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Reporting vs. reality

Fear of recession may itself undermine the economy, but not for long

Slowdown in UK economy in 1998 was expected, although domestic demand has been surprisingly weak in the last few months

Some slowdown in the UK economy was expected at the end of last year, when the typical forecast of 1998 output growth was 2 1/2% after 1997's 3 1/2%. But some features of the economy this year have been surprising. The "Asian crisis" has been more severe than envisaged, mainly because domestic demand in Japan has slumped. More puzzling is that UK domestic demand - which remained strong in the opening months of 1998 - has deteriorated since the spring. For example, the volume of retail sales was lower in September than in May. One argument is that the rises in interest rates since May 1997 ought to have restrained spending. However, few of the standard precursors of recession are flashing alarm signals at present. Personal incomes are rising steadily, while the personal sector's balance sheet is in good shape after several years of stock market gains and increasing house prices. Money supply growth has stayed rather high, and both corporate liquidity and institutional money holdings are above-normal.

Weakness of domestic demand may be due to a "mood change",

The explanation for the particular weakness of domestic demand in recent months may be a change in mood, following newspaper reports of falling share prices and financial turmoil in emerging markets. In normal circumstances economists who appeal to "mood changes" to support their views deserve to be fired. Nevertheless, there must be a possibility that collective mood swings make a difference to expenditure for a few months, and that lower expenditure then hits incomes and the next round of expenditure. Something like this may have happened in the summer and autumn of 1998. It is a rather thin analysis, but it may be viable.

but balance sheets remain strong, asset prices are high and money growth is comfortable,

However, the historical record is that big cyclical swings in expenditure are a response to balance-sheet disequilibrium (i.e., large asset price divergences from normal levels in association with balance-sheet strength or weakness, usually following fluctuations in broad money growth). In this context the recent mediocre performance of domestic demand is odd. If newspaper reporting about a looming recession has been enough to cause spending cutbacks, if people and companies have indeed been afraid of fear itself, the dip in the economy is likely to prove temporary. One point needs to be heavily emphasized. Because money holdings are comfortable and balance sheets are in good shape, the economy ought to be highly responsive to interest rates. The Bank of England was right to respond to gloomy business surveys by a 1/2% cut in base rates at its latest meeting, but if interest rates were slashed to, say, 5%, the rebound could be surprisingly powerful. The virtual 20% jump in American share prices in the last month - which makes a mockery of early October's newspaper stories about "wealth shrinkage" - is a clear warning against big interest rate cuts in an economy with excess liquidity (such as the USA's today).

arguing against big rate cuts

Professor Tim Congdon

6th November, 1998

Summary of paper on

"The City's long-term prospects remain good"

Purpose of the paper

Media reports of large cutbacks in City employment have proliferated in recent weeks. This research paper asks "will the cutbacks be a cyclical interruption of a long-term growth trend or something worse?".

Main points

* **Despite the reputed dynamism of international financial services, total employment in the Square Mile has fallen since the early 1970s. (See p. 6.)**

* **This decline in total employment has occurred despite substantial increases in employment and output in international financial services. The long-term boom in such services has led to:**

  - a "displacement effect", with low-value-added non-financial employment leaving the high-cost City (see p. 4),

  - an "overspill effect", with City-type employment spreading outside the Square Mile (see p. 7), and

  - an "upgrading effect", as incomes in the City have risen sharply relative to the national average (see p. 9).

* **The long-term trend growth of the City's output is probably 6% - 7% a year in real terms, although much depends on how "the City" is defined.**

* **The driving forces behind the growth of international financial services are the post-war global liberalization of trade, finance and capital movement, and "the offshore revolution".**

* **Assuming that these driving forces remain in place, the City can look forward to a few decades in which its output and employment will grow faster than the national average.**

This paper was written by Professor Tim Congdon, with help from Mr. Stewart Robertson, and is based on Lombard Street Research's study on *Growth Prospects of City Industries*, which was published by the Corporation of London in April.

The City's long-term growth prospects remain good

A cyclical setback? Or something worse?

Financial turmoil already causing some job losses

Recent turmoil in financial markets has prompted media comment about job losses in the City. For example, Mr. Anthony Hilton, the City Editor of the *Evening Standard*, noted in the October issue of Deloitte & Touche's *Securities and Banking Update* that, "Forecasts of 50,000 job losses across the City equivalent to 5% of the relevant labour force are now commonplace." Some significant redundancies have already occurred. Organizations as different as Merrill Lynch and the London International Financial Futures Exchange have made announcements that they will have reduce their employment in London by several hundred people.

Concern in last recession about over-supply of office space

Is this setback cyclical or is it the prelude to something much worse? In the last downturn, back in 1990 and 1991, job losses coincided with a large increase in office floorspace, as property developments started in the boom of the late 1980s were completed. The office vacancy rate soared, raising concerns that the City's industries had become internationally uncompetitive. These concerns led to some heart-searching among leaders of City opinion, including the Corporation of London, which financed the large and ambitious City Research Project to see whether anything was fundamentally wrong.

