FOREIGN AND COMMONWEALTH OFFICE
WESTERN EUROPEAN DEPARTMENT
WRF 014/2

DD 1990/271
DESPATCH
SELECTIVE/ECONOMIC DISTRIBUTION
FRANCE
31 JULY 1990

PARIS AS A FINANCIAL CENTRE

HER MAJESTY'S AMBASSADOR AT PARIS TO THE SECRETARY OF STATE FOR FOREIGN AND COMMONWEALTH AFFAIRS

Summary

1. The modernisation of the Paris financial markets over the past decade (paragraphs 3 to 5).

2. The position today: Paris a growing market more suited to service a strengthening French economy, with both European and international aspirations (paragraphs 6 to 8).

3. A limited direct competitive threat to London, inevitable as the Single Market encourages economic liberalisation throughout Europe (paragraphs 9 and 10).

4. The European dimension: the French ability to concert the public and private sectors. Doubts that the French have game plan for promotion of Paris through EMU: but may see indirect benefits, particularly if London seen not to take part in future development of EMU. French bid to site a European monetary institution? (paragraphs 11 to 19).

5. Conclusions: London has every chance of seeing off challenge from Paris. But French ambitious and economy healthy. Should watch closely (paragraphs 20 and 21).

The Rt Hon Douglas Hurd CBE MP
Secretary of State for Foreign
and Commonwealth Affairs
LONDON

31 July 1990

Sir

PARIS AS A FINANCIAL CENTRE

1. In the run up to the Inter Governmental Conference on Economic and Monetary Union in December there may be renewed talk about threats to the position of the City of London, were the UK to be marginalised in the negotiations. Paris is sometimes seen as posing one such threat. Indeed, according to an article in the June issue of Euromoney, written after the collapse of the British and Commonwealth Merchant Bank, London is already "losing the battle to remain Europe's premier financial centre", and Paris or Frankfurt "could take over more quickly than anyone expects".

2. What is the background to this resurgence of Paris? Does Paris really pose a serious threat to London? What is the connection - if any - with EMU? What are the French ambitions? These are the questions which I thought that it would be useful to address before the IGC.

../The Background

The Background

3. The French financial markets have undergone a period of transition over the past decade in some ways comparable to the transition from command economy to market economy now facing the countries of Eastern Europe. At the beginning of the 1980s French business raised most of its finance through direct loans from banks. The banking system itself was controlled by the government, who determined the volume of credit allowed each year, the price at which credit was given and who even subsidised credit to ensure it reached appropriate parts of French industry. There was feeble competition between financial institutions. Strict exchange controls insulated the financial system from the rest of the world. Because it was bypassed as a channel of financing, the Bourse stagnated during the entire period from 1961 to 1982.

4. The 1980s have witnessed a remarkable shift away from a debt financed economy towards a financial market economy. Deregulation has included the scrapping of credit controls and the phasing out of credit subsidy; the gradual lifting of all foreign exchange controls and the privatisation of some important French companies. Unit trusts developed strongly in this period after an initial tax concession in 1978. In 1985 short term money market instruments were created. In 1985 the Paris financial futures market (MATIF) was launched. In 1987 a stock options market (MONEP) was launched. In 1988 a programme of reforms of the Paris Bourse was launched, transforming the ancient

monopoly corps of agents de change, dating back to Napoleon, into financial intermediaries trading on their own account and open - like their counterparts in London - to ownership by French or foreign partners. In 1986 the government debt market was streamlined and a system of primary dealers, aimed at keeping the market liquid, introduced. The regulatory structure has been overhauled, and the Bourse watchdog (the Commission des Operations de Bourse) was given real teeth in 1989.

5. The statistics show how the financial markets have mushroomed as a consequence of these reforms. The circulation of money market instruments rose from F395 billion in 1985 to F1,195 billion in 1989. Equity capitalisation at the Bourse increased threefold in the same period. Bond capitalisation rose by almost 50%. The volume of equities and bonds traded increased more than fourfold. New equity issues by companies rose from F17 billion to F56 billion. The Bourse index rose over the whole decade from a base of 100 to current levels of around 550. Financial futures traded at the MATIF grew in volume by 56% in 1989 over 1988: options traded at MONEP grew by 54%. Funds held by unit trust type collective savings vehicles rose from virtually nothing in 1980 to F1,400 billion by 1989, making France far and away the largest user of such vehicles in the EC. France boasts an estimated 9.5 million shareholders, either direct or through such vehicles. France is no longer a country in which saving means the gold coin in the sock under the bed.

