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The Merrill Lynch Center for the Study of International Financial Services and Markets

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The Director's View ...

George J. Papaioannou, Ph.D.

When a near financial collapse hit the economies of East Asia in 1997, few would have predicted that these same afflictions – self-dealing and crony capitalism – would find their way into the U.S. corporate/financial system less than five years later. Coming on the heels of the terrorist attacks of September 11 and the slowdown of the world economy, and amidst the severe financial crises of Argentina and Brazil, the recent corporate misdeeds have shaken people's trust in the market system and the American corporate model as a global paradigm of corporate governance.

The reaction to the failures of corporate governance has been equally severe. Market values have fallen precipitously, investment funds have left the U.S. markets, and new regulation and listing rules are placing additional burdens on corporations. Even worse is the contagion effect of the market and regulatory retaliation. They punish not only those who have committed or intend to commit misdeeds; they also punish those who behave responsibly. And herein lies the harmful effect of corporate irresponsibility on society and the economy at large. Although reliance on stricter laws and negative market reaction can contribute to greater corporate responsibility, the still large residual cost to the economic system warrants that societies cultivate and support stronger and more resilient market ethics as the first inhibitor of moral hazard problems.

The fallout of recent events has caused serious reexamination of several important matters that relate to the function of organizations and markets on a global scale. The alleged failure of financial analysts, investment and commercial banks, and auditors to disclose essential information and monitor their corporate clients has eroded public confidence in their ability to certify value. Information asymmetry models suggest that high-quality firms rely on reputable agents to signal value. The fact that allegations of financial misdeeds include some of the most reputable financial and accounting firms makes effective signaling all the more difficult and questionable.

Recent failures in corporate responsibility have hit the securities open markets hardest. The resultant fall in share prices and the need for closer monitoring by creditors may swing the pendulum again toward bank-based, as opposed to market-based, financing. This could have the potential to retard the growth of securities markets and securitization of illiquid claims around the world

Several of the recent irregularities involve integrated financial conglomerates, which became possible in the United States after passage of the Financial Services Modernization Act of 1999. The jury is still out on the question of whether in the absence of "fire walls," the incidence of excesses is the result of some sporadic and aberrant behavior or is endemic to the integration of financial services.

"American-style" managerial compensation such as stock and stock option allocations was supposed to motivate managers to seek shareholder value maximization. As this model started to gain ground abroad, recent events have given rise to contradictory views on the efficacy of this type of compensation. More critical is the emerging notion that the objective of value maximization is responsible, in part, for some of the recent excesses. What this view misses, however, is that value maximization is the reward for the efficient allocation of scarce economic resources. The market should have the ability to recognize which firms allocate resources most efficiently and reward these firms with maximum value. Recent events have shown that self-interest can motivate people to take actions that reduce the market's ability to serve its purpose and instead causes it to reward poorly performing firms with more value than they deserve. It is against this type of human behavior that we need protection, not the value maximization principle. The words of Socrates, responding to his disciple Kallikles, who advocated greed, are still pertinent: "Compare the soul of such a person to a sieve, because this kind of soul cannot hold anything and thus can never be full with a finite and limited amount of things."

IN THIS ISSUE ...

The Merrill Lynch Center Mission Statement:

"Established to promote and facilitate faculty and student study in the field of international financial services and markets and to communicate knowledge to the academic and business communities."

A Message From the Editor ...

Professor Gioia P. Bales, Merrill Lynch Center Coordinator

The content of this issue of the *Newsletter* reflects our growing commitment to the study of international financial services and markets. This academic year, it is our intention to expand the Center's activities by strengthening our information dissemination systems. New initiatives are currently underway to more effectively convey knowledge by focusing on Web-based development (see page 9).

In May 2002 the Merrill Lynch Center hosted a one-day conference on strategies for financial services firms in a global economy. A review of this conference, including a listing of distinguished speakers, appears on page 8. We were honored to begin this event with a breakfast presentation by Dr. Gerald Grisse, Minister of the European Delegation in Washington, D.C., and Permanent Representative of the European Central Bank to the International Monetary Fund. The text of his speech, "Financial Market Integration and Regulation in Europe: Perspectives for Financial Services Firms," begins below. Dr. Grisse's comments were indeed timely, given the profound ramifications and challenges that are presented to regulators by a single-currency system.

Dr. Wi Saeng Kim, a Merrill Lynch Center Associate, explores other areas of interest in his article titled "World Prosperity and Globalization" (see page 6).

In an effort to promote the scholarly achievements of our Associates, we have expanded our *Newsletter* to include a list of their recent publications and conference presentations (begins on page 9). Please contact us for copies of these works or any other information relating to the Center's activities.

Financial Market Integration and Regulation in Europe: Perspectives for Financial Services Firms

Extracted from a speech given by Dr. Gerald Grisse, Minister, European Delegation in Washington, D.C., and Permanent Representative of the European Central Bank to the International Monetary Fund, on May 6, 2002, at Hofstra University.

INTRODUCTION

In this discussion, I will investigate the progress that has been made until now for financial market integration. I will do so by making a distinction between different business areas as the degree of integration depends on the type of activity. Secondly, I will discuss what the implications are of increasing financial market integration for public authorities, in particular in terms of financial regulation and the institutional arrangements.

FINANCIAL MARKET INTEGRATION

Before assessing the present state of financial market integration in Europe, I would like to explain why the Eurosystem is interested in this area, and in particular in the integration of banking markets.

