Charity and Justice in the Relations among Peoples and Nations
Pontifical Academy of Social Sciences, Acta 13, Vatican City 2007
www.pass.va/content/dam/scienzesociali/pdf/acta13/acta13-derbez.pdf

FAIRNESS IN INTERNATIONAL INVESTMENTS AND FINANCING

LUIS ERNESTO DERBEZ BAUTISTA

When speaking of fairness in financial markets, one has to be aware of the many aspects this implies. Because I framed my thoughts in terms of the capital markets of the world, I would like to start my presentation with the following quote. Quote that appeared in the March 31st issue of the magazine *The Economist*, as it referred to the current situation of the world's financial markets:

'The next wave of distress will be unlike the last in two respects. First, commercial banks no longer dominate the process. Non-banks such as hedge funds now make roughly half of all high-yielding leveraged loans and hold the lion's share in the secondary market. Secondly, borrowers' capital structures – the various layers of debt and equity, each with different rights in the event of default – are now more complex'.

Fairness and Unfairness of the Financial Markets

What does this mean? It means that globalization, and the appearance of new actors in the market has modified the rules in such a way that fairness in international flows of capital is difficult to evaluate. The explosion of financial instruments based on derivatives make it extremely difficult to understand even by experts in the field, why the access that many developing nations should have to required capital, either as foreign aid, or foreign direct investment, is not occurring.

Indeed, unlike the expectations that globalization of the markets brought in the last part of the past century, the many financial instruments now available to the world and the fact that speculation has taken hold of the markets, has led the world to a financial system with greater vulnerability to accidents than it ever was before. As a result, time and again we have observed that the possibility occurs that through no fault of its own, a developing nation suddenly finds itself without access to capital in a very quick period of time . Today, as a result of this globalization process, we are facing two major financial risks which throw initial light on the unfairness of the current system to developing nations. The first one has to do with the proliferation of derivative instruments; the second with an excessive appetite for dollar denominated debt to finance current account deficits in large nations. I would like to talk about both today, as I believe they are the source of the great inequality and unfairness in today's world that developing nations face when looking for financial support to their economic programs.

First, proliferation and profusion of financial instruments have increased the potential risks to the international financial system. The instability that they produce, translates into fewer opportunities for financing projects in developing nations. The nominal (face) value of derivative instruments amounts to multiples of global GDP. Based on this massive number, it is easy to tell stories about how a financial crisis can occur, as a chain of interlocking derivative contracts unravels due to a failure to settle one contract, which is hedging another contract, which in turn is a hedge to something else. Pretty soon, as in stories in which the payments system grinds to a halt due to a relatively small payments failure, a small event can be made to have frightening consequences.

Scenarios involving the unraveling of a chain of derivative transactions may be unrealistic, because there are netting arrangements among most institutions which mean that it should generally be possible to offset obligations that have not been settled. Nevertheless, it may be equally possible that the risks that are passed on through derivative contracts may be inappropriately placed and not adequately recognized. For instance, when banks securitize or hedge a risk, the risk migrates to other places – frequently, it is believed, to insurance companies. The concern is that the risks move from people who understand them to those who do not. If that is the case, the world may soon be facing a major financial collapse; one where poor and disadvantaged nations may end up with the worst part of the cost.

On the other hand, superfluous consumption in developed nations has created an excessive demand for funds to finance their current account deficits. The ease with which a country as the United States of America manages to attract funds is remarkable, leading to question a system which provides large amounts to finance consumption, and few resources to finance projects in developing nations which could help them to reach higher levels of growth and employment, thus to lower levels of poverty. Moreover, the consequences of this mismatch between demand and supply of financial flows could lead to consequences that would hit in a stronger negative way developing nations, once again, through no fault of their own.

Let me explain this last point.

We are all aware of the devastating effects that excessive international debt had in the economies of nations who found it easy to finance a consumption period in their histories. The Mexican crisis of 1994, the Asian crisis of 1997, and the Argentine crisis of 2001 are examples of currency mismatches and their aftermaths. However, in those cases the size of the economies involved and the nature of the foreign exchange risks taken by them are different from what could happen today. The punishment brought about by the solution to those crises was borne mostly by the borrowing countries which had indebted themselves in foreign currency. Devaluation punished the debtors, but we all know the effect on growth caused by the ensuing financial crises, I will refer to them later on.

