Foreword

by Professor James Tobin

The fantastic revolution in financial markets of recent decades is still gaining momentum. Thanks to technological miracles of communication and computation, the scope and volume of financial activities rapidly multiply, greatly surpassing the growth of other industries. Advances in mathematical sophistication and statistical technique, combined with powerful entrepreneurial response to new opportunities, have kept pace with the new hardware. The number and range of financial instruments and markets have ballooned.

These developments are encouraged by the dominant trends in political ideology and economic policy throughout the world – in leading capitalist democracies and in former communist countries, in the Third World and in the First. Prevailing doctrines foster deregulation and privatization; they downsize governments and exalt free markets; they stress international trade and investment as against economic nationalism and protectionism.

Not surprisingly, the approach to free worldwide markets has been more rapid and more thorough in the financial sphere than in the production of goods and services. Likewise the expansion of financial activity has dwarfed the growth of output and trade in 'real' economic activity. Even in the emerging economies enjoying spectacular real growth, the 'paper economy' has zoomed even faster. In Russia and other former Soviet republics, finance has been virtually the sole growth sector. Indeed in transition economies financial markets are welcomed as the hallmarks of capitalism. They are the easiest institutions to import, and they are the avenues to fabulous wealth for the privileged elites who understand them.

In the advanced capitalist democracies, too, financial ebullience contrasts with disappointing real performance. Productivity growth has yet to recover from a slowdown that began in the early 1970s. In addition, Western Europe and Japan have been suffering macroeconomic stagnation since the early 1980s. Even in these countries, with well-established monetary and financial institutions, paper-economy enterprises have been the sources of new concentrations of wealth, attracting the energies and abilities of the best young minds.

Globalization of free markets has been much more rapid in finance than in trade. Barriers to cross-border transactions in capital assets have been falling away much faster than national obstacles to movements of goods and services. Current financial orthodoxy is pressed on developing and transitional economies by international lenders: the International Monetary Fund, the World Bank, and the European Development Bank; by the United States, the European Union and other sources of intergovernmental credit; and by private investors and lenders worldwide. Economists from First World countries, offering advice to fledgling capitalist regimes, deliver the same messages: Welcome foreign banks and financiers. Integrate your financial markets, old and new, with those abroad. Make your currency freely convertible into dollars both by foreigners and by residents. Follow resolute anti-inflationary monetary and fiscal policies. These, they are told, are the first requisites of successful reform.

Likewise, in the First World itself, countries of the European Union are moving under the Treaty of Maastricht to a single currency, with integrated and largely deregulated asset markets and financial institutions. Not only are microeconomic financial regulations being minimized, but governmental macroeconomic policies are being virtually abandoned. The member governments will, of course, have no monetary policies. Their fiscal outcomes will also be strictly circumscribed, by the rules of the Union and by private bond markets, which will punish members who 'misbehave' in deficit finance and inflation. The Union itself will have too small a budget to have a fiscal policy. As for monetary policy, the mandate of the Union central bank will be to stabilize the price level, evidently regardless of outcomes in unemployment and production.

The orthodox prescriptions have not, at least not yet, generated the prosperity and growth that are supposed to be the glories of free markets. The problems of Europe, and specifically the difficulties of recent years in the European Monetary System, are not reassuring. The Mexican crisis of 1994 and its economic aftermath appears to be a case where the government followed orthodox precepts and its economy was severely punished for crimes it had not committed.

In this book Stephany Griffith-Jones reviews the breathtaking recent history of financial deregulation, liberalization, and globalization. She sees considerable merit in these trends, at the same time that they can and sometimes do generate volatility and instability that inflict real costs on whole economies. She earnestly seeks some feasible compromises.

A great advantage of financial liberalization is the creation or perfection of markets where buyers and sellers can make transactions of mutual benefit. An important feature of the invention of new instruments and contracts is that the markets where they are traded achieve welfare-increasing reallocations of risks. The range of possible losses that can be insured is enlarged.

Sometimes events that bring losses to A bring gains to B, so A and B welcome the chance to do business. But typically markets are not naturally balanced, and 'risk management' requires the participation of speculators, who assume part of the risk. They perform important functions. At the same time, their self-generated expectations, enthusiasms, and fears can impact excess volatility to asset prices.

Some of the risks most important to ordinary individuals and families are still not covered by private markets: inflation, unemployment, disability, obsolescence of skill. Insurance of many individual risks is rife with moral hazard, especially when there is a residual public commitment, even if only implicit, to victims of misfortune.

Enthusiasts for free financial markets boast that they make assets liquid to all holders, even when they are intrinsically illiquid. A creditor can sell off his loan to a farmer or a businessman or a government long before it is due. A share-owner can liquidate her equity in a joint stock company, though the shares are titles to durable machines and buildings of no use or value outside the company. Facilitation of such liquidations is a public service. However, it is feasible only if prices are not guaranteed.

