Globalization, Stability and the Financial Markets

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Fifty-year anniversary celebrations are rare events and require long planning. Given the events of recent weeks, I must congratulate Mario Sarcinelli on his exceptional foresight in arranging a programme focusing on globalization of markets and its implications for financial stability.

The turbulence in East Asia, the contagious effects on financial markets of other emerging economies and even on the major world stock markets, and the renewed instability in exchange rates are, I think, warnings of trouble in paradise – paradise defined as a world in which capital is free to flow as never before around the world in amounts and at a speed without precedent.

In calling attention to these troubles, I do not want to be misunderstood. There are powerful forces supporting growth through much of the developing world. That is certainly true in East Asia, where the recent financial pressures have been centred. Progress toward freeing trade has been a big factor in releasing those forces. Conceptually, the growth process should be greatly enhanced by flows of international capital, and we can find specific examples where that has been the case.

Yet, we would be naively optimistic to think that all is serene – that the recent disturbances are simply a passing blip on our radar screen, without systemic implications, and that rapid growth is assured.

We have seen for a long time, even among large and strong countries, that exchange rates are prone to wide swings even in the absence of major economic disturbances. Today, the dollar/mark and the dollar/yen are surely the most important exchange rates. In the

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□ New York (USA).

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three countries, a high degree of price stability has been maintained over a good many years. Yet, contrary to the expectations of most economists and to textbook orthodoxy, those exchange rates have continued to fluctuate widely, sometimes by 50 percent or more over a year or two.

A full generation after floating exchange rates among the major currencies became the norm, I still hear among economists the same plaintive wail of enthusiastic fans of losing American baseball teams – "just wait until next year"; exchange rates will stabilize! But just as with my favorite ball team, next year never seems to come. Markets remain volatile in ways that simply cannot be consistent with careful calculations of comparative advantage, optimal investment decisions and market efficiency.

I know one response to all this is that other policy priorities are more important than stable exchange rates. In particular, domestic stability should not be sacrificed. What that view overlooks are the links, some obvious and some subtle, that translate external instability into domestic problems. Take, for instance, the strong yen appreciation three years or so ago. That was clearly a drag on domestic growth and investment when the economy was already weak. It also contributed to a surge in foreign investment, into Thailand among other places, in an effort of Japanese companies to reduce costs of production. Now that the yen rate has swung sharply the other way, fears arise that Japanese industry is overly competitive in external markets even as the domestic economy limps along.

We have long known that exchange rate volatility among the major currencies leads to difficult dilemmas for smaller, emerging economies. How can they get it right? Stabilizing their own currency against one of the major currencies (or even against a basket) leaves them vulnerable to sharp swings in competitiveness in export markets over which they have no control. The opposite choice of free floating is hardly possible for small countries. Small currency markets, relatively undeveloped and vulnerable financial institutions, and typically uneven track records on inflation mean that floating will almost inevitably be prone to a high degree of volatility. And in those countries no one can pretend that domestic prices and production can be insulated from exchange rate shocks.

We should not be surprised in these circumstances that there is a lot of experimentation with exchange rate regimes and that even IMF doctrine seems to change over time.

The understandable inclination after each episode of extreme instability is to identify specific causes: fiscal policy is too loose; banks are undercapitalized; there is too much corruption and too little transparency; the wise advice of the IMF has been ignored or maybe never even articulated; more generally, political objectives have thwarted sound economic policy. And of course, there is truth in those judgments.

At the same time, we have to recognize that no government – not even in the most settled and sophisticated industrial democracies, not even yours or mine – will succeed year after year in maintaining appropriate budgetary discipline, avoiding political impasse and escaping misjudgments in economic policy. If reasonable stability in world exchange and financial policies must rest upon error-free policies, a high degree of volatility is inevitable.

But even beyond those exigencies, I sense we can see other forces at work in free global markets – forces of a systemic nature that tend to generate damaging recurrent financial crises. Smaller emerging economies are especially vulnerable.

The ironic fact is that those emerging nations that have been deemed to be making the most progress in adopting orthodox policies are at risk.

Take those countries that have been successful in opening markets, in taming inflation, in restoring a sense of budget discipline, in privatizing. They become a magnet for foreign capital. To the extent that capital takes the form of direct investment, the chances are good that it will bring productivity improvement, needed technology and export competitiveness. But what is likely to come the fastest and in the largest volume is portfolio capital.

There is an enormous volume of portfolio capital ready to move in world markets today in an almost desperate search to maintain the kind of double digit returns characteristic of world stock markets for a decade. A shift in the flow of that capital – marginal from the standpoint of institutions controlling hundreds of billion of dollars – can quickly overwhelm the absorptive capacity of even the most responsibly run countries. Deluged with a capital inflow, how does an emerging economy avoid inflation or an appreciating currency or some of both? Will consumption not tend to rise even faster than production? Will credit standards not almost inevitably erode under the pressure of the ready availability of capital? How can a construction and real estate boom be avoided under the circumstances?

Most significantly, the current account will run into deficit. With confidence running high, even large deficits can be sustained for years. Think of Mexico in the Salinas years. Think of the Czech Republic following with almost religious fervor the most orthodox of capitalistic policies. Yes, think of Thailand, which until this year was considered among the economic miracles of Asia.

