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Towards an Effective Regulation of International Capital Markets*

The fundamental objective of all financial policy is to ensure the best possible outcome in the real economy. In this respect the simplistic complaint that the financial sector produces nothing by itself contains an element of truth. But it is only a small element. In a complex economy, with widespread division of labor through products, space and time, a sophisticated financial sector is necessary for the organization of production and distribution. An international financial system is *necessary* to sustain world trade and investment.

An economy without money markets would not work at all. The mobilization of large quantities of capital, and the allocation of that capital to profitable investments is the device that has transformed standards of living throughout the world in the past 200 years. Financial institutions must therefore be judged by the contribution they make to that process and hence to growth and employment. There is no point in having a financial sector that is in some sense »efficient« in its own terms if the result is a less efficient real economy.

Over the past year the persistent economic crisis in Asia has called into question much of the received wisdom that liberalization has enhanced the economic contribution of international capital markets. The Asian crisis is but the most recent example of other similar episodes: the financial crises in Latin America in the early 1980s, the European exchange rate crises of 1992, and the Mexican bond crisis of 1994. The explanations offered for these severe disruptions are various; indeed each crisis has a set of local explanatory factors. But they also have a common element – the impact of highly liquid international capital markets. These recurring episodes, most of which involve severe costs in terms of unemployment, loss of real income, and even stagnation, pose important questions for policy-makers:

- Given that every crisis has its own specific characteristics, what do their common factors suggest about particular strategies in international financial policy?
- Should the ubiquitous policy stance of the past three decades in favor of international financial liberalization be qualified in the light of experience? If so, how?
- Is any consistent policy toward financial markets, other than liberalization, practically possible? Or can the genie never be put back into the bottle?

The succession of financial crisis in the past 20 years, the scale of what is happening now in Asia, and the reverberations of the Asian problems throughout the word, suggest that there is an urgent demand for answers to these questions. Increasingly, financial crises are not »local«. They have worldwide systemic implications. Satisfactory answers will require a clear *and convincing* theoretical and empirical characterization of the relationship between financial liberalization and economic performance. For without such a widely shared characterization it will be almost impossible to formulate an internationally acceptable policy stance, even at the most general level. It is the objective of this article to present the skeleton of such a characterization, and to draw from the argument a number of specific policy recommendations. These are neccessarily tentative. If there is anything economists should have learned from the experience of the past two years, it is humility! Nonetheless, in distinctly un-humble manner, we believe the arguments presented here do provide an intellectual framework that might guide practical and successful reform.

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The Argument in Brief

International capital market liberalization began in the late 1950s when American and British banking authorities permitted external Eurocurrency credit markets to emerge, beyond their regulatory control. However, the crucial change came in the early 1970s with the collapse of the Bretton Woods system of fixed exchange rates buttressed by capital controls of varying effectiveness. With that collapse, foreign exchange risk, previously borne by the public sector, was privatized.

The assumption of forex risk by the private sector required the dismantling of exchange controls to permit the hedging of risk, and so precipitated the development of the plethora of new financial instruments and the explosion of trading which characterize present day financial markets. Together with increased private sector risk went increased opportunity for profit: from the provision of risk-bearing services, from the potential for speculative profit inherent in fluctuating exchange rates, and, of course, from the extensive new opportunities for profitable arbitrage. Combined with domestic pressures for the removal of financial controls, the collapse of Bretton Woods was a significant factor driving the worldwide deregulation of financial systems. Exchange controls were abolished. Domestic restrictions on cross-market access for financial institutions were scrapped. Quantitative controls on the growth of credit were eliminated, and monetary policy was now conducted predominantly through the management of short-term interest rates. A highly geared global market in monetary instruments was created. Today the scale of activity in this market dwarfs payments associated with foreign trade. Daily flows approach 10% of the world's annual GDP. In stark contrast to most domestic financial markts, it is largely unregulated.

