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Globalisation and Financial Markets

Introduction

I am delighted to have been invited to participate in this 34th Economics Conference of the Oesterreichische Nationalbank. Austria has an exceptional history of contributing to economic thought and that makes Vienna a very fitting venue for a conference on the opportunities and challenges of globalisation. In particular, I hope this conference will provide the opportunity to discuss how advances in corporate finance impact on the way economic, financial and structural policies are formulated and implemented in international financial markets. These advances emphasise the roles of incentives and control in financial decision-making, and they highlight the importance of each country's domestic legal system and institutions. Thus they build on the insights of the great Austrian economist Joseph Schumpeter in seeing the evolution of national institutions as a key element in the process of "creative destruction" that constitutes the central dynamic of economic growth and development.

In my comments this morning, I want to address the question: Do industrial countries' national institutions still matter in our globalised financial system? And if so, why?

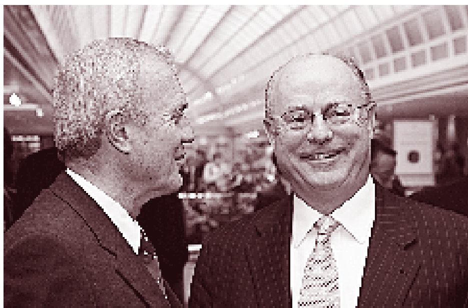
Only a few decades ago, long after Schumpeter undertook his great work, cross-border trade in financial instruments was still very effectively discouraged by the authorities of most countries. Back in the 1970s, only a handful of countries – particularly the United States and my own country, Canada – were exceptions to the prevailing world of tight controls on international capital flows. But since then many countries, motivated by the promise of benefits to be derived from open capital accounts, have markedly reduced barriers. We have come to refer to these liberalisations of international transactions in financial instruments, collectively, as "financial globalisation".

Over the same period, our general understanding of the role of financial mechanisms in both advanced and emerging market economies has also undergone a process of evolution. For example, we have come to appreciate the importance for the development of equity markets of the ways in which securities laws treat questions such as: what information needs to be made public, and who is liable if false information is provided, or meaningful information is not disclosed. Given the narrow financial border between my home country and the United States, I am very aware of the relevance of these issues as well. While it is often emphasised that globalisation has consequences for the terms offered to attract foreign capital, it is less frequently acknowledged that globalisation also affects incentives for residents of a country to continue to hold the preponderant portion of their financial assets at home. This has been another striking lesson that I have drawn, over the years, from the Canadian experience with financial globalisation.

The Globalisation of Finance

During the 1980s, capital account liberalisation came to be seen as an essential, and even inevitable, step on the path to economic development, analogous to the earlier reductions in barriers to international trade in goods and services. But the financial crises that erupted during the 1990s

in the Nordic countries, east Asia, Russia, and Latin America – which were often associated with periods of rapid liberalisation of the domestic financial system and the opening up of the capital account – prompted some commentators to go so far as to suggest that open capital markets could actually be detrimental to economic development. I think this assessment is simplistic. Instead, the episodes of instability that often occurred as capital accounts were liberalised during the 1990s warn us that we must consider the quality of a country's institutions and how they need to change in order to manage a complex transformation to free international financial transactions that ultimately can lead to major improvements in a country's economic efficiency. And the characteristics that seem to matter most are those related to the execution of enforceable contracts and those that ensure clear property rights and the integrity of the associated legal processes.



New Financial Products

The global financial system of today is vastly more accessible by companies and households than it was twenty years ago, or even a decade ago. The financial marketplace offers greatly enhanced risk management properties, particularly for credit risk pools. For example, over the past five years the trade in credit risk transfer instruments, such as credit default swaps and asset-backed securities, has made possible the sharing of credit risks among often geographically dispersed firms and households on a scale never witnessed before. Both the scope and scale of involvement of non-financial companies and households in cross-border financial transactions are unprecedented.

