GLAECONOMICS

# London's Economic Outlook: Autumn 2006

## The GLA's medium-term planning projections

October 2006

Transport for London

LONDON DEVELOPMENT AGENCY

MAYOR OF LONDON

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GLA Economics provides expert advice and analysis on London's economy and the economic issues facing the capital. Data and analysis from GLA Economics form a basis for the policy and investment decisions facing the Mayor of London and the GLA group. The unit is funded by the Greater London Authority, Transport for London and the London Development Agency.

# Contents

# 1. Executive summary

The Greater London Authority's (GLA) ninth London forecast[i], suggests that:

- London's Gross Value Added (GVA) should grow at 3.1 per cent in 2006 and at 3.0 per cent in 2007 and 2008.

- London is likely to see above trend growth in employment throughout the period 2006 to 2008.

- London household spending will probably grow more slowly than GVA throughout the forecast period. Household spending is also forecast to grow more slowly than household income in 2007 and 2008.

Table 1.1 summarises this report's forecasts and provides an average of independent forecasts.

**Table 1.1: Summary of forecasts**

| **Annual growth rates (per cent)** | **2005** | **2006** | **2007** | **2008** |
|---|---|---|---|---|
| London GVA (constant 2003 £ billion) | 2.8 | 3.1 | 3.0 | 3.0 |
| *Consensus (average of independent forecasts)* | | 3.0 | 3.1 | 3.3 |
| London civilian workforce jobs | 1.5 | 1.3 | 1.1 | 1.1 |
| *Consensus (average of independent forecasts)* | | 1.2 | 1.1 | 1.4 |
| London household spending (constant 2003 £ billion) | 1.3 | 2.5 | 2.1 | 2.8 |
| *Consensus (average of independent forecasts)* | | 2.4 | 2.8 | 3.1 |
| London household income (constant 2003 £ billion) | 2.4 | 2.3 | 3.1 | 3.4 |
| *Memo: Projected UK RPIX[ii] (Inflation rate)* | 2.3 | 2.7 | 2.8 | 2.4 |
| *Projected UK CPI[iii] (Inflation rate)* | 2.0 | 2.1 | 2.2 | 1.9 |

*Source: GLA Economics' Autumn 2006 forecast and consensus calculated by GLA Economics.*

# 2. Introduction

The Autumn 2006 edition of *London's Economic Outlook* (LEO) is GLA Economics' ninth London forecast. The forecasts are issued every six months to assist those preparing planning projections for London in the medium term. The report contains the following:

- An overview of recent economic conditions in London, the UK and the world economies with analysis of important events, trends and risks to short and medium-term growth (Chapter 3).
- The 'consensus forecast' – a review of independent forecasts indicating the range of views about London's economy and the possible upside and downside risk (Chapter 4). In this document, 'consensus forecast' refers to the average of the four independent forecasters listed under Section 2.1.
- The GLA Economics forecast for output, employment, household expenditure and household income in London (Chapter 5).
- An in-depth assessment of a topic of particular importance to London's medium-term future (Chapter 6). This issue features a supplement on globalisation and London's financial services sector.

## 2.1 Note on the forecast

Any economic forecast is what the forecaster views as the economy's most likely future path and as such is inherently uncertain. Both model and data uncertainty as well as unpredictable events contribute to the potential for forecast error. GLA Economics' forecast is produced by Experian Business Strategies (EBS) on the basis of assumptions provided by GLA Economics. GLA Economics' review of independent forecasts provides an overview of the range of alternative opinions. Independent forecasts are supplied to the GLA for the main macroeconomic variables by the following organisations:

- Cambridge Econometrics (CE)
- The Centre for Economic and Business Research (CEBR)
- Experian Business Strategies (EBS)
- Oxford Economic Forecasting (OEF)

Only the most likely outcomes, which the different forecasting organisations provide, are recorded. Each forecaster may also prepare scenarios they consider less likely but these are not shown here. The low and high forecasts combine the lowest and highest forecasts respectively taken from each year separately and which, may therefore, come from different forecasters. High and low estimates therefore may not represent the view of any one forecaster over the whole of the forecast period.

Economic forecasting is not a precise science. These projections provide an indication of what is most *likely* to happen, not what will *definitely* happen.

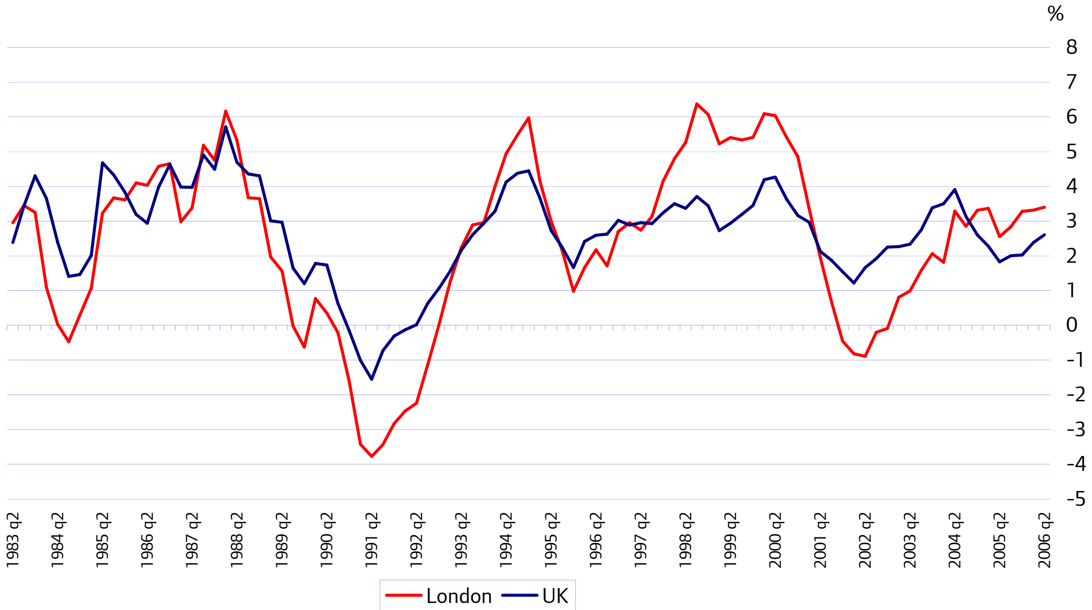
# 3. Economic background: World growth remains robust but risks increase and US economy slowing

This chapter provides an overview of recent developments in the London, UK and world economies.

## 3.1 The London economy

London's economy continued to outperform the UK in terms of annual GVA growth in the second quarter of 2006. Annual output grew at 3.4 per cent in quarter two, an increase from annual growth of 3.3 per cent in the previous quarter. Economic growth has been positive in London since 2002.

**Figure 3.1: Output growth – London and UK**
Real GVA, annual % change, last data point is Q2 2006




*Source: Experian Business Strategies*

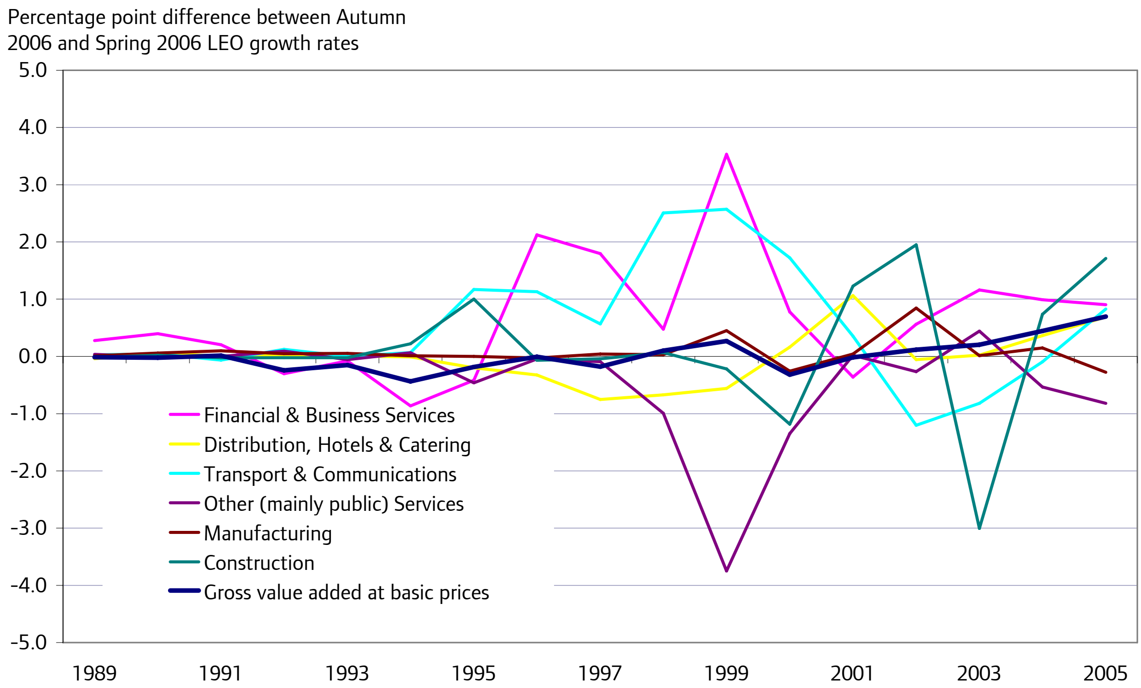
### Box 3.1: Revisions to past London annual output growth

The historic path of London's output growth has been revised since the publication of LEO Spring 2006. At the time of LEO Spring 2006, real output growth in London over 2005 was estimated to be around 2.1%. Currently, 2005 output growth is estimated to be around 2.8%.

The revisions to the London real GVA data supplied to us by Experian Business Strategies (EBS) reflect recent revisions to ONS data, at both the UK and regional level. Revisions to macroeconomic variables such as UK GVA are rarely a correction of past 'mistakes', but generally reflect progress towards the (ultimately unobservable) true value. Official series are only ever estimated using surveys, and the ONS will often revise such series when new survey information comes to light, or a new methodology is developed.[iv]

The revisions to London's overall annual GVA growth supplied to us by EBS go back to the early 1990s. Since LEO Spring 2006 was published, the ONS released its 2006 annual 'Blue Book', which resulted in a number of significant revisions to the detailed sectoral GVA data for the UK. The regional (i.e. London level) data provided by EBS to GLA Economics is constrained to ONS sector output data for the UK, hence Blue Book revisions to the back run of UK data filter down to the London data (see Figure 3.2).

**Figure 3.2: Revisions to London total and sectoral GVA growth rates**




*Source: Experian Business Strategies and GLA Economics' calculations*

Routine revisions by the ONS included the re-referencing of all chained-volume measures (CVM) of output, which advanced the reference year forward from 2002 to 2003.[v] By itself, this would have had no effect on growth rates prior to 2003 – but there were also a number of methodological improvements, including:

- Revisions to chained-volume service sector GVA (from 1995 onwards) due to a review of the short-term indicators and methods used to measure service sectors' GVA
- New survey data for purchases in the construction, distribution and service industries
- Replacing model-based estimates of exports of insurance services with survey-based data
- New estimates of banks' earnings from foreign exchange, derivatives and securities trading.

Given the relative size of the effected industries in London, these revisions to UK service sector GVA by the ONS have resulted in a number of large revisions to the London sectoral GVA data provided to us by EBS from the mid-1990s onwards.

The strong performance of financial markets over the last couple of years has meant that the City of London has performed well in 2006 so far. More restrictive financial regulation introduced in the US following the Enron and WorldCom scandals has been a factor in attracting companies to London to do business. London is an attractive destination for international companies to list and raise capital since in addition to its less onerous regulation, it has cultural, linguistic and time zone benefits. London's status and international reputation as a major centre for hedge funds is also growing. London is the top European centre for hedge funds and competes globally with New York. Chapter 6 looks in more detail at London's financial services sector.

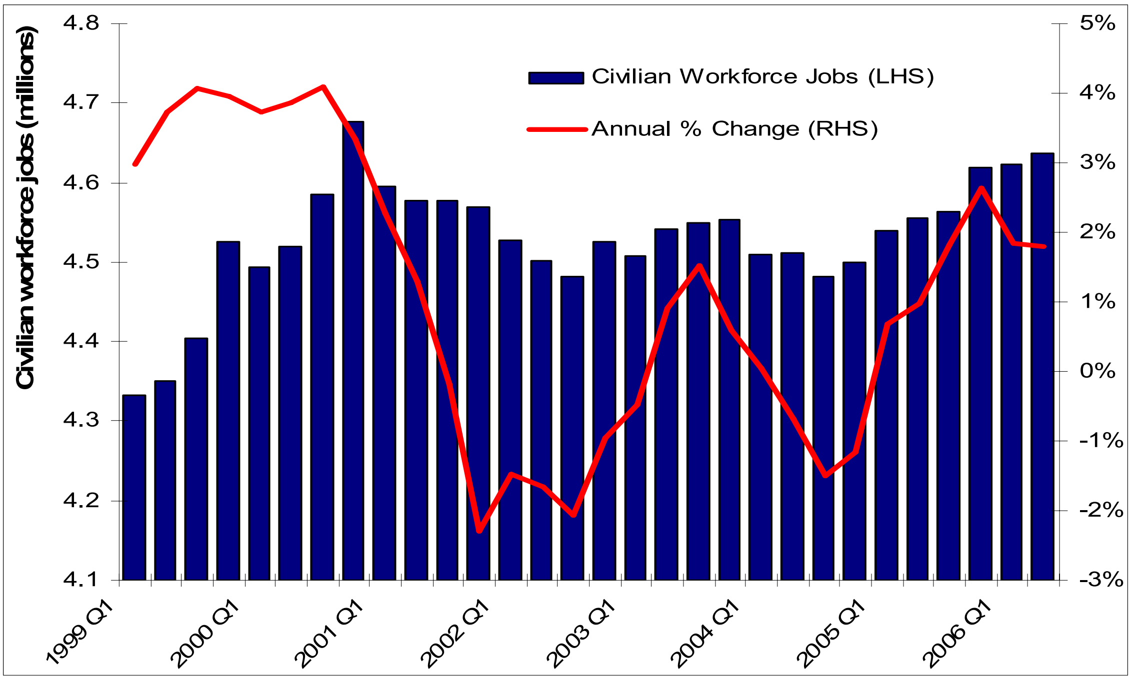
Moreover, a recent survey by Ernst & Young's European Investment Monitor found that London ranks as the most popular destination for foreign direct investment (FDI) by Chinese companies, having attracted 15 per cent of all Chinese FDI into Europe since 2002.

The London office market is performing well. Rents in the City began to increase rapidly at the end of 2005 after four years of virtual stagnation and spare capacity. The commercial property consultant Jones LaSalle estimated that £2.83 billion of offices in the City of London changed hands in the second quarter of 2006.[vi]

Employment in London is also growing more rapidly than in the UK as a whole. The number of workforce jobs in London continued its rising trend in the first two quarters of 2006. Employment has been rising since quarter three of 2004. The total number of workforce jobs is just over 4.6 million, which is only around 40,000 short of the peak in quarter four of 2000 (see Figure 3.3). However, the ILO unemployment rate in London climbed to 7.9 per cent in quarter two, the highest rate since 1998.

**Figure 3.3: London civilian workforce jobs**

Level and annual % change, last data point is Q2 2006

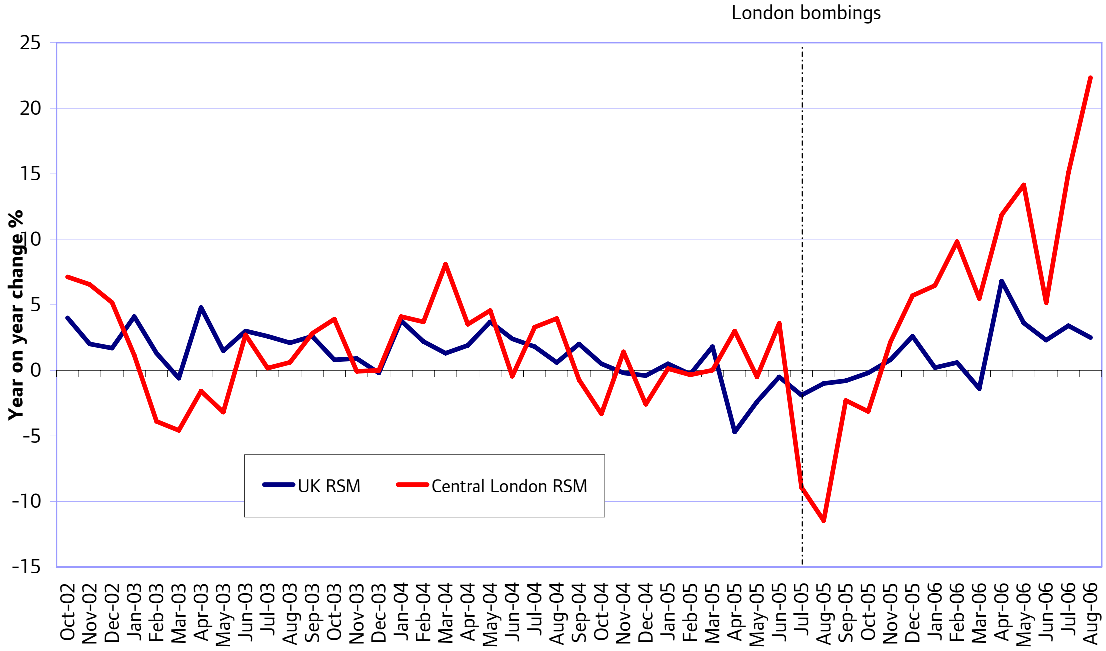



*Source: Office for National Statistics*

London's housing market has performed strongly in 2006 with an acceleration of house price inflation during the first half of the year. Surveys by the Royal Institute of Chartered Surveyors indicate that house prices in London will continue to rise over the next few months. However, house price inflation could begin to slow later in the year following the increase in the Bank of England's base rate to 4.75 per cent in August, particularly if there is a further interest rate rise in 2006.

**Figure 3.4: Retail sales growth – Central London and the UK**

Annual % change, last data point is August 2006



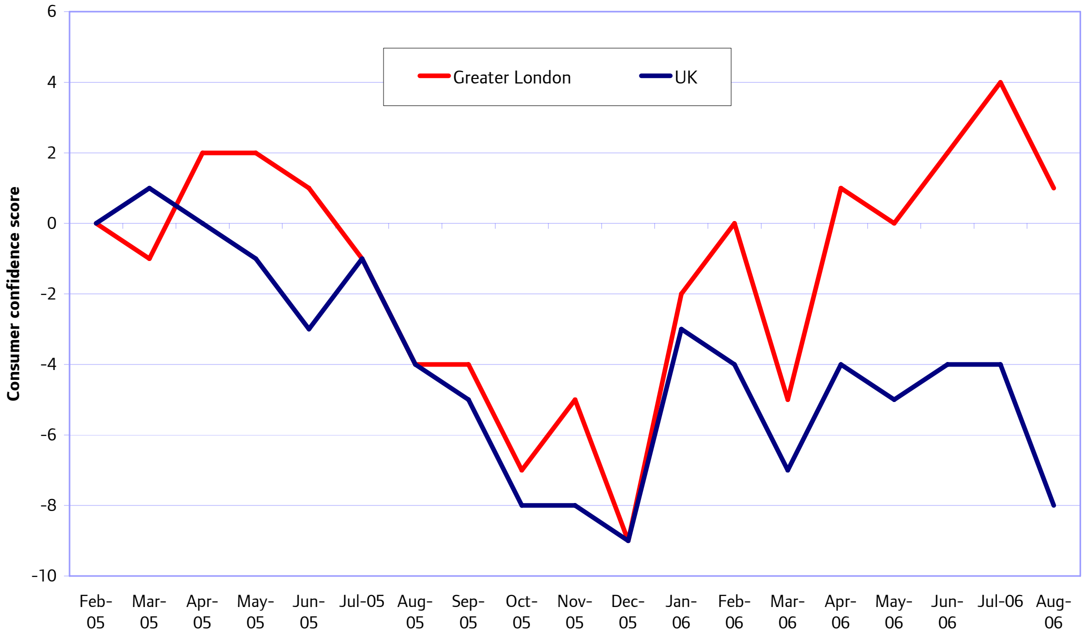

*Source: UK Retail Sales Monitor – BRC/KPMG, Central London Retail Sales Monitor – London Retail Consortium*

The retail sector in London has performed well in the first half of 2006. Following the London bombings in July 2005, retail sales in Central London dropped sharply year-on-year throughout July to October 2005. However, this downturn was short-lived and by November 2005 positive annual growth in retail sales returned. Strong year-on-year growth has continued to August 2006, rising significantly above the growth seen in the UK as a whole (see Figure 3.4).

Visit London's London Visitor Index[vii] showed positive annual growth in visitor numbers in six of the first seven months of 2006 and indicates that the London bombings in July 2005 have not had a lasting impact on London's tourism sector. Moreover, figures for visits by overseas visitors to the UK show reasonable growth with arrivals during June to August 2006 five per cent higher than in the same period last year.[viii] Spending by overseas visitors to the UK is also up on 2005 levels. Up to half of overseas visitors to the UK spend time in London. Business travel has been a factor in this solid growth.

GfK NOP's regional consumer confidence index shows that confidence in London has remained positive since April 2006, and remains significantly above that of the UK as a whole (see Figure 3.5). The index reflects peoples views on their financial position and the general economic situation over the past year and their expectations for the next 12 months (including whether now is a good time to make major purchases).

