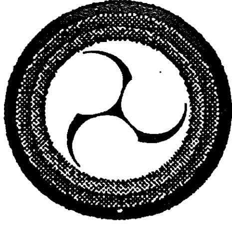

InterAction Council

Introductory Paper on "Regulating Globalized Financial Markets"

ARE GLOBAL CAPITAL MARKETS OUT OF CONTROL?

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ARE GLOBAL CAPITAL MARKETS OUT OF CONTROL?

Introduction

I have been asked to introduce the topic of today's meeting, and I am very pleased to do so. We are here to discuss an issue of great national and international concern: the rapid evolution of global capital flows, the possible risks that may result from an enormous increase in capital mobility and above all, the question as to what, if anything, national and international policy makers can and should do to deal with such risks.

This issue has certainly been at the top of the agenda in the past months. We have witnessed dramatic events in the sphere of international finance. Not only were we all shocked to hear that Baring Brothers, a more than century old financial institution, had collapsed after it lost control over its transactions in financial derivatives. The international community has also faced the dramatic results of international and domestic investors suddenly loosing confidence in a major country, Mexico, and withdrawing funds on a massive scale from all of Latin America. These events and their implications will undoubtedly be with us for some time, and will provide much food for thought amongst investors, bankers and policy makers alike.

Moreover, the worries which Barings and Mexico have brought to the fore are in no way new: Ever since the eruption of the Latin American debt crisis in the early 1980's, which first seemed to threaten the near collapse of the global banking system and, subsequently, led to a protracted stagnation for the entire continent, the question as to whether "too much" capital is flowing across borders has been with us. In Europe, the issue has also arisen, if in different form. The European exchange rate mechanism crisis in 1992 is regarded by some as proof of the destructive power of international speculative capital flows. Not only has domestic economic policy, it appears to many, become powerless to pursue national priorities in the face of the massive onslaught of international financial flows; active international integration programs like the European Union project appear threatened by financial market volatility. Calls for tighter controls of capital flows in general and of foreign exchange markets in particular have been mounting. The demand to dampen the "volatility and instability of financial markets" is being voiced in many quarters. This is certainly the reason we are here to discuss the topic amongst this distinguished group.

Basic principles

Let me, right up front, lay out my basic position on the issue, which, I might add, is based not on analysis of every technical detail but on the consideration of basic economic principles: it is my fundamental and general belief that markets do work. Financial markets are no exception. In the final analysis, they must and will reflect fundamental and real economic and political factors. The spread of market economics — and with it the spread of international and domestic *financial* markets — is with us to stay. The rapid rate of rate change in international financial market practices reflects, I believe, some very profound advances in communications, information processing, and financial technology. The world has become smaller, and must rely more on the markets to successfully manage its increased complexity and more rapid pace. I suspect that the full effects of this new technology are yet to be fully incorporated into market practice and that we will face further changes. I also believe that more countries will want to join in this progress, and hope that the evolving global financial system will not impose serious obstacles to their participation. Reforming countries like the Czech Republic, new industrial countries like Korea, and more advanced Latin nations like Chile

are obvious candidates for full participation in world markets, and even countries long reticent to admit market forces like India are beginning to open their doors.

Yet, I do not want to, in any way, deny that the freeing up of financial markets, the surge in international capital flows, and the development of new financial techniques also bring some major risks that must be clearly recognized. Ignoring them is dangerous. I would go further than that: not just knowledge is required, but action too, both by national and international policy makers. Markets for instance — and also for goods like energy — do not always deliver the best outcome in terms of economic welfare. They depend heavily on expectations about an uncertain future. Speculative excesses show up when expectations overshoot future reality. Prices often change by more than will be needed to balance the markets in the future. Damping these excesses without at the same time destroying the signals that markets must give, requires a careful application of rules and regulations, and in many cases, clear government signals about prices they find inconsistent with basic policy goals.

