

Robert Triffin International



THE CHANGING GEOGRAPHY OF FINANCE SHIFTING FINANCIAL FLOWS AND NEW HUBS: SHANGHAI AND PARIS?

March 2018



CENTRO STUDI SUL FEDERALISMO



A watch on the international financial and monetary system

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Foreword

Robert Triffin International (RTI) supported the Palais Royal Initiative on the reform of the international monetary system, promoted by Tommaso Padoa-Schioppa, Michel Camdessus and Alexander Lamfalussy. It continued to pursue this aim through international conferences, leading to the production of the report *Using the SDR as a Lever to Reform the International Monetary System*. The achievement of its first objective, the entry of the renminbi into the SDR basket, encouraged the RTI to continue its research on the idea that a multi-currency monetary system, which resulted with the entrance on the scene – alongside the dollar – of the euro and now of the renminbi, needs an anchor and that this can be provided, in the first place, by the SDR. Six SDR Notes and two Research Papers have been published on the topic:

- ▶ the first on the importance of the success of the ECU for the creation of the euro, with an official and a private market side by side. The SDR is a world basket, for which the study of the European case can be useful without underestimating significant differences;
- ▶ the second on the distortions that the dollar price exerts on the price of oil and wheat, due to the intention of exporters to defend their real value and the consequent financialisation of commodities, in particular through the futures markets.

The RTI then illustrated in Moscow, during a meeting of the Eurasian Economic Union, an application of the latter to the case of Russian exports.

This new research by Professor Miriam Campanella is focused on the rise of the East Asian financial market and the affirmation of Shanghai as a new global financial centre.

A profound difference characterises this new phase of world finance: for the first time, financial flows tend to concentrate in new areas, especially in Asia, and for the most part they no longer flow into historic financial centres like London.

It confirms the decisive importance of the hinterland for the lasting affirmation of financial centres. Therefore New York, which has the United States' real economy behind it, appears to be more stable than London, which has instead unexpectedly renounced its hinterland, constituted by the European Union. With the Chinese economy regaining the weight in the world economy that it had before the industrial revolution, Shanghai has become the first financial centre of East Asia, supplanting Hong Kong. The latter seems destined to be surpassed even by Singapore, which can point to Asia's financial services leadership, which includes countries like Malaysia and Indonesia and that is even moving towards a banking union. Singapore also depends on its own real economy in the most advanced technology sectors, which Hong Kong lacks.

For this reason, while centres such as New York, Shanghai and Singapore can count on markets of at least continental size, and on the issuing of financial instruments in local currency, London and Hong Kong appear destined to fall back on an offshore role, sustained in the short term by de-regulation, but without the real, solid foundations on which stand centres destined to have a future. In the current phase of globalisation, interdependence is maximised at the continental level, the centres of gravity – real financial hubs – multiply, and the function of off-shore hubs is precarious.

The research, even if it is not focused on Europe, begins to identify some post-Brexit perspectives that can be explored. It indicates four competitors (Frankfurt, Paris, Amsterdam and Dublin) and two

winners (Frankfurt and Paris). Therefore, there is only one winner, the European Union, which, under Michel Barnier's guidance, is leading the separation negotiations with intelligence and speed. The biggest battle is over the Clearing Houses that generate the bulk of profits earned by the City of London on the euro market.

The RTI intends to further examine the possible development of European financial centres, in the post-Brexit period, using a virtually unexplored perspective, that of specialisation. Edinburgh compared to London, or Boston compared to New York, are examples of successful specialisations in the management of long-term "patient savings". From this perspective, the superiority of Frankfurt in insurance and of Paris in the banking sector may suggest the direction of research, with ideas useful for other vocations that may concern, in addition to Dublin and Amsterdam, other cities such as Turin and Milan.

Elena Flor
Secretary General, Robert Triffin International

THE CHANGING GEOGRAPHY OF FINANCE

SHIFTING FINANCIAL FLOWS
AND NEW HUBS: SHANGHAI AND PARIS?

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Executive Summary¹

Miriam L. Campanella

Ten years after the global financial crisis, the recovery of the global economy remains bumpy and uncertain. Global trade, a major driver of globalisation, no longer appears to be growing faster than the world economy, opening questions over if it has passed its peak, or just is going through a cycle, perhaps associated with weak investment and weak commodity prices. In parallel, cross-border capital flows, one major indicator of financial globalisation, have substantially declined from the pre-crisis peak at 65 percent lower in absolute terms than they were in 2007. Even assuming that trade and financial globalisation have passed these twin peaks, does this mean that a de-globalisation trend is fully in place? The gyrations of capital flows during and after the recent financial crisis have declined somewhat, as shown by the weakening of uphill flows of capital to US Treasury bonds. Financial flows to emerging economies have stabilised, and reserve managers in central banks are taking a few credit risks compared to the usual “flight to quality”, as the economy emerges from a structural reduction in US Treasury bonds. These themes are reflected in the new geography of capital markets, which is beginning to see new large continent-sized jurisdictions taking centre stage. The purpose of this Report is to provide, through an overview of the structural factors that are shaping the new geography of finance, the rationales behind the emergence of Financial Hubs in Asia-China and Europe.

► **Chapter 1** addresses the gyrations of capital flows during and after the recent financial crisis. These themes are critical of the geographical dynamics of capital markets from developed economies to emerging ones, and are especially relevant to the growth of East-Asia capital markets. In the wake of the crisis the uphill flow of capital to US Treasury bonds was largely from the build-up of emerging market reserves. Though, in the aftermath of the crisis a new trend emerged, a downhill capital flow, explained by a turn of central bank reserves’ managers to taking a little credit risk rather than the usual “flight to quality”. The trend’s metrics are relevant, and are observed as a structurally reduced demand for US Treasuries.

In the current low interest rate environment Sovereign Investors need higher interest rates for long-term investments, so nearly half of Sovereign Investors’ assets are located in emerging economies. In the decade since the Global Financial Crisis, more than US\$200bn has been raised by investment funds to deploy long-term capital into infrastructure, and at least the same amount has been allocated to infrastructure by organisations seeking to invest directly rather than through investment funds.

East-Asia has largely benefitted from this downhill trend. The region has received net FDI inflows, remaining largely on the upswing in recent years, with several factors keeping investors interested in the region: big-ticket infrastructure projects, the resilience of domestic demand, the aggressive drive of some governments to develop industries related to information technology and e-commerce through investment incentives. The region’s deeper regional financial integration, even stronger in the post-2008 crisis period, growth of GDP between 6 to 7 per cent in 2017 in real terms, and an infrastructure investment gap estimated in the range of about \$8 trillion, all attract investment funds, as fiscal spending alone would not be sufficient to address the funding gap.

¹ The author would like to thank Elena Flor, Alfonso Iozzo, James Laurenceson, Antonio Mosconi, Jessie P.H. Poon, Thomas Rixen, Sebastian Schipper, Jun J. Woo for discussing previous drafts, and introducing me to the dazzling and elusive world of Financial Centers. All errors remain mine.

► **Chapter 2** deals with the rapid growth of Local Currency Bond Markets (LCBMs). Motivated by the 1997-98 Asian financial crisis, LCBMs have helped diversify the sources of corporate financing in the region, for infrastructure and urban development, as robust local capital markets are essential to diversify the sources of funding necessary to support long-term investments and sustain emerging Asia's high growth rate. This intra-regional trend has also been enhanced, and secured against contagion risks, through a regional banking integration framework, which, according to ASEAN member governments, is designed to allow banks qualified in one member jurisdiction to operate freely in others.

► **Chapter 3** maps the thick intra-regional banking system, and the active intermediation deployed by Hong Kong and Singapore, the region's Financial Hubs, that has helped Asia economies to fare better than other emerging regions in the recent financial crisis, and perhaps even to grow stronger compared to developed countries.

We identify a fully-fledged Asian Financial Triad, comprising: Emerging Asia's increasing integration into global capital markets, driven by FDI and portfolio investments; the growing size of LCGB markets; and the thick networking of intra-regional banks. Although we identify inadequacies that still remain in the institutional setting, and financial openness, to allow these to compete with the depth and breadth of Western economies. The real story at this juncture is China and, to a lesser degree, India. China, from a total market capitalisation of US\$418 billion in 2003 (or US\$200 billion less than Apple's total market cap today), has grown by an incredible 1,479 percent to US\$6.6 trillion, and in just 13 years, has passed every country in Europe and Japan for total market capitalisation. Today, China's stock markets are worth more than those of France, Germany, and Switzerland – combined.

► **Chapter 4** tackles a critical theme of financial development in emerging economies, which is especially relevant in Asia as it is closer than other emerging areas, to thus benefit from financial deepening. With its successful economic performance, large saving pot, and developed banking system, China is pivotal to financial deepening. Yet, financial reforms that will favor the Region's financial integration and scope are still piecemeal and ongoing. Indeed, China has plans to accelerate a much-needed financial liberalisation, loosening capital account restrictions, and a marked valued RMB; if truly effected, these measures will help savers find more outlets abroad and allow foreign investors to diversify more effectively by buying Chinese assets.

These measures are likely to fall into place as a consequence of China's determination to foster the country's Financial Centres, an indispensable and strategic objective that would be instrumental to China's financial deepening, and appropriate to its pursuit of outward financial projection. The trend, driven particularly by the central Administration, has boosted the plans and the ambitions of established centres like Beijing, Shanghai, and of fresh ones, such as Shenzhen and Chengdu, and recently of the fintech hub in the Xiongan New Area, southwest of Beijing. This move is spurring an intense intra-regional competition, and sees the evolution of specialised financial niches, and international primer centres, with Shanghai expected to be the stage for the "International Financial Window" of China.

Several economics studies uphold that proximity to the nearest IFC is positively associated with foreign investment, and that the increasing demand for financial intermediation will be better provided by financial centers within the region. These findings are persuading several Asian governments to establish new financial centers within their nations, as in the case of the Malaysia International Financial Centre in Kuala Lumpur, and the International Centre in Jakarta.

► **Chapter 5** explores some effects of the UK's withdrawal from the EU, and the relocation of financial services to Mainland Europe. The beauty contest that is developing in Asia, and more so in China, shows distinctive elements, which are delivering brand-new financial centres not only in Asia, also in Europe.

The relocation of the financial activities to the Mainland, and the emergence of new financial hubs, has again focused public attention on the financial industry, and occasioned a deeper examination of what Financial Centres, entrenched in Mainland Europe, should look like. Currently, the focus overemphasises the ways the City of London is likely to manage its withdrawal from the EU. Instead, what is more relevant, is whether the London "global" model is a successful model for Mainland's financial centres.

The process of the relocation of the financial industry from London to Mainland Europe uncovers some of the downsides of the City of London, and raises reservations over its suitability for the Mainland economy; notably the continental scale, so different from a nation-size economy. Continental jurisdictions, as in the case of Europe, China, or the USA, cannot sustain their economies on the basis of the activities of the financial sector alone, but also have to defend the financial sector's interactions with the real economy, extending right down to tax rate regimes, and financial regulations. Nation-size economies may just about tolerate low taxes, and light financial regulations, as in the case of the UK and the City of London. However, large continental-size economies would be exposed to indulgent fiscal regimes and almost self-regulatory finance, to inadequate tax revenues, and may suffer from very low financial regulatory standards vis-à-vis the size of foreign financial activity that IFCs would, unsurprisingly, attract.

From these very distinctive features comes the need to craft European Financial Centres in relation with the Region's economic hinterland, and make them appropriate to the mechanisms through which capital markets could help to achieve these objectives, for example by better matching savers and borrowers, improving private-sector risk sharing, and identifying potential reform areas. In doing so, the implications of greater financial diversification and integration for relocating financial industry within the Eurozone are of outmost relevance to the single currency, and the deepening of European capital markets integration. Equipped by distinct and interrelated functions, Paris and Frankfurt are prepared, with their mass and diverse capabilities, to play primary roles in the second largest economy of the world. As for Frankfurt, hosting the ECB, and an increasing number of regulatory agencies, leverages these advantages and adds not only to its ambition, even more so as it will serve as the EU primary regulatory and surveillance centre.

In Paris, the banking sector, with six French banks among the Global Systemically Important Banks (G-SIBs), is one of France's main economic assets, and the location of EU institutions will make Paris the backbone of Europlace. Fittingly, two relevant agencies are (to be) located in Paris. The European Banking Authority, exercising regulatory powers over the whole European banking system, will soon leave London and be relocated to Paris, close to largest systematically relevant banks. The European Securities and Markets Authority is based in Paris, close to Euronext, the leading pan-European exchange in the Eurozone, tasked with acting in innovative financial markets and in Europe's international financial projection.

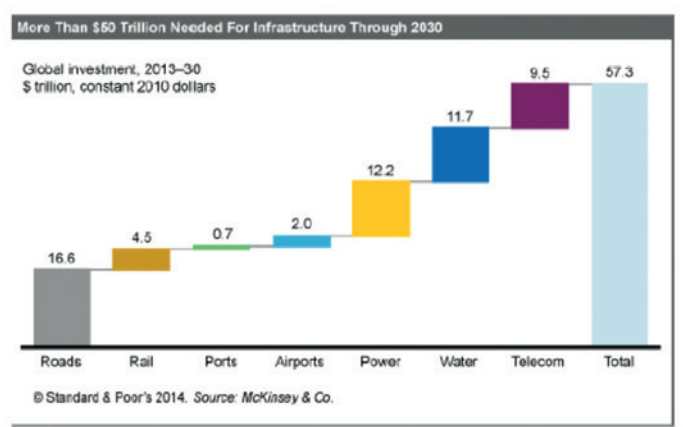
1. Asia's Capital Markets: Matching Needs to Deeds

“From the aqueducts of ancient Rome to the 47,000-mile interstate highway system in the U.S., to the breath-taking bridges, sweeping power projects, and futuristic architecture of 21st-century China, infrastructure has long been a central component of economic and human progress. Historically, funding for these projects has been the domain of governments-emperors, central planners, and legislative bodies. Although this is still the case, the public resources needed for new construction, or to repair existing infrastructure, are now under sustained downward pressure” (S&P 2014).

The objective of this Chapter is to identify the sources and resilience of Asia's capital markets, as factors of infrastructure finance and economic growth in the Asia Pacific region.

An estimated \$57 trillion will be needed to finance infrastructure development around the world by 2030, according to a report from consultant McKinsey & Co. (Chart 1). Standard & Poor's Ratings Services believes this presents institutional investors with an unprecedented opportunity to fill some of the huge gap created by public-funding shortfalls.

Chart 1. Global Infrastructure Gap 2013-2030



In developing and transition economies, government provides around 70% of infrastructure, mostly in the form of public goods (IMF 2015). Most infrastructure is financed by government: this is increasingly difficult to sustain in the medium term with global economies expected to converge on an average 3% GDP in 2020, which is insufficient to make progress, given the shortfall in investment that has accrued over the past decade (S&P2014). For developing countries, the problem is exacerbated by changes to prudential rules that are being introduced in the banking system over the period to 2019 (Basel III). The changes apply new liquidity and capital adequacy requirements that limit the capacity of the banks to provide limited recourse and long-term loans (Regan 2017: 3).

Asia faces very large demands for funding its infrastructure development: about \$800 billion a year during 2010–2020. Asia has large savings, significant international reserves and rapid accumulations of funds that can be used to meet these infrastructure investment needs. Infrastructure funding can be facilitated by building effective capital markets, but often must also be supplemented by public invest-

ment initiatives and guarantees to promote the desired types of infrastructure investment. This requires efficient and stable financial markets that provide investment signals promoting the most productive use of capital for infrastructure (Biswa Nath Bhattacharyay 2015: 354-356).

In emerging economies, strong and resilient capital markets can find it particularly difficult to thrive, given the high volatility of capital flows; these economies may experience periods of rapid growth and subsequent contraction. Increased capital inflows can lead to credit booms and the inflation of asset prices, which may be offset by losses due to depreciation of the currency based on exchange rates and declines in equity pricing. The economics literature identifies two critical global drivers of capital flows to emerging economies; global push, generated from the monetary policies of advanced economies (Forbes and Warnock, 2012; Miranda-Agrippino and Rey, 2015), and local, or pull factors, seen in recipient countries output growth, sovereign credit risk, and the degree of capital account openness.

Since the 1970s, EMEs have experienced large and wild capital flows, linked to considerable effects on national currencies valuation, and on financial stability. In several episodes extreme financial volatility has been principally linked to push factors, triggered by the dollar's exchange rate, and the flight to advanced economies.

In a competing explanation of the volatility capital flows in EMEs, Fratzscher suggests "pull" factors, as "real [economy] divergences between EMs and advanced economies" (2011) should be identified as the main driver of the current pattern of post-crisis capital flows.

Push-pull dynamics have taken centre place in the debate over the cause and responsibilities of the Great Financial Crisis, reviving policymakers' concerns over the upshots of financial volatility in developed economies, and especially in EMEs. Push factors have fired up a blame game in international fora such as the G20, which is considering a code of conduct for capital flow management, including the imposition of capital controls to deal with volatility. The empirical evidence reported in a study (Sarno et al. 2014) essentially confirms public perceptions that forces related to financial globalisation are the primary determinants of international portfolio flows. Therefore, countries exposure to global (rather than domestic) risks appear to be more important in informing the domestic policy response to time-varying international portfolio flows (2015: 24-25).

In a more nuanced view, Fratzscher (2011) indicates that push, or common factors, were more important overall as a driver of net capital flows for many countries during the 2007-08 financial crisis. In the recovery period since March 2009, common factors appeared to have become less important as drivers of global capital flows, whereas it is domestic pull factors that have generated capital flows, in particular for countries in Emerging Asia and Latin America.

In a review of 40 studies over push and pull factors from 1996 to 2014, Koepke (2015) sees different drivers of capital flows, varying across different kinds of capital flows. While quite robust evidence gives weight to the role of external, or "push" factors, like U.S. interest rates and global risk aversion for portfolio flows, these factors have a reduced impact on FDI. Instead, shocks generated domestically, or "pull" factors, like economic growth and country risk are most important for banking flows (2015: 22-25).

This debate is still critical in the current transition to a more normal monetary policy. As the cycle of capital flows to EMEs that followed the implementation of QE in advanced economies nears the end, volatility could again resume in EMEs, triggered by the US Federal Reserve lifting the monetary rate, and the US Treasury increasing interest rates.

Against this backdrop questions arise over the sustainability of Asia's economic growth as the reduction of net capital inflows might generate a "quantitative tightening", which would quash expectations on the shift of the gravity axis to East, at a time of uncertain trade deals.

Push factors in EMEs

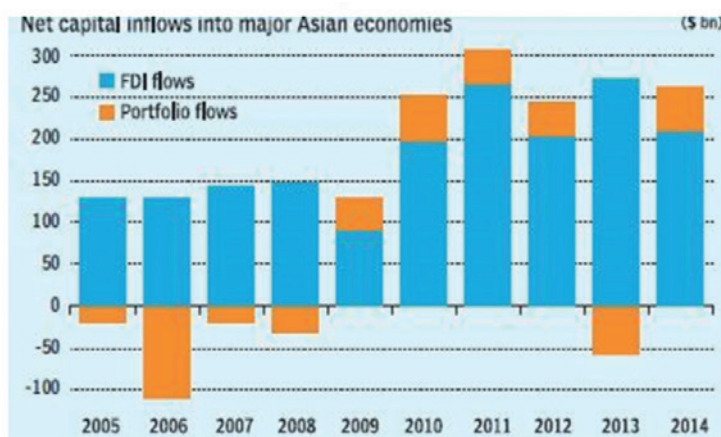
1. Some studies maintain that improvements in the internal situation in EMEs over the past decade could fend off major financial risks: including stronger policy frameworks with more flexible exchange rate regimes, a better anchoring of inflation, higher levels of foreign reserves (IMF, 2016) and the ability of macroeconomic stabilisation policies and prudential measures.
2. Others warn that the growing importance of the global financial cycle resulting from global financial integration could crash country's shield against financial turmoil, with sudden stops in capital inflows (Rey, 2013; Eichengreen and Gupta, 2016).

And Asia?

A clue on how the new financial cycle is likely to play out in Asia comes from studying two episodes of large capital inflows in Asia. Balakrishnan et al. (2012) find that Asia has received net inflows notwithstanding abrupt stops which occurred during the 1997-98 financial crisis, and at the start of GFC 2008. An examination of the resumption of inflows shows some interesting features:

1. The speed of the recovery in the episodes has accelerated. Within just five quarters since the halt of 2009, net inflows rose from a recent trough (in early 2009) to the peak (in mid-2010). In contrast, the length between the lows and peaks was about 25 quarters (more than 6 years) during the pre-Asian crisis period and the period before the crisis.
2. Major Asian economies, China, Hong Kong SAR, India, Indonesia, Malaysia, Philippines, Singapore, South Korea and Thailand, enjoyed net capital flows - based on the IMF balance of payments database (Chandrasekhar, Ghosh 2016).
3. A further peculiar feature of milder and less volatile capital flows, which has been evident for all emerging market economies but especially in Asia, is the accumulation of a large amount of foreign exchange reserves, the upshot of current account surpluses, which have shielded emerging economies foreign exchange against shocks originating from monetary policy in advanced economies.

Chart 2. Net Capital Inflows to Asia



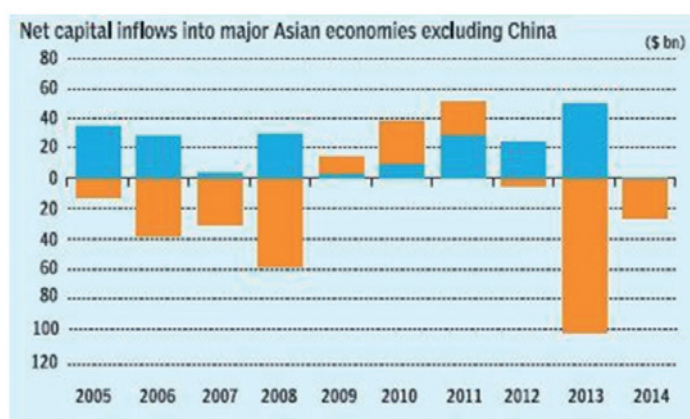
(Source: Chandrasekhar, Ghosh 2016)

The above factors played in more than ten years from 2005, and in the aftermath of the ending of the Fed's use of unconventional monetary policies as shock-absorbers. "Net capital inflows into these countries stayed positive", while "portfolio inflows were far more volatile and negative for particular years, notably 2006 and

2013, when the ‘taper tantrum’ occurred”. For Chandrasekhar and Ghosh this “confirms the perception that FDI flows tend to be more stable and long-term in orientation than portfolio flows” (2016). What is really noteworthy in Chart 2, as they assert, “is that many of these capital flows have been directed to China” (Ibid.), and then the pattern of capital movement across the region in general was largely driven by China.

In Chart 3 the same data for this set of countries, but excluding China, shows a different trend. So, they conclude, “[once] China is excluded, we find that net capital inflows into these countries were more often than not negative over this period, incidentally despite very large gross inflows for certain countries in particular years” (Chandrasekhar, Ghosh 2016).

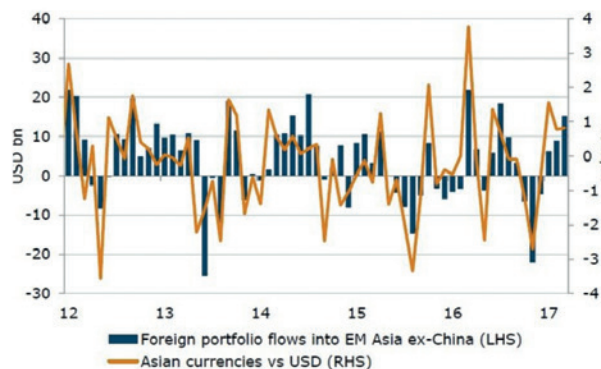
Chart 3. China Impact



(Source: Chandrasekhar, Ghosh 2016)

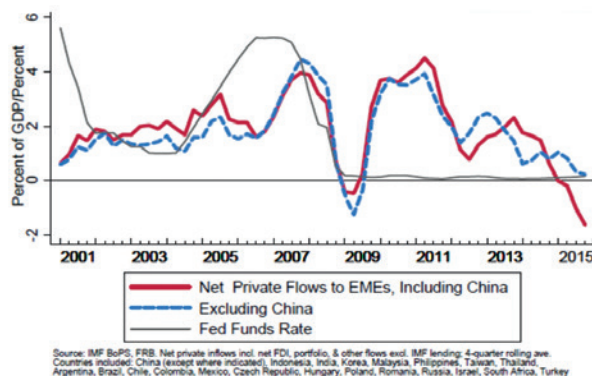
By narrowing the focus on the last few years, there is evidence of a renewed dynamism of capital inflows in Emerging Economies, especially in Asia, where capital inflows have in net terms prevailed, establishing an inflow trend touching on different sectors. In 2015, nearly a third of the record setting \$1.76 trillion in global foreign direct investment (FDI) flowed into Asia (ADB 2016; Bank of Japan 2016). In 2017, The Institute of International Finance highlights some USD 100 billion of portfolio inflows in the first quarter, and expects flows to increase from USD 174 billion in 2016 to USD243 billion in 2017 (IIF 2017). Inflows are expected to break the USD1 trillion mark in 2018.

