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Labour/Management Programme

RECENT AND FUTURE NATIONAL AND INTERNATIONAL GOVERNANCE INITIATIVES ON THE GLOBAL FINANCIAL MARKET ARCHITECTURE

Report on a meeting of trade union experts held under the OECD Labour/Management Programme

Paris, 12th December 2001

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OECD LABOUR/MANAGEMENT PROGRAMME

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(Paris, Wednesday 12th December 2001)

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After meetings held under the Programme, a rapporteur draws up a report of the discussion on his own responsibility, for distribution to the social partners and to the relevant OECD Committees. The opinions expressed in such reports are those of the rapporteur, except where they are specifically attributed to individual participants, and do not necessarily reflect the views of other participants or of the OECD.

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FOREWORD

Under the OECD Labour/Management Programme for 2001, a meeting of trade union experts on "Recent and Future National and International Governance Initiatives on the Global Financial Market Architecture" was held in Paris on Wednesday 12th December 2001. The meeting was prepared in collaboration with the Trade Union Advisory Committee to the OECD (TUAC).

Below you will find the Agenda for this meeting, along with the Discussion Paper and the overall report of the discussions of the meeting of experts, which were both prepared by Mr. Dean Baker, designated as General Rapporteur for this activity.

AGENDA

1. General introduction

2. Recent national and international financial market reform initiatives, including greater transparency and supervision

   Discussion

3. The economic and social impacts of financial market liberalisation and de-regulation in developed and developing countries

4. A forward looking perspective on further reforms, including:

   - Issues concerning G3 policy co-ordination on monetary and fiscal policy
   - Strengthening the prudential regulatory framework for financial markets
   - Bailing in the private sector, including sovereign debt restructuring, an international chapter 11 bankruptcy procedure?
   - Directing capital inflows and outflows: speed bumps and restrictions on hot money. An examination of the alternative proposals, including the Tobin Tax

   Discussion

5. Opening up the debate. Views on a broad based and inclusive Commission of Enquiry on financial market reforms

6. Summary of the results of the meeting

7. Concluding remarks by the Chair

DISCUSSION PAPER

by
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INTRODUCTION

The last two decades have witnessed an ambitious economic experiment in financial market liberalisation. During this period, the leading economic powers, along with the international financial institutions, have sought to remove obstacles to financial flows both within and between nations. Nationally, the removal of barriers has been associated with eliminating regulations and institutional structures that have sought to direct capital flows towards specific sectors, such as residential housing or small businesses. At the international level, governments have been encouraged to remove barriers to the free flow of capital in and out of their countries. The financial crises of the last four years have caused many to question whether these liberalisation measures have gone too far, or at least need to be altered in ways that will increase the stability of the international financial system.

This paper outlines some of the issues that have been raised in this context. The first part examines issues that have arisen primarily in the context of the developed nations, while the second half looks more broadly at issues that have affected both the developing and developed nations.

FINANCIAL GOVERNANCE ISSUES IN THE DEVELOPED NATIONS

G3 Policy Co-ordination

With the United States and Japan both having entered recessions, and the European Union experiencing growth well below its potential, if not an actual recession, there have been many proposals for greater co-ordination of economic policy between the G3 in order to reverse the downturn. In principle, policy can be more effective if the world's major economic actors plan collectively. For example, a co-ordinated expansion of monetary and fiscal could arguably provide the boost needed to pull the world out of the current downturn. The G3 may also seek to target exchange rates, thereby removing some of the volatility in currency markets in recent years. The question is whether co-ordination can be carried through more effectively than it is at present.

Currently, co-ordination takes place at an informal level through discussions at G8 summit meetings, the meetings of G8 finance ministers, and through numerous other formal and informal contacts. However, it is not necessarily the case that co-ordination would be more effective if carried through in some more formal process. No process is going to force any of the G3 to carry through economic policies that are perceived to be detrimental to its interests. Therefore, if concerns about domestic interests are preventing effective co-ordination presently, it is not clear how a more formal process would overcome these barriers. Similarly, a more formal process of co-ordination could actually be counter-productive, if it proved impossible to agree on policy goals, since such a failure could have a negative impact on financial markets and business confidence. Also, domestic opposition could prevent agreements from being fully implemented, thereby undermining effective co-ordination. In addition, if goals, such as exchange rate targets, prove impossible to maintain, it could undermine the credibility of future efforts at co-ordination.

