

CITY ECONOMY DIGEST

Volatility and gloom (revisited)

In the three months since the previous digest, both the global economy and the financial markets have continued to suffer under the twin uncertainties of the post-dot.com bubble subsidence and the threat of war in the Middle East. Economic prospects have worsened: although the Economist's February survey of forecasts of GDP growth shows higher expectations for 2003 than 2002 for most countries, the improvements are generally small and from a very low base. Only Australia and Canada, both of which enjoyed 3%+ growth in 2002, can look forward to that level this year, with the US and the UK expected to manage 2½% growth, at best. The Eurozone is facing another bad year: although its GDP is forecast to rise by more than last year's 0.7%, an increase of 1.3% still qualifies as a growth recession (and early year forecasts are generally a poor guide to the eventual outcome).

The financial market indices have continued to suffer from excess volatility. Since the beginning of 2003, not only has the Dow Jones Industrial index fallen by 9%, its daily movements have regularly been more than a percentage point up or down (and the lower the index goes, the greater the propensity for mood swings, it seems). In London, meanwhile, the FTSE 100 index endured its longest-ever losing streak of 11 days during January and, to boot, has been even more volatile than the Dow Jones.

It has not been totally bad news, however: London continued to hold a dominant share of foreign equity trading throughout 2002 and increased its share of the international legal services market; the City retained its market share as a leading financial centre despite the UK's continued non-membership of the euro; the LSE and Euronext both increased their shares of the (admittedly) depressed European IPO market; and a report from the London Business

School put the bear market into a (very) long-term perspective. Finally, the burning, if parochial, question raised in the previous CED can now be answered: the publication of the 2001 Annual Business Inquiry in December 2002 has given us data on the size of the workforce both in the City and elsewhere in Great Britain. All of this is discussed in greater detail below together with the regular updates of the property market; the CBI/PwC survey of financial services; and levels of activity on the various City trading markets.

City Activity

Detailed information and comments on recent trading on the major City exchanges appear at the end of the digest. The data in Table 1 have been updated, where possible, to reflect the position at the end of 2002 in order to provide a run of annual figures. Note that the two BIS/IFSL figures have not been updated from the previous digest.



Table 1 UK Financial Market Activityⁱ

	Unit	Source	1999	2000	2001	2002
Foreign exchange	Daily t/o	BIS/IFSL	\$637bn (1998)	N/a	\$504bn	N/a
OTC derivatives	Daily t/o	BIS/IFSL	\$171bn (1998)	N/a	\$275bn	N/a
LIFFE contracts	Daily t/o	LIFFE	€306bn	€368bn	€613bn	€718bn
LME Futures & Options contracts	Daily ('000s)	LME	244	265	235	233
LSE total equities	Daily volume	LSE	4,219m	5,998m	7,151m	6,994m
	Daily value	LSE	£15.2bn	£21.5bn	£22.1bn	£18.3bn
UK government gilts	Annual t/o	LSE	£1,692bn	£1,595bn	£2,030bn	£2,158bn
UK equities (inc AIM)	Annual t/o	LSE	£1,416bn	£1,909bn	£1,905bn	£1,815bn
International equities	Annual t/o	LSE	£2,420bn	£3,520bn	£3,676bn	£2,780bn
Money raised by UK cos	Annual	LSE	£101bn	£126bn	£105bn	£103bn
Market capitalisation						
UK companies (inc AIM)	Year end	LSE	£1,821bn	£1,797bn	£1,535bn	£1,158bn
International companies	Year end	LSE	£3,577bn	£3,526bn	£2,580bn	£1,902bn
FTSE-100 index	@ year end	LSE	6,930	6,298	5,217	3,940

Some comments on Table 1:

The comments in the previous digest still pertain, with minor additions as follows:

- the 6% rise in turnover of UK government gilts during 2002 was largely due to growth in mediums (7-15 years), up by 21%. Longs (over 15 years) rose by 4% while other types of issues fell
- the FTSE-100 index continued to fall during 2002 from its December 1999 peak of 6,930, hitting a low point of 3,671 on September 24th. It recovered to 4,190 on November 21st before resuming its downward path, finishing the year at 3,940, 24% below its start point. It has since continued to fall, and stood at 3,658 on February 19th 2003

