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Keynote Speech: Financial Market Liberalization

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It is a pleasure to be in Paris any time, and in particular a pleasure to be participating in this conference on globalization. The title of the conference – “Managing Globalisation” – expresses well the fact that we have to live with globalization: it is part of the environment, and the question is how best to live with and try to mold globalization rather than whether to approve of it or not.

I will talk today about financial globalization, about the opening of the capital account and the increasing global integration of the financial markets. I will first sketch the background for our discussion, then discuss the process of integration into the global capital markets especially from the viewpoint of emerging-market and developing countries, and finally comment on two possible risks in the current international financial system.

I. Background

We are living in the second great era of financial globalization. The first era of globalization ended in 1914. By every measure of financial sector globalization,¹ international capital markets were more open in 1914 than they were at any time up to the 1970s.

That first great era of financial globalization started with the invention of the telegraph. If you look at when it was that rates of return in different financial markets began to move together, it was when the telegraph was invented and thereafter within minutes, interest rates and prices in different financial centers were essentially tightly linked. Now in the twenty first century we have cut the minutes down to micro seconds, but the critical change took place 150 years ago.

We are living, in this second age of financial globalization, in a world of far greater financial sophistication than ever before. I mean by that particularly the explosion of financial instruments based on derivatives – on the Black-Scholes derivatives pricing formula and developments from it, and on the insights of Modigliani and Miller as to how to think of the value of a firm. And of course we are also living in an age of far wider and greater access to information, far greater flows of information and more rapid communications and transportation. This acceleration and widening potentially adds to the efficiency of the system, but also leads many to fear that the system is more vulnerable to accidents than it ever was before.

¹ See Maurice Obstfeld and Alan Taylor (2004), *Capital Markets: Integration, Crisis, and Growth*. Cambridge: Cambridge University Press.

Among the industrialized countries, financial sector liberalization is seen as a desirable goal, although the legacy of controls from the 1930s and from World War II took a very long time to disappear. As you know in France, it took until the late 1980s to finally get rid of capital controls, and even in the UK capital controls were finally abandoned only in the early 80s.

Why did it take so long? In part because of the inertia that comes from having lived for a long time in a particular environment – with controls – and thinking that any change in the system would be destabilizing. The OECD played a major role in promoting capital account liberalization among the industrialized countries, and it was understood within the European common market and later the EU that capital mobility was essential to economic integration. It is interesting that this point was grasped early – partly under German influence – among a group of countries that were in other regards quite dirigiste. It was good from the view point of the development of the capital markets and indeed of the industrialized countries that this view prevailed.

There has been a more questioning attitude to capital account liberalization among emerging-market and developing countries. These countries too had emerged from World War II with extensive controls. In addition, most economists were not used to analyzing financial markets. The fundamental economic case for free capital movements is the same as the case for free trade, and you can even use the same diagrams to show that. But there are leading trade theorists who think capital mobility is different, and that there is something about trade in financial instruments that is different than trade in goods. This may due to the failure to recognize that while regulation is almost certainly more necessary in financial markets than in goods markets, the need is not for regulation of international capital flows, it is for regulation of financial markets, domestic and/or foreign – and that distinction may not have been drawn sufficiently.

II. The Capital Account Crises of the 1990s

Despite the underlying concerns about the potential dangers of international capital flows, a growing momentum developed during the middle 1990s to promote capital flow liberalization. Shortly before the Asian crisis, the G7, following an initiative by the British, introduced a proposal to amend the articles of the IMF to make the promotion of capital account liberalization one of the goals of the IMF. As you know the charter of the IMF makes the promotion of free trade in goods and services a goal of the Fund. But with regard to capital movements, the Articles of Agreement state that the Fund may require a country to impose capital controls (to prevent or mitigate a balance of payments crisis) but do not suggest the Fund should support liberalization of the capital account.

As the capital account amendment initiative gathered strength, Managing Director Camdessus and I emphasized that what we were supporting was not immediate liberalization of the capital account, but rather orderly capital account liberalization. However, while we were busy emphasizing orderly capital account liberalization, the Asian crisis intervened, and the crisis countries, and others, blamed the crises on aberrant and excessively powerful capital flows – and particularly on hedge funds.

