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Editor

NEW YORK'S FINANCIAL MARKETS

The Challenges of Globalization

Conservation of Human Resources
Studies in the New Economy

Westview Press

New York's Financial Markets

The Challenges of Globalization

EDITED BY

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WESTVIEW PRESS
BOULDER AND LONDON

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The materials presented in this publication were prepared with financial support from the New York State Urban Development Corporation (UDC) on behalf of the Governor's Advisory Panel on Financial Services. However, points of view and opinions expressed in this book are solely those of the authors and do not represent the positions or policies of either UDC or the Advisory Panel.

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Published in 1989 in the United States of America by Westview Press, Inc., 5500 Central Avenue, Boulder, Colorado 80301, and in the United Kingdom by Westview Press, Inc., 13 Brunswick Centre, London WC1N 1AF, England

Library of Congress Cataloging-in-Publication Data

New York's financial markets : the challenges of globalization/
edited by Thierry Noyelle.

p. cm.—(Conservation of Human Resources studies in the new
economy)

Includes index.

ISBN 0-8133-0832-1

ISBN 0-8133-0833-X (pbk.)

1. Financial institutions—New York (N.Y.) 2. Money market—New
York (N.Y.) 3. Capital market—New York (N.Y.) I. Noyelle,
Thierry J. II. Series.

HG184.N5N38 1989

332.1'09747'1—dc19

88-27784
CIP

Printed and bound in the United States of America



The paper used in this publication meets the requirements of the American National
Standard for Permanence of Paper for Printed Library Materials Z39.48-1984.

New York's Financial Markets

**Conservation of Human Resources
Studies in the New Economy**

New York's Financial Markets: The Challenges of Globalization, edited by
Thierry Noyelle

Immigrant and Native Workers: Contrasts and Competition, Thomas R. Bailey

Beyond Industrial Dualism: Market and Job Segmentation in the New Economy,
Thierry J. Noyelle

Computerization and the Transformation of Employment: Government, Hospitals, and Universities, Thomas M. Stanback, Jr.

Technology and Employment: Concepts and Clarifications, Eli Ginzberg,
Thierry J. Noyelle, and Thomas M. Stanback, Jr.

Acknowledgments

As the final touches are put to this book, I cannot but thank all of the contributors for their unusual kindness and exceptional assistance in preparing their chapters for the publisher on very short notice. I also want to thank Matthew Held of Westview Press, whose own excitement for this book guaranteed that it could be published in record time. I also wish to extend my gratitude to Ellen Levine and Shoshana Vasheetz. As always, they demonstrated great patience and skill in dealing with the unnerving process of endless revisions, corrections, and copy editing. Finally, I must express my very special thanks to Penny Peace, my associate at the Conservation of Human Resources Project, who took prime responsibility for overseeing the preparation of this book. Without her work, this book would not be quite the same.

This book was inspired by a seminar I organized on May 26, 1988, at the request of New York State Governor Mario Cuomo's Advisory Panel on Financial Services and Panel Chairman Vincent Tese, New York State Commissioner of Economic Development. I am most grateful to Rick McGahey and Mary Malloy at New York State's Department of Economic Development for their encouragement and support throughout the course of this project. Last but not least, I am most thankful to Laura Dillon and Pat Dempsey, at J. P. Morgan, for their hospitality and that of their institution, where the conference was held.

Points of views and opinions expressed in this book are solely those of the contributors and do not represent the positions or policies of either the Governor's Advisory Panel on Financial Services or New York State.

Thierry Noyelle

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Overview: Issues for the 1990s

Thierry Noyelle

Shortly after October 19, 1987, a long-time observer of the New York economy suggested that that day's market crash marked the end of the 1980s.¹ If October 19, 1987, does indeed represent such a benchmark, then the pickup in financial activity and renewed regulatory developments in the United States, in Europe, and among the central banks of the largest developed countries during the first half of 1988 suggest that the restructuring of financial industries will continue during the 1990s at a pace as furious as that of the 1980s.

Indeed, while 1987 saw retrenchment in corporate bond markets in both New York and London, a spate of new issues beginning in the first quarter of 1988 breathed new life into these two largest markets. Likewise, after barely a pause, mergers and acquisitions, leveraged buy-outs, and related financial engineering gained new strength in New York in early 1988 and suddenly blossomed in Europe where such activities had remained quite limited in scope until then.

