

South East England Economy Review - May 2008

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Global Competitiveness Objective

Smart Growth Objective

Sustainable Prosperity Objective

Executive Summary

- In the UK, output growth was strong in 2007, remaining above the long-term average growth rate of 2.7 per cent.
- In the South East, growth for 2007 was estimated at 3.7 per cent last Autumn – well above the national average. However, the latest revised Experian forecasts suggest that growth in 2007 was significantly lower, at 2.7 per cent. These forecasts have yet to be verified with official GVA data, though.
- Both the UK and South East labour markets performed strongly in 2007, with high and rising economic activity and employment rates, and falling unemployment. In the South East there are now 68,000 more people in employment than at the beginning of 2007, and 18,000 fewer unemployed people.
- The US sub-prime mortgage crisis has led to a lack of confidence amongst banks and financial institutions, resulting in tighter credit conditions in the UK. Inter-bank lending has reduced, and there have been large losses in equity markets.
- At both national and regional levels, business activity has declined since the credit crisis first hit last summer, and business confidence has fallen to an all-time low in the UK. Amongst South East businesses, survey evidence shows that the cashflow position and investment in plant and machinery both declined in the first three months of 2008.
- The extent and precise nature of the impacts of the credit crunch on the South East economy are still uncertain. However, it is likely that the region will be particularly vulnerable, because of its greater exposure to global markets, the financial and business sectors, and any slowdown in consumer demand.

- The financial sector and related activities are likely to be affected by the credit crunch first. The financial services sector accounts for 8 per cent of output and 3 per cent of employment in the South East as a whole, but where there are concentrations of employment in this sector the effects of the credit crunch are likely to be felt more keenly. These districts include Reigate and Banstead, Worthing and Mid Sussex.
- Some small and medium sized businesses could be vulnerable to the effects of the credit crunch, because of their tendency to have a smaller spread of revenue sources than larger firms. Borrowing and loan financing has become more difficult and expensive, which has had a negative impact on some smaller firms' investment plans. The greater concentration of micro businesses in some areas within the Rural and Inner South East (in parts of Oxfordshire and Surrey particularly) could mean that some of these areas are more exposed to the slowdown.
- Since South East residents are the most heavily indebted of any region in the UK, the credit crunch could have a particularly significant effect on consumer spending here. Although a slowdown in consumer spending is not yet evident from the data for the South East or UK, recent substantial rises in food and energy costs are affecting disposable income. Over the next few months, inflation is expected to hit 3 per cent, well above the Bank of England's 2 per cent target.
- A greater threat to consumer spending is a house price correction, which is already underway in the UK. Forecasts from Nationwide and Halifax suggest further falls in house prices this year and in 2009, but the consensus is that both the South East and the UK will avoid a 1990s-style crash.
- Despite the current uncertain economic conditions, most economic forecasts suggest that the current slowdown, both at UK and regional level, is likely to be a 'blip'. The Treasury has forecast growth of 1.7 per cent for the UK economy in 2008, with growth of between 2.25 and 2.75 per cent in 2009. The latest independent forecasts from Experian show the South East economy expanding by 2 per cent in 2008 and 1.6 per cent in 2009, with a substantial recovery after 2009. However, oil and commodity prices have risen substantially over the past year and the price of oil is expected to increase further this year. This could impact on the UK and regional economic outlook.
- According to Experian, employment growth in the UK is likely to come to a standstill this year, with small job losses largely confined to the financial and business services sectors. In the South East, employment growth of 0.8 per cent is forecast for 2008, with a small fall in employment in 2009 – particularly in the manufacturing, hotels and catering and construction sectors.
- Despite possible falls in employment, recent data suggests that the manufacturing sector could be undergoing a revival. The pound's weakness against the Euro could help to boost the competitiveness of manufacturing through lower export prices. Although regional survey data on manufacturing is inconclusive, the latest national data shows strong output growth in the first quarter of this year, particularly in the automotive sector. However, any revival of manufacturing will depend on the strength of global demand for goods.
- Several risks could have an impact on the economic outlook – including inflationary pressures hampering the opportunities to keep lowering interest rates; the persistence of the credit crunch leading to a sharp decline in house prices and consumer spending; and weakening global demand for UK goods and services. However, over the long term the South East is capable of weathering any slowdown. This is because the region is at an advantage in terms of its industrial mix (a high proportion of private sector services), its large and growing supply of labour, and its relatively highly skilled population. All of these factors are key determinants of productivity and growth over the longer term.
- The expected slowdown in GVA growth in the South East over the next two years implies that GVA per head will be below the RES target growth rate this year and in 2009. However, given the structural advantages of the South East economy, it is likely that growth will expand significantly faster after 2009. The latest independent forecasts from Experian show significantly higher growth after 2009.

- If the credit crunch persists, this could have a serious impact on the region's ability to meet the RES productivity per worker target. Investment in capital and skills is already being adversely affected by the credit crisis, which will ultimately impact on productivity. However, slower growth in one period can be offset by faster growth in the second half of the RES horizon, so it is still possible to meet the target.
- It is difficult to assess the impact of the current slowdown on the region's ecological footprint, but it is possible that any falls in consumption or imports over the next two years could have a small positive impact on the ecological footprint. However, without the appropriate investment in this area any gains are likely to be short-lived.

The UK Overview and Outlook

Strong output growth last year

2007 was a year of buoyant output growth for the UK economy. By the end of the year the UK economy had experienced its 62nd consecutive quarter of positive growth. This was the longest period of uninterrupted growth since the Second World War. In the first quarter of the year the UK economy expanded by around 3.1 per cent compared to the same period last year (Figure 1). Although in the second half of the year output growth slowed to 2.8 per cent, the rate of growth was still above the long term trend average rate of growth (around 2.7 per cent). Growth was driven by strong expansion in the financial & business services and transport and communication sectors.

