

In Brief:

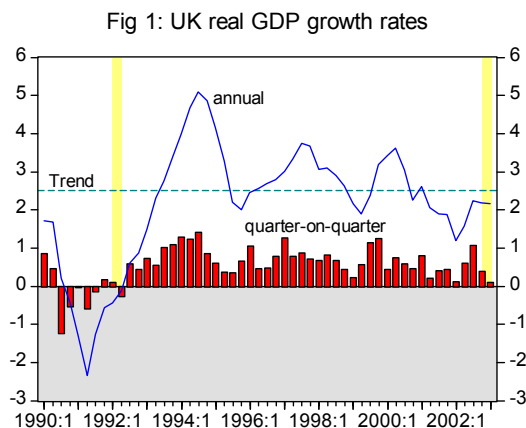
- UK real GDP increased by just 0.1% in the first quarter – the South East economy unlikely to have performed much better than the UK as a whole
- Significant decline in manufacturing and service sector output
- Fourth consecutive monthly rise in claimant count unemployment
- Slowdown in earnings growth in 2002 likely to persist in 2003
- Significant discrepancies in the distribution of earnings by sex and sub-region
- The collapse of the housing market continues to pose a major threat to the regional and national economies
- Slower growth in consumer expenditure in 2003

ECONOMIC GROWTH GRINDS ALMOST TO A STANDSTILL IN THE FIRST QUARTER

The UK real GDP increased by just 0.1% in the first quarter, from 0.5% in the last quarter of 2002.¹

This was the slowest quarter-on-quarter growth since the second quarter of 1992.

It was the significant growth of the public sector (some 2.5%, quarter-on-quarter) that kept the economy growing, as the private sector contracted by 0.4% in the first three months (it expanded by 0.3% in the last quarter of 2002).



The main reason behind the sluggish growth in the first quarter was a slowdown in growth of service sector output and a fall in construction output. Furthermore, the output of production industries continued to decline, with a significant contraction in energy output (due to a mild winter). Telecommunications and health were the only sectors that showed strong growth.

Sluggish world demand, turbulent stock markets and the impact of the war in Iraq have been largely responsible for bleak business and consumer confidence in the first three months of the year.

Given the poor performance of the UK economy as a whole, the likelihood is that the South East economy did not perform much better in the first quarter. This is in particular true given the large concentration of financial, manufacturing, construction and tourism sectors in the region.

REGIONAL OVERVIEW

Manufacturing Sector

The manufacturing sector is one area that has been affected significantly over the past few years, first by the strong value of the pound and then by the slump in world demand. Employment in manufacturing sector in the South East decreased by 56,400 jobs (-11.5%) between 1998 and 2002.²

The latest *British Chambers of Commerce (BCC) Quarterly Economic Survey* (April 2003) shows that, in the first three months of this year there has been a significant slowdown in the home sales market as the percentage balance of companies reporting increases in home sales decreased by 27 points to +6%.³ There was a sharp decline in export sales with only +2% of companies reporting an increase in sales (down 53 points on the last quarter last year). Home orders and export orders also decreased significantly, possibly reflecting the pessimism at home and abroad about the speed of economic recovery (the war in Iraq significantly, contributed to this). The pessimism about the speed of the recovery is further highlighted by the significant decline in the balance of firms reporting an increase in investment (down 20 points to +4%).

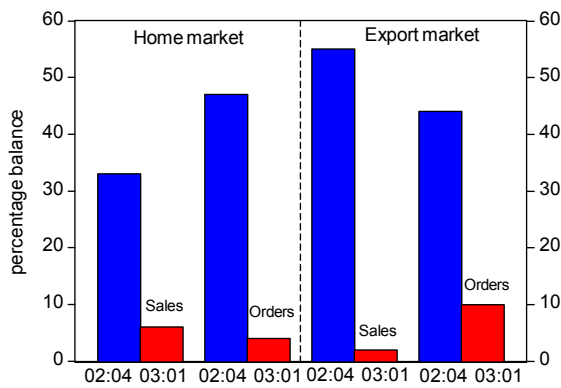
¹ ONS 2003

Note: Growth rate would have been marginally greater, had Easter been in March as opposed to April.

