David Clementi: The City and the Euro: innovation and excellence

Speech by Mr David Clementi, Deputy Governor of the Bank of England, at the City Seminar on 'London into the 21st Century' at the Palace Hotel, Tokyo on 13 February 2001.

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Introduction

The City of London is, and always has been, a centre of innovation and excellence. I want to talk to you today about the City's role in the euro markets as an example of how London proposes to maintain its standing and reputation for innovation and excellence in the 21st century.

For me, it is a great pleasure to be able to talk to you about this here in Tokyo. There are historic links between Tokyo and the City of London, and I am glad that these links are continuing to flourish. We welcome the fact that so many important Japanese financial institutions are represented in London; and, of course, that UK-based financial institutions have operations here in Tokyo.

It is not surprising that there are such strong links between Tokyo and the City of London, because London is one of the three global financial centres, alongside Tokyo itself and New York. Tokyo and New York are global centres because of their large domestic markets. Unlike Tokyo and New York, London's primary focus is <u>international</u>.

London is much the largest international financial centre in Europe. Historically, London developed as a financial centre because of the international role of the pound sterling. But nowadays, London's role depends mainly on making markets and providing financial services in foreign currencies, like the dollar. That means that London continues to thrive only by remaining internationally competitive. And I should add that we in the Bank of England take a close interest in this. Maintaining the stability of the financial system and the effectiveness of the UK's financial services are key objectives for us.

The City is a centre of innovation and excellence

London is internationally competitive, because it acts as a centre of innovation and excellence, in a whole range of complementary ways.

- London has a vast, critical mass of markets and financial services in commercial and investment banking, securities and derivatives, fund management, insurance and commodities.
- London has a long track record of innovation, and a ready availability of financial skills and professional support services in law, accountancy, tax, property and communications. More than 300,000
- people work in financial services in London, and nearly a further 600,000 work in the supporting professions and services.
- London is at the forefront of technology, with an effective financial infrastructure.
- London has a reputation as a 'clean' market, and it has a commitment to openness in welcoming foreign firms. There is a genuinely level playing-field for foreign firms, with no overt or covert advantages given to domestic institutions.
- And in London, we have a non-bureaucratic but rigorous approach to regulation. The FSA brings together within a single organisation responsibility for financial regulation to deal effectively with the oversight of increasingly complex and diverse financial groups. The Bank meanwhile retains responsibility for monitoring the stability of the financial system as a whole. This regulatory structure is designed to provide confidence in financial institutions and markets, whilst not stifling innovation and risk-taking. Indeed the new Financial Services and Markets Act balances the objectives of prudential supervision and consumer protection with an explicit objective of promoting efficiency and competition.
- London has flexible <u>labour</u> markets, and low levels of corporate and personal <u>tax</u>. The UK compares favourably with many other European countries in this regard and has been the beneficiary of high levels of overseas direct investment as a result.

- English is the language of international finance.
- We are lucky enough in London to find ourselves in a convenient time-zone so that market firms can trade with Asia in the morning and New York in the afternoon.
- And finally, London has great attractions as a place to live! Like Japan, the UK has a long heritage, and a rich culture.

The euro is an opportunity for the City, not a threat

Since London is an international financial centre, the launch of the euro at the beginning of 1999 was a major event for the City, as well as for the euro area itself. As you know, the UK decided not to participate in Economic and Monetary Union at the outset. But although the UK is 'out', the City of London is effectively 'in' already. And this is because of the City's international role, making markets and providing financial services, regardless of currency.

So the City of London needed to be well prepared for the introduction of the euro in January 1999. And it was well prepared. As a result, London remains a competitive market place for euro business. You can trade euro in London, just like dollars. There is a wide variety of euro payment routes available in and from London. And London is playing a key role in pioneering the development of the euro markets and financial services across Europe. This means that London can, and does, provide a gateway to the euro for Japanese financial institutions.

The City of London does not depend on the currency used by the UK. Financial activity will be carried on where it can be carried on most conveniently, profitably and efficiently. The City thrives on deep and liquid markets, regardless of currency. Measured in these terms, we have, over the last few years, seen the euro as an opportunity for London, not a threat.

And the City has been taking advantage of this opportunity, since the euro's launch, by innovating and setting standards of excellence in the euro markets. Helping to develop deep and liquid euro markets is arguably the main contribution that we in the UK can make to the success of the euro from the 'outside'. And in this sense, the UK has been making a positive and constructive contribution. Deep and liquid euro markets have become well established in London. They have replaced the previous, more segmented, markets in the old national currencies (like the Deutsche mark and the French franc). As a result, the European Union has begun to achieve one of its objectives in introducing a single currency in place of the old national currencies.

The City is pioneering the changes in the euro markets

The volatility in the euro exchange rate has diverted attention from the structural changes taking place in the euro markets. Yet these changes are of fundamental importance. They will affect all businesses using the euro - Japanese businesses as much as UK and euro area businesses. I would like briefly to mention five of these structural changes. It is of course important to recognise, as I do so, that while the euro has been the catalyst for these changes it is not the only cause. But in each case, the City of London has been playing a leading role as a centre of innovation and excellence.