Figure 1: Strong output growth in 2007

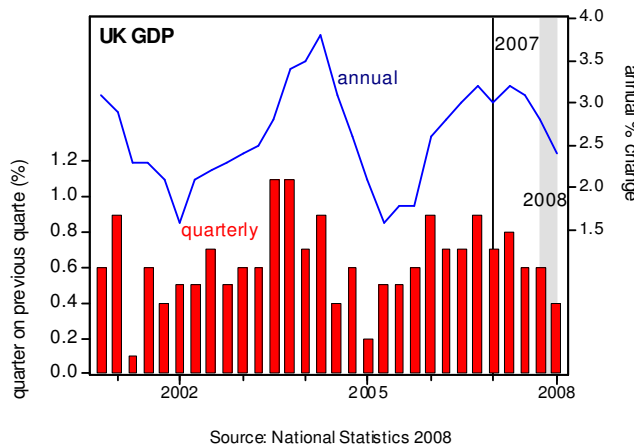
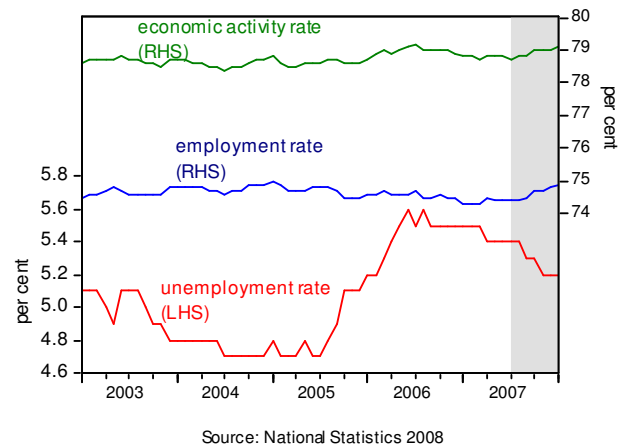


Figure 2: Labour market remains remarkably strong



The labour market remains remarkably strong but the credit crisis unfolds

The labour market has remained remarkably strong over the last year. By early 2008 the economic activity rate was the highest since July 2006 (Figure 2). Employment has increased by over 450,000 to a record 29.51 million (the employment rate is the highest since 2004). The Labour Force Survey (LFS) measure of unemployment decreased by around 90,000 to 5.2 per cent, the lowest in the past two years. The claimant count (number of people receiving Job Seekers' Allowance) is at its lowest since 1975 and there are nearly 700,000 vacancies in the economy, the highest since the current series began in 2001. If you were to take your eyes away from the gloomy headlines in the press, such figures would normally be associated with a booming economy. However, the jobs market is a lagging indicator of economic activity and normally it only signals problems when it is already too late.

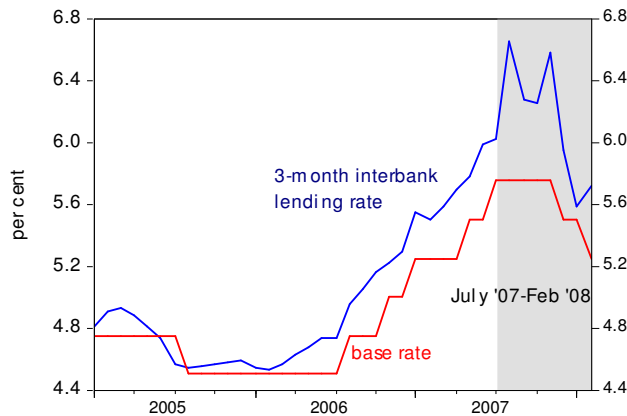
Caution amongst lenders has spilled over from the US sub-prime market to the financial markets in the UK. The US sub-prime mortgage crisis has led to a lack of confidence amongst banks and financial institutions, resulting in tighter credit conditions in the UK. Banks have reduced their lending to other banks (in the inter-bank market), which has led to a liquidity squeeze, pushing the inter-bank loan interest rates well above the base rate (Figure 3). Deteriorating conditions in the money markets contributed to large losses in equity markets early this year. Central banks have responded by injecting large volumes of cash into the financial markets to try to get the system moving again, which did little to relieve the strain within the financial sector or reduce the likelihood of a 'credit crunch' impacting on economic activity.

The latest survey evidence shows that the credit crisis has started to have a greater impact on economic activity across the country. The Purchasing Managers' Index (PMI) from the Royal Bank of Scotland/NTC Economics (RBS/NTC) shows UK business activity declining steadily from last summer (Figure 4).¹ The volume of new orders (incoming new business) has also steadily declined. The latest British Chambers of Commerce (BCC) survey for the first quarter of 2008 also paints a gloomy picture, with virtually all critical

¹ The Purchasing Managers' Index (PMI) survey provides an advanced signal (leading indicator) of changing economic conditions in the region and is the most timely (monthly) survey of economic conditions in the South East. The survey is used by the private and public sectors including the Bank of England.

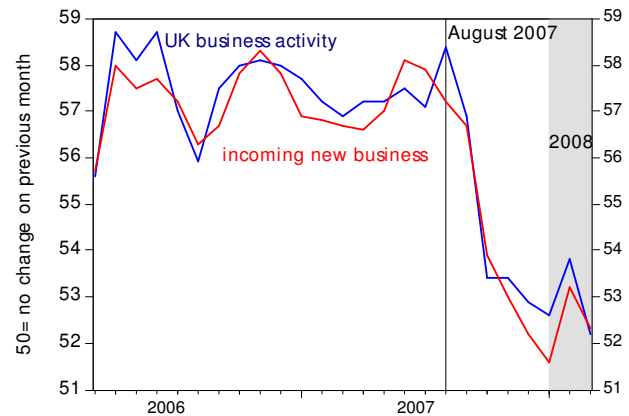
balances getting worse, whilst the Institute of Chartered Accountants shows business confidence declining to an all time low due to the effects of the credit crunch.

Figure 3: Credit crisis unfolds ...



Source: National Statistics 2008

Figure 4: ... and impacts on business activity



Source: RBS and NTC Economics Ltd 2008

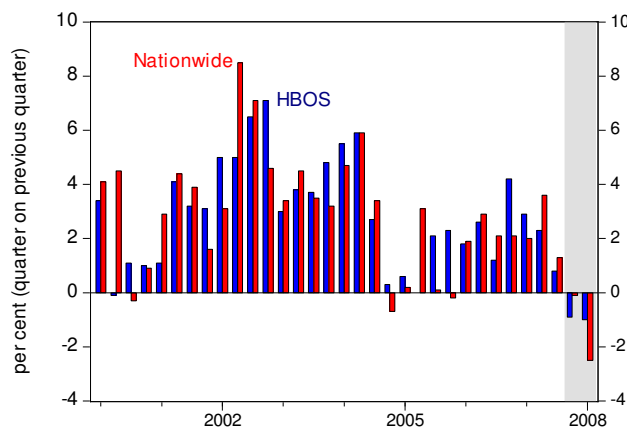
The latest survey evidence of a slowdown in economic activity has been supported by the latest (preliminary) estimate of output growth released on 25th April, which showed UK GDP growth slowing to 0.4 per cent in the first quarter of this year.

Housing market correction and an upside risk to UK inflation

The latest evidence shows that a UK housing market correction could be underway. The tighter credit conditions in the UK have not just affected bank and business borrowing but are also having a profound impact on consumer borrowing. Since the start of the liquidity crisis UK banks have been hoarding cash in order to shore up their balance sheets. This has resulted in a wholesale lending freeze and pushed mortgage rates higher. Banks are also increasingly demanding larger deposits and have significantly reduced the number of products they offer on the market. Significantly tighter lending conditions and a decline in confidence following the US housing market collapse and concerns about the wider health of the economy have helped to undermine the housing market over the last six months.

