

# **BALANCED GLOBALIZATION: THE ROLE OF FINANCIAL MARKETS**

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*Note:* The views expressed in this paper do not necessarily reflect those of UNDP.

## ***Introduction***

We are all familiar with the contribution that well-developed—and adequately regulated—financial markets can make to economic growth, namely by allocating savings to where there they can best be used.

There is, however, another contribution that financial markets are providing: that of risk management.

Today, the demand for less volatile, more balanced globalization is gaining strength, encouraging a vibrant search for innovative risk management instruments. We now realize that globalization presents risks but that economic openness, notably financial market integration, also presents new opportunities to manage these risks. The hallmark of the emerging new finance instruments is that they often involve public-private partnering, and national and international-level action.

Through their contribution to risk management financial markets help promote public policy goals like sustainability, stability and security. They do so not (or not only) because they intend to do "good" but because risk management generates social as well as private returns—attractive new business opportunities.

However, many of the new financial instruments are still at the stage of innovation. The challenge ahead is to move promising instruments from innovation to adoption. OECD countries might want to take on the challenge of moving these instruments from innovation to wider adoption. As this paper shows, the gains could be considerable.

### ***I Growing demand for balanced globalization: the new policy context***

Governments today face a growing volume of expectations about "good national public policy", formulated by domestic and international business and civil society as well as intergovernmental organizations. Consider, for example, the rise in recent years in the number of composite indices that measure, and often, rank government performance. Their number moved from 15 in 1980 to more than 130 in 2005 (see figure 1).<sup>1</sup>

Taken together, these indices expect governments to pursue two main clusters of policy goals (see figure 2):

- *Openness and competitiveness; and*
- *Development, sustainability and security.*<sup>2</sup>

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<sup>1</sup> All figures, tables and boxes are presented in the annex to this note.

<sup>2</sup> These policy clusters have been identified based on a categorization of the indicators included in the composite indices. For more detail see Bandura (2005) and Kaul and Conceição (2006).

Put differently, governments are expected to foster openness, but at the same time also new forms of national "closure". This means in particular, to reduce negative crossborder spillovers like greenhouse gas emissions, help contain or eradicate communicable diseases, seek to prevent financial crises, and avoid conflict and war that could burden the international community. And while governments are expected to promote competitiveness, they should, at the same time, provide protection against external shocks to the economy as a whole as well as against idiosyncratic risks. In brief, good national public policy should result in less volatile, more balanced globalization.

But do governments take into account what is expected of them? The data presented in Box 1 suggests they do: national public policy seems to echo the call for more balanced globalization.

## ***II Responding to the challenge of balanced globalization: innovation in public and private finance***

Meeting the goals of improved sustainability, stability, and security requires in particular, enhanced risk management. Governments have initiated action to this effect, often relying at least initially, on conventional policy tools like budgetary restructuring (i.e. according higher expenditure priorities to the new challenges), disincentives (like taxes) or incentives (like tax deductions and subsidies).

Yet new policy paths are also being pursued. And financial markets are playing a key role in this context. Consider for example, the following:

- **Investors entering into extended (contingent claim) contracts with governments**
  - *Collective action clauses*--The inclusion of this device in sovereign bonds has significantly expanded in recent years. The clauses are intended to facilitate--should default occur--a more orderly debt workout, which may also prove to be less costly--for the borrowing government/country as well as for the investors.
  - *Sovereign bond indexation*--Sovereign bonds indexed for example, to the country's GDP or to the price of one of its major export commodities, afford investors an opportunity to participate in the country's economic fortune (to enjoy higher returns when growth/prices move up). But they also expect them to accept lower returns when a downturn occurs. Compared to plain-vanilla bonds that involve fixed payments, indexed bonds protect the issuer government during economic downturns against a drain of resources away from counter-cyclical measures, potentially contributing to the prevention of financial crises. (See also figure 3)

Indexed bonds of this type are not yet widely used. However, they are under active consideration as a technology that would allow governments to tap financial markets at less risk of suffering a financial crisis.<sup>3</sup>

