

John Gieve: The City's growth – the crest of a wave or swimming with the stream?

Speech by Sir John Gieve, Deputy Governor of the Bank of England, to the London Society of Chartered Accountants, Bank of England, London, 26 March 2007.

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Introduction

Over the past few months there has been renewed talk of London overtaking New York as the world's leading financial centre. And it has reflected fears in the US as much as self congratulation in this country.

We should take some of this with a pinch of salt. Talk of an external threat may be helpful to those building a case for change in the US financial system. The US market remains the biggest in the world by many measures. More fundamentally this is not a zero sum game. Even if London establishes a comparative advantage and gains market share, New York (and Paris and Edinburgh for that matter) can prosper too.

Yet something interesting is going on. The report by McKinseys commissioned by Mayor Bloomberg concluded that "London is transforming itself into an increasingly sizeable and attractive talent hub for people with ... skills that used to be available only in New York ..." and "... superior conditions for innovation, capital formation, risk management and investment in these markets [derivatives and debt financing] are beginning to emerge (or have already done so) in London, which is building momentum relative to New York".¹

On this side of the pond too, the growth of financial markets in the City is attracting more attention. While much of that is favourable, we have seen renewed worries that London's prominence and the wealth it attracts and generates may be distorting the broader economy possibly adding to social tensions – that it may be more a cuckoo in the nest than a golden goose.

So the future of the City is a significant issue not just for Londoners but for the development of the wider British economy. And the development of the financial sector is of particular interest to the Bank not just because it is an important part of the economy itself but because it shapes the way that our monetary policy impacts on the wider economy and because of our responsibility with the FSA and Treasury for maintaining the stability of the financial system.

I will be speaking about the impact of the City's rapid growth on the broader economy in coming months but today I want to focus on what underlies that growth and, therefore, to address the question whether we should expect it to be a passing phase or to continue. Is London just on the crest of a wave or is it swimming with a persistent stream?

Putting it into perspective

To start with, how important is the City? Is its press profile greater than its real contribution to the economy?

The City's output is hard to measure.² We know that financial intermediation as a whole accounted for about 8.5% of UK Gross Value Added in 2005. And a recent estimate³ of the professional services supporting financial services accounted for a further 3.6% of economic activity in 2005, giving a total of some 12%. That compares with around 14% of GDP for the UK manufacturing sector and the jobs in financial and business services taken together have increasingly outnumbered those in manufacturing.

¹ "Sustaining New York's and the US' Global Financial Services Leadership". Report by McKinsey & Company to Mayor Michael Bloomberg of New York and Senator Charles Schumer (pages 14 and 54).

² Indeed the ONS has announced that it will be revising its estimates of the level and composition of GDP to incorporate changes to the measurement and treatment of value added for banks and to take better account of in-house software development.

³ International Financial Services, London. "International Financial Services in the UK", November 2006.

And since 1999 financial services and insurance taken together have accounted for over 20% of the UK's exports of services. So it is clear that the financial sector is an important industry for the UK.

But financial intermediation covers a great deal more than the City. Retail banking and insurance, like other retail services from restaurants to hairdressing, is widely dispersed across the country. In general one would expect this part of the industry to reflect the size of the population and their wealth. To the extent that the UK's industry may be relatively efficient and competitive, we may even have fewer people engaged at this end of the business than some other countries. While in 2003 the share of Gross Value Added from financial intermediation was a little higher for the UK than for France, Japan or Germany (5%, 7% and 4% respectively) there was not that big a gap and the figures for the US were about the same as the UK (8.5%).

It is London's position in the wholesale and international markets that is special and it is harder to get a handle on that. A recent estimate put the total number employed in "City" jobs at around 320,000.⁴ There are other significant European centres in Paris and Frankfurt and, within the UK, in Edinburgh for instance. But London is estimated to have 75% of UK's wholesale financial jobs and to be the largest European centre for wholesale finance with 35% of the jobs (up from 30% in 2000). So by this measure those working in "City" represent a little more than 1% of the UK workforce. While this is estimated to be twice the equivalent proportion for Germany and three times that of France, we should not get it out of perspective.

The economic geography of financial centres

Geographical concentrations, clusters, are common in many industries. In some cases they reflect the availability of raw materials or power sources. Elsewhere the underlying reasons are not so obvious. Watch making in Switzerland, films in Hollywood, the high-tech sector of Silicon Valley are all classic examples. But the pattern of geographical hubs is particularly prominent in the financial industry. In most countries, one city has tended to become predominant even if cities such as Chicago and Edinburgh have developed important niches in particular financial services. Over time some of these have become hubs for international finance like New York in the US, Zurich in Switzerland, Hong Kong and Singapore in Asia and, of course, London in the UK.