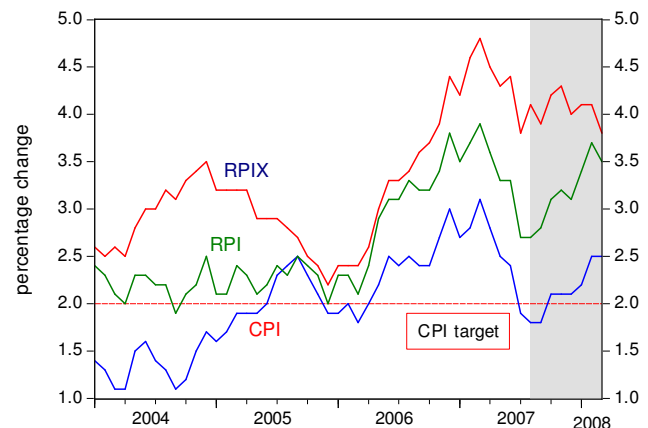
According to Nationwide, house prices fell for the fifth consecutive month in March. Halifax data shows similar movement in house prices (Figure 5). The majority of city forecasters (including Halifax and Nationwide) expect housing market readjustments this year and in 2009, but following the expected recovery in economic activity most do not expect a 1990's style crash.

Figure 5: Housing market correction?



Source: Nationwide and HBOS

Figure 6: Risk to UK inflation



Source: National Statistics 2008

Whilst this is encouraging, any significant fall in house prices coupled with a further squeeze on disposable incomes from higher energy and food prices could have a significant impact on consumer spending and the wider economy.

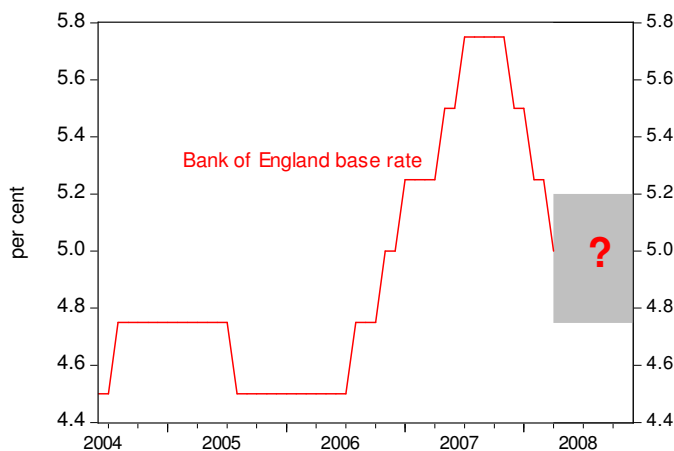
The latest data shows risk of rising UK inflation persists. Making the Bank of England (BoE) independent coupled with the deflationary impact of globalisation (cheap imported goods from emerging economies such as China and India) have kept price pressures low for over a decade and allowed the BoE to keep the base rate significantly lower than in the past. However oil and commodity prices have surged (oil recently reached nearly \$120 per barrel), global food prices have jumped to their highest level since 1945 and energy bills and factory input prices have risen substantially. Since July 2007 the Consumer Price Index (CPI) and Retail Price Index (RPI) inflation rates have risen to 2.5 per cent and 3.8 per cent respectively and over the next couple of months inflation is expected to hit 3 per cent – well above the Bank of England target of 2 per cent.

Monetary policy and the UK outlook

The Bank of England (BoE) under pressure to reduce the base rate. Faced with the persistent credit crisis and a growing slowdown in economic activity the BoE is under pressure to impose substantial cuts in the base rate. However the Bank's room for manoeuvre has been significantly reduced by several developments. There are severe upside risks to UK inflation, namely tightening of the labour market, an increase in price expectations, substantial increases in prices of commodities such as oil and natural gas over the past year, weak currency and the danger of imported inflation. Three previous cuts in interest rates have made little impact on the financial markets and the danger is that further cuts could have little impact on liquidity (Figure 7). The Bank's latest response to the credit crisis has been to offer to swap up to £50 billion or more of residential mortgages on lenders' books for government bonds in order to encourage banks to lend to each other and consumers. It remains to be seen whether the latest policy response will bear fruit, but it is more likely that the banks will have to reveal further losses before the system returns to normality.

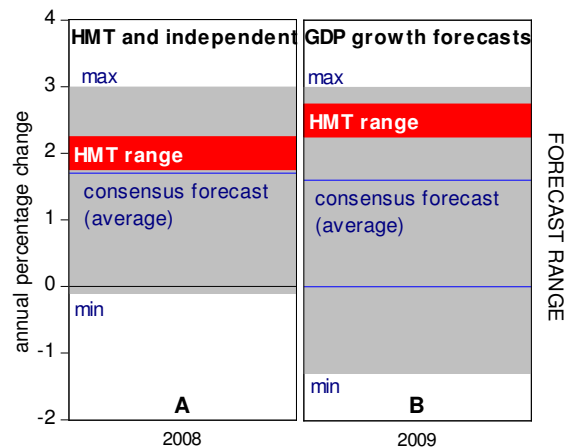
The current slowdown in economic activity and the turbulence in the financial markets imply that growth rather than inflation is likely to become the priority and that further cut(s) in interest rates are forthcoming this year.

Figure 7: UK base rate - where next?



Source: National Statistics 2008

Figure 8: How likely is a UK recession?



Source: HM Treasury 2008

The current slowdown likely to be just a blip. The latest economic data is still consistent with a 'soft landing' for the economy in 2008 (Figure 8A). Furthermore, the consensus of independent forecasts compiled by HM Treasury also points to a slowdown in UK output growth to around 1.7 per cent, marginally below the Chancellor's lower range estimate (announced in the 2008/9 Budget) of 1.75 per cent.² In 2009 the consensus independent forecasts show marginally slower growth than this year whilst the Treasury is more upbeat with a range of between 2^{1/4} per cent and 2^{3/4} per cent. The range of independent forecasts (grey shaded area in Figure 8B) is much wider in 2009 than this year, which simply

² HMT (2008) *Forecasts for the UK Economy*, April 2008 and HMT (2008) *The Budget*.

reflects a greater degree of uncertainty next year. The Treasury appears to be more optimistic about the prospects for next year (HMT range in Figure 8B is above the consensus forecast), but it also has a much better forecasting record than most independent forecasts.

Employment growth is likely to come to a standstill with small job losses in 2009 largely confined within the financial and business services sectors and construction related activities. The unemployment rate is projected to marginally increase before falling back in 2010.³

Although the latest forecasts point towards a slowdown in output growth, several risks could lead to a more severe slowdown, namely: inflationary pressures hamper policymakers' ability to keep lowering the base rate, the credit crisis persists throughout this year, leading to a sharp decline in house prices and consumer spending ('consumer crunch'), and global demand weakens, further impacting on demand for UK goods and services.