The City's economy growing faster than that of the rest of the UK

A research paper in the December 1994 issue of this *Monthly Economic Review* was stimulated by the City Research Project. It tried to answer the question, "is the City of London internationally competitive?". The verdict was that "the City has many high- growth industries", implying that there was "a good chance that the City of London's GDP will continue to grow faster than the UK's GDP". In 1995 Lombard Street Research was commissioned by the Corporation to conduct an analysis of the *Growth Prospects of City Industries*. The report was published in April this year. However, much of the data related to 1995 and was slightly out-of-date when the report appeared. The purpose of this research paper is to summarize the key points of Lombard Street Research's report and to add more recent statistics.

Anomaly of declining total employment in the Square Mile since the 1970s

Projections of the future have to start from a review of the past. A reasonable presumption was that the City ought to have enjoyed strong growth in employment over the 25 years to the mid-1990s because of the dynamism of international financial services, its principal economic activity. The first analytical challenge was that the facts appeared to contradict this presumption. Official data indicated a sharp decline in employment in the Square Mile from 390,400 in 1971 to 229,300 in 1993, followed by only a small rise to 249,200 in 1995. How could the decline in employment be reconciled with the assumed dynamism of international financial services?

The resolution of this conundrum was a fascinating exercise. There was no doubt - from a mass of data on various business flows - that international

Anomaly explained by i. a "displacement effect",

financial services were long-term high-growth activities. The apparent anomaly of falling employment could, in fact, be explained in three ways. First, closer inspection of the employment data showed that - although total employment in the Square Mile had fallen in the 22 years to 1993 - employment in financial services had risen. The working population of 390,400 in 1971 was divided between 162,700 in financial services and 227,700 in other activities; in 1995 the total of 249,200 was split between 195,100 in financial services and 54,100 in other activities. In other words, financial services' employment did increase, as expected, but other kinds of employment collapsed by 76%. The main theme here was the departure of relatively low-value-added activities (such as the move of newspaper publishing and printing to Docklands, and the rundown in British Telecom employment) to other parts of London or the UK. In effect, low-value-added activities were displaced by high- value-added international financial services.

ii. an "overspill effect", and

Secondly, employment in City-type activities (i.e., international financial services and the headquarters functions of UK financial services' businesses) spilled over from the Square Mile as such to other parts of London and even, to a much smaller extent, to the rest of the UK. Adopting a technique suggested by the City Research Project, Lombard Street Research estimated that City-type employment outside the Square Mile increased from around 15,000 at the start of the 1970s to 55,000 in 1995.

iii. an "upgrading effect"

Thirdly, within financial services' employment itself, a major compositional change occurred. In essence, low-value-added domestic financial services (such as insurance claims processing and back-office settlement work) moved out and was replaced by high- value-added international financial services. The result of this up-grading was a dramatic widening in the premium of City of London incomes over other incomes. According to the *New Earnings Survey*, between 1971 and 1995 the average earnings of full-time, non-manual, male workers increased by 10.7% a year in the UK as a whole, whereas in the City of London it increased by 12.5% a year, an excess of 1.6%. Over a 24-year period the City premium therefore widened by almost 50%.

Trend growth of international financial services' output is 6%-7% a year

These three effects - the displacement effect, the spill-over effect and the up-grading effect - were the key to reconciling the drop in the Square Mile's employment with the rapid growth in financial services, which are its distinctive industrial activities. Indeed, a mass of data on financial sector business flows suggests that these activities have been growing faster than world output for several decades. Given a trend growth rate of world output since 1950 of 3 1/2% to 4% a year, a realistic assessment is that the trend growth of international financial services' output has been 6% - 7% a year in real terms.

If the City has been maintaining its market share in competition with other international financial centres, its own output ought to be increasing at a similar rate. On the assumption that incomes received are equal to value added, total incomes of all people working in City-type activities ought also to have been growing at a similar rate. The analysis showed that, in fact, since 1971 the

which is consistent with City employment and income growth

number working in City-type industries had grown by about 1 1/4% a year and the City income-per-head premium by over 1 1/2% a year. With the trend annual rate of increase in productivity and pay nationally being 2 1/4%, that implies a typical annual increase in City incomes and output of about 5% a year from 1971. Further, a clear acceleration in the growth of the City took place around 1980, perhaps because of the abolition of exchange controls both in the UK and elsewhere. (See p. 10.) Since 1980 the average annual growth rate of City output and incomes has probably been 6% - 7% in real terms, in line with the global pattern for international financial services' activity.

Growth in City office stock, despite contraction in total employment

The next task was to match up the increase in employment with the increase in office space. One of the problems here was that different firms of chartered surveyors had competing estimates of the size of the office stock, both in the Square Mile and in Greater London. At any rate, all estimates agreed that the size of the Square Mile's office stock increased between the 1970s and the mid-1990s. (For example, DTZ Debenham Thorpe had figures for the City office stock increasing from 60m. sq. ft. in 1974 to over 70m. sq. ft. in 1995.)