**Figure 3.5: GfK NOP's regional consumer confidence index**
Last data point is August 2006

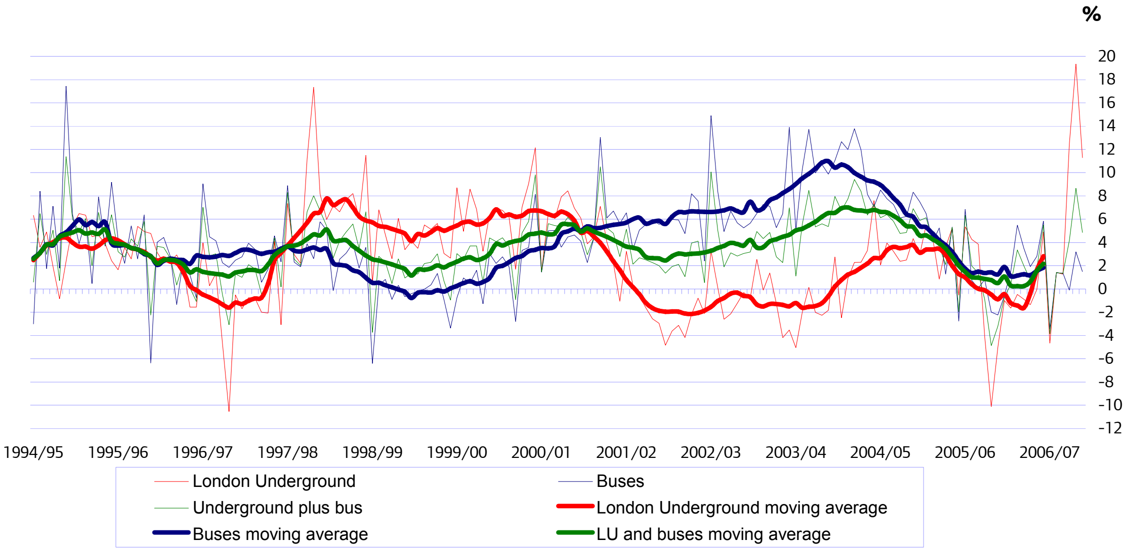



*Source: GfK NOP on behalf of the European Commission*

Figure 3.6 shows annual growth in the use of the underground and bus systems combined has been slow during 2006 but remains positive.

**Figure 3.6: London public transport usage**

Annual % change in passengers using London Underground and buses (adjusted for odd days). Last data point is the 28-day period ending 16 September 2006.

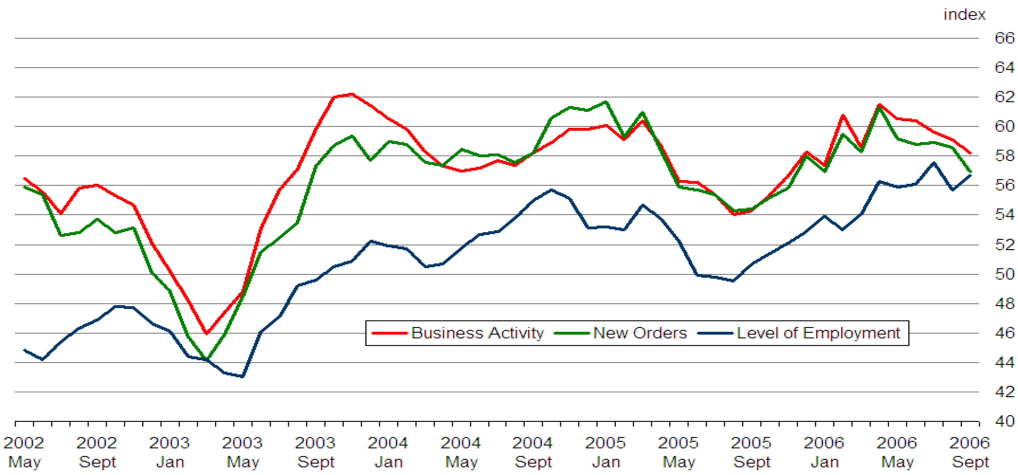



*Source: Transport for London*

Business survey results indicate that the rate of London's expansion remains strong. Figure 3.7 shows that PMI's surveys of seasonally adjusted business activity, new orders and the level of employment all picked up since September 2005, although the rate of growth in both business activity and new orders has slowed somewhat since April 2006. Private sector employment growth continues to perform strongly.

**Figure 3.7: Recent survey evidence on London's economic climate**

Purchasing Manager's Index (PMI) survey, last data point September 2006
Seasonally adjusted index (above 50 indicates increase, below 50 indicates decrease)



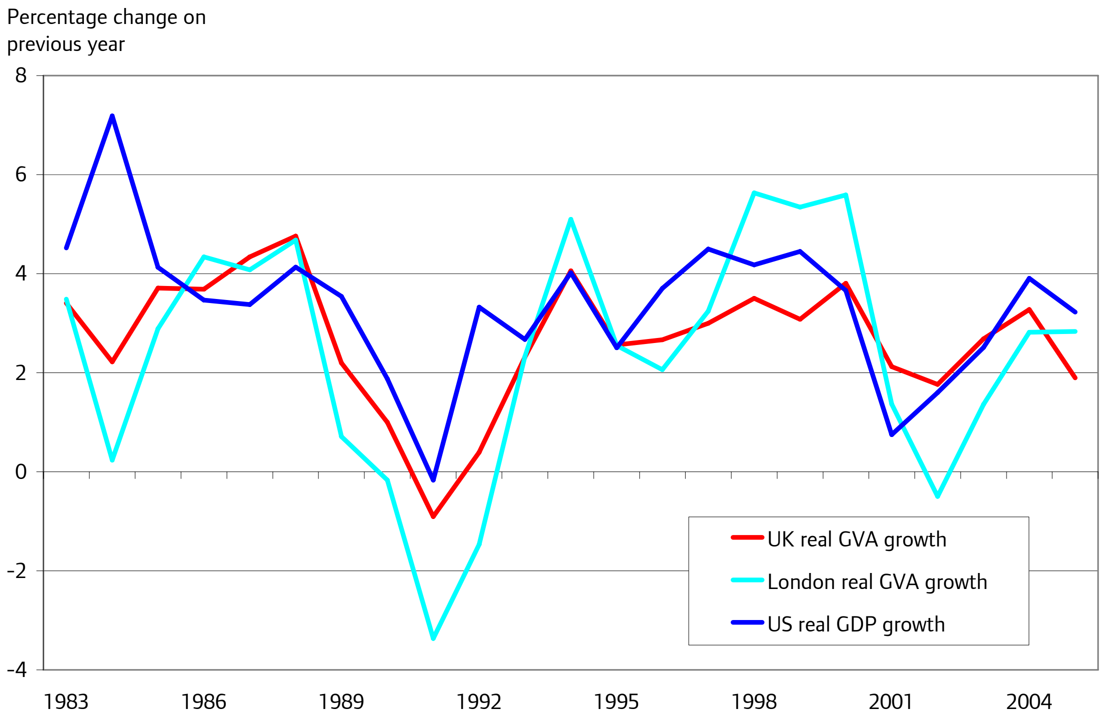

*Source: Purchasing Manager's Index/Royal Bank of Scotland*

The London economy is currently outperforming the UK in terms of both annual output and employment growth. This is largely due to the strong performance of the financial and business services sector which has seen a surge of activity. However, this sector is sensitive to global factors such as a slowing of the US economy. Box 3.2 explores in more detail the possible relationships between the Central London and US economies. The outlook for London is healthy but this remains vulnerable to a sharp downturn in the US and world economy.

### Box 3.2: Does Central London's economy move more closely with the US economy than with the UK?

Many commentators believe that one of the largest risks to the outlook for the global economy is a downturn in the US economy – in particular, how US consumer demand will respond to a weakening housing market and recent rises in interest rates.[ix] Anecdotally, we know that Central London has many ties to the US – most notably through its financial and business services sector. This was demonstrated most starkly in the wake of the September 11 terrorist attacks in 2001, when London's economy went into a brief recession (Figure 3.8).

**Figure 3.8: Real output growth in the US, UK and London**




*Source: Experian Business Strategies and US Bureau of Economic Analysis*

We begin with **two working hypotheses**:

1) That the Central London economy moves more closely with the US than it does with the UK; and (a weaker hypothesis)
2) That the Central London economy moves more closely with the US than the UK economy moves with the US.

## Testing the hypotheses

To test the hypotheses, we examine whether there is more co-movement between the economies of Central London and the US than between Central London and the UK or between the UK and the US. Ideally, we would want to compare relationships and trends between a number of different economic indicators for Central London, the US and the UK. For example, in its assessment of whether the UK economy has converged with the Eurozone, HM Treasury[x] suggests a variety of indicators for examination, including GDP growth, output gaps, labour market conditions and exchange rates.

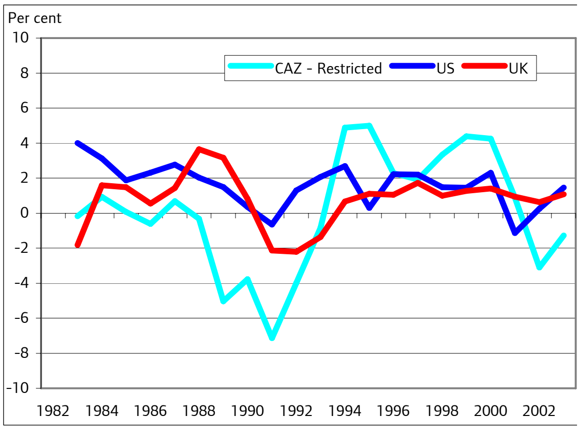
The only data in the above list available at a detailed enough geographical level for Central London that will enable a meaningful comparison with the US and the UK are employment and unemployment levels. However, when looking at the relationship between London and the US economy (whether we look at Central London or the whole of the Greater London region), the economies we are comparing are so different in size that the relative volatility of London's economic indicators will likely outweigh any co-movement. Additionally, comparing the relationship between Central London and the US with the relationship between the UK and the US is also problematic: Central London is an important part of the UK's economy and even by looking at 'rest of UK' data it is not obvious that this will enable a fair comparison. Growth in Central London and the rest of the UK is not a zero sum game – there are many spillovers and economic benefits crossing between both areas.

## Employment levels

Data on employment for Central London is available by borough from Experian Business Strategies (EBS). The Central Activities Zone (CAZ) is not defined on borough boundaries, so we use the boroughs of the City of London and Westminster as a second-best proxy.[xi] UK employment data is from the ONS, while US data is from the US Bureau of Labour.

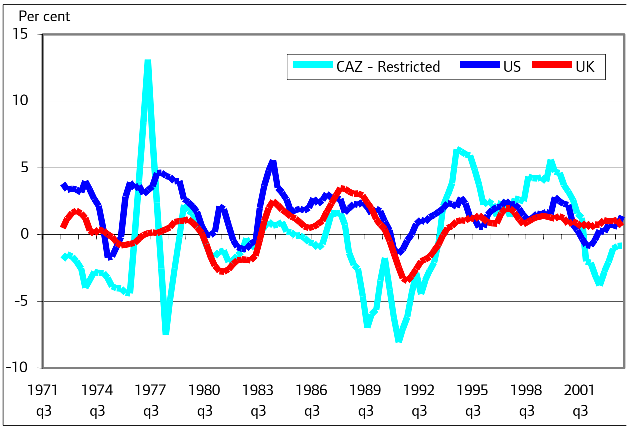
**Figure 3.9: Growth in employment level -** Annual (percentage change on previous year) and Annual quarterly rates (percentage change on same quarter in previous year)

**Annual rate (1982-2003)**




*Source: ONS, US Bureau of Labour, EBS*

**Annual quarterly rate (1971-2003)**




*Source: ONS, US Bureau of Labour, EBS*

Figure 3.9 plots annual growth in employment levels for the US, UK and Central London economies, using both annual and quarterly data. London's labour market (and Central London's in particular) is relatively volatile – which is expected, given its smaller size. As expected, the cross-correlations show a mixed picture (we have looked at both employment and unemployment data, but report mainly on employment cross-correlations here).

Overall, both the annual (year-on-year) and annual quarterly rates (quarter-on-same-quarter a year previous) data show that generally, over the whole sample period, Central London employment trends have tended to move more closely with the UK than with the US (going against hypothesis 1). Unemployment data shows Central London moving very closely with the UK, and not so closely with the US. Regarding hypothesis 2, the whole-sample annual data shows that Central London employment moves more closely with the US than the UK does – but the annual quarterly data does not support this. Breaking up the data across time-periods also gives somewhat inconclusive results.

**Conclusion**
The majority of studies that assess co-movement between economies compare de-trended GDP or other economic variables such as consumption, investment, prices and output gaps[xii]. However this data is not available for Central London, so the analysis here has been restricted to labour market data.

Based on the available data, there is no overwhelming evidence in support of the hypothesis that the Central London economy moves more closely with the US than with the UK. Meanwhile the evidence for hypothesis 2 is not conclusive, but this likelihood remains a distinct possibility. However, overall the main conclusion is that current analysis is severely limited by the lack of sufficiently disaggregated data available at the Central London level.

## 3.2 The UK economy

UK Gross Domestic Product (GDP) rose by an estimated 0.7 per cent in the third quarter of 2006, the same rate as in the previous three quarters. The annual growth rate in the third quarter of 2006 was 2.8 per cent, compared with 2.6 per cent in the second quarter of 2006. This is the highest annual growth rate since the third quarter of 2004.

**Table 3.1: HM Treasury and consensus forecasts for the UK economy (September 2006)**

Annual % change, unless otherwise indicated

| | Average of Independent Forecasters | | Budget March 2006 | |
|---|---|---|---|---|
| | 2006 | 2007 | 2006 | 2007 |
| GDP growth (per cent) | 2.6 | 2.3 | 2-2 ½ | 2 ¾-3 ¼ |
| Inflation rate (Q4: per cent) | | | | |
| CPI | 2.6 | 2.0 | 2 | 2 |
| RPI | 3.6 | 2.6 | - | - |
| Claimant unemployment (Q4: mn) | 0.98 | 1.04 | - | - |
| Current account (£bn) | -30.5 | -30.0 | -32 ¾ | -36 ½ |
| PSNB (2006-07, 2007-08: £bn) | 38.4 | 36.7 | 36 | 30 |

*Note: CPI = Consumer Price Index, RPI = Retail Price Index, mn = million, bn = billion*

*Source: HM Treasury Comparison of Independent Forecasts, September 2006*

*HM Treasury Financial Statement and Budget report Chapter C: The Public Finances*

The IMF's September forecast expects the UK economy to grow by 2.7 per cent this year and next. This has been revised up from its April forecast of 2.5 per cent growth in 2006 and 2.6 per cent in 2007.[xiii] Healthier retail sales than previously expected, boosted by the World Cup, and a strong housing market have been factors in the improved outlook for the UK economy in 2006.

The service sector has continued to show healthy growth. In particular the business services and finance sector has seen robust annual growth of over five per cent in the second and third quarters of 2006 (see Table 3.2). The distribution, hotels and catering sector has recovered from slow annual growth during 2005. Annual growth in manufacturing has picked up in 2006 but remains slower than in the service sector.

**Table 3.2: Recent growth in broad industrial sectors of UK economy**
Annual % change

| | 2005 | | 2006 | | |
|---|---|---|---|---|---|
| **Industrial sectors** | **Q3** | **Q4** | **Q1** | **Q2** | **Q3** |
| Agriculture, forestry, and fishing | 1.9% | 1.7% | 0.5% | -2.0% | -1.2% |
| Mining & quarrying inc oil & gas extraction | -10.9% | -8.1% | -6.8% | -11.1% | -6.6% |
| Manufacturing | -0.5% | -2.1% | -0.4% | 1.0% | 1.5% |
| Electricity, gas and water supply | 0.1% | -0.5% | 0.4% | -4.0% | -2.5% |
| Construction | 0.6% | -0.4% | -0.2% | -0.1% | 1.7% |
| Distribution, hotels and catering | 0.3% | 1.5% | 2.6% | 3.5% | 3.2% |
| Transport, storage and communication | 3.7% | 4.1% | 2.6% | 2.9% | 2.6% |
| Business services and finance | 4.4% | 4.6% | 4.9% | 5.1% | 5.2% |
| Government and other services | 2.7% | 2.6% | 2.4% | 2.3% | 1.6% |

*Source: Office for National Statistics*

Table 3.3 shows that there was a pick-up in household spending in the second quarter of 2006. Investment spending has also seen a recovery since the middle of 2005, with strong year-on-year growth in the first two quarters of 2006. By contrast, annual growth in government spending moderated somewhat in the first half of 2006 with weaker growth than in recent years. The Bank of England expects that the public sector will make a declining contribution to demand growth over the next few years[xiv].

**Table 3.3: UK domestic expenditure growth**
Annual % change

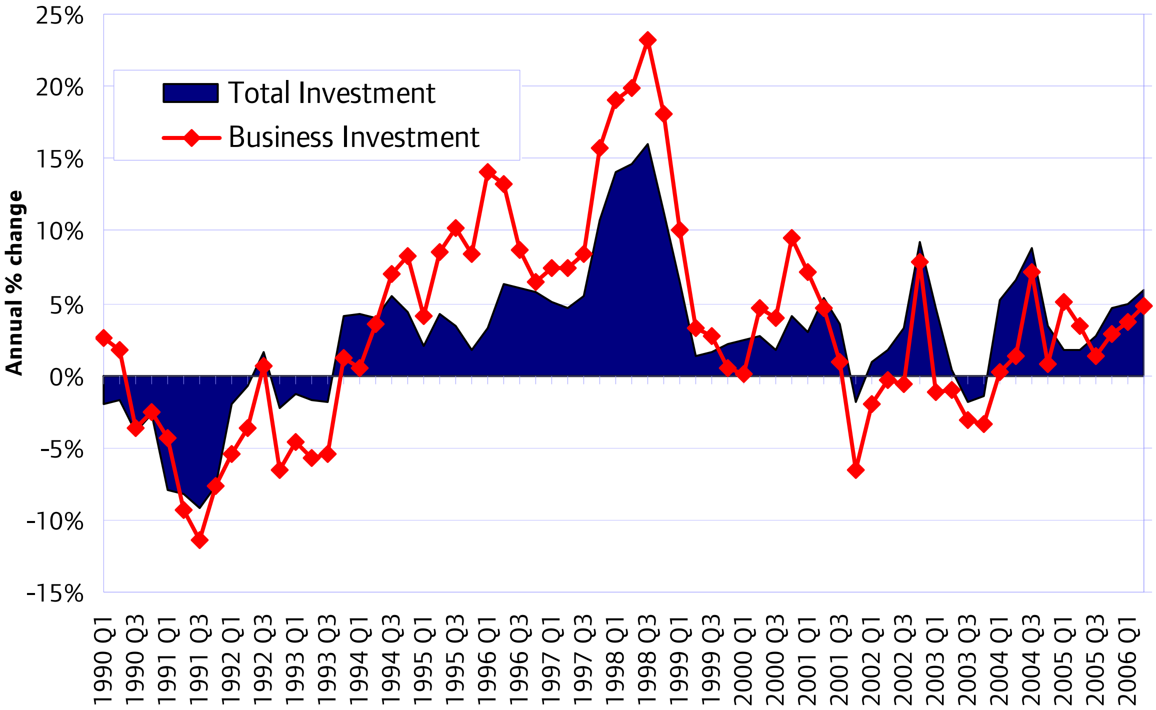
| | 2005 | | | | 2006 | |
|---|---|---|---|---|---|---|
| **Expenditure** | **Q1** | **Q2** | **Q3** | **Q4** | **Q1** | **Q2** |
| Households | 2.2% | 1.0% | 1.0% | 1.2% | 1.4% | 2.3% |
| Non-Profit Institutions | 3.0% | 2.9% | 2.8% | 2.6% | 2.2% | 2.6% |
| General Government | 1.5% | 3.5% | 3.4% | 2.7% | 2.6% | 2.1% |
| Gross Fixed Capital Formation | 1.8% | 1.7% | 2.7% | 4.6% | 4.9% | 5.9% |

*Source: Office for National Statistics*

Following a subdued performance in recent years, business investment has improved, as can be seen in Figure 3.10. The estimate of business investment in the second quarter of 2006 shows an annual increase of 4.8 per cent. Business surveys echo this improvement. Although business investment accounts for only around ten per cent of GDP (in chained volume terms) it tends to be a volatile component of GDP. HM Treasury has been relying on a recovery in business investment to achieve growth targets.

**Figure 3.10: UK Total and Business investment, annual growth**

Gross fixed capital formation, last data point – Q2 2006




*Source: Office for National Statistics*

The Bank of England raised interest rates in August for the first time in two years and in its August Inflation Report indicated that a further rise is likely. The Bank cited stronger than expected UK growth combined with limited spare capacity and rapid growth in broad money and credit as threats to inflation. The Bank's August Inflation Report forecast that the UK economy would continue to perform well as consumer spending picked up, investment recovered and net trade provided a boost.

Annual CPI inflation has been above its target of two per cent since May 2006. It rose to 2.5 per cent in August, falling back slightly to 2.4 per cent in September. The CPI inflation rate has not been higher than 2.5 per cent since the official series began in 1997. The above target inflation rate has largely been due to rising energy prices. However, the Bank of England notes that domestically generated non-energy price inflation (DGI) has been falling, and has in part compensated for rising import and energy prices. The Bank's hypothesis is that the introduction of inflationary targeting has helped to reinforce the inverse relationship between DGI and import and energy price inflation by anchoring inflation expectations around the two per cent target. Nonetheless, the Bank expects higher utility prices to continue to put upward pressure on CPI inflation in the short term. In addition, rising university tuition fees could lead to a rise in CPI inflation in the last couple of months of this year. Over the medium term DGI is expected to pick up as energy price inflation eases back.

The UK's balance of payments gap fell in the second quarter of 2006, helped by the surplus in services. Due to revisions, net trade is estimated to have been less of a drag on real GDP growth in recent years. However, import and export growth data is affected by VAT fraud such as Missing Trader Intra-Community Fraud and the ONS has warned that trade figures may still need to be revised further. Nonetheless, business surveys and reports from the Bank of England's regional agents point to strong export performance, and this is likely to be helped by the improvement in the Eurozone economy.

Employment in the UK has been rising which is in part due to larger than anticipated inward migration from new EU members, although ILO unemployment has also moved steadily higher reaching 5.5 per cent in the three months to August, the highest rate since 2000. This indicates that there remains potential slack in the labour market.

### 3.3 The world economy

The global economy has remained robust despite some slowing in the US in the second quarter of 2006. The slowdown in the US has been moderated by a pick-up in the Eurozone and to some extent Japan. The rapid growth in the emerging economies of India and China continues. The IMF forecasts world output growth of 5.1 per cent in 2006 (an increase from 2005) and 4.9 per cent in 2007, both a quarter percentage point higher than in its April forecast.[xv] The world economy has now seen three years of growth significantly above trend.