- **Securities backed by new types of assets--"joint donor promises to deliver foreign aid in future"**

Some industrial country governments are coming together and jointly backing the issuance of debt to frontload investments in development-related activities (such as in the case of the International Financial Facility for Immunization, IFFIM).<sup>4</sup> Participating governments are *collectively* held accountable by financial markets (namely the investors that buys the issued debt) for making good on commitments to provide foreign aid in the future. (See also figure 4)

The advantage for governments is that they can deliver urgently needed foreign assistance at the desired level. This can be done now, without sudden expenditure/taxation hikes, a fact that contributes to fiscal discipline. And the advantage of jointly backing debt--through the IFF--is to reduce the risk of attempting free-riding on the part of individual governments that would exist would debt issuance left to each country to undertake on its own.

- **Public/private partnering**

- *(Global) public-private partnerships*--The main purpose of these partnerships often is to assign the risks involved in undertaking a particular project to the party/actor group best able to bear them. While long recognized at the national level, public-private partnerships are being extended into the international-cooperation context. An example at the international level is the Galileo project initiated by the European Commission.<sup>5</sup> Like many national public/private infrastructure projects, the Galileo project follows an approach of splicing risks, thus facilitating public expenditure smoothing.<sup>6</sup>
- *Public subsidies for major-incidence insurance*--Private insurers have done a lot to shift and expand the boundaries of insurability. However, some risks cannot be covered alone by the private sector, including catastrophic events

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<sup>3</sup> For an overview of the current state of the debate on this instrument, see Borensztein and Mauro (2004); Council of Economic Advisers (2004); Griffith-Jones and Sharma (2006) and UN/UNDP (2005 and 2006).

<sup>4</sup> For more detail, see [www.iffim.com](http://www.iffim.com)

<sup>5</sup> In the case of the Galileo project the public actors re-assigned the right to collect user fees for a defined period of time to the participating private actors in return for the latter's bearing the risks associated with the resource mobilization and the implementation (construction) of the satellite system.

<sup>6</sup> By not having to provide the full investment from public revenue, governments can achieve expenditure smoothing and predictability. They may have to pay the private partner a defined amount of money annually or monthly for service delivery, or where they temporarily gave away the right to collect user fees, they may even have to pay nothing for some time.

and terrorism attacks. Many of the emerging programs in this area involve private insurance and reinsurance coupled with government funding.<sup>7</sup>

- **Overcoming access problems to financial and insurance markets**

- *Futures and options*--Futures and options contracts exist since a long time for a variety of commodities and financial assets. But now, more governments are availing themselves of these opportunities for hedging risk and more governments (notably those of developing countries) are also facilitating, often in cooperation with international agencies like the World Bank, access for domestic private economic actors (e.g. farmers) to these markets.<sup>8</sup>
- *Weather insurance*--Much the same holds true for this instrument. Only recently, for example, the World Food Programme (WFP) of the United Nations took out a weather-insurance contract on behalf of Ethiopia.<sup>9</sup>
- *Home equity insurance*--Many people's main asset is their house. Home prices often fluctuate considerably, and are subjected to boom-and-bust cycles like any other equity-like asset. They are affected by basic changes in a country's comparative advantage (that may entail the rise or vanishing of major industries and hence ups and downs in neighborhoods and communities, and hence, housing prices). Yet it was not until 22 May 2006 that a mechanism for hedging against the decline in real estate prices was introduced, when futures and options indexed to real-estate prices in 10 US markets were offered on the Chicago Mercantile Exchange.<sup>10</sup>
- *Affordable health, life and unemployment insurance*--For many developing countries economic globalization (i.e. increased openness and competitiveness) still presents the challenge of introducing the most basic insurance mechanisms that would help people cope with the increased volatility that tends to accompany globalization. In industrial countries the challenge is more one of ensuring public affordability of these schemes. The design of dual (public/private)-pillar schemes thus is a key policy issue in these countries.

