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Closing the Casino

Reform of the global financial system

John Grieve Smith

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The programme will develop these arguments in three themes. First, it will examine the institutions of economic management, particularly at a European and international level, asking whether existing arrangements are best placed to promote left of centre objectives. The second focuses on the future of work. How might job security be enhanced without jeopardising employment levels? Can work be organised in a manner which increases the opportunity of employees to participate more fully in family life or educational activities? The third theme considers competitiveness and the firm, and the roles that government can play in improving corporate performance.

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1. Introduction

The instability of the global financial system is now a serious threat to industry and jobs throughout the world. Nevertheless, since the Western industrialised countries came through the 1997 Asian crisis relatively unscathed, there has been a tendency in the West to underplay the severity of the crisis and the need for reform. Although they are recovering now, the impact on the countries involved was devastating. Unemployment in Indonesia, Korea and Thailand rose from 5 million at the end of 1996 to 18 million at the end of 1998; and in Indonesia 17 million more people fell below the $1 a day poverty line. This represents human tragedy on a vast scale. But it was only one in a series of crises. Looking at the last five years, it was preceded by the Mexican crisis in 1995 and followed by the Brazilian and Russian crises in 1998.

It should not be assumed that only developing countries are vulnerable to such events. We are all at risk. The volatility of international capital flows, bubbles in stock market and property prices, and unstable exchange rates can cause problems anywhere. The most obvious risk at the moment is that a collapse in the Wall Street boom in stock market prices and a rush of foreign investors to get out of the dollar could hit the American economy and induce a widespread recession. But this is only one of a variety of possible scenarios including, for example, the possibility that Japan might not be able to extract itself from the current recession.

Crises apart, the instability of exchange rates presents serious problems for industry world-wide. The recent problems of the British car industry are only one dramatic example. Multi-national firms cannot plan their investment and operations rationally when future exchange rates are so uncertain. The uncertainty inhibits industrial expansion. Manufacturers whose exports become unprofitable close plants and cut their labour force when the exchange rate is high, but do not necessarily expand again directly it falls because they have no means of knowing whether export sales will remain competitive.

There is an urgent need for fundamental reform of the global financial system. In the immediate aftermath of the Asian crisis, this was widely recognised and there was much talk of the need for a 'new global financial architecture'. But as the threat of a wider recession receded, Western leaders became less concerned about root and branch reform and finance ministers, for example, soon limited their discussions to what one American commentator called 'interior decoration' rather than 'new architecture'. Official discussion has focused almost exclusively on the need to improve the prudential regulation of banks and other

financial institutions, paying little attention to other aspects of reforming the operation of global financial markets.

International economic crises are not a new phenomenon. Major financial crises in the inter-war period contributed to the emergence of mass unemployment in the thirties, a major factor in the rise in fascism and a good reason for not being complacent about the high levels of unemployment prevalent in many parts of Europe today. In a policy statement as early as 1933, the Labour Party said that 'the world has become a single economic unit and governments must pursue an active policy of International Economic Co-operation'.[1] As this attitude took hold, and with the achievement of full employment during World War Two, there grew a widespread resolve among the Allies to establish a more stable international economic system which would help to prevent a recurrence of mass unemployment. The result was the Bretton Woods Agreement of 1944. The spirit of the time was exemplified by Keynes's concluding speech to the Conference, of which he had been the prime architect:

> If we can continue in a larger task as we have begun in this limited task, there is hope for the world.... We have been learning to work together. If we can so continue, this nightmare, in which most of us present have spent too much of our lives, will be over. The brotherhood of man will become more than a phrase.[2]

However, over the last fifty years, international economic co-operation has weakened rather than strengthened, despite the fact that 'globalisation' has made it more imperative than ever. The development of more effective international institutions not only for economic policy, but also in such fields as the environment and peacekeeping, presents the major political challenge of our time. We can only tackle these problems if national governments are prepared to work more closely together.

The object of this pamphlet is not to make specific policy proposals in every area of this very wide field, but to broaden the range of discussion by focusing attention on the need for more comprehensive reform. The next chapter discusses briefly the growing instability of world financial markets since Bretton Woods, culminating in the 1997 Asian crisis. This leads on to a discussion of ways of improving financial regulation (Chapter 3) and ensuring a more stable flow of capital to developing countries (Chapter 4). One potential new instrument for dampening down fluctuations in financial markets, the taxation of foreign exchange and other financial transactions, is discussed in Chapter 5. A more stable exchange rate system is an essential requirement of any new international financial regime and the need to find effective ways of managing exchange rates should lie at the heart of any reforms (Chapter 6). Finally, the present structure of international institutions must be updated to meet the need for international management of the global financial system (Chapter 7). The discussion and conclusions are summarised in Chapter 8.

2. The growth of instability

Although the world economic system has changed considerably since then, we are still living in the shadow of the Bretton Woods Agreement. The two leading international economic institutions, the International Monetary Fund and the World Bank, were set up under that Agreement, and the constitution under which they operate has remained to a large extent unchanged – although their actual method of operation has evolved in a manner that their founders had not envisaged.

A prime objective at Bretton Woods was to devise an international payments system which would help countries to maintain full employment. To this end it set up a 'stable' exchange rate system and arrangements to enable countries in balance of payments difficulties to borrow from the new International Monetary Fund. The so-called 'fixed' exchange rate system was intended to provide a basis for stability whilst allowing countries to adjust their rates from time to time when they got out of line. In principle this meant that countries with chronic surpluses should adjust their exchange rates upwards (to curb their exports and encourage imports) as well as those in deficit adjusting their rates downwards. But in practice the onus of adjustment nearly always fell on those in deficit, who found they had to devalue under pressure of circumstances and in conditions of crisis. The symmetry in adjustment between creditors and debtors sought by Keynes and others never materialised.

