Globalisation – our unstoppable destiny

Investors prepare for a new economic architecture

Economic crises tell us there is much wrong with the structures within which countries' wealth grows and declines. Increasingly, says LEIGH HALL, if the remedies are to endure, they will have to be globally based rather than regional.

LEIGH HALL AM FSIA, a life member of the Securities Institute of Australia, delivered this presentation at the opening session of the 1999 conference of the Asian Securities Analysts Federation in Kuala Lumpur.

Recent events in Asia and elsewhere have called into question the ability of markets and the appropriateness of regulations, or rather the lack of regulations, to deal with the potential for ever-faster developments which can overwhelm good order. We are hearing a number of views regarding perceived shortcomings in the existing arrangements, and about possible ways to go forward. Interestingly, a number of important parties appear to be departing from their long-held traditional views.

The literature on the subject is quite extensive. I will draw on it selectively, and will be guilty of not always giving attribution where it is due. I have spoken to a number of fund managers in several financial centres. Their views were remarkably similar, but this might have been the result of my biased sample.

Despite economic and market setbacks, and political and regulatory intervention, globalisation is certain to continue. Individual countries may choose the extent to which they wish to take advantage of the benefits of globalisation. Not many will wish to go to the extreme of North Korea and keep themselves in perpetual penury. However, there will be different preferences, and some of these may be appropriate given the relative state of maturity of the subject economy and markets, and according to the prevailing external environment.

International institutional investors will be driven as always by varying combinations of fear and greed. They will seek advantages when they perceive them. The most aggressive will no doubt be the quaintly named highly leveraged organisations. It is an interesting debate as to what level of supervision they should be subject to, and indeed even whether it is possible. Investors will, of course, be driven by the returns they anticipate. However, they will also be influenced by regulatory and corporate governance matters.

They will desire transparency and fair dealing in markets, and impartial enforcement of the local regulatory codes.

THE ASIAN MELTDOWN

Capital flows — both domestic and foreign — have been instrumental in the spectacular development of the Asian region. However, it was these same flows, or rather the reversal of these flows, which obliterated wealth and prosperity across 1997 and 1998 on a scale never seen previously in the region. Investor confidence was replaced with investor panic as both domestic investors and global fund managers whipped their money out of the region and into designated safe-haven instruments.

The IMF raced in to assist and imposed tough regimes upon the mendicant states. Some countries obliged. It was observed by some that the cure was creating an even worse outcome for some countries.

Given the increased globalisation and liberalisation of world financial markets, liquidity can now flick in and out of markets at whim as never before. Investors are continually looking for new, and increasing exotic, places to invest their money to achieve higher returns for an acceptable level of perceived risk. Those countries or instruments that match these criteria are in hot demand; and this was Asia until mid-1997.

The previous policy of preserving the exchange rate encouraged investors to take advantage of seemingly secure above-market rates. There appeared to be the backing of the central bank as well as the backstop of the International Monetary Fund.

Eventually, when investors realised that the respective currencies could no longer be protected, they took their money and ran. They were not alone. Many domestic interests did exactly the same rational thing, with the resulting run causing the crash.

The crash, as Eichengreen and Bordo observed, was particularly severe as there was the confluence of both a banking and a currency crisis. However, they noted that for the most part this century, countries bounced back from such crises quite quickly. Interestingly, they also observed that many industrialised countries performed well during the period of currency stability under the Bretton Woods regime and when there was extensive regulation of capital flows. Other countries were less fortunate during this period as they were not the beneficiaries of capital flows.

The IMF raced in to assist and imposed tough regimes upon the mendicant states. Some countries obliged. It was observed by some that the cure was creating an even worse outcome for some countries. Subsequently it was interesting to see the level of criticism leveled at the IMF approach of rigorously imposing the supposed economic orthodoxy. Even the then chief economist of the World Bank, Joseph Stiglitz, has been openly critical of the IMF.

Malaysia, as has been detailed by other speakers, took another path. The irrepressible Paul Krugman noted at the time that stopgap measures are sometimes necessary to plug gaps. He then warned in a somewhat impertinent letter to the prime minister that great care needs to be taken to ensure that the measures are temporary; that there is as little disruption as possible to ordinary business; that an overvalued currency not be defended; and that the controls should not be used as an excuse to defer necessary reforms.

He concluded that "the point of the policy departure should be purely and simply to buy space for economic growth. It should not be used to prove points about the soundness of the pre-crisis economy, or about the wickedness of hedge funds! A Malaysian recovery will be lesson enough for the rest of us."