More importantly in the case of financial markets, much of the regulation that is now in place, is, as our American friends would say "behind the curve". It is outmoded and may generate rather than reduce risks. However, as governments contemplate the development of new rules and regulations to replace the old or fill a vacuum, they must be very cautious. Regulations can do just as much harm as they can do good; regulations can create strong incentives for market participants to run in the wrong direction.

And let me add a final, and I think important, general introductory remark. Let us, before even we even devise new rules and new regulations, face up to a key test of ourselves. Let us be aware of the inherent instinct of policy makers to blame others when they cannot achieve the goals they, or their voters, have set. Let us not instinctively blame speculators and technology for market instability, but first check whether the basic policies are appropriate under the constantly changing circumstances. The financial crises of the past decades have taught me that their root often lies in misguided economic policy itself. And one thing is quite sure: the individuals that depend on markets for their livelihood often uncover these policy errors more quickly than the policy makers themselves.

The benefits and costs of greater capital mobility

As I said at the outset, I am convinced that the enhanced mobility of international finance brings many significant benefits. It also can have some costs. Let me briefly mention what I think are the key issues to consider:

First, it is clear, that investment will be more efficient if capital is free to flow to where the resources for producing goods are available at lower cost. This has certainly been the driving force behind the recent surge in *foreign direct investment,* behind firms building new plants and buying ownership and control over enterprises in developing and industrial countries alike. The surge in direct, and other international, investment has been well documented in the background paper prepared by Teizo Taya for this conference. I will not repeat the details he has so ably provided, but do want to comment briefly on what I see as some of the important policy implications for direct investment as well as international portfolio, or capital market, investment flows.

Direct investment has surged, both among industrialized countries and into the developing world. Here in Japan, one is especially aware of this growth, as Japanese corporations have deliberately and massively shifted production out of high cost Japan to the lower cost Asian neighbor countries, into the United States and even into Europe. The same is also true for my home country,

Switzerland, where outward direct investment has a long tradition and is, relative to the size of our economy, quite enormous.

Foreign direct investment clearly enhances global productivity, growth and welfare. But foreign direct investment is certainly not without problems. It is a problem when recipient countries offer excessive subsidies to attract firms and industries, and a problem for individual workers in the capital exporting country who may be displaced when production is shifted abroad. In Switzerland as in other industrial countries, increasingly I am told also here in Japan, many blue as well as white-collar workers are worried about the possible job losses that result as companies shift production of goods and services to the emerging, labor surplus economies of Asia, Latin America or Europe.

Yet the response to this problem should certainly not be to provide artificial and costly protection to the old and dying "sunset" industries. Rather, the policy response should be to assure that the appropriate environment exists for *viable* industries to flourish. Governments everywhere are called upon to assure that excessive regulation and tax barriers are removed and internal labor mobility enhanced. Building the skills of workers, *human* capital becomes all the more important in a world with greater physical and *financial* capital mobility. Finally, when job losses do occur, governments must assure that those who suffer can count on an adequate safety net which carries them over to their next occupation without, however, reducing the incentive to search for employment.

I think it is a simple truth that protectionism is the absolutely wrong answer to greater capital mobility. It ultimately fails and — until such failure becomes apparent — creates enormous costs. In sum: direct foreign investment is certainly a greatly beneficial form of capital flow. It should be encouraged rather than *dis*couraged. Incidentally, if governments create the proper environment for private investment, foreign or domestic, not just the drain on the domestic public sector but also on the resources of multilateral development organizations will diminish, something that most of us who are keenly aware of the severe financial constraints in the public sector should heartily welcome.

Let me turn to portfolio investment where I think this conference can best help focus policy attention. The increased mobility of portfolio capital we have recently seen is also basically desirable. Portfolio investors do not build factories, but they provide the funds to those who do. Greater international portfolio investment raises returns to savers, and thus raises world savings. Individuals and entire countries that generate savings surpluses assure their future welfare when these funds are placed in countries with good growth prospects. The savings flows let recipient nations build their productive capacity faster and generate the future revenues from new goods and services to repay the loans. All this is certainly no secret, and most observers would agree to the logic of the argument.

