

Embracing financial globalisation

May 2008



HM TREASURY



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E

EXECUTIVE SUMMARY

The world is changing rapidly

E.1 The global economy is in the midst of a radical transformation, with far-reaching and fundamental changes in technology, production and trading patterns. Previous reports by HM Treasury have assessed how this impacts on trade in goods and services, or on a specific sector of the economy, like the UK financial services industry. This paper assesses the nature and impact of financial globalisation, defined as the extent to which the world's economies are linked through cross-border financial holdings.

E.2 Driven by technological innovation, institutional developments and a supportive policy environment, the world's economies are currently experiencing an unparalleled level of financial integration. For developed economies, growth in international finance has increased particularly rapidly over the past 30 years. While in the 1970s the value of international trade in goods and services and international finance were almost the same, now the level of international finance is 7 times that of international trade. Since 2003, the value of cross-border portfolio investment has more than doubled to US\$25 trillion.

And the challenges of financial globalisation are clear

E.3 This presents challenges. Instability in the financial markets is now more likely to affect the real economy for three reasons. First, the importance of financial markets has increased relative to the rest of the economy. Second, large, global financial institutions, and the markets in which they operate, are now much more interlinked. Finally, in recent decades there has been a significant transfer of risk to the household sector in the advanced economies, for example through the decline in defined benefit pension schemes.

E.4 Events since August 2007, when financial markets were destabilised by losses associated with chains of assets backed ultimately by sub-prime mortgages, have demonstrated how quickly financial instability can transmit to ostensibly unrelated parts of the global financial system. These events are still playing themselves out and, as was made clear at the April 2008 meetings of G7 Finance Ministers, it is essential that lessons are learnt and the appropriate policy response implemented.

But the opportunities are significant

E.5 However, a return to financial protectionism would be enormously damaging to global economic prospects, as has been experienced during previous periods of financial protectionism. Moreover, financial globalisation can deliver significant benefits to all countries. Three particular opportunities are identified in this report:

- economic growth;
- macroeconomic stability; and
- support in tackling other strategic challenges of our generation, notably development and climate change.

Economic growth

E.6 Financial globalisation can contribute to economic growth. Direct benefits include allowing international capital to be allocated to where it is most efficient, intensifying internal competition, the spread of managerial and technological expertise through the presence of foreign financial services firms, and spurring the development of secondary market liquidity, which promotes the mobilisation of domestic savings. Finally, though temporary capital controls can be suitable for some emerging and

developing economies, in other cases they exert economic inefficiencies that are not borne by more liberalised economies.

E.7 Advanced economies already capture the growth benefits. And the emerging countries, where the level of integration is growing the fastest, are showing benefits, particularly from foreign direct investment and foreign equity ownership. Even within the least developed countries, which are less integrated into the global financial system, exposure to foreign capital supports improvements to the domestic financial sector and the macroeconomic policy framework: essential components to future sustainable growth.

Macro-economic stability

E.8 With the appropriate regulatory and supervisory framework in place, financial globalisation can help improve economic stability by spreading risk throughout the financial system. While this means that financial market instability is rarely confined to one part of the world, the likelihood that financial market instability will have a serious impact on the real economy should be lower. Economic stability should be particularly enhanced when an economy is reliant on a particular sector because the globalisation of finance should shield consumers and investors against idiosyncratic output shocks.

E.9 There is evidence that this is happening among the advanced economies, which have, until recently, experienced a period of sustained economic stability. For example, in the UK, volatility in economic growth and inflation has fallen significantly over the past decade. Some less advanced economies are also reaping stability benefits. Overall, there is clear evidence that financial sector development, institutional quality and responsible macroeconomic policies are all important to harnessing the full stability benefits of financial globalisation.

Addressing strategic challenges

E.10 Supporting greater financial globalisation means supporting international efforts to tackle two of the greatest challenges of this generation: development and climate change. For example:

- international remittances represent the second largest flow of capital to developing countries. Some of the poorest countries are the most dependent on money sent home from workers based abroad;
- technological innovation is poised to further drive financial globalisation through the establishment of cross-border payments via mobile banking; and
- the UK, in collaboration with the financial sector and other countries, has recently led efforts to both help achieve the Millennium Development Goals through mechanisms like the international financing facility for immunisation (IFFIm); and support the development of a global market for carbon, which will help the fight against climate change.

Capturing the benefits of financial globalisation

Policy objectives

E.11 Given these benefits, the international community has a responsibility to embrace the challenges of financial globalisation and ensure that the potential benefits are delivered in a manner that minimises the potential risks. The UK's long-term aspirations for the global financial system are that it should be:

1. open to all countries, supporting economic growth for all;

2. effectively regulated and supervised to afford stability to investors and taxpayers;
3. functioning efficiently to minimise costs for investors and consumers.

Policy framework **E.12** To achieve these aspirations, the UK's policies will sit within a carefully defined framework of:

- making the case for financial openness and taking practical steps to achieve it; and
- developing an effective international regulatory system that:
 - i. provides an early warning system for emerging financial risks;
 - ii. is based on a responsive international regulatory framework that:
 - keeps pace with market developments and new financial instruments; and
 - pursues, where appropriate, the convergence of international regulatory standards and approach.
 - iii. delivers effective cross-border supervision of firms.

E.13 Given that this is a paper about financial globalisation, the policy proposals contained within this document focus on international reforms or actions. A detailed consultation on proposed reform to the UK financial system is found in *financial stability and depositor protection*, published by HM Treasury, the Financial Services Authority (FSA) and the Bank of England in January 2008.

Making the case for openness **E.14** Financial globalisation offers significant opportunities for all countries. However, this can only happen if the open economies resist pressure for becoming more protectionist and the closed economies are supported in their efforts to liberalise. Therefore, the UK's approach in this area will consist of:

- articulating the benefits of openness;
- supporting measures to improve transparency among investors;
- using regulatory and financial dialogues as a practical means of learning from experiences and sharing best practice; and
- making further progress in helping economies liberalise.

Developing an effective international regulatory system **E.15** Open financial markets are closely integrated with one another, and instability generated in one open market can now spread through a greater number of transmission channels, and more rapidly, to others. Financial instability reduces the ability of the financial system to allocate capital and diversify risk and, at the extreme, can seriously affect the global economy, causing hardship and dislocation to people far removed from global finance. Mitigating these risks above all requires the international community working together to develop an effective international regulatory system that:

- is equipped to detect emerging risks, assess the threat they present and coordinate national responses;
- learns rapidly from previous experiences and keeps pace with current market developments; and

- effectively manages cross-border financial transactions, including through the establishment of supervisory colleges, both within the EU and globally.

Conclusion

Embracing the challenges of financial globalisation

E.16 Today, we are in the midst of what the IMF terms the most profound financial shock since the Great Depression of the 1930s. The speed with which instability spread from relatively narrow problems associated with a small part of the US housing market to envelope much of the global financial system clearly illustrates the challenges of financial globalisation. However, and as identified in this report, the benefits of financial globalisation can be significant. Turning our backs on these benefits would cause serious economic dislocation. Therefore, the international finance community, working together, must embrace these challenges and lead the way towards a more open, a more robust, and a more efficient global financial system.

INTRODUCTION

1.1 This paper analyses the nature and impact of financial globalisation on advanced, emerging and developing economies¹.

1.2 The world is changing with remarkable speed. Four trends, identified in previous HM Treasury documents, are reshaping the global economy²:

- the rapid expansion of the major emerging economies is shifting the global balance of economic activity, with an increasing proportion of global output produced in the rising Asian and other economies, most significantly India and China;
- the increasing integration of global markets and diversification in the pattern of trade and foreign direct investment, which intensifies competition among producers and service providers, thereby increasing the importance of competitiveness and efficiency among producers in the advanced economies;
- technological change has lowered transport and communication costs and acted as a powerful driver in facilitating global transactions and information flows. Though technology has been key to previous periods of economic growth, the rate of change currently experienced is without precedent; and
- finally, demographic change will have a profound influence over the rate of economic growth experienced in the next ten years. The United Nations projects that the world's population will increase by over 15 per cent³, with much of the growth concentrated in the developing economies.

1.3 All four factors affect, and are affected by, financial globalisation, defined as the extent to which the world's economies are linked through cross-border financial holdings⁴. Financial globalisation is driven by a number of factors, which are outlined in annex A, and has increased rapidly in the last thirty years, particularly for the advanced economies. While in the 1970s the value of international trade in goods and services and international finance were almost the same, now the level of international finance is seven times that of international trade, as illustrated in chart 1.1.

1.4 This paper describes the impact that it has on the global economy and outlines the UK's proposed policy response. The rationale for the paper is three-fold:

- **financial globalisation can and should benefit all economies.** All countries can and should benefit from financial globalisation, most importantly through enhanced economic growth and the diversification of economic risk. Many countries are already benefiting. For the remainder, the benefits will be realised when accompanied by the development of robust domestic financial systems and supporting institutions. However, increasing levels of financial globalisation should support and advance such developments.

¹ This work has benefited from a number of discussions with academics and external experts. The authors would like to specifically thank Richard Portes from the London Business School, Ayhan Kose from the IMF and Claudio Borio from the Bank of International Settlements for their insights.

² HM Treasury (2005): *The UK Financial Services Sector: Rising to the Challenges and Opportunities of Globalisation*, HMSO, 2004

³ United Nations (2008): *Department for Economic and Social Affairs*, <http://www.un.org/esa/desa/>

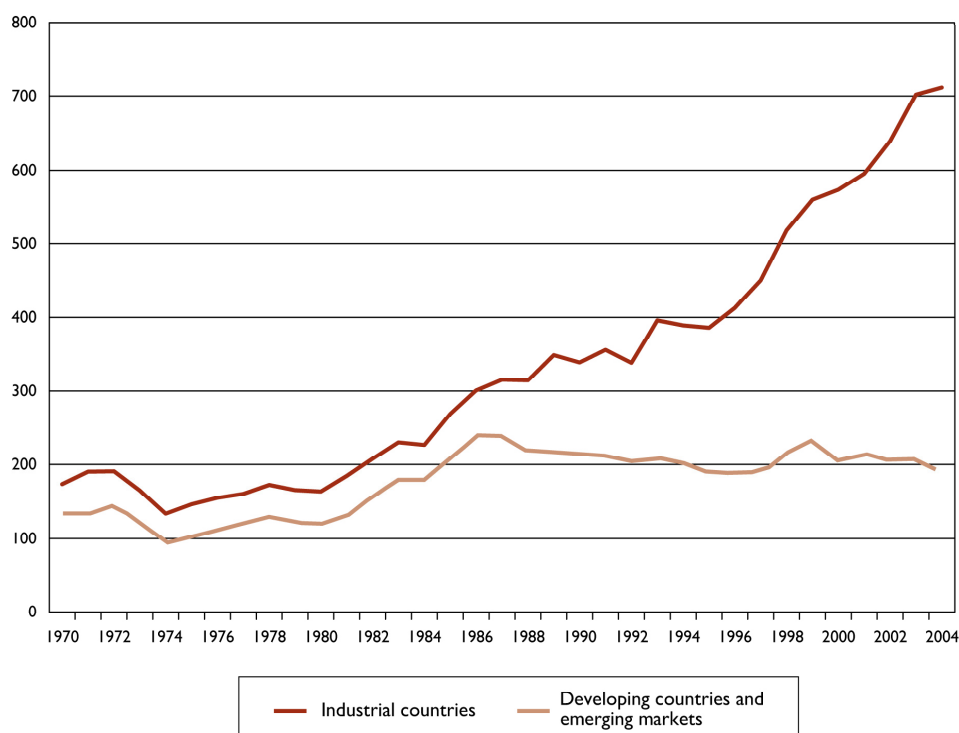
⁴ International Monetary Fund (2007): *Reaping the Benefits of Financial Globalisation*, IMF, Washington D.C., 2007

- **a retreat into financial protectionism will be costly for the global economy.** Financial globalisation supports economic growth, but it is not a panacea. Improperly supervised, it can present risks to financial market stability. However, a retreat into financial protectionism would not guarantee protection from such crises and would harm the global economy. The goal of policy makers, therefore, should be to identify and respond effectively to the risks of financial globalisation, while encouraging closer financial integration as an important driver of economic growth.
- **a coordinated policy response is essential.** Responding effectively to the challenges presented by financial globalisation requires, above all, international cooperation. The UK is at the forefront of the international policy debate on financial globalisation through its membership of the G7, the IMF, the Financial Stability Forum and the EU. These institutions, together with national supervisory and regulatory bodies, have an essential role in ensuring that the full benefits of financial globalisation are captured.

Organisation of the paper

1.5 Chapter 2 describes what is meant by financial globalisation, how the process has evolved over time, and the current situation in advanced, emerging and developing economies. Chapter 3 and 4 assesses the impact of financial globalisation – both the opportunities and potential risks that it presents. Chapter 5 concludes by describing the policy actions, some unilateral, but most requiring collective action, that the UK proposes to ensure that the benefits of financial globalisation are captured by all.

Chart I.1: Financial integration versus trade integration: industrial group and emerging markets/developing countries group, 1970-2004



Note: Sum of external assets and liabilities in percent of sum of exports and imports.

Source: Lane, P. and Milesi-Ferretti, G.M., 2006

2

DESCRIBING FINANCIAL GLOBALISATION

2.1 Financial globalisation is the extent to which the world's economies are linked through cross-border financial holdings¹. The most common forms in which capital is transferred internationally are foreign direct investment (FDI), equities and debt, which are all defined in box 2.1. When referring to increasing financial globalisation, we are concerned with two closely-related processes:

- the reduction in official barriers to cross-border flows of capital – i.e. official policy towards capital mobility; and
- the increase in cross-border holdings of financial assets and liabilities – i.e. the actual extent to which capital is flowing between different economies.

Measuring financial globalisation

2.2 Assessing the extent of financial globalisation requires looking both at the *de jure* measurements, which refer to the level of government restrictions on capital mobility, generally captured as indices of legal restrictions on capital inflows and outflows, and the *de facto* measurements, which refer to returns - or volumes-based measures to highlight changes to external balance sheets or the equalisation of asset prices across borders. Annex A gives further information on how *de jure* and *de facto* measures of financial globalisation are quantified.

Box 2.1: Defining global capital flows

The three main types of global capital flows addressed in this paper are FDI, equity and debt.

FDI is when one economic entity establishes a lasting interest, defined as a greater than 10 per cent ownership stake, in an enterprise located in a different economy. An example of FDI would be if a German car manufacturer took a 20 per cent stake in a Chinese car factory.

Equity refers to the ownership interests of stockholders in a firm in the form of shares or American Depository Receipts. In the data used in this paper, equity refers to ownership of less than 10 per cent of a company's value. An example of equity would be if an American investment fund bought US\$200 million of stock in an Indian power company.

Debt refers to the undertaking of the borrower (the debt issuer) to make one or more payments to the lender (the debt holder) at a specified point in the future. A debt will usually carry a specific rate of interest, referred to as the coupon. It could also be sold at a discount to the amount that will be repaid at maturity. An example of debt would be if a British investment company purchased US\$300 million of bonds issued by a development company in the Middle East.