² Oxford Economic Forecasting (OEF) 2003

³ Percentage balances determined by subtracting the percentage of those companies reporting decreases from the percentage of companies reporting increases.

Fig 2: Manufacturing sector
South East England

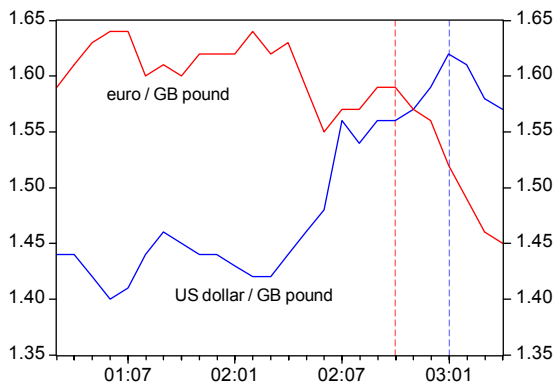


Source: BCC Quarterly Economic Survey 2003

One factor likely to aid competitiveness of the manufacturing sector is the recent significant depreciation of the pound against the dollar and in particular the euro.

However, the recovery of export volumes (as a result of an improvement in competitiveness) will obviously depend on the recovery of world demand and relative price elasticity of demand for UK exports. Since there is a considerable lag between the devaluation of currency and its impact on the balance of trade, we are unlikely to see any significant benefit of this improvement in competitiveness until the early/mid 2004. In addition to this, since the interest rates in the United Kingdom are much higher than in the euro zone or the United States, the pound is likely to recover some ground lost over the next few months.

Fig 3: Exchange rates



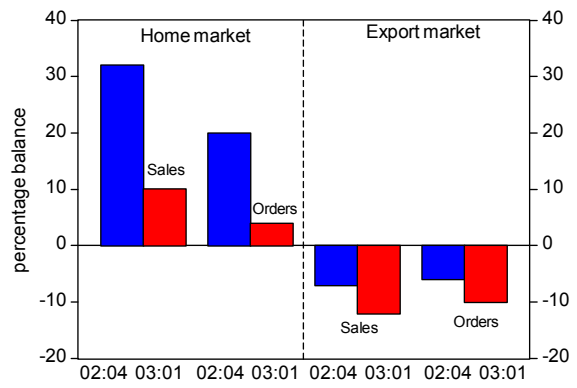
Source: Bank of England 2003

Service Sector

The service sector did not perform much better in the first three months of the year.

Percentage balance of firms reporting an increase in home orders decreased by 22 points to +10%, while -12% of firms reported an increase in export deliveries (down 5 points from the last quarter). Furthermore, only 49% of manufacturing and 40% of service sector firms reported operating at full capacity.

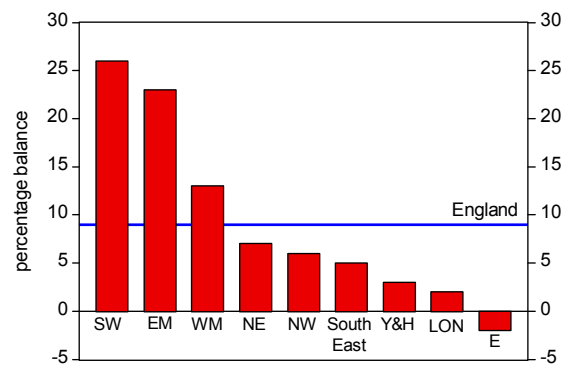
Fig 4: Service sector
South East England



Source: BCC Quarterly Economic Survey 2003

According to the latest *Confederation of British Industry/Experian Business Strategies (CBI/EBS) Regional Survey of UK Economic Trends* (April 2003), businesses felt that the overall business environment would improve over the next six months. The southern regions remained more pessimistic than the rest of the country.