Financial Services Survey

The CBI-PricewaterhouseCoopers quarterly survey of financial services firms began in 1989. In its first ten years, it recorded two downturns, one major and one minor, and two recoveries, and it is thus able to put its findings into a wider context. The December survey, which received 103 responses, seems to confirm that it is currently recording its third downturn, though it is unclear yet as to whether it will be major or minor. The balance of overall business optimism fell from -1% to -16%; however, this still compares favourably with the -60% lows of 1990 and 1998, and the -40% reading of late 2001.

The -36% balance of respondents reporting that their current level of business is below normal is back to where it was at the beginning of 2002 after a relatively cheerful summer. Both volumes and value expectations have also suffered severe turnarounds, especially

regarding business with private individuals. The balances on average commissions and total operating costs have also switched sharply from positive to negative leading, not surprisingly, to a swing in overall profitability from a positive balance of +26% in June to a negative balance of -27% in December.

Also unsurprisingly, employment prospects have dimmed, the balance of those expecting their workforce numbers to rise having dipped from -2% in June to -34%. Leading this rush to leanness is life insurance (current balance of expectations -98%), banking (-56%), and fund management (-51%). Providing a welcome beacon of hope, as it has for the past year or more, is the general insurance sector, which reported a positive balance of +81%, reflecting its trend-busting level of optimism about the overall business situation. The sector's threatened loneliness in this optimistic stance was softened by fund management, which recorded an even higher positive balance despite levels of business well below the norm.

The December survey marked a severe deterioration in the outlook for building societies. The overall balance of optimism has slipped from +13% in the summer to -63%, the gloomiest figure among the nine sectors. The societies recorded their first drop in business volumes for 2½ years, and the steepest drop since 1992. Less business with private individuals was given as the reason for the fall, though rising doubts about the sustainability of the current house price boom, especially in London and the South East, will surely have played their part.

Research Round-up

Most of the regular market and employment data (see next section) have been less than cheerful over recent months. However, not quite so gloomy findings have emerged from a number of one-off reports published during the past quarter which suggest that London has been maintaining, and in some cases extending, its market share throughout the current downturn.

In November, the **Bank of England** reportedⁱⁱ that the City has retained its market share as a leading financial centre over the last four years despite the UK not having joined the European single currency. The Bank said that the City's market share has remained broadly unchanged in wholesale euro payments, foreign exchange trading, international bank lending, eurobond issuance and trading, foreign equity trading, OTC derivatives trading and short-term interest rate trading. It even claimed that it could see no indication of the City having lost share in any of its other markets, to boot. The Bank's view that non-membership of the euro has not caused any problems to the City had been backed up a couple of months earlier by the chairman of the US Federal Reserve, Alan Greenspan, who said that the UK had continued to stay on top in the provision of financial services.

Further proof of the City's relative success was provided in January by the **World Federation of Exchanges** who reported that the London Stock Exchange (LSE) had maintained (in fact, to two decimal points, grown) its dominant 55.9% share of foreign equity trading in 2002. This was achieved despite a 21% fall, in dollar terms, over the previous year, a fall which matched the global decline almost to the very last cent, as Table 2 shows. One point to note is that the combined share of the New York and Nasdaq exchanges has fallen by almost half over the past five years, from 45.8% in 1997 to 25.4% in 2002.

Another area where London has increased its share of a global market, only this time without recourse to the second decimal point, is international legal services.

International Financial Services London^{iv} reported that London extended its lead in this sector in 2002: five of the six largest firms are now from the UK, which also provides four of the six top revenue-earners. The number of solicitors employed by the largest 100 firms in London rose by over two-thirds between 1994 and 2002 to reach 16,000, while fee income generated more than doubled to £8.4bn over the same period. Meanwhile, exports by UK law firms rose threefold between 1990 and 2001 to reach £1.3bn.

