The Emergence of IFCs: A brief history

chapter 1

1. Meeting cross-border trade, investment and other needs

The growth of international finance has been shaped by history. It is a chronicle of episodic needs for capital across geographies outgrowing the domestic resources available. Financial services, institutions and markets have evolved in response to requirements for capital. As colonial empire-building and industrial development took off – in Europe, the Orient and elsewhere – large financing needs arose that triggered the need for large cross-border financial firms and markets to emerge. Such needs were compounded by new technologies that enabled the geographical separation of production from consumption (of goods and services) around the world. They fuelled exponential growth in cross-border trade and investment. These economic forces were, and are, the main drivers of international financial services (IFS).

At first, merchants who became bankers worked alone to raise or put together funds for large investments. They gradually diversified their sources of funds to royalty, church, landed aristocracy, and wealthy professionals. Modern-day financial infrastructure did not exist. Central banking and financial regulation were nascent and primitive. Securities exchanges/markets were few and far between. Credit-rating facilities were nonexistent. Resort to law for the settlement of financial disputes was virtually unknown. In this raw environment, vendors in each centre of finance acted alone or collaborated with partners in other locations with extreme caution. That resulted in delays and inefficiencies. Yet these early impulses saw incipient clusters of financial expertise emerge that evolved into IFCs. Over time, many city-states specialised in arranging complex financing deals and providing trade financing services to specific regions.

In this chapter we take a synoptic look at the evolution of IFCs around the world, consider how they might classified in terms of what they do and whom they serve, look at recent trends in the formation and spread of IFCs and, finally, we examine at the case for Mumbai to emerge as an IFC as India takes its place in the world.

2. Evolution of international financial services (IFS) and centres (IFCs)

The provision of IFS has a longer chronology than commonly recognized. The world had a global currency (based on gold and silver) for several centuries. IFS–in the most basic conceivable forms – were provided by merchant traders-cum-financiers for at least two millennia; if not before. Pre-modern IFS flourished across Europe, the Middle East, and coastal Africa, under the umbrella of the Roman Empire – which also traded with Persia and the Orient. Its trajectory was nearly extinguished between the 5th and 11th centuries AD but IFS revived to finance the Crusades in the 12th and 13th centuries.

The antecedents of modern IFS are traceable to the Renaissance when the city-states of Venice, Florence, Naples and Genoa became mercantile centres that dominated trade between Europe and the Orient from the 14th to 16th centuries. In the 17th and 18th centuries these Mediterranean centres were superseded by the rise of Amsterdam, Lisbon, London, Madrid, and Paris as IFCs, with the discovery of the New World, the Antipodes, and the establishment of colonial empires across the Americas, Africa and Asia by European powers; viz. Britain, France, Holland, Spain and Portugal.

The nature of mercantile IFS was transformed with the first round of globalisation that occurred from the mid-19th to the early 20th century. It was revolutionised again by the second round of globalisation that had its origins in post-2nd world war reconstruction and recovery, but gathered real steam since the 1970s. Since the 1980s globalisation has entered a new and more intensive phase. It has become the principal force driving and reshaping the world economy. In the process, it is increasing the tensions caused by an economy that is increasingly global, being inadroitly governed by polities that remain national and, as yet, incapable of graduating toward the kind of supranational governance that globalisation demands.

3. The first round of globalisation: circa 1860–1914

From around 1860 onwards, there was a quickening of the pace of first-round globalisation, owing in part to the following major developments among others:

1. In 1856, a 4,000-mile telegraph system linking Calcutta, Agra, Mumbai, Peshawar and Madras was completed. It was the first high-speed messaging system in India.
2. After the US Civil War, economic growth in the US took off based on liberal, market driven egalitarian economic relationships, *i.e.*, without relying on slave labour. In the 1860s the First Transcontinental Railroad was built, with construction from both coasts linking up in 1869.
3. In parallel, railways were being constructed in India where, by 1870, over 6,400 kilometres of railway lines had been put in place.
4. In 1865, telegraph links between Europe and India became operational, so that a message could get from London to Mumbai in less than 4 minutes. In 1866, the first transatlantic telegraph cable was completed.
5. In 1869, the Suez Canal was built halving sailing time between London and Mumbai.

By 1870, two large, productive and politically stable, economic blocs – the British Empire (with India as its economic centrepiece) and the US – had emerged as dominant. They straddled the extremities of the globe from west to east with well established intra-imperial trade routes connected by steamships, railways and the telegraph. But the world economy of the 19th century was not limited to these two blocs. Other European powers also had 'intercontinental' empires in the Americas, Africa, and Asia. These were similar to, but much smaller than, the British Empire. The Russian and Ottoman empires exerted domain over territories in Eastern/Central Europe, and the Middle East and North Africa respectively. Japan established its own empire in Korea and Formosa (now Taiwan).

Cross-border trade occurred mainly *within* the geographies of these separate empires, rarely *across* them. But there was inter-empire trade in Africa, Asia and Latin America across contiguous borders of neighbouring colonies (*e.g.*, between British Kenya and German Tanganyika as well as Italian Ethiopia, between British Nigeria and French Cote d'Ivoire, or British Malaya, Dutch Indonesia and French Indochina).

The 19th century saw a historically unprecedented surge of intra-colonial trade with accompanying demand for trade and investment related IFS. Sophisticated trade finance spilled over into long term investment finance, for plantation farming, ranching, mining and infrastructure (*e.g.*, railroads and steamships) as well as the production of agro-industrial and industrial manufactures. Thus trade and investment (for localised production, based on natural and comparative advantage, but aimed at empire-wide consumption) provided the principal impulses for the development and growth of IFS in enabling economic decentralization and geographical dispersion. They still do that today; but, on a much larger scale, with the growth of cross-border trade and investment far exceeding the rate of global output growth.