Fig 5: Expectations of the overall business situation
(next six months)



SW=South West, EM=East Midlands, WM=West Midlands, NE=North East, NW=North West, Y&H= Yorkshire and the Humber, LON=London, E= East of England

Source: CBI/EBS Regional Survey of UK Economic Trends, 2003

THE HEADLINE UNEMPLOYMENT IN THE SOUTH EAST INCREASED BY 800 TO 76,700 THE FOURTH CONSECUTIVE MONTHLY RISE

Given the already tight local labour market (high employment rates), firms have been less willing to give up skilled labour over the last two years in the South East than in other parts of the country.⁴ However, as shown by the latest employment statistics, there seems to be some evidence of firms finally giving up on 'labour hoarding'.

The headline count of those out of work and claiming benefits in the United Kingdom increased by 9,700 in May to 950,800, the highest increase in claimant count since December 1992. The seasonally adjusted Labour Force Survey (LFS) estimate showed the increase of 36,000 in the three months leading to April, to 1.49 million for the UK as a whole.⁵

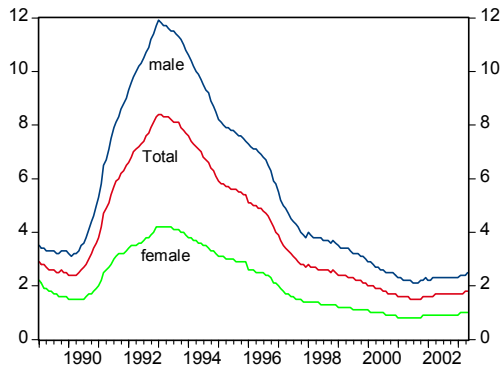
⁴ This unwillingness to give up labour is known as 'labour hoarding'.
⁵ Nomis / ONS 2003 preliminary estimates.

The headline claimant counts of those out of work and claiming benefits in the South East in May increased by 800 (month-on-month) to 76,700, the highest total since July 2000.

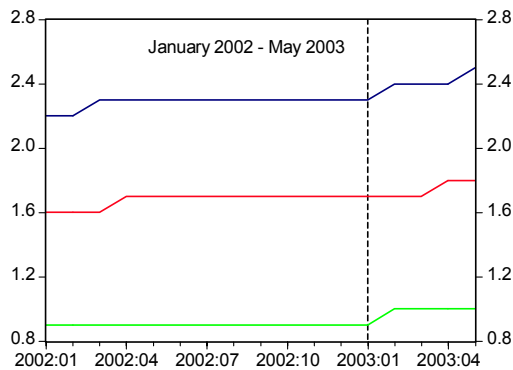
More importantly, the increase marked the fourth consecutive monthly rise in unemployment

Since February 2003, the total number of those out of work and claiming benefits increased by 4,300, an increase of 0.1% to 1.8% (2.5% for male and 1% for female).

Fig 6: South East England - claimant count rates



Source: Nomis 2003



Furthermore, in the period February to April of this year, the seasonally adjusted LFS unemployment rate was up by 0.1% (year-on-year) to 3.8%.

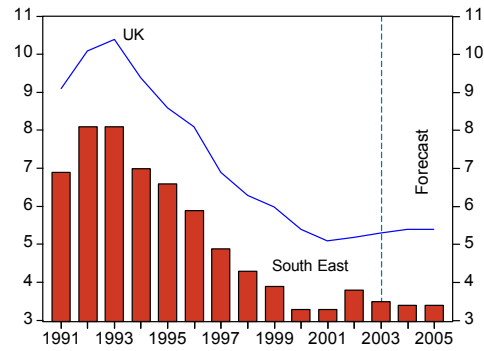
In absolute terms the total number of unemployed increased by 2,000 on the same period a year ago to 159,000.

The Labour Force Survey (LFS) estimate of employment in the South East in May 2003 was 0.9% down on the same period a year earlier to 79.3%, while the economic activity rate also decreased by 0.9% to 82.9% on the same period a year ago.

