

ECONOMIC BULLETIN



A quarterly update from Franklin + Andrews

Volume 10.2 | July 2007

The UK economy – healthy growth in prospect

The development of the UK's economy looks on the surface to be increasingly promising. GDP grew by 2.6% during 2006, representing a solid recovery from a weak performance of 1.9% in 2005. In the first quarter of 2007 the UK economy rose by 0.7%. A healthy economic performance is in prospect for the UK with a forecast growth of 2.5%, 2.4% and 2.6% for 2007, 2008 and 2009 respectively.

Consumer spending, the key driver of UK growth, picked up in 2006 after a sluggish performance in 2005. The latest figures suggest that consumer spending growth will remain strong but below its long-term trend in 2007 and 2008 with 2.3% growth, compared to an average of 3.4% per year, in the ten years to 2004.

The annual rate of inflation as measured by the Retail Price Index (RPI) fell to 4.3% in May 2007 from 4.5% in the previous month. The UK government's target measure of inflation, the Consumer Price Index (CPI), fell to 2.5% in May 2007 from 2.8% in the preceding month, remaining above the government's 2.0% target. We anticipate that the consumer price inflation will remain above its target mark throughout 2007.

In its 2007 Budget, published in March, the government set out its core targets on economic growth and innovation. Education remains at the top of the government's priorities. With an extra investment of £10 billion in the education

sector over the next three years, spending is anticipated to grow by 2.5% a year in real terms on average from 2007/08 to 2010/11. Included in the spending is the provision of a nationwide network of 3,500 Sure Start children's centres by 2010.

There is a positive outlook for the year ahead in the construction industry. An upward movement in the UK economic growth looks set to deliver a year of buoyant activity for our clients. It is expected that output growth will increase in a similar profile to that of GDP over the next two years with a forecast growth of around 2.5%, 2.4% and 3.2% in 2007, 2008 and 2009 respectively.

The majority of sectors in the construction industry will be busy through 2007 to 2009 although the growth will vary from one

sector to another. Private commercial and infrastructure projects will make significant contributions to growth, largely due to a buoyant office sub-sector, and the commitment for Olympic related construction kicking in from mid 2007 (although major construction is not due to commence until summer 2008). Figure 1 highlights the construction output growth forecast within the different sectors of the construction industry. With the expected buoyant

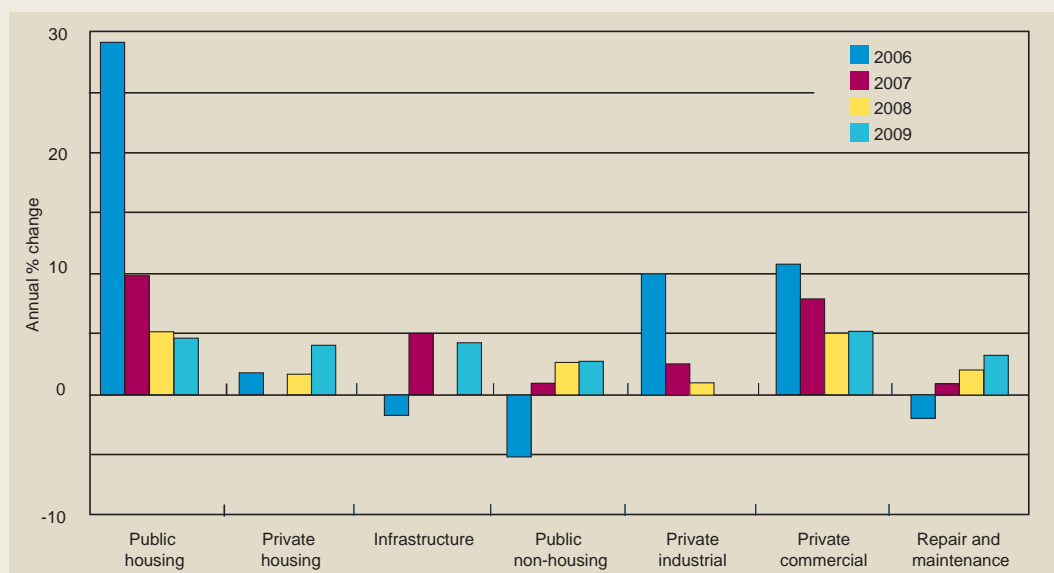
construction activities, we are forecasting tender prices to remain well above the level of retail inflation throughout the forecast period. We still anticipate price pressures to remain predominantly focused to within the South East region with an annual additional Olympic premium on tender price of 1.0% to 1.5%. Table 1 below plots the annual tender price inflation forecast for the UK construction industry in relation to a medium UK economy scenario.

Table 1 UK macroeconomic and construction inflation forecast (annual % change)

	2006	2007*	2008*	2009*
TPI	4.6	5.9	6.0	6.2
RPIX	2.8	2.8	2.5	2.5
GDP	2.6	2.5	2.4	2.6

*Forecast

Figure 1 Construction output forecast (annual percentage change)





A view from the Managing Director

by Andrew Williams

The world economy – a promising future ahead?

With sustainability high on the agenda in most parts of the world, and climate change a real issue, it was appropriate that Think07 was held in early May at the Excel centre in London. One of the key actions from Think07 was a ten point charter to address the real threat posed by climate change for this industry which was presented to the UK government. The Charter is a proactive step by the UK construction/property industry to declare its willingness, and acknowledge its responsibility, to translate the debate into solid actions. With our parent company Mott MacDonald sponsoring the Charter we are now looking ahead to the future role that the Group will play in helping to shape how the industry can best respond to this challenge.