The history of each centre has been shaped by a myriad of factors from empire, the role of guilds, and the proximity of kings and governments. But a number of economic forces have also been at work and are still reinforcing the pattern.⁵

First, there are great advantages for both firms and workers from operating in a market with a deep pool of labour with the right skills. Workers know that if their firms fail or shrink they can easily find another job; firms can easily acquire new workers to start up or expand. Second, firms which have expertise in supplying the main industry become established close to the cluster so new front-line firms find the inputs they need on the spot. The 37,000 strong membership of the London Society of Accountants is a good example of this. Third, where specialist firms and highly skilled workers are grouped together the transfer of skills and information can be quicker. Knowledge and information pass between workers in different firms, formally and informally, as they trade with each other, so innovation is encouraged and productivity improves. Fourth, clustering tends to promote both competition and cooperation. Clusters tend therefore to increase productivity, drive innovation and stimulate the formation of new business. In these ways the clustering helps to create and reinforce the comparative advantage which drives trade.

In the case of the financial industry some additional factors promote clustering. In the past of course there was the physical need to be close to the market places but it appears that the centripetal forces remain strong even in a world of electronic trading and video conferencing. There is a reputational advantage of locating in an established financial centre, which signals you are part of the Premier League. And in wholesale finance where the firms can be both sellers and buyers, business is

⁴ "City type" jobs in London include securities dealing, international banking, corporate finance, derivatives and foreign exchange activity, fund management (including hedge funds), specialist insurance (such as Lloyds) and professional services such as legal, accountancy and consultancy directly supporting other City jobs. They include jobs in Canary Wharf and in the West End as well as those in the Square Mile.

⁵ See, for example, Fujita, M, Krugman, P and Venables A.J, "The Spatial Economy: Cities, Regions and International Trade" MIT 2001.

attracted to liquid markets, in cash and securities. Each firm benefits from a pool of competitors taking different positions.

There are also some centrifugal forces that tend to limit the size of clusters and ultimately drive firms away. The more concentrated the activity, the more vulnerable trade can be to external shocks, whether from earthquakes, wars or taxes. If there are restrictions on the supply of labour, concentration can lead to shortages. And of course clustering can drive up prices of other factors of production. In a successful urban centre, land in particular can become expensive.

The history of the City of London

But on balance the history of London's financial sector illustrates how powerful the factors leading towards concentration and clustering have been.

During the 18th and 19th centuries, it was not hard to see why international finance developed in London alongside Britain's pre-eminence as an economic and trading power. The need to provide finance for trade stimulated the development of the money markets here, based around commercial bills, and that in turn provided essential liquidity for longer-maturity securities markets.⁶

By 1914, while Britain had been overtaken as the world's leading economy, it remained the hub of the international monetary system – the Gold Standard. UK had 42% of the world stock of overseas investments and around one third of all the negotiable instruments in the world were traded on the London Stock Exchange. And if London was important to the world, the world was also crucial to London; more than half the value of securities quoted on the London Stock Exchange was accounted for by loans for foreign companies and governments.⁷

As an editor of the Economist during the period put it: "It [the City] is the greatest shop, the greatest store, the freest market for commodities, gold and securities, the greatest disposer of capital, the greatest dispenser of credit, but above and beyond, as well as by reason of all these marks of financial and commercial supremacy, it is the world's clearing house."⁸

The benign international environment disappeared with the outbreak of the Great War, and the UK's political and economic standing in the world fell away steadily through the following 60 years. By 1950, average incomes in the UK were below those in the United States, and they fell below Germany and France by 1970. The economic dominance of the United States ensured New York's place as the leading financial centre and the American commercial banks became the world's largest. In the 70s and 80s the growth of Japan propelled Tokyo up the rankings. And in Britain, the share of foreign securities issuance fell to only 6% in 1961, as against more than half before 1914.

So by the 1970s London was benefiting from few of the factors which had produced its golden period before the first War. It had suffered from the destruction of the wars and the Depression, and from the loss of Empire and protectionist policies at home and abroad, including capital and exchange controls. In a faltering economy trade in government debt had supplanted much of its international business, sterling had declined as an international currency, and the major British merchant banks and brokers had been overtaken by the investment banks in the US and the universal banks in Europe and Japan. Nonetheless, through all this London remained a leading international financial and banking centre. On some measures, indeed, it retained its position as the leading centre for international finance for all but a few years after the second war.⁹ It had the critical mass to keep the skillbase and networks to retain the professional trade in many markets. So, even in the 1960s the Euro markets developed here.

