Lecture 18: Global Finance

Money Makes the World Go Round
KEYS FOR TODAY

- Finance operates at many scales
  - & concentrates in certain places
    - Financial centers & havens
    - Same logic of clustering

- Finance flows around the globe
  - Crossing borders, linking centers
  - Both capital investment & income

- A world of monies
  - National money & exchange rates
  - National monetary policy
  - The dollar & its rivals
Global Finance

I. Financial Spaces

II. Financial Flows

III. International Money
I. Financial Spaces

A. • Financial Scales

B. Financial Centers

C. Offshore Finance
Local Finance

- Local Banks
  - Recycle savings
  - HQ & branches

- Decline of local banks
  - End of Jacksonian system
  - Niche banking

- Local investors
  - Key capitalists & families
    - E.g., Ralston, Haas, Crocker in SF
    - Silicon Valley ‘angel’ investors
Regional Finance

- Banks & regional economy
  - Key players
  - Recycle savings
  - SF banks & California

- Regional exchanges & capital markets
  - Pacific, American, CBOT
    - List regional corporations
  - Regional investment banks
    - E.g., Montgomery Securities

- Financial hierarchies & regional economies
  - Major & minor financial centers
    - Chicago & SF vs. Atlanta & St. Louis
National Finance

- Nation-wide banks
  - NatWest, Sumitomo, BNP, etc.
  - Now US has Bank of America, JP Morgan-Chase, Wells Fargo, Citibank

- National exchanges & investment
  - NYSE, NASDAQ, London Stock Exchange
  - List all major corporations

- National economies & financial institutions
  - Basis for size & strength
  - Rise of the US, Japanese & Chinese banks
Global Finance

- British system of 19th C.
  - Global banking
  - Global investment (mostly bonds)
  - Pound Sterling & gold standard

- Interwar retreat (like trade)

- Re-Globalization after WW2
  - Dominated by US
  - Global branch banking by 1960s
    - Euro-Dollar market
Global Finance Today

- International banking
  - E.g., HSBC, Barclay’s, BNS, Deutsche Bank, etc.
  - Branches, deposits & lending around the world

- International exchanges
  - E.g., NYSE-Euronext, LSE, Tokyo, Hong Kong
  - Global investment flows in securities
I. Financial Centers
   
   A. Financial Scales
   
   B. Financial Centers
   
   C. Offshore Finance
Financial Districts

- Logic of clustering
  - Interaction of firms
  - Specialized labor pools
  - Business services
  - Prestige addresses

- Industrial corporations more dispersed than finance
  - MNCs more self-contained

- Big cities are financial centers
  - Finance is key element of urban growth
Finance & Urban Hierarchies

- Finance is a big part of linkages & hierarchies of city systems

- Global cities
  - Global banks & branches
  - Major exchanges & funds
  - Huge supporting clusters

- Major centers
  - Regional & national banks
  - Exchanges & investors
    - ‘boutique’ investment banks

- Minor centers
  - Local banks
  - No securities & funds

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Major US Financial Centers

- **Chicago and Midwest**
  - Banks & exchanges
  - Derivatives market (CBOT)

- **Minneapolis & Upper Midwest**
  - Cf. Detroit, St. Louis & other losers
  - Lack major financial institutions

- **Charlotte & Bank of America**
  - Stole SF's crown & became #2
  - But then Wells got Wachovia

- **Miami banks and Latin elites**
  - Not to mention drug money

- **San Francisco & innovation**
  - Branch banking
  - Credit cards
  - Discount brokerage
  - E-trading
  - NASDAQ
The Global Financial 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

- New York took top spot during WW2
- London regained primacy by end of 1960s
  - Eurodollar market & less regulation than US
- NY back on top by 1980 under Reagan
  - High interest rates drew in global funds, stocks boom, deregulation
  - London hurt by weak pound, stuffy banking, insurance collapse
- London regained #1 after Thatcher ‘Big Bang’ (1986)
  - Swept out old bankers & brought in Americans & Japanese
- NY rebounded in 1990s with stock market boom
  - Then NASDAQ bubble burst in 2000
  - NY hurt by Oxley-Sarbanes public disclosure
- London bounced back in 2000s
  - Developed derivatives (LIFFE) (which are in Chicago in US)
  - Spectacular growth in shipping, brokerage, accounting & law
  - London passed NYC in IPOs in 2002
  - London biggest in FOREX
New Global Financial Centers

