

THE IMPACT OF GLOBALISATION ON THE FINANCIAL MARKETS OF THE DEVELOPING COUNTRIES

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The purpose of this paper is threefold. First, it surveys the globalisation of capital markets in a historical context. Second, it discusses the implications of globalisation for the developing countries' capital markets. Finally, it sheds light on the future course of action that each member of the international community ought to undertake for a smooth and effective functioning of the international financial markets.

1. INTRODUCTION

In the last decade, global financial markets and intermediaries have faced several costly and contagious financial crises. There have been abrupt declines in asset prices (for example, global equity markets in 1987, real estate values in the late 1980s and early 1990s, and global bond markets in 1994); major bouts of volatility in the foreign exchange markets (for example, the European exchange rate mechanism (ERM) crises in 1992-93, the dollar-yen market in early 1995); an exchange rate crisis together with a debt crisis in the emerging markets in early 1995; and a number of costly banking problems in several industrial and some key emerging market countries. In addition, there has been a string of serious, albeit nonsystemic problems in individual institutions around the world (Barings, Bank of Credit and Commerce International, Daiwa Bank, Metallgesellschaft, Orange County, and Sumitomo Corporation). Although many factors have contributed, including macroeconomic policies and management control failures, these events appear to have been a by-product of the transformation and restructuring of international finance that has taken place during the last ten years, including the increase in competition that accompanied the liberalisation of the financial sector in most of the major industrial countries, and developing countries; the integration of capital markets; the increasing dominance of institutional investors; the development of new financial techniques and instruments, particularly in the derivatives area; and the growth of the emerging markets.

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The evolution of international financial markets since the early 1990s, as well as more recent developments, provide some tentative evidence that international markets and their major participants--financial intermediaries and their supervisory authorities--are settling down into a more steady pattern of growth and innovation. It should be expected that international markets will continue to become more global and more dominated by institutional investors, that the continuing international diversification of institutional portfolios will mean that the exposure of these investors to emerging markets will grow along trend, and that the spread of global derivative finance will continue. The evolution will take place against the backdrop of improved risk management in the international banking sector, strengthened market surveillance within an adaptive regulatory environment, a more resilient market structure, and with an official sector that has made it top policy priority to create the infrastructure required for a stable market environment.

2. CHARACTERISTICS OF A DEREGULATED AND INTEGRATED GLOBAL ECONOMY

An appraisal of the key features of a deregulated, broadly integrated, increasingly internationalised, yet inadequately supervised capital market structure reveals first excessive indebtedness on the part of numerous corporations, households, and governments in several countries. This is the undesirable legacy of dramatically increased access to credit during the past 10-15 years. Second, many developed and developing countries have impaired financial institutions. When many of their most creditworthy commercial borrowers gravitated to the opening credit markets, a large number of banks reacted by going into a variety of questionable activities--balance of payments loans to less developed countries (LDCs) that cannot be fully repaid, a headlong rush into financing commercial real estate, and funding speculative ventures such as leveraged buyouts and corporate take-overs.

Third, there is an absence of a truly level playing field among different types of financial institutions, despite the high degree of globalisation of capital markets. Some institutions such as commercial banks are regulated on a consolidated international basis; other institutions such as securities firms and insurance companies are regulated piecemeal; others such as finance companies have no formal official oversight whatsoever. The persistence of gaping anomalies casts great doubt on how the system as a whole would be impacted by a major failure and who would have responsibility for holding the system together.

Fourth, the world savings rates are smaller. Alongside the development of more integrated capital markets, savings rates have declined in virtually every major industrial country. According to official estimates, total national savings, including households, businesses, and governments, declined from an average of 23% of GDP for the major industrial countries for 1974-79 to 20.4% during the decade of the 1980s. The savings rate fell for every major industrial country except West Germany, where it held roughly steady. One important consequence of this decline has been a historically high cost of capital.

Fifth, there exists a large role of government debt in national capital markets. High real long-term interest rates, averaging 5% per annum or more in most major industrial countries, are also a product of the continuing large-scale borrowing requirements of many governments, the debt of which dominates most domestic fixed-income markets.

In sum, while deregulation and globalisation of capital markets have provided some benefits in terms of greater flexibility and efficiency, the preservation of the safety and soundness of the financial system requires a more forceful and internationally co-ordinated supervisory presence.

3. THE GLOBAL CAPITAL MARKET DURING 1870-1939 PERIOD

The 1870-1939 period was dominated by the London financial market as a source of capital for other countries. Europe's industrial revolution produced a strong demand for food and raw materials, which could be satisfied only by investment in many other parts of the world. Expansion of railroads and other infrastructure was externally financed, and foreign investors were repaid later from the resulting export earnings. Some of the countries where these investments were made--such as Argentina, Australia, Canada, and the United States--were able to buy imports of manufactures from the more industrialised countries in Europe. Then, as now, this growing economic interdependence was facilitated by international finance.

What was unique about the years 1870-1914 was the scale of international finance. Over the period as a whole, Great Britain invested 3% of its GNP abroad, reaching a peak of 10% just before World War 1. Its net receipts of investment income from abroad were in the range of 5 to 8% of GNP, implying that new foreign investment did not keep up fully with inflows of interest and dividends. As a proportion of British savings, capital outflows ranged between 25 and 40%. France and Germany also invested heavily

abroad, though not as much as Britain. By the late nineteenth century, French and German gross capital exports were averaging 2 to 3% of GNP.

The nature of the capital flows varied considerably in 1870-1914. The largest single group included the market-oriented investments, largely undertaken by Britain, in the resource-rich countries of North America, Latin America, and Oceania. In 1914, these accounted for 70% of Britain's total foreign investments and more than half of all gross foreign assets. A second group, accounting for a quarter of all foreign investment, involved investments in Russia and other Eastern European countries and in Scandinavia; France and Germany were the principal investors. A third group covered the primarily politically motivated investments in China, Egypt, India, Turkey, and some African colonies. These three groups received capital at different times, so new regions were financially linked with the world economy only gradually.

For the large debtors in the nineteenth century, capital inflows had only a small weight in their economies. For most decades, capital inflows to the United States were around 1% of its GNP and never exceeded 6% of its domestic investment. For the smaller debtors, however, capital inflows as a proportion of GNP were higher than they are for many developing countries today. Capital inflows to Canada averaged 7.5% of its GNP, accounting for between 30% and 50% of annual investment from 1870 to 1910. Ratios were similar in Australia and the Scandinavian countries. The most striking case was that of Argentina, where capital inflows annually ranged between 12 and 15% of GNP and financed about 40% of its total investment during the first two decades of the twentieth century. By contrast, net capital inflows to all developing countries averaged 2 to 3% of GDP between 1960 and 1973. Since 1973 they have not exceeded 6% of GDP and have financed between 12 and 20% of gross investment.

Differences do not stop with geography and the relative volume of external finance. In the years 1870-1914, almost all lending came from private sources, in the form of stock and bond issues. Lending terms were long: maturities of up to ninety-nine years were not uncommon. Nearly two-thirds of foreign capital went to finance investment in railroads and utilities.

A large proportion of the flows went to the then relatively high-income countries; North America, Latin America, and Australia received more than half of the total. The international capital market in the nineteenth century did not, and was not designed to, provide poorer countries with access to capital. For example, even India—though favoured in British capital markets—received very little investment. Capital was drawn to investments that yielded higher

returns than were available in the domestic economy. Thus it operated selectively, to the advantage of high-income borrowers; although there were some politically motivated investments with marginal economic returns, they were not significant in terms of the volume of flows.

