

EMERGING ECONOMIES AND INTERNATIONAL FINANCIAL CENTERS

George G. Kaufman*
**(Loyola University Chicago and
Federal Reserve Bank of Chicago)**

I. Introduction

Becoming an international financial center (IFC) has traditionally had strong appeal for many countries and particularly, in more recent years, for more advanced emerging economies. In the early 1990's, for example, Thailand established an "offshore" Bangkok International Banking Facility (BIBF), to compete with Hong Kong and Singapore and capture the perceived benefits of being an IFC. Singapore's Senior Minister Lee Kuan Yew ("You Shape Up or Perish," 1999, p. 54) has stated that "in the long-term, we [Singapore] see ourselves as a cosmopolitan, regional and world [banking] center" and the government of Abu Dhabi is actively developing an IFC on Saadiyat Island ("Sandcastles in the Air," 1999, p. 67). At the same time, industrial countries with developed IFCs are attempting to protect or strengthen them. In evaluating a recent proposal for a merger of three of France's largest commercial banks, the Governor of the Bank of France urged the participants to seek a solution "for the higher interests of Paris as a financial center." (Kamm and Fleming, 1999, p. A19). The French government had previously assisted in the expansion of Paris as an international financial center by supporting the

* Earlier versions of this paper were presented at a conference on Pacific Basin Financial Markets and Policies, New York, NY, March 25-26, 1999, at the seventh annual conference on Pacific Basin Finance, Economics, and Accounting, Taipei, Taiwan, May 29, 1999, and at the annual meeting of the Financial Management Association Orlando, Florida; October 7-9, 1999. I am indebted to Adrian Tschoegl (University of Pennsylvania) for comments on an earlier draft. The views expressed in this paper are those of the author's and not necessarily those of the Federal Reserve Bank of Chicago or the Federal Reserve System.

development of Paris-based securities and derivatives markets. However, as noted by Choi, Park, and Tschoegl (1996), analyses of IFCs by economists have been sparse. More attention has been devoted to this area by geographers, who have focused primarily on why IFCs are located where they are. Good reviews of the literature are provided by the above authors and by Choi, Tschoegl, and Yu (1986) and Tschoegl (2000). This paper adds to the extant literature by examining additional economic costs and benefits of being an IFC, with particular reference to emerging economies in the current environment.

II. Benefits and Costs of IFCs

A number of commonly perceived benefits of being an IFC are listed in Table 1. Particularly appealing to many countries are the high value added and the ability to establish an IFC quickly and without substantial investment in high fixed-cost plant and equipment, as is required in many other industries. It has recently been estimated that fully 7 percent of British GDP is originated by the 1 million employees in the financial sector working in the one square mile roughly encompassing the "city" financial center (Fairlamb, 1999).

But IFCs may also have significant drawbacks or costs. A number of these are listed in Table 2.¹ Some, particularly fragility resulting from high leverage of the institutions and the potential for serious adverse spillover to other sectors of the economy beyond the IFC if and when large and abrupt capital overflows occur, are of sufficient importance that they should give domestic policy-makers, particularly of smaller and emerging economies, reason to pause before they commit their countries to policies intended to gain IFC status. Smaller IFCs in effect surrender some control over their domestic economy. Indeed, it is widely agreed that, by permitting the banks to engage in excessively large currency (foreign exchange) speculation, the

¹ Additional drawbacks of affiliated offshore centers are discussed in Financial Stability Forum 2000.

Bangkok Facility contributed both to the start of the recent banking and currency crisis in Thailand and to its severity (World Bank, 1998b). In the mid-1990s, Thai banks both within and outside the BIBF borrowed heavily on an unhedged basis in U.S. dollars and Japanese yen at low interest rates and lent in local currencies at much high interest rates. Local deposit rates exceeded U.S. LIBOR rates by 4 percentage points. Foreign bank loans through the Facility alone grew rapidly from \$8 billion in its first year of operation in 1993 to \$50 billion only three years later in 1996². This was equivalent to 27 percent of Thailand's GDP. Contrary to its stated purpose, \$30 billion, or fully 60 percent, of this lending was in the form of "out-in" transactions used to finance domestic firms (Council on Foreign Relations, 1999 and World Bank, 1998a and b). These loans accounted for 17 percent of all private sector loans. The remaining \$20 billion was relent outside Thailand or "out-out", the stated purpose of the facility. The resulting large and expanding risk exposure helped to undermine the credibility of the Thai government's commitment to maintain the exchange rate at its fixed value and eventually contributed to the speculative run that caused the devaluation. In 1997, the initial large capital inflows were reversed almost instantaneously to equally large capital outflows that dominated domestic capital flows and severely impacted domestic macroeconomic activity adversely.

