

Taming international capital flows in the age of globalisation towards better regulation of the free market system

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Let me start with a somewhat provocative proposition:

There is no need to tame international capital flows. The financial crisis was not caused by an overabundance of international capital flows. The situation is totally different to the currency crises that we had ten or twenty years ago, when central banks were flooded with foreign money, which in the end led to an increase of domestic money supply and inflationary dangers. Wrong currency-relationships were at the origin of market turmoil at that time.

This time all is different. We need not less international capital flows. We may even need more. Look at the banking systems in the last months, even the insurance industry. Both desperately approached international investors, especially the sovereign wealth funds in the Middle East and in Asia to get new capital from them to deal with their asset write-offs or trading losses. The fact that at the end of the day the governments had to come to help with huge rescue packages in all the leading industrial nations was due to the lack of enough international capital flows. The fact was that money and capital did not flow to the places where it was needed.

It's not the time to complain about international capital flows and to think about regulations to tame them. It is rather time to praise their advantages. They improve the allocation of resources in the world. They help to increase productivity, economic growth and employment. We just have to bear in mind what the textbooks say. International trade and the mobility of capital and labor lead to the optimal allocation of resources in the world! This is how international trade over the last twenty years outperformed international production. Trade grew at 6% p.a., production at 2,6 %. Trade grew by almost 70%, production only by about 25%.

Apart from these standard arguments international capital flows are also necessary for another reason, less often quoted. International capital flows help to safeguard the supply of oil and other raw materials for the users countries. Never forget that the oil producers presently swap their oil reserves into investments in the capital markets. They always have the alternative to leave the oil in the earth if we do not offer them the possibility to invest the proceeds of their oil extraction in the international capital markets, or if we energy-users offer them only depreciating currency-investments. Taming the international capital flows could therefore lead to turmoil in energy and other raw material prices, as an unwanted side-effect.

So we should be careful with all those plans to restrain international capitals flows. Especially I want to caution about all the efforts to install some kind of Tobin tax (which in some quarters in Germany currently enjoys merry resurrection). We all know that the Tobin tax as a levy on the turn-over on capital markets, especially in the foreign exchange markets, is seen by many as an easy way to collect money and to use it to increase development aid (or other public objectives). But never forget that in the end it leads to worse allocation of resources. It thus reduces growth. In addition it is not viable because nobody can ensure that the Tobin tax will be collected in all places of the world.

Here is my first summary: we do not have too many international capital flows. It is not a question to tame them but rather to continue to encourage them.

Of course, I do not mean to deny that there are problems connected with international capital flows. However it is not the quantity per se which is so troublesome, NO - it is (a) rather the direction of these flows, (b) sometimes the instruments used, and (c) very often excessive leverage factors used by the operators behind the management of capital flows, i.e. investment banks, hedge funds, banks, insurance companies etc. etc.

My first point: capital flows should go from the mature and the rich countries to the poorer ones in order to help them in their development process. This should not only be a moral necessity but it is attained by economic incentives, namely the fact that

the productivity of capital normally is often higher in emerging markets than in industrialized countries (of course, the increased country or investments risks need to be put into the balance).

Unfortunately year by year a very large portion of the international capital flows go the other way round. They flow from many emerging markets to the richest country in the world, namely to the United States. Due to the huge annual current account deficit (2008 alone about 650 to 700 bn Dollar) the US needs money (i.e. attract Dollar-investments) to finance the deficit. On the other hand the emerging world has increasing current account surpluses (2008 about 380 bn Dollar) and it can thus afford to invest money in the US under the motto “safe place, acceptable return”.

But that is not a situation that should be tolerated to continue forever. It puts the economic rules upside down. The emerging markets should invest their funds in their own countries. The US should be a creditor instead of a debtor-country. The US should not rely on the funds from the emerging markets and be increasingly dependent on them. The US rather should be supplier of funds for the poor people in the world. The situation therefore must be corrected.

To do that we do not need better regulation of the market system. We need a reduction in the US current account deficit. This requires less budget deficits in the US, more savings of the US consumers and more efforts of the US companies to increase exports on world markets and to be competitive vis-à-vis imports. Some of these changes are on their way. The deficit is coming down a bit. But we all know that such changes take their time. It will be a process of years. Unfortunately the process currently is interrupted again due to the increased budget deficit in the US in connection with fiscal stimulation, the rescue package for the financial industry, and most likely the policies of a newly elected administration.

To be fair, it is not only the US that is to blame for these distortions of the international payments flows. There are also others. China for example has a huge surplus in its current account and should therefore expand its domestic market and persuade its consumers to reduce the savings rate. The Chinese are therefore rightly pressured

by the international community to revalue their currency. For some time, the Chinese indeed have let the Renminbi appreciate. But recently due to the weakening of the economic activity and the pressure of increasing costs in the country (especially wage and energy costs) this adjustment process has been stopped.