The Eurosystem, which consists of the ECB and the national central banks of the countries that have adopted the euro, has a special interest because the maintenance of price stability requires that monetary policy impulses be transmitted in a smooth way throughout the euro area by means of integrated and efficient financial markets. The banking sector, together with the unsecured money market and securities markets, plays a key role in this respect. Moreover, banks are key operators in the payment system and play a crucial role in financial stability because of their role as liquidity providers. Also the practical implementation of monetary policy in the euro area may be affected by the degree of integration of securities markets, since monetary policy operations are fully collateralised and therefore rely heavily on the smooth delivery of securities. **For all these reasons, enhanced banking and financial integration is likely to lead to a smoother transmission of the single monetary policy to the real economy. Central bankers have therefore a natural interest in an integrated banking and financial market.**

But how does such an integrated market manifest itself, and how can we measure it? According to a popular idea, a single banking industry will only emerge when cross-border mergers occur. By this standard, the European banking and financial industry

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shows only a low degree of integration as merger and acquisition activity has until now been predominantly domestic. However, using this standard can be misleading because it focuses rather excessively on the ownership structure.

A better approach consists of looking at market conditions in the euro area. If the euro area would really consist of an integrated market, one would expect that market conditions have become equalised for the users of financial services. This equalisation is usually evaluated in terms of prices, such that in an integrated market the "law of one price" should apply. This law-of-one-price yardstick is very useful when products are reasonably homogeneous and price data are readily available and comparable. Unfortunately, this is seldom the case in banking and other financial services, especially in the retail area.

A paradigm that better fits the specific features of banking is that of "contestable markets." A contestable market is one where there are no excessive costs of entry or exit. If entry barriers are not prohibitively high, incumbent firms are not in a position to charge excessively high prices to customers or maintain cost inefficiencies, since this would attract external suppliers. In line with this approach, the focus to assess integration would be more on cross-border entry and cross-border business flows.

Finally, although banks are identifiable as a well-defined type of firm, they are very clearly "multi-product entities." Various banking products are sold in different markets, which can be of different geographical coverage and can exhibit different degrees of integration. **This calls for differentiating the analysis by product categories, as I will do now by examining wholesale banking, capital market-related services, and retail banking services separately.**

Wholesale banking

In the bank-dominated financial system of continental Europe, the interbank transmission of liquidity among universal banking groups is the major component of wholesale activity. Unsecured deposits and corresponding derivative contracts make up the largest share of the overall interbank activity in euro, more than 70 percent. The remaining part consists of secured repo-transactions, whereby liquidity is exchanged against collateral.

In the unsecured interbank market, the law of one price apparently began to work within a few days of the launch of the euro, as the interbank rates fast became virtually identical in all countries. In parallel, major banks' cross-border interbank trades have increased substantially.

This very fast integration of the unsecured interbank market is supported by an efficiently working infrastructure for wholesale payments. TARGET, a payment system composed of one RTGS system in each of the 15 EU countries and the ECB payment mechanism, allows for a quick and efficient cross-border transfer of large-value payments. Another indication of uniform pricing and full integration is the quick adoption of indexes, such as the EONIA and the EURIBOR, which have become market benchmarks. **Concluding, one can therefore say that the European unsecured interbank market has become truly integrated.**

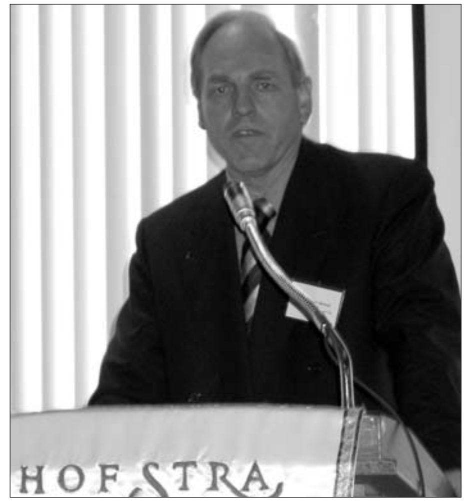
However, wider price differentials continue to prevail in the secured financing or repo-segment. These price differentials reflect the lower liquidity and remaining segmentation of the national markets, due to legal and fiscal obstacles in collateralised cross-border transactions and, in particular, difficulties in clearing and settling such transactions.

Capital market-related activities and services to large corporations

This is mainly due to the fact that business expansion across the single market does not require the establishment of a very wide delivery network, but rather involves contacts between large firms and financial intermediaries. Moreover, the activity is stimulated by the strong growth of European capital markets driven by the disappearance of obstacles such as differences in risk-free yield curves and foreign exchange risks. In 2000, for example, euro area companies issued 10 times more bonds than were issued in 1995.

Clear evidence of integration is that large intermediaries – which represent the major European banks and European offices of the U.S. investment banks – have progressively replaced domestic intermediaries. According to the data available from commercial databases, in 1995 domestic intermediaries were involved as a book runner in all of the major bond issues by euro area firms, but in 2000 this involvement dropped to only 6 out of 10 transactions. In 2000 a U.S. intermediary was involved in already about 8 out of 10 transactions, which demonstrates that U.S. firms had made quite aggressive inroads into the European market. In equity issuance, the national franchise has not yet been affected to the same extent, because of the greater importance of local information. Also with reference to syndicated loans, integration has increased, but to a lesser extent than in bond markets.

Even more direct evidence of greater integration and increased market contestability is provided by the decline in fees for investment



Dr. Gerald Grisse

banking services. Gross fees in underwriting and arranging securities issues by euro area resident firms have declined "trend-wise" for transactions of all sizes and different instruments, but in particular for large bond issues.

