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The Policy Challenges of Global Financial Integration

Edited by
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Forum on Debt and Development (FONDAD)

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Abbreviations

ACP	African, the Caribbean and the Pacific
BIS	Bank for International Settlements
CAP	Common Agricultural Policy (of the EU)
CBI	Cross-Border Initiative
CFA	Communauté Financière Africaine
CU	customs union
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECLAC	Economic Commission for Latin America and the Caribbean (of the UN)
ECU	European Currency Unit
EMS	European Monetary System
EMU	Economic and Monetary Union (of the EU)
EPZ	export processing zone
ERM	Exchange Rate Mechanism (of the EU)
EU	European Union
FDI	foreign direct investment
FRS	Federal Reserve System
FTA	free trade area
G-7	Group of Seven
G-15	Group of Fifteen
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GDR	German Democratic Republic
GNP	gross national product
GSP	Generalised System of Preferences
IDB	Inter-American Development Bank
IFC	International Finance Corporation (of the World Bank)
IFIs	international financial institutions
IISD	International Institute for Sustainable Development
ILO	International Labour Organization
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
LDC	less developed country
LLDC	least-developed country
MAI	Multilateral Agreement on Investment
MDBs	Multilateral Development Banks
MERCOSUR	Southern Cone Common Market (in Latin America)
MFN	most-favoured nation
MNC	multinational corporation
NAFTA	North American Free Trade Agreement
NATO	North Atlantic Treaty Organization
NTMs	non-tariff measures
OECD	Organisation for Economic Cooperation and Development
PPP	purchasing power parity

PTA	preferential trade arrangement
RDBs	regional development banks
SAP	structural adjustment programme
SDR	special drawing right
SEC	Securities and Exchange Commission (of the US)
SITC	Standard International Trade Classification
TNCs	transnational corporations
UK	United Kingdom
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
US	United States
USSR	Union of Soviet Socialist Republics
VERs	voluntary export restraints
WBG	World Bank Group
WIDER	World Institute for Development Economics Research (of the UN)
WTO	World Trade Organization

Introduction

I Fondad's Three-Year Research Projects

When the Forum on Debt and Development (Fondad) started its three-year project on regional economic integration and multilateral cooperation in October 1994, its main objective was to explore how the ideals of regional integration and multilateral cooperation could be promoted, in a mutually reinforcing manner. Specific questions included: What roles can regional markets and institutions play? Is regional integration a stumbling block or a stepping stone to an improvement in the functioning of the global, multilateral finance and trading system?

Over the past three years regional seminars were held in Latin America, Africa and Eastern Europe, at which experienced researchers and high-level policymakers jointly addressed these and other questions. In addition, workshops were organised to discuss the issue of how the system of multilateral economic cooperation could be improved from a more global perspective. One such workshop, for example, discussed ways in which future Mexico-style currency crises could be prevented or better managed. The research was further complemented by two studies on the financial policies and practices of the multilateral development banks, and on the issue of how the multilateral debt problem of low-income countries could be resolved. Both studies were authored by Indian economist and investment banker Percy S. Mistry who also wrote the background study of the project. For the publications resulting from the project see the list of Fondad publications at the end of this book.

Fondad's project was concluded by a two-day conference held in November 1997 in The Hague. Conference papers included the prospects and priorities for integration in Latin America, Africa, Eastern Europe, Asia and the Middle East. In addition, papers were prepared on the topics of economic globalisation and regionalism versus multilateralism.

After the conference we realised that the papers and the ensuing discussions were so rich and encompassing that it would be better to publish them in two separate volumes. The first volume focuses on the main question raised in the project – does regionalism contribute to national development as well as to multilateral cooperation? – whereas this second volume focuses on the policy challenges of the globalising economy.

This book serves as a kind of "bridge" between the Fondad project

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which has come to a close and the new three-year research project on which it has now embarked. Fondad's new project examines the implications of rapid global financial integration for national and international policymaking. It focuses in particular on the dynamics of private capital flows to non-OECD countries and its consequences for bilateral and multilateral development cooperation. The first book resulting from the new project is included in the list of Fondad publications (see the first title).

II The Political and Historical Context of Globalisation

Fondad's project on regionalism and multilateralism has focused mainly on the *economic* aspects of regional integration, multilateral cooperation and globalisation because we believe that the economic aspects of these processes are crucially important, particularly since the general public is often ill-informed about the economic forces behind these processes which shape the lives of peoples all over the world. However, I also believe that regional integration, multilateral cooperation and globalisation are basically *political* projects.

In my introduction to the first volume I illustrate this point by referring to the region which has become the success story of regional integration *par excellence:* Europe. In a brief account of Europe's integration attempts, I stress that while the post-war success in the deepening and widening of the European integration process was substantially facilitated by *economic* institutions and forces, the success was ultimately due to the *political* push for a united Europe. Without such a push the impressive shift from a European Coal and Steel Community with only six member states in the 1950s to a European (Monetary) Union with fifteen member states in the 1990s (and ten more candidate countries in Eastern Europe anxiously waiting to join the EU), would never have been possible.

I also allude to the fact that Europe has not only gone on record as a successful 'regional' integrator but as a successful 'global' integrator as well. I refer to the British Empire as a primary example of the dominant role that European countries have played (and still are playing) in the globalisation process.

In this introduction, I would like to dwell for a moment on the *politics* of globalisation (rather than the economics of it) by looking at the political forces and ideas behind the globalisation process of the last two centuries, which are predominantly West European and American – although the emerging economies are now playing their part in the global economy.

From a broad point of view, one could argue that the process of global-

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isation of the last two centuries has gone hand in hand with the development of capitalism. It is no coincidence that the three waves of globalisation we have seen over the last two-hundred years – the globalisation of trade, the globalisation of companies, and the globalisation of finance – run parallel to the three stages of capitalism: commercial capitalism, industrial capitalism and financial capitalism. Thus, globalisation seems to be rooted firmly in capitalism, and vice versa. What are the political implications of this state of affairs?

First, since capitalism has become the dominant ideology in most parts of the world, there are no powerful forces which are opposing continued globalisation. But while globalisation is generally seen as a necessary, inevitable or even highly desirable process which cannot or should not be stopped, we still need critique and alternative policy proposals. In fact, as the intertwined processes of globalisation and capitalism proceed and their deficiencies are revealed, the need for ideas and policies that can remedy their flaws becomes more urgent. Second, since the driving forces behind the two processes cannot only be located in powerful economic groups such as companies and countries but also in powerful desires and beliefs of human individuals, both forces deserve the attention of those who are committed to the search for remedies. And third, since human desires and beliefs are substantially influenced by the dominant ideology, today's opinion leaders (politicians, journalists, entrepreneurs, union leaders, academics, clerical authorities and others) should have a particularly critical view on capitalism and globalisation, especially when they are presenting ideas and policies which aim to address the challenges of both processes.

III The Policy Challenges of Globalisation

Each of the four authors whose papers are included in this volume deal with a different aspect of the process of economic globalisation. In a broad and in-depth paper, former IMF Managing Director H. Johannes Witteveen argues that even though globalisation seems to be developing in a positive and successful way from a macroeconomic point of view, it also raises "some serious concerns". One of the concerns he dwells on is the volatility of private capital flows which, particularly in emerging economies, "creates a serious risk of cyclical disturbances to the development process". Distinguishing between the various forms of capital flows –'low-risk' foreign direct investment (FDI), 'higher-risk' portfolio investment, and 'highest-risk' short-term bank loans – Witteveen proposes a number of specific measures "to act more forcefully against speculative capital outflows".

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A second concern that Witteveen deals with rather extensively in his paper is the effect of globalisation on the environment. In his view, we are "painfully confronted" with a deterioration of the environment brought about by the globalisation process. In light of the "extremely strong" capitalist forces that cause "increasing damage to the environment" and the unlikelihood that internationally agreed targets to reduce pollution levels will be met, Witteveen suggests the adoption of alternative measures such as the inclusion of "certain minimum levels of taxes" and "other restrictive measures on energy and trans-border pollutants" in trade liberalisation agreements.

A third concern Witteveen discusses in his paper is a spiritual one. While he recognises that the capitalist market economy has proved to be a powerful engine for economic growth and wealth, he advocates the need (and urgency) for a shift from materialistic concerns to the preservation of the environment and an improvement of the quality of life. In his view, any measures taken by governments and international institutions will have limited success in introducing such a turnaround. Reviewing Buddhist, Islamic and Christian thinking about market capitalism, Witteveen stresses that "the turnaround has to come from the depths of man's being".

Stephany Griffith-Jones, an economist from Chile who has gained reputation as a policy-oriented academic specialised in international finance, analyses in a rather technical but highly interesting paper the recent growth and volatility of portfolio flows to developing countries. Given the "insufficiency" of current regulatory strategies to deal effectively with the market volatility and systemic risk of these flows, she suggests a number of specific measures that regulators in both *source* and *recipient* countries could take to diminish the volatility of portfolio investments.

Zdeněk Drábek, a Czech economist working with the World Trade Organization in Geneva, deals with the other form of capital flows mentioned by Witteveen, i.e. foreign direct investment. At this moment, the need for and the details of a multilateral agreement on investment (MAI) are being hotly debated. In his paper Drábek discusses the arguments against and in favour of an MAI. Even though he is convinced that the benefits from an MAI could greatly exceed the costs, "several difficult problems would (still) have to be resolved before the negotiators (can) sit down to negotiate the actual agreement". These include the intellectual debate, 'green light' measures, regional cooperation, transition periods, exemptions and technical assistance.

In the fourth and last paper, Percy Mistry gives a detailed and lucid analysis of the future challenges of financial globalisation. In his view, these challenges are becoming more urgent by the day and need to be addressed more effectively – nationally, regionally and internationally.

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"The Asian currency and capital market crisis which is still unfolding suggests that many of the lessons of the Mexican crisis of 1994-95 have been left unlearnt," says Mistry.

The major section of Mistry's paper consists of a discussion of "pragmatic solutions" to what the author sees as seven key 'market' issues. These include: The need to develop regional financial markets for *small* countries; The need to rationalise fragmented markets and players in *large* countries; The need to address information imperfections and asymmetries in financial markets; The need to improve financial market regulation; The need for enhancing the capacity of central banks to intervene in financial markets (including a reappraisal of the role of international reserves); The need to improve 'market mechanics and market architecture' in emerging economies; The need for interaction across the three principal tiers of financial system governance – national, regional and global.

One of Mistry's provocative observations is that curative measures are mostly taken *after* financial market disruption occurs and a chain reaction ensues. In his view, national as well as international institutions still "seem ill-equipped in dealing with the challenges which a rapidly globalising financial world poses in the 1990s and beyond."

Let me conclude with a political thought. In my view, global financial integration ought to be a matter of concern not only to public policymakers and private entrepreneurs, but also to the public at large. Because ultimately, it is not the economic arguments of the experts alone that count but the political arguments of everyone concerned (including the 'minority' group of experts). No economic project (be it capitalism, socialism or globalisation), should become an end in itself – a dogma. On the contrary, each and every economic project should be evaluated in light of the broader and 'higher' human goals of justice, social equality, cultural identity and respect for nature.

I think the four papers included in this book make an important contribution toward increasing our understanding of the issues that are at stake in this globalising world.

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Director
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Economic Globalisation in a Broader, Long-Term Perspective: Some Serious Concerns

H. Johannes Witteveen[1]

I Introduction

The economic globalisation which increasingly characterises the world situation is a final stage of a two-century old growth process. In the 19th century, the world economy was already becoming more integrated through international trade and capital movements (see the *World Economic Outlook*, May 1997). From the middle of the 19th century until 1914, world trade expanded more rapidly than real output: 3.5 percent compared to 2.7 percent. This was a consequence of the reduction of effective import duties which decreased from 15% to 5% on average, and greatly reduced transportation costs (IMF, 1997: 112).

But the First World War and subsequent depression of the 1930s set back this integration process considerably. It was only after the Second World War, with the creation of GATT and its successive tariff rounds, that the integration process was again set in motion. Nevertheless, the share of exports in world output did not reach its 1913 peak again until 1970.

Capital movements were also important in the 50 years before WWI. For some countries, capital flows as a percentage of GDP were even larger before the First World War than after the Second World War. After the 1970s, however, the dispersion of real interest rates had again become so small by the dismantling of capital controls that capital markets were clearly linked together.

In light of this long-term view, we might wonder what is so special about recent developments. Have some new factors emerged which warrant the term 'globalisation' and all the attention focused on it?

The IMF mentions two major factors (IMF, 1997; 45-46):

1. New technological advances have strongly reduced transport, telecommunication and computer costs, so that national markets may

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1 This is a revised and expanded version of a paper that was prepared as an opening address for a FONDAD conference held on 18-19 November 1997 at the Dutch Ministry of Foreign Affairs.

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be integrated more easily at a global level. In doing so, it has become efficient for a firm to locate different phases of production in different parts of the world. For example, the costs of a 3-minute telephone call New York-London came down from $188.50 in 1940 to $3.32 in 1990. And prices of computers have fallen much more sharply still.

2. Foreign direct investment plays an important role in this process. It also leads to intensive technological transfers. Thus we see that more and more companies become not only multinational, but global with their decisions relating to the world economy as a whole. The World Bank (1997) has found that approximately one-fifth of the world's GDP is now produced in affiliates of multinational firms.
3. In line with all this, a larger part of the world and a larger number of independent countries are participating in this process of integration. This makes the process increasingly global, i.e. the whole world economy is linked together. Thus, while in the 50 years before WWI, capital flows went from Western Europe to the developing economies of the Americas and Australia and a few others in the context of colonial relationships and the gold-standard, capital movements now go to a growing number of emerging developing countries who are opening their economies to the world market. At the same time, a funda mental restructuring in former communist countries has begun as they shift from central planning to a market economy and increased openness to the world market. These developments are indeed creating an encompassing trade network around our whole world – a global system.

   (However, in spite of the doubling of average real GDP per capita in developing countries (LDCs) from 1965 to 1995, there was no convergence with the industrial countries which achieved the same strong growth. And substantial differences evolved among the developing countries themselves. Some LDCs developed so rapidly that they are now being classified as newly industrialised countries. Many other lagged behind, however, and some actually fell back.)

Part of the explanation for this lack of convergence is the stagnation of Latin American countries as a result of the 1982 debt crisis. Their real per capita GDP increased only 0.5% over the whole 1979-1988 period, and it was still falling in 1989 and 1990. In general, one might expect more convergence because of the large potential for technological catching-up and lower capital-labour ratios which would result in a higher return on investments in developing countries. That this did not occur in all developing countries is primarily the consequence of the politics of LDC countries: their degree of openness to the world economy, macroeconomic stability, the extent of state intervention, government efficiency and the protection of property rights. Thus, the quality of government has become a crucial factor. Globalisation accentuates the benefits of good governance and punishes bad governance.

The importance of these factors has become increasingly clear and is now more generally accepted. This is emphasised in the 1997 *World Development Report: The State in a Changing World*, where the importance of the quality of governance is the focus of the analysis. The implication is that as governments recognise the importance of the quality of government and begin to act accordingly, they will be able to join the fast-growth caravan. Indeed, this is what we are beginning to see in the 1990s.

The IMF sees the pace of globalisation quickening considerably now. From the mid-1980s, world trade has increased nearly twice as fast as world GDP. Developing countries have been involved more intensively in this growth process by increasing their share in world trade from 23% in 1985 to 29% in 1995. Inter-LDC trade also has increased. And the share of manufactures in LDC exports increased from 47% to 83% in this period, reflecting a rapid industrialisation process. This was made possible by a shift from protectionism to liberalisation. During this period, 33 countries shifted from relatively closed to open trading regimes (IMF, 1997: 72-73).

Private capital flows to developing countries also increased strongly – to more than 4% of their GDP in 1996. At the same time, there was an important shift from bank loans in the 1970s to foreign direct investment (FDI) and portfolio investment in the 1990s.

Thus, more countries are beginning to attain high growth rates. IMF data, for example, show that the number of Sub-Saharan African countries with GDP growth rates of 4% or more has increased from 14 in 1990 to 25 in 1995 (IMF, 1997: 91). In 1995, Botswana, Equatorial Guinea, Lesotho and Uganda reached GDP growth rates between 6 and 10 percent.

India has also achieved more rapid growth; 7% in both 1995 and 1996. The average annual per capita growth of all LDCs has accelerated to more than 4% annually from 1992 until the present (IMF, 1997; 137-138), and this is more than double the rate of advanced economies. Thus, globalisation is indeed spreading more widely, and is finally starting a movement towards convergence. The World Bank expects this process to continue so that the share of world real GDP for all developing countries would almost double from 15.7% in 1992 to 29.1% in 2020. Especially striking will be the increasing share of world GDP (from 7.8 to 16.1%) of the 'big five' countries of China, India, Brazil, Indonesia and Russia which have one-half of the world's labour force (World Bank, 1997: 23).

This picture is completed by the gradual integration of the ex-communist or transition countries into the global economy. From 1990 to 1995, a

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larger portion of their trade went to the Western world. Financial integration is also slowly making progress in these countries. Foreign investment in equities, which remained modest until 1995, surged in 1996 (IMF, 1997: 108). Real GDP which has been falling sharply during the transition, has now begun to increase again, with the Czech Republic, Poland, Romania and the Slovak Republic achieving rapid growth rates (p. 141).

So from this macroeconomic point of view, globalisation now seems to be developing in a positive and successful way. More countries are being embraced by it and are pushing forward to rapid growth. This, in turn, is reducing income differences between advanced and developing countries and should also diminish poverty in developing countries.

But, of course, this powerful and fundamental change in the world economy also raises some serious concerns.

II Globalisation and Unskilled Labour

The strong increase of trade between developing and advanced countries has caused a shift in the relative scarcity of production factors. Labour, and especially unskilled labour, has become more abundant in the advanced countries as developing countries increased their exports of low-skill manufactures. Indeed, there has been a decrease in demand for unskilled labour in advanced countries in the last 20 years. In the US, this has increased wage inequality, and even lowered real wages of unskilled workers since the early 1970s. In Europe, unskilled wages have been propped up by labour market institutions and here the relative abundance of unskilled workers has resulted in rising unemployment. In line with this, imports of low-skilled manufacturers from developing countries have been increasing rapidly.

These changes have also coincided with the rapid diffusion of computers in the workplace. This autonomous technological development displaces unskilled labour, and could also serve to explain the decreasing demand for unskilled labour in advanced economies.

What is the relative importance of these two factors? Intensive discussion of this question has taken place among economists. Many argue that the effects of growing trade should not be overestimated because they are statistically difficult to trace. The IMF concludes that the most convincing estimate of the portion of the increased wage dispersion which can be explained by trade with developing countries is 10 to 20% (IMF, 1997: 58). Wood argues that the impact of trade is about 20%. Among other points, he argues that technological progress is also influenced by trade. Low-wage competition often forces firms to find new methods of production

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which economise on unskilled labour. He also points out that trade in services has lowered the demand for unskilled labour in advanced countries through imports of shipping, tourism and key-punching services from developing countries (Wood, 1995: 67-68).

In addition, statistical studies show that when mulitinationals transfer parts of their production process to other countries ('outsourcing), employment *within* industries – as compared to *between* industries – shifts towards skilled workers. Thus from 1979 to 1990, it was found that outsourcing accounted for 30.9% of the increase in the non-production wage share ('non-production' taken as a measure of higher skills)(Feenstra, 1996).

This unfavourable effect of globalisation on unskilled labourers in the advanced countries is a reason for serious concern in these countries. And while it often leads to negative commentary on the process of globalisation, it should not be an argument against globalisation. The other side of this effect is the favourable impact on unskilled workers, i.e. the poor, in developing countries. And the overall welfare gain in trade for the advanced countries should enable them, in principle, to compensate the unskilled for their weakened relative position. This could be done by better education and training and, if necessary, by subsidising those who are unable to follow the minimum required education and training courses. The difficulty lies in the fact that some advanced countries have already done so much to protect and increase the real disposable wage of the unskilled that it becomes complicated to design appropriate additional subsidies. Therefore, the advanced countries face serious adjustment problems in this respect.

III The Volatility of Private Capital Flows

The growing importance of private capital flows to developing countries creates a serious risk of cyclical disturbances to the development process. These capital flows, and especially portfolio investment, can be highly volatile. In a period of expansion when prospects seem rosy, capital inflows can accelerate beyond the absorptive capacity of some countries. It can then become tempting for governments and private firms to borrow in international credit markets – sometimes even short-term and denominated in foreign exchange. In this way, a serious overinvestment situation can develop with a large deficit on the current account of the balance of payments.

The risks are different for the various forms of capital movements. They are somewhat limited for foreign direct investment. While FDI can fluctuate according to the economic prospects of a country and the psychology

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of investors, the capital is invested in real assets and cannot be withdrawn. Portfolio investment, which is playing an increasingly important role, can be highly volatile because of the psychology of investor expectations. And while individual investors can withdraw their money, net withdrawals are only possible insofar as domestic investors are willing to take over their shares, probably at lower prices. Thus, an inclination to withdraw portfolio investment will lead to falling stock prices, but will lead to a limited outflow of net capital from the country.

The greatest risks are created by short-term bank loans in foreign currency. While borrowers may count on their loans being renewed, it may not happen. If the confidence of the banks diminishes, they can request repayment; this will immediately cause a net-capital outflow on the balance of payments. The consequence of such a credit crisis, and the most appropriate remedy for it, will depend on whether the bank loans have mainly been given to the government or to the private sector. In the Latin American debt crisis of 1982, the government sector was the main problem. The IMF has adequately tackled this crisis by a combination of adjustment programmes under regular fund drawings with negotiated loan reschedulings by commercial banks.

The current credit crisis in East Asia has a very different character. It is mainly caused by short-term bank lending in foreign currency to a large number of local banks and businesses. These bank loans mainly served to finance private investment; not government deficits. It was a situation of overinvestment, stimulated by optimistic expectations in the climate of rapid economic development. Such a situation contains the seeds of a crisis. Sooner or later, over-optimistic expectations will be crushed. Bottlenecks may appear; profit margins may not fulfil expectations; over-optimistic investment projects may fail and – as a consequence of this or other disappointments – capital inflows will not increase but decrease, placing pressure on exchange rates which may already have become somewhat overvalued. This can easily undermine investors confidence to such an extent that foreign investors try to withdraw some of their money, leading to a stock-market crash in addition to the currency crisis. And as foreign banks then refuse to renew their short-term loans, a dramatic liquidity crisis will develop with numerous business failures as a consequence.

This kind of crisis has the same character as the classical overinvestment crisis at the upper turning point of many 19th century business cycles in the industrial countries. But developing economies run a greater risk in the present financial system. While in 19th century business cycles, overinvestment was mainly caused by a large expansion of internal bank credit,[2] some developing countries also finance their investment boom through portfolio investment and bank credit from abroad.

These flows originate in international capital markets that are enormous in size compared to the LDC economies. Besides the large internal capital markets of the advanced countries, there is also the highly elastic supply of international credit in the unregulated Euromarket (Witteveen, 1995).

This market can create additional international liquidity just as money-creating banks within a country. Additional lending can always be financed through the Euro-dollar market because part of it will automatically be re-deposited while the rest, flowing back to the United States, can easily be attracted to the Euro-dollar market by a minimal increase in the interest rates. As I have previously explained, this lending in the Euro-market will not result in a capital movement out of the United States, but will result in international credit and liquidity creation (Witteveen, 1995: 423- 424). This might have been an aggravating element in the current Asian crisis.

All of these factors give mass investment psychology enormous scope to cause capital inflows and outflows of a magnitude that can completely overwhelm the financial systems of these still relatively small economies. And it goes without saying that corruption or cronyism in government or in the banking system greatly increases the risk of overambitious and failed investments.

The IMF has acted with great courage and massive financial support to contain and solve the crisis, but its approach does not seem entirely suited to the particular character of this crisis. It has not been able to prevent dramatic currency depreciations, which make it practically impossible for many businesses to make the required repayments on their bank loans. The reason the IMF did not manage to arrange a rescheduling of bank loans is that they were unclearly scattered over a large number of borrowers. Neither was the disbursement of IMF financial support sufficiently adjusted to the repayment needs of short-term debt and speculative outflows. It was hoped that tough conditions of fiscal and monetary restraint and structural improvement in the financial system would restore market confidence and exchange rate stability. But instead market participants were frightened by the serious recessionary consequences of the liquidity crisis combined with restrictive IMF conditions. And, in fact, the apparently unforeseen recessionary consequences of the liquidity crisis became so severe that most of the restrictive measures prescribed by the IMF were unnecessary and worsened the down-turn.

The result was an extraordinary drop in the exchange rates of the affected countries, which made the liquidity crisis extremely serious, and left no alternative for debt rescheduling by the US Federal Reserve and other cen-

2 The 1873 crisis in the US was quite similar to the present Asian crisis and had serious consequences because European investors pulled out their money (Bradford de Long, 1998).

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tral banks.

Given these developments, the crisis is causing a serious recession, or even depression, with grave social problems resulting from business failures and rising unemployment. It will take a number of years to restart economic growth, and this will slow the convergence between advanced and developing countries that had just begun. We can hope that the painful IMF programmes will eliminate serious weaknesses in the economic and financial systems of these countries. Greater openness, competition and integrity, together with an improved quality of financial services and banking supervision, would provide better prospects for healthy and balanced growth.

Nevertheless, the question remains whether and how such painful disruptions of the development process can be prevented or limited in the future. These questions are now being explored and debated in different official gremia. One suggestion, which was proposed and put into practice after the Mexican peso crisis of 1994-1995, is to improve information. This is the easiest approach, but does not seem very effective. A great deal of information has already been available. Alexandre Lamfalussy noted that BIS data had fully signaled the worrisome increase of short-term debt in Asia; but these published warnings from the BIS were ignored (International Herald Tribune, 1998).