At this time the Malaysian experiment cannot be said to have been a failure. Whether it really is a success may not be claimed with certainty for some time. Often following the crash after an extended boom, some of the damage does not become apparent for some years. The reason for this is that there is a conspiracy between debtors, creditors and others to keep the extent of the problem quiet in the hope that time will overcome the problem. While an expansion of liquidity and the breathing space given by controls over capital flows will allow a papering-over of the problems for a period, if the underlying shortcomings are not overcome then there must be an ultimate day of reckoning. We are seeing this in the Japanese economy after many years of denial.

'IT'S THE TECHNOLOGY, STUPID'

Those who follow Woody Brock will recognise this statement. He sees technology as the driver of much of the increased volatility in financial markets.

"It is all too tempting to seize upon the more obvious deficiencies of the status quo as the source of what is wrong. It is thus not surprising that we read daily of such bromides as:

- If Asians did not suffer from crony capitalism, then . . .
- If only markets in emerging nations possessed transparency, then . . .
- If only the disincentives of moral hazards were eliminated, then . . .
- If only societies enjoyed the discipline of a gold standard, then . . .
- If only more nations adopted currency boards, then . . .
- If only investors were rational and took the long view, then . . .
- If only speculators were not so greedy, then . . .
- If only hedge funds were outlawed, then . . .
- If only life were fair, and rich nations did more for the poor, then . . .

"Each of these 'if only' conditions possesses a certain validity, although some (such as the last three) amount to wishful thinking at best. The problem is that none of the stipulated conditions addresses the root problem of today's crises, namely asset market overshoot — particularly currency market overshoot. Thus, while increased transparency and reduced cronyism would improve the efficiency of capital and product markets, they would not reduce excess price volatility per se."

He described technology-based increases in:

- speed of response — everyone can have instant information;
- short-termism — managers' performance is micro-measured;
- "belief correlation" — following market gurus;
- model uncertainty, largely from changing factors;
- leverage.

And each of the above amplifies the others.

G7 REPORT

The report of G7 finance ministers to the Koln Economic Summit in June titled "Strengthening the International Financial Architecture" is probably the most authoritative recent publication. Certainly I had empathy with their views.

They see a well functioning international financial system is essential to allow an efficient allocation of global savings and investment, and provide the conditions needed to improve worldwide growth and living standards in all countries. Recent events in the world economy have demonstrated that a strengthening of the system is needed to maximise the benefits of, and reduce the risks posed by, global economic and financial integration.

They say that reform of the international financial architecture will also reinforce the open multilateral trading system. Keeping markets open for goods and capital will make the global economy more resilient to shocks. The benefits and economic opportunities derived from open markets have led to a significant improvement in living standards in industrialised and emerging economies. The process of globalisation offers great additional potential to create wealth and employment.

They recognise their responsibilities for improving the conditions for a proper functioning of the international financial and monetary system and, in particular, enhancing sound fundamentals necessary for exchange-rate stability.

They propose that there be a strengthening and reform of the international financial institutions and arrangements governed by the following principles:

- The IMF and World Bank have the central role in the international economic and financial system, and in facilitating cooperation among countries in these fields.
- The international supervisory and regulatory bodies have a crucial role to play in making the international financial system more robust.
- The accountability and transparency of these bodies and of the international financial institutions should be strengthened.
- A broad range of countries should be involved in discussions on how to adapt the international financial system to the changing global environment.
- A system based on constituencies is appropriate for the governance of the institutions.

ENHANCING TRANSPARENCY AND PROMOTING BEST PRACTICES

The G7 report also stated that the availability of accurate and timely information is an essential ingredient for well functioning financial markets and market economies. Such information is necessary for market participants and should be used by them to make good decisions. It also provides greater incentives for policymakers to implement sound economic policies. Improved information will help markets to adjust more smoothly to economic developments, minimise contagion and reduce volatility.

The benefits and economic opportunities derived from open markets have led to a significant improvement in living standards in industrialised and emerging economies.

Transparency of the private sector is of particular importance to the orderly and efficient functioning of financial markets. IOSCO has assisted in issuing its "Disclosure Standards to Facilitate Cross Border Offerings and Initial Listings by Multinational Issuers". They welcome the completion by the International Accounting Standards Committee of its core set of international accounting standards, and await the outcome of the current review by IOSCO and others.
They note that investors and creditors often tend to underestimate risks as they reach for higher yields. In periods of market euphoria, market participants can make credit and investment decisions that might not otherwise have been made.

