Joachim Wuermeling: Collaboration instead of rivalry – thoughts on a digital financial centre of Europe

Text of the SAFE Policy Lecture by Prof Joachim Wuermeling, Member of the Executive Board of the Deutsche Bundesbank, at the House of Finance, Goethe University, Frankfurt am Main, 15 February 2018.

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1 Introduction

Ladies and gentlemen

I am delighted to have been invited to speak to you here today. I can scarcely think of a better platform for my lecture than Goethe University's SAFE Policy Center – and I say that for three reasons.

First, programme directors Jan Pieter Krahnen and Hans-Helmut Kotz have made it their priority to provide more opportunities to bring academics, policymakers and market participants closer together in the field of financial market development. I am very much in support of such an approach. I myself have moved, and continue to move, in all three circles, and I am aware of the concerns in some quarters. Truth be told, however, academics, policymakers and market participants are natural bedfellows, even in the debate on Europe's future financial centre, which I would like to talk about today.

Second, universities have always been a key factor to consider when choosing where to locate major financial centres. In London, for instance, it is commonplace to drop by university research institutions and think tanks over lunch to discuss the latest financial market developments. Goethe University has long since recognised the wealth of potential waiting to be tapped by bridging the gap between theory and practice. In this sense, we are also doing our bit today to add to Frankfurt's appeal as a location.

Third, I have had the honour of being appointed to the SAFE Policy Council. With that in mind, this talk is a debut of sorts.

So what is my lecture about? In a nutshell, it's all about whether the rivalry between financial centres in continental Europe is a zero-sum game, especially with respect to Brexit. Does one financial centre's loss have to be another's gain, or is there another way? I can't give you a definitive answer to that question, but I can feed in some food for thought for a variety of stakeholders.

I would like to proceed in three steps with three key messages:

First, Brexit marks a turning point that will weaken the City of London's role as continental Europe's financial centre. On a side note: Incidentally, I will be using the term "continental Europe" throughout this lecture to refer to the EU after Brexit, which includes the Republic of Ireland.

Second, a global financial centre – or, as Britons would call it, a "City" – can come into being in the EU even after Brexit. Information technology is opening up the possibility of financial centres in the rest of the EU becoming a networked digital city of Europe, which would, to a large extent, overcome the existing fragmentation.

Third, if this became the new horizon of continental financial markets, a lot of stakeholders would need to pool their resources for the project to establish a digital city of Europe. In this context, policymakers can serve as a catalyst.

But let us now turn our attention to the heart of the action by setting our sights across the English Channel, on London.

2 Brexit – a turning point for the financial systemof the EU

London has long been not only the most important global financial centre, but also the main hub for Europe's financial system. Enormous amounts of capital flow in from investors on the continent. And from there capitals flow back out to the EU: to governments, financial institutions, enterprises and households.

The City benefits from what are known as economies of agglomeration. In fact, the metropolis on the Thames is often regarded as having its own financial ecosystem. The local concentration of banks, funds, private equity firms and insurers, but also related service providers such as law firms, auditors, consultancy firms and IT specialists makes for a wide range of financial products and high market liquidity. With that in mind, there is virtually always demand to feed supply and supply to feed demand in the City. Countless options are on offer to cater for the widest range of tastes with respect to the magic triangle of return, risk and liquidity.

It is not for nothing that London tops the widely recognised Global Financial Centres Index[1], closely followed by New York. Continental European financial centres trail behind in these rankings, with Frankfurt in 11th place, Luxembourg in 14th, Paris in 26th, Dublin in 30th and Amsterdam in 33rd.

London's significance is also corroborated by hard structural data on individual financial market segments.

The United Kingdom and London in particular host around 43 percent of euro trades on the foreign exchange market, which is more than twice as much as the share accounted for in the rest of the EU as a whole.

The United Kingdom plays a major role as an issuing and trading centre on the bond market, too, not least for international bonds that were not issued in the borrower's home market. The outstanding volume of securities issued in the United Kingdom by non-resident borrowers, primarily financial institutions, stands at around US$3 trillion. That's the highest value worldwide, and more than a quarter of that figure is euro-denominated.

On the equity market, market capitalisation on the London Stock Exchange is around double that on the Deutsche Börse, the leading continental European exchange. Comparing monthly exchange trading volumes, London outstrips Frankfurt by over 60 percent.

Around 70 percent of euro-denominated OTC interest rate derivatives trading takes place in London. And an even greater percentage – some 90 percent – of these instruments are cleared there.