A further good news/bad news scenario was the initial public offering (IPO) market in Europe in 2002. While the market was one of the slowest in recent years, both Euronext and the LSE increased their market shares. A report^v from consultants **PricewaterhouseCoopers** said that while the number of listings in London fell by 34% in 2002 to 91, the city's total market share of IPOs on Europe's principal exchanges rose from 44% to 54%. Euronext was similar, with listings down by 38% but its share up from 17% to 19%. The most spectacular collapse was in Germany, where the number of IPOs fell by 76%. Overall, there were 170 IPOs in Europe in 2002, raising €11.4bn – barely a third of the amount raised the previous year.

Further context for the financial sector is provided by the London Business School in its latest annual **Global Investment Returns Yearbook**^{vi}, published by ABN-AMRO. There is much of interest and relevance to the City in the 165-page report, but this summary will restrict itself to one area – the current three-year bear market in equities. The report takes a very long-term view of the market, putting it into a one hundred year perspective. It compares performance across 16 global markets in equities and bonds over this timescale, and

Table 2: Trading in International Equities 2002ⁱⁱⁱ

Stock exchange	2001		2002	
	\$ billion	% share	\$ billion	% share
London	2,651	55.85%	2,100	55.87%
New York	787	16.6%	702	18.7%
Bermuda	436	9.2%	414	11.0%
Nasdaq	469	9.9%	252	6.7%
Deutsche Börse	136	2.9%	101	2.7%
Others	268	5.5%	190	5.0%
Total	4,747		3,759	

shows that returns on the former have generally been higher than on the latter over almost any chosen period. The report points out that the current bear run in equities is rare but not unprecedented – it happened four times in the first half of the 20th century, though not since the late 1940s. However, it estimates that globally there is a 31% historical chance of a fourth year of negative real rates of return following three previous years.

One question which emerges from this analysis is of particular relevance to the City: how long will it be till the Footsie regains its all-time high? The LBS median case, based on an 8% expected return, is that the index has a 50% chance of doing this by 2018 (and a 50% chance of not doing so until later). This excludes the impact on investors of dividends: bringing them into the calculation pulls the date back to 2010, emphasising the importance of dividend income to long-term investors. The report does not try to predict future stock market returns. What it is confident about, however, is that the market will remain volatile, and that future returns will be choppy rather than smooth.

Employment & Businesses

Employment Numbers

In December 2002, the Office for National Statistics released Annual Business Inquiry (ABI) data for 2001. It should be noted the ABI is a sample survey which carries the usual caveats. An article in Economic Trends in November 2000 explained the ABI and its methodological aspects, and it is worth noting the paragraphs which highlight potential pitfalls inherent in sub-national and lower level ("minimum domain") data. The final sentence reads, somewhat ominously, "Sampling error does not increase beyond minimum

domain level, but other forms of error may be introduced and these are not quantifiable."

Nationally, the 2001 ABI shows a rise in GB employment of 223,000 (0.9%) over 2000. This accords well with the UK Labour Force Survey (LFS) rise of 235,000 between the September-November quarter in 2001 and the previous year. However, the ABI figure masks a swing away from London (46,000 jobs lost) and the South East (9,000) to, most notably Scotland (75,000 extra jobs), the South West (67,000 jobs) and the North West (41,000 jobs).

Driving the fall in the London ABI figure were the Finance (SIC codes 65-67) and Business Services (SIC codes 70-74) sectors where 35,000 jobs disappeared. 23,000 of these were so-called 'City-type' jobs - finance, legal and accountancy, referred to below as Finance & related Business Services (F&RBS).

Total City employment, across all sectors, fell from 330,000 in 2000 to 306,000 in 2001, and 98% of this decline was in City-type jobs. Meanwhile, F&RBS employment in Canary Wharf rose from 11,000 to 26,000; the net decline in the sector in the two areas was therefore 7,000 jobs. However, it should be noted that there was an overall fall of 19,000 jobs in the sector across the entire Central Business District. Table 3 gives details of total and F&RBS employment in selected areas for 2000 and 2001, while Table 4 provides a wider view of employment change. Points of interest in the latter table include the strength of the other Business Services and the Recreation & Culture sectors in London, especially the Central Business District, and the perhaps surprising London-wide decline in public sector employment, against the trend elsewhere in Great Britain.