Financial liberalization and the massive increase in financial flows have undoubtedly brought some benefits to some countries at some times. Flows of investment toward emerging markets were seen, in the early 1990s, as a welcome replacement for official development financing. The relaxation of external capital constraints led to increases in growth and reductions in inflation. However, the overall economic record of the post-liberalization period, 1970 to the present, is less satisfactory. There has been the series of severe financial crises. But as well as these shocks and the associated losses in real income, trend growth rates have slowed throughout the world. In every G–7 economy trend growth in the 1980s and 1990s has slowed to around two-thirds of the rate in the 1960s. In developing countries taken as a whole the average rate of growth has also slowed, to roughly the same extent. Even prior to the current crisis in East and Southeast Asia, trend growth per capita slowed in four out of seven of the region's major economies.

The fundamental point at issue is what might be the connection between international financial liberalization and this widespread deterioration in performance. It has become the conventional wisdom that trend performance is determined by »the structure of the real economy«. From this perspective, financial factors may result in severe shocks and significant deviations from trend, but will not alter the underlying performance of the economy. Financial factors will not change the fundamentals. The only qualification of this separation of real and monetary phenomena is that liberalization, by removing financial imperfections, should improve trend performance.

An alternative view is that financial institutions do indeed affect the medium- to long-term trend performance of the economy. Liberalization not only increases the likelihood of shocks, it also alters the fundamentals. Hence financial factors can effect the medium-term characteristics of the economy. They could be the factors behind the poor trend performance observed in many economies, as well as periodic crises.

Three factors have forged a link between liberalization and low growth: volatility, contagion and changes in public and private sector behavior.

- Liberalization has undoubtedly resulted in financial markets becoming more volatile, whether measured by short term swings in exchange rates and interest rates, or the longer swings such as that in the real value of the dollar from an index of 100 in 1980, to 135 in 1985, down to 94 in 1990, and up again to 134 in 1998. Volatile financial markets generate economic inefficiencies. Volatility creates financial risk, and even if facilities exist for hedging that risk, the cost of capital formation is raised. The impact of financial market volatility is felt not only in Latin

America and East Asia. In the face of higher and more volatile real interest rates, US corporate defaults have increased enormously since the earl 1970s.

- The damage done by financial volatility is not confined to countries with real economic imbalances – volatility is contagious. The Mexican bond crisis of 1994 propagated the »tequila effect« throughout Latin America. The Asia financial crisis has spread throughout emerging-markets, including Eastern Europe, Latin America, and South Africa. The stock market crash of 1987 spread rapidly from New York to all financial markets. A recent study of the 1992 ERM crisis (Buiter, Corsetti and Pesenti, 1998) has concluded that systemic contagion makes the link between domestic macroeconomic conditions and the size of currency devaluations, let alone the likelihood of a crisis, »tenuous«. Indeed, the link may even have the »wrong« sign, with the financially virtuous suffering the greater punishment!
- It will be argued below, that the volatility, contagion, and hence uncertainty associated with liberal financial markets have not only imposed short-term shocks on the real economy of affected countries and regions, but have in fact led to changes in trend performance by inducing changes in behavior in both public and private sectors.

That there has been a significant change in public sector behavior is incontestable, and that change is typically attributed to the »discipline« imposed on governments by the international financial markets. In contrast to the 1950s and 1960s when public sector objectives were typically expressed in terms of employment and growth, objectives are now defined in terms of financial and monetary targets, typically summarized as »macroeconomic discipline«. It is clearly true that *lack* of macroeconomic discipline is no way to secure sustainable growth. But what is most striking about the superior economic performance of the 1960s, when objectives were customarily defined in terms of growth and employment, is that fiscal balances typically displayed lower deficits than has been the case since liberalization, and, indeed, fiscal surpluses were not uncommon (Matthews, 1968). The reason for this outcome was, of course, the interdependence between public sector and private sector balances. High levels of investment by the private sector, encouraged by a public sector commitment to growth and employment, in turn resulted in healthy fiscal balances, a result reinforced by relatively small current account deficits.

