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Joseph P. Daniels
Marquette University, joseph.daniels@marquette.edu

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7 Global Capital Flows: Maximising Benefits, Minimising Risks

JOSEPH P. DANIELS

Recent events in the world economy have demonstrated that a strengthening of the system is needed to maximize the benefits of, and reduce the risks posed by, global economic and financial integration.
- *Report of the Finance Ministers to the Köln Economic Summit*

Introduction

Much has been made of the role of capital flows and financial speculators in the context of global integration. Yet in much of the literature on reforms to the international financial system, it is taken for granted that the economic benefits of broader and deeper liberalised financial markets and the economic role that speculators play in these markets is well understood. In the early 1990s, the industrialised countries, particularly the United States and Europe, have unabashedly promoted financial liberalisation as the obvious and inevitable policy choice for developing and emerging economies.

Following the financial crises of 1994 and 1997, however, criticism of globalised financial markets for their shortcomings has been unremitting. Various policy-making fora have also followed this path, concentrating on risks and considering ways in which to contain the level or constrain the pace of financial liberalisation and global activities of financial speculators, as opposed to promoting the benefits of continued liberalisation as they once had. Because of advances in telecommunications and financial engineering, continuing integration of financial markets appears inevitable.

If history has anything to offer us, as James (1999) argues, liberalisation can be reversed. The lack of clear and consistent leadership in international economics may explain, in part, the recent surge in isolationism and protectionism. Leadership in this complicated issue area requires close

attention to the normative and positive aspects of financial liberalisation in order to gain credibility to co-ordinate at the international level and advocate at the national level.

Capital market liberalisation has become an appealing goal to many nations because of the perceived allocative benefits and efficiency gains. The risks inherent in this process, however, have been made painfully obvious and, as a result, policymakers have elected to "reform" the financial system - meaning measures designed to prevent possible crises and better manage those that do occur - so as to maximise said benefits while minimising the risks. The overall purpose of this chapter is to offer an understanding of the basis for a strengthening or reform of the international financial system and, therefore, the rationale behind the *preventative* reforms advanced by the G7 Finance Ministers. It seeks to add to the existing literature by identifying and discussing, in an accessible manner, the root benefits of capital market liberalisation, the risks and imperfections inherent in capital markets, and the constraints that liberalised capital markets place on the conduct of microeconomic and macroeconomic policies. The role of financial speculators in the recent financial crises in East Asian is also considered. Instead of offering yet another list of reform proposals, this chapter focusses on those proposals most likely to be acted upon, that is, those drafted by the G7 Finance Ministers in *Strengthening the International Financial Architecture, Report of the G7 Finance Ministers to the Köln Economic Summit*. Finally, as the members of the G7 are the architects of the current international financial system, they have key responsibilities in its reform and management. We outline these responsibilities in the final section.

The conclusion drawn here is that the G7 has put forward worthy proposals for reducing variability and for responding to and containing future crises. These proposals should be acted on with haste. The G7 has fallen short, however, in providing the likely victims of future crises, the larger emerging and developing economies, with solid working proposals and examples appropriate to the conditions of these economies and broader participation in the reform process. The G7 Ministers' report implies that market participants will continue to be the principal agents pressing the integration of the financial systems of the major developed economies with those of the emerging and developing economies. Likewise the market will continue to be the primary supervisor of macroeconomic and exchange rate policies, rewarding nations with sound and credible policy and punishing those without. Nonetheless, the G7 has key responsibilities in the reform process and in managing these markets.

Benefits of International Capital Flows

Advocates of capital market liberalisation argue that unhindered capital movements allow savings to flow to their most productive use and, therefore, financial speculators play an important and beneficial role as they are the agents that provide liquidity, regardless of host location, to projects with potentially high marginal products. Those projects that do eventuate in high returns reward speculators for the risk they have assumed. In this way, resources are directed in the most efficient pattern, resulting in real sector development and productivity increases. Financial speculators, therefore, take the risky side of a financial transaction and provide essential liquidity to the economy.

With access to foreign capital, domestic households and businesses may expand their lending and borrowing activities abroad, allowing agents to continue to spend and invest during domestic economic downturns and repay during periods of economic growth, thereby mitigating typical business cycles. Hence, domestic agents can diversify savings internationally and reduce their exposure to domestic economic shocks. These positive aspects reinforce capital flows as domestic residents enjoy higher risk-adjusted rates of return, spurring yet higher levels of saving and investment activity. In turn, increased saving and investment induce additional economic growth.