At the time of Bretton Woods, strict exchange controls over all payments, whether current or capital, were part of wartime arrangements. The Agreement provided that controls on imports and other current transactions should be liberalised as soon as possible but controls on capital movements could remain in place. (The case for free trade in goods and services among industrialised countries was generally accepted – assisted by US pressure to liberalise dollar imports; but Keynes, in particular, had seen volatile capital movements as a major source of financial instability in the interwar period, and their control as a continuing necessity). With the restoration of peace-time conditions, controls on current transactions were gradually relaxed. The fixed exchange rate regime lasted until the early 1970s when it began to break up – partly because of the difficulty of agreeing on changes in rates when the existing structure was no longer appropriate, and partly because of the increasing importance of capital movements in putting pressure on, or determining, exchange rates. We then entered a period in which exchange rates were for the most part 'floating' (ie determined mainly or entirely by activity in currency markets), although some countries, particularly developing ones, 'pegged' their rates to a leading or neighbouring country's currency, such as the dollar. It is in this unstable world that we still find ourselves today.

The advantage to countries like the UK of abandoning the fixed rate system was that they no longer faced devaluation crises, such as we experienced in 1949, 1967, and again in a different context when we left the ERM in 1992. But a major disadvantage of the new regime is that exchange rates have become markedly unstable, bearing no necessary relation to relative costs in different countries, as the recent punishingly high level of sterling testifies. Exchange rates nowadays are determined by the enormous volume of short-term financial transactions, which completely dwarf the volume of transactions carried out for international trade.

Volatile movements of short-term capital into and out of countries not only affect exchange rates but also the prices of assets such as shares and property. Typically, investment in a particular country or countries, for example those in the so-called 'Asian miracle', becomes highly fashionable: money pours in, stock market and property prices soar, and the exchange rate comes under upward pressure. Some catalytic event then leads to a reversal of sentiment, money moves out, asset prices collapse, and the exchange rate plunges.

The Asian crisis

The Asian crisis of 1997 was a dramatic illustration of these dangers. Before it struck, the spectacular speed of industrialisation and economic growth in Korea and other East Asian countries became familiarly known as the 'East Asian Miracle' – the title of a World Bank report on their achievements. Their rates of growth of production were much higher than most other countries, inflation was in single figures and their budgets were either in surplus or had small sustainable deficits. The general perception of these economies as highly successful led to a heavy inflow of foreign investment which enabled them to run substantial current deficits in their balance of payments. But these deficits left them vulnerable to a reversal of such capital movements. When it occurred, there was a dramatic turnaround in Western opinion, with constant references to 'crony capitalism' and 'structural weaknesses'. The crisis provided an excuse to try to force those countries to abandon any degree of public planning and control and adopt the neo-liberal model of capitalism or so-called 'Washington consensus', driven by the 'US Treasury – Wall Street complex' with its emphasis on privatisation and liberalisation of financial markets. Attention was initially focused on the supposed structural weaknesses in these countries' economies rather than those of the world financial system in which they operated. As time passed, however, it was increasingly acknowledged that the economic devastation inflicted on these countries reflected structural faults in the way international markets and financial institutions operate rather than their particular form of capitalism.

Countries at all stages of development and with a variety of forms of industrial and financial organisation are now vulnerable to the vagaries of the financial markets. Far from the distinguishing features of the Asian economies being a

cause of the crises, the premature pressure on them to follow the Western pattern and liberalise capital flows into and out of their countries was a major contributing factor.[3]

The fragility of the exchange rate regime was evident in the way their currencies went down like dominoes in a matter of days. The process started on 15 May 1997 when Thailand introduced capital and exchange controls in an effort to maintain its exchange rate peg to the dollar after a succession of speculative attacks on the baht in 1996 and early 1997. Thailand was suffering from a large current account deficit, high short-term foreign debt, the collapse of a property price bubble, and a loss of competitiveness resulting in part from the rise in the dollar against the yen. Equity prices had been falling. On 2 July 1997, Thailand abandoned its exchange rate peg and allowed the baht to float, raising doubts about exchange rates elsewhere in the region. The Philippines had also been maintaining a *de facto* peg to the dollar, and after seeking briefly to defend it, the authorities floated the peso on 11 July 1997. Malaysia came under pressure and the ringgit was allowed to depreciate. In Indonesia the rupiah fell sharply within the intervention band on 21 July and was floated on 14 August. The Singapore dollar and the new Taiwan dollar weakened moderately in July and the Hong Kong dollar came under temporary attack in early August. By mid October the baht and rupiah had depreciated by over 30 per cent against the dollar, and the ringgit and peso by over 20 per cent. The Korean won also came under pressure. Contagion was rapid.

As the crisis developed, equity prices throughout the region fell sharply. By December, the fall for Asian developing countries as a whole was over 40 per cent. The combined effect of falling stock market prices and currency depreciation led to spectacular losses for foreign investors with falls from highs to lows in dollar terms of 89 per cent in Indonesia, 82 per cent in Malaysia and 85 per cent in Thailand.[4] Financial developments in the stock markets and currency markets were linked to a series of solvency crises in financial institutions and industrial companies across the region. In May 1997, Thailand's largest finance company, Finance One, closed along with 15 other cash-strapped finance firms. By December, 56 of the 58 finance companies were permanently shut. In Indonesia 16 banks in difficulties closed at the beginning of November. In just a few months the financial systems of these countries had been brought to their knees.

Bankruptcies seem to have been a particularly important factor in Korea. Whereas the economies of the developing countries in South East Asia could be said to be intrinsically vulnerable to attack, the Korean economy was much more advanced, and in industrial terms a major player on the world stage. But the Korean chaebols (or conglomerates) had financed their expansion by excessive reliance on short-term foreign loans which left them vulnerable. In January 1997, Hannbo Steel collapsed under $6 billion in foreign debt – the first bankruptcy of a leading conglomerate in a decade. In March, another steel company,

Sammi, failed. In July, Korea's third largest car maker, Kia, asked for emergency loans and was eventually nationalised after the banks refused additional credit.

The reversal of the flow of bank credit played a major role in the Asian crisis, accounting for the greater part of the changes in the flow of private capital. Between 1996 and 1998 there was a reversal of total net private capital flows of $108 billion to the five crisis countries, Korea, Indonesia, Malaysia, Philippines and Thailand (from an inflow of $62 billion to an outflow of $45 billion in 1998.) The corresponding changes in foreign bank loans was $114 billion (from an inflow of $46 billion to an outflow of $65 billion).

In the autumn of 1997, the 'Asian 'flu' spread to Brazil. Foreign investors lost confidence, there was a sharp fall in stock market prices, and downward pressure on the real. In the summer of 1998, Russia came into the firing line. Stock markets were in a state of turmoil and the ruble came under heavy pressure. The Russian economy is in such a poor state that its involvement in such a crisis may seem of little significance. But the moral is that volatile capital movements present a threat to a wide variety of economies.