### **III Moving from innovation to adoption: policy recommendations**

The aforementioned finance innovations are not surprising, given the context of great vitality in today's financial markets. We can't open a newspaper without reading

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<sup>7</sup> For more details see Swiss Re (2005).

<sup>8</sup> A case in point is the International Task Force on Commodity Risk Management in Developing Countries: [www.itf-commrisk.org](http://www.itf-commrisk.org)

<sup>9</sup> See Turner (2006).

<sup>10</sup> See [www.cme.com/trading/prd/env/housingover16250.html](http://www.cme.com/trading/prd/env/housingover16250.html).

references to the expanding breadth and scale of financial innovation that is taking place. Derivatives, especially those traded over-the-counter but also many in exchanges, are multiplying and growing to a volume that approaches now – in notional amounts – more than 7 times the size of the global economy (see table 1). Previously not traded risks are now being exchanged and actors have more opportunities than ever to choose to hold only those risks that they are prepared to withstand – buying one financial product or another that enables them to off-load the risks they don't want to bear.

However, the innovations discussed here do not merely allow private actors to realize enhanced private gains. They also generate social returns and thus contribute to a more balanced globalization. They help avoid costly crises and most importantly, they reduce the threat of risk-aversion and over-caution among economic actors, behavior that would stymie innovation, creativity and dynamic efficiency--dampening economic growth and development.<sup>11</sup>

While all of the tools discussed here exist, many still find themselves at the stage of innovation: They exist as pilots, as first test cases. They are not yet in the policy mainstream.

So, what role could OECD countries play in making these innovations happen?

OECD countries could play a major lead role in realizing balanced globalization, if they were to absorb some of the up-front costs involved in moving promising new financing instruments towards broader adoption.

For example, they could take the lead in issuing GDP-linked bonds, giving financial markets and potential issuer countries an opportunity to better understand and price these instruments. Once accepted by issuers and investors, "generations" of future issuers, notably emerging-market issuers could benefit from the availability of this financing technology--adding to enhanced economic growth and development.

OECD countries could go even further and bring the idea of risk-sharing to a much deeper level. For example, they could encourage policy research and development (R&D) aimed at enabling not only governments but individual people and firms to protect themselves against macroeconomic downturns. This could be done if they had the chance of buying securities that have their payouts inversely related with the economic conditions of the country in which they live – instruments that Robert Shiller (2003) has called “macrosecurities”. (See also box 2 on this issue.)

OECD countries and other donor nations could also work with developing countries in the area of capacity building, assisting them to create the appropriate conditions for financial markets to flourish and innovations like GDP-indexed bonds to take off. This might require allowing foreign aid to focus more strongly on capacity building in this area.

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<sup>11</sup> For an elaboration of this point, see Shiller (2003).

Last but not least, it would be interesting to explore--and demonstrate--in more detail the gains from meeting the Millennium Development Goals (MDGs) in time through such mechanisms as the IFF. Compared to not achieving the Goals in full, on target--i.e. to allowing severe world poverty with all its potential negative consequences to persist--would it not be a modest cost to incur to issue aid promise-backed securities to speed up decisive investments in poverty reduction as soon as possible?

The gains from enhanced risk management could be significant. Even if only considering six tools applied to just six select challenges, the resultant gains amount to \$ 360 billion in U.S. dollar and \$ 7 trillion when measuring the benefits in net-present value terms, as shown in table 1.

The opportunities that integrating, deepening and expanding financial markets present for better meeting some of today's main public policy goals are significant. Tapping these opportunities requires innovation--a greater focus on risk management and new finance technology. Both should be do-able. Clearly, more balanced globalization is in our reach.

