C:\WP51\PAPERS\CURRENTH.WPD: October 13, 1998

The Tyranny of the Financial Markets

Barry Eichengreen
July 1997

Nowhere is the process of globalization more apparent than in financial markets. Trade may be booming, and migration may be on the rise, but these trends pale in comparison with the explosive growth of international financial transactions. Turnover in global foreign exchange markets is estimated to have risen from $188 billion in 1986 to $1,190 billion in 1995 -- almost three times as fast as trade. Direct foreign investment by the advanced industrial countries has risen nearly as fast, by a factor of five between the mid 1980s and mid-1990s. Cross-border transactions in bonds and equities in all the G-7 economies but one have risen tenfold over this period, even normalizing for the growth of their economies. Japan is the exception, but with Tokyo now launching a financial "big bang" its exceptionalism may soon be a thing of the past.

Nor is there doubt about the global scope of the process. It is as pervasive in the developing as the advanced-industrial countries. One indication is that private capital flows have risen from 1/2 of 1 per cent of developing-country GDP in 1983-89 to more than 3 1/2 per cent of GDP in 1994-96. Merely listing the principal destinations for foreign funds makes evident the global reach of the markets: the most important capital importers in the period 1990-95 were, in descending order of importance, China, Mexico, Brazil, Korea, Malaysia and Argentina, Thailand and Indonesia. Foreign capital has been flooding into Bolivia, into

Poland, into Russia, into India, into Vietnam, none of which was viewed as recently as a few years ago as offering many attractions to foreign investors.

The creditors -- be they corporations seeking acquire foreign production facilities or "speculators" in foreign bonds --naturally appreciate the opportunity to partake of investment opportunities abroad. And in the age of emerging-market mutual funds this is not an opportunity limited to the few. Indeed, small savers may benefit the most insofar as the investment professionals managing their pensions have learned not to place all their eggs in one national basket.

It is true that many observers are disquieted rather than reassured by financial globalization. Their fear is that capital mobility is threatening the welfare state. It is creating a "race for the bottom" in which the advanced industrial countries, desperate to keep capital from fleeing to lower-cost production sites and taking manufacturing jobs with them, are ruthlessly dismantling social programs. The backlash against these pressures is clearly evident, especially in Europe where the welfare state is most highly developed. The victory of the left in the recent French elections is a case in point.

Economic theory supports the notion that financial globalization has shifted the burden of financing the welfare state onto labor, which must now choose between higher taxes, lower wages and fewer social benefits. The most basic principle of the theory of tax incidence is that elastically-supplied inputs into production escape the burden of taxes; try to tax them and they vanish. The international mobility of capital has just this effect of offering capital an exit option. It is not surprising in this light that capital's share of taxes paid in OECD countries has been trending steadily downward in recent years.

But there are also countervailing forces. Social spending that makes workers more productive and investment more profitable will be attractive to capital as well as labor. In Germany, for example, a nationwide training and apprenticeship scheme, underwritten by employers as well as unions, makes young workers more productive and industry more profitable. It hardly encourages German firms to shift their operations to Eastern Europe.

Paid vacations, unemployment benefits and the like, being less obvious sources of enhanced productivity, might be thought to be more seriously threatened. But even there it can be argued that such provisions enhance productivity and, if not taken to excess, attract rather than repel capital.[1] In today's dynamic economy, competitiveness requires workers to accept the introduction of new technologies and forms of work organization. It requires them to accept the demise of sectors which become automated or in which their country loses its comparative advantage. It requires them to live with the uncertainties of a high-turnover labor market. The welfare state can be thought of as recompense for accepting these insecurities. In return for social spending, workers refrain from advocating domestic policies that would stifle change and limit economic flexibility.

This is one way of understanding the postwar rise of the welfare state in the U.S. and the social market economy in Europe. These institutions compensated labor for the insecurities associated with the postwar deregulation and international opening of the advanced industrial economies. The consequent improvement in productivity and in labor-management relations provided more than adequate incentive for savers to invest at home. If

[1] A nice discussion of this point is Dani Rodrik, Has Globalization Gone Too Far? (Washington, D.C.: Institute for International Economics, 1997).

this same model continues to apply today, then there is reason to think, paraphrasing Mark Twain, that news of the welfare state's death has been greatly exaggerated.