These differences compared with the recent past were also accompanied by some close parallels: periodic debt-servicing difficulties and an early version of what is now known as conditionality. Lenders and borrowers operated against a backdrop of large cyclical swings in international economic activity compounded by rebellions and wars. Sometimes borrowers failed to make their payments. They fell into two broad categories. First, countries such as Argentina and Brazil, where foreign capital was important in integrating their economies into an expanding world economy, experienced cyclical problems related to abrupt declines in foreign exchange earnings. Foreign loans were used, along with domestic policy changes, to alleviate liquidity crises until exports recovered. In some cases, foreign creditors got involved in domestic policy issues. In the Brazilian crisis of the 1890s, for example, the government pledged all its customs receipts and agreed to a moratorium on new (internal and external) debt issues.

The second kind of debt crisis was the result of stagnant domestic revenues and expanding fiscal deficits. Countries in this group included Egypt, Peru, and Turkey in the 1870s, and Greece in the 1890s. Capital inflows could not continually finance deficits and became increasingly expensive. These countries' export growth slowed considerably before they defaulted. In these cases, creditors intervened not only at the moment of default but sometimes much sooner. In the Turkish crisis, for example, a foreign loan (the first in series) was issued in London with the encouragement of the British government. A condition of the loan was that commissioners should be sent to oversee the expenditure of the proceeds.

Notwithstanding all these difficulties, the record up to 1914 shows that investment abroad was profitable for investors in Great Britain and continental Europe. It earned returns that have been calculated to be between 1.6 and 3.9 percentage points higher than returns on domestic investment. Within that average, although there were a number of defaults on foreign loans, the most profitable investments were in railroads in the United States. Although they were untypically lucrative, they helped to foster a general climate in favour of foreign investment. Another influence working in the same direction was that loans were used to purchase British exports, so financial and real flows went together. When borrowers got into difficulty, they found that the London capital market was not an unyielding taskmaster.

Between the two world wars, the pattern of international investment shifted dramatically. The United States emerged not merely as a net creditor country, but as the main source of new cashflows. In certain respects, it played a role similar to Britain's earlier one. It financed many long-term bond issues: of the 1,700 foreign dollar issues offered in the United States in the 1920s, almost half had average maturities of twenty years. Some 4% had average maturities of forty years and 1% of more than forty years. At least forty-three governments borrowed during the 1920s, and none defaulted. During the peak period of flotations, from 1924 to 1928, the interest differential in favour of new foreign issues was between 1.7 and 1.9 percentage points. The US also financed a large amount of direct investment, mainly in Canada and Latin America. Its direct investment rose by almost \$4 billion in the 1920s, two-thirds of it going to Western Hemisphere countries.

However, the 1920s were different from earlier decades in several vital respects. First, the volume of government lending and borrowing was far greater. Borrowings by governments accounted for nearly half of the foreign dollar issues in the United States. No less important, World War I had left a legacy of official debt. The United States was owed almost all the debts made between the Allies, totalling more than \$16 billion. In addition, the Allies had heavy reparation claims against Germany.

The second difference was that foreign capital was no longer part of an integrated pattern of population and trade. By the mid-1920s, commodity prices were falling. Some countries borrowed to finance a growing stockpile of unsold commodities; one example was Brazil in the 1920s, to finance coffee stocks. In the mid-1920s, there was an increase of 75% in commodity stocks, financed indirectly by foreign capital.

The third difference with the pre-World War I period was the trade policy followed by the major global creditor. British free trade had served to guarantee debtors a market for their products. The United States was more protectionist and its external trade was a relatively small portion of its GDP. Following the recession of 1920-21, it raised tariffs back to where they had been before some liberalisation in 1913. If debtors could not generate export surpluses, they needed capital inflows to service past debts. The process inevitably produced ever-increasing debt.

The Great Depression of 1929-32 turned a potential threat into a disaster. Between 1929 and 1932, output in industrial countries fell 17% and the volume of world trade by more than a quarter. The international monetary

system disintegrated. There was no lender of last resort to provide liquidity, a function that the United Kingdom had previously undertaken. And the liberal trading system of the pre-war years virtually disappeared. Most countries raised tariffs and applied quotas and exchange controls. Lack of finance contributed to the decline of international trade, and vice versa.

Several industrial countries defaulted on their war debts and reparation. Germany, facing declining production, exports, and prices, first obtained a one-year moratorium in 1931 and then defaulted on all its external debts in 1932. Developing countries were also failing to service their debt. Bolivia defaulted on its dollar obligations in 1931 and was soon followed by most other Latin American countries. By the end of 1933, Argentina was the only Latin American country that maintained full servicing on its external debts. Effectively, access by developing countries to commercial markets ceased until the 1960s.

Although the deterioration in the general economic climate was the proximate cause of defaults in the interwar period, it was not the only one. Other contributions came from excessive borrowing, particularly between 1925 and 1929; poor risk assessment on the part of lenders; panic; and an abrupt cessation of lending just before a default. In general, the financial penalties for defaulting were rather small in the 1930s. Defaulting governments had established a precedent, and the number of private defaulters was too large for sanctions to be enforced. However, the cost in domestic adjustment could be severe. Between 1929 and 1938, the maximum peak-to-trough declines in output for major Latin American countries ranged from 7% for Brazil to 26% for Peru.

Three broad lessons emerge from the experience of international finance between 1870 and 1939. First, finance seeks out profit: in general, the highest returns were from investments that directly or indirectly exploited natural resources. Technological innovation--such as the expansion of railroads in the nineteenth century--was also a major absorber of capital, and international capital in particular. Repayments were more likely when investments led to increased exports (as was generally the case before 1914) than when the ability to export was constrained by protectionist measures in capital-exporting countries (as was the case in the interwar period). Political risk was minimised by investing in colonies or in countries that were integrated with capital exporters through trade and finance.

Second, the volume and composition of finance changes to reflect shifts in the world economy. Before World War I, private capital markets were

dominant; in the interwar period, public borrowing and lending assumed a much larger role. Financial innovation is also influential: for example, the nineteenth century saw the establishment of mutual funds, which separated ownership from the management of portfolios and spread risk more widely.

Third, reschedulings and defaults were the result of inadequate policy responses by borrowers to declining terms of trade. Defaults were typically settled in negotiations with bondholder committees on terms that seldom preserved more than a small fraction of the original capital value. Negotiators explicitly assessed the borrowers' ability to undertake policy reforms; this "capacity to repay" formed the basis for determining how much debt should be forgiven. In most cases, existing debt was consolidated and extended with a significant reduction in principal and interest due; interest arrears were often waived entirely. External intervention, including military force, was common where lending had been determined by political factors. When countries ran into liquidity difficulties, they were able to borrow more if they revised their policies and while they waited for their export earnings to recover.

4. THE GLOBAL CAPITAL MARKET DURING THE POST-1945 PERIOD

The Bretton Woods Conference in July 1944 outlined the post-war international economic system and led to the creation of the International Monetary Fund and the International Bank for Reconstruction and Development. After World War II, the United States continued as the major creditor country, and its dollar became the main reserve currency. In 1947, it announced the Economic Recovery Program (or Marshall Plan), designed for the reconstruction of the war-ravaged countries of Europe. Between 1948 and 1951, the program provided over \$11 billion to Western Europe, with a further \$2.6 billion between 1951 and mid-1953. The aid primarily took the form of grants of commodities. The counterpart funds were used to finance investment. This helped Europe to make a dramatic recovery: the countries participating in the Economic Recovery Program increased their industrial product by 39% between 1948 and 1952.

The ending of Marshall aid did not produce a swing in the US balance of payments. On the contrary, US foreign investment expanded as a result of incentives to US banks and corporations to invest abroad, plus a big devaluation of European currencies against the dollar in 1949 and the large US military presence in Europe. The US also increased its loans and grants to developing countries, and private direct investment increased sharply in Latin America. The overall US balance of payments moved into deficit in 1950 and

stayed there for many years. During the 1950s, this aroused little concern. It was a commonly held view that there was a “dollar shortage” and that such deficits were appropriate for the leading international creditor.

