Oxford Review of Economic Policy, Volume 37, Number 4, 2021, pp. 690–706

The global capital market reconsidered

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Abstract While the globalization of production has been a prominent target of anti-globalization backlash, globalized finance has seemed to be much less in the public bull's-eye. The blueprint for the post-war international economy agreed at Bretton Woods in 1944 envisioned nothing like today's extensive and fluid global capital market. The demise of the 1946–73 fixed exchange rate system, however, also brought a progressive dismantling of barriers to international financial flows motivated by special-interest politics, national economic competition, and ideology—alongside the benign desire for a more efficient international allocation of capital. Unfortunately, free cross-border financial capital mobility can compromise governments' capacities to attain domestic economic and social goals in several ways. This essay links the dynamics of financial liberalization to the Teflon-like resilience of finance to backlash so far, and suggests that stronger backlash could emerge if national governments fail to enhance multilateral cooperation to manage the financial commons.

Keywords: global capital market, embedded liberalism, financial stability, globalization, multilateralism
JEL classification: E52, F02, F21, F30, F65, O19

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I. Introduction

The resurgence of domestic and international finance over the past five decades was neither planned nor foreseen by economic policy-makers at the end of the Second World War. While the globalization of production has been a prominent target of anti-globalization backlash, especially in the United States, globalized finance has seemed to be much less in the public bull's-eye. This is true notwithstanding its essential role in the great 2007–8 financial crisis and other crises that have had long-lived negative economic effects. Overall, however, prevalent attitudes about finance remain neutral compared with public reactions during the Great Depression of the 1930s. That experience shaped much of government policy towards the financial sector in the quarter-century after the Second World War, particularly the global community's initial post-war policy stance towards private international financial transactions. But things have changed. Within

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I am grateful for helpful comments from Anat Admati, Kevin O'Rourke, Dani Rodrik, Isabel Ruiz, an anonymous referee, the editors, and participants at the April 2021 Blavatnik School of Government conference on 'Capitalism: What Has Gone Wrong, What Needs to Change, and How Can It Be Fixed?'. Hiro Ito graciously provided the data for Figure 1. Jianlin Wang provided valued research assistance. All opinions and errors are mine alone.

https://doi.org/10.1093/oxrep/grab023
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the high-income countries that account for the bulk of global capital market activity, earlier official scepticism towards unfettered international finance is long gone.

General dissatisfaction with capitalism as practised today has risen since the great financial crisis—the reasons include adverse trends in income distribution, market power, economic growth, and environmental degradation—but public debate has yet to focus sufficiently on the role of globally footloose money. This comparative neglect is puzzling because international financial activity, despite providing important economic benefits, extends far beyond the point where net social benefits are maximized and reaches into areas likely to prove counterproductive. In particular, financial globalization is a potential conduit through which national efforts to reform domestic capitalism may be frustrated. The fundamental reason is that the scope of international financial markets far exceeds the limits of any one national sovereignty, undermining nation-level levers for influencing market outcomes and thereby reaching domestic policy objectives.

Hoping to illuminate the role of modern global finance, this essay addresses three basic questions:

- What explains the evolution of trans-national financial markets over the past 50 years? My answer focuses on the policy trade-offs governments have faced, the growing political clout of the finance industry, and ideology.
- Where does global finance capitalism most challenge national policy-makers and the international community? Prime challenges reside in the areas of financial stability; tax competition, avoidance, and evasion; and facilitation of corruption. I focus on the first of these.
- What explains the Teflon-like resilience of financial globalization to the popular backlash against production globalization that now prevails in US politics, notwithstanding the recent Global Financial Crisis (GFC)? I suggest that different political dynamics apply to trade and finance, while admitting that this hypothesis leaves important unanswered questions.

Each of these areas deserves a much more thorough treatment than it will receive, so my proposed narrative is necessarily terse, incomplete, and tentative. Nonetheless, in an era where trade and outsourcing have captured the political spotlight, I believe that it is useful to begin drawing the role of finance out of the shadows.

We cannot return to the financial environment of 1945—nor should we wish to—but we can find a better balance between financial licence and governments' legitimate desires to achieve domestic policy goals. I argue that national measures coupled with more effective intergovernmental cooperation can enhance domestic policy space without materially compromising gains from financial integration.

II. The post-1945 economic settlement

In the decade between the Versailles conference of 1919 and the financial crash of 1929, national political elites in the victorious countries tried to restore pre-war world economic arrangements that, even before 1914, had been fraying. Assessing that effort in 1933, John Maynard Keynes drily observed, 'The decadent international but individualistic capitalism, in the hands of which we found ourselves after the war, is not a success' (Keynes, 1933, p. 183).