Driving forces behind the City's expansion have been the internationalization of trade and finance, and the offshore revolution,

What about the future? The driving forces behind the City's expansion have been the internationalization of trade and investment in the post-war period, and "the offshore revolution". The impact of the internationalization of trade and investment is obvious, because of the linkages with, for example, international banking flows, multi-currency capital market financings, cross-border corporate finance activity and international fund management. The offshore revolution is more interesting. It can be summarized as "the realization that financings of all kinds (bank loans, bonds, equities and their many hybrids) could be conducted in any geographical location subject to any legal or regulatory system chosen by the contractual parties" (p. 15 of the report). In other words, no necessary connection exists in the modern world between the geographical location of borrowers and lenders. Indeed, there is no necessary connection between the geographical location of either borrowers or lenders and that of the financial services activities which bring the two together. The world's largest wholesale financial markets are in London, but the customers for most of the work it performs are scattered all over the globe.

which have many years to run

It is pivotal to the City's future that the post-war trends towards the liberalization of international trade, finance and capital movement be maintained. Despite the turmoil in emerging markets in the last two years, the historical record demonstrates overwhelmingly that the best formula for any country's prosperity is to participate fully in the international trade and financial systems. But many countries still have high tariff barriers, as well as exchange controls, ownership restrictions and other regulatory impediments to the free cross-border flow of goods, services and money. If it is assumed that the long-run global trend towards market liberalization is deeply entrenched, the City's industries will continue to enjoy faster growth than the rest of the UK economy for at least two or three more decades. On this basis, any interruption to the City's growth in late 1998 and 1999 will prove temporary.

Total employment within the Square Mile

Non-financial activities have been squeezed out

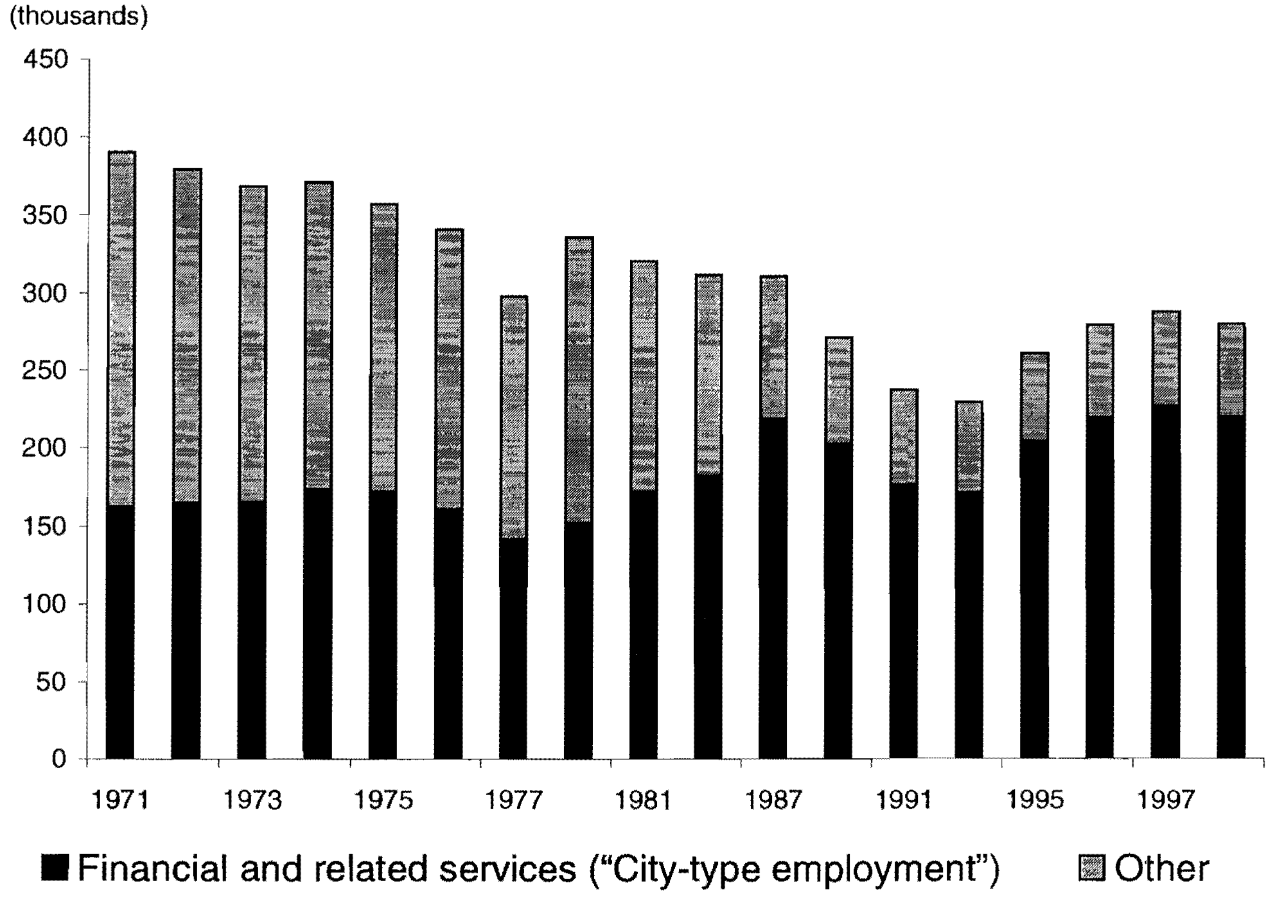


Chart shows the total numbers employed within City-type and other activities within the Square Mile. 1997 and 1998 are partly estimated.

