Working Paper Number 23

The Security of International Finance

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This lecture, presented at Oxford on 19 January 1999, opened the Wolfson College Lectures 1999 series Globalization and Insecurity. The first part of my lecture attempts to explain the origins of inherent instability in international capital flows, and why this requires public institutions to maintain an orderly market. In the second part, it is argued that despite widespread recognition of this problem, the necessary institutions do not exist due to the mismatch between intergovernmental power and the requirements of a global market. The third and last part of the lecture sketches some of the implications of this dilemma for belief in the efficiency of markets, the establishment of international property rights, and ultimately for global citizenship itself.

February 1999

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THE SECURITY OF INTERNATIONAL FINANCE

> (The inter-war experience suggests that without controls on capital movements) ... “loose funds may sweep round the world disorganizing all steady business” (John Maynard Keynes ‘The Post-War Currency Policy’, 8 ix 41 *The Collected Writing of John Maynard Keynes, Vol XXV*)

1. INTRODUCTION[1]

Half a century after Keynes’ dictum, the security of international finance - the topic of this lecture - has clearly become a cause for acute concern far beyond Wall Street and Canary Wharf.[2] ‘Steady business’ - and thus the livelihoods of almost all the world’s population ranging from British pensioners to Indian peasants - is apparently threatened by the volatility of paper assets, the very existence of which they are unaware. Daily news headlines tell us of yet another financial crisis in some far-flung corner of the globe; while world leaders gathered in Davos or Hong Kong seem to regard currency instability as the critical threat to western civilization at the close of the twentieth century - in sharp contrast to the threat of socialist revolution with which it opened.

A significant and even symbolic characteristic of current global financial insecurity is the uneasy combination of the speed and sophistication of computerized trading systems with the faltering economies of ‘emerging markets’. Sudden exchange rate collapses lead not only to steep income declines for millions of poor people but also to major bank and stock market losses in advanced industrial countries. For the first time, economic events in the developing world are affecting the financial security of developed countries.[3] The G7 has mobilized some US$ 300 billions as lender of last resort to major economies such as Mexico, Korea, Indonesia, Russia and Brazil because of the threat to the international market system.[4] This concern reflects in turn the fact that although 28 advanced industrial countries still dominate the international financial and trading system; 48 percent of global production and 55 percent of world investment now takes place *outside* this group of rich countries.[5] Discussions on ‘global financial architecture’ thus necessarily involve the two-fifths of the world population living in countries who until recently were seen only as clients for development assistance. The debate on the security of the international financial system thus extends beyond technical economic issues to encounter problems derived from the problematic nature of globalization itself.

In the first part of my lecture I shall try to explain the origins of inherent instability in international capital flows, and why this requires public institutions to maintain an orderly market. In the second part, I shall argue that despite widespread recognition of this problem, the necessary institutions do not exist due to the mismatch between intergovernmental power and the requirements of a global market. In the third and last part of the lecture I shall sketch some of the implications of this dilemma for belief in the efficiency of markets, the establishment of international property rights, and ultimately for global citizenship itself.

2. THE INHERENT INSTABILITY OF INTERNATIONAL FINANCIAL MARKETS

Sources of Systemic Volatility

Global capital markets are characterized by asymmetric and incomplete information derived from the fact that all financial assets are promises to pay in an uncertain future. The increasing international exposure of bank balance sheets and equity funds in industrial countries to the financial systems in emerging market economies has not been accompanied by a corresponding depth of information about the true value of the assets and liabilities. The speed and scale of shock transmission between markets has increased enormously due to technological advances in trading and settlement, which forces traders to act without knowledge of wider price movements, exacerbating random fluctuations into serious instability.

There are also substantial agency problems for bank lenders and portfolio investors. Unlike multinational corporations involved in direct foreign investment, they can exercise little direct control over the asset acquired and thus cannot protect its market value. To the extent that banks and funds cannot count upon their own governments or the international financial institutions to ensure payment of their loans or maintenance of asset value, their logical response is to avoid assets which cannot be rapidly sold if things go wrong.

These information and agency problems explain the two main characteristics of so-called ‘portfolio’ investment in emerging markets. First, international portfolio investors and bank lenders seek liquidity and use rapid exit as a means of containing downside risk by buying quoted securities or rolling over short loans. In consequence, indicators such as the ‘quick ratio’ of a country’s short-term foreign liabilities to central bank reserves become critical to market stability, and can easily trigger self-fulfilling runs on a currency. Second, fund managers control risk not by seeking more information or control, but by portfolio diversification based on an assumed lack of covariance between emerging market indices. The competition between funds for clients[6] drives them towards high-yield, high-risk assets; and by the same token obliges them to make frequent marginal adjustments to their portfolios in response not only to changes within these emerging markets but also in anticipation of what all other fund managers are likely to do next.[7]

The effect of these behavioural characteristics is exacerbated by the way in which financial markets clear. It is now well established in theory and practice that financial markets are in permanent disequilibrium in the sense that demand for funds always exceeds supply at the equilibrium interest rate.[8] In consequence, asset prices and interest prices do not fully reflect risk: lenders use portfolio allocation rules - and thus rationing - to reduce uncertainty. Domestic banks and securities firms are closely regulated to make sure they do this prudently and always have sufficient collateral and adequate reserves. In this way an ‘orderly market’ is established.

In contrast, international investment flows - which often enjoy neither legal collateral nor prudential regulation - react sharply to changing perceptions of country solvency rather than to variations in underlying asset value. Even if information on the return (or risk) on a particular asset can be acquired at a cost, the value of this knowledge declines as the opportunities for diversification increase, so investors have no incentive to search for information. Herding behaviour becomes endemic as the observed asset prices, exchange rates and reserve levels send the same signal to all participants but they all attempt to anticipate the same trend in order to make a capital gain.

