerable to the credit crunch in terms of risks to jobs in the downturn.¹⁴

In the Financial Services sector, the biggest impact at present is on mortgage providers, who are suffering much reduced levels of business and higher finance costs. In the Business Services sector, Oxford Economics have identified two groups that are thought to be particularly vulnerable: those related to the property and construction industries and those with stronger supplier links to financial services (e.g. labour recruitment and provision of personnel). All the retail and consumer-related industries are, to some extent, vulnerable to the squeeze on households' spending power, however major purchases such as cars and other durables and other more discretionary spending such as drinking and eating out are also considered to be most at risk.

Figure 28: Geography of the 'credit crunch' within the South East



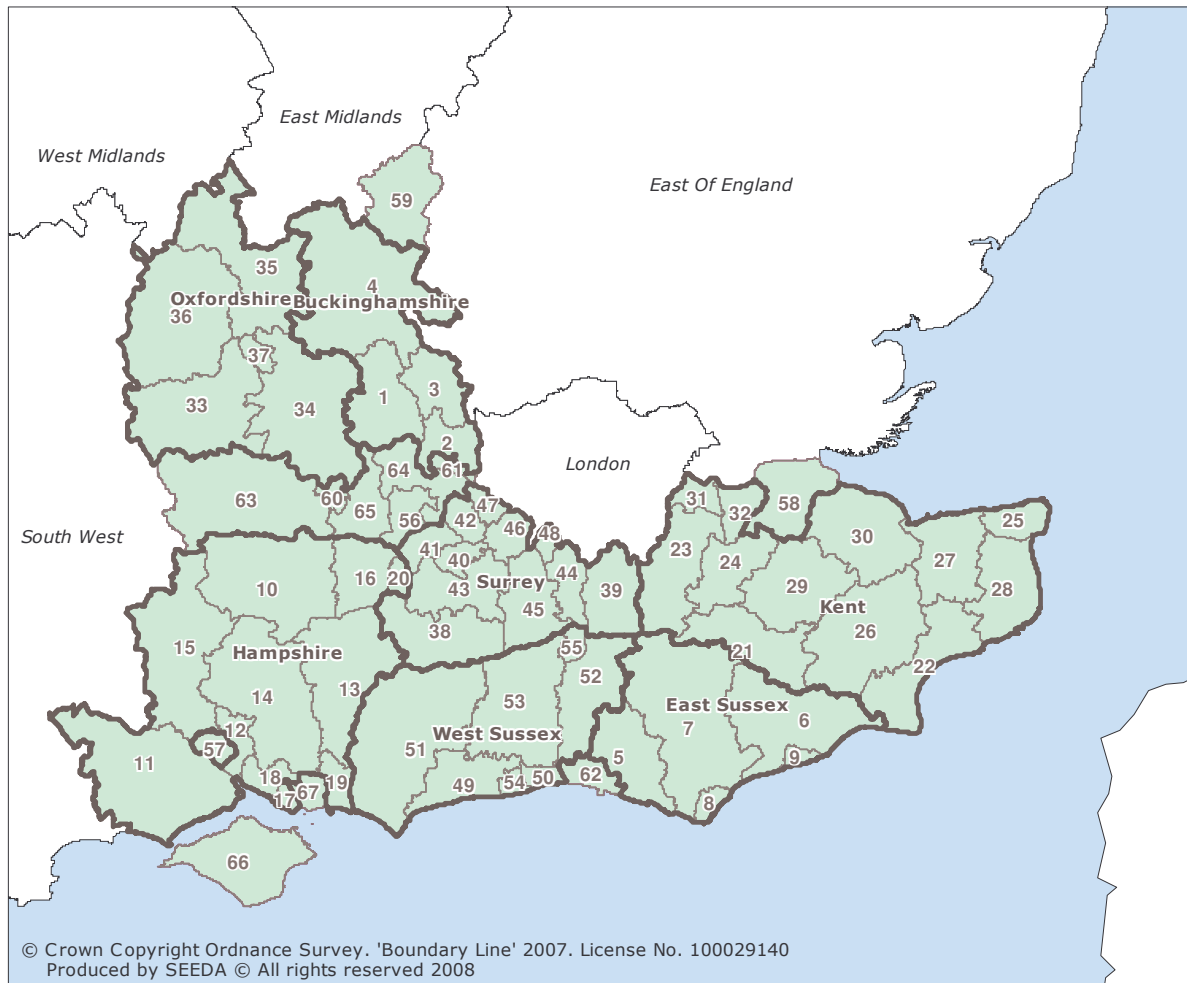
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The analysis by Oxford Economics shows that the Inner South East, the areas around Gatwick Diamond and Brighton & Hove are more vulnerable than other areas within the South East to the credit crunch (Figure 28). Milton Keynes, the area which has recently seen the strongest increase in unemployment (see previous section) is the most exposed local authority in the South East, ranked 10th most exposed local authority nationally (out of 408 local authorities in Great Britain).