With total assets amounting to the equivalent of around €9.3 trillion, the British banking system is the largest in the EU. One indication of its close ties with continental Europe is the fact that around 20 percent of British banks' balance sheet assets are denominated in euro.

It's no coincidence that, of the 160 foreign bank branches operating in the United Kingdom, 77 are from the European Economic Area. Banks headquartered in continental Europe contribute 17 percent to British banks' aggregate total assets, which is slightly more than the 16 percent attributable to US banks. Only roughly half of British banks' total assets come from British institutions.

Other financial market segments in which London plays a prominent role are easy to find and include funds, insurance, commodities and private equity.

Essentially, the City brings the demand and supply of capital together from all over the world. These days, its distinctive role as a connecting and distributing point is of paramount importance for Europe's investment and financial flows.

But what will the relationship between the United Kingdom, or London, and continental Europe look like in future once Brexit has been implemented? Signs are pointing to a watershed moment.

Many observers suggest that it will not be possible for London to remain the EU's financial centre once the United Kingdom has left the single market. The Wall Street Journal wrote recently: London's position as Europe's financial centre is definitely under threat.

A fairly logical and highly probable legal consequence of Brexit is that the United Kingdom will probably lose its EU financial services passport, meaning that banks domiciled there would no longer have access to the European single market. As a result, it would no longer be possible to sell a financial product approved in the United Kingdom anywhere in the European Economic Area without barriers.

Of course, the same would hold true in reverse: Continental European institutions will also no longer be able to provide their services in the United Kingdom without those same barriers.

In such a scenario, they might even be forced to establish a subsidiary in the United Kingdom so as to continue to be able to serve their British customers. If no such arrangements were put in place, it would be necessary after Brexit to establish separate legal frameworks in individual jurisdictions, be they in the form of licences for market participants or product approvals, in order for the United Kingdom and the EU to conduct cross-border business.

The British want to strike an ambitious free trade deal with the EU under which the cross-border trade in financial services would continue under the most favourable terms possible. However, EU negotiators resoundingly rejected British calls for such a deal in late January.

In any case, conventional trade agreements have thus far not covered financial services to the degree desired by the United Kingdom. The freedoms provided by the WTO are rudimentary at best. Globally, the following rule still applies: all players need to comply with all locally applicable regulations – regardless of the regulations in place at home.

Up to now, mutual recognition has been selective at best, only one-sided and, above all, only made possible when it has been in the interest of the recognising country. For instance, the EU has made 17 and 19 case-by-case decisions on the equivalence of US and Japanese financial products respectively. However, all this means is that markets open up for individual financial services. It has nothing to do with comprehensive passporting rights. Such rights would be conditional on joint European rules and regulations also applying to, and being enforceable in, institutions domiciled in such non-euro area countries.

As yet, virtually no one across the globe has ever taken the objective of liberalising financial services seriously, which is why financial services have thus far largely failed to feature in trade agreements. I doubt whether it is realistic in the EU-British case.

Look at it from a supervisor's point of view: The EU will, at any rate, no longer be able to adequately pursue financial market policy objectives such as financial market integration and financial stability in the City of London.

As the Financial Time stated a few weeks ago: Why would the EU give up any measure or regulatory control over finance?

What this makes clear is that London will not, as some have suggested, maintain its current role as the financial centre of the EU after Brexit. Even with the best will in the world, there is no substitute outside the EU for the freedoms, rights and obligations that come with being part of the

single market.

In various scenarios, financial institutions in London and the EU have a wide range of options open to them. At this stage, most discussions simply centre on how to overcome the negative effects of Brexit. But the current situation could also provide a good opportunity to look at the suitability of business models from a more strategic point of view.

As regards the many options for financial institutions, just let me say this much: financial institutions domiciled in the United Kingdom must be prepared to shift any continental business that can no longer be carried out from there to the EU. Other business may well migrate to other global financial centres if London's attractiveness fades as access to the EU's financial markets becomes more difficult. Large foreign institutions could also move parts of the value chain back to their home countries, or business with continental European clients could simply be discontinued entirely if an EU presence is not worthwhile.

Conversely, market participants who have, until now, conducted transactions with British counterparties while based in Europe may have to look for business partners in the EU. Alternatively, they might have to be prepared to face additional legal hurdles if they wished to remain active in London. But in this case, London would then be competing with other global centres since it would no longer be able to take advantage of the benefits provided by the single market. Ultimately, it all depends on institutions' individual cost-benefit analyses.