The evolution of financial globalisation

2.3 It is perhaps surprising that the level of financial integration today is barely higher than it was between 1870 and 1913², during which period technological innovations, like the introduction of international telegraph links in the 1870s, and the financing needs of the frontier economies, such as for railways in Argentina, sparked the first Age of Financial Globalisation. During this period, it is estimated that international trade grew annually by 4 per cent and international capital flows increased from 7 per cent of global GDP to nearly 20 per cent³. Unlike today, when net

¹ International Monetary Fund (2007): *Reaping the Benefits of Financial Globalisation*, IMF, Washington D.C., 2007

² International Monetary Fund (2003): *Effects of Financial Globalisation on Developing Countries*, IMF, Washington D.C., 2003

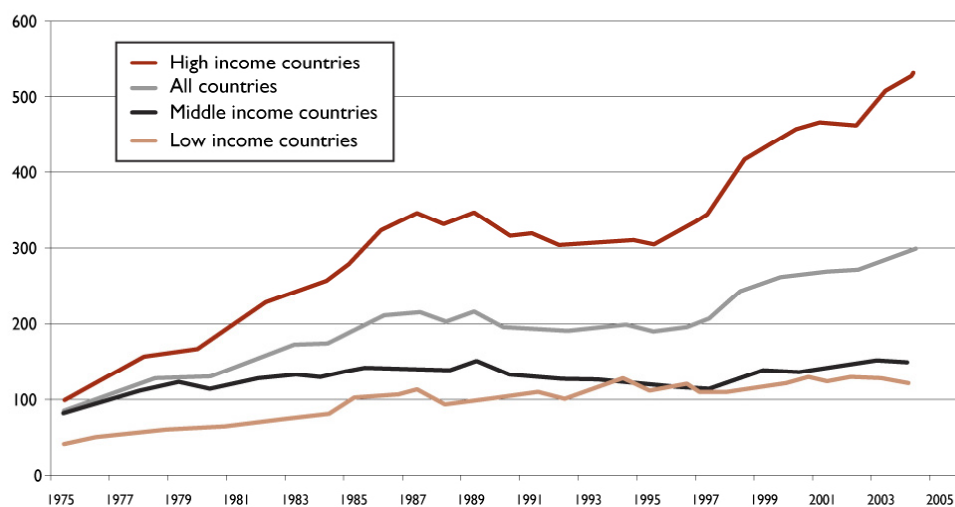
³ Mishkin, F. S. (2006): *The Next Great Globalisation*, Princeton University Press, 2006

capital flows are unusually running ‘uphill’ from the emerging markets to the advanced economies, this period was characterised by capital flowing from Europe to emerging economies in the Americas and Australia. This period closed with the onset of the First World War, the Great Depression and concomitant introduction of rigid capital controls. It was not until the early 1990s that the degree of financial integration experienced between 1870 and 1913 was surpassed.

2.4 However, since the early 1990s, the value of external financial assets and liabilities has increased significantly – see chart 2.1 below. In 1990, only 33 countries had total financial assets whose value exceeded that of their respective GDPs. By 2006, this had doubled to 72 countries, and Brazil, Russia, India and China (the BRICs) now all possess financial assets far in excess of their gross national products. The value of banks’ assets and liabilities held abroad has increased from about US\$5 trillion in 1990 to more than US\$20 trillion in 2006. Cross-border portfolio investment doubled from about US\$12 trillion in 2001 to around US\$25 trillion in 2005⁴.

2.5 It is estimated that in 1990, foreign investors owned less than 10 per cent of equities around the world; by 2006 this had increased to 25 per cent. Similarly with government and corporate bonds: foreign ownership increased from 11 per cent in 1991 to 31 per cent in 2006 for the former and from 7 per cent to 21 per cent in the latter⁵. In 2007, it is estimated that the total value of cross-border financial deals represented over 40 per cent of all financial deals.

Chart 2.1: Gross external assets and liabilities by income group, 1975 – 2004 (% GDP)



Source: IMF, 2007.

Advanced economies

2.6 So far, the advanced economies have experienced the greatest degree of financial integration. While in the 1970s the value of international trade in goods and services and international finance were almost the same, now the level of international finance is 7 times that of international trade⁶.

⁴ Ferguson, J.W. et al (2007): *Ninth Geneva Report on the World Economy: International Financial Stability*, CEPR, 2007

⁵ McKinsey Quarterly (2008): *Long-term Trends in the Global Capital Markets*, McKinsey, 2008

⁶ Lane, P., and Milesi-Ferretti, G. (2006): *The External Wealth of Nations Mark II*, IMF Working Paper, Washington D.C., 2005

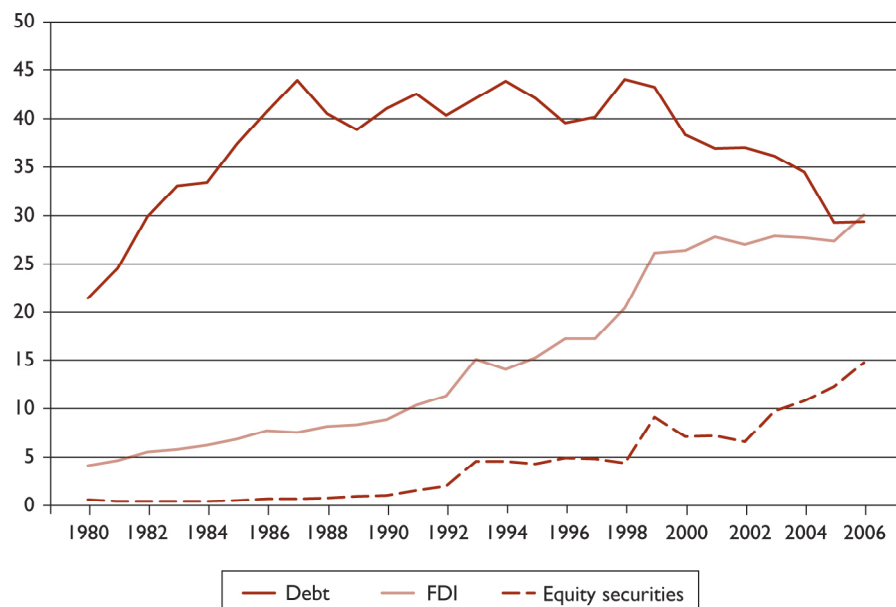
2.7 There are a number of factors specific to the advanced economies that explain such a rapid rise in financial globalisation. Levels of *de jure* financial openness have increased greatly, most visibly following agreement on the Treaty of Rome and subsequent efforts to create a fully integrated EU market for financial services. In addition, the development and spread of common reporting standards across advanced economies, for example International Financial Reporting Standards in accountancy, has greatly reduced financial transaction costs. Finally, the last 15 years have witnessed significant improvements in regulation, transparency and general governance.

Emerging economies

2.8 The emerging economies currently hold only about 14 per cent of global financial assets, far less than their share of global GDP, which exceeds 20 per cent. However, in the last five years, financial globalisation has increased most rapidly within and between the emerging economies. Capital flows into and out of these economies increased nearly 500 per cent between 2002 and 2006: from US\$173 billion to US\$990 billion⁷-see chart 2.2. In India alone, flows rose from less than 32 per cent GDP in 1992 to more than 90 per cent of GDP in 2006⁸.

2.9 In the emerging markets, there has been an overall move away from debt and towards equity and FDI, as shown in chart 2.2 below. Equity inflows totalled US\$419 billion in 2006, accounting for almost three-quarters of capital inflows, up from two-thirds in 2004. Roughly one quarter of the US\$1.2 trillion in worldwide FDI in 2006 went to the emerging and developing economies⁹. Overall, there has been a general decline in external debt-to-GDP ratios in most emerging economies, which represents an improvement in the macroeconomic fundamentals of the emerging economies.

Chart 2.2: Composition of emerging market economies' gross outstanding external liabilities (% of GDP)



Source: Bank of England, 2008

⁷ International Monetary Fund (2007): *Global Financial Stability Report*, IMF, Washington D.C., 2007

⁸ Indian Ministry of Finance (2007): *Making Mumbai an International Financial Centre*, Delhi, 2007

⁹ The World Bank (2007): *Global Development Finance: The Globalisation of Corporate Finance in Developing Countries*, World Bank, Washington D.C., 2007

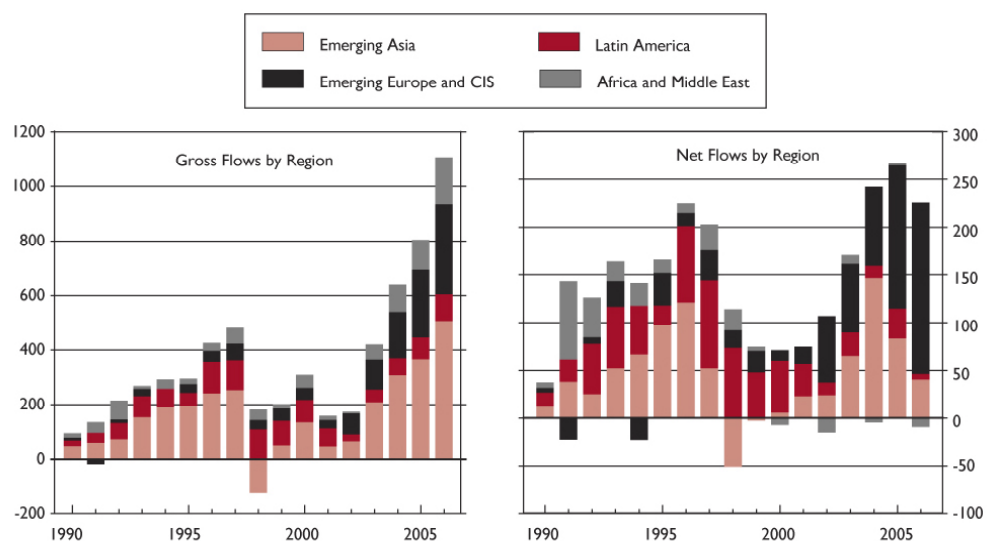
2.10 Emerging economies have become significant net exporters of capital, the bulk of which comes from the central banks. While only ten years ago, at the time of the Asian financial crises in 1997-1998, the emerging markets as a whole were running a current account deficit, in 2007 they collectively ran a US\$685 billion surplus, nearly 1.5 per cent of global GDP. Such surpluses have been accompanied by a dramatic increase in foreign asset ownership by the emerging market central banks and governments, which are currently worth US\$7 trillion, including an estimated US\$61 billion invested in G7 financial institutions¹⁰. This compares with the US\$60 billion in foreign assets held by the British authorities¹¹. Box 3.1 in chapter 3 has more information on the nature of impact of global economic imbalances.

Least developed economies

2.11 The least developed economies have so far been the least affected by financial globalisation. Sub-Saharan Africa, for example, was the destination of only 6 per cent (US\$292 billion) of the US\$4.9 trillion in private capital that flowed to all developing economies between 1990 and 2006¹².

2.12 This is partially due to the prevalence of capital controls in these economies which, while significantly lower than they were 30 years ago, remain higher than in more developed economies. However, capital controls are only partially effective. The main explanation for the inability of the least developed countries to attract global capital flows relates to a weaker domestic investment environment and a limited ability to absorb foreign capital inflows, which are both attributed to an undeveloped domestic financial system, weaker institutions and poor financial governance.

Chart 2.3: Private capital flows to developing and emerging economies (US\$ billions)



Source: IMF, 2007

¹⁰ International Institute of Finance (2008): *Capital Flows to Emerging Market Economies*, IIF, Washington D.C., 2008

¹¹ Bank of England (2008): *Sovereign Wealth Funds and Global Imbalances*, speech by Sir John Gieve, Friday 14 March 2008.

¹² The World Bank (2007): *Global Development Finance: The Globalisation of Corporate Finance in Developing Countries*, World Bank, Washington D.C., 2007

3

THE OPPORTUNITIES OF FINANCIAL GLOBALISATION

- 3.1** The main opportunities presented by financial globalisation are:
- economic growth;
 - economic stability; and
 - tackling strategic challenges like development and climate change.

FINANCIAL GLOBALISATION AND ECONOMIC GROWTH

- 3.2** Financial globalisation can contribute to economic growth through¹:
- improving the allocative efficiency of capital;
 - intensifying internal competition;
 - spreading technology and managerial expertise; and
 - spurring the development of secondary market liquidity.

3.3 In addition, an economy that is open to international capital flows does not bear the economic inefficiencies that accompany capital controls.

Allocating resources **3.4** The main channel through which financial integration should promote growth is via increasing the allocative efficiency of capital. Under an open investment regime, capital should flow to where it can be put to its most productive uses, which is not necessarily in the host economy. The flow of capital into and out of formerly constrained economies should reduce the cost of capital to firms, thereby boosting growth. The effect should be particularly marked for firms that require large initial capital outlays, for example, utility firms. In the longer term, external finance should help to influence resource allocation decisions in ways that support increased productivity growth.

Increasing competition **3.5** Greater competition from inward investment forces less productive firms out of the market, removes monopoly rents, and reduces prices for consumers. Further, it reinforces the incentives for innovation, helping to create more competitive firms. Competition is a key driver of “productive churn”, the process by which resources and market share are reallocated from inefficient to more efficient producers. Increased efficiency is the main contributing factor to economic growth.

Spreading technology and expertise **3.6** Inward flows of equity and FDI can provide access to new technologies, particularly where more open investment regimes lead to different stages of the production process being undertaken in different countries (termed ‘unbundling’²). Inward investment can also speed up the process of technology diffusion. Better technology raises aggregate productivity, which in turn boosts economic growth³. Large inward investments, for example involving mergers and acquisitions, may also help

¹ There is lively academic debate about the extent to which financial globalisation supports growth in developing countries, the most recent contribution to which is ‘*Why did financial globalisation disappoint?*’ by Danny Rodrik from Harvard University. This paper supports the view that financial globalisation can ultimately contribute to economic growth in all countries, subject to certain caveats. For example, see IMF ‘*Reaping the Benefits of Financial Globalisation*’, 2007 for more information.

² Baldwin, R (2007): *Globalisation: the great unbundling(s)*, prepared for the Finnish EU Presidency, 2007

³ Borensztein et al (1998): *How does Foreign Direct Investment Affect Economic Growth?* Journal of International Economics, Vol. 45

influence economic growth via increases in organisational efficiency, better corporate governance and better management, which will improve allocative and productive efficiency.

Spurring liquidity 3.7 In addition, financial integration may also promote growth by spurring liquidity. If domestic markets are small, the introduction of a larger pool of capital and an increased investor base may provide liquidity to the domestic market. This increases the ability of residents to enter and exit the market with small effects on price. It also increases the likelihood of finding ready buyers for an asset. This may encourage increased mobilisation of savings in the domestic economy.

Removing inefficiencies 3.8 Capital controls can be suitable for some emerging and developing economies. However, capital controls also exert economic inefficiencies. The IMF estimates that a one-standard-deviation increase in controls on foreign exchange transactions reduces trade by the same amount as a hike in external tariffs by 11 per cent⁴. Furthermore, efforts by firms to evade capital controls, and those of the public authorities to enforce them, exert an economic drag. These economic growth benefits of capital account liberalisation should be set against the potentially destabilising impact of inappropriately timed or sequenced capital account liberalisation - see paragraphs 4.11 to 4.14 for more information about capital account liberalisation.

Indirect growth benefits

3.9 In addition to the potential direct benefits, financial globalisation may also support growth through a number of indirect channels:

- **spurring financial sector development.** Opening up domestic markets to foreign direct investment, foreign capital and foreign financial institutions increases competitive pressures on domestic financial institutions, obliging them to support those institutional reforms, such as better accounting standards and disclosure requirements, that underpin an efficient financial sector⁵. Capital account liberalisation should also increase the availability of funds, thereby raising liquidity and lowering the cost of capital, which spurs greater investment and economic growth⁶;
- **promoting stable macroeconomic frameworks and institutional improvements.** There is a particularly strong correlation between financial openness and low inflation, which, by increasing certainty and stability, attracts investment from both domestic and international firms. Foreign commercial involvement in domestic markets also spurs regulatory improvement; and
- **contributing towards total factor productivity (TFP) growth.** IMF analysis shows a significant positive correlation between *de jure* financial openness and TFP growth through its contribution towards enhancing economies' efficiency⁷.

⁴ International Monetary Fund (2007): *Reaping the Benefits of Financial Globalisation*, IMF, Washington D.C., 2007

⁵ World Bank (2001): *Finance for Growth: Policy Choices in a Volatile World*, World Bank, Washington D.C., 2001

⁶ Mishkin, F. S. (2006): *The Next Great Globalisation*, Princeton University Press, 2006

⁷ International Monetary Fund (2007): *Reaping the Benefits of Financial Globalisation*, IMF, Washington D.C., 2007

The growth experience

Advanced economies **3.10** The advanced economies are best placed to make the most of financial integration, as they exhibit a number of features that enable the efficient transmission of the potential benefits listed above. Most importantly, these include well-developed domestic financial sectors and strong governance and supervisory institutions, which enable the economies to absorb and efficiently distribute large inflows of foreign capital.

3.11 In their benchmark survey of the empirical literature, the IMF have identified direct growth benefits from financial globalisation for the advanced economies, accompanied by increased financial depth⁸. And a Brookings Institute study estimates that a 1 percentage point increased reliance on foreign capital increases growth in income per person by 0.09 percentage points⁹.