For developing nations in particular, access to global capital reduces the cost of financing investment projects considerably. More investment projects are undertaken, leading to real sector development. In the long run, this translates into higher standards of living as higher rates of growth are enjoyed. Private speculative capital, therefore, may substitute for uncertain development aid that often comes with inefficiency costs associated with bureaucratic red tape and constraints.

The Role of Financial Intermediaries

For speculative capital flows to deliver promised real sector development and growth, a well-developed system of financial intermediaries is required. Pagano (1993) identifies three key functions of financial intermediation that lead to economic growth. The first is funnelling savings to firms with minimum x-inefficiencies. The process of intermediation absorbs a fraction of each dollar of savings so that less than one dollar is invested. An efficient system of intermediaries faces low reserve requirements, transaction taxes and unnecessary regulation, reducing these inefficiencies.

Secondly, financial intermediaries make it possible for many people to pool their funds together, thereby increasing the size, or *scale*, of the amount of total amount of savings managed by a central authority. This centralisation of management can reduce average fund-management costs below the levels that savers would incur if they were to manage their savings alone, thereby enjoying financial economies of scale. In this way, intermediaries may increase the amount of savings ultimately invested by reducing unnecessary costs.

Another outcome of an efficient system of intermediaries is the reduction of information asymmetries and an improvement of capital allocation and market stability. An information asymmetry exists when one party to a transaction, say a borrower, has more or better information than does the other party, the lender. For financial markets in particular, information asymmetries can lead to a number of potential problems including inefficient allocation of savings, herding behaviour, and even financial crisis. Intermediaries who specialise in the assessment of the quality of debt instruments and continuously monitor the performance of firms that issue these instruments are able to reduce the degree of information imperfections.

Intermediaries also provide a means for savers to pool risk. If savers are unable to pool risk, they will invest in the most liquid projects. More productive but less liquid projects are not financed, resulting in lower potential economic growth. Hence, intermediaries play a key three-part role: relying on their informational capabilities, they evaluate investment projects and determine those with the highest marginal product and then induce savers to invest in higher risk but more profitable projects through risk sharing at reduced average costs.

Financial Sector Development and Economic Growth

Reduced costs, higher quality information, and the pooling of risk are only some of the ways in which intermediaries may affect the rate of saving in an economy. Economic theory shows, however, that financial sector development may either increase or decrease saving and the effect on economic growth is unclear *a priori*. Improvements in hedging instruments may reduce precautionary saving and improvements in household credit markets may allow agents to dissave in favour of current consumption or low-marginal-benefit projects. Hence, if financial development induces lower saving, economic growth may suffer.

One view on the contribution of the financial sector is that long-run trend performance is determined solely by real sector development. An alternative view is that the development of the financial sector alters economic fundamentals and, therefore, alters long-run performance. Why financial development evolves differently across economies and the casual relationship between financial development and real sector growth is still unclear. Recent empirical literature, however, supports the view that financial development does indeed affect economic growth. Eatwell and Taylor (1998) argue, therefore, that the ultimate measure of a system of intermediaries is the effect on the real sector of the economy.

Misallocation of Capital

The fact that "reform" of the international financial system is being widely discussed is an admittance that unhindered financial markets do not achieve the utopian view of efficient capital allocation expressed above. Such an outcome is the quintessence that one would like to see reached, but there are a number of market imperfections and policy-created distortions that cause the system to fall short. In the presence of a deep and well-regulated system of intermediaries, financial development and capital market liberalisation may positively affect the path of potential long-run growth. Yet, under lesser conditions, intermediaries may channel capital flows in ways that undermine domestic policies, increase shocks and contagion, and trigger financial crises (Crockett, 1997, p. 7). The benefits of efficient capital allocation described above may be offset and economic growth actually suffer.

The potential costs of financial crises is well documented in the literature. For example, it is believed that the costs of the 1980s banking crisis in Argentina equalled one-half of the nation's GDP, while the United States' bailout of banks during the early 1990s totalled at least US$200 billion. The 1995 real estate collapse in Japan resulted in the nonperformance of more than US$250 billion in bank loans. In South Korea more than 10 percent of all bank loans are nonperforming, and for India and China nonperforming loans are estimated to be nearly 20 percent of outstanding loans. Since 1980, the International Monetary Fund (IMF) estimates that 133 of 181 IMF member nations have suffered banking problems it considers to be "significant" (Lindgren, *et al.* 1996).

The conclusion is that there are potential allocative and efficiency gains to be enjoyed from liberalising capital markets. A well-developed and regulated system of intermediaries is necessary for these gains to be realized.