During the first round of globalisation, London was the pre-eminent IFC, with Amsterdam and Paris playing supporting roles. New York was still in its infancy then. It did not come into its own till around 1918. This was an age of universal capital convertibility. Citizens of the world were free to move their assets across boundaries without governments or central banks impeding them. Enormous pools of capital were intermediated in Europe for investment abroad. Savings were mobilised in London from around the British Empire (including India) for investment in the Americas, as well as the British colonies in Canada, the Caribbean, Africa, the Middle East, Asia (West, South and East), the Indian Ocean and the Antipodes.

In this period, large amounts of capital flowed from rich to poor countries. Funds for investment in the colonies of continental European empires were raised in their imperial capitals; but augmented by global funds raised in London for large risky ventures: *e.g.*, ranching and mining in Chile and Argentina, mining in almost all of Southern Africa, and for financing telegraph systems, railroads, sailing and steamship lines, telegraphy, and such monumental projects such as the Erie and Suez Canals.

4. An interregnum, the second round of globalisation (1945–71), and beyond

In the late 19th century IFS accelerated dramatically, driven by the industrial, transport (steamships) and communications (telegraph) revolutions, resulting in a structural transformation of the world economy. More technologically-driven change in the world economy occurred in the course of the 19th century than in the two previous millennia. It triggered profound geopolitical change, resulting in a series of European wars culminating in two world wars.

The 20th century that followed made the remarkable 19th century appear primitive by comparison. Progress – in air transport, information, communications and process technologies for manufacturing, in semiconductors, transistors and silicon chips – was made in decades that previously had taken centuries.

The 30-year period (1914–45) between the end of the first, and beginning of the second, rounds of globalisation was disrupted by two world wars and an unstable 20-year interregnum. The second round of globalisation had its hesitant origins in an era of post war recovery, adjustment and decolonization (1945-1970) that again changed the economic structure of the world and the trajectory of the global economy. The revival of cross-border trade across the Atlantic and Pacific, along with massive investment for post-war reconstruction financed by the US, played a major role in resurrecting IFS and galvanising it at a more frenetic pace than before. During this period (*i.e.*, 1914–70) New York replaced London as the world's pre-eminent IFC.

In both rounds the distinction between *domestic* and *overseas* financing for trade and investment became blurred in determining the content of IFS. And, in both rounds, the process of financial integration and globalization was driven by:

1. Financial innovation in instruments, services and risk management arrangements that spread instantaneously across borders (when it was permitted to) to meet the evolving needs of clients (savers and users of funds) in the real economy.
2. Different risk/return and portfolio diversification demands of global savers and investors.
3. The injection of information processing and communication technologies into massive-scale gathering, dissemination and processing of data. Ubiquitous access to low-cost information tended to undermine relationship-based banking and fuel the growth of arms-length securities markets, particularly when it came to large issuers of securities.

In many countries, imported capital financed domestic investment and vice-versa, as direct and portfolio investors (in an increasingly integrated global market) diversified their investment portfolios to manage/balance country and sector risk.

The second round of economic and financial globalization began with the US being the world's locomotive and sole provider of surplus investment capital for the global economy. While driven initially by the reconstruction needs of Europe, the USSR, and Japan, global economic recovery resulted in dispersing manufacturing capabilities (and consequently enhanced trade in goods) throughout the *developed* world. Second round globalization was boosted by new investment needs created by the decolonization of the *developing* world after 1950.

The US drove second round globalization single-handedly in 1945–70. But that role diminished rapidly with the collapse of Bretton Woods in 1971. The global monetary system that prevailed from 1945 to 1970 was designed by Harry Dexter White, John Maynard Keynes and others. It consisted of pegged exchange rates and closed capital accounts to support large amounts of public spending for reconstruction and social welfare without risking capital leakage from resource-starved economies. But that historically anomalous and unnatural confinement of capital lasted for just 25 years.

The primordial nature of unrestrained capital flows across borders (that national governments consider sacred, but 'capital' is oblivious to) was restored in the face of unsustainable global pressures. These arose from chronic global imbalances in savings, consumption, investment and trade. They were driven by the shifting geographies of production, the economic revival of Europe and Japan, and decolonisation. Between 1971–90 the Bretton Woods regime was replaced in all OECD economies by the new stable regime based on floating exchange rates and open capital accounts.

In the *developing* world, the role played by the US as the principal global creditor-cum-investor was supported by capital flows (official and private) from former imperial countries: *i.e.*, Britain, France and, to a lesser extent, Holland. They were catalyzed and augmented by multilateral institutions such as the IMF, World Bank and regional banks. Governments and official institutions have played a useful role in global finance; especially in times of crises. But that role has been dwarfed by private capital flows throughout the second half of the 20th century, except in 1982–90.

As happened through the 19th and early 20th centuries, financial products became more diversified. Plain vanilla finance ceded to more complex structures following the introduction of financial derivatives in the 1972–1981 period. IFS grew horizontally and vertically. Financial firms innovated imaginatively. IFS enabled rapid changes in a number of new technologies (*e.g.*, ICT, bio, nano, eco, to name a few) to be translated into equally rapid changes in products, services and markets served by entirely new companies. The PC was not invented till 1982. Cellular phones came on the scene in the 1990s.

IFS – vastly enhanced by ICT – enabled these changes to be transmitted globally and instantly with the management of a variety of attendant risks. In response, risk management techniques, instruments, products, services and risk-trading markets evolved rapidly. They became more sophisticated with the unbundling of risk, specialisation in risk-taking, and synthesis of risk management packages in a variety of different forms. IFS also financed the tides of geopolitical flux – both the conflicts that have taken place and the reconstruction that has followed in their aftermath.

The changes of the 19th and 20th centuries seem dramatic in retrospect; indeed almost unimaginable in the context of progress made over the previous millennium. But, the time-span for progress in the 21st century is becoming even more compressed in considering the speed with which new technologies keep emerging and shortening product/market life-cycles. Technological innovation is occurring on a log rather than linear scale. Financial innovation is struggling to keep pace.

