



South East Diamonds for Investment and Growth

Building a Knowledge Economy

Report 1: Executive Summary

March 2010


CLES
Centre for Local
Economic Strategies


**SOUTH EAST
DIAMONDS**
for investment and growth



March 2010

***BUILDING A KNOWLEDGE ECONOMY: RESEARCH AND ACTION PLANNING FOR
THE SOUTH EAST DIAMONDS FOR INVESTMENT AND GROWTH***

REPORT 1: EXECUTIVE SUMMARY

Final report by

CLES Consulting

Presented to

South East Diamonds for Investment and Growth

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1 INTRODUCTION

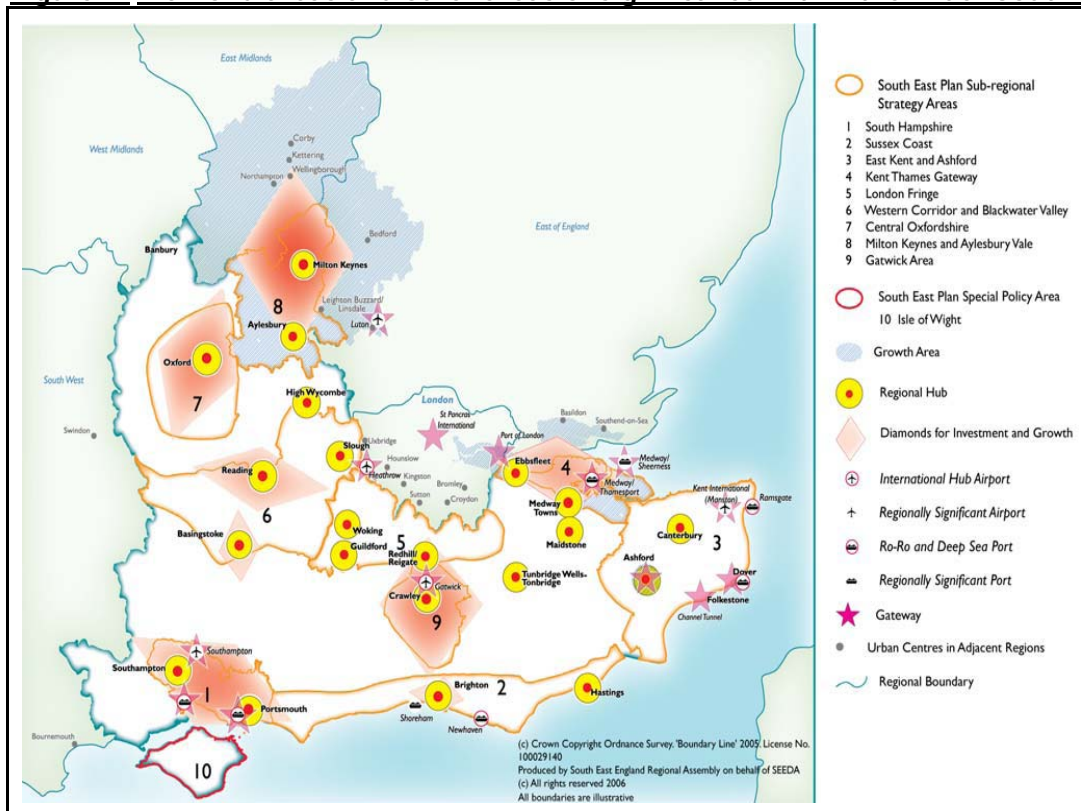
CLES Consulting was commissioned by South East Diamonds for Investment and Growth (SEDFIG Partnership) in October 2009 to undertake research and action planning on the knowledge economy within the 'Diamond' areas shown in figure 1 below; i.e. the functional economic areas with the most potential to accelerate long-term sustainable economic growth in the South East of England.

The purpose of the commission was to assess the size and potential of emerging industrial sectors within South East Diamonds focussing on knowledge economy sectors and the development of related policy actions. However, as part of a wider consideration, it also makes reference to the 'enabling factors' of growth including regional assets and infrastructure.