This is not a sufficient condition, however, as there are policy-created distortions and financial markets imperfections that must be dealt with. With the potential benefits of financial speculation and the importance of a well-developed financial market in channelling global funds outlined, the risks and policy constraints inherent in liberalised financial markets are considered next.

Financial Markets and Economic Policy

There are a number of potential imperfections and risks inherent in financial markets. It is useful to focus on those that are central to the stability of global capital markets. For liberalised capital markets to function at the level of practical expectations, microeconomic and macroeconomic policies must be consistent with an environment of free-flowing capital. To promote stability of the system, these policy constraints must be realised and respected, policy-created distortions minimised, and imperfections addressed.

Risks, Distortions, and Microeconomic Policy

One type of market imperfection, that of asymmetric information, is believed by some economists to pervade financial markets in particular (Eichengreen, *et al.* 1999). As discussed above, asymmetric information can induce an inefficient distribution of capital and increased market volatility. Two key problems associated with information asymmetries are adverse selection and herding behaviour. In financial transactions, lenders are often not privy to all of the information - particularly information about risk - regarding a capital investment project. The existence of an information gap between savers and borrowers can result in adverse selection, or the potential for those who desire funds for unworthy projects to be the most likely to want to borrow or to issue debt instruments. A result of adverse selection is that the issuance of poor-quality instruments can make savers less willing to lend to or hold debt instruments issued by those seeking to finance high-quality projects (Daniels and VanHoose 1999). Additionally, poor information may result in herding behaviour. That is, in the presence of information gaps, savers follow the behaviour of someone else they feel is better informed. In a global context, herding behaviour can be a catalyst for contagion and spreading financial instability to regional levels. Herding behaviour can also lead to a reduction of asset prices or currency values that greatly exceeds what is warranted.

In global capital markets, the problem of information asymmetries can be extensive as multinational enterprises engage in transactions spanning the globe. High-quality intermediaries are able to reduce the degree of asymmetric information by having offices around the world, creating economies of scale in information processing. By continuously monitoring and evaluating the performance and activities of multinational enterprises, they are able to reduce, albeit not eliminate, information asymmetries and thereby encourage savings and reduce herding behaviour.

Another potential problem is that of moral hazard, that is the borrower engages in behaviour that increases risk after the debt instrument has been purchased. Again intermediaries are able to reduce moral hazard by continuously monitoring the performance of the borrower. In the context of global capital markets and in light of recent financial crises, moral hazard may arises when a domestic government implicitly guarantees that a firm or bank will not be allowed to fail. International organisations, such as the IMF, have also been accused of creating moral hazard when standing by ready to bail out sovereign nations facing a liquidity crisis.

Finally, capital flows may respond to policy-created distortions, leading to an inefficient and capricious allocation of capital. Cooper (1999) points out that differential national taxation, trade restrictions, and macroeconomic policies are but a few policy-created distortions that may lead to a misallocation of capital. In addition, differential national regulation on financial transactions may generate regulatory arbitrage, when domestic institutions either locate abroad or conduct certain types of operations abroad in order to avoid domestic regulation and supervision. This mitigates the regulatory abilities of governments and exposes domestic intermediaries to the very types of risk regulators seek to minimise. These distortions result from domestic microeconomic policies yet need to be judged in an international context as well. Without proper international co-operation and co-ordination, there exists a potential "race to the bottom" or a move to the regulatory and tax environment of the least stringent nation.

Financial Market Liberalisation and Macroeconomic Policy

Financial market liberalisation also constrains macroeconomic policy in ways determined by the exchange rate regime, one of the most important macroeconomic institutional choices a nation faces. For developing nations, the exchange rate is an extremely important nominal price that affects export

performance, the cost of important commodities and inputs, and directing business planning and investment. Pegging the exchange rate, therefore, is an attractive option. The well-known "impossible trinity" of fixed exchange rates, capital mobility, and discretionary monetary policy prescribes that these three conditions cannot exist simultaneously and policymakers must be willing to forgo one aspect.[1] For developing, transitional, and emerging nations seeking to gain exchange rate stability and domestic price credibility through pegged-exchange rates while liberalising financial markets to take advantage of cheaper foreign financing, the lesson is that monetary authorities must be independent and conduct policy in a manner consistent with the first two objectives. This means that discretionary monetary policy via sterilised foreign exchange interventions is not sustainable in the long run. The typical outcome of countries trying to practice all three is an overvalued currency and inevitable devaluation. In turn, the devaluation focusses attention on the improper past conduct of monetary policy and the loss of credibility is dramatic. As a result, the devaluation often leads to a complete collapse of the exchange rate regime and eventual floating of the currency until a new trading floor is found and the currency stabilises.

