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What Makes A Successful Global Financial Centre? Transcript

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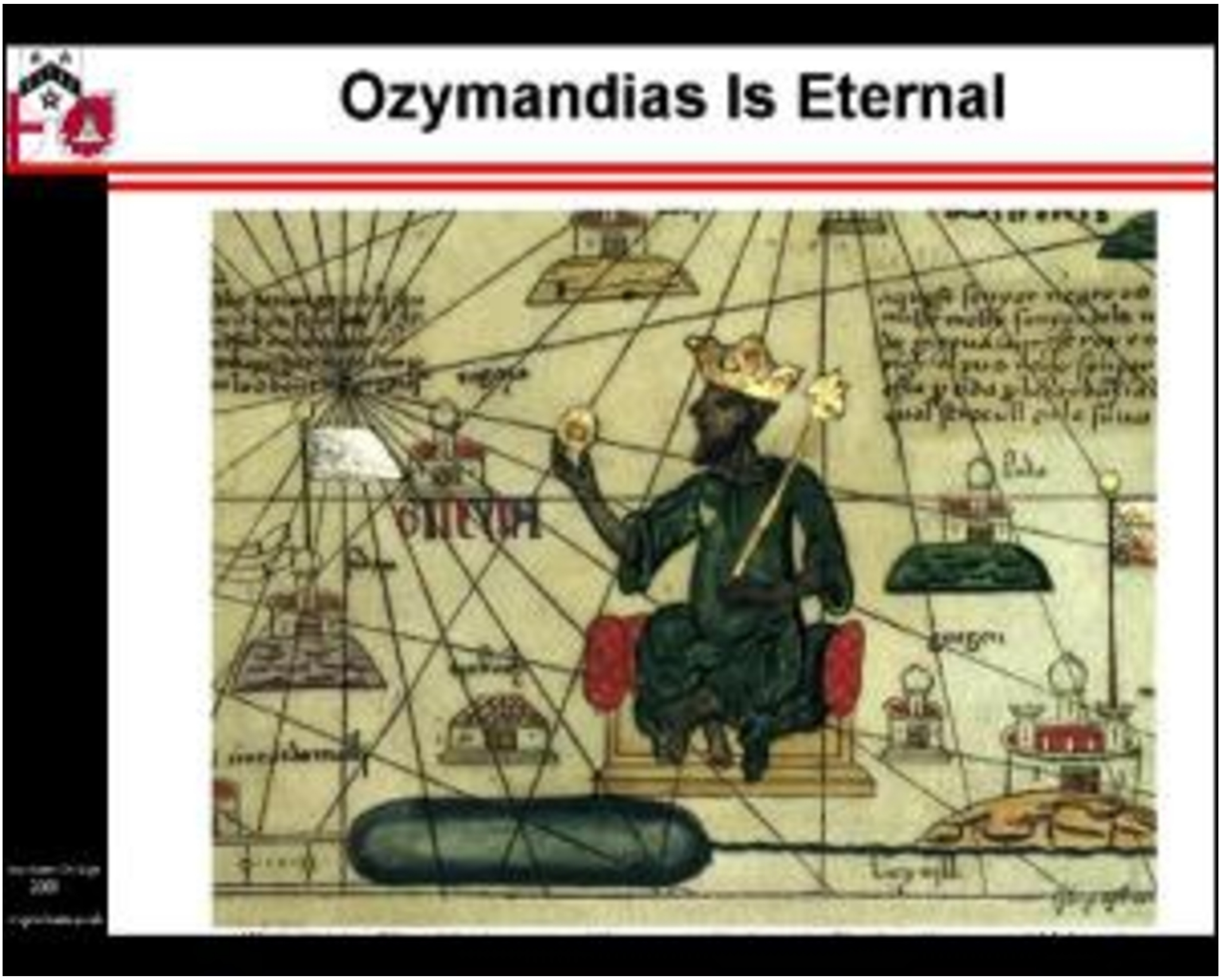

What Makes a Successful Financial Centre?

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[SLIDE: OUTLINE]

Good afternoon Ladies and Gentlemen. Today we explore the rise and fall of global financial centres. As Gresham regulars know, it wouldn't be a Commerce lecture without a commercial. There are several forthcoming Gresham events on the rise and fall of finance, including tomorrow's London Accord conference at the Museum of London, and a special conference on Long Finance next year on 1 February 02010. Later this month we have two related guest events "Are Bankers Good or Bad for Society?" with Chris Skinner on Wednesday, 28 October, and "Capitalism's Transparent Failures: Exchanges As The Epicentre Of Markets – A Contradiction In Terms?" with Patrick Young on Thursday, 29 October. Gresham is also holding a symposium on the future of London on 24 May 2010.

An aside to Securities and Investment Institute, Association of Chartered Certified Accountants and other Continuing Professional Development attendees, please be sure to see Geoff or Dawn at the end of the lecture to record your CPD points or obtain a Certificate of Attendance from Gresham College.

Well, as we say in Commerce – "To Business".

Financial centres have existed since antiquity. London and New York City vie with Hong Kong or Singapore or Zurich for today's top spots. But competition is hot. Is financial centre competition a zero-sum game or can everybody win?