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The international economic settlement that the victorious Allied powers envisioned at the end of the Second World War differed from the Versailles settlement, which implicitly assumed a return to free trade and payments, based on the gold standard (Eichengreen, 2019, p. 7). Instead, the post-1945 settlement rested on a foundation of what John Ruggie (1982) famously called 'embedded liberalism': a politico-economic framework in which political authority would have a legitimate and central role in mediating the relationship between the market and society. As Ruggie (p. 393) put it:

> Liberal internationalist orthodoxy, most prominent in New York financial circles, proposed to reform the old order simply by shifting its locus from the pound to the dollar and by ending discriminatory trade and exchange practices. Opposition to economic liberalism, nearly universal outside the United States, differed in substance and intensity depending upon whether it came from the Left, Right, or Center, but was united in its rejection of unimpeded multilateralism. The task of postwar institutional reconstruction . . . was to maneuver between these two extremes and to devise a framework which would safeguard and even aid the quest for domestic stability without, at the same time, triggering the mutually destructive external consequences that had plagued the interwar period. This was the essence of the embedded liberalism compromise: unlike the economic nationalism of the thirties, it would be multilateral in character; unlike the liberalism of the gold standard and free trade, its multilateralism would be predicated upon domestic interventionism.

The central element of the post-Second World War framework was the Bretton Woods agreement, negotiated in its planning stages mainly between the US and the United Kingdom and finalized in 1944. It was a compromise within a compromise. Its foundational compromise between market and state contained another one between a US Treasury team led by Harry Dexter White, which sought to promote American economic interests and hegemony, and a UK Treasury team let by Keynes, which sought to protect Britain's position and influence through a more symmetrical global distribution of economic power.

The blueprint for the new International Monetary Fund (IMF) contained five critical ingredients:

(i) an ambition to return to general currency convertibility for the purpose of current account transactions—a necessary requirement for restoring a multilateral trade system consistent with an efficient international allocation of productive factors;
(ii) official multilateral funding (through the IMF) for short-term balance of payments gaps;
(iii) exchange rates pegged to the US dollar (which in turn was convertible for gold at a fixed price by official dollar holders);
(iv) the possibility to devalue or revalue currencies in the face of persistent payments imbalances (so-called 'fundamental disequilibrium');
(v) a presumption that countries could and in some cases should restrict private international financial transactions.[1]

[1] Article VI, section 3, of the IMF Articles of Agreement states: 'Members may exercise such controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments [with two technical exceptions].'

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The final ingredient above was necessary to give countries some degree of monetary policy autonomy for managing the domestic economy. Otherwise, the open-economy monetary trilemma would dictate that with international capital mobility and fixed exchange rates, IMF members would have no leeway to move domestic interest rates away from US levels (Obstfeld and Taylor, 1998).[2] In addition, without constraints on private capital movement, the 'fundamental disequilibrium' option of a possible exchange parity change could become a huge destabilizing force, potentially setting off uncontrollable speculative capital flows across borders. Thus, the embedded liberalism compromise aimed for a system in which episodic exchange-rate changes could adjust countries' balance-of-payments positions to the needs of the domestic economy, rather than the domestic economy adjusting to balance-of-payments constraints as had been the case under the gold standard. The compromise also might facilitate government policy more broadly construed. Harry Dexter White argued that governments needed the tools to prevent capital flight motivated by aversion to 'the burdens of social legislation' (Helleiner, 1995, p. 318). Overall, the goal of embedded liberalism was to create 'a form of multilateralism that is compatible with the requirements of domestic stability' (Ruggie, 1982, p. 399).

III. Financial leakages and the collapse of pegged exchange rates

Sealing off the economy from international financial flows proved to be difficult—and the system ultimately allowed too much leakage for the pegged-but-adjustable exchange rate system to survive. The main European currencies became externally convertible (for current account transactions) at the end of 1958. The subsequent growth of global trade, while fulfilling one of the prime goals of the Bretton Woods architects, provided many opportunities for disguised cross-border capital movements (for example, through leads and lags in trade-related payments). Furthermore, as US multinationals expanded their operations during the 1960s, their demand for financial services outside the US led to a large expansion in American banks' overseas branches. As early as 1961, speculative money inflows into Germany forced a revaluation of its currency. The year 1964 saw the start of the protracted sterling crisis that would lead to devaluation in 1967.

There were two other destabilizing factors at work: the growth of an offshore currency market in London and US inflation.

The unregulated Eurodollar market (where international banks traded US dollar deposits) emerged in London in the late 1950s. UK and US authorities not only tolerated but also promoted the market. While maintaining a strict cordon around its domestic banking system, the British government hoped to enhance its banks' international business opportunities, thereby recapturing some of London's historical role as a global financial hub. The US had its own motivations. The US Interest Equalization Tax of 1963 aimed to strengthen the US balance of payments by taxing capital outflows, but

[2] The monetary trilemma holds that only two of the following three can be mutually compatible: monetary policy geared towards domestic objectives, a fixed exchange rate, and internationally open capital markets.

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also made it more expensive for US-based banks to lend directly to multinationals abroad. Responding to pressures from banks and industry, the US allowed and even encouraged US banks to set up shop in London. However, the offshore market ultimately provided another venue for speculation against the US dollar.

Inflation was the second destabilizing factor. It accelerated in the US in the latter 1960s. Under the pegged exchange rate system, this inflation spilled over to the rest of the world. Inflation interacted with pre-existing distortions in the financial sector to raise pressures for financial liberalization. In the US, the Depression-era Regulation Q limited the interest banks could offer for onshore deposits, driving them offshore for wholesale funding. With deposit rates capped, mounting US inflation also implied that the real interest rates depositors could earn were becoming increasingly negative. Financial activity moved to commercial paper markets and new money-market mutual funds. As a result, pressures for bank deregulation grew in the US as well as in other industrial countries.

