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Interdependence of Capital Markets And Policy Implications

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In this essay, I will take for granted the common sense view that, in the past decade or so, the world has become increasingly globalized—politically, socially and economically. The pace of globalization has not been uniform by any means, and some individual countries and regions have attempted to fend off or reverse external influences. However, in the narrow area of capital markets around the industrial world—where this essay focuses—globalization, meaning greater international integration of markets, appears to be proceeding with all deliberate speed. Some countries are attempting to control the pace, such as Japan, and all are jockeying in various ways for international position, as exemplified by the Big Bang in London, Rule 144A in the United States and the pressures for European monetary integration.

I will first review two basic aspects or causes of the recent trend toward greater world market integration: the emergence of Japan and the revolution in financial technology. These two causes help to define an era and provide a context for a discussion of capital market integration and its relation to economic policies in the 1987-90 period—a time when stock and bond markets in the leading industrial countries went through some major adjustments, not to say panics. Finally, on the expectation that the trend toward globalization of capital markets continues and even intensifies, I will assess some broad macro- and micro-policy implications, including the movement toward European monetary and market integration and the process of policy coordination among major countries or currency blocs.

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Aspects of Recent Globalization

The rise of Japan is not an unprecedented event. In past eras, other countries have had their turn as powers on the world financial stage, notably Britain and the United States in the last 200 years. The recent emergence of Japan, in combination with the dismantling of exchange and capital controls more generally in the industrial world, has unleashed huge international capital flows that have greatly intensified the globalization process.

However, the changes in financial technology are quite a new phenomenon. The enlarged flows of recent years take place in a market environment that has been qualitatively changed by modern advances in financial technology. While these flows no doubt reflect an extension of past developments, modern financial technology makes the current stage of globalization qualitatively different from the past and brings it to a new level. Thanks to the computer and its capacity for virtually instantaneous communication and computation, and thanks to marketmaking without regard for national boundaries, we seem to have entered a unique era of globalization characterized by a truly international culture, which homogenizes the attitudes of active market participants around the world.

Emergence of Japan. The arrival of Japan as a key player on global capital markets was inevitable, but in its timing it can be construed as a response to macro-economic policies adopted in the 1980s. The decision early in the 1980s to reduce the Japanese fiscal deficit led, in the economic conditions of the time, to a large Japanese export surplus. Otherwise, full employment could not have been maintained in the face of a growing surplus of domestic saving.

Japan's domestic financial institutions had to be given the opportunity to shift surplus domestic saving into foreign markets, to provide financial support to the current account surplus. Then, the increasing flows of long-term Japanese funds and, eventually, of businesses to foreign shores brought with them an expansion in the overseas operations of Japanese security firms and banks—partly for customer relationship reasons.

As Japanese institutions, investors and borrowers moved abroad, the Japanese domestic market had to adjust to conform more with international norms. It had to be restructured to provide domestic participants with efficient and diverse services similar to those obtainable abroad. For reciprocity reasons if no other, foreigners also had to be given adequate access.

The consequent internationalization of the yen is a slightly different phenomenon from the earlier internationalization of the pound and the dollar. For, while it marks a new stage of even more closely linked, interdependent capital markets, it may herald a globalization that will be without a single key currency, unlike earlier eras when the pound and then the dollar were clearly and unequivocally dominant.

The emergence of Japan has occurred along with the dismantling of exchange and capital controls in major industrial countries. This has led to a huge increase in cross-border flows, net and gross. Figures published in the latest annual report of the Bank for International Settlements show that net long-term capital outflows into securities from residents of 13 industrial countries rose from an annual average of \$17.5 billion in 1975-79 to \$269 billion in 1989, with almost 45% of that rise coming from Japan. Direct investment outflows showed a similar though somewhat less spectacular rise over the same period—from \$34 billion to \$174.5 billion, with about 30% of the increase coming from Japan.

In the first instance, net cross-border flows can reflect persistent payments imbalances as much as the internationalization of credit markets. But those imbalances are likely to lead to greater globalization, as was the case over the past decade. After more globalized markets are established, it then may become possible for current account imbalances to persist—as, for example, when capital outflows keep the capital-exporting country's exchange rate relatively low. I am not going to make any detailed evaluation in this essay of whether capital flows determine or are determined by current account imbalances, with distinctions necessarily made between short- and long-term and between private and official flows. However, I would argue that in the past decade, capital flows have influenced payments imbalances.