As a result, Brexit could, at least in theory, reduce the range of financial intermediation services available in the EU, weaken institutions' productivity, and reduce market depth. In a nutshell, it could entail higher costs. And there is not the slightest guarantee that business will move to the continent after Brexit. A fair number of people suspect that it may well be the financial centres outside the EU that will emerge as the real winners after Brexit. New York, in particular, could well benefit from Brexit, as could other global financial hubs such as Singapore or Hong Kong.

Frankfurt, Paris and Amsterdam are by no means in the second division in this tournament, but neither are they candidates for the Champions League. As things stand, it is unlikely that any financial centre in continental Europe could take over London's role on its own. Although Europe's national financial centres are more than capable of processing day-to-day financial transactions, all of these locations lack the capacities on the required scale to handle global transactions, not to mention the service providers, consultants and infrastructure that surround these.

So let's not be under any illusions: no other financial centre in continental Europe can fully replace the City of London. Brexit could have a detrimental impact on and fragment the EU's major funding channels. From the point of view of financial market efficiency, financial market integration, financial stability, but also real economic development, a scenario such as this is clearly harmful.

Initiatives are therefore needed. The most far-reaching objective would be to strive for a globally significant financial market in continental Europe.

Until now, this has not been one of the EU's objectives. The single market was intended to increase competitiveness within Europe, the banking union was created to strengthen the resilience of the European banking system, and the capital markets union was aimed at increasing the possibility of cross-border risk sharing via the equity markets. With Brexit, we could now face a new strategic challenge: setting up an alternative financial centre on the continent.

3 Even after Brexit, the EU will still have what it takes to become its own global financial centre

That brings me to my second step: What does a globally competitive financial centre require? The Global Financial Centres Index, or GFCI, I referred to earlier lists five factors for success:

1. Business environment: Financial centres perform well in this regard if their framework conditions mean that it is easy for (international) market participants to relocate there. Such conditions include a stable political system that includes a reliable legal system and a consistent institutional framework, efficient regulation, low levels of red tape, a lack of corruption, cost competitiveness as well as favourable and reliable fiscal conditions. The macroeconomic environment also plays a role.
2. Human resources: How many people with the required level of education are available at the respective financial centre? The more complex financial transactions become, the more qualified employees will have to be in order to continue generating business potential. Another element is the flexibility of the labour market.
3. Infrastructure: In terms of infrastructure, the GFCI assesses the quality of many components that are often taken as read in financial centres in modern economies. These include the supply of residential and commercial real estate, the electricity and water supply etc., the telecommunications and IT infrastructure, transport links and connectivity, in particular to other international financial centres, educational establishments and, increasingly, environmental factors, too.
4. Financial sector development: The depth and breadth of clusters of resident market participants with similar or complementary features as well as sufficient availability of capital and market liquidity are the preconditions for good market access and intensive trading activity. They include. A high level of or dynamic economic activity at the relevant financial centre is an advantage, although not decisive.
5. Reputation: Reputation as a factor for success depends on the attractiveness of the financial centre as a brand, how its creative potential and cultural diversity are perceived, and what it has to offer in this regard compared to other financial centres.

Simply listing all these ingredients would not be doing justice to the GFCI. The index is not simply a set of static building blocks. It is, in fact, a complex and dynamic system.

The importance of a particular success factor can vary depending on the level of development of a financial centre. For example, while the business environment and infrastructure of a financial centre tend to form a basis for success initially, human capital is more important at centres in more advanced stages of development. At the top end of the scale, the smallest differences in infrastructure can then start to play an essential role again.

The EU and, in particular the euro area, already tick the most essential of the boxes listed above.

For instance, we live in strong, diversified economic areas with high living standards and a broad cultural landscape. Our political systems are stable and our legal frameworks are reliable. We do business in a single market with a harmonised regulatory framework within which people, goods, services and capital can move freely and quickly.

As a single currency, the euro enjoys global confidence. Around a fifth of the world’s currency reserves are held in our shared currency. Investors in the euro can draw on a huge array of financial products.

The regulatory requirements that apply to financial products are largely standardised. With its single supervisory mechanism and extensively harmonised regulation, the banking union has continued to deepen trust in the European financial system. The emerging capital markets union may move European financial integration even further forward. And we also have efficient market infrastructures – for both payment and securities transactions.

What’s more, the Eurosystem, and the Bundesbank in particular, is heavily involved in many of these aspects – the single monetary policy, banking supervision, or market infrastructures such as TARGET2 or TARGET2-Securities, which, to a certain extent, form the backbone of our European financial system.

As the second strongest economic area in the world, the European single market easily has the required global pulling power in any case. It offers financial market services and leads the way worldwide in certain areas of research and (information) technology.