Both rising US inflation and the ongoing US external payments deficit eventually led to uncontrollable speculation against the dollar. After vain attempts to stem the tide, industrial countries allowed their exchange rates to float. By March 1973 the Bretton Woods network of dollar pegs was gone. What at the time seemed like a temporary retreat from pegging turned out to be permanent, as the floating rate system remains in place nearly 50 years later and, indeed, has expanded to include most of the major emerging market economies (China being a notable exception).

Freed from the constraint of pegged exchange rates, policy-makers had less need to restrict international payments to achieve monetary policy autonomy. They could liberalize international financial flows while still enjoying freedom of action on interest rates. This observation, however, does not explain *why* they did so (Obstfeld and Taylor, 2017), in a protracted process that began in the early 1970s and has ultimately moved the world far from the embedded liberalism that underlay the immediate post-war decades.

IV. The great liberalization

The financial account liberalization process for industrial economies began immediately after the move to floating exchange rates. In less affluent countries, the process began later and has not gone as far. The updated index of capital account liberalization developed by Chinn and Ito (2006), shown in Figure 1 for industrial, emerging, and less developed countries, conveys the timing and extent of liberalization in the different country groups.[3]

The economic case for liberalizing financial flows rests on two main pillars. First, cross-border financial controls are difficult to enforce and enforcement efforts can entail escalating distortions, including opportunities for rent-seeking and corruption. Second, there is the promise of the classical gains from trade: from efficient international risk sharing, capital transfer, and liquidity provision. But international financial flows can entail drawbacks, too, as I detail further below. Moreover, the prospect of *aggregate* efficiency gains is rarely determinative in reality—what matters is the balance of political

[3] Basing Figure 1 on GDP-weighted averages would result in a qualitatively similar chart.

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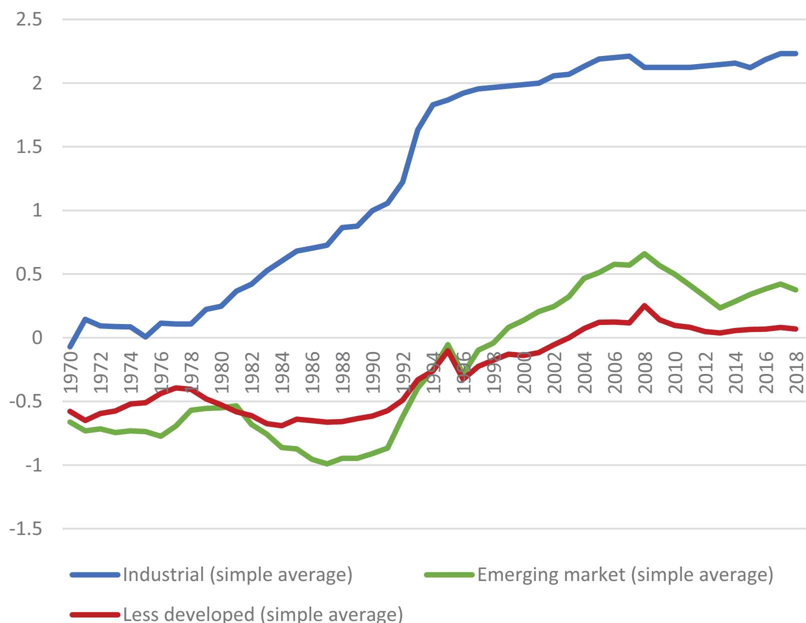
Figure 1: Index of capital account openness, 1970–2018



Notes: The index ranges from −1.92 (most closed) to 2.33 (most open). The figure shows simple unweighted averages over countries. China enters the index in 1984. Russia and other former Soviet states enter in 1996.
Source: Chinn and Ito (2006) *de jure* index updated to 13 July 2020. URL: http://web.pdx.edu/~ito/Chinn-Ito_website.htm.

power of the interests that benefit or lose from liberalization. So what forces drove the post-1973 process of global liberalization? While it is artificial not to treat cross-border liberalization as integrally connected to *domestic* liberalization (and I will not ignore domestic liberalization completely), I nonetheless focus on a few key trends that specifically promoted freer international flows.

A strong initial impetus towards open capital accounts came from the US. The fixed exchange rate system might have been preserved through a cooperative international system of capital controls, as Japan and European countries proposed in 1973, but the US was strongly opposed and, moreover, announced that its own controls would be abolished the following year (Helleiner, 1995, pp. 322–3). These moves channelled a generally free-market bent within the Nixon administration, associated with both high-level officials (such as George Shultz at Treasury and Herbert Stein at the Council of Economic Advisers) and outside counsellors (such as Milton Friedman and Alan Greenspan). But the US desire to see international financial controls dismantled also reflected ambitions to cement further the US position as the leading global financial centre and to let the dollar weaken in foreign exchange markets. The US's deregulation offensive gathered force in the 1980s under the Reagan administration. Ideology coincided with the more pragmatic desire to ease the foreign financing of historically big US current account deficits.

Financial liberalization has a *snowball effect*, in that it enriches some elements of society (in this case financial firms and multinationals), who use their financial clout

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to steer the political process away from potential re-regulation and towards further relaxation. In turn, success in these lobbying efforts enriches the beneficiaries further, allowing them to extend their political gains.