Technological changes that took centuries before 1800 occurred in decades in the 19th and 20th centuries. But, just one year in the 21st century, is seeing changes that took five years or a decade in the 20th. Techno-economic and 'financial world' changes keep racing ahead unbridled. But the social, cultural, political and institutional changes needed to accompany them – and cope with their consequences – are occurring too slowly. In the developed world these social and political changes are being made faster than in developing countries like India, where structures and institutions for policy-making and governance are adapting at a glacial pace. In the process, governance is becoming dysfunctional in coping with transformations in consumer expectations and behaviour (as well as in goods/services markets and industries) that are now occurring at 'warp-speed' in the real and financial worlds.

As with the first round of globalization, the propagation of new technologies (jet engines, transistors, computers, television and telecommunications) and relative real wage cost differentials (adjusted for productivity) are playing a significant role in accelerating globalization in its second avatar. In the first round, cross-border capital movements were free. The world was financially more integrated, albeit informally, because of the absence of capital controls. But, the early stages of the second phase of globalization (*i.e.*, 1945–70) saw economies being heavily regulated and financially segregated under the Bretton Woods regime monitored by the newly established International Monetary Fund (IMF). Global financial integration began to catch up in earnest with the breakdown of Bretton Woods and a reversion to freedom of money and capital flows.

5. The 'take-off' of second round globalisation after 1980

Since 1980, the nature and direction of global capital flows, and the continued geographical dispersion of production, have changed significantly; with aligned changes in the nature and direction of IFS. From being the world's largest creditor, the US has become the world's largest debtor in just two decades. In 1980, the world owed the US almost US$ 1 trillion. By 2000, the US owed the world the same amount. By 2006, it owed the world nearly US$ 3 trillion. The US' debt to external creditors (mainly Asia and OPEC), denominated in USD, is growing at an annual rate of US$ 700 billion. This astonishing reversal of global capital flows now supports the US as the world's consumer of last resort. That role is unsustainable for much longer; especially if the global distortions now being exacerbated by chronic imbalances in savings, consumption and investment across the world's economies, are to be rectified in an orderly manner over time: *i.e.*, without worldwide disruption and a damaging loss of confidence in the value of the USD as a reserve currency.

As the tides of global finance change, so do the fortunes of IFCs. Until 1914, London was the world's premier IFC. After the First World War, New York – as the IFC of the only capital-surplus country in the world at the time – eclipsed London. It remained ahead for nearly nine decades from 1918–2006. New York lost its primacy again to London just this year. London began recovering its position as an IFC in the late 1960s and 1970s when misguided financial regulation in the US – *i.e.*, the infamous Regulations K and Q – resulted in the surplus dollars of American MNCs in Europe (from profits, dividends, and repayments of intra-corporate loans by subsidiaries) being retained in Europe for global reinvestment instead of being repatriated to the US where they would have been taxed exorbitantly.

That resulted in the creation and growth of the Eurodollar market with its centre of gravity in London where the authorities seized the initiative with a 'light touch' approach to financial market regulation. Financial regulation in the UK has been continuously refined ever since to maintain London's competitive edge. Macroeconomic policy in the UK, which went through a distressing period including one IMF program and one speculative attack on the GBP, has been put on an even keel through a mix of fiscal rules and the Bank of England reforms. These factors have been the key to London's re-emergence as the world's premier GFC in 2006.

The Eurodollar market exploded in the 1970s when the first round of cartelised oil price increases resulted in petrodollar surpluses being accumulated by oil-exporting countries. Their domestic economies were incapable of absorbing such a sudden, large increase in the volume of resources available. They were recycled around the world – mainly through London and New York – by banks with global branch networks and established correspondent relationships. The Eurodollar market has since diversified into a multi-currency Euro-market that is global in nature. It establishes the benchmark for interest rates in all commonly traded currencies. It has been mimicked in Singapore by the Asian dollar market although that market is yet a pale reflection of its Euro-counterpart.

The second round of globalisation has entered a new phase in the 21st century. The world's centre of economic gravity has shifted to Asia. It is possible, even likely, that – with greater market-driven integration of Asian economies – the Asian dollar (or multicurrency) market may equal or exceed the present size of Eurocurrency markets within the next two or three decades. That depends on whether Asian bond markets develop in the same way, by taking a lead from Japan.

For that to happen, wide and deep markets will need to be created for currency trading in Asia and for a wide range of derivatives (for currencies, interest rates and commodities) in the more adroitly regulated Asian GFCs like Singapore and, hopefully, Mumbai. The growth of an Asian multi-currency market will have major implications for the internationalisation of the INR as a world currency and perhaps even for the emergence of common currencies for two or three Asian sub-regions.

6. Classification of IFCs

Financial centres that cater to customers outside their own jurisdiction are referred to as *international* (IFCs) or *regional* (RFCs) or *offshore* (OFCs). These three adjectives are often (but wrongly) used synonymously in the literature on IFCs. The three types IFCs they identify are difficult to define in a clear-cut, mutually exclusive, fashion. But they are quite distinct. All these centres are '*international*' in the sense that they deal with the flow of finance and financial products/services across borders. But that does not differentiate them sufficiently in terms of their scope.

We categorise IFCs in this report as: (a) **Global (GFCs)**; *i.e.*, those that genuinely serve clients from all over the world in the provision of the widest possible array of IFS; (b) **Regional (RFCs)** that serve their regional rather than simply their national economies (see below) – examples of such RFCs would be Dubai or Hong Kong; (c) **International** non-global and non-regional **IFCs** like Paris, Frankfurt, Tokyo and Sydney that provide a wide range of IFS but cater mainly to the needs of their national economies rather than their regions or the world – one might be tempted to call them *national* IFCs although that term is awkward because its two defining adjectives are contradictory; and (d) **Offshore (OFCs)** that are primarily tax havens for wealth management and global tax management rather than providing the fully array of IFS.

6.1. Global financial centres

Global Financial Centres (GFCs) such as London, New York, and Singapore are full-service centres. They offer a complete range of markets, products and services to clients worldwide, along with advanced settlement and payments systems. All three support large hinterlands whether national (*i.e.*, New York) or regional (*e.g.*, London and Singapore). All have deep and liquid *national* financial markets. Their sources and users of funds are global and diverse. Their legal/regulatory frameworks are robust enough to safeguard the integrity of all principal-agent relationships and supervisory functions. GFCs generally borrow short from residents and non-residents and lend long mainly to non-residents. In terms of assets and trading volumes, London is the premier GFC, followed by New York. The key difference is that the proportion of international to domestic business is much greater in London.