In addition, the relatively small investment in fixed capital in IFCs is offset by a relatively large investment in human capital. But unlike fixed capital, human capital is highly mobile. Thus, IFCs are relatively footloose and what is attracted easily can be lost just as easily and quickly. Through the years, many cities and countries have at times served as IFCs, but few have survived as IFCs to the present. Moreover, continuing improvements in communications

² At yearend 1996, 45 banks were licensed to operate in the facility. Of these, 15 were Thai banks, 11 branches of foreign banks already operating in Thailand and 19 other foreign banks. These banks benefited from a number of tax exemptions and other favorable provisions not granted other banks in Thailand and helps to explain their rapid growth (Lindgren et al, 1999)

and transportation are likely to reinforce any potential economies of scale and contribute to the reduction in the number of IFCs.

III. History of IFCs

Tschoegl (2000, p. 23) has noted that:

The location of international centers is not random. They are where they are because of a historical process that has resulted in certain places offering a cluster of attraction to the banks that have established their activities there.

Kindleberger (1974) has traced the history of financial centers, at least in Western countries. Before 1870, a large number of cities provided regional and global financial services, but none greatly dominated the others. At times, more than one city in a country competed for this business. These centers included Amsterdam, Berlin, Florence, Frankfurt, Genoa, Hamburg, London, Milan, New York, Paris, Philadelphia, Rome, Turin, Venice, and Zurich. Near the end of this period, London and Paris began to emerge as the strongest centers and competed against each other vigorously.

After 1870 and the Franco-Prussian War and France's defeat by Germany, London won out as the dominant IFC in the world and remained so until the outbreak of World War I in 1914. After the war, New York City challenged London for the top spot and shared this billing through the Great Depression of the 1930s, when it surpassed London. New York remained the leading IFC through and after World War II, until the combination of restrictive regulations on U.S. banks (popularly referred to Regulation Q) hampered their ability to offer competitive interest rates on deposits and encouraged large depositors to shift their funds abroad and the development of the Eurodollar and Eurocurrency markets in major financial centers in the early 1970s permitted dollar deposits and loans to be offered at banks outside the U.S. The creation of the Eurodollar market was in part as a consequence of the Regulation Q restrictions. As a result of

the restrictions in the U.S., the heaviest volume of international financial activity shifted back to London.

The rise and fall of cities and countries as IFCs in part reflects their changing fortunes as leading transportation hubs, particularly as a port for water transportation, political (national) capitals, commercial centers, and central bank headquarters and in being affected by war. In the post-World War II environment, London and Tokyo satisfied all these characteristics, as did Hong Kong and Singapore on a lesser scale. New York satisfied most but not all of these characteristics. Even though it was not a port, when the Bundesbank settled there, Frankfurt won out over a number of German competitors, such as Dusseldorf and Hamburg, to replace Berlin, which was not included in the Western sector when Germany was partitioned after World War II. More recently, Frankfurt's place as a financial center for continental Europe as a whole was strengthened by the location there of the new European Central Bank (ECB), which conducts monetary policy for all 11 member countries. In addition, the Bank operates its important TARGET large value interbank clearing and settlements system there. The introduction of the single currency Euro increases the importance of these facilities. Likewise, Zurich won out over a number of other Swiss cities for those who valued more secretive financial transactions, although it also was not the national capital. But, it was primary home to the Swiss central bank.

Regional IFCs have waxed and waned similarly. Havana lost out to Panama after the Cuban revolution, which in time appears to have lost out to Miami as the Caribbean financial center. Bahrain and Dubai, which as noted earlier are being challenged by Abu Dhabi, succeeded Beirut, which had earlier succeeded Tangiers, as the regional financial center for North Africa and the Arabian Peninsula.