The still fragmented infrastructure for cross-border clearing and settlement of securities transactions represents a major obstacle to cross-border trading and the provision of related asset management services. Notwithstanding these impediments, the share of domestic investments by equity mutual funds in the euro area declined from 49 percent in 1997 to 32 percent in 2001, reflecting already significant diversification across borders.

Services offered to small and medium-sized enterprises and private individuals

These retail markets are becoming European at a significantly slower pace, and banks still have to get close to their customers through wide physical distribution networks. This feature can explain differences in interest rates even within the same country. It is important to note that these economic obstacles to integration are not peculiar to Europe, but reflect the nature of the retail business. According to a survey conducted by the Federal Reserve, more than 90 percent of banks' retail clientele is located within a distance of less than 20 miles of the banks' premises. Proximity is thus an intrinsic characteristic of the retail market, which is likely to make this market segment less affected by the emergence of a single currency.

Retail services cover a very wide range of services and can be quite heterogeneous across banks. As I said earlier, such market features would support the use of the "contestable market" paradigm to assess the advancement

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of market integration. In line with this approach, cross-border entry into the banking sector and cross-border business flows provide an indication of progress in integration.

Looking at the internationalisation of European banks within the single market via the establishment of branches, a clear increase can be seen in recent years. However, in terms of the market share in the target country, branches from other EU countries hold a relatively minor position of on average less than 5 percent of the total local banking assets.

The branching strategy implies high entry costs via the establishment of the delivery network and a customer base. Therefore, the most effective way of gaining access to the retail sector has been to merge or acquire an existing local bank. Cross-border mergers and acquisitions have until now been relatively rare, but not as few as is often suggested. Overall, during the past decade almost one-quarter of the total value of deals involving banks was accounted for by cross-border deals. Moreover, the importance of cross-border operations has been increasing over time. Hence, when looking at the ownership structures, the extent of foreign activity appears wider than suggested by the branching figures. For large European banks as a whole, the average foreign ownership is about one quarter of total banking capital. These ownership stakes are mostly held by other European banks.

Financial regulation and the institutional arrangements for prudential supervision and financial stability

The evidence discussed thus far points at a substantial progress in financial market integration after the introduction of the euro. This shows quite clearly that public policies have not prevented substantial changes from occurring. An argument frequently raised in the public debate, according to which institutional arrangements based on national competence and the remaining differences in national rulebooks in EU countries would significantly hinder the development of cross-border activities, thus preventing financial market integration, seems to be disproved by empirical evidence. **However, it would be a mistake to take the opposite stance, arguing that what has been done so far for the creation of the single market is enough, and no further efforts are needed. This is not the attitude of EU authorities, which are carefully reviewing the working of present institutional arrangements and promoting further progress in the harmonisation of the regulatory framework.**

There are two basic questions that EU authorities must address. The first relates to the steps that need to be made in order to remove obstacles to financial market integration stemming from public regulations. The second question concerns the adequacy of present institutional arrangements for prudential supervision and financial stability to deal with the challenges posed by financial market integration.

Removing regulatory obstacles to financial market integration

Before entering into a discussion of the regulatory obstacles to financial market integration, it is important to stress that differences across national institutional settings, rulebooks and supervisory practices are not, themselves, a hindrance to financial market integration. **As a matter of fact, the construction of the single market has been built upon the very notion of regulatory and supervisory competition among member states.** A member state where domestic regulations were more burdensome for financial services firms than in other EU countries was confronted with pressures from the industry, threats of relocation of financial activities abroad and fears of decreasing competitiveness of national financial centres. These pressures were very effective in pushing toward a simplification of the regulatory framework. They entailed the removal of regulatory barriers to the conduct of financial activities inherited from a distant past, which were maintaining significant geographic and product segmentation in the market for financial services, also within single countries.

In hindsight, the choice to rely on competition between national regulatory and supervisory frameworks was a wise one. It supported the main trends that have radically changed the European financial landscape in the last decade, favouring the blurring of frontiers between different financial products, the trend toward conglomeration and the increasing internationalisation of financial business. The extensive restructuring of the financial services industry in the second half of the 1990s could not have taken place without the support of national public policies, concerned about the competitiveness of their industry. In general terms, the European experience showed that an institutional framework providing all market participants with a menu of options as to the regulatory and supervisory setting, within some basic common principles, might prove less cumbersome and more effective in dealing with financial innovation and structural change.

Yet, the approach followed so far in the EU needs to be reviewed in light of the changes triggered by the introduction of the euro. The disappearance of exchange rate risk in the 12 countries participating in EMU highlighted some relevant remaining costs the regulatory environment are levying on financial market firms that do really want to operate on an area-wide basis.

There are three main areas in which improvements can be and are being achieved. First, there are areas in which further harmonisation of rules or practices would substantially alleviate the costs for financial firms operating cross-border. Second, the common rules are sometimes implemented inconsistently across countries. This could reinforce existing segmentations of markets, in particular in those sectors where the home country principle is not extensively applied. Third, the EU regulatory process is fairly rigid and cumbersome, so that it might face difficulties to keep pace with market developments.

The report of the Committee of Wise Men chaired by Alexandre Lamfalussy was the first to delve into these issues, with specific reference to securities markets.

The need for further harmonisation stems from the observation that issuers, intermediaries and investors now face a variety of costs for operating in more than one EU country. For instance, firms wishing to raise capital in other jurisdictions are still obliged to comply with different additional requirements in order to gain the approval of local regulatory authorities. Rules on disclosure of price-sensitive information differ greatly between member states, and accounting rules are not yet harmonised. Securities trading is still characterised by fragmentation, reflecting a host of national differences in market practices, regulation, tax and legal treatments. Major legal difficulties still hinder the cross-border use of collateral, which is creating problems in the development of a pan-European repo market.