Table 3: Finance & Related Business Services Sector Employment 2000-2001

Employment ('000s)	Total			Finance (1)			Related Business Services (2)		
	2000	2001	±chg	2000	2001	±chg	2000	2001	±chg
Total GB	25,233	25,456	+223	1,520	1,508	-12	460	458	-2
London	4,061	4,015	-46	343	324	-19	156	152	-4
Central Business District (3)	1,942	1,929	-13	274	258	-19	121	120	-19
<i>of which</i>									
City	330	306	-24	158	134	-24	52	54	+2
Canary Wharf (4)	46	62	+16	11	26	+15	1	2	+1
City Fringe boroughs (5)	800	812	+12	76	89	+13	36	35	-1

(1) SIC codes 65-67 (finance). (2) SIC codes 7411 (legal) & 7412 (accountancy). (3) City, City Fringe plus LBs of Kensington & Chelsea, Lambeth, Westminster. (4) Blackwall & Millwall wards only. (5) LBs of Camden, Hackney, Islington, Southwark, Tower Hamlets.

Table 4: Employment by Sector 2001

	GB		London		City/City Fringe		CBD	
	2001	±chg	2001	±chg	2001	±chg	2001	±chg
F&RBS	1,966	-14	476	-23	312	-10	378	-38
Other Business Services	3,030	+62	849	-12	236	-1	462	+25
Manufacturing	3,589	-183	259	-26	66	-3	92	-7
Construction	1,149	+22	134	+4	24	+2	32	+2
Wholesale & Retail	4,518	+58	614	-9	95	-1	210	-1
Hotels & Restaurants	1,657	+46	278	+13	59	+5	151	+6
Transport & Comms	1,558	+23	322	+4	82	-8	128	-8
Public, Health & Education	6,299	+142	794	-22	179	-2	324	-8
Recreation & Culture	690	+46	178	+24	41	+6	96	+15
Other	1,000	+21	111	+2	24	±0	56	+1
Total employment	25,456	+223	4,015	-46	1,118	-12	1,929	-13

Numbers of businesses

The previous digest gave the numbers of VAT-registered businesses, of which there are around 12,000 in the City alone. The ABI also records numbers of data units, a potentially confusing entity in that it does not readily correspond to the terms firms, companies or businesses by which employers are usually identified. A data unit is roughly equivalent to a workplace but, because of the way in which data are collected, two or more units can be present in the same workplace. (For example, a bank may have several branches and offices in a city, each one of which would be counted separately.) In addition, a single workplace can be counted as two data units where there are two distinct business activities at the same site, since each activity will be coded to its own SIC code and counted as a separate unit.

As a guide, there were 2.17m data units in Great Britain at the end of 2001 compared to 1.62m VAT-registered companies, an excess of a third. This ratio is not quite matched in the City, where there are 15,000 units for 12,000 companies, though the presence of

name-plate businesses in the Square Mile may have a distorting effect. Between 2000 and 2001, the number of units across Great Britain rose by 8,500. However, the total fell in London by 1,500, a decline to which the City contributed almost 900.

Table 5 gives data unit numbers by the usual geographic analysis, splitting the units into five employee sizebands. As might be expected, smaller units predominate, more than 90% nationally having 25 or fewer employees based there. The City has a greater number of larger sites, with almost three times the national ratio of places with 500 or more workers. (Note that the GB numbers are shown in thousands: data for other areas are in units.)

Property

According to Insignia Richard Ellis^{vii}, the key factors in the Central London office market during Q4 2002 were low interest rates and a weak stock market which together led to strong investment in the sector. £1.5bn was invested during the quarter, taking the annual total to £6.5bn, of which the West End accounted for

Table 5: Data Units by Location and Employee Sizeband, 2001

Employee sizeband	GB		City		City Fringe		CBD	
	'000s	%	Units	%	Units	%	Units	%
1-4	1,476	68%	9,860	65.5%	48,040	72.2%	49,680	71.1%
5-24	519	24%	3,485	23.1%	13,760	20.7%	15,300	21.9%
25-99	138	6%	1,220	8.1%	3,520	5.3%	3,740	5.4%
100-499	32	1.5%	412	2.7%	1,010	1.5%	1,030	1.5%
500+	4	0.2%	83	0.6%	170	0.3%	150	0.2%
Total	2,169		15,060		66,500		69,900	

£2.4bn, a new record. However, investment was the only piece of good news: take-up in Central London fell for the third successive quarter, the decline of 20% taking the figure to its lowest level for eight years.