Discussion items:

- What could be gained from a more formal process of co-ordination of economic policy between the G3?

- What sort of institutional framework could support a greater degree of co-ordination between the G3?

- How serious are the downside risks from failed co-ordination?

Central Bank Independence

In the three years since the creation of the euro, the ECB has been subject to serious criticism over what has been perceived as excessively restrictive monetary policy. This criticism has come from economists throughout the world, the international financial institutions, and several members of the governments of the nations that comprise the euro zone. The ECB has been able to largely ignore these criticisms, since it was deliberately structured to have an extraordinary degree of independence. This has been part of a general trend towards increasing central bank independence in the last two decades. As part of this process, both England and Japan recently made their central banks independent of the government. It is reasonable to ask whether this drive towards central bank independence has gone too far.

Economists have generally favoured central bank independence, under the belief that an independent central bank will be better able to contain inflation. There have been numerous studies that seem to support the view that independent central banks are associated with lower rates of inflation, but this can be attributed in part to the fact that the nations that are most concerned about inflation are also the ones that are most likely to have independent central banks. Furthermore, there are important examples – notably England and Japan – where central banks operating under government control were able to carry through effective anti-inflation policies over long periods of time. Whether or not an independent central bank may be more effective in controlling inflation, clearly central bank independence is not necessary to keep inflation under control.

It is also important to note that most studies find little, if any, negative impact of moderate rates of inflation.[1] This raises the possibility that an independent central bank may be more likely to focus on controlling inflation, at the cost of reducing employment and output. With the ECB and many other central banks now targeting inflation as their only policy goal, there would seem to be a real basis for this concern.

Discussion items:

- Does the evidence of the greater effectiveness of independent central banks in containing inflation warrant removing monetary policy from democratic control?

- Is it desirable for central banks to focus exclusively on inflation targets, or is the model of the Federal Reserve Board in the United States, with its twin goals of price stability and full employment, more appropriate?

- Are there ways to mix elements of democratic accountability and central bank independence?

1 One study found no negative impact of inflation on growth for inflation rates up to 40 percent (Bruno, M. 1995, "Does Inflation Really Lower Growth," *Finance and Development* (September)).

Structuring Capital Markets

In the last two decades, most OECD countries have taken steps to remove structures that funnelled capital into specific sectors. For example, in the United States, savings and loan institutions, which had been required to make the vast majority of their loans to support residential housing, now function in almost exactly the same way as commercial banks. There have been similar changes to institutions in other OECD countries that were designed to support residential housing or small business lending, or other socially desired ends. The argument for weakening or eliminating these systems for directing capital is that the overall development of the capital market has effectively eliminated the need for previously favoured sectors to have special access to capital. For example, in the case of the United States housing market, the secondary mortgage market has mushroomed into a multi-trillion dollar market, making vast sums of capital available to support residential housing. As this process of capital market liberalisation progresses, it is reasonable to ask whether the growth of the capital market has eliminated the need for allocating capital towards socially favoured ends.

Partly in the wake of the apparent success of the U.S. economy in the nineties, there has been some movement among other OECD nations, most notably Germany, away from bank oriented systems of financing, towards a market system like that in the United States. This is consistent with the view of many economists that markets can more effectively allocate capital, especially to new innovative firms, than a system of bank lending. With the collapse of the tech bubble in the United States, the case for the superiority of the market system is somewhat less apparent. Hundreds of billions of dollars were funnelled to firms that had no plausible hope of ever earning significant profits. There have also been numerous instances, Enron being the most prominent, in which the mis-reporting of financial data led to high stock prices.

