ALTERNATIVE VISIONS OF INTERNATIONAL MONETARY REFORM

By

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I . INTRODUCTION

The international financial system has experienced a number of crises over the last two decades. Not a single geographical area or major country has been spared the effect of these crises. In general, the early-warning indicators such as interest rate spreads and credit ratings have proved to be ineffective in predicting the crises (BIS, 1999b, p. 56). Even the IMF was unable to foresee the crises in spite of its access to a great deal of information not available to others. Moreover, the policies it adopted after the crises came under severe criticism, in particular its rescue operations which, according to some of its critics, have only created a moral hazard that would tend to weaken market discipline in the future (Schultz et al., 1998; Meltzer, 1998). Hence there is an uneasy feeling that there is something basically wrong somewhere. This has led to a call for comprehensive reform of the international financial system to help prevent the outbreak and spread of financial crises or, at least, minimize their frequency and severity. The needed reform has come to be labelled ‘the new architecture’.

There is perhaps no one who would challenge this call for a new architecture for the international financial system. However, as Andrew Crockett, General Manager of the Bank for International Settlements and Chairman of the newly created Financial Stability Forum, has rightly pointed out ‘More than two years after the outbreak of the Asian financial crisis,, and after innumerable conferences and papers on the subject, a grand new design for the international financial system has still to be devised’ (Crockett, 2000, p. 13). What could be the reason for the inability to prepare a convincing reform programme in spite of so much investment in terms of time and effort? Could it be the failure to determine the ultimate cause of the crises?

2. CAUSES OF THE CRISES

A number of economists have tried to determine the causes of the crises. Some consider financial liberalization to be the cause in an environment where financial systems of many countries are not sound as a result of improper regulation and supervision (Glick, 1998; Bisignano, 1998). Others feel that the ultimate cause is the bursting of the speculative bubble in asset prices driven initially by the excesses

of financial intermediaries (Krugman, 1998). It has also been argued that the root cause of the crises was the maturity mismatch: short-term international liabilities were far greater than short-term assets (Chang and Velasco, 1998; Radelet and Sachs, 1998). The available literature indicates a number of other causes as well. However, even though all these factors may have had some role to play in the crises, no consensus seems to have developed so far in pinpointing the ultimate cause or the cause of all causes. In the absence of a proper understanding of the ultimate cause, conflicting remedies have been proposed. This makes it difficult to lay down an effective reform programme. Hence the proposals for the new architecture have been unable to step beyond the basic principles of conventional wisdom that emphasizes sound macro-economic policies along with healthy financial systems that incorporate sustainable exchange rates, proper regulation and supervision, and greater transparency. (For these principles, see Camdessus, 2000, pp. 1 and 7-10.)

These principles are undoubtedly indispensable because in the last analysis all crises have their roots in unhealthy fiscal, monetary and exchange rate policies. Hence, no one has ever denied the need for their honest implementation. They have, nevertheless, been violated. This brings to mind a number of questions. The first is about what it is that enables the continuation of macroeconomic imbalances, unsustainable exchange rates and unhealthy financial systems over a prolonged period. One would expect that market discipline itself would normally ensure the honest and effective implementation of these principles. However, the persistence of the crises suggests that either market discipline does not exist or it is ineffective in preventing the continued rise in macroeconomic imbalances in the public sector and living beyond means in the private sector, such that it becomes possible to have excessive leverage and to blow the speculative bubble to the point of bursting. A second related question is why some of the countries that have followed sound fiscal and monetary policies have also faced crises. The European Exchange Rate Mechanism (ERM) crisis of the early 1990s challenges the view that foreign exchange market crises stem from undisciplined fiscal and monetary policies. Many of the countries caught up in the crisis did not have overly expansionary policies (IMF, 1999, p. 67). Even the East Asian countries do not convincingly fit into the mould of inconsistent exchange rates and macroeconomic policies. A third but equally important

question is why some of the apparently well-regulated financial systems have also faced crises and whether greater regulation, supervision and transparency will by themselves help minimize the volatility of the international financial system.

3. WHY THE INADEQUATE MARKET DISCIPLINE?

The available literature has been unable to answer these questions satisfactorily. It may not be able to do so without looking at the underlying reason for the failure to implement the basic principles of the new architecture in spite of their being a part of conventional wisdom. The primary cause, in our view, is inadequate market discipline in the conventional financial system. Instead of making the depositors and the bankers share in the risks of business, it assures them of the repayment of their deposits or loans with interest. This makes the depositors take little interest in the soundness of the financial institution. It also makes the banks rely on the crutches of the collateral to extend financing for practically any purpose, including speculation. The collateral cannot, however, be a substitute for a more careful evaluation of the project financed. This is because the value of the collateral can itself be impaired by the same factors that diminish the ability of the borrower to repay the loan. The ability of the market to impose the required discipline is thus impaired, which leads to an unhealthy expansion in the overall volume of credit, to excessive leverage, and to living beyond means. This tendency of the system is further reinforced by the bias of the tax system in favour of debt financing - dividends are subject to taxation while interest payments are allowed to be treated as a tax-deductible expense.

The system's inadequate market discipline is, however, not something new. It has existed all along with the development and spread of the conventional financial system. Then, why, one may ask, has there been greater volatility in the last two decades compared with what prevailed before? What has created the difference is the rise in the volume of funds as a result of rapid economic development after the Second World War, the revolution in information and communications technology, and liberalization of foreign exchange markets. These developments are, however, a manifestation of human progress and cannot be blamed for the crises. When the volume of funds was small and there were also controls on their free movement,

inadequate market discipline was not able to create havoc. However, the position is different now.

