Private Capital Flows, Emerging Economies, and International Financial Architecture

A Paper from the Project on Development, Trade, and International Finance

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A Council on Foreign Relations Paper

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FOREWORD

In the wake of the 1997–98 financial crises in emerging economies, many prominent thinkers focused their energies on what went wrong, how it could have been prevented, and what reform measures are required for the future. While some concentrated specifically on financial markets within the economies in question, others examined the larger system-wide implications. The Council on Foreign Relations Project on Development, Trade, and International Finance convened a Working Group in an attempt to look at the problem from both levels, to investigate the problems in the world economy that led to the crises, and to propose policy options calculated to prevent future large-scale disturbances.

Specifically, the goal of the Working Group, which began in 1999, was to promote discussion of different perspectives about the necessity for change in the world economic system, and to look at concrete forms that change might take. These included, but were not limited to, discussions about reforming the international financial architecture to facilitate a transition from export-led growth to internally or regionally demand-driven development strategies that offer the populations of the developing world an improved standard of living.

One of the Working Group's several undertakings was to commission papers from the participants on a broad range of subjects related to the international financial architecture. The authors come from a variety of backgrounds, and their papers reflect a diversity of perspectives. However, we believe that all of them provide useful insights into international financial architecture, and that they represent collectively factors that should be considered by both U.S. and international economic policy makers.

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Maurice R. Greenberg Chair, Director of Studies
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Private Capital Flows, Emerging Economies, and International Financial Architecture[1]

INTRODUCTION

Firms and development strategies based on a rear-view mirror view will leave companies, projects, and entrepreneurs scrambling for capital access. The control of capital in the developed world continues to shift away from private and state-owned institutions and toward public markets. Small and medium-sized firms with the best prospects for innovation and income/wealth generation need to be liberated from their dependence upon bank-based financial systems. They must also have the ability to turn to market-based systems with access to institutional capital providers at home and abroad.[2]

[1]This paper was presented to a meeting of the Council on Foreign Relations Working Group on Trade, Development, and International Finance, New York, New York, June 10, 1999. It represents ongoing work underway at the Milken Institute with my colleagues Lalita Ramesh, James Barth, and R. Dan Brumbaugh.

[2]The credit channel magnifies monetary/financial shocks disproportionately on the basis of firm size. During the Korean crisis, spreads (which capture credit channel effects) were disproportionately larger for small and medium-sized enterprises, which had no access to close substitutes for bank credit. This echoes classic credit crunch problems in the U. S. markets as well which gave rise to financial innovations and new capital market developments in the 1970s and 1980s. See Ilker Domac and Giovanni Ferri, "The Real Impact of Financial Shocks: Evidence from Korea," World Bank Working Paper (Washington, D.C., World Bank, October 1998).

Discussion of financial architecture cannot be separated from the problems of concentration of political power, industrial control, and financial capital. Growth and equity in the economy is limited by entrepreneurs' dependence upon commercial banks that are state-owned or directed, and thus historically removed from shareholder and creditor accountability. If politically connected holding companies can shift most of their liabilities to a few subsidiaries and then give those units to the government for liquidation through restructuring authorities, new investment will not occur. As the *Wall Street Journal* recently reported, hints of recovery promoted by financial assistance packages may well have stalled efforts at financial reform and corporate restructuring.[3] In Thailand, where thousands of companies stopped paying their debt in 1997, restructuring is at a standstill. In Malaysia, corporate debtors have been insulated with a government-directed credit committee. In South Korea, *chaebols* have expanded their debt and state-linked companies and family conglomerates have resisted change throughout the crisis countries.

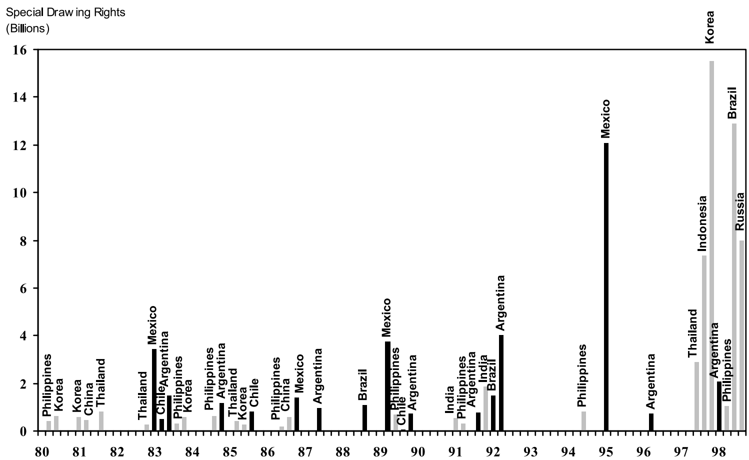
Table 1 and Figure 1 recite the rescue packages in East Asia, Russia, and Brazil. This suggests that existing financial-aid strategies

Table 1. Rescue Packages in East Asia, Russia, and Brazil: 1997–98 (Billions of U.S. dollars.)

Country	*IMF*	*Multilateral*	*World Bank*	*Bilateral*	*Total*	*Total as a Percent of 1997 GDP*	*Total as a Percent of 1997 Bank Assets*
Indonesia	11.2	10.0	5.5	26.1	42.3	19.7	43.8
Korea	20.9	14.0	10.0	23.3	58.2	13.2	16.3
Thailand	4.0	2.7	1.5	10.5	17.2	10.9	7.0
Russia	11.2	1.5	1.5	9.9	22.6	5.1	17.2
Brazil	18.0	9.0	4.5	14.5	41.0	5.2	7.7

[3] "Bankers Worry that Signs of Asian Recovery will Forestall Crucial Corporate Restructurings," *Wall Street Journal*, April 28, 1999. In a study of 106 bankruptcies of 4,569 publicly traded East Asian firms, Stijn Claessens, Simeon Djankov, and Leora Klapper found that the likelihood of bankruptcy filing is lower for firms with ownership links to banks and families, controlling for leverage and Tobin's Q. See "Resolution of Corporate Distress: Evidence from East Asia's Financial Crisis," World Bank Working Paper (Washington, D.C.: World Bank, May 1999).

Figure 1. Increasing Financial Assistance From the IMF: 1980–98



have effectively recapitalized not only existing banking institutions, but also a considerable proportion of the respective countries' economies. The growth and expansion of bank credit supported by this assistance appears to have exacerbated these crises.

Figure 2 correlates the growth in lending with a crisis index (the sum for each country of the depreciation rate minus the percentage change in international reserves). The countries with the

Figure 2. Bank Credit Boom: 1990–96

highest rates of bank-credit growth had the highest crisis index ratings as well. Similar to banking and financial institution crises in developed countries, the combination of real estate overexposure and restrictive regulation appears to have contributed to these ongoing crises (see Table 2 and Table 3). The dominance of banks and underdevelopment of secondary debt and equity markets along with the minimal role of privately owned or directed debt and equity capital sources (see Figures 3 and 4) is suggestive of the fundamental structural problems in financial reform and capital access for more entrepreneurial growth.

