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INTRODUCTION

The origins of this project are to be found in the projected liberalisation of the European Community in 1992. When the United Kingdom acceded to the European Economic Community in 1973, concern was expressed about the relative efficiency of British manufacturing industry and how that sector would fare in the Common Market. It was appreciated that with the full liberalisation of the Community’s internal market in 1992, attention would need to be focused on the competitiveness of Britain’s financial service industries relative to those of other countries. Interest in this question has also been stimulated by the fact that negotiations in the Uruguay Round of GATT trade negotiations are directed largely towards liberalisation of international trade in services.

This interest in the impact of 1992 on the Community’s financial service industries has been reflected in debates about a wide variety of relevant aspects. These include the nature of the financial and prudential regulatory regimes to be implemented by individual member countries, the extent to which member countries’ tax regimes will influence the location of financial services, and the implications of the international integration of financial markets for exchange controls and monetary policy. It is clear, however, that an especially significant ingredient which needs to be taken into account when gauging the impact of market integration and service trade liberalisation on the performance and development of national financial service industries is their relative competitiveness. It is with this issue, and especially with Britain’s comparative performance, that this study is essentially concerned.

The objective of the study is to determine and explain the comparative efficiency of certain British owned and managed financial service institutions, regardless of whether the operations in question are conducted from the United Kingdom or are based overseas. It is not directly concerned with comparisons of financial centres in an attempt, for example, to identify the relative strengths and weaknesses of the City of London as a base for financial operations. The results should make it easier to assess how British financial institutions are likely to fare in competition with foreign
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owned and managed companies, wherever they are located, when trade in financial services is liberalised.

Until recently – perhaps on account of the pre-eminent position which the City was assumed to occupy as the leading European financial centre – it was generally thought that with the advent of full market integration, and in sharp contrast to expectations for UK manufacturing in 1973, British financial service industries would ‘clean up’ at the expense of their overly-protected, less efficient, and smaller continental competitors. Moreover the possibility has been raised that some recent developments affecting British financial services (technological changes associated, *inter alia*, with the Big Bang, sharper competition resulting from both the diversification of British financial sectors and also the arrival of overseas financial groups) may have further enhanced the efficiency of British financial service activities. However the comparative position of British financial services is currently regarded in a more circumspect fashion, partly as a result of the impact of the ‘prudential’ regulations to which they have recently become subject.

Whilst interest in the question of the comparative efficiency of British financial services was thus triggered by the advent of 1992, initial work on the project indicated that its scope would need to be widened in some important respects. In particular it was quickly appreciated that given the major roles which they play in international financial markets, coupled with relatively free access which they may enjoy in Community markets, the financial sectors of such countries as the United States, Japan and Switzerland would need to be included and examined alongside those of the United Kingdom and other member countries.

The scope of the study also needed to be enlarged in order to encompass a review of the appropriate methodology for quantifying inter-country comparisons of sectoral competitiveness and comparative advantage. In contrast to the position with international studies of manufacturing industry, the methodology for such comparisons has barely reached beyond the embryonic stage in the case of service industries.

Chapter 2 of this study is devoted to a review of possible approaches and the identification and selection of a measure that is suitable and practicable for the present purpose. The various approaches have been examined in a critical fashion and all were found wanting in one or more critical aspects. In the case of those measures which are based on international productivity/cost/price comparisons, the principal weaknesses are as follows. First, they fail to distinguish between the foreign-owned segment of a country’s financial sector (frequently
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large) and the performance of domestic financial institutions. Second, little or no attention is paid to capital inputs (again very important in financial services) as opposed to labour resources. Finally, the analyses are invariably highly aggregative, typically relating to the whole of a country’s financial service industry. In each of these cases the problems are attributable, au fond, to data limitations for which there appears to be no prospect of any immediate improvement.

Chapter 2 also reveals that data restrictions, too, impair the usefulness of some of those international comparisons of the performance of financial service industries which are based on revealed comparative advantage: the extent to which financial services feature in a country’s exports and the share of global exports of financial services gained by a given country. The data which are available in the standard national and international compilations of trade information are such that, again, comparisons can be made only for service sectors as a whole and not for individual financial service industries. More fundamentally, the revealed comparative advantage approach based on direct trade flows fails to take any account of the trade implications of foreign direct investments, the role of which can be of paramount importance in the case of financial services.

More positively, Chapter 2 serves to emphasise that a sharp distinction must be made when analysing the competitiveness and performance of financial institutions between their ownership and location. Another lesson which is drawn is that, ideally, any quantitative analysis needs to be conducted at a disaggregated level and also take full account of foreign direct investment in financial facilities.

