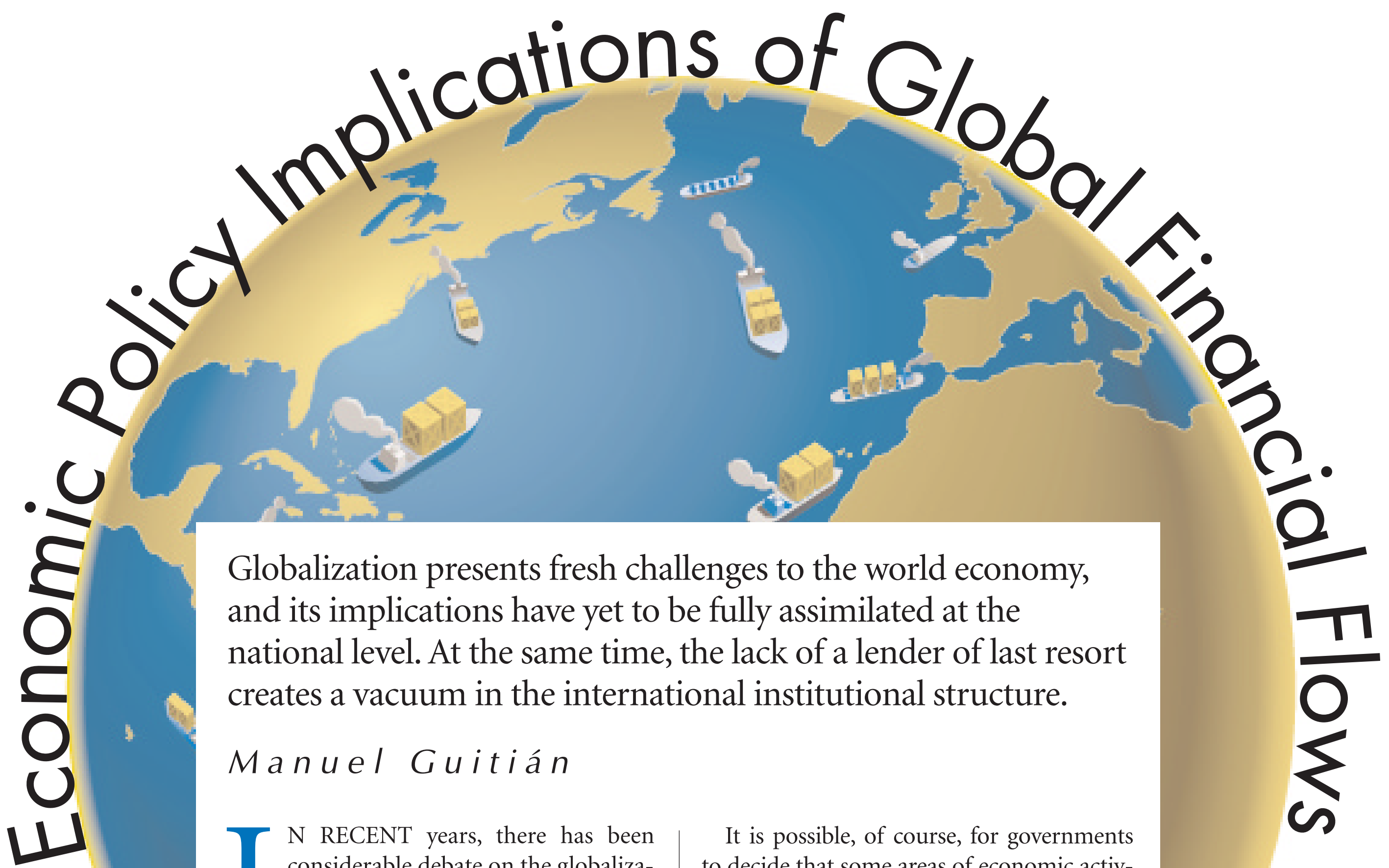
Economic Policy Implications of Global Financial Flows



Globalization presents fresh challenges to the world economy, and its implications have yet to be fully assimilated at the national level. At the same time, the lack of a lender of last resort creates a vacuum in the international institutional structure.

Manuel Guitián

IN RECENT years, there has been considerable debate on the globalization of economic activities and its impact on national economies. Yet this process has been under way for over half a century. In its early stages, globalization stemmed from governments' policy decisions and aroused little debate because its effects were viewed as benign. It was seen in the context of economic integration, achieved through linking markets for goods and services. From 1945 until 1971, the era of the Bretton Woods fixed-exchange-rate system, national governments focused on liberalizing the current accounts of their balances of payments and have made much progress since then.

