Liberalisation of financial markets: is everybody enjoying the game?

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Globalisation of the world economy is proceeding at a rapid pace, particularly in the arena of international finance. The presumed virtues of globalisation, however, are far from materialising and being fairly distributed among nations. The opening of domestic capital markets to foreign investment is still a relevant component of the "Washington consensus", although many experts argue that free mobility of private capital in the 1990s was one of the major causes of the financial crises in emerging markets.

The liberalisation of capital accounts brings equal benefits to both developed and developing countries only theoretically. In practice it leads to increasing benefits for western investors and banks that can take advantage of expanded opportunities for portfolio diversification and the efficient allocation of global savings and investment. It also offers broader investment and risk-diversification opportunities to creditor countries at a time when their ageing populations with growing pension funds seek higher returns on their investments.

A country can take advantage of greater capital mobility only when its domestic financial market is sufficiently structured. Therefore, while an open capital account is a positive instrument for financially developed countries, countries with emerging markets and economies in transition are constantly being undermined by uncontrolled and unexpected capital flight and by sudden and unsound deregulation and liberalisation policies. As a result, greater capital mobility brings high costs and limited benefits to countries with emerging markets who lack sound, modern national financial institutions and are vulnerable to the volatility of financial flows.

The financial crises in the 1990s showed that the liberalisation process is disastrous when it is not properly managed. Liberalisation can be extremely costly and highly dangerous in countries that do not have proper bank regulatory and supervisory structures, well-functioning legal and judicial systems, and adequate safeguards against highly risky and unethical behaviour. Unfortunately, these measures are far from being implemented in emerging countries. Despite their importance, such measures are unlikely to be implemented in the near term because of the complex processes involved.

There are temporary measures, however, that can be taken to protect vulnerable national economies from financial instability before strong financial structures are in place. Amongst others, these include limits on loan-to-value ratios and consumer credit, maximum repayment periods and minimum down-payment percentages. Additional measures that reduce vulnerability of national financial systems include restrictions on foreign-denominated debt and prudential controls to limit capital inflows.

Chile's experience with capital controls in the 1990s is a concrete example of such a temporary measure. Chile introduced restrictions on capital inflows in June 1991. Initially, all portfolio inflows were subject to a 20% reserve deposit with no interest. For maturities of less than one year, the deposits applied for the duration of the inflow, while for longer maturities the reserve requirement was for one year. In July 1992, the rate of the reserve requirement was raised to 30%, and its holding period was set at one year, independently of the length of the flow. The results achieved so far by the authorities with this policy have been:

- a decrease in the volume of short-term inflows and an increase of longer maturities. As shown in Table 1, the reduction in shorter-term flows was fully compensated by equivalent increases in longer-term capital inflows. Thus, aggregate capital inflows to Chile were not decreased by capital controls!;
- a decrease of the country's vulnerability to international financial instability;
- the ability of the central bank to implement an independent monetary policy (despite the presence of pegged exchange rates) and to maintain a high differential between domestic and international interest rates.

TABLE 1

Capital inflows (gross) to Chile (USD millions)

YEAR	SHORT-TERM FLOWS	PERCENTAGE OF TOTAL	LONG-TERM FLOWS	PERCENTAGE OF TOTAL	TOTAL	DEPOSITS*
1988	916,564	96.3	34,838	3.7	951,402	/
1989	1,452,595	95.0	77,122	5.0	1,529,717	/
1990	1,683,149	90.3	181,419	9.7	1,864,568	/
1991	521,198	72.7	196,115	27.3	717,313	587
1992	225,197	28.9	554,072	71.1	779,269	11,424
1993	159,462	23.6	515,147	76.4	674,609	41,280
1994	161,575	16.5	819,699	83.5	981,274	87,039
1995	69,675	6.2	1,051,829	93.8	1,121,504	38,752
1996	67,254	3.2	2,042,456	96.8	2,109,710	172,320
1997	81,131	2.8	2,805,882	97.2	2,887,013	331,572

* Deposits in the Banco Chile

Source: Central Bank of Chile.

This example shows that temporary measures such as restrictions on capital flows are useful instruments, which safeguard financial stability, prevent financial crises and encourage long-term capital inflows. Thus, without a stable and sound international financial system, capital controls can be considered as valid, safe and valuable policy options to promote development.

