INTERACTION COUNCIL

REGULATING THE GLOBAL FINANCIAL MARKET

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InterAction Council's 13th Session

May 22-26, 1995
Tokyo, Japan

Ladies and Gentlemen:

First, I would like to thank our Japanese hosts for the excellent organization of the meeting and the hospitality extended to us.

It is a great pleasure for me to be here in Tokyo today to discuss with you the challenges facing the global financial market, such as free capital mobility, speculation and the tendency of the market toward excess volatility.

I will concentrate my remarks on challenges and concerns rather than on the benefits of free capital mobility. Allow me also to say at the outset that to my mind the challenges have more to do with the coordination of national economic policies to achieve stable economic performance than with speculation and volatility as such.

1. Financial market volatility which cannot be fully justified by the underlying economic fundamentals is harmful.

First I would like to note some basic facts about growth, wealth and welfare. As we all know, people are constantly seeking to enhance their welfare. Without taking a view on whether this is good or bad, an increase in wealth and welfare seems to require economic growth, that is more investment, production and trade. Investments increase production capacity and possibilities. Comparative advantages in resources, knowledge and experience induce people and nations to specialize and to trade with each other.

At the micro level there are always two parties in every transaction, essentially two persons or companies that are buying and selling something. These parties may speak different languages or live in different places on earth. However, such differences should have nothing to do with the possibility or the price of a transaction; they do not call for restrictions or obstacles. Theoretically speaking, boundaries, which are erected, among other things, to collect money for public spending, to maintain uncompetitive economic structures or to restrain free mobility of information, are eventually harmful for every party. Every step toward effective production or free trade is a step toward greater growth, wealth and welfare.

In this sense every effort to remove obstacles to free movement of commodities, labour or capital is desirable. Indeed, the General Agreement on Tariffs and Trade has been negotiated and the mobility of labour has been enhanced for instance, within the European Union; but the greatest advances have been made in the freeing up financial markets. Innovations in new markets and institutions and in computing and communications technologies have contributed to an astonishingly rapid increase in financial transactions. Today, after 10 to 15 years of financial deregulation, we can consider the financial markets to be perfectly competitive. We have set a target and we have managed achieve it. The case is closed. Or is it?

If we have managed to liberalize the financial markets in order to increase trade, production and, ultimately, the welfare of people, why are we now discussing the possibility of reregulating the global financial markets? Does not unrestricted arbitrage ensure globally identical prices for a given asset? Does it not ensure effective pooling of risks? Does it not ensure that new saving is allocated to the world's most productive investment outlets?

I understand that the frequency of recent speculative attacks against major currencies, coupled with the view that in some cases the attacks could not be fully justified by the underlying economic fundamentals, has led to growing concern. Some commentators argue that the financial markets are dominated by short-term speculators whose collective actions may generate unnecessary volatility and move market rates away from levels consistent with underlying economic fundamentals. In the extreme case, this may distort the efficient functioning of those markets, as they contend.

Given all this, there have recently been demands for a return to tighter financial market supervision and control. For instance, the introduction of a non-interest-bearing deposit requirement on net foreign exchange positions and a tax on gross transactions have been proposed. When applied to a broad range of financial transactions, it is argued, these measures would raise the cost and, thus, reduce the volume of short-term speculative trading, which reflects only irrational investor behaviour. This should reduce excess volatility, encourage greater focus on the longer-term economic fundamentals and further improve the efficiency of the financial markets. The expectation is that rates or prices would more closely track fundamental values. With less volatility and risk, therefore, the cost of capital would be lower and investment spending higher and more efficiently allocated.

2. Only wide-ranging and tight multilateral capital controls are effective in reducing volatility.

If the solution for avoiding excess volatility is such a straightforward one, why have deposit requirements or transaction taxes not been widely introduced? One reason is that only wide-ranging and tight multilateral capital controls are effective in reducing volatility. In other words, even if we had a strong will to reduce the volatility of the financial markets, we would no longer necessarily have the power to do so.

First, numerous innovations in computing and communications technologies, together with the considerable amount of time, money and human intelligence invested, have resulted in an ever - increasing number of exotic financial instruments. They are being developed to allow firms to operate internationally without exposing themselves to undue risk of exchange rate changes. Had there not been a demand for them, they would not have been developed in the first place. As always, history cannot be changed and useful innovations cannot be dis-innovated.

The idea and elegance of the new instruments is that one transaction can be mimicked by a combination of other transactions. As investors always try to avoid extra costs, they probably try to avoid the costs of a transaction tax or a deposit requirement as well. If the controls are not complete, investors can switch from taxed to non-taxed or from highly taxed to lightly taxed transactions. And furthermore, if taxes cannot be avoided by using existing instruments, they will be circumvented through the immediate development of new instruments.