Meanwhile, total available space increased for the ninth successive quarter, taking the total to its highest level since 1994. This available space now represents 11% of total existing stock, but not only is this vacancy rate still well short of the figures achieved in the early 1990s, its rate of increase has also started to slow.

Take-up in the City resumed its downward path after the one-off boost in Q3 2002 due to one big pre-let – which accounted for a quarter of the annual total – and hit a new all-time low. Space under offer rose slightly though it remains well below trend and, as a result, the availability rate also rose for the ninth straight quarter to hit 9%, its highest figure since Q2 1993. At the end of 2002, there were 9.2m ft² of available space in the City and it is not therefore surprising that average rents fell by 18% over the previous year, taking the top rental norm to £50 per ft². Total investment in the City during 2002 reached £2.8bn – less than during 2001 but nevertheless the third highest figure on record.

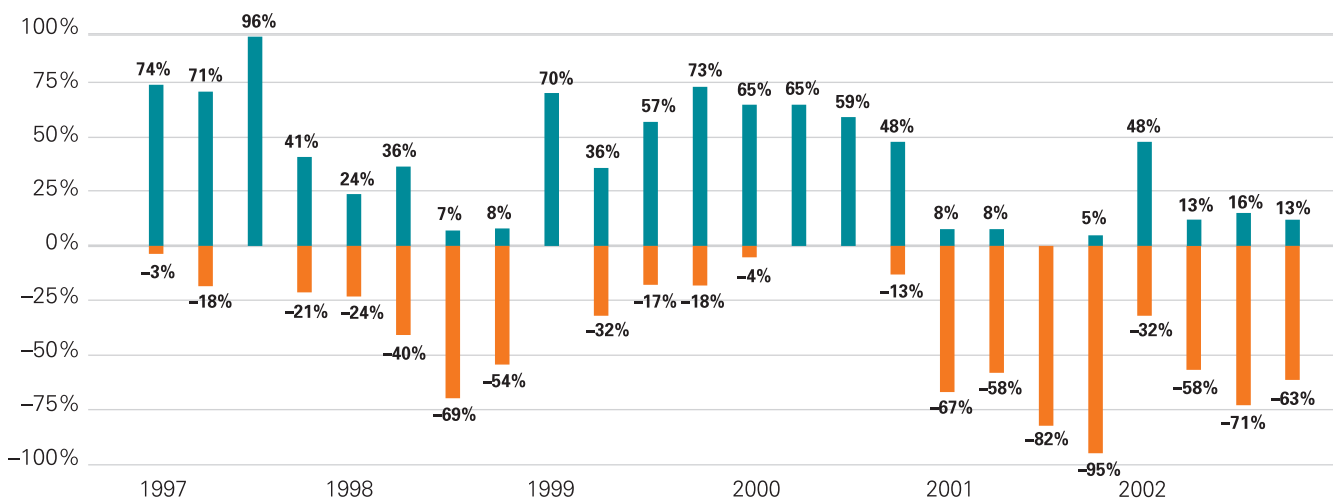
The picture was less clouded in the West End where take-up during the year was just 10% shy of the 2001 total. The majority (87%) of this was secondhand, albeit good quality, space, and there was only one deal in excess of 50,000 ft², indicating the caution in the market. The availability rate fell slightly but this

did not help the top rental norm which had fallen by 7½% by the end of the year to £67.50 (though there are instances where rents have exceeded this figure). Elsewhere, Midtown had a good quarter, boosted by one major deal in the Strand. However, rentals fell faster than in other areas, the year end rate of £40 per ft² representing an annual decline of 23%. Annual take-up fell in Docklands to 0.7m ft², a quarter of what it had been in 2001, while availability rose to almost two million ft², two-thirds of which is at Canary Wharf. The void rate of ready to occupy space hit 10.5% in Docklands, the same figure as in the City.