There also seems to have been confusion about the total stock of short-term debt of particular countries. The essential figure in this respect is net short-term foreign exchange debt of a country compared to its foreign exchange reserves. Comprehensive figures for this ratio should be calculated by all central banks and made publicly available.

But then, if warnings are ignored and short-term lending continues to grow dangerously, additional measures are needed to limit or prevent a crisis. Restrictive monetary policies should be focused on short-term credit flows. This could be done in the recipient as well as in the source countries. Central banks in the recipient countries could, for example, impose non-interest bearing foreign exchange deposits on additional borrowing with the central bank. At the same time, monetary policy in recipient countries should generally become more restrictive whereas part of the capital inflow should be sterilised. Central banks in *source* countries, on the other hand, could impose such foreign exchange deposits on further lending by commercial banks to the risk countries. These restraining monetary policies of both recipient and source countries should be internationally coordinated by the IMF and BIS. Such cooperation could create a nucleus for a more systematic surveillance system for international liquidity, where the focus should become more global, i.e. including the *total* increase of international credit and liquidity. This is becoming increasingly desirable.

As I have previously argued, the exclusive focus of central banks on their own money supplies is no longer sufficient in our internationally integrated financial markets (Witteveen, 1995: 429-430).

Finally, we can ask what the best future approach would be if a similar crisis would develop in spite of warnings and restraining policies. Two questions arise here.

First, should the IMF be able to act more forcefully against speculative capital outflows? We have seen how seriously exaggerated depreciations of a currency can dislocate the economic and financial system. To counter speculative outflows and maintain the exchange rate within a reasonable range, a larger part of the IMF's financial support should be immediately available on a sufficiently large scale, and not meted out gradually in successive installments. This could diminish the IMF's power to enforce correct performance under its conditions to some extent. But in cases where the problem emerges through capital outflows, there is often less need for restrictive measures. With respect to structural problems, strict conditionality should still be required, and part of the financial assistance should still be disbursed over time under performance criteria. Also, exchange rates should be a central concern of the IMF. In recent developments, the stability of exchange rates seems to have received insufficient attention.

Second, problems of repayment of short-term bank loans should be tackled at the same time. The international financial community could design an internationally accepted rescheduling mechanism – also for private bank debt – under the guidance of the IMF and related to IMF programmes. Such a mechanism would provide essential help in preventing a melt-down in currency markets while limiting the amount of financial assistance that would have to be made available by the IMF. It would also lead to a more equitable distribution of pain among debtors and creditors. This would, at the same time, eliminate or reduce moral hazard.

In this field, the global economy demands the creation of international institutions comparable to those we have within countries. There are essential tasks here for international monetary cooperation. Healthy further growth in the global economy will become increasingly dependent on this cooperation.

IV Tax Competition

The size and speed of international private capital is creating other problems for both advanced and developing countries. It leads to a kind of tax competition. The importance of foreign investment for economic growth and employment motivates governments to make their tax climate more

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attractive for foreign investors. This may lead to lowering or withholding taxes on investment income and corporation profits. There may also be pressure on countries with relatively high marginal rates of income tax to lower them. The inclination to lower these tax rates may be further strengthened because highly mobile capital and high-quality staff can more easily avoid or evade these taxes. Thus, as the IMF concludes, "globalisation will increasingly tend to cause tax systems to converge either through tax-harmonisation or via tax-competition across jurisdictions" (IMF, 1997: 70). The tax-sovereignty of countries will thus be eroded, and tax-regimes will become more favourable to investors and high-income earners and less favourable to wage-earners. From the point of view of income distribution, this may cause concern, even though part of these changes can be viewed as a necessary correction of overly redistributive tax-systems.

But the freedom of capital movements in general also creates a strong financial discipline. The risk of capital outflows will motivate governments to maintain the sound and sustainable fiscal and monetary policies that the IMF recommends and that financial markets expect.

Failure to take these risks into account, has led to the financial crisis in Southeast Asia that is now unbalancing financial markets worldwide.

V Globalisation and the Environment

A more fundamental concern about rapid global growth of the world economy is its effect on the environment. We are painfully confronted with damage to the environment as a consequence of growth. Industrial and agricultural development produce a number of toxic substances which pollute our air, water and soil, and growing energy use produces CO_2 which may result in a warming of the atmosphere with dangerous climatic consequences. The advantages of growth in material welfare should therefore be evaluated against environmental deterioration.

Could we avoid such a painful choice because growth beyond a certain level reduces the environmental impact? This possibility has been discussed in the context of the green Kuznets curve, which is based on certain statistics that show a reduction in toxic or energy intensity per unit of GDP beyond a certain level of GDP per head.

Three reasons are seen for this effect:

1. Population growth would slow down as GDP per capita increases. This is a very long-term effect that would reduce the pace of growth to some extent, but not necessarily reduce toxic or energy intensity.
2. With increasing wealth, there will be a shift from manufacturing to services which have smaller environmental effects. This is what

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Hettige, Lucas and Wheeler have measured in 1992. Indeed, they found an inverse U-shaped pattern for toxic intensity per unit of GDP due to the shift from industry towards lower-polluting services. But this effect cannot be strong enough to reduce total pollution since the manufacturing industry will continue to grow albeit at a slower rate.

3. The third effect of higher levels of GDP per head is that more resources would be available for environmental protection measures, and there would be greater willingness to use these resources for the environment. But this is not a firm technical relationship; conscious decisions are required.

This brings us again to the problem of the optimal evaluation of material growth against environmental damage. This evaluation is difficult, and there are various reasons why it tends to be strongly biased against the environment.

First, the forces for creating economic growth in a capitalist market economy are extremely strong while the effets of growth-creating decisions on the environment are not visible to individual decisionmakers. Forces leading to growth include:

- When a minimum level of welfare has been reached, there will always be a tendency to save a portion of GDP, and these savings will have to be invested.
- There will also be a tendency to improve technology and efficiency, so that productivity is increasing. This will generally require investment.
- Competition between firms forces them to maximise efforts in this direction. Standing still can place survival at risk.
- Even though governments see the effects of growth on the environment, they generally aim for the highest possible growth. They feel that they need additional resources to meet strong pressures in society for higher spending or lower tax rates. They also want full employment and realise that investment and growth are needed for this. Moreover, there is also a kind of competitive nationalistic spirit that does not want to see the country lagging behind in growth with respect to other countries.

Second, since deliberately slowing down growth in order to protect the environment is not a realistic option, the only possibility is to give higher priority to environmental measures compared to other needs, sometimes with growth-reducing consequences. This is also difficult. Additional tax revenues resulting from economic growth are not freely available for the environment. Growth creates many claims for increases in government spending, for example, for infrastructure which has to keep pace with economic activity.

Fortunately, the most effective environmental measures do not require government spending but a restructuring of the tax system so that the environmental effects of different economic activities are integrated into the price mechanism by special taxes or possibly by auctioning emission permits. This would be an extremely efficient method since the price mechanism is the most powerful instrument for motivating and guiding both business firms and consumers to adjust their own choices, including the direction of their technology innovation. These pricing measures could even provide additional government revenues which could be used to lower other taxes.

But here we face another difficulty. Such taxes, for example on energy, will be strongly opposed by industries which fear that their competitive situation would be endangered. So it would be difficult for a country to undertake tax measures unilaterally since growth and employment might be harmed. Furthermore, other countries would benefit as the favourable effects of such measures spread beyond national borders. Such pricing measures can therefore only be introduced in a meaningful way through international coordination, and this requires difficult negotiations where the outcome will strongly be influenced by countries with the lowest priority for the environment, i.e. lower income developing countries whose need for growth is urgent in order to alleviate the poverty of their population.

We must conclude that globalisation tends to remain unbalanced and strongly weighted against the environment. Continuing economic growth and spreading it to a larger number of countries of the world will cause increasing damage to the environment. The cumulative effects of this damage may be difficult to restore.

What could and should be done to turn this dangerous development around? Clearly, international coordination is essential. The United Nations has made an encouraging start in the Rio de Janeiro conference on environment and development.

Excellent principles have been adopted in the Rio Declaration and a comprehensive list of desirable measures has been worked out. Follow-up conferences have been organised so that awareness of what needs to be done is strengthened and circulated more widely, but a great deal still needs to be done on implementation. The United Nations' report on the progress reached so far notes that the aim of reducing CO_2 emissions in 2000 to the 1990 level will only be achieved by very few countries (UN Commission on Sustainable Development). Low fossil fuel prices have discouraged alternative energy use, and financial commitments to a Global Environmental Facility have not met the target.

The urgent problem of reducing CO_2 emissions has now been seriously discussed. The agreement that was finally reached in Kyoto in December 1997 sets a target of reducing these emissions to 5% below the 1990 level

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in the commitment period 2008-2012. It hopes to achieve this without energy taxes although a system of trading emission rights would be introduced. But developing countries have refused to participate in this agreement. They still refuse to accept such obligations. In light of this slow and difficult progress in protecting the environment from the negative effects of globalisation, one might wonder whether it is right to push for further trade liberalisation which would stimulate world economic growth and, at the same time, sharpen international competition which could make environmental measures even more difficult.

A better approach would be to build certain environmental protection measures into new trade liberalisation agreements. The international debate is already moving in this direction. Trade and the environment are now firmly incorporated into the work programme of the WTO, UNCTAD and other organisations.

My suggestion would be to include in trade liberalisation agreements certain minimum levels of taxes or other restrictive measures on energy and trans-border pollutants. Liberalised access of exports to the world market should then depend on the observance of these minimal environmental measures. Such measures would not only promote a better world environment, but also be justifiable from a free trade point of view because it would create equal competitive conditions with respect to rules for trans-border effects. As part of such an agreement, some financial assistance from advanced countries to developing countries may be needed to make it easier for them to meet these environmental requirements.

Since an international consensus would develop in this direction, the IMF and World Bank could then go further in including environmental concerns in its consultations and in its conditional facilities with member countries. The focus of the IMF could be on environmental developments that would threaten the economic equilibrium in the future – as has already been done in a few cases with respect to forestry policies and fisheries managements; the World Bank should look at the effect of taxes and subsidies on trans-border environmental damage.

VI Spiritual Concerns

The capitalist market economy has proved to be the most powerful engine for economic growth. It is the moving force behind the present globalisation of the world economy. It is so strong because it uses the individuals' desire for material gain in an optimal way, harnessing that egoistic desire within a competitive pricing system so that it leads to high long-term growth of welfare for the community under the necessary conditions of

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stability, reasonable competition and flexible markets.

But at the same time, this system gives a strong impulse to these materialistic and egoistic inclinations. Material consumption has become a very tempting aim. Sulak Savaraksa, a prominent Buddhist thinker and activist, expresses a deep concern as he sees how Buddhist values of spirituality, harmony and friendliness have been turned around and completely overwhelmed by market capitalism in Thailand during his life-time (Savaraksa, 1992). People are captured by a feverish pursuit for higher material wealth that does not always improve the quality of life and is opposed to Buddhist virtues of sobriety and control of self-interest. He calls this 'consumerism' and sees it as a pseudo-religion which will be unable to give satisfaction and inner peace.

Similar concerns seem to lie behind 'Islamic economics', which aims to restructure economic thought and practice on the basis of fundamental Islamic teachings. As Timur Kuran (1996: 438) argues, its main purpose is not to improve economic performance, but to prevent Muslims from assimilating into the emerging global Western culture. In fact, economic performance is impeded because capitalist practices such as interest, insurance, speculation and indexing are considered un-Islamic.

Payment of interest on loans was also forbidden in medieval Christianity, but interest is of course an essential aspect of the capitalist system. In order to overcome this ethical objection of a whole epoch, capitalism needed support from religion, and as Max Weber has shown, this crucial support came from Protestantism and especially Calvinism (Weber, 1930). This was a paradoxical development, as Weber demonstrated in his masterful analysis, because Calvinism had a very ascetic spirit. But Calvin's desire to see God as high and perfect led to a theology of absolute transcendency of God, which separated man from God by an unbridgeable gulf. Since every possibility for man to come in contact with God was precluded, the only choice left to man was to turn his attention to the outer world. Thus, as Max Weber put it, "The Christian ascetic now left the monastery and strolled into the market place" (pp. 153-154). The doctrine of predestination was then developed in such a way that one had to believe in being chosen by God's grace. And working actively, work in a 'calling', was the most suitable means to attain this self-confidence. Action should "originate from the faith caused by God's grace" (p. 113).

Thus, a strong religious motive was created for the typical capitalist virtues of sobriety, hard work and capital accumulation. Interest came to be viewed as justified between traders – as distinct from the sphere of personal help.

This Calvinist spirit became highly influential in the Protestant world. In Roman Catholicism it was weaker since the mystical idea of inner con-

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tact with the divine was kept alive in the monasteries. The influence of Protestantism and of Catholicism on economic growth has been statistically confirmed in two recent research papers. For the 1870 to 1979 period, Bradford de Long has found a striking *ex ante* association between growth of nations that seemed to have growth potential in 1870, and Protestant versus Roman Catholic cultures (Bradford de Long, 1988). And Alain Desdoigt captured an unanticipated structure in his projections of a religious dimension, by identifying Protestant and Roman Catholic groups of countries, with the former experiencing higher growth rates (Desdoigt, 1996).

After this subtle religious analysis, Max Weber then shows with the worldly success of this ascetic Calvinism, how the religious spirit vanishes as wealth increases. He quotes John Wesley who wrote, "I fear, wherever riches have increased, the essence of religion has decreased in the same proportion". And Wesley continues, "but as riches increases, so will pride, anger and love of the world in all its branches". He then concludes, "so, although the form of religion remains, the spirit is swiftly vanishing away" (Weber, p. 175).

Weber concludes that "today victorious capitalism, since it rests on mechanical foundations, needs its (religious) support no longer" (pp. 181-182). In the last two centuries, we have seen how capitalism gradually developed globally, overpowering very different religious cultures, as we have seen in the case of Buddhism.

Thus the world is caught in "a tremendous cosmos" of the modern economic order, ... which determines the lives of all the individuals with irresistible force". "Perhaps", Weber then adds almost prophetically, "it will so determine them until the last ton of fossilised coal is burned" (p. 181).

VII Conclusion

As we have seen, widening world economic growth indeed begins to create serious concerns – not so much of exhausting coal reserves, but of a dangerously deteriorating environment. The forces behind this growth are very strong. Of course, it still has positive effects in many developing countries where it is needed to reduce absolute poverty. But in the advanced countries and in emerging economies which achieve higher welfare levels, a shift in emphasis from material growth to the environment and the quality of life will become desirable and increasingly urgent. Can such a turnaround be achieved without a change in the spiritual and religious motivation of man? Max Weber wondered whether "at the end of this tremendous development entirely new prophets will arise, or there will be

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a great rebirth of old ideas and ideals ..." (p. 182).

It is indeed encouraging that we can see the beginning of significant spiritual counter-forces at the present time. There is a growing dissatisfaction in Western culture with our materialistic and outward-directed life. There is a growing longing for spirituality. Meeting this need is an undercurrent of movements offering a path to meditation, to contact with the divine spirit, bridging that distance between God and man that became so "unbridgeable" in Calvinism. Buddhist and Hindu spiritual teachers, schools of yoga, transcendental meditation and other spiritual organisations encounter growing interest. A new focus on spiritual experience may also emerge in some Christian communities. Inayat Khan's universal Sufi message reveals the inner unity and universal values of the great religions. This opens a path to the inner life for Western man. Thus, as the Western technological economic advance begins to impose itself top-down on Eastern culture, different forms of Eastern spirituality begin to change Western culture bottom-up and from deeper levels.

This could lead to a more balanced world situation, a new synthesis between Eastern and Western culture. A shifting focus from outer life to inner life, and the creation of a better balance between the two, would then lead to a greater preference for free time, shorter working weeks and earlier retirement so that people can devote themselves to spiritual and religious pursuits.

The greedy strife for higher material consumption would then abate. This would naturally slow down growth. It would also diminish over-ambitious and corrupt practices and increase the willingness of business firms to take the general interest of the community into account in their decisions.

Such spiritual developments take time. They always move slowly. But how much time do we still have before environmental damage becomes too severe and, perhaps, irreversible?

Governments and international institutions are limited in what they can do to promote these spiritual forces. They cannot be created by legislation. They have to grow in freedom from the depths of the human heart. But the education system and the media, especially television, have an enormous influence. There is an important task for the government in introducing or stimulating the introduction of universal spiritual values in education and in government-sponsored radio and television programmes. Governments could also take action with respect to the enormous amounts of consumption-stimulating advertising. Taxes on advertising expenditure could discourage it and provide a correction to the present exaggerated 'consumerism'. There is also an economic argument in favour of such taxes because this kind of monopolistic competition, based on brand-name preferences created and maintained by advertising, is sub-optimal since it keeps

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prices higher than would otherwise be the case. The proceeds of such taxes could then be used to create greater room for inspirational developments in the fields of art and education.

These measures could help to some extent, but fundamentally, the turn around has to come from the depths of man's being. Western individuals with their incredible scientific, technological and economic achievements in the outer world now have to find a better balance by learning to turn within to rediscover the enrichment, satisfaction and peace of the inner life.

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Regulatory Challenges for Source Countries of Surges in Capital Flows

Stephany Griffith-Jones[1]

I The Growth of Portfolio Investment in Developing Countries

One of the more surprising developments in international financial markets over the last decade has been the growing role of foreign portfolio investment as a channel for international capital flows to developing countries. This is not, however, the first time there has been an abrupt shift in channels or in the volume of flows to these countries (see Table 1). From 1977 to 1982, for example, commercial bank lending was the dominant channel and the largest lenders were US multinational banks lending primarily to middle-income countries, particularly (but not only) in the Western Hemisphere. Although loans were also the primary channel for flows to Asia in this period, the World Bank and the regional development banks provided a larger share of total lending to low-income Asian countries and to Africa than did commercial banks. Foreign direct investment was an important channel for flows to all regions in these years but portfolio investment was relatively unimportant and largely involved bond issues in the Euromarkets by a few of the more creditworthy developing countries.

The second oil price increase in 1979, the ensuing recession in the industrialised countries and the shift in US macroeconomic policy in the period from 1979 to 1982 ushered in a new and difficult decade for developing countries. The Mexican debt crisis in 1982 quickly escalated into a Third World debt crisis that involved a large number of countries, particularly in Latin America, the Caribbean, Africa and Eastern Europe. It is interesting that most Asian countries did not suffer a debt crisis in the 1980s.

Between 1983 and 1989 there was a marked decline in net international

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Table 1 **Capital Flows to Developing Countries**[1]
(in billions of dollars)

	All Developing Countries	Asia	Western Hemisphere	Other Developing Countries[2]
1977-1982				
Total net capital flows	183.0	94.8	157.8	-69.6
Net foreign direct investment	67.2	16.2	31.8	19.2
Net portfolio investment	-63.0	3.6	9.6	-76.2
Bank lending & other	178.8	75.0	116.4	-12.6
1983-1989				
Total net capital flows	61.6	116.9	-116.2	60.9
Net foreign direct investment	93.1	36.4	30.8	25.9
Net portfolio investment	45.5	9.8	-8.4	44.1
Bank lending & other	-77.0	70.7	-138.6	-9.0
1990-1994				
Total net capital flows	524.5	260.5	200.5	63.5
Net foreign direct investment	195.5	117.0	59.5	19.0
Net portfolio investment	218.0	62.0	133.0	23.0
Bank lending & other	111.0	81.5	8.0	21.5

Notes:
1 Flows exclude exceptional financing.
2 Includes countries in Africa, Eastern Europe and the Middle East. Excludes capital-exporting countries such as Kuwait and Saudi Arabia.

Source: IMF, *International Capital Markets*, August 1995.

capital flows to developing countries, largely due to the very high negative net transfer of financial resources from Latin American countries to commercial banks. Foreign direct investment (FDI) was the only channel for net capital flows into Latin American countries in these years. FDI increased in other developing countries as well, particularly in Asia. Asian countries remained attractive to the international banks that continued to lend – especially to Japanese banks who had opportunities to invest growing surpluses of Japan's current accounts, and had incentives to follow Japanese direct investors into rapidly developing countries in Asia.

The slowdown in international capital flows to developing countries in the 1980s contributed to larger flows to industrialised countries, particularly the United States, while the decline in international bank lending encouraged the growth of the Eurobond market as a source of financing for corporations and governments of OECD countries. As the Eurobond market became the dominant channel for international capital flows and an increasingly attractive substitute for more expensive domestic markets in some industrialised countries, it became more difficult for countries with low credit ratings to attract external capital. Although Middle Eastern countries issued large amounts of international bonds in this period, external bond markets were closed to most developing countries. International investors' growing interest in foreign equities also diverted flows away from developing countries in this period as more funds were invested in the US, UK and Japanese stock markets.

As the industrialised countries shifted into recession in 1989-1990, and particularly as US interest rates fell, there was once again an abrupt shift in the direction of international capital flows with substantially larger flows to developing countries. By 1993, the aggregate net inflow to developing countries was 2% of world saving, up from 0.8% in 1990 (IMF, 1995). As Table 1 shows, the growth in net foreign portfolio investment in all developing countries in 1990-1994 was extraordinary and flows to Latin America were predominantly through this channel. In the late 1980s, portfolio flows to Latin America averaged $3 billion annually; by 1993 they had increased to $56 billion (an increase of 1,700%), although they also fell in 1994. In the same period, portfolio flows to Asia grew from $1 billion in the late 1980s to $25 billion in 1993 (an increase of over 1,900%), although they fell in 1994 (Griffith-Jones and Cailloux, 1997). In parallel, the capitalisation of emerging markets doubled between 1987 and 1990 and grew at an even more rapid pace in the years 1991-1994 (see Table 2). Moreover, emerging markets' share of world market capitalisation jumped almost three-fold from 4% in 1987 to 11.6% in 1993. By 1994, stock market capitalisation in relation to GDP in Chile, Hong Kong, Malaysia and Singapore was comparable to that of the United States and the United Kingdom; in Mexico and Korea it was even larger than in Germany and France (BIS, 1995).

Developments Contributing to the Growth of Foreign Portfolio Investment

The increased flows of securities investment from industrialised countries to emerging markets was made possible by a number of developments in

Table 2 Emerging Markets Capitalisation
(in trillions of dollars and percentages)

	1987	1988	1989	1990	1991	1992	1993	1994
In trillions of dollars	0.3	0.5	0.7	0.6	0.75	0.8	1.57	1.93
As a share of world capitalisation (percent)	4.1	5.0	6.3	6.5	7.5	8.8	11.6	–

Sources: International Finance Corporation, *Emerging Stock Market Factbook*, various issues; and IMF, *International Capital Markets*, August 1995.

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all the countries involved. One critical development was a marked change in investment patterns in the national markets of the major industrialised countries in the 1980s. The so-called institutionalisation of savings – that is, the choice of pooled funds held by pension funds, life insurance companies, mutual funds and investment trusts as repositories for the majority of savings – increased the share of funds invested in securities and enhanced the role of institutional investors compared to that of depository institutions. In the United States, for example, the share of total financial sector assets held by institutional investors rose from 32% in 1978 to 52% in 1993, while the share of depository institutions fell from 57% to 34% over the same period (Federal Reserve System, *Flow of Funds*, various years). There were equally dramatic increases in assets of institutional investors in other G-7 countries as well. Measured as a percentage of GDP, their assets doubled over the period from 1980 to 1992 in the United Kingdom, Germany and Japan, and almost doubled in Canada (see Table 3). By 1993, the assets of UK and US institutional investors had risen to 165% and 125% respectively of GDP. They continued to increase in the mid-1990s and are projected to continue doing so.

As the assets of institutional investors expanded, their diversification strategies increasingly resulted in an expansion of cross-border investments. Cross-border transactions in bonds and equities among the G-7 countries (excluding the United Kingdom) rose from 35% of GDP in 1985 to 140% in 1995 (BIS, 1996). This was possible because all industrialised countries had removed exchange controls in the 1980s and were adopting full capital account convertibility by the early 1990s. Similarly, the shift toward foreign portfolio investment in emerging markets became possible when many developing countries began to relax exchange controls and open their capital account at the end of the 1980s and the beginning of the 1990s. These actions increased opportunities for cross-border investment by residents of all countries. Institutional investors increasingly saw international diversification as beneficial, which made them willing to take up these opportunities. Drawing on modern portfolio theory, a number of studies using long-term data showed that investors free to choose foreign assets can obtain a significantly better risk/return trade-off than if they are restricted to assets from one country (Fischer and Reisen, 1994). Also it has often been argued that diversification into developing country markets is particularly beneficial, especially because there is low correlation of returns yielded between the emerging stock markets themselves and in relation to developed stock markets (while OECD stock markets are quite highly correlated). Also, on average developing countries are expected to grow faster than developed ones, leading to higher dividend growth and share price increases (Reisen and Williamson, 1994).

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Table 3 **Assets of Institutional Investors**
(in billions of dollars and percentages)

	1980	1988	1990	1991	1992	1993
Canada	93.2	257.0	326.2	373.0	376.4	–
Germany	164.7	442.6	626.5	677.9	763.5	811.8
Japan	244.3	1,458.7	1,649.5	1,835.4	1,972.1	–
United Kingdom	345.1	991.7	1,208.2	1,353.6	1,432.0	1,553.4
United States	1,606.9	4,316.1	5,220.8	6,516.0	7,182.9	8,008.4
Total	**2,454.2**	**7,466.1**	**9,067.2**	**10,755.9**	**11,726.9**	–
In percentage of GDP						
Canada	35.2	52.2	56.8	63.3	66.1	–
Germany	20.3	37.1	41.7	42.7	42.7	47.4
Japan	23.1	50.3	56.3	54.8	53.8	–
United Kingdom	64.1	118.3	123.5	133.8	137.1	165.3
United States	59.3	88.1	94.5	113.9	119.0	125.6

Source: IMF, *International Capital Markets*, August 1995.