Policy failures in crisis countries converted national savings into nonperforming loans. The fact that savings can be invested inefficiently and retard growth is at the core of the financial architecture debate. As Rene Stulz has recently argued, differences in the organization of financial activities affects business formation and the efficiency of investment in existing firms. A growing body of empirical research supports this conclusion.[4]

Table 2. Commercial Property Price Declines, Bank Real Estate Exposure, Bank Restructuring Cost and Bank Ownership

Country	*Percentage Commercial Property Price Decline*	*Bank Real Estate Exposure (%)*	*Cost of Bank Restructuring (Percent of GDP)*	*Limitation on Foreign Ownership of Domestic Bank*	*Percentage of Commercial Bank Total Assets*	
Japan	68.3	NA	20	No	7	0
Thailand	48.3	30–40	30	Yes	19	7
Indonesia	35.0	25–30	19	Yes	7	43
Hong Kong	28.4	40–55	NA	No	67	0
Korea	23.0	15–25	30	Yes	6	0
Malaysia	14.0	30–40	20	Yes	21	10
Singapore	11.0	30–40	NA	Yes	44	0
Philippines	8.0	15–20	NA	Yes	14	20

Source: Bank for International Settlements, World Bank, [U.S.] Office of the Comptroller of the Currency, U.S. Treasury Department, and Bertrand Renaud

[4]For a review of this empirical literature, see Rene Stulz, "Financial Structure, Corporate Finance, and Economic Growth," Annual Bank Conference on Development Economics (Washington, D.C.: World Bank, June 1999).

Table 3. Real Estate Investment, Development, and Management as Allowable Activities of Commercial Banks and Bank Problems in Selected Countries: 1997

Income Group	*Subgroup*	*Yes*		*No*	
Low Income		Armenia*		Albania*	Pakistan*
		Gambia*		Ghana*	Rwanda*
		Moldova*		Madagascar*	Tanzania**
				Mozambique*	Zimbabwe*
		Russia**	Korea*	Belize	Jordan**
		Peru*	Papua New		
	Lower		Guinea*	Bolivia*	Latvia**
		Suriname	Philippines**	Fiji*	Morrocco
		Belarus*	Thailand**	Guatemala	Namibia
				Guyana*	Tonga
Middle Income		Czech Republic*	Saudi Arabia	Bahrain	Malaysia**
		Estonia**	Seychelles	Barbados	Malta
	Upper	Hungary*	Slovakia*	Botswana*	Mexico**
		Isle of Man	South Africa**	Brazil*	Oman
		Poland*		Chile**	Turkey**
				Lebanon**	Venezuela**

(*cont.*)

Table 3. (continued)

High Income	OECD Countries	Austria	Luxembourg	Australia*	Japan*
		Canada*	Netherlands	Belgium	Portugal
		Denmark*	New Zealand*	Greece*	Spain**
		Finland**	Norway**	Ireland*	Sweden**
		France*	Switzerland	Italy*	United States*
		Germany*	United Kingdom		
		Iceland*			
	Non-OECD Countries	Aruba	Hong Kong[1]	Cyprus	Liechtenstein
		Cayman Islands	Netherlands Antilles	Gibraltar[1]	Qatar
		Guernsey[1]		Kuwait**	Slovenia*

Note: Countries with a *denotes a significant banking problem and a **denotes a banking crisis during the 1980 to 1998 period. A "crisis" refers to runs or other substantial portfolio shifts, collapses of financial firms, or massive government intervention. A "significant problem" refers to extensive unsoundness short of a crisis.

How can we move beyond obfuscatory language and the growing policy backlash against globalization and global capital markets and disentangle the policies that could restore world economic growth and keep it alive?

Figure 3. Commercial Bank Total Assets Relative to Equity Market Capitalization and Bonds Outstanding for Selected Countries: 1997

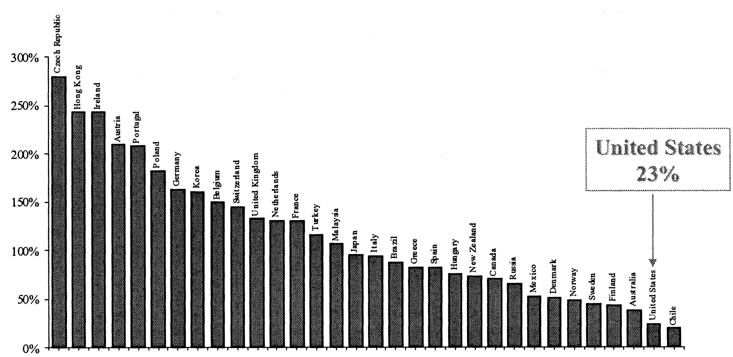
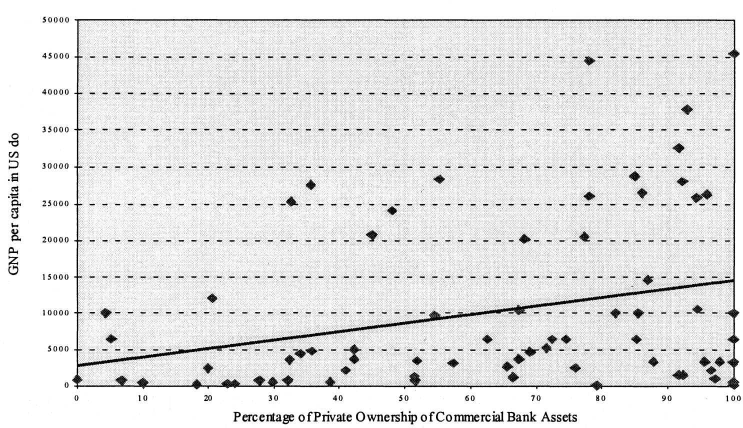


Figure 4. Relationship between GNP per capita and Percentage of Private Ownership of Commercial Bank Assets for Selected Countries: 1997



CONTAGION AS METAPHOR

Contagion hysteria has infected most intelligent discussions about global financial policies since the Asian crisis struck in the summer of 1997. But is fear of "contagion" a sociological, psychological, and political phenomenon, or is it an economic one? Careful economic analysis emerging from the crisis confirms the interdependence of national economies, but does not confirm some kind of pathological and irrational "contagion." Common structural problems in those economies most exposed to crisis persist.[5] The "contagion" characterization of the global financial crisis basically pathologizes and institutionalizes bad economic policies and financial practices.[6] For example, contagion language paints Argentina and Chile with the brush of Brazil. Michael Bordo and

[5]Aaron Tornell, *Common Fundamentals in the Tequila and Asian Crises*, Working Paper (Cambridge, Mass.: Harvard University and National Bureau of Economic Research, July 1998); James R. Barth, R. Dan Brumbaugh, Lalita Ramesh, and Glenn Yago, "The Role of Governments and Markets in International Banking Crises: The Case of East Asia," in George Kaufman, ed., *Research in Financial Services: Private and Public Policy*, vol. 10 (New York: JAI Press, Inc., 1998), pp. 177–233.

[6]"Contagion" was indeed the most overused word to describe the global crisis both in the press and including the recently released *Economic Report of the President*, February 1999. Carmen Reinhart and Graciela Kaminsky define contagion as a situation where a crisis elsewhere increases the probability of a crisis at home even when the fundamentals are accounted for. Possible transmission channels of "contagion"—international bank lending, cross-market hedging, and bilateral and third-party trade in propagating crisis—are found to be indistinguishable from trade-linked effects; see "On Crisis, Contagion and Confusion," Working Paper (University of Maryland at College Park, 1999). Robert Rigobon examined the correlation between Mexican and Argentinean stock markets and finds no evidence of such contagion in any recent crisis when account is taken of endogenicity, unobservable variables, and changes in the variance of stock market returns. In fact, there is little to distinguish this recent financial crisis from earlier ones; see "On the Measurement of Contagion," presentation at Conference on Globalization, Capital Markets Crises, and Economic Reform (Cartagena, Colombia, January 1999). Sergio Schmukler and Graciela Kaminsky examine financial cycles in twenty-eight countries during the last two decades, looking at duration of upturns and downturns, amplitude, and spillover effects across countries and regions. They find that financial cycles have not become more unstable in the 1990s and that they replicate experience with Latin America in the 1980s; see "On Booms and Crashes: Are Financial Cycles Changing," Working Paper (Washington, D.C.: George Washington University, 1999).