Financial liberalization also has had a *competitive effect* globally, as financial and industrial elites outside the US have pressured their governments to liberalize in order to compete for global market share with US banks and non-banks, as well as with other liberalizing countries. Having promoted the Eurodollar market as a way to maintain its traditional position in banking and securities trade, the United Kingdom in 1979 eliminated capital controls dating back to the 1940s and in 1986 deregulated the London Stock Exchange in a 'Big Bang'. Financial liberalization on the European continent during the 1980s, in particular the dismantling of capital controls by the end of that decade, was motivated by a desire for closer economic union, but also by local pressures to be more competitive with Anglo-American finance.

The role of ideology in these developments should not be understated. Disillusion in the 1970s with slower growth, higher inflation, and, in many countries, industrial unrest, helped fuel the spread of neoliberal approaches to economic policy that glorified free-market outcomes and by implication rejected what Ruggie (1982, p. 382) refers to as 'legitimate social purpose' in policy or policy regime design.[4] This development was of central importance in providing not just an intellectual framework that beneficiaries of financial liberalization used to promote and justify their advocacy, but also one that those who wished to deconstruct aspects of embedded liberalism even beyond the financial sphere could weaponize.

Building on ideas like those of Friedrich Hayek and Friedman, the neoliberal school, with intellectual roots in the interwar period, favoured a minimal state devoted above all to protecting property rights and safeguarding the primacy of the market as the ultimate arbiter of resource allocation. Neoliberals naturally defined the market to be global in scope: by definition, national interventions at the border could only be counter-productive of efficiency, and therefore illegitimate. On this view, the market, not the state, would be master.

Margaret Thatcher and Ronald Reagan were the most prominent political manifestations and sponsors of this worldview. Their impacts on economic policies and politics were consequential and persistent, even inducing leaders of nominally left-wing parties to 'triangulate' towards the right during the 1990s. The Soviet bloc's economic failure and political collapse reinforced the trend. In this environment, industrial countries essentially completed the journey to fully open finance over the 1990s (Figure 1).

Neoliberalism captured economic policy-making a bit earlier in parts of Latin America, where it was associated with radical opening and macro stabilization programmes in Argentina, Chile, and Uruguay. These ended in tears, as Díaz-Alejandro (1985) memorably described in the Chilean case. As the 1980s debt crisis engulfed large parts of the developing world, financial openness, already low there, fell further.

But in the 1990s, low- and middle-income countries (LMICs) gradually began to embrace financial liberalization initiatives, along with a raft of economic reform measures

[4] Brown (2019) argues that the neoliberal project essentially denies the legitimacy of 'society' as a conceptual category and therefore denies the legitimacy of government policies aiming to manage market outcomes in pursuit of social goals.

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intended to boost growth after the doldrums of the 1980s. Reforms differed from country to country, and different governments took different approaches to external financial liberalization. Figure 1 suggests, however, that a general push towards financial openness started in the early 1990s in many emerging market and less developed economies, with the peak (around the time of the GFC) stopping quite a bit short of what the more affluent economies chose—followed by some retrenchment.

Why did this happen? Again, the answers differ across regions and even across countries within regions, but some common trends stand out. Many countries (albeit in different ways across country groupings) opened up further to international trade. Many also promoted domestic financial development as essential for economic growth. A sophisticated, deep financial system is hard to insulate from the rest of the world, especially given the reality of growing merchandise trade. These factors supported external financial liberalization. In addition, growing pressure from domestic financial interests as well as governments' desires to deepen markets for their bonds played roles.

Also important was cheerleading from the international financial community. As Obstfeld and Taylor (2017, pp. 14–15) observe:

> The doctrinal shift regarding capital mobility seen in advanced economies in the 1970s and 1980s began to spread globally in the 1990s. By September 1997, the IMF's management was proposing that the Fund's executive board amend the Articles of Agreement to give the Fund an explicit role in guiding countries towards more open capital accounts. To be clear, the proposal was not advocating an indiscriminate rush towards opening; indeed, it recognized the role of capital inflows in financial crises, such as those that had afflicted Latin America from the mid-1970s through the mid-1990s, and it therefore explicitly sanctioned gradualism, based on country circumstances (Fischer, 1997). But it took as a given that an open capital account was the desirable ending point for all countries.

Fischer's proposal was more nuanced than much of what had gone before. Indeed, an assessment by the IMF's Independent Evaluation Office (2005, p. 4) found that through the mid-1990s, the Fund's staff 'clearly encouraged capital account liberalization' and seldom stressed the accompanying risks (although the IMF Articles of Agreement did preclude the Fund from *requiring* countries to liberalize—a legacy of embedded liberalism).

In any case, the Asian crisis of 1997–8 dealt a blow to the IMF's advocacy of this plan. But for LMICs, capital-account liberalization nonetheless crept ahead as some repaired weaknesses in their financial systems, as many embraced more exchange-rate flexibility better to navigate the trilemma, and as the world entered a period of buoyant commodity prices and abundant global liquidity. Accommodative global conditions made it hard for governments to resist advocates of financial openness. Figure 2 shows the remarkable surge in global capital flows from 1985 through the late 2000s (most of it between rich countries) compared with the growth of world GDP and world trade.