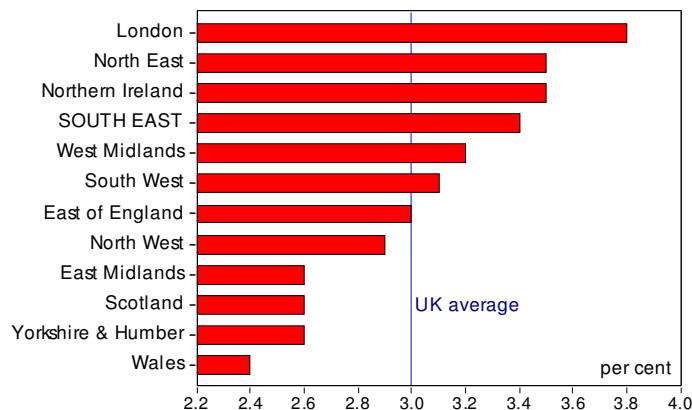
³ Experian (2008) *Regional Planning Service*, April 2008.

The South East Overview and Outlook

Strong output growth in 2006 followed by a slowdown in 2007?

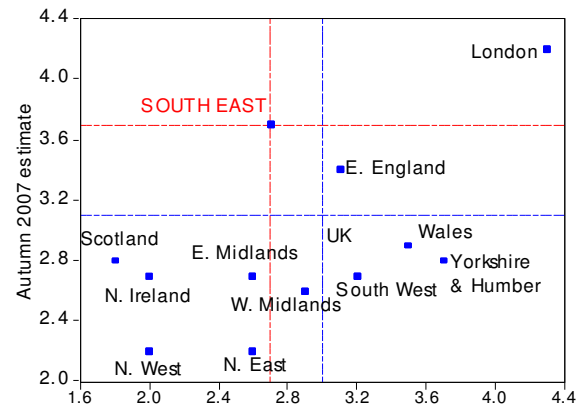
Experian revises the South East growth rate downwards. According to Experian, in 2006 the South East economy expanded by a healthy 3.4 per cent, well above the national average (Figure 9). In Autumn last year inflation adjusted GVA growth in the region for 2007 was projected at around 3.7 per cent.⁴ However in their latest Regional Planning Service forecasts released last week Experian have revised downward their estimates of GVA growth in the South East. The latest forecast is for GVA growth of 2.7 per cent, or 1 percentage point below what was projected late last year. The latest forecasts show that the fortunes for several regions have changed. For example, after having the slowest growth in 2006 Wales is forecast to have one of the fastest growth rates in the country. London's economy, driven by a strong expansion in the financial and business services sectors, is the fastest growing economy.

Figure 9: Strong GVA growth in 2006



Source: National Statistics and Experian 2008

Figure 10: A slowdown in 2007?



Spring 2008 estimate

Source: Experian 2008

According to Experian the downward revision reflects "an estimate of slower growth in private services that can be tracked back to two elements used to calculate GVA estimates: downward revisions to the workforce job series for 2006/7 in contrast to modest revisions at UK level and the balance of service sector sales in the BCC Survey below the national average for the second half of 2007".⁵

Based on understanding of business conditions within the region and the alternative evidence from other regional surveys we believe that the rate of growth in 2007 was much higher than in the latest estimate by Experian.

The credit crisis leads to a slowdown in activity

The Purchasing Managers' Index (PMI) Survey shows a slowdown in business activity and incoming business. In line with the national trend the PMI Survey shows a slowdown in business activity and new orders (incoming new business) in the region since last summer (Figures 11 and 12). The survey shows the sharpest slowdown in the South East since May 2003.

Cashflow and investment position of businesses in the region deteriorate further. According to the British Chambers of Commerce, businesses' cashflow position and investment in plant and machinery have deteriorated in the first three months of the year. Investment in training declined for manufacturers and slightly increased in the service sector, whilst there were mixed messages about confidence in turnover (the service sector remains more optimistic than the manufacturing sector).

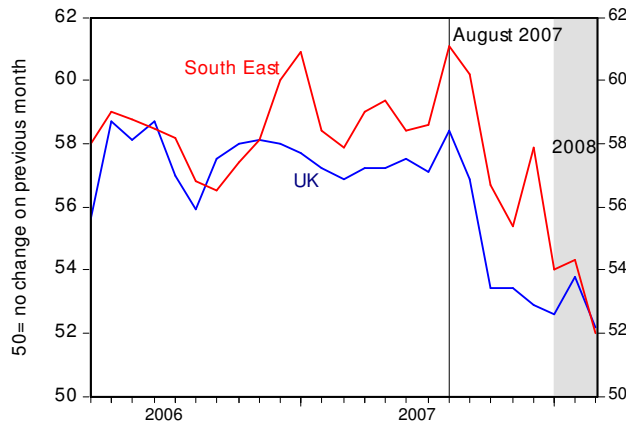
Survey evidence is often contradictory and it remains to be seen whether Experian's forecasts will bear any fruit when official regional GVA data becomes available. Whilst the latest evidence points to a slowdown in activity, the South East economy rarely grows at a rate below the national average and the

⁴ The latest official GVA estimates are for 2005 with preliminary estimates available for 2006.

⁵ Response from Experian regarding our query about the latest revisions to regional forecasts.

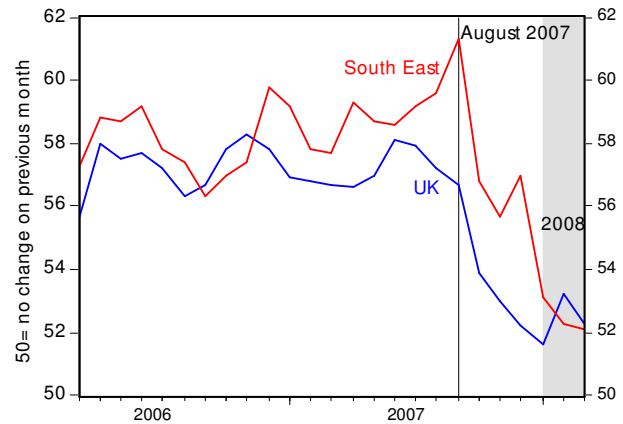
latest revision of GVA growth for 2007 of 1 percentage point appears to be large relative to the other regions in the Greater South East.

Figure 11: Sharp slowdown in business activity ...