Anna Schwartz lead us to a more differentiated conclusion about the propagation effects of structural crises:

> Pure contagion would occur only in circumstances in which other emerging countries were free of the problems facing the first emerging country. We know of no evidence of pure contagion. Transmission is another story. Shocks to one country will spill over to other countries through trade and the capital accounts. When investors withdraw their capital from countries with the same problems as were present in the first such country, this is a demonstration effect, not contagion.[7]

When used in analyzing financial crises, contagion language employs a sometimes lethal metaphor of fear to supplant empirical analysis. As cultural critic Susan Sontag long ago observed, using illness as a metaphor can have damaging consequences for those afflicted.[8] This is as true in clinical situations in economics and finance as in medicine. The contagion metaphor has stigmatizing effects through the myths it creates; damaging the prospects of recovery both in diagnosing the problems and resolving them. Fear and loathing about globalization becomes common when such rhetoric dominates debates.[9]

International economic integration has always been a politically contentious topic. A spate of new books and conferences from Davos to Delhi have provided caricatures of the capital market operations and financial-institution complexity that drive expanded participation in the global economy.[10] But most empirical evidence

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[7] Michael D. Bordo and Anna J. Schwartz, "Under What Circumstances, Past and Present, Have International Rescues of Countries in Financial Distress Been Successful?" Working Paper no. 6824 (Cambridge, Mass.: National Bureau of Economic Research, December 1998), pp. 44–45.

[8] Susan Sontag, *Illness as Metaphor* (New York: Farrar, Straus & Giroux, 1990).

[9] See *New York Times* series on Global Contagion, February 15–18, 1999, and its editorial "Global Markets Lethal Magic," February 21, 1999.

[10] Timothy Goringe, *Fair Shares: Ethics and the Global Economy* (London and New York: Thames & Hudson, May 1999); Dani Rodrik, *The New Global Economy and Developing Countries: Making Openness Work* (Washington, D.C.: Overseas Development Council, November 1998); Harry Shutt, *The Trouble with Capitalism: An Enquiry into the Causes of Global Economic Failure* (New York: St. Martin's Press, Inc., August 1998).

suggests that continued crises reflect the persistence of corporatist and socialist statist economies, not entrepreneurially driven market economics.

Nevertheless, the policy backlash against globalization permeates most discussions about the global financial crisis. Reaction to the Anglo-American model of financial liberalization is widespread. The vice finance minister of Japan, Eisuke Sakakibara, put it this way:

> The Asian financial crisis occurred not because Asia had a problem. The problem is the global capitalism that allows funds to move all over the world based on a profit-oriented motive.[11]

Or take the position articulated by Karel van Wolferen:

> The project of a globalized economic order ruled by unregulated markets is utopian, as much as the notion of the withering away of the state was in Communist imagery.[12]

Or former Mexican President Carlos Salinas de Gortari:

> Insisting that North American neoliberalism is the only way turns people into enemies of the market because they see the markets as enemies of the people.[13]

Lionel Jospin (prime minister of the Republic of France), Gerhard Schroeder (chancellor of the Federal Republic of Germany), Oskar Lafontaine (finance minister of the Federal Republic of Germany), and other European Union political leaders continue to hammer away at the need for new international regulation and state-mediated responses as opposed to market responses.[14]

Compare this blame-mongering by politicians to the recently released essay by the currently embattled former deputy Malaysian prime minister, Anwar Ibrahim, who introduces his per-

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[11]Eisuke Sakakibara, "Mahathir is Right," *New Perspectives Quarterly* (Winter 1999), p. 10.

[12]Karel van Wolferen, "The Global Conceptual Crisis," *New Perspectives Quarterly*, vol. 16/1 (Winter 1999), p. 17.

[13]Carlos Salinas de Gortari and Roberto Mangabeira Unger, "From North Atlantic Neoliberalism to Market Pluralism," *Challenge*, vol. 41/6 (February-March 1999).

[14]Oskar Lafontaine and Christa Mueller, *Keine Angst vor der Globalisierung* [*Don't Fear Globalization*] (Frankfurt: Dietz Verlag, 1998).

spective by noting that ". . .it is not normal to conduct economic discourse from behind prison walls." He writes:

> Do we not take the individual and collective responsibility for our problems, just as we have taken credit for our successes in the last decade?. .Asian nations would do well to put their houses in order first. The international financial system does indeed need a new architecture, but structural reforms must begin at home. . . The Asian renaissance should encompass not only political transparency and better corporate governance, but also reforms to society and culture, and respect for human rights, the environment and the independence of the judiciary. Without this commitment to these values, debate on resolving the Asian crisis may well turn out to be mere lip service.[15]

Taking Anwar's lead, we should deconstruct the debate about global financial architecture. We must understand both its context and component parts. In this paper, we focus upon the emerging globalization backlash in policy that could limit future capital and job formation in both emerging and developed economies. Discussions of global financial architecture, when decomposed, represent a new technocratic language that obscures discussion of the structural problems. At the recent Davos conference of the World Economic Forum, for example, there was a great deal of discussion about protectionism, prospective government controls over capital flows, exchange rate differentials, and mergers and acquisitions.[16]

Remarkably absent was a discussion of how new job, income, and wealth creation are to occur in Europe and in the transition and emerging economies, particularly during the process of business consolidation, restructuring, and transition to the new economy. These topics lead to the fundamental question of alternative regulatory proposals to achieve those goals.

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[15]http://members.tripod.com/~Anwar_Ibrahim/main.htm

[16]Lawrence Minard, "What They Didn't Talk About in Davos," *Forbes Global* (February 22, 1999), p. 2.

The following questions need to be discussed as we evaluate discussions of global financial architecture.

- How much globalization is there?
- Does globalization exacerbate inequality?
- How significant are the benefits of globalization?
- Are global governance structures adequate to deal with globalization?
- Are financial integration and globalization to blame for crises and volatility, or do they simply reflect structural problems in corporate governance and unevolved financial institutions and capital markets?
- Does global capital market integration require the loss of national macroeconomic policy autonomy?
- Can the International Monetary Fund and World Bank—designed for a world of fixed exchange rates and limited capital mobility—promote stability in a radically changed world, or do their practices destabilize markets further?

Globalization and Deglobalization: Back to the Future?

Today's globalization is a resumption of trends that preceded World War I. Indeed, many of the present debates about globalization echo debates of that period. In examining globalization before World War I, a sobering picture emerges. The economy of the late nineteenth century was one of rapid globalization: capital and labor flowed and commodity trade boomed as transport costs dropped. The convergence of incomes, prices, and wages that occurred from 1850–1914, due to open trade and mass immigration, came to a halt between 1914–50 as deglobalization and autarky emerged as dominant economic and political forms.