The worries over the enhanced capital mobility have, hence, not primarily concerned direct investment flows or the potential benefits to savers. The worries have, rather, referred to the alleged instability associated with the rapid expansion of portfolio flows. Such flows have, in the past decade, increasingly replaced the flows through international banks. This "securitization" is a pervasive phenomenon, by no means only in international markets, but in domestic markets as well.

What caused this change? It results primarily from the fact that financial information is more readily available and cheaper to process. Loans previously made by banks from deposit balances are now sold indirectly to savers through mutual funds, pension funds and other "institutional" investors. This change is taking place fastest perhaps in the international markets, and in domestic markets that have been deregulated. A more competitive environment in deregulated markets seems to encourage the move to the most cost effective forms of financial transaction. At the same time an increasing number of governments, beginning in the advanced industrial world but extending increasingly to the

emerging countries, have decided to open up their domestic financial markets to foreign portfolio investment. The greater availability of portfolio funds has also increasingly allowed countries and their firms to raise capital in the international, or so-called Euro-markets, where costs imposed by prudential regulation are once again lower than in may domestic markets. Not all the new instruments, techniques, and institutions in these newly competitive national and international capital markets will survive the test of time, and there is a certain amount of "learning by doing" here that unsettles many observers. I will return to this point.

Not all the worries surrounding the rapid expansion of international portfolio flows concern the form of finance per se, but the fact that such investment positions are *highly liquid.* As the Mexican case showed, billions of dollars can be liquidated within a matter of days or even hours. If buyers — or sellers — are difficult to find, portfolio transactions are by their nature accompanied by sharp changes in the prices of these assets. Stock and bond market prices appear to have become more volatile as their role in financial intermediation has expanded. It is this *volatility* that worries many observers. But, the fears of price volatility are, in my view, largely misplaced. Price movements are the process which equilibrates markets, be they for apples or for Brady bonds. *Preventing* the price movements is not the solution to a problem, but rather the cause of a new one: it creates a system of *rationing.*

It is also far from clear to me that the replacement of banking flows through portfolio finance is a worrisome development. Spreading the risk of large investments in individual firms, classes of borrowers, and countries among a large number of portfolio investors would pose less risk to the financial system than concentrating it in a relatively small number of few banks. This reduction in the systemic risk posed by the failure of a large borrower should be a positive development.

Concentrating risks in a small number of banks also has a public and development policy aspect. As the lond-winded negotiations after the Latin American debt crisis of the early 1980s showed, the wrangling over how the costs of defaults were to be divided between the banks and the taxpayer immobilized the international system. International financial flows to Latin America dried up for almost an entire decade and this was one cause for that continent's prolonged economic stagnation. I doubt whether, this time around, these countries will once again have to wait for the resumption of flows for such a long period of time.

Does enhanced capital mobility destroy control over domestic economic affairs?

The key concern regarding the new regime of free capital mobility has, however, been this: both policy makers and the public are increasingly worried that they have *lost control over their economic destiny.* Financial shocks, it appears, hit out of the blue. Interest rates shoot to the sky and exchange rates collapse virtually over night. Policy makers are forced to respond to critical situations for which they generally do not seem to be responsible. The market value of wealth — be it bonds, equities or homes — moves in Japan or Switzerland, just because the Federal Reserve Board in Washington has decided to raise interest rates. Fundamental *domestic* economic factors appear to have lost their relevance for interest rates and exchange rates. The forces of speculation — or in the language of finance — of *international arbitrage* instantaneously affect virtually the entire globe. This worries a large number of policy makers, and the public too. Calls for intervention to stop the "speculator" are quite common. They reflect an acute sense of frustration at seemingly having lost control over one's fate.