According to a research by ANZ, continued weakness in the US dollar against currencies in the region was probably a contributing factor to the pickup in capital flows to the region, with record capital inflows to the region rising to US dollar 15.3 billion in March 2017, the largest one-month increase since the middle of last year (Scutt, 2017).

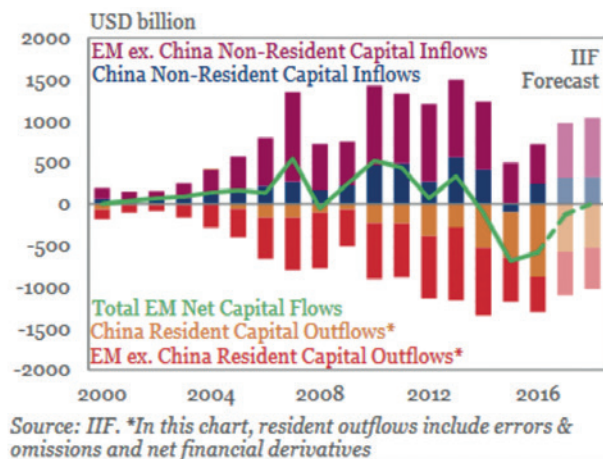
Chart 4. Foreign Portfolio flows into EM Asia versus Asian currencies

(Source: Business Insider 2017)

Larger, and stable capital inflows, especially in portfolio investment, signal Asia financial resilience to external shocks. In 2013 Taper Tantrum and Federal Reserve's exit of QE, have only marginally affected the region's economies.

Chart 5. Net Private flows to EMEs

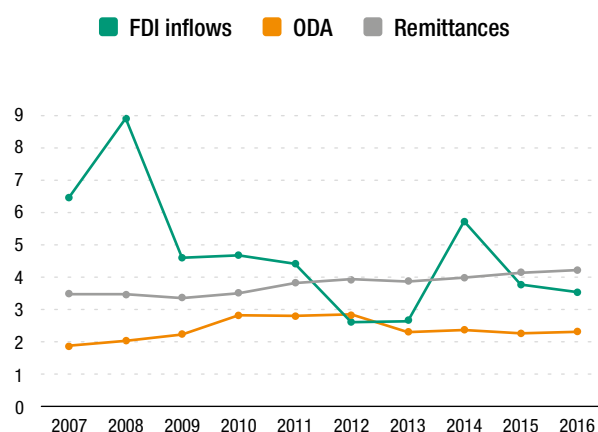
(Source: Clark 2016: 3)

Chart 6. Capital Flows to Emerging Markets

(Source : IIF 2017)

Yet, the both the continuation, and the composition of capital inflows should be taken into account when assessing their costs and benefits. Global external financial flows to developing economies were estimated at \$1.4 trillion in 2016, down from more than \$2 trillion in 2010. FDI remains the largest, and one of the least volatile, of all external financial flows to developing countries.

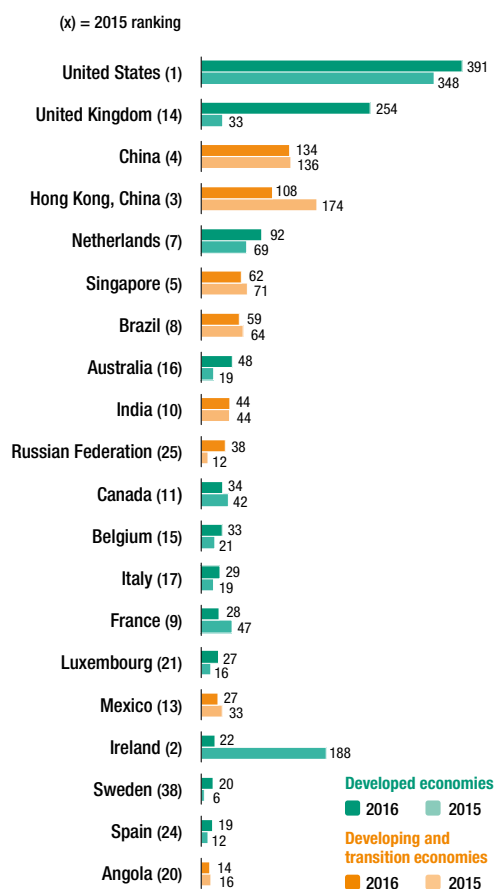
Chart 7. External sources of finance for developing economies, 2007-2016 (billions of dollars)



Source: ©UNCTAD, based on FDI/MNE database (www.unctad.org/fdistatistics) (for FDI inflows), OECD (for ODA) and the World Bank (for remittances).

(Source: UNCTAD World Investment Report 2017)

Prospects for FDI to developing economies for 2017-2019 are moderately positive in most regions, with developing economies as a group expected to gain about 10 per cent, with a sizeable increase in developing Asia, which shows an improved outlook in major economies. Investor confidence is less positive towards Latin America and the Caribbean, due to persistent macroeconomic and policy uncertainties. Here investment flows are expected to fall by about 10 per cent, to some \$130 billion (Chart 8).

Chart 8. FDI inflows, top 20 host economies, 2015 and 2016 (billions of dollars)

Source: ©UNCTAD, FDI/MNE database (www.unctad.org/fdistatistics).

(Source: UNCTAD World Investment Report 2017)

With China and India the top prospective FDI destinations, Asia comes second only to the USA as a major FDI recipient area. Here, investors maintain their confidence in Asia's developing economic performance and predict increased investments in South-East Asia, with Indonesia, Thailand, the Philippines, Vietnam and Singapore, in that order, all improving their ranking among the most promising host countries.

Wrapping up

Discerning the sources and the pattern of capital flows to emerging economies, the author underlined a factor that has substantially changed from the previous uncontrolled, back and forth pattern into a more stable trend. In emerging Asia capital flows show signs of a further positive feature, in that steady inflows in portfolio investments and FDI outweigh outflows, so that the region's economies benefit from a net gain. As capital flows becomes less push-driven, and thus less contingent on the gyrations of monetary policy of the US Federal Reserve, and more pull-driven, country-specific fundamentals are more likely to influence investors decisions, rather than short-term speculative motivations.

In addition, FDIs frequently involve more than just a capital investment; in common with FDIs made in open and developed economies, these may contain provisions of management or technology, which upgrade the recipient economy. So steady capital inflows, especially of the FDI kind, support one of the basic components of Asia financial markets and its potential for infrastructure financing.

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2. Asian Local Currency Government Bond Markets, and the China-Hong-Kong Bond Connect

Institutional Background

In response to the 1997-98 financial crisis, Asian governments actively undertook initiatives to promote local currency bond finance through the initial Asia Bond Market Initiative (ABMI) and through the Asian Bond Funds 1 and 2 (ABF1 and ABF2). The increase in local currency issuance since 2008 indicates that local corporate bond markets can indeed play an important “spare tyre” role. In 2002, the Federal Reserve Chairman Alan Greenspan suggested that better functioning capital markets in the late 1990s might have provided the Asian countries with a “spare tyre” in terms of an alternative source of financing and might have made the 1997-1998 Asian financial crisis more benign (Greenspan 2000 quoted in Chan et al. 2011).

The crisis of 2008-2009 lends support to that idea. During the recent crisis, as fund raising in the global corporate bond markets became difficult, Asian corporations turned to the local corporate bond markets to raise funds, and they were able to do so in large quantities. Although by 2007 local currency issuance by large Asian corporations had already started to exceed foreign currency issuance, the crisis of 2008-2009 accelerated this shift.

The Asian Bond Fund was structured by the Bank for International Settlements (BIS), and its portfolio was invested in a basket of liquid US dollar bonds of major Asian economies (excluding Australia, Japan and New Zealand) with an initial size of approximately USD 1 billion.

At the time of its setting up, BIS General Manager Malcolm Knight said that

“The Asian Bond Fund is a significant step in fostering regional cooperation in Asia. It will facilitate the re-investment of a small portion of Asia’s reserves back into the region while at the same time aiding the development of regional capital markets. We are delighted to be working with the EMEAP group of central banks on this important initiative. It also marks a major development in the activities of the BIS in the region” (BIS 2003).

Since then BIS has managed fixed income portfolios for central banks for many years and the ABF mandate is a natural addition to its already significant business in Asia. In addition to its market development and cooperative aims, the ABF offers its investors an appropriate means of diversifying away from more traditional reserve assets. The Bank’s investment management unit, BIS Asset Management, manages the ABF with teams based in its Representative Office for Asia and the Pacific and in the BIS head office.

2.1 Asian Local Currency Government Bond Markets²: a paradigm for EMEs

The outmost important objective – that Finance Ministers agreed to promote the Asian Bond Markets Initiative (ABMI) to develop the bond market in the region – was to develop efficient and liquid

² LCGBM

bond markets so that savings in the region can be better utilised for investments. The ABMI would also contribute to reduce the risk of maturity and currency mismatches (“double mismatch”) in financing. In brief, the Initiative aimed to develop efficient and liquid bond markets in Asia, which would enable better utilisation of Asian savings for Asian investments.

The potential roles and challenges of the LCGBM initiatives identified the sectors where the 1997-98 had hit mostly – risks of sudden capital outflows, implementation of monetary policy, emerged again in the course of the global financial crisis. Yet, this time ASEAN countries plus three (PRC, Republic of Korea, and Vietnam) were better equipped to avoid the consequences of previous episodes.

At the Cannes Summit in 2011, the G20 saw Asian LCGBMs as a paradigm for other EMEs to follow, to cope with the turbulent macroeconomic and financial context left by the crisis. The G20 launched an action plan for EMEs to develop LCGBM aimed at enabling governments to fund public in local currency, to avoid risks associated with foreign currency funding. The role of LCGBM in public funding is also associated with a further deepening of EMEs financial markets, as it provides several benefits:

- ▶ it increases a country’s ability to withstand volatile capital flows,
- ▶ it reduces the reliance on foreign borrowing and the risks linked to currency mismatch,
- ▶ it contributes to the reduction of current account imbalances,
- ▶ it mitigates the need for large precautionary reserve holdings, and
- ▶ it allows balance sheets to adjust more smoothly, therefore improving the capacity of macroeconomic policies to respond to shocks.

Table 1. Size of Asian LCBM

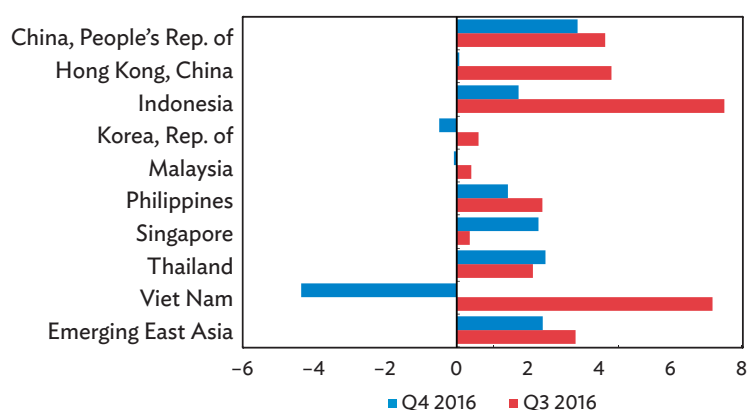
Economy	as of Dec 2015			as of Dec 2005			as of Dec 1995 ^a		
	Government	Corporate	Total	Government	Corporate	Total	Government	Corporate	Total
US	18,901.7	21,019.4	39,921.1	9,801.2	16,629.1	26,430.3	5,499.4	6,102.9	11,602.3
JPN	8,274.0	656.0	8,930.0	6,301.6	743.7	7,045.3	2,763.5	1,093.6	3,857.1
Emerging									
Asia	6,431.5	3,796.5	10,228.0	1,886.4	681.9	2,568.3	244.2	36.5	280.6
PRC	4,067.0	2,083.0	6,150.0	835.2	64.5	899.6	57.7	0.0	57.7

(Source ADB 2016)

The total outstanding as a share of gross domestic product (GDP) increased to 62.9% at the end of 2015, from 50.2% in 2005. The Republic of Korea posted the highest bonds-to-GDP share, at 129.6%, followed by Malaysia (96.7%), Singapore (77.7%), and Thailand (74%). However, along with their smaller market sizes, local currency corporate bonds have generally shallower market depth than government bonds. The average depth of emerging Asia’s corporate bond markets is 23.3% of GDP. The Republic of Korea has the deepest market at 76.9% of GDP and it alone has a depth above 50%. The shallowest three corporate bond markets are Indonesia (2.2%), the Philippines (6.1%), and Vietnam (0.7%).

In full operation since 2003, almost a decade before the G20 Action Plan, Asian LCGBMs have reached 10 trillion US dollar total market capitalisation, and comprise more than 60% of the underlying gross domestic product (GDP) of the ASEAN plus 3 economies, which is 18 times larger than the pre-crisis level.

**Chart 1. Growth of Local Currency Bond Markets
in the Third and Fourth Quarters of 2016 (q-o-q, %)**



q-o-q = quarter-on-quarter, Q3 = third quarter, Q4 = fourth quarter.

Notes:

1. Calculated using data from national sources.
2. Growth rates are calculated from local currency base and do not include currency effects.
3. Emerging East Asia growth figures are based on 31 December 2016 currency exchange rates and do not include currency effects.
4. For Singapore, corporate bonds outstanding data based on *AsianBondsOnline* estimates.

Sources: People's Republic of China (*ChinaBond* and *Wind Information*); Hong Kong, China (Hong Kong Monetary Authority); Indonesia (Bank Indonesia; Directorate General of Budget Financing and Risk Management, Ministry of Finance; and Indonesia Stock Exchange); Republic of Korea (*EDAILY BondWeb* and the Bank of Korea); Malaysia (Bank Negara Malaysia); Philippines (Bureau of the Treasury and Bloomberg LP); Singapore (Monetary Authority of Singapore, Singapore Government Securities, and Bloomberg LP); Thailand (Bank of Thailand); and Viet Nam (Bloomberg LP and Vietnam Bond Market Association).

(Source: Asian Bond Monitor March 2017)

The region's LCY bond market remains dominated by government bonds, which totalled USD7.2 trillion and accounted for 65.9% of the regional LCY bond market at the end of June. The outstanding amount of LCY corporate bonds reached USD3.7 trillion at the end of June with a share of 35.4 percent at the end of 2016. China accounts for the lion's share of corporate bonds in emerging East Asia, comprising 59.8% of the region's total outstanding stock of corporate bonds, followed by the Republic of Korea at 28.0%. In a recent analysis the IMF indicates that China's issuance of local renminbi bonds has contributed to an increasing share of local currency bond issuance across emerging markets since the global financial crisis, despite a substantial increase in foreign currency issuance in countries like Indonesia (IMF 2015).

As a share of GDP, emerging East Asia's LCY bond market was the equivalent of 68.5% at the end of December, down from 69.2% in the previous quarter (Table 2). The decline was due to much weaker growth in the corporate bond market. Corporate bonds as a share of GDP fell to 24.3% in Q4 2016 from 25.0% in Q3 2016, while the share of government bonds to GDP was broadly unchanged at 44.2%. The Republic of Korea was a significant driver of the decline. Despite this, it maintained its position as the market with the largest share of bonds to GDP at 117.3% in Q4 2016, although this was down from 129.1% in the previous quarter, stemming from a decline in the share of corporate bond to GDP from 75.9% in Q3 2016 to 69.2% in Q4 2016. Malaysia's LCY bond market as a share of GDP was the second largest in the region.

Table 2. Size and Composition of Local Currency Bond Markets (% of GDP)

	Q4 2015	Q3 2016	Q4 2016
China, People's Rep. of			
Total	58.9	66.0	66.5
Government	38.3	45.7	46.4
Corporate	20.6	20.3	20.1
Hong Kong, China			
Total	67.4	74.5	73.6
Government	38.7	43.4	43.8
Corporate	28.7	31.1	30.8
Indonesia			
Total	15.2	17.7	17.7
Government	13.0	15.4	15.1
Corporate	2.2	2.4	2.5
Korea, Rep. of			
Total	129.6	129.1	117.3
Government	52.7	53.2	48.1
Corporate	76.9	75.9	69.2
Malaysia			
Total	96.7	96.9	94.9
Government	52.9	52.4	51.5
Corporate	43.8	44.5	43.4
Philippines			
Total	35.8	34.0	33.7
Government	29.7	28.0	27.5
Corporate	6.1	6.0	6.2
Singapore			
Total	79.2	80.0	81.3
Government	44.9	44.8	47.1
Corporate	34.3	35.1	34.2
Thailand			
Total	73.2	74.7	75.6
Government	54.8	55.1	55.3
Corporate	18.4	19.6	20.3
Viet Nam			
Total	22.4	23.8	22.1
Government	21.6	22.8	21.1
Corporate	0.8	0.9	1.0
Emerging East Asia			
Total	63.6	69.2	68.5
Government	38.6	44.2	44.2
Corporate	24.9	25.0	24.3

*

(Source: Asia Bond Monitor March 2017)

Japan alone makes more than four times the Chinese government debt bond (Table 3)

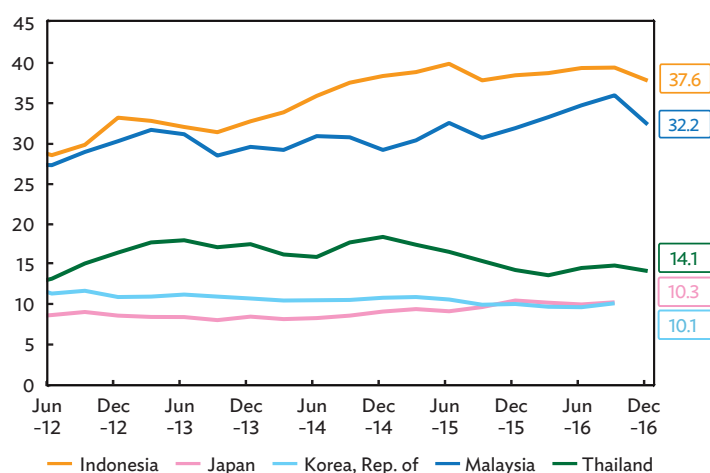
Table 3. Japan: Size and Composition of Local Currency Bond Markets % of GDP

	Q4 2015	Q3 2016	Q4 2016
Japan			
Total	202.4	210.4	209.8
Government	187.5	195.6	195.2
Corporate	14.9	14.8	14.6

(Source: Asia Bond Monitor 2016)

The share of foreign holdings in most emerging East Asian markets declined in Q4 2016 due to a stronger US dollar and expectations of accelerated US interest rate hikes in 2017. At the end of December, non-resident holdings of LCY government bonds had declined on a quarter on quarter basis for most markets for which data are available (Chart 2). More recent data indicated a partial reversal, reflecting improving sentiments for emerging market assets.

Chart 2: Foreign holdings of Local Currency Government Bonds in Selected Asia Economies (% of total)

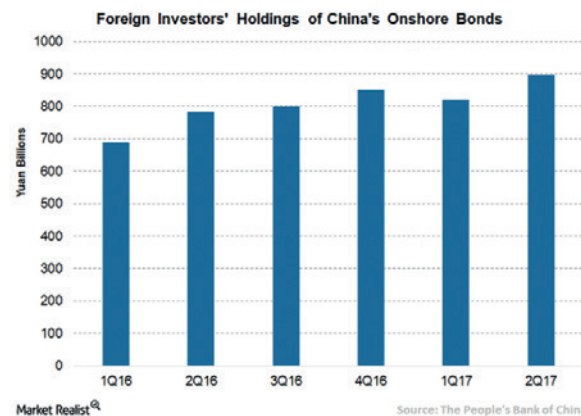


Note: Data as of end-December 2016 except for Japan and the Republic of Korea (end-September 2016).
Source: AsianBondsOnline.

(Source: Asia Bond Monitor March 2017)

The ability of Asian economies to tap bond funding in their own currencies reflects the continued development of their financial systems, attractive economic fundamentals, and perceived improvements in macroeconomic management. This, combined with the extraordinarily low interest rate environment of the past decade, increased confidence in emerging Asia, and diversification imperatives, has led investors to emerging Asian local currency bond markets. Yet, a share of about 10 percent of the whole stock of foreign holdings indicates a still low integration of East Asia bonds in the global market place. In 2016, the share of foreign holdings in most emerging East Asian markets declined due to a stronger US dollar and expectations of accelerated US interest rate hikes in 2017.

China's bond market is the third largest in the world after the US and Japan, but has a miniscule 3% holdings of foreign investors. However, with a further relaxation of rules and the renminbi's inclusion into International Monetary Fund's Special Drawing Rights (SDRs), this percentage is expected to treble by 2020 to "an amount equivalent to 8.5% of China's GDP".

Chart 3. Foreign Investors' holdings of China's Onshore

(Source: Market Realist 2017)

In June 2017, in a move set to accelerate the inclusion of China in the MSCI index, China launched the Shanghai-Hong Kong Bond Connect. The arrangement enables Mainland and overseas investors to trade bonds tradable in the Mainland and Hong Kong bond markets through connection between the Mainland and Hong Kong Financial Infrastructure Institutions. A sister of the Stock Connect, the China-Hong Kong Bond connect will allow foreign fund managers to trade in China's \$9tn government, agency and corporate debt markets without, for the first time, having to set up onshore accounts. The link aims to facilitate China's inclusion in global bond index.

"Bond Connect" is a new mutual market access scheme that allows investors from Mainland China and overseas to trade in each other's respective bond markets. Northbound trading commenced on July 3 in the initial phase, allowing overseas investors from Hong Kong and other regions to invest in the China interbank bond market through mutual access arrangements in respect of trading, custody and settlement. There are no quota limits imposed on the Northbound investment while Southbound trading will start at a later date³.

Access to China's bond market through the program will remain restricted to overseas institutional investors such as banks, insurance companies, securities companies and fund managers. Trades through "Bond Connect" will not be subject to quotas. China granted eligible foreign institutional investors access to its interbank bond market in 2016, but "Bond Connect" should add another, more convenient channel for foreigners looking to access the world's third largest bond market via Hong Kong.

In the short term, the impact of the market size of "Bond Connect" could be limited as there is uncertainty facing the yuan's exchange rate, and bond yields are likely to rise further amid China's economic recovery. Estimates expect likely inflow of 300 billion yuan into China's onshore bond markets, and cumulative inflows of as much as US\$800 billion over the next five years. And as foreign ownership of Chinese bonds is much lower than that of other developing countries, Ping An Asset Management expect potential increases in the foreseeable future, so that China will attract US\$250 billion, once its bond market is added to global debt indexes.

³ Trading through "Northbound" means foreign investors will be able to buy and sell Chinese bonds. The authorities have not yet indicated when Chinese investors will be able to trade Hong Kong and overseas bonds, known as "Southbound" trading.

However, the types of bonds that foreign investors⁴ are likely to buy are still government bonds and policy financing bonds. As China's basic problem of domestic credit ratings is still unclear, credit bond investment will become a more viable option to investors.

This notwithstanding, opening the bond market to international investors is a good move, as an important first step that could significantly affect the flow of capital into China, and in the world market place. Fens Gao of Deutsche Bank lists several benefits to China's deepening its integration in the global market place:

- ▶ improve the balance of payments condition over the medium to longer term,
- ▶ help diversify the domestic market investor structure,
- ▶ improve bond market liquidity and pricing efficiency,
- ▶ drive greater transparency in the market, and enhance connectivity between onshore and global market infrastructures,
- ▶ eventually boost the long-term prospects for RMB internationalisation (Deutsche Bank 2017)

Wrapping up

In Chapter 2 the motives that pushed Emerging Asia countries to set up an Asian Local Currency Bond Market indicate that, while still immature, Asian finance infrastructures continue to expand, making EMEs in the region more resilient to global shocks. China, with its huge debt bond market, and gradually opening to foreign investors, has the potential to significantly impact capital flows towards China and Asia; China's opening up to international investors is likely to deliver interesting advantages to the Chinese, and the world, economy.

1. Being the world's third-largest bond market, its opening up will offer domestic companies an alternative source of capital to State-owned banks. It will also help firm up Chinese banks' balance sheets and improve corporate governance amid scrutiny from foreign investors. Citigroup Inc. estimates inflows of \$3 trillion dollars by 2025.
2. Opening the debt markets will support the internationalisation of the yuan, helping it climb the ranks of global reserve currencies. For that to happen, policy makers will need to free up the capital account so that global investors know they can get their money out, not just in.

And for the world economy:

3. Chinese borrowers can become a new source of competition for investors' money should its bond market keep opening. That change, as China's role as a creditor nation shifts, may mean higher borrowing costs for the rest of the world. As David Loevinger, a former China specialist at the U.S. Department of the Treasury, argued: If "the biggest story of the last 15 years has been China's integration into the global trading system, for the [next] ten 10 years the big story will be its integration into the global financial market" (Bloomberg, 2017).