Therefore, instead of blaming the new developments, it would be more appropriate to examine carefully the fault line in the international financial system resulting from the lack of adequate market discipline because of the absence of explicit risk-sharing.. It is this fault line that makes it possible for the financier to lend excessively and also to move funds rapidly from place to place at the slightest change in the economic environment. A high degree of volatility is thus injected into interest rates and asset prices. This generates uncertainty in the investment market, which in turn discourages capital formation and leads to misallocation of resources (BIS, 1982, p. 3). It also drives the borrowers and lenders alike from the long end of the debt market to the shorter end. Consequently, there is a steep rise in highly leveraged short-term debt, which has accentuated economic and financial instability. The IMF has acknowledged this fact in its May 1998 *World Economic Outlook* by stating that countries with high levels of short-term debt are 'likely to be particularly vulnerable to internal and external shocks and thus susceptible to financial crises' (p. 83).

One may wish to pause here to ask why a rise in debt, and particularly short-term debt, should accentuate instability. One of the major reasons is the close link between easy availability of credit, macroeconomic imbalances, and financial instability. The easy availability of credit makes it possible for the public sector to have a high debt profile and for the private sector to live beyond its means and to have a high leverage. If the debt is not used productively, the ability to service the debt does not rise in proportion to the debt and leads to financial fragility and debt crises. The greater the reliance on short-term debt and the higher the leverage, the more severe the crises may be. This is because short-term debt is easily reversible as far as the lender is concerned, but repayment is difficult for the borrower if the amount is locked up in loss-making speculative assets or medium- and long-term investments with a long gestation period. While there may be nothing basically wrong in a reasonable amount of short-term debt that is used for financing the purchase and sale of real goods and services, an excess of it tends to get diverted to speculation in the foreign exchange, stock and property markets.

3.1 The East Asia Crisis

The 1997 East Asia crisis has clearly demonstrated this. The Eastern tigers had been considered to be among the global economy's shining success stories. They had high domestic saving and investment rates coupled with low inflation. They also pursued healthy fiscal policies, which could be the envy of a number of developing countries. Since one of the major causes of financial instability is the financing of government deficit by bonds or fixed-interest-bearing assets (see Christ, 1979 and Searth, 1979), the fiscal discipline of these countries should have helped save them from such instability. However, it did not. The rapid growth in bank credit in local currency to the private sector by domestic banks on the basis of easily available short-term inflows in foreign currency loans from abroad created speculative heat in the stock and property markets and generated a mood of `irrational exuberance' which pushed up asset prices far beyond what was dictated by fundamentals..

The large foreign exchange inflows from abroad also enabled the central banks to peg exchange rates. This helped provide the assurance needed by foreign banks for lending and, along with high domestic interest rates, attracted further inflows of funds from abroad in foreign currencies to finance direct investment as well as the ongoing boom in the assets markets. Since about 64 per cent of the inflows in the five seriously affected countries (South Korea, Indonesia, Thailand, Malaysia and the Philippines) were short term (BIS, 1999b, p. 10), there was a serious maturity and currency mismatch. This joined hands with political corruption and ineffective banking regulation to lend heavily to favoured companies, which became highly over-leveraged.

The fast growth of these companies was thus made possible by the availability of easy money from conventional banks which do not generally scrutinize the projects minutely because of, as indicated earlier, the absence of risk-sharing. It was the old mistake of lending on collateral without adequately evaluating the underlying risks. Had there been risk-sharing, the banks would have been under a constraint to scrutinize the projects more carefully, and would not have yielded even to political pressures if they considered the projects to be too risky. Therefore, there is a strong rationale in drawing the conclusion that one of the most important underlying causes of excessive short-

term lending was the inadequate market discipline resulting from the absence of risk-sharing on the part of banks as well as depositors. It is very difficult for regulators to impose such a discipline unless the operators in the market are themselves rightly motivated. The assurances of receiving the deposits or the principal amount of the loan with the predetermined rate of return stand in the way.

There was a reverse flow of funds as soon as there was a negative shock. Shocks can result from a number of factors, including natural calamities and unanticipated declines in the economies of borrowing countries due to changes in interest rates or relative export and import prices. Such shocks lead to a decline in confidence in the borrowing country's ability to honour its liabilities in foreign exchange. The rapid outflow of foreign exchange, which would not have been possible in the case of equity financing or even medium- and long-term debt, led to a sharp fall in exchange rates and asset prices along with a steep rise in the local currency value of the debt. Private sector borrowers who were expected to repay their debts in the local currency were unable to do so on schedule. There was a domestic banking crisis, which had its repercussions on foreign banks because of the inability of domestic banks to meet their external obligations.

Governments have only two options in such circumstances. The first is to bail out the domestic banks at a great cost to the taxpayer, and the second is to allow the problem banks to fail. The second alternative is not generally considered to be politically feasible in spite of the recent calls to the contrary (Schwartz, 1998; Meltzer, 1998; Calomiris, 1998). In a financial system that assures, in principle, the repayment of deposits with interest and does not, therefore, permit the establishment of Islamic banks because they do not provide such an assurance, it would be a breach of trust on the part of the governments to allow the violation of this principle. Moreover, there is also a presumption, right or wrong, that if the big problem banks are allowed to fail, the financial system will break down and the economy will suffer a severe setback as a result of spillover and contagion effects. Hence the 'too big to fail' doctrine. The governments, therefore, generally feel politically safer in choosing the first alternative.