As cost consultants and economic research specialists within the construction industry, we are looking at the implications of embracing this initiative on the cost of construction. Putting any government intervention aside – which could for example be tax breaks or taxation – we are anticipating that as the market for sustainable products develops, the cost of using these will become more competitive. In addition, as the use of whole life costing becomes more prevalent, the value of these products will be realised, thus fuelling the growth in that area of the industry. We are planning to publish a special bulletin on this later this year.

Concurrent with this debate, there is also real evidence that many regions of the world are experiencing robust growth. This is reflected throughout this bulletin in a series of articles looking at the way in which the world is changing and growing at varying rates driven by domestic

and international demand for commodities. It is not surprising that of the regions demonstrating most growth, China and India, between them have manufacturing growth racing ahead of the rest of the world, due in no small part to low labour costs. The growth within China, fuelled to a large part by its own domestic demand, has had a significant impact across the world. China's continuing appetite for raw materials, sourced from every corner of the globe, has been fuelling the international trading price of many essential commodities.

The impact that China and other countries raw materials demands have had and continue to have on the rest of the world has been significant and my colleagues have prepared a number of commodity price studies included within this economic bulletin to illustrate globally the significance on the rest of the world of this growth taking place in China and elsewhere.

Whilst the World economic outlook has improved in 2006 it was not a consistent message in all countries. Expectations are for a slight easing in further global growth during 2007. Forecasts for 2007 suggest World GDP growth of between 3.0% and 4.5%, Eastern Europe at 5.0%, India at around 8% and China at 9.8%. The US economy is, however, cooling with many economists now expecting growth of just 2.5% in 2007. The underlying risk is a weakening US Dollar that may trigger a slowdown in US economic activity and a consequential knock-on effect on the UK economy.

The latest indicators of the Eurozone suggest a slowdown in 2007 following a robust 2006 with the largest nation Germany having undergone significant improvements in its economy. GDP growth in the Eurozone is expected to achieve around 2.2% during 2007. France is however experiencing a stagnating economy and our forecast GDP growth in 2007 is just 1.5%, with Germany likely to achieve 2.5% over the same period. Inflation trends have been more stable. With the increase in the value of the Euro against the US Dollar causing some economists concern, the Eurozone may be facing a period of difficult international trading.

The dilemmas posed by the enlargement of the European Union and increased labour migration have continued to influence the economy of the UK. It is suggested that over one and a half million migrant workers were employed in 2005 representing over 5% of the UK workforce. With over 400,000 new migrants in 2005, the study further established that the migrant workforce was employed predominantly in the more highly-skilled occupations and centred in the South East, with 41% of migrants located in the Greater London area. This growth in migrant labour, viewed by some as a problem, has in fact helped the UK economy respond to its economic growth drivers more easily than it might otherwise have done and has inevitably helped keep inflation lower than it might otherwise have become through an overheated labour market. The many skilled migrant workers were able to satisfy the UK's growing demand without disrupting the employment opportunities for the UK labour force.

The UK economy picked up pace during 2006 with growth at 2.6%. GDP growth for 2007 is expected to stabilise in the region of 2.5%.

A slowdown is forecast in consumer spending over the next 12 months. However government investment is predicted to compensate for some of the downturn. Business sentiment and profitability are expected to remain good as global demand continues upwards in 2007, however there remains a risk of the US Dollar weakening further impacting upon our ability to sell UK goods and services. The Chancellor's recent Budget statement shows continued determination to provide extra resources for public services and means government consumption is forecast to grow in 2007.

The Bank of England's MPC May rate increase indicating that the Bank may be displaying their customary cautious approach and keeping a watchful eye on world events as much as on the UK economy. Any further uplift in rates is now more likely than a reduction.

With the strong performance of the world economy reflected within the construction/property markets, there is a unique opportunity to make the investments required now to protect our future environment.

Enjoy the bulletin.

Import labour market

Import labour market and the impact on UK construction

The number of overseas nationals working in the UK fluctuated up to 1996, after which they rose strongly, to top the million mark for the first time in 1998 (4% of the total in employment), continuing this trend in subsequent years. By 2006 1.75 million were recorded, 16% up from 2005 (and a rise of 40% since 2002).

Europeans account for 45% of the foreign workforce. Europe can be sub-divided into three main regions; Western, Central and Eastern and Other Euro. Western European countries supply 27% of foreign workers. The Irish continue to be the clear leaders, but their dominance has been falling, from 23% of all foreign workers in 1995 to 9% in 2006. A clear shift has occurred with the numbers of Central and Eastern Europeans in the labour force growing rapidly, reaching 292,000, 17% of all foreign workers in 2006. Table 2 indicates the top 10 overseas nationals entering the UK and obtaining a national insurance number.

Figure 2 depicts the geographical split of the foreign nationals living and working in the UK in 2006. The migrant workforce tends to inhabit the more highly-skilled occupations and centred within London. However, London is becoming less important, its proportion has fallen from 45.3% in 2005 to a fraction over 41% in 2006. The rest of the South East appears to be witnessing the growing trend with 18.5% of the total in 2005 which has increased to just over 20% in 2006.