Europe’s balance of payments improved considerably in 1958, boosting its foreign reserves. At the end of that year, most European governments declared their currencies convertible (Japan did the same only in 1964). Capital markets in Europe and the United States started to integrate, with private capital flows becoming responsive to movements in interest rates. In the late 1950s, European banks, notably in London and Switzerland, began to deal in dollars. This marked the inception of what came to be known as Eurocurrency markets. The decade had begun with official capital flows contributing to economic growth and trade expansion; it ended with a growing volume of private capital flowing between industrial economies.

The post-war years also saw the progressive decolonisation of the developing countries. The United States and later other industrial countries began their formal programs of foreign aid. In the early 1950s, the World Bank shifted its focus from reconstruction to development, though it continued lending to industrial countries, including Japan, during the 1950s and 1960s. In 1956 the International Finance Corporation (IFC) was created to assist the private sector in developing countries through loans and equity investments. In 1960 governments formed the International Development Association (IDA) to provide a multilateral source of concessional finance for low-income countries. These years also saw the establishment of several regional development banks, including the Inter-American Development Bank (1959), the African Development Bank (1964), and the Asian Development Bank (1966).

For most of the 1960s, the world economy enjoyed a period of largely untroubled progress. Industrial economies grew by an average of 5% a year, with little year-to-year variability in growth rates. World trade grew even faster, at an average of 8.4% a year, helped by the progressive trade liberalisation policies pursued under the GATT. Inflation rates in industrial economies as a group varied between 2 and 4% a year, though individual countries had bouts of more rapid price increases. Nominal interest rates adjusted for inflation (that is, real interest rates) were usually in the 2 to 3% range.

Developing countries benefited from these international conditions. As a group, their output increased by over 5% a year. Some developing countries grew much faster than others, accentuating the differences in average incomes.

Current account deficits were financed chiefly by official flows (loans and grants), by private direct investment, and by trade finance. Official aid grew by about 3% a year in real terms in 1950-65. Direct foreign investment also increased rapidly, as multinational corporations sought new supplies of raw materials in developing countries. Export credits revived as a source of finance for developing countries--a mixed blessing, as their relatively short maturities contributed to debt-servicing problems for many countries.

Several developing countries ran into debt difficulties in the 1950s and 1960s. Between 1956 and 1970, there were seventeen debt reschedulings involving seven countries (Argentina, Brazil, Chile, Ghana, Indonesia, Peru, and Turkey), each of them more than once. The reasons for their difficulties varied. Argentina, Brazil, Chile, Peru, and Turkey shared certain problems: large budget deficits; rapid inflation and delayed adjustments of the exchange rate; deteriorating terms of trade; declining export earnings; the accumulation of short-term external debt. Ghana and Indonesia also had these problems--though more acutely, because they launched large, long-term projects that they financed with short-term credits and executed inefficiently. In a number of other cases, including India, debt rescheduling was used to provide increased capital flows to low-income countries when concessional flows from industrial economies were constrained.

Creditors rescheduled their loans through ad hoc multilateral groups, such as the Paris Club. The International Monetary Fund was also involved in providing extra finance to support policy reforms. In general, creditors did not incur capital losses; they extended maturities and received interest on schedule. Borrowers undertook policy reforms designed to bring their balance of payments into better equilibrium and to establish the basis for economic growth.

Although the 1960s saw a rapid expansion of world output and trade, some international monetary problems started to emerge. The United States made efforts to control capital outflows. Many countries experienced difficulty in maintaining their exchange rates, notably Britain in the mid-1960s and France a few years later. The need for reform of the international monetary system was formally recognised as early as 1963.

By the end of the 1960s, the rate of growth of industrial economies had begun to slow and inflationary pressures to build up. Continued deficits in the US balance of payments found their counterpart in surpluses in Europe and Japan. The dollar's exchange rate started to come under pressure. In August 1971, the United States temporarily suspended the convertibility of the dollar

into gold. In December 1971, it devalued the dollar as part of a general realignment of currencies. Further pressures on exchange markets led to generalised floating of exchange rates in 1973.

5. KEY CHANGES IN GLOBAL CAPITAL MARKETS: 1940s TO 1990s

Since the start of the post-World War II era, there have been a number of basic changes in global capital markets. Any reform of the international economic institutions supporting a new world order should take these vital changes into consideration.

First, at the end of World War II, the United States was the dominant economic superpower, and this made it relatively easy to fashion international economic agreements. The Bretton Woods conference was essentially a discussion between two dominant parties--the United States and the United Kingdom. The Germans, Italians, and Japanese were not included for obvious reasons. France was still occupied. The Russians were there, but they were not a major force, and much of the rest of the world was somebody else's colony. As a result, it was possible for the two close allies to settle their modest differences between the so-called Keynes' plan and the American approach.

The economic realities of the 1990s are quite different from those of the 1940s. If the Bretton Woods conference were attempted now, there would, of course, be many more countries, and groups of countries, with many different points of view about how to set up any new financial institutions, and the chance for success would be thin.

Second, at the end of World War II, many leading governments practised exchange and capital controls. Currently, few leading governments practise these controls, and deregulation has vastly altered the landscape in many financial markets. A sweeping transformation from rigorously government-controlled, segmented, and frequently inefficient national markets to the far more open, broadly interconnected, and inventive capital markets has occurred. This transformation did not come about as a result of careful, deliberate planning by government officials, academics, or market participants themselves. Instead, it came in fits and starts. It was spawned by repeated bursts of financial opportunism, as borrowers, lenders, or intermediaries sought ways to avoid regulations, side-step taxes, gain access to cheaper sources of funds, trade currencies or securities at lower cost and without onerous restrictions, or find new avenues for speculative activity.

Third, at the start of the post-World War II era, a major portion of international capital flows was between government (or quasi-government)

agencies. As a result, a major portion of international capital flows often did not strictly follow the dictates of so-called free market forces. However, in the 1990s, a major portion of international capital flows occurs between private sector, profit-maximising corporations. These corporations follow the dictates of market forces, and they often give priority to short-run influences over long-term factors. This shift has dramatically influenced the environment in which global capital markets function, and it has created the possibility of instability in many financial centres.

A fourth difference is the relative reversal in importance of international trade and international finance. In the 1940s, international trade was treated as “king” and international finance was viewed as somewhat of a “junior partner”. In large measure, this was due to the relative magnitudes of international trade and international financial forces. International trade was viewed as being much larger and generally more important than international finance. This picture has changed in recent years, of course, as the growth of international financial markets has outstripped the growth of international trade. In the short and intermediate terms, exchange rates often follow the dictates of international capital markets and not international trading forces.

For example, in the early 1980s, when the United States followed a macroeconomic policy of significant government deficits--due in large part to tax reductions and a military build-up coupled with substantial growth in entitlements--most economists predicted that high interest rates would choke off any economic recovery. However, the United States experienced the longest peacetime expansion of the post-World War II era in the 1980s. This was primarily due to the significant role of international capital markets, as foreign lenders were willing to finance the US government budget deficits at unprecedented levels. The change in size and quality of international capital markets often is not fully appreciated by decision-makers.

A fifth major change in global capital markets centres on technological and entrepreneurial innovations. In the 1940s and 1950s, computers and derivative instruments (such as interest rate swaps, futures, and options) had no real influence on, and did not exist in, most global capital markets. Given major advances in microelectronics, telecommunications, and deregulation, computers and derivative instruments will have a major influence on global capital markets in the 1990s. National and international regulators have often lagged well behind these innovations.