Another critical development that contributed to the rise in foreign portfolio investment over the last decade was the worldwide wave of privatisations initiated by the Thatcher government in the United Kingdom in the early 1980s that culminated in the restructuring of Third World economies and formerly centrally planned economies in the 1980s and 1990s. Privatisations of state enterprises in a growing number of countries greatly expanded the menu and volume of financial instruments available in national equity and bond markets for purchase by foreign portfolio investors.

The US Role in Foreign Portfolio Investment

Over the last two decades, the United States has continued to be both a major recipient of, and source for, international capital flows. There were large net capital inflows into US markets throughout the period 1982-1994, and substantial inflows of foreign private portfolio investment in every year from 1985 to 1994, though with quite sharp fluctuations, except for 1990 when there was a small outflow (see Table 4). The US experience with surges of foreign investment in the 1980s created problems similar to, but less severe than and with less severe impact on the domestic economy, those experienced by some emerging market countries in the 1990s: an overvalued currency, rising current account deficits and a boom in consumption that led to a massive increase in domestic debt. The aggregate debt of US borrowing sectors – government, households and businesses –

Table 4 Net Changes in Portfolio Investment in the US by Foreign Investors and in US Residents' Purchases of Foreign Securities
(in billions of dollars and percentages)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Foreign Official											
Treasuries	4.7	-0.8	34.4	43.4	41.7	0.3	29.6	14.8	18.5	49.0	30.7
Other Securities	-2.8	-1.7	-2.1	0.5	-1.2	3.2	-0.9	2.7	3.2	6.7	3.6
Total	**1.9**	**-2.5**	**32.3**	**43.9**	**40.5**	**3.5**	**28.7**	**17.5**	**21.7**	**55.7**	**34.3**
Foreign Private											
Treasuries	23	20.4	3.8	-7.6	20.2	29.9	-2.5	18.8	36.9	24.1	33.8
Other Securities	12.6	51.0	70.9	42.2	26.3	39.6	1.6	35.1	29.9	79.9	58.6
Total	**35.6**	**71.4**	**74.7**	**34.6**	**46.5**	**69.5**	**-0.9**	**53.9**	**66.8**	**104.0**	**92.4**
Total Foreign Portfolio Investment	**37.5**	**68.9**	**107.0**	**78.5**	**87.0**	**73.0**	**27.8**	**71.4**	**88.5**	**159.7**	**126.7**
US Purchases of Foreign Securites (outflow)	-4.8	-7.5	-3.3	-4.5	-7.8	-21.9	-28.8	-44.7	-46.4	-142	-49.8
Memo Items:											
Total Foreign Net Capital Inflows	102.5	129.9	221.2	211.5	221.3	214.5	105.3	83.3	153.9	248.5	291.4
Foreign Portfolio Investment as a % of Total Net Foreign Capital Inflow	36.6	53.0	48.9	37.1	39.3	34.0	26.4	85.7	57.5	64.3	43.5
Total US Private Net Capital Outflows	-22.3	-31.4	-98.0	-76.0	-84.1	-127.0	-44.1	-59.9	-68.1	-183.0	-131.0
US Foreign Portfolio Investment as a % of Total US Private Net Capital Outflows	21.5	23.9	3.4	5.9	9.3	17.2	65.3	74.6	68.1	77.5	38.0

Source: Federal Reserve System, Board of Governors of the, "US International Transactions," In: *Federal Reserve Bulletin*, various issues.

more than doubled in the seven-year period from 1983 through 1990, from $5.4 trillion to $10.9 trillion (Federal Reserve System, *Flow of Funds*, various years). This was, obviously, an unprecedented development in US financial history.

Just as the explosion of debt in the United States would not have been possible without sizeable increases in net capital *inflows*, sizeable increases in capital *outflows* from the US in the early 1990s (particularly of portfolio flows) to developing countries – especially dramatic in the case of Latin American and later to Asian countries – would not have occurred if US institutional investors had not played a dominant role in channelling funds. While net capital outflows from the United States in the period 1990-1992 were not large compared with earlier years, the share of the total attribut-

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Table 5 **Net Assets of Emerging Markets Mutual Funds**
(in millions of dollars)

	1988	1989	1990	1991	1992	1993	1994
Equities	**5,857**	**9,975**	**13,320**	**19,180**	**29,531**	**84,102**	**123,849**
of which:							
Global	900	1,350	2,300	3,750	5,040	18,033	34,977
Asia[1]	4,437	7,435	9,240	11,575	18,823	55,472	71,889
Latin America[2]	520	985	1,455	3,525	4,862	9,741	14,706
Europe[3]	–	205	325	330	806	757	1,430
Africa and Middle East	–	–	–	–	–	99	847
Bonds	**275**	**500**	**900**	**1,700**	**3,750**	**5,954**	**8,149**
Total Funds	**6,132**	**10,475**	**14,220**	**20,880**	**33,281**	**90,056**	**13,1998**

Notes:
1 Includes regional funds and the following individual country funds: China, Hong Kong, India, Indonesia, Korea, Malaysia and Singapore, Pakistan, Philippines, Taiwan Province of China, Thailand, Viet Nam.
2 Includes regional funds and the following individual country funds: Brazil, Chile, Mexico.
3 Includes regional funds and the following individual country funds: Hungary, Russia, Turkey.

Sources: IMF, *International Capital Markets*, August 1995.

able to foreign portfolio investment was unprecedented. Foreign portfolio investment accounted for over 65% of total US net private capital outflows from 1990 through 1993, falling to only 38% in 1994 (see Table 4).

Major sources for foreign portfolio investment in developing countries were the predominantly US-based emerging markets mutual funds, which led the surge in investment in emerging market equities. Information on mutual funds' assets suggests that they were the dominant channels for portfolio flows to Asia and an important channel for Latin America (see Table 5). The combined assets of *all* closed and open-ended emerging market funds grew from $1.9 billion in 1986 to $131 billion at mid 1996; a high proportion of these funds were US based (World Bank, 1997). These trends have meant that emerging markets are accounting for a rising proportion of international investment by mutual funds. More than 30% of new international investment by US mutual funds went to emerging markets during 1990-1994 (World Bank, 1997).

US pension funds have followed, investing through mutual funds or directly on their own account. Even though they began investing more recently in emerging markets, according to the World Bank (1997), allocations of US pension funds to emerging markets are now comparable with those of mutual funds. Reportedly, US pension fund investments in emerging markets, including investments made on their behalf by mutual funds,

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Table 6 Industrialised Country Securities Investment Flows in Emerging Markets
(in billions of dollars and percentages)

	1987	1988	1989	1990	1991	1992	1993
Africa	-0.74	-0.21	-0.28	-0.34	-	3.52	-0.49
Asia	1.97	0.42	2.21	1.02	4.60	7.37	13.37
Europe	0.25	1.24	1.66	0.68	0.92	3.20	8.42
Middle East	0.37	4.56	1.10	0.68	0.92	0.64	2.48
Western Hemisphere	-1.23	0.42	-1.10	18.21	24.85	32.67	56.46
Mexico	-0.99	1.04	0.28	3.40	12.88	17.94	28.23
All Emerging Markets	0.62	6.33	3.59	20.25	31.29	47.40	80.24
Memorandum Items: Industrialised country foreign securities investment flows	123.40	207.50	276.40	170.10	306.80	320.30	495.30
Investment flows in emerging markets as a percentage of industrialised country foreign securities investment flows	**0.5**	**3.1**	**1.3**	**11.9**	**10.2**	**14.8**	**16.2**

Sources: International Finance Corporation, *Emerging Stock Markets Factbook*, various issues; and IMF, *International Capital Markets*, August 1995.

have been a significant factor in propping up investment in emerging markets during 1994 and 1995. This may indicate that flows originating in pension funds are less volatile than those originating in mutual funds. More information and data are required than are currently available on flows from mutual funds and pension funds to emerging markets and their interactions, particularly since these evolve so rapidly, and since systematic information is so scarce.

Additional evidence of the dramatic increase in foreign portfolio investment to developing countries in the 1990-1993 period is shown in the regional breakdown of all industrialised country securities investment flows to emerging markets in Table 6. There was a four-fold increase in total annual flows to all emerging markets in these years with a nine-fold increase in flows to Mexico. The rapidity of the shift in both the volume and channel of flows is indicated by the rise (from 0.5% in 1987 to 16.2% in 1993) in the share of total industrialised country foreign securities investment flows invested in emerging markets. A very rapid increase had occurred in 1990 when there was an $18 billion foreign securities investment inflow into emerging markets in the Western Hemisphere after net outflows from this region in previous years and despite an overall drop of $100 billion, or 62%, in total industrialised country foreign securities flows as the OECD countries moved into recession. Both the scale and abrupt-

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ness of the inflow into Latin America in 1990 announced the nature of the problems associated with this channel for capital flows to developing countries.

Surges of capital flows to developing countries pose two major sets of challenges to those countries' economic authorities. First, they pose important policy dilemmas for the macroeconomic management of large inflows, particularly to avoid surges leading to overvalued exchange rates and excessive expansion of the money supply (Ffrench-Davis and Griffith-Jones, 1995). Second, they pose the risk of sharp reversal, should conditions (economic or political) in the country and/or in the international economy change, as was illustrated dramatically by the Mexican peso crisis (Griffith-Jones, 1997). Preliminary empirical evidence indicates that there is a 'hierarchy of volatility', and that securitised flows may be more volatile than medium-term bank loans since – provided the markets are liquid – the stock of securitised flows can leave a country in a few hours, whereas in the case of medium-term bank loans, even in a very serious crisis like the 1982 debt crisis, the stock of the debt cannot leave the country. Speed of inflows (and especially outflows) is further facilitated by technological developments, like computers. Furthermore, the speed with which capital moves in and out of countries also seems related to the growing importance of global institutional investors described above, which would imply that flows to emerging markets are now mainly driven by liquidity and short-term performance considerations rather than the more long-term banking relationship of the past.

As a consequence of the increased speed with which capital moves in and out of countries, there is a growing asymmetry with other markets, e.g. goods markets or labour markets, which makes the adjustment process more difficult. Also, there is a growing asymmetry between speed of movements in capital flows, and the slower speed with which the political process can respond to such movements. The speed with which the assets of these institutional investors have grown, combined with the fact that this growth coincided with a period of liberalisation of financial markets, has implied that flows originating from those global institutional investors are almost completely unregulated in their source country, particularly with regard to market risks. We will return to this issue below.

II Effects of Capital Inflows on Developing Countries' Macroeconomic Policies

After the Mexican peso crisis in 1994, discussions focused on how developing countries should handle capital inflows. The Bank for International

Settlements (BIS) 1995 *Annual Report* stated that it is "... now widely agreed that prudence in liberalising capital inflows implies that short-term operations should not be free until the soundness of the domestic financial system is assured." As the IMF noted, most developing countries that experienced inflows had already taken measures to limit their impact because of concern about the effect of exchange rate appreciation on the competitiveness of their tradable goods sectors and because the volatility of capital flows increases the vulnerability of their financial systems (IMF, 1995).

The measures adopted by various countries to cope with surges of capital flows included sterilising intervention through open market operations or increases in reserve requirements, increasing exchange rate flexibility and discouraging certain types of capital inflows. BIS and IMF evaluations of their experiences concluded that sterilisation policies had proved to be short-lived and their effectiveness in mopping up liquidity tended to cause a rise in interest rates that preserved the incentive for capital inflows. A flexible exchange rate policy presented other problems. While it gave more control over monetary aggregates and exerted downward pressure on inflation, it resulted in real appreciation and a deteriorating current account position. It also led to surges in lending over which the central bank had no control if inflows entered directly through portfolio investment instead of being intermediated by the banking system. Thus, given the limitations of monetary policies in cushioning the impact of capital inflows, several emerging market countries (e.g. Chile, Colombia, Brazil, Indonesia, Malaysia, the Philippines and Thailand) imposed or retained measures to discourage certain types of capital flows during the first half of the 1990s (BIS, 1995; IMF, 1995; Ffrench-Davis and Griffith-Jones, 1995). It is interesting that the IMF (1995), the World Bank (1997), and the BIS (1995) now explicitly recognise that despite some limitations, measures taken by recipient governments to discourage short-term capital flows may play a positive role if they are part of a package of policy measures that lead to sound macroeconomic fundamentals. Therefore, it has become fairly widely accepted that regulation by recipient countries of excessive surges of capital can be a desirable policy.

However, no complementary action by source countries has been taken to regulate potentially volatile flows from them, even though such regulation would both protect their domestic investors (especially, but not only the less informed retail investors) and discourage excessive surges of potentially volatile capital flows to developing countries. The proposal developed below falls into mainstream, current regulatory thinking which sees risk-weighting as the key element in regulation

It is also in the mainstream of current theoretical thinking on capital markets. Stiglitz has highlighted how the existence of asymmetries of

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information gives rise to market imperfections, thereby casting doubt on the first fundamental theorem of welfare economics, i.e. that markets are efficient. Stiglitz has shown that when markets are incomplete and information is imperfect, the actions of individuals have externality-like effects on other individuals who fail to take these into account. As Mishkin (1996) shows, securities markets are particularly imperfect, largely because asymmetries of information are acute. This leads to profound adverse selection problems since low-quality firms will be more eager to issue securities. Furthermore, the possible market solution to this problem – the private production and sale of information – leads to the free-rider problem: since individuals who do not pay for the information can still use it, there is not enough private production and sale of information and adverse selection remains a problem. More importantly, the free-rider problem makes it less likely that securities markets will act to reduce incentives to commit moral hazard. Monitoring and other measures are needed to reduce moral hazard, to help lenders prevent borrowers from taking risks at their expense; because monitoring and other measures are costly, the free-rider problem discourages this kind of activity in securities markets.

A valuable insight deriving from the asymmetric information analysis is that because moral hazard and adverse selection problems are endemic to all market situations, the market failures are pervasive in the economy. Intervention by governments (e.g. through taxes or regulation) is potentially desirable in most sectors. However, the practical information needed by governments to implement corrective measures may not be available, or the cost of administering such measures may exceed the benefits where market distortion is small. Thus, Stiglitz' conclusion that governments should focus attention and efforts to those instances where large and important market failures occur seems very reasonable; it highlights imperfections of capital markets as a prime example. International capital markets are particularly prone to substantial market imperfections given the serious degree of asymmetric information.

Why would source countries need to regulate international capital market flows, and why is it not sufficient for recipient countries to do so, particularly since these flows are a larger proportion of the latter's economies? There are two specific reasons why source countries should take measures to discourage potentially unsustainable short-term capital flows coming from them. First, even recipient countries – like Chile and Colombia – which have deployed a battery of measures to discourage or limit short-term capital inflows have, on occasion, found these measures insufficient to stem massive inflows with problematic effects on variables such as exchange rates. Second, some important recipient countries do not discourage short-term capital inflows or do so insufficiently. Particularly if com-

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bined with inconsistent macroeconomic policies, this may lead to a crisis. This is not only costly for the recipient country and its people (especially the poorer sectors of the population), but it may also result in the source country government acting as a lender of last resort in order to protect its own investors and also to avoid a damaging crisis in the recipient country which could spread to other emerging markets. This was illustrated by the scale of the massive financial package put together by the international financial community during the Mexican peso crisis. To make it less likely that such a lender of last resort facility will be used again and reduce 'moral hazard' on the part of institutional investors, i.e. discourage excessively risky investment in the expectation that there will be a bail-out if things go wrong, source countries will need to impose some additional regulatory and/or disclosure restrictions on institutional investors. Furthermore, given the important shift in the channel for savings toward institutional investors and the growing diversification of these investors into emerging markets, there is also a case for new regulatory strategies in source countries to protect retail investors who put their savings in mutual funds and who are beneficiaries of pension funds.

III Proposals to Increase Market Stability of Portfolio Flows to Developing Countries

In the past it was thought that regulatory strategies for banks were very different from those appropriate for securities markets. In the United States, for example, requirements for disclosure of material information and the prevention of fraud were considered essential and sufficient to protect the public, promote public confidence in securities markets and thereby enhance market stability. Similar criteria exist in the other developed economies. While requirements for diversification are applicable to mutual funds, liquidity requirements such as levels of cash reserves or the requirement for insurance coverage to promote confidence are not. Nor is enough consideration given to the impact of national macroeconomic developments (known by securities regulators as 'market risk' and including variables such as exchange rates and interest rates) on securities markets. The effect of 'market risks', i.e. of national macroeconomic developments and international factors such as US interest rates, are particularly crucial for determining the evolution of securities markets in developing countries.

Now, however, views on the appropriateness of certain soundness strategies for mutual funds are changing, and the importance of 'market risks' for institutional investors is increasingly stressed by securities regulators. Even so, institutional investors and regulators continue to evaluate market

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risks poorly in emerging markets. This is mainly because substantial investments in emerging markets are relatively recent and asymmetries of information are large. Nevertheless, since institutional investors have assumed a dominant role in financial markets, and as the distinctions between banks and mutual funds become less clear, strategies promoting public confidence in banks are beginning to be adapted to the needs of mutual funds.

Strategies to Provide Liquidity

The most important of these adaptations is contained in legislation enacted in the US in 1991 (12 CFR, 201.3 (d)). This legislation permits any individual, partnership or corporation to borrow from Federal Reserve Banks using US government securities as collateral if the failure to lend would adversely affect the economy. It also permits loans against collateral other than US government securities with the affirmative vote of five of the seven members of the Federal Reserve Board of Governors. In short, the 1991 Act not only gives securities markets explicit access to the lender of last resort, it also expands the types of collateral against which the Federal Reserve can lend in an emergency to include corporate stocks and bonds – securities in which banks cannot invest depositors' funds under current US law.

The enactment of this measure resulted largely from the 1987 and 1989 market declines, and it reflects concerns about the potential damage such declines may have on the US economy. Certainly, as former Federal Reserve Board Chairman Marriner Eccles noted in the 1930s, there is no source of liquidity in an emergency "... except that liquidity which can be created by the Federal Reserve or the central bank through its power of issue ..." (US Congress, 1935: 194). Nevertheless, central banks have historically – and rightly – used their emergency powers sparingly, and the 5-member approval requirement suggests that interventions to halt a market disruption would be weighed carefully and occur infrequently.

The market itself is concerned about assuring that sources of liquidity for mutual funds are available under volatile conditions that may not be viewed as damaging to the US economy; that is, circumstances which would not activate Federal Reserve Bank resources. As part of its highly successful strategy to compete with banks for US (and, increasingly, foreign) savings, US mutual funds have marketed their shares as virtually payable on demand. Next day settlement of redemptions is now standard practice even though mutual funds are only required to redeem shares within a 7-day period or, if a broker or dealer is involved in the transaction, within a 3-day period. The problem for the industry is that if a fund must sell securities, the current 3-day settlement requirement results in a 2-day gap between outflows for redemptions and the receipt of funds from sales. Similar concerns about redemption and settlement risks are being expressed in the UK and in international organisations. Particularly in the US, the industry has become increasingly concerned about establishing back-up sources of liquidity such as interfund lending using repurchase agreements within a family of funds, the creation of money market 'fund of funds' within a family of funds and committed lines of credit from banks. As explained by one large family of funds, "With the increased specialisation and internationalisation of mutual fund portfolios, the industry is appropriately giving greater attention to alternative methods for funding redemptions during periods of market volatility" (SEC, March 1995). The US Securities and Exchange Commission (SEC) has also indicated greater concern about liquidity in this context. It now "... urges money funds to monitor carefully their liquidity needs in light of the shorter settlement period ...", and consider the percentage of the portfolio that will settle in three days or less, the level of cash reserves and the availability of lines of credit or interfund lending facilities (SEC, March 1996).

Certainly the time gap between redemptions and settlement of securities sold has highlighted the importance of liquidity and focused investor interest on the level of cash reserves of individual funds or types of funds (McGough, 1997). But the concern is heightened by the potential for increased redemptions during a market decline. One securities firm found that 40% of mutual fund shareholders surveyed said they would sell some or all shares in equity funds if the market fell 15% or more (Kinsella, 1996). Others believe that shareholders would simply move to other types of funds and then back into stocks as the market stabilised. Even so, the disparity between the timing of redemptions and settlement would create a scramble for funds that might exacerbate price declines.

These developments and the discussions involving US mutual funds indicate that alternative sources of liquidity for securities investment funds is a priority issue – even when a fund's portfolio is invested in domestic assets. The problem becomes greater when cross-border holdings are involved, particularly holdings in emerging market countries. Market volatility and/or disruptions will certainly continue to prompt abrupt shifts in foreign portfolio investment in emerging markets (as occurred in the Mexican peso crisis and, more recently, in the Asian currency crises), resulting in adverse effects on their economies. Thus, arrangements for managing the liquidity needs of US mutual funds could have significant benefits for developing economies in that they could discourage excessive, too rapid outflows. Such arrangements could also serve as a model for similar strategies in other developed countries.

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The US experience to date suggests two potential solutions to the liquidity problem. One solution, purely market based, would be to use the 'fund of funds' created by the enormous Fidelity family of funds – $416 billion in assets mid-1996 (Gasparino and Jereski, 1996) – as a model for the industry as a whole (SEC, August 1996). This would allow all mutual funds to buy shares in an 'umbrella' or 'top' fund whose shares would not be sold to the public. The 'fund of funds' would invest in highly liquid money market instruments which would be sold to redeem the shares of mutual funds seeking liquidity to fund redemptions by public shareholders. In addition, the 'fund of funds' would be authorised to invest for short periods in the shares of funds that had exhausted their redemptions, up to a given amount (proportional to the size of their portfolios) if other means for funding redemptions were unavailable.

One problem with using the Fidelity model is that market declines and disruptions may affect all participating institutions at the same time. Moreover, its contribution to maintaining public confidence in markets may be limited; unlike deposit insurance for banks, this type of liquidity facility will not guarantee that shares can be redeemed without losses. Nevertheless, if it were seen as contributing to public confidence in a market recovery, it could reduce shareholder redemptions and thus cushion the downward spiral of price declines that make a market recovery and the restoration of confidence more difficult.

The issue of confidence is becoming more important given the growing share of national savings held by mutual funds in the United States – 10% of total credit market assets held by financial sectors at year-end 1994, up from 8.4% in 1991 (Federal Reserve System, *Flow of Funds*, various years) – and the increasingly large shares held by comparable institutions in other OECD countries. The potential loss of value of such a large share of the US public's savings in a market disruption would certainly have serious consequences for the economy that would precipitate some form of intervention by the Federal Reserve Board. If that were to happen, a facility like the 'fund of funds' would give the central bank more time to assess the situation, making it less likely to miss the point at which prompt action might halt the downward spiral of share redemptions and securities sales and moderate the price decline. However useful, it would therefore seem that this first solution is insufficient to cope with the scale of the problem, particularly as it affects emerging markets.

Proposal of a Prudential Capital Charge

The Federal Reserve's authorisation under the 1991 Act suggests a second solution: to require that some portion of mutual funds' cash reserves be placed in the form of interest-bearing deposits in commercial banks as a prudential capital charge. Such deposits would constitute a first line of defence for access liquidity in the event of a significant market decline. They would also reduce market volatility associated with the timing of settlement, particularly in situations of large redemptions.

The use of the term 'capital charge' in discussions of liquidity facilities for mutual funds refers to their particular structure as intermediaries for direct investment. Because shareholder capital backs 100% of the invested assets, the normal capital or provisioning requirements applicable to banks are not directly applicable to mutual funds. Nevertheless, the need for defined sources of liquidity for mutual funds has become more apparent as their role in financial markets has expanded and concern about the ability of shareholder withdrawals to precipitate serious market disruptions or declines has increased.

The imposition of capital charges on mutual funds, in the form of required, segregated cash reserves deposited in commercial banks to ensure defined sources of liquidity, may also contribute to removing distortions in the financial industry by reducing the cost advantage currently enjoyed by mutual funds in competing with banks to attract savings. Making the capital charge comparable to the capital adequacy requirements that apply to banks in OECD member countries would tend to lower earnings for some mutual funds that do not maintain adequate levels of cash reserves since interest bearing deposits may earn less than other financial assets in which funds invest. At the same time, the introduction of an industry-wide standard would tend to increase investor confidence and attract a larger volume of funding over time. Also, it would provide a structure that would make the current key element in regulation – risk weighting – applicable to mutual funds. Furthermore, and most important, it would reduce volatility and risks of reversibility of institutional investors' flows to developing countries. Increased stability in flows would be beneficial to developing countries and increase the likelihood that those countries remain open to such flows. Smoother flows would also reduce the chances of foreign exchange crises, thus giving greater protection to investors. The somewhat lower returns would be more than compensated by smaller volatility of returns.

Similarly for emerging market economies, the requirement of cash reserves on mutual funds assets invested in them could increase their costs of raising foreign capital, but this would be compensated by the benefit of a more stable supply of funds at a more stable cost. Indeed, often during and after currency crises, the cost of external funds for emerging markets can become very high or even infinite (implying that the country may, for a time, be totally unable to raise any funds on the markets).

Introducing a risk-weighted capital charge for mutual funds would require that these (and perhaps other) institutional investors perform risk analysis under standards provided by regulatory authorities which, in the United States, would result from consultations among officials of the Federal Reserve Board, the Securities and Exchange Commission and the Treasury. In the case of cross-border investments, weights should be given to the views of market analysts such as credit rating agencies as well as the views of international agencies such as the IMF and BIS in assessing countries' macroeconomic performance. This would provide guidelines for defining macroeconomic risk and for its measurement in determining the appropriate level of cash reserves. Thus, cash reserves would vary according to the macroeconomic risks of different countries.