Perhaps more significant, June and July 1988 were witness to a series of regulatory developments, both here and abroad, which suggested that more churning was in the offing. Remarkably, on the very same day that the European Community's (EC) financial ministers approved a plan that would end all restrictions on capital movement within the twelve-nation trading block—namely, on June 13, 1988—the U.S. Supreme Court let stand a decision that gives commercial banks limited new authority to underwrite and deal in U.S. commercial paper, mortgage-backed securities, consumer loan-backed securities, and municipal revenue bonds.² Less than a month later, on July 11, 1988, the heads of the world's twelve largest central banks, including Japan, the United States, Switzerland, and the key EC countries, signed a final agreement setting more stringent and standardized capital requirements for international banks.³

Sensing that October 1987 hardly marked the end of the long period of intensive transformation characteristic of the 1980s, but rather marked the beginning of a new phase of change, a few weeks after the crash, New York State Governor Mario Cuomo called upon New York's financial industries to help his administration assess their sector's own future. The Governor's Advisory Panel on Financial Services was created in November 1987. A few weeks later, I had the privilege to be asked by the Panel to organize for May 1988 a one-day seminar focusing on the implications of the continuing globalization of financial markets for New York with a view to help the Panel map out some of the issues.

Thanks to the tremendous support and interest from the members of the Advisory Panel, and the very special assistance from J.P. Morgan which hosted the meeting, the seminar produced strong discussions among participants and raised very tough questions; so much so, that it seemed appropriate to bring together, in a book, a number of the themes that emerged there.

I believe this book is one of the very first ones to look beyond the 1980s and to address some of the critical issues that New York will need to confront in the early 1990s. In this respect, I hope that it will be a useful contribution to the policy debates that must take place among industry representatives and local, state and federal officials if New York is to retain its role as a leading world financial center.

Issues for the 1990s

Is the size of New York's capital markets likely to continue to shrink in the years ahead relative to London or Tokyo, even if the volume of local financial activity continues to grow in the absolute? Or, on the contrary, is New York so positioned today that it may enjoy faster rates of growth in the years ahead than its two principal competitors? If so, where do New York's future market opportunities lie?

Where will the challenges to New York come from in the future? As financial service industries enter a new phase of geographical decentralization, will the challenges come from London or Tokyo, as was the case during the 1980s; from Hong Kong and Singapore in Asia; from Paris, Frankfurt or Milan in Western Europe; or from Chicago, Los Angeles and Toronto in North America? Or will they come from New York's own inner weaknesses, including the difficulties encountered by its largest banks in mounting a successful counteroffensive to Japanese and European banks?

Finally, in the face of the continuing restructuring of the industry and its markets, what can public officials and regulators do to strengthen

and prepare New York for the 1990s? These and others questions are addressed by the authors of the chapters presented in this collection.

In "International Stock Market Transactions," Roy Smith argues that international equity transactions, including cross-border transactions in secondary markets and new issues offered to investors under one of several different "globalized" distribution techniques, represent one area of financial activity where new growth can be expected and where New York should be well positioned to capture a large share of new business.

Smith reasons that New York, unlike London, is a relative latecomer to international financial transactions. The city, with its equity markets, stands at the center of the world's largest and perhaps most stable economy. Japanese and European investors are increasing their holdings in the United States and will continue to do so in the years ahead. Many U.S. companies still have no significant foreign stockholders; and many U.S. institutional investors have yet to make significant international equity transactions. Volume of new international issues and new activity in secondary markets will thus increase faster in New York than in London where the internationalization of the local markets is already more advanced. Furthermore, New York should be helped in the coming years by the fact that, relative to London or Tokyo, it has become a low-cost location, thanks in part to the dramatic exchange rate readjustments of the last two years—a theme explored also in several of the other chapters. Smith concludes with a note of caution, however, warning that the international financial community has become highly mobile and that New York will need to be attentive to adverse changes in taxation and regulation that could quickly undo the city's current advantage.

In "The Foreign Challenge to U.S. Commercial Banks," Robert Cohen is far more guarded in his assessment of New York's future. Implicit in Cohen's analysis is the notion that New York's strength as a world financial center will remain, in part, a function of the strength of U.S. commercial banks and securities firms. But this is where things have changed considerably during the 1980s, as the result of the successful challenge to U.S. dominance mounted by the leading European and, even more so, leading Japanese banks.