Emerging market assets form a relatively small part of savers' portfolios in developed countries, but a large part of firms' and banks' liabilities in developing countries. Because of this asymmetry between borrowers and lenders, marginal shifts in lenders' positions tend to destabilize borrowers.[9] These surges are then worsened by herding behaviour because as opportunities for diversification increase the impact of news on the allocation of funds in a single country relative to initial allocations grows without bounds, resulting in a massive flows further threatening financial stability.[10]

Why the security of international finance matters

The international financial system is vulnerable to emerging market volatility; rather like banking in the US and the UK in the nineteenth century, when huge fluctuations in the real economy were associated with banking booms and busts.[11] . There is often a high degree of leverage in short term flows; banks making loans to hedge funds and similar intermediaries based in largely unregulated offshore international banking markets. In other cases they are on-selling risky securities to their clients; or extending short-term loans which are renewed every six months. Banks and other financial intermediaries have financial assets far larger than their own capital, so that the loss of only a small part of their loans threatens their survival. This is why they are restricted in the loans they can make by regulators. In consequence, when such losses do occur, they must sell other assets in order to recover the liquidity necessary to maintain their own capital. This exacerbates market fluctuations, leading to collapses more rapid and more deep than the preceding boom, for two reasons.

The first is a process known as 'rolling margin calls' where other assets (many of which are not owned, but rather obligations or options to buy or sell at some future date) have to be quickly sold, depressing their price and forcing other investors to sell further assets and so on. Thus the selling wave moves through the market far more rapidly than the original buying surge. When this results in a reduction of credit to firms in the 'real' economy, firms which have relied on the renewal of bank credit to finance operations are forced into bankruptcy.

The second reason is the effect that losses have upon the reputation of banks and funds, in a process known as 'contagion'. In the absence of reliable information as to the value of the assets held by a particular bank or fund, depositors withdraw their funds rapidly from this and related institutions - thus bringing about the very situation they fear and panic spreads - affecting firms in the same sector or country indiscriminately independently of their solvency. It this situation which usually obliges central banks to intervene by supplying sufficient liquidity for banks to meet their short-term obligations without becoming bankrupt.

Financial markets are thus inherently unstable, which is why at a domestic level they are so closely regulated. At the international level, it is precisely at the interstices between regulatory authorities that the largest short-term profits are to be made and the greatest risks of systemic collapse are to be found.[12] Emerging markets are particularly vulnerable[13] to this instability, not only because they have weak and inexperienced financial regulators.

Developing countries have shallow and narrow capital markets, where relatively small flows of foreign capital can have a large effect on prices, particularly those of government bonds and privatization issues which tend to make up the bulk of traded securities. Their firms tend to be highly geared and dependent on borrowed funds, so that credit restrictions have a disproportionate effect upon production. Their populations in turn are vulnerable because much of their population lives near the poverty line, unprotected by modern welfare systems; so that macroeconomic fluctuations - particularly large deteriorations in the exchange rate - can have serious social consequences.

Despite this vulnerability, rapid financial liberalization has been pressed by both international agencies and local modernizing elites in emerging market countries. As a result, large international liabilities have been built up by the private firms and households to finance both investment and consumption. The currency risk was perceived as low by foreign lenders due to the strong growth record and nominal exchange rate stability underpinned by the same capital inflows.

The volatility of short-term capital flows (or ‘capital surges’) is now recognized as a major problem for macroeconomic management in developing countries; which subsequently translates into investment, growth, employment and welfare.[14] Government expenditure cannot be efficiently allocated to the satisfaction of social priorities when both the borrowing ability and the cost of funds varies so sharply.[15] The impact of short flows on output and investment by firms through the availability of bank credit is also large, reducing private investment. Employment levels and real wage rates are affected by the influence of capital surges on real exchange rates and domestic demand levels.

Missing institutions

In response to these problems, special institutional arrangements have emerged historically in industrial countries as part of the process of constructing orderly financial markets. It would seem logical, therefore, to expect that an orderly global capital market would require similar institutions at an intergovernmental level.

These would be four:[16]

> *first* the core central banking functions of providing liquidity to the market, including last-resort lending under distress conditions in order to support otherwise sound banks and prevent contagion; this is the putative function of the IMF - although it at present has insufficient funds and is only empowered to lend to governments (or their central banks) and cannot deal directly with global or local private banks;
>
> *second*, the prudential regulation of financial intermediaries, in order to prevent not only fraud but also unsafe lending with wider consequences; to some extent this service is provided by the Bank for International Settlements, but it leaves the greater part of global financial intermediaries still unregulated;
>
> *third*, the existence of private financial institutions ('market makers') who stand ready to buy and sell assets at the current price - creating 'depth' and thus stability in the market - and to take over insolvent financial intermediaries when necessary; such cooperation is notable by its absence - particularly in international rescue operations;

fourth, and possibly most significantly, a sound and transparent legal system that secures contracts and provides for efficient dispute settlement between contracting parties and between financial intermediaries and the regulators; such a ‘multilateral framework for investment’ which could stabilize expectations and thus asset values does not yet exist.

