View metadata, citation and similar papers at core.ac.uk

brought to you by CORE

provided by IDS OpenDocs

Global Capital Market Volatility and the Developing Countries

Lessons from the East Asian Crisis

Valpy FitzGerald

IDS Bulletin Vol 30 No 1 1999

1 Introduction*

'[The inter-war experience suggests that without controls on capital movements] loose funds may sweep round the world disorganizing all steady business.' *John Maynard Keynes*

'We have this false theory that markets, left to their own devices, tend towards equilibrium . . . To argue that financial markets in general, and international lending in particular, need to be regulated is likely to outrage the financial community: yet the evidence for just that is overwhelming' *George Soros*

The globalisation of capital markets is now an undisputed fact, but opinions differ widely as to the origins of the evident volatility of exchange rates and capital flows, and the proper means of stabilising them. Even though there is broad agreement that integration to international capital markets has considerable potential for increasing investment, growth and employment, there is a growing concern that the impact of this volatility on developing countries – particularly but not exclusively 'emerging market' economies – is deleterious. The present asset deflation and currency collapse in East Asia have brought this topic into the headlines, raising public action issues which not only are important in themselves but also throw light on the broader question of the social benefits of economic globalisation, when there is such great asymmetry between large firms and states on the one hand, and small nations and the poor on the other; and by extension the type of institutions which would be required in a truly global economy.

The extension of a global capital market and the rapid integration of developing countries into this market are a fact of life (World Bank 1997); but so are the consequences of marginalisation of those groups or nations not able to compete efficiently due to lack of resources, skills or institutions (UNRISD 1995). Moreover, there are good reasons to believe that financial markets are inherently unstable, and have historically required strong

* I would like to thank the MacArthur Foundation for support to the research programme at the Finance and Trade Policy Research Centre from which this article is derived.

institutions to control them (Kindelberger 1996). This argument is intrinsically stronger at the international level than at the national one, but international institutions for prudential financial regulation and emergency intervention are weak or even non-existent compared with those existing at the national level. Further, such regulatory mechanisms are strongest precisely in the most advanced market economies (IMF 1998b). Even leading representatives of the 'market' themselves feel that there is something wrong.[1]

In this article I intend to step back from the immediate issues of international crisis management in East Asia in order to look at some current policy debates on the construction of the international institutional 'architecture' intended to cope with global capital market volatility, from the point of view of developing countries – and by extension the three-quarters of humanity that inhabit them. It is not my intention, therefore, to discuss policies by which individual developing countries can mitigate the effects of short-term capital 'surges'.[2] The structure of the article is thus as follows. Section 2 addresses the global causes of emerging market volatility, its local consequences, and the failure of international financial institutions (IFIs), such as the IMF, to contain it. The current attempt to extend multilateral bank regulation towards emerging markets is then discussed in section 3, and its limitations identified, as are those of transborder mutual recognition agreements and the proposed international credit insurance scheme in section 4. The prospects for establishing a binding set of rules for international investment, with logical consequences for both global capital taxation and international debt write-offs, are examined as the basis for a long-term solution in section 5, which also includes a brief discussion of the institutions that are required to create an orderly market in international capital flows. Section 6 concludes, and derives the implication of the argument for the concept of 'global citizenship'.

2 Coping with Volatility in International Capital Markets

Systemic characteristics of flows towards emerging markets

Global capital markets are characterised by asymmetric and incomplete information. The increasing international exposure of both equity funds in industrial countries and financial systems in emerging market economies, has not been accompanied by a corresponding depth of information about the true value of the assets and liabilities. The speed and scale of shock transmission between markets has increased enormously due to technological advances in trading and settlement, which forces traders to act without knowledge of wider price movements, exacerbating fluctuations. There are also substantial agency problems for bank lenders and portfolio investors. Unlike multinational corporations involved in direct foreign investment, they can exercise little direct control over the asset acquired and thus cannot protect its market value. To the extent that banks and funds cannot count upon their own governments or the IFIs to ensure payment of their loans or maintenance of asset value, the logical response is to avoid assets which cannot be rapidly sold if things go wrong.

These information and agency problems lead logically to the two main characteristics of short-term investment in emerging markets. First, international portfolio investors and bank lenders seek liquidity and use 'quick exit' as a means of containing downside risk. In consequence, indicators such as the 'quick ratio' of a country's short-term foreign liabilities to central bank reserves become critical to market stability, and can easily trigger self-fulfilling runs on a currency. Second, fund managers control risk not by seeking more information or control, but by portfolio diversification based on an assumed lack of covariance between emerging market indices. The competition between funds for clients[3] drives them towards seeking high-yield, high-risk markets, but by the same token leads

[1] 'Unless we review our concept of markets, they will collapse, because we are creating global financial markets without understanding their true nature' (Soros 1997).

[2] For the results of a recent WIDER research project on this issue, see Griffith-Jones *et al.* (forthcoming).

[3] Because depositors in (say) pension funds cannot know the eventual value of the asset acquired when they retire, they can only rely on the *current* return on the fund in question. This encourages short-termism by fund managers in order to gain market share – a bias which is exacerbated by the system of quarterly bonuses as a form of remuneration.

them to make frequent marginal adjustments to their portfolios – adjustments which are marginal to the aggregate portfolio of savers in developed countries but non-marginal and highly destabilising for the investors of developing countries.

The effect of these behavioural characteristics – which are sometimes confusingly characterised as 'speculation' – is exacerbated by the way in which financial markets clear at the aggregate level. It is now well established in theory and practice that financial markets are inherently 'credit-rationed' in the sense that demand for funds always exceeds supply at the equilibrium rate. There are good reasons why the profit-maximising market equilibrium should take this form, arising from information and agency problems. In consequence, asset prices and interest prices do not fully reflect risk, but lenders use portfolio allocation rules – and thus rationing – to reduce that risk. In the case of domestic banking, this is reflected in loan limits to any one borrower based on collateral rather than the return on the project, and small differentials in lending rates; while bank regulators prevent excessive portfolio bias towards individual borrowers independently of the rate of return. Offers of high interest rates by dubious borrowers will lead to less rather than more funds being supplied.