The project follows the requirements outlined in the original brief, providing SEDFIG with an evidence base to help identify future priorities around the development of its knowledge economy. As such, it follows the standard geographical definitions set out in the Diamond's prospectus and uses the same (latest) supporting methodology agreed with partners to quantify each local economy. The work's outputs consist of the following **five** reports:

- 1) **Executive Summary** – Providing a synthesis of the research findings and recommendations;
- 2) **Policy Review** – Identifying policy initiatives in various sectors of the knowledge economy within the UK and its implications for SEDFIG, together with a narrative on defining the knowledge economy and outlining critical success factors;
- 3) **Place analysis** - of economic performance within the Diamonds, including a review of sector strengths by location and supply side issues including employment, skills;
- 4) **Sector analysis** – detailed analysis of the sectors outlined for potential growth in the Diamond's 'Prospectus for Prosperity' and HMG 'New Industry New Jobs' policy documents;
- 5) **Action plan** – outlining a series of development actions for partners and lobbying messages for central and regional policy makers, as well as summarising potential research-paths to drive further strategic thinking and understanding in this area.

Figure 1: Diamond areas and other areas of significance within the wider South East ¹



¹ Source: SEEDA, Regional Economic Strategy 2006

2 INTRODUCTION

The following report provides a synthesis of the research findings and recommendations. As an executive summary, it should be read in conjunction with the action plan and supporting reports.

2.1 Definitions

In the 1990s, the Organisation for Economic Co-operation and Development (OECD) proposed a generic definition of the term in developing strategies for individual countries:

'A knowledge economy is one that encourages its organisations and people to acquire, create, disseminate and use codified and tacit knowledge more effectively for greater economic and social development.'

Approaches to defining and measuring the development of the knowledge economy have concentrated on the growing importance of:

- ❑ **Knowledge Based Industries/Sectors - KBIs (OECD definition)** – high technology industries (ICT, aerospace, pharmaceuticals) and financial and business services;
- ❑ **knowledge based functions in all sectors** – knowledge creation (research and development; and design), economic co-ordination (marketing, distribution, administration) and internal transfer of knowledge (training);
- ❑ **knowledge workers** – professional, managerial, scientific and technical occupations across all industry sectors;
- ❑ **knowledge related investments** – research and development, public/private education, ICT hardware, software and services; and
- ❑ **intangible capital** – production and dissemination of knowledge (education, training, research and development, information and co-ordination) and investment geared to sustaining the physical state of human capital (health expenditure).

Throughout the study we make reference to Knowledge Based Industries (KBIs) and knowledge sectors, covering those identified by recent government policy – New Industry, New Jobs (NINJ). These are typically sectors which employ over 40% of graduates within their workforce.

However measuring the size and economic value of the knowledge economy – with high degrees of precision - is a complex issue. It must be realised that the knowledge economy is not just limited to a few high technology products and services and that it extends across a wide range of firms and industry sectors which we outline throughout the study.

Another important consideration is that not all jobs which fall under a KBI 'industry sector definition' (i.e. employed within KBI firms/organisations) are knowledge intensive. This is important in two respects, as follows:

- 1) that public administration, education and health sectors cannot be classed entirely as knowledge intensive - but it is not possible to disaggregate the sectors further using existing national statistics - making it difficult to quantify the 'knowledge economy' with degrees of precision; and
- 2) that KBI's/firms support a range of occupations, ranging from knowledge intensive professional activities to auxiliary jobs that deliver essential support services.

It is therefore important to consider both the stock of skills - and the skills development needs - of the whole labour force that contributes to local productivity, performance and 'knowledge economy'. Indeed high skilled niches cannot thrive in a sea of low skills; and the productivity of the most skilled workers inherently depends on the skills and productivity of those around them.

