John Gieve: London, money & the UK economy

Speech by Sir John Gieve, Deputy Governor of the Bank of England, at The University of Surrey, Guildford, 26 June 2007.

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Introduction

The past year has been one of rapid growth and record profits for much of the financial sector worldwide. The strength of the world economy has provided a favourable wind but the spectacular growth of derivative markets and the spate of leveraged buy outs have also fuelled the growth. And, of course, London has been at the centre of the story.

In a speech in March I discussed the renewed ascent of London as a centre of international finance and concluded that it was based on powerful economic forces which were likely to persist.[1] I showed how the leading position London built up in the days when Britannia ruled the waves gave it a strong comparative advantage based on language, law, time zone and, above all, by a concentration of expert labour. This allowed London to maintain an important role in international finance even while Britain's overall economic and political position was eroded. In the last twenty years we have seen a resurgence in the City which has established a strong position not just in traditional markets like foreign exchange, where its share is around 30% of trading, but in new products, with a share in OTC derivatives markets over 40%.[2] The rapid growth of hedge funds in the West End is the latest example of the innovation that this cluster of financial skills has produced. You know something must be happening when the Mayor of New York commissions a review of the threat London poses to New York's position.

London's recent growth certainly has a cyclical element but it also reflects two more structural changes – the removal of barriers to international capital movements and the advances in information technology. These have led to a growing role for international capital markets compared to national banking and to a growing concentration of those markets in a few hubs among which London and New York are dominant. And this finance revolution is still underway. It is far more advanced in the US than in Europe and in Europe than in Asia. In the absence of disasters therefore London, as the pre-eminent centre outside the US, can look forward to a long period of fast growth and expect its share of the UK economy to increase.

This evening I want to discuss the implications of that trend for the UK economy and for economic policy. On the first, is London a goose laying golden eggs for the rest of the country or is it more of a cuckoo in the nest? On the second, how does the growth of London and financial markets generally impact on the Bank's core functions of setting monetary policy and maintaining financial stability. Finally I discuss the impact of financial developments on the growth of money and credit and the significance of that for the broader economy.

London's impact on the wider economy

In principle, when one sector of an economy enjoys rapid growth, we would expect to see three broad developments:

- rewards earned by factors which are specific to the booming industry rise;
- unless there are sufficient unemployed resources available, productive resources shift into the booming industry; and
- employment in other tradable goods industries falls.

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1 Gieve, J "The City's Growth: The Crest of a Wave or Swimming with the Stream", to the London Society of Accountants, 26 March 2007.

2 I use "the City" here loosely to cover not just the Square Mile but the whole of London's wholesale financial sector including in Canary wharf and the West End. A fuller exposition would also give more attention to successful regional centres including Edinburgh.

The results were illustrated by the Dutch experience with gas in the 1960s and by the UK experience with North Sea oil in the early 1980s.[3] In both cases, part of the mechanism was a rise in the real exchange rate and consequent pressure on other sectors.

Is that happening now in the UK? It is much harder to identify the impact of the City than the impact of the discovery of gold or oil. London's position has developed gradually and the statistics rarely separate the group of wholesale financial markets and supporting legal, accounting and other services that make London special from a broader group including retail banking and insurance and business services. But there is some evidence that all three factors are at work.

The story seems clearest with the specific factors of production. The cost of commercial property in London, for example, has grown rapidly. According to Jones Lang Lasalle Research, in the City average capital values are over $25,000 per sq.m, above both Paris and New York. And the costs in the West End, the main home of the new hedge fund industry, are almost twice as high. There is no doubt that the success of London's financial centre is helping to fuel demand for office space from Canary Wharf to Mayfair.

And of course it is not just commercial property in London that has been booming. House price inflation in London has outstripped the rest of the UK (Chart 1), and in Kensington and Chelsea average house prices have risen by almost 40% since the start of 2005, compared with 20% for Greater London as a whole. ECA International published a survey comparing average monthly rents for a 70-square metre unfurnished flat in the largest cities and showed London over € 2,100, compared with New York around € 1,750 and Paris below € 1,500.

The figures on output also show that London has been growing relative to the rest of the country (Chart 2), and that has reflected the growth of financial and business services compared with other tradable sectors throughout the UK (Chart 3 and Chart 4). And despite the fall in oil production in the North Sea, we have seen a rise in the real exchange rate by over 15% when comparing the period 1987-1997 to 1997-2007, although of course the financial sector would not have been the only factor behind that rise.