The first change is the growth of euro issuance - particularly in the private sector, as the financing needs of euro-area governments are limited by fiscal discipline and special influences, such as the proceeds of mobile phone auctions. The flow of corporate euro bond and equity issuance has grown significantly, though it is important to keep this in proportion: the stock of issuance outstanding in both cases is still - by some margin - lower than the US. (Domestic debt securities in the euro area, taking governments and corporates together, amount to the equivalent of around $6 trillion, compared with some $14 trillion in the US. And the equity market capitalisation of companies in the euro area amounts to the equivalent of around $6 trillion, compared with some $16 trillion in the US.) Since the launch of the euro, the focus of risk assessment in the corporate debt market has shifted from currency risk towards credit and liquidity risk. A growing number of companies in the euro area have been seeking external credit ratings. And an equity culture is beginning to take root in the euro area, despite the volatility in TMT stocks over the past two years. In Europe as a whole, for example, there were over 17,000 M&A transactions with a combined value equivalent to $1.5 trillion last year.

The second change concerns the integration of euro trading and settlement. Trading has increased in most euro markets, and dealing spreads have narrowed. Electronic trading and communication networks have greatly increased the reach of traditional financial markets, while allowing new providers to enter at relatively low cost. In particular, there has been much greater cross-border activity in Europe, supported by fully-integrated pan-European systems for making wholesale payments. But many systems for the trading, clearing and settlement of securities are still fragmented nationally by sector. Market firms are keen to see consolidation of the arrangements for clearing and settling securities trades, where costs are still considerably greater in Europe than in the US. Even without mergers, market firms can of course trade remotely from a single location, though this does not address the issue of duplicate investment costs. But it seems that full rationalisation may take years to implement and, while the broad vision of integrated European systems is widely shared, there are still differences of view about how best to achieve it.

The third change is the diversification of investment. The launch of the euro has begun to encourage a shift in funds away from the particular national market in which they have traditionally been invested, and towards investment across the euro area as a whole. This helps to explain the increasing use by fund managers of European benchmark indices against which to measure investment performance, rather than national benchmark indices. Portfolio diversification has so far been rather slower than originally expected. But there is evidence that diversification is continuing to take place, and it is expected to pick up over time.

Fourth, financial institutions themselves are consolidating, including in some cases across borders, so that they can better provide a service to clients across the Single European Market as a whole. Consolidation is already far advanced in investment banking, where critical mass is of particular importance to profitability, and a US link has proved a competitive advantage. The recent mergers between Citibank, Salomon Smith Barney and Schroder, and between Chase, JP Morgan and Robert Fleming, affect investment banking activity in Europe as much as in the US. Consolidation is much less far advanced in retail banking in Europe, where national differences in the retail markets are still pronounced.

Finally, regulation. Much has already been done to remove obstacles to the integration of Europe's capital markets. But the launch of the euro has served to highlight the barriers that remain. To remove these barriers, market practitioners in London do not believe that it is necessary to provide uniform regulation of European securities markets. Rather, the changes required can be implemented by relying on the principles of the Single European Market, and giving the necessary priority to implementing the European Commission's *Financial Services Action Plan*. And a Committee of Wise Men, chaired by Baron Lamfalussy, has been established in an attempt to speed up the process of change. We welcome the direction of the Wise Men's initial report last autumn, and we look forward to its final report, which is due shortly.

The City has maintained its market share

16 I have identified five main ways in which the structure of the euro markets is developing. The City of London has been making a positive and constructive contribution to their development by doing what it does best: providing a lead through innovation; and setting the standard for excellence. As a result, all the available evidence continues to indicate that, since the launch of the euro, London has fully maintained its market share. Let me give you a few figures.

- There are 482 foreign banking institutions in London, around double the number in Frankfurt, and more than double the number in Paris.
- The wholesale euro payment system in London, CHAPS euro, has recently accounted for 19% by value of cross-border payment flows in TARGET, the pan-European payment system. This figure has grown from 15% since the launch of the euro, and the UK now accounts for more cross-border payment flows in euro than any other country, except for Germany, even though the UK is not participating in EMU.
- London is estimated to have a 32% share of global foreign exchange turnover, compared with 5% for Germany and 4% for France.
- London's global market share of over-the-counter derivatives is around 35%, compared with 5% for Germany and 6% for France.
- Over 98% of the euro short-term interest rate contracts on the three major European derivatives exchanges (in London, Frankfurt and Paris) are traded on LIFFE. And taking STIR, bond and

other contracts together, LIFFE is the largest derivatives exchange in Europe by value, although Eurex is the largest by volume.

- London originates over 19% of cross-border international bank lending, compared with 7% for France and 9% for Germany.
- London has a market share of 55% of underwritten euro-denominated Eurobond issuance, and an estimated market share of 70% of secondary trading in the Eurobond market.
- Around 500 foreign companies are currently listed on the London Stock Exchange. This is more than any other exchange. 59% of global foreign equity turnover is reported to the London Stock Exchange by London market firms. And just under 40% of equity trades reported to the London Stock Exchange by market firms are denominated in euro.
- The market capitalisation of the London Stock Exchange, at & 128;2.7 trillion, is nearly double that of either Frankfurt or Paris.
- London is the largest global centre for the fund management of institutional equities, with $2.5 trillion of institutional equities under management.
- And London is the global market leader in aviation and marine insurance, with a combined market share of 22%.

Conclusion

It is early days. London is not complacent. But our view is that London will continue to thrive in the 21st century, so long as it remains internationally competitive. In particular, the environment which London provides for financial business must remain attractive and consistent with international 'best practice'. This means: maintaining the right approach in areas like labour flexibility, low taxation and regulation; and continuing to foster open markets and to welcome foreign firms. Among such firms, we hope that many of the largest Japanese financial institutions will continue to see London as their natural European home.

London is determined to remain internationally competitive as a centre for innovation and excellence in the 21st century. And we hope that it will also continue to be Japan's gateway to the euro.

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