London's Economy Today


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In this issue

GLAECONOMICS

Sterling heads above $2 as higher inflation increases expectations of further interest rate rises

by Christopher Lewis, Senior Economist

London is a world city with a global outlook and reach. Its global status is especially prominent in the field of financial services and related business services. The capital has recently gained from rapid mergers and acquisition (M&A) activity and has enhanced its role as a hub for credit derivatives trading and a centre for hedge funds and private equity firms. With cheaper IPO fees, a convenient time zone, a suitable legal environment and a principles-based approach to regulation through a single regulator, London seems to be building momentum in becoming a more desirable place to carry out financial services activity than New York. This was highlighted by a recent report by McKinsey's, which is covered in this month's supplement written by Kathryn Grant and Simon Kyte.

London's recent robust performance in the field of financial services has been set against a favourable background of rapid growth in international financial liberalisation and trade. The expansion of emerging market economies, especially China, have

Latest news...

- **Three-year position as a GLA Economics Research Fellow in Urban Systems based at UCL.** This role will work to develop land use transport modelling and enhance the use of GIS and spatial analysis within GLA Economics. Please contact Margarethe Theseira on tel: 020 7983 4198 or email: margarethe.theseira@london.gov.uk for further information. Closing date: 4 May 2007.

- **Working Paper 21: The GLA's interim metro area dataset,** a new GLA Economics report on the economic performance of 35 European cities, should be the GLA group standard for benchmarking and evaluation. It is one of the most complete datasets available, covering population, employment, output and productivity from 1980-2005. Visit **www.london.gov.uk/mayor/economic_unit** to download this publication. Alternatively please telephone **+44 (0)20 7983 4922** or email **glaeconomics@london.gov.uk** for a copy.

broadened and deepened globalised links to the benefit of international financial centres such as London. 'The Competitive Impact of London's Financial Market Infrastructure', a report published by the City of London Corporation, highlights the importance of remaining open to competition and innovation as a key to future success as it has in the past. This is also key in encouraging more foreign direct investment (FDI) into the capital. Think London's third annual London Focus report showed that over 90 per cent of executives surveyed at London-based FDI companies said that the capital plays an important role in their company's global strategy.

The strength of the capital's financial services sector is having a positive knock-on effect on other sectors in the capital, such as construction. A report by the Royal Institution of Chartered Surveyors (RICS) shows that the number of London land surveyors reporting rising construction workloads outnumbered those reporting declines by 36 percentage points in Q1 2007, the largest positive balance since the survey began in 1994.

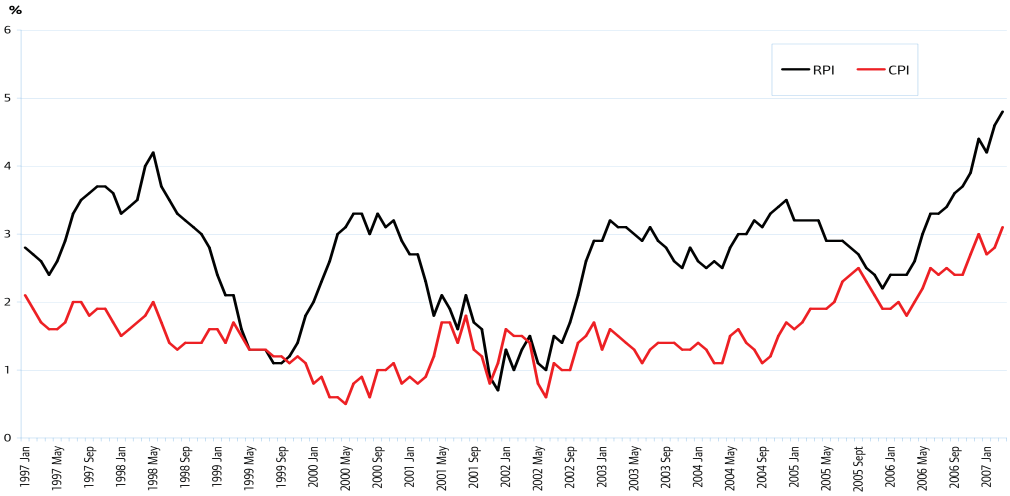
Jump in inflation triggers open letter from the Governor of the Bank of England

On the back of rising food and petrol prices, UK CPI inflation rose from 2.8 per cent in February to 3.1 per cent in March (see Figure 1). With the inflation rate over one percentage point above the two per cent target, the Governor of the Bank of England wrote an open letter to the Chancellor of the Exchequer on the 16th April to explain why inflation had risen above target and what the Bank of England's Monetary Policy Committee (MPC) propose to do about it. This was the first such letter that had to be written since the MPC was given full control of interest rates in 1997. The letter explained that with robust growth since 2005 capacity pressures have increased and businesses have become more confident in raising prices. However, as the substantial increases in household gas and electricity prices that occurred a year ago drop out of the annual comparison, and the falls in those prices which have already been announced take effect, CPI inflation should fall back within a month or so. CPI inflation is still expected to head down towards, or even slightly below, the two per cent target by the end of the year. In the Chancellor's response he stated that the Government would continue to be disciplined in the fight against inflation and that fiscal policy has been supporting monetary policy with a fiscal tightening in the Pre-Budget Report and a fiscally neutral Budget.

Meanwhile RPI inflation, which is often used as a basis for pay claims, rose from 4.6 per cent to 4.8 per cent, its highest rate since July 1991. Average annual earnings growth including bonuses jumped to 4.6 per cent in the three months to February its fastest pace since March 2004. To a large degree this was due to bonus payments, which in the City of London have been exceptionally good this year, as average annual regular pay growth (which excludes bonuses) remained at a subdued 3.6 per cent in the three months to February. The overall increase in inflation firmed up the belief that interest rates will rise in May and could go even higher later in the year. This provided additional support for Sterling, which rose above the $2 mark on the 17th April (the day inflation figures were released) for the first time since the UK exited the Exchange Rate Mechanism in September 1992. Since then Sterling has reached levels last seen in 1981 against the weakening dollar, which has also fallen to a two year low against the euro.