[SLIDE: OZYMANDIAS IS EPHEMERAL]

Ozymandias Lives

Well it's clear that centres win and lose. This colossal bust of Ramesses II, the 'Younger Memnon' (1250 BC), in the British Museum is presumed to have inspired Shelley's 1818 poem "Ozymandias" –

> "My name is Ozymandias, king of kings:
> Look on my works, ye Mighty, and despair!"
> Nothing beside remains. Round the decay
> Of that colossal wreck, boundless and bare,
> The lone and level sands stretch far away"

Not far from Egypt, well not far from a London perspective, lies Timbuktu. Timbuktu, a fabled city on the Niger now in the modern west African country of Mali, was an important centre for the gold, salt, cotton and slave trades from the 10th to the 17th centuries. We have tales from Ibn Battuta in the 1300's and Leo Africanus in the 1500's celebrating its success and praising it as a centre of learning, of universities, of libraries.

[SLIDE: OZYMANDIAS IS ETERNAL]

"Tin" or "tain" is Tuareg for a water well. According to popular etymology, an old Malian woman, Buktu, lived by a well and was known for her honesty. Travellers, including the Tuareg would entrust Buktu with possessions when they were on the road and the location became known as Tin Buktu, meaning Buktu's well. So Timbuktu started with trust, a familiar theme in Commerce lectures.

This picture is from the 1375 Catalan Atlas of the known world (mapamundi), drawn by Abraham Cresques of Mallorca just after Ibn Battuta died and well before Leo Africanus. The section to the right translates as: "This Negro lord is called Musa Mali, Lord of the Negroes of Guinea. So abundant is the gold which is found in his country that he is the richest and most noble king in all the land."

[SLIDE: ON THE ROAD TO NOWHERE?]

But aside from trust why did Timbuktu rise? Timbuktu was rather inaccessible, far upriver. This perhaps enhanced its mystical image, but was a practical hindrance. The native tongue is a Songhay family language Koyra Chiini, hardly a lingua franca, so traders probably spoke many languages, principally Arabic, later enriched with Portuguese and French. Aside from lying on several trade route intersections and having a water supply, Timbuktu challenges many conventional assumptions about why financial centres form – it's not just the location or seapower, not just the language, not just the time zone, not just the local industry needs for finance. These arguments are too simplistic. Or are they? Here's a familiar speech by the Permanent Secretary for Financial Services and the Treasury:

"What is it … that attracts investors and financial institutions to this city? The answer lies in our fundamental strengths. These include our simple and low taxes; high-quality services; free flow of capital with no foreign exchange controls, and a stable, fully convertible currency; as well as a free economy buttressed by the rule of law and an independent judiciary. Our regulatory regime is on par with international standards; and our regulators are tasked to ensure a fair, transparent and orderly market."

But that wasn't a speech from London. Yes, that was Miss Au King-chi, at the Hong Kong Investment Funds Association 3rd Annual Conference on 29 September 2009 positioning Hong Kong as an International Financial Centre.

[Source: http://7thspace.com/headlines/321747/speech_by_psfs_at_hk_investment_funds_association_3rd_annual_conference.html]

So, how do you get a small financial centre? Start with a large one… The BBC describes Timbuktu differently in our century, "Today, it is a desolate and impoverished town - renowned for its heat, isolation and sand dunes." [Source: http://news.bbc.co.uk/1/hi/world/africa/1911321.stm].

[SLIDE: CITIES & CENTRES]

Cities & Centres

Before we examine what makes financial centres successful, we should define them. The definition of a financial centre is bound up in the definition of a city. We can start by observing that financial centres are cities or districts of cities where finance is conducted. However, the definition of a city is problematic, as anyone who has tried to compare city populations knows. Is Paris bigger than London? Did you mean the core city, perhaps the medieval walls, the city as defined by political boundaries, the greater metropolitan area? In certain cases, such as offshore centres like the Cayman Islands, the financial centre is really just the jurisdiction.

Likewise, the definition of finance is problematic. All cities have financial transactions. Is a shipping transaction finance? Paying for fuel? When does a shipping transaction become just finance? Are we talking about transactions that are wholly financial. Funding a vessel, insuring it? So much finance is conducted electronically that one might be able to claim that server farms located anywhere are financial centres.

Interestingly, the OECD doesn't define financial centres yet it defines offshore financial centres starting with, "Countries or jurisdictions with financial centres that contain financial institutions…". While the omission of normal financial centres from the OECD glossary strikes me as a large oversight, I do think they point us at the heart of the issue, so my definition might be "financial centres are places with strong concentrations of financial professionals and their firms". It's the people that matter.

[SLIDE: WHY STUDY FINANCIAL CENTRES?]

Financial centres funnel investment toward innovation and growth. Vibrant, competitive financial centres give cities economic advantages in information, knowledge and access to capital. A strong financial centre, whether domestic, niche, regional, international or global, connects the wider economy to the global financial community. Cities that are part of the global financial network gain from global trade and growth. Inward and outward investment opportunities increase the wealth of cities that have financial centres and the wealth of their citizens.

'Traffic' between the domestic economy and the global financial community is critical to national economic performance. The key function of the domestic financial community is not its ability to service the domestic economy's needs domestically, rather its ability to service the domestic economy's needs wherever and however they are best serviced. But after a point a well functioning financial centres attracts global financial transactions in its own right, and this confuses matters.

