Comment on “Globalisation of Financial Markets,” by Stephany Griffith-Jones

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In this well written and comprehensive paper, Dr. Griffith-Jones provides a timely discussion of a range of supervisory and regulatory issues affecting international financial markets. Specifically, the paper (i) reviews recent trends in international capital market flows; (ii) analyses structural changes in markets, with emphasis on deregulation and financial innovation; (iii) assesses their impact on the magnitude and nature of systemic risk; and, (iv) evaluates supervisory and regulatory issues.

The paper’s broad coverage poses a difficult challenge for discussants – which aspects to cover in the limited time available. The approach that I would propose to adopt focuses on selected aspects of the analysis. Thus following a brief summary of the main points of the paper and some general comments, I intend to provide some thoughts aimed at deepening the analysis of developing country issues. This reflects three factors. First, while the paper recognises their importance, it devotes relatively less attention to them. Second, there are important linkages to the other topics that are being discussed in this conference (including ways to improve developing country access to international liquidity and, more generally, the financing of development). Third, I am able to draw on work undertaken in the IMF in the context of (i) policy discussions with member countries; (ii) regular analysis of issues in the areas of surveillance, international capital markets, and private market financing for developing countries; and (iii) special studies including on such issues as recent surges of capital flows to developing countries.

Main findings

The paper’s main findings may be classified into three groups; quantitative aspects, structural changes, and policy recommendations.

In its quantitative assessment of recent developments, the paper points to the large increase in borrowing on international capital markets in 1991-92 led by securities issues (in absolute terms) and non-underwritten facilities

1 The views expressed are those of the author and do not necessarily reflect those of the International Monetary Fund.

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(with the highest growth rate). It notes that the developing country share in total borrowing has risen compared with the 1980s but that flows remain concentrated in a few countries. Finally, based on measures of the current weight of developing country exposure in the portfolios of institutional investors in industrial countries, it suggests that there is considerable scope for growth in flows to developing countries.

Underlying these quantitative aspects is a process characterised, inter alia by: greater globalisation and integration of financial markets; an erosion of functional boundaries, as reflected in increasingly complex institutions and a broader range of instruments; and greater institutionalisation of savings. The paper argues that this process has been associated with an increase in systemic risk which has not been fully matched by strengthening of the regulatory and supervisory regime. Accordingly, the paper conjectures greater financial instability and fragility as reflected in "very large fluctuations in asset prices and/or distress among financial institutions". Moreover, it notes that developing country markets have shown far greater volatility than those in industrial countries and argues that the new capital flows provide an additional source of potential macroeconomic instability.

The paper's policy recommendations include enhanced regulatory and supervisory coverage of financial conglomerates; greater harmonisation of accounting and disclosure standards; improved organisation of settlement systems for securities; establishing a level playing field between securities and banking entities; and strengthening the institutional structure at the international level.

Some general comments

The paper provides a useful overview of regulatory and supervisory issues as they affect financial markets. However, the analysis does leave the reader with several unfinished items. Five may be mentioned at this stage with a view to identifying areas where further research is warranted under the general theme and direction of this conference and FONDAD's activities in general.

First, to what extent can linkages be drawn between the analysis of the different sections of the paper – particularly between the structural aspects covered in Section III and the policy discussion of Section IV. Among the factors that would be worth addressing more explicitly is the design of policy responses which provide for the efficiency gains associated with structural changes while avoiding "over-regulation" that unduly increases transactions' costs of financial operations.

Second, the paper's discussion of systemic risk could be usefully expanded to go beyond a simple identification of the potential sources of such risk. Thus, and following up on a point made by Professor Kenen

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during the morning session, there is a need for greater differentiation between the impact of (i) deregulation, (ii) inadequate macroeconomic policy harmonisation, and (iii) market failures. [2]

Third, the bulk of the policy recommendations put forward in the paper cover areas where international deliberations are, in fact, already on-going in various fora (Basle Committee, IOSCO, EC, etc.). Perhaps something more could have been said in the paper about the approach being taken in these deliberations and the scope for progress – particularly in harmonising the implementation of a comprehensive regulatory and supervisory framework which promotes efficiency gains while minimising the opportunities for disruptive arbitrage among national jurisdictions.

