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## SPECIAL REPORTS

### Magnets for money

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Illustration by Michelle Thompson



**Financial centres are booming, despite predictions that new technology would spell their doom. But competition is getting keener, says Julie Sell (interviewed here)**

THE late Middle Ages were a golden age for city-states. Merchant guilds created a network of them that dominated trading along the Baltic and North seas for centuries. Cities such as Lübeck, Hamburg and Bergen flourished in this early form of globalisation.

In time, the early 21st century may come to be seen as a golden era for a different sort of globalised city-state. Its protagonists are found in London's Mayfair, lower Manhattan and Hong Kong's central business district. Rather than loading ships, they spend their days (and many nights) in front of computer screens, moving zillions of dollars, pounds, euros and yen around the globe at the flick of a key.

Technology, some predicted, would end this sort of clustering in city centres. Why would financiers want to live and work in pricey, jam-packed urban jungles? Armed with broadband, mobile phones and BlackBerries, they could work from almost anywhere. Yet as this summer's market turmoil showed, a BlackBerry operated from a beach is not always enough. Besides, those urban jungles have their compensations. So rather than dying out, financial centres are proliferating.

Today's financial centres—the cities where big financial transactions are done and a dizzying array of financial products are traded—include not only long-established places such as New York, London and Tokyo, but also a growing number of newer financial hubs in Asia, the Middle East and beyond. As Dubai has shown, following in Singapore's earlier footsteps, a determined government can build an international financial centre from scratch.

Unlike the walled medieval city-states, today's financial centres are increasingly dependent on their connections to one another. Technology, the mobility of capital and the spread of deregulation around

the globe have created a vibrant and growing network. When one city is asleep, another is wide awake, so trading goes on round the clock. The number of transactions between financial centres has surged recently as investors have diversified across regions and asset types.

Yet interconnectedness has a cost. In an era of greater volatility, the latest market news spreads from one continent to another in an instant, as financiers have recently been reminded; and knock-on effects on things like bonuses and property prices soon follow.

New York and London have firmly established themselves at the top, but not even the biggest centres can afford to be complacent. New York, still number one in global financial terms by many measures (see chart 1), has recently acknowledged the competition it faces from other centres. London has surged on a wave of new money and talent, but needs to resolve problems of its own. Some cities that once aspired to global status have lost their edge, and new ones are starting up.

Michael Klein of Citigroup cites two big changes that have encouraged the proliferation of financial centres around the globe: the shift of economic activity and jobs towards China, India and other developing countries, and growing demand for natural resources from the Middle East, Russia and parts of Latin America. The resulting shift in liquidity is "one of the greatest transfers of economic activity and wealth in the past 100 years," says Mr Klein. With barriers to trade falling in many developing countries, the cost of capital has also fallen dramatically.

These changes have made governments in emerging countries more conscious of the benefits of a strong financial sector. More capital and more jobs are good for social and economic stability, so countries that used to rely for capital on banks, the rich or the state are allowing new capital providers into their markets. Money that used to be routed through the world's biggest hubs now often goes through non-traditional capital markets, or directly between emerging markets.

Although financial hubs have proliferated, few of them can claim to be truly global. Many members of the financial community feel that only New York City and London deserve this title. Both are one-stop shops for a full range of financial services. Any big financial organisation has to be represented there. From investment banking to insurance, stocks to derivatives, everything can be found in the world's two pre-eminent financial hubs.

What do they have that others don't? They score well on a package of key criteria that global financial firms are looking for: plenty of skilled people, ready access to capital, good infrastructure, attractive regulatory and tax environments and low levels of corruption. Location and the use of English, the language of global finance, are also important. Based on those measures, a survey by Z/Yen, a consultancy, picks London, New York and Hong Kong as the world's top three financial centres.

Finding and retaining good people has become an ever more important factor. Steven Kaplan and Joshua Rauh, a pair of economists at the University of Chicago, reckon that capital deployed per employee (the amount of money firms have invested divided by the number of staff) at the top 50 American securities firms surged from an average of \$136,000 in 1994 to \$1.79m in 2004. For many skilled professionals who can pick and choose their place of work, quality of life matters a lot.

Although New York and London are pre-eminent, other big cities play important international roles of their own. Some have prospered as the financial capitals of big national markets (Tokyo and Sydney) or the gateways to emerging regions (Hong Kong, Singapore and Dubai). Others have found success in



niches. These include Geneva (private banking), Zurich and Bermuda (insurance and reinsurance), Chicago (futures and options), Qatar (infrastructure finance) and Bahrain (Islamic finance). Yet many of these, too, are trying to diversify.

Governments are paying more attention than ever to wooing and keeping financial firms because of the benefits they bring with them, such as highly paid jobs, large tax revenues and international connections. In New York and Hong Kong the financial sector accounts for more than one-third of total city tax revenues. In smaller centres it often makes up a large chunk of total employment.

Aside from the political and economic gains to the host countries, economists and investment bankers point to two wider benefits from having a range of financial centres around the world. One is the increase in overall liquidity as new countries and regions become integrated into the global financial system. The second is increased efficiency as competition between centres drives down the cost of trading and other financial transactions. New and developing financial centres are knocking down protectionist barriers and emulating the regulatory practices of the more established hubs.

## **Making connections**

The city-states that dominate today's financial world are connected not only by mobile capital and people, but increasingly by exchanges too. Exchanges have traditionally been at the heart of important financial cities. They grew up serving mainly national markets, but have changed fundamentally in recent years. A growing number are now publicly owned, which has forced them to shed their clubby ways and compete more openly.

Now they are teaming up across national borders. The first ever transatlantic merger between exchanges took place earlier this year when the New York Stock Exchange bought Euronext, a pan-European exchange group. The deal is being closely watched as a precursor to further cross-border consolidation. The London Stock Exchange is merging with Borsa Italiana, Italy's main market. Deutsche Börse is teaming up with the International Securities Exchange in New York. The big exchanges in Western countries are linking up with counterparts farther east as well, from the Dubai Mercantile Exchange to the Tokyo Stock Exchange.

This consolidation raises questions about the future relationship between exchanges and global financial centres. Exchange listing fees and affiliated services are a big source of income for host cities. Exchanges are also seen as important political prizes. But the rapid growth in cross-border trading has made life more difficult for national regulators.

This special report will examine the factors that create and sustain global financial centres and explain why physical financial hubs—teeming with banks and exchanges but also with legal, accountancy and public-relations firms and consultancies—continue to matter so much. It will also consider what their rise means for the global financial system, and how it is changing the cities that are home to these clusters.