But let me once again ask whether this sentiment is really justified. The answer is, I think quite simple: Yes, indeed, *interest rates, share prices and exchange rates* can, for considerable periods of

time *overshoot* the level that reflects the real value of a country's productive assets and real international purchasing power of its money. But, ultimately, *fundamental economic forces prevail.* These are determined by the real quantity of goods and services produced by a country over time, the debts it incurs, its savings rates and opportunities for investment, and the quantity of money which the authorities decide to provide.

If I let pass in my mind the major movements in financial prices which have occurred - *and persisted* — in the past years, it is hard to find one which did not ultimately have fundamental economic causes:

- The crisis in the European Monetary System beginning in the fall of 1992 was the consequence of the lack of correction to overvalued exchange rates. Higher trends in inflation had led some members to price levels that were clearly out of line with the exchange rates that had been fixed five years earlier. Some countries, like Italy and Great Britain, that faced the option of severely tightening liquidity were eventually forced to allow the rate to adjust. Others, like France, who chose the painful path have to this day largely maintained stable currencies.

- The Mexican crisis was also by no means without fundamental cause. The external balance of Mexico had been deteriorating for some time and the government failed to tighten its monetary and fiscal stance when it began to loose exchange reserves in the middle of 1994. Investors who rightly feared the capital loss that the government was going to impose on them, pulled out and the markets collapsed.

- The dollar's recent sharp decline and yen's surge also have some fundamental causes. These movements result quite simply from very different attitudes of the two governments and central banks toward policy making. The U.S. Federal Reserve appears content with inflation in the 3% range while the Bank of Japan appears to be targeting less than 1%. The U.S. government appears quite content with a falling dollar to pressure Japan into trade concessions. The slow expansion of Japan's fiscal position, despite a serious recession, and uncertainty about tax cuts or deficit reduction in the United States, adds to the pressure on the dollar against the yen.

There has clearly been some market overshooting in all these cases, but also some very fundamental truths in the market signals. In general, and over the longer run, I am convinced that financial prices do reflect economic fundamentals. But, over shorter periods, prices can diverge a lot from their fundamentally correct value. This causes pain and puts pressure on policy makers to act. Exporters suffer from overvalued exchange rates. Homeowners and businessmen suffer from excessive interest rates. Consumers pay when exchange rates are too high and savers suffer a real loss when interest rates are too low. Everybody would be better off if things were always "just right". Our experience in Switzerland — especially regarding temporary exchange rate overvaluations — suggests, however, that governments should not try to change financial prices, so long as they have strong evidence that their monetary and fiscal policies are on the right path. Increasing monetary growth in Switzerland simply because of a temporary appreciation is certainly not warranted at this time. But if the overvaluation persisted, as it has done in Japan for a number of years, policy makers must begin to believe that the *market* is telling them something.

This brings me to the great advantage of capital mobility for investors and, potentially, for policy makers. Financial markets may cause pain, but they also can act as *"teachers"*: signals from markets should not be ignored for too long. They can, in many cases, indicate that policies are on a wrong trajectory and require correction. Via financial markets — rather than via ballot box — the private sector has found a new means to *discipline governments.*

For short periods of time, financial markets allow governments and countries to live beyond their means. In 1993 for example, countries whose policies were clearly out of balance — I refer not just to Mexico but also to European countries such as Italy as well as many others — were recipients of enormous capital inflows. Markets created a *false sense* of comfort The tendency of markets to do so is a risk which policy makers must increasingly become aware of. For once markets lose confidence in policy makers, "retribution" is indeed swift.

But the implications of such potential punishment are certainly not that the mobility of international capital funds should — *globally* — be reduced through government intervention, *transactions, taxes* and alike. This would, in my view, be the wrong way to go about things. The lessons from Mexican and other crises, are rather the following: First, capital mobility *does* not *relieve governments from keeping their house in order.* The opposite is the case. Governments must refrain from sticking to unsustainable policies, monetary or fiscal. Policy stability and consistency help enormously in stabilizing expectations. Stable expectations, in turn, will ultimately entail more stability and less volatility in the financial markets.