Bad as these episodes of financial world crises were, we have a more dangerous situation today. It is no longer small economies that are at risk; it is the United States of America, the world's largest economy. The US has borrowed heavily abroad to finance ever larger current account deficits derived from an insatiable appetite for consumption goods. But whereas in the past indebted countries did so in currencies other than their own, the US has done it almost entirely using dollar-denominated liabilities. This implies that, just at the time that creditor countries could be facing the challenge of appreciating currencies and more competitive trade markets, they would also be facing the 'headwinds' of sharp wealth losses on dollar-denominated assets.

The negative effect would be a double negative impact on developing nations: first, a loss to financial access product of a reduction in financial official aid from many developed nations, as well as a fall in foreign direct investment arriving to their economies. Secondly, the heavy losses which such a crisis could bring to the world undoubtedly would translate in a more protective trade environment, affecting the developing nation's access to the very markets they would need to receive income needed for their development.

The Evolution of the Market

How did this unfairness in financial flows for development come to be?

Fifty years ago, foreign direct investment and capital market flows were negligible. Official financial aid was the dominant factor in financial flows arriving to developing nations. Thus, an orderly manner of transferring capital was in place. This was possible because first, foreign direct investment was strongly curtailed by limitations imposed by many developing nations. Sectors of national interest were the recipients of such flows, the result was productive investments and growth which helped create jobs and welfare in the economies when the funds arrived. No speculative flows arrived, which was a major difference from where we are today.

Indeed, investing in foreign securities was practically impossible for most investors. Typically, nationals were forbidden to take their money away from the country, or foreign currency restrictions made it impossible for them to obtain foreign currency to pay for foreign securities. In addition, the countries in which they would have wanted to invest almost always did not allow them do so. As a result, capital markets in most countries were completely segmented. As financial liberalization took hold of the world, explicit barriers to international investment were brought down and, for the largest and most developed countries, largely eliminated. To use the analogy of bestselling author Thomas Friedman, when one focuses on explicit barriers, the financial world has become flat when one looks at developed countries, and has become flatter when one considers emerging markets.

Unfortunately, the financial world is much flatter de jure than de facto. The results we have observed from this new arrangement in the international financial system have limited the sharing of risks internationally and prevented capital from flowing to where neo-classical models suggested it would have the highest return: developing nations in need of it.

Leading trade and financial theorists now know that capital mobility is different to goods mobility, and that there is something about trade in financial instruments that is different from trade in goods. This is due to the failure to recognize that while regulation is almost certainly more necessary in financial markets than in goods markets, the need is not for regulation of international capital flows, it is for regulation of financial markets, domestic and/or foreign – a distinction that may not have been drawn sufficiently when recommendations to liberalize financial markets were pushed by multilateral institutions like the World Bank and the International Monetary Fund.

The proposed liberalization of financial markets pushed by the multilateral financial institutions was based on the neo-classical model of portfolio choice which predicted that, under liberalized markets investors would hold portfolios that were well-diversified internationally, so that risk was shared across countries efficiently and capital flows where it could be used most profitably. Unfortunately experience has shown us that instead of this result capital does not appear to flow to where neo-classical models predicted it would. Today, investors hold portfolios that are overweighed in the securities of emerging countries which are approved by international financial agencies. And foreign investment funds follow the same approach, reducing substantially the offer of capital to those nations not considered safe by the international rating agencies. Furthermore, as the governments of developed nations consider that a sufficient amount of financing exists in the world, they have reduced their official aid flows, a situation that clearly has created a more unfair financial system than the one we had in the second half of the 20th century. In other words, an inherent bias is very much with us, one which unfairly discriminates against many of the countries where the financial flows would do the most good, both in terms of return to productive investments, as well as, more importantly, to the return of investment in people, a fact which is leading to today's migration processes: migration of people instead of trading of goods, a doubly unfair result.