More immediately, the GDP figures in May showed that financial intermediation grew by 6% in the sixth months to 2007 Q1 – an annual rate of over 13%. That is not the same as the City of course; but there is every reason to think the City has been growing at least as fast as the rest.

However, while the success of the City is currently one factor in these trends, it is not the whole story. For a start there is a lot more to London than finance. There are other successful industries and, on the other hand, London is home not just to the wealthiest boroughs but also to some of the poorest and most deprived areas in the country. As a result it has one of the highest regional rates of unemployment overall. Secondly employment and profits in the City have been highly cyclical.

On scale first, a recent estimate put the total number employed in "City" jobs, including supporting professions like lawyers and accountants as well as bankers and asset managers, at around 340,000. That amounts to about 9% of the total in London; significant but still lower than the number in distribution or in government services. And the growth of employment will continue to be the net result from the expansion of activity and from the economies made possible by IT and by the relocation particularly of back office work to cheaper areas elsewhere in the UK or abroad.

The jobs figures understate the importance of the sector in the economy because on average pay may be twice as high in the financial sector as in the rest of the economy; 9% of wages and salaries in the year to March compared to 4% of employment. And within London its share is even greater. The average earnings of someone working in London's financial intermediation sector in 2006 were around £90,000. On that basis, the financial sector might account for around 20% of remuneration in London. However it is still far from the only game in town. For example the Work Foundation's fascinating new report on the creative industries suggests that their growth has contributed at least as much as the City to London's overall performance.

Moreover, while the trend is upwards, there is a marked cycle in the financial sector. Over the last 10 years, for example there has been a striking swing in employment with rapid growth during the dotcom boom followed by a sharp fall and subsequent recovery (Chart 5).

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[3] The UK is a net exporter of financial services, running a surplus in 2006 of £26 billion (or 2% of GDP) on financial services and insurance. North Sea oil production peaked in 1999, and in 2006 was nearly 40% below this peak.

That reflects a strong cycle in financial sector profits (Chart 6) which is an international phenomenon – indeed, in the last 10 years major European financial firms and US securities dealers saw an even bigger cycle in their profitability than major UK financial firms (Chart 7).

The same is true for earnings (Chart 8). This reflects the importance of bonuses which account for around 20% of remuneration in the financial sector compared with around 5% across the economy as a whole. The figures in the City itself can be considerably higher. A figure of 50% is common in investment banking, in which a rough rule of thumb is that firms distribute about half their pre bonus profits to staff. It is estimated that 4200 workers in the City received bonuses worth more than £1million in 2006/07.

Of course the growth in those bonuses is contributing to the widening inequality of incomes at the top of the earnings distribution. Chart 9 compares the 90th, 95th, and 99th percentile with the median and shows that the main change is at the top. If we break that top percentile down further, we see a more dramatic widening. This is not just true of the City or of the UK. The average CEO in the UK earns around 100 times more than the average worker but there is an even wider gap in the US, with the average pay of CEOs over 250 times that of the average worker in 2005, having risen from around 100 times in 1995.

In 1999 Eddie George likened the change in the City since Big Bang to Wimbledon.[4] The UK still prospered by providing the venue even though most of the players were foreign.

Today I think the Premiership may provide an even better analogy. That is partly because foreigners now own an increasing number of the venues as well as supplying many of the players. That is a striking illustration of Britain's openness to foreign ownership which sets it some way apart from most other countries both in Europe and America. But it is also because both the City and the Premiership have become the centres of global industries with a dramatic impact on revenues and on earnings.

One of my first footballing heroes was Johnny Haynes, the David Beckham of his day as a passer of a football. In the 1960s he became the first player to earn £100 per week (roughly £1500 in today's terms) in the British game which was then about four times the average male wage. Top Premiership players now earn more than 200 times the average wage.

What has changed is the fact that pay is now being set in a world market. We have in the Premiership as in the City some of the best paid people in an international industry which is developing rapidly. We have imported the top of the world earnings scale and at a time when the stretch at the top world wide is increasing very fast.

