NEEDS FOR GLOBAL FINANCIAL REGULATION

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The East Asian crisis has shown up the threats of volatile and large short–term capital flows to the economic stability of developing countries. What is urgently needed is greater transparency of how the global financial players and markets operate, and reforms at both international and national levels to regulate these speculative flows.

LACK OF TRANSPARENCY

The workings and movements in the international financial markets and system have played the most important part in the East Asian financial crisis. The crisis is also manifesting now in Russia, South America and will likely spread to other countries.

It becomes obvious that this global system needs to be monitored and also reformed. Yet there is a great lack of transparency on what constitutes the financial markets, who the major players are, what are their decisions and how money is moved from market to market, and with what effect.

Financial crises cannot be prevented or resolved unless this lack of transparency is removed. That is a first step.

After greater transparency, there is the need to improve the system, to remove its worst aspects and excesses, and to put in place a system in which currency and other financial instruments (shares, bonds, etc) are used for legitimate trade or real– investment purposes and not for non–beneficial speculative gain. Transparency and reforms are needed in the following areas:

- We need to know who the major institutions and players are in the ownership of financial assets, and their behaviour and operational methods, and the markets they operate in.
  How do they gain their leverage? From where do they get their funds and credit and on what terms? How do they operate and through which channels? In particular, how do they view emerging markets and what are their methods to derive maximum profits there?
  These institutions include hedge funds, mutual funds, pension funds, investment banks, insurance companies, commercial banks and the finance departments of multinational and big companies.
- What is the system by which central banks of the major Northern countries regulate, deregulate (or decide not to regulate) the behaviour of funds, speculators and investors? How do central banks coordinate among themselves? Do they (or some of them) coordinate among themselves to influence parameters such as exchange rates and interest rates? What is the role (or lack of role) of the Bank for International Settlements?
- The IMF is the major international financial institution, whose policies can determine the finances and fate of nations.
  There is lack of transparency on how the staff (who are powerful in the institution) set their policies and conditions, globally and for each nation.
  How do the staff determine the policy framework and the specific conditions for loans for each client country? Do they come under the political influence of particular countries (especially the US) and of the major shareholders, and thus lead to a situation where decisions are not made only or mainly on professional grounds?
  How do they major shareholders collaborate among themselves? What is the linkage of interests between the IMF secretariat, the US Treasury and other major countries' finance ministries, and the international banks (whose interests they usually serve in getting loans repaid from developing countries)?

There are some studies relating to some of the questions above. However these studies are few. Much more investigation has to be done, so that some basic knowledge of the institutions

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and system can be gained. On that basis, proposals for changes and reforms can be made.

THE NEED FOR REFORM

The present system suits the interests of financial owners and speculators. These players have powerful backers in governments or in the U.S. Congress and other Parliaments in the North. Thus getting global reform going is an uphill task.

Nevertheless it is becoming daily more evident that the present system is very unstable and will continue to produce large–scale crises which is becoming too costly for the IMF or the Group of 7 rich countries (G7) to bear. Therefore the question of «a new financial architecture» is being raised by the G–7 themselves.

However the G–7 approach is to try as far as possible to have business as usual. This means not reforming the present system of free and liberal flows of short–term or long–term capital. They do not want regulation at global or national level.

Their approach is to get national governments in developing countries to strengthen their banking systems so that the banks can withstand more shocks that volatile flows will bring in future.

The G7 countries' focus is to have «greater transparency» at national level (so that investors will not foolishly put money in weak spots) and tighter banking regulation so that there will be less chance of a systemic bank collapse.

Such an approach may of course be useful in itself, as no one doubts the importance of strengthening national policies and financial systems.

But surely this «national approach» in developing countries is grossly insufficient and needs to be complemented by a global approach to monitor and regulate cross–border financial flows. At national level, governments should also be allowed and encouraged to institute regulations to reduce the power of speculative funds (this needs to be done especially in the rich countries) and to reduce the volatile inflows and outflows of short–term capital.

There is a strong case (getting stronger by the day) for greater international and national regulation of financial flows, players and markets, as well as reform of the IMF.

At global level, there should be a system of monitoring short–term capital flows, tracing the activities of the major players and institutions, so that the sources and movements of speculative capital can be publicly made known.

There can be also be serious pursuit of a global tax on short–term financial flows, such as the well–known Tobin Tax, where a small tax is imposed on all cross–country currency transactions.

This will penalise short–term speculators whilst it will have only a very small effect on genuine traders and long–term investors. The advantage is that not only will speculation be discouraged, but there can be far greater transparency in the markets as movements of capital can be more easily traced.

At national level, in the North countries, which are the major sources of international capital flows and speculation, national regulations can be imposed to reduce the power and leverage of funds.

For example, banking regulations can be introduced to limit the amount and scope of credit to hedge funds. Proposals can be made for this and other similar objectives.

At national level, in the South, countries should explore options of regulating and discouraging inflows of short–term speculative capital. The well–known case of Chile where a percentage of all incoming foreign capital has to be deposited with the Central Bank interest– free for up to one year, can be emulated by other countries.

This device was introduced after an episode of excessive inflows of funds. It has helped to reduce short–term speculative inflows and outflows whilst at the same time it was not a disincentive for the inflow of long–term foreign investment.

Another measure worth emulating is the requirement that local companies seek Central Bank permission before securing foreign–currency loans, and permission should be given only if or to the extent that the project being financed is shown to be able to yield foreign exchange earnings sufficient to service the loan.

This is a requirement established by the Central Bank in Malaysia, and it helped to prevent the country from having the large and excessive short–term foreign–exchange private corporate loans that flooded other countries like Thailand, Indonesia and South Korea.

Further, countries that face a possible danger of sudden and large outflows of funds can consider some limited restrictions (at least for a limited time when the danger is imminent) on the freedom of residents and resident companies to transfer funds abroad.

Such limitations had in the past been in place in countries that now practice financial liberalisation. Indeed restrictions on capital outflows still exist in many developing countries (such as China and India) and have helped to stabilise their financial situation.

Whilst the desirability of regulations on inflows and outflows of short–term capital make eminent sense, countries that have already liberalised and are dependent on the «goodwill» of the financial markets are afraid that reintroducing them could generate a backlash from the market and from the G7 countries.

Thus, it is crucial that the G7 countries themselves review their own anti–regulation position, and give the stamp of approval and legitimacy for developing countries to have these measures. Otherwise countries may not be able to institute measures that are good or necessary for their financial stability and their economic recovery on the fear of being labelled as «financial outcasts.»

Once again, the ball is at the feet of the G7 countries to take the lead in both international level and national level reforms.●