Tackling the problem

Successive international economic crises have all had their own special features, and we should not make the mistake of basing proposals for future reform solely on the experience of any one episode. Nevertheless, the closely interrelated phenomena of volatile capital flows, asset price bubbles and unstable exchange rates tend to be common factors. We need to tackle the problem of reforming and strengthening the global financial system on a broad front so that measures to damp down the volatility of capital movements, asset prices and exchange rates all reinforce each other.

Financial market activity is not (or should not be) an end in itself, but a means of providing a service to industry and investors. Its prime functions are to provide efficient means of financing trade in goods and services, linking potential investors to industries needing capital. If exchange rates, bank lending and stock market prices are excessively volatile, financial markets are not performing those functions efficiently and need to be reviewed.

3. Improving financial regulation

A key element in the evolution of international financial crises is the so-called 'herd behaviour' of financial institutions and investors, in particular their tendency to follow each other into investing in whatever country or market is fashionable at the moment. This can lead (as in the Asian crisis) into excessive bank lending and over-borrowing in a particular country or group of countries, with each lender paying insufficient heed to the extent of their collective total commitment. The practice gives rise to a two-fold risk to the lender. The initial risk is that the borrowing bank or firm may have difficulty in meeting the interest payments or repaying the loan. The secondary or 'systemic' risk is that the group of borrowers as a whole may get into difficulty, thus making it more difficult for each of them to meet their obligations. This in turn puts additional pressure on the lenders to recover their money. Recent crises have highlighted this problem and focused attention on the role of the regulators of financial institutions in reducing such risks by improved 'prudential' regulation.

In 1999, finance ministers in the G7 group of leading industrial countries set up a new Financial Stability Forum to co-ordinate the work of (mainly national) regulatory organisations under the Chairmanship of the General Manager of the Bank for International Settlements in Basel. The supervisory code for banks will continue to be the responsibility of the Basel Committee on Banking Supervision which in June 1999 issued a consultative document proposing a New Capital Adequacy Framework with improved provisions for the 'capital backing' (or amount of capital) banks should have available to absorb potential losses on different types of loans. These provisions play an important part in determining the pattern of bank loans. In the interests of profitability banks wish to maximise their loans in relation to their capital base, subject of course to what they regard as the risks involved. An important illustration of the effect of the existing Basel provisions was the high proportion of bank lending to Asia that was for periods of 1 year or less. By mid-summer 1996 bank loans maturing within one year made up 70 per cent of the total for South Korea, 69 per cent for Thailand, 62 per cent for Indonesia, but 47 per cent for Malaysia. This reflected the fact that under the Basel rules loans for less than a year required only one-fifth of the capital backing that longer term loans required. The rationale of this was that individual banks were seen to be at less risk with loans that the borrowers knew they would have to repay or renew in the short-term. The weakness was that while this might be true for any one bank on its own, it was not the case when they all refused to renew one year loans at much the same time.

There is clearly a case for keeping the pattern of capital backing requirements under review in order to reflect up-to-date assessments of the risks involved in

lending to different countries or in particular forms. But it seems unlikely that the regulators, who are in close touch with those they regulate, will be altogether immune to the vagaries of investment fashion. More fundamental than the *pattern* of capital banking requirements is the general *level*. A basic weakness of the international financial system today is excessive 'leverage', ie the ability to achieve a large gain (or loss) from a small stake. Take the domestic example of someone who buys a house putting down 10 per cent in cash and raising a 90 per cent mortgage, ie a leverage of 10:1. If house prices rise by 10 per cent they will have doubled their original deposit when they sell. But if prices go down by 10 per cent, they will have nothing left. The financial press recently carried a series of advertisements directed at private investors, 'Trade Shares at Margin.... Deposit as low as 20 per cent'. Similar leverage exists throughout the financial system, both directly through the use of credit to buy financial assets and through the development of 'derivatives', which make it possible to make a large bet on asset prices, interest rates or exchange rates with a small stake. Products developed to enable people to 'hedge' (i.e. safeguard themselves against changes in interest rates, exchange rates, asset prices or creditworthiness) became new fields for speculation by others.

A prime example of the consequences of excessive leverage was the collapse of the Long Term Capital Management hedge fund in 1998 which had to be rescued by a consortium of leading financial institutions – despite the fact that it depended on the work of two Nobel prize-winning economists who, *The Economist* prematurely rhapsodised, had 'turned risk management from a guessing game into a science'! It was operating on a leverage ratio of over 25:1 with assets nominally valued at about $120 billion and a capital base of only $4.8 billion.[5] If other financial institutions had not come to its aid, the sale of its assets would have led to a sharp fall in prices which would in turn have placed others in difficulties.

A major objective of any reform of financial markets should be to reduce the amount of leverage in the system. One way of doing so would be to raise permanently the general *level* of capital backing required under the Basel agreement, as well as keeping the *pattern* under review. But there is a need for a wider international review of the use of derivatives and the role of credit in world stock markets. Such a review needs to be undertaken before there is a major stock market crisis, rather than as with the 1929 Wall Street crash when the Federal Reserve tightened up on bank lending for stock purchases after the event. Banks are unlikely to welcome any curb on their ability to lend, regarding it as a threat to their profitability. In the long run such restrictions may well save them from themselves.

The argument for taking *precautions* against such economic dangers is not (as is so often suggested) invalidated because the threatened danger has not materialised in the period since such precautions were proposed. If that were a valid ap-

proach in other walks of life, few safety precautions would ever be taken. If we tell our children to 'mind how they cross the road', the admonition is not needless merely because they scamper across a few times without getting run over! Whatever the precise probability of a stock market crash with disastrous effects on industry and jobs, it is only sensible to take precautions now to reduce the chances of its happening.

4. The flow of capital to developing countries

Recent crises belie the neo-liberal thesis, that removing restrictions on the international flow of capital benefits all concerned. Many developing countries have paid a devastating price in terms of instability for any temporary increase in the inflow of foreign capital. Pressure on developing or newly industrialised countries from the Washington institutions and Western finance ministers to liberalise their capital markets has exacted a heavy toll in bankruptcies and lost jobs. It is time to rethink the official attitude to capital controls in order to reduce the instability of short-term capital movements, and re-examine ways of improving and stabilising the flow of long term investment.