For instance, the structural shift to more open Japanese credit markets may have been necessitated by domestic policies, but the ensuing capital flows helped drive down the yen, and drive up the dollar, in the early part of the 1980s. This process facilitated the trade imbalances that developed, imbalances that were probably greater than expected by policymakers. Of course, the surpluses in Japan would not have become so large without the huge saving deficiency in the United States. That led to a very large trade deficit and, also, to the relatively high interest rates that helped attract foreign capital.

In the latter part of the 1980s, after the dollar had declined, the willingness of Japanese and other foreign investors to keep investing in the United States prevented the dollar from declining further, as many

had expected. It enabled the United States to finance the external payments deficit then consistent with its saving deficiencies at near full employment. Less integrated world capital markets might have led to even higher US interest rates (along with a lower dollar) and, in the domestic conditions of the time, a weaker US economy, with the domestic savings gap and the external imbalance adjusting to and matched at lower levels of income and higher levels of unemployment.

The greater interconnectedness of major markets that has emerged is seen not only in the net capital outflows from countries, but more spectacularly in the gross purchases and sales abroad by domestic residents. These gross flows are likely to remain even as reduced payments imbalances over time reduce net capital flows, including long-term outflows. Some figures from Japanese experience are instructive.

Net purchases of foreign public and corporate bonds (largely dollar bonds) by Japanese investors rose from around \$27 billion in 1984 to \$94 billion in 1989. But at the same time gross transactions—purchases and sales together—rose from \$86 billion to \$3.3 trillion. On a greatly reduced scale, the same trend was evident for equities.

The very rapid expansion of gross flows and their absolute size suggest that the dollar market has become absorbed more into the ordinary in and out trading of Japanese investors. The Japanese and the US markets are becoming more interlinked and globalized.

Implications of Modern Financial Technology. The enlargement and greater interconnectedness of international capital markets has been intensified by the revolutions in communications and computer technology. Through the immediacy of computer communication, all markets—anywhere trading stations are equipped with similar screens—have the capacity to react simultaneously to the same information. This speed and the enormous increase in the number of individual players involved have created the potential for mob psychology in high risk markets. Markets may interact more than before and overreactions are more probable on an international scale. Modern technology has led to an increasingly homogenized culture of international and domestic market participants.

There are other aspects of computer technology that have enhanced the interconnectedness of major markets. One is the ease with which domestic markets can be displaced to foreign shores. Roughly 30 years ago, Euro-dollar markets were established as essentially a US domestic market that was based partially, for regulatory reasons, in a foreign country. Euro-dollar interest rates were affected mainly by conditions in

US domestic-based markets, after allowance for the cost of the regulatory impediments in the United States. But the displacement also worked to internationalize the US domestic market by bringing in foreign custom-ers who might otherwise have not been involved in dollars, thereby enlarging the scope for movement of investors among major markets.

Nowadays, even apart from Euro-markets, US and other securities can trade rather easily anywhere in the world. Financial technology provides immediate access to the same information around the globe and readily permits the international clearing of domestic currency trades taking place in foreign countries. The US Treasury market is fairly active in both Tokyo and London, though it does not have nearly the volume and liquidity it has in New York. The basic liquidity and ability to undertake large transactions are still in the time zone of the home country. But the market has nonetheless become more active and volatile as more participants are drawn into it, increasingly comparing interest rates across countries and adjusting positions quickly for fear of what will happen in the next time zone.

Financial technology advances are also the basis for the burgeoning worldwide markets for derivative instruments. The enhanced capacity of computers makes it easy to devise and to implement sophisticated strategies involving the futures, options and cash markets. All of this makes for great increases in overall trading volumes as market participants, drawn into arbitrage and hedging operations, take advantage of opportunities to bet on volatility or on price ranges.

Home market derivative instruments are, like cash instruments, quite capable of being traded in any number of foreign markets now. That process is picking up speed, and foreign participation will not only increase volumes in domestic instruments but also increase cross-currency comparisons and serve to sensitize other major world markets to domestic market circumstances.

The development of derivative instruments, and the relative ease with which those markets can be entered (given comparatively low margins) by players with limited capital relative to risk exposure, has enhanced volatility in all markets, cash and derivative. The internationalization of markets means that this volatility is more likely to be transmitted across national borders.