2.2 Drivers of change

Before setting out the size and performance of the knowledge economy across the Diamond areas it is useful to set out the key drivers of change that will affect the future growth potential of the UK economy. The following are heavily linked to the prominence of knowledge intensive activities:

- ❑ **population and socio-economic change** – meeting the challenges of an ageing population (and the opportunities for business and employment that may emerge);
- ❑ **globalisation** – the balance of international economic activity is currently shifting towards the emerging markets of both China and India, increasing cross-border competition;
- ❑ **innovation and technological diffusion** – the pace of innovation and technological diffusion is a key driver of productivity in the economy and in the creation of more competitive markets;
- ❑ **increasing pressures on natural resources and global climate** – as the cost of carbon rises in response to tighter climate change policies, further industrial restructuring will be required;
- ❑ **continued global uncertainty** – addressing the ongoing threats of international terrorism.

The Government has recently set out a strategic vision for Britain's recovery, *New Industry New Jobs*, highlighting how it will work with business, markets and industrial sectors to address these challenges and opportunities. The NINJ paper sets out how the Government will:

- ❑ adapt and strengthen policies towards innovation, skills, finance, infrastructure and access to global markets;
- ❑ use its role and influence in the market in a new and more strategic way, addressing market failures and shaping outcomes by acting on the environment in which businesses operate; and
- ❑ use a new approach to targeted interventions.

NINJ identifies a number of market areas where the UK has comparative advantage and where interventions to support future growth may be undertaken. Sectors covered include:

- ❑ **financial and professional services** – this sector represents one of the country's core strengths. Despite the recession, the UK's position as a global financial centre will continue;
- ❑ **engineering construction** – the Gibson Review, published in December 2009, has made a number of recommendations on improving productivity and skills within this sector;
- ❑ **opportunities in an ageing society** – covering economic opportunities both in manufacturing and services, e.g. leisure needs and care, drug treatments for old age;
- ❑ **advanced manufacturing** – a number of new engineering opportunities have been identified, including aerospace/composite materials, industrial biotechnology and plastic electronics;
- ❑ **life sciences and pharmaceuticals** – the Government is reviewing how the NHS can promote innovation, and how the UK can get medicines to market faster;
- ❑ **digital Britain** – the Government plans to update digital networks, establish a climate for investment in digital content, and provide quality infrastructure for UK users;
- ❑ **low carbon/environmental technologies** – covering opportunities facing businesses across the economy through rising demand for low carbon products and services;

The sector strengths identified in the SE Diamonds' 'Prospectus for Prosperity' correspond strongly with the agenda outlined in the New Industry report. Where possible we use a combination of national statistics, literature review and local consultation to explore industry performance across the Diamond's. Our main findings are set out in the rest of this executive summary, more detail is provided within each of the constituent policy and analytical reports.

3 BUSINESS, ENTERPRISE AND INNOVATION

The knowledge economy is vital for the future of the Diamonds and for the wider South East. With a greater concentration of people, businesses, skills development and support services, knowledge networks and cluster development, and greater scope for improving shared infrastructure and public services, all mean that urban centres within the Diamonds are vital hubs of the knowledge economy.

The Greater South East and London have clearly been the key economic engine of the UK's economy over the last 20 years. This position will remain unchanged as the UK returns to growth, with the South East remaining the home to some of the UK's most productive firms - in both manufacturing and service industries - a centre for global headquarters with strong international connections, and nationally significant concentrations of knowledge workers and high value employment opportunities. Looking across the South East, we find that, up until the current recession, the Diamond's economies are some of the best performing in the UK, with business start-up and survival, and economic activity rates exceeding national averages, and the region's urban centres driving the knowledge economy. The Diamond areas constitute half of all Knowledge Business Industries (KBI) employment within the wider South East. As a percentage of total employment, KBI employment is, on average, higher in the Diamond's than both the corresponding regional and national levels.

We find that across the Diamond sub-regions, the areas with the highest KBI employment, by volume, are: Oxford, Reading and Urban South Hampshire; areas which also have a high proportion of their total employment in KBIs. However, the Diamond with the highest share of KBI employment is Brighton and Hove, with almost two-thirds of its workforce working within KBIs. This is due to high levels of employment within sectors such as creative/digital/new media, business services, education and healthcare. KBI employee growth has been particularly pronounced within Milton Keynes and North Hampshire in the last decade, two of the fastest growing areas in the UK, driven primarily by growth within business services and also by ICT and education activities. Brighton and Hove and Thames Gateway are two other recent key growth nodes, with Thames Gateway in particular experiencing significant employment growth in the last five years, particularly in business support services industries.