Hence, the delayed impact of the economy's downturn and business pessimism about quick economic recovery may be finally having an impact on the relative stability of the labour market.

Providing that the expected economic recovery in the second half of the year takes place, our baseline forecast of marginally smaller ILO unemployment rate in 2003 than in 2002 is still on course, in spite of the recent increase in unemployment.

Fig. 7: ILO Unemployment rates (time series and forecasts)



Source: EBS 2003

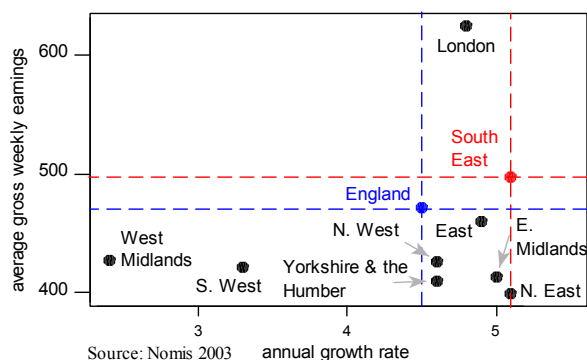
GROWTH IN EARNINGS SLOWS DOWN IN 2002 - SLOWER GROWTH LIKELY IN 2003

Apart from the uncertainty about the state of the economy and future economic recovery, one of the factors that affected consumption expenditure and contributed to slower than expected GDP growth was the slowdown in wage inflation in 2002. General slowdown in average growth in earnings in 2002 had a lesser impact on the South East economy than on the UK economy as a whole.

According to the latest data from the Office for National Statistics, in April 2002 average gross annual earnings, for full-time employees in the South East stood at £26,449, higher than in any other English region except London.

The South East had the highest average gross weekly earnings in the country after London: £496.7 for full-time adults whose pay was not affected by absence. Average gross weekly earnings growth in 2002 was 5.1%, alongside the North East the highest annual growth rate in any English region. The prime factor behind this increase in average earnings is the tight local labour market, as it is easier to bid wages up in a labour market characterised by high levels of employment.

Fig 8: Average gross weekly earnings (April 2002)



Source: Nomis 2003

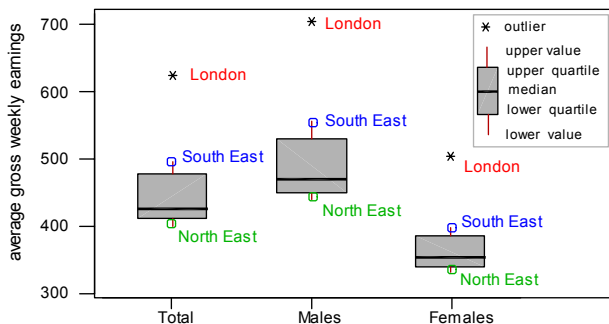
Average gross weekly earnings were lower than in 2001, when the growth rate was 6.7%. The slowdown in wage inflation is not surprising, given the impact of declining profits on private sector wages.

The growth in public sector earnings remained buoyant due to a significant increase in public spending by central government.

At the sub-regional/UA level, Bracknell Forest UA and Slough UA had the highest gross weekly earnings of £613.5 and £605.2 respectively. At the other end of the distribution, the Isle of Wight and East Sussex had the lowest average gross weekly earnings of just £370.3 and £393.9 respectively. The Isle of Wight UA was the only part of the South East where total average weekly earnings had decreased by 0.8% between April 2001 and April 2002.⁶

Looking at the distribution of gross weekly earnings by sex across government office regions, there is a clear discrepancy in the average gross weekly earnings between male and female employees.

Fig 9: Distribution of average gross weekly earnings by sex: government office regions, April 2002



NOTE: The 'box' encloses the middle 50% of the data, while 'whiskers' illustrate the range of the data ('whiskers' extend from the box to the highest and lowest values)
Source: ONS 2003

While the distribution of earnings for females is relatively equally spread across the regions, the distribution of earnings for males is characterised by a much wider spread, in particular in the upper quartile range.