Soon there was no capital account amendment of the IMF Articles of Agreement. And driven by similar fears, the proposal in the OECD for an agreement on foreign direct

investment, for a code on foreign direct investment, fell by the wayside around the same time.

With an extra ten years of perspective, how should we evaluate the capital account crises of the 1990s? First, and critically, almost every crisis of the 1990s involved a de facto or de jure pegged exchange rate: that applies to every emerging market crisis of the period except that in Brazil in 2002. Fixing the exchange rate or protecting an exchange rate, provides an invitation to the private sector to bet against the authorities if the capital account is open: in short, the impossible trinity.

I believe that the move to flexible exchange rates has made more of a difference to the international financial system than any other change. That change takes away a major risk factor. By flexible exchange rates I do not mean *only* freely floating rates, exchange rate systems in which the central bank does not intervene; what I mean is a system in which, if the pressure rises, the country can allow the exchange rate to adjust without changing the entire basis of economic policy. So managed floating comes within this definition of a flexible exchange rate – provided that the currency is indeed allowed to be flexible.

The move to flexible rates does not altogether rule out foreign exchange crises. There has just been a foreign exchange crisis in Iceland, which despite Iceland being a very small economy, produced ripples in many other countries. Although Iceland has a floating exchange rate, the markets believed that the current account deficit was excessive, and when that became the predominant view, the exchange rate moved very rapidly. Similarly the Brazilian crisis in 2002 took place in a floating exchange rate system; it was caused by the fear that Brazil might not service its debt if Lula were elected president.

However, it is noteworthy that the economy in both these crises did not collapse in the sense that economies collapsed in the crises of the 1990s. In each case, the economy suffered a major and unpleasant shock, but the system did not suffer the stresses that the crisis economies of the 1990s and early 2000s did.

Beyond pegged exchange rates, inappropriate macro policies were a significant factor in almost every one of the crises. So was the lack of transparency. The more I reflect, particularly from my current position in the central bank, on the role of transparency, the more I would like to emphasize not only the aspect emphasized in the 1990s – that transparency is important so that the markets know what is happening – but also equally the aspect that policy makers cannot do certain things when they have to publish the information.

Consider the Thai example. By the time Thailand devalued in mid-1997, it had essentially run out of reserves and had forward commitments to pay out foreign exchange in very large amounts relative to the scale of the economy. That simply could not have happened if the markets had known the facts.

In addition, in both Korea and Thailand, the liberalization of the capital account opened the economy to short-term rather than long-term capital inflows first. We will shortly discuss the appropriate sequencing of current account liberalization.

During the emerging market financial crises many predicted that the affected countries and perhaps others would close their capital accounts. One of the most impressive aspects of the aftermath of the crises is that there was very little change in the openness of the capital accounts. Almost no country withdrew from the international financial system. There were of course changes in Malaysia, which pegged the exchange rate and imposed restrictions on some short-term flows, and restrictions on short-term flows were imposed also in other countries. But no country tried to cut off its capital account interactions to a drastic extent.

That is, countries that went through a very difficult experience, not one that citizens, or governments, or central bankers, would like to suffer through again, reflected on it, and concluded that despite the crises, they would be better off staying in the international capital markets. During one of the crises of the 1990s, I asked a finance minister of a crisis country whether he and his colleagues had contemplated imposing capital controls. The answer was that they had, but that they had concluded against. He said, "We worked with capital controls in the 1980s, and we are not going to try to do that again; it is a bad system, which does not in the end succeed."

Now let me return to the question of why capital account liberalization is desirable. There is a very simple text book story about the intertemporal allocation of resources, which says that some countries want to save more, some countries have better investment opportunities, and capital needs to flow between them so that those who have a relative desire for saving can save more, and the capital gets allocated to where its rate of return is highest. This is the basic story, though no-one expected that the intertemporal allocation would end up with most of the capital inflows going to the richest of the major countries, namely the United States.