Figure 1. UK inflation (year-on-year percentage change)

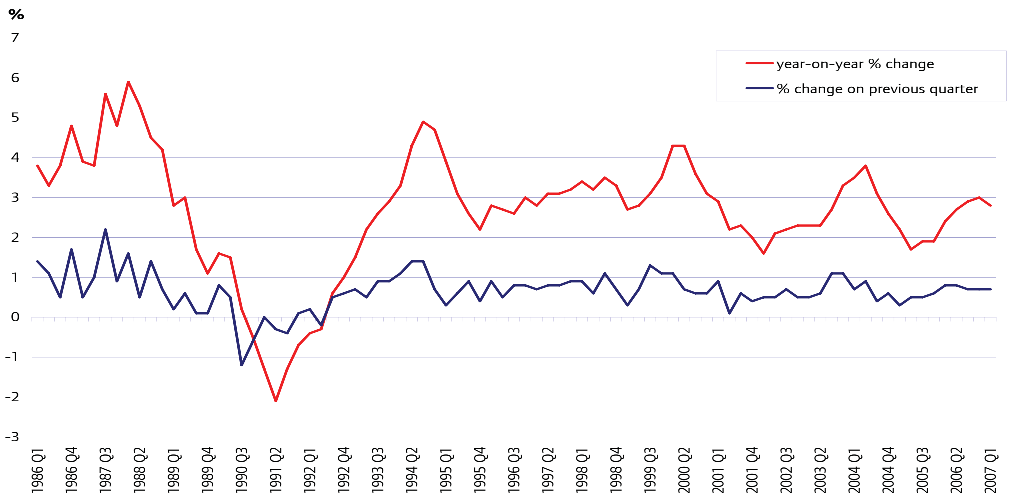
Source: Office for National Statistics



The UK economy is estimated to have grown by a reasonably strong 0.7 per cent in Q1 2007, the same rate as in the previous two quarters (see Figure 2). The annual growth rate in Q1 2007 eased slightly to 2.8 per cent from 3.0 per cent in Q4 2006. The UK services sector is still growing robustly at an annual rate of 3.5 per cent compared to the 0.2 per cent by the struggling production industries. The business and services sector, which represents around 28 per cent of the UK economy, continues its excellent performance with buoyant quarterly and annual growth of 1.1 per cent and 5.2 per cent respectively in Q1 2007. This is especially good news for the London economy where this sector plays a key role.

Figure 2. UK GDP growth

Source: Office for National Statistics



Slowing US and higher oil prices are risks to strong world economy

The world economy remains robust with continued buoyant growth in China and India. China's growth heated up even further in the first three months of this year to an annual rate of 11.1 per cent. The pick-up in the eurozone economies also seems slightly more entrenched with investment strengthening, employment rising and unemployment falling. This means conditions are in place for faster consumption growth. However, signs of vulnerabilities in the US economy continue. The housing market is suffering, non-residential investment is weak and the Institute for Supply Management (ISM) non-manufacturing index eased further in March to its weakest since April 2003. Overall the global economy is performing well but there is a risk that the US economy slows sharply having a knock-on effect on the rest of the world. Oil prices have also picked up by around a quarter since mid-January, but at less than $70 per barrel are below their peak of last summer. Continued volatility appears likely with geopolitical tensions in the Middle East and political turmoil in Nigeria impacting upon oil markets. Any surge in oil prices would add to inflationary pressures and lead to the already expected further rise in global interest rates to be higher than would otherwise be the case. This could have a significant dampening impact on the world economy over the next couple of years.

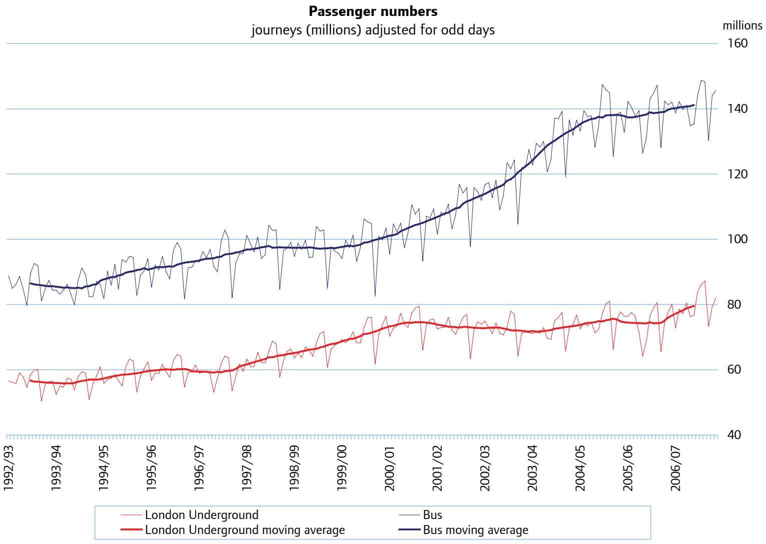
After the global stock market jitters at the end of February and the beginning of March there has been a major recovery in most equity markets. The FTSE 100 fully reversed its losses during this period by the middle of April and actually closed above 6,500 for the first time since autumn 2000 on 16th April. Meanwhile the Dow Jones closed at all time highs on the 18th, 19th, 20th and 25th of April (when it went above 13,000 for the first time ever). However, the possibility of future turbulence in world equity markets has increased with a general re-pricing of risk. This was demonstrated by a one day near five per cent fall in China's main share index in mid-April. Any sudden loss of confidence across the world's stock markets could have a major impact on London. Overall, London's economy continues to outperform the rest of the UK, but alongside the UK it is likely to slow gently as past interest rate rises, and the prospect of future rises to come, start to bite.