In the United Nations Secretary General's Report prepared for the preparatory process of the high-level conference "Financing for Development" (FfD), which will take place in Mexico in March 2002, capital controls are mentioned in article 21 as a temporary measure to protect national stability. The wording underlines, however, that capital controls should not replace the implementation of adequate reforms in the financial system. We support this argument, although we reiterate that such reforms are far from being implemented in most emerging markets. Meanwhile the international community should recommend and support immediate measures to protect national financial stability.

Furthermore, the so-called policy dilemma of the "impossibility of the holy trinity" – that is, achieving free capital mobility, a pegged exchange rate and an independent monetary policy simultaneously – is false. There is no valid argument or evidence to support the need for full liberalisation of capital markets and flows at all cost. On the contrary, *ad hoc* measures to control capital flows, specifically designed and implemented for each individual country, should be pursued by national governments and strongly encouraged by international institutions. An additional argument in support of capital control measures is the acknowledgement of the speculative nature of a significant proportion of financial inflows.

To accomplish the goal of capital control, one must analyse the composition of financial flows and their ability to support development. In the last two decades, the combination of liberalisation, speculation and technology innovation has given rise to a system of huge dimensions, which functions more on rumour than on economic fundamentals. The main players in this system, *inter alia* commercial and investment banks, exchange USD 1,862 billion daily in currency transactions and Over The Counter Transactions (OTC). Moreover, the currency market has grown. Table 2 shows that foreign exchange transactions increased from USD 18.3 billion/day in 1977 to USD1.5 trillion in 1998. With derivative transactions added, this figure is almost USD1.6 trillion. Furthermore, from 1977 to 1998, the ratio between annual currency value in foreign currency and foreign export increased from 3.51 to 55.97, while the ratio of central bank reserves to daily currency activities in foreign currency decreased from 14.5 to a mere 1.

TABLE 2

Daily average turnover in currency exchange markets in 1998, by length of contract (USD millions)

MATURITIES	2 DAYS	3-7 DAYS	1 YEAR	1 YEAR	TOTAL	%
1. Spot	577,737				577,737	40.1
2. Outright		65,892	58,680	5,099	129,671	9.0
3. Forward						
4. Forex swaps		530,683	192,592	10,847	734,122	50.9
Total	**577,737**	**596,575**	**251,272**	**15,946**	**1,441,530**	**100.0**
%	**40.1**	**41.4**	**17.4**	**1.1**	**100.0**	

Source: B.I.S. (1998)

Table 3 shows that 40.1% of contracts are two-day spot transactions, 41.7% are three to seven day transactions, and only 1.1% are for more than one year. It should be noted that contracts on currencies are purely speculative. This market is beyond any public control and totally disconnected from productive activities.

TABLE 3

Official Reserves, foreign exchange trade and exports, 1977-98

YEAR	OFFICIAL RESERVES (USD BILLIONS)	RESERVES+ GOLD (USD BILLIONS)	DAILY GLOBAL TURNOVER* (USD BILLIONS)	RESERVES / DAILY TURNOVER	
	(1)	(2)	(3)	(1)/(3)	(2)/(3)
1998	1,636.1	1,972.0	1,500.0	1.0	1.3
1995	1,347.3	1,450.0	1,190.0	1.1	1.2
1992	910.8	1,022.5	820.0	1.1	1.2
1989	722.3	826.8	590.0	1.2	1.4
1986	456.0	23.0	270.0	1.7	2.0
1983	339.7	494.6	119.0	2.8	4.2
1980	386.6	468.9	82.5	4.7	5.7
1977	265.8	296.6	18.3	14.5	16.2

*excluded derivative contracts

Source: B.I.S. (1998)

This economic sector grew at an incredible rate compared to the international trade of goods and services. The total amount of the goods traded in 1998 was USD 6,700 billion, registering a 14% growth rate from 1995. Financial activities involve 76 times more financial resources than global trade in goods and services: for each dollar spent on trade, USD 75 is invested in financial assets. In the financial markets, monetary returns – and risks– are much higher than in the real economy, thus increasing resources are shifted from productive and long-term investments into speculation. Capital controls can, as the Chilean case showed, allow governments to welcome long-term investments and discourage short- term ones by making them more costly.