[SLIDE: FINANCIAL CENTRE ROLES]

Successful financial centres can and do fulfil more than one role:

- 'Global' financial centres that are truly global foci, where only a fewcan claim that role, London, New York, Hong Kong and Singapore;
- 'International' financial centres such as Seoulor Shanghai or Frankfurtthat conduct a significant volume of cross-border transactions;
- 'Niche' financial centres that are worldwide leaders in one sector, suchas Hamilton in reinsurance or Zurichand Edinburghin fund management;
- 'National'financial centres, often within federal countries, that act as the mainfinancial centre for financial services within one country, such as Toronto or Frankfurt;
- 'Regional' financial centres that conduct a large proportion of regionalbusiness within one country, e.g. Boston or Vancouver.

Bank robber Willie Sutton reputedly (he denied this later) replied to a reporter's inquiry on why he robbed banks by saying "because that's where the money is". In a circular fashion, why do we have financial centres? Probably the most important reason is “because that’s where the clients are”. “Global financial centres are places with intense concentrations of financial professionals and their firms transacting international business”. ‘International’ activity involves at least two locations in different jurisdictions. Global deals increase the number of involved parties markedly, e.g. adding lawyers and analysts to a mix of syndicated finance.

A direct foreign exchange deal between a retail bank in Korea and a Tokyo investment bank is international, the addition of a third party, e.g. backing with a credit derivative, is likely to make the deal global.

Global financial centres are not hub-and-spoke arrangements. A Sydney mortgage bank may well be working on regional financial deals but the bank’s international dealings could be direct with counter-parties in London or New York City. You cannot compartmentalise financial services distribution neatly into a typical retail model – a central warehouse, then a regional distribution centre and finally a local store.

[SLIDE: HOP TO IT!]

People Need People

So financial centres are based around people meeting people in an atmosphere of trust. London’s financial history retraces the exit and entry of foreign merchants and foreign ideas. Following the expulsion of the Jews in 1290, King Edward I provided land for goldsmiths from Northern Italy, hence Lombard Street. Expensive land at the heart of the City. The Italians made their mark, from coining (sic) the word bank (‘banco’) to the words for cash, debtor, creditor and ledger, as well as pound sterling - £sd (librae solidi denarii). Moves toward modern banking followed repeal of the usury laws under Henry VIII and further liberalisation under Elizabeth I.

At the risk of seeming to pander to a Gresham College audience, I want to dwell for a moment on the innovation that the Tudor merchant Sir Thomas Gresham imported from the Low Countries, the bourse.

Londoners knew how to trade physical goods – Billingsgate for fish, Smithfield for meat, Leadenhall for poultry, Spitalfields for general foods. But in 1565 Gresham opened a London version of the Antwerp bourse, known as the Royal Exchange. For the first time, London had an organized market where intangible things could be sold, such as shares in ships. The concept is astounding. You just go and meet people and do business with them about things that don’t exist. From this invisible trade sprang securities, commodities, foreign exchange, futures, and options. Exchanges bring together brokers and dealers.

People meet.

A brushstroke history of financial London would move on to the Huguenots, the Empire, the Germans, the Americans, the Asians, pointing out that there are now many exchanges in many cities. London today is a global financial centre based on many types of financial transactions both on exchange and off exchange. Structured betting, stock, shipping, insurance and commodities exchanges are dwarfed by unstructured foreign exchange markets operating daily in the trillions. And these exchanges overlap. A lawyer who can help structure an insurance contract can help with a securities insurance hybrid.

[SLIDE: PEOPLE WHO NEED PEOPLE ARE THE LUCKIEST PEOPLE IN THE WORLD]

As an international financial centre grows, staff gain skills and move jobs, the availability of skilled staff grows, thus enabling further growth of the international financial centre. Soon, aspiring financial services job-seekers begin their careers by moving to the international financial centre, further reinforcing its reputation as a place to go to find suitably qualified staff.

Studies have shown that experienced international financial staff significantly outperform regional financial staff trying to do international work. For this reason, productivity in global financial centres may be above productivity in regional financial centres, despite significantly higher salaries.

A valid question in today’s modern world of advanced telecommunications is why do people need to meet physically? If the London Stock Exchange moved its server farm to Iceland would London cease to be a financial centre? There’s a joke which goes, “I saw a bank that said it offered 24 Hour Banking. I didn’t go in. I didn’t have that much time.” You might even think that online financial centres ought to displace physical financial centres using their ability to transcend space and time. Physical proximity matters for a variety of reasons in many markets, efficiency, less miscommunication and faster decisions to name three. Despite online chat rooms and instant messaging, face-to-face contact seems to remain at the core of financial transactions. To quote a participant from one of Z/Yen’s studies:

"Access to international financial markets: you can access them from anywhere nowadays: but there's a personal factor which requires proximity to other people..."

Three weightless factors matter especially for finance – trust, secrecy and chance.

Communications via modern telecommunications are still not as trusted as physical contact. Financial transactions require some degree of secrecy as well. Physical meetings limit information leakage, while online you're only a broadcast email away from sharing a top secret negotiating point. Modern financial transactions involve bringing

together a wide range of skills at particular points – the buyer and seller, their brokers and agents, their lawyers, accountants, actuaries, surveyors, consultants and public relations experts.

On the one hand, they're easier to manage in larger set piece meetings, on the other hand new opportunities emerge from these physical encounters. An accountant working on a deal mentions to a principal an interesting company that becomes the focus of the next deal. As the team grab a meal in a nearby restaurant, one of them meets a colleague they'd been meaning to call, etc. Everybody likes to 'be in the loop'. As the online world gains trust, increases security and develops alternatives for structured and chance meetings, perhaps all financial centres are in danger.

