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# Financial Globalization<sup>1</sup>

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Globalization is a fashionable word to describe trends perceived to be dramatically and relentlessly increasing connections and communications among people regardless of nationality and geography. These trends are a general source of amazement and excitement, often of pleasure, often of fear. In the economic sphere, markets are less and less segmented by national boundaries. Both buyers and sellers face wider horizons of opportunity, and by the same token new sources of competition. Globalization affects markets of three kinds: (1) commodities—goods and services of all varieties; (2) labor—workers who produce goods and services; (3) assets and debts—securities, bank loans and deposits, titles to land, and physical capital. Markets of the third type are the subject of my discussion of financial globalization. The speakers who follow will have much to say about other kinds of markets and other aspects of globalization.

Trades of financial assets are the easiest to globalize. Nothing is involved beyond exchanging pieces of paper or making entries in electronic ledgers. The communications revolution makes transactions easy, fast, and cheap. No movements of physical goods or of people are involved. No frontiers have to be crossed. The only barriers are national regulations. As these have been liberalized in country after country, international financial flows have flooded into national securities markets and banking systems all over the world. These flows could be the vehicles by which savings in the advanced capitalist democracies are channeled into productive capital investments in the developing countries of Asia, Africa, and Latin America. Or they could be causes of currency crises, recessions and depressions, unemployment and deprivation in those countries. Or both.

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<sup>1</sup>Read 14 November 1998, as part of the Symposium on the Globalization of the World Economy.

The 1990s have been a decade of disturbances in international finance, beginning in Europe in 1992, followed by Mexico in 1994-95, climaxed by East Asia in 1997-98, Russia this year, and perhaps Brazil in the near future. Is the problem that liberalization in developing and transition economies is still incomplete? Or has it gone too far? That is the big debate today.

Despite the apparent pace of recent financial globalization and its spectacular technological support, it is in fact nothing new. Finance was much more completely internationalized in the nineteenth century, particularly the period 1870-1914, the heyday of the gold standard. All countries made their currencies convertible into gold at fixed prices per ounce; for example, the pound sterling was worth about the ratio between the gold value of sterling set by Isaac Newton and the gold value of the dollar set by Alexander Hamilton. There were virtually no restrictions on international financial transactions. In particular, the United Kingdom lent overseas as much as half its national saving, financing the economic development of the Americas, Australia, India, and other realms of the British Empire in Asia and Africa. The Bank of England served as a sort of world central bank and lender of last resort. This regime was destroyed by the First World War, the debts it left in its wake in the 1920s, the unwillingness or inability of the United States to take over Britain's pre-1914 role, the Great Depression, and the Second World War. Globalization gave way to a maze of national restrictions on currency transactions, as governments sought competitive trade advantages in vain hopes of rescuing their economies from depression.

The Bretton Woods Agreement of 1945 brought some order out of world monetary chaos and inaugurated a period of liberalization. Yet, taking into account the new national participants in world financial markets, the pre-1914 degree of liberalization has not yet been restored, and, more important, transfers of saving from developed to developing economies are still, relative to the size of the world economy, much smaller than at the beginning of this century.

Nostalgia for the gold standard is understandable, but it is misplaced. In the 1920s and 1930s it was disastrous. During the First World War Britain had to sell off its foreign wealth and suspend the gold convertibility of the pound. In 1925, Winston Churchill, chancellor of the Exchequer, bowed to the City and returned sterling to gold at the pre-war value, i.e. \$4.86, prompting John Maynard Keynes to write "The Economic Consequences of Mr. Churchill." Because of its wartime inflation of prices and wages, Britain couldn't compete at that exchange rate, and suffered depression and high unemployment from 1925 to 1931, when the coalition government finally gave up and devalued. In 1931-33

the determination of other governments and central banks, including the Hoover administration and the Federal Reserve, to defend their gold parities by high interest rates and austere budgets, aggravated their depressions and provoked bank crises. In Weimar Germany the resulting distress hastened Hitler's advent to power. In America, FDR devalued the dollar in 1933-34; this act was the most effective New Deal policy for recovery from the Great Depression.

The worldwide system of exchange rates agreed at Bretton Woods was a sort of gold standard. Every member of the International Monetary Fund set the gold content of its currency. In practice, conversions of currencies into gold were rare; the U.S. dollar was used instead. The United States Treasury stood ready to exchange gold and dollars at a fixed price (\$35 an ounce)—with foreign governments, not with private individuals. Countries' pegs to gold and the dollar were adjustable, and devaluations were frequent. This exchange rate system lasted until 1971, when the Nixon administration abandoned the U.S. commitment to redeem dollars in gold. The dollar was under pressure, and the administration was frustrated because it could not get Germany and Japan to appreciate their currencies against the dollar. The upshot was that since 1973 the exchange rates among the three major currencies—dollar, Deutsche mark, and yen—have floated in free currency markets. Other countries have generally fixed their currencies in terms of one of these three "hard" currencies or some combination of them.