As shown in Figure 3.11, oil prices have remained high over the last six months with Brent crude hitting record nominal highs in August of close to $80 per barrel during the Israel/Lebanon conflict. However, since then prices have begun to ease somewhat having fallen in September to below $60 per barrel for the first time since March 2006. Nonetheless, prices remain at historically high nominal levels driven by strong demand from the emerging economies and continued geopolitical tensions in the Middle East.

## Figure 3.11: Brent crude oil price


*Source: FT.com*

After strong growth in early 2006, growth in the **US** has since moderated largely due to higher interest rates and a subsequent slowdown in the housing market, as well as continued high oil prices. Although the US economy remains strong it is expected to continue to slow in the second half of 2006 and into 2007. The IMF has revised downwards its forecast for annual growth of the US economy to 2.9 per cent in 2007, from a previously forecast 3.3%.

The Federal Reserve now expects growth of below potential over the next six quarters. The concern appears to be that the slowing housing market will impact on growth. Although US inflation is now looking slightly softer, it is too early to conclude that inflationary pressures have been halted. Monetary easing may not occur as quickly as markets expect and it is still possible that US interest rates could rise slightly further before being cut.

The US trade deficit remains very high and is projected to exceed seven per cent of GDP in 2007[xvi], although currently this continues to be financed by foreign investors purchasing US assets.

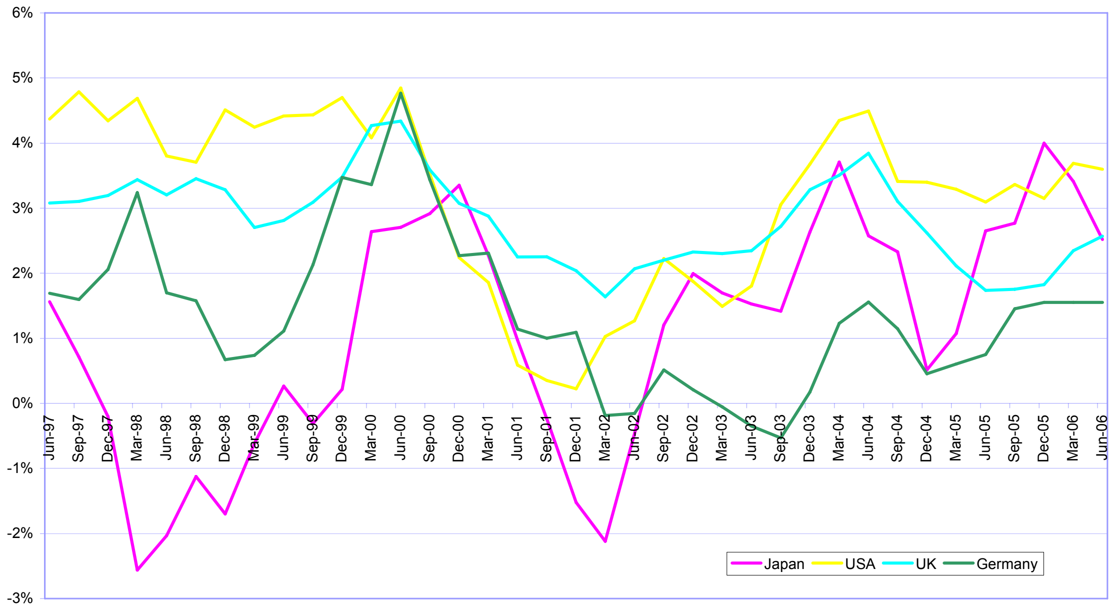
In contrast to the US, recent data indicates a stronger than expected performance in the **Eurozone** due to improved domestic demand, especially investment. Activity accelerated in the Eurozone in the second quarter and unemployment fell. According to Eurostat quarterly GDP in the European Union grew by 0.9 per cent in the second quarter of 2006, its fastest pace in six years[xvii]. Firm Eurozone economic growth is expected in the second half of 2006.

The IMF forecasts Eurozone annual growth of 2.4 per cent in 2006[xviii], up from 1.3 per cent in 2005. The OECD has also recently revised up its forecast for annual Eurozone growth to 2.7 per cent in 2006, up from 2.2 per cent in its May forecast[xix].

The European Central Bank (ECB) raised interest rates by 0.25 per cent in August and by a further 0.25 per cent in October. This took the ECB rate to 3.25 per cent and was the ECB's fifth rise since December. With growth in the Eurozone picking up, further rate increases by the ECB are expected this year and next.

**Germany** grew at its fastest quarterly rate for over five years in quarter two of 2006 helped by the boost in spending associated with the World Cup. Germany has now dropped back within the EU budget deficit limit of three per cent of GDP for the first time in five years. However, the IMF believes that the increase in VAT from 16 to 19 per cent due to come in from January 2007 is likely to lead to a slowing of growth in Germany. Nonetheless, the IMF forecasts growth of two per cent in 2006 and 1.4 per cent in 2007, which is an increase on its forecast in April 2006. Economic growth in France is also recovering.

**Figure 3.12: GDP growth in selected industrialised countries**
Real GDP, annual % change




*Source: Ecowin*

GDP growth in **Japan** in the first quarter of 2006 was stronger than expected boosted by strong domestic demand. Unemployment fell to an eight year low of four per cent in May of this year. This is a welcome trend as one factor that had threatened to hold back growth was the reluctance of consumers to spend because of fears about job prospects. Although growth slowed slightly in the second quarter, the IMF forecasts growth of 2.7 per cent for 2006, moderating to 2.1 per cent in 2007.[xx]

Inflation in Japan has picked up slightly despite downward revisions to past CPI data. Land prices also rose for the first time in 14 years in 2005. Consequently, the Bank of Japan raised interest rates in July to 0.25 per cent ending its five-year policy of zero rates. Japan's economy is still vulnerable to adverse external factors such as rises in oil prices and a slowing US economy.

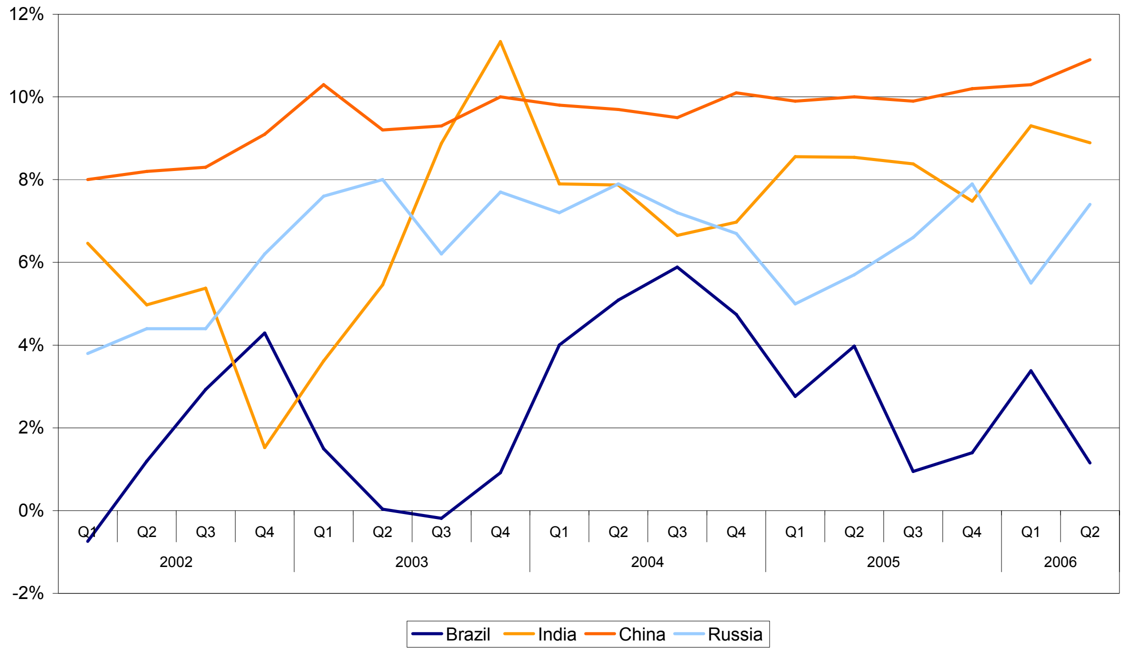
### 3.4 Emerging market economies

Emerging economies continue to help drive global growth. In September the IMF agreed to increase the voting rights of China, Mexico, Turkey and South Korea which is evidence of the growing importance of these economies in the global arena. The IMF forecasts that in the next five years emerging economies will grow at an average of 6.8 per cent per year, while the developed economies will grow at 2.7 per cent per year.[xxi] However, any major slowdown in US consumer spending will also be a concern for growth in the emerging markets.

**China** continues to boom. Official figures show that in the third quarter of 2006 the Chinese economy grew at an annual rate of 10.4 per cent. This comes despite efforts to control the pace of growth via limiting the availability of bank credit as well as two recent increases in interest rates. Private sector investment and exports remain strong and the rapid expansion of the economy continues. China is increasing its trade deals with other developing countries to help satisfy its demand for raw materials. The Asian Development Bank increased its forecast for China's growth in 2006 to 10.4 per cent from 9.5 per cent. The IMF predicts 10 per cent annual growth in both 2006 and 2007.

In September the IMF revised up its forecasts for growth in **India** to 8.3 per cent in 2006 and 7.3 per cent in 2007. India's strong performance in services continues, particularly in telecommunications and financial services. However, inflationary pressures are growing. In June India's inflation exceeded five per cent for the first time in almost a year largely due to higher food and petro-product prices. India's Central Bank has tightened monetary policy in 2006 and further monetary tightening may be necessary in order to resist inflationary pressures. This is likely to slow the momentum of growth in 2007.

**Figure 3.13: GDP growth in selected emerging market economies**
Annual % change




*Source: Ecowin*

**Russia** is set to continue to grow rapidly. The IMF forecasts growth of 6.5 per cent for 2006, up slightly on 2005. Russia also has a large current account surplus and is benefiting from high energy prices. Overall, the expansion of the emerging economies of eastern Europe remains robust having seen annual growth of 5.5 per cent in 2005. The IMF forecasts a similar rate of growth for 2006 and 2007 helped by the strengthening economies in the Eurozone.

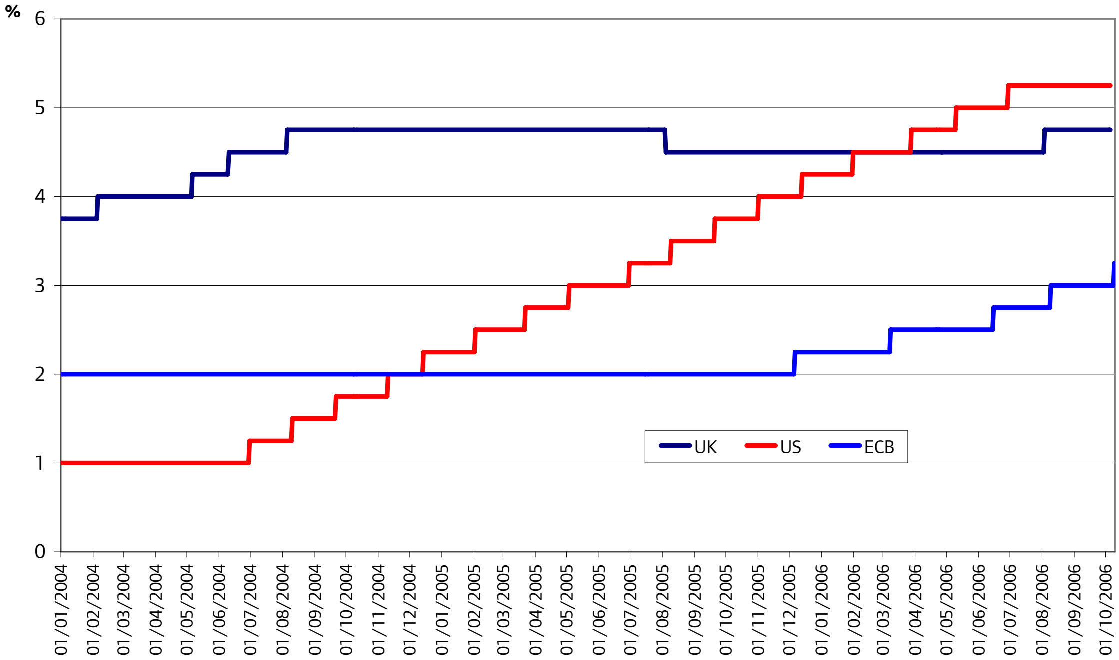
**Brazil** is forecast to see annual growth of 3.6 per cent in 2006 and 4.0 per cent in 2007[xxii]. **Latin America's** economy picked up pace in the first half of 2006 and is forecast to see annual growth of almost five per cent this year.[xxiii]

### 3.5 Risks to the world economy

World economic growth currently remains robust. However, risks to the economic outlook of the global economy remain on the downside.

Inflationary pressures have generally increased during 2006 and there has been widespread monetary tightening in industrialised economies with the UK and the Eurozone following the US, as shown in Figure 3.14. Inflationary pressures are also building in the emerging economies of India and China. Greater capacity utilisation as well as any further increase in energy prices would exacerbate these inflationary pressures.

**Figure 3.14: Central Bank Interest rates**




*Source: Ecowin*

The Federal Reserve faces a difficult situation in terms of trying to control inflation without causing too sharp a slowdown in the US economy. In global terms, the slowdown in the US economy is being moderated by the pick-up in the Eurozone and to some extent Japan. However this pick-up in other industrialised countries may not be sufficient or long-lasting enough to fully compensate for slower US growth, particularly if the US housing market cools more abruptly than expected. Emerging economies are also taking up the slack from a slowing US economy but, by their general export-led nature, they will also be adversely affected by any sharp US slowdown.

Large global imbalances remain a concern for the world's economic outlook. The US current account deficit remains high and is close to two per cent of world GDP.[xxiv] There are some factors that are slowly starting to move in the right direction in reducing these imbalances. These include the recent depreciation of the US dollar, stronger growth in US exports, the rising growth in the Eurozone and Japan and some increased exchange rate flexibility in emerging Asia (i.e. China). However, the concern remains that there could be a disorderly unwinding in currency and financial markets if there is a sudden unwillingness to hold US assets in the rest of the world (especially China and OPEC countries).

The suspension of the Doha round of World Trade Organisation negotiations this summer is also a blow to the prospects for world trade and hence growth in the world economy. The aims of the Doha round were to liberalise trade rules to make them fairer to developing countries. Some countries such as India are nonetheless pursuing bilateral and regional trade agreements but any increase in protectionist sentiment in industrialised economies is a threat to global growth.

### 3.6 Summary

The outlook for the London economy over the medium term remains positive. The London economy continues to outperform the UK in terms of annual output and employment growth, largely due to the performance of the financial and business services sector which has seen a surge in activity. Nonetheless this sector is vulnerable to any downturn in the world economy.

The UK economy as whole is growing around trend and this is forecast to continue into 2007. However, with inflation remaining above its target, the Bank of England may well increase interest rates further. There is though evidence of slack remaining in the labour market. A further increase in interest rates could lead to a slowing in the housing market and consumer spending.

The world economy remains robust with recent upward revisions by the IMF to the outlook for growth in 2006 and 2007. Stock markets have been performing especially well over the last couple of years with the Dow Jones reaching all time highs in October 2006, above the previous peak in January 2000. The emerging economies of India and China remain engines of growth and while the US economy is slowing, the Eurozone economies and, to some extent Japan, are picking up. It is somewhat surprising that the global economy has so far remained so resilient despite sustained high energy prices, widespread monetary tightening and heightened geopolitical tensions. Risks to the global economic outlook remain in terms of inflationary pressures combined with possible further monetary tightening, substantial global imbalances and increased protectionist sentiment. The potential downside risks seem greater than in Spring 2006 LEO.

# 4. Review of independent forecasts

## What the forecasts provide

In Chapter 5, GLA Economics' forecast of four economic indicators is provided: workforce employment, real output, private consumption (household expenditure) and household income in London. In this chapter the consensus view on the first three of these indicators is summarised, drawing on forecasts from outside (independent) organisations.[xxv] Both annual growth rates and 'standardised' absolute levels are reported. All the data is in real terms (constant prices).

Additionally, both the consensus and GLA Economics' own forecasts provide predictions of employment and output growth in six broad sectors:

- manufacturing
- construction
- transport and communications
- distribution, hotels and catering
- finance and business services
- other (mainly public) services.

## Output

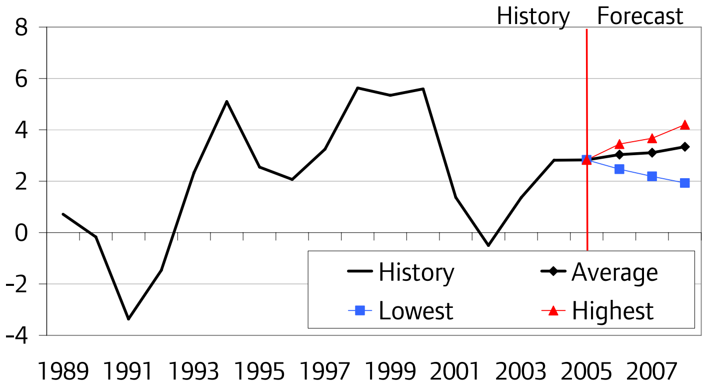
(London GVA, constant prices (2003 base year), £ billion)

The recent path of output growth in London has been revised up.

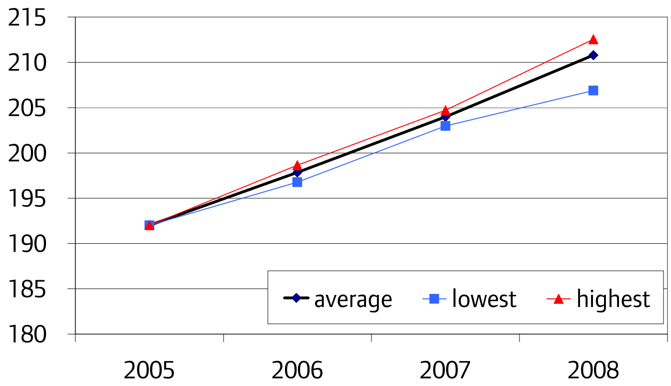
The consensus (mean average view) is for above-trend output growth to continue over the medium term: 3.0 per cent in 2006, 3.1 per cent in 2007 and 3.3 per cent in 2008.

However, the spread of predicted growth rates (over the medium term) is quite large, reflecting increased uncertainty.

**Annual growth (per cent)**




**Level (constant year 2003, £ billion)**




| Annual growth (per cent) | | | |
|---|---|---|---|
| | 2006 | 2007 | 2008 |
| Average | 3.0 | 3.1 | 3.3 |
| Lowest | 2.5 | 2.2 | 1.9 |
| Highest | 3.4 | 3.7 | 4.2 |

| Level (constant year 2003, £ billion) | | | |
|---|---|---|---|
| | 2006 | 2007 | 2008 |
| Average | 198 | 204 | 211 |
| Lowest | 197 | 203 | 207 |
| Highest | 199 | 205 | 213 |

**History: Annual growth (per cent)**

| 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 0.7 | -0.2 | -3.4 | -1.5 | 2.3 | 5.1 | 2.6 | 2.1 | 3.2 | 5.6 | 5.3 | 5.6 | 1.4 | -0.5 | 1.4 | 2.8 | 2.8 |

**History: Level (constant year 2003, £ billion)**

| 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 136.9 | 136.7 | 132.0 | 130.1 | 133.1 | 139.9 | 143.5 | 146.5 | 151.2 | 159.7 | 168.3 | 177.7 | 180.1 | 179.2 | 181.6 | 186.7 | 192.0 |

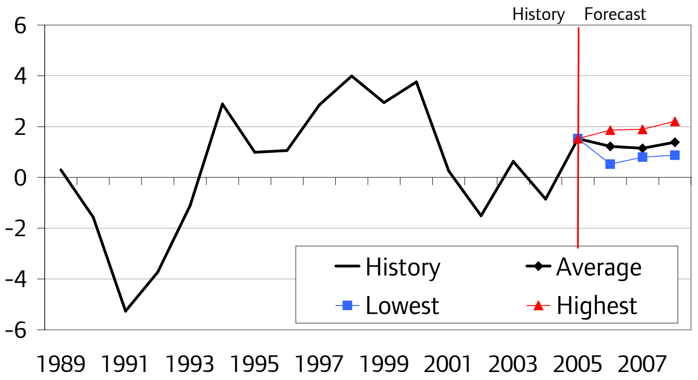
## Employment
(London workforce jobs)

London's labour market showed a recovery in 2005 with employment growth standing at 1.5 per cent.

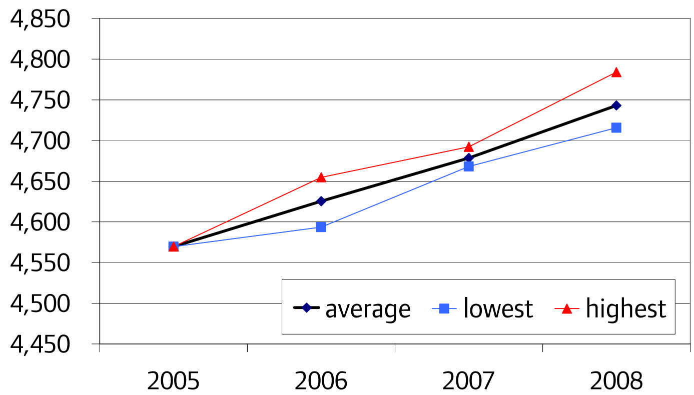
The consensus view is for employment growth to continue at above trend. The average forecast is for employment growth of 1.2 per cent, 1.1 per cent and 1.4 per cent in 2006, 2007 and 2008 respectively.

The independent forecasters are in broad agreement over the future level of jobs. The forecasts for total London jobs by 2008 range from 4.72 million to 4.78 million.

