1. Defining the problem

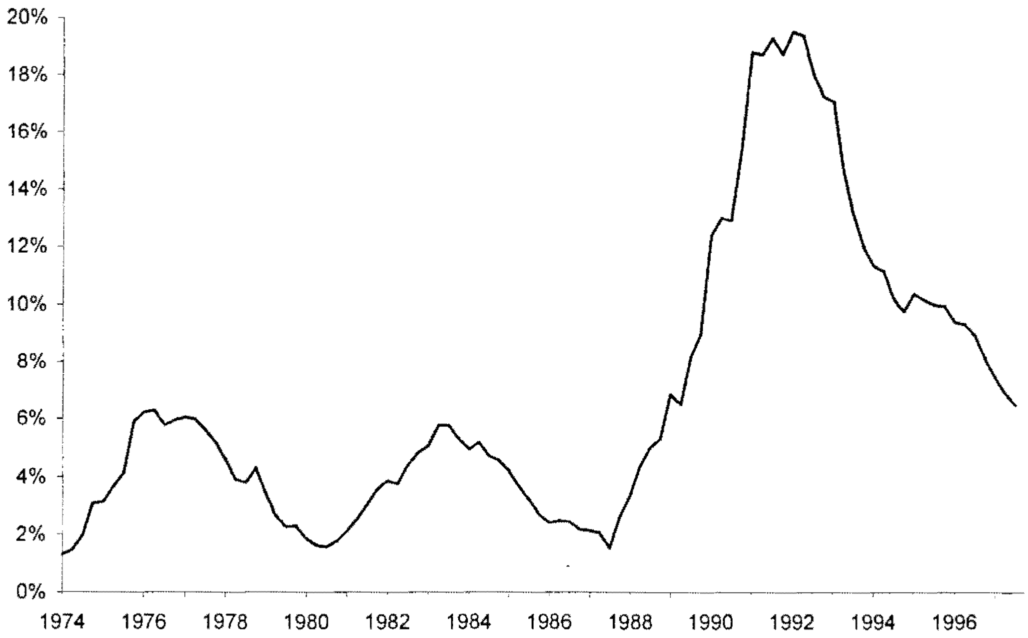
The mismatch in planning horizons

The City of London is the world's leading international financial centre and the centre of the UK's own financial system. Since 1945 financial services have been growing rapidly, in both the world as a whole and in the UK. This growth has led to substantial increases in employment and, hence, in the requirement for office space to house financial services activity.

It has also created an interesting and difficult planning problem. Although financial services have enjoyed rapid growth over the last 50 years considered as a whole, the growth has fluctuated sharply from year to year, and even between one five-year period and the next. The typical planning horizon of financial services companies is quite short, being often no more than two or three years. Uncertainty about their medium- and long-term business prospects is such that they cannot give meaningful forecasts of employment and office-space requirements for periods of 20 years or more. But nearly all office developments proceed on the assumption that buildings will last at least 20 years, while construction itself may take more than two years. Further, institutional investors in commercial property have traditionally bought buildings in the expectation that leases will run for 25 years and will include upward-only rent reviews. (This traditional expectation has, however, broken down in the 1990s, particularly for secondary properties. Perhaps partly in consequence, institutional investors' commercial property holdings have declined as a proportion of their total assets.)

The mismatch in planning horizons is potentially very harmful. The simplest forecasting assumption for property developers in the City is that the future will be like the recent past. If employment and the occupied office space have grown on average by 4% a year in the last five years, developers might quite reasonably envisage that employment and the occupied office space will continue to grow by 4% a year over the next five and indeed the next 20 years. If instead a sudden change in the business environment causes growth to halt or to go into reverse, large amounts of office space may have to be left empty. The office vacancy rate rises sharply, evidence of a massive and conspicuous waste of resources. As shown by Chart 1.1, the recession of 1990 and 1992 had precisely this result. It stemmed from over-building, due to a mistaken extrapolation of the rates of office space take-up and absorption experienced during the boom of the late 1980s.