The technological advances of the past decade or so have had another effect that tends to increase volatility. For a variety of reasons, including the speed of information flow and the virtually instantaneous display of price information to anyone on computer terminals, bid-ask

spreads have greatly narrowed. Thus, the profit from a traditional dealer or specialist function has become, or is becoming, negligible. With less interest in performing the function, a certain amount of liquidity is removed from the market—liquidity that would have tended to dampen volatility.

Greater volatility has implications for governmental policies. There is the risk that a “random” sharp decline in prices or a rise in interest rates will itself, because of the environment in which it occurs, set off a broader or deeper and more fundamental decline than might otherwise have evolved. The crashes of major stock markets in October 1987 were such developments. On the other hand, the sharp price decline in US stocks in October 1989 was an example of a “random” movement that did not lead to a dangerous cumulative decline.

Policy authorities should react to volatility that is likely to have adverse consequences for the markets or for the economy as a whole. But, of course, they should hold back when volatility is not threatening. So they face the difficult problem of judging, in the middle of an ongoing market disturbance, whether a developing market movement reflects a necessary price adjustment or portends potentially disruptive volatility.

The Experience of 1987–90

Experience over the past three years illustrates how interdependent world capital markets interact with the policy instruments used by the national authorities of the major industrial countries.

While the increasing international sensitivity of markets had an independent effect on policy, policy changes cannot be explained mainly in those terms. Policy and markets for the most part responded jointly to the problems stemming from the continued interplay between international payments and domestic saving imbalances, from efforts to contain domestic inflationary pressures and from a desire to keep economies growing in the process—that is, they responded to more or less conventional international macro-economic issues.

Nonetheless, the stock market crashes of October 1987 were evidence of the increased interdependence of major capital markets. This interdependence is also evident from bond market behavior, for example in early 1990. But we have not yet become so much one world and one capital market, that prices in major markets always respond to each other quickly. The lag can be very long. Among other things, the Japanese stock

market decline over the first three months of 1990 might be interpreted as a long delayed reaction to the October 1987 crashes.

The international linkages among equities markets have been studied extensively in light of the 1987 stock market breaks. Particularly useful studies can be found in the Federal Reserve Bank of New York's *Quarterly Review* for the summer of 1988.

The studies showed, among other things:

—“...in last year's [1987] crash, the spread of high volatility from one major market to another was considerably greater than the earlier statistical relationships would have predicted.” (p.17)

—“Viewed from a longer time perspective, stock price movements in major markets have become increasingly similar in the 1980s, compared to the 1970s and before. This development appears generally consistent with the ongoing strengthening of cross-border trading, listings and investment activities. The increased similarity of price moves has been comparatively small, however...” (p.17)

—“For the three largest equities markets, a discernible role for cross-border investment and overseas trading in equities during the market break was confined to two instances: heavy sales by nonresidents in Tokyo on October 20 and price declines in UK ADRs [American Depository Receipts that foreign companies issued in US equity markets] in New York around October 19.” (p.38)

—“...the principal international linkage between national stock markets appears to be the unobservable and indirect one created when sharp price declines in overseas markets contribute to panicky market psychology.” (p.45)

These findings would seem to buttress the practical observation of market participants that markets around the world can now react to the instant internationalization of the flow of information and gossip, including as well the underlying feeling and tones of fear, bravery or uncertainty, as the case may be, that are somehow communicated. The culture of active market participants is becoming internationalized—that is, homogenized—and fear in New York, whether justified or not, becomes fear in Tokyo or London, whether justified or not, to a greater extent than it used to. So, while reactions can be greatly delayed as in the case of the Japanese market decline, major world markets can also easily move together, or in response to each other, and they can in fact do so without a large flow of international funds.

The policy authorities' own fear of worldwide international contagion effects became an important factor in macro-economic policies of major countries for a while, particularly for the United States and Japan following the trauma of the October 1987 worldwide stock market crashes. Policies became more cooperative for a time, but also in their domestic anti-inflationary application a bit more timid.

The timing of the October 1987 stock market collapse in the United States had a number of causes, but one I would stress was the markets' concern that a breakdown in international exchange market and macro-policy cooperation was imminent. Such a breakdown would, it was feared, lead to a sharp decline in the dollar and a rise in US interest rates, thereby undermining asset values in the United States. With the exchange rate and bonds already under pressure, the stock market, which was fundamentally overvalued, was particularly hard hit as participants scrambled to take profits before they disappeared.