The consequences of financial globalization for the low-income countries are, if anything, even more controversial. Marxist economists have long argued that dependence on international capital markets is at best a mixed blessing for the developing world. Investment by multinational producers attracted by cheap labor, they argue, shunts such countries into low-value-added activities. Foreign investment attracted by natural resources, they warn, lures capital and labor away from the manufacturing activities that are the engines of productivity growth. While these voices have not fallen entirely silent, it is revealing that they *have* been muted in the developing countries themselves. There, few question the desirability of capital imports. Whatever their ideological stripe, political leaders seem ready to tailor policy to attract foreign funds. Politicians and the man in the street both clearly believe that reservations about foreign investment are a luxury they can ill afford.

The most recent decades of experience support the notion that these individuals know of what they speak. There is now an overwhelming accumulation of evidence confirming that financial integration leads to financial deepening (that is, to more active, liquid and efficient domestic financial markets), and that financial deepening encourages higher investment, faster growth and more rapidly rising living standards.[2] The link between financial integration and financial deepening is evident in the fact that countries receiving relatively large portfolio capital inflows have seen disproportionate growth in the volume of transactions on their stock

[2] A recent compendium and restatement of these findings, just published, is World Bank, Private Capital Flows to Developing Countries: The Road to Financial Integration (New York: Oxford University Press, 1997).

markets, disproportionate growth in stock market capitalization, and disproportionate growth in bank loans to the private sector. The link between financial deepening and economic performance, evident in the strong positive correlation between the ratio of liquid financial assets to GNP in, say, 1960 on the one hand and economic growth over the subsequent three decades on the other, is equally unambiguous. In few areas of economics is the evidence so clear.

Recent experience with direct foreign investment (DFI) is equally compelling.[3] Developing countries which have attracted relatively large quantities of DFI enjoy higher levels of investment overall. That is, the domestic investment replaced by DFI is less than the additional domestic investment triggered by DFI (in domestic parts supply industries, in the transport sector, in the distribution system). There is mounting evidence of positive spillovers -- that domestic firms learn from foreign-investment enterprises. How else are we to understand that DFI generally leads to increased exports not just by foreign-owned enterprises but by domestic producers as well? The overall effect of DFI on economic growth is strongly positive for countries with a sufficiently educated labor force to take advantage of potential spillovers.

All this will come as a shock to dependency theorists and other left-leaning thinkers raised to believe that markets are rigged against low-income countries. They must face the fact that the developing countries have grown faster than the developed world in the period of global finance (say, over the last three decades). And developing countries which have

[3] See for example Eduardo Borensztein, Jose de Gregario and Jong-Wha Lee, “How Does Foreign Direct Investment Affect Economic Growth,” National Bureau of Economic Research Working Paper no. 5057 (Cambridge, NBER, 1995).

integrated themselves into international financial markets (whether measured by the value of their capital imports, the extent to which their investment is funded by sources other than domestic savings, or the conformance of domestic interest rates with world rates) have grown faster than those which have not.

But like a more powerful motor car, financial integration offers its developing-country drivers additional risks as well as additional opportunities. While global capital markets allow even small countries to attract large amounts of capital and lever up their growth opportunities, even a modest change in circumstances can lead to a dramatic change in sentiment, prompting investors to scramble for the door. This, of course, is what is known as a crisis. Thus, while foreign investment opens up additional scope for growth, it also heightens countries' vulnerability. It places a premium on good policy and good luck and meets out harsh punishment for policy mistakes.

This downside has been especially evident in recent years. Just ask any Mexican. To understand why the risks associated with capital mobility have been so evident recently, it is useful to pursue our vehicular analogy a little further. It is a fact that the risk of automobile accidents rises in the period before motor way design -- the sharpness of curves, the angle of embankments -- is adapted to the appearance of larger engines and speedier vehicles. The risk of a financial crash has similarly been heightened by the failure of domestic and international policy making institutions to rapidly accommodate the explosion of international financial activity.

