Financial challenges for the new millennium

Fariborz Moshirian *

School of Banking and Finance, The University of New South Wales, Sydney, NSW 2052, Australia

Abstract

This article highlights the main issues raised in 13 articles that were selected from papers presented at the 12th Australasian Finance and Banking Conference held in Sydney in December 1999. It also analyses the issues related to global financial coordination and integration for the new millennium. It highlights the cost associated with foreign exchange volatility and the significance of macroeconomic coordination at the global level for further integration of the financial market. It also highlights the challenges facing international institutions such as the International Monetary Fund (IMF) and the need for global financial institutions with greater influence, which could address the major financial challenges facing the new millennium. © 2000 Elsevier Science B.V. All rights reserved.

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1. Introduction

Technological changes, the removal of some trade barriers, the deregulation of the financial market and the revolution in telecommunications have contributed to further state of integration of the global financial market. The emergence of new nations and the financial, social and political forces, which led to the emergence of regional groups such as the European Union (EU), APEC and North Atlantic Free Trade Association (NAFTA) have also contributed to the emerging global integrated financial market. At the same time, lack of global coordination for resource allocation, development of human resources and the opportunity to reap the
benefits of technological change have created a significant imbalance between developed and developing countries and a number of global challenges to be dealt with by all nations. The recent call by the United Nations (UN) for the millennium forum and the UN’s millennium assembly is not only a step in the right direction but also demonstrates the disparity between the developed and developing countries and the need for a holistic approach for challenges facing all nations. The recent World Bank (1999) annual report has clearly identified four major lessons learnt in the last 50 years regarding the development experience. These four principles can be applied at the global level to address those factors which could contribute to the emergence of an integrated global society and hence an integrated financial market. These four lessons are, (i) macroeconomic stability is an essential prerequisite for achieving the growth needed for development; (ii) growth does not trickle down, development must address human needs directly; (iii) development is not triggered by one particular policy, a comprehensive approach is needed; and (iv) institutions matter. The purpose of this paper is to consider the lessons of the last 50 years and apply them at the global level in an attempt to argue that unless these four factors are also taken up at global level so that consequently financial and human resources as well as new international institutions are in place, the international community will not be able to ensure a balanced, fair, sustainable and all-embracing global economy. To this end, based on the recent work by Moshirian (1999), Stiglitz (1999), Section 2 will discuss global financial coordination, Section 3 will discuss the localisation and internationalisation of the financial market, Section 4 will discuss the fact that financial growth does not trickle down, and Section 5 review the papers selected for this special issue.

2. Global financial coordination

One of the factors contributing to macroeconomic instability is related to the current financial structures of various national economies. In the absence of effective international institutions, national governments follow their national financial policies without considering the effect of their policies on other countries.

Due to the fluctuation of exchange rates in all countries, the current financial market has invested billions of dollars in resources to hedge against these fluctuations in an attempt to create financial stability. Indeed, there is an enormous amount of financial resources not used for productive purposes and many investments are delayed or do not eventuate due to the unpredictability of the market, a problem which would be overcome by an international single currency. One of the ways in which we can create global macroeconomic coordination is through the creation of a World Central Bank (WCB) which would be responsible for, amongst other things, an international single currency, a world interest rate and coordination with all national central banks. Obviously, we need to take a number of financial and economic steps before we can achieve to this level of global financial integration. At the present time, there is some regional macroeconomic coordination due to the emergence of the EU and, to some extent, amongst the countries...
form NAFTA. The EU’s economic and financial integration and the establishment of a European Central Bank is one example which other regions such as the Asia-Pacific region, under the auspices of APEC, and America under NAFTA could follow in order to ensure more coordinated macroeconomic policies. At the present time, due to a significant disparity between the developed and developing countries and the lack of any regional or global coordination between these two groups, many developing countries are unable to hedge their national financial policies against global forces, which are often initiated due to the economy of developed countries. However, it appears that while one could argue that national currencies could converge to form a regional currency and regional currencies could eventually form an international single currency, the pressure for change, the need for more effective macroeconomic stability, and global forces may accelerate this process of change due to the fact that regions such as the EU have been able to solve some of their challenges by becoming more inclusive and more global. It should be noted that the reason why an international single currency could be one of the main factors to ensure global macroeconomic stability is that significant economic and financial coordination, regulation and cooperation would be required from all nations of the world for the realisation of a WCB, and an international single currency. In other words, the WCB and the international single currency would be the outcome of collaboration between nations in order to achieve an integrated global economy. One of the consequences of a WCB is the need for a world federal government (WFG) also which would not only address issues related to the global financial market but also other international issues such as economic, social and financial challenges facing the emerging global market.