We should have expected this bias when pushing for financial liberalization in the world. While experts were emphasizing financial liberalization, the Asian crisis intervened, and the countries most affected by the crisis were those of developing nature. As an example take the Brazilian crisis of 2002. If a country was following the experts' advice on implementing the so called 'Washington Consensus' measures it was Brazil. The crisis, thus, was the result not of poor economic management of the country; it was caused by the fear of international investors that Brazil might not service its debt if Lula were elected president. Clearly such a response to good management was an unfair outcome.

The unfairness derived from: a) the short-term nature of many of today's financial flows, b) the high turnover in financial markets and the multiplicity of agents who decide about a country's prospects, c) the speed with which market participants react to new information in negative ways, and quite importantly, d) the global reach of financial institutions with monopolistic power in the sector, commercial banks and financial rating agencies. These complexities of the new financial markets and the dominance by a few global financial institutions have a number of implications which affect the fairness in the way that capital is allocated in today's world.

Let me briefly consider a few of these, before turning to how they can significantly complicate the lives of policymakers.

The first implication to note has been the growing integration of financial markets, including those in emerging market countries, with subsequent impact on the covariance (perhaps even 'excessive covariance') of asset prices. Over the last year or two, equity prices in virtually every emerging market economy (EME) have risen strongly while sovereign spreads have dipped to record lows. Even more astonishing, the sharp increase in house prices in most industrial countries has also been reflected by similar sharp increases in many EMEs. While arguments can be put forward to explain these developments in terms of 'pull' factors (better policies) in EMEs, there seems a reasonable chance that 'push' factors are also in play. The sharp increase in competition in the financial services industry in the industrial world, together with high hurdle rates and very low policy rates, has fostered a search for yield that has affected markets everywhere.

In what way does the international dimension complicate the lives of policymakers in developing nations? Consider first the conduct of monetary policy in tightening mode, with price stability as the ultimate objective of policy. As interest rates begin to rise, the currency will tend to strengthen. This will have a downward influence on inflation, implying that interest rates have to rise less than otherwise. This can have two dangerous effects. To start with, if the combined effect on the price of tradeables is greater than on non-tradeables, the trade account may deteriorate. Then, with domestic interest rates relatively low, asset prices could rise and even take on "bubble"-like dimensions. With spending further supported by this phenomenon, there would likely be further deleterious effects on the trade account. In the end, the markets could lose patience and a crisis might follow for the country involved.

This sounds very much like the dynamics of the Mexican and Southeast Asian crises. And while it would be tempting to say that the international complication is really only material for small open economies, what has been going on in the United States seems qualitatively similar. The rate at which the United States is becoming externally indebted is, in itself, a cause for concern. Moreover, such concerns must be heightened by the recognition that the money lent by foreigners has been spent on bigger houses and higher oil prices, rather than investment in the tradable goods sector. As I mentioned before, the US deficit also has the potential to unleash a bout of global protectionism, which is not the case when small economies run into similar problems.

A second implication has to do with the management of monetary policy to help reduce cyclical effects in the emerging economies. Monetary policy in a financially integrated world is more complicated than it was in the past. The danger here is that an orderly management of the monetary mass could turn into a disorderly one, necessitating a sharp increase in policy rates to stabilize the situation. We saw this on a number of occasions in Canada in the 1980s, and we have had a more recent example in Turkey. The end result of such policies could be a tightening of monetary policy which affects growth and investment in the host country, rather than an intended easing which would help increase investment possibilities in the nation concerned. As we in Mexico know, it is not a pleasant experience to find yourself going in the opposite direction from that originally intended.

The third problem arises from the globalization of commercial banks, and the presence of hedge funds as the major suppliers of financial flows in today's domestic and international markets. Banking supervision in a globalized world poses huge challenges for the relationship between home and host supervisors as they collectively seek to prevent crises from happening. The oversight of international payment and settlement systems is another important cross-border issue, one that affects the fairness of the international financial system.

Should the global financial system be subject to a sharp shock somewhere, the issue of how large, complex financial institutions might be wound down remains unresolved. The question of who might bear the costs of an adjustment under such shock still remains undecided. But we have then to ask ourselves the following: in a domestic financial crisis provoked by lax supervision of large dominant international banks in our economies, when emergency liquidity assistance is required, who is to provide it? In what currency?