⁴ Foreign investors are specially thrilled by China's bond market opening. David Lyenne "The opening of China's domestic bond market, already the world's third largest with an estimated size of more than USD10 trillion, significantly expands the asset universe for global investors with RMB to put to work. Deutsche Bank's branch in Hong Kong supplements our China onshore capabilities with world-class clearing and custodian services, enabling clients from across the world's major financial markets to gain exposure to the domestic Chinese bond market." (China Daily 2017)

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3. Asia's Thick Banking Network, and the Role of Hong Kong and Singapore

A peculiar feature of the Asia-Pacific banking sector is defined by cross-border banking activity. In the years leading up to the 2008-2009 financial crisis, much of the cross-border activity in the region had been driven by dollar credit intermediated largely by European banks. In the wake of the crisis, European banks withdrew their global intermediation throughout, letting regional banks move in, and soon capture cross-border activity. Boosting this drive towards an intra-regional trend, ASEAN member governments adopted a regional banking integration framework. Aware of the lessons of European banking integration, the banking authorities in the Region have been making efforts to balance the efficiency gains of regional integration against the risks of financial instability.

Cross-border banking in Asia and the Pacific has steadily increased over the last dozen years, interrupted only by the Great Financial Crisis of 2007-09, with major changes happening in the pattern of financial intermediation. In the global cross-border banking boom of 2001-07, most of the activity took the form of a flow of dollars from the United States to Europe and then to Asia-Pacific as well as back to the United States, with European banks serving as the major intermediaries (Avdjiev et al. 2015). Since the crisis, however, European banks have withdrawn, and banks from Asia-Pacific have stepped in, so that the bulk of intermediation in the region is now conducted by these banks.

ASEAN member governments have supported the intraregional trend. With the regional banking integration framework, ASEAN members allowed banks qualified in one member jurisdiction to operate freely in others⁵. The rise of large regional banks is a positive factor, as it could bring efficiency gains, but could also amplify regional contagion. Remolona and Shim of the BIS warned that “benefits [of deeper cross-border banking activities] include greater competition and enhanced efficiency, the availability of a wider range of banking services and greater risk-sharing”, but they also bring contagion risks, giving rise “to some financial stability risks, such as financial contagion through common and concentrated creditors, liquidity risks in foreign currency funding, and the shortening maturity of foreign currency loans provided by Asia-Pacific banks” (2015 p.133).

Putting the trends of Asia's regional banking activity in the context of the post-Great Financial Crisis, banks in the region have undoubtedly been largely influenced by the shifting patterns in global banking, and especially the cross-border provision of dollar credit has had an important impact on banking flows in the Asia-Pacific region. According to Remolona and Shim

⁵ “The ASEAN Economic Community, planned to come into effect in 2015, is expected to liberalize goods, capital and skilled labor flows in the ASEAN region. While there has been considerable progress in the area of trade integration, financial integration still lags behind. The ASEAN Banking Integration Framework, which aims to liberalize the banking market by 2020, could help pave the way for further integration and the entry of ASEAN banks into regional banking markets. Greater banking integration in ASEAN will benefit the region. Allowing banks to operate across borders enables them to take advantage of economies of scale to increase efficiency and reduce costs. The entry of regional banks into domestic markets can increase competition, leading to lower prices and a greater variety of banking products and services. Heightened competition may also spur banks to expand into rural areas which are traditionally underserved by banks. Extending banking to the rural poor is an important means of promoting inclusive economic growth in ASEAN”. (Thiam Hee Ng Banking integration in ASEAN gathers pace, East Asia Forum 2014 August 2014).

“Before the Great Financial Crisis, global banks increased leverage to provide cross-border dollar funding, and European banks played a prominent role in cross-border dollar intermediation. After the crisis, an extended period of low global long-term interest rates, new bank regulations and efforts to repair balance sheets led to a major turn in the pattern of cross-border financial intermediation. Global banks increasingly gave way to asset managers investing in long-term debt securities” (2015:120).

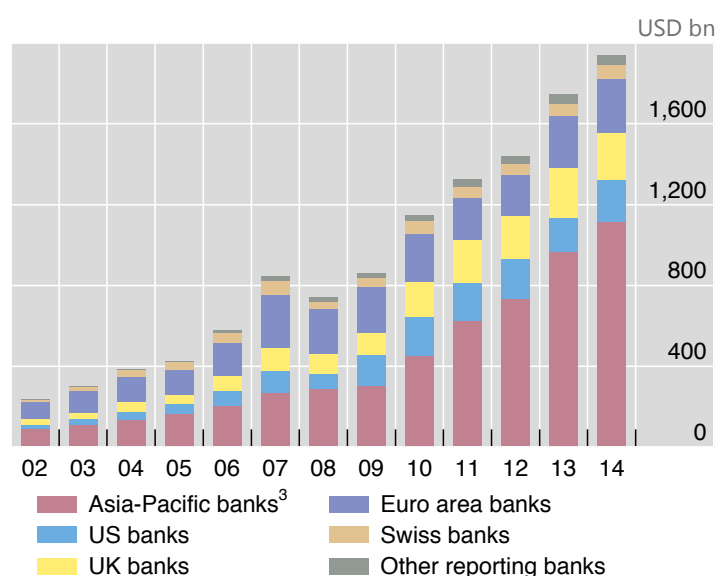
This shift also opened up opportunities for Asia-Pacific banks to expand their activity within the region⁶. The Great Financial Crisis was a watershed moment in international banking, and the Asia-Pacific region was no exception. Between 2007 and 2008, international lending in the region fell by \$120 billion. But this halt was only temporary: international lending in Asia rebounded from 2009. International claims on the region more than doubled in five years (Chart 1). China stands out, with cross-border claims on the country growing almost six-fold from 2008 to 2014 (Table 1). Hong Kong SAR and Singapore played an important role as regional banking centres, by intermediating a large amount of cross-border funds relative to GDP (Remolona, Shim 2015 p.120-121).

The strong growth in international claims on the emerging Asia-Pacific region between 2009 and 2014 stands in contrast to developments elsewhere. During the same period, international claims on Latin America and the Caribbean grew by 48%, while those on emerging economies in Europe shrank by 11%. By March 2015, international bank claims on the emerging Asia-Pacific region totalled \$1.9 trillion, while those on Latin America and the Caribbean and emerging economies in Europe stood at \$624 billion and \$597 billion, respectively.

With the resurgence of cross-border lending, the set of leading players changed. In the wake of the crisis and amid sovereign debt problems in Europe, the cross-border activity of euro area banks fell off. As a result, they failed to keep up with the Asia-Pacific region's growing demand for dollar funding. By 2014, the share of these banks in international claims on emerging Asia-Pacific was down to 14%, less than half its 2007 level, although in absolute terms their claims were essentially unchanged. The banks that stepped in were largely from Asia and the Pacific: their share went up from 31% in 2007 to 57% in 2014 (Chart 1).

⁶ The last dozen years have seen a strong increase in cross-border banking in the Asia-Pacific region. Between 2002 and 2007, international bank claims on emerging Asia-Pacific almost quadrupled to \$844 billion. In 2007, euro area banks accounted for about a third of these claims, Asia-Pacific banks for a similar share, and Swiss, UK and US banks for roughly the other third. Over the same period, international bank claims on Latin America and the Caribbean grew more slowly, while those on emerging economies in Europe almost quintupled, albeit from a smaller base.

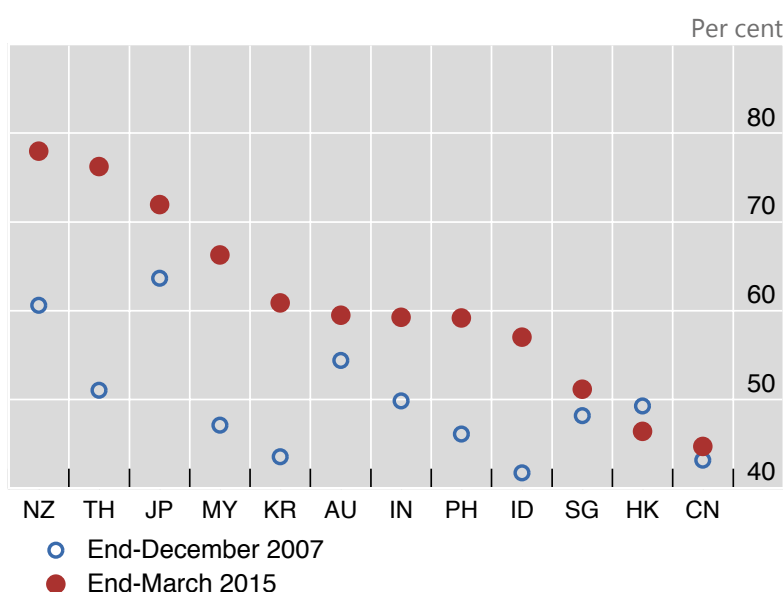
Chart 1. Who's lending to emerging Asia and the Pacific?
International claims on emerging Asia-Pacific



(Source: Remolona, Shim 2015)

The shift overlapped with a greater concentration in the creditor banking systems. Between the fourth quarter of 2007 and the first quarter of 2015, the combined market share of the three largest creditor countries – Australia, Japan and Singapore, and outside of the region the United Kingdom and the United States – rose for most of the major economies in the region (Chart 2), and has continued to rise with a higher lending concentration in favour of Indonesia, Korea, Malaysia, New Zealand, the Philippines and Thailand. As of the first quarter of 2015, Australia was the most important creditor for New Zealand, Japan for Indonesia and Thailand, and Singapore for Malaysia.

Chart 2. Market share of the three largest creditor countries



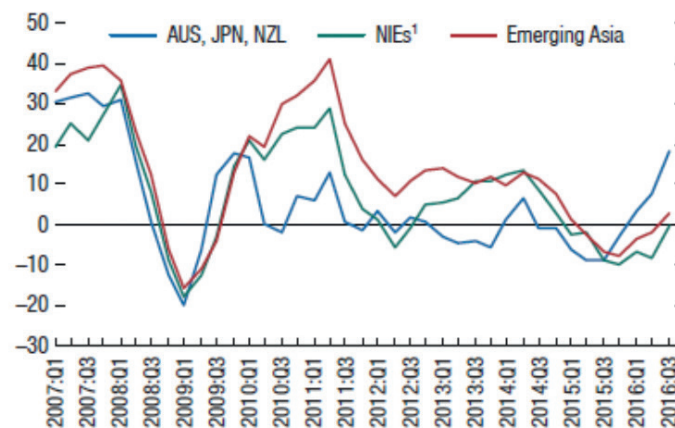
(Source: Remolona, Shim 2015)

Table 1. Increasing lending to Asia and Latin America

	China	Hong Kong SAR	India	Japan	Singapore	Brazil	Mexico
Fourth quarter 2008 ¹	154	309	135	677	451	156	102
Fourth quarter 2004 ¹	1,036	621	196	1,120	588	307	129
Growth rate (unadjusted) ²	575	100	45	65	30	96	26
Growth rate (unadjusted) ^{2,3}	561	114	58	80	34	98	26
Cross-border claims/GDP ^{2,4}	10	214	10	24	191	13	10

¹ In billions of US dollars. ² In per cent. ³ Calculated on an exchange rate- and break-adjusted basis. ⁴ As of end-2014.
Sources: IMF WEO database; BIS locational banking statistic (Table 6A); author's calculations.

(Source ADB 2016)

Chart 3. Consolidated Foreign Claims

Sources: Bank for International Settlements, International Banking Statistics database; and IMF staff calculations.

Note: Data labels in the figure use International Organization for Standardization (ISO) country codes.

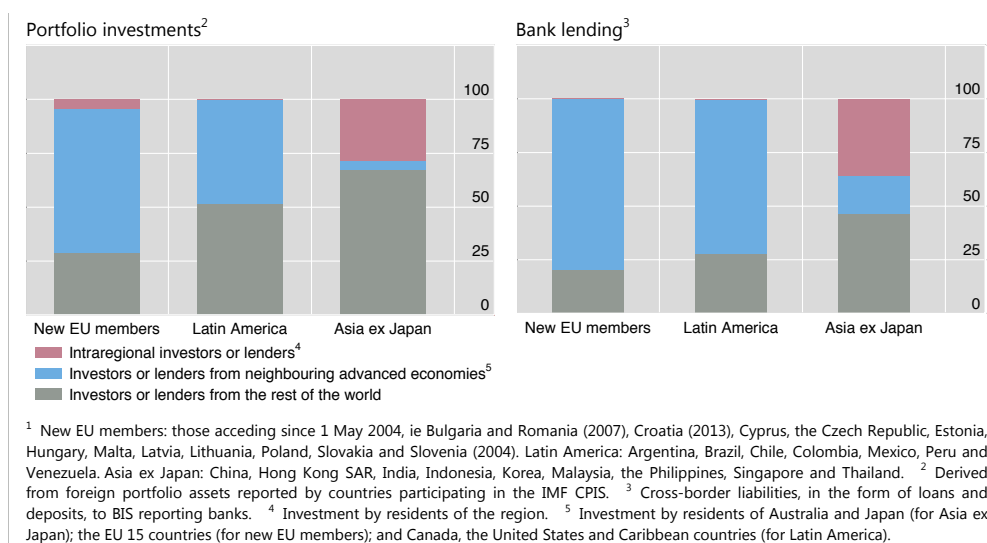
¹Newly industrialized economies (NIEs) comprise Hong Kong SAR, Korea, Singapore, and Taiwan Province of China.

(Source: IMF April 2017:5)

The Asian thick banking network shows significant signs of finance self-reliance. Cross-border lending data based on the location of the creditor bank (“residence basis” rather than “consolidated basis”) indicate that cross-border banking in Asia, excluding Japan, are much more intraregional than that in emerging economies in Europe and Latin America.

Contributing factors to this fundamental feature of Asian banking sector are twofold: a) Asian economies, ex-Japan, obtain a larger share of their financing from other economies within the region than do emerging economies in Europe and Latin America (red bars in Chart 4), and b) the larger share of funding could in part originate elsewhere, but is channelled to borrowers in Asia ex-Japan through domestic and foreign banks located in Hong Kong SAR and Singapore. This is the case for portfolio investment, but it is more pronounced for bank lending.

Chart 4. How important are intraregional investors in foreign financing?
As a percentage of the stock of foreign investment in the host region¹, at end-June 2014

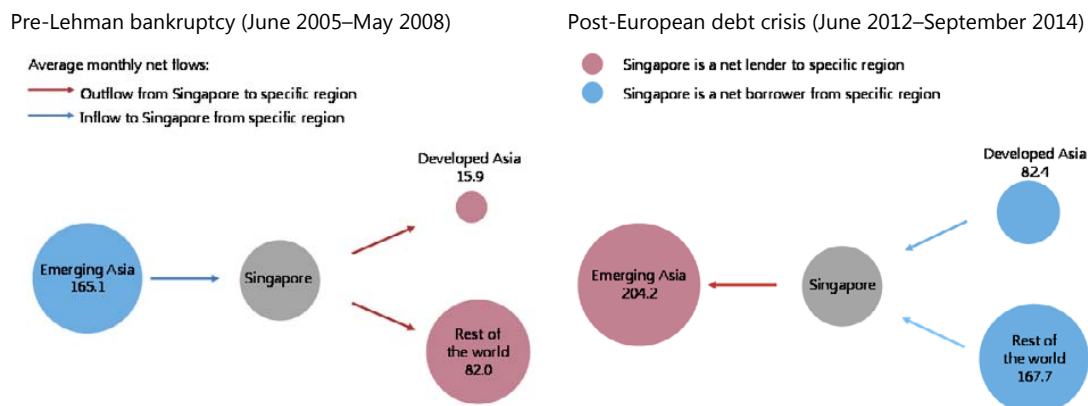


(Remolona, Shim 2015: 122)

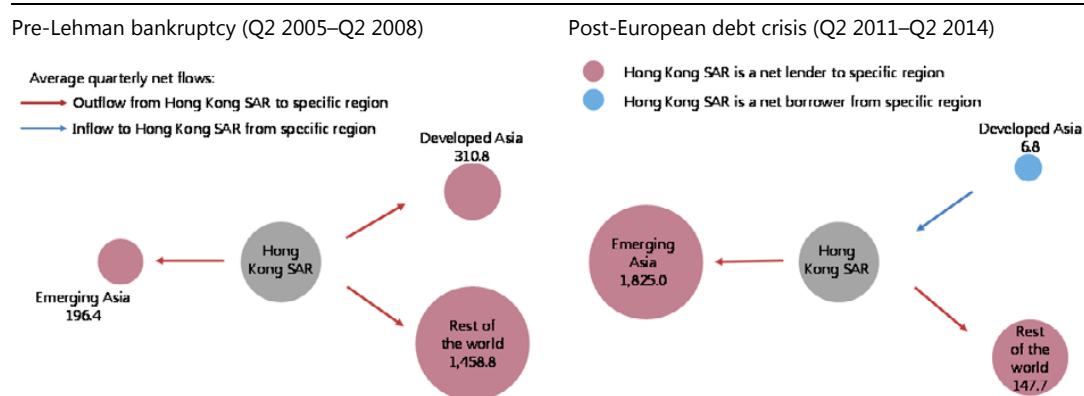
Funds to emerging economies in Latin America and Emerging Europe are supplied from neighbouring advanced economies, and in particular, a substantial part of portfolio investment and cross-border loans come from investors and lenders located in the United Kingdom for new European Union (EU) members, and for Latin America from Financial Centres in the United States (blue bars in Chart 4 left). By contrast, Asian economies ex-Japan obtain a relatively small part of their foreign financing from neighbouring advanced economies of Australia and Japan.

At this point we turn to the role of banks in Hong Kong and Singapore, which from 2012 started an intermediation activity aimed at filling the gap left by the European banks' withdrawal, aimed at pivoting funds from inside and outside into the region. In the three years prior to 2008, banks in Singapore borrowed an average net amount of SGD 165 billion (USD 107 billion) a month from emerging economies in Asia and lent most of the funds either domestically or to borrowers outside Asia (Chart 5). When the crisis reversed this pattern from June 2012 to September 2014, banks in Singapore turned net borrowers from advanced economies, and lenders of most of these funds to emerging economies in Asia, lending an average of SGD 204 billion (USD 163 billion) a month (Chart 5).

Banks located in Hong Kong SAR also became bigger net lenders in the emerging Asia-Pacific region (including Singapore) over this period, while reducing their net lending outside the region (Chart 6).

Chart 5. Changing Role of banks in Singapore (in SGD bn)

(Source: Monetary Authority of Hong Kong, BIS 2014)

Chart 6. The changing role of banks in Hong Kong

(Remolona, Shim 2015: 122)

Wrapping Up

Intraregional cross-border banking activity in Asia and the Pacific has steadily increased since the Great Financial Crisis. Tapping into the region's large savings pot and external resources, banks in Hong Kong SAR and Singapore have acted as intermediaries to borrowers in Asia ex-Japan. Their intermediation has not only greatly helped the region's economies to move forward in the mid of the crisis, but also contributed to finance deepening.

Defined as Asia Financial centres, they are somewhat different from established centres. While a common feature of many centres is to act as hubs or waypoints attracting foreign capital, but then investing it abroad (McKinsey 2017), Hong Kong and Singapore have largely intermediated their lending activities within Asia. This marks their special liaison with Asia, and even more with China (Chapter 3.3). In a paper of the Lee KuanYew School of Public Policy (2017), Hong Kong's and Singapore's financial services industry will most certainly be deeply affected by the rise of China. Currently, Hong Kong and Singapore are already recognised as major hub for offshore RMB (renminbi) transactions, fostering also the creation of markets for new RMB denominated financial instruments.

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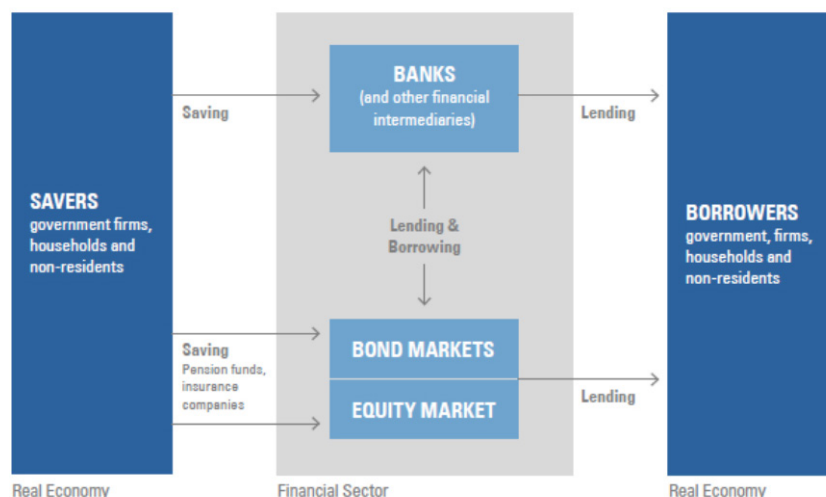
4. Asia Financial Deepening and the Role of International Financial Hubs: Shanghai

“The development of infrastructure in cities and regions across the world is critical to economic growth and social well-being. As such, securing the funding needed to support the global infrastructure sector – currently in the tens of trillions of dollars – is a key issue for governments and policymakers. Government funding constraints have limited public investment in recent years; however, the private sector is increasingly willing to construct, lease, operate, and maintain infrastructure assets from airports and toll roads to power plants and schools. Due to the long-lived nature of these assets, debt capital plays an important role in financing infrastructure” (Standard& Poor’s 2014).

Introduction

Previous Chapters have tracked the increasing integration of global capital markets driven by FDI and portfolio investments, the growing size of LCGBMs, and the thick networking of intra-regional banks. Though the basic components of the Asia’s capital markets fall into place and underline the interconnectedness of Asia’s Financial Triad, structural reforms in each sector and in the overall system are much needed for pushing development forward.

Chart 1. Components of the Asian Financial Triad



(Source: adapted after Hentov 2017)

The above picture offers a clear architecture of the component parts of Asia’s financial system, and the functional interactions they perform in support of the real economy. However, financial deepening barely features in the picture, a factor that is essential in driving emerging economies in their sustained rapid growth from a largely middle-income to a largely high-middle income. As the Asian Development Bank argues “The transition from middle income to high will not be driven by the same factors that lifted economies out of low income.... The risks are high that countries could remain for very long time at the stage of ‘middle-income’” (ADB, 2017). Latin America and East Asia are examples of the critical correlation of finance for innovative activities, particularly R&D, and the innovative potential of an economy.

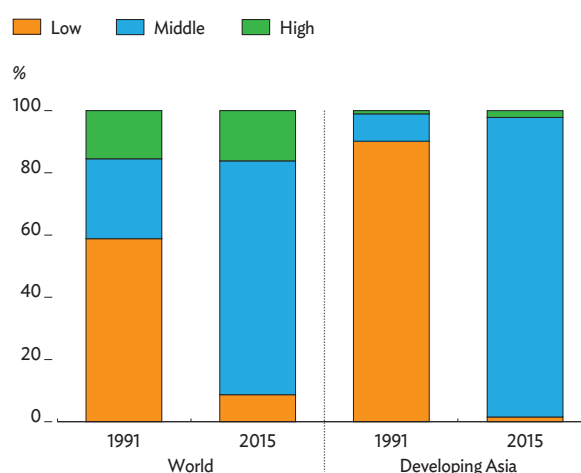
While for many East Asia economies including Hong Kong SAR (China), Japan, the Republic of Korea, Singapore, and Taiwan (China) the strong correlation between R&D inputs and innovation has fared them well in the transition from middle- to high-income status, Agénor et al. argue that Latin America, “where credit market frictions have limited access to finance for R&D activities have experienced poor innovation capacities, and as a result, limited growth in the later part of the 20th century” (2014).

A lesson that Emerging Asia should learn from the success story of the “Four Dragons” is that fostering a productivity and technological upgrade is critical to sustain economic growth in order to escape the “middle-income trap”.

To successfully challenge the “middle income trap” and rise to become a higher income country, countering financial repression should be a priority agenda. Ronald McKinnon (1973) and Edward Shaw (1973) were the first to explain the notion of financial repression, and argue that in many countries, including developed ones but especially developing ones, financial repression prevents the efficient allocation of capital, discourages savings, in the end impedes the overall economic growth of a nation. Interventions and regulations in financial sectors should be reduced, and ultimately removed. In a constrained environment, financial intermediaries do not function at their full capacity and fail to channel savings into investments efficiently, thereby impeding the development of the overall economic system (Campanella 2016). Emerging Asia has largely benefitted from trade liberalisation, yet several measures of financial repression are still widely in use. The policies that cause financial repression, among others include interest rate ceilings, liquidity ratio requirements, credit ceilings or restrictions on directions of credit allocation, and, last but not least, government ownership or domination of state-owned banks. So, it is mostly up to political regulators’ choices⁷ to engage with financial development

Financial deepening and the removal of financial repression are without doubt Asia’s new barrier to advancing economic growth and citizens’ income, and to catching up with Western countries.

Chart 2. Population share by income groups, developing Asia and world



Source: Estrada et al., forthcoming.

(Source: ADB 2017)

⁷ In a Wikipedia’s excellent definition “Financial deepening refers to increasing provision of financial services, with effects on both individuals’ and societies’ economic situations. In this definition, financial deepening is associated to economic growth through the expansion of access to those who do not have adequate finance themselves (Wikipedia 2017).