3. The Political economy of Global Financial Reform

The Effectiveness of International Financial Institutions

The existing international institutional ‘architecture’ to cope with these problems in emerging markets is based on the agencies founded at Bretton Woods in 1944; the International Monetary Fund in particular. As intergovernmental institutions, the IFIs are essentially lenders of last resort, against which facility they can impose policy conditionality designed to restore long-term solvency in return for the provision of liquidity. Whatever the effectiveness of this approach in the sovereign debt crises of the 1980s, or to the chronic economic problems of the least developed countries, it is not appropriate for the emerging market crises of the 1990s. The recent Latin American and East Asian crises are essentially related to private sector asset deflation and illiquidity, not state failure.

The root causes of the breakdown were not prevented (and possibly have been exacerbated) by Bretton Woods policies of accelerated financial liberalization, exchange rate anchoring and encouragement of private portfolio investment as a substitute for sovereign borrowing.[17] The IFIs appear to have taken the pre-crisis position that because the external deficits reflect private investment-savings gaps rather than fiscal deficits, they must reflect rational market decisions and thus be respected. However, even had they wished to prevent such inflows, their ex-ante influence over lenders is limited to issuing negative macroeconomic evaluations with the consequent danger of market collapse.[18]

Ex-post, their insistence on large devaluations, high interest rates, credit restrictions and fiscal retrenchment have tended to further undermine both corporations and bank, worsening the crises they attempt to resolve. The failure of recent IMF interventions in East Asia and Mexico essentially derive from the failure to recognize and correct private debt problems. In the commercial world, of course, insolvent companies are placed under new management and the unserviceable debt is written off by the creditors. There is, however no equivalent in international debt crises.[19]

Of course, global surveillance is not only carried out by the IFIs. In principle, if the issue were one of information as such, the ratings agency should be able to invest in better information on country risk than any one investor and then provide what is effectively a public good for a modest fee. However, the failure of the leading private ratings agencies to predict collapse in Mexico and East Asia is notorious. The way in which information is used by ratings agencies seems to be deficient - an issue of economic interpretation rather than economic statistics.[20] There are various reasons for this, including the methodology used to construct ratings (which is largely backward- rather than forward-looking) and the natural desire not to destabilize already fragile markets.[21]

One of the key reasons for the volatility of capital flows is doubts about the solvency of particular developing countries. The existence of a large international public debt overhang represents a major constraint on further long-term foreign investment on any significant scale - due to the uncertainty caused by the prospect of severe stabilization measures in order to meet debt service, or the sovereign risk inherent in debt default. This debt overhang is also a major disincentive to private domestic investors, for the same reason.

In effect, the process of financial intervention in developing countries by the Bretton Woods institutions has led to the transfer of sovereign debt from commercial creditors to the IFIs themselves. Once so refinanced, it has become almost impossible to write off. The main reason given for not cancelling this debt is one of ‘moral hazard’[22] - the belief that if developing country sovereign debt is cancelled, then their governments - freed from the external constraint - will return to ‘irresponsible’ policies. Unfortunately, the current HIPC initiative[23] is both insufficient in scale and too lengthy in process to make a substantive contribution to the reduction of investor uncertainty.

Global Financial Architecture

The recurrent financial crises since Mexico in 1995 have naturally tested policy makers' enthusiasm for deregulation; but no lasting lessons were drawn from Mexico: it was only the East Asian collapse of 1997 followed by the Russian and Brazilian collapses of 1998 that forced discussion of institutional reform. All four required the US Treasury to engage in large support operations[24] through the IMF with somewhat reluctant assistance from Europe and Japan and without the consent of Congress. Indeed, Republican legislators remain unconvinced of the need to strengthen the capacity of the IMF to intervene in such crises, believing that losses should be fully borne by investors. It can be argued that it was only the collapse of Long Term Capital Management and its bailout by the Federal Reserve Bank of New York in order to prevent systemic collapse of Wall Street, that finally made the case for reform.[25]

It is generally agreed that reform is needed but there is little evidence of tangible progress. One problem is the lack of a clear idea as to what to do; but more crucial is the unwillingness of major states to act together. Even a minimal measure such as restoring the previous reserve requirements on international bank lending and doing so effectively would require concerted G10 action and vigilance of offshore operations. However, the US financial services industry has sufficient lobbying strength to block even this limited measure. Indeed similar supervision is required to combat the narcotics trade and has not yet been implemented.[26]

The two proposals on the table at present are relatively timid and yet the source of considerable disagreement:

> The 'G22 proposal' supported by Washington, is for the ad hoc grouping of leading industrial and emerging market countries convened by the US Treasury for the first time in 1998 to become more formalized. This is the only existing forum containing financial authorities from both developed and developing counties. The idea is to both strengthen financial supervision in emerging markets and maintain US control of the process. Washington believes that Europe is over-represented in the G7, the G10 and even the IMF; although abolition or restructuring of the IMF seems unlikely.

> The UK proposal is for an international standing committee of the IMF, the World Bank, Bank for International Settlements and key national regulators to monitor international capital markets and report on the cross-border activities of major financial institutions. Supervisory authority would remain with national regulators, but the standing committee would ensure exchange of information; their work would be based on the Basle Committee's 'Core Principles for Effective Banking Supervision', and the IMF's 'Framework for Financial Stability' which is derived from it.[27]

None the less, regulators in industrial countries are responding to the increasing consolidation of the financial services sector itself. In the US cross-sectoral mergers are accelerating in anticipation of the repeal of legislation which prohibits linkages between banks and securities houses and insurance companies.[28] Trans-border banking consolidation in Europe is being accelerated by the introduction of the Euro and thus riskless cross-border transactions. The ECB may be forced to take a more active part in bank regulation and act as lender of last resort like the Federal Reserve.