There are a lot of issues to think about here, particularly since the absence of clarity about the limited role of the public sector brought about by liberalization policies positively encourages moral hazard behavior of the large financial institutions that control the domestic markets of many emerging nations. Thus the globalization of financial markets may provide enormous opportunities, but what we know is that it does create enormous concerns on their effect in providing a fair and just financial world system.

What may seem to the parent organization to be marginal decisions in a global business strategy may have major consequences for the availability of credit and liquidity in the host country when the local financial institution is large relative to local markets. While competitive forces, relatively free entry, and a global market for corporate control should replenish any gap in capital or risk tolerance over time, in practice, frictions, entry restrictions and information asymmetries can slow that process. The process could become more disorderly in periods of individual institution or general financial distress.

To resolve this situation which clearly is a major factor in the unfairness of the current international financial system, home and host country supervisors need to coordinate their supervision of large, multinational financial institutions. Where foreign-owned institutions make up a large proportion of the financial sector of an emerging market country, the health and well-being of the country's financial system may depend greatly on the financial strength and managerial effectiveness of the parent organization, as well as the local subsidiary or branch. In turn, host country supervisors would like to benefit from that comprehensive overview of the parent as they carry out their supervisory responsibilities. In particular, host country authorities want to receive information that is material to the operation of banking and financial markets within that country, recognizing that some constraints exist, especially for public parent companies.

After all the above is taken into consideration, it is difficult not to be skeptical of the fairness of the present financial international system of allocation of capital. The more we look at it, the more we feel concerned about its current structure. The skeptics now claim that the costs of financial opening in emerging markets are likely to outweigh its uncertain benefits. However beneficial the globalization trends may be in terms of economic efficiency, the implied changes, increased cross-border competition and pressure to adjust have provoked negative economic results and calls for protection, and not only in emerging markets.

The Mexican and Asian crises, in particular, were of a systemic nature, reminding us that financial markets have a growing capacity to transmit shocks, both across borders and across markets. The list of financial shocks in recent decades also includes the global stock market crash of 1987, the bursting of real estate bubbles in the late 1980s, and credit and asset price booms and busts. Experience has shown that in a number of instances the bust phase of the cycle has been accompanied by a crisis in the financial system. In many emerging market economies, domestic tendencies towards credit, asset price and investment booms have been reinforced by capital flows. Their abrupt reversals have deepened the bust phase. Moreover, emerging market economies – unlike developed ones – as a rule have not been able to borrow in their own currency. The resulting costs to the real economy have thus been greatest when, due to currency mismatch problems, banking crises and foreign exchange crises have coincided.

As if all this were not enough, even though international capital markets have become deeper and more capable of taking on risk, they have become more sensitive to fads and fashion. Changes in perceptions or attitudes towards risks can abruptly alter the funds that a country can expect to receive (sudden stops). These changes can prove costly, in terms of sharp price variations, pressure on the exchange rate, projects having to be abandoned for lack of funding, and so on. In such a scenario, what can small countries do?

Thus, the new financial order of integrated markets comes as a mixed blessing for developing nations. Certainly, integration does bring great benefits to these economies: external funds begin flowing in; countries can enjoy lower costs of capital and take advantage of greater opportunities for risk diversification. In addition to cost reduction, through increased competition, it pushes local industry to increase efficiency and adopt best practices. In a more open environment, competition and market discipline are enhanced.

However, financial integration also entails the danger of amplifying the costly distortions and imperfections of domestic financial markets, as they are internationalized through financial flows between countries. It may also uncover the incompatibilities that arise between countries with inconsistent macroeconomic policies. But what is probably even more important, financial integration creates an additional source of domestic volatility, as irrational exuberance, bubbles and crashes in international markets are imported and contagion effects and sudden stop dynamics make it almost impossible to remain isolated from shocks elsewhere in the world. When financial imbalances grow too far and/or for too long, they do have the potential to trigger financial instability, especially if financial institutions' balance sheets are exposed to such risks.