The most recent entrant to the GFC club is, arguably, Singapore. When its financial services sector was confronted by the deregulation of Tokyo's markets in the mid-1980s, and when Hong Kong's future was rendered uncertain by the Anglo-Sino accord of 1981, the Singapore government responded by adopting a strategy aimed at creating a niche for Singapore in Asian and global IFS markets. It imported the best expertise, enhanced IFS support services, and adopted globally competitive tax and regulatory regimes. The success of these policies was reflected in global firms transferring their Asian regional financial operations from Tokyo and Hong Kong to Singapore through the 1990s. Singapore also looked west and took steps to encourage the emergence of a non-deliverable forwards market on the INR. It is now actively gearing its IFS industry to capture a larger market share of Indian IFS business.

6.2. Regional financial centres

The phrase ***regional financial centre*** causes some confusion because it is commonly used in two different senses: (a) when a particular IFC actually serves not just its national economy but its surrounding neighbourhood region – it is genuinely a RFC – and probably derives more IFS business from its neighbourhood than from its own economy; and (b) while an IFC may be *regional* in the sense of being located in a particular region – it may not necessarily serve that region but be confined to serving its own economy instead. This report tries to avoid that confusion by accepting only the first definition and disregarding the second.

For example, Paris and Frankfurt are *European* IFCs. But they do not provide IFS for the EU to the extent London does. In the same way, Tokyo is an *Asian* IFC. But Singapore and Hong Kong serve more Asian economies with a wider range of IFS except for the global market for JPY denominated bonds, which Tokyo dominates. Paris, Frankfurt and Tokyo are not, in our definition, RFCs. They are more national than regional in orientation. RFCs differ from GFCs in that they have reasonably developed financial markets and infrastructure; but they are not as sophisticated, wide or deep as GFCs. They intermediate funds in and out of their region, but they have relatively small domestic economies (compared with their regions) and are not as globally competitive as GFCs. Regional centres include IFCs such as Hong Kong and Dubai.

London and Singapore are RFCs in a way that Frankfurt, Paris and Tokyo are not. New York also serves the North American and Latin American regions. But all three centres go well beyond serving their neighbourhoods to serving the world; so we classify them as GFCs. Paris and Frankfurt serve the IFS needs of the French and German economies. Paris also serves, to a limited extent, the Francophone world while Frankfurt is becoming an increasingly useful IFC to neighbouring Eastern European economies. But neither are RFCs, nor GFCs, as yet.

This digression was necessary because **HPEC was tasked to look into making Mumbai a 'regional financial centre'. But the Committee has deliberately chosen to avoid using that nomenclature because of its implications and connotations**.

Under present circumstances, it is difficult to see Mumbai becoming a RFC of choice for the South Asian region. India's immediate neighbours may, for geopolitical reasons, prefer to use Dubai or Singapore instead for their IFS needs. So, while Mumbai is located in South Asia, it is unlikely to become a South Asian RFC in the foreseeable future. Instead, the HPEC believes that it is more likely to leapfrog from emerging as an IFC that serves India, into becoming a GFC that serves the world, without serving its South Asian neighbourhood along the way. In that sense Mumbai's emergence as a GFC may be different from that of London, New York and Singapore which are all RFCs as well as GFCs. Whether Mumbai becomes a GFC depends on whether the preconditions necessary for it to play that role are met by the concerned authorities. The irony is that if South Asia's geopolitics are eventually ironed out, and reach an equilibrium that permits meaningful economic interaction, Mumbai may become an RFC *after* it has achieved GFC status.

6.3. Offshore financial centres

OFCs comprise a third category of IFC. They are smaller, and provide more limited specialist services in the areas of tax, transfer

Box 1.1: *Examples of Uses of Offshore Financial Centres (OFCs)*

Offshore banking licenses: A multinational corporation sets up an offshore bank to handle its foreign exchange operations or to facilitate financing an international joint venture. An onshore bank establishes a wholly owned subsidiary in an OFC to provide offshore fund administration services (*e.g.*, integrated global custody, fund accounting, fund administration, and transfer agent services). The owner of a regulated onshore bank establishes a sister parallel bank in an OFC. The attractions of the OFC may include no capital tax, no withholding tax on dividends or interest, no tax on transfers, no corporation tax, no capital gains tax, no exchange controls, light regulation and supervision, less stringent reporting requirements, and less stringent trading restrictions.

Offshore corporations or international business corporations (IBCs): are limited liability vehicles registered in an OFC. They may be used to own and operate businesses, issue shares, bonds, or raise capital in other ways. They can be used to create complex financial structures. In many OFCs, the costs of setting up IBCs are minimal. They are generally exempt from all taxes and, for that reason, are a popular vehicle for managing investment funds.

Insurance companies: A commercial corporation establishes a captive insurance company in an OFC to manage risk and minimize taxes. An onshore insurance company establishes a subsidiary in an OFC to reinsure certain risks underwritten by the parent and reduce overall reserve and capital requirements. An onshore reinsurance company incorporates a subsidiary in an OFC to reinsure catastrophic risks. The attractions of an OFC in these circumstances include favourable income/withholding/capital tax regime and low or weakly enforced actuarial reserve requirements and capital standards.

Special purpose vehicles: One of the most rapidly growing activities in OFCs is the use of special purpose vehicles (SPV) to avail of a more favourable tax environment. An onshore corporation establishes an IBC in an offshore centre to engage in a specific activity. Issuance of asset-backed securities is the most frequently cited activity of SPVs. The onshore corporation may assign a set of assets to the offshore SPV (*e.g.*,, a portfolio of mortgages, loans credit card receivables). The SPV then offers a variety of securities to investors based on the underlying assets. The SPV, and hence the onshore parent, benefit from the favourable tax treatment in the OFC.

