Economic Brief

August 2003

South East England Development Agency
Policy and Economics Group

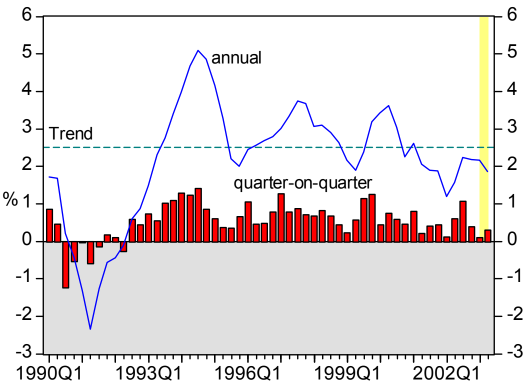
In Brief:

- The UK real GDP increased by 0.3% in the second quarter of the year.
- Output in business sector declined in the first and second quarters of the year.
- The UK and the South East economies likely to underperform in 2003.
- According to our estimates the gap in real GVA per head of population between the South East and London narrows between 1991 and 2001.
- Average annual growth rate in real GVA per capita in the South East between 1991 and 2001 the highest in the country.
- Strong growth rates in real GVA per capita in most sub-regions between 1991 and 2001.

SLUGGISH GROWTH IN OUTPUT IN THE SECOND QUARTER

The UK economy grew by 0.3% in the second quarter of this year (quarter-on-quarter) or at annual rate of growth of 1.8%. This was a modest improvement from the first quarter when the growth rate (quarter-on-quarter) was just 0.1%.

Fig 1: UK real GDP growth rates



Source: ONS (2003)

The recovery of post and telecommunications and computing services observed in the first quarter continued in the second quarter of the year. Furthermore, there was a small growth in construction output and strong growth of distribution, hotels and catering sectors. Strong growth in hotels and catering output may be the first sign of recovery within the sector that has been affected significantly over the past few years, first by the 'foot and mouth' disease and then by the geo-political uncertainty following September 11th and the slump in demand. However, unusually warm weather is likely to be the main factor behind the strong growth in output.

Production output increased by 0.1% on previous quarter largely fuelled by a strong increase in energy output (electricity output), while manufacturing output (which has been broadly flat since late 2002) also increased by 0.1% on previous quarter.

The latest cut in interest rates and depreciation of the pound are some of the factors behind this increase in output. However, without the recovery in foreign demand (in particular within the euro zone economies and the United States) we are unlikely to see any strong growth in manufacturing output in the second half of the year.

Transport and, more importantly business sectors declined in the second quarter of the year. The decline of business sector output is in particular a worrying sign, as it is the largest and the most important sector of the economy.[1]

Given the size of the business sector in the South East it is probable that the South East economy has also under performed in the second quarter of the year.

Just like in the early 1990's, it is likely that the South East, London and East of England will be affected by the current economic slowdown by a much greater degree than the northern regions.[2]

THE SOUTH EAST ECONOMY LIKELY TO UNDERPERFORM IN 2003

Given the poor performance of the UK economy in the first half of the year, Treasury's 2.25% growth in output forecast for 2003 is likely to be well off the track.

The slower growth in 2003 is going to lead to decrease in tax revenue and further worsening in public finances (increases in borrowing from projected £27 billion up to £35 billion) with its implication upon the public sector spending, as it is possible that we may see some reduction in public sector spending next year.[3]

---

[1] Sections J and K of SIC92 i.e. Banking, Insurance, Real Estate, Computing, Consultancy, Advertising etc.

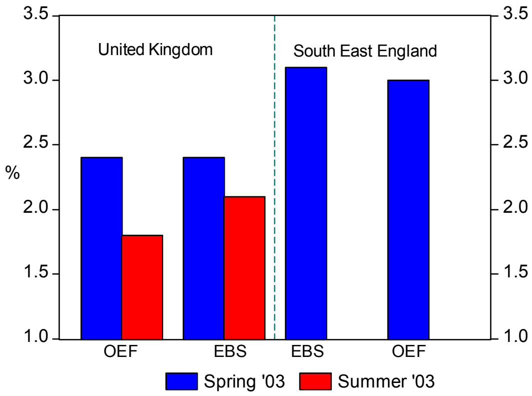
[2] During the 1970's and 1980's it was the manufacturing sector that bore the brunt of economic slowdown, unlike in the 1990's when business sector was affected by much greater degree than manufacturing.