After this Introduction, the author touches on three major themes pertaining to the potential that financial deepening or development would likely grant to Emerging Economies in Asia. A first question relates to the relationship of finance and the real economy. A review of themes synthesised in the question: “Is too much finance a good thing?”, aims at weighing the pros and cons of financial opening versus financial repression in Emerging Asia within the framework of the post-financial crisis (4.1). A second aspect of financial deepening relates to the role of International Financial Centres (IFCs), to foster financial and economic development (4.2). For the systemic relevance of China’s economy in the global economy, the transition to a market-driven economic growth is critical to make Shanghai China’s leading Financial Centre (4.3). A review of the literature of IFCs points to questions over China’s readiness for its International Financial Centre (4.4). Finally, the ties of Hong Kong to China are considered in the light of Shanghai’s rise as China’s onshore global financial hub (4.5).

4.1 Financial development, and economic growth

In 1873, Walter Bagehot anticipated by several decades the notion that a financial system played a critical role in driving industrialisation in England, by facilitating the mobilisation of capital for immense works. In 1912, Joseph Schumpeter went further, assigning to sound functioning banks the task of spurring technological innovation, and as competent agents the capability of identifying and funding those entrepreneurs with the best chances of successfully implementing innovative products and production processes.

The notion that finance is an accelerator of economic growth re-emerged at the forefront of thinking in the 1970s.

In the new wave of industrialisation in Latin America and Asia, the importance of financial deepening or financial development turned into a hot issue. Typically, developing economies are faced with an underdeveloped financial system. In these circumstances incumbents have better access to financial services through relationship banking. The obvious consequence is that in an underdeveloped financial system, economic growth is constrained by the potential expansion of incumbents. Conversely, in mature financial systems, financial institutions develop assessment techniques, information gathering and sharing mechanisms, which enable banks to finance even those activities or firms that are at the margin, thereby leading to their growth-inducing productive activities in addition to the incumbents.

McKinnon (1973) and Shaw (1973) also emphasised the role played by financial intermediaries and markets in the growth process of developing economies. They argued that impediments to financial development were likely to hamper growth by limiting the amount of savings that could be mobilised for investment purposes, preventing financial intermediation from channelling these resources into the most productive activities. The 1990s saw many new theoretical models formalising these ideas, relying on endogenous growth and focusing on the various functions of the financial system.

Shaw (1973) postulated that financial intermediaries promote investment and raise output growth through borrowing and lending, leading to increased output growth (Sahay 2015). The McKinnon-Shaw model maintains that the success of the financial liberalisation process depends upon the following hypothesis: (i) the effective deepening of the financial sector, (ii) a positive correlation between savings and the real interest rate, and (iii) a perfect complementarity between money demand and investment. This has inspired a substantial flow of studies in developing economies, corroborating the model’s major theses.

Calderón and Liu (2002) listed a number of interesting advantages deriving from financial liberalisation.

1. Financial development enhances economic growth for all countries. This suggests that financial deepening in many countries has yielded the desired result – a more prosperous economy.
2. A bi-directional causality sets in motion with financial depth stimulating growth and, simultaneously, growth propelling financial development. The expansion of the real sector can significantly influence development of the financial sector, although this is more the case in developed economies.
3. Financial depth contributes more to the causal relationships in developing countries, thus, implying that financial intermediaries have larger relative effects in less-developed economies than in more developed ones. Hence, developing countries have more room for financial and economic improvement.
4. The longer the sampling interval, the larger is the effect of financial development on economic growth. This suggests that the impact of financial deepening on the real sector takes time.
5. Financial development may enhance economic growth through both more rapid capital accumulation and technological changes, though it appears that the productivity channel is stronger (Calderón, Liu 2002:6-8).

The main channels through which finance is expected to influence growth include: producing information; allocating capital to productive uses; monitoring investments and exerting corporate control; facilitating trading, diversification, and management of risk; mobilising and pooling savings; and easing the exchange of goods and services (Levine 1996).

In recent decades, the financial sector, in combination with the information technology (IT) industry, has witnessed a substantial expansion. The GDP share of value-added by the U.S. financial sector more than tripled from 3 percent in 1950 to over 9 percent in 2007. Similarly, U.S. financial industry profits quadrupled from about 10 percent of total U.S. business profits in the early 1980s to 40 percent in 2006 just before the onset of the recent global financial crisis. Gross financial assets in the United States increased from 100 percent of GDP in 1950 to 450 percent in 2010. A comparable development also took place in the United Kingdom, with its gross financial assets increasing from 50 percent of GDP in 1970 to 550 percent in 2010. Yet, the 2008-09 Financial Crisis has led to a negative interpretation of this phenomenon. Economists of different quarters have started to doubt the contribution of finance to growth after the current crisis, and dispute the direction of causality between financial development and economic growth (Bertocco, 2008; Adusei 2012).

The recent global financial crisis was not the source of doubts about whether financial development is beneficial for growth, but certainly intensified them. Consistent with empirical studies that reveal a nonlinear relationship between the two variables, new research finds that financial development contributes to economic growth, but only up to a point, after which it may even adversely affect growth. The global financial crisis validated such evidence.

A stream of studies, however, finds that concerns about too much financial development and the deleterious effect of finance on economic growth are much more relevant for advanced countries than for developing countries. Estrada et al. contend that financial development should be dropped in Emerging Asia. As they put it “[t]he complex financial innovations of global Financial Centres such as New York and London are a world away from financially underdeveloped Asia, which remains well inside the global finance frontier” (2015). Their argument goes that financial development promotes economic growth only up to a point, and this implies that in economies with a high level of financial development

a further expansion of finance could generate financial instability, or a financial crisis with consequences on economic growth. The global financial crisis of 2008-09, which caused financial paralysis, and nearly brought down the world economy, is clearly a case in point. Conversely, Asia does not present the same traits of highly developed countries, as Estrada et al. discuss:

“With the possible exceptions of the financial centers of Hong Kong and Singapore [...] developing Asia is at a significantly lower level of financial development than the level at which too much finance becomes a concern. Financial development in developing Asia requires building up sound and efficient banks, equity markets, and bond markets that intermediate savings into productive investments while mitigating their vulnerability to shocks” (Ibid. p. 2-5).

In the wake of the Great Financial Crisis, robust evidence that financial openness, a proxy of integration, systematically increases growth are also difficult to find (Syed Zulfiqar Ali Shah et al. 2014). Over longer time periods, if a positive link between the two variables emerges, financial openness could help promote better financial infrastructures, especially when financial integration stimulates the hosting economy to adopt supportive conditions such as good policies and institutions. However, despite limited positive evidence, countries have engaged in greater financial openness, more of necessity than choice, since governments cannot afford for the domestic finance sector to be insulated from cross-border financial flows. In consequence, financial opening is the only way left to upgrade domestic financial system in the attempt to lure investment capital in a country's economy.

4.2 Financial deepening and the role of International Financial Centres

Studies of finance development spell out the benefits of market integration – getting rid of local and sectoral monopoly and monopsony – and especially stimulating financial integration via formation of savings and resources pooling (Shaw, 1973). To seize more benefits from financial integration, finance should also have a spatial dimension: Financial Centres or Financial Hubs are essential financial infrastructures to financial development, and economic growth.

Kindleberger is one of the pioneers in the research on Financial Centres; prior to his research, discussions of banking innovation and financial intermediation or deepening lacked a spatial dimension. In his classic *The Formation of Financial Centers* (1974), Kindleberger wrote that without a “spatial dimension banking innovation and financial intermediation or deepening risk lacking their function”. As he explains

“Banking and Financial Centers not only balance through time the savings and investments of individual entrepreneurs and transfer financial capital from savers to investors but also effect payments and transfer savings between places”. (ibid.)

In his analysis, he attributed critical functions to banking and financial centres: medium-of exchange, interspatial store-of-value, payments and clearing activities, and furthermore, specialised functions of international payments and foreign lending or borrowing.

At the time, Kindleberger was just thinking about the need for a still remote European currency to have its own financial centre, which, he specified, should perform within the intraregional European space, and on international markets. In this regard, he insisted that the specialised functions of interna-

tional payments and foreign lending or borrowing are typically best performed at one central location, that is also the specialised centre for domestic interregional payments. In his description of a European Financial Centre he stressed a few basic features: a straight spatial link to the European Central Bank, the institution issuing the European currency; and one or two central locations, where Multinational Corporations were clustered. These days, these requirements fall into place for Frankfurt and Paris, and maintain the role of IFC for the Eurozone.

In stressing spatiality, Kindleberger had, by several decades, anticipated a core notion of a financial centre. Normally a financial centre is located in a city or even a quadrangle within a city's boundaries, in which financial activities are highly concentrated (Yeandle 2017). Despite the development of information technology during the last decades, contemporary definitions of Financial Centres include a clear spatial component. For example, Gehrig (2000 p.416) defines Financial Centres as geographical locations with agglomerations of branches and subsidiaries of banks and other financial intermediaries in narrowly defined regions. These spatial components highlight that powerful forces of agglomeration can reinforce established Financial Centres in a path dependent mode.

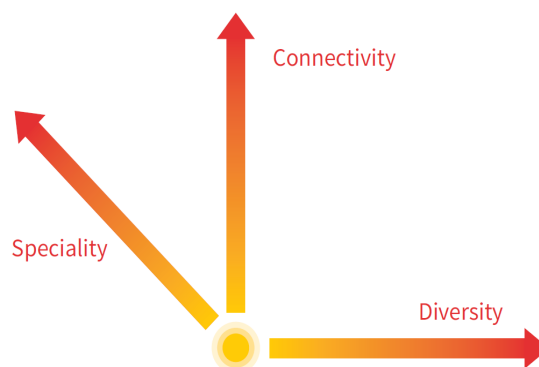
While finance does not live like Epicurus' gods in the *metakosmia*,⁹ as it moves along with capital investment, recently information and communication technologies have increasingly made it footloose. So, the stability of established centres faces new competitors¹⁰. Laurenceson and Tang (2005) observe that financial centers "are not immune to decline due to competition from new challengers", and that, they argue, brings to investigate the evolution and dynamics of financial centres, and what should policymakers do to continue to attract financial corporations.

For the first question, a response may likely come from a research study, conducted on the basis of high frequency surveys, in which three major factors come forward: connectivity, specialty, and diversity (Yeandle 2017).

- ▶ Connectivity defines the extent to which a centre is well known around the world, and how many non-resident professionals believe it is connected to other Financial Centres. One of the most important benefits of hosting thriving financial centres is the extent to which that centre is connected to other Financial Centres. One way of measuring this connectivity is to look at the number of assessments given to and received from other Financial Centres. Charts 4 and 5 use London and Frankfurt as examples to contrast the different levels of connectivity that the two Centres enjoy.
- ▶ Diversity, a critical feature of financial development, measures the breadth of financial industry sectors that flourishes in a financial centre. A high score means that a centre is well diversified; a low diversity score reflects a less rich business environment.
- ▶ Speciality, the depth within a financial centre of the following industry sectors: investment management, banking, insurance, professional services, and the government and regulatory sector.

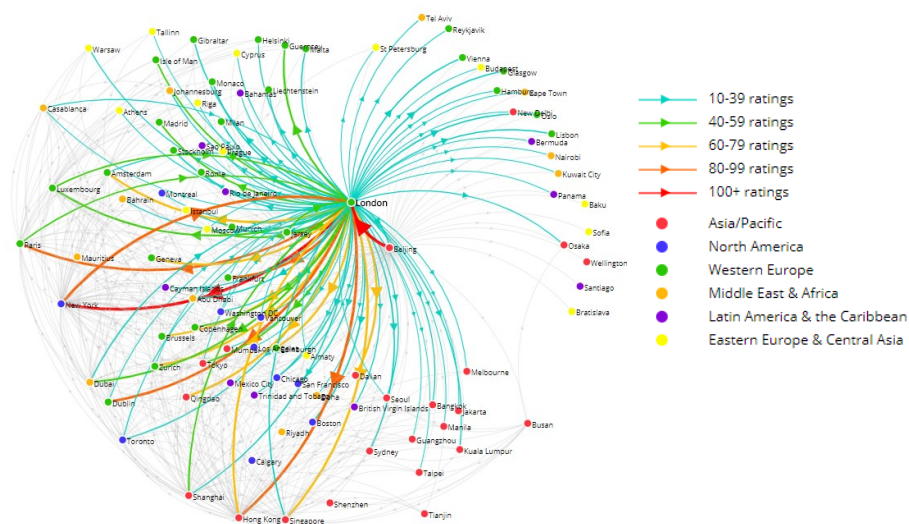
⁹ From Wikipedia "The metakosmia (Greek: μετακόσμια; Latin: *intermundia*), according to Epicurean philosophy were the relatively empty spaces in the infinite void where worlds had not been formed by the joining together of the atoms through their endless motion. Epicurus held that the *metakosmia* were the abode of the gods, whom he considered to be immortal and blissful living beings made of atoms".

¹⁰ On concerns about the future of London after Brexit see Jenkins (2016).

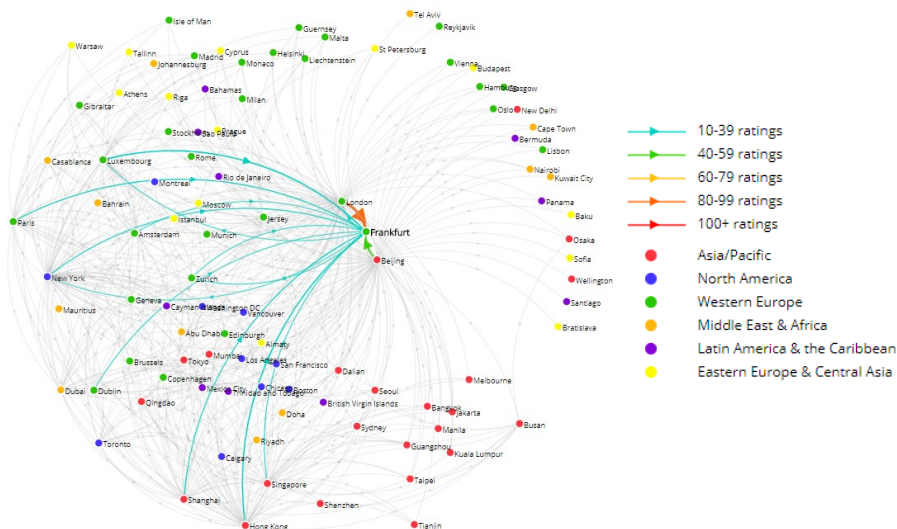
Chart 3. Three drivers of IFHs development

(Source: GFCIs 2017)

Comparing London and Frankfurt Charts 4 and 5 show unmistakable evidence of still weak connectivity of Frankfurt.

Chart 4. Connectivity in London

(Source: GFCIs 2017)

Chart 5. Connectivity in Frankfurt

(Source: GFCIs 2017)

As for the second question, what policymakers should do to attract financial corporations, the Global Financial Centers Index (GFCI), published by the City of London, lists five factors:

- ▶ business environment;
- ▶ financial sector development;
- ▶ infrastructure;
- ▶ human capital;
- ▶ and reputational and general factors.

GFCI's surveys are produced along these parameters and allow interesting facts to emerge. GFCI (2010) listed eight Asian financial cities among the 20 largest centres, compared with only three Asian centres in the GFCI (2007). GFCI (September 2017) saw in the first top 10 Hong Kong, Singapore and Shanghai, and Shenzhen climbing two places to reach the top 20, scoring highly in the infrastructure category.

Table 1. Top 20 most important Financial Centres

Centre	GFCI 22		GFCI 21		Change in	Change in
	Rank	Rating	Rank	Rating	Rank	Rating
London	1	780	1	782	0	▼ 2
New York	2	756	2	780	0	▼ 24
Hong Kong	3	744	4	755	▲ 1	▼ 11
Singapore	4	742	3	760	▼ 1	▼ 18
Tokyo	5	725	5	740	0	▼ 15
Shanghai	6	711	13	715	▲ 7	▼ 4
Toronto	7	710	10	719	▲ 3	▼ 9
Sydney	8	707	8	721	0	▼ 14
Zurich	9	704	11	718	▲ 2	▼ 14
Beijing	10	703	16	710	▲ 6	▼ 7
Frankfurt	11	701	23	698	▲ 12	▲ 3
Montreal	12	697	14	713	▲ 2	▼ 16
Melbourne	13	696	21	702	▲ 7	▼ 6
Luxembourg	14	695	18	708	▲ 4	▼ 13
Geneva	15	694	20	704	▲ 5	▼ 10
San Francisco	16	693	6	724	▼ 10	▼ 31
Vancouver	17	692	17	709	0	▼ 17
Dubai	18	691	25	696	▲ 7	▼ 5
Boston	19	690	9	720	▼ 10	▼ 30
Shenzhen	20	689	22	701	▲ 2	▼ 12

(Source: GFCI September 2017)

Climbing and Tumbling

20. **Shenzhen** - The Chinese city climbed two places to reach the top 20, scoring highly in the infrastructure category.
19. **Boston** - The US city tumbled 10 places this year, making it one of the biggest fallers alongside San Francisco.
18. **Dubai** - Up seven places in the ranking, Dubai was boosted by a strong showing in the reputation category, placing sixth in the world.
17. **Vancouver** - The Canadian city is the fifth most powerful financial centre in the North American continent, according to the index.

16. **San Francisco** - Along with most other US-based Centres, San Francisco saw a fall in the rankings, down 10 places to 16th.
15. **Geneva** - Rising five places, Geneva is the fifth-most important European city for finance, and Switzerland's second-most important behind Zurich.
14. **Luxembourg** - The tiny city-state is Europe's fourth highest-ranked hub, and punches well above its weight in finance.
13. **Melbourne** - The city rocketed seven places to 13th, and, along with Montreal and Zurich, is seen as one of the most stable Financial Centres.
12. **Montreal** - Up two places this year, Montreal is Canada's second highest-ranking Financial Centres.
11. **Frankfurt** - The German powerhouse surged up 12 places in the list this year. The city has benefited both from Brexit and from being the home of the European Central Bank.
10. **Beijing** - The Chinese capital raises six places after a strong showing in the infrastructure and human capital categories.
9. **Zurich** - The Swiss city increases its ranking by two places to become the second highest-placed European city on the list.
8. **Sydney** - The Australian city retains its crown as the highest-ranked city in the southern hemisphere.
7. **Toronto** - The Canadian city takes the second-highest ranking of any city in the Americas, rising up three places from last year.
6. **Shanghai** - The Chinese city jumps seven places in the rankings, and was voted the most likely financial centre to become more significant.
5. **Tokyo** - The Japanese capital remains a global financial centre, coming out fifth overall.
4. **Singapore** - The city state comes in fourth overall, but took a slight dip of one place, after losing 18 points.
3. **Hong Kong** - The former British colony takes the highest spot of any Asian city, as both a well-developed financial hub and a gateway.
2. **New York** - The US financial powerhouse dropped 24 points since the last survey, coming in just fourth for reputation.
1. **London** - The UK capital extends its lead to 24 points over New York, despite concerns about the City's future within the Europe.

4.3 Asia's Financial Centres

The GFCI (September 2017) indicated a steady hierarchical shape of the leading financial centres, with the City of London understood to represent the model of global financial centre. Though the survey still does not reveal the Brexit effect on the City of London, the UK's withdrawal from the European Union and China's resolve to push its own financial centre, have awakened new interest in the construction of financial centres in the two regions. Yet, questions have emerged over whether the City of London still epitomises the role model, and which characteristics are likely to mark the construction of new centres.

Despite the substantial differences which characterise East-Asia and Europe, the two regions also have similarities. Neither region has the benefit of many natural resources, so that they have a strong

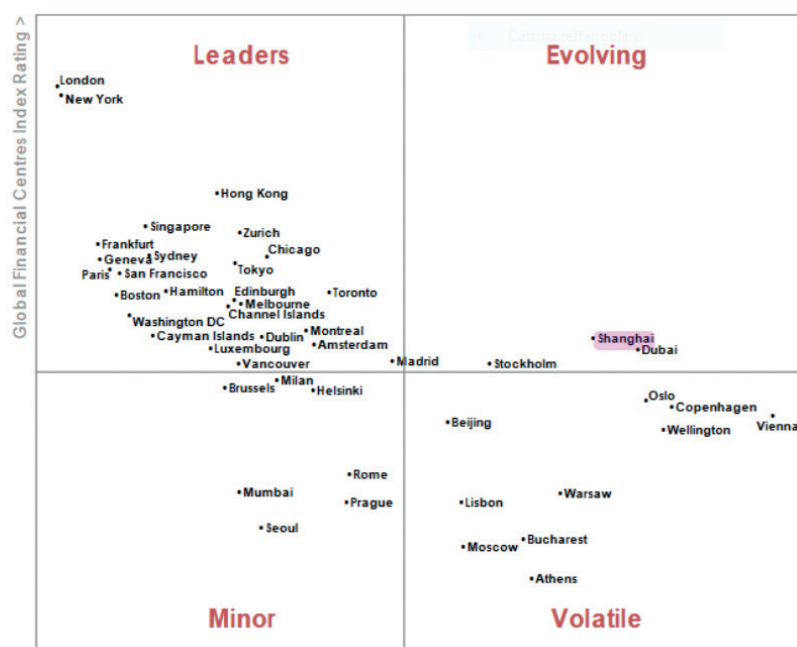
common interest in an open international economic and financial system. Both regions have been hit by serious economic, currency and banking crises, so they share the same ambition to better control the forces of economic and financial globalisation, and are oriented towards a stable economic and financial system. What's more, both East-Asia and Europe contain economies at different levels of economic development, so that financial centres should carry out objectives of financial inclusion and economic development.

In Asia, Shanghai – picked by the Central Government in 2009 to accomplish by 2020 the role of the country's primary financial centre – makes an interesting case study. For its large hinterland, and political assignment in the China's modernisation and economic growth, Shanghai's policymakers should better eye New York than London as a model.

In this Chapter, the author has selected four GFCI surveys, drafted in 2007, 2008, 2010 and 2017, that show a steady hierarchical shape of leading financial centres, with London and New York at the top, and in Asia, Hong Kong and Singapore ahead of Shanghai. In March 2007, one year before the GFC, the drafters of Global Financial Centres 1 (March 2007), commenting on the outcomes of the survey, stated that notwithstanding many rumours, Shanghai, Hong Kong, Tokyo or Singapore were unlikely to emerge as the global financial centre after London and New York.

A major reason was that the liquidity generated by the growth of the main Asian economies was split between two or more centres, with Shanghai the most commented-upon Asian city. But, they concluded that responses from their interviewees didn't favour Shanghai and Tokyo turning into truly global centres (Chart 6).

Chart 6. Global Financial Centres 2007



(Source: GFCIs 2007)

In 2008, The City of London changed its mind. With London and New York at the forefront of the start of the spreading international financial crisis, the survey registered for the first time in ten years that a shift in the centre of gravity was underway. In the Report "The Future of Asian Financial Centres:

Challenges and Opportunities for the City of London (2008)", they openly admitted that as the centre of gravity was shifting to Asia, sooner than later new financial centres would be added to established ones in Asia:

"[C]urrently [Asia is] home to a number of well-established financial centres, notably Hong Kong SAR, Singapore and Tokyo. There are also a number of aspiring financial centres such as Shanghai, Mumbai and Beijing, which have the potential to grow rapidly influence the development of the financial services industry in Asia" (City of London 2008).

As the centre of gravity of global financial markets shifts from North America and Europe to Asia, the hubs in the region, including those on the Chinese Mainland, are rapidly rising in importance.

The study placed great emphasis on the challenges and opportunities these developments were exerting on the world's leading financial centres of London and New York. Having set up offices in Beijing, Shanghai and Mumbai, the City of London emerged the best positioned to seize benefits from the periphery of global finance. Strengthening trading, investment links with China and India, and overall sales of financial services, the City secured its life-line to survive the financial crisis and even outshine New York as the number one global centre¹¹.

In the survey, Shanghai is still in decline. The Report's drafters admitted there had been considerable speculation as to whether Shanghai, Hong Kong, Tokyo or Singapore were likely to emerge as a global centre. Once again, the drafters' conclusion was that no single Asian centre would emerge as global centre, and even Shanghai, which benefited from elite-directed state investment during the 1990s, not likely would make it.

However, the threat from Shanghai vis-à-vis Hong Kong's strength in capital raising hub for the most significant Mainland companies is seriously considered. The study observes that the increasing domestic liquidity of Chinese companies will be inevitably met through Shanghai's ever-growing capacity to raise capital. Consequently, over the longer-term Hong Kong's capacity to raise funds would not be sustainable compared to Shanghai's financial markets growing sophistication. For these reasons, the drafters suggested that "Hong Kong will need to focus more resolutely on its role as an internationally-oriented centre – as a genuinely global player – when looking to secure its competitive advantage" (GFCI City of London 2008).

¹¹ Globalization creates new competitive pressures for the financial sector. The integration of the global economy means that easily replicable 'commoditized' jobs will tend to shift to the lowest cost locations in emerging markets. In this environment, the challenge for London is to ensure that it remains the world's most attractive and competitive environment from which to provide sophisticated and high value-added financial services to the rest of the world".

