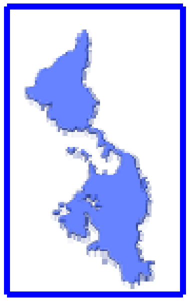

Financial Centers: Lessons from History

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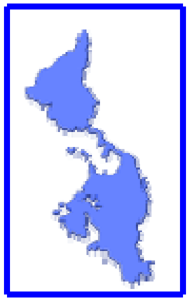
International Financial Centers

"Although we would like to pretend otherwise … the financial markets are, basically, pretty simple things. All they require is a surplus of capital … a roughly offsetting deficit of capital … and an intermediator or intermediation process…"

David Scholey, chairman of S.G. Warburg & Co.

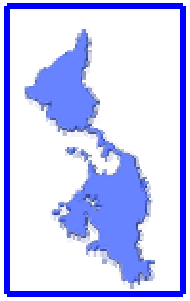
A More Precise Definition

- **A Financial Center:**
  - **The grouping of a certain number of financial services in a city.**
  - **Intermediaries coordinate financial transactions and arrange for payment to be settled.**
  - **External economies (cost reduction due to competition proximity and the size of the grouping) trigger the concentration of intermediaries.**



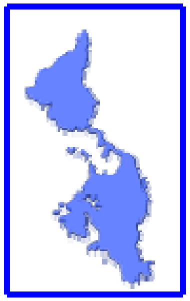
International Financial Centers: Amsterdam

- **At the end of the sixteenth century world trade shifted from the Mediterranean to the Atlantic and the Netherlands gained commercial supremacy.**
- **The Netherlands commercial supremacy was built above all on the role of entrepot played by Amsterdam, with goods and foodstuffs arriving to its port from all over the world. The goods were for the most part re-exported.**
- **The Netherlands had a high level of urbanization and its agricultural sector and industries were highly productive. In the earlier 1700s, its per capita income surpassed that of the closest competitors.**
- **International trade in turn contributed to the development of the insurance and financial sector. Lending to governments around the world prospered.**
- **During the 18th century the center of gravity of world trade gradually shifted towards London. Even then, Amsterdam remained the world's financial center throughout the 18th century.**



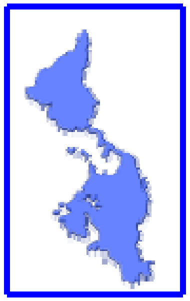
International Financial Centers: London in the 18th Century

- During the 18th century, England was already a great trading and colonial power. It was also the cradle of the Industrial Revolution in the last third of the 18th century (Mechanization of the textile industry, the use of coal in the metallurgical industry and the use of steam as a source of energy). By mid-19th century , income per capita in England was twice as large as that of the rest of continental Europe.
- British overseas trade doubled between 1700 and 1780.
- Commodity trade (sugar, tobacco, tea, coffee) increased, fueling the creation of commodity markets.
- Insurance markets developed starting with the marine insurance market, Lloyd's and the Royal Exchange Assurance Company and the London Assurance Company were both granted a Royal Charter in 1720.
- Banking activities started closely linked to trade through the use of the bill of exchange as the main credit instrument. Private banks also developed.



London's Origins as: The Financial Capital of the World

- **The Napoleonic Wars: The straw that broke the camel's back.**
- **The first London international issue was arranged in 1817. It was a loan to finance French war reparations. (This loan was denominated in francs). In 1818, Rothschild arranged the first foreign loan in sterling for Prussia.**
- **The early 1820s were years of increasing liquidity fueled by the decline in military spending and also because of the monetary injections of the Bank of England. The newly independent Latin American countries were able to tap London for funding. The first country to issue was Gran Colombia, but it was followed by Argentina, Chile, Mexico, and Peru.**
- **Merchant banks , with the Rothschilds and Barings as the leading firms, were the main players in floating foreign bonds. Still private bankers focused on the domestic economy still dominated the scene. In 1823 foreign loans were allowed to be listed on the London Stock Exchange.**

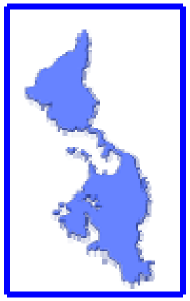


Paris: London’s Contender

- **Paris’ s appeal resided on its role in financing domestic and international trade.**