Source: RBS and NTC Economics Ltd 2008

... and in incoming new business

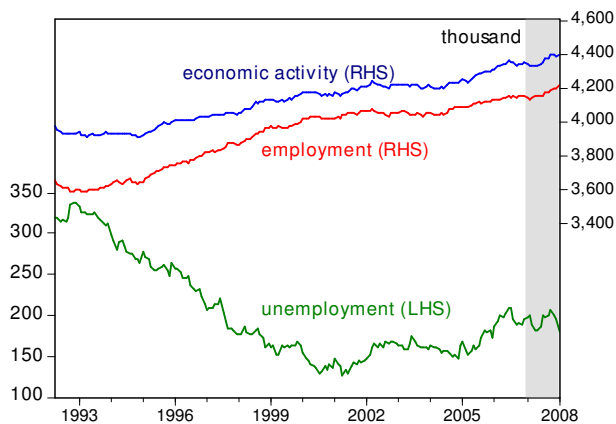


Source: RBS and NTC Economics Ltd 2008

Labour market tightening

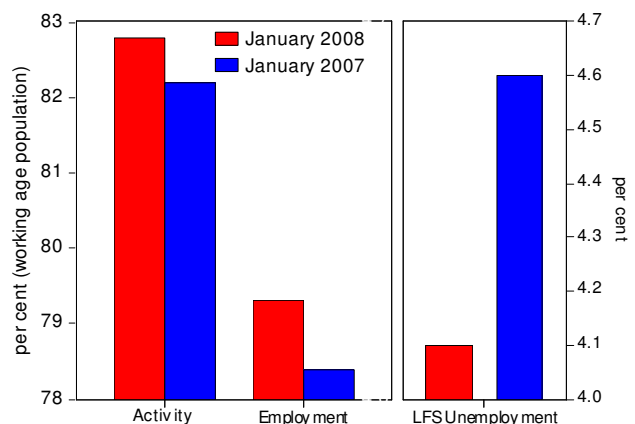
Falling unemployment and rising activity and employment. The latest data up to January this year shows that over the past 12 months economic activity has risen by 0.6 percentage points to 82.8 per cent. There are 68,000 more people in employment than a year ago and 18,000 fewer unemployed people in the region. Over the period the unemployment rate has fallen to 4.1 per cent (-0.5 per cent) and the employment rate has risen to 79.3 (+0.9) per cent. The employment rate for males and females has risen to 83.8 (+1) per cent and 74.4 (+0.7) per cent respectively.

Figure 12: Activity and employment increasing unemployment down ...



Source: National Statistics 2008

... highest activity and employment and second lowest unemployment rate



Source: National Statistics 2008

In December last year there were some 47,000 vacancies in the region (+12,500 on the same period last year). By March this year the number of vacancies had declined to 42,366, indicating a further rise in employment or employers reining back on their expansion plans.

Who is being affected?

The extent of the impact of the credit crunch on the South East is uncertain. The latest survey data shows that the recent turmoil in credit markets is having an impact on the South East economy. Given that the impact of the credit crisis is uncertain at UK level, it is of course difficult to assess to what

extent the region will be affected as the current market sentiment could prove to be just a blip or alternatively it could have a much more prolonged impact on the performance of the economy and its long-term prospects.

What we can say with some certainty is that 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. For example, the US accounts for nearly half of all inward investment into the South East. As a consequence the slowdown in the American economy could have a significant impact on inward investment from the USA and on the demand for South East goods and services. The impact of the global slowdown on European economies could also have a knock-on effect on the South East, as the European market accounts for more than 60 per cent of all South East exports of goods.

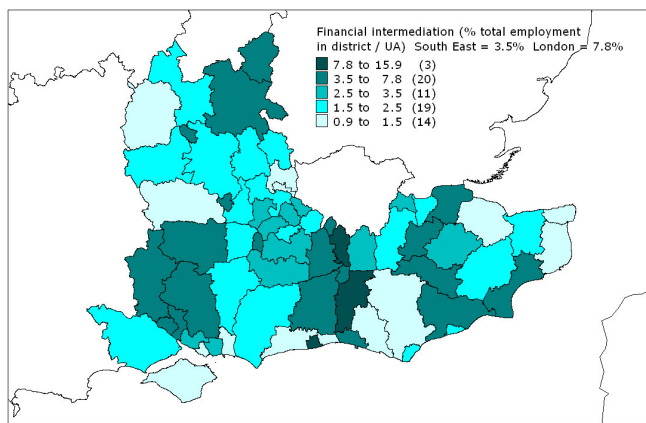
There are several channels through which the credit crunch can impact on the regional economy:

- Through a direct impact on financial institutions, lowering growth and having an impact on employment within the sector and indirectly affecting other sectors such as those closely related to the financial sector (i.e. legal services and business services), or those which are more exposed to consumer behaviour (i.e. tourism or construction).
- The shortage of credit could have an impact on business investment, which is an important component of productivity and growth.
- The credit crisis coupled with falling house prices could have a large impact on consumer sentiment and spending.

The financial sector and related activities are likely to be affected first. 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 a large concentration of financial services in London.

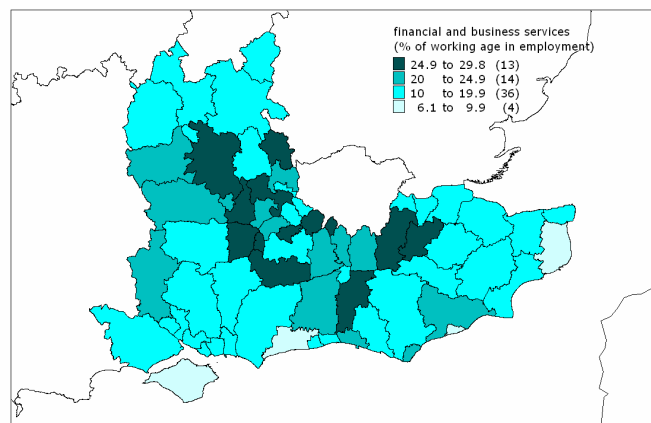
Several areas in the South East are more exposed to any fallout affecting the financial sector. This is simply due to the fact that they have a greater proportion of employment in the financial sector than elsewhere in the region. This is particularly the case in Reigate and Banstead, where almost 16 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 13. Possible negative effects could also be felt in several other districts located in the north of the region (Aylesbury Vale, Milton Keynes, Oxford), 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).

**Figure 13: Financial Services
% of total employment in the area (workplace)**



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**Figure 14: Residents of working age employed
in Financial Services, % (residence),**



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The extent of the slowdown within these areas will depend on the composition of the financial sector, since some sub-sectors are more exposed to the credit crunch than others.