Over two million people are currently employed in the UK construction industry. The make-up and capacity of the current UK labour market is viewed as the primary cause for concern when assessing the industry's ability to deliver major construction projects on time and within budget. Skilled labour shortages have fuelled wage inflation whilst at the same time we have seen an increase in delays coupled with diminishing quality levels.

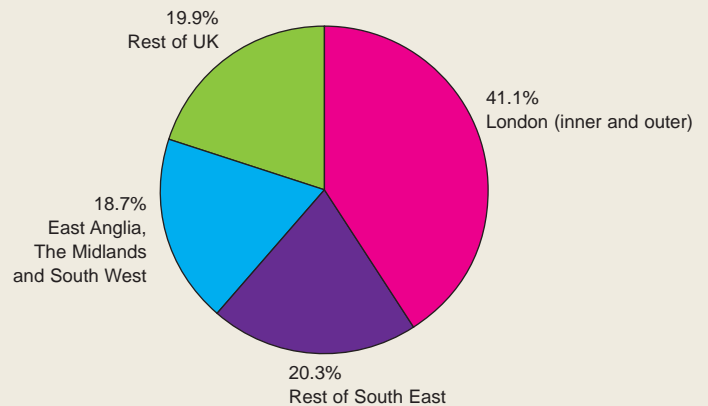
The perception of utilising migrant labour within the construction industry is mixed. Where employers are seeking skilled workers, recruitment of migrant workers is directly related to skills shortages. It is perceived by some that migrant workers are helping to address these difficulties. In London in particular, where demand is set to expand with the build-up to the Games in 2012, some employers believe that without the influx, the building industry would not be able to deliver the volume of projects proposed. Outside of London, in other parts of the UK the reasons cited include poor communication, little or no qualifications and,

more importantly in the past, a lack of legal documentation as the main problems with employing migrant labour.

On balance the influx of foreign labour has tended to increase supply above the level of demand in the UK and therefore has been one of the factors contributing to reducing wage inflationary pressures within the industry. There is, however, a definite trend appearing which indicates that, although the inflow continues to be relatively skilled, the foreign inflow is now more concentrated at the lower skilled end of the labour market. If continued, this will lead to an overall reduction in the skill level of the immigrant workforce.

This article has identified that in terms of the major projects which are taking place over the next five years, including the Olympic Games, the ability to source low and medium level skills from the international labour market will help to keep inflation costs under control. However, while cheap unskilled labour may be readily available to help support these projects, the greater concern can be found at the top-end of the industry. It is reported that an average annual requirement of approximately 4,500 and 6,800 new professional construction staff is required in Greater London and the South East respectively between 2006 and 2010. Finding these skilled, and more to the point, UK construction industry-experienced professionals to coordinate the projects is the biggest and potentially costliest problem the industry faces.

Figure 2 Foreign nationals working and living in UK, by region, 2006



(Source: Labour Force Survey, Office for National Statistics)

Table 2 Top 10 overseas nationals entering the UK

Country	2002/03 thousands	% of total	Country	2005/06 thousands	% of total
India	25.0	7.2%	Poland	171.4	25.9%
Australia	18.9	5.4%	India	46.0	6.9%
South Africa	18.6	5.3%	Lithuania	30.5	4.6%
Pakistan	16.8	4.8%	Slovakia	26.4	4.0%
France	13.8	4.0%	South Africa	24.0	3.6%
Phillipines	11.8	3.4%	Australia	23.8	3.6%
Spain	11.7	3.3%	Pakistan	22.3	3.4%
Zimbabwe	10.3	2.9%	France	17.2	2.6%
Iraq	10.1	2.9%	Latvia	14.2	2.1%
Portugal	9.8	2.8%	Germany	13.3	2.0%
Total	349.3		Total	662.4	

(Source: Labour Force Survey, Office for National Statistics)



International viewpoint

Spotlight on the international economy

Global economic growth rose strongly (4%) in 2006 despite higher oil prices and natural disasters, aided by exceptionally strong growth in the US (3.3%), a continuing boom in China (10.7%) and India (9.2%) and rapid expansion in Japan (2.2%). Notwithstanding the uncertainties of the world, the global economic forecast still looks well set to maintain its pace, with an average growth of 3.4% per annum towards 2009.

The US economy grew strongly in 2006. However, the economy has begun to show signs of a sharp slowdown this year. The housing market remained a substantial drag on growth with residential investment declining. It is expected that the economy will slow during this year before it return to moderate growth in 2008, with a forecast growth of 2.3%, 2.6% and 2.9% for 2007, 2008 and 2009 respectively. Inflation has eased in recent months, with CPI falling to 2.7% in February from 2.9% in September. Consumer price inflation in the US is predicted to increase in a similar profile to that of GDP over the next two years.

Japanese economic expansion appears to be well established and remains on track, picking up strongly in the first half of 2006 while deflationary pressures continue to ease. The Bank of Japan has raised its policy rate gradually since exiting its zero interest rate policy in July 2006, after seeing robust growth of the economy. The interest rate is now steady at 0.5%. The Japanese economy will see a strong growth during this year with a forecast growth of 2.6%. GDP is expected to grow by 2.2% in 2008 but forecast to slow to 1.7% in 2009. A marginal increase (0.2%) in consumer prices was seen in 2006, and an increase of 0.4% and 0.7% is forecast for 2007 and 2008.