Just as in the Premiership, the stars of the City – the people who have not just the talent but the recent experience and networks to perform at the top level today – can command a high proportion of the returns from being at the hub of the industry. The growth of hedge funds and private equity can be seen in part as a move by the small group who have sufficient expertise in new instruments and markets to take more of the returns on ownership.[5]

To sum up so far, internationalisation and technology favour the clustering of financial markets in London so we should expect London to continue to prosper relative to the financial industry worldwide and to the rest of the UK economy. That will tend to reinforce the trends of recent years with:

- a continuing shift of resources into the financial markets and into London itself,
- a continuing pressure for higher rents and rewards for those with the right combination of talent and experience, but also
- a strong cycle in profits, pay and employment.

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4 E George, "Before the Millennium: From the City of London", 7 December 1999.

5 Even for a footballer, being at your peak at the right time and place is critical to earnings. But with football like athletics, it is obvious that the best have outstanding talent. It is harder to believe the all the high earners in the City are intrinsically more intelligent or determined than others whether in universities, hospitals or factories. But the demand for the best paid reflects not just talent but experience. There may be many people who could run a trading floor given the right training but there are inevitably only a few who can demonstrate current success in doing so. Experience, like status and talent, is a "positional good".

Implications for economic policy

That leads straight on to the first implication for policy makers. As London strengthens its position in financial markets, the cycle in international finance will have direct effects not just through the shifts in interest rates and asset prices but through jobs and pay in an important sector of the London economy. Any international financial crisis will be important not just because of its knock on effects on the core banks and markets on which British industry and households depend but because of its direct impact on the real economy.

The growth of the City also affects the interpretation of some of the core statistics we use to monitor and assess how the economy is developing, including those on output, earnings and, above all, money and credit.

First our GDP numbers don't pick up financial sector very fully. In most sectors the contribution to GDP is roughly the sum of pay and profits. Measuring the output of the financial sector is more difficult. In the financial sector some types of banking activity are excluded from the final GDP figures. In 2008 the ONS plan to expand the GDP figures to include what is called FISIM and reflects those activities of banks which they cover by their net interest income.[6] That will improve estimates of GDP, but they will continue to exclude income that banks earn through proprietary dealing. This is probably be right as a matter of national accounting principle but dealing in securities is a part of what some international banks do. As a result changes in the level of activity in the City may not be fully captured in the GDP figures which most economic models, including the Bank's, use as their summary statistic for the real economy.

Second the growing importance of bonuses in the financial sector can make it harder to interpret statistics on earnings. City bonuses are generally paid at the start of the year. As Chart 10 shows this leads to big peaks and troughs. At times when changes in earnings growth are of great interest, as they have been in recent months, it is difficult to identify the underlying path.

The difficulty is partly a technical issue of how to smooth out the monthly variations. Do we spread the bonuses backwards over the last 12 months on the grounds that they are deferred pay conditional on profits in that period (with the consequence that you don't know the true earnings figure for any month until over a year later)? Do you spread them forward because they will tend to be spent over the coming year? Or do you do a bit of both? To that uncertainty we can add the fact that there several different measures of earnings growth including two – the AWE and AEI – which are telling a somewhat different tale.[7]

There is also a more conceptual challenge. Are bonuses to be treated as part of the cost of labour or are they a form of profit sharing? The economic implications may be quite different. In practice they are probably a bit of both; bonuses are much higher when profits are good, but they are unlikely to disappear entirely in tough times (witness the concept of the "guaranteed bonus"). But estimating how they divide up is not easy.

Money and credit

The third area in which the development of financial markets is complicating the interpretation of statistics is money and credit. And again that is an area of keen attention at the moment. The question is whether the recent growth of the money supply is telling us something about the prospects for inflation and the economy that we are not getting from other variables – like consumption, interest rates, prices, or inflation expectations.

Chart 11 shows monetary growth over 130 years in the UK against consumer inflation. The association is obvious. But even in the days of the gold standard when the Bank had a more direct control of the money supply, money growth and inflation diverged for periods (eg in the late 19th century and in the late 1920s). More recently, the growth of money in the 1970s did act as a leading indication for inflation. But in the early 1980s the relationship appeared to break down despite,

6 "Improving the measurement of banking services in the UK National Accounts", Leonidas Akriditis, ONS Economic and Labour Market Review, May 2007

7 I have used the AWE in this speech, even though it is the more recent and less well established of the two, because it is designed to handle outliers at the top and bottom of the ranges better and the City has a disproportionate number of outliers.

or possibly because of, the fact that the monetary authorities were explicitly targeting the monetary aggregates as a means of controlling inflation.