Emerging economies **3.12** Emerging economies have grown strongly at a time when they have become vastly more financially integrated with the rest of the world. However, accurately determining causality is difficult. Decomposing financial flows into debt, equity and FDI reveal differing impacts on growth:

- There is evidence that **equity market liberalisation** has led to economic growth due to the “investment boom” that typically follows. As countries have opened up their stock markets to foreign capital, the growth rate on investment has typically risen by 1.1 per cent and the growth rate of output per worker has increased by 2.3 per cent¹⁰.
- The beneficial impact of **FDI** appears to be conditional on the level of financial sector development, institutional quality or human capital availability, though at the firm level it is clear that FDI supports growth in certain sectors of the economy, for example banking;
- Conversely, **debt** does not appear to yield significant growth benefits, particularly if it is short-term and denominated in foreign currencies. This might be because debt does not either solve “agency” problems (as equity might through the ownership rights that equity confers) or that it does not bring technology spill-overs (as FDI might). The main benefit of debt for emerging economies is, therefore, less concerned with growth and more to do with the access to short-term liquidity it provides, especially where there is little access to equity finance.

Least developed economies **3.13** The least developed economies are currently the least integrated in the global financial system. Consequently, they have been unable to capture all the potential economic growth benefits of financial globalisation. Foreign investment, for example, has focussed on large firms, while the bulk of most low-income countries’ economies is made up of small and medium enterprises (SMEs) or micro-enterprises.

3.14 However, the potential for the least developed economies to benefit from financial globalisation is significant. A number of studies have demonstrated a link between finance and growth in developing countries, with a 2002 analysis indicating that a doubling of the size of private credit in an average developing country is

⁸ International Monetary Fund (2007): *Financial Globalisation: A re-appraisal*, IMF, Washington D.C., 2007

⁹ Prasad, E. et al (2007): *Foreign Capital and Economic Growth*, Brookings Papers on Economic Activity, 2007

¹⁰ Henry, P. B. (2003): *Capital Account Liberalisation, the Cost of Capital and Economic Growth*, American Economic Review 93 (2), 2003

associated with a two percentage point increase in economic growth. In 2004, a World Bank paper commented that ‘the causal link between finance and growth is one of the most striking macroeconomic relationships uncovered in the last decade’¹¹. Furthermore, there is increasing evidence that while foreign banks in developing countries tend to favour loans to large firms, the increased competition that they present encourages local banks to focus more on providing profitable services of the economy like SMEs that had previously been neglected¹².

3.15 The extent to which the least developed economies benefit from financial globalisation is determined by their level of financial sector development, perceived institutional quality and macroeconomic policies. Those economies above a certain level in these ‘thresholds’ show strong growth benefits. For the remainder, it is less clear. However, as set out above, financial globalisation itself promotes development in these areas¹³. The role of external portfolio equity investment, FDI and private equity in the least developed economies are all likely to increase in coming years¹⁴. Therefore, it is important that policies are focused on making progress towards reaching the thresholds.

FINANCIAL GLOBALISATION AND ECONOMIC STABILITY

The importance of economic stability

3.16 Macroeconomic stability - characterised by predictable, low inflation and low-amplitude fluctuations in economic growth - allows businesses, individuals and governments to plan effectively for the long term, improving the quality of investment in human and physical capital, thereby raising productivity.

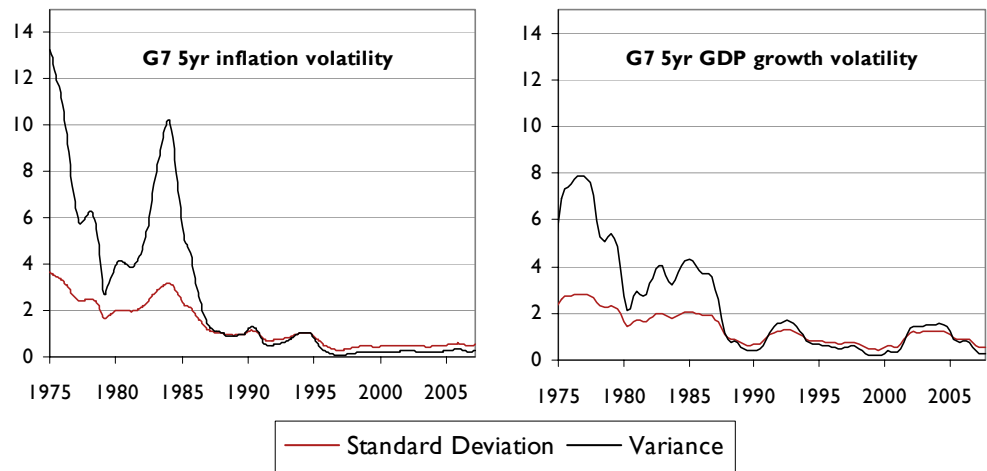
3.17 Since the early 1980s, the global economy has experienced a substantial increase in macro-economic stability, often termed ‘the Great Moderation’- see chart 3.1. This has been particularly pronounced in the advanced economies. For example, in the US the variability of quarterly growth in real output has declined by a half since the 1980s, while in the UK the volatility of growth and inflation has declined significantly over the past decade, a marked contrast to the 1970s.

¹¹ World Bank (2004): *Financial Development, Growth and Poverty: how close are the links?* World Bank, Washington D.C., 2004

¹² World Bank (2007): *Finance for all? Policies and pitfalls in expanding access*, World Bank, Washington D.C., 2007

¹³ For a detailed explanation of this process please see International Monetary Fund (2007): *Reaping the Benefits of Financial Globalisation*, IMF, Washington D.C., 2007

¹⁴ World Bank (2007): *Finance for all? Policies and pitfalls in expanding access*, World Bank, Washington D.C., 2007

Chart 3.1: Trends in G7 inflation and growth volatility (1975 – 2007)

Financial globalisation and economic volatility

3.18 Financial globalisation should allow a country to insure itself against adverse idiosyncratic and regional income shocks. This should help promote greater macroeconomic stability. One should also expect the volatility of consumption to fall relative to output volatility, as a result of increased insurance against income risk from financial globalisation. Studies by the IMF on the benefits of risk-sharing suggest:

- **the potential risk-sharing benefits from full financial integration with the rest of the world are substantial for every country.** Between 1975 and 2004, the standard deviation of world output growth was 0.8 percentage points, which is far lower than the median standard deviation of consumption growth for individual countries (4.4 percentage points);
- **the potential gains from financial globalisation are larger for countries whose economies are more volatile,** for example, smaller, less-diversified economies. This could be either because they are subject to more and more-damaging economic shocks, or because they are unable to implement the necessary countercyclical policies to smooth over shocks; and
- **the potential gains are far greater for those countries who are currently the least financially integrated with the rest of the world** and whose economies are therefore less correlated to worldwide economic developments¹⁵.

Evidence supporting the theory

3.19 Recent empirical research has shown that consumption volatility is indeed significantly improved by cross-border capital flows, especially portfolio investment¹⁶. The advanced economies in particular have benefited¹⁷. Importantly, international risk-sharing occurs even in open countries possessing poor institutions, such as limited property rights or limited contract enforceability. Even closed economies, provided adequate institutions are in place, benefit from consumption insurance provided by

¹⁵ International Monetary Fund (2007): *Reaping the Benefits of Financial Globalisation*, IMF, Washington D.C., 2007

¹⁶ Imbs, J., Fratzscher, M.(2007): *Risk Sharing, Finance and Institutions in International Portfolios*, CEPR July 2007

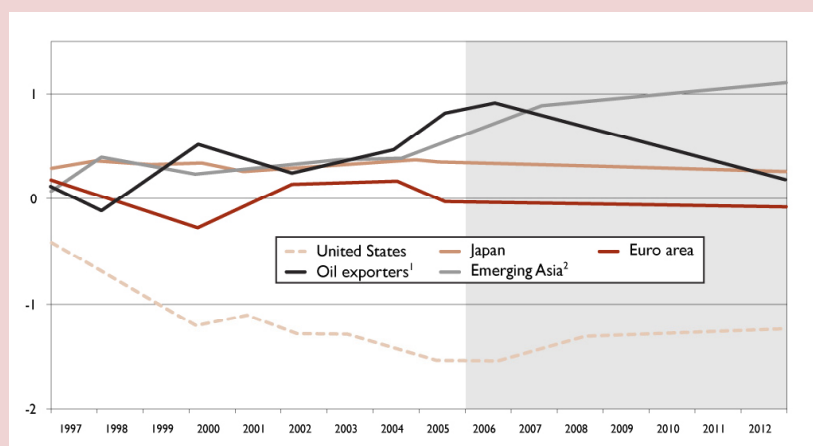
¹⁷ Kose, A et al (2007): *How does Financial Globalisation Affect Risk Sharing?* IMF Working Paper, Washington DC, 2007

capital flows. It is only countries that are either closed or lack adequate institutions that have not experienced some degree of consumption smoothing.

Box 3.1: Implications for economic stability of global imbalances

Since the start of the 1990s, global current accounts have become highly imbalanced. This is attributable largely to an expanding US deficit, peaking at US\$857 billion (6.5 per cent of GDP) in 2006, and high surpluses among the emerging market economies and oil exporters¹⁸. Though imbalances are likely have peaked in 2006, profound imbalances are likely to persist for the foreseeable future.

Current account balance (% of global GDP)



Source: IMF, 2007

IMF analysis shows that, over the past 40 years, reversals of current account deficits have typically been accompanied by slower demand growth relative to other countries and exchange rate depreciation. While deficits can be reduced gradually, countries with large deficits may also be vulnerable to more rapid reversals in capital flows, which can have profound consequences, as demonstrated in Latin America in the 1980's, in the Nordic countries in the early 1990s and the East Asian economies a decade ago¹⁹. If foreign investors lose confidence in an economy, it becomes more difficult to finance domestic current account deficits through foreign investment. As capital inflows reduce in line with decreased demand for assets, currencies can fall sharply.

There are also dangers for those countries running large surpluses. Large foreign exchange inflows related to large surpluses are often associated with asset price bubbles and higher inflation. Such effects are further compounded when exchange rates are pegged or managed against a depreciating dollar, as shown recently in a number of oil-exporting economies, and China, where rising inflation represents a significant threat to economic and financial stability²⁰.

3.20 Though all countries can receive stability benefits from financial globalisation, the extent to which they benefit is determined by:

¹⁸ International Monetary Fund (2007): *Global Imbalances and Financial Stability*, IMF, Washington D.C., 2007

¹⁹ Bank of England (2008): *Sovereign Wealth Funds and Global Imbalances*, Bank of England, London, 2008

²⁰ International Monetary Fund (2007): *Regional Economic Outlook: Middle East and North Africa*, IMF, Washington D.C., 2007

- **financial sector development:** well-developed domestic financial markets may be instrumental in both moderating boom-bust cycles that could be triggered by sudden stops in financial flows and in efficiently allocating foreign financial flows to competing investment projects, thereby establishing a platform for sustainable economic growth;
- **institutional quality:** using the Institutional Quality Index, which averages institutional indications like political stability, government effectiveness, regulatory quality and control of corruption, the IMF have indicated that better institutions help shift the composition of financial flows towards FDI and portfolio equity, which have a greater impact than debt flows on promoting macroeconomic stability²¹.
- **responsible macroeconomic policies:** without sound economic policies, financial integration may lead to excessive borrowing and debt accumulation, thus raising macroeconomic vulnerability, as demonstrated in Latin America and Asia during the 1990s-see box 4.1 below.
- **trade integration:** a high degree of trade openness, including liberalised financial services markets, is associated with fewer stops and current account reversals. Countries that are more integrated into global trade routes also tend to recover faster from financial and economic crises, like South Korea in 1998.

FINANCIAL GLOBALISATION AND GLOBAL CHALLENGES

3.21 Financial globalisation can contribute to tackling some of the most important challenges that the international community faces today, notably development and climate change.

Development

3.22 The macroeconomic impact of financial globalisation on developing countries has been addressed earlier in this chapter. However, financial globalisation will also have a significant microeconomic impact through:

- facilitating the flow of remittances between countries;
- allowing the introduction of new payment methods; and
- making possible new financing arrangements to help meet the Millenium Development Goals (MDGs).

The flow of remittances

3.23 Remittances, a personal manifestation of financial globalisation, are the largest source of external financing for developing countries after FDI and private equity and debt financing. Total global flows of international migrant remittances to developing economies reached an estimated US\$221 billion in 2006, up from US\$96 billion in 2002²². This is more than twice the value of total foreign aid. Though China, India and Mexico account for more than a third of total remittances, it is in the poorest countries where remittances have the greatest impact. In Ghana, for example, between 10 and 15

²¹ International Monetary Fund (2006): *Country insurance: the role of domestic policies*, IMF, Washington DC, 2007

²² World Bank (2007): *Global Development Finance: The Globalisation of Corporate Finance in Developing Countries*, World Bank, Washington D.C., 2007

per cent of national income in 2005 came from remittances, compared with only 3 per cent from foreign investment²³.

3.24 The flow of remittances tends to increase when the recipient economy suffers an economic downturn following a financial crisis, natural disaster or political conflict, thereby helping to provide a form of insurance. Remittances are person-to-person capital flows that are well targeted to the needs of the recipient, who are often poor. Analysis of money remitted from the UK found that 33 per cent of the money is spent on food, 21 per cent on medical bills and 17 per cent on education. An important challenge for the future will be to reduce the cost of remitting funds²⁴.

3.25 The advanced economies are already undertaking important work to facilitate the flow of remittances. On the 10 January 2008, Ministers from the UK's Department for International Development (DFID) launched a Remittance Charter, developed by the UK Remittance Task Force. The Charter primarily focuses on remittances to the developing world, but encourages firms to extend the standard to all remittance transactions. The Charter commits participating firms to giving clear, transparent information in a standard format for processing remittances. In addition, the European Commission proposed the Payment Services Directive (PSD) in December 2005, with the aim of achieving a single market in retail payment services that provides a fair and open access to payments markets, and increases protection for consumers. The PSD introduces a new EU-wide licensing regime for non-credit or e-money institutions, known under the Directive as 'payment institutions.' Member States must implement its provisions into national law by 1 November 2009.

**Introducing
new payment
methods**

3.26 The combination of financial globalisation and technological progress is allowing more people to participate in the global financial system. Companies such as Safaricom in Kenya now allow consumers to send and receive cash through their mobile phone handset - see box 3.2. The advantages of this are clear: consumers and businesses no longer need to carry large quantities of cash in order to remunerate workers, buy raw materials, or make long journeys. Though these systems currently operate on a national level, they could represent the new model for remitting money across borders. The challenges will be to ensure that an appropriate regulatory and competition environment is created and that even the poorest are able to take advantage of these new developments.

²³ DFID (2007): *Remittances Information Note*, DFID, London

²⁴ ICM (2006): *BME Remittances Survey: Research Report*, DFID, London

Box 3.2: Mobile banking in Kenya²⁵

Vodafone have now signed up 1.5 million customers in Kenya for their mobile phone banking service, M-PESA. M-PESA (which in Swahili means 'mobile money') is a fast, safe and affordable way to send and receive money through mobile phones without the need for a bank account. DFID helped set up the pioneering service by matching Vodafone's investment of £1m, through the Financial Deepening Challenge Fund, to pilot M-PESA in Kenya. The service has now become so popular that approximately 200,000 people are signing up every month to be able to send and receive money.

M-PESA targets poor customers, who until now have been excluded from formal bank networks, due to their remote location and small transaction volumes. With more than 46% of the population living below the poverty line, the introduction of M-PESA may have huge developmental benefits for poor people in Kenya. Vodafone have recently partnered with Citigroup to pilot the use of this platform to send international remittances from people in the UK to friends and relatives in Kenya by mobile phone. They are also working with DFID Kenya to determine if M-PESA could be used to distribute social payments to poor families in remote areas.

Meeting the Millennium Development Goals

3.27 Innovative financing mechanisms, often supported both by governments and the private sector, have recently been introduced to bring forward the funding urgently needed to achieve the Millennium Development Goals. Innovative financing can also provide long-term, predictable resources to overcome the problems of uncommitted and short-term flows that have constrained aid effectiveness in the past. The UK is an international leader in this field.

3.28 Working with a number of international partners, the UK Government has already launched the International Finance Facility for Immunisation (IFFIm) and the pilot Advance Market Commitment (AMC) for a pneumococcal vaccine. By issuing bonds, IFFIm leverages money from international capital markets, which allows the money to be disbursed in a single, early instalment. IFFIm will raise US\$4 billion to deliver immunisation programmes in 72 of the world's poorest countries. Spending this money without frontloading would save an estimated 2.5 million lives before 2015. But by frontloading US\$4 billion, an estimated 5 million lives could be saved in the years to 2015, and a further five million lives saved afterwards.