Second, responsible monetary and fiscal policy is, however, not always enough I do believe that governments of potentially vulnerable countries may also need to make the conscious *decision not to become dependent on* international financial markets especially when money is offered at very low rates. Such finance can dry up quickly, borrowing rates may rise rapidly and refinancing the debts may become possible only at great cost, or not at all. The stories of bankers literally "throwing" money after Latin American governments in the late 1970s are well known. Neither the bankers nor policy makers appeared to be aware of the risks. That the story was repeated in 1993 and 1994 is a sad recognition of the fallibility of markets.

"Contagion by association", as we have seen recently in Argentina, shows that some countries, above all those that have not yet established a *long history of policy credibility,* may suffer disproportionately even if their fundamentals are not seriously out of order. They would do better restraining speculative inflows. Some countries in Asia as well as Chile have, I believe, shown the way forward. Exercise *voluntary caution* — that is my advise to governments — rather *than prohibition.* Full liberalization of domestic financial markets should probably be postponed until economics have developed a strong productive base, domestic savings levels are sufficiently high and financial as well as monetary stability and policy credibility have been established.

The role of multilateral institutions

What is the role of *multilateral institutions* in the face of growing capital flows? One thing is clear: *bailouts such as in Mexico must remain the strict* exception. There is a *moral hazard* here Rescuing borrowers and lenders from their own mistakes tempts them, and others, to repeat the mistakes. If we are quite honest, such bailouts ultimately involve a *transfer of funds from* taxpayers *in industrial countries to investors* in the same countries that have made wrong investment decision. This is not the kind of income redistribution governments should aim for. Of course, a bailout may be essential to avoid undue hardship on the great bulk of the innocent residents of a troubled debtor nation. But conditions on the use of the funds, and policies to be followed are entirely appropriate. Such bailouts should also help to regain the debtor country's access to international markets; that may be important, but funds advanced in a crisis should be on hard terms and scheduled for priority repayment.

The multilateral institutions may be best placed to reduce the risk of the crisis and bailout occurring in the first place. Publicizing their honest assessments of policies followed, and of data

released by member countries would greatly help improve the market's assessments of future events and avoid unpleasant surprises. Mexico's failure to promptly release data on the initial loss of reserves no doubt contributed to the voracity of the capital flight when it finally did come. Providing implicit financial guarantees would be quite wrong, and boosting the funds available to the IMF for such purposes would also send the wrong signal. But the IMF may well need more liquidity if it is to fulfill its traditional role of bridge finance in liquidity crises now that private capital is flowing more freely and new countries are becoming active in the global capital markets.

At the same time, we should not make the mistake of assuming that these portfolio flows can somehow replace the decline in official support for the development efforts of most of the world's poorest countries. While many countries are mentioned in the discussions of "emerging markets", the bulk of the funds actually flowing are going to only a handful of the largest and more advanced countries in Asia, Latin America, and Eastern Europe. Direct investment flows offer more promise to some of the poorest and least organized among the non-market developing countries, but most will need official financial support for basic infrastructure, health and education to reach the stage where they are being seriously considered by even the most risk and diversification oriented international investor.

The benefits and costs of derivatives

The final topic I would briefly like to address is that of derivatives and other new financial instruments that have grown most rapidly and have also caused such great concern in recent months and years. I would in no way like to claim to be an expert in this field. Again, I have only very simple ideas to offer.

My first observation is simply this: Derivatives don't create risk. It is the leverage they provide and their inherent complexity that encourages users of derivatives into positions that they would never imagine if the cash were up front. In fact, I would go so far as to suggest that the creation of derivative instruments is a *natural reaction of financial markets to potential financial instability.* As I have argued, this instability is as much the result of the lack of policy stability and consistency as anything else. Greater global monetary stability would reduce, though not remove, the need for interest and exchange rate derivatives.