Since the domestic banks' external liabilities were in foreign exchange and the central banks' foreign exchange reserves had declined steeply, a bailout of external banks was not possible without external assistance, which the IMF came in handy to provide. This has, as indicated earlier, raised a storm of criticism and a call for the reform of the IMF itself by reducing its role (Schwartz, 1998; Meltzer, 1998). The IMF did not perhaps have a choice. Not having any way of assuring its influential members that its refusal to provide resources would not destabilize the entire international financial system, it chose the safer way out. The IMF bailout, however, got the debt unintentionally transferred from the private foreign banks to the central banks and the governments of the affected countries. Professor James Tobin, the Nobel Laureate, has hence rightly observed that when private banks and businesses can borrow in whatever amounts, maturities and currencies they choose, they create future claims on their country's reserves' (World Bank, 1998, p. 3).

Discussion of the role of excessive reliance on short-term credit or inflow of funds in the Asian crisis need not lead to the false impression that this is not possible in industrial countries with properly regulated and supervised banking systems. The IMF has clearly warned of the existence of such a possibility by stating that 'whatever their causes the market dynamics of surges and reversals are not peculiar to emerging markets and it is unrealistic to think that they will ever be completely eliminated' (IMF, 1998b, p. 98). The boom in the US stock market has been fed to a great extent by short-term flows of funds from abroad just as it had been in East Asia. If these inflows dry up or are reversed for some unpredictable reason, there may be a serious crisis. This happened in the late 1960s when confidence in the US dollar declined as a result of the persistent. US budgetary and current account deficits. Consequently, there was a substantial outflow of funds from the US, leading to a steep decline in the US gold and foreign exchange reserves, a significant depreciation in the dollar's external value, and the demonetization of gold. This flight away from the dollar also fuelled inflation through a rise in international commodity prices.

3.2 The Collapse of Long-Term Capital Management

The collapse of the US hedge fund, Long Term Capital Management (LTCM), in 1998 was also due to highly leveraged short-term lending. Even though the name

'hedge fund' brings to mind the idea of risk reduction, 'hedge funds typically do just the opposite of what their name implies: they speculate' (Edwards, 1999, p. 189). They are, according to *The Economist,* 'nothing more than rapacious speculators, borrowing heavily to beef up their bets' *(The Economist,* 1998, p. 21). These hedge funds are left mostly unregulated and are not encumbered by restrictions on leverage or short sales and are free to take concentrated positions in a single firm, industry, or sector – positions that might be considered 'imprudent' if taken by other institutional fund managers (Edwards, 1999, p. 190). They are, therefore, able to pursue the investment or trading strategies they choose in their own interest without due regard to the impact that this may have on others.

There is a strong suspicion that these hedge funds do not operate in isolation. If they did, they would probably not be able to make large gains, and the risks to which they are exposed would also be much greater. They therefore normally tend to operate in unison. This becomes possible because their chief executives often go to the same clubs, dine together, and know each other intimately (Plender, 1998). On the strength of their own wealth and the enormous amounts that they can borrow, they are able to destabilize the financial market of any country around the world whenever they find it to their advantage. Hence they are generally blamed for manipulating markets from Hong Kong to London and New York *(The Economist,* 1998). Mahathir Muhammad, Malaysia's Prime Minister, charged that short-term currency speculators, and particularly large hedge funds, were the primary cause of the collapse of the Malaysian ringgit in summer 1997, resulting in the collapse of the Malaysian economy (Muhammad, 1997, p. C1). It is difficult to know whether this charge is right or wrong because of the skill and secrecy with which these funds collude and operate. However, if the charge is right, then it is not unlikely that these funds may also have been instrumental in the collapse of the Thai baht and some other South Asian currencies.

The LTCM had a leverage of 25:1 in mid-1998 (BIS, 1999a, p. 100), but the losses that it suffered reduced its equity (net asset value) from the initial $4.8 billion to $2.3 billion in August 1998. Its leverage, therefore, rose to 50:1 on its balance-sheet positions alone. However, its equity continued to be eroded further by losses, reaching just $600

million, or one-eighth of its original value, on 23 September 1998. Since its balance-sheet positions were in excess of $100 billion on that date, its leverage rose to 167 times capital (RAF, 1998c, p. 55). The Federal Reserve *had* to come to its rescue because its default would have posed risks of systemic proportions. Many of the top commercial banks, which are supervised by the Federal Reserve and considered to be healthy and sound, had lent huge amounts to these funds. If the Federal Reserve had not come to their rescue, there might have been a serious crisis in the US financial system with spillover and contagion effects around the world.[2] If the misadventure of a single hedge fund with an initial equity of only $4.8 billion could take the US and the world economy to the precipice of a financial disaster, then it would be perfectly legitimate to raise the question of what would happen if a number of hedge funds got into trouble.

A hedge fund is able to pursue its operations in secrecy because, as explained by Chairman of the Board of Governors of the Federal Reserve System, Alan Greenspan, it is 'structured to avoid regulation by limiting its clientele to a small number of highly sophisticated, very wealthy individuals' (Greenspan, 1998b, p. 1046). He did not, however, explain how the banks found it possible in a supposedly very well-regulated and supervised banking system to provide excessively leveraged lending to such 'highly sophisticated, very wealthy individuals' for risky speculation when it is well known that the higher the leverage, the greater the risk of default. The unwinding of leveraged positions can cause major disruption in financial markets by exaggerating market movements and generating knock-on effects (IMF, 1998c, pp. 51-3).

This shows that a crisis can come not merely because of improper regulation of banks, as it did in East Asia, but also in a properly regulated and supervised system, as it did in the US. Even though the hedge funds were not regulated, the banks were. Then why did the banks lend huge amounts to the LTCM and other funds? What were the supervisors doing and why were they unable to detect and correct this problem before the crisis? Is there any assurance that the regulation of hedge funds would, without any risk-sharing by banks, stop excessive flow of funds to other speculators?

