Remembrance of Things Past

Thank you, Chairman

If all the fathers of the Euro bond market were laid end to end, we would give a sigh of relief and bury them in a mass grave. Success has many fathers – only failure is an orphan – but I will admit, I did happen to be in the right place at the right time with the right house. It was called White, Weld & Co, and some of your fathers and grandfathers may remember it.

I will start by trying to expose two myths or legends. The first is that the international bond market – then known as the Euro bond market (they stole our prefix for a currency experiment the less said about the better), that this market was a brilliant innovation, a new departure in finance, its practitioners great pioneers. Nonsense. There was nothing new about this market – it was merely a revival of something which had existed since earliest times. The contracting of loans across frontiers on behalf of sovereign or other established borrowers goes back to ancient times, when Greek bankers lent to Roman senators. In the middle ages, Lombardy bankers operated in London and Antwerp, and in addition to developing the bill of exchange in order to circumvent religious laws against usury, they also contracted loans on behalf of the rulers of Europe. In the nineteenth century, international lending became securitised and liquid, and bearer bonds had coupons payable at agents in several centres. Between the two World Wars a veritable orgy of international bond issuance took place, in particular on behalf of new countries carved from the Austro Hungarian empire, such as the Kingdom of Serbs, Croats and Slovenes. Latin American countries exploited the market, and all this paper, at a nice premium over gilts and treasuries, was gobbled up by widows and orphans. By 1939, a large proportion of these issues were in default and the expensively engraved certificates now decorate the walls of collectors.

Even the so-called Euro equity market is nothing new. Before WW2, in the 20s and 30s there was a cross border arbitrage market in leading equities that were often quoted on several exchanges. An example is Victor Talking Machine, the precursor of RCA which was quoted, and owned roughly half and half in the US and in the UK. There were days when arbitrageurs (time arbitrage, of course) turned over 25% of the shares outstanding arbitraging between London and New York . In the City, the arbs clustered in Shorter's Court, an alley near the Stock Exchange, and dealt in “Yanks” and “Kaffirs” - South African mining shares between New York, Paris and Johannesberg. There was primary market activity. The Swedish Match Company, for example (which turned out to be a massive fraud), had rights issues subscribed through out Europe. So, yes there was an International Capital Market up and running a century ago.

So all we did in the early 1960's was to revive something that had existed for centuries and had been temporarily suspended by WW2. And the so-called innovations which punctuated the rise of the Euro bond market were all of US origin, including floating rate notes, zero coupon bonds and perpetuals. Virtually every derivative product is a US invention. So all we so-called pioneers were doing was adapting and reviving well established financial techniques.

The second great myth is that this market was unregulated in its formative years. At a stretch, one can admit that secondary market trading, as a dealer market, was unregulated in the modern sense, but the bonds were all listed, mostly in Luxembourg and so had passed an admission hurdle. And the participants were all authorised businesses in the countries of origin – their employees were also mostly what we would call today authorised persons. I would also dare to say that this so-called unregulated market activity rarely produced ethical lapses. An organized bear ramp in government bonds would have been unthinkable. No one took advantage of fat finger mistakes. Of course, it was a telephone market, but if your counter-party made a mistake in the big figure – you pointed it out. What annoyed the authorities was the lack of transparency - there was little statistical evidence of turnover in those days. This prompted a celebrated economist of the age, Jacques Rueff, to characterise the euro-market as a dangerous engine of inflation. He considered that trade in mostly US dollar denominated instruments out side the regulatory orbit of the US Treasury, was tantamount to printing money. For a trained academic economist, this is a strange position – high turnover in a stock doesn't increase the number of shares outstanding. But, in those days, the greats of the financial world hated anything they couldn't measure. One wonders what Mr Rueff would have made of today's swap markets.

Most history repeats itself, and because financial markets are cyclical, financial history repeats it self with even greater accuracy. Let me cite a few historical staging posts during the rise of the post war international capital market. The Swiss, a country of indirect taxation, had always imposed a stamp tax on securities trades – yes, a transaction tax – sound familiar? Before Mr Tobin was born. Early trading in euro – bonds was heavily Swiss centred, but it became evident that even trades between non Swiss counter parties would be caught if intermediated in Switzerland, so my own firm, perhaps the largest player at the time, moved its bond trading from Zurich to London. All the others followed. Switzerland lost the chance of being the epicentre of this new market. Of course, this didn't bother the Swiss banks at the time – they still believed there was a conflict between origination and underwriting, and their main business of wealth management. Still, it was a transaction tax that drove the market from it's then natural home.

The next key event – in the early 1960's - was the establishment of capital controls in the United States during the Kennedy administration, through the Interest Equalisation Tax. Capital controls are a virus which, if unchecked, eventually kills international finance. The IET ended the chances of New York becoming the epicentre of the new market for international finance and a huge boost was given to the emerging euro-market in London. Now, for the first time since it's inception, capital controls have been introduced in a part of the Euro zone. And we have not seen the last of them – they will be the final rampart in the desperate fight to save a doomed currency project. Draw your own conclusions.