Part of the explanation of the divergence was that the 1980s were a period of rapid financial innovation following the removal of exchange controls and of pricing, income and dividend policies. This changed the amount of money people were willing to hold for a given amount of money spending (which in economics is known as the velocity of circulation). So the increase in money growth did not lead to a pick up in inflation.

Even so the acceleration of monetary growth at the end of the 1980s did foreshadow the upturn of inflation at the end of the Lawson boom.

The chart shows that since 1992 the rates of growth in broad money and inflation have diverged again and that broad money growth has picked up sharply since 2003. A key question is whether this reflects a further spurt in financial innovation or is telling us that we should expect increasing growth of money spending and inflation.

There are good grounds for attributing part of the increase to structural changes in the financial markets which have led “other financial companies” (OFCs) to hold more deposits with the banks for a given level of economic activity.[8]

It is within this OFCs sector that the growth in money has been the most rapid (Chart 12). The view that much of this growth reflects structural changes of this sort is supported in my view by the way the spread between deposit and loan rates of interest has vanished in the last few years (Chart 13). Of course that might be the product of competition between banks to lend more and attract more deposits; it also seems plausible that much of this lending is more about balance sheet restructuring than making a profit.

However deposits associated with special purpose vehicles and intra-group only account for part of the growth. Even if we strip out all OFC deposits the growth rate of money has still been strong compared with the growth rate of money spending (Chart 14). In my final section I want to discuss what we should make of this.

The significance of the money supply

In the Treasury in the 1980s I was a close observer of the attempts to find a monetary aggregate as an intermediate target to guide policy. We were looking for both a predictable relationship between the policy instrument, interest rates, and the measure of money and a predictable relationship between that and our final objective, inflation. I remember the frustrations when both links proved unreliable. I am in no doubt that we are better off focussing directly on our final target, inflation.

However I was struck, returning eighteen months ago to the economic debate, how the place of money in our debates had changed. Our model, like most others, is “new Keynesian”. As a result, the discussion sometimes seems to resemble the discussions of “demand management” in the 1970s more than the monetarist debates of the 1980s. But, if anyone was in any doubt, monetarism was not dead but only resting. And it has recently taken wing again as persistent monetary growth and rising asset prices have given us food for thought.

At times the discussion of money can seem detached from the rest of the policy debate. Having listed all the other aspects of the economy factors – like world growth, consumption, financial markets and the labour market – “money” emerges as though it was a separate determinant impacting directly on inflation or inflation expectations like Heineken “refreshing the parts other beers cannot reach”.[9] But money is very much part of the real world and we don’t need any hidden or ghostly mechanisms to see how it feeds through credit, asset prices and consumption in the wider economy.

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[8] The clearest example is the service offered by London Clearing House, where dealers effectively transact with each other (via gilt repo transactions) across the balance sheet of LCH, which results in an increase in both OFC’s deposits with and borrowing from banks. Similarly, in the case of a synthetic securitisation of corporate bonds, a special purpose vehicle (SPV) is set up to issue securities to investors and holds a cash deposit at a bank from which it makes payments if any of the securitised loans default. Both of these examples result in an increased in measured deposits at banks, but neither presages more nominal spending.

[9] G Ryle “The Concept of Mind” London (1949) Hutchinson. Ryle was criticising as incoherent a dualist view of mind and body in which the mind is instrumental in determining action but is wholly distinct from the physical realm.

We need to start as the Governor has said by trying to distinguish supply shocks from demand shocks.[10] Where growth in money is driven by the wish of consumers or companies to increase their holdings of money for a given level of spending, there need be no effect on nominal GDP or inflation. As I have discussed there is clear evidence of changes in demand of that sort in the financial sector. But that is not the whole story. So have there been increases in supply of money and if so how will they feed through into the economy?

What does a supply shock look like? It is easiest to visualise in a closed economy in which the money supply is mainly notes issued by the monetary authorities. One can imagine then a direct increase in supply – a helicopter drop of extra notes. In that world people would really find themselves with extra cash in their pockets and would be expected to go out and spend some or all of it. With more money chasing the same goods, we would see a direct impact, first on money spending, then on inflation.

