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

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

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<tr>
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<tbody>
<tr>
<td>Foreign banking institutions (share of bank assets)</td>
<td>515 (na)</td>
<td>556 (56%)</td>
<td>478 (55%)</td>
</tr>
<tr>
<td>Share of cross border bank lending</td>
<td>17%</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>Share of foreign exchange dealing</td>
<td>25%</td>
<td>33%</td>
<td>31%</td>
</tr>
<tr>
<td>Foreign listings</td>
<td>544</td>
<td>552</td>
<td>464</td>
</tr>
<tr>
<td>Share of foreign equities trading</td>
<td>na</td>
<td>65%</td>
<td>52%</td>
</tr>
<tr>
<td>Share of OTC derivatives trading</td>
<td>na</td>
<td>36%</td>
<td>36%</td>
</tr>
<tr>
<td>Share of exchange traded derivatives</td>
<td>5%</td>
<td>11%</td>
<td>8% (2000)</td>
</tr>
<tr>
<td>Primary international bonds (in euros)</td>
<td>75%</td>
<td>na (32%)</td>
<td>60% (60%)</td>
</tr>
<tr>
<td>Secondary international bonds</td>
<td>80%</td>
<td>70%</td>
<td>70%</td>
</tr>
</tbody>
</table>
## European asset management centres

<table>
<thead>
<tr>
<th></th>
<th>$ billion</th>
<th>Percent of total</th>
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<tbody>
<tr>
<td>United Kingdom</td>
<td>4132</td>
<td>40</td>
</tr>
<tr>
<td>Switzerland</td>
<td>1997</td>
<td>19</td>
</tr>
<tr>
<td>Germany</td>
<td>1456</td>
<td>14</td>
</tr>
<tr>
<td>France</td>
<td>938</td>
<td>9</td>
</tr>
<tr>
<td>Netherlands</td>
<td>936</td>
<td>9</td>
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## Developments in Frankfurt and Paris

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<tbody>
<tr>
<td>Foreign banking institutions</td>
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<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>231</td>
<td>320</td>
<td></td>
<td>187</td>
<td>214</td>
</tr>
<tr>
<td>Cross border bank lending share</td>
<td></td>
<td>8.6</td>
<td>9.3</td>
<td></td>
<td>6.8</td>
<td>6.2</td>
</tr>
<tr>
<td>OTC derivatives share</td>
<td></td>
<td>5.2</td>
<td>12.7</td>
<td></td>
<td>8.2</td>
<td>8.8</td>
</tr>
<tr>
<td>Foreign exchange turnover share</td>
<td></td>
<td>4.8</td>
<td>5.4</td>
<td></td>
<td>3.7</td>
<td>3.0</td>
</tr>
<tr>
<td>Foreign equity turnover share</td>
<td></td>
<td>3.7</td>
<td>5.8</td>
<td></td>
<td>0.5</td>
<td>1.3</td>
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</table>
The investment banking industry

<table>
<thead>
<tr>
<th></th>
<th>1990-3</th>
<th>1994-6</th>
<th>1997-9</th>
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</thead>
<tbody>
<tr>
<td>Top ten firms</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>% market share</td>
<td>51.7</td>
<td>59.2</td>
<td>75.6</td>
</tr>
<tr>
<td>Herfindahl Index</td>
<td>297.4</td>
<td>433.9</td>
<td>650.7</td>
</tr>
<tr>
<td>No of firms from</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>US</td>
<td>6.5</td>
<td>8.7</td>
<td>8.0</td>
</tr>
<tr>
<td>Europe</td>
<td>3.5</td>
<td>1.3</td>
<td>2.0</td>
</tr>
<tr>
<td>Japan</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Memo: % market share of top 20</td>
<td>78.1</td>
<td>78.4</td>
<td>95.6</td>
</tr>
</tbody>
</table>
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 lock-in 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