Discussion items:

- Are there functions served by special lending institutions, such as the saving and loans institutions in the United States, that will not be served in a liberalised capital market? Specifically, are there sound loans that would be made by these institutions, which will not be made in a liberalised capital market?

- Do the benefits from the greater access to capital for newcomers in a U.S. style market system, offset the risks associated with equity markets?

- Are there ways in which accounting rules can be more rigidly imposed on corporations to prevent the sort of financial manipulations that occurred in the United States in recent years?

FINANCIAL GOVERNANCE ISSUES AFFECTING BOTH DEVELOPED AND DEVELOPING NATIONS

The liberalisation of international capital flows, along with the other changes of the last two decades, has not led to obvious gains for developing nations. At the broadest level, the developing nations have seen less growth in per capita GDP, a slower reduction in infant mortality rates and illiteracy, and less improvement in life expectancy in the era of financial market liberalisation (1980-2000) than in the prior two decades.[2]

[2] A comparison of the performance of developing nations in this period can be found in "The Scorecard on Globalization 1980-2000: Twenty Years of Diminished Progress," by Mark Weisbrot, Dean Baker, Egor Kraev, and Judy Chen, Center for Economic and Policy Research 2001, (http://www.cepr.net/globalization/scorecard_on_globalization.htm).

More narrowly, the trend towards financial liberalisation has been accompanied by a series of financial crises in developing nations. These crises have often led to harsh austerity measures. In addition, developing nations have perceived the need to vastly increase their reserve holdings (relative to their GDP), in order to protect against future crises. The table below shows the average ratio of reserve holdings to GDP for each region of the developing world over the last four decades.[3]

Table 1 – Reserve Holdings As a Share of GDP, by Decade and Region (weighted by GDP)

Region	1960's	1970's	1980's	1990's	'97-99
East Asia and Pacific	8.9%	6.8%	12.4%	20.4%	24.2%
South Asia	1.9%	3.8%	4.3%	5.7%	6.9%
Latin America and Caribbean	3.0%	6.3%	6.2%	7.9%	8.4%
Sub-Saharan Africa	5.5%	6.8%	4.8%	6.9%	9.5%
Middle East and North Africa	8.2%	20.0%	13.8%	16.1%	17.0%

Source: World Bank 2001 and authors' calculations.

Reserve holdings increased substantially in all regions of the developing world from the sixties to the nineties, with a further increase in the last three years of the decade. This increase was most pronounced in East Asia, where the ratio of reserve holdings to GDP rose by more than 15 percentage points from the sixties to the late nineties.

This rise in reserve holdings imposes an enormous cost on developing nations. The real return on reserves is typically no more than 1 to 2 percent. By contrast, to build up reserves nations must forego other imports, which could be used to support investment in physical or human capital. Such investment could be expected to have returns that are at least 10 and as much as 20 percentage points higher than the returns to holding reserve deposits. Simple arithmetic implies that developing nations are being forced to forego an amount of income that could exceed 2.0 percent of GDP in order to sustain their current levels of reserves, as opposed to the levels of the sixties.

While there is little dispute over the problems posed by recent financial instability, it is not clear how best to stabilise capital markets. Most attention has been focused on restraining the flows of short-term capital. Trading in the foreign exchange market now exceeds $400 trillion a year. The overwhelming majority of these trades involve short-term transactions intended to take advantage of small interest rate differentials or in anticipation of currency movements. The magnitude of these flows can create enormous distortions in emerging markets by raising or lowering currency values. There have been several policy proposals put forward in recent years designed to curtail destabilising short-term capital flows, without affecting the flow of capital to finance trade or investment.

