# The Transformation of Financial Landscapes

In recent months, currency turbulences in Asia and the race for the final qualification for the European single currency almost caused the fundamental transformations international financial markets are undergoing at the moment to be forgotten. True, London, New York and Tokyo are still the predominant places both in their regions and worldwide but their position is no longer undisputed. In Asia, Singapore and Hong Kong are becoming a serious threat to Tokyo's leading role, and in Europe, Frankfurt and Paris seek to strengthen their competitiveness, challenging London's supremacy in the wake of EMU. The extent to which these places manage to increase market shares at the expense of the major centres will determine the nature of international banking and financial relations in the years to come and largely influence matters such as the success of EMU, market vulnerability to financial crises and the prospects for international monetary policy cooperation and a greater stabilisation of exchange rates. Japan's Big Bang, which entered its first stage with the liberalisation of the foreign exchange market this month, and the decision on the founder members and final conversion rates under a single European currency in May, switch attention back to the risks and opportunities involved in the long-term changes.

To assess the major centres' future fate it is necessary to develop some idea as to how financial centres emerge and international financial landscapes evolve. As a rule, markets are not evenly spread over the world. Regionalism and clustering prevail. First hints as to the determinants of the underlying processes and locational decisions can be found in economic geography concepts, such as Paul Krugman's Edge City model, which are rooted in the early works of von Thunen, Christaller, Losch and others. Those theories emphasise the role of attracting as well as repelling influences on firms' choices. For example, there are economies of scale from clustering. For the individual firm, to have other businesses close by can be advantageous because they attract customers and provide complementary functions, thereby reinforcing the existing infrastructure. An agglomeration of firms from the same branch attracts experts in the field adding to the sophistication of the market-place: Another advantage is that personal networks are built up more easily in such a location. On the other hand, clustering can also be disadvantageous since it forces firms to compete for customers as well as for scarce resources such as human capital and office space.

In theory, it is the interplay of both effects - the "centripetal" and "centrifugal" forces in Krugman's model - which determines the process of businesses' migrating from less desirable to more desirable sites over time, ending up in polycentric patterns and clusters. In reality, external forces can be found to be at work as well. With respect to international financial landscapes, the latter often Bven play a decisive role since otherwise, despite their generally being characterised as "footloose" industries, financial markets show particularly strong tendencies to persist where they are. Both the Japanese Big Bang programme and the introduction of a common currency in Europe can be interpreted as external "shocks" in this sense.

However, the effects in both cases may differ. There are indications that although EMU will almost certainly start without UK participation London's position in Europe may not be affected severely. In its list of comparative advantages the Bank of England refers to record trading levels in UK securities markets, the London Stock Exchange's lead in foreign equities trading worldwide, the high volume of cross-border trading in foreign equities and London's strong position in international bond trading in the Eurobond market and in bonds issued by European governments. They all hint at considerable economies of scale and help explain why some firms in London consider the euro as an opportunity rather than a threat.

Reactions by foreign financial institutions confirm the overall impression. Banks from outside Europe as well as from other European countries are strengthening their presence in London in preparation for EMU. There is a growing shift of derivatives trading, drawing activity from Chicago and other places to the London International Financial Futures and Options Exchange (LIFFE). Leading non-UK banks such as Citibank, Deutsche Bank, Credit Lyonnais and ABN Amro are becoming members of Chaps, the UK large value interbank payments system. Chaps is the largest real-time-gross-settlement system in Europe and is already processing a daily average of 60,000 payments, or 135,000 items on a peak day with a peak day value up to £ 240 billion. There are even considerations in some smaller European countries to use Chaps as their principal channel for euro payments.

The two main arguments against London in the wake of EMU are that the UK is not in the first wave of members and that the European Central Bank (ECB) is not located there but in Frankfurt. Both are not particularly convincing. First, the bulk of currency trading worldwide so far is in dollar, yen and D-mark, none of which is the local currency in London, where about 30 per cent of activity takes place compared to only 16 per cent in the USA. Second, a central bank's location is not necessarily the place where its policy is put into effect. For example, the US Federal Reserve is in Washington but its main executive arm is the Federal Reserve Bank of New York. In the same way, the ECB's decisions will be executed on the level of its subsidiaries which are the national central banks.

With regard to the transformation of financial landscapes in Asia things look different. Following the burst of the speculative bubble which hit the Japanese economy in the second half of the 1980s the country's financial system became weaker and weaker and the Tokyo market experienced a massive "hollowing out". Foreign companies were delisting from the Tokyo Stock Exchange, more and more Asian companies were bypassing Tokyo in favour of listing in New York and elsewhere and foreign banks and securities houses were increasingly shifting activities to Hong Kong and Singapore. New markets emerged in the region, above all in Malaysia and Thailand, adding to the list of competitors. The recent currency crisis in Asia did nothing to stop this process: on the contrary, it revealed once again the weakness and vulnerability of Japanese banks.

Japan's Big Bang programme is a desperate attempt by the government to halt the decline. In June 1997, the Japanese Financial System Research Council (FSRC) and the Securities and Exchange Council (SEC) published a plan for structural and regulatory reform, the underlying objective of which was to establish fair, efficient and internationally competitive financial markets. The plan comprised market liberalisation as well as the diversification of financial products. Although much of the initial glamour of the plan has gone - the badly needed advance regulation of banks' capital standards has been postponed indefinitely in reaction to a credit crunch - the reform has started with the lifting of existing restrictions on foreign exchange trading on April 1. But given the weak state of Japan's economy and the fragility of its banking system the dangers of a reform at this time may easily outweigh its advantages. The dangers are twofold. On the one hand, it seems almost certain that the banks' situation will deteriorate further as a direct consequence of increasing competitive pressures. On the other hand, firms inexperienced in foreign exchange trading whose access to the market had been limited so far may be tempted to take excessive risks in order to compensate for poor performance in their core business. Both will aggravate existing uncertainties rather than increase Tokyo's attractiveness. In the long run, the future financial centre in Asia seems unlikely to be in Japan.

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