../The Position Today

The Position Today

6. Where do these changes leave Paris today? Much of what has happened was part of a catching up process whereby the French financial markets, once released from governmental constraint, have grown naturally and rapidly to a size nearer what one might expect of an economy of France's weight. This process could probably go further: stock exchange capitalisation in France in 1988 was still only a third of that in the UK, and the President of the Paris Bourse has said recently that the Bourse should double in size to bring it up to international norms. But the purpose of this modernisation is not just to meet the needs of the French economy, but also to promote Paris as a financial centre in European and international terms. The Single Market programme has in fact only accentuated an existing trend: the French have realised for some while that finance is global and that financial markets need to be international to compete. Thus the MATIF has been keen to join the Globex 24 hour futures trading system which the American derivatives markets are launching; foreign institutions (including several from the UK) have been allowed to buy up French stockbroking firms; and the French Trésor have taken great pains to attract international investors to French government securities - and have been successful in doing so. So Paris today is a growing market nearer the size which the French economy needs to service it, with both European and international aspirations.

../7. There

7. There is no doubt that Paris has its problems. For example, French brokers are going through a bad patch at present with a reduction in volume and stiff price competition - it may well be that more independent companies will go to the wall following the collapse of Tuffier in July. The French language still acts as a cultural barrier between Paris and the international markets. There is still suspicion of French business practices by foreign investors. The fear of political interference remains, not helped by the occasional Presidential outburst against capitalism or speculation. There always seem to be one or two murky financial scandals, with a hint of political double dealing, simmering gently.

8. Paris has its advantages too. A young market that has grown up within a period of years can pick and choose its operating methods, regulatory system and supporting infrastructure from wherever in the world seems best. Paris is trying to make its broking system more like UK market making; the regulatory authority (the Commission des Operations de Bourse) has been given powers modelled on the US SEC; and the price display system used at the Bourse is Canadian. Being young, there is no weight of the past when it comes to introducing reforms. Paris hopes to introduce an electronic share settlement system (Relit) from the end of this year, bringing settlement delays down to 5 days by the end of 1991. In London, arguments about the introduction of an automatic share settlement system have lasted for years.

../Perhaps

Perhaps most importantly, Paris as a market is developing on the back of a strengthening French economy, with growth well balanced and inflation under control. Although Mitterrand delivers attacks from time to time against speculative finance (most famously sounding off recently against those who "grow rich while they sleep") the thrust of French economic policy in the period since 1984 has been that of competitive disinflation based on the stability of the franc against the DM in the ERM. It has brought results. And this strategy has prevailed through changes of government. Although Balladur as Finance Minister to Chirac ran a successful privatisation programme, now on ice under Rocard, Bérégovoy is if anything even more appreciated as Finance Minister by French business than Balladur.

The Threat to London

9. Does all this amount to a threat to London in any way? Paris seems to me to pose a direct threat to London in only a few specific ways. It is, for example, an avowed objective of reform of the methods of dealing on the Paris Bourse to repatriate trading in French stocks currently taking place in London via SEAQ International. To that extent there is risk of loss of business in London. The MATIF would dearly like to take market share in international financial futures trading away from LIFFE, and sees participation in Globex as a way of stealing a march on LIFFE. (The MATIF has, for example, negotiated exclusive rights to retail ecu futures contracts through Globex, and will launch a long term ecu contract in

October). The MATIF have relaunched a programme to modernise commodities trading in Paris and would like to bring back to Paris trade (eg in sugar) lost to London.