Important retail financial products are now produced and marketed globally in a manner that is closely analogous to the supply chain we are so familiar with for the production and distribution of goods like automobiles or personal computers. For example, mutual fund companies market equity funds to their global clients that feature not only stocks listed on the exchanges of advanced economies, but also equity portfolios in more than two dozen emerging market countries. Such mutual funds are frequently managed separately by specialist asset management companies. And much of the communication among firms at various points in this financial supply chain is conducted at arm's length, through sequences of market transactions.

As a result, the internationalisation of finance has heightened the need for close cooperation among those involved in supervision and those responsible for national financial infrastructures, as well as those who oversee critical elements of the global financial infrastructure. The global financial infrastructure, in turn, incorporates a number of specialized cross-border clearing and settlement mechanisms, such as the continuously linked settlement sys-

tem which is designed to eliminate credit risk in the settlement of large transactions in foreign exchange.

But, as Schumpeter would immediately recognise, financial globalisation is a work in progress: it is constantly evolving through the interaction of the financial markets, institutions and legal systems in individual countries with the analogous systems at the international level.

For example, even with "globalised markets" in their present state, most capital-poor countries seem only to be able to raise a small fraction of the financing for capital investment that they might be able to employ productively. By contrast, the residents of capital-rich countries, in the aggregate, continue to hold large proportions of their total financial assets as exposures to obligors resident in their own country. This persistently high degree of 'home bias' is rather surprising. One would, for example, expect it to elicit negative comment in a corporate risk management audit. For me, this challenge of global risk management comes into even sharper focus at the present juncture because of the fact that net international capital flows are going in the "wrong" direction – that is, net financial savings from "capital-poor" emerging market countries are currently flowing in large amounts to finance "capital-rich" advanced countries.

Good Financial Reporting and the "Basel Process"

How does one judge a corporation's financial performance in our globalised world? International initiatives such as the Basel Capital Accord and, in the accounting sphere, International Financial Reporting Standards, have drawn wide support in many countries because they carry the promise of improving markets' ability to distinguish strong financial performance from financial performance that is weak. This in turn underpins the proposition that choices among regulatory regimes matter because of the way they influence the character of private sector transactions in free and open markets.

The reworking of the Basel capital framework for ensuring the financial soundness of private sector banks operating in global markets is a case close to home – at least it is close to my home at the Bank for International Settlements (BIS) in Basel, Switzerland. Basel II is a package of cooperatively agreed and reasoned solutions to common issues in establishing norms and standards of bank soundness. Announced in June 2004, it was developed by experts on banking supervision and regulation from a number of countries, and the process was organised by the Basel Committee on Banking Supervision. One of the purposes of the extensive involvement of the BIS with the Basel Committee is to host its Secretariat and facilitate the exchange of views and information to the community of financial supervisors, standard setters, and policymakers.

The scale and breadth of the central banking and supervisory communities served by the BIS have both grown in recent years, with the addi-

tion of new BIS shareholding member central banks, and with the increased participation of financial sector supervisors, such as those allied with the International Association of Insurance Supervisors (IAIS) and the International Association of Deposit Insurers (IADI). Academics and practitioners participate in BIS activities as well. We are all elements of a "variable geometry" that has come to be referred to as the "Basel process". Over the last few years, the coherence of the efforts I have mentioned has been further enhanced by the

coordinating role played by the Financial Stability Forum, where finance ministries, central banks and financial supervisors from a number of countries, as well as key international financial institutions, are each represented at a high level.

Consequences of Globalisation for the Organisation of Finance

The relationship between institutional reform and economic development that I have just described is, of course, not novel. It is, indeed, fully consistent with Joseph Schumpeter's evolutionary view of economic growth and development. Thorstein Veblen, a North American social thinker in the early part of the 20th century, expressed the timelessness of the challenge we continue to face: *"Institutions are products of the past process, are adapted to past circumstances, and, are therefore never in full accord with the requirements of the present".*

Over the past ten years, we have come to understand better the primacy of legal and regulatory frameworks that ensure enforcement of contracts in fostering the complex process of financial development. Meanwhile, we have also come to question the extent to which the choice of financial contracts may reflect the character of underlying agency costs; namely, the costs incurred by an organisation because of the divergent objectives of various stakeholders. This has led us to an analysis of many aspects of financial globalisation that is, to a greater extent than before, rooted in the tradition of the old institutionalists. Attention is paid to the character of agents involved in a given financial activity, as well as to institutional structures themselves.