But even if harmonisation were achieved in all the fields mentioned, differences in national implementation of common rules could still prevent the attainment of all the desired effects in terms of market integration and containment of costs for financial firms operating cross-border. This is particularly true in the securities field, where the application of the principles of minimum harmonisation, mutual recognition and home-country control have not provided the necessary workability between national legal systems, as compared with what has been accomplished in the provision of banking services. In fact, the protection of retail investors justifies that, in order to conduct business, investment firms must meet the requirements set by the host authorities. The preservation of fairly high diversity among national rules of conduct may have an adverse effect on cross-border competition and contribute to the segregation of markets, given that investment firms will prefer to concentrate their business in certain jurisdictions in order to limit their operational costs.

Both the industry and the EU authorities recently highlighted that regulations are not

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the only source of costs for cross-border activities in the EU. For instance, according to the so-called Gyllenhammer report, prepared by the European Financial Services Roundtable, increased convergence in supervisory practices and standardisation of reporting requirements could substantially reduce compliance costs of financial services firms operating throughout the area. Now basically the same information has to be forwarded to a number of authorities according to different definitions and reporting formats.

Finally, the EU regulatory process is far too slow and unable to keep up with the pace of change of dynamic financial markets. The procedure for adopting, updating and implementing regulatory initiatives through directives is extremely lengthy, since agreement among member states is difficult to achieve. It is sufficient to recall that the project for a directive on take-over bids is being discussed since the late 1980s. But even when political problems do not arise, it takes three years on average to agree on a regulation or directive, and delays often occur also in the transposition process by member states. Until recently, fast track mechanisms for updating community legislation to market changes were either unavailable or rarely adopted.

In all the areas mentioned, workable solutions are being devised.

- **The financial services action plan set out an ambitious program for filling the gaps in the EU regulatory framework, furthering harmonisation in important areas and removing regulatory obstacles to financial integration at the EU level.** The action plan has four strategic objectives: (1) a single EU wholesale market; (2) open and secure retail markets; (3) prudential rules and supervision; (4) optimal financial market. A detailed plan of directives and regulation is envisaged to pursue these objectives. Among other initiatives, the single passport for securities issuers, the directives on market abuse, collateral, take-over bids, distance marketing of financial services, conglomerates, winding down of banks and insurance companies, accounting, and taxation of interest income from cross-border investments could be mentioned as major examples of the effort in stepping up the harmonised part of the EU regulatory framework. The action plan was launched in 1999 and includes 42 measures, of which 26 have already been finalised.

- **The Committee of Wise Men on securities regulation has proposed a new and more flexible regulatory process that aims at ensuring consistent implementation of regulation at the national level.** The approach entails four levels. At the first level, directives and regulation will be issued focusing only on core principles, which are unlikely to need frequent updates. At the second level, a committee representing national regulators will define, propose and decide the implementing details of the framework principles. This will allow a speedy change in the technical details of directives and regulations, through a fast-track procedure. At the third level, national regulators working in a network will ensure consistent transposition and implementation of community legislation. The fourth level entails a strengthened enforcement of community rules, basically entrusted to the European Commission. It also envisages a system to report on the functioning of the legislative and regulatory processes, which should identify bottlenecks and assess whether there is real progress toward removing obstacles to financial market integration. In the first instances, the implementation of this approach in the securities field faced difficulties because of concerns raised by the European Parliament on the institutional balance. The establishment of strong accountability of the committees toward the European Parliament and the European Council, the high transparency of the regulatory process, which also entails open consultations with the industry, and the introduction of a time threshold for the validity of the rules issued via the new process favoured an agreement between all the European institutions. Now the process is being tested in the securities field and might in the near future be extended to banking and insurance.

Dr. Herman Berliner, Provost and Senior Vice President for Academic Affairs; Dr. Ralph Polimeni, Dean of Frank G. Zarb School of Business; Dr. Gerald Grisse; and Dr. George Papaioannou.

The number of reports on financial regulation and supervision commissioned and produced in the last two years attest to the effort to devise the best solution. The strong support of the recommendations issued in these reports is a clear signal that there is political commitment to support progress toward a framework more supportive of financial market integration.

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The following Hofstra faculty serve as Merrill Lynch Center Associates for the 2002-2003 academic year:

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Tao Gao, Ph.D.
Marketing and International Business
Nancy Huckins, Ph.D.
Finance
Richard Jones, Ph.D.
Accounting, Taxation, and Business Law
Ahmet Karagozoglu, Ph.D.
Finance
Wi Saeng Kim, Ph.D.
Finance
Steven Krull, Ph.D.
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K.G. Viswanathan, Ph.D.
Finance
Edward Zychowicz, Ph.D.
Finance

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Safeguarding financial stability in integrated financial markets

Public policies are not only asked to contribute to fostering the integration of financial markets in the EU. They must also ensure that the mechanisms for preventing financial crises from occurring and for managing them if they were to occur are adequate.

In the first months of EMU a series of criticisms were raised to the institutional arrangements for prudential supervision and financial stability. The IMF argued that an integrated market, with common payment infrastructures, requires more unified arrangements for prudential supervision and, in particular, a clear assignment of lending of last resort functions. The Centre for Economic Policy Research, a think tank monitoring the behaviour of the ECB, also highlighted that the institutional arrangements of EMU would not have passed the test of a period of recession and financial stress, supporting some form of centralisation of supervisory tasks.