In consequence, shifts in portfolio composition (i.e. rationing rules) correspond to changes in perceptions of country solvency by international investors rather than to variations in underlying asset value. Because of the asymmetry between borrowers and lenders – emerging market assets form a relatively small part of savers' portfolios in developed countries, but a large part of firms' and banks' liabilities in developing countries – marginal shifts in lenders' positions tend to destabilise borrowers' liquidity.[4] These surges are worsened by herding behaviour due to mean variance portfolio optimisation as the market grows. This can be explained by the fact that, as opportunities for diversification increase, the impact of news on the allocation of funds in a single country, relative to initial allocations, grows without bounds resulting in a massive outflow further threatening financial stability. Even if information on the return (or risk) on a particular asset can be acquired at a cost, the benefit from this knowledge eventually declines as the opportunities for diversification increase, causing massive information problems as investors have no incentive to search for information since they are shielded by diversification opportunities and liquidity. Therefore prudential regulation may be needed of global lenders rather than of global borrowers.

The volatility of short-term capital flows (or 'capital surges') is now recognised as a major problem for macroeconomic management in developing countries; even though the precise consequences for the 'real' economy – that is, the behaviour of government, firms and households which subsequently translates into investment, growth, employment and welfare – are not yet fully understood. Short-term capital flow instability arises from the desire of investors to hold liquid assets in the face of uncertainty, affecting the real economy both through variations in prices, such as the interest rate and the exchange rate, and quantities such as levels of bank credit and government bond sales. In FitzGerald (forthcoming), government expenditure is shown to respond in an asymmetric manner to sudden changes in investor perceptions of fiscal solvency associated with portfolio capital surges. The impact of short flows on output and investment by firms through the availability of bank credit is also found to be large and asymmetric. The macroeconomic effect of capital surges on employment levels and the real wage rate is shown to arise from their influence on real exchange rates and domestic demand levels, although whether employment or wages adjust depends on the monetary stabilisation policy adopted. The implications of the analysis for longer-term growth and policy design are considerable, but not our direct concern here except insofar as international regulatory arrangements should not prevent appropriate national policies.

The effectiveness of international financial institutions

The existing international institutional 'architecture' to cope with these problems in emerging markets is based on the Bretton Woods bodies, and the IMF in

[4] In addition, financial liberalisation means that in an economy such as Mexico, the entire domestic money supply is–in effect–a contingent foreign exchange claim on the central bank because bank deposits can be converted into dollars on demand.

particular. As intergovernmental institutions, the IFIs are essentially lenders of last resort to developing country governments, against which facility they can impose conditionality in return for the restoration of liquidity. The common requirements are for both specific monetary and fiscal policies in order to stabilise the economy, and structural reforms (financial reform, trade liberalisation, privatisation etc.) in order to restore long-term solvency. Whatever the effectiveness of this approach in the middle-income sovereign debt crises of the 1980s, or to the chronic economic problems of poor economies with weak states in Africa, it is not appropriate for the emerging market crises of the 1990s. The Mexican and East Asian crises are essentially related to private sector asset deflation and liquidity shortages. Large international liabilities have been built up by the private sector in emerging markets to finance infrastructure and real estate. The currency risk was perceived as low by private lenders due to the strong growth record and nominal exchange rate stability underpinned by the same capital inflows. Private borrowers were encouraged to seek foreign finance by financial liberalisation: on the one hand, the lifting of restrictions on corporate borrowing abroad as a means of balance of payments control, and on the other hand, higher interest rates made domestic borrowing increasingly unattractive.

Therefore, the root causes of the breakdown were not prevented (and possibly have been exacerbated) by Bretton Woods policies of accelerated financial liberalisation, exchange rate anchoring and encouragement of private portfolio investment as a substitute for sovereign borrowing. The problem has been worsened by decreasing clarity and agreement as to what 'fundamentals' actually are. Once gross fiscal and monetary imbalances have been overcome, inflation is under control, growth is reasonably rapid, and market liberalisation is underway; all the main indicators become positive signals for investors. Large current account deficits are seen as a sign of success in attracting foreign investment, while corporate foreign debt is seen to express financial diversification. The IFIs appear to have taken the position that, as long as the external deficit reflects a private investment-savings gap rather than a fiscal deficit, it must reflect rational decisions about consumption-smoothing over time and is thus sustainable. What is more, even if the IFIs had wished to prevent such inflows, their only instrument for controlling borrowers is last-resort lending to borrowing countries, while their influence over lenders is limited to issuing negative macroeconomic evaluation with the consequent danger of market collapse.

Global surveillance is not only carried out by the IFIs. The failure of the leading private ratings agencies to predict collapse in Mexico and East Asia is notorious. There are various reasons for this, including the methodology used to construct ratings (which is largely backward- rather than forward-looking) and the natural desire not to destabilise markets.[5] In principle, if the issue were one of information as such, the ratings agency should be able to invest in better information on country risk than any one investor and then provide what is effectively a public good for a modest fee. However, in practice the problem appears to be different: on the one hand, the way in which information is used by ratings agencies seems to be deficient – an issue of economic interpretation rather than economic statistics[6]; on the other hand, portfolio investors and banks engaged in securitising loans to their clients rely on portfolio diversification, rather than careful risk assessment, to prevent losses.

In sum, the emerging market financial collapse problem has three key characteristics. First, it is largely a 'private sector' problem of excessive lending by private banks and non-bank financial intermediaries in developed countries to private banks and corporations in developing countries. It is not an issue of sovereign borrowing as such, as was the case in the 1980s, and thus is not really suitable for

[5] It is sometimes suggested that as such agencies have emerging market governments as clients for the rating of new issues, they are reluctant to downgrade them – but there is no reliable evidence of this.