3.29 The pilot AMC for a pneumococcal vaccine provides a financial commitment to subsidise the future purchase of a vaccine if one is developed and demanded. If successful, it will immunise nearly 100 million children and prevent over 5 million deaths by 2030. Once this pilot is established, focus will shift to the next AMC and work to accelerate the development of vaccines for malaria, tuberculosis and, ultimately, AIDS.

Climate change

3.30 Tackling climate change is one of the greatest challenges that global society faces. However, with an increasingly integrated global financial system, it is possible to create a global market for externalities such as carbon dioxide, thereby correcting the market failure. Furthermore, as described in the 2007 Stern Report²⁶, it is possible to do

²⁵ Adapted from Vodafone (2008): press release "M-Pesa Reaches 1.6 million customers in 12 Months", 10 February 2008: http://www.vodafone.com/start/media_relations/news/group_press_releases/2007/m-pesa_reaches_1_6.html

²⁶ Stern, N. (2007): *The Economics of Climate Change*, HM Government, UK.

so at an acceptable economic cost. Achieving this will require coordinated action and resolve from both governments and the private sector.

Creating a global carbon market

3.31 Well-designed international carbon pricing policy will encourage private investment into less polluting activities, while retaining the efficiency advantages of market resource allocation. By putting a price on emissions, the carbon market is driving emissions reductions and the development and deployment of low carbon technology, while allowing private investors and traders to find the most efficient means of doing so.

3.32 The global carbon market was worth an estimated €40 billion in 2007, up by 80 per cent from 2006²⁷. This market is dominated by the EU Emissions Trading System (EU-ETS), in which carbon transactions totalled €25 billion. EU-ETS is an example of a ‘cap-and-trade’ system whereby the authorities place an overall limit on emissions, establish obligations and initial allowances for market participants within that overall cap; and then allow trading.

3.33 Recognising the advantages of a globally integrated carbon market, the UK is working with a number of other countries and sub-national bodies, such as US states, as they develop their schemes. The UK is a founder member of the International Carbon Action Partnership, a partnership of 23 states and provinces in Europe, North America and Australasia, established in October 2007, committed to sharing experience and best practice in order to develop scaleable and linkable trading schemes. In addition, HM Treasury hosted an International Carbon Markets Conference in November 2007 and subsequently established a Carbon Markets Experts Group to discuss developments in this area with carbon market participants.

Carbon-based finance

3.34 Another major part of the development of the global carbon market is project-based carbon finance. The key instrument that delivers this is the Clean Development Mechanism (CDM). The market for the CDM was worth approximately €12 billion in 2007. The CDM allows for entities in developed countries to meet their emissions obligations by paying for projects in developing countries that reduce emissions, and thereby contributing to sustainable development, in return for a regulated (or ‘certified’) flow of carbon credits. This allows the developed world to reduce the cost of reducing global emissions, while providing a mutually beneficial stream of finance and technology to poorer countries - see box 3.3 for example of CDM in practice.

3.35 The UK supports the growth of carbon-based finance and has established a dedicated team (the ‘Climate Change Projects Office’) to support and promote UK private sector involvement in CDM. This team works closely with UK Trade and Investment teams in British embassies around the world, facilitating CDM partnerships involving the UK private sector.

²⁷ Point Carbon (2008): www.pointcarbon.com

Box 3.3: China Datang Corporation Windfarms

On 15 April 2008, agreement was reached to conclude the largest ever Clean Development Mechanism transaction in the Chinese power sector. China Datang Corporation, one of five major state-owned power companies in China, brought 39 wind farm CDM projects to market in three separate packages. Each package will reduce Chinese emissions by the equivalent of 5.6 million tons of carbon dioxide. The deal was constructed through a public tender and awarded to Ecoscurities Group, plc (a UK-based carbon buyer), Tricorona (a Swedish carbon buyer) and Credit Suisse (a Swiss bank).

Ecoscurities were awarded a tender by the China Datang Corporation to purchase just over 6,000,000 Certified Emissions Reductions (CERs) from 13 of the Chinese wind farms, to be completed between July 2008 and July 2009. The tender represents one of the largest single offerings of CERs for wind power development under the Clean Development Mechanism of the Kyoto Protocol. The additional revenue generated by the sale of the CERs to Ecoscurities will make the wind farms economically viable to construct, and will contribute 618 MW of installed capacity and supply an expected 1,366 GWh of power annually to China's otherwise carbon-intensive electricity infrastructure.

4

POTENTIAL RISKS OF FINANCIAL GLOBALISATION

- 4.1 The main risks associated with financial globalisation are
- the risk of increased instability in financial markets; and
 - enhanced opportunities for financial crime and market abuse.

FINANCIAL MARKET INSTABILITY

Causes and consequences of financial market instability

4.2 There are exogenous and endogenous causes of financial market instability. The main endogenous cause is the overextension in risk-taking and balance sheets in good times, creating financial vulnerabilities that are exposed only when the economic environment becomes more challenging. Such a build-up and unwinding of financial unbalances is sometimes referred to as the 'procyclicality' of the financial system¹. Financial markets can also be destabilised by exogenous shocks, such as pandemic flu or terrorism, which present operational risks to the global financial system. More information on operational risks, and the UK's response to them, is found in box 4.1.

Box 4.1: Managing operational risks to the UK financial system

Events such as the 7 July bombings underline the importance of robust business continuity planning, and the Tripartite Authorities are committed to strengthening the resilience of the UK financial services sector. Key initiatives include the FSA-led Resilience Benchmarking Project, which assesses the resilience and recovery capability of major market participants and infrastructure providers. The Tripartite Authorities also hold a regular Market Wide Exercise with the private sector, to enable market participants to test coordination of their responses to sector-wide disruption and demonstrate the role of the Authorities in a contingency.

In 2006, the Tripartite Authorities ran a six week Market Wide Exercise on pandemic flu. Over 70 organisations participated, and all reported that the exercise had helped to improve their preparedness. A number of workstreams emerged to take forward lessons learned, and good progress has been made: for example, the retail banks have developed a principles-based framework to improve coordination arrangements to maintain banking services during a pandemic. Internationally, the UK exercise has been recognised as ground-breaking by other regulators, some of whom have sought advice in developing their own pandemic exercises.

4.3 Financial market instability is important because of the potential impact it has on the real economy. Over the past 20 years the potential for financial instability, wherever it occurs, impacting on the domestic and global economy has increased for three reasons:

- **financial markets have increased in importance relative to the real economy:** since 1986 the value of assets traded on the capital markets of the major industrial countries has grown from 1.6 times as large as GDP to 2.5 times. Similarly, the financial sector's share of economy-wide value added has increased by about one third over this period - from 5 per cent to around 6.7 per cent².

¹ Borio, C.E.V. (2007): *Change and constancy in the financial system: implications for financial distress and policy*, Bank of International Settlements, 2007

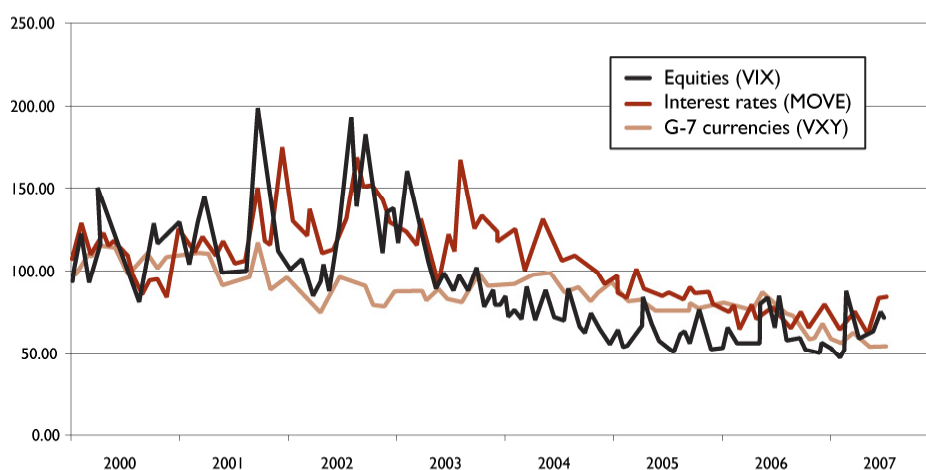
² Ferguson, J.W. et al (2007): *Ninth Geneva Report on the World Economy: International Financial Stability*, CEPR, 2007

- **financial markets and financial institutions around the world are now much more interlinked. There has been a reduction in home bias among institutional and private investors, who seek to diversify their risks.** It is estimated that in 1990, foreign investors owned less than 10 per cent of equities around the world; by 2006 this had increased to 25 per cent. A similar trend has been followed with government and corporate bonds³. Furthermore, the differences between commercial banks and investment banks have shrunk, which has expanded the number of systemically important financial institutions judged ‘too big to fail’⁴;
- **recent decades have witnessed a transfer of risk to the household sector in advanced economies.** This is more clearly illustrated by the larger proportion of household assets that are now held in a form that is vulnerable to market risks, for example the prevalence of defined contribution over defined benefit retirement schemes. Furthermore, the percentage of home ownership around the world has risen, increasing both household debts and assets relative to current incomes⁵.

Trends in financial market instability

4.4 Until recently, the G7 economies, which account for nearly 80 per cent of the global financial transactions, had experienced a significant decline in financial instability across a wide spectrum of asset classes and markets. In the three years preceding the summer of 2007, the volatility of short-term interest rates, long-term bonds, stocks, exchange rates and corporate spreads had been significantly below the historical norms of the previous two decades, as illustrated by chart 4.1⁶.

Chart 4.1: Implied volatility indices (January 2000 = 100)



Source: IMF, 2007

³ McKinsey Quarterly (2008): *Long-term Trends in the Global Capital Markets*, McKinsey, 2008

⁴ The liquidity support extended by the New York Federal Reserve Board in March 2008 to Bear Sterns, an investment bank, is an example of this.

⁵ Borio, C.E.V. (2008): *Change and constancy in the financial system: implications for financial distress and policy*, Bank of International Settlements, 2007.

⁶ Ferguson, J.W. et al (2007): *Ninth Geneva Report on the World Economy: International Financial Stability*, CEPR, 2007

Events since August 2007 **4.5** This extended period of financial stability came to an abrupt halt in August 2007. A fuller analysis of the events since then is set out in *'Financial stability and depositor protection'*, published by HM Treasury, the Bank of England and the FSA in January 2008.

4.6 As discussed, the disruption in global financial markets in the second half of 2007 followed a prolonged period of macroeconomic and financial stability and low interest rates in the UK and globally. Historically-low interest rates encouraged investors to 'search for yield' by investing in increasingly risky financial products, without being fully compensated for the additional risks, leading to a general under-pricing of risk. Benign macroeconomic conditions and the search for yield also encouraged an erosion of credit risk assessment standards in some markets, most notably US sub-prime mortgages.

4.7 Financial markets have also seen a wave of innovation and restructuring in recent years, partly driven by this search for yield. As well as an increase in the interconnectedness of financial markets across borders, there has been a growth in the non-bank financial sector (such as off-balance sheet financing vehicles), and the development of higher-yielding, but riskier and more complex, products capable of delivering returns demanded by investors. A key aspect of recent innovation has been a rapid growth of markets for securitised products and the development of the 'originate and distribute' model of banking.

4.8 In July 2007, renewed concerns about the US sub-prime mortgage market, following earlier periods of stress in February and March, triggered a re-pricing of risk that spilled over with unexpected speed and force into financial markets globally. Difficulties in the US sub-prime mortgage market were caused by loosening of lending criteria, interest rate structures that many borrowers could not ultimately afford, unrealistic expectations about house prices, and, in some cases, fraud. Defaults have risen far higher than expected when the securities were issued and rated. In some areas house prices have fallen, further aggravating the problem. As a result, many financial firms have suffered losses from holding these instruments, the market value of which has fallen. Although the US sub-prime mortgage market is small in relation to the global financial system, difficulties in valuing many of the residential mortgage-backed securities (RMBS) and uncertainty about where the risks associated with sub-prime mortgages had been distributed, led to significant uncertainties about the losses and their impact on banks' balance sheets.

Financial globalisation and financial stability **4.9** Accurately assessing the impact of financial globalisation on financial stability is very difficult and there is no clear consensus among economists. The theoretical impact is ambiguous⁷. There are a number of channels through which it should enhance stability, for example by:

- **enabling investors to manage better their own risks by diversifying their portfolios into foreign assets.** This helps protect against country specific shocks. Concurrently, the internationalisation of financial institutions may have increased the robustness of bank balance sheets through similar diversification effects;
- **improving market and funding liquidity,** thereby creating a deeper and more resilient financial system. In terms of the former, financial globalisation brings an increased set of financial agents active in a given

⁷ Ferguson, J.W. et al (2007): *Ninth Geneva Report on the World Economy: International Financial Stability*, CEPR, 2007

market. For the latter, financial globalisation can ease the access to finance for firms;

- **ensuring that financial risk is allocated to those best equipped to hold it.** The price of risk within a global market should be more accurate than within a more closed market and this optimal diversification of risk would be expected to increase financial system resilience and stability; and
- **diluting the impact of financial crises around different financial markets,** thereby limiting its effect on individual markets. In the sub-prime crisis, for example, the globalisation of capital markets has ensured that the bad loans that originated from the US mortgage market were widely spread around the world, thereby reducing the impact on the US financial system.

4.10 However, financial globalisation can also increase systemic risk in the financial system through contagion between financial centres and markets. This can occur through:

- **enhancing information asymmetries between the distributor and purchaser of risk.** While theory suggests that under global capital markets economic risk will be allocated to those best equipped to carry it, in reality increasing financial sophistication, coupled with the increasing ease of cross-border transactions has led in cases to the real economic risk getting lost in the system. The recent turmoil surrounding collateralised debt obligations exemplifies this process;
- **increasing the correlation of asset prices across borders,** with subsequent contagion risks in the event of asset price collapses. For example, the simultaneous collapse of several large hedge-funds could create contagion across unrelated asset classes, as they are forced to unwind their positions simultaneously;

Box 4.2: Case study: financial crises in Latin America and East Asia

Some leading economists have asserted that recent emerging market financial crises were caused by financial globalisation⁸. International capital flows, especially flows of short-term debt, certainly exacerbated the damage. However, most analysis now suggests that the crises were not an inevitable part of liberalising markets for capital and financial services. Instead, the crises were a result of inappropriately sequenced reforms and inadequate regulation and supervision of the financial sector, as illustrated by these two case studies.

Mexico 1994-1995: In the early 1990s, the Mexican banking system was privatised. A comprehensive government deposit insurance scheme created incentives for risky behaviour and the unreformed regulatory regime permitted banks to avoid revealing their losses by issuing new loans to be used to pay off the principal and past-due interest on previous loans. Between 1988 and 1994, bank credit to the private sector grew from 10 to 50 per cent of GDP and the percentage of bad loans rose from 5 per cent in 1990 to 15 per cent in 1995⁹.

A pegged-exchange rate required the Mexican authorities to raise interest rates in line with US policy, thereby exacerbating adverse selection among borrowers. This, combined with political turmoil in early 1994, led to the Mexican stock exchange falling 20 per cent between September and December 1994. This caused many speculators to sell their Mexican pesos, forcing the Mexican authorities to devalue the peso. By March 1995, the peso had fallen in value by 50 per cent. This made many Mexican private sector debts unserviceable, because they were usually held in dollars. A large number of companies and financial institutions went bankrupt and in 1995 real GDP growth fell to -10 per cent, unemployment rose to 7.5 per cent and poverty rose.

South Korea 1997-1998: Encouraged by the large private sector conglomerates (*chaebols*) and external policy advice, the South Korean authorities opened their capital accounts to short-term debt in the early 1990s. They also made it clear that the government would intervene to rescue a number of the *chaebols* in the event of a crisis. This created enormous incentives for high-risk behaviour among both the South Korean borrowers and foreign lenders. South Korean external liabilities rose from 30 per cent GDP in 1992 to 130 per cent of GDP in 1997, with a commensurate deterioration in bank balance sheets¹⁰.

Two shocks precipitated the crisis. First, the currencies of South Korea's major markets depreciated, reducing the competitiveness of South Korean exports, upon which the economy was heavily reliant. Second, Hanbo, a large *chaebol*, went bankrupt. The South Korean stock exchange fell by over 30 per cent between April 1996 and March 1997. This reduction in collateral, combined with the reliance on short-term foreign capital and financial crises across much of east Asia, led to a collapse in confidence in the Korean economy, with a massive, abrupt withdrawal of foreign capital. This led to a 47 per cent depreciation in the Korean won between October and December 1997, which raised import costs and inflation expectations, causing market interest rates to surge to 20 per cent. High interest rates, coupled with highly dollarised private sector debt, led to the bankruptcy of a large number of banks and *chaebols*. Economic growth fell from 5.7 per cent in the first half of 1997 to -5.4 per cent in the second half¹¹.