3.3 Foreign Exchange Market Instability

The heavy reliance on short-term borrowing has also injected a substantial degree of instability into the international foreign exchange markets. According to a survey conducted by the Bank for International Settlements, the daily turnover in traditional foreign exchange markets, adjusted for double-counting, had escalated to $1490 billion in April 1998, compared with $590 billion in April 1989, $820 billion in April 1992 and $1190 billion in April 1995 (BIS, 1998).[3] The daily foreign exchange turnover in April 1998 was more than 49 times the daily volume of world merchandise trade (exports plus imports).[4] Even if an allowance is made for services, unilateral transfers, and non-speculative capital flows, the turnover is far more than warranted. Only 39.6 per cent of the 1998 turnover was related to spot transactions, which have risen at the compounded annual rate of about 6.0 per cent per annum over the nine years since April 1989, very close to the growth of 6.8 per cent per annum in world trade. The balance of the turnover (60.4 per cent) was related largely to outright forwards and foreign exchange swaps, which have registered a compounded growth of 15.8 per cent per annum over this period. If the assertion normally made by bankers that they give due consideration to the end use of funds had been correct, such a high degree of leveraged credit extension for speculative transactions might not have taken place.

The dramatic growth in speculative transactions over the past two decades, of which derivatives are only the latest manifestation, has resulted in an enormous expansion in the payments system. Greenspan himself, sitting at the nerve centre of international finance, finds this expansion in cross-border finance relative to the trade it finances startling (Greenspan, 1998a, p. 3). Such a large expansion implies that if problems were to arise, they could quickly spread throughout the financial system, exerting a domino effect on financial institutions. Accordingly, Crockett has been led to acknowledge that ‘our economies have thus become increasingly vulnerable to a possible breakdown in the payments system’ (Crockett, 1994, p. 3).

The large volume has also had other adverse effects. It has been one of the major factors contributing to the continued high real rates of interest that have tended to discourage productive investment. Foreign exchange markets, being driven by short-run

speculation rather than long-run fundamentals, have become highly volatile. This impedes the efficient operation of these markets, injects excessive instability into them, and creates pressures in favour of exchange controls, particularly on capital transfers. The effort by central banks to overcome this instability through small changes in interest rates or the intervention of a few hundred million dollars a day has generally not proved to be particularly effective.

The Tobin tax on foreign exchange transactions has, therefore, been suggested to reduce the instability. This proposal needs to be reviewed against the ineffectiveness of the securities transaction tax which is levied on the sale of stocks, bonds, options and futures by a number of major industrial countries, including the US, the UK, France, Germany and Japan. This tax proved to be ineffective in preventing or even diluting the October 1998 stock market crash (Hakkio, 1994). Is there any guarantee that the foreign exchange transactions tax would fare any better? Critics of the Tobin tax have accordingly argued that even this tax would be ineffective. One of the reasons given for this is that the imposition of such a tax would be impractical. Unless all countries adopted it and implemented it faithfully, trading would shift to tax-free havens. However, even if all countries complied, experienced speculators might be able to devise ways of evading or avoiding the tax because all countries do not have an effective tax administration.[5]

4. THE REMEDY

If heavy reliance on short-term debt is desired to be curbed, then the question is about the best way to achieve this goal. One of the ways suggested, as already indicated, is greater regulation (Edwards, 1999; Calomiris, 1999; Stiglitz, 1998). Regulations, even though unavoidable to a certain extent, cannot be relied upon totally, due to a number of reasons. First, it is difficult to reach an agreement on what and how to regulate. There are serious disagreements even on fundamental, issues. For example, the Basle Committee has found it difficult to decide how to calculate how much capital banks need and whether hedge funds should be regulated (*The Economist, 2000,* p. 93). Without a proper consensus, regulations may not be uniformly applied in all countries and to all institutional money managers. In such a situation, there will be a flight of funds to offshore havens where almost half of all hedge funds are already located (Edwards,

1999, p. 191). Second, even if there is agreement, regulations may be difficult to enforce because of the off-balance-sheet accounts, bank secrecy standards, and the difficulty faced by bank examiners in accurately evaluating the quality of banks' assets. Emerging market banking crises provide a number of examples of how apparently well-capitalized banks were found to be insolvent as a result of the failure to recognize the poor quality of their loan portfolio. Even the LTCM crisis shows how banks in an apparently well-regulated system can become entangled in a speculative spree. Third, bringing banks under a water-tight regulatory umbrella may not only raise the costs of enforcement but also mislead depositors into thinking that their deposits enjoy a regulatory stamp of security.

This does not mean that regulation is not necessary. However, regulation and supervision would be more effective if they were complemented by a paradigm shift in favour of greater discipline in the financial system by making investment depositors as well as the banks share in the risks of business. Just the bailing-in of banks, as is being suggested by some analysts (Meltzer, 1998; Calomiris, 1998; Yeager, 1998), may not be able to take us far enough. What is necessary is not just to make the shareholders suffer when a bank fails, but also to strongly motivate the depositors to be cautious in choosing their bank and the bank management to be more careful in making their loans and investments. Without such risk-sharing, the depositors may keep on receiving competitive rates of interest because the banks receive a predetermined higher rate. However, the quality of the assets may not be good from the very beginning and may even be declining. Suddenly, one day, there may be a revelation to the bank examiners about the poor quality of the banks' assets. It would be unjust to dump these losses on deposit insurance or the taxpayers through a bail-in process if the banks' capital is not adequate to cover them. However, if the banks share in the risks, and the depositors get a share only of what the users of bank funds *actually* earn, then the quality of the banks' assets will remain transparent all along by the return that the banks and the depositors are actually able to get every quarter/year. Bank managers are better placed to evaluate the quality of their assets than regulators and depositors, and risk-sharing would motivate them to take the decisions that they feel are in the best interest of banks and depositors.