Economic indicators

Moving average of passenger numbers continues to rise

- The most recent 28-day period is from 4 February to 3 March 2007. London's public transport had 227.6 million passenger journeys; 145.6 million by bus and 82.1 million by Underground.
- The moving average increased to 220.7 million from a revised 220.0 million passengers every period.
- The moving average for buses was 141.2 million. The moving average for the Underground was 79.5 million.

Latest release: April 2007
Next release: May 2007

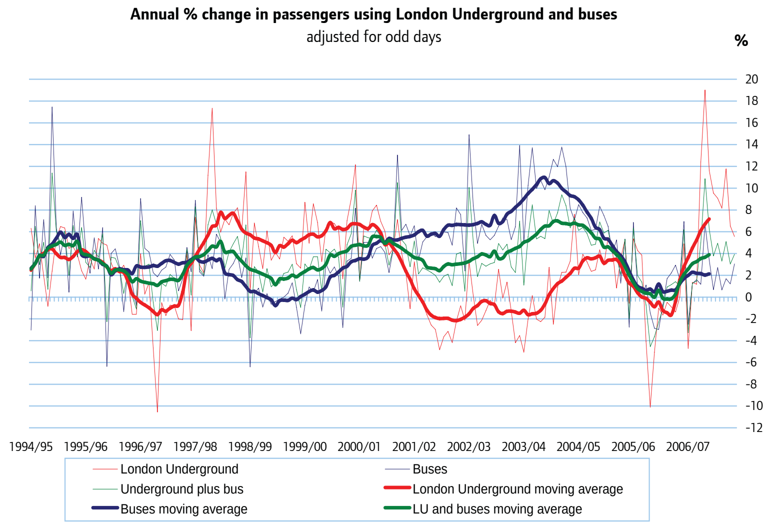


Source: Transport for London

Average annual growth rate of passengers still increasing

- The moving average annual rate of growth in passenger journeys increased to 3.9% from 3.7% in the previous period.
- The moving average annual rate of growth in bus journey numbers increased to 2.1% from 2.0% in the previous period.
- The moving average annual rate of growth in Underground passenger journey numbers increased to 7.2% from 6.7% in the previous period.

Latest release: April 2007
Next release: May 2007

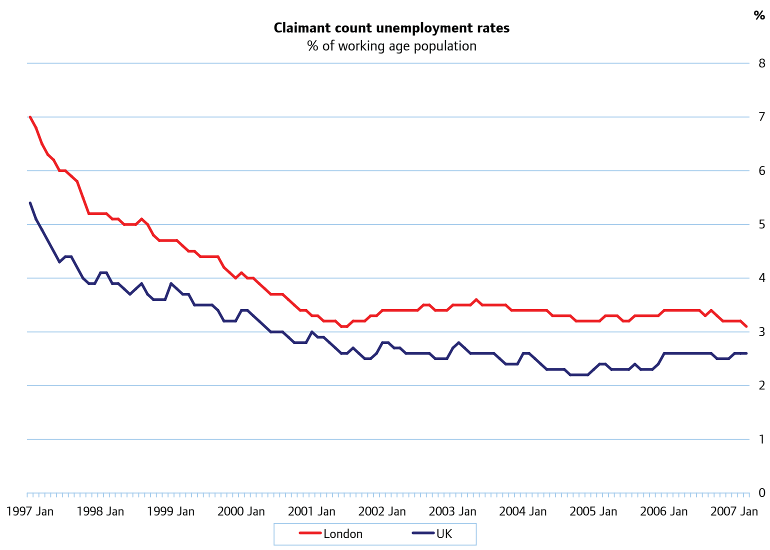


Source: Transport for London

Claimant count unemployment

- The rate of claimant count unemployment (the percentage of resident working age population who are unemployed and claiming Jobseeker's Allowance) in London was 3.1% in March 2007.
- There were 158,200 unemployment claimants in London in March 2007 compared with 170,300 in March 2006.
- The claimant count unemployment rate in the UK remains below that of London's.

Latest release: April 2007
Next release: May 2007

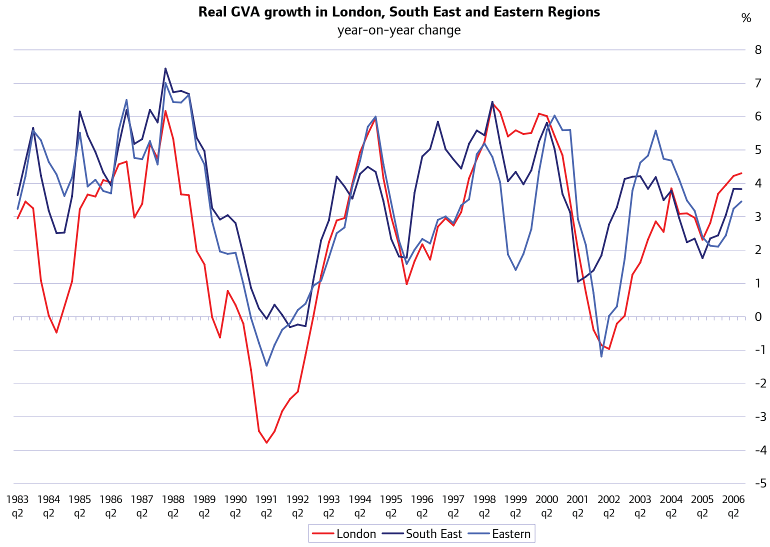


Source: Claimant Count, Nomis

Faster annual output growth in London than in the South East or Eastern region

- London's annual growth in output was 4.3% in Q3 2006, an increase from 4.2% in Q2 2006.
- Annual output growth in the South East in Q3 2006 was unchanged at 3.8% from the previous quarter.
- Annual output growth in the Eastern region was 3.5% in Q3 2006, up from 3.2% in the previous quarter.