These case studies are instructive. They highlight the potential risks of opening up an economy to short-term foreign exchange debt in accompaniment of a fixed exchange rate regime. The case studies also demonstrate the critical role played by prudential supervision of the financial system¹².

⁸ For example, see Stiglitz, J. E. (2002) 'Globalisation and its Discontents', New York, 2002

⁹ Bank of Mexico

- **exposing financial systems to cross-border spill-overs via capital markets or bank balance sheets.** The recent market volatility can be cited as an example of how market volatility can transmit across markets, financial institutions and countries. Such volatility can be attributed to both ‘real’ economic forces and a loss of investor sentiment, which can now spread with alacrity through the financial system;
- **exposing emerging economies to rapid surges and withdrawals of foreign capital flows,** which can cause exchange rate volatility and asset price bubbles. The rapid withdrawal of foreign capital from South East Asian economies, following the devaluation of the Thai currency, exacerbated the subsequent financial crisis that affected many Southeast Asian economies in the late 1990’s-see box 4.2 for more detail.

Capital account liberalisation

4.11 Full financial liberalisation requires the eventual liberalisation of both financial services and the capital account. National capital controls across income groups have fallen over the past 30 years-see chart 4.2. Maintaining rigid capital controls imposes a significant economic cost, as described in paragraph 3.7. However, the strong economic growth experienced in recent decades by a number of countries that maintain binding capital controls, most notably India and China, suggest that the economic cost borne by controls can be outweighed by the benefits derived from a more predictable exchange rate and smoother flows of capital¹³.

4.12 It has been argued that capital account liberalisation causes financial crises, with the Asian and Latin American financial crises often used as the supportive evidence. Box 4.1 on page 29 showed that, although the crises in Mexico and South Korea in the 1990s were caused by inadequate financial supervision, their impact was exacerbated by sharp volatility in capital flows at key moments.

4.13 However, there are also examples of financial crises in countries that had in place very strict capital controls, for example India in 1991¹⁴. And cross-panel empirical evidence about the relationship between capital controls and crises is ambiguous and suggests that capital controls are at best largely ineffective, as they:

- have little effect on the impact, likelihood or nature of single or contagious currency crises, except in the pre-euro European Monetary System, where capital controls tended to increase the likelihood of a crisis¹⁵.
- do not reduce the frequency or impact of banking crises. Indeed, once a banking crisis has occurred, the long-term economic growth impact of a

¹⁰ Hahm, Joon-Ho, and Mishkin, F.S. 2000, *The Korean Financial Crisis: an Asymmetric Information Perspective*, Emerging Markets Review 1(1), 2000

¹¹ Mishkin, F. S. (2006): *The Next Great Globalisation*, Princeton University Press, 2006

¹² Mishkin, F. S. (2006): *The Next Great Globalisation*, Princeton University Press, 2006

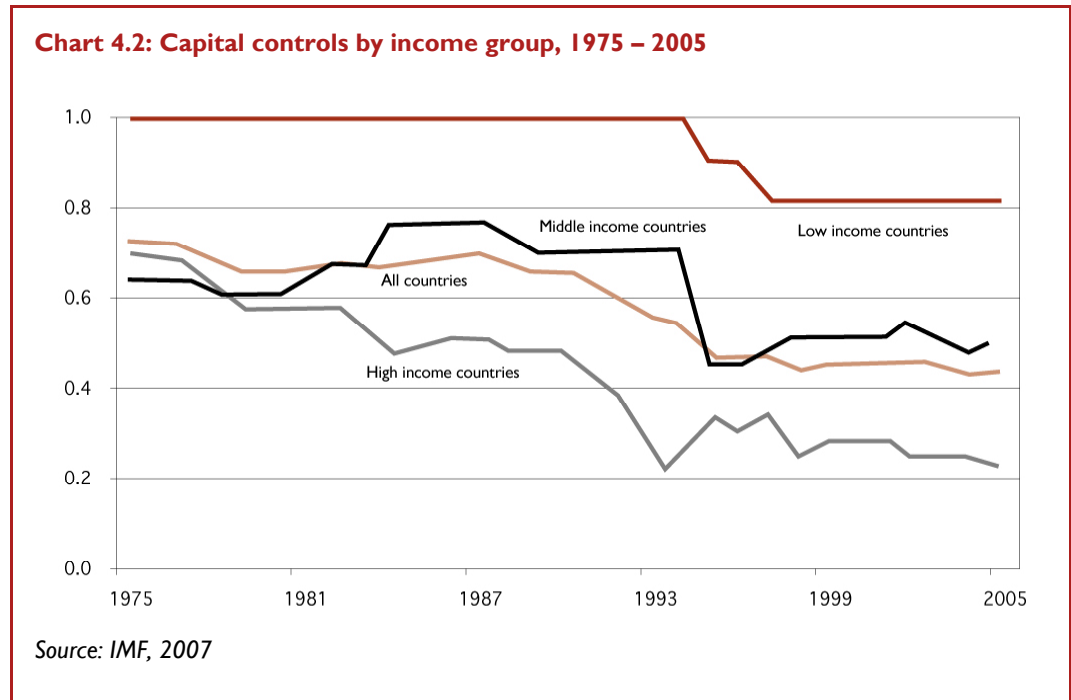
¹³ Ma, G. and McCauley, R. (2007), *Do China’s capital controls still bind? Implications for monetary autonomy and capital liberalisation*, Bank of International Settlements Working Paper, 2007

¹⁴ Cerra, V. and Saxena, S (2002) *What caused the 1991 currency crisis in India?*, IMF Staff Working papers, Vol 49, No.3, 2002

¹⁵ Eichengreen, B. et al (1996): *Contagious currency crises: first tests*, Scandanavian Journal of Economics, 98 (4), 1996

banking crisis is less severe in countries with less restricted capital controls¹⁶.

4.14 Therefore, there are economic arguments both for and against the presence of capital controls. However, it is clear, in order to minimise the potential risks of capital account liberalisation, there must already be in place a developed domestic financial sector and a robust framework for domestic financial supervision.



¹⁶ Bonfiglioli, A., and C. Mendicino (2004): *Financial Liberalisation, banking crises and growth: Assessing the links*, SSE/EFI Working Paper Series in Economics and Finance, no.567, 2004

Box 4.2 Sovereign wealth funds - a source of financial stability

Sovereign wealth funds (SWFs) are government controlled, foreign currency assets that are managed separately from official foreign exchange reserves. In recent years, SWFs have become an increasingly important part of the international financial system. However, they are not a recent phenomenon - the first commodity-based SWF, the Kuwait Investment Authority, opened its office in London in 1953.

Commodity-based funds are an economically rational use of finite reserves that will help provide economic stability when the commodity is depleted or falls in price. For example, returns on the Kiribati Revenue Equilisation Reserve Fund, established in 1956 to manage profits from the sale of now-depleted guano, provides approximately 10 per cent of the island's annual GDP¹⁷.

Since the start of the millennium, at least ten new SWFs have been established, largely as a result of the current account surpluses accumulated by the emerging market economies. The latest, the Chinese Investment Corporation, was established in 2007 with an initial endowment of US\$200 billion. These surpluses are typically invested in US Treasury Bills to provide insurance against a sudden currency shock. However, having accumulated sufficient foreign exchange reserves to guard against conceivable crises, governments are eager to earn higher returns.

The IMF estimate that SWFs currently hold between US\$2 and US\$3 trillion, representing about 2 per cent of global managed funds. The rate of SWF growth will depend on commodity prices, currency movements and levels of domestic investment and consumption. Based on the estimated trajectory of current accounts, they are likely to exceed US\$10 trillion by 2012, which would represent about 6 per cent of global financial assets¹⁸.

Sovereign wealth funds play an important stabilisation role in the global financial markets. They generally have long investment horizons and few commercial liabilities and therefore face fewer pressures to reduce the size or increase the liquidity of their investments. Moreover, they represent an important source of capital – since November 2007 alone they have provided around US\$40 billion of new capital to some of the world's largest and systemically most important commercial and investment banks¹⁹.

The UK Government welcomes the role of SWFs in the global financial system as a source of liquidity and stability. However, SWFs need to build confidence to allay suspicions that some have raised about their objectives. The UK Government supports the work of both the IMF and the OECD in this area, on which paragraphs 5.9 – 5.11 in Chapter 5 provide further detail.

FINANCIAL GLOBALISATION AND FINANCIAL ABUSE AND CRIME

Financial crime

4.15 In the same way that the financial system provides a mechanism for legitimate trade and investment, so it is open to abuse by organised criminals and terrorists for their own purposes. And just as globalisation has created new opportunities for legitimate business, it has also created potential new risks as criminals and terrorists

¹⁷ The Economist (2008), *Invasion of the Sovereign Wealth Funds*, January 2008

¹⁸ Bank of England (2008): *Sovereign Wealth Funds and Global Imbalances*, speech by Sir John Gieve, Friday 14 March 2008.

¹⁹ Bank of England (2008): *Sovereign Wealth Funds and Global Imbalances*, speech by Sir John Gieve, Friday 14 March 2008.

can, for example, move funds internationally more easily – with an estimated £3 billion of criminal profits moved out of the UK alone every year²⁰.

Financial globalisation and crime

4.16 Financial globalisation is an important element of these threats. Organised criminals use the financial system to move money, and launder and disguise it in other types of assets. Terrorists move funds through the financial system to promote militant ideologies, train new members, pay operatives, acquire weapons, stage attacks and sometimes carry out ostensibly legitimate activities to provide a veil of legitimacy for essentially terrorist organisations.

4.17 The extent of links between terrorism and organised crime varies from country to country. In general they are distinct phenomena with differing drivers. But together they pose a serious and immediate threat to the UK and other open societies. Both criminal and terrorist threats also share important common characteristics – in particular, a requirement to utilise and disguise money flows. Formulating a coordinated response to this common characteristic enables both phenomena to be tackled simultaneously using similar means.

Tackling financial crime

4.18 Tackling financial crime and terrorism must involve law-makers, financial institutions and companies, and law enforcement agencies. Given that the financial system, organised crime and terrorism are global in their reach, so the financial challenge to crime and terrorism must also be global.

4.19 Based on international standards and agreements therefore, the UK has a set of financial measures—from freezing assets of terror suspects to requirements to report suspicious flows of money—with the objectives of:

- deterring crime and terrorism in the first place - by increasing the risk and lowering the reward faced by perpetrators;
- detecting the criminal or terrorist abuse of the financial system; and
- disrupting criminal and terrorist activity – to save lives and hold the guilty to account.

4.20 Crime and terrorism are global threats. Recognising that the shared efforts of stakeholders in the UK and internationally are required to succeed, the Government will prioritise efforts to deepen the culture of engagement internationally, to provide a global solution to a global challenge. Working closely with stakeholders overseas helps ensure a coordinated international response to financial crime. The UK is, therefore, a strong supporter of the development of an international framework to fight money laundering and terrorist financing. The UK was instrumental in creating the Financial Action Task Force to develop a set of anti-money laundering/counter terrorist financing (AML/CTF) standards that are applied consistently by all countries.

UK FATF Presidency 2008

4.21 Under the headline objective of “equipping the Financial Action Task Force (FATF) to be more responsive, strategic and outward-looking in its efforts to protect the international financial system from abuse”, the UK FATF Presidency has secured some significant achievements, including:

- a Ministerial meeting in Washington that endorsed the revised FATF Mandate in line with the objective of enhanced FATF accountability to Ministers;

²⁰ HM Treasury, Home Office, SOCA and FCO (2007): *The financial challenge to crime and terrorism*, HMSO, 2007

- deepened global surveillance through regular FATF reporting of emerging and fast evolving criminal and terrorist threats identified, including the regular production of a FATF Global Threat Assessment;
- a stronger partnership with the private sector who are at the frontline of the global fight against money launderers and terrorist financiers, including the establishment of the FATF Private Sector Consultative Forum; and
- support for global efforts to raise AML/CFT standards, especially through the production of Guidance for Low Capacity Countries.

4.22 The IMF has collaborated on a number of specific initiatives during the UK Presidency, such as a project to analyse Terrorist Financing trends and indicators. The IMF has also continued its country surveillance activity, contributing to assessing the AML/CTF safeguards in place, identifying technical assistance needs, and evaluating assistance that has been provided.

Market abuse

4.23 Market abuse describes any type of behaviour that would not be regarded as acceptable by a normal user of the market. Market abuse offences can be classed as either insider dealing or market manipulation. Insider dealing is where insiders use or seek to use certain information that is not publicly available ('inside information'), to their own advantage or to the advantage of others. Market manipulation is where someone seeks to distort the price of financial instruments, or effect transactions or orders to trade or disseminate information in a manner that gives, or is likely, to give false or misleading signals about financial instruments.

4.24 Market abuse is undesirable for a wide range of reasons. At its simplest, it results in some investors being unfairly and unreasonably disadvantaged. Controlling market abuse is therefore important to maintain investor confidence. Research has suggested that market abuse increases the cost of equity, as shareholders demand a higher rate of return to compensate for the fact that they find it difficult to analyse firms²¹. Insider trading has also been shown to increase market volatility²². Specific benefits from robust market abuse regimes have been shown to include:

- the possibility of greater ownership dispersion;
- more informative stock prices; and
- greater stock market liquidity²³.

4.25 An effective market abuse regime is therefore an essential part of a successful capital market. The UK keeps its domestic regime under review, ensuring that the FSA has the appropriate tools to meet its objectives: recently new powers for plea bargaining have been announced.

²¹ Bhattacharya, U., Daouk, H., (2002). The World Price of Insider Trading. *Journal of Finance*, 57(1), 75-108

²² Du, J., Wei, S-J., (2004). Does Insider Trading Raise Market Volatility? *Economic Journal Royal Economic Society*, 114(498), 916-942

²³ Beny, L.N. (2007). Insider Trading Laws and Stock Markets Around the World: An Empirical Contribution to the Theoretical Law and Economics Debate, *Journal of Corporation Law*, 32(2), 237-300

Financial globalisation and market abuse **4.26** Financial globalisation has increased the inter-linkages between markets. Investors trade in foreign shares and with foreign brokers. This increases both the diversity of markets that require oversight and also the range of participants. This complexity has increased the challenges for domestic regulators of delivering effective market oversight, and hence potentially increased the scope for market abuse.

4.27 Enforcement of market abuse has become more complicated because offences will often have a cross-border component - be this the location of the market on which the trade is effected, the client carrying out the trade or the source of information. Clarifying who has jurisdictional responsibility is not always obvious, but largely results in overlaps rather than underlaps.

Tackling market abuse **4.28** The importance of cooperation to deliver effective market oversight is widely recognised both in the EU and internationally and has been for some time. This cooperation rests on two pillars:

- common standards for regulation (more harmonised in EU, but internationally IOSCO has established best practice); and
- shared information to enable pursuit of cross border enforcement cases.

4.29 At the EU level a common framework has been established as to what type of behaviour constitutes market abuse (the 2003 Market Abuse Directive), which is currently being reviewed. Supervisors cooperate closely via the Committee of European Securities Regulators (CESR) and the CESR enforcement subcommittee (CESR-Pol). Such cooperation is necessary to

- increase harmonisation of approach;
- share experience on enforcement; and
- enhance cross-border cooperation through, for example, the framework for establishing urgent issues groups to coordinate and jointly conduct investigations in urgent cases.

4.30 Internationally, securities supervisors have also cooperated both to establish best practice on regulation and to share information on cross-border enforcement matters. In 2002, International Organisation of Securities Commission (IOSCO) adopted a multilateral memorandum of understanding (the IOSCO MOU) designed to facilitate cross-border enforcement and exchange of information among the international community of securities regulators.

4.31 IOSCO has also sought to highlight and tackle those jurisdictions that are historically under-regulated and uncooperative jurisdictions. IOSCO has engaged these jurisdictions in a dialogue on how they can improve their regulatory oversight and abilities to cooperate with foreign counterparts.

5

THE UK POLICY RESPONSE

5.1 The UK believes that the long-term benefits of financial globalisation are substantial, particularly for the emerging and developing countries that are yet to integrate fully into the global financial system. Moreover, it will not be possible to fully avoid the challenges that financial globalisation presents. A retreat into financial protectionism would cause damaging economic dislocation, without delivering protection against instability.