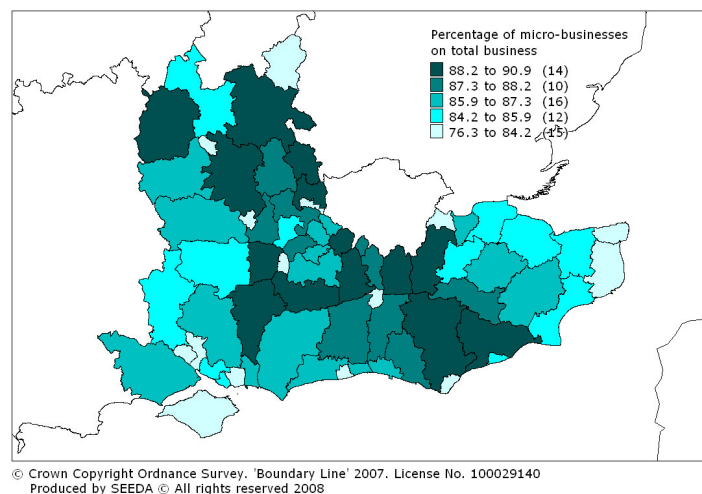
Given the inter-linkages between the South East economy and London any analysis which is just based on a workplace based measure (as above) gives us an incomplete picture for the South East.

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 14).⁶ There are 13 districts in the South East where more than one in four people of working age in employment are employed 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 downturn in commuter income is also likely to have an impact on demand within a number of sub-regions within the South East.

Some small and medium sized businesses (SMEs) could be vulnerable. Some SMEs could be affected as they naturally tend to have a smaller spread of revenue sources than larger firms. They are more exposed to the UK wholesale markets, and borrowing and loan financing has become more expensive and more difficult over the past nine months. Furthermore, the cost of credit could have an impact on investment plans (both capital investment and human capital).

In a number of districts within the Rural and Inner South East, micro businesses constitute a much greater share of business stock than elsewhere in the region, (Chiltern, Wealden, South Buckinghamshire, Elmbridge, Hart, South and West Oxfordshire) and some businesses in these areas could be more affected by the credit crunch than elsewhere, Figure 15.

Figure 15: Micro businesses as a proportion of total business stock



The corporates are more likely to tighten their belts in the current economic climate and focus on core business. Therefore non-core activities such as training could suffer.

Consumer spending is an important factor affecting growth and current sentiment is on the downside. Since South East residents have the highest debt to income ratio of any region, the credit crunch turning into a consumer crunch could potentially have a significant impact on consumer spending and growth. Although a consumer slowdown is not evident from the latest data, higher food and energy costs are having an impact on disposable incomes, which, coupled with the higher cost of credit is likely to lead to some reining in of consumer spending. A greater threat to consumer spending is a significant housing market correction. Whilst the latest data is in support of a housing market correction, the

⁶ The residence-based estimate includes people who commute to work outside the region.

consensus amongst forecasters and housing experts is that the region will manage to avoid a 1990s style crash. The risks in this area remain on the downside.

Tourism is another sector that could be affected by the slowdown in consumer spending within the UK, but it is also a sector that is likely to benefit from depreciation of the pound. Over the past six months the pound has declined by around 18 per cent against the Euro which makes foreign holidays far more expensive for South East and UK residents. Furthermore, currency depreciation implies that the South East is a far more attractive location for European holidaymakers.

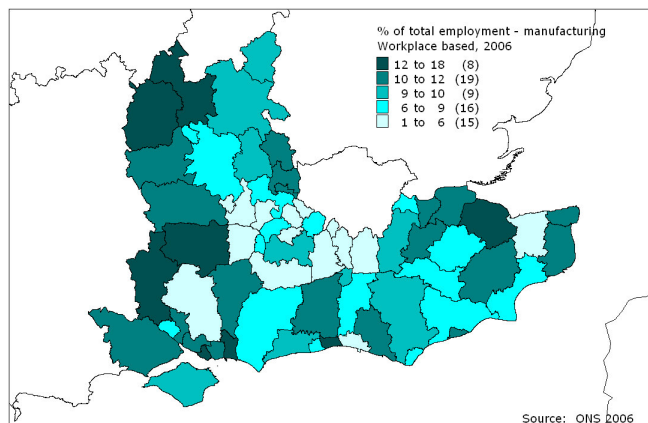
The construction industry is likely to be affected by the current slowdown in the housing market and the expectations of future growth. A rising cost of living coupled with labour shortages in some sectors (such as agriculture) could lead to some employers potentially having to increase wage levels to attract staff.

Overall the latest data and consensus forecasts are consistent with a brief downturn which is unlikely to reverse the region's economic fortunes in the long term. This is because the South East is at an advantage in terms of its industrial mix (a high proportion of private sector services), its large and growing supply of labour and its relatively highly skilled population. All of these factors are key determinants of productivity and growth over the long term.

Is the manufacturing sector undergoing a revival?

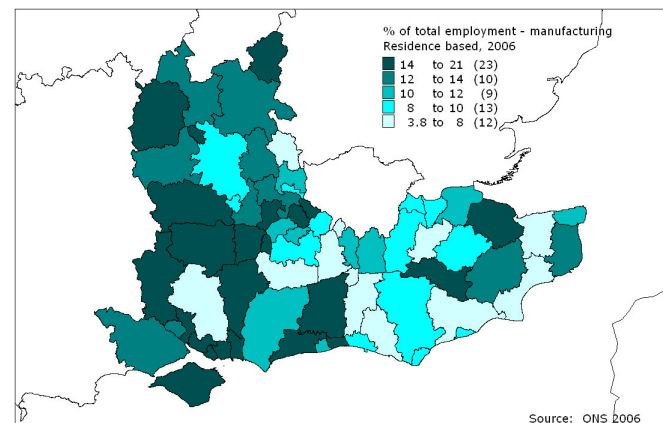
The fortunes of the manufacturing sector have changed. Since last summer the pound has slipped to a record low against the Euro and a basket of other currencies. A weaker currency is one of the factors that could boost competitiveness of the manufacturing sector through lower export prices. However, any positive impact on export orders and sales will depend on global demand and in particular European demand. The latest data from Germany and France (the South East's largest export markets) show an increase in consumer demand which is an encouraging sign. However, inflation remains an important factor that could impact on the scale of any revival of this sector in the South East and nationally.

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



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



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Several districts in Oxfordshire and Hampshire have a high concentration of manufacturing jobs (Figure 16). Furthermore, Hampshire, Oxfordshire, parts of Kent and several districts on the coast have a significant proportion of their working age population employed in manufacturing (Figure 17).

Whilst regional survey data on the manufacturing sector is inconclusive, the latest national data shows strong output growth in the first quarter of this year. This is particularly true for the automotive sector, which expanded by around 12 per cent on the previous year. Although the Oxfordshire economy with its strong automotive sector is likely to benefit the most from global demand, this benefit will spread throughout its supply chain. Demand from within the UK is likely to be hit as consumers are less likely to purchase non-essential items such as new vehicles. Hence, stronger global demand, in particular from the EU, is likely to be needed for the region to benefit further from a competitive manufacturing sector.

The South East outlook

Experian forecasts show output growth slowing this year and in 2009. The latest market turmoil and the evidence from surveys have lead to downward revisions of UK and regional growth in 2008 and beyond. The latest independent forecasts from Experian show the South East economy (GVA growth) expanding by 2 per cent in 2008, followed by even slower growth of just 1.6 per cent in 2009. Although significantly slower than in 2006, the rate of growth is still above the national average (Figure 18).