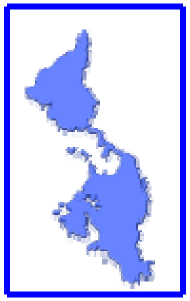
- **The franc as an international currency: France had a positive trade balance with the Anglo-Saxon countries while other countries in continental Europe had negative balances. British and Americans purchased bills of exchange on Paris to pay for some of their purchases and merchants of continental Europe using Paris to clear their debt with the Anglo-Saxon Countries.**

- **International loans remained limited until the 1880s. Still at the heart of these transactions was the so-called *haute banque,* with the Rothschilds Freres at the helm.**



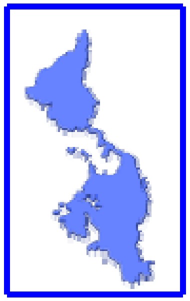
Financial Innovations of the Mid-19th century

- The creation of joint-stock banks with limited liability with far larger capital than private banks and the possibility of taking larger risks.
- Deposit banks, banks that collected their deposits through a network of branches. Credit Lyonnais in Paris.
- Investment Banks: Paribas
- Overseas Banks: Hongkong and Shangai Banking Corporation in 1865.
- Capital markets also developed as a result of the railway revolution.
  - Primary markets issuing securities
  - Secondary markets: listing railway companies on the main stock exchanges.



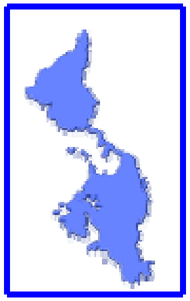
Another Competitor: Berlin

- The unification of Germany in 1871 fueled Berlin's rise to the top ranks among international financial centers.
- Germany's fast pace of industrialization and growth needed to have a financial center of similar dimensions.
- Berlin was dominated by the big banks, the Deutsche Bank, the Dresdner Banks, the Disconto-Gesellschaft Bank, and the Darmstadter Bank.
- Berlin like London also had overseas banks to finance German foreign trade.
- Still the Berlin Stock Exchange was less international than London and Paris.
- The euphoria of the early 1870s following the war reparation payments and the collapse of 1873 triggered the first world recession, with defaults around the world (Ottoman Empire, Egypt, several Latin American countries).
- The law of 1896 to curb speculation introduced tight control over stock-market activities, above all it limited forward transactions. These transactions migrated to Amsterdam and London.



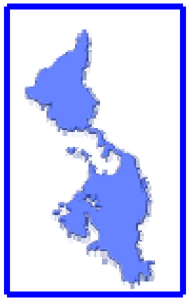
Relations Among Financial Centers

- **Primary Markets:**
  - **Cooperation: Creation of syndicates to issue government bonds. For example, Argentina's loans were issued in London by Baring Brothers, in Paris by Paribas, in Berlin by the Disconto-Gesellschaft.**
  - **Competition and Specialization: Paris specialized in issues for continental European countries, with Russia as the most important client. London specialized in Latin America and overseas. Competition in Latin America.**
- **Secondary Markets:**
  - **Arbitrage operations (buying stock in one center and reselling it in another) kept the financial centers closely integrated. Naturally, the same security had to be quoted in at least two centers. Instantaneous information was essential and a large number of partnerships across firms in different centers were formed.**



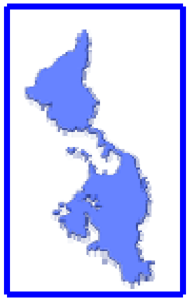
The Great War and Capital Controls

- The onset of the war in 1914 heralded the end of the heydays of international financial integration.
  - End of the gold standard with a transitory restoration in the interwar period.
  - Transfer of world leadership from Britain to the United States.
  - Capital controls reinstated at the end of WWI lead to the decline of Paris as an international center and reduce the importance of London.
  - Still, rebound of international capital flows in the 1920s with New York at the center.
  - With exchange controls, the use of the pound became more difficult. Drafts in dollars came to replace those in sterling.



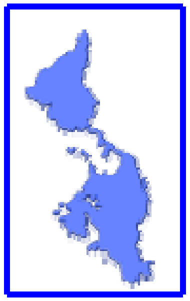
The Rise of New York

- Export of capital
  - Increase in savings in the United States, with the U.S. becoming a creditor country.
  - Interest on foreign stocks.
  - Foreign stocks placed in New York exceeded those offered in London by 50 percent.
- New Finance Companies
  - Investment trusts and holdings of public utilities quickly spread fueling the speculative frenzy in the late 1920s.
- American Stocks Bull Market in the mid 1920s with New York as the American financial center.
- The collapse of Wall Street in 1929 and the great depression.



