THE CITY, FINANCIAL-CENTRE DEVELOPMENT AND EMU

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Introduction

- City’s major and growing importance to UK economy, and Treasury criterion for EMU entry
- Hence need to assess factors that could change City’s status
- Major focus of this presentation is providing a framework for addressing the issue
- Some suggested key issues highlighted also

The City and the UK economy

- Importance of financial services in national and Greater London GDP
- Level of employment in financial services
- Net overseas earnings of UK financial institutions
- ...all motivate impact on City as criterion for EMU entry

Indicators of the importance of the City and the UK financial sector

	1998	2001
Employment in financial intermediation (London)	315,000	324,000
(City)	138,000	na
Net overseas earnings of UK financial institutions (of which earnings from services)	£31.1 bn (£11.8 bn)	£31.2 bn (£19.7 bn)
Growth in real output of business services and finance since 1995 (weight in Gross Value Added)	19.2% (23.1%)	29% (23.8%)

London’s markets and the City’s share

- Four key markets (Clark) serviced by global firms in London
  - Domestic UK market
  - Interchange between US and Europe
  - Financial services for Continental Europe
  - Rest of the world
- Indicators of London’s share
  - Share of international banking
  - Stock exchange listings and turnover
  - Foreign exchange turnover
  - Derivatives turnover
  - Share of international bond market

The City's market share

	1989	1998	2001
Foreign banking institutions (share of bank assets)	515 (na)	556 (56%)	478 (55%)
Share of cross border bank lending	17%	20%	20%
Share of foreign exchange dealing	25%	33%	31%
Foreign listings	544	552	464
Share of foreign equities trading	na	65%	52%
Share of OTC derivatives trading	na	36%	36%
Share of exchange traded derivatives	5%	11%	8% (2000)
Primary international bonds (in euros)	75%	na (32%)	60% (60%)
Secondary international bonds	80%	70%	70%

European asset management centres

	$ billion	Percent of total
United Kingdom	4132	40
Switzerland	1997	19
Germany	1456	14
France	938	9
Netherlands	936	9

Developments in Frankfurt and Paris

	Frankfurt		Paris	
	1998	2001	1998	2001
Foreign banking institutions	231	320	187	214
Cross border bank lending share	8.6	9.3	6.8	6.2
OTC derivatives share	5.2	12.7	8.2	8.8
Foreign exchange turnover share	4.8	5.4	3.7	3.0
Foreign equity turnover share	3.7	5.8	0.5	1.3 (Euronext)

The investment banking industry

	1990-3	1994-6	1997-9
Top ten firms			
% market share	51.7	59.2	75.6
Herfindahl Index	297.4	433.9	650.7
No of firms from			
US	6.5	8.7	8.0
Europe	3.5	1.3	2.0
Japan	0.0	0.0	0.0
Memo: % market share of top 20	78.1	78.4	95.6

An approach to assessing financial centre development

- Industrial location theory and financial centres
- Potential for self sustaining growth
- The role of sunk costs
- Possible threats to financial centres

Industrial location theory

- Location depends on:
  - Tradeoff of economies of scale and distance costs
  - Supply of factors of production
  - Demand for the product
  - External economies and diseconomies
- …relative to other locations
- Sunk costs induce some inertia, as may uncertainty about conditions elsewhere
- “Stress” may precipitate moves

Application to financial firms

- Supply side factors
  - Rights of establishment
  - Variety of markets
  - Personnel available of appropriate quality
  - Taxation
  - Premises/available land
  - IT and telecoms
  - Political and economic stability
  - “Costs”

Cost factors

- Demand and supply of loanable funds
- Domestic regulation consistent with sophisticated financial products
  - Prudential
  - Structural
  - Related uncertainty
  - Versus global agreements
- Financial taxes
- Efficiency of payments and settlements

Demand, stress and sunk costs

- Demand is access to customers-attenuated for wholesale
- Stress factors such as lack of space less important than for manufacturing, but excess capacity could be important
- Sunk costs of start-up –but especially relationships, reputation and expertise
- Indivisibilities traditionally low at plant level, more important at firm level (capitalisation)

External economies of scale 1

- Liquidity and efficiency of thick markets (asset management complementary)
- Business contacts, importance increases with complexity of activity
- Interfirm networks (specialised firms)
- Supply of skilled labour available, essential for e.g. product innovation, tailoring of products, shifting between markets
- Fund of expertise and innovation (technological and information spillovers)

External economies of scale 2

- Reputation available to firms, which enables a better fee to be obtained for services
- Low search costs and wide choice of vendors available, offering diversity of risk preferences
- Business and ancillary services (including advice on competing vendors)
- Combination of expertise relevant to different financial environments (market and bank based)
- External diseconomies – cost of labour, rents and transport

Some caveats

- Can technology offset the benefits of common location? Commodity versus specialised financial services
- Benefits vary across sectors
- Are markets more footloose than institutions?
- Moving in may require higher net benefit than moving out?
- The role of global financial conglomerates (“bulge bracket”) seeking internal economies of scale and scope in an oligopolistic environment

Development of financial centres

- Diverse causal factors favour establishment:
  - Capital export
  - Regulatory advantages
- But key to development is self sustaining growth on basis of external economies
  - Static economies- commuter railways
  - Dynamic economies- contacts, labour force, participation in markets etc.

Threats to financial centres

- Ways in which external economies overridden:
  - Diseconomies of congestion and office costs
  - Asymmetric tightening of regulation or taxation
  - Loss of market links
  - Technical changes rendering “product” obsolete
  - Predominance of small number of giant firms seeking internal economies
- Self stabilising and self reinforcing factors
  - The danger of cumulative loss of business, especially given oligopolistic interdependencies

Some alternative approaches

- New economic geography – centripetal and centrifugal forces (identifies similar factors)
- Resource based view from strategic management
- Path dependent processes and lockin effects
- Complementaries between and within firms

Selected empirical results

- Survey results typically highlight availability of staff, access to special services, access to markets and clients, prestige
- Ansidei (2000): Panel econometric approach. Dependent variable assets of banks headquartered in EU centres; found bank HQ, corporate HQ, equity market activity, concentration of national activity - and euro membership – significant positive effects

Threats to London

- Non EMU
  - Tightening of regulatory and taxation regime in London
  - Aggravation of external diseconomies
- EMU
  - Loss of link to TARGET
  - Establishment of large and liquid cross border EU equity markets
  - Cumulative shift of global financial institutions
  - The location of asset management
  - Interpretation of Frankfurt’s recent gains? (“Missed opportunities” for London?)

Future opportunities for London – in or out of EMU?

- Increasing flow of pension assets from EU, seeking asset management expertise mainly in UK
- Mergers, acquisitions and restructuring expertise sought so far in London
- Major EU banks’ ongoing strategies to focus on global investment banking and – so far - locate the business in London
- Securitisation of finance in EMU, making more business footloose and not relationship driven – but will it be on a Continental model (e.g. Pfandbriefe) if UK not in EMU?

Research items

- Up to date econometric work on financial-centre activity, dependent variables including employment and activity
- In depth analysis of the corporate dynamics and location decisions of global investment banks
- The pivotal role of asset management in the development of financial centres

Conclusions

- I am agnostic at present about potential harm to London from not being in EMU in the short to medium term
- More likely is that there are missed opportunities, which could have longer term adverse effects
- More generally, more research is needed