Latest release: February 2007
Next release: May 2007

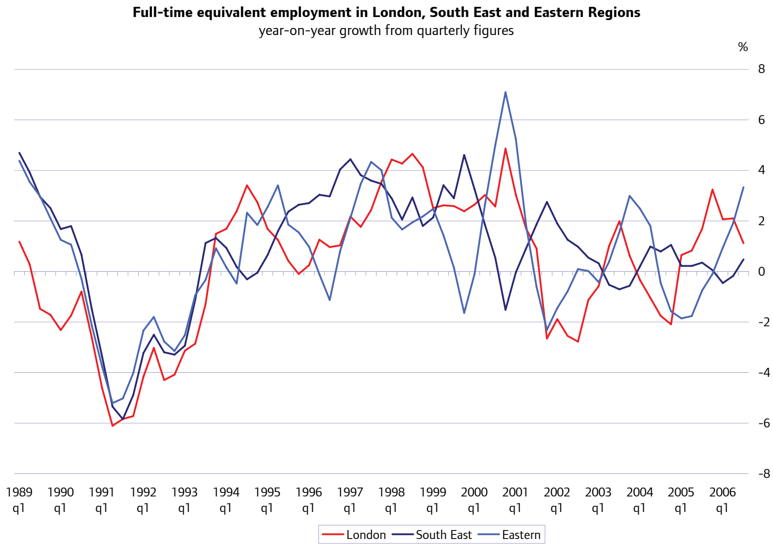


Source: Experian Business Strategies

Positive annual employment growth in London and its neighbouring regions

- London's year-on-year employment growth was 1.1% in Q3 2006, down from 2.1% in Q2 2006.
- Annual employment growth in the South East increased to 0.5% in Q3, from –0.2% in the previous quarter.
- Annual employment growth in the Eastern region rose to 3.3% in Q3 2006, from 1.9% in Q2.

Latest release: February 2007
Next release: May 2007

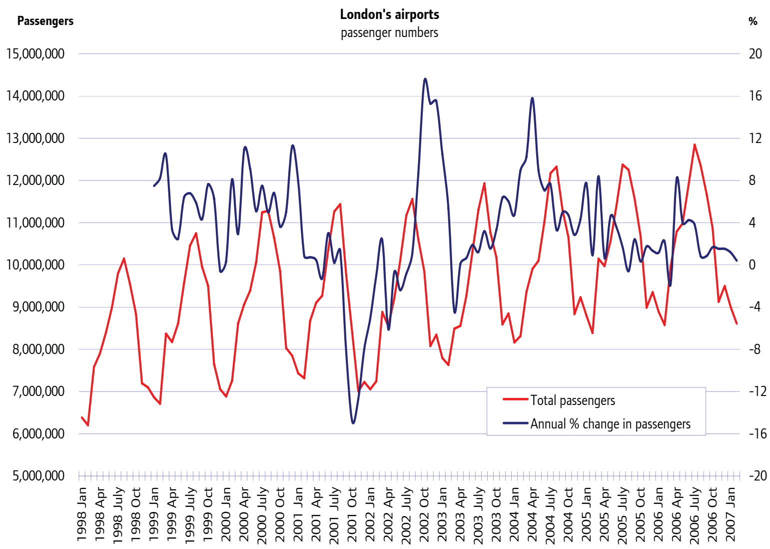


Source: Experian Business Strategies

Low annual growth in airport passenger numbers

- 8.6 million passengers travelled through London's airports in February 2007.
- The number of passengers using London's airports increased by 0.4% from February 2006 to February 2007.
- The number of passengers at London's airports has seen positive annual growth in the last eleven months.

Latest release: April 2007
Next release: May 2007

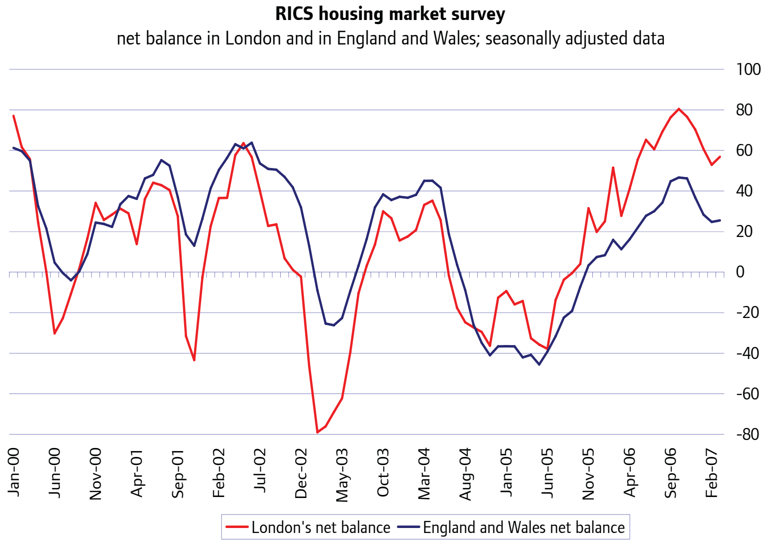


Source: Civil Aviation Authority

Surveyors report that house prices are still rising

- The RICS survey shows a positive net balance of 57 for London house prices over the past three months up to March 2007. This net balance is higher than the upwardly revised 53 for February.
- Surveyors also reported a positive house price net balance for England and Wales of 25 in March, unchanged from February.
- London's net balance for house prices remains above that of England and Wales.