Western European currencies have typically been pegged to the D-mark, the key currency of the European Monetary System. Now eleven of those currencies are being permanently merged into the euro, which will supplant the D-mark and will float against the dollar and the yen. The new European Central Bank will make monetary policy for all of "Euroland," the new European Monetary Union. The mighty Bundesbank will be just one of the new bank's branches.

Here is a "trilemma" of which international economists are quite fond: A nation can maintain no more than two of the following three conditions: (1) a fixed rate of exchange between its currency and other currencies; (2) unregulated convertibility of its currency and foreign currencies; (3) a national monetary policy capable of achieving domestic macroeconomic objectives.

For example, consider a government and central bank that wish to reduce unemployment by raising aggregate demand for the goods and services its economy produces. This typically requires cutting the interest rates facing domestic businesses and households and making its products more competitive in world trade. But this is not possible if the exchange rate is fixed and arbitrages across currencies are unimpeded. The

country's central bank will then be unable to reduce interest rates below those available elsewhere in the world, particularly in big centers like New York or Tokyo or Frankfurt or London. Maybe the government can empower its central bank by giving up condition (2) and imposing direct controls over movements of funds across the exchanges. Alternatively, the government could sacrifice condition (1) and let its currency float in the market to a lower level at which activity and employment, especially in export industries, would be greater, while lower local interest rates would also be tenable.

In the wake of World War II, it was apparent that the economies of Europe and Asia were in no position to make their currencies wholly convertible. The articles of the International Monetary Fund adopted at Bretton Woods did not, and still do not, require that of its members. What they do require is "current account convertibility," namely, that foreigners be free to convert any of a country's currency they earn in trade. "Capital account convertibility," which would allow any holder of a currency, resident or non-resident, to buy foreign-currency assets, was put off to the indefinite future. Under the Marshall Plan, 1948-51, the United States encouraged European countries to set up a multilateral clearing system for their currencies, while restricting conversions into dollars. Currency exchange restrictions in Western Europe were not wholly abandoned until the mid-1980s. Today, however, the world financial powers, private and public, are impatiently pushing developing countries and transition economies toward full convertibility.

Likewise, fixed exchange rates, adjustable pegs to hard currencies, are the prevailing exchange rate regime among developing economies, "emerging" and "transition" and others. Typically, they are "managed crawling pegs," which do allow for some flexibility. Markets are allowed to move the exchange rate within a specified band. The entire band is itself moved from day to day by an announced percentage, usually designed to depreciate the currency to compensate for a local inflation trend in excess of the inflation trend in the hard currency's economy. For example, the central parity and the band of Brazil's *reals* rise at a monthly rate of 0.7 percent. However, if under market attack the price of a dollar in terms of *reals* should rise to its upper limit (depreciation of the *real*) then the central bank would have to use its dollar reserves to redeem *reals* just as if it were defending a simple fixed peg.

An attack on a currency is like a run on a bank. A depositor worried about the ability of a bank to redeem deposits will want to ask for her cash before the bank runs out, and any depositor worried about what other depositors will think and do will act the same way even if she thinks the bank is solvent. A country on a fixed exchange rate is like a

bank, its holdings of hard currency reserves are like the bank's cash, and the local currency assets outstanding are like the public's deposits in a bank. The same instability and vulnerability apply in both cases. For a domestic banking system, deposit insurance is an effective protection against runs, and a nation's central bank acts as a "lender of last resort" to provide liquidity to banks under attack. The analogous institutions do not exist on an international scale, to protect currencies against runs.

The recent epidemic of currency crises makes it unmistakably clear that fixed but adjustable exchange rates are a bad idea. The only viable regimes in our increasingly globalized financial world are floating rates, on the one hand, and irretrievably fixed rates, on the other.

Floating rates have since 1973 worked for the Big Three currencies. They have fluctuated, but there have been no crises. From 1995 to 1997, the yen gradually and unobtrusively fell 50 percent against the dollar, but this decline never rated headlines or evening TV news. (One of the causes was Japan's recession and stagnation, a disaster for Japan itself and for its neighbors—indeed a principal source of their currency crises and economic recessions. But this macroeconomic disaster would have been worse if the yen/dollar rate had been fixed.)