Source: *Census of Employment*, Lombard Street Research estimates

In the early 1970s employment in the Square Mile was diverse. Financial services were the largest single type of employment, but it was from preponderant. But in the last 25 years non-financial employment has collapsed. It is now only a quarter of the 1971 level, while financial services' employment is about 80% of the total. (Note that people in legal, accounting and related activities are deemed to be in "financial services", if they depend on financial sector clients for the bulk of their fees. This wide definition of financial services can be criticized.) A key influence on the changed employment pattern has been the reluctance of non-financial employers to pay the high wage costs and rents associated with a Square Mile location. This did not imply that the financial services industries themselves were internationally uncompetitive.

City-type employment within Greater London

Financial employment has spilled over

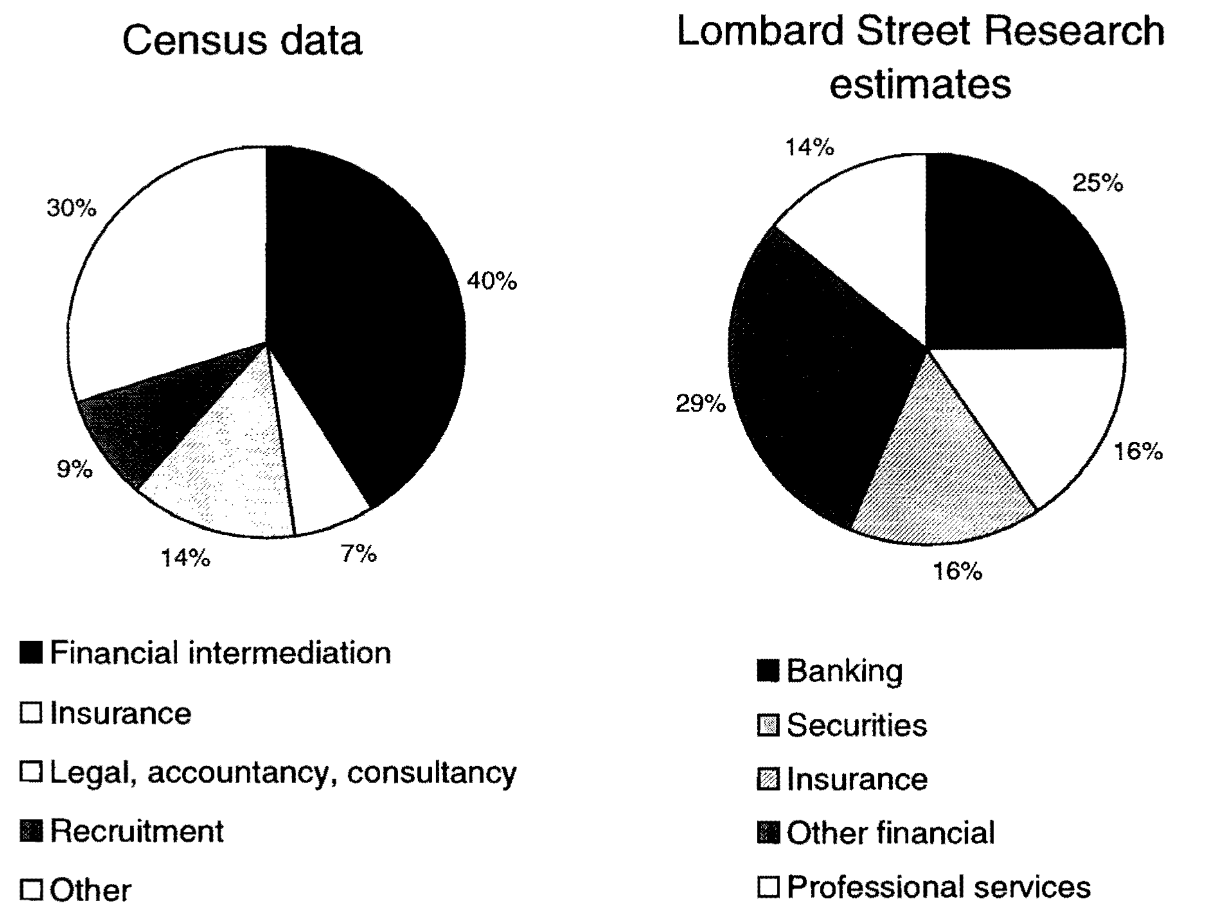
Chart shows the number of people employed in City-type activities in Greater London split into those who worked within the Square Mile and those who worked elsewhere. 1997 and 1998 are partly estimated.