The Tobin Tax and Capital Controls

The Tobin tax is the most commonly proposed policy in this vein. The basic argument is straightforward. A modest tax (0.1 percent on the value of a trade is the rate most commonly put forward) will be almost invisible to anyone engaged in trade or planning a long-term investment, but it can provide a significant deterrent to speculators who intend to buy and sell currency in a short period of time. By raising the cost of this sort of speculation, a Tobin tax could substantially reduce the amount of speculation in the market. If speculation is destabilising, then reducing the volume of speculation will lead to more stable currency markets. In addition, even a modest tax would raise tens of billion of dollars that could be used to

[3] This table is taken from "Money for Nothing: The Increasing Cost of Foreign Reserve Holdings to Developing Nations," by Dean Baker and Karl Wallentin, Center for Economic and Policy Research 2001, (http://www.cepr.net/Reserves%20paper.htm).

support development. It is also worth noting that the Tobin tax could potentially eliminate a vast amount of wasted resources, by reducing the amount of labour and capital engaged in financial speculation.

The argument against a Tobin tax hinges on whether it would in fact have the effect of stabilising financial markets. The argument that financial speculation is destabilising dates back to Keynes and was more recently formalised in several articles on "noise trader" theory authored or co-authored by Larry Summers.[4] The basic point is that if a large number of actors in the market trade on factors unrelated to fundamentals, then this can move markets, and impose costs on traders who focus on fundamentals. If a Tobin tax can push these noise traders out of the market, then it can reduce volatility in finance markets. The response of those opposed to Tobin taxes is that the tax will primarily hit arbitrage traders, who trade on very thin margins. Arguably, reducing the role of arbitrage traders will lead to greater volatility in currency markets.[5]

There have also been issues raised about whether a Tobin tax is enforceable, but this seems more a matter of political will than economics. The most commonly proposed rate for a Tobin tax is 0.1 percent of the value of a transaction. By comparison, copyright laws effectively impose a 100 percent tax (privately collected) on items such as software or recorded music which could otherwise be transferred at no cost. Since copyright can still generally be enforced, even though the incentive for evasion is far greater, then it is reasonable to conclude that a Tobin tax is enforceable.

While a Tobin tax may offer relatively limited benefits in stemming short-term capital flows, other types of capital controls may be more effective. From 1991 to 1998, Chile imposed a system of controls in which foreign investors were forced to hold a non-interest bearing account with the central bank for periods of up to a year, equal to a percentage (varying between 20-30 percent) of the amount of Chilean pesos they had borrowed. This form of capital control provides a large disincentive to traders seeking to buy pesos for short-term speculation, but would have very little impact on firms planning long-term investments in Chile.

Malaysia imposed more extreme capital controls in the wake of the East Asian financial crisis. Whether Malaysia suffered any long-term damage from the controls it imposed in 1998, which temporarily all but prohibited trades out of Malaysian currency, is a debatable question.[6] The fact that controls that were imposed with no international support, and which were rather extreme and seemingly ad hoc, did not have a clearly measurable negative impact, suggests that there is a much wider range for effective capital controls than economists generally recognise. Presumably better planning and more international support would have led to a better outcome.

Discussion items:

- Are the capital flows discouraged by a Tobin tax more likely to be stabilising or destabilising?
- Can a modest currency transactions tax be a significant stabilising influence on currency markets?
- Can stronger and more direct controls on capital flows be more effective, especially in getting nations through a temporary crisis?

4 e.g. see "Does the Stock Market Rationally Reflect Fundamental Values?" by Lawrence Summers, *Journal of Finance*, 1986, pp 591-60.

5 This argument can be found in "Security Transactions Taxes and Financial Markets," by Karl Habermeier and Andrei Kirilenko, International Monetary Fund Working Paper, 2001, WP/01/51.

6 See the discussion in *Preventing Currency Crises in Emerging Markets*, edited by Sebastian Edwards and Jeffrey Frankel, NBER and University of Chicago Press, 2001.

International Bankruptcy Rules

Developing nations have repeatedly found themselves in financial crises in which they often face unpayable debt burdens. Many economists and policy makers have argued that there should be an international bankruptcy law, modelled after the chapter 11 procedures in the United States, under which nations could be absolved of a substantial portion of their debts. In principle, this law would require that the creditors absorb losses on a portion of their debt, but it would ensure that all creditors are treated fairly, with the loss apportioned according to established rules.