Macroeconomic discipline is a necessary component of sustained economic growth. Burgeoning fiscal deficits and high and rising inflation will undermine any growth strategy. But discipline needs to be associated with a public sector commitment to high levels of investment and employment. Small fiscal deficits, or even fiscal surpluses, may be more readily achieved when private sector investment is encouraged both by the financial environment *and* by public sector commitment to employment. If private sector investment is discouraged by an absence of public sector commitment to the high levels of employment and growth, fiscal prudence may be combined with recession.

Three elements link international financial liberalization to this change in public sector behavior: the potential threat posed to financial stability and the real economy by large capital flows, the belief that those flows are motivated by a particular view of »sound finance«, and the additional belief that contagious financial crises may strike without warning. As the Bank for International Settlements (1995) has argued: »In the financial landscape which has been emerging over the past two decades, the likelihood of extreme price movements may well be greater and their consequences in all probability further reaching. ...At the macro level, the new landscape puts a premium on policies conducive to financial discipline. Strategically, a firm longer-term focus on price stability is the best safeguard, one which can only be achieved with the support of fiscal discipline«. However, the BIS then warns, »yet such a safeguard is by no means always effective«.

The identification of changed behavior in the private sector is more problematic. Ratios of investment to GDP have typically been lower in all countries since liberalization, suggesting a fall in private sector confidence. More specifically, defaults on US corporate bonds, which were at an all time low in the 1950s and 1960s, have increased significantly since the early 1970s. This finding may be explained by higher and more volatile real interest rates post-1970. Unsurprisingly, US business failures, which were also low in the 1950s and 1960s have been much higher since, and are correlated with high real interest rates and high debt-equity ratios. These patterns suggest, at very least, a less propitious climate for investment.

A decline in confidence in the private sector would also produce an increase desire for the opportunity of exit, further reinforcing the possibility of extreme swings in market sentiment which inflict both short-term and long-term damage.

These negative effects are reinforced by the emergence of pro-cyclical forces associated with liberalization. The ability of governments to moderate cyclical forces by monetary policy has been severely diminished both by international liberalization and by the shift in corporate finance from the banks to the securities market. The result is that all monetary policy is now focused on manipulating the demand for money via major swings in increasingly high short-term interest rates, damaging private sector investment.

In developing countries, the recent round of crises has been associated with clearly destabilizing behavior by the private sector. The tell-tale signs included rapidly rising ratios of foreign and domestic debt to GDP as a consequence of external deficits readily financed by capital inflows (at least for a time), together with maturity and currency imbalances in national balance sheets. Standard market practices pushed local financial sectors toward taking long positions in domestic assets and short positions in foreign holdings. A private sector build-up of foreign currency borrowing (without proper hedging, despite the alleged ability of international capital markts to provide such services) was an immediate precursor of both the Mexican and East Asian crises. It was abetted by pro-cyclical financial regulation.

Finally, the macroeconomic effects of liberalization can generate instability on a global scale. Industrialized economies can be destabilized by imbalances between flows and stocks induced by capital movements, although the time spans are likely to be longer and institutional responses more robust than those recently observed in Latin America, Eastern Europe and Asia. In the case of the major economies there can be important feedbacks from national developments to the global system: Does the major borrower or lender, for example, behave in stabilizing or destabilizing fashion? What are its own weak points in terms of changes in stocks and flows? Such situations evolve over time. It seems likely that when imbalances emerge they are lagging indicators of the more fundamental processes which international financial liberalisation has set in train. It follows that the global system can be at substantial »market risk«, in the phrase that regulators use for dangers transcending mere price fluctuations.

If international financial liberalization has indeed led to a change both in the environment for investment and in public and private sector attitudes toward investment and has resulted in the mutually reinforcing hurt of severe swings in market sentiment *and* a general deterioration in medium-term confidence, then a deterioration in rates of growth and levels of employment is to be expected.

