London's Apotheosis and the rebalancing of the UK economy

Good afternoon.

Welcome to this Economic Perspectives webinar, the second online and the ninth in all. Today's topic is "London's apotheosis and the rebalancing of the UK economy". Our pattern has been to address an inflation-related topic in the spring and a theme relating to credit, leverage or financial stability in the autumn. Given the dramatic interventions by governments and central banks designed to subvert depressive forces and to block the natural tendency of credit spreads to widen, this did not seem a good time to comment on global credit developments. Instead, our focus is narrowed to the issue of UK financial stability and its impact on London's economic health. However, in researching this topic, it became clear that the threat of UK financial instability was but one of several threats converging on the capital.

I would like to make two things clear from the outset. First, I confess that I am a Northerner by birth, a Lancastrian who might still be carrying vestiges of northern bias. Second, London was my home in my early adult years and has been at the centre of my profession life for 45 years and I am full of admiration and gratitude for this wonderful city. My first job was as a research officer in the econometric forecasting unit at the London Business School. London is my favourite city.

My assertion is that London's fabulous decade has ended. Its apotheosis – the highest point of development - was probably in 2018. It is painful to me to watch the calamity that is unfolding before our eyes as London's economy suffers multiple and compounding blows from misguided domestic monetary policy, a mishandled pandemic and a mangled EU exit. London's extraordinary status – in the country and the world – is under serious threat. Rather than levelling up the regions to London's success, the likelihood is that London will level down over the next few years. While there are several regional success stories – for example, Cambridge, Oxford, the West country and Edinburgh – and others that show great promise, these do not yet include the populous cities of Manchester, Birmingham, Leeds and Glasgow. London is the jewel in the crown, and it is inconceivable that the UK economy will prosper while London is languishing. I believe that these developments are of critical importance to the medium-term outlook for Sterling, UK financial and property markets.

Dr Gerard Lyons, formerly economic adviser to Boris Johnson, then mayor of London, summed up the reasons for the capital's success in a *Spectator* article in August like this: "Successful economies need at least one of three C's: cash, commodities or creativity. The UK is lucky that London leads globally in two of these: the City's financial know-how and the capital's creative and cultural uniqueness. The creative industries are economically significant, but more importantly, they enhance London's appeal as an exciting place to live, work and visit." London's global allure embraces banking, insurance and financial services, supported by legal and professional services, its culture, history, architecture, museums and galleries, the performing and visual arts and all the associated technical skills, life sciences and technology, and world-renowned universities. By some accounts, London had become the number one tourist destination in the world.

London's growing stature, supercharged by the 2012 Olympics, has attracted foreign capital, talent and labour to a disproportionate extent, as compared to the rest of the UK. London's global franchises have wealth creating capacity that far outstrips that of other regions. The subtlety of the Great Financial Crisis of 2008 is that it may have marked the peak for the financial services sector as a share of UK output, but it unleashed the unconventional monetary policies that inflated financial wealth, to the strategic advantage of those living in London and the South East. Over the past decade, London has been flying higher than ever above the average of the rest of the UK in labour force participation,

in employment, earnings and average house prices. These widening divergences have fuelled regional resentment and disenchantment towards London's success. Arguably, the Brexit referendum vote was intended as much a rebuke to London's wealth and power as to an overbearing Brussels.

It is not commonly appreciated that the income generated by London's prodigious franchise has yielded huge tax revenues – not least from the financial sector – that raised a net £34bn in 2017-18 to fund public services and resource transfers to the rest of the country. London and the regions are tightly connected: London trades more with the rest of the UK than with the rest of the world. For every pound spent in London, 24p of production is generated elsewhere in the UK. 35% of jobs created by the construction of new office space in London are spread across the rest of the UK. London's pain will be felt across the whole country.

What are the stormclouds that have gathered over London and why should we take Chancellor Rishi Sunak's 'brave face' speech on financial services, delivered on 9 November, with a ton of salt? We have identified six ingredients of London's impending demise.

First, we assert that UK monetary policy has taken a succession of bad turns since 2015, failing to grasp the nettle of interest rate normalisation until November 2017, with only one further quarter-point increase in August 2018. These are the only examples of interest rate tightening since the GFC in 2008. The Bank of England became obsessed by Brexit, under Mark Carney's guidance, culminating in a package of ill-judged pre-emptory easing measures in August 2016, including a token rate cut to 0.25%. None of the Bank's original large-scale asset purchases (almost entirely of gilts) has been reversed, and over the past year the facility has been substantially increased.