The ECB has consistently argued that institutional arrangements based on national competence can effectively work, provided that cooperation between national authorities is significantly stepped up. This is particularly the case for cooperation between supervisors and central banks, since the introduction of the euro has introduced a clear-cut separation between the jurisdiction of supervisory functions (i.e., nationally chartered institutions) and central banking functions (i.e., the euro area).

The external criticisms have been taken seriously, and an extensive review of the mechanisms for dealing with the challenges raised by the increasing integration of financial markets has been conducted. Two reports of the Economic and Financial Committee (the so-called Brouwer reports) concluded that institutional arrangements based on national competence are adequate, but their operational functioning has to be significantly enhanced. This means that exchanges of information among supervisors and between supervisors and central banks have to be intensified, that the procedures for cooperation in the occurrence of a crisis have to be specified and that cooperation needs to be stepped up in order to promote convergence in supervisory practices.

The ESCB Banking Supervision Committee, comprising all EU banking supervisory authorities and central banks, is actively working to strengthen the macroprudential monitoring of threats to banking stability and to develop analysis of structural developments in EU banking markets. The committee could also provide an adequate setting for fostering convergence in supervisory practices, to which central banks without supervisory responsibilities are also keen to contribute.

Closer cooperation between national authorities can provide for both a speedier removal of regulatory obstacles to financial market integration and an effective approach to financial stability issues on an area-wide basis. **Differences in national arrangements and practices can and will persist, but cooperation is entrusted with the difficult task to gradually reduce the costs for financial services firms operating on a cross-border basis and to allow national authorities to create an effective network to deal with common concerns.**

The Associates of the Merrill Lynch Center represent Hofstra faculty from a wide range of disciplines. Each of our 21 Associates is committed to contributing to the study of one specialization within the field of international financial services and markets. Their responsibilities include: maintaining current familiarity within their area; moderating roundtable discussions; and initiating and organizing programs – such as seminars and symposiums – that enhance the understanding and expand the knowledge base in their areas.

World Prosperity and Globalization

by Dr. Wi Saeng Kim, Associate Professor of Finance and Merrill Lynch Center Associate

GLOBALIZATION AND RECENT DEVELOPMENTS

Globalization is the process whereby corporations move their money, factories and products around the world to maximize firm values. Some firms increase firm values by employing advanced production technologies and management skills possessed in host countries; these firms tend to be concentrated in research-and-development-intensive industries. Therefore, they are expected to generate monopolistic rents from foreign direct investment (FDI), while other firms go abroad in search of cheaper labor and raw materials; the profit opportunities of these firms may soon disappear when local labor costs reach the global equilibrium level.

Dr. Wi Saeng Kim

Globalization, in the form of FDI, accelerated in the mid-1980s, as many developing countries realized the benefits of FDI and utilized it as a key element of their economic development strategies. The general consensus on the impact of FDI is that inflows from advanced countries function as a vehicle for the transfer of technology and managerial practices that create growth-promoting efficiencies in the recipient economies. This improves the labor productivity of FDI recipient countries and, consequently, increases the economy's potential to generate greater output. To this extent, at least 143 countries had enacted FDI-specific legislation to create more favorable conditions for FDI by 1997. Consequently, the share of world FDI by emerging economies increased from 15 percent in 1990 to approximately 40 percent in 1997.

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GLOBALIZATION AND THEORETICAL BACKGROUND

The formal theory of globalization dates as far back as Adam Smith. *The Wealth of Nations* (1776) claims that the free movement of goods and production factors will increase the wealth of all nations involved. The theory suggests that it is not a coincidence that economically developed countries were the major players with international capital flows in the early stages of globalization. Further, in recent decades, several Asian countries, referred to as newly industrialized economies, have experienced an influx of foreign technologies and capital. Asia and the Pacific countries received only 13 percent of all FDI flows to developing countries in 1970, but this figure increased to approximately 52 percent in 1997. In contrast, however, Latin American countries received about 53 percent of all FDI flows to developing countries in the early 1970s, but their share declined to 33 percent in 1997.

GLOBALIZATION AND ECONOMIC GROWTH OF DEVELOPING COUNTRIES

Since 1993, China has been the largest recipient of FDI in the developing world. The total stock of FDI increased from $6,251 million in 1980 to $346,694 million in 2000. Similarly, FDI stock as a percentage of the gross domestic product of China increased from 3.1 percent in 1980 to 30.9 percent in 1999. The gross domestic product of China increased from 362.4 billion yuan in 1978 to 9,593.3 billion yuan in 2001.

However, the economic growth for the whole of Africa has lagged behind in contrast to other developing countries. The weak economic performance of the continent may be linked with the lack of FDI inflows, partly due to the unfavorable image of Africa as a location for FDI. FDI statistics indicate that Africa's position of attracting foreign capital has weakened during the last decades. For example, African developing countries attracted $7.9 of FDI per $1,000 of GDP in 1970, while Asian developing countries attracted $2.7 of FDI per $1,000 of GDP. In 1997, however, the ratio is 14.7 for African countries, and 28.3 for Asian countries. Many research papers have used the ratio of FDI to GDP as a measure of the openness of an economy and to show that positive associations exist between the two; the more open an economy is, the greater the economic growth rate. It is interesting to note that Japan, the second largest economy in the world, is one of the most closed economies among the advanced countries as measured by the FDI/GDP ratio. It has experienced no real economic growth during the last decade. In contrast, the Netherlands has been one of the most open and prospering industrialized countries.