### Annual growth (per cent)




### Level (thousands)




| Annual growth (per cent) | | | |
|---|---|---|---|
| | 2006 | 2007 | 2008 |
| Average | 1.2 | 1.1 | 1.4 |
| Lowest | 0.5 | 0.8 | 0.9 |
| Highest | 1.9 | 1.9 | 2.2 |

| Level (thousands) | | | |
|---|---|---|---|
| | 2006 | 2007 | 2008 |
| Average | 4,630 | 4,680 | 4,740 |
| Lowest | 4,590 | 4,670 | 4,720 |
| Highest | 4,660 | 4,690 | 4,780 |

### History: Annual growth (per cent)

| 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 0.3 | -1.6 | -5.3 | -3.7 | -1.1 | 2.9 | 1.0 | 1.1 | 2.8 | 4.0 | 2.9 | 3.8 | 0.3 | -1.5 | 0.6 | -0.9 | 1.5 |

### History: Level (thousands)

| 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 4,290 | 4,220 | 4,000 | 3,850 | 3,810 | 3,920 | 3,960 | 4,000 | 4,110 | 4,280 | 4,400 | 4,570 | 4,580 | 4,510 | 4,540 | 4,500 | 4,570 |

## Household expenditure

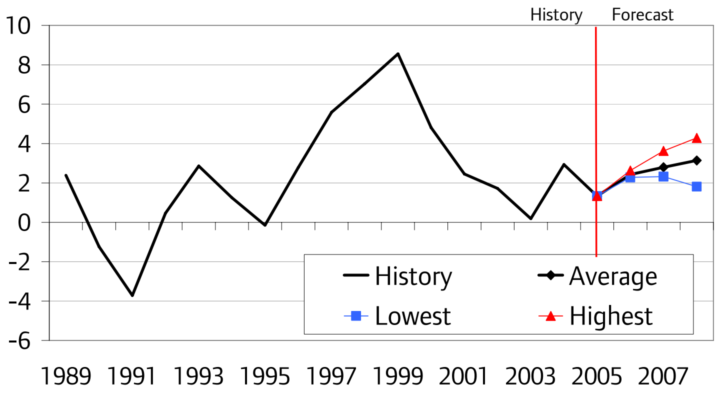
(London household spending, constant year 2003, £ billion)

Growth in household expenditure was 1.3 per cent in 2005.

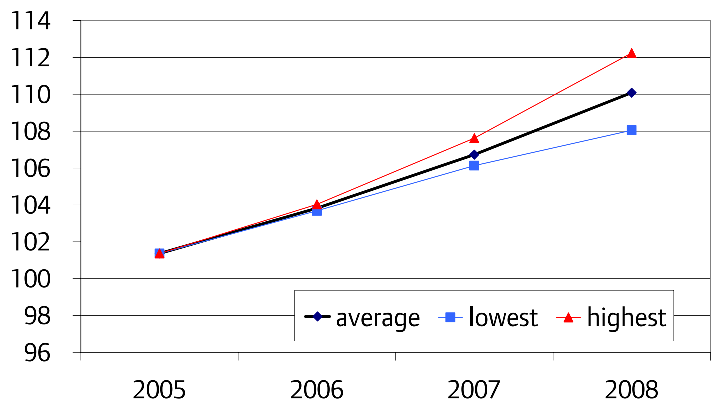
The average of independent forecasters is for stronger household expenditure, with growth rising to 2.4 per cent in 2006, 2.8 per cent in 2007 and 3.1 per cent in 2008.

Even the most pessimistic forecasts expect household expenditure growth to be higher in 2006, 2007 and 2008 than it was in 2005.

### Annual growth (per cent)




### Level (constant year 2003 £ billion)




| Annual growth (per cent) | | | |
|---|---|---|---|
| | 2006 | 2007 | 2008 |
| Average | 2.4 | 2.8 | 3.1 |
| Lowest | 2.3 | 2.3 | 1.8 |
| Highest | 2.6 | 3.6 | 4.3 |

| Level (constant year 2003, £ billion) | | | |
|---|---|---|---|
| | 2006 | 2007 | 2008 |
| Average | 104 | 107 | 110 |
| Lowest | 104 | 106 | 108 |
| Highest | 104 | 108 | 112 |

### History: Annual growth (per cent)

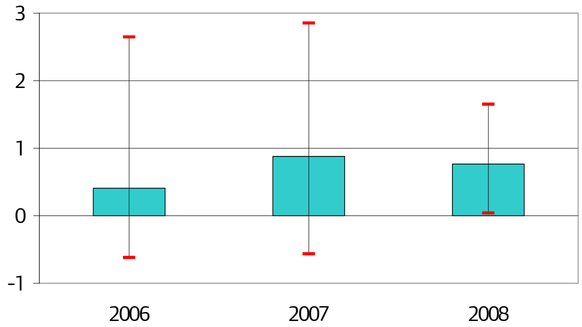
| 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2.4 | -1.2 | -3.7 | 0.5 | 2.9 | 1.2 | -0.1 | 2.8 | 5.6 | 7.0 | 8.6 | 4.8 | 2.4 | 1.7 | 0.2 | 2.9 | 1.3 |

### History: Level (constant year 2003, £ billion)

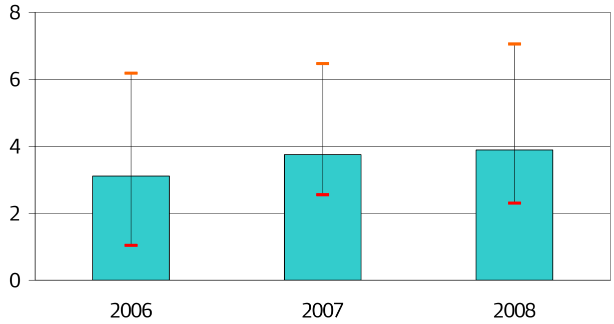
| 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 70.9 | 70.0 | 67.4 | 67.7 | 69.7 | 70.5 | 70.4 | 72.4 | 76.4 | 81.8 | 88.8 | 93.1 | 95.4 | 97.0 | 97.2 | 100.0 | 101.4 |

**Output growth by sector** (per cent annual change)
Growth is expected across all sectors over 2006 – 2008, with manufacturing expected to have the slowest growth on average. Construction, transport and communications, and finance and business services are forecasted to have the fastest growth.

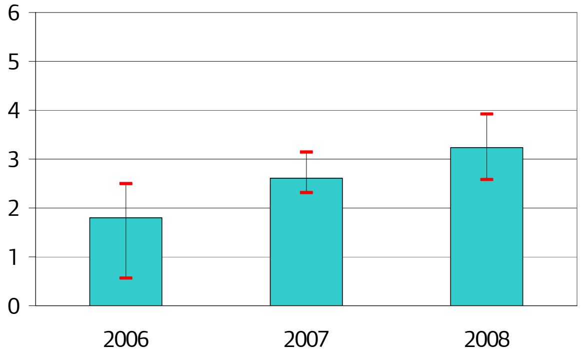
**Manufacturing**



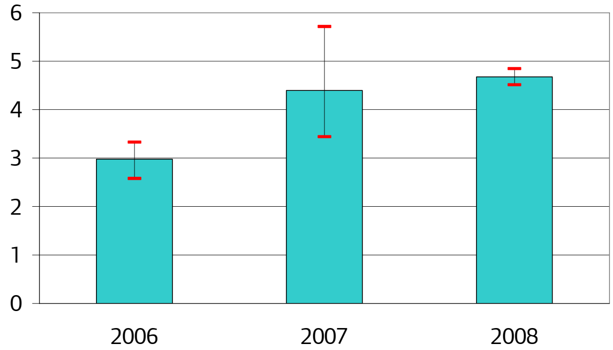

**Construction**



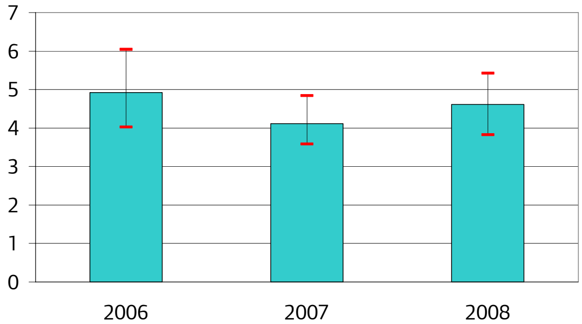

**Distribution, hotels and catering**



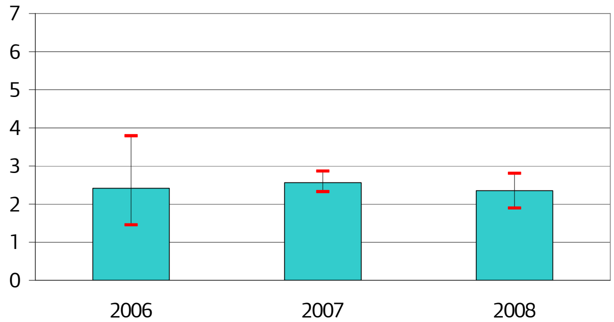

**Transport and communications**




**Finance and business**



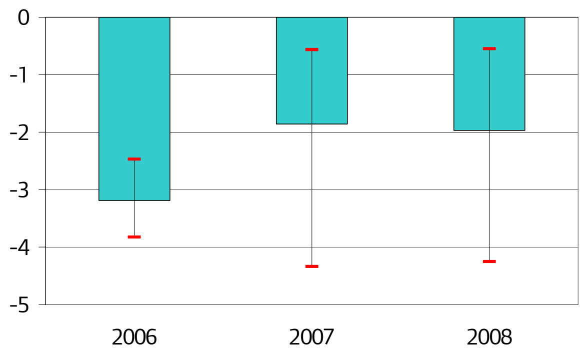

**Other (mainly public) services**



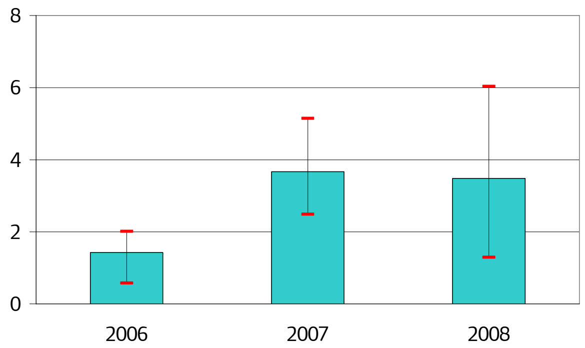

| | | 2006 | 2007 | 2008 | | | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|---|---|
| **Manufacturing** | *Average* | 0.4 | 0.9 | 0.8 | **Construction** | *Average* | 3.1 | 3.8 | 3.9 |
| | *Lowest* | -0.6 | -0.6 | 0.0 | | *Lowest* | 1.0 | 2.6 | 2.3 |
| | *Highest* | 2.6 | 2.9 | 1.7 | | *Highest* | 6.2 | 6.5 | 7.1 |
| **Distribution, hotels and catering** | *Average* | 1.8 | 2.6 | 3.2 | **Transport and communications** | *Average* | 3.0 | 4.4 | 4.7 |
| | *Lowest* | 0.6 | 2.3 | 2.6 | | *Lowest* | 2.6 | 3.4 | 4.5 |
| | *Highest* | 2.5 | 3.1 | 3.9 | | *Highest* | 3.3 | 5.7 | 4.8 |
| **Finance and business** | *Average* | 4.9 | 4.1 | 4.6 | **Other (mainly public) services** | *Average* | 2.4 | 2.6 | 2.4 |
| | *Lowest* | 4.0 | 3.6 | 3.8 | | *Lowest* | 1.5 | 2.3 | 1.9 |
| | *Highest* | 6.0 | 4.8 | 5.4 | | *Highest* | 3.8 | 2.9 | 2.8 |

**Employment growth by sector** (per cent annual change)
Forecasted employment growth shows a more mixed picture across the sectors. Construction and financial and business services jobs are expected to grow the fastest, while manufacturing jobs are expected to decline.

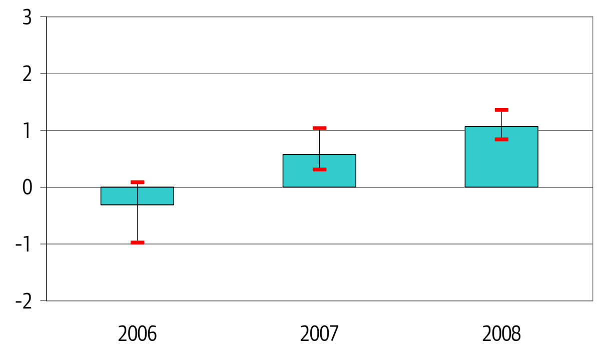
**Manufacturing**



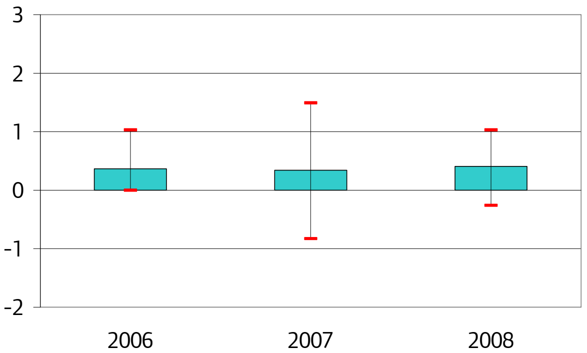

**Construction**



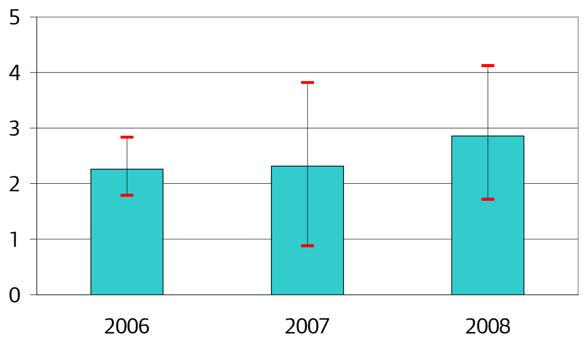

**Distribution, hotels and catering**



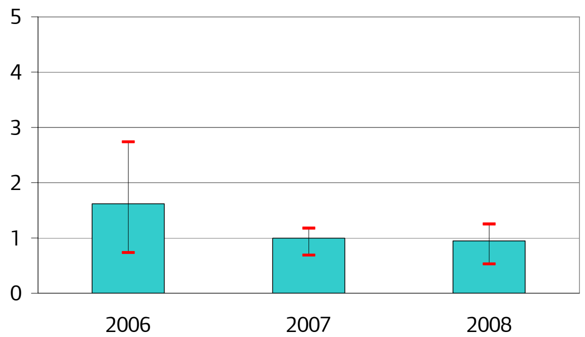

**Transport and communication**




**Finance and business**




**Other (mainly public) services**




| | | **2006** | **2007** | **2008** | | | **2006** | **2007** | **2008** |
|---|---|---|---|---|---|---|---|---|---|
| **Manufacturing** | *Average* | -3.2 | -1.9 | -2.0 | **Construction** | *Average* | 1.4 | 3.7 | 3.5 |
| | *Lowest* | -3.8 | -4.3 | -4.3 | | *Lowest* | 0.6 | 2.5 | 1.3 |
| | *Highest* | -2.5 | -0.6 | -0.5 | | *Highest* | 2.0 | 5.1 | 6.0 |
| **Distribution, hotels and catering** | *Average* | -0.3 | 0.6 | 1.1 | **Transport and communications** | *Average* | 0.4 | 0.3 | 0.4 |
| | *Lowest* | -1.0 | 0.3 | 0.8 | | *Lowest* | 0.0 | -0.8 | -0.3 |
| | *Highest* | 0.1 | 1.0 | 1.4 | | *Highest* | 1.0 | 1.5 | 1.0 |
| **Finance and business** | *Average* | 2.3 | 2.3 | 2.9 | **Other (mainly public) services** | *Average* | 1.6 | 1.0 | 0.9 |
| | *Lowest* | 1.8 | 0.9 | 1.7 | | *Lowest* | 0.7 | 0.7 | 0.5 |
| | *Highest* | 2.8 | 3.8 | 4.1 | | *Highest* | 2.7 | 1.2 | 1.3 |

# 5. The GLA Economics forecast

## 5.1 Assumptions and methods

This forecast combines the GLA's long-term trend projections for employment and population with medium-term assumptions about the growth of the UK economy derived from HM Treasury's comparison of independent forecasts.

The model is constrained for the year 2020 to London-based employment projections derived from the long-term growth rate of London's workforce. The UK assumptions comprise the medium-term growth rates of UK total output. The GLA's long-term employment projections for London have been updated from those underlying the London Plan and updated projections were published in December 2005.[xxvi]

## 5.2 Detailed assumptions for the UK

Table 5.1 shows the assumptions adopted by the GLA for its forecast and compares them to HM Treasury's Budget 2006 forecast. Note that the GLA forecast is based on assumptions up to 2020, though the forecast itself only goes up to 2008.

**Table 5.1: UK economic assumptions**
(annual percentage growth rates)

| | | 2006 | 2007 | 2008 |
|---|---|---|---|---|
| GLA forecast[xxvii] | GVA | 2.5 | 2.5 | 2.5 |
| | Consumption | 2.1 | 2.2 | - |
| Budget 2006 | GVA | 2-2½ | 2¾-3¼ | 2¾-3¼ |
| | Consumption | 2-2½ | 2¼-2¾ | 2½-3 |

GLA Economics has adopted consensus growth estimates throughout. These estimates, when applied to EBS's UK model, generate UK growth rates for manufacturing and non-manufacturing which impact on the London forecast, since London has a higher share of non-manufacturing production than the UK average. These growth rates are shown in Table 5.2.

**Table 5.2: Implicit UK annual percentage growth rates**

| | 2006 | 2007 | 2008 |
|---|---|---|---|
| Manufacturing output | 0.8 | 1.4 | 1.5 |
| Non-manufacturing output | 3.1 | 2.8 | 2.9 |

*Source: EBS's UK forecast using GLA Economics assumptions on UK GDP growth*

## 5.3 Projections and forecasts

It is necessary to distinguish carefully between the GLA's long-term employment projections and this forecast which contains the GLA's medium-term planning projections. Trend projections, by definition, do not incorporate cyclical variations and constitute estimates of jobs and output at comparable points in the cycle. The actual course of output and employment will vary around this trend. Trend projections are essential for planning to provide capacity (such as office space, housing and transport) to accommodate the needs of the economy throughout and at the peak of the cycle, not just at its low points. For business planning (for example, in deciding the timing of investments and the likely course of revenue) estimates of actual numbers of jobs and actual output at any point in time are required. The medium-term planning projections provide these estimates.

As time progresses and more data become available, it becomes possible to identify turning points in the data: whether underlying trends are continuing or new trends are being established. While the forecast is calibrated to the GLA's employment projections for 2020, it provides early warnings of significant deviations from these projections because it accounts for the most recent data and incorporates the latest estimates of UK growth rates.

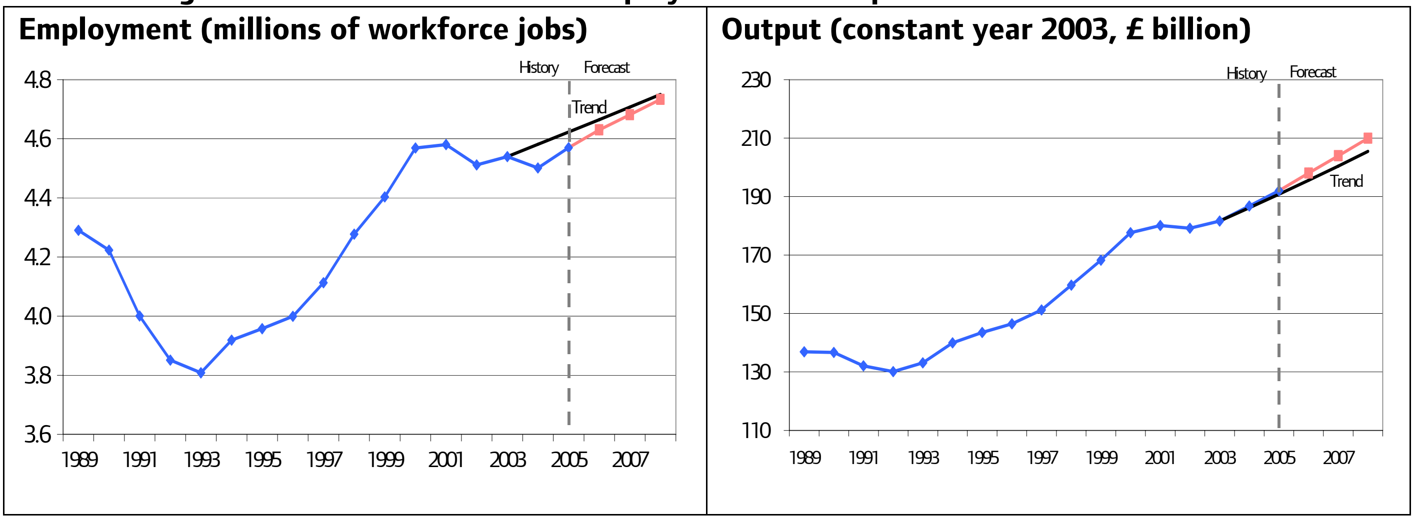
In 2005 the GLA commissioned new employment projections from Volterra Consulting which now form the trend projection on which the medium-term forecast is based. The start point for the trend projection has moved forward to 2003, from 2002 in previous publications.  For this reason 2003 is taken as the start point for all trend (long-term) projections. For comparison purposes, absolute (level) trend projections are derived by applying the trend growth rates to the latest-available historical data for 2003. These levels may differ from the absolute levels for GVA, employment and household expenditure published elsewhere as a result of revisions to historical data as better information becomes available.

## 5.4 Results

Output is expected to grow at around three per cent a year throughout 2006-2008, above the long-term trend of 2.5 per cent a year. Employment is also forecast to continue to grow above the trend rate.

Following a slowdown in 2005, household spending growth is expected to recover in 2006. Household spending growth is forecast to recover to 2.5 per cent in 2006, 2.1 per cent in 2007 and 2.8 per cent in 2008.