Of course, Cohen knows that in a world in which securities market activity has become dominant, traditional measures of asset size or market valuation may not be sufficient to compare competitiveness among major players. In his chapter, Cohen focuses on U.S. commercial banks and examines several measures of competitiveness, including not only traditional measures of "firepower" (assets and market value) but also indicators of "placing power," cost competitiveness, productivity, profitability, international market presence, and innovativeness. His find-

ings are mixed. For, while measures of asset size and market valuation give the Japanese and leading European banks a growing advantage, other measures suggest that U.S. banks have retained competitive strength. In this respect, Cohen does discuss the implications of the new capital adequacy standards and of the shift from asset growth to profit growth for major groups of banks. While Cohen agrees that the shift of focus from assets to profits does present a challenge to Japanese banks, he does not think that the new capital adequacy requirements will be as big a challenge for them as some analysts have predicted.

Cohen concludes with a strong warning. In his opinion, the recent past suggests that Japan's Ministry of Finance (MoF) will promote the competitiveness of Japanese banks and their adaptation to the new market conditions (i.e., new capital adequacy requirements, the shift from asset growth to profit growth) in very much the same way that Japan's Ministry of International Trade and Industry (MITI) played a role in promoting the Japanese auto and semiconductor industries. Thus, in addition to developing the infrastructure and the policies that will further promote the city as a world financial center, New York State and City officials may need to take a lead in helping to develop institutional mechanisms that will enable U.S. banks to respond to a possible neo-mercantilist challenge.

The fact that the United States is no longer the undisputed economic, political, and financial power that it once was is, in Richard Levich and Ingo Walter's opinion, a factor that must form the basis of any analysis of New York's future as a world financial center. In "The Regulation of Global Financial Markets," Levich and Walter retrace the transformation of global financial markets. They identify those factors that help to explain the formation of major national and international financial centers in the past and those that will determine which, among them, will remain in the top league in the years ahead.

Focusing on the implications of the 1963 U.S. Interest Equalization Tax and later U.S. regulations that effectively closed foreign access to the U.S. bond market, thereby promoting the development of offshore markets out of London and Luxembourg, Levich and Walter argue that the daunting task for regulators is to design an "optimum" structure of regulation. Such a regulatory structure must provide a reasonable degree of prudence and stability at minimum cost to efficiency and financial innovation, while aligning policies among banking authorities internationally, so that no one market is at a competitive disadvantage. As Smith does in his chapter, the two authors recognize that the issue has become all the more pressing in that recent changes, including technological change and the relative decline of the United States, have contributed to making financial industries increasingly mobile.

Levich and Walter argue both that it is in New York's interest to ensure that the process of financial "deregulation" continues and that such a process is not inconsistent with the maintenance of a *positive* regulatory tax to protect the national financial system. In Levich and Walter's opinion, deregulation and a positive regulatory tax, combined with a push to truly open up both foreign and U.S. markets on the basis of "national treatment," should be the basis to define a new international level playing field in which New York stands a chance to preserve its role as a leading international financial center. But the road ahead is likely to be rugged and may require a much more proactive strategy on the part of state and local officials than has been historically the case.

The increasing mobility of financial industries and the challenge that such mobility represents for New York's future as a leading international financial center is also a central theme of my chapter. In "New York's Competitiveness," I try to identify and examine which forces of transformation—be they technological, market, regulatory, or public policy changes—may undermine or, on the contrary, strengthen New York's position. To do so, I review eight dimensions of New York's current competitiveness, including its traditional role as a magnet to issuers, investors, and financial intermediaries, its strength as a center of financial innovation, its technological infrastructure, its human resources, its operating cost environment, and its exceptional infrastructure of business support services.

A principal conclusion of my analysis is that New York is emerging from a phase in which international financial activity moved further away from New York, toward Tokyo, and even more so, toward London, but during which national financial activity became increasingly concentrated in New York. It is now entering a new phase. In this phase, New York may be in a good position to recapture some of the growth in international activity that slipped away from its grasp during the 1980s; but the city may also be confronted by a renewed challenge from second tier financial centers—Los Angeles, Chicago, Toronto, and others throughout North America.

It is to a somewhat similar conclusion that Dennis Weatherstone arrives in "A U.S. Perspective on Europe 1992."