Figure 18: Slower GVA growth ... still above the national average

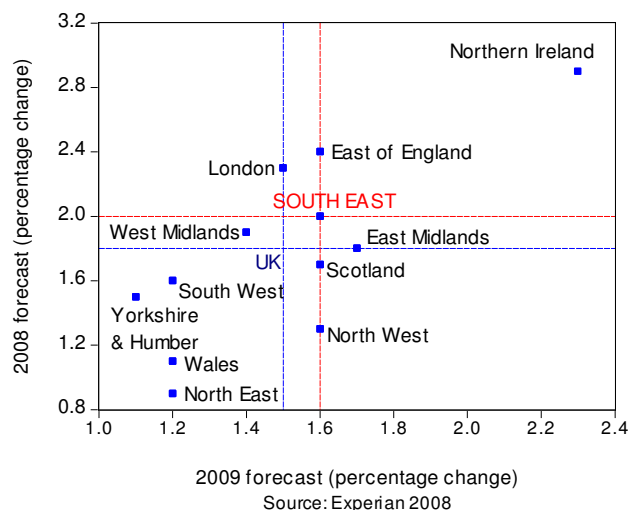
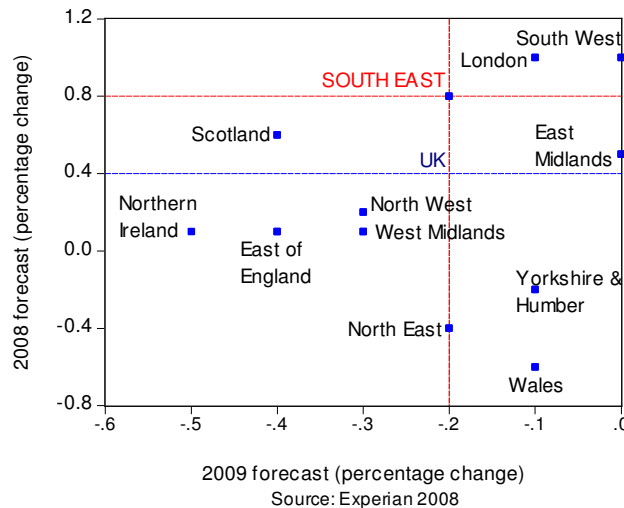


Figure 19: Strong employment growth this year ... employment growth dips in 2009?



Construction related activities will bear the brunt of the slowdown with output growth contracting this year and the next. The housing market slowdown and lower public sector spending will dampen the growth of this sector, whilst distribution, hotels & catering is likely to be affected by slower consumer spending. Perhaps surprisingly, the latest outlook from Experian shows manufacturing output coming almost to a halt in 2009, whilst the financial and business sector expands faster this year and in 2009 than in 2006 (Table 1).

Table 1: GVA and full-time equivalent employment growth this year and in 2009 (percentage change)

Sector	GVA growth				FTE			
	2006	2007	2008	2009	2006	2007	2008	2009
Agriculture	-0.1	-4.3	-0.7	-2.5	-6.6	-7.9	1.6	-2.1
Metals, Minerals & Chemicals	0.3	0.0	2.6	-0.5	-6.4	0.1	0.0	-0.9
Engineering	8.6	2.3	0.6	0.2	-4.1	-3.7	-2.9	-0.5
Other Manufacturing	4.3	1.0	1.8	0.1	-0.9	-0.4	-1.0	0.3
Construction	-0.9	1.7	-0.2	-0.6	4.3	1.7	-0.6	-2.0
Distribution, Hotels & Catering	3.3	2.8	1.6	0.9	-3.6	1.0	0.7	-1.9
Transport & Communications	4.4	4.5	4.9	3.5	0.8	-1.0	3.0	-0.2
Financial & Business Services	4.3	6.2	5.0	4.6	0.0	1.1	2.6	1.1
Mainly Public Services	5.2	3.3	1.1	0.9	4.0	0.5	-0.2	0.4
Total	3.4	2.7	2.0	1.6	0.2	0.4	0.8	-0.2

Source: Experian, RPS 2008

Experian forecast small job losses for 2009. The current momentum in the labour market continues throughout this year with employment growth of around 0.8 per cent. As indicated earlier, employment is

a lagging indicator of economic activity and is forecast to marginally contract in line with the national average (Figure 19). Manufacturing, distribution, hotels & catering and construction will bear the brunt of employment decline. After 2009 output and employment growth in the South East is projected to recover, with both output and employment expanding significantly faster than this year and the next.

There is a high degree of uncertainty with any forecasts, especially so with the latest set constructed during a period of turmoil in the UK and other developed world economies. The South East economy is clearly capable of riding any slowdown, although the extent of the slowdown will depend on a number of factors. South East policy makers are in a position to mitigate some negative impacts arising from the global credit crunch affecting the economy. However, developments at the macro level (policy responses to the slowdown) and perhaps more importantly at the international level will determine the fortune of the South East and the other UK regions and sub-regions.

Implications of the current slowdown for Regional Economic Strategy (RES) targets

The new RES stretches over a 10-year horizon and since the current slowdown is forecast to be temporary it is unlikely that it will have a significant impact on the region's ability to achieve the RES targets. Although there are several potential 'winners' and 'losers' from the current slowdown, overall given the current economic climate the risks of not meeting some RES targets are slightly increased.

The Headline Targets

GVA per head: The expected slowdown in GVA growth over the next two years will lead to growth in real GVA per head below the RES target this year and in 2009.⁷ However, the RES target refers to an average rate over a 10-year horizon, and it is common for economic growth to be cyclical (with, for example, slower growth for two or three years followed by faster growth in succeeding years). The latest independent forecasts, (which are largely policy neutral) point towards a soft landing for the South East economy and a return to its trend rate of growth after 2009. Since the rate of growth this year and in 2009 is expected to be low, a higher rate of growth will be needed after 2009 for the region to achieve its headline GVA target. That said, an advanced knowledge based economy such as the South East is more than capable of expanding at rates above its long term trend (indeed this was the case in the South East between 1997 and 2002).

Productivity per worker: The strength of the labour market combined with a slowdown in output growth is likely to lead to slower productivity growth this year and the next. Investment in capital (such as plant or new machinery) and skills is an important component of longer term productivity growth and the latest evidence shows that business investment and training plans are being affected by the credit crisis. If the credit crisis were to persist this could have a significant impact on an already stretching RES productivity target. However, just as in the case of the GVA headline target, the productivity target allows for slower growth in one period, which can be offset by faster growth in the second half of the RES horizon. Since productivity (alongside employment) is a driver of prosperity this is one of the main policy areas in the new RES.