A second reason is that financial sector liberalization is a way of increasing financial sector competition and improving the quality of the financial system by allowing foreign competition. This is something I see daily: the Israeli economy benefits both by allowing our financial firms to compete internationally and by allowing foreign firms to supply services to Israeli companies. The foreign companies have a better technology or had a better technology. They know how to do things - financial sector engineering - that the locals do not, and if you allow that competition, your companies benefit.

There is a third reason that financial sector liberalization is a good thing: it changes the outlook of domestic companies, and leads them to think globally. I will expand on this point in a while, drawing on Israeli experience.

III. How to Liberalize

A country that wants to integrate into the capital markets needs to ensure that its macroeconomic framework is sufficiently strong and that the domestic financial system is sufficiently strong to deal with the possible strains that liberalization might create. The first element in the macroeconomic framework is the fiscal situation, which needs to be sustainable, and preferably robust – not least because it is not desirable that the financial system should be dominated by the financing of the government, which has been the situation in the past in many countries.

On the monetary policy side, the exchange rate regime is a key issue. It is theoretically possible to run an open capital account and have a pegged exchange rate but in that case, the impossible trinity raises its head: a country cannot have an open capital account, a pegged exchange rate and a monetary policy that is dedicated to domestic policy goals. In those cases, the monetary policy can only be dedicated to maintaining the exchange rate peg. So it is theoretically possible to operate an open capital account with a pegged exchange rate, and many countries have done that at times, but I believe that experience suggests that if the capital account is open, it is better to operate with a flexible exchange rate. The domestic and foreign shocks that impact an economy are easier to deal with if the exchange rate can absorb part of the strain, rather than imposing all the adjustment on domestic wages and prices.

If the exchange rate is flexible, then the goals of monetary policy need to be defined. Increasingly countries are adopting a system of flexible inflation targeting, in which the government defines a target range for inflation, and the central bank's job is to hold the rate within that range. But the goal needs to be interpreted flexibly, which is to say that if the economy is hit by shocks, the inflation rate may for a time be permitted to stay outside the target range while the central bank tries to bring it back gradually to within the range.

In my new position, I sometimes reflect on what it is that we have got from inflation targeting. The conclusion is that the big achievement is to tie down long-term inflation expectations. The expected 10-year inflation rate in Israel, which has an inflationary history of which we are not proud, is 2.3%, very close to the centre of our band. Once you have stabilized long-term inflation expectations, nominal wages are not going to go crazy, price-setters are not going to go crazy, nominal interest rates are not going to go crazy. And that makes an enormous difference to the overall stability of the system.

Beyond the macroeconomic framework, it is necessary to create a reasonably stable banking and financial system and that takes a lot of work. And beyond that, a country needs to liberalize gradually, not all at once.

In terms of the type of capital flow, the principles of liberalization are:

- To liberalize inflows before or simultaneously with outflows;
- To liberalize long-term capital flows before short-term flows;
- To liberalize foreign direct investment before portfolio investment.

In terms of which sectors to liberalize: first, the business sector; second, individuals; and third, the financial sector.

This is simply a set of principles, but it is not based on deep theory. Rather it is based on what seems to have worked.

Israel went through two liberalizations, which are consistent with the lessons stated above. In 1977, after 30 years, the founding Labor Party lost the elections and a new party came to power. The finance minister was a liberal in the European sense – someone who believed in markets, particularly in liberalizing the capital account and getting rid of capital

controls. At that time the macroeconomic situation was a mess, inflation was high, the financial system was dominated by the banks, and none of the preconditions specified above for a successful liberalization were in place. Nonetheless the government went ahead and liberalized the capital account soon after coming to power. Within a very short period, the inflation rate had jumped, the economic situation had deteriorated, and soon thereafter the capital account was closed.

That was a liberalization whose failure taught the lessons that we have learned since then about how not to liberalize the capital account. You should not liberalize with a poor macroeconomic situation, nor with a weak financial system, nor very rapidly.