⁶ Michie, RC "The City of London: Continuity and Change, 1850-1990" Macmillan, Basingstoke and London, 1992.

⁷ Cassis, Y. "Capitals of Capital. A History of International Financial Centres 1780-2005" Pictet and Cie, Geneva, 2005.

⁸ Kynaston, D. "The City of London", Volume II Golden Years 1890-1914.

⁹ Reed, H. "The pre-eminence of international financial centres", 1981.

The recent growth of the City of London

Over the last twenty years, a number of reforms have improved the environment and helped the City to build on its position. Exchange controls were removed in 1979, facilitating capital flows into and out of the UK; and Big Bang, in 1986, opened up the Stock Exchange and paved the way for the participation of the leading foreign investment banks in London's market. At the same time the growth of international trade and thus capital flows has brought in more business.

In some of the activities that London has long dominated, its growth in the last 10 years has largely reflected the growth of global capital market activity.

In the foreign exchange market, for example, where the London market is and remains the largest in the world, turnover was a bit over 30% of the global total in April 2004, broadly unchanged from 1998. But turnover in London had increased by nearly 20% over the same period – a big increase despite the creation of the euro, which removed the necessity for trading between so many currency pairs. On an even larger scale the UK's share of cross border bank lending – which has long been a strength of London's – remained unchanged at around 20% between 1998 and 2006. But over that same period, the market grew by about 150%.

But there are several areas where London's share of business is rising, particularly in new, innovative and technically demanding areas of finance.

London's share of world over-the-counter derivatives business, for example, has risen from around 35% in 2001 to nearly 40% in April 2004. And within that the notional amount of credit derivatives traded in London multiplied by more than 100 between 1997 and 2006. While the US remains the main centre of the hedge fund sector, at the latest count twelve of the world's largest 50 hedge funds were based in London, as against only three in 2002. London has a share of nearly 80% of the European based hedge fund market, up from around 70% in 2002. The UK private equity market has been another prominent area of growth recently. UK private equity funds raised in 2005 were over £25 billion, around twice the size of the previous peak in 2001, with the UK private equity industry accounting for over 50% of the total European market.

The drivers of the City's recent growth

In part the City's recent growth reflects – as it did a century ago – a rapid growth in international trade and financial liberalisation. Globalisation has brought an expansion of world imports by 180% since 1990 compared with an 80% increase in world GDP. Progressive upgradings of a number of emerging economies have broadened and deepened international links. Higher savings in the emerging Asian economies, in particular, have combined with demographic change in the West to increase demand for long-term savings instruments and a fall in their yields.¹⁰ All these trends taken together have led to a period since 2002 of unusually high returns for holders of many financial assets and the explosive growth in new products and markets.

But what is driving the growth of London in particular? One approach to this question is to ask executives in major financial companies, both in the UK and abroad, why they choose to locate business here. A number of these surveys have been conducted recently and they show several common factors.¹¹

London benefits from English as an international language of commerce, and from its time zone, which means the working day overlaps with Asia in the morning and America in the afternoon. London also has well established financial infrastructure and telecommunication networks.

Many of those surveyed point to the regulatory and legal environment. This is partly a matter of the regulatory style – the “risk based and proportionate” approach that the Financial Services Authority has adopted based on general principles where possible. It is partly the simplicity of dealing with a single regulator.

¹⁰ Caballero, R. “On the macroeconomics of asset shortages” NBER WP 12753, December 2006.

¹¹ For example, Cook, G. A. S., Pandit, N. R., Beaverstock, J. V., Taylor, P. J. and Pain, K. (forthcoming in 2007). “The role of location in knowledge creation and diffusion: Evidence of centripetal and centrifugal forces in the City of London financial services agglomeration”. Environment and Planning A.

English law, which is also the basis for financial services law in the United States, prevails here, with the added advantage that practitioners are less likely actually to invoke the legal system. And what has been called the Wimbledonisation of the UK financial markets – the sale of nearly all the British merchant banks and stockbrokers and the dominance of foreign players – gives confidence to prospective market participants that the competitive environment is genuinely open to all comers. London is also a growing centre for Islamic banking. Finally, London may be benefiting from measures elsewhere; certainly in the years since the Enron and WorldCom scandals, commentators have suggested that the application of the Sarbanes-Oxley legislation to foreign firms listing in New York may have encouraged some firms to list here instead.

But the single most important factor is the first one suggested by economists: London's comparative advantage lies in its skilled labour and financial know-how both in the financial firms and in the professions which support them.