**Figure 5.1: Trend and forecast employment and output**




*Source: EBS and GLA Economics' calculations*

**Table 5.3: Forecast and historical growth rates**

Annual % change

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|---|---|
| **GVA** | 5.6 | 1.4 | -0.5 | 1.4 | 2.8 | 2.8 | 3.1 | 3.0 | 3.0 |
| **Workforce jobs** | 3.8 | 0.3 | -1.5 | 0.6 | -0.9 | 1.5 | 1.3 | 1.1 | 1.1 |
| **Household spending** | 4.8 | 2.4 | 1.7 | 0.2 | 2.9 | 1.3 | 2.5 | 2.1 | 2.8 |
| **Household income** | 6.5 | 4.6 | 1.1 | 2.7 | 0.5 | 2.4 | 2.3 | 3.1 | 3.4 |

**Table 5.4: Forecast and historical levels**

(constant year 2003, £ billion except jobs)

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|---|---|
| **GVA** | 177.7 | 180.1 | 179.2 | 181.6 | 186.7 | 192.0 | 198 | 204 | 210 |
| **Workforce jobs (millions)** | 4.57 | 4.58 | 4.51 | 4.54 | 4.50 | 4.57 | 4.6 | 4.7 | 4.7 |
| **Household spending** | 93.1 | 95.4 | 97.0 | 97.2 | 100.0 | 101.4 | 104 | 106 | 109 |
| **Household income** | 101.5 | 106.1 | 107.3 | 110.2 | 110.8 | 113.5 | 116 | 120 | 124 |

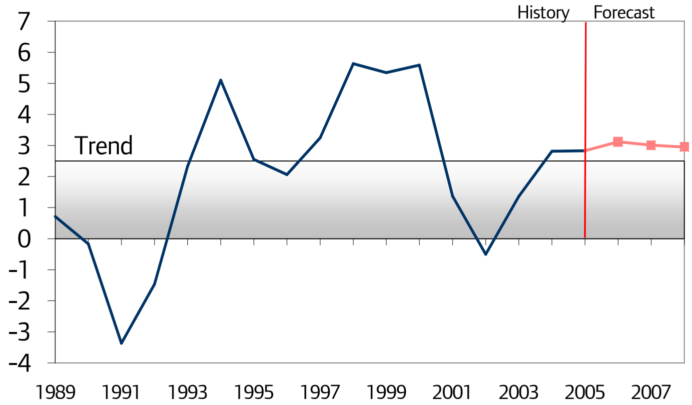
## Output

(London GVA, constant year 2003, £ billion)

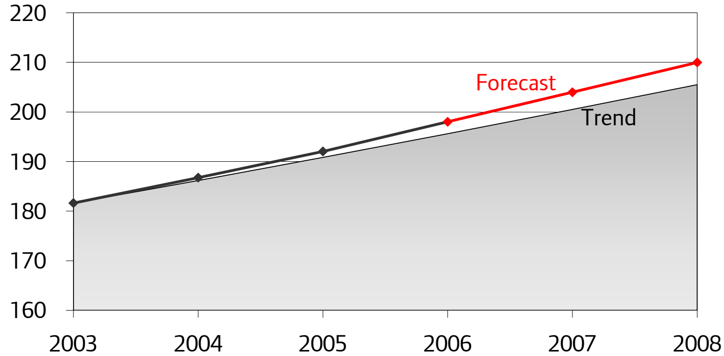
London real GVA growth is forecast to remain above trend throughout 2006-2008, at around three per cent per annum.

The GLA forecast is slightly below the average of independent forecasts for 2007 and 2008.

### Annual growth (per cent)




### Level (constant year 2003, £ billion)




| Growth (annual per cent) | | | | |
|---|---|---|---|---|
| | 2005 | 2006 | 2007 | 2008 |
| GLA | 2.8 | 3.1 | 3.0 | 3.0 |
| Consensus | | 3.0 | 3.1 | 3.3 |

| Level (constant year 2003, £ billion) | | | | |
|---|---|---|---|---|
| | 2005 | 2006 | 2007 | 2008 |
| GLA | 192 | 198 | 204 | 210 |
| Consensus | | 198 | 204 | 211 |

### History: Annual growth (per cent)

| 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 0.7 | -0.2 | -3.4 | -1.5 | 2.3 | 5.1 | 2.6 | 2.1 | 3.2 | 5.6 | 5.3 | 5.6 | 1.4 | -0.5 | 1.4 | 2.8 | 2.8 |

### History: Level (constant year 2003, £ billion)

| 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 136.9 | 136.7 | 132.0 | 130.1 | 133.1 | 139.9 | 143.5 | 146.5 | 151.2 | 159.7 | 168.3 | 177.7 | 180.1 | 179.2 | 181.6 | 186.7 | 192.0 |

## Employment

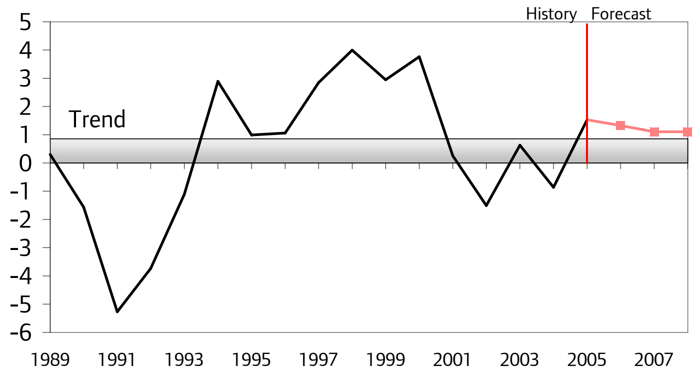
(London workforce jobs)

London's employment is forecast to grow above the trend rate from 2006 through to 2008. Employment growth of 1.3 per cent is forecast in 2006, falling back to 1.1 per cent in 2007 and 2008.

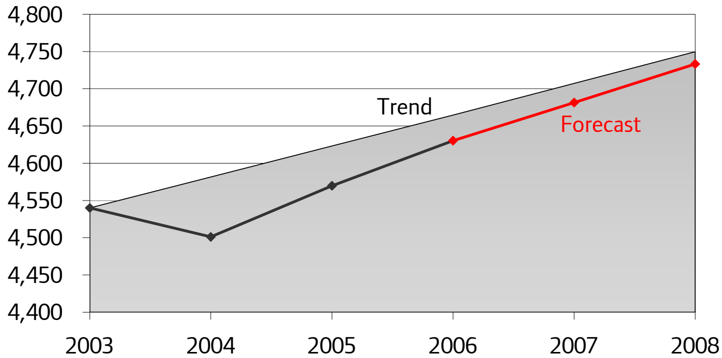
The GLA forecast for employment growth is broadly consistent with the average of independent forecasters.

By 2008, London is expected to have 4.73 million workforce jobs.

### Annual growth (per cent)




### Level (thousands of workforce jobs)




| **Growth (annual per cent)** | | | | |
|---|---|---|---|---|
| | 2005 | 2006 | 2007 | 2008 |
| GLA | 1.5 | 1.3 | 1.1 | 1.1 |
| Consensus | | 1.2 | 1.1 | 1.4 |

| **Level (thousands of workforce jobs)** | | | | |
|---|---|---|---|---|
| | 2005 | 2006 | 2007 | 2008 |
| GLA | 4,570 | 4,630 | 4,680 | 4,730 |
| Consensus | | 4,630 | 4,680 | 4,740 |

### History: Annual growth (per cent)

| 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 0.3 | -1.6 | -5.3 | -3.7 | -1.1 | 2.9 | 1.0 | 1.1 | 2.8 | 4.0 | 2.9 | 3.8 | 0.3 | -1.5 | 0.6 | -0.9 | 1.5 |

### History: Level (thousands)

| 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 4,290 | 4,220 | 4,000 | 3,850 | 3,810 | 3,920 | 3,960 | 4,000 | 4,110 | 4,280 | 4,400 | 4,570 | 4,580 | 4,510 | 4,540 | 4,500 | 4,570 |

## Household expenditure

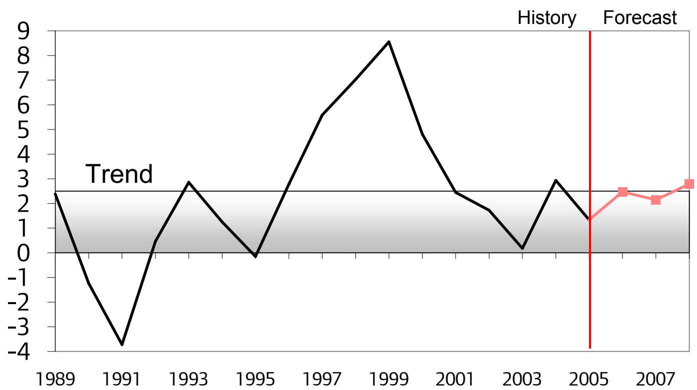
(London household spending, constant year 2003, £ billion)

Growth in London household spending is expected to remain below GVA growth over the medium term.

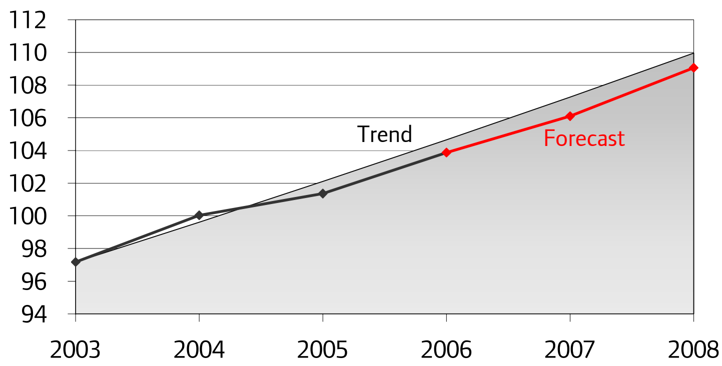
Nonetheless, spending growth is expected to recover from its dip in 2005, reaching 2.5 per cent in 2006, 2.1 per cent in 2007, and 2.8 per cent in 2008.

This places the GLA forecast below the average of independent forecasters during 2007 and 2008.

**Annual growth (per cent)**




**Level (constant year 2003, £ billion)**




| Growth (annual per cent) | | | | |
|---|---|---|---|---|
| | 2005 | 2006 | 2007 | 2008 |
| GLA | 1.3 | 2.5 | 2.1 | 2.8 |
| Consensus | | 2.4 | 2.8 | 3.1 |

| Level (constant year 2003, £ billion) | | | | |
|---|---|---|---|---|
| | 2005 | 2006 | 2007 | 2008 |
| GLA | 101 | 104 | 106 | 109 |
| Consensus | | 104 | 107 | 110 |

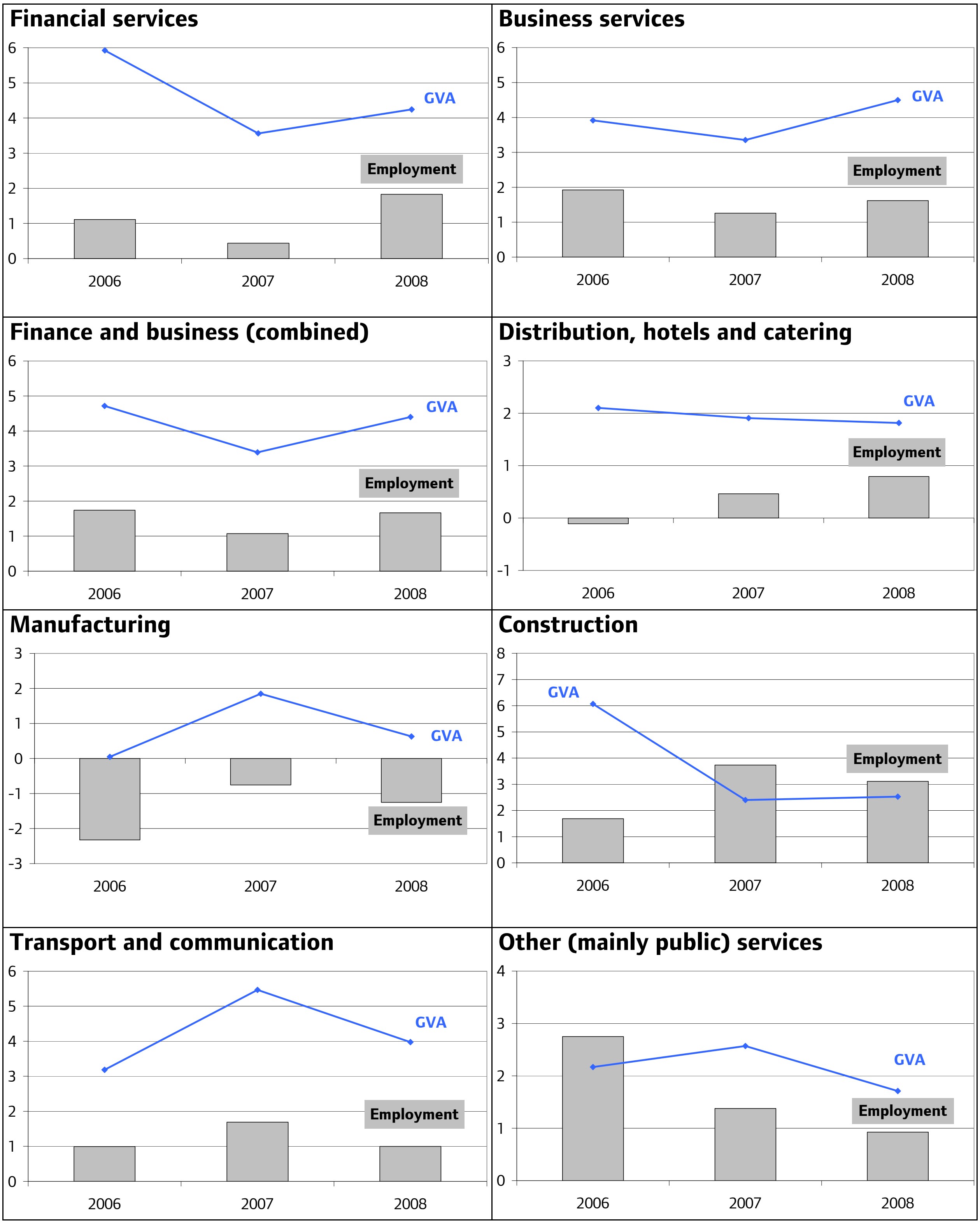
**History: Annual growth (per cent)**

| 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2.4 | -1.2 | -3.7 | 0.5 | 2.9 | 1.2 | -0.1 | 2.8 | 5.6 | 7.0 | 8.6 | 4.8 | 2.4 | 1.7 | 0.2 | 2.9 | 1.3 |

**History: Level (constant year 2003, £ billion)**

| 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 70.9 | 70.0 | 67.4 | 67.7 | 69.7 | 70.5 | 70.4 | 72.4 | 76.4 | 81.8 | 88.8 | 93.1 | 95.4 | 97.0 | 97.2 | 100.0 | 101.4 |

**Output and employment growth by sector** (per cent annual change)



**Output and employment growth by sector** (per cent annual change)

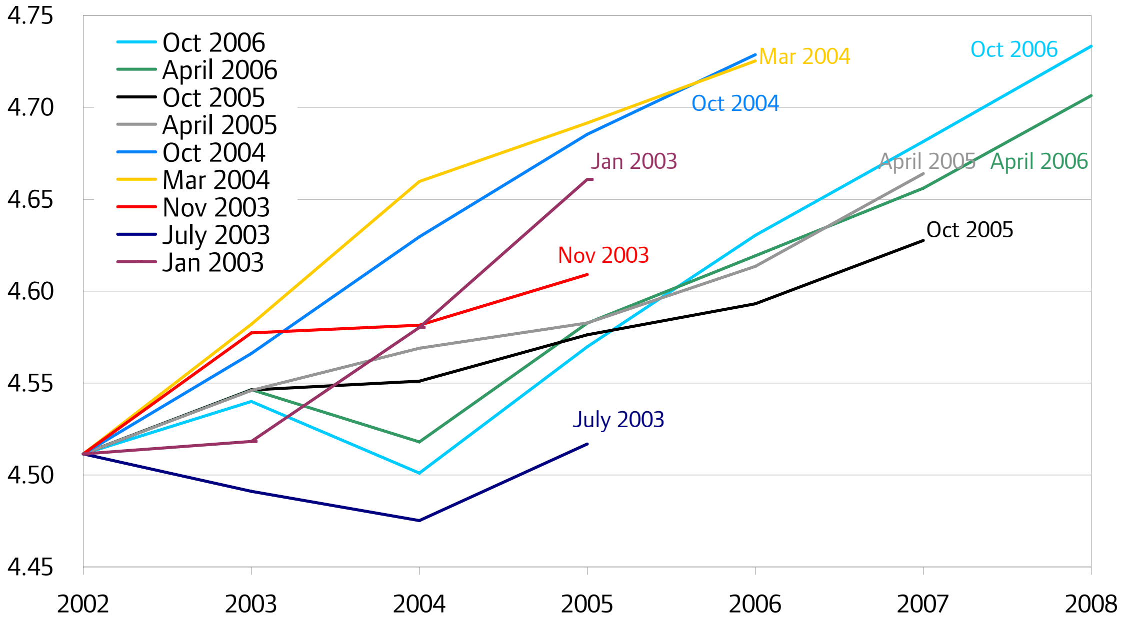
| | 2006 | 2007 | 2008 |
|---|---|---|---|
| **Financial services** | | | |
| Output | 5.9 | 3.6 | 4.2 |
| Employment | 1.1 | 0.4 | 1.8 |
| **Business services** | | | |
| Output | 3.9 | 3.4 | 4.5 |
| Employment | 1.9 | 1.3 | 1.6 |
| **Financial and business services combined** | | | |
| Output | 4.7 | 3.4 | 4.4 |
| Employment | 1.7 | 1.1 | 1.7 |
| **Distribution, hotels and catering** | | | |
| Output | 2.1 | 1.9 | 1.8 |
| Employment | -0.1 | 0.5 | 0.8 |
| **Transport and communications** | | | |
| Output | 3.2 | 5.5 | 4.0 |
| Employment | 1.0 | 1.7 | 1.0 |
| **Other (mainly public) services** | | | |
| Output | 2.2 | 2.6 | 1.7 |
| Employment | 2.8 | 1.4 | 0.9 |
| **Manufacturing** | | | |
| Output | 0.0 | 1.8 | 0.6 |
| Employment | -2.3 | -0.8 | -1.3 |
| **Construction** | | | |
| Output | 6.1 | 2.4 | 2.5 |
| Employment | 1.7 | 3.7 | 3.1 |
| ***(Memo: non-manufacturing)*** | | | |
| *Output* | *3.6* | *3.1* | *3.3* |
| *Employment* | *1.6* | *1.2* | *1.2* |

## 5.5 Comparison with previous forecasts

This section compares the current forecast with previous forecasts in this series. Since the base years for the forecasts change and the base data is continuously revised, the forecasts have been rebased into a common base year for the comparison in Figures 5.2 and 5.3.

Both current employment and GVA growth forecasts (October 2006) have been revised up since the previous (April 2006) forecast.