Failures are due to poor risk management practices, inadequate information as well as inadequate attention to available information, and capital standards that provide incentives to lend to risky borrowers.

Measures to induce creditors and investors to act with greater discipline should aim at avoiding excessive leverage and encouraging more prudent assessment of the risks associated with lending to emerging markets. As well, there is a need for improving risk assessment and risk management. Hedge funds and other highly leveraged institutions can create problems when there is a concentration of excessive leverage along with excessive concentration of risk.

Offshore financial centres — that is, tax havens of convenience — should comply with international standards by strengthening their supervisory systems and standards. In respect of hedge funds, the Basle Committee in January promulgated guidance on sound practices for banks, including credit analysis practices, and the development of more accurate exposure measures. The sound practices also include setting meaningful overall credit limits and monitoring credit exposures of hedge funds. A financial stability forum is yet to report on such matters as systemic issues relating to market dynamics generally and vulnerable economies in particular.

The Joint Forum on Financial Conglomerates is dealing with the supervision of complex, internationally active financial organisations. A paper was issued in February 1999 dealing with techniques for:

- assessing the capital adequacy of conglomerates;
- facilitating the exchange of information among supervisors, including the identification of coordinators;
- facilitating coordination among supervisors; and
- testing the fitness and propriety of managers, directors and major shareholders of conglomerates.

STRENGTHENING EMERGING MARKETS

A broad international consensus has recently been formed on a number of issues:

- Countries need to pursue sound macroeconomic policies, including sustainable exchange-rate regimes and prudent fiscal policies.
- Countries choosing fixed rates must be willing, as necessary, to subordinate other policy goals to that of fixing the exchange rate.
- There are particular risks and vulnerabilities associated with excessive short-term borrowings, particularly in foreign currencies.

Capital account liberalisation should be carried out in a careful and well sequenced manner, accompanied by a sound and well regulated financial sector and by a consistent macroeconomic policy framework. The use of controls on capital inflows may be justified for a transitional period as countries strengthen the institutional and regulatory environment in their domestic financial systems.

They encourage the IMF to continue its work on the appropriate pace and sequencing of capital account liberalisation. Particular attention should be paid to eliminating policy biases in favour of short-term capital flows, particularly in foreign currencies, and promoting sound debt management policies.

The IMF should also further refine its analysis of the experience of countries with the use of capital controls. In this regard, there is a strong case for further studying the benefits and costs of market based prudential measures aimed at curbing excessive capital inflows, including those used by the Chilean authorities in the recent past.

CRISIS MANAGEMENT

Prevention of financial crises is the key. As well, new clear principles and new tools are needed to limit contagion and to fully recognise the crucial role private investors play in today's integrated financial markets.

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Countries should take *ex ante* steps to strengthen the framework for the market-based, cooperative and orderly resolution of debt payment difficulties that do arise. Sound and efficient bankruptcy procedures and strong judicial systems are encouraged.

The approach to crisis resolution must not undermine the obligation of countries to meet their debts in full and on time. Otherwise, private investment and financial flows that are crucial for growth could be adversely affected and the risk of contagion increased.

Market discipline will work only if creditors bear the consequences of the risks that they take. Private credit decisions need to be based on an assessment of the potential risk and return associated with a particular investment, not on the expectation that creditors will be protected from adverse outcomes by the official sector.

POSSIBLE SOLUTIONS

There are some surprising observations. George Soros in *The Capitalist Threat* states: "Although I have made a fortune in the financial markets, I now fear that the untrammelled intensification of laissez-faire capitalism and the spread of market values into all areas of life is endangering our open and democratic society. The main enemy of the open society, I believe, is no longer the communist but the capitalist threat."

However, someone else used the Churchill-like statement: "Financial markets do not work perfectly, to be sure, they are the worst way of allocating resources except for all other forms that have been tried!"
Barry Eichengreen observed that many proposals are contradictory and mutually incompatible. Some recommended that policymakers renew their efforts to liberalise international capital markets, while others plump for the reintroduction of capital controls. Some insist on the need for greater exchange flexibility, while others want stable, even fixed, rates between countries. Some want international agency intervention, while others want it left to market forces.

However, there is some consensus for the following approach:

- Countries should liberalise their domestic financial systems before opening up to foreign capital. This can assist in avoiding excessive foreign investment in certain sectors.
- Financial liberalisation requires strict bank regulation and supervision, to prevent banks being ruined by a reversal in capital flows or a sharp rise in interest rates.
- Exchange-rate flexibility is preferred as free capital movement together with fixed exchange rates is a potential problem.
- Financial markets need reliable information to work effectively.