It may be significant in this context that the IMF has now published a staff report on *Country Experiences with the Use and Liberalisation of Capital Controls* which expresses an unexpectedly open attitude to the use of such controls. Its review of the various types of control adopted in different countries in varying circumstances suggests that no one pattern of control is universally most effective. The most acceptable have been those which in effect use the price mechanism rather than quantitative controls or outright prohibition of particular activities. Chile, Columbia and Malaysia have been the prime examples.

In 1991, the Chilean Government imposed an *Unremunerated Reserve Requirement* of 20 per cent on foreign loans. This had to be deposited at the central bank, interest free, and left there until maturity for credits of less than a year, and for 12 months for credits over a year. In the following year the requirement was raised to 30 per cent for a year irrespective of loan maturity. In 1998 this was reduced to 10 per cent and then abolished; however, foreign investors had to keep their money in the country for over a year. Similar measures were introduced in Columbia. The Chilean measures effectively imposed a tax (in the guise of a loss of interest) which was steepest on short-term capital inflows and tapered downwards as the period of the loan lengthened.

Malaysia has recently employed a more direct approach. In 1998, as part of a wide range of exchange and capital controls, the authorities imposed a 12 month waiting period on the repatriation of ringgit proceeds from sales of securities held in external accounts. In February last year they replaced this with a graduated levy on the proceeds of repatriating portfolio investment, ranging from 30 per cent for assets held less than 7 months to zero for assets held for over a year.

Such controls avoid detailed regulation and can help curb short term speculative movements, although the longer they are in force, the more adept investors become at finding ways to evade them. IMF policy on capital controls needs to

be revised in two respects. The first is that developing countries should no longer be pressed to open their capital markets to international investors more rapidly than their governments consider prudent. The second is that their use of capital controls in various forms when inflows seem excessive, or crises threaten, should be regarded as acceptable behaviour.

Long-term capital

Apart from damping down unstable movements of short-term capital, the principal need of developing countries is a stable flow of long-term capital. In practice this depends mainly on foreign direct investment (fdi) in firms or plants in those countries. The encouragement of fdi does, however, carry with it problems when the control of firms in one country comes under the control of headquarters situated elsewhere. This is, of course, not just a problem for developing countries as our own motor industry shows. The spread of overseas control is in danger of further weakening firms' concern for the people and institutions in areas in which they operate – a trend strongly associated with the short-term approach of financial interests to the firms in which they are involved.

Whereas direct investment is a relatively stable source of foreign capital, portfolio investment in equity or debt issued by companies in developing countries is essentially foot-loose. Whilst such investment may be long-term as far as the companies themselves are concerned, it may be very volatile from the point of view of the country as a whole if foreigners start to sell their holdings – although a wave of selling will only result in an actual outflow of capital if foreigners can sell their investments to domestic investors; in so far as they unload them on other foreign investors, such sales will only result in falling prices. Either way, the country concerned will suffer some currency outflow and pressure on the exchange rate, and falling stock market prices will depress domestic spending and make it more difficult for those firms to raise further capital.

It is time for a fresh examination of the role of the World Bank and its affiliate, the International Finance Corporation (IFC), in promoting the flow of development capital, particularly to poorer countries. In this connection, George Soros's recent proposals for insuring loans to developing countries could provide a basis for evolving new ways of stimulating a steady flow of capital at a time when confidence is low. Soros proposed that a new institution:

> would explicitly guarantee international loans and credits up to defined limits. The borrowing countries would be obliged to provide data on all borrowings, public or private, insured or not. This would enable the authority to set a ceiling on the amounts it was willing to insure. Up to those amounts, the countries concerned would be able to access international capital markets at prime rates plus a modest fee. Beyond these limits, the creditors would be at risk.[6]

Lenders would be obliged to pay an insurance premium to cover the risk, and the cost of this would be passed on to the borrower.

Soros acknowledges the problem of rationing the availability of insured credit within the recipient country and suggests that this should be done by competition among authorised banks (who would presumably profit from the difference between insured and uninsured lending rates). There are obviously considerable problems in devising a workable scheme, not least determining a reasonable level of premiums. What sort of borrowers would be eligible for guaranteed loans? Would the availability of guarantees depend on the apparent creditworthiness of the borrower? Despite these unanswered questions, the insurance concept deserves further consideration, including the possible role of regional development banks.

Private investment in developing countries needs to be buttressed by official development finance in the form of grants and loans for investment in basic social capital, such as public utilities, and as finance for the provision of guarantees and investment insurance for industrial investment. This is particularly important for poorer countries. Official grants and loans have become relatively less important in recent years. Since the mid-1980s the flow of such finance to developing countries had declined from over half total net capital inflows in the period 1983-89 to only 20 per cent in 1990-98, approximately half in grants and half in loans. The shift in emphasis from official to private capital has been to the detriment of poorer countries. But with the decline in private investment following the Asian crises, official development finance assumes increasing importance and new ways need to be found to fund it. The Tobin Tax (discussed in the next chapter) is one possible source of additional finance for such purposes.

5. The role of taxation

One measure which would help to damp down excessive speculative activity in currency markets and raise money for international purposes is the Tobin Tax – a small tax, say 0.1 per cent, on foreign exchange transactions. This was first proposed by the American professor, James Tobin, in 1972 as a means of curbing currency speculation. In recent years increasing attention has been paid to its revenue raising potential for international purposes such as increasing aid to developing countries or environmental measures. The growth of foreign exchange trading has meant that its revenue potential is increasing rapidly. Revenue estimates depend on how effective the tax would be in reducing market activity; on the basis of 1995 turnover, the potential revenue has been put at between $150 and $200 billion a year[7] depending on how far the new tax reduced market activity. Between 1995 and 1998, however, the average daily turnover of foreign exchange transactions including derivatives rose by a third – trading in traditional foreign exchange instruments rose by one quarter, trade in derivatives nearly doubled.[8] Thus the potential revenue today would be over $200 billion.