Because the US market and economy are so central to world economic conditions, and because the dollar has been the safe haven currency, a debacle in US equities—that is, a sharp decline in the valuation of the US economy as a whole—could be expected to produce intense and widespread effects of psychological contagion on world markets. Of major world equity markets, the Japanese market was, it turned out, least affected in the short term, declining by a little more than half of the US market. This occurred despite the fact that the Japanese market saw a sizable withdrawal of foreign funds. Apparently, Japanese domestic investors were least subject to contagion effects.

Still, the crash in the United States and the potential effects on an even more overvalued Japanese equity market probably influenced the attitudes of the monetary authorities in Japan. No doubt they felt lucky to have dodged a bullet and did not wish to chance it again.

Indeed, following the crashes, all the major countries seemed to soften their anti-inflationary attitudes for a while. They focused instead on ensuring adequate liquidity to shell-shocked markets. The United States, Japan and Germany all later tightened money market conditions, but they were slow in beginning, having overestimated the effects of the crash on the real economy. Japan in particular delayed action over a long period, partly out of sensitivity to its own stock market and partly to help stabilize the dollar by keeping Japanese interest rates relatively low. That in turn was done with an eye to supporting the US stock market and avoiding any potential indirect contagion effects on the Japanese market.

Following the crash, the United States did produce a fiscal restraint

package within a few months. While it was a lame one, it was viewed as the token of good faith needed to bring about the international cooperation in monetary and exchange market policies that stabilized the dollar.

These policies permitted inflation abroad to rise relative to the rate in the United States even while the US inflation rate was creeping upward. The US consumer price index rose from an annual rate of about $3\frac{1}{2}\%$ in 1987 to around $4\frac{3}{4}\%$ in 1990. Over the same period Japanese and German price inflation went from near zero to between $2\frac{1}{4}\%$ to $2\frac{1}{2}\%$, narrowing the gap with the United States by about a percentage point.

By 1989 concern with the dollar and stock markets as sources of instability began to give way in Japan before fears of domestic inflationary pressures and a weakening currency that seemed to be a by-product, at least to some extent, of Japanese efforts to stabilize international and domestic capital markets. The policy approach changed. Exchange market intervention, when used, shifted from buying to selling dollars. More fundamentally, Japan's monetary authorities actively began to tighten market conditions, particularly in the latter half of 1989 and the first part of 1990.

This tightening in Japan, and further tightening in Germany, involved global bond market effects. Bond yields in those two countries rose about another one-and-a-half percentage points over the first three months of 1990 and, at the same time, US bond yields rose by about 75 basis points. In each case, domestic forces were largely responsible for the rise in long rates, but influences felt from the other two major markets were also clearly at work.

The most spectacular result of the monetary tightening in Japan was the sharp stock market decline there during the first three months of 1990. The increase in long-term interest rates accelerated and led to the long overdue downward revaluation of the equity market. Over the first three months of 1990, the decline in the Tokyo market was similar in magnitude to the much more compressed 1987 crash in the United States over the three trading days culminating on October 19. But, unlike experience with the US crash of 1987, the price break in Japan was not reflected in other major equity markets.

The contrast between the behavior of Japanese and world stock markets in October 1987 and early 1990, and also the behavior of bond yields, suggests certain conclusions—tentative at best—about the extent of, or limitations on, capital market interdependence at this stage of globalization. Risking considerable oversimplification, I would offer the following.

(1) The drop in Japanese equity prices over the first three months of 1990 did not affect other major equity markets in large part because it represented a belated downward adjustment in price/earnings ratios toward more realistic, sustainable values, an adjustment that had already occurred to a greater extent in the aftermath of the October 1987 debacle in other major markets. So there was no need for other markets to respond commensurately. Markets in an interdependent world obviously adjust to each other, but the adjustment can be delayed or muted in varying degrees because of differential monetary policies or weak contagion effects on domestic investors, given their psychology in reaction to international factors.

(2) Contagion effects on foreign markets, which may occur with or without substantial international fund flows, are likely to be largest when there is a panic in the market of the central currency country—still the United States in my view, though less so than before. When the price adjustment occurs over an extended period, and does not take on the aspects of a panic, contagion effects are likely to be less strong, and international effects more limited by the importance of actual cross-border flows to the markets in question.