Latest release: April 2007
Next release: May 2007

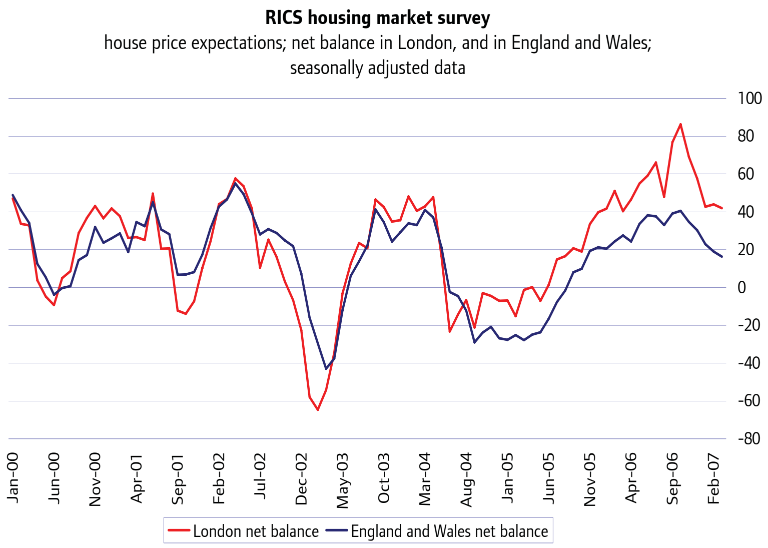


Source: Royal Institute of Chartered Surveyors

Surveyors expect house prices to increase

- The RICS survey shows that surveyors expect house prices to increase over the next three months in London and in England and Wales.
- The net house price expectations balance in London was 42 in March, down from an upwardly revised 44 in February.
- For England and Wales, the net house price expectations balance was 16 in March, down from 19 in February.

Latest release: April 2007
Next release: May 2007

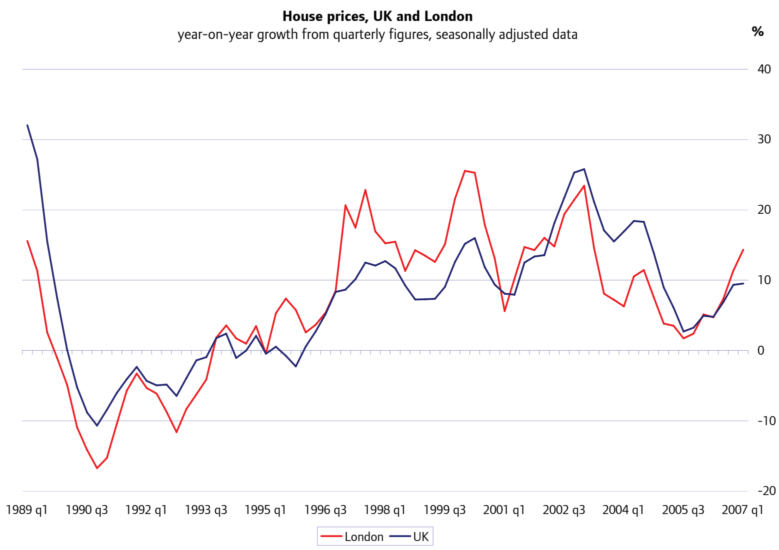


Source: Royal Institute of Chartered Surveyors

House price inflation continues to be higher in London than the UK

- Nationwide reported stronger annual house price inflation for London than the UK in Q1 2007.
- Annual house price inflation in London was 14.3% in Q1 2007, up from 11.3% in Q4 2006.
- Annual house price inflation in the UK was 9.5% in Q1 2007, up from 9.3% in the previous quarter.

Latest release: April 2007
Next release: July 2007

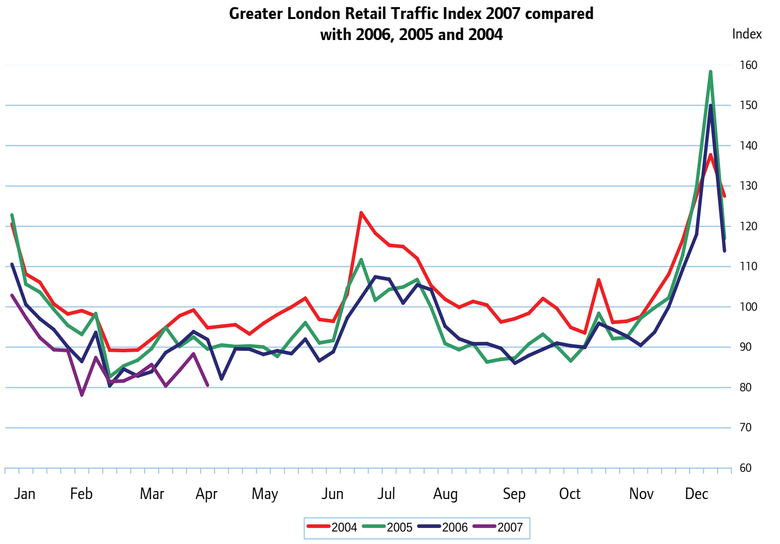


Source: Nationwide

SPSL Retail Traffic Index below 2006 levels

- The SPSL Retail Traffic Index of shoppers in London was 80.6 in the second week of April compared to 88.3 in the previous week.
- The index has generally been lower than 2006 levels throughout 2007 so far.
- SPSL's Retail Traffic Index measures the number of shoppers and does not necessarily reflect the level of spending.