Floating rates would work for most currencies. They would forestall extreme crises. Of course, exchange rates would go up and down, people would speculate on them, and often the fluctuations would be unpleasant for the economies affected. But the trauma of discrete regime change, default of solemn official promises, and the bandwagon momentum these events generate, would be avoided. Foreign lenders would be more careful if they understood that exchange rates were not guaranteed. Events that triggered the Asian crises would have likewise pushed down those currencies had they been floating, but surely not nearly as far as they plunged in the panicky free falls following the collapse of fixed rates. Fixed rates are, after all, a hangover from the pre-globalized Bretton Woods system.

At the other extreme is the alternative of fixing the national currency irretrievably to the dollar or some other hard-currency standard. The trouble with this course is that it surrenders monetary sovereignty. This is what the eleven European countries are doing. They will no longer have their individual monetary policies, or even discretionary fiscal policies. It remains to be seen whether political and economic advantages, comparable to those of the two-hundred-year-old monetary union of the American states, can be quickly manufactured in Europe.

An individual country can tie itself tightly and permanently to a hard currency. Examples are Hong Kong and Argentina, which are effectively dollarized. The idea is to sacrifice every other possible

objective of monetary and fiscal policies to the defense of the exchange rate. Indeed the dollar may partly or wholly replace local currency as unit of account and means of payment. This is the essence of a “currency board”—one well enough endowed with reserves of the hard currency to convince the world of convertibility, and convincingly determined to protect those reserves. For example, if it takes double- or triple-digit interest rates to attract and hold enough reserves, so be it, regardless of macroeconomic consequences. The rule is that local currency outstanding must be covered 100 percent by the central bank’s hard currency reserves. In terms of the trilemma, the country meets condition (1) fixed exchange rate, and (2) convertibility. But it sacrifices (3) monetary sovereignty, and thus forfeits all possibility of controlling its own macroeconomic fate.

In contrast, consider China. Like Hong Kong and Taiwan, China is evidently immune to the “contagious” currency crises that began in East Asia in 1997. But the reason for the stability of the renminbi is quite different. It is not currency-board austerity or any other capitalist virtue. China allows no “capital account convertibility,” only “current account convertibility,” like European countries in the early days of Bretton Woods. In terms of the trilemma, violating condition (2) enables China to maintain the other two conditions, (1) fixed exchange rate, and (3) monetary sovereignty.

The economic rationale for internationalization of asset markets is movement of productive capital from wealthy developed economies to poorer developing countries. But what matters is the net flows of capital, not the gross volumes of transactions. Despite the limited convertibility of its currency, China is benefiting from a quarter-trillion dollars worth of direct investment in plant, equipment, and technology in China by foreign companies around the world. The emerging economies of East Asia, as well as some in Latin America and Eastern Europe, are also beneficiaries of foreign business investments. But much of their capital inflows have taken the form of loans of hard currencies from banks in financial centers like Tokyo, New York, and Frankfurt to banks in Korea, Thailand, and Indonesia. Many of these were short-term, and crises came when the lenders became distrustful and refused to renew the loans.

Although developing countries have increasingly benefited from inflows of capital, the investments that have propelled their growth have been mainly due to their own internal saving. Capital flows from the world economic core to the periphery, only \$150 billion a year in the 1990s, have been less than 15 percent of their investment and less than 5 percent of the saving of the developed capitalist economies. These shares

are much smaller than comparable figures before 1914, when they were both close to 50 percent.

The worldwide gross volume of foreign exchange transactions is mind-boggling, 1.3 trillion dollars per business day and growing. Nine-tenths of these transactions are reversed within a week, mostly within a day. Clearly many of these are speculative. The gross volume dwarfs the net capital transfers that carry the economic benefits globalization is advertised to bring.

Most observers, Western and Eastern, public and private, in governments and international institutions, in banks and businesses, in big countries and small, now agree that financial globalization went too far too fast. Some reforms are the responsibilities of the borrowing countries. They need to develop the institutions that make financial markets work in the developed world, banking regulation and supervision, transparency requirements like the U.S. Securities and Exchange Commission, bankruptcy procedures. Since their international reserves are at stake, those governments should limit the hard currency exposures of banks and businesses. They should feel free to slow down inflows of liquid capital, by devices such as extra reserve requirements on new foreign deposits in their banks, used successfully in Chile. They should stress import of capital in the form of direct investment and equity. As argued above, they should let their exchange rates float.

I have proposed a system-wide international measure to slow down flows of "hot money," without interfering significantly with currency transactions related to trade and productive investment. This is a simple small tax on foreign exchange transactions, levied at an agreed common rate by all countries where such transactions originate in significant amount. The tax, perhaps only 0.1 or 0.2 percent, means nothing for a round trip of a year or more from one currency to another and back. But for one-week round trips it would be equivalent to a difference between interest rates in the two markets of 10 or 20 percent per year, a palpable protection of monetary sovereignty. Alas, the lords of finance throughout the world will have none of the "Tobin Tax." How would you like to have a tax named after you?