[6] The assessment of whether the current account deficit of a particular country reflects longer-term debt solvency, and thus the evaluation of the exchange rate risk and the probability of a policy shift which could affect asset values, depends not only on knowing what the current payments and debt situation is, but also the expected rate of growth, the expected world interest rate and what investors will regard as an acceptable debt ratio. These are all matters of economic (and political) judgement rather than statistical information.

intervention by the intergovernmental IMF or for fiscal remedies. Second, insofar as developing countries are credit rationed in global capital markets (that is, their demand for funds exceeds supply at the going rate) then it is decisions by *lenders* which determine the level of flows; and insofar as these lenders employ liquidity as a means of reducing uncertainty, reactions to news inevitably causes volatility. Third, the problem for lenders is largely one of risk management – assessing the risk inherent in exchange rates and the covariance between different elements of an emerging market portfolio – while that for international authorities is ensuring an orderly market. These inconsistencies are of course inherent in *national* financial markets too, and have led to strict domestic bank supervision systems. In consequence, a logical alternative to the IFIs would seem to be global prudential regulation of banks engaged in cross-border operations. To this topic we now turn.

3 Extending the Global Bank Regulation System to Emerging Markets

Bank failure outside the G10

High profile failures of a number of financial institutions among the leading industrialised countries[7] have highlighted the need for effective international supervisory standards. In addition, there is a growing recognition of the risk posed to the international financial system by the poor supervision of financial institutions in emerging markets. The globalisation of financial markets and the resulting linkages between national financial systems has increased the scope for problems in emerging market banking systems to spill over into the international financial system with unpredictable, but potentially very serious, results. Moreover, the costs of rectifying problems resulting from a banking crisis can act as a significant obstacle to the economic progress of developing economies. Pervasive lapses in sound banking practice in developing countries have been highlighted not only by the Asian crisis but also by banking sector fragility in Latin America.[8] Moreover, doubts remain about the soundness of banking systems in a number of other jurisdictions, in particular Russia and countries of the former Soviet bloc, where the limited availability of fiscal resources for supporting ailing banks will compound the effects of a crisis.

The Basle Capital Accord standards are being employed by an increasing number of industrialised and industrialising countries outside the G10. This trend[9] is likely to be reinforced by the publication last year of the Basle Committee on Banking Supervision's 'Core Principles for Effective Banking Supervision' (reproduced in IMF 1998a), which establish best practice for bank regulators in all jurisdictions. Amid increasing concern about the systemic risks posed by ineffective banking supervision in emerging markets, the Basle Committee itself is seeking to extend its reach beyond the G10 countries, reflecting continuing concerns about the quality and effectiveness of banking supervision. The Basle standards were originally designed for the industrial economies; extending them to emerging markets, which have very different characteristics, has proved problematic. Failure to adjust bank capital for non-performing loans has been a particular problem in emerging markets owing to poorly developed accounting systems and inadequate information on the quality of bank assets. As the East Asian crisis has unfolded, a number of apparently well-capitalised local banks have been found to be insolvent; their parlous financial position having been disguised by a failure to recognise the poor quality of their loan portfolios (BIS 1998).

Cross-border supervision

In October 1996, the Basle Committee issued a report on 'The Supervision of Cross-Border Banking', which had been agreed with the Offshore

---

[7] Most notably Barings Bank.

[8] The direct and indirect costs of the 1982 banking crisis in Chile may have amounted to 30 per cent of GDP while the total costs of the crisis in Venezuela in 1995 has been estimated at around 20 per cent of GDP. Fatal weaknesses in the Mexican banking system arising from hasty privatisation and financial deregulation were also exposed by the 1995 economic collapse.

[9] Almost all emerging markets have adopted the Basle Committee's 8 per cent minimum ratio as the standard for regulating their banking systems. However, they are subject to much greater financial volatility than developed countries. An 8 per cent risk- asset ratio may therefore be too low to guarantee capital adequacy. Bank regulators in a number of emerging markets have adopted a higher standard – for example, Singapore applies a 12 per cent minimum ratio – but at present there is no obligation for them to do so.

Group of banking supervisors, representing 19 offshore financial centres including Hong Kong, Singapore, the Cayman Islands and the Isle of Man. The report provided a checklist of principles for effective consolidated supervision, intended to ensure that no internationally active banking group escapes the oversight of a regulator capable of effectively supervising its global operations. The report also contained principles which could be used to assess the quality of supervision in financial centres.[10] More importantly, the report represented a formal recognition by the Basle Committee that agreement among the leading industrialised countries alone was no longer sufficient to preserve the integrity of the international financial system in an increasingly integrated global economy. In this regard it is significant that the report was endorsed by banking supervisors from 140 countries at the latest biannual International Conference of Banking Supervisors in Stockholm.

The Core Principles build on the process initiated by the report on cross-border banking supervision, developing the standards outlined in the report in greater and more prescriptive detail.[11] In addition, the Principles emphasise the need for national banking supervisors to be allowed to share information with their counterparts in order to permit effective supervision of banking supervision on a global consolidated basis. Despite the emphasis on information sharing and consolidated supervision, it is likely that 'fault lines' between regulatory jurisdictions, with considerable potential for both profit-making and bank failure, will remain.

Reflecting the Basle Committee's attempts to extend the reach of its standards to emerging markets, the Core Principles were drawn up in close cooperation with a group of non-G10 supervisory authorities.[12] One particularly sensitive area for developing countries concerns the supervisory arrangements for state-owned banks: the committee identifies a problem of 'regulatory forbearance' when a bank is state-owned: regulators may be reluctant to close a bank, or to take rapid corrective action, when the government is known to stand behind it. At the same time, the managements of state-owned institutions may take excessive risks in the knowledge that taxpayer funds will be made available to rectify their mistakes. Implicitly, the same principles should logically be applied to large domestic *private* banks with a privileged relationship to governments.

The limitations of the Basle approach

In line with the earlier report on cross-border banking supervision, the Core Principles reflect a more prescriptive approach by the Basle Committee. This represents a recognition by the committee that its traditional approach – which relied on the willingness of non-G10 countries to adopt its standards on a voluntary basis – is no longer adequate for a world in which national financial systems are increasingly integrated. What is more, a large proportion of private short-term capital flows (that is, excluding both official flows and direct foreign investment by multinational corporations) now takes the form of negotiable securities rather than bank credit as such. The picture is further complicated by the fact that a great part of these securities are marketed by banks or by securities houses linked with these banks, where the final purchaser may not be fully aware of the fact that the risk is not being borne by the bank at all.