Finally, the reinstatement of capital controls are being reconsidered by a number of emerging market governments in the wake of the East Asian crisis.[29] Although administrative controls are unlikely to return, financial liberalization is likely to be much more cautious in future. Taxes and reserve requirements on short-term capital flows based on the Chilean model are likely to become more common; while greater emphasis will be placed on encouraging FDI as a more stable form of external finance.[30]

Triad Coordination

The provision of an orderly international capital market clearly requires not only improved banking regulation but also a reasonable degree of coordination between the three major currencies in order to reduce uncertainty and encourage longer-term lending. Indeed this was the aim - and achievement - of the post-War 'Bretton Woods System', although this was based on the US dollar as a single world currency.

After the successful launch of the Euro, the dollar is no longer the only key trading and asset currency. Moreover, encouraged by this opening, the Japanese government is pressing for a currency grid system between the three currencies, supported by their respective central banks. In addition the Hong Kong Monetary Authority has suggested that an ‘Asian monetary area’ be established with cross asset holdings by central banks in the region (rather than holding reserves in dollar assets) and eventually a common currency for trading purposes. These notions are strongly opposed by Washington which fears the decline of the dollar as the leading world currency.

Moreover, the Federal Reserve is tasked to maintain low inflation and steady economic expansion in the United States. It is not responsible for the parity of the dollar, and traditional policy has been one of ‘benign neglect’ of the exchange rate. On the one hand, international financial affairs are the concern of the US Treasury. Indeed finance has become the principal instrument of US foreign policy since the end of the Cold War. On the other hand, Congress is wary of international monetary commitments, and has effectively prevented monetary coordination even with Canada and Mexico within the NAFTA - despite this being one of the contributory causes of the Mexican crisis in 1995.

The European Central Bank has an even narrower brief - to maintain low rates of inflation. Frankfurt has no responsibility for euro parity, and there is no provision for a central treasury function in Brussels either. Although there is every expectation that the euro will steadily strengthen against the dollar, this is not the result of a considered policy but rather due to demand for the euro as a reserve currency and the growing US trade deficit. The Bank of Japan is subject to the Ministry of Finance, which does attempt to intervene to stabilize the yen, but its effective powers are limited by the domestic banking crisis and thus the need to keep its own banks solvent and accommodate the reflationary fiscal initiatives of the government.

These are more than conjunctural limitations. In the case of the Federal Reserve and the European Central Bank they derive from a political axiom that monetary policy should be removed from elected governments and entrusted to ‘independent experts’ with strictly limited responsibilities. In addition, the difficulty of coordinating three asynchronous economic cycles is often given as a reason why nothing further can be done; despite the successful experience of the Bretton Woods system in the 1950s and 1960s.

This stalemate can be characterized in two ways. On the one hand, it can be regarded as a classic problem of collective action, where there is a need for pooled sovereignty in order to increase the welfare of all three participants - and by extension the rest of the world.[31] Failure to agree essentially reflects misguided nationalism and a 'lack of leadership' in this explanation. On the other hand the stalemate can be seen as a classic problem in international relations, with the declining hegemon - that is, the US driven by strategic objectives and bank lobbyists - unwilling to cede global economic dominance to rising regional powers.[32] Meanwhile, international financial crises will probably become more frequent.

4. Financial Security, Market Rationality and Global Democracy

The Rationality of Markets

Global policymakers share the orthodox doctrine that the liberalization of trade and investment will increase efficiency, raise human productivity and eventually eliminate world poverty.[33] In political terms this has been reinforced by the widespread belief that governments are inherently self-seeking and inefficient, or at best hostages to populist pressures from their electorates. In contrast, markets provide a superior and in some sense more equitable rationality upon which social organization can be based. This view of the market as an objective standard is not fully shared by business people even though they naturally prefer as few regulatory restrictions as possible,[34] but it is a doctrine which appears to be received wisdom for most senior politicians and civil servants.

This has a number of corollaries. One is the tendency to entrust economic management to 'independent' and 'technical' bodies such as autonomous central banks,[35] independent of the control of the legislature or elected government. The fact that such institutions inevitably derive their autonomy as much from their coalition with leading banks (or in the case of emerging markets, multilateral agencies) as from their constitutional mandates is often overlooked. Another such corollary is the frequent argument that 'there is no alternative' (TINA) to conservative economic policies such as welfare restrictions and employment flexibility at the national level because acceptable standards of conduct are set by international capital markets. Any other policy will be 'punished' by capital flight.[36]

In consequence, to admit that international capital markets are inherently unstable - as I have been arguing explicitly and the proposals for a new financial architecture do implicitly - is to undermine a central *political* doctrine which is not confined to the realm of ideas moreover. The shift away from occupational and state pension funds on the one hand, and away from bank deposits and fixed-rate mortgages on the other, towards greater involvement of ordinary households (and voters) in financial markets also has profound political implications. The exposure of voters' sense of well-being to financial asset values (the 'wealth effect') has obvious benefits when stock markets are booming and interest rates are low; but any reversal (despite the small print) has equivalent political costs.

In the specific context of the security of internal finance, the neo-liberal trend has been reflected in the gradual move of regulatory practice away from the traditional prescriptive approach based on rules and prohibitions towards designing incentives for private financial institutions to behave in socially optimal ways. After determined lobbying from international banks, 'risk modelling' has been permitted by regulators in order to determine the capital reserve requirements of banks. As a result of the 1996 modification to the Basle Capital Accord, leading securities authorities announced in May 1998 that IOSCO members could permit the use of statistical models for regulatory purposes. However, these models have performed so poorly in the recent financial turmoil that it has become clear that the assumptions upon which these models were based were incompatible with extreme market stress.