IV. Characteristics of IFCs

A review of both theory and history of IFCs indicates that successful current centers appear to have a number of characteristics that may be viewed as important requirements or prerequisites. These are listed in Table 3. Economically strong and credible banks and a strong legal system, including property rights, contract enforcement, a functional and credible court system, and bankruptcy processes, are basic requirements. Few countries, particularly developing economies, possess these. The credit status of banks by country as rated by Moody's as of April 1999 is shown in Figure 1. Among developing countries, only Singapore is ranked in the top ten, coming in tenth. It is also the only Asian country in this group. Indeed, Hong Kong is the only other Asian country rated in the upper half of the countries listed. With the exception of Japan, every country in the bottom half of the rankings is an emerging or transition economy. Thus, few developing countries appear to satisfy the requirement of possessing strong and credible banks.

Nor, with the exception of Singapore and Hong Kong, do many developing economies have strong free market orientations. Most favor significant government intervention, if not control or actual ownership, particularly in the banking system. They also tend to be short on both sophisticated bankers and sophisticated bank regulators, supervisors, and examiners.³ Entry by foreign banks is generally restricted, in large part to protect less efficient domestic banks. Property rights and contract enforcement and bankruptcy laws are typically weak. Thus, recovery on loans in default is low, making banking riskier and less efficient. Moreover, both attaining IFC status and successfully maintaining it effectively constrains the economic and financial policies of the home country to those that are consistent with achieving and then preserving the prerequisites for an IFC. This is likely to reduce the economic and political policy options of

³ In addition, many emerging countries locate their international banking activities in "offshore" banking or financial centers. These centers are special economic jurisdictions or zones that are granted more favorable banking powers than the remainder of the country, such as lower taxes, no withholding taxes, and less reporting. They are primarily intended to attract nonresident business. Because the activities of banks in these centers may not be as familiar to bank supervisors as those at other banks and are often more complex, supervision may be more difficult and less effective. As a result, some offshore centers have magnified any financial problems in their countries. (A more complete discussion of offshore financial centers appears in Financial Stability Forum, 2000)

governments and the attractiveness of becoming an IFC to many governments of emerging countries.

IFCs engage in a variety of different financial activities. One such traditional activity is foreign exchange (FOREX) trading, including cash, forward, and swap transactions. A ranking of IFCs by their FOREX activity is shown in Table 4. By this measure, the U.K. (London) is by far the largest IFC, accounting for one-third of such FOREX trading activity in April 1998. The U.S. (New York) is a distant second. Japan, which had competed with the U.S. for second place in 1989, declined sharply in importance and had only one-fourth the activity of London in 1998. It barely ranked above Singapore, which had only been one-half as important in 1989. The sharp decline in the importance of Japan reflects both the ongoing financial problems of its banks as is reflected in their low Moody's ratings and the depreciation of the yen during this period. The importance of Hong Kong has also declined substantially. Only Singapore, among the three current Asian IFCs, has held its own in the last decade. On the other hand, Germany (Frankfurt) has climbed from relative insignificance in 1989 to being a substantial player and the leading center on continental Europe.

IFCs also engage in a wide range of equity and debt securities and derivatives trading on the cash, futures, and options markets both on organized exchanges and over-the-counter, as well as money management, payments clearing and settlement, merger and acquisition, and securities underwriting activities. (Additional activities are listed in Rose, 1994.) New York and London appear to dominate most of these activities. Nearly 50 percent of all wholesale financial transactions in the European Union are estimated to be conducted in London (Fairlamb, 1999). As with FOREX trading, Frankfurt appears to be rapidly challenging London as the major European IFC in these activities, particularly as the U.K. has not joined the new European and Monetary Union (EMU) and the European Central Bank and adopted the Euro as its currency. The Euro effectively expands Frankfurt's single currency market to 10 additional countries.

Trading in derivatives in Frankfurt exceeds that in London and Paris, -- Eurex in Frankfurt is the world's leading derivatives exchange -- and the capitalization of the Frankfurt stock market exceeds that of Paris but falls short of that of London (Ewing, Zammert, and Resch, 1999). The growth in these two market activities is noteworthy as Germany has traditionally been a bank oriented economy hostile to capital market development.

Despite focusing only on FOREX trading, the ranking of IFCs in Table 4 does not differ greatly from that developed by Choi, Park, and Tschoegl (1996) for 1990 based on an analysis of the number of large banks headquartered in each center and the presence in these centers of offices of banks headquartered in other centers as a measure of financial interconnection. Indeed, seven of the top eight centers are the same in both studies, as are the relative ranking of the top three centers -- London, New York, and Tokyo. Only Frankfurt fails to appear in the top eight in Table 4 for 1989, but ranks fifth in 1998.