However, Europe’s overall potential is spread over various locations across the whole continent and therefore does not have a cumulative effect. During the financial crisis, fragmentation along national borders became even stronger. Its financial centres are competing with each other for market shares, tax revenues and jobs. They do not pool their expertise and resources to face global competition, but instead serve regional needs and niches.

Individually, each of the larger continental European financial centres has at least some of the factors needed to become a global financial centre – just not enough.

Take market liquidity, for example. Supply and demand are not available in the required quantities to be able to offer the entire range of products. The numbers I gave you earlier for London as the main hub for Europe’s financial system are telling.

The units at the various sites are too small to provide a globally competitive cost structure through economies of scale.

The required services are insufficient to establish a comprehensive, fully functional ecosystem. Specialist knowledge, for example relating to investment and financing, accounting, tax, law, information technology or consulting, is scattered across various locations that are hundreds of kilometres apart.

As I already mentioned, a glance at London reveals that economies of agglomeration made an important contribution to its growth as a financial centre. Ultimately, all market participants benefited from the concentration of different – but complementary – stakeholders, even if they were competing with each other. This concentration at a single location provided easy access to a wide range of financial services which, in turn, attracted more market participants. London became more important, thus further boosting the city’s attractiveness – a self-reinforcing cycle.

This makes it clear that it is spatial proximity, above all, that has made successful financial centres like London possible in the past. In addition, uncomplicated and direct personal contact was also made easier by the use of English as the “lingua franca” of the global financial system. The resulting trust among those trading made it possible to make fast, sound decisions, leading to commercial success.

However, digitalisation could mean that geographical proximity may become less and less important. By fully exploiting the possibilities and potential of current and future information technology, it might be possible in future to overcome distances in space and time almost without any losses in directness and efficiency in the financial markets, too. This creates a totally new opportunity for the geographically fragmented continental market. But – my third step – how to seize those opportunities?

4 Many stakeholders will have to join forces

In a competitive environment, a leading role as a global financial centre is not set in stone. Looking back over the past three centuries, the balance of power has clearly shifted among Europe’s financial centres. For instance, in the 18th century, it was Amsterdam that held the leading position for a long time. As of the 19th century, London began to emerge as a leader

driven by Great Britain's position as a colonial power. Over the past 60 years, the City of London has continued to cement its dominant position, boosted by stringent US regulatory requirements and tax regulations in the 1950s and 1960s, Britain joining the European Community in the 1970s, the Big Bang of the 1980s under Margaret Thatcher and the controversial "light touch" approach adopted by the UK Financial Services Authority around the turn of the millennium. The Eurodollar and Eurobond markets were born in London, international – especially US – banks relocated, securities trading business expanded and, later, London went on to become a centre for – partly contentious – financial innovations. However, in the period of recovery following the financial crisis, the City of London demonstrated its power of innovation. Yet this does not have to spell the end of the story. And Brexit is not the only force of change at play. Digitalisation has unleashed a period of upheaval that is calling into question the way in which established financial centres usually function. New competitors with innovative technologies and business models are challenging the traditional financial system. Digital platforms enable the supply of and demand for financial services to be matched much quicker. The use of digital instruments, such as distributed ledger technology, is changing value chains; automated securities trading is gaining ground.

With old structures becoming less rigid, a new opportunity is opening up for the financial centres on the European continent; they can pool their potential and work together as a single financial centre on the global market – not as a replica of the old systems, but in a new, forward-looking way.

The new digital technologies provide a whole host of ways to overcome the geographical distance between individual locations. Various (financial) locations can connect as if they were all in the same place, coming together to form an agglomeration. Real-time communication, distributed leger technology, platforms and co-working are just a few ways of reducing the importance of physical distance. Digital intermediation helps suppliers find customers, and vice versa. Just as value chains of services can today be forged across continents, the inner-European financial metropolises could work together. Regional markets could be merged on a European financial platform to create a networked economy. With time, it may even be possible to develop or at least maintain strong and stable personal relationships online.

The digital, decentralised market is definitely part of the future, and it is calling traditional financial centres into question. The European continent has an incredible opportunity to set up a technologically first-class, networked financial hub from scratch and to become a highly relevant global player. But what would this require? Let me briefly address five relevant issues.

First, specialisation and cooperation: The utmost challenge is for the financial centres in continental Europe to limit their own range of services, to find a specialisation and – at the same time – to cooperate online with other financial centres despite all the other competitors. However, political competition among financial centres is likely to stand in the way of this approach of specialisation and cooperation. Market-driven specialisation could help to create economies of scale and increase the potential for innovation which would, in turn, optimise cost structures and strengthen competitive positions. Complementary cooperation could ensure the necessary range and quality of the financial services provided decentrally. The principle of cooperation also requires a culture of openness towards other international financial centres and players – which is a prerequisite for successful global competition.