The free movement of labour within the European Union, and relative openness to immigration by those with specific expertise from outside it, has also meant that employers in the financial sector can access the world labour market. And the relative flexibility of the labour market here in the UK compared to others in Europe may also be a factor.

That concentration of skilled labour has spurred competition and innovation. We have seen a very striking illustration of this in the last few years with the rapid growth of hedge fund management and private equity firms in London. Many have been established and are staffed by people who acquired their skills and earned their capital at the more established investment banks and fund management firms of the City. Being at the heart of world markets helped them spot the opportunities and assess the competition. Once they struck out on their own, they could draw on a network of former colleagues and contacts for staff, information and expertise.

Future prospects of the City of London

So what are the prospects of the City of London?

One of the clear lessons from history is that any position can be lost. It is always possible to throw away an advantage by ill judged decisions. Any widespread operational disruption or fear about security could also be very damaging, which is one reason why we and the other tripartite authorities are spending so much time on improving crisis response and management.

But in the absence of disaster the structural factors I have discussed seem likely to favour further concentration of financial business in the City.

First, the entry of China and India international market has been associated with a massive expansion of international trade and finance in relation to overall world GDP. That seems likely to continue and has been a major factor in the growth of London in the past.

Fifteen years ago people worried that developments in information technology would undermine centres like the City of London. When anyone could log on to receive market information and trade in real time, wouldn't traders flee the hurley burley and relocate to other, quieter and cheaper financial centres or even out of cities altogether? What seems to have happened is the opposite. The reducing costs of collating information and trading at a distance have led to operations relocating to London and the City becoming an even more important cluster for financial activity. The technology which could have allowed the dispersion of business has instead allowed greater concentration.¹²

So whereas in 1997 the largest share of market turnover of Frankfurt's Eurex market came from traders based in Germany (over 80%), the largest share in 2005 came from the UK (with over 45%). As more assets can be traded remotely, this may further drive the growth of centres like London with large pools of skilled financial workers.

The growth of European capital markets relative to traditional commercial banking should reinforce that process. Historically, European and equity markets have been smaller relative to their economies than in the US. With around some \$30 trillion in assets, euro-zone financial markets are still significantly smaller than the \$50 trillion in the US. But Europe is closing the gap. In 2005 the

¹² HM Treasury, "The location of financial activity and the euro", 2003.

eurozone's financial stock grew by over 20%, compared with around 6% in the US. And the eurozone's financial depth has increased at twice the pace of the US over the past 10 years.¹³ If this gap continues to narrow, I expect this to favour the growth of London as the main centre for Europe's capital markets. The development of capital markets in Asia is further behind still and I would expect to see continued rapid growth in these markets in the next decade.

The rationalisation brought by the single financial market in Europe should push in the same direction. The number of central counterparty (CCPs) clearing houses by ownership has halved in Europe since 1999. And there were over 650 mergers and acquisitions in the EU banking sector between 2001 and 2005, a quarter of which were cross-border within Europe. But the process has some way to go and as the European financial sector becomes more consolidated, and financial institutions become larger and more complex, they tend to become more intensive users of capital markets. The major UK banks' trading book assets, for example, now account for over 30% of their balance sheet assets compared with little over 15% back in 2000.

What of the countervailing – centrifugal pressures? The creation of Canary Wharf, the expansion of office space in the Square Mile and the West End has helped to allow the rapid expansion of recent years. But of course London is an expensive city with high land and labour costs. So we have seen financial firms outsourcing functions like IT support, systems development and HR both within the UK and Europe and to India. That too seems likely to continue so further growth of trading and management in London may well not lead to proportionate growth in jobs. On current trends we might expect a greater concentration of high value, high skill jobs in London.

Conclusion

So back to my question: wave or persistent stream? The answer is, as you will have spotted, both.

Readers of the Bank's Financial Stability Report (next edition due next month) – or those that have read the financial news – will know that the financial markets have been buoyant recently; in particular the premia for risks in the credit market are very low and profit growth and bonuses have been spectacular. Some of this may well be the crest of a wave. However, for the reasons I have set out this afternoon, London is also benefiting from a longer lasting and a strong current. We may expect that cycle to turn at some stage – and London will be affected because of its international position. But there are good reasons to expect London to further enhance its position as a global financial centre in the long term. And that will have implications for the rest of the economy and the risks it faces. It will continue to affect the labour market, the housing market, and the distribution of wealth and income. And it will further sharpen the dependence of the British economy on wider international movements in financial markets. I plan to return to these implications in coming months.

¹³ McKinsey Global Institute, McKinsey & Company's economics research institute.