Looking across industry sectors, we find that the highest concentrations of KBI employment, within the Diamonds, was in ICT and creative/digital/new media. These sectors were highly specialised within Reading (IT hardware development and software) and North Hampshire (IT and communications), with both areas experiencing significant comparative advantages due to the clustering of international headquarters and deep labour markets within the surrounding Diamond areas. These sectors have also seen significant growth across most Diamond areas over the last decade, in particular within North Hampshire and Milton Keynes (e.g. software consultancy) and in Brighton and Hove (e.g. Creative / Digital / New Media technologies).

Despite the overall decline in manufacturing employment within the UK's economy (through a combination of growing capital intensity, increased outsourcing and geo-sourcing), the sector still remains an important part of the region's economy – both in jobs terms but most importantly due to the concentration of some of the most productive advanced industries in the UK's economy. We find key concentrations of advanced engineering and manufacturing firms exist across many of the Diamond areas, many linked to large global firms in the automotive (e.g. Oxfordshire), marine and aerospace (Urban South Hampshire) or pharmaceutical sectors (Gatwick); however particular global specialisms in space science, material science, life-sciences and bioscience exist within Oxfordshire linked to internationally renowned research institutions and development facilities (e.g. Harwell Science and Innovation Campus and Rutherford Appleton Laboratory; Universities and many National Research Institutes.)

During the course of our study, we noted several key initiatives in place to boost enterprise and innovation throughout the South East which will invariably affect the future performance of the Diamonds. Our consultation highlighted that, alongside Knowledge Transfer Partnerships, there is a potentially greater role for Universities and Research Institutions to play in supporting both regional and local innovation. That is, using the "low competitive/secretcy spaces", knowledge contacts and opportunities afforded by HEIs to help pull different sector networks together within the region – the view by practitioners in the area that inter-sector networks and firm collaboration works best to support new ideas and growth, especially around joint supply chain opportunities or in tackling joint technical problems. Again, the region's Development Agency and relationships with regional science and innovation campus will also be key in helping join up activity across Diamond areas.

4 EMPLOYMENT AND SKILLS

As the economy becomes increasingly knowledge intensive, the recruitment and retention of talent becomes even more important. A growing population, a healthy, skilled labour market, and access to the right training and education are all factors that support economic growth. The Diamonds need to ensure all these criteria are met to warrant its future as a globally competitive region.

The South East Diamonds have a strong labour market in terms of employment, skill levels, earning and occupational structure, reflecting the highly productive economies and diverse mix of knowledge based industries within the sub-regions (and the wider South East). This strong labour market performance is not uniform however, with some Diamonds driving growth with considerably weaker labour markets, leading to potentially difficult policy choices around focussing investment within the knowledge economy. The lower skills performance in some Diamonds is acting as a brake on productivity growth and the development of long-term economic resilience in the South East.

We find that Reading, Oxford and North Hampshire have, in line with economic performance, experienced the strongest labour market performance in terms of growing the proportion of high level employment opportunities and workforce skills, whereas areas such as Thames Gateway and Urban South Hampshire continue to face significant challenges in developing a deep labour market and a highly skilled workforce. Issues of deprivation, worklessness and skills continue to inhibit growth.

The occupational characteristics of the labour market remain central to the Diamonds competitiveness. They shape the economic opportunities that residents are able to access and are a key indicator to the strength of the existing knowledge economy. Over the last decade, there has been a structural change in occupations from non-skilled occupations to management and professional, resulting in a declining demand for skilled craft workers and lower skilled manual workers, as the economy shifts further towards knowledge intensive activities within the economy. Overall, we find Reading, Oxford and Brighton and Hove have the highest proportion of people employed in the higher skilled and professional and managerial occupations, however in the case of the latter, many also commute to other areas such as London.