10. It is difficult to argue that such competition is unhealthy, even if it may be unwelcome in certain quarters of the City. It is inherent in the creation of a modern financial centre that that centre should be competitive. London has itself thrived on being internationally competitive with New York and Tokyo, compared to which Paris is small beer. London is still far ahead of Paris in global wholesale financial services such as foreign exchange dealing, eurobond transactions and international banking. Nor would it be realistic to expect that London alone could dominate the continental Europe of the Single Market. As the Single Market is opened up so each member state will be forced to liberalise its economy, and with that liberalisation it seems likely that an indigenous financial services sector will develop. The Chairman of S G Warburg, Sir David Scholey, told me recently that we could expect to see a growth of multiple financial centres in Europe with no single market dominating. Instead, for the foreseeable future major savings institutions and major corporate and state borrowers would continue to deal in local, national, markets, even though those markets would draw closer together. Although the City would not dominate everything it would prosper as the European economy integrated - and so would other financial centres.

../ In five

In five or ten years time he thought that S G Warburg might have 2,000 staff operating in London, 500 in Paris, 500 in Germany and, say, 200 each in Italy and the smaller European markets.

The European Dimension

11. So far I have talked about Paris in relation to London as if the developments of the markets resulted solely from the free interplay of competitive forces. We are assuming, for the purposes of comparison, that the famous playing field is level. But that is to ignore an extra dimension, which is that the French have views of the kind of European Community which they wish to see evolve, and against which all this activity will take place, and which may be different from our own. The French might be willing to play on a level playing field: but they prefer having a hand in the writing of the rules of the game in the first place.

12. It is this, long term, indirect threat from Paris which I would like to address last. It is by definition the most difficult to quantify. But it may be that it is in this area that the French have their strongest hand; because one factor which emerges from the development of Paris - a factor which is common to French handling of EC questions in general - is their capacity to plan and operate a strategy over the long term which is of benefit to France. This capacity involves cooperation and concertation between the public and private sectors. Indeed it is striking how, compared with the City and its growth as a financial centre <u>escaping</u> regulatory control

elsewhere, particularly in the US, the development of Paris has been led if anything more by the public authorities than the market. Firms in the financial services sector in France have, as like as not, preferred stitched up markets and anti competitive cartels to the stiff wind of free competition. It has been the Trésor which has pushed the markets down the path of reform. The spirit of Colbert lives on; enterprise has most often come from the initiative of the central government!

13. An example of this concerted approach is in the French handling of cross border investment services in the Community. Two strands of a strategy can be discerned. In the first instance the French government, with the Trésor in the lead, have argued that the Investment Services Directive is defective in that it excludes a reference to transactions passing through organised markets. It so happens that the method of dealing on the Paris Bourse would be compatible with such a reference. Perhaps more importantly, it so happens that the wholesale markets in international equities traded on SEAQ International probably would not be - at least in the original French conception. The second strand of strategy is more offensive; the Paris Bourse authorities have launched, through the medium of the Federation of EC Stock Exchanges, the idea of a "Eurolist" system whereby all major EC stocks would be quoted simultaneously on all EC exchanges. In this way, for example, the top 300 EC companies with capitalisation higher than F7 billion could be quoted in Paris, compared with the 50 or so companies which are actually quoted at present. At least in theory a neat device for boosting French market share.

../14. I should

14. I should not want to hazard a guess as to how these negotiations will turn out. There are, of course, British counterproposals to the Eurolist. The French will certainly not get all that they want - and, seen from the French point of view, London probably poses a greater threat to Paris than Paris to London. The City is still looked at with admiration and with fear. But my general point is that the French are good at turning difficult negotiating positions in the Community to their own ends and changing the terms of the debate as needs be. In shaping Community negotiations of whatever character they are on familiar terrain.

15. Which brings me to EMU. For us, an important and underestimated part of Economic and Monetary Union is Stage One, during which (to quote the Delors report) "all monetary and financial instruments circulate freely and banking, securities and insurance services are offered uniformly throughout [the Community"]. Our approach to EMU - including the Chancellor's proposals for a hard ecu for Stage Two - is market led. But the French view EMU from the other end of the telescope. For them it is institutions, not markets, which matter most; both because they see institutions as the mechanisms by which to get a hold of German economic and monetary policy, and because they are still - despite the liberalisation in France recorded above - suspicious of unrestrained market forces. ("Markets can't exist without strong support from the authorities", to quote a senior Trésor official in some recent Anglo-French

financial services talks). So the French tend to discount Stage One of EMU and lay stress on Stages Two and Three - the stages requiring institutional and Treaty change. Some even fear that Stage One, with all its attendant economic and financial liberalisation, could be destabilising precisely because the European economies will be exposed to market forces. They would like that period of exposure - before full union is in place - to be as short as possible.