This has revealed a fundamental problem in the dominant view of market rationality. While it is clear that asset markets are volatile by their nature, banks argued that the volatility involved could be estimated from past performance and certain 'fundamentals'. The measurable risk involved could be priced (in much the same ways as insurance premiums are calculated from actuarial tables) and compared to the yield on a safe asset (such as US Treasury Bills) in a portfolio constructed so as to offset the risk in one asset against another. However, this was to confuse risk with uncertainty and it is now clear that future outcomes were not effectively priced into asset values - which reflect subjective enthusiasms (and fears) rather than rational expectations of a predictable outcomes.

The problem has been worsened by a lack of clarity as to what ‘fundamentals’ actually are. Once gross fiscal imbalances have been overcome and market deregulation is under way; the main indicators can become confusing signals for investors. Thus large current account deficits are seen by some as a sign of success in attracting foreign investment and by other as a sign of an overvalued currency; while growing corporate foreign debt is seen by some to reflect efficient financial diversification, and by others as dangerous exchange rate exposure by unhedged corporate treasurers.

This means that the notion that markets would be more stable if more information were available is probably misguided. If the way in which probabilities should be constructed from available data is in doubt, then more data will not necessarily help and may even confuse. Unlike risk, uncertainty cannot be insured against and arguably is the main reason why institutions exist in the first place. Thus, despite the neo-liberal paradigm still being firmly entrenched, it is not surprising that there is a discernable change of mood back towards a desire for stronger international market rules, even in some business circles.[37]

Global Property Rules

Although over the past decade all countries have embarked on an unprecedented liberalization of their financial regimes, international investment agreements - such as bilateral investment treaties, double taxation treaties, regional trade agreements and certain WTO provisions have all multiplied. These trends reflect a move away from national rights to control foreign investment and norms for corporate conduct; and play key role in building investor confidence by locking in policy commitments over time.[38] They are usually based on general standards of treatment; coupled with norms on specific matters such as expropriation, compensation and the transfer of funds, as well as mechanisms for the international settlement of disputes.

In consequence, the twenty-nine OECD members launched negotiations in 1995 on the world's first multilateral agreement establishing comprehensive and binding rules for investment providing market access, legal security and a 'level playing field' for international investment flows.[39] Negotiation was between OECD members only although the Multilateral Agreement on Investment was intended to be eventually open to accession by non-member countries who could reach the required regulatory standards.

This non-inclusive negotiating format had a precedent in the early GATT rounds, but it was clearly a fundamental weakness insofar as emerging market interests could not be directly reflected. Moreover, a number of non-governmental organizations became concerned by the apparent exclusion of strict safeguards on labour standards and environmental protection from the MAI. None the less, the eventual breakdown of the Paris negotiations in 1998 arose from the nature of the exceptions claimed by OECD members (particularly the USA and France) rather than the development issue as such.

It now appears that negotiations on a 'Multilateral Framework for Investment' will be transferred to Geneva this year, not least because of the many investment-related trade issues already built into the WTO framework. France, Canada and the United Kingdom all support this approach, and the European Commission has included investment in its proposed list of agenda items for the comprehensive 'Millennium Round' of multilateral trade talks which it wants to see launched in 1999.

Effective multilateral taxation of corporate profits and asset incomes has also become a topic of increasing concern to industrial countries. There are current moves towards tax harmonization and establish withholding taxes in the EU order to reduce the tax loss on the profits generated there. In order to strengthen this process of fiscal capture, it will become necessary to eliminate tax havens - or at the very least deny the benefits of international investor protection to firms registered there. Such an agreement would not only improve the fiscal revenues participating countries[40] but would also strengthen the effort to combat money laundering and financial fraud - again, stabilizing financial flows.

If such a multilateral tax treaty were to include developing countries it would confer a number of advantages. First, it would prevent wasteful tax competition between developing countries in order to attract foreign investors. Second, as all tax paid in developing countries is deductable against tax liability in (developed) home countries, increased effectiveness in tax collection by developing countries would be a net transfer between the treasuries of home and host country - far more effective than the present system of development assistance. Third, this would provide a stable source of long-term funding for the public investment in education, health and infrastructure that developing countries require. Fourth, it would permit effective taxation of their own nationals with considerable overseas assets; and reverse the trend towards national tax systems being forced to taxation their main immobile factor of production - labour.

Such an approach would be superior to proposals for a so-called ‘Tobin’ tax on short-term financial transactions.[41] Such a turnover tax would have little effect on speculative flows, because at any feasible rate it would imply a penalty of marginal importance compared to the prospective losses from maintaining asset holdings in a currency under attack. In addition the Tobin tax would be impossible to collect in view of the complexity, speed and substitutability of cross border currency transactions - leaving aside the problem of offshore transactions.

In contrast, multilateral corporate taxation can be based on the statutory requirement to present accounts in some jurisdiction, and only requires the effective coordination of the vast web of existing bilateral tax treaties. It would also deliver resources to developing country governments rather than to an international body and not require - in principle - a new international bureaucracy to administer it.

Global Citizenship?

The difficulty in establishing international rules as the basis for global financial security underlines the fact that no system of international commercial law exists. There does exist a system of international public law which regulates - albeit under some strain at times - the relations between states.[42] However there is no equivalent in the fields of trade and investment, beyond the treaty obligations of governments under - say - the World Trade Organization.