## References

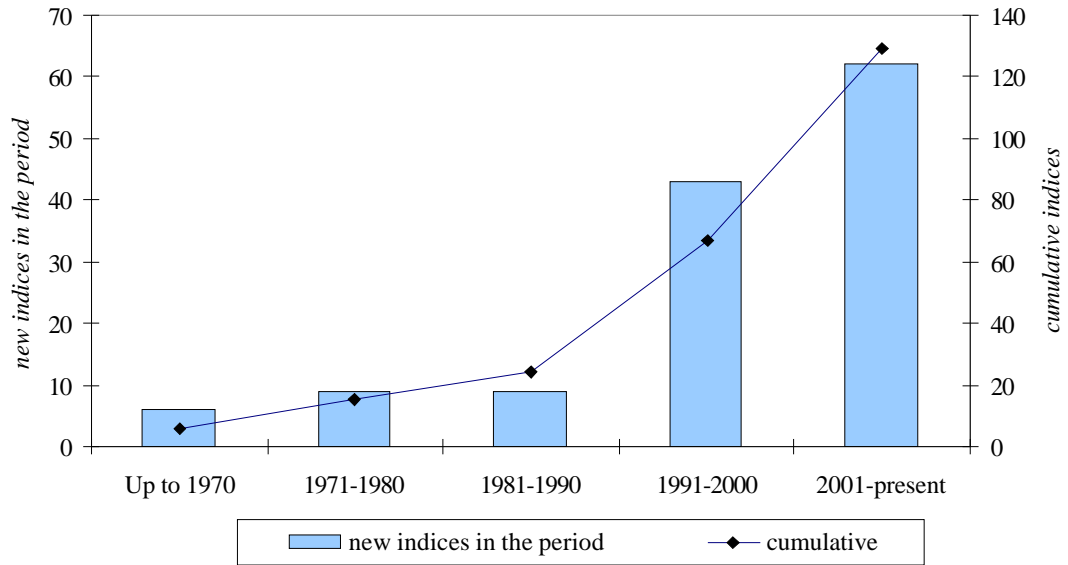
This paper is based on Kaul, Inge and Pedro Conceição, eds. 2006. *The New Public Finance: Responding to Global Challenges*. New York: Oxford University Press. See also [www.thenewpublicfinance.org](http://www.thenewpublicfinance.org).

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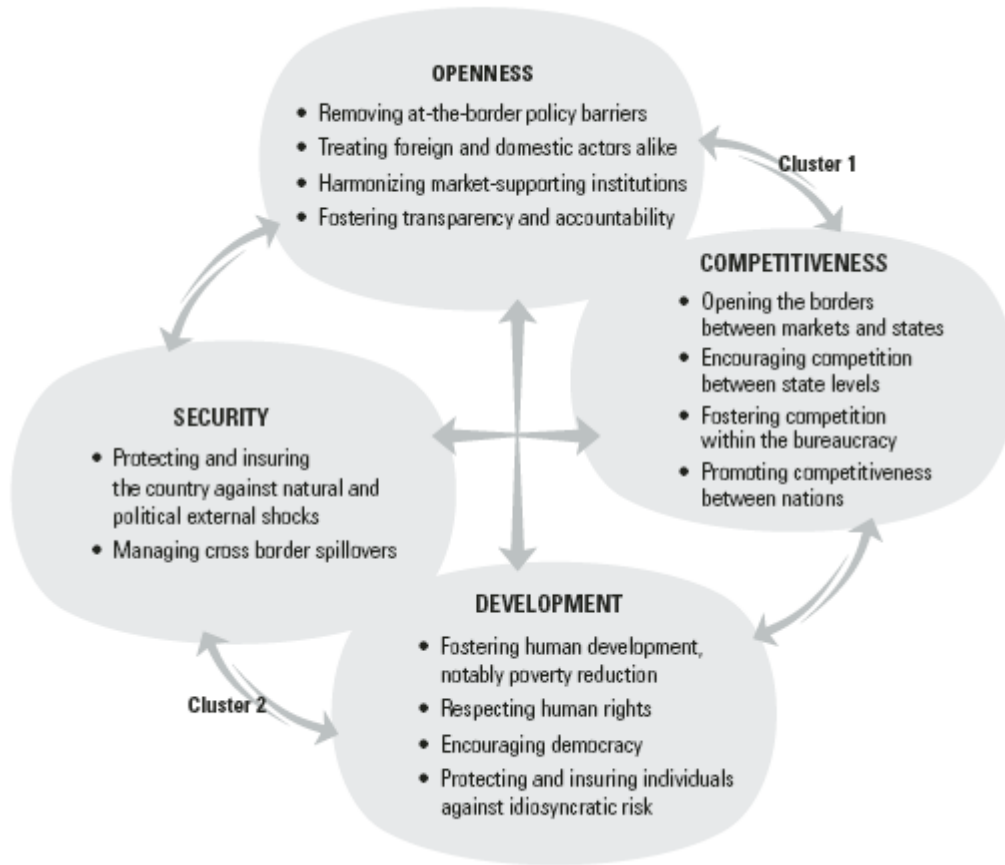
## Annex