The GFC of 2007–8 (closely related to the prior global liquidity spike evident in Figure 2) brought this period of exuberance to a close. Since then, global capital flows have been occasionally very large, but quite volatile. For rich and poor countries alike, the international financial system in its current state looks quite different from what

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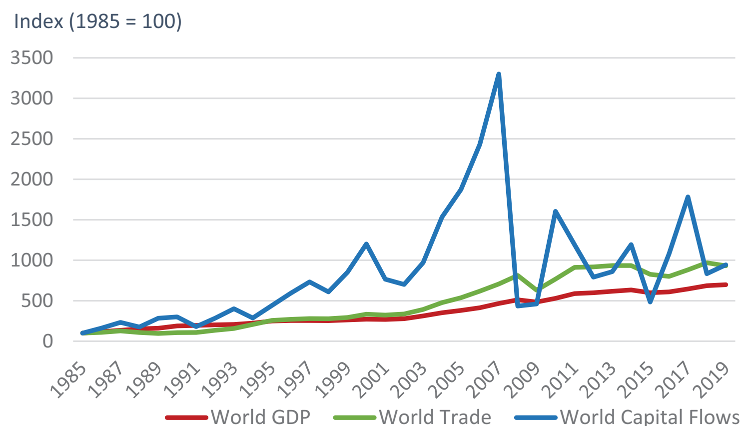
Figure 2: Comparing the growth of world GDP, world trade, and world capital flows (nominal US dollars, all series rebased to 1985 = 100)



Notes: Trade is sum of world merchandise imports, in US dollars. Capital flows are the sum of world gross inflows, in dollars. World GDP is measured in US dollars at market exchange rates. Only countries with data reaching back to 1985 are included.
Source: Data come from United Nations, Comtrade database, and International Monetary Fund, *World Economic Outlook* and *Balance of Payments Statistics*.

Keynes and White had envisioned at the close of the Second World War. Fixed exchange rates are largely gone. Governments do pursue countercyclical macroeconomic policies, as the authors of Bretton Woods intended, but generally within real or perceived market constraints that for emerging and developing economies depend heavily on the reactions of global capital markets. Finally, international financial mobility remains extensive and as free of official barriers as it ever has been since the Second World War. At least as far as finance is concerned, the international economy has moved on from embedded liberalism towards a system of global capitalism. What challenges does this policy regime pose?

V. Stability challenges from global financial capitalism

In democratic societies, national governments cannot ignore voters' legitimate demands for security and prosperity. But the global capital market extends beyond the regulatory and fiscal perimeters of any one country, making it harder for governments to deliver. On the other hand, international market integration yields undeniable aggregate benefits. Because the market spans national jurisdictions, mass democracy and globalization clash in the absence of an all-internalizing global economic policy-maker, as Dani Rodrik (2000) has stressed.

The genie unleashed by a half century of global financial development cannot be stuffed back in its bottle. So the best governments can do is to undertake effective domestic regulation while cooperating on their common challenges from financial globalization—preferably in a way that makes transparent to voters the benefits of a

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multilateral approach. In so doing, governments can jointly enhance the benefits from the global capital market while reducing its drawbacks. Effective cooperation between sovereign nations, however, is necessarily a dynamic and arduous process that needs to grow as experience reveals previous shortcomings and as new pressure points emerge.

One salient problem area is taxing global profits—where, as in financial deregulation, there has been a competitive race to the bottom that deprives governments of the revenues they need to fund necessary public goods. Another is global tax evasion, money laundering, and corruption, which both large and small financial centres facilitate (Zucman, 2015). There are some hopeful signs in these areas. Regarding taxation, the Biden administration's proposal for a 15 per cent worldwide minimum corporate profits tax rate, in line with the Organization for Economic Cooperation and Development (OECD)'s long-running initiative on base erosion and profit shifting, has drawn support within a large group of countries, including all of the Group of Twenty. Regarding illicit cross-border money flows and corruption, a major development for the US (and therefore for the world) has been the Corporate Transparency Act, which forces corporations to disclose their beneficial owners at the time of formation. Also notable is the Biden administration's publicized recognition of global corruption as a 'core United States national security interest' that requires international cooperation to address effectively (White House, 2021).[5]

Here I focus on another area where multilateral cooperation is much needed, but one in which it has long occurred and continues to evolve: financial stability.

Early in the floating exchange-rate period, cross-border fissures in financial regulation emerged. In response, 11 countries, including the Group of 10, established the Basel Committee on Banking Supervision (BCBS) under the auspices of the Bank for International Settlements (BIS). Following the developing country debt crisis of the 1980s, which posed threats to capital levels in money-centre banks, the BCBS in 1988 issued the first of three accords aimed at setting minimum international capital adequacy standards, while addressing other market risks. These were widely adopted, with the most recent framework, known as Basel III, aimed at repairing deficiencies of its predecessor that became evident in the GFC. In 1999, the Group of Seven industrial countries formed the Financial Stability Forum, also housed at the BIS, to bring together a broader group of national financial officials concerned with a wider range of financial market activity and infrastructure. The Forum became the current Financial Stability Board (FSB) after the GFC, with an expanded membership.