Therefore, reinforcing regulation and supervision of banks by profit/loss-sharing by both the banks and the investment depositors would help ensure the soundness of banks. It would help introduce a dimension of self-discipline into the financial system. The depositors would not then be led into a state of complacency by the regulatory framework but would rather be motivated to exercise greater care in choosing their banks. Bank management would also be obliged in their own self-interest to scrutinize more carefully the projects they finance. A good deal of the credit available for unhealthy speculation and unsound projects would thus be eliminated and the possibility of speculative bubbles would thereby be reduced substantially. Governments would also be unable to obtain financing for everything and would thus be under a constraint to rely less on debt by streamlining their tax systems and reducing their unproductive and wasteful spending.

4.1 Speculation?

If credit for speculative purposes is to be curbed, speculation would need to be defined precisely because of the different forms in which it is expressed (see Tirole, 1994, pp. 513-14). We are not concerned here with all kinds of speculation but only with that which is related to short sales and long purchases in the stock, commodity, and foreign exchange markets. The speculator either sells short or buys long. A `short' sale is a sale of something that the seller does not own at the time of sale and does not intend to deliver from his own portfolio. The short seller, popularly called a bear, expects the price of the security sold short to decline and hopes to be able to 'cover' his short sale through an 'offsetting' purchase at a lower price before maturity date so as to be able to secure a profit. The long buyer, known as a bull, buys stock which he does not want in the hope of making an 'offsetting' sale at a higher price before the date of maturity. Only about 2 per cent of all futures contracts are settled by actual delivery and the rest, about 98 per cent, are liquidated before the delivery date by offsetting transactions (Madura, 1992, p. 246). In fact it is generally felt that trading in futures contracts is for purposes other than the exchange of titles (Altman, 1981, pp. 21 and 15; Hieronymus, 1971, p. 28).

The ability to make margin purchases provides the speculator with a high degree of leverage and enables him to make a larger purchase with a smaller amount.

In a margin purchase, the customer is required to deposit with the broker a fraction of the purchase price, either in cash or in acceptable securities, to protect the broker against loss in the event of default. The balance is loaned to the customer by the brokerage house that obtains the funds, usually by pledging the purchased asset with a bank for a collateral loan. The long buyer is required to keep the margin good by depositing additional cash or acceptable securities in the event of a decline in prices by more than the minimum margin requirement. Conversely the customer may withdraw cash or securities from his account if a rise in price should increase his margin substantially above the requirement.

Speculative sales combined with margin purchases bring about an unnecessary expansion or contraction in the volume of transactions and, hence, contribute to excessive fluctuations in stock prices without any real change in the fundamentals. A strong evidence of this is the stock market crash of October 1987. Hardly any fundamental change can be identified to justify the precipitous plunge of 22 per cent in stock prices. A study by Shiller (1981) also reinforces this conclusion. It found that stock prices have been more volatile than is justified by variations in dividends.

Variations in margin requirements and interest rates tend only to add a further dimension of uncertainty and instability to the stock markets. The lowering of margin requirements and/or interest rates generates unnecessary heat in the market. Raising them afterwards with the objective of restoring 'sanity' to the market only forces speculators to liquidate their positions. This brings down prices and ruins some of the speculators at the altar of others who are usually 'insiders' and know what is coming. In a study of 23 industrial countries, Roll (1989) failed to find any relationship between stock price volatility and stock market regulatory devices like market price limits, margin requirements and transactions taxes. Hence speculation has attracted widespread criticism for the role it has played in stock price volatility, and particularly in the stock market crashes of 1929 and 1987 (see Karpoff, 1994, p. 446).

The claim that speculation helps stabilize prices would be true only if the speculators operated in different random directions and their separate actions were mutually corrective. The claimed stabilizing effect would require that there be no marked disparity in the speculators' purchases and sales. But speculation involves

judgement, or anticipation of a rise or fall in prices, and is accentuated when something happens or some information is available on which judgement can be based. The same events or rumours give rise to the same judgements. In the real world, rumours, sometimes purposely spread by insiders and vested interests, lead to a wave of speculative buying or selling concentrated in the same direction and brings about an abnormal and unhealthy fluctuation in prices. It is generally acknowledged that prices in the stock markets are susceptible to manipulation and rigging. There are, in the words of a stock market insider, ‘intrigues, lethal competitions, tense lunch-time deals, high-stake gambles, the subterfuges, cover-ups, and huge payoffs that make Wall Street the greatest playground in the world’ (Sage, 1980, p. 1). There are ‘safeguards against such rigging but they don’t work’ because ‘Wall Street plays its games seriously, sometimes so well that neither you nor I - nor, seemingly, the Securities Exchange Commission - knows who is in there playing’ (Lechner, 1980, pp. 108 and 94).