[10] Including: the standards and procedures for authorisation, the supervisory authority's ability to gather information about the banks and banking groups it authorises, and the powers available to the supervisory authority to take action against authorised institutions which breach their authorisation requirements.

[11] The Principles reflect generally accepted best practice in the G10 countries and include: clear definition of the permissible activities for institutions authorised as banks and controls on an institution's ability to use the word 'bank' in its name; powers for the licensing authority to set criteria for authorisation and to reject applications from institutions which do not meet the standards set; supervisors must have powers to vet controlling interests of banking institutions and to reject proposals to transfer significant ownership stakes to other parties; supervisory authorities must ensure that banks maintain adequate capital and risk management systems; supervisors must require banks that lend to related companies and individuals do so on an arm's length basis to prevent abuses arising from connected lending; and banks must have procedures in place, including 'know-your-customer-rules', to prevent them from being used, intentionally or unintentionally, by criminal elements.

[12] Comprising representatives from Chile, China, the Czech Republic, Hong Kong, Mexico, Russia and Thailand. Eight other countries (Brazil, Hungary, India, Indonesia, Korea, Malaysia, Poland and Singapore) were also associated with the group's work.

The Core Principles in turn form the basis of the 'Framework for Financial Stability' (IMF, 1998a) supported by the Bretton Woods institutions, although here again the *international* dimension is mainly that of *borrowing* banks, who then lend domestically. Increased surveillance by the IMF and the World Bank of member countries' financial systems is intended to provide the kind of enforcement mechanism currently missing from the G10 framework.

In 1996 Brazil, China, Hong Kong, India, South Korea, Mexico, Russia, Saudi Arabia and Singapore were invited to become members of the Bank for International Settlements (BIS). Although the BIS has no regulatory function as such, the Basle Committee (member central banks and other supervisory agencies where these are separate from the central bank) does mean the acceptance of best practice. However, it would seem appropriate for the BIS to take a more active position. None the less, the political sensitivities implicit in supervisory standards assessment have meant that the BIS has been reluctant to undertake this role; a hesitation doubtless reinforced by the unwillingness of the US Treasury to relinquish the power of cross-border intervention to a body that it does not control – where agreement must be reached with Europe and Japan in particular, and in future with major powers such as China and Russia as well.

In consequence, under US leadership the IMF has expanded its regular Article IV consultations with member countries to examine the quality of domestic banking supervision (IMF 1998b). Similarly, IMF pressure for capital account liberalisation, and for reform of its own constitution to enforce this for all member countries, is intended to enhance its capacity to control financial policies beyond the present conditionality imposed on countries requesting last-resort lending or Enhanced Structural Adjustment Facilities (ESAFs).

However, the IMF has relatively little experience in financial surveillance and has made serious mistakes in its emergency policy packages in East Asia (FitzGerald 1998). Significantly, the BIS bid successfully in 1996 to host the International Association of Insurance Supervisors (IAIS); and will soon bid to provide a secretariat for the International Organisation of Securities Commissions (IOSCO). This will give the BIS the potential to supervise non-bank financial intermediaries as well as banks, but the political will to exercise this power will depend on the US being far-sighted enough to cede authority to a truly multilateral institution. There are no signs of this perception as yet, and while Europe is preoccupied with the initiation of European Monetary Union on the one hand, and Japan is embroiled in its own financial crisis, there is insufficient momentum for international pressure to resolve the impasse.

4 Contrary Responses: Mutual Regulatory Recognition, Regional Monetary Arrangements and a Credit Insurance Scheme

Mutual regulatory recognition

A significant alternative proposal that has recently emerged in official US circles is that foreign banks (or security houses etc.) should be permitted to operate in the US only if their domestic regulatory authorities have been certified as competent. For instance, doubts about the competence of Korean bank regulators would be translated into refusal to grant (or renew) the licences of Korean bank subsidiaries to operate in the US. The attraction of this approach is that it would provide a very powerful incentive for regulatory authorities of leading emerging market economies to act in a more rigorous and transparent manner; and it is in fact implicit in many multilateral trade agreements and the 'mutual recognition agreements' (MRAs) upon which most bilateral treaties on services trade are based.

However, there are two problems inherent in this approach. On the one hand, there is a danger that this system could be used as a form of disguised protection for US banks. These would be naturally tempted to lobby for excessively strict controls to be placed on foreign banks – particularly in view of the increased competition being unleashed by the ongoing liberalisation process.[13] On the other hand, such an approach would increase the extraterritorial power of the Securities and Exchange Commission (SEC) and the Federal Reserve, obliging them to extend their supervisory powers overseas in a dramatic way. It would also expose the US monetary

[13] Recent and ongoing changes in US banking legislation will undoubtedly have a major impact on this process.

authorities to claims from US investors if there were to be a further crisis in an emerging market whose regulatory system had been so certified. None the less, an approach of this kind does have the advantage of avoiding the diplomatic complications of constructing multilateral supervisory arrangements through (say) the IMF or the BIS, and of avoiding the anticipated opposition of an increasingly isolationist Congress to further pooling of US economic sovereignty to international institutions.

Regional monetary cooperation

The structure of regional rescue arrangements also clearly needs to be reassessed. While rescue packages for Thailand, Indonesia and South Korea were assembled under IMF auspices, they have reflected US policy objectives. The Clinton administration has sought to protect US investors in the region while simultaneously maximising the pressure on East Asian countries to open up their financial services markets to US banks and insurance companies. In doing so, it has exploited and – to some extent – inspired the Fund's attempts to make emergency financing for countries in the region conditional upon capital market liberalisation.

