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The End of Globalism

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Introduction

For those following the 1999 summit meeting of leaders from industrialized countries in Cologne, discussions on the Kosovo conflict and Yugoslavia were of primary interest. Japanese authorities, on the other hand, watched anxiously to see what affect the unexpectedly good economic growth figures for the first quarter of fiscal 1999 would have on the rest of the world. A finance ministers' meeting was also held in Germany, prior to the summit, which, as such meetings always do, produced a with communiqué ambiguous wording. I am sure many read this communiqué wrapped in deep thought.

The finance ministers' communiqué has provoked this paper, which will review several points that I have often commented on, and will also muse on the theme of financial "globalism," which has been a constant message from the leaders of the international financial and monetary community throughout the 90s.

Necessity of Regulating the Flow of Capital

The finance ministers communiqué cited the following points as major issues

in reforming the international financial system:

- Reforming the international financial institutions; involving reorganization and restructuring of the IMF.
- Enhancing transparency; related to statistics announced by the IMF.
- Strengthening financial regulations; this portion discusses the risk management of banks and information disclosure by hedge funds.
- Improving crisis prevention and management involving the private sector; concerning, among other things, creation of new IMF contingency credit lines and a framework for the private sector's involvement in crisis resolution.

In addition, the finance ministers have reportedly discussed supervision and control of short-term capital flow, to strengthen economic policies and financial systems in emerging markets. According to the published communiqué, there were expressed opinions acknowledging market-friendly regulations as exceptions to this.

Following these arguments, I cannot but be amazed by how many things have happened over the span of a single year. From early to mid-1998, the popular analysis of the Asian economic crisis was that Asia was “doomed” to face a crisis because “Asia was Asian.” This argument was heard most loudly in May 1998, during the political turmoil in Indonesia. The crisis then spread to Russia, and made it around the globe to Brazil by the summer.

In the course of this turmoil, we witnessed different degrees of flight-to-quality in all the markets of the industrialized countries, resulting in an expansion of the gap between the yields of the more credit-worthy issues, like government bonds, and more general investment issues. Hedge funds suffered as a result, and there were cases where central banks mediated emergency loan syndication as a rescue measure.

A comment by an eminent American economist which left me with a lasting impression. Addressing private financial institutions, he said on a television program that: “Preserving the current credit and loan balance is the way to avoid the deterioration of your assets and ultimately to save yourselves.” This comment was made in the context of discussing the situation in Brazil, and left such a strong impression because of its contrast to what he said on the Asian crisis. Previously, when asked to comment on the situation in Asia, he said that it had been hit with a crisis because countries there had been managing themselves and their economies in ways that were not acceptable to the market, and that the market was therefore punishing them.

The argument that can be deduced from these comments is that it is rational market behavior for private capital to react with a herd mentality and withdraw completely from Asian markets, but, conversely, it is a suicidal act to withdraw from Latin American or Russian markets. It is difficult to accept this.

The IMF was also very discriminatory in its application of policy. Under the banner of reform, it pushed even for some structural changes that were unsuitable as short-term policy, and, as a result, worsened the situation. When the IMFs policies were not carried out by a borrower country, it announced that no further loans would be extended, which unnecessarily undermined the credibility of that country in the market. A result of this policy was the overshooting of currency values on foreign exchange markets, drastically weakening the currencies of Asian economies. The social cost of such a phenomena was huge.

The new IMF contingency credit line mentioned in the finance ministers' communiqué was created for and extended to Brazil. If the IMF had extended the same scheme to crisis-afflicted Asian countries, and had private financial institutions had maintained their credit lines, I am sure the Asian crisis would have followed a completely different course. The explanation for extending contingency credit to Brazil but not to Asian countries was that Brazil had been extensively consulting the IMF and World Bank, thereby making it unnecessary to apply any strict conditions. But wasn't it the World Bank that reported in the early summer of 1997—only half a year before the crisis erupted—that the Indonesian economy was managed exceptionally well, and that there was no concern for the foreseeable future?

Dato' Seri Dr. Mahathir Bin Mohamad, Prime Minister of Malaysia, poses a question in his Budget Message for fiscal 1999 as to whether the policy of the Federal Reserve Bank of New York regarding the Long Term Capital Management issue was not a form of cronyism. He asks what the American authorities would have said if the same policy were applied in Asia. He certainly has a point. We cannot help having the same sense of frustration with IMF policies and comments by economists from private institutions.

Discussions on the Regulation of Short-term Capital

Further points of interest in the G-7 finance ministers communiqué are the discussions on hedge funds and policies on emerging economies. Considering the fact that many emerging economies were extensively affected by hedge funds,

the two issues can be discussed together.