The Policy Challenge

The policy challenge is clear: Is it possible to secure the benefits of a flexible financial system, capable of mobilizing capital on a large scale, whilst at the same time ensuring that national economies and the wider world economy are protected from the systemic risks which financial liberalization brings in its wake? The basic components of a new international financial order may be gleaned from the above analytical sketch:

- Since international financial liberalization results in a major increase in risk to both the national and the international real economy, an effective policy toward capital markets must be international in character. That is in the best interests of all.
- The performance of international financial institutions should be assessed in terms of their contribution to growth and stability of the real economy.
- Financial stability requires an effective lender of last resort.
- Efficient regulation is a *necessary* condition for there to be an effective lender of last resort.
- In the face of the sheer scale of capital movements today an international financial policy will only be possible if there is a high degree of mutually reinforcing co-operation between national monetary and financial authorities.

- The international economy is made up of national economies at widely differing levels of development in both real and financial sectors. It is most improbable that one simple policy prescription will be appropriate to all. National policies must be respected and supported within the context of an overall international financial framework. A blanket commitment to liberalization, openness, and transparency will end in failure, and will endanger the development of the international market economy.
- It is a commonplace, accepted by virtually all, that national financial markets should be regulated. But once financial markets are open there is no meaningful distinction between the operations of national markets and the international market. Thus the regulatory principles which apply to the former also apply to the latter. The objectives of national regulator are consumer protection, the maintenance of the highest possible standards of integrity, market conduct and professional skills in the financial services industry, and the minimization of systemic risk. These should be the objectives of international financial regulation.
- The predominant task of international financial regulation is to minimize systemic risk arising from the operations of securities and futures markets. At the same time, the regulator must avoid the creation of moral hazard. It is vital to guard against the failure of firms endangering the effective operation of the market as a whole. Yet securities firms that make bad judgements must be allowed to fail.
- The demands of international financial regulation cannot be coped with by purely co-operative structures. A new international regulatory entity with appropriate powers is required. An agreed framework should link that entity and national regulatory structures which will play a vital component part.

The history of the modern world economy teaches us that the disadvantages of the spread of liberal financial markets can be offset by sensible public intervention. After all the 25 years after World War II were characterized by strategic liberalization within a controlled international environment, and by the enjoyment of the highest rates of growth and employment in modern times. But in recent years indiscriminate deregulation has dominated domestic and international economic policy, and re-regulation has been in political disfavor.

The Asian crisis should have changed all that. Some commentators continue to seek explanations of the crisis in the peculiar characteristics of the Asian economies – the same characteristics which a year or two ago were typically lauded for their contribution to the Asian miracle. But increasingly, economic policy-makers are recognizing the global risks inherent in international liberalization. The political equation will certainly change if western markets crash or global macro performance deteriorates significantly. It would be better to revise the system to avoid such misfortunes before they happen.

Proposed Reforms

The reforms proposed here are not supposed to be definitive. Rather they are proposed in order to provide a starting point for subsequent debate and development. These reforms would, we believe, substantially improve real economic performance, reduce systemic risk, and significantly diminish the likelihood of collapse.

The overall objective of these proposals is to arrive at a pragmatic consideration of the relationship between capital market liberalization and economic performance, and to create an institutional framework that can put such a pragmatic consideration into effect. If liberal financial markets are not to be perceived as imposing unacceptable costs on national economic performance, then markets must be regulated. If necessary restrictions must be placed on capital flows, national governments must have the opportunity to exercise control over the opening of their own capital markets. Nothing brings liberal financial structures into disrepute so much as the spectacle of national economies being forced into recession by »contagion« effects that bear no relation to their real economic circumstances. The success of Chilean and Chinese restrictions on short-term capital movements in limiting the damaging impact of contagion has been a salutary lesson.

The creation of an international body within which national policies on market openness can be debated and co-ordinated provides a route, perhaps the best route, to maintaining the benefits of liberal financial markets whilst minimizing the costs. The international body would also have the responsibility, in co-operation with national authorities, for directing and maintaining international regulatory structures.