Source: *Census of Employment*, Lombard Street Research estimates

In the boom of the mid- and late 1980s rents soared in the Square Mile, making new development very profitable. But, as planning consents were not forthcoming on the necessary scale, some international financial organizations suggested to the Government that it create a new financial zone in the East End. One result was the Canary Wharf development, which then prompted a flurry of planning consents from the Corporation of London in order to restore the Square Mile's position. At any rate, over time the net result has been a spill-over of financial services' employment from the Square Mile into neighbouring boroughs. Lombard Street Research estimates that City-type employment outside the Square Mile rose from about 15,000 in 1971 to 55,000 in 1995, with most of the growth since the mid-1980s.

The structure of City-type employment in London in 1995

Census data offers little insight into the differing City activities



Charts show the estimated split of City-type activities in 1995 according to official Census data and Lombard Street Research's own disaggregation.

Source: *Census of Employment*, Lombard Street Research estimates

The City's industries are diverse and complex, and embrace such different activities as ship broking, bond underwriting, derivatives trading and private client stockbroking. At first sight they have little in common, creating definitional problems. The left-hand pie above shows the Census of Employment breakdown of Square Mile financial service employment in 1995. Arguably, its categories are less than illuminating on important subjects like the relative size of employment in banking as opposed to capital markets or in activities for international clients rather than domestic. The right-hand pie gives Lombard Street Research's assessment, which tries to be more functional. By way of contrast, the City Research Project found that foreign exchange trading was the largest single "industry" in the City, but this is not separately identified by the Census of Employment.

City incomes

The City "premium" has widened steadily since the early 1970s

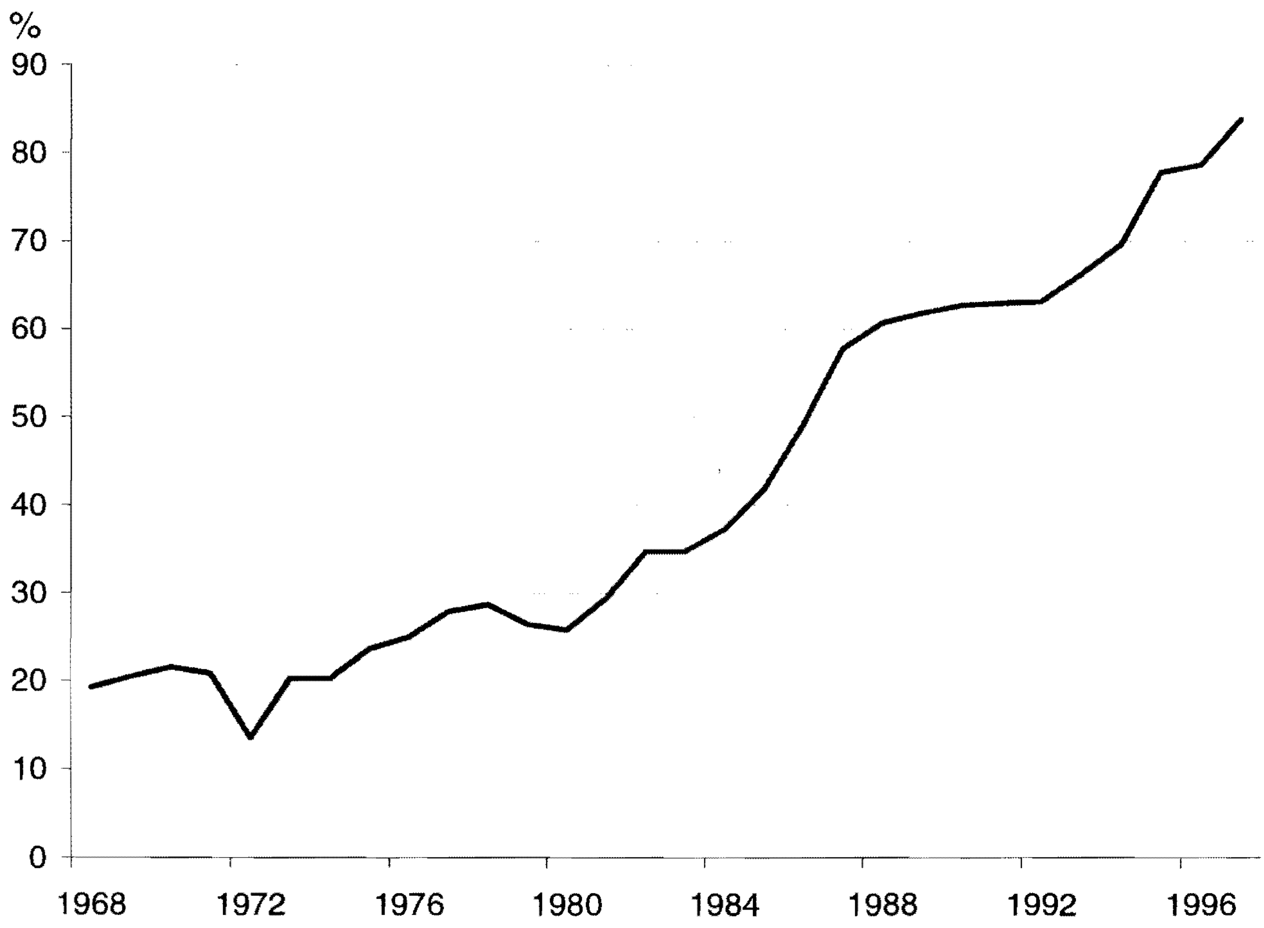


Chart shows the % by which the average gross salary of a male, non-manual, full-time employee working within the Square Mile exceeds the national average.

