

APG on Wholesale Financial Markets & Services

**Breakfast Roundtable Discussion
Dining Room A – House of Commons
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Will the massive changes taking place in financial services and their regulation generate the migration of the last global business from the UK and what are the potential economic consequences for UK plc?

Speech by:

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Introduction

My Lords, ladies and gentlemen, I would like to make 3 points.

- First, the relationship between London and the rest of the UK is largely complementary, not competitive and a weaker London economy damages the other parts of the UK.
- Second, the fiscal model which has operated until now, where huge tax revenues generated by the City and more generally in London and the South East are used to finance heavy public spending elsewhere in the UK, has been broken and will not be revived to any significant extent within the next 10 years. This has important implications for the levels of public spending in Scotland, Wales, Northern Ireland and the English regions.
- Third, it is critical that any reregulation of the City should be carefully constructed so as not to damage its competitive position.

The knock on effect of London on to other regions

There are three areas where London has a broadly positive impact on the other UK regions. These are:

- The demand created in the regions by the goods and services that London buys from them;
- The benefits which accrue to the regions from that element of the earnings of London commuters which are spent locally; and
- The regional allocation of the net fiscal contribution that London makes each year to the UK Exchequer.

There have been 5 major studies of this in the past 10 years by different economics groups and they have all said essentially the same thing. I will quote the numbers from the cebr research for 2001. This is quite a good year for comparison because it is not one of the superbloom years like 2006 or early 2007 nor a recession year like this one or 1991. It is a more normal year – in fact one where the London economy had been impacted a bit by the dot.com crash.

By far the most important impact comes from London's demand for goods and services produced elsewhere in the UK. The calculation indicates an impact of about 3 ¼ million jobs. These are spread throughout the country.

The second largest impact comes from the fiscal contribution which supported 420,000 jobs in 2001. This is mainly in the North of England, Scotland Wales and Northern Ireland.

Finally, commuters into London and their spending in the regions outside London – obviously mainly in the South East – generated just over 300,000 jobs.

London's fiscal contribution – 422,000 jobs

In total, therefore, London's economy in 2001 was responsible for 4m jobs across the rest of the UK in addition to the 4m of its own workforce.

Impact of London doing less well

Some commentators have suggested that London doing less well will eventually be good news for other regions of the UK as lower interest rates and a lower exchange rate boost the industrial sectors.

Obviously the short term evidence does not seem to support this. The rest of the UK is being hit very badly as the recession spreads from the financial sector. But plenty of other things are going on at the same time – like a slump in international trade – and I think it would be literal minded to draw conclusions based on this.

We have therefore done some very careful economic modelling to investigate what the impacts might be. The particular case that was studied was the impact of reducing the size of the UK's financial service sector to the average size for the EU – cutting it by about 3 percentage points of UK GDP.

The impact of this modelling exercise was to reduce base rates by 2.4% compared with what they otherwise would have been and to reduce the real exchange rate by 8.5%.

These on their own ultimately generate around 320,000 jobs outside London. But this job gain is more than offset by the loss of 730,000 jobs outside London (and 260,000 jobs in London) from the knock on effect of a less successful London economy. UK GDP is 4.5% lower of which the fall in GDP in London accounts for about 2/3^{rds} and outside London the rest.

There is a limit to what you can take from this sort of economic modelling but when all the different economic studies point in the same direction and no one has done any serious analysis that contradicts it, you have to take it seriously.

The fiscal model is broken

The calculations about fiscal transfers from the early 2000s indicated that London subsidised the rest of the UK by about £13 billion. My rough and ready estimate is that this rose to about £30 billion by 2007. This comes mainly from a mixture of corporation tax, national insurance contributions, income tax and VAT on spending raised on the relatively higher incomes and spending in London.

I expect this to drop back to about £8 billion next year and to edge up to about £12 billion by 2013, and to continue to grow very slowly thereafter.

What this means is that there is a shortfall of just under £20 billion (1.5%) of GDP that will ultimately have to be made up. Now in a world where multi billion banking bailout packages seem to be announced almost monthly, this may seem like small beer. But unlike some of the other figures, which are often exaggerated and where the government has realistic hopes that it might eventually get most of its money back, this is a real shortfall.

Can it be replaced? One option is higher tax rates, but very few studies are optimistic that this raises much more money. A second potential option is sustained high borrowing. But the bond markets would be most unlikely to accept it. The only alternative is for the regions with higher levels of public spending to cut their coats according to the cloth available. The high spending parts of the UK – Scotland, Wales, Northern Ireland, the North of England, the North West and Yorkshire and Humberside will need to cut their levels of public spending as a share of GDP by around 5% of local GDP to offset the end of the subsidy from the rest of the country but mainly from London.

Reregulation

Finally I would like to deal with the issue of reregulation. I can only echo Michael Mainelli's key point that the greatest problem has been lack of competition.

There is a subsidiary point of weak corporate governance.

Lack of competition has allowed the City to charge excessive fees which in turn has encouraged overpay. The main task for reregulation will be to rekindle competition.

The market will probably deal with the bonus problem – our forecasts show bonuses down by 70% from their peak this year and even in 2012 at about half their peak level.

But I think that the regulators will also have to be quite tough on the failures of corporate governance. Directors of banks that have been responsible for inappropriate remuneration structures that have encouraged excess risk taking have failed in their jobs and the FSA should take appropriate action. This may be rough justice, but if they are seen to suffer, their successors will take the hint. And this will be passed on through the management chain.

Too many directorships have been given to the great and good, rather than to experts who understood the nature of the risks that have been taken. I resigned as a trustee of the GEC Pensions Trust when I disagreed with the risks that had been taken with the investments. Unfortunately not enough people have had either the knowledge or the character to do similar things.

But the worst possible action would be to start to micromanage the financial services sector. This would hit London's major competitive advantage at a time when it is already under some threat. It would stifle innovation and scare off the international element which is so important.

Conclusion

I think I have now offended pretty well everyone in this room so I had better stop and put on protective clothing before the flack starts flying.