In the event the shares of selected financial markets obtained by the relevant financial institutions have been aggregated on a nationality basis to yield the basic measure for comparison between countries. To some extent this is a form of the revealed comparative advantage approach, though one which is designed to avoid weaknesses in methods hitherto attempted, and is best suited to the data available. Since inter-country contrasts in such shares reflect not only the efficiency differentials of national financial institutions but also the influence of formal and informal barriers to domestic and global markets, the resulting measures are best regarded as indicators of comparative performance, one of the most important influences on which will be national contrasts in the inherent efficiency of the financial service industries.

Chapter 2 also sets out criteria for the selection of those financial markets for which country shares are measured and analysed. To make the research manageable, consideration is first restricted to the general ambit of the operations of security houses, investment banks,
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merchant banks and the non-retail activities of commercial banks. At a second stage individual markets were selected on the basis of a variety of criteria: market size; participation by all banking types; the coverage of both old and new markets; and data availability.

In the event country shares have been measured and analysed for the following markets: the market for foreign exchange; the market for merger and acquisition advice; the market for syndicated bank loans; the Eurobond market; the international equity market; the Eurocommercial paper market; and the market for Euro medium-term notes. As can be seen, market selection has been strongly biased in favour of international rather than domestic arenas since these tend to be large, less regulated and have few entry barriers, so that the financial institutions of all countries compete on an equal footing.

Preliminary work on the project also made it apparent that merely to assess, by whatever means, the comparative efficiency of the financial service industries of different countries as it is at present would fail to provide an adequate basis for judging comparative performance after 1992. Clearly it is equally important to know in which direction, relative to other countries, Britain’s performance has been changing. This requires that considerable attention be devoted to recent and longer-term developments in country market shares, a task undertaken in Chapter 3 where each of the selected markets is allocated a sub-section tracing the manner in which the shares of countries participating in that market developed during the 1980s.

This historical chapter also opens the search for explanations of the size of market shares obtained by British financial institutions and their principal rivals. This quest is pursued in Chapter 4, which comprises a more detailed analysis of the selected markets for 1989. Each country’s share in each market is explained in terms of the number of its financial institutions active in the market, the number of financial units produced per firm, and the average value of these units. Britain’s performance relative to its competitors is then compared for each of these share-determining factors, first vis-à-vis the United States and second relative to other countries. Country shares have also been aggregated across markets, an exercise which suggests that, in terms of this study’s product coverage, the United Kingdom ranks second overall, after the United States. An important by-product of this 1989 market analysis is a Schedule of Market Participation, which lists, by nationality, all the financial institutions which held significant shares in 1989 in one or more of the selected markets. This list, which runs to almost a hundred institutions, has been further exploited in this study.

First it forms the basis of a statistical comparison of national
banking sectors which is presented in Chapter 5. Data derived from the 1989 annual reports and accounts of these financial institutions have been grouped and aggregated by nationality and then compared between countries in an attempt to determine whether there exist specific national characteristics which may influence the performance of a nation's financial institutions in international markets. These inter-country comparisons relate to average firm size, factor ratios, income components, cost structures and personnel remuneration.

Secondly, this same list of participating financial institutions constituted the framework for a series of interviews undertaken to identify the causes of inter-country contrasts in the performance of financial institutions. This facet of the research was facilitated by the fact that virtually all firms on the list had branches, subsidiaries or other kinds of representation in London. An approach by letter yielded 36 such interviews. Country coverage was good, with institutions from most of the major players (the United Kingdom, United States, Japan, Switzerland, Germany, France, Canada and the Nordic Group) participating. There was also full cross-sectional representation of the financial service sector, with the inclusion of commercial banks, investment banks, merchant banks and security houses. The bulk of the interviews took place in London but some were conducted in Paris, Geneva and Frankfurt.

The information and views recorded in these interviews constitute the main basis (though other sources have also been drawn upon) of Chapter 6. This chapter extends the search for, and identification of, the factors which do most to explain the relative performance of Britain's financial institutions and their principal rivals. Among the explanatory factors which have been considered and analysed are: human resources, capital, levels of technology, innovation and the more significant regulatory parameters.

Another set of influences on the comparative performance of national financial sectors, discussed at length, are those associated with economies of scope and scale in banking operations of the type covered in this study. It was felt necessary to pay special attention to the impact on comparative performance of the structures, and changes therein, which characterise the banking industries of different countries, in particular to mergers within commercial banking and investment banking sectors, and between commercial banks and investment banks, in each case both domestic and cross-nationality.