Imposing such a tax would raise problems of coverage, in particular the treatment of various derivatives. But compared with many existing taxes, it would be relatively simple. Only a fairly small number of institutions are involved and the tax calculations could be built into their computerised systems. The real problem is to secure the necessary international agreement to introduce it, the rules under which it would operate and the rate at which it would be charged.

One suggestion is that as an incentive to take part, countries which levied the tax might keep some of the proceeds for their own use, possibly in varying proportion according to their stage of development. As one-third of all transactions take place in the London market, this could be of particular interest to the UK. (Wider considerations apart, any British Chancellor is liable to be torn between the revenue raising possibilities involved and the strength of the financial lobby against any such tax!) If the tax were levied according to the market in which the transaction took place, all countries would have an incentive to participate, rather than become off-shore tax havens. In so far as tax havens did remain, a penalty tax could be levied on all transactions with them by markets in the participating countries.

The role of the tax in reducing speculative activity would be one of damping down the vast volume of day-to-day speculative activity, but it would not be an effective antidote to speculation on major changes in exchange rates. A very

high proportion of transactions are for periods of less than 7 days and are intended to exploit minor changes in exchange rates or interest rates. An indication of the order of magnitude involved is that a tax of 0.1 per cent would mean that transactions to exploit very short term differences of interest rates of less than 10 per cent a year (0.1 per cent a week) would no longer be profitable. On the other hand, a tax at this rate would be immaterial in speculating against a currency liable to devalue by 10 per cent in a matter of days or weeks.

The extent to which it is desirable to damp down short-term activity in currency markets depends on a judgement as to how far such activity is doing industry a service by providing a more stable market, as orthodox opinion has hitherto asserted, or how far such market activity has itself become a cause of instability. A standard reference book on currency trading gives the game away when it cautions aspiring dealers that 'there are few worse scenarios for currency traders than a relatively flat market.... The solution to the problem is options trading.'[9] Currently, it is clear that such activity has become excessive and destabilising. Short-term transactions are a major factor in the herd-like movements into and out of currencies. When currencies are rising (or falling), the odds on the movement continuing in the same direction for a few more hours or days are always very strong and, as dealers chase the currency up (or down), such short-term speculation becomes self-validating.

Taxing financial transactions

The proposal to tax foreign exchange transactions goes back nearly 30 years. Since then the growth of global financial markets has exposed our economies to a growing threat of instability not merely from exchange rate fluctuations and crises, but also in stock markets. The use of taxation to damp down speculative activity needs to be considered in relation to a much wider range of financial transactions. It has long been considered acceptable to tax purchases on goods and services (eg by VAT) but it has been argued that financial transactions should broadly speaking be left untaxed to make markets more 'liquid'. It is clear now, however, that financial markets have become too liquid, and any taxation that reduced the volume of transactions would be desirable, rather than the reverse. It is interesting that the Stock Exchange, in campaigning for the abolition of 0.5 per cent stamp duty on share deals, argued that this would raise trading volume by 40 per cent.[10] In so far as this is not merely a transfer of trading from one market to another, this seems an overwhelming reason against doing so. The moral rather is that the Chancellor should seek international agreement to harmonise taxes on such transactions – an initiative for which his fellow finance ministers might well be grateful.

It is becoming increasingly apparent that taxes on financial transactions need to be harmonised on a global and not just a regional basis now that such activity can take place anywhere in the world – whereas while sales taxes on goods need some degree of harmonisation in areas between which they can be easily

transferred (eg bringing wine or beer across the Channel), this does not have to be global. Taxes on financial activity and the mobile rich will, however, increasingly require internationally agreed rules and rates. This is an area of international co-operation which has barely taken off but will become much more important in the coming decade.

New international machinery will be needed to handle both tax harmonisation in these fields and any new international taxes such as the Tobin Tax. While the Tobin Tax was originally mooted as a way of curbing speculative activity, it has recently been put forward by War on Want and other NGOs as a means of financing international aid and development and would be an appropriate means of raising additional finance for the UN and other international agencies.

6. Managing exchange rates

Exchange rates lie at the heart of the global financial regime, and as George Soros has said: 'If people like me can crash a currency system, there is certainly something wrong with the system.'[11] Exchange rates set the terms on which countries trade each others' goods and services, and the level of rates can have a powerful effect on industrial output and employment. From industry's point of view, the two objectives are that rates should be competitive and stable. Under the present regime of floating rates, neither objective is assured – as British industry is uncomfortably aware.

Foreign exchange markets do not, as economic theorists once suggested, adjust rates so that countries' international payments come into balance – they never did. But today the overwhelming determinant is the movement of short-term capital. The result is that a fashionable currency like sterling may become overvalued and its exports uncompetitive, with disastrous consequences for many of its industries. But if and when sterling does come down, firms will not automatically increase export capacity again and take on more staff simply because they will have no means of telling where the exchange rate will be in 6 months' or a year's time. Such a situation is starkly at odds with the development of multi-national industrial companies who find themselves unable to plan future investment or operations rationally when variations in exchange rates can alter the relative costs of plants in different countries from month to month in an unpredictable fashion. An unjustifiably high exchange rate in one country may lead to production cuts or plant closures in that country with disastrous economic and social consequences for the people and areas concerned.

The answer to the problem of achieving a more stable system is not to go back to a fixed rate regime. Both fixed rate and free floating systems suffer from serious weaknesses. The major weakness of the fixed rate system is the difficulty of adjusting rates when relative costs in different countries get out of line. Such adjustments are generally delayed until they are long overdue and then forced on the country by a run on its currency and consequent devaluation in crisis conditions. Industry suffers from the delay in adjustment and finance ministers are compelled to commit virtual political suicide. To deter speculation they are forced to deny that devaluation is a possibility until a run on the currency market makes it inevitable. Their credibility is then in tatters. No wonder they tend to prefer floating rates: even if industry suffers, finance ministers do not get the blame!

One answer to the quest for stability is to form a currency union, such as the EMU, which effectively fixes the rates of the participants for all time by adopt-

ing a common currency. But this is only a practical route for countries which have achieved a high degree of integration, and even then may cause serious strains if costs in one area get out of line. A more general solution is to adopt some form of 'managed' rate system under which countries seek to achieve target rates for their currencies: these can be either informal and unstated, or publicly stated parities and bands, as in the ERM.

