The Impact of Worldwide Financial Integration

Eugene H. Rotberg

Communications now permit buyers and sellers to respond to each other virtually instantly, while simultaneously aware of competing financial opportunities throughout the world. National savings and markets are increasingly freed from legal, regulatory and practical constraints that were designed to inhibit the transfer of capital across domestic borders. Financial engineering permits mistakes once made from getting worse; wise decisions to be captured; the hedging of risks attributed to currency, interest rates, and spreads; and the leveraging of financial decisions through options and warrants. All of this leads to the pressures that we should "measure our performance" frequently and intensively, and judge ourselves by the quality of short-term decisions that are facilitated by new financial instruments.

The "integration of markets" makes the valuation of credit more difficult, links together virtually all important players in the world's financial system, and makes virtually impossible any "orderly" market response or regulation by domestic monetary authorities.

It would seem reasonable to conclude, therefore, that we are in the midst of a fundamental restructuring of how savings move worldwide as well as an opening up of a whole range of possibilities—extending from disaster scenarios to explosive and exciting implications for growth in both the industrialized and developing world. Indeed, issues involving national sovereignty and the political economy are likely to confront us with as much drama as the industrial and managerial revolutions.

Everyone seems to be writing and talking about pieces of the picture. The political and social implications, however, are illusive. I suspect that one of the reasons for the lack of focused public-policy attention is that, when one is in the midst of a structural change, it is hard to notice and harder yet to resolve the political implications. These may be outside the expertise—or interest—of the participants who have the technical familiarity with what is going on. A logical conclusion: Learn Chinese!

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Savings will be outside the control of national authorities.

For the financial system, the 1990's will be the decade of the intermediaries, when the financial services sector will, in and of itself, become a major determiner of international integration, financial product supply, and instability. The transfer of wealth will be only one element, the beginning of any transaction. A commercial bank (or syndicate) will make a loan to an LDC. In 1981, that would have been the last step; and if the country later got into servicing difficulties, everybody would know whom to call together into a single room to work it out—and preserve financial stability.

Let me suggest what is coming:

—The bank makes a loan to an LDC in fixed-rate dollars.

—The loan is converted into a security and sold into the trading market, with a 20 percent guarantee by an AAA insurance company.

—The LDC does a cross-currency interest swap with an investment bank, whereby the investment bank exchanges with the country floating-rate dollars for fixed rate DM, every quarter.

—The investment bank buys an over-the-counter option

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from another commercial bank to cap the floater at 12 percent. That means if short-term rates go above 12 percent, say to 15 percent, the investment banks will receive $3 on each hundred from the commercial banks, to add to its $12, to exchange with the LDC for fixed-rate DM.

—The LDC now buys a currency option from the Philadelphia exchange for protection on the DM rate.

This is just the beginning: The permutations could go on and on. And consider the sources and transmission of instability that exist because of the pyramid of intermediation. If the LDC has liquidity problems, it is impossible to reschedule given the diversity of security holders who have become lenders—whether or not "of record." Moreover, the quality of the asset can be impaired by problems at the options exchange (for DM), problems at the second commercial bank (for the OTC floating cap), problems at the investment bank (for the swaps exchange), and a downgrading of the insurance company (for the underlying value of the dollar asset).

These problems will occur repeatedly until, with a Darwinian twist to Adam Smith's market, a relatively few major financial houses will dominate the global flow of funds. But one need not fear any conspiracy, since no one in or outside of these organizations will know what their consolidated financial position or exposure is at any point in time! Along with the major universal financial services institutions, there will be financial "boutiques" exploiting the intermediation opportunities that do not require capital from the intermediary (such as mergers and acquisitions), and a proliferation of exchanges for currency and interest-rate hedging or speculation.

Even the Chinese will become interdependent—through finance, not politics. And private capital from outside their own country will increasingly become available to meet their saving requirements. And wealth will concentrate in relatively few pockets where immediate returns are deemed highest and safest—and savings essentially will be outside the control of national authorities. But the key question in all this, of course, cannot be avoided—what is the overall supply of wealth in the world economy? For the intermediaries can run havoc with velocity and the multipliers, but only growth and a constraint on inflation can lead to an increased supply of resources in real terms. And so let me pass the ball back to the economists—with a little help from the regulators and a little hindrance from the accountants, or is it vice versa?