The guidelines for risk analysis by institutional investors themselves should take into account such variables as the ratio of a country's current account deficit (or surplus) to GDP, the level of its external debt to GDP, the maturity structure of that debt, the fragility of the banking system, as well as other relevant country risk factors. Factors such as custody-related risks (which already greatly concern securities regulators) could be included where relevant. It is important to use sophisticated analysis in order to avoid the unnecessary and arbitrary stigmatising of countries. The views of the Federal Reserve, the Treasury and of the IMF and the BIS should be helpful in this respect, especially given their substantial experience with foreign exchange crises and their causes.

The fact that the level of required cash reserves capital charge would vary with the level of countries' perceived 'macroeconomic risk' would make it relatively more profitable to invest more in countries with good fundamentals and relatively less profitable to invest in countries with problematic macro-fundamentals. If macroeconomic fundamentals in a particular country were to deteriorate, investment in that country would decline gradually, and this would – hopefully – force an early correction of macroeconomic policy. Once this happened, flows would resume. The smoothing of flows would hopefully discourage massive and sudden reversals of flows as occurred in the Mexican peso crisis and, more recently, in the Asian currency crises.

Given the dominant role and rapid growth of institutional investors in the US and UK market, both of these proposals – a liquidity facility structured as a 'fund of funds' and the imposition of risk-weighted cash requirements capital charges on mutual funds – could be adopted first in these two countries without creating significant competitive disadvantages. However, given the growth of these sectors in other industrial countries, efforts to harmonise such measures internationally need to be given priority for discussion at the global level by the International Organization of Securities Commissions (IOSCO).

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Finally, it is important to stress that additional regulation of mutual funds should be symmetrical with regulation of other institutions (e.g. banks) and other potentially volatile flows, e.g. excessive short-term bank credit (see Witteveen's paper in this volume). I emphasise mutual funds because these funds are clearly under-regulated in comparison with other financial institutions. Because the growth of mutual funds is so recent, particularly in relation to their increased investment in emerging markets, additional regulation is needed.

The Need for Better Disclosure

A third strategy to diminish market volatility and systemic risk of mutual funds as well as enhance protection of investors is improved disclosure. The case for transparency is particularly strong for institutions like mutual funds since investors in those institutions are not protected by mechanisms like deposit insurance. While there is a great deal of support for improved disclosure, progress in most countries has been slow and insufficient.

Based on the need to assist investors in mutual funds in making an informed investment decision, the US Securities Exchange Commission presented a comprehensive proposal to improve the description of risks in April 1995 (SEC, 1995). The SEC requested comments and suggestions both from the industry and the investors.

Before 1995, mutual funds were already required to discuss the main risk factors associated with investing in the fund in their prospectuses. One of the SEC's concerns was that lengthy and highly technical descriptions of policies and investments may make it difficult for investors to understand the total risk level of a fund. Also, according to the SEC, "funds provide only the most general information on the risk level of the fund as a whole". Therefore the SEC proposed to improve disclosure requirements to improve the communication of fund risks to investors. The SEC stresses that risk factors include those that are peculiar to the fund as well as those that apply generally to funds with similar investment policies.

The SEC justifies need for better disclosure on three grounds. First, average Americans place growing reliance on funds to meet key financial needs, such as retirement and college expenses. Understanding the risks of their investment in mutual funds is therefore crucial for them. In 1994, 31% of US households owned shares in a mutual fund, up from 6% of households in 1980 (Investment Company Institute survey); in the mid-1990s these ratios have increased even further. Second, new ways of describing risks may improve investor understanding of risks associated with increasingly complex instruments. Third, information needs have grown due to the proliferation of numbers and type of funds. Furthermore, the rapid international diversification of assets also poses new disclosure needs, even though the SEC did not make this point explicitly.

In its initial document, the SEC requested comments on:

1. goals of risk disclosure, e.g. risk of loss of capital versus risk of variability of returns as dominant concerns;
2. narrative and non-narrative (such as quantitative measures) graphs and risk disclosure options;
3. quantitative measures of risk, including measures of total risk, market risk and risk-adjusted measures of performance; and
4. the relative merits and limitations of three different quantitative risk measures: historical, portfolio-based and risk objectives or targets.

In the context of our analysis, it is interesting that the SEC (1995) document recognises that requiring disclosure of a quantitative risk measure may affect portfolio management, e.g. by causing fund managers to adopt more conservative investment strategies. In the context of flows to developing countries, this could have mainly positive effects as better informed investors would be less likely to rush in and – especially – out of developing countries. Thus, the objective of increasing the stability of flows would more likely be met even though there may be a cost in somewhat lower flows.

As a result of these consultations (which led to 3,700 comment letters) and its analysis, the SEC has recommended shorter, more readable "profile prospectuses". Indeed, investors will be given the option of receiving those documents instead of the longer, more detailed forms they have received until now. Also, the SEC is likely to recommend that new profile prospectuses compare the fund's returns with general market indexes and that the full prospectus sent to investors is more readable.

However, the SEC has not included certain items of disclosure that many investors and commentators seek, but that the fund industry opposes, such as the requirement that funds list their ten largest holdings and a discussion by the management of what affected fund performance the previous year. More broadly, there is criticism that the SEC disclosure requirements are not specific enough since the fund can decide what information is relevant to its risk profile. In a second stage, the SEC may press for more information if it thinks certain kinds of material information were not disclosed, but this process of additional information is on a one-to-one basis (not systemic) and it applies only to funds that the SEC believes failed to fully disclose. The fact that the SEC has lost three important cases in court, on the grounds that they exceeded their authority under the securities act, may make it difficult for the SEC to push for more specific system-wide disclosures.

To conclude, better disclosure can play an important role not just in

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investor protection, but also in smoothing investment flows. Efforts like the recent one by the SEC are very valuable. In some cases, appropriate disclosure requirements may be difficult to impose by regulators due to pressures from the industry, however, even in an ideal world with no pressures from the industry on regulators, it is very difficult to design an optimum disclosure package given the conceptual complexities involved and especially given the problem of asymmetric information (Mishkin, 1996). Insufficient attention seems to be placed on specific disclosure requirements referring to specific risks originating from investments in emerging markets. In particular, the question that has not even started to be asked is to what extent are market risks (that is risks attributable to general economic conditions) different for emerging markets and for developed markets.

IV Conclusions

We can conclude that better disclosure of risk is valuable but insufficient. It needs to be complemented by other measures to achieve better investor protection as well as less volatility of flows – which is particularly damaging for developing countries. Two possible, complementary measures have been discussed: market-based improvements of liquidity, and risk-weighted capital charge cash requirements. Naturally other proposals or variations of the present proposals could be considered, but what is clearly important is that meaningful measures should be taken to help stabilise capital flows to emerging markets. Given the evolution of the markets, it is also important to stress that past strategies, such as prohibiting investment in certain markets, are no longer appropriate. Such prescriptive rules could have some potentially negative effects on both investors (who could lose some profitable opportunities) and some emerging market economies since their access to portfolio flows could be curtailed either in general, or abruptly in times of macroeconomic difficulties. The measures suggested here would seem better suited to the new circumstances since more gradual changes in cash requirements would contribute to a greater smoothness of the level of flows. Such smoothness is the desired objective for the developing economy, and it would also give greater protection to developed country investors. Furthermore, risk-weighted capital charge cash requirements for institutional investors is consistent with modern mainstream regulatory thinking which views risk weighting as the key element in regulation.

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A Multilateral Agreement on Investment: Convincing the Sceptics

Zdeněk Drábek[1]

I Introduction

We have recently witnessed an explosion of interest in a multilateral investment agreement in the press and in the academic and policy circles. The interest mainly originates in the spread of regionalism and in controversies about the merits of globalisation in general and the role of foreign investment and multinational enterprises in particular. Moreover, the recent currency turmoils and the widespread concerns about the volatility of international capital flows have provided an additional impetus to the debate on the desirability of a multilateral agreement on foreign investment.[2] Finally, and perhaps more importantly, the topic has been highly debated in recent months in the aftermath of the Uruguay Round. Reviewing the existing agenda of the World Trade Organization and preparing its future agenda at the recently held Ministerial Conference of the WTO in Singapore, many member countries were pressing for the inclusion of a Multilateral Agreement on Investment (MAI) on the agenda of the WTO. At the end, the topic was not included, and the countries have basically only agreed to further explore on the analytical level the issues related to trade and investment.[3] For the time being, the question of whether and when an MAI will be negotiated remains uncertain.

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2 The recent meeting of 15 developing countries in India leading to a joint G-15 declaration as well as the public support of President Chirac to some of these countries' positions serve as a testimony to the general nervousness in the community of world leaders. President Chirac's statement was made at the press conference in Langkami, Malaysia on 17 November 1997 during his state visit.

3 The issues and the controversies have been amply reviewed in a number of studies including, for example, WTO (1996), UNCTAD (1996) and Graham (1996).

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These controversies clearly demonstrate that there has not been enough agreement about the need for an MAI, even though the pendulum is swinging more towards the 'multilateralists'. While the need for foreign direct investment (FDI) is generally recognised – even among the sceptics – the push for an international agreement has been rather lukewarm in some countries. This lack of enthusiasm or sometimes even an outright hostility could be a serious problem for the international trading system and for capital markets. *First*, the question of MAI divides the WTO member countries into those who support the idea of an agreement and those who are against it. In other words, this is a divisive issue which could also hamper progress in other areas of WTO jurisdiction. *Second*, the division has gone along the lines of important country groupings – developed versus some less developed countries (LDCs). This, too, is a serious business because of the interest of developed countries in having LDCs integrated into the multilateral trading system. *Third*, FDI has been growing dramatically over the last decade or so, resulting in a rapid pace of globalisation, and a significant contribution of foreign capital to investment in many countries of the world. Unfortunately, the growth of FDI has been uneven, with some LDCs benefiting more than others, leading many people in academia and policy circles to fear that the latter countries, or at least some of them, will be 'marginalised'. *Fourth*, there does not seem to be an agreement on the need for an MAI among international public institutions that give advice on trade and investment policies to countries. For example, the recent *World Investment Report* of UNCTAD (1996a) concludes that the present system "is working well, and we could go both ways to regulate FDI – through regional and bilateral approaches or a multilateral approach". In contrast, the WTO (1996) is quite clear about its position when it argues that, "based on the available evidence, the case for a multilateral agreement on investment is strong". More or less the same position is taken by OECD member countries which have been negotiating their own plurilateral investment agreement. Notwithstanding the recent difficulties in resolving the remaining negotiating hurdles and the relatively limited country coverage, the OECD member countries have been sympathetic to the idea of a worldwide agreement, and hope that other countries will sign-up on the agreement.[4]

The crucial question of whether an MAI is desirable, therefore, still lingers over the heads of trade ministers and other politicians. But even if one believes that there is an unambiguous need for an MAI, the question

4 In the meantime, the negotiations among OECD countries have run into difficulties, and their outcome still remains uncertain. This paper is written on the assumption that some sort of an agreement will ultimately be reached.

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remains what kind of agreement should be proposed. 'Too much' regulation can be costly, while 'too little' regulation may be imprudent. Additional questions are: Who should be responsible for the conduct and the implementation of such an MAI? Should countries seek an agreement on a relatively smaller scale such as, for example, the ongoing negotiations of the OECD, or should they aim for 'higher' goals and involve all countries that are members of, say, the WTO or some other bodies?

The purpose of this paper is to respond to at least some of these questions. The principal question is whether there is indeed a need for a multilateral agreement on investment. As we shall see, there are arguments in favour and against but, on balance, I argue that the positive side of an MAI is considerably more powerful than the negative effects. Since much has already been written about the merits of MAI, I shall only summarise the main arguments. What is novel in this paper is the attempt to address the concerns of the sceptics. Given the lukewarm reaction in some countries, it seems sensible to pay more attention to those arguments that have been critical or outright negative about an MAI. This paper will not address other important questions such as what should be the content of an MAI and who should be responsible for its negotiations and implementation.[5]

Another qualification is in order. The discussions about the merits or flaws of MAI are often clouded by misunderstandings. A first one is the fear that an MAI will not guarantee an increase in FDI for a signatory (Third World) country. This is clearly true since the argument in favour of MAI simply states that MAI is a necessary but not a sufficient condition. Proponents of MAI only argue that MAI will increase the transparency of government commitments and, hopefully, improve conditions for access of FDI. Obviously, MAI does not provide a guarantee of increased FDI. As an English saying would have it, "you can lead a horse to water, but you cannot make it drink". A second misunderstanding about MAI is the concern that the effects of FDI on economic development are not fully known. During the last WTO Ministerial Meeting in Singapore, some members argued that these effects should first be studied before governments engage in negotiations. Once again, this is more an empirical question rather than a question of substance. A third misunderstanding is that the push for a multilateral agreement is inconsistent with the recent trend towards liberalisation in all parts of the world. However, a multilateral agreement should not be interpreted as a regulatory agreement even though it would have elements of regulatory provisions. The merit of MAI would be that it increases the credibility of government commitments. As Graham recently

5 Some of these questions have been covered in a number of articles such as in Graham (1996).

put it, "policy reforms in nations, even in one where there is a groundswell moving in the direction of liberalisation, are likely to be more profound and enduring if these reforms are backed by international standards ...". Moreover, "the international standards would help, or prevent any future 'backsliding'" (1996b, p. 6).

The paper is divided into four sections. Section II summarises the main arguments in favour of MAI. Section III, which is the main part of the paper, discusses the arguments against an MAI. Section IV addresses the issues raised by the critics from a somewhat different angle by trying to evaluate the relevance of the specific arguments. Section V offers some policy recommendations.

II Arguments in Favour of MAI

There are powerful arguments in favour of MAI. Many of these have been recently discussed and documented in a WTO report (1996) which also contains a useful review of the main arguments. They are as follows.

Growing Importance of FDI. The reality of the post-war economic developments has been the growing importance of FDI in many countries of the world and in international economic relations. This trend has accelerated in the last decade. During 1986-1989, and again in 1995, outflows of FDI grew much more rapidly than world trade. Over the period 1973-1995, the estimated value of annual outflows multiplied more than twelve times (from \$25 billion to \$315 billion) while the value of merchandise exports multiplied more than eight and half times (from \$575 billion to \$4900 billion). Sales of foreign affiliates of multinational corporations are estimated to exceed the value of world trade (\$6100 billion in 1995). In many countries, FDI has already 'taken over' as the most important component of external financial flows, exceeding even official assistance.

The growth of FDI has its origin in powerful forces of capital movements which go hand in hand or may even replace trade flows. It is generally thought that these forces work very strongly both on the supply-side (home country) and demand-side (host country). In home countries, these forces include the benefits from increased market access and improved competitiveness due to a better access to cheaper inputs or to strengthening of the company's capital base as result of strategic alliances with foreign partners. For the host countries, the benefits of FDI include an improved access to technology, marketing channels, organisational and managerial skills, and the contribution to domestic savings and investment.

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A number of studies such as WTO (1996) and the research carried out by the Centre d'Etudes Prospectives et d'Informations Internationales in Paris clearly show that there is a strong element of complementarity between trade and FDI, both in the home and host countries. In other words, trade tends to encourage FDI, and FDI tends to encourage trade. The contribution to domestic resource allocation and investment can also be very positive. For example, in Czech Republic the share of total capital flows in GDP represented 17 percent in 1995 and, in the case of domestic savings, the share was even an astonishing 84 percent![6] The corresponding numbers in Hungary and other countries are equally impressive.[7]

The dramatic growth of FDI also has several downsides. One of these is the rising investment risk to investors as they expand their foreign portfolios of FDI. As a result, the costs of risk cover of FDI increases which, in turn, will tend to increase the costs to host countries. At the same time, as the country exposure to FDI increases, the host countries will become subject to increased risk of capital flight and vulnerability.

Transparency, Predictability and Legal Security. Foreign investors need transparent and predictable rules on which they can operate, and these rules must include legal security. Otherwise, they would require a corresponding financial return as compensation for these additional risks. In many circumstances, such risk and the corresponding rewards would be prohibitive for the host countries. A powerful argument for an MAI is, therefore, that it will provide the needed transparency, predictability and legal security. The opposite – the lack of transparency, predictability and legal security – is precisely what is often the origin of difficulties for countries to attract FDI and other types of foreign capital. Unclear, ambiguous, biased and controversial rules are the classical deterrent to foreign investors. Unwritten conventions or traditions do not have the same value as agreements signed by governments.

National Legislation Is No Alternative. Many developed and developing countries have been undergoing a rapid and profound process of policy liberalisation. The process has affected fiscal, monetary, financial, infrastructural, trade and other policies (Drábek and Laird, 1997). The process has made both outward and inward FDI more attractive but the legal provisions underlying this process are not sufficient. In fact, the absence of an international agreement can have serious consequences for

6 Some of these questions have been covered in a number of articles such as in Graham (1996).

7 See, for example, Drabek (1997).

FDI flows. First, foreign investors need a legal protection to do business. Without such a protection, the risk of doing business in a foreign country may be so excessive that they decide not to invest. Moreover, the cost of compliance may be too high, resulting in investment that would typically be highly speculative and short term. Second, national legislation is often not sufficient to provide adequate security to foreign investors. National laws and their enforcement may differ between the host and home country requiring, in the very least, an international mechanism for dispute settlement. What is typically needed is an international agreement which must be reached by governments in order to have moral authority. These agreements should be supported by national legislation in order to be enforceable. Third, given the risks of doing business in foreign countries, investors will, *ceteris paribus*, choose those countries in which the legal protection of their investment is most secure.

The need for an intergovernmental agreement can be clearly seen in the example of the financial sector. The deregulation of financial markets together with technological progress has led to an explosion of cross-border financial services. This, in turn, generated the need for international agreements among different participants in the market. Two types of agreements have emerged over time; agreements signed by private sector agents and agreements signed by governments. There are merits to both types of agreements. However, the agreements signed by the public sector have been the ones that encouraged the growth of cross-border competition.[8]

Policy Coherence. There has been a dramatic proliferation of various international agreements in the past. Many of these agreements have been signed bilaterally, others are regional (such as NAFTA and Mercosur) or plurilateral. By June 1996, the total number of bilateral investment treaties was nearly 1160, of which two thirds were signed during the 1990s (WTO, 1996 and UNCTAD, 1996). In brief, we are already facing what Jagdish Bhagwati has termed a 'spaghetti bowl' of bilateral, sub-regional and regional agreements which is associated with a number of serious systemic dangers. The existence of all these agreements and the initiative of a limited number of countries to negotiate an MAI are highly problematic. Different agreements often have different coverage of issues and may even apply different rules. Separate negotiating initiatives increase the risk of inconsistent rules established in different agreements. As WTO (1996) has pointed out, the current members of the WTO would have to sign 7503 agreements if they wished to provide the investment protection through bilateral treaties. With such a large number of treaties, inconsistencies are

8 See, for example, Drabek (1997).

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virtually inevitable. All of this tends to lead to confusions, uncertainties and legal conflicts. Moreover, the presence of different agreements also increases the costs of doing business, something that is often overlooked by the proponents of bilateral and regional approaches. This, too, is an impediment to FDI. In sum, the need for rule and policy coherence is now well recognised among all major analysts who have been involved in the discussion.[9]

Marginalisation of Non-Signatories. One serious problem of regional or bilateral agreements is the marginalisation of those countries that are not signatories of these agreements and remain outside the MAI or the existing plurilateral or regional investment agreements. It is evident that foreign investors will always prefer to do business with those countries in which they have a legal protection through an international agreement. Clearly, a major disadvantage of the current OECD-sponsored initiative to negotiate an MAI is the fact that the agreement is negotiated by OECD countries. Countries that are not OECD members remain outside of the negotiation process even though it is assumed that any country will be invited to sign on the actual agreement once it is concluded.

Thus, there are two main advantages of a truly multilateral MAI. First, it is a 'complete' instrument while regional, bilateral and plurilateral agreements are not. Second, a non-MAI would have to be a stand-alone agreement which would still have to be integrated into international law.

Competition for FDI. It is sometimes argued that governments should adopt policies of fiscal incentives to encourage FDI. In practice, the policies have indeed been adopted quite frequently. However, while there may be a theoretical argument in favour of such incentives under rather extreme conditions, the general position of most economists is that incentive schemes are distortionary, inefficient and also costly. Moreover, a system of fiscal incentives may not even be effective to achieve the desired objective of attracting FDI because other countries that provide more generous fiscal incentives may divert FDI away from those countries that provide less generous incentives. Last but not least, competition for FDI is intense as more and more countries are hoping for a greater share of FDI inflows. Richer countries can provide more attractive incentives leading to further marginalisation of poorer countries.

In order to reduce the likelihood of further marginalisation of poorer

9 The need is recognised even by those who may not necessarily favour an MAI but may prefer to rely on a set of regional, bilateral and plurilateral agreements such as UNCTAD (1996: 161).

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countries and the waste of resources needed to finance these incentives, the recourse to fiscal incentives as a stimulus to attract FDI must be eliminated. The problem is, however, how to convince countries to stop using incentives even if they know that these policies are wrong. In the presence of competition from other countries using fiscal incentives, it is very unlikely that any single country will be willing to abandon the practice of fiscal incentives unilaterally. The country will be prepared to do so only if other countries are prepared to give up their policies of fiscal incentives as well. Such a concerted action would clearly require an international agreement.

III The Opposition to MAI

The arguments against an MAI are relatively less powerful but have so far been effective enough to block all serious attempts for multilateral negotiations of FDI rules. The arguments are less powerful because they have been supported by fewer countries, and because their intellectual merit tends to be weaker. In addition, the arguments are often not directed at MAI but rather at FDI and 'globalisation' in general. We shall, therefore, make the corresponding distinction in our treatment of the criticism in the following presentation. We shall start with the criticism that, in my view, does not stand on firm foundations and can be remedied through negotiations of an MAI (Section A). The separate question of 'globalisation and its effects' is the subject of Section B. Finally, sensible criticism of MAI is discussed in Section C.

A. Responding to Concerns of Critics of MAI

The criticism of MAI can be divided into the following categories.

Security Considerations. Security considerations are arguably the one legitimate reason that can give governments a certain degree of discretion over decisions concerning foreign investments. Most writers, including economists, would probably agree that investment decisions concerning, for example, defence industries or police would justify governments giving preferences to domestic suppliers and investors over foreign ones. The problem that is often encountered in practice, however, is that the definition of what constitutes a security interest for a country is ambiguous and, as a result, countries have defined their security interests differently. For some this may mean a protection of special interest groups. Thus, for example, speaking on the eve of a Confederation of British Industries Conference on Zimbabwe, President Mugabe insisted that his

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"government will play a leading role in the choice of foreign partners". He went on to say that privatisation and foreign investment will be used to give the country's black majority a greater share of the white-dominated economy.[10] For others, it may mean a greater concern with equity which is what the Indian Prime Minister Deve Gowda had in mind when he argued that India wants "growth with equity".[11] Doing business with Cuban companies that had been established from American assets nationalised by Fidel Castro's government has also been seen by many American politicians and commentators as contrary to the American 'security interests'. For others still, the security interest may call for a protection of certain industries or companies, often identified as the 'national jewels'.

Negotiations of MAI are, therefore, unlikely to succeed unless countries have a clear understanding of what constitutes a national interest, and this understanding does not fundamentally deviate among countries. At present, this is not the case as we have already noted in the case of the Helms-Burton Act and the Cuba issue. Similar concerns have also been raised in the case of the recently proposed merger between Boeing and McDonnell Douglas. In reviewing the merger proposal, the EU competition body has been approaching the application for approval on the basis of 'users' impact. The competition authorities assess the merits of the case on the grounds of its effects in user countries rather than its effects on domestic competition.

Security interests are often also associated with the loss of sovereignty. The fear of 'losing control' due to globalisation, of losing the right to tax the residents on their territories and of foregoing the right to promote economic activities that are a national priority, are all examples that fall into this category. Clearly, no country has ever succeeded in hermetically closing its market to the power of technology and information, and it is unlikely that it will succeed in doing so against the forces of competition. No advocate of MAI has also ever proposed that countries will not be able to tax their own citizens. The countries may need to increasingly harmonise their tax regimes but they will do so to protect *their own interest*.[12] The promotion of certain economic activities is more controversial. Generally, this form of discrimination is not acceptable even on the grounds of 'infant industry', but certain exceptions can be envisaged. For example, measures to promote a regional balance, the unimpeded access to information or even environmental standards have long been an acceptable area of the so-

10 "Role of state vital, says Mugabe"; *Financial Times*, 5 March 1997, p. 7.

11 "India talks the talk", In: *Wall Street Journal*, 10 March 1997.

12 See, for example, the need for coordination policies of fiscal incentives to promote FDI in the previous section.

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called 'green light measures' in most bilateral and international agreements, and they should also be acceptable in a future MAI.[13]

Other Political Arguments. Closely related to the 'security interests' are other political objectives of governments. These may include a variety of interests such as (a) national priorities[14], (b) 'social engineering' which identifies an attempt to restructure the countries' political and other institutions in accordance with the demographic characteristics of the society concerned;[15]and (c) 'economic power' argument. This argument states that indigenous firms in developing countries will be destroyed and will not be able to compete with economically powerful transnational corporations. This argument is, for example, implied in the recommendation of UNCTAD (1996) when it suggests that "liberalisation of FDI would be too soon at present time since many LDCs have not yet adjusted to liberalisation measures adopted in the Uruguay Round". Finally, (d) some politicians have called for measures to protect countries from foreign investors on the grounds protecting 'culture' which could be destroyed through globalisation of investment. All of these arguments are identical or similar to those already discussed above and must be addressed through political discussions. There is very little that an economic theory can contribute. Perhaps the only exception concerns the 'economic power' argument which has a strong reflection in the 'new trade' theories.