The excitement raised by and attention bestowed upon hedge funds as being at the cutting edge of high-tech operations may be characteristic of the 1990s. Hedge funds began operation by creating a speculative position several times larger than their original capital, such as in foreign exchange futures trading, and accumulating gains when the speculation was correct. This began attracting interest because the profit generated was disproportionately large, when compared to the capital. In the autumn of 1992, hedge funds proved their potential when they took advantage of the distortion in the European Monetary System, and initiated confusion in the foreign exchange markets.

They were confident that they had calculated every possible risk, and had created an operation that would always create gains without any risk, with the help of Nobel Prize winners. Inevitably, such an operation does not bring huge gains, so they proceeded to create huge positions in order to increase them. What enabled such funds to carry out operations of huge magnitude was the investments by groups of banks called “ money-center banks."

Hedge funds were created on the basis that they would operate without being bound by previously accepted rules and customs, and so were usually established, at least in name, in some small country in the Caribbean. Although problems related to the transparency—or the lack thereof—of hedge funds had been discussed among the well-informed, there was no way to regulate them in an official way, as they were regarded as a form of private investment trust fund. When the rescue operation by money-center banks was carried out with the mediation of the Federal Reserve Bank of New York last autumn, a small part of the picture was revealed (partly as an explanation to bank syndication), and we came to have a vague idea of how they operate.

Every time there was an argument for regulating hedge funds, counter-arguments arose from the United States, and the money-center banks would drag their feet by pointing out the technical difficulties created by the question of the nationality of these funds. This time, however, we are witnessing more serious arguments. This is perhaps because the crisis is seen as not just regional, but global, and the US is beginning to realize that the markets of industrialized countries cannot be immune from the consequences.

I am very skeptical as to whether these hedge funds will be required to have the same level of transparency as is demanded of financial institutions of crisis-stricken Asian countries. I am led to believe, from the rather reluctant American

attitude displayed so far, that such will not be the case.

Let me make one point clear: Regardless of where their registered nationalities are, and regardless of whether that country has any form of financial supervision or regulation, it can be said that the real nationality of these private trust funds is the United States. This is because all the players involved are American nationals. First, there are the subscribers to the hedge funds (even officials responsible for government regulatory bureaus are said to have been among them). There are also the financial institutions which have lent several hundred times more than the total subscribers capital, in effect helping the hedge funds to create speculative positions thousands of times larger than the total subscribers capital. Then there are the executives who were responsible for fund management. They calculated the ways to avoid risk, raised funds, and created speculative positions with those funds. All of them are American nationals.

Keeping in mind that these hedge funds were one of the sources of confusion and turmoil (in some countries these hedge funds were the direct cause of the crisis; they themselves became victims after the autumn of 1998), we must keep a close eye on future US policies. We must insist on more stringent policies towards hedge funds, until there are adequate supervisory and regulatory measures in place which are then revealed in acceptably transparent manner.

I would like to refrain from an extensive discussion on regulating short-term capital, since I have already discussed the same subject (as well as the supporting arguments and prospects of effective regulation) in another article[1]. Instead, I would just like to touch upon the aspects that are not covered in that article.

First of all, I would like to comment on “market friendly” regulation. In Japanese, it is translated to mean “market-oriented,” of the type applied in Chile.

The Chilean type of regulation relates to the achievement of a near-impossible “holy trinity” of deregulation of capital transactions, stabilization of national currency against the US dollar, and sustainability of an independent monetary and interest rate policy. Regulations were devised to stop the flow of foreign capital into Chile, which would be free of any foreign exchange risk (i.e. a free ride) as long as this“ holy trinity" is maintained. These regulations are designed so that non-interest-bearing deposits against foreign capital flows into the Chile must be maintained with the central bank, with a higher reserve requirement ratio when

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[1] Shinohara, Hajime; Regulating International Short-Term Capital; The Quarterly Review (No. 3, 1998); The Asia Friendship Association

the sojourn period is shorter. The rationale for this is that foreign capital inflow aiming for a gain from interest rates while enjoying a free ride on the foreign exchange will lose incentive once the net yield (i.e. interest gained from foreign capital, minus the reserve requirement cost) equals the cost of capital in foreign currency such as the US dollar. The term "market friendly" is perhaps meant to reflect the fact that the recipient country only controls the reserve requirement ratio against the flow of foreign capital, while the rest is left to the market, which will determine capital flows by its own calculation. On the other hand, regulation is not regarded as market friendly when capital transactions are placed under strict laws, as was previously the case in Japan and still is in China and Malaysia.

Reflecting on this thinking for a while, it is easily observed that there is no capital regulation which is by nature "market friendly." It is clear that as long as the market seeks complete freedom and national treatment, any regulation, in whatever form, is anti-market. Consequently "market" friendly regulation in effect includes indirect criticism of direct capital controls, which could be taken as criticism of Malaysia or China. I believe it is well within the sovereign right of a nation to protect itself from the unrestrained rampages of irresponsible international short-term funds, and a country should choose the form of regulation best suited to it.

