Lecture 18:
The Geography of Global Finance
Money Makes the World Go Round
KEYS

- Location of financial institutions
  - Stocks (sources) of money

- International flows
  - When money moves between countries
  - Types of flows – capital vs. income

- The world of national monies
  - The puzzle of floating currencies
  - Money management
  - The almighty dollar
Geography of Global Finance

I. Financial Centers

II. Financial Flows

III. National Monies
I. Financial Centers

A. • Financial Areas

B. Global Cities

C. Offshore Banking
Local Finance

- Local Banks
  - recycle savings
  - HQ & branches

- Decline of local banks
  - End of Jacksonian system

- Boutique banking
  - Niche banks among the mammoth
Regional Finance

- Banks & regional economies

- Regional exchanges
  - Pacific, American

- Regional rivalries
  - SF vs. LA, etc.
  - Osaka vs. Tokyo
  - Toronto vs. Montreal

- Regional/urban hierarchies
  - Major & minor financial centers
National Finance

National bank assets (deposits & loans) build up
[currency value & nominal assets
Japan in the 1980s]

■ National banks
  - New York, Tokyo, Bangkok, Paris, etc.

Bank of America goes national (below)

■ National exchanges
  - NYSE, NASDAQ
Global Institutions

- British system of 19th century
  - Global banking
  - Gold standard & settlements
  - Global investors (bonds & stocks)

- Interwar retreat (like trade)

- Re-Globalization of banking
  - Global branch banking

- Global securities
  - Government bonds
  - Corporate stocks & bonds

- Global funds
  - Private equity, sovereign equity, hedge, mutual, etc.
I. Financial Centers

A. Financial Areas

B. • Global Cities

C. Offshore Banking
Global Keystones

- **London**
  - Commercial banking
  - Investment banking
  - Stock (LSE) & bond markets
  - Derivatives (LIFFE)
  - Holding companies
  - Currency trading

- **New York**
  - Commercial banks (Citibank & Chase)
  - Investment Banks (oops -- all gone now!)
  - Stocks (NYSE) & bonds
  - Hedge Funds (Greenwich, CT)
  - Insurance (Hartford CT)
  - Equity funds
London vs. New York

- Households: Upper East Side vs. NYU

- Income range: Upper East Side vs. NYU.

- High school: Upper East Side vs. global base, 15% more.

- Crime rates: Upper East Side vs. NYU.

- Housing costs: Upper East Side vs. NYU.

- Entertainment options: Upper East Side vs. NYU.

- Public schools: Upper East Side vs. NYU.

- Transportation: Upper East Side vs. NYU.

- Weather: Upper East Side vs. NYU.

- Sports: Upper East Side vs. NYU.

- Nightlife: Upper East Side vs. NYU.

- Public services: Upper East Side vs. NYU.
Global Financial Nodes

- Hong Kong passed NY in IPOs in 2000s.

- Euronext Exchange
  - Paris, Amsterdam, Lisbon and Bruxelles.
  - Euronext bought LIFFE in 2002
  - Euronext and NYSE merged in 2006.

- Deutsche Börse AG
  - Frankfurt
  - Euronext rebuffed Deutsche Börse

- Zurich (Eurex) in derivatives
US Nodes

- Chicago and derivatives
  - Chicago Mercantile Exchange & Chicago Board of Trade
    - Merged in 2006

- San Francisco & innovation
  - Branch banking
  - Credit cards
  - Discount brokerage
  - E-trading
  - NASDAQ growth

- Miami banks and Latin America
Global Derivatives

- Derivatives trading
  - Chicago BOT
  - Eurex - Swiss-German
    - world’s largest until Chicago merger
  - London - over-the-counter derivatives
    - LIFFE (futures, founded 1982)

- Hedge funds
  - Greenwich, CT.
  - London (Canary Wharf)
  - Cayman Islands

- Greenwich ahead because...
  - Near NYC financial center
  - NY investment bankers hive off new hedge funds
  - US investors are risk-takers
  - Hedge funds evade Oxley-Sarbanes regulations
Financial Districts

- Logic of districts
  - Interaction of firms
  - Specialized labor pools
  - Auxiliary services
I. Financial Centers