The history of the ERM highlights the two fundamental difficulties that have to be overcome if a system on similar lines is to operate successfully elsewhere. The first is the difficulty of getting agreement on adjustments in rates. The second is the need for an effective mechanism for intervening in the markets to keep rates within their stated bands. The break-up of the ERM in September 1992 reflected the inability of the members to agree on such changes and their inability to resist speculative pressure when their increasingly unrealistic rates came under attack. These two problems are inter-linked because an essential prerequisite for being able to resist speculation is that the rates should be seen to be realistic and sustainable.

One way to overcome these problems is to review the rates at relatively frequent intervals, say monthly, and make only relatively small adjustments in rates. (There is an analogy with the way central banks review interest rates once a month.) For example, if the agreement was that rates would be kept within a band of ±2.5 per cent of their stated parities (as in the ERM), the convention might be that changes in exchange rates might be made in steps of 1 per cent. Small changes of this kind would limit any major gains to be made when rates changed. If, for example, the pound were moved down by 1 per cent after the monthly meetings the new parity would still lie within the old band and the spot rate the next day might be no lower than it was before. The broad aim would be to keep 'real' rates stable, ie rates after allowing for differing rates of inflation.

The second innovation would be that intervention in currency markets to stabilise rates should be *automatic* rather than discretionary. Discretionary intervention involves *ad hoc* consultation and action by central banks. It takes time and their foreign exchange resources are limited in relation to market turnover. Automatic intervention would be most effective if it were the responsibility of a special stabilisation fund set up with adequate resources for this task, rather than left to co-operation between central banks. Making the same committee of central bank and governments officially responsible both for setting rates and running the stabilisation fund should ensure that the rates are realistic and maintainable. Once the system is seen to be effective, the stabilisation fund should in practice have little cause to intervene.

A two-tier system

A system of this type, and indeed any managed rate system, formal or informal, can only operate effectively among a small enough number of participants to be able to reach mutual agreement on rates. It would not be practical on a world-wide scale. This suggests that the achievement of greater exchange rate stability depends on a two-tier approach, with arrangements to manage rates both within regional country groupings and also between such regions. Such a movement is likely to take the form initially of developing regional arrangements in Europe, America and Asia, based on the euro (and sterling), the dollar and the yen, and then a 'tri-polar' system for managing the rates between these three groupings. The euro grouping would operate a new ERM mechanism on these lines to stabilise the relation between the euro and EU members outside EMU, including sterling.

In Asia there are already burgeoning signs of active cooperation in this field, with arrangements to monitor foreign exchange markets, and swap and repurchase mechanisms to aid currencies in difficulties. China, with its huge foreign exchange reserves of over $150 bn, has now agreed to participate and arrangements are in hand to formalise the present *ad hoc* arrangements. The US, which shot down an earlier Japanese plan for an Asian monetary fund, is supporting the new initiative.

In Latin America, the current issue is 'dollarisation', i.e. other countries adopting the US dollar as their own currency. This raises serious political and economic problems for both sides, since American monetary policy could become the monetary policy for the dollarised countries without their participation in the Federal Reserve System. A more flexible form of mutual currency management on the lines outlined above would be a more widely acceptable alternative.

Stability at the global and regional levels is inter-related. It would, for example, be much more practical to maintain a stable relationship between the pound and the euro if the euro were more stable relative to the dollar. Similarly, in the East it would be easier for Asian countries to have stable rates vis-à-vis the yen if the yen were stable relative to the dollar. The regional arrangements would probably vary from continent to continent but there is a strong case for *stated* parities and bands (perhaps to be reviewed on a monthly basis) and *automatic* stabilisation arrangements.

If exchange rate parities are to be determined by discussion between the participants in the system, two conditions are essential. The first is that upon entering the system, countries' rates must be at a reasonable level. It is essential to avoid countries entering at unrealistically high rates which damage their industry and cannot be maintained, as happened when sterling entered the ERM in 1990 – if the UK does enter EMU, it would be essential to do so at a lower rate than that

prevailing early in 2000. The danger of doing so is always greatest when financial interests take precedence over those of industry. As Winston Churchill wrote before he succumbed to Treasury and Bank of England pressure and made the mistake of going back on the gold standard in 1925 at the pre-war rate, 'I would rather see Finance less proud and Industry more content.'[12]

The second and more complex condition is that any national discussion of exchange rates must be based on a view as to the desired pattern of payments between the countries concerned. Where most members of the group are more or less in payments balance this is not of prime concern. However, where there are countries with substantial deficits or surpluses there has to be a view (tacit or overt) as to whether the continuation of these surpluses and deficits is acceptable in setting rates, or whether rates should be adjusted to reduce the imbalance.

The prime example of this arises in considering the rate between the yen and the dollar at a time when the US is running a substantial deficit (over $300 billion in 1999) and Japan a large surplus (about $140 billion in 1999).[13] At the moment US expansion is the 'locomotive' of growth in demand throughout the world and the Japanese economy is faltering badly. A stronger yen would make it more difficult to get the Japanese economy expanding again. But in the longer run, possibly over a 5-year period, the continuation of the US deficit at recent levels seems unsustainable. Its continuation depends on the willingness of investors in other countries to find it by buying US bonds or shares, and industrial or property investment there. A setback on Wall Street or a loss in confidence in the dollar could reduce or even reverse, this flow, creating a serious financial crisis. In the longer run, the US deficit must come down and the Japanese surplus, to some extent its mirror image, must also come down. This means that eventually the dollar must come down and the yen go up. Agreement on this will be a delicate matter and will require careful timing. The relationship of the yen and the dollar with the euro will be less difficult because the European surplus is less significant.

Similarly, within regions there will need to be consideration and agreement on the pattern of payments between participating countries. In other words, regional as well as global payment strategies.

Fiscal and monetary policy

One corollary of moving into a more stable system of managed exchange rates would be that countries would no longer be free to use monetary policy as their prime means of managing demand. Interest rates in different countries would have to be kept broadly in line, subject to differences in their rates of inflation. (Their general level would reflect global economic conditions with particular reference to the state of the US economy.) Budgetary policy would then become the main tool available to national governments for regulating demand in ac-

cordance with differing national circumstances – as it must *a fortiori* in a currency union like EMU with a single currency and monetary policy. Greater use of fiscal policy would run counter to the prevailing political and economic fashion inherited from the monetarist 1980s, but it is a natural consequence of the globalisation of international financial markets, if industry is not to pay a heavy price (as at present) in terms of exchange rate instability.