Tax planning: Wealthy individuals make use of favourable tax environments in, and tax treaties with, OFCs, often involving offshore companies, trusts, and foundations. There is a range of schemes that, while legally defensible, rely on complexity and ambiguity, often involving types of trusts not available in the client's country of residence. Multinational companies route activities through low tax OFCs to minimize their total tax bill through transfer pricing.

Tax evasion and money laundering: Individuals and enterprises rely on banking secrecy to avoid declaring assets and income to the relevant tax authorities. Those moving money gained from illegal transaction also seek maximum secrecy from tax and criminal investigation.

Asset management and protection: Wealthy individuals and enterprises in countries with weak economies and fragile banking systems keep assets overseas to protect them against the collapse of domestic currencies and banks, and outside the reach of existing or potential exchange controls. If these individuals seek confidentiality, then an account in an OFC is often the vehicle of choice.

Source: Financial Stability Forum's Working Group on Offshore Financial Centres Report (April 2000).

pricing, wealth management and private banking. Offshore finance is, at its simplest, the provision of financial services by banks and other agents to non-residents. These services include borrowing money from non-residents and lending to non-residents. This can take the form of lending to corporates and other financial institutions, funded by liabilities to offices of the lending bank elsewhere, or to market participants. It can also take the form of the taking of deposits from individuals and investing them elsewhere.

OFCs are typically found in the island economies of the North Atlantic, Caribbean, Indian and Pacific Oceans as well as in a few exotic European jurisdictions (*e.g.*, Andorra, Monaco, Lichtenstein and of course Switzerland). They range from large and well-established private banking centres like Switzerland – that provide specialist and skilled wealth and asset management activities, attractive to major financial institutions – to smaller, more lightly regulated centres that provide services to high-net worth individuals and small companies or trusts. They are almost entirely tax driven. They have limited resources to support financial intermediation. Many of the financial institutions registered in OFCs have little or no physical presence beyond a nameplate; although that is not the case for all OFCs. They are mainly providers of corporate and accounting services for 'passively managed' offshore accounts.

7. Why did Tokyo and Frankfurt not emerge as credible GFCs?

In considering the prospects for Mumbai as an IFC, and later as a GFC, it is instructive to examine why Frankfurt and Tokyo did not become successful GFCs? Tokyo is located in the world's second largest economy, measured in nominal USD. Frankfurt was located in the world's third largest national economy (till China overtook it in 2005). It is at the centre of the world's largest regional economy – the EU. So why did these two centres not become GFCs despite their hinterlands while London and Singapore did?

One explanation lies in historical IFS demand from a large hinterland (home or regional) capital market that is *more sophisticated*, *better regulated* and more *sensibly taxed*, than elsewhere. This allows financial firms to diversify and exploit economies of scale to become globally competitive while being able to offer services that are not over-taxed. It explains London's and New York's success as GFCs because their financial firms (mainly investment banks and asset managers) developed by serving the largest, most sophisticated and most demanding capital markets in the world.

It also explains why Tokyo (with its huge but unsophisticated and tightly regulated domestic market) and Frankfurt (with its heavily taxed home market) have not succeeded in emulating them. Both Frankfurt and Tokyo are centres in economies with more traditional, rigid *bank-dominated* rather than *capital market dominated* financial systems; resulting in their being relatively uncompetitive. Their banks have not developed the same institutional capabilities for inducing financial innovation as more capital-market institutions in the US and UK have.

Tokyo's example is instructive for Mumbai. Tokyo possessed many of the attributes needed to rise to global prominence. But it was unable to capitalize on them. Powered by Japan's economic strength and external surpluses, Tokyo achieved GFC status in the late 1980s, when the top global investment banks and brokerages headquartered their Asian operations there. Indeed, the global capital market could not ignore Japan's enormous surplus assets in public and private savings. Nor could the world go anywhere else to issue bonds or raise funds denominated in JPY.

The bursting of the real estate bubble, and Japan's economic decline since 1990, ended Tokyo's rise. The city lost business to competing centres. But its role as a GFC was circumscribed even without the crisis. Barriers to competition and lack of openness restricted its potential. Although Japan deregulated its financial system, as the UK and USA did in the 1970s and 1980s, it left residual controls in place. Its regulatory mindset did not change. Japan's financial markets and institutions were sharply segmented and segregated. New financial products had to be approved by the MoF, which banned instruments that were commonplace elsewhere, such as OTC equity options. Banks were not allowed to fail, however weak.

Japan's Big Bang reform program in the mid-1990s to deregulate the financial system had a positive effect. A collapse in domestic prices and the value of the JPY made Japanese firms and real estate attractive targets for foreign investors. More of Japan's assets and business came under international management. However, its reforms did not go far enough. Tokyo still lacks the right combination of human and market resources for producing and exporting sophisticated financial services.

Tokyo functions as a large financial plantation, producing a commodity – money – in huge amounts. But it lets London and New York process that commodity and add value to it. Thus, while Tokyo has many of the ingredients needed for a GFC, it has not unfettered its institutions nor deregulated its financial system properly. It has protected its banks at the expense of its capital markets. It has not attracted foreign institutions, in a way that encourages more competition and financial innovation. Equally importantly, Tokyo does not use English as its *lingua franca*. It has a mono-cultural environment that inhibits it from becoming a genuinely global city. But Japan is reviving again and may learn from its mistakes. For that reason it would be premature to dismiss the prospect that Tokyo may yet emerge as a GFC although Japan's outlook would need to change dramatically for that to happen.

Frankfurt, for different reasons, also does not pose a challenge to London and New York. Initially it was thought that London would be eclipsed by Frankfurt as Europe's GFC because Britain did not adopt

Box 1.2: *How London lost the German interest rate futures market*

The German bond market is one of the world's most liquid and diversified capital markets. Trading on the "Bund futures" began at London International Financial Futures Exchange (LIFFE) in September 1988. It was a futures contract based on notional German Government bond with a 4% coupon and a maturity between 8.5 and 10.5 years. By 1990, the Bund futures contract accounted for almost one third of the total volume on LIFFE. Trading at LIFFE was then carried out by open outcry. Bund futures trading was also initiated at Deutsche Terminborse (DTB) at Frankfurt in Spring 1990, but this market failed to gain liquidity; LIFFE remained the dominant exchange.