With flexible prices, these markets are necessarily speculative. Their volatility and the associated risks must be weighed against the liquidity they provide. After all, the wealth of nations, in the sense of Adam Smith, is intrinsically quite illiquid. Whatever illusions financial markets may create for individuals, nations cannot consume all their wealth at once.

The traditional crises of financial markets generally arise from liquidity promised at fixed prices. This is the business of banks and other depositories, borrowing short and riskless while lending long and risky. The contrast is the reason for regulating their balance sheets. The folly of combining deregulation with contingent guarantees at taxpayers' expense was demonstrated by the debacles of the United States Savings and Loan industry in the 1980s, and by the bankrupt conditions of giant Japanese banks in the 1990s.

Governments must be chary of extending guarantees to owners of mutual funds, pension claims, and other assets of uncertain value. Whenever this is done, institutions' portfolios must be regulated. In the absence of government guarantees, protections of ultimate investors are still essential, but should be informational. Government must insist that investors be fully informed of the risks they are assuming. The United States Securities and Exchange Commission is a good example of informational regulation. It is hard to understand why free market ideologues should oppose measures of this kind, which increase the economic efficiency of these markets. Unfortunately in emerging and transition economies, enactment of such regulations lags far behind the introduction of the markets.

The volatility of liquid flexible-price asset markets stems in part from the Keynesian 'beauty contest' game played by herds of speculators. High liquidity also facilitates arbitrage between assets which are close substitutes, diminishing the costs of moving from one to another, as across stock markets and currency markets. To limit these unwelcome effects, Keynes suggested transactions taxes, which are incentives for longer holding periods. A similarly motivated measure is a capital gains tax rate inversely related to holding period.

I have advocated, beginning at the demise of Bretton Woods in 1971, a small tax on foreign exchange transactions, a bit of sand in the wheels of the over-efficient machinery of currency deals. I am gratified that the author of this book likes the 'Tobin tax'.

The thin markets in bills, bonds and currencies in less developed economies are particularly vulnerable to swings of speculative fashion. It takes big changes of price to bring forth 'fundamentalists' to buck the speculative tides and arrest or reverse such swings. Meanwhile real production and trade may be devastated, as occurred in Mexico. Millions of third parties, innocent bystanders, lose jobs, business and savings.

Those who rush emerging and transition economies into premature currency convertibility and free trade in financial instruments are not doing those countries a favour. After all, during 1947–72, the halcyon quarter century of economic growth, world trade, and international real investment, some major capitalist democracies maintained controls on currency transactions and capital movements. These were not fully dismantled until the 1980s. Experience has not, not yet anyway, vindicated current orthodox confidence that free global financial markets are the keys to stable worldwide prosperity.

Stephany Griffith-Jones expounds these themes with clarity and conviction, firmly grounded in her thorough knowledge of the theory and practice of the economics of finance.

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Introduction

I would like to greatly thank SIDA and its Chief Economist, Dag Ehrenpreis, not only for very valuable financial support, but also for his encouragement in doing much of the research leading to this book. I am also very grateful to Luciano Martins for opening up new and fruitful avenues of research, and to UNDP of Brazil for financing such research. I would also wish to thank ECLAC and particularly Barbara Stallings for encouraging me to work on the Mexican peso crisis, and providing funding for it.

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John Toye encouraged me to transform my research into a book. Many colleagues (academics, policy-makers and regulators) offered valuable analysis, insights and information. Particularly stimulating have been Caroline Atkinson, Amar Bhattacharya, Guillermo Calvo, Andrew Crockett, Richard Dale, Jane d'Arista, Ricardo Ffrench-Davis, Mohammed El-Erian, Stanley Fischer, Valpy Fitzgerald, Inge Kaul, Peter Kenen, Jan Klacek, David Peretz, Helmut Reisen, Philip Turner, Jan Joost Teunissen, Steve Wallman, John Williamson and Charles Wyplosz. As always the responsibility for the views expressed and for any mistakes is entirely my own.

This book examines the incredibly rapid growth and dramatic change of structure of global capital flows and of flows to developing and transition economies. It also explores the important changes in the sources of those flows. While naturally accepting the important benefits that growing capital flows have generated, both for source and recipient countries, this study also highlights some of the costs to them, and particularly to recipient countries. The volatility of these capital flows is shown to be perhaps their most problematic feature, as was dramatically demonstrated by the Mexican peso crisis.

Regulators, nationally and especially internationally, have not been able to keep pace with the speed of change in international capital markets. Their task is made more difficult by the lack of global governance in this field.

This book suggests regulatory measures – to be taken both