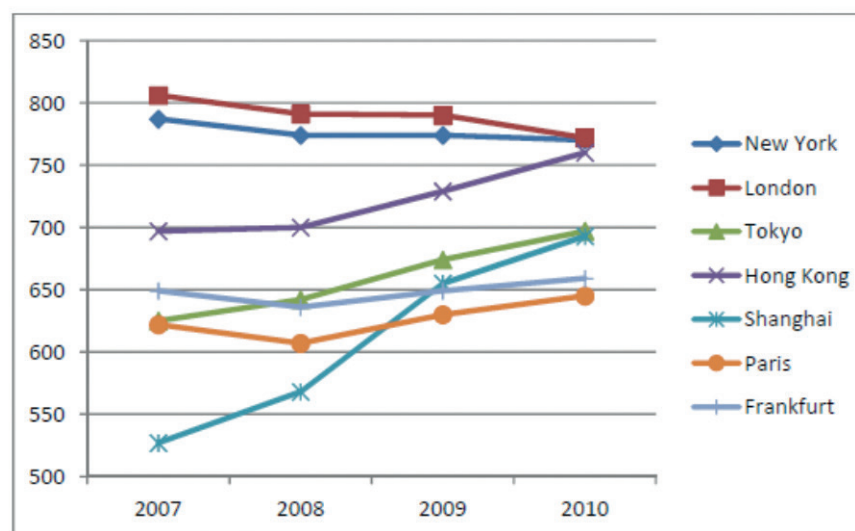
Table 2. The Global Financial Centres March 2008

London	1(1)	795(806)	London remains in top place in GFCI 3, despite losing 11 points from its rating in GFCI 2, after slipping slightly across the board in assessments made after the difficulties of Northern Rock and the publication of proposed changes in the tax treatment of non-domiciled residents, and in the light of continuing criticism of its airport and other transport infrastructure. London does, however, remain in the top quartile of instrumental factors (see Appendix C), and is still rated very highly by most questionnaire respondents, demonstrating its resilience as a financial centre.
New York	2(2)	786(787)	New York also remains in the top quartile in over 80% of its instrumental factors and has only dropped by one point since GFCI 2. For the first time, respondents from the banking sector rated it more highly than London, and it remained strong in all other sectors in spite of continued criticism from respondents over burdensome regulatory requirements under Sarbanes-Oxley.
Hong Kong	3(3)	695(697)	Hong Kong remains comfortably in third place, losing only two points overall in the ratings. It also retained a strong position in the five key competitiveness areas, though slipping one place to 4th among respondents in the insurance sector.
Singapore	4(4)	675(673)	Singapore performs well in GFCI 3, moving two points closer to Hong Kong. It was one of only two of the top ten to gain points (the other being Tokyo), and was rated 5th in the world by respondents in the insurance sector, where it had failed to make the top ten previously. Singapore's banking regulatory environment is still perceived as very strong.
Zurich	5(5)	665(666)	Zurich remains the strongest niche centre in GFCI 3. Private banking and asset management are its key specialisms. Its high ratings in the key areas of competitiveness have not changed since GFCI 2 and it has gained 35 points in Insurance.
Frankfurt	6(6)	642(649)	Frankfurt remains a key European hub for finance. It improved its standing on people and labour issues since GFCI 2 among respondents, and remained strong on other competitive factors, including professional services.
Geneva	7(7)	640(645)	Geneva is the third financial centre in continental Europe, with continuing high ratings for asset management, banking, and government/regulatory issues. It has, however, slipped in ratings for insurance and professional services.
Chicago	8(8)	637(639)	The number two centre in the US received higher ratings in GFCI 3 than previously in several competitive areas, especially business environment, and general competitiveness, as well as for banking and government/regulatory issues.
Tokyo	9(10)	628(625)	Tokyo has overtaken Sydney to move into ninth place. It and Singapore are the only two centres in the top ten to gain points in the GFCI 3 ratings. Its economy continues to strengthen, and it has the second-largest stock market in the world (by capitalisation). These two features offset long-term regulatory difficulties and poor access to international financial personnel.
Sydney	10(9)	621(636)	Sydney dropped to 10th place in GFCI 3, but was rated highly by respondents in the banking sector and will continue to be a key regional hub in Asia-Pacific. In spite of its geographic isolation, it has strong advantages in English language markets, and quality of life.

(Source: The City of London)

In 2010, Shanghai jumped to the sixth rank in the GFCI (Chart 7), and 8th on Xinhua-Dow Jones IFC Development Index (Table 3). This ranking, the highest among all IFCs in developing economies, still undercuts its ambition to a handful of cities: New York, London, Tokyo, Hong Kong, Singapore, Paris and Frankfurt.

Chart 7. Shanghai



Source: Global Financial Centres Index 1-8.

(Source GFCI 2010)

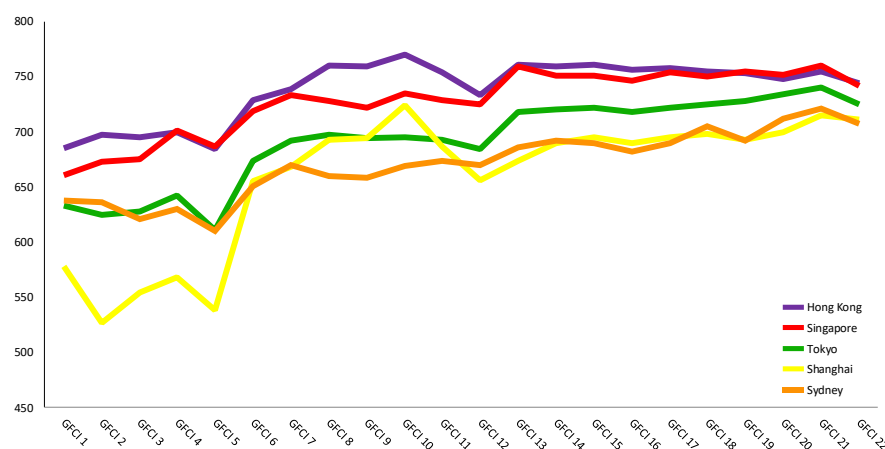
Table 3. Top 10 international financial centres in 2010-2013

Ranking	2013	2012	2011	2010
1	New York	New York	New York	New York
2	London	London	London	London
3	Hong Kong	Tokyo	Tokyo	Tokyo
4	Tokyo	Hong Kong	Hong Kong	Hong Kong
5	Singapore	Singapore	Singapore	Paris
6	Shanghai	Shanghai	Shanghai	Singapore
7	Paris	Frankfurt	Paris	Frankfurt
8	Frankfurt	Paris	Frankfurt	Shanghai
9	Chicago	Zurich	Sidney	Washington
10	Sidney	Chicago	Amsterdam	Sydney

(Source: Xinhua-Dow Jones International Financial Centers Development Index 2013)

Just seven years later, the GFCI (September 2017) signalled that four of the world's top six centres were based in Asia. Hong Kong, Singapore, Tokyo, and Shanghai, vie for primacy, attempting to attract dense clusters of financial services firms and reap the lucrative rewards associated with this, with Singapore and Hong Kong jostling over the second and third global ranking, successfully holding off Tokyo.

Chart 8. The dynamics of the five top Asian IFHs mirror the fast-changing landscape of the financial power in Asia 2017.



(Source: GFCI September 2017)

The acceleration of Shanghai's rank in the Global Financial Index should mostly be attributed to the policies passed through the Shanghai Pilot Free Trade Zone (FTZ). Instituted in 2015, it allowed for the opening of China's financial sector to more foreign financial services and accelerate RMB internationalisation, also by experimentally driving capital account convertibility (Wang 2016). However, the scope and the uncertain phasing of reforms have been widely criticised, for failing to live up to high expectations, and the remaining doubts over further commitments.

4.4 Is China ready for its International Financial Centre?

A November 2017 announcement of a proposed easing of access to China's market, through raising ownership limits in China's financial sector, has aroused great interest among investors eager to gain a greater share of the world's second largest economy. Should it be regarded as a turning point? China's commitments to financial opening largely comprise repetitions of previous plans. The Shanghai FTZ which was originally aired as a new centre of reform has subsequently been widely regarded as a disappointment in terms of financial reform and market opening.

The most recent announcement by the Chinese Government came a day after US President Donald Trump called on his Chinese counterpart Xi Jinping to allow American companies greater market access, during a state visit to Beijing. In the program, there are provisions for joint venture requirements and ownership caps in a broad range of industries to protect domestic groups from competition and induce sharing of foreign technology and management of expertise with local partners.

Is this new announcement merely a symbolic and politically motivated gesture to alleviate pressure from the US government?

On this subject, Alicia Garcia Herrero of Natixis expresses similar remarks: "Beyond the lack of progress so far, the announcement does not fully cast away doubts about the speed and depth of the

opening going forward” (2017). As she wrote:

“This is the case of the foreign ownership cap of domestic securities firms, which will increase from 49 percent to 51 percent and then to 100 percent in the coming three years. Within this context –Herrero concludes – one should not be too surprised at the general lack of interest in the opening of China’s financial sector” (ibid.).

The Chinese political establishment has been wavering on these questions (Yu Yongding 2017b). In influential circles, specifically the China Finance 40 Forum (CF40), economists have warned that China’s significant headway in opening up its financial sector over the past 40 years, and the prudence to carry forward reform to realise sustainable economic development, to prevent systematic financial risks, do not justify the slow pace of financial reform: as stated in their Jingshan Report, “the pace of reform hampers the healthy operation of the economy”, and especially the slow allure of financial opening up has fallen behind the real economy (see Xinhua 2017).

These statements should be read as an alert to Chinese policymakers to engage more deeply in the financial sector.

As Yu Yongding warns, China should address once and for all RMB foreign exchange rate, and opening to foreign financial services.

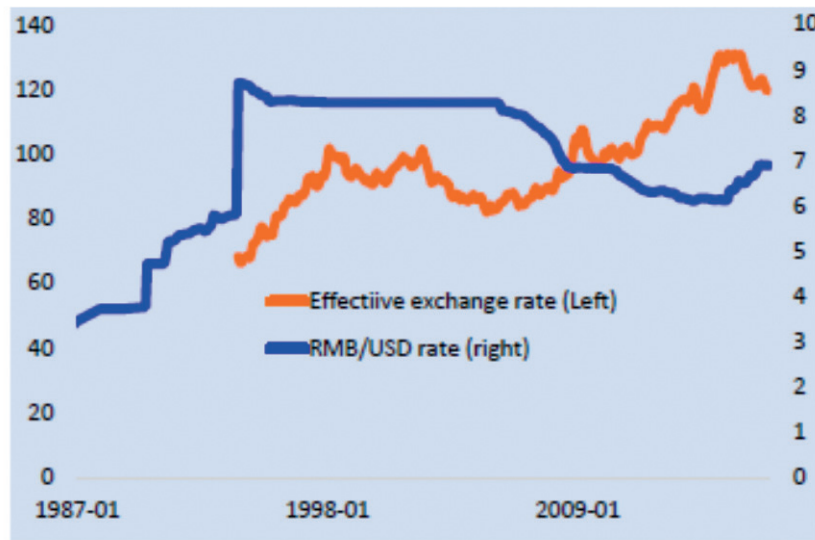
“China’s exchange rate reform has been dragging on for far too long. Instead of showing steady progress toward a more flexible exchange rate, the PBOC is back to square one. China has already paid very high costs for its hesitation in adopting a floating exchange rate regime. It is already overdue for the Chinese government to make up its mind on completing reform of the exchange rate regime. A further delay, let alone backtracking, is not only costly but also unnecessary” (2017).

In respect of the admission of foreign financial services that China started in November 2017, Yu Yongding emphasises the need of the opening of the financial service sector, which China promised to make in 2000 when it entered the WTO. These measures, though, are nothing new or surprising in China’s financial liberalisation strategy.

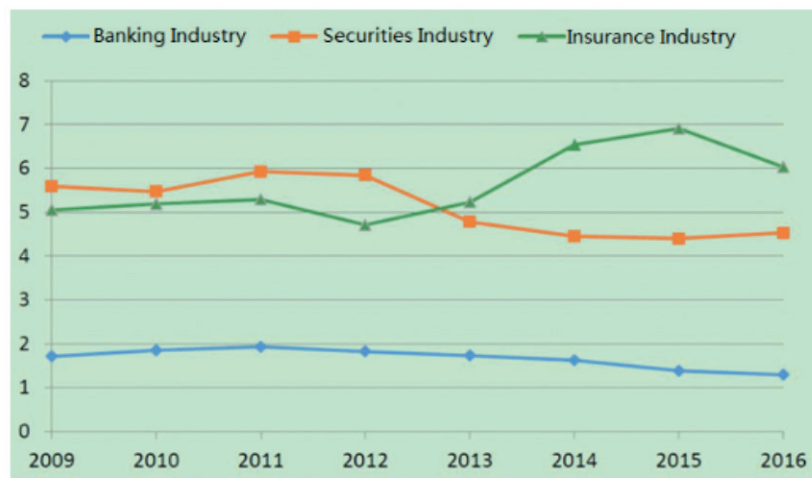
The Jingshan Report of CF40, discussed above, also

“calls for giving overseas-funded banks ‘pre-establishment national treatment’, which means giving equal treatment to overseas and domestic companies even before they make investments. Overseas securities firms and life insurers should be allowed to operate sole-funded ventures in China. The asset threshold of overseas banks should be removed, according to the report.” (Xinhua, 2017).

For now, as Huang (2018) wrote, China has shown a lack of direction in exchange rate policy, or in any ambitious commitments to opening up to foreign capital. This slow rate of change is indicative of the problems in the current financial environment, and shows in the RMB/Dollar rate (Chart 9) and in the still narrow share of foreign finance into the Chinese corporations (Chart 10).

Chart 9. RMB/Dollar exchange rate

Source: Huang (2018)

Chart 10. Share of foreign finance into Chinese corporations

Source: Huang (2018)

Though China is still lacking in provision for typical monetary and financial conditions, the financial services industry is an area where Western financial investors have been lobbying for many years. Contrary to pessimistic opinions expressed by some analysts, investors' reaction to the announcement of financial opening has mostly been upbeat.

The proposed easing of ownership limits in China's financial sector has aroused great interest among investors, eager to gain a greater share of the world's second largest economy. Following the November 2017 announcement, foreign financial companies and other interested parties are considering their next steps. The chronicle by CNN-Money (10 November 2017) is instructive in the subject.

Investors' Reactions to China's financial Sector's opening

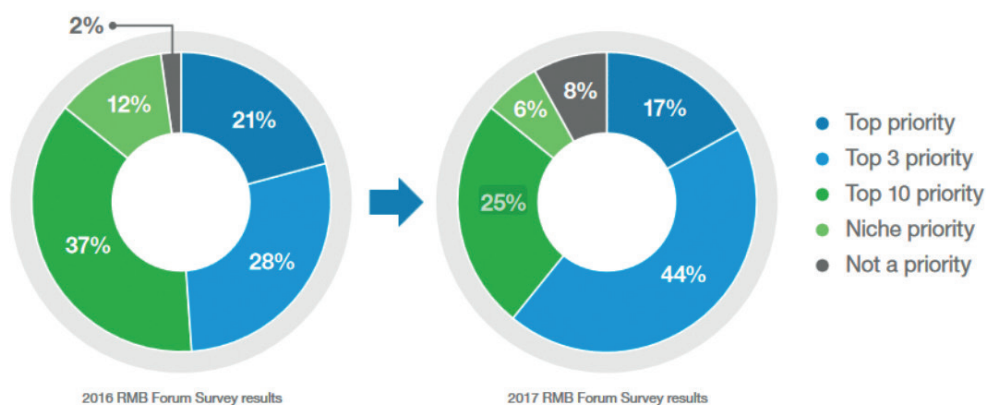
"Big Western banks are largely absent in China. Only HSBC has a significant presence through its 19% stake in Bank of Communications, but they are keen to take advantage of the country's growing wealth." These reforms were already in Xi Jinping's playbook," said Aidan Yao, an economist at AXA Investment Managers, referring to the Chinese President. Still, they could prove tantalising for foreign investors. China's financial sector is the world's second-biggest, with \$33 trillion in assets. "China's size and growth potential are irresistible attractions," Yao added.

Jamie Dimon, CEO of JPMorgan Chase, has since said he would be up for a second crack at China if the bank could control its business there, and a spokesman for America's biggest bank welcomed the rule change. JPMorgan would "evaluate viable options to strengthen its position in China"

A top European bank voiced similar approval. "The Chinese government's decision to allow foreign companies to take up to 51% in securities joint venture represents an important step in further opening up China's financial sector," said Eugene Qian, chairman of UBS China Strategy Board. The news came at the end of President Trump's visit to China in November 2017. Trump frequently points out China's huge trade surplus with the U.S., which stood at almost \$350 billion last year. Making it easier for American firms to sell financial services in China could help to achieve a better trade balance.

Actually, China's financial services package has spurred a great interest among investors. A Standard Chartered survey (2017) found that 25% of investors were planning to grow their China exposures and were doing so because of the new access channels, while 18% said it was due to improvements to the existing entry-point into China's market. The survey, quite surprisingly, recorded that the reform will add to a substantial role for Shanghai in helping to meet the needs of multinational companies, notwithstanding the current international status of the renminbi and the state of capital controls.

China is an increasingly a core priority. How important is China to you/your clients' investment strategy?



(Source, Standard &Chartered 2017)

What to Expect for 2018?

The Jingshan Report, published by CF40 (see Ch. 4.4) bets on three themes:

- ▶ the internationalisation of the RMB,
- ▶ rollback of temporary capital flows measures,
- ▶ financial services opening.

RMB market-driven exchange rate and relaxation of restrictions on foreign shares holding in Chinese financial institutions are critical first steps to China's finance development.

- Convergence between domestic and foreign market rules and regulations.
- Management frameworks at the micro and macro levels for cross-border capital flows.
- Resumption of RMB internationalisation.

4.5 The Shifting Geography of International Financial Centres. Hong Kong, Shanghai, and the Race to the Top

Economics theory (Kindleberger 1974; Gehrig, 2000) links the evolution of IFCs to the size and wealth concentration of large cities. The world's 750 major cities are the powerhouses of global growth currently accounting for some 57% of global GDP; by 2030 they will contribute around US\$80 trillion to the world economy (61% of total world GDP). Which cities are likely to make the top 10 in the league? How do these expected seismic changes underway in the global cities economic order play out on the map of International Financial Centres?

In the Oxford Economics 2017 (OE 2017), Chinese cities will be at the heart of a radical shift in the urban centre of economic gravity by 2030. Eight European cities will drop out of the global top 50 cities by GDP by 2030, while nine new Chinese cities will join that group. This will take the Chinese total to 17 in the world's top 50 by 2030, more than North America and four times more than Europe. China's lesser-known megacities such as Chengdu, Hangzhou and Wuhan will become as prominent in 2030, in economic terms, as Dallas and Seoul are today. The aggregate GDP of China's largest 150 cities overtook Europe's 139 largest cities in 2015, and North America's largest 58 cities in 2022 (OE 2017). Financial and business services are expected to fill the gap left from manufacturing sector exit, with Chinese cities gaining around 25 million more financial and business services jobs. "Nevertheless, the leading European and US cities will continue to top the rankings in terms of their financial and business services contribution to global GDP. The world's three prominent global financial centres remain top in 2030" (OE 2017: 13).

Table 4. Top Ten Cities Rank 2030

Global 750 cities top 10: Financial and business services GDP

Rank (2030)	Rank (2013)	Change in rank	City
1	2		New York-Newark-Jersey City
2	1		Tokyo
3	5		London - Metro
4	3		Los Angeles-Long Beach-Anaheim
5	17		Beijing
6	4		Paris - Metro
7	8		Washington-Arlington-Alexandria
8	6		Chicago-Naperville-Elgin
9	22		Shanghai
10	9		Philadelphia-Camden-Wilmington

Source: Oxford Economics Global Cities 2030

(Source: OE 2017)

Research on IFCs might raise questions over how respondents assess the consistency of the hierarchical ranking and the underlying economic fundamentals.

- Is the current hierarchical ranking of IFCs in Asia sustainable, and does it reflect the real economic fundamentals of the country where the surveyed Financial centres are located?
- How does the special relationship between Shanghai and Hong Kong¹² matter, and where is this relationship heading?
- What model among the current ones, if any, is likely to better suit Shanghai, and what specific features are likely to be designed for it to adequately perform its objectives?

The first question leads to ask what we can learn from a survey research. While this instrument provides critical evidence about what makes a great financial centre, it has several hidden biases which include at least three issues which weaken the long-term reliability of the data.

- The interpretation of answers will tend to reflect the unconscious, and occasionally conscious, biases of whoever commissioned the survey.
- Difficulties in comparing emerging and existing centres, since the attributes of rising ones are changing over time and may differ significantly from those of the existing centres.
- Knowing that the survey will be used to influence politicians and other decision makers, respondents are likely “talking their positions”, thus projecting their “self-images” of future development (Elliott 2011: 6).

On the whole, these biases have a tendency to be conservative, to replicate the status quo, and contribute to the maintenance of the lasting hierarchical shape of IFCs. Even in the course of the deep turmoil in the financial sector following the 2008-2009 financial crisis, IFCs substantially preserved

¹²Hong Kong also has a special relationship or trade off with UK that largely has credited its financial expertise. At the same time UK through Hong Kong’s “Closer Economic Partnership Arrangement” (CEPA) has largely enjoyed tariff-free treatment in Mainland China, including financial services in several areas. “UK companies can take advantage of this because the beauty of CEPA is that it is nationality-blind: by setting up an operation in Hong Kong, foreign enterprises can use the city as their platform to enter the vast Chinese market. Indeed, many UK companies are already using HK as the means of accessing this enormous resource and opportunity, to the mutual benefit of the UK, Mainland China and Hong Kong.”, as stated by Mrs Agnes Allcock, Director General of the Hong Kong Economic and Trade Office (Allcock 2010).

their pre-crisis rankings, only showing a tiny variance in GFCIs¹³. Additionally, survey research, being prone to in-built biases, are often likely to underrate the formation of new clusters at the border, whose fresh competitive advantages are likely to challenge the existing ranking order. These developments are observable in Asia where established financial centres Singapore, Hong Kong, and Tokyo are struggling to adapt not just to London but also to cope with Chinese financial centres of the like of Shanghai, or Shenzhen.

For the objectives and strategies that the new centres are designed to achieve, they are prepared to deviate from the economic principles and policies of established centres, which are often based on the schemes of neoclassical financial theory.

The East Asian miracle economies prove the point that finance can be socially efficient if bankers can be set to work within the 'developmental mindset', the institutional arrangements and political compulsions of a 'developmental state', as argued by Wade (2018) – China's recent move to (securities) market-based finance may be the beginning of the unravelling of its growth miracle (Gabor 2018; BIS 2017).

Based on the mishmash that "the provision of knowledge and capital likewise creates opportunities for strategic financial action", the neoclassical theory of finance excludes one issue that appears patently obvious: the fact that the "external economy" shapes events on the stock markets (Spremann 2010)¹⁴. In a similar vein, Woo (2015) questions the neoliberal 'orthodoxy' that has justified financial sector development in Western countries in top financial centres such as London and New York. While there is not one model-fits-all IFC development, the underlying theory of this neoliberal model of IFC development needs a critical review "in the process of providing a better understanding of other alternative financial policy regimes" (2015). Woo identifies leading Asian IFCs such as Hong Kong, Singapore and Shanghai, which "have employed distinctly different models of financial sector governance and development, based on their unique political economic contexts" (ibid.)

The limits of neoliberalism go beyond modes of governance. The recent crisis has questioned the link between financial development and economic growth, and not only because financial development has altered the nature of the typical transaction in the financial sector, making it more at arm's length (Rajan 2005). A further concern relates to the size of a state's financial sector compared to the size of its domestic economy. When the size of finance to GDP nears the threshold at around 80-100% of GDP, and continues to rise above, it starts having a negative effect on economic growth (Arnaud et al. 2012).

These findings counter the neoliberal notion that finance draws the real economy forward, and raise questions over institutions built on it. A practical demonstration of these axioms is the neoliberalism account of the predominance of Hong-Kong on Shanghai¹⁵. From the neoliberal perspective, independently of its strong ties with the Mainland, Hong Kong is set to maintain its stature as a global hub.

¹³Similarly to complex systems observed in the physical, biological and social sciences, financial markets are organized in a nested hierarchical structure, where the elements of the system can be partitioned in clusters which in turn can be partitioned in subclusters and so on up to a certain level (Simon 1962).

¹⁴"Investors who adhere to the neoclassical and corporate finance schools are portfolio investors. To them, the capital market is a good and attractive institution. (...) They have no interest in transactions that bypass the market. They diversify their investments, accept market prices as given and adapt their portfolios to changing circumstances. A large number of such portfolio investors can shape what happens on the capital market. Individually, however, none of them has sufficient power to break the rules by which the market operates" (Spremann 2010).

¹⁵ In Chapter 5 the author expands this perspective to the case of London and Paris, the rising EU international financial center.

As McCauley and Chan argue, because “finance is not the same as goods trade”, as long as

“Hong Kong’s share of China’s external bank assets and liabilities is not falling, when China is more open financially and Shanghai returns as a competing centre, Hong Kong will still play as China’s major international financial center”¹⁶. (2006)

So, they argue that the “prospect that Shanghai’s reintegration into the global financial system will not only narrow the gap between itself and Hong Kong but also narrow the gap between Hong Kong and New York and London”, and in the end they conclude the “To write that Shanghai will displace Hong Kong is just dog-bites-man journalism” (ibid.).