**Figure 5.2: Employment – latest forecast compared with previous forecasts** (millions of workforce jobs)

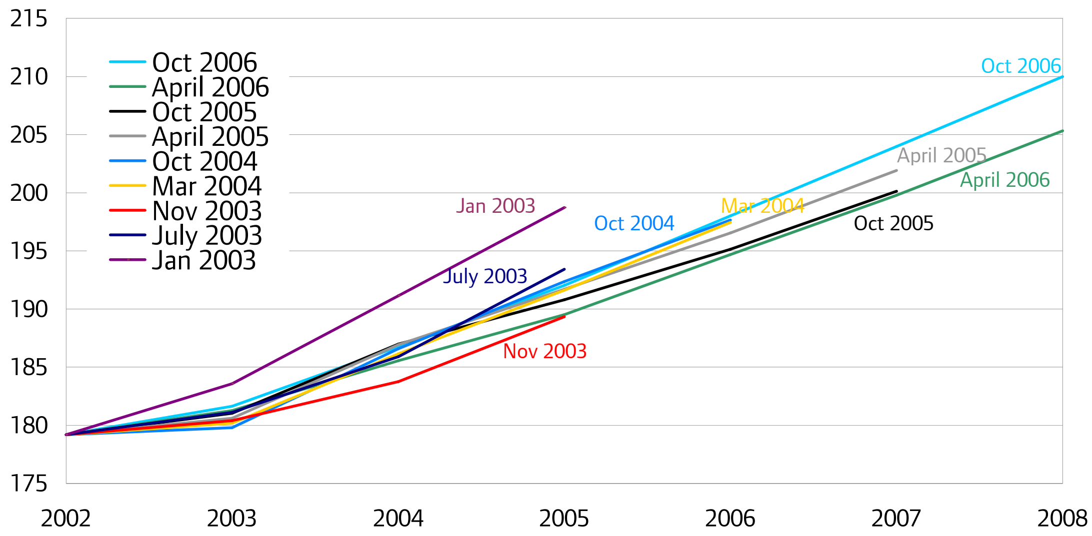



*Source: Various London's Economic Outlooks*

**Table 5.5: Comparisons with previous published forecasts**
(London workforce jobs, per cent annual growth)

| Forecast | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|
| **Oct 2006** | | | | 1.3% | 1.1% | 1.1% |
| **April 2006** | | | | 0.8% | 0.8% | 1.1% |
| **Oct 2005** | | | 0.6% | 0.4% | 0.8% | |
| **April 2005** | | | 0.3% | 0.7% | 1.1% | |
| **Oct 2004** | | 1.4% | 1.2% | 0.9% | | |
| **Mar 2004** | | 1.7% | 0.7% | 0.7% | | |
| **Nov 2003** | 1.5% | 0.1% | 0.6% | | | |
| **July 2003** | -0.5% | -0.4% | 0.9% | | | |
| **Jan 2003** | 0.2% | 1.4% | 1.8% | | | |

**Figure 5.3: Output – latest forecast compared with previous forecasts**
(constant year 2003, £ billion)




*Source: Various London's Economic Outlooks*

**Table 5.6: Comparisons with previous published forecasts**
(London GVA, per cent annual growth)

| Forecast | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|
| **Oct 2006** | | | | 3.1% | 3.0% | 3.0% |
| **April 2006** | | | | 2.7% | 2.6% | 2.8% |
| **Oct 2005** | | | 2.0% | 2.3% | 2.6% | |
| **April 2005** | | | 2.6% | 2.5% | 2.7% | |
| **Oct 2004** | | 3.8% | 3.1% | 2.7% | | |
| **Mar 2004** | | 3.3% | 2.9% | 3.0% | | |
| **Nov 2003** | 0.7% | 1.9% | 3.0% | | | |
| **July 2003** | 1.1% | 2.6% | 4.1% | | | |
| **Jan 2003** | 2.4% | 4.1% | 4.0% | | | |

# 6. Globalisation and London's financial services sector

## 6.1 Introduction

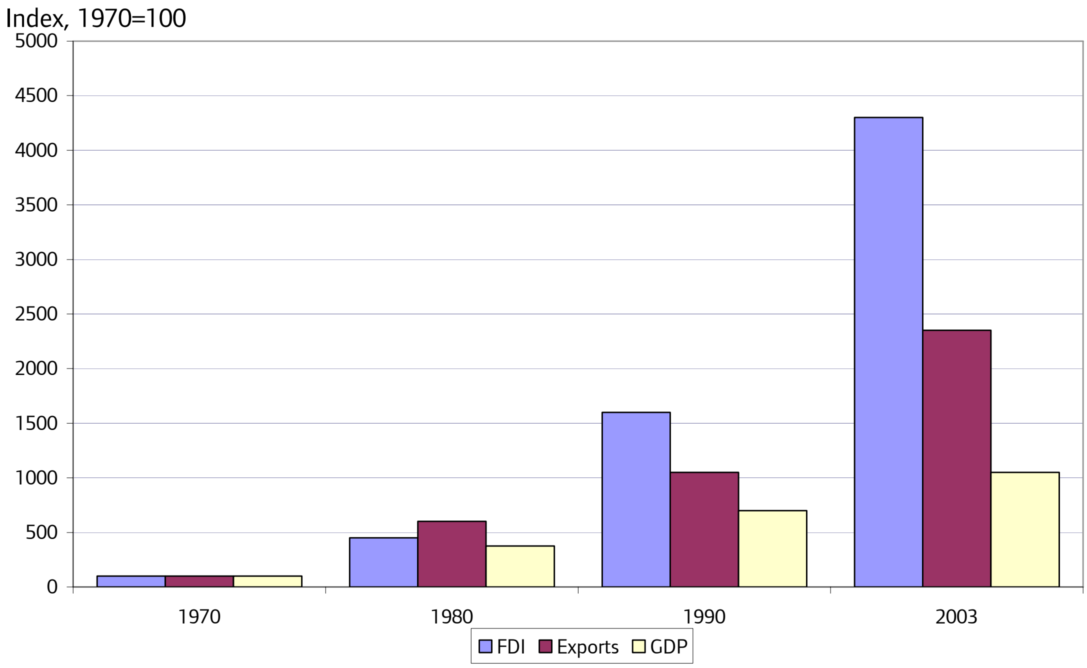
Globalisation has been usefully defined in the economic context as 'the integration of economies through markets across frontiers'.[xxviii] This integration has been characterised by an increasing global movement of capital, goods, services, and labour, and has resulted in unprecedented levels of interaction and interdependence between economies. In general, periods of globalisation have been associated with strong world economic growth.

The driving forces behind globalisation have primarily been:

- advancements in production technology and in the international organisation of production and business
- a reduction in transport and communication costs
- economic liberalisation – countries opening up markets to capital flows and international trade.

The growing importance of capital flows can be seen in Figure 6.1.

**Figure 6.1: The rising importance of trade and capital flows. World output (GDP), Foreign Direct Investment (FDI) and exports**




*Source: HM Treasury, 2004, 'Long-term global economic challenges and opportunities for the UK'*

The rest of this chapter summarises the main features of the most recent phase of globalisation – including some of the key implications for London's economy (Section 6.2).[xxix] Within the context of the new global economy, this chapter also takes a look at three topical areas (hedge funds, private equity and the stock market sector) within London's strongly growing financial services sector (Section 6.3).

## 6.2 The main features of the most recent phase of globalisation

The globalisation process itself is not new – although in the early twenty-first century there are some new elements such as global branding, and both a more global division of production within companies and a global distribution of plants. In the nineteenth and twentieth centuries the countries, continents and regions of the world also went through periods of increasing openness and trade, as well as periods of greater protectionism and isolation. However, the current period is one in which the pace of globalisation has once again picked up and the scale and scope of change is affecting ever more people and products across the world. This current phase of globalisation is characterised especially by the emergence of the major Asian economies back onto the world stage and a resultant shift in the balance of economic power. In particular, China, India and Russia are predicted to play an increasingly important part in the world economy over the coming decades.[xxx]

The channels through which globalisation occurs centre around major world cities such as London. World cities act as 'control centres' housing corporate headquarters, corporate orientated financial services, and supporting business services. Together this bundle of activities allows business establishments within world cities to co-ordinate economic activity and flows of capital across the world. In effect cities are now centres of 'management and co-ordination' of the global economy.[xxxi] Major cities can also act as 'hothouses' for human capital, innovation and new products. As a result, the nature and impact of globalisation is particularly important for London.[xxxii]

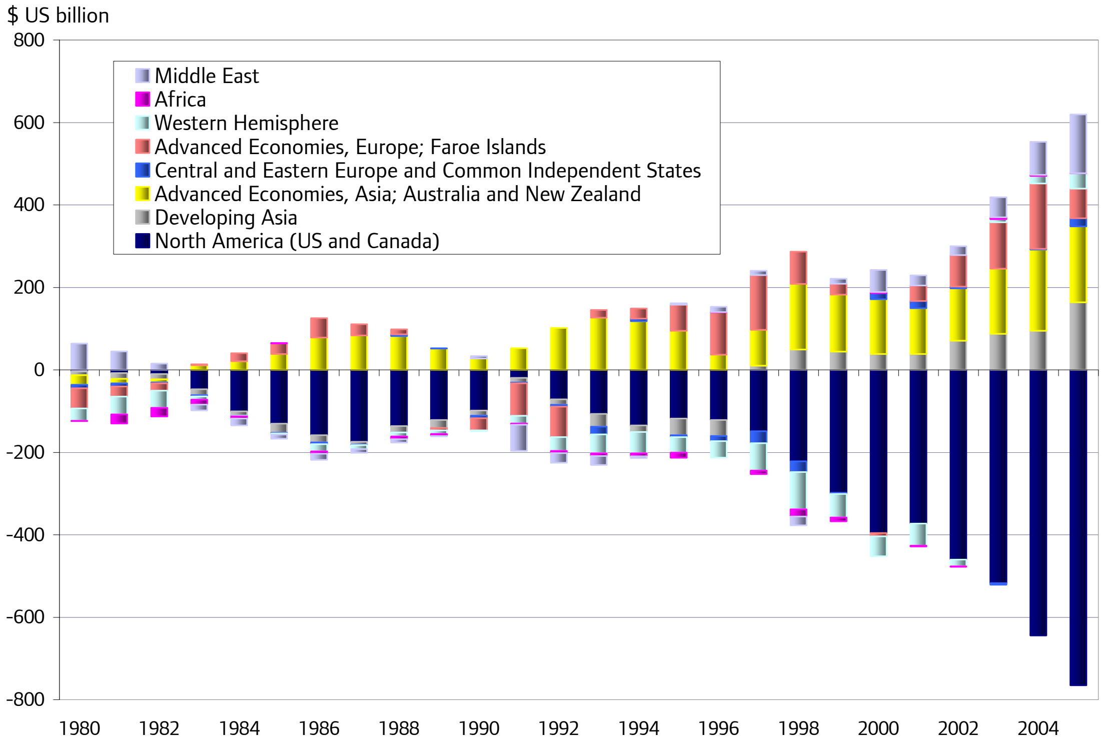
*The impact of globalisation on macroeconomic stability*

One of the benefits of globalisation has been that the growth in low-cost production in emerging economies as well as the spread of innovation has led to a drop in end-user prices. This trend has until now reduced global inflationary pressures and eased pressure on monetary authorities worldwide, allowing interest rates to be lower than they would otherwise be.

Financial globalisation has facilitated increased integration in global capital markets. Two arguments have been put forward as to how this has increased macroeconomic stability. Firstly, as international capital flows become more important for national economic development, assuming they respond negatively to bad monetary and fiscal policies, governments are encouraged to conduct macroeconomic policies providing greater economic stability.[xxxiii] However, Tytell and Wei's (2004)[xxxiv] empirical studies suggest that this 'discipline-effect' is not that strong, finding only modest evidence that financial globalisation has induced countries to pursue low-inflation monetary policies.

Secondly, financial globalisation has enabled the US to sustain a large current account deficit by attracting capital inflows from economies with large and rising current account surpluses (see Figure 6.2), whilst at the same time world long-term real interest rates have been low. This has been made possible due to the emergence of a so-called 'global saving glut' in emerging economies such as China and other East Asian economies (who have built up reserves to promote export led growth policies and to act as buffers against future financial crises) as well as in oil-exporting countries.[xxxv] Without globalisation in financial markets, this global private sector balancing-effect would not be possible; moreover, some have argued further saying that the same forces that underpin this balancing effect will enable a 'benign' transition towards lower external imbalances.[xxxvi]

**Figure 6.2: Current accounts by regions**




*Source: Ecowin, IFS and WEO from IMF*

*Note: Only countries available through Ecowin's IFS service have been included. For some countries, 2005 data are estimates taken from IMF's (Sep 2006) World Economic Outlook.*

However, increased interdependence between countries also means that macroeconomic stability is more exposed to international shocks. When US interest rates rise, or there is a cutback in oil production, or there has been a natural disaster somewhere else across the world the UK economy is affected. These effects are even more pronounced in London. Given that London is a financial centre with links across the world, and that the London economy has a high proportion of financial and business services, events like these increase exposure and hence have significant repercussions on the level of economic activity. For example, the September 11 attacks and the world slowdown that followed helped produce a recession in London in 2002, a feature that did not occur in the UK economy as a whole.

*The emergence of new economic power bases*

Over recent years, China, India and other major emerging economies have been playing an increasingly important role in the global economy. Figures from the IMF show that over the period of 1990-2005, India's share of world output grew by 40 per cent while China's share grew by over 2.5 times. In 2005, China and India's respective shares of world output reached 15.4 per cent and 5.9 per cent in PPP[xxxvii] terms. Over the period 2001-2005, China and India accounted for 33 per cent of global economic growth (again, in PPP terms), compared with a 30 per cent contribution by the G7 countries over the same period.[xxxviii]

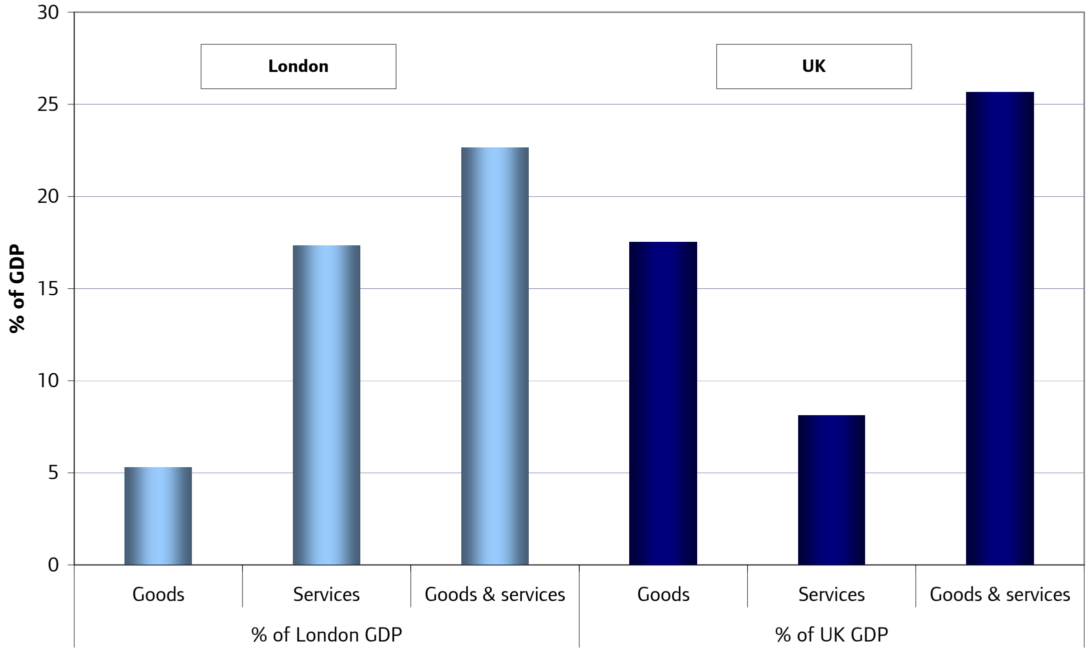
Until recently, the primary role of emerging economies in the globalisation process has been to offer low-cost locations for multinational businesses in relatively labour-intensive and low value-added stages of the production process. However, China and India, given their rapidly increasing position in the world economy, have begun to move beyond this role. As noted by HM Treasury[xxxix], both have been investing heavily in improving the skills-base and skills-level of their workforce. In addition, China has been investing heavily in technology and R&D, while India continues to increase its presence in the international outsourcing and business services industries. Brazil and Russia have been growing slightly less rapidly but are still likely to prove important for both London and the UK in terms of securing markets and fuel supplies. All this has resulted in increased competitive pressure for industrialised economies, not only in traditional areas such as manufacturing but also in the more knowledge-intensive and service-based industries.

Given the growth forecasts for these emerging economies, these competitive pressures will almost certainly increase. But this is not the only effect they will have in the globalisation process. As they grow, the emerging economies will become increasingly important markets for other countries to tap into, both in terms of exports to these emerging economies as well as foreign direct investment from them.

The globalisation process therefore presents both challenges and opportunities to London and the UK. Whilst its effect is a re-location of industry to lower-cost alternatives, it enables the UK and London – as in other parts of the world – to focus on areas of comparative advantage. Since London has already seen a large part of its more standardised manufacturing industry move to other parts of the country, it is likely to be less vulnerable to any further weakness in the manufacturing sector than the UK as a whole. In addition, with its strength in specialised services including the financial and business services and creative industries sectors, London can strengthen its position in these areas. In Section 6.3 we go on to discuss some niche financial services which London is already leading in.

The rise of the emerging economies provides a major growth opportunity for the London economy. As these countries grow and become richer they are also becoming huge markets for goods and increasingly services. Chinese, Indian and other consumers will purchase more insurance of various types as their incomes increase, and as businesses grow they will demand more professional services - legal, accountancy, advertising and consulting. London (and more generally the UK) can continue to capitalise on this by using its comparative advantage in these 'specialist services', largely based on its knowledge base and expertise, to satisfy this expanding demand. London has a particular role to play in this regard. As shown in Figure 6.3, London is much more orientated towards the export of services rather than goods relative to the UK as a whole. Indeed GLA Economics estimates that London accounts for around a third of total UK service exports.

**Figure 6.3: Exports of goods and services as a percentage of GDP – UK and London, 2002**




*Source: GLA Economics (2005) 'Our London Our Future: Planning for London's Growth II'*

As well as increasing trade, as emerging economies grow richer, they will also provide valuable investment into the London and UK economies. Studies by GLA Economics into Foreign Direct Investment (FDI) from China and India[xl] suggest that London accounted for around 13 per cent of the number of Chinese FDI projects into Europe in 1997-2004, and the UK as a whole accounted for around 46 per cent. Most recent figures show that London's share of Chinese inward investment to Europe had increased to around 15 per cent by June 2006.[xli] Indian FDI projects into Europe also seem strongly concentrated in London, with London accounting for 46 per cent of projects between 1997 and 2004 and the UK as a whole accounting for around 59 per cent. Given that the Asian outbound travel market is growing at a faster rate than in any other part of the world,[xlii] business and leisure travel from these countries is also an important source of inward investment into London and the UK.

Investors from China, India and other parts of the world are attracted to London by a range of factors. Research undertaken for Think London, the official inward investment agency for London, highlighted the following as being the main rationale for overseas business locating in London:[xliii]

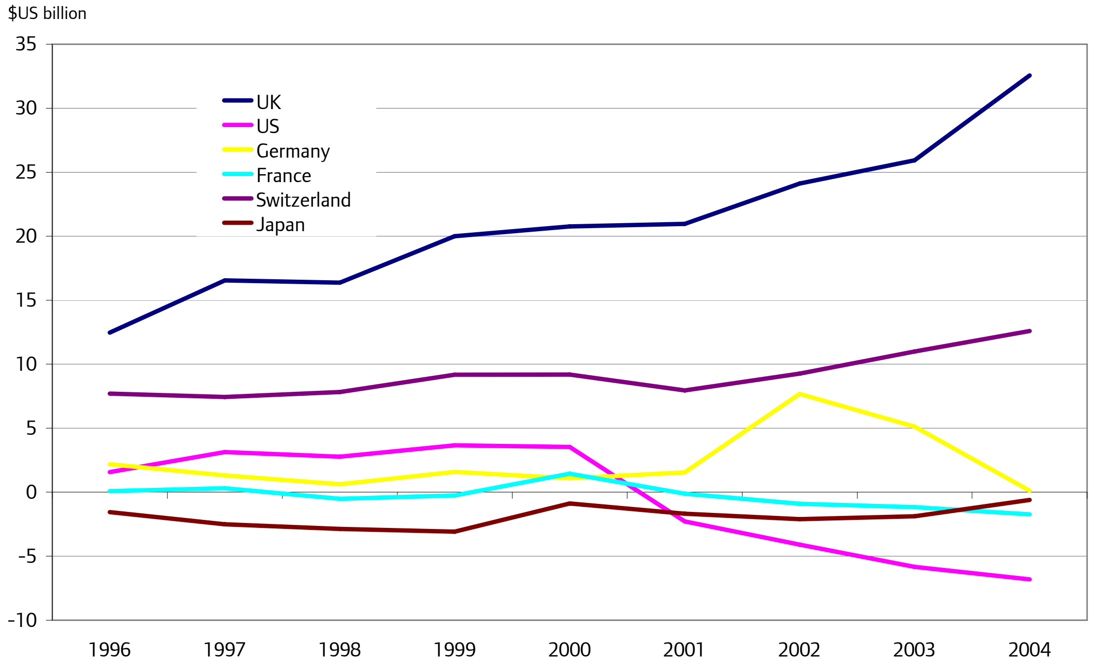
- London's status as a global business city and the access to markets afforded
- proximity to client base
- ease of international travel
- prominence of the English language
- access to skilled labour.

In addition, London is particularly attractive for overseas investors due to the diverse communities within it and the networks they provide, plus a cosmopolitan city culture that is generally welcoming to people of all nations.

*Trade in financial services*

Globalisation has also had a positive impact on London's financial services sector. A key part of London (and the UK's) success over the last decade has been the expansion of financial services. The UK as a whole has enjoyed a much stronger trade balance in financial services than other industrialised countries (Figure 6.4).

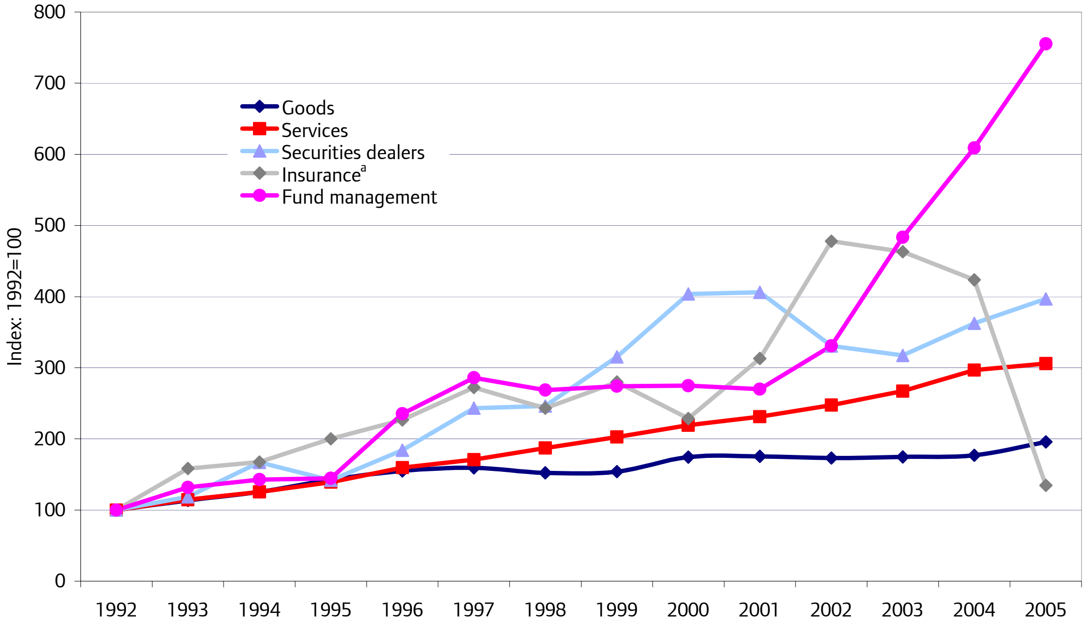
**Figure 6.4: Financial services trade balance in selected countries**




*Source: IMF data reproduced as in International Financial Services, London (2006) 'UK Financial Sector Net Exports'*

Figure 6.5 shows the export side of the UK's healthy financial sector trade balance in more detail. UK exports of services as a whole have tripled since 1992. One of the fastest-growing export industries has been fund management (an industry that is heavily concentrated in London, and which we go on to cover in more detail in Section 6.3).