Among emerging market and developing countries, rapid growth was led by China and India. In China, GDP grew more than 10% in the first half of 2006 following the announcement of the re-assessment of its GDP size and growth, which suggests that China is fast becoming the fourth largest economy in the world. Fuelled by strong growth in investment and lending and booming construction activities, the economy is expected to continue to exceed expectations, with forecast growths of 9.8%, 9.1% and 8.1% for 2007, 2008 and 2009 respectively. China maintains relatively modest inflation while enjoying strong economic growth. China is not expected to suffer from excessive inflation over the next two years. CPI inflation is forecast to grow by 2.5%, 2.7% and 2.8% for 2007, 2008 and 2009 respectively.

In India, GDP growth has continued strongly, driven by strong domestic demand. GDP is expected to grow by 7.8% in 2007 but will slow to 7.6% in 2008. India witnessed a higher inflation (6.2%) in 2006. A similar rate of inflation is expected during this year before cooling down to 4.8% in 2008.

In the UK, the pace of GDP growth is expected to cool slightly during this year as the consumer recovery is stalled by tight policy conditions. The UK economic performance is discussed further on the front page as well as in a view from our Managing Director article on page two.

The Eurozone recorded a growth of 2.7% in 2006, its best since 2000, boosted by healthier consumer demand and strong investment in many member countries. In particular, Germany had enjoyed strong economic growth and low inflation during 2006. The GDP growth of the region is forecast to slow to 2.2% in 2007 and expected to maintain the same pace through to 2009.

GDP growth in sub-Saharan Africa posted a strong growth at 5.1% in 2006 aided by surging growth in oil-producing countries and improved macroeconomic and structural policies. As well as increasing external aid, the economic growth trend in the region is encouraging. Economic outlook in Africa remains positive with a forecast growth of 4.9%, 5.2% and 5.2% for 2007, 2008 and 2009 respectively. Inflation (excluding Zimbabwe) is on a declining trend while fiscal and current account balances are in surplus at the regional level.

Middle East oil exporters enjoyed a year of solid growth of 5.7% in 2006. Having taken into account the current military conflict in the region, GDP growth is expected to maintain its pace in 2007, with a forecast growth of 5.3% and increased slightly to 5.5% in 2008.

Our viewpoints on the global GDP and CPI over the next five years (2006-2011) are included in this edition and can be seen on the maps opposite on page five. The GDP growth map is designed to give the reader an indication of an average range of economic growth between various countries around the world. The CPI growth map gives the expected inflation that different countries in the world are likely to suffer or enjoy over the next five years. We hope you will find this of interest.