Bank regulation is a case in point. When developing countries throw open their doors to capital from abroad, a substantial share of the foreign funds flows through their banking systems. Banks fund themselves abroad; they attract foreign investors by offering high interest rates on deposits. The rapid increase in bank lending financed by the influx of funds can set the stage for an ugly fall. If banks have inadequate trained personnel to properly evaluate the risks of the increase in their lending, the quality of their asset portfolios will decline. If they offer foreign-currency deposits to shelter investors from losses due to exchange rate fluctuations but denominate their loans in domestic currency, they end up shouldering that exchange-rate risk themselves. If banks engage in "connected lending" (that is, if loans go mainly to influential insiders), more resources for the banks only adds risk and worsens the allocation of resources. And if everyone expects the government to bail out troubled banks because they are too big to fail and management is too well connected for its pleas to be ignored, foreign investors will not hesitate to take up the offer of high deposit rates (since the promise of a government bailout guarantees that they can escape without loss in the event of difficulties). This, clearly, is a combustible mix: the World Bank has concluded that the countries with the largest lending booms during periods of capital inflow more often than not end up with banking crises.[4]

The tendency for rapid internationalization to place banking systems at risk is important because banks are crucial for macroeconomic stability, perhaps most so in developing countries. They account for a larger share of total financial assets in developing than developed economies. The collapse of bank lending has its most pronounced impact on small firms without access to alternative sources of funds, small firms which account for the vast majority of output and employment in developing countries. Cleaning up after banking

[4] Private Capital Flows, p.241.

crises -- reorganizing, recapitalizing or winding down insolvent banks -- is enormously expensive and especially difficult for poor countries whose budgets are already under strain.

It is the purpose of bank supervision and regulation ("supe and reg" as they are known in the trade) to prevent banks from succumbing to temptation. Financial integration increases the premium on oversight while at the same time straining the capacity of regulators to carry out their tasks. Not only can a surge of capital inflows lead to a dramatic increase in lending which strains the supervisory capacities of regulators, but financial internationalization allows banks to invest in derivative instruments whose consequences for systemic risk are costly and difficult to evaluate.

One possible response is to put the process on automatic pilot, holding banks to higher capital and liquidity standards in developing than advanced industrial countries. Governments can raise minimum provisioning against loan losses, enhancing banks' ability to withstand shocks and encouraging them to invest in safer assets. They can raise reserve requirements, reducing the free resources the banks retain for lending. But higher capital, liquidity, reserve and provisioning requirements are extra costs of doing business. Policy makers concerned about the international competitiveness of domestic financial institutions are understandably reluctant to go this route.

International agreement is the obvious solution to this problem. If countries agree that financial internationalization requires them to hold their banks to higher standards and all impose those more demanding standards simultaneously, none need fear that domestic banks will lose market share as a result. It is the role of the Basle Committee on Bank Supervision (supported by the Bank for International Settlements) to negotiate such agreements. But these entities have been reluctant to mandate stricter standards for banks in countries more vulnerable to reversals in capital flows. In any case, Basle Committee provides guidelines only for international banks. And membership is limited to high-income countries (although many developing countries have voluntarily adopted the 8 per cent capital adequacy rule set down in its 1988 Capital Adequacy Accord). The expansion of the BIS to include the high-growth East Asian tigers is a step in the right direction. So is the Market Risk Amendment to the 1988 Capital Accord, which mandates higher capital requirements for banks with riskier portfolios. But it remains to transform BIS and the Basle Committee into truly global fora suitable for coordinating the regulation of global banking and to address the special risks to emerging-market banks.[5]

Financial internationalization poses equally fundamental challenges for macroeconomic management. For low-income countries, a surge of capital flows can feel more like a tidal wave; it can throw off course even the best-thought-out macroeconomic strategy. A prudent monetary policy consistent with price stability can produce raging inflation and an alarmingly overheated real estate market if a surge of capital inflows is suddenly superimposed. A policy of balanced budgets can feed a runaway consumption boom if a surge of capital flows intervenes. Less domestic production being left over for export by the consumption boom, a yawning current-account deficit and dangerously overvalued exchange rate can result.

The stage is thereby set for the denouement. Foreign investors may grow concerned about the current-account deficit and the overvalued exchange rate, or capital inflows may be

---

[5] A concrete proposal for moving in this direction is provided by Morris Goldstein, The Casee for an International Banking Standard (Washington, D.C.: Institute for International Economics, 1997).

interrupted by extraneous events -- say, a neighboring country unexpectedly devalues its currency, or the Federal Reserve Board raises U.S. interest rates. Interest rates rise. Bank lending dries up. The real estate bubble bursts. And with slackening demand comes slower growth. Companies that depend on bank credit now face higher interest rates, and as sales slow they develop problems repaying. This brings into play the weak link in the chain, namely the banks, as depositors fearful for bank solvency scramble to get their money out of the banks and out of the country. The authorities are forced to jack up interest rates in the effort to lure back skittish finance, but higher interest rates only worsen the domestic economic situation and the banking system's plight.

