

Network of Global Agenda Councils

Discussion highlights on Global Capital Flows

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This reflects work that is still in progress. It will continue to be updated and revised.

The views expressed here emerged from the Council meeting and do not necessarily reflect the views of the World Economic Forum or those of all the Council Members.

1) What is the state of the world on this issue and how is the economic crisis impacting it?

Over the past decade, there has been a phenomenal growth in cross-border capital flows, to the benefit of nearly all sectors, regions and asset classes. Cross-border capital flows are the oxygen for the entire economic system, from consumer purchases to funding infrastructure in developing countries. If the flow of international capital stops, all areas of the global system will wither. This Council advocates cross-border capital flows, and a regulatory system that protects without being protectionist.

How did we get here?

Despite the positive aspects of the growth in capital flows (from US\$ 1.5 trillion in 1995 to US\$ 8.2 trillion in 2006), the system may have been a victim of its own success. Capital markets were perceived to operate so efficiently that they became taken for granted. This made the system susceptible to its most fragile aspects, and made diagnosis, to stop contagion, difficult.

The current crisis began with the housing slump in the US, but quickly became a global crisis for three reasons. Accelerated mortgage creation and sale to securitizers by government incentives led to increasing use of securitized mortgage backed securities (MBS), financed off-balance sheet and sold around the world. Finally, MBS securitization was overlaid with credit default swaps (CDS) and instruments that added leverage and amplified risk.

The crisis played out from there.

1. **Lack of transparency and accountability:** When mortgages began to default, no one knew where the losses would be taken, because the hyper-efficiency had resulted in such extensive division of financial assets into securities that it became difficult to find information. In addition, actors made decisions that would benefit them in a bonus-cycle to the detriment of the long-term health of the institution or ultimate owner(s) of an asset.
2. **Freeze in short-term lending:** The lack of transparency led to a freeze in short-term lending, especially after Lehman Brothers was allowed to fail in September.
3. **Demise of institutions:** Subsequent aggressive short selling led to the demise of AIG and Washington Mutual, and the conversion of Morgan Stanley and Goldman Sachs into bank holding companies.
4. **Amplification:** The greater interconnectivity of markets as a result of increased capital flows led to increased negative reverberations once the crisis started. As investors avoided risk, by investing in short-term treasuries, the emerging markets suffered and businesses in many countries could not get their hands on enough money to fund their operations or pay debt.
5. **Real economy impacts:** This is still unfolding, but is tangible in the sharp decline in auto sales – and subsequent cuts in jobs – partly driven by consumers' limited ability to access loans to finance purchases.

Additional factors are the misalignment of incentives in business and regulators; failures of management and corporate governance; the chase for high returns in a low-interest rate world leading to over-leverage; and the natural cyclicity of economic activity.

The implications of the crisis

There will likely be a protectionist and regulatory backlash. However, it is critical that we identify the types of capital flows that should be fostered to benefit global economic growth. If capital flows are not restored, everything from the normal flow of commerce to the building of critical infrastructure in developing economies hangs in the balance.

What kinds of capital flows should be encouraged?

Capital flows can be thought of in four tiers:

1. The payments system (the daily flow of settlements and clearance representing the “plumbing” of the financial system)
2. Foreign Direct Investment (FDI)
3. Cross-border bank lending
4. Debt and equity markets (portfolio flows)

The priorities for action include:

1. Keeping the “plumbing” working
2. Ensuring capital flows to vulnerable portions of the economy
3. Protecting capital flows, prioritized per the tiers above. Protection should target:
 - a. Encouraging inflows from “new capital” sources, by setting the conditions to favour long-term investors and large share holders. These are the stakeholders with the greatest vested interest in long-term success and stability
 - b. Ensuring capital flows for both capital projects as well as working capital requirements for companies in the real economy
 - c. Mitigating reverberations and contagion
 - d. Protecting without being protectionist

2) What should be done to improve the state of the world on this issue and by whom?

The governing principles are to regulate well, without over-regulating, and to protect, without being protectionist. Specific financial sector, private sector and economic policy elements follow:

Financial Sector Regulatory Principles	<p>Promote principle-based regulation with the teeth to enforce; inhibit regulatory arbitrage</p> <p>Standardize financial products and ratings, where appropriate, much as gold is measured in standard quality and weights</p> <p>Base regulatory rules and oversight on the type of activity vs type of institution</p> <p>Differentiate based on goals of regulation (consumer protection, system stability, etc.)</p> <p>Ensure compensation, stature and accountability of regulators are comparable to the private sector</p> <p>Migrate towards an international collaborative framework that leverages existing institutions</p>
Private Sector Incentive Principles	<p>Align incentives so risks and rewards have appropriate timeframes</p> <p>Ensure technical expertise on the boards of financial institutions</p> <p>Eliminate conflicts of interests and moral hazard (e.g., M&A arbitrage)</p> <p>Ensure risk management takes liquidity risk, not just credit and interest rate risk, into account</p> <p>Incorporate the value of avoiding risk into compensation and valuation</p> <p>Enforce more stringent lending targets and leverage ratios</p> <p>Match the timing of assets and liabilities to account for liquidity risk (e.g., no funding land deals with overnight paper)</p>
Economic and Financial Policy Principles	<p>Avoid erecting barriers to the free flow of capital</p> <p>Avoid government guarantees that crowd out private flows</p> <p>Exercise extreme caution when considering further downward action on interest rates</p> <p>Encourage new intermediaries and capital sources through open policies</p>