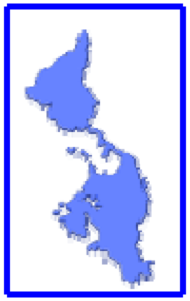
The Interregnum and the Revival

- The depression, the collapse in foreign trade, and protectionism were responsible for the collapse of international capital markets. International capital markets continued to languish even after the end of WWII.
- Ironically, the revival of international capital markets can be traced to new financial restrictions in Great Britain and the United States in the late 1950s and 1960s.
  - In 1957, the restrictions made London-based banks create a new market to avoid losing their share of financial transactions: Banks' dollar deposits started to be used to provide dollar loans in an unregulated market: the Eurodollar market.
  - In 1964, U.S. banks turned to the Eurodollar market following the introduction of restrictions in the United States.
- The collapse of the Bretton Woods System and international capital mobility.



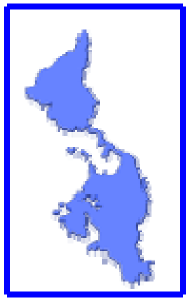
London's Rebirth

- London: the leading beneficiary of the Euro Market.
- The city was well prepared for taking charge of the eurodollar market
  - Bankers' experience
  - Expertise in international financial transactions.
  - Role of the British monetary authorities: differentiating between regulated sterling market and unregulated international activities in foreign currencies on behalf of non-residents.
- Foreign banks and banking consortia in London. By 1979 the number of foreign banks in the city had increased to 328.
- The oil shocks of the 1970s, OPEC countries savings channeled via the eurodollar market, international lending to Latin America, U.S. financial crisis, and the Debt crisis.
- The 1986 Big Bang



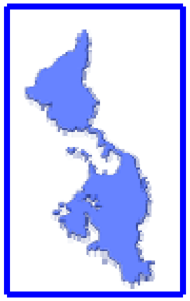
New Arrivals: Tokyo

- **Tokyo Stock Market opened in 1878. The size of the stock market in prewar Japan was substantial, with the value of the stocks listed on all the stock exchanges in Japan divided by GNP, higher in the prewar period than that in the postwar period (except in the 1980s).**
- **In the 1980s, many predicted that Tokyo was going to overtake New York as the leading financial center.**
- **Differential growth in the United States and Japan relegated Tokyo as a secondary international financial center.**
  - **The burst of the bubble and the banking crisis**
  - **Asian crisis in 1997**
- **The deregulation of the 1998-2001 period.**



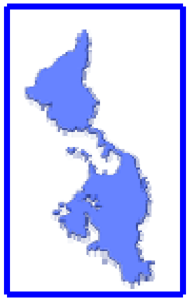
New Arrivals: Hong Kong and Singapore

- Both Hong Kong and Singapore have been important entrepots for trade and transhipment during colonial times.
- They were not newcomers. They have solid banking institutions dating to the 19th century and heirs to the British overseas banks, especially the Hongkong and Shanghai Banking Corporation.
- The re-emergence of both centers in the 1980s is connected to the emergence of newly industrialized countries in South-East Asia but also to a systematic effort made by authorities to turn the two cities into international financial centers.



Hong Kong and Singapore: Policies to Build International Financial Centers

- **Singapore:**
  - **In 1968 authorized the Bank of America to open an Asian currency unit to carry out foreign currency operations: the Asian dollar market was born. The government also intervened directly to encourage the emergence of a bond market.**
  - **In 1984 the Singapore International Monetary Exchange is created.**
  - **By 1995, 185 foreign banks set branches in Singapore.**
- **Hong Kong:**
  - **At the end of the 1960s, Hong Kong decided to keep a 15% withholding tax on the interest on foreign currency deposits, with foreign currency operations being attracted to Singapore.**
  - **Moratorium on bank licensing only lifted in 1978.**
  - **Non-interventionist government stance.**
  - **Currency board in 1983**



Reflections

- Most current literature emphasizes the role of financial development on growth but forgets to examine the role of economic conditions on financial development and particularly on the consolidation of an international financial center.
  - International trade
  - Economic growth
  - Economic development and domestic savings
- Not just one financial center. On-shore and off-shore financial centers can compete and complement.
- Creation of niches
- Necessary conditions: no capital controls, good information technology, professional services (legal and accounting), ability to bring a skilled labor force from overseas and educate a domestic labor force,
- The thin line between regulation and the ability of the center to innovate.