Latest release: Mid-April
Next release: Every week

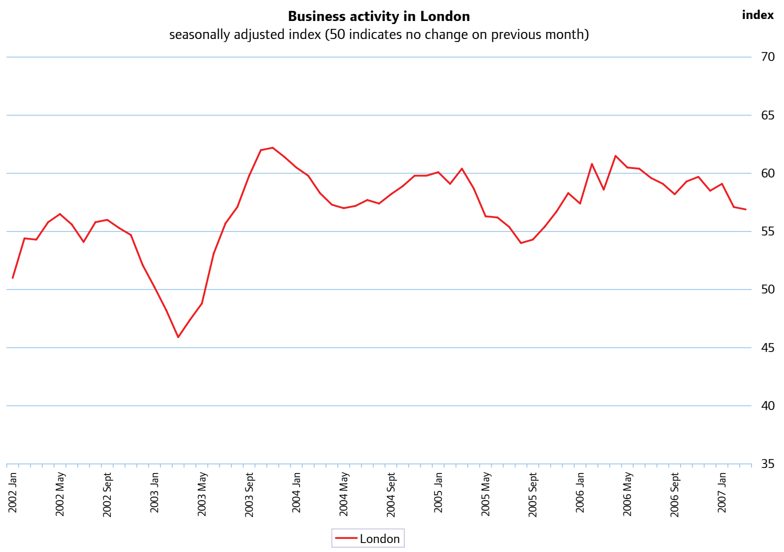


Source: SPSL

London's business activity still expanding

- London's firms continued to expand their output of goods and services in March 2007.
- The Purchasing Managers' Index (PMI) of business activity recorded 56.9 in March compared to 57.1 in February.
- A rate of above 50 on the index indicates an increase in business activity from the previous month. The PMI for business activity has been above 50 since June 2003.

Latest release: April 2007
Next release: May 2007

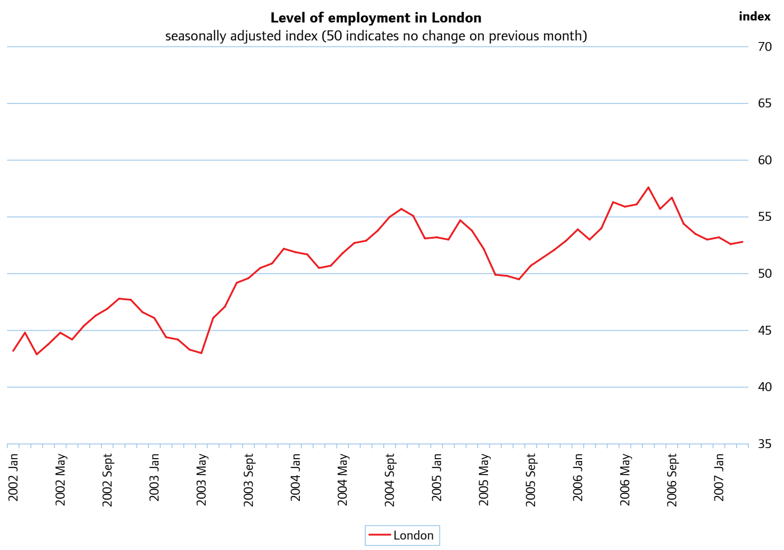


Source: PMI/The Royal Bank of Scotland

Employment continues to grow in London

- London firms continued to increase their level of employment in March 2007.
- The PMI for the level of employment was 52.8 in March compared to 52.6 in February.
- A rate of above 50 on the index indicates an increase in the level of employment from the previous month.

Latest release: April 2007
Next release: May 2007



Source: PMI/The Royal Bank of Scotland

The McKinsey report and its relevance to London's financial services sector

Kathryn Grant,
Economist
Simon Kyte,
Economist

The Mayor of New York, Michael Bloomberg, commissioned McKinsey Financial Services to write a report on the state of the US' financial services sector and its competitiveness in a changing world economy. The resulting 'Sustaining New York's and the US' Global Financial Services Leadership' report ('McKinsey report' hereafter) is a comprehensive health check on not just New York, but on other major and emerging global financial centres. Many US financial markets are still the world's largest; home to more of the world's top financial services institutions than any other country, and the trading place of most of the world's total financial stock by value. However, the rate of growth of this financial stock is higher outside the US than within it.

Although the McKinsey report identifies London as the 'main competitor' to New York, it also recognises that there are significant challenges from Dubai, Hong Kong and Tokyo. Perhaps the fiercest competition between London and New York is in two key markets: derivatives and debt. London has been building momentum relative to New York particularly in terms of superior conditions for financial innovation, capital formation and risk management. The speed of London's movement here has led some in the United States to believe that New York might shift to being merely a domestic market – albeit a very large one.

Survey research in the McKinsey report suggests that New York has become less attractive when compared with London over the last three years. London is now widely perceived as the city with the greatest momentum. The narrowing of the gap between the United States and the rest of the world is seen partly as natural market evolution. These movements throw up important regulatory and competitive challenges.

The McKinsey report highlights three 'critically important' factors determining global competitiveness in financial markets:

- The availability of talent
- The legal environment
- Regulation

McKinsey finds that although New York does well on attracting a talented pool of labour, it lags behind London on the legal and regulatory fronts. What is more, leading New York financial services' Chief Executive Officers (CEOs) suggest the gap is widening.