This commitment did not extend to liberalizing asset markets, however. For this reason, the Bretton Woods agreement of 1944 included an acceptance of capital controls, a provision that is still valid today. At that time, the focus on the current account was based on the need to restore freedom to the flow of trade in goods and services, combined with the fact that international capital movements had not yet acquired the importance they did later on. It was also felt that capital controls would preserve the independence of domestic economic policies.

It is possible, of course, for governments to decide that some areas of economic activity will be liberalized while others will remain subject to control. It is far more difficult for policymakers to maintain the boundary between free and controlled activities. Growing freedom in trade in goods and services can be expected to lead to closer financial relationships among countries. These, in turn, will bring about a liberalization of cross-border financial and capital flows. This liberalization has long been a feature of the international economy and has led to a period of progressive economic integration. As a result, this integration moved to a higher level, namely, globalization.

Causes and consequences

Besides the influence of growing trade relationships among countries in fostering financial ties, the evolution toward liberalizing international capital movements was stimulated by a major change in the perception of the role and scope of government in the economy during the last two decades. Government evolved from being a predominant agent in economic activity toward a situation in which government activity was designed mainly to provide an appropriate setting for private economic

activity, which became the dominant force in resource allocation.

This open, liberal economic regime gave a prominent role to market forces and had profound implications for macroeconomic policy management, in general, and for monetary and exchange policies, in particular. Although much of the discussion of these issues has centered on the domestic economy, the discussion cannot be divorced from its external aspects. This interaction is two-way: experience with external liberalization underpins domestic deregulation, while domestic deregulation leads to greater external openness.

Thus, forces developed in the international economy as a result of deliberate government decisions to liberalize capital movements. These, in turn, tightened the links between national economies. Consequently, the world economy entered the era of globalization, with all its risks and opportunities.

The opportunities were evident from the outset. But there was also a danger that countries would either misuse them or fail to take advantage of them. A first demonstration of the potential benefit of open capital flows was their sudden and dramatic increase in the 1970s following the two major oil price rises, when capital flows helped smooth adjustment to higher prices. These developments were followed by the debt crisis of the 1980s, which reflected a misuse of the new opportunities that capital flows offered.

The recent experiences of the Asian economies provide additional examples of the benefits and costs of an open, integrated, international capital market. Some of these economies recorded a long period of rapid growth and development to which growing foreign capital flows contributed, at the same time as those flows were encouraged by such economic performance. But then policy inconsistencies and institutional shortcomings surfaced and stimulated an abrupt reversal in capital flows.

From a national standpoint, globalization will also have marked consequences. Key among these is the progressive divergence between political and economic boundaries. The nation-states to which governments address their economic policies often deviate from the economic areas in which global market forces operate. The resulting cross-border externalities and spillovers will reduce both the scope and the effectiveness of government economic policy and the autonomy and power of governments in the economic sphere.

The road ahead

The challenges confronting governments as we enter a new millennium already appear intimidating. But, in the midst of a spreading crisis such as the present one, they become even more daunting, if only because the time available to address any challenge grows progressively shorter. Although globalization results from the decisions of national governments, they have yet to absorb and draw implications for their own autonomy and scope for action from the presence of a seamless global market.

Two distinct, though interrelated, issues are raised in current debates about globalization that reflect the impact of the crisis on the international economy. The first debate casts doubt on the view, known as the Washington consensus, of the efficient functioning of markets. The second questions the wisdom of an open system of capital movements from a national perspective. Fundamentally, these doubts bring to the fore issues of the role of government and economic policy in the operation of domestic economies.

The challenges I am discussing confront only those countries that have opened their economies to the external world and have become components of the global system. What options are available to economies that are part of the integrated world setting? In principle, a reversal of the process of integration, or "disintegration," is one of them. This has been tried in the past and the experience is not particularly attractive (for example, the beggar-my-neighbor policies and competitive devaluations of the 1930s). The option of disintegration is equivalent to turning the clock back toward nationalism and thus toward a regime in which the government, as the administrator and enforcer of controls, once again becomes dominant in the economy.