Let's turn to analysing all this. It's not easy. Analysing successful global financial centres requires analysis of cities and people.

There are a number of metaphors for this analysis.

[SLIDE: CITY OR STATE?]

City or State?

It is difficult to work out what is the appropriate 'unit of analysis' for financial centres. Should we be examining these financial centres at the level of the culture (Anglo-Saxon, Han Chinese, Continental European or Arab), or of the nation-state (USA, UK, Germany or Japan), or at a regional level (Far East, Near East, Europe, North America) or perhaps some economic trade zone? One of the more interesting observations by Jane Jacobs was that cities, rather than nations, have been the drivers of economies [Jacobs, 1984]. Cities are where people go to trade, and live to trade. A city is a unique combination of residential, industrial, business and administrative activity. A city is distinguished from other human habitations by a combination of population density, extent, social importance or legal status. Of course, defining a city is not straightforward and involves cultures and people in ways that can elude straightforward analysis.

Defining a city requires value judgements on what is, or isn't, a city that elude straightforward categorisation. One can try to focus on 'global' cities using ranking systems, for instance the Globalization and World Cities Study Group and Network at Loughborough University (see http://www.lboro.ac.uk/gawc/index.html) have published [Beaverstock, Smith and Taylor, 1999] a decade's worth of rankings. Alpha World Cieites such as New York City, London, Hong Kong, Paris, Singapore, Sydney, Tokyo, Shanghai, Beijing. Beta World Cities such as Melbourne, Barcelona, Los Angeles, Johannesburg, Manila, Bogota, New Delhi, Atlanta, Washington DC. Gamma World Cities such as Panama City, Casablanca, Chennai, Brisbane, Quito, Stuttgart, Denver, Vancouver. Note that many beta and gamma global cities aren't significant financial centres.

[SLIDE: NETWORKS AFFECT]

The Santa Fe Institute has found evidence of increasing returns to scale in city inventiveness and creativity. These increasing, and accelerating, returns emerge from the fact that the value of connections rises with the number of participants in the network and show up as power laws in things such as the concentration of petrol or gas stations.

Each participant connecting to the network improves their productivity markedly, while also contributing to the productivity of those already connected. A thought experiment affirms the idea of network benefits – if there were two world wide webs, wouldn't they be even more powerful if they were connected into one? And network dangers - might they also be more vulnerable? We touched earlier this year in a lecture on Local or Global Professor Geoffrey West's question, "Why are large cities faster?". By implication, how does one take the social temperature of a city? The Boltzmann Constant relates particle energy to temperature of a gas. Is there a Boltzmann Constant linking the energy consumption of a city to its social temperature, or the metabolic rates of cities and villages?

Professor Saskia Sassen at Columbia University studies how globalisation affects cities.

She emphasises the difficulty of analysing global cities and their networks; it’s complex. She looks at the denationalisation effects of globalisation and the increasing tension between nations and cities. She points to the complexity of cities being valued as nodes rather than places of production, the intricate networks of immigrants and diaspora, as well as the way information technology changes social relations. Analysing cities is more akin to analysing ecosystems or biological organisms than any straightforward decomposition analysis.

[SLIDE: RESEARCH, RESEARCH, RESEARCH]

The City Of London Corporation needs to know what makes a successful global financial centre. Don’t forget that as recently as 2000, people in London worried about the relative ranking of London with Paris and Frankfurt, and the effect on London of the UK being outside the Euro zone. Less than a decade later the challenges are seen as coming from half a world away in Hong Kong and Singapore. One of the first Corporation studies in 2003, compared London, New York City, Frankfurt and Paris, “Sizing Up the City: London’s Ranking as a Financial Centre” [Centre for the Study of Financial Innovation, 2003]. The 2003 report considered six main competitive factors (skilled labour, regulatory competence, tax regime, government responsiveness, regulatory “touch” and living environment). A second study in 2005 by our Z/Yen team compared the same four centres considering 14 factors. We soon realised that if one asks for key opinions on financial centres much beyond a handful of cities, surveys become too complicated. If one asks for opinions on too few centres, one excludes respondents’ thoughts on emerging centres.

[SLIDE: THE GFCI PROCESS]

In order to better understand what makes a successful financial centre, the City of London Corporation and Z/Yen Group created the Global Financial Centres Index (GFCI) in 2006. GFCI 1 was published in March 2007 and has been updated five times since.

The GFCI provides ratings for over 75 financial centres calculated by a ‘factor assessment model’ that combines instrumental factors with the responses of financial services professionals to an online questionnaire (the assessments of financial centres):

¨ *instrumental factors* - Objective evidence of competitiveness was sought from a wide variety

of comparable sources. Over 60 external measures in five areas of competitiveness, i.e. people, business environment, market access, infrastructure and general competitiveness, are used in GFCI. For example, evidence about the infrastructure competitiveness of a financial centre is drawn from a survey of property and an index of occupancy costs. Evidence about a fair and just business environment is drawn from a corruption perception index and a property opacity index, etc.;

¨ *financial centre assessments* – the GFCI incorporates responses to an ongoing online questionnaire completed by international financial services professionals assessing financial centres with which they are personally familiar. The online questionnaire runs continuously to keep the GFCI up-to-date with people’s changing assessments. Responses are weighted by time, i.e. more recent contributions have more weight.