[3] Given their 'high profile' spending on health and education are likely to be less affected than other sectors.

For further information contact: Ivan Perkovic (Ext. 4162) or
Rashid Bashir, Head of Policy and Economics (Ext. 4719)

In July, the average growth rate of UK GDP for 2003 (by 22 major independent forecasting organisations) was downgraded to 1.8%, with the lowest forecast of just 0.4% and the highest of 2.2%.

Chart 2: Economic growth forecasts for 2003



Source: EBS (2003), OEF (2003), Treasury (2003)

Note: EBS regional forecasts were based on GVA while OEF forecasts were based on GDP

In spring of this year Experian Business Strategies (EBS) and Oxford Economic Forecasting (OEF) predicted growth rate of 3.1 and 3.0% respectively for South East England.[4]

Given the recent performance of the national economy and in particular financial and business sectors those forecasts for the region are also likely to be off the track. Providing that the economic recovery takes place in the second half of the year, we expect the regional economy to grow by between 2.1 and 2.6% this year.

THE REGION NARROWS THE GAP IN REAL GVA PER HEAD WITH LONDON

Since official regional GVA per capita estimates were not available estimates were obtained at national, regional and sub-regional level based on Experian Business Strategies GVA estimates, the Census 2001 and revised 1991 population estimates.[5]

The latest GVA per head of population estimates show that between 1991 and 2001 the South East has reduced its GVA per head of population gap with London. In 1991, GVA per head of population in the South East stood at approximately £10,283 (71.7% of London's GVA per capita.

However by 2001 GVA per capita in the region increased to £14,216 (76.2% of London's GVA per capita).[6]

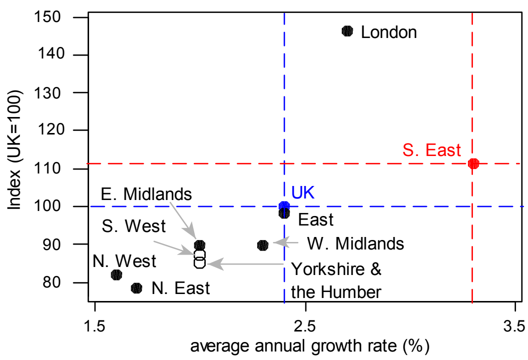
Table 1: GVA (constant 1995 prices) per head of population, 1991 and 2001

	1991	2001
South East	102.2	111.4
Greater London	142.6	146.3
UK	100	100

Source: SEEDA (2003) estimates

Furthermore, between 1991 and 2001, average annual growth rate in real GVA per capita of 3.3% in the South East outstripped every other region in the country including London, whose growth was 2.7% per annum.[7]
At the same time, the UK real GVA per capita grew at approximately 2.4% (it's long trend rate) on average per annum.

Chart 3: GVA (constant 1995 prices) per head of population, 2001



Source: SEEDA (2003) estimates based on EBS (2003) GVA estimates and the Census 2001 population estimates

STRONG GROWTH IN REAL GVA PER HEAD OF POPULATION IN MOST SUB-REGIONS BETWEEN 1991 AND 2001

At the sub-regional level, most sub-regions have performed relatively well over the decade.

This is particularly true for the more developed (western) part of the region (area A in Chart 4), which had average annual growth rates of between 3.7% in Buckinghamshire and 4.3% in Berkshire.

Furthermore real GVA per capita in Hampshire and East and West Sussex (area B) increased by around 3% per annum (just below the region's long trend growth rate) outperforming the UK as a whole and even marginally outperforming Greater London.

---

[4] We report regional and sub-regional GVA estimates in line with European Standards (ESA95). GVA is the total net product measured at market prices, less taxes on output (levied at the point of production) plus subsidies (levied at the point of production). NOTE: GVA = GDP at basic prices.

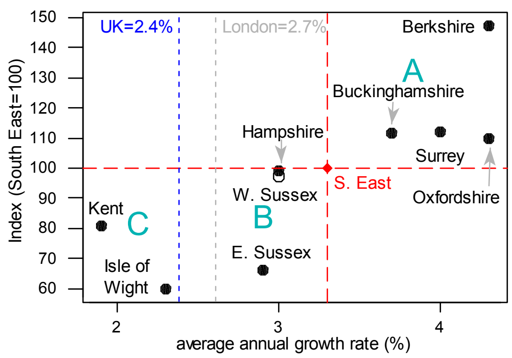
[5] The latest ONS regional GVA estimates per capita are available until 1999 and sub-regional until 1998, however these estimates are wrong as they are based on wrong population projections. We have used mid 1991 population estimates, which were revised in light of the results of the 2001 Census.

