NEVER MIND THE ECONOMICS

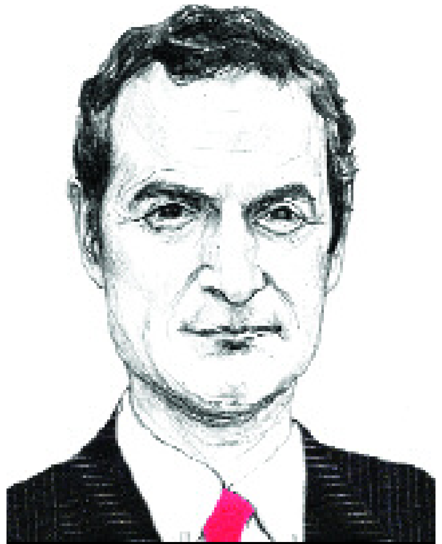
From a cost perspective the merging of stock exchanges in a particular region makes perfect sense, but nationalistic politics dictates this cannot be, hence partnership is the only way forward, says Ruben Lee

Never has there been more uncertainty about the future structure of the world's stockmarkets.

For five years, the creation of a dominant European stock exchange looked inevitable. The three major European exchanges – Deutsche Börse, Euronext and the London Stock Exchange (LSE) – made offers for each other, were rebuffed, and made further counter-offers. Yet this year, it is quite possible that two of these exchanges will be bought by their major US counterparts. Euronext has agreed a merger with the New York Stock Exchange (NYSE), and the Nasdaq is making a hostile bid for the LSE. And this, after a long period of indifference to international deals on the part of the NYSE, and a long series of international failures on the part of Nasdaq.

In Asia, rivalry between the major markets has been intense for many years, with each seeking to become the solitary hub for the region. Now, there is talk of co-operation.

Despite all this uncertainty, two facts are clear. First, and unsurprisingly, economic and financial issues remain vital in determining the future structure of the world's markets. And second, governance, regulation and politics will be more important in shaping the outcomes.



POLITICAL CONCERN FOR NATIONAL STOCK EXCHANGES REMAINS COMMON

Question of liquidity

The central economic question is whether competition for the provision of trading services between exchanges is viable. To answer this, liquidity is key. But it is the most elusive of concepts. Economists use liquidity to refer to how efficient it is to deal on a market. In contrast, for investment banks and exchanges, liquidity is all about order flow and who controls it. Market efficiency and order flow are linked, but not the same. If more order flow goes to a trading venue, typically it becomes more efficient. And more efficient markets are precisely what traders want, so order flow typically does get sent to them. But not always.

The big question is when can order flow move. Despite the creation of many new trading systems, almost no single national stock exchange has been supplanted by a new trading system. The reason is the positive "network externality" associated with order execution: order flow attracts order flow. So it is very difficult for a new trading system to threaten an incumbent exchange.

This network externality is not, however, all-powerful. Five factors can contribute to the success of a new trading system in attracting a sufficient set of users to become sustainable:

- The use of significantly superior technology.
- The provision of access to the market to a new group of customers.
- A conducive regulatory environment sanctioning the establishment of new trading mechanisms.
- An inability or lack of incentive on the part of incumbent exchanges to react to the presence of competition.
- A cost-efficient technical link between existing trading systems and new entrants.

Challenging exchanges

One form of competition that increasingly worries many exchanges is "internalisation". This occurs when financial intermediaries do not send orders to an exchange, but instead execute them on their own books. Internalisation is not, however, new. Financial intermediaries have always had incentives to internalise trades. By doing so, they avoid both exchange fees and exchange rules that limit whether and how their orders can be executed. They may also be able to pocket the bid-ask spread.

Whether internalisation can offer credible competition to incumbent exchanges is doubtful. In Europe, a group of major investment banks have announced the establishment of their own trading platform – Project Turquoise – to challenge the dominant stock exchanges. But they face two big problems: the history of co-operation between the major banks on infrastructure projects has been mixed, at best; and Project Turquoise also needs to beat the ever-present network externality.

Reasons to merge

The reasons that exchanges have sought to merge have less to do with competition than other factors, as illustrated by the proposed Euronext-NYSE merger. There appear to be three major benefits for the NYSE in the deal. First, domestic US equity market growth is limited. Most major US companies that could list on the NYSE have already done so, and those that have not are listed on Nasdaq, and it is not easy to persuade them to migrate to the NYSE. International growth therefore looks attractive.

Second, major international companies have progressively chosen not to list on the NYSE, or indeed in the US as a whole, because they do not wish to be subject to Sarbanes Oxley. A Euronext deal could allow the NYSE to offer companies the more attractive regulatory environment of the EU. Of course, this is contingent on the US authorities not seeking jurisdiction over any newly merged exchange and the companies listed on it.

Third, the NYSE can diversify its revenue base by moving into the derivatives market through Euronext's ownership of Liffe, the London-based futures exchange. US futures exchanges look relatively expensive.

Euronext's incentives for the deal, in contrast, are essentially political. The key advantage of doing the deal with the NYSE is that it is not Deutsche Börse, the other potential bidder for Euronext until recently. The NYSE option would supposedly allow Paris the best chance of remaining a financial centre, as the European arm of a US-based global exchange.

Double act: Euronext CEO Jean-François Théodore (L) and NYSE CEO John Thain announce NYSE plans to buy Euronext for $10bn in June, 2006. For Euronext, the deal is more political than economic

In contrast, a merger with Deutsche Börse might lead trading to migrate to Frankfurt. Even when this view is not accepted, as for example by French President Jacques Chirac, it is his political concern that motivates his stated preference for a "European solution" to the merger.

Such political concern for national stock exchanges remains common. In many countries, the national exchange is still believed too much a part of the national fabric for its identity to be subsumed into any foreign entity. It is, for example, inconceivable that any of the major Asian governments could sanction the disappearance of their national exchange in the current environment.

So if merger is an anathema to many exchanges, the talk is now of partnership and integration. The hope is to deliver the economic benefits of a merger without the attendant political problems. Given the relative maturity of most developed markets, and the rapidity with which some of the emerging markets are growing, partnerships between the two might appear a natural opportunity. The major markets could share their capital and expertise in return for sharing in the growth of the emerging markets.

Reality versus rhetoric

Unfortunately, the rhetoric of integration is not matched by the reality. Of the many attempts at co-operation between exchanges that have been proposed, few have been implemented. Of those that have been realised, almost all have failed. This trend will continue. It is hard to create credible contractual commitments between co-operating partners on an ongoing basis.

To achieve this, not only do such agreements have to be initially beneficial for the participants, they have to continue to be so even in a changing environment. But circumstances always vary, and the interests at stake are typically so large that breaking the original agreement is often seen as the optimal choice.

There may be trouble ahead. But the key lesson remains. It is not just the economics, stupid. Politics matters as well. TB

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