The reluctance of East Asian governments to cede ownership of domestic financial intermediaries to foreign investors has led to renewed interest in regional arrangements for monetary cooperation. At least in the short term, the US administration has successfully sidelined proposals to create an Asian Monetary Fund with an emergency financing facility independent of the IMF. Washington is anxious to ensure that regional monetary arrangements do not undermine the IMF's role by circumventing the conditionality attached to the Fund's own lending. However, the US Congress remains unenthusiastic about enhanced international financial cooperation, even if it is centred on the IMF.

The experience of financial turbulence in Latin America has also led to a perceived need for greater monetary coordination. Within the North America Free Trade Agreement (NAFTA), there has been a strong reluctance on the part of the US Congress to establish formal institutional mechanisms, although in practice the three central banks have become engaged in closer operational coordination in the wake of the 1995 peso crisis. In the Mercado Común del Sur (MERCOSUR), although there do exist institutional fora for economic coordination, this has been mainly concerned with tariff harmonisation and infrastructure provision rather than capital flows. None the less, as financial markets become more integrated, there is a growing interest in the harmonisation of financial regulatory rules – and by extension for macroeconomic coordination (FitzGerald and Grabbe 1997).

Among developed countries, the European Central Bank (ECB) will become a major player in international finance once it has settled down, even though the European Union itself does not have a policy for intergovernmental financial regulation, relying still on MRAs (FitzGerald and Grabbe 1997). In the longer run, a 'global G3' of quasi-autonomous central banks (i.e. the ECB, the Federal Reserve and the Bank of Japan) will presumably emerge, once Japan is able to turn away from domestic problems towards international ones. The current move to include Russia, China, Brazil and India in the Organisation for Economic Cooperation and Development (OECD) also implies a greater capacity for regulatory coordination.

An international credit insurance corporation?

Finally, the leading international investor George Soros has proposed that an 'International Credit Insurance Corporation' (ICIC) should be established as a sister institution to the IMF (Soros 1997). The proposed institution would exist in order to monitor and guarantee international loans, and would evaluate the risks involved in investing in a particular country. When a country has exceeded safe borrowing limits the ICIC would stop giving guarantees and thus prevent excessive inflows. The ICIC would set limits to the amounts countries could borrow and guarantee loans up to that limit. Borrowers would have to provide details of all their loans, both public and private, to the ICIC and thus to the market. The new authority would set a strict ceiling on the amount of credit it was prepared to insure, based on data provided by borrowing nations.[14] It is not clear whether it is

[14] 'Up to these amounts, the countries concerned would be able to access international capital markets at prime rates; beyond these the creditors would have to beware.' (Soros 1997.)

sovereign risk which is to be insured or whether loans to private banks and corporations in emerging markets would also be covered; given the nature of recent crises, the latter would have to be included. By guaranteeing international loans 'for a modest fee', the ICIC could generate the resources over time needed to cover normal risks, as does any other insurance system. However its initial capitalisation would consist of special drawing rights (SDRs) issued for this purpose, which would 'render its guarantees watertight' from the start. This issue of SDRs would potentially add to the global money supply, but would not be inflationary because they would only be drawn down in a major international default situation.

In essence, therefore, the ICIC would apparently be a combination of an export credit guarantee type scheme and an official ratings agency, with a capitalisation comparable to the existing Bretton Woods institutions. Insurance schemes such as the Multilateral Investment Guarantee Agency (MIGA) already exist, of course, but their scope is extremely limited in the assets covered (direct investment) and the market share so that they have been marginal to global financial crises. Similarly, export credit guarantee schemes are largely confined to supporting credit (not market) risk to national capital goods exporters and in any case are in secular decline (DAC 1998). The technical[15] difficulties with a proposal such as the ICIC seem to be of two kinds. First, the existing private ratings agencies and the intergovernmental agencies (i.e. the IMF) responsible for monitoring have a poor record in assessing national debt solvency, as the Mexican and East Asian crisis have illustrated dramatically. It is not clear how the ICIC would be able to gather more information than is presently available, assess this information more effectively, or downgrade countries without causing panics. Second, any insurance scheme involves risk pooling, which assumes a low covariance between clients' risk and a mechanism to prevent adverse selection and moral hazard. The problem with major financial crises is that they are contagious, so that a number of countries or a whole region are affected at once (i.e. high risk covariance) which could leave the ICIC dangerously exposed. Adverse selection would arise because major borrowers (pre-crisis) already have access to international capital markets at prime rates, so the ICIC would have an initial client base of poor, insolvent countries. Moral hazard implies that the ICIC would inevitably become involved with complex negotiations (equivalent to IMF conditionality) with countries requesting access to the scheme or trying to avoid exclusion.

Thus this proposal does not seem viable. None the less, the principle of funding of this scheme (or any other last-resort lending programme) by the issue of SDRs is extremely attractive, for two reasons. First, in view of the scale of capital availability required (presumably at least US$100bn) the funding could be virtually impossible to raise from the budgetary resources of the member governments, but could be provided in the form of a conditional right to issue SDRs immediately in a crisis situation. This would certainly have made intervention in the Mexican and East Asian crises more rapid and thus more effective. Second, as major international crises involve large-scale asset deflation, the addition of liquidity to the world economy represented by a major SDR issue would not be inflationary but rather stabilising. Moreover, in the post-crisis recovery these loans could be quickly paid back by central banks or replaced by longer-term borrowing.

5 An Alternative Approach to Capital Volatility: Investment Rules, Taxation and Debt, and 'Missing Institutions'

International investment rules

Over the past decade developing countries have embarked on an unprecedented unilateral liberalisation of their investment regimes. Stability, transparency and objectivity in policymaking are also desired – leading in many cases to the independence of central banks and the accession to international agreements in order to enhance the credibility of the new economic regime. International investment agreements are thus intended to 'lock in' this liberalisation and thereby enhance investor confidence in regulatory environments. International agreements – such as bilateral investment treaties, double taxation treaties, regional trade agreements and certain World Trade Organisation (WTO) provisions – play a key role in

[15] Leaving aside the likelihood of political opposition to such scheme in the US Congress.

building investor confidence by locking in policy commitments over time (WTO 1997). In particular, there is a close relationship between trade and investment agreements at the bilateral, regional and multilateral levels.