It was the Bank for International Settlements (BIS) which pioneered international financial regulation with the formation of the Committee on Bank Supervision and Regulation in 1975. It was that Committee which formulated the capital adequacy requirements for banks in the 1980s to which all 13 then BIS members agreed to adhere and use as a tool to keep foreign banks who did not adhere out of their markets. The result was that countries voluntarily signed on to BIS requirements in order to achieve market credibility. The BIS has also sponsored a tripartite committee of banking, securities and insurance regulators to propose regulatory standards for financial conglomerates.

The International Organization of Securities Commissions (IOSCO) is the forum within which national regulators are developing common standards, and developing techniques of cross-border regulation. But IOSCO is essentially a co-operative organisation. This is not enough. An executive authority with surveillance capabilities is required. The World Trade Organization (WTO) illustrates that it is possible to establish an international executive authority with enforcement powers. The key task will be to devise a set of arrangements geared to the maintenance of national and international financial stability, and supportive of high levels of growth and employment.

A World Financial Authority

We propose that a World Financial Authority (WFA) be established. This organization would be complementary to the WTO. A central task of the WFA is the development of policies to manage systemic risk. The objectives of the WFA should include the requirement to pursue policies to maintain high rates of growth and employment.

It would be the task of the WFA both to develop rules which would ensure the adoption of best regulatory practice and effective risk management procedures, and to oversee the development of a credible guarantor and lender of last resort function. It will therefore need to build on the achievements of IOSCO to develop a framework for international financial regulation (including risk management procedures) and to ensure, via the powers ceded to it, that those rules are implemented.

But the WFA should not simply be a body that develops and imposes regulatory procedures. It should also be a forum within which the rules of international financial co-operation are developed and implemented. Many of the goals of an efficient international financial policy can be achieved by effective co-ordination of the activities of national monetary authorities. The problem is that the means of achieving that co-ordination are, at the moment, very limited. The WFA will fill that gap. It will also be the responsibility of the WFA to ensure that once national polices have been agreed by the WFA, states support each other's national policies. It is that mutual support which is the key to success.

The WFA should also be given the responsibility of ensuring transparency and accountability on the part of international financial institutions such as the IMF and the World Bank. There is at present no systematic evaluation of the activities of the Bretton Woods institutions, and this lacuna may well have contributed to the damaging criticism that the IMF in particular is imposing an essentially political program in the guise of technical conditionality. Martin Feldstein, for example, has argued that the IMF »should not use the opportunity to impose other economic changes that, however helpful they may be, are not necessary to deal with the balance of payments problem and are the proper responsibility of the country's own political system«. Making the Bretton Woods institutions accountable to the WFA would introduce a »safety valve« of evaluation and accountability that would make the IMF more effective.

Finally, the WFA should provide the necessary regulatory framework within which the IMF can develop as an effective lender of last resort. In many countries the WFA would simply certify that domestic regulatory procedures are effective. In those countries in which financial regulation is unsatisfactory, and which would therefore not have access to the IMF in a financial crisis, the WFA would assist with regulatory reform.

It is clear that there is no appetite today (especially in Washington) for the creation of a new international bureaucracy. Fortunately, the infrastructure for the WFA already exists in the form of the BIS and the co-operative cross-border regulatory framework already developed by IOSCO. With the backing of international agreement, adequate resources, and surveillance »teeth«, these institutions could be developed into the needed world authority.

A Reorganized IMF

The IMF should be reorganized to take responsibility on behalf of the WFA for co-ordinating and partially funding international rescue operations when the need arises and when WFA-approved regulatory procedures are in place. There should be explicit consideration of how the IMF procedures should be developed to deal with problems of liquidity, and the development of a lender-of-last-resort function. For example, the IMF could develop procedures to ensure that in the case of liquidity crises creditors should be »bailed-in« to support the rescue rather than have their own positions »bailed-out«. Whilst reducing systemic risk, care should be taken to minimize moral hazard. To the extent that creditors are protected, this should be at not insignificant cost. Most importantly, rescues should be based on prompt injections of liquidity instead of the current disastrous policy of prolonged attempts to restructure national economic systems using conditionality-laden credit disbursement as bait.