The work of the BCBS and FSB has reduced the global financial risks posed by regulatory gaps across borders and a race to the bottom in prudential standards. By setting minimum global standards with the aim of enhancing financial stability everywhere, that work has made it easier for countries to attain their own macroeconomic stability goals—while leaving them free, in principle, to mandate stricter standards for domestic activity if they wish. International regulatory cooperation thus stands out as one of the more positive arenas of international policy collaboration.[6] Multilateral work on

[5] Sutton and Judah (2021) offer a far-reaching proposal that operationalizes the Biden administration's stated aspirations on global corruption. Devereux *et al.* (2021) propose principles for more efficient solutions to the problems of base erosion and profit shifting.

[6] For criticism that the Basel III standard still permits excessive financial stability risk, see Admati (2016).

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payments and market infrastructure has also been beneficial, leading, for example, to more efficient settlement of foreign exchange transactions.[7,8]

This progress owes in part to the highly technical work of the groups, largely escaping the glare of politics (though not the attention of industry lobbyists), as well as an epistemic framework that negotiators broadly share. The framework recognizes that the risks of broad crises in which all countries suffer must limit to some degree the pursuit of national objectives. However, the very successes of the process have promoted the expansion of cross-border financial activity—which otherwise, more countries might have tried to limit. The same applies to the last-resort lending and bailout interventions of central banks and finance ministries in various crises—they are inescapable *ex post*, but *ex ante*, the expectation that they will be forthcoming can encourage higher volumes of cross-border financial activity and, in the worst case, imprudent financial behaviour.

While in many ways conducive to financial stability, the process of international collaboration may therefore also accentuate some financial vulnerabilities. In general, financial regulation can become a game of whack-a-mole in which well-intentioned actions set in train destabilizing market adaptations. Indeed, the GFC revealed the potential for national regulatory failures to interact in explosive ways, notwithstanding the prior international coordination process. In the years following the crisis, national actions supplemented international reforms, for example, Dodd–Frank and the prime money market mutual fund reform in the US, as well as the redesign of the euro area's regulatory framework for banking. All of these measures seem to have had the net effect of strengthening global financial resiliency, but they have had some unintended consequences, and inevitably markets will adapt further—in analogy to the evolution of viral variants that may evade vaccines. Sustained vigilance is in order.

In the US, the Trump administration weakened several aspects of Dodd–Frank, such as the Volcker rule. Overall, however, the US remained engaged with the process of international regulatory collaboration throughout the Trump presidency—unlike with other aspects of international cooperation, such as climate and health policy (Véron, 2020). It could easily have turned out differently and might well do so down the road in a future nationalist US administration.

It is hard to believe that the pre-crisis surge in gross cross-border financial activity shown in Figure 2 arose from a sudden rise in the inherent potential gains from international asset trade. A more likely reason is euphoria in financial markets and a reach for yield, supported by expectations of protection from the official sector and complemented by tax-related incentives for capital flow round-tripping or detours

[7] Governments clearly face a commitment problem in standing up to home industry lobbyists pushing for deregulation. This dynamic produces the race to the bottom. Common standards negotiated by regulators (and monitored by the IMF) can better fortify governments to push back. In this case, the resulting shared commitment capability is an important public good, produced by 'soft law' rather than treaty law (Brummer, 2010). The cooperative process also contributes to the related public goods of global financial stability (because instability in a major market endangers everyone) and smoother international payment, settlement, and clearing systems. The BCBS–FSB example shows how international cooperation can mitigate a domestic dynamic inconsistency problem of government policy, but there could also be settings in which the opposite occurs (e.g. Rogoff, 1985). Of course, a direct approach to mitigating the dynamic consistency problem at its source would restrain the lobbying power of the financial sector.

[8] Problem areas remain in cross-border payments, however, notably including remittances to poorer countries.

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through offshore havens.[9] These transactions can cause gross capital flows to balloon, with much of the resulting activity being socially counter-productive. It is important to find the appropriate corrective policies for such cases. Further study can lead to refinements of the macroprudential toolkit, but we do need a robust toolkit, including the possibility of some differential treatment of international transactions.[10] The adverse incentives that an expanding international safety net creates require a strong offset.

In sum, the threat of financial crises remains—not least, from origins in the less regulated non-bank sector—and potential gaps in international financial coordination persist. As Cecchetti and Tucker (2015, p. 106) summarize:

> Cooperation means agreement, implementation, and enforcement of a common resilience standard. This, in turn, requires mutually agreed mechanisms for monitoring, combined with candid, honest, and regular communication. Should it be thought that those arrangements already exist, our experience suggests that it is, at best, a work in progress.

Turning to another weakness, we still do not know if international regulators would be able to pull off the orderly resolution of an insolvent globally systemically important bank. Such risks warrant further contingency planning by global regulators, but national fiscal authorities will also have to be on board.