One should also mention another country which plays its part in the world wide distortions of the international payments flows. That is the Federal Republic of Germany. Last year it had a current account surplus of 250 bn Dollar (even higher than that of China). At the beginning of the decade Germany still had a deficit in the current account. However here comes the working of the E.U. into play. Germany is the surplus country off-setting the accumulated deficits of most other European partners.

And there is another difference between the current account surplus of a country like Germany and a country like China. The German surplus leads to a corresponding capital export by the private sector, it is therefore vastly diversifying on the global markets, whereas the Chinese surplus leads to a huge accumulation of reserves by the Central Bank. This surplus results from the interventions on the foreign exchange markets. Presently the Chinese have reserves of more than 1 900 bn Dollar. That is the highest FX-reserve number ever achieved by a country. It is much higher than the reserves of the rich oil countries. Abu Dhabi for example has reserves of about 1 000 bn Dollars. Reserves of this magnitude in countries that are no oil and raw material producers should not be tolerated by the international community.

This brings me to the question of sovereign wealth funds and international capital flows. Many are fearful of the investments by the sovereign wealth funds. They could lead to a sell-off of the national industry and to foreign control. The investors could gain too much influence in our countries. All that has to be taken seriously. Nobody could for instance agree to an investment of sovereign wealth funds in the defense industry. On the other hand the sovereign wealth funds supply us with capital and help to make more investments und thus promote economic growth and employment.

Therefore, I think, we do not want to constrain these flows generally. Most of our experience shows that the investments of sovereign wealth funds are driven like other foreign direct investment by profitability considerations and not by political motives. But what is needed are two things: transparency and reciprocity. We need to know where the funds are investing, how much money they are putting in certain companies and how far they are able to influence the strategy of the companies by way of Board-representation. And we need to have reciprocity in the sense that they themselves keep their countries open to our investments there. That is especially important for Russia which pressures to invest in western countries but is not really ready to let foreigners invest in Russia.

On both fronts progress is made. In the last meeting of the International Monetary Fund in Washington the representatives of the sovereign wealth funds met to continue work on a world-wide commitment on the issue of transparency.

What I do not feel sensible at the present time is the proposal of the French President Sarkozy to create national wealth funds in the industrialized countries too. That would only lead to more state interference in private companies, would thus weaken the principles of the market economy and harm economic growth. That is not helpful in times of a global recession.

Now I come to the point of regulations for international capital flows. It is often said these days that it was the international capital flows that led to the global diffusion of the current banking crisis. It was the investment banks that distributed dangerously structured products such as CDO's to investors all over the world. Would it not be better to prohibit the sale of such products? Couldn't we thus avoid big damages like the losses in the recent financial crisis?

The answer is:

What has to be done – and here we need regulation indeed - is that these problems do not re-occur. Regulation should either prohibit the suppliers to offer such products without adequate risk-description (*“where is the famous strictness of US consumer protection laws for US and international investors?”*), and/or regulation should re-

mind buyers of the risks to acquire these products, and buyers in turn can rely on the risk-analysis. So we need all those regulations that are presently discussed to preclude any repetition of the subprime product crisis. We need a banking supervision that stops the granting of subprime credits, as a matter of fact the US should bring all mortgage credit extensions into a banking supervision. Then we need urgently rating agencies which identify the risks of the instruments such as CDO's correctly (to avoid massive downgrading from AAA to BBB only when the risks were starting to become apparent). In other words: Rating Agencies should be supervised and performance reviewed like banks or instruments like share-documentation. We need more transparency so that structured products and special investment vehicles should appear in the books of a bank and not to be listed "below the balance-sheet". We need a restructured banking industry (no pure investment banks anymore, control over the leverage factors of hedge funds etc.), and in Germany finally an end to the three-pillar split banking industry! We need better and more sophisticated risk management in the banking industry worldwide. We need better banking and financial market supervision, we need in particular much more transparency in the oil-trading markets (much too much influenced by obscure speculation, we need one top regulator for the European (Euro) markets and then we need only one regulator for the banking industry in Germany (namely the Bundesbank for the banking industry and BaFin for the securities industry – and not constant overlaps between Bundesbank and Bafin as two regulators in the same business), and on a worldwide level do we need a re-activated I.M.F. – not for emergency lending but rather for guidance, control and policy overview to avoid embarrassing accidents such as the Island-insolvency or other candidates to come in from Eastern Europe, or on the US/China trade and monetary conflict, or (why not?) on US monetary policy – if lowest interest rates and uninterrupted liquidity - allocation for years may start to unbalance the global markets and the global financial industry!

So far my comments on the issues of taming international capital flows at this time.

Thank you for your attention.