An important lesson from the implosion of past globalization is that growing nation-state and intra-state inequality created a backlash against globalization. Significant distributional events caused a drift toward more restrictive policies—in trade, migration, and capital flows. The deglobalization implosion after 1914 was not independent of economic events. The retreat from open immigration policies was driven by a defense of the deteriorating relative position of the working poor. The retreat from free trade that culminated in rabid protectionism after World War I was manifested in protection of domestic agriculture from negative price shocks associated with globalization and trade-induced deterioration in the relative economic position of classes within Europe and the United States.[17]

[17]As Jeffrey Williamson writes, "(Prior to World War I) the evolution of well-functioning global markets in goods and labor eventually brought a convergence between nations. This factor price convergence planted, however, seeds for its own destruction since it created rising inequality in labor-scarce economies and falling inequality in labor-abundant economies. The voices of powerful interest groups who were hit hard by these globalization events were heard, however, and these were in particular the ordinary worker in labor scarce economics and the landlord in the labor abundant economies. These interest groups generated a political backlash against immigration and trade, and this backlash, which had been building up for decades, was brought to a head by event around World War I." See *Journal of Economic Perspectives*, vol. 12/4 (Fall 1998), p. 61.

THE INTEGRATION OF GLOBAL CAPITAL MARKETS

Today globalization, particularly of capital markets, is both exaggerated and can be reversed as it has been in the past.

The two driving forces of globalization are technology and liberalization. The natural barriers of time and space that separate national markets are collapsing at record speed as communications, information, and transportation technologies have transformed and integrated national economies.

In examining product, labor, and capital markets, the degree of integration can be overstated. Though the ratio of trade to output in product markets has increased sharply in most countries since World War II, it is not substantially higher in Western European countries than it was in 1914, and in Japan it is relatively less. Price convergence across countries is still elusive, and other indicators of product market integration still lag. Financial markets are also not fully integrated. Until recently, the index of capital controls was declining and net private capital flows by banks, foreign direct investment, and portfolio investment were increasing.[18] The strict test of capital market integration—real (inflation-adjusted) interest rates—should converge; but real interest rates differ substantially. Only 10 percent of domestic investment in emerging economies has been financed from abroad. Foreign direct

[18]Survey evidence on the use of capital controls to attain objectives of monetary control are largely pessimistic; see Michael P. Dooley, "A survey of Literature on Controls over International Capital Transactions," IMF Staff Papers 43 (Washington, D.C.: International Monetary Fund, December 1996), pp. 639–87). Reports on panel studies of the incidence of capital controls for twenty industrial countries during the years 1950–89, and for sixty-one industrial and developing countries from 1966–89 find that the probability of capital controls lowers the likelihood of more flexible exchange-rate regimes and greater central bank independence; see Vittorio Grilli and Gian Maria Milesi-Ferretti, "Economic Effects and Structural Determinants of Capital Controls," IMF Staff Papers 42 (Washington D.C.: International Monetary Fund, September 1995), pp. 517–51. Using liquid asset reserve requirements as opposed to capital controls might be a more effective strategy of reducing credit risk.

investment relative to domestic GDP is much smaller now than during the period before World War I. The net outflow of capital (i.e., the current account surplus) for most developed countries is actually lower than before World War I. Today the average level of current account balances has not quite attained the magnitude common before World War I. Labor markets are considerably less integrated than at the turn of the century, despite integration of product and capital markets.

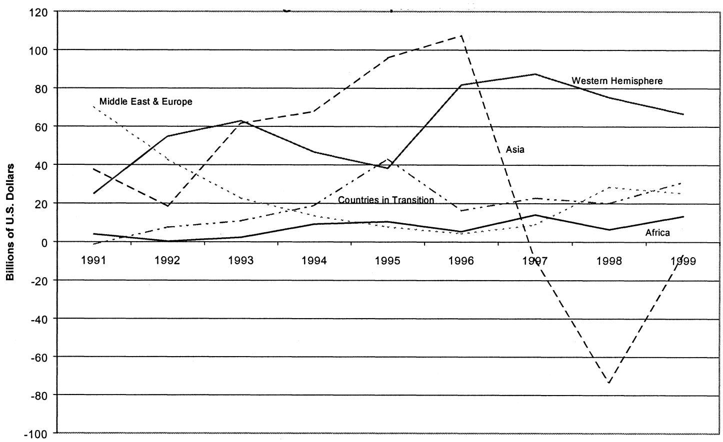
In short, gross capital flows may be very large. But net flows are actually smaller than those observed during the period of the gold standard. Trade flows are not significantly higher than they were prior to 1914, if measured against GDP, but are higher if measured against industrial production. While international investment flows commonly topped 3 percent of GDP before 1914, they slumped to less than half that level in the 1930s and only began to move upward after 1970.

Current Trends in Financial Integration

Foreign direct investment is the largest source of net capital flows to developing countries. The largest share of such investment is by multinational corporations in their overseas operations under their own control. It is the only area that has shown some stability. Net flows in portfolio equity, bond, and commercial bank loans grew substantially during the 1990s but face severe declines, as shown in Figure 5.

The fundamental global financial crisis is this: The turmoil at the end of the 1990s has created very wide spreads and curtailed market access. Net private capital flows to leading emerging market economies have fallen to $160 billion compared to $240 billion in 1998, which was after a peak of $310 billion in 1996. Portfolio equity, bonds, and bank lending all reflect similar declines. (See Table 4). The context of this crisis, after ten years of explosive growth in international financial transactions, needs to be recalled: a tenfold increase in global foreign exchange markets, a fivefold increase in foreign direct investment, and a tenfold increase in cross-border bond and equities transactions.

Figure 5. Regional Net Capital Flows



Source: Milken Institute; World Economic Outlook October 1997 & October 1998

Table 4. Emerging Market Economies' External Finance (billions of U.S. dollars)

	1995	*1996*	*1997*	*1998f*	*1999f*
Current account balance	−95	−95.4	−76.2	−44.8	−27.1
External financing net	267.8	311.1	282.4	200.4	184.6
Private flows, net	228.1	307.6	241.7	158.2	158.3
Equity investment	106.7	128.2	144.9	116.7	119.9
Direct equity	82.2	94.9	119.7	105.9	101.8
Portfolio equity	24.5	33.4	25.2	10.7	18.1
Private creditors	121.4	179.3	96.8	41.5	38.3
Commercial banks	103.1	113.3	22.2	−0.7	11.9
Non-bank private creditors	18.3	66	74.6	42.2	26.4
Official flows, net	39.7	3.5	40.7	42.2	26.3
International financial institutions	20.4	7.2	28.3	32.2	14.1
Bilateral creditors	19.3	−3.7	12.4	10	12.2
Resident lending/other, net*	−77.7	−128.6	−161.3	−115.9	−95.7
Reserves excl. gold (− = increase)	−95	−87.1	−44.8	−39.7	−61.8

e = estimate f = forecast

* Including resident net lending, monetary gold, and errors and omissions

Source: Institute of International Finance, Inc.

Regulatory frameworks in developed countries have until recently created and exacerbated this problem. Present bank regulation evaluates asset riskiness individually by using risk-based capital standards. As Credit Suisse First Boston Global Credit Strategist David Goldman has pointed out, "modern portfolio theory offers a different view, namely that portfolio risk is not additive: the riskiness of a portfolio is an entirely different thing from the sum of the risks of the individual assets. In effect the present risk-based capital standards sum the risk of individual assets. Diversified portfolios, however, may have a far lower level of risk than the average riskiness of their elements." Portfolio-based risk measures currently contemplated by the Bank for International Settlements would lower the cost of capital to borrowers and raise the return to equity for financial institutions.

Regulatory restrictions of various kinds[19] discourage mainstream financial institutions such as banks, life insurance companies, and pension funds from participating in the market for riskier credits in emerging countries. Most of the world's population lives in emerging markets. Such countries must sell risky assets to obtain capital. Newer market entrants in the developed world are also riskier. Accordingly, given these restrictions, the unregulated segment has taken a disproportionately large role in such markets.

