Preface

After a period of gradual internationalisation of the goods markets since World War II, we have witnessed a fast internationalisation of the financial markets in the last decade. Some people might say that this process of globalisation is nearing its end. In fact, it is far from being completed. John McCallum showed that Canadian inter-provincial trade exceeds 19 times the intensity of trade with neighbouring US provinces.[1] John Helliwell made a comparison of intra-national and international financial markets based on the Horioka-Feldstein hypothesis.[2] It showed that for provinces within Canada investment and saving is uncorrelated, in sharp contrast to the high correlation that exists between these aggregates within a country, as Feldstein and Horioka have found.[3]

What does all this really mean? That the Canadian provinces are de facto integrated into a single goods market and a single financial market, but that the world economy is still far away from such integration. Borders do matter, even between countries of such similar cultural heritage as the United States and Canada, and we are still a long-long way from having a global market, either for goods or for capital. Therefore, the questions addressed in this book are not simply how to adjust to the integration of markets that has emerged in the past ten years, but how to adjust to the greater integration yet to come. While it is true that globalisation has reached unprecedented dimensions, we cannot say that we live in a global economy as long as 94% of US portfolios and 98% of Japanese portfolios are still invested at home. We have only started the globalisation process. What this book discusses is not so much the past, but the future.

Ever since Adam Smith and David Ricardo there has been a consensus on the benefits of free trade in principle, but also a perpetual controversy about the constraints in its implementation. The reason is straightforward: implementation means restructuring and that implies temporary costs; it has losers and hurts vested interests. The benefits of free capital move-

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1 McCallum, John (1995), "National Borders Matter: Canada-US Regional Trade Patterns", In: *American Economic Review*, pp. 15-23.

2 Helliwell, John F. (1998), *Comparing Capital Mobility across Provincial and National Borders*, NBER Working Paper No 6624.

3 Feldstein, M. and C. Horioka (1980), "Domestic Saving and International Capital Flows", In: *The Economic Journal*, pp. 314-29.

ments are generally recognised, although the idea of risk pooling (or risk diversification) is probably a more subtle notion than that of comparative advantage in the goods markets, and the gains achieved by capital markets integration are more difficult to measure. During the implementation of capital market integration, we probably have to face more difficult challenges, but especially challenges of a different kind.

One challenge arises from the problem of restructuring costs. The issue is analogous to that in the goods market: financial liberalisation faces problems similar to those of outdated coal and steel industries that the liberalisation of the goods market has to cope with. What are the coal industries of financial markets? Projects or industries that survive only at preferential interest rates or misaligned exchange rates implicitly or explicitly guaranteed by governments, or imprudently managed and supervised banks that have disregarded the fact that they have become exposed to international market risks.

Does financial liberalisation bring about losses? In the short run, certainly. The higher is the shelter, the higher are the costs of restructuring. Hiding or covering weaknesses in the financial system may lead to crises and costs. Transparency and prudence of the financial sector, backed by stable macroeconomic environment, are the conditions for a smooth liberalisation process. This conclusion does not essentially differ from the lessons learned in the goods market: do not let develop non-viable economic projects or structures.

Another set of challenges is more specific to the financial markets and calls for more sophisticated solutions. Tobin's suggestion to pour sand into the wheels of the financial market does not mean that he did not understand the idea of comparative advantage, even in its more sophisticated form that applies to financial services. What he meant was that trade in financial assets is a very information-intensive activity with very small physical transaction costs. This raises behavioural problems, e.g. herd-behaviour, that are definitely new compared with the goods market. Coping with these problems calls for regulations and institutions which are specific to financial markets and which we are still learning how to design and operate. This is one of the issues that this book discusses.

Policymakers have many choices how to enforce prudence and enhance transparency of the banking sector and the availability of information for investors. However, one policy choice could be excluded beforehand: that of keeping national markets separate in the long run. In the goods market this policy was feasible in certain periods, but today – in the new world of information and communication technology – financial markets are much too elusive to be reined in by such restrictive policies. We are going to live in a global world and have to find the way of doing our best in such a world. We cannot go back to the past, but we have to try to understand it as much as possible in order to improve the functioning of the markets in the new globalised world.

György Surányi

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