In consequence, international commercial cases are arbitrated either in the national jurisdiction of the contracting parties' choice[43] or at private tribunals. Indeed the only persons traditionally recognized under international law are pirates, and more recently perpetrators of genocide. The right of foreign investors to make claims against states on their own behalf has, however, been established recently for the first time in a major plurilateral treaty in the North American Free Trade Agreement (NAFTA); a precedent which generated considerable disquiet when it was included in the draft of the MAI.[44]

The recognition of firms ('juridical persons') in international law as the basis for international property rights, would have considerable implications for global citizenship - although what these implications might be is far from clear. Many critics of globalization would argue that the consequences of such a development would be to further strengthen the hand of multinational corporations free to move around the world and hold governments to ransom, as against local labour forces confined to their national territory and forced to reduce wages and work conditions in order to find employment.[45]

This would seem to me to be an argument for stricter *international* regulation of investment, rather than attempts at national withdrawal from the global economy. Equitable negotiations of international investment and taxation rules, along the lines discussed above, would seem to be a first step towards this. What is more, the recognition of firms under international law would make the recognition of persons almost inevitable - thus strengthening the subsequent development of international human rights. A historical precedent is the way in which property rights formed the basis for civil law in England, and subsequently for civil and thus human rights.

It is true that the growing mobility of capital contrasts markedly with the increasing immobility of labour[46]. However, this would reflect a serious challenge to the notion of citizenship even if an equitable financial architecture were in place and multinational corporations all behaved in an irreproachable manner. As modern economic theory has shown, it is not just financial capital, management skills, modern technology and skilled labour - all of which are internationally mobile in principle - which determine productivity growth and living standards at the national level. Rather it is the 'social overhead capital' of infrastructure, institutions and even culture which account for the larger part of international income differences.

These common assets are built up historically through social investment (and tax payments) of previous generations, and thus are specific to nations (or cities) and not internationally mobile. This form of capital is 'owned' by the nationals of the country in question; and is essence means that their passport is the principal asset which citizens of rich countries possess. Their incomes depend upon the 'dividend' from joint ownership of their country's social overhead capital - an equity which they mainly inherit through birth and deny to other members of the global community by prohibiting immigration. [47]

In the strict sense of liberal political philosophy set out by Rawls, this arrangement is clearly unjust. All parents in poor countries would doubtless prefer that their children be born citizens of a rich nation, independently wherever they were to eventually reside.[48] Once behind the 'veil of ignorance' and not knowing which passport their children would receive in a lottery system, future parents from both poor *and* rich countries would logically vote for the free movement of labour around the globe. In Rawls' rigorous sense, the 'indifference test' demonstrates that the current situation is manifestly unfair and unacceptable.[49]

It can be argued, of course, that the citizens of individual countries do not belong to a single political community and can only be represented internationally by their respective states. This is a realistic interpretation, but leads logically towards more equitable representation in international organizations charged with the regulation of the international economic system. Specifically, this implies that the United Nations should be the forum in which investment issues are settled through the equal representation of states,[50] or possibly by the creation of an 'economic security council' reflecting regional economic interests.[51]

None the less, it is worth considering the implications for the Hegelian moral imperative of the debates on international financial security outlined in this lecture, however hypothetical these may be. All human beings *are already* members of a single political community by virtue of their participation in a global market; a participation in which they were not consulted. If financial assets become internationally recognized as they must be if they are to be effectively regulated, and if a multilateral property (and tax) system emerges, then this eventually means the recognition of natural persons as subjects of international law. Finally, such recognition opens the door to the redistribution of the global income from capital towards the labouring poor and the eventual elimination of global poverty in the form of social transfers rather than 'aid' in the twenty-first century in much the same way in which social citizenship replaced charity in modern Europe during the twentieth.[52]

5. Conclusions

In less than an hour I have leapt somewhat unsteadily from economic theory to political economy and then on towards political philosophy - a somewhat perilous inter-disciplinary expedition which I trust has been worthwhile.

To recap, my three main points have been:

> *first*, financial markets are inherently unstable because they deal in expectations; they require strong regulation to underpin contracts and prevent systemic collapse; so that global financial markets require global regulation - not as a means of protecting consumers or small investors, but just so that they can function at all; the consequences of this instability - particularly for the three-quarters of the world population outside the OECD;
>
> *second*, it has taken repeated international crises to convince global policymakers that the Bretton Woods Institutions are wholly inadequate to provide the required international security; but the implementation of the required regulatory framework faces the opposition of both the major global economic power and private financial

intermediaries; resolution of this impasse may only come about through the geopolitical balance between new currency areas;

third, the process by which a new inter-governmental financial architecture is established will be slow and driven by successive crises; but it will entail a more critical approach to markets ‘rationality’ as a substitute for political process, to the nature of international property rights, and possibly ultimately towards the concept of global citizenship itself.

My argument has thus *not* been against global financial integration - which in any event is an inevitable trend - but rather a case *for* the construction of an appropriate international framework which an orderly market requires. The construction of that framework will be slow and driven by national interest, but I believe that it just might contain an opportunity for global emancipation.

ENDNOTES

1. I would like to thank the MacArthur Foundation for support to the research programme at the Finance and Trade Policy Research Centre from which this paper is derived.