In March 1996, DTB provided screen-based trading in London, competing against the open outcry trading at LIFFE. At the time, LIFFE continued to insist that pre-computer trading mechanisms were superior.

In early 1997, the Eurex futures and options exchange was created by a merger of Germany's DTB and the Swiss Options and Financial Futures Exchange. In March 1997, the US CFTC gave Eurex permissions to place trading terminals in the US. By October 1997, 10 firms in the US had terminals, and accounted for 18% of Eurex Bund futures volume. In August 1997, Eurex extended trading hours to match those of LIFFE. In September 1997, Eurex announced that until the end of 1997, fees on Bund futures trading on Eurex would be zero. In January 1998, Eurex introduced a new pricing structure which effectively set the marginal cost of trading to zero for medium and large traders.

From January 1998 onwards, LIFFE started losing market share. Even though the impact cost on LIFFE was at first superior, the lower charges at Eurex were big enough to sway some of the order flow to shift from LIFFE to Eurex. The trade processing efficiencies on Eurex were sufficiently large to overcome LIFFE's initial liquidity advantage. Once this started happening, the order flow started shifting and impact cost on Eurex started improving.

In early 1997, 65% of Bund futures trading took place on LIFFE. By the end of 1997, market share was roughly 50–50. Over the next 21 months, market share was decisively lost by LIFFE. By late 1998, the 10-year Bund futures contract traded on the Eurex was the third most actively traded derivative in the world, after Treasury bond futures on the CBOT and Eurodollar futures on the Chicago Mercantile Exchange. In 1999, the Eurex Bund futures contract became the biggest contract in the world.

LIFFE was stung by this loss of a lucrative contract, and abandoned manual trading. But by this time, merely matching the electronic system at Eurex was not enough to bring the liquidity back to LIFFE. From 1972 onwards, the financial community had engaged in a debate about the merits of electronic trading as opposed to trading floors or telephone calls. The Eurex versus LIFFE story on the Bund futures in 1998 marked the end of this debate.

The loss of the Bund futures contract set off substantial soul searching in the UK about the failures of LIFFE and of public policy which led to this debacle. The loss of this contract led to a substantial decline in revenues of UK finance. These events formed the backdrop and helped provide impetus for the major reforms to the Bank of England and the FSA in 1998.

the Euro. The presence of the European Central Bank (ECB) was a significant development for Frankfurt. It bolstered the city's international reputation and enhanced its importance as a financial centre. Frankfurt profited from German financial market reforms as well as European integration; and especially from the accession of contiguous Eastern European countries formerly in the ambit of the Soviet bloc. In the future it is expected to be a bridgehead to Russia, the rest of Europe and Turkey. However, Frankfurt lags behind London and New York in terms of most GFC criteria – regulation, taxation, asset management expertise, securities trading, and banking. Like Tokyo its language is not English. Nor is it a global city on the same scale as the other GFCs. London has a great edge because of its established global networks and historical interdependencies with the rest of the world.

The 'decentralization' of Germany (into *lander* or states) has also worked to the disadvantage of Frankfurt as an IFC. Not all German banks are headquartered in Frankfurt. Non-German banks in the EU have a larger presence in London than in Frankfurt. Focused IFS activities at one centralized location are important for the development of a GFC. Businesses that are clustered in a confined geography gain from one another by deriving external economies of scale. By crowding together, they create large, liquid markets that drive down trading costs and reduce risks by allowing large deals to be handled. Frankfurt has not benefited from a process of national consolidation for providing IFS. It could, possibly, head a secondary network of smaller European IFCs.

8. The Race to establish more IFCs around the world

Since 1970, the resurgence of the European, Japanese and East Asian economies and the revival of petrodollar surpluses has resulted in a plethora of IFCs (of some form or other) blossoming in other major (but not all global) cities including the following:

* San Francisco, Los Angeles, Chicago, Philadelphia, Boston, and Miami in the US
* Santiago, Sao Paulo, Buenos Aires, and

Montevideo in Latin America

* A large number of islands in the Caribbean (*e.g.*, The Bahamas, Caymans, Barbados *etc.*.)
* Amsterdam, Frankfurt, Luxembourg, Paris and Milan in Europe
* Tokyo, Hong Kong, Shanghai, Labuan, Jakarta, Bangkok, Seoul, and Taipei in East Asia
* Sydney in the Antipodes
* Bahrain, Dubai, Kuwait, Riyadh, Doha and Muscat in the Persian Gulf
* Johannesburg, Gaborone, Mauritius and the Seychelles in sub-Saharan Africa

The race amongst cities to establish themselves as IFCs has intensified. Cities in emerging economies look upon having an IFC as a relatively low-opportunity-cost initiative worthy of government support. The apparent ease of establishing an IFC and the promise of high value-addition have prompted many countries to create IFCs to increase the contribution of their financial services sectors to output, employment and exports.

In the Middle East, several governments have been competing to establish RFCs. At present Bahrain, Abu Dhabi, Dubai, Qatar and Muscat are all vying for that stature in the Gulf. The earliest entrant, Bahrain, went for an IFC because it was faced with stagnation of its offshore-banking business and felt pressed to introduce a series of reforms to attract more investment. The government of Abu Dhabi – anxious to diversify its economy beyond oil and to create jobs in the private sector – declared in 2005 that it planned to develop an IFC. Incentives were offered, such as a zero company tax, full repatriation of all profits and capital, free import of labour, and no forced local partnership requirements. Banks were exempt from reserve requirements.