V. IFCs and International Currencies

Seigniorage from having one's currency used by others as an international currency, so that the government can raise funds at a lower interest cost, is often considered one of the advantages of being an IFC (Council of Economic Advisers, 1999).⁴ The importance of a currency in FOREX trading and as use as an international reserve by central banks may reasonably be used as a proxies for the currency's use as an international currency. The volume of FOREX trading by currency is shown in Table 5 and the use of currencies as official reserves in Table 6. Both tables show data for 1998, before the introduction of the Euro. As may be

⁴ The Council of Economic Advisers (1999) lists four other advantages often attributed to countries whose currencies are used as international currencies - - use of own currency in international transactions, increased business for domestic financial institutions, greater international reputation and prestige, and enhanced ability to borrow internationally in own currency. However, it does not find much evidence in support of these arguments. In addition, the council lists two potential disadvantages - - increased fluctuations in exchange rates and loss of control over capital flows.

quickly seen, although the rankings in Tables 5 and 6 are similar, there is only a weak correlation between a country's ranking as an IFC (Table 4) and the use of its currency as an international currency. For example, the U.S. dollar is by far the most actively traded currency, even though the U.S. ranked only a distant second as an IFC in terms of total FOREX trading. On the other hand, although the U.K. is by far the leading IFC, the pound sterling ranks only fourth in FOREX trading below the U.S. dollar, which had eight times the activity, German deutsche mark, which had three times the activity, and Japanese yen, which had twice the activity. Thus, significant seigniorage gains do not appear to automatically follow from being an IFC. By uniting the currencies of the 11 ECB member countries, the new Euro is likely to be both a more desirable reserve currency and a more heavily traded international currency - very likely greater than the sum of the individual countries - and could provide significant economic seigniorage, particularly for those countries whose national currencies were not used as a reserve currency and did not trade very greatly as an international currency (Mundell, 1999).

The acceleration in advances in telecommunications and computer technology in recent years is likely to further reduce the need for physical and permanent IFCs. Electronic FOREX and other securities trading may be done through computers located almost anywhere throughout the world and that are mobile. Only final settlement is likely to be required to be conducted at a permanent physical center. Traders and money managers may be located anywhere they prefer at any time, as long as the locations are amenable to rapid communications, although there may still be some preference to be located in an area that has reached a critical mass for purposes of personal information exchange and socializing as well as easy and near seamless changes in employment. These changes are likely to make IFCs even more footloose than before and endanger investments made in physical facilities. Thus, although FOREX trading and other international financial activities may reasonably be expected to continue to increase significantly as international trade and capital flows continue to increase, the accompanying growth in IFCs

and their values added may increase more slowly. As a result, even if the countries could satisfy the requirements enumerated in Table 3, this does not appear to be an opportune time for emerging economies to devote considerable public resources into developing their own IFCs, although there may be opportunities for some relatively small regional niches that are currently overlooked by the major players operating in large IFCs⁵.

⁵ Small and, in particular, new IFCs also risk the danger of being used for illegal financial transactions, such as money laundering, although the recent exposure of such activities by Russian nationals through U.S. banks indicates that these activities are not restricted to such centers.

References

- Choi, Sang Rim, Dackeun Park, and Adrian E. Tschoegl, "Banks and the World's Major Banking Centers, 1990," Review of World Economics, Vol. 132, No. 4, 1996, pp. 774-793.
- Choi, Sang Rim, Adrian E. Tschoegi and Chow Ming Yu, "Banks and the World's Major Financial Centers, 1970-1980," Review of World Economics, Vol. 122, No. 1, 1986, pp. 48-64.
- Council of Economic Advisers, Annual Report, 1998, Washington, D.C.: U.S. Government Printing Office, February 1999.
- Council on Foreign Relations, Safeguarding Prosperity in a Global Financial System, Washington, D.C.: Institute for International Economics, 1999.
- Ewing, Jack, Andrea Zammert, and Inka Resch, "Booming Frankfurt," Business Week, September 13, 1999, pp. 63-70.
- Fairlamb, David, "Dueling Markets," Institutional Investor, May 1999, pp. 106-114.
- Financial Stability Forum, Report of the Working Group on Offshore Centres, Basel, Switzerland, April 5, 2000.
- Gehrig, Thomas, "Cities and Geography of Financial Centers," Discussion Paper Series No. 1894, London: Centre for Economic Policy Research, 1998.
- Kamm, Thomas and Charles Fleming, "France Puts Freeze on Stock Battle Between Societe General, Paribus, BNP," Wall Street Journal, June 20, 1999, p. A19.
- Kindleberger, Charles P, "The Formation of Financial Centers: A Study in Comparative Economic History," Princeton Studies in International Finance No. 36, Princeton: Princeton University, November 1974.
- Lindgren, Carl-Johan, Tomas J. T. Balino, Charles Enoch, Anne-Marie Gulde, Marc Quintin, and Leslie Teo, Financial Crisis and Restructuring: Lessons From Asia (Occasional Paper 188), Washington, D.C.: International Monetary Fund, 1999.
- Mundell, Robert A., "The International Impact of the Euro and Its Implications for Transition Countries." in Mario Blejer and Marko Skreb, eds. Central Banking, Monetary Policies, and the Implications for Transition Economies, Boston, MA.: Kluwer Academic, 1999, pp. 403-427.
- Park, Yoon S. and Musa Essayyad, International Banking and Financial Centers, Boston: Kluwer, 1989.