**Figure 1: Growth in number of indices**



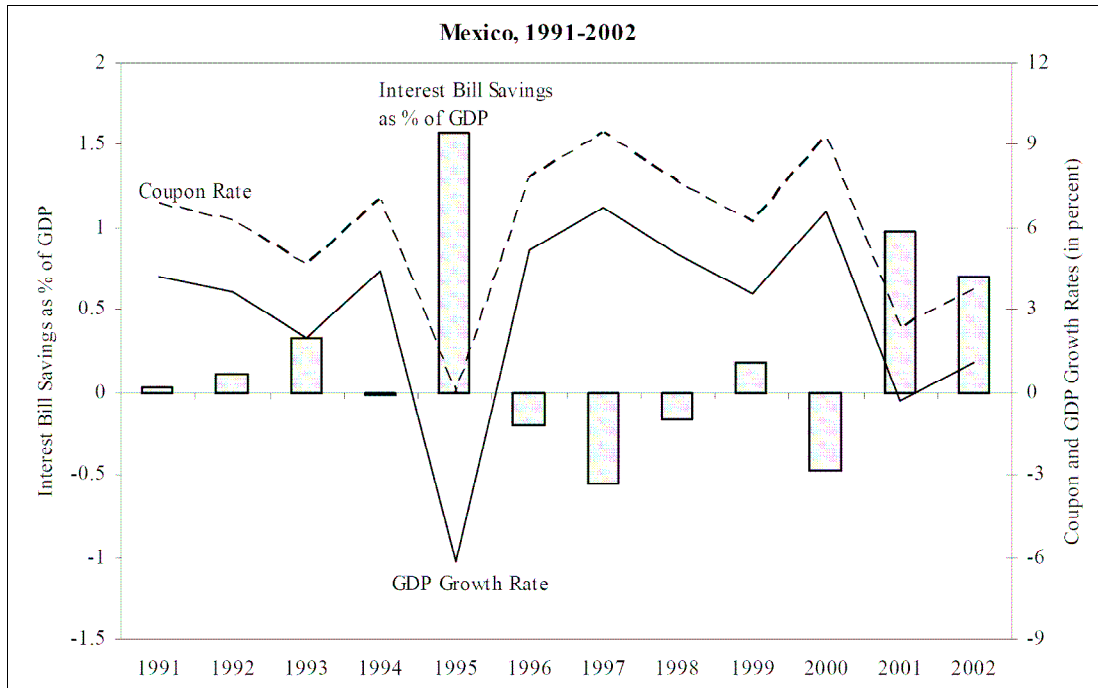
Source: Bandura 2005.

