MODULE 2 – The Growth

Introduction

In this module the growth of IB will be discussed regarding the menu of financial services that was offered throughout its development. The role played by the laws and regulatory agencies that were enacted for providing checks and balances in the operation of IB, and the roles of the different economic models played in its growth and development from the contemporaries to the present time will be discussed. Also, we will discuss how the role that the Internet has played from its inception is changing the total picture of the type of growth, due to globalization, for every aspect of the financial market and economic system, and hence IB.

Objectives

Upon successful completion of this module, the student should be able to:

- Describe the financial services provided by IB.
- Examine the roles different laws and regulatory agencies played in the growth of IB.
- Identify the role that the Internet played in facilitating IB activities, especially in the capital market.
- Examine the financial intermediaries’ role in monetary policy decisions.

As far as the history of international banks is concerned, it goes way back to the Middle Ages when Italian merchants set the foundation for trading activities through lending and borrowing throughout southern Europe and beyond. As businesses grew and commercial activity expanded, some form of IB entities were gradually shaped. This activity complimented the continuous growth of business and commercial activity, especially in the European continent. Since domestic and international trade without a financial intermediary is not possible, this led to the growth of international banks in the European continent and beyond.

To define IB, we can summarize it as such: IB is banking activity, such as making loans and financial involvement in the worldwide securities, trading and exchange markets. When a bank’s operations and financial activities are taken beyond its domestic boundaries, the bank becomes internationally involved, and therefore it is called an international bank.

The other factor that played an important role in the growth of IB was the availability of a large amount of US denominated deposits in foreign countries, which in financial terms are known as Eurodollars. To tap into those large deposits, American banks branched out in different parts of the globe in order to have access to that pool of deposits. Access to these reserves was the catalyst for international banks to become active in international capital and bond markets.

Another important issue for the growth of IB, especially US banking, was removal of the limitations that were imposed by regulations on US banking institutions. For example, we can look at the Glass-Steagall Act. For further information, please see Footnote #1. As we know, the US economy experienced a serious downturn in 1929, also known as the Great Depression. The US economy was guided by the economic model known as the Classical Economic Model. In this model, two main forces directed the market in determining the output and the pricing
system: supply and demand. Furthermore, the idea of the Invisible Hand (liaise-fair) prevented any regulatory institution from interfering in the market. After the Great Depression, the Classical Economic Model was blamed, especially in the notion that no regulatory institution can prevent any fluctuation that occurs in aggregate economic activity. This also applied to the banking institutions that were mainly blamed for the crash of 1929. Therefore, it was concluded that the banking system needed to be regulated in order to separate a bank’s securities market activities from its general banking operation. With that note, the Glass-Steagall Act was enacted to serve two purposes: 1) separating traditional banking operations from securities market activities and capital preservation, and 2) establishing the Federal Deposit Insurance Corporation (FDIC). **For further information, please see Footnote #2.**

The fundamental purpose beyond enactment of this Act was to enhance public confidence in the banking industry, since there were several bank panics in the early 20th century. To avoid and escape these regulatory limitations imposed by the Glass-Steagall Act, some American banks branched out throughout the world, especially in major economic hubs, such as the European continent. This Act fulfilled its purpose throughout the 20th century but, in a way, limited competition and innovation in banking and the securities market. There were several attempts to repeal this Act since its inception, and it was eventually repealed in 1999.

As we noted before, during the decades of the ’80s and ’90s, competition among international banks increased drastically. The presence of Japanese banks and their subsidiaries throughout the world and the resurrection of the European banks were the causes of the said competition. Therefore, their economic influence expanded among the developing nations and thus increased consortium lending activities. This generated economic and trading activities by multinational corporations in developing nations, facilitated by IB’s involvement in lending and trading activities.

The growth of IB necessitated a series of agreements among nations to facilitate IB activities. These agreements were also catalysts for growth of IB in Western Europe, Canada, Japan, the United States and some other economic hubs throughout the globe. One example is the Basel Agreement, named after the city of Basel in Switzerland. **For further information, please see Footnote #3.**

IB capital adequacy guidelines were the major issue that was agreed upon among the participating nations. With this, the era of downsizing began for many international banks. Capital adequacy guidelines forced international banks to strengthen their capital bases and conduct more business with sovereign nations which required less allocations of capital for private loans. **For further information, please see Footnote #4.**

The Bretton Woods Agreement also set up the International Bank for Reconstruction and Development, commonly referred to as the World Bank (WB). Headquartered in Washington DC, it provides long-term loans to help developing countries build economic infrastructures and other physical capital that contribute to their economic development. The WB raises capital by issuing bonds throughout the financial world that are sold in the capital markets in major developing countries. **For further information, please see Footnote #5.**
World War II ravaged the European continent, and the economic ripple effect spilled over into many developing nations that were dependent on the European economy. It was agreed at the Bretton Woods Conference that the World Bank’s focal point and orientation would be to help in building ravaged economies and contributing to the overall economic development of the nations. Whether the institution of the World Bank fulfilled its purpose or not is yet to be agreed upon and debated by many schools of thought in the political and academic arenas, since there are many disagreements with the policies of the World Bank that apply within developing nations. The disagreements sometimes manifest themselves in the form of protests, which sometimes turn out to be violent, regardless of where this body meets. Eventually, in 2000, the Millennium Development Goals were set and agreed upon. For further information, please see Footnote #6.