This, in a nutshell, is a description of the Mexican financial crisis that broke out at the end of 1994. Experts may disagree about what precipitated the crisis -- lax monetary and fiscal policies, inadequate preparation for the December 20th peso devaluation, or developments that were no fault of Mexico's own (like higher U.S. interest rates) -- but they do not dispute the consequences that followed.

Unfortunately, all of the obvious policy responses have drawbacks. Raising interest rates to counter the consumption boom only threatens to attract additional foreign funds and to make servicing the public debt more expensive. Revaluing the exchange rate to limit the inflationary consequences and shift demand toward foreign goods threatens to aggravate the trade deficit and damage the competitiveness of domestic producers. Tightening fiscal policy to damp down demand, while attractive in principle, is difficult in practice, tax increases and public expenditure cuts being too politically divisive to be pushed through with the requisite speed. Treating the problem at its source by taxing selected capital inflows (as countries like

Brazil have done) runs the risk of frightening off foreign investors -- a solution worse than the problem -- now that there are so many alternative tax-free destinations for their funds.

There being no optimal solution, the best advice is to operate cautiously on all these fronts. Tighten monetary and, if possible, fiscal policies. Consider the judicious and limited application of Brazilian-style taxes on short-term foreign investments. Allow the exchange rate to fluctuate more widely in order to introduce an element of risk that will moderate surges of foreign capital.

The advantages of this last recommendation -- a more flexible exchange rate -- are not restricted to periods of capital inflow. The greatest advantage of currency flexibility may be that it helps to avoid the problem of crisis to which pegged currencies are prone when capital flows turn around. If recent international monetary experience has one lesson, it is that pegged exchange rates are exceedingly difficult to maintain in a world of global capital markets. They may be successfully operated for a time, but if speculators come to doubt the government's commitment to their maintenance, they come crashing down. And doubts about the government's resolve are unavoidable in democratic societies. Defending a currency peg requires jacking up interest rates, at inconvenience and cost to producers, which is bound to arouse domestic political opposition. This makes the policy something in which few governments can persist. And the resources available to currency speculators vastly exceed those at the command of central banks, allowing the markets to force the issue. Anyone who is skeptical that pegged rates are associated with crises need only recall Europe in 1992-3, Mexico in 1994-5, or Thailand, the Philippines and Malaysia earlier this year.

This caution against committing to an overly rigid currency peg is a general point which applies to rich and poor countries alike. Reflecting this recognition, the share of IMF members with floating currencies has risen from well under one third in 1975 to nearly two thirds at the beginning of 1997. This trend is pronounced among developing countries: whereas in 1975 countries with pegged exchange rates accounted for 70 per cent of developing countries' total trade and countries with flexible exchange rates 30 per cent, these proportions have now been reversed.[6]

This shift in strategy has helped to reconcile capital mobility with banking stability. Banks in developing countries are fragile. The capital flows to which they are subject are immense. However adept macroeconomic management, there will still be the need when things go awry for governments to intervene as domestic lenders of last resort. And propping up collapsing banks is not an option for a government simultaneously pegging its currency. Supporting the exchange rate means limiting the provision of liquidity in times of crisis, while stabilizing the banking system requires providing additional liquidity. In a world of internationally mobile capital, policy makers must choose. They seem increasingly willing to recognize that the stability of the banking system is more important than the trophy of an exchange-rate peg.

The implications of financial globalization for the Bretton Woods institutions are if anything even more far-reaching. The International Monetary Fund was established to manage the postwar system of pegged currencies, a system that has given way to flexible exchange

[6] International Monetary Fund, World Economic Outlook (October 1997, forthcoming), chapter 4.

rates precisely because rising international capital mobility made pegging so difficult and costly. Capital mobility and its consequences have thus forced the Fund to fundamentally rethink its role. In principle, its mission is straightforward, namely, to provide governments support and advice to prevent floating exchange rates from going haywire and destabilizing growth, prices, and financial systems. This is a task that can only be discharged by an international entity like the Fund, since national policies have international repercussions that the responsible governments, left to their own devices, have little incentive to take into account.