Developing nations, therefore, face a dilemma; should they choose fixed or flexible exchange rates? Cooper (1999), an advocate of a common world currency, see the only practical choices as being flexible exchange rates and some type of capital controls or capital market liberalisation and strongly fixed exchange rates with the complete loss of discretionary policy. With capital market liberalisation, a developing nation with a flexible exchange rate regime will experience a highly volatile exchange rate that responds primarily to the flow of foreign capital and, as a result, will be driven to capital controls. Otherwise, full capital mobility requires these nations to adopt a true fixed exchange rate regime with the loss of monetary policy, such as in Hong Kong or Argentina.

A pegged exchange rate regime, such as that employed in Thailand, Indonesia, and Malaysia prior to the fall of 1997 is problematic in combination with capital market liberalisation.[2] A key consideration is that under a pegged-exchange-rate regime, currency risk is shifted, to a given degree, from private market participants to the government. To private agents, the marginal benefit of employing hedging instruments appears less than the marginal cost. Many foreign exchange exposures, therefore, go unhedged and the foreign currency denominated debt of firms and businesses will balloon with a devaluation. According to Cooper, at the point when authorities realise that the exchange rate needs to be devalued so do private market participants

and currency speculators, who are able to profit at the expense of national reserves. Further, as foreign currency indebted businesses scramble to buy up reserves so as to hedge their exposure, they exert significant downward pressure on the value of the domestic currency. The outcome is a free-falling exchange value. This is combined with the fact that the G7 nations lack an exchange rate policy that provides for long-term stability among their currencies. What this means for developing countries that choose to peg to one or more of these currencies is that, eventually, a revaluation or devaluation is inevitable. If the conduct of macroeconomic policy or microeconomic reform was wanting in the interim, or if the adjustment to parity was postponed too long, markets are likely to make these nations pay harshly for their shortcomings.

Another concern regarding financial liberalisation, somewhat separate from the choice of exchange rate regime, is the potential loss of monetary control. As pointed out by Williamson and Mahar (1998), nations that practised monetary policy through capital controls typically do not have any, or least not well-developed, money and bond markets. Removing these controls leaves authorities with no means to control monetary growth through open-market operations. Eventually liberalisation leads to the development of government securities markets and monetary control is restored. The transition period, however, may prove to be quite unstable, providing one explanation of why many nations experience a financial crisis following liberalisation.

The Role of Foreign Capital in Recent Crises

Before moving on to consider the appropriateness of reforms, it is important to first consider the role of foreign speculators. At the time of the East Asian crisis, Malaysian Prime Minister Mahathir Mohamad blamed foreign speculators for the financial crisis that engulfed the region, sparking a bitter debate with the likes of George Soros. Did foreign speculators truly cause the financial crisis in their blind pursuit of profit, as some claimed? Or, as argued by other, was it the result of improper macroeconomic and microeconomic policies?

Now that some time has passed since the start of the East Asian crisis, empirical assessments of the crisis are beginning to materialise. Though the evidence so far is rather scant, it supports the notion that foreign speculators *were not* the cause of the crisis. One of the most recent studies, by Choe, Kho,

and Stulz (1999), considers the role of foreign investors in the collapse of the Korean stock market in 1997. The authors show that the market adjusted quickly to sales by foreign investors and that negative abnormal returns were not persistent following foreign sales. The authors provide evidence of herding behaviour by foreign investors but convincingly argue that such behaviour need not be destabilising. Their results show that domestic buying activity dominated foreign selling activity in the last three months of 1997. Hence, there is no evidence that foreign speculators were a destabilising force. Regarding Thailand, Lauridsen (1999) concludes that private sector intermediaries mishandled short-term capitals flows leading to a misallocation of capital. Though, in the author's opinion, this is the main cause of the crises, it was accompanied by political instability and mismanagement. Jomo (1999) concludes that the reliance on short-term financing, speculation against the currency-basket peg, and injudicious policy responses led to the collapse of the Malaysian ringgit. The "Tequila Crises" of 1994-1995 is examined in a special volume of the *Journal of Banking and Finance*, edited by Calomiris (1999). Though the review of the literature on this episode shows some disagreement on the role of speculators, what is apparent is that is was problems in macroeconomic and microeconomic fundamentals that made Mexico "vulnerable to the whims of speculators" (p. 1458).