The problem with emerging markets during 1998 stemmed from the fact that virtually all capital flows to emerging capital markets came from hedge funds buying emerging-market securities:

> The regulatory system in effect matched up borrowers with volatile returns to lenders with volatile sources of capital and produced a near catastrophe. The problem with hedge funds and the unregulated market was the interaction between well-informed specialists and uninformed investors in the markets. As margin calls forced hedge fund specialists to liquidate part of their holdings, the price downturn was amplified. To the extent that emerging markets and

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[19]James Barth, R. Dan Brumbaugh, and Glenn Yago, eds., *Restructuring Financial Regulation* (Santa Monica, Calif.: Milken Institute, Forthcoming).

> their participants were liquidity-constrained, emerging-market security and bond prices were slow to recover. High interest rates combined with the slow recovery to adversely affect demand, output, and employment.[20]

In response, securitization is only part of the answer. Changing the regulatory structure in the industrial world is just as important.

The application of portfolio risk analysis in place of risk-based capital standards in financial institution regulation could well increase capital access and decrease imprudent uses of leverage. However, the incentives for expanding net credit exposure by regulated institutions may not be implemented as fast as the disincentives for hedge-fund lending, which could further exacerbate liquidity shortages in the global financial markets.

Global Financial Architecture and the Evolution of International Capital Mobility

There is an underlying tension between markets and governments that explains the long stretch of high capital mobility prior to World War I, its subsequent breakdown, and then the slow rebuilding of the postwar world financial system. This tension involves the way in which openness to the world capital market constrains government power through the choice of the exchange rate mechanism.

Before 1914, currency prices were pegged in terms of gold, which maintained a fixed rate of exchange. The Great Depression discredited gold-standard orthodoxy. Financial products and markets were banned or otherwise more closely regulated. The Bretton Woods conference set up a fixed, but adjustable, exchange-rate parity system in the belief that floating exchange rates would exhibit instability that would damage international trade. Accordingly, after 1973, industrial countries moved to a floating dollar-rate regime.[21]

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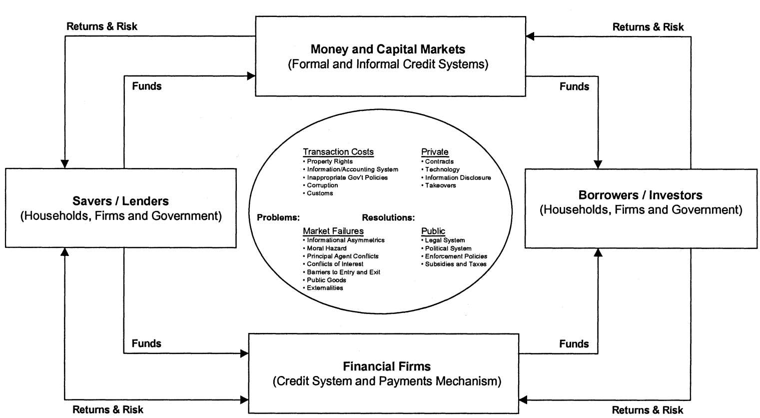
[20] David P. Goldman, "Risk-Based Capital Standards and the Future of Banking," (Credit Suisse First Boston, September 30, 1998), p. 4; see also Glenn Yago, Lalita Ramesh, and Noah Hochman, *Hedge Funds and Systemic Risk Demystified* (Santa Monica, Calif.: Milken Institute, December 1998).

[21] Maurice Obstfeld, "The Global Capital Market: Benefactor or Menace?" *Journal of Economic Perspectives*, vol. 12/4 (Fall 1998), pp. 9–30.

Debates over financial architecture are part of that ongoing discourse as markets discipline governments and meet resistance. Each country's financial system is an important intangible asset that can help to facilitate both its own and others' economic growth. Given the enormous disparity in national wealth between rich and poor countries, developed countries offer an important source of development funds for countries unable to finance their future solely with internal savings. In order for an efficient and innovative global financial system to evolve, borrower countries' financial systems need some fundamental compatibility with those of lender countries. Any discussion of global financial architecture must deal directly with the form developing financial systems take.

Financial systems are intangible assets that promote economic growth by facilitating the transfer of funds from savers (savers or lenders) to borrowers (spenders or investors). This relationship is depicted in Figure 6. The benefits provided to individuals by financial systems involve risk sharing, liquidity, and information. Savers can hold many different types of assets and thus diversify risk. Likewise, investors can fund projects in large numbers of different ways.

Figure 6. Designing Financial Systems



However, there are a host of economic obstacles to matching savers and investors. These obstacles include transaction costs, market failures, firm size, available information, sources of capital, property rights and information, regulation, negative externalities, bank runs, moral hazard, agency problems, barriers to entry, and exit by investors, to name a few.

DECONSTRUCTING GLOBAL FINANCIAL ARCHITECTURE PROPOSALS

The Major Proposals (see Table 5)

Since the spring of 1997, when the East-Asian financial crisis began to develop, a proliferating number of proposals for a "new financial architecture" have come forward to reduce the turbulence in world financial markets.

Table 5 presents a representative listing of the major types of reform proposals that have evolved. Although there are a seemingly ever expanding number of reform proposals, as the table shows, several trends have emerged among prominent economists and government officials.[22]

These proposals can be roughly classified as those that advocate:

- major new government institutions;
- changes in government regulatory practices;
- a mix of policy changes and market-based reforms; and
- market-based reforms alone.

For those who want to rely on either increased or improved government or trans-national agency intervention in financial markets, there are three major strands of proposals. Many have proposed some form of international lender of last resort or global central bank. Others have argued for perfecting in some way how the IMF presently works. Still others have proposed currency boards.

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[22]George Soros' model suggests a new international agency that would insure investors against debt defaults. Countries would pay a fee when floating loans in order to underwrite the cost of insurance. Each country's debts would be limited to a ceiling set by the IMF. Loans in excess of the ceiling would not be insured. And the IMF would not aid countries having difficulty servicing uninsured loans. See George Soros, *The Crisis of Global Capitalism* (New York: Public Affairs Press, 1998).

Table 5: Global Financial Architectural Proposals

A. Major New Government Institutions			
Author	**Affiliation**	**Proposal**	**Source**
Gordon Brown	Chancellor of the Exchequer, U.K.	New permanent Standing Committee for global financial regulation involving the IMF, the World Bank, the Basel Committee, and other regulatory groups.	" Reforming the International Monetary Fund: ...And Impose New Codes of Conduct," Wall Street Journal, October 6, 1998
Sebastian Edwards	UCLA	Replace the IMF with three specialized institutions: Global Information Agency, Contingent Global Financial Facility, and Global Restructuring Agency.	"Abolish the IMF," Financial Times, November 13, 1998
Stanley Fischer	International Monetary Fund	International lender of last resort to serve as crisis manager and crisis lender, not necessarily global central bank.	"Frequency of Global Crises Highlights Need to Consider International Lender of Last Resort," IMF Survey, January 11, 1999
Jeffrey Garten	Yale University	Independent global central bank that could inject liquidity to spur growth and oversee operations of troubled financial institutions; should not be able to override the decisions of the Federal Reserve.	"Needed: A Fed for the World," New York Times, September 23, 1998
Henry Kaufman	President, Henry Kaufman & Co.	Board of Overseers of international financial markets that would develop global financial standards, and also supervise and evaluate institutions under its purview.	"Preventing the Next Global Financial Crisis," Washington Post, January 28, 1998