The accelerating trend towards bilateral, regional and multilateral arrangements for investment regulation (UNCTAD 1997) thus reflects a move away from national rights to control foreign investment and norms for corporate conduct. Such new agreements are usually based on general standards of treatment; coupled with norms on specific matters such as expropriation, compensation and the transfer of funds, and mechanisms for the international settlement of disputes.

A Multilateral Agreement on Investment (MAI) is currently under negotiation at the OECD between developed countries, with the prospect of accession for developing countries (FitzGerald *et al.* 1998). It is based on existing bilateral arrangements in general, and on the provisions of NAFTA in particular, and contains strong guarantees of property rights and investor recognition. Membership of the MAI could have strong positive effects in stabilising short-term flows. On the one hand, it would encourage investors to shift away from liquid assets towards fixed investment. On the other hand, it would reduce the uncertainty of banks as to the sovereign risk involved in lending. However, the MAI would not prevent appropriate measures to ensure monetary and fiscal stability, nor would it prevent control of short-term capital flows for balance of payments purposes; and it would provide more security for longer-term direct investment. If the MAI negotiations are not successfully concluded, the same approach will be taken up in the WTO in 1999, with the added advantage that developing countries will be directly represented – even though negotiations for the 'Millennium Round' are likely to take a number of years.

However, these proposed investment agreements suffer from two major shortcomings from the point of view of reducing the volatility of capital flows to developing countries: the difficulty of taxing international capital in order to provide fiscal resources for social investment; and the working off of the existing sovereign debt overhang which increases uncertainty as to national solvency. Unless these problems are resolved, it is difficult to see how capital flows to developing countries can be stabilised and used to support sustainable development.

Global capital taxation

Moreover, neither the MAI nor the foreseeable WTO arrangements on investment address international investment taxation. Most developed countries have entered into bilateral tax agreements among themselves, but unfortunately not with many developing countries. Only when a multilateral tax agreement (possibly based on the model treaty proposed by the OECD) is implemented, would the legal framework of international investment be complete. Such an agreement would not only improve the fiscal revenue position of developing countries and reduce the attractiveness of tax incentives to foreign investors, but would also strengthen the effort to combat money laundering and financial fraud – again, stabilising financial flows.

From the point of view of individual countries, corporate profits are difficult to tax for two reasons. First, because capital is mobile it can be driven abroad by high tax rates or deterred from investing in the first place. This leads to downward fiscal competition between developing countries and a lower average tax rate. Second, by arranging their international transactions appropriately, companies can accrue profits in the lowest tax jurisdictions – which are often 'tax havens' – and thus further reduce the tax burden on capital. In both cases there is a clear loss in global welfare to the extent that the tax revenue would have been used for social infrastructure investment or effective poverty relief.[16]

Effective multilateral taxation of corporate profits (or perhaps of dividends if it is desired to promote the reinvestment of profits within firms) has become a topic of increasing concern to developed

[16] It might be argued that a higher international tax on global capital would reduce the rate of global investment. However, it is not clear that this would occur: on the one hand, modern macroeconomic theory indicates that the effect of tax on savings is indeterminate, due to 'ricardian equivalence'; on the other, the 'hurdle rate' of return for investment is far more responsive to uncertainty than tax rates, so that there is a potentially positive trade-off between the two.

countries in recent years, with active proposals from the OECD for a multilateral tax treaty. In addition there are current moves to establish withholding taxes in major financial centres in order to reduce the tax loss on the profits generated there. In order to strengthen this process of fiscal capture, it will become necessary to eliminate tax havens and, at the very least, deny the benefits of international investor protection to firms registered there.

If such a multilateral tax treaty were to include developing countries it would confer a number of advantages. First, it would prevent wasteful tax competition between developing countries in order to attract foreign investors. Second, as all tax paid in developing countries is deductable against tax liability in (developed) home countries, increased effectiveness in tax collection by developing countries would be a net transfer between the treasuries of home and host country – far more effective than the present system of development assistance. Third, this would provide a stable source of long-term funding for the public investment in education, health and infrastructure that developing countries require.

Such an approach would have several advantages over proposals for a so-called 'Tobin tax' on short-term financial transactions.[17] A turnover tax would have little effect on speculative flows, because at any feasible rate it would imply a penalty of marginal importance compared to the prospective losses from maintaining asset holdings in a currency under attack. In addition it would be very difficult to collect in view of the complexity, speed and substitutability of cross-border currency transactions – leaving aside the problem of offshore transactions. In contrast, multilateral corporate taxation can be based on the statutory requirement to present accounts in some jurisdiction in order to satisfy shareholders. The other apparent attraction of the Tobin tax is to provide resources for international development assistance in general and for the UN in particular. However, aside from the fact that there are easier forms of raising international taxation[18] the major barrier is clearly political: the unwillingness of national legislatures to devote more funds to aid, or *a fortiori* to the United Nations. In contrast, a multilateral corporate tax agreement already has considerable support among developed countries; it only requires the coordination of existing bilateral tax treaties and would not need a new instrument. It would also deliver resources to developing country governments rather than to an international body and not require – in principle – a new international bureaucracy to administer it.

The alternative is for national tax systems to be gradually forced back on the taxation of the immobile factor of production: labour.

International sovereign debt

One of the key reasons for the volatility of capital flows is doubt about the solvency of particular developing countries (FitzGerald, forthcoming). It is evident that the failure of traditional structural adjustment programmes (SAPs) to revive private investment, both foreign and domestic, on a sustainable basis is closely connected to persistent sovereign debt overhang. Similarly, the failure of recent IMF interventions in East Asia and Mexico are related to the failure to recognise and correct private debt problems. In the commercial world, of course, insolvent companies are placed under new management and the unserviceable debt is written off by the creditors. There is, however, no equivalent in international sovereign debt matters (Eichengreen and Portes 1995).