It is also worth noting that it was George Soros who first suggested that regulations on capital transactions be imposed, especially in capital-importing countries. Since we do not know what his fund did or did not do, we cannot be sure of his true intentions. It may be that he had a concern that the Asian countries, which were later hit by the crisis, were in haste to implement tangible measures towards liberalization, almost inadvertently following Wall Street's demand for liberalization and market deregulation based on the so-called Washington Consensus.

It must have been very easy for the fund managers of hedge funds to take advantage of such naivet on the part of some Asian countries and collect huge profits. Different fund managers took advantage of the situations in different ways and in different countries. Some may have aimed at high interest rates prevailing in some countries, while also enjoying a free ride on the foreign exchange risk. Others pumped funds into the stock market, creating a stock price bubble. Still others may have borrowed the local currency of a targeted country in off-shore markets, sold it in the domestic market of the targeted country, and created speculative positions.

Of course, it was not only hedge funds tried to gain profit in such ways. On the contrary, the role of hedge funds in the Asian crisis was reportedly limited. The key players were commercial banks with extended international operations, corporate investors, and the usual investment trusts.

Market deregulation became of prime interest to international financial institutions. As if to speak for them, international organizations propounded deregulation as their basic policy. Deregulation was also pushed at bilateral or multilateral meetings. In the 1990s, the key targeted area for deregulation was financial markets, supported by what seemed on the surface to be a very rational explanation: that market deregulation would bring about the most efficient allocation of funds which global markets promise, and thus countries will therefore be able to achieve the most efficient economic growth with market deregulation. Many countries, however, failed to examine carefully the dangers hidden behind these words. They deregulated their financial markets, providing a playground for massive amounts of foreign capital, and were able to achieve high economic growth due to its inflow.

Where Has the Voice From Heaven Gone?

As expansion of trade and foreign direct investment eliminated the notion of international borders, globalization became the buzz word. The word "globalism," with an ideological connotation, was created out of this context. Globalism in the trade and investment sectors often went hand-in-hand with production in the real sector by subsidiaries of foreign corporations. Asian countries benefited from such production because it provided an incentive to creating better manufacturing and social structures. Further, we may even say that Asia was the most globalized region in the world. Compared to other regions, where there are exclusive preferential tariffs and trade benefit arrangements, Asia is the only region where there are no such arrangements. Among the OECD members, South Korea and Japan are the only countries that do not participate in any such arrangement. This shows that "globalism" has not been the only concept in the field of trade and investment. More controversial were the globalism of capital, finance, and indirect investment, which were subsequently promoted after the "globalism" of trade and direct investment. Asian countries took this trend seriously, and continued to deregulate foreign exchange regulations and financial markets. The liquidity crisis erupted when foreign capital began to

withdraw helter-skelter, in the way a flock of sheep runs uncontrollably in such directions as a shepherd never imagined.

Initially, it was explained that the foreign capital outflow occurred because host countries lost the confidence of the market and were therefore being punished by it, and that capital would return when houses are put in order and an environment is created to which foreign capital is attracted. This explanation sounded hollow for those of us who know how much time is wasted before a market moves from one equilibrium to the next, as well as how many times the market overshoots in a meaningless way during the process towards the next equilibrium. The cold fact is that once capital has precipitously fled a market, it will not easily return. It becomes a case of "once bitten, twice shy." It was especially annoying that the IMF messed up one house after another, and then the markets declared that those houses would not regain trust unless those houses were cleaned up.

Since autumn last year we have heard voices, even from within the IMF, that the IMF was too complacent in Asia. Since then, the voices claiming market supremacy have been replaced by calls for regulations on short-term capital movement and close monitoring of short-term capital by capital-importing countries. It is outrageous that those who once screamed for globalism, and gained huge profits in the crisis-hit countries that liberalized their financial markets under pressure from them, induced the IMF to provide the necessary resources for them to get their money out. They then claimed that those countries were hit because they did have an adequate capital control systems. Do they realize that when they blame the lack of short-term capital controls, they are actually announcing the end of "globalism"?

At the Obuchi-Clinton summit meeting in September 1998, the US confirmed that its priorities lay in North and South America. It is easily assumed that private capital will follow suit. Europe, with its new single currency, will concentrate on its own region, as well as Russia, the Middle East and Africa. This trend, which reflects an ideology of regionalism, is undoubtedly contrary to financial "globalism."

Unless Asian countries have a strategic concept to defend themselves and the region from capital and financial "globalism," they will again be taken advantage of by international capital, and will communiqué also again suffer from crisis and confusion. I believe that this is another reason why the Asian Monetary Fund would be a valuable forum for discussing shared basic understandings and strategies.

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