Sooner or later, some event triggers a reversal of sentiment. The capital stops flowing in. The exchange rate collapses. The inflation threat recurs. Interest rates skyrocket, and immature financial institutions come under heavy pressure.

Rescue packages are debated and assembled to stem the financial distress. Despite that aid, prospects for sustained growth come into question, even for countries with the strongest prospects. Moreover, the financial strains are contagious, as investors question earlier assumptions.

Now, you may respond that I have simplified things to the point of caricature. But a simple cartoon can capture the essence of reality. I believe we can indeed see symptoms of a repetitive pattern in our global financial markets. If what is at stake is simply a pattern of big gains and losses among financial capitalists, ready and able to absorb risk, then perhaps it need not be at the centre of our policy concerns. But if the net effect is to wash out a significant part of the practical benefits of the free flow of capital, then we have cause for some concern.

Beyond that looms a larger question – I do not say a reality – but a question.

There is one basic rationale for all the progress that has been made toward eliminating exchange controls, toward encouraging free flows of capital internationally, and toward developing the apparatus of modern finance, including arcane techniques of hedging and risk management. That rationale is to contribute to more rapid and sustained growth. We have a lot at stake in the success of that effort. And the stakes are not only economic.

We rightly associate concepts of the rule of law, reduced corruption, and opportunities for individual freedom with the operation of open competitive markets.

If (and on the basis of recent experience, it is an 'if' we cannot entirely dismiss) emerging economies have difficulty in sustaining rapid growth – say growth comparable to that sustained for decades by Japan and Korea and some Latin American countries before world financial markets were liberalized and money flowed so freely – then new questions will arise about the acceptability of free and open international capital markets.

I cannot offer my simple answers to the challenge. Certainly in these days of cyberspace, ever cheaper and quicker communication and ease of travel, we cannot comprehensively and effectively control capital movements for long even if that course were conceptually attractive, which it is not. But that need not mean we should frown upon those countries that take reasonable administrative measures to slow inflows of capital that tax their absorptive capacity. Neither am I convinced that the popular mantras of more transparency, budget discipline, and independent central banks can provide anything like a full answer, however worthwhile those prescriptions in and of themselves may be. The point is that even the best of intentions and policies can be undercut by excessive volatility in the money and exchange markets.

In specific circumstances, emergency financial assistance, whether marshaled by the IMF, the United States, or regional partners, may well be helpful. That is particularly true if the assistance helps a country to overcome political resistance to needed policy steps. The difficulty is that we seem to be drifting into circumstances in which such international rescue missions – inevitably bailing out imprudent lenders as well as improvident borrowers – are becoming both more frequent and larger. That is a trend that seems neither sustainable nor supportable over time. Old questions of moral hazard – the possibility that protection against risk encourages the very risk-taking that leads to crisis – arise with new relevance.

Well, it is one thing to analyze and to warn, quite another to suggest ways out of the dilemma. The fact is that there are no easy answers. But I think we can reach some general conclusions.

Surely, we cannot turn the clock back. There is no escape into comprehensive and permanent controls, and there would be much to lose by making efforts in that direction.

Instead, I suspect the answer will have to be found in more integration of world markets, rather than less. We see clear tendencies in that direction:

– More and more emerging economies are finding it necessary and desirable to permit and encourage foreign ownership of indigenous financial institutions, providing greater strength and stability. The same tendency is true in the non-financial world. Conversely, large local companies are more likely to diversify abroad, limiting their exposure to domestic crisis.

– The rapid internationalization of equity markets offers new channels for portfolio investment that may both pose less systemic risk and provide great benefit to the emerging economies. Equity markets are, of course, inherently volatile. But even wide swings in prices may be more easily absorbed, without so much systemic risk, precisely because the investors are better prepared to take losses.

– In the absence of more stable local currency conditions, regional currency arrangements are a natural response to the need to protect against excessive volatility. The long-standing drive for a common European currency is, of course, one manifestation of that desire – and one example of the enormous challenge such arrangements pose. But despite the difficulties, I suspect there will be further efforts, although other regional arrangements will surely be less formal.

None of that suggests quick progress. It inevitably implies – I would argue that new technology itself implies – less national policy autonomy. That is a politically painful point for any country, and it is a particularly difficult lesson for countries just now emerging not only into a highly-developed economic and financial world, but into more democratic political systems.

One danger is that there could be a retreat into a kind of full-blown regionalism. So far, the clear tendency toward regional free trade or customs areas has been generally benign, despite their inherently discriminatory character. That is because they have taken place within the general context of a global reduction in trade barriers.

What we do not want to see materializing is a crisis-prone financial system providing new incentives for a retreat into protective regional blocs. That is, broadly, why I think the evident (and ultimately constructive) spread of economic integration needs to be accompanied by much more attention to monetary reform on a global scale.

Permit me to conclude with one osservation.

A world in which the rates of exchange among the principal currencies can swing so widely, and so seemingly capriciously, is not a world that will maximize the efficiency of world capital markets or the potential for world growth.