Wage earnings are another key indicator of the interaction between labour supply and demand in an economy, and the living standards of its employees. High earnings can be an indicator of strong labour demand as well as higher value activities in an economy, whilst low wages imply either low demand for labour or lower value added activities. The highest wages are within the Reading, Gatwick (due primarily to commuters into London) and North Hampshire Diamonds, with low averages in Thames Gateway and Urban South Hampshire. The pattern of high resident earnings across the Diamonds illustrates many of the residents will commute, perhaps to another Diamond, but this also highlights the economic relationship with, and pull of, London. This is less so the case for North Hampshire and Reading, reflecting the concentration of high value, knowledge intensive jobs within these Diamonds.

In terms of labour market performance and skills we find a significant positive correlation between high level graduate skills and the proportion of the workforce within knowledge industries. Oxford, Reading, Brighton and Hove, and North Hampshire all have Level 4 skills profiles above the national and regional average. Oxford and Reading have a particularly strong labour market performance in terms of both resident skill levels (linked to the presence of HEIs) and also in workforce skill levels, linked to the concentration of knowledge employment within these Diamonds. Whilst a detailed sectors skills analysis was outside the scope of this study (we understand a skills study is currently in progress within the Diamonds) we noted a number of high level skills issues during our consultation work, including the following:

- ❑ **ICT and Creative / Digital / New Media skills** – despite the economic conditions there were still shortages of particular specialist technical skills including hardware programming and CAD;
- ❑ **Advanced Engineering** – new entrants perceptions of employment within the sector compounded by perceptions of economic uncertainty (especially with some key employers), giving rise to shortages in specialist engineering skills; and
- ❑ **Generic / high Level Skills** - general attraction and long-term retention of graduates due to issues of housing affordability and lack of career opportunities in particular Diamonds.

5 INFRASTRUCTURE

The purpose of the commission was to assess the size and potential of emerging industrial sectors within South East Diamonds focussing on knowledge economy and the development of related policy actions. However, as part of a wider consideration, it also makes reference to the 'enabling factors' of growth including regional infrastructure, transport and housing.

Transport

The transport network of the South East acts as a gateway to mainland Europe and the global economy. As well as much of the M25, the M3 and M4, the region is home to key strategic sea ports, airports and strategic rail links. The Diamond's relationship with London is also clearly important, with the wider South East providing good connectivity to the economic markets in and around London. However, we note a number of challenges that the Diamonds face, including:

- ❑ ***over reliance on the road as road capacity has not kept pace with demand*** – with the worst road congestion is concentrated in and around the M25 both into and out of London;
- ❑ ***low uptake of public transport*** – train commuting figures are lower than the UK average and the proportion commuting on buses is lower than other UK regions; and
- ❑ ***low investment in transport infrastructure relative to the UK*** – capital expenditure per capita on transport in the South East is the lowest of all of the UK regions.

Congestion is clearly a particular issue in the South East, with future prosperity of the Diamonds and the wider region being threatened by this challenge. The cost to business will increase and as the road network exceeds capacity, the effectiveness to connect people and goods across the region.

Digital Connectivity

It is critical that the appropriate levels of digital infrastructure are in place for knowledge based businesses to thrive in the Diamond areas. In particular, high speed broadband connectivity is now seen as a prerequisite for businesses. The take-up of broadband has increased markedly over recent years – and the South East having faster take-up rates than any other UK region - however there is still a concern that other cities around the world are investing more and developing high speed internet connectivity far quicker than in the UK. Whilst we note that ethernet access has been rolled out extensively within the Diamonds, the next generation super fast broadband rollout will be key in achieving optimum connectivity - providing access to over 1 million premises by spring 2010.