"Twin Agency" and the Role of National Institutions in Global Finance

Rene Stulz, a well-known professor of finance, has considered this issue in several recent interesting papers. Specifically, he lays out an analytical framework that is useful for explaining why a country's international border seems to matter for the location of various financial transactions and investments, even after the legal and institutional barriers to them have been dismantled. That this is the case can be attributed to the fact that corporate finance involves a "twin agency" problem. The problem arises in cases where there is a rational concern on the part of outside investors

in a company that a significant portion of the firm's return on capital could potentially be siphoned off by corporate insiders or by tax authorities. This work suggests that perceived weaknesses in the corporate governance mechanism or the legal framework in foreign countries serve to explain at least some of the incentives for wealth owners to continue to hold their assets in their home country. Thus, this approach provides an explanation for the role of a country's border as a barrier to international investment, even after capital controls have been removed.

Traditional analyses of the determinants of a country's international capital account transactions have largely overlooked these sorts of agency-based explanations of the composition of cross-border financial flows. Too often, commentators have instead focused on the so-called "hot money" character of portfolio capital flows into equity markets. This means that we have become conditioned to be more optimistic about the capacity of a country to finance its external position over time if it has attracted foreign direct investment (i.e. controlling equity), as opposed to portfolio purchases.

Let me be clear about my view on this. In many circumstances there are very strong rationales for direct foreign investment transactions. Such transactions provide mechanisms that relate to information transfers that could not take place with portfolio capital flows. To give just one example, many foreign direct investments accommodate transfers of information related to proprietary technologies. Such considerations can create powerful incentives for foreign direct investment, even in the presence of the sorts of agency problems that can act as strong disincentives for international flows of portfolio equity and debt.

But international portfolio equity holdings can also yield important side benefits to recipient countries. For example, the activities of foreign shareholders can help local economic agents to develop their skills in analysing the financial performance of companies and monitoring corporate management actions. Or a country might take action to increase the

confidence of minority shareholders, both at home and abroad, that they will receive the information they need to make informed investment decisions. As just one example, all shareholders can be given the right to receive information on transactions between an issuing firm and its largest shareholders.

In general, policymakers need to incorporate into their thinking the extent to which improvements in communication and information-processing technologies now drive financial markets. It is not a coincidence that the financial system has come to play a much greater role in resource allocation in both advanced countries and emerging market economies during the past fifteen years. In many countries, this has required an updat-

ing of financial sector rulebooks. The common motivation for such updates has been effective incentives to incorporate the opportunity cost of equity capital in decision processes. In other words, it is important to appreciate that market-based incentives are the common source of interest in the development of economic capital allocation frameworks by market-based economies.

I have no doubt that, in many instances, the decisions taken by central banks, financial supervisors and other financial sector participants have been informed by what has been learned through the Basel process. In the same vein, appreciation of the growing impetus for international financial firms to be managed on a global basis has encouraged invaluable discussions among central banks and financial supervisors in Basel, and at BIS meetings around the world. This helps, for example, to clarify the differing perspectives of home and host supervisors.

Globalisation and Asset Prices

Let me now turn from the consequences of globalisation for the organisation of finance, to its consequences for asset prices and global financial imbalances. Certainly, the picture that emerges from the literature is that globalisation matters. In particular, I would point to the heightened significance of common, even global, determinants of the prices of internationally-traded financial assets; that is, a more consistent pricing of risk exposures across financial markets.

Globalisation has also enhanced the capacity of present pricing to capture both the past, and expectations about the future. Things that used to develop in the fullness of time happen today, and right now. Diverse views are now routinely collapsed in real time into a global consensus in markets as to both the pricing of risk factors and the way the volatility of those factors should also be priced. The latter development is no doubt a reflection of the now established position of financial options as a core component of systemically-critical cross-border risk transfer mechanisms.