A second option would be to accept the constraints that a global setting imposes on national decision making and to design international norms and rules that countries would agree to respect. As already noted, the first option is favored in the arguments for capital and exchange controls, while recent calls for internationally comparable standards and frameworks to be monitored through appropriate international surveillance lean toward the second option.

A third option—which is appealing in theory but can be dismissed in practice because few, if any, governments have resorted to it—would be to entrust market forces with the tasks of ensuring both efficiency and stability.

Obsolescence or progress

The choices countries will face in the future will depend on whether they decide to isolate themselves from the consequences of globalization or to accept them. Isolation seems to me to be a futile objective. It will mean introducing progressively broader and tighter controls that, to be effective, will require establishing a bureaucratic structure able to anticipate and thwart market efforts at circumvention. Such steps would be unlikely to succeed.

Acceptance of the constraints of globalization is a more constructive, but also a more challenging, approach. It implies recognizing that national economic policies can insulate a country only to a limited degree from the undesirable effects of being a part of a whole it does not control. It also requires a consensus on the acceptable response to those undesirable effects, particularly the loss of economic policy independence.

Governments are formulating norms and standards that could be a basis for an international consensus. Also, they are reaching understandings or agreements to guide their

actions and, in particular, to limit their discretionary activities in areas likely to generate adverse spillovers. Such measures deal in an orderly way with the loss of national autonomy that countries have experienced in the global system. The real challenge for governments is to convert a de facto reduction of national autonomy (that caused by global markets) into a formal acknowledgment of its existence (through adopting agreed rules of the game).

International regime for capital flows

Economics, long known as the "dismal science," every so often encounters episodes that encourage observers to argue that it is about to shed its dismal nature. There are perennial hopes that sophisticated risk-management techniques will be developed to tame risk once and for all, despite evidence to the contrary. The recent collapse of Long-Term Capital Management, a U.S.-based hedge fund, is a sobering example of the inability of supposedly sophisticated risk-management strategies to tame risks. The only certainties are that markets will continue to be volatile, economic cycles will persist, risk will not be completely tamed, and crises will continue to occur. The best we can do is contain market volatility, limit cyclical gyrations, and improve risk-management techniques.

A first issue is to determine what individual countries can do to cope with volatile capital flows. Country-specific experiences and policy actions can provide a wealth of information. The essential question is what national monetary and exchange rate policies, as well as domestic fiscal management and exchange controls, can contribute in this area. This issue is critical because it concerns the extent to which such individual country policy instruments may be able to counter the impact of capital flows.

In addition to the lessons that can be learned about particular country reactions and approaches, a second issue, that of the global dimension, must be considered. The complexities of capital account liberalization, and the policy constraints it imposes, should be distinguished from the procedures that must be designed to guide and monitor each country's experience and progress in this domain.

The first issue is fundamentally empirical and has to be approached from a country-specific perspective. While such subjects as the pace and sequence of liberalization may be analyzed in the abstract, their translation into actual policy action will depend on the situation of each country.

For the orderly liberalization of capital flows, we need to address the second issue: the development of norms and procedures that all countries agree upon and that are flexible enough to cover all potential country situations. In this regard, a few time-tested principles of international relationships are eminently well suited for the purpose at hand:

- *a provision to allow countries a measure of flexibility* in liberalizing capital transactions—that is, a transitional arrangement giving countries the chance to pace and sequence the process according to their individual circumstances;
- *a set of common prudential norms*, based on generally recognized practices, to underpin and ensure proper management of cross-border risks;
- *a principle of temporary international acceptance of restrictive measures* on capital transactions when these are necessary for balance of payments or macroeconomic management reasons; and
- *a provision to allow countries to resort temporarily to controls* in emergency situations.

These principles, properly implemented, can address issues of capital account liberalization for all types of countries. All the ingredients to establish and operate such a set of principles already exist in the surveillance responsibility that countries have vested in the IMF. There are also grounds to build a consensus on common prudential norms that have been and are being developed by national regulatory and supervisory authorities, such as the Core Principles of the Basle Committee on Effective Banking Supervision.

All the necessary elements for a commonly accepted set of procedures to monitor the evolution of capital flows and capital accounts are in place. All that remains is for governments to show they are willing to accept and abide by them.