The impact and relevance of domestic conditions on relative performance is also explored in Chapter 6. Whilst the study is essentially concerned with competitiveness in international financial markets, it emerged that the nature of domestic markets, their size
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and accessibility, is highly relevant to the performance in these markets of a country’s financial institutions, as are interest-rate levels and the international role of the domestic currency.

The salient findings are assembled in Chapter 7, where special attention is directed towards the comparative performance of the British financial sector and to its competitive prospects in the immediate, post-1992, future. The timing of this project requires that great care must be exercised when gauging future developments. The research extended over the period 1989 to 1991, when the financial markets upon which attention has been focused were for the most part severely depressed and characterised by excess capacity in the financial sectors which served them. For this, and a variety of other reasons amongst which bad debt provisions rank high, the national banking sectors which are the central focus of this study were in general experiencing difficult trading conditions. As the study was being concluded there were indications, primarily in the operational results of American investment banks though rather less so in the case of commercial banks, that a corner was being turned. An attempt has been made when assembling the results of the study to minimise and look beyond the relatively short-term vicissitudes of this period in the search for an assessment of Britain’s underlying comparative performance.
ASSESSING THE COMPARATIVE PERFORMANCE OF FINANCIAL SERVICES

An article which analyses the impact on the British economy of the 1992 initiative to remove barriers in a single European market begins in the case of the financial service industries: ‘It is generally accepted that the UK has a comparative advantage in the provision of financial services’ (Lloyds Bank, 1989). Below we survey and assess the kind of evidence which hitherto has been used to gauge the comparative efficiency and performance of national financial sectors and devise a measure which, against this background and taking account of data availability, can be pressed into use for the purposes of this study.

THE COMPARATIVE SIZE OF FINANCIAL SERVICE SECTORS

At one end of the analytical spectrum the comparative efficiency of different countries’ financial sectors has been inferred very simplistically from the attitudes of their respective governments to the liberalisation of trade in financial services. The support for freedom of competition and international establishment in banking which tends to be a feature of the policy, for example, of the United States and the United Kingdom, is thought to imply and reflect the fact that these countries ‘enjoy a comparative advantage in banking relative to nearly all other nations in the world’. Thus ‘one reflection of the belief in United States comparative advantage in service industries is the strong effort the United States has been making to reduce barriers to what is referred to as trade in services’. In contrast a predominance, at least until recently, of protectionist attitudes in countries such as Canada, Sweden, Australia, Brazil and Taiwan has been seen to indicate the absence of such comparative advantage (Kravis and Lipsey, 1988, and Gray and Walter, 1983).

In a somewhat more sophisticated fashion attention is frequently drawn to the size of a country’s financial sector as a positive indicator of its efficiency. In some cases attention is focused on the absolute scale of activities, an approach based in part on expectations of the internal and external economies which may in consequence arise. Thus in support of the above assertion about the superior efficiency of British financial services emphasis was placed inter alia on the fact that
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‘daily foreign exchange turnover is estimated to be roughly twice as high in London as in New York or Tokyo’ and that ‘London has 56 per cent of the international market for insurance’; the external economies associated with the scale of financial activities in the City were also stressed (Lloyds Bank, 1989). The importance of size, both of individual firms and whole sectors, in the context of international banking has received a great deal of attention (Revell, 1985).

More frequently, however, interest is directed towards the size of a financial sector in relation to the total economy of the country in question. Although no rationale for such an approach may be explicitly cited there is an expectation, based on international trade theory, that activities in which a country enjoys a comparative advantage will bulk relatively large in the economy. Another, again implicit, reason for focusing attention on proportionate industry size is that, assuming each developed country has approximately the same (proportionate) domestic need for financial services, there is a presumption that the surplus output will be exported from those countries where the financial service sector is relatively large, and this in turn is taken to be a reflection of the comparative efficiency of financial services in that country.

For thirteen countries Oulton has collated and presented data for the relative sizes of the financial services sectors (Oulton, 1986, table 2.3). Based on OECD sources the results reveal that in 1983 value added in British financial services constituted 15.6 per cent of total GDP, somewhat greater than the (unweighted) average of 12.9 per cent registered for all the selected countries. The individual proportions in descending order were: United States 22.3 per cent, France 17.4 per cent, Japan 16.9 per cent, United Kingdom 15.6 per cent, Denmark 14.5 per cent, the Netherlands 14.3 per cent, Belgium 13.0 per cent, Canada 12.8 per cent, Germany 11.4 per cent, Spain 9.5 per cent, Portugal 7.7 per cent, Greece 7.3 per cent and Ireland 4.5 per cent. A feature of such comparisons which emerged in the above exercise is the difficulty of ensuring international comparability in the definition of the financial services sectors being measured. Whilst in principle the above measures relate to ‘finance, insurance, real estate and business services’, in the case of Canada, Greece, Japan and the United Kingdom business services were excluded and for Germany, Ireland, Portugal and Spain, business services and real estate, wholly or in part, were left out of account.