[SLIDE: GFCI WORLD]

The instrumental factors and financial centre assessments are combined using statistical techniques to build a predictive model of financial centre competitiveness using support vector machine mathematics. The predictive model is used to answer questions such as: “If an investment banker gives Singapore, Chicago and Sydney certain assessments, then, based on the instrumental factors for Singapore, Chicago, Sydney ***and Paris***, how would that person assess Paris?” Two things distinguish GFCI from a straightforward ranking questionnaire – the construction of an index and the instrumental factor methodology. The disadvantage of an index is the large upfront cost of establishing one. The advantage of an index is that, over time, we can correlate changes in factors and perceptions to reputation and intentions. Obviously we analyse by sub-sector, i.e. banking, insurance, asset management, professional services and regulators. We also analyse in new ways, for example looking at implied and actual volatility on factors and assessments. From a tremendous amount of research over the past five years gained from around 40,000 assessments by 2,000 people we’re starting to see how centres compete through time.

[SLIDE: REPUTATIONAL ADVANTAGE]

The instrumental factor approach is potentially a significant innovation in social research. It simplifies questionnaires, leading to more confidence in the sampling and opinions, and the index approach removes home bias while stabilising results. This new approach allows us to compare over time.

Further, we can see where reputation exceeds fundamental factors or vice versa. We've been able to use this approach, combined with more detailed analysis, to help specific centres answer questions such as when should they be marketing (when their factors are better than their reputation) or when they should soft pedal/peddle (when their reputation exceeds their factors); or improving which factors will make the most difference. Most importantly, we're beginning to see how factors vary in importance as centres advance.

Evolution Of A Financial Centre

[SLIDE: COMPETITIVE AREAS]

There are five key areas of financial centre competitiveness:

'People' - the availability of good personnel and the flexibility of the labour markets;

'Business Environment' – regulation, tax rates, levels of corruption and ease of doing business;

'Market Access' - levels of trading, as well as clustering effects from having many financial services firms together in one centre;

'Infrastructure' - the cost and availability of property and transport links;

'General Competitiveness' - the concept that the whole is 'greater than the sum of the parts'. From running thousands of variations of the predictive model, we can now state the order of importance of the areas of competitiveness. Before we start to examine each of the five, it's important to recognise that a criterion that helped to cause success may not be particularly strong today, but set in train a sequence of positive events. For instance, low taxation might draw participants in, but not persist. Likewise, a criterion that is strong and important today, for instance, the availability of skilled personnel, may be an effect rather than a cause.

[SLIDE: EVOLUTION]

Still, using the predictive model at various GFCI ratings we can see what matters at each stage. First, infrastructure. Infrastructure is all the stuff that's taken for granted. In major financial centres, many things are assumed, for instance, reliable electricity supplies and water, an absence of natural threats such as hurricanes or flooding. Yet London used to have significant flood risk, and may again as the Thames Barrier comes to the end of its projected usefulness. A recent report on the future of London warned of looming electricity supply problems [SAMI Consulting, 2009]. Up to 400 points on the scale, basic 'infrastructure' matters. This shouldn't surprise anyone. You can't have a financial centre without basic infrastructure. While it might appear that infrastructure ceases to matter after 400 points, actually it's rather the contrary.

It tends to get taken for granted as it grows in line with wealth and expectations. On the contrary, Stuart Fraser at the City Corporation believes London must upgrade its infrastructure if it wants to stay ahead. "You don't get to the top by being complacent. You have to be somewhat paranoid." ["On Top Of The World", Sunday Times, 9 October 2009]

Second, from roughly 400 to 600 points 'market access' is what matters. There's no point in building infrastructure and being open for business without having fundamental market activity. It's at this point that things such as setting up a stock exchange matter.

There are many statements that can be made saying, "we're open for business".

The third area of competitiveness, from 600 to 800 points, is 'people'. This may seem oddly late, after all people are the most important part of the business, no? However, the going only starts to get tough after 600 points as more and more advanced skills are required to win and transact more and more complex transactions – transactions of advanced financial, structural or legal complexity in multiple languages.

Finally, after 800 points, and here we're at the edge of our data envelope, it appears that infrastructure may start to matter again. However, throughout the climb from 200 to 800, business environment is always the key area of competitiveness, always the most important – stable politics, good regulation, low bureaucracy, low corruption. Policy matters. Interestingly, though we have grouped taxation in business environment, when you examine taxation on its own, it tracks business environment almost perfectly.

[SLIDE: ANNA KARENINA PRINCIPLE]

So, in summary, always always work on being business friendly then emphasise infrastructure, followed by market access, followed by good people. But what of general competitiveness? General competitiveness is where everything links up, the transport system goes to right places at the right cost, the theatres are attractions for conferences, etc. It is a combination of factors that makes a financial centre successful, not just a single factor. Anyone who has heard me on this subject before knows that I will point out Jared Diamond's Anna Karenina Principle from the opening line of Tolstoy's novel: "Happy families are all alike; every unhappy family is unhappy in its own way." The Anna Karenina principle describes situations where a number of activities must be done correctly in order to achieve success, while failure can come from a single, poorly performed activity. As one of our respondents noted:

"I think that the [above] factors cannot be considered in isolation - the combination of factors has a greater impact on a financial centre being competitive than the individual elements."