Finally, in a theoretical context, Aghion, Bacchetta, and Banerjee (1999) show that economies at an intermediate level of financial development are more unstable than economies with either fully developed or underdeveloped financial markets. As a result, intermediate economies that undergo financial liberalisation may destabilise their economies. Foreign direct investment, however, is not destabilising. The authors suggest, therefore, that economies with financial markets at an intermediate stage of development should carefully plan and pace financial liberalisation, allowing FDI but restricting portfolio flows. The importance of creating incentives for FDI is addressed by Alan Rugman in a later chapter of this text.

Hence, the literature suggests that the sources of these financial crises lies in the mix of inappropriate macroeconomic policy and inadequate microeconomic reform coupled with capital market liberalisation, as opposed to foreign speculation. Whether one blames speculators, the conduct of microeconomic and macroeconomic policies, or the level of financial development for the financial crises of the 1990s, the previous sections of this chapter demonstrate the overarching importance of a well-developed, high-quality system of financial intermediaries. Financial intermediaries exist to save potential holders of financial instruments from incurring the risks and

allowing them to enjoy reduced costs, thereby encouraging financial speculation in the most efficient sectors of the economy. In turn, speculators provide the most promising sectors of the economy with the liquidity needed to develop and expand. While these institutions cannot eliminate adverse selection and moral hazard problems, they can collect information about the underlying riskiness of financial instruments and monitor the continuing performance of those who issue such instruments, thereby reducing the extent of these problems in financial markets.

Preventative Policy: G7 Recommendations

With the benefits and risks of unhindered capital flows considered, what type and to what extent should reform efforts take? Should there be a new international financial architecture, or should reforms be modest? Eichengreen (1999, p. 9) makes a compelling, though blunt, argument against proposals that are too grandiose, claiming that they are impractical and have "not a snowball's chance in hell of being implemented". Given the complex and dynamic nature of the system, one must realise that there is no definitive answer to the questions proposed here. Thus, there will be considerable disagreement on reforms that are complex and broad sweeping. As such, grand proposals are non-starters in the current political environment.

As stated at the outset of this chapter, the objective of policy and reform should be to maximise the benefits while minimising the risks associated with capital market liberalisation. The literature has shown that liberalisation needs to be paced according to the level of financial development the nation finds itself at. Microeconomic policy actions should free trade flows, encourage flexibility and competition, and improve regulation and supervision of the nation's system of intermediaries. The deepening of the market for government debt is essential for controlling the money supply and allowing for direct financing. The ability to finance directly reduces the impact of banking crises on the real sector of the economy and provides for long-run stability.

In evaluating the G7's proposals designed to prevent possible future crises, this section reviews those put forward in the Report of the Finance Ministers to the Köln Economic Summit (see the appendix for the full text of the Report). Beginning in Halifax and continuing in Lyon, the Finance Ministers were requested by the leaders to identify key areas of reform in the international financial system and to report on initiatives prior to the summits.

The Köln Report, therefore, is a document that has been in construction for four years and has evolved along the way. It allows for a comprehensive view of the Finance Ministers' assessment of the state of the international financial system, reforms that have taken place, and proposals to date.[3] The report, however, is not necessarily a set of policy commitments. Rather it is a proposal prepared for the G7 leaders' consideration. Nonetheless, it provides a useful means for evaluating the types and likelihood of reforms to the system.

After reviewing the report, the role of the G7 as a body of global governance in the context of the international financial system is considered. In light of the centrality of the G7, the dominance of the G7 economies in global trade and capital flows, and the fact that the G7 nations were the architects of the current system, a set of responsibilities is put forward. Fulfilment of these responsibilities is critical to the success a well-functioning global financial system.

General Overview of Assessment and Proposals

The report of the Finance Ministers reflects well the work that has taken place since Halifax. The document addresses the key areas of strengthening and reforming international financial institutions (IFIs): enhancing transparency and promoting best practices, strengthening financial regulation in industrial countries, strengthening macroeconomic policies and financial systems in emerging markets, improving crisis prevention and involving the private sector, and promoting social policies. At 28 pages in length it is indeed comprehensive in its assessment and long in recommendations. The report reads as a text on various reforms implemented, recommended, and proposed for further study. It does an excellent job of framing the current situation in the most general sense. The overall quality of the document reflects the efficient workings of the G7 Finance Ministers' meetings and the competence of the current ministers and their staffs.

The report makes it clear that no new international organisations are needed (a point which is emphasised again below). The theme of the report is that for international financial markets to work properly, enhanced transparency and disclosure as well as improved regulation and supervision are necessary. Involvement of the private sector in crisis management and prevention, as well as requiring the private sector to bear responsibility for risk assumed, is also emphasised.