The US Residental Mortgage Market and Global Finance

Let me take one example. Over the last few years, the US residential finance system – the system of mortgage financing of purchases of housing in the United States – has become a primary, and immensely important, mechanism of global financial risk transfer. Foreign investors now finance somewhat more than 10 percent of the more than USD 8 trillion in US residential mortgages through their investments in the debt securities of the US housing agencies, and through their purchases of mortgage-backed and other securities.

This nearly USD 1 trillion investment reflects globalisation on a colossal scale. Interestingly, a key feature of the US system is that the standard US residential mortgage contract incorporates an option that allows the mortgagee to prepay part or all of the principal amount of the mortgage loan at any time. One result of this optionality embedded in US residential mortgages is the creation of a principal prepayment risk for holders of mortgages or mortgage-backed securities that is notoriously difficult

to model. In our now globally-connected financial system, such modelling risk is dispersed among both domestic participants in US mortgage markets and global market investors. In some periods, such as the summer of 2003, transactions undertaken to hedge this prepayment risk were probably a key driver of volatility in global fixed-income markets.

Cross-border balance sheet linkages have also been made much tighter by globalisation. This is a direct consequence of the free movement of capital. The link between financial globalisation and residential property prices is, of course, not just a US phenomenon. What is different in the United States is the sheer size and transparency of the linkage. This exceptional transparency can, in turn, be accounted for by the fact that – through mortgage loan securitisations – US residential finance has become an embedded element of global capital markets.

Global Imbalances, Foreign Investment, and US Residential Finance

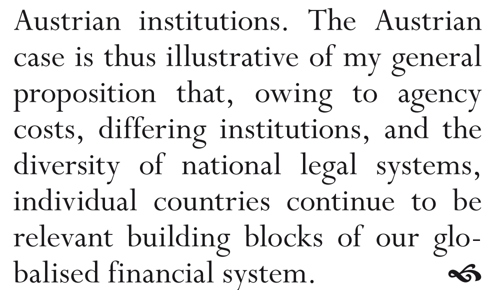
According to research by former US Federal Reserve Chairman Alan Greenspan and James Kennedy, also of the Federal Reserve, discretionary extraction of home equity amounted to nearly USD 3 trillion dollars for the period 2000–2004. In a public discussion of his research Chairman Greenspan noted that "... it is difficult to dismiss the conclusion that a significant amount of consumption is driven by capital gains on some combination of both stocks and residences, with the latter being financed by home equity extraction". Thus, by implication, the US current and capital account positions have, over the last few years, reflected cross-border balance sheet linkages among US households and global investors.

Concluding Remarks: What Would Schumpeter Say?

For many years, the particulars of Joseph Schumpeter's vision that the character of a country's financial system matters for its long-term growth and development were pushed to the sidelines of policy discourse. Simply stated, he would have us focus on the governance of financial activities, and most diligently on the way particular sorts of incentives shape entrepreneurial behaviour. Fortunately, this emphasis on governance issues is now very much at the centre of public discussion. Lessons have been learned and continue to accumulate, growing out of the experiences of both mature and emerging market economies. Today we have a better understanding of how factors relating to the organisation of an economy – its legal system, accounting rules, disclosure principles and market practices – influence its long-term economic growth. And perhaps not too belatedly, we have also come to appreciate the crucial role of economic institutions in shaping the structure of economic incentives, both nationally and globally.

In closing, I need not look beyond the borders of Austria to illustrate what I have been saying about the role of individual countries in financial

globalisation. Over the past decade, Austrian commercial banks have implemented a comprehensive strategy that has established them as important financial service providers and innovators in the emerging markets of central and eastern Europe. Their ongoing capacity to implement this strategy will reflect the quality of Austrian institutions. The Austrian case is thus illustrative of my general proposition that, owing to agency costs, differing institutions, and the diversity of national legal systems, individual countries continue to be relevant building blocks of our globalised financial system.



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