¹⁴Oxford Economics (2008) Which parts of Great Britain are vulnerable to the credit crunch? July 2008.

Oxford Economics has compiled a Vulnerability score for each sector (as defined by the three digit Standard Industrial Classification codes), ranging from 12 for the most vulnerable sectors to 1 for the least vulnerable. The sectors judged to be most vulnerable in the current climate are mainly part of the Financial and Business services, Construction and consumer-related industries. In order to link the Vulnerability scores applied to the sectors to local authorities, the scores for each sector have been applied to the shares of employment taken by each industry for each local authority in Great Britain and the results have then been normalised to give a Vulnerability Index where 100 represents the Great Britain average. Therefore scoring more than 100 means that jobs in a local authority are at greater risk than the GB average, and vice-versa.

Figure 29: South East England



- | | | | |
|---------------------------|--------------------------|-------------------------|---------------------------|
| 1 - Wycombe | 17 - Gosport | 34 - South Oxfordshire | 51 - Chichester |
| 2 - South Buckinghamshire | 18 - Fareham | 35 - Cherwell | 52 - Mid Sussex |
| 3 - Chiltern | 19 - Havant | 36 - West Oxfordshire | 53 - Horsham |
| 4 - Aylesbury Vale | 20 - Rushmoor | 37 - Oxford | 54 - Worthing |
| 5 - Lewes | 21 - Tunbridge Wells | 38 - Waverley | 55 - Crawley |
| 6 - Rother | 22 - Shepway | 39 - Tandridge | 56 - Bracknell Forest |
| 7 - Wealden | 23 - Sevenoaks | 40 - Woking | 57 - Southampton |
| 8 - Eastbourne | 24 - Tonbridge & Malling | 41 - Surrey Heath | 58 - Medway Towns |
| 9 - Hastings | 25 - Thanet | 42 - Runnymede | 59 - Milton Keynes |
| 10 - Basingstoke & Deane | 26 - Ashford | 43 - Guildford | 60 - Reading |
| 11 - New Forest | 27 - Canterbury | 44 - Reigate & Banstead | 61 - Slough |
| 12 - Eastleigh | 28 - Dover | 45 - Mole Valley | 62 - Brighton & Hove |
| 13 - East Hampshire | 29 - Maidstone | 46 - Elmbridge | 63 - West Berkshire |
| 14 - Winchester | 30 - Swale | 47 - Spelthorne | 64 - Windsor & Maidenhead |
| 15 - Test Valley | 31 - Dartford | 48 - Epsom & Ewell | 65 - Wokingham |
| 16 - Hart | 32 - Gravesham | 49 - Arun | 66 - Isle of Wight |
| | 33 - Vale of White Horse | 50 - Adur | 67 - Portsmouth |

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Note: delete before publishing externally, keep for internal release and SEEDANET (it will allow easy location of documents, charts, maps and data).

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