Europe's Rising Financial Power

Wall Street dominated global financial markets from the late 1980s through the 1990s. Now London is moving to center stage. New York may have more funds under management and a higher market capitalization, but London is getting more initial public offerings, it leads in currency trading and cross-border banking, and, most important, it is growing faster than New York on almost all accounts. New York Mayor Michael Bloomberg and senior U.S. Senator Charles Schumer argued in July 2007 that the country must act now to preserve its leadership in financial services. Even with decisive action, however, they admit that New York will continue to lose ground given the powerful forces for change.

Such concerns about the fate of New York and the future of American financial leadership are both right and wrong. They are right insofar as Europe's financial weight is growing, particularly in London but elsewhere as well. The reason is that European governments have deepened their domestic financial markets even as the process of European integration has brought those separate national markets together. Yet concern about the rise of Europe is misplaced in suggesting that it constitutes a threat to American leadership in financial services. On the contrary, Europe's deeper and more integrated financial markets offer growth opportunities for the American financial services industry and they offer new sources of financing for American firms. Many of the major financial services groups in London are based in the United States and at least some of the increased activity on European stock exchanges is American as well. There is nothing new here. Transatlantic economic relations have long been driven by investment rather than by trade. The rise of European financial power is not a measure of the decline of New York but of the deepening of this transatlantic relationship.

Size and Leadership in Global Financial Markets

Financial markets exist to provide firms with alternatives to self- or bank-financing. Therefore the size of financial markets depends upon both the size of the economy (meaning the size and number of firms) and the willingness of firms to look beyond banks and their own resources for their financial needs. Obviously, market size also depends upon the volume of resources available for market financing (meaning, again, the size of the economy) and the willingness of firms and individuals to provide those resources to financial markets. Relatively small economies should have relatively small financial markets, and yet even large economies can have small financial markets where firms prefer to fund their own investments or to work with banks, or where firms and individuals are reluctant to invest in market instruments (like shares or bonds).

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In any comparison between the United States and Europe, both economic size and market attitudes have an influence on the relative size of national financial markets. The data in Table 1 show that the London Stock Exchange (LSE) is smaller than either the New York Stock Exchange (NYSE) or the Nasdaq. This difference is due primarily to the fact that the British economy is smaller than the economy of the United States. Even so, the LSE is roughly as large as the combined stock exchanges of France, Belgium and the Netherlands (Euronext) and larger than the German stock exchange (Deutsche Börse). The continental economies are larger than Britain's but British firms have a much longer tradition of resorting to (and investing in) market finance.

Table 1: Market Size and Growth – 2006-2007.

	2006 (January through December)		2007 (January through June)	
	Capitalization (dollar billions)	Percent Growth (national currency)	Capitalization (dollar billions)	Percent Growth (national currency)
NYSE	15,421	13.1	16,604	19.1
Nasdaq	3,865	7.2	4,182	18.1
LSE	3,749	8.8	4,037	11.2
Euronext	3,708	22.5	4,210	26.4
Deutsche Börse	1,638	20.0	1,956	35.0
Source: World Federation of Exchanges.				

Market size is usually measured in terms of "capitalization", which is the value of all shares listed on the exchange. However it is also possible to look at market turnover, or the value of all trades that have been executed over a fixed period of time. There the story is much the same, although the differences between New York and London and between the London and the rest of Europe are sharper. These data are presented in Table 2. It is worth noting for both tables that the relative magnitudes are distorted over time by changes in the value of the dollar. By the same token, growth rates expressed in national currency explain only part of the differences in final dollar values.

Financial markets in the United States benefit from the large size of the U.S. economy and the long tradition of market financing for American firms. Financial markets in London benefit more from tradition than from size. Both advantages are historical in nature. As times change, these advantages should be expected to give way as well. These are the powerful forces to which New York should be expected to give ground, albeit perhaps slowly. Moreover, they operate on all markets and not just in the United States. The lead of London over the rest of Europe should diminish as firms on the continent

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shift ever more financial resources into the marketplace. Relative growth in market size already seems to point in that direction. It is possible that the combination of London and the rest of Europe could even grow to eclipse the exchanges in New York as well as European markets grow to accommodate the larger European economy.

Table 2: Market Depth and Change – 2006-2007.

	2006 (January through December)		2007 (January through June)	
	Turnover (dollar billions)	Percent Growth (national currency)	Turnover (dollar billions)	Percent Growth (national currency)
NYSE	21,790	22.0	13,111	16.5
Nasdaq	11,807	17.1	6,857	10.8
LSE	7,572	30.5	5,557	34.8
Euronext	3,853	29.2	2,698	22.2
Deutsche Börse	2,737	40.0	2,124	36.9
Source: World Federation of Exchanges.				