Housing

Housing, together with transport, is clearly a critical issue within the South East Diamonds. The economic vitality of the wider South East and its relationship with London has attracted substantial in-migration over the last 20 years which has stretched demand and increased house prices. The link between housing, skill levels and the knowledge economy cannot be overplayed. It is critical that the appropriate housing offer is in place for the skilled knowledge workers, without which it will be difficult to retain talent in the long run. We note a number of housing issues faced by the region which could potentially constrain growth:

- ❑ ***supply and demand pressure*** – the success of the South East's economy has led to intense housing pressure. The region has the highest house prices in the UK outside London;
- ❑ ***lack of housing affordability*** – house prices within the region rose by 70% during the last decade, whilst annual earnings increased by just 30% over the same period; and
- ❑ ***quality issues in public accommodation*** – in absolute terms the South East has the third largest number of sub-standard properties in the UK.

Our study highlighted that high house prices continue to be one of the most restrictive factors on business growth. During our consultations, examples were provided that firms were considering relocating from particular areas where housing markets were particularly constrained due to the difficulties of attracting and retaining workers – both existing staff and new graduates in particular.

6 ISSUES AND IMPLICATIONS

6.1 The UK economy

Despite a period of improving business opinion (measured in the national PMI surveys and opinion polls), the preliminary estimates of GDP from ONS illustrate that the UK economy continued to contract throughout 2009 – including the three months to September (latest) – with national GDP some 5 per cent lower than in the third quarter of 2008. Whilst there is a consensus that the worst of the economic slowdown is over, what is clear is that the road to recovery will not be straight forward. Looking forward a number of challenges remain. The supply of credit is a continuing source of concern; in particular the feeling from business that funds may not be available to support firms as signs of an upturn emerge. Without access to credit, low interest rates, a weaker currency and quantitative easing will count for very little. Secondly, there is a widespread view that public sector spending has to be reduced – potentially curbing the one part of the economy that has supported output over the last 12 months. A third concern is inflation. While many companies have seen costs rise and margins squeezed, inflation has remained higher for longer than many have expected. If inflation does come back, the risk arises that rates could be increased before recovery takes hold.

What is clear is that in the short-term, the Diamond's must work within the context of slower growth as the economy begins to recover - meaning potentially fewer opportunities. This is where supporting a highly productive knowledge intensive economy will be increasingly important to future prosperity. To do this, policy practitioners and businesses will need to work innovatively within future constraints around access to liquidity and public finance, ensuring highly focused and targeted approaches to supporting long-term economic development and creating the 'right' conditions, conducive for growth. Broadly there are two ways to help bring about a stronger – more productive – knowledge economy. One is to enhance and intensify the benefits of agglomeration (the benefits of proximity and connections between businesses, knowledge/innovation assets (HEIs and R&D institutions) the workforce/supply of skills) - to make the Diamond areas more attractive for business to continue to invest and people to continue move into these areas. The other is to reduce the costs of agglomeration within the Diamond areas, including a focus on delivering affordable housing, key transport links (both road and rail) and managing congestion costs – each frequently cited in this study (and others) as major "inhibitors to further growth" in a number of successful Diamond areas.

6.2 Future opportunities

The economy that emerges from the current downturn will continue to be defined by globalisation. The South East Diamonds need to plan for more than simply recovery from recession as the region (and UK) faces continued structural changes in the global economy. The world's economy is set to double in size and will present significant new opportunities for businesses – growing populations and rising prosperity; new technologies; the transition to a low carbon economy; changes in age profiles; and the spread of international supply chains will have an impact on the Diamond's performance. As other economies respond to the same opportunities, or try to replicate the UK's strengths, the competitive pressure our businesses face will intensify. The South East Diamond's response has to be to continue to raise productivity, improve resource efficiency and concentrate on developing comparative advantages. All this must help to differentiate the region's economy from that of other international regions. It will therefore be critical for the UK economy and businesses in the Diamonds to invest and skill-up to win in high-value markets and sectors. Two key inter-related elements will be critical to succeeding in this challenge:

- 1) The continued focus on ensuring that the South East (and UK's) economy is driven by, and has the relevant supply of, high levels of skill and creativity; and
- 2) ensuring that its economic base is continually moving to the front of technological change – where this is reshaping industries and demanding high levels of innovation, skills and investment from those businesses who will ultimately lead these markets.