A sixth change centres on the relative roles of the International Monetary Fund and the World Bank. In the 1940s, the IMF and the Bank had clear and

different roles to play in the international economic system. In general, the IMF was supposed to manage macroeconomic forces and exchange rate matters. The mission of the Bank was to make long-term loans for various development projects. In contrast to the IMF, the Bank was supposed to deal with issues on the microeconomic level.

In recent years, a certain amount of overlap has developed in the operations of the World Bank and the IMF, and this implies possible bureaucratic waste and unnecessary expense. The roles of the Bank and the Fund were originally quite different and distinct. The World Bank was in the business of lending for specific projects, such as railroads or hydro-dams. These were long-term loans, and their evaluation was primarily on a macroeconomic or individual project efficiency basis. The International Monetary Fund, in contrast, was in the business of making shorter-term loans--normally for three to five years--for balance of payments support. The Fund had mostly a macroeconomic focus--it judged fiscal and monetary policies, exchange rates, and other macroeconomic factors.

Over the past decade or so, the distinction between these two roles has become unclear, particularly with the World Bank's involvement in structural adjustment loans. These loans are not based on specific projects, but instead are designed to produce financial (which really means balance of payments) support during a period in which various structural adjustments are made in a country. With an extended Fund facility and the structural adjustment facility, the IMF began longer-term lending. At the same time, the Bank became more involved in macroeconomic or broad policy considerations. To some degree their functions began to overlap, suggesting the possibility that operational expenses were being duplicated.

The less developed countries (LDCs) have been unhappy over the way that the IMF has operated its conditionality program. Conditionality means that loans from the Fund are conditional upon the pursuit of macroeconomic and exchange rate policies that make it likely that the loan will be repaid. Thus, countries may get loans, or are allowed drawings, if their budgets move toward balance and if their money supply growth is reduced. Also, their loans are conditioned on their exchange rates being set at appropriate levels. In addition, the Fund looks at various structure problems like price controls. Many LDCs think that conditionality is an imposition on their sovereignty, and they view it as "mother" telling them what to do. However, the Fund's policies are designed to make repayment possible. If such policies were not pursued, it is unclear how the Fund would be repaid. The central issue for the Bank and the Fund is lack of money. There are numerous new borrowers coming into the

system with the admission of the republics that were in the USSR. There are also enormous needs in Eastern Europe.

Lastly, the start of the post-World War II era was associated with fixed exchange rates. Although there have been some recent proposals to go back to fixed exchange rates--or narrow exchange rate bands--the 1990s have been an era of flexible or floating exchange rates. However, this does not mean that governments in this decade are willing to take a hands-off view toward exchange rates. Governments frequently still become involved in supply and demand management when dealing with exchange rates. Thus, it may be more accurate to call the 1990s a period of "dirty" or managed floats than a period of perfectly free exchange rates. Also, at the start of the post-World War II era, national regulators were able, for the most part, to cope with the international side of financial markets. Currently, national regulators are often unable to cope with this aspect of financial markets.

A key goal of the IMF should be to redefine a credible role for itself in the management of the international monetary system. While the Fund has proved to be an effective agent in promoting financial stability and reform in the developing world, it has yet to be drawn into the policymaking councils of the industrialised governments. That role is of far greater importance from the standpoint of the international economy than the quite valuable role that the Fund has played in promoting a sound financial environment in the developing world. Also, the Fund is clearly the preferred instrument in promoting the transition to market economies in the former Soviet Union and Eastern Europe. Again, however, in terms of the world economy, that role is dwarfed by the contribution the IMF could make to future economic prosperity and global growth by bringing about better co-ordination of the monetary and financial policies of the industrialised countries. The Fund needs to make sure that monetary and exchange rate policies are conducive to economic growth rather than the reverse.

In general, a major economic initiative is undertaken only when political leaders are deeply convinced that the time is right for a change and when key political constituents appear to be willing to support that shift. The 1990s probably will see marginal reforms of the international economic system and not the wholesale and sweeping reforms that took place after World War II.

6. FINANCIAL SYSTEMS IN DEVELOPING COUNTRIES

The evolution of financial systems in developing countries reflected their diverse political and economic histories. Latin American and Mediterranean

countries, politically independent since at least the first quarter of the nineteenth century, suffered frequent bouts of financial instability. These prevented the emergence of mature financial systems. In contrast, developing countries in Africa and Asia, under colonial rule until the end of World War II, enjoyed relative financial stability, but their financial systems suffered from colonial neglect and stagnation.

The financial systems of most developing countries were heavily oriented toward agricultural exports, other primary production, and foreign trade. In Africa and Asia, financial systems catered principally to expatriate communities. Financial services for the indigenous populations were limited. Foreign banks confined their operations to port towns and other centres of commerce where the expatriate communities were gathered. The domestic population, especially in Asia, hoarded precious metals and jewellery. Hoarding was insurance against financial emergencies caused by war, crop failure, natural disaster, and personal mishap, but it was saving denied to productive investment.

Sound banking promoted financial stability in Africa and Asia. Currency boards regulated the money supply and maintained reserves that were invested in London and Paris. The financial systems of most African countries, however, were underdeveloped until independence. They comprised a few foreign colonial banks, post office savings banks, co-operative societies, and moneylenders. Nigeria was the only African country with indigenous commercial banks before the late 1940s.

Financial development was more advanced in Asia. As in Africa, foreign banks confined their operations largely to the financing of foreign trade, but they also helped to finance internal trade. Most Asian countries also had a fairly well-developed indigenous banking system, with commercial banks, co-operative credit societies, and informal bankers and moneylenders. India, in particular, had a sophisticated indigenous banking structure. It had evolved over several centuries, developing the use of commercial bills known as hundi for financing nonlocal trade and relying on an elaborate system of personal relations to finance local, mostly small-scale activities.

Foreign banks operated in pre-1949 China, mostly in treaty ports, and some indigenous banks (shansz) remitted funds across regions and financed local trade. Foreign banks promoted foreign direct investment in railroad construction, mining, and manufacturing. They also made massive loans to the Chinese government and in the process gained control of its customs and salt revenues. Modern Chinese banks came into being in the 1930s. They had close

links with the government and the ruling families and were able to seize the initiative from foreign banks and emerge as the dominant group. After 1949 China built a monobanking system typical of centrally planned economies.

Indigenous bankers and moneylenders were able to meet the borrowing needs of local traders and farmers by maintaining close personal contact with them and acquiring intimate knowledge of their operations. Their services were accessible but expensive. Informal financial institutions, such as rotating savings and credit associations (ROSCAs), also emerged in most countries. Indigenous bankers and informal financial institutions, however, could not mobilise the resources required for industrialisation.

Throughout the nineteenth century, Latin American countries relied too much on foreign capital. Argentina and a few other countries developed active mortgage-bond markets and stock exchanges alongside thriving but fragile banking sectors. Unfortunately, however, recurring financial crises undermined attempts to develop the system adequately. Finance lagged behind the region's achievements in infrastructure, agriculture, and mining. Instability resulted from too much foreign borrowing; the overissue of currency; imprudent domestic banking; speculation in commodity, securities, and foreign exchange markets; excess capacity in industry and commerce; regional wars; and internal political unrest. Many of these were to figure in the debt crisis of the 1980s.

Latin American economies ran for long periods with inconvertible paper money, high inflation, and depreciating exchange rates. Producers and exporters of primary commodities welcomed this; they stood to benefit and had a strong hold on government policies. Latin American countries occasionally suspended the servicing of their external debt. Foreign lenders, however, were usually lenient, probably because the region had immense potential for profitable investment. Major international houses arranged so-called funding loans, such as the Brazilian loan of 1898, which had many features in common with the multiyear rescheduling agreements of recent years. In contrast, foreign lenders imposed strict controls on the finances of many other countries, such as China, Egypt, Greece, and Turkey. Their governments were forced to cede revenues from stamp and customs duties and from state monopolies (on salt, matches, and tobacco) until the debts were fully repaid.