By the same token, Subacchi *et al.* (2012) state that

“Looking ahead, Hong Kong is expected to remain the international financial centre in the region that could rival New York and London. This is not only because of its well-developed regulatory system and its reputation as the most liberalized financial centre in Asia but also because of its unique competitive advantage over London and New York, namely the ‘China dimension’. More importantly, despite concerns that the Mainland’s authorities may expect Hong Kong to provide traction to ultimately make Shanghai the largest RMB onshore IFC in Mainland China by 2020, Hong Kong has its own competitive edge such as its legal system, abundant financial talent and liberal market environment, which no policy decisions can erode”.

In sum, it is unlikely that Shanghai will be able to compete with Hong Kong and emerge as the international financial centre in the region over the next few years. Though, McCauley, Chan and Subacchi admit that that situation could radically change, with the convertibility of the RMB and subsequent comprehensive liberalisation of China’s capital account (2012:40-41).

Hong Kong Financial Centre

From a prospective that includes the real economic hinterland, Hong Kong’s top position is less assured. Its ranking depends entirely upon the relationship with the Mainland, and it is likely that Hong Kong will continue to enjoy a pre-eminent role as the gateway for international investors seeking to do business on the Mainland for as long as it is able to offer legal infrastructure and economic transparency that the finance community regards as mostly relevant. Yet, these factors are necessary but not sufficient to maintain its leading position over Shanghai¹⁷.

Furthermore, cracks appearing in Hong Kong’s declining gross domestic product (GDP) raise concerns over its weight and relevance in the Mainland economy. At the time of the handover (1997), the city accounted for close to 20% of the country’s gross domestic product (GDP), compared with less than 3% today. This sounds that “Hong Kong’s relevance to China has shrunk dramatically” (Balding 2017). Until the late 1980s, Hong Kong’s economy had four industry pillars: financial services, trading and

¹⁶McCauley and Chan associate their thesis to Kindleberger (1974), “who argued that federal states can support more than one financial center”. However, Hong Kong is not part of a federation, as it is an autonomous region and issues its own currency.

¹⁷Beijing remains the country’s political center and as such, a preferred location for many of China’s largest (state-controlled) financial institutions. Moreover, it continues to see a significant agglomeration of international financial and corporate services.

logistics, tourism, professional and producer services. Its financial hub status depends on its being the nearest RMB clearing Centre to mainland cities and the largest offshore trading hub in the Asia-Pacific region. Yet, the four pillars have been reduced to three in the last two decades, as the manufacturing sector has completely migrated to China. But the remaining three pillars are further shrinking since the city's cost competitiveness continues to erode without a corresponding increase in efficiency and productivity (Wu et al 2015).

In the latest survey (September 2017), Hong Kong still remains a major global financial centre, surpassing by several notches Shanghai, placed at the sixth rank. The latter, though, counts a larger stock exchange with total market capitalisations overtaking Hong Kong's by more than 9 trillion yuan (\$1.3 trillion). Shenzhen, which borders Hong Kong, is not far behind. Shenzhen also happens to be at the cutting edge of China's boom in technological innovation, giving rise to giants such as the world's largest consumer drone-maker, Dajiang Innovation, as well as gaming titan, Tencent Holdings (Asia Times 2017).

Though Shanghai climbed by 15 points in the latest survey (September 2017), its ranking does not reflect its role as the flagship of the second largest economy in the world. In understanding its modest ranking, a number of reasons appear. Limited policy capability, and legal constraints vis-à-vis Hong Kong and Singapore, appear the most tangible factors. Shanghai does not have the freedom to adopt independently the policies needed to compete with its peers, so it lacks room for manoeuvre to enhance financial competitiveness, and "curtail and damper its race for positioning itself among the first three top Asian Financial Hubs" (Laurenceson and Tang, 2005).

For the same reasons, Peter Wong sees room for Shanghai to take over from Hong Kong by "playing global" rather than wait for the central government provisions. The strategy, Wong wrote, is for Shanghai to "focus more resolutely on its role as an internationally-oriented centre – as a genuinely global player – when looking to secure its competitive advantage" (Wong, 2015).

Shanghai Financial Centre

To be sure, the current China's financial and monetary framework represents a compelling constraint on Shanghai staging the leading China's Financial Centre. Back to 2006, Xiang Junbo, Deputy Governor of the People's Bank of China, explicitly made the point that Shanghai's growth as international financial centre is part of the nation strategy established in 1992, and that "[t]his strategy has two aims: one is to promote economic and financial development of the Yangtze River Delta and even of the whole country; the other is to develop Shanghai into a window for China's opening-up, foreign capital utilization and international financing." (BIS 2006).

For more than a decade now, "China is still in motion to complete its difficult but necessary transition from a growth model that emphasizes heavy industry, construction, and exports, to one that focuses on the development of services and greater domestic consumer demand." (Bernanke, 2016). At the same time, Shanghai, though not consented to self-governance of the like enjoyed in Hong Kong, London or New York, but not Singapore, sees the State and the municipality to play a relevant role defining its financial policy regime (Table 5).

Table 5. Policy regimes in London, Hong Kong, Singapore and Shanghai

	Low State Intervention	High State Intervention
Industry actor influential	London Industry interest group dominant	Singapore State-industry “cocreation”
Industry actors not influential	Hong Kong “big market, small government”	Shanghai State-dominated

(Source: Woo, 2015)

State-owned banks including the Bank of China, the China Construction Bank, the Agricultural Bank of China and the Industrial and Commercial Bank of China and other smaller commercial banks are also strongly involved in Shanghai’s development as an IFC. And the State’s influence on Shanghai’s financial markets also extends beyond the banking sector, with listings on Shanghai’s stock market dominated by state-owned companies (Laurenceson and Tang 2005, 161).

In 2014, with the establishment of the free trade pilot zone (FTPZ) in Shanghai, the State Council aimed to liberalise the municipality’s financial markets and hence reinforce its position as an IFC through a number of measures.¹⁸ Yu Peng, of the China Development Institute, commenting on the GFCI 2017, said that “Shanghai has to follow the national strategies such as the yuan internationalisation and the ‘One Belt One Road Initiative’ (OBOR), further strengthen collaboration with developed global financial centers” and, at the same time, policymakers [in Beijing and Shanghai should] “open the finance industry wider to enhance the influence of Shanghai as a global financial hub.” (Yixuan, 2017).

The eruption of the 2008-09 financial crisis has further hampered and slowed the process of China’s financial liberalisation, damaging Shanghai, the country’s most international financial centre. The decision by the Chinese government, announced in early 2009, to make Shanghai an international financial centre by 2020 sounded too optimistic in the fearful days of the crisis. For Shanghai it was a new and defining phase in its development as an international financial centre. The announcement by itself would have said little. Only China’s economy and the nation’s economic policies evolution during the next 10 years will determine whether this very ambitious goal for Shanghai will be achieved. In 2015, China announced the establishment of Shanghai as the global Hub for yuan trading, clearing and pricing over the next three years as part of broader plans to make the commercial hub an international financial centre on par with the likes of New York and London by 2020. That goal was set in 2009 by the State Council and analysts have taken 2020 as a broad deadline for liberalising the currency.

In fact, the State Council for Shanghai aims to attain a status of a global financial and shipping centre “consistent with China’s economic strength and the international status of the renminbi by 2020”. Once these targets were achieved, how would Shanghai’s model look like? The London-Global or the like of Hong-Kong? Or should Shanghai rather choose a different economic paradigm?

¹⁸Measures include arbitration: the FTZ features a distinctive mechanism for dispute resolution than exists elsewhere in China. The zone cancels out a number of financial requirements for setting up a company in China. Foreign exchange: As announced by the State Administration of Foreign Exchange (SAFE) Shanghai branch on 28 February 2014, the Free Trade Zone will permit yuan convertibility and unrestricted foreign currency exchange, and a tax-free period of 10 years for the businesses in the area as a means to simplify the process of foreign direct investment (FDI) and facilitate the management of capital accounts. Special Administrative Measures on the Entry of Foreign Investment into China (Shanghai) Free Trade Zone aimed to favor foreign investment management in all sectors unless listed as prohibited or restricted under the Negative List.

4.6 Leveraging Shanghai's Strengths: "One Belt, One Road Initiative"¹⁹ and the Asian Infrastructure Investment Bank (AIIB)

Positioning the role of finance in the context of theories of economic development,

"McKinnon and Shaw prepared the task of building money and capital markets in developing countries, and creating financial centres was as vital to economic development as and more important than foreign aid or export expansion. A large stream of studies promoted by World Bank and its branches have since long debated the role of finance in Latin America, Asia and Africa" (Kindleberger 1974).

While China's economic growth, and its engagement with the international economy, have gone far ahead of other Asian economies, it has still to even up its asymmetrical development. Its policy focus shifts to internal and Western regions, the AIIB and OBOR represent great expectations. The AIIB is the vehicle through which China's overheated investment capacity can be diverted out of the domestic economy, and OBOR is the roadmap of destinations for that investment. While the government's 'going out' policy initiative left Chinese multinationals relatively free in deciding the direction of outward investments, OBOR provides a much more directed strategic master plan, mapped out in the March 2015 announcement, "Vision and actions on jointly building China's OBOR initiative." (NDRC, 2015).

Shanghai plays a critical role in meeting the great expectations represented by OBOR and the AIIB. The city's economic, political, and geographical advantages, being the pivot to a global, economic focus, provide an opportunity for Shanghai. It will stake out a position as a new, respected financial centre in shifting global finance. While China's financial integration into the world economy continues, Shanghai has a unique opportunity to shape a new kind of international financial centre, one with Chinese characteristics: a deep connection to the country and regional companies, wealth, and markets, and a global perspective attractive to the rest of the world (Wang 2016).

The creation of massive financial wealth, and the hegemony of neoliberalism, based on the self-regulated and efficient markets, has underpinned the idea that financial centres are where "the liquidity is, and market liquidity is hard to move", so that the idea that developing economies could be the right place for the formation of Financial Centres did not take root among economists and adepts of the industry.

In the wake of the recent financial crisis, the appeal of this narcissistic mantra is diminishing. Thinking about the long-term consequences of the GFC, Elliott warns that "liquidity can occasionally move rapidly if a significant factor changes suddenly" (2011) when two types of factors materialise: factors acting over a number of years; sudden, dramatic alteration in the status quo.

The rise of Hong Kong and Singapore as a consequence of the retreat of European banks from Asia, and recently the uncertain future of the City of London, are both examples of liquidity looking for new place and opportunity. Brexit makes an interesting case to understand inbuilt vulnerabilities of a global financial centre when a "black swan event" materialises. While still the top centre of financial flows, the City of London seems to be losing out to other nation's cities. In 2017, "London was the worst-perform-

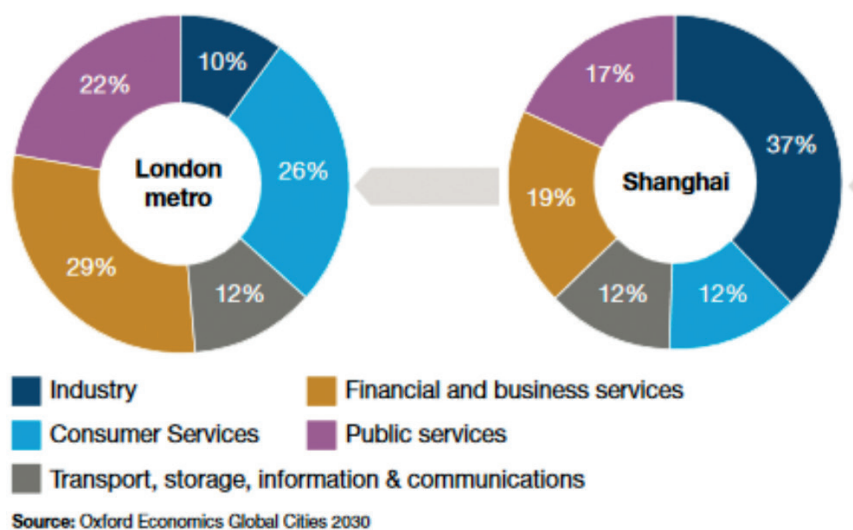
¹⁸Henceforth OBOR

ing home market in the U.K. for the first time in more than a decade and may be stuck there”²⁰ (quoted in O’Brien, 2018).

The UK’s withdrawal from the EU may bring far larger consequences on London. Giving up the large European economic hinterland, the size of UK’s economy may be more vulnerable to external shocks, and if so, London’s retention of its seat at the top of the global hierarchy may seem unlikely.

In the OE Report 2017, Shanghai is described as in a rapid catch-up with the most advanced cities in the world. The drafters go far to suggest that Shanghai might look to London, one of the few truly global, tradable services cities, as a template for success; perhaps learning lessons from the history of that city’s experience in order to manage the industrial transition more smoothly.

Chart 11. Urban Development Story: London, Shanghai



(Source: OE Report 2017)

However, since June 2016, London experienced an alteration in its status quo, and the imbalances generated by its model of financial centre.²¹ Nicolas Véron of the Bruegel Institute has explained in a nutshell what made London the European global financial centre, and how much the single market helped London to turn into a global centre.²² Véron (2016) argued that the European single market

“has always been much more than a free trade zone. From its very inception as the 1950s European Coal and Steel Community, the EU has been about removing ‘behind-the-border’ barriers to business and creating a single economic space regulated by supranational authorities... this is why EU-level competition policy is so central to the whole project” (2016).

²⁰“Nationwide Building Society said values in the capital fell 0.5 percent – the first full-year decline since the 2009 recession – lagging behind a 2.6 percent increase nationally. It’s the first time since 2004 that the city has ended the year as the slowest-growing region” (Bloomberg 2018).

²¹The point is analyzed in Chapter 5.

²²John Gapper in the Financial Times (July 9, 2016): “... the City could thrive after Brexit but there is a serious risk that it will be diminished. It has largely had the best of both worlds in the EU, strengthening its global status while taking advantage of services passporting and freedom of movement to entrench itself as Europe’s financial hub.”

Véron goes on to argue that the irritation expressed by London towards EU supranational administrative capacity, and the claim of its self-governance institutions²³ have underscored a critical lesson for GFCs: “Deep economic integration goes hand-in-hand with supranational administrative capacity, especially in economic sectors that require intrusive public oversight, such as regulated services and especially in finance” (ibid.).

In two ways the European single market and the supranational governance have well served London’s escalation to the global top rank:

1. by way of its large and integrated market, the European Single Market was London’s hinterland,
2. supranational regulatory oversight is indispensable especially in finance and were a benefit for London’s clearing houses, which dominated with daily deals worth €1tn of foreign-exchange contracts (converting an amount of euros into another currency), compared with €400 bn in New York.

At a first sight, New York’s story may seem quite similar to London’s in that it is the other great world financial centre and has been for many years. Thus, New York also has a wide and deep set of markets, personnel, and institutions that give it a strong position for the future. However, London and New York are two different models of global financial centre. An advantageous feature of New York “is that [it] is somewhat less global than London, in that a substantial portion of the business has a natural American connection, with one or both sides of the transaction are based in the US” (Elliott, 2011). For New York, sitting in a large and sophisticated economy, its hinterland is a strategic advantage compared to London, as Elliott’s summarises:

“This is a great strength of New York, since its vast hinterland in the US means that even if its global competitiveness temporarily slips, it will be able to maintain a very large volume of business, and the people and institutions it supports, based purely on the American business. This would make it easier to overcome temporary bumps in the road” (2011, p. 11).

So, in contrasting London and New York it emerges that while jostling for several years to be the top global financial hub, they mostly represent two entirely different models of financial hub. Yet, the difference has clearly emerged in the occurrence of a “fairly dramatic alteration in the status quo”. In the wake of the Brexit, UK’s government is struggling to retain the “hinterland”, the European Single market, which made London seem on par with New York.

Though the story of London is unlikely to apply to other “global centres”, Hong Kong and Singapore are unlikely to miss their hinterland; Hong Kong for the dense and important ties with China, and Singapore for tapping into China and India economic growth, and leveraging information and communication technologies. Singapore’s unified economic and financial governance performs a high-degree of prudential management of the finance sector (Guo, Woo 2017).

²³On London special status see Monbiot (2011).

Wrapping up

The differences between New York and London underpin two models, and tell an interesting story for the new financial hubs in Asia, and likely in Europe.

1. Being more global doesn't guarantee a financial hub to retain lasting supremacy.
2. Even for finance, a foot-loose industry, a strong and large hinterland is critical to the survival of Financial Hubs.
3. *"After Brexit, [London] is likely to become an offshore centre, relatively more vulnerable to policy decisions, especially regulatory decisions, made elsewhere, particularly by the Eurozone"* (Wolf 2016).

In a concluding note, this Chapter has engaged in a lengthy and complex analysis of the objectives and fundamentals that underpin Shanghai's financial centre. Art and culture can do it in a straight, fulminant image. Arturo Di Modica's second version of the Charging Bull, nicknamed as Bund Bull, installed in Shanghai on May 2010, likely tells more than this study attempted to do.

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5. Relocation of Financial Hubs on Mainland Europe. Is Paris the Right Place to go?

“The British ‘second’ empire emerged partly as an accident of history, partly because of the traditional role of the City in the first empire. Once an unregulated financial market developed in London, it became clear that trading through the small remnants of the empire gave London a distinct advantage. The UK was never too keen on making political capital out of these developments, maintaining relatively low key profile in the international arena but always insisting on maintaining London’s system of financial self-regulation.” (Palan 2015)

Introduction

Increasing global financial integration and a concentration of financial markets, alongside the UK’s inclusion within the European Union, have greatly played in favour of the City of London for several decades now. London acted as Europe’s prime financial hub providing the gateway for international capital flows to Continental Europe. In this role it achieved full dominance of the EU’s financial markets. The Bank of England and the UK Financial Conduct Authority have comprehensively seized oversight of Mainland Europe’s markets. By leaving the EU, the UK has broken with the European economic area, the critical bond that profited the City of London with substantial wealth. But, London will not only lose the link to mainland economic activity, valued at over \$19 trillion. Having prospered with its inclusion in a European single market far exceeding than its own economy in size, London now faces a real and serious risk of losing out to the mainland’s Financial Centres, Paris, Frankfurt and others, and will, in all likelihood, decline the financial centres’ league ranking.

After tracking some aspects of the relocation of financial activities to Mainland Europe, this study considers Paris a persuasive candidate in the process of re-setting the European map of Financial Centres, especially for the international projection of its banking system and stock exchange that outpace others in Mainland Europe.

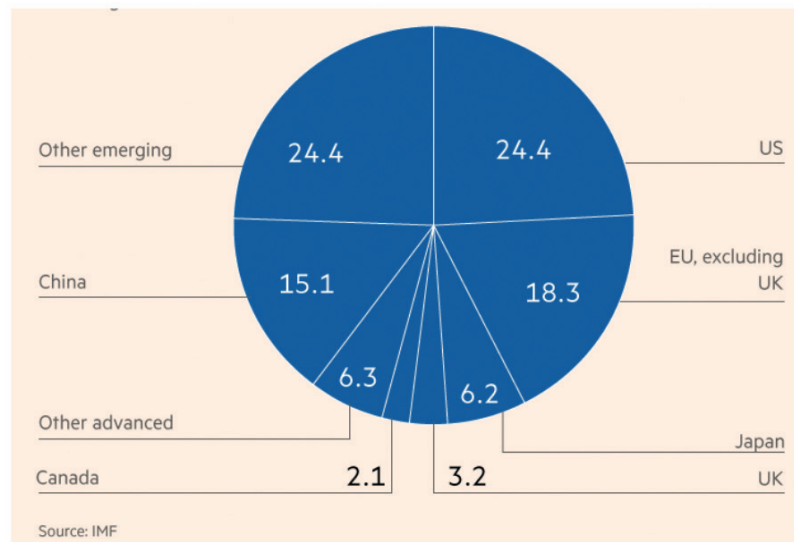
In respect of the city’s size, Paris is by definition the only “global city” in the European Union, on a par with New York. Paris is not only the European largest banking centre in Europe representing total assets of €6.3tn, it is also the largest asset management pool in Europe, and number one insurance market in the EU. From its side, Paris has driven French central Administration towards a high-profile lobbying campaign to lure banks away from London. The French Administration is moving closer to Paris’ ambition, taking action on tax and labour market reforms, in a move to boost country’s attractiveness.

The Chapter does not primarily aim to list all the “beauties” of Paris vis-à-vis London, or other Mainland’s competitors; the contribution of this Chapter is rather to address the motives that support the creation of International Financial Centres on Mainland Europe, and the advantages that a deeper and broader financial industry would likely bestow on EU economic growth. The similarity of the continental size of the EU economy to China, and the US,²⁴ brings out the issue of whether a London-like model, or a different class of International Financial Centre would suit Mainland heterogeneous economies (5.1).

²⁴In 2016, China was the world’s largest economy for the second year in a row. It produced \$21.3 trillion in economic output. The European Union was in second place, generating \$19.2 trillion. Together, China and the EU generate 33.9 percent of the world’s economic output of \$119.4 trillion. The United States fell to third place, producing \$18.6 trillion. The world’s three largest economies combined produced \$59 trillion.

Kindleberger, as discussed in Chapters 4.1. and 4.2, identifies underlying motivations through which at least two primary financial centres in mainland Europe: Frankfurt and Paris, with two distinct and converging objectives, are set to take a leading role in the process (5.2).

**Chart 1. The EU is an Economic Superpower:
share of global nominal GDP% 2017**



5.1 Brexit and the Relocation on Mainland Europe

Michael Bloomberg, who once described Brexit as the “single stupidest thing any country has ever done” (Ruddick, 2017), admitted that London would stay as a leading financial hub.

“London is always going to be the financial centre of Europe for the foreseeable future . . . It has the things the finance industry needs: it is English speaking, it is family friendly, it has a lot of cultures so you can attract those people here.” (BBC News, 2017)

What will happen with Brexit is that

“some jobs will move, although they may have very well be replaced here, but the growth rate of London as a financial centre will certainly not be what it would be if Brexit didn’t take place”. (ibid.)

The billionaire’s company recently opened its new £1bn headquarters in London, where 4,000 employees will work, with room for an additional 4,000.

With London’s withdrawal and the finance relocation from London underway, are the 27 European Members ready to grasp their huge opportunities? Which one of the euro-cities contenders is likely to emerge as the Global Financial Hub? The primary objectives are:

- ▶ Accelerating the development of EU financial markets, by way of policy measures, among others the Banking Union and Capital Markets Union (CMU).

- ▶ Relocating financial market infrastructures presently located outside of the euro-area that clear and settle large amount of euro-denominated transactions, and are of systemic importance to the euro.
- ▶ Shaping a strong convergent European supervisory culture and institutions.
- ▶ Putting trends, risks and vulnerabilities in financial markets at the centre of European policymakers' agenda.

The City of London

The place of the City of London as a major financial centre goes back to the Suez Canal Crisis; when reacting to speculation over the pound the British Government imposed strict restrictions on the use of the pound sterling in trade credits with non-residents. These measures fatally wounded the City of London's banks in their core business, "international lending, particularly to British Commonwealth countries and the so-called British informal empire in Latin America, thus saw their core business disappear overnight". The response was to circumvent British Government restrictions and the surveillance of the Bank of England, by using dollars rather than pound sterling, thus allowing the Banks to continue. As Palan (2010) wrote:

"The unique regulatory regime that has made London into the world's premier financial centre emerged, in fact, for reasons that neither the Corporation [the City of London] nor the Bank of England would like to advertise too widely. It had to do with the emergence of a unique type of unregulated financial market in the late 1950s, (...) due to a tacitly accepted understanding by which the Bank of England regarded certain types of financial transactions as if they were taking place elsewhere" (2010 pp. 160-161).²⁵

The UK's remarkable dominance in many financial markets, and especially in forex activity, has largely drawn from EU membership, the principal reason that has contributed to London's staging as the world's global financial centre. The concentration of the finance industry in London, and the number of people involved, raise issues over the relocation process.²⁶

The physical setting of new financial centres on Mainland Europe is still uncertain. Recently, the 'beauty contest' in the EU over the distribution of Agencies (EMA and EBA) has left confusion over which of the would-be centres would emerge. Though a fair competition is necessary to motivate administrations to assume the burdens of competition, measures for identifying natural and industry qualities should also play a part in the process. Yet, banks' significant systemic choices will inevitably shape the EU's primary financial hub(s).²⁷

²⁵Differently European Parliament praises among others "the predictability of the British legal system", and seems ignoring a well-known feature of London's self-governance (European Parliament 2016).

²⁶The largest center for derivatives market, foreign exchange markets, money markets, issuance of international debt securities, international insurance, trading in gold, silver and base metals through the London bullion market and London Metal Exchange and international bank lending.

²⁷"Thirteen major banks including Goldman Sachs, UBS, and Citigroup have given an indication of how they would bulk up their operations in Europe to secure market access to the European Union's single market when Britain leaves the bloc. Talks with financial authorities in Europe have been underway for several months, but banks are increasingly firming up plans to move staff and operations. "It's full speed ahead. We are in full motion with our contingency planning," said the head of investment banking at one global bank in London. "There's no waiting." The Independent April 2017.