[6] GVA estimates are workplace based, while population estimates are residence based. The implication of this is that the estimates for London are inflated and the estimates for the South East and East of England are deflated.

[7] East of England's average annual growth rate was affected by relatively large increase in population and a small contraction in real GVA in 1999.

On the other hand average annual growth in real GVA per capita in Kent and the Isle of Wight between 1991 and 2001 (area C in Chart 4) was below the UK average.

Chart 4: GVA (constant 1995 prices) per head of population, 2001



Source: SEEDA (2003) estimates based on EBS (2003) GVA estimates and the Census 2001 population estimates

The prime reason for such divergent performance in growth rates between 1991 and 2001 lies in different industrial structure.

As shown in Table 2, there is a much greater concentration of employment in those less productive sectors of the economy such as agriculture, manufacturing, hotels and catering and public sectors in Kent and Isle of Wight than in Surrey.

Table 2: Location Quotients [8]

	Agriculture	Manufacturing	Public Admin	Health & Social Work
South East	100	100	100	100
Isle of Wight	91	110	114	170
Kent	54	112	115	117
Surrey	35	79	73	99
	Hotels & Catering	**Financial Intermediation**	**Business Services**	**Computing**
South East	100	100	100	100
Isle of Wight	191	33	33	19
Kent	120	84	67	35
Surrey	86	121	129	150

Source: SEEDA (2003) estimates based on ABI (2001) data

Throughout the 1990's the impact of the BSE and the 'foot and mouth' diseases had a devastating impact upon the agriculture, while the strong pound (alongside other factors) had a significant impact upon the manufacturing and hotels and catering sectors.
The implication of these and other factors resulted in decline in employment and a slower growth in output than in other industrial sectors.

On the other hand the 1990's were characterised by a significant growth in both productivity and employment in financial and business sectors.
It is not surprising then that Surrey and other western parts of the region (area A in Chart 4) which have much greater concentration of employment in these sectors had much higher growth rates in real GVA per capita than Kent or the Isle of Wight.

The same principle applies to the great north-south divide. The main factor behind different growth rates in real GVA per capita lies in different industrial structures between the north and the south of the UK. [9]

The real GVA per head of population in Kent, East Sussex and the Isle of Wight is not much higher than the average real GVA per capita of the ten countries which are about to join the European Union in less than twelve months time.[10]
The sheer scale of the problem is highlighted further by the fact that if it were possible to reverse the growth rates so that annual growth rate in real GVA per capita in the region as a whole equals 1.9% and Kent's growth rate equals 3.3% (all the other factors remain constant) it would take just below sixteen years (15.8 years) for GVA per capita in Kent to reach the regional average.

Some industrial sectors such as manufacturing over the past twenty years have been characterised by the 'survival of the fittest' i.e. closure of those traditionally less productive sectors and survival of those high-tech, high productivity manufacturing sectors. As this process continues and as those less productive sectors are being replaced with higher productivity sectors in the years to come we are likely to see greater positive impact of manufacturing sector on growth rates than it was the case in the 1990's.

Obviously in some cases the market forces seems to be at work and there is little the policy makers can do to alter the situation. However in other cases, there is a strong case for intervention as the final outcome if left entirely to the market forces may be less than desirable.

This is especially true with regard to the supply side i.e. rising the productivity through tackling the poor skill base. However, this does not mean tackling the skill base of only those people who are about to enter the labour force but perhaps even more importantly tackling the skill base of those people already in employment.

Furthermore the change in business attitude is necessary as it has become far too common that businesses are often demanding high-level skills from their new staff and then fail to adequately utilise their skills. This often leads to dissatisfied labour force, high staff turnover and lower rates of productivity.

In addition to this encouraging high-tech investment in those less developed parts of the region would certainly lead to more balanced growth rates which would eventually lead to narrowing the gap between the high and low growth parts of the region.

[8] Location Quotient = the sectors share of total sub-regional employment divided by the sectors share in total regional employment. A value of 100 implies that the sector accounts for the same share of employment in the sub-region as in the region as a whole.

[9] We must not forget that London and the South East were service sector economies almost a hundred years ago, while the north was characterised by a heavy manufacturing base just twenty years ago.

[10] This is in particular true if we look at real GVA per capita adjusted for Purchasing Power Parity.