A. Financial Areas

B. Global Cities

C. Offshore Banking
Offshore Banking

- Havens for big (& hot) money
  - Beyond national regulations, taxes & policing

- 26% of world’s wealth
  - 30+% of US MNC net π

- Bahamas, Isle of Man, Cayman Islands, Dubai, etc.
Back Offices

- Offshoring bank services, just like industry
Geography of Global Finance

I. Financial Centers

II. • Financial Flows

III. National Monies
Globalization of Flows

- Financial (money) flows
  - Capital + transfers

- Capital flows
  - Industrial investment (FDI)
  - Bank loans (loan capital)
  - Securities (‘Portfolio’)

- Transfers
  - Remittances (wages)
  - Corporate profits
    - [currency exchanges]

- Flows move along pathways
  - Through global institutions
  - Through global city system

Chart 1

New peaks
Gross international capital flows have risen dramatically since 1995.
(totai global capital inflows, percent of world GDP)

1Other flows include derivative transactions.
III. Financial Flows

A. Industrial
B. Bank Loans
C. Portfolios
D. Transfers
Global FDI

- ‘Foreign direct investment’
  - Plant & equipment
- Industrial expansion
  - From core & rising NICS
- Mergers & buyouts
  - Is it net investment?
III. Financial Flows

A. Industrial
B. • Bank Loans
C. Portfolios
D. Transfers
International Loans

- Types of loans
  - Bank to state
  - Bank to business
  - State to state

- Era of international lending
  - Explodes in 1970s
  - Recycling petro-dollars
  - [blows up in 1980s]

- What do states do with it?
  - Infrastructure projects
  - State loans & banks
  - Corruption & personal fortunes
  - Debt repayment
    - Short term debt trap

Chart 4
Shortening of debt maturities and crises in developing countries
Ratio of short-term debt to total bank debt

Note: Oil crisis 1 and oil crisis 2 refer to the crises that followed the raising of oil prices by the Organization of Petroleum Exporting Countries in 1973 and 1979.
III. Financial Flows

A. Industrial
B. Bank Loans
C. Portfolios
D. Transfers
Portfolio Investment

- Buying foreign securities
  - Government bonds
  - Corporate stocks & bonds

- Growth after 1990
  - Eclipses bank lending
  - [triggers new kind of crises]

Source: Federal Interagency Council for Statistical Policy

Source: Authors’ calculations based on Cowan et al. (2006).
Global Stock Markets

- 24-hour trading
- Overlapping hours
III. Financial Flows

A. Industrial
B. Bank Loans
C. Portfolios
D. Transfers
Remittances

- Wages from immigrants
- Social security to retirees

Federico Mandelman, a research economist and assistant policy adviser at the Federal Reserve Bank of Atlanta, recently found a similar relationship between the American housing market and remittances to Mexico.

Below is his graph, which shows monthly United States housing starts (lagged five months) and remittances to Mexico:

Financial flows to developing countries, 1980-2002

Capital inflows can act as a growth accelerator to developing economies. They typically take one of three forms: (1) official aid includes grants and loans by governments and international institutions to developing countries to promote economic development and welfare; (2) foreign direct investment (FDI) is private investment in a foreign economy to obtain an ownership interest in an enterprise; (3) worker's remittances include the transfer of earned wages by migrant workers to their home country.

Source: World Bank 2005
Reproduced from World Resources 2005. All rights reserved

Federico Mandelman
Immigration & employment (outtake from lecture 16)

- Tight link of illegals & unemployment

Figure 1: Apprehensions versus Detrended Employment, 1991-2009

Graph courtesy of Pia M. Orrenius. Sources: Bureau of Labor Statistics; Department of Homeland Security; author’s own calculations. Note: Employment is expressed in deviations from long-run trend and Border Patrol apprehensions are lagged six months. Employment and apprehensions have been seasonally adjusted.