In the modern world the nearest equivalent to helicopter drops has been the monetary financing of government deficits. But monetary financing is not a problem we face at the moment, indeed it is not allowed within the EU under the Maastricht Treaty.

So what we need to be concerned about today is the creation of extra money through the banking system and the way that happens is through the granting of credit to willing borrowers who borrow to spend on assets, investment or consumption. The supply changes we need to spot are changes in banks' willingness to lend. And we don't have to look far to find some.

Take, for example, the growth of consumer credit in the UK (Chart 15). We see rapid growth in the late 90s and early years of this century followed by a sharp decline as banks began to see defaults rising.

Another recent example is the sub prime market in the US. Chart 16 shows the arrears rates on successive cohorts of loans, marking very clearly the reduction in credit quality in 2006 as the market overshot.

In both cases the figures and the market explanations confirm that these movements reflect at least in part changes in the supply curve for credit. The borrowers were willing but the banks were also pushing the supply by reducing costs and conditions (culminating some said in NINJA mortgages – for those with no income, no job and no assets).

So I have no doubt that we have seen some supply changes to credit. Next we need to distinguish the sustainable changes from the cyclical. Sustained changes either in the economy or in financial sector technology may justify some increase in supply. For example, we have seen a long period of low and stable inflation and unemployment and that is expected to continue. That reduces some of the risks to lenders and borrowers and may increase both the demand and supply of credit and the value of assets on a lasting basis. The development of information technology allows banks to collect and analyse more information about borrowers which should allow them to target credit better and justify a change in supply. Finally the development of derivative markets has allowed the risks in loans to be split into their separate components and distributed to the people best placed to bear them. Again that should lower the supply curve for credit.

All these factors were at play in the consumer credit and the sub prime markets but, despite the new sophistication of credit scoring and the derivatives markets, they both also showed all the classic signs of a credit cycle. Banks competed for business by lowering the costs and conditions on lending while the economy expanded, defaults were few, and profits appeared high. They overdid it, defaults started to rise, losses were taken and they toughened their terms again. The speed and severity of that cycle can have implications for financial stability as well as the stability of the broader economy. It is for that reason that there is a wide acceptance that there may be a case for monetary policy to "lean into the wind" in a cyclical upswing.[11] That has been one factor in my support for the four interest rate rises of the last year.

If there is evidence of a cyclical, unsustainable, element in the supply of credit and asset prices the next questions are:

- where are we in the cycle, and

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[10] M King "Speech to CBI Dinner, Wales", 11 June 2007.

[11] C Bean "Inflation Targeting: The UK Experience", speech at the Annual Conference of the German Economic Association, 1 October 2003.

- is the present stance of monetary policy sufficient to bring it back to a sustainable trend or, given the lags in the impact of interest rate changes, is it set to exacerbate the downturn?

Current conjuncture

So where are we now? The consumer credit market in the UK and the sub prime and broader housing markets in the US have turned down and, while the sub prime saga is still not played out, it still seems unlikely that it will have severe knock on effects on the broader economy.

Elsewhere the commercial property in the UK looks to be at or close to its peak (Chart 17).The housing market is showing some glimmers of a slowdown in activity but prices are still rising fast, especially in London; indeed the rate of increase of house prices is higher today in nearly every region than it was last autumn. And there is no sign of a slowdown in corporate lending. Overall lending to PNFCs is accelerating (Chart 18), investment is high, and on a global basis we are seeing spectacular growth in the LBO market (Chart 19) and the emergence of lower prices and conditions with so called "covenant lite" loans.

Against that background the question is whether we have done enough. In reaching a judgement, of course, we need to take account of the full range of information on the real and nominal economy. We know that the full impact of past increases in rates has yet to come through. Yet we cannot be sure how much of a restraint current rates will be at this point in the cycle. It is not surprising therefore that there are different views on the MPC or that those views change in response to more information.

My stance in recent months has reflected a judgement on the balance of risks taking account of both probabilities and likely impacts. The risks we face are: first that we may increase interest rates too fast or push them up too far, with an unnecessary loss of growth, and second that we may raise rates too slowly with a cost in higher inflation and potentially higher interest rates and a sharper slowdown in the end.