Recent trends in market shares

All regions of the world are increasing their revenues from financial services. Key points of interest are:

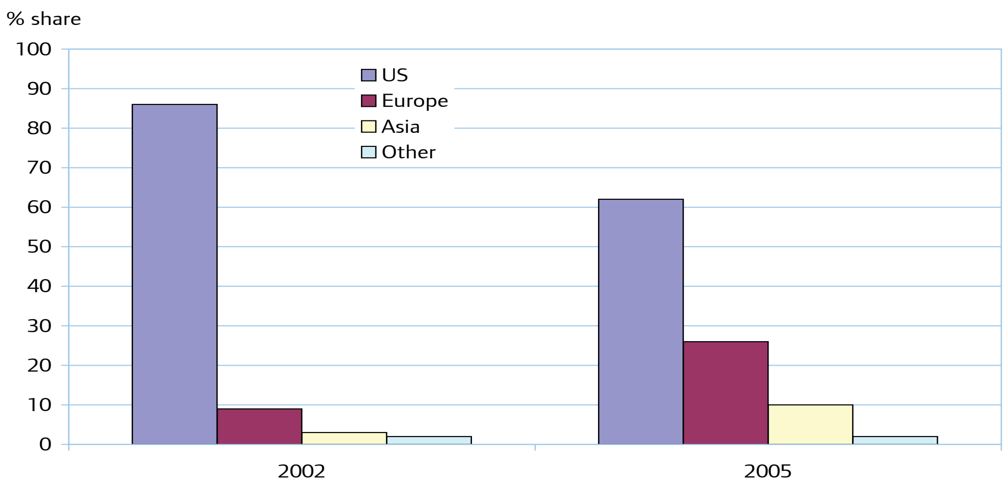
- London is already ahead of the US in 'Over the Counter' (OTC) derivatives and Europe now has a 56 per cent share in the $52bn revenue pool from derivatives in total
- In terms of initial public offerings (IPOs), in 2001 the US had a 57 per cent share of the global market; over the first 10 months of 2006, Europe managed a 63 per cent share
- In 2005, six of the ten largest IPOs on the London Stock Exchange (LSE) were from foreign issuers in contrast to just one on NASDAQ and none on the NYSE
- Many small-cap companies are choosing to list outside the United States and the foremost worry for NASDAQ is the LSE's Alternative Investment Market (AIM)
- London now has around half the foreign exchange market and more than a third of the interest rate derivative market
- In the debt financing market New York still maintains a lead but London is now emerging as an effective alternative for non-US corporations
- The US remains the centre of innovation for both leveraged lending and securitisation with more than 80 per cent of the global market in each, dwarfing Europe. However, even here American dominance of the global market may be nearing an end with the transformation of China's economy.

Finally, as Figure 3 shows, one very noticeable example of shifting market share is seen in the hedge fund industry. These began as a US innovation. However, over the last three years, more and more funds have been locating in London and elsewhere.

Part of the strength of hedge funds in London is that they have located very close together. GLA Economics has conducted extensive research in the area of industrial clustering[1]. Clustering is central to idea generation, and the talent cluster in both London and New York has been one of the main reasons for their global lead in innovation.

Figure 3: Global hedge funds by geographical source of investment

Source: IFSL



Labour markets

London and New York's financial services sectors are now very similar in size, in terms of employment. Between 2002 and 2005 London's financial services workforce grew by 4.3 per cent whereas New York's actually fell.

From the survey results in the McKinsey report, New York remains ahead on workforce skills issues, though London is closing the gap. In particular, the free movement of labour within the EU is attracting more and more talented people to London. In contrast, the United States' immigration policies work directly against New York's comparative advantage, in particular in terms of the annual cap on H-1B visas and the gap between student visas and H-1Bs.[2] The result is that the US advantage in the talent field is now being whittled away by London.

Talent is attracted to, and perpetuates, innovation. New York is faced with a challenge to maintain its position as a centre of innovation for leveraged lending and securitisation. European lenders are beginning to embrace US-style credit terms and the report believes that this will lead to 'explosive securitisation growth in the near future' comparable to the previous decade in US markets. London's lead in derivatives has helped promote innovation and close the traditional gap with New York – which has been further eroded by its own surge in litigations.

However, it is not just an innovative environment that attracts talent. Another key factor is quality and cost of living. In these areas, the survey of leading CEOs still marks New York with some strengths: high quality of life, low crime, a lively cultural environment and less traffic issues than London. Nearly 80 per cent of Chief Executives consider London to be 'very high cost' compared to fewer than half for New York. In a separate study commissioned by The Economist, New York was considered to be 25 per cent less expensive than London. Figures quoted in the McKinsey report from Cushman and Wakefield[3] suggest that office rents in midtown New York were around $64 per square foot in 2006 – around the same as Canary Wharf, whereas the City was at $84 and the West End at $138.

The legal and regulatory environment

The legal system is an area where New York is seen as falling significantly behind London. McKinsey reports that the total bill for securities legal settlements in 2005 was $3.5 billion.[4] By comparison, 63 per cent of McKinsey's survey respondents felt that the UK had a less litigious culture than the US. Litigation does not just affect companies (which are forced into liquidation) but also individuals. For example, s.302 of the Sarbanes-Oxley Act imposes personal liability on corporate executives for failure to comply with the Act.

Following the Enron and WorldCom scandals, companies listing on US exchanges have faced steep regulatory costs. Regulatory changes in the US may have been made in haste – US regulators are now considering an easing of the burden of Sarbanes-Oxley specifically for foreign companies considering where to make their IPO.[5] The 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 on 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. The first Trans-Atlantic exchange was created by the NYSE – Euronext merger and started trading on 4 April 2007. 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.

Concern has recently been raised over the prospect of the US regulatory reach extending to European exchanges which have an increasingly large American ownership. GLA Economics highlighted this threat in its analysis of global exchange consolidation in 'London's Economic Outlook: Autumn 2006'[6]. The UK government has recently proposed the 'Investment, Exchanges and Clearing Houses Act' to deal with this problem. It would provide the Financial Services Authority (FSA) with power to veto any new rules from foreign regulators if they have a 'disproportionate' impact on UK exchanges.