A specific potential coordination failure arises from possible asymmetry in macroprudential frameworks over the financial cycle. Financial history is replete with euphoric booms, during which vulnerabilities build up, followed by busts. Figure 2 gives striking testimony to the footprint of the 2000s boom in global financial markets. White (2020) makes the case that existing policy approaches focus excessively on ameliorating downturns and insufficiently on controlling the upswings that precede them and that sow the seeds of later problems. White argues that one factor encouraging such asymmetry is regulators' unwillingness to disadvantage their own financial institutions relative to foreign competitors. Thus, an uncooperative equilibrium in policy rules—one without international agreement on macroprudential reaction functions—features excessive laxity in the cycle's boom phase.[11]

Evidence has accumulated that the global financial cycle is worldwide in scope, with global movements in asset prices, commodity prices, leverage, and capital flows highly correlated internationally (for example, Miranda-Agrippino and Rey, 2020). Due to America's weight in international finance and trade and the US dollar's unique global role, US monetary policy and financial conditions are the main drivers of the global cycle. Financial shocks originating in world markets pose special risks for LMICs, which generally have thinner foreign exchange markets and more fragile financial systems. Exchange-rate flexibility provides a partial buffer where practised, but it cannot fully insulate LMICs from global financial forces. Figure 3 illustrates the high correlation between the global financial cycle indicator of Miranda-Agrippino and Rey (*GFCy*) and the growth rate of the aggregate real GDP of LMICs.

[9] On the important role of offshore financial centres in global capital flows, see Lane and Milesi-Ferretti (2018), Bertaut *et al.* (2019), and Coppola *et al.* (2020).

[10] Macroprudential policies are policies that aim to enhance the stability of the aggregate financial system.

[11] Cecchetti and Tucker (2015) also stress the need for dynamic macroprudential policy coordination.

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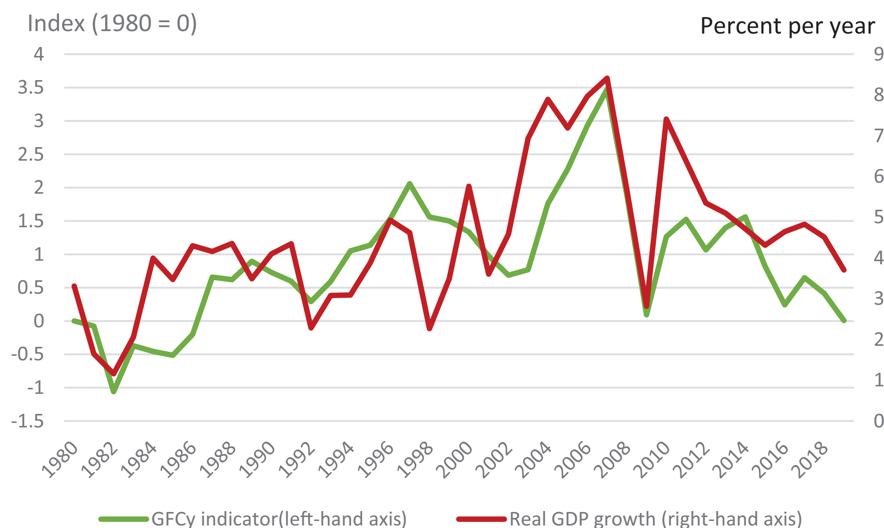
Figure 3: Growth in emerging and less developed economies is highly correlated with the global financial cycle



Source: *GFCy* variable with data updated through 2019 is available at http://silviamirandaagrippino.com/code-data. The raw monthly data are averaged to derive annual observations. Real GDP growth is from IMF, *World Economic Outlook* database, April 2020.

This vulnerability makes it understandable why so many less affluent economies, even emerging market economies, have stopped short of full financial opening (recall Figure 1). Indeed, in 2012 the IMF officially recognized this reality by developing an 'institutional view' (IV) on capital controls that allows for their use in some circumstances, notably when financial flows threaten economic or financial stability and the capital flow measures (CFMs) do not substitute for necessary adjustments in macroprudential, monetary, or fiscal policies (International Monetary Fund, 2012). The Fund's acceptance of CFMs as a legitimate policy tool was a huge shift in approach: an aversion to exchange control resides deep within the institution's DNA.

Nonetheless, the IV is in several ways too restrictive. Research shows that CFMs are rarely imposed in the temporary manner the IV envisions, in response to cyclical tides in the global capital market. Instead, they are generally structural and thus long-lived in nature (Gupta and Masetti, 2018). Notwithstanding the IV, many Fund members feel that global markets might stigmatize them if they vary CFMs reactively. Thus, the Article IV surveillance process has regularly featured disagreements between Fund staff and country authorities as to whether particular policy measures should be labelled as CFMs or MPMs (macroprudential measures), with the authorities often advocating for the latter designation (Everaert and Genberg, 2020).[12] In additon, the IV is asymmetric

[12] CFMs can play a macroprudential role—for example, when they limit foreign funding of imprudent domestic investments—but they can also play other policy roles that IMF rules proscribe—for example, preventing adjustment of an undervalued exchange rate. The overlap in the roles of MPMs and CFMs has sometimes blurred the distinction between them, as has the difficulty smaller countries face in counteracting the global financial cycle through MPMs without the support of measures that could be characterized (at least partially) as CFMs.

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with respect to inflow and outflow controls, restricting use of the latter to situations of imminent or ongoing crisis. The Fund's internal Independent Evaluation Office (2020) recognized these criticisms in a comprehensive review and recommended rethinking the IV. The recently revised *OECD Code of Liberalisation of Capital Movements* addresses some of the same criticisms IMF member countries have raised concerning the IV (OECD, 2020).