Since 2015, the regime of near-zero interest rates, expansive QE and subsidised lending to the banks has fostered an increase in bank lending growth, but one of minimal relevance to households or non-financial businesses. The big borrowers over the past 5 years have been financial intermediaries, accounting for 43% of total lending over 5 years and 62% in the past year. Alarmingly, the largest category of borrower over the past 2 years, after household mortgages, was the fund management industry. Unspecified financial intermediaries, securities dealers, central clearing counterparties and commercial real estate were also well represented. This re-leveraging of the financial sector has provided fundamental support for asset prices, but at the cost of ratcheting up financial stability risk.

The other key risk that has accompanied the continuation of historically low interest rates is their impact on the present value of long-term liabilities for insurance and pension funds, pushing the former towards insolvency and the latter towards ever larger deficiency. As if this were not peril enough, in October the Bank ordered UK commercial banks to demonstrate their preparedness for the possible introduction of a negative interest rate policy (NIRP). While this may appear as a prudent step that enhances the central bank's policy toolkit, it is a further unwarranted and perilous step towards the complete abandonment of monetary control.

This highly leveraged UK financial sector can ill-afford any external threat to capital asset values or corporate revenue streams, but there are plenty of visible threats on the horizon.

Second, as so often in the past, London has been confidently adding to its commercial real estate portfolio. According to Knight Frank, roughly 3 years' worth of added space (15m square ft) was due to be delivered by the end of 2021. Unsurprisingly, active requirements for leased space have plunged this year – by 49% in City & Southbank and by 39% in the West End. A glut of office and retail space is in prospect as large employers adjust to the step change in the adoption of flexible and remote working habits. It would be unusual and remarkable if this was not reflected in falling capital asset values.

Third, the progressive downgrading of the ambitions of the UK government towards the negotiations on continued access to EU markets in financial services, from the goal embedded in the 2018 political declaration, leaves the City facing significant losses of business and revenue over the next few years. To continue trading in the EU, Britain needs an "equivalence" ruling to replace the "passporting" regime enjoyed by member states. The failure to secure "super-equivalence" in the critical and lucrative investment banking sector leaves the UK as a passive rule-taker scrambling for a fraction of the revenues that it has previously enjoyed. Despite the reassurances of the Chancellor regarding the protection of the UK's economic interests, the likely outcome of this "no deal" resolution is prejudicial to the interests of the UK financial sector.

While UK clearing houses have an 18-month extension of equivalence, this is only to enable the smooth transfer of derivatives business exposure from UK clearing houses to EU ones that do not yet have the capability. What is more difficult to assess is the degree of migration of business from overseas banks and financial institutions that have been using the UK as a gateway to the EU.

Fourth, to add to the financial sector's headaches, hard on the heels of a no-deal Brexit is the replacement of the LIBOR market by the secured overnight funding rate (SOFR)/ SOFIA at the end of 2021 (subject to the possibility of a Covid-justified postponement). My understanding is that US financial institutions constitute about 70% of the activity in this segment, with offshore hedge funds accounting for another 20%. When LIBOR closes, the funding source switches from interbank liability (with uncollateralised counterparty risk) to secure collateral based offshore. The positioning of collateral for repo is critical: where will US financial institutions house their collateral in future? Will they use the UK's jurisdiction and infrastructure to the same extent?

A fifth threat is posed by the souring of UK-China relations after the reversal of the decision to embed Huawei's 5G equipment into UK infrastructure, under threat of exclusion from intelligence-sharing with America. While Chinese direct investment in the UK has been relatively modest (excluding the commitment to the Hinckley Point nuclear power plant), the volumes of trade, inward tourism and influx of Chinese students to UK universities have exhibited rapid growth in recent years. Hopes of building significantly stronger trade ties with China after UK departure from the EU look forlorn unless the UK can find a middle path. However, the temptation to take the Chinese shilling will become the greater if London ceases to be a strong magnet for foreign capital.

Finally, we come to Coronavirus and its disease, Covid-19. The downside of being a global city with 270 nationalities represented is that London, with New York, became a clearing house for the disease and suffered more significantly during the initial onslaught than other parts of the country. The attractiveness of London's vibrant high density living, networking and socialising was transformed into a liability and a risk. Even before the second national lockdown was announced, footfall in central London was running at a mere 35% of pre-lockdown levels, easily the worst experience in the country. While the profile of London employment across sectors was not particularly a cause for concern in terms of the effects of Covid-19, the devastating impact of social distancing on commuter activity has hit London far harder than anywhere else.

London is uniquely exposed to policy error in relation to Covid-19. An economic region in which the public sector dominates the private sector as an employer, and where a significant proportion of the population is in receipt of pensions and social security payments, is at much lower risk of economic damage than one in which the private sector is many times larger an employer than the public sector. The empirical evidence that supported the imposition of the economic lockdown in March is lacking

today. Since the summer, a failure to take proper account of virus seasonality has skewed policy towards the re-imposition of restrictions on mobility and social activity that will hinder recovery, wreaking further havoc on London's economy this autumn and sapping the enthusiasm for a return to centralised workplaces.