If there is a notion of financial market "leadership" to be found in this data it can be expressed as a simple story of convergence: European firms are moving from own- or bank-financing to alternatives provided by the market; the United States (and Great Britain) have led the way. In this sense, the data for market capitalization and turnover tell more about the past then about the future. What is interesting in the data is not that Europe is catching up to the United States but that New York had such a large lead in the first place.

The same data also reflect a financial economy that is primarily domestic in scope. Despite all the hype about globalization, these financial markets trade primarily in domestic securities and they are dominated by a small number of very large firms. Foreign firms account for only about 8 percent of the trading value on the NYSE and 6 percent on the Nasdaq. The share of foreign firms in London trading is much larger (43 percent), but the corresponding share of foreign listings on the Deutsche Börse is close to the American value (9 percent) and the share of foreign listings traded on the Euronext is much smaller (less than 0.5 percent). Moreover, whatever the share of foreign listings on the exchange, the top five percent of domestic firms attract the lion's share of market value and activity. As the data in Table 3 reveal, this concentration is particularly acute in London, where 131 firms account for almost 85 percent of the market.

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Table 3: Domestic Concentration on Exchanges, 2006.

	Total Value of Share Trading (dollar billions)		Concentration of Share Trading (in top 5% of domestic firms by value)		
	Domestic Companies	Foreign Companies	Percent Concentration		Number of Firms
			Market Capital	Trading Value	
NYSE	19,916	1,795	47.8	26.2	91
Nasdaq	9,985	712	61.7	82.1	158
LSE	4,283	3,288	84.1	84.8	131
Euronext	3,834	19	72.3	57.0	48
Deutsche Börse	2,483	254	70.3	77.1	34
Source: World Federation of Exchanges.					

Investments and Opportunities

By itself, market size offers little insight on the future. Instead we should look at the firms, industries, and technologies that will shape the way both companies and individuals meet their financial needs. This is where the debate about new listings becomes important. Mayor Bloomberg and Senator Schumer use new listings (or initial public offerings [IPOs]) as a barometer for future market performance. In essence they assert that the market that leads in IPOs is the market that leads. There is a great deal of logic to this claim. As the McKinsey consultants whose report underpinned the Bloomerg-Schumer case explain:

> IPOs matter because they are the first in a series of events that generate substantial recurring revenues for the host market. After the IPO itself, income comes from secondary trading, secondary public offerings, and the ability to directly tie derivative instruments to the underlying security. Everything being equal, new issuers will also look to raise equity in the markets they see as most vibrant. Thus, perceptions around IPO market competitiveness really do matter to exchanges, broker-dealers, and financial markets more broadly.[1]

Whatever the logic to the argument, however, it is worth considering who the companies

1. "Sustaining New York's and the US' Global Financial Services Leadership," p. 43. http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf

are that choose to list on a particular exchange and why they make that choice. It is also important to consider the other side of the equation – meaning those companies that choose to leave the market because they would prefer to meet their financial needs some other way. The point is that the choice for listing on a particular exchange is not a straight comparison between New York and London as rivals. Instead it has to do with a variety of factors including eligibility, cost, and name recognition. Firms will not choose to list where they are not eligible, where the cost is too high, and where demand for their securities is low (because no one knows much about them). Recent analysis shows that much of the difference in IPO activity in London and New York can be explained in terms of eligibility and cost: the newly listed firms would not qualify for the NYSE or the Nasdaq and, even if they did, the value of their listing is small enough that it is much cheaper to go onto the LSE.[2] Beyond that – as the McKinsey consultants working for Bloomberg and Schumer are careful to note – many of the new public offerings on European exchanges are domestic firms that are being privatized away from public ownership. Such firms are unlikely to be listed on a foreign exchange for political reasons and are likely to have a much stronger name-recognition in the domestic market in any event.

As with the market as a whole, the pattern of new listings is heavily biased toward domestic industries. The same is true of de-listings as well. This can be seen in Table 4, which gives the total number of firms, both domestic and foreign, that have joined and left the major American and European exchanges.

Table 4: New Listings and De-Listings, 2006.

	Newly Listed Companies		De-Listed Companies	
	Domestic	Foreign	Domestic	Foreign
NYSE	100	28	120	30
Nasdaq	135	21	n/a	n/a
LSE	544	32	394	34
Euronext	40	12	54	n/a
Deutsche Börse	31	4	n/a	n/a
Source: World Federation of Exchanges.				

The data on de-listings is not as complete as the IPO data, but what is there is

2. Craig Doidge, George Andrew Karolyi, and René M. Stulz, "Has New York Become Less Competitive in Global Markets? Evaluating Foreign Listings Over Time." *Fisher College of Business Working Paper No. 2007-03-012*. July 2007. Http://ssrn.com/abstract=982193. "The Cost of Capital: An International Comparison." Oxford: Oxera Consulting, June 2006.