Source: *New Earnings Survey*, Lombard Street Research estimates

In the late 1960s and early 1970s London salaries were typically 10% - 20% above salaries for equivalent jobs nationally, reflecting living costs and a "London weighting". At that time most financial sector activity in the Square Mile was UK-oriented, including much routine clerical work. The City "premium" soared in the 25 years from 1972 to 1997. Financial services catering for the UK market declined relative to international financial services, which were typically wholesale and large-scale. As the Euro-markets expanded, and products based on derivatives and swaps emerged, the type of work done in the City became more complex. Incomes per head increased because of the greater skill requirement. The Square Mile's full-time non-manual males now earn over 80% more than the national average for such workers.

The growth of "the City's GDP"

The City's erratic growth is faster than the rest of the UK economy

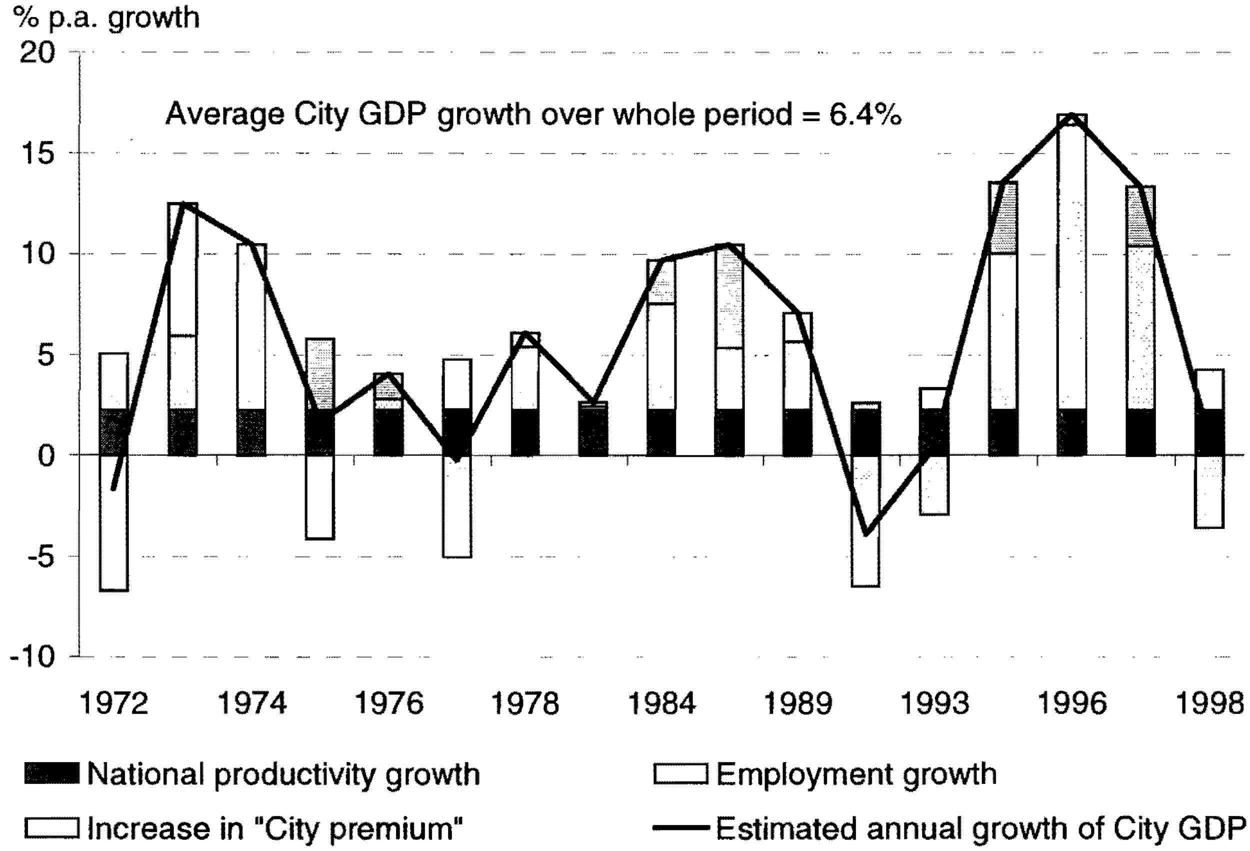


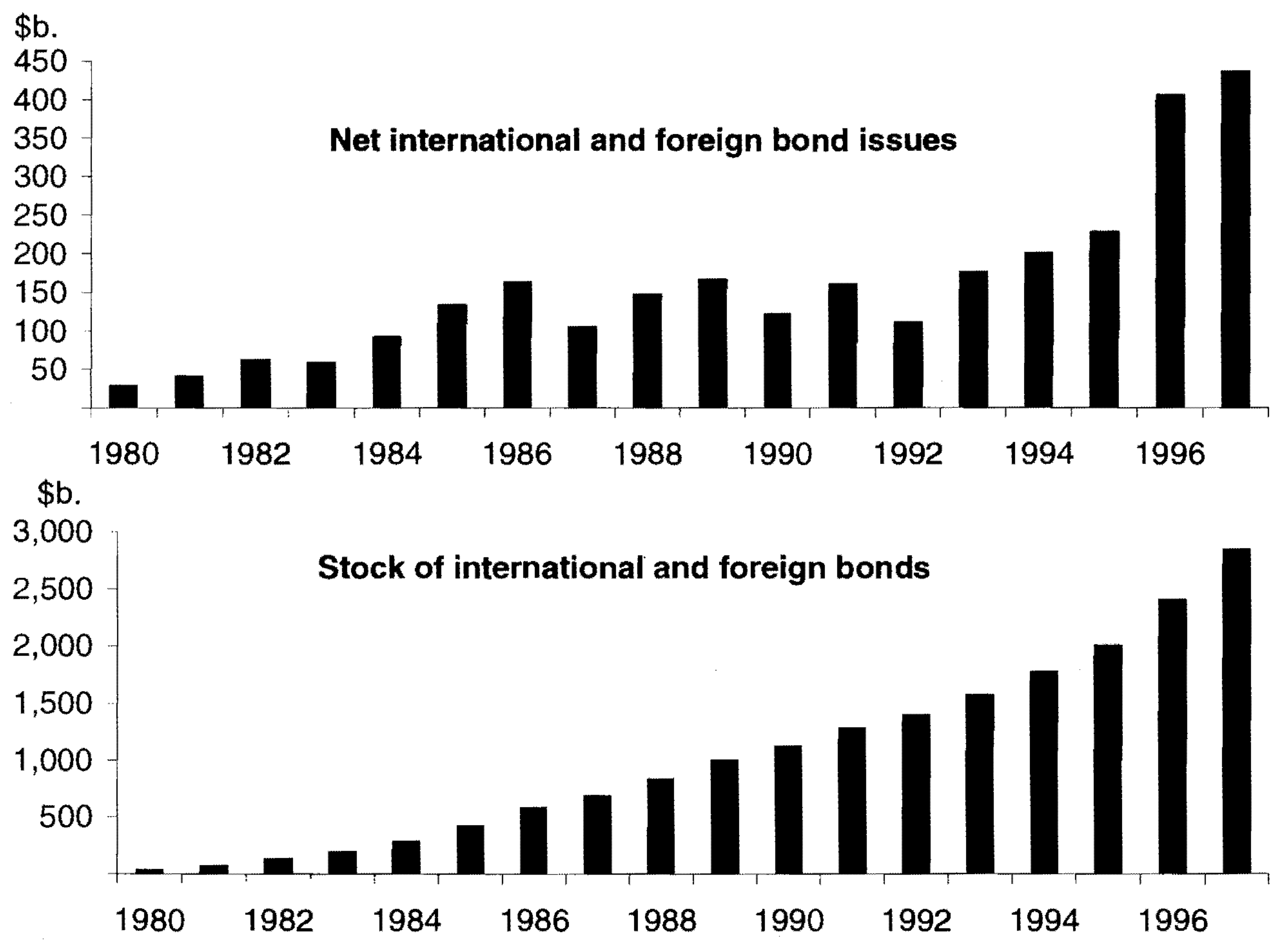
Chart shows the contributions to the growth of the output of City industries from national productivity growth, increases in City-type employment, and the relative increase in City incomes. Annual growth is shown where data is available for successive years. Where it is not, the chart shows the average annual growth for the period of two or three years. 1997 and 1998 are partly estimated.

Source: Office for National Statistics, *Census of Employment*, Lombard Street Research estimates

Data for "the City's gross domestic product" are not available from official sources, not least because of the difficulty of demarcating the City's output from that of the rest of London's economy. However, a concept can be made meaningful if City-type employment is understood as international financial services plus the headquarters functions of UK domestic financial services. If it is assumed that financial employment in the Square Mile is predominantly of this kind and that the value of output is equal to the value of incomes received, a guesstimate of the growth rate of the City's GDP becomes possible. (The estimates are at two-year intervals because of the Census of Employment is published biennially.) The chart identifies two expected features, a high long-run average annual growth rate of 6% - 7% and marked cyclical volatility.