The latest City Agents Quarterly Office Demand Survey, research for which was carried out in January 2003, shows that although the low level of enquiries continues, there has been a slight recovery from the depths of last autumn. 37% of respondents said that the level of enquiries was up or steady, and while this is undoubtedly a half-full rather than half-empty reading of the data, at times like these, every little bit helps.

Once again, larger agencies had a worse quarter than did their smaller comrades, with the latter group actually seeing some light at the end of the tunnel, dim and distant though it may be. Unfortunately, for larger agencies, the outlook is getting foggier every day. What demand there is comes from the public and insurance sectors, while banking remains beleaguered. Furthermore, the majority of enquiries are of a downsizing rather than upgrading nature. To finish on a cheerful note, however, an air of anticipation is still abroad: the balance of those expecting enquiries to increase has risen to –10%, which may not sound

Chart 1: Change in number of enquiries 1997-2002^{viii}



much but it's a lot better than the -38% reading in the previous quarter.

Finally, data on office development, which are unchanged since the previous digest. However, for completeness, the figures are given again. The Corporation's Department of Planning and Transportation reported that gross City office stock at the end of June 2002 was 79.8m ft², 0.8% higher than at the end of 2001 with completions exceeding demolitions by a factor of 3:1. The pipeline of developments under construction grew by over 7% during the first six months of 2002, while those which have received permission but not yet started rose marginally. The total pipeline was 23% of total stock, a rise of more than a percentage point over the previous twelve months. Growth was particularly strong in medium-sized developments (c100-250,000 ft²), where the area under construction rose by 50%.

Earnings

No new earnings data have been published since the last digest. However, Table 6 has been repeated for the benefit of new readers, and data for the Central Business District (see Table 3 for definition) added.

Trading on City Exchanges

The previous digest referred to one factor that has characterised all markets recently, and not just those in the City, which is their day-to-day unpredictability. Although this nervousness has lessened slightly over recent weeks, the volatility of the FTSE-100 index during the second half of 2002, measured by its daily standard deviation, was more than twice what it had been during the first half of the year. This ratio was higher than in Germany and the US, while volatility in Japan was actually lower during the second half of the year (though this could reflect a desperate implacability born out of a decade-long recession rather than simply a Zen-like philosophy). This global phenomenon continues, of course, not to be necessarily bad news for activity-driven exchanges.

As Chart 2 shows, the volume of trading on the LSE has been broadly steady for the past three years (the exception of November 2002 was driven by a 49% leap in international equities traded. Over the three months to January 2003, however, the total is actually slightly down on the previous year, suggesting November's spike was an issue of timing). Value, on the other hand, has been on a downward path for the past two years, and the total for the twelve months to January 2003 was 20% below the peak of mid-2001. The two elements that make up the total – UK and international equities – continue to perform in a diverse manner, the former having risen by 21% in volume but fallen by 3% in value over the past year while the latter fell by 15% in volume and by 24% in value.

The once brightly shining flame that was the techMARK sector for TMT stocks continues to gutter in the harsh wind created by the exploding dot-com bubble. The value of shares traded on the exchange fell by 30% in the year to January 2003, and the annual total is now just 54% of what it was at the peak of the sector.