As the chart indicates, the gargantuan dimensions of private flows in the financial markets seriously affects the capability of central banks to react to speculative attacks. Global central bank reserves amount to no more than what is traded in one day of currency transactions on financial markets, and data from March 1999 indicates that this situation is worsening. Two controversial issues require immediate reaction:

- The volume of short-term capital flows, in particular massive inflows and outflows of speculative capital (spot transactions), leads to substantial exchange rate instability;
- The excessive liquidity of financial markets means that national institutions such as central banks are unable to protect national currencies from speculative attacks. Traditionally, a central bank buys and sells its national currency on international markets to keep the currency's value relatively stable. The bank buys currency when a glut caused by an investor sell-off threatens to reduce the currency's value. In the past, central banks had reserves sufficient to offset any sell-off or attack. Currently, speculators have larger pools of cash than all the world's central banks together. This means that many central banks are unable to protect their currencies, and when a country cannot defend the value of its currency, it loses control of its monetary policy.

The international community should address adequately this new situation and design new rules and institutions capable of guaranteeing stability and more equitable growth in the system. The United Nations Conference on Financing for Development represents an historical event to promote a constructive dialogue on these issues among the different actors: governments, UN agencies, international financial institutions including the WTO, civil society and the private sector. The agenda for the meeting contains most of the major current challenges, among others domestic resources for development, private financial flows, trade, official development assistance, debt, and the international financial architecture.

During the preparatory process and the FfD conference itself, civil society will monitor the decisions made. If these decisions are not adequate, another precious opportunity will be lost. Civil society expects that there will be a consistent discussion on the implementation of a currency transaction tax (CTT) in the context of this conference. A study of the CTT was recommended by the United Nations General Assembly Special Session on Social Development (UNGASS) in Geneva in June 2000. Subsequently, UN Secretary General Kofi Annan established a high level panel chaired by the former Mexican President Zedillo. It is hoped that the report of this group, due in May 2001, will contain concrete and effective proposals.

Civil society and academics from many countries have already produced studies on the economic feasibility of currency transaction taxes. Currency transaction taxes are uniform international taxes payable on all spot transactions involving the conversion of one currency into another, in both domestic security markets and foreign exchange markets. They would discourage speculation by making currency trading more costly. The volume of short-term capital flows would decrease, leading to greater exchange rate stability.

Achieving this stability through taxation would require high rates, however, and this would seriously obstruct the workings of international financial markets. A small charge on international financial transactions would not create distortions, but it would also not inhibit speculative behaviour in foreign exchange markets. One possible compromise, suggested by Paul Bernd Spahn, Professor at the University of Frankfurt, would be a two-tier structure: a minimal rate transaction tax and an exchange surcharge that, as an anti speculation device, would be triggered only during periods of exchange rate turbulence. The minimal rate transaction tax would function on a continuing basis and raise substantial, stable revenues without impairing the normal liquidity function of world financial markets. It would also serve as a monitoring and controlling device for the exchange surcharge, which would be administered jointly with the transaction tax. The exchange surcharge, which would be dormant as long as foreign exchange markets operated normally, would not be used to raise revenues, but would function as an automatic circuit breaker whenever speculative attacks against currencies occurred. A minimal nominal charge of, *e.g.*, two basis points on foreign exchange transactions, would raise the cost of capital insignificantly and would probably have no effect on the volume of transactions involving currency conversions. The exchange surcharge would avoid the negative effects of other monetary policy measures that sacrifice valuable international reserves or offer excessively generous interest rates to combat speculative attacks. It would also eliminate expectations of recurrent bailouts by central banks and reduce unethical behaviour and the impacts of financial crises.

To summarise, the implementation of currency transaction taxes would:

- Reduce short-term speculative currency and capital flows;
- Enhance national policy autonomy;
- Restore taxation capacity of individual countries eroded by the globalisation of markets;
- Distribute tax pressures more equitably among different sectors of the economy;
- Trace movements of capital to fight tax evasion and money laundering.

In addition, currency transaction taxes could collect resources for development purposes. The revenues generated should not, however, replace the fulfilment of fundamental commitments, such as the internationally agreed level of official development assistance (ODA), adequate debt reduction and cancellation initiatives, and more equitable trade agreements. All these crucial commitments will be discussed in the FfD conference.

Civil society will work hard to make this conference a concrete success. Our overall objective is the definition – in a participatory and transparent process – of new rules for an international financial system based on a more equitable redistribution of benefits and costs. Redistribution should be the core of the political agenda for this conference, as it should be for the new Millennium, so that we can reach social and economic development for all. ■

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