Like all other changes and evolutionary processes that have occurred in the industrial sector in advanced and emerging economic societies, such as North America, Europe, Southeast Asia, and some other economic hubs, IB activities have also changed drastically. International banks have gone through drastic changes in terms of how they conduct banking activities, and the major issues that they are facing, such as socio-political limitations, and how these ever changing economic, political and social changes will shape the future conduct of international banks in a world that is becoming smaller by the hour. The planet became a neighborhood overnight with the invention of the Internet. For further information, please see Footnote #7. For example, since the early ’90s, globalization has helped businesses and financial institutions like banks to offer different electronic services. Consequently, international trade has been impacted by this new medium. Therefore, we can easily conclude that the Internet has helped the globalization process and brought many nations financially and economically together. This, coupled with pockets of economic unions throughout the world, has created a situation where multi-national corporations are doing business worldwide without limited boundaries or obstacles. These sudden changes of globalization and economic interdependencies among nations and trading partners forced IB to grow in line with these economic changes and trends. Also, geographical economic unions among the nations, for the purpose of competition and trade in the world economic arena, were a catalyst for the growth of IB. Advances in communications and computer technology have played an important role in the growth of IB. These advances helped banking activities to be conducted with much lower cost and need for human resources. As a result, the importance of financial activity via Internet was magnified, since international economic and trading activities necessitated fast access to the capital necessary for the said activities. Thus, international banks made a quantum leap in offering financial services, and hence their rapid growth.

As I mentioned above, this new mode of electronic communication (Internet) brought the planet closer together. International banks have been trying to adapt themselves to this new communication medium so they can provide services in this rapidly growing industry. IB is also facing growth in the money, capital and securities markets throughout the world. Economic interdependencies and the expansion of international trade were catalysts for this growth which brought competition for the money, capital and securities markets among international bankers. There is a global understanding in IB activities which dictates closer cooperation among the international and central banking institutions. This cooperation is absolutely necessary for all interested parties in order to see the smooth operation of international financial and trading
activities, whether they are situated in a geographical economic union, or span throughout the planet.

International banks, like all central banking, can also play a major intermediary role in international financial, economic and securities markets. As we know, a bank is a financial intermediary, which means its role is to bring economic entities with surpluses and deficits together.

Like every other industry, IB activities will continue to grow in this century along with trends and changes in the global economy. International banks contributed in many ways to the growth of international trade over the past several decades, and we can assume that their role in economic and financial activity will evolve in the ever-changing economic and international trade activities.

According to a simple economic model, saving and investment are the two (2) major factors that operate interdependently in order for consumers to consume, investors to hire factors of production, and so forth. Therefore, the role of the intermediary is important in bringing savers and investors together. International banks are very much interested in maintaining an intermediary role to improve the profit margin in international financial and economic activity. Thus, in the process of avoiding disintermediation, international banks are facing fierce competition in order to attract savers and investors in the international financial and capital markets.

We cannot separate the role of intermediaries, our economic system, and financial market from one another when making economic decisions. In other words, if you could draw a triangle, in one angle of the triangle would be the economic system operating. In another angle would be financial markets and the role of institutions. In the third angle we would have laws and regulations, and the managerial decisions in public and private entities. This interconnection between these three processes impacts the operation of IB. In the event that one of the above processes was corrupted by externalities, it would also influence the operation of the banking system. International banks must continuously adjust and adapt to changes in economic activity and the political system. For example, the collapse of the Soviet Union resulted in the convergence of the economic system in that nation and throughout Eastern Europe. To maintain competitiveness, international banks must continuously adapt to these economic and financial changes.

International banks are now involved in the undertaking of activities from which they were previously prohibited. This has brought a competitive ingredient into international trade and commerce, and it has its own shortcomings. The bank crashes and failures of the 80's in the United States, France and Scandinavia could be a good testimony to the convergence of banking activity in the past two (2) decades.

Finally, international banks, like commercial banks, need to be concerned about the cost of information, or the lack thereof, to avoid a situation known as asymmetric information. One can ask this question: why do savers need a financial intermediary to reach borrowers? Well, if you talk to any economist they will tell you that borrowers and lenders have different liquidity
preferences. The classical economist notion of liquidity differs from the Keynesian economic notion of liquidity, since Keynes promoted the idea that individual economic entities need liquid assets for the purpose of transaction, precautionary and speculative motives. Since there are different motivations and preferences from borrower to lender, all banks, including international banks, need to worry about information and the cost of obtaining it on a timely basis to avoid the emergence of adverse selection and moral hazard in their operation.

Conclusion

In this module, you learned about the growth of the financial services offered by IB. You learned about different laws and regulatory agencies that were established throughout the development of IB. You became familiar with the different economic models and the role of intermediaries in economic policy making processes. And finally, you learned about the role of the Internet in today’s IB.
FOOTNOTES

(1) Understanding How Glass-Steagall Act Impacts Investment Banking and the Role of Commercial Banks

(2) What Was the Glass-Steagall Act?
http://www.investopedia.com/articles/03/071603.asp

(3) Basel II
http://en.wikipedia.org/wiki/Basel_II#History

(4) Basel II Capital Accord
http://www.federalreserve.gov/generalinfo/basel2/default.htm

(5) 1944 – Bretton Woods Agreement: Developing a New International Monetary System

(6) The World Bank – Strategic Direction

(7) Safe Internet Banking
http://www.fdic.gov/bank/individual/online/safe.html