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PROSPECTS FOR THE GLOBALIZATION OF CAPITAL MARKETS

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The last few years have been very difficult for many companies and governments — and for investors — on both sides of the Pacific. I would like to reflect a bit on what we have learned in this period — and the changes and challenges it foreshadows for coming years.

First, we have learned that even though globalization has suffered a number of hard blows, the internationalization of markets, financial flows and overseas investment has proven remarkably resilient.

Despite globalization having been subject to a number of daunting “stress tests” in the past few years — the Asian financial crisis, the synchronized downturn in world growth and the shocks of September 11 — there has not been a breakdown in international trade cooperation, a prolonged global financial crisis or a wholesale retreat by nations to “beggar thy neighbor” policies. Indeed, we have seen more nations — the People’s Republic of China (PRC) being the most visible and largest — take significant steps to increase their participation in the global economic system; the Russian Federation has done so as well.

Notwithstanding this, threats to globalization and to the expansion of free market policies are greater than they have been for a number of years.

In many quarters the perception has been growing that closer integration with the rest of the world makes a country more vulnerable to events that originate outside its borders and are therefore beyond its control.

The agreement at Doha last fall to begin a new round of trade negotiations could provide an important counterweight to any weakening of global economic cooperation in the period ahead. There are also powerful free trade constituencies that would seek to prevent a breakdown in the process of globalization. The cross-border integration of business, financial markets, technology and personnel mobility runs deep and benefits large numbers of people in Asia and many other parts of the world.

- Roughly one-third of all international trade is intra-company trade — and production around the world relies on the steady intra-company flow of intermediate goods across borders.
- Multinational corporations and international technology partnerships form rich outsourcing, production, sales, procurement and distribution networks that crisscross borders.
- Companies around the world depend on foreign workers and need the freedom to move employees freely from one country to another — and many countries count on remittances from their citizens working abroad.

There would be many dislocations were there to be extensive new restrictions on such cross-border activity.

The Global Economic Agenda

For years Americans have embraced the seductive myth that distance from the world's major trouble spots protected them from harm. Now most Americans understand more clearly that their safety is bound up in alliances, coalitions and cooperative arrangements with other nations. This is true on the international political-military front. It is even truer on the economic front. During the Cold War, Washington saw most international issues through an anti-communist prism. No longer is the world so simple. While anti-terrorism is a top priority, it is not the only item on the global agenda. Many other matters such as expanding trade, avoiding financial instability and reduction of poverty are of considerable importance to many other nations.

In addition, a go-it-alone policy on economic issues for the United States is completely unfeasible — and has been so for a number of years. Virtually no American objective in the global economy can be accomplished without a substantial amount of international cooperation. Most Americans understand this, and I believe that most of America's leaders recognize that US interests and those of most of the world lie in a more open, rules-based global economy — and that the US has a leadership responsibility now as in the past to promote such objectives.

Yet the danger remains that unilateralist pressures on trade, foreign aid and environmental issues will grow in some quarters in the US, especially if there is friction between the US and its coalition partners over the next stage in the war against terrorism, over how to deal with Iraq or over divisive economic matters. The recent decision by President Bush on steel, for instance, could ignite frictions that might spread to other sectors, weakening trade cooperation and growth prospects for a number of countries.

Another series of pressures for unilateralism could emerge from the growing US current account deficit. There is a high probability that America's already large trade and current account deficits will widen in coming years. This is likely to occur because US growth rates will probably exceed those of its major trading partners, because the US continues to have a high propensity to import and because the strong dollar has eroded the competitiveness of a number of American products. The current account deficit could in several years approach 6% of US GDP — up from just over 4% now.

Trade and current account imbalances have not been a major public issue in the US for many years, nor have they affected the value of the dollar — which remains robust. But the wider these imbalances become and the longer they last, the greater the risk that they will become a contentious public policy issue and will adversely affect the value of the dollar, pushing it sharply downward. And that would be of concern to business throughout this region.

Three Steps Toward Improved International Economic Cooperation

Three steps are, in my view, needed to strengthen international economic cooperation in order to better address the key challenges to global prosperity and economic stability.

Step one is recognition that neither the US alone nor the industrialized democracies together can successfully deal with the many complex challenges affecting the world economy. The Doha WTO meeting provided a stark example of why collaboration between industrialized and emerging economies is essential. In the past, a handful of industrialized democracies dominated high-level trade meetings. At Doha success depended on cooperation with a number of increasingly influential emerging economies — many of them here in Asia. And their role will only grow in significance in the future, especially as the PRC exercises its influence in the WTO.

Step two is to reorder the key forums to improve international economic cooperation. Since 1975 the Group of Seven, now the Group of Eight, has served as a kind of Board of Directors of the global economy. This arrangement was appropriate for the late 20th century. But given the realities of the new century, it now has to be restructured to include influential emerging countries, such as the PRC and India, in a more systematic dialogue on the interaction among political, security and economic issues.