2. According to the *OED* the use of the word 'security' in a financial sense is at least as old as that of personal safety , and that the latter originally implied carelessness. **Security**: **I.** The condition of being secure. 1. The condition of being protected from or not exposed to danger; safety. 2. Freedom from doubt. Now chiefly, well founded confidence, certainty. 1597. 3. Freedom from care, anxiety or apprehension; a feeling of safety. *arch.* Formerly often culpable absence of anxiety, carelessness. 1555 ('Security Is Mortals cheefest Enemie' SHAKS) **II.** A means of being secure. 1. Something which makes safe; a protection, guard, defence 1586. 2. Ground for regarding something as secure, safe or certain; an assurance, guarantee 1623. 3. Property deposited or made over, or bonds, recognizances, or the like entered into by, or one behalf of a person in order to secure his fulfilment of an obligation, forfeitable in the event of non-fulfilment 1450. 4. One who pledges himself (or is pledged) for another, a surety 1597. 5. A document held by a creditor as guarantee of his right to payment. Hence, any form of investment guaranteed by such documents. Chiefly *pl.* 1690 ('Liquid Securities, or in other words, those easily convertible into cash when necessity arises' 1879). The sense of 'state security' frst appears in the 1965 *Addenda.*

3. The oil crisis did of course cause serious problems for industrial countries, and was accompanied by calls for a 'New International Economic Order' from critics of the Bretton Woods system; but it did not lead to any change in the way the OECD countries viewed the world or arranged their institutions.

4. It is to say the least ironic that the in an attempt to broaden the membership of the OECD to include industrializing powers Mexico and Korea were admitted in 1994, while the candidates in 1997 were Russia, Indonesia, India, Brazil and China. Five of these 'big seven' have since suffered financial collapse.

5. Calculated from IMF *World Economic Outlook* Washington DC: International Monetary Fund (October, 1998). As is frequently pointed out, these countries account for only 16 percent of the world population.

6. Because depositors in (say) pension funds cannot know the eventual value of the asset acquired when they retire, they can only rely on the *current* return on the fund in question as an indicator of the fund manager's capability. This encourages short-term maximisation of returns by fund managers in order to gain market share; a bias which is exacerbated by the system of quarterly bonuses as a form of remuneration.

7. Just as good driving consists in correctly anticipating the actions of pedestrians and other motorists rather than efficient use of the vehicle as such.

8. 'Global saving and interest rate behaviour: why don't international capital markets clear?' in S. Sharma (ed) *John Maynard Keynes: Keynesianism into the Twenty-first Century* London: Elgar (1998) pp. 223-239

9. In addition, financial liberalization means that in an economy such as Mexico, the entire domestic money supply is - in effect - a contingent foreign exchange claim on the central bank because bank deposits can be converted into dollars on demand.

10. See IMF (1998) *Toward a Framework for Financial Stability* Washington DC: International Monetary Fund

11. Kindelberger, C.P. (1996) *Manias, Panics and Crashes: a history of financial crises (3rd edn)* Basingstoke: Macmillan

12. BIS (1998) *Sixty-eighth Annual Report* Basle: Bank for International Settlements. The BCCI and Barings cases are two of the best known examples.

13. There is an interesting parallel with the epidemiological concept of vulnerability to (say) tuberculosis, which combines exposure to a particular environment and the resilience of the victim.

14. E. V. K. FitzGerald 'International capital markets and open-economy macroeconomics: a Keynesian view' *International Review of Applied Economics* vol 10.1 (1996) pp. 141-156

15. See FitzGerald, E.V.K., 'Capital surges and sustainable macroeconomic policy' in International Economic Association *Adjustment and Beyond: the Reform Experience in South East Asia* Basingstoke: Macmillan 1999.

16. For further details, see E. V. K. FitzGerald 'Coping with uncertainty: global capital market volatility and the developing countries' (paper presented to the North-South Roundtable Seminar at Easton MD, June 26 1998)

17. E. V. K. FitzGerald 'Global Capital Market Volatility and the Developing Countries: Lessons from the East Asian Crisis' *IDS Bulletin*, vol 29.4 (1998)

18. E. V. K. FitzGerald 'Intervention vs regulation: the role of the IMF in crisis prevention and management' *Unctad Review 1996* (1966) pp. 35-53

19. Eichengreen, B. and R. Portes (1995) *Crisis? What Crisis? Orderly Workouts for Sovereign Debtors* London: Centre for Economic Policy Research

20.The assessment over whether the current account deficit of a particular country reflects longer-term debt solvency, and thus the evaluation of the exchange rate risk and the probability of a policy shift which could affect asset values, depends not only on knowing what the current payments and debt situation is, but also the expected rate of growth, the expected world interest rate and what investors will regard as an acceptable debt ratio. These are all matters of economic (and political) judgement rather than statistical information.

21. It is sometimes suggested that these agencies have emerging market governments as clients for the rating of new issues, they are reluctant to downgrade them - but there is no reliable evidence of this.

22. The concept of moral hazard originates in accident insurance, where car owners once insured may be careless of damage to their vehicle unless there is a minimum claim or no-claims bonus. Whether this notion can be rigorously applied to major macroeconomic crises where the outcome (ie a bail-out) is uncertain seems very doubtful - it is not applicable to life insurance after all. The other justification - that cancellation would reduce the IFIs credit ratings and thus ability to mobilize further development resources - is wholly implausible because the ratings depend not on the quality of lending but underwriting provided by the member governments. In other words, IFI borrowing on international capital markets is secured against fiscal receipts in *developed* rather than developing countries.

23. DAC *Development Assistance Report 1998* Paris: OECD/Development Assistance Committee, 1998

24. Each of these has required funds of the same order of magnitude as the entire annual aid budget to all developing countries.

25. Ironically it had two Nobel laureates in economics on its board. It should be noted that although LTCM was a hedge fund registered in Bermuda and thus unregulated, it was speculating in US Treasury bill futures at the time.

26. The argument that offshore financial centres are autonomous states and thus cannot be forced to cooperate is of course nonsense - their very existence depends on the protection of a G7 member.