Financial instability implies that due to some shock the financial markets are not properly performing their standard functions, i.e., effective mediation between creditors and debtors, spreading of risks and efficient allocation of resources to particular activities and over time. Such a situation, with its serious implications for payment and other systems, can be quite disruptive to economic activity. Although the advanced countries have also gone through episodes of boom and bust in credit and asset prices, experience has shown that the probability of a full-blown financial crisis is higher in emerging market economies. The latter are constrained by their institutional and structural weaknesses. Unlike developed countries, they cannot borrow in their own currency. By their nature these economies are susceptible, in particular, to foreign exchange and currency crises, which are rare in advanced countries.

All of this suggests that a continuation of past policies that seemed appropriate when initiated is now desirable. In particular, because it is hard to say when, where, and how future shocks will hit, developing countries have to start thinking about weaning themselves off reliance on global savings and look for a more stable source of funds, while surplus countries have to find ways to depend less on external demand. Since adjustment is inevitable, would it not be better to commit ourselves to a medium-term policy framework? One that should be agreed by all governments and international financial institutions involved, so that public policy can support the needed private sector adjustment and ensure the process is smooth? One that would define a sufficient level of official aid funds as promised under the Millennium goals?

There are many interesting questions when analyzing the fairness of today's financial systems in the world. But we do not have the time to go over all of them, so please let me conclude my remarks.

Conclusions

First, under the impact of financial globalization, a gradual shift from the government-dominated official aid/multilateral aid system of the Bretton Woods tradition to a market-led system has evolved. Exchange rates, liquidity conditions and adjustment to shocks are increasingly determined by decentralized market forces. In the changed environment, a gradual shift from bank-centered to market-based financing is taking place, albeit at a different pace in individual countries and regions. The resulting decline in banks' core business areas has forced them to search for other opportunities both at home and abroad. They have found a niche in emerging economies, an action that has its positive and negative aspects, but above all that defines the unfairness of the current system with its bias against small and less developed nations.

Second, changing rules in the financial markets have meant a changing structure of power on who makes the decisions to provide financial flows to developing nations. Whereas the Bretton Woods system had a clear mandate to create a fair system of aid to developing nations, a system like the one we have now where private agents and speculative investments dominate, is a system where the governance structure is biased against fairness. It is a system that does not care for the need to give each country the possibility of reaching growth and eliminating poverty. It is therefore, a system without the legitimacy or the appearance of impartiality necessary to undertake the sometimes intrusive tasks entailed in facilitating international policy dialogue or international lending.

A financial system that can finance the running current account deficit of 6.5 percent of its GDP in the USA – in the process absorbing nearly 70 percent of world external savings – while denying funds to countries in dire need of them to rescue their population from poverty and hunger seems hardly a fair system.

A system that can impose in small emerging economies the mood of foreign investors at their will, not so much because foreign investors will inflict a 'sudden stop' but because they are likely, at some point, to start demanding a much higher premium for continuing to finance, is not a fair system.

This system, thus, needs to be changed to operate in a different more just manner.

First, it should recognize that trade imbalances are a shared responsibility and help prevent concerns about imbalances degenerating into protectionism, or into calls for one country alone to narrow its deficits or another to appreciate its exchange rate, measures that will be ineffective by themselves.

Second, it should reassure financial markets that a policy framework for supporting adjustment without undue pain is in place, thus limiting the risk of an abrupt and costly market-induced adjustment.

Third, it should create conditions to otain a sufficient amount of donor aid to ameliorate the poverty conditions of extremely poor nations.

Unfortunately, even if the politicians in a country are far-sighted, only domestic benefits enter their calculus: the effects of their actions on reducing risks for everyone else are heavily discounted. As a result, policies that have large external spillover effects may not be undertaken because:

1. Politicians don't think the risks of an abrupt adjustment are high or that the recommended policies will do anything to narrow imbalance; or

2. They think the risks are high but they care more about the high cost to their own political futures if they undertake corrective policies; or

3. They think the risks are high, and they want to do what is right for the country, but the domestic cost of action outweighs the domestic benefit because much of the benefit redounds to the rest of the world; or

4. They think the risks are high but they cannot move unless others move?

This means some way has to be found to persuade countries to internalize the beneficial effects their policies will have on everyone else – to internalize the spillover effects. That, my friends is a task that only an Academy as this we are in now can undertake. A task that I am sure most of us would gladly undertake, because it is a task that would help those in the world in more need of our support, the poorest of the poor.

Thanks.