In fact, the process of financial intervention in developing countries by the Bretton Woods institutions has led to the transfer of sovereign debt from commercial creditors to the IFIs themselves. Once so refinanced, it has become almost impossible to write off. The current HIPC initiative (DAC 1998) is both insufficient in scale and too lengthy in process to make a substantive contribution to the reduction of investor uncertainty. The main reason given for not cancelling this debt is one of 'moral hazard'.[19]

[17] The case for such a tax is set out in Haq *et al.* (1996). The reasons why it would not in fact reduce volatility are set out in Arestis and Sawyer (1998).

[18] Such as a tax on international air travel, which could be easily collected through the airlines themselves as a condition for international certification.

[19] The concept of moral hazard originates in accident insurance, where car owners, once insured, may be careless of damage to their vehicle unless there is a minimum claim or no-claims bonus. Whether this notion can be rigorously applied to major macroeconomic crises where the outcome (i.e. a bail-out) is uncertain seems very doubtful – it is not applicable to life insurance after all.

The other justification – that cancellation would reduce the IFIs credit ratings and thus ability to mobilise further development resources – is wholly implausible because the ratings depend not on the quality of lending but on underwriting provided by the member governments. In other words, IFI borrowing on international capital markets is secured against fiscal receipts in *developed* rather than developing countries.

The concept of moral hazard in this context refers to the belief that if developing country sovereign debt is cancelled, then their governments, freed from the external constraint, will return to policies inimicable to the promotion of private investment. However, the existence of a large international public-debt overhang in a considerable number of the poorer developing countries also represents a major constraint on further foreign investment on any significant scale – due to the uncertainty caused by the prospect of severe stabilisation measures in order to meet debt service, or the sovereign risk inherent in debt default. This debt overhang is thus a major disincentive to private foreign investors, due to the uncertainty it causes. The accession of a country to an international investment arrangement and a multilateral tax agreement, if combined with a write-off of old debt, could guarantee *future* private debt and thus constitute a form of conditionality more conducive to private sector development than the present systems operated by the IMF and other international financial institutions.

Missing institutions

Any long term view of the development of international investment regulation as a means of underpinning an equitable flow of capital towards developing countries must logically confront these four large gaps in the institutional arrangements, which the experience of constructing orderly financial markets in developed countries suggests might be necessary to contain the negative effects of global financial instability on developing countries. However, the problem is not just how the existing arrangements might be improved. Rather the logical question is what a desirable structure would look like. The obvious approach to an answer is to ask what institutions have proved necessary in developed market economies. These are:

- The core central banking functions of providing liquidity to the market, including last-resort lending under distress conditions in order to support otherwise sound banks and prevent contagion; this is the putative function of the IMF, although it has insufficient funds at present and is only empowered to lend to governments (or their central banks) and cannot deal directly with global or local banks.
- The collective provision of prudential regulation of financial intermediaries, in order to prevent not only fraud but also imprudent behaviour with wider consequences, and to protect vulnerable consumers of financial products; to some extent this service is provided by the Basle system, but it only covers key banks and leaves the greater part of global financial intermediaries still unregulated.
- The recognition of a small number of leading financial institutions ('market makers') who in principle stand ready to buy and sell assets at the current price – creating 'depth' and thus stability in the market – and can be called upon to take over the operations' insolvent financial intermediaries when necessary; these do not exist in the global market, and although as international banking and securities management becomes more concentrated they could emerge, there is no indication of how they might be coordinated.
- The existence of a sound and transparent legal system that secures contracts and provides for efficient dispute settlement between contracting parties and between financial intermediaries and the regulators; this does not exist at the international level – indeed international investors have no status other than in municipal jurisdictions and only have recourse to essentially political mechanisms to solve investment disputes.

6 Conclusion

In sum, the emergence of a global capital market in general and the East Asian crisis in particular have called into question the adequacy of existing international arrangements for financial supervision and monetary cooperation (Stiglitz 1998). We have examined a number of issues which illustrate the social inefficiency of global capital markets and the need for strong regulation to prevent them from having strongly negative effects on developing countries. This is not an argument against global financial integration – which in any case appears to

be an unstoppable trend – but rather a case for the construction of an appropriate international framework which an orderly market requires. The official view of the developed country governments is that if the liberalisation of trade and investment continues then investment rates in developing countries will rise, growth become sustainable and poverty be gradually reduced.[20] However, suppose that all this architecture were to be constructed and an orderly market in capital were established, the fundamental asymmetry represented by the immobility of labour[21] in a world with free movement of capital would still remain.

In a world where capital is perfectly mobile, rates of return will tend to equalise worldwide. Insofar as the wage rate itself (i.e. primary income) for labour of similar quality will tend to equalise through the free trade process, national incomes would seem to reflect the stock of skilled/unskilled labour and the natural resource endowment.[22] The building up of such a stock is the prime objective of development policy, although of course the competition between exporting countries may drive down the world price (wage) as the process unfolds worldwide. However, this view of the world underestimates the role of social overhead capital (infrastructure, collective skills, institutions etc.) in determining national income.[23] Once we allow for this accumulated stock (much of which is financed out of public – or at least social – expenditure) then international income differentials become much more explicable (Barro and Sala-i-Martin 1995). This in turn helps to explain why foreign investment does not in fact go to the poorest countries where the wage rates are lower – unless they have particular resource endowments such as oil.

The implication is that the main asset which *all* citizens of rich countries possess, in addition to their individual skills or financial wealth, is the 'dividend' from joint ownership of their country's social overhead capital – an equity which they deny to other members of the global economy.[24] This equity is 'inherited' in the sense that it has been built up by previous generations and is essentially funded by taxation. To the extent that taxation is progressive and the dividend is received by all citizens (nearly) equally, the net effect is strongly redistributive – but only *within* rich countries.[25] There is no reason, therefore, to believe from modern growth theory that the unequal distribution of income between poor and rich countries would improve from market forces alone.