WINNERS AND LOSERS IN GLOBALIZATION

Globalization is a powerful engine of world prosperity for the parties involved, as Adam Smith claims. Poor countries that receive FDI enjoy a faster economic growth, and the share values of multinational corporations (MNCs) that provide FDI are advanced. MNCs that provide FDI immediately benefit because they can reap "monopolistic rents" from the intangible assets that they possess. FDI improves the employment opportunities of local workers, and enhances the consumer welfare of underdeveloped countries, as consumers have more choices to shop for better prices and a higher quality of goods and services. However, to the extent that domestic producers in developing countries are inefficient and cannot compete with the foreign producers, they are the potential losers in globalization.

GLOBALIZATION AND SELF-INTEREST PURSUANCE

Total annual global FDI outflows amounted to $1,149 billion in 2000. Approximately 90 percent of world FDI outflows are provided by developed economies, with about 12 percent provided by U.S.-based MNCs. Total annual global FDI inflows amounted to $1,270 billion in 2000; developed economies received approximately 79 percent of world FDI inflows, and the U.S. economy received approximately 22 percent of global FDI inflows. This suggests that most economic gains of globalization will accrue to MNCs that are based in advanced economies.

Such a domination of FDI outflows can be viewed as an opportunity for exploitation of an underdeveloped and weak host country by the developed and strong, not only in economic gains but also in the sovereignty of the nation-state. Statistical evidence and/or anecdotal observations of historical events support this possibility. The potential losers in the globalization would be quick to use these fears as ammunition against globalization.

THE PROMOTION OF GLOBAL PROSPERITY

Although globalization is a powerful engine of world prosperity, recent world events may slow down the globalization process, to the extent that involved parties merely seek their own interests. On the one hand, FDI providers seek the maximum return from their investments. On the other hand, the domestic economic power groups of FDI recipient countries instigate the fear of economic "imperialism" through the FDI inflows, in order to enjoy unchallenged domestic economic power at the expense of domestic consumers. In the long run, the pro-growth logic of globalization will prevail. But the short-term battle is likely to be won by the domestic power group, suggesting that the globalization process will be further delayed.

A Pareto optimal solution to promote globalization and world prosperity is to align the interests of both FDI providers and recipients, and specifically to alleviate fears of the FDI-receiving countries. If we calculate the global wealth that a smooth process of globalization can create, and if we calculate the contributions of each party, then we can determine a fair way to distribute the created wealth. To the extent that about 90 percent of the total global FDI was provided by advanced economies in year 2000, initiatives to promote globalization should come from MNCs based in advanced economies.

NEWS ALERT

The Merrill Lynch Center congratulates Walter Molano, Research Director at BCP Securities and Member of our Business Advisory Board for his first place tie in the *Latin Finance 2002 Research Olympics.* After polling 138 global institutions, Molano tied for first place in overall Latin American debt strategy. He was also named the region's second best economist for what his followers call his "daring and exciting to read" research.

ANNOUNCEMENT

We are pleased to announce the forthcoming publication of a volume of proceedings titled *Financial Services in the Evolving Global Marketplace*, edited by Professors Esmeralda Lyn and George Papaioannou. The volume includes articles written by academicians and professionals on globalization, market development, managerial, strategic and risk issues, and empirical studies in markets. Published by the Center under the auspices of the Frank G. Zarb School of Business, the volume is available in a limited quantity and may be ordered by contacting the Merrill Lynch Center at: MLCenter@hofstra.edu.

May 2002 Conference on Marketing Strategies for Financial Services Firms *Co-Directed by Dr. Elaine Sherman and Dr. Tao Gao, Faculty of Marketing and International Business and Merrill Lynch Center Associates.*

The Merrill Lynch Center regularly holds conferences and seminars on pressing issues facing the financial services industry. On May 6, 2002, it hosted a conference on strategic marketing issues facing financial services firms. The conference committee included Drs. Tony Gao and Elaine Sherman, who served as Conference Co-Directors, and Drs. Keun S. Lee, James P. Neelankavil, and Rusty Mae Moore.

In recent years, the financial services industry has witnessed major changes in its business environment. Prime examples of these changes include the broadening of globalization and regionalization efforts, the occurrence of financial crises in emerging regional markets, the advancement and spreading of new technologies, the proliferation and acceleration of deregulation initiatives in many developing as well as developed countries, the increased pace of merger and acquisition activities, the rising expectation by investors, the terrorist attacks on American homeland, and the ongoing war on terrorism being waged in Afghanistan and beyond.

Each time there is a major change in the business environment, there exists a need to review and change a firm's marketing strategy. Faced by a confluence of major environmental challenges, financial services firms large and small need to critically evaluate their marketing strategies and make more informed decisions as to what services and products to offer, how many services and products to offer, where to offer, to whom to offer the services and products, how to deliver the offerings, how to promote the offerings, how much to charge, how to charge, in which currency to charge, and how they want their customers to pay for the services and products. The objective of this year's conference was to summarize and disseminate knowledge on financial services marketing, learned from both practical experiences and academic research. We were fortunate to have a truly distinguished group of panelists with wide experiences in the industry, media, and academia.

More than 100 attendees from the New York metropolitan financial services community and Hofstra campus participated in this conference, and the discussions were stimulating and enriching. The following is a recap of the presentations and the composition of the panels.

BREAKFAST AND KEYNOTE SPEECH

This session focused on the mergers and acquisitions of financial services companies and the integration of financial services, as well as the practice of one-stop shopping that have become increasingly possible as a result of industry consolidation.

Dr. Tao Gao, Conference Co-Director.

The Keynote Speaker was Mr. Gerald Grisse, Permanent Representative of the European Central Bank to the International Monetary Fund.