Figure 3 Average annual GDP growth 2006 – 2011

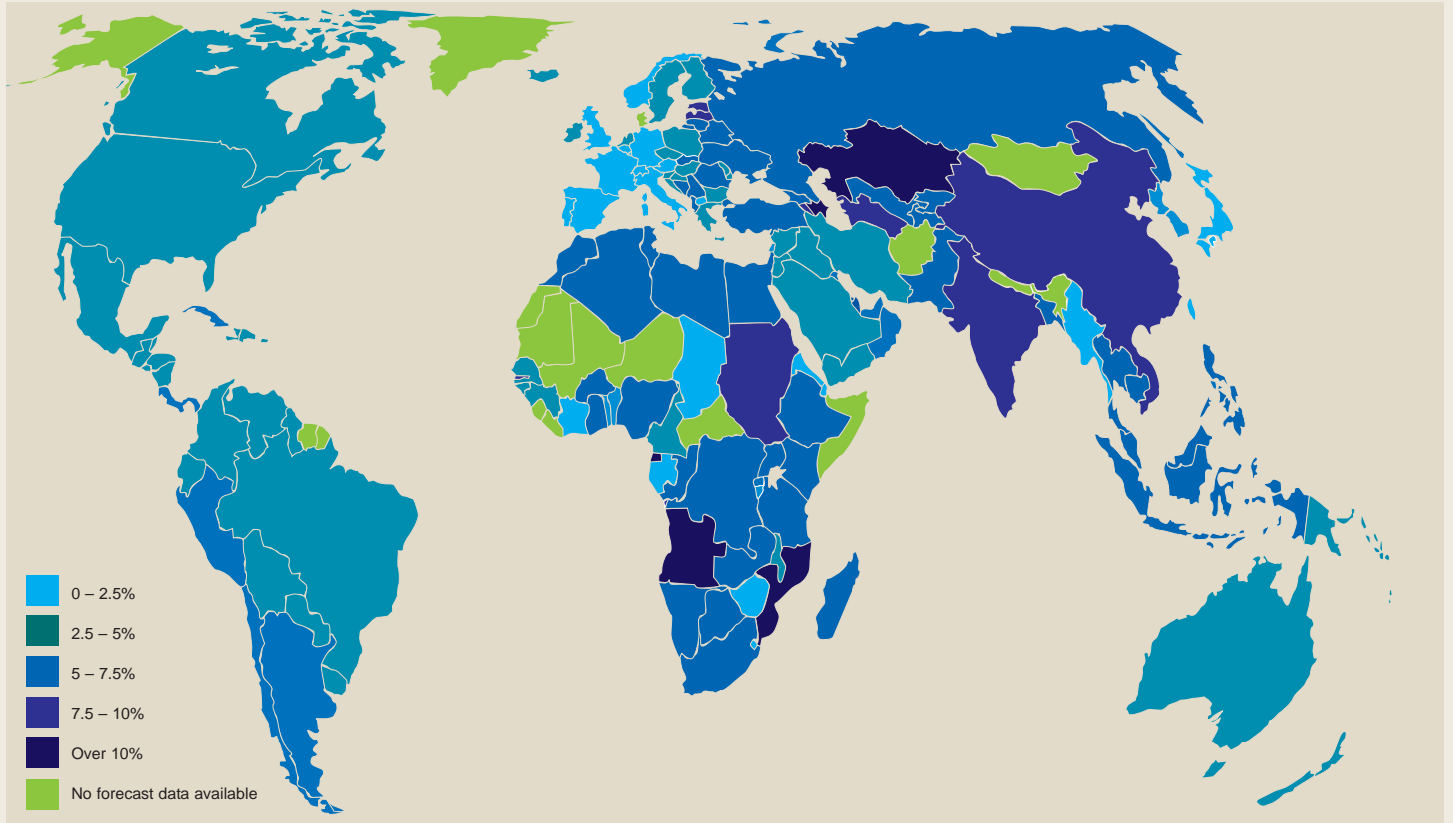
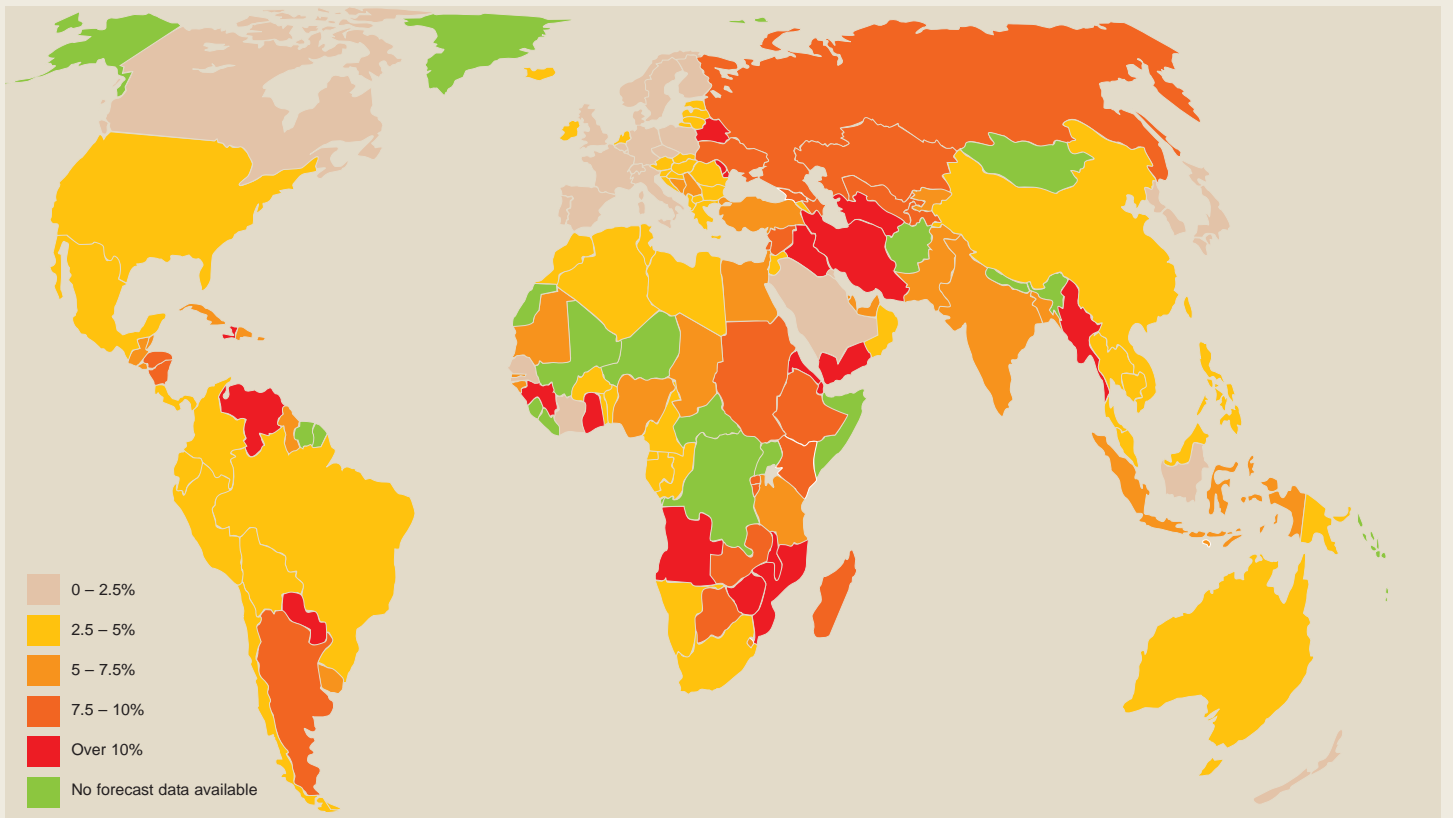


Figure 4 Average annual CPI growth 2006 – 2011





Commodity analysis – copper

Sources and destinations – where is it all going?

In this issue of the commodities analysis, we take a look at the relationship between imports and exports of copper to help us understand the impact that economic growth internationally is having on supply and demand between the UK and other regions around the world. This article features information on volumes traded between 2002 and 2006 and market prices for the period March 2005 to March 2007.