Dubai, which has become the region's busiest services hub, may yet become the most successful RFC in the Gulf. The emirate has successfully transformed itself from a small-scale oil producer into a regional services hub in just 20 years. Its free zone has achieved a critical mass of importers, traders and light manufacturers. DIFC came into existence in September 2004, offering a wide range of services, and generous fiscal incentives and other benefits. It has strong commercial connections internationally and with India, the upcoming giant in Dubai's near neighbourhood. Indeed, DIFC is likely to be a competitor for some IFS to an IFC in Mumbai.

With the Asia-Pacific region registering high rates of economic growth, its economies deregulated their financial sectors during the 1980s and attracted substantial inflows of foreign capital in search of investment opportunities. As a result, financial markets in many of these countries expanded rapidly. Apart from well-established IFCs in the region – Hong Kong, Singapore, and Tokyo – a successful financial reform programme during the 1980s led to the emergence of Sydney as a potential rival.

The perceived benefits of an IFC have attracted other Asian countries such as: Korea, Indonesia, Taiwan, Thailand, Malaysia, and the People's Republic of China (PRC) to launch new initiatives for capturing IFS business, at the beginning of the 1990s. The South Korean government announced its Northeast Asian Financial Hub in Seoul and, in July 2005, published a detailed action plan aimed at achieving this goal.

There has also been an explosion in the number of small enclave tax-haven OFCs around the world providing more limited services. But these are not germane in the context of the kind of IFC that India must develop now.

9. Implications for India and need for Mumbai to emerge as an IFC

A retrospective look at the evolution of IFS from 1945 onwards, and particularly from 1971 onwards, suggests three major differences between the first and second rounds of globalisation where international finance is concerned:

1. Global finance has been transformed by the combination of better data, com-

puters, communications, and analytical financial economics; which has resulted in improved financial risk management. These factors have generated a worldwide shift away from bank-dominated finance to securities markets.

2. The supposed stability of the gold standard that shaped the first round of globalization has been absent after 1971. The abandonment of that anchor was disconcerting at first for central bankers and financial markets. Now the world is coming to recognize that having a gold standard may be anachronistic if not antediluvian. The modern consensus holds that the right anchor for fiat money is the CPI-basket, *i.e.*, that monetary policy should be tied down by inflation targeting. After centuries of exploration, it appears that we now know the correct technique for creating fiat money. Floating exchange rates, open capital accounts, and inflation targeting monetary policy which stabilises the local business cycle are now the reality pervading and shaping international economics and finance in the second globalization. Every developing country faces the task of mastering the institutional dance that is required to pull off this combination.

3. IFS production is now dispersed across a number of GFCs, RFCs, IFCs and OFCs spread across the globe. But it is still concentrated mostly in the developed world. This was unlike the first globalization, where London was clearly the dominant IFC. There is a striking difference between financial services production, and that of most other goods and services, in that the bulk of global financial services production takes place at a few IFCs in what have come to be known as *global cities*.

What can usefully be deduced from this brief history of IFCs, in the context of India rapidly becoming one of the world's most significant economies post-1991? How should India cope as a third and more intense phase of globalization emerges with India and China playing key roles? Simply put, the main deductions are these:

* Given its present role and size in the world economy India is becoming a major user of IFS. The locus of the world economy is increasingly shifting to Asia, the home of Japan, China, India and ASEAN. Soon, trans-Himalayan and trans-Malaccan trade will rival trans-Atlantic and trans-Pacific trade in size and global importance.
* As that happens, India's needs (as well as those of its Asian trading partners, most importantly China) for IFS will grow exponentially as global trade and investment (and intra-Asian trade and investment) account for a larger proportion of its economy.
* India cannot afford to remain a *taker* of IFS from the global market indefinitely as its needs for such services grow. Like the US, the EU and Japan, India must develop its own IFS-provision capability as an essential concomitant of its growing role in the world economy. So must China, although China is already able to rely on a world-class financial centre in Hong Kong, and to a lesser extent by Singapore (which serves the regional ASEAN economy even more).
* India has emerged in the world as a competitive, reliable provider of IT services. The provision of IFS on a competitive basis to the global economy is highly dependent on IT capability and an endowment of human capital that is numerate, adept mathematically and entrepreneurially inclined. Given the critical importance of those ingredients, IFS provision is an arena in which India has natural advantages for competing successfully. It would be making a major error in not developing its policy-making, operational and regulatory capacities to compete globally in the IFS arena as quickly as possible.
* India's aspiring to enter the market for globalised financial services provision is synonymous with India aspiring to have an IFC in Mumbai, that connects the Indian financial system with the global financial system. This is in contrast with conventional goods and services,

where production is dispersed across a very large number of locations across the world; financial services production requires clustering.

But what precisely is meant by developing IFS-provision capability via an IFC? An IFC provides individuals, institutions of various types (including most importantly productive commercial corporations) and governments (sovereign and sub-sovereign) with a wide range of financial products and services through an array of appropriate institutions and markets that are regulated in consonance with recognized international best practices.

These financial products and services include: banking, insurance, short and long-term asset management, private wealth management, corporate treasury management, and, most importantly, a well structured and fully developed capital market (with its array of institutional appurtenances in terms of brokers, dealers, exchanges and regulators) for debt, equities, commodities as well as risk management through derivatives. To become a player and compete in the IFC space, India will need to build requisite infrastructure (institutional and physical) and harness the skills and expertise needed to launch these products and services. Mumbai's prominence as the capital of Indian finance, the existence of exchange infrastructure, and its supply of skilled manpower, makes it a natural contender as an IFC.

9.1. The SEZ model as an Alternative for an IFC in Mumbai

In discussions on creating an Indian IFC in Mumbai, its location in a Special Economic Zone (SEZ) in Navi Mumbai has been aggressively promoted by enthusiastic SEZ developers as the best, if not the only, alternative. In the Indian context, a SEZ is a sequestered or quarantined geographical area operating under a framework of economic laws and tax exemptions that are more liberal than the country's typical economic laws. The raison d'etre for establishing SEZs is to accelerate the inflow of private investment (domestic and foreign) into developing infrastructure more rapidly – and thus to galvanise further investment in productive activity (especially in encouraging the faster and larger exports of goods and services) – than would otherwise be the case.