I voted for a further increase earlier this month partly because I was not convinced that current rates would be sufficient to bring credit growth and nominal demand back to their long term sustainable path. I also felt that the impact of moving too slowly on the credibility of the regime and thus the future prospects for the economy was of greater concern, given the robust rate of growth, than an unnecessary slowdown in activity. In reviewing the position again in future months I will be watching the trends in the growth of credit and money carefully.

Chart 1: House prices

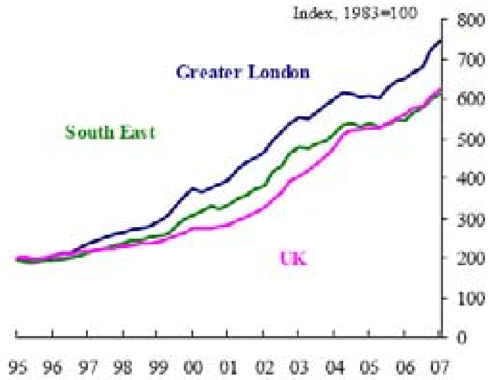


Chart 2: Gross Value Added per head

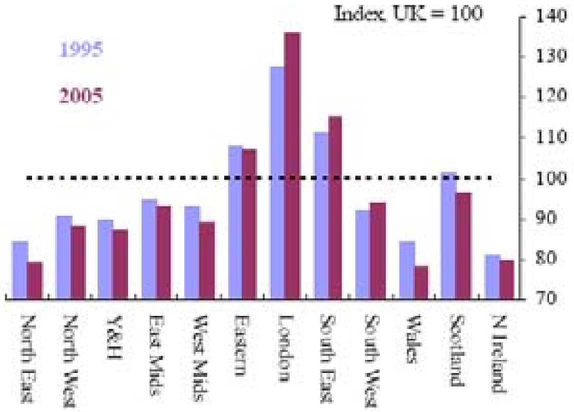


Chart 3: Output growth

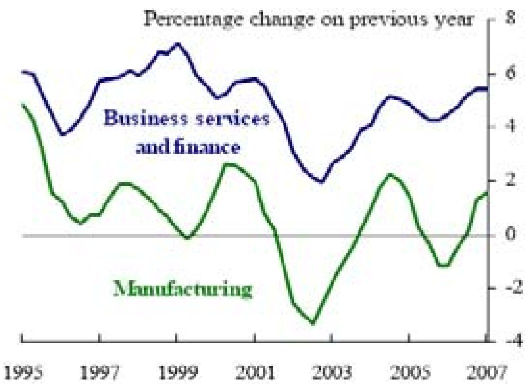


Chart 4: Employment growth

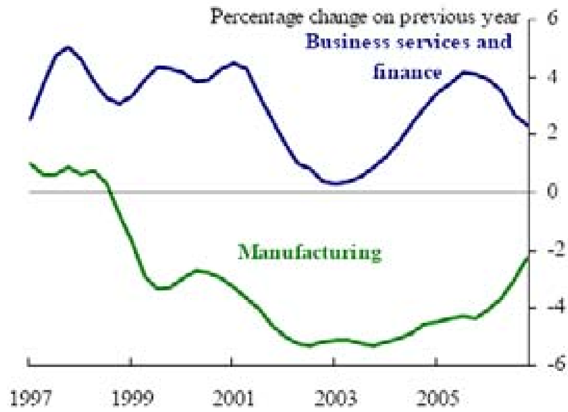


Chart 5: London jobs in finance

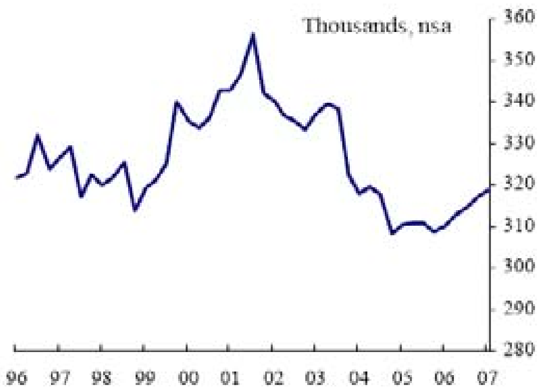
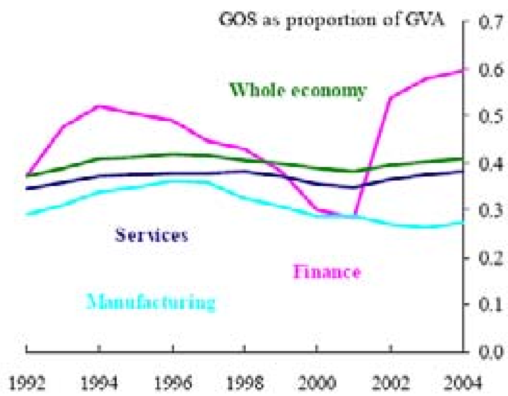