7. The future of international economic institutions

Whatever improvements are made in prudential regulation and other fields, crises may still occur. Contingency plans are needed to deal with them, including agreement in advance on the machinery for managing such crises. When the Asian crisis came, no such coherent management structure for dealing with it existed.

It is important to distinguish three different strands in international crises of this nature.

1. The lack of liquidity or the threat of insolvency facing banks or other major financial institutions.
2. Sovereign debt default, i.e. the inability of national governments to meet debt repayments or interest when they fall due.
3. Foreign exchange crises putting critical pressure on the exchange rate and foreign exchange reserves of a country or countries.

The provision of liquidity to the banking system and the rescue of failing national banks is primarily a function of national central bankers and regulatory authorities. But when the institutions are effectively international, or so large that their collapse would have international ramifications, international (rather than purely national) action is required. When the Long Term Capital Management hedge fund collapsed in 1998, a group of American banks, with the Federal Reserve in the background, formed an *ad hoc* group to deal with the situation. The question today is whether such major international operations should be made the responsibility of the IMF or any new international regulatory authority. The recently created Financial Stability Forum in Basel hardly qualifies for this task as it is essentially a policy co-ordinating body.

The question of dealing with debt default has been under discussion for some time without agreement on any general approach. The initial objective must be to ensure if possible that the debtor country can meet its obligations, if necessary with assistance from the IMF. Failing that, the aim must be to seek agreement between the debtor and creditors for an orderly 'debt workout', ie agreement to stretch out the schedule of capital or interest payments. It is crucial so far as possible to solve the problem in such a way as to avoid a general crisis of confidence in the debt of countries believed to be similarly situated.

Dealing with foreign exchange crises is primarily the task of the IMF. There needs, however, to be a distinction between a country's need to borrow from the IMF because (a) it has a balance of payments deficit, and (b) there is a run

on its reserves for speculative reasons. The two have, of course, always been connected. Before capital movements were liberalised, sterling crises, for example, tended to reflect balance of payments deficits but were then precipitated by sales of sterling. Today speculative pressures can dwarf the effects of payments deficits and we need to rethink the traditional approach that the subsequent exchange rate problems are primarily a matter for the country concerned to solve, with some help from the IMF and possibly other central banks as a last resort. Exchange rates are essentially a *mutual* affair between a country and its trading partners – something which is much clearer when considering groups of countries rather than the world as a whole.

Maintenance of an existing pattern of exchange rates should be regarded as a matter for both an individual country under pressure and its main trading partners. This will become of increasing significance with any move towards managing exchange rates, informal or formal – hence the proposal in an earlier section that an essential feature of any formal managed system is the creation of a new Stability Fund committed to automatic intervention in currency markets to maintain the agreed rates. This signifies the need to distinguish between (a) the IMF's traditional role of lending to countries in deficit, and (b) the role of market intervention to maintain exchange rate stability – a function in which strong countries must in effect help the weak because the latter are least able to intervene effectively in adverse market conditions.

Most of the proposals now under discussion for reforming the IMF, such as the recent Meltzer Report to the US Congress, are based on a long out-dated view of the problems of global financial instability. They see them essentially in terms of individual countries getting into difficulties and needing assistance from the Fund, rather than as breakdowns of the world financial system as a whole. In updating the remit of the Fund, its role should be seen primarily as that of keeping the international financial system operating smoothly and its country funding as only a part of that responsibility.

Reforming international institutions

A prime weakness of the present system is the way in which the IMF is able to force inappropriate policy prescriptions on countries with difficulties. This takes two forms. The first is to prescribe deflationary budgetary or monetary measures to countries already threatened with rising unemployment (as they did in Indonesia and Thailand) under the pretext of 'restoring confidence'. This runs counter to the original purpose of the IMF which was to provide support for countries in difficulty, thus enabling them to avoid the orthodox prescription of deflation which had such disastrous consequences in the inter-war period.

The second feature is pressing for so-called 'structural reforms', such as privatisation. It is totally undemocratic for the US and other Western countries who dominate the IMF to force their own neo-liberal economic ideology on

other countries who wish to choose a different path. The Fund and Bank should recognise the case for *diversity* of institutional and economic frameworks in different countries and not insist that everyone should adopt one uniform model.

In addition to changes in policy at the IMF and World Bank, there is a need to reconsider their roles more generally and their relation to other international organisations in the economic field, in particular United Nations organisations and the OECD, many of which seem to have outlived their usefulness. The problem is to reach a workable compromise between the realities of power and the democracy of numbers: in effect the balance between the US and other leading industrialised countries on the one hand, and the rest of the world on the other. At the present time, the developing countries and their massive populations are under-represented in the decision-making structure. This tends to be accentuated by the fact that effective decision making frequently requires finance ministers to meet in small groups, such as G7, which are almost always composed predominantly, or entirely, of representatives from the leading industrial countries.

One development which could improve the balance is the emergence of more effective regional organisations. Europe has gone furthest down this road with the evolution of the EU and now the EMU. It illustrates the way that economic integration, active regional economic governance and political cohesion go hand in hand. The economic and political power of any regional organisation depends to a large extent on the scope of the duties it has to undertake. The proposal in an earlier chapter that countries should establish regional arrangements for managing exchange rates parallels other developments in regional cooperation for trade and other purposes, eg NAFTA and MERCUR. Such developments are not, however, likely to bring much closer political co-operation if they are each the responsibility of a different regional organisation (with differing membership). The architects of the UN created regional economic commissions for Europe, Asia and Latin America but these have been solely a focus for discussion, with little or no executive responsibility. If there is to be more effective international co-operation for economic and other purposes, building more effective regional organisations must be a key part of the project.

8. Summary and conclusions

The instability of the global financial system is a threat to economic growth and employment not just in developing countries, but throughout the world. Financial markets are in danger of becoming the master rather than the servant of industry and the real economy. Evolving more powerful and effective machinery for international economic co-operation must be a major political objective in the coming decade. The British Government is in a good position to give a lead, with London a major international financial centre and with our close links with the United States as well as our membership of the European Union.