General competitiveness is interesting in two ways. First, the GFCI shows that you need to be good at most things to be a leading centre. People locate their businesses based on a number of criteria at once, so any taxonomic approach has difficulties. London and New York are in the top quartile of over 80% of the instrumental factors used to build the GFCI. London appears to be particularly strong on regulation and the quality of its people. The main negative comments are corporate tax rates, transport infrastructure and operational costs. New York is also very strong in most areas - people and market access are particular strengths. Regulation, such as Sarbanes-Oxley, is the main negative factor for New York.

The second interesting thing about general competitiveness is that the financial centre and the city are inextricably linked. As a city become 'cool' or 'with it' or 'happening' so that helps the financial centre. As a city becomes more recognised as a financial centre, then people presume it is 'cool' or 'with it' or 'happening'.

So it's all wrapped up then. An easy Meccano or Lego construction set for a financial centre. Well, not so fast. A number of interesting research issues emerge. Let's start with the iconic status of exchanges.

[SLIDE: BUILDING ON EXCHANGE]

The Need For Exchange

As we saw, from 400 to 600 points financial centres need to show they're in the market.

In all the discussions about building global financial centres, the role of formal exchanges is increasingly unclear.

The concept of transactions in invisibles is so widespread that most trading is actually off-exchange, though there is a new desire to increase on-exchange trading for better regulatory supervision. While there are many financial centres that make much of their exchanges, for others exchanges are peripheral, e.g. Geneva or Boston. In London the scale of OTC foreign-exchange trading dwarfs exchange-based trading. Further, in London the largest exchange by transaction volume (though not value) and probable market capitalisation (still unlisted) is Betfair, not the London Stock Exchange.

We may be confusing cause and effect, i.e. because you have a good financial centre you are more likely to have an exchange, but it's not required. Exchanges may be a bit like USA cities' football teams. USA cities often pay to attract or keep a football team. Yet development economists claim that football teams add no net value, though they may be nice to have around.

There are two other relations worth a brief exploration – the relationship of a financial centre with its domestic hinterland and the presumed win-win relationship with other financial centres.

[SLIDE: DON'T FORGET THE HINTERLAND!]

Front For The Hinterland

In academic

literature of financial centres, concentration is considered important. A 1990 consensus on the global financial centres would have been London, New York City and Tokyo. The assumption underpinning 1980s literature was that global financial centres grew from large domestic needs. However, if that were the case, why did Tokyo fall from the top rank when Japan's economy is still over twice the size of the UK's? Why is London comparable to New York City which, generously to the UK, has a domestic economy at least five times as large as the UK's? Perhaps London and other international financial centres are best analysed as two entities – a global financial centre and a domestic financial centre, with little cross-influences among them. This may, at first, appear naïve, but is simply an extension of the earlier argument that transactions change markedly once a number of international parties are involved. More research is needed on whether having a global financial centre leads to more support jobs in country but out of the financial centre, or whether outsourcing out of the financial centre is itself global. There are a number of front-office/back-office pairs whose development complicates both defining a centre and analysing its hinterland relationship, for example London City and Docklands, New York City and New Jersey or Connecticut, Hong Kong and Shenzhen.

[SLIDE: WIN-WIN FINANCIAL CENTRES?]

Win-Win Financial Centres?

The role of cooperation amongst financial centres is another area worthy of much more study. Although financial centres compete with one another, the competition is not a 'zero sum' game. How can financial centre competition be win-win? In theory, a wider, global allocation of risk and reward increases overall economic efficiency. In practice, the ability to tap cheaper capital for inward investment increases overall economic activity for the host country, increases portfolio diversification for the investor, and thus benefits both. More prosaically, a back office in Mumbai supporting a Singapore trading operation benefits both financial centres.

More deals mean a bigger pie for everybody. Business people are attracted to jurisdictions with fair and stable rules (I often wonder if that's why business people use so many sports metaphors – a firm belief that somebody enforces stable rules fairly seems core to their being).

Business people like governments without too much party fanaticism, because party fanaticism means the rules of the game can be changed rapidly. Business people can handle uncertainty. A fair and stable system is not necessary predictable, but system rules should be stable and rule changes predictable, which almost certainly implies numerous stakeholders and a wide polity. So an 'open' business centre is important. This may be of increasing significance as governments, now the shamed owners of concentrated banks, may be tempted to rewrite rules to favour domestic players.

An open competitive environment helps to encourage diversity. The resulting open and diverse financial centre ecosystem can be very robust. Still, this doesn't explain how moving jobs from London to Singapore helps London. A financial centre has a high fixed infrastructure – expensive ICT, buildings, transport, accommodation, schools. The primary measure of success cannot just be financial centre jobs. The measure for financial centres should be how effective they are at providing choice and access to global financial services. Then domestic and global markets both win. On this measure, protected domestic financial players are clearly a hindrance.

Global finance is a non-zero sum game, but only for those centres who accept that they have to be open and diverse. Open competition leads to appropriate connectivity with the global financial markets.

So where might things be heading? First, the global financial centres.

[SLIDE: ASIAN AGE?]

Leaders - Plus Ca Change? Well Maybe, And Remember We Told You So

Today it's London and New York City, with Hong Kong and Singapore rising fast. But might things change?