World War I and the depression of the 1930s played havoc with the world economy. Latin American countries were particularly affected by the development of man-made raw materials and the transformation of the British

Commonwealth into a protectionist bloc. Most of them defaulted on their foreign debts, but the central and other state banks that had been created in the 1920s averted the panics of earlier periods.

Before World War II, developing country governments had a poor record on financial development. In Latin America and the Mediterranean countries, they failed to create sound legal and regulatory systems and to maintain macroeconomic stability. Borrowers relied excessively on foreign capital, and financial systems were undermined by imprudence. In Africa and Asia the restricted use of bank credit, the limited spread of the banking habit, and the persistence of the hoarding habit were all legacies of colonial banking systems that had failed to reach the indigenous population.

In the late 1960s and early 1970s, high inflation and changes in financial markets undermined many of the credit and banking controls then in use. Several countries, including Britain, Canada, France, the Netherlands, and Sweden, enacted a series of wide-ranging banking reforms. These abolished the distinctions among different types of institution, relaxed both global and selective credit controls, removed branching restrictions, and liberalised interest rates on lending and wholesale deposits.

Financial deregulation was interrupted by the macroeconomic turmoil that followed the rise in oil prices in 1973. Many countries reimposed credit controls, hoping to contain monetary expansion without raising interest rates. But deregulation resumed in the late 1970s. It ranged from the elimination or relaxation of controls on credit, interest rates, and foreign exchange to the removal of restrictions on the activities of institutions and on new financial instruments. In most countries the changes were cautious and gradual. This contrasted sharply with the experience of some Latin American countries.

Deregulation was prompted by the growing realisation that direct controls had become less effective over time. The growth of the Euromarkets, the development of new financial instruments, and the advent of electronic technology all made it easier to bypass the restrictions. Governments also recognised that the prolonged use of directed and subsidised credit programs would lead to the inefficient use of resources and hinder the development of better systems.

7. MACRO-FINANCIAL INDICATORS OF DEVELOPING COUNTRY CAPITAL MARKETS

We discuss major macro-financial indicators of developing countries and their implications in the context of globalisation of world capital and financial markets. Among developing countries, Asia had the largest GDP which constituted slightly above 50% of the total GDP of developing countries. The Western Hemisphere comes in second place with 22.2% followed by the Middle East and Europe with 12.0%. The least was Africa with 8.2%. For exports of Goods and Services, nonfuel exports dominated by 78.7% and fuel exports only 21.3%. More than 50% of the nonfuel exports were manufactures. For total debt outstanding, about 96.1% are net debtor countries while only 3.9% are net creditor countries (See Table 1; Source: IMF).

Although there were fluctuations, the GDP deflators and consumer prices of industrial countries had an overall downward trend from 1986 to 1996. In contrast, consumer prices of developing countries and countries in transition had an upward trend. For developing countries, consumer prices rose steadily from 1986 to 1990 and dropped by approximately 50% in 1991. It increased steadily from 1992 to 1994 and declined substantially in 1995 and 1996. For countries in transition, consumer prices rose steadily from 1986 to 1991, skyrocketed in 1992, and declined thereafter with a substantial drop in 1996 (See Table 2: Source: IMF).

For industrial countries, the central and general government fiscal balance increased from 1987 to 1990, decreased from 1991 to 1993, and increased steadily from 1994 to 1996. The growth of broad money of industrial countries increased from 1987 to 1989, decreased from 1990 to 1992, increased in 1993 and declined in 1994. No figures were reported for 1995 and 1996. For developing countries, the central government fiscal balance increased from 1987 to 1992, decreased in 1993 and increased thereafter up till 1996. The weighted average of growth of broad money of developing countries rose from 1987 to 1989, declined in 1990 and 1991, rose in 1992 and 1993, and declined thereafter till 1996. For countries in transition, the central government fiscal balance was stable in 1987 and 1988, rose steadily from 1989 to 1992, and declined in 1993 and 1995 - with a slight increase in 1994. Except for the drop in 1990, the growth of broad money increased from 1987 to 1992 and dropped in 1993 and 1994 (See Table 3: Source: IMF).

The broad money aggregates of developing countries increased by 75% from 1987 to 1989, dropped by 27% from 1989 to 1991, increased by 20% from 1991 to 1993 and declined steadily thereafter with a total decrease of 77% from 1993 to 1996. The bulk of this amount came from the Western Hemisphere. The Western Hemisphere contributed approximately 70% of the

total. Africa, Asia and Middle East and Europe constituted roughly 30% (See Table 4: Source: IMF).

There has been a lot of fluctuations in the volume of world trade between 1986 and 1996. The volume of world trade increased from 1986 to 1988, decreased in 1990 and 1991, increased in 1992, decreased in 1993, increased in 1994 and declined in 1995 and 1996. World trade prices of manufactures have not followed a steady pattern as well. It increased in 1987, decreased in 1988 and 1989, increased in 1990, decreased in 1991, increased in 1992, decreased in 1993, increased in 1994 and 1995 and decreased in 1996. Oil prices dropped substantially by 117% from 1987 to 1988, increased significantly by 205% in 1989, increased slightly in 1990, dropped in 1991, increased in 1992, dropped in 1993, increased from 1994 to 1995 then dropped in 1996. World trade prices for nonfuel primary commodities increased from 1986 to 1988, dropped from 1989 to 1990, increased in 1991 and 1992, dropped in 1993, increased in 1994 and dropped in 1995 and 1996. Overall, world trade volumes and prices have been very unstable between 1986 to 1996 (See Table 5: Source: IMF).

There has been a lot of fluctuations in the pattern of payment balances on current account for industrial countries, developing countries and countries in transition. For industrial countries, their payments balances increased by 10.67% from 1987 to 1988, declined by 47.7% in 1989 and further dropped by 21.2% in 1990. Thereafter, from 1991 to 1996, there was an upward trend with a significant increase of 155.3% in 1993. While the payments balances on current account of industrial countries have had an upward trend, the overall payment balances of developing countries have steadily declined from 1987 to 1996 with significant increases only in 1989 and 1990. For countries in transition, there has also been a downward trend in the pattern of payments balances from 1987 to 1996 with a significant decrease of 197% in 1990. Despite the fluctuations, the figures show that the total payments balances on current account have been on a downward trend with a significant increase only in 1993 which is probably due to the increase from the industrial countries (See Table 6: Source: IMF).

We can divide the discussion of external financing situation of developing countries according to their various criteria. In the predominant export criterion, the total net external financing of fuel exports decreased by 35% in 1988, increased by 316% from 1988 to 1991, decreased by 11% in 1992, increased by 27% in 1993, declined by 78% in 1994, further dropped by 42% in 1995 and rose by 146% in 1996. Except for the fall in 1988, we could say that there was an upward trend in the external financing of fuel export from

1987 to 1991. The trend from 1992 to 1996 has been mixed with increases and decreases. For net external financing of nonfuel exports, there was a steady increase from 1987 to 1993, and a downward trend thereafter.