**Figure 2: Clusters of external expectations about national public policy**



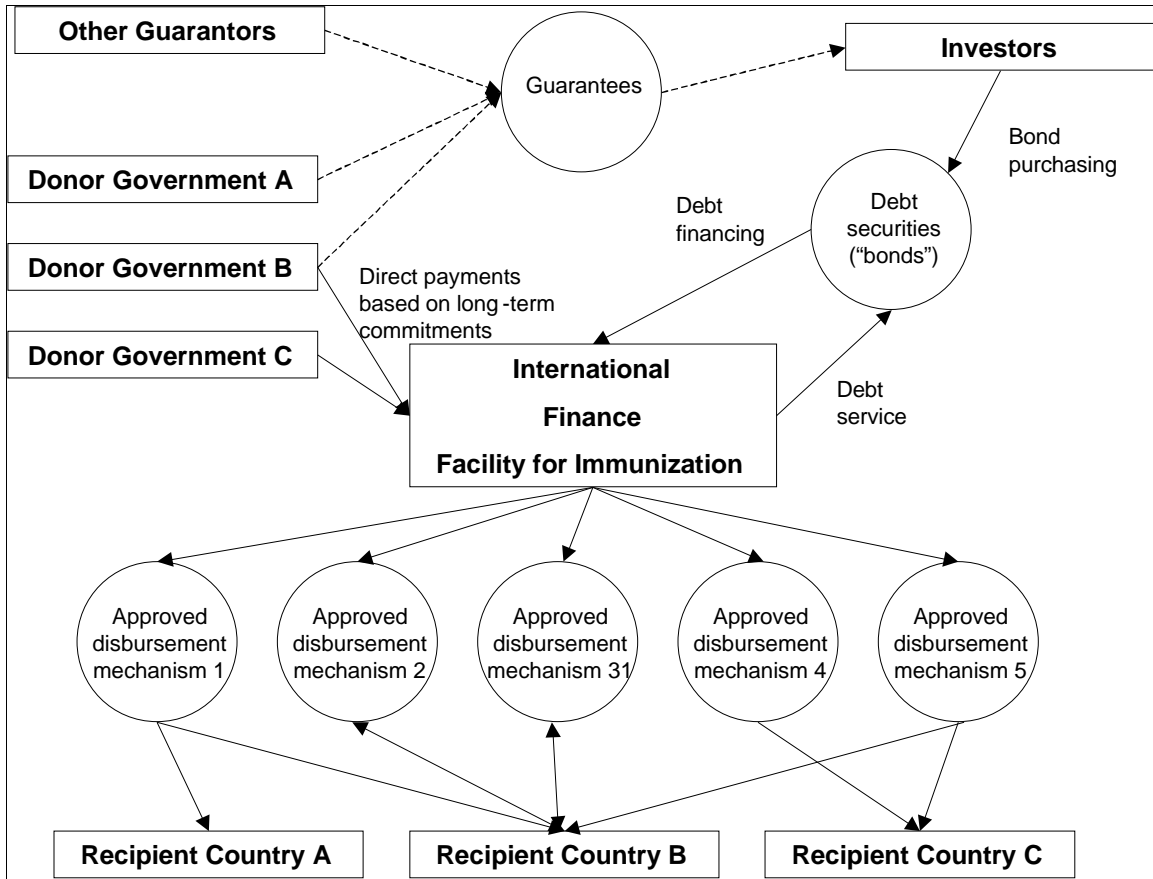
Source: Kaul 2006 (p. 78)

**Figure 3: Example of the Payouts Using GDP-Indexed bonds as Compared with Plain-vanilla bonds (Application to the Case of Mexico).**



Source: Borensztein and Mauro (2004).

**Figure 4: International Financial Facility for Immunization**



**Table 1: The size of financial markets**

	<i>Size</i>	<i>Year</i>
GDP	41,254.7	2004
Stock Market Capitalization (a)	37,168.4	2004
Bank Assets (b)	57,315.8	2004
Debt Securities (c)	57,696.1	
Domestic	43,732.1	2004
International	13,964.0	2004
Derivatives (d)	298,415.4	
Exchange Traded	46,592.4	2004
OTC	251,823.0	2004
<b>Total Financial Markets = a+b+c+d</b>	<b>450,595.7</b>	
Total Financial Markets (% of GDP)	1,092.23	

*Note:* In billions of US current dollars, unless otherwise noted

Source: Based on data from the IMF and BIS. Detailed information on sources available upon request