"Rather than a trinity of equally powerful global cities that have formed in response to a common stimulus, an emphasis on history and structure points to variations in the past and present of the global city." [Slater, 2004]

Back in 1999 Sir Willie Purves (former Chairman of HSBC) questioned whether "the UK is to Europe more as Manhattan is to the USA, or more as Hong Kong is to China?" Today we could raise an analogous question, "will China develop an onshore Manhattan or need an offshore London?" As we seem to have gone in 15 years from three to two financial centres, one could make a strong case that soon there will be only one, a "Highlander" imperative from the 1986 film of the same name where "there can be only one" who will win The Prize.

We could argue for London and the Wimbledon Effect. We could argue that New York City's proximity to the largest and most liquid domestic economy ensures it will ultimately prevail. On the other hand, we could argue that Europe is London's domestic market as North America is New York City's. Both cases beg the question, where is the equivalent Chinese financial centre? The rise of a Chinese global financial centre is not inevitable. Perhaps, similar to the development of the Euromarkets, there will be a need for an offshore Chinese market. Is that Hong Kong (perhaps not offshore enough), Singapore or Taipei, or more speculatively Sydney, Tokyo or Dubai? Or is offshore already defined by London or New York City.

Second, we need to re-examine niche offshore centres.

[SLIDE: FIND, EXPLORE THE FUNDS OFFSHORE…]

Offshore – Tax & Secrecy Versus Long Term Finance & Regulatory Simplicity

People seek scapegoats for the Credit Crunch - greedy bankers, incompetent regulators, dopey rating agencies, useless accountants, hysterical journalists. There are victims, "us", so someone with suspect motives must have caused the harm; we just need to name them.   Sadly, off-shore centres are easy targets and risk joining the cast of Templars, Bavarian Illuminati or Rosicrucians that routinely feature in conspiracy theories.

Out of the world's 221 sovereign states and dependent territories in 2009, 67 have a population of less than 1 million (30%), such as the Bahamas, Guernsey, Isle of Man, British Virgin Isles, or Gibraltar. Off-shore centres have used their constitutional independence to develop legislation, regulation and tax vehicles that attract non-resident business.

> *"It's fun to charter an accountant*
> *And sail the wide accountancy,*
> *To find, explore the funds offshore,*
> *And skirt the shoals of bankruptcy."*
> ("Accountancy Shanty", Monty Python, <u>The Crimson Permanent Assurance</u>, 1983)

Off-shore centres have four comparative advantages, long-term finance, regulatory simplicity, tax mitigation and secrecy.

Off-shore centres are famous for two of their four roles, tax mitigation and secrecy. Secrecy is easily attacked – why do you have something to hide? When looked at from a stable country, this seems a cutting question, but there are many legitimate reasons to desire secrecy. When looked at from an unstable country, secrecy can mean being less vulnerable to extortion or kidnap, or more able to consider positive reforms. Still, secrecy can too easily correlate with criminality, particularly where money laundering is involved. One solution is what Bermuda, Barbados and other off-shore financial centres do, have information agreements that allow competent authorities to share essential information responsibly, without risking legitimate people. There are many small states that need to attain these essential levels of transparency, but so too do many larger states.

Tax mitigation, as with all things to do with tax, is more complex. Off-shore centres act as “way stations” that facilitate complex international trade and investment flows. Taxes are paid at the beginning of the journey where the activity takes place and when the investors are at the end of the journey, but not along the way. Tax mitigation (legal) can too easily become tax evasion (illegal), particularly where secrecy is too highly guarded.

The comparative advantage of off-shore centres is displayed in how they ‘signal’. In biology and economics, animals and people convey information about their abilities and intentions by ‘signalling’. Off-shore centres walk a tight-rope signalling that they are both capable of rapid change, and that they are havens of stability. For example, off-shore centres simultaneously claim that they can change legal codes rapidly when laws impede sensible decisions, yet also avoid hasty legislation when larger nations are senselessly reacting to domestic calls for action. Unlike larger economies, financial services are so important to off-shore centres that they must keep their balance.

A more integrated perspective of comparative advantage is that savvy off-shore centres enable longer-term financial planning. ‘Long finance’ structures, i.e. structures that can endure for a generation or two or three, benefit from avoiding the capriciousness of larger nations’ domestic agendas. A large nation can change tax rules or ownership rules at short notice. Well-regarded off-shore centres have achieved a reputation for avoiding hastily-enacted changes that would harm their own self-interests.

And what of near-shore or mid-shore?

[SLIDE: CENTRE OR SPIN?]

Up and Coming?

Meanwhile, for potential financial centres in Asia (e.g. India or Indonesia), Africa or South America, closing the gap could take decades as infrastructure and a strong regulatory environment take time to develop. How can these centres further improve their attractiveness? To oversimplify it, SPIN:

- **Structure**: good quality basic infrastructure is essential. Obviously information systems, communication,telephony, transport links and commercial property must be of significant quality, but ‘lifestyle’ infrastructure – housing, schools and leisure facilities - must also be good;
- **People & Regulation**: financial services skills such as IT, legal, accountancy and actuarial professionals are essential, but a balanced regulatory environment with knowledgeable people overseeing markets is equally necessary;
- **Information & Interaction**:while a formal stock, commodity or derivatives exchange isn’t always required, a “buzz” is - marketplaces need prices;
- **Networking**: financial centres need to be nexus points formany activities. Deals are inherently unstructured, otherwise they could be automated, and require face-to-face contacts to build trust. Thus, a mining conference leads to a property deal, or a legal conference on structured contracts leads to a trial document exchange.