Fourth, I would suggest that there is a need for the paper to be more explicit as to what are the objectives of strengthening the regulatory and supervisory regime. There are hints in some parts of the paper that an objective is to sustain individual firms. I would argue that the aim is to preserve the integrity of the financial system, which may be best safeguarded in some circumstances by allowing individual firms to fail. Indeed, the "too big to fail" doctrine must be weighed carefully against concerns for avoiding moral hazard and sustaining market discipline. [3]

Finally, in discussing the prospects for effective multilateral harmonisation of regulation and supervision, it is important to recognise the need to go beyond the technical elements. At the heart of an effective system is a willingness for national authorities to yield a degree of sovereignty.[4] This can take the form of either going from discretion to rule-based systems, or transferring policy making to an international level. Here, and in addition to socio-political factors, we are immediately confronted with a range of enforcement problems.

I believe that these are important issues that need to be explored in greater depth in order to address this session's central question – i.e. "How can monetary authorities improve their supervision" with a view to encouraging efficient international mobilisation and allocation of financial resources.

2 A related discussion of these issues may be found in Goldstein, M. et al. "International Capital Markets", Part I, IMF, 1993.

3 See, for example, the discussion of key issues in official safety nets contained in Leipold, A. et al. "International Capital Markets – Development and Prospects", IMF, 1991.

4 For a discussion of related issues see Guitian, M., "Rules and Discretion in International Economic Policy", Occasional Paper No. 97, IMF, 1992.

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Developing country issues

Having provided some general thoughts on the paper, allow me to comment more specifically on developing country issues. In this context, there is a strong need for a systemic analysis of the regulatory adaptations required if developing countries are to be effective participants in, and benefit in a sustained manner from, the process of globalisation and integration of financial markets. Such an analysis would cover two groups of issues: (i) adaptations in developing countries, including aspects of financial sector reform, strengthening of prudential regulations in line with international standards, improved accounting and disclosure mechanisms, better circuit breakers, etc.; and (ii) adaptations in industrial countries including actions to remove possible impediments to market access by developing countries and specific regulatory issues (capital adequacy risk weights, bond risk rating cut-offs, provisioning baskets, etc.) [5]

It is also important to gain a comprehensive understanding of the nature of different flows to developing countries in order to assess their actual and potential micro- and macroeconomic effects and to craft the appropriate policy response. Generalisations of the type included in the paper, while tempting, may be misleading when applied to specific cases. Let me illustrate by referring to the surge in capital inflows that has been experienced by some developing countries in Latin America, Asia, and the Middle East.[6] An understanding of the factors behind the surge is critical to the design of policy responses which seek to balance the accommodation of potentially higher investment and growth afforded by the inflows with the containment of their potential destabilising effects. Theoretical and case study work in this area undertaken at the Fund has pointed to the importance of (i) "push factors" associated with the stance of policies in industrial countries (particularly monetary policy) and "bandwagon effects" in financial markets; and (ii) "pull factors" ranging from improvements in country productivity and competitiveness (and therefore expected return to investments) to a macroeconomic policy mix placing a relative importance of such factors (admittedly difficult to determine in practice), as well as the composition of flows, influences judgement about the sustainability and impact of the capital inflows and, accordingly, the balance in policy response between improving

5 See, for example, Collyns C. et al., "Private Market Financing for Developing Countries", IMF, 1992.

6 A more detailed discussion may be found in Calvo, G.A. et al., "Capital Inflows and Real Exchange Rate Appreciation in Latin America: The Role of External factors", IMF Staff papers, 1993; and, Schadler S. et al., "Recent experiences with Surges in Capital Inflows", mimeo, IMF 1993.

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the absorptive capacity of the economy and containing the disruptive elements.

My final comment on developing country issues relates to the proposition in the paper that the potential for macroeconomic instability has increased in developing countries as a result of international financial market integration. It must be recognised that emerging markets in their initial stages are likely to be volatile and that the broadening of the investment base could reduce this volatility over time. More importantly, it seems to me that there is greater ambiguity here than the one-to-one mapping between financial integration and macroeconomic instability that is suggested in the paper. Financial market integration increases the channels for savings – both domestic and foreign – to be channelled into productive investment in developing countries. It also facilitates the operation of price signals in lieu of what has repeatedly proved to be disruptive market clearing through quantitative rationing. Indeed, and as illustrated by developments in some Latin American markets in the past year or so, there is now greater scope for price changes to signal the need for policy adjustments in the face of emerging problems before the situation evolves to the point of a cutting off of market access. These factors can in fact serve to reduce macroeconomic instability (including through credibility, signalling, and early market discipline mechanisms) in the context of the sustained implementation of sound economic and financial policies.

Concluding remarks

In conclusion, allow me to than Dr. Griffith-Jones for providing us with a comprehensive coverage of regulatory and supervisory issues in international financial markets. The paper's analysis provides a good basis for discussion of aspects that affect the mobilisation and allocation of financial resources.

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