Ecological footprint: The ecological footprint is a composite indicator and assessing the impact of the current slowdown in this area is far from straightforward. However, since consumption makes a significant contribution to the footprint and since imports (amongst several other factors) are likely to decline over the next couple of years, there could be a small positive impact on the footprint. However, without appropriate investment any gain is likely to be short-lived.

Global Competitiveness Objective

The impact of the current slowdown on the Global Competitiveness Objective is likely to be mixed. The slowdown in the US economy could have a negative impact on Foreign Direct Investment in the region. However, a weakening of US investment could be offset by stronger investment from elsewhere (the EU and emerging economies). A weaker pound is likely to boost the competitiveness of the region's exporters. In other areas the impact is more uncertain: Research & Development could be negatively affected due to the availability of credit, and since R&D investment is an input to innovation this area could be affected. Nevertheless the impact would be felt differentially across sectors. R&D expenditure is of greatest importance to a relatively small number of sectors – such as the chemical and pharmaceutical industries – so these are most likely to feel the effects of a drop in R&D investment.

It is unclear to what extent investment in infrastructure will be affected by the slowdown since investment in this area usually takes place over the long term. Shortage of credit combined with the higher cost of financing investment is likely to have an impact on the private sector, while a significant decline in public sector spending announced in the Budget will impact on public sector activities.

⁷ Until the latest revision to the South East GVA growth for 2007, the South East GVA per capita growth rate over 2006 and 2007 was on average around 3 per cent (in line with the target).

Smart Growth Objective

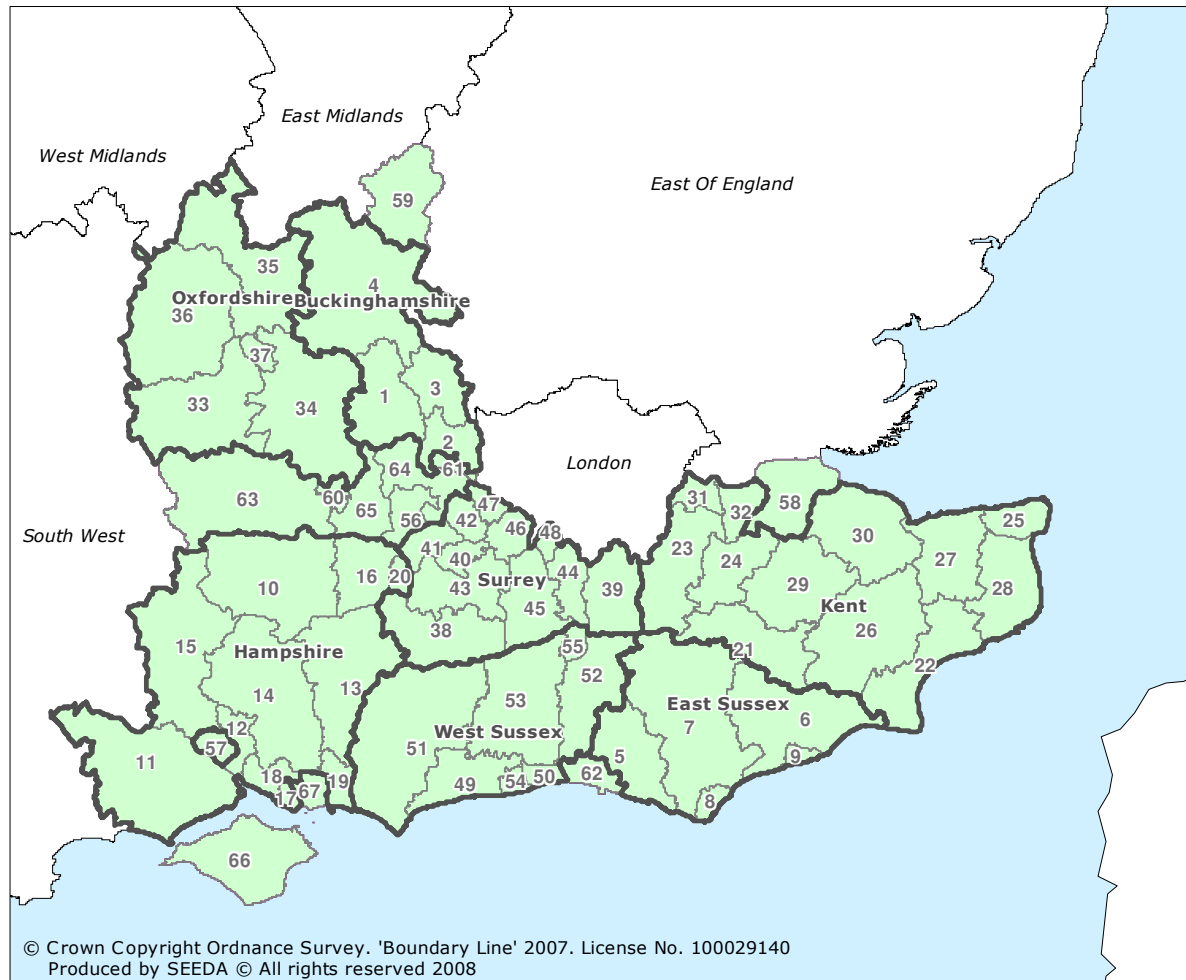
There are several 'winners' and losers' under this objective. Growth in the number of new enterprises is likely to be negatively affected by the availability and cost of credit, and this is likely to prove one of the challenging areas over the next couple of years. The latest data on economic activity shows a strong upward trend and the measures announced in the 2008/9 Budget aimed at moving people from incapacity benefits back into the labour market will help towards achieving this target. Falling house prices could improve affordability, although the availability and cost of credit act as a constraint over the short term. Any improvement in affordability resulting from a fall in house prices is likely to be short lived since the housing market in the region is characterised by strong demand and significantly constrained supply. The impact on transport is unclear, although it is possible that the higher cost of petrol could lead to a modal shift, at least in the short term.

The impact on skills is likely to be mixed: on the one hand firms are likely to cut their training budgets which could impact on skill gaps, but a strong upward trend in the number of people with higher level qualifications (i.e. NVQ4+) is likely to continue. The latest evidence from business schools shows that there has been a significant increase in applications for places on postgraduate (in particular MBA) qualifications since September last year. On the other hand, the slowdown in the construction sector could lead to a loss of skilled labour that could be difficult to replace.

Sustainable Prosperity Objective

A slowdown in consumption and economic activity is normally associated with a fall in emissions. However, any boost to the target is likely to be short lived since it has more to do with a slowdown in the economy and perhaps less with a genuine improvement in economic efficiency within the economy or a change in consumer behaviour. Growth in metered households, higher water bills and a greater awareness of the need to conserve water are helping the per capita water consumption target to remain on track.

Figure 20: South East England



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|---------------------------|--------------------------|-------------------------|---------------------------|
| 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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