Corporate Practices. Another critical argument concerns what I call 'corporate malpractices' for the lack of a better word. What I am referring to are practices of MNCs such as 'transfer pricing' which are often used as an example of the power of MNCs depriving host country governments of fiscal resources and leading to persistent dependence of these countries on MNCs. Similar criticism has been made by corporate critics when they argue that MNCs are taking advantage of globalisation to get around environmental and operating rules such as rules on labour conditions. In doing so, one needs to add, MNCs do not necessarily violate any law or rule in either in the home or the host country. However, the critics see these practices as unethical and highly detrimental to the development of

13 The legitimacy of certain types of subsidies, typically associated with policies to correct for elements of market failure, is also recognised in the WTO Agreement on Subsidies and Countervailing Measures, Article 1.

14 The position has been strongly articulated in the recent declaration of the Group of Fifteen (1996).

15 For example, such calls have been made for Malaysia by Khor (1996) who calls for a 'fine tuning' of the social and economic fabric through equity distribution. These issues are similar, if not identical, to those discussed under the heading of 'Security interests' above.

poor countries. They fear that a full-blown international treaty such as an MAI, facing approval by each signatory's parliament, will simply hand corporations more power if it is signed.[16]

Status Quo (UNCTAD Proposal). The need for an MAI has been contested by UNCTAD. In its annual report on foreign investment, UNCTAD (1996) concluded that the "current arrangements (concerning foreign direct investment regulation) are working well in providing an enabling framework that allows FDI to contribute to growth and development and in supporting a high and growing volumes of FDI".[17] UNCTAD goes on to suggest that the current arrangements also "allow for countries of similar strength to enter into agreements". They also suggest that "transnational corporations are flexible and experienced enough in operating diverse policy frameworks and they can adapt to regulatory differences among countries". Rule coherence could be ensured in a "number of ways, e.g. by negotiating a global model bilateral investment treaty. Allowing countries and regions to develop their own approaches fosters policy competition which leads to a relatively rapid spread of best practices to FDI".[18] The UNCTAD position is based on a detailed analysis of various agreements and, given its importance as a platform for the voice of developing countries, its proposal must clearly be taken very seriously.

However, the preservation of *status quo* hardly provides a satisfactory answer. We have already demonstrated above that there are strong arguments to support the idea of MAI. These have not been in any way repudiated or altered by the UNCTAD study. One implication of the UNCTAD proposal is that it will be necessary to create differentiated approaches to regulatory frameworks for FDI in order to allow for different national characteristics and conditions. This clearly would be highly impractical and costly as we have argued above. While it may be true that transnational corporations are flexible and can adjust to national differences, it will be naive to think that they will not seek less costly alternatives. These less costly alternatives must surely include those regulatory frameworks that reduce administrative costs of designing and implementing 'tailor-made' regulations. To me it is inconceivable that transnational corporations would accept a system in which they have to deal with hundreds of regulations as economically meaningful. Moreover, the high administrative costs

16 See *Journal of Commerce*, article on 'Giants', quoting the recent studies from the Washington-based Center for Public Policy and the Geneva/Gland-based Worldwide Fund for Nature.

17 UNCTAD (1996), p. 161.

18 *Ibid.*, p. 163.

of the present system will continue to discourage many potential investors who would find the regulatory framework expensive and lacking transparency.

Negotiation Strategy. One, and the least serious, argument against the MAI, has been that many countries are not ready for negotiations of multilateral investment rules. Some argue that they do not have the necessary administrative support, others point out that they do not fully understand the issues. In a meeting of experts from recent international organisations in Bangladesh in June 1997, Mr. Alamgir Farouk Chowdhury, the Bangladesh's Commerce Secretary stated: "In conferences we cannot play a meaningful role and as a result our comparative advantages are undermined. ... The least developed countries often do not know their obligations and rights under the world trading system."[19] Some LDCs have also expressed their preference for negotiations on a regional basis. There is clearly not a universal agreement that trade and investment dispute should be resolved on the multilateral level. For example, in the recent Asian Executive Poll conducted by the Far Eastern Economic Review and Asia Business News 49.7 percent of respondents thought that bilateral negotiations are the best way to resolve trade disputes. The corresponding figures were 80 percent in Indonesia, 68.4 percent in Malaysia, 57.1 percent in South Korea and even in Singapore and in Australia the respondent preferred bilateral dispute settlement mechanism – 55.6 percent and 52 percent respectively.[20]

These criticisms should in my view be treated as 'procedural'. They should not, therefore, be a stumbling block to countries' concerns about their negotiating strategies. Without spending much time on this argument, it is probably true that foreign investment rules are a relatively new subject and some countries may simply feel uncomfortable to join in discussions and negotiations. However, it is very unlikely that foreign investment constitutes a more difficult subject for countries to digest than, say, commercial policy affecting merchandise trade. Technical assistance and advise would go a long way in making sure that countries are well informed and can actively participate in negotiations. Moreover, even the most insecure governments will sooner or later work out for themselves their negotiating strategies and should be able to participate in the negotiations. Thus, the present reluctance to do so should be seen as temporary and a matter of proper timing rather than a resentment in principle. Furthermore, many countries' governments would feel much more self-

19 Reported in *Financial Times*, 4 June 1997.
20 See *Far Eastern Economic Review*, November 28,1996, p. 39.

confident if they entered the negotiations in informal alliances of like-minded governments of other countries.

Mechanism of Global Negotiations. There are strong arguments against MAI, however, on the grounds of the inefficient mechanism of global negotiations. First, bilateral treaties can be negotiated faster and more easily than multilateral treaties. Prolonged negotiations could create uncertainties and further delay of FDI. Clearly, the negotiations of MAI in the OECD is a response to the recognition that a WTO deal is not imminent and that a separate OECD initiative was required to push forward with an international agreement. Second, commitments negotiated by like-minded governments are often 'stronger' and deeper than those achievable at the multilateral level (see also UNCTAD, 1996: 163). Third, there is a risk (and fear of LDCs) that multilateral negotiations could be dominated by the agenda of the strongest economies. LDCs fear that their priorities – restrictive business practices, technology transfer, standard of behaviour of TNCs in host countries and labour mobility – would not receive adequate attention. The issue is not the same as in the case of trade where countries are both importers and exporters while FDI originates in developed countries only (UNCTAD, 1996: 166). Fourth, some LDCs may also fear that they will be forced to adopt too strong liberalisation measures too fast. However, this is very unlikely. As Graham (1996b, p. 16) pointed out, "the task (of negotiating an MAI) would centre around negotiation, nation by nation, sector by sector, of the exceptions of the main obligations. ... The yeoman's work of creating such an agreement will not rest on drafting the language of the obligations, but rather on the negotiation of what exceptions will be allowed." Fifth, the resentment against MAI among some LDCs may have been also tactical. They wanted a further negotiation of other important issues such as the agreement on textiles or agriculture and are holding back on MAI as a bargaining chip.

A higher efficiency of a regional approach notwithstanding, the case for multilateral negotiations remains strong. A regional approach does not exclude a multilateral approach, *pari passu*. In such a scenario, regional agreements may always be extended to other countries. Alternatively, elements of regional agreements may become a basis of an MAI.[21] Whatever road is taken, both approaches may be fully and mutually supportive. The

21 I am aware of the dangers of going the 'regional road.' The proliferation of regional agreements is precisely what I have criticised above in the context of the UNCTAD proposal. However, the proliferation does not seem to be an issue at present time and is unlikely to become one if multilateral negotiations are started concurrently.

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crucial conditions for success is that the number of all the regional approaches will eventually be reduced to one – an MAI and that the regional agreements tend to push the market openings faster that it would be the case under an MAI.

B. Costs and Benefits of Globalisation: Theoretical Arguments and Empirical Evidence

Perhaps the most sensitive criticism has been targeted on economic benefits of globalisation. As demonstrated in this paper, the merits of FDI and globalisation are undeniable even though globalisation may also have adverse effects. The positive features are recognised even by the most vocal critics of globalisation who acknowledge that FDI and globalisation in general have positive economic effects.[22] However, the economic arguments of the critics concern other aspects of globalisation, which, in my view, are not substantiated.

Decapitalisation and Denationalisation. The negative, or poor impact of FDI on development is based on two types of arguments – fear of globalisation which corresponds to what Graham termed "the residual of the 1970s thinking". The argument does not have a strong following these days but it is still pursued by institutions such as The Third World Network (see Atan, 1996). The proponents of these ideas claim that FDI leads to 'decapitalisation' of host countries and their 'denationalisation'. 'Denationalisation' is seen as the result of fundamental weaknesses of developing countries which do not have economic power to compete with strong MNCs. The same critics go on suggesting that FDI has an adverse impact on balance of payments, savings and, through the 'decapitalisation' effect, on domestic growth.

These arguments are not viable and receive declining support from academics, policymakers, journalists and other experts. There is no theoretical reason to provide support for these ideas, and the empirical evidence clearly contradicts them as illustrated by the economic successes of Southeast Asian countries.

Sustainable Development. More recently, we have seen an emergence of critiques of globalisation by various advocacy groups, using a variety of arguments that range from 'social issues' to 'labour standards' and 'environment'. The main idea is that globalisation does not promote sustainable development. Thus, the criticism is typically not directed

22 The recognition is well documented in UNDP (1997).

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towards multilateral rules on investment *per se*; it is concerned with the functioning of the multilateral system in general and of the WTO in particular. The concept of 'sustainability' is blurred as different groups define it differently. 'Sustainable development' can refer to poverty (e.g. Woodward, 1996), the environment, income distribution, or to other aspects of economic development such as gender issues, health, education etc. Some identify the problems of 'sustainability' with the deficiencies of the multilateral system of trade and finance.[23]

With these concepts, it is clearly difficult if not impossible to argue one way or the other. What can be said, however, is that the support for multilateralism and for MAI should not be seen as a lack of compassion or concern for economic development. Those who support MAI usually believe that FDI is 'good' for the host country and its economic development. Labour standards and environmental issues have also been discussed by the ministers participating at the Ministerial Conference in Singapore who agreed to explore the issues in the activities of international organisations with the appropriate mandate.[24] This, by the way, has significantly narrowed the range of issues for negotiations under the umbrella of an MAI.

Positive Linkages Between Trade and FDI. One of the frequently heard arguments against an MAI among politicians is that the linkages between trade and FDI are not known. It is said that we should not move ahead with an MAI until we are sure that FDI is beneficial for the host and home countries. This view is clearly incorrect in that the empirical evidence already exists and points quite strongly to a positive relationship between trade and FDI (see e.g. WTO, 1996 and UNCTAD, 1996a). In addition, I have compiled what I believe to be all the major studies that address the question of the extent to which trade and FDI are substitutable or complementary from both the home and host countries' perspectives. The summary of my compilation is presented in the following discussion.

Impact on Trade. Most of the literature points to the case of complementarity between trade and FDI. Even though the relationship may be slightly stronger in the case of the host country's imports than the host country's exports, the evidence is quite striking. It is possible that the degree of complementarity varies from country to country and from investor to investor. The impact is positive for the *host* country as FDI

23 A concise presentation of all of the main ideas can be found in IISD (1996). See also Helleiner (1996).

24 For example, labour standard issues have been put on the agenda of the ILO. The status of environmental issues in relation to trade remains more dubious but continues to be outside the WTO agenda.

leads to more exports and imports including imports of technology which is typically one of the main objectives of the host countries. The impact of FDI on trade is also positive in *home* countries as FDI stimulates the country's exports and imports. There is obviously room for further tests, but the strength of the existing evidence is already powerful. Calls for additional work in this area should not be used as a pretext for stalling negotiations on MAI.

Impact on Employment. Another line of criticism against globalisation has been the impact of FDI on employment and wages and, in general, on labour markets. An interesting aspect of the criticism is that it usually does not come from critics of an MAI in developing countries, but from labour interests in developed countries. Nevertheless, the criticism has been also made in LDCs which we shall now address.

There is nothing in theory to suggest that FDI should lead to a permanent decline of employment. The issue is, therefore, once again empirical. Unfortunately, the employment effects are notoriously difficult to measure. The first attempts to measure the impact of 'globalisation' on employment date back to the early 1970s. Since then, the employment effects in LDCs have been studied by a great number of specialists and institutions. In particular, the ILO has had a long history of analysing the employment impact of MNCs, and taking a fairly sympathetic view of the plight of LDCs. Its work has been recently reviewed by Bailey, Parisotto and Renshaw (1993). As they point out, there are no precise employment figures to provide a statistical basis for empirical assessments, and this makes it extremely difficult to make comparison over time or cross-country. Nevertheless, what they find is that MNCs generate new employment in the host countries. My additional review of the literature leads to the same conclusions even though the effects may not always be immediately visible. For example, Bailey *et al.* (1993) also suggest that "the upsurge in FDI which was registered in the late 1980's mainly took the form of a reshuffling of ownership patterns of existing multinationals through mergers and acquisitions, and thus had an 'employment-acquiring' rather than 'employment-creating' impact. Employment growth in export processing zones (EPZs), moreover, partially supplanted employment in labour-intensive production in industrialised regions".[25] But even the ILO studies come out relatively clearly to suggest that the employment expansion is a function of growth of the FDI inflows.

25 See Parisotto (1993), p. 34. Once again, these conclusions are also evident from the review of the literature on the employment impact on the home countries that we have collected at the WTO.

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Impact on Wages. Related to the criticism of FDI and its impact on employment are the wage policies of MNCs. The critics often charge the MNCs with 'exploitation' and paying wages that are well below the wage levels in the home countries or even below the 'social minimum' in the host countries. Once again, the problem is primarily empirical.

Unfortunately, the empirical literature on the impact of wages is even more limited than that concerning employment. This is partly due to a lack of statistics but there is also a fairly general shortage of studies. From the literature I have reviewed, the indications are that the evidence can be divided into two groups – evidence on the impact of wages in host countries and that concerning home countries. For some countries – typically *host* countries – the empirical evidence is fairly encouraging, i.e. a significant boost to the growth of wages as a result of FDI (see Fenstra and Hanson, 1995a,b and Welge and Holtbrügge, 1992). This runs against the idea that transnational corporations only pay 'market rates' and will leave the host countries if they have to pay higher wages than their local competitors. The evidence about the impact of globalisation on wages in *home* countries is perhaps even more scarce even though more and more studies are currently undertaken. One of the earlier studies was Leamer (1993) who found that globalisation led to a decline in the American wage level.

The third crucial question is whether trade (and FDI) is important for domestic growth and reduction of poverty. The answer to the question concerning the impact on growth is unequivocally affirmative as supported by empirical evidence reviewed in a number of studies.[26] The impact of FDI on poverty has also been subject to a growing body of literature. Even though the answer is more complicated, as discussed at length, for example, in UNCTAD (1996b), the evidence is once again pointing to a positive contribution of FDI to poverty alleviation. In China, for example, FDI has been instrumental in significantly expanding the low-skill employment and, therefore, reducing poverty (Mallampally, 1996). The evidence from Latin America also supports the finding that economic growth combined with liberalisation of economic policies has lead to a reduction in the proportion of people living in poverty in Mexico, Argentina and Chile (Urani, 1996). A study of Husain (1996) provides a cross-country and comprehensive assessment.[27]

In sum, the concerns about the employment and wage effects originate primarily from the home countries which fear that FDI will lead to reloca-

26 For the most recent review see, for example, van den Berg (1996).

27 There are obviously some people who would still advocate the return to protectionists policies such as Mosley (1996) who argues that tariff liberalisation and removal of agricultural input subsidies have been detrimental to economic growth and to poverty alleviation.

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tion of firm activities and thus to job losses. Interestingly enough, however, it is not the home countries that are typically reluctant to negotiate the MAI.

Marginalisation of Africa and Other LLDCs. Closely related to the argument of 'decapitalisation' and 'denationalisation' are the views that globalisation and the accompanying flows of FDI are responsible for the relative impoverishment of Africa and many other least developed countries (LDCS). In other words, globalisation is said to lead to the so-called 'marginalisation' of these regions and countries and growing income disparities. For example, Woodward (1996) argues that "while the Asian countries have benefited from globalisation, Africa and other least developed countries have been harmed". The critics of globalisation often point to the empirical evidence which shows that the positive effects of globalisation have not been spread equally. Eight developing countries, which account for about 30 percent of GDP of all developing countries, received about two-thirds of all FDI going to this group of countries. The share of exports in GDP increased for the group of developing countries between 1983 and 1993 but the increase was also due to only a small number of countries (10).[28] As a result, the gap between the world's poorest economies and the rest of the world has increased. As WTO (1996) has pointed out, however, there were 35 developing countries in 1994 whose merchandise exports were below the 1985 level. Since the value of world trade more than doubled during the same period, the share of these countries in world trade dropped dramatically. Similar conclusions would be reached if we were to analyse the growth and distribution of global FDI.

The above example shows how differently, and sometimes incorrectly, empirical evidence can be interpreted. The low level of trade and FDI in Africa can clearly be also a symptom of low level of income rather than the effect of the growth of FDI in other parts of the world. The first elementary question is whether Africa and other LDCS have been hurt by inflows of FDI. That is clearly not the case since the problem of these countries has been a lack of FDI. The second crucial question is whether, globalisation effects – positive or negative – represent a sufficient condition for economic growth in any given country. The answer is again negative. Many other factors are also important such as domestic policies which in the case of Africa have played a clearly negative role.

28 These figures come from Brahmbhatt and Dadush (1996).

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C. *Sensible Criticism: The Costs of Globalisation and MAI*

Arguably the most important critical argument about globalisation and MAI concerns adjustment costs of globalisation. The intentions of 'globalisers' have typically been good but in their zeal to push for 'multilateralism' they have often presented 'globalisation' as costless. Adjustment costs have so far been largely ignored until the recent work of Rodrik (1997). Moreover, many critics have also pointed to two negative features of globalisation – growing income inequality and poverty within each country and the marginalisation of some countries. These are grave errors of judgments in my view because it is often the adjustment costs that particularly scare off some countries from market openings. In other words, we have 'thrown the baby out with the bathwater'. Furthermore, given the recent financial turmoil affecting capital and foreign exchange markets in Mexico, Argentina, the Czech Republic and Thailand, many developing countries are asking the fundamental question of what net benefits will an MAI bring to them?

Adjustment Costs. Let us start with the question of costs and, in particular, with the question of adjustment costs. There is no doubt in my mind that a deeper globalisation implies an economic (and possibly other type of) adjustment and such an adjustment leads to adjustment costs. Domestic firms may be replaced by foreign firms, companies may relocate abroad in the search for cheaper labour, the growth of domestic wages may be constrained by the threat of companies to relocate abroad, inefficient industries have to restructure, firms will have to adopt new technologies and production processes, governments have to adjust the pattern of budgetary expenditures and to changes in the budgetary base and so on. All this takes time and resources and should be recognised by countries when considering the negotiations of MAI.

Equity Considerations. The other negative aspect of globalisation concerns income distribution. Suppose first that a country makes the equity issue a top social priority. Suppose further that a deeper market opening (i.e. globalisation) increases income inequality. Should the country's government be concerned? Or, suppose that a government has a policy of maintaining a fine social balance among different races or other social groups in order to maintain a social order and political stability. This is what is sometimes known as 'social engineering'. I have quoted an example of such policies above. Suppose further that globalisation would disturb this fine balance. Again, should the government be concerned? The answer to both questions is in my view – yes, it should.

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Political Stability. Widening income inequality, increasing poverty or the break up of the social balance among different social groups can all be highly politically destabilising. Political instability, in turn, would seriously complicate the pursuit of other economic policies, however rational and sensible they may be. Ultimately, it will also discourage inflows of foreign capital which requires politically stable regimes as a condition for long-term investment. There are countries in which the question of rising income inequality and poverty does not raise social reaction but there are countries which are very sensitive to these issues. Similarly, there are countries which do pursue a policy of maintaining a social balance while there are other, more homogeneous countries, where the social issue is not a matter of serious concern.

It then all boils down to empirical evidence. What is the empirical evidence that income inequality and poverty worsen during globalisation? Are such changes permanent or temporary? In countries without large 'social safety nets', the answer is relatively clear. The evidence provided from different sources such as UNCTAD (1996 and 1997) and Rodrik (1997) shows that globalisation has increased income inequality among countries and even within countries individually. This is not only a matter in developing countries but also in developed countries.[29] These features are not surprising. As countries open up to foreign capital, returns to capital will increase since productivity of foreign capital tends to be higher than that of domestic capital. In the meantime, foreign capital may displace some less efficient domestic firms, and workers may be unemployed as they seek new job opportunities.

It should also be kept in mind that these changes may not be permanent. For example, as the displaced labour is retrained, it will improve its chances to be re-employed and, quite likely, to access a market with better paying jobs. The practical problem is that the reversal in the income inequality trends only rarely has enough time to work itself out through the system. The governments will typically look for ways of mitigating the impact of income inequality through budgetary transfers or perhaps even protectionist policies.

IV The Politics of MAI Negotiations

The brief overview of various arguments concerning MAI shows how history can often repeat itself. Most of the critical arguments are quite famil-

29 See, for example, Laura D'Andrea Tyson, "Inequality Amid Prosperity", In: *International Herald Tribune*, 12-13 July, 1997, 6.

iar. Many have been already used in the past in discussing the merits of industrial policies but have been since abandoned or, at least, considerably muted. The fears of 'marginalisation' of the weak, the appeal for protection against foreign competition, the emphasis on improper business practices rather than the acknowledgement of positive effects of foreign business activities, these are all arguments that have been used before even though the context might have been different.

Nevertheless, it would be too easy to attribute the resistance to MAI to ignorance of basic facts or lack of access to information, even though both have played a role. Why have these arguments reappeared with such an intensity and, in general, why is there in a few number of countries such a strong opposition to MAI?

The explanation seems to me to be various political pressures that always emerge whenever international agreements are proposed. Such political pressures have, of course, different origins in different countries, but several common denominators can be identified. We could start with what may be called a 'cost-benefit' analysis of an MAI. As noted above, the critics would point out that there are strong arguments against FDI and, consequently, against the establishment of MAI. This suggests that supporters of MAI have not paid adequate attention to these concerns, and that each side has so far been more preoccupied in the pursuit of its own position rather than understanding the positions of its opponents. Yet the polemics should be relatively mild. Most of the criticism reviewed above, however, has either a weak theoretical foundation or poor empirical support, or both. But at the same time, there are three arguments that are sensible and should not be disregarded. The first one is that governments feel that they are fully entitled and, typically, that they are required to protect their national interests. After all, if the United States can challenge foreign companies for investing in Cuba on national security grounds, it is only reasonable to expect that other countries also have their genuine security concerns which should be acknowledged in negotiating any MAI. The second sound argument concerns equity considerations which may be a top priority of governments whenever they make policy changes. And third, governments may attach a high degree of importance to overall political stability and social cohesion which may cause delays or even prevent them from adopting policy measures that may be economically optimal. I shall return to these three questions further below.

Another political battle has emerged from the perception of the distribution of gains from an MAI among countries. We have seen that many developing countries feel vulnerable when they come to negotiate a multilateral agreement. Many also fear the impact of globalisation. *Pari passu*, some countries also argue that MAI is to primarily benefit developed coun-

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tries. What can be said about the distribution of gains from globalisation? Take, for example, the case of the impact on employment and wages. The evidence that I have been able to collect points fairly strongly to *positive* effects of globalisation on employment and wages of those countries in which MNCs operate. However, the overall effects in developing countries have so far been relatively modest since the bulk of FDI is still located in developed countries where MNCs have most of their activities. Hence, the gains from globalisation will most likely not be distributed equally over time between the developed and developing countries – the latter may benefit relatively less in the beginning even though the pattern is likely to be reversed at a later stage. Moreover, the distribution of gains has also been skewed among developing countries, which has driven a wedge into the cohesion among these countries.

The distribution of power between, broadly speaking, the governments, the business sector and labour within each country has been another origin of political frictions. The criticism of MAI in developed countries – typically the home countries of FDI – come mainly from labour and from some opposition politicians. Governments tend to be sympathetic to the idea of MAI as documented by the ongoing negotiations at OECD. In contrast, the criticism in developing countries is more broadly based. The business sector may feel threatened by foreign competition, and it has indeed been a strong lobby against market opening in some, albeit limited number of countries. However, the strongest opposition typically comes from governments, and the main reason is their fear of loss of control. Both of these factors seem to have been playing a major role in the relatively negative stance of the Indian government – a major force behind the cautious approach to the discussions about MAI at the Ministerial meeting in Singapore.[30]

V Proposed Solutions

I am putting my faith on negotiations. In a way, everything should be negotiable except perhaps questions related to national security. This means that even the most difficult issues could be addressed through negotiations. This must include, I believe, the adoption of MFN and national treatment principles, an agreement about the treatment of fiscal incentives and, possibly, some harmonisation of tax regimes and accounting standards. The establishment of a dispute settlement mechanism would be also important.

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30 See, for example, the recent discussions in the WTO balance of payments committee as reported in *Financial Times*, 2 July 1997.

However, several difficult problems would have to be resolved before the negotiators sit down to negotiate the actual agreement. These problems include the definition of national security and the treatment of equity issues in the negotiations. Unfortunately, the ambiguities and differences of opinion surrounding the definition of 'national security' and some important equity issues are quite significant. At the same time, it should be kept in mind that some concerns of LDCs can be better handled by specially targeted policies. For example, equity concerns can be more effectively addressed through domestic policies such as budgetary transfers rather than by trade policies.

Intellectual Debate. It is clear that countries will need to complete a substantial intellectual groundwork before any negotiations of MAI on a world-wide level can be negotiated. Even if there is a general agreement about the need to negotiate MAI, there is not an agreement about (1) the venue of such an agreement, i.e. under what umbrella the agreement should be negotiated. Clearly, WTO is a logical candidate. Other substantive issues that would need to be resolved in such an 'intellectual' debate include (2) the scope of the agreement (such as investment protection, taxation, employment of foreign nationals etc.) and agreement about the definitions of concepts (such as 'national interest', 'foreign direct investment'), and (3) the range of exceptions. It may also have to include (4) the minimum standard that would be acceptable to all parties concerned. Without prejudging the range of issues, the main objective of the debate would be the need to identify the main issues for negotiations.