Of course, London still had exchange controls in those early days, but this only affected sterling, no longer a reserve currency of importance. Guest currency transactions, mostly in US dollars, were entirely free of restrictions. Furthermore, London was anti protectionist and welcomed foreign banks. And here is another isolated but significant event In the 1960's - that first decade of explosive growth in international issuance and trading- a London merchant bank launched an issue for the City of Copenhagen denominated in DM – without the consent of the German monetary authorities.. All hell broke loose. The Bundesbank would not tolerate the use of the DM as a guest currency. The DM was in increasing use as a currency of denomination for international bond issues, but only under the management of German banks and in a regulated new issue queue. Foreign banks were not allowed to participate in domestic DM capital market activity. They were only just tolerated in Euro DM syndicates So ended any hope of Frankfurt becoming the euro-market epicentre.

Perhaps the most fundamental characteristic of international capital market activity is the ability of issuers to issue securities in currencies other than their own, and of international investors to invest in securities denominated in currencies other than their own – in other words the principle of guest currency transactions. Any attempt to impede this traffic, by requiring, for instance that transactions be settled and/or cleared only through facilities located in the jurisdiction of the currency involved, is by definition a form of capital control and eventually undermines the full convertibility of the currency involved. The US never sought to impede the use of the US dollar as a guest currency – the first clearance facility for the euro-bond market was Brussels based. The Euro zone threatens to do just that. Again – draw your own conclusions.

In this fast changing world the debate continues as to where the action will remain concentrated. Can London maintain its predominance? Many said it could not if the UK did not join EMU – it didn't, and London is the financial centre of the Euro zone. But I would maintain the discussion is academic because the whole concept of a financial centre – in the sense of a heavy concentration of activity in one particular city – is redundant. And I don't believe London will maintain its ascendency for very long. The City rose to its present position through a combination of circumstances unique at the time – language, supporting services, benign supervision and taxation, middle time zone, tradition and life style. It's monopoly of these attributes is broken. English is now the universal language of finance – and actually they speak it better in Mumbai than they do in London these days. Legal and accounting services are available from all the top firms in all the major centres. Other services, like financial printing, are no longer relevant. Supervision and regulation in London are now in a hopeless muddle with competing forces at the national and EU level. Costs are out of control. Yes, there is still the Lord Mayor and the Corporation of the City of London, but their moral authority has been overwhelmed by a massive culture change, a culture change which has eroded the ethical standard which was another City hallmark. Worse, however, for the future of the City, has been a consistent failure by HMG to defend it's most important economic activity from regulatory and administrative encroachment by a bitter and anti Anglo-American Commission of the EU.

But in fact, the entire institutional structure which provided the framework for the domiciliation of the nascent international capital market has become redundant, although vestiges hang on through sheer historical momentum. Let's take the stock exchange as an example, although the London exchange played virtually no role whatever in the euro-bond market. But it served as an iconic centre piece in the community that was the City of London. But, in today's financial world, there never was a more useless institution than a traditional stock exchange. Hedge funds and prop traders are better providers of liquidity and will continue to be post Volker, even if that initiative is ever enforced, which is doubtful. Order matching and bloc distributions are effected electronically through off market facilities. The exchanges lost their role as a listing authority. And the so-called prestige of a listing is fatally undermined by relaxed standards. The growing market share of passive funds has distorted the whole process. Demutualisation of stock exchanges – a justifiable monopoly, if there ever was one - was a classic mistake, assuming the profit motive would increase competition and lower costs – but it didn't as the exchanges found ways of seeing off competitors and the members just passed the costs to the end users, mostly institutions who passed them on to their ignorant customers. The underlying economic concept was flawed; like putting more than one club house on the same golf course. Stock exchanges in Europe have become merely instruments of financial protectionism. They destroyed every initiative to create a pan European equity market by lobbying to maintain the requirement that offer documents be in national languages, this despite Commission lip service in favour of pan European capital markets. The idea that the EU can be a force in international capital markets when they can't even consolidate their own equity market is risible. It struggles to find a place in a global context, because the ethos underlying the drivers of the EU and the Euro zone, in particular, is not capitalism, it is corporatism, and international finance does sit well in a corporatist context.

So, if not London, and if not Frankfurt or Paris - where? Nowhere and everywhere is my answer; cyberspace, if you prefer. But let me end with some geopolitical observations. I know bankers are not supposed to dabble in politics. Our role is to finance the fecklessness and errors of the political class – not to lecture it. Still, I have the privilege of retirement – I'm not pitching for mandates.
Slowly but surely, the international capital market will shift its centre of gravity from the Atlantic region to the Pacific region. Europe is in economic decline and Asia is in economic ascendency. And already in Europe, we see the tendency towards protectionism and inward vision which always accompanies economic decline. The US tilts towards the European model and therefore tends towards decline. This fundamental geopolitical reality is at the heart of the basic international economic imbalances which, in turn, are at the heart of the continuing financial crisis. As Europe declines, its savings base will either be eroded by inflation or confiscated by taxation, or both, as the only means of paying its debts and, as the economy declines, so does the need for capital formation. The reverse process is in play in Asia whose laissez faire economies, with increasing productivity and free of burdensome social entitlements, offer the best platform for the intermediation of savings and capital formation – so that's where the international capital market will settle. But it won't be in one place: Dubai, Singapore, Mumbai, Bangkok, Hong Kong, Shanghai, Tokyo – yes, even San Francisco. All will share in the action. Keep street maps of them all, and check out the best restaurants. In the meantime, thank you for listening, and have a nice conference and a nice evening.

Stanislas M Yassukovich CBE

May 2013