According to financial criteria, for net creditor countries, the total net external financing decreased substantially from 1986 to 1990 by 112%, it increased in 1991 and 1992, declined in 1993 and 1994, and increased in 1995 and 1996. For net debtor countries, the net external financing increased steadily from 1987 to 1993 by a total of 448%, declined by 34% in 1994 and increased by 7% in 1996. For market borrowers, the net external financing increased steadily from 1987 to 1993, declined in 1994 and 1995 and increased slightly in 1996. For diversified borrowers, the net external financing increased from 1987 to 1990, decreased in 1991, increased in 1992 and 1993, decreased in 1994 and increased in 1995 and 1996. Overall, except for the decreases in 1991 and 1994, the net external financing for diversified borrowers has followed an upward trend from 1987 to 1996. For official borrowers, the net external financing fluctuated between 1987 and 1996. There was an upward trend from 1987 to 1989 with a total increase of 49%, a decrease of 27% from 1989 to 1991, no change in 1991 and 1992, increase of 58% from 1992 and 1994, and a decline of 34% in 1994 and 1996. For countries with recent debt-servicing difficulties, except for the decrease in 1989, the overall net external financing increased steadily from 1987 to 1993, decreased in 1994 and 1995 and increased in 1996. For countries without debt-servicing difficulties, the net external financing increased steadily from 1987 to 1993, declined in 1994 and 1995, and increased in 1996 (See Table 7: Source: IMF).

Except for the decrease in 1988, the reserves of developing countries have followed an upward trend from 1987 to 1996. The ratio of reserves to imports of goods and services in developing countries remained between the range of 39.1 to 32.1 from 1987 to 1996. It decreased by 16% in 1988, experienced no significant change from 1988 to 1989, increased by 3% in 1990. Although there were fluctuations from 1991 to 1996, there was no change that exceeded 7% (See Table 8: Source: IMF).

The net credit and loans from the IMF to developing countries increased steadily from 1987 to 1991 by a total of 123%, and decreased from 1991 to 1994 by a total of 173%. For countries in transition, the net credits and loans from IMF increased steadily from 1987 to 1991 by 418% and declined thereafter. The total decrease between 1992 and 1994 was 41%. Overall, it could be said that the net credit and loans from the IMF to developing

countries and countries in transition had an upward trend from 1987 to 1991 and a downward trend from 1992 to 1994 (See Table 9: Source: IMF).

The amount of external debt of developing countries increased steadily from 1987 to 1996. Although there were mild fluctuations in the external debt of countries in transition, there was an overall upward trend from 1987 to 1996. Except for the mild decreases in 1989 and 1992, the amount of debt-service payments of developing countries increased steadily from 1987 to 1995. It declined slightly in 1996. For countries in transition, there were major fluctuations in the amount of debt-service payments from 1987 to 1996. In percent of exports of goods and services, the external debt of developing countries had a downward trend from 1987 to 1996. For countries in transition, except for the decrease in 1988, the overall external debt in percent of exports of goods and services showed an upward trend from 1987 to 1994. It declined in 1995 and 1996—although not substantially. Although there have been fluctuations, the overall debt-service payments of developing countries in terms of percent of exports of goods and services has had a downward trend from 1987 to 1996. For countries in transition the trend has not been that smooth. Although it maintained stability between 11.4 and 13.3%, there were significant drops in 1990 and 1993 (See Table 10: Source: IMF).

The overall ratio of external Debt to GDP for developing countries has had a downward trend from 1987 to 1996. Overall, the interest payments of developing countries has decreased from 1987 to 1996. There were mild increases in 1991, 1993 and 1995, but not significant. The amortisation decreased from 1987 to 1989 and remained stable in 1990. Thereafter it fluctuated (within a 20% range) (See Tables 11 and 12: Source: IMF).

The net capital inflows to developing countries and countries in Transition increased in 1991, dropped in 1992, increased in 1993, dropped in 1994 and increased again in 1995. The foreign direct investment plus portfolio investment (net) increased steadily from 1990 to 1993, dropped in 1994 and increased in 1995. The net foreign direct investment increased steadily from 1990 to 1995. The net portfolio investment increased from 1990 to 1993 and dropped in 1994 and 1995. The total net capital inflows of all other short- and long-term credits, loans, currency and deposits, etc., had major fluctuations from 1990 to 1995. It increased from 1990 to 1991, dropped in 1992 and 1993, increased in 1994 and 1995 (See Table 13: Source: IMF).

There have been fluctuations in the intraregional flows. They decreased by 13% in 1990, increased in 1991, and decreased in 1992. In 1993 it increased substantially by 192% and continued with an upward trend to 1995. The trend

of equity flows from Japan to Asian Developing countries remained between 24.40 to 22.70 billion dollars from 1989 to 1992, thereafter it skyrocketed. In 1993 it increased by 175% and the upward trend (but with mild increases) continued till 1995. Except for the decreases in 1990 and 1994, the equity flows from the rest of the world to Asian Developing countries had an upward trend from 1989 to 1995. The total equity flows to Asian Developing countries remained between 24.1 to 28.2 billion dollars from 1989 to 1991. It rose steadily from 1992 to 1995 with a slight drop in 1994. The equity flows from Japan constituted the bulk of these flows.

8. GLOBAL CAPITAL SCARCITY AND ALLOCATION

In the 1990s, increasing demands will be made for capital and when the supply of capital will be constrained for various reasons. Besides traditional demands for capital from the Third World nations, new demands will be made by the republics of the former Soviet Union and other Eastern European nations. Meanwhile, demands for capital in industrialised countries such as the United States and Germany will remain strong. The World Bank and the International Monetary Fund can help to mitigate potential capital shortages. However, they can only play marginal roles at best, and the major role must be played by the private sector.

In a broader context, the question needs to be raised whether it ever makes sense for banks to shoulder a substantial responsibility for financing long-term international capital transfers. Banks in the main have very short-dated liabilities with interest rate costs that fluctuate widely over a business cycle. Floating rate financing may very well mitigate the problem of rising liability costs to the bank, but it will surely contribute to the problems of marginal borrowers. Moreover, in a market system, it hardly seems advisable for a bank to put itself in the position of extending credit to official borrowers abroad, with the near certainty that, if there is a problem somewhere down the road, the bank will be largely dependent on its own government to negotiate on its behalf with other governments. Privately-owned banks ought to confine their activities to market conditions where legal equality is the operative norm. Other private sources of funds, essentially major multinationals will increase their exposure internationally. Over time, they will make sizeable direct investments, particularly in Eastern Europe.

The 1990s could become a decade of international equity rather than of international debt. The Achilles heel of the past resource transfers to Eastern Europe and most developing countries was that the financing took the form of debt, with lending margins that were little different from those available on

loans to corporations of high credit quality, but with risks that were equity-like in virtually every one of those countries. Hence, it is simple logic that future financial resource transfers must take the form of equity-related instruments, and that means yields to permanent investors must be equity-like as well.

By process of elimination, the main untapped source of financing for the developing countries and the emerging economies of Eastern Europe and the former Soviet republics is the risk-taking equity investor. Realistically this cannot be the retail investor who has little or no interest in investing anywhere but at home. Therefore, it can only be the large institutional equity investor from the industrial countries--corporate pension funds, other retirement funds, investment companies and other specialised financial enterprises, and insurance companies--which must be attracted to unconventional equity investments. That will require time and fundamental change by those countries which would like to see a sizeable transfusion of foreign capital to speed their economic development and some important changes in the industrial world as well.

First, there needs to be moderate economic recovery in the industrial countries that are now in or near recession and continued moderate expansion in the rest. Too rapid a rebound, rightly or wrongly, will incite inflationary concerns; interest rates will be pushed up by financial markets; and the relative attractiveness of foreign investment will diminish.

Second, there needs to be a pronounced change in the composition of expenditures in many countries. Most importantly, military spending needs to be de-emphasised globally. Reductions in military spending are required to help achieve budgetary balance in the developed countries. The resources, both human and physical, that are devoted to weaponry need to be made available to the civilian sector, where they can help enterprises achieve higher rates of return on capital.

Third, there needs to be a continuing process of rehabilitating the financial health of deposit institutions. This includes regulatory reforms and capital infusions into marginally capitalised banks. It also would be helpful to have a continuation of a positively sloped yield curve, which provides opportunities for banks to increase their earnings by taking modest interest rate risks, rather than having to absorb additional credit risk.