The mission may be clearcut, but the instrumentalities for achieving it are not. An increasingly important instrument is multilateral surveillance, in which the Fund raises governments' consciousness about the risks of their policies not only for their own economies (something they are presumably already worrying about) but also for other countries and the international system. It provides loans to countries that are temporarily denied access to commercial credit because of serious balance-of-payments problems, so that stringency in the period while adjustment is underway does not result in a meltdown of the banking system and a catastrophic recession.

The implication of financial globalization is that the IMF must be quicker on its feet. It must be alert to problems in one emerging market that might spread contagiously throughout the developing world, as the Mexican crisis spread to Argentina in 1995, and the crisis in Thailand infected Indonesia, Malaysia, the Philippines and even Brazil in 1997. It must consult with such countries more regularly. And given the speed with which the markets move, it must disburse funds more quickly. Responding to this need, the Fund has now created an Emergency-Financing Mechanism to disburse funds after fast-track consultations.

The challenge to the World Bank is if anything even more profound. The need for a multilateral development bank to provide loans to those denied access to private finance is no longer obvious in an age when the vast majority of countries can borrow commercially and more do so every day. The problem in most cases is not lack of access to private markets but how to manage their embarrassment of riches. It follows that capital-market imperfections no longer provide the rationale they once did for the lending activities of the Bank.

Some of the poorest countries, notably in Sub-Saharan Africa, still have little access to commercial markets. To them the Bank provides aid as well as loans. Some 30 per cent of World Bank lending is concessional finance administered through its International Development Association arm. Looking forward, one can confidentally predict that the share of the Bank's lending taking this form will continue to rise as a result of the blossoming of private capital markets.

More generally, where access to external funds is conditional on the recipient's adoption of painful policy reforms, there will be a role for multilateral lending. Private lenders and national governments provoke hostile reactions when they make the availability of funds conditional on reform of the policy environment. By comparison, multilateral institutions like the Bank and the Fund which are not owned or controlled by any one country or group of countries are better positioned to withstand such criticism. Demonstrations against World Bank- and IMF-endorsed austerity programs are hardly unknown, of course. Still, one can think of many instances in which the Fund and Bank's "good housekeeping seal of approval" has strengthened the hand of reformist governments and in which their "catalytic finance" has helped restore access to private financial markets.

Few economic trends are irreversible. One can imagine a scenario, however far-fetched, in which the trend toward financial globalization is reversed, as it was in the 1930s. By some measures, the internationalization of financial markets was even more extensive in the late 19th century and the first decades of the 20th. The share of investment financed by imported funds was greater. Countries ran larger current account surpluses and deficits than today and imported and exported more capital relative to the size of their economies. Interest rates in different countries moved even more closely together than over most of the present century.[7] But global financial markets disintegrated in the 1930s, as economies collapsed into depression and policymakers walled off their countries from the rest of the world. It took nearly half a century for the legacy of these events to be reversed.

In fact, a replay of this scenario is now exceedingly unlikely. Central bankers may not have perfected their task, but they have learned to avoid the disastrous mistakes committed by their predecessors in the 1930s. The spread of deposit insurance is no panacea, but it removes the danger of a wholesale collapse of industrial-country banking systems. Consequently, there is unlikely to be the kind of global economic crisis that would cause countries to sever their international financial links *en masse*.

Moreover, institutional and technological changes now make it more difficult for countries to control international capital flows. So long as banks were tightly regulated, it was

---

[7] "Globalization in Historical Perspective," Annex to International Monetary Fund, World Economic Outlook (Washington, D.C.: International Monetary Fund, May 1997).

possible to limit their offshore activities. But with the liberalization of domestic financial markets, controls on international financial transactions become more difficult to enforce. While the laying of the transatlantic cable in the 1860s allowed such transactions to be completed more quickly, the implications of that innovation pale in comparison with those of today's computer and communications technologies. Billions of dollars can now be transmitted across borders by a key stroke. Efforts to ban certain categories of transactions are easily frustrated by moving them offshore or repackaging them as derivative securities. Countries can insulate themselves from international capital flows only by adopting comprehensive measures to suppress domestic financial transactions, which would be costly in terms of economic growth..

For these reasons, schemes to turn back financial globalization are pie in the sky. Rather than longing for a return to less turbulent (but also, it is important to remember, less prosperous and promising) times, policy makers have no choice but to learn to live with global financial markets.

Barry Eichengreen is John L. Simpson Professor of Economics and Political Science at the University of California, Berkeley. He is currently on leave as Senior Policy Advisor at the International Monetary Fund. None of the views expressed in this article are necessarily those of the IMF.