

RESEARCH PROJECT: International Competitiveness of Australia's Financial Services Sector: Fulfilling the Mandate of the Financial System Inquiry

Working paper summary

What Turns Cities into International Financial Centres?

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International financial centres (IFCs) are icons of modern capitalism. Accordingly, competition among cities to achieve IFC status occurs across the world, in both advanced and emerging economies.

However, the process by which cities achieve IFC status remains unclear. This raises interesting questions, such as why is London, and not Paris, the financial capital of Europe? Or what is the likelihood of Shanghai becoming a global financial centre?

The relative paucity of research to date on the development of IFCs that goes beyond descriptive history and case studies partly reflects a bias towards manufacturing in economic and economic geography studies. The question of location in the services sector is disregarded as trivial. Indeed, the term financial centre hardly features in economics literature, despite it being a self-evident pre-occupation of finance firms and local policy makers.

This bias is compounded by empirical issues. Data on financial activities is mostly available at the country level. Accordingly, city-based research on financial centres tends to resort to proxies such as stock exchange size, level of employment in financial services, number of financial firms represented in the city, and indices of competitiveness. However, such proxies do not clearly distinguish between domestic and international activity, which limits their use in a systematic analysis of factors related to local geography that affect the development of financial centres. As a consequence, existing research tends to neglect the more analytical question of why most cities never become IFCs.

This study analyses a novel dataset that encompasses capital markets and city-level observations, covering the period from 2000 to 2014. The dataset facilitates the estimation of gross fee revenues from almost 600,000 capital market transactions worldwide. These transactions encompass merger and acquisition activity, and also cover the equity, debt, and syndicated loan markets. Fees related to individual cross-border transactions are identified and assigned to the city where the relevant financial advisory firm is located. This methodology generates a measure of international financial activity that is based on the actual business transacted within a particular city. It yields a unique ranking of IFCs that is arguably more direct than those in existing indices. Importantly, it facilitates a systematic analysis of specific factors that affect the development of IFCs.

The study shows that cross-border financial activity is strongly influenced by city size, institutional environment, labour market flexibility, and the concentration of financial advisors. In particular, a city needs size to offer a sufficiently large and deep labour market necessary for the financial sector. Moreover, the labour environment has to be flexible, reflecting the cyclical nature of the financial industry. In addition, institutional factors such as the rule of law are important, as it is almost impossible for a city to become an IFC without a mechanism to effectively and efficiently enforce contracts. Interestingly, once labour market and contract enforcement variables have been accounted for, it does not appear to matter whether a city has an English- or French-based legal system.

Membership of regional bodies, such as the EU, appears to enhance the ability of cities to attract deals, and it is evidently advantageous for an IFC to host several large global financial firms rather than a myriad of small firms. IFCs also tend to be characterised by the presence of many large non-financial companies' headquarters, particularly if these are internationally active. The study also finds that the domestic financial status of a city significantly impacts its ability to attract cross-border deals.

In contrast, the study also identifies several factors that do not appear to impact the likelihood of a city becoming an IFC. These factors include: stock market returns; corporate and financial tax rates; whether the city is a capital centre; location in the world time zone; and whether English is the official language.

At the overall level, it is evident that IFC development is a complex phenomenon, subject to a wide range of influencing factors that span both the country and city levels. Moreover, it does not appear that reliance can be placed on booming stock markets, low tax rates or other short-term factors in any endeavour to rapidly establish an IFC. Rather, it appears that an IFC comes into being following a long and slow process of economic and institutional development.

It is evident that cross-border finance is a strategic pursuit undertaken predominantly by large cities that have already attained the status of the top financial centres within their respective domestic economies. To maintain their IFC status, these cities need to sustain a large and internationally active non-financial corporate sector.

The practical implications of the study findings may be illustrated using the example of China, where a scenario involving two or more Chinese IFCs of comparable size appears unlikely to eventuate. Worldwide, cities that play a leading role in domestic finance also tend to dominate internationally related finance in their respective countries. Although Shanghai is surrounded by much hype as the rising star of IFCs, the city remains at a disadvantage relative to Beijing, which is China's leading domestic financial centre.

Both Shanghai and Beijing currently occupy lowly positions in terms of IFC rankings. Accordingly, it is feasible that Shanghai may yet overtake Beijing, particularly if it builds up a larger and more internationally active non-financial sector, and surpasses Beijing's labour market in size and depth. However, the study findings suggest that neither city will be realistically able to challenge Hong Kong, let alone foreign IFCs, without significant legal reforms being implemented in mainland China.