Rose, Harold, International Banking Developments and London's Position as an International Banking Centre, London: London Business School, July 1994.

"Sandcastles in the Air" Economist, July 24, 1999.

Tschoegl, Adrian E., "International Banking Centers, Geography, and Foreign Banks," Financial Markets, Institutions and Instruments, January 2000, pp 1-32.

World Bank, Global Economic Prospects 1998/99: Beyond Financial Crisis, Washington D.C.: World Bank, 1998a.

World Bank, East Asia: The Road to Recovery, Washington, D.C.: World Bank, 1998b.

"You Shape Up or Perish," Business Week, June 21, 1999, p. 54.

Table 1**POTENTIAL BENEFITS OF IFC**

- **High Value Added**
- **Can Develop Quickly**
- **Little High Fixed-Cost Plant and Equipment**
- **Pollution Free**
- **Seigniorage**
- **More Efficient Banks Through Competition From Foreign Banks**

Table 2**POTENTIAL COSTS OF IFC**

- **Fragile**
- **If Problem, Spillover to Banks Outside IFC**
- **High Cost of Failure**
- **Footloose Industry**
- **Susceptible to Fraud and Corruption**
- **Susceptible to Government Interference**

Table 3**REQUIREMENTS FOR IFC**

- **Economically Strong and Credible Banks**
- **Free Market and Private Enterprise Environment**
- **Open Economy (Free Flow of International Capital)**
- **Politically Independent of Government**
- **Stable Exchange Rate**
- **Good Telecommunications**
- **Well-Educated and Sophisticated Bankers**
- **Well-Educated and Sophisticated Bank Regulators/Supervisors**
- **Minimum Nonprudential Bank Regulation**
- **Critical Mass of Financial Activity**
- **Free Entry of Foreign Banks and Bankers**
- **Strong Legal System, Including Property Rights, Contract Enforcement, Functioning Court System, and Bankruptcy Processes**
- **Peacetime Environment**

Table 4
CURRENT IFCs
(Foreign Exchange Trading by Country*)

	<u>April</u> <u>1989</u>	<u>April</u> <u>1998</u>
	(percent of total)	
United Kingdom (London)	26	32
United States (New York)	16	18
Japan (Tokyo)	15	8
Singapore	8	7
Germany (Frankfurt)	--	5
Switzerland (Zurich)	8	4
Hong Kong	7	4
France (Paris)	3	4
Other	<u>17</u>	<u>18</u>
Total	100	100

* Based on traditional FOREX activity

Source: Bank for International Settlements, Central Bank Survey of Foreign Exchange and Derivatives Market Activity, 1998, Basle, Switzerland, May 1999, p. 11.

Table 5
FOREIGN EXCHANGE TRADING BY CURRENCY

	April <u>1989</u> (percent of total)	April <u>1998</u>
U. S. Dollar	45.0	43.5
Deutsche Mark	13.5	15.0
Japanese Yen	13.5	10.5
British Pound	7.5	5.5
Swiss Franc	5.0	3.5
Other ECU	2.0	8.5
Other	<u>13.5</u>	<u>13.5</u>
TOTAL	100.0	100.0

Source: Bank for International Settlements, Central Bank Survey of Foreign Exchange and Derivatives Market Activity, 1998, Basle, Switzerland, May 1999, p. 11.

