Kurzberichte

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Will Brexit dwarf London's competitiveness as a financial centre?

The British referendum might be a game changer for financial centres competitiveness. The City of London might lose business after Brexit as the United Kingdom loses access to the European Union's (EU) single market. But London might stay competitive as a global offshore financial centre as long it is able to attract talented people. However, its ability to attract business by deregulation is limited. This is an opportunity for Frankfurt to become the EU's leading financial centre.

Finance as a knowledge-based business needs the proximity to a financial centre, where finance professionals work close to central banks, regulators, financial news providers, exchanges, consultants, and international law firms.

One driving force behind the emergence of financial centres is the agglomeration externality. Urban density drives innovation and growth because it enables the efficient exchange of ideas and an efficient implementation of knowledge (Smith, 2016). Financial centres attract talented people trough high salaries and these talented people are responsible for the high productivity of financial centres.

The other driving force is liquidity. Investors profit from a large number of other investors. But due to advances in instant communication and trading technology, physical proximity is not needed for standardized financial instruments, like stocks of global firms, which can be traded from offshore financial centres. But trading of stocks of small and medium-sized companies still needs local knowledge and thereby the proximity to the national financial centre. Proximity is also relevant for complex non-standardized transactions that need a lot of communication over a longer period of time, e.g. mergers and acquisitions, syndicated loan origination or structured finance.

Every larger economy has its own financial centre and these financial centres can be subdivided into three groups (Lannoo, 2007)

- **National financial centres** are characterized by developed financial markets, but which are focussed only on serving the domestic economy, e.g. Athens, Nicosia and Tallinn.

- **Regional financial centres** are characterized by sophisticated financial markets. They are interna-

Frankfurt scores with cheap and available office space

Selected indicators of attractiveness

	Dublin	Frankfurt	London	Luxembourg	New York	Paris
Office vacancies in percent	8.4	11.8	3.9	4.4	5.3**	6.8
Office prime rent in Euro per square metre and month	51.6	39.5	83.3*	46	123.5	60.1
Z/Yen Global financial centres ranking						
Rank in 2008	45	13	1	23	2	22
Rank in 2016	39	18	1	14	2	32
Passenger traffic of local airport (only biggest airport) in million in 2013	20.2	56.4	69.4	2.1	47.6	61
Mercer Quality of Living Ranking	33	7	39	19	44	37

*City of London **Midtown Manhattan

Sources: ACI Annual World Airport Traffic Report (WATR), CBRE, Knight Frank, Mercer (2016), Z/Yen Group

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tional in scope, but they are not of global reach. Frankfurt and Paris are regional financial centres which serve the EU’s single market.

- **Global financial centres** are full-service providers for the global economy. New York City is such a global financial centre because it has a large and highly-developed financial market. However, New York City is not as global as the City of London. Although the US’ bond market capitalization is larger compared to the UK’s one, UK plays a larger role for the issuance of international debt securities. The US’ bond market capitalization sums up to 212 percent of the US GDP, but international bonds amount only to 13 percent of its GDP. The UK is different here. Its bond market capitalization consists of domestic bonds with a notional value of 93 percent of the UK’s GDP and international debt securities with a notional value of 102 percent if the UK’s GDP. While international firms prefer to issue dollar-denominated bonds in London, New York’s attractiveness for international bond investors comes from the high foreign demand for US-treasuries, which count as super-safe assets.

After the British referendum the question arises if London can longer defend its place as the number one global financial centre. After Brexit, London might lose access to the EU’s single market, so non-EU banks have to relocate to the continent. However, transactions with the EU are only one part of London-based financial activities. For example, China will need a global financial centre in the future for financing its large and growing economy. Thereby, Shanghai might support financing the huge Chinese onshore market and it can be the entry point for foreign investors to the Chinese economy. But Shanghai’s success as a global offshore market is limited by China’s opaque political processes, concerns of international investors to use Chinese law for financial transactions and China’s less developed financial system with a limited ability to use sophisticated financial instruments (Elliot, 2011). Thus, London will remain relevant for the Chinese market, as well as for the Arabian World and other regions with much liquidity but underdeveloped capital markets.

Nevertheless, the Kingdom has to rethink its economy’s business model. As many other islands, the UK might start focussing on financial services, for which the UK has to deregulate its financial sector in order to attract business. Regulation was a driving force of financial centres competitiveness in the past, but because level-1-regulations are to a large degree influenced by global players such as the G20, the Bank for International Settlements (BIS), the Financial Stability Board (FSB) and the International Organisation of Securities Commissions (IOSCO) London's deregulation efforts are limited. When it comes to regulation of funds and supervision financial supervision, the UK might make use of its leeway in order to offset some of the Brexit losses.

But who attracts banks and workplaces as a result of lost banking passports of non-EU banks located in London? Cities like Frankfurt, Paris, Dublin or Luxemburg are named as potential winners. Firms often prefer the proximity to a certain financial centre because of the availability of qualified talent (PfNYC, 2015). Frankfurt can attract business which needs knowledge about regulation, because it hosts the European Central Bank (ECB) which bundles the governing council for the Eurozone's single monetary policy, the Single Supervisory Mechanism (SSM) of the European Banking Union as well as the European Systemic Risk Board (ESRB), which is the EU's macroprudential supervisor. Moreover, the European Insurance and Occupational Pensions Authority (EIOPA) is located in Frankfurt. Paris, instead, headquarters the Organisation for Economic Co-Operation and Development (OECD), but it is less relevant for finance professionals to be located in its proximity. Luxemburg is ranked higher in the global financial centres ranking in 2016 than Paris or Frankfurt, as it hosts the majority of investments funds due to favourable tax treatments, but Luxemburg fails to provide the needed transportation infrastructure that is necessary to attract financial experts. Passenger traffic of the Luxemburg airport sums up to only 2.1 million in 2013, while the major airport of Paris dealt with more than 60 million passengers, Frankfurt with 56 million (table). Dublin is only ranked 39 in the global financial centre ranking, which measures financial flows, the number of banks and other financial indicators, and it has also deficits in international accessibility, at least compared to Frankfurt and Paris.

Frankfurt other advantage compared to its competitors which is office space. The vacancy rate is above 11 percent in Frankfurt, indicating that even larger spaces are available in short-term. The Paris office market, by contrast, is a very tight and tensed market. In addition, prime rents are 50 percent higher than in Frankfurt. As it takes time to get a new bank pass, a re-location in short-term might be an important reason for banks.

Besides hard facts, also soft facts like the quality of living play a role for locational decisions. This might be a disadvantage of Frankfurt, but a recent analysis of Mercer (2016), ranked Frankfurt at number 7 of 230, while Paris was only at rank 37. Frankfurt scores with a good housing supply, good medical infrastructure and less crime. Of course, quality of living is in particular a question of preferences and without doubt some bankers will prefer Paris and Dublin over Frankfurt, but at least the analysis of Mercer hints at some of the amenities of Frankfurt. Given the whole picture (financial market, institutions, office space and infrastructure), Frankfurt is likely to be the main profiteer of Brexit.

References

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