The UK's objectives

5.2 The international community, therefore, has a responsibility to embrace the challenges of financial globalisation and ensure that the potential benefits are delivered in a manner that minimises the potential risks. To this end, the UK's long-term aspirations for the global financial system are that it should be:

1. open to all countries, supporting economic growth for all;
2. effectively regulated and supervised to afford stability to investors and taxpayers; and
3. functioning efficiently to minimise costs for investors and consumers.

The policy framework

5.3 To achieve these aspirations, the UK's policies will sit within a carefully defined framework of:

- making the case for financial openness and taking practical steps to achieve it; and
- developing an effective international regulatory system that:
 - i. provides an early warning system for emerging financial risks;
 - ii. is based on a responsive international regulatory framework that:
 - keeps pace with market developments and new financial instruments; and
 - pursues, where appropriate, the convergence of international regulatory standards and approach.
 - iii. delivers effective cross-border supervision of firms and markets.

5.4 Given that this is a paper about financial globalisation, the policy proposals that follow focus on international reforms or actions. A detailed consultation on proposed reform to the UK financial system is found in *Financial stability and depositor protection*, published by HM Treasury, the FSA and the Bank of England in January 2008.

MAKING THE CASE FOR FINANCIAL OPENNESS

5.5 Financial globalisation offers significant opportunities for all countries. However, this can only happen if open economies resist pressure to become more protectionist and closed economies are supported in their efforts to liberalise. Therefore, the UK's approach in this area will consist of:

- articulating the benefits of openness;

- supporting measures to improve transparency among investors;
- using regulatory and financial dialogues as a practical means of learning from experiences and sharing best practice; and
- making further progress in helping economies liberalise.

Articulating the benefits of openness

5.6 Globalisation in any form is driven by economics, business and technology. However, it is made possible by politics. The major milestones in the history of globalisation are all political, including:

- the Chinese reforms initiated by Deng Xiaoping in 1979;
- the abolition of UK currency controls in 1980;
- the EU's commitment to creating an internal market in the 1980s and the more recent programme of financial market liberalisation through the Financial Services Action Plan – see box 5.1 below; and
- the fall of the Berlin Wall in 1989 and subsequent abandonment of centrally planned economies in Russia, Eastern Europe and Central Asia.

5.7 Politics can also lead to a reduction in financial globalisation, most clearly illustrated by the global move to financial protectionism at the start of the 20th Century.

5.8 It is the responsibility of national governments around the world to clearly articulate the benefits of globalisation and ensure that these benefits are evenly distributed throughout society. If they do not, the more tangible costs of globalisation may dominate the popular narrative and it may be forgotten that the risks of financial globalisation can be overcome by responsible policies and international cooperation. This would prevent governments from capturing for their populations the significant benefits of globalisation that can accrue to all countries.

Supporting measures to enhance transparency

5.9 Supporting this, investors around the world must allay fears by improving their transparency, thereby paving the way for a more predictable international investment climate. This is particularly important for Sovereign Wealth Funds (SWFs), where there is concern among the recipients of investment about national security implications.

5.10 The IMF is developing a voluntary code of conduct for SWFs on corporate governance and transparency, based on industry best practice. The code, which should be finalised by the end of 2008, will enhance the confidence of recipient countries that sovereign wealth funds are taking decisions solely on a commercial basis. In addition, recipient countries are working through the OECD to develop best practice inward investment policies to encourage the free flow of investment, while protecting legitimate national security concerns. This work will give recipient countries confidence in the tools available, and SWFs will benefit from a more transparent and predictable investment climate.

5.11 This ongoing international work is the best way of ensuring continued global market access for SWFs and, being based on best practice, should support their profitability. It is critically important that SWFs engage constructively with this work. Potential recipient countries also need to make their policies towards SWF investment clear. During the UK-China Economic and Financial Dialogue in April 2008 both countries recognised the importance of actively participating in the IMF and OECD work.

Box 5.1: Financial regulation in the EU

Over the past decade, EU member states have advanced from a patchwork of often disparate systems of financial regulation to one which is much more harmonised around common standards. Although financial regulation rightly remains rooted in national legislation and needs to accommodate legitimate differences in national markets and structures, increasing levels of harmonisation have contributed a great deal to economic welfare throughout the EU.

The EU Financial Services Action Plan (FSAP) has, since 1999, been the legislative framework for filling gaps and removing remaining barriers, to provide a legal and regulatory environment that supports the integration of financial markets across the EU. The Lamfalussy arrangements, which were established in 2001, include committees of national supervisors that encourage and foster greater supervisory cooperation and convergence of outcomes.

The FSAP measures and the work of the Lamfalussy arrangements have made great progress. In particular, the adoption of the Capital Requirements Directive (CRD) and the Market in Financial Instruments Directive (MiFID) has created a robust prudential framework for banks and securities exchanges. The UK entirely supports the general principle of the EU's approach. However, as articulated in previous HM Treasury documents¹, the UK believes that the EU process can be improved in important areas, namely:

- supporting convergence of regulatory frameworks and supervisory practices, provided it focuses on regulatory outcomes, not processes;
- promoting better regulation, which aims to deliver financial stability, consumer protection and market integrity, while recognising that the benefits of regulatory measures need demonstrably to outweigh their costs;
- enforcing the consistent implementation of EU directives throughout all EU member states. The use of peer review has a key role to play in this;
- allowing national authorities sufficient time to develop robust and comprehensible implementation strategies for new EU directives; and
- ensuring greater efficiency to cross-border groups by making greater use of supervisory colleges, to be coordinated by the lead supervisor.

The benefits of this progress in these EU processes have been made clear in a number of studies, the most prominent of which concluded that a fully integrated EU market for financial markets would lower the cost of capital for companies by 0.5 per cent in absolute terms, and relatively increase the GDP-level over time by 1.1 per cent².

The role of regulatory dialogues

5.12 Regulatory dialogues are an effective way of both making the political case for financial openness and agreeing practical steps towards achieving it. Bilateral dialogues provide a helpful forum in which countries can share experiences on the approach, sequencing and implementation of liberalisation policies. Countries in the EU in particular have useful experiences to share, both with other advanced nations and the emerging economies.

¹ HM Treasury (2007): *Strengthening the EU regulatory and supervisory framework: a practical approach*, HMSO, 2007

² London Economics (2002): *Quantification of the macro-economic impact of integration of EU financial markets*, London, 2002

5.13 In addition to the existing bilateral dialogues between national regulators, the main regulatory dialogues through which the UK will be looking to deliver practical measures in support of financial openness are:

- the EU-US dialogue on financial services; and
- the economic and financial dialogues with the emerging markets.

The EU-US dialogue on financial services

5.14 A 2005 OECD study suggested that removing barriers to trade and investment and opening up product markets could give a permanent increase in GDP per capita of up to 3.5 per cent in the EU and 3 per cent in the US - or up to a full year's worth of earnings over an average working life³.

5.15 Transatlantic financial markets are central to realising these benefits. Together, the EU and the US comprise over 80 per cent of global financial transactions. According to a recent industry report⁴, the transatlantic financial marketplace supports nearly 7 million jobs, nearly US\$4.1 trillion/€2.8 trillion in direct investment and stock and bond flows in excess of US\$51.3 trillion/€35 trillion.

5.16 Ongoing cooperation between the EU and US must continue to identify and reduce unnecessary regulatory and supervisory barriers to financial services trade, and thus allow markets to function more efficiently, reduce costs and increase competitiveness. Reducing such barriers ought to lead to a convergence in the cost of financial transactions and of raising capital, which are both currently significantly different in the EU, as compared with the US. Studies by the London Stock Exchange have shown:

- end-users in Europe pay close to six times more in post-trade transaction costs than in the US (€2.78 vs. €0.53), due to higher operating expenditures per transaction (€1.97 vs. €0.53) and to higher European margins on each transaction (29 per cent in Europe vs. 0 per cent in the US)⁵; and
- the typical underwriting fee for an issue of £20 million is £700,000 (3.5 per cent) in the UK, France and Germany, compared with £1.3 million (6.5 per cent) in the US⁶.

5.17 The EU-US Financial Markets Regulatory Dialogue, set up in 2002, has steered important progress in reducing transatlantic barriers. Notably, the US Securities and Exchange Commission (SEC) announced in November 2007 that it would permit overseas firms to report according to International Financial Reporting Standards (IFRS), used throughout the EU since 2005, without the requirement to reconcile their accounts with US Generally Accepted Accounting Principles (GAAP). This will substantially reduce the compliance burden facing international firms operating in the US and is already the existing practice in the EU.

5.18 The European Commission and the US Securities and Exchange Commission (SEC) have both acknowledged that “the concept of mutual recognition offers

³ OECD (2005): *The benefits of liberating product markets and reducing barriers to international trade and investment: The Case of the United States and the European Union*, OECD Economics Department Working Paper No.432, May 2005

⁴ EU-US Coalition on Financial Regulation (2008): *Mutual Recognition, Exemptive Relief and “Targeted” Rules Standardisation: The Basis for Regulatory Modernisation*: <http://www.foa.co.uk/publications/eu-us%20report-%20mar08.pdf>, 2008

⁵ London Stock Exchange (2002): *Clearing and Settlement in Europe – Response to the First Report of the Giovanni Group*, London Stock Exchange, London, 2002.

⁶ London Stock Exchange (2006): *The Cost of Capital: An International Comparison*, The City of London Corporation, 2006

significant promise as a means of better protecting investors, fostering capital formation and maintaining fair, orderly, and efficient transatlantic securities markets”.

5.19 The UK strongly supports discussions within the EU-US Financial Markets Regulatory Dialogue, as well as broader efforts between G7 Finance Ministries, aimed at facilitating early progress on a mutual recognition framework that could, supported by exemptive relief, reduce transatlantic regulatory barriers and make transatlantic capital markets more efficient (see also paragraphs 5.67 to 5.68).

Economic and financial dialogues with the emerging markets

5.20 Both emerging and advanced economies will benefit from financial sector development in the emerging economies: advanced economies by allowing their consumers and companies to access new markets and investment opportunities; emerging economies by facilitating capital inflows, the advantages of which are described in Chapter 3. The current period of strong economic growth in many emerging economies provides an important opportunity for all countries to work together to ensure that the regulatory frameworks in emerging economies develop in accordance with international best practice.

5.21 Among the key fora for sharing regulatory expertise are the bilateral UK-China and UK-India economic and financial dialogues-see box 5.2 on page 42-and the EU’s dialogues with India, China and Russia.

Box 5.2: The UK's Economic and Financial Dialogues with India and China.

The UK's Economic and Financial Dialogues with China and India, led by senior government ministers from each economy, are key fora for substantive policy discussion and enhancing partnership between the UK and these two key emerging economies.

India: The UK–India Economic and Financial Dialogue was established in January 2007 by the Rt Hon Gordon Brown MP and Mr. P. Chidambaram, India's Finance Minister. It meets annually at ministerial level and is scheduled to take place again in summer 2008. The first dialogue included a discussion of financial services reforms being carried out in each country, to ensure competitiveness and stability in banking, insurance and other financial markets, including the Indian Government reaffirming their commitment to legislate to open up further its insurance market in the future; progress on promoting financial inclusion; and the use of public-private partnerships for infrastructure investment.

China: Building on the success of the UK-China Financial Dialogue, which met five times between 1998 and 2007, the Prime Minister, the Rt Hon Gordon Brown MP and Chinese Premier Wen Jiabao agreed during the UK-China summit in January 2008 that the Dialogue should be upgraded to Chancellor and Vice-Premier level, as is the case for the US, Japan and the EU, and expanded to cover a wider range of economic issues.

The first UK-China Economic and Financial Dialogue was led by the Chancellor of the Exchequer, Rt Hon Alistair Darling, MP and Vice-Premier Wang Qishan in April 2008. This discussed a range of issues aimed at further cementing financial and economic links. Both sides stressed the importance of open, efficient, and transparent financial markets, and recognised the vast potential for UK-China cooperation in the financial sector. A programme of UK-China financial services cooperation and exchange of expertise was agreed, which covers banking, capital markets, insurance and pensions, regulatory reform, and financial education and training. The programme, which will involve public authorities and senior practitioners, will start in June 2008.

The Dialogue also reaffirmed the importance of both sides taking steps to increase the level of bilateral trade between the UK and China, contributing to the new annual target of US\$60 billion by 2010 announced by Premier Wen and Prime Minister Brown during the UK-China summit.

Supporting further liberalisation 5.22 Many countries have undertaken extensive programmes of financial services liberalisation. However, barriers to the free movement of financial services and capital remain. These include restrictions on:

- the cross-border supply of financial services, for example, imposing limits on the total value of insurance transactions or capital flows;
- the ability of service providers to establish a commercial presence in new markets, for example, imposing limits on the level of foreign capital allowed in a joint venture, or the number of foreign bank branches allowed; and
- the temporary access of foreign financial services professionals into a country to perform special functions (e.g. negotiating a contract) through the establishment of special quotas or the requirement of an economic needs test.

5.23 Removing these barriers will take time and country-specific circumstances will determine the pace of reform. However, it is important that progress continues to be made.

Supporting liberalisation of financial services

5.24 Liberalisation of financial services trade is closely linked to domestic financial sector development, which is a key determinant of the growth and stability benefits of financial globalisation. In addition, the liberalisation of financial services would help those advanced economies, like the UK, that successfully export financial services.

5.25 Financial services liberalisation is a complex and resource intensive process. The least developed countries, in particular, often lack necessary infrastructure such as an appropriate regulatory framework or means of enforcing financial regulation. Official development assistance can play an important role building up domestic capacity in these areas, for example through ‘aid for trade’ programmes, on which the UK’s Department for International Development (DFID) will spend US\$750 million by 2010.

Multilateral negotiations for liberalisation

5.26 Within the World Trade Organisation (WTO), the General Agreement on Trade and Services (GATS) provides the framework for multilateral negotiations on services. Financial services are defined as “any services of a financial nature offered by a financial service supplier of a Member⁷” and include banking, insurance, and trading.

5.27 Across all services sectors, multilateral and bilateral trade negotiations have been ineffective at achieving new levels of liberalisation. However, they have proved useful in tying-in existing levels of openness that have come about through unilateral liberalisation. Therefore, to achieve greater progress within GATS, it will be important to both articulate clearly the benefits of openness to countries considering unilateral liberalisation and ensure that these countries are provided adequate support in implementing the appropriate sequence of reforms.

5.28 Within GATS itself, financial services trade liberalisation is currently treated separately from capital account liberalisation. However, in varying degrees, the two processes must take place in parallel to achieve full financial openness. It would, therefore, assist those countries seeking to liberalise their economies, if GATS made a more explicit link between the services and capital account liberalisation processes.

Role of Official Development Assistance

5.29 Donors can help low-income countries to meet the threshold conditions required to benefit from financial globalisation. For example, the Financial Sector Reform and Strengthening (FIRST) Initiative, a multi-donor grant facility launched in 2002, provides technical assistance in areas as diverse as capital market development, pensions and insurance policy, and central bank capacity. DFID has played an important catalytic role in the success of the FIRST initiative to date, and will remain a strong supporter moving into Phase II, with a renewed commitment of £5.5m for the period 2007 to 2013. In addition, the Government strongly supports the Financial Services Assessment Programme (FSAP), a joint IMF and World Bank effort introduced in May 1999, which aims to increase the effectiveness of efforts to promote the soundness of financial systems in member countries⁸.

5.30 Improving general financial capability in developing countries will be key, ensuring that the benefits of financial openness are evenly distributed. To this end, in

⁷ http://www.wto.org/english/tratop_e/serv_e/gatsqa_e.htm

⁸ International Monetary Fund (2005), *Financial Sector Assessment Programme – Review, Lessons, and Issues Going Forward*, IMF, Washington D.C., 2005

January 2008, DFID launched a Financial Education Fund (FEF)⁹, which seeks to bring forward the best ideas on how to improve the financial literacy of poor consumers and businesses in Africa. The fund will have initial start-up capital of £4 million over three years and will fund, on a competitive basis, proposals from governments, non-governmental organisations, training institutes, industry associations, and consumer bodies for financial education projects which have the potential for rapid scaling up and for replication across other countries.