A Refocused World Bank

The World Bank should direct its lending activities towards poorer countries unlikely to get access to open credit markets, subject to oversight from the WFA. It should also act as a co-ordinator and guarantor for a new global closed-end investment fund for emerging markets, a task completely in accord with the powers and functions incorporated in the Bank's charter. The fund could be capitalized by purchasing and holding government securities of the industrial countries in proportion to its shares held by residents of these countries. It would concentrate on long-term investments in the production of goods and services in developing countries, rather than short-term portfolio placements. The fund's shares could be bought and sold freely in many markets and many currencies. Although its share values would fluctuate, the fund would not be forced to sell off its underlying portfolio in the event of a downswing. This would protect emerging markets from abrupt fluctuations in capital movements of the sort observed in Mexico, East Asia, and elsewhere, reducing the need for capital controls. The creation of such a fund should improve the efficiency of investment by significantly reducing the cost of information needed by investors to put together balanced and diversified portfolios.

The Role of National Authorities

Governments should be required by the WFA to improve control of national financial systems by imposing risk-weighted capital and/or reserve requirements on *all* major institutions, banks, mutual funds, insurance and pension funds, for all on-shore and off-shore and on-balance sheet and off-balance sheet operations (recognizing how difficult the identification of some of these operations may be). It should be recognized that traditional notions of capital adequacy monitoring are seriously inadequate in today's capital markts. Capital is no substitute for effective management. Risk management should be central to regulatory activity, internalising, as far as may be possible, risk externalities, though the authorities will need to be aware of the pro-cyclical nature of risk assessment by firms. Particular attention should be paid to the management of foreign exchange risk.

The goals of the development of a new financial framework are to give the authorities leverage over both the supply and demand sides of credit markets, and to prevent imbalances in which national financial systems have long internal and short external net positions or blatant stock-flow disequilibrium positions. The former task will take some of the pressure off short-term interest rates and limit the pro-cyclical consequences of a monetary policy that is directed only at the demand side. The latter task will reduce systemic risk by focusing more attention than at present to system-wide implications of individuals agents' attempts to take profits as well as hedge and insure their portfolios.

The Management of Capital Movements

The experience of the past twenty years has demonstrated that complete liberalization is inefficient. Unmanaged financial markets are too prone to volatility and contagion to provide the stable financial framework necessary for high rates of growth and employment. Instead, a regulated international system, operating through a WFA will create the possibility of securing the benefits of capital mobility, whilst diminishing the costs. Indeed, such management is necessary if there is not to be a swing back to widespread protectionism. Campaigns to rewrite the IMF articles to require full capital market liberalization by all nations, and OECD proposal to write full capital liberalization requirements into a multilateral agreement on investment, are without sound intellectual foundation and should be abandoned.

National governments, after appropriate consultations with the WFA, should be empowered to impose restrictions on external capital movements as they see fit. Effective controls, particularly on short-term capital inflows may well be necessary if free trade in goods and services is to be sustained. Yet there is a significant difference between limiting short-capital flows into a country, and closing markets to foreign goods. In the latter case a country may attempt to acquire a beggar-my-neighbor advantage. The same argument does not apply to the former case. So the usual requirement of regulatory capital and reserve ratios imposed on firms may be supplemented with quantitative or tax-based obstacles to cross-border flows of funds. Whilst there should be a presumption in favor of national policies, the form, scale and duration of such restrictions (which may, if necessary, be deemed permanent) should, however, be determined in consultations with the WFA. Once particular conditions for the management of capital movement have been agreed then member states of the WFA should be required to provide assistance to fellow members in their operation.

Financial Insurance

To diminish the damaging effects of moral hazard on institutional decision making, national compulsory deposit insurance and similar financial guarantee insurance systems should be associated with individuals and households rather than institutions. ◀

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