In his chapter, Weatherstone projects what the implications of Europe 1992—the European Community's deadline to remove its remaining barriers to a fully integrated internal market for goods and services—might be for both Europe itself and the United States. He ventures that the standardization of banking regulations and the lifting of controls on capital movement throughout the EC will likely benefit Paris, Frankfurt, Milan, or even New York, by weakening London's current competitive

advantage. At the same time, he sees that the EC's demand for "reciprocity" will put new pressures on both Tokyo and New York to further liberalize access to their own markets.

The previous remarks are only sketches of chapters that have much greater bite to them than can be expressed in a few paragraphs. Also, this short overview is not meant to ignore possible differences of opinion among the six authors. In the end, however, it is remarkable that all six authors agree that New York is entering a new phase in its development as an international financial center and that preparing for the future will require a much more proactive role on the part of state and local officials than was needed in the past.

Notes

1. Samuel Ehrenhalt, Regional Commissioner of the U.S. Department of Labor, during his March 1988 monthly press conference.

2. "U.S. Court Backs Fed Rule on Bank Power" and "EC Finance Ministers Agree to Liberalize Capital Flow," *Wall Street Journal*, June 14, 1988.

3. "Agreements on Banks' Capital Set: 12-Nation Accord Forces Institutions to Raise Billions," *New York Times*, July 12, 1988, p. D1.

2

International Stock Market Transactions

Roy C. Smith

Financial markets around the world have become linked as never before into a single global pool of funds that can be accessed by users of funds and investors from all of the industrialized countries. Market centers have formed around the main areas of financial activity—New York, London, and Tokyo. These centers act as the principal linkages between domestic market participants and the markets serviced by other centers. They also serve as continental “hubs” attracting business and activity from satellite financial subcenters such as Boston, Chicago, and Toronto in the case of New York; Paris and Frankfurt in the case of London; and Hong Kong, Osaka, and Singapore in the case of Tokyo. This chapter describes the current activities in international stock market transactions, both those that involve new issues of equity securities and those that occur in secondary markets. It also explores the expanding role of New York City as one of the global financial centers in the market for international equity transactions.

International Equity Transactions

Within the last few years international transactions in equity securities have expanded enormously, as reflected in the substantial increase in cross-border transactions in secondary markets and by new issues offered to investors under one of several different “globalized” distribution techniques. This market phenomenon is the result of the convergence of many factors which have led toward the integration of capital markets around the world, factors such as the opening up of national markets through various deregulatory processes, the substantial improvements in financial information gathering and dissemination technology, and the

growing involvement of major financial institutions as investors and providers of services to the markets.

As rapidly as the volume in international equity transactions has grown, only modest progress has been realized in terms of the integration of the different stock markets of the world. Considerable differences continue to exist in the methods the markets use to value shares and in the area of commissions, trading practices, new issue regulation, and settlement procedures. For many of these differences, a long time will be required before (or if) common ground can be reached. In other cases, some movement toward an international standard is clearly in evidence. Precedents occurring in one market will be observed and emulated by others. The abolition of fixed commission rates by the New York Stock Exchange in May of 1975 ("Mayday") generated a number of changes in equity markets, not only in New York but in London, Toronto, Zurich, Tokyo, and Sydney as well. In less than a decade many of the principles established as a result of Mayday were adopted by these other markets.

In general terms there are three types of international equity transactions: (1) those in which investors and issuers (e.g., from the United States) tap equity market resources in other countries to enhance the market liquidity that is available domestically; (2) those in which international markets are used (e.g., by Europeans) because the domestic market cannot meet the requirements of domestic participants; and (3) those in which the international markets are employed (e.g., by Japanese) as a way to avoid domestic market restrictions and entanglements. As in the case of the Eurobond market, the lack of regulation and the presence of a large, highly diversified, and very liquid pool of international investment funds has caused equity markets to evolve and develop internationally in such a way as to provide something for everyone.

This process has begun but is a long way from being finished. Much of what is now happening in international equity markets was just invented and not all of it will survive future innovations. Almost everything that is happening, however, contributes to the laying in of a foundation for a future, more integrated, international market. For these reasons, this is a uniquely instructive time to observe how a new market operating in a free international environment is formed, or perhaps, how it forms itself.

The international equities market is not a clone of the Eurobond market (though on occasion it travels down the same path), but it has proven to be equally resourceful in adapting itself to the new and varied requirements of its principal users. As in the Eurobond market, this free market adaptation is watched by domestic regulators and as a result is likely to play back into national markets some of its more successful