3. Localisation and globalisation of financial market

The emergence of new nations has accelerated since the second World War. The number of new nations increased from 96 in 1960 to 192 in 1998. This increase is in addition to all the new nations, which emerged since the French revolution in the 18th century. It appears that the evolution of society from family to tribe to city-state and then to nation is steadily moving towards unity at the international level. The globalisation of markets, economies and society may be the consequence of this gradual evolution. In the process of the globalisation of this planet, the emergence of localisation in many parts of the world is an important development. According to the International Monetary Fund (1999) report over 70 countries have now decentralised some political power to regional or local levels. In Africa, Latin America, Eastern Europe and other parts of the world localisation is emerging as an important political and economic force. According to the same report by the IMF, while in 1980, only 12 of the world’s 48 largest countries had national elections, 34 nations have held both national and local elections in recent times. It is argued that localisation is popular because people can (unlike the forces of globalisation) influence the issues affecting their lives and interests. Indeed, a number of global issues such as global environmental damage, the absence of
minimum wages, unregulated competition and investment by the multinational companies (MNCs) have made some people become more skeptical about globalisation. However, the criticism of globalisation should be seen in the broader context. For instance, some of the recent legitimate criticism of the proposed new round of trade negotiations under the auspices of the World Trade Organisation (WTO) stem from the fact that while technologically the world is globalised, the unwillingness of national leaders to recognise the evolution of society toward international unity, (maintaining diversity) at global level led to the underdevelopment of international institutions and has given institutions inadequate power to coordinate, regulate and compensate for some of the consequences of globalisation. Some of the specific issues such as minimum wages, more global environmental protection, job security, better coordination of technology and its impact on individuals and society are not being solved due to the lack of global institutions such as a WFG, a world parliament and an international tribunal which should have the capacity and power to coordinate, compensate for and, if necessary, regulate some of the activities which have global implications. In other words, the failure to solve some of the legitimate issues raised by people against globalisation is because of the inadequacy of the current international institutions which should facilitate and accommodate, in the wake of globalisation, the needs and requirements of all the people of this planet. Indeed, the leaders of the world accepted a world federal system with its agencies at the outset of the emergence of rapid technological changes and the emergence of the global financial market and the global communications system, many of the current problems and challenges facing developing and developed countries could have been avoided. The formation of the EU may well be an example of how national governments and European agencies and institutions have been able to compensate, retrain, regulate and coordinate all human, financial and social resources which were affected by the gradual emergence of economic, financial and social integration under the auspices of the EU. While one cannot deny the short-term pains suffered by some individuals, groups and sectors associated with the emergence and expansion of the EU, the long-term benefits of regionalism in Europe has far exceeded those pains. Indeed, given the bloody history of European nations and the first and second World Wars, the current degree of success in coordination, through the EU, far exceed the short-term pains associated with the formation of this Union. A similar case may well be argued for other regions and particularly a global society where a WFG and its agencies including the WCB could create faster and better technological changes, larger economies of scale, coordinated global investment and competition, better protection of the global environment, universal protection of both workers and employers, better use and mobilisation of human, financial and natural resources, the eventual eradication of military rivalries, the implementation of a universal education and health system etc. Once the process of globalisation is seen as a universal and all embracing process, localisation becomes the prerequisite of globalisation. Indeed, a global civilisation should be like an edifice where localisation is the foundation, the national governments are the pillars and the world federal system is the roof of this edifice which relies on the support and contribu-
tions of both the local/regional and national levels in order to ensure the integrity of the global system. In this context, localisation is a welcome development, which should ensure that a world federal system would not become a dictator that only concerns itself with certain global issues, in isolation from both national and local interests, needs and freedom.

4. Financial prosperity does not trickle down

The International Monetary Fund (1999) report argues that the financial and economic prosperity of an aggregated economy may not necessarily imply that all people in that economy will benefit from such prosperity and hence the disparity of wealth and poverty has even been aggravated in many developing countries. One could also, in this context, consider the global economy and argue that the fruits of the industrial and information revolutions have not been evenly spread amongst nations and hence the existence of technology and wealth in some parts of the world do not necessarily imply that all people are going to benefit from technological changes. Poverty, underemployment, global environmental damage, low agricultural productivity in some countries, violation of human rights etc. may well be related to the lack of global international institutions and the recognition of human evolution on this planet. Thus, one of the challenges of the new millennium is to ensure that global financial resources are distributed in such a way that all nations and people will be able to reap the benefit of technological changes and the global financial market. One of the mechanisms by which such global security and prosperity could gradually emerge is through the Ministries of a WFG similar to the way that local and national governments exert their policies through the ministries responsible for various social and economic issues, such a mechanism could also be in place at the international level. In other words, at the global level, the agencies of the WFG, which may well include a modified version of the IMF, the UN, the WTO and the World Bank, should be able to mobilise, coordinate, and financially support the activities and engagements of the national and local Ministries through their respective governments. It should be noted that the literature refers to the incompetence of some national or local governments in dealing with social and economic issues facing their countries and hence the support of the international agencies should not be an excuse for local and national governments to not fulfil their full national responsibilities and mandates for their own people. However, there are a number of global factors which directly and indirectly affect national and local governments and hence an effective WFG with financial responsibility is a natural progression of the evolution of human institutions. As local and national governments raise taxes to finance a number of local and national projects and activities, the WFG could also raise taxes for those global projects and activities, which affect the welfare of all nations. Environmental issues, an effective source of energy, research in the areas in which national governments are myopic or reluctant to commit themselves, partnership with national governments to finance effective universal education and health systems and the enhancement of
agricultural productivity are amongst many projects that the agencies of a WFG in collaboration with national governments could carry out. One of the issues related to a WFG is its capacity to raise money for all projects and activities, which are global and universal. As Paul Streeten in the International Monetary Fund (1999) report indicated there are a number of proposals for international taxation. These proposals include taxes on international trade, tourism, carbon emissions, fishing in international waters, tax on short-term capital movements and on international flights. One of the underlying assumptions of an emerging WFG is the removal of all offensive weapons and the redistribution of enormous human and financial resources for civilian purposes. These resources could be at the disposal of both the WFG and national governments in order to carry out all the important social and economic projects and activities required in the process of the integration of all national and regional economies into a global economy. For an effective and integrated global economy and global institutions, it is imperative to allow all local and national governments to be elected democratically and in turn directly participate in the election of the members of the international institutions. If such a process is followed, then there is a direct connection between and ownership of the local, national and international institutions and hence this connection and ownership will assist in the creation of a sense of interdependency and copartnership amongst all nations and people.

