

Marketplace



Tim Congdon

‘The City of London, like all financial markets, does resemble a casino—but it is better to have a successful and productive casino here than to push it abroad’

Is the City of London a casino? And are its activities “socially useless”, as Adair Turner alleged in 2009? Indeed, are they so socially useless that we should impose extra regulations on them and force them to move elsewhere?

The truth is that a wide variety of financial services share an embarrassing characteristic with gambling: they involve taking substantial risks. Customers are charged either for the kicks they get from dreaming about potential winnings or for the safety they enjoy from avoiding possible losses. Even worse, much of the income earned in modern finance is rather dubious. It consists of such items as trading profits (from buying and selling securities or currencies with third parties, with the deliberate intention to make a profit at the expense of those third parties), and an assortment of fees and commissions, the pricing of which almost inevitably leads to negotiations of some sort. The negotiations are often as undignified as in an oriental bazaar.

London is, for example, the world’s leading centre for foreign exchange trading. When a big multinational asks its bank to use its £1 billion sterling balance to buy \$1.6 billion of dollars (at the current exchange rate of \$1.6 to the £), the bank typically will not have the \$1.6 billion of dollars on its own balance sheet. It has to take a risk to achieve a profit. Specifically, after selling the dollars to the multinational it must acquire dollars at a lower price than the 62.5p in this transaction (i.e., the inverse of 1.6 multiplied by 100) or face a loss. It does not take a mathematical genius to see that if it buys the dollars at, say, 69.4p (i.e., an exchange rate of \$1.44 to the £) it will lose over £100 million.

The foreign exchange market is a casino in which the proprietors need to be on good terms with a large number of diverse customers, so that the risk (of losing over £100 million on a fairly routine £1 billion trade) can be removed from the balance sheet quickly and with little fuss. After helping its multinational customer, the bank sets about either borrowing the \$1.6 billion of dollars, perhaps from other banks, or sells a sterling asset (on its balance sheet for £1 billion) for, say, \$1.605 billion (with the dollar implicitly valued at 62.3p). The bank has then provided a foreign exchange service to the multinational and pocketed \$5 million for its stakeholders.

Foreign exchange turnover in London each day is of the order of \$2,000 billion, with the bulk of it at much finer margins than our bank has just made on its \$1.6 billion trade. Banks do occasionally charge fees for arranging options and derivatives to currencies, but the greater part of the income stream from foreign exchange activity consists of profits from deals of the kind described. Many people would regard such profits as speculative winnings from short-term jockeying, and as justifying the epithet “socially useless” in much the same terms as the work done by croupiers in casinos or bookmakers at racetracks.

But don’t mock. In the year to the third quarter of 2011 the UK’s exports of financial services—predominantly from the City of London, and mostly arising from trading profits, commissions, fees and such like—totalled £42.3 billion, about 3 per cent of our national output. The UK’s surplus on trade in financial services was somewhat smaller, at £31.7 billion, as British companies carry out some foreign exchange trades elsewhere than London, issue securities in New York and Hong Kong as well as the City, and so on. At any rate, the massive surplus on international financial services is basic to the UK’s ability to pay its way in the world.

In the third quarter of last year the UK had a current account deficit of £15.2 billion, said to be the highest on record. Bluntly, the City is vital to its international creditworthiness. In broad terms, without the surplus on financial activities, the payments deficit would be twice as large as it is. If excessive regulation were to cause banks and other financial institutions to relocate, we would face the challenge of having to develop new export products and industries in a highly competitive world marketplace. A disturbing trend is that in the last few years the UK’s imports of financial services have been growing at a much faster rate than its exports, although they remain smaller for the time being. That trend may partly reflect British officialdom’s attack on the banks and the consequent emigration of highly skilled professionals. Croupiers and bookmakers may be disliked, but they tend to be well paid. Financial markets always resemble casinos to some degree. It is better to have large, successful and productive casinos in our own country than to overregulate them and push them abroad.