- Rise of the Asian centers – global shift in finance?
  - Banks in Asian mega-cities
  - Exchanges in Tokyo, HK, Singapore, Shanghai
  - Sovereign wealth funds in Persian Gulf
  - Massive flows of investment K to Asia
    - But NY still recycles much of Asian savings

- Growth of European centers
  - Paris
    - Major banks, like BNP, Credit Agricole, etc.
    - Euronext Exchange
      - Also in Amsterdam, Lisbon and Bruxelles.
      - Merged w/ LIFFE in 2002 & NYSE 2006
  - Frankfort
    - Deutsche Börse, big German banks
    - European Central Bank
  - Zurich
    - Swiss banks, like UBS
    - Eurex in derivatives
Global Derivatives Centers

- Derivatives exchanges now 4-5x stocks
  - Chicago - BOT
  - Zurich - Eurex
  - London - LIFFE

- Hedge funds
  - Greenwich, CT. (c 200 firms)
  - London (Canary Wharf)
  - Cayman Islands

- Greenwich ahead because…
  - NY bankers spin off new hedge funds
  - US investors are risk-takers
  - Hedge funds evade Oxley-Sarbanes
I. Financial Centers

A. Financial Scales

B. Financial Centers

C. Offshore Finance
“Treasure Islands”

- Havens for big (& hot) money
  - Beyond national territory, taxes & controls

- Key Havens
  - Bahamas, Switzerland, Dubai, Lichteinstein, etc.
  - Most run out of London & are Crown Dependencies
    - Channel Is., Isle of Man, Cayman Islands, Gibraltar

- Bank branches & investment funds
  - Hedge Funds big on the Cayman Islands & Channel Islands


Haven on Earth

- Havens are false-fronts for avoiding taxes
  - ~ 50% of all world trade runs through tax havens – on paper
  - >50% of all bank assets routed through havens
    - Shaxson, Treasure Islands

- Havens hold 25%+ of world’s wealth
  - 30+% of US MNC net π
  - 1/3d of the wealth of “high net-worth individuals”—$6/$17.5 trillion—held offshore
Back Offices of Banks

- Offshoring bank services, just like industry
Global Finance

I. Financial Centers

II. Financial Flows

III. National Monies
Globalization of Flows

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

- **Income Transfers**
  - Remittances (wages)
  - Corporate profits

- **Flows & pathways**
  - Via global institutions
  - Via global city system

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**Chart 1**

**New peaks**

Gross international capital flows have risen dramatically since 1995.

(total global capital inflows, percent of world GDP)


1 Other flows include derivative transactions.
III. Financial Flows

A. Industrial
B. Banking
C. Securities
D. Income
Global Industrial Investment

- ‘Foreign direct investment’ (FDI)
  - Plant & equipment
- Industrial expansion
  - From G8 & now G20
  - To new NICs
- Mergers & buyouts
  - Is it net investment?
III. Financial Flows

A. Industrial

B. Banking

C. Securities

D. Income
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
III. Financial Flows

A. Industrial
B. Banking
C. Securities
D. Income
Portfolio Investment

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

- Mostly by major institutions
  - Investment banks, pension funds, mutual funds, ETFs, etc.

- Huge growth after 1990
  - Eclipses bank lending
  - Triggers new kind of crises
  - See lecture 20
III. Financial Flows

A. Industrial
B. Banking
C. Securities
D. Income
Remittances

- Wages from immigrants
- Social security to retirees
- Huge dollar amounts
Corporate Profits

- Repatriation of revenues
  - Internal pricing to hide flows
- Leaving profits abroad
  - For further expansion
  - Or to avoid taxes?
  - Current debate in Congress
Global Finance

I. Financial Centers

II. Financial Flows

III. • International Money
Monetary Spaces – or Money At Many Scales

- National money
  - Sovereignty, territory, currency
  - Monetary policy

- A multitude of monies
  - International exchange rates
  - Global currency markets

- International money
  - The dollar system
  - The Euro
III. International Money

A. • Exchange Rates
B. Managing Money
C. The Almighty Dollar
D. The Euro
Exchange Rates

- Ratio of national currency values
- Office rates, market rates & black market rates

All international production, trade & investment must take exchange rates into consideration
What’s It Worth?