**Table 2: Six tools, \$7 trillion gain (billions of U.S. dollars)**

Tool	Challenge addressed	Primary beneficiary	Annual gain	Net present value of gain <sup>a</sup>
Guarantees issued by aid agencies	Infrastructure investment	Developing countries	1.1	22
Securitization of future flow receivables	External borrowing	Developing countries	1.5	31
Advanced purchase commitments <sup>b</sup>	Malaria control	Malaria-endemic regions, especially Sub-Saharan Africa	1.4	47
GDP-indexed bonds	Public expenditure/debt repayment smoothing	Developing countries	30.0	600
Macro markets <sup>b</sup>	Risk management	Group of Seven industrialized countries	145.1	2,902
International pollution permit trading	Reduction in greenhouse gas emissions	Industrialized countries	182.0	3,640
Total <sup>c</sup>			~360	~7,000

a. The sum of the gains is provided here for illustrative purposes only, since the methods used to estimate the gains refer to different base years.

b. The gains from these tools are expressed net of costs.

c. The discount rate is 5 percent for all the tools, except for advanced purchase commitments, where a discount rate of 3 percent is used in line with the common practice of using lower discount rates in health-related cost benefit analyses.

Source: Kaul and Conceição 2006 (p.51)

## Box 1: Echoes of external policy expectations in national public policy

The following examples highlight a few national policy changes that appear to echo cluster 1 and 2 expectations.

### *Cluster 1: openness and competitiveness*

- *Openness.* Trade and financial liberalization have progressed in the past decades and to that end states have even introduced changes in that most jealously guarded domain of national policymaking, the tax system. In many countries value-added taxes (VAT) have replaced trade taxes and other taxes on financial cross-border transactions (Cnossen 1998; Heady 2004; Keen and Simone 2004). As of 2001, more than 120 countries had adopted a VAT (Ebrill and others 2001, p. 8).
- *Competitive government.* States have also accepted competitiveness challenges. Both privatization and public-private partnering are on the rise (Bangura 2000). Central bankers and finance ministers the world over strive to adhere to established rules of monetary and fiscal prudence, watching carefully how markets respond to their policy choices (Barlow and Radulescu 2002; Canova and Pappa 2005; de Ferranti and others 2000). Countries have also devolved fiscal, political, and administrative powers to lower levels of government. Some 95 percent of the world's 120 democracies have now elected subnational governments (Freedom House 2005; World Bank 2000, p. 107).
- *Fostering a conducive business environment.* Many developing countries are seeking to improve their business environment (Porter and others 2004a,b; World Bank 2004). Countries have sometimes created special economic zones that offer investors more advanced infrastructure and often more favorable investment conditions. As of 2002 there were some 3,000 export processing zones in 116 countries (World Bank 2004, p. 168). Moreover, regulatory restrictions have been removed, especially those that could impede foreign direct investment. Since 1995 some 60 countries have introduced regulatory changes considered favorable to foreign direct investment (World Bank 2004, pp. 111–12).
- *Innovation.* Innovation “hot spots” are emerging in developing countries, among them China, India, Israel, the Republic of Korea, the Russian Federation, Singapore, and Taiwan Province of China (Carey 2004). Industrial countries, feeling the pressure, are launching their own initiatives aimed at staying ahead in the technology and productivity game. For example, the Lisbon Strategy of the European Union is designed to make it the most dynamic and competitive knowledge-based economy in the world by 2010 (European Commission 2004).