Chart 2: LSE average daily trade in equities by value & volume 1997-2003

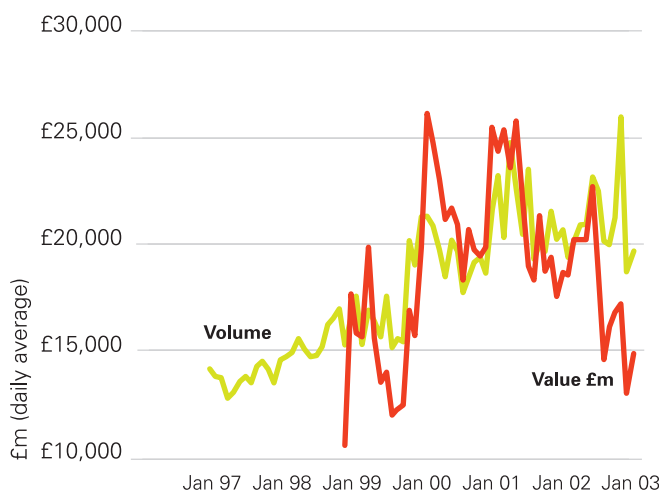


Table 6 Gross Annual Salaries of All Employees 1999-2002^{ix}

	1999	2000	% change	2001	% change	2002	% change
City	£39,200	£42,400	+8.2%	£44,400	+4.7%	£47,500	+7.0%
City Fringe	£26,400	£28,700	+8.7%	£32,200	+12.2%	£32,600	+1.2%
CBD	£29,000	£31,000	+6.9%	£33,800	+9.0%	£35,000	+3.6%
Total London	£23,700	£25,100	+5.9%	£26,500	+5.6%	£27,700	+4.5%
Total GB	£17,600	£18,300	+4.0%	£19,300	+5.5%	£20,100	+4.1%

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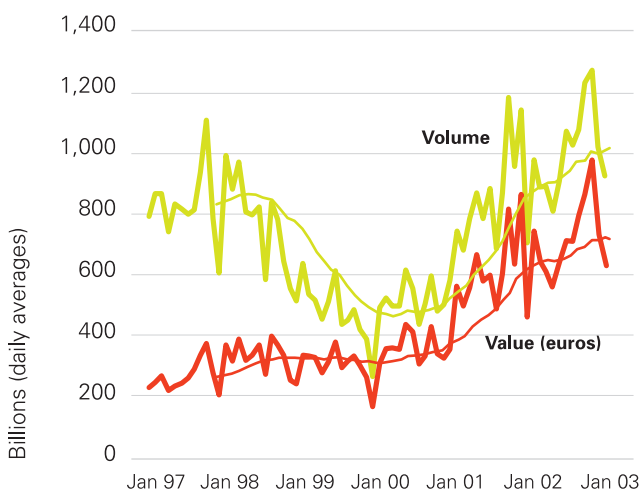
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Trading on LIFFE (Chart 3) has risen steadily from the double low, both by volume and value, of December 1999. Although there has been a falling-off since the all-time daily peaks achieved in October, total trading in the last two months of 2002 was up on the previous year in both volume and value terms. For calendar 2002, total volume was up by 18% and total value by 17%. Though these figures are impressive, particularly in relation to performance elsewhere, it should be noted that they compare to growth rates in excess of 65% the previous year. The smoothed lines on the chart represent moving annual total data.

On the London Metal Exchange, meanwhile, the daily average of Futures and Options contracts traded has now been steady for a year or more, and appears to have settled at the level it was just before the sudden leap in trading in late 1999/early 2000. The disconcerting fall to the lowest level for five years in August 2002 seems to have been forgotten though the exchange has been infected by the volatility seen elsewhere: in the last seven months, the minimum monthly change over the previous year has been 10%, while the maximum has been 45%.

Chart 3: LIFFE average daily trade in contracts by value & volume 1997-2002^{xi}



Notes

- i Bank for International Settlements; London Stock Exchange (LSE); London International Financial Futures & Options Exchange (LIFFE); London Metal Exchange; International Financial Markets in the UK, IFSL November 2002
- ii Practical Issues Arising From The Euro, Bank of England, November 2002
- iii WFE, IFSL, January 2003
- iv CBS Legal Services 2003 report, IFSL January 2003
- v IPO Watch Europe January 2003
- vi ABN-AMRO Global Investment Returns Yearbook 2003
- vii "on the market" Central London Offices, Insignia Richard Ellis, 4th quarter 2002
- viii City Agents Quarterly Office Demand Survey, February 2003
- ix ONS/ABI New Earnings Survey y/e April 2002
- x LSE, February 2002
- xi LIFFE January 2002