LMICs participate in the broader process of international financial cooperation, but that process frankly is skewed towards the interests of the big advanced economies, which dominate international financial activity. Unlike the advanced economies, most LMICs will continue for now to use modes of direct unilateral intervention to enhance their control over home financial markets, similar to what the original Bretton Woods blueprint foresaw. The distinctive problems LMICs face in coping with policy spillovers from the advanced economies would justify a more robust dialogue about those policies, and their impact on financial stability, in the councils of international financial institutions.

VI. The future of the global capital market

In a 1998 survey of the global capital market, I concluded:

> Compared to the world of the late nineteenth century gold standard . . . we increasingly reside in broadly democratic societies in which voters hold their governments accountable for providing economic stability and social safety nets. These imperatives sometimes seem to clash with the reality of openness. Despite periodic crises, global financial integration holds significant benefits and probably is, in any case, impossible to stop—short of a second great depression or third world war. The challenge for national and international policy-makers is to maintain an economic and political milieu in which the trend of increasing economic integration can continue. (Obstfeld, 1998, p. 28)

More than two decades later, I have four reactions to that *fin-de-siècle* assessment:

- We came close to a new great depression in 2008–9 and came close again in 2020—the second time owing to a world war, not a war of country against country but one of all countries against a contagious pathogen.
- In addition, politicians and policy-makers have not done a good job of maintaining 'an economic and political milieu in which the trend of increasing integration can continue'. Among the consequences are trade and immigration backlash in the US, political instability in Latin America, immigration backlash and growing nationalism in Europe, and Brexit. Related to these developments, my earlier optimism about expanding democracy now seems out of date.
- Global financial integration did continue after 1998 nonetheless, as measured by volume of transactions and interdependence of national financial systems, and has likely passed the point where further integration yields social benefits in excess of social costs.

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- Despite all of this, there has been no significant rollback of the international capital market's reach, and certainly no backlash against international finance comparable to the backlash against globalized production.

The seeming imperviousness of cross-border finance to broader political currents is a puzzle, especially after the GFC.[13]

One factor relates to Mancur Olson's (1965) account of the difficulty of enacting policy reforms with a concentrated set of losers, each losing a great deal, and a dispersed set of winners, each winning a small amount. International trade textbooks teach that the success of the multilateral trade rounds under the GATT, which opened world trade between the late 1940s and 1994, owed to their mobilization of a concentrated set of winners in each participant country—exporters—to act as a counterweight to import-competing sectors. Without such mobilization, trade opening is much more difficult because each of the dispersed winners has little to gain by joining in to promote collective interests.

Political scientists such as Helleiner (1994) have suggested, however, that for international financial opening, the situation is the reverse: the winners are concentrated—the most influential are major exporters of financial services—while the losers, those harmed by financial instability—are dispersed. Moreover, the losses from trade opening, as exemplified by abandoned factories in the US Rust Belt, are much more salient to the general public than the losses from globalized finance, such as forgone tax revenues or a higher risk of crises that in most cases policy-makers have ameliorated or contained. Most citizens find debates over financial regulation to be arcane and the likely consequences opaque. In sum, once the door cracks open, there is scant political resistance to the snowballing effect of financial-sector lobbying. These dynamics have led to financial regulatory cycles over centuries (Dagher, 2018).

If this story helps explain why international financial liberalization has seemed to proceed so inexorably compared with trade liberalization, it may also explain the relative absence of a backlash against financial globalization. In the US at least, backlash against trade has been strong enough to have captured both of the major political parties, whereas opposition to global financial activity is muted. But the losses from global finance have generally been more dispersed and less visible than those due to trade, while the financial community is well organized to resist restrictions on its cross-border activities.

The GFC stands out as an episode significant enough to have triggered a more durable backlash against finance in general. It did not. The crisis did lead to substantive financial reforms in the US and, briefly, to popular protests in the form of the Occupy movement. But the policy approach of the Obama administration was specifically intended to keep the financial sector in business, out of concern to avoid greater harm to the economy. There was no repeat of the Depression-era vilification of finance. The more enduring political legacy of the crisis, perhaps paradoxically, was a grassroots right-wing movement that *enabled* financial-sector political influence, as seen in the deregulatory bent and greater tolerance for global corruption of the Trump

[13] Adding to the puzzle, the lack of a broad public outcry coexists with cogent economic critiques of modern finance both from before the GFC and euro area crisis (e.g. Rajan, 2006) and after (e.g. Wolf, 2015).

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administration. How this happened is still debated, but the political mobilization of cultural and racial resentments certainly played a role.

The Biden administration is addressing some of the harms from international tax avoidance and corruption, and it will certainly adopt a stricter financial regulatory approach than its predecessor did. It will also retain a multilateral orientation in international financial policy that a generic future Republican administration might well repudiate. The result of such repudiation could be greater financial instability, more public backlash against finance in general, and market segmentation along national or regional lines.

The current prospective policy mix of multilateral cooperation backed by internal guardrails will still concede much more to global financial capitalism than the original Bretton Woods settlement did. But it is more likely to produce a safer, more beneficial, and more sustainable version of financial globalization than an alternative path of beggar-thy-neighbour deregulation. In the end, the electoral appeal of President Biden's overall economic policy package may well be the major factor that determines the future of the global capital market.

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