(3) Cross-border flows appear to be a relatively more important factor in bond than in equity markets—certainly this is the case in the United States and Japan. But cross-border flows will not be dominant factors for domestic markets as large as the United States, for example. No doubt, some part of the approximately 75 basis point rise in longer-term bond yields in the United States over the first three months of 1990 reflected the rise in German and Japanese long-term rates. But much of the increase reflected purely domestic conditions, specifically, market disappointment that the Federal Reserve's lowering of interest rates, started in the late spring of 1989, had come to a halt. The market had been priced to a further easing, and the disappointment caused a reversal in bond yields.

(4) In general, recent experience suggests major capital markets are becoming more interdependent. The real rates of return in major markets cannot diverge much from each other, although lags among markets seem to be long and variable, to apply a phrase made famous in another context by Milton Friedman. The Japanese stock market was insulated for over two years from the decline in price/earnings ratios in New York and London, following the October 1987 crashes, but eventually it was forced to succumb. Long-term real interest rates in Germany and Japan may for a time be higher than in the United States—as seemed to be the

case in the autumn of 1990—but eventually either nominal interest rates, partly influenced by international investors, or domestic inflation rates will adjust to bring them roughly into line. Globalization as it proceeds should have the effect of shortening the lags in adjustment.

(5) In any event, recent experience suggests clear interdependence between markets, particularly at times of crisis (such as in equity markets) but also to a degree at other times. Domestic policy independence itself (including its ability to affect markets generally, not just overnight money market rates) has already been marginally eroded. In the 1987-90 period, it would seem that (a) Japanese monetary policy was too easy for too long in some degree because of interdependent equity market fears; (b) a tightening in US credit markets (as in early 1990) occurred in some degree as a result of the tightening or prospective tightening of Japanese and also German monetary policies; and (c) a fiscal policy adjustment in the United States (after the 1987 crash) was given added impulse by fears that international investor attitudes (including investors located at home) could greatly upset US markets.

Globalization and Policy

As major markets become increasingly interdependent, nations may naturally seek ways to insulate or to protect themselves from the full and instantaneous impact of outside forces. In this modern world, however, it seems clear that interdependent effects will keep on expanding to such a degree that countries will be forced to cooperate more at both micro-market and macro-policy levels in the interest of stabilizing market performance.

If a country cannot insulate its capital markets from the rest of the world even for what might be termed a “decent interval” it can chose to immerse itself, undifferentiated, into a large grouping, losing its independence, but sharing in the greater market power of the large group. This was a factor behind the drive toward a European market and monetary unity.

But the European experience can also be viewed from another perspective, as a paradigm for eventual world adaptation to globalized markets by eliminating currency and national market distinctions altogether. It is not practically applicable now as a model for joining the major capital markets in Europe, the United States and Japan; and in any case it is not a perfect paradigm since there is political and economic resistance

within Europe to unification. Nonetheless, this approach toward market structure, regulation and toward macro-policies has elements that are generally relevant and instructive.

On a micro-market level the European approach does illustrate the need for a minimum of international market regulation. Such regulation is necessary as domestic markets migrate abroad, and it also represents wise policy when domestic markets can become volatile as a result of international contagion or international flows.

In the Europe to come, banks and securities firms—probably—licensed in one country will be able to do business in another based on the types of activities permitted in the home country. This requires some minimum agreement on banking powers and some standardization in securities markets—of margins, trading hours, settlement procedures and other business practices. This standardization across markets and exchanges would work to minimize the potential for communicable crises beginning in a weakly or carelessly managed marketplace to which certain firms and participants had been tempted to migrate.

It is unlikely that Japan or the United States will go so far as to accept firms based on foreign licenses in the foreseeable future. But it does seem that the United States, Japan and Europe all now accept the need for at least some reasonable minimum coordination of international market regulation. Efforts are proceeding in one way or another through various official and private channels, but progress is quite slow because securities markets are inherently complex, and national practices and stages of market development differ even among the more advanced industrial countries.

On the macro side, the European drive toward a common central bank and a common currency represents the ultimate in international policy and market coordination. In general, if a country can no longer have an independent capital market, it should adopt a currency in common with some of its neighbors, once politicians are willing to give up the illusion of a monetary policy that can be independent over the long term.

I believe Western Europe will in fact end up with a common currency and some form of common central bank before we are too far into the next century. But that the United States and Japan (and their respective economic spheres) could also move toward such institutions, and ones that might be hooked up with each other and with Europe, strikes me now as utopian, although in a hundred years, who knows.