Derivatives provide a cheap way to hedge or insure against many of the inherent risks that borrowers, lenders, producers, and even consumers face in today's world of open and fast paced markets. They cannot, of course, protect against all risks. There is always the possibility that a market will freeze up, that a counterpart will default, or that an unimaginably large price change will overcome the best designed strategy to insure against loss. But derivatives do provide very valuable protection against many of the risks that participants face in the global financial markets today. They have not grown so fast because they are *user friendly,* but because they are very useful. Yet, derivatives are certainly not problem-free. The leverage that makes them a cost effective way for some to offset risks, also makes it cheap for others to take on large risk positions. Moreover, the inherent complexity in many of the more sophisticated, and sometimes the most useful, derivatives leads even some of the large financial institutions that use, deal in, and issue derivatives to loose track of the risks that remain. In this situation, ordinary policy makers and company directors may be forgiven perhaps for being a little skeptical of some of the latest innovations in modern risk management.

Along with the growing concern over derivatives, there have been numerous proposals for dealing with the risks that they may pose. These have come from public bodies like the Basel Committee of Financial Supervisors, from industry groups like the Institute of International Finance, from multinational groups like the European Community, and from many individual national and

market regulatory agencies and their advisors in the academic community. The problem is that few of these proposals have been put into practice. Differences between national regulatory systems and regulators of different kinds of institutions and markets appear to be part of the problem, but the changing nature of the markets, instruments, institutions involved and a constant evolution in the techniques to mange derivative risk has also played a role.

To their credit, I should note that the Basel Committee's 1988 accord for integrating banks' credit risk on derivatives and other instruments have been adopted in most major countries. Thus, the likelihood that a large counterparty will default and spread losses around the international banking system has been reduced. Unfortunately, not only banks, but *other* non-bank financial institutions and unregulated firms, are also becoming major participants in international derivatives markets; thus, the risk to banks may be reduced but we cannot be certain that a major non-bank failure will not produce similar results. Moreover, similar rules governing market risk, the likelihood that a securities price, interest rate, or exchange rate change will produce a loss, have not yet been adopted. As market risks seem to produce most of the losses reported, the new Basel Committee proposals made just on April 12 appear more than overdue and deserve our solid support. These rules both set minimum common standards and are flexible enough to encourage better risk management and control techniques to evolve.

In fact, I suspect that the biggest problem in getting a common basic regulatory standard around the world is not that the regulators cannot agree, but that basic legal and accounting systems around the world have simply not kept pace with the evolution of financial practices. It seems a little silly to ask banks to put up capital against the likelihood that a change in the government bond yield will create losses, when most accounting systems do not even recognize this as a change in the value of the underlying bond. Of course, it is quite counter-productive to require capital against an instrument that in fact offsets risks that are not recognized elsewhere on a bank or company's books!

My final point on derivatives is that we must not think that regulations will solve all the problems. Regulations almost always lag behind practices. Unless we want to stop progress altogether, regulation can only assure a common basic playing field and prevent the most serious abuses. The rules recently proposed by the Basel Committee of Banking Supervisors seem to provide that base. They should be rapidly adopted by all countries, by non-bank regulators, and seen as a voluntary standard of good practice for others participating in these markets.

The next critical steps are to bring better legal and accounting systems around the world up to date so that they deal clearly with the risks and rewards in derivatives, other new instruments and old instruments that are also subject to financial market fluctuations. But most needed is a greater awareness of the risks derivatives pose and rewards they offer by the senior management and the directors of the companies, public and private pension funds, and others that make use of them.

I mention rewards in particular, because many financial institutions seem to be putting incentive systems in place that reward profits without considering the risks involved. Responsible management and control by the participants themselves seems to me to be the only true security against derivative market excesses.