People take it for granted that business clusters, once they come into existence, would forever sustain the benefits of such an ecosystem for all the companies located there. For example, the assumption is that Silicon Valley will be there to provide the ecosystem succor to all the companies stationed there. That precept is subject to lots of ifs and buts. With California’s financial standing taking a marked turn for the worse, lesser and lesser money would be available to provide for the physical infrastructure and the knowledge infrastructure in terms of state funding for research and universities. What holds the ecosystem together are- great physical infrastructure, great knowledge infrastructure and the presence of venture capitalists for whom it is convenient to have the firms they finance located within a certain physical distance from where they reside. But for established companies, who already have a credit story, the presence of venture capitalists is not important. They would be the first to walk when the physical infrastructure and the knowledge infrastructure crumbles. High taxes would be an issue for such companies though it does not matter for start ups which pay no corporate taxes. So, if things do not change fast, Silicon Valley might become an incubator for start ups- not a place where flourishing technology companies want to reside and pay taxes. Will the cluster evolve into mini clusters, with parts of it migrating to Israel and Bangalore and linked together by Cisco’s video conferencing technology?

Clusters crumble when the driver that caused their existence ceases to exist. The business clusters in China’s Dongguan city might cease to flourish when western households start rebalancing their balance sheets. Italy’s clusters for production of shoes and household products have been hit by their inability to compete with cheap Chinese labor.
A variation of cluster risk is the risk on account of an interconnected system such as the credit risk of an individual bank on account of its exposure to other banks of a banking system. This could be on account of counterparty credit exposure, perhaps due to derivative transactions with other banks or on account of investing in the securities of other banks. When weak entities of an interconnected system get leveraged and big, they put the whole system at risk. Lehman Brothers and Bear Sterns put at risk the whole banking system because these weak players were connected to others of the system through derivative transactions. For analyzing the credit strength of an entity belonging to such a system, one has to identify the weakest entities of the system and the extent to which the entity in question is exposed to the weak entity—either directly or indirectly on account of exposures to third entities, which in turn have direct exposure to the weak entities. When the weak entities get big, the cancer spreads through out the system and all entities of the interconnected system have to be avoided like the plague (unless one subscribes to the too big to fail thesis). Similar interconnection occurs among insurers and reinsurers when either the insurer holds a big chunk of a reinsurer’s equity or the reinsurer invests in the securities of the insurer.

**The Future of the London Financial Cluster**

For some vague reason, finance is regarded as a standalone activity by individuals who believe in the notion of financial centers such New York, London, Hong Kong and Tokyo. Finance for such wise men is an end in itself and not an efficient way of transferring capital from savers/providers of capital to the users who can generate the highest possible return. Financial centers such as New York and London came into existence historically because stock exchanges were located there. Because in the pre-internet world a lot of contract notes had to be delivered physically, you needed to be close to the stock exchange. In the eighteenth century, when the New York Stock Exchange came into being, and advanced communication devices such as telephones had
not come into existence, being close to the stock exchange provided competitive advantage over people located far away. Naturally, brokerage firms all gravitated to New York. But, as long as the Glass Steagall act was the law of the land, big commercial banks were located all over the place. Only commercial banks which in the pre-Glass Steagall Act era had brokerage operations were headquartered in New York. In Europe, where there was no equivalent of the Glass Steagall Act, obviously the big commercial banks also gravitated to the place where the stock exchange was located. In the post internet world this is an anomaly, as efficient use of resources will dictate moving away from places where commercial real estate is expensive.

Services such as financial services, restaurant services, janitorial services etc are there where they can add most value to their clients. You can’t have a restaurant center in the middle of the Kalahari Desert. You can’t have real financial services – of the type that involves transfer of capital, located far away from the providers and users of capital. Financial services of the Las Vegas type obviously can gravitate towards financial centers. That brings to mind another reason why financial centers came into being historically. Silly regulations. For instance, Regulation Q in the US which capped the amount of interest that could be paid on borrowings was what provided impetus to London becoming an international financial center (in addition to being a domestic financial center on account of its stock exchange). Because of restrictions on gambling elsewhere, Las Vegas became a gambling center.

As silly regulations fall by the wayside and as being close to the stock exchange provides limited competitive advantage and as the stock exchange itself shifts to the cloud, financial centers will increasingly be less important. The model for financial services being close to users of capital is the venture capital fraternity in Silicon Valley. Likewise, it makes sense for a big bank to have operations in industrial clusters such as at an auto industry cluster. And you need to have an efficient mechanism for tapping the funds of savers. A slim head office can be located at a
financial center, which has access to advanced golfing resources. In fact, it makes more sense for a country club to be located at a place where a number of financial firms have their headquarters than for a financial services firm to be located at a financial center. The argument that asset managers need to be located at a center was somehow not conveyed to a certain individual in Omaha. Great asset managers can be located anywhere and need to travel a lot to meet the providers of funds such as pension schemes, endowments, owners of rich companies etc and to meet companies which afford investment opportunities. In fact, being located in one place, more likely than not, makes them and their investors vulnerable to becoming victims of groupthink. The 2008 credit crisis amply showed that fund managers who were not part of traditional cliques were the ones who made money- the others lost their investors a pile. Services like fund accounting will no longer be based out of the financial centers but delivered over the internet from India.

The UK’s household and government sectors are deep in debt- so it is as far from savers as the east is from the west. Unlike continental European countries like Germany, which have great manufacturing firms, the UK does not have sectors which can use capital efficiently. But London has some other advantages. It will continue to be a great tourist center. It will have restaurants from across the world catering to those tourists. In fact, the future users of capital in London would be providers of restaurant and tourism services. These companies will require very little long term capital and perhaps not much working capital. This should make lenders to the London commercial real estate market, particularly office space, shudder.

Finance has two branches- one branch deals with wealth creation and the other with transfer of wealth through trading of financial instruments. The branch of finance that deals with wealth creation will move to be closer to providers and users of capital. Financial firms involved in wealth transfer will be based out of those financial centers that double up as tax havens and
centers for money laundering. Such firms might be involved in “high frequency trading”, where having servers as close as possible to a stock exchange is a source of competitive advantage as long as this pernicious practice is not taxed away to oblivion.