► Relocation of activities and people

For an estimated 35 percent of activities moving to the EU, potential cities should be prepared to receive at least 30,000 people leaving UK, and Administrations should be prepared to supply, or support relocations of residences, headquarters etc. (Sapir et al 2017; Véron et al 2017). Actually, relocations of people from London may number up to 200,000. So only very large cities can contemplate accommodating them. On the Mainland, Paris with its 10 million inhabitants emerges as the only city comparable to New York and London, currently the two top global centres.

► Banks. Four Contenders, Two winners: Paris, Frankfurt

In the EU, four contenders have attracted the analysts' attention (Véron et al. 2017; Sapir et al. 2017): Frankfurt, Paris, Amsterdam, and Dublin. Yet, only cities with the highest number of indigenous banks are most likely to attract foreign peers' banks. Dublin seems out of the game, lacking large national banks, and Amsterdam, according to the largest Dutch banking group ING, will not replace London given its shortage of skilled personnel.²⁸

► Clearing Houses

Clearing is the backbone of modern financial markets. The London Stock Exchange owns the biggest clearing house. It commissioned a report (2016) that found up to 83,000 British jobs could be lost over seven years if this activity was to move out of London and into the Eurozone.

► Large Banks' Relocation

With Dublin and Amsterdam out of the game, Frankfurt and Paris appear most likely to host the new EU27 wholesale markets. As at early 2017, they only hosted the European headquarters of a few large companies. Yet, the speed with which international banks are enacting contingency plans will increase these initial numbers. Last year, the Bank of England warned that as many as 10,000 City jobs could go by March this year without a Brexit deal. A partial migration of financial firms will thus have a major impact on these cities and their infrastructures.

5.2 Examples of how Germany and France could benefit from Brexit

Frankfurt:

- Supervisory institutions report increased interest of UK-based banks in a move to Frankfurt
- Germany has overtaken the UK in FinTech investments: In the first three quarters of 2016 FinTech in Germany raised 398 million USD, compared to 320 million USD in the UK.

²⁸ "We do not see Amsterdam or Brussels developing into major European trading centers", the Financieele Dagblad quotes an internal staff memo by the Dutch banking group ING about the shift of several dozen trading jobs to London. The bank also points to the Global Financial Centers Index, which is led by London. Amsterdam is in 33rd place in the ranking, which is based on business environment, financial sector developments, infrastructure, human capital and reputation. In particular Amsterdam has a shortage of skilled personnel, such as traders who are experienced in developing markets, according to the ING memo. It also remains to be seen if traders are willing to leave London. The tough Dutch rules limiting bonuses to 20% of annual salary are an added factor, the memo said.

Paris:

- Paris hosts a subsidiary of LCH, London's major clearing house. This entity could take over euro area government bond clearing that is currently conducted in London (the monthly trade volume amounts to €6 trillion).
- Insurers are already concentrated in Paris, which provides a good basis for further growth. They are, however, less affected by Brexit since they mostly operate through subsidiaries.

Currently, the City is at the very heart of the euro trade; City clearing houses make around €1 trillion a day, and losing even a share of it makes the Brexit talks very unforgiving. It is no wonder that Frankfurt and Paris are competing to take an increasing share of London's euro business. To this end, Paris has taken the bold move to call for the abolition of all euro trading in the UK and have all trading in the currency done inside the Eurozone.

After the Brexit decision, Paris' Euro market improved its share of euro-denominated derivatives, from 10.6% in 2013 to 13.2% in 2016, while Frankfurt dropped from 6.6% to 2.2% over the same period. As the ownership of clearing is often intertwined with stock exchanges, a lot will depend on whether the LSE's clearing arm (LCH) will go to Frankfurt or Paris.

With Brexit talks deadlocked for months, firms including Goldman Sachs Group Inc., Morgan Stanley, UBS Group AG and Royal Bank of Scotland Group Plc will start moving people, infrastructure and capital into their new trading hubs inside the bloc in the first quarter, according to sources, who declined to be identified as the plans are not public. While banks would like to delay or ideally avoid implementing their contingency arrangements, likely to cost more than \$500 million per firm, they need at least 12 months to establish full-scale operations inside the EU staffed by significant numbers of senior employees.

With some 35% of wholesale market activities supposed to migrate from London, almost 30,000 people might relocate from London to the EU27: 10,000 related to core wholesale banking and 18,000 to 20,000 related to professional services. The large investment banks from the US, and the large universal banks from Europe are essential players in the wholesale markets. These banks bring together the suppliers of capital (investors) and those with a need for capital (corporates, governments and households). In this way, these banks are the gatekeepers of the EU Capital Markets Union, which aims to improve access to funding, allocation of capital and better savings rates for savers. Investment bank league tables rank investment banks by market share and typically cover four major sectors: mergers and acquisitions, equity, bonds and loans (i.e. syndicated loans). Table 1 shows the top 20 banks, representing about 80 percent of the European investment banking market.

Table 1. European Investment Banking, top 20 banks, mid-2016.

Rank	Bank	Country of origin	Fees (US \$ million)	Market share (%)
1	JP Morgan	US	549	6.1%
2	Goldman Sachs and Co	US	483	5.4%
3	Morgan Stanley	US	462	5.1%
4	Barclays	UK	432	4.8%
5	BNP Paribas SA	Euro area	400	4.4%
6	Deutsche Bank	Euro area	373	4.1%
7	Citi	US	358	4.0%
8	Bank of America Merrill Lynch	US	338	3.7%
9	HSBC Holdings PLC	UK	329	3.7%
10	Rothschild	UK	246	2.7%
11	Société Générale	Euro area	212	2.4%
12	Crédit Agricole CIB	Euro area	209	2.3%
13	UBS	Switzerland	194	2.2%
14	Lazard	US	192	2.1%
15	UniCredit	Euro area	184	2.0%
16	Credit Suisse	Switzerland	151	1.7%
17	ING	Euro area	137	1.5%
18	Evercore Partners	US	129	1.4%
19	Santander	Euro area	116	1.3%
20	Natixis	Euro area	112	1.2%

Source: Bruegel based on Thomson Reuters (2016), Investment Banking League Tables.

(Source: Schoenmaker et Alii 2017)

Table 2. Geographic Split and wholesale vs. retail split of top 13 systematically important banks (SIBs) in the euro area, end-2015

	Geographic split				
	Assets (€bns)	Home	Other euro area	EU non-euro area	Non-EU
BNP Paribas	1,994	25%	36%	11%	28%
Crédit Agricole	1,699	81%	8%	2%	8%
Deutsche Bank	1,629	26%	19%	9%	46%
Santander	1,340	28%	11%	31%	29%
Société Générale	1,334	72%	8%	10%	11%
BPCE	1,167	91%	2%	1%	6%
UniCredit	860	40%	35%	22%	3%
ING	842	36%	38%	9%	17%
BBVA	750	39%	10%	4%	47%
Crédit Mutuel	707	89%	8%	1%	3%
Intesa Sanpaolo	676	85%	5%	6%	5%
Rabobank	670	74%	5%	2%	20%
Commerzbank	533	52%	19%	16%	13%

	Wholesale and retail banking split				
	Corporate & global	Asset management	Retail	Other	Reporting
BNP Paribas	54.4%	0.9%	30.1%	14.6%	Total assets
Crédit Agricole	51.1%	5.3%	13.3%	30.4%	Total assets
Deutsche Bank	76.4%	5.5%	15.8%	2.3%	Total assets
Santander	11.6%	0.0%	88.4%	0.0%	Operating income
Société Générale	56.6%	9.8%	24.6%	9.0%	Total assets
BPCE	40.3%	0.0%	59.2%	0.5%	Total assets
UniCredit	15.8%	6.2%	77.6%	0.4%	Operating income
ING	33.3%	0.0%	66.7%	0.0%	Operating income
BBVA	8.7%	0.0%	91.3%	0.0%	Loans
Crédit Mutuel	9.1%	2.1%	71.4%	17.4%	Operating income
Intesa Sanpaolo	17.3%	13.5%	63.1%	6.1%	Total assets
Commerzbank	33.2%	31.2%	21.0%	14.6%	Total assets

Source: Bruegel based on SNL financials and annual reports of banks. Note: Data split for Rabobank is not available. Insurance activities of banks are included in others. Data for Commerzbank is for 2014, instead of 2015.

(Source: Shoenmaker et Alii 2017)

- Most of the large euro-area banks appear to have a substantial presence in London. Table 2 further highlights that the large French banks (BNP Paribas, Crédit Agricole and Société Générale) and Deutsche Bank have substantial wholesale market activities (shown as corporate and global banking). These activities cover more than 50% of their total business. It is thus no surprise to find these universal banks in the top 12 of the investment bank league.
- Table 2 lists the largest euro-area banks with assets over €500 billion (Schoenmaker 2017), and lists the geographical segmentation of their assets by home country, other euro-area countries, non-euro EU countries (mainly the UK) and non-EU countries.

From this review it becomes clear that the core group of banks which will contribute to the building up of the EU27 wholesale markets, comprise the five US and two Swiss investment banks, two large UK

banks (Barclays and HSBC), the top three French banks and the biggest German bank. In the second circle, there are some Italian, Dutch and Spanish banks.

It is where US and Swiss banks, Barclays and HSBC, place their headquarters and trading rooms, that will determine the new EU Financial Hubs. From a quick review press, Paris emerges as the first choice of large banks;²⁹ with two out of three supervisory authorities, The European Securities and Markets Authority and European Bank Agency, and with the latter (200 staffers) expected to attract bankers and law firms, and lots of tax revenue, it appears that Paris is the best candidate to become the primary EU financial hub.

En passant, in 2016, after the Brexit referendum and the deep devaluation of the Euro and pound, French banks suffered less than others: four French banks, three based in the UK, one in Spain, and one in Germany remained with one trillion dollars of total assets, compared to six in China, four in the US and four in Japan.

5.3 Clearing Houses, and the Euro

According to Barker and Stafford (2015)

“Britain has won a landmark legal battle over the place of the City of London in Europe’s single market, forcing the European Central Bank to scrap a policy requiring big clearing houses to decamp to the Eurozone. The suit over the ECB’s so-called “location policy” was a test of whether Britain could remain Europe’s top financial centre and enjoy the full benefits of the EU’s common market while remaining outside the euro.”

The big UK-EU contest is indeed over the relocation of the clearing houses. The daily average total turnover in foreign currency traded in London was \$2.426bn in April 2016. This, according to the BIS, is nearly double the size of the trade sent through New York’s institutions (\$1.272bn).³⁰ London has held the top spot since 1995 when the data series was first produced. London has however seen volumes traded decline from the \$2.726bn recorded in 2013, as has New York which turned over \$1.263bn. It would appear that London and New York have both seen some of their market share slip at the expense of Asian trading centres.³¹

The City of London is pre-eminent in foreign exchange and over-the-counter (O-T-C) derivatives,

²⁹ Jamie Dimon, head of JPMorgan and HSBC’s Stuart Gulliver have turned up for the Paris. Gulliver said the Macron government, which has pledged significant tax cuts, was “very, very positive” for France’s attempts to lure business from London. HSBC is the only big bank to have talked publicly, or even privately, about moving large numbers of jobs to Paris. HSBC owns a large French bank, Credit Commercial de France. On Tuesday Mr. Gulliver reiterated a longstanding pledge to relocate up to 1,000 roles to the city (FT 2017).

³⁰ The BIS offer the most comprehensive snap-shot of global foreign exchange trade via their Triennial Central Bank Survey of foreign exchange and over-the-counter (OTC) derivatives markets.

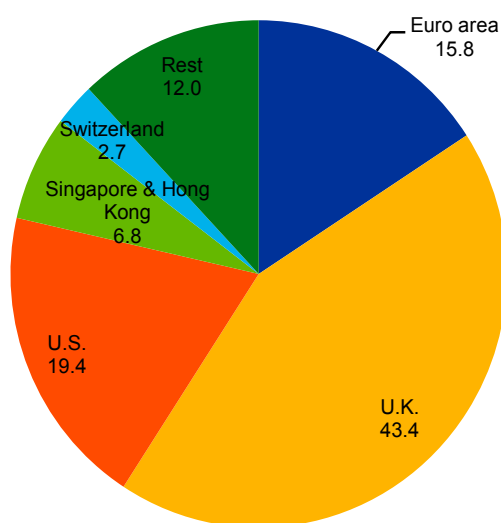
³¹ Singapore occupied third spot once more in the global rankings with \$517BN USD; up from 2013’s \$383BN. Hong Kong SAR has over taken Tokyo for fourth spot having turned over \$437BN, up from 2013’s \$275BN. But Tokyo still increased turnover over the past three years having recorded \$399BN, up from \$374BN in 2013.

³² Despite the UK’s preeminence in global foreign exchange trade, the British Pound remains the world’s fourth most traded currency on a net-net basis on account of the daily \$650BN worth of Sterling traded. This accounts for 13% of the market, which is actually up on 2013’s 12%. The largest share of the market held by GBP was at 16% in the 2004 survey. The US Dollar retains top spot with \$4.458BN worth of turnover, the Euro second with 1.591BN and the Yen at \$1.097BN. The Australian Dollar falls under Sterling as the world’s fifth most traded currency with daily turnover recorded at 353BN USD. The Canadian Dollar is the 6th most traded (\$261BN), the Swiss Franc 7th (\$243BN), China’s Renminbi 8th (\$202BN) and the Swedish Krona is 9th (\$113BN).

used by investors to hedge their portfolios against swings in currencies, interest rates and commodity prices. Nearly 40 per cent of the global currency market, worth a notional \$5tn a day, is traded and booked in London. The UK also accounts for about half of the global OTC \$600tn market. An estimated \$5.3tn changes is handed every day in the foreign exchange markets,³² that is an entire year's worth of the European Union's GDP, gambled every three days. More than 40% of these trades happen in the UK. On a daily basis, the financial institutions of the City of London make speculative currency trades worth nearly as much as the entire nation's GDP for a whole year. In a paper annexed to ECB Report (2017), tackling the issue of the international use of the euro, Mehl draws an interesting map of the geography of the euro foreign exchange, in which it unsurprisingly emerges that "the bulk of foreign exchange transactions in euro are initiated outside the euro area, notably in the City of London. In 2016, around 84% of transactions in euro are initiated outside the euro area" (2017). In the Eurozone, Paris and Frankfurt - with almost 16% - trade less than New York (Chart 2).

Chart 2. Euro's transaction share in the City of London

Bulk of euro FX trades initiated outside the euro area, notably in the City of London
(percentages)

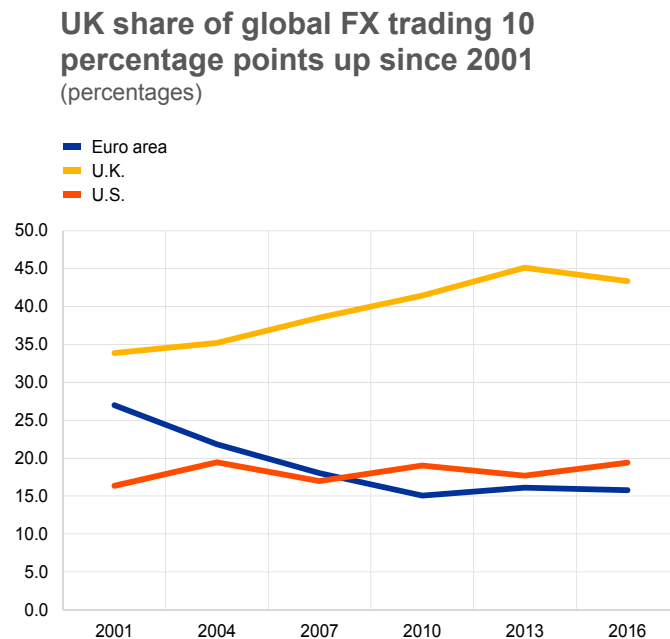


Sources: BIS and ECB calculations.

Notes: Share of selected countries in global foreign exchange transactions in euros, 2016. The data include spot, forward, swap and other transactions. They are adjusted for local inter-dealer transactions.

(Source: Mehl 2017)

The City's trade of foreign exchange transactions has jumped in 2001, correlating with the birth of the single currency; since then the share of the United Kingdom in global foreign exchange transactions involving the euro has increased by almost 10 percentage points (Chart 3).

Chart 3. Increase of UK share in global forex transactions

Sources: BIS and ECB calculations

Notes: Evolution of the share of selected countries in global foreign exchange transactions in euros, 2001-2016.

(Source: Mehl 2017)

The metrics above show that London's attractiveness as international centre is due to its clearing houses' dynamism, which act as an intermediary between two sides of a trade conducted in euros, such as derivatives contracts designed to shield businesses from sudden shifts in interest rates or currencies. By using a UK license as European passport, foreign financial firms can offer their financial services throughout the European Economic Area (EEA). London as financial centre is also home to the vast majority of euro denominated trading with access to euro-settlement and clearing systems (Target 2).

Before the Brexit, the euro trading business was the subject of a legal war between the ECB and the UK, with the latter prevailing. The ECB claimed that clearing houses that mainly process trades denominated in euros ought to be based in one of the 19 eurozone countries. The European Central Bank ejected the UK entity of LCH from Target2 because of the UK's failure to meet the 'location requirement'. Yet, as a result of UK legal action against the ECB, the European Court of Justice (ECJ) decided that the ECB had no competence under the "Treaty on the Functioning of the European Union" (TFEU) to impose the "location requirement" on the clearing houses. The ECJ's ruling was based on the notion that in imposing location requirements, the ECB violated the freedom of establishment, freedom to provide services and freedom of movement of capital in the single market, and as clearing houses act as an intermediary between buyers and sellers for financial assets, barring their activity would violate a major tenet of the European single market (Batsaikhan, 2016; Armstrong, 2016).

In passing, the Court's ruling was very welcomed by the City, with LCH Group by far the biggest with clearing playing a lucrative and crucial role for London as a financial centre.

On a more technical side, there is no problem for LCH.Clearnet Group to continue its operations, as it is involved in a strategic deal with Euronext in respect of strengthening Paris' role in capital markets, and long-term control of clearing activities for Euronext's markets. So, if needed, LCH can thus move its euro-denominated clearing business to Paris.

The case of “location requirements” of euro clearing

ECB against UK

The ECB acted either de jure or de facto to impose a residence requirement on CCPs (Central Counterparty Clearing Houses) that undertake clearing or settlement operations in the Euro currency whose daily trades exceed a certain volume.

UK against the ECB

The UK Government launched three separate actions against the ECB requesting the annulment of the relevant parts of the Eurosystem: 1. the Oversight Policy Framework of July 2011. 2. The Statement of Standards of 18 November 2011, and 3. The Decision of 11 December 2012 amending the terms and conditions of TARGET 2.

ECJ's Ruling March 2015

Judgment in Case T-496/11 United Kingdom v European Central Bank

“The General Court annuls the Eurosystem Oversight Policy Framework published by the ECB, which requires central counterparties to be located in the Eurozone. The ECB does not have the competence necessary to impose such a requirement on central counterparties involved in the clearing of securities” (ECJ 2015).

The EU general court found the ECB “does not have the competence necessary to regulate the activity of securities clearing systems” and therefore cannot force operators to be eurozone based when handling significant euro-denominated business. (ECJ 2015)

The UK's referendum on EU membership, and the victory of the “leaves” has an immediate impact on the City's clearing houses business. By withdrawing from the EU, the City will lose the passporting rights and access to the euro-settlement and clearing systems. Immediately after the Brexit referendum, the European Central Bank, which only emerged from a legal battle with Britain over where clearing houses should be based, called for the European Commission to secure extra-legal powers to govern the market. The ECB's move was also motivated by a political aspect that needed to be taken into consideration. During the EU sovereign debt crisis in 2012, London increased margins³³ on all euro derivatives that raised the cost of borrowing in the Eurozone, making the crisis worse. Therefore, the European Union and the ECB were concerned that if this huge market that sets margin levels is no longer in the EU, this could have serious implications for the euro. So, immediate measures were proposed by the European Commission to ensure new powers to monitor overseas clearing houses.

³³ Definition of clearing margin: “Funds that brokerages and other investment companies are required to have on hand to guarantee the completion of transactions with customers. Companies selling foreign exchange options and futures contracts must maintain a clearing margin to ensure that the contracts can be delivered” (Investor.Guide.com). If the margin levels are set depending on the level of risk and the risks go up, so do the margin levels.

Table 4. LCH.Clearnet Group

LCH.Clearnet Group			
Subsidiary	LCH.Clearnet Limited	LCH.Clearnet SA	LCH.Clearnet LLC
Location	London, UK	Paris, France	New York, US
Products	OTC Swaps, Forex, Derivatives, Equities and Bonds, Repos	Derivatives, Equities and Bonds, Credit default swaps, Repos	OTC Swaps
Profit after tax (mln. Euros), 2015	63.8	28.2	10.2
Headcount, 2015	452	168	12

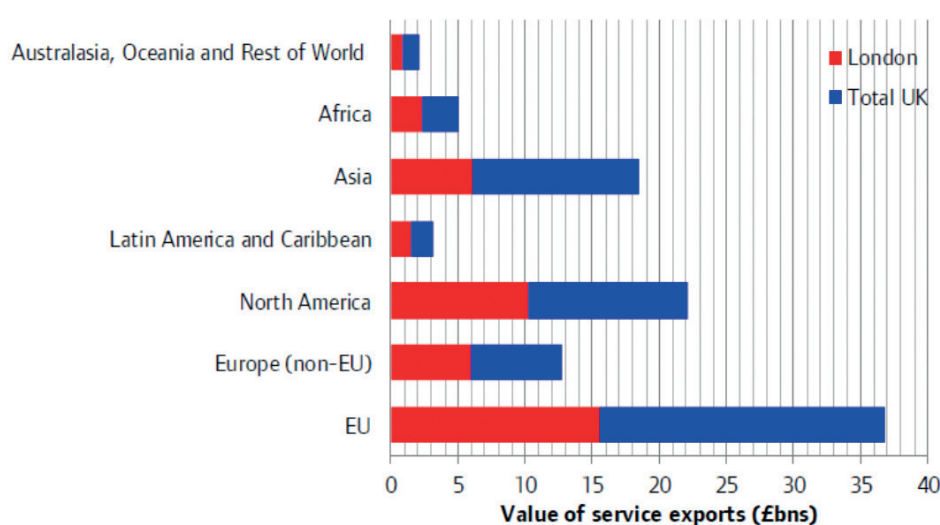
(Source: LCH Annual Report 2015)

5.4 Brexit, the City and UK's Rebalancing

A hard Brexit will mostly hit three sectors: international trade, foreign direct investment and tourism. Metrics of trade and FDI, indicating the pivotal role played by London, give a sense of relevant losses on the UK's whole economy.

In 2015 London exported £131.1 bn of goods and services, up from £126.4 bn in 2011. More than three-quarters (77 per cent) of this were exports of services, i.e. in 2015 London exported £30.7 bn of goods, down from £36.3 bn in 2011 and up from £25.4 bn in 1996, and £100.4 bn of services, up from 90.2 bn in 2011.

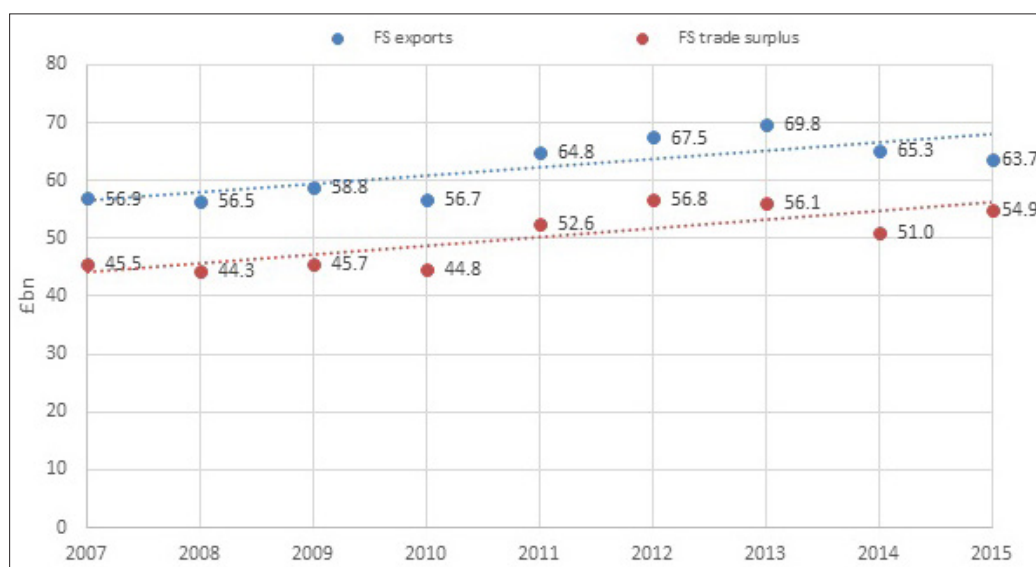
The data show that the EU was London's largest service exports destination by global region. Around £15.6 bn of London's service exports went to the EU in 2015 (Chart 4), which was the equivalent of 37 per cent of the total. This was followed by North America (£10.2 bn, 24 per cent) and Asia (£6.1 bn, 14 per cent).