SESSION ONE

This session emphasized the interface between financial services companies and their customers in the new marketing environment. It included discussions on the market segmentation, targeting, positioning and servicing strategies of financial services firms. The presentations and discussions also touched on the role of financial analysts in consumers' and institutional investors' security buying decisions, how investors could better protect their investing interests, and how the government could better help protect investors.

Panelists:

David Ross, Director, Global Fixed Income Research Marketing, Merrill Lynch & Co.
"Fixed Income Research Marketing and the Institutional Investor"

Man Ho Yoon, Senior Deputy General Manager, Korea Development Bank
"Target Marketing and Segmentation Strategies for Corporate Clients"

Kwong Sai, Vice President, Agency.com
"Target Marketing and Segmentation Issues in the Marketing of Financial Services"

Moderator:

Keun Lee, Ph.D., Associate Professor, Department of Marketing and International Business, Frank G. Zarb School of Business, Hofstra University

SESSION TWO

This session reviewed emerging trends in the global business environments facing financial institutions, examined the methods of country risk assessments, and investigated how firms should reformulate their marketing strategies in response to these changes. There were discussions on ways to evaluate international markets in terms of their attractiveness and risks, the outlooks of various emerging markets, and how multinational companies could prepare for and deal with erupting financial crises in foreign markets such as the one in Argentina.

Panelists:

Jose M. Barrionuevo, Ph.D., Director, Global EM Strategy, Barclays Capital
"Latin American Business and Investment Risks and the Argentinian Financial Crisis"

Edward M. Graham, Ph.D., Senior Fellow, Institute for International Economics
"The Future of the Global Economy in the Context of the War on Terrorism"

Vitali Meschoulam, Co-Head, EG Americas Group, and Research Analyst, Eurasia Group
"Methods for Political Risk Assessment and Political Risk and Scenarios in Argentina"

Moderator:

James Neelankavil, Ph.D., Professor, Department of Marketing and International Business, Frank G. Zarb School of Business, Hofstra University

SESSION THREE

This session featured discussions on the issue of technological innovations and their implications for the production, communication, delivery, and customer evaluation of financial services.

Panelists:

Jennifer A. Kingson, Senior Editor, American Banker
"The History of Online Financial Services Marketing, Paradigm Shifts in Marketing Practices, and the Current State in the Online Financial Services Markets"

Vijay Velu, President, Turret Technology
"The Use of Technology in the Marketing of Financial Services"

Fred Patykewich, Head of Marketing, Asset Management Group, CIBC Oppenheimer
"Marketing Financial Services - Where Technology Plays a Role"

Michael Alesandro, President, Integrated Business Systems, Inc.
"The Global Marketing of Web-based Portfolio Management Software"

Moderator:

Elaine Sherman, Ph.D., Professor, Department of Marketing and International Business, Frank G. Zarb School of Business, Hofstra University

The Merrill Lynch Center Announces New Initiatives

During the 2001-2002 academic year, the Center embarked on exciting new initiatives to diversify methods of information dissemination. Over the past four years, our seminars and conferences have explored crucial topics relevant to global finance. These events have been well received by professionals, academics and students. The Center plans to streamline these programs into two regular series. The first series, which will be held every other year, is targeted at academics, while the second series will be held on an annual basis and targeted at business professionals. We remain committed to providing the same high-quality programs in the future.

A primary focus this academic year, however, is to develop Web-based references on global finance. One such initiative, a "financial Web site bank," will be launched this fall. Accessed through the Merrill Lynch Center site, this bank will provide key links to sites important to the study of global finance. Updated on an ongoing basis, the bank will be categorized according to such topics as: macroeconomic data; international organizations data; securities markets; consumer products and marketing; and country-specific data.

The second Web-based project – "financial tutorial online" – is in the development stage. This initiative aims to create a bank of widely used terms and concepts relating to global finance. Watch for further information at the Merrill Lynch Web site. Finally, the Web will provide a forum for dissemination of research authored by our associates or presented at conferences.

Spotlight on Research by Merrill Lynch Center Associates

RICHARD JONES

"Accounting and Auditing Issues Regarding the September 11th Disaster," *The CPA Journal,* November 2001 (co-authored with Jill P. Giles).

"The Auditing Standards Board Takes on a Global Perspective," International Business and Economic Research Conference, October 2001 (also published in conference proceedings).

"International Accounting and Standards," *Accountants' Handbook, Ninth Edition* (1999), edited by D.R. Carmichael, Steven B. Lilien, and Martin Mellman. New York: John Wiley and Sons, Inc. (co-authored with A.N. Dalessio and M.E. Seiler).

"Auditing Standards Board in United States Steps Up International Initiatives," *IFAC Quarterly,* October 1998.

WI SAENG KIM

"The Effect of Insider Ownership on Predisclosure Information, Timeliness of Earnings Announcements, and Earnings Response Coefficients," *Academy of Accounting and Financial Studies Journal,* Vol. 6, Number 1, 2002, pp. 125-137 (co-authored with In-My Haw, Kooyul Jung and Chandra Subramanian).

"Role of Corporate Governance Structure and Financial Systems on FDI Decisions," Eastern Finance Association Meeting, April 2002 (with Esmeralda Lyn and Edward Zychowicz).

ESMERALDA O. LYN

"The Wealth Effects of Capital Expenditure Decisions: Pre- and Post-Crisis Evidence from the Korean Market," to be presented at the Financial Management Association Meeting, San Antonio, October 2002 (with W.S. Kim, T. Park and E. Zychowicz).

"The Current Trends in Corporate Cash Holdings: A Survey of U.S. Certified Cash Managers," *Journal of Financial Education*, Spring 2002 (co-authored with Erika Gilbert).