A. Major New Government Institutions (continued)

Author	Affiliation	Proposal	Source
Steven Radelet & Jeffrey D. Sachs	Harvard University	• International regulator of bankruptcy laws, deposit insurance, lender of last resort. • Floating exchange rate. • Reform IMF conditionality.	"What have we learned, so far, from the Asian Financial Crisis?" mimeo, Harvard Institute for International Development, January 4, 1997. Available at: www.hiid.harvard.edu
lender of last resort to select	Fund Management	• Restrictions on short-term capital flows.George Soros "The Crisis of Global Capitalism," group of countries. • Mandatory insurance (similar to deposit insurance), issued by an international credit insurance corporation to maintain creditor confidence.	Chairman, Soros • International central bank; Wall Street Journal, September 15, 1998

B. Changes In Government Regulatory Practices

Author	Affiliation	Proposal	Source
C. Fred Bergsten	Institute for International Economics	G-7 governments should adopt target zones for exchange rates to contain destabilizing swings in the dollar-yen/ dollar-euro exchange rates.	"How to Target Exchange Rates," Financial Times, November 20 1998
Charles Calomiris	Columbia University	• Banks should police themselves by financing a small proportion of their assets by selling subordinated debt to other institutions. Yield on this debt should not be allowed to rise beyond a point. Since these debt holders only have downside risk, they would be rigorous monitors of bank behavior. • Recasts the IMF as a provider of liquidity, only to countries that fulfill a strict set of conditions. All IMF lending would be short-term; if a country did not make timely payments it would not be eligible for IMF money for five years.	"Blueprints for a New Global Financial Architecture," October 7, 1998. Available at: www.house.gov/jec/imf/blueprnt.htm
Michel Camdessus	International Monetary Fund	• Make IMF surveillance more effective and enhance transparency. • Strengthen financial and banking systems as well as their supervision. • Establish more effective procedures to involve the private sector in preventing and resolving debt crises. • Continue to liberalize international capital flows.	"The IMF and its Programs in Asia," Remarks at the Council on Foreign Relations, New York, February 6, 1998

B. Changes In Government Regulatory Practices (continued)

Author	Affiliation	Proposal	Source
Barry Eichengreen	University of California, Berkeley	• New international standards for bank regulation, bankruptcy laws, auditing, corporate governance. • Taxation of all short-term capital inflows into emerging markets. • Promotion of orderly debt restructurings through majority voting, burden-sharing, and collective representation of creditors to avoid lawsuits and obstruction of settlements. • Flexible exchange rates. • Capital controls for emerging markets. • Independent central bank. • Perhaps an independent national fiscal council. • Measures that enhance transparency.	Toward a New International Financial "Architecture: a Practical Post-Asia Agenda," Institute for International Economics, February 1999 "Capital Mobility: Ties Need Not Bind," Milken Institute Review, First Quarter, 1999
Alan Greenspan	Chairman, Federal Reserve Board	Restricting controls to short-term capital inflows—as often recommended—is not a solution. 21st-century financial regulation must increasingly rely on counterparty surveillanceto achieve safety and soundness. There is no credible way most government financial regulation can be anything other than oversight of process.	Remarks at the Annual Meeting of the Securities Industry Association, Boca Raton, Florida, November 5, 1998

B. Changes In Government Regulatory Practices (continued)

Author	Affiliation	Proposal	Source
Group of Thirty		Among the recommendations are: • Create a standing industry committee to promulgate and review global principles for managing risk. • Agree upon how auditors should approach audits of financial statements and other information for portraying risk. • Supervisors should agree upon a lead coordinator for all global financial institutions. • National legislatures should provide a reliable legal framework for international transactions.	"Global Institutions, National Supervision and Systemic Risk," A Study Group Report, Group of Thirty, 1997
Paul Krugman	MIT	• Limit capital flows to emerging-market countries that are unsuitable for currency unions, free floating exchange rates. • Reregulate capital markets to some extent. • For some countries, low inflation might be a preferred alternative to price stability.	"Depression Economics Returns," Foreign Affairs, January/February, 1999

C. Mix of Policy Changes and Market-Based Reforms

Author	Affiliation	Proposal	Source
APEC Business Advisory Council		• The IMF should take into account social implications of its programs. • Enhance domestic capital-market infrastructure. • Countries should undertake legal, regulatory, and accounting reforms to facilitate financial reorganization. • Develop domestic capital markets through the developmentof liquid bond and asset-backed securities markets. • Countries should consider mechanisms for restructuring corporate debt through debt-equity swaps. • Remove restrictions on and encourage the use of securitization structures of trade receivables for trade finance.	"Letter from the APEC Business Advisory Council to the Economic Leaders," The 1998 APEC Report to the Economic Leaders
Robert Barro	Harvard University	• Capital controls, while not ideal, are preferable to the IMF's customary fix of intervention with high interest rates. The best policy would entail a fixed exchange rate without capital controls, with the central bank intervening, but not sterilizing. • A currency board is worth considering in more countries.	"Malaysia could do worse than this economic plan," Business Week, November 2, 1998
Basel Committee on Banking Supervision	Bank for International Settlements	• Emphasizes complementary interaction of prudential supervision and market discipline. • Reinforce the efforts of supervisors by rewarding banks that manage risk effectively and penalizing banks whose risk management is inept or imprudent.	"Enhancing Bank Transparency," September 22, 1998, Publication of the Board for International Settlements

(cont.)

C. Mix of Policy Changes and Market-Based Reforms (continued)

Author	Affiliation	Proposal	Source
G-7		•Countries adopt and apply codes of conduct founded on minimum standards and best practice. •Countries must comply with an internationally agreed code of conduct on monetary and fiscal policy. •Countries must comply with an international standard of best practice for transparency and disclosure by financial institutions and their regulators.	HM Treasury News Release, October 30, 1998. Available at: www.hm_treasury.gov.uk/pub/html/press98/p179_html
Robert Rubin	U.S. Treasury Department	• Countries should provide better information through improved disclosure and transparency. • Countries building strong national sectors should create mechanisms so that the private sector more fully bears the consequences of its credit and investment decisions. • Need to provide for international surveillance of countries' financial regulatory and supervisory systems.	Office of Public Affairs, U.S. Treasury Department, April 14, 1998
Joseph Stiglitz	World Bank	• Greater transparency and more information about capital flows. • Countries should try to influence the pattern and composition of capital flows.	Address to the Chicago Council on Foreign Relations, Chicago, February 27, 1998
Paul Volcker	Former Chairman, Federal Reserve Board	Emerging economies should seek financial safety and currency stability in diversity (foreign ownership in financial sector) and size (regional currency arrangements). Emerging markets should link up with leading regional currency.	"Global Finance," Economist, January 30, 1999