Key pending challenges

Each period of global turbulence adds fresh instruments to our arsenal of prevention tools. The crisis in Mexico in 1994–95 underscored the importance of information and data, of debt-management strategies, and of sound financial sectors. This message has been even more forcefully conveyed by the continuing crisis that began in Asia over a year ago, which highlighted the importance of proper governance and of arm's-length relationships between governments and other sectors in the economy. These lessons acquire even greater relevance as economies become more closely integrated.

There is general agreement that transparency, disclosure, proper governance, and sound financial standards are necessary for a well-functioning market environment. As market forces are provided with better information that is both timely and appropriately disclosed, as well as with a measure of policy certainty, their ability to make efficient decisions is enhanced. A key challenge will be to find ways to let markets bear the costs of their decisions when their arbitrage is incorrect or when they fail to differentiate properly. An inability to ensure that market forces not only reap the benefits but also bear the costs of decisions carries consequences that go beyond the normal concept of moral hazard. It eliminates the relevance and validity of the concept of underlying economic fundamentals.

Besides letting markets bear the costs of their own decisions, governments must ensure systemic stability. At times, this aim conflicts with achieving market-driven outcomes. Solutions to this dilemma have yet to be found, but they would seem to flow logically from the conclusions to which

the current crisis is leading. These emphasize the importance of sound policies and frameworks; transparency based on accurate, comprehensive, and timely information; and proper governance standards. Presumably, capital would flow away from economies that deviated from these principles, encouraging them to resume observing them. At the same time, capital would flow toward economies that abided by the principles, thereby underpinning their performance.

The much-touted evidence of contagion, though, implies that not only is such differentiation not taking place but also that attempts to encourage it are failing. The implications of such failures are serious. Fundamentals that are sustainable with efficient arbitrage will no longer be sustainable when markets do not perform this function well. When contagion sets in, a mechanism must be put in place to protect economies with sound fundamentals.

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This line of reasoning uncovers a vacuum in the existing institutional structure at the international level: the absence of a lender of last resort. Consensus is still to be reached on the need for this building block in the institutional architecture. One reason is a resistance to accepting the resource implications of setting up such an entity.

Less well known and more relevant is a reluctance to accept the supranational authority that a lender of last resort requires if it is to discharge its systemic responsibilities properly. The cession of national sovereignty implicit in such authority has not yet been accepted, even though global markets have already de facto curtailed it. Recognition of this situation would soon lead to a willingness to construct an international structure sufficiently robust to deal with global market forces and safeguard systemic stability.

Conclusion

The growing threat of global crisis is fueling a debate over the means available to contain and resolve it, as well as over the ways in which countries can protect themselves from its consequences. The world economy has become so closely integrated that not only do countries need to ensure that they manage their own economies well; they must also be ready to anticipate, and adapt to, economic mismanagement elsewhere. We have yet to agree on a set of rules to manage international capital flows. Those I described would go far toward helping countries gauge the risks they faced in capital markets by making acceptable behavior transparent and by bringing to the surface some of the problems capital flows have posed for countries with proper economic fundamentals.

Just as the specter of contagion has led me to advocate a lender of last resort endowed with resources commensurate with the scale of potential systemic threats, the prospect of efficient arbitrage channeling capital flows to economies on a scale that far exceeds their size must be confronted.

Ways must be found to bring those inflows to a sustainable level. This calls for the lender of last resort to exercise surveillance over capital flows to ensure that sound policies are in place in the countries in which the capital flows originate, so that their scale and direction do not reflect policy inadequacies. This is a key task for international surveillance and it will require an analysis and understanding of the factors underlying global capital flows. More generally, it will also require those countries with the most influence in the world economy to accept responsibility for ensuring its stability, including in the domain of capital flows.

Maintaining order in the world economy in the absence of a global authority is a hard challenge. If we are to meet it, we need to acknowledge that all countries are part of the global society. Establishing universally applicable orderly norms is not the same as asking individual countries to bend to outside pressure. On the contrary, such a common endeavor will benefit everyone. In the words of José Ortega y Gasset: "Order is not a pressure which is imposed on society from without, but an equilibrium which is set up from within." F&D

This article is based on a keynote speech given by the author at the thirteenth Pacific Basin Central Bank Conference on Monetary Policy and the Structure of the Capital Account in Los Cabos, Mexico, on November 9, 1998.

Suggestions for further reading:

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Manuel Guitián, 1997, "Scope of Government and Limits of Economic Policy," in Macroeconomic Dimensions of Public Finance, *ed. by Mario Bléjer and Teresa Ter-Minassian (London and New York: Routledge).*

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