**Figure 6.5: The growth in UK exports of services (indexed to 1992 values)**




[a]The dip in insurance sector exports in 2005 is primarily due to Hurricane Katrina pay-outs

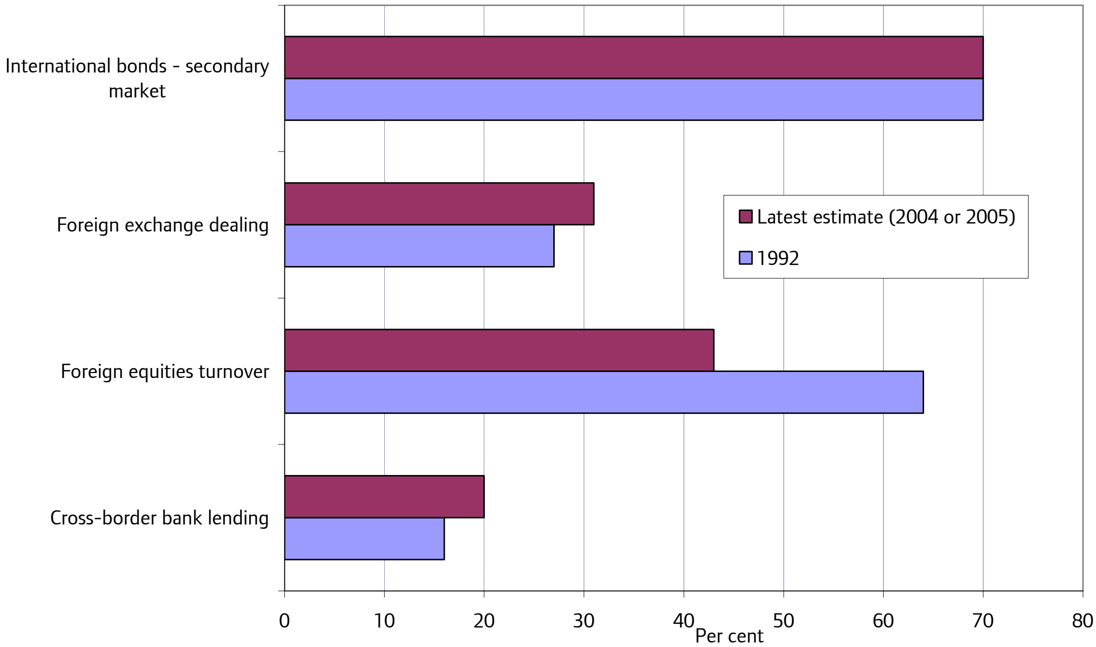
*Source: Office for National Statistics*

## 6.3 London's financial services in the new global context

London is matched only by New York as the world's leading financial centre. In 2000, both cities had close to $2.5 trillion of assets under management.[xliv] Although sterling-denominated assets are not in as high a demand as the US dollar, London is at the forefront of financial trading patterns due to its geographical location, and its long history of trade and commerce.[xlv]

The provision of funding services and managing the movement of capital are areas of specialisation (and comparative advantage) for the London economy. Matching the supply and demand for investment funds across the world and providing the right contractual basis for such funds, as well as rates that reflect appropriately the riskiness of ventures, has been a function of the City of London over several centuries. The expertise and agglomeration benefits that have resulted means that even in a technology-driven world the City still specialises in niche markets: for example, according to International Financial Services, London (IFSL) calculations, 43 per cent of the world's over-the-counter derivatives in 2004 were traded in London.[xlvi] The range of skills and businesses involved in such activity should not be underestimated. Figure 6.6 illustrates London's position as the world's leading financial centre (with New York).

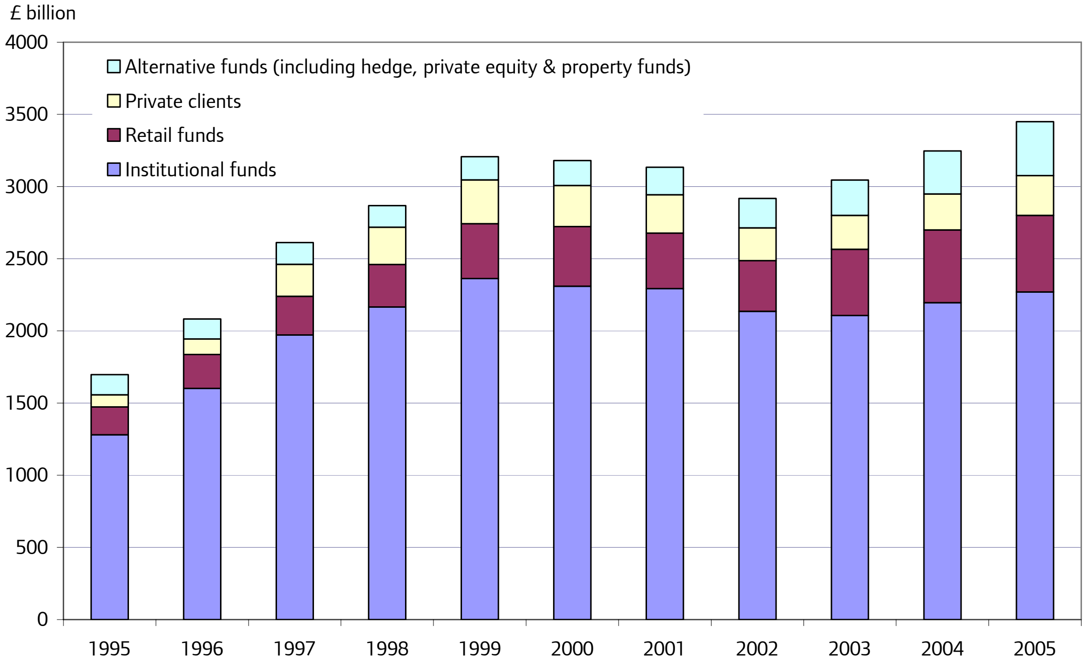
### Figure 6.6: London's share of selected international financial markets




*Source: International Financial Services, London (IFSL) estimates*

UK funds under management (of which the majority is managed in London) reached a record £3.5 trillion in 2005, according to IFSL research (Figure 6.7). The vast majority of funds under management are institutional (mainly insurance companies and pension funds), but it is the 'alternative funds' which have been growing most strongly in recent years. In this section, we discuss hedge funds and private equity funds in slightly more detail – before also summarising some recent trends in the stock market sector.

### Figure 6.7: Growth of funds under management in the UK




*Source: IFSL estimates, from IFSL (2006) 'City Business Series: Fund Management'*

## Case study 1: London's hedge fund industry

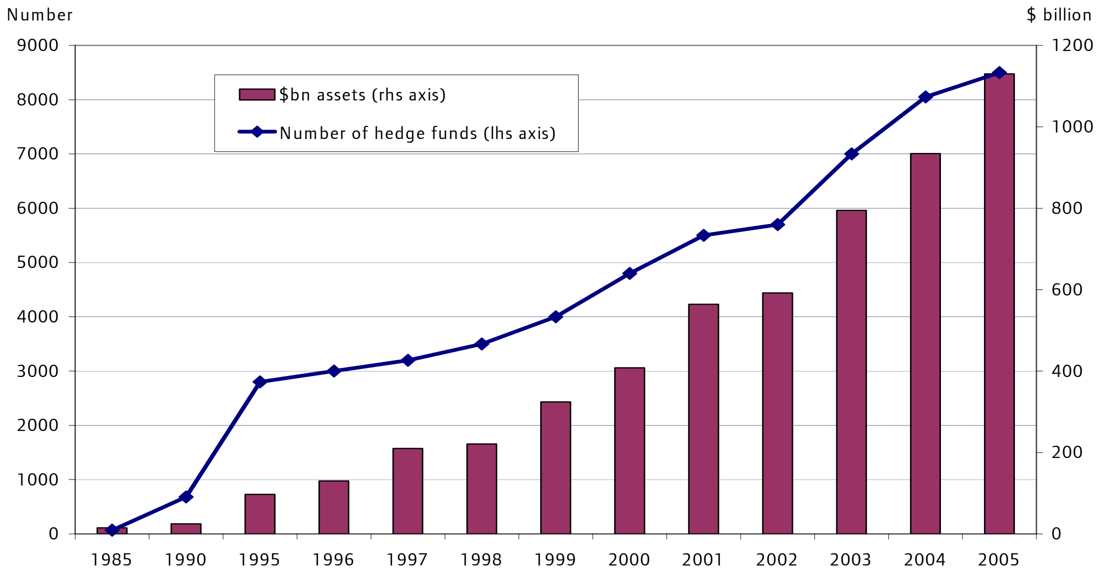
*IFSL definition of hedge funds*
"Hedge funds are private pooled investment limited partnerships which fall outside many of the rules and regulations governing mutual funds. Hedge funds therefore can invest in a variety of securities on a leveraged basis. Today, the term hedge fund refers not so much to the hedging techniques hedge funds may employ as it does to their status as private investment partnerships."[xlvii]

In brief, the hedge fund industry offers investors higher potential returns, along with higher risk. They do this by borrowing in order to invest, using techniques such as short-selling (profiting during a falling market) and investing in more complex instruments such as derivatives. The hedge fund 'product' was originally intended to be strictly limited to high net worth and experienced investors only.

Given the advertising restrictions placed on hedge funds, and the voluntary basis by which they give information to third parties, accurate information on the size of the hedge fund industry and the specifics of where and how it operates, is difficult to come by.[xlviii] In this section, we draw on secondary sources such as IFSL and Corporation of London research.

*Role of globalisation*
Hedge funds are a prime example of a truly globalised industry: they can be domiciled (registered) in one country, managed in another, and funded from all over the world. The number of hedge funds and the assets that they have under management have both grown sharply since the early 1980s (Figure 6.8). It is thought that while growth of the *number* of hedge funds may be slowing down, the *volume* of hedge fund assets is likely to continue to grow strongly.

**Figure 6.8: The global hedge fund industry**




*Source: IFSL estimates, based on Van Hedge Advisors International Inc. and Morgan Stanley*

London is the second-largest hedge fund centre in the world, after New York. While, for tax reasons, the majority of hedge funds are registered in Offshore locations, most managers are based in the US (54 per cent) and EU (23 per cent). Of the European-managed hedge funds, around two thirds are located in London. A fifth of the world's hedge fund assets (including 80 per cent of Europe's) are managed out of London, compared with a tenth in 2002.[xlix] Investments in hedge funds are sourced from around the world as well: the proportion of global hedge fund investments originating in the US fell from 86 per cent in 2002 to 62 per cent in 2005, while the share of investments from Europe and Asia increased.

IFSL have identified many factors which attract hedge funds to London, including:

- local expertise
- proximity of clients and markets
- strong asset management industry
- favourable regulatory environment.

Many London hedge fund managers are making a conscious decision to eschew the City and Canary Wharf in favour of areas such as Mayfair and Soho. This creates a physical as well as a regulatory/legal separation from the more traditional managed fund industries. Partly, this could be due to the type of manager hedge funds aim to attract – offering them a more pleasant (as well as less regulated) environment in which to work by comparison to the big banks.

The Corporation of London commissioned Radley & Associates to investigate the potential impact of the hedge fund industry on City of London jobs and offices.[l] This report (based on conventional data sources and interviews with a range of hedge fund market actors) found that 61 per cent of UK hedge funds were based in the West End (W1, SW1 and SW3), 30 per cent in the City and nine per cent elsewhere in the UK. West End (Mayfair) office rents are the most expensive per square foot, but most hedge fund managers interviewed stressed that it was a personal, lifestyle-driven choice to move away from the City. Competition for highly-skilled staff between hedge funds and more conventional City-based employers is small in relative terms – the typical hedge fund company tends to employ a small number of people, each supporting a large quantity of funds.[li] The interviewees also stressed that competition between the City and the West End was not necessarily a zero sum game in terms of skills and expertise.

While New York is home to many more hedge fund managers than London, London is in a good position to grow over the next few years. In a recent *Economist* article ('Capitals of Capital', 2 Sep 2006), New York and London are both compared (they stand out as the two world financial centres) and contrasted. London hedge fund managers claim that while the Financial Services Authority's regulatory principles provide useful requirements on new funds, once established the funds benefit from 'a relatively light touch based on broad principles, including protecting consumers and promoting competition'. In contrast, the US approach is to allow 'virtually anyone' to start a hedge fund – but then to bring down a 'legal sledgehammer' on those who fail.

The expected future growth of the global hedge fund industry should not be seen as alarming for economic and financial stability, especially in the long run.[lii] Due to the variety of investment techniques used by the sector, there is no inherent reason why hedge funds should be any more or less risky than a traditional 'long only' fund. And it is estimated that average leverage positions have fallen since a peak in 2000 (perhaps due to concerns after one of the largest US hedge funds, LTCM, had to be rescued from collapse in late 1998).[liii]

The picture of London's hedge fund industry that emerges from these secondary sources is one of a highly specialised industry slowly evolving into a more mature industry, with increased involvement of institutional investors (insurance companies and pension funds looking to diversify). Subject to an FSA consultation process, retail customers could also be given limited access (as in the US). These trends mean that hedge fund investment strategies are likely to evolve over time to meet these particular demands. Overall returns may fall, but (as the Corporation of London/Radley & Associates report suggests) it is also possible that the industry will divide into two: small, higher risk (and higher expected return) funds which cater to the 'High Net Worth Individuals' (HNWIs) and remain largely unregulated; and larger funds (which bear more similarity to traditional asset management) which service the demand from institutional and retail investors.

### Case study 2: Private equity

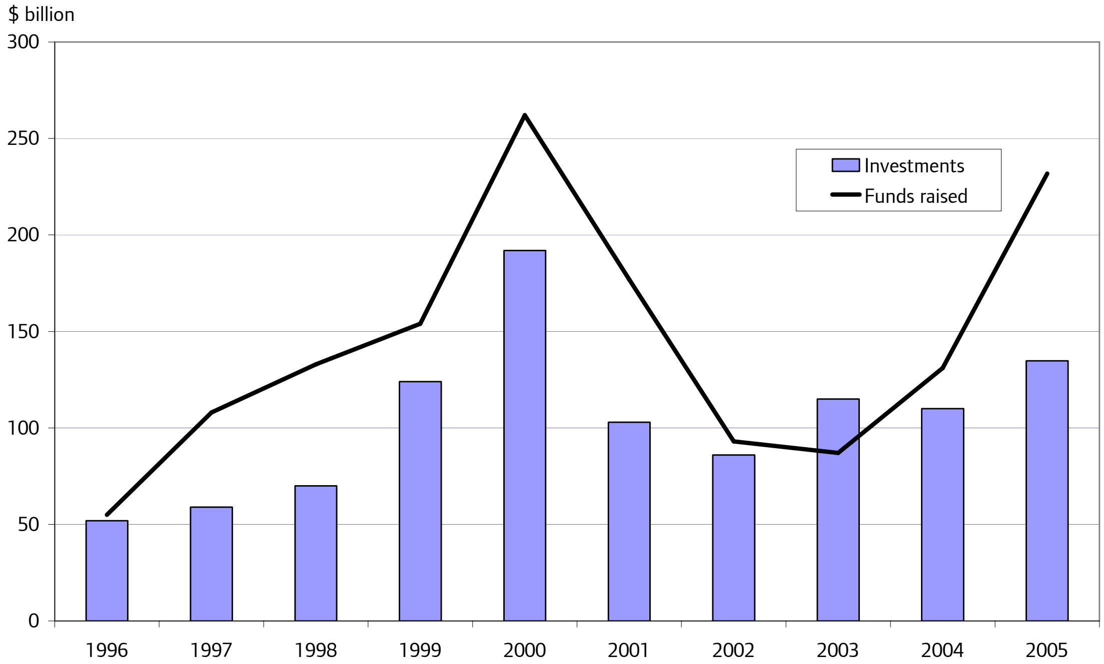
*IFSL definition of private equity*
The term 'private equity' covers "any type of equity investment in an asset in which the equity is not freely tradable on a public stock market… Categories of private equity investment include all types of venture investing, buyout investing and special situations" [investment in specialised debt instruments].[liv]

Similar to hedge funds, analysis of private equity activity is limited by data availability. Here, we rely on IFSL estimates, along with recent reports from within the industry.

Private equity, since its beginnings in the 1940s and 1950s, has always played a role in helping young businesses become established. As an industry, it has grown from venture capitalists directly investing in new or small enterprises into a much more managed set-up, often involving private equity funds – along with hedge funds (and property funds), part of the burgeoning alternative managed funds industry.

Private equity firms source funds from around the world and spread these funds globally as well, across a range of industrial sectors. IFSL has estimated that (after a dip in activity in 2001 and 2002) the private equity industry recovered to make nearly $135 billion of private equity investments around the world in 2005 (Figure 6.9).

**Figure 6.9: Global private equity**

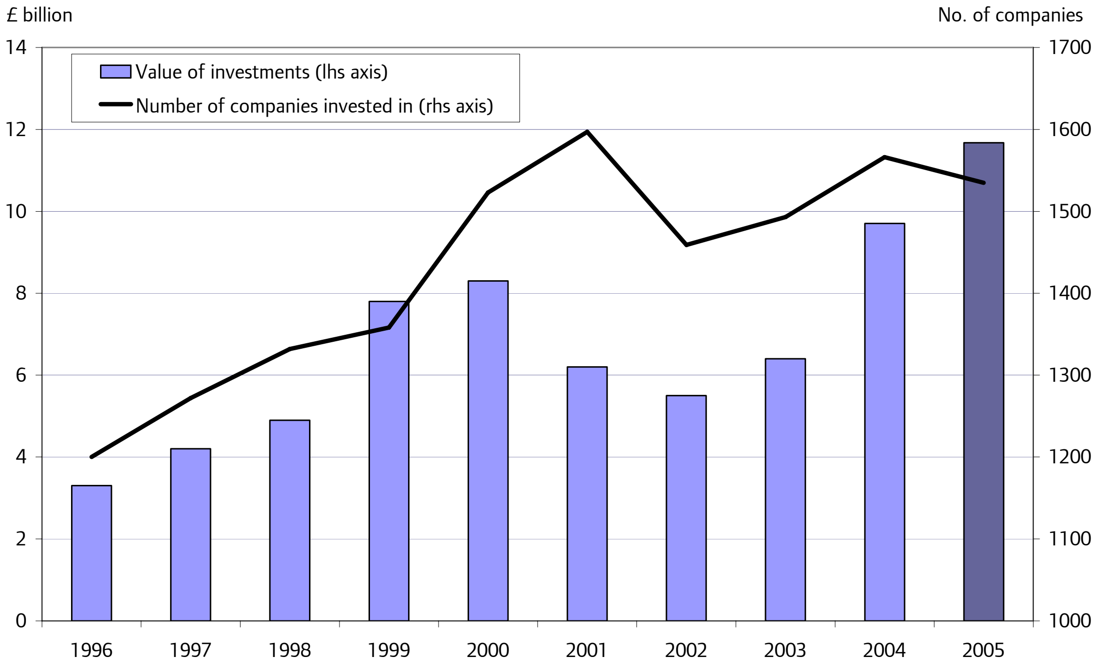



*Source: IFSL estimates from IFSL (2006) 'City Business Series: Private Equity'*

As with hedge funds, the UK is the second largest global centre of private equity activity after the US and is the largest in Europe. In 2005, the UK managed 22 per cent of the world's private equity investments – less than the US (40 per cent) but much more than its closest European rival (French private equity investments accounted for seven per cent). London is a leading international centre for private equity and plays the key role in the UK.

Data from the British Venture Capital Association (BVCA) confirm the strength of the UK industry in 2005, with BVCA members reporting over £27 billion of funds raised in 2005 and around £11.7 billion of funds invested worldwide (Figure 6.10). While the value of investments made increased strongly, the number of companies being invested in remained broadly flat – the average private equity deal size has been increasing, and going forward the vast majority of UK funds raised in 2005 are intended for the largest investments.

## Figure 6.10: UK private equity investments




*Source: IFSL (2005) 'City Business Series: Private Equity' and BVCA (2006), 'Report on Investment Activity 2005'*

It is difficult to gauge the *quantitative* importance of London within the UK private equity industry, and hence the overall effect of private equity on the London economy. The BVCA's regional breakdown of the UK industry's total investments states that in 2005 35 per cent were made in London – but this is not the full picture. More qualitatively, it is London's leading position as an international financial centre that facilitates the business of private equity itself (for example, its Mergers and Acquisitions (M&A) and Initial Public Offerings (IPOs) activity) *and* the key supporting services such as debt provision (from investment banks) and advisory firms.[lv] The generally supportive atmosphere of London and the UK for private equity activity is highlighted in several industry reports. For example, a report by the private equity firm Apax Partners (in association with the Economist Intelligence Unit) has ranked countries on their private equity 'environment' (financing, legal/policy, marketing, entrepreneurial) and again the UK comes second only to the US.[lvi]

Private equity transactions have recently come under close scrutiny by financial supervisors and the press, as the number of private equity 'buyouts' (where publicly-listed companies are bought over by private equity funds) has been increasing sharply. The value of worldwide private equity buyouts increased from around $100 billion in 2000 to almost $300 billion in the first half of 2006 alone.[lvii] IFSL estimate that in 2005, buyouts accounted for 73 per cent of private equity investment activity in Europe. As such, private equity transactions can be controversial – opinion varies between those who believe it is asset-stripping by another name and those who believe it carries out a true venture capital goal.

Additionally, recent commentary on the private equity industry has highlighted the potential pitfalls of using debt instruments to buy out publicly-listed equity. A major potential problem is that, given the level of debt (balance sheet leverage) involved in these takeovers and buy-outs, the private equity industry is very exposed to interest rate risk. If global interest rates were to increase sharply it is possible that some private equity funds would become liquidity constrained.

### Case study 3: Stock market sector

There are a number of different exchanges operating in the City of London, the main ones operating under the auspices of the London Stock Exchange (plc).