Step three is to refocus the agenda. A joint initiative among multilateral economic institutions, developing and developed nation governments and the private sector to encourage a more fertile environment for entrepreneurialism, and more investor-friendly legal and economic reforms, could lead to more dynamic growth and sounder flows of long-term capital. This effort would be enhanced by agreement to reduce pressure on emerging nations to open their economies to flows of short-term money in favor of greater attention to strengthening their domestic financial institutions and corporate governance.

Public sector-private sector cooperation is needed to strengthen social safety nets in virtually all emerging economies to provide a cushion against economic turbulence. *Pension and social security reform will, in particular, be vitally important issues in the period ahead in light of major demographic changes in much of the world.* Demographic change, and the growing tsunami of retirees, could overwhelm nations that fail to build sound pension plans now. Those countries that tackle the problem early on will likely enjoy greater social stability — and become more attractive to investment. Those who wait too long and, as the result, have to sharply raise taxes, borrow a lot more or see deterioration in the living standards of large numbers of retirees, will suffer socially, economically and politically. Countries that continue with a largely pay-as-you-go system will have neither public nor private sector managed long-term investment funds, that play a major financial role in the US, Canada, Britain, much of Northern Europe and Australia — as well as Hong Kong, China, and Singapore. These large pools of investment funds are vital to dynamic capital markets and their ability to finance new investment. This should be a goal for other countries in the region.

A second area in which such cooperation is needed relates to overcoming problems that numerous countries in the area have with respect to their domestic banking and financial systems, growing out of significant asset quality issues. In a number of countries in this region, large amounts of non-performing loans point to the need to continue and strengthen efforts to reform, restructure or in some cases recapitalize banking and financial systems. How well this is done and how quickly will have an enormous influence on the general commercial and financial environment in many countries in Asia. Again, tackling the problem sooner rather than later will produce substantial long-term competitive and social benefits.

And, importantly for the longer term, a global initiative by governments and private research institutions to supply very low income nations with the resources and technology to expand health and education services would go a long way to overcome desperate conditions in many regions.

Combating Anti-Globalization Pressures

The expansion of international flows of trade, capital, people and ideas exerts centripetal forces pulling nations together. In contrast, a growing desire to assert national or sub-national political, economic and cultural interests — and resistance to the notion that opening economies or societies rapidly to the inflow of foreign capital, goods or ideas is an unambiguous good — might create centrifugal forces that can push countries apart.

Globalization and modernization have an impressive record of boosting growth and living standards. But they are often blamed for increasing poverty and inequality. There is substantial evidence that these problems are often more directly the result of government policies that deny many of their people the benefits of participation in open markets, or the ability to exercise private initiative, or the education required to thrive in this changing world economy.

Focus on this divisive issue and placing inordinate blame on globalization frequently diverts attention away from finding genuine answers to the problems of poverty, income inequality and vulnerability to disruptions from shifts in global trade and financial flows. These pose enormous problems for hundreds of millions of people in Asia and around the world.

Growing numbers of people in low-income societies can see the benefits of prosperity in other parts of their own countries, or abroad, on television or in the movies. But they often lack the needed skills to achieve them — or are held back by poor health or inadequate education. Where large numbers of low-income peoples do not benefit from globalization or modernization, are injured by them or feel left behind, frustration can become intense.

For corporations and governments alike, the challenge is to demonstrate that globalization and foreign investment can not only produce growth but can also advance social justice. There is much evidence that this is true, but many in both the industrialized and developing world remain unconvinced.

Making the case cannot be left to governments alone. The response to the anti-globalization movement requires business leaders to explain and visibly demonstrate how their companies' environmental, hiring, worker-relations and investment policies provide benefits to countries in which they do business.

And they need constantly to make the case in countries where they operate that policies that encourage investment and the development of local entrepreneurs are vital to dynamic growth and job creation. Legal and financial institutions that produce a stable environment for the creation and defense of intellectual property are particularly important in a world economy in which the effective application of ingenuity, knowledge and entrepreneurial creativity are essential factors in generating more and higher value-added jobs.

This also means demonstrating how companies can integrate the efficiency benefits of international markets, supply chains, technologies, and flows of people with a stronger recognition of local identities, traditions and influences. Even that great driver of global integration, the Internet, once seen as an American technology dominated by the English language, is now experiencing around the world demands for increased local content and use of local languages. Globalization does not mean homogeneity. Companies that adapt to local markets, cultural requirements and values have demonstrated that they are likely to encounter less resistance to themselves and to their products.

Credibility, Earnings Quality and Responsibility

The last point I would like to raise goes to the growing emphasis of investors, and capital markets, on corporate creditability, earnings quality and responsibility as keys to successful business.

Many companies in the US have learned that there is something worse than losing money during a given quarter or even a given year — and that *something* is losing credibility, losing the *trust* of investors, customers or employees. That is one of the lessons of Enron — and other

companies as well. If a corporation has a losing year, it can make it back. If it loses *trust* — that is much *harder* to regain. This is true for the management of companies, for accountants, for stock analysts and for others.