### *Cluster 2: development and security*

- *Democracy and human rights.* The number of democratic states rose from 57 in 1985 to more than 120 in 2000 (Freedom House 2005, p. 5; UNDP 2002, p. 15). While there is still a long, unfinished agenda, recent decades have seen unprecedented advances in human rights. Nearly half the countries in the world had ratified all major international human rights instruments by 2000, up from 10 percent in 1990, laying the basis for national policy change (UNDP 2000, p. 3).
- *Poverty reduction.* More than 50 of the poorest countries have prepared Poverty Reduction Strategy Papers (PRSPs), reconfirming their commitment to poverty reduction (World Bank 2005b). In return, the international donor community has promised to increase official development assistance and has stepped up measures to promote policy coherence for development (OECD/DAC 2005).
- *Social security.* Social security reform is among the most hotly debated policy issues in many countries, industrial and developing alike (Blanchard 2004; de Ferranti and others 2000; Kapstein and Milanovic 2002; Södersten 2004). As of 2003 some 24 countries around the world had already incorporated private pillars to complement (or in some cases partially replace) their public pension schemes (Palacios 2003, p. 4). For many developing countries the main issue is introducing a system of protection and insurance or expanding a rudimentary one. For all countries a basic contested issue is the balance between a social, collective system and reliance on private responsibility, initiative, and choice, in line with cluster 1 expectations for enhanced competition between markets and states.
- *Economic risk management.* The search for a better public-private mix also marks national policy discussions on aggregate risk management. Many countries have built up sizable savings and stabilization funds to protect against external economic shocks (Fasano 2000; Davis and others 2001). Other countries

are increasingly using futures and options markets to hedge against commodity price risks and exchange rate volatility (Institute for Financial Markets 2005; Morgan in this volume).

- *National security.* The terrorist attacks of September 11, 2001, raised new concerns about how to combine openness and national security. Many countries responded with increased public spending for international terrorism control (Bandura 2005a; Sandler in this volume). By 2002 some 70 countries had raised or imposed new airport taxes ([www.traveltax.msu.edu](http://www.traveltax.msu.edu)), and many proposed even higher levies. Alarmed by the number of catastrophic events in recent years, some states are encouraging markets for such new products as terrorism insurance or catastrophe bonds (Michel-Kerjan and Kunreuther 2004).

- *Management of cross-border externalities.* Countries have instituted national-level measures to curb transborder environmental pollution (Merlen 2005; Ocampo and Martin 2003; UNDP, UNEP, World Bank, and World Resources Institute 2003; World Watch Institute various years), along with market-based policy approaches (IETA 2003; Stavins 2003). For instance, in January 2005 the EU Greenhouse Gas Emission Trading Scheme commenced operations as the largest multicountry, multisector greenhouse gas emission trading scheme in the world. There is also evidence that spending on global communicable disease control has increased in many countries (UNAIDS 2003; U.S. GAO 2004).

*Source:* Kaul 2006 (pp. 88-9)

## Box 2: Macro Securities

Macro securities are issued in pairs—an “up macro” whose price moves up when a country’s GDP index moves up, and a “down macro” whose price moves down when the index moves up. Each member of a pair has a cash account that is adjusted according to the index by reallocating across accounts. Each macro security pays dividends equal to interest on its cash account.

Suppose a pair of securities is issued for \$200 when the index is 100. The accounts of the up and down macros are each credited with \$100. If the index rises to 102, the custodian of the cash accounts takes \$2 from the down macro, reducing the account to \$98, and puts them in the up macro account, so that the balance in that account again equals the index at \$102. Thereafter, dividends on the down macro security will be lower, and the holder of the up security will be rewarded through subsequent dividends by the rise in the index. Because investors can anticipate these higher dividends now that the account balance is higher, investors should bid up the price of the long security (the one betting on an increase in the index) immediately, even before any of the new higher dividends are paid. Responding quickly to new information, the price of the security will likely be rather volatile, just as prices are in the stock market.

Since dividends are tied to the index value, the up macro is really a claim on the flow of index values extending into the indefinite future and therefore resembles a stock, which is a claim on corporate earnings extending into the indefinite future. The price of the up macro should in equilibrium reflect market valuation of a claim on the cash flow represented by the index. The price of the down macro security will move opposite that of the up macro, since the value of the two together sums to the value in the combined accounts, in this case \$200.

People who want to invest in the index can buy the up macro security, while those who want to protect themselves at a preexisting risk related to the index can buy the down macro security.

*Source:* Shiller 2006 (p. 162)