For example, if spot exchange transactions are controlled by a transaction tax or a non-interest-bearing deposit requirement, speculators can always switch to derivatives, which offer a wide range of possibilities for taking a speculative position. Derivatives markets are linked to spot markets, and, in one way or another, speculation in a derivatives market can always be translated via arbitrage or hedging to the spot market. As a result, a tax can be avoided and the speculative activity remains unaffected.

(It must, of course, be remembered that although derivatives have facilitated speculation at low cost, they have on balance improved the stability of the financial system by unbundling and transferring risks to those entities best able to manage them. Needless to say, derivatives and other new financial instruments pose regulators and supervisors considerable challenges. They have led authorities to consider profound changes in the way banks are supervised and regulated, as evidenced in the latest proposal addressing market risk and bank capital by the Basle Committed on Banking Supervision.)

Secondly, our power to limit short-term speculative activity is restricted by the absence of simultaneously applied global measures. Even extensive controls covering every possible spot, forward or derivative transaction are ineffective if they are imposed only at the national level. National efforts to control capital mobility will cause an immediate shift of foreign exchange transactions over the border to another country or to some off-shore centre. As a result, the transactions are carried out by international banks or by the subsidiaries of national banks. Again, as in the case of limited regulation, controls are evaded and speculative activity remains unaffected. The ensuing growth of the euro-currency market in the 1950s and 1960s serves as a good example of this effect.

Furthermore, if national controls are comprehensive enough to cover the operations of the subsidiaries of domestic banks, the only real result of the controls is that the transactions are carried out by other banks while the national banks are completely excluded from the foreign exchange business.

Thus, in order to be effective multilateral controls should apply to all jurisdictions. A multilateral organization should be established to administer the global measures and to supervise national regulatory authorities. Such an organization should have the authority to levy sanctions on countries that fail to comply with the agreed measures. Although we have some encouraging examples of effective international organizations of this kind, the GATT for example, I very much doubt, that it would be possible to agree on the measures, organizations and sanctions necessary to control the global financial markets. So far, the human capacity to develop imaginative financial instruments has proved to be unbeatable.

3. **Because of the resulting decrease in world trade and, hence national welfare, the real cost of effective control is high.**

Another reason why deposit requirements or transaction taxes have not been widely used is that the real cost of effective control would be very high. Actually, even if we had all the necessary means to reduce the volatility of the financial markets - that is, extensive and tight multilateral capital controls - we would not necessarily want to use that power because of the real costs involved.

It is obvious that transaction taxes and deposit requirements would not only affect foreign exchange speculation, but also seriously limit financial operations and the risk hedging associated with foreign trade. Effective controls would increase operating and hedging costs for all economic agents. Since operators in foreign exchange would have no reason to carry the excess burden alone, a wider bid-ask spread would result and this would be borne by all investors, both short-term and long-term. Furthermore, effective controls would affect stock prices negatively since controls decrease the stream of income, on which the price of a security depends. This in turn would increase the cost of capital raised through issuing shares. An increase in the overall cost of capital would eventually reduce the volume of investments.

Although short-term speculative transactions would be the target of all controlling measures, it is in practice impossible to penalize them without affecting the longer-term transactions associated with normal hedging against exchange rate changes in foreign trade as well. Speculators cannot be hurt without simultaneously affecting other economic agents. Some analysts even conclude that, in the absence of total regulation, controls will almost certainly be evaded by those for whom they were meant. The dead weight costs will instead fall on those involved in regular commercial transactions.

Thus, the only real result of reregulation of the financial markets would be a worldwide decrease in investments, production, trade, and hence in welfare. The results would be just the opposite of those intended. Furthermore, as the cost of capital would increase, the refinancing cost of debt would also increase, which would ultimately hit the indebted industrial countries and especially developing countries.

4. The most sensible way of reducing financial market volatility is to remove the causes of volatility by increasing global economic policy coordination.

But if capital controls are not a viable alternative, what can be done to reduce excess volatility in the financial markets?

In Finland we have a saying that goes something like this: Do not blame the mirror if your face is twisted. In this case one could say: Do not blame the speculator if you are not able to pursue sound economic policies. In other words, speculation and volatility in the financial markets are basically reflections of unsustainable economic policies at the national level and of uncoordinated economic policy at the international level. As we have experienced lately, even the currencies of countries with sound fundamentals have been subject to speculative attacks. In such instances only international cooperation, for example in the form of unlimited intervention commitments, can provide the necessary safeguards.

At best, international cooperation should stretch into the economic sphere. However, this is, as we all know, no easy task. Fortunately, we do not need 100 per cent participation of countries in economic policy coordination in order to achieve good results. I am sure that if the major economic powers were able to agree on wide-ranged coordination in a credible way the rest of the world would have every incentive to join in that cooperation and enjoy the benefits of the more stable economic environment that would result. To sum up, I believe that the most sensible and feasible way to reduce financial market volatility and remove the ground in which speculation thrives is to conduct economic policy aimed at stability at the national level and to develop the international economic cooperation that is lacking today.

Thank you!