D. Market-Based Reforms

Author	Affiliation	Proposal	Source
James Barth, R. Dan Brumbaugh, Lalita Ramesh, & Glenn Yago	Milken Institute	• Eliminate state-owned banks. • Allow foreign bank entry. • Permit the freer flow of international capital. • Promote allocation of credit by market forces. • Discourage inappropriate bailouts for creditors.	"The Role of Governments and Markets in International Banking Crises: The Case of East Asia," Research in Financial Services: Private and Public Policy, JAI Press Inc., 1998
Michael Bordo & Anna Schwartz	National Bureau of Economic Research	• Floating exchange rates. • In a world of deep capital markets, few good reasons why private markets cannot perform as the role of lender of last resort instead of the IMF.	"Under What Circumstances, Past and Present, Have International Rescues of Countries inFinancial Distress Been Successful?" NBER, Working Paper no. 6824
Rudiger Dornbusch	MIT	Establishment of a currency board.	"After Asia: New Directions for the International Iinancial System," July 1998 Available at: http://www.mit.edu/~rudi/papers.html
Steve Hanke	Johns Hopkins University	Developing countries should unify their currencies with stronger ones via fixed exchange rates supported by currency board monetary institutions.	Cato Instituteís 16th Annual Monetary Conference, mimeo, October 22, 1998
Randall Kroszner	University of Chicago	• Public regulation should not crowd out private regulation. • A unified international regulator is likely to slow innovations and growth of international financial markets. • Public regulations should be subject to a rough cost-benefit analysis to assess feasibility.	"The Role of Private Regulation in Maintaining Global Financial Stability," 16 Annual Monetary Conference, Cato Institute, October 22, 1998

(*cont.*)

D. Market-Based Reforms (continued)

Author	Affiliation	Proposal	Source
Robert Litan	Brookings Institution	• Countries should pass simple bankruptcy legislation. No need for new international bankruptcy agency. Debt problems are internal and plague firms, not governments.	“Bankruptcy Bailout Could Fix Asia’s Woes,” Newsday, March 4, 1998
Allan Meltzer	Carnegie Mellon University	The BIS (as a central bank for all central banks) can perhaps replace the IMF.	“Asian Problems and the IMF,” testimony prepared for the Joint Economic Committee, U. S. Congress, February 24, 1998
George Schultz, William Simon, and Walter Wriston	Former U.S. Secretary of State; Former U.S. Secretary of Treasury; Former Chairman of Citicorp	Contend that the IMF is “ineffective, unnecessary, and obsolete.” Bailouts insulate financiers and politicians from consequences of unwise economic and financial practices.	“Who Needs the IMF?” Wall Street Journal, February 3, 1998

There have also been specific policy proposals that do not necessarily require new or improved government or trans-national agencies but would nonetheless rely on some additional government intervention. These include establishing regional currencies, new forms of bank supervision, and limitations on international capital flows, as well as on monetary and fiscal policies.

In contrast to these types of proposals, many proposals would rely on less intervention on the part of governments or trans-national agencies. Three senior public and private figures have called for the outright abolishment of the IMF.[23] Others have endorsed more limited policy changes. These include greater transparency of information and also development of mechanisms that would require the private sector to bear more fully the consequences of their private decisions. A particular form of the latter proposal would, for example, require banks to issue subordinated debt, relying on the debt holders to monitor and limit excessive risk-taking.

How to Evaluate the Global Financial Architecture Proposals

Whether or which global financial architecture proposals make sense must depend on how well they address the causes and exacerbating factors that seem to be involved in contemporary global financial difficulties. Contemporary international financial difficulties have demonstrated remarkably similar patterns of development from Mexico in 1994 to East Asia in 1997–98 to Brazil in 1998–99.

In the crises affecting these countries, the final stage of the crises has been when the countries attempt, successfully or not, to use foreign reserves to defend the value of their currencies. This stage is really the result of preceding events. Those events have tended to be excessive lending and investment in projects that failed, with subsequent severe consequences to the real economy of the affected country. The perception of an imminent decline in the real economy has tended to precipitate the final stage of the crises.

Two extremely important but often overlooked characteristics have affected contemporary crises. First, state-owned banks have

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[23] George Schultz, William Simon, and Walter Wriston, "Who Needs the IMF?" *Wall Street Journal*, February 3, 1998.

been involved with the excessively risky lending and investment, often to state-owned or influenced enterprises. Second, the financial sectors of the stricken countries have lacked breadth and depth, with relatively smaller and less-well-developed non-bank sectors. Thus, direct and indirect government influence is greater in bank-dominated financial markets.

Global financial architecture proposals should be evaluated on how well they address these key events in contemporary financial difficulties.

How Do the Proposals Stack Up?

Clearly, proposals that call for an international lender of last resort or a central bank essentially would deal with the final stage of a crisis when currencies need to be defended with foreign reserves. They would not deal directly with the process that created the crisis. Assuming that an international lender of last resort would work as intended, it raises a moral hazard problem that already exists with IMF interventions. Would the prospect of even more effective interventions (by an international lender of last resort instead of the IMF) tend to exacerbate the underlying causes of the crisis, such as excessively risky or imprudent lending and investment?

This, of course, is a major criticism of the IMF and why some have argued that the IMF should revise the conditions upon which it will lend to countries experiencing difficulties. IMF conditionality should have dampened the likelihood of further crises. But this does not appear to have been the case. As a result, marginal changes in IMF policies cannot be expected to bear great fruit. In the long run, the moral hazard incentives of a complete bailout cause a rise in the probability of financial runs.

Similarly, currency boards have proved effective in some, but may not be feasible in all cases. The conditions necessary for currency boards to work could rule them out in some countries because under this arrangement, foreign exchange reserves would have to be high enough to fully cover domestic notes and coins as well as deposit liabilities.

The remaining proposals that rely on new forms of intervention are limited because of the problem of state-owned banks in financial systems that are bank dominated. New forms of regulation and the imposition of subordinated debt requirements, for example, will not address the effects of state-owned or influenced banks often lending or investing in state-owned or influenced enterprises.

Likewise, restrictions on foreign capital flows also do not address the problems caused by state-owned banks. Inappropriate short-term foreign lending, moreover, has often been encouraged in countries that have subsequently suffered, and may well have been exacerbated by the moral hazard problem created by the IMF. Again, there appears to be a dubious rationale for a proposed resolution with a relatively modest promised contribution.

What About the More Market-Based Approaches?

The primary rationale for proposals that would eliminate the IMF is based in the moral hazard problem caused by predictable IMF lending. The worry is that predictable IMF lending leads to excessive risk-taking by entities—both governments and private parties—who are "bailed out" by subsequent IMF loans. Ongoing rounds of excessive risk-taking in turn lead to future, and perhaps escalating, crises. On balance, those who would eliminate the IMF think that increased market discipline would lead to fewer and less severe crises.

To some extent all of the remaining major proposals are designed to increase market discipline. They include increasing subordinated debt for banks, increasing foreign ownership in the financial structure, maintaining floating exchange rates, establishing more efficient bankruptcy systems, increasing disclosure and transparency, and making certain that private parties bear the consequences of their credit and investment decisions.

Private lender of last resort methods are just beginning to be explored. The Central Bank of Argentina, for example, has set up contingent repurchase arrangements with a group of New York banks that would provide $17 billion if Argentine banks faced an emergency, such as a run on deposits. Between liquid reserves and repurchase agreements, around 40 percent of the deposit base is protected. Variations on capital controls such as those explored by Chile are more capital-market sensitive. Specifically, Chile's plan uses short-term exit taxes, which are more promising than the customary fixed-entry fees in reducing the probability of crises relative to fixed-entry fees.[24]

While there are clearly pluses and minuses to each of the more market-based proposals, these are the kinds of proposals that will survive and provide a basis for efficient, and hence more stable, capital markets in the future. Still underestimated, however, is the extent to which state-owned banks in bank-dominated financial systems remain a major source of instability in financial markets.

Corporate Capital Structures and Macro Financial Architecture
A key to the future of efficient financial markets is:

- to eliminate direct state involvement in financial markets, and
- to increase the depth and breadth of financial markets.

The overwhelming emphasis of most global financial architectural proposals is upon macro-policy reform, which, while necessary, is not nearly enough to revitalize these countries and prepare them for entry into the global financial system. Micro-reform is fundamental to:

- reform of legal, regulatory, and accounting systems;
- reform of banking systems and banks;
- create secondary debt markets; and
- restructure corporate balance sheets.

Sovereign and corporate capital structure both matter and are interrelated. Explanations of the global financial crisis have largely focused on macroeconomic factors leading to crisis. Recent research on the

[24]Ilan Goldfajn and Rodrigo Valdés, *Liquidity Crises and the International Financial Architecture* Working Paper (Santiago: Central Bank of Chile, 1999).

micro-areas has highlighted the paradox that, in a time of increasing capital mobility, corporations did not adhere to global standards of creating shareholder value. Corporate financial analysis shows unsustainable investment in fixed assets financed by excessive borrowing, which resulted in poor profitability, as well as declining returns on equity and returns on capital employed. Poor capital structures, and the inability to manage them, led to heightened financial distress.

As suggested by Figures 7 & 8, financially distressed regions have exhibited over-dependence on the banking sector and under-reliance on capital markets in both absolute and relative terms.

This suggests the need for a more open, balanced, and competitive financial system, in which capital is allocated in a more transparent fashion. In addition to rehabilitation of the banking system, development of domestic capital markets will be required. Attendant benefits in terms of transparency, risk assessment and pricing, and dispersion of risk among participants would have an important effect upon corporate accountability and performance. These problems of financial concentration are exacerbated by corporate capital concentration as well. Despite the increase in foreign participation, the context has been one of limited floats and

Figure 7. Structure of Financial Markets: Latin America

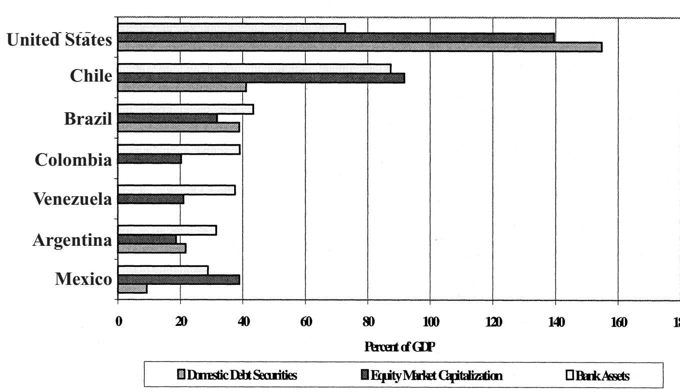
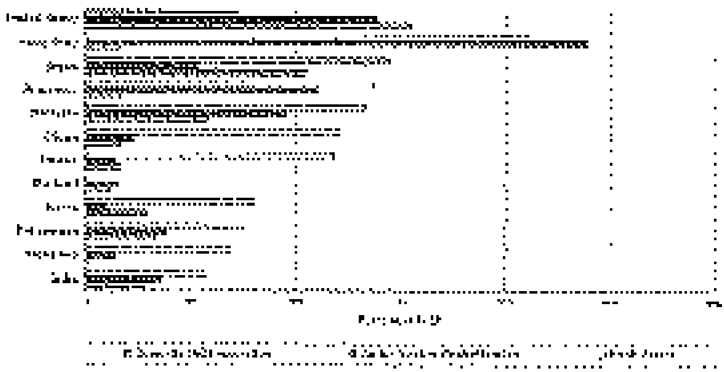


Figure 8. Structure of Financial Markets: Asia



large, closely held positions of shares. Large portfolio equity inflows in an illiquid market have had a disproportionate impact on valuations unhinged from performance fundamentals.[25]

Inflexibility in corporate capital structures, resulting from the absence of local capital markets and the capacity to manage corporate balance sheets, also has reflected and amplified the macro crisis. Because East Asian corporations used outside equity sparingly, leverage was high and short-term borrowing became increasingly important.[26] The aforementioned concentration of ownership was enhanced by pyramid structures, as well as diminished economic and institutional development. In short, increasing ownership and control concentration hurt market performance. As predicted by economic theory, the interests of small shareholders are damaged by concentration when corporations are affiliated with business groups or when there is uncontested control by a single large shareholder, or when there are large cross-holdings.[27] The weaknesses of the legal system and the lack of an independent judiciary

[25]Michael Pomerleano, *The East Asia Crisis and Corporate Finances: The Untold Micro Story,* Policy Research Working Paper no. 1990 (Washington, D.C.: World Bank, 1998).

[26]Stijn Claessens, Simeon Djankov, and Larry Lang, *Corporate Growth, Financing, and Risks before the Crisis,* Working Paper no. 2017 (Washington, D.C.: World Bank, 1998).

[27]Stijn Claessens, Dimeon Djankov, Larry Lang, and Joseph Fan, *Ultimate Ownership and Performance of East Asian Corporations*, Working Paper (Washington, D.C.: World Bank, February 1999).

are influenced by these prevailing ownership structures and the resulting corruption and lack of transparency. The absence of institutional and transaction trust in market arrangements acts as a drag upon growth.

The linkages between capital and job formation to income growth and wealth creation are becoming more apparent in economic research.[28] The linkage between degrees of financial regulation and economic growth has been demonstrated.[29] Growing securities markets in the private sector positively affect the labor market through the supply side. Market capitalization and valuations combine two things that make assets a desirable investment: the current rate of profit and the price that investors will pay for those profits. When the market is highly valued, assets are worth more than they cost, so additional fixed investment makes sense. Resultingly, a shift toward higher investment increases employment at any given level of aggregate demand. As Edmund Phelps has recently shown, highly valued markets indicate that profits from investment have increased and/or that the market value of those profits has increased, resulting in higher employment.[30]

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[28]Glenn Yago, *The Jobs/Capital Mismatch: Financial Regulatory Chokeholds on Economic Growth* (Santa Monica, Calif.: Milken Institute, November 1999).

[29]James Barth, Gerard Caprio, and Ross Levine, *Financial Regulation and Economic Performance*, Policy Brief (Santa Monica, Calif.: Milken Institute, March 1999).

[30]Edmund Phelps, "Behind the Structural Boom: The Role of Asset Valuations," *American Economic Association Papers and Proceedings* (May 1999). Economic evidence confirms that global financial integration leads to more active, liquid, and efficient domestic financial markets. The increased depth and breadth of those markets encourages faster growth and more rapidly rising living standards. World Bank, *Private Capital Flows to Developing Countries: The Road to Financial Integration* (New York: Oxford University Press, 1997)

Countries that have structured their capital markets to receive relatively large portfolio capital inflows have seen disproportionate growth in transaction volume, liquidity, market capitalization, and growth in bank loans to the private sector. The ratio of liquid financial assets to GNP will have a strong correlation with subsequent economic growth in the years ahead. This development accompanies foreign direct investment findings as well. Domestic firms learn from foreign investment enterprises evidencing positive spillovers from foreign direct investment. The overall effect is positive for countries with the educated labor force to take advantage of investment spillovers in export growth and additionally triggered domestic investment. Eduaardo Borenzstein, Jose de Gregario and Jon-Wha Lee, *How Does Foreign Direct Investment Affect Economic Growth*, Working Paper no. 5057 (Cambridge, Mass.: National Bureau of Economic Research, 1995); Barry Eichengreen, *Globalizing Capital*: A History of the International Monetary System, (Princeton, N.J.: Princeton University Press, 1998)

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