16. Is there a French game plan involving the promotion of Paris as a financial centre to the detriment of London through the vehicle of EMU? Although one cannot of course be certain it seems doubtful that anything has been quite as consciously worked out as that. As we have seen, the French do not really see EMU as a process connected with the markets. For them it is primarily a political and strategic machine to permit the French to reassert some measure of control over monetary policy dominated by the Germans and only secondarily - say through wider use of the ecu - a project of benefit to businessmen.

17. However, one cannot exclude that the French will see potential secondary benefits for Paris arising from the debate on EMU. Although different officials are responsible, it is the same Trésor which leads on both subjects. And, as we have seen, it has been the public authorities - in the shape of the Trésor - who pushed Paris down the path of modernisation in the first place. The Trésor has also taken the lead on

 ../promoting

promoting the use of the ecu in France - denominating 10-15% of government bond issues in 1990 in ecus. To put it no higher, were international investors to come to believe that London had lost out in the IGC in the sense that London was not taking part in the future development of EMU, the French would be only too happy to have a go at promoting Paris as the market best suited to service the financing of the Single Market.

18. Another factor in the equation is the siting of any future European monetary institution. A decision on that will presumably await the conclusion of the IGC. We have not so far picked up any hint that the French will be promoting Paris - although I would not exclude that emerging at some point. There have however been hints that, if a German (Poehl) were given the Presidency of a new institution, the French would promote Strasbourg or Lyons as a site. Strasbourg is not a financial centre. Lyons is an important regional financial centre but it is not a national financial market and nor could it plausibly lay claim to be an international centre. Strasbourg and Lyons are each about 250 miles distant from Paris. (That compares with the 212 miles separating the Federal Reserve in Washington from its operating arm in the New York markets). The journey time to Strasbourg is a good four hours by either road or rail from Paris. But by TGV the journey time to Lyons is an easy two hours, and it is planned to reduce that slightly in the years to come. The Paris terminus for trains to Lyons is right beside the Trésor in the Bercy district to the east - which coincidentally is also

the zone of Paris earmarked for development for financial services in the decade ahead. In other words, if Lyons were chosen as the site for a European monetary institution it would not be serious competition to Paris in terms of a financial market. Nevertheless, it would have excellent communications with the Paris based markets and financial authorities and might therefore boost their importance. Moreover, if the European monetary institution had to base its market operating arm in an international financial centre Paris would be the nearest, with the attendant risks that the "principal money, government debt and foreign exchange markets within the Community would be likely over a period of time to develop there" (to quote the Paul Richards paper on EMU sent to the Prime Minister).

19. For some, it will seem at best curious to put a new major financial institution in a provincial centre, no matter how easily modern technology can facilitate communications with and between the major financial markets. Neither Strasbourg nor Lyons has comparable status to Washington. On the other hand, jealousies within the EC and the perennial problems of establishing EC sites could well lead either to seem attractive compromise candidates to some other member states. We should not assume that what for us could in effect be a boost to Paris would necessarily be opposed by all our partners.

../Conclusions

Conclusions

20. My purpose in writing has not been to draw conclusions for those handling the UK position in the IGC or considering the future of the City. It has instead been to assess, as far as we can from here, the factual position concerning Paris and to suggest possible ways in which French minds might turn. As seen from here, London has every chance of seeing off the challenge of Paris. Few people here think Paris at present has a serious chance of overhauling London. For most people ambition stops at becoming the premier market in continental Europe.

21. Nevertheless, we should remain alert. One thing the French are good at is thinking and acting over the long term. They are certainly interested in financial services and their economy is healthy. They are ambitious. We should continue to watch developments in Paris closely.

22. I am copying this despatch to the Chancellor of the Exchequer, the Secretary of State for Trade and Industry, the Governor of the Bank of England, HM Ambassadors in European Community posts and HM Consuls General in Frankfurt and Lyons.

I remain, Sir
Yours faithfully

Ewen Fergusson

Ewen Fergusson