The location of financial activity and the euro

EMU study

HM TREASURY

Executive Summary

Introduction

1 To inform the assessment of the financial services test, the fourth of the Government's five economic tests for EMU entry, this study considers the factors that drive the location of wholesale financial activity, and examines the evidence and emerging trends in the sector. The study's main focus is on the cluster of wholesale financial services activity in the City[1], and the relative impact, if any, of currency as a factor affecting the competitiveness, and the location of, wholesale activity. The study is essentially backward looking and focuses on the performance of the City to date. The question of the effects that UK membership of the single currency would have on the City is not addressed in the study. This is a matter for the assessment itself.

Why location?

2 Firms operating in the wholesale financial sector in the UK are internationally mobile. If they consider that the UK is not a competitive location, they can quickly relocate some or all of their activity to more competitive locations. Should they relocate, it could have important implications for the UK economy, where the financial services sector makes a significant contribution in terms of employment and invisible earnings. An efficient financial services sector also has a key role in raising the productivity and growth of the UK economy.

3 Key to the study is the evidence that, since the advent of the Euromarkets in the late 1950s and early 1960s when large dollar deposits were placed in regulatory jurisdictions outside the US (mainly in banks located in Europe), London has reinvented itself from being an international clearing centre for sterling to making international markets in a variety of currencies and providing international financial services across borders. Its competitiveness in these markets has been largely divorced from both the strength of the underlying economy and sterling. The basis for its competitiveness has instead been grounded in the clustering forces that attracted a critical mass of international wholesale activity to the City.

The study's approach

4 This study sets out to understand how London arrived at this position of strength. Section 2 begins with an overview of London as a financial centre today. London enjoys a strong presence across a very wide range of markets and in many cases is the dominant international financial centre. This dominance stems from a number of factors but, above all, from the critical mass of financial expertise that is present in the City. No other financial centre in the European time zone currently possesses such a depth of expertise, and probably only New York can currently match London on this measure.

5 Sections 3 and 4 offer two contrasting but complementary approaches to explain why this intensive pattern of financial services activity has developed in London: economic geography and economic history.

Economic geography

6 Section 3 draws on recent developments in new economic geography. This highlights the benefits for wholesale financial market participants of locating in a cluster of activity such as that in the City. This is because of the strong external economies of scale that individual firms enjoy as a result of the presence of other firms in the same location.

7 The theory suggests that London has become an international financial centre through creating centripetal or agglomeration forces that have made it attractive relative to other financial centres. Current evidence suggests significant centripetal forces would include: a critical mass in financial expertise, offering a wide range of complementary services to the international investor; market infrastructure which can support high levels of activity, offering liquidity to traders; institutional infrastructure, both formal (appropriate regulation) and informal (market practice); and a large pool of skilled labour and flexible labour markets relative to other financial centres.

[1] 'The City' is a descriptive rather than geographical term which includes all financial market activity in Greater London and not just that in the City of London or Square Mile. The terms 'the City' and 'London' are used interchangeably throughout this study.

8 New economic geography also defines dispersion or centrifugal forces that may encourage relocation by some businesses to lower cost locations. There are a number of these forces at work in London: a physical infrastructure under stress (transport and housing); relatively high living costs compared to other financial centres; and, until recent market downturns which have affected the growth of both London and overseas financial centres, a tight labour market where recruitment problems were experienced. Technology has also been an important dispersion force, in some cases allowing the relocation of lower value added, bulk processing operations to lower cost locations outside clusters. The Prudential's recent decision to establish an offshore service centre in Mumbai, India is one example of this trend.

9 If centripetal forces outweigh centrifugal forces and a critical mass of activity is reached, the theory suggests that a financial centre can enter a process of self-sustaining growth. How far it develops relative to other financial centres will depend on the relative strengths of these centripetal and centrifugal forces in each centre. As this agglomeration process strengthens, so a location's development can become self reinforcing or path dependent. Such path dependency implies that the prospects of a rapid decline of a cluster such as London are diminished (though not altogether removed), and that the forces holding the cluster together exhibit a degree of robustness against adverse changes in circumstances.

Economic history

10 Section 4 offers alternative insights into the factors behind London's development since the 18th century from the perspective of economic history. Again, these can be mapped onto the picture of London as a financial centre today portrayed in Section 2.

11 A number of themes repeat themselves as playing an important role in London's success, notably the UK's long history of openness to foreign firms and to immigrants who brought their financial expertise to the UK. The open-door policy of the authorities allowed London to develop at an early stage a critical mass of financial expertise, liquid markets and a range of complementary services to support international wholesale financial activity.

12 This critical mass of expertise enabled London to overcome the gradual decline through much of the 20th century of the relative global importance of the UK economy and sterling that together had been its previous sources of strength. Coupled with a favourable regulatory and legal environment that encouraged financial innovation, they provided the springboard that allowed London to take full advantage of the development of Euromarkets in the late 1950s and early 1960s which was to change profoundly international wholesale markets. The abolition of exchange controls in 1979 and 'Big Bang' in 1986 were other key moments in a trend towards greater international openness which has led to foreign ownership playing a significant role in today's City.