The misguided extension of these colossal budgetary interventions until next March has inflated the fiscal cost, which was already immense. It will require a Herculean effort to bring the public finances under a semblance of control even by 2023-24. Meanwhile, London's financial wealth and premium incomes will be prime targets for additional taxation, including owners of second homes and buy-to-let landlords. The Treasury will be examining many options, but an increase in personal tax rates and the curtailment of reliefs will be close to the top of their agenda. It is understood that there are proposals to raise the rate of corporation tax to 24% (from 19%). Already, it is planned to withdraw VAT refunds for non-EU visitors from January 2021, a move which would drive away business from the retail sector.

To summarise, London's economic and financial outlook has deteriorated dramatically since 2018. A diverse cocktail of geopolitical, political, economic, financial and epidemiological forces has conspired against London's success, but a combination of neglect and poor policymaking has compounded their likely impact. A weakened London is levelling down, closing the gap with the regions from above. Can the regions pick up the pace and provide some offsetting hope?

I will keep my remarks on the outlook for regional rebalancing mercifully brief. In recent years there has been much talk of building a Northern Powerhouse, of upgrading the infrastructure and speeding the transition to renewable energy. Arguably, the rebalancing of the UK economy has been gathering pace for a few years as sectoral leadership has been provided by distribution, storage and communications services, construction and scientific administration and support rather than banking and finance over the past 5 years.

Detailed regional and city-level data is slow to appear – typically 2 years behind real time. On the available evidence of relative improvement in household incomes, 4 UK clusters stand out: Cambridgeshire and Peterborough, West of England, Edinburgh and south-east Scotland and Stirling. On another analysis, Cambridge and Oxford score highly across a range of innovation indicators; Bristol, Derby, Edinburgh and Manchester perform well in terms of business and university innovation, but less so on patents and trademarks; Slough, Reading, Crawley and Aldershot score well on innovation output and business innovation but lack university backing.

There are grounds for hope that regional success stories will abound in the 2020s as diverse strategies are pursued. The devolution of economic initiative to regions and clusters will necessitate an expansion of local borrowing capacity and local government bond issuance. It is difficult to envisage the completion of HS2 in this devolved environment. More likely, that it will be postponed or abandoned, and the resources diverted to regional infrastructure development. Within 5 years, our prediction is that the London's premiums will have shrunk significantly, and a much larger proportion of local talent will commit to work in their native cities and towns rather than prospect for gold in the capital.

What does mean for investors?

Our biggest call is that Sterling will act as a safety valve as the London – and UK economy – negotiates the stormy waters of the next 2-3 years. The US elections were a source of great consternation and uncertainty lifting the VIX briefly above 40. The VIX has receded but remains around 25 and above the threshold which has been associated with Sterling vulnerability and negative returns over the past 30

years. One wonders whether the Bank of England has an ulterior motive in entertaining the possibility of the use of negative interest rates at this juncture: namely to seek to weaken Sterling ahead of the inevitable buffeting of the UK economy as it confronts the simultaneous impacts of Covid-19 and exit from the EU on trade terms worse than those obtained by Canada. The foreign exchange market is like a bird with a very small brain: it can focus on only one thing at a time. The focus on the outcome of US elections will soon be replaced by the multiple challenges that confront the UK.

Secondly, it should come as no surprise that UK sovereign debt has been downgraded a notch by Moody's to Aa3, and it is likely that further indignities will follow the extension of emergency supports by the Chancellor this month. The prospective underperformance of the UK economy, the elevated risk of an inflationary outbreak and the gravity of the political challenge to restore the public finances to health are sound reasons for scepticism on gilt pricing. 40 basis points for 10-year gilts and 100 basis points for 30-year gilts are artificial prices emanating from a manipulated market. Indeed, more widely, the relative pricing of government 10-year bonds makes little sense: Greece is now able to issue benchmark bonds more cheaply than the US!

Thirdly, and more speculatively, divergences in the path of regional house prices are likely to become an investable opportunity. In an inflationary world, residential housing portfolios have the potential to become preferred substitutes for fixed income securities, offering similar long-run returns as equities but with around half the variability. Innovators in this space will be rewarded handsomely. In the UK context, Savills forecasts suggest an over-weighting of the North West, Yorkshire and Humberside and Scotland and an under-weighting of London.

I am indebted to you for your attention, to my colleagues Tom and Yvan for their invaluable assistance and to Dari for administering this call. The slidepack and script will be made available, as will a recording of this talk.

I am happy to take any questions.