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

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The paper presented by Stephany Griffith-Jones covers a very broad set of issues, making it difficult to do the argument full justice in a short comment. I will therefore concentrate on two issues: (i) implications for regulation and supervision of the increased international integration of financial markets; (ii) implications for the LDCs.

Regulation and supervision in global financial markets

One of the main messages of the paper is that the emergence of global financial markets and the trends towards financial liberalisation and deregulation not only increased competition and reduced profit margins and economic rents – thereby increasing efficiency and, "all other things being constant", ensuring better terms for both borrowers and lenders – but also increased the risks for the stability of the financial system. These risks constitute a major challenge to the ability of regulators both at the national level and at the level of international coordination.

One message of the paper is that it is crucial "to achieve close coordination in the supervision of financial institutions". This is certainly a message that has to be taken seriously. Actually it seems that it is already being taken seriously at different international forums. But assuming that the current efforts to strengthen international cooperation in regulating and supervising banks prove successful, then one could perhaps avoid the conclusion in the paper that "financial liberalisation has proceeded too far or at least too fast". As stated in the paper, the efforts at the international level ought to seek to achieve, among other things, a levelling of the field of play in the regulation sphere through a general improvement of the standards of transparency and disclosure requirements, through the improvement of settlement systems' safety features, and through the consolidated supervision of financial conglomerates.

Let us consider for a moment the particular role of banks. Banks perform the important functions of delegated monitoring of investment opportunities and the transformation of non-liquid assets into liquid liabilities.

The function of delegated monitoring is crucial to the understanding of economies of scale and scope, which is in banking derived from the activities

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of information-gathering in the form of screening and monitoring. To an important extent, imperfections – that is, deviations from the perfect competition benchmark – in the functioning of financial markets derive from uncertainty and asymmetrical information. It is therefore crucial to provide sound incentives in order to deal adequately with moral hazard or adverse selection problems. One possibility would be to increase the use of price and cost signals to avoid excessive risk-taking. This approach could be used, for example, in the field of Deposit Insurance Schemes.

In other words, it seems to me that the conclusion should be that financial liberalisation increases the role for official supervision of financial institutions; not necessarily that we should tamper with market mechanisms. Therefore I would be extremely cautious about accepting Tobin's proposal for a tax on foreign exchange transactions, on the grounds that any transactions tax is a tax on the functioning of markets, and therefore will (probably) induce efficiency losses.

Implications of global financial markets for LDCs

The 1980s witnessed the emergence of a true global financial market. Nevertheless, the enormous increase in activity registered in the international financial markets was not directed to developing countries. Despite the rapid growth registered in the period 1987-1992, borrowing by developing countries in international capital markets was lower in 1992 than the levels attained in 1981. Of course, the trend during the 80s was marked by the so-called debt crisis. Further, as stressed in the paper, recent trends differ very much from country to country. It is extremely difficult to speak of developing countries as a bloc.

The importance of international financial flows as an engine for economic growth in LDCs is probably quite limited. According to an accounting exercise first presented by Robert Solow[1] the direct impact of a capital inflow of, say, 5 per cent of GDP (which is a relatively large figure) would yield a maximal 0.55 per cent growth in GDP.

One may also follow Krugman[2] and distinguish between:

- *capital flows involving long-term transfers of real resources*, the benefits from which include the allocation of savings to the best investment

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1 Robert Solow, "Technical Change and the Aggregate Production Function", In: Review of Economics and Statistics, 39, (1957), pp. 312-20. The same argument is made by Paul Krugman in "International Finance and Economic Development", In: Alberto Giovannini (ed), "Finance and Development: issues and experience", Cambridge University Press, 1993.

2 "Economic Integration in Europe: Some conceptual Issues", In: Tommaso Padoa-Schioppa, "Efficiency, Stability and Equity", Oxford University Press, 1987.

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opportunities available internationally, and the possibility of income smoothing in response to national economic shocks; and,

- *bilateral capital flows*, allowing for portfolio diversification, economies of scale and scope associated with financial intermediation and information networks, and for increased competition. Bilateral capital flows make it possible to have important effects on market efficiency in the absence of sizeable net resource transfers.

Therefore, openness to international financial flows should increase competition and efficiency in the domestic financial system, constituting an important element in the transition to a market-based resource allocation mechanism.

Despite the limited direct impact of capital flows involving a net transfer of resources, it is possible, as stated in the paper, that private financial flows reflect better growth prospects. In this sense, the recent trends in the financing of developing countries could be a consequence of policy reforms instituted in the second half of the 1980s and early 1990s, including greater openness to trade and fiscal consolidation. Private capital inflows into developing countries could be regarded as an important signal of sustained economic regime change, which could have a by no means negligible impact on growth prospects.

The paper seems to argue that greater openness to international capital flows increases the volatility of LDCs' capital markets. To my mind the impact is ambiguous. The volatility of asset prices in LDCs' markets reflect this narrowness. Therefore the broadening of participation and the deepening of the market that is associated with greater openness should help to stabilise the market. Nevertheless, as the paper points out, there are risks. But these risks would, in turn, improve the benefits from:

- adequate mechanisms for enforcing property rights and financial contracts;
- adequate regulatory, supervision and settlements systems;
- stable and consistent macroeconomic policies.

If this is the case, then greater openness to international financial markets would improve the likelihood of sound economic policies which are necessary conditions for sustainable growth.

The fact that international financial market integration decreases the room for autonomous economic policies and therefore limits the scope for discretion may prove to be a very important benefit. In this sense the absence of autonomy may be a blessing.

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