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"The Source of FDI as a Determinant of Economic Output: The Evidence from Japanese and U.S. FDI in Emerging Countries," Multinational Finance Society, Lake Garda, Italy, June 24-27, 2001 (with W.S. Kim and E. Zychowicz).

"The Determinants of U.S. and Japanese FDI Location Decisions: Evidence from Emerging Markets," Eastern Finance Association, Baltimore, April 10-13, 2002 (with W.S. Kim and E. Zychowicz).

"The Anatomy of a Failed IPO: The Case of Wired Ventures Inc., An Internet Media Company," *Journal of Applied Finance* (formerly *Financial Practice and Education*), Fall/Winter 2000 (co-authored with Peter Acimovic).

JAMES NEELANKAVIL

"Strategic Resource Commitment of High Technology Firms: An International Comparison," *Journal of Business Research*, forthcoming December 2002 (co-authored with V.T. Alagnar).

"Critical Managerial Motivational Factors: A Cross-Cultural Analysis of Four Culturally Divergent Countries," *International Journal of Cross-Cultural Management*, December 2001 (co-authored with Anil Mathur and Yong Zhang).

"Determinants of Managerial Performance: A Cross-Cultural Comparison of the Perceptions of Mid-Level Managers in Four Countries," *Journal of International Business Studies*, first quarter 2000 (co-authored with Anil Mathur and Yong Zhang).

GEORGE PAPAIOANNOU

"Internet Applications in Investment Banking: Implications and Significance," *Journal of Financial Education*, 2002.

"Stock Dividend Distributions in Greece: Market Value Effects," *European Financial Management*, December 2000 (co-authored with N. Tsagarakis and N. Travlos).

ELAINE SHERMAN

"Towards a Better Understanding of the Interplay of Personal Values and the Internet," *Psychology and Marketing,* forthcoming (co-authored with M. Long and L. Schiffman).

"Political Marketing Research in 2000 U.S. Election," *Journal of Political Marketing*, Vol. 2, forthcoming Fall 2002 (co-authored with L. Schiffman).

"Trusting Souls: A Segmentation of the Voting Pubic," *Psychology and Marketing*, forthcoming December 2002 (co-authored with L. Schiffman and N. Kirpalani).

"The Influence of Gender on the New Age Elderly's Consumption Orientation," *Psychology and Marketing*, Vol. 18(10), pp. 1073-1089, October 2001 (co-authored with L. Schiffman and A. Mathur).

Merrill Lynch Center Awards Support Research in the International Arena

In an effort to support research of international financial services and markets — which is one of our primary objectives — the Merrill Lynch Center distributed the following awards during the 2001-2002 academic year.

TRAVEL GRANTS

Professor David Flynn, Department of Management, Entrepreneurship, and General Business, received a travel grant to help fund his trip to Bangkok, Thailand, to attend the Pan-Pacific Conference on E-Globalization and the Pacific Age.

RESEARCH GRANTS

Professor Wi Saeng Kim, Department of Finance, received a research grant to support his study titled "Wealth Effects of Foreign Direct Investment to China by Korean Firms."

Professor James Neelankavil, Department of Marketing and International Business, received a research grant to support his study titled "Strategic Resource Commitment of High Technology Firms: An International Comparison."

STUDENT AWARDS

Recent Hofstra B.B.A. graduate **Rosemary Alonge** was awarded the Honor's Essay Award for her paper titled "Variance-Covariance Analysis and Portfolio Optimization for Investors in Public Real Estate Investment Trusts: An International Perspective."

Recent Hofstra B.B.A. graduate **Geir Meloy** was awarded the Honor's Essay Award for his paper titled "The Economics of Aviation: Managing the International Airline of Tomorrow."

THE MERRILL LYNCH CENTER FOR THE STUDY OF INTERNATIONAL FINANCIAL SERVICES AND MARKETS

ACTIVITIES REPORT: 2000-2002

March 17, 2000
"Broadband and Wireless Technologies—What Are They? Who Are the Public and Private Companies Poised to Take Advantage of This Tectronic Shift?"
Presentation by Evan Misshula, Managing Director, Sabe Capital Partners
Held at Hofstra University.

May 10, 2000
"The Strategic Impact of Mergers in the Financial Sector"
Presentation by John Morris, Managing Director, Salomon Smith Barney
Held at Hofstra University.

November 16-18, 2000
"International Conference on Financial Modeling"
Conference held at the Yale Club, New York City.

April 25, 2001
"The Culture of the New European Multinationals"
Presentation by Dr. Irene Finel-Honigmon
Held at Hofstra University.

May 4, 2001
"Wall Street Analyst and Corporate News Disclosure – Have the Crystal Balls Turned Cloudy?"
Panel discussion held at Hofstra University.

October 5, 2001
"E-Commerce: Emerging Realities"
Panel presentation, including representatives from Integrated Business Systems, 1-800-Flowers, and Hofstra faculty
Held at Hofstra University.

March 3, 2002
"Style Investing"
Presentation by Kari E. Bayer, Senior U.S. Strategist, Merrill Lynch and Co.
Held at Hofstra University.

May 6, 2002
"Marketing Strategies for Financial Services and Firms"
Conference featuring speakers from Merrill Lynch, Korea Development Bank, Agency.com, Barclays Capital, Institute for International Economics, Eurasia Group, American Banker, Turret Technology, CIBC Oppenheimer, and Integrated Business Systems
Held at Hofstra University.

If you would like additional information regarding the Merrill Lynch Center, please contact us at:

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