The 'McNulty Memorandum' of 2006 was an attempt by US legislators to improve the US regulatory environment. This 'should ensure greater consistency in the pursuit of future federal criminal indictments' as it requires that only those cases where a minimum level of evidence exists (and where enforcement is deemed appropriate by the Attorney General's office) will receive scrutiny.

A good regulatory framework can help the financial services industry on several fronts: competitiveness, productivity, innovation and confidence. Historically, US regulations were seen to serve New York well, but, more recently, US regulators have struggled to keep pace with global trends. For many of McKinsey's respondents, London's regulatory model is the better one. There are three broad reasons for this: structure, approach and enforcement.

In terms of regulatory structure, the UK has one single entity for the entire UK financial services industry – the FSA. A single regulator is easier to deal with and more responsive to individual businesses' needs. It can also take decisions faster, increasing 'speed-to-market'. The US has a number of different regulators at both the state and federal level, and for different types of products and services. Different regulators can be in conflict with one another.

Furthermore, the way in which the FSA operates is distinct from its US counterparts. The FSA works under overarching principles, with four statutory objectives: maintaining public confidence in the financial system; promoting public understanding of the financial system; securing the appropriate degree of consumer protection; and reducing financial crime. Its 'principles of good regulation' include: efficiency and economy; proportionality; innovation; international character; and competition. This principled and clear approach is critical to the success of the UK's regulatory environment.

We have already mentioned the problems associated with the Sarbanes-Oxley Act. It is argued that other developments, such as US regulatory amendments to the Basel II standards, could put US banks at a further disadvantage relative to New York's international competitors.

Concluding remarks

London as an international financial and business services centre has become increasingly competitive over the last decade. It has seen its share of new and innovative markets such as derivatives, foreign exchange, debt finance, private equity and hedge funds expand significantly. New York, by contrast, has struggled to maintain its leading position in the wake of regulatory and legal challenges.

The McKinsey report recognises this shift in momentum – but also points out that both New York and London are under pressure from emerging centres such as Dubai, Hong Kong and increasingly Shanghai and Mumbai. For London, the onus is on capitalising on its existing strengths (its principled, united regulatory front embodied in the FSA, its open labour market markets and reputation for innovation) whilst also tackling some of its many bottlenecks. These bottlenecks – especially its transport and housing infrastructure, income inequality and inner-London worklessness – threaten to slow London's growth and encourage international firms to locate elsewhere in Europe and increasingly in Asia and South America. GLA Economics believes that London's businesses and policy-makers will have to rise to these challenges and work increasingly hard to overcome them. However, if London is successful at removing these pressures and maintaining its strengths, the possibilities for even further growth and success in this field are impressive.

Footnotes

1 See, for example, GLA Economics (2006), 'Why distance doesn't die: agglomeration and its benefits', Working Paper 17, June 2006, available at http://www.london.gov.uk/mayor/economic_unit/docs/wp17_agglomeration.pdf .
2 The regulations surrounding H-1Bs, which allow US companies to employ graduates on a temporary basis, are not just constraining the financial sector; they are also having significant effects on engineering, technology and venture capital employers.
3 See 'Office space around the world' at http://www.cushwake.com/cwglobal/jsp/researchLanding.jsp?Country=GLOBAL&Language=EN
4 This does not include WorldCom-related settlements of approximately $6.2 billion.
5 Financial Times, 10 August 2006
6 GLA Economics, 2006, London's Economic Outlook: Autumn 2006. Available online at http://www.london.gov.uk/gla/publications/economy.jsp#leo_1006

Additional information

Data sources

Tube and bus ridership	Transport for London on 020 7941 4500
GDP/GVA growth	Experian Business Strategies on 020 7630 5959
Tourism – overseas visitors	www.statistics.gov.uk
Tourism – domestic visitors	www.visitlondon.com
London airports	www.caa.co.uk
Business activity	www.rbs.co.uk/pmireports
Employment	www.rbs.co.uk/pmireports
House prices	www.nationwide.co.uk/hpi/
Unemployment rates	www.statistics.gov.uk

Glossary

Civilian workforce jobs

Measures jobs at the workplace rather than where workers live. This indicator captures total employment in the London economy, including commuters.

Claimant count rate

Unemployment rate based on the number of people claiming unemployment benefits.

Employee jobs

Civilian jobs, including employees paid by employers running a PAYE scheme. Government employees and people on training schemes are included if they have a contract of employment. Armed forces are excluded.

Gross domestic product (GDP)

A measure of the total economic activity in the economy.

Gross value added (GVA)

Used in the estimation of GDP. The link between GVA and GDP is that GVA plus taxes on products minus subsidies on products is equal to GDP.

ILO unemployment rate

The International Labour Organisation's calculation of the number of people out of work.

Tube ridership

Transport for London's measure of the number of passengers using London Underground in a given period. There are 13 periods in a year – twelve 28-day periods and one 29-day period. Period 1 starts at the beginning of the financial year rather than the calendar year.

Acronyms

ABI Annual Business Inquiry
BAA British Airports Authority
BCC British Chamber of Commerce
BITOA British Incoming Tour Operators Association
CAA Civil Aviation Authority
CBI Confederation of British Industry
DCLG Department for Communities and Local Government
EBS Experian Business Strategies
GDP Gross domestic product
GVA Gross value added
ILO International Labour Organisation
IMF International Monetary Fund
LCCI London Chamber of Commerce and Industry
LET London's Economy Today
MPC Monetary Policy Committee
ONS Office for National Statistics
PMI Purchasing Managers' Index
PWC PricewaterhouseCoopers
RICS Royal Institute of Chartered Surveyors

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