The benefit of this sort of process could be enormous if it allows nations to avoid the sort of austerity and recessions that have been associated with recent financial crises. However, there are many obstacles to its effective implementation. The first is setting rules that struck the right balance between the interests of the creditors and debtor nations. If the rules are too generous to debtors, then it would discourage lending to developing nations and may also provide incentives for nations to pursue bankruptcy protection in cases where it is not really needed. On the other hand, rules that are too stringent would not provide badly indebted nations with the relief they need.

The control of the process will also be very important. Inevitably, many decisions will involve subjective judgements. Unlike chapter 11 proceedings, there is no absolute ceiling to the assets that can be taken to repay creditors. If developing nations do not have confidence that the agent administering the bankruptcy proceeding will treat them fairly, then they will not take advantage of the process. Since some nations (Russia and Ecuador) have recently unilaterally defaulted on portions of their debt – without apparent negative consequences – a bankruptcy proceeding will have to appear more attractive than a unilateral default path, before developing nations will use it.

Discussion items:

- Chapter 11 bankruptcy in the United States implies that a company is being run for the benefit of its creditors, not its shareholders. What principle would guide an international chapter 11 proceeding?

- In the East Asia financial crisis, the vast majority of the debts were privately incurred. Can an international bankruptcy law be established that would apply across national boundaries to private corporations?

- If a bankruptcy process were put in place, who should administer it? Can it be established in a way that would gain the confidence of both creditors and developing nations?

FINAL REPORT ON THE MEETING

by
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INTRODUCTION

After introductions by Bob Baldwin, the Chairman, the meeting began with comments from Mr. Pecchioli, outlining what he saw as the major changes and areas of progress in the financial system in the last thirty years. He noted that this period had seen a tremendous increase in the variety of financial instruments available, which he saw as providing large gains to consumers.

He listed five areas in which he saw significant and continuing progress:

1. international codes and standards – there are now some 60 widely accepted standards, 12 of which have been identified by the Financial Stability Forum as key for all countries;

2. openness of the reform process – the process of regulatory reform has been opened up for input from all sectors of society, in contrast, even completed documents were often kept secret thirty years ago;

3. geographical scope of reform – the basic regulatory and supervisory principles now being crafted are seen as applying to all nations, which (in various forms) have been involved in the process of developing codes and standards, while in the past the scope was restricted to the major financial centres;

4. the rise of ethical considerations – issues such as money laundering, corporate governance, offshore financial centres and corporate anonymity are now being raised in the debate over financial regulation. Such issues were not considered relevant thirty years ago;

5. development of a broadly based architectural umbrella – there is much greater contact between regulators and policy makers than was the case thirty years ago. This means that the regulations being approved are more likely to enjoy broader political support and therefore are more likely to be effectively enforced.

In summarising his comments, Mr. Pecchioli listed four reasons for his general optimism about the future of the financial system:

1. a new financial architecture is being constructed to address the very complex problems of the new financial landscape;

2. there is much greater public awareness of the changes that are taking place than in the past;

3. a large number of countries are actively co-operating in the process of designing and implementing new rules; and

4. the regulatory system is reacting much more quickly to problems, when they develop.

Mr. Baker presented the issues that had been raised in discussions among the trade union representatives:

1. whether there could be more effective macroeconomic policy co-ordination among the G-3;

2. whether there was sufficient scope for public input into the monetary policy being pursued by central banks, with the European Central Bank being the biggest cause of concern. It was noted that the bank's exclusive focus on price stability stood in sharp contrast with the mandate of the Federal Reserve Board in the United States to pursue both price stability and full employment;

3. the possibility that the liberalisation of domestic financial systems left financing gaps – for example in the cases of small businesses and housing. Regulatory policy had previously been designed to steer capital towards these sectors. There was concern that they may not be adequately served in a deregulated financial system;

4. the Tobin tax – there is continuing interest in the Tobin tax as a means to reduce the volume of trading in foreign exchange. It is hoped that a reduction in trading volume would reduce the volatility of foreign exchange markets. It also would reduce the resources – capital and labour – used in carrying through foreign exchange transactions. In addition, the Tobin tax could raise a substantial sum to finance development or other social goals;