The second Israeli capital account liberalization came in the 1990s, following the stabilization of the economy in 1985. The second liberalization was very gradual, taking about a decade, and that followed essentially the principles laid out above. By 2003, all capital controls had been removed. This, combined with a move to a flexible exchange rate and an inflation targeting monetary policy, was a very successful liberalization – one in which there are now no capital controls, and nor is there any central bank intervention in the foreign exchange markets. Indeed, there has been no central bank intervention since 1997, but nonetheless we have a very stable exchange rate.

Let me add two points. One is that it is important to liberalize outflows as well as inflows. As a result of the liberalization of the capital account and the rapid growth of the economy, and the very successful high tech sector in Israel, we have large capital inflows – about 9% of GDP last year, about half of that foreign direct investment, the remainder portfolio investment. If we were not permitting outflows, there would be great pressure on the exchange rate, because we are also running a current account surplus.

But Israel also liberalized capital outflows. In 2005 outflows amounted to about 9% of GDP, roughly equal to the inflows. At the start of this process, the pension funds, the mutual funds, and Israeli households' investments were entirely domestic. That is not natural in a small economy, it is not even natural in a big economy, not to be diversified internationally. As a result of the liberalization of outflows, we basically do not have net pressure on the exchange rate from capital flows. Because outflows were liberalized, we do not have to deal with the results of the Dutch disease that would otherwise have followed from the pressure of the capital inflows. Our calculation at present is that about 6% of Israeli household assets are held abroad. We believe that process has got considerably further to go, so we expect that the outflows will continue roughly to match the inflows without creating pressures for appreciation.²

The second point I would like to make is one that I had not appreciated until recently. I had not appreciated that when you liberalize the capital account, especially in a small economy, you change the philosophy of almost everyone in the economy. Before the liberalization, people thought locally. By regional standards, we have a reasonably large economy, with a GDP of about 125 billion dollars. By global standards, this is a very small economy, whose GDP is about 1% of EU GDP, and about 1% of US GDP. As soon as the capital accounts opened, business began to think globally – businesses looking for investors began to think globally, their marketing became more actively global, and

² It might be asked whether inflows and outflows do not have to match precisely if the central bank is not intervening. The answer is no, because short-term flows are not included in the above totals.

domestic savers began to think globally. This change transformed the approach of business in what, to my mind, is a wholly positive direction.

In brief, as a result of a successful liberalization, people begin to understand that the world is their stage and not just the local economy.

IV. Current International Financial Concerns

Let me turn now to address briefly two other issues of current concern: the potential dangers associated with the proliferation of derivative instruments; and global imbalances.

The proliferation and profusion of financial instruments naturally gives rise to concerns about potential risks to the international financial system. The nominal (face) value of derivative instruments amounts to multiples of global GDP. Based on this massive number, it is easy to tell stories about how a financial crisis can occur, as a chain of interlocking derivative contracts unravels due to a failure to settle one contract, which is hedging another contract, which in turn is a hedge to something else. Pretty soon, as in stories in which the payments system grinds to a halt due to a relatively small payments failure, a small event can be made to have frightening consequences. This appears to be consistent with examples from chaos theory in which a butterfly flapping its wings somewhere in Africa can create a typhoon in China.

At the same time, the proliferation of derivative instruments has made it possible to separate risks from their original context, and to shift them to those most willing to bear them. It is for this reason that many regard the development of financial instruments as making the financial system more robust and more efficient. By contrast, Warren Buffett is on record as saying that derivatives are instruments of financial mass destruction. Of course, both those views could be true at different times.

How should we think about the risks? Scenarios involving the unraveling of a chain of derivative transactions are more frightening than realistic, because there are netting arrangements among most institutions, which mean it should generally be possible to offset obligations that have not been settled.

The other concern is that the risks that are passed on through derivative contracts may be inappropriately placed and not adequately recognized. For instance, when banks securitize or hedge a risk, the risk migrates to other places, frequently it is believed to insurance companies. The concern is that the risks move from people who understand them to those who do not. There is another possibility, which is that the risks may be moving from places which are forced to mark to market, to places which are not forced to mark to market – because many participants in financial markets prefer to retain the capacity to smooth their revenues and profits.