A clear discrepancy in earnings between males and females is equally evident at the sub-regional/UA level within the South East.

Average gross weekly earnings for full-time males on adult rates increased by 5.6% to £555.3 with Bracknell Forest UA recording the highest average gross weekly wage of £703.3, marginally smaller than the average wage in London of £704.8. At the other end of the distribution, the average gross weekly wage in the Isle of Wight decreased by -0.5% to £394.7.

In April 2002, average gross weekly earnings for full-time females increased by 4.6% to £398.6. The highest average gross weekly earnings of £459.5 was recorded in Surrey, an increase of 5.3%, while the lowest average gross weekly earnings were recorded in Medway UA of £333.7, an increase of 3.7%. Perhaps surprisingly, the only decrease in earnings of -2.7% was recorded in East Sussex. Such a significant decrease is likely to be associated with the larger concentration of certain sectors such as tourism, in East Sussex than in other sub-regions/UA.

Duality of the regional labour market is further evident if we look at the distribution of average gross weekly earnings for manual and non-manual occupations of £395.1 and £636.2 respectively.

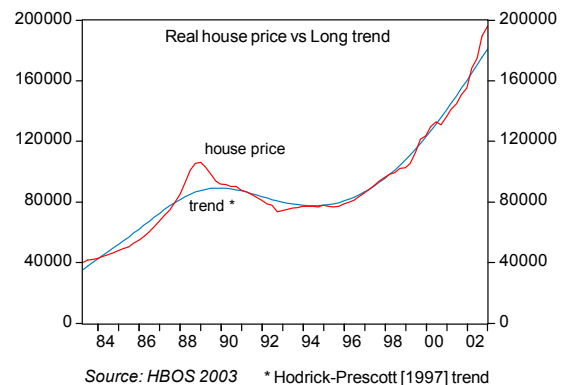
The recent performance of the economy implies that a further cut in interest rates is necessary and likely to be coming at the next Bank of England meeting.

The Housing Market

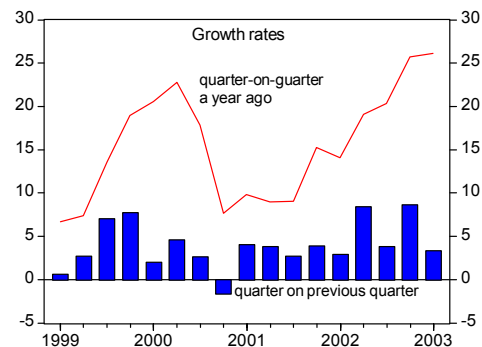
The danger of lowering the rates further is that the house price bubble may burst and push the South East economy into recession.

Currently, the house price/earnings ratio is at its highest level since the late 1980's, implying that the prices in relation to earnings have reached potentially unsustainable levels. However, mortgage payments/earnings ratio is relatively low in comparison to the late 1980s early 1990s. Relatively low mortgage payments-earnings ratio is one of the factors often used by analysts who argue that we are unlikely to see the collapse of the housing market. However this claim is misleading, as the ratio includes new mortgages and those mortgages near maturity. One of the factors that prevent the collapse of the housing market, low interest rates, is stable and is likely to remain stable in the short and medium term. The other factor, employment, has marginally declined over the last year. The decline in employment is likely to be just temporary, thus we are not likely to see an imminent crash in house prices. However, given the unsustainable prices and growth rates, some form of significant price readjustment is likely to happen in the medium term.

Fig 10: Real house prices: South East England



Source: HBOS 2003 * Hodrick-Prescott [1997] trend



Over the past few years, buoyant growth of the market has allowed a significant increase in consumer expenditure. However, in the short to medium term, slower house price growth (or decline in prices) is likely to have an impact on consumer expenditure and economic growth in the region. The likelihood is that the combined impact of slower house price growth and slower growth in earnings is likely to lead to slower growth in consumption than was the case over the past few years.

⁶ Source: ONS 2002, New Earnings Survey