What sets currency values?
- Trade balance
- Payments balance
- Underlying economy
- State policy
Fixed Exchange Rates

- The 19th C. Gold Standard
  - British hegemony & Bank of England
  - Settling accounts in gold

- The Postwar Dollar Standard
  - Bretton-Woods, 1944
  - US gold reserves
Floating Exchange Rates

- **1970-73 dollar devaluation**
  - US ends payments in gold
  - End of Bretton Woods fixed rates

- **Floating rates**
  - Currencies seek own value
  - Currency markets arise

- **Pegged rates**
  - Pegging to the dollar
  - The ‘fix’ for small countries
    - c. 80 nations
Global Currency Exchanges

- Forex is largest
  - Dispersed around globe

- Players
  - Multinational corporations
  - International investors
  - Currency speculators
Global Currency Markets

- Largest of all financial markets
  - Trillions $ per DAY

- Hedging & risk
  - Move to small changes
III. International Money

A. Exchange Rates
B. Managing Money
C. The Almighty Dollar
D. The Euro
Trade Balance & Exchange Rates

- Currency rates affect trade balances
- Trade balances alter currency values
- States adjust currency to manage trade balance
Financial Flows & Exchange Rates

- The balance of payments
  - = Net inflow & outflow of capital & income

- Capital flows & 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 state action
  - Works best in large economies
  - Globalization has weakened state control of finance
  - 3 basic options – often in conflict

- Stimulate economy
  - Lower interest rate & expand credit

- Stimulate exports
  - Lower money value aids exports
  - & improves the balance of trade
    - Bias to devaluation

- Attract capital inflows
  - High interest rates & strong economy
  - Plus politics & image
Policy Versus 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)
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
III. International Money

A. Exchange Rates
B. Managing Money
C. The Almighty Dollar
D. The Euro
The World’s Money

- “Dollar sovereignty”
  - Largest economy, most powerful country

- Dollar serves as basic unit of account
  - Other currencies subordinate

![Pie chart showing currency usage percentages](chart.png)
The World’s Banker

- Capital flows to US
  - World puts savings in US
    - US financiers recycle global funds
  - 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)
  - Keeps capital abundant & interest rates low in US
Ironies of the Dollar

- Trade deficit & US debt
  - Dollar should fall hard
  - IMF should step in
  - Instead, everyone buys T-bills

- Financial crisis & US gain
  - Wall Street melted down, but…
  - Capital flowed in & dollar rose
  - Global fear & dollar security
End of the Dollar Era?

- **Economic causes**
  - Trade deficits & weakness
  - National debt & fear of devaluation

- **Political causes**
  - Resentment & pride
  - Weakening of US hegemony

- What could challenge the $?
  - Euro, Swiss France, Yuan
  - Basket of currencies
  - Super currency (IMF)

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**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.
III. International Money

A. Exchange Rates
B. Managing Money
C. The Almighty Dollar
D. • The Euro
Creation of the Euro

- Continuation of the EU project
  - But same lack of sovereignty

- Success since 2001
  - Gained dramatically against dollar
  - Holding up in crisis

- European Central Bank (ECB)
  - Lack of backup fund (no Fed)
European Crisis

- Greek debt
  - Owed to German & French banks
  - Banks want repayment
  - Greece can’t pay
  - Even with austerity

- Solutions
  - Squeeze the Greeks harder
    - But Greeks in full rebellion
  - Let banks take ‘haircut’ (50%+)
    - Bail out banks (big fund)
  - Greece defaults & leaves the Euro
    - Helps Greece but bad for finance K
And It Could Get Worse

- Greece may reject deal
  - Call for a general vote
- Panic in global markets
  - Bank stocks hit hard
- Portugal, Spain & Italy on the brink
  - And their debts are much bigger