DEVELOPING AN EFFECTIVE INTERNATIONAL REGULATORY SYSTEM

5.31 Open financial markets are closely integrated with one another, and instability generated in one open market is now able to spread through a greater number of transmission channels, and more rapidly, to others. Financial instability reduces the ability of the financial system to allocate capital and diversify risk and, at the extreme, can seriously affect the global economy, causing economic hardship to people far removed from global finance. Mitigating these risks, above all, requires the international community, working together, to develop an effective international regulatory system that can:

- provide an early warning mechanism for emerging risks;
- develop a responsive international regulatory framework; and
- deliver effective cross-border supervision of firms.

Providing an early warning system

Role of the IMF and FSF

5.32 Recent market turbulence has highlighted the importance of increasing international capacity to detect emerging risks, assess them and coordinate national responses. At the international level, the key bodies for monitoring international financial and economic stability issues are the Financial Stability Forum (FSF) and the IMF. The roles of each are relatively well defined, each has provided important analysis of risks to financial stability, and both are undertaking significant work in response to the recent financial market turbulence. The FSF and IMF can offer much to global financial stability through enhancing their current work.

Establishing an Early Warning System

5.33 The UK suggests that the IMF should continue its work to enhance its tools for identifying risks that may impact across national boundaries. On the basis of these assessments, the IMF should assist the FSF, the Basel Committees, and other relevant international bodies, in their roles to develop practical and timely recommendations to mitigate threats to international financial stability. Together these efforts should form an early warning system (EWS) on the threats to the global economy from the international financial system.

5.34 To be effective, the EWS needs to:

- be clear on the respective roles of the FSF and IMF;
- ensure that authorities maximise their influence by focusing on the most important risks and communicating to the right people in the clearest possible way; and

⁹ <http://www.dfid.gov.uk/news/files/alexander-lessons-in-banking.asp>

- have sufficient tools and a monitoring system to ensure the job gets done.

5.35 The FSF and IMF should enhance their cooperation to bring together the intelligence gathered from IMF surveillance and from FSF members. The IMF should rank the top risks to the international financial system according to probability and impact. In particular, it should identify risks that might spill over to other countries if they crystallise, or vulnerabilities that are common to a number of countries. Risks with potentially important macroeconomic effects can be monitored and raised with the authorities in the IMF's Article IV surveillance. It should also set out who is responsible for monitoring each of the key risks identified.

**Clarity,
brevity and
quantitative
assessment**

5.36 Conveying the most important risks will require clarity, brevity and quantitative assessment. Where the IMF has ideas for risk mitigating policy actions, it should make these clear. The FSF should set out a work plan to address these risks, prioritising risk mitigation work on the most important risks and recognising that most policy actions will be for individual countries to decide, and they should then report on progress with mitigation actions.

5.37 For this cooperation to be fully effective, the FSF should also:

- carry out a strategic oversight and coordinating role of the international regulatory and standard setting bodies to ensure international regulatory policy development is both coordinated and focused on the priorities;
- develop mechanisms to increase interaction with the global financial services industry, to better understand the challenges facing industry. Members of the FSF are well placed to do so individually in their own countries. Collectively, they can reach out to the world's most developed financial markets; and
- recognising that the FSF is not an organisation with a large staff ready to fire-fight a crisis, it should, nevertheless, explore mechanisms that would allow it flexibility to swiftly discuss emerging crises, and the appropriate response, both within its own ranks and with other organisations, as required.

5.38 The IMF Executive Board has agreed to publish a statement of priorities and responsibilities for IMF surveillance. The financial sector risk assessment and risk mitigation work streams to be identified in the joint financial stability report will be complementary to this. The report will cover narrower ground, but in more detail, focusing on the financial sector. However, these work streams should be consistent with the overarching priorities for IMF surveillance.

5.39 The goal would be to publicise widely this joint international financial stability monitoring report to policy makers and market participants, to make them consider changing their behaviour. The report should be discussed by G7 Finance Ministers at joint ministerial meetings of the IMF and FSF. Targeted ways of communicating to market participants should also be considered and, in some circumstances, national regulators may need to reinforce messages.

A responsive international regulatory framework: keeping pace with market developments

International reform **5.40** At the October 2007 meeting of G7 Finance Ministers and Central Bank Governors, the FSF was asked to analyse the causes of recent market turbulence and develop a global policy response. At the Spring Meetings in April 2008, the FSF's final

report, *Enhancing Market and Institutional Resilience*, was presented to G7 Finance Ministers. The report contains detailed recommendations in the following five areas:

- enhancing transparency and valuation;
- strengthening prudential oversight;
- changes to the role and uses of credit ratings;
- strengthening the authorities' responsiveness to risks; and
- installing robust arrangements for dealing with financial stress.

5.41 G7 Finance Ministers strongly endorsed the report and committed to the rapid implementation of its recommendations, which will require actions by international bodies, such as the Basel Committee on Banking Supervision (BCBS), national authorities and market participants.

5.42 The FSF's analysis of the current period of financial market instability is echoed in many respects by the International Institute of Finance (IIF), an industry body representing the financial services sector, in their April 2008 interim report on market best practices¹⁰.

Enhancing transparency

5.43 Sound disclosure, accounting and valuation practices are essential to achieve transparency, to maintain market confidence and to promote effective market discipline. Current market volatility and illiquidity have further highlighted the importance of reliable valuations and disclosures, especially when concerning relatively new financial or accounting innovations, like structured credit products and off-balance sheet entities. Adherence to accounting standards, which permit the measurement of the financial condition and performance of firms, is a key component of a sound financial system.

5.44 The FSF have identified four areas where action must be taken to improve the transparency of the global financial system:

- **risk disclosure by market participants:** financial institutions should strengthen their risk disclosure, and supervisors should improve risk disclosure requirements under Pillar 3 of Basel II;
- **accounting and disclosure standards for off-balance sheet entities:** the International Accounting and Standards Board (IASB) should improve the accounting disclosure standards for off-balance sheet entities, and work with other international standard setters towards international convergence.
- **valuation:** international standard setters should enhance their accounting, disclosure and audit guidance for valuations, and firms' valuation processes and related supervisory guidance should be improved; and
- **transparency in securitisation processes and markets:** securities markets regulators, like the FSA, should work with market participants to expand information on securitised products and their underlying assets.

Strengthening prudential oversight

5.45 The market turmoil has revealed weaknesses in risk management in the banks and securities firms at the core of the global financial system. Deficiencies in regulatory capital and liquidity requirements have also been exposed. Regulation may, in some

¹⁰ Institute of International Finance (2008) : *Interim Report of the IIF Committee on Market Best Practices*, IIF, Washington D.C., 2008

cases, have contributed to problems by creating undesirable incentives for firms to structure their businesses in a manner that minimises the impact of regulation. It is especially important to strengthen the prudential framework for securitisation and off-balance sheet activities.

5.46 The FSF have identified four areas where prudential oversight needs to be strengthened:

- **capital requirements:** the existing Basel II capital framework needs timely implementation and the capital requirements for structured credit and securitisation activities should be strengthened;
- **liquidity management:** by July 2008, supervisors in the Basel Committee of Banking Supervision will issue for consultation sound practice guidance on the management and supervision of liquidity;
- **supervisory oversight of risk management:** supervisors will use Basel Pillar 2 to sharpen banks' control of tail risks and mitigate the build-up of excessive exposures and risk concentrations, including through aligning compensation models with long-term, firm-wide profitability; and
- **operational infrastructure for over-the-counter (OTC) derivatives:** market participants should act promptly to ensure that the settlement, legal and operational infrastructure underlying OTC derivatives markets is sound.

Changing the role and uses of credit ratings

5.47 Credit rating agencies (CRAs) play an important role in evaluating and disseminating information on structured products. Poor credit assessments by the CRAs contributed to both the build-up to, and unfolding of, recent events, as outlined in paragraph 4.8 above.

5.48 The FSF have identified four key areas where changes to the CRAs are required:

- **the quality of the rating process:** CRAs should improve the quality of the rating process and manage conflicts of interest in rating structured products;
- **differentiated ratings and expanded information on structured products:** CRAs should differentiate ratings on structured finance from those on bonds, and provide more information on the risk characteristics of structured products;
- **CRA assessment of the underlying data quality:** CRAs should enhance their review of the data input and the due diligence performed on underlying assets by the originators, arrangers, and issuers involved in structured products;
- **uses of ratings by investors and regulators:** investors should address their over-reliance on ratings, and investor associations should consider developing standards of due diligence and credit analysis for investing in structured products.

5.49 CRAs have begun to take steps to strengthen the quality of ratings, enhance the rating process, better manage conflicts of interest and enhance transparency. In addition, IOSCO's taskforce on CRAs is reviewing the applicability of its Code of Conduct for CRAs to structured finance business. The Government believes that the preferred approach to tackling these issues is through market action and, where

appropriate, changes to the IOSCO Code of Conduct on CRAs. However, if steps taken by the markets do not adequately address the concerns about CRAs' activities identified by the FSF and others, alternative measures should be considered.

**Strengthening
the
authorities'
responsiveness
to risks**

5.50 Some of the weaknesses that have come to light were known or suspected within the global financial community, prior to their manifestation. And much work was already underway at international levels that – if it had already been implemented – might have reduced the impact of the problems experienced. Authorities need to enhance the prioritisation and coordination of their risk assessments and international policy development work, and increase the effectiveness of their communication with markets.

5.51 The FSF have identified three areas where the authorities' responsiveness to risk should be strengthened:

- **translating risk analysis into action:** supervisors, regulators and central banks will take additional steps to more effectively translate their risk analysis into actions that can mitigate their risk;
- **improving information exchange and cooperation among authorities:** authorities' exchange of information and cooperation in the development of good practices will be improved at national and international levels; and
- **enhancing international bodies' policy work:** international bodies will enhance the speed, prioritisation and coordination of their policy development work. Paragraphs 5.33-5.39 detail UK proposals for how this should be achieved with the IMF and the FSF.

**Improving
management
of financial
stress**

5.52 Market turbulence has also focused attention on arrangements for dealing with stress in the financial system, both domestically and on a cross-border. Central banks' operating frameworks should be able to supply liquidity effectively when markets and institutions are under stress. The extended tensions in inter-bank markets, which have continued with varying intensity since August 2007, have severely tested these frameworks, and central banks have responded in a variety of ways, including innovations in the instruments that they use and levels of coordination in their responses. While existing arrangements on cross-border issues have not been severely tested during the current turbulence, the global nature of market problems has highlighted the importance of robust cross-border arrangements for dealing with weak banks.

5.53 The FSF have identified the following areas for improving the management of financial stress:

- **central bank operations:** central banks' operational frameworks should be sufficiently flexible, in terms of potential frequency and maturity of operations, available instruments, and the range of counterparties and collateral, to deal with extraordinary situations; and
- **arrangements for dealing with weak banks:** authorities will clarify and strengthen national and cross-border arrangements for dealing with weak banks.

A responsive international regulatory framework: pursuing convergence of international regulatory practices

5.54 Many regions, like the EU and the US, have now removed internal legal barriers to the movement of capital and services. However, cross border financial transactions between these markets are still restricted by practical regulatory or supervisory barriers, for example, the presence of substantially different regulatory regimes in the host and destination countries that increases transaction costs for firms and, therefore, costs for investors. This both reduces the efficiency of the global financial system and impedes the ability of regulators to guard against financial risk. To mitigate these effects, the UK believes that national regulators should prioritise the convergence of international regulatory standards and practices

5.55 Three issues are particularly important:

- developing the right regulatory approach;
- enhancing the role and accountability of the international standard setting bodies; and
- making full use of regulatory dialogues between key regions.

Developing the right regulatory approach

5.56 Cross-border financial regulation will, and must, continue to have its foundation in effective domestic regulation. However, there is significant scope for national regulators to further harmonise their domestic approach around international best practice.

5.57 The UK believes that regulatory best practice is based around the regulatory outcome, rather than the regulatory process. While detailed specific rules will always be required for certain aspects of the regime, for example, capital requirements, a principles-based approach acknowledges the need for modern regulators to stay sufficiently flexible to respond to rapid changes in global financial practices, products and services.

5.58 This is the approach adopted by the UK's FSA, which since 2001 has had 11 high-level principles in place that determine the regulatory outcome which the authorities seek to achieve. This approach gives greater responsibility to firms' senior management to decide how best to align their business objectives and processes with specified regulatory outcomes. Principles-based regulation allows firms more flexibility to take decisions that are right for their business and their customers, and more freedom to innovate, while ensuring that risks to consumers and financial stability are fully addressed. Consumers also benefit from a more competitive and innovative financial services industry, through both lower costs and greater choice.

5.59 The UK's principles-based approach to financial regulation has been replicated in a number of jurisdictions, including Dubai, South Korea and, most recently, Poland. The recent US Department of the Treasury Blueprint for a Modernised Financial Regulatory Structure also recommends that the US Securities and Exchange Commission should adopt a more principles-based approach.

5.60 The UK believes that there is a need for research, debate and training on the most effective approaches to financial regulation, drawing from experiences around the world. This is illustrated in the UK's support for the International Centre for Financial Regulation – see box 5.3 below.

Box 5.3: The International Centre for Financial Regulation (ICFR)

The Government recognises the need to stay abreast of cutting-edge regulatory developments. In 2007, following detailed discussions with industry through the Chancellor's High-Level Group, HM Treasury and the Department of Innovation, Universities and Skills committed £2.5 million over three years to support the establishment of an independent global centre of excellence in financial regulation – the ICFR. Further financial commitments have been made by 19 private sector firms and the City of London Corporation. It is hoped that the ICFR will officially launch at the end of 2008.

The goal of the ICFR is to shape the strategic direction of regulatory research and training for financial services professionals in the UK and overseas. Bringing together national regulators, businesses and academics, the ICFR will commission, procure and deliver world-class and practical research into, and training on, cutting-edge regulatory issues affecting banking, insurance and securities in both developed and emerging economies. Based in London, but with a global reach, the ICFR will act as an international forum for discussion and innovation, hosting conferences, seminars and training.

**Enhancing the
role of
international
standard
setters**

5.61 Global financial markets benefit from having commonly agreed standards to operate effectively and efficiently. Indeed, much new financial services regulation at the national level emanates from international standard setting bodies such as the International Accounting Standards Board (IASB), the International Organisation of Securities Commissions (IOSCO) and the Financial Action Taskforce on Money Laundering (FATF), whose principles-based recommendations and guidelines are often subsequently translated into law.

5.62 Convergence on a single standard is appropriate when there is a clear cost-benefit case for avoiding duplication of preparation and compliance activity and the costs of translating and comparing disclosures prepared under different regulatory standards. Recent progress towards creating international financial reporting standards, developed by the IASB, is an example of this. More information on the IASB is found in box 5.4 below.

5.63 Well-governed international standard setters can be expected to have:

- a sound understanding of the market failure being addressed;
- a robust methodology for examination of different options for achieving its objectives; and
- well-established processes for testing regulatory proposals with a wide range of stakeholders to ensure that regulation is proportionate and risk-based, including through use of quantitative analysis such as cost-benefit studies.

5.64 As the role of international standard setters increases, it becomes more important to have a clear framework and process for stakeholders to contribute to the setting of clear objectives and to ensure that governance arrangements are appropriate. The G7 should work to improve the functioning of international standard setters through the agreement and use of high-level principles that would act as a framework in assessing the G7's approach in defining the role, responsibilities and governance arrangements for international standard setters in the financial sector. The principles should ideally be consistent with, but not seek to duplicate, principles already agreed

for certain sectors, for example, by IOSCO, which agreed a set of objectives and principles in 2003 aimed at regulators and supervisors of capital markets.

5.65 This set of principles could emphasise the importance of regulation that:

- is based on a clearly understood goal of harmonisation, convergence or mutual recognition;
- is proportionate, risk-based and grounded in market failure analysis;
- is, wherever possible, based on principles;
- is based to the maximum extent possible on quantitative analysis, including cost-benefit analysis and impact assessment; and
- aims to be consistent across different sectors, financial instruments and institutional forms.

5.66 The principles should also emphasise the importance of regulators and standard-setting bodies that:

- have appropriate governance and accountability arrangements in place;
- have processes in place that enable effective cooperation and information-sharing; and
- are transparent in their decision-making procedures, involving market participants and other stakeholders.

Box 5.4: Role of international standard setting bodies: IASB

Accounting standards provide a recognised set of rules for financial reporting. They are critical to understanding the performance of a business, and in valuation and capital-raising, and thus essential to the efficient functioning of capital markets. A common international accounting standard improves understanding among investors, thereby reducing transaction costs and lowering the cost of capital for securities issuers.