'Green Light' Measures. 'Green light' measures, i.e. measures to correct for a certain element of market failures, are closely related to the issue of *exemptions* discussed further below. The main point is that MAI does not exclude the possibilities for countries to promote certain economic activities, as we have already indicated earlier in the text. As we have also seen above, this support has been acceptable in most international agreements in a selected number of cases such as regional development, the promotion of certain research and development expenditures and protection of environment.

Regional Cooperation. A weak negotiating position must be a legitimate concern of many small developing countries. The problem can be addressed in at least two different ways – by building up expertise through the provision of technical assistance and through regional cooperation of these countries. Clearly, many of these countries face serious resource and manpower constraints to negotiate effectively in big international fora and this handicap can be eased by pooling resources, information and knowledge with like-minded countries.

Transition Periods. Most importantly, the problems discussed above have, in my view, a relatively simple solution – the recognition of the concept of *transition period* for countries entering the MAI negotiations. This is not a new concept in the multilateral trading system which recognised transition periods for developing countries. I have recently proposed the same for those countries in transition that are applying for accession in the WTO (Drabek, 1996).

Transition periods would allow countries to adopt the main features of an MAI – the national treatment and the MFN principles over time and with a speed that would have to be negotiated with their trade and investment partners. It would allow them to do so as fast as practical and in a way which is minimising costs of adjustment. Developing countries in general have the possibility in the WTO system to negotiate a 'transition period' during which the national treatment principle need not be applied. This is after all what the critics imply when they reject the national treatment principle as discriminatory against the developing nations. The real problem, however, seems to me to be the inability to agree on what constitutes 'security interests' of countries, as noted above. Unfortunately, protection of 'infant industry' is often presented and understood by the critics as a necessity on national security grounds.

Exemptions. It should also be possible to negotiate *exemptions* from the general commitments. Many countries would be particularly interested in negotiating sectoral exemptions. A relief from the 'national treatment' principle should surely be possible in certain instances such as defence or the police which are seen as exceptions under standard circumstances. In addition, I see no reason why other sub-sectors could not be added to this 'negative' list, provided the list is transparent and relatively short to make it acceptable for other countries. Alternatively, countries could agree on a *set of criteria* to qualify industries as a special case and conditions under which they will continue to be so.

Technical Assistance. A great deal of emphasis will have to be put on technical assistance. Many developing countries and countries in transition do not have either the knowledge, the experience or the staff to deal with many complexities that multilateral agreements bring along. The technical assistance will be particularly important in LDCs and in the countries in transition to negotiate the agreement. Many countries would probably also benefit from a better cooperation with other (developing) countries with

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similar interests in order to prepare themselves better for the actual negotiations.

VI Conclusion

The arguments in favour of an MAI ultimately rest on the benefits the countries can reap from such an agreement. I am convinced that, on balance, the benefits from such an agreement could greatly exceed the costs. The list of major benefits to the international community at large is impressive, and we have reviewed them in Section II. Moreover, the host countries should also consider other benefits which are particularly important for developing countries and countries in transition. For example, MAI would reduce transaction costs to MNCs resulting in greater supply of 'investible funds', or lower costs of FDI or both. The agreement would also reduce uncertainty which is typically a major component of investors' risks. Since the agreement would also most likely include elements that can be seen as 'prudential regulations' it would certainly reduce the volatility of capital flows. Moreover, MAI would be an important instrument towards avoiding unilateral restrictions against each countries' exports. Last but not least, since MAI would also include a dispute settlement mechanism, it would give weaker and smaller countries a better chance to protect their rights.

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The Challenges of Financial Globalisation

Percy S. Mistry

I Introduction

The challenges posed to institutions and policymakers by the progressive global integration of financial markets are becoming more urgent by the day. They need to be addressed more effectively – nationally, regionally and internationally as recent financial turmoil in Asia demonstrates. The Asian currency and capital market crisis which is still unfolding suggests that many of the lessons of the Mexican crisis of 1994-1995 have been left unlearnt. Institutions and policymakers at all levels need to be better equipped to anticipate and prevent local financial disturbances from becoming larger regional or global accidents – especially when their likelihood of escalating can be gauged in advance. But, at present, they seem more geared to repairing post-accident damage with the usual 'tough measures' after markets and economies have been traumatised; often unnecessarily.

In the 33 months between the Mexican and Asian crises there have been a number of mini-crises – if those are what abnormal, swift price adjustments represent – affecting banking, currency, securities and property markets in countries influenced by financial globalisation such as Venezuela, Brazil, South Africa, India and Pakistan. Though commented on *en passant* by the IMF in its *World Economic Outlook* and *International Capital Markets* reports, these have otherwise gone unnoticed in the same way that tremors were once ignored before an earthquake. Yet each has signalled something about the way in which globally linked markets force changes in prices and policies when governments seem intent on avoiding reality. They presaged a larger shock in weaker parts of the system, which were more vulnerable to outward portfolio flows and currency attacks, especially where asset prices and currency values had been driven up to unsustainable levels. Yet little was done to put safety nets in place; regionally or globally. There was generalised complacency about the success of a few developing countries in attracting large quantities of foreign capital in a short period of time even though neither their absorptive nor their institutional (in the broadest sense of the term) capacity had improved much. Yet, although the media emitted early warnings, no part of the official system wanted to risk being seen as

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alarmist about the possibility of further shocks likely to be caused by the growing nervousness of international private capital.

It is disappointing that as this decade approaches its close, the world of global finance still emphasises curative measures *after* financial market disruption occurs and a chain reaction ensues, rather than on prophylaxis to prevent crises from erupting and spreading contagion. Perhaps that is because neither institutional defences nor policymaking mindsets – at all tiers of governance – have yet shaped themselves to deal with the world of the present and future. Their architecture and procedures appear ill-suited to: (i) monitoring the right information to assess tectonic shifts in markets – which occasionally have more to do with information asymmetries affecting market perceptions and sentiments, rather than with policy fundamentals suddenly going awry; (ii) anticipating failures in market mechanics; or (iii) responding in real time to national and global financial system dysfunctions. National and international institutions created to deal with the financial problems of the 1950s and 1960s, have tried to adapt, with differing degrees of success, to addressing the problems of the 1970s and 1980s. But they seem ill-equipped in dealing with the challenges which a rapidly globalising financial world poses in the 1990s and beyond. This rather basic reality may well lie at the root of the system's apparent impotence.

The analogy between monitoring financial markets and seismic technology is perhaps apt. Despite the relatively rapid globalisation of finance, the world appears to be a long way from developing the necessary algorithms and putting in place remote sensing systems (at national, regional and global levels) needed to predict and prepare for financial quakes. National governments, as well as regional and international institutions, do not have a clear view as to what to measure, where to measure it, with what frequency, or how to use information in real time. At present, the quantity and quality of information (see Section IV.3 below) available in developing markets is much too inadequate and untimely to justify the volume of private flows to emerging markets from global sources. Also, the quality of interpretation and dissemination of the information that is available, especially by players in emerging markets, leaves much to be desired. The research publications of major global banks and brokerages on investments in emerging markets have become bulkier and glossier with time; as have their advertisements to attract a wider range of investors. But their content remains devoid of value-added substance.

II The Current Problems of Financial Globalisation

At the ***national*** level, markets (exchanges and players) and governments –

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especially in developing countries – have been maladroit in avoiding the double-edged sword of financial globalisation. Their nonchalance in dealing with its costs matches their anxiety to attract its benefits. They have yet to deal adequately with some fundamental issues which need to be resolved before markets can work: i.e. competition; transparency; acceptance and application of global accounting, disclosure and due diligence standards; institutional restructuring, especially of domestic securities brokerages and investment banks; dematerialisation of scrip, electronic registers; establishment of national depositories, integrated custody, settlement, transfer and ownership registration mechanisms; the rapid development (technological, ethical and management) of securities and currency exchanges; and the properly articulated regulation of cross-border operations of financial institutions and markets. Instead they have focused on less crucial, but politically more contentious, issues such as: the role of foreign vs. domestic players in their banking and capital markets; protecting public banks, instead of restructuring and privatising them as quickly as possible; and protecting the vested interests of insufficiently qualified, inadequately capitalised, and technologically backward domestic brokerage houses and broker-dominated securities exchanges, which invariably place their own interest in manipulating securities markets and prices above the interests of securities issuers and of institutional and individual investors.

Most damagingly, developing country governments have been slow to realise that financial globalisation has an immediate impact on breaking down – in a speedy but disorderly fashion – barriers between banking, securities, currency and property markets in their domestic economies which had previously been artificially compartmentalised. They have been equally slow in seeing that when economic policies result in erratic price and trading behaviour in any one of these segments, the pressures generated inevitably spill over into other segments before asset value bubbles, which are artificially pumped up, burst. Major price corrections are then forced in all segments through large exchange rate and asset price adjustments – usually by foreign rather than domestic players. The compartmentalised control that developing country governments used to exercise over each segment in quarantined conditions is no longer applicable or effective in a globalised financial world.

The Regional Level – the 'Missing Link' – of Financial System Governance

At the ***regional*** level, with the qualified exception of the EU, there appears to be a vacuum in terms of institutional structures as well as defence mechanisms (special market stabilisation and cut-out mechanisms, facilities and

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funds) to cope with the malign effects of currency and capital market ructions. This is surprising since the contagion effects, and the real economic and financial costs, of financial market failure are most serious for, and spread most quickly to, immediate neighbourhoods. Moreover, private capital flows are becoming intra-regionally concentrated, particularly in Europe and East Asia, and increasingly in Latin America. With this being the case, failure in one market is likely to have immediate and large regional repercussions (as the current Asian crisis demonstrates) before it has global consequences. With trade issues assuming overwhelming priority (and receiving the most attention) in debates on regionalisation, most developing regions have paid insufficient attention to dealing satisfactorily with related *macro-financial* issues; despite the rapidly growing importance of intra-regional trade-related and portfolio investment. Consequently, supranational (regional) bulwarks have not yet emerged to prevent or contain currency and capital market crises in vulnerable countries, or to insulate the regions surrounding them from negative spillover effects. This is puzzling since volatility and uncertainty in currencies, and large contractions in wealth, are more damaging to long-term regional (and global) trading and investment interests, especially at the level of firms, than any other phenomenon.

That reality underlines both: (a) how unidimensional and limited trade preoccupations are in the process of regionalisation; and (b) the falsity of the *regionalism* vs. *multilateralism* dichotomy that underpins much debate on the merits of the latter over the former. The point is often overlooked that the post-1990s emphasis on regionalism (sub-optimal though it may seem from a trade perspective) is a reaction to: (i) the perceived failure of nationalism and of multilateralism; and (ii) inherent structural weaknesses in the functioning of global economic institutions. The latter operate in a fashion which denies inclusion – i.e. the effective participation of economies other than the large powerful ones in their policy and decisionmaking processes and protocols. Thus, the twin processes of regionalisation and globalisation are not seen as complementary or mutually reinforcing over an interim period: i.e. until a form of multilateralism emerges, based on interaction among regional blocs, within which nation-states feel empowered. Instead these processes are seen to be competing and antagonistic, resulting in the wrong question being asked, about whether to create regional or global defences to stabilise global financial markets; when the answer is that both are needed.

The Global Level of Financial System Governance

At the ***global*** level, international financial institutions and global economic

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policymakers seem trapped in a timewarp. Their responses and approaches to new financial market crises are redolent of the way in which they dealt with sovereign debt crises. It is not immediately obvious that new dimensions and needs which have emerged to prevent or manage capital account and (private) capital market crises, have been properly recognised. These needs became apparent seven years ago and have gathered momentum since. The newest era of private capital flows coincided with the (alleged) demise of the developing country debt crisis at the end of the 1980s. The sudden emergence and explosive growth of private capital flows in the 1990s has invariably been seen (and represented) as a vindication of successful debt crisis management, or as a prize which 'good' countries win when they have reformed and embraced the 'magic of the marketplace'. Rapid growth in private capital flows has been understandably applauded. Developing countries have also been proselytised with missionary fervour about reforming faster to attract such flows. Yet, questions have been raised as early as 1992 about whether a sudden explosion in private flows and their concentration in just a few emerging markets, might not produce the same pressures, breakdowns and rounds of stabilisation and adjustment as the debt crisis; especially in the absence of commensurate development of market and institutional capacity to accommodate such flows.

History does repeat itself, but rarely in the same way. The sovereign debt crisis of the 1980s was triggered by the herd-instinct of global commercial banks competing to make syndicated loans in volumes greater than the digestive capacity and creditworthiness of developing country borrowers (especially governments and their instrumentalities) could absorb. The inclination of global financial markets in the 1990s to channel a large volume of private funds into emerging markets through different funnels, though also driven by herd-instinct, is based on a different set of premises, more acceptable motivation and on an inexorable process of equilibration between the global distribution of productive (cash-generating) assets and financial claims on them. Even so, it raises the same concerns about: (i) the absorptive capacity of private sectors and the institutional and regulatory capacities of governments in emerging markets; and (ii) whether such capacities are growing at the same pace as the flow of private funds. But that is where the similarity ends. It would be ironic and inequitable if – as a result of intervention to deal with the after-effects of a financial crisis (e.g. in Thailand and Indonesia) along the same lines as the debt crisis – the end result were to be the same, i.e. classical harsh adjustment with the burden falling on the poorest people in these countries in order to protect global private investor interests from the full consequences of the risks they took.

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Transitional Problems with Equilibrating Financial Claims on Productive Assets

The globalisation of finance in the 1990s represents a long-delayed but entirely natural adjustment. Processes of financial deregulation in the developed world and economic liberalisation in the developing world occurred independently through the 1980s. They converged in the early 1990s creating push-pull forces which caused a surge in private capital flows into markets formerly out-of-bounds. The effect was similar to flooding created by mis-sited dams crumbling under pressure. As artificial cross-border obstructions to the broader ownership of claims on future cash flow streams were lowered, finance from global sources inevitably attempted to acquire assets (generating future cash flows) to which access had been denied.[1] That in turn triggered anticipatory as well as reactive swings in the flow of domestic savings with disintermediation out of banking into capital, currency and property markets. When prices overshot in securities markets, gains were taken by investors with privileged access to information and invested in other segments where prices were deemed low and assets undervalued, offering attractive returns and exits; especially in currency and real estate markets with gold and oil being out of vogue. However, when returns failed to materialise and exits (in terms of liquidity) proved illusory, the inevitable financial ructions ensued.

Cross-border flows of private capital into financial and related markets were bound to have exchange rate effects especially as over-controlled capital accounts were progressively opened and other barriers such as foreign ownership of domestic securities were dropped. Such processes were never likely to be smooth or problem-free; especially in the initial phases of such a major global adjustment. That adjustment is still taking place, and it has a long way to go before any sort of equilibrium is achieved. Market prices for securities, currencies and real estate invariably overshoot when large volumes of foreign capital invade small, highly imperfect secondary markets which are not resilient or robust. Then they over-correct. Cycles of overshooting and over-correction recur in a volatile manner until the amplitudes of such fluctuations are dampened over time with market maturation. That happens only with continuing reductions in information asymmetries and commensurate improvements in the functioning of mar-

1 Of course, for global markets to work properly and symmetrically, the point is missed (especially when waxing lyrical about financial globalisation) that openness to capital flows may need to be mirrored in openness to labour flows as well so that labour markets can function as freely as capital markets in order to maximise welfare.

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ket mechanisms, player capacity and regulation across emerging markets to internationally acceptable standards.

Vested Interests Generating Price Instability

One of the unintended consequences of financial deregulation has been that global (private) financial institutions have, during the 1990s, created vested interests within their organisations which may actually be generating price instability in all financial markets. They pose a systemic risk in global financial markets given the way in which they operate; especially when herd instincts take over. Global financial institutions – whether banks, investment houses, securities brokerages, hedge funds and even asset managers – appear to have created a global whirlpool of their own by: (i) creating profit centres out of currency, derivatives and emerging market security trading departments; (ii) taking large positions in leveraged instruments on proprietary accounts; and (iii) staffing such departments with overpriced talent which is then pressured to produce results: i.e. profits derived from daily over-trading of currencies, derivatives and other leveraged financial instruments.

Too many traders around the world are now engaged in frenetic trading (churning) often unrelated to anything 'real'. For example, the volume of global forex trading in 1996 exceeded $280 trillion, nearly 10 times world GDP ($29 trillion) and over 40 times world exports of goods and services ($6.5 trillion). Such 'froth' results in amplifying out of all proportion small missteps in fiscal and monetary policy and creates market conditions which then require unnecessarily large policy corrections with consequent adverse effects on the real economy.

In that sense, traders in emerging markets, currencies and derivatives are operating in much the same way that syndicated loan salesmen operated through the 1970s. Belief in the view that markets are safer and wiser conduits for private flows than banks to governments are as mistaken as earlier beliefs that countries do not go bankrupt and can therefore be lent to indefinitely. Moreover, markets have been conduits for private flows to undeveloped areas on several occasions before. The managements of global securities firms are just as unable as the managements of commercial banks were in 1982 to control risk in such 'perverse incentive' operating environments with the conflicts of interest and moral hazards they pose. Even though they rely on sophisticated risk-management techniques involving mathematical models with computer-activated buy-sell triggers – which most senior managements do not have the basic wherewithal to comprehend – it would be idle to pretend that they are in fact managing risk at all.

In such 'over-hyped' environments populated by volatile and continuously recycled talent, markets are driven more by sentiment, perception and rumour rather than by reality. More dangerously, they are influenced by frequent misinterpretation of policy and its consequences; especially in emerging markets when traders extrapolate too much from unreliable and often misleading data. Such institutional characteristics can result in amplifying the effects of financial disruptions and spreading contagion far faster than underlying circumstances warrant, creating unnecessary pressures for economic policymakers who are rarely accomplished in reading market minds.

III The Future Challenges of Financial Globalisation

The foregoing introductory sections depict, somewhat simplistically, the inevitable transitional problems being created by financial globalisation. But if it is generally accepted as being in the ballpark, then what is inexplicable is the somnambulance of governments, institutions, and market players – at national, regional and international levels. They have had the benefit of experience with adjustments of this broad nature before in one form or another in the 1970s and 1980s. The same cycles have occurred in the US, Europe and most recently in Japan, where the after-effects of precisely such market excesses and failures continue to persist in a dogged fashion after seven years of economic stagnation. They could have been expected to be repeated in overextended and oversold emerging markets where large flows resulted in rapid asset overvaluation followed by the inevitable corrections. The same cycle was seen in Mexico in 1994. Yet was enough done to anticipate the problems that were bound to arise or to construct appropriate devices for dealing with them?

It is almost as if a prolonged fit of absent mindedness or retrospect blindness has seized the system afflicting it with irremediable myopia. With that somewhat depressing thought in mind, the remaining sections of this paper elaborate on a few ideas and attempt to make a few observations about how the challenges of global financial integration might be addressed at various levels of governance. I will concentrate on issues that arise with the increasing integration of global capital markets, and I will not deal with issues concerning banking systems which have been dealt with more extensively in the literature.

The Growing Prominence of Emerging Markets in Global Finance

It has now become a cliché that growth in private capital flows and in the size of financial markets in the last decade has been breathtaking. Tables 1-

10 (at end of paper) illustrate how rapidly financial markets have grown in the last decade and how quickly they have been globalising. Another point they make is that from 1990 onwards emerging markets have begun to play a prominent role in world markets (Tables 1, 7, 8 and 9). They have grown more rapidly than the smaller OECD markets (outside G-7 countries) such as Austria, Denmark and Luxembourg. Together, with a market capitalisation of over $2.2 trillion in 1996, emerging markets are approaching the size of the combined markets of OECD excluding G-7. Financial securities traded in these markets are constituting an increasing share of global institutional and individual asset portfolios. Moreover, entities from emerging markets are floating an increasing proportion of securities in *developed* markets (especially global markets such as London, New York, Tokyo and Singapore). That process will continue until rough equilibrium is attained between securities associated with emerging financial markets and the productive capacities of their real economies (accounted for in PPP rather than market terms); which will continue to grow at a faster rate than in the industrial world for some decades to come.

For example, China and India are now the world's second and fourth largest economies in real output (PPP) terms. Together they account for over 15% of world GDP. But they account for only 1% of world market capitalisation. Their debt markets account for less than 0.5% of total debt traded. Their combined market capitalisation at the end of 1996 was less than that of Taiwan, Malaysia or South Africa taken individually. That serves to illustrate how far the related processes of continued emerging market development and financial globalisation still have to go before equilibrium is reached. But that will not happen without disruptions and downward corrections in individual cases. Take the case of Japan: in 1987 before its equity market corrected in a rather spectacular fashion, it accounted for nearly 36% of world market capitalisation, even though its output (PPP) was about 10% of world GDP. In 1996, Japan's market was down to 15% of world market capitalisation with its share of global output declining to 8% (PPP). Further downward adjustments in Japan's markets and its currency are almost inevitable. A similar sharp downward adjustment has taken place in Malaysia, Indonesia and Thailand in the first round, and Korea and Taiwan in the second.

But these individual cases notwithstanding (representing markets overshooting and over-correcting when assumptions about future growth rates are proven wrong), the argument in the aggregate is not likely to be affected. It is a simple argument relying on crude proxies to make the point that, in a perfect global market economy with perfect financial markets, the volume of financial claims on future cash flow streams (i.e. on assets which generate tradable output wherever they may be located) must eventually

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equilibrate in net present value terms; so must risk-adjusted discount rates as economic endowments are gradually equalised. Obviously the process of financial market development and its relationship to output (and stocks of assets which generate output) and future cash flow is more complicated than that. Also, market capitalisation is a crude proxy. It is affected by: (i) market structure; and (ii) the extent to which a local market has international dimensions.

Germany is a good example of the first case. In 1987, Germany accounted for about 5% of global output (PPP) but less than 2.7% of world market capitalisation. Most German equities were closely held by banks and rarely traded in volume, thus dampening stock prices and lowering market capitalisation. By 1996, that situation had corrected a little. A larger Germany accounted for 4.7% of global output (PPP) and 3.3% of world capitalisation. Examples of the second case are London, Singapore and Hong Kong, whose markets are disproportionately large when compared to the share of their domestic economies in world output.

At the end of 1980, developing countries as a whole accounted for about 28% of world GDP but accounted for less than 2% of stock market capitalisation and 1.5% of debt market volume. In 1990, those proportions had changed to 35% of world GDP, 7% of world market capitalisation and 4% of debt market volume respectively. By 1996, they had changed again to over 42%, 11% and 6% respectively. In the 1990s, financial market enlargement in developing economies has proceeded faster – at an annual rate of about 25% – than output growth (at about 5.5%). It is of course impossible to predict whether those same differential rates of growth will persist over the next few decades. Both are likely to slow down.

But even assuming, *ceteris paribus*, that the rate of financial market growth in developing countries slows to an average of around 15% and output growth to 4% over the next three decades, equilibrium between traded financial claims in markets (i.e. securities) and output-generating assets in the real economy will be approached by around 2030. By then, what presently comprises the *developing* world should account for over 60% of world GDP and over 50% of market capitalisation. That extrapolation assumes that the *developed* world (as presently constituted) grows at a rate of around 2.5% annually and its financial markets expand at around 10% annually. Of course by 2030, the goal posts will have moved (as they have already) as more countries transit from the developing to the developed category.

Emerging Markets: Facing the Transitional Problems of 'Catching Up'

From the viewpoint of financial globalisation, emerging markets have

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more catching up to do in global forex and derivatives markets than in equity and debt (bond) markets. Global forex markets are likely to be transformed as the larger developing economies (especially India and China) open their capital accounts completely and resort to issuing sovereign and corporate bonds in world markets. The use of derivatives too, which is highly concentrated in North America at the present time (Tables 4 and 5), is likely to grow exponentially as a wider range of market players and regulators become familiar with them and as derivatives become as familiar (for risk-hedging) in emerging markets as they are in developed ones.

None of these developments is likely to occur without market failures, public trauma, and forced policy adjustments in a number of individual countries; especially as complex, leveraged instruments are introduced in markets which are fragile and insufficiently developed. Yet, in a globalised financial system dominated by transnationals, efforts to prevent, obstruct or delay the entry of sophisticated products until markets are more developed, will be about as successful as King Canute's efforts to hold back the tide.

A slowed pace for introducing derivatives, for example, may restrict the flow of portfolio funds from institutional investors accustomed to hedging their exposure risks and locking in gains through derivatives. Similarly, an inefficient market in forex is also likely to deter inward portfolio flows although such a market also facilitates outward flows at a much faster rate than imperfect forex markets. National governments, independent regulatory agencies, private accounting and legal firms, and international financial institutions (regional and global) will need therefore to cooperate on an unprecedented scale in order to accelerate the processes of orderly financial market development and put in place adequate safety nets to cope with accidents that are bound to occur even as efforts are made to prevent them.

The extent of the effort needed can be glimpsed through the following figures. Of the 209 economies in the world, IFC in its *Emerging Stock Markets Factbook of 1997*, lists 51 as 'developed' although only 24 of these have stock markets of any significance. Of the 158 countries classified as 'developing' only 71 have stock markets. Of these, just 11 accounted for over 80% of the total capitalisation of all emerging markets: i.e. Brazil, China, India, Indonesia, Korea, Malaysia, Mexico, the Philippines, South Africa, Taiwan and Thailand. And even these 11 emerging markets are characterised by major institutional gaps, operating weaknesses and regulatory lacunae; as indeed are many of the smaller developed markets.

Almost all of these eleven countries have imbalanced financial markets with equity markets being excessively large in relation to debt markets and

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other financial market segments; their forex and derivatives markets have hardly developed at all. These figures impart a nuanced dimension to the term 'globalised finance'. Most countries, including some small developed ones, are connected only tenuously to global financial circuits. Although private financial market operations (and therefore private capital flows) have now spread to parts of the world which they did not reach before, there remains a long road to travel before private capital can flow through efficient market mechanisms with equal facility everywhere and before all countries can be served by financial markets in the same way.