There are three closely inter-linked aspects of this instability – as evidenced in the Asian crisis: the volatility of international capital flows, bubbles in stock market prices, and exchange rate instability. In a typical crisis, inflows of foreign capital and booms in share prices feed on each other and put upward pressure on exchange rates. Then a sudden reversal of sentiment leads to an outflow of capital, a stock market collapse and a fall in exchange rates. Measures are needed to tackle these inter-related phenomena on a wide front.

Capital movements

The premature liberalisation of capital controls played a major part in the Asian crisis. The IMF should no longer seek to ban the use of capital controls by developing countries either as a precautionary or crisis measure. The industrialised countries should consider means of ensuring a greater and more stable flow of long-term capital to developing countries, including a more active role for the World Bank.

Improving financial regulation

Attention has so far been mainly concentrated on improving the prudential regulation of financial institutions. Finance ministers of the leading industrial countries have set up the Financial Stability Forum to co-ordinate the activities of supervising authorities. The Basel Committee on Banking Supervision has put forward proposals for revising the *pattern* of capital backing requirements; for example, to remove the incentive to banks to make short-term rather than longer-term loans.

But the fundamental problem of excessive *leverage* in the financial system, and hence the general *level* of backing requirements, has been largely ignored. The ability to take a large chance of gain (or risk of loss) for a small stake lies behind virtually all speculative movements. The extent of such risk-taking depends on the availability of credit (directly or indirectly) for such purposes, and the evolution of derivative instruments which have increased the ability of participants to bet on stock market prices, interest rates or exchange rates for a payment of only a fraction of the gross sums involved.

The Basel Committee should be considering a general increase in the *level* of backing requirements, particularly for forms of bank lending which may fuel financial speculation. Stock market and other regulators should look more closely at the types of derivatives available.

Taxing financial transactions

Taxation of financial market transactions could be a useful means of damping down speculative activity. The long standing proposal to impose a small (Tobin) tax of 0.1 per cent on all foreign exchange transactions would both serve this purpose and raise funds for international purposes such as development aid, environmental projects and peace-keeping.

In addition, the issue of wider taxation of financial transactions must now come onto the political agenda. The UK and other countries already levy taxes on stock market transactions, but with the development of global markets these need to be harmonised and extended. Otherwise, in the longer run, market activity will gravitate to the areas with the lowest or no taxes, and taxes on large corporations and rich investors will be whittled away at the expense of the ordinary taxpayer.

Managing exchange rates

Exchange rates lie at the heart of the international financial system, and a more stable exchange rate regime is the least discussed but most fundamental reform that we should be addressing. Both fixed and freely floating exchange rates have serious disadvantages: 'fixed' rates tend to be adjusted only under crisis conditions while floating rates leave industry at the mercy of inappropriate and unforeseeable movements in rates. We need to devise systems of managed but flexible rates which can be adjusted to changing conditions, such as relative movements in costs, but which provide greater stability.

The general model for such systems should be to have publicly stated parities and bands, as within ERM. But to make such systems more effective than the ERM, two key problems need to be addressed: getting agreement on changes in rates and ensuring effective market intervention to keep rates within agreed bands. Rather than making dramatic changes in parities infrequently, rates should be reviewed monthly, and any necessary changes made in small steps. Intervention should be *automatic* and the responsibility of special stabilisation funds set up for this purpose, rather than of central banks.

Moving towards a more stable, managed exchange rate regime requires a two-tier approach with (a) (varying) regional systems, and (b) global arrangements to link the rates between them. Initially this would embody a European grouping managing the rates between the euro and non-EMU countries in the EU, a North and Latin American group based on the dollar, and an Asian group based initially on the yen. Such a tri-polar system would then require a global arrange-

ment (under the IMF) to manage the rates between these three groupings. But until such groupings were established, informal moves to manage the relation between the three major currencies would help to achieve greater stability.

One corollary of a more stable system of managed exchange rates would be that countries would need to keep their interest rates broadly in line – subject to differences in their inflation rates. This would mean that budgetary, rather than monetary policy, would become the main instrument of demand management.

Reforming international institutions

A new and more stable international financial system will require changes in both the policies and structures of the present international financial institutions. In particular, the IMF should stop prescribing deflationary measures which increase the risk of massive increases in unemployment in countries with difficulties, instead helping them to stabilise their economies in such a way as to maintain employment. The Fund should also recognise the democratic right of member countries to determine their own economic structure and not dictate highly political changes like privatisation. The voting structures of both the IMF and the World Bank should be updated to give the developing countries more weight.

The structure of the present multitude of international organisations, the IMF and World Bank, the UN institutions and the OECD needs to be streamlined and updated. Regional organisations should play a greater part in any new structure and developing countries should have a more powerful voice. Given the large number of countries (around 200) which now make up the membership of international institutions, more effective international governance in future may depend on a two-tier system of representation and decision-making with regional organisations eventually becoming part of the formal constitution of global organisations such as the UN.

Controlling our own destiny

If elected governments are to control our own economic destiny and not be at the mercy of the vagaries of financial markets, they must work closely together to establish more effective means of world economic governance.There is no excuse for politicians wringing their hands helplessly and pleading that they are powerless in the face of globalisation of markets. Given the will of governments to act together, it is perfectly possible for them to reassert control over economic policy and make the greater interdependence of national economies a force for progress rather than a threat of disaster.

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Closing the Casino

The instability of the global financial system is now a serious threat to industry and jobs throughout the world. Crises, such as those which recently beset the Asian economies, are the most extreme manifestation of this instability. Yet, exchange rate instability presents serious problems for industry world-wide. Multi-national firms cannot plan their investment and operations rationally when future exchange rates are so uncertain. The uncertainty inhibits industrial expansion.

In the immediate aftermath of the Asian crisis, there was much talk of the need for a 'new global financial architecture'. But as the threat of a wider recession receded, Western leaders became less concerned about root and branch reform and soon limited their discussions to what one American commentator called 'interior decoration' rather than 'new architecture'.

Grieve Smith challenges this limited vision and argues that there is an urgent need for fundamental reform of the global financial system. If governments are to reassert control over the global casino, then the development of more powerful and effective machinery for international economic co-operation is the major political challenge of the coming decade. Only then will greater interdependence of national economies become a force for progress rather than a threat of disaster.

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