Chart 6: Profit margins by sector



Source: ONS

Chart 7: Pre-tax return on equity

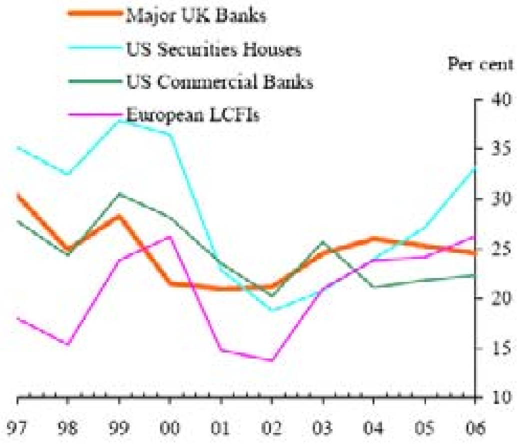
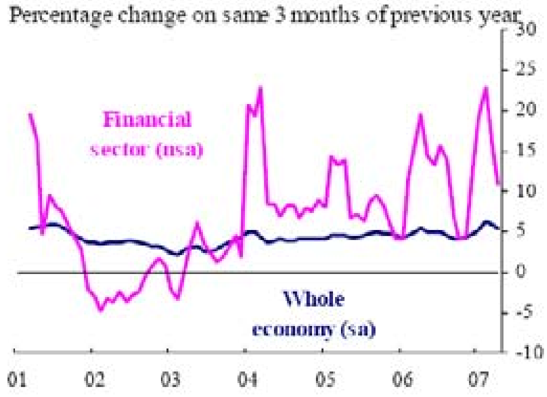
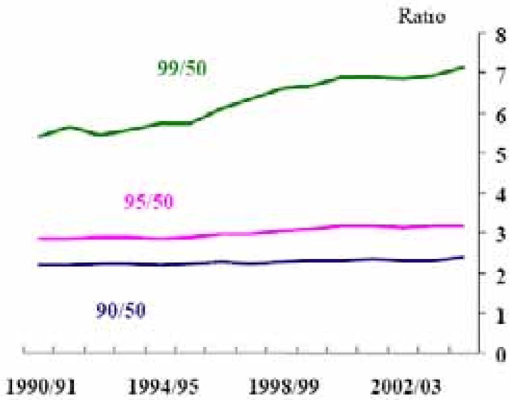


Chart 8: Earnings growth[1]



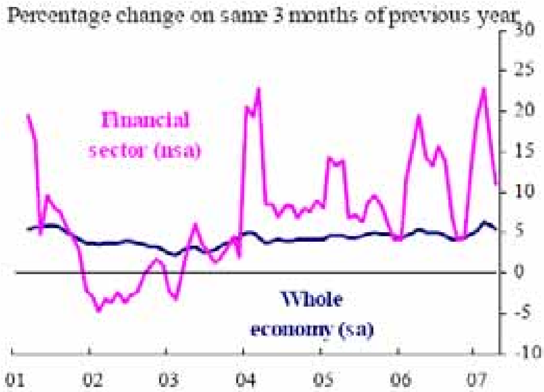
1. AWE data, including bonuses

Chart 9: Pre-tax income inequality[1]



1. 90/50 shows ratio of pre-tax income at the 90th percentile to the median

Chart 10: Earnings growth[1]