Some of the key recommendations are that the IMF and World Bank need

not only co-operate, but need also to forge a clear division of responsibilities between the two. Improved and increased transparency and accountability of these institutions and other IFIs is pressed. Involvement of developing and emerging nations is limited to the New Arrangements to Borrow (NAB), the Interim Committee of the IMF, and the new Financial Stability Forum.[4] A number of other proposals are made for reforming and improving the existing IFIs. We leave these to the experts in policy architecture to gauge their merit.

The Ministers' report opens by stating that a "well-functioning international financial system is essential to allow an efficient allocation of global savings and investment, and provide the conditions needed to improve world-wide growth and living standards in all countries". In the process, it is made clear that policy responsibility still rests with national authorities and what is envisioned is international co-operation rather than international regulation. International institutions, particularly the IMF and the World Bank, are asked to improve performance in core responsibilities, increase transparency, clearly delineate responsibilities, and co-operate rather than increase their scope of regulatory and supervisory activities.

Risk Management

Much attention is given to risk assessment, a challenging task in today's environment of sophisticated financial engineering. Banks and other financial intermediaries are the focus of reform, given the important role they play in filling information gaps and allocating capital. The reforms of the Basel Committee are held as the standard that all countries should consider for domestic implementation. Unfortunately, the revisions have come under fire for not doing enough and not being particularly useful to developing country systems. Developing nations have argued that they would be at the mercy of rating agencies, and though the new standards might tighten controls over banks in developed nations, may very well hurt banks in their nations (Diaz, 2000). Clearly the emphasis is minimising market imperfections and improving supervision of financial institution activity rather than regulating it.

Capital controls are suggested for developing nations only as a transitory tool while the financial sector develops and supervisory abilities improve. The purpose is to limit unhedged short-term borrowing of developing country banks. Though not a first-choice policy instrument, the views of the finance ministers are consistent with the literature suggesting that financial development is a necessary condition for stability and foreign direct

investment (FDI) is preferred to short-term capital flows, as FDI is not destabilising. Eichengreen (1999) argues that such taxes are indeed warranted in certain cases, but that they are a third-choice, where improvements in risk management and regulatory abilities are the first and second choices. The problem with capital controls is that they reduce the pressures on policy makers to implement the first and second choices. Further, as the report states, they have not been a very effective instrument in most cases.

Private Sector Bail-In and Involvement

Private sector bail-in, that is having private sector investors assume responsibility for risk undertaken, is not only a critical component of crisis management but also crisis prevention, as clear terms for bail-in would reduce moral hazard. By forcing private sector participants to bear the financial consequences of their investment decisions through changes in debt financing and the reduction of domestic and international safety nets, *ex ante* expectations are changed and, it is assumed, a more conservative approach to risk will be adopted.

The report outlines a framework that recommends linking official support to the country's programme of meeting its debt obligations, balancing classes of debt holders if the debt is to be restructured, establishing a reserve floor for private sector contributions in relation to official contributions and allowing lending into arrears and the use of payment suspensions and capital controls in "exceptional" cases. The report further states that no category of private creditors (bondholders) should be viewed as senior to any other group (banks). It concludes, however, with an acknowledgement that the general approach will remain to be applied on a case-by-case basis. This reflects the disagreement that exists between, primarily, the Americans and other G7 members on how to bail in private bondholders. Because bonds do not typically contain collective action clauses, rescheduling of this type of debt is difficult, if possible at all. This has led to a mistaken belief that bondholder rights are held higher than those of other debt holders (*The Economist*, 1999). The problem with these types of provisions, as well as standstill arrangements and exchange controls, is that they may reduce the quality of the debt instrument. Because of this, some have argued that they may actually create an unstable environment that is conducive to a financial crisis.

Co-ordination of Reform

Private sector involvement in crises prevention is also called for. Little detail is forthcoming on how to accomplish this, however. Eichengreen (1999, p. 7) points out the obstacles to IMF-led standard setting and the need to rely on private sector expertise as the "only practical way of promulgating effective standards in the relevant areas". The number and variety of agencies involved in financial architecture reform is quite expansive. In an attempt to categorise the various bodies, the agencies and organisations mentioned *explicitly* in the report are grouped according to their affiliation with international organisations, private sector organisations, and the G7.