Second, digital infrastructure: Specialisation and cooperation require a digital infrastructure. The financial centres in continental Europe need to be digitally networked in such a way that enables the agglomeration effects I mentioned earlier to be generated.

For high frequency trading, a separate cable was installed in the Atlantic to connect London and New York. Nothing similar exists between Paris and Frankfurt.

But we will not be on an equal footing with other global financial centres until digital intermediation

on the continent matches supply and demand in a more effective way than traditional trade practices. We need to create digital hubs and platforms that are more effective than in the analogue world. This requires not only future-proof digital infrastructures but also a pooling of all parties' digital power of innovation, be it financial institutions, infrastructure providers, IT service providers or FinTech. This takes place already, as we could see in the recent past.

Third, a competitive legal framework: The principle of specialisation and cooperation as well as a high-performance digital infrastructure are only two components of a whole range of elements that a "digital finance hub of Europe" requires. In spite of all efforts aimed at harmonisation in the EU, in many areas continental Europe still does not have a joint, internationally applicable legal framework that can compete with English common law.

There are debates at the EU level as to whether the 28th regime could be used as an alternative to the traditional harmonisation of legal provisions. This refers to a private law which does not replace national legislation but provides an alternative at the European level, such as the legal form "European company" (Societas Europaea, SE) instead of a public limited company. The contractual parties can decide independently whether they want to apply such a law. This is of particular interest in areas in which complete harmonisation does not appear possible or is not easy to achieve. A 28th regime for business on a continental platform could be an option.

The aim of further harmonising the legal framework must be to ensure that there are no additional costs for cross-border transactions within the EU – either in a direct form, by means of taxes or fees, or in an indirect form, for instance by requiring legal advice.

Fourth, compatible IT structures: The merging of existing IT architectures with the least possible friction represents another challenge. This requires a high level of standardisation. Ideally, technical or administrative issues within the EU should not play any role in investment decisions.

Fifth, market forces have to take effect: Specialisation and cooperation, digital networking, a competitive legal framework, and compatible IT can help a digital city of Europe to grow. However, a project like this can only succeed if it is market driven. The market has to set the agenda.

Policymakers could assume the role of a catalyst, sitting the main players down at one table. In addition to market participants and representatives of financial centres, these could also be operators of market and IT infrastructures or consultancy firms. One key is to strengthen the links between the finance and IT industries – in the same way as has been seen in recent years for FinTech.

There are numerous challenges to overcome in this context. As profit-driven companies, market participants will naturally have different and, sometimes, clearly opposing individual interests, a varying degree of motivation and a variety of target coordinates. However, it is essential that inner-European competition is not seen as a zero-sum game where the win of one financial centre is a loss for another, but instead that all financial centres develop their potential together with everyone reaping the benefits.

5 Conclusion

Ladies and gentlemen

Let me conclude: It is clear from this initial outline that the digital city of Europe is a very ambitious project.

There is – of course – no guarantee for success. But I would like to cite an example from recent financial history which illustrates the power of technology on the financial markets: the "battle of the Bund". Maybe some of you can remember it. At the end of the 1990s, the Deutsche

Terminbörse – the forerunner for today's Eurex – succeeded in beating the London International Financial Futures and Options Exchange to win option trading for German Bunds, which is still important to this day. Years later, an English account of this episode from financial history states "... Frankfurt leapfrogged us with better technology". And it is just this type of "leapfrogging" that we need again now, in a team of continental European financial centres, on the digitalisation race track.

The effort will be worth it, also from the specific viewpoint of a central banker. Our viewpoint is made up of those targets – in addition to that of price stability – that we, along with the other Eurosystem central banks, are pursuing, notably safeguarding the stability of the financial system and promoting financial market integration. It is a great deal easier to do so if the majority of European financial market operations take place within our European jurisdiction. Yet that doesn't change the fact that open, globe-spanning capital flows and financial markets are still highly desired and necessary.

A self-assured digital city of Europe project requires the input of many stakeholders, all working together in a new direction. The Eurosystem and the Bundesbank may not by any means be at the fore but it can make recommendations and suggestions and help where possible to make the project a success. However, the stimulus has to come from policymakers and the markets.

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[1] The GFCI is published twice per year by Z/Yen Group in London, and the China Development Institute in Shenzhen since 2015.