Those risks are out there, and we cannot ignore them, but we should also consider that we have been living in the world of derivative instruments for some time, and that we do have experience with them. When the various crises broke out in Asia, we in the IMF would talk to investors and explain the debt situation of the affected country, and the investors would say, “Does that include the value of derivatives?” And we would say “No, those are the debt instruments.” “Ah well, you do not have any understanding of the magnitude of the

problem; when they come to settle the derivatives, you will understand that the problem is five times what you think.” It did not happen. That is one bit of experience.

Another piece of evidence comes from the one major international financial crisis which was a derivatives crisis – LTCM in 1998. What is interesting about the LTCM crisis is that if Walter Bagehot were writing about it, he would not have to change his basic story very much. Something happened in the financial system – people could not meet obligations – and a central banker got the relevant parties together in a room and told them they had to solve the problem. Somehow they solved it. Three months later, it turned out that none of the companies forced into the deal had lost money, in fact they made money. And the major risk to the financial system had passed – but not without decisive action by the Fed, and not without damage to some emerging market countries.

In the LTCM crisis there was massive leverage on a scale which turned out to be impossible to deal with in the very short run, and it took time to unwind the effects of the leverage. There are other highly leveraged institutions in the financial system – banks. We do not think very often of how leveraged banks are, but the whole basis of a bank is to use relatively little capital to generate a huge balance sheet. In many 19th century banking crises the banks were illiquid and not bankrupt.

So crises like the LTCM crisis have happened in the past, and may well happen in the future even if hedge funds are not involved. They do not necessarily pose a different scale of risk to the system than we have dealt with in the past. They will require the intervention of the lender of last resort, frequently not to lend money but to force a solution that is in the interests of everybody, on people whose individual interests at a particular moment of time seem to diverge from the overall interests of the system.

The second issue causing major concern at present is that of global imbalances. Many believe that the international financial system has permitted imbalances in the US current account that simply would not have been possible before, and that are bound to end badly. Here too it is easy to tell a dismaying story, in which people rush out of the dollar, US stock prices decline, US interest rates rise, the US economy slows or even goes into recession, and the global economy follows.

This is clearly possible. But there are many other possibilities including a decline in the dollar that may be relatively rapid but that does not have a massive impact on output because the system adjusts to it. This may sound unlikely, but we have had a similar adjustment that had almost no macro economic consequences between 2002 and 2005 when the value of the euro against the dollar changed by around 50%. That appreciation of the euro must have contributed to a slight slow-down of European growth. But there were no financial crises associated with the appreciation of the euro, no major institutions collapsed, and economies adjusted.

Now, of course, if an economy adjusts without a collapse, it adjusts more slowly. It may well be that the US current account will take longer to change than we think. Further the adjustment need not be from a current account deficit of over six percent of GDP to zero, rather the adjustment could be to a sustainable level around 2.5-3 percent of GDP. Indeed the current account of the US has already taken longer to change than we thought it would. The dollar very likely will depreciate, but it is not going to happen steadily, rather it will take the form of movements around a trend that is hard to discern from day to day and

month to month. As my former Citigroup colleague Bob Rubin says, “Markets go up and markets go down”, and that will apply too to the dollar.

If I can put this issue in slightly different words, we are frequently told that we should realize that we are like the famous story of people falling out of a high building and being asked by somebody as they go by, “How are you doing?” and they say “Fine so far”! There is another possibility: that we are living in a new world with much deeper financial systems, much more sophisticated financial instruments, much better information flows, that is more resilient than the world we lived in and that we do not yet understand – that is, the issue may not be how far we have got to fall till the inevitable collapse occurs, but rather that we do not yet understand the ground on which we are standing today.

We cannot know for sure in which of these situations we find ourselves, but the situation may not be as drastic as many believe. In any case, the role of economists is to keep pushing for policy changes that will resolve this situation favorably, and we all know what those policies are. And I am very happy to see that the IMF is now taking a lead in promoting action to implement those policies.

V. Concluding Comment

The title of this conference is “Balancing Globalisation”. That is a good title. An even better one might have been “Benefiting from Globalisation”.

Thank you very much!