Those directly affiliated with the G7, or created by the G7, are the; Financial Action Task Force, created by the G7 at the 1989 Paris Summit and includes 26 member countries; G7 Financial Experts Group on Supervision and Regulation in the Financial Sector; and the G7 Working Group on Financial Crime. International organisations and affiliate bodies are; the World Bank; the IMF; the New Arrangements to Borrow (NAB); the Interim Committee or International Financial Monetary Committee; the IMF / World Bank Development Committee; the Financial Sector Liaison Committee (FSLC); the IMF-World Bank Financial Sector Assessment Programme (FSAP); the United Nations (UN), and the Organisation for Economic Co-operation and Development (OECD). Private sector-based bodies and affiliates are; the BIS; the Paris Club; the BIS Committee on the Global Financial System (CGFS); the Financial Stability Forum chaired by Andrew Crockett, General Manager of the BIS and supported by a small secretariat at the BIS; the Counter-party Risk Management Group; the International Organisation of Securities Commissions (IOSCO); the International Accounting Standards Committee (IASC); the International Association of Insurance Supervisors (IAIS); the Joint Forum on Financial Conglomerates (Basel Committee, IOSCO, and IAIS); and the Core Principles Methodology Working Group (Basel Committee, IOSCO, and IAIS).

Far from being an exhaustive list, the above is merely a subset of the bodies involved in reforming the financial architecture. It does illustrate, however, the Finance Ministers' point that no new international body is needed. Rather what is essential for success is overall management of the process that is already in motion.

Exchange Rate Management: A Special Problem

As discussed earlier, the appropriate approach to exchange rate management is a perplexing problem and continues to be an area of practical disagreement. Many emerging nations choose to peg the value of their currency relative to a vehicle currency because of their dependence on dollar-priced basic commodities, to gain credibility and convertibility, to reduce transaction costs, thereby promoting trade and investment, and as a means of fighting inflation. There are, however, two practical problems with rigid exchange rate regimes.[5] The first is that they require adopting nations to subjugate monetary policy to exchange rate management rather than domestic objectives. Many nations resist this by sterilising exchange rate interventions, a practice that cannot be sustained. Hence, in the long run the conduct of macroeconomic policy is often inconsistent with the exchange rate regime. The second is that it encourages unhedged borrowing, as discussed earlier.

The finance ministers' position is that the exchange rate regime must be backed by consistent macroeconomic polices. Further, they judge that the international community should not provide official financing to countries that peg their exchange rate unless the exchange value is sustainable and "certain conditions" are met. The report is not firm on this issue and no alternative regimes are offered developing countries. Experience shows that basket-pegs and single-currency-pegs will continue to be a popular choice among developing country policymakers. They are, however, difficult to sustain when the G7 nations do not co-ordinate on their own exchange values. What this means for developing countries that choose to peg to one or more of these currencies is that, eventually, a revaluation or devaluation must be made. If macroeconomic policy or microeconomic reform were wanting in the interim, or if the adjustment to parity were postponed too long, markets are likely to make these nations pay harshly for their shortcomings. This was the case for East Asian countries such as Thailand, Malaysia, and Indonesia, which pegged or managed their currencies against a basket that attached a large weight to the US dollar.

Emerging G7 Responsibilities

Fischer (1999) points out that the reform of the international financial architecture really means microeconomic and macroeconomic corrections undertaken by the developing nations - the recipients of capital flows - the

developed nations - the originators of capital flows - and IFIs. Clearly the points of emphasis in the G7 report, banking reform and increased transparency for example, are required by all participants of the system, but are primarily directed at the recipient nations. What is the role of the G7 as an institution with global leadership responsibilities?

The G7 nations are in a unique position in regard to the new financial architecture. They are the architects of the current system, as detailed by Nicholas Bayne in Chapter 2. They also dominate global markets in terms of trade and capital flows, and are the issuers of the world's vehicle currencies. They have, therefore, special responsibilities for its reform. Based on the points put forward in this chapter, the following 7 roles for the G7 are suggested.

1. Actively Serve as the New Financial Architecture's General Contractor

The G7 should co-ordinate and set agendas, establish time lines for results, and make recommendations for research. As an institution, the G7 does not have any "turf" issues with other organisations, it is not an agent of any organisation (other than the leaders themselves), and can exercise considerable control over many institutions such as the IMF. Being at the centre of the process, the G7 Ministers must take responsibility for co-ordinating the process, serve as the driving force for implementation, and act as the leading advocates of the benefits of capital market liberalisation.