IV Pragmatic Solutions

There are a multitude of challenges therefore which face national and international institutions and policymakers under such circumstances. All of them cannot possibly be dealt with in a paper such as this. For that reason, the following sections deal with a few select issues which have not been dealt with elsewhere. I will focus deliberately on pragmatic 'market' issues rather than theoretical or policy issues on which much weight has been placed in the burgeoning literature on this subject.

1. The Need for Regional Financial Markets for Small Nations

There are many countries in the world (especially in Africa, the Caribbean and the Pacific (ACP)) which are too small to justify having their own markets with the panoply of support facilities as well as the liquidity, width and depth that financial markets need in order to function properly. These countries will need to accept the reality that ***regional*** capital and banking markets will fulfil their needs and purposes better, more efficiently and more cost-effectively than national markets can. The headlong rush therefore by small countries (in Eastern and Southern Africa for example) to establish their own stock markets, often aided and abetted by international agencies, makes little sense especially in a financial world which can be electronically linked and networked with small markets being linked to larger hubs.

In that context the initiatives taken by francophone West African countries sharing a common currency (the CFA franc) to take a regional approach to capital market development seem more sensible and deserve strong support from the international community. It would be timely for small ACP countries, the regional organisations to which they belong, and the international financial community (especially the EU and the Commonwealth which both have special links with the small ACP states)

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to come to early understandings on the need to develop regional financial markets in specifically amenable environments before the tendency to 'go it alone' becomes over-exuberant, unstoppable and results in a waste and duplication of scarce financial, technological and human resources.

That proposition may apply equally to Maghreb and Mashreq countries as well as small states in the Arabian Gulf, South Asia, the Indian Ocean and Indo-China. Also, small illiquid markets are particularly prone to market manipulation which can occur in either direction with relative small amounts of capital driving speculative price movements. Larger regional markets with greater liquidity, breadth and depth would reduce, but not eliminate, such risks.

2. *Rationalising Fragmented Markets and Players in Large Countries*

By the same token, but in an opposite sense, there is equally a need to rationalise fragmented local markets in large countries. These local markets emerged under different conditions, when transport and telecommunications constraints were binding in a primitive technological environment. In India, for example, there are 22 stock exchanges, and over 4,000 small domestic brokerage firms virtually all of which are under-capitalised, technologically antediluvian, professionally undeveloped, and operationally inefficient, conducting transactions in a paper-driven environment. Most of these exchanges and brokerages have trading volumes which are too small to justify independent existence. Their existence expands the scope for counter-productive inter-market price arbitrage through collusive price-rigging by brokers acting in concert, by corporates which regularly trade in their own shares through third-party brokers or their own intra-group brokerages. A handful of large, competent domestic brokerages have already become part of the transnational structures of international securities firms (many of them owned by global banks) through joint ventures in which the foreign partner is becoming increasingly dominant. Meanwhile over 90% of trading volume is concentrated in the four major metropolitan (and one national) exchanges. This picture is also generally true of other large emerging markets, although perhaps not quite as extreme as in the Indian case.

Thus a two-tier industry structure has developed: with the upper tier, which is globally influenced and catering mainly to large domestic and foreign *institutional* investors, driving the market. The lower tier – which deals with the bulk of domestic *individual* investors – is increasingly illiquid and poses a systemic threat; i.e. the possibility of widespread brokerage failures resulting in a loss of public confidence. To some extent that unhappy situation is already unfolding. Continuation of such an industry

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structure does little to enhance the credibility of local capital markets, either at home or abroad. Also when the policies, internal surveillance and operations of exchanges are dominated by member brokerages whose viability and operating standards leave much to be desired (when compared with international standards), too many opportunities are created for collusive malfeasance by unethical market operators. And ethics have not been the hallmark of operators in the Indian capital markets as a series of annual financial market 'scams' between 1992-1997 suggests.

Surprisingly, although the Indian authorities have laboured mightily to protect the preserve of domestic banks (in terms of market share) and misdirected large volumes of tax resources to re-capitalise large parts of the banking system – which is mostly publicly owned and still highly inefficient by international standards – they have done the opposite in the case of capital markets. The authorities have neglected restructuring the domestic brokerage industry (which is almost entirely privately owned) either through positive incentives or through punitive measures which are uniformly enforced in the face of frequent default. And despite large loans by IFIs for financial sector reform, the urgent matter of reforming the industry and support structure of the Indian securities industry has gone unattended.

Some attention has been paid to improving the quality and effectiveness of capital market functioning (with the introduction of electronic trading on the National Stock Exchange, the establishment of a national depository and the gradual dematerialisation of scrip, albeit in a clumsy way) and of regulation. But the point has obviously missed the authorities, as well as the IFIs involved with financial sector reform in India, that regulation would improve automatically and the regulatory task made much easier, if the industry's structure were to change in a more amenable manner and the objects of regulation were to become stronger, more competent professionally and more viable financially. What exists in India is an extreme case. But similar problems exist in most large countries with fragmented local markets which require rationalisation and electronic linkage.

3. *Information Imperfections and Asymmetries in Financial Markets*

All parties involved in dealing with emerging markets and financial globalization have frequently expressed concerns about: (a) the urgency of improving the quality and timely availability of economic and corporate information; (b) the timeliness of its dissemination; and (c) the creation of competitive markets in interpreting information and broadcasting it widely – especially by encouraging the creation of a vibrant financial press and of a market-supporting independent market analysis capacity. Those con-

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cerns apply not just to emerging markets but to all financial markets; although the problem in emerging markets is gargantuan. Yet despite the rhetoric, the progress made – in reducing information imperfections and asymmetries, and in suppressing the use of privileged insider access to trade unethically – has fallen far short of expectations. The gap between rhetoric and reality is explained in part by the absence of a concerted effort by authorities at all levels to improve the situation; another part is explained by 'regulatory capture' in emerging markets where regulators are co-opted by market players and issuers to tolerate 'non-disclosure' practices which are often deployed for proprietorial gain.

A major effort now needs to be made to improve the quality, frequency and timeliness of: (i) relevant economic information at a sufficiently disaggregated level to enable real-time market analysis (which will require a substantial investment in statistical systems at all levels of government) produced by governments; (ii) real-time information on fiscal developments (by line item) as well as monetary developments including daily movements in all key interest rates, yield curves, exchange rates, use of reserves for intervention, and levels of reserves, which is produced by central banks; (iii) real-time market information produced by exchanges in all primary and secondary financial markets, i.e. equity, debt, convertibles, derivatives, money etc.; (iv) real-time information on corporates and securities issuers, sovereign and quasi-sovereign, and on trading undertaken by parties closely related to security issuers; and (v) real-time information on exchange trading activities, over-the-counter and kerb deals, the financial health of intermediaries and counterparties; (vi) real-time credit-rating information; as well as (vii) information on intermediaries in regulatory default. Such an effort should involve the same players who participated in dealing with a similar problem of poor information at the time of the debt crisis; especially the IFIs (along with the OECD, UN agencies, the Commonwealth Secretariat, the South Centre and others).

In connection with item (i) above, one possibility might be to make more transparent, and publish immediately, the outcome of IMF Article IV consultations and have the IMF (or the multilateral development banks) come out with pithy annual or semi-annual economic reports on significant emerging markets, equivalent to those published by the OECD on its member economies. Such reports need to be presented in a manner which markets can understand and digest. At present the IFIs gather a large amount of data in developing countries which rarely enters the public domain although the reasons for it to remain confidential and private are becoming less valid by the day. In the interests of the better functioning of financial markets these established conventions of confidentiality and secrecy between national governments and IFIs now need to be reviewed and overhauled to meet the needs of a globalised financial world.

Efforts to improve information flows will need to involve global wire agencies such as Dow Jones, Reuters and Bloomberg, as well as information-based rating and index agencies (S & P and Moody's). It will need to skip several generations of technology. Most emerging markets and their governments will need to leap into the electronic age to cope with the task that confronts them. That, in turn, will require major investments in local, national and global (fail-safe) power and telecommunications infrastructure dedicated to supporting financial markets. How critical this aspect is was recently demonstrated when a satellite supporting the V-SAT electronic trading on India's National Stock Exchange failed. There was no back-up to which the system could immediately be transferred. Trading was interrupted for 10 days resulting in a trading loss of around $2 billion and a financial loss to the securities industry estimated at about $150 million (or the cost of several equivalent satellites).

Apart from overall 'broad' economic and market information needed to support analysis, position-taking or risk-hedging assessments by market players, there is an even greater need for accurate, frequent, regular and timely financial and operating micro-information on corporates and security issuers. Accounting and disclosure standards in most emerging markets remain abysmally low – a condition for which there can no longer be any legitimate excuse. These need to be upgraded swiftly through positive and negative incentives applied by: national authorities, exchanges which allow listings, as well as at the international level by regulators and IFIs; especially those involved in financial sector reform. Global and national legal and accounting firms need to be brought into such an enterprise as equal partners on a basis which impels issuers of traded financial securities (whether governments, quasi-sovereigns or private corporates) to provide more useful and accurate information as a matter of course with creative accounting veils being penetrated immediately.

Though mundane, the task of improving present standards of information in emerging as well as developed markets is crucial. It requires urgent attention with the mobilisation of efforts from a wide range of sources under the aegis of the appropriate authorities. Yet, its importance is invariably overlooked until markets fail and authorities overreact. Financial markets are information sensitive and particularly vulnerable to failure when information is imperfect or opaque. Markets and prices become volatile and vulnerable when rumours (often deliberately floated in emerging markets by unscrupulous intermediaries) dominate perceptions. Markets also fail when there are major asymmetries between information available to issuers and market intermediaries vis-à-vis information available to regulators, investors and the public, or when essential information is absent or

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late, leaving markets to speculate on the intentions of governments or central banks. For these reasons, authorities at every level of governance, can ill-afford to be negligent on this score.

4. *Financial Market Regulation in a Globally Integrated Regime*

As is generally recognised, regulation remains comparatively weak in most emerging markets. Indeed, even in developed markets, regulators strive (usually in vain) to keep abreast of market developments. Market players thus have a permanent edge technologically, and in terms of instrument and trading knowledge, over regulators. They are invariably ahead of them except when markets fail due to their own excesses; at that point retroactive pleas for improved regulation emerge from the industry itself.

The need has long been recognised for: (a) improved regulation in emerging markets at macro, meso and micro-levels; (b) more attention by regulators in source countries to portfolio flows from institutional asset managers into emerging markets; and (c) improved interaction and regular communication between regulators in source and recipient countries. Happily, action is being taken on all three fronts although there is, of course, much more that could be done by authorities at national, regional and global levels.

Regulatory institution and capacity building in emerging markets is an urgent task that needs to be supported by private agents as well as bilateral donors in developed markets and IFIs which could underwrite: (a) more regulator-to-regulator exchange programmes; (b) enhanced training inputs into regulatory training institutes established specifically for emerging market regulators at the *regional* level to achieve both economies of scale as well as closer bonding between neighbouring regulators; (c) information and experience sharing; and (d) exchange-to-exchange programmes involving the training of surveillance staff to improve self-regulation within exchanges. Also, the compliance function within brokerages in emerging markets is hardly developed at all with most securities firms in such markets being more accustomed to a non-compliance culture. It is usually the case that regulatory agencies in emerging markets issue edicts, rules, regulations and clarifications faster than they can enforce or the securities industry can absorb. That usually results in significantly increased violations which go unchecked because market operators anticipate under-enforcement due to lack of regulatory capacity. That, in turn, reinforces an ethos of 'violation tolerance' in emerging market regulation which, when embedded, becomes extremely difficult to reverse.

Although a specific and detailed agenda for improvements in the regulatory arena is not for a paper such as this to develop, the broader issue

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needs to be highlighted at all tiers of financial system governance. Specifically, as the author has urged on various occasions, there is a role for organisations such as the Commonwealth Secretariat, the South Centre, regional organisations and development banks, as well as securities exchanges in developed markets, to play in improving financial market regulatory capacity (both official and intra-market) and intermediary compliance capacity on a programmed basis. The initial costs of such capacity building may need to be subvened from sources of official support; but these could easily be recovered in the medium term from levies on markets and market players to make continual investment in improved regulatory capacity a financially self-sustaining enterprise.

Well-developed, specific programmes for improving financial market regulation on a time-bound basis, like information enhancement, should be an intrinsic part of the package of conditionality which accompanies loans or facilities extended by the IFIs and regional development banks for financial sector reform. Such programmes need to be particularly carefully constructed when it comes to enhancing regulatory and supervision capacity over derivatives markets in developing countries which, at the present time is almost non-existent.

In that context, the time has come (if it is not overdue) for the world at large to follow the UK's model of creating a single financial services regulatory authority under one roof with permeable internal walls. Instead, at present, financial regulation in most countries is fragmented across several agencies: i.e. central banks for banking systems; securities and exchange commissions or boards for capital markets, and separate organisations for regulating long-term contractual savings, insurance, and non-bank financial intermediaries.

The current model of fragmented regulation, has its roots in the history of financial market evolution. But it has long outlived its usefulness. It leads to key issues falling between the cracks because no agency is regulating a particular activity, or results in unending turf battles between different regulators; accompanied by confusion caused by conflicting edicts from different regulators. Certainly supranational regulation and regulatory coordination is likely to be enhanced immeasurably if the single institutional model were to be separated from the implementation of monetary policy, and more widely adopted for regulating the financial services industry. A degree of global standardisation could be built into the functions, organisations and activities of such independent free-standing regulatory agencies. That core issue should be placed high on the agenda of IFIs involved in reforming financial systems in emerging markets. It needs to be equally high on the agenda of developed countries as well.

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5. *Official Intervention in Financial Markets*

That residual official intervention capacity needs to be built into financial markets (especially debt markets and forex markets) to safeguard the integrity of financial systems goes without saying. It is an unarguable proposition that central banks need to have intervention capacity, along with the resources necessary, to intervene in disorderly markets and stabilise prices before volatility results in a collapse of public confidence and a public crisis ensues. That is fine as long as policies are correct, fundamentals are sound and intervention is essential as a corrective device to prevent market overreactions affecting adversely the stability of interest rate and exchange rate policy.

Some authorities in emerging markets have taken this further by having public contractual savings institutions (such as publicly owned unit trusts or life insurance companies or government monopoly pension funds) intervene in *equity* markets as well. Intervention of this type, and the need for it, is debatable. It is usually resorted to when governments feel it necessary to override market signals about overvaluation which are usually proven right even if the market has a tendency to discount values far in advance. Experience suggests that such intervention is generally unsound. Rather than stabilising markets, it can have the opposite effect if the buying and selling behaviour of public institutions is misread by market players or taken as an opportunity to unload stock on public agencies when their liquidity – which is dependent on voluntary savings flows and small investor preferences for risk-reward mixes which change continually – may be running dry. In such situations a market collapse is deferred, not avoided. When public institutions try to readjust their portfolios by selling stock they have bought to stabilise markets they usually discover, in unsettled market conditions, that there are no private buyers left in the market.

Although individual cases may differ, broad experience in developing countries suggests that governments would be better off professionalising and privatising public pension funds, insurance companies and unit trusts and opening entry to foreign players in these areas of financial activity and asset management, so that a real market involving a large number of independent players emerges. There is a clear role for IFIs, developed country governments, and global financial institutions in accelerating such a transition in a frictionless manner. The operations of large public institutions in equity and other asset markets (like property) are usually prone to large-scale failures of administrative judgements which have a highly concentrated effect, no different to the effects when a number of private players indulge in herd-instinct behaviour, but often more aggravated.

Though intervention in debt and currency markets may be more accept-

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able and justifiable to a wide spectrum of opinion (although some market economists would argue that such interventions are counterproductive and inefficient) such intervention has implications for the management of domestic monetary policy which need to be taken into account; especially when intervening agencies and the markets in which they operate lack the instrumentation, capacity and experience for sterilisation or post-crisis correction. Also, for intervention to be credible it has to be backstopped by: (a) soundness of fundamental macroeconomic policy and sustainable macrobalances in internal and external accounts; and (b) a sufficiency of resources for markets to perceive clearly that intervention will be effective. There is much for economic managers in emerging markets to learn about intervention in open markets and about the relatively greater efficacy of intervention when leaning in the direction of the market rather than against it. The IFIs and developed country central banks have a crucial role to play in transferring such knowledge effectively and keeping it updated. At the extreme they can even participate in such interventions either on a case-by-case or on a wider transparent rule-driven basis.

The Role of International Reserves

In that context, there needs to be a fundamental re-appraisal of the role of reserves in a financially globalised world of open capital accounts to overturn traditional thinking about the role of reserves in the context of closed capital accounts and persistent trade or current account deficits. In a globalised financial world with open capital accounts, the holding of reserves to provide credible liquidity for financing a required level of imports over a conscionable period of time becomes almost a meaningless notion, at least for countries with sufficient creditworthiness. Thus the reporting of reserves in terms of months-of-imports is slowly becoming an irrelevant indicator for IFIs to highlight. In the world of the future, most countries (other than the destitute) will not need to hold reserves to finance imports. Reserves will be needed instead to maintain the credibility of open capital accounts and the stability of financial systems; particularly the stability of monetary policies as reflected in interest, inflation and exchange rates. The case for holding commensurate reserves will be even stronger in those systems which: (a) have attracted large volumes of foreign flows, especially portfolio flows, which are liquid, volatile and footloose in nature; and (b) depend on the residency of such flows for the stability and liquidity of their financial markets, and by implication, of their fiscal and monetary policies. In such a world, reserves take on an entirely new and different meaning. They have to be sufficiently large, in proportion to stocks of volatile portfolio capital, to prevent market perceptions of vulnerability to sudden and large outflows of capital for whatever reason.

At the same time, reserves will only impress markets if the credibility of economic governance and policy management is such as to assure players that reserves will be used intelligently when necessary; and usually in a prophylactic manner. That was patently not the case in either Mexico or Thailand although it was more the case in Malaysia and Hong Kong. Moreover, reserves can most effectively be used for intervention in tandem with a number of other liquidity-influencing measures to bolster domestic systems against purely speculative attacks (i.e. attacks which are not inspired by fundamental misalignments in economic policies or asset values and prices in financial and property markets).

But, in a world of open capital accounts, the holding of sufficient reserves is not a costless exercise for most developing countries. When the reserves held are not earned (i.e. the outcome of cumulative trade surpluses over a number of years) but borrowed, they can become an albatross, especially if active reserves management results in a negative spread for the central bank concerned. Even when they are earned, holding reserves usually has high opportunity costs in terms of foregone investment and development alternatives. Also, in the case of most small countries, other than the trading dynamos like Singapore, Hong Kong or Taiwan, the amount of reserves that can reasonably be mustered and held are unlikely to be sufficient on their own to withstand speculative attacks on a collusive basis by large hedge funds or by a group of forex or derivatives traders in global transnationals acting in concert.

Therefore, there is a strong case for instantaneous reserves augmentation for intervention purposes. There is a *prima facie* case for such augmentation first, at the sub-regional or regional level (similar to current arrangements available to members under the ERM in the EU) and then, at the global level. Such arrangements could be in the form of bilateral support arrangements between neighbouring central banks or, at the other extreme, contractually binding plurilateral or multilateral arrangements which automatically trigger mutual reinforcement by pooling reserves to intervene on behalf of a member country under a binding regional monetary arrangement. Studies are already underway in various regions of the world (with Asia being at the forefront) to explore whether such arrangements can be constructed and implemented in a feasible and cost-efficient manner.

These debates are likely to unleash the usual sterile arguments about the efficacy of regional arrangements vs. global facilities. Hopefully such diversions will be put to bed quickly since reason seems to: (a) suggest the need for both; and (b) support the legitimacy of regional intervention – if only because contagion should be arrested in the immediate neighbourhood

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before it is permitted to spread. At whatever level these arrangements come into effect there is a need to consider new ideas – which may be anathema to the usual opponents of liquidity creation for any purpose whatsoever – such as the possibility of temporary liquidity creation to withstand speculative attacks if pooled intervention reserves are insufficient, accompanied by associated arrangements to withdraw liquidity when stability has been restored.

The notion that liquidity creation always has a ratchet effect, which results in its prompt withdrawal being nearly impossible, needs to be challenged (in theory and practice) with new arrangements being designed to make liquidity withdrawal as feasible and as easy as liquidity creation in a globalised financial world. Such an approach would certainly lessen the costs to individual countries, and to the world at large, of being compelled to hold a much higher level of reserves than is either necessary or desirable to maintain the credibility of universally open capital accounts, simply to provide insurance against the vagaries and occasional failures of a globalised financial system which is likely to evolve and behave in ways which are as yet impossible to predict and might be difficult to contain. Such a concept might actually be designed on the principles of insurance, or of tailored options contracts (involving a "market" in which all central banks participate) with associated premia, which are triggered under certain circumstances in a specific way for a specific purpose.

But in creating such facilities the problems of moral hazard and of exercising administrative judgements to intervene prophylactically in real time need to be recognised. Arrangements like these, if devised, will need to be accompanied by strict, continuous, and more frequent (than IMF Article IV) surveillance and monitoring arrangements which are applied to economic management and to surveillance of financial market behaviour. Intervention can only be justified to fend off attacks on markets and currencies which represent fits of frenzy or when market perceptions and sentiments are misaligned with underlying fundamentals. In theory, the latter phenomenon should be rare if markets are operating with adequate information. It would be difficult to justify intervention in the case of legitimate attempts by markets to correct imbalances which governments are unwilling to rectify through timely policy adjustments and mid-course corrections. But, in practice, it is difficult to differentiate between a 'speculative attack' and a 'corrective adjustment'. What is happening in Asia at present, does have its roots in policy fundamentals being out of kilter although not by as much as market movements suggest. It may also reflect a sentiment on the part of markets that creeping hubris in Asian governments, convinced about their miraculous powers, is approaching intolerable levels representing a danger to markets and to their own economies.

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6. *Emerging Market Mechanics and Architecture*

As with information inadequacies and regulatory lacunae, financial authorities at all levels need to focus urgently on improving 'market mechanics and market architecture' in emerging markets to bring it up to the standards which apply internationally. In contrast to experience with banking systems, it is surprising to discover that most policymakers – whether at the national, regional or international levels – possess very little practical knowledge of the mechanical intricacies or functioning of securities exchanges (whether equity, bond, forex or derivatives) and markets. Unfortunately, where non-banking financial markets are concerned, the devil is usually in the detail. Regulators who have never actually operated in such markets tend not to understand how they actually work, at which nodes they are vulnerable to abuse, and how markets are likely to be affected by regulatory changes.

Most emerging markets have fundamental weaknesses when it comes to the four main pillars of market architecture; and all of these affect market probity and efficiency: (a) the structure, operations and governance of different types of securities exchanges themselves; (b) the structure and operating characteristics of the securities industry comprising the key market players, i.e. investment banks and, more particularly, securities brokerages; (c) the clearing, settlement and transfer mechanisms employed by the exchanges; and (d) the custodial and registration institutions and mechanisms. A major effort needs to be made by authorities at all levels to address problems in all four areas, problems which are usually exacerbated by environments which are still in the paper age and not yet in the electronic age.

Stock exchanges in emerging markets are generally antediluvian in terms of their technology, operating practices and reluctance to adapt and transform to meet international standards; especially when they are dominated by domestic broker members. Exchanges which are independently run corporations, providing trading platforms for the brokerage community to use on a subscription basis, are usually more professionally managed and more likely to keep abreast of state-of-the-art developments in technology and customer service orientation. Broker-dominated exchanges tend to put the interests of brokers above those of other market participants, in particular small individual investors.

There is an urgent need to transform the functioning of exchanges in emerging markets and to move toward self-regulating, independent (i.e. not broker-dominated) multi-market exchanges which provide trading for equities, debt instruments, forex, and derivatives under one overarching structure rather than segmented exchanges which deal in only one type of

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security. Such exchanges are more likely to emphasise internal surveillance over brokers and floor traders, work closely with regulators thus making the regulatory task much easier, keep up with international developments in standards of disclosure and in technological upgrading, link up with other international exchanges, and balance the interests of issuers, intermediaries and investors in their operations. All exchanges should be encouraged to move to electronic trading platforms and be provided with finance on appropriate terms to make this transition.

National authorities, working together with the IFIs (particularly the World Bank, IFC and regional development banks (RDBs)) need to emphasise securities exchange reform and transformation at least as much as banking system reform and bank restructuring, through loans and programmes designed specifically for this purpose; either as free-standing operations or as an integral part of financial sector adjustment lending operations. Regrettably, none of the IFIs nor RDBs have developed any internal expertise worthy of respect on securities exchange operations despite the obvious priority which developing such in-house expertise should have had over the last five years. Failure to develop such expertise reflects poorly on the lack of knowledge and absence of initiative on the part of the leaderships of the private sector and financial sector units of these institutions.

To rectify this shortcoming, the RDBs should develop cooperative partnerships with a number of major exchanges with strong internal institution-building capacity (such as those in New York, Philadelphia, London, Chicago, Singapore, Hong Kong, Amsterdam, Toronto and Montreal) under a wide-ranging special programme to upgrade and reform securities exchanges in emerging markets (at least the 11 major ones) and bring them up to international operating standards within the next five years. The financial sector departments of the MDBs should be innovative in designing and funding such partnerships to overcome their own lack of internal capacity to handle this particular area. Absence of progress by exchanges to meet international operating standards within a reasonable period of time should result in their disqualification from handling secondary market trade transactions involving international portfolio investments.