In a similar vein, more and more attention is being paid to the *quality* of earnings as well as to the *quantity* of earnings. How much an investor trusts the numbers he or she is provided — and how sustainable they are — have become extremely important in the post-dot.com crash, post-Enron era.

This emphasis on quality encompasses several factors.

The first, obviously, is *good management, sound business strategy, good technology, and excellent human resources*. Added to this is good corporate governance — sound accounting, transparency, protection of shareholders' rights and a vigilant board, etc. A vigilant board, in my opinion, ideally includes outside board members. However, if they are not truly independent and able to provide critical judgment, they tend to lull other shareholders into a false sense of complacency that their interests are being looked after. So in some cases a critical and vigilant group of insiders might be just as, if not more, effective.

This concept of quality also encompasses a number of less quantifiable factors — broadly grouped together under the heading of Corporate Social Responsibility. This includes ethical conduct, community relations, employee relations, environmental responsibility, workplace diversity, labor standards, human rights and charitable contributions. These have an impact on customer loyalty, the morale of employees and creating a favorable reputation — and ultimately profits. And they give the company the benefit of the doubt if it becomes the subject of negative publicity.

Increasingly, also, the overall policies and practices of *countries* are being examined more closely for quality. As an example, CalPERS, America's multi-billion dollar pension fund, has recently adapted criteria for determining whether it will or will not invest in a particular country. These criteria were employed to enable the fund's managers to make decisions as to whether or not a country was developing the corporate or governmental institutions and practices to sustain long-term, stable growth and maintain robust financial systems.

I am aware that these criteria are controversial, and that others would use different sets of criteria. But whether one agrees or disagrees with these criteria, or on the list of countries on their approved or disapproved list, this kind of approach is likely to induce other institutions to at least consider adopting a similar approach.

Included in CalPERS criteria were political stability (which includes judgments about civil liberties, judicial independence and political risk), transparency (press freedoms, accounting standards, listing disclosures), labor practices, market liquidity and volatility, legal and regulatory systems, investor protection and market openness, ability to settle transactions, trading costs and taxes. Although other investment funds may have different sets of criteria — and some have already said that they do — the broad concept of considering such factors or similar ones is likely to grow in significance and influence the flow or allocation of investment funds to emerging economies.

The Asian Outlook

With this in mind, there are significant changes in the Asian region that should improve the investment environment for domestic and foreign capital.

First, the shift to more flexible exchange rate regimes will allow greater monetary policy independence. Countries with an open capital account cannot simultaneously pursue a policy of targeting their exchange rate while maintaining an independent monetary policy — or at least not on a prolonged basis. Many Asian countries learned the hard way in the 1990s.

The crisis of 1997-1998, however, left a positive legacy. Many countries moved to a more flexible exchange rate system. The flexible exchange rate regime will become even more important, assuming the US Federal Reserve embarks on a tightening cycle. For the most part, Asia's output gap remains substantial, suggesting the need for loose monetary policy until recovery gains further traction. The ongoing process of domestic corporate-sector deleveraging in particular will remain a key reason why Asian central banks will both need to and be able to lag a US tightening. While domestic consumer demand is selectively showing buoyancy, aggregate credit demand remains extremely weak, weighted down by the corporate sector.

There will be exceptions to this story, of course, most notably Hong Kong, China, with its true peg. And some economies already have shown such significant upward momentum, especially in domestic demand, that local conditions might in time warrant some degree of tightening. The key point is that policy tightening in these countries would be home-grown, not forced by the US Fed.

In addition, current account surpluses are now robust, providing a balance of payments buffer. There has been a concern that if interest rate differentials widen against Asian currencies, Asian currencies would then weaken, forcing central banks to raise interest rates. However, Asia is starting this cycle with very strong balance of payments positions, which, I believe, will remain for a while. Current accounts have been in surplus for nearly five years. That has helped improve the net external creditor position of the region. Moreover, these current account surpluses are unlikely to unwind rapidly into deficit. The corporate sector net savings balance is the main swing variable for the current account. Aggregate national savings rates have been remarkably stable since the crisis, while the investment rate, which is dominated by swings in corporate sector behavior, has been the main adjustment mechanism. Given the likelihood that aggregate corporate capex will be slow to rebound, it follows that the unwinding of Asian's current account balances will be a modest process stretching over years, not months.

Capital accounts are now also starting to improve, primarily reflecting greater investor optimism on the cyclical outlook. That will be important in order to sustain investor confidence.

Conclusion

I have attempted to describe a few of the issues that I believe will affect the business environment in many parts of the world in coming years. In each of these areas I am optimistic that the ingenuity, sound judgment and determination of business executives and governments in this region will be sufficient to rise to the challenges ahead. Asia will, in my view, be one of the very dynamic growth areas in coming years. We have all weathered difficult times. The lessons learned should make us a lot wiser and stronger in the years ahead.