Large blocs and countries can probably retain monetary policies that

can independently affect their capital markets in an interdependent world—or at least can affect them long enough to retain the illusion of practical independence. The US capital markets today are affected in some degree by external events; they may rise or fall in response to others, but the strongest exogenous force is still the Federal Reserve. Because of the residual dominance of the dollar in world markets, events in the United States are more likely to act as an exogenous force on foreign markets than vice-versa. But the increased globalization of the past decade, including the emergence of other currencies and financial centers, reduces that asymmetry, and it will decline further once Europe moves to a common financial and currency market.

The financial unification of Western Europe will mean that another bloc, by its very size, will have some of the same resistance to external influences as the United States. It will not be impermeable, however, just as the United States no longer is. European markets, once unified, will presumably become much more liquid and attractive than they now are, and thus more hospitable to foreign players and more exposed to the vagaries of international portfolio selection, speculation and psychological disturbances. Moreover, because of the enhanced market power of any single large market, the interaction of two or three large blocs may make markets in each area more sensitive to the other.

Whatever the exact mix of global and domestic effects on national capital markets and national monetary policy, it is clear that the global interdependence of finance has become important enough to be added permanently to the agenda on macro-economic policy coordination. It would take another essay to define macro-policy coordination properly and to examine its relation to an exchange rate system, to the political and legal context of economic policymaking in major countries, and to the role of major official international organizations. But, for the limited purposes of this essay, I can offer some general observations—at the risk of making it seem that the capital market tail is wagging the economic policy dog.

By coordination, I mean that the major financial powers—the United States, Japan and Europe—should agree on a general approach to exchange markets and to a domestic use of monetary and fiscal policies that can be interpreted by capital markets as stabilizing. This is important because a perceived breakdown in the ability of countries to undertake policies that are mutually in balance—or, worse still, to talk to each other rationally—may itself set off an internationally communicated disturbance.

There are two aspects to international coordination of policies that

are worth stressing in this context. For one, a reasonably stable set of exchange rate ranges among the major countries would contribute to international capital market stability overall. These should not be fixed for eternity, but should be sufficiently durable that they do not themselves become a source of disturbances communicated to capital markets. Such ranges cannot be employed, or carry conviction, without consultation and agreement about practical exchange market intervention and other basic policy adjustments on the part of the countries involved. Of course, exchange rates will change over time, but the point is to ensure orderly changes in the context of perceived cooperation and broader policy coordination.

The other aspect of coordination I would stress is the need for policies that lead to convergence of inflation at reasonably low rates. This is desirable, of course, whether capital markets are more or less globalized. But it takes on more urgency as markets become more internationalized.

For example, if inflation gets out of hand in one important country, capital outflows may be so great that inflationary pressures are encouraged in other countries because nominal and real long-term interest rates are forced down. Or, to take another example, if an inflationary country tries to return to stability too quickly, it may tighten so much as to communicate higher interest rates and unnecessary economic weakening to other countries. In that context, and looking ahead a decade or two, a few large currency blocs in a globalized world may have a great potential for harming each other and world markets by pursuing divergent monetary policies, thereby unleashing capital flows yet more massive than those we have seen in the past decade.

From another perspective, though, globalized capital markets provide an advantage for policymakers. They can provide more time for domestic policymakers to implement needed adaptations in their fiscal or monetary posture. The process of adjustment to domestic and external imbalances—such as have faced the United States, Japan and Germany over the past decade or so—can with more time be more orderly. The greater willingness and ability for private capital to flow across borders—so long as the flow is stabilizing, as it was for the most part in 1988 and 1989—extends the period over which countries can make the fiscal or other domestic adjustments that fundamentally correct the imbalances.

However, private capital will continue to flow in a generally stabilizing way—that is, from surplus to deficit countries—only if it is perceived that the countries are making mutually consistent adjustments. Moreover, the direction and amount of capital flows may be limited over time

by international portfolio balance considerations. Thus, the more that countries take advantage of globalization to extend the period for adjustment, the more there is the need for cooperative domestic policies to ensure that no excessively large debtors or creditors are created in the process. If countries do become excessive debtors or creditors, globalized markets will then exert their own discipline by greatly shortening the time period for adjustment.

As capital markets develop, they are becoming forces in their own right, linking economies closer together and weakening the independence of domestic monetary and fiscal policies. I believe this trend will continue and intensify. And, as it does, it will become increasingly urgent for each nation, in its own interest, to cooperate fully on international economic and financial policy.

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