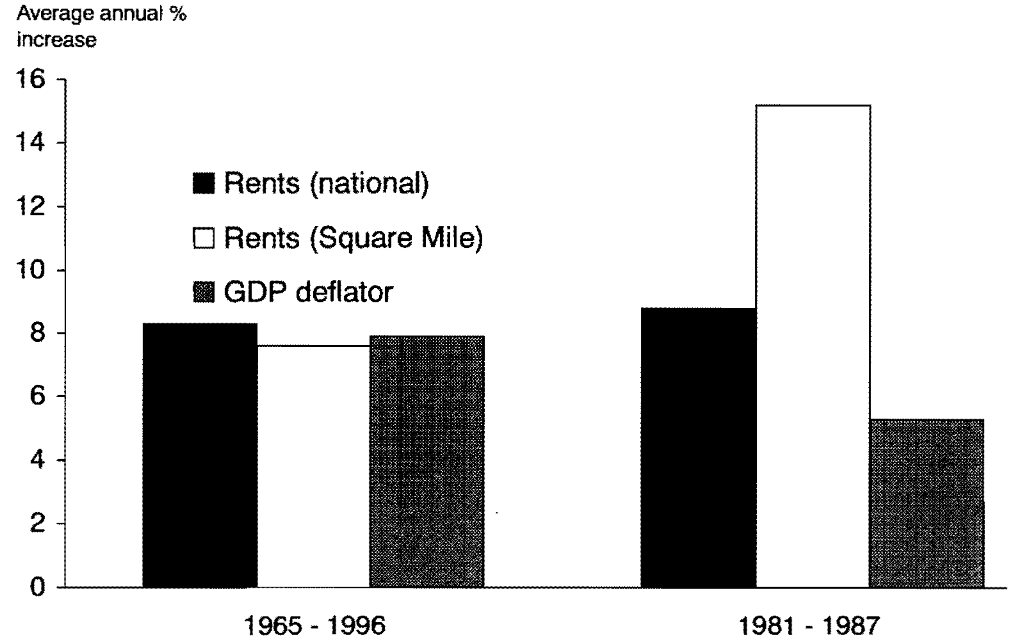
Chart 1.1: Availability of office space in the City of London (as a % of the stock)



Source: DTZ Debenham Thorpe

Chart 1.2 shows another dimension of the City property market's instability, the large swings in rents. Over the whole period from 1965 to 1996 Hillier Parker estimates that rents in the City grew at much the same rate as rents in the country as a whole, and that both increased in line with the GDP deflator (i.e., the general price level). But - during the boom years of the 1980s - City rents increased at almost double the national average. This was offset in the early 1990s by a sharp fall in City rental levels.

Chart 1.2: Rental Growth in the Square Mile



Rents data is for year to May, GDP deflator to the second quarter. Sources: Hillier Parker, ONS

A further aspect of the problem is the difficulty of forecasting the appropriate amount of infrastructure investment. The level of employment in the City has implications for the transport infrastructure, since only a very small proportion of the City's labour force both lives and works within the Square Mile. Moreover, office buildings place demands on various services, such as telecommunications, gas, electricity, and water and sewage. Forecasts of employment growth over the medium and long term are needed to plan the transport infrastructure and to make the correct provision for these services, but employers themselves cannot give clear guidance over the relevant time-horizon. Again, there is a risk of substantial over- or under-supply of transport infrastructure and other services.

The purpose and key assumptions of the study

The purpose of this study is to make medium-term and long-term forward projections of the "business flows" of the City's main industries, and so of employment growth and office space needs. The aim is to bridge the gap between the time-horizons of, on the one hand, the City's various financial services industries and, on the other, property developers, investors in City office buildings, and the public and private sector agencies responsible for transport and other ancillary services.

A central assumption of the analysis is that the requirement for office space depends on two main variables, the number of people at work and the average space each person occupies. In terms of equations,

The stock of office space (in sq. mt.) = No. of people at work in offices X Average space per person (in sq. mt.), and

Growth rate of office space requirement (in sq. mt.) = Growth rate of no. of people at work + Growth rate of average space per person (in sq. mt.)