Continued sanity in the stock market could only be attained through a number of reforms. The most important of these may have to be the abolition of short sales and the imposition of 100 per cent margin, which implies that buyers can make only cash purchases. Speculators will not then be able to take a large position with a small amount at risk. Largay has concluded, on the basis of his analysis of 71 New York Stock Exchange and 38 American Stock Exchange stocks placed under special margin requirements during 1968-69, that, ‘the empirical results support the a priori hypothesis that banning the use of credit for transactions in individual issues is associated with a "cooling off "of speculative activity in these stocks’.[6] Bach has also observed that:

> if rising stock prices have been financed by borrowed money, a downturn in the market may precipitate a major collapse in stock prices, as lenders call for cash, and may place serious financial pressure on banks and other lenders. A high market based on credit is thus far more vulnerable than a cash market and is more likely to be a cyclically destabilizing force. (Bach, 1977, p. 182)

The only adverse effect of such moves would be a decline in the short-term trading volume in the stock market. As Gordon has aptly remarked, 'the market machinery encourages turnover and consequently price fluctuations' because 'the greater the volume of sales, the more money made by the brokers' (Gordon, 1980, p. 223). The near-elimination of gyratic movements in prices would exert a healthy effect on the long-run trend. If the purpose of financial markets is to channel household savings into productive investments for boosting employment and output, then speculation in the stock market does the reverse. It rather diverts resources away from productive activity. Accordingly, the Nobel Laureate, Professor James Tobin, stated that:

> Very little of the work of the securities industry, as gauged by the volume of market activity, has to do with the financing of real investment in any very direct way. Likewise those markets have very little to do, in aggregate, with the translation of the saving of households into corporate investment. (Tobin, 1984, p. 11)

The elimination of speculative short sales and long purchases need not necessarily close the door for hedging future payments and receivables arising out of trade in real goods and services.

4.2 Greater Reliance on Equity Finance

The reduction in reliance on short-term borrowing and confining such borrowing to the financing of real goods and services would result in greater dependence on medium- and long-term borrowing and equity financing. Of these two, equity financing would be preferable because, by making the financiers participate in the risks of business, it would induce them to assess the risks more carefully and to monitor the borrowers. The double assessment of investment proposals by both the borrower and the lender would help raise market discipline and introduce greater health into the financial sector. The IMF has also thrown its weight in favour of equity financing by arguing that:

> Foreign direct investment, in contrast to debt-creating inflows, is often regarded as providing a safer and more stable way to finance development

> because it refers to ownership and control of plant, equipment, and infrastructure and therefore funds the growth-creating capacity of an economy, whereas short-term foreign borrowing is more likely to be used to finance consumption. Furthermore, in the event of a crisis, while investors can divest themselves of domestic securities and banks can refuse to roll over loans, owners of physical capital cannot find buyers so easily. (IMF, 1998a, p. 82)

Moreover, as Hicks (1982) has argued, interest has to be paid in good or bad times alike, but dividends can be reduced in bad times and, in extreme situations, even passed. So the burden of finance by shares is less. There is no doubt that in good times an increased dividend would be expected, but it is precisely in such times that the burden of higher dividend can be borne. 'The firm would be insuring itself to some extent', to use his precise words, 'against a strain which in difficult conditions can be serious, at the cost of an increased payment in conditions when it would be easy to meet it. It is in this sense that the riskiness of its position would be diminished' (ibid., p. 14). This factor should tend to have the effect of substantially reducing business failures, and in turn dampening, rather than accentuating, economic instability..

Greater reliance on equity financing has supporters even in mainstream economics. Rogoff, a Harvard Professor of Economics, states that 'In an ideal world equity lending and direct investment would play a much bigger role.' He further asserts that: 'With a better balance between debt and equity, risk-sharing would be greatly enhanced and financial crises sharply muted' (Rogoff, 1999, p. 40). However, the linking of credit to the purchase of real goods and services would take us a step further in reducing instability in the financial markets by curbing excessive credit expansion for speculative transactions. Thus it is not necessary. to be pessimistic and to join Stiglitz in declaring that 'volatile markets are an inescapable reality' (Stiglitz, 1999, p. 6). With the introduction of the above-mentioned basic reforms in the financial system, it should be possible to reduce volatility substantially.?

4.3 Raising Savings

This leads to the question of why developing countries are so heavily dependent on external loans for financing their development. The answer lies in their low saving rate, which forces them to import savings. The greater their dependence on an inflow of capital, the less capable they are to liberalize capital outflows. This makes it more difficult for them to attract equity capital and thereby increases their reliance on debt with government guarantees.

Raising domestic savings should hence receive high priority in the national reconstruction plans of developing countries. How can this be achieved? By raising interest rates and tax incentives? The evidence generally shows that interest rates and tax incentives have little or no effect on saving (Schmidt-Hebbel et al., 1996, p. 101). Hence cutting of consumption, particularly that of luxury goods and services, may prove to be more productive. This would make it necessary to restrain the spread of Western consumer culture in developing countries. The insistence of the industrial countries that developing countries reduce their tariffs on all goods and services may, therefore, be uncalled for. Moreover, while the resort to higher taxation of luxury goods would undoubtedly be helpful, greater success may be attained if an effort is also made to bring about a change in life-styles so that consumption of status symbols becomes a social taboo. This may not be possible without the injection of a moral dimension into the life-styles. This may perhaps be one of the reasons why all religions, and in particular Islam, have encouraged humble life-styles and discouraged ostentatious consumption. One of the important elements of this moral dimension in all major religions is the abolition of interest because of the living beyond means that an interest-based financial system promotes and the adverse effect that this tends to exert on saving, investment and employment.

However, in spite of a rise in savings, developing countries may need to attract a larger volume of medium- and long-term capital. For success in this goal, there can be no escape from providing all the needed incentives and facilities and also liberalizing repatriation of capital with dividends. This they would be more willing to undertake when the speculative part of the foreign exchange markets has been substantially reduced and the fear of exchange rate volatility is minimized.