Ultimately, the issue is one of the ways in which economic interests are best represented internationally. At present this is done intergovernmentally, with substantial lobbying from labour (and NGO) groups on the one hand, and larger multinational firms and domestic business groups on the other. Individual companies and social groups are not recognised under international law despite their growing importance (Brownlie 1990). This makes the construction of a legally binding set of international rules to underpin the global economy very

[20] This is the perspective set out by the OECD countries (DAC 1998; OECD 1998).

[21] The reasons, of course, are largely political. None the less, it is striking how few (if any) libertarian advocates of an unregulated global economy are willing to mention (let alone propose) the free movement of labour. Incidentally, it is not clear that there would in fact be an unmanageable (say more than 10 per cent) mass movement from South to North, if immigration controls were lifted.

[22] See Wood (1994) for this argument in terms of an elegant model of skilled and unskilled labour in a neoricardian trade framework.

[23] Alternatively, we might consider that (a) skilled labour has considerable externalities and thus there are scale economies from which individual members benefit beyond their own marginal product, and (b) that skilled labour requires a specific 'social infrastructure' (i.e. education) to support it; in which case we reach a formulation similar to that given here.

[24] Supposing a unitary elasticity between per capita income growth and relative poverty, then to reach the DAC target of halving the proportion (not the number) of developing-country people in poverty by 2020 would require a doubling of per capita incomes over 20 years – 4 per cent per annum. This is far beyond the track record of poor countries and not far off that of East Asia (before the crisis). In contrast, since the poor receive only 1 per cent of world income, a transfer of 1 per cent of the income of industrial countries (i.e. 0.5 per cent of world GDP) would double their average incomes immediately. But there is clearly no support for social transfers on this scale, let alone the building up of social overhead capital on the scale required.

[25] For a formal model of this notion of 'the asset value of citizenship' and a preliminary approximation of its financial valuation, see FitzGerald and Cuesta (forthcoming).

difficult. None the less, the existence of such a framework is essential if the interests of weak states and vulnerable social groups are to be protected (Schreiber 1997). Meanwhile, the discretionary powers of the Bretton Woods institutions within an unstable and unregulated global capital market effectively prevent the exercise of *either* the domestic policy autonomy *or* the international rules that would permit uncertainty to be reduced – and thus productive investment, remunerative employment and social provision to be raised on a sustainable basis. This perhaps is the central lesson to be learned from the East Asian crisis.

References

Arestis, P. and M. Sawyer (1998) 'What role for the Tobin tax in global governance', mimeo, University of East London and University of Leeds

BIS (1998) *Sixty-Eighth Annual Report*, Basle: Bank for International Settlements

Barro, R.J. and X. Sala-i-Martin (1995) *Economic Growth*, New York, NY: McGraw Hill

Brownlie, I. (1990) *Public International Law*, 4th edn, Oxford: Clarendon Press

DAC (1998) *Development Assistance Report 1998*, Paris: OECD

Eichengreen, B. and R. Portes (1995) *Crisis? What Crisis? Orderly Workouts for Sovereign Debtors*, London: Centre for Economic Policy Research

FitzGerald, E.V.K. (1996a) 'Intervention versus regulation: the role of the IMF in crisis prevention and management', *UNCTAD Review 1996*, Geneva: United Nations Conference on Trade and Development

FitzGerald, E.V.K. (1997) 'Rethinking development assistance: the implications of social citizenship in a global economy', Geneva: UN Research Institute for Social Development (also as *Working Papers Series* QEHWPS01 on http://www.qeh.ox.ac.uk)

FitzGerald, E.V.K. (1998) 'Caveat Creditor: the implications of the Asian crisis for international investment regulation', paper presented to the UNCTAD seminar on 'The Asian Financial Crisis', 1 May 1998 in Geneva

FitzGerald, E.V.K. (forthcoming) 'Short-term capital flows, the real economy and income distribution in developing countries' in Griffith-Jones *et al.*, op cit.

FitzGerald, E.V.K. with R. Cubero and A. Lemann (1998) *The Development Implications of the Multilateral Agreement on Investment*, London: Department for International Development

FitzGerald, E.V.K. and J. Cuesta-Leiva (1998) 'The asset value of a passport: a model of citizenship and income determination in a global economy', mimeo, Finance and Trade Policy Research Centre, Oxford: Oxford University

S. Griffith-Jones, M. Montes and A. Nasution, (eds) (forthcoming) *Managing Capital Flows in Developing Countries*, Oxford: Oxford University Press

Haq, M.U., I. Kaul, and I. Grunberg, eds (1996) *The Tobin Tax: Coping with Financial Volatility*, Oxford: Oxford University Press

IMF (1998a) *Toward a Framework for Financial Stability*, Washington DC: International Monetary Fund

IMF (1998b) *World Economic Outlook, May 1998*, Washington DC: International Monetary Fund

Keynes, J. M. (1941) *The Collected Writings*, Vol. XXV, 8 September

Kindelberger, C.P. (1996) *Manias, Panics and Crashes: A History of Financial Crises* (3rd edn), Basingstoke: Macmillan

OECD (1998) *Open Markets Matter: The Benefits of Trade and Investment Liberalization*, Paris: Organization for Economic Cooperation and Development

van der Ploeg, J. (1994) *Handbook of International Macroeconomics*, Oxford: Blackwell

Schreiber, N. (1997) *Sovereignty over Natural Resources: Balancing Rights and Duties*, Cambridge: Cambridge University Press

Soros, G. (1997) *Financial Times*, 31 December

Stiglitz, J.E. (1998) 'More instruments and broader goals: moving towards the post-Washington consensus', *1998 WIDER Annual Lecture*, Helsinki: UNU/World Institute for Development Economics Research

UNCTAD (1997) *World Investment Report*, Geneva: United Nations Conference on Trade and Development

UNRISD (1995) *States of Disarray: The Social Effects of Globalization*, Geneva: UN Research Institute for Social Development

Wood, A. (1994) *North–South Trade, Employment and Inequality: Changing Fortunes in a Skill-driven World*, Oxford: Clarendon Press

World Bank (1997) *Private Capital Flows to Developing Countries: The Road to Financial Integration*, Washington DC: World Bank