1. AWE data, including bonuses

Chart 11: Broad money growth and inflation

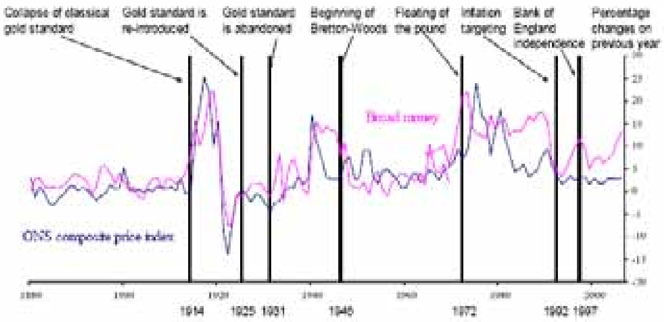


Chart 12: Annual M4 growth

Chart 13: OFC interest spreads

Chart 14: M4 and nominal GDP growth

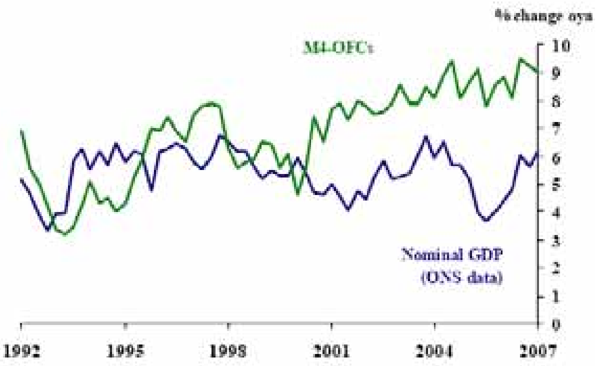


Chart 15: Lending to individuals

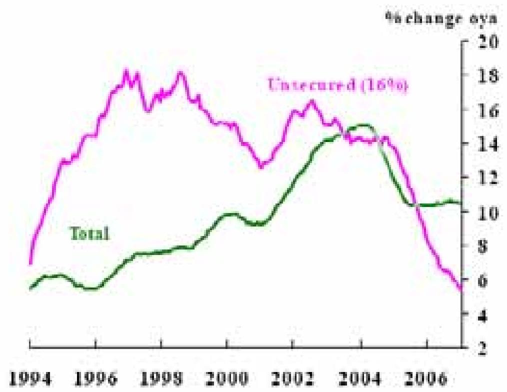
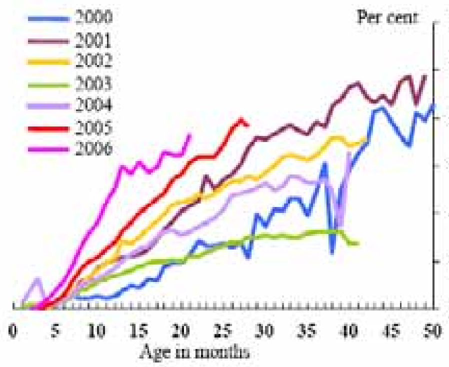


Chart 16: US sub-prime arrears[1]



1. Arrears of 60+ days on US second-lien sub-prime home equity loans

Chart 17: Commercial property capital values growth

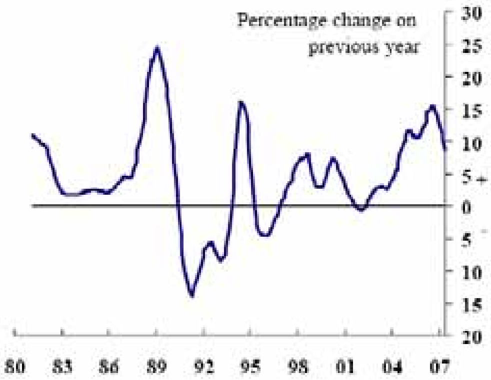
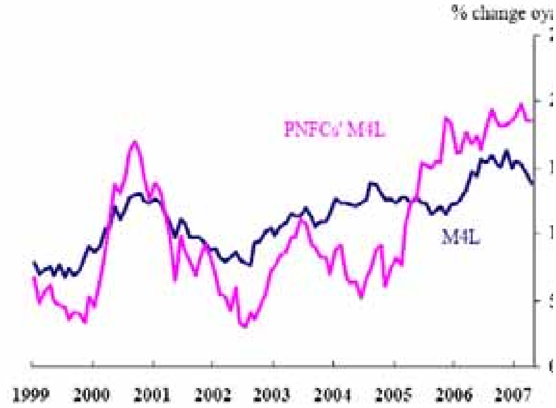


Chart 18: Annual M4L growth[1]



1. Excluding the effects of securitisation

Chart 19: Real LBO loan issuance