The argument for having SEZs in India is based on the claim that it is too difficult for various levels of government to propose and implement the policy changes needed to make that happen on an India-wide basis; because of the diversity of views in its plural and democratic system.

Thus the SEZ approach is a strategy of '*change management by exception*' rather than a strategy of managing change through country-wide inclusion. Opponents of this 'change management by privileged exception' strategy argue that the downsides of a SEZ strategy outweigh any benefits for the following reasons:

* *First*, SEZs will worsen rather than ameliorate the egregious degree of 'development concentration' in new privately governed urban areas.
* *Second*, SEZs may create enclaves owned and run by India's major corporations – that are self-governing, autonomous and exempt from normal rules. Thus SEZs will create immense scope for regulatory and legal arbitrage that may prove quite difficult to manage.
* *Third*, SEZs will result in the fragmented, incoherent and sub-optimal development of infrastructure rather than having it develop it on a more optimal area wide basis for capturing essential economies of scale.
* *Fourth*, SEZs open up opportunities for malfeasance through property development that has become the new channel for rent-seeking and realising speculative capital gains. At the same time, such developments will create inequities for small landholders compelled to yield land for SEZ development.
* *Fifth*, SEZs are likely to result in a net loss to the exchequer that the inflow of incremental investment – and any indirect public revenue benefits that may accrue therefore – will not offset to any reasonable degree.

SEZs have been established in several countries, including the People's Republic of China, India, Iran, Jordan, Poland, Kazakhstan, the Philippines and Russia. North Korea has attempted this to a degree, but failed. But, these SEZs have generally been large in size, limited in scope, and less fragmented than the SEZs approved in India. Also, they have been mainly restricted to the bonded production of *goods* for export with the movement of inputs and outputs from SEZ boundaries being tightly controlled to prevent leakage and arbitrage opportunities vis-à-vis the local economy. Many SEZs in India meet those stringent tests. But many do not.

Proponents of the SEZ approach to IFS provision argue that the fastest way to make progress in establishing an IFC is to suspend Indian capital controls and repressive financial policy for a zone of about 20-50 square kilometres. That special financial zone would, for all intents and purposes, be cut off from the rest of India for the SEZ strategy to be compatible with continued capital controls and financial repression in the domestic financial system. The argument is also made that a SEZ would have world class urban infrastructure and thus bypass the intractable urban infrastructure deficit and the enormous governance problems of Mumbai.

But, the difficulties with this approach are threefold:

1. A key strength underlying an Indian attempt to establish an IFC is the economies of scale obtained by virtue of having a trillion-dollar GDP as the home market. If an enclave approach is used, India's hinterland advantage is lost. The enclave would be required to restrict itself to dealing only with non-resident clients and transacting in all convertible currencies but not in the INR.
2. It is easy to think of a SEZ where capital controls are absent – this requires stroke of the pen reforms that remove hindrances faced by firms and individuals. But it is harder to have a SEZ where financial repression is absent. An IFC located in an SEZ would still need to have its operations and transactions governed by a world-class framework of financial sector policy formulation and regulation. It cannot operate in a regulatory vacuum. A SEZ that is not regulated by internationally acceptable regulators will not be respected by customers of IFS globally and will fail to attract business. If an effort has to be made to build world class financial sector competencies, and regulatory capacity for a SEZ, such an effort would better be directed to India as a whole rather than just to the SEZ.
3. A substantial additional inspector *raj* will inevitably need to be created, surrounding the SEZ, to avoid leakages of financial products and services between the SEZ and the 'Indian mainland'. When a free trade zone like SEEPZ was created, inspectors were used to ensure that physical goods did not flow between SEEPZ and India. Preventing flows of capital and international financial services is more difficult. It will require a correspondingly onerous inspector *raj* that will vitiate having an IFC in a SEZ in the first place.

In the Committee's view the disadvantages of having an IFC in Mumbai located in a SEZ outweigh any conceivable advantages. Rather than facilitate start-up, a SEZ based IFC will compromise development of the kind of IFC that India needs – *i.e.*, one that is rooted in its own financial system. It will create opportunities for arbitrage between dual financial regimes. It will complicate the process of financial regulatory liberalisation and have a counter-productive effect in delaying changes in the regulatory system. It may involve external regulatory authorities wishing to intervene in regulating IFS offered via a SEZ, thus compromising Indian regulatory sovereignty. It will delay the swifter removal of capital controls throughout the Indian economy. It will result in an IFC not yielding public revenues from the outset and obtaining fiscal protection that it does not need. An SEZ-based IFC would be an artifice that would detract from global credibility. It may facilitate more BPO/KPO in finance; but it will prevent or delay the provision of broad-based IFS.

A SEZ-based IFC, that sought to sidestep India's capital controls and financial regulation would, in the opinion of the HPEC, not be the right path for India to take in establishing an IFC in Mumbai. The right way would be to make Mumbai an IFC and a global city by making the urgent adjustments that are needed to: (a) *financial* policies, structures, institutions, markets and to financial regulatory and governance regimes; as well as to (b) Mumbai's urban infrastructure and governance.

Interestingly enough, there may be some symbiosis between: (a) a narrower notion of a SEZ located near Mumbai; and (b) the initiative to make Mumbai an IFC.

If good quality urban infrastructure develops in a SEZ close to Mumbai, and if – quite separately – Mumbai has made some progress towards establishing a credible IFC, then many financial firms (and their employees) might choose, of their own accord, to locate in an SEZ with superior facilities. In this sense, a SEZ orientated towards improving the quality of urban infrastructure in the proximity of Mumbai – without requiring as a precondition that an IFC must be located within it from the outset – may turn out to complement the goal of creating an IFC in Mumbai.

Financial firms located in Mumbai for the purpose of providing IFS may decide voluntarily to relocate to the SEZ simply for reasons of convenience in enjoying better quality infrastructure rather than to escape draconian regulation. That would mean that the regulatory regime that applied to them in Mumbai would apply to them in the SEZ as well.