5. capital controls – it was noted that Chile and Malaysia both had some success in limiting the destabilising effects of short-term capital movements through the imposition of capital controls. The trade union experts were interested in the possibility that such controls could be effective elsewhere; and

6. international bankruptcy rules – many developing nations have found themselves in situations where they are facing unpayable debt burdens. In such circumstances, some form of bankruptcy, which relieves debtors of a portion of their obligations – and requires creditors to accept losses – may be preferable to a continuing pattern of bailouts, such as has occurred with Argentina, Turkey, and other developing countries.

Mr. Evans then began the discussion by distinguishing between what he characterised as Mr. Pecchioli's focus on micro efficiency and the issues of macro efficiency raised in Mr. Baker's comments. He noted that unions feel the need to intervene in the setting of financial policy in a way that they did not 20 years ago, because their members are feeling its effects. As an example, he noted that in the mid 1990's the competitive gains which were supposed to result from a half percentage point wage moderation by German workers, were completely negated by a 10 percent appreciation of the German mark the following year.

He noted that unions feel that there is not an effective forum in which they can have input, as the focus of policy has shifted from the national to the international level. He also pointed out that different parties will approach financial reform with different interests, for example the concerns of merchant bankers are not identical to the concerns of trade unions.

Mr. Elmeskov responded by taking issue with comments suggesting that financial markets do not contribute to job creation or raising living standards. He referred to studies by the OECD that showed that countries with deeper financial markets experienced more rapid economic growth, which he attributed to more efficient resource allocation. He also noted that the movement to central bank independence was a response to the high inflation of the seventies, which he attributed to lax central bank monetary policies. He questioned whether liberalised capital markets left significant gaps, and argued that if it was desired to favour specific sectors, such as housing, that it be done in a transparent way through direct subsidies.

Mr. Baker noted that the results of some of the studies showing links between GDP growth and deep capital markets were driven by the inclusion of outliers such as Thailand and Taiwan in a sample of industrialised nations. He also pointed out that an unusual percentage of the GDP growth of the United States in recent years – a country with a deep capital market – was attributable to a growing share of GDP being devoted to depreciation. This output has little beneficial effect, since it cannot be consumed, nor does it increase the capital stock.

Mr. Reisen argued that macroeconomic issues are important, but that liberalisation was desirable because markets allocated capital better than heavily regulated financial systems, pointing out that information technology spread most quickly in countries with well-developed market systems. He argued that the answer to excesses lies in better rules, not re-regulation. He also acknowledged that there is a counter-cyclical role for monetary policy, and that controlling inflation is not the only goal.

Mr. Thompson responded to earlier comments pointing out the waste in market systems – such as the billions loaned to Enron and failed telecom and Internet companies – noting that regulated systems, such as those in Japan, also misallocated capital.

Mr. Baker commented that he agreed with Paul Krugman's assessment, that the major source of Japan's current problems is a lack of demand, which could best be addressed by the Central Bank targeting a small rate of inflation.

Mr. Kennedy commented on the benefits that nations had experienced due to central bank independence, noting that England experienced a significant drop in interest rates immediately after making its central bank independent. On the topic of capital gaps, he noted studies which showed that when small banks were taken over, their clients continued to be served by the combined bank.

He responded to Mr. Baker's earlier comments on studies relating growth to financial market deepness by noting that the results of the OECD studies were robust and did not depend on outliers. He also argued that gross output, rather than net output, was the best measure of growth. The real gains would come from how firms reorganised themselves to use the new technology available. In this sense, net output could start to rise as well. In addition, he pointed to studies which showed that exchange rate volatility has actually been declining.

Mr. Janssen commented that he was not interested in returning to the seventies either, but that he believed central banks had shifted too far in the other direction, with an exclusive focus on price stability.

Mr. Baker commented that the criticisms of the East Asian financial system seem peculiar since these countries experienced the highest sustained growth rates the world has ever seen. The response that they would have done even better, if they had liberalised their financial markets sooner, seems to contradict the evidence, since there are no examples of countries with liberalised financial systems sustaining similar growth rates.