In response to the first of these, increasing the number of Knowledge Business Industries and the level of demand that can be sustained in turbulent time will be critical. Research testifies that there are strong positive correlations between the concentration of high-level skilled jobs and levels of innovation and economic growth. The Diamond's have emerging and distinctive high-skill specialisms in particular around ICT, Bioscience and Advanced Engineering (Automotive Defence and Homeland Security, and Aerospace).

Actions to build upon these internationally renowned strengths and to manage the costs (the balance of what economists refer to as positive and negative externalities) to businesses located and trading within the Diamonds where these sectors are predominantly located (Oxford, Reading, North Hampshire and Milton Keynes) will be an important priority for future support and investment. The response to the latter will depend on ensuring the success of the private sector in developing product and process innovation and forging global trading networks with firms at the vanguard of technology and creativity. Leveraging the impact of the region's Higher Education Institutions (HEIs), and key regional science and innovation assets such as Harwell Science and Innovation Campus will be vital to the future success of the knowledge economy in the SE and for the economic engine that will drive much of the UK's future growth as the country moves out of recession.

6.3 A 'New' Industrial Activism

It is important to be clear throughout this study, that whilst we recommend setting a new agenda of industrial activism, we do not recommend picking winners, nor ignoring market signals, but taking steps to remove barriers which hold business back within the Diamonds. The South East Diamonds have the skills, resources and knowledge base to do well. However the response of regional and local policymakers must not be one of complacency. Nor has it been. It must be to strengthen the Diamond's competitive position further, creating the best possible conditions in which businesses can thrive; removing barriers to success and offering targeted support to unlock new potential in existing and new technologies. Key areas for the Diamonds, identified by NINJ for immediate action and reform, are centred on innovation, skills, finance, infrastructure and trade. They include above all:

- 1) more support for **innovation** - turning bright ideas into products that win in the marketplace by maximising opportunities from the work of HEIs, public and private research establishments;
- 2) improving policymakers ability to identify the **skills** needed for future success and making sure the education and training system delivers them;
- 3) making sure high growth, high innovation firms get the **financing** they need, including examining urgently whether, and in what form, further intervention could help increase the supply of long term growth capital to small and medium sized businesses; and
- 4) a coherent strategy for making sure Britain has the modern **infrastructure** and networks, from energy to broadband, that will be the foundation of future prosperity.

6.4 London and the South East

Finally, it is important to recognise the positive economic relationship between London and centres across the wider South East. The Diamond areas are crucial in providing London with the skilled labour pool it needs to be a global economic centre, and clearly transport, housing and other critical infrastructure have an important role to play here. The Diamond's will also continue to be important in ensuring there is no overheating in London's property market in the long-term, offering opportunities for firms looking to relocate or grow – whilst maintaining connections with businesses in the City centre – and across the South East. The spatial dimension and Diamond's relationship with London (and with each other) raises four critical areas that will need careful future management, ideally addressed within the forthcoming Regional Strategy, that will set out the framework for achieving long-term sustainable development. Considerations include:

- 1) ***Achieving balanced sub-regional development***, addressing growth in both knowledge-driven businesses and job opportunities – at the same time addressing economic inclusion;
- 2) ***managing the sprawl effects of London's knowledge economy*** – addressing pressures on housing, key worker shortages, house price inflation, traffic congestion and other negative spill-over effects (this will be critical in maintaining the South East's offer as a location for both inward investment and as a residential 'location of choice' for knowledge workers);
- 3) ***continuing to develop an 'urban backbone' across the South East*** - that drives and spreads growth and innovation in the knowledge economy: the answer here will lie in continuing to develop a dynamic and well connected 'poly-centric' region; and
- 4) ***meeting the challenge of developing effective local and sub-regional dimensions to the regional strategy*** - (including economic/skills and spatial strategies), while maintaining a strong sense of regional direction and identity. The South East's local authorities, local strategic partnerships and regional agencies each have to continue to be pro-active players in enabling the development of the knowledge economy.