By the same token, the securities brokerage industry in almost all emerging markets needs to be transformed within the next five years to ensure that brokerage firms operating in emerging markets meet minimum qualifying requirements which would assure that they are: (i) adequately capitalised; (ii) have access to institutional liquidity against their own holdings of stock, especially at times of market tightness; (iii) are professionally competent in dealing with issuers and investors; (iv) employ international ethical standards; (v) have strong internal compliance departments and

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procedures; (vi) professionally managed by qualified and properly trained specialists. All brokers should be required to undergo a period of training and apprenticeship experience before being licensed to trade or deal directly with customers and should receive special training in dealing with international clients. Professional broker associations which employ a measure of self-regulation to maintain professional standards need to be encouraged and supported.

In coping with the rapid evolution of the global brokerage industry, emerging markets need to pay more attention to the role of foreign brokerage firms and their impact on the domestic structure of the industry. The mistakes that emerging markets like India have made (through a combination of official ignorance and negligence) in destroying the market position of domestic brokerages and creating a two-tier system which discriminates against domestic individual investors in quality of service should not be repeated. Instead, local brokerages need to be provided with a level playing field and be given sufficient lead time for restructuring to meet international competition through acquisitions, mergers and recapitalisation.

The costs of not doing so are glaringly obvious in the Indian case. There the secondary market has now shrunk with 90% of secondary trading concentrated in about 30 stocks (out of 8,000) which are preferred by foreign investors because of the large market capitalisation of the companies involved and the liquidity of the scrip. Trading in the shares of competitive medium-sized companies has virtually disappeared with the result that they are now being denied access to capital on primary markets because their stocks have little appeal to foreign investors who now dominate market sentiment. The small domestic investor, who was the bulwark of investment in Indian equities between 1985-1994, has virtually disappeared from the marketplace, both because of the unforeseen consequences of foreign entry in changing the industry's market structure, as well as the malfeasance and malpractices of a small number of brokers, investment banks and unscrupulous issuers.

In the meantime, most small domestic brokerages which used to make markets in mid-cap stocks have become illiquid, unable to trade the stocks which they hold in such companies. The result has been a capital market which has become dysfunctional in meeting the needs of the real economy. Yet, no action has been taken by the authorities or by the IFIs involved in financial system reform to rectify the situation with appropriate responses when intelligent and timely intervention could have prevented the outcome. Instead the authorities have chosen to rely on jawboning public investment institutions to behave in one way or another to prop up the market and prevent a total collapse. Such experiences are not unique to

India. They have occurred at some time or another in almost all emerging markets and were characteristic of many developed markets *circa* 1920. What is incomprehensible is that such events are still tolerated by national authorities and the international community at the threshold of the 21st century in a world that is supposed to be financially globalised.

Emerging markets have also been slow in responding to the demands of the international marketplace for introducing more efficient and responsive clearing, settlement and security transfer procedures and mechanisms (i.e. transferring, registering and recording the transfer of a financial security from one owner to another upon its sale and purchase). Too many emerging markets remain characterised by a paper-driven regime in which the ownership of securities is manifested by the personal possession of a physical certificate. Transfer of ownership is not effectuated or recorded until a physical transfer actually takes place. In developed markets, there is no longer any physical transfer involved with most securities being dematerialised and immobilised by being kept on electronic registers in centralised depositories. Any change of ownership resulting from trades is recorded through electronic book entry, registration and transfer by custodians and registrars with most investors being content with proof of ownership via brokers' confirmations and receipts of buy-sell transactions, along with their portfolio positions being recorded in monthly statements.

The log-jams created by continued reliance on the physical movement of vast quantities of paper in securities markets have become almost unimaginable in their effect on constipating exchanges and brokers' back-offices when market volumes are high. So are the possibilities for a variety of malpractices which emerge by way of bad deliveries, forged signatures on transfer forms, the circulation of easily forged share and bond certificates, delayed settlement to individual customers while brokers use customers' share certificates to trade on their own account, or for repo transactions, and so on. All of these market malfunctions can be avoided by having emerging market players leap-frog into the electronic age and by taking steps to create a dematerialised environment.

This, of course, is easier said than done in environments where investors have virtually no faith in the ethics of brokers and where brokers' receipts would not easily be accepted as satisfactory proof of ownership. Nor are most brokers capitalised sufficiently to instil confidence. And telecommunications infrastructure in most emerging markets is not sufficiently well-developed to support such changes. Major architectural changes therefore need to be made in overall market infrastructure in a properly sequenced fashion taking local circumstances into account over a pre-determined period of time. Such changes need to be adequately designed and properly financed both in terms of changes in large-platform architecture where

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securities exchanges, custodians and depositories are concerned, and at the level of individual brokerages which need long-term financing (as well as additional capital) to make the necessary investments in new systems, hardware-software packages, qualified people with entirely different talents, and new accounting, control and compliance systems.

Similar transformations are needed in market-supporting mechanisms and institutions such as clearing, settlement and payment systems (which require dovetailing with commercial banks) as well as in the reformation of custodians, registrars and depositories; all of which involve their own complexities. Transformations are also required in the secretarial departments of corporates issuing securities which need to make matching investments in electronic systems to keep their own shareholder registers up to date. Taken together these measures require revolutionary transformations in the way in which the securities industry presently functions in emerging markets.

Financial system reform involves more than policy change and wishful thinking; the practical details cannot be left ignored or left to the domestic brokerage industry to sort out. That approach rarely works and often backfires. Transforming the architecture and functioning of capital markets and brokerages is a major national undertaking which requires an unusual degree of planning, the formulation of a clear strategy and the proper sequencing of tactics. It entails an extraordinary effort at public-private cooperation and participation, and a high level of committed external support from the IFIs as well as from exchanges and brokerages in developed markets. While the importance of such ingredients is recognised in programmes for reforming banking systems in developing countries, they are not as evident in reforming capital markets. In the larger emerging markets, both need to be tackled simultaneously.

7. *Interaction Across Tiers of Governance in a Globalised Financial World*

The last of the selected issues or challenges which this paper chooses to deal with concerns the obvious necessity for interaction across the three principal tiers of financial system governance: national, regional and global. Much has already been alluded to in the foregoing sections of the paper which underlines the need for such interaction. Yet, though the need for it may be obvious, it is not clear that the issue is being addressed at all except perhaps in the case of case-by-case interaction among regulatory agencies.

What is clear from experience thus far is that interaction at all three tiers needs to be widened and deepened at every level: i.e. at the level of: (i)

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apex economic policymaking institutions and personages, i.e. ministries of finance and central banks; (ii) regulatory agencies, in particular central bank supervisors and securities and exchange commissions; (iii) securities exchanges themselves and especially their surveillance and monitoring departments; (iv) the brokerage community; (v) the asset management industry; and (vi) investor protection bodies.

Such interaction needs to be well organised and needs to take place on a regular, and not just on a crisis-management, basis by way of: (a) regular professional exchanges through conferences, symposia and industry conventions and associations; (b) training and professional development programmes for all agencies involved in capital markets which permit wide interaction, exchange of information and experience sharing; and (c) specific institutional arrangements for coordination and cooperation at national, regional and global levels which requires cooperation on certain issues of mutual concern. Such interaction is not just a matter for policy-makers or officials. It is perhaps even more important for the senior managements and boards of private financial institutions whose staff and organisations operate at the front line of the investment community. In developed markets such interaction occurs so frequently that it is no longer worthy of specific note. But for emerging markets that is not the case.

To fill the gap that exists, there is a special role to be played by regional organisations as well as by unique organisations such as the Commonwealth and the South Centre – in addition to the roles that the IFIs and RDBs should be playing but are not, or at least not to the extent that the occasion demands. A clear and crisp programme of needed interactions could easily be developed but it would prove to be valueless, simply because once the process is kick-started, an internal dynamic will take over which would govern the intensity and direction of voluntary interaction thereafter. The role that needs to be played in fostering interaction is a catalytic one but one which no global institution has contemplated playing seriously as yet.

V Conclusions and Recommendations

In going through its various sections, the paper has reached its own conclusions and made several recommendations of a generic kind. The more important among these are pulled together and reiterated below for convenience:

- National governments, independent regulatory agencies, private accounting and legal firms, and international financial institutions

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(regional and global) need to cooperate on an unprecedented scale in order to accelerate orderly financial market development and put in place adequate safety nets to cope with accidents that will occur even as efforts are made to prevent them.

- Although private financial market operations (and therefore private capital flows) have now spread to parts of the world which they did not reach before, there remains a long road to travel before private capital can flow through efficient market mechanisms with equal facility everywhere and before all countries can be served by financial markets in the same way.

- Small ACP countries will need to accept the reality that *regional* capital and banking markets will fulfil their needs and purposes better, more efficiently and more cost-effectively than national markets can. It would be timely for: (i) such countries; (ii) the regional organisations to which they belong; and (iii) the international financial community – especially the EU and the Commonwealth which both have special links with the small ACP states – to come to early understandings on the need to develop regional financial markets before the tendency to "go it alone" results in a waste and duplication of scarce financial, technological and human resources.

- Equally there is a need to rationalise excessively fragmented local markets in large countries such as, for example, India.

- Financial markets are information sensitive and vulnerable to failure when information is imperfect or opaque. Markets and prices become volatile and vulnerable when rumours dominate perceptions. Markets also fail when there are asymmetries between information available to issuers and market intermediaries vis-à-vis information available to regulators, investors and the public, or when essential information is absent or late leaving markets to speculate on the intentions of governments or central banks.

- The progress made – in reducing information imperfections – has fallen far short of expectations. A major effort needs to be made involving the IFIs (along with the OECD, UN agencies, the Commonwealth Secretariat, the South Centre and others) on improving the quality, frequency and timeliness of broad economic information at all levels in emerging markets.
- One possibility which might be considered is to make more transparent

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and publish immediately the outcome of IMF Article IV consultations and have the IMF (or the MDBs) publish pithy annual or semi-annual economic reports on significant emerging markets, equivalent to those published by the OECD on its member economies.

- Apart from overall broad economic and market information needed to support analysis, position-taking or risk-hedging assessments by market players, there is also a need for accurate, regular and timely financial and operating micro-information on corporates and security issuers.

- Regulatory capacity building in emerging markets is an urgent task that needs to be supported by private agents as well as donors in developed markets. There is a role for organisations such as the Commonwealth Secretariat, the South Centre, regional secretariats and regional development banks, as well as securities exchanges in developed markets, to play in improving regulatory capacity (both official and intra-market) and intermediary compliance capacity on a programmed basis.

- Emerging markets should contemplate creating a single financial services regulatory authority under one roof with permeable internal walls (following the UK model). That should also be placed on the agenda of IFIs involved in reforming financial systems in emerging markets.

- The experience of developing countries suggests that governments would be better off professionalising and privatising *public* pension funds, insurance companies and unit trusts and opening entry to foreign players in these areas of financial activity and asset management, so that a real market involving a large number of independent players emerges. There is a clear role for IFIs, developed country governments, and global financial institutions in accelerating such a transition in a frictionless manner.

- There is much for economic managers in emerging markets to learn about intervention in open markets. The IFIs and developed country central banks have a crucial role to play in transferring such knowledge effectively and keeping it updated. They can participate in such interventions either on a case-by-case or on a wider transparent rule-driven basis.

- In a globalised financial world with open capital accounts, the holding

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of reserves to provide credible liquidity for financing a required level of imports over a conscionable period of time becomes a meaningless notion, at least for countries with sufficient creditworthiness. Reserves are needed instead to maintain the credibility of open capital accounts and the stability of financial systems; particularly the stability of monetary policies as reflected in interest, inflation and exchange rates.

- There is a strong case for instantaneous reserves augmentation for intervention purposes. There is a *prima facie* case for such augmentation first, at the sub-regional or regional level (similar to current arrangements available to members under the ERM in the EU) and then, at the global level. In that connection new ideas need to be explored; e.g. the possibility of temporary liquidity creation to withstand speculative attacks if intervention reserves are insufficient, accompanied by arrangements to withdraw liquidity when stability has been restored.

- Financial authorities at all levels need to focus on improving "market mechanics and market architecture" in emerging markets to bring these up to the standards which apply in international markets. Exchanges should move toward becoming self-regulating, independent (i.e. not broker-dominated) multi-market exchanges which provide trading for equities, debt instruments, forex, and derivatives under one overarching structure.

- All exchanges in major emerging markets should adopt electronic trading platforms and be financed on appropriate terms to make this transition.

- National authorities, working together with the IFIs (particularly the World Bank, IFC and regional MDBs) need to emphasise securities exchange reform and transformation at least as much as banking system reform and bank restructuring, through sector adjustment loans and programmes designed specifically for this purpose.

- Under a wide-ranging, special 'emerging markets accelerated development programme' the MDBs should: (i) develop partnerships with major exchanges in developed markets, to upgrade and reform securities exchanges; (ii) transform the securities brokerage industry to ensure that brokerage firms operating in emerging markets meet minimum qualifying requirements; (iii) introduce more efficient and responsive clearing, settlement and security transfer mechanisms with a shift to electronic trading, book-entry and registry and revamped custodial, registrar and depository services.

- The architectural changes that need to be made in overall market infrastructure must be implemented in a properly sequenced fashion, and take local circumstances into account over a pre-determined period of time. Such changes need to be adequately designed and properly financed.

- Interaction among the three tiers of financial system governance – national, regional and global – needs to be widened and deepened. Such interaction needs to be well organised and take place on a regular, not just a crisis-management, basis.

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Table 1 Private Capital Flows to Emerging Markets
(in billions of dollars)

	1990	1991	1992	1993	1994	1995	1996
Total Private Flows to Emerging Markets	44.4	56.9	90.6	157.1	161.3	184.2	243.8
of which:							
Foreign Direct Investment	24.5	33.5	43.6	67.2	83.7	95.5	109.5
Foreign Portfolio Investment	5.5	17.3	20.9	80.9	62.0	60.6	91.8
of which: Bonds:	*2.3*	*10.1*	*9.9*	*35.9*	*29.3*	*28.5*	*46.1*
Equity:	*3.2*	7.2	*11.0*	*45.0*	*32.7*	*32.1*	*45.7*
Memo: Net Issues of International Debt				150.7	285.7	313.2	n.a
of which: OECD Countries				85.2	232.3	261.8	n.a
Developing Countries				65.5	53.4	51.4	n.a
Commercial Bank Loans:	3.0	2.8	12.5	-0.3	11.0	26.5	34.2
Other Flows	11.3	3.3	13.5	9.2	4.6	1.7	8.3

Source: World Bank, *Global Development Finance, 1997*, and IMF, *International Capital Markets*, September 1996.

Table 2 Cross-Border Transactions in Bonds and Equities for G-7 Countries
(as percentage of GDP)

	1985	1990	1995	1996
United States	35.1	89.0	135.3	151.5
Japan	63.0	120.0	65.1	82.8
Germany	33.4	57.3	169.4	196.8
France	21.4	53.6	179.6	229.2
Italy	4.0	26.6	252.8	435.4
Britain	367.5	690.1	950.0*	1,350.0*
Canada	26.7	64.4	194.5	234.8

* personal estimate.
Source: IMF, *World Economic Outlook*, May 1997.

Table 3 Foreign Exchange Markets
(in billions of dollars and percentages)

	1986	1989	1992	1995
Estimated Daily Global Turnover	188	590	820	1,190
of which percentage traded in:				
London	n.a.	26.0	27.0	30.0
New York	n.a.	16.0	16.0	16.0
Tokyo	n.a.	15.0	11.0	10.0
Singapore	n.a.	8.0	7.0	7.0
Hong Kong	n.a.	7.0	6.0	6.0
Zurich	n.a.	8.0	6.0	5.0
All Other Markets	n.a.	20.0	27.0	26.0
Global Forex Trading				
Turnover as percentage of:				
World Exports of Goods and Services	7.4	15.8	17.4	19.1
Total Global Reserves (minus gold)	36.7	75.9	86.0	84.3

n.a.: not available
Source: IMF, *World Economic Outlook*, May 1997.

Table 4 Markets for Derivatives (Principal Outstanding on Unclosed Contracts)
(in billions of dollars)

	1986	1989	1992	1995
Interest Rate Futures	370.0	1,200.8	2,913.0	5,863.3
Interest Rate Options	146.5	387.9	1,385.4	2,741.6
Interest Rate Swaps	511.0	1,502.6	3,850.8	12,810.7
Currency Futures	10.2	16.0	26.5	37.9
Currency Options	39.2	50.2	71.1	43.2
Currency Swaps	280.0	898.2	1,720.7	2,394.8
Equity Index Futures	14.5	41.3	79.8	172.2
Equity Index Options	37.8	70.7	158.6	326.9
Total Principal Outstanding on Swaps	791.0	2,400.8	5,571.5	15,205.5
Total Principal Outs. on Futures/ Options	618.3	1,766.9	4,634.4	9,185.3
of which outstanding in:				
North America	518.1	1,155.8	2,694.7	4,847.2
Europe	13.1	251.0	1,114.3	2,241.3
Japan-Asia-Pacific	87.0	360.0	823.5	1,990.1
Other Regions	–	0.1	1.8	106.7

Source: IMF, *International Capital Markets*, September 1996.

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Table 5 Annual Turnover in Organised Derivatives Markets
(millions of contracts)

	1986	1989	1992	1995
Interest Rate Futures	91.0	201.0	330.1	561.0
Interest Rate Options	22.3	39.5	64.8	225.5
Currency Futures	19.9	28.2	31.3	98.3
Currency Options	13.0	20.7	23.4	23.2
Equity Index Futures	28.4	30.1	52.0	114.8
Equity Index Options	140.4	101.7	133.9	187.3
Total Derivatives Contracts Traded	315.0	421.2	635.6	1,210.1
of which traded in:				
North America	288.7	287.9	341.4	455.0
Europe	10.3	64.4	185.0	353.3
Japan-Asia-Pacific	14.4	63.6	82.8	126.5
Other Regions	1.6	5.3	26.3	275.4

Table 6 The Global Syndicated Commercial Bank Loan Market
(in billions of dollars)

	1992	1993	1994	1995
All Countries	221.4	220.9	252.0	320.2
Industrial Countries	165.2	168.3	199.4	251.6
Emerging Markets	48.2	41.6	38.2	50.9
Offshore Financial Centres	6.1	9.8	14.3	17.4

Table 7 Secondary Market Transactions in Emerging Market Debt
(in billions of dollars)

		1993	1994	1995
Total Annual Debt Trading Turnover		1,978.9	2,766.2	2,738.8
of which:	Africa	79.8	111.4	109.2
	Asia	18.2	24.7	31.1
	Latin America /Caribbean	1,621.6	2,259.3	2,284.2
	Eastern Europe/Other	154.8	198.5	n.a
by instrument:	Loans	273.6	244.4	175.3
	Brady Bonds	1,021.3	1,684.0	1,580.3
	Corporate and Sovereign Bonds	176.6	164.9	232.8
	Local Currency Bonds	361.9	518.9	572.4
	Options and Warrants on Bonds	57.4	142.4	178.0
	Unspecified Securities	–	11.6	–

Source: IMF, *International Capital Markets*, September 1996.

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Table 8 Net Assets of International Emerging Market Equity Funds Floated
(in billions of dollars)

	1992	1993	1994	1995
Total Emerging Market Funds	29.63	72.79	109.03	108.82
of which: Global Funds	7.75	24.75	34.72	36.00
Asia Region Funds	8.00	21.50	32.66	34.80
Asia Country Funds	8.45	16.33	22.67	22.07
LAC Region Funds	2.00	5.20	10.92	8.50
LAC Country Funds	2.67	3.87	5.62	4.31
Europe (R+C)	0.74	1.09	2.00	2.54
Africa (R+C)	0.02	0.05	0.44	0.60

Source: IMF, *International Capital Markets,* September 1996.

Table 9 Market Capitalisation and Value Traded in World Equity Markets
(in billions of dollars)

	1987	1990	1993	1996
World Market Capitalisation	7,831.82	9,399.36	13,963.34	20,177.66
of which: Developed Markets	7,499.07	8,784.77	12,326.26	17,951.71
of which: USA	2,588.89	3,059.43	5,136.20	8,484.43
Japan	2,802.95	2,917.68	2,999.76	3,088.85
Britain	680.72	848.87	1,151.65	1,740.25
Other Markets	1,426.51	1,958.79	3,038.65	4,638.18
Emerging Markets	331.75	614.59	1,637.08	2,225.96
World Value Traded	**5,846.86**	**5,514.05**	**7,190.05**	**13,597.88**
of which: Developed Markets	5,677.32	4,614.01	6,090.90	12,011.06
of which: USA	2,423.07	1,751.25	3,354.96	7,121.49
Japan	2,047.22	1,602.39	954.34	1,252.00
Britain	389.83	278.74	423.53	578.47
Other Markets	817.20	981.63	1,358.07	3,059.10
Emerging Markets	169.55	900.05	1,099.15	1,586.82

Source: IFC, *Emerging Stock Markets Factbook,* 1997

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Table 10 Shares of World Output
(in billions of dollars and percentages)

		1980	1994	1995	1996
World GDP	Market	10,768.09	25,677.21	27,846.24	29,935.00
	PPP*	12,028.47	31,271.00	33,153.00	35,113.00
	% Nominal and PPP	100.00	100.00	100.00	100.00
OECD Countries (and Arab OPEC)	Market	7,758.41	19,676.45	21,263.39	22,780.53
	PPP	7,457.65	17,574.30	18,002.08	18,609.89
	% Market	72.05	76.63	76.36	76.10
	% PPP	62.00	56.20	54.30	53.00
Developing Countries (and NICs)	Market	1,615.21	4,716.90	5,246.23	5,732.55
	PPP	3,416.08	12,148.78	13,294.35	14,958.14
	% Market	15.00	18.37	18.84	19.15
	% PPP	28.40	38.85	41.10	42.60
Transition Economies	Market	1,394.46	1,283.86	1,336.62	1,421.91
	PPP	1,154.73	1,547.92	1,525.04	1,474.75
	% Market	12.95	5.00	4.80	4.75
	% PPP	9.60	4.95	4.60	4.20

* All of the PPP figures for 1980 are derived estimates applying PPP calculations for the 1980 market data series based on work done in developing PPP methodology for the Human Development Report.

Sources: This table has been extrapolated from several sources: (i) IMF, *World Economic Outlook*, May 1997; (ii) World Bank, *Global Development Finance*, 1997; (iii) International Finance Corporation, *Emerging Stock Market Factbook*, 1997; (iv) World Bank, *World Development Indicators*, 1997; (v) World Bank, *World Development Report*, 1997; (vi) World Bank, *Global Economic Prospects*, 1997; and (vii) UNDP, *Human Development Report*, 1997.

Appendix

List of Participants in the Conference on "Regional Economic Integration and Global Economic Cooperation: The Challenges for Industrial, Transitional and Developing Countries", held at the Dutch Ministry of Foreign Affairs on 18-19 November 1997

Mr. Ernest Aryeetey	Senior Research Fellow, Institute of Statistical, Social and Economic Research, University of Ghana
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Mr. Hein Bogaard	Junior Advisor, Multilateral Banks Division, Ministry of Finance, the Netherlands
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Mr. Ron van Dartel	Director, European Affairs Department, Ministry of Foreign Affairs, the Netherlands
Mr. Robert Devlin	Chief, Integration, Trade and Hemispheric Issues Division, Inter-American Development Bank, Washington, D.C.
Mr. Jean-Paul Dirkse	Director, Cultural Cooperation, Education and Research Department, Ministry of Foreign Affairs, the Netherlands
Mr. Zdeněk Drábek	Senior Adviser, Economic Research and Analysis, World Trade Organization, Geneva
Mr. Dag Ehrenpreis	Chief Economist, Policy Department, Swedish International Development Cooperation Agency (SIDA), Stockholm

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Mr. Ricardo Ffrench-Davis	Principal Regional Advisor, UN-Economic Commission for Latin America and the Caribbean (ECLAC), Santiago de Chile
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Mr. János Gács	Acting Project Leader, Economic Transition and Integration Project, International Institute for Applied Systems Analysis, Laxenburg, Austria
Mr. Branislav Gosovic	Director, The South Centre, Geneva
Ms. Stephany Griffith-Jones	Senior Fellow, Institute of Development Studies, Sussex University, UK
Mr. Jan Willem Gunning	Professor of Economics, Free University of Amsterdam
Mr. Göran Hedebro	Head of SAREC's Division for Thematic Programmes, Swedish International Development Cooperation Agency (SIDA), Stockholm
Mr. Barry Herman	Chief International Economic Relations Branch/MD, Department of Economic and Social Information and Policy Analysis, United Nations Headquarters, New York
Mr. Ingmar van Herpt	Economist, Foreign Financial Relations Directorate, Ministry of Finance, the Netherlands
Mr. Björn Hettne	Professor in Peace and Development Research, Göteborg University, Sweden
Mr. Winfried Houtman	Head, European Union Division, Ministry of Finance, the Netherlands
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Mr. Mats Karlsson	Under-Secretary of State, Ministry for Foreign Affairs, Sweden
Mr. Fred van der Kraay	Inspector, Policy and Operations Evaluation Department, Ministry of Foreign Affairs, the Netherlands
Mr. Maarten Lak	Deputy Director, European Affairs Department, Ministry of Foreign Affairs, the Netherlands
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Mr. Frans van Loon	Director Emerging Markets Group, ING Bank International, Amsterdam
Mr. Jens Lund-Sörensen	Managing Director, Nordic Development Fund, Helsinki
Mr. James Lynch	Political Counsellor, Canadian Embassy in the Netherlands
Mr. Gavin Maasdorp	Director, Economic Research Unit, University of Natal, South Africa
Mr. Mark Malloch Brown	Vice-President for External Affairs, The World Bank, Washington, D.C.
Mr. Percy S. Mistry	Chairman, Oxford International Group, Oxford, UK
Mr. Carlos Neves Ferreira	President, Institute for Economic Cooperation, Ministry of Foreign Affairs, Portugal
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