Howard Davies, Director of Britain's Financial Services Authority and Chairman of the Committee on highly leveraged institutions set up by the Financial Stability Forum, has rightly remarked that: 'If you cannot give open economies some kind of assurance that they will not be subject to speculative attack, then they will close up' *(The Economist,* April 2000, p. 94).

5. THE ISLAMIC REFORM PROGRAMME

Implementation of the above-mentioned reform programme for the financial system may be difficult in the Western world because, as Mills and Presley have put it, 'Western societies have been stripped of the ethical presuppositions conducive to the proscription of interest' (Mills and Presley, 1999, p. 113). Even the proscription of short sales may not be possible in spite of a great deal of support for it because it is difficult to reverse a system once it has become significantly advanced in a certain direction. Moreover, there is the vested interest of stockbrokers who are able to gain from the large volume of transactions. These limitations need not, however, create a great difficulty in the Muslim world because all elements of the suggested reform programme are an integral part of the Islamic paradigm. The prohibition of interest in Islam should help increase reliance on equity and profit/loss-sharing *(mudārabah* and *mushārakah)* and reduce the proportion of credit in total financing. However, while the *Sharī'ah* has banned interest, it has not prohibited credit It has allowed credit but through the sales-based modes of financing which are intended not only to remove interest but also to restrain excessive credit expansion by confining the availability of credit to only real goods and services. Some of these modes are: *murābahah, ijārah, salam* and *istisnā'. All* these are essentially sales transactions related to real goods and services. The return on capital in all these transactions becomes a part of the price.

Since the additional purchasing power created by the credit available under these Islamic modes is backed by real goods and services, there is no possibility of creating unnecessary heat in the market. Credit available for speculative purposes would at least be minimized, if not eliminated, thereby creating a balance between the expansion of credit and the expansion of output of real goods and services. Hardly anyone should have qualms about this because lending against the collateral of

stocks to purchase stocks does not create wealth. It only breeds speculation and instability. The purpose of credit should be to finance productive investments and not to encourage speculative buying or hoarding. Paul Volcker, Ex-Chairman of the Federal Reserve System, had, in a letter to the chief executives of all member banks, warned against speculative loans, loans made to retire stocks, loans to finance takeovers, and loans involving any extraordinary finance, 'except as they may clearly involve the improvement in the nation's productive capabilities' (Volcker, 1979, p. 110). This warning of Volcker has remained more or less unheeded in the conventional system because the system is not tuned to its acceptance. In the Islamic system, however, the participation of banks in the risks of business should help minimize the use of scarce credit resources for all unproductive purposes.

The *Sharī'ah* has also put a stricture on speculative short sales by prohibiting the sale of something that the seller does not own and possess .[8] The *Sharī'ah* has not, however, prohibited all forward transactions. It has allowed the forward purchase or sale of agricultural commodities *(salam)* or manufactured goods *(istisnā').* Forward transactions in real goods and services with the intention of taking and giving delivery perform an important economic function. They make an allowance for the time period it takes to produce the goods and thus provide producers as well as users with the assurance that they can sell or receive the goods when ready or needed. In contrast with this, short speculative sales do not perform such a function. In such sales, the 'forward' seller has no role to play. He sells 'something he cannot consume or use in his business, upon which he performs no work. and to which he adds no value' (Rix, 1965, p. 204). Spot purchases against cash payment and the reciprocal receipt constitute a real investment and cannot be equated with speculation irrespective of when the purchaser decides to resell what he has purchased. This is because the spot seller already owns the sold items which he purchased against cash, and his decision to resell them will be determined by changes in his economic circumstances or his perception of the market, both of which may not necessarily change immediately. The prohibition of interest and the sharing of the depositor and the lender in the risks of business, along with the removal of speculative sales, should help inject greater discipline into the financial market.

6. CONCLUSION

The establishment of Islamic banks in the Muslim world, even though in an embryonic stage, has created a hope that the programme may ultimately be implemented in the future and thus set the stage for its acceptance by the rest of the world. However, due to a number of problems. Islamic banks have so far not been playing a significant role in promoting greater reliance on profit-sharing modes. They are primarily involved in extending credit. Nevertheless, since this credit is on the basis of Islamic modes, it remains confined to the purchase and sale of real goods and services and does not become available for speculative purposes. Moreover, the proportion of total banking assets of the Muslim world that the Islamic banks have so far been able to bring under their financial net is relatively small. There are also a number of *fiqhi* issues that still need to be resolved. The shared institutions that are necessary for the proper functioning of Islamic banks have yet to be established. A proper regulatory and supervisory framework for Islamic banks has also not yet been formulated. This may not even be possible until the central banks start taking a keen interest in Islamic banking and all the *fiqhi* issues related to banking and finance are satisfactorily resolved. Hence it may be quite a while before the implementation of the Islamic programme makes real headway in the Muslim world in spite of a great deal of support for it among the masses.

NOTES

1. The more important of these are the US stock market crash in October 1987, the bursting of the Japanese stock and property market bubble in the 1990s, the breakdown of the European Exchange Rate Mechanism (ERM) in 1992-93, the bond market crash in 1994. the Mexican crisis in 1995. the East Asian crisis in 1997, the Russian crisis in August 1998. the breakdown of the US hedge funds in 1998, and the Brazilian exchange rate crisis in 1999.

2. This was clearly acknowledged by Alan Greenspan in the following words: 'Had the failure of the LTCM triggered the seizing up of markets, substantial damage could have been inflicted on many market participants, including some not directly involved with the firm, and could have potentially impaired the economies of many nations, including our own' (Greenspan, 1998b, p. 1046).