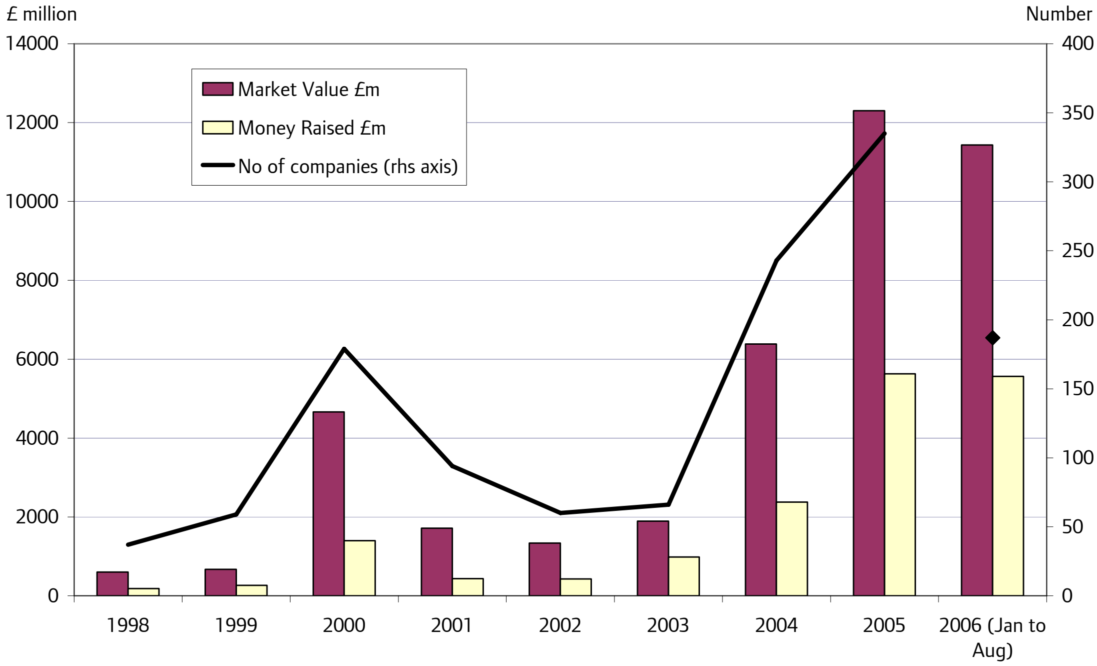
**Table 6.1: Exchanges in the City of London**

| Exchange | Purpose | Status |
|---|---|---|
| ***London Stock Exchange, plc*** | Owns and operates its 'Main Market' and AIM | Became a plc in 2000, at the same time as transferring its powers as UK listing authority to the FSA. Listed on its own Main Market in 2001. |
| *LSE Main Market* | The London Stock Exchange's senior, global market for more mature companies that not only need to maximise their capital-raising efforts, but also their international profile and liquidity in their shares | Operated and promoted by LSE, but regulated by the FSA |
| *(o/w techMARK)* | Companies which demonstrate a commitment to R&D | Started Nov 1999 as an 'of which' of the main LSE market – separate indices but not separate stock market |
| *LSE Alternative Investment Market (AIM)* | Small, growing companies: accounted for 65 per cent of all IPOs in western Europe in 2004. | Opened 1995: operated, regulated and promoted by LSE |
| ***Euronext-LIFFE*** | International electronic trading platform offering global access points to all major financial centres. | Euronext formed in 2000 by merging Paris, Amsterdam and Brussels exchanges – the first electronic, pan-European bourse. Acquired London's derivative market (LIFFE) in 2002, providing a single trading platform for European derivatives. |
| ***ICE Futures*** | The leading electronic regulated futures and options exchange for global energy markets | Operates under the oversight of the FSA |
| ***LCH - Clearnet*** | Range of clearing services from futures to fixed income, and from cash equities to interbank interest rate swaps | Independently owned and governed – London Clearing House (LCH) merged with Euronext's Clearnet in Dec 2003. Provides clearing and settlement services to a number of different exchanges around the world. |
| ***London Metal Exchange*** | Non-ferrous metals market. Provides a daily price for metals; futures and traded options contracts. | London Metal Exchange Ltd is regulated by the FSA (it is a Recognised Investment Exchange) |

*Source: City of London, London Stock Exchange*

There has been a recent surge in the number of companies making IPOs on London's exchanges. For example, there were almost 350 IPOs on AIM in 2005, and almost 200 in the first eight months of 2006 alone (Figure 6.11). An increasing number of these IPOs are from non-UK companies (28 per cent in the first eight months of 2006, up from eight per cent in 2003). And what is more, the LSE is out-performing the main US exchanges (the New York Stock Exchange (NYSE) and the Nasdaq) in attracting new international listings – 50 international companies (from 15 different countries) listed on the main market and AIM over the first half of 2006, with only 15 foreign companies listing on NYSE and Nasdaq over the first five months of 2006.

**Figure 6.11: Initial Public Offerings on LSE's Alternative Investment Market**




*Source: London Stock Exchange statistics*

The LSE listed as a public company on its own main market in 2001. Its share price remained broadly flat until the end of 2004 but has increased markedly since, especially in 2006 (Figure 6.12).[lviii] The increase in share price is likely to reflect higher profits and earnings (basic earnings per share in LSE plc increased from 17.0p in financial year 2002/03 to 27.8p in 2005/06), and also takeover speculation.

**Figure 6.12: London Stock Exchange plc daily closing share price**


*Source: London Stock Exchange plc*

One reason for the LSE's strengthening position is its favourable regulatory environment. Following the Enron and WorldCom scandals and the resulting Sarbanes-Oxley Act of 2002, companies listing on US exchanges have faced steep regulatory costs (for example, Section 404 requires company executives to check their own internal controls, and then use outside auditors to check them again). Regulatory changes in the US may have been made in haste – US regulators (the Security and Exchanges Commission (SEC)) are now reported to be considering an easing of the burden of Sarbanes-Oxley specifically for foreign companies considering where to make their IPO.[lix] But the SEC's harsher rules and regulations may not be the only worry of the US exchanges. As the chief executive of the NYSE Group said himself (in a *Financial Times* interview of 19 June 2006), 'international companies could be choosing to list in London simply because of London's dominant position in international finance.'

In order to compete on international share listings, the two main US exchanges – the NYSE and rival Nasdaq – have both made attempts to buy into the European stock exchange market, including the LSE. This has been part of a widespread consolidation movement within the global stock market sector, with many rival exchanges becoming involved in a series of take-over bids, mergers, modernisations and collaborations. Recent examples of this include:

- Euronext formed in 2000 - provides a shared market platform for Brussels, Paris and Amsterdam bourses
- In 2002 Euronext acquired the London derivatives market LIFFE
- Euronext and the New York Stock Exchange (NYSE) in process of merging (October 2006)
- Deutsche Bourse has thus made (so far rejected) offers for both the London Stock Exchange (LSE) and Euronext
- To date, NYSE rival Nasdaq has gradually acquired a 25.3 per cent share of the LSE (following an LSE rejection of outright takeover by Nasdaq)

Nasdaq's interest in the LSE began with an unsuccessful £2.4 billion (950 pence per share) bid in March 2006. Nasdaq withdrew its initial bid after the LSE rejected the offer – under UK Takeover Panel rules, Nasdaq could not then make another full bid for the LSE until six months after its withdrawal on 30 March 2006. During this time, Nasdaq has been strategically acquiring shares in LSE – although now the six month abstinence period is over, Nasdaq's current strategy is as yet unclear (the company still has to wait until May 2007 before a minimum limit on the price per share it can offer in a full bid is lifted).

These consolidation movements build into a picture of an industry keen to harness the benefits of new technology (in clearing and settlement systems) and to maintain a competitive edge in a market where global companies can access capital anywhere in the world. Exactly who owns what share in each of the exchanges is likely to be of less importance than maintaining London as an attractive place for companies to do business and source funds. As mentioned above, one of these main attractions is the regulatory environment in the UK. Given the proposed transatlantic stock exchange mergers, keeping the 'sovereignty' of UK financial regulation could be a priority for the London Stock Exchange over the next few years.

## 6.4 Concluding remarks

The most recent phase of globalisation has heralded a shift in the balance of economic power around the world, and the structure of the London economy has developed and adapted to this. This chapter has studied aspects of London's financial services sector in some detail. It is overly simplistic to attribute all trends in diverse products and markets to a wide-ranging phenomenon such as 'globalisation' – but given the pervasive effect of globalisation it is certainly having an important impact on London's economy.

# Appendix A: Explanation of terms and some sources

**Definitions, differences, and revisions**
Forecasting organisations use varying definitions of the regional indicators they supply. It is not therefore always possible to assign a completely consistent meaning to the terms used.

Throughout this report, as far as is compatible with the individual definitions applied by the forecasters, 'employment' refers to 'workforce employment' as defined in *Labour Market Trends. London's Economic Outlook: December 2003* and *The GLA's Workforce Employment Series* provide a more detailed explanation of this term.

Forecasters' definitions are broadly compatible with this but in some cases differences arise from the treatment of small items such as participants in government training schemes or the armed forces. The GLA uses civilian workforce employment throughout.

Output refers to GVA, a term introduced by the 1995 revision of the European System of Accounts (ESA95). Some forecasters still estimate GDP which can differ slightly from GVA. Imputed rental income from the ownership of property is included in some cases but not in others. GLA Economics' *London's Economic Outlook: December 2003* provides a more detailed explanation of this term.

Estimates of nominal regional GVA are available up to 2004 from the ONS. No official estimates of real regional GVA are available because of the difficulties in producing authoritative regional price deflators, although the ONS has now produced regional price indexes for the year 2004[lx]. Most regional forecasters supply their own estimates of London's real GVA. The real London GVA figures used in the GLA Economics' forecast are supplied by EBS.

GVA estimates are less reliable than employment estimates because there is no independent source of information from which to judge the size of total sales by London-based agents. ONS estimates are calculated by the factor incomes method, beginning from wages paid to people with workforce jobs located in London. Profits are imputed on the basis of these earnings estimates from knowledge of national sectors of employment. Most regional forecasters adopt a variant of this technique.

Consumption refers to private consumption, otherwise known as household expenditure; in some cases the expenditure of non-profit organisations is included and in other cases it is not.

'Distribution' refers to Retail, Hotels and Catering. 'Other (mainly public) Services' refers to Defence, Health, Education and Other Services. All other sectors have their standard meaning.

# Appendix B: Glossary of acronyms

| | |
|---|---|
| **bn** | Billion |
| **BRC** | British Retail Consortium |
| **CE** | Cambridge Econometrics |
| **CEBR** | The Centre for Economic and Business Research |
| **CIPS** | The Chartered Institute of Purchasing and Supply |
| **CPI** | Consumer Price Index |
| **EBS** | Experian Business Strategies |
| **ECB** | European Central Bank |
| **EU** | European Union |
| **FDI** | Foreign Direct Investment |
| **FT** | Financial Times |
| **GDP** | Gross Domestic Product |
| **GLA** | Greater London Authority |
| **GVA** | Gross Value Added |
| **HBOS** | Halifax Bank of Scotland |
| **HM Treasury** | Her Majesty's Treasury |
| **ILO** | International Labour Organisation |
| **IMF** | International Monetary Fund |
| **LEO** | London's Economic Outlook |
| **LFS** | Labour Force Survey |
| **LHS** | Left Hand Scale |
| **mn** | Million |
| **MPC** | Monetary Policy Committee |
| **OECD** | Organisation for Economic Co-operation and Development |
| **OEF** | Oxford Economic Forecasting |
| **ONS** | Office for National Statistics |
| **OPEC** | Organisation of Petroleum Exporting Countries |
| **PMI** | Purchasing Managers' Index |
| **PPP** | Purchasing Power Parity |
| **PSNB** | Public Sector Net Borrowing |
| **Q2** | Second Quarter |
| **R&D** | Research and development |
| **RHS** | Right Hand Scale |
| **RPIX** | Retail Price Index (excluding mortgage interest payments) |
| **RPI** | Retail Price Index |
| **TfL** | Transport for London |
| **US** | United States of America |

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## Footnotes

[i] The forecast was commissioned by GLA Economics and prepared by Experian Business Strategies.

[ii] RPIX = Retail price index excluding mortgage interest payments. Although not part of the GLA Economics forecast for London, for reader information the forecaster's view of the UK inflation rate is reported. Up to December 2003, the Bank of England's symmetrical inflation target was annual RPIX inflation at 2.5 per cent.

[iii] CPI = Consumer Price Index. Although not part of the GLA Economics forecast for London, for reader information the forecaster's view of the UK CPI inflation rate is reported. Since December 2003 the Bank of England's symmetrical inflation target has been annual CPI inflation at two per cent.

[iv] See Humphries, S (*Economic Trends*, April 2006) 'Revisions planned for the 2006 annual Blue Book, Pink Book and Input-Output analyses' http://www.statistics.gov.uk/articles/economic_trends/ET629Humphries.pdf for details of the revisions policy governing the 2006 Blue Book. For a perspective on how policymakers should work with data uncertainty, see Ashley *et al* (*Bank of England Quarterly Bulletin*, Spring 2005) 'Dealing with Data Uncertainty' http://www.bankofengland.co.uk/publications/quarterlybulletin/qb050101.pdf .

[v] The ONS introduced annual chainlinking in the 2003 *Blue Book*. See their chain-linking project homepage at http://www.statistics.gov.uk/about/Methodology_by_theme/chainlinking/methods.asp .

[vi] City of London Corporation, City News Monitor, 26 July – 1 August

[vii] Visit London, London Monthly, September 2006

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[ix] For example, the IMF in its September 2006 *World Economic Outlook*, states that the balance of risks to the global economy is slanted to the downside – and a more abrupt slowdown of the US housing market is one of the key risks mentioned.

[x] HM Treasury, UK membership of the single currency: An assessment of the five economic tests, Chapter 1, (2003), http://www.hm-treasury.gov.uk/documents/international_issues/the_euro/assessment/report/euro_assess03_repchap1.cfm

[xi] Aside from this restricted definition, an extended definition of the CAZ has also been used in the testing procedure.

[xii] See for instance:
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[xiii] IMF, World Economic Outlook, April 2006

[xiv] Bank of England, Inflation Report, August 2006, p6

[xv] IMF, World Economic Outlook, September 2006

[xvi] IMF, World Economic Outlook, September 2006

[xvii] The Times, 2 September 2006

[xviii] IMF, World Economic Outlook, September 2006

[xix] OECD, What is the economic outlook for OECD countries, An interim assessment, 5 September 2006

[xx] IMF, World Economic Outlook, September 2006

[xxi] The Economist, A survey of the World Economy, 16 September 2006

[xxii] IMF, World Economic Outlook, September 2006

[xxiii] IMF, World Economic Outlook, September 2006

[xxiv] IMF, World Economic Outlook, September 2006

[xxv] Most forecasters do not yet provide forecasts of household income.

[xxvi]GLA Economics, Working Paper 14: Working Future – Employment projections for London by sector, December 2005.

[xxvii] For 2006: the median of new forecasts from HM Treasury, August 2006, Comparison of Independent Forecasts. For 2007 onwards: the average of medium-term forecasts from the same publication.

[xxviii] Wolf, 'Why globalization works – the case for the global market economy' (2004)

[xxix] This section is based on a final submission to the Treasury Select Committee by the Greater London Authority (prepared by GLA Economics) on 19 May 2006 as evidence for their enquiry into *Globalisation: impact on the real economy*.

[xxx] See Goldman Sachs, 'Dreaming with BRICs: The path to 2050' (2003)

[xxxi] Sassen, 'The Global City' (1991)

[xxxii] The Greater London Authority has undertaken considerable analysis of London's global economic role. See for example: London Development Agency, 'Sustaining Success: Developing London's Economy, The Economic Development Strategy' (2005), GLA Economics, 'Growing Together: London and the UK Economy' (2005) and GLA Economics, 'Our London, Our Future' (2005).

[xxxiii] Fischer, 'Capital Account Liberalization and the Role of the IMF' (1997); Stiglitz, 'Capital account liberalization, economic growth and instability' (2000)

[xxxiv] Tytell and Wei, 'Does financial globalisation induce better macroeconomic policies?' (2004)

[xxxv] Bernanke, 'The global saving glut and the US current account deficit' (2005)

[xxxvi] Greenspan, 'Globalisation' (2005), Remarks given at the Council of foreign relations, 10 March 2005

[xxxvii] PPP stands for purchasing power parity. PPP exchange rates are calculated to equate the value of a representative basket of goods and services produced / consumed across countries. They will typically differ from the actual prevailing market exchange rates. The use of PPP exchange rates is generally the preferred method for comparing different countries' output or GDP levels.

[xxxviii] IMF World Economic Outlook Database (September 2006)

[xxxix] HM Treasury, 'Globalisation and the UK: strength and opportunity to meet the economic challenge' (2005)

[xl] GLA Economics, 'Enter the Dragon' (2004); GLA Economics, 'From the Ganges to the Thames' (2005)

[xli] Think London and the Ernst and Young European Investment Monitor (released 15 September 2006)

[xlii] Visit London, 'China Mission' – The Asian Outbound travel market is predicted to rise by six per cent per year until 2010, with China leading the way. Chinese outbound visitors are expected to reach 50 million by 2010.

[xliii] Think London, 'One in seven: The Impact of inward investment on the London economy' (2004). Prepared by DTZ Pieda Consulting.

[xliv] Thomson Financial Investor Relations, Target Cities Report, (2000)

[xlv] A recent Bank for International Settlements (BIS) study (Wooldrige, 2006) finds that sterling now accounts for around 12 per cent of the foreign bank deposits held by governments around the world (previous estimates from the IMF had put this figure closer to just four per cent).

[xlvi] See IFSL time series statistics for London's share of international financial markets at http://www.ifsl.org.uk/uploads/statistics/UK_1.xls

[xlvii] IFSL, 'City Business Series: Hedge Funds' (2006)

[xlviii] For more details on this see Bank of England, 'Financial Stability Review' (June 2005), box 'Hedge fund data and surveillance', p64-66.

[xlix] The Economist, 21 October 2006, p13

[l] See Radley & Associates, 'The Hedge Fund Industry and the City' (June 2006) available at http://www.cityoflondon.gov.uk/Corporation/business_city/locating/CPAT_publications.htm .

[li] The Radley & Associates report found that the typical (median) hedge fund company (in 2004/05) had 13 funds, of $135 million each, employing 5-6 full-time equivalents each, with each worker 'supporting' $24 million funds under management.

[lii] See Sir John Gieve, Deputy Governor of the Bank of England, speech at the HEDGE 2006 Conference entitled 'Hedge Funds and Financial Stability', 17 October 2006.

[liii] See Bank of England, 'Financial Stability Report', (July 2006), p32. Most recently, when another large US hedge fund (Amaranth) got into trouble through its speculative positions on natural gas, markets reacted calmly to the news (see The Economist, 21 September 2006) http://www.economist.com/opinion/displaystory.cfm?story_id=7950137 .

[liv] IFSL, 'City Business Series: Private Equity' (2006)

[lv] See IE Consulting for BVCA, 'Private Equity: A UK Success Story' (February 2006)

[lvi] See Apax Partners 'Unlocking global value: Future trends in private equity investment worldwide' (April 2006) at http://www.apax.com/Unlocking_global_value_-_Future_trends_in_private_equity_investment_worldwide.pdf . These findings are consistent with the EVCA (2004) benchmarking report (as quoted in IE Consulting/BVCA's 'Private Equity: A UK Success Story' Chapter 7).

[lvii] Thomson Financial data quoted in The Economist, 'In the shadows of debt', 21 September 2006

[lviii] A potential risk to the stock exchange sector may be that the EU's Markets in Financial Instruments Directive (due to come into force in late 2007) will allow equity brokers to report their trades to any registered entity, potentially bringing competition to trade reporting. It is reported (see, for example, *The Independent*, 15 August 2006) that some UK investment banks are developing plans for equity reporting that would bypass the London Stock Exchange – but these talks are at a very early stage.

[lix] Financial Times, 10 August 2006

[lx] Fenwick D and Wingfield D, 2005, Relative Regional Consumer Price Levels in 2004, Economic Trends No. 615, ONS, February 2005

# other publications

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### Hindi

यदि आप इस दस्तावेज़ की प्रति अपनी भाषा में चाहते हैं, तो कृपया निम्नलिखित नम्बर पर फोन करें अथवा दिये गये पता पर सम्पर्क करें।

### Vietnamese

Tiếng Việt
Nếu bạn muốn bản sao của tài liệu này bằng ngôn ngữ của bạn, hãy gọi điện theo số hoặc liên lạc với địa chỉ dưới đây.

### Bengali

আপনি যদি আপনার ভাষায় এই দলিলের প্রতিলিপি (কপি) চান, তা হলে নীচের ফোন্ নম্বরে বা ঠিকানায় অনুগ্রহ করে যোগাযোগ করুন।

### Greek

Αν θα θέλατε ένα αντίγραφο του παρόντος εγγράφου στη γλώσσα σας, παρακαλώ να τηλεφωνήσετε στον αριθμό ή να επικοινωνήσετε στην παρακάτω διεύθυνση.

### Urdu

اگر آپ اِس دستاویز کی نقل اپنی زبان میں چاہتے ہیں، تو براہِ کرم نیچے دیئے گئے نمبر پر فون کریں یا دیئے گئے پتے پر رابطہ قائم کریں.

### Turkish

Bize telefon ederek ya da yukarıdaki adrese başvurarak bu belgenin Türkçe'sini isteyebilirsiniz.

### Arabic

إذا أردت نسخة من هذه الوثيقة بلغتك، الرجاء الاتصال برقم الهاتف او الكتابة الى العنوان

### Punjabi

ਜੇ ਤੁਹਾਨੂੰ ਇਸ ਦਸਤਾਵੇਜ਼ ਦੀ ਕਾਪੀ ਤੁਹਾਡੀ ਆਪਣੀ ਭਾਸ਼ਾ ਵਿਚ ਚਾਹੀਦੀ ਹੈ, ਤਾਂ ਹੇਠ ਲਿਖੇ ਨੰਬਰ 'ਤੇ ਫ਼ੋਨ ਕਰੋ ਜਾਂ ਹੇਠ ਲਿਖੇ ਪਤੇ 'ਤੇ ਰਾਬਤਾ ਕਰੋ:

### Gujarati

જો તમને આ દસ્તાવેજની નકલ તમારી ભાષામાં જોઈતી હોય તો, કૃપા કરી આપેલ નંબર ઉપર ફોન કરો અથવા નીચેના સરનામે સંપર્ક સાધો.


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