Chart 4. London and UK's exports of services by destination in 2015, £ billions

(Source: Greater London Authority, November 2017)

The chart below highlights the growth of FS trade more generally over the period, as well as FS trade surplus. In absolute terms, FS exports have increased by £6.8bn (12%) over the period, although they peaked in 2013, reaching nearly £70bn.

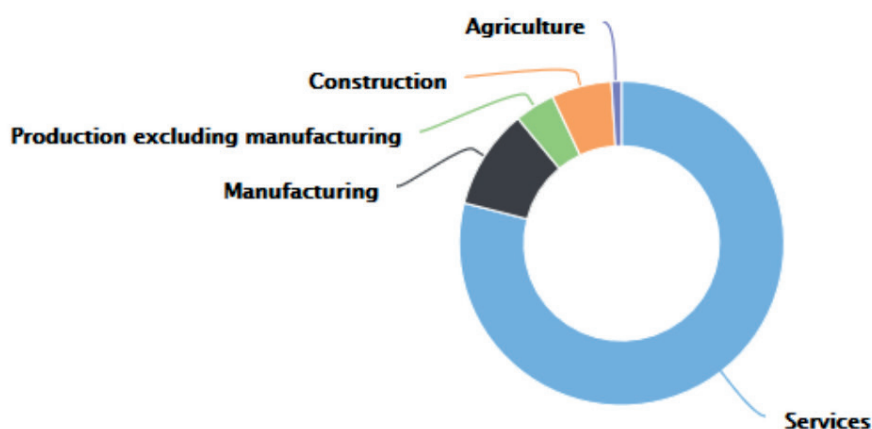
Chart 5. Growth of Financial Services



(Source: City of London 2017)

FS and insurance make up the largest proportion of the UK's services trade, accounting for £22.7bn (26%) of services exports to the EU. Once again, it is the larger economies in the EU that are the dominant markets for UK financial services exports, with France (£4.7bn), Netherlands (£3.5bn) and Germany (£3.3bn) being the biggest recipients. The bulk of London's output growth comes from finance, banking, insurance and related services, and it dominates this sector of the economy. In the 1990s and 2000s these areas triumphed in the extraordinary growth of the new 'finance-led economy', what proved between 2007-2008 to be an unstable and unsustainable financial bubble (Martin et al. 2013).

Chart 6. UK: Distribution of Economy Sectors



(Source: Martin et al. 2013)

Looking at the whole UK economy, the huge weight of finance and the meagre shares of non-finance activities indicate symptoms of a severely unbalanced economy. While the need for a more spatially uniform distribution of economic growth has grown in the UK government, with the need to 're-balancing' the economy toward Northern regions, the British economy is still skewed towards London and the surrounding South-East region (Martin et al 2013). And what's more, paradoxically, is a major consequence of London's excessive financial weight; the scarce accessibility of the UK's SMEs and start-ups to finance. UK banks' lending flows into unproductive sectors, such as consumer credit borrowing, neglecting support to businesses. As far as the regulatory body is concerned, the focus is on eliminating perceived 'risks' within the financial sector, concentrating on banking resilience (regulatory capital and liquidity), rather than on productive and unproductive lending, so that it "fails to address the real risks of the banking sector lending policies," which should be geared towards stimulating productive investment" (GFC Economic Report December 2017). So, a major dislike of London's banking policies is the lack of linkages with the country's real economy.³⁴

Would the City of London model of self-ruling and financial leverage instruct the new, developing Financial centres in Mainland Europe?

5.5 Is London a role model for Mainland Europe's Financial Centres?

The recent financial crisis had had significant implications for the politics of international financial centres, as it deeply undermined the legitimacy of the self-regulatory norm upon which much of the Anglo-American model was based, and raised serious doubts over the trade-off between growth and stability (Chwiero 2010).

Under the aegis of the G-20, Europe and Asia have enacted a shift toward regulatory policies that may result in a less integrated financial system. Noticeable examples include: (1) the centralisation of clearing of over-the-counter derivatives, which may lead to a diminution of systemic risk associated with these instruments, but is likely to result in a division of previously global markets into regional or national ones associated with different clearing houses; (2) the liquidity standards associated with the Basel III Capital Accord, which create incentives for banks to hold large portfolios of home-currency sovereign bonds, even though the Eurozone crisis demonstrated that such assets could not be considered free of credit risk; (3) the drive toward regulation of credit rating agencies in all major jurisdictions, which creates the temptation for local authorities to exert a degree of influence over ratings methodologies, with the risk of loss of global methodological consistency (Asia Development Bank 2012).

The framework in which the International Financial Centres in Mainland Europe are set to operate is very different from the pre-crisis model.

If before 2008 the general impetus of EU financial legislation had been to dismantle barriers to cross-border financial integration in order to achieve its aim of a single EU financial market, after 2008, the emphasis has been on re-regulation of an expanding scope of financial market segments, in several cases with conditions of business location in the EU (Posner, Véron 2010). This applied, among others, to private equity and hedge funds (Alternative Investment Fund Managers Directive, 2011), credit rating agencies (CRA Regulations, 2009/2011), and clearing houses (European Market Infrastructure Regulation, 2012) as well as trading venues (review of Markets in Financial Instruments Directive, ongoing). In

³⁴ Quotations are from the Report produced by GFC Economics Ltd & Clearpoint Corporation Management Ltd for the Shadow Chancellor of the Exchequer.

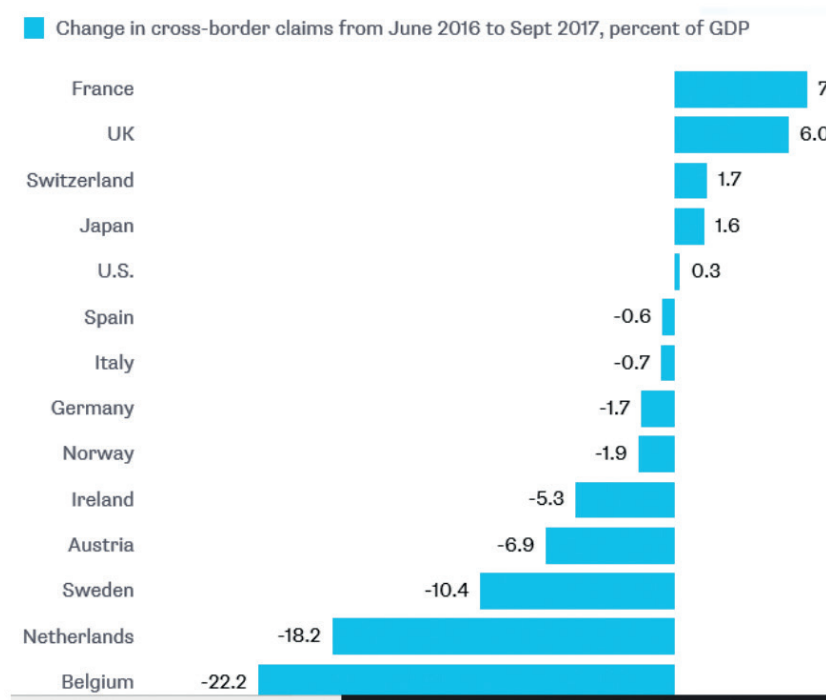
these, the general philosophy of the European Commission towards third parties appears to be to seek a mutual recognition of “equivalent” status for the respective regulatory regimes, under which non-EU market participants are allowed to do business in the EU only if they submit to an oversight regime deemed equivalent to the EU one in their respective jurisdictions, with the assessment of equivalence in the hands of the European Commission.

The above measures are likely to impact directly on the core business of International Financial Centres, and clearly on the self-governance model, epitomised by the City of London. At the roots of new models in Europe and China is the notion that for a financial system’s leverage the metrics that matter are the size of the jurisdiction, in which the Financial Centres operate, and the relationship with financial growth and the real economy. Thomas Rixen has made the point:

“Large developed countries cannot sustain their economies on the basis of the activities of the financial sector alone, but also have to guard the financial sector’s interactions with the real economy. The domestic economic base, which would be subjected to inefficiently low taxes and may suffer from very low financial regulatory standards, is too big relative to the size of foreign financial activity that could be attracted” (Rixen, 2013 p.440).

Unsurprisingly, the City of London, the leading advocate of light touch regulation, given its greater innovativeness, dynamism, and size of revenues, still attracts wide support among international investors. A large part of London’s pull comes from its membership of the internal market of the wider European Economic Area (EEA). In leaving the EU London will lack access to Mainland Europe, and with it the very attractiveness of the City’s model of functioning.

In the banking sector, though, there are early signs of changes in UK dominance. The cross-border exposures of banks located in the UK - including loans and securities - increased by \$155 billion from June 2016 through September 2017, which makes as a share of gross domestic product (GDP), UK the second-largest gain among European countries after France (Chart 7).

Chart 7. Change in Cross-border Claims (June 2016- September 2017)

(Source: BIS - in Whitehouse, 2018)

5.6 Mainland Europe's International Financial Centres: Frankfurt, Paris

While these changes are indicators of the increasing pull of the French banking sector compared to London, they also evidence a developing competition between Paris and Frankfurt, which can provide a practical way to paper over differences between them.

Frankfurt A/M,³⁵ home to the European Central Bank (ECB) and the Bundesbank, is building a cluster of regulatory agencies: the European Insurance and Occupational Pensions Authority (EIOPA), the Federal Financial Supervisory Authority (BaFin) and the Federal Agency for Financial Market Stabilisation (FMSA), which is turning it into a centre of supervision and regulation for the whole of the EU. These and other ECB-related Agencies have considerably boosted Frankfurt's status as a financial hub and are playing a significant part in the city's internationalisation.

The large cluster of regulatory agencies, and the proximity to regulators, are undoubtedly a major factor in Frankfurt's favour. In fact, Frankfurt's development as an EU financial centre fulfils Kindleberger's theory

³⁵ The Main metropolis was first mentioned on 22 February 794 in a document of Charlemagne for the Regensburg monastery, St. Emmeram. However, there is proof that the cathedral hill has been under continuous settlement since as early as 3000 BC. At the same place, a Roman military camp was established around 83 AD and in the Merovingian era, the court of a Franconian king. In 843, Frankfurt became at times the most important royal palatinate of the Eastern Franconians and the site of parliaments. In 1220, Frankfurt became a free imperial city. From 1356 onwards, the Golden Bull declared Frankfurt as the permanent city of choice for the Roman kings.

“If the administrative machinery of the European Economic Community, including the European Central Bank, were located in an existing financial centre, it would be likely to serve as a magnet to other financial institutions and to attract them into a single primary location” (1974).

Thus, Frankfurt will further consolidate and expand its position as a centre of regulation and supervision, indispensable to the functioning of the second largest global economy.

At a distance of less 500 kilometres to West, Paris acts as Frankfurt’s Mainland competitor. Standing at the crossroads of European and worldwide trade, Paris is France’s leading economic region and one of Europe’s foremost business hubs, and is becoming a preferred destination. Its economy is that of a major urban region structured around the capital city and bearing all the hallmarks of an efficient metropolitan economy, namely: size, a diverse production base and real estate offering, world-class infrastructure, a cosmopolitan and qualified workforce and a wealth of cultural amenities.

Paris’ Main Assets

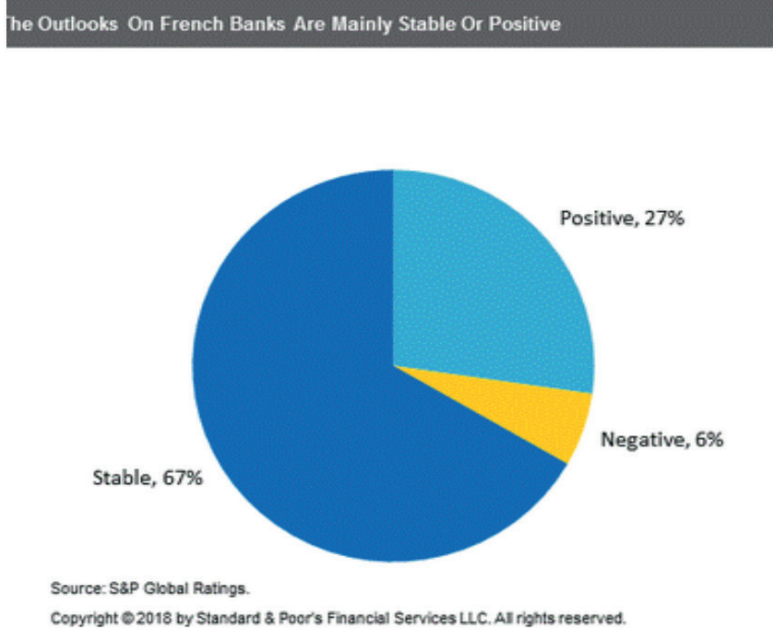
- ▶ The highest GDP in the European Union (EU28) in billions of euros: 30.3% of the French nation’s GDP and 4.6% of the EU28’s GDP, ahead of Greater London and Lombardy (Italy).
- ▶ Concentration of jobs, corporate headquarters, SMEs/SMIs, technology companies, business start-ups, world-class competitiveness clusters, foreign groups.
- ▶ Wide range of business sectors, deep-rooted industrial tradition, and one of the highest concentrations of activity in the science and technology sectors
- ▶ A consumer marketplace of considerable importance: 12 million inhabitants, 8.3 million visitors in the Region’s main conference and exhibition centres, 47 million tourists.

Paris Europlace

However, the banking sector is one of France’s main economic assets; With six French banks among the Global Systemically Important Banks (G-SIBs), Europlace has the largest financial projection among EU banks. In 2016, with the fall of the euro and pound in the aftermath of Brexit referendum, four French banks, three based in the UK, one in Spain, and one in Germany remained with one trillion total assets, compared to six in China, four in the US and four in Japan.

In 2017, according to S&P, the outlook for French banks was mostly stable and positive (Chart 8).

Chart 8. Outlooks on French Banks



Paris remains the largest IFC in western Europe by assets, extending its lead over its rivals. Based on *The Banker's* latest Top 1000 World Bank Rankings, the list of Western Europe's largest international financial centres (IFCs) by assets shows the distance between the leader, Paris, and its peers widening further. The French capital continues to overshadow others with a total of \$6,018bn in aggregate assets for lenders headquartered there. While this figure is only a modest improvement on the previous year, in 2016 all the centres in the subsequent positions, through to ninth, witnessed a contraction.

Table 5: Top Ten IFC in Western Europe By Bank Assets

Rank	City	Country	Total assets (\$m)	% change (yoy)	ROA (%)	Pre-tax profits (\$m)	% change (yoy)	Tier 1 capital (\$m)	% change (yoy)	ROC (%)
1	Paris	France	6,018,463	1.53	0.52	31,455	1.04	256,392	3.66	12.27
2	London	UK	5,609,258	-6.63	0.34	19,077	-21.29	303,265	-9.94	6.29
3	Frankfurt	Germany	3,086,606	-3.73	0.11	3,255	L→P	123,912	-2.75	2.63
4	Zurich	Switzerland	2,073,531	-2.36	0.2	4,210	-14.43	114,331	-5.18	3.68
5	Madrid	Spain	1,931,949	-4.76	0.4	7,797	-43.36	107,284	-5.05	7.27
6	Montrouge	France	1,813,525	-1.79	0.45	8,162	-20.28	88,344	4.52	9.24
7	Stockholm	Sweden	1,504,636	-5.46	0.77	11,615	-7.92	71,735	1.36	16.19
8	Amsterdam	Netherlands	1,319,065	-2.02	0.7	9,177	-7.69	68,246	1.07	13.45
9	Bilbao	Spain	829,865	-5.56	0.85	7,059	35.09	57,574	-0.2	12.26
10	Turin	Italy	763,263	3.8	0.59	4,475	-1.16	41,536	-2.54	10.77

(Source: The Banker, March 2018)

Turin is in 10th place with an expansion of 3.8%. This is explained by movements in the size of Intesa Sanpaolo, Italy's second largest bank by assets and largest lender by Tier 1 capital, which is headquartered in the Piedmont city.

Most other IFCs in the lower part of the ranking saw assets shrink during the 2016 financial year. The largest drop is Wiesbaden in Germany, with an 11.06% contraction, followed by Dublin, with 10.87%. Assets reductions are mirrored by even larger cuts in profits across the region. Madrid's pre-tax profits dropped by more than 43% while London, and Montrouge in France, home to Crédit Agricole, contracted by more than one-fifth.

The noticeable exception is Frankfurt, where aggregate results moved from loss to profit thanks to Deutsche Bank's improved performance. Although still in the red, Germany's largest lender has contained its losses to \$853m, a figure 87% smaller than previously recorded. Frankfurt is western Europe's third largest IFC by banking assets and Tier 1 capital. When it comes to capital size, however, London displaces its French rival, with \$303bn against Paris's \$256bn.

Only data for banks included in *The Banker's* Top 1000 World Banks ranking was considered. All figures refer to the 2016 financial year.

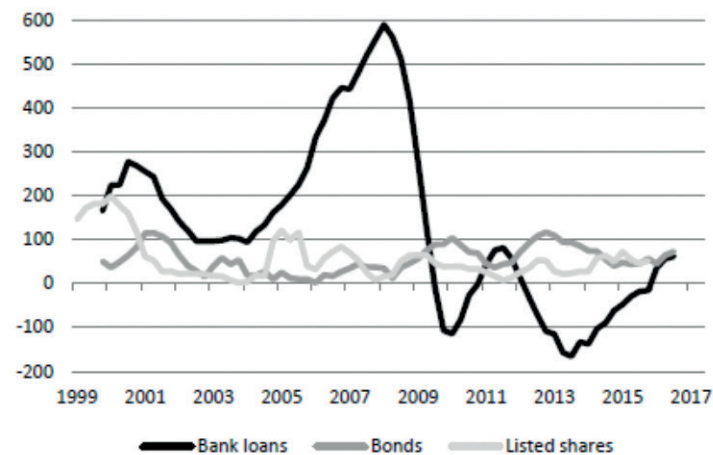
So, what is the potential contribution of Europlace to Mainland Europe? S&P Market Intelligence (February 2018) puts it simply: "This year's Menu for French banks: Digitalization and Efficiency". In the meantime, however, Europlace should take action on its low ranking vis-à-vis Frankfurt in terms of a banking centre; it has a relative low inflow of capitals, an indication of protectionist features. The French banking industry is moving towards upgrading financial services, and in taking a leading role in the FinTech ecosystem (Halle Freyssinet). Europlace should further engage the Central Administration on proactive measures much needed to make it more attractive for foreign banks to settle and trade in Paris.

A further influence of Paris Financial Centre should come through the full operability of the ESMA beyond the current limited powers. A further centralisation, and attribution of powers and personnel should turn the ESMA into the capital market supervisor for the whole Mainland, raising to the level of the SEC in New York to fulfil its tasks.

5.7 A Final Note on EBU and CMU

In the wake of the UK's withdrawal from the EU, the relocation of large chunks of the financial industry and the emergence of primary Financial centres in Frankfurt and Paris are the tipping point in the European Financial system, and will also test Mainland Europe's preparedness to play centre stage in global finance.

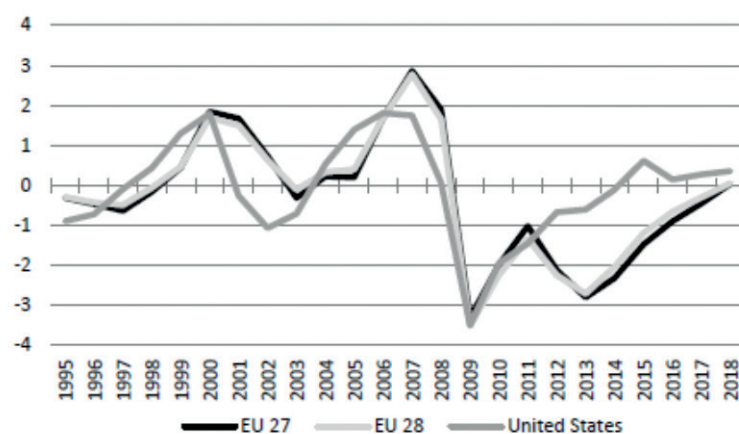
A key feature of European financial markets is the predominance of bank financing relative to other sources of financing, which makes a sub-optimal diversification of the financial system in Europe, exposing the system to further instability caused by the volatility of some financial flows when there is a structural shock.

Chart 9. Financial flows to non-financial corporations (EUR bn, net amounts)

(Source: European Commission Staff 2017)

For example, banks provide 70% of European firms' external financing through loans.

"This differs from the United States market where consumers, small and medium sized enterprises (SMEs) and larger corporates all benefit from raising financing through the capital markets. European economies are still struggling to get back to normal. The difference between actual and potential GDP (i.e. output gap) is constantly below zero and the economy is performing below its potential" (European Staff Document 2017).

Chart 10. Output gap (actual minus potential GDP %)

(Source: European Commission Staff 2017)

The weak spot of public and private investments plays a large role in this output gap , which compared to other advanced economies will take until 2023 to recover to 22%, its level in the years 2000-05 (European Commission Staff 2017).

In Mainland Europe, capital markets are still an untapped source, while they are still important tools for infrastructure investments to complement public investments, for instance in public-private partnerships (PPP). Capital markets allow the use of risk premia to evaluate public and private investments (risk evaluation). Greater capital markets activity also stimulates private and public investments by providing an exit to investments, especially illiquid ones. Their development across regions in the EU will rely on actions to build capacity in terms of investor base, market infrastructure and supervisory practices

So, in losing London's entry point of European capital inflows, the EU must find new ways to counterbalance the loss in capital market depth, accelerate capital markets provisions, for a failure may shake investment confidence, and fail to enhance economic growth.

Against this backdrop, urgent actions should be taken to further opening capital markets, and finalise the finishing touches on the EU flagship projects, the European Banking Union (EBU), and Capital Markets Union (CMU). As for the EBU, the EU27 have fully agreed on two pillars. Presently, ECB banking supervision in the euro area includes the 120 largest banks, amounting to more than 80% of the banking system (Single Supervisory Mechanism), and the European bank resolution mechanism is in operation, the third pillar, the European deposit insurance scheme (EDIS), is still work in progress.

In a Post-Brexit environment, the combination of the emergence of fintech, and new financial companies with a more market-based approach, could re-place bank-based financing. The risks they carry might fall outside the spectrum of the institutions that European regulators have so prudently constructed in the EU. While market-based financing is a welcome model pursued with the CMU, policy-makers should be at the forefront of these developments and develop a fresh approach. This should not be a whole different type of construct than envisioned by Jonatan Hill in the early version, as it would rather be a top-down exercise in institutional rule-building, but should be made an innovative alternative to London's model.

As Staender put it clearly

"The EU27 member states could convey two clear messages in this context: First, the EU is determined to compensate the detachment from UK capital markets by developing deeper and better integrated capital markets in continental Europe, and second, the EU will build the necessary regulatory capacities to manage a potential influx of financial industry, regardless to which location in the EU27" (Staender 2016).

The strategic relevance of the European CMU is succinctly summarised in the following Box:

Table 6. Area of Intervention of the CMU

1. Strengthening supervision and deepening capital markets in the EU
2. Financing for innovation, star-ups and unlisted companies
3. Making easier for companies to raise capital on public markets
4. Investing for long-term, infrastructure and sustainable investments
5. Strengthening banking capacity to support the wider economy
6. Fostering retail investment
7. Facilitating cross-corder investment

(Source: European Commission Staff 2017)

Wrapping up

To achieve the above objectives the European Securities and Markets Authority (ESMA) is the right tool for the job. Yet, it urgently needs to raise up its institutional profile. With decisions taken by the Board of Supervisors (BoS), consisting of national competent authorities (peers), currently the ESMA exercises direct supervisory powers over trade repositories (TRs), and credit rating agencies. Yet, as capital markets deepen and become more integrated, there is a need to ensure that the capacity to supervise and manage risks, especially cross-border, keep pace; this raises questions on whether the ESMA's current toolbox and powers are sufficient and appropriate to underpin efficient and cost-effective supervision in a deeper CMU. The development of more integrated capital markets could justify the centralisation of supervision in areas where risk emerges from this cross-border dimension.

The ESMA could most productively focus on those market segments or functions where the degree of integration creates strong spill-over effects or synergies that cannot be effectively overseen by nationally segmented operators³⁶

Strengthened powers for the ESMA would ensure that market participants with a similar business model, size or risk profile are subject to the same intensity and extent of oversight to ensure a level playing field among market participants and equal protection for domestic and cross-border investors. It would also ensure that potential risks to financial stability that might arise, following the integration of the markets, would be monitored and mitigated in an effective manner across Member States.

In the end, ESMA will mimic the SEC in New York, but with European characteristics.

³⁶ While writing, a case in point is the recent suspension of trading shares in the "dark pools" or off public exchanges across the EU started on March 12. Industry analysts had expected London to be particularly hit by the caps as the majority of daily equity trading in Europe takes place in the UK, home to the London Stock Exchange and CBOE Europe, as well as a series of alternative trading venues and dark pools.

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