3. The Bank for International Settlements (BIS) conducts a survey of foreign exchange markets every three years in the month of April.

4. World trade (exports plus imports) rose from $499.0 billion in April 1989 to $908.7 billion in April 1998 (IMF. *International Financial Statistics,* CD-ROM and November 1998). The average value of daily world trade in April 1998 comes to $30.3 billion.

5. See the arguments in favour of and against the feasibility of the Tobin tax by various writers in Haq et al. (1996).

6. Reported by Irwin Friend in his paper 'Economic Foundations of Stock Markets' in Bicksler (1979), p. 156.

7. A number of Islamic economists have argued this point. See, for example, Chapra (1985). pp. 117-22; Chishti (1985); Khan (1987); Mirakhor and Zaidi (1987), Siddiqui and Fardmanesh (1994).

8. For a valuable discussion on stock and commodity market speculation from the point of view of the *Sharī'ah,* see the *Fiqhī* decision entitled 'Sūq *al-Awrāq al-Māliyyah* wa *al-Badā'i' (al-Brusah)'* issued by the Majlis al-Majma' al-Fiqhī al-Islāmī of the Rābitah al-'Ālam al-Islāmī in *Qarārāt Majlis al-Majma' al-Fiqhī al-Islāmī* (Makkah, al-Amānah al-'Ammah, Rābitah al-'Ālam al-Islāmī, 1985), pp. 120-25; and the article of Ahmad

Yusuf Sulayman in Al-Ittihad a1-Dawli li al-Bunuk al-Islāmiyyah, *Al-Mawsū'ah al-māliyyah.* vol. 5, pp.389-431. particularly the summary on pp.429-31. See also, Bayt al-Tamwil al-Kuwaiti, *Al-Fatāwā al-Shar' iyyah* (Kuwait, 1980, pp. 45-9).

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COMMENTS

John G. Sessions

This is an important chapter which will help to disseminate the important lessons that the West can learn from the Islamic approach to economics and finance.

The chapter investigates the causes of the various financial crises that have hit the international financial system over the past two decades. Three key questions are asked. First, what is it that has enabled the continuation of macroeconomic imbalances, unsustainable exchange rates and unhealthy financial systems over such a prolonged period? Second, why have some of the countries that have followed sound monetary and fiscal policies also faced crises? Third, why have some of the apparently well-regulated financial systems also faced crises, and will greater regulation, supervision and transparency by themselves help minimize the volatility of the international financial system?

The author considers a number of causes for the crises, namely, financial liberalization; the bursting of the speculative bubble in asset prices driven initially by the excesses of financial intermediaries; and maturity mismatch whereby short-term international liabilities exceeded short-term assets. He comes down, however, in favour of inadequate market discipline as the ultimate root cause, focusing in particular on the rise in (especially short-term) debt. He cites three examples of the link between easy availability of credit, macroeconomic imbalances and financial instability - the East Asian crisis, the collapse of the US hedge fund Long Term Capital Management, and foreign exchange market instability.

The author concurs that the greater regulation that has been advocated by various commentators will help to alleviate some of the stresses. Regulation, however, cannot be relied upon totally: it is often difficult to reach a consensus on what and how to regulate. Even if there is agreement, regulation may be difficult to enforce because of the off-balance-sheet accounts, bank secrecy standards, and the difficulties faced by bank examiners in accurately evaluating the quality of bank assets; and bringing banks under tighter regulations may mislead depositors into thinking that their deposits enjoy a regulatory stamp of security.

A more fundamental remedy is argued to be a paradigm shift in favour of making both depositors and banks share in the risks of the business through the introduction of profit/loss-sharing.

I think the chapter makes a very valuable contribution to the literature. In particular I like the focus on macroeconomic finance aspects of profit/loss-sharing. This is an area that has been relatively neglected in previous research. I do, however, have reservations about some of the arguments put forward in the chapter:

1. It would be helpful if more statistical evidence were given in support of some of the arguments. For example, the author alludes to ‘a reasonable amount of debt’ but offers no guidance as to what this figure might actually be. Moreover, he argues that ‘an excess [of short-term debt] tends to get diverted into speculation in the foreign exchange, stock, and property markets’ but offers no evidence for this.

2. The fundamental premise that lenders will be more cautious under profit/loss-sharing ignores bankruptcy/collateral constraints under conventional Western loan arrangements. Banks are unlikely to lend to purely speculative projects if they are unable to guarantee a return.

3. The chapter focuses too much on the supply-side implications of profit/loss - sharing. It has been shown that profit/loss-sharing will affect the microeconomic demand for finance by acting as an efficient revelation device. The basic idea is that if the project outcome is stochastic, and if managers have an informational advantage regarding this stochasticity over investors, then a profit/loss-sharing contract between managers and investors will lead to a more efficient revelation of that information.[1] This could imply an increase in the demand for finance and a fall in the level of entrepreneurial effort and we could have a situation where borrowers are demanding more finance for, but supplying less effort to, risky projects. This could lead to similar problems of excessive, ill-disciplined finance as are claimed to occur under conventional lending contacts.

4. What are the implications for economic growth? If, as the author claims, banks will be more cautious under profit/loss-sharing, then how *will* this affect high-risk, high-return projects?

If these issues were also addressed, the chapter would make a very substantial contribution to both the Islamic and non-Islamic literature on loan *vis-a-vis* profit-sharing financing.

NOTE

[1]. See J.R. Presley and J.G. Sessions, 'Islamic Economics: The Emergence of a New Paradigm'. *Economic Journal, 104, 584-96, 1994.*