Table 6

**USE OF CURRENCY AS OFFICIAL FOREIGN EXCHANGE
RESERVES BY CENTRAL BANKS
December 1998**

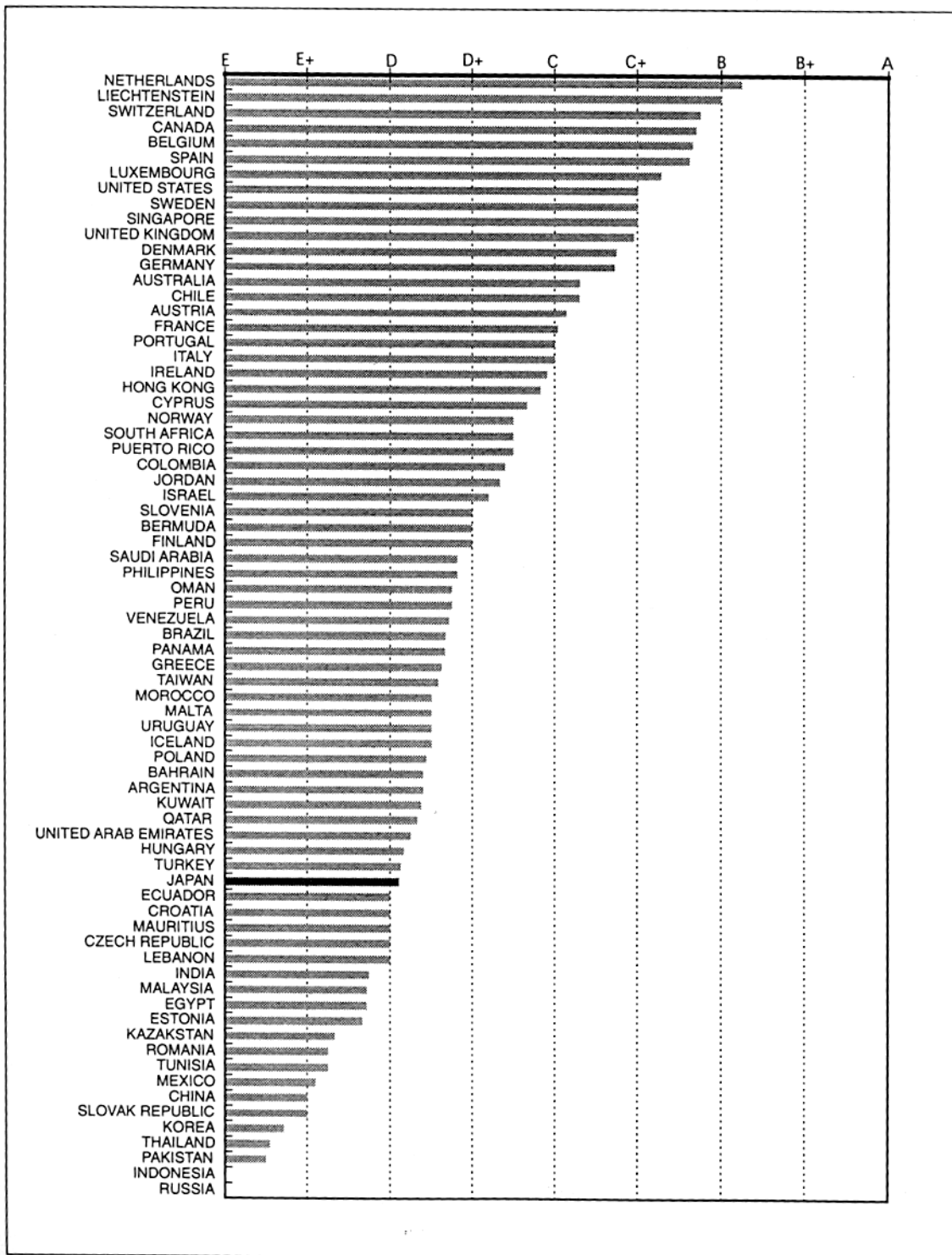
	<u>Percent of Total</u>
U.S. Dollar	57
Deutsche Mark	13
Japanese Yen	5
ECU	5
British Pound	3
French Franc	1
Other	<u>15</u>
Total	100

Source: Council of Economic Advisers, Annual Report, 1998, Washington, D.C., February 1999, p. 301.

Figure 1

Average Bank Financial Strength Rating by Country

April 1999



B = strong intrinsic financial strength; C = good; D = adequate; E = very weak

Source: Moody's Banking System Outlook; Japan. April 1999