The first steps on the international convergence of accounting standards were made in 1973 with the establishment of the International Accounting Standards Committee (IASC). The International Accounting Standards Board (IASB), the successor body, has now developed a single set of high quality, understandable and enforceable global accounting standards (IFRS). Many jurisdictions, including EU member states have adopted, or are adopting, IFRS, and by 2012 more than 150 jurisdictions will be using IFRS

Convergence of US accounting standards with IFRS would effectively create a single global financial reporting standard. Significant progress towards this has been made. Last year, the US authorities agreed that foreign entities reporting in IFRS could issue securities in US markets without reconciliation to US standards, and US authorities are now actively considering whether US firms should be able to exclusively use IFRS. In addition, the EU will be assessing the equivalence of US standards with IFRS later this year.

Delivering a set of sound global principles-based accounting standards requires a robust governance structure for global accounting standard setting. This in turn requires an efficient, independent and funded IASB, capable of driving principles-based global convergence, and capable of working effectively with national and supra-national stakeholders, with robust and transparent accountability and governance structures.

Current perceptions of a lack of political accountability need to be addressed. The IASC's current constitutional review and the proposed establishment of an international oversight body present opportunities to address issues, such as the nature and balance of representation and the role of different institutions. The UK believes it is important that the review takes into consideration the principles for international standard setters that are set out in paragraphs 5.61- 5.66 above.

Enhancing cooperation between markets

5.67 Significant progress on regulatory convergence can also be made through bilateral cooperation between regulators in key jurisdictions. The example of EU/US cooperation has been set out earlier in this chapter. Experience in that and other such dialogues indicates that there are three main ways through which more effective cross-border regulation can be achieved. These approaches are not mutually exclusive and, in practice, the greatest progress is most likely to be achieved through a combination of these approaches:

- **using common rules**, for example through the creation of international standards, such as International Accounting Standards as discussed above. These can simplify compliance and reduce costs for firms undertaking cross-border transactions, where a consensus exists among national governments and regulators;
- **regulatory recognition**, where a host state regulatory authority allows authorised firms that meet relevant criteria to transact business on the basis of its home state authorisation, can be used where regulators have confidence in the regulatory framework of a firm's home state, but where full harmonisation of rules is not yet feasible. Within the EU, this approach has worked well in promoting higher standards.

- **exemptive relief**, whereby relief from compliance with certain host state rules is granted to foreign firms already subject to comparable rules in their home state. The UK Overseas Persons Exemption, which allows the conduct of institutional business without UK authorisation, subject to certain conditions, is an example.

5.68 The Government in particular is supportive of discussions within the EU-US Financial Markets Regulatory Dialogue and between G7 Finance Ministries to establish, as a matter of priority, a structure within which to reach mutual recognition agreements, which could take the form of bilateral agreements within a multilateral framework. While the Government recognises the benefits that would accrue to the industry from harmonisation, it believes that mutual recognition, supported by exemptive relief, would appear to offer the most scope for progress in the short to medium term, while the development of international standards over the medium to longer term would entrench and underpin these.

Delivering effective cross-border supervision of firms

Supervisory colleges for cross-border firms

5.69 The Government believes it is important that supervisors dealing with cross-border groups work more closely together to identify, prioritise and agree a supervisory programme for addressing risks to the group as a whole. To facilitate this enhanced cooperation, the Government has proposed the establishment of supervisory colleges for the ongoing prudential supervision of all large and complex and internationally active cross-border groups. Supervisory colleges have the potential to bring clear benefits for the prudential supervision of groups, including:

- by being tailored to the individual firm, the college directly meets the supervisory challenges posed by the firm;
- the involvement of those authorities within whose jurisdiction the firm has a significant presence. This particularly benefits host country supervisors, which gain greater information on the group, and an enhanced role in its oversight. This is important in the case of high impact branches, where host states currently have few powers and minimal oversight of firms. It is also important for subsidiaries where host authorities have a key role but lack full knowledge of the group's activities;
- providing a structured framework for information collection and exchange, the establishment of regulatory programmes and the delegation of supervisory tasks; and
- increasing the efficiency of supervision by removing duplication, thereby reducing costs for firms and supervisors.

5.70 Overall, these colleges, which already exist for some financial institutions, allow a better understanding of the activities and financial soundness of the firm, improve risk mitigation, and aid supervisory cooperation and effectiveness.

EU colleges in law

5.71 Reflecting the unique institutional setup in the EU, the Government has proposed that supervisory colleges be established in EU law. The exact composition of each college, together with its method of operation, will need to be determined on a case by case basis, depending on factors such as the number of host jurisdictions and the nature of its operations. It is important to balance the need to ensure that colleges are small enough to be effective, with the legitimate needs of all host jurisdictions to be provided with information and have an input. The Government fully supports the

Conclusions of the May ECOFIN Council on colleges, and will play a full part in its translation into law through the ongoing discussions on sectoral legislation.

International colleges **5.72** For the most important international firms, however, it is clear that colleges need to operate effectively at the international level. The Government welcomes the G7 agreement that international colleges of supervisors will be established for each of the largest global financial institutions by September 2008.

5.73 The operation of colleges at the international level must be structured to produce the most effective supervisory outcome. Given the potentially large number of supervisors and jurisdictions involved, this may necessitate a differentiated or tiered system. There are three categories to which a host state supervisor might be allocated:

- **category A:** host supervisors of key entities (either subsidiaries or branches) whose activities are central to operations and viability of the group. In general this will be because the scale or the activities undertaken by the entity are fundamental to the soundness (or in a crisis, the survival) of the group;
- **category B:** host supervisors of entities (whether subsidiaries or branches) whose activities are not fundamental to the operations or survival of the group, but whose failure could nevertheless have systemic consequences for the host state concerned. These host supervisors would not be part of the core college that conducts a prudential review of the group as a whole, but they would be involved in a dialogue about the group and the group's operations in the host state, and through the extensive two way sharing of information the supervisory oversight of the domestic operations of the firm would be enhanced; and
- **category C:** those entities whose failure would not have a significant impact either on the group or the host state. The supervisors overseeing these entities would have a single point of contact with the home supervisor from whom they would receive information.

5.74 There may also be advantages for the very largest global groups having regional colleges. Their views would feed into the core college, comprising the home and category A hosts. It will be important to ensure that the arrangements put in place at the international level dovetail with those at regional level, including in the EU. The FSA is leading work on the design of such college arrangements through the FSF.

Crisis management **5.75** It is important to distinguish between the college arrangements put in place for ongoing prudential supervision and the arrangements for crisis management. Arrangements for cross-border stability groups (CSBGs) that will plan and, as appropriate, address the management and resolution of difficulties that a cross-border financial group gets into are being developed in parallel with the work on colleges. The Government has been an active participant in this work, and is fully committed to the Memorandum of Understanding updated in April 2008 that outlines cooperation arrangements between Europe's finance Ministries, supervisory authorities and central banks.

A

MEASURING FINANCIAL GLOBALISATION

A.1 Measuring the extent of financial globalisation requires looking at both:

- the *de jure* measurements, which refer to the level of government restrictions on capital mobility, generally captured as indices of legal restrictions on capital inflows and outflows; and
- the *de facto* measurements, which refer to returns - or volumes-based measures - to highlight changes to external balance sheets or the equalisation of asset prices across borders.

De jure measures **A.2** *De jure* measures vary widely. They can take the form of 0 - 1 indicators for the overall capital account, which is what is used for the purposes of this report. There are also more complex indicators, which take weighted averages of 0 -1 scores for each asset category. They are designed to reflect the ease with which capital can flow across borders.

A.3 *De jure* measures provide a useful indicator of financial openness and official policy attitudes towards financial openness. However, they fail to fully capture the extent of financial openness for three reasons:

- they often do not take into account the intensity of capital controls;
- capital account restrictions tend to be very complex, which *de jure* measures inevitably fail to reflect fully; and
- actions by the private sector to circumvent controls mean that a control that is written in law may not be a relevant control in practice.

De facto measures **A.4** *De facto* measures attempt to reflect financial integration through the actions of agents active in international capital markets. In theory, there are two notable reflections of financial integration. First, financial integration should reflect an increase in stocks of cross-border assets and liabilities relative to some metric. Second, it should eliminate arbitrage opportunities in different economies, and it should be observed that the returns on the same asset expressed in the same currency should be identical.

A.5 The most widely used volume-based measure attempts to measure integration by normalising external assets and/or liabilities against some measure of economic activity. This is necessary to maintain some meaning. Without a base for comparison, the scale of the external balance sheet is not particularly informative.

A.6 The best *de facto* metric would be the size of the external balance sheet as a ratio of the total balance sheet of the economy. Or, if one were looking at assets only, to take the ratio of assets held abroad to assets held both at home and abroad¹. However, this has become increasingly difficult as increased internal financial development has expanded the numbers, scale and complexity of household and firm balance sheets in many economies. This is, in large part, due to an increasing range of financial instruments.

A.7 An alternative metric is to use the capital stock in the economy. However, this is complicated by serious difficulties in getting reliable measures for many countries. This

¹ Hali J. Edison & Francis E. Warnock (2003): *Cross-Border Listings, Capital Controls, and U.S. Equity Flows to Emerging Markets*, IMF Working Papers, Washington D.C., 2003

has led to the use of nominal GDP as the yardstick. Over shorter horizons, the capital share of output is fairly constant and so this can be taken as a fairly good measure of the degree of foreign capital penetration into an economy. Other economists have proposed the following volume based measure of financial integration²:

$$(FA_{it} + FL_{it})/GDP_{it}$$

A.8 Where FA is the stock of foreign assets and FL is the stock of external liabilities in country i at time t . This is designed to reflect the scale of a country's external balance sheet.

A.9 The external balance sheet can be decomposed into its component parts by asset class. Foreign direct investment (FDI) is the category of international investment that reflects the objective of a resident entity in one economy to obtain a lasting interest in an enterprise resident in another economy. The threshold is 10% of an entity's equity.

A.10 Portfolio investment is the category of international investment that covers investment in equity and debt securities, excluding any such instruments that are classified as direct investment or reserve assets. Equity refers to the value of the interest of an owner or partial owner in an asset. Equity capital comprises:

- equity in branches;
- all shares in subsidiaries and associates (except non-participating, preferred shares that are treated as debt securities and included under direct investment, other capital); and
- other capital contributions.

A.11 Debt is defined as a promise on the part of the issuer (i.e. the borrower) to make one or more payment(s) to the holder (the lender) at a specified future date or dates. Such securities usually carry a specific rate of interest (the coupon) and/or are sold at a discount to the amount that will be repaid at maturity.

A.12 The returns-based measure is premised on the argument that arbitrage should mean that returns on assets with the same risk properties should be the same when expressed in identical currencies. If they are not, then there must be restrictions to the free movement of capital that prevent this arbitrage from taking place. Returns on bonds are frequently taken as an indicator of capital mobility.

A.13 Provided that two near identical assets can be found, this measure is a strong reflection of financial globalisation. However, there are a couple of important shortcomings:

- the requirement of near identical assets for comparison makes it extremely difficult in practice to include emerging markets in the sample, as rates of return will also include sometimes large unobservable risk and liquidity premia;
- arbitrage costs may not reflect international costs for emerging markets, but rather domestic costs owing to less developed financial systems.

² Lane, P., and Milesi-Ferretti, G. (2006) *The External Wealth of Nations Mark II: Revised and Extended Estimates of Foreign Assets and Liabilities*, IMF Working Paper, Washington D.C., 2005

B

THE DRIVERS OF FINANCIAL GLOBALISATION

B.1 There is no single explanation for rising levels of financial globalisation. It is attributed to a confluence of factors, the five most prominent of which are:

- technological progress;
- policy liberalisation;
- development of robust regulatory rules and institutions;
- financial sector development; and
- a benign macroeconomic and political environment.

TECHNOLOGICAL PROGRESS

B.2 New technology has encouraged innovation, which has increased the sophistication of the financial instruments that firms can offer and the strategies that they pursue. The increasing use of derivatives to manage risk is an illustration of this. Between June 2005 and June 2007, the notional amount outstanding of over-the-counter (OTC) derivatives rose by 84 per cent¹. Similarly, the use of securitisation, where portfolios of financial commitments are pooled and segmented according to risk, has risen dramatically since the late 1990s. The impact of these changes on financial stability is discussed in chapter 3.

B.3 Advances in telecommunications also enable financial firms to manage their activities across continents and reduce their marginal costs through shifting IT services and back-office services to low-wage countries. The economic benefits of outsourcing these services are estimated at a net US\$0.47 for every US\$1.00 that is outsourced². Furthermore, financial markets can now often be accessed remotely, which allows the execution of trades from multiple locations, decoupling the location or country of ownership of the market from the location of traders using the market.

POLICY LIBERALISATION

B.4 External liberalisation is another key driver of financial integration. Although they are rarely completely effective, capital controls curtail cross-border financial flows. Consequently, the size of the external balance sheet invariably increases following liberalisation.

B.5 In addition, liberalisation of the financial services encourages financial integration. Foreign trade restrictions protect domestic banks from global competition, allowing them to charge higher rates for their services and operate less efficiently³. The entrance of foreign players, either as subsidiaries, branches or through mergers and acquisitions (M&As), increases efficiency and reduces transaction costs for consumers, thereby encouraging greater volumes of cross-border financial transactions.

¹ Bank for International Settlements (2008): Semiannual OTC derivatives statistics at end-June 2007

² International Financial Services London (2005): *Offshoring of Services: Impacts and Implications*, IFSL, 2005

³ Kalirajan, Mcguire, Nguyen-Hong and Schuele (2000): *The Price Impact of Restrictions in Banking Servic'*, London, 2000

B.6 Trade, whether foreign investment in factories in Eastern China or importing medical equipment from the US, requires financial transactions. In particular, there is a strong empirical link growth in intra-industry trade and FDI flows, both of which have increased rapidly over recent decades. Trade in goods also encourages trade in financial assets, as investors become more familiar with the counterparty country.

REGULATORY DEVELOPMENTS

B.7 In the last 20 years, a majority of financial jurisdictions have changed either the location of their financial supervision authority or the level of integration of supervisory function across major financial sectors⁴. Internationally, this period has seen both the expansion of international financial institutions, such as the Bank of International Settlements and the introduction of new institutions, such as the Financial Stability Forum (FSF). Finally, global standards for regulation and financial reporting, such as the International Financial Reporting Standards, have become more commonplace.

B.8 While acknowledging that further progress is needed, in particular to address the regulatory weaknesses exposed in the last half of 2007, these developments have increased confidence in the financial system. Domestically, authorities are better equipped to regulate their financial markets, thereby better achieving their primary objectives of maintaining confidence in the financial system and affording investors sufficient protection. International developments have enhanced the international community's ability to avoid financial crises occurring or minimise their impact when they do. The spread of international standards has reduced the regulatory compliance burden faced by firms, thereby enhancing the efficiency of the financial markets.

FINANCIAL SECTOR AND INSTITUTIONAL DEVELOPMENT

B.9 As financial sectors develop, they become more efficient at allocating investment, tapping internal markets and managing domestic portfolios internationally. Furthermore, financial sector development is usually accompanied by the development of those institutions that support contract enforcement and property rights, both of which are critical to attracting investment.

B.10 The banking sector in particular has been transformed. The value of cross-border mergers and acquisition deals has more than doubled to an average US\$24 billion from 2000 and mid-2006. In 2005 and 2006, GCC acquirers have spent more than US\$70 billion on international mergers and acquisitions⁵. The internationalisation of financial institutions, combined with the globalisation of capital markets, has enhanced the importance of a small number of international financial centres, especially in the US, the UK, the Euro Area and Japan. Between them, these financial centres have accounted for the bulk of global cross-border capital flows in the recent past.

STABLE MACROECONOMIC ENVIRONMENT

B.11 Finally, the decade 1997 – 2007 witnessed one of the most benign macroeconomic environments in recent history. Dubbed “the Great Moderation”, this period has been characterised by strong and stable global growth, declining global inflation and easy funding conditions, due to historically low global interest rates.

⁴ Financial Stability Institute (2007): *Institutional Arrangements for Financial Sector Supervision*, FSI, 2007

⁵ McKinsey Global Institute (2007): *The new power brokers: how oil, Asia, hedge funds and private equity are shaping global capital markets*, McKinsey's, 2007

B.12 On a global level, such stability has given rise to new sources of international funding, for instance, the carry trade, where investors have taken advantage of increased exchange rate stability to borrow at Japanese rates and use the proceeds to invest in higher yielding assets, in particular in a number of emerging markets.

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