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nevertheless revealing. Firms join and leave in roughly equal numbers and in similar proportions, domestic over foreign. In all cases, the number of domestic firms predominates. The contrasts are between the relatively high number of IPOs in London and the relatively high number of de-listings from the NYSE and the Euronext. This is partly due to an anomaly in the data and partly due to a change in the industry. IPO numbers are low in Europe because the Euronext data does not include the small capitalization alternative investment market, while the LSE data does. The difference does not explain the gap between London and the continent, but it would alter the balance between new listings and de-listings in Europe. The change in the industry is more interesting and important. The large number of de-listings in New York is due to the rapid growth of the private equity business. The role of private equity groups is to pull firms out of the exchanges using own- and bank-financing as a substitute for market access. The bigger and more important these private equity groups become, the more firms will necessarily move away from the exchanges.

Causes and Consequences

Private equity groups are only one example of the firms and technologies that are leading the evolution of markets today. Other examples would include the growth of mutual funds and hedge funds, the increasing sophistication of financial derivatives, the elaboration of new on-line trading platforms, and the emergence of large sovereign-backed investment groups. Indeed, there are many signs that financial markets no longer exist primarily to provide firms with an alternative to bank- or self-financing. On the contrary, financial markets now appear to have a life of their own with trading instruments – like credit default swaps – that have little or no relationship to the real financial requirements of industries. The challenge for the United States is to adapt to this new financial environment. The challenge for Europe is to adapt to this new environment while still working to converge on the past achievements – in terms of creating broader, deeper financial markets – of the United States.

The European response to the changes in financial markets has been to push for a consolidation of the financial services industry, to facilitate the merger of separate national exchanges, to implement a more coherent real-time gross settlement system (TARGET) for cross-border payments, and to encourage the development of pan-European trading (through the "Markets in Financial Services Directive" [MiFD]). These developments have helped London's financial services sector to consolidate its share of the global market in areas such as cross-border lending, foreign exchange turnover, and the secondary trading of international bonds. As data published by the London-based organization *International Financial Services* reveal, the market shares captured by London in these areas is virtually unchanged since 1995.[3] Meanwhile, the number of UK and foreign banks represented in the London financial community has collapsed. There were 142 British banks and 339 foreign banks in the UK in 1995. By 2007, there were

3. "International Financial Markets in the UK." London: International Financial Services, May 2007. Http://www.ifsl.org.uk.

only 68 British banks and 252 foreign banks remaining.[4]

The point to note is that the consolidation of the London financial services sector was not limited to UK banks. The number of foreign banks declined as well. As the market became more competitive, all members of the financial services community had to adapt. Indeed, there is some evidence to suggest that the foreign banks have done better in the process than their British competitors. In the ten years since 1997, the foreign share of assets under management in London has increased from 51 percent to 53 percent even as the volume of assets has exploded from just under GBP 2.5 trillion to just over GBP 6 trillion.[5] The implication is that these foreign banks have much at stake in ensuring the successful adaptation of the City of London as a financial center. And what is good for these foreign banks is good for their foreign owners as well.

A Deeper Transatlantic Relationship

Many of the major banks in London are American. And many of the major developments in the London financial services community are being spearheaded by American banks. Of these, probably the most important is the new multilateral trading facility developed under MiFD by a consortium of banks including Citibank, Goldman Sachs, Merrill Lynch, and Morgan Stanley. This new trading facility, called "Turquoise", will give these banks the ability to tap markets across Europe in their search for capital. It will also make it possible for them to trade directly with one another without the need for going through one of the national exchanges, and it will allow them to conduct post-trading settlement and clearing operations directly. In turn, this should lower costs and increase liquidity across the European marketplace.

Transatlantic cooperation is taking place between exchanges as well as between banks. In June 2007, the NYSE completed its merger with Euronext – effectively linking exchanges from the Paris to the Pacific. The merger will not end the domestic bias in market trading, but it will facilitate foreign listings where there is demand. It will also encourage the development of new technologies, investment in common trading platforms, and the adoption of common rules and standards for market practices.

Whether through banks or exchanges, the changes underway in European financial markets complement the heavy interdependence between the United States and Europe in terms of foreign direct investment. Firms that operate on both sides of the Atlantic will find it cheaper and more efficient to work with banks and exchanges that operate on both sides as well. American financial leadership does not suffer with this new consolidation. But the transatlantic relationship will be deeper, more liquid, and more competitive as a result.

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4. Http://www.ifsl.org.uk/research/news.cfm.
5. "International Financial Markets in the UK." London: International Financial Services, May 2007. Http://www.ifsl.org.uk.

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