If anything, SPIN emphasises accelerating the frequency of informal contacts – conferences, annual meetings, airport lounges, social and leisure facilities – and then seeing what develops. Which leads to one to question the role of offshore centres, often off the beaten track and not natural nexus points. Yet many offshore centres do well in the GFCI.
A good degree of networking can arise if there is a favourable tourist element, for example the Cayman Islands or Bermuda.

This suggests at least two ways for smaller centres to compete. First, make sure that the inducements to explore the centre and set up new businesses are high, e.g. Dubai. After you have the people, help them stay. This approach is an old one, witness the large number of development agencies, conference subsidies, overseas representative offices and other inducements to help people and organisations make the first big step, any presence at all.
To this mix should clearly be added regulatory competitiveness. Second, promote your focal sector with zeal. Rather than stretching credulity by claiming to be a global financial centre across the board, be very specifically honest. Define your competitive sphere so narrowly that you are guaranteed to be ‘first in your class’. Then proclaim loudly that you are the pre-eminent centre for that small global financial sector. You can’t be the Big Apple overnight, but meanwhile being a “big fish in a small pond” might do nicely. Given today’s venue, I’d like to say a few words on London before we close.

[SLIDE: LONDON AS A GLOBAL FINANCIAL CENTRE]

London - Treating All Comers Fairly

The heritage of London and the UK is treating all comers fairly – the so-called Wimbledon effect - the local champion may have little chance, but the judging will be fair. London thrives when it's open to foreigners, from French Huguenots to Hong Kong Chinese. London suffers when it's unfair to foreigners - the expulsion of the Jews in 1290 or the closed shops of brokers and jobbers until 1986.

London has been built on others' mistakes. Eurodollar markets grew swiftly in the 1960s when US tax rule changes meant multinationals found it attractive to leave dollars outside the control of US authorities. Then in the 1980s, US companies began to borrow offshore, finding Euro markets an advantageous place for holding excess liquidity, providing short-term loans and financing imports and exports. Sarbanes-Oxley requirements after 2000 increased the attractiveness of London as a "light touch" regulatory environment. AIM listings increased listings at the expense of NYSE.
It's a good discussion point as to whether US litigation itself prevents principles-based regulation in the US.
But when the UK makes mistakes, for example with the shipping industry last year, retribution is non-existent, but exodus is swift.

[SLIDE: CONNECTIVITY MATTERS]

When people are able to enter a financial centre quickly, they rate it highly. This slide shows the percentage of people who are foreign, i.e. outside a financial centre, who rate financial centres. Over half of the GFCI respondents rate London, New York, Hong Kong and Dublin, and nearly half Zurich and Singapore.

It is unlikely that the credit crunch will change London's underlying attractiveness rapidly - the regulatory environment, the availability of skilled personnel, the dominance of the English language and a culture open to innovation persist. On the other hand, there have been discombobulating changes for foreign financiers and deal-makers that question their faith in the idea that stable old London "treats all comers fairly". Since September 2007 rapid changes to non-domiciled resident taxation, foreign dividend income, trusts, capital gains taxes and high earners' taxation rates (first 45%, now a proposed 50%), all raise questions about the predictability of the UK tax system. Equally, 'treats all comers fairly' has suffered from changes to visitors' visa and workers' visa, as well as the introduction of ID cards for non-EU nationals. Finally, the use of anti-terrorist legislation against Iceland and the concentration of government ownership of the financial services industry raise questions about political risk for overseas investors in financial services.

[SLIDE: A GLOBAL PHENOMENON]

Whither or Wither?

The current financial crisis allows us to speculate that large states may have a comparative disadvantage in global finance.
They seem unable to combine wholesale and retail financial regulation without incurring booms and busts. Nor are they paragons of virtue. The largest amounts of recorded money laundering took place through London, Zurich and New York, and there is no shortage of large nations' banking sleaze.

Credible, long term, off-shore centres must build reputations based on longer-term stability and regulatory simplicity. Today's off-shore centres contain good and bad, from money launderers and tax evaders to long-term planners and legitimate but complex wholesale financiers. Off-shore centres will exist as long as regulators and tax authorities implement unfair financial regulations and are subject to bouts of rapid regulatory change in response to domestic crises.

A bad reaction, particularly for London, would be to assume that lack of regulation was the cause of the credit crunch, when what's probably required is more open regulation. Still, as the US Congressman Thomas "Tip" O'Neil said, "all politics is local". Large electorates out for blood are unlikely to care about the preservation of an international financial services industry. Being a beacon of stability and not over-reacting should be everyone's strategy, but may favour the smaller centres and the offshore centres. Meanwhile, London and New York City face a tough challenge, while Hong Kong and Singapore rise, to try and remain 'light touch' while local electorates call for greater regulation. The issue for London and New York City is really whether they are trusted by the up and coming financiers, though ultimately the challenge may be electronic – if trust can go electronic then all of the rules change. When does a financial professional decide it is less efficient to stay in the financial centre than to try and establish an electronic practice in the countryside? The challenge for all aspiring financial centre remains, as ever, "to think global, act local, be social". But technology seeks to change those social relations.

[SLIDE: DISCUSSION]

Thank you.

[SLIDE: THANK YOU]

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