Europe easily dominates as both the largest source of copper for the UK, as well as being the largest export target of copper from the UK between 2002 and 2006. The balance between imports to the UK from Europe and exports from the UK to Europe is fairly close, but has reduced over the period studied. The volumes are considerably greater than those of the next largest import source to the UK, Latin America.

Latin America is a net exporter of copper primarily to feed the growing markets of Asia, and in particular India and China.

Extracting copper from increasingly remote and expensive locations is becoming more acceptable due to the lack of copper within lower cost copper deposits. This supply issue is weakened further with the huge increase in demand from China with its rapidly growing construction and electronic industries. The impact on the rest of the world is higher commodity prices and supply constraints.

Copper imports

We looked at UK copper imports in terms of weight and value between 2002 and 2006 to determine the size of the UK copper industry. Europe and Latin America are the main exporters of copper to the UK. During 2002 the UK imported 357 thousand tonnes of copper from Europe and 180 thousand tonnes from Latin America, followed by an import of 11 thousand tonnes from Asia (excluding China) as shown in Figure 5. Europe and Latin America continued to be the largest exporters to the UK. However, imports from these two regions to the UK dropped around 0.83% and 73.5% respectively in 2006 compared to 2002. In contrast, there was an increase in copper imports to the UK between 2002 and

2006 from Asia (excluding China) of 34% and from China itself with the highest increase of 160%.

In 2002, the import weight of copper to the UK from Latin America was over three times higher than during 2006, but was not reflected in the import value as can be seen in Figure 6. Between 2002 and 2006 the copper import weight from Latin America dropped by 73%, but the import value only showed a 6% reduction. This demonstrates that there has been inflation in the cost of importing from Latin America to the UK between these two years. This inflation trend can be seen throughout all regions but especially Africa where the import weight to the UK dropped by 15% in 2006, but imports by value rose by 206% (from £2.38 million to £7.29 million) for the same year.

Copper exports

Similar to the import studies in this part of the article, we have highlighted UK copper exports in respect of weight and value for the period 2002 and 2006. From Figure 7 it is clear that exports from the UK to Europe, Asia and China dominated all of the other regions for both 2002 and 2006. Europe was the largest importer of copper from the UK in 2002, with 286 thousand tonnes, but decreased by 10% to 257 thousand tonnes in 2006. China imported 36 thousand tonnes in 2002 which since then has seen a massive 274% increase to 136 thousand tonnes in 2006.

There has been an overall increase of copper export values between 2002 and 2006 for all the regions studied. However, North America had the third largest import value of copper from the UK in 2002 of £48 million, after Asia (excluding China) which had an import value of £71 million and Europe with £395 million, as shown in Figure 6. The export value to China was the fourth highest at £19 million during 2002. During 2006 there were major changes in the market. The 274% increase in copper exports by weight to China (as described in the previous paragraph) resulted in an astonishing 943% increase in export value here in 2006, a value of approximately £202 million. Therefore,

Figure 5 UK copper import by weight (tonne)

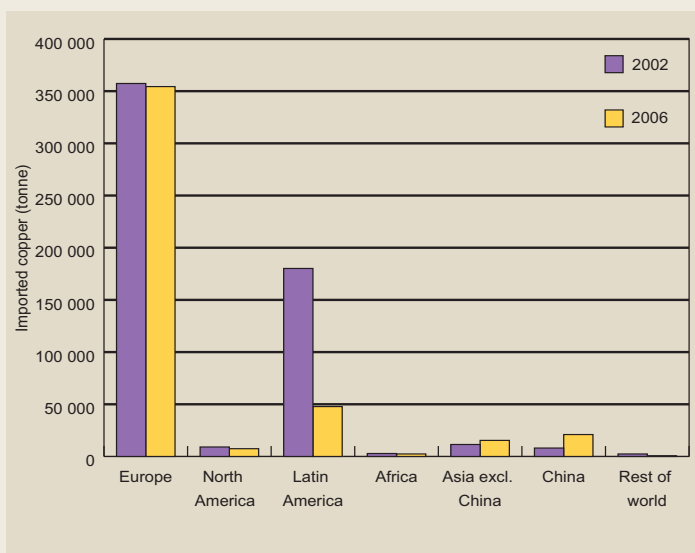
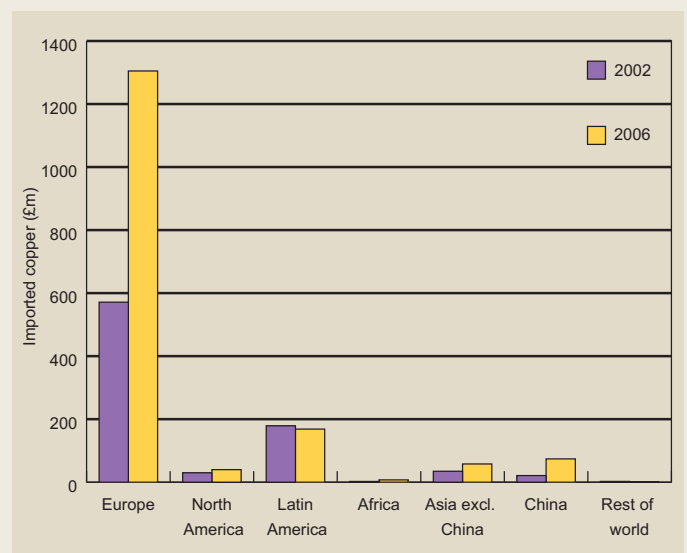


Figure 6 UK copper import by value (£m)



during 2006, export values to China were the second largest after Europe; followed by Asia (excl. China) with £131 million and North America dropping down to fourth in the rankings with a value of around £58 million. Similarly, there was a major hike in the value of exporting copper from the UK to Europe between 2002 and 2006 where copper value rose from £395 million by 121% to approximately £873 million.