Mr. Elmeskov responded that the East Asian systems may have been appropriate for one phase of development, but that these nations outgrew them. He also commented that the OECD did not necessarily and always view capital account liberalisation as good. He said that the OECD had noted the dangers in opening of markets first to short-terms flows, arguing that it would be better to liberalise long-term capital flows first or, at least, simultaneously.

Mr. Reisen acknowledged that mistakes were made after the onset of the East Asian crisis, but said that the bigger mistakes took place before the crisis, specifically, allowing for the accumulation of non-performing loans. He claimed that Hong Kong and Singapore had followed good banking procedures, and therefore escaped the worst effects of the crisis.

Mr. Evans commented that there seems to be debate about whether or not there is a problem. He pointed out that Mexican workers have experienced a decline in real wages over the last decade. He also noted that union members in South Korea, Argentina, and Turkey all think they have real problems attributable to the malfunctioning of the international financial system. He also commented that there was little visible criticism of the capital inflows into East Asia, prior to the crisis.

He pointed out that the issue is not a contrast between state control and complete lack of regulation, rather the concern is that stakeholders have an opportunity to take part in the debate internationally in the same way as they would if decisions were being made at the national level.

Mr. Reisen commented that if it had not been for the financial crises, more trade union jobs in the OECD nations would be shifted to developing nations. He also argued that the rise in the ratio of foreign reserves to GDP, noted by Mr. Baker, was not evidence of the instability of the world financial system. He attributed the increase in reserve holdings to efforts by developing nations to keep the value of their currency low, in order to make their exports more competitive.

He also said that capital account liberalisation does not always lead to gains for developing nations. It will only increase growth if the nations are otherwise in sound economic shape.

BREAK

After the break Mr. Kennedy commented on the issue of greater G-3 co-ordination. He noted the distinction between co-operation and co-ordination, responding to the concerns that had been raised about the possibility for greater G-3 co-ordination. He argued that co-operation already existed, and that if nations do the right thing, things will generally turn out right, even without formal co-ordination.

He argued that co-ordination could prove cumbersome – nations are differently situated, for example they can be at different points in the business cycle, have different demographic structures, and other important differences.

He commented that exchange rate targeting could prove misguided. He referred to studies indicating that volatility was primarily the result of new information. He also noted that trade continued to grow rapidly in the seventies, despite substantial exchange rate volatility. He attributed this primarily to the availability of cheap hedging instruments.

He noted that a fixed exchange rate can take away a policy instrument and could force nations to move their domestic economy to conform to an exchange rate target. In addition, there can be a moral hazard problem if people wrongly come to believe that the government will stick to a target.

Mr. Pecchioli then set out his view of the major challenges to efforts to strengthen the prudential regulatory framework:

1. the structure of the market is changing, which means that distinctions between different types of financial institutions are disappearing, as are distinctions between financial and non-financial institutions;

2. the growth of large sized actors and the attendant potential increase in the scope for systemic risks;

3. the need to avoid excessive regulation that might stifle innovation and competition;

4. the need to promote transparency while protecting privacy;

5. the need to enhance supervisory capacity to handle new forms of risks, especially those stemming from technology advances;

6. the need to improve the hands-on expertise of the supervisors;

7. the need to find more effective systems of international co-operation.

Mr. Larson then commented on the problems created by short-term capital flows. He acknowledged that financial crises are a problem, and that liberalisation has brought both benefits and costs. At the same time, he doesn't want to go back to the era of government intervention. The main issue is that capital flows are pro-cyclical, the question is whether this can be changed.

He noted that international bankruptcy rules may prove helpful, but they are not likely to be implemented soon. He indicated that it may be possible to negotiate standstills on debt payments, but the problem will be how they can be made binding on all creditors.

Mr. Reisen then discussed the Tobin tax and capital controls. He noted the political appeal of the Tobin tax, which has won the support of the Prime Ministers of both France and Germany, in spite of objections by their finance ministers.