A forecast of the City's office space requirement therefore becomes, substantially, a forecast of employment in the City. It needs to be said here that this central assumption - although it may appear banal - is in fact quite controversial. A fundamental truth of office development is that - once office space has been built - it always fills up sooner or later, as no developer wants to knock down a building before it has a tenant. The rental level varies until a tenant is found. In this sense, employment and the intensity of office use adjust to the amount of space available, not the other way round. The purpose of the central assumption is to simplify the analysis; it is not to deny that, in the real world, the variables are inter-dependent, with the supply of space influencing employment growth as well as employment growth influencing the demand for space.

The problem of defining "the City"

The analysis is beset by some important definitional problems. Even the phrase "the City" is ambiguous. Sometimes its meaning is geographical, denoting the so-called "Square Mile". But sometimes it has an industrial meaning, referring to financial services activities located in Central London, whether inside or outside the Square Mile. As this study is interested in both concepts of "the City", an attempt ought to be made to pin down - in all contexts - which meaning is intended. The geographical and industrial meanings of "the City" will therefore often be differentiated. The convention adopted hereafter is that "City" or "City-type" corresponds to the industrial definition while "the Square Mile" corresponds to the geographical definition.

A closely-related issue is the difficulty of specifying the types of employment believed to determine the demand for office space in the City. A basic premise is that the Square Mile is concerned with the provision of financial services. Again, this may seem banal, but it could be criticised. For example, some of the office-using industries traditionally located in the West End could move to the Square Mile, and vice versa, so that the connotation of a Square Mile location with financial service activity would be false.

Perhaps even more artificial is a distinction which is crucial to the study's conclusions. This distinction is between two kinds of financial services activity, "mainstream" and "City-type". Mainstream financial services activity is that found in any High Street in the UK; almost exclusively it serves UK-based customers and is largely "retail" in character (i.e., it looks after people's financial affairs). By contrast, City-type employment is to be understood as international financial services plus the headquarters operations of UK-based financial services companies. City-type employment is predominantly "wholesale" (i.e., it looks after companies).

A distinctive characteristic of City-type activities is that they are very much involved in the assessment of risk, often high risk with large amounts of capital at stake.

Typically, capital is invested, at least in part, in highly liquid securities, where the risk is limited, and it earns a safe but low return. A second tier of risks is then accepted by the capital-providers. (Banking, securities underwriting, the trading of securities and the underwriting of insurance risks all conform to this pattern.) Unlike manufacturing, capital is not invested to a great extent in plant and equipment. Unlike mainstream financial services, people working in the City do not follow set routines, but must instead think through new risks (and the potential profits and losses) constantly. In economic jargon, manufacturing requires "physical capital", whereas City-type activities need skilled "human capital". One result of the high levels of risk, and also of potential profit, is that incomes in the City are well above those in the rest of the economy. One defence of the distinction made here between mainstream and City-type employment is that a similar procedure was adopted in the City Research Project. Indeed, it was vital to the Project's estimates of the City's output and employment.

By assuming,
- first, that the office space requirement depends on employment growth, and,
- secondly, that the City is about financial services, especially international financial services,
the key analytical task is identified as projecting the future growth in UK employment in international financial services.

A preview of the study's contents

The study tries to blend the analysis of the past trends with its projections of the future. Chapter 2 describes past trends in the output and employment of the financial services industries in the UK. Chapter 3 reviews the determinants of growth in international financial services, both in the world as a whole and in the UK. An estimate is derived of total City-type employment and of its "industrial composition" (i.e., the split between different kinds of financial services) in 1995. Chapter 4 examines changes in the Square Mile's employment structure since the 1960s; it attempts to reconcile Chapter 2's discussion of national trends and Chapter 3's discussion of international financial services with the more specific circumstances of the City. Chapter 5 considers whether the forces that have been behind the rapid growth of international financial services in the past will continue in the future.

The analysis now reaches its critical stage. Chapter 6 uses the growth assessment in Chapter 5 to make projections of City-type employment (both in total and with industrial disaggregation) over various time-horizons. It then examines the evidence on past trends in office space per person. Conclusions are drawn about the size of the required office stock at future dates. Chapters 7 and 8 review the City's growth patterns in both the past and the future, and offer tentative comments on what the study may mean for planning policy, including such matters as infrastructure spending and the granting of consents for office development.