Woody Brock suggested that the new architecture:

- Recognise the critical role of flexible prices.
- Recognise the need to dampen endogenous risk in global markets by reducing leverage and other strategies.
- Recognise the complex nature of hedging "risk" in an economy where many key risks cannot be privately hedged.
- Recognise the distinction between mistakes and malfeasance at both individual and government levels.
- Recognise the need to keep clear of "bail-outs".
- Recognise the need for transparency and unfettered competition (in place of cronyism).

- Recognise that progress occurs.
- Recognise that human nature won't change — and that this matters.
- Recognise the need for an "incentive compatible" solution.

INTERNATIONAL INSTITUTIONAL INVESTORS

For investors, globalisation has a number of dimensions. As well as the impact on global markets there are the ways in which the investment management business itself is responding to globalisation. One aspect is the emergence of ever-larger financial services companies. These companies have a real impact on smaller locally based companies. The impact will be all the more pronounced as the customers of these companies demand a global service. While there will, no doubt, always be a place for the niche player, other service providers who do have a global reach could be disadvantaged.

Traditionally, most equity investors have taken a regional approach. They have concentrated on the local market and then over time taken increasing stakes in markets abroad. But the approach has been regional. Money has been allocated to particular parts of the world, and within each region a portfolio has been built up.

An approach which is now starting to gain more currency is one which looks at the whole world as one market. Under this regime the asset allocation is to a market sector, say technology. The subset portfolio is made up of the best companies in that sector in the world. From my Australian experience this has been an approach to resources companies over many years by some managers, even though it confused the consultants who at that time preferred the traditional regional box.

If the sector type of investment allocation becomes prevalent it will have considerable consequences for investment managers. The benefit will move to those who have the ability to research on a global basis, and regional skills will seem less important.

My institutional investor mates prefer democratic capitalism, that is a version of the market economy in which they operate. However, as Rosenthal has observed, capitalism has shown itself flexible enough to have worked for the security of rulers, and the profit of investors, under governments based on fascism, religious fundamentalism, slavery, internal terrorism, apartheid, absolute monarchy, militarism — the whole nasty mess of non-democratic regimes. Some international investors have demonstrated a willingness to embrace opportunities in these places.

However, investors going into less preferred areas will seek out a higher return to compensate for the higher risks involved. Whether the risk premium is high enough will be seen in hindsight. Whether there is a moral issue to be resolved is an argument for another place. In any event, markets requiring a higher rate of return will have a higher cost of capital. As a result, local enterprises will find it more expensive to fund their businesses, and in a competitive world will either be less competitive or less profitable. Either way, the country will be poorer as a result.

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In assessing the risks, investors will be looking at a variety of aspects which can impact on their ultimate returns. They will not wish to see anything which is likely to prejudice their situation. They will want to see a sound corporate governance regime where all parties are treated fairly. They will want to see a regulatory regime which is sound and properly enforced without favour to particular groups.

CONCLUSION

Every shock results in measures being established to reduce the severity of the adverse consequences next time around. Hopefully, the various steps being taken by the world community will have that result. There is no one formula which should be universally applied, and there should be a preparedness to be flexible in tackling situations as they arise.

On the other hand, as Geoffrey Wood observed: "Helping illiquid countries is not the same as helping illiquid banking systems within a country. The fact is, no new 'architectures', however appealing in theory, can shore up financial systems destabilised in large part by poor government policies."

Up to a point, a majority of investors will be rational in their approach. Investors are very attuned to the prospect of opportunities abroad. Despite setbacks in recent years they will return when they judge the risk/reward ratio to be right. The more the risks can be reduced, then the lower the reward that has to be offered. A lower cost of capital has very real benefits for any country.

Not that investors can be saved from their own foolishness. As Walter Bagehot said last century: "At particular times a great deal of stupid people have a great deal of stupid money and there is speculation and there is panic." Nothing seems to have changed, and it is unlikely that the future will be any different as the varying combinations of greed and fear take hold on a great number of investors. We will have periods of rationality followed by extremes of elation and despair.

An improved world economic order should also allow for improved economic growth in the respective countries. In turn, this will provide comfort for international investors to return to other markets. This will be a far better outcome for everyone than the alternative return to protection.

Global investing is likely to undergo a change from being primarily region-based to being sector-based. The competitive implications of this for investment institutions themselves will be considerable. So too will be the implications for regions whose investment opportunities will have to stand comparison with those of all other regions.

The period ahead will not be without interest for both the authorities and investors. J