Fourth, the developing countries have a lot of work to do in making the transition to a market-based economy. This includes establishing a reliable legal system, including a reasonable bankruptcy law, dependable and

transparent accounting standards, adequate protections of the right of an equity investor to sell his position or repatriate dividends, and a host of supportive regulatory codes.

Finally, an atmosphere of capital scarcity will force the world's credit system onto a sounder footing. There will be less abuse of the credit structure when credit is harder to come by and the tolerance for financing marginal investors is reduced. Credit allocation will be based more on disciplined analysis and objective evaluation of creditworthiness than on what the levels of fees were and how much the financial intermediary could take out of the deal for itself.

It is worth bearing in mind that many countries have been able to achieve highly satisfactory rates of economic growth without relying on access to large amounts of foreign capital. What is necessary is a framework of law, institutions, government policies, and social attitudes that reward effort, promote change, and rely on markets. But access to moderate amounts of foreign capital does provide clear benefits: One, it allows a country to let its consumers enjoy a better living standard, even as it maintains a high rate of business investment, and this can have a definite impact on motivation and the willingness to work hard. Two, it allows domestic businesses to leapfrog the level of technology that they might otherwise have had to settle for. And three, it helps keep a lid on inflation while these positive developments are taking place. The trouble arises when the foreign capital comes in too readily, in unsustainably large volumes, and in the wrong form.

9. THE DEMAND AND SUPPLY OF GLOBAL BOND AND EQUITY MARKET

The rapid shift to a global securities market is a result of two major trends that accelerated through the 1980s and are set to continue into the next century. The first is a significant increase in the demand for a global securities market. The key source of this demand is the pool of institutional assets which have grown exponentially and have diversified internationally. The second is deregulation which has opened up the world's economies and securities markets, increasing the breadth and depth of investment opportunities.

The expected growth in the global pension fund industry is staggering. According to the InterSec Research Group, a US pension consultant, global pension funds will top \$11.2 trillion in assets by the end of 1999, an increase of 59% from the \$7 trillion at the end of 1995. International investments will form the largest part of that growth, more than doubling to \$1.7 trillion from

\$788 billion last year. To put this in perspective, international growth represents a 464% increase from \$302 billion invested outside domestic markets at the end of 1989.

Much of the increased commitment to overseas investment has and will continue to come from the major pension markets, given their dominant size. The US, Japan and UK pension funds, for example, accounted for 80% of total global pension assets last year, with total assets of \$5.7 trillion. US pension assets alone (\$3.76 trillion) accounted for 53% of global pension assets. These assets are set to grow sharply, particularly as a result of changing legislation covering state funds in Europe. In addition, as a result of ageing populations in the Western economies, there will be a rapid rise in the private provision of pensions forcing individuals to invest in markets for the first time.

But it is not so much the growth of pension fund assets that is creating the global market place, rather the decision to diversify pension assets overseas. A geographically diversified portfolio has a superior risk/return profile to single country portfolios. It is widely agreed amongst the actuarial profession that a 30% diversification to overseas assets gives the maximum benefit of risk reduction, irrespective of base country. Of the major pension industries in the world, only the UK is near to this target at 28%.

While InterSec expect British pension funds to keep overseas investments at around 28% of assets, they expect a significant move into foreign markets by US and Japanese funds. US pension funds have more than doubled their international investments over the past five years. These investments are expected to increase further from 8% of assets in 1994 to 12.5% by the end of 1999. This would increase overseas funds to \$725 billion from \$300 billion, 19.3% compound growth rate during the period.

In Japan, foreign investment has contracted because of the combined effect of the collapse of the local equity market and the weakness of the US Dollar. Overseas investment by Japanese institutions is expected to triple to \$252 billion from \$85 billion last year over a five-year period ending 1999. A surge in foreign investment by Japanese public pension funds, triggered by the liberalisation of pension rules by the Japanese government, will be a major factor in the funds flowing into international investments.

The process of deregulation has been led by a massive wave of privatisations and international equity offerings over the last ten years. The trend towards privatisation both boosts the liquidity and market capitalisation in individual markets as well as raises the scope for cross-border investment.

The UK's success with its privatisation program has encouraged state sell-offs elsewhere in the world. The increase in shares of privatised corporations around the world has raised the liquidity of the global capital market and the interest by investors in them. The deliberate underpricing of most issues has helped the markets' willingness to accept privatisation issues. Privatisation, which involves international distribution, is intensifying the development of the global market. The process includes a wide marketing effort to investment institutions. Moreover, the trend towards privatisation is not restricted to the major economies. Despite the collapse last year in the Mexican market, the enthusiasm for privatisation issues from Latin America, Asia and Africa has been undiminished, while investors' long-term belief in these markets remains intact. In 1994 governments from emerging markets raised a total of \$17.6 billion, about \$2 billion more than in 1993.

Privatisation has led to an increasing tendency for investors to look at the world in terms of large global industries and to compare stock valuations across markets. Privatisation has given the world markets large telecommunications and electric utilities to trade in and compare, while deregulation and the increase in world trade has put them, and other industries such as steel, mining, pharmaceuticals and oil, into competition with each other, in what were once their own protected markets. It is, therefore, increasingly possible to compare Thyssen with British Steel or Roche with Eli Lilly and view them as competing investment alternatives. This focus on global industries is, of course, also making it easier for large multinational companies to raise both debt and equity on stock markets across the world, rather than concentrating on the market where their main listings lie.

In addition to the growth in the international equity markets, there has been a significant expansion in the sources of international debt finance. For example, total net issues of Euronotes and international bonds soared by 45% between 1993 and 1994. Announcements of new Euro-securities surged to \$197.2 billion last year. Despite the rise in world interest rates in 1994, announcements of international bond issues were still equal to \$372 billion last year.

The growth of financial derivative instruments has benefited global markets by providing liquidity to institutional investors and facilitating portfolio construction. A major shift between countries can be made cheaply and quickly through the futures markets, without having to sell the underlying securities.

Improvements in infrastructure, the regulatory environment and information technology are rapidly being put into place in order to facilitate the increasing free flow of capital around the world. This is essential if the trends of the last fifteen years are to be continued.

A key barrier to the development of a global capital market is the multitude of different accounting standards. That has meant accounts prepared in one country are frequently difficult for investors in another market to comprehend. Eliminating such barriers will stimulate capital flows through the improvement in investor confidence.

In July 1995, an agreement between IOSCO, the International Organisation of Securities Commissions, and the International Accounting Standards Committee (IASC) was a significant step towards creating a unified global accounting standard. It is hoped that by 1999, companies preparing their accounts according to IASC rules will be able to list their shares on any of the world's capital markets. More importantly, they will be able to list their shares in the US, gaining more immediate access to the world's biggest capital market, without adapting to stringent US rules. Unlisted American Depository Receipts (ADRS) have, until now, been the only way most non-US companies have of tapping the US market.

Governments have played a key role in the development of a global securities market by opening up their markets to foreign investors. The most important development was the wholesale removal of exchange controls in the 1970s and 1980s. The process of liberalisation continues.

Authorities in a number of countries continue to deregulate their domestic bond markets and facilitate access by domestic companies to Eurobond financing. Measures taken in domestic markets have generally been designed to improve efficiency, liquidity and cost-effectiveness for resident issuers and to make the markets more attractive to foreign investors. For example, in Italy the stamp duty on the regulated trading of government bonds was removed; in Portugal the 20% withholding tax imposed on foreign holders of government bonds was abolished and non-residents are allowed to issue on the domestic market without requiring official permission; in Switzerland the authorisation requirement for foreign issuers was lifted in February 1995. In Japan there have been widespread initiatives to remove the restrictions on foreign issues of Euro-yen bonds while about \$200 billion of public pension funds have been opened up to foreign investment advisers.