He then went on to question whether it was either feasible or desirable. He noted the possibilities of shifting to different financial instruments and also moving the location of trading. He also noted that the tax would make arbitrage more expensive, possibly increasing volatility. He pointed out that high frequency volatility among the G-3 currencies has been decreasing in any case, and that the tax was not likely to prevent major movements of currencies. In addition he argued that foreign exchange trading has been declining, therefore the potential tax base is shrinking. Finally, he argued that the tax would be passed on to consumers.

He argued that capital controls instituted by Chile and Malaysia were not especially successful. In Chile, investors were able to largely evade the controls, since they applied to a narrow category of loans. In Malaysia, the restrictions on converting the currency led to large rents for those with ties to the government.

Mr. Coldrick responded to Mr. Kennedy's comments on co-ordination by arguing that there must be a way to get beyond national boundaries to create policies at a level where they can effect the economy.

Mr. Larsen agreed that there can be cases where international co-ordination proves effective. He noted the example of the Plaza accord which helped to bring down an over-valued dollar in the late eighties.

Mr. Baker responded to Mr. Reisen's comments on the Tobin tax by noting that he had not mentioned the reduction of the resources wasted in the financial sector as a goal of the Tobin tax. Mr. Baker pointed out that plausible estimates of the decline in trading that would result from a Tobin tax imply that $80 billion a year could be freed up if a Tobin tax were implemented. This savings from reduced trading would be the main source of the revenue generated by the tax. There would be no need to pass on costs to consumers.

He also challenged Mr. Reisen's claim that the tax could not be enforced. He accepted the argument that trading could shift to different instruments, but said this just meant that the tax would have to take the form of a broadly based financial transactions tax. He noted that copyrights effectively impose a 100 percent tax (privately collected) on software, and recorded music and video material. Yet, copyrights are still generally enforced. By contrast, the rate most often proposed for a Tobin tax is just 0.1 percent.

Mr. Reisen responded by saying that copyrights cannot be enforced. He reported that his 13 year-old daughter downloads copyrighted material off the Internet.

Mr. Janssen noted the need for more anti-cyclical monetary policy. He pointed out that the OECD reports that most nations had an output gap of 1.0-2.0 percentage points of GDP for the whole decade of the nineties, which indicated a very serious and prolonged failure of policy.

Mr. Evans expressed a need for greater co-ordination in setting policy. He again stressed the need for a public forum in which different voices could be heard.

Mr. Baker summarised the discussion. He noted considerable areas of disagreement remained between the representatives of TUAC and the OECD on most of the issues raised. Taking the item in the order raised:

1. Co-ordination – the OECD representatives seemed to believe that the current level of co-operation was adequate, whereas the TUAC representatives believed that more co-ordinated policy decisions could improve outcomes;

2. Central Bank decision making – the TUAC representatives felt the need for greater input in setting the policy goals for central banks, especially the ECB. The OECD representatives seemed to believe that the move towards greater independence was an appropriate response to past errors;

3. Capital Market Structure – the OECD representatives felt that liberalised capital markets were unlikely to leave important gaps in access. The TUAC representatives remained concerned that such gaps could arise.

4. Tobin tax – the OECD representatives argued that a Tobin tax was both unenforceable and undesirable. The TUAC representatives consider the tax a policy that could potentially be a stabilising force in currency markets and a large source of revenue to finance development.

5. Capital controls – the TUAC representatives consider capital controls a possible way of reducing the volatility of the foreign exchange markets. The OECD representatives believe that well designed capital controls can occasionally be helpful, but there are likely to be many problems associated with any capital controls, and they will often counter-productive.

6. International Bankruptcy rules – both sides agreed that international bankruptcy rules could provide an attractive alternative to current methods of dealing with financial crises in developing nations. It was agreed that it will not be easy to design the right rules, but both sides were interested in seeing more work in this area.

Mr. Baldwin concluded the meeting and thanked everyone for their participation.

ANNEX – LIST OF PARTICIPANTS

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