Recent developments in euro financial markets

13 Section 5 provides a brief review of developments in euro financial markets since 1999. The euro is one of a number of factors affecting the development of financial centres such as London. It has in some cases added an additional stimulus to existing trends, and London would have expected to face these challenges either inside or outside the euro area.

14 The evidence shows that London has participated fully in recent developments in euro financial markets. London benefits from access to euro financial market infrastructure. The UK is the second largest user of TARGET[2] behind Germany, providing a cheap and effective route for wholesale euro payments across borders. London-based traders have unrestricted access to trading platforms in most other euro area financial centres (e.g. Eurex based in Frankfurt). Where restrictions do remain, for example to cross-border access to settlement systems, they are the result of national rules and not related to membership or otherwise of the single currency.

[2] **T**rans-European **A**utomated **R**eal-time **G**ross settlement **E**xpress **T**ransfer system: this links the 15 euro-denominated Real-Time Gross Settlement (RTGS) systems in the EU and the ECB payment mechanism to provide an EU-wide RTGS system.

15 Similarly, the boost which the euro gave to the growing euro corporate bond market has benefited London. The European Central Bank (2002a, p. 25) notes that the City is *"one of the main channels through which non-euro area residents purchase euro-denominated bonds issued inside and outside the euro area"*. The Bank of England estimates that London's market share of the issuance of euro-denominated Eurobonds in 2002 was around 60 per cent, compared with 50 per cent in 1999.[3]

Factors shaping financial centres' development

16 Section 6 sets out some of the factors that are shaping the development of financial centres such as London. Identifying the likely factors behind future structural change is complicated by the current strong cycle in global equity markets, and its consequences. Nonetheless, five influences are identified:

- **globalisation**, as evidenced by increased integration and the establishment of trends and transmission of shocks across national boundaries;
- **supply-side determinants,** especially technology;
- a changing **business environment**, including regulation and tax;
- changing **business strategies**, in particular further consolidation, for example in the banking sector; and
- the role of **currency** – the advent of the euro being the most important in this context.

Globalisation

17 Globalisation will undoubtedly continue be a strong over-arching factor. Policy action – for example in the next trade round, and with the EU – is likely to remove more barriers to trade. Companies are likely to develop global strategies further. In financial markets, there is likely to be a greater take-up of international and global standards and norms.

Supply-side determinants

18 Technology has a complex impact on location and clustering. One the one hand, it has allowed market firms to concentrate their wholesale operations in one place (in the European time zone, usually London) and offer their services from there. On the other, it creates the potential for firms to relocate to lower-cost sites, so undermining clustering forces. Thus far, these latter effects have largely been seen on lower value added activities (back-office functions for example) and core wholesale operations still see large benefits from locating in a cluster. However, by increasing the mobility of some forms of activity, locations may become more 'contestable' whereby small changes in the relative attractiveness of locations may provoke a quicker response by firms than in the past.

Business environment

19 Developments in the EU's regulatory approach contained in the Financial Services Action Plan (FSAP) – which applies to all Member States whether inside or outside the euro area – are an important influence on London as a financial centre. In principle, the removal of barriers in the Single Market should deliver significant economic benefits for users of financial services and opportunities for providers, and the Government strongly supports the aims of the FSAP. As well as potential benefits, there are, however, potential risks for London. First, unnecessary harmonisation of standards or procedures might affect competition in the Single Market, with potential implications for the location of some activities within the EU. Second, if new EU legislation has costs which are not justified by the benefits, this may force activity out of the EU altogether. Tax, both personal and business, could also be an important factor determining firms' location choices – the UK has a competitive personal and corporate tax regime for wholesale financial firms.

[3] Bank of England (2002).

Business strategies

20 Recent equity market downturns have slowed the trend towards greater industry consolidation, certainly in the short term. Business strategies are, however, likely to evolve in response to the growing opportunities and challenges posed by EU market liberalisation, technology and the increasingly global nature of financial services outlined above. Another issue is the high level of foreign ownership in London's wholesale markets. One possible consequence of this may be a greater potential risk of relocation away from London if circumstances do not remain favourable.

Currency: the euro

21 The final factor is the single currency. The euro will become a more important international currency, with the eventual likely take-up of the euro by the new EU entrants adding a further boost to its role as an international currency. In some areas, the euro is already encouraging deeper and more liquid capital markets in the euro area, and providing an added impetus to existing trends. Increases in demand for euro-denominated assets, whether in equity or bond markets, have not however been to the detriment of London, which has been able to participate fully in euro financial market developments and maintain market share.

Conclusions

22 The locational advantages of the UK – the UK business environment, and particularly the significant clustering benefits offered by London – have provided it with the conditions to be competitive in international wholesale financial activity. While there are challenges and risks, as highlighted in the study, to date the euro has not affected London's ability to compete in international wholesale markets. However, the dynamic nature of the sector means that London's performance in the four years since the start of EMU provides no grounds for complacency.

23 This study is essentially backward looking and focuses on the performance of the City to date. The question of the effects that UK membership of the single currency would have on the City is not addressed in this study. This is a matter for the assessment of the financial services test, the fourth of the Government's five economic tests for EMU entry. The test assesses the specific question of the potential impact entry to EMU might have on the City's competitive position, particularly its wholesale markets and their ability to attract euro business.