27. IMF *Toward a Framework for Financial Stability ...*

28. Specifically, the 1933 Banking ('Glass-Steagall') Act and the 1956 Companies Holding Companies Act

29. FitzGerald, E.V.K. (1998) '*Caveat Creditor*: the implications of the Asian Crisis for international investment regulation' [paper presented to the UNCTAD Seminar on 'The Asian Financial Crisis', May 1 1998 in Geneva]

30. S. Griffith-Jones, M. Montes and A. Nasution (eds) *Managing Capital Flows in Developing Countries* Oxford: Oxford University Press (forthcoming).

31. See Krugman, P. and Obstfeld *International Economics*

32. See Wyatt-Walter, A. *World Power and World Money: the role of hegemeony and monetary order* Hassocks: Harvester Wheatsheaf, 1993.

33. This is the perspective set out by the OECD countries: OECD (1998) *Open Markets Matter: the Benefits of Trade and Investment Liberalization* Paris: Organization for Economic Cooperation and Development. See also World Bank (1997) *Private Capital Flows to Developing Countries: the road to financial integration* Washington DC: World Bank.

34. See the lecture by John Kay in this series 'Global Business, Global Economics?'.

35. Sometimes referred to as 'institutions of restraint' - a significant choice of words.

36. See World Bank *World Development Report 1997* Washington DC: World Bank, 1997.

37. " We have this false theory that markets, left to their own devices, tend towards equilibrium. ... To argue that financial markets in general, and international lending in particular, need to be regulated is likely to outrage the financial community: yet the evidence for just that is overwhelming" (George Soros, *Financial Times* 31 xii 97).

38. *World Investment Report, 1997* Geneva: United Nations Conference on Trade and Development, 1997; and WTO *World Trade Report, 1997* Geneva: World Trade Organization, 1998

39. See Fitzgerald, E., R. Cubero-Brierly and A. Lehmann, *The Implications for Developing Countries of the Multilateral Agreement on Investment* London: Department for International Development; Paris: OECD 1998.

40. From the point of view of individual countries, corporate profits are difficult to tax for two reasons. First, because capital is mobile it can be driven abroad by high tax rates or deterred from investing in the first place. This leads to downward fiscal competition between developing countries and a lower average tax rate. Second, by arranging their international transactions appropriately, companies can accrue profits in the lowest tax jurisdictions - which are often 'tax havens' - and thus further reduce the tax burden on capital. In both cases there is a clear loss in global welfare to the extent that the tax revenue would have been used for social infrastructure investment or effective poverty relief.

41. The case for such a tax is set out in Haq, M.U., Kaul, I. and Grunberg, I. *eds* (1996) *The Tobin Tax: coping with financial volatility* Oxford: Oxford University Press. The reasons why it would not in fact reduce volatility are set out in Arestis, P. and M. Sawyer (1998) 'What role for the Tobin tax in global governance' [mimeo] University of East London and University of Leeds. The other apparent attraction of the Tobin tax is to provide resources for international development assistance in general and for the UN in particular. However, aside from the fact that there are easier forms of raising international taxation (such as a tax on international airline tickets) the major barrier is clearly political - the unwillingness of national legislatures to devote more funds to aid, or *a fortiori* to the United Nations.

42. This contrasts with advances in international public law, though even here the 'right to development' established by the UN is not effective - see Brownlie, I (1990) *Public International Law, 4th edn* (Oxford: Clarendon Press, 1990) and also his lecture in this series 'The Peaceful Settlement of Disputes between States and the Problem of Globalisation'.

43. Frequently the New York courts, which are reputedly collapsing under the strain.

44. See FitzGerald, Cubero and Lehmannl, *op cit*. Interestingly, the MAI draft also includes a proposal that the senior executives of foreign firms should be granted exemption from migration controls.

45. UNRISD (1995) *States of Disarray: the social effects of globalization* Geneva: UN Research Institute for Social Development.

46. The reasons, of course, are largely political. None the less, it is striking how few (if any) libertarian advocates of an unregulated global economy are willing to mention (let alone propose) the free movement of labour. See also the lecture by Robin Cohen in this series ‘Labour in an Age of Global Insecurity’.

47. For a formal model of this notion of ‘the asset value of citizenship’ and a preliminary approximation of its financial valuation, see FitzGerald, E.V.K. and Cuesta-Leiva, J. (1998) ‘The Asset Value of a Passport: a model of citizenship and income determination in a global economy’ *Working Papers Series QEHWPSxx* on http://www.qeh.ox.ac.uk

48. Indeed many Latin American mothers - both rich and poor - strive to give birth in the USA for just this reason.

49. This argument is developed in FitzGerald, E.V.K.(1997) ‘Rethinking Development Assistance: the implications of social citizenship in a global economy’ Geneva: UN Research Institute for Social Development [also as *Working Papers Series QEHWPS01* on http://www.qeh.ox.ac.uk]

50. Schreiber, N. (1997) *Sovereignty over Natural Resources: balancing rights and duties* Cambridge: Cambridge University Press

51. Stewart, F. ‘The Governance and Mandates of the International Financial Institutions’ *IDS Bulletin* vol 26.4 , 1995: 28-34

52. To reach the target agreed by OECD members of halving the proportion of developing country population living in poverty by 2020 would require a doubling of per capita incomes over the next 20 years, and thus a sustained GDP growth rate of over 5 percent per annum (DAC *Development Assistance Report 1998...*). This is far beyond the track record of poor countries and similar to that of East Asia between 1970 and 1990. In contrast, since the poor receive only 1 percent of world income, a transfer of 1 percent of the income of industrial countries (ie 0.5 percent of world income) would halve the number of poor immediately.