The graph, which shows border apprehensions lagged by six months against overall American job market conditions, is from Pia M. Orrenius, a senior economist at the Federal Reserve Bank of Dallas.
Corporate Profits

- Repatriation of revenues

- Internal pricing to hide flows

- Can’t find a chart – what does that tell you?
Global Currency Markets

- Largest of all
  - Trillions $ per DAY

- Corporate holdings
  - Balancing & risk

Which leads to our next topic...
Geography of Global Finance

I. Financial Centers

II. Financial Flows

III. National Monies
National Monies

- State sovereignty & national territory
  - Monetary space

- Multitude of monies
  - How to handle international transactions?
III. National Monies

A. • Fixed & Floating

B. Trade & Rates

C. The Almighty Dollar
Fixed Exchange Rates

- The Gold Standard
  - British hegemony & Bank of England
  - Settling accounts in gold

- The Dollar Standard
  - Bretton-Woods
  - Gold reserves
The Float

- 1970-73 dollar devaluation
  - US ends payments in gold

- Floating rates
  - Currencies seek own value

- Pegged rates
  - Small countries & the dollar
Currency Exchange

- Currency markets & floating rates
- Daily trillions
- Hedging & risk
III. National Monies

A. Fixed & Floating

B. • Trade & Rates

C. The Almighty Dollar
Currency Rates & Trade

How currency value affects trade
What’s It Worth?

- What sets currency values?
  - Exports & imports
  - Underlying economic strength
Capital & Currency

The kicker
  - Capital flows & balance of payments

Finance capital flows (portfolio) & currency value
  - Value rises with influx, falls with outflow

Why does finance capital flow across borders?
  - Depends on interest rates, stock markets & risk
Monetary Policy

- National policy
  - Stimulate economy by increasing money supply (credit)
  - Works less in open systems/porous borders

- Monetary policy & trade
  - Lower value aids exports (& balance of trade)
  - Devaluation (Who revalues upward?)

- Monetary policy & financial flows
  - Higher value attracts flows (balance of payments)
  - Raise interest rates
Policy versus the Markets

- International deals & coordination
  - Plaza Accord, Reverse Plaza
  - What about China?

- Countervailing trade & payments flows
  - Japan & China vs. U.S.

- Currency speculation (e.g., Soros)
III. National Monies

A. Fixed & Floating

B. Trade & Rates

C. •The Almighty Dollar
The World’s Money

- “Dollar sovereignty”
  - Largest economy, most powerful country
- Dollar serves as basic unit of account
  - Other major currencies subordinate
  - Small currencies pegged
Benefits of the Banker

- The world’s banker
  - Dollar = gold
  - World puts savings in US
  - US financiers (NYC) recycle global funds
  - Keeps capital abundant & interest rates low in US

Savings flow to US

- K should flow from rich countries to poor, but goes the other way
  - Because K less secure in poor countries
- Easy to borrow to fund US deficits (everyone trusts the bank)
  - China & Japan hold $1.5 trillion in US assets (mostly T-bills)
Ironies of the dollar

- Trade deficit & US external debt
  - Dollar should fall hard
  - IMF should step in!

- Financial crisis
  - Dollar rose!
  - Influx of capital
  - Global fear & dollar
End of the dollar era?

- Economic causes
  - Trade deficits & devaluation (inflation)
  - Risk to creditor nations
  - Weakening of US economy

- Political causes
  - Resentment
  - Competing currencies
  - Weakening of US hegemony

China challenges US dollar’s dominance

On March 23, China’s central bank governor, Zhou Xiaochuan, threw down the gauntlet in an essay posted on the Web site of the People’s Bank of China challenging the global hegemony of the US dollar and proposing its gradual replacement with a super-sovereign currency, based on the International Monetary Fund’s (IMF) Special Drawing Rights (SDR), created in 1969 and managed by the IMF.

This currency would be "... disconnected from individual nations and ... remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies." Without mentioning the US dollar explicitly the essay, titled "Reform the International Monetary System," indirectly blamed the dollar’s hegemony for the current global financial crisis. The challenge re-emerged on March 26 in the report of a UN advisory committee of economists chaired by Nobel laureate Joseph Stiglitz.
International regulation

- There isn’t much...
  - Mostly by nation-states

- IMF
  - Not a Central Bank
  - Lender of last resort
  - Lends to governments

- Lowering the bar
  - Competition to unleash banks
    - ‘the Big Bang’ & NY response

- Bank havens
  - Deregulation of offshoring

  - Terror & tightening