5. A review of papers in this issue

The articles that make up this special issue of the journal address various issues relating to the international financial market and each of them contributes to a better understanding of the financial challenges facing the new millennium and the international institutions which need to facilitate further global financial integration.

L. Shanker shows that the tax incentive to hedge depends on the magnitude of tax losses carried forward and the firm’s reported value of derivatives is a misleading measure of its hedging activity. The paper proposes innovative measures of the tax incentive to hedge and hedging activity. X.Z. Wang demonstrates that the size effects of stocks can be largely explained by data truncation that is caused by survival. The paper argues that small stocks’ returns are more volatile, and small stocks are more likely to go bankrupt and less likely to meet the stock exchanges’ minimum capitalisation requirement for listing. D. Brookfield and P. Ormrod proposes a new rationale for understanding managerial contracts which set-out to induce stock price volatility in the form of granting of executive stock options. The paper finds that option-based remuneration does not result in increased incentives for managers to enhance corporate performance. J.M. Carson and R.E Hoyt examine significant variables in the early detection of financially distressed life insurers and also consider the information of these variables to the evaluation of life insurer insolvency risk in the EU. The paper demonstrates the importance of
capital and surplus, geographic focus, asset mix and leverage in determining the likelihood of insurer bankruptcy. H.G. Fung and W.P.H. Poon examine information flow between China-backed securities, red chips, Shanghai and Shenzhen listed common shares. The paper finds that the EGARCH-M model appears to describe adequately the return process of the China-backed securities and that both H shares and red chips are more sensitive to good news than bad news. H.C. Sheng and A.H. Tu examine the linkages among the stock markets in 12 Asia–Pacific countries. The paper finds the existence of cointegration relationships among the national stock indices. The relationship for the South–East Asian countries seems to be stronger than for the North–East Asian countries. B.H. Lin and S.K. Yeh study the distribution and conditional heteroscedasticity in stock returns on the Taiwanese stock market. The empirical results show that the mixed-normal-GARCH model is the most probable specification for Taiwan stock returns. The results also show that skewness seems to be diversifiable through portfolio. C.S. Tai examines the role of market, interest rate, and exchange rate risk in pricing a sample of US commercial bank stocks. The paper finds strong evidence of time-varying interest rate and exchange rate risk prima and weak evidence of time-varying market risk premiums for all US commercial banks. B. Sjoo and J.H. Zhang analyses the information diffusion between A shares and B shares. The results show that there is important long-run information diffusion between A and B shares. In the Shanghai stock market, information flows from foreign to domestic investors. R. Burlacu investigates the relation between announcement effects and equity components for 141 French convertible bond issues. The paper finds that the market reaction is significantly positive for the subset of mixed convertible bonds. This finding supports the revised Myers and Majluf model, which predicts positive announcement effects under certain conditions. M. Engstrom and L. Norden examine the value of the early exercise opportunity embedded in American put option prices by using Swedish equity options data. The paper finds that the early exercise premium is substantial, and it is positively correlated with the moneyness option and with time left to expiration. M. Kulpmann develops some fundamental rules in a principal agent framework. The paper demonstrates that these rules concern decentralised risk taking in a bank, the role of position limits, competition across local branches, and balanced incentives if the local branch manager can engage in different activities. K. Chan, M. Chockalingam and K.W.L. Lai examine how overnight price movements in local markets affect the trading activity of foreign stocks on the NYSE. They find that local price movements affect not only the opening returns of foreign stocks, but also their returns in the first 30 min interval.

It is hoped that the points raised in this article and other articles to follow will provide an opportunity for further analysis of the financial challenges facing the new millennium and how best the global financial institutions can create better financial prosperity for all nations of the world.
References

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