Capital Requirements for market operators (brokers, banks, etc.) are being stepped up in many countries. The norm is to use Bank of International Settlement guidelines. This encourages major international investors. Listing Qualifications increasingly seek to meet international criteria in terms of financial history, share capital structure and liquidity, etc., though efforts have been made to create simpler qualifications for small companies. Compliance with new insider trading and market manipulation rules is being enforced. Market operatives are being required to pass professional exams to ensure compliance with best practices, and thereby helping to create universal professional standards and greater transparency. Membership of exchanges is increasingly being opened up to foreign participants.

The technological revolution, aided by information services such as Reuters and Bloomberg, is rapidly improving the dissemination of financial news and the exchange of information around the world. Other developments in CD ROMs and interactive communications systems will also facilitate international communications for financial services.

Screen-based trading systems are not only leading to the demise of traditional trading floors, but also opening up the possibility of direct access to markets from overseas locations. For example, a new electronic trading system is being introduced on the Chicago Mercantile Exchange (CME) in 1996. The Globex system has been developed in conjunction with Reuters. The CME has heralded the advance of Globex as the benchmark for the industry, and has made an effort to sign up other exchanges in a bid to turn Globex into an industry-wide network. The LIFFE electronic system, APT, has so far been used to extend the trading day on the London Futures Exchange. Although only currently used for an hour and half a day, it is likely to be extended to replace the floor system.

At the end of 1993, a new electronic trading system, "Bridge", was established between Cedel and Euroclear thereby eliminating a time delay between the delivery of securities and payment for them. With the move to electronic overnight processing, Cedel can settle trades with Euroclear on the same day.

Such developments will clearly contribute to improving the access of exchanges to investors around the world, as well as to providing global 24-hour trading. They will also bring considerable savings in transaction costs as well as improving processing speed and accuracy and market liquidity.

An important factor that promises to ensure the continued growth of international investment is the increasingly sophisticated custodian and settlements practices. Improving standards are being fuelled by international regulatory drives and technological advances. In the UK, the move to a five-day settlement halves the previous settlement period. The US runs a five-day settling settlement; Japan three days; France three days and Germany two days, while the situation in emerging markets is tougher. Swifter settlements is a world-wide trend stimulated by the desire to reduce the risk of failed trades and by the rapidly growing number of securities in issue. There are likely to be more improvements in the future. Taiwan, for example, settles on a T+1 basis now.

Coupled with improved settlement practices, the growth of custodial and settlement agency facilities is increasingly being restructured and dominated by a handful of global banks, such as HSBC, which have the international reach and technological capability to handle the massive increase in this business. The benefits of such concentration include greater efficiency, security and lower costs. To institutional investors, however, the greatest benefit is the knowledge that even in some of the world's more exotic emerging markets, their trades will be settled.

The success of American Depository Receipts (ADRS) in encouraging international companies to raise capital from US stock markets is well known. They enable companies to access foreign capital while giving US investors an ability to settle trades and receive dividends in their home market and currency. Global Depository Receipts (GDRS) are a new form of this type of instrument, increasing the potential for raising capital and liquidity. Typically, GDRs are issued to facilitate a London or other European listing, but priced in dollars in conjunction with a local equity issue. The convenience of trading GDRs is popular with investors and will therefore grow in importance. This may, in part, substitute for trading on local exchanges, as has been the case in Latin America. If that continues to happen, the fear of losing trading business to off-shore exchanges can only spur local stock markets in developing countries to reforms that make their markets more attractive for international investors.

10. SUMMARY, CONCLUSIONS AND IMPLICATIONS

Expanding global capital markets have brought many benefits to both the developed and developing nations. However, global capital markets also have produced various shortcomings. The emerging new world order should face these difficult shortcomings, which centre on problems such as the potential

for financial instability; the lack of international “rules of the road” in key areas; the inability of national regulators to keep pace with certain financial innovations; the tendency of many institutions to take on high debt levels that are not prudent; and the reality that international economic agencies sometimes lack a clear mandate or mission. Added to these are the issues of capital shortages and the plight of the Third World.

During periods of global economic stability, such as the 1950s and 1960s, international finance has contributed significantly to economic growth. Within the total flows of capital to developing countries, shifts from equity to debt financing and from official to private sources were to be expected. As developing economies grow and their structure change, their relations with the world economy increasingly resemble those of the industrial countries. As industry expands, as exports shift from primary to manufacturing products, as the domestic financial system matures, so developing countries increase their ability to exploit opportunities in international financial markets. However, the flow of private external capital to developing countries did not increase slowly, in line with their economic progress. It expanded suddenly in the 1970s and was accompanied by unprecedented imbalances in international payments. The potential for using foreign capital to expand investment was therefore limited by the immediate need to pay for dearer oil.

Emerging market countries have been prone to banking problems; the problems have been costly, and they have the potential to spill across national borders. Hence, the extension of international supervisory arrangements to include emerging market countries is important not only to safeguard the stability of the international financial system, but also to increase the effectiveness of the surveillance over domestic banking institutions in emerging markets. The growing internationalisation of the financial sectors in emerging market countries—including increased access to offshore derivative transactions for the purpose of blunting the impact of domestic financial regulations—also implies that a supervisory approach with a national focus will be inadequate. Furthermore, the extent to which the emerging market countries will be integrated into the international financial system will depend largely on their success in raising supervisory standards and the risk-management capabilities of internationally active financial firms to international standards.

Closer integration of the supervisory authorities in emerging market countries into a co-operative international arrangement for the supervision of international banking markets would have at least five main benefits: it would facilitate the surveillance over international banks on a consolidated basis a necessary condition for the effective supervision of the banking sector; it

would facilitate a broader and more intensive exchange of relevant supervisory information; it would create a co-operative atmosphere helpful for the quick resolution of financial crises; it would provide the emerging market countries with an opportunity to have their views reflected in the formulation of international agreements in the supervisory and regulatory area; and membership in an international arrangement and the possibility of being identified as not being in compliance with international standards would provide increased authority and incentives for supervisors to achieve a timely and credible implementation of internationally agreed regulatory and supervisory standards.

A number of conclusions can be drawn on the impact of globalisation on the capital and financial markets of the developing countries. First, the underlying financial problem of the world is in its scope: it is the problem of too much debt and too little equity. It is as much of an obstacle to adequate capital formation in the advanced Western countries, including especially the United States, as it is in Eastern Europe and in developing countries elsewhere.

Second, relying primarily on more debt to finance the physical capital needs of the emerging economies is mistaken and will not succeed in supporting either higher levels of capital investment or greater economic efficiency. What will be successful are significant capital transfers that take the form of equity. But an emphasis on equity investment carries with it preconditions for the recipients as well as the providers.

Third, the major commercial banks will play a supporting role but not a leading role in facilitating global transfers of financial resources. They will not resume large-scale balance of payments lending during the decade of the 1990s, to the former Soviet republics or anyone else, unless they can pass the risks onto their governments or onto one of the multilateral official lending institutions.

Fourth, whether there is a useful shift toward equity financing or whether financial flows stay mainly in the form of debt, financing of looming capital needs will almost surely involve some degree of regional specialisation. European investors will focus on Eastern Europe and the former Soviet republics. The Japanese will concentrate on east and Southeast Asia. The US investors will lean somewhat toward investing in Mexico and the rest of Latin America. This greater regionalism in finance may provide certain benefits. Investment decisions are apt to be better when they are made by investors who are committed to a particular market and who are prepared to do whatever is necessary to gain an intimate insight into the workings of the enterprises in

which they invest. But there will be a policy challenge to keep financial regionalism from justifying a departure from the liberal, multilateral environment for world trade that we all benefit from.

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