The offshore revolution

Ever-increasing demand for people to manage the issue and trading of bonds



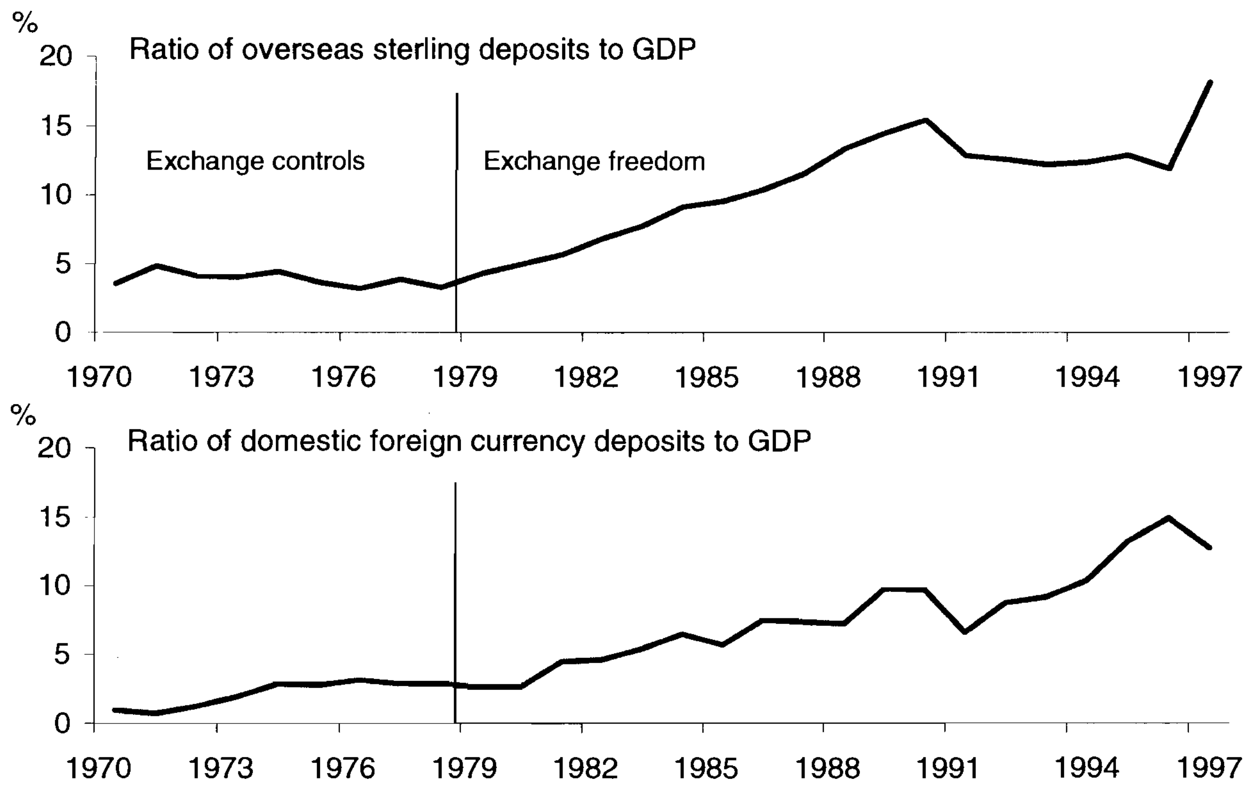
Charts show the annual total of new bond issuance, not subject to national regulations, across the OECD area and the end-year total of outstanding issues.

Source: OECD *Financial Market Trends*

The offshore revolution has been crucial to the City's prosperity in the last 25 years. As financial institutions realized that in a world free from exchange controls they could conduct their business in any jurisdiction, savings moved out of their national confines and became offshore. Deposits were increasingly placed with banks in London and other centres. Logically, bond business - in terms of both the initial arrangement, underwriting and distribution, and later trading in the secondary markets - was then concentrated in the largest international banking centre. London came to dominate the so-called Euro-markets. The chart shows that the volume of new bond issuance (which generates arrangement fees and underwriting commissions) is volatile, but the stock of outstanding bond issues has been rising relentlessly for almost 20 years.

Some results of exchange control abolition

End of exchange controls in 1979 boosted international banking flows



Charts show end-year sterling deposits held by foreigners and foreign currency deposits held by domestic (i.e., UK-based) residents, both expressed as a proportion of UK GDP. The surge in the top chart and the dip in the bottom chart in 1997 were due to re-classifications. The Channel Islands, for example, were re-classified as "overseas", leading to a large increase in overseas sterling deposits.

Source: Office for National Statistics

The global trend towards exchange freedom is basic to the increasing volumes of international financial business seen in the post-war period. The chart here demonstrates the effect of exchange control abolition in 1979 on two banking series. The first is the level of sterling deposits held by overseas residents. (They could hold sterling before 1979, but the procedure was somewhat bureaucratic, as their holdings had to be clearly differentiated from those of UK residents.) In the 1970s it was stable at under 5% of the UK's GDP. In the 1980s it soared to 15% of GDP. The second is the level of foreign currency deposits held by UK residents. (Again, UK residents could hold foreign currency deposits before 1979, but special permissions were needed.) The ratio of such deposits to GDP was stable also at under 5% in the 1970s, but has subsequently trebled.