2. Co-ordinate and/or Co-operate among Themselves

The G7 must actively co-operate, and when practically feasible, co-ordinate microeconomic and macroeconomic polices. Co-operation is needed on microeconomic policies, such as financial market regulations and taxes so as not to create distortions that lead to an inefficient flow of capital. Co-ordination on debt-holder clauses is needed since no country will unilaterally adopt such clauses and run the risk of lowering the quality of their debt. Macroeconomic co-operation is need to maintain a environment conducive to stable capital flows, including exchange rate stability and the avoidance of unsustainable external deficits.

3. Encourage Competition

The G7 must encourage competition, particularly multilateral trade

liberalisation and the Multilateral Agreement on Investment (MAI). As discussed earlier, trade liberalisation is a precursor to financial liberalisation. Without it, distortions exist that result in the inefficient distribution of capital with bubbles resulting in particular sectors of the economy. Competition is also required in the banking sectors of both developed and developing nations to ensure a healthy system of intermediaries.

4. Encourage and Allow for Broader Participation

The G7 should, and will, remain an exclusive club. It should allow, however and whenever appropriate, broader participation. Inclusion of the developing and emerging nations will enhance the credibility of reforms that are forthcoming from the process and give these nations some "ownership" of the process. These two aspects are certainly needed to summon the political will for change, given the current backlash that exists against integration, and the political will to endure in the midst of a crisis.

5. Continue Work on Standards

Because of the dynamic nature of financial markets, financial engineering, and the activities of multinational enterprises, appropriate standards and best practices are not static. The G7 is the body that must see that work on transparency, corporate governance, and risk management standards continues, even though stability may temporarily return.

6. Provide Incentives

Many of the reform measures mentioned above require major change and unilateral adoption by developing nations. The G7 must encourage their adoption by providing incentives and rewards for those countries that conform and maintain compliance. The Council on Foreign Relations (1999, p. 172) refers to this as "Rewards for joining the Good Housekeeping Club". These incentives would include conditioning lending terms with performance and reducing regulatory capital requirements for banks. The G7 must also avoid generating market distortions through its own regulatory actions, such as the standards for capital requirements are alleged to have done.

7. Do Not Over-Advertise

The G7 must avoid overstating, or allowing to be overstated, the benefits of modest reform measures such as improved transparency and surveillance. Financial crises will occasionally occur; that is the nature of the beast. Overstating the effects reduces the credibility of reform efforts in the eyes of the most shrewd market participants whilst understating the existing market risk to those participants less savvy.

The international financial architecture is a public good and, therefore, its reform affects many nations outside of the G7. Given the centrality of the G7 in global governance, however, the G7 finds itself in a unique position of responsibility. The seven responsibilities outlined above constitute an important role for the G7 Ministers. Meeting these obligations is critical for a credible and balanced approach to strengthening the international financial architecture.

Conclusion

Capital market liberalisation offers developing nations the capital necessary for growth and increased standards of living. Increasing capital mobility is the means for more efficient capital allocation and world-wide economic gains that result. These benefits, however, are accompanied by risks that pervade financial markets. The appropriate approach to reform of the international financial architecture is one that seeks to maximise the benefits while minimising the risks.

The Report of the Finance Ministers to the Köln Economic Summit is a living document that reflects the efforts of the G7 and various international and domestic organisations reform efforts since the Halifax Summit in 1995. The recommendations contained in the report are conservative in nature and, in cases where differences in opinion remain, maintain a market-oriented approach. As such, few details are given, making implementation in many areas more difficult. Further, as reflected in the report, a vast number of organisations, agencies, and committees are involved in the process and overall co-ordination presents a daunting task. Nonetheless, appropriate private sector expertise is included in forming accounting and auditing standards, and standards for supervision, regulation, transparency, private sector involvement, and risk management are the core elements needed for effective reform. The most important challenge that the G7 now faces is to co-

ordinate the process and, as stated in the report, "to encourage implementation". The endurance of the G7 in this regard will ultimately determine the success or failure of reform.

Notes

1 See Jeffrey A. Frankel (1999) for an excellent and intuitive discussion on this issue.
2 See Daniels, Toumanoff, and von der Ruhr (1999) for a discussion of the currency-basket-peg arrangements and estimates of their currency weights for these nations.
3 The reliability of communiques as a public record of policy intentions is now well established in the literature, e.g., von Furstenberg and Daniels, 1992.
4 Hence, we concur with Duncan Wood's position in Chapter 4 that much more needs to be done to include the likely candidates of the next significant crisis, the large developing nations experiencing financial liberalisation and financial development.
5 In addition to the two papers on this subject that appear in this text, see Eichengreen *et al.* (1999) for an analysis of the problem of transition from one regime to another.

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