This source shows that, for the same year and again based on OECD data, when measured by the proportion of the occupied population, the relative size of the British financial services sector, 8.7 per cent, is somewhat larger than the (unweighted) arithmetic
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average for 12 countries, 6.5 per cent, and in fact ranks third from the highest after the United States, 11.8 per cent, and Canada, 9.7 per cent (Oulton, 1986, table 2.5).

The ‘Cecchini Report’ contains a similar analysis but one based on European Community statistics for 1985 and defines the financial service sector as ‘credit and insurance institutions’. This shows that compared with an unweighted average of 7.3 per cent (weighted 6.4 per cent) for eight principal members of the Community, value added in the British financial service sector constituted 11.8 per cent of total GDP. In descending order the relative sizes of the sector in these countries were: Luxembourg 14.9 per cent, United Kingdom 11.8 per cent, Spain 6.4 per cent, Belgium 5.7 per cent, Germany 5.4 per cent, Netherlands 5.2 per cent, Italy 4.9 per cent and France 4.3 per cent (EEC, 1988).

Apart from suggesting that the relative size of the British financial sector is large compared with that of its major continental competitors these data emphasise, as much, the discrepancies in results which can arise using different statistical sources and alternative definitions of financial services. In the case of the six countries for which the comparison is feasible (Belgium, Germany, Spain, France, the Netherlands and the United Kingdom) there is a negative correlation between the sizes of their financial service sectors as measured on the basis of OECD and EEC value added data and definitions.

Other indicators assembled in the Cecchini Report also suggest that the British financial services sector may be comparatively large: Britain emerges as top of the above eight member countries in terms of insurance premiums as a percentage of GDP, second on the basis of bank loans (headed by Luxembourg), and third using stock market capitalisation (after Luxembourg and the Netherlands).

INTERNATIONAL PRODUCTIVITY COMPARISONS OF FINANCIAL SERVICES

For both goods and service industries there are two broad approaches to the comparison and assessment of international competitiveness. On the one hand the cost-based approach focuses, in particular, on such variables as relative labour productivity, unit labour costs and export prices. On the other attention can be directed to revealed comparative advantage using data for export values and market shares. Here we consider the first of these approaches in the context of financial services and return to the latter in the following section.

Over the past two or three decades a whole economic discipline has
developed around international productivity comparisons for manufacturing industries, especially those for labour productivity. Such analyses are still rare in the case of service activities principally, but not entirely, because of practical difficulties associated with output measurement.

Two methods have been favoured for making international productivity comparisons in industrial activities. The first, normally based on census data, seeks to compare between countries for a given activity, physical output per person employed or per man-hour, with different units being aggregated on the basis of suitable value weights. Whilst there is no record of this approach having been applied to financial services, the development of inter-temporal output measures based on numbers of service output units suggests that it is an avenue which might be fruitfully explored in an inter-spatial context. It has been found practicable in the case of both the British banking and life insurance industries to base inter-temporal output measures on changes in numbers of the various kinds of accounts, transactions and insurance policies, new and in existence (Smith, 1989). It might prove feasible to extend this methodology to international output and productivity comparisons using national statistical sources equivalent to those drawn upon in the United Kingdom, or in the case of banking, the type of data collected periodically by the Bank for International Settlements (BIS, 1985).

A second method used for making international labour productivity comparisons in the case of goods-producing industries involves deflating to a common currency, using appropriate purchasing power parities, the value added per unit of labour for a given industry in different countries. Some use has been made of this kind of approach for international labour productivity comparisons in the distributive trades (Smith and Hitchens, 1985) and more recently it has been essayed by the National Economic Development Council (NEDC, 1988) in the case of financial services.

The results of this latter exercise suggest that if real value added per employee in the British banking and insurance sector is taken as unity then corresponding productivity levels in major continental rivals are lower at: Italy 0.85, Germany 0.62, France 0.52, Belgium 0.46 and the Netherlands 0.45. Results which are similar in nature, though not numerically identical since the approach obviates the use of purchasing power parities, can be derived from combining the proportions of value added with those for manpower shares of the financial sectors presented in the ‘Cecchini Report’. If in each country the sector’s share of value added is divided by its manpower share the following results emerge: Belgium 1.50, Germany 1.80, Spain 2.29, France 1.54,