Copper prices

Copper prices recovered during 2005 from the surge of 2004 and began to move up again at the beginning of 2006. Copper trading prices on the London Metal Exchange (LME) peaked in May 2006, recorded at \$8,042 per tonne, the highest prices for copper we have seen so far. Copper prices declined by around 31% by the end of 2006 enabling the price of copper pipe and fittings to drift downward from September but move up again in March 2007, which shows the volatility of the copper market.

Figure 9 illustrates the movement of copper trading prices on the LME against both the manufacturing of copper pipes and the complete cost of supply and installation. It shows that the rise and fall in copper trading price has a similar impact on both the manufacturing and supply/installation but not at the same level. This is because there is more than one factor in the production of the base metal; factors such as labour, the manufacturing process, packaging, branding, distribution, overheads and profit, which all play an important part in production.

During the period (March 2005 to March 2007) copper trading prices on the LME have increased by 98.6% while the price of copper pipes leaving the factory gate has risen by 51.6%. We expect that the copper market will continue to sustain high prices during this year driven by supply tightness and robust demand particularly from China.

Figure 7 UK copper export by weight (tonne)

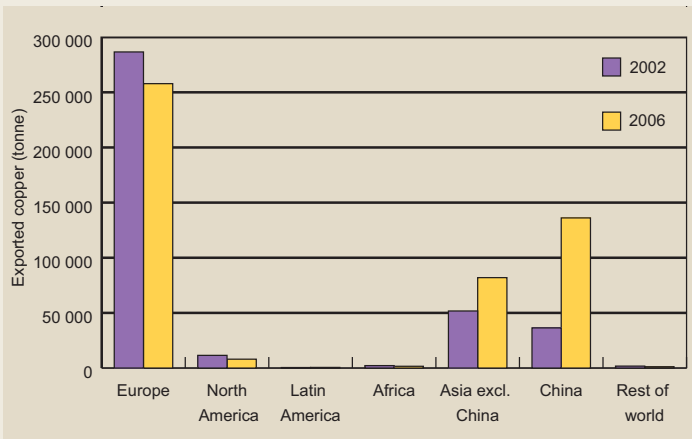


Figure 8 UK copper export by value (£m)

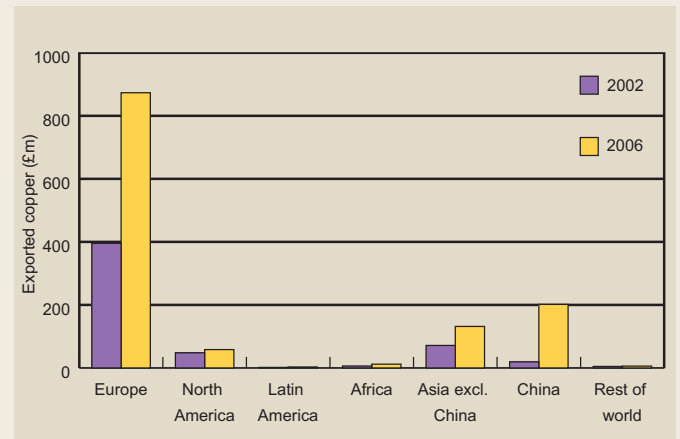
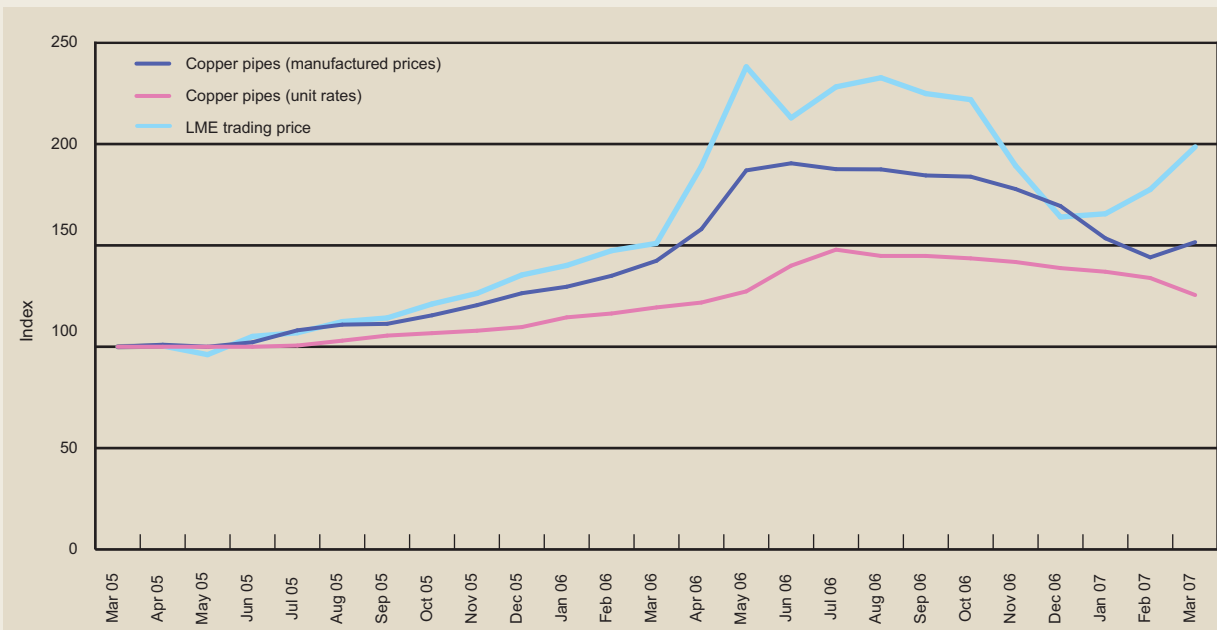


Figure 9 UK copper price trend (March 2005 – March 2007)





Inflation analysis

Landfill tax update

Landfill tax, first introduced on 1 October 1996, had as its main purpose the objective of encouraging waste producers to generate less waste, recover more value from waste, for example through recycling, and to use more environmentally friendly methods of waste disposal. The tax is charged by weight and there are two rates. The standard rate which is associated with 'active' waste (waste that gives off emissions) and the lower rate which is associated with 'inactive' waste (inert waste which does not react, biodegrade or adversely affect other material matter in a way likely to give rise to environmental pollution).

In addition to the tax a landfill tax credit scheme was introduced which enables landfill operators to donate up to 6% of their landfill tax liability to environmental projects in return for a 90% tax credit. Up to August 2006 the value of donations had reached over £834 million of which over £695 million was reinvested in environmentally qualifying projects.

Every year the landfill tax is reviewed in the budget with subsequent changes taking affect at the beginning of each financial year as illustrated in Table 3. The Chancellor of the Exchequer continued with his strategy of increasing the rate progressively in his latest budget.

Changes in the landfill tax have been announced, the lower rate for inactive waste will increase for the first time by 25% in 2008 and the standard rate for active

waste is set to continue increasing as it has done each year since 1999. The standard rate increased for the third consecutive year by £3 per tonne this year and is set to increase by £8 per tonne for each of the following three years until 2011, culminating in a rate of £48 per tonne.

The cost of landfill is becoming increasingly unattractive and is reinforcing the pressure on waste producers to seek alternative waste management solutions. Landfill tax is set to increase to more than five times its original amount by 2010 since its introduction. Putting this into perspective, Franklin + Andrews building cost index (BCI) is forecast to increase by just 74% over the same period.

The focus of construction on brown-field sites has increased the potential threat of dealing with contaminated waste. However, contaminated land can be treated by a variety of site remediation techniques that become viable in comparison with the traditional 'dig and dump' option. A number of environmentally friendly options are available and should be considered according to the function they need to fulfil.

Insitu solidification with cement grout
A technique that involves the injection of a cement grout into the contaminated soil. The result contains the contaminants within a solidified mass.

Bio-remediation
Using biotechnology the contaminated materials in the ground are converted to reduce toxic and harmful elements.

Soil flushing
As the name implies, effectively flushing the impurities out of the soil.

Soil stabilisation/chemical immobilisation
This is a process of containing the contaminants with cementitious materials or filtering them out using a permeable active barrier, then treating the

containment with bio-remediate chemicals.

Some of the techniques can also be carried out ex-situ and would enable the reuse of that material into other projects in their vicinity. Treatment of the contaminated soil would enable lower category waste products to be produced with a more environmentally friendly impact and, therefore, lower disposal fees.

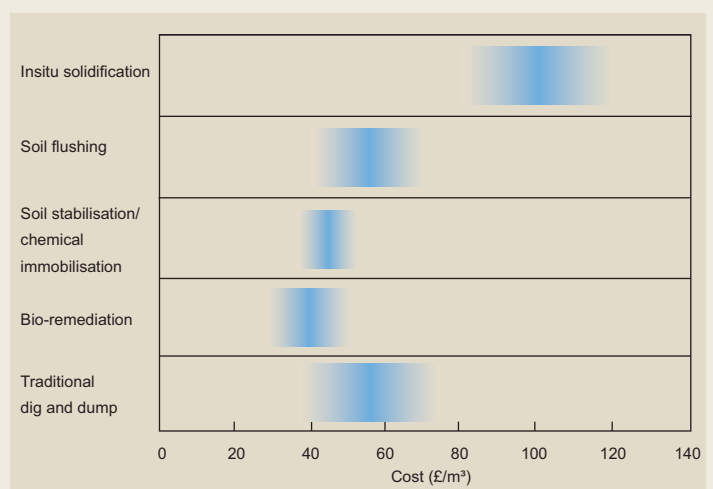
Costs for each option vary dramatically according to the size, nature and complexity of each project but would typically be as demonstrated by figure 10.

Table 3 Landfill tax rates (£ per tonne), including proposed changes

Date of change	Active waste (£ per tonne)	Increase per annum	Inactive waste
2004	£15.00	7%	£2.00
2005	£18.00	20%	£2.00
2006	£21.00	17%	£2.00
2007	£24.00	14%	£2.00
2008*	£32.00	33%	£2.50
2009*	£40.00	25%	£2.50
2010*	£48.00	20%	£2.50

*Proposed

Figure 10 Typical ranges of site remediation cost



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