

Maier, Gerhard

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Gerhard Maier*

International Financial Markets: Control or Liberalization?

Exchange rates, interest rates and share prices are subject – at least occasionally – to great fluctuations. Diverse economists regard the volatility of international financial markets as a threat to the goods and labour markets. They blame the price turbulences on the speculative behaviour of a large section of market participants, and claim that the deregulation and liberalization of the international financial markets in the eighties has therefore already gone too far. Under discussion today are approaches to a re-regulation of the money, capital and foreign exchange markets. These proposals are evaluated in the following paper.

Some US\$ 300 billion are turned over daily on the world's foreign exchange markets. Only 5% to 10% of this serves to finance trade in goods and services, whereas the remaining capital flows serve exclusively either to increase or to reduce bank balances and security holdings abroad. Changes in exchange rates and interest rates are therefore essentially a result of international portfolio switching. It is often assumed that these movements of assets are simply the result of speculative decisions with a more or less short-term orientation,¹ and that international speculators make use of the room for manoeuvre which has come into existence as a result of the liberalization of the international financial markets (flexible exchange rates instead of fixed ones, the removal of limitations to capital transactions). The suspicion is often voiced that international speculators exert a decisive influence on the quotations of currencies, bonds and shares. Speculative decisions are believed to lead to the volatility of interest and exchange rates and to cause exchange rates to be under- or overvalued. The criticism aimed at speculation – and thus at the liberalization of financial markets – can be summarized in two basic theses:

- ☐ The volatility of exchange rates caused by speculation limits cross-border trade in goods and reduces the incentive for investments, thus in the long run endangering incomes and jobs.
- ☐ Speculation has the effect that exchange rates deviate quite considerably from the economic

fundamentals over longer periods of time. Distinct over- or undervaluations of currencies send out false price signals and thus exert a negative influence on decisions concerning production and investment.

According to these arguments, the freedom of the financial markets exists at the cost of the real economy. The danger of drastically over- or undervalued exchange rates, in particular, is seen as being adequately confirmed by the escapades of the US dollar. Because the greenback rose to a value of around DM 3.50 in the middle of the eighties, it is argued, there was a basic weakening of the competitiveness of the American economy – due to the rise in the prices of US goods which this exchange rate implied – and at the same time the structure of the economy in the devaluing countries (Japan, Federal Republic of Germany) whose currencies were undervalued, was distorted in favour of the export sector.

Target Zones Concept

A number of market interventions have been proposed in order to reduce the danger of volatile and "wrong" exchange rates. If these proposals are summarized, two groups crystallize: one group wants basically to abide by the liberalization of the financial markets but to reduce exchange rate fluctuations by coordinating the macropolicies of the economies involved. The second group wants to follow the opposite

¹ Cf. Felix G. Rohatyn: A Financial House of Cards, in: Time, 17. 10. 1988; for an overview of the current state of discussion cf. Stuart E. Weiner: Financial Market Volatility: Summary of the Bank's 1988 Symposium, in: Federal Reserve Bank of Kansas City, Economic Review, January 1989, pp. 9-19.

* Deutscher Sparkassen- und Giroverband, Bonn, West Germany.

path and limit international capital mobility in order to create room for manoeuvre for national economic policies. The target zones concepts developed by Williamson and others belong to the first group.² These concepts imply the steering of the basically flexible exchange rates between the US dollar, the yen and the D-mark within certain margins. Although apart from France none of the governments of the major industrial countries has officially embraced it, the concept of influencing exchange rates has gained ground since the middle of the eighties. In the 1985 Plaza Accord, the major industrial countries agreed that the exchange rate – regarded as overvalued – of the greenback had to be reduced via appropriate measures (foreign exchange market interventions, changes in interest rates, etc.)

In the spring of 1987, the circle of major industrial nations (the Group of Seven, or G7) agreed that the dollar exchange rate had now fallen enough and should be stabilized via a closer coordination of economic policies. The Louvre Accord, which emphasized their preparedness to cooperate on economic policy in the service of exchange rate policy, was signed. In fact, since Louvre the greenback has moved within relatively narrow margins compared to its previous fluctuations, although these margins were never officially confirmed. The readiness to cooperate was expressed in the occasionally massive foreign exchange market interventions and the frequent talks within the G7 framework on the coordination of economic policies. Nevertheless, those responsible were at no time prepared to subjugate their national economic policies completely to the common concept.

Limited Optimism

The experiences made with the intensified international cooperation only give cause to limited optimism.³ The central problem of exchange rate target zones and other concepts for international cooperation is above all that they demand preparedness to reduce economic policy autonomy. This abandonment of sovereignty has, however, until now found only limited acceptance. Furthermore, there is little agreement on the question of common goals. The EMS is an exception.⁴ Its exceptional position is based on the fact

that it is dominated by the (stabilization) policy of the Deutsche Bundesbank and has thus developed into a D-mark zone. Only because the Deutsche Bundesbank's partners have been prepared to put the Bank's monetary policy measures into practice themselves, have they been able since the beginning of 1987 to avoid a major realignment.

It is questionable whether the Plaza and Louvre Accords really reduce the volatility of the financial markets. The margins within which the dollar fluctuates have become markedly narrower compared to the first half of the eighties, but not the extent of interest rate or share price fluctuations. It would appear, rather, that these have increased. This appears to confirm the fears expressed by various economists that the greater stability of exchange rates is paid for simply by a greater instability of interest rates. The reduction of exchange rate fluctuations reduces the risk of cross-border capital transactions, thus making them more attractive. This increases the interdependence of the money and capital markets. The markets are more strongly infected by the turbulences on neighbouring markets. Monetary policy measures to stabilize exchange rates, namely foreign exchange market interventions and interest rate changes, trigger off additional turbulences on the markets for interest-bearing securities.

On the basis of the experiences made it is not surprising that recently politicians, too, have become disenchanted with the usefulness of a global exchange rate stabilization. At the G7 conference in April 1990 the turbulences of the yen exchange rate were mainly characterized as a national Japanese problem. The readiness to intervene with the aim of stabilization was limited to vague formulations and sporadic foreign exchange market interventions.

Sand in the Works

Motivated not least by their scepticism regarding the international coordination of macropolicies, a group of economists has suggested measures to inhibit the international flow of capital. The leader of this movement is James Tobin. His main concern is to throw "sand into the works of foreign exchange speculation".⁵ For this purpose, in his opinion, a levy of one percent on foreign exchange transactions should be introduced in order to limit the attractiveness of speculative cross-border financial movements.

² On this, cf. for example John Williamson, Marcus M. Miller: *Targets and Indicators: A Blueprint for the International Coordination of Economic Policy*, Washington D.C. 1987; John Williamson: *Zielzonen für Wechselkurse*, in: Jean-Pierre Blancpain (ed.): *Floating. Auf der Suche nach Alternativen*, Zürich 1989, pp. 39-43.

³ A critical review of the cooperation approaches is to be found in Beate Reszat: *Prospects of Macro-economic Policy: A German View*, paper prepared for a joint project on trilateral policy cooperation with the Institute for International Economics, Washington D.C., and the Sasakawa Peace Foundation, Tokyo, Hamburg, December 1988.

⁴ Cf. Gerhard Maier: *Monetary Cooperation in Europe*, in: *INTERECONOMICS*, Vol. 23 (1988), No. 1, pp. 3-7.

⁵ Cf. James Tobin: *Sand ins Räderwerk der Devisenspekulation*, in: Jean-Pierre Blancpain, op. cit., pp. 62-67.

Bhaduri and Matzner have made a modified proposal.⁶ They call for the imposing of a tax on all short-term cross-border financial transactions. The starting-point of their reflections is the model developed by Fleming and Mundell.⁷ According to them, the desired effect of a – Keynesian oriented – expansionary fiscal policy is frustrated because it leads to rising interest rates, which attract capital flows and thus cause an upward revaluation of the domestic currency, which weakens the international competitiveness of the domestic economy. Curbed exports and accelerating imports in the end nullify the originally expansionary fiscal policy stimulus.

International Capital Transactions Tax

Bhaduri and Matzner are concerned to eliminate the negative international influences on Keynesian policy. They therefore propose an international capital transactions tax to break the causal chain described by Fleming and Mundell. This tax would, in their opinion, not only revive world trade and encourage investment, thus supporting labour markets, but it would also at the same time be an additional source of revenue for the budgets of the states concerned. Bhaduri and Matzner propose using the funds raised by these taxes to finance labour market programmes (training, environmental protection projects).

The introduction of an international capital market tax makes little sense, however. If the hindering of transborder capital flows, as intended, were in fact successful, the international division of labour would be disrupted. In this case, capital would be prevented from flowing to the best host, i.e. to the place where at a given risk it could achieve the highest return. The curbed

international mobility of capital could no longer contribute towards the increasing of the productivity of the world economy. The growth of international welfare would be endangered.

In the coming years there will be above all in Eastern Europe, but also in the developing countries of the Pacific, a quite considerable need for funds. This need cannot be fulfilled alone by direct investments; short and medium term credit relationships will also be necessary. An international capital transactions tax could place considerable difficulty on the flow of capital to these economies and thus hinder their process of development.

If it is to be attempted to limit the international capital transactions tax to short-term capital movements, the question is how these are in fact to be differentiated from long-term ones. For example, even the purchase of a thirty-year bond can take place with the intention of disposing of it again in a few weeks, i.e. on the basis of short-term considerations. Furthermore, experience with international financial innovations has shown how inventive the markets can be in the question of getting round regulations. The Tobin tax, too, would in the end lead to financial innovations, whose sole aim would be to avoid the tax. New distortions would appear in the place of those which are possibly caused by wrong exchange rates.

It is in any case counterproductive to attempt to limit speculation. Basically, all economic decisions are taken in uncertainty and are therefore speculative. Investments abroad and/or in a foreign currency may as a rule bear a greater risk than domestic investments, but they are not fundamentally different. Furthermore, it is a

⁶ Cf. Amit Bhaduri, Egon Matzner: Relaxing the International Constraints on Full Employment, Report to the 4th Session of the LME's International Conference: No Way to Full Employment?, Proposals for Institutional Reform, Evidence from LME's Research, Berlin, 5th to 7th July 1989, mimeo.

⁷ Cf. J. Marcus Fleming: Domestic Financial Policies under Fixed and under Floating Exchange Rates, in: IMF Staff Papers, 9, 1962, pp. 369-379; Robert A. Mundell: The Appropriate Use of Monetary and Fiscal Policy for International and External Stability, in: IMF Staff Papers, 9, 1962, pp. 70-79.

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fact that even speculative investments are not irrational. In the final analysis they are made to achieve a profit. The market participants base their decisions on the general known setting. If this setting changes rapidly, repeated corrections to the decisions will be necessary. One example of this today are events in the Arab world, which have caused considerable turbulence on the international foreign exchange and financial markets. The volatility of international financial markets is largely due to the fact that the internationally oriented investors must continually evaluate new information. It is also wrong to disqualify strong upward or downward exchange rate trends as purely speculative phenomena. They are the reflection of strong changes in the general situation, particularly in the political environment. Thus, the soaring of the dollar in the first half of the eighties was desired politically because the American administration – and not only it – had regarded the dollar boom as a sign of strength.

Stabilizing Speculation

He who wishes to limit speculation ignores the fact that it plays an important role in the economy as a whole. Milton Friedman invented the term “stabilizing speculation”. The speculator in Friedman’s sense acquires assets when they are, for some reason or another, plentiful and therefore cheap; he sells assets when they are scarce and expensive. In doing so he contributes to the reduction of market disequilibria. There are, however, also other speculators, who buy when prices are rising and sell when they are falling, because they wish to profit from a supposed trend (bandwagon effect). This destabilizing speculation is, however, very risky and tends to be a temporary phenomenon. If serious over- or undervaluing of assets does in fact take place, e.g. due to the bandwagon effect, then opportunities will arise for a profitmaking counterspeculation. Strong price fluctuations are in practice often a sign that markets are too thin, i.e. that there is too little speculation. If an international capital transactions tax is successful in reducing speculative financial flows, this will not guarantee that exchange rates will fluctuate less strongly or that they will be less under- or overvalued. Volatility might possibly even increase.

It is also controversial whether the effects of large exchange rate changes are really as dramatic as is often claimed. The lack of international competitiveness of the US economy, for example, is not due alone to the overvaluation of the greenback, but also to the fact that US industry is on the one hand strongly oriented towards the domestic market and on the other hand

supplies foreign markets mainly through local subsidiaries. This is not the least important reason why the export capacity of the American economy has improved only hesitantly in spite of the halving of the dollar rate which has meanwhile taken place. It has in any case become evident that enterprises as a rule manage very well with volatile exchange rates. Fixed but changeable exchange rates, such as existed in the Bretton Woods system, are a greater problem for enterprises. In this case the changes in exchange rates are not continual but erratic. Indeed, the dynamic and sustained economic growth in the USA, Japan, the Federal Republic of Germany and other countries in the eighties certainly does not indicate that the volatility of exchange rates caused any considerable problems. It is impossible, however, to form a hypothesis as to whether the growth of world trade would have been even higher if exchange rates had remained more stable.

The usual arguments against transborder capital flows include the fact that they limit the autonomy of national economic policies. The greater interdependence of economies need not be negative, however. International capital movements cause competition between currencies to exist in the sphere of interest-bearing financial assets. Globally oriented investors show a preference for assets with certain characteristics. Not only the rate of interest is decisive, but also the risk. Currencies which have shown relatively low rates of inflation over longer periods of time are particularly attractive. This is demonstrated by the success of the D-mark, which has gained ground as an international investment and reserve currency. The close interlinking of the financial markets can thus lead to a certain disciplining. If, for example, a government follows an economic policy which greatly endangers monetary stability, this can trigger off devaluation if exchange rates are flexible. Since this would have negative social and psychological effects, the government in question sees itself forced in the end to steer the ship in the other direction. The international competition of currencies has possibly contributed to the fact that rates of inflation have been relatively low in recent years, at least compared to the seventies.

The uncertainty which still exists today regarding the causes and effects of volatile interest rates and exchange rates makes it advisable to be cautious in the question of economic policy countermeasures